

## The Absolute Return Letter



### January 2016 The Biggest Stories of 2016?

*“Cheers to a new year and another chance for us to get it right.”*

Oprah Winfrey

At this time last year I wrote the first ever January Absolute Return Letter. I committed to making it an annual statement of sorts, but I also promised not to turn it into an archetypal annual forecasting exercise, of which there are so many.

It has always baffled me how the financial industry in general, and financial newspapers in particular, appear to be hell-bent on forecasting this or that in early January. I actually find it outright laughable when someone projects the FTSE100 to be at 7,000 by Christmas time, or for the U.S. 10-year T-bond to hit 2.5% by mid-summer. How on earth do they know? The generally poor predictive record proves they don't, I suppose. On the other hand, that is perhaps what the majority of investors want. If you belong to that majority, there is no need to read any further. You will be wasting your time.

If you see any forecasts from me (and you do), you will note that (i) they are very long term in nature, and (ii) they are based on structural trends, not tactical (cyclical) trends. Why is that? Partly because I think short-term forecasting is a sucker's game, and partly because I know for certain that the structural trends that we have identified **will** happen. It is only a question of when, but more about that later.

Having said that, 2015 was in many ways an extraordinary year. It was the year where the credit bonanza in China finally keeled over; it was the year where the simmering conflict between Islam and Christianity elevated to another level and left many horrific scars around the world and, here in Europe, it was the year of terrible refugee problems. At a far more mundane level, it also turned into a year of very modest – in some markets even negative – equity returns despite steadily improving fundamentals. I am sure that took one or two by surprise.

One more note before I start. Last year I gave the prize for the silliest 2015 forecast to the Daily Telegraph for publishing [this article](#). The 2016 prize goes to – surprise, surprise – the Daily Telegraph for [this outrageous article](#). Admittedly, it is not about asset classes but about the future of the European Union – a structure which so

many people in the UK would like to see being blown to pieces as soon as possible. Trust me - the EU won't disappear in 2016, however much some people want it to happen.

### What changes did we make in 2015?

Long-term readers of the Absolute Return Letter will probably be aware of this already, but newcomers may not be. At Absolute Return Partners we maintain a list of structural trends at all times. We spend a considerable amount of time assessing that list. Should anything be added or deleted? The list is divided into two – a list of structural mega-trends and a list of structural sub-trends. To a large degree, those trends drive our investment strategy.

Two structural trends were added in 2015. In March we added '*Capital's share of national income to mean revert (i.e. drop)*', and in August we added '*Mean reversion of wealth*'. The former was added to our list of structural sub-trends and the latter to our mega-trends, of which there are now six.

In November I took the rather embarrassing step of removing '*Capital's share of national income to mean revert*' again. A well-researched paper from BofAML on automation convinced me that labour's share of national income can continue to fall for quite a few years to come. It is not that the mean reversion won't happen eventually, but I am concerned that it is further away than I initially thought. In its place I added a new sub-trend that I call '*Automation of industry to intensify*'.

In addition to our list of structural trends, we also keep a relatively short list of shorter-term tactical - mostly cyclical - trends (but we don't make quantitative forecasts off this list!). During the course of 2015, we added a new such trend. It happened in August, and we called it '*A material slowdown in economic growth to unfold in many OECD countries in the second half of 2015*'. The call was driven by a deteriorating credit impulse on both sides of the Atlantic and has been broadly correct so far, although the slowdown has not been universal in nature (but we never said it would be). Here in Europe, the country taking the biggest hit in Q3 was Finland which posted a GDP growth rate of -0.6%. The Eurozone as a whole grew by a modest +0.3%.

### Why we focus on the long-term

There are (at least) two reasons why we focus on the long-term as far as our investment strategy is concerned; why we consider structural trends far more important than shorter-term tactical trends. Firstly, the market is more efficient in the short-term because it is more populated. There are simply fewer investors who give credit to longer-term structural trends when constructing their portfolios, and that creates more long-term opportunities.

I am not necessarily pointing fingers at anyone in this regard. Equity mutual fund managers simply cannot afford not to think about the near-term, as their clients demand outperformance every month. Having said that, I find it hard to understand why investors with a longer-term perspective don't focus more on structural trends.

Secondly, most of our clients allow us to think long-term, as we work predominantly with alternative investments, where the investment horizon is typically measured in years, and that is admittedly a luxury.

The implication of all of this? I think it is much easier to make money on the back of longer-term structural trends. Some of our best investment decisions over the years have had nothing to do with the economic cycle. An example: Back in early 2004, when WTI traded around \$40, I predicted that it would go to \$100 within ten years. I got a lot of stick because of what seemed like a crazy forecast, and I admit that I got it wrong. It took only three!

Another example: Back in 2010-11, before Greece blew up, and nearly everybody expected interest rates to rise again relatively soon, I went against the trend and suggested that deflationary powers were indeed very strong and that interest rates would stay low for much longer than most investors expected. Again, my call was based on a structural trend (demographics).

### [The next leg of the Global Financial Crisis?](#)

The main part of this month's Absolute Return Letter will take a closer look at some of the stories that I think could dominate the financial newspapers in the months to come but, before I go there, I would like to make a few observations on the Global Financial Crisis ('GFC'), which is now in its ninth year and still shows no signs of going away anytime soon.

To begin with, a brief note. You can hardly open a newspaper these days without some commentator looking to buy fame by attempting to predict the next crisis but, as I just pointed out, the last one isn't over yet. Therefore a far more relevant question is: What is likely to be the next leg of the GFC?

The GFC began to unravel the world as we had come to know it in the summer of 2007, when a subprime crisis in Florida, California, Phoenix and Nevada began to unsettle investors. The first Wall St. victim was Bear Stearns, which ran into serious problems a full year before Lehman Brothers did. However, at this relatively early stage of the GFC, equity investors chose to largely ignore the brewing calamity. That overall attitude continued until the summer of 2008, when the seriousness of the situation began to sink in. It all peaked in the autumn of that year, when Lehman Brothers went bust. That is now widely known as the first leg of the GFC.

The European sovereign crisis is considered the second leg of the GFC. Ireland, Portugal, Spain, Italy and Greece all went through a horrid time but Greece more so than anyone else. It is probably fair to say that Greece is still years away from more settled conditions, even if it is widely recognised that the European sovereign crisis peaked in early 2012, when Greek 10-year government bonds yielded in excess of 40%.

Now the \$64 million question: Do we expect a third leg to the GFC and, if so, what will it be? First things first. We do *not* subscribe to *the-next-major-crisis-is-just-around-the-corner* philosophy that so many do. Crises of the magnitude that we experienced with the onset of the GFC are extremely rare. We had one in the 1930s, and it took over 70 years for the next major one to unfold.

Having said that, another leg to the GFC is an absolute possibility; I am almost tempted to call it a certainty. Major crises like the GFC do not go away quietly; some sort of *end game* will have to unfold first, and that hasn't happened yet. World War II became a much needed end game to the Great Depression of the 1930s. Following over 15 years of economic uncertainty which was kicked off by hyper-inflation in Germany in the early 1920s, the world needed *something* to clear the air once and for all. World War II did precisely that, even if it came at an unpleasantly high price.

Back to my question: What could be the next leg of the GFC? I will answer the question more thoroughly below, as I think it could possibly be one of the main stories of 2016. Suffice to say for now that I am indeed worried about rising credit spreads and poor liquidity in U.S. credit markets. The sad news in that context is that such a crisis in all likelihood won't be big enough to serve as the end game of the GFC.

### [The biggest stories of 2016](#)

Now to the real juice. Which (financial) stories are going to create the biggest headlines in 2016? Allow me to start with a brief disclaimer. I can only answer that question on the basis of what I know today. Don't expect me to make silly

assumptions or wild speculations as some do. I never engage in that sort of speculation.

Secondly, remember that this is a financial newsletter. Although I think the ongoing conflict with ISIS will worsen as the year progresses, it is likely to have only a modest impact on financial markets in our part of the world and have therefore not made my list (at least not directly), but it could quite possibly be a topic I get horribly wrong.

### **Headline no. 1?**

#### ***All sanctions against Russia to be lifted and trade relationships to be normalised***

The relationship between Russia and the West could quite possibly (sort of) normalise as 2016 progresses. Putin's behaviour in Ukraine won't necessarily be forgiven, but suddenly we are all on the same side of the table, facing the same enemy and, despite the very unfortunate downing of the Russian fighter aircraft in Turkey in late November, we all share the same interest.

It is still too early to say how the ISIS crusade will end, but things will most likely get worse before they get better, and it will become increasingly clear, even to the most anti-Russian evangelists, that we need the Russians on our side to win this war. The biggest beneficiary - in economic as well as in financial terms - of such a re-union is likely to be Russia. It could make Russian equities rather interesting going forward.

### **Headline no. 2?**

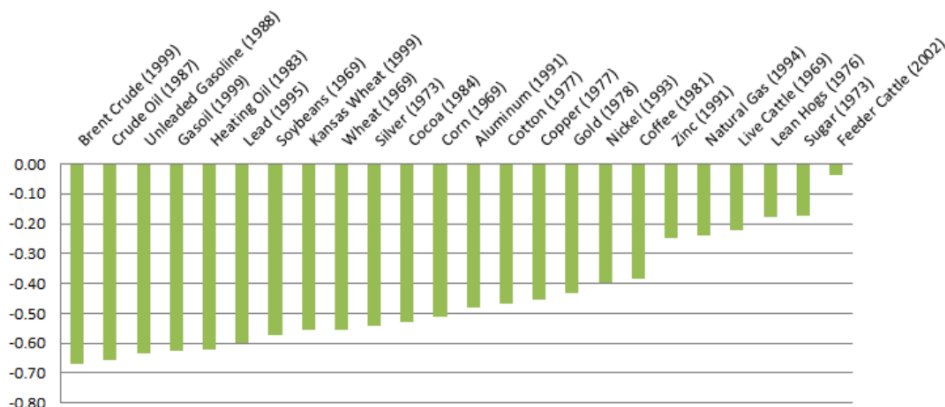
#### ***The EM crisis to widen as commodity prices continue to fall***

My second headline candidate is about something altogether different. Whereas the U.S. and the Eurozone economies are gradually coming back from years of Zombie-like conditions, EM economies are going from bad to worse with South America being particularly badly hit.

At the onset of the Global Financial Crisis, in late 2007, total private sector debt as a % of GDP was on average 73% across emerging markets. Today, EM debt is 107% of GDP and rising and, if one adjusts for all lending taking place outside the banking system (so-called shadow banking), the real number is closer to 130%.

Almost all of the increase is due to a rise in corporate debt, and much of it has been borrowed in U.S. dollars as a result of the extraordinarily benign borrowing conditions in the United States since the outbreak of the GFC. As the Fed has now embarked on a cycle of rate hikes, which is likely to drive the dollar to new heights, and because commodity prices tend to be very negatively correlated with the dollar (Chart 1), I would expect the fall in commodity prices to continue well into 2016.

**Chart 1: Commodity correlation to the U.S. dollar (10 years)**



Source: Business Insider, S&P Dow Jones

Christine Lagarde of the IMF wrote a piece in the German business daily Handelsblatt the other day. In it she said that global GDP growth in 2016 will be “disappointing and uneven”, so I am obviously not the only one concerned. Her worries are largely based on EM “over-borrowing”, as she calls it. In the decade between 2004 and 2014, total EM borrowing increased by no less than \$3 trillion.

Her article has reinforced my belief that my apprehensions about emerging markets are not at all unfounded. EM economies are still expected to grow the fastest in 2016; the IMF GDP growth estimate is 4.5%, leading to global GDP growth of 3.6%, but the risk to those numbers is almost entirely on the downside (you can read about the article in Handelsblatt [here](#)).

The combination of rising debt servicing costs and falling commodity prices is outright poisonous for the many EM companies that make a living out of exporting commodities to the rest of the world. If the U.S. dollar continues to appreciate (as we expect it to do) and commodity prices sink to new depths, the overall conditions for EM exporters can only deteriorate further.

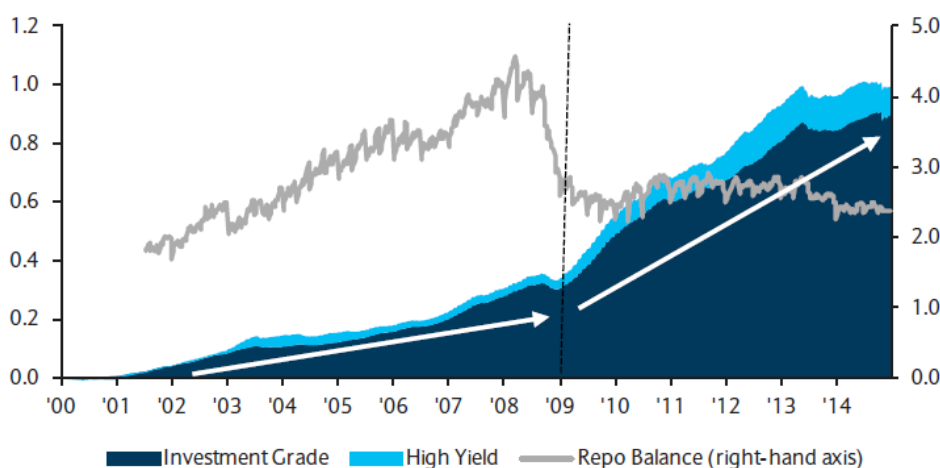
### **Headline no. 3?**

#### ***The credit market spoils the party again***

Liquidity in corporate credit declined significantly as 2015 progressed with all sorts of implications to follow. Turnover dropped, transaction costs spiked, and quite a few credit funds simply threw in the towel. Far worse than that, at least from a systemic point of view, is the growing gap between the liquidity offered to investors in credit mutual funds and actual liquidity in the underlying bonds.

Let me back up for a second. Changing regulations have reduced banks’ repo activities, which have fallen in half from peak levels in late 2007 (Chart 2). As a result, investors looking for safe opportunities to park cash short-term have been forced to look for alternatives to the repo market, and this is where credit mutual funds enter the frame. Because banks offer daily liquidity on these types of products, they are increasingly used as an alternative to repos, regardless of the questionable underlying liquidity.

**Chart 2: Cumulative flows into U.S. credit mutual funds v. repo balances (\$ trillion)**



Source: Barclays, Federal Reserve, Lipper

This is, as Manny Roman (CEO of Man Group and ex-colleague of mine many moons ago, when both of us worked at Goldman Sachs) says: “It is an accident waiting to happen. The more liquid securities offering daily liquidity may simply be sold indiscriminately.” I don’t disagree. Credit spreads could widen significantly as a result, and mutual fund investors could face long lock-ups. Not pretty.

Could it spread to equities? It certainly did in 2008, although hardly anyone expected it to do so at first, when Bear Stearns' two credit funds blew up in the summer of 2007 (although the world is now full of people who claim they did). And that is precisely the reason I don't expect it to happen this time (in a major way).

Crises almost always happen as a result of excessive optimism and not when scepticism runs deep – as it does at the moment. Equities had a rather difficult time in the second half of 2015, partly because of the problems in the credit markets. In other words, it would be entirely wrong to postulate that equity investors have so far ignored the brewing liquidity crisis in credit.

### Concluding remarks

So in conclusion, I think three topics are particularly likely to steal the limelight in 2016:

- ✓ All sanctions against Russia to be lifted and trade relationships to be normalised.
- ✓ The EM crisis widens as commodity prices continue to fall.
- ✓ The credit market is spoiling the party again.

The second and third topic both have the potential to develop into the third leg of the GFC, but neither is likely to be big or devastating enough to serve as the end game. The first could possibly develop into precisely that, but most likely only if the conflict with parts of the Muslim world escalates, and who would want that to happen?

Below I have summarised how I would expect each of the three topics to affect financial markets. Please note that I haven't attempted to quantify the likely impact. As I hinted at in my opening remarks, I find such attempts rather pathetic; it really is my pet hate!

	Probability of it happening	Impact on interest rates	Impact on DM equities
<b>Sanctions against Russia to be lifted</b>	Medium to high	Economic growth to increase as a result, so yields to rise modestly	Moderately positive
<b>EM Crisis</b>	High	Economic growth to be lower as a result, so yields to fall modestly	Moderately negative
<b>Liquidity crisis in U.S. credit markets</b>	High	Credit spreads to rise, but overall yields not expected to move much. If anything, they will fall	Very negative

In other words, a year from now, I expect to be able to write to you that the GFC is now in its tenth year, and we will have a discussion not too dissimilar to the one we are having today. The chances are that the decks won't have been cleared, that economic growth continues to disappoint, that interest rates continue to be impenetrably low, and that equity performance will be so and so.

If 2016 turns into a very difficult year for equities, it probably won't be so much because of the problems in emerging markets, which have limited effect on corporate profits in developed markets. A more likely cause is the brewing liquidity crisis in U.S. credit markets. One thing is certain, though. 2016 is not very likely to go over in history as one of the more uneventful years.

**Niels C. Jensen**  
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