Weekly Market Summary

25th of Dec 2015

2015 Comes to an End….. Welcome 2016!!
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As I look back on 2015, there is one thing that instantly comes to mind: How mistaken I – and most other market players – was in my projections for global economic activity, commodity prices and bond yields!! Out of previous/historic observations or optimism about the US recovery, I was strongly in the camp expecting Fed hikes to come sooner and larger than the recent timid 25 bps Fed rate hike at the December 16th FOMC meeting, and so too expectations for Treasury yields and the yield curve to behave differently than they have (*January 15th, 2015: A Bloomberg survey of 55 economists' forecasts as to where US 2-year, 10-year and 30-year Treasury yields would close the year resulted in median values of 1.42%, 2.80% and 3.35% respectively. With almost one week to go before 2015 ends, 2-year, 10-year and 30-year US yields remain depressed at 0.97%, 2.25% and 2.97% respectively!)*

However, it is hard to blame me and the market for this misperception. The Fed's own projections for growth and inflation have been overly optimistic for years now, and thus their own expectations for policy changes have been off. Further, a series of unfortunate and unrelated events from external sources have conspired to keep US rates subdued over time, from the Greek debacle earlier this year to slower growth trajectories in Europe, Japan and Asia, to foot dragging stimulus from other central banks, to Syria, ISIS and too much oil and gas for the current state of demand.

In other words, Central Bankers* – like many economists – poorly projected how the financial world would look like today: No one saw economic growth remaining as mediocre as it has been; No one saw Chinese growth slowing down the way it has, coupled with a move to focus its economy more on consumption and less on investment; No one foresaw the European Union stalling the way it has; No one could imagine oil prices falling from around $110 a barrel to close to $35 a barrel; No one could have projected the fall in commodity prices to the levels they are now at; No one saw emerging market nations such as Venezuela, Brazil or Argentina facing their current deep problems; and surely No one expected the unsettling situation in the Middle East to worsen and expand throughout 2015 (with the possible worldwide terror threat arising out of this chaos)!

**Central Bankers "best" definition: A group of economists who believe that their current forecasts will turn out to be accurate even though their past forecasts have been unreliable, that their present policies will succeed even though their past policies have failed, that they can prevent inflation from occurring next time even though they didn't prevent it last time, that they can foster lower unemployment in the future even though their practices worsened in the past, and so forth.*

If we should learn anything from the 2015 experience, it is that overseas events and trends have been the tail wagging the dog (US rates market), while US growth has, on average, continued to do well (what the Fed refers to as modest to moderate improvement). In this relatively serene and neutral environment, overseas events/developments have had a greater influence than US domestic factors. This has driven the dollar's strength and inhibited a rise in Treasury yields due to the resulting low inflation story and inspiring interest rate differentials (the spread between US rates and other G7 government bond yields has reached its widest level in a decade!). These elements remain very much intact in the year ahead.

Interestingly enough, the fixation on the Fed should slightly diminish in 2016. At least, the uncertainty over the start of the Fed hiking cycle is out of the way! That leaves it largely now to timing the next rate rise, which as things currently stand does not seem to be happening before the scheduled March 18th, 2016 FOMC meeting (barring any unpleasant economic or geopolitical surprises!). There is a convergence of views that the tightening cycle will be extremely shallow, possibly 2 rate hikes per year for the upcoming three years, and thus is largely priced in the current depressed US forward curve. We note that such is a very restrained path compared to previous rate hike cycles (on average 2 percentage points / year) and current Fed projections for a full percentage yearly rise in short term rates ; In addition there a lot of time between now and March 2016, and thus a lot of other things will surely come into play and most likely change market's perceptions!

As we head into 2016, I would also caution all against holding mainstream views on financial markets (USD will continue strengthening, oil is still headed much lower, gold will be stuck in a tight range, the ECB will implement additional quantitative easing, volatility will return with a vengeance, geopolitical risks will persist, etc..). I mention that to provide a clear reminder that what "*everyone knows or assume to know*" is usually unhelpful at best and wrong at worst ! And what CFOs/Finance Officers should worry most about & really focus on are the risks/things that other market participants haven't considered. Forecasters usually stick too closely to current levels in markets ($36 on WTI oil today, but that level was in excess of $ 100 just 1-1/2 year back!), and on those rare occasions when they call for change, they often underestimate the potential magnitude!

Once again many thanks to all our clients for your continuous support throughout 2015! Best of luck navigating markets in 2016 !!

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