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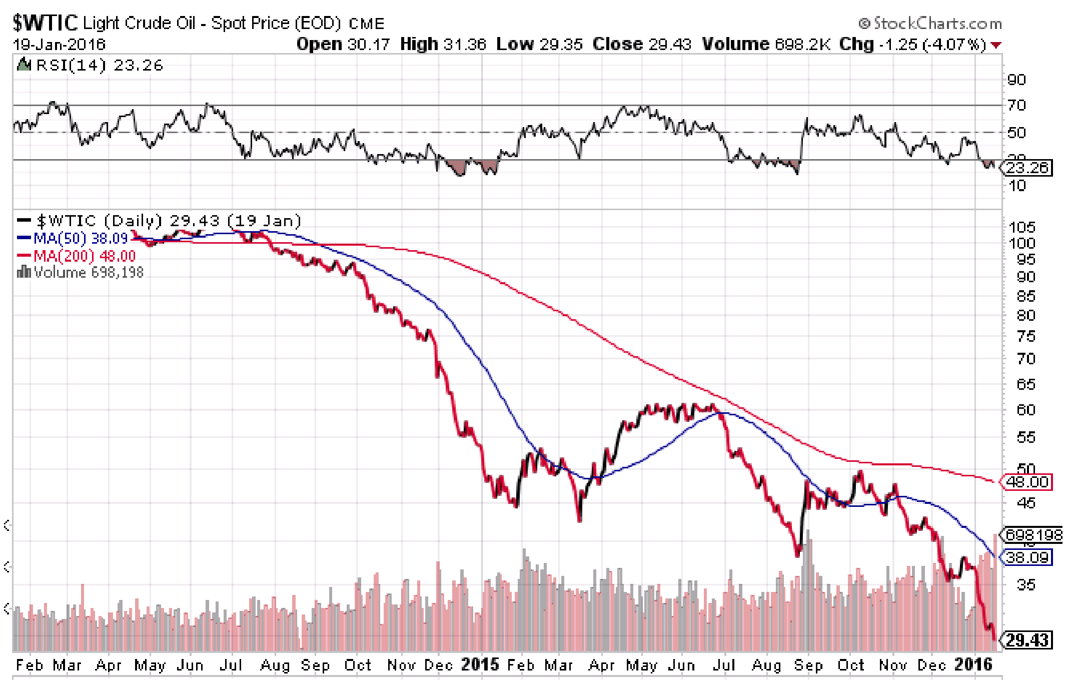
January 2016 Update

Mike Tyson once said that "Everybody has a plan until they get punched in the mouth." While it's obvious to all now that the world stock markets are in a bear market, there may be some inclination by some to call a bottom after a brutal January. I think the bottom is a long way off, probably not until 2017. I'd like to add that the "punch in the mouth" may not be the blow that floors the boxer, it's more likely to be the punch that comes unforeseen, out of nowhere that knocks out the investor.

I strongly believe the invisible punch is looming soon and it will be delivered by China in the form of a severe devaluation of its currency, the Yuan.

The world is transfixed by the global slowing growth story and the linkage between oil, credit, debt and liquidation. Regardless of one's politics be they be Green or Koch brothers fossil fuel oriented, the decline of West Texas Intermediate Crude (WTIC) at $29.43 and falling is not good news for anyone.



Oil is traded in USD and most of the World's debt is USD denominated as well. Falling oil prices means that countries are being forced to increase the amount of oil on the world markets in order to raise dollars to cover their sovereign loans. Countries like Saudi Arabia are currently running such deficits that their forced to liquidate holdings in their sovereign funds which include US stocks and bonds.

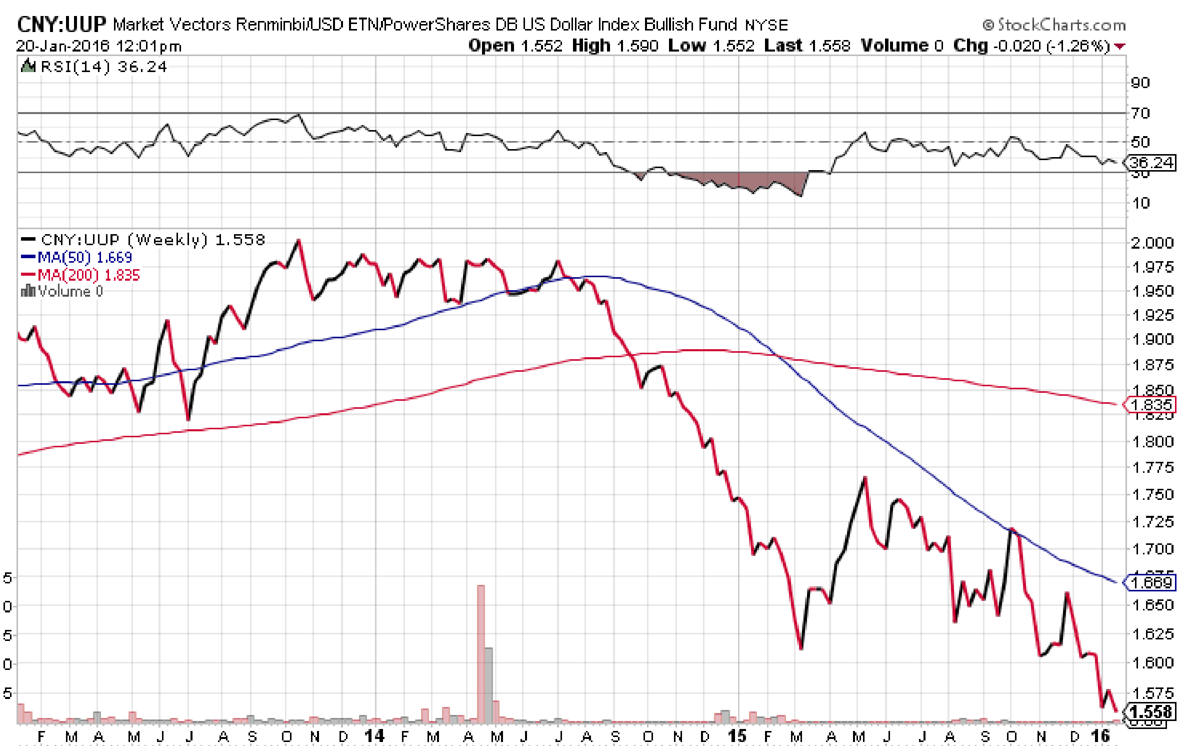
It's estimated that the current oversupply of oil on a daily basis exceeds 1 million barrels and that does not include Iran which will soon be exporting oil as well. The price of oil will not stop falling until we see some signs of production cuts which may not happen until defaults and bankruptcies become commonplace.

China

It would be an understatement to say that China has issues. The Chinese centralized government plan of 10% annual GDP growth is over and there exists a mass exit of capital from foreign investors and Chinese citizens which is putting severe pressure on the Yuan. China is being forced to convert from capital spending economy to a service economy and there is the risk that the centralized Chinese government is losing its grip.

In 2015 China lost over $1 trillion USD as foreign investors pulled their capital. In 2015 the PBOC spend $500 billion defending the Yuan which included $100 million in December alone. Several analysts expect the PBOC to spend upwards of $200 billion this month to offset the steep decline in the Chinese stock market and the Fed's decision to raise short term interest rates in the US. Defense of the Yuan comes from China's foreign exchange reserve fund which is estimated at $3 trillion USD. Worth Wray of Gavekal estimates that 1/3 of the $3 trillion is illiquid and unavailable leaving just $2 trillion. Of the remaining $2 trillion Chinese leader Xi Jinping has earmarked another $1 trillion to his "One belt-One Road" strategy which is a fiscal stimulus plan to potentially avoid a Japanese style stagflation.

When the Fed recently hiked interest rates the PBOC allowed the Yuan to depreciate in order to gain export competitiveness but managing the decline of the Yuan has become increasingly expensive and the PBOC does have face a limit to how much they can spend defending their currency. I fully realize it sounds a bit incredulous that the PBOC could actually run out of the money but the strength in the USD relative to the Yuan/CNY means that it's a losing proposition owning the Chinese currency.



China also faces a loss of face issue with several failed interventions in their stock market and currency manipulation. Just about every country manipulates their currency to some degree so I don't use the term in a negative context.   But China has resisted lowering the Yuan in the face of severe Korean and Japanese devaluation but their leaders must be reaching the point where they decide enough is enough.

My main point is: If China suddenly overnight devalues the Yuan (also known as the Renminbi) by 25% or 30%+ at a time when the US is raising rates and teetering into recession it could be the blow that knocks the US into a full blown recession.   U.S. and World stock market would be thrown into chaos and a market decline of a 1000+ points in the Dow in a single day could be expected. This would mean our current decline in the 15% range would expand to at least 25%, in my opinion.
The devaluation would likely mean a tremendous boost to Chinese manufacturing, but it would come at the cost of pushing China's trade partners and manufacturing rivals into recession.

If the Yuan devaluation occurs it would clearly highlight that the US Federal Reserve made a severe error in raising short term interest rates and that they'd likely have to reverse course by lowering rates.   In addition, it's likely that the US would initiate a new round of massive Quantitative Easing (QE).

Estimating how the dominoes will fall is my primary focus for 2016 into 2017. As I've said many times I expect to see a mass migration of the World's capital into the USD and US Treasury notes and bonds. If the Fed embarks on QE4 I would expect the Fed to target Treasury bond yields to extreme lows (As yields decline, bond prices rise).

The US 10-year Treasury bond currently yields approximately 2%.   In recession and with a tailwind of unrelenting QE and natural risk averse buying we could expect to see the yield on the 10-year to drop to 1%.   A favorite strategist of mine, Raoul Pal believes the yield could fall as low as 0.5% by 2017.

The 30-year Treasury bond could easily fall to 1.5% from its present 2.72% by 2017.

The TLT is an ETF that is an accurate proxy for the 30-year Treasury bond.   If the buying occurs the way I'd expect the price of the TLT will easily hurdle the 2015 high of $135 and approach the $175-$200 range.

TLT [NYSE]
iShares 20+ Year Treasury Bond
Financial | Exchange Traded Fund | USA

The 10-year Treasury which we own via the TLH and IEF would also see similar results. $180 is not out of the question for the TLH. In my opinion, this may be the best risk-adjusted investment in the world right now. Owning the 10-year Treasury right now defies the traditional concepts that conservative investing is low return investing. In owning the 10-Y Treasury your principal is assured and the capital gain from a sharp drop in yield akin to a very strong stock market return but without the risk.

TLH [NYSE]

iShares 10-20 Year Treasury Bond

Financial | Exchange Traded Fund | USA

In summary, 2016 and at least early 2017 are going to be brutal years for the stock market and a recession is due in the US. We can expect that China will shock the world with a massive devaluation of the Yuan which will reset investor and economic expectations to the lowest levels seen since 2008-09.

Our goal is to maintain high cash levels, have zero stock market exposure and remain invested heavily in US Treasuries. It would not be a surprise at all to see stock market like returns in T-bonds over the next year to year and a half.

Eventually this market phase shall pass like all the others. There is always the tendency to extrapolate economies and markets long into the future but I've seen so many of these cycles to understand this is all cyclical. Eventually the recession will be full blown and on the cover of every magazine. At that point in time the stock markets will have a great deal of risk purged and a massive buying opportunity will exist. My goal is to make sure all of our clients reach that point in time with the most opportune but risk-averse strategies.

Brad Pappas

Long TLT, TLH, IEF and EDV

Disclosures

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