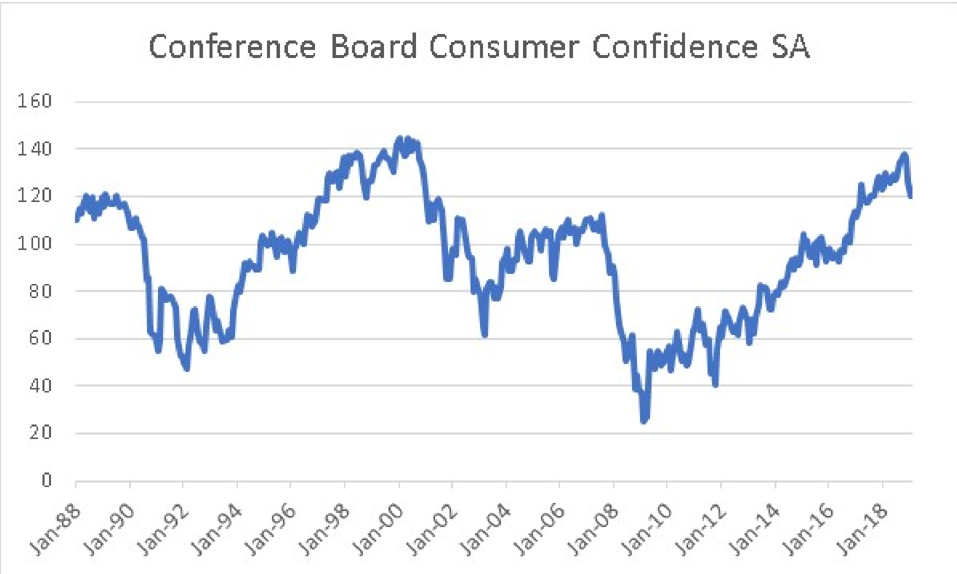
THE DIFFERENCE BETWEEN 2015-16 AND NOW

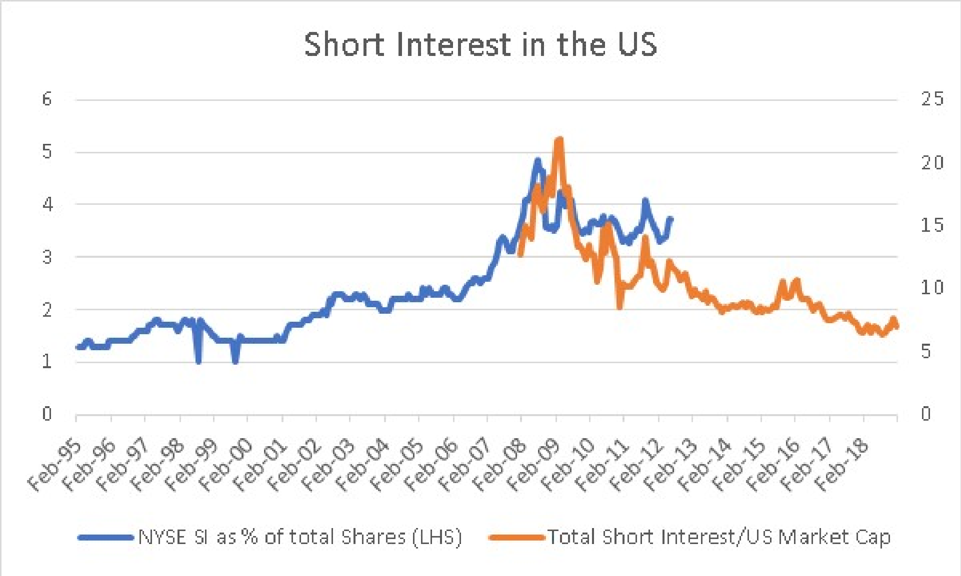
Russell Clark's
Market Views

"In 2015-16 various signals gave a mixed message on market outlooks, but short positioning increased substantially. This meant the market rallied substantially when recession was avoided. In 2018-19, the bearish signals are much clearer, but markets have not positioned themselves bearishly."

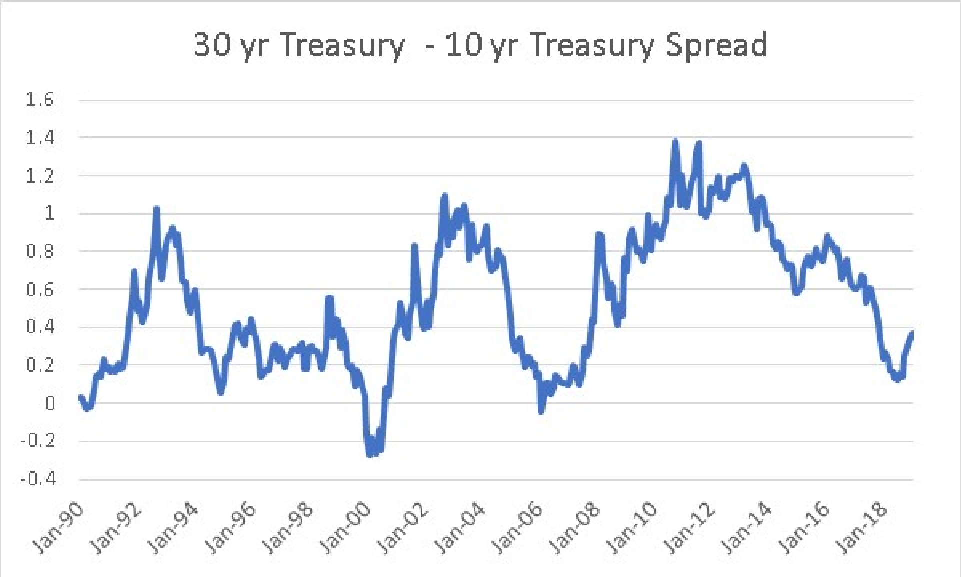
Recent market action bears some similarity to the market moves in 2015 and early 2016. However, the differences are much more striking than the similarities. One has been the rapid drop in consumer confidence, from much higher levels.



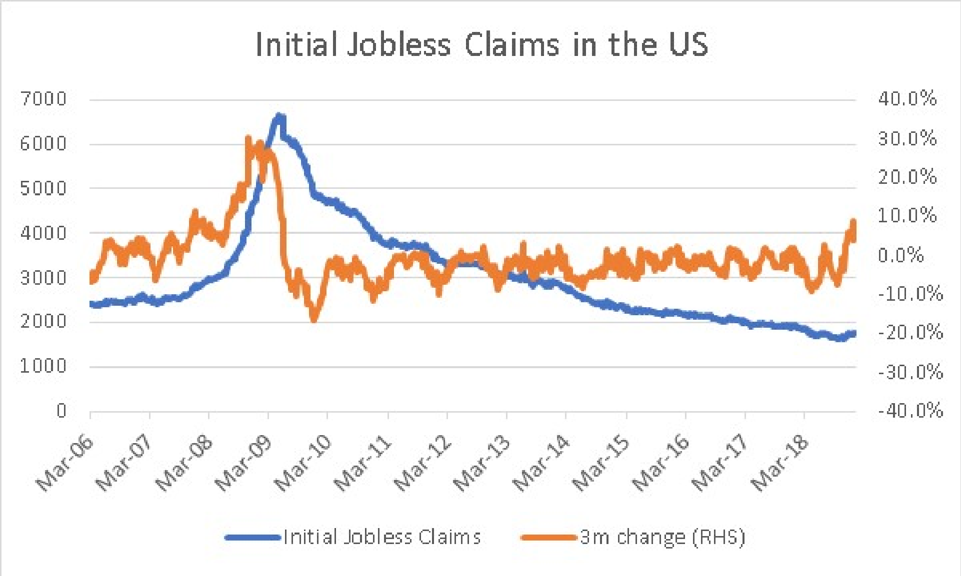
Given the long bull market, short interest in the US market has collapsed. We use two measures, the first is NYSE US short interest as % of total shares outstanding. Sadly, this was discontinued in 2012. The second is the total short interest, from 2008, which is a more complete measure of value of short interest across all exchanges. We normalise this by dividing by total US market capitalisation. The absolute numbers do not match up, but the trend would suggest we are close to lowest levels of short interest this millennium.



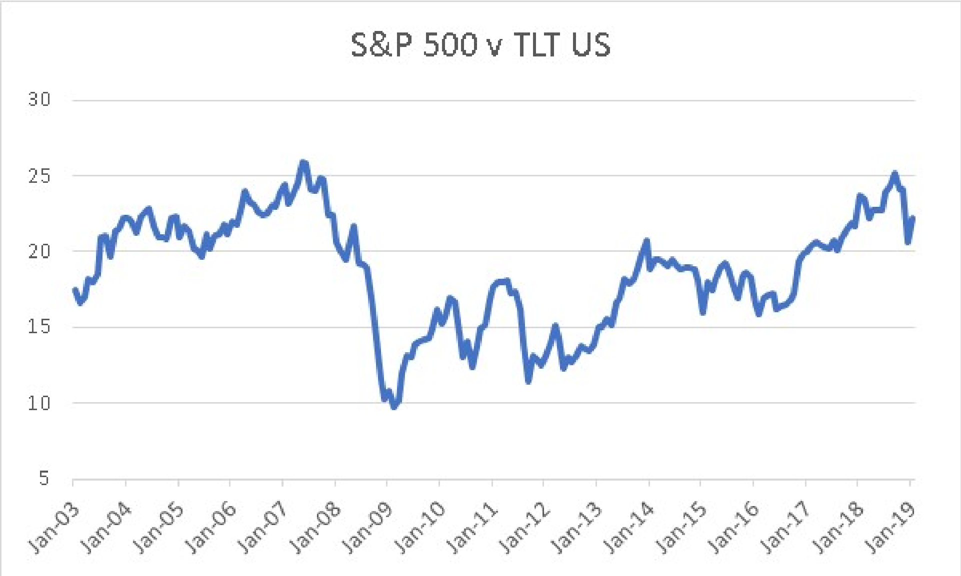
I have found the 10 to 30 spread in the bond market is a good lead indicator on cycles. Here we see that the US 10yr has dropped below the 30 year yield. This is typically seen at the beginning of recessions and bear markets. In 2015-16 this curve also moved bearishly, but then inflected in early 2016. The current signal is much more clearly signalling an inflection point, as it did in 1990, 2000 and 2007.



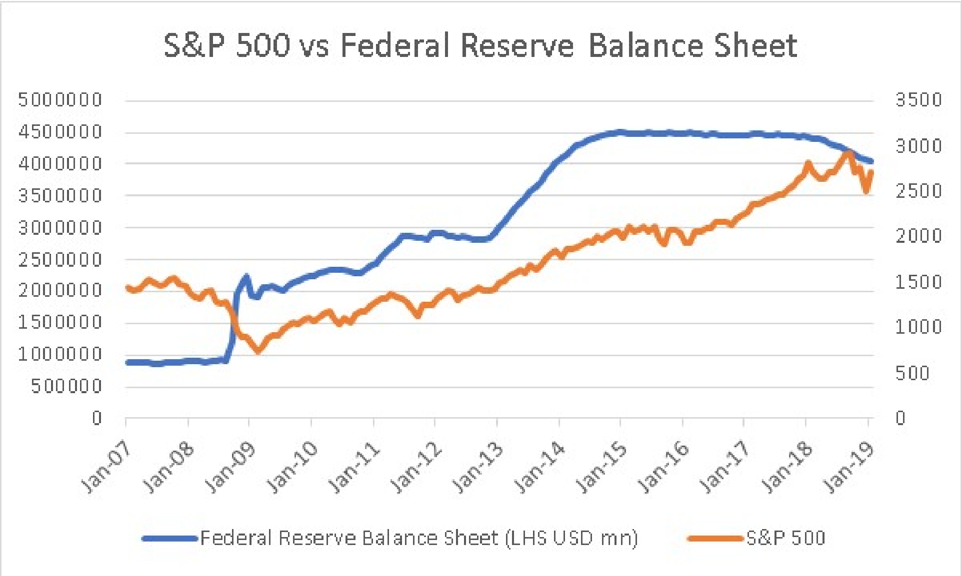
I find the US market tends to follow employment trends. Equities tend to outperform bonds when employment is rising, and bonds tend to outperform equities when unemployment is rising. Looking at initial jobless claims we can see that employment has been steadily rising until recently and looks to have inflected.



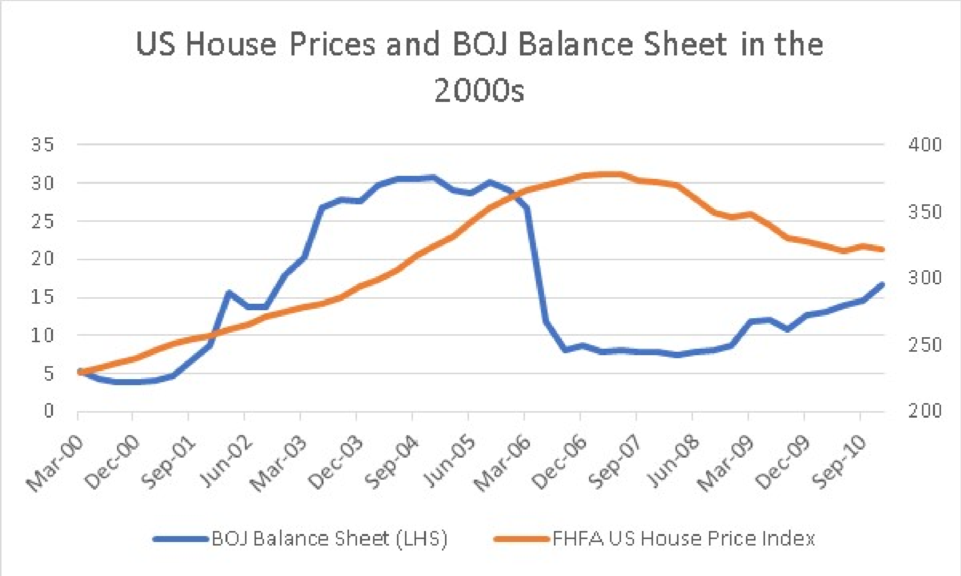
Financial markets have been signalling a change, with the TLT US (a bond ETF) beginning to outperform S&P 500. This is very similar to 2007.



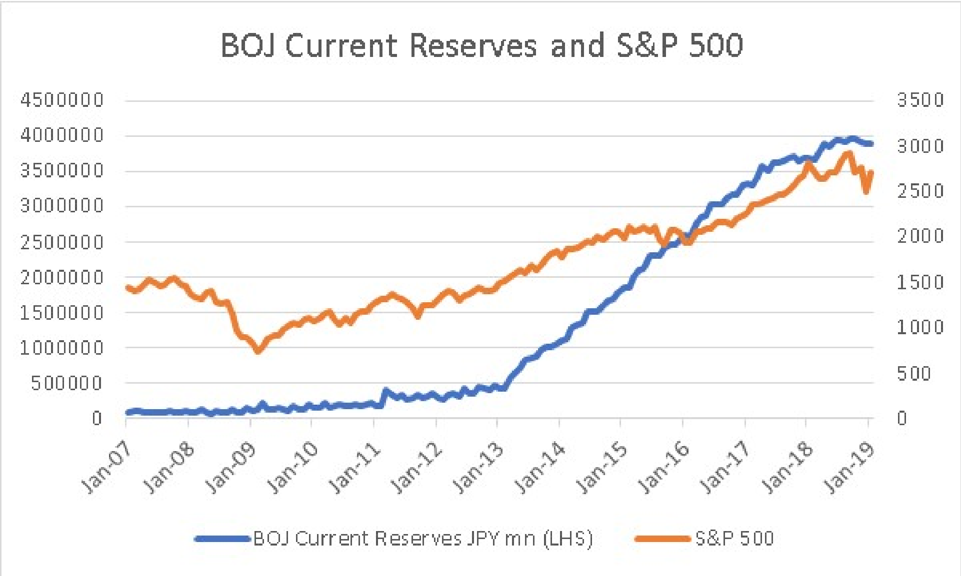
In 2015, you could have argued that with the Federal Reserve not increasing its balance sheet anymore, stocks could weaken. In early 2016, this looks plausible but ultimately wrong.



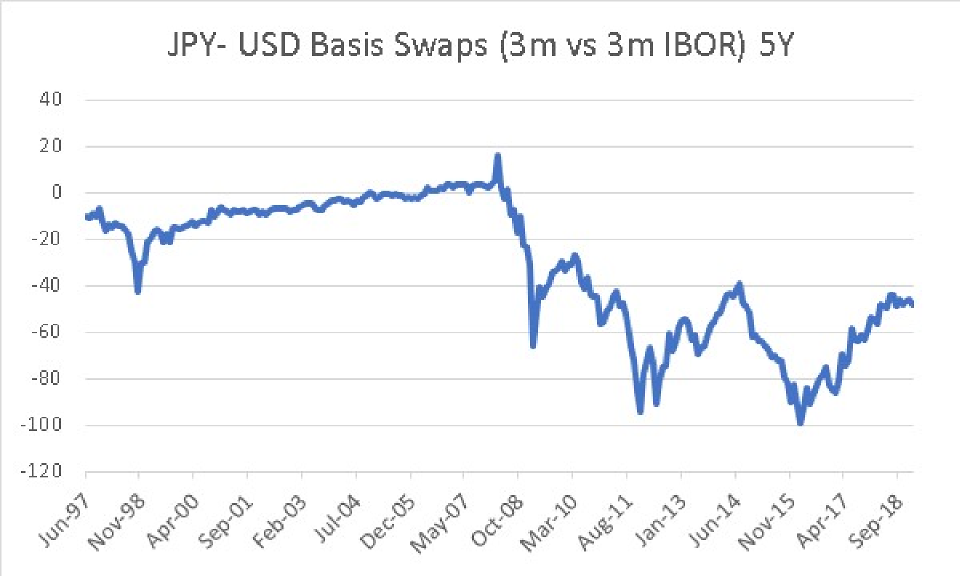
One reason for this is that, in my view, the Bank of Japan (BOJ) is the ultimate driver of liquidity globally. One example of this is the BOJ last contracted its balance sheet in 2006, and US house prices topped out soon after.



The BOJ adopted aggressive monetary easing in 2012, and, in 2016 increased the expansion of its monetary base. However, the BOJ is now tapering, and its balance sheet is beginning to contract. This is in stark contrast to 2015-16.



Furthermore, a good indicator of Japanese private sector demand for US assets is the cross-currency basis swaps. I consider this is a good indicator of demand for USD hedging from Japanese investors. When this is declining, Japanese investors are getting nervous and demand more hedging, and when it is rising, they are more confident, and hedging costs decline. In early 2016, this was at an extreme, and turned upwards, indicating rising Japanese demand for US assets. Now, it is beginning to inflect again, indicating falling demand for US assets. Unlike 2015-16 when Japanese demand for US assets had already fallen, 2018-19 is just inflecting lower.



In 2015-16 various markets signals gave a mixed message on market outlooks, but short positioning in the market increased substantially, which meant the market rallied substantially when recession was avoided. In 2018-19, the bearish signals are much clearer, but markets have not positioned themselves bearishly. Risks are all to the downside.

INFORMATION

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