December 2015 Investment Newsletter

Are we celebrating the Christmas eve of 2007 or 2004?

1. 2007. The eve of the storm.

It's been seven years since the last great financial crisis in 2008. For those of us who remembered, 2007 was going nowhere, being at the tail-end of a bull market cycle. It had its own mini-crash in Aug (down over 9%), quickly rallied back up to break new highs (barely), before plunging 10% again in Nov. It finally ended the year up 3.5% (sounds familiar?).

Coincidentally, the Shanghai Composite peaked in Oct 07 as it gained ***one hundred and twenty-eight percent*** year-to-date.

2008 started with heart stopping action, with the S&P 500 carving through 2007 resistance levels in a matter of days. It continued to stay below the 200 day moving average right up to the plunge in Oct 08.

Chart 1: The chart shows the performance of the S&P 500 from Jan 2007 to Dec 2008. The index was going nowhere in 2007. In Jan 08 it tore through key resistances quickly and made new lows.

Chart 2: The chart shows the Shanghai Composite index from Jan 2007 to Dec 2008. The index was up a whooping 128% year-to -date in Oct 2007 before it came crashing down.

2. 2004: the last round of rate hikes

The chart below shows the performance of the S&P 500 and US Fed fund rate. The Fed hiked from mid-2004 to early 2006, and during this period the US economy was strong, jobs were created and the stock market performed in line with the economic growth.

We can see similarities here. The US economy appears to be in a good shape as 2015 draws to a close. I like what economist Brian Wesbury from First Trust Global Portfolios said about the US economy—it is like a plough horse; not going to win any races, but not going to keel over and die either.

Moreover, Yellen has always positioned herself to be supportive of market stability and I expect the coming round of rate hikes to be gentle and that rates are going to be 'lower for longer'. Lest we forget, Yellen is not going to hike unless she is absolutely convinced that the economy is on solid footing and that inflation is poised to rise as the labor market tightens.

Therefore this is the scenario that I feel is more likely to play out.

Chart 3: The chart shows the performance of the S&P 500 overlay with the Fed reserve rate. The Fed hiked rates from mid-2004 to early 2006.

3. Cautiously positive about global prospects

Here is a quick discussion on why I am cautiously positive about global growth prospects.

Fears of firms blowing up when the Fed hikes are probably overblown

One often discussed fear is that there are a number of firms which have become over-leveraged during this extended low-rate period and they will quickly collapse and/ or disrupt the economy when the Fed hikes. While I believe some poorly managed companies will collapse, I don't see why the generally smart and competent people in blue chip firms can allow this to happen. Given that the Fed hike has been clearly telegraphed, firms should have been prepared regarding their USD funding. Europe and Japan are still going ahead with their monetary easing and plans could also be made to diversify funding sources to EUR and JPY.

China: turbulent but long term trend is up

Regarding the Chinese economy, the general feeling is that we will see some turbulence, we will see some corporate defaults, but overall we are positive about its medium and long term prospects. The Chinese stock market has been described as 'emotional', with the large percentage of retail investors involved. Changes are afoot however; just today the yuan is accepted into IMF's currency basket. With the gradual internationalization of the currency and therefore more institutional participation, markets should become less 'emotional' and the volatility curbed. We can also see that the Chinese government is very determined on stabilizing the ship and I must say they have so far come across as credible.

Europe: stimulus having an impact

Within Europe, the Paris attacks could act as a drag to European growth. Specifically, trade, travel and consumption would be impacted. Historically however, geopolitical risks tend not to leave lasting impact on global markets, partly because it is usually regarded as a constant factor. In the same vein, the criticisms levelled against Europe — immigration issues, currency issues, weaker peripheral nations such as Greece, etc—these are not new issues and have been discussed for some time. They take time to resolve and will not go away anytime soon. Meanwhile the stock markets did perform well over the past year as the ECB rolled out its quantitative easing program. Right now, Draghi is still weighing up more stimulus which should be positive for equities.

Date sources: Bloomberg

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