Jan 2016 Investment Newsletter

2016: A New Hope

Season's greetings, dear readers. As I write, 'Star Wars: The Force Awakens' crossed $1bn in sales in 12 days, becoming the first picture to reach that mark so quickly. This success reminds me of Disney, the producer behind the latest Star Wars movie.

What were you doing in May 1977? Suppose, if instead of catching the first Star Wars movie with your date, you put that money into Disney stock, what would be the stock be worth now? **150x**. Disney shares have since gone up **150 times**, *not 150%*. Now I might not necessarily recommend that as your date probably wouldn't be too happy; this example* merely serves to illustrate the principle of long-term investing and looking through temporary market noise.

The Force is strong with this dollar

The dollar awakens this year as the Fed successfully raised its interest rate by 25 bps last December. Policy divergence is set to continue in 2016 with the European Central Bank (and possibly Bank of Japan) ramping up quantitative easing, while the Fed will look to tighten again. As such I view this as bullish for the dollar, and bearish for the Euro especially since the Euro has rallied back to an undemanding 1.10 level (at time of writing). I wouldn't be at all surprised to see Euro in 2016 to fall to the 12 year low of 1.0459 and further.

The RMB and Asian currencies should also depreciate against the dollar in 2016, with some observers believing RMB could fall 15-20% to get back to 'trendline'. After we experienced a shock one-time devaluation of the RMB in August 2015, China unexpectedly published a peg of the RMB to a basket of currencies in December 2015.

Since late 2013, the RMB has weakened against the USD, but has strengthened against its trade partners' currencies. Therefore this new measure provides ample justification for the RMB to ease further, and to inevitably depreciate against the USD. Simply put, China has also joined the dark side in unleashing monetary force like what the US, Japan and EU have done. As China weakens its currency, other Asian currencies would likely follow suit.

How far would RMB depreciate? While I think it will be a meaningful depreciation China may be constrained by international backlash from allowing it to weaken too much or too rapidly. As of the time of writing, the 1-year offshore RMB forward rate is predicting another 3-5% depreciation against the dollar.

All in all, suffice to say it is a fairly contrarian view to bet against the dollar next year. At any rate (pun intended), I prefer to keep most of my assets in dollars if possible since my book is based in dollars.

* This is a positive example of an investment which has gone right. For the sake of clarity I do not pretend to be unaware of the multiple blow-ups that have littered the history of finance. Again, sound investing and risk management go hand-in-hand.

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"When seven years old the bull market reach, look as good it will not."

The way analysts are describing the age of the bull market, it has more wrinkles than Yoda's face. However, I think we should examine the merits of the economy by itself and outside the framework of this mystical 7-year boom-bust cycle. Perhaps we should also remember that in 2011, doomsday naysayers were prophesying that it would be the shortest bull market cycle in history.

Labor conditions in US have been strong while wages and earnings have increased, which should drive consumption. Indeed, the US consumer and domestic demand have been solid; for example auto sales are risen consistently since the end of 2008 recession. Household balance sheets are also in very good shape.

Supposed we have agreed that the US economy is in reasonably good shape. What about financial markets? For the S&P to move higher, we need revenue and earnings growth, and the index as a whole has actually seen revenue decline last year. This was why the S&P was going nowhere in 2015. As basic as it sounds, I believe returns next year will be driven by sectors and stocks which are expected to report revenue and earnings growth.

Will stocks fall off a cliff? If we believe the economy is in a reasonable shape on a fundamental level or that the stock is fundamentally a good stock, plunges in markets could be viewed as buying opportunities. I don't think stocks will fall into a bottomless pit for many reasons, one of them being that central banks as a powerful player in the market also prefer financial market stability. Like it or not, central bank support of financial assets is going to be a feature of the market for the foreseeable future. It probably started in October 1987, when the stock-market crash — a one-day 23% plunge in US equity prices—prompted the Fed to move aggressively to support the brokerage system and purchase government securities. Since then the Fed has always added massive liquidity to markets in times of crisis. These days central banks see asset markets and financial market *stability* as playing important roles in economic growth. Therefore, until we see some massive social backlash on central bank support this is how the markets will operate and I don't think US equities will fall into a bottomless pit.

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