THE REVENANT, THE WALKING DEAD AND THE BEST NEW TV SHOW

Who wants to watch a TV show live when you can DVR it and fast forward through the too frequent and most of the time annoying commercial breaks? This has been my philosophy for the last few years but, for some shows, I can barely wait and I had to come up with an alternative strategy. Through experience and trial and error, I now know that if I start watching the still recording show 17 minutes after the start, it will allow me to skip the commercials and finish watching pretty much at the same time that the show is over. One of these shows is The Walking Dead (9PM on Sunday’s). On February 28th, using my highly astute strategy, I was therefore able to witness “quasi live” the nascent romance between Rick and Michonne. However, the price I had to pay was that I would be unable to watch the Oscars. Against all odds (not a great movie, but a Grammy Award winning original song), The Revenant did not win the Oscar for best picture, although Leonardo DiCaprio still ended up in the Spotlight and, at last, won his first Oscar for best actor.

If there is one TV show that has won the hearts and minds of the public in recent months and one that every citizen of this Great Nation (or soon to be great again) should absolutely watch live, it is the Republican Presidential Debates.

After 12 episodes, we are getting closer to the Season Finale and questions still abound - will little Marco be the next comeback kid? Will Lyin’ Ted be the first Canadian President? Or will small-hands Donald have to downsize and move to the White House?

But wait a second - what does that have to do with the financial markets?

Well, over the past four weeks, it seems that several areas of the financial markets have staged a very powerful comeback (one that any lightweight or self-proclaimed socialist politician can only dream of), but the question remains - are these areas true revenants or barely walking dead? Are we experiencing the beginning of new trends, or are these rallies only dead cat bounces?

We have witnessed a powerful rotation since the lows reached on February 11th. Indeed, past losers are significantly outperforming past winners, in a way that would please any evangelical voter (the last shall be first, and the first last). Such a sharp change in leadership should probably not come as a surprise during an election year.
Without further ado, here are my nominees for the best comeback, trend reversal or counterclockwise rally:

1. The Oil Patch (not be confused with the Nicotine patch that I know all too well)
2. High Yield
3. Emerging Markets
4. Financials

THE OIL PATCH

WTI crude oil price has rebounded nearly 50% from the February 11th low of $26.21/barrel. This is obviously a very significant bounce (although it is only $11/barrel) and key technical levels have been broken, such as the 50- and 100-day moving averages. The primary trend however (200-day moving average) has not been broken and continues to decline. Since the start of the current oil bear market in mid-2014, WTI prices have crossed above their 50-day moving average twice already – nearly exactly one year ago and briefly again in October 2015 – only to fall back thereafter and reach new lows. The 40% rally in WTI between March and June 2015 ended badly and was followed by another 50%+ decline. Back then, the rally did not appear to be supported by any meaningful improvement in supply-demand fundamentals. In our previous newsletters, we made the case that a rebound in oil prices (and a stable or weaker US dollar) would go a long way in supporting risk assets in the near-term. Given that the correlation between the price of oil and so many asset classes has moved up sharply over the past few months, this comeback is probably the most important development in recent weeks. The entire oil industry is breathing a sigh of relief. While the rebound for major integrated oil companies is not particularly stronger than what we have
seen for the broader market, the rally for some of the most beaten down E&P names (Murphy Oil, Apache or Chesapeake) has been extremely violent. Energy Master Limited Partnerships have also staged an impressive rebound, up nearly 30% in the past four weeks.

While headwinds have not disappeared and recent price action was partially driven by technical and sentiment factors (oversold condition, short-covering, extreme pessimism), we have seen a marginal improvement in fundamentals as well and our view is that the 2/11 lows will most likely prove to be the bottom. Record high oil inventories continue to be the main negative for oil prices going forward but supply adjustments seem to be taking place at a slightly more rapid pace than expected just a few weeks ago. Non-OPEC production (particularly in the US) is expected to fall further this year and next year while OPEC spare capacity is largely limited to Saudi Arabia. The tentative agreement between Saudi Arabia, Russia, Venezuela and Qatar to freeze production at January levels is not a major concession (since Russia and Saudi Arabia pumped oil at near-record volumes in January), but it does significantly reduce the tail risk of another major meltdown in crude oil prices. This agreement will reportedly be discussed on 3/20 as major oil producers meet in Moscow. Moreover, recent events in Iraq and Nigeria (pipeline explosions and sabotage) resulted in a temporary output loss of an estimated 750-800,000 barrels/day, roughly 40% of the current excess supply. These events are a reminder of the ongoing risks to production in these unstable regions. Based on past and expected production cuts, the oil market is expected to move closer to equilibrium in terms of supply/demand in 2017. However, this outlook incorporates major assumptions in terms of supply (Iran, production freeze implementation, US shale production and reaction function to higher oil prices) and global growth. Although the lows in this cycle may already be behind us, volatility will remain elevated and we doubt that the sharp rally seen over the past few weeks can be sustained.

HIGH YIELD

Financial conditions have tightened significantly since October 2014. This tightening is due to a variety of factors such as the rapid appreciation of the USD, the decline in Chinese FX reserves, the sharp slowdown in the amount of petrodollars recycled in US financial markets, tighter lending standards for C&I loans, and a significant widening of credit spreads, in particular in the high yield space. As discussed in previous newsletters, tighter financial conditions tend to be leading indicators of potentially much softer economic growth going forward. As such, any rally in equity markets will be short-lived if not confirmed by an improvement in credit markets. There is good news on this front since high yield spreads have come down decisively in recent weeks, from a high of 887 basis points (bps) to the current level of 715 bps. While the rebound in oil prices was a major positive for the energy
sector where implied default rates had shot up considerably, the improvement was broad-based and extended to most sectors. The selloff in credit, and high yield in particular, was particularly pronounced and disproportionate compared to equity markets. Investment grade and high yield corporate bonds were priced as if we were already in the early stage of a US economic recession (during the two most recent recessions, high yield spreads stood at 765 bps and 615 bps respectively at the start of the economic downturn). Recent economic data, particularly in the manufacturing sector, has helped ease investors' concerns about the growth trajectory of the US economy. The rebound in oil prices is therefore not the only driver behind the improvement seen in credit markets. On a risk-adjusted basis, we find high yield (and other areas of the credit markets) more attractive than equities and we have shifted some of our equity exposure into high yield.

EMERGING MARKETS

Emerging markets are probably the area where investors have been the most pessimistic over the past few years. Granted, emerging markets are faced with a long list of headwinds. These include the ongoing economic slowdown in China, the plunge in commodity prices, the buildup in dollar denominated debt in the context of a surging USD, a global trade recession and weak productivity gains, to name just a few. On the other hand, the asset class has been pummeled, particularly since mid-2013, with a sharp selloff in equity markets, wider sovereign and corporate spreads, as well as rapidly depreciating currencies. At some point, one has to wonder whether all the bad news is already discounted or maybe even over discounted. From a valuation perspective, these markets are trading at a steep discount to developed markets and even compared to their own history. As already mentioned, from a
sentiment perspective, it seems that we have also reached some extremes looking at fund flows and investors' allocation to this area. As we all know however, valuations can stay depressed for much longer than any investor betting on a normalization of these metrics can stay solvent. We also know that being a contrarian can generate huge benefits when it works. But, most of the time, it doesn't work - unless we have one or several catalysts in place to fuel a trend reversal. Although developing nations are faced with a series of structural issues (lack of structural reforms, deleveraging pressures, transitions to a different economic model, weak productivity gains and corruption), our view has been that catalysts for a rebound in emerging markets would have to be more cyclical in nature. We have made the case in the past that a stabilization or a reversal in the dollar and commodities would go a long way in helping these markets find a firmer bottom and start to unlock the very real value they offer in the medium-term. As mentioned above, we believe that crude oil prices have hit a bottom earlier in the year and although volatility will remain elevated, oil will probably not be such a significant headwind going forward. The same can be said about the dollar which seems to have reached a high in this cycle around mid-2015. Recent aggressive policy measures announced by both the BOJ and the ECB have not delivered the expected outcome of weaker currencies, to the contrary. While we remain slightly underweight in emerging market equities, we have recently increased our allocation to EM debt and we expect to do the same with our equity exposure later in the year. Our reticence to implement this trade right now is partially related to the outlook for the Fed policy (and its impact on the US dollar), which we still perceive as a major risk for a variety of asset classes.

FINANCIALS

The financial sector has been one of the major casualties during the most recent market selloff earlier this year. Indeed, together with energy and materials, this is the only sector...
in the US which is officially in a bear market (as defined by a 20%+ drop from the most recent highs). In Europe and Japan, the banking sector declined by nearly 50% between April 2015 and 2/11/2016. The unforeseen negative consequences of NIRP (Negative Interest Rate Policy) are mostly to blame for this massive drop. Some major European bank shares recently traded at levels last seen at the depth of the 2008-2009 financial crisis, at a time when the very survival of some of these institutions was in doubt. While several European banks will need to further strengthen their capital ratios, the current environment is obviously very different compared to 2008-2009. For US banks in particular, their balance sheets have been significantly strengthened in recent years and appear very solid. The sector’s exposure to energy loans, while material, should not be overestimated and is highly unlikely to result in major write-downs (with the exception of a few regional banks in states more directly impacted by the oil bear market). The major issue facing the banking sector is one of profitability. This is particularly true in Europe and Japan due to the impact from negative deposit rates charged by the central bank on excess reserves (or a portion of these reserves in the case of Japan), and the significant decline in bond yields seen across the curve. The pressure on banks’ net interest margin has therefore been quite substantial. While not quite as extreme, the situation for US banks is similar, given the significant flattening of the yield curve seen over the last few months. Hopes for a reversal of this trend are primarily hinged on additional Fed rate hikes, but the markets are significantly at odds with what the Fed seems to have in mind. Indeed, on February 11th, fed funds futures contracts were pretty much discounting no additional rate hike this year. Combined with the gravitational pull on US bond yields from negative yields in Japan and Europe, this darkened the outlook for any meaningful improvement in net interest rate margins going forward. A combination of better economic data (particularly on the manufacturing and inflation fronts) and the
rebound in commodity prices (and its likely positive impact on inflation trends in coming months, as well as on banks' balance sheets given the sector's loan exposure to the oil patch) helped financials recover over the past few weeks. Our view is that the current rebound is an opportunity to reduce exposure to the sector given the significant profitability headwinds. In an environment where equity markets will likely continue to struggle and where bond yields are likely to remain depressed for longer than previously anticipated, we believe that a better strategy to maintain exposure to this sector is through preferred stocks, given the attractive coupon and the strong capital position of the industry.

THE JURY IS STILL OUT

All the nominees for our best comeback award share one common theme - seemingly cheap valuations, an attractive feature in an environment where many asset classes trade at premium to historical averages. For long-term investors, valuations matter as asset classes have a natural tendency to trade back towards fair value over time. In the more immediate-term however, valuations are unlikely to act as the main trigger for these beaten down sectors, although they might help provide a more stable floor and limit the downside risks. For the rebound seen in these asset classes to morph into something bigger and better than merely a countertrend rally from oversold conditions, fundamentals and sentiment will need to further improve. Despite some improvement in recent weeks, we are concerned that the current rebound may have gone too far compared to the underlying fundamentals. Our nominees share something else in common as they have all become very sensitive to similar market trends and macro factors. In particular, they would probably all suffer another setback if the economic outlook worsens once again and pressures for the Fed to refrain from any additional tightening resurface in a more meaningful way. Although supply dynamics in the oil industry have been and will continue to be another major factor for the performance of these sectors, it is no coincidence that the rebound occurred against a backdrop of more positive economic news flow, as evidenced by the turnaround in the Citi Economic Surprise index.

More generally, we believe that the nice and refreshing rally we have seen since the 2/11 lows does not fundamentally change the outlook for risk assets in the medium-term, and we still expect a continuation of the current risk-on/risk-off pattern in the coming months. Our recommendation is to keep the asset allocation broadly in line with long-term targets, while focusing on two main strategies in order to (hopefully) add some value in the near-term.

The first strategy is to position portfolios in order to limit and/or benefit from this elevated volatility. As mentioned last month, we believe that minimum volatility ETFs can help in such an environment given their tendency to deliver asymmetric returns (less downside
than upside capture). We also believe that tactical asset allocation has to become a bit more aggressive in such an environment (reducing risk exposure on decent near-term rallies and rebuilding those positions on market weakness).

The second strategy is related to the outlook for global monetary policy, interest rates and bond yields. Our expectation is that bond yields are likely to be capped at extremely low levels for quite some time, as global growth remains weak and disinflationary pressures are still intense on a global basis. In such an environment, we believe investors will be rewarded by maintaining or increasing their exposure to some income-generating assets. We have already stressed that we believe corporate debt (both investment grade and high yield) offer a more attractive risk/reward profile than equities. We have also recently added some exposure to EM debt and switched our exposure to financials from equities into preferred stocks. Additionally, we have also added to our positions in REITs given their attractive dividend yields.

Maybe the best comeback in financial markets and the only true revenant so far this year is gold. The rebound in gold started as early as the very first trading day of 2016. Gold is up 20% so far this year and has been performing well irrespective of the trends seen in equities and other cyclical assets, which is quite impressive. After three consecutive years of decline, gold is emerging from a painful bear market and both momentum and trend are looking up. Fundamentally, this turnaround also makes a great deal of sense since the two major headwinds for gold have become tailwinds – the dollar is weakening and bond yields are moving lower. For many European and Japanese investors, the opportunity cost of owning gold (as opposed to clipping a periodic coupon by investing in bonds) has not only disappeared but has turned into a positive carry as more and more bonds in these markets are offering negative yields. Gold is often perceived as a safe store of value and the growing perception (exacerbated by some presidential hopefuls) that central banks and governments globally are manipulating their currency in a race towards the bottom, reinforces the yellow metal’s appeal.

In financial markets, such as in a presidential campaign, momentum can quickly shift from one candidate to another, but this momentum will rapidly peak if the underlying trend remains unchanged. While more clarity will most likely be achieved by March 15th on the political front, uncertainties will stay with us for a bit longer when it comes to financial markets. Stay tuned.