Economic Updates and Outlook



"Cup of Joe"

The market once again is in correction territory (down 10%), leaving many wondering: when will the market start to recover? Remaining consistent with what has been discussed in past email blasts, we are going to shed some light on what is causing the newest bout of volatility and how we think the rest of the year is going to play out.
Here is what we know for sure -

1. Oil has been sinking like a rock the past month, taking into account new Iranian oil hitting the already oversaturated market.
2. The market has also become highly correlated (proportional) to the decline of oil - when oil drops, so does the stock market.
3. The Yuan, the Chinese currency, was devalued yet again, causing concerns that China is continuing to have growth concerns (this is what supposedly caused the last correction).
4. The High Yield market has been experiencing high volatility due to the fear of many highly-leveraged energy companies defaulting on their loans.
5. The Volatility Index, or the VIX (which measures the market's expectation of the amount of fear and volatility in the market) has not reached anywhere near panic selling.

Looking at these highlights, fundamental analysis would point to the oil price decline as a tailwind for the economy. Cheap gas provides the consumer extra money to spend, which helps the economy. We then would ask, "why is oil so highly correlated with the stock market if a strong consumer is the result?". Many have been emphasizing the negative aspects of low oil, but no one seems to point out the other side of this. That being said, we have a theory…one that involves thinking outside of the box for a second:

Within the past week, Leon Cooperman, a famous and wildly successful investor, came out and said that he felt the market was nearing a bottom and the recent decline was caused by big firms (hedge funds) hedging (protecting) their exposure in the high yield market and energy sector. All that means is that the big boys (the guys managing billions of dollars) are getting massacred because they are highly exposed to oil and high yield debt (loans given to the energy companies that pay high interest). The amount of energy debt these institutions are holding is estimated to be around $500 billion. When you have such a huge position in something and it takes a turn for the worse, an issue known as "liquidity risk" presents itself. What this means is that they are unable to find a buyer for the large sums of debt they are holding. If forced to sell, it would be at a HUGE LOSS, which they are unable to handle. So, if you are losing your shirt in oil and energy debt, a hedge fund does what they know best -- they HEDGE!

Well, the hedge funds figured out that if they drum up enough fear in the market (examples would be China devaluing their currency, 2008, oil, etc.), that all of the little people would freak out and sell. All they had to do was force the market down, flood the market with fear, and their bets that the S&P 500 would fall come true. But before they did all this, they placed their bets that this would happen. This is called “short selling”. Short selling is the practice of selling securities that you don’t own in hopes that they will decline. Once it declines, those hedge funds make the difference between the price they sold those borrowed stocks at a high price and the projected lower price where they are hoping to repurchase the stock (known as the spread). The term for this is “short and distort”. The practice of short and distort is when you make a bet that the market will fall, and then force it to do so by distorting the market and making investors think the world is coming to an end. Once they develop the fear, the rest is history. They keep selling and driving the market down until they make enough to cover their losses in energy and high yield debt sectors.

Now, I admit that is wild theory and not talked about in the media, but here is why I think it may be true. After Leon Cooperman came out and made this revelation, Goldman Sachs predicted the S&P 500 had an upside of 11%. So, how is it that during this major sell-off does a big bank such as Goldman have the gusto to make a call like that? For starters, Leon Cooperman used to work for Goldman. Second, they can look at the amount of short interest on the S&P and realize that someone is forcing the market down ARTIFICIALLY. If they know that the market should not have sold off, this gives them confidence to make this brave call of an 11% upside. Here is the next piece of the puzzle. Remember when I talked about the strange phenomenon of the oil market being highly correlated with the stock market and how this didn’t make much sense? Well, it makes sense when you have guys forcing the market down by shorting. The further oil declines, the more the short sellers force the market down. The last bit of evidence would be the VIX, or the volatility index, that I discussed briefly. Why, after such a big sell-off is the volatility gauge nowhere near what it was during the correction in August? Well because it’s an artificial decline!!! Fundamentals were not in play, the market wasn’t overly expensive, nothing of substance was happening, yet the market falls 10% in a week or so. **THAT DOES NOT MAKE SENSE**. And the historic nature of how much the market sold off (the most to start a year in history) just highlights the fact that this may be an outlier caused by the big money on Wall Street. As Morgan Stanley’s James Gorman pointed out recently, “how is it that every sector in the market was down 10% since the beginning of the year yet nothing fundamentally changed?” This is a market based issue, not a fundamental one.

Having said all of that, I do believe certain bits of data are true. I believe that the world does have growth concerns. I believe that we are experiencing a massive oil shock. The FED just began its process of raising rates, which history says the markets do not like. China did devalue the Yuan. And the high yield market is pricing in the chance of some energy companies defaulting. But do I think we are on the verge of a recession? No. The consumer in the U.S. is strong. Unemployment is at or below 5%. Gas prices are very low. And the rest of the world is undergoing highly accommodative monetary policy. In terms of the stock market, I want everyone to answer this question. If CD’s are paying nothing, and 10-year treasuries are only paying 2%, where else are people going to invest their money they need to retire? Unfortunately, there is no other game in town which is good news for markets in the future. With a 50% chance of a recession in the market already priced in with this last downturn, if the recession doesn’t play out like many think, then the market has room to run.

To our clients, hang tight. The market always moves in cycles. It goes up and it goes down. And remember, too, that no one (and this is backed up by statistics) can time the market. As long term investors, we must understand that throughout history, this is how healthy markets work. The worst thing to do in times of volatility is panic. When people panic, they sell at a loss and generally never have the courage or the proper timing to get back in, compounding their losses. A “lose-lose” scenario. This is when the smart money wins and the dumb money loses. This is why you have advisers.

We hope that you all had a great holiday season. And thanks to everyone for their referrals. Please remember to keep funding those IRA’s and pension plans. Have a great and prosperous 2016.

Joe, Ryan, and the Chapel Hill Investment Team

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