MV CAPITAL MANAGEMENT

Weekly Market Flash

One of Those Weeks

December 4, 2015

The headline macro calendar does not dispense its favors evenly throughout the year. Some weeks are notable more for the sound of crickets chirping than anything else, while others are a cacophony of urgent headlines sending market indexes hither and yon. This past week falls resoundingly into the latter category. As we look ahead to 2016 we are focused on the possible direction of three key current trends: interest rate divergence, commodity price weakness and below-target inflation. Thanks in part to the Fed, ECB, OPEC and the Bureau of Labor Statistics, we have plenty of new inputs to our scenario models.

The Divergence Insurgency

Within the space of 24 hours yesterday and today we learned that interest rate divergence is basically a done deal, put a fork in it. The immediate reaction to ECB Chairman Mario Draghi's announcement of a 0.10 percent reduction in the deposit rate was negative; while that action was exactly in line with consensus expectations, markets were hoping for a more aggressive 0.20 percent cut and threw a tantrum when it didn't materialize. Nonetheless, 10 basis points still qualifies as "easing". So, when the Fed meets two weeks from now and in almost every likelihood raises the target Fed funds rate by at least 25 basis points, we will officially have divergence. Today's jobs report, with a slight November beat and healthy upward revisions to October and September, effectively removes whatever outside chance there was of staying put for one more FOMC session.

The economics textbooks would tell us that markets will at some point adjust to the effects of policy divergence; namely that European exports will become more competitive and eventually lead to an appreciation in the Euro. For the more immediate future, though, we see the most likely reality as more of the same in terms of US dollar strength, with all the attendant implications for US companies' stagnant top-line growth. That, in turn, plays into our general thesis that equity markets in 2016 will be far more selective in according preference to those companies which can still turn double-digit revenue and EPS numbers against the currency headwinds.

Commodities: Waiting for Demand

A strong dollar won't help the price of crude oil and neither, for the time being, will OPEC. Today's meeting reaffirmed that the Saudi-led hands-off bloc continues to carry the day. WTI crude is just barely defending a $40/bbl support level as we write this, and further weakness could be in store in the days and weeks ahead. There was a high volume of chatter leading into today's meeting in Vienna, with intermittent tales of a Saudi-led production cut bubbling up out of the rumorsphere, but in the end the consensus outlook was right.

Logically, it would have made little sense for the Saudis to change their position now, just as the impact of US production cuts in nonconventional drilling is likely to be felt. They stake their case on preserving/gaining market share and reaping the benefits as demand rises in response to lower prices. That being said, demand for any commodity is a function of global growth. China is expected to substantially increase its crude purchases next year, perhaps even doubling them, in no small part to bulk up its strategic petroleum reserves. But China's overall economic slowdown, and rebalancing away from raw material-intensive sectors towards domestic consumption, is likely to continue as a restraint on how robustly energy and industrial commodities generally can recover.

Inflation: The Joker in the Deck

Once the Fed raises rates later this month and markets collectively exhale, chant *om* and bid each other *namaste*, attention will shift to the cadence of future policy actions. Those, in turn, will be largely influenced by general price trends. There is little today in the way of conclusive evidence for a widespread inflationary breakout, and the wage numbers in today's BLS jobs release remained well within the modest tenor of recent months (in the neighborhood of 2 percent on an annual basis). But anecdotal evidence of upward wage pressures continue to percolate into the discussion threads of the quarterly analyst calls for retailers and other labor-intensive sectors. Portfolio allocations to TIPS and other inflation-protection assets appear to be gaining currency as a key variable for 2016 strategic allocation models. There are many factors at play, but we see a net bias towards higher than expected inflation as a potential near-term development. That in turn would imply a brisker rate hike cadence than we see being factored into current expectations. Which, to close the circle of this commentary's thought process, could widen further still that EU-US monetary policy divergence. We may indeed be heading into a year of "interesting times" in the ancient Chinese sense of the phrase.

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