15 Jan 2016 | Abhimanyu Yadav, PRM, CFA

BITTER PILL

If fireworks are any measure of a great New Year party, 2016 has had the best ones so far. At least in the financial markets, but unfortunately not the kind we wanted

Market	Year to Date Change
US Stocks	-5.97%
German Stocks	-8.83%
Japanese Stocks	-10.10%
Indian Stocks	-5.46%
Hong Kong Stocks	-10.60%
Mauritian Stocks	-0.18%
Oil	-17.44%
US Dollar	0.32%
10 year treasury	1.6%
US High Yield	-2.02%
US Investment Grade	0.26%
Africa Local Currency Bonds	-2.78%

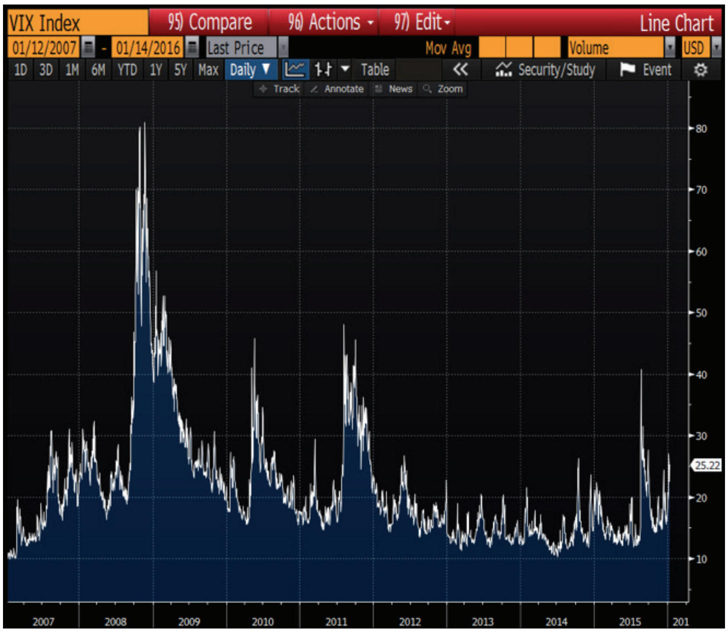
* As of 15/1/2016. Please reach out to us if you have any questions on the indices used

By most measures, this has been an abysmal start to the year in almost every risk asset class, as the table on the left shows. The selloff has at times been a lot more in developed markets than emerging markets - perhaps because EM already corrected a lot in 2015.

All this in the span of a short two weeks. And this on the back of year that was not overly exciting for financial markets, with returns in stocks and bonds only marginally positive in 2015 (but with lots of ups and downs in between).

So where does this leave us?

Somewhat disconcertingly, there still appears to be an apparent lack of panic. While the VIX, aka the "fear gauge", has jumped up, it's nowhere near the panic highs of August 2015, or the 2008 GFC.



Source: Bloomberg

But then again, you only have to look at USD/ZAR to get a sense of what panic could look like. This pair has been an excellent bellwether for just how much market liquidity is deviating from fundamentals, and it certainly implies that in some parts of the market we remain in a heightened sense of fear.

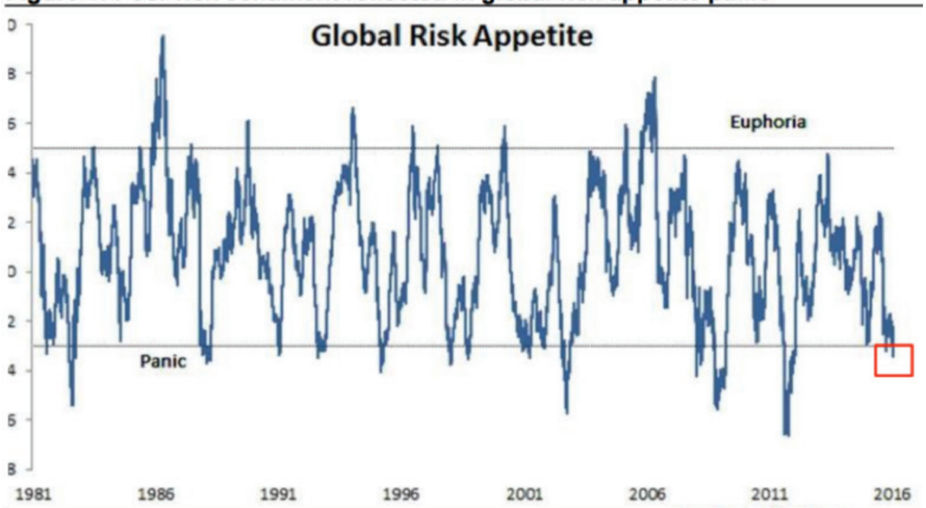
Source: Bloomberg

When you have moves like these, unfortunately everyone starts watching their portfolios - every day, every minute, at the moment - and risks being the class example of "buy high, sell low". Correlations become high and people panic.

For while there's been enough technical damage done of late, it's worth looking through a somewhat longer-term lens. Some risk asset classes were overdue for a correction and still have a ways to go (stocks, high yield, EM), but there are more than a few that have already had the pain and taken their bitter pill as well (risks for oil price moves to the upside are becoming more asymmetric, Financials - which are almost utility like now post regulations, non USD FX, non-energy high yield credit, even non-commodity sensitive African bonds). These markets actually benefit with lower oil prices! And while they might get cheaper of course, everything might, but adding selectively now, when you can, should pay. In quite a few places existing deterioration in fundamentals is largely priced in and that's about as optimistic as one can be at the moment.

Credit Suisse creates a Risk index, which has had a strong correlation with increased performance in risk assets whenever it moves into Panic territory and vice versa when it's in euphoria territory. The Index recently made a move into Panic territory - suggesting that the market has overcorrected in its zealousness to put a lot of weight in what wasn't really new news.

Figure 1: Poor risk sentiment reflected in global risk appetite panic



Source: Credit Suisse Economics

It's like that old Warren Buffett line: "Be fearful when others are greedy and be greedy when others are fearful". Admittedly you need a healthy appetite for risk to take advantage of that, while being mindful that "the market can remain irrational longer than you remain solvent"

Disclaimer

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