



2016 Outlook: Stop Waiting for Godot!

January 7, 2016

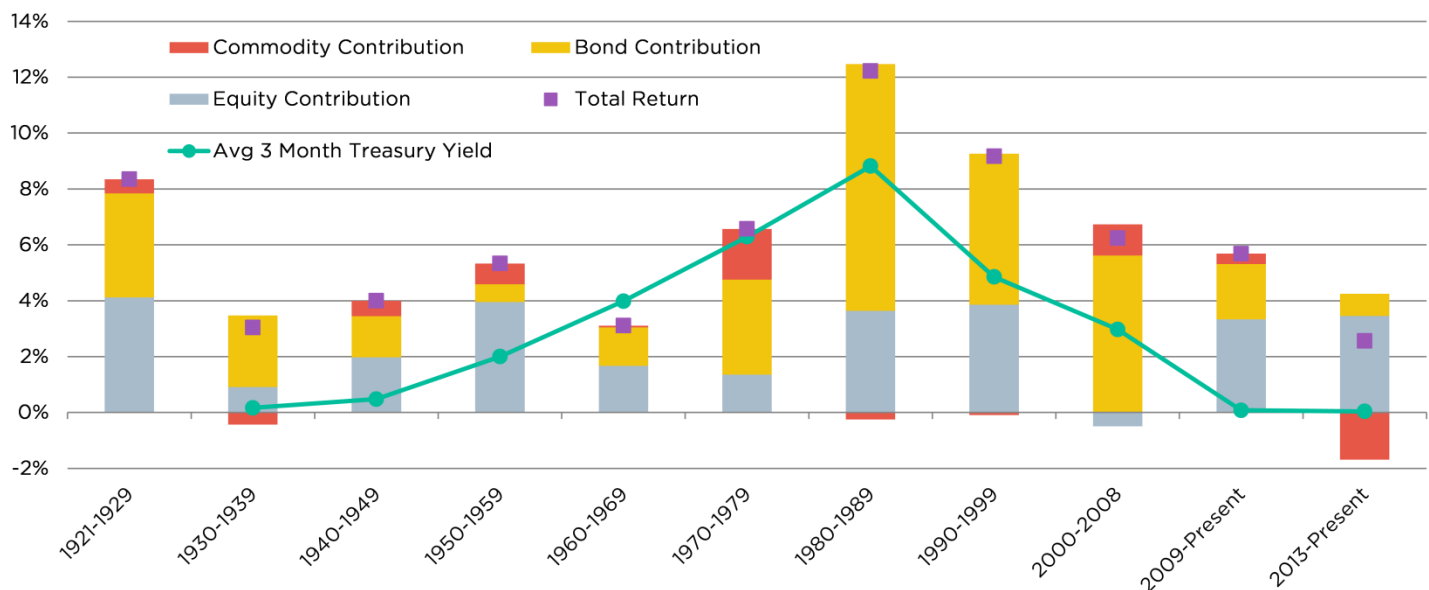
It's the time of the year again when investors and the media publish their market outlook for the coming year. Historically, such outlooks would focus on whether growth and inflation will increase or decrease and what that might mean for monetary policy. From there, authors decide on which sectors will be strong or weak within that macro environment and then extrapolate which individual companies will thrive or suffer. But this year something feels different to me. This year, it feels like the global economy, assets and industry are all stuck.

The feeling reminds me of my son's pet hamster. Whenever it's quiet in my house, I can hear the buzzing of the hamster in his wheel. I have no choice but to think of the hamster spending a lot of time and energy going nowhere. Often over the course of 2015 that buzzing sound reminded me of the markets and the persistent sentiment I heard from people in the industry; the mood in recent years has shifted. I wouldn't go so far as to say the mood is either pessimistic or optimistic. Rather the mood is one of waiting for change.

This year, in particular, seemed to frustrate people more than most. The total return for the SPX finished 2015 up a little over 1%. This was the 7th consecutive positive total return year and left the index just 3%, roughly, off the all-time highs. The mood does not reflect those statistics but neither is it negative. I think the malaise can best be explained in the visual below. [Exhibit 1](#) shows the historical performance of a balanced investing approach across equities, commodities and bonds decade by decade over time going back to the 1920s. The last three years have been historically bad. Today, with volatility and anxiety rising and asset returns struggling, I hear the sound of that hamster wheel. People keep waiting for a catalyst to get off the wheel.

Exhibit 1: Beta's Recent Struggles

Average Annual Returns of a Typical Balanced Risk Portfolio¹



Source: Robert Schiller, Bureau of Labor Statistics, Bloomberg

All of this waiting around for change reminds me of the play by Samuel Beckett, *Waiting for Godot*. For those who have not read it, the play is about two characters and their interminable wait for the arrival of Godot and the “important” information he has for them. There have been many interpretations over the years as to the deeper meaning behind *Waiting for Godot* and who Godot is or is meant to be. The unknown aspect of what, or who, these two characters are waiting for seems apropos as we exit 2015. As 2015 progressed, many hoped, the bottom was in for commodities and emerging markets after an early fall. Following that, there was hope that the Fed raising rates would be the catalyst in September only to be followed by the belief that the delay in Fed action in September was a positive. More recently, December brought hope that OPEC would cut production, the ECB and BOJ would do more than expected, and the Fed would finally raise rates. As of yet, none of these have been the Godot information the market was looking for in order to bring the market back to a state of “normalcy.”

One of the lines in *Waiting for Godot* that comes to mind when I hear the buzzing of the hamster wheel and reflect on the market in 2015 is, “Nothing happens, nobody comes, nobody goes, it’s awful!” Frustration has been mounting for several years now. Back in 2013, I wrote two papers entitled “Adapt or Die; An Investment World Driven by QE, Tweets, Clouds, Robots, Singularity and Luddites” and “Adapt or Die Part 2: The Signal or the Noise”, both addressing the beneficial impact that exponential innovation was going to have on our thinking. Last year, in my paper *Being Mindful in 2015: An Investor’s Dilemma*, the focus shifted from the benefits of rapid innovation to the disruption that comes with it. For 2016, I believe this will be the year market

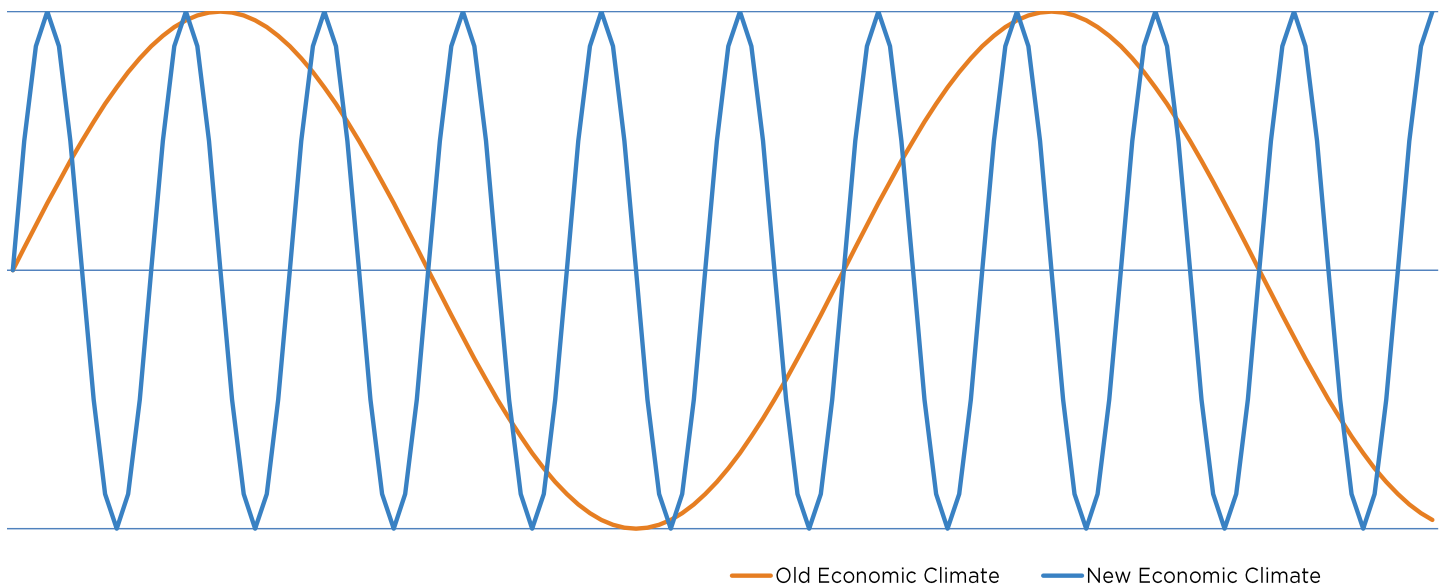
¹ Average 3 month Treasury yields for 1930-1939 are approximated using data from 1934-1939, due to lack of available data.

participants stop waiting for a return to the world of 1920-2008 and accept the reality of a low growth, low inflation digitized world and what that means for investing going forward because Godot is unlikely to show up.

But enough with the metaphors. The schematic below in [Exhibit 2](#) is something we worked on last year to highlight the type of environment we see today compared to that of the past. The orange line is meant to represent a business cycle in the past. The blue line is our view of the current economic/investment cycle. In a low growth, low inflation, low market liquidity, digitized world, investment cycles are shorter and sharper. In that world, positioning becomes crowded quickly as there are fewer and fewer ideas supported by growth. For me, Godot is everyone hoping the orange line still exists. But the orange line represents the business cycles of the industrial revolution. The Fed was created in 1913 and is integral in helping to manage business cycle through its turns. Historical business cycles, the relationship between growth and inflation and the Fed's response to them are all part of our experiences in market cycles. It is also the premise behind risk parity, which has received a good deal more attention in recent years. When risk weighted investments across bonds and equities do poorly, as [Exhibit 1](#) suggests, investors will have trouble generating returns. [Exhibit 3](#), below, shows this difficulty by way of risk parity proxy. At this point, I don't think it should come as a surprise that even Tony Robbins put out a book on risk parity last year titled *Money: Master the Game*.

Exhibit 2: Economic Climate Change

New vs Old Investment Climates over Time



Source: Weiss²

² This schematic is for illustrative purposes only in order to show what shorter cycles could look like, and is not based on proprietary Weiss models or other such data

Exhibit 3: Risk Parity's Recent Struggles*Salient Risk Parity Index**Source: Bloomberg*

As I wrote in my last paper in October 2015, "[Market Anxiety: The Spirit of Elly Kedward](#)", I believe now that China has moved from their industrial revolution age to the digital revolution, the majority of global growth, as represented by the U.S., Europe, Japan and China, has joined the digital revolution. At the same time, exponential innovation due to cloud computing and big data continues to increase efficiency on the demand and supply side of the economy, shifting us from overconsumption towards sharing. Add to the mix a demographic shift with a growing asset liability mismatch and you have structural forces which do not appear to be reversible. Because we have 100 years of asset data supporting the concept of the business cycle, we generally believe that, eventually, we will see growth and inflation. We are taught to laugh at the phrase, it's different this time. If you read the writings of Thomas Edison, John Maynard Keynes and John Von Neumann (the Godfather of the computer and lead scientist on the Manhattan Project), they all talk, in some way or another, about a world in which we will eventually live known as the post-scarcity world, or a world of abundance. All this leads us back to the fact that the Fed, and even the actual calculation of GDP, were created during the most volatile periods of the industrial revolution in the first half of the century. Over the coming years, I expect more and more people to question the validity and usefulness of GDP as we move from hardware to software and brick and mortar to virtual. It is difficult to make the argument that the laws of supply and demand are not being rewritten given the exponential move in technology. With that, I believe, comes a new economic environment and I think now is the time to acknowledge it.

The question then becomes, "What does all that mean for 2016?" With that in mind, let's start with another update of my recession model. I have finally reached 100% chance of recession on my model ([Exhibit 4](#), below). The driving factor which threw the model over the top was the

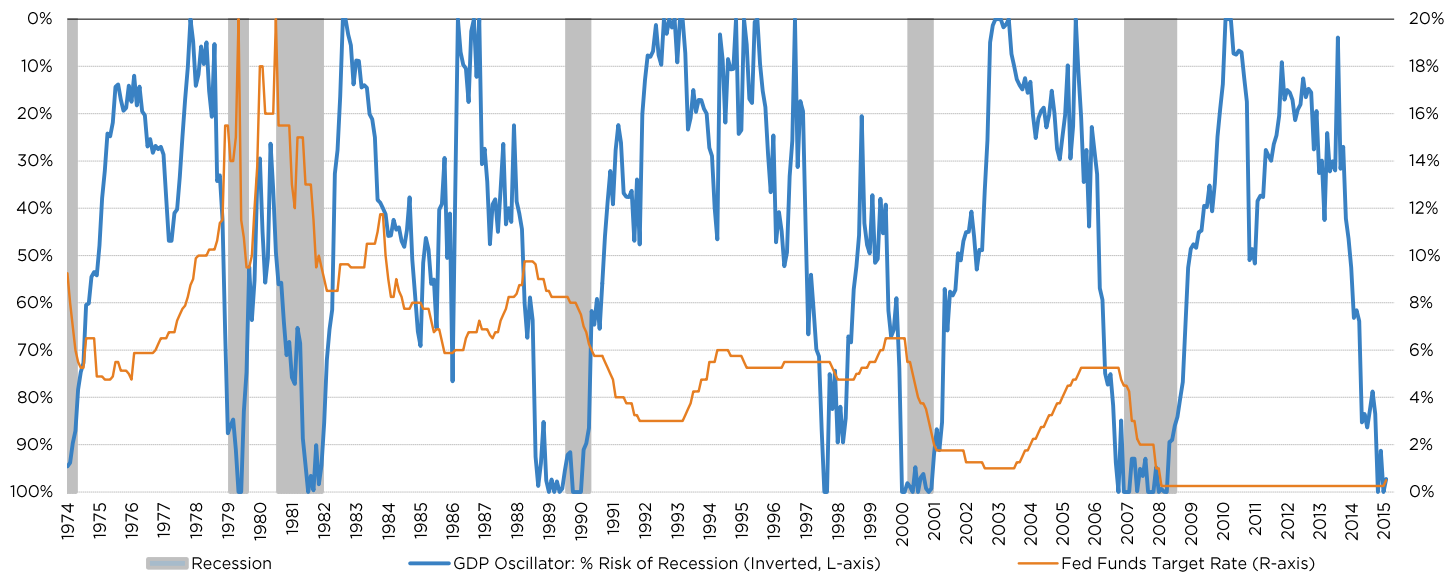
household net worth component. Household net worth in Q3 of 2015 had its first negative quarter since Q3 of 2011. More importantly, historically a negative quarter of this magnitude would suggest we are in a recession already. Looking for asset confirmation, the equal weight SPX finished 2015 down 4%. Aside from the recession related years of 2008, 2002 and 1990, it was the worst year dating back to 1989. Here is a line from the most recent Factset Earnings Insight regarding sales growth for the SPX:

The estimated revenue decline for Q4 2015 is -3.2%. If this is the final revenue decline for the quarter, it will mark the first time the index has seen four consecutive quarters of year-over-year revenue declines since Q4 2008 through Q3 2009.

In addition, we obviously have a high yield market that remains illiquid and representative of problems in the economy. And finally, the Institute for Supply Management Manufacturing's PMI number for November was at the lowest level since 2009 and the annual decline was the highest in the last 15 years except for 2008 and 2000. In my mind, there is no question we are already in a recession.

Exhibit 4: Recession Risk Remains High

GDP Oscillator: Risk of Recession (Proprietary)



Source: Bloomberg, Weiss Calculations

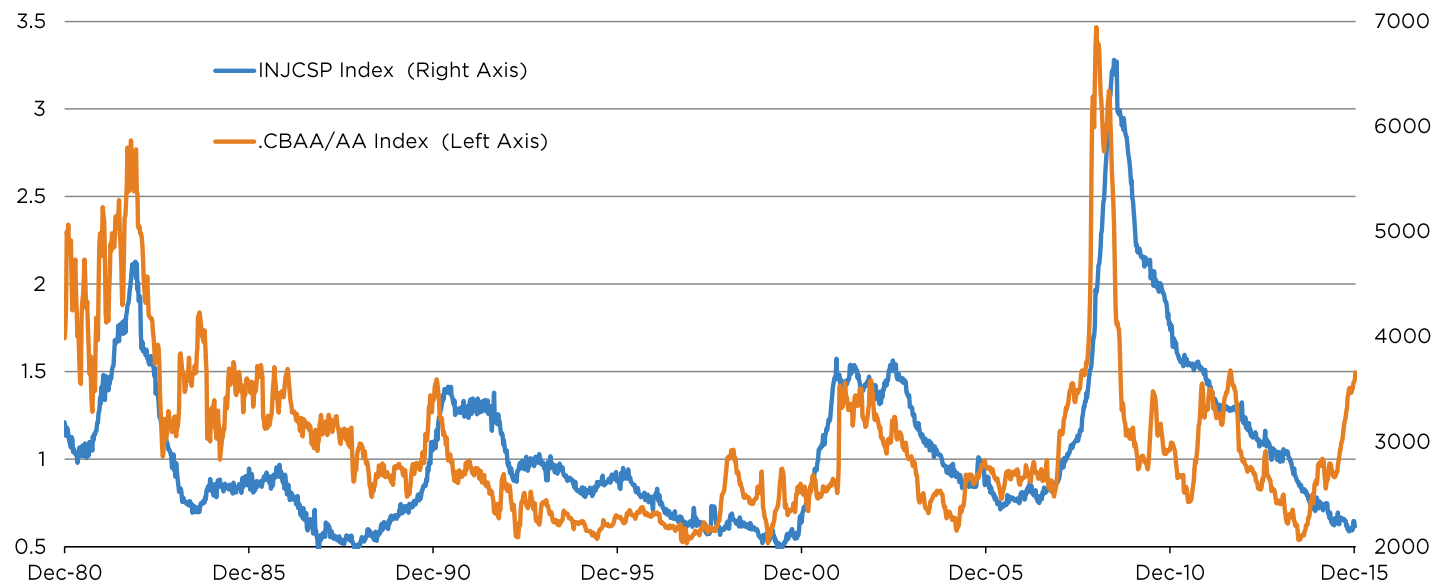
However, before there is officially a recession, we need to start seeing job losses. In addition, despite weakness in various parts of the economy and data, we are not seeing the broad based weakness we would normally see at this level in the model. [Exhibit 5](#), below, highlights how strange this cycle has been so far for jobs. This is an overlay of continuing jobless claims and the spread of the Moody's Baa yields to AAA yields. Historically, claims would have already been moving higher. [Exhibit 6](#), below, also shows that as ISM falls, typically YoY nonfarm payroll

growth follows shortly after. In this chart, ISM is lagged six months because of its historical lead time. I believe this delay in the job market's response is due in part to the low growth, low inflation world where there are few places for yield to allow troubled companies to borrow longer than normal and part to this *Waiting for Godot* scenario of commodities eventually bouncing. December seems to have changed things though with OPEC deciding to continue to produce, companies finally announcing large layoffs and dividends being cut. In addition, December brought to light the reality of the liquidity crisis in the high yield market as a respected value investing firm shuttered its mutual fund and was forced to put up gates on outflows. Once that announcement came out, we saw an increase in outflows from mutual funds across assets. This liquidity risk has been discussed for some time and needs to be watched closely. The following is from the April 15th 2015 IMF Global Financial Stability Report:

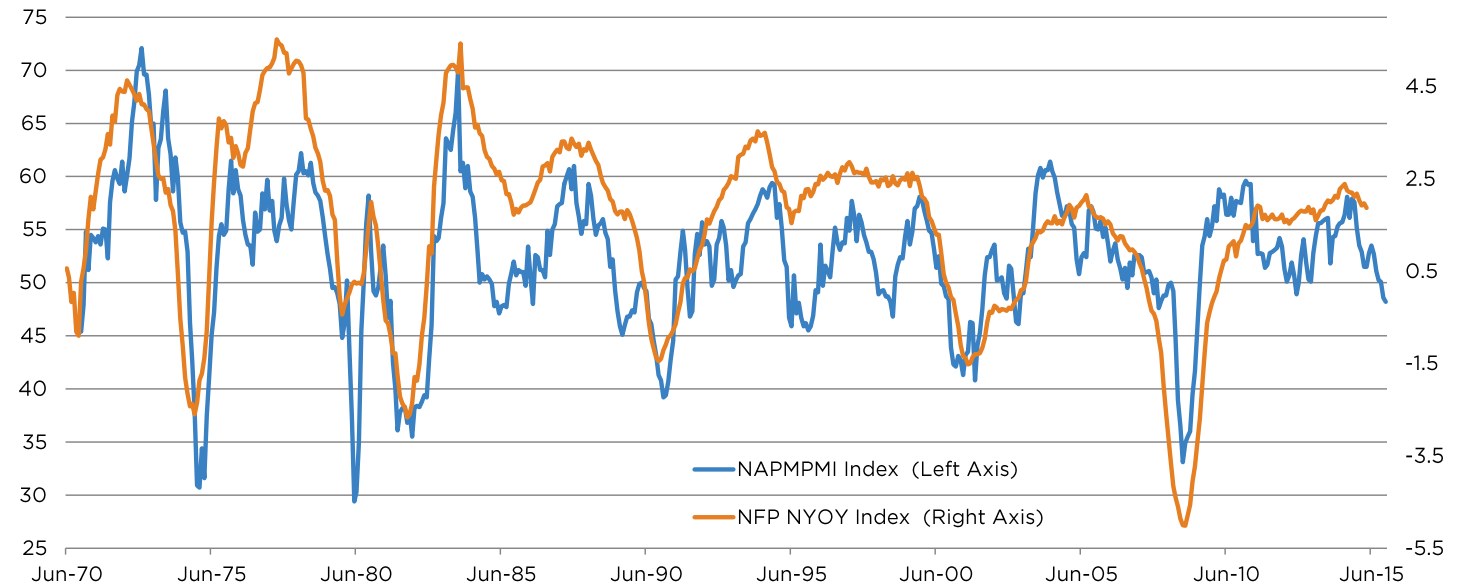
"Policymakers should seek to address the liquidity mismatch in the asset management sector. As discussed in the October 2014 Global Financial Stability Report, a major concern is the market liquidity risk arising from the mismatch between the liquidity promised to mutual fund owners in good times and the cost of illiquidity when meeting redemptions in times of stress, particularly in the less liquid corporate and emerging market bond markets."

Exhibit 5: Divergence Between Credit and Jobs

Jobless Claims vs. Yield Spreads



Source: Bloomberg

Exhibit 6: ISM Leads Nonfarm Payrolls*YOY Nonfarm Payrolls vs. ISM (lagged 6 months)**Source: Bloomberg*

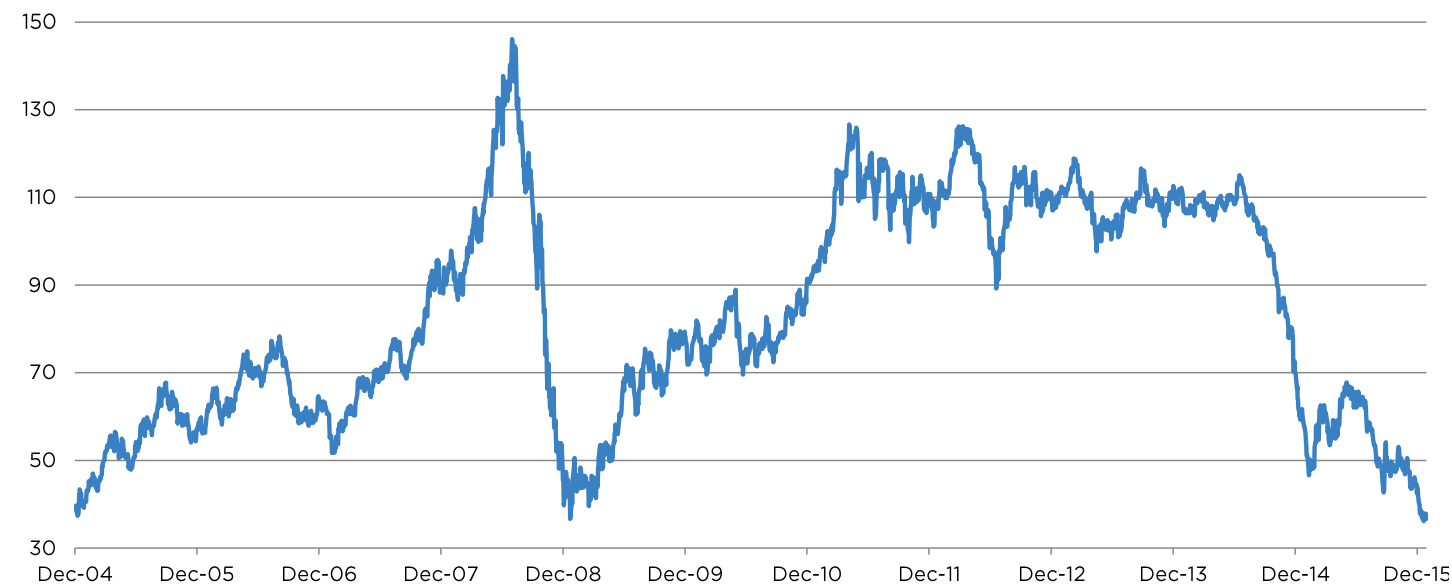
Behind all of these December issues is the move in oil. With that in mind, the most important event over the past several weeks for me was the realization seen in the Brent crude chart in [Exhibit 7](#). Last month it made 11 year lows. The second chart, [Exhibit 8](#), is a reminder of how important this fact is and why the events in December as a whole should not be ignored. The chart shows the history of the outstanding debt of Petrobras with a vertical line at that 11 year mark. I did not select this chart to single out Petrobras but rather to help highlight the bigger picture which can be summed up best by this line from a Bank For International Settlements report from March 2015 (http://www.bis.org/publ/qtrpdf/r_qt1503f.pdf).

The total debt of the oil and gas sector globally stands at roughly \$2.5 trillion, two and a half times what it was at the end of 2006. The recent fall in the oil price represents a significant decline in the value of assets backing this debt, introducing a new element to price developments. In common with other episodes of retrenchment induced by rapid declines in asset values, greater leverage may have amplified the dynamics of the oil price decline. The high debt burden of the oil sector also complicates the assessment of the macroeconomic effects of the oil price decline because of its impact on capital expenditure and government budgets, and due to the interaction with a stronger dollar.

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Exhibit 7: New 11 Year Low in Oil

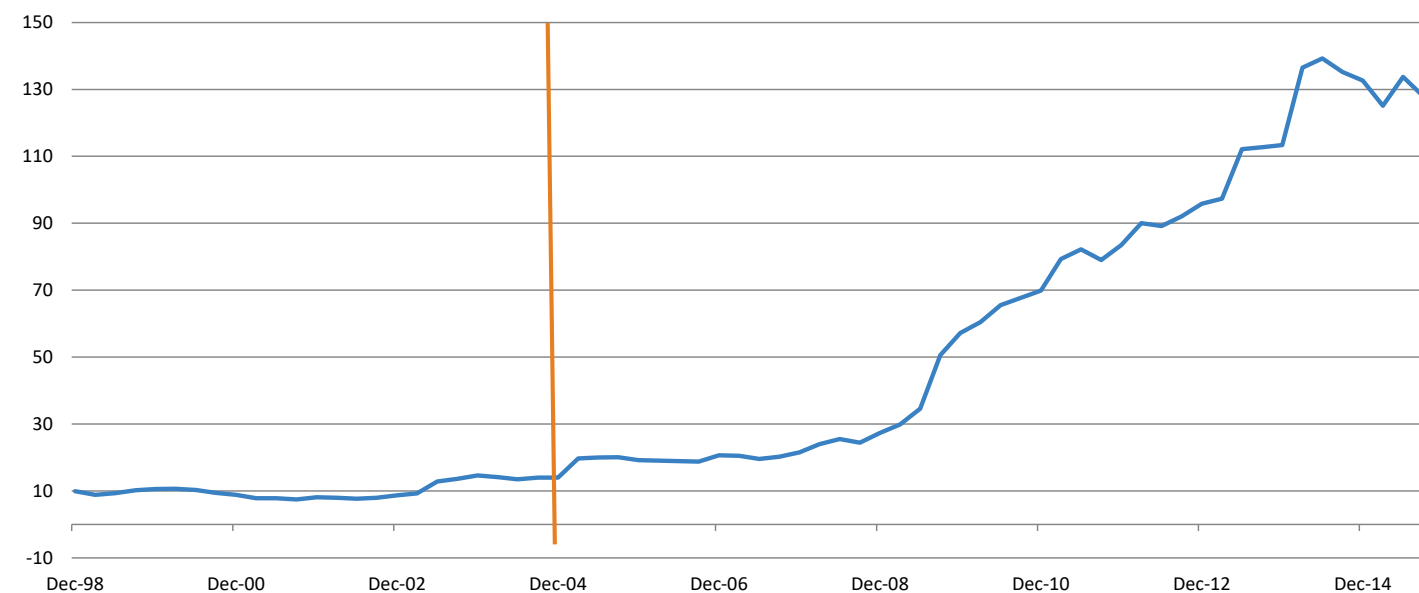
Brent Crude



Source: Bloomberg

Exhibit 8: Why Oil Matters

Petrobras Total Outstanding Debt



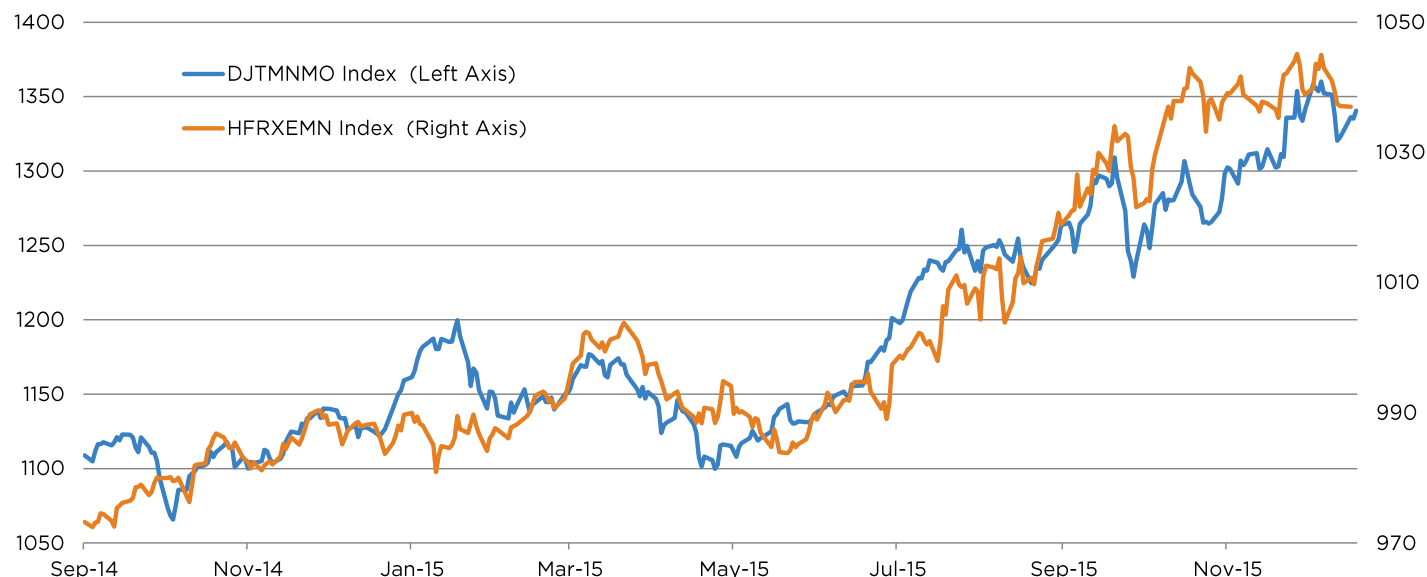
Source: Bloomberg

As with other debt scenarios that have led recessions in prior years, it seems unlikely that the fallout from this will go away without causing more problems in 2016. These numbers and analysis can be extended outside of energy to almost all commodities and the periphery industrial

industries built for higher prices and volumes. As I wrote in my last paper, the world is built for a China that no longer exists. Because of these recent developments in December, I think the contagion of the commodity sector to the broader economy will intensify in the beginning of 2016. As I write this outlook though, I am thinking about how outlook for 2015 the focus was also on oil surprising lower than people anticipated and causing an unexpected accelerant to a recession. Now a year later, my position in this paper with respect to oil is the same, however, unlike last year, few people expect a significant bounce in oil. At this point, I direct you back to [Exhibit 2](#).

If you subscribe to the shorter and sharper business cycle argument, you should believe there will be similar turns in investment cycles. Since my emerging market days, I have always looked at these as market regime shifts. Emerging market cycles shift in violent fashion like trying to make a turn while driving at 90 miles an hour. I believe the reason for this is the lack of diversity to their GDP or investments which leads to asset correlations moving to one very quickly. Effectively positioning gets very crowded and the liquidity door shuts very quickly. This makes me think about how after 18 months of weaker commodities, weaker EM and a stronger dollar, investors appear vulnerable to a sudden market regime shift in 2016. These dominant macro trends have clearly had a large impact on positioning. With little to no top line growth, value not working as a factor, the statistically outside moves in commodities and the need for investors to chase performance, in some way returns appear to be driven more by momentum than usual. To illustrate this, [Exhibit 9](#), below, shows the Hedge Fund Research Index for Equity Market Neutral overlaid with the Dow Jones Momentum factor index. My biggest concern with regard to this chart is what an abrupt market regime shift would mean for quantitative driven strategies. There can be little dispute that quantitative strategies may be better than humans at identifying existing alphas at a given time, but I still believe the lessons of LTCM during the 1998 crisis and the quant unwind in 2007 still hold. When diversified quantitative approaches get too crowded into alphas that become correlated, you are at risk to market regime shifts.

Exhibit 9: Momentum Dominates Hedge Fund Returns

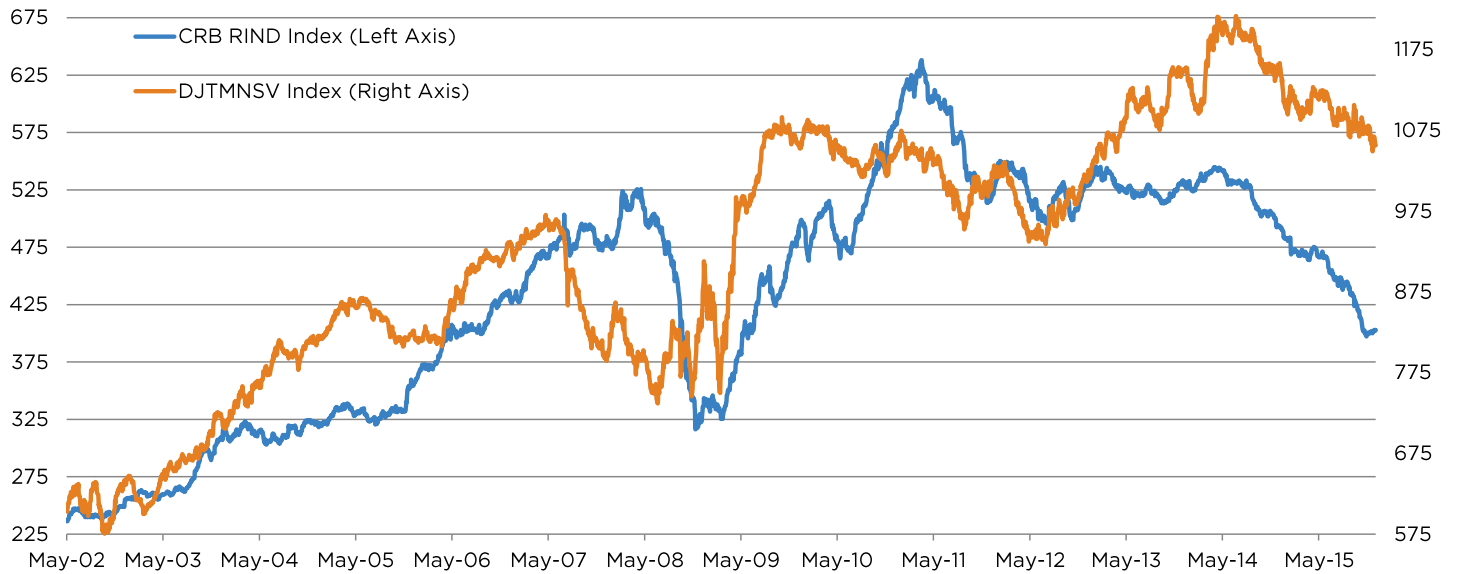
HFR Equity Market Neutral vs. Dow Jones Momentum Index

Source: Bloomberg

Assuming there is a market regime shift coming, I do not think the most likely trigger would be due to a commodity/EM rally where global growth picks up. In the first half of next year I expect, 1) China to continue to focus on helping its own GDP at the expense of others around the world by weakening their currency and exporting their overcapacity, 2) defaults in the commodity industry to pick up and, 3) the liquidity situation in the debt markets to worsen until regulators are forced to intervene. All of these would initially contribute to commodities weakening but the key point for me this year is the notion of being forced to intervene. Intervention by regulators and/or central banks is what normally causes regime shifts and I think we will reach that point in 2016 for all the reasons mentioned in this paper. [Exhibit 10](#) shows the sensitivity of value (Dow Jones Value Factor index) over the last 14 years to commodities. The two best periods were after the Fed intervened in March 2009 to stop the financial sector collapse and after August 2012 when the ECB said it would do whatever was necessary to save the periphery. Right now, everyone knows commodity companies and countries are in trouble but the Fed is raising rates and China is letting its currency weaken. If and when it worsens to the point where everyone worries it may become systemic, I would expect the Fed to come to the rescue in some way to help value and force a market regime shift when liquidity is non-existent. One thing about a lack of liquidity; it hurts not only on the way down but sometimes even worse on the way back up.

Exhibit 10: Factors Correlated to Energy

Dow Jones Value Index vs. CRB Raw Industrials



Source: Bloomberg

For the record, when I say the central banks come to the rescue, I want to make clear that part of my prediction is based on my opinion that central banking has reached the point where there is not much left for them to do when it comes to creating growth and inflation. This brings us back to the question of whether the end of the industrial revolution has made expansive monetary policy useless in this digital world in which we live today. [Exhibit 11](#), below, shows the velocity of M2 which clearly illustrates that when it comes to an increase in money supply's ability to create nominal GDP, there has been little proof of it recently. However, increasing money supply remains effective at keeping assets higher. It continues to serve the function of being the psychological net under the trapeze of asset prices. This is why I think it is important to continue to separate economic growth from assets moving higher. This is particularly true when it comes to stocks and profit margins. We have already had the benefits of lower rates and software for profit margins but in the years to come we also expect lower commodity costs and further enhancements to technology.

Exhibit 11: Increased Money Supply Can't Spur Growth

M2 Velocity*Source: Bloomberg*

Up until now this paper has focused on continued contagion risks to the commodity fall in the first half of 2016. In addition, I believe there are some surprises I think worth mentioning from a risk to reward perspective, many of which are dependent on the regime shift I mentioned earlier. And for those looking to step in and call the bottom of commodities, I think the chart of commodities over the next five years will be similar to the chart of natural gas over the last five years; range trading at lower levels but still headed lower long term. Despite this view, I do think that, first, by the end of the year emerging markets will outperform global developed markets driven by value in their currencies and sovereign bonds. Second, on the same note, an acknowledgement by the Fed that commodity debt is a problem will lead to something which causes the dollar to weaken next year. Third, despite continued weakness in the Chinese economy with more defaults, the Shenzhen Composite continues to be the best investment story few talk about and the one we cannot invest in as of yet. It was up +63% in 2015 after +33% in 2014 as China continues to focus on the entrepreneurial digital side of their economy.

And finally, I think it is time to move away from the commodity story being impacted by innovation and transition to another idea that could be affected in a similar way. Energy prices have been driven lower by advancements in technology in the industry affecting both demand and production when few predicted it and when it was identified as a crisis. I view healthcare as being in a similar place today to that of energy five years ago: a crowded sector with the future based on an inevitable linear forecast. In 2009, that linear story was China's growth. For healthcare, that linear story is demographics. Last year the government and media began the attack on pricing which is always something to watch particularly as voters get older and more worried about the cost of healthcare. However, like with energy, the major force for this sector

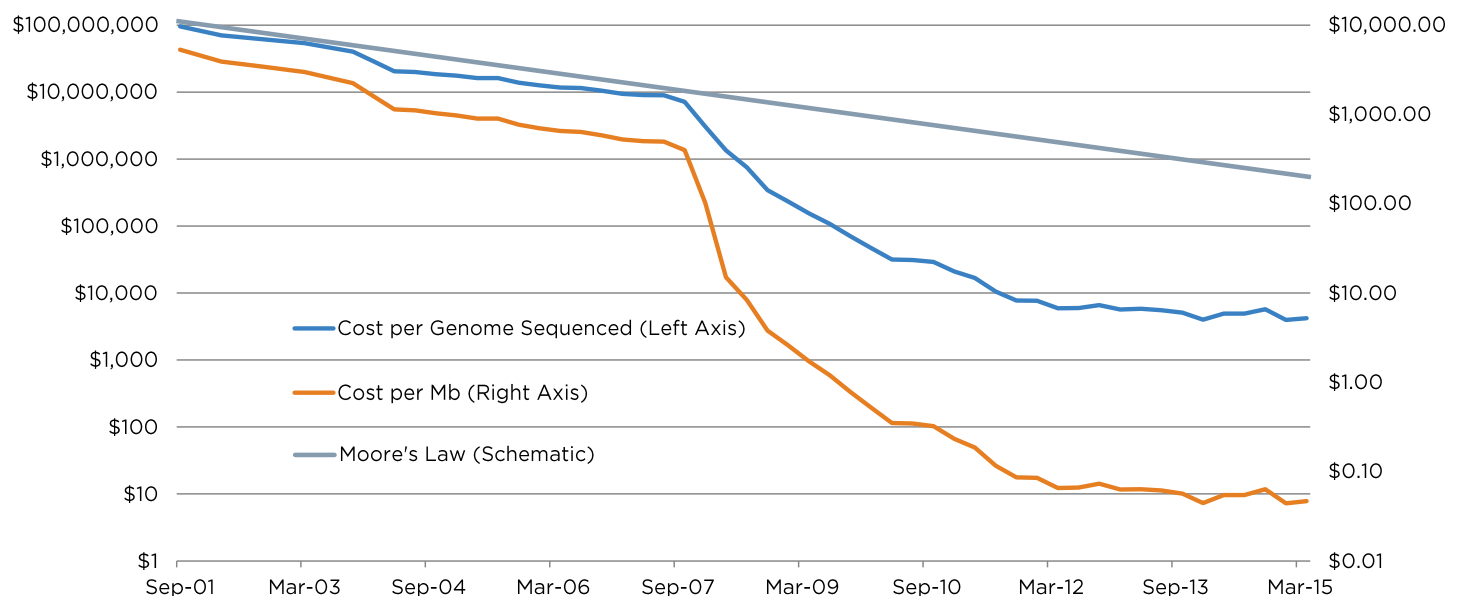
over the next five years will be technology. Technology is allowing healthcare to move from being reactive to, as Stanford Medicine calls it on their website, “proactive, predictive and precise.” There are many factors behind this move relating to big data and sensors but for me **Exhibit 12** below suggests genome pricing relative to Moore’s law will cause disruption throughout the healthcare industry in the coming years. I will always remember this excerpt from the great Steve Jobs book by Walter Isaacson.

According to Mr. Isaacson, Mr. Jobs was one of 20 people in the world to have all the genes of his cancer tumor and his normal DNA sequenced..... A doctor told Mr. Jobs that the pioneering treatments of the kind he was undergoing would soon make most types of cancer a manageable chronic disease. Later, Mr. Jobs told Mr. Isaacson that he was either going to be one of the first “to outrun a cancer like this” or be among the last “to die from it.”

Every Sunday as I watch football, it seems like every other commercial is an ad for some medical procedure or pharmaceutical product. It reminds me of the gold ads five years ago....

Exhibit 12: Faster than Moore’s Law?

Advances in Genome Sequencing vs Moore’s Law



Source: National Human Genome Research Institute

Disruption is defined as a disturbance or problem that interrupts an event, activity, or process. It’s a word I used in many of my speaking engagements and thought pieces in 2015. As time goes on, and the disruption doesn’t stop but rather continues and accelerates, eventually it starts to feel like the new normal. It starts to sound like a hamster wheel and reminds me of those two men waiting for Godot. The following is from a report of the 2014 Aspen Institute Roundtable of Institutional Innovation titled Navigating Continual Disruption:

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The list of potentially disruptive technologies keeps getting longer. Each one, by itself, is likely to have a substantial impact on many different aspects of society. Taken together, they are creating an environment that is dramatically different and far more volatile than the world that came before—an environment filled with novel challenges and opportunities.

When I read excerpts like this and think about how difficult it has become to forecast the future, utilizing a calendar year as the basis for writing a market outlook begins to feel arbitrary. It's a reminder to remain flexible and agile and to be prepared for more surprises in 2016. But most importantly, stop waiting for Godot.

Happy New Year!

Jordi

AUTHOR

Jordi Visser
jvisser@gweiss.com

NEW YORK OFFICE

320 Park Avenue, 20th Floor
New York, NY 10022

HARTFORD OFFICE

One State Street, 20th Floor
Hartford, CT 06103

INQUIRIES

Gillian Tullman
Director of Investor Relations
and Marketing
gtullman@gweiss.com
+1 212 390-3451

Jena Roche
Vice President, Investor Relations
and Marketing
jroche@gweiss.com
+1 212 390-3445

WEBSITE

<http://gweiss.com>

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