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GLOBAL MACRO RESEARCH

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2nd Half 2015 Investment Outlook: Global Liquidity Evaporates; Bottom in Uranium and Gold

By Henry To, CFA, CAIA, FRM

2nd Half 2015 Outlook: The Global Scramble for U.S. Dollars – Global Liquidity Evaporating

Recall that our "three-pillar" model for determining the attractiveness of any asset class or security is based on the following three overarching, time-tested set of benchmarks. Major bull markets begin when all three of our pillars are bullish; they end when all three are bearish:

1. **Valuations (12- to 36-month timeframe)**: For equities, we track "traditional" ratios such as P/E, PEG, P/B, EBITDA/EV ratios; we also track corporate profit margins, free cash flows, inventory turns, earnings quality, etc., to determine the sustainability and growth potential of either a major index such as the S&P 500 or an individual stock. For interest rates, we track indicators such as expected global economic growth, forward-looking inflation, population growth, etc., in an effort to determine the "correct" level of interest rates. For commodities, we track more "subjective" indicators such as marginal cost of production, cash costs of production, as well as global demand growth;
2. **Global Liquidity (6- to 12-month timeframe)**: Hedge fund managers who refused to participate in the technology boom (or who shorted technology stocks more than 4 months prior to the March 10, 2000 NASDAQ peak) understand that valuations are a horrible timing indicator for any asset class, unless one is willing to underperform for several years in a row. This is why we have developed a set of global liquidity indicators with a shorter, 6-12-month timeframe. Many of these could be used for timing the equity markets, the commodity markets, foreign currencies, or for speculating against the "marginal countries" that are desperately short of US$ or foreign currency reserves. These indicators include:
    a. US$ liquidity indicators such as the absolute level and change in the U.S. current account deficit, as well as US$ reserves of foreign central banks held at the custody of the Federal Reserve[1];
    b. As chronicled by the IMF, foreign reserves readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate, and for maintaining confidence in the domestic currency and the economy;
    c. The shape of the U.S./global yield curve, as well as the shift in overall U.S/global interest rates, including sovereign yields and corporate yield spreads; e.g. a spike in corporate borrowing costs, all else equal, will result in an immediate decline in corporate liquidity and an immediate shift in valuations from a discount of cash flows (DCF) standpoint;

[1] The U.S. dollar is the world's reserve currency and has actually cemented its status given the doubts over the euro's long-term viability. As such, the Federal Reserve sits on the top of the hierarchy of the world's major central banks. Practically speaking—since all commodities and most of the world's trade are conducted in US$--this means the world's economy and financial markets need an increasing supply of dollars in order to grow and function properly, as well as to avoid price deflation. Two of the most reliable measures of global US$ liquidity (and thus, global liquidity) are the U.S. current account deficit and the amount of foreign reserves held in custody by the Fed. When both measures are increasing, this means global liquidity is strong—leading to increases in global trade, precious metals prices, and commodity prices.

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d. Equity market breadth indicators, such as the NYSE Advance/Decline line, the new highs vs. new lows index, and the action of the Dow Industrials vs. the Dow Transports. Weakness or divergence in these indicators have preceded major peaks such as the September 1929, December 1968, March 2000, and the October 2007 U.S. equity market peaks.

3. **Investors Sentiment (3- to 6-month timeframe)**: We track U.S. equity sentiment through our proprietary indicator, the **Combined Bulls-Bears% Differential Ratio**[2], the net long position of U.S. equity hedge funds (which is at an all-time high and thus bearish from a contrarian standpoint), the VIX, margin debt outstanding, U.S. equity mutual fund inflows/outflows, and price indicators such as the CB Capital Global Overbought-Oversold Model and the S&P 500's or NASDAQ Composite's percentage deviation from its 200-day moving average. E.g. at the peak in March 2000, the NASDAQ Composite traded at more than four standard deviations above its 200-day moving average, which we discussed at the time (we sold all our technology holdings by late January 2000 and had built a major short position in the NASDAQ through LEAP puts by March 2000).

As I have discussed for the last several months, U.S. equity valuations are at historically high levels. Combined with record high profit margins, rising interest rates, and a slowdown in earnings momentum, I expect U.S. stocks to return just 4%-6% over the next several years. In the meantime, our global liquidity indicators have been deteriorating significantly since the beginning of this year. As I alluded to in my June 21, 2015 newsletter, there is now a major "scramble" for US$ liquidity. An extreme example is Saudi Arabia, which has lost more than $50 billion in reserve assets since January this year—driven by an increase in social welfare spending and the recent decline in crude oil prices. Saudi Arabia's budget deficit is expected to hit 20% of GDP this year; the country is now scrambling for US$-based hard currency by increasing oil production and competing for market share—such action will only serve to put a lid on crude oil prices going forward.

The Global Scramble for US$: A Once-in-a-Decade Decline in Central Banks' Balance Sheet Reserves

The fact that global liquidity is deteriorating means that both global asset prices and the global economy are now highly vulnerable to a systemic crisis. The situation today is particularly distressing given historically high valuations in the U.S. equity markets, the U.S. high yield market, and various pockets of the U.S. residential and commercial real estate markets. One way to measure global liquidity—which I discussed in my June 21, 2015 newsletter—is to track the amount of foreign dollar reserves held in the custody of the Federal Reserve. Global financial crises or economic recessions have usually occurred when the annual change in US$ reserves is slowing down or experiencing negative growth. Over the last 18 months, annual growth in US$ reserves has slowed down dramatically—sitting in the -2.5% to +2.5% range—a range which has typically preceded major corrections in global asset prices. Note that the asset price corrections during 1982, 1990, the 1997 Asian crisis, the 1998 emerging market and LTCM crises, the 2001 recession, and the 2012 European sovereign debt crisis were all preceded by a dramatic decline in foreign US$ reserves.

Another way to measure global liquidity is to track the amount of foreign reserves readily available to and controlled by monetary authorities.[3] For a typical central bank with no access to a US$ swap line, its foreign reserves holdings are typically the "last line of defense" in the event of a capital flight; it is also used on a daily basis for meeting balance of payments financing needs and for intervention in exchange markets to affect the currency exchange rate. A central bank that holds a substantial amount of foreign reserves also inspires more confidence in its domestic currency and economy.

Total currency reserves (excluding gold) held by monetary authorities around the world have only declined three times since records have been kept (beginning in 1995): 1) during the 1997 Asian and 1998 Brazilian/Russian/LTCM crises, 2) the late 2008 to early 2009 global financial crisis, and 3) late 2014 to today. Figure 1 below shows total global reserves broken down into those held by advanced and emerging economies, along with their year-over-year changes.

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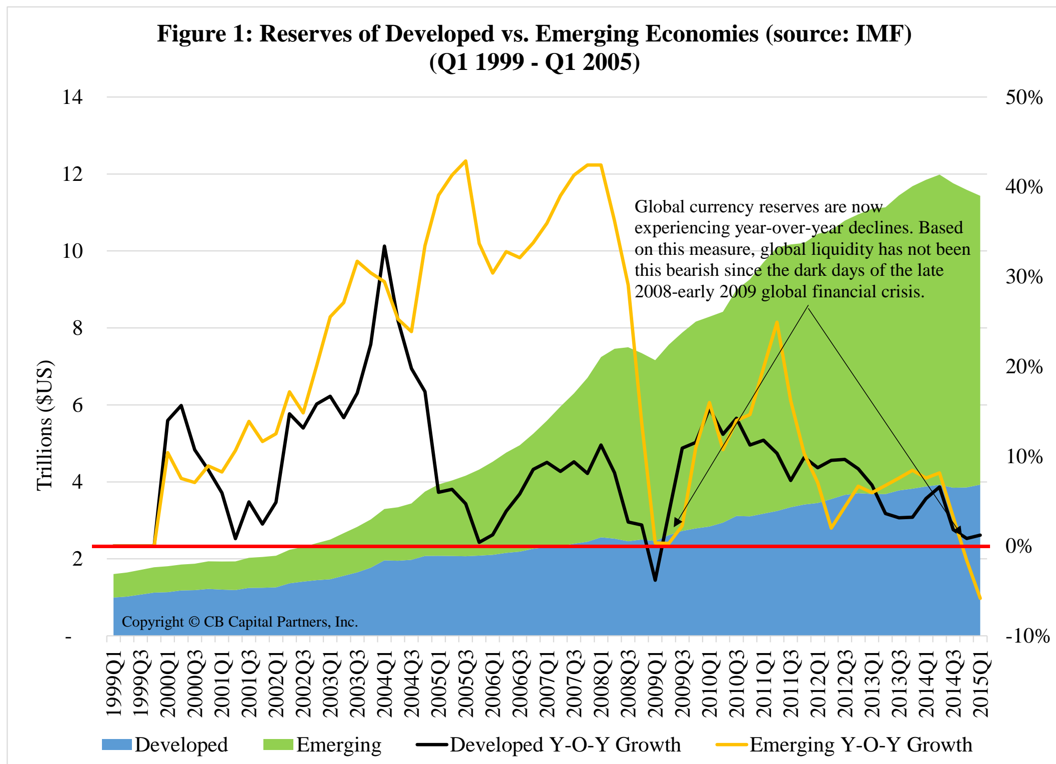
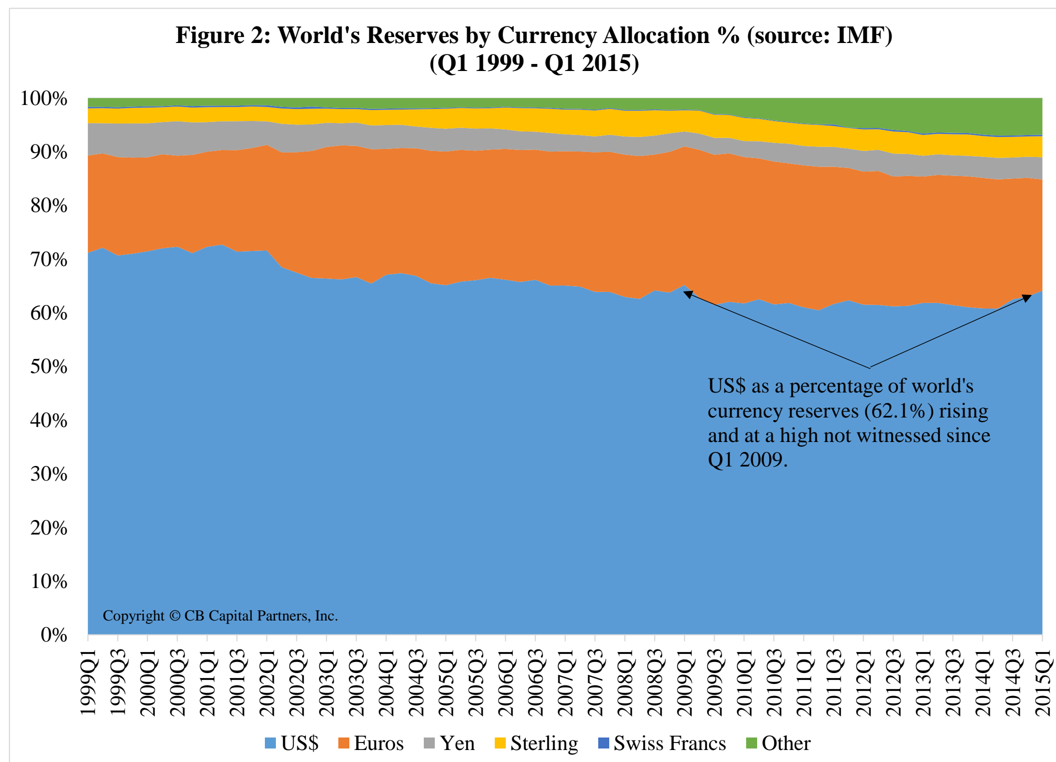
[2] See Appendix A for the latest reading and a description of the Combined Bulls-Bears% Differential Ratio.

[3] The IMF has been publishing foreign reserves data on a quarterly basis for all its members since Q1 1999. The impetus for the disclosure of countries' international reserves was the Asian/Brazilian/Russian crises in the late 1990s, when the lack of reserves information made it difficult for central banks to anticipate such crises. Moreover, the IMF believes that timely disclosure of reserves information can strengthen the accountability of global central bankers by keeping the public informed and limiting the contagion effects of a potentially systemic effect.



In particular, emerging economies—such as Russia, Turkey, Thailand, and Saudi Arabia—have experienced significant reserve outflows, due to a combination of: 1) deteriorating trade balances, 2) capital flight, 3) increased domestic social welfare spending, and 4) FOREX interventions to stabilize or defend the value of the country's domestic currency.

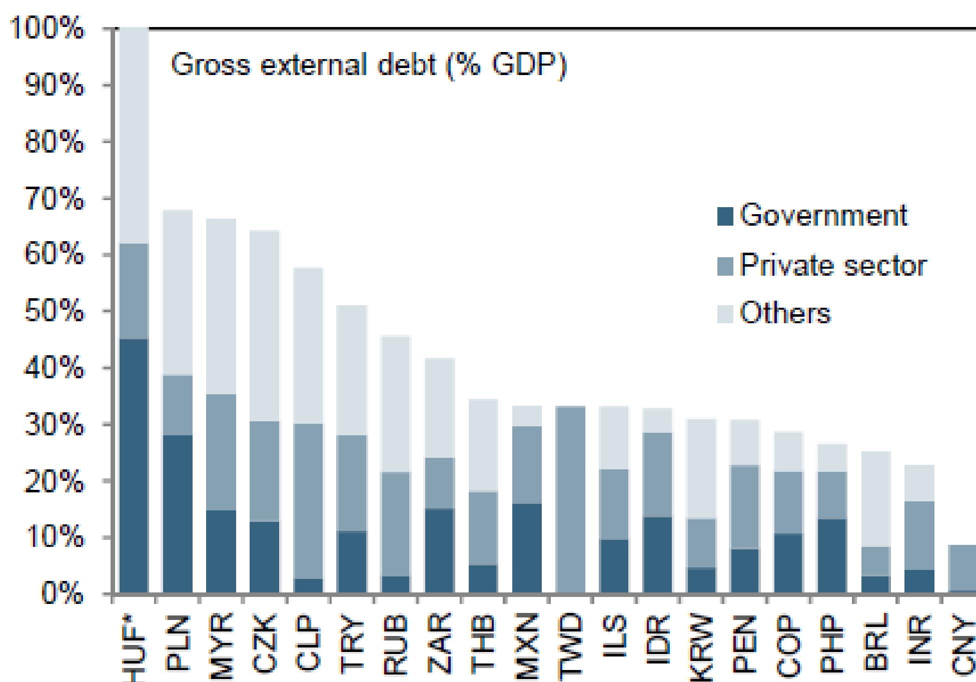


Moreover, as shown in Figure 2 above, monetary authorities around the world are now favoring US$ reserves versus all other currency reserves, particularly against the euro. The share of US$ reserves as a percentage of total reserves[4] as of Q1 2015 is now at 62.1%--the highest level since Q1 2009. In other words, there is now a "global scramble" for US$-based liquidity as the combination of: 1) last year's Fed tapering, and 2) the significant reduction in the U.S. current account deficit reduce the amount of U.S. dollars available for the balance sheets of global central banks and for conducting global trade. The fact that the euro is currently suffering from an existential crisis means monetary authorities around the world are now even more desperate to hold U.S. dollars—further diminishing global liquidity and increasing the chance of capital flight from countries with deteriorating reserves balances.

The Global Scramble for US$: Which Country is the Next to fall?

The countries that are most vulnerable to a capital flight are those with: 1) a deteriorating reserves balance, and 2) a high amount of externally-funded debt (see Figure 3 below). This list of most vulnerable counties includes: **Hungary, Poland, Malaysia, the Czech Republic, Chile, Turkey and Russia** (especially with the recent weakness in oil prices). Note that Eastern European countries are especially vulnerable given the Greek debt crisis and the country's clash with Germany and its fellow Euro Zone members.

Figure 3: EM Countries with Large Amounts of Externally-Funded Debt (source: Haver Analytics, Goldman Sachs)



U.S. stocks overbought; Australia oversold based on the CB Capital Global Overbought-Oversold Model

As of this writing, European equity indices are selling off while the Shanghai Composite are off about 28% from its recent peak on June 12th. However, I am convinced that U.S. equities are also highly vulnerable to a correction, given historically high valuations, a declining global liquidity situation (note that nearly 50% of the S&P 500's revenues come from international markets), historically high margin debt levels, and the lack of positive momentum in all of the S&P 500's ten sub-sectors with the exception of the health

[4] The percentage of US$ reserves is estimated based on known information, as some monetary authorities do not break down their reserves holdings by currency.

care and consumer discretionary sub-sectors. In fact I would contend that even healthcare stocks have peaked for 2015 and that the announcement of Aetna's $37 billion acquisition of Humana ($16 billion of which will be funded with debt) marked the peak of both U.S. healthcare stocks and definitively, the S&P 500. I am especially bearish on U.S. stocks, since—based on the CB Capital Global Overbought-Oversold Model—the U.S. stock market is the most overbought market in the world on a 36-month timeframe (at its 82.8th percentile of readings going back to December 31, 1997).

To recap, we first discussed the CB Capital Global Overbought-Oversold Model in our January 10, 2014 blog entry ("The Message of the CB Capital Overbought-Oversold Model").[5] The model is designed to keep track of all country-specific MSCI market indices and country-specific equity ETF products, including all developed and EM investable countries and regions. The results for the Developed Markets indices as of June 30, 2015 are shown in Figure 4 below. Percentile rankings highlighted in red or green represent rankings: 1) in or below the 10th percentile (i.e. oversold), and 2) in or above the 90th percentile (overbought), respectively. That is, relative to the historical percentage deviations of the same country or region, a ranking highlighted in red is more oversold than 90% of its readings going back to December 1997; while a ranking highlighted in green is more overbought than 90% of its readings. As shown in Figure 5 below, the MSCI USA remains highly bought on a three-year time frame. Its deviation from the 36-month moving average is currently at 82.8%, suggesting significant downside potential.

Figure 4: CB Capital Global Overbought-Oversold Model as of June 30, 2015

	Timeframe (months)				
Developed Indices	**3**	**6**	**12**	**24**	**36**
MSCI North America	26.6%	31.4%	30.0%	39.5%	50.0%
MSCI USA	26.7%	30.5%	37.7%	63.3%	82.8%
MSCI Canada	14.2%	24.7%	15.7%	20.4%	19.0%
MSCI Developed Europe	19.0%	30.4%	30.9%	27.6%	36.1%
MSCI Austria	22.3%	48.0%	39.0%	23.3%	29.0%
MSCI Belgium	34.2%	33.3%	41.4%	45.7%	51.9%
MSCI Denmark	20.9%	47.1%	41.9%	47.6%	59.0%
MSCI Finland	34.7%	29.0%	30.4%	36.1%	49.5%
MSCI France	20.0%	28.5%	32.8%	29.5%	38.0%
MSCI Germany	20.0%	27.1%	30.9%	28.0%	34.7%
MSCI Ireland	57.1%	69.5%	65.7%	60.0%	68.5%
MSCI Israel	32.3%	46.1%	54.2%	57.6%	70.0%
MSCI Italy	28.0%	45.2%	38.5%	37.1%	46.6%
MSCI Netherlands	31.9%	45.2%	49.5%	43.3%	55.2%
MSCI Norway	17.1%	30.0%	17.6%	14.7%	15.2%
MSCI Portugal	19.0%	40.9%	32.8%	11.4%	16.1%
MSCI Spain	22.3%	34.2%	24.2%	29.5%	42.3%
MSCI Sweden	20.0%	25.7%	28.0%	23.3%	27.1%
MSCI Switzerland	14.7%	31.4%	36.6%	34.7%	40.4%
MSCI United Kingdom	18.0%	28.5%	29.0%	24.7%	31.9%
MSCI Developed Pacific	28.5%	49.0%	47.1%	46.6%	53.8%
MSCI Developed Pacific x Japan	16.1%	23.8%	22.3%	26.6%	27.1%
MSCI Australia	10.4%	16.1%	9.5%	8.0%	7.1%
MSCI Hong Kong	24.7%	44.7%	49.0%	51.4%	60.0%
MSCI Japan	42.8%	61.4%	70.0%	64.2%	69.5%
MSCI Japan Small Cap	61.9%	65.7%	68.5%	64.2%	74.2%
MSCI New Zealand	6.6%	7.1%	10.4%	15.2%	31.9%
MSCI Singapore	21.4%	36.7%	34.5%	35.5%	41.8%

[5] The inner workings of the CB Capital Global Overbought-Oversold Model are simplistic. For each country or region, we compute the month-end percentage deviation from its 3-, 6-, 12-, 24-, and 36-month moving averages. Each of these percentage deviations are then ranked (on a percentile basis) against all their monthly deviations (from their respective moving averages) dating back to December 1997 (May 2005 for the MSCI Frontier Market Index). This way, we can compare apples to apples as we can control for country- or region-specific volatility. Note that I generally do not believe in shorting overvalued or overbought markets. I do, however, believe in going long distressed or oversold markets, as long as the long-term economics make sense. Our model was designed with this goal in mind.

Note that the MSCI Australia index is now highly oversold (at its 10th percentile or below) on a 3-, 12-, 24-, and 36-month moving average basis. As such, Australian equities may be a good bet later this year—especially if one is looking for a bottom in copper, iron ore, coal, or natural gas prices.

Eastern European Equities Not Yet Oversold Based on the CB Capital Global Overbought-Oversold Model

While there may have been pockets of selling in EM equities (e.g. Malaysia and Colombia; note that the MSCI China index is not yet oversold since the index does not contain any domestic "A" shares)—in general, EM equities are not oversold and are thus not attractive to me. As I stated above—the most vulnerable countries (driven by a deteriorating reserves balance and a significant dependence of external sources of capital) are generally in Eastern Europe. These countries include: **Hungary, Poland, the Czech Republic, Turkey and Russia**. Based on our CB Capital Global Overbought-Oversold Model of EM equities (see Figure 5 below), none of these countries are yet oversold. As such, I would not purchase shares in any of these countries until they become more oversold or unless global US$ liquidity increases; moreover, they could act as good hedges on the short side for one's European long exposure.

Figure 5: CB Capital Global Overbought-Oversold Model as of June 30, 2015

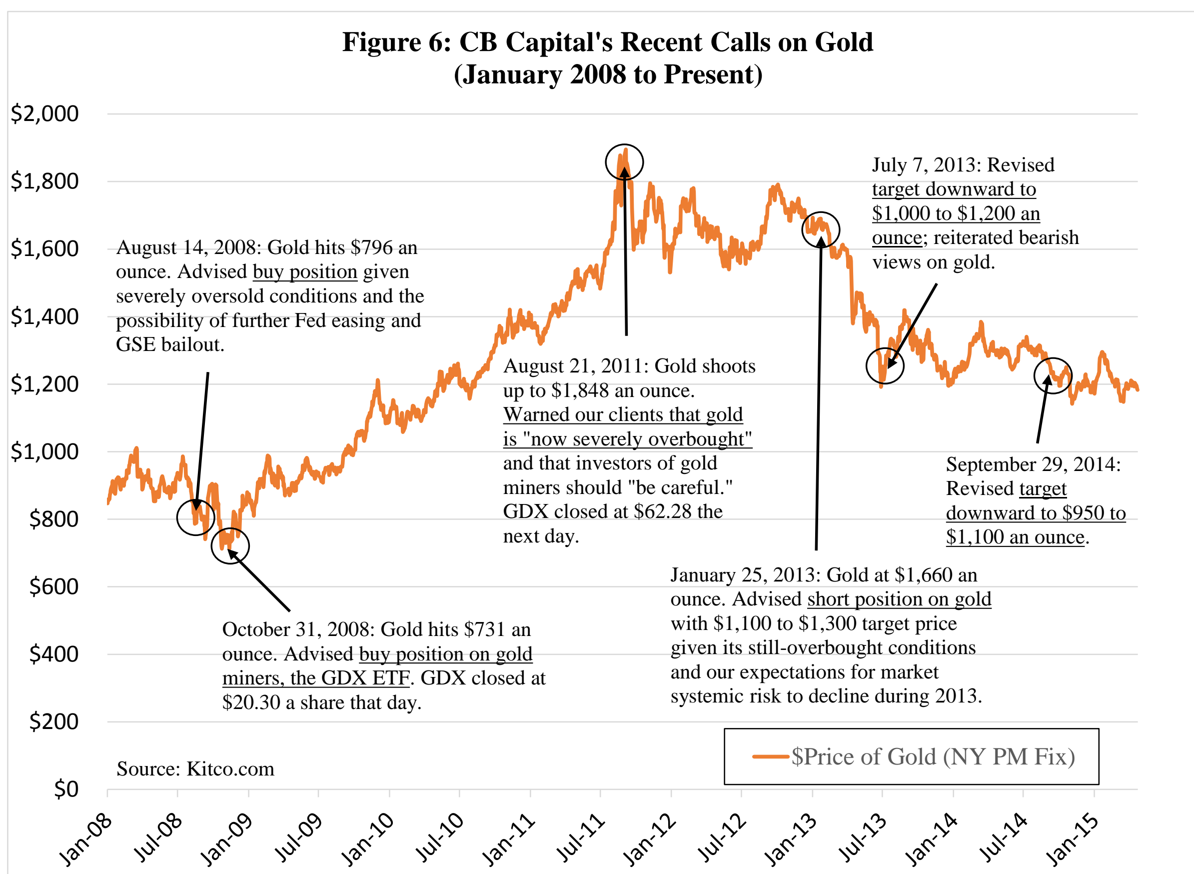
	Timeframe (months)				
Emerging Market Indices	**3**	**6**	**12**	**24**	**36**
MSCI EM Asia	17.6%	31.9%	33.8%	40.9%	50.9%
MSCI EM Far East	16.6%	33.3%	35.2%	40.0%	49.0%
MSCI China	14.7%	44.7%	67.1%	70.0%	70.4%
MSCI India	44.2%	32.3%	35.2%	50.9%	53.3%
MSCI Indonesia	22.3%	20.0%	20.4%	26.6%	31.4%
MSCI Korea	18.5%	26.6%	25.2%	20.0%	20.0%
MSCI Malaysia	10.4%	13.3%	12.8%	13.8%	12.8%
MSCI Philippines	35.2%	30.9%	38.0%	49.0%	50.9%
MSCI Taiwan	29.0%	39.0%	41.9%	51.9%	65.2%
MSCI Thailand	35.7%	29.5%	23.3%	28.5%	34.2%
MSCI EM Latin America	30.0%	35.2%	19.0%	17.1%	12.3%
MSCI Brazil	33.3%	39.0%	20.4%	20.0%	16.6%
MSCI Chile	10.9%	22.3%	25.2%	24.7%	13.3%
MSCI Colombia	25.2%	26.6%	9.5%	10.0%	10.4%
MSCI Mexico	34.2%	39.0%	20.4%	15.7%	13.8%
MSCI Peru	19.5%	27.1%	23.3%	38.0%	25.7%
MSCI EM Europe & Middle East	22.3%	42.8%	22.3%	15.7%	10.9%
MSCI EM Europe	23.3%	42.3%	23.3%	16.1%	12.3%
MSCI EM Eastern Europe	20.0%	38.0%	17.6%	13.3%	11.9%
MSCI Czech Republic	22.8%	30.9%	22.3%	22.3%	21.4%
MSCI Greece	36.1%	46.6%	14.2%	12.3%	23.8%
MSCI Hungary	20.9%	61.4%	61.9%	37.6%	38.5%
MSCI Poland	16.6%	29.5%	22.3%	19.5%	24.2%
MSCI Russia	25.7%	56.6%	30.9%	18.0%	17.6%
MSCI Turkey	42.8%	33.8%	28.0%	28.5%	22.8%
MSCI Egypt	32.8%	29.0%	32.3%	49.5%	57.1%
MSCI South Africa	34.2%	31.9%	32.3%	40.9%	41.9%

Gold and Uranium to Hammer Out a Bottom in the 2nd Half of 2015

Gold has been in a four-year bear market while investors have been liquidating both uranium and uranium miners since the March 11, 2011 Fukushima nuclear disaster. Since the end of 2012, global gold miners have cut CAPEX by about 50%; because of this, the World Gold Council is expecting global gold mining production to decline in the 2nd half of 2015; this comes after gold mining

production had grown by 4.7% annually from 2008-2013, and another 2% last year. Assuming the price of gold stays below $1,200 an ounce, global gold mining production is projected to decline by 5%-10% over the next three years.

Absent a new gold extraction technology (e.g. the increased use of heap leaching during the early 1990s which increased global gold production by nearly 50% in ten years), it is highly unlikely that gold miners could continue to lower their costs of production. As discussed in my previous newsletters, gold has already declined to the marginal all-in-sustaining-cost (AISC) of production, as evident by the 2 ½ year decline in global CAPEX. Should gold decline to the $950-$1,000 an ounce level, miners may start closing producing mines in order to cut costs. Figure 6 below summarizes our most recent calls on the price of gold; my latest call (dated September 29, 2014) is for gold to ultimately bottom in the $950-$1,100 an ounce range.



With central banks and investors around the world "scrambling" for US$ liquidity, I am now looking for gold to continue its descent during the 2nd half of this year. I believe the price of gold will hit a tradable bottom over the next six months—supported by declining gold mining supply, and ongoing purchases by Chinese and Indian investors.

Investors' sentiment in gold could be tracked by both the change and the absolute levels of holdings in the gold ETF, GLD. The creation of GLD in 2004 spiked investors' interest in gold—as for the first time, investors could easily trade, speculate, and hold gold in a brokerage account without having to deal with intermediaries or take delivery of physical gold. While the creation of GLD effectively increased demand for gold (thus creating a tailwind in the gold bull market), it also amplifies moves on the downside—as investors could now more easily sell gold when they panic as well. Over the last six months, the amount of GLD holdings[6] has vacillated in the 22.5-25.0 million ounce range. As I previously said, I do not expect a bottom in gold until investors' sentiment has turned more bearish; i.e. until the amount of GLD holdings declines to the 18-22 million ounce range.

[6] At one point in August 2011, GLD was the world's biggest ETF by assets. Today, it has fallen to outside of the Top 10.

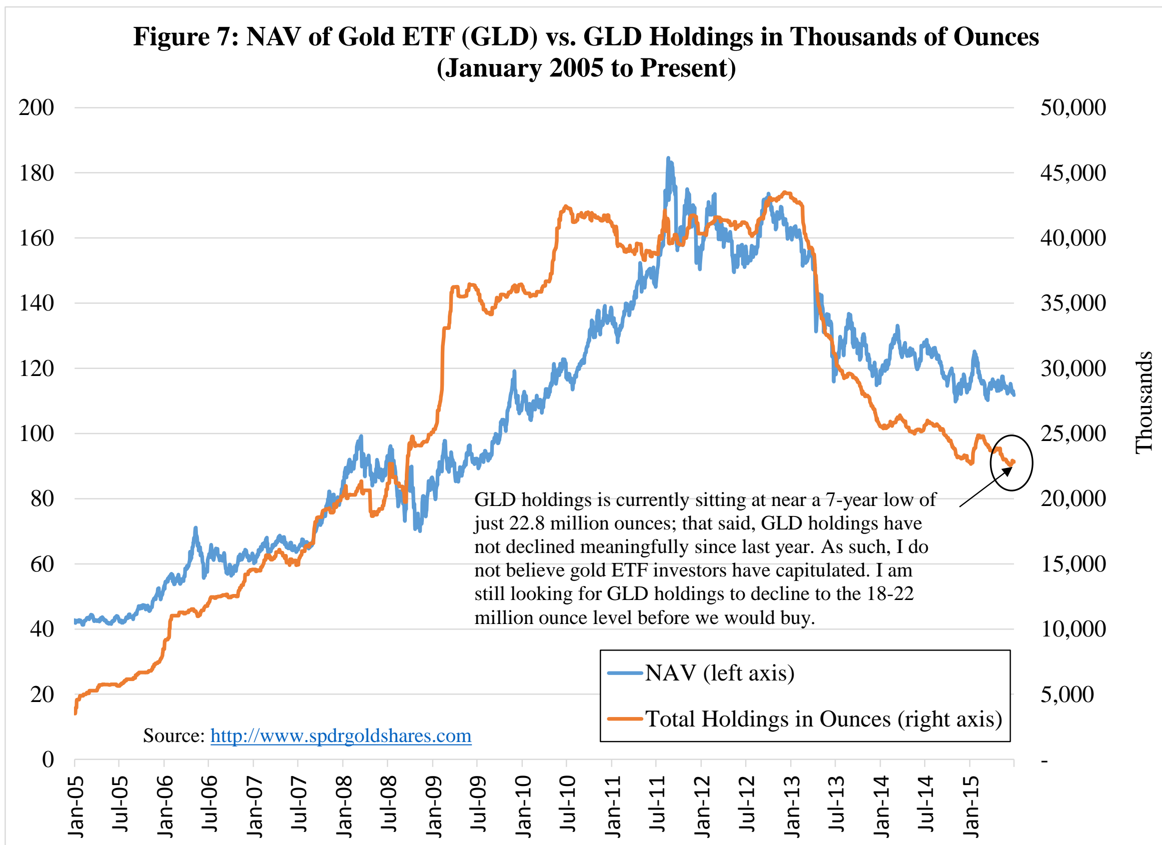
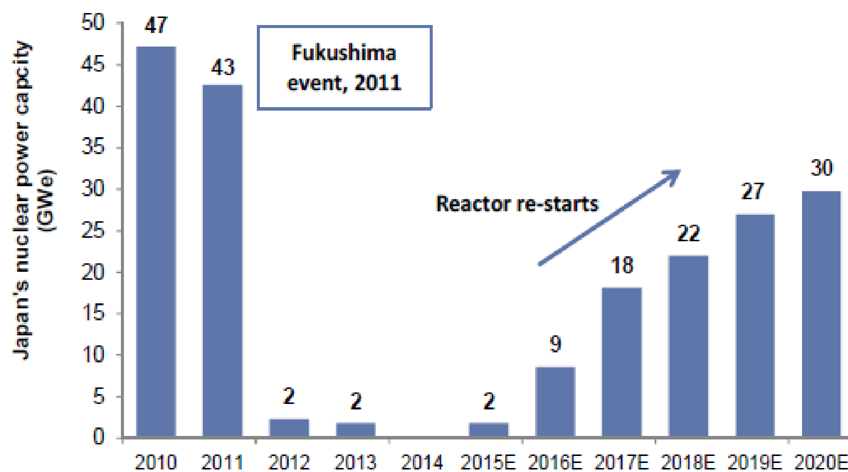


Figure 7: NAV of Gold ETF (GLD) vs. GLD Holdings in Thousands of Ounces (January 2005 to Present)

Still Long-term Bullish on Uranium and Uranium Miners

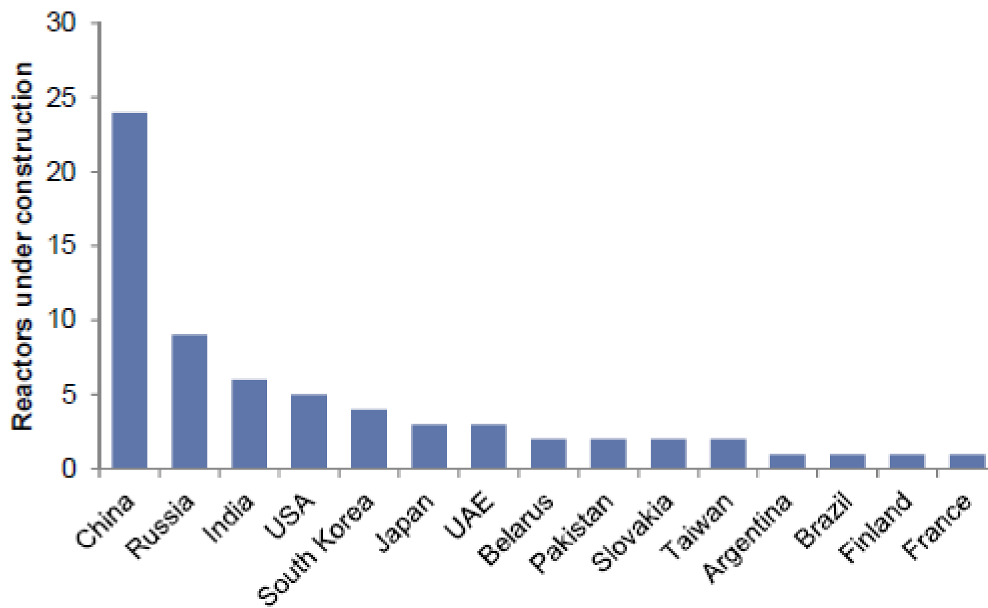
I remain long-term bullish on uranium prices and uranium miners, driven by: 1) the Japanese nuclear power plant restarts in mid-August 2015, 2) the doubling of Chinese nuclear power generation capacity over the next two years, and 3) Energy Resources of Australia's decision to mothball its Ranger 3 Deeps project three weeks ago, which essentially removes around 9 million pounds per annum of future production, the equivalent of 6% of the world's annual mine supply; the Ranger 3 Deeps project would have been the world's third largest uranium mine if completed. I expect the uranium market to move into a deficit situation as early as 2018.

Figure 8: Japan's Historical and Expected Nuclear Power Capacity (GWe; source: Goldman Sachs)



Investors who want to bet on the renaissance of low-cost, baseload nuclear power generation capacity could invest in the **URA** ETF, which consists of a basket or uranium miners, along with a uranium trust that holds uranium oxide in physical locations in North America and France. **URA** is down 80% since inception (five months before Fukushima), but we believe uranium is under-owned and is the only commodity in the world that has the potential to shift to a deficit situation sometime in the next several years.

Figure 9: Nuclear Reactors Currently under Construction (sources: World Nuclear Association, Goldman Sachs)

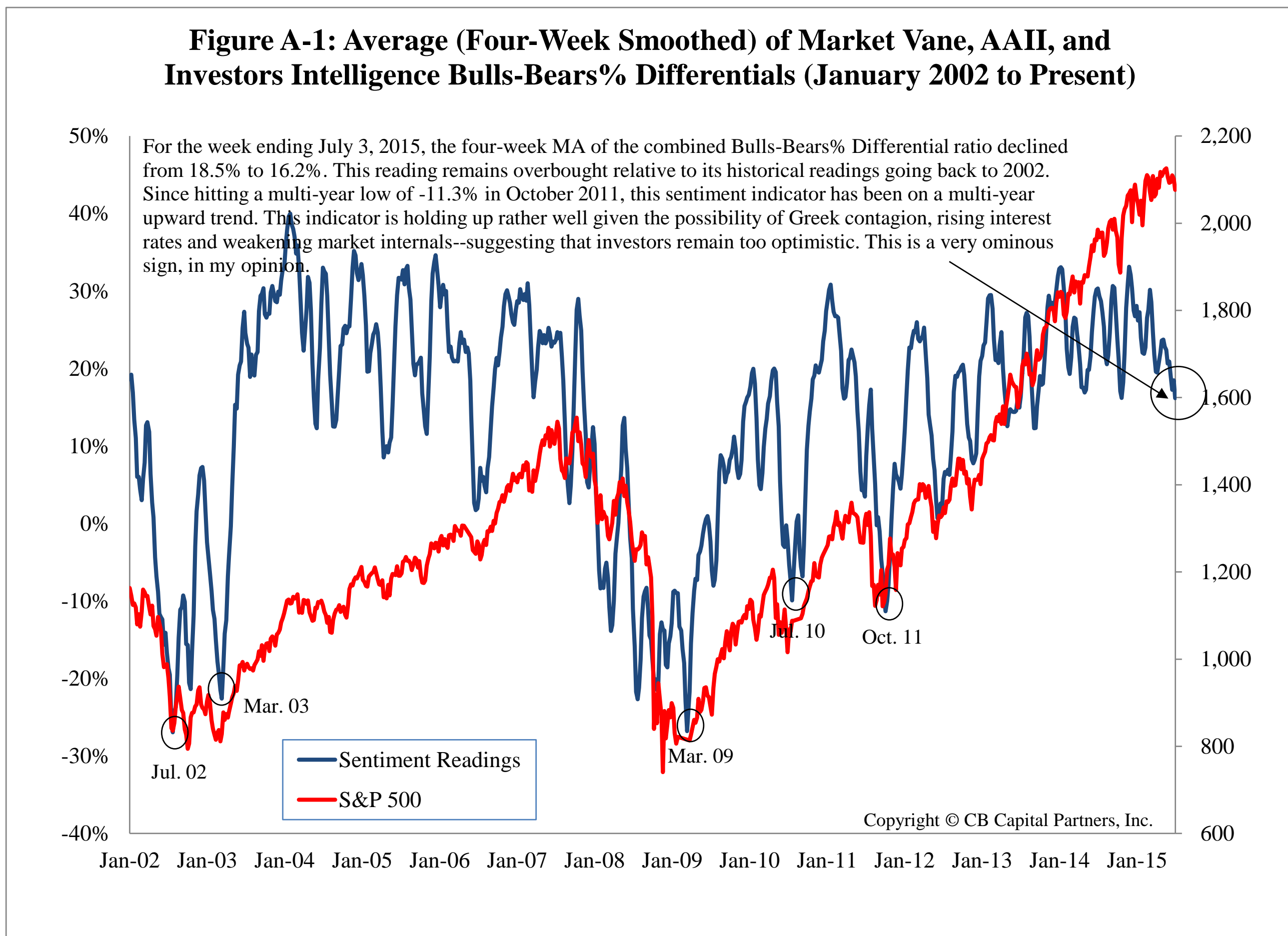


Appendix A

One of the most reliable measures of U.S. investor sentiment is our proprietary U.S. stock market sentiment indicator—the "**Combined Bulls-Bears% Differential Ratio**."[7] Calculated on a weekly basis, it is a contrarian indicator, i.e. highly bearish sentiment usually indicates a major stock market bottom, while highly bullish sentiment indicator suggests the lack of potential upside. Over the last 15 years, the Combined Bulls-Bears% Differential Ratio was instrumental in calling the stock market bottoms of July 2002, March 2003, March 2009, July 2010, and October 2011.

Figure A-1 below shows that—since the October 11, 2011 bottom—this sentiment indicator risen relentlessly and has not once dipped into negative territory (i.e. a reading where bearish outweighed bullish forecasters). The Combined Bulls-Bears% Differential Ratio dipped to 16.2% during the October 2014 sell-off, which is neutral territory at best. This means U.S. retail investors remain very complacent. Last week, this reading declined from 18.5% to 16.2%. The fact that this reading is holding up despite the possibility of Greek contagion, higher interest rates and weakening market internals is a bearish sign—we remain short U.S. equities.

Figure A-1: Average (Four-Week Smoothed) of Market Vane, AAII, and Investors Intelligence Bulls-Bears% Differentials (January 2002 to Present)



[7] The Combined Bulls-Bears% Differential Ratio is constructed by aggregating the three most reliable and time-tested sentiment indicators that track retail investors' sentiment on a real-time basis. These are: 1) the Market Vane's Bullish Consensus Index, which tracks the buy and sell recommendations of leading market advisors, 2) the American Association of Individual Investors (AAII) Sentiment Survey, which measures the percentage of individual investors who are bullish or bearish on the U.S. stock market for the next six months, and 3) the Investors Intelligence U.S. Advisors' Sentiment Report. We then smooth the aggregate of these three using a four-week moving average, which we label as the "**Combined Bulls-Bears% Differential Ratio.**"

Biography

Henry To, CFA, CAIA, FRM

Partner, Chief Investment Officer

Mr. To currently serves as Partner and Chief Investment Officer for CB Capital Partners by leveraging his many years of investment, consulting, and valuation experience. Mr. To has extensive experience in institutional asset management, portfolio allocation, global macroeconomics, and international public policy. Mr. To brings his unique business ideas, entrepreneurial mindset, managerial experience, and professional consulting skills to CB Capital Partners.

Previously, Mr. To was the Founder and Managing Partner of MarketThoughts LLC, an investment advisory service catering to global investors, including the world's largest alternative asset management firms (e.g. Tudor Funds and Raptor Group). Prior to MarketThoughts LLC, Mr. To held Investment, Energy Consulting, and Actuarial Consulting positions with firms such as Buck Consultants, Lukens Energy Group (now part of Black & Veatch), and Mercer, where he obtained substantial experience in institutional asset management, project management, and performed valuations on non-traditional assets such as ERISA pension/actuarial contracts, natural gas storage fields, and weather derivative contracts.

Mr. To is also an Adjunct Professor at the UCLA Luskin School of Public Affairs. In that capacity, Mr. To created a class curriculum and lectured on a variety of public policy areas, including international monetary policy, national security, education, and crime policy. In addition, Mr. To has been an instructor in the USC/CFALA Review Program, where he taught the CFA Exam Level II Economics section. Mr. To is a regular contributor on the Forbes 'Great Speculations' blog and has been interviewed and quoted by CNBC, CCTV, the New York Times Business Section, the Wall Street Journal, MarketWatch, and TraderPlanet. Mr. To has also been a featured speaker at the Western Pension & Benefits Conference (Orange County Chapter), where he discussed the role of private equity and infrastructure investing in pension fund portfolios.

Mr. To received a BA in Mathematics and Economics from Rice University, an MBA in Finance from UCLA Anderson School of Management, and a Masters of Public Policy (MPP) in International Policy from UCLA Luskin School of Public Affairs.

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