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Potential Retest of WTI Crude Lows; U.S. Stock Market Action Looking Ominous

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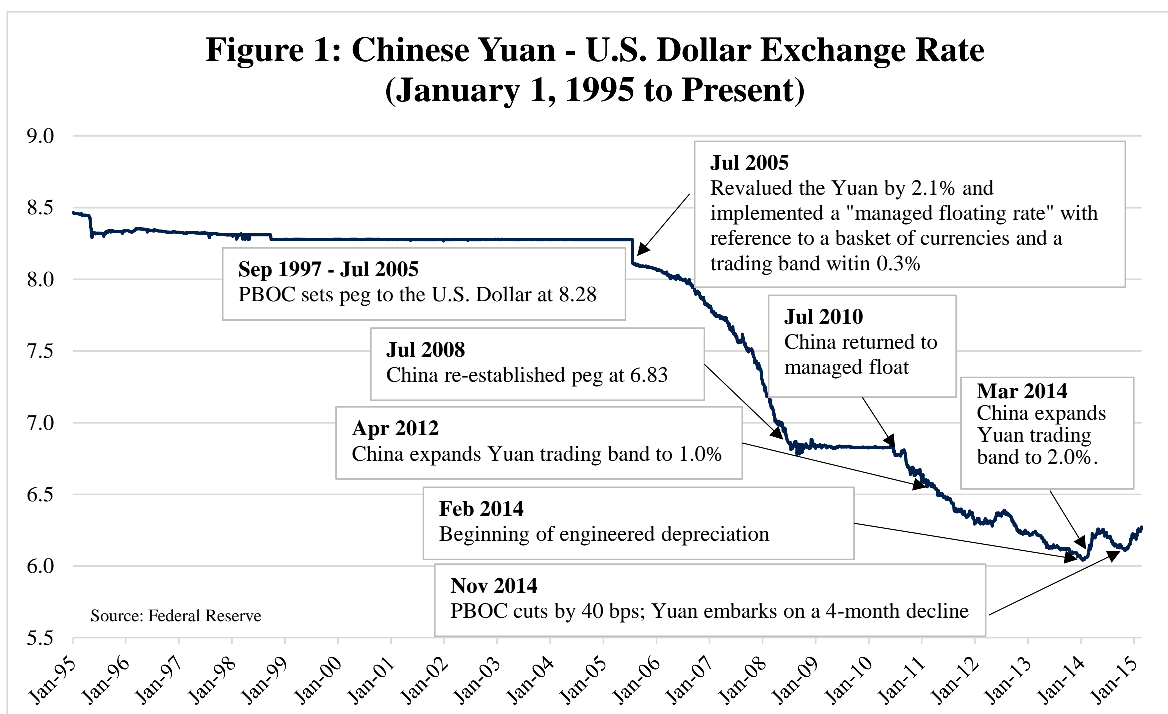
The Global Impact of the Chinese Rate Cut Will Be Negligible – Tracking DSUM

The People's Bank of China last cut its policy rate (the one-year benchmark lending rates) on November 21, 2014. The cut amounted to 40 basis points and was the first official monetary easing (the PBoC had previously injected liquidity into the Chinese banking system on an ad hoc basis) in two years. The front-month WTI oil futures subsequently rallied by 1.3%, while copper prices rose 1.0%—as global investors expected Chinese demand for commodities to pick up in response to easier monetary policy. The rally was short-lived, however, as commodity prices began a renewed decline the following Monday which did not end (or pause, we don't know yet) until the end of January.

We do not expect the latest rate cut to have any significant impact on either financial asset or commodity prices. Firstly, the latest cut of 25 bps is too small, both relative to the size of the last cut, as well as the pace of the Chinese economic slowdown and the debt overhang (Chinese total debt-to-GDP ratio, including leverage in its financial sector, sits at 282%, vs. 262% for the U.S.). Secondly, the Chinese yuan is down by 2.4% since the last rate cut on November 21, 2014. This means the Chinese currency has been losing buying power and consequently, the Chinese impact on global asset prices has been diminished, for now.



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For those of us who are concerned about the Chinese economy (every investor should be)—and especially those of us looking for a buying opportunity in Chinese Dim Sum bonds[1]—we will be looking for signs of a greater depreciation of the yuan vs. the dollar as traders will be pricing in a more aggressive easing schedule for the People's Bank of China. This is one reason why we have not bought any Dim Sum bonds for our internal, Absolute Return hedge fund—even though Dim Sum Bond yields remain very attractive (e.g. the UK government sold a 3-year dim sum bond at a 2.7% yield last October, vs. a yield of 0.9% for a similar, 3-year sterling-denominated bond).

According to the Bank for International Settlements (BIS), China's foreign debt levels totaled $1.1 trillion as of June 30, 2014, vs. $311 billion for Brazil, and about $200 billion each for India and South Korea. While China has sizable foreign reserves totaling $3.8 trillion—as well as capital controls on "hot money"—a more aggressive easing schedule by the People's Bank of China could encourage more capital outflows and result in greater yuan depreciation against the US$ for the foreseeable future. This could also further strain the balance sheets of Chinese companies who have borrowed in US$. Furthermore, China's total debt, including leverage in its financial sector, has quadrupled from $7.4 trillion in 2007 to $28.2 trillion by 2Q 2014. Its debt-to-GDP ratio of 282% is higher than that of the U.S., Germany, and Canada. An extrapolation of its current growth rate suggests that China's debt-to-GDP ratio would hit 400% by 2018, equivalent to that of Spain. Surely, this is not a sustainable path.

While China was growing at near double-digits, a high debt level, per se, does not matter as much—as a fast-growing economy could easily service its principal and interest payments or "grow out" of its high debt levels. With the Chinese economy now decelerating, however, servicing (increasing) principal and interest payments will become more challenging by the day. For now, we will take a "wait-and-see" approach with respect to the Chinese yuan and Chinese Dim Sum Bonds (**DSUM**)[2] as we believe there is more yuan depreciation; however, we anticipate a buying opportunity in **DSUM** later this year.

The Indian Annual Budget: Evolutionary, not Revolutionary – But it will Get the Job Done

We believe the Indian bull market in equities, real estate, and bonds—as well as India's economy acceleration—remain in play. The "three pillars" supporting the Indian bull market remain strong. As we discussed in last week's newsletter, these three pillars include: 1) growing investors' and business confidence amid the Indian government's business-friendly reforms, 2) a much more credible central bank leadership with an inflation-targeting framework, and 3) an improving macro-economic backdrop as declining crude oil prices allows India to reduce its current account deficit and rebuild its FOREX reserves. The unveiling of the 2015-2016 national budget, while incremental, will be bullish for Indian assets and economic growth.

By far the bravest move by the Modi administration was the new fiscal target deficit of 3.9% vs. our expectations of a 3.5%-3.7% fiscal deficit for the 2015-2016 fiscal year. Critics argue that India should be reducing its deficit as there is scope to do so given the recent decline in oil prices. I would argue otherwise. With Indian real GDP growth projected to hit 8% for the 2015-2016 fiscal year—and with declining inflation and foreign appetite for Indian assets rising—the Indian government should be spending/investing more in order to further accelerate long-term economic growth. Finance Minister Jaitley did not disapoint: The administration will spend an additional $11.3 billion in infrastructure investments, cut the corporate tax rate from 30% to 25% in the next four years, build five ultra mega power plants each capable of producing 4,000 MW, and under its "Housing for All by 2022" mandate, build 60 million homes to alleviate a nationwide housing affordability issue. Finance Minister Jaitley also pushed back by one year the country's fiscal deficit target of 3.0%. It will now be met in the 2017-2018 fiscal year instead.

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[1] Dim sum bonds are offshore bonds denominated in the Chinese currency, the Renminbi, or Yuan. Dim sum bonds are not limited to those issued by Chinese or Hong Kong companies. McDonald's was the first foreign company to do a dim sum bond offering in September 2010. Similarly, the UK government sold $490 million worth of dim sum bonds in October 2014, with a 2.7% yield. The bonds were sold in London.
[2] DSUM is the PowerShares Chinese Yuan Dim Sum Bond Fund, which seeks to replicate the investment performance of the Citi Custom Dim Sum (Offshore CNY) Bond Index. This index is composed of RMB-denominated bonds issued by governments, agencies, supranationals and corporations. Each security must have a minimum of one year to maturity to enter the index and one month to maturity to remain in the index. As of February 27, 2015, DSUM has a SEC 30-day yield of 4.88% and an effective duration of 2.02 years.

Both Indian bonds and the Indian Rupee-US$ exchange rate (both the bond and currency markets were closed when the budget was announced over the weekend) held steady on Monday morning—suggesting that financial markets are happy with the higher-than-expected 2015-2016 fiscal deficit target.

Another reform that we liked and that we believe will have a long-term, positive impact on the Indian economy is the new "monetary policy framework agreement" which the government signed with the Reserve Bank of India (RBI). This agreement essentially ties the government and the RBI to commit to an inflation-target policy, which the RBI itself already committed to (but without the government's explicit support) when it unveiled its inflation targeting proposal in January 2014. The agreement calls for both sides to set a CPI target of 4.0%, with a 2.0% band either side, for the fiscal year ending March 31, 2017. The RBI act will be amended to formalize the new mandate of the RBI. This is India's biggest overhaul to its monetary policy since the "big bang" reforms of 1991 when India opened up its economy to foreign investors.

The one disappointment was that the national GST issue was not covered in more detail (as discussed in our January 20, 2015 article; the only reference to the national GST was the government's promise to meet an April 2016 implementation deadline). Otherwise, there were no major surprises in the Indian budget and we believe both Modi and Finance Minister Jaitley has put India on the right path to 8%+ real GDP growth with this budget for the foreseeable future. With India's demographic dividend (the median Indian is aged 27), its economy could arguably sustain 9%+ real GDP growth for the next two decades as it"catches up" with that of China and other countries that have more recently industralized, such as South Korea and Taiwan. ETFs that we are tracking and that we may purchase for our Absolute Return strategy include: **INDA**, **EPI**, and **INXX**.

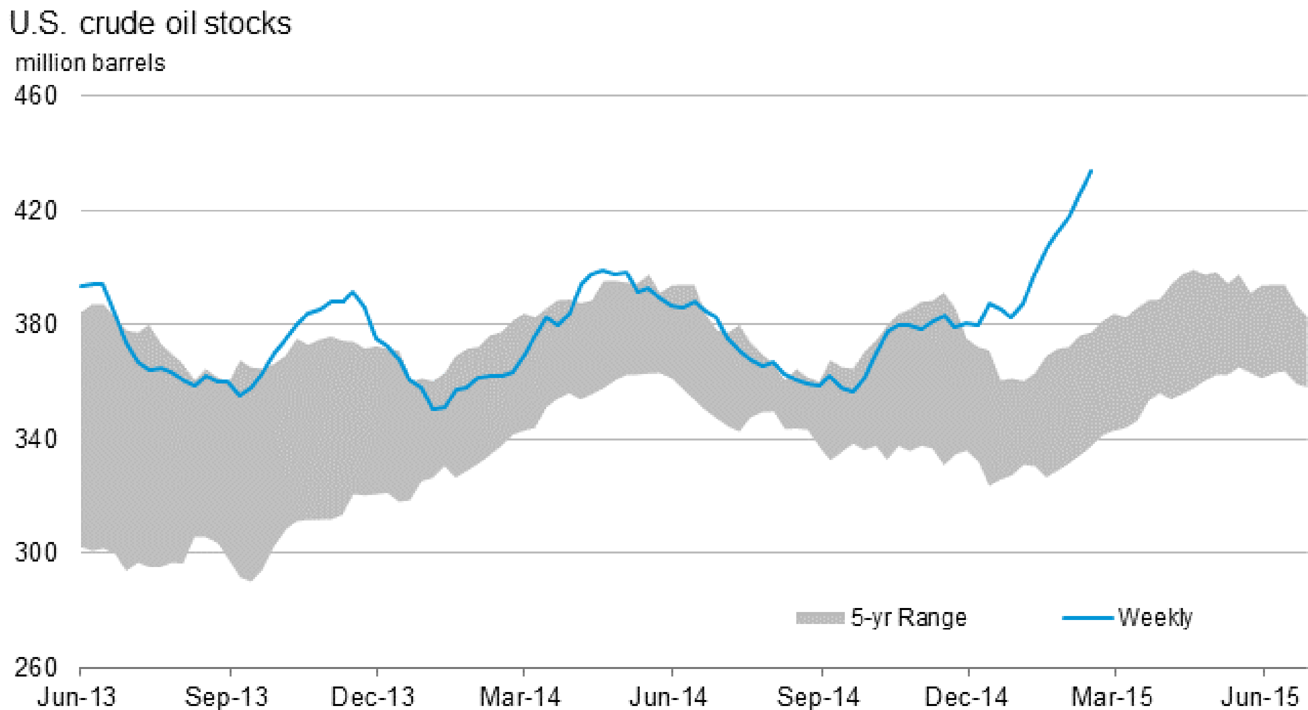
Clarifying our position on U.S. Treasury rates – Still neutral overall but potential long trading opportunities

In our February 15, 2015 newsletter, we revised our position on U.S. Treasuries from "mildly bearish" (i.e. higher rates) to "neutral" this year. This came after a 35 basis point rise in the U.S. 10-year yield over the February 2-15 timeframe; but more importantly, we revised our position as the spread in the German bund and U.S. Treasury yields (across their entire curves) soared to 25-year highs. The 10-year spread is at 1.66% (the German 10-year yield is at 0.34%) as we are writing this. With net issuance of DM sovereign debt forecasted to hit a 30-year low this year—and with the ECB sovereign QE policy due to begin this month—we believe there is every incentive for Euro Zone investors to seek higher yields by investing in U.S. Treasuries or other spread products. That being said, we continue to believe that U.S. real GDP growth will hit 3.0% this year, which will put some upward pressure on U.S. Treasury yields. As such, we believe that U.S. Treasuries may be only good for trading opportunities (or as a hedge for a potential correction in U.S. equities) on the long side this year. Our Absolute Return strategy currently has a long position in **TLT**, an ETF that replicates the returns profile of long-term U.S. Treasuries (with maturities of 20+ years).

WTI crude oil may retest its recent lows, but another buying opportunity is coming

In our January 25, 2015 newsletter, we mentioned that we would purchase **USO** as a short-term speculative play. USO closed on January 23 at $17.00 a share; we bought at $17.20 the following week. We subsequently sold our **USO** position on February 27 at $19.56 a share for a 13.72% gain, as: 1) the price of WTI crude oil (front-month contract) was reacting less to what we deem to be bullish U.S. oil rig count data, and 2) instead, it was reacting more to inventory data, which was far less bullish than we were projecting as U.S. oil storage continues to build. According to the U.S. Energy Information Administration (EIA), U.S. crude oil inventories (excluding those in the Strategic Petroleum Reserves) hit 434.1 million barrels for the week ending February 20, a record high for this time of the year. We expect U.S. crude oil inventories to continue to build over the next several weeks, which could put further downward pressure on both the WTI spot price and the WTI front-month futures contract. However, as we have discussed, we believe U.S. shale oil production will peak in the April/May timeframe, especially if the WTI spot price retests its January lows of $44-$45 a barrel.

Figure 2: U.S. crude oil inventories at its highest level for this time of year (week ending February 20, 2015)



Our April/May 2015 projection for a shale production peak is being boosted by Lynn Helms, North Dakota's head of Department of Mineral Resources. In a February 13, 2015 publication, Mr. Helms reported an ongoing postponement of completion work by operators in order to avoid the low current prices. In addition, Mr. Helms also mentioned that the oil rig count in North Dakota could shortly dip below 130, which he estimates was necessary to maintain the state's current output at 1.2 million barrels/day. According to Baker Hughes, the North Dakota oil rig count has now declined to below 130 since Mr. Helms' February 13 statement, suggesting an imminent peak in North Dakota's oil production. Other states' data that we are tracking individually include those of Texas and New Mexico.

As we are writing this, the April 2015 contract is trading at $48.78 a barrel; for the May 2015 contract, $51.06 a barrel. The contango between the two contracts is at $2.28 a barrel, or 4.7%. As such, we do not believe it makes sense to purchase an ETF such as **USO** (which holds the front-month WTI futures contract), as one will lose 4.7% within 30 days just on a roll basis! We will revisit a potential long position in the **USO** later this month once the ETF rolls over to the May 2015 contract. Should the contango narrow at that time—and should U.S. crude oil inventory growth decline—we will think about going on the long side of **USO** again. We are also tracking the **XLE** and **XOP**, as well as our favorite North American natural gas producers[3], but we do not believe there are any long opportunities in these stocks just yet.

Reiterating our cautious stance on U.S. equities – looking for an imminent correction

Over the last two weeks, we have repeatedly emphasized our short-term cautious outlook for U.S. equities, given the declining earnings outlook for 2015, the overbought conditions in U.S. stocks as indicated by our CB Capital Global Overbought-Oversold

[3] The April 2015 Henry Hub natural gas futures contract is trading at $2.71/MMBtu as of this writing. We believe U.S. natural gas prices will remain weak, thus dampening our enthusiasm for our favorite North American natural gas producers: **CNQ, COG, RRC, SWN, and UPL**.

Model, and extreme investors' complacency as signaled by the overbought readings in our proprietary U.S. stock market sentiment indicator, the **Combined Bulls-Bears% Differential Ratio.**[4]

As of this writing, the trade-weighted U.S. Dollar Index is at a six-year high, which will further dampen the 2015 earnings outlook for the S&P 500, as foreign sales account for more than 40% of the companies in the S&P 500, while 261 companies in the index derive more than 15% of its revenues from outside the U.S. Within the S&P 500's ten major sectors, the technology sector has the highest percentage of foreign sales at 57%. The declining earnings picture, combined with elevated valuations as measured by the forward P/E and P/B ratios of the S&P 500, suggests that the market is ripe for a correction.

Figure 3: S&P 500 NTM P/E ratio at its highest level since 2001… (Source: Goldman Sachs)

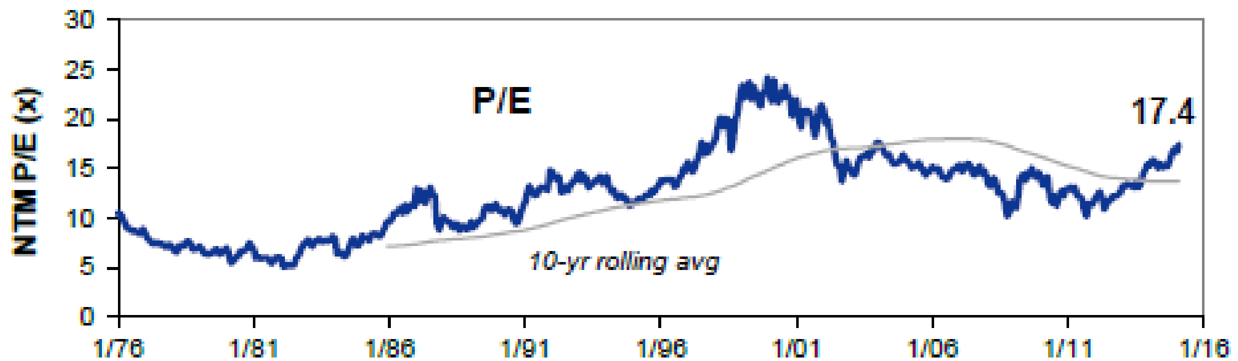
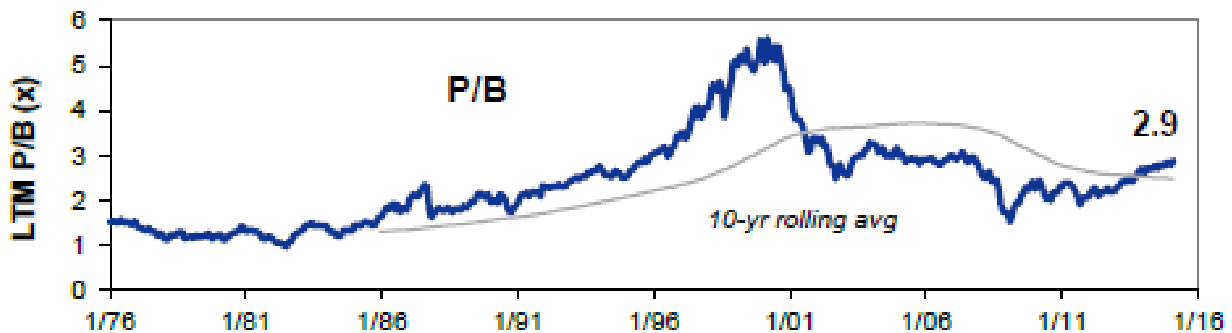


Figure 4: S&P 500 P/B ratio also at its highest level since 2001… (Source: Goldman Sachs)



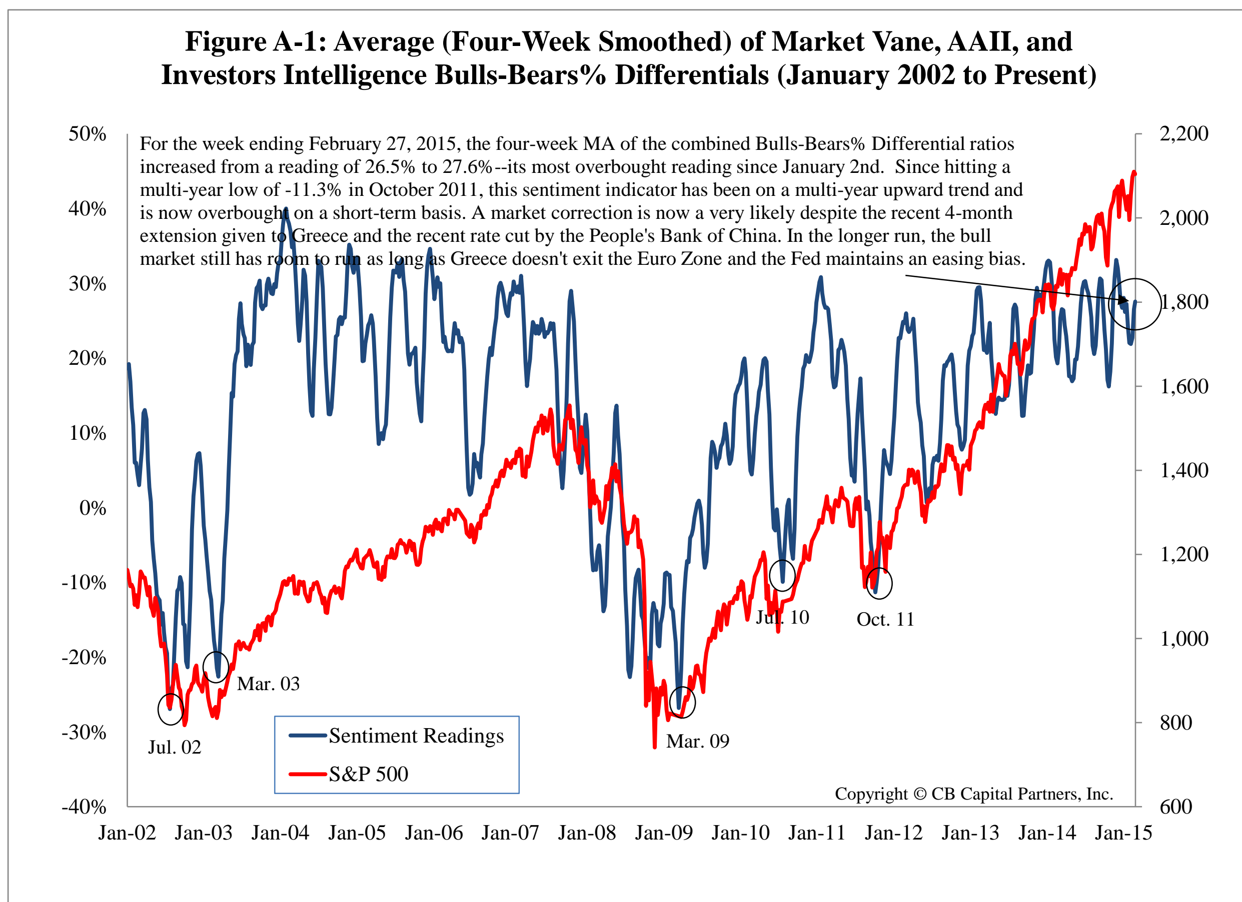
The S&P 500 NTM P/E ratio has recently spiked as earnings for the energy sector declined due to lower energy prices. The elevated NTM P/E ratio means that many investors are looking beyond the current downturn in earnings, i.e. their expectations are for the earnings of both the S&P 500 and the S&P 500 energy sector to normalize in 2016, and beyond. This may or may not happen; for now, we believe that investors are being too optimistic. This complacency is also being demonstrated in the elevated P/B ratio of the S&P 500, which is at its highest level since 2001 (see Figure 4 above).

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

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**."[5] 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 has been on a consistent uptrend 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 we is neutral territory at best. This means U.S. retail investors remain very complacent. Last week, this reading increased again from 26.5% to 27.6%--its most overbought reading since January 2, 2015. From a contrarian standpoint, this is bearish; as such, U.S. stocks are thus highly vulnerable to a correction, especially given the lack of a 10%+ correction over the last 3 ½ years.



[5] 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 the New York Times Business Section, the Wall Street Journal, MarketWatch, TraderPlanet, among other publications. 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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