At the National People’s Congress in Beijing in March 2015, China’s Premier Li Keqiang announced a growth target of 7 percent, acknowledging that “deep-seated problems in the country’s economy are becoming more obvious.”

Three months later and thousands of miles away in Washington, the World Bank lowered its growth forecasts across the board and asked the US Federal Reserve Bank to delay any contemplated rate hikes. The World Bank’s chief economist said that it had “just switched on the seat belt sign. We are advising nations, especially emerging economies, to fasten their seat belts.”

So it’s going to be a bumpy ride? How bumpy? And for how long? (Source: McKinsey Global Institute. They address these questions. You’ll find the link below.)

And the Fed? Jeffrey Lacker, president and CEO of the Richmond Fed said this morning, the “real side” of the economy is calling for a higher interest rate. Adding that, “It’s time to align our monetary policy with economic progress.” The market is under pressure again today.

Will they, won’t they? They have created a bipolar market. What is clear, at least to me, is that the global economy is in a deflationary stranglehold. Debt and demographics are the immediate enemy.

“To be clear, while we might see a tiny tightening akin to what was experienced in 1936, we doubt that we will see anything much larger before we see a major easing via QE,” Ray Dalio

Sorting valuations into 5 categories ranging from 1 (least expensive) to 5 (most expensive) and looking at the 10-year returns you would have received if you bought “when the hamburgers” were cheap (see Buffett Burgers and The Hallelujah), category 1, or if you bought when the burgers were expensive, category 5, you can get a good sense of what your stocks are going to do for you over the coming ten years. Here are the stats (source – NDR):
• Quintile 1, GPA = 15.91% (Lowest P/E)
• Quintile 2, GPA = 13.82%
• Quintile 3, GPA = 10.38%
• Quintile 4, GPA = 8.29%
• Quintile 5, GPA = 2.94% (Highest P/E)

Give me 1, 2, 3 or even 4. We are in quintile 5. The data says we should expect the equity market to return close to 3% over the coming ten years. That’s before inflation. It is hard to get excited about equities. It is also hard to get excited by bond yields at 2.15%. I wish I could but I can’t. Think differently we must.

Therefore, underweight equities (and hedge), underweight fixed income (tactically managed) and overweight alternative strategies (defined as anything other than traditional buy-and-hold). That category is not dependent on a one directional up market to make money. Broaden your set of combined risks. In this regard, send me an email if you’d like a free copy of our white paper on Correlation and Diversification.

Back to McKinsey – McKinsey believes there will be three sets of forces shaping the global economy over the coming decade. 1) Stimulus policies and shifting energy markets. These are near-term forces whose effects are felt on a daily basis. 2) Urbanization and aging are powerful, inexorable trends aggravating ongoing structural challenges and 3) Technological innovation and global connectivity.

The report is well done. I summarize some of their findings below and provide you with a link to the full piece.

Volatility and uncertainty are nothing new in financial markets. In my latest Forbes piece, “Welcome To The Opening Round Of The New Bear Market”, I share a few ideas around hedging. QE4 may right the ship but that is the bet. No guarantees in this game.

Finally, we conclude this week’s letter with a look at the technical evidence. The charts are updated in Trade Signals and suggest a new cyclical bear has begun.

Included in this week’s On My Radar:

- Shifting Tides – Global Economic Scenarios for 2015-25, McKinsey Study
- Welcome To The Opening Round Of The New Bear Market, Forbes
• Trade Signals – Extreme Pessimism Supports ST Rally. Trend is Bearish. Sell/Hedge on Rallies.


McKinsey is perhaps the world’s most respected global corporate consulting firm. Though I note that I am a biased fan.

The McKinsey model incorporates more than a dozen major international databases from such institutions as the United Nations, the World Bank, the International Monetary Fund, and the Bank for International Settlements. Selection of data sources is based on their authoritativeness, comparability, extended time series, and country and concept coverage. The result is a historical database that provides complete time series data for more than 150 concepts and 110 countries over 30 years.

Following I share a number of bullet points that attempt to get to the heart of the piece (13 pages). I provide a link to the full piece below.

• Of immediate concern is the persistent problem of weak aggregate demand relative to overall economic capacity. The International Monetary Fund estimates that production in the ten largest advanced economies was 2 percent below potential in 2014. This gap was smaller than it had been in 2009 (3.3 percent) but significantly worse than the surplus of 0.8 percent that prevailed in the early 2000s.
• All major economies except China experienced significantly weaker demand in the aftermath of the global financial crisis. Many governments and central banks responded with fiscal and monetary stimulus programs that fostered the low real interest rate environments which have endured for over five years.
• The McKinsey Global Institute reviewed the recent performance of advanced economies and found that they had all increased rather than reduced their overall debt levels—in some cases, by more than 50 percent. (SB: emphasis mine)
• Complicating the picture is the question of whether real interest rates will remain low (Exhibit 2). (SB: The real interest rate is the current rate less inflation. Europe, England, Japan and the US are all negative. Put Germany in that camp as well.)
Persistently low interest rates encourage investors to search for yield and safety, creating the preconditions for asset bubbles and further volatility in international financial flows.

Economists are concerned that unconventional monetary policies have distorted rather than bolstered the demand picture. (SB: see Fed comments here)

In the United States, for example, the Federal Reserve signaled for months that it would raise rates by the end of 2015, heralding a return to a more conventional, interest rate–driven monetary policy. In the interim, however, results were tepid and now a rate hike may be further delayed.

Europe and Japan are in the same situation. McKinsey adds, “Demand in major markets remains weak enough, furthermore, that a misstep in any one of them will be felt by the others.”

Oil prices fell by 50 percent in the latter half of 2014. Even after a slight rebound, they remained well below average levels of the past five years. For energy consumers, the lower energy prices have provided a welcome respite; for producers, they challenge fiscal stability.

The breakeven oil price—the price at which a fiscal surplus turns into a deficit—is estimated at $57 for Kuwait and $119 for Algeria. Countries have so far managed the crunch by drawing down reserves and through exchange-rate movements, but these are short-term actions and direct fiscal adjustment lies on the horizon. (SB: emphasis mine)

Persistent demand weakness and falling oil prices are the stuff of daily headlines, but associated effects could drive alternative economic outcomes for the next decade. The complication is that deeper forces are at work.

The effects of urbanization and aging are predictable and are tilting the global economy in one general direction: toward emerging markets.
Increasing urban congestion and an aging labor force impose burdens—among them, lower productivity, falling demand, and rising health and pension loads—on all economies. The challenges are clear.

McKinsey research indicates that 46 of the world’s 200 largest cities will be in China by 2025, a sign too of the eastward migration of the global economy’s center of gravity.

On China’s demographic pressures. The labor force, on which economic activity depends, is both aging and shrinking. It is expected to contract by 11 percent in China by 2050, even as the country’s economy expands.

The shrinkage in continental Europe is expected to be even more dramatic.

As life spans are growing and birthrates falling, furthermore, an aging working population in advanced and emerging economies will be supporting ever-higher numbers of retirees.

Among the major economies, only the United States has a demographic profile favorable to long-term economic growth.

For the rest of the leading economies, expected productivity improvements will not bridge the gap.

Without a fundamental economic and cultural shift, favoring continued participation of older workers and the introduction of more women workers and immigrant labor, many economies would face serious growth constraints within ten years.

The report takes a well thought out look at the interconnected nature of the global economy. There is so much more in the paper and I don’t want to do a disservice to their research so I’ll jump to the conclusion on potential global economic scenarios 2015-2025 (Exhibit 9) and encourage you to click on the link to the full piece below.
“Global synchronicity” (scenario 1) describes a world where most major economies tackle their structural challenges, and are able exit from aggregate demand stimulus smoothly. “Rolling regional crises” (scenario 4) describes the opposite outcome.

My personal view is we must somehow move through the debt and coming pension mess. Promise more, tax more, spiral lower. Some form of restructure is in our not too distant future. We have choices yet what we chose will set the path. I’m praying for Scenario 1 yet we seem to be in Scenario 3. Let’s hope the worst case is Scenario 3. Scenario 4 is deflation that moves to depression.

The end game is inconclusive for our path is yet to be determined. Overall, the McKinsey report does a great job in laying out the possible outcomes between 2015 and 2025.

Here is the link to the full piece:

Welcome To The Opening Round Of The New Bear Market, Forbes

I believe we are in a modest correction period – a new cyclical bear cycle has begun. If we do not experience a U.S. recession, the downside should be limited to less than 20%.

Another QE, from my view, is in the cards. That may stem the fall. I hold less hope in structural reform.
Unfortunately, we’ll need another crisis to goose our leaders in that direction.

As you’ll see in the charts posted in Trade Signals, I believe we are now in a cyclical bear market. How long and how much, in my view, depends on the response of global central bankers or our collective loss in the confidence we have placed in them.

Read the piece and let me know what you think. On page 4 you’ll find several ideas that may help you hedge your equity exposure and I mention a fund that has almost zero correlation with both the stock and bond markets. That can help with diversification.

Click here for the Forbes article.

Trade Signals – Extreme Pessimism Supports ST Rally. Trend is Bearish. Sell/Hedge on Rallies.

Since last week’s post, the S&P 500 Index has rallied 77 points off of last week’s Investor Sentiment Extreme Pessimism low. A gain of 4.11%. Following are several charts that look at the 2011 correction and today. Let’s see if we can get a sense for reasonable bounce targets (levels to either raise cash or re-establish hedges).

Sentiment remains Extremely Pessimistic which is short-term bullish for stocks. The overall trend is bearish for equities. I also note that the Zweig Bond Model is back to a sell signal which is bearish for bonds.

Along with the usual weekly charts, I share several technical charts that reflect near-term upside and downside price targets for the S&P 500 Index.

Included in this week’s Trade Signals:

- Cyclical Equity Market Trend: Sell Signal
  - CMG NDR Large Cap Momentum Index: Sell Signal
  - 13/34-Week EMA on the S&P 500 Index: Sell Signal
  - NDR Big Mo: Neutral – Nearing a Sell Signal
- Volume Demand is greater than Volume Supply: Sell signal for Stocks
- Weekly Investor Sentiment Indicator:


  - Don’t Fight the Tape or the Fed: Neutral signal
  - S. Recession Watch – My Favorite U.S. Recession Forecasting Chart: Signaling No Recession
  - The Zweig Bond Model: The Cyclical Trend for Bonds is Bearish

Click here for the link to all of the charts.

Concluding thoughts
All 'bout that Fed. If the Fed raises rates in September. Look out. I remain of the view that they will not raise rates in 2015.

With kind regards,
Steve

Stephen B. Blumenthal
Chairman & CEO
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Stephen Blumenthal founded CMG Capital Management Group in 1992 and serves today as its Chairman, CEO and CIO. Steve authors a free weekly e-letter titled, On My Radar. The letter is designed to bring clarity on the economy, interest rates, valuations and market trend and what that all means in regards to investment opportunities and portfolio positioning. Click here to receive his free weekly e-letter.

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