John Dessauer Investments, Inc.

www.johndessauerinvestments.com

John Dessauer's market review and update as of Wednesday December 23, 2015

Stocks fell sharply last week, but don't blame the Federal Reserve. The 367 point plunge in the Dow Jones Industrial Average was due to Friday's being a Quadruple Witching Day, the last one for 2015.

When a series of derivatives expire on the same day it is called a Witching Day. When four specific types of derivatives expire, it becomes a Quadruple Witching Day. The four are: stock index futures, stock index options, stock options and single stock futures. Quadruple Witching happens once each quarter, on the third Friday of the last month in the quarter. On the expiration day, futures and options holders must close out their positions. That usually leads to an increase in stock market trading volumes. And, as we saw last Friday, it can also increase volatility and exaggerate market moves. But the expiration of futures and options does not change underlying fundamentals. Nor does it provide any special insights for future market performance.

The Federal Reserve, as expected, raised short term U.S. interest rates by 0.25% last week. Investors were right to celebrate. It is positive that the Federal Reserve board members unanimously saw the U.S. economy as strong enough to require an interest rate increase. The celebration, however, turned out to be short lived. Normal profit taking after a market rally was exacerbated by the Quadruple Witching Day. Triple digit stock market declines are scary. Pessimists use them to boast and cite them as evidence of more pain to come. However, the pessimists are likely to be wrong again. The U.S. economy is

still chugging along, growing at about a 2%-2.5% annual rate - good enough to provide fuel for modest growth in corporate profits and higher stock prices.

Another source of investor anxiety was news that a few obscure funds had either been forced to liquidate or stopped allowing withdrawals. The best known was a fund managed by a firm called Third Avenue. The fund once had assets of $3 billion, but lost 27% and was subject to massive withdrawals. With $790 million left, Third Avenue was forced to suspend redemptions. The day after the Third Avenue announcement, a hedge fund manager called Stone Lion Capital suspended redemptions from its high yield or junk bond funds. On December 14, Lucidus Capital Partners said it had liquidated all its high yield or junk bond investments.

In August 2007, three investment funds managed by a French bank BNP suspended redemptions. The three funds accounted for a tiny 0.5% of assets managed by the bank at that time. But, like the canary in the coal mine, the closings turned out to be one of the first signs of the coming credit crunch and financial crisis of 2008. The question now is: are the recent fund closures, like the BNP funds of 2007, the first sign of another global credit crisis? *The Economist* magazine examined this question and concluded that this time the junk bond fund troubles are a Canard, not a Canary. First, overleveraged companies in the energy sector account for most of the recent junk bond problems. However that is not typical of the industry. Schlumberger, for example, recently sold $6 billion in bonds at a 1-2% premium over Treasuries. In addition, high risk bonds associated with oil or commodities account for only $225 billion of the $1 trillion market for high yield or junk bonds. Second, by their very name junk bond funds

are recognized as high risk investments. The BNP funds that collapsed in 2007 were conservative, modest risk investments.

High risk investments do not always fail. Sometimes, as was the case with Greek government debt, they can provide exceptional returns. That is why some investors knowingly take the risk and buy shares in junk bond funds. And because the risk is well known, junk bond funds make poor Canaries. The recent closures are no more than another consequence of falling oil and commodity prices. And low oil and commodity prices are already proving to be positive for consumers and the overall economy.

While Quadruple Witching Day and the closure of a few junk bond funds may be capturing headlines and currently scaring investors, there is another risk to global financial markets, one that has not drawn much media attention. That is Beijing's control over China's currency. For decades leading American politicians have accused China of currency manipulation, keeping the yuan low to favor Chinese exporters. This accusation has been heard recently from some of the candidates for next year's presidential election. Their assumption is that the free market would push the value of the Chinese yuan significantly higher. That assumption is looking very wrong.

China has been loosening the controls on its currency. The Yuan is now directly convertible into all major world currencies, including the Swiss franc. The yuan is now also a recognized reserve currency. In addition China has opened the door to investing in Chinese stocks, allowing more foreign direct investment. The problem that American politicians do not appreciate is the high personal savings rate in China. As China has reduced capital controls, there has been an increase in money flowing out of China. Chinese with excess savings want to diversify by investing outside of China. Nikolaos

Panigirtzoglou, a strategist for JP Morgan, calculates that $30-$40 billion will flow out of China every month for the next year. The problem is that no one, including government officials, really knows what the potential outflows might be. There is, therefore, a risk that Beijing will go too far in loosening controls and the yuan will spin out of control, pushed down by huge capital outflows. If that were to happen, it would force other neighboring countries to follow and devalue their currencies. The result would be a global currency crisis and a plunge in global trade.

Beijing has promised the International Monetary Fund and its global trading partners that it will act to make the Chinese currency more market driven. But no one wants to see a precipitous decline in the yuan. Hopefully, poorly informed political leaders, especially in the United States, will awaken to the real Chinese challenge, namely capital outflows, and stop pressuring Beijing. That would be a positive development. However, if they do not awaken and continue their misguided pressure, you can be sure Beijing will take action and not allow a free fall in the yuan. Beijing has endured decades of misguided pressure from American politicians and can endure a few more months. While a yuan collapse is a risk, odds are that Beijing will maintain control and the yuan's decline will remain orderly.

While risks abound, and pessimists proliferate, stocks will continue to climb the wall of worry. When the coast is clear and investor sentiment migrates to euphoria, there will come a time to sell. Meanwhile, the best returns will be from stocks in companies with strong cash flows and solid dividends.

I will have the next market review and update for you one week from today on Wednesday December 30, 2015.

Merry Christmas and a belated Happy Hanukkah,

John Dessauer

©December 2015