January 5, 2016

2016 Outlook: On Verge of Deflationary Recession

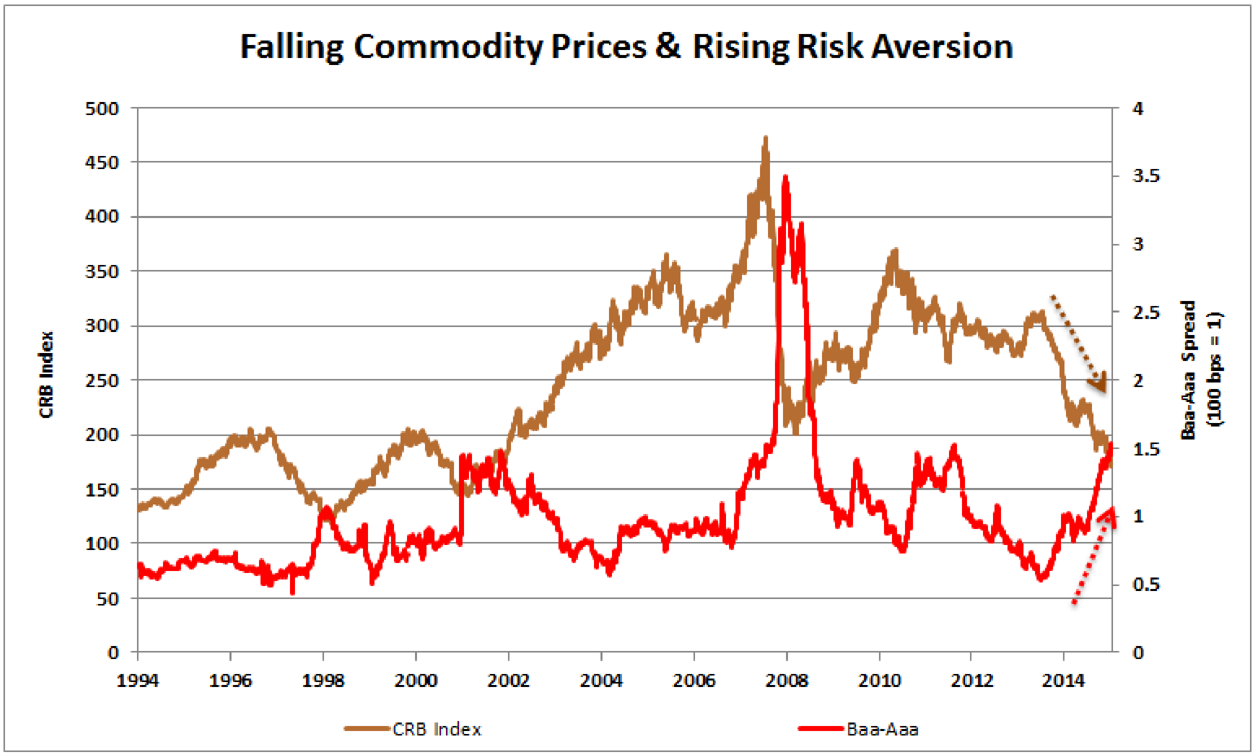
Executive Summary: As 2016 dawns we see the U.S. economy teetering on the brink of a deflationary recession, led by an excessively strong dollar and the Federal Reserve's threat to raise the cost of capital. We believe things are likely to get worse before they improve. A slow, gradual interest rate hiking cycle, as the FOMC is telegraphing today, would weaken an already sub-par growth environment. The disturbing gap between the FOMC's expected rate path and the market's more dovish expectations will likely narrow on the back of increased economic and market volatility. We believe there is a strong chance for equities to sell-off 10% or more during the first two quarters of 2016, which could send a number of commodities to new lows. For instance, oil could fall below $30/bbl. We expect the economic and political ramifications of such volatility will cause the Fed to shift back to defense in 2016. This forms the basis of an optimistic scenario for equities. Currently, Iowa Electronic Markets suggest that the Democratic Party is the odds-on favorite (61/39) to win the upcoming presidential election, with even odds of Republicans retaining Congress. Any pronounced market weakness, however, is likely to give Donald Trump, who we now believe will be the Republican nominee, the political advantage over Hillary Clinton. Because of that we expect the Yellen Fed to abandon its current, relatively hawkish posture by the second half of 2016. It may even begin to revisit the possibility of QE IV. So long as enough political pressure is exerted on the FOMC to compel an about-face on monetary policy, it could lead to important relief to the ongoing deflation. Such a pivot could wipe out 2016 year-to-date equity losses in a hurry. If this is followed by improved pro-growth fiscal possibilities following the November elections, look for a Santa Claus rally. Under such a scenario, we expect the S&P 500 to end the year at 2105, delivering a ~3% return on the year. We also believe the gold price will rise to $1175 and the 10-year Treasury yield will remain subdued between 2.0% and 2.15%. We expect oil to rise by at least 35% in 2016, ending the year above $50/bbl. We predict the euro will end the year at $1.05/€ and the yen at Y125/$.

2015 Review: 2015 was defined by an increasingly strong, deflationary dollar, and an increasingly hawkish Federal Reserve. A global glut of oil and natural gas emerged due to waning global demand, thanks in part to an increasingly spotty global growth outlook. Trade sanctions between Europe and Russia continued, crimping growth for both; meanwhile the dramatic economic slowdown in mainland China added to an increasingly bearish outlook for end-market demand for commodities.

For equities, this combination proved bearish, with the S&P 500 finishing at 2,043.94, well below our year-end 2015 forecast of 2250. Our 10-year Treasury yield and gold price predictions were also off the mark. The 10-year yield closed at 2.2694% (above our forecast for a 1.4% yield); and gold at $1060.20, well below our prediction of $1200. Still, our broader themes of 1) continued dollar strength, 2) avoiding commodities, and 3) favoring tech-related sectors (that traditionally outperform in deflationary environments) paid off. For example, the Biotech and Technology ETFs, Biotech (XBI) and Technology (XLK), respectively produced for the year a simple return of 13.59% and 3.94% versus losses of 23.71% and 9.84% respectively for ETFs for Energy (XLE) and Basic Materials (XLB).

As 2015 drew to a close, signs of growing financial stress and deflation coincided with oil falling below $40/bbl and the gold price falling below $1100/oz, with layoffs and bankruptcies in the oil and gas sector beginning to accelerate. Not surprisingly, risks to the oil patch and the financial institutions bankrolling them increased, with evident and likely related turmoil increasing in the high yield bond market.

The inverse relationship between growing risk aversion and weakness in the commodity sector is illustrated in the following chart, which shows a strong inverse correlation between the Baa-Aaa spread and the Thomson Reuters/Core Commodity Index (CRB). Interestingly, both began to move inversely to each other in March 2014, as the first set of sanctions were applied on Russia following the Crimean referendum, which led to its split from Ukraine and eventual union with Russia.



For contrarians and optimists, such circumstances may represent a ripe opportunity to go bullish on the dogs of 2015, such as energy and equities in general.

Market consensus seems to believe that 2016 will be better than 2015. On financial networks, guest strategists appear to be preaching a turnaround year for the S&P 500 with at least an 8% appreciation. There also seems to be a popular sense that sub-$40/bbl oil prices will give way to higher prices in 2016, even “shortages” appearing as the growth picture firms during the next twelve months and shuttered oil investments leave overall production capacity in a state of von Misean scarcity.

For us, such a prediction is hard to fathom if deflation and contraction persist during the balance of 2016. If dollar strength and an interest rate hike campaign continue, there is more trouble ahead for the growth outlook and consequently equities. **We need a major "macro shift" to become more optimistic.**

2016 Elections: Republicans will retain control of the House and the Senate; this despite facing a number of strong challenges among the 24 GOP Senate seats up for re-election. We expect Hillary Clinton to be elected president in November, beating Donald Trump (or the eventual GOP nominee) in an election contest that will likely be closer in the popular vote than the last two presidential elections. Whereas Obama earned a blowout victory with the electoral college, gaining 332 votes versus Romney's 206 in 2012, we expect Hillary to win with less than 300 electoral votes.

Because Hillary is currently running as an extension of President Obama's second term, her embrace of the status quo could become a liability. In a worst-case scenario for the Democratic Party, it could cause political realignment. Speaking in late December, Obama admitted that he may "represent change that worries" Blue Collar America. Specifically, he opined that in "this new economy" the day a "single paycheck" at a factory could support a family is over. In sharp contrast, the implied acceptance of a falling capital-to-labor ratio is rejected by the platforms of Trump, and supply-siders such as Senator Ted Cruz.

A black swan event exposing perceived inadequacies with the status quo (Administration support for anti-growth Fed policy or lax security and surveillance on radicalized Muslims) could quickly tilt the race in the GOP's favor. A non-Establishment Republican such as Trump (or Cruz, who backs a gold-anchored, stable dollar policy) could certainly make the race more competitive if the Federal Reserve continues to blunder by derailing the U.S. economy growth and/or another jihadist incident occurs, similar to the Paris & San Bernardino attacks. Of course, such hypotheticals are not part of our baseline scenario. We believe the Fed will pivot away from austerity in 2016 and we believe Federal surveillance and security are being beefed up in the wake of San Bernardino.

Four more years of a redistributionist Democrat heading the oval office might be off putting to the pessimist. But we believe the possibilities for pro-growth tax legislation coming through Washington will stand a better chance during the next two years under a Clinton-Ryan Regnum than at any time during Obama's tenure.

For one thing, unlike the Obama-Boehner Regnum, where GOP leadership mainly played "defense" on tax policy, we see the House transitioning to "offense" under Ryan's new leadership. His agreement to make the House a more deliberative body opens the door for long dormant, but necessary national conversations over fiscal policies to encourage economic growth, the best monetary policy to preserve dollar stability, and an examination and reform of the anti-growth regulatory burdens created by Sarbanes-Oxley and Frank-Dodd.

In recent months, we have seen a more committed supply-sider in Paul Ryan as House Speaker. 2015's year-end tax extenders, which included a capital gains tax exemption on the sale of start-ups that have been in business for 5 years, suggests the direction ahead is positive. And with Texas supply-sider Kevin Brady chairing the all-important tax-writing House

Ways & Means Committee, we see Congress serving as the intellectual hothouse for pro-growth policymaking ideas.

For her part, Clinton has demonstrated an ability to tack toward the center on tax policy. On the campaign trail she has already begun to the process of triangulating on fiscal policy by saying that she would not allow a single tax increase on the "middle class" if elected. We view her as more likely to win some accommodation with the base of her party in fashioning a compromise that makes it into law.

Economic Statistics: Unemployment, GDP, CPI but no sign of "deflation?"

Because we use the gold price signal as that most perfect of monetary indicators of incipient deflation/inflation, the deflationary problems of an excessively strong dollar have been building over several years. Since peaking in 2011 at nearly $1900/oz, the dominant monetary trend during the last four years has been deflation with the dollar-gold price declining nearly 44%, and the CRB 47%. The average gold price in 2012 was $1668, in 2013 $1411, in 2014 $1265 and $1160 in 2015. It closed out 2015 at $1062.51.

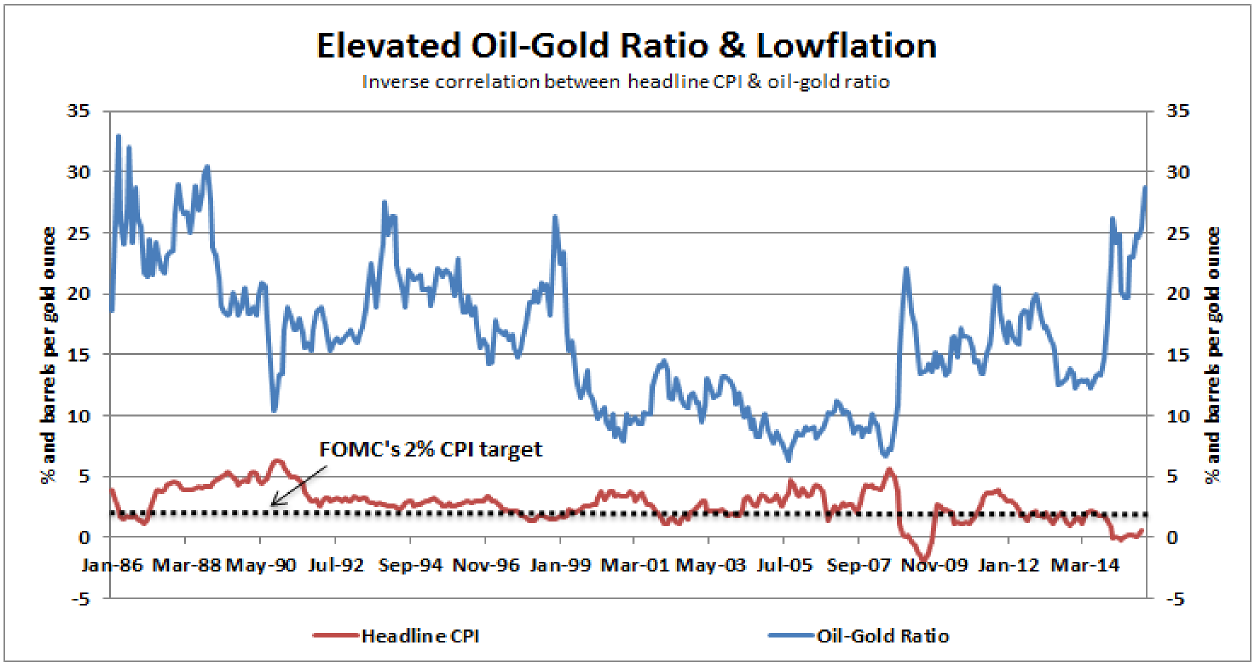
During the past twelve months, the dollar has strengthened more than 10% against the euro, 9% in dollar trade-weighted terms (DXY), more than 23% against the Thomson Reuters/Core Commodity CRB Index (CRB) and more than 30% against oil. This follows on a 2014 where the dollar strengthened against the euro (11.7%), DXY (12.8%), CRB (17.9%) and oil (45.9%).

Despite the warning signs of a deepening deflation and growing financial stress as 2015 wound down, the majority of Fed policymakers remain confident that the economy is healthy enough to shoulder the burden of rising capital costs. FOMC policymakers were satisfied with economic conditions to begin "tightening" in December. That headline and PCE inflation data were declining and flirting with zero (both were 0.5% and 0.4% annualized for November) was an afterthought at the last FOMC meeting. In her press conference on December 17, Fed Chair Janet Yellen expressed confidence that inflation could reach the Fed's 2% target by 2019, euphemizing the current deflationary trend as a "shortfall" on inflation.

Following Yellen's talking points, even if zero or negative inflation statistics show up this year, they will likely be explained away as 'transitory' impacts stemming from weakness in the energy sector or the result of a 'strong dollar' over which it professes the U.S. Treasury has dominion. But the persistence of deflation will remain a manifestation of the Fed's monetary errors.

The median forecast of the FOMC is for unemployment to reach 4.7% annualized in 2016. We believe that could happen during the first half of the year, but we expect unemployment to eventually tick higher and stabilize around 5% due to the higher cost of capital and the expected pain ahead for the commodity and commodity-related space given the persistence of a strong dollar. We expect GDP to decline slightly in 2016, with annualized GDP averaging 2.4% versus an estimated 2.55% for 2015. An elevated oil-gold ratio of about 28 barrels per gold ounce suggests below consensus headline CPI and PCE numbers in 2016. So long as the Fed allows deflationary conditions to persist alongside a sub-par growth environment, we expect CPI to persist well-below the bank's 2% target.

CPI & PCE may even go negative at times during 2016. We expect CPI and PCE to end the year at 0.7% and 0.65%, respectively; far from the Fed's 2% inflation goal.



Of course, any improvement to the growth outlook via improved fiscal policy and/or regulatory improvements could make the deflationary circumstances more tolerable, but would not likely bring monetary relief. Only a dovish, reflationary shift by the Fed could lay the foundation for a torrid rally for equity prices.

A quick reflation, say to $1150+, could even lead to a von Misean scarcity scenario where supply shocks catapult prices higher. For example, with oil, we note that the amount of excess capacity today is less than what existed during December 2012. With so much medium- and long-term production being cancelled or postponed due to a weak demand outlook, a reflationary, growth-led demand increase could quickly increase oil prices, sending statistical inflation higher, forcing the Fed to either characterize the price swings as 'transitory' or as indicative of an inflationary threat. We do not expect such a scenario until the latter half of 2016.

Monetary Policy: Our baseline scenario is that the Fed shifts during the course of 2016 and abandons its tightening stance by the second half of 2016.

Although the Fed's stance on interest rates may turn dovish later in the year, markets are beginning 2016 with the understanding that the Fed has no intention of increasing the money supply over the next twelve months. If growth stays positive, the supply of liquidity is to remain constant or, if the Fed begins 'normalizing' the balance sheet, it will shrink significantly. It's not difficult to paint a scenario for more deflation under this logic. If economic growth is expected to remain positive (although subpar) with headline unemployment reaching 4.7%, ceteris paribus, the demand for money should rise despite a frozen or shrinking supply of liquidity. The value of the dollar should increase.

Without a course correction to the Federal Reserve's de facto deflationary monetary policy, we would expect the gold price to decline below $1000/oz by the end of 2016.

Of course, the problem is as the dollar strengthens, it will likely put more stress on dollar debtors worldwide, especially emerging markets and commodity and commodity-related sectors in the U.S. and abroad.

In short, we expect more things to break. Such dislocations and the layoffs that accompany increasing bankruptcies from those affected sectors could quickly ratchet up political pressure on the Fed to abandon its current posture. Certainly, Republicans such as Trump and Cruz could make things interesting, if growth meaningfully falters under the direction of a hawkish Fed.

We believe odds of a Fed pivot to end the current deflation are rising, if only because the present trend suggests the environment for equity appreciation is likely to get worse.

Among a number of warning signals for volatility in the near-term are:

- Baa-Aaa spread is now at crisis levels circa 150 basis points;
- Internationally, sovereign default risks continue to rise for commodity-producing countries: Brazil, Russia, and in the Gulf and North Africa, including Saudi Arabia;
- Oil-gold ratio trades at 25+ barrels per ounce of gold, indicative of recessionary, non-threatening inflationary conditions;
- Credit spreads among all domestic investment sectors have widened in 2015 more than 400 basis points; Industrials are second worst, reflecting an 'industrial recession';
- Normally 'safe' utility sector spreads are the fourth widest, suggesting the strong dollar is taking its toll on heavily-indebted sectors;
- Average credit spreads in the energy sector are now above 1200 bps;
- 10 bankruptcies in the oil patch occurred in 2015, as the average oil price collapsed to less than $50/bbl vs. $90+/bbl from in 2014. More bankruptcies are likely in 2016 so long as oil remains depressed.

The Fed's inability to correct the slow-drip, chronic dollar deflation will likely continue to intensify those negative trends from 2015. Additionally, with the Fed recently committed to a gradual campaign of "normalization" which includes raising the cost of capital and reducing the supply of liquidity (shrinking the Fed balance sheet) regardless of money demand, we expect economic conditions to worsen before they improve.

We've seen such 'crisis points' before. For example, in mid-2012 with Europe, markets needed to see the utter repudiation of Jean Claude Trichet's brand of austerian rate increases & the introduction of the Draghi Put, which did much to diminish the threat of sovereign, currency and banking default in the Eurozone.

Geopolitical Risks Contained But Simmering: Last year, fighting persisted in geopolitical flashpoints such as Ukraine and Syria, but did not escalate into an all-out war between major powers. The Minsk II Accords signed without a U.S. delegation present in February helped contain the Ukrainian conflict. Although sanctions on Russia are being extended to July, the conflict is unlikely to escalate. The government in Kiev is being weighed down by anti-growth austerian policies, endemic corruption, a decision late last month to default on its $3 billion Russian debt and additional sanctions on Russia as it tries to force a political and economic shift closer to Europe by toeing the line on anti-growth austerity from the IMF and Brussels. Eastern Ukraine meanwhile, and perhaps out of desperation, has effectively begun to ruble-ize. Still, it is no closer politically to joining Russia than it was in March. Moscow remains committed to Minsk II.

Violence in the "Arc of Instability," including Iraq and Syria with Islamic State and Africa with Boko Haram, sent a flood of refugees into Europe which led to the rise of nationalist sentiment in the EU, sentiment that exploded after the Paris attacks on November 13. While France sought to lobby Western capitals for support in retaliating on ISIL-held territory in Syria and Iraq and collaborating with Russia, the net resolve of European nations has been to provide air support or logistics. No major commitment of ground troops has been struck. Meanwhile the U.S. remains very standoffish with openly allying with Russia, perhaps out of concerns for its main Mideast ally, Saudi Arabia, which still seeks regime change in Damascus and remains wary and perhaps a little paranoid of its own situation now that Iran is emerging from its diplomatic isolation.

On the Russian side, Vladimir Putin has made clear that he intends to aid Syrian President Bashar al Assad in reclaiming territory from rebels with airstrikes hitting Al Qaeda-affiliated al Nusra and other rebel groups along with strikes against forces of the Islamic State caliphate. Even with Turkey's shooting down of a Russian SU-24, which resulted in the death of one pilot and a Russian marine sent to rescue him, Russia has only responded with economic sanctions. We do not see both nations engaging in open hostilities, although Putin continues to allege that Turkey's President Erdogan has been a complicit partner in assisting ISIL with weaponry and finance (cash for oil).

A Saudi-led coalition intervened in the Yemeni civil war against the Shiia Houthis, but the Houthis are proving capable of counterpunching. They have recently taken Saudi territory in the Saudi's own southwestern provinces, despite daily airstrikes. Meanwhile, the House of Saud is reportedly in turmoil. Several members of the royal family disapprove of the Saudi war on Yemen, the country's stock market is performing terribly (down 17+% in 2015) and the kingdom's budget deficit is running currently at $93 billion, and there is a reported shift toward a more austerian footing. The country's recent decision to execute a Shiia cleric who preached non-violence and free speech has ignited protests in Iran and Iraq. Diplomatic relations with Iran have been suspended following the destruction of the Saudi Embassy in Tehran. 2016 opens with Saudi Arabia veering toward internal instability.

Although President Obama has taken incoming salvos from Republican candidates on his handling of Middle East troubles including the rise of ISIS and instability in Iraq, Afghanistan and Syria, he continues to stick to the center by refraining from a more aggressive policy response that could include large deployments abroad. The low poll numbers for neoconservative candidates such as Marco Rubio and former candidate Lindsey Graham testify to the unpopularity of interventionism with a war-weary electorate.

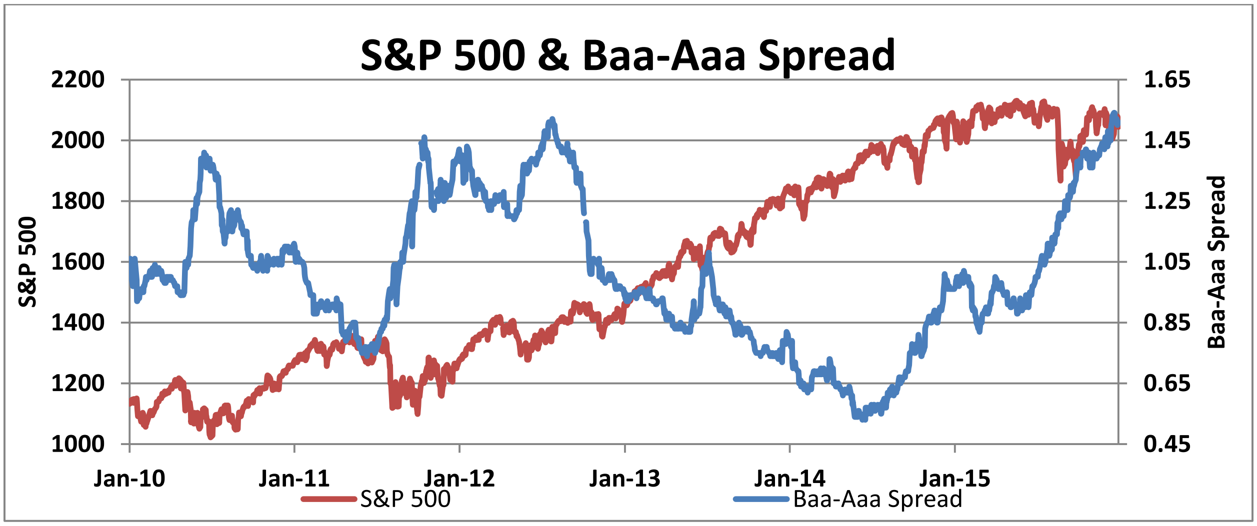
Foreign policy could prove to be one of Hillary's biggest vulnerabilities heading into November. She has been a leading proponent of a Wilsonian kind of interventionism that has led to the foreign policy disaster of Libya and the destabilization of Egypt, Syria, and Iraq. Trump opposes the idea that the U.S. should continue to be the policeman of the world. Indeed, so long as Trump continues to advocate that line, his foreign policy positions may be closer in line with Obama's 2008 campaign, which stopped Hillary's presidential ambitions cold.

2016 Tail Risks

Because we expect continued economic distress during the first half of the year there are a number of tail risks that could quickly ratchet up market volatility. We identify some of them below.

- Frontier markets of Middle East already suffering from a strong dollar environment could see greater economic and political instability ahead. Elevated CDS prices have been witnessed in Saudi Arabia, Turkey, Syria, Lebanon, Tunisia.
- Assassination/further political violence in Mideast, e.g. Turkey, Saudi Arabia, Syria, Lebanon.
- Dollar-tied countries depreciating their currencies relative to the dollar (or abandoning their pegs altogether), so as to create currency uncertainty for financial markets and economic actors – akin to the Asian flu of 1997-1998. China, Saudi Arabia and other Gulf currencies are the most at risk.
- Brazilian/Venezuelan/South African default/devaluation.
- EU refugee crisis leads to more obstacles for free movement of labor as well as trade, leading to utter break-down of the Schengen Pact and tax increases.
- Ukraine civil war heats up.
- Major corporate default(s) due to commodity price collapse.
- Additional terrorist incidents; more "terrorist tax."

Range-Bound Equity Market, Not Worth Holding Equities Until Fed Shifts: The U.S. stock market will be challenged by the headwinds of a tightening Fed and an anemic global growth outlook against the backdrop of monetary deflation. To be sure, the level of risk aversion as indicated by a Baa-Aaa spread widening to 150 basis points suggests we are at the cusp of a new crisis.

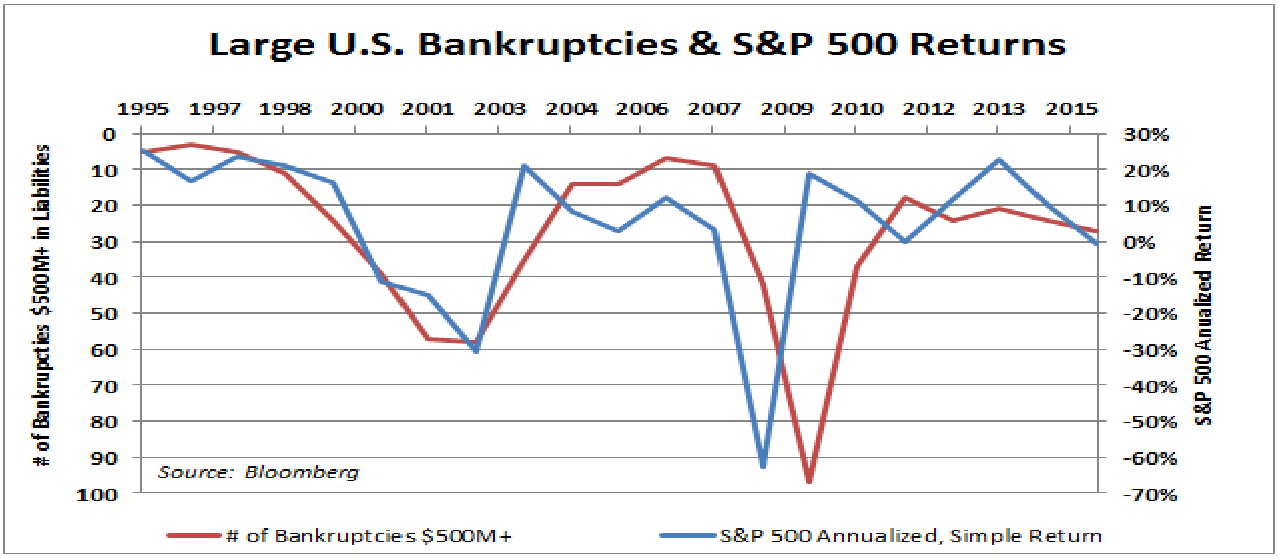


Historically, large bankruptcy volumes seem to coincide with peak risk aversion and negative equity performance.

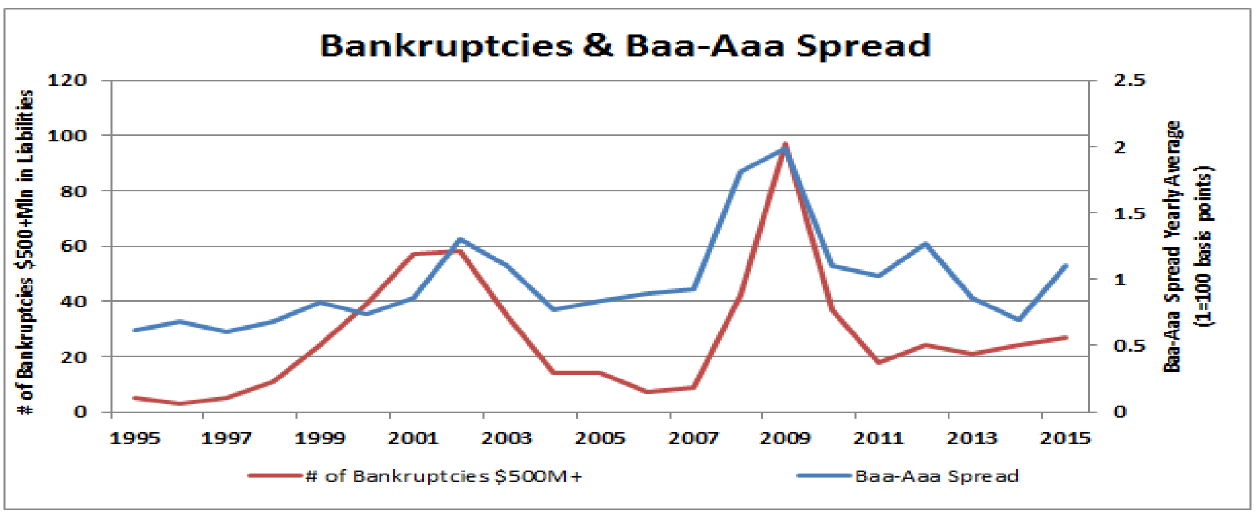
So long as the Fed's deflationary monetary tilt continues to drive risk aversion, it is likely that the number of bankruptcies will increase. Of the 27 bankruptcies filed in 2015 (for businesses with $500+ million in liabilities), 10 came from the oil & gas sector, 3 from coal and 2 from mining. For comparison, of the 25 bankruptcies in 2014, only 1 came from oil & gas, 3 from coal and 1 from mining. There is a good chance that 5 or 6 additional bankruptcies in the oil and gas sector are filed during the first half of 2016.

This kind of pain could ultimately cause the Fed to switch policy approaches.

As one case see in the following chart, since 1995 the volume of bankruptcy cases relate to the level of annual returns for the S&P 500. 2013 was the best year of the last eight in terms of annual returns. It was also the last time that large bankruptcies actually declined from the year before (18 in 2011 vs. 24 in 2012 vs. 21 in 2013). Since 2013, the annual number of bankruptcies has steadily increased, with annual market performances growing weaker each year. When bankruptcies rise rapidly, e.g. reaching 42 bankrupcties in 2008 from 9 in 2007 or 39 in 2000 from 24 in 1999, that generally coincides with ugly bear markets and the near-inevitability of recession.

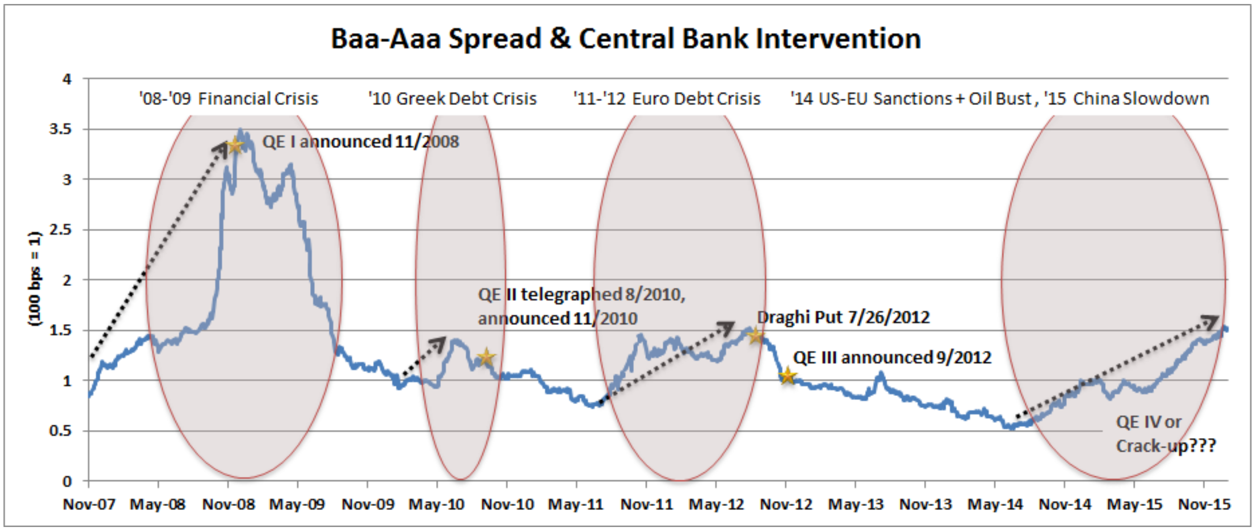


The connection between bankruptcies and the Baa-Aaa spread is understandable and instructive for 2016. The following chart shows how a widening average spread often coincides with rising bankruptcies. At about 150 basis points currently, the Baa-Aaa is signaling that the economy at large is hovering in the danger zone, presently. We believe risk aversion must decline or we will see more bankruptcies and more weakness in equities.



Certainly if the present trend of rising bankruptcies since 2013 continues and/or intensifies, the S&P 500 could easily deliver negative returns for the year. Bankruptcies in the oil patch, mining and other sectors affected by the excessively strong dollar will bear watching. Enough bankruptcies could set off a daisy chain effect similar to 2008 that could affect financial stability and cause extreme financial and economic volatility. Given a continuation of the same deflationary tilt we saw during the second half of 2015, we would not be surprised to see the S&P 500 decline 10-15+% during the first half of the year.

We certainly hope the S&P 500 does not end the year in negative territory, but we fear that a ‘stay the course’ policy by the Fed will likely make a negative equity performance and ensuing recession baked in the cake. An optimistic scenario would see the "Fed Put" for equity markets surfacing as we witness some sort of intervention by the Fed to correct the present deflation and prevent a full-on market crash. The chart below illustrates how the Fed has responded during the past eight years to rising risk aversion episodes.



The current degree of credit market risk aversion is the most extreme since the height of the 2012 European crisis, and more importantly, at a level that has coaxed previous Fed interventions.

This should provide relief on a number fronts. Because of this, we hope any major decline in equities during the first half of 2016 to be clawed back by the third or fourth quarters. Under such a scenario, we could expect the S&P 500 to return 3%. If markets get a sense of pro-growth tax legislation percolating between Congress and the new President-elect, we could see a gain of 10% for 2016 – a best-case scenario.

Commodities: While a Reflationary Shift Could Produce Welcome Rally, We Don't Expect Relief until Gold Rises

We see two things going on with commodities. First, the economic deceleration of China and the anemic economies in Europe have weakened the global demand outlook for commodities. Second, the 43+% rally in the dollar in gold terms since September 2011 has placed deflationary pressures on commodity prices.

We expect the dollar-gold price to trade between \$975 and \$1175 during 2016, ending the year at \$1175 as the Fed eventually relents on its tightening campaign. Below is a table of the commodities we monitor with respect to their historic relationship with gold. Our 18-month price targets conservatively assume a gold price of \$985/oz.

Bretton Woods Research's Commodity Matrix Assuming $985 Gold Price					
Category	Commodity	Recent Price (Spot/Index)	BWR'S Long-range Price Target	Change Since Year-End 2014	Potential Upside/Downside
Energy	Oil (NYMex Sweet, Lt Crude)	37.04	67.84	-30.47%	83.15%
Energy	Natural Gas (Henry Hub)	2.31	3.70	-22.79%	59.98%
Energy	Unleaded Gasoline (US Retail)	2.03	2.95	-11.53%	44.87%
Energy	Coal (Newcastle)	61.80	79.12	-1.98%	28.03%
Grains	Wheat (S&P GSCI)	318.91	366.02	-20.31%	14.77%
Grains	Soy (S&P GSCI)	343.13	391.98	-15.56%	14.24%
Grains	Corn (S&P GSCI)	296.18	336.69	-9.64%	13.68%
Grains	Rough Rice (JP Morgan)	11.84	11.95	0.58%	1.00%
Meats	Lamb (New Zealand)*	94.87	124.57	-99.77%	31.31%
Meats	Lean Hogs (S&P GSCI)	87.70	109.66	-26.35%	25.04%
Meats	Chicken (FOB Georgia Docks)	149.50	179.00	-24.11%	19.74%
Meats	Live Cattle (S&P GSCI)	466.89	388.38	-16.36%	-16.82%
Metal	Nickel (LME)	8,780.00	15,564.08	-41.75%	77.27%
Metal	Uranium (NUEXCO)	35.75	47.18	0.70%	31.98%
Metal	Platinum	891.10	1,167.12	-26.25%	30.97%
Metal	Aluminum (LME)	1,500.25	1,838.88	-17.79%	22.57%
Metal	Copper (LME)	4,705.75	5,697.33	-26.10%	21.07%
Metal	Silver	13.85	16.32	-14.17%	17.84%
Metal	Zinc (LME)	1,592.75	1,865.48	-26.50%	17.12%
Metal	Palladium	562.95	639.34	-29.88%	13.57%
Metal	Tin (LME)	14,591.00	15,736.41	-24.92%	7.85%
Metal	Iron Ore (China 62% Ferrous)*	40.80	39.76	-41.13%	-2.55%
Metal	Lead (LME)	1,797.00	1,683.49	-2.50%	-6.32%
Softs	Cotton (S&P GSCI)	90.04	99.28	4.99%	10.26%
Softs	Coffee (JPMorgan)	1,535.33	1,665.90	-20.33%	8.50%
Softs	Lumber	256.10	265.83	-22.11%	3.80%
Softs	Sugar (S&P GSCI)	160.42	153.42	4.96%	-4.36%
Softs	Orange Juice (JPMorgan)	144.65	124.47	3.35%	-13.95%
Softs	Bananas (US Gulf Delivery)*	932.32	785.96	-0.11%	-15.70%
Softs	Cocoa (S&P GSCI)	126.12	91.17	10.34%	-27.71%

*Sources: IMF, Bloomberg includes S&P Indices, JP Morgan Indices, and Dominant Spot Prices (*Most recent value from IMF Series)*

In general we would **avoid commodities in 2016**, **except** for those commodities that show themselves to be at extreme valuations with respect to gold, such as **oil**, (–exchange-traded fund, USO) with an 80+% upside, and **nickel** (exchange-traded fund, JJN) with a 75+% upside.

While we expect a strong dollar environment overall, we do not see much reason to hold commodities until the Fed shifts away from its strong dollar, hawkish posture.

Long Oil: The thing about oil is that it is never a clean one-way bet. In fact, during every single year since 1985 the oil price has seen peak-to-trough/trough-to-peak swings of at least 40%. In addition to monetary influences, supply/demand shifts along with geopolitical risks (e.g. Saudi Arabia-Iran tensions) at the margin, can quickly lead to higher/lower oil prices.

We believe oil is poised to offer at least a 20% gain during the balance of 2016. But our expectation for pain for the commodity space until the Fed shifts has us scoping out an absolute bottom for crude. Looking at the all-time high in the oil-gold ratio of 41.1 barrels per gold ounce in 1973, a similar extreme today, with gold at $1062.51 would send oil down to $25.85/bbl. That would be about 30% lower than the current price.

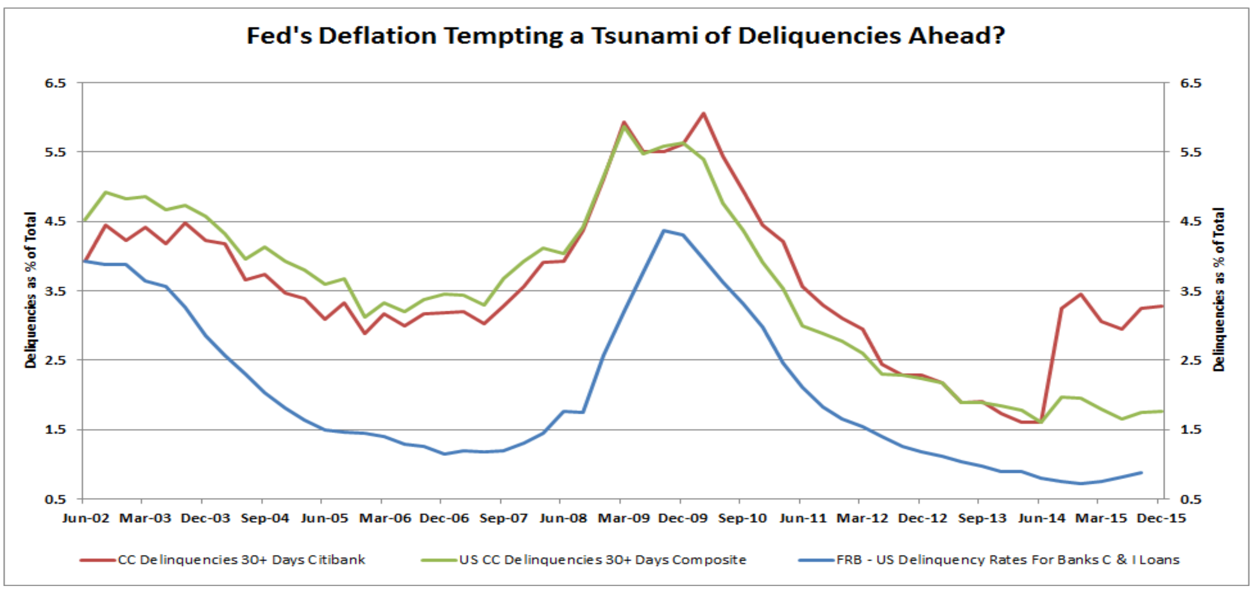
Following a Fed shift toward dovishness we believe the oil/gold ratio will fall toward 22 barrels per gold ounce. Given our year-end gold price target of $1175, we see oil ending 2016 at $53.40.

Sectors – Wanted: the Right Timing & Monetary Environment: So long as the present deflation monetary trend holds, we would **avoid energy (outside of oil), basic materials, and highly indebted utilities, as well as financials.**

In a deflation, debt service becomes more difficult as dollars become more dear. And insofar as widening credit spreads signal increasing distress for leveraged commodity players, more dollar strength will likely lead to more delinquencies, charge-offs and bankruptcies.

2015 saw a profits recession emerging by Q3 as earnings continued to decline on the back of a strong dollar. The current business cycle now appears to be turning.

In the following chart one can see how delinquency rates for credit cards (which give a good indication of consumer health) track with delinquency rates for banks offering commercial and industrial loans.



Credit card delinquencies appear to lead C&I loan delinquencies and could therefore be a useful canary in the coal mine for a souring credit cycle.

We have included the rate of 30+ day delinquencies for Citibank cardholders, which began their ascent in mid-2014 and have remained elevated above 3% since Q3 2014, after hitting a low of 1.6% in 2014. To be sure, the Citibank example is unique among credit card issuers, as we have not yet seen a similar, sustained jump in delinquency rates for competitors such as American Express or Bank of America that might suggest delinquencies for C&I loans are about to surge, but it does seem to portend to the “bottoming” in the rate of C&I delinquencies in Q4 2014.

Certainly, financials tied to the oil patch are suspect the further oil prices remain depressed.

As for what sectors might benefit from a reflationary second half of 2016 we would reverse polarity on our avoid recommendations and **go long energy and basic materials. Agriculture and real estate would also look attractive.**

Outlook on Bonds: Consistent with our expectation for a worsening commodity outlook in the first half of 2016, we expect yields to move dovishly. Indeed, bond prices may be more attractive than equities for the balance of 2016. We believe a 10+% equity market selloff would be sufficient for the 10-year Treasury yield to fall below 2%. If the Fed produced another iteration of quant easing, we would expect the 10-year to reach 1.75%.

It is our belief that only as the growth outlook improves will the 10-year yield rise significantly above 2.25%. Because we expect overall economic growth to weaken in 2016, we expect the yield to end the year between 2.05% and 2.15%.

Euro & Yen: We see the ECB continuing to rely on quant easing measures, with the currency weakening to $1.05/€ by year-end. Meanwhile, we believe the Bank of Japan will encourage more yen weakness, allowing the yen to reach Y125/$ by year-end. **We will publish a 2016 outlook on the major foreign stock markets within the next week.**

Bretton Woods Research