EDMOND DE ROTHSCHILD

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HYPNOSIS

One might describe hypnosis as a natural state of altered consciousness. It is quite indistinct, isn't it?

Yet in our daily lives, we all experience moments of hypnosis. When we are absorbed in reading a novel or watching a movie—that is to say, when our attention is focused solely on one particular thing—we are less perceptive of our surroundings. We are aware of what is happening, but our minds wander.

Hypnotists help people regain this state of concentration, and once it is achieved, they are able to convince the subject to accept their suggestions.

Every hypnotized person is fully aware of what is happening around him but his reality is altered by the hypnotist's instructions.

In order for the hypnotized person to accept the hypnotist's suggestions as his new reality, two conditions must be met:

1- The subject must know how to respond to a stimulus
2- There mustn't be any reason for the subject to go against the proposed suggestion

If these two conditions are fulfilled, then anything is possible. For example, the hypnotist could make the hypnotized person think that the number 4 no longer exists. When waking from his sleep-like state, the hypnotized person will have purely and simply forgotten the very existence of the number 4 (provided that he knows how to count and is not opposed to living without the number 4). In his new reality, he only needs nine fingers to count to ten!

Those of you who have had the opportunity to see a hypnotist perform will remember how funny it is to see hypnotized people unable to remember a number, or feeling compelled to dance after hearing a particular word.

Especially since the person remains fully aware of his behavior during his hypnotic sleep. Moreover, it is impossible to make someone make a gesture or say a word if he sees an objection to it. Thus, a person under the influence of hypnosis can instantly regain his faculties when faced with something dangerous that requires an immediate reaction from his body (a reaction that doesn't involve conscious thought).

Once the experience is over, the hypnotist snaps his fingers and everything returns to normal. The hypnotized person remembers everything he did and can have a laugh about it; the experience is over and normalcy is restored: we need the number 4 to count to 10.

By implementing a zero interest-rate policy and buying a significant amount of financial assets, central banks in developed countries—the Fed chief among them—played the role of the white knight, preventing the collapse of the state, the banks, and, indirectly, all major companies, whether they were profitable or not. While these actions were paved with good intentions, they led to a herd behavior and wealth transfers (particularly between those who had listed assets and those who did not).

In a conventional environment, the economy alternates between periods of creation, growth, recession, and bankruptcy. Central banks modified this natural state. As a result, the world was transported to an altered state of consciousness in which bankruptcy was removed from the economic cycle.

Consequently, just as the number 4 doesn't exist for a hypnotized person anymore, the markets have been operating with the near certainty that bankruptcy wasn't possible because central banks wouldn't let such an event take place: prices could not drop.

But one can't remain under permanent hypnosis. In 2016, the Fed will modify this altered state by modifying its monetary policy—an attempt to encourage the patient to return to reality: the hypnotic awakening.

2016: a year of awakening and transformation

It is customary for New Year strategy letters to forecast distinct market trends for the year ahead. This was the case in 2015, when the vast majority of research offices of major international banks (ourselves included) predicted that European stocks would have a very successful year on account of the ECB's highly-accommodative monetary policy, a weaker euro, and the resumption of European growth. This prediction proved to be correct for the first three months of the year, but was then undermined by various events such as the debt crisis in Greece (in June), fears about Chinese growth (July–August), and the drastic drop in the price of raw materials (throughout the year). Given the exceptionally high expectations at the beginning of the year, the investment returns of various asset classes turned out to be particularly weak in 2015 (+7% on European stocks, 1% on US stocks, bonds made virtually no contribution, with null or even negative performances for High Quality Corporate Bonds). For once, the most prevalent and the most popular conviction was the one that turned out to be the most profitable. Everyone anticipated that the euro would decline against the dollar and that is indeed what happened. The euro depreciated by 10% against the greenback.

Yet sometimes, there are no trends. At the beginning of this new-year, we haven't identified any. 2016 is expected to be a year of transformation for financial markets, because 2 major elements that have impacted the last decade are on their last legs:

1- Ricardian-type growth
2- Zero interest-rate US monetary policy

1- From Ricardo to Schumpeter:

The last decade has been marked by strong global economic growth due in large part to China's influence on the rest of the world. During this period, China and Asian countries have become the world's center of production because of their inexpensive labor supply and deliberately favorable currency levels. Companies from developed countries have relocated their factories to this region in order to take advantage of less expensive production conditions. They were thereby able to improve their margins while contributing to the rise of a new category of workers in developing countries. In turn, these workers also increased their wealth and boosted global growth.

The optimal allocation of labor, land, and capital is a cherished value for the economist Ricardo. This reorganization on a global scale is precisely what allowed for a decade of strong global growth.

However, this trend is near exhaustion and the movement is largely behind us; many multinationals already have a production center in China.

Therefore, economic growth can no longer depend on offshoring; another way forward must be found.

This is where innovation plays a major role. We have a vested interest in promoting the emergence and creation of innovative companies; they alone will create the jobs and wealth of tomorrow. Ideally, capital will no longer be used to save existing companies from bankruptcy, but for creating new ones that are suited to our new technological environment. This is what the economist Schumpeter described as creative destruction.

Innovation creates growth but also leads to the demise of companies that are unable to adapt, and in turn, leads to the creation of new jobs. In the same way that most carriage manufacturers closed up shop after the arrival of the automobile, companies that don't know how to adapt are bound to collapse.

This phenomenon isn't groundbreaking in itself, provided that there is no desire to prevent creative destruction from taking place. Yet this is precisely what happens when central banks reduce interest rates to record lows. According to Schumpeter, capital resources are limited. Capital managed by regulations or policies suited to less profitable companies is capital that is not oriented towards the creation of innovative companies.

In other words, by preventing destruction (i.e. maintaining negative real interest rates), we also prevent creation. Companies destined to disappear survive by accumulating debt at rates that are well below where they should be.

What is now changing is that this monetary policy aimed to prevent bankruptcy is no longer a reality.

2- The normalization of US monetary policy

On December 16, Janet Yellen finally implemented the Fed's first federal funds rate hike in nearly 10 years. This monetary tightening by a quarter point was widely expected by the market (the Fed has been preparing investors for at least a year).

While US monetary policy is still very accommodative and the direct impact of a 0.25% rate hike is limited, the direction has changed. Normalization, i.e. rising federal funds rates (and not the opposite), is what is now expected. This causes a natural increase in the cost of capital, but above all, it removes the moral hazard or hypnotic effect that led investors to believe that central banks would stop the slightest market downturn and prevent all bankruptcy.

Uncertainty in financial markets

The combination of these two elements represents a fracture in the dynamics that drove market trends during the last decade. A new period is dawning for financial markets.

During the period of awakening, a hypnotized person gradually resumes contact with the reality surrounding him. He had never truly left it but it had been altered by the hypnotist's suggestions.

The dynamics of the economic world have changed; what was true yesterday probably won't be in 2016. We are obviously not immune to shifting opinions but it would be difficult for us to imagine the Fed going back on its decision to normalize its monetary policy.

Therefore, we are entering new economic times. Unfortunately, the starting point isn't necessarily favorable:

- ❖ High indebtedness and interest rates at their lowest (but in a recovery phase in the United States)
- ❖ High stock valuations
- ❖ Raw material prices significantly down

Investment strategy

When the economic environment changes, as we believe it has, management methods must adapt.

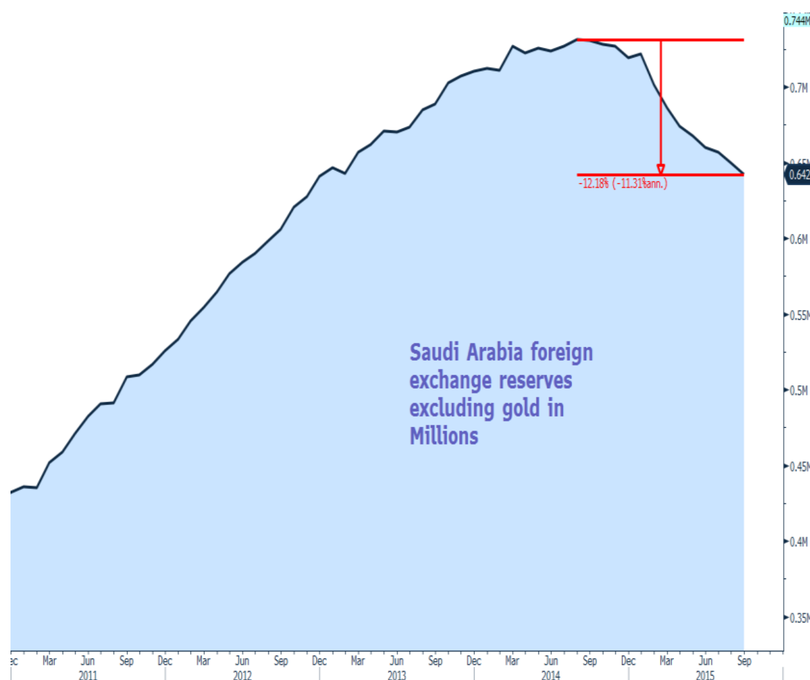
Thus, rather than investing in a particular asset class over a long period, we believe that avoiding market pitfalls and permanent capital losses will be essential to achieving satisfactory performances in 2016. While the economic environment still appears favorable, particularly in the United States, and to a lesser extent in Europe—where monetary policy will remain accommodative throughout the year—we are anticipating the markets to be volatile in all asset classes (stocks and bonds). The alternating periods of depression and euphoria will create opportunities for those who know how to invest during market troughs and sell during quieter periods. No disasters in the forecast, but a lot of pitfalls that one must know how to avoid and/or deftly manage.

This sounds like an obvious conclusion that is more easily said than done. Still, we believe that by identifying the biggest probable risks in advance, we will emerge unscathed. Avoiding permanent losses of capital is a far more meaningful ambition than fully participating in any market rally.

Therefore, rather than focusing on a highly-recommended asset class, we have listed the biggest risks, which we hope to protect ourselves from.

1. **A lack of dollar liquidity, which would lead to a further decrease in growth in emerging countries and currency devaluations at the back end**

The US dollar is the base currency for world trade. Over 80% of international trade transactions are conducted in USD even when the United States isn't involved in them. Thus, to feed its population, supply energy to companies, or provide gasoline for cars, a country must import the resources it is not able to produce, and it needs dollars to pay its bills. This seems obvious, but the truth is that if this same country is importing on a long-term basis, it has no choice but to use its foreign-exchange reserves. When these reserves reach critical levels, the country generally decides to devalue its currency in order to make it more competitive for exporting and then be replenished in dollars. This causes a collapse in domestic demand and profits decrease for companies operating in these countries.



As you can see, the drop in oil prices has already resulted in the decrease of a portion of Saudi Arabia's reserves.

If these events were to occur, economic growth in emerging countries would be revised downwards.

2. **Difficulties (re)financing companies in developed countries**

The zero interest-rate policy implemented by central banks allowed many companies to significantly reduce their financing costs.

In most cases, debts were raised in order to optimize balance sheets.

Companies tended to raise debts in order to buy back securities or make acquisitions rather than making productive investments (purchasing software, machines, etc.). Therefore, operational profits didn't necessarily increase, whereas debts did.

This trend is particularly true in the United States; corporate debt increased, which makes companies weaker if faced with a market reversal and/or interest rate hike.

3. **The return of inflation in the United States, which would push short-term and long-term rates up**

The United States could experience an inflationary surge due to its tight labor market henceforward (only 5% unemployment), a stabilization of raw material prices (following a 70% decline in barrel prices), and a growing real estate market. This potential inflationary surge is all the more crucial because the base effect is significant. The PCE price index measured inflation at only 1.3%.

If this risk materialized, interest rates would move up and automatically lead to a decrease in bond prices.

4. Tightening of liquidity on the bond market

The bond market is an over-the-counter market (unregulated). To function properly and to guarantee a certain amount of daily liquidity, “market makers” have been taking positions on securities to ensure that purchase and sale prices continuously exist. Prior to the regulation’s modification (beginning in 2009), this role was primarily played by banks. Now their influence has considerably declined, further reducing bond market liquidity.

5. Political risks

They are obviously very present. Great Britain’s exit from the European Union, openly anti-European parties coming to power, geopolitical tensions in Middle East…all currently have a strong resonance on the markets and will likely increase volatility.

Key messages:

In a phase of contracting liquidity, hold on to dollars, short-term liquidities, liquid instruments, and companies with healthy balance sheets (low debt ratios) generating cash flows in USD appear to be the solid pillars for 2016. Similarly, companies in developed countries operating in the domestic economy seem to be a less risky strategy than investing in multinationals that earn a significant portion of their revenue in emerging countries.

We have seen that valuations aren’t attractive enough to constitute a sufficient reason to invest. Changes in the global economy’s dynamics (from Ricardo to Schumpeter) and to US monetary policy should create short alternating periods of euphoria and depression, as was the case in the second half of 2015.

Fortunately, the volatility that we anticipate can be leveraged by investing in tailor-made short volatility derivatives that benefit from conditional capital protection and distribute generous coupons. These instruments should be very useful during the coming year—which promises to be turbulent but rich with opportunities.

For many years, central banks have altered our vision of reality, closely resembling what could be described as a state of hypnosis. By maintaining negative real interest rates for seven years, central banks led investors to believe that risk had disappeared and that bankruptcies were no longer possible. 2016 echoes with the sound of the hypnotist’s fingers snapping, bringing the subject out of his hypnotic state. Risk hadn’t disappeared but had insidiously concealed itself in monetary policy.

The year should be marked by major questions like the ones we just mentioned. These phases aren’t necessarily negative, but uncertainty and volatility will likely be a leitmotiv during the next 12 months, which we must capitalize on.

Finally, we would like to take this opportunity to wish you and your loved ones an excellent 2016.

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