



**From the desk of Komal S. Sri-Kumar, Ph.D.**  
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### ***Five Things to Shake Up 2016***

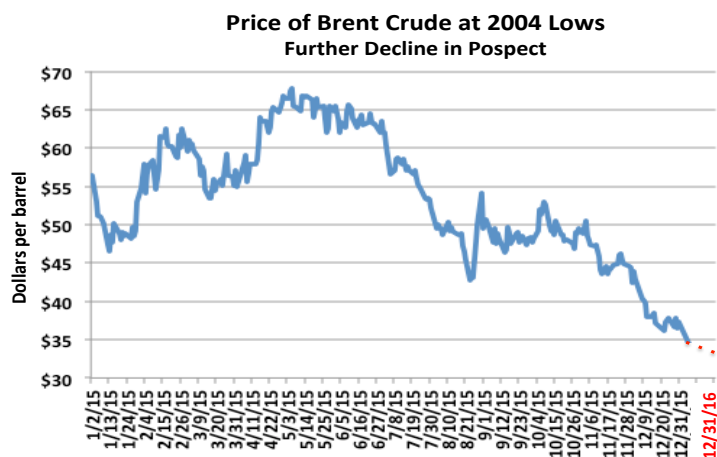
Here is my list of five developments that may shape where the global economy and markets may be headed this year, with implications beyond. Some of them have been much discussed, like the outlook for oil. Others are more obscure indicators, such as the Baltic Dry Index. I have been intrigued for a while on which way the five factors may go, and what they mean for world financial markets.

#### **(1) Where is Oil Headed?**

Oil is a crucial input in the production process, but energy also accounts for 16% of the US high-yield market. Non-investment grade companies were responsible for the bulk of the expansion of US production through fossil fuel in recent years. Weaker US economic growth in 2016 will probably result in bankruptcies on the oil patch and the need to restructure debt payments. In turn, this will likely influence Federal Reserve policy in coming months. Despite signals from senior Fed officials that they will increase the Federal Funds rate four more times in 2016, oil-related debt problems may well deter them from implementing the tightening.

Continued low energy prices also have a major influence on the Fed meeting its inflation target of 2% - - something that has been frequently forecast since 2009 but never met! The plunge in oil prices will again make the Fed's inflation goal a distant one and is likely to result in the 10-year Treasury yield going through the 2% level. Ideally, the Fed would like to see the yield rise toward the 3% mark reflecting healthier economic growth and a rising inflation rate.

Revenues earned from oil and gas exports are also a major determinant of the wellbeing of a number of emerging markets. Renewed weakness in oil prices since the beginning of 2016 has been reflected in additional depreciation of currencies of geographically diverse oil producers such as Russia and Mexico. While some emerging markets benefit from low oil prices - - India heads the list - - many of them suffer larger deficits on the fiscal front as well as in the current account of the balance of payments as a result of falling oil revenues.



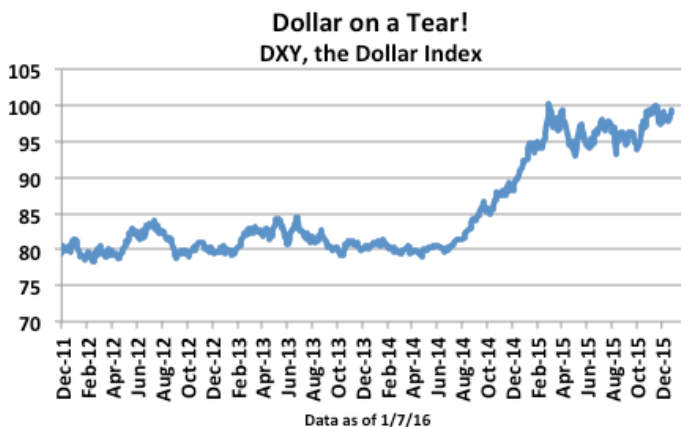
Unless the ongoing geopolitical conflict between Saudi Arabia and Iran results in a destruction of production capacity in the Middle East, the global glut will probably get worse in the first half of 2016, resulting in the price of Brent crude heading toward about \$32 per barrel. This assumes that Western sanctions against Iranian exports will be lifted during coming months, adding some 500,000 barrels per day in additional supply to a global glut current estimated at 2 million barrels per day. Risk to the forecast? Oil heads even lower.

## **(2) Will Dollar Strengthen Further?**

The dollar has been on a tear for the past 18 months. Partly, this was due to market perception that the US had recovered better from the financial crisis than Europe or Japan. Second, Federal Reserve officials made frequent statements about shifting to tightening at a time when the European Central Bank, the Bank of Japan and the People's Bank of China saw the need for further easing.

Whether the dollar's bull run has ended is of keen interest to the global economy. A stronger dollar would attract capital from the rest of the world, especially from emerging markets, making it more difficult for those capital-short countries to attract new investments. Key commodities including oil, natural gas and copper are generally quoted in dollars, and a stronger dollar would mean weaker commodity prices. In turn, this would be a big negative for commodity exporters such as Canada, Brazil and Australia.

If the global economy slows markedly this year as I anticipate, and global debt problems worsen, the dollar's status as a safe haven will be enhanced. Counteracting dollar strength are the realities of an election year in the United States. Washington politicians do not like to see an overly strong dollar that could hurt export competitiveness and slow economic growth. I see the net effect of the opposing forces as a slightly stronger dollar, at \$1.03 against the euro, or 101 in terms of DXY, the Dollar Index.



## **(3) Will Brexit Occur?**

UK Prime Minister David Cameron has promised to hold a referendum by the end of 2017 on whether the country would stay in, or leave, the European Union. While an exit was initially thought of as a low-probability event, Mr. Cameron's lack of success in getting key demands met by other EU leaders has increased the probability, but to still less than 50%. Perception in Europe that the UK may have more to lose by its departure than the rest of the countries would in a UK-less European Union has made the negotiation difficult for the UK Prime Minister who would like to stay in the group of nations.

Even if the referendum is not held until next year, the campaign leading up to it will increase uncertainty for foreigners considering investment in the UK, and will probably weaken the pound sterling further after the depreciation that occurred over the past four weeks. Also, London's standing as a global financial capital is likely to suffer in a post-Brexit situation.

## **(4) Will the Chinese Renminbi Undergo a Major Devaluation?**

With the rapid growth that the Chinese economy has experienced over the past two decades, it has become the second largest in the world, and its growth contributed some 30% of global growth - - far greater than the share of the United States or the European Union - - in recent years. Growth has been slowing over the past few years, and actual growth may be even slower than the official 6.9% figure. Authorities are also dealing with corporate debt that may have surged to US\$2 trillion, accumulated largely since 2008, and a large proportion through "shadow banking" channels.

Following plunging equity markets since mid-June and a surprise devaluation of the currency on August 11, officials have signaled that the renminbi (RMB) will not undergo a large one-shot devaluation again. However, the People's Bank of

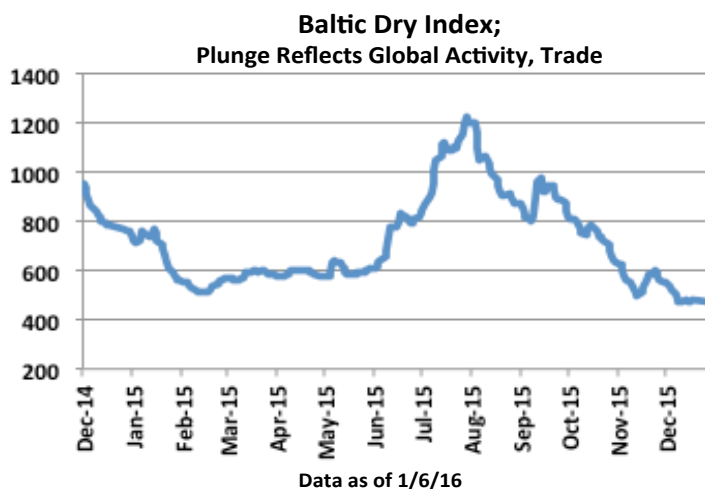
China has moved the reference rate for the currency up by more than 0.2% per day since beginning of 2016, and by a large 0.5% today. The gap between the onshore (Shanghai) and offshore (Hong Kong) exchange rates has widened sharply. The offshore rate plays the same role as a “parallel market” rate does in countries with foreign exchange controls, and a widening gap with the onshore rate is a measure of growing capital flight.

Whether the RMB undergoes a big move or several small moves as the central bank has been implementing this week, the cumulative effect would be a sharp weakening of the RMB against the dollar. My expectation is a move from the current 6.59 to the dollar to 7.00 by the end of the first quarter, and 7.25 by mid-2016.

In turn, an RMB weakening would lead to other central banks also depreciating their currencies to maintain competitiveness. The Japanese yen, the Korean won, the Vietnamese dong and the Brazilian real are all likely contenders in the ensuing “Currency War.”

### **(5) Will the Baltic Dry Index Keep Plunging?**

The Baltic Dry Index (BDI) is issued daily by the London-based Baltic Exchange to measure the cost of transporting major raw materials by sea. It may be an obscure index for some, but the BDI is nevertheless a crucial measure of the demand for shipping for moving commodities such as coal, iron ore and grain.



In recent days, the BDI has plunged to a record low in response to the contraction in US manufacturing data, and indications of weakness in Chinese factory orders and PMI numbers. Compared with a high of 1222 on August 5, BDI fell to 478 at the end of the year, a decline of 61% in about five months. Since, it has dropped to a fresh low of 445 today. The BDI is a measure of the level of global economic activity as well as of the pace of global trade. Its decline reflects the ongoing downturn in both the world economy and slowing trade, reducing the demand for shipping materials.

I expect that the BDI will continue falling for another 6 months, with a low point of around 350. BDI starting to move up would be an indicator that things are starting to improve for the global economy.

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