BULL & BEAR BULLETIN

Volume 7, Issue 1 February 2016

Cultivating relationships for over 30 Years Since 1984

VALICENTI ADVISORY SERVICES, INC.

400 East Water Street
Elmira, NY 14901
607-734-2665
Fax: 607-734-6845

447 East Water Street
Elmira, NY 14901
607-733-9022
Fax: 607-734-6157

24 West Market Street
Corning, NY 14830
607-936-1203
Fax: 607-936-0213

www.valicenti.com

Asset management as individual as you

2015 TOP 100 FEE-ONLY Wealth Managers *Designated by* CNBC

An on-line publication by The Investment Committee

Negative Feedback Loop:

Over the past six months, we have outlined the negative impacts a strong U.S. dollar and lower oil prices have had on financial markets. Unfortunately, the fallout has intensified through the first six weeks of the year. At the time of this writing, the U.S. stock market is off more than 8% year-to-date and 10% from the all-time high achieved in the summer of 2015. From a global perspective, over $15 trillion worth of market value has been erased since the 2015 high – almost the equivalent of the entire S&P 500 Index, which represents 70% of all U.S. stock value (Chart 1).

To recap the current economic scenario, the U.S. Federal Reserve policy decision to end its monthly bond purchases in October 2014 and its eventual interest rate increase in 2015 is completely divergent of all other major central banks' policy actions. By raising rates while other central banks are looking to lower their respective interest rates, the Federal Reserve produced a massive strengthening of the U.S. dollar against most other world currencies. Perhaps, unintentionally, the Federal Reserve's actions also burst the oil market bubble and produced one of the most dramatic selloffs in modern history.

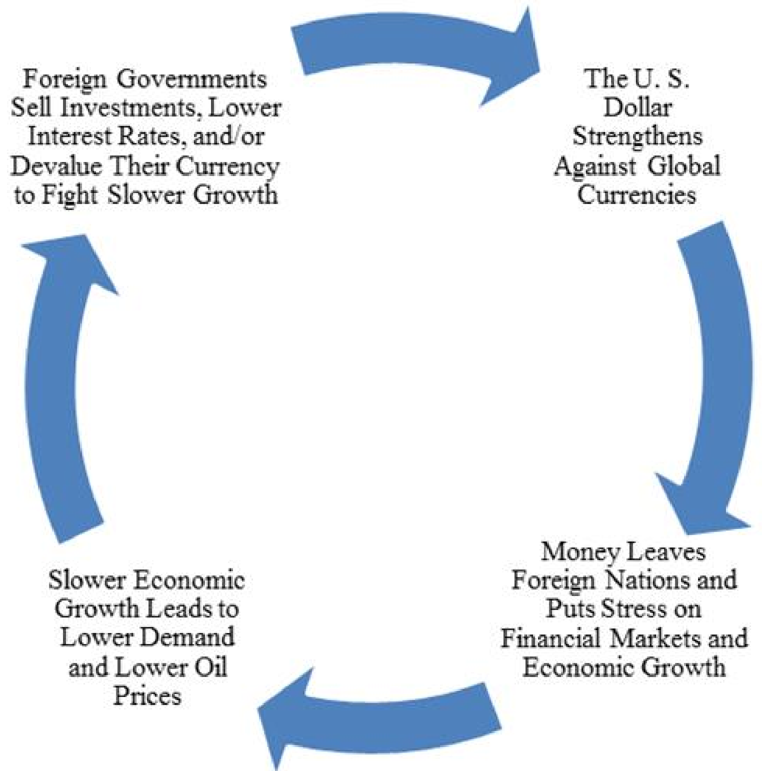
As the U.S. dollar strengthened and oil prices declined, there was an unwinding of the decade long money flow into emerging markets. As dollars were withdrawn from emerging markets, it yielded slower global growth. The slower global growth negatively affected oil demand, reinforced the supply and demand imbalance in the industry and put further downward pressure on oil prices.

With oil prices down more than 75% from their 2014 levels, energy companies are facing significant financial stress. Most companies borrowed heavily to expand their production and take advantage of $100 per barrel oil prices. Now that oil prices are below many companies' break-even costs, they are struggling to service their debt.

In anticipation of higher energy defaults, banks are beginning to increase their loan loss provisions and to tighten their lending standards. As banks begin to constrict the availability of credit, it will make it harder for all companies to access financing. Any reduction in loan supply will negatively affect the growth of the U.S. economy.

In the case of nations that depend on oil revenue, they are now facing budget deficits and are being forced to sell investments from their sovereign wealth funds to close their budget holes. This selling activity includes stocks, bonds and real estate throughout the world. The forced liquidation of investments and the reduction of government spending negatively affect both global investments and the global economy.

What makes the current economic scenario dangerous is the prospect of a negative feedback loop. A strong U.S. dollar puts pressure on foreign economies, which affects economic demand including the demand for oil and, in turn, forces foreign governments to liquidate their reserves, lower their interest rates and/or cheapen their currencies to bolster their economies, which ultimately reinforces the strength of the U.S. dollar.



While it is tempting to believe that the worst may be over following a $15 trillion decline in global market value, markets may continue to struggle until the negative feedback loop ends. Currently, we see two ways to break the cycle: a supply disruption in the oil markets or the Federal Reserve reversing its recent interest rate increase.

A disruption of energy supply could potentially push oil prices high enough to alleviate some of the credit stress within the energy industry. Likewise, higher oil prices would give oil producing nations the funds needed to avoid asset sales and support global growth.

While we do expect oil production to eventually decline in 2016, oil inventories remain well above historical norms. It is more likely that oil prices remain range-bound between $20 and $40 per barrel, which may prove inadequate to break the feedback loop.

If oil does fail to rebound, the Federal Reserve may need to reverse its December interest rate hike. By becoming more “dovish” and lowering rates, the Federal Reserve would be putting downward pressure on the U.S. dollar and U.S. interest rates. A lower dollar would help slow the reversal of funds out of emerging markets and would potentially stabilize the decline in global growth.

Most of the economic damage from this negative feedback loop is occurring overseas. The U.S. economy, outside of the manufacturing sector, has remained resilient and continues to generate additional jobs and wage growth. As long as bank lending does not become too restrictive and the fallout from the energy industry remains contained, the market decline may be limited to just a prolonged correction. If, however, lending does become restrictive and energy defaults mount, we could see the odd scenario of a bear market without an economic recession.

As discussed in our December publication, there are significant macro currents that are exerting influence on financial markets. Despite the 10% market correction, it may be too early to call a bottom and predict that stabilization and a recovery are likely in the coming weeks. Investors would be wise to remain cautious on the markets until there are signs that the negative feedback loop has been broken.

Chart 1

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Valicenti Advisory Services, Inc.), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Valicenti Advisory Services, Inc. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Valicenti Advisory Services, Inc. is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the Valicenti Advisory Services, Inc.’s current written disclosure statement discussing our advisory services and fees is available for review upon request. Please Note: Fee-Based services. The Registrant provides investment advisory services on a fee basis. The Registrant does not receive any transaction/commission-based compensation for its investment advisory services. Rather, its only compensation is derived from fees paid to it by its clients as discussed on Part 2A of its written disclosure statement. However, because the Registrant is now affiliated with Valicenti Insurance, a NY insurance agency that is licensed to offer insurance products on a commission compensation basis, the Registrant cannot hold itself out as a "fee-only" advisory firm.