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The Navigator

*Nov 2017*

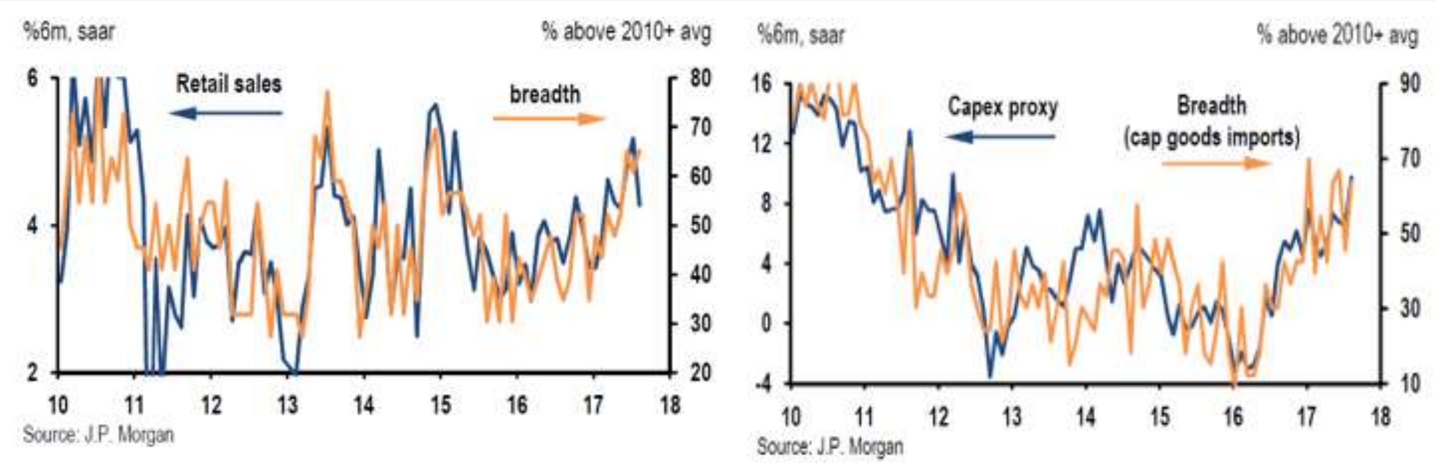
# Melt-up

By Edward Lim, CFA

This will be our last edition for the year. We would like to thank you for reading our musings over the past few years. We have rebranded the publication from "The Month Ahead" to "The Navigator" as it appropriately serves as a compass to our asset allocation in the various mandates we manage. We have now reached an audience of 200+ active readers and we hope more will find this weekend afternoon read useful or the least a bit black humour in it.

**We end the year by recapping some of the critical calls made throughout the year, both the good and the bad ones.** We started the year proclaiming the end of QE as we know it but we are confident that strong and synchronized global growth will offset the potential risk of the tapering in QE (QT as we call it), The Year Ahead 2017: It's the end of QE as we know it (And I feel fine). The synchronicity of the growth is emanating from buoyant global consumption and also the return of the capex cycle. This view has played out accordingly with past months data indicating a swath of countries that are registering above their 2010-2016 average growth rates in retail sales and capex investments.

**Global retail sales and capex are trending higher and larger % of countries growing above 2010-2016 trend**




We extended our view to overweight equities over fixed income as valuation was still accommodative for equities but extended for fixed income. We also added to various commodities complexes such as copper and steel producers. Equities have outperformed Fixed Income by 10% year-to-date while copper and steel prices are up 19% and 13% respectively. We reinstated our bullish USD view at the start of the year premising on stronger growth differential of the US vs ROW alongside rising inflation and a more hawkish Fed versus other regions. A terrible wrong call as the Dollar Index fell -8% when the upshot of inflation in the US we were expecting did not materialize and the absence of reflation from the failure of Trumpnomics exacerbated its drop. We advocated a relative value trade overweighing EM debt over EM equities as the specter of protectionism between the US and EM ratchet and uncertainty in US foreign policy prompted the preference for safety in debt instruments than equities while still capturing the growth differential EM had over DM; It's complicated. That was the costliest strategic mistake for a good part of the next 6 months as EM Equities outperformed EM bonds by 20% and was the best performing region within equities.

As we moved into the half-year mark, all asset prices continued to rally but we witnessed a potentially deadly combination of global growth transitioning from an accelerated growth phase to a stable growth phase while earnings momentum have also started to roll over in April's Don't forget to breathe and June's Clairvoyance. These observations prompted us to reduce our overweight in equities and to hedge for risk-off scenarios by adding long-dated US Treasury in our fixed income portfolio while reducing our commodities trades opting to buy Gold as a defensive hedge. By August, in our And the three bears never saw her again musing, we have altered our longstanding view to be overweight equities bringing down to neutral while raising substantially more cash than we had in a year. We argued that strong global growth in 1H17 will not be replicated and have forecast a slowdown in the pace of growth instead. We have little experience to understand the effect of QT as it draws closer beyond the circumstantial knowledge when the flow of central bankers' balance sheet turns negative, the concomitant effect is the decline in bonds and equities prices and the theoretical expectation that Fed's QT will add 15-20bps increase in rates every year on top of its prescribed cumulative 125bps 4-hikes from now till end of 2018. Given our apprehension, we raised more cash to 15-20% of the portfolio. Nonetheless, we acknowledged that markets can go parabolic and built up plenty of irrational exuberances before bear market ensues in The epitaph of QE and his mates. We presented empirical data to show that it doesn't benefit much in selling ahead of a bear market, assuming one has the prophetic ability to foretell one or selling after a bear market. While we have raised cash, we have added numerous options strategies that will benefit should the market melts up without putting too much capital at risk. It last month's edition Are we there yet, Minsky? we elucidated the anatomy of a financial crisis according to the economist, Hyman Minsky, and concluded the past years of experimental unorthodox monetary policies and the unintended consequences that came along with have all the hallmarks of a potential financial crisis in the making.

**However, we are comforted by two recent developments. First is the willingness of central bankers to delink the unwinding of their balance sheet and the much-needed normalization of interest rates.** This new-found confidence in central bankers is critical as it accommodates future policy responses should another crisis erupts global or in local economies. For example, the Fed has begun unwinding its balance sheet last month, if a crisis erupts 12 months later, they would have the ability to pump prime the economy with $600bn they have unwound during this period. Likewise, on interest rates, the Fed has moved away from its zero-bound constrain for a good part post GFC by raising rates from 0% in 2015 to 1.25% now and it anticipated to raise another 125bps to 2.50% by end of 2018. If a crisis evolves, they have the latitude of cutting rates back to 0%. We note that PBOC, Bank of Canada and Bank of England have also rebuilt their policies arsenal by embarking on the dual path of reducing the quantity of money and normalizing cost of money in the past 12 months. However, we are more worried about ECB and BOJ as their policies remain unchanged and we believe they are behind curve in normalizing.

**The second development is we are surprised by the momentum of the global economy. Hard and soft data thus far are indicating GDP growth of 3.4% in 2H17 as strong as 1H17 growth debunking our earlier fear of a slower 2H.** Critically, a 3.4% global GDP prints in the past 2 halves are a good 20bps above global potential. The latest The J.P. Morgan global all-industry output PMI in October edged up one-tenth to 54.0 in October; a reading that is consistent with 3.2% annualized growth in global GDP for the early part of 2018. On the back these strong than expected data, we are seeing consensus upgrading 2018 GDP forecast noticeably from 3Q17 onwards. The current consensus forecast is for global GDP growth to end 2017 at 3.4% and for 2018 to grow by 3.6%.

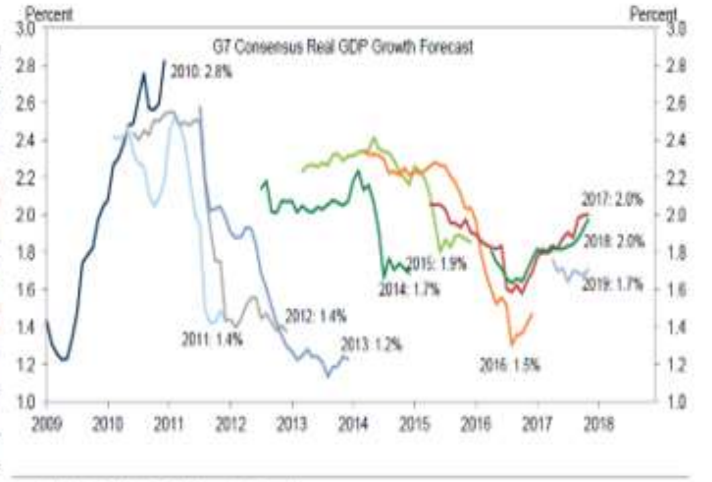
**PMI indicating 3.2% ar GDP growth next 3-6 months**

J.P. Morgan global PMI summary

| | | Jun | Jul | Aug | Sep | Oct |
|---|---|---|---|---|---|---|
| Output | Total | 53.7 | 53.6 | 54.0 | 53.9 | **54.0** |
| | Manufacturing | 53.2 | 53.1 | 53.7 | 53.9 | **53.8** |
| | Services | 53.8 | 53.7 | 54.1 | 53.8 | **54.1** |
| New orders | Total | 54.1 | 54.3 | 54.6 | 54.4 | **54.1** |
| | Manufacturing | 53.3 | 53.7 | 54.2 | 53.8 | **54.2** |
| | Services | 54.4 | 54.5 | 54.8 | 54.6 | **54.1** |
| Employment | Total | 52.2 | 52.5 | 52.6 | 52.5 | **52.7** |
| | Manufacturing | 51.7 | 51.6 | 52.0 | 52.2 | **52.7** |
| | Services | 52.4 | 52.8 | 52.8 | 52.6 | **52.7** |

Source: J.P. Morgan, Markit

**GDP upgraded in 2017 and 2018 noticeably from 3Q17**




Source: Bloomberg, Goldman Sachs Global Investment Research

**A key tenet of this strength lies in the capex recovery.** In the last 3 months, JPM latest capex proxy is annualizing 9.3% growth, a pace not seen since 2012. Rising business confidence, higher profits and stock prices underpinned this vigor for corporates to spend. Capex story normally is a multi-quarters story. The importance of capex in driving equity gains stems from the fact that the benefits of investment are felt almost instantaneously and with a multiplied effect to the customers of those firms carrying out the capex. The cost of capex can be depreciated over many years boosting profits of corporates during the early phase. Moreover, capex-driven growth boosts nominal GDP growth much more than wages, allowing revenue growth to outpace cost growth. While the consumers account for c.80% of US and 55-65% of global demand, the vagaries of consumption growth are low, but changes in capex are larger and can alter growth trajectories significantly and are bigger swing factor for equities performances. Capex growth tends to outpace GDP growth during later part of a business cycle. As a rule-of-thumb, business investment tends to grow twice as fast as potential GDP on average in expansions once the economy has reached full employment like where we are now.

**Capex data strongest in a long while**


**Capex story is long-legged and +ve for equities**

| Start Date | End Date | Number of yrs | S&P Performance during (CAGR) | 3yr before | 3yr after | EPS performance during (CAGR) | 3yr before | 3yr after |
|---|---|---|---|---|---|---|---|---|
| Aug 1967 | Aug 1969 | 2 | -0.4% | 4.8% | 6.0% | 5.2% | 6.3% | 1.2% |
| Feb 1971 | Nov 1972 | 2 | 9.0% | 2.9% | -7.4% | 12.0% | -1.3% | 7.7% |
| Nov 1975 | Feb 1979 | 3 | 2.5% | -7.4% | 5.0% | 16.5% | 7.7% | 4.9% |
| May 1983 | May 1984 | 1 | -4.2% | 15.5% | 22.1% | 26.7% | -5.9% | -2.7% |
| May 1992 | Nov 1998 | 7 | 16.8% | 9.1% | 0.5% | 11.3% | -4.7% | 1.8% |
| May 2003 | Feb 2005 | 2 | 15.0% | -13.3% | 3.7% | 20.2% | -3.0% | 9.2% |
| Aug 2010 | Aug 2014 | 4 | 16.0% | -8.5% | 8.0% | 11.0% | -6.5% | 3.0% |
| Average | | 3 | 7.8% | 0.4% | 5.4% | 14.7% | -1.1% | 3.6% |

Source: Thomson Reuters, Credit Suisse research

## Asset Allocation Strategy

While the economic backdrop has certainly surpassed our expectations, valuation remains a bug bear. Since turning Neutral equities in August, MSCI World Equities have rallied another 5% brining YTD returns of 18%. But with earnings upgrade momentum stalling since 3Q17, except for Europe, it implies asset valuations for equities and even for fixed income has become even more expensive. Equities in the US are now at the 88% percentile of expensive on many metrics, Rates and Credit fare no better as well.

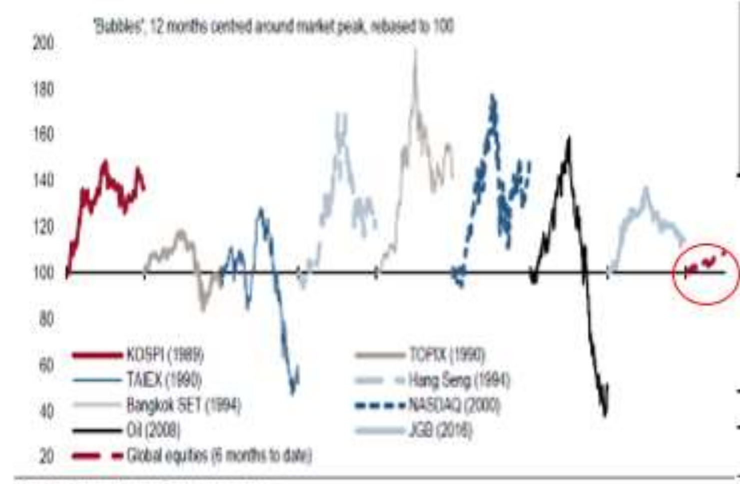
### Not quite pretty pictures below: Expensive in every way you look at it


| | Metrics | Current Level | Historical Percentile | Median |
|---|---|---|---|---|
| Equity (SPX) | Cash flow yield (CFO) | 7.1 | 88% | 88% |
| | EV / Sales | 2.3 | 96% | |
| | EV / EBITDA | 11.7 | 87% | |
| | Price / Book | 3.3 | 86% | |
| | NTM P/E | 18.1 | 88% | |
| | Free cash flow yield | 4.3 | 51% | |
| | Cyclically Adjusted P/E | 26.5 | 88% | |
| Rates | Nominal 10-year Treasury | 2.3% | 90% | 80% |
| | Real 10-year Treasury | 0.5% | 76% | |
| Credit | High Yield YTM | 6.2% | 94% | |
| | Investment Grade YTM | 3.3% | 83% | |
| | High Yield spread | 376bp | 77% | |
| | Investment Grade spread | 106bp | 73% | |

**Equities: Upgrade to Overweight but just slight and preferring to use options to participate in the further upside.** Yes, valuations are expensive. We are moving away from regional preferences instead opting for sectoral overweights in Technology, Financials and Commodities. These three sectors are experiencing strong earnings revision momentum and are expected to post one of the strongest if not the strongest EPS growth in FY18. They are also late cyclical plays exactly where we are now in the economic cycle. Growth and small-cap strategies are emphasized in the total return mandates we are managing while sustainable dividends, low gearing and rising free cashflow are important in our income mandates.

We are also reminded of a few salient points about bear markets chief of which is a career suicide pill calling for one too early. Bull markets tend to peak only after a significant run-up in prices and valuations. We are almost there but not quite yet.

## Not quite parabolic compared to other bubbles




Source: Thomson Reuters, Credit Suisse research

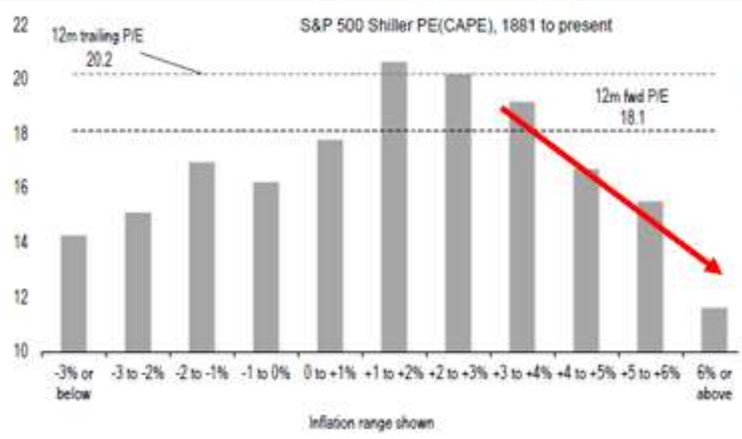
## Valuation exuberance still has slight bit to go

| | Market performance | | | PE | | |
|---|---|---|---|---|---|---|
| Peak | 6m prior return | 3m prior return | 6m after loss | PE change 6m prior to peak | PE at peak | PE change 6m after peak |
| 28/11/1980 | 25% | 15% | -5% | NA | NA | NA |
| 25/08/1987 | 19% | 19% | -22% | +1.3 | 15.2 | -4.1 |
| 16/07/1990 | 8% | 7% | -14% | +0.9 | 12.6 | -1.4 |
| 17/07/1998 | 23% | 6% | 5% | +3.4 | 22.4 | +1.5 |
| 24/03/2000 | 20% | 5% | -5% | +2.9 | 24.7 | -2.3 |
| 09/10/2007 | 8% | 2% | -13% | +0.1 | 15.1 | -1.6 |
| **Average** | **15.6%** | **7.8%** | **-10.1%** | **+1.7** | **18.0** | **-1.6** |
| Current | 9.3% | 4.1% | - | +0.7 | 18.2 | - |

Source: Thomson Reuters, Credit Suisse research

Valuation de-rates only when inflation hits above 3%; we are now less than 2% on core CPI and at 2% overall CPI in the US. Markets tend to peak 4 months ahead of a recession. Latest Fed recession model is indicating only a 8% probability of recession in the next 12 months, way below the 20% level that has marked previous recessions.

## Inflation not quite there yet to trigger PE derating




Source: Professor Robert Shiller, http://www.econ.yale.edu/~shiller/data/ie_data.xls, Credit Suisse research

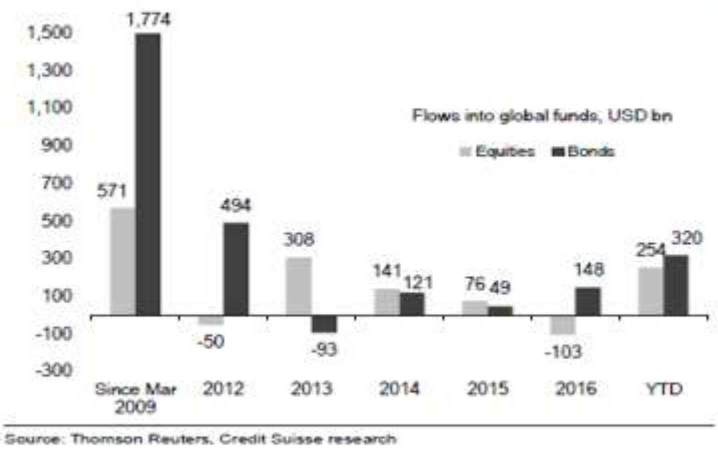
## Market peaks 4 months ahead of recession

| Market Peak | Market Trough | Duration in months | Change in the S&P (peak to trough) | Business cycle peak | Business cycle trough | Duration in months | Market lead time to business cycle peak (in months) |
|---|---|---|---|---|---|---|---|
| 28-Nov-80 | 12-Aug-82 | 20.7 | -27% | Jul-81 | Nov-82 | 16.27 | 7 |
| 16-Jul-90 | 11-Oct-90 | 2.9 | -20% | Jul-90 | Mar-91 | 8.10 | 0 |
| 24-Mar-00 | 09-Oct-02 | 31.0 | -49% | Mar-01 | Nov-01 | 8.17 | 11 |
| 09-Oct-07 | 09-Mar-09 | 17.2 | -57% | Dec-07 | Jun-09 | 18.27 | 2 |

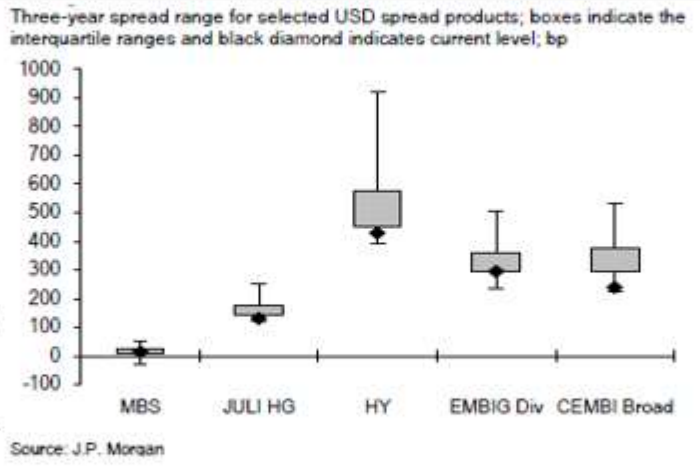
Source: Thomson Reuters, Credit Suisse research

**Fixed Income: Underweight.** We have been built up our case that market is under-estimating inflation and mispricing interest rate risk in the many past editions. Recent strength in data underpins shrinking output gap on both capital resources and labour market and warrants scrutiny in the coming months. If inflation does overshoot as we fear, the implications for bonds are obvious but the deleterious dislocations of bonds because of rising rates will not be confined to bonds only but to all other asset classes including equities. For now, we monitor and remind ourselves the relative positioning is heavier in bonds than equities. We remained committed to absolute return bond managers, managers in capital structure arbitrage, EM credit and preferred securities.

**Bonds inflows eclipsed equities since GFC and YTD**




**No value to be found in credit beyond a little carry**




**FX: Neutral.** Our view that US will have to normalize rates faster than most G7, we remain long USD.

**Commodities: Overweight.** We are long oil producer, basic materials companies and have increased exposure in a fund manager that specialized in industrial, commodities and discretionary spending.

**Alternatives Investments:** No change in our preference for long/short equities manager in the US due to expensive valuation, will continue to add/search absolute return managers in fixed income. We are exploring a few non-correlated strategies such as selected real estate PE funds owning to added security of collateral and yield, clearly defined venture capitalists and fund managers that rely solely on AI and big data analytics in their investment decisions.

**Cash:** Cash is reduced to 10-15%.

**Featured Picture/Quote:**

When I see the rainbow in the sky, I will always remember the promise that I have made to every living creature. 17 The rainbow will be the sign of that solemn promise.

**Edward Lim,** CFA

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