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# SUPER TRENDS AND TACTICAL VIEWS

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## AMERICA'S OUTPERFORMANCE: A MOVEABLE FEAST

"If you are lucky enough to have lived in Paris as a young man, then wherever you go for the rest of your life, it stays with you, for Paris is a moveable feast."

- Ernest Hemingway



### SPEED READ

- A big surprise in 2017 has been that the US dollar has stopped rising. And, in general, broad outperformance is moving away from the US toward Europe and Emerging Markets, driven by cheaper valuations, earlier stage economic expansions and monetary policy that is nowhere near substantial tightening. This trend will be measured in years, not quarters like many are forecasting.
- Overall, Trump will have far less impact on the global economy than originally envisioned by markets. But it is clear that reduced regulation will be the key support for business confidence, rather than lower taxes and public investment programs. As such, Trump's sectoral impact will be substantial.
- The most important facts about China today are not the problems of slowing growth and high leverage. Rather they are the shift away from exports and capital spending to consumer-led growth, improving margins and financial liberalization. On balance, this will be positive for Chinese asset prices.
- 2017 continues to be a year of massive asset and sector rotation. **For the intrepid macro investor, this is our time.**

## PART A: SUPER TRENDS (3-5 Year Outlook)

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**America and the Rest of the World: Divergent Paths.** One of Woody Allen's most critically acclaimed films, *Midnight in Paris*, is a 2011 fantasy comedy that follows Gil Pender, a successful but creatively unfulfilled Hollywood screenwriter, who is pushed to confront the incompatibilities of his relationship with his materialistic fiancée, Inez. The mismatch is painfully obvious. Gil loves Paris in the rain, while Inez longs for a glamorous life in Malibu.

Everything changes one night when Gil is time-transported back to the sizzling Paris of the 1920s. Besotted with the "moveable feast" days of Hemingway, Fitzgerald and other American expatriates, Gil shuttles back and forth each night — between nocturnal bliss and his sobering daylight reality. As he travels back in time every midnight, Inez and Gil's divergent goals become increasingly evident.

A similar drama is unfolding in financial markets. With each passing week, it is apparent that America's policy path is diverging from most of the world. Consider the latest example: America's departure from the Paris climate change accord. Whether readers agree with the science or not, the US's exit further isolates its administration, leaving Trump alone with Bashar al-Assad of Syria and Daniel Ortega of Nicaragua as the world's only non-participants. Oops?

Meanwhile, announcements overseas further highlight the differences. For example, under new policy plans in India, every car sold in the country from 2030 will be electric. In China, policymakers recently reaffirmed their commitment to produce as much clean electricity by 2030 as the US does from all sources today. Cracks within the US have even surfaced. News of the US's exit from the Paris accord prompted Elon Musk, arguably the world's favourite face of climate change, to resign from Trump's strategic and policy forum, tweeting: "*Am departing presidential councils. Climate change is real. Leaving Paris is not good for America or the world.*"

We return to a theme in this quarter's report: America's retreat from its global leadership position. Consider Obama's "pivot to Asia", with the Trans-Pacific Partnership being the centerpiece. It is now dead. That leaves Chinese President Xi Jinping's "Belt-and-Road" strategy (his own version of "Make China Great Again") as the uncontested blueprint for future economic integration in Asia.

China's diplomacy now also offers a positive vision. In Davos this year, President Xi (a first time visit for any Chinese President) defended globalization, positioned his country as a protector of free trade and urged policymakers to "just say no" to protectionism. "Pursuing protectionism is just like locking one's self in a dark room. Wind and rain may be kept outside, but so are light and air," he said during his address. "No one will emerge as a winner in a trade war." Trump was conspicuously absent from the gatherings.

In Europe, Emmanuel Macron's presidential victory, with his *La République en Marche* party securing a record parliamentary majority, was won on a platform of pro-globalization, pro-free trade, and, importantly, potential federal solutions to the EU's structural problems (which could

renew a cooperative Franco-German axis that drove the EU project since the early 1950s). That contrasts starkly with Trump's "America first" agenda, whereby the US effectively withdraws as global hegemon. Expect global leadership to continue to fill the vacuum left by the US's nationalistic policies.

→ *Investment Implications. It has been a long — and many would say — well-earned period of outperformance for US assets. Since 2009, America's stocks and its currency have trounced their global counterparts. By early 2017, the US dollar index had surged to a 14-year high as investors bet that Trump's projected eye-watering fiscal expansion would prove a replay of early 1980s Reaganomics. Yet the big surprise of 2017 has been that the US dollar has stopped rising. This is remarkable considering that the Fed is hiking rates and preparing to shrink its balance sheet.*

*What should investors make of this? There should be no doubt that America's waning leadership plays a key role in the value of its currency. However, we have argued in the past few reports that US equities are set to underperform. Why? 3 key drivers of US equity outperformance are going into reverse: 1) In recent years the Fed was the most aggressive liquidity provider in the world—this is no longer the case. The Fed is now tightening, while everyone else is on hold. 2) In recent years the US benefitted from an extraordinarily competitive currency—this is no longer the case. In a very short period, the US dollar has gone from being significantly undervalued against almost all currencies, to being fairly valued against most, to now being overvalued against the likes of the euro and the yen. 3) In recent years US equities were attractively priced—this is no longer the case.*

*Indeed, American past performance is this year's moveable feast. Where may the next phase of outperformance direct itself? Europe and Asia are the most likely candidates — regions that have cheap currencies, are showing signs of earnings and economic acceleration and trade on much cheaper valuations.*

**Bubble Watch: If It Ain't Broke, Don't VIX It.** Stocks around the world are hitting new highs, the media is brimming with bubble alerts and notable bears repeatedly cite Wall Street's fear gauge (^VIX) as a warning of broad complacency (it just sank to its lowest level since 1993). In short, a market top seems to be the consensus. What gives?

For one, the VIX's own history shows that it's not reliable at predicting market peaks. Yes, the VIX hit a multi-year low in 2007, before the global financial crisis. But the VIX was hitting important lows as early as 2004, and again in 2005 and 2006. Rummaging further back in the VIX's history shows that the indicator was incredibly low between 1993 and 1995 — a period that kicked off a spectacular boom in US stocks (the S&P 500 increased by more than 20% every year from 1995 to 1999).

Moving on, the more important story is that we continue to live in a post-financial crisis period. Investors, still carrying crisis-made scar tissue from 2008, have tended to cling close to shore. Endless fears of another financial meltdown prevail. And, each time volatility erupts, capital quickly flows back to perceived safe assets (how else can you explain a sub-3% 30-year US treasury bond?).

Crucially, history shows that these periods tend to be protracted affairs. The private sector deleverages, inflation stays low and traditional industry is disrupted. Meanwhile, public policy fumbles around in search of an elusive “right mix” (i.e. witness the rolling alphabet soup of credit facilities: TARP, QE, LTROs and now frantic forays into fiscal stimulus). Ultimately, the key observation is that post-crisis recoveries are stretched out over long periods.

This episode has been no different. Many economic engines, like those in the EU, are just starting to rumble. Yet, we are still left with the haunting question: are stocks in a bubble? Self-confessed “bubble historian”, Jeremy Grantham of investment firm GMO, in a late 2016 report, nails the difficulty that investors face: for those “eager to see pins used on bubbles and spoiled by the prevalence of bubbles over the last 30 years, it is tempting to see them too often. Well, the US market today is not a classic bubble, not even close”. Bingo JG.

As card-carrying members of the change-anticipation field, we understand the desire to divine the big turns. To be first to spot the outlines of a looming crash can be glorious. But most warnings in the investment industry are false alarms simply because big turns are rare events. Experts overreact to small turns, mistaking a cyclical adjustment for the secular, career-enhancing kind (for full disclosure, we have erred in that fashion before).

Occupational hazards aside, Grantham is right. There is limited evidence of those essential properties of a classic bubble: broad investor euphoria, stable geopolitics and, importantly, a massive credit expansion. None exist today, with the exception of expensive valuations in some countries around the world (notably the US stock market).

→ *Investment Implications. To be sure, this has been a long cycle, particularly for the US. At eight years, it ranks third out of 33 cycles recorded since 1854. But the attendant bull market has been an unloved one. Since 2008 global investors have endured rolling geopolitical concerns, dramatic elections, viruses, Brexit, terrorist attacks, Trump’s erratic tweets, etc. ... and guess what? The market has been incredibly resilient. Now try to imagine what happens if the news actually turns positive. While we are not rabid bulls on global growth, a mild and, importantly, globally synchronized recovery has taken hold. Yes, volatility will move higher and specific global asset booms and busts will rotate, but bubble-ologists will likely have to wait another few years for an elegant pricking of the “big one”. Or, using Grantham’s roadmap, the market is unlikely to “go bang” in the way that recent bubbles have. Instead, “mean reversion will be slow and incomplete ... it is heartbreaking for there will be no histrionics, no chance of being a real hero. Not this time.”*

**Global Stock Market Valuations: Time To Trust Men Wearing CAPes?** *Seinfeld* fans will fondly remember Season 6, Episode 4. Larry David makes his most memorable onscreen cameo when he appears as Frank Costanza’s divorce lawyer, wearing a long black cape for no apparent reason. Everyone spends the rest of the episode critiquing and puzzling over the cape. As George says, “I don’t trust men in capes.”

A similar episode is taking place in the financial world. So-called “value investing” is out, and



investors who relied on measures like Yale Professor Robert Shiller's "CAPE" valuation measure have been tragically left behind. For the uninitiated, CAPE stands for "cyclically-adjusted price to earnings" and it is created by smoothing the average earnings of the last ten years rather than the typical PE ratio we see employed, which uses a year's worth of data (last year's or next year's).

While there is much controversy over the construction of Professor Shiller's index (ten years is an arbitrary duration to smooth earnings, profit margins may be structurally higher, etc. — debates, which in my experience on the conference circuit, are better held in venues that serve adult beverages), it does serve as a reasonable gauge of value. The current CAPE Ratio for the S&P 500 stands at 30.02, almost double the long-term average of 16.76 (but nowhere near the vertiginous heights of 1999 which almost reached 45).

We get it. In our post-modern world of monetary largesse and central bank-sponsored puts, valuations are out, liquidity is in. Sovereign nations are printing money, prices are trending higher and those investors held back by such quaint notions as fundamental support, reasonable price/earnings multiples and the sober hand of history are missing out. Or, at least that's the consensus view.

Yet, it may be truly time to start listening to men wearing CAPEs — at least, relatively. Consider the synchronicity of the global recovery. 2017 is on track to be the first year since 2010 when all major regions will post both output and earnings growth. And, according to IMF data, the variation of growth rates this year among G20 economies will be the lowest since at least 1980. What's more, interest rates around the world have converged toward similar levels. In short, with such a convergence among major country's broad financial indicators, global asset allocators are left with fewer anchors to determine positioning. Valuation, despite its current unpopularity, remains the best guide to longer term returns. Like the law of gravity, expensive stocks will generally have lower returns and cheap stocks will have higher ones.

→ *Investment Implications. Value investing may yet come back into fashion. Colleague and Forstrong Research Manager, Ken Hawkins (who, despite an affinity for buying dollar bills at 50 cents, has never worn a CAPE to the office), reports that our US equity composite value ranking now registers a 100th percentile extreme — in other words, the US stock market is the most expensive it has been since 2007. By contrast, many global markets currently showcase good value. Using the same composite value measure, developed Asia and Emerging Markets are sporting percentiles of 34 and 29, respectively. Who can argue with rotating into cheaper markets, where business cycles have only just begun their expansion phases, where profits have plenty of scope for improvement and where monetary policy is years away from any substantial tightening?*

**China: Unloved and Under-owned.** It's no secret — China is slowing. The country's GDP growth averaged 11% in the 2002-2011 decade. It's now under 7% and further moderation is almost certain in the years ahead.

But let's separate fact from fiction. Importantly, much of China's slowdown has been coordinated by policy. Many starry-eyed China watchers predicted real GDP growth of

10% plus indefinitely. But there are limits to linear thinking. While trends can stay in place for some time, lines often bend, or even break and gallop off in unexpected directions.

China's new path is driven by broad recognition that the growth model of the last 30 years is neither balanced nor sustainable. The new model must rebalance away from export and investment-led production toward private consumption. "Made in China" and Western consumerism can no longer be intimately linked. This is a necessary shift if China is to avoid the so-called middle income trap, which ensnares most emerging economies that rely on cheap labor for growth.

GDP per head in China is now approaching USD \$10,000. To move beyond this level, policymakers know productivity must dramatically improve. That requires a litany of change — reduced corruption, middle class rights and an improved operating environment for the private sector. A critical next step is to establish a robust social safety net and thereby reduce fear-driven high household savings rates. This will lead to a virtuous cycle of consumption, job growth and, ultimately, higher real wages and corporate profits.

China is also moving from the rapid industrialization stage of growth (where the main objective was to build up infrastructure and heavy industry) to the resource efficiency stage (where the main goal is to maximize the return on investment). Therefore, over the next several years China will see slower but better growth — due to reduced capital waste and improved profitability.

Lastly, it cannot be ignored that China has an eye-watering amount of debt, reaching the dizzying height of 220% of GDP by the end of 2015. But the fundamental reason behind this credit surge is rooted in its high savings and banking-centric intermediation system. Chinese households have long been the primary providers of savings in the economy and their assets are far larger than liabilities. Thus, viewed from a balance sheet perspective, the debt situation is much less dire than commonly perceived. Further, the bears ignore that most debt has been used for infrastructure buildup rather than funding consumption (imagine that in any Western country!).

*→ Investment Implications. Investors naturally worry whether equity prices can keep rising even as the economy keeps slowing. This is the wrong question. Headline GDP should not be the focus. In fact, GDP growth tends to be negatively correlated with equity markets (most likely because investors overpay for headline growth).*

*The most important facts about China today are not the problems of slowing growth and high leverage. Rather they are the shift away from exports and capital spending to consumer-led growth, improving margins and financial liberalization. The makeup of China's stock market is also rapidly changing. January 2017 saw the most IPOs of any month in the market's history. The upshot is that the Chinese stock market will come to more closely resemble the underlying economy as a whole, rather than being dominated by state-owned enterprises. Short interest for three of the biggest China equity ETFs is massive, totaling about \$6.1 billion in assets. Yet now is the time to be investing in an unloved sector. As China makes progress*

*in face of the many naysayers, equities have much room to be revalued upward. The recent decision by MSCI to add 222 China A-share stocks starting in May 2018 is icing on the cake. Stay long ASHR, FXI.*

**Regime Change: Limits of Low Rates and Keynes Returns.** Replying to criticism during the Great Depression for changing his position on monetary policy, John Maynard Keynes famously quipped “When the facts change, I change my mind. What do you do, sir?” Our Investment Committee may use the same words regarding our interest rate outlook. Having been vocal proponents of a “lower for longer” view since 2009 (with a fair share of rotten tomatoes thrown our way), we adjusted our positioning in the summer of 2016: the 35-year bond bull may be over.

Note that our core scenario is not for a bond market crash. However, yields have very likely seen their lows. Several reasons support this view. For one, valuation. Can there be a more expensive asset class than the global bond market? Secondly, there is a growing awareness (both in policy and public circles) that low rates are actually impeding economic growth, increasingly seen as (1) hindering the process of what Joseph Schumpeter gleefully called “creative destruction” (i.e. witness Japan’s stagnation since the mid-1990s), (2) creating uncertainty causing companies to delay investing, (3) promoting social discontent, as the wealthy have been prime beneficiaries of the era of easy money, and (4) fueling asset price inflation without similar benefits bestowed upon the real economy.

Given the above it is not surprising that fiscal stimulus — or at least a retreat from austerity — is making a comeback. We are indeed entering a regime shift away from loose monetary, tight fiscal policies to tight monetary, loose fiscal settings (at least in the US, which has become a leading indicator of what other global policymakers will do in the post-crisis period). Consider the Fed’s latest moves. For only the second time since June 2006, they raised the benchmark interest rate by 25 basis points in December 2016 and twice again in 2017. Given the positive tone of the Fed’s comments on the economic outlook and its slightly more hawkish view on the trajectory of rates, the unnerved market reaction underscores that investors recognize this profound monetary to fiscal shift.

→ *Investment Implications. In the same way that investors took more than a decade after 1980 to believe that inflation would not rise again into double digit figures, today’s investors — conditioned by at least 35 years of disinflation and declining interest rates — will take years to become convinced that the secular environment has changed. Bond rallies will still present themselves. However, for Western bond market exposures, keep duration strategically short and tactically take on floating exposures when bonds become overbought. Finally, keep in mind, that we expect a gradual reversal in yields that will play out over many years. And while a spike in rates is clearly detrimental to fixed income investors, a slow and steady rise allows for a higher reinvestment rate without incurring large capital losses. This is wonderful news for retirees who have had considerable difficulty generating sufficient income in an abnormally low interest rate environment.*

**Achtung, Fidget Spinning Verboten!** Readers with young children (including this author) will no doubt be aware of the latest shiny bauble to capture the imagination of planet Earth: the fidget spinner. Even Barron Trump has one. But views on this latest trend are strongly divided. Its promoters argue that the toy is effective at relieving stress and increasing focus. Critics contend that it is just another distraction in an overly stimulated world. Even worse, Frankfurt airport customs authorities claim that they pose a choking hazard, confiscating 35 metric tons of the tiny twirling gadgets in May alone and plan to “crush them out of existence” (we are with the Germans on this one).

A similar division has emerged in opinion toward the efficacy of President Trump’s administration. While the first 100-plus days of Trump have witnessed everything from a Watergate-type scandal linked to Russia to more mundane, fidget spinning-like matters of Melania moving into Trump House (formerly known as “the White House”), the money manager’s job is to put things in perspective by pointing out what counts for client portfolios. Of course, the critical question for asset markets is how much business can hope to gain from the new administration’s promised tax cuts, deregulation and infrastructure projects.

The fog is still thick, but some of it is lifting. First, infrastructure spending. It is now clear that there will be significantly less than the \$1 trillion of new investment promised by the Trump campaign. Elaine Chow, Trump’s Transport Secretary, has repeated several times that the federal government accounts for only 16% of US infrastructure spending — that means less than US\$200bn of federal money. The rest is up to state governments. Where they will raise the money seems not to have been a consideration, except floating the idea of more public-private partnerships. In any case, it is clear that there is no urgency to any of this. Even if the \$1 trillion infrastructure promise could be financed, it was meant to be spread over ten years.

Sticking with the bad news, what about employment? Trump promises to “bring the jobs back”. But which jobs? In recent years, factories have been coming back (because of rising wages in China, the need for shorter supply chains and other factors) but the jobs haven’t followed. The reason is that factories are now heavily automated, employing a fraction of the workers they would have a generation ago. The numbers speak for themselves. Since the recession ended in 2009, manufacturing output has risen by more than 20%, while manufacturing employment is up just 5%.

What about taxes? Here, again, a huge chasm lies between the promised “biggest tax cut in the history of our country” and reality. With savings from an Obamacare repeal and revenues from border tax adjustments both not likely to happen, the cuts are constrained by the amount of deficit financing fiscal conservatives in Congress will accept. To date, we have only received a scant 2-page account of tax reform details. As Steve Mnuchin, Treasury Secretary, has said, “it was purposely vague” so that legislators could craft something that “Congress will pass.”

Now for some good news. It is very clear that the protectionist rhetoric and plans have backed off. Large scale changes in trade policy are extremely unlikely. Wilbur Ross, Trump’s



supposedly protectionist Commerce Secretary, admitted that he has adjusted his view of the US's trade negotiators: "I've been heartened," he said, "to find the quality of people in the government was very high — they were just trapped in a dysfunctional system." What about regulation? This is the most encouraging development for certain sectors of the market. Mnuchin and Ross are clearly determined to deregulate wherever they can. Even if the Congressional Democrats block specific changes (like Dodd-Frank), the administration has room to weaken regulations simply by re-interpreting existing laws.

→ *Investment Implications. Overall, Trump will have far less impact on the global economy than originally envisioned by markets. But it is clear that reduced regulation will be the key support for business confidence, rather than lower taxes and public investment programs. As such, Trump's sectoral impact will be substantial. From that perspective, US policy should support financials and homebuilders, be neutral for tech and multinationals and be negative for some manufacturing exporters, infrastructure companies and energy (as prices should stay soft while supply continues to ratchet up).*

**Emerging Markets: Seven Year Famine Over.** Since 2010, US stocks have more than doubled while emerging market equities have gone nowhere. Like the biblical Joseph interpreting dreams for Pharaoh, our Investment Committee has declared the seven year famine over. It is time for abundance.

We have been here before. EM underperformed US stocks for much of the 1990s, especially the latter part of the decade. From 2000 on, however, they outperformed the US for 10 of the next 12 years.

Could we see a similar path today? Absolutely. It has likely already begun with EM stocks outperforming the Canadian stock market by 15 percentage points this year (meanwhile, Canadians are missing out, with record "home bias" weightings in their portfolios).

Behind this relative outperformance of emerging markets lie four positives 1) the US dollar's likely peaking (wonderful for emerging markets) 2) dovish monetary policy and lower commodity prices are driving long term domestic interest rates lower 3) the valuation gap between Asian and Western markets today stands close to 2003 levels (the last time a secular bull started) and 4) fiscal easing, notably in China and India, bodes well for corporate earnings.

It is also important to recognize that EMs already had a large slowdown between 2010 – 2016. Since then, currencies have weakened (boosting competitiveness), commodities have fallen (raising consumption) and policy has turned stimulative (lowering the cost of capital). These benefits always show up with a lag. Why should this time be different?

Now, all signs to point to a rebound in EM economies. Upward EPS revisions are stronger in EM than any other major regional index and earnings growth is stronger than any other index (with the

exception of the UK's FTSE 100). What's more, a global upturn has almost always been a reliable signal for identifying inflection points in EM's growth and profits cycle. Since most EM firms typically have high operating leverage and work in globalized supply chains, their earnings and investment cycles are disproportionately influenced by changes in world trade and demand. In contrast with the US, EM business cycles are only just entering a broad-based expansion phase, inflation is not on the horizon (meaning that monetary policy will remain accommodative) and profits have plenty of room for improvement. In short, the conditions that the US has enjoyed over the last seven years have arrived in EM.

Skeptics may argue that the recovery is built on last year's Chinese-made reflation and will falter as China's crackdown on credit growth slows infrastructure spending. But those perspectives miss the main point: consumer spending, especially in Asia, is now a solid growth driver. This remains the biggest macro story of the next few decades.

Of course, bull markets are built on fact and sentiment. Both have to be positive. When examining fact, it is difficult to construct a causal line running from China's economy to the recent performance of EM stock markets. This year has seen radical differentiation in the performance of individual country EM ETFs and not in a way that obviously correlates with China's reflation.

When examining sentiment, we are at a classic stage where investors are just starting to take notice. There is a long way to run before this market is overheated.

→ *Investment Implications. The last EM boom featured stellar performances of countries and sectors that catered to China's rapid industrialization era (where their urban labour force grew by 200 million people in the ten years spanning 2002 through 2011). Think Brazil and Russia. Now, as the emerging market story transitions, favor domestic-focused, reform-minded, commodity importing countries. Country selectivity will be key. But, make no mistake, the famine is over.*

**The Supertanker That Couldn't.** "I think I can, I think I can, I think I can", is the famous line of my five year old son's favourite book *The Little Engine That Could*. In the story, a long train has to be pulled over a large mountain so the children can enjoy their toys and candy. After several larger engines refuse to try, a small engine overcomes a seemingly impossible task and succeeds. Optimism and hard work pay off.

In the oil market, a more difficult set of circumstances exist for the sector. If a single supertanker can capture the current state of the global oil market, it is Saiq, floating idly about 850 kilometers south of the Canary Islands. The 330-meter-long engine, chartered by Royal Dutch Shell, was originally destined for the Chinese port of Tianjin. Suddenly, it stopped (according to ship-tracking data compiled by Bloomberg). The problem: it cannot find a buyer for its cargo. And, unlike the little engine that could, Saiq cannot conjure an oil recovery by summoning the confidence fairy.

Around the globe, the plight of Saiq highlights a super trend in the oil market: the world is literally

swimming in a supply glut. The longer-term supply picture may be even more bleak. BP recently pointed out in its long-term energy outlook that oil reserves already discovered around the world far exceed the amount of oil that will ever be consumed, with twice as much technically recoverable oil available than the world needs between now and 2050. Pricing pressure is coming from both the supply and demand side — from strong growth in US shale oil and from the relentless rise of renewable energy, led by Silicon Valley’s innovation engine. So much for “peak oil”. However, do expect wide volatility. In the period from 1985 – 2004, the oil price frequently doubled or halved in the course of a few months.

→ *Investment Implications. We remain steadfast that oil and commodities are in a “lower for longer” phase. Yes, stability may have arrived. However, a renewed bull market is unlikely. Prices went through a very typical secular phase — rising demand amidst constrained supply in the early 2000s was met with an enormous surge in capital spending. This increase in supply will keep a ceiling on prices for years.*

*Looking ahead, global investors should learn to love low oil prices. Cheap oil is a very powerful stimulant for world growth. A tectonic wealth transfer is now underway. Because the world burns 34 billion barrels of oil every year, a US\$10 bbl fall in the oil price shifts roughly US\$340bn from oil producers to consumers. Thus, the enormous price fall since August 2014 will easily redistribute more than \$2 trillion annually to oil consumers, providing a bigger income boost than the combined US and Chinese fiscal stimulus in 2009. This will become more apparent as the positive impact on global consumption, investment and liquidity materializes over time. Falling oil prices have never correctly predicted an economic downturn. On all recent occasions when the oil price has at least halved, faster global growth followed. Conversely, every global recession in the past 50 years has been preceded by a sharp increase in oil prices.*

## PART B: BEHAVIOURAL BIASES (<12 Month Outlook)

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**European Banks: Less Stress Ahead.** Europe has been mired in seemingly endless turmoil since 2008. Sovereign debt crises, fiscal austerity measures and a massive inflow of Syrian refugees have weighed on economic and geopolitical stability. As a result, real GDP in the Eurozone took over eight years to eclipse the high watermark set in 2008.

However, a number of factors argue for a turning point for the broad European economy. With encouraging economic momentum materializing (dispersed across countries and sectors) and the risk of a Eurozone breakup receding, the financial sector should be buoyed by improving consumer and business confidence translating into a pickup in credit growth.

Europe’s underperformance since the Global Financial Crisis has left a fair amount of slack in the economy, allowing for an extended period of catch-up growth without a great risk of overheating. The gradual normalization of ECB monetary policy should help bolster net interest margins, while a loosening regulatory environment in the US may put competitive pressure on European regulators to

follow suit. On aggregate, balance sheet strength has improved in recent years, as demonstrated by rising tier 1 capital ratios and falling NPL ratios; providing a more solid base for renewed lending activities.

To be sure, potential contagion from Italian banks cannot be taken lightly, as NPLs have risen by more than 500% over the last 7 years. But the recent handling of the Spanish Banco Popular's liquidity crisis should help bolster sentiment. With insufficient collateral to access ECB funding, the Single Resolution Mechanism was triggered for the first time ever, bailing in equity and subordinated bond holders. Banco Santander stepped in and purchased the Banco Popular for one euro and will now need to inject capital. This can provide a template for troubled Italian banks going forward.

→ *Investment Implications. Initiate positions in European banks via EUFN. While this ETF has a large weighting to British banks (29%) and hence carries risk from Brexit discussions, these companies are multinationals with subsidiary offices in the Eurozone and elsewhere around the globe, limiting the risk of a major disruption. EUFN's juicy 4.2% dividend yield is particularly attractive in a region dominated by sub-zero interest rates.*

**Make Mexico Great Again.** Arriving at Benito Juárez international airport is often a painful experience due to long queues at immigration. During our February 2017 visit, however, we whisked through the electronic passport scan and were immediately greeted in arrivals by a cheerful local group wearing hats bearing the ironic slogan "Make Mexico Great Again". Somewhat unexpectedly, this enthusiasm set the tone for the entire trip. Of course, outside of Mexico, many believe that Trump's threats have catapulted the country into terminal decline (an ETF company has even launched a global ex-Mexico listing).

Boots on the ground tell a different story — one of resurgent patriotism and an eagerness to enlarge Mexico's global trading ecosystem. Many Mexican business owners with both domestic and US footprints have decided to re-focus their efforts in Mexico. Others are pivoting their trade efforts to entirely different regions.

Clearly, real risks lie directly ahead. With the recent stampede out of the Mexican peso and the currency currently undervalued by around 50% (vacation in Cabo, anyone?), real risks are present. But this wouldn't be the first time. After all, crisis is a recurring feature of Mexican history. The list is long: the 1976 peso devaluation, the 1982 debt crisis (and the "década perdida" — the lost decade — which followed), and the hyperinflation of the early 1990s which ultimately led to the Tequila crisis of 1994.

But pessimism has likely gone too far, pricing in a worst-case scenario for Mexico. There are limits to portraying the US as a victim of Mexico. The US trade deficit is only a quarter of its exports to the country, compared to a deficit with Japan of twice exports and with China of three times. As with many asset classes damaged by Trump rhetoric, there is plenty of room for positive surprises.

→ *Investment Implications. With the Mexican currency back at a level not seen since the depths of the Tequila crisis, it is time to keep Mexico on the "watch list". Ironically, Trump's anti-trade rhetoric has*

*made Mexico far more competitive (via a cheaper currency) and engineered domestic optimism. This is also true for other emerging markets and confirms our overweight in Asia — countries that have already radically sharpened their competitiveness through currency debasement over the last four years, benefit more from a lower oil price and trade on far cheaper equity valuations than Mexico.*

**Justin Trudeau’s 2 Trillion Dollar Problem.** In the last few years, Canada’s star has fallen and several macro headwinds have surfaced, including a fragile housing market (Canadian household debt just cracked the two-trillion-dollar ceiling, representing household liabilities of 100.5% of GDP), weak private-sector wage growth and the end of a multi-year uptrend in commodity leadership. And while prolific shale plays in Texas and Oklahoma are going through an investment boom, the oil sands have fallen out of favor. In fact, business investment in Canada as a whole has been abysmal. While Canada’s GDP averaged quarterly growth of 3.2% in the second half of 2016, non-residential business investment has fallen in eight of the past nine quarters, and is down 19% over that time.

But now, our newly elected anti-austerity (and telegenic) prime minister, Justin Trudeau, has revived hopes that Canada can regain its former glory, funded in part by “responsible deficits”. While Trudeau’s “sunny ways” and a potential lift from Trump-induced fiscal stimulus have engineered some optimism, the more important story for Canada is the ongoing softness in commodity markets. Politics cannot change that meaningfully. Since oil now accounts for half of Canada’s production-weighted commodity price index, the lower crude oil price continues to represent a big downside risk to the outlook for business operating profits. The potential hit to investment, incomes and employment may even eventually persuade the Bank of Canada to cut interest rates further. Meanwhile, Canadians continue to be over-exposed to domestic assets. This is all going into reverse as Canadians scramble to embrace global diversification. In fact, Canada is now a creditor to the US for the first time on record, reflecting Canada’s renewed love affair with assets south of the border.

*→ Investment Implications. Until the global resource cycle turns up in a secular fashion again, strategic “overweights” on the Canadian dollar and the TSX are no longer justified. This could still be several years away. Tactically, however, Canadians should hedge their CAD/USD exposure. Pessimism has gone too far, as evidenced by net short positions in the Canadian dollar hitting an all-time high going back more than two decades. Historically, this has been the time to go against consensus.*

**Japan: Batter Up.** In November 2016, there was momentary panic when news spread that Haruhiko Kuroda, governor of the Bank of Japan, abruptly resigned from his post. However, it soon became clear that the Kuroda in question was actually Hiroki Kuroda, a pitcher for the Hiroshima Carp baseball team. While we can laugh at the story, it does underscore the waves of Japanese misinformation flowing in social media.

To be sure, Japan faces some serious structural headwinds (high debt levels, aging demographics, etc.). But everyone and their brother-in-law knows that. Fewer understand the micro story. Over the last



decade, Japanese companies faced the twin burdens of chronic deflation and an overvalued currency.

What has been the result? First, corporate Japan is now extremely lean and efficient. Aggregate Japanese return on equity has been trending upwards as companies have focused on improving corporate governance and benefitted from a weak yen. Japan is also a veritable hotbed of companies at the forefront of several technologies reshaping the global economy — including robotics, electric cars and alternative energy (in the words of one analyst, “they make cool stuff”).

Second, Japanese equities are priced at the frontier of value, if not over the edge — deep into bargain territory. More than two-fifths of Japanese shares trade below their book values. Cash flow has rarely looked better — more than a third of Japanese companies are generating a cash flow yield of 15 per cent or more, twice as many as in the US or the UK. 50% of Japanese companies have no debt, with more than \$3 trillion in cash on their balance sheets (figures that would cause Ben Graham to eagerly open his cheque book). And, companies have been steadily increasing their dividends, yet payout ratios still average only 25 to 30 per cent of earnings. The Japanese yen itself is also dramatically undervalued — more than 2 standard deviations on a purchasing power parity basis.

Thirdly, lower oil prices are indisputably positive for Japan, which imports most of its energy needs. Fourthly, Japan is likely transforming itself from a nation of savers to a nation of investors. Contrary to popular belief, the Japanese savers have never been wealthier, having a net worth that is double what it was at the peak of the 1980s bubble. This marks the big difference between Japanese private savers and their counterparts in other countries. While more than a third of savers in the UK or the US buy stocks, less than 10% of Japanese people do. Viewed another way, a mere 6% of Japan’s household wealth is invested in listed equities, compared with 38% for the US.

Finally, and perhaps most importantly, Japan continues to lead the world in unconventional monetary policy. On November 14, 2016, Kuroda (the one that is not retiring anytime soon) announced more forceful measures to raise inflation expectations and introduced an “inflation-overshooting commitment.” “Specifically, under this commitment,” Kuroda said, “the Bank will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI exceeds 2% and stays above the target”. Further, the IMF estimates that the Bank of Japan will run out of government bonds to buy in 2018 when its ownership will reach JPY400trn (the bank also owns 47% of domestic ETFs). Expect further forays into the realm of unorthodox policy.

→ *Investment Implications. Abe’s true master plan is to stoke a stock market rally and Japanese “animal spirits”, which in turn should lead to wage increases, capital investment and ultimately, an increase in the return on invested capital. That’s the theory, anyway. But don’t bet on it. However, do believe that Abe and the Bank of Japan will continue to aggressively underwrite a rising stock market (and depreciating currency). Couple that familiar macro story with strong micro underpinnings and Japan’s equity market*

*looks set to prosper. Sentiment appears to be shifting rapidly, with strong flows into Japanese ETFs. Property REITs are experiencing strong flows too. Housing in Greater Tokyo remains relatively affordable by international standards. Across the desirable Tokyo and Kanagawa prefectures, median home prices were just 4.9 times median household income in the third quarter of 2014. That's a favorable ratio compared to other "global gateway" cities, such as New York-New Jersey at 6.1, London on 8.5, Sydney on 9.8 and Hong Kong at an eye-watering 17 times. With fixed rate mortgages available at less than 1%, Tokyo's inhabitants are responding to improved economic conditions by buying new homes.*

*It is not only local residents who have noticed the pick-up in the capital area's property market. Chinese real estate investors are increasingly attracted by Tokyo's robust demand for top-grade buildings, the influx of visitors in need of lodging, and the steady returns on offer. The yen's weakness is an additional lure. A ¥60mn property that would have cost US\$761,400 in July 2012 today costs just US\$492,000. As sentiment strengthens, and the perception spreads that prices have acquired a robust upward momentum, construction activity is likely to accelerate as developers increase the supply of new housing projects. As a result, the gathering pace of the recovery should support the continued outperformance of Japan's construction sector.*

**Modi Keeps Winning.** After a shaky few months, the run of Prime Minister Narendra Modi's reform project is back on track. His party's unexpectedly strong performance in state elections — particularly a landslide victory in Uttar Pradesh, India's most populous and politically important state — will enable the Prime Minister to continue with pro-business policies that should deliver both economic growth and buoy stock markets.

The five state elections conducted over the past month were presented by the Indian media as a referendum of sorts on Modi's contentious policies — in particular the "demonetization debacle". In December 2016 we wrote that, despite some short-term pain, there were likely to be many more long-term benefits including (1) improved circumstances for more legitimate and better companies because of elimination of some "informal" competition, (2) damaged terrorist and counterfeiter activity, (3) expanded tax base by digitizing many economic transactions and (4) improved tax collections — which could fund lower tax rates or fiscal stimulus. Our main point was that this initiative fits squarely into Modi's program of structural reform and financial modernization. A big focus is directed at pulling India's vast, but unproductive informal economy (which, unbelievably, accounts for about half of India's national product and some 80% of employment) into the ambit of the formal economic and banking ecosystem. If pulled off, the benefits to India are enormous.

Now with the Prime Minister's renewed mandate, Modi's administration will push ahead with bold reforms, including a swift rollout of the Goods and Services Tax — undoubtedly, the biggest fiscal reform since independence in 1947. The GST will create a common market for 1.3 billion Indians, allowing goods and services to move freely within its borders. The result should be boosted aggregate demand and lower costs of business. Modi will also further target black money and revive the campaign to enlarge the formal economy, which should raise both tax

returns and productivity. Add it all up, and Modi's pro-business agenda is gaining serious traction.

→ *Investment Implications.* While the next few quarters could see a hit to India's headline economic growth, a V-shaped rebound in 2017 is highly likely. Pent-up demand will be quickly released once the new smaller denomination notes are made available for individuals to withdraw from their bank accounts. Such a recovery should be aided by the fact that Indian bond yields have collapsed as a result of the demonetization policy. Assets right across India may benefit, but the small cap sector may be poised for a big re-rating. Looking at the wider Asian region, a number of Asian countries—including India, the Philippines, China—may well be starting once again to see a triple merit scenario of falling interest rates, rising currencies, and rising asset prices. Also, growth of financial services in South Asia, one of the world's most underbanked areas, remains a compelling Super Trend. When Modi came to power, it was estimated that a quarter of the world's "unbanked" population lived in India. Since then, at least 175 million Indians have opened a bank account. Where else in the world can you find this type of opportunity? The problem is that the global investment community has recognized this, making India one of the top performing equity markets in 2017. Pare back positions with the intention of buying back once the enthusiasm has subsided.

**Breaking Down Brazil: Buying Opportunity?** "All life is a process of breaking down," the great F. Scott Fitzgerald once wrote. "But the blows that do the dramatic side of the work...don't show their effect all at once." Fitzgerald was writing about his own challenges, but his comments may also apply to Brazil's economy over the last decade. Stuck in a grinding bear market for years, the country was caught in a vicious stagflationary environment with a weakening currency causing higher inflation, and the resulting monetary tightening crushing domestic demand. In turn, tax revenue was lower than expected and the cost of servicing the government's debt stayed elevated.

Our Investment Team has watched this Fitzgeraldian slow-motion train wreck from the sidelines, abstaining from any investment positions for two main reasons: (a) with a material dependency on commodity exports, it clashes with our outlook for a grinding commodity bear market and (b) so chaotic was the political scene that real reform seemed impossible.

While we have not changed our view on point (a), point (b) merits some close attention. We have likely arrived at a positive turn in the political cycle. This may not be obvious at first glance. After replacing Dilma Rousseff in August last year following her impeachment, incumbent president Michel Temer is now caught up in his own corruption scandal. Temer has been a driving force in pushing through difficult reforms to Brazil's social security, regulatory, labour and tax laws. Continuing such progress is critical to shoring up fiscal stability, restoring productivity and attracting investment. However, the reform agenda has enjoyed broad, multi-partisan support. Whether or not Temer is able to stay in power, positive political initiatives should continue to move in the right direction.

→ *Investment Implications.* From time to time, tactical opportunities present themselves that may not align with our above Super Trends. Currently, Brazil is a case in point. Our sentiment models are signaling maximum pessimism and rotational models have turned positive. Initiate equity positions with only a tactical hold.