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SUPER TRENDS AND TACTICAL VIEWS

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THE LEGACY OF QE

"It's good to be king / if only for a while / to be there in velvet ...

Yeah I'll be king when dogs get wings / can I help it if I still dream from time to time?"

- Tom Petty from the 1994 album *Wildflowers*

SPEED READ

→ 2017 continues to be a year of massive asset and sector rotation. For the intrepid macro investor, this is our time.

→ Quantitative tightening (QT) is not the equal and opposite of QE. Compared to the fast moving dynamics of QE during the financial crisis (when central bankers were desperately trying to boost confidence in the entire financial system), QT will be a glacial affair that plays out over several years.

→ Every secular bear market has an intermission. If a counter-trend rally in the US dollar unfolds over the next few quarters, don't be fooled if it gives a lively performance.

→ Broad fundamentals remain excellent in emerging markets and are primed for multi-year outperformance. However, EM stocks and bonds may experience temporary underperformance versus developed ones.

→ Trump's sectoral impact will be substantial. However, he will have far less impact on the global economy than originally envisioned by markets. But it is now clear that reduced regulation will be the key support for business confidence, rather than lower taxes and public investment programs.

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

Global Financial Crisis Anniversary: What Have We Learned? This year marks the tenth anniversary since the onsetof the global financial crisis, the credit crunch that changed the world and, in many ways, serves as a demarcation line in reshaping economies, financial markets, politics — even our culture. And it remains unfinished business.

Few predicted that the topography of the post-crisis period would be so foreign: freakish monetary policies that dragged interest rates below the previously-unthinkable zero bound, advanced economies stuck in "slower for longer" growth phases (with lost decades now stretching into quarter-centuries in countries like Japan) and alarmingly rapid wealth convergence of the developing world with the developed one (where China's near 40% contribution to global growth last year dwarfs the contribution of other major economies).

All of this is new territory. And the ground is constantly shifting, with collateral effects in international markets running far higher than normal. For example, the tentacles of the Federal Reserve's post-crisis monetary easing reached far beyond American borders. Policy convergence became the rage where central bankers had no choice but to try to outdo the effects of one another. Of course, currency volatility soared in this environment and remains elevated today.

Many more of these "super trends" have taken hold since 2008. Some were crisis-borne; others had deeper roots dating back a few decades. But because economic and financial factors have become more inter-connected than ever before, each of these trends are now truly global in scope. It's more important than ever for investment managers to incorporate a top-down global view of the world even where they are constrained within one particular asset class or strategy. New realities are calling for new approaches.

→ ***Investment Implications.*** *Every major financial event leads to changes in investor behavior and the global financial crisis was no different. What is clear is that the world in which we invest today bears little resemblance to the past. That doesn't mean investors should repudiate many of the basic principles that have served investors well — diversification, maintenance of low transaction costs, and so on. But it does mean we need to revisit our approaches.*

Portfolios today must be highly diversified, not only across asset classes, but also across global risk factors. Compared to traditional asset allocation approaches that are typically backward looking, fixed and statistically driven, macro approaches are forward looking, dynamic and informed by global macro trends. When included in a portfolio of strategies, a global macro strategy provides a key offset to the classic bottom-up approach. In this new landscape, the value of managers with global-macro, multi-asset class experience will become increasingly evident.

Welcome to Quantitative Tightening: No Need To Panic. The US Federal Reserve has at long last confirmed the demise of quantitative easing. The central bank will begin so-called quantitative tightening

(“QT”) this month, gradually lowering their holdings of treasuries and mortgage-backed securities.

How should investors respond? If QE was positive for asset prices, then simple logic suggests that QT would be negative. Undoubtedly, this reasoning will be endlessly promoted by many pundits. If only it were that simple.

We do not dispute Newton’s Third Law: every action has an equal and opposite reaction. Every surge has a backwash. Booms are followed by busts. And, no rally lasts forever.

But financial markets do not conform to Newtonian theory. In physics, principles and formulas are universal and, importantly, durable. Their permanency doesn’t fade. Conversely, financial markets — much to the chagrin of those still carrying the torch for the Efficient Market Hypothesis — are driven by ephemeral opinions. Yes, they are arenas of action and reaction. But they are also layered with dialectics of suppositions, crowd-driven opinions and, importantly, flawed assumptions. Unlike in physics, what’s right in one regime will be wrong in the next.

Therein lies the rub. A widespread misunderstanding of QE has defined the post-crisis policy period. Most simply got it wrong, forecasting that the monetary largesse created in response to 2008’s financial crisis would lead to soaring inflation and crashing bond markets. The opposite actually occurred. Bond yield shrunk across the world (some going subterranean) and deflationary forces loomed large.

This month, even Fed chairwoman Janet Yellen came close to admitting that QE is still poorly understood by the Fed: “we believe we understand pretty well what the effects are on the economy.” Translation: it’s complicated.

What did the consensus miss? They misread the transmission dynamics of QE. What is now clearly known (and forecast as early as 2009 by your favourite Canadian macro managers) is that QE had more impact on the financial economy than the real economy. The liquidity created was distributed to capital owners (i.e. the wealthy) who have a far lower marginal propensity to consume compared to the lower and middle classes. Thus, the injected liquidity boosted asset prices rather than being multiplied by the credit and banking systems. This at least partially explains the apparent paradox of rampant asset price inflation with lower consumer price inflation.

Given the above, a useful exercise is to ask, if most market participants missed QE, what could we miss now? This is the symmetry investors should focus on.

To start, we must acknowledge that an impending QT is unprecedented. No one knows for sure what may unfold. However, there are strong reasons to believe that the Fed’s actions will have less impact than they have in the recent past. Retrospectively, and perhaps as would be expected, QE had a bigger impact the closer it was to the global financial crisis. A comprehensive study last year by the Bank of England found that QE had double the effect on economic growth during the panic period of the financial crisis compared with later iterations.[1] Removing QE (when markets are functioning well) is very likely to have far less impact than if markets were in turmoil. Today, the actions of central banks have become predictable, even boring. Every major world central bank is committed to a gradualist approach. Therefore, compared to the fast moving dynamics of QE during

the financial crisis (when central bankers were desperately trying to boost confidence in the entire financial system), QT will be a glacial affair that plays out over several years. It is not the equal and opposite of QE.

*→ **Investment Implications.** QT will have some impact on markets. However, it will not be the Armageddon scenario currently being portrayed in much financial commentary. In the months ahead, beware of luxuriating in the polemics of many well-known bears. That was not a winning portfolio strategy since the crisis and it will not be one now.*

Emerging Markets: It's Good To Be King. Tom Petty's vast contribution to the soundscape of modern rock will be dearly missed, especially for "Generation X" (which includes this author). His vocals have always been unmistakable, defining an era of angst-filled alt rock and avant-garde music videos. Each song created a distinct mood, arguably most powerfully in his 1994 hit "It's Good To Be King".

The song's first line leads us to a dreamy vista ("it's good to be king / if only for a while / to be there in velvet"), but quickly serves up a sobering dose of realism ("yeah I'll be king when dogs get wings / can I help it if I still dream from time to time").

In the world of high finance, investors may be wondering if the dramatic outperformance of emerging market stock markets in 2017 is just a passing dream. After all, the rally in EM this year is almost surreal, outperforming most developed stock markets by double digits (meanwhile, Canadians are missing out, with record "home bias" weightings in their portfolios).

Yet, 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. 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 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.

What's more, any concerns that globalization is heading into reverse have quickly been dismissed this year by markets and economies, collectively surrendering to Chinese President Xi Jinping urging earlier this year to "just say no" to protectionism. To wit, The Economist recently pointed out the obvious irony: "the presidency of Mr Trump, an avowed opponent of globalism, has coincided with a recovery in globalization." Global economies are experiencing a truly synchronized upturn (for the first time in a decade, all 45 OECD economies are on track to show growth). EM exports are booming too, up 4.6% y-o-y in the first half of this year, the fastest growth since 2011.

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. But we are only in the foothills of a long journey. By the time this rally is nearing completion, the consensus will be declaring emerging markets king. We are nowhere near that phase.

*→ **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, the emerging market story is transitioning. In aggregate, EM fundamentals look attractive (particularly versus Western countries) and have been broadly improving for some time. Beyond younger demographics, lower debt levels and orthodox monetary policy, the numbers tell a compelling story. For example, in the mid-1990s inflation rates above 20% were not uncommon. Today's EM inflation is trending below 5%. Or consider that most EM central banks have historically replicated the Fed's interest rate moves. Because the US has always been a leading indicator of global business cycles, EM countries with hard or soft pegs to the USD were forced to broadly imitate the Fed to prevent the interest rate gap from widening too much and capital flight following. This time there is no lockstep. In fact, three of the largest EM countries have cut rates*

this year as the US has raised them. Remarkably this was done without en-masse capital flight. All three currencies have risen against the dollar in 2017. Looking ahead, EM country and sector selectivity will remain key. Favor domestic-focused, reform-minded, commodity importing countries. Most are found in Asia.

Sorry Ms. Jackson, "Lower For Longer" Oil Is For Real. A collective gasp in the global oil market last month was nearly audible when Royal Dutch Shell PLC's CEO, Ben Van Beurden, made the comment: "lower forever; yeah, that's the mindset." Huh ... forever? Like "forever-ever"? (in the words of 1990s hip hop group OutKast).

Turns out Van Beurden's comment was less a forecast and more directed at describing Shell's new culture of thrift. The company does not want to depend on higher oil prices to boost profits.

To state the obvious, this is a different set of conditions than the heady days of triple digit oil prices. In 2013 alone, Shell's capital expenditures peaked at $40 billion. Today, the world is literally swimming in a supply glut with capex budgets slashed across the world.

The longer-term 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 and China, the largest maker and seller of electric cars in the world (and, for now at least, buyers of more GM-branded cars than America).

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 and global cyclical upturn may help boost prices. However, a renewed bull market is unlikely any time soon. 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 decline 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.

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, Fitzergerald 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 country leader. Expect other leadership to continue to fill the hegemonic void 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). Nearly half of the respondents to the Bank of America Merrill Lynch Fund Manager Survey in August said stocks were too expensive. The survey has been running since 1998 and has never recorded a higher percentage. 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 (Ed Yardeni has counted 57 so-called "panic attacks" in this 8.5 year bull market). 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 a strange and melancholic affair … seemingly better suited on a therapist's couch than splashed all over the cover of Barrons. And why not? Since 2008 global investors have endured rolling geopolitical concerns, dramatic elections, viruses, Brexit, terrorist attacks, Trump's erratic tweets, etc. But 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 analysts 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 the biggest China equity ETF (FXI) is massive, totaling about $1.28 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. Over time, Chinese bonds are also likely to become core assets. Why? Simply because the world's "safe haven" label is morphing. During the North Korean flare up this summer, the Chinese renminbi acted as an effective hedge, rising versus the US dollar during the conflict. The recent decision by MSCI to add 222 China A-share stocks starting in May 2018 is icing on the cake. Stay long 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 36-year bond bull that started in 1981 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? Secondarily, 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 (not 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 (FLRN) 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.

PART B: BEHAVIOURAL BIASES (<12 Month Outlook)

2018: The Return Of Central Banking Credibility? Since 2008, the business of central banking has suffered some serious blows. With governments refusing to engage the fiscal lever (prior to abandoning austerity initiatives), central bankers were not only forced to carry the entire policy burden but also suffered the indignity of jeering from the market-watching masses for consistently missing their inflation and growth forecasts. The Fed's own inflation targets have been missed for five straight years.

It wasn't always this way. In the 1990s, central banker reputations approached near-deity like status, heralded as miracle workers (recall Alan Greenspan's luminous halo). But, to be fair, how long could this reverence for the world's monetary priests last during such a tumultuous period in market history?

In the post-crisis period, investors learned that the monetary priesthood is fallible. The modern monetary toolkit may not have been a work of divine brilliance. Rather, behind the curtain, it may have been a frantic search for any solution that would work. Perhaps they were making it up as they went along?

In this environment, it has become fashionable to criticize the Fed and other CBs. The zeitgeist was perfectly captured last year by British politician, Michael Gove: "people in this country have had enough of experts."

In a world aflame with populism, nothing is now more contrarian than declaring that finally — at long last — central bankers may be right. At least in one category, they may be onto something for the year ahead.

The subject at hand is consumer price inflation. Hardly the hawk, Janet Yellen has said time and again that pricing pressures remain a worry for 2018. The market does not agree with her. How else can you explain falling longer-dated bond yields in 2017?

The question before the house is whether we, too, agree with Chairwoman Yellen. What could she see that Mr. Market does not? Disclaimer: we radically increase our career risk in the words that follow.

For years, we have tracked the deflationary forces in global economies. Some were structural, others cyclical. Longer-running deflationary forces remain in play, whether from globalization, technological disruptions, etc. It is the cyclical inflation variety that keeps us up at night.

As part-time deflationistas for years (suffering our own heckling from the masses), what has changed our view? First, the American economy is no longer deleveraging. Private sector lending is expanding rapidly. Second, with an economy operating near full capacity, a tighter labour market in the US is finally boosting the bargaining power of workers. Higher incomes mean increased purchasing power, bidding up prices. Finally, the US dollar's depreciation this year will increase the cost of imports, with the impact becoming apparent in the coming months.

→ ***Investment Implications.*** *We are aware that central banks have become the lead sponsors of rising asset prices, effectively becoming victims of their own success. In many ways, central banks are creatures of financial markets rather than stewards of the real economy. Is this good? Of course not. Attempts to cushion volatility always end up creating instabilities in the future. Yet, almost nine years after the financial crisis, here we are. Still, the best investors always look for unexpected changes at the margin. What could change? Perhaps the biggest consensus in markets is that world economic and inflation volatility will stay low … decent GDP growth and tame inflation as far as the eye can see. The OECD has even reported that variability in GDP growth across countries is the lowest in 50 years. What to make of this? While equity volatility is very low (and we have explained our benign view above), fixed income volatility is also low. But it is a different beast. Arguably, the bond market has become the most boring asset class in the world. It is also the one that could experience a big surprise. If inflation steadily rises from here (as we believe), bond markets will be anything but boring. Keep durations short and floating, where possible.*

US Dollar Counter-Trend Rally: Weekend At Bernie's. Despite receiving mixed reviews, the 1980s comedy, *Weekend At Bernie's*, became a cult classic. That's somewhat surprising for a film where the central joke is that its main character is a corpse. Moviegoers were forced to drag themselves through nearly two painful hours of making Bernie look alive for the weekend.

The US dollar may be making its own Lazarus-like appearance, giving the market a vibrant rally since mid-September. But, in recent reports, we have argued that the currency has entered a longer-running downtrend. Both broad currency metrics that we follow — valuation (expensive) and sentiment (over-loved) — suggest that this will be a multi-year affair (for more on Forstrong's fundamental currency view, see here https://www.forstrong.com/wp-content/uploads/2017/02/Currency-Primer-02-21-2017.pdf).

A number of catalysts could have revived the currency — announcements of QT, flare ups in Euro politics, or take your pick. But what is unfolding is most likely simply a bounce from a deeply oversold level. For example, speculators on Canadian dollar strength surged to the highest level in five years recently, just months after amassing record short positions against the currency.

→ ***Investment Implications.*** *If a counter-trend rally in the US dollar unfolds over the next few quarters, don't be fooled if it gives a lively performance. Every secular bear market has an intermission. But, like Bernie, the US dollar will end up dead on arrival.*

Lessons in Swedish. Spoiler alert: the Swedish stock market is a buy. The country is also one of the most open economies in the world with a strong industrial sector. As a result, Sweden's exchange rate is a key variable in forecasting profits.

Where are we now? After a long period of monetary experimentation (including subzero interest rates), we

have arrived at a deep undervaluation in the Swedish Krona. Unsurprisingly, the undervalued currency has left Sweden highly competitive, swelling its current account surplus to more than 5 percent. Historically, aggressive currency debasement is generally followed by stock market rallies. This time should not be different.

What's more, the majority of Sweden's exports are sold to other European nations. Its largest export market is Germany, a country with record low unemployment and real wages rising at the fastest pace in more than 20 years. Sweden is also in the "winner" camp from lower oil prices, importing 100 percent of its oil and natural gas needs. Given our "lower for longer" view on oil, this should provide a steady tail wind.

Looking ahead, the Eurozone's nascent recovery is gaining traction. The money supply is expanding, retail sales have turned positive, and confidence is returning. Jobless numbers have been swiftly declining in a number of the core and peripheral economies across the region. If the Eurozone recovery takes hold as we expect, the Swedish stock market should boom.

*→ **Investment Implications.** Initiate a long position in Sweden's highly pro-cyclical equity market (EWD), which has a much higher weight than the global benchmark in industrial stocks, and at the same time has much less weight in defensive sectors and resources, whose earnings are poised to lag. Swedish financials should continue to benefit from very easy monetary policy and the associated housing boom, while any credit quality concerns (reflecting the high household debt-to-income level) will fade as the economic upturn gets on a stronger footing. The key risk for Swedish equities would be: an end to the housing boom or a deterioration in global trade, since exports represent nearly half of GDP. Keep both risks on high watch.*

Hurricanes, Fake News And Other Natural Disasters. Some investors may believe that natural disasters lead to increased economic growth. In the short run, this may appear to be the case. For example, American manufacturing expanded in September 2017 at the fastest pace in 13 years, in part due to the effects of Hurricane Harvey and Irma.

But fortunately we have the late French economist, Frédéric Bastiat, to set enquiring minds straight: destruction does not benefit the economy. In his "parable of the broken window", a man's careless son breaks a window pane. A crowd gathers and begins to contemplate the damage. They optimistically conclude that the boy has actually performed a community service.

Their logic? His father will have to pay someone to replace the window. That individual will spend the income on something else, multiply to another and so on. Voilà! The local economy is stimulated.

Bastiat, however, gently nudges us to consider "that which is seen and that which is not seen." What is less evident is that the father's income is reduced and used to fund a maintenance cost (simply replacing something that has already been purchased). What's more, the father could have spent the money on other goods or services. Ultimately the crowd was wrong — overall economic growth has actually been reduced.

Looking at the wider infrastructure thrust from the Trump administration, the fog is still thick. But some of it is lifting. 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, 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.

*→ **Investment Implications.** Overall, Trump's infrastructure spending will have far less impact on the economy than originally envisioned by markets. The most encouraging development is the prospect for reduced regulation. Treasury Secretary, Steve Mnuchin, and Commerce Secretary, Wilbur 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. As such, Trump's sectoral impact will be substantial. From that perspective, US policy should support financials (our clients are long XLF) and be neutral to negative for infrastructure companies and energy (as prices should stay soft while supply continues to ratchet up).*

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.*

Japanese Bull Market: Built To Last? Japan faces some serious structural issues — high debt levels, aging demographics, and so on. But everyone already knows the macro headwinds. Far fewer understand the micro story.

Over the past 25 years, Japanese companies faced the twin burdens of chronic deflation and an overvalued currency. What has been the result? Corporate Japan is now extremely lean and efficient. Aggregate Japanese return on equity has been quietly trending upwards and corporate profits just hit a record high relative to GDP. Japanese companies also happen to sit atop USD $4 trillion in cash. That means capex can be radically increased without borrowing.

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").

Fortunately for the intrepid investor, one does not have to pay up for this growth. Japanese equities are priced at the frontier of value, if not over the edge — deep into bargain territory. The small cap sector in Japan trades below their book value. And, companies have been steadily increasing their dividends, yet payout ratios still average only 25 to 30 percent of earnings.

Finally, the Japanese Yen itself has become dramatically undervalued — the currency is the cheapest it has been in 32 years. In a globalized world, corporate profits typically show a strong correlation with cheaper exchange rates. This is the crucial difference between now and previous Japanese bull markets over the last 20 years, where the Yen was expensive. Those rallies were never built to last. This one will be far more durable.

→ **Investment Implications.** *Japan is transforming itself from a nation of savers to a nation of investors. Contrary to popular belief, 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.*

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 at 8.5, Sydney at 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.

Diversifying Fire and Fury. What danger does North Korea present for global investors? Clearly, Trump's indulgence in nuclear brinksmanship carries risk. Pyongyang potentially firing missiles at US territory in the Western Pacific is also real. And there is a global existential threat should it ever escalate into intercontinental warfare.

Yet, rather than add to the volumes of prognostications about North Korea's specific situation, consider the track record of major events and their impact on markets.

First, most geopolitical events are false alarms. As card-carrying members of the change-anticipation field, we understand the desire to divine the big events. To be first to spot the outlines of a looming disaster can be glorious (and career-enhancing).

But most warnings are false alarms simply because big turns are rare events. Remember Y2K, Saddam Hussein's so-called "weapons of mass destruction" and, recently, Brexit? None of these widely-feared threats materialized or they delivered benign outcomes.

Second, more often than not, geopolitical events create opportunity. Rummaging through past post-crisis periods produces a long list of stellar returns after the initial event. For example, the Cuban Missile Crisis in October 1962 was a 13-day confrontation between the US and the Soviet Union, widely considered the closest the Cold War came to full-scale nuclear warfare. However, after the crisis subsided, the Dow went on to gain more than 10% that year. Or take the Korean War, when the North invaded the South. This conflict lasted from June 1950 — July 1953. During that time, the Dow was up an annualized 13.6%. History is brimming with similar examples.

Finally, geopolitical events may have binary outcomes. By this we mean that a negative scenario would either produce an extremely large portfolio loss or gain. There is no knowing which ahead of time. As such, narrowly focusing on one type of risk is speculative at best.

What's more, such speculation hinges upon achieving two near-perfect tactical portfolio actions. One is

getting out at the right time; the second is to get back into the markets at the right time. The first decision is difficult at best. The second step is often overlooked. There are plenty of analysts who have predicted doom (most far too early) only to fail to re-invest at the appropriate time. Both errors can be catastrophic.

Consider that investors who went to cash before 2008's global financial crisis looked like heroes for a time. Less widely reported is that a large proportion of them utterly miscalculated their re-entry. Even today, after missing out on a 150% rally in global stocks since early 2009, many of these doomsters remain defensively positioned.

A far better approach is to accept that a wide possible set of scenarios may unfold. From there, investors can insulate against a number of outcomes by diversifying portfolios across global investment classes and also readying them for a change in the macro outlook.

→ ***Investment Implications.*** *A large number of people have become financially poor, constantly trying to avoid popularly perceived risks by running for the hills. They fail to realize that if there were no risks for which to be compensated, there would be no returns possible above a bogey risk-free rate. But that doesn't mean that one shouldn't manage risks. To the contrary. What we advise against is a non-diversified definition of risk. Now that "fire and fury" has caught the world's eye (whether based upon real facts or orchestrated histrionics) everyone is focusing on only one form of risk — a "double dare" shouting match between two politicians. Sadly, most investors will continue to suffer for their behavioral extremes, while-longer-sighted strategists with strong risk management disciplines make off with gains.*

[1] http://www.bankofengland.co.uk/research/Pages/workingpapers/2016/swp624.aspx