FORSTRONG GLOBAL

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SUPER TRENDS AND TACTICAL VIEWS

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WILL THE REAL SATOSHI NAKAMOTO PLEASE STAND UP? (AND OTHER TALES FROM THE CRYPT)

To begin with basics, the term "cryptocurrency" is a misnomer—"crypto," yes, but "currency," no. Nonetheless, it is natural that transactions using electronic payments … continue to grow in volume and value relative to cash. It is certainly possible that the demand for digital cash could grow over time. If so, there could be very strong arguments for the central bank to provide it, given its obligation to fulfill the public good function. All central banks are researching this.

Bank of Canada Governor, Stephen Poloz: December 14, 2017

SPEED READ

→ Nearly 9 years after the financial crisis, a truly coordinated global cyclical upturn has finally arrived.

→ The biggest opportunity is the narrowing of the enormous cyclical gap that has opened up between America and the rest of the world. While America has been recovering for some time, other country economic engines have only begun to rumble.

→ 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 most emerging markets, notably in Asia, and are primed for multi-year outperformance.

→ However, risks have grown higher for 2018. Expectations and positioning are the most bullish they have been in several years.

→ 2018 will continue to be a year where heightened global exposures will be necessary for success. <u>For the intrepid macro investor, this is our time.</u>

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

Bitcoin And The Future Of Money: Two Sides To Every Coin. There are tales of fortunes made and dreamed to be made. We are hearing the familiar refrain, 'this time is different,'" begins a public statement on cryptocurrencies and initial coin offerings by SEC Chairman Jay Clayton. He goes on to warn investors to ask several questions before investing, including "are there substantial risks of theft or loss, including from hacking?" and "is the product legal?"

We begin this quarter's publication on a philosophical note: what is money? Webster's defines it as something accepted as a medium of exchange. But it also must be stable, portable and, importantly, widely used. The last feature is crucial. After all, currencies completely depend on a collective confidence that they actually have value — even if that conviction is a "consensual delusion", as some claim.

Crypto evangelists believe digital currencies will have all of the above and more. These new offerings are anonymous, more secure, eliminate intermediaries, transcend national borders, carry almost frictionless transactions costs and have a fixed supply.

We, too, like our fees low and our privacy heavily guarded. However, we take issue with "fixed supply". To us, the central boast by crypto-enthusiasts is that, compared to fiat government-issued currencies which can be inflated by quantitative easing, negative interest rates and deflation-phobic central banks, their supply is constrained. Really? We hear about new coins and tokens daily. And, we know the rules in markets: trends, especially in financial innovation, will always be driven to excess.

If history is a guide, then, an over-supply issue will instead become the core problem. Bitcoin purists will quickly shoot back: "ah, but Bitcoin is the first and only digtial currency that will matter". Right. Try telling that to proponents of Litecoin, Ethereum et al.

To be sure, we have no doubt that the technology will be transformative. Underpinning cryptocurrencies is blockchain technology which has a variety of applications to increase efficiency, lower costs and limit fraud. We are all for that. The SEC's Chairman seems to agree too: "the technology on which cryptocurrencies and ICOs are based may prove to be disruptive, transformative and efficiency enhancing."

But all of this has a striking historical parallel: technology stocks in the late 1990s. During that mania an oversupply and overvaluation of every stock with a "dot com" suffix became the issue. Eventually, the mania collapsed under its own weight and most companies didn't directly profit. In fact, most of them don't exist anymore. But the game changer was the internet and its infrastructure. That did truly transform the world as we know it. The same will happen in crypto land.

→ ***Investment Implications.*** *Unfolding before our eyes is a mania with an unknown timeline but is certain to get ugly. Promoters are already knocking on our door, flooding our conference halls and deluging our inboxes. Promises* *will be made. People will win and lose. And those who prefer to watch from the sidelines will look foolish for a time.*

But serious investing starts with an understanding of present and future value. Conversely, speculation begins with a premise that others will pay more for it in the future, with no regard for intrinsic value. In general, we counsel investors to stay away from the latter.

The good news is that when this mania subsides the collateral damage should be limited, simply because of the lack of credit and leverage involved. That means the banking system will not be damaged and spillover effects into the economy should be relatively minor. Ironically, the instability of the crypto-world may even bolster confidence in traditional money and banking.

For now, however, digital currencies are largely unregulated. Good thing for their promoters, as any prospectus would have to disclose the main risks, including the exogenous consideration that crypto-speculators have collectively lost their minds.

Dear Global Economies: Here We Are Now, Entertain Us. One has to be a certain age to feel nostalgia for the grunge rock band Nirvana. However, their seminal 1991 song, *Smells Like Teen Spirit*, managed to garner widespread appeal and can still get a diverse crowd rocking. Lead singer, Kurt Cobain's, repeated refrain "here we are now, entertain us", captured the new nonchalance of the so-called slacker generation — an early manifestation of the now ubiquitous "whatever".

A parallel to the above has played out in financial markets. Since the depths of the financial crisis, corporate profits have boomed and global risk asset markets have soared. It's been quite the show.

In this environment, one would expect a little *joie de vivre*. Yet, for many, all of this has been met with a shrugged "whatever" response. Volatility has been low. Turnover has been low. And, this is the only multi-year bull market in history where trading volumes are declining rather than increasing.

What's happening? Behavioral psychologists would point to 2008's global financial crisis and, since then, the lingering presence of what they call recency bias — the greater weight that recent experience can have on our decision making. The effect is even more powerful when recency is combined with salience — the more something means to you the more vivid your recollection of the event.

Prior to the crisis, investors largely underestimated the probability of such an event precisely because they had no personal experience of one (the most comparable precedent occurred in the 1930s). But then the opposite occurred. Since 2009, many investors, hostage to their recent and vivid crisis experience, overestimated the probability of a recurrence. In large part, this explains the broad apathy toward stock markets.

However, there is solid evidence that all of this lingering risk aversion is finally fading as the global economy gains more traction. Risk appetites are now returning with zeal. And why shouldn't they?

The record breaking streak of gains in global stock markets in 2017 has been supported by the broadest global growth in a decade. For the first time since 2008, all 45 of the largest economies tracked by the OECD have been in a synchronized expansion. That economic momentum has lifted earnings per share for global corporations above $30, a level first reached about 10 years ago.

Where to next? The next phase of the global recovery will close the wide cyclical gap that has opened up between the US and the rest of the world. While the US started recovering almost immediately in 2009 (providing a monetary roadmap for global policymakers along the way), many other economies have been stuck in grinding recessions and are now only starting to liftoff. This still has a long way to run.

→ ***Investment Implications.*** *To be sure, this has been a long cycle, particularly for the US. At 8.5 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 slouching apathetically 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 twitter feed, etc. Many investors have been happy to sit this one out. But stock markets have been incredibly resilient, at least in the US. Now try to imagine what happens if the data actually turns positive everywhere around the world. While we are not rabid bulls on global growth, a mild and, importantly, globally synchronized recovery has taken hold. But with enthusiasm for risk-taking finally making a comeback, expectations have become higher. That means this next growth stage in the post-crisis period will need to provide an encore with even more lively entertainment: robust momentum and profit growth will need to show up quarter after quarter. Otherwise, many investors will just shrug and respond with an "oh well, whatever, nevermind".*

Trump One Year Later. The Crisis That Never Showed Up. We have spilled much ink over the last year writing about Trump and his administration's policy impact on markets. In June 2016, after Brexit was announced (and with the higher possibility of a Trump victory — another populist win against the political establishment), we wrote: "…presidential cycles are very weak actionable trends and have been overstated in terms of their predictive ability for market returns (link here: https://www.forstrong.com/wp-content/uploads/2016/07/Ask-Tyler-07-06-2016-FINAL.pdf). And, our counsel to clients on the morning of November 9, 2016 was not to panic — our post-crisis era of "new realities" continues as before (link here: https://www.forstrong.com/wp-content/uploads/2016/11/Ask-Tyler-11-09-2016-Final.pdf).

Of course, most media frames these big events in binary terms. If Hillary wins, the status quo will prevail. If Trump wins, disaster will unfold.

All of this may sell newspapers but is very unhelpful to the individual investor. 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.

With Trump now in the oval office, the good news is that the world did not end. In fact, despite many of the dire forecasts, the Super Trends and themes that we follow have not only remained on course but have accelerated.

The last 12 months have been full of irony. First, we have had the most volatile American president in modern memory. His twitter feed alone is chaotic, a free-wheeling style resembling a stream-of-consciousness — sometimes coherent, other times causing consternation ("covfefe" anyone?). In the first six months in office, Trump sent 991 tweets.

All of this commotion and, yet, market volatility has stayed stubbornly low. Stock markets have been quietly trending upwards (we are forgetting what corrections feel like!) and, according to IMF data, the variation of growth rates this year among G20 economies will be the lowest since at least 1980.

We have also had the most protectionist president in recent history. And yet 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. And EM exports are booming, up 4.6% y-o-y in the first half of this year, the fastest growth since 2011.

With each passing week, it is apparent that America's policy path is diverging from most of the world. Consider this year's most telling 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. At the time, it left 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. "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.*** *Trump has incredibly lucky timing. By mid-2016, economic momentum in both the US and the broader global economy were evident. That means stocks were likely ready for liftoff, even before Trump took office. But 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 has begun shrinking 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 almost 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. 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?

Welcome to Quantitative Tightening: No Need To Panic. The US Federal Reserve has at long last begun 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 yields 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 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). Monetary policy is still easing. Blackrock calculates that seven major EM central banks, collectively delivered more than 1,000 basis points in rate cuts through October of this year.

The reason? EM disinflation. 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.

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 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.

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 Chinese equities.

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? Yet, enthusiasm for yield can only be described as irresponsible. Investment Committee colleague and bright mind David Kletz points out that Argentina, despite a long history of default, was not only able to float a 100-year sovereign bond this summer but it was 3.5 times oversubscribed. How long can this last? At the very least, it is late stage. 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 three more times 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)

Global Stock Markets: A Pause in *El Toro*? "Cash Levels Fall To Lowest In Four Years" ran a recent headline in a financial newspaper. Inquisitive investors stopped and stared. It was the premise of the heading that caught them. Who knew that there was any cash to draw down at the 102nd month mark of the post-2008 stock market levitation?

El Toro is the subject at hand. Of course, the bull bottomed in March 2009. But it has been relentlessly robust in 2017. In fact, this will be the first year that the MSCI All Country World Index records a gain every single month in its 30-year history (provided December posts a positive number).

Not that there is anything wrong with that. Profits have been booming and a global cyclical upturn is underway. Prices are simply keeping up this year.

The problem is performance chasing. When everyone is positioned bullishly who is left to put in the next buy order? And, with higher expectations comes higher hurdles. Earnings and economic data must deliver.

Each quarter we peer into BAML Global Fund Manager Survey, a kind of investor voyeurism, giving us statistical snapshots of our competitor's asset mix positioning and other revealing trends. These can provide useful tactical signals for inflection points (hey, even the professionals can provide good contrarian signals!).

The latest report exposes a bullish posture. Consider that in early 2016 more than 20% of fund managers forecast weaker profits in the year ahead (the most negative outlook since 2012). Today, they are much more optimistic, with 41% of them expecting stronger profits in the year ahead.

Their asset mixes are more bold too. Equity exposures are the highest in 2.5 years and bonds are heavily underweight: only 5% of those surveyed expect global rates to be lower next year.

It's not just the pros. Everyone seems to have increased their expectations this year. Excluding the 2000 stock market bubble, US households are the most exposed to stocks in 65 years. Small business owners are showing nearly the highest optimism readings in 45 years. And the US's Citigroup Economic Surprise Index just hit a 5.5 year high (meaning economic releases have been coming in better than analysts had estimated).

What's more, there are huge expectations for Trump's tax cuts. In many ways, this is the exact opposite of December 2012. Back then, the so-called "fiscal cliff" was widely forecast to plunge the US economy into the abyss. But then a funny thing happened. 2013 was not only a solid year economically, but the Dow rallied 26.5%. So much for the dangers of cliff jumping.

Given all of the above, our investment team has become somewhat tactically cautious. However, we do not yet see this as a bubble that is about to burst. Yes, there are some signs of bubble-like conditions. It's notable that one group of stocks (large cap tech) have been anointed with their own acronym (FAANGs). This is typical during late stage stock market booms.

But self-confessed "bubble historian", Jeremy Grantham of investment firm GMO 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. 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). And, importantly, bull markets usually end when economic expansions end. We don't have those conditions today. In fact, quite the opposite. Global economies are accelerating. While *El Toro* may take a breather, the bull still lives.

→ Investment Implications. *It's always tricky when a macro manager's Tactical Views do not necessarily line up with the main Super Trends. However, from time to time, markets run ahead of themselves, setting themselves up for a stumble. The issue today is that the underlying fundamentals and the behavioural side of markets are showing conflicting signals. In this environment, the right thing to do is reduce risk and rely on global diversification for defense. In balanced portfolios that our team runs, asset mixes are approximately neutral with an emphasis on generating alpha via currency, sector, country and other opportunistic biases.*

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 versus a yawing complacency when Trump recently elected Jay Powell to replace Janet Yellen). 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, fixed income volatility is also very 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.*

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. 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 near 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.

A Word On Forecasting: It's Wildness Lies In Wait. December is the time of year where our inboxes are bombarded with outlooks for the year ahead. Economists, strategists, and other financial commentators trip over themselves to issue precise forecasts for the next 12 months. Where will the Dow end in 2018? How much growth will Japanese GDP show?

Our industry should stop doing this. Forecasting variables, such as where stock markets will exactly end the year (impossible), what GDP will be (subject to multiple revisions), is an exercise in futility. History shows a horrific track record here.

The issue is that the world is not that perfect. How can we expect our models to offer such precision? As the prolific British writer G. K. Chesterton (known as "the prince of paradox") observed in 1908:

> *"The real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable, but not quite.*

Life is not an illogicality; yet it is a trap for logicians. It looks just a little more mathematical and regular than it is; it's exactitude is obvious, but it's inexactitude is hidden; it's wildness lies in wait."

Why then is forecasting such common practice? In short, people crave certainty. This danger lies in the illusion of safety that this false sense of precision creates. Overconfidence results and portfolio mistakes are made.

One of our favorite concepts over the years has been Andrew Lo's observation that the financial industry suffers from "physics envy". We want our models to be as predictive as those in physics, but there is a behavioral element to finance that cannot be modelled. Humans can be capricious and, what's right in one regime will be wrong in the next. As one physicist remarked, "Imagine how much harder physics would be if electrons had feelings!"

→ ***Investment Implications.*** *Not all is lost. Rather than playing the mug's game of point-forecasting all these variables, we strongly believe it is the macro themes that matter (https://www.forstrong.com/wp-content/uploads/2017/10/Why-Macro-Matters-Print_BPMSept17.pdf). Of course, forecasting these super trends (as we call them) is not an exact science. We are looking at a range of possibilities and positioning portfolios for the probable environment ahead. This is one part fundamentals (where we are in the cycle, valuations, etc.) and one part behavioral (where the consensus thinks we are in the cycle, levels of euphoria or complacency, fund flows, etc.).*

In the post-crisis environment it has been critical to have this type of disciplined process. Ed Yardeni has counted 57 so-called "panic attacks" in this 8.5 year bull market (taper tantrums, Brexit, etc.). At panic points, it is always useful to revisit the role of the portfolio manager: why do clients pay us to manage their wealth? It is not for flawless clairvoyance. Rather, we are paid to anticipate probable risks, prepare for opportunities and, importantly, not lose our proverbial minds when everyone else has lost theirs. That requires a disciplined decision-making framework that can extract emotion from the process. Forstrong's investment team remains committed to this approach.

Thank you for your readership in 2017. Wishing you and yours a healthy, happy and prosperous 2018.

Tyler Mordy, December 2017

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