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SUPER TRENDS AND TACTICAL VIEWS

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ALL'S FAIR IN LOVE AND TRADE WARS

“Trade wars are good, and easy to win.”

- President Trump's tweet on March 2, 2018

“Just let it rip, for heaven's sake.”

- Larry Kudlow, Trump's recent appointment for director of the National Economic Council, speaking of economic growth in the United States on March 14, 2018

SPEED READ

- After a lengthy sabbatical, volatility has returned to world financial markets. This is normal. What is not normal are years like 2017 where the US stock market's maximum peak to trough decline was just 3%.
- Yet, several Super Trends are now shifting. US household incomes are finally rising. Fiscal stimulus levers have been engaged. And, animal spirits are back. The game is changing.
- While trade wars and shifting regimes make the world a more risky place, economic growth is unlikely to weaken in the year ahead given massive US fiscal stimulus and a steady retreat from austerity in Europe.
- The biggest investment opportunity remains the narrowing of the enormous performance gap that has opened up between America and the rest of the world in the post-crisis period.
- While America has been recovering for some time, other country economic engines have only begun to rumble. Broad fundamentals remain excellent in most emerging markets, notably in Asia, and are primed for outperformance.
- 2018 will continue to be a year where heightened global exposures will be necessary for success. For the intrepid macro investor, this is our time.

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

Trump's Trade War And The Existing World Order: Cohn Job? Who does not support the notion of “fairness”? Everything is better when it is endorsed. Even defeat is more pleasant when it is fair and square. It is one of those warm-blanket words that no one disputes. But the concept of fairness is becoming astoundingly complex when discussing world trade.

We return to a theme in this quarter's publication: the divergence of America's policy path from the rest of the world. In the post-war period, free trade has become something of a sacred cow in the economics profession. Few challenge its benefits and almost all — at least theoretically — support the unhindered movement of goods and services across national borders. Of course, in practice, global trade doesn't always happen in a frictionless fashion. But the so-called “comparative advantages” of each nation (where countries focus on their industry specialties and lower opportunity costs) support the theory that international trading partners are best served without trade restrictions. Each country plays by the same rules, fairness is upheld and overall global economic welfare is improved. Everybody wins.

Yet, this decades-old orthodoxy is now under siege. The resignation in early March of Trump's top economic adviser, Gary Cohn, dealt a big blow to free-trade proponents inside the White House. Not many are left — certainly none as prominent as Cohn — to defend the economic establishment.

The main danger is that the rules may now be re-written, with the world moving from an era of liberal trade and open markets to one of growing protectionism. Full-blown protectionist policies in the US (i.e. imposing tariffs, threatening to tear up trade agreements and other unilateral actions) would not only be unprecedented in the post-war era, but would undoubtedly prompt retaliation from other nations and convince the world that the existing global trading system is unravelling. Such a shift would mark the largest and most dangerous change in economic thought and order in decades. Larry Kudlow, Trump's recent appointment for director of the National Economic Council, has even identified the counterproductive nature of recent tariff action, referring to them wryly as “sanctions on our own country”.

On the one hand, you cannot blame the US for acting in their own best interests. Trump has rightly identified some deep inequities in world trade. But the US's foray into protectionism will almost certainly be a pyrrhic victory. In a globalized world defined by a move toward closer interconnectedness, the “biggest loser” would be the US.

Chinese President Xi Jinping, who has worked steadily over the past four years to strengthen China's position in Asia, likely views Trump's retreat from globalization as his own triumph. Consider Obama's “pivot to Asia”, with the Trans-Pacific Partnership being the centerpiece. It is now dead. That leaves Xi's “Belt-and-Road” strategy (his own version of “Make China Great Again”) as the uncontested blueprint for future economic integration in Asia.

Ironically, China's diplomacy now also offers a positive vision. In Davos last 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."

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.** *All may be fair in love and trade wars, but will the president actually carry out extreme protectionist policies? The knee-jerk reaction may be to answer yes. After all, the president does have broad legal powers to restrict international trade and he has already imposed tariffs on steel and aluminum (conditionally excluding Canada and Mexico subject to NAFTA negotiations). And he's shown no shortage of enthusiasm for trade brinksmanship.*

Yet, several reasons suggest that Trump's bark will be bigger than his bite. In the week where the first round of tariffs were delivered, Cohn resigned and a huge public backlash emerged from at least half the Republican caucus in Congress. Corporate leaders also issued sharp rebukes against trade protectionism. It is also becoming clear that the president is curiously trying to protect a world that no longer exists — the manufacturing and industrial economy of the US is long-lost. Most importantly, US trade law provides an almost infinite range of possible policies. The Trump administration could easily take several trade measures that would draw huge headlines and appease supporters, but would not have a material impact on overall trade volumes (much as the Obama administration did with its aggressive pursuit of anti-dumping and WTO cases against China). Although this seems the most probable scenario, we continue to closely monitor risks.

Looking ahead, America's waning leadership should contribute to the underperformance of US equities relative to global indices. Since 2009, America's stocks and its currency have trounced their global counterparts. From its low in 2009, the MSCI US index has risen by roughly 400%, while the MSCI All Country World ex-US index has risen by only slightly more than half as much. However, we have argued in the past few reports that US equities are set to underperform. Three 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. Where may the next phase of outperformance direct itself? Europe and Asia are the most likely candidates — regions that generally have cheap currencies, are showing signs of earnings and economic acceleration and trade on much lower valuations. Who can argue with rotating into less expensive 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?

Investor Mistakes: Misreading China. Sophia Loren once famously said that “mistakes are the dues one pays for a full life.” In the world of investing, as in life, the trick is not to repeat the same ones twice. Yet investors seem to make similar missteps with disheartening regularity. Even the well-staffed professional portfolio manager labors under a long list of occupational hazards: the seductive lure of linear extrapolation, the itchy trigger finger, and, of course, the vice-like grip “group think” effortlessly secures on the collective conscience.

Where may these mistakes be occurring today? China may be one. The bulls (if we may speak for the handful of them still holding their day jobs) are seemingly near extinction. China bear sightings are much more common. The gloomy case is widely known. Overleverage, overbuilding and overcapacity plague the economy. Return on investment for the state sector is in chronic decline and residential home prices remain elevated. On top of that, a large, opaque “shadow banking system” poses a systemic risk to the entire credit system.

What’s more, the Communist party has agreed to a constitutional revision that eliminates term limits for the office of president. This ensures that President Xi Jinping can remain at China’s helm beyond 2022-23 and possibly for his entire life. China is clearly moving toward a more centralized and top-down political system.

We get it. China comes with risks. And the economy 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 previously 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. And it is entirely consistent with former

Premier Wen Jiabao's critique, who famously warned in March 2007 that China's economy was becoming increasingly "unstable, unbalanced, uncoordinated, and unsustainable."

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). For the last three decades China has overinvested in manufacturing capacity, securing global market share by keeping prices low.

This has now changed. At the 19th National Congress in October 2017 in a marathon speech lasting 3.5 hours, Xi Jinping confirmed the new direction: companies and local governments must now focus on the quality of growth. Supply-side structural reforms are clearly the highest priority of Chinese policymakers, with an emphasis on productivity, innovation, environmental protection and moving up the value chain in manufacturing and services. The days of bloated capacity are fading. Therefore, over the next several years China will see slower but better growth — due to reduced capital waste and improved profitability.

All that said, it cannot be ignored that China has an eye-watering amount of total debt, reaching the vertiginous height of 257% of GDP by the third quarter of 2017 (according to the Bank for International Settlements). 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.** *Chronic "China crash" false alarms in Western media have diverted attention from the ongoing positive transformation occurring in the world's second largest economy. Today, 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. Consider the IPO market in China. It is booming. 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) continues to be massive, totaling about \$790 million in assets. Yet now is the time to be investing in an unloved sector. As China makes progress in face of the many naysayers, equities have much room to be revalued upward. The recent decision by MSCI to add 222 China A-share stocks starting in May 2018 is icing on the cake.

Over time, Chinese bonds are also likely to become core assets. Why? Simply because the world's "safe havens" are morphing, driven by shifting fundamentals. For evidence look no further than the recent performance of traditional safe havens. Recent research by Gavekal (hat tip to Charles Gave) looked at previous spikes in volatility (August 1990, May 2010, August 2011, August 2015 and recently in Feb 2018) and those assets that typically provided relief for portfolios (US 10-Year Treasuries, Swiss Franc, Japanese Yen, and gold). During the first four volatility spikes, at least three of four traditional safe havens performed well. Yet, during the most recent period of market stress in Feb 2018 not one did its usual job. Safe havens are indeed morphing. Another notable example is the North Korean flare up in the summer of 2017. While traditional safe havens did not provide any shock absorbing performance, the Chinese renminbi acted as an effective hedge, rising versus the US dollar during the conflict. Expect this broad trend to continue.

Canada's Big Chill. Readers may recall the famous line from the 1983 American comedy-drama film, *The Big Chill*. After a long lament about responsibility and adulthood, one of the lead characters states: "The thing is no one ever said it would be fun — at least no one ever said it to me."

Recently, Canada's recent stock market and currency underperformance has not been much fun either. Many did not get the memo that Canada's tailwinds (primarily driven by a multi-year commodity boom) were quickly turning to headwinds. No one told them it would be this way.

To be blunt, the investment environment in Canada has become downright chilly. Figures from Statistics Canada for 2017 show that foreign direct investment into the country fell to the lowest since 2010, dropping 26 percent to C\$33.8 billion. This is the second year flows have dropped and are down more than 50% since 2015.

Net foreign purchases of Canadian corporations also turned negative for the first time in a decade (meaning that foreign companies sold more Canadian companies than they bought). High profile exits from ConocoPhillips and Royal Dutch Shell led the capital exodus last year.

The above underscores the impact of a lingering commodity slump and the declining attraction of Canada as an investment destination. And while energy prices have recovered somewhat, prolific shale plays in Texas and Oklahoma are following through with their own investment boom, while the oil sands have

fallen out of favor. What's more, the additional headwind of growing US protectionism and worries about the fate of the North American Free Trade Agreement has foreign capital on hold.

All of the above is clearly a major setback for Trudeau's Liberal government, which has continually emphasized attracting foreign investment.

To be sure, not everyone is suffering. Canada's unemployment rate hit the lowest level in four decades in February. And, while Trudeau's "sunny ways", "responsible deficits" and a potential lift from Trump-induced fiscal stimulus have engineered some optimism, the cyclical outlook is still constrained.

The Bank for International Settlements has even singled out Canada as one of three countries in the world vulnerable to a credit crisis, given maxed-out credit cards and extreme household debt levels in the wider economy (the country's ratio of household debt to disposable income reached a record 171 percent in the third quarter of 2017).

Our central bank also recognizes macro risks. Governor Stephen Poloz, delivering a speech to his alma mater Queen's University (wearing a 1978 Queen's maroon leather jacket nonetheless), observed: "... there remains a degree of untapped potential in the economy. It means Canada may be able to have more economic growth ... without generating higher inflation." Translation: the economy is not yet on solid footing — the punch bowl is here to stay for some time.

→ **Investment Implications.** *Canadian assets have fallen out of favour on the world scale. And while Canada is not just a petro-country, international capital will remain on the sidelines until firm evidence surfaces that economic growth is on a more sustainable path and some policy uncertainty is removed (not least of which is clarity on NAFTA). That makes it difficult for Canadian stocks, bonds and the currency to catch a lasting bid. Meanwhile, concerns over household debt, investment activity, business formation, and trade will keep our country's central bank committed to a very gradualist approach, providing less appeal for global bond investors.*

Of course, as we have reminded readers for some time, Canadians continue to be over-exposed to domestic assets. However, change is happening at the margin, as many Canadians now scramble to embrace global diversification. In fact, Canada is now a creditor to the US for the first time on record, reflecting Canada's renewed love affair with assets south of the border. Expect this trend to widen to investments outside of the United States. A secular portfolio shift has begun.

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. Trading volumes have spiked in 2018. Correlations are shifting. And, 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. In the US, corporate profits have been booming, with sales growing 9% and earnings rising 23% in 2017. And, margins hit a new all-time high of 10.8%.

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 almost 9 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”.

Welcome to Quantitative Tightening: No Need To Panic Yet. The US Federal Reserve has at long last begun so-called quantitative tightening (“QT”) in September 2017, 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.

Former Fed chairwoman Janet Yellen even came close to admitting that QE is still poorly understood by policymakers: “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 last year was 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. Monetary policy is still easing. Blackrock calculates that seven major EM central banks, collectively delivered more than 1,000 basis points in rate cuts from January to October 2017. 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 cut rates in 2017 as the US has raised them. Remarkably this was done without en-masse capital flight. All three currencies rose 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.*

Oil's Crude Awakening. To state the obvious, we are observing a very 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. Even OPEC admits that new sources from US shale will exceed growth in world demand. In a February 2018 report, the organization forecast that while oil demand will climb by 1.6 million barrels per day this year, it will easily be covered by an increase of 1.66 million barrels per day of supplies from outside OPEC.

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.** *Oil prices have bounced back sharply since the first quarter of 2016, but energy stocks all around the world seemingly failed to get the memo. To illustrate, the relative performance of the MSCI ACWI Energy Index versus its parent MSCI ACWI Index is currently near lows hit in January 2016, when WTI was trading under \$30 USD per barrel. This is an unusual divergence for financial prices that are normally highly correlated.*

The lagged equity performance could simply be related to the lack of new investment hitting their bottom lines or high debt levels. More likely, however, investors are pricing in longer running risks within a sector that is adapting to a new, lower-price environment and, with the rapid rise of renewables, a global energy system that is on the cusp of revolution.

Looking ahead, we remain steadfast that oil and commodities are in a "lower for longer" phase. Yes, stability may have arrived and a 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.

All that said, 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. Also, a look back in history shows that 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.

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 is likely 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 was not only able to float a 100-year sovereign bond last summer but it was 3.5 times oversubscribed (despite defaulting on its debt eight times since independence 200 years ago).

What’s more, 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. And while quantitative easing was not inflationary (for reasons described in our “Welcome to Quantitative Tightening” section), fiscal stimulus is a different beast altogether. Importantly, the transmission effects of fiscal thrusts are much different than monetary ones.

To be sure, fiscal stimulus looks entirely inappropriate at this stage in the cycle. Ten years after the financial crisis, governments are only now engaging the fiscal stimulus lever (rather than forcing the monetary side to carry the entire burden). Why bring the sugar now? With many economies closer to full capacity (notably in the United States), the conditions for inflation to surface have finally arrived. A fiscal push will only exacerbate pricing pressures. Looking ahead, benign bond markets should not be expected. The path of least resistance for yields is now up. Welcome to regime change.

→ **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. Also, investors should recognize that many assets were bid up on the “lower forever” thesis. This includes a variety of interest rate sensitive investments in the West — REITs, dividend payers and the vast assemblage of ETF product that, through financial alchemy and a masterstroke of marketing genius, produced a higher and more tantalizing yield. To be sure, our clients relished in this yield bonanza (with our Global Income Focus producing double digit annualized returns since its June 2008 inception). But no party lasts forever and we are now shifting strategy in income-oriented mandates.*

Finally, bear 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)

Powell To The People: Growth Is Very Good. After years of post-crisis gloom, the broad consensus of forecasters is now quite upbeat about prospects for the world economy in 2018. Global growth is viewed as increasingly strong, synchronous and sustainable. Financial markets could hardly ask for more.

Incoming Federal Reserve Chairman Jerome Powell, the first non-economist in nearly 40 years to hold the job, also shares the majority view. In his first testimony before the House Financial Services Committee, Powell moved markets with his upbeat economic assessment. In a style departure from his predecessor (the more guarded, consensus-driven Janet Yellen), he continually expressed his own personal convictions. Whether that was a rookie central banker mistake or a deliberate shift in the Fed's communication dynamic, his economic optimism was evident: “I think our view -- my personal view -- would be that there will be a meaningful increment to demand, at least for the next couple of years, from the combination of those two things,” he said, referring to the US's \$1.5 trillion tax package and the recent budget deal to lift spending caps and increase government outlays.

We generally agree with Powell. Economic growth is solid and the global economy has sustainable momentum (our base case is even that we are less “late cycle” than the consensus). What's more, inflation, a force virtually unseen in the post-crisis world, is starting to reappear in a meaningful way — as it normally does in booming economies.

In this climate, equities should generally do well and fixed income should not. But the bond market has likely run ahead of itself at this juncture. Large and steady spikes in yields, even if they generally drift higher over the coming years, are not likely to be sustained in 2018. There are several reasons for this. Lifting deflationary forces and, more importantly, the perceptions of continuing “low-flation” will take time to change. The popularity of so-called “secular stagnation” theories has mistakenly convinced many, including policymakers, that higher inflation is not possible. Central banks are committed to staying “behind the curve” until inflation and growth trends are well-advanced. What’s more, regulatory requirements for banks and pension funds ensure continuing demand for government bonds at any price. The recent selloff in bond markets creates a tactical buying opportunity for these institutions. Expect these institutions to continue “buying the dips”, even while bond prices continue their long-term decline.

While our investment team will likely be generally underweight and bearish on Western bond markets in the coming years, there may be a tactical opportunity. 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 toward stocks and the economy. Bond pessimism, by contrast, has hit a new record. According to the report, fund managers are avoiding bonds to the largest degree in the decades-long history of the survey, having their largest “underweight” ever. Additionally, a “bond crash” is what worries fund managers the most. When such uniform consensus views surface it is time to pay attention and look for alternative scenarios.

→ **Investment Implications.** *It’s always tricky when a macro manager’s Tactical Views do not necessarily line up with the main Super Trends. However, with volatility spiking and inflation surfacing this year, correlations and dynamics are shifting. The world has changed and the market is simply changing with it. Global asset prices are unlikely to go back to the always-rallying and well-behaved creatures they once were. This makes markets more treacherous but also can be more rewarding for the intrepid investor. At the current juncture, bonds now present opportunity. But how much can investors hope to gain from what may only be a modest reduction in yields? And, more importantly, several Super Trends are conspiring to produce higher bond rates. A better strategy to capitalize on a moderation in yields is to look for income-oriented and other assets that have been heavily — and perhaps indiscriminately — sold off during this year’s bond market rout. These stand to gain the most should our view be correct. One such asset is US Mortgage REITs (MORT, REM). We have added exposure to our Special Opportunities strategy to benefit from the above dynamic.*

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 soon make own Lazarus-like appearance. However, 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 revive the currency — announcements of a more monetary tightening, flare ups in Euro politics, or take your pick. But what will unfold is most likely a bounce from a deeply oversold level.

→ **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 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: a disorderly end to the housing boom (which abruptly softened in late 2017) or a deterioration in global trade, since exports represent nearly half of GDP. Keep both risks on high watch.

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

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”).

Japan is also ideally positioned in Trump’s “de-globalized” world. Over the last four years, Japanese corporations have capitalized on the earnings boost delivered by the yen’s post-2012 depreciation by aggressive M&A and building up overseas operations as production and distribution bases for foreign markets (and hence moving production of its major products— automobiles, electric machinery and electronic equipment—closer to the end market). Given that Japan’s population is shrinking, this makes sense and has introduced a profound change in the nature of Japanese business. In 2012, Japanese firms passed the threshold of producing more goods and services outside of Japan than inside (that ratio had risen to 58.3% at the end of the 2015 fiscal year, according to an August report by the Japan External Trade Organization). In short, most of Japan’s familiar names should no longer be considered as exporters but truly globalized multinationals.

Finally, and perhaps most importantly, Japan continues to lead the world in unconventional monetary policy. On November 14, 2016, Kuroda (the one that is not yet retired) announced more forceful measures to raise inflation expectations and introduced an “inflation-overshooting commitment.” “Specifically, under this commitment,” Kuroda said, “the Bank will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI exceeds 2% and stays above the target”.

Fortunately for the value-conscious 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 at a price to book ratio of just 1.33. And, companies have been steadily increasing their dividends, yet payout ratios still average only 25 to 30 percent of earnings.

What's more, 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. However, sentiment appears to be shifting rapidly, with strong flows into Japanese equity ETFs. We expect this to continue.*

Populism And 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 rapidly 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.

On the populism front, encouraging news has surfaced. Just when most were convinced that the EU and its currency would be drowned by an irrepressible current of national populism sweeping the region, the tide turned abruptly. In retrospect, the key pivot point occurred last year with the Dutch elections in March and then more decisively with the French victory of Emmanuel Macron in April.

More recently, the best possible outcome for Eurozone integration has occurred in Germany with a coalition deal between Angela Merkel's center-right grouping and the Social Democratic Party. Crucially, the new head of the finance ministry is Olaf Scholz, a large supporter of European integration (in contrast to his predecessor Wolfgang Schäuble, an ultra-orthodox euroskeptic who continuously blocked intra-eurozone fiscal transfers and arguably extended the euro crisis). Berlin's new integrationist stance should bring serious progress on Eurozone reform and fiscal union. Importantly, the SPD shares similar views to those of President Macron.

Finally, what about developments in Italy? While the anti-establishment Five Star Movement received more votes than any other single party in the recent election, it was not enough to prevent the formation of a conventional coalition government. Therefore, investors should expect the status quo in Italy — a traditional coalition party that will not challenge country's membership in the euro or change the current policy on bank recapitalization.

→ **Investment Implications.** *With political risk receding and a move toward more Eurozone integration, greater financial stability and higher growth is the most likely outcome. European banks are likely to be big beneficiaries. Stay long 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 dividend yield is particularly attractive in a region still dominated by sub-zero interest rates.*

¹ <http://www.bankofengland.co.uk/research/Pages/workingpapers/2016/swp624.aspx>