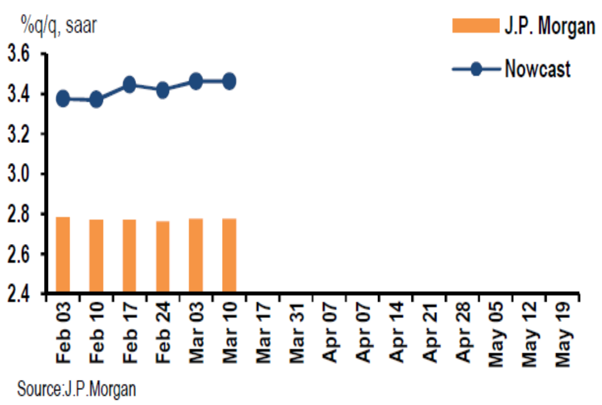
The Month Ahead Mar 2017: Focus on your core.

This writer has the ignominy of having two slip disc operations in the same section of the spinal cord in the last 20 years. The chance of having a slip disc in the same vertebrate is rare. In the eloquence of my surgeon "The chances of you getting a slip disc in the same place is akin to a delicious kaya between bread. After the a few bites of the bread, most of the kaya is already out. But you still managed to spill the remaining kaya out of the bread!" With those wise and demeaning words, this writer spends a lot of effort to strengthen his core in hope that he wouldn't have to go under the knife again.

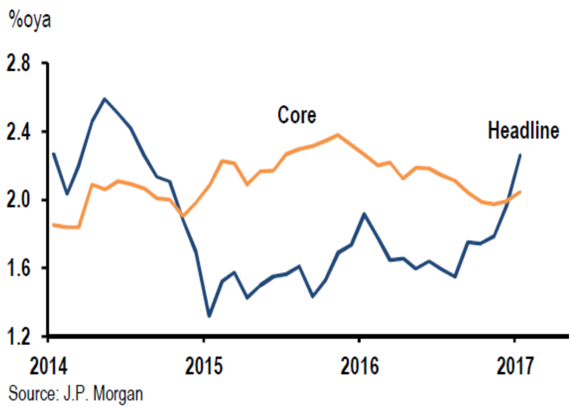
This month musing isn't about kaya or core muscles. Is about core inflation. Specifically**, the concern that core inflation may rise faster than current market expectation** as our growth reflation story asseverates and is exacerbated on the back of tightening output gaps for both capital and human resources. A steeper rise in core inflation **would then necessitate a faster normalization of uber-low interest rate environment by central bankers.** The ramifications of a quicken pace of rates increases must be assiduously monitored especially with sovereign bond markets at 140-year expensive, credit spreads already a cycle low and equity valuations are not universally cheap.

Data across the globe is clearly pointing to a very strong 1Q17. Current JPM Nowcaster is tracking global growth of 3.5% for 1Q17 and if momentum prevails, this would be a good 0.3% points higher than current consensus forecast for 2017 and would put the global economy above its growth potential. Consequently, we are seeing global inflation rising at annualised rate of 3.5%; 0.5% points higher than forecast of 3% for the whole year. If we hit this level of inflation, this would be the highest inflation print we have seen since 2012.

JPM GDP Nowcast indicating a very strong 1Q17

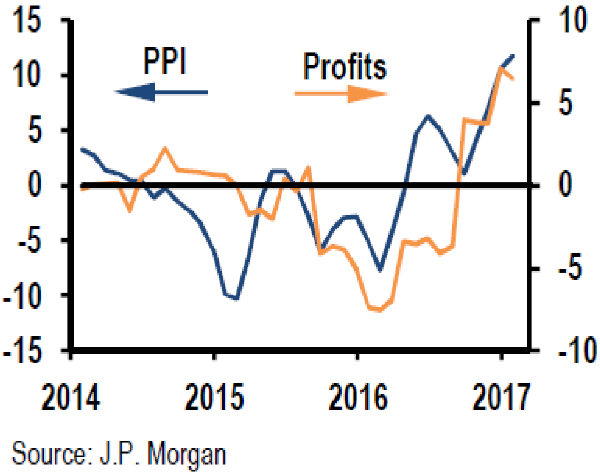


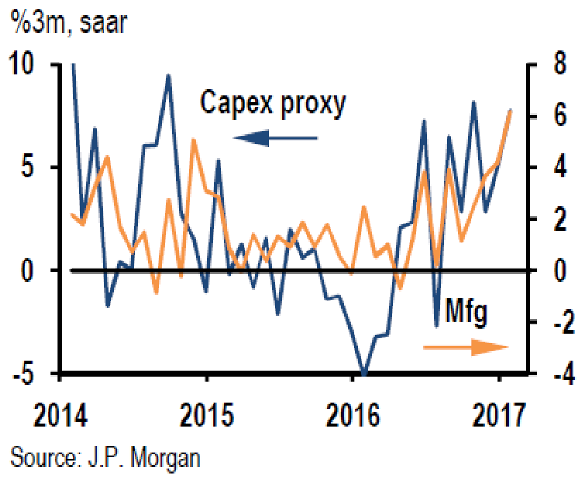
Core is picking up in tandem with headline



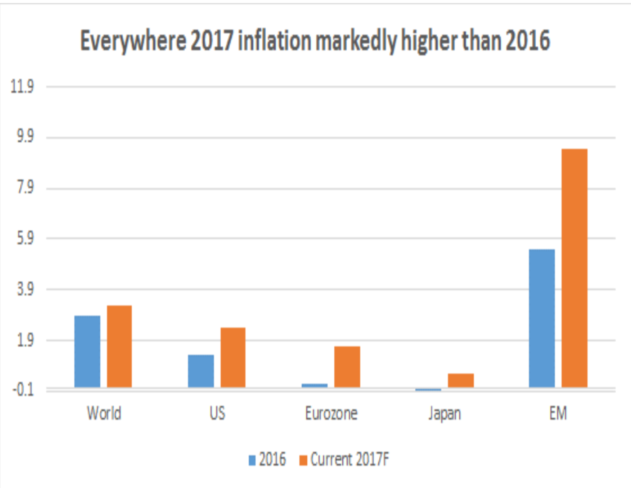
There is good reason we believe the economic momentum will continue throughout the year in contrast to the intermittent false dawns we have witnessed in the last 5 years. The key tenet of this view lies with improving profitability a higher inflation environment has brought to corporates. This in turn leads to a more confident corporate sector who are willing to invest in capex to replace capital structures that are way over-due for upgrades. JPM global capex proxy jumped 4.1% annualised in 4Q16 which is a significant trend reversal of abysmal capex activity that was negative from 2015-2016 and less than 3% in the years of 2012-2014. Latest capex proxy rolling the last 3 months till January 2017 suggest global capex proxy up by 8% annualised. Concomitantly, manufacturing activity and manufacturing employment have rebounded supplementing an already resilient consumer segment.

Profitability improving, increasing propensity to capex are propelling manufacturing activity higher





While the rise in energy and commodities prices have been a key inflector of headline inflation, core inflation is also starting to pick up. **Global core inflation is accelerating to 2.1% yoy in January print in sharp contrast of 0.4%pt decline in 2016.** As detailed in tables below, Inflation pressure is noticeable higher in 2017 versus last year for all the major economic blocs. Even in Europe and EM where there is the presence of a bigger slack in employment, inflation is still forecast to rise quite materially in 2017. Inflation in Europe jumps from 0.2% to 1.3% in 2017 and 1.5% in 2018 in contrast to last three years of essentially zero inflation. Inflation forecast for EM has been upgraded by 3.8%pt since the start of the year to 9.5% in comparison to 2016 inflation of 5.5% with China, India and Brazil contributing to the increase. Furthermore, consensus have also been revising up their inflation forecast since the start of the year for most regions as well as for global aggregate.



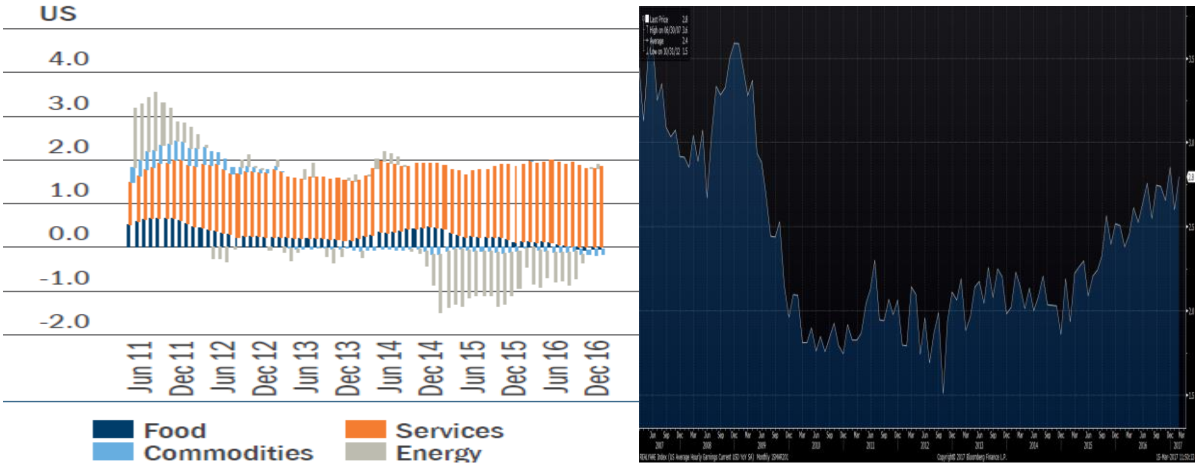
Change in Inflation forecast YTD

	World	US	Eurozone	Japan	EM
Current 2017F	3.3	2.4	1.7	0.6	9.5
Change from Dec 2016 Forecast (%pt)	0.1	0.1	0.4	0.0	3.8

Some commentators have dismissed the recent jump in headline inflation as unsustainable as it is driven by cyclical factors such as the rebound in energy and commodities prices and assert the global economy remains mired in deflationary pressure so pre-eminent in the past 15 years since China joined the WTO and imported its deflationary deluge to the world. **We contend that decade long of deflation is about to end and core inflation will rise more than expected but market is complacent of the accompanying risk that it could bring.**

We start by analysing the reasons **core as well as headline inflation prints in the US have started to rise and will likely exceed market forecast.** In the last four years, US have seen tepid inflation of around 1% pa, however by 4Q16 inflation have started to pick up and forecast have inflation at 2.3% by 2017; a good 1%pt higher than 2016 and far higher than 0.1% CPI in 2015. For 2018, consensus have inflation rising further to 2.5%.

<u>US Service sector driving inflation and wage increases are driving PCE close to Fed's target</u>



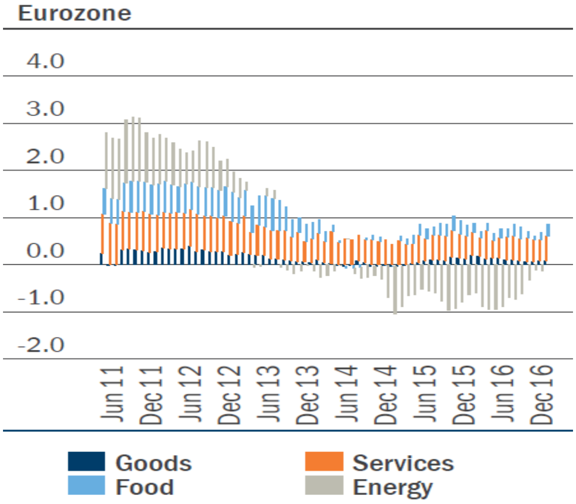
Source: Pioneer Investment and Bloomberg

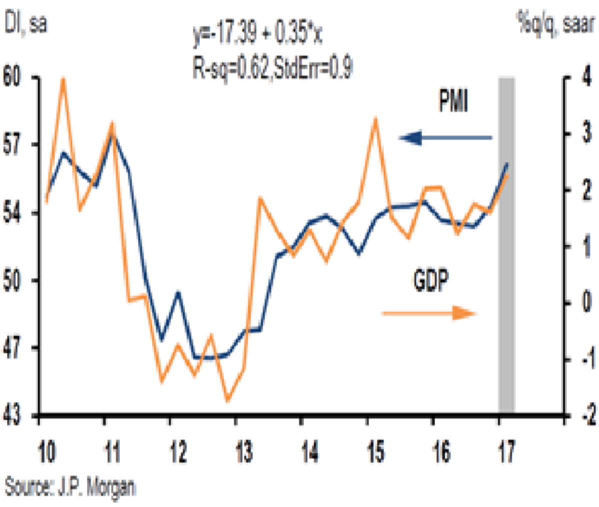
The rise in energy price throughout 2016 have merely become less of a detractor to inflationary pressure as seen in chart above. **Instead, the main contributor of inflation pressures is coming from the US service sector**. Service sector in the US has been rising slightly above 3% since the start of 2016 contributing most of the inflationary build-up. Within the service sector, rising medical costs and housing rents are the key contributors. We believe the rise in these two sectors are not going to abate anytime soon and in fact could exacerbate in the coming years. Housing costs should increase due to improving job market spurring demand as well the record number of young adults 25-34 years old who are still living at their parents' home but will be looking for their own abode as they find employment. This pent-up demand should drive house and rental prices higher. Medical costs should continue to rise even with a repeal of Obamacare stemming from ageing demographics that will demand higher medical attention.

We believe wage costs are also set to increase as unemployment rate and jobless claims have recovered to 2007 lows. Average wage growth is accelerating with Feb's data pointing to +2.8% increase. The past 3months average wage growth was 0.2% pt higher than average of 2016 and good 0.90% pt point higher than average of 2012-2015. These increases are percolating to higher Personal Consumption Expenditure. PCE report is key inflation indicator Fed watches most closely. January's PCE's core and headline releases are now just 0.1% pts close of Fed's target of long-term sustainable inflation. Chairman Yellen has commented yesterday night post their FOMC meeting that inflation "is moving close to" their 2% target.

But the biggest under-estimation of inflation risk by the market is in Europe. Similar to the US, energy has become less of deflationary force for Europe but is the service sector and food costs that have been constant sources of inflation build-up. As the service sector inflation is driven mainly by domestic factors such as demand and employment, we argued that these two drivers are going to turn significant positive and drive inflation higher in the 2nd half of the year. **Euro PMI in Feb came very strong despite all the political noises. The readings would be consistent with a 2.5% GDP growth far higher than consensus estimate of 1.8% for the full year.**

<u>**Europe Service sector inflation has been constant, but strong GDP could push ECB to end QE earlier**</u>

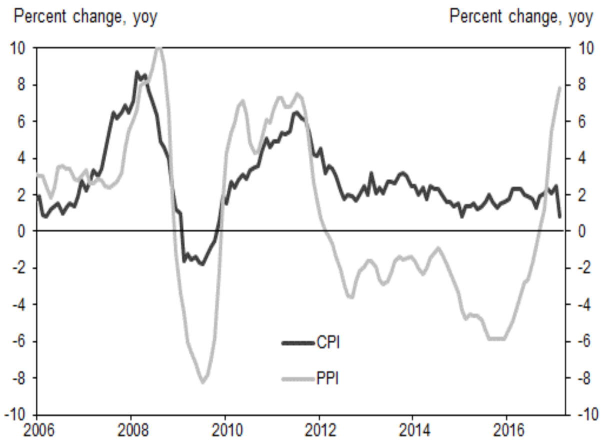


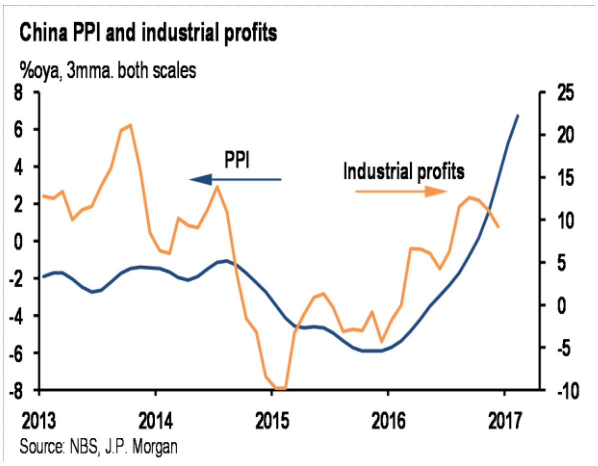


We have observed that an average GDP growth of 1.8% pa in Europe has delivered a 0.8%-pt average annual decline in the unemployment rate in recent years. Absent a revival of productivity growth, **the unemployment rate in Europe could fall even faster in 2017 if we do achieve a 2.5% GDP print.** JPM conducted an analysis which attempts to gauge ECB's reaction function by extrapolating how the US Fed has responded to the outcome of Taylor's rule (Taylor rule is a sacrosanct economic theory that governs the relationship between interest rates and economic conditions). In their analysis, they commented that there is a risk that ECB could bring forth its end of QE from their current declaration of the end of this year to one quarter earlier as the current unemployment rate of 9.6% is not far from the ECB's full employment estimate of 8.5%. There is also a risk that they may raise rates by as early as 3Q18.

We expect China CPI to move in tandem with its surging PPI in the coming months. Producers Price Index (PPI) in China has seen a noticeable increase since the middle of last year. Latest release continues to surprise higher than market expectation with Feb's PPI up 7.8%; the highest since 2008 and a good 1% pt clip higher than in January. The driver of PPI are largely upstream industries product prices and based on observable and anecdotal evidences, we expect upstream product prices to continue to rise further into rest of 1H17. The **benign CPI print so far is about to change as believe higher raw materials prices will soon feed into consumer product prices.** Historically, CPI has lagged PPI by 6 months. PPI has bottomed in 2H16, we believe the coming months will see CPI moving in tandem with PPI increase, albeit at slower magnitude. Most importantly, PBOC recent manoeuvres including increasing MLF and SLF rates, moral suasion on credit increases and recent PBOC press conference where the governor stress "more neutral" monetary stance as affirmations to our views that they see inflation picking up and asset price imbalances as key considerations to alter their monetary policy towards more tightening.

<u>Surge in PPI has translated to higher profits and should soon feed into consumer prices.</u>





In summary, we believe the inflation complex is about to increases more than market is currently prepared for. The momentum is building in many economies with Europe and China likely to surprise market the most. Consequently, the path of monetary policy normalisation may morph from the current state of ataraxia to something more sinister and rapid that surely warrants great scrutiny and concern.

<u>Asset Allocation Strategy:</u>

This view reiterates our preference to underweight bonds quite substantially in GAP (Global Anchor Portfolio) while opting to search for income in GIP (Global Income Portfolio) bond portfolios via yields pick up in different regions, credit curve and capital structures such as emerging markets, CoCos and leveraged loans in the US. We have also trimmed our overweight in Equities in part due to technical reasons as well as overlapping concerns a faster than expected increase in central bank reference rates could impact equities.

As we have highlighted in last month musing, http://www.covenant-capital.com/wp-content/uploads/2016/07/The-Month-Ahead-Feb-2017-Its-complicated.pdf ,our preferred asset class is to overweight the USD and it remains so.

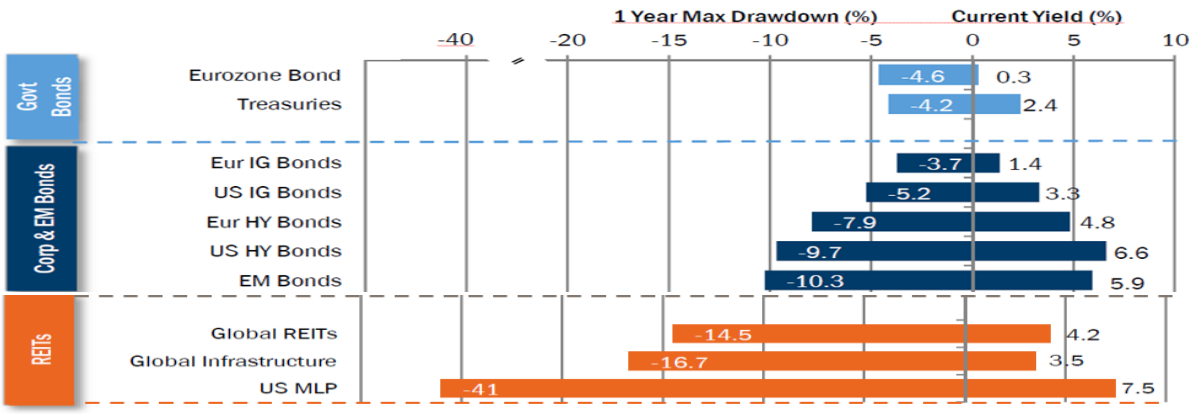
FX: Long USD in the short-term, but we are looking for entry point to long EUR. We have been spot on in calling for Fed to raise rates in March as early as in January during our 2017 outlook dinner event. This has come to pass and we expect Fed to be more hawkish in the subsequent meetings especially if Trump's tax and fiscal policies are implemented. In descending order of preferences, USD/JPY, USD/KRW and USD/SGD are the best ways to express this view. However, we are scouting for opportunity to **go Long EUR/USD because we are of the opinion the economy may surprises the most among the major economic bloc and ECB and the market are behind the curve on inflation risk**. We prefer to ride past French election in April and mark to market our views on its economic momentum, inflation risk and ECB responses before building up a position. The pairs would likely be EUR/JPY more than EUR/USD.

Europe's Citi Macro Economic Surprise Index is the highest since May 2015

Equities: Maintain Overweight but we have reduced our exposures. At current cycle, equities are still preferred over bonds. We are most overweight in Japan equities but are looking to increase overweight in European equities by the most in early 2Q17. EM remains neutral due to concerns of higher rates and dollar strength and our preference in EM is to buy China equities. We are still slight underweight In the US because of valuations and gathering evidence that earnings revision momentum is slowing. Sectors of preference remains technology, financials and commodities, prefer small-caps over broader market. In our Global Income (GIP) mandates, we like cyclicals that pays high dividends and companies with high dividends supported by earnings and free cash flow generative capabilities. We are running at the upper range of maximum allocation for equities in GIP.

Fixed Income: Maintain Underweight (No change). Low on sovereigns and less on duration, really just picking up yields rather than hoping for further spread compression. A reminder to our readers that as rates increase from current super low levels, capital losses from duration and convexity are the most acute while credit default risk may also surface. We have also sold US High Yield and added Emerging market debt instead as valuation are more attractive for the latter and we expect a relatively more benign rate environment in EM than the US. Moreover, given our concern on oil prices, US High Yield asset class have a strong positive correlation to oil.

Capital loss from rising rates may wipe out any yields or coupons you think you are earning



Source: Bloomberg. Data as at November 28, 2016. Eurozone Bond = JPMorgan GBI Germany, Treasuries = JPMorgan GBI US, EUR IG Bonds = Barclays Pan European Aggregate Corporate Bond, US IG Bonds = Barclays US Aggregate Credit, EUR HY Bonds = Barclays PanEuropean High Yield Bond, US HY Bonds = Barclays US Corporate High Yield, EM Bonds = JPMorgan EMBI Global, US Equities = S&P 500, Global Equities = MSCI World, European Equities = MSCI Europe, Eur High Div Equities = MSCI Europe High Dividend Yield, Global REITs = FTSE EPRA/NAREIT Global, Global Infrastructure = Dow Jones Brookfield Global Infrastructure Index, US MLP = Alerian MLP Index. All indexes are total return in local currency. Max Drawdown is the largest 1 year decline in value registered since December 2010 based on an analysis on monthly data. Drawdown – The peak-to-trough decline during a specific record period of an investment, fund or commodity, usually quoted as the percentage between the peak and the trough. Yield is the Yield to maturity for bonds and the dividend yield for equities. **Data represents past performance, which is no guarantee of future results.** Please see additional MSCI disclaimer in the Additional Notes.

The search for Income have now become far more complex than just buy and hold bonds or reits while leveraging them for higher returns. We urged readers to consider our alternative, Global Income Fund, where we search for income across regions and asset classes. We deploy a combination of best of breeds fund managers, high dividend stocks, bonds for coupon and yield, ETFs and potentially futures and options to optimize risk/return profile. Please speak to your Financial Stewards for more info. (CEO will explain in due course the choice of title)

Commodities: Zero positions currently as we have taken profit on Copper and have downgraded our views on oil 2 months ago and see increasing risk of correction below $50 bbl. We like Asia steel but is not for the faint-hearted and for first time, like to own Gold at this level. We have taken profit on Copper as the key event we were looking for which is labour disputes in Chile has already happened and we believe we are close to a resolution in the coming weeks. But the 2year story for Copper remains constructive and we are looking for entry points to re-enter. For oil, we are making another bold call contending the risk of oil breaking below 50 is increasing. As some of you have may recalled, we upgrade oil when it was trading at $25 bbl back in early Jan 2016 with a near term view of 40 within 3 months, subsequently upgraded our target to 55-60 in 3Q16 based entirely on supply discipline while demand remains stable. By Jan 2017, we downgraded our range to 50-55 as we were increasingly concern on rising rig counts in the US and technology induced cost-down for shale producers to $20-25 bbl production cost. We think consensus bullish call of $60-70 bbl in 2017-2018 could be wrong again as we doubt the OPEC supply discipline will adhere once Saudi Armaco is listed in later part of this year. Moreover, the spectre of risk of a US border tax could alter global oil prices materially (See last month musing for detailed discussion on this topic). Lastly, we are introducing a positive view on steel prices especially in Asia due to significant capacity removal in China and spate of private partnership projects and One-Belt-One-Road initiatives kick off. You can trade steel futures in Shanghai Exchange though a word of caution is it is not for the faint-hearted. For the first time in years we have turned positive on Gold due to our inflation concerns.

Alternatives Investments: 1H17 will be period of reviewing our AI strategies which have generally fared poorly when compared to the broad market last year. Over the long term, AI strategies remain an integral part of our strategy especially in market when valuation are steep like in the US where alpha generation becomes critical.

Featured Picture/Quote: Work those cores or refill your kaya.

https://www.youtube.com/watch?v=Ut4GJuNuOM4

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