The Month Ahead June 2017: Clairvoyance

Professor Allan Litchtman of American University, who has gained a reputation for predicting the US Presidential winner correctly since 1982 including Trump's victory, has recently predicted Trump will be impeached. His new book, *The Case for Impeachment*, outlines eight possible reasons to impeach Trump, including his team's connections to Russia as well as his business-related conflicts of interests. In his own words, "he is more vulnerable to impeachment than any other figure who has been elected for the first time to the presidency of the United States" and "what might distinguish a Trump impeachment from that of Clinton and Johnson is that the transgressions could be more Nixonian — that is, more serious, more threatening to our constitutional order, our liberties, our freedoms and our national security."

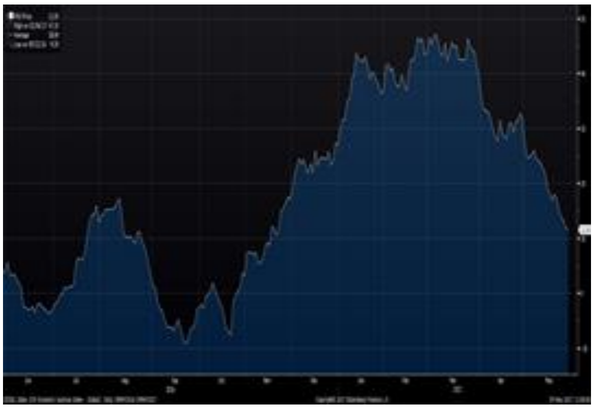
We do not claim to have such clairvoyant capabilities in making this bold prediction, but **we certainly acknowledged that our expectations of a Trump inspired tax and healthcare reforms and much-needed infrastructure fillip are waning quickly.** Some of market barometers that we use to gauge these expectations have reversed from its peak and for some to levels before Trump's victory in Nov of last year. The strength of the USD is the first barometer we look to gauge the underlying strength of the economy. The USD rose sharply post Trump's victory because the market has built-in expectation that his pro-growth policies will have high chances of congressional passage given all chambers of power belongs to the same party now; a confluence of power that has not happened since Obama first terms in 2009. However, the broader-US Dollar index has since retraced 6% from its peak in Jan 2017 and is now back to pre-Trump victory level. The other barometer we look is the yield on US Treasuries as well as the shape of the yield curve. Yield of UST10 years has fallen 40bps from the peak of 2.6% in March while the US yield curve has flattened with front end rising 40-50bps but the back end is unchanged. The retracement of the yield of UST10s and the flattening of the US yield curve reflect market has reduced their expectation of inflationary pressure induced from a better growth environment.

US dollar retraced all the gains post Trump

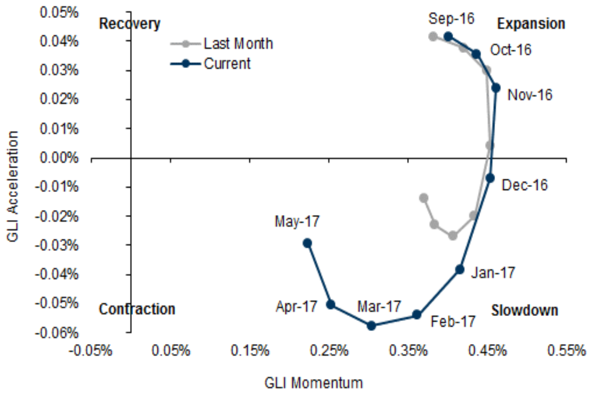
UST10 fallen 40bps and at risk losing 2.135% support

In our April 2017 musing, [Don't forget to breathe](), we have laid out the reasons why we have **reduced our maximum bullish equities views held since 3Q16 to just slight overview.** We also have lengthened our duration in fixed income portfolio by adding to US Treasuries. **The main reason underpinning these changes is we believe the global economy has moved into a stable growth phase where the rate of improvements has either peak or is reversing. This is in sharp contrast back in 3Q16 and into early 1Q17 where we witness an accelerating momentum in growth improvements.** Citi's global macro-economic surprise index best encapsulates this view. The magnitude of positive surprises has reversed since peaking in March and in fact is in negative surprise territory now. Another indicator that tracks global economic momentum is GS Global Leading Indicator. It has moved from an expansionary phase in Sep-Dec 2016, to slowdown phase by 1Q17 and is in outright contraction phase now. Only two of its ten indicators improved from the previous readings while five indicators saw significant declines of more than -1sd.

Citi macro surprise index rolled over

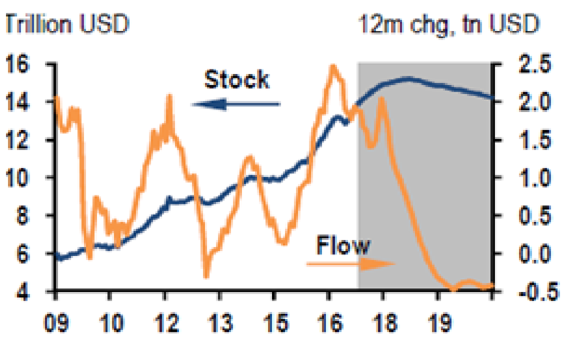


GS global leading indicator in contraction phase



Adding to the list of issue to worry in the coming quarters is central banks' balance sheets are set to contract significantly. The US Fed has already communicated their intention to unwind QE program by end of this year. ECB will end their QE purchases by end of the year as well. In all, we expect central bank's balance sheet to grow only $235bn in 2018 in sharp contrast $1trn and more of balance sheet expansion seen every year since 2014. According to JPM, a $1.5trn decline in Fed's balance sheet every year from 2018 till 2020 is equivalent to 25bps increase in interest rate. If QE has been instrumental in supporting the global economy from contracting and has been the cause for causing asset bubbles in other countries/sectors, would a withdrawal of QE leads to the opposite outcome of recession and crisis in certain asset prices? Since nobody has live through this phase of unorthodox monetary policy, it would be too bold for this author to suggest the unwinding of easy money will not have any repercussions to asset prices. We just must calibrate our views along the way as this experiment unwinds.

The consequences of the stock and flow of QE unwind are unknown



Source: Fed, ECB, BoJ, BoE, J.P. Morgan.

12m chg as of Dec, bn USD

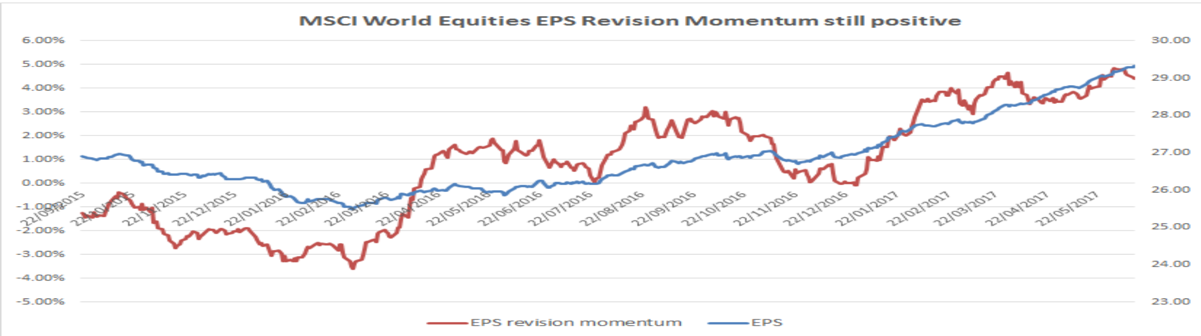
	2015	2016	2017	2018	2019	2020
Fed	-11	-28	-3	-336	-483	-378
ECB	298	845	1049	102	-96	-75
BoJ	635	958	954	454	91	23
BoE	23	116	50	14	15	15
Total	**945**	**1891**	**2050**	**235**	**-473**	**-415**

Source: Fed, ECB, BoJ, BoE, J.P. Morgan.

Equity markets have risen a lot since the start of the year. From a valuation standpoint, MSCI Global Equities, SPX, Europe and MSCI Emerging Markets are all trading above their +1sd from their ten-year averages. In financial parlance, the return driver for the rest of the year must come entirely from earnings growth specifically positive earnings revision momentum. Take S&P as an example and using the simplified CAPM model, should S&P valuation multiple revert to its ten-year mean, its year-to-date performance of 8.6% has already accounted for 100% of our EPS growth derived target price. Current premium valuation leaves little room for error should EPS revision momentum turned negative. For now, the overall markets are still seeing positive revision momentum.

<u>**Valuation multiple are expensive; driver of return is single-handed coming from EPS growth.**</u>

	Price Change YTD	PE FY17	Average 10 yrs PE	Std deviation from 10 years average	EPS Growth FY17	EPS revision momentum YTD
SPX	8.6%	18.7	14.3	2.8	10.7%	-0.4%
Stoxx Europe 600	8.0%	15.1	12.8	1.5	16.7%	2.0%
Topix	4.8%	14.2	14.8	-0.4	5.2%	2.9%
MSCI EM	18.1%	12.9	11.2	1.9	22.4%	7.8%
HSCEI	11.6%	8.4	9.7	-1.6	3.7%	4.9%
MSCI World	**10.7%**	**17.4**	**13.7**	**1.9**	**12.3%**	**2.4%**
Source: Bloomberg and Factset						



We are most cautious on tech especially the much fangled, FAAMG (Facebook, Amazon, Apple, Microsoft and Alphabet (ex-Goggle). While the FAAMG is 13% of S&P weights, they have accounted for 40% of the index performance year-to-date. Similarly, while it accounted for 42% of NASDAQ, it has driven 55% of the index performance. The market capitalization of this five stocks is equal to the GDP of Hong Kong and Singapore combined. All five stocks are currently in GS hedge fund most owned stocks while mutual funds are overweight these stocks versus their benchmark. Such performance driven by a narrow and crowded few are prone to dislocation from even the minutest event.

FAAMG YTD performance and index contribution, as of June 7, 2017

Ticker	YTD Price Perf (%)	% of SPX	% of SPX Move	% of NDX	% of NDX Move	Market Cap Created ($,bn)	Equivalent to the Mkt Cap of:
AAPL	34%	4%	13%	12%	18%	200.1	CMCSA
GOOGL	26%	3%	7%	9%	11%	145.4	IBM
AMZN	35%	2%	6%	7%	11%	125.1	UPS + KR
FB	33%	2%	5%	5%	8%	111.0	BA
MSFT	16%	3%	5%	8%	7%	78.7	MS
Top 5		13%	37%	42%	55%	660.4	
S&P 500/Total	9%					1,808.1	

FAAMG is 13% of the SPX but responsible for ~40% of the YTD perf.

FAAMG is 42% of the NDX but responsible for ~55% of the YTD perf.

Note: For purpose of this exercise we combine GOOGL and GOOG.

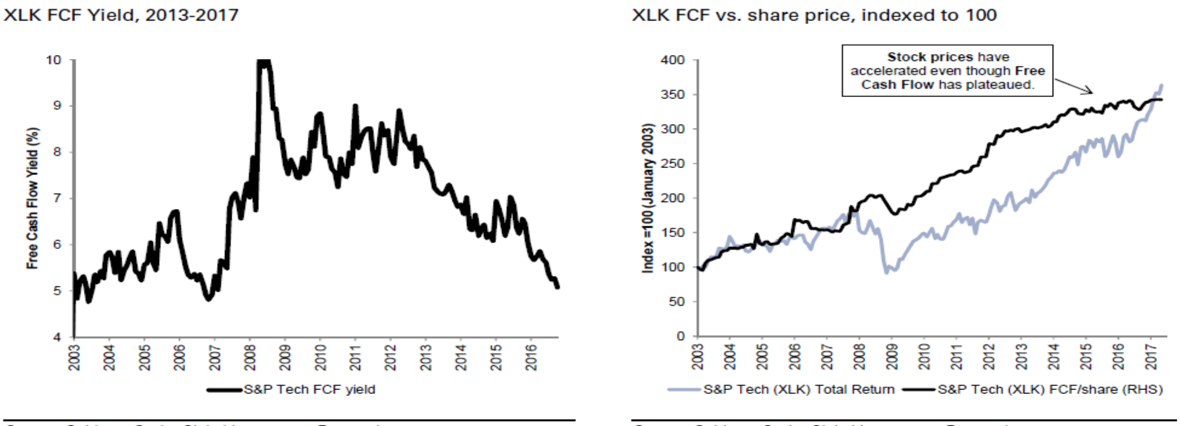
Source: FactSet, Bloomberg, Goldman Sachs Global Investment Research.

Our team have been tracking their earnings revision assiduously for the last 2 months. Our group is different from GS sample but the implications are the same. Our group consists of Facebook, Apple, Amazon, Netfil, Google (Alphabet), Alibaba and Tencent which we term them as FANNGAT. The group is now trading at 30x Fy17PE with EPS growth of 25%. As a firm, when we start paying more than 1x PE to EPS growth, we are normally quite uncomfortable with this valuation multiple. The group have risen 32% YTD and if you ascribe that they are trading at fair multiple, ie within their 10-year average PE, the group future return expectation have to be fully dependent of EPS revision upwards. This is where we are most concerned. **Of the 7 names, only 2 names (BABA and Apple) are showing improving earnings revision trend in the last 3 months, 3 names (Amazon, Netflix and Google) are exhibiting clear trend of negative revision trend.**

	Price Change YTD	PE FY17	Average 10 yrs PE	Std deviation from 10 years average	EPS Growth FY17	EPS revision momentum YTD	EPS Revision tend last 3 months
Facebook	31.0%	24.4	37.5	-1.6	29.8%	4.6%	Flattening
Apple	26.6%	13.5	16.0	-0.4	7.8%	-0.4%	Improving
Amazon	30.8%	65.8	55.5	0.5	38.6%	-13.0%	Deteriorating
Netflix	23.4%	84.9	69.2	0.3	67.4%	15.6%	Deteriorating
Google (Alphabet)	22.5%	21.9	19.3	0.6	20.7%	12.2%	Deteriorating
Alibaba	55.6%	28.4	27.1	0.3	31.1%	38.1%	Improving
Tencent	44.8%	33.5	29.2	0.7	29.8%	2.2%	Flattening
FAANGAT	**32.1%**	**30.2**	**29.6**	**0.1**	**24.7%**	**6.0%**	
Source: Bloomberg							

Taking the broad technology ETF as a macrocosm, actual free cash flow accumulation has plateaued as capex for the sector has increased faster than cash generated from operations. However, share prices continue to rise depressing Free Cash Flow yield to its decade low.

<u>**FCF Yield falling and share price running ahead despite FCF accumulation has plateaued**</u>



Source: Goldman Sachs Global Investment Research. *Source: Goldman Sachs Global Investment Research.*

Because of this analysis, we have been trimming our tech exposure in the past month and as of now, we have completely delta-hedge our tech exposure.

<u>**Asset Allocation Strategy:**</u>

Equities: We have been trimming our overweight in equities in the past 3 months and we are advocating only a slight overweight heading into summer. As articulated above, our concerns that year-to-date performance has already been fully priced and without the singular force of upwards EPS revision, market is vulnerable to correction. Furthermore, we are dialling down of our growth cyclicality view from an acceleration to a stable phase and there are growing evidence we might have to downgrade GDP and inflation growth forecast in the coming months. Our preference remains for Europe equities over US, neutral for EM (prefer China in EM), Japan and most cautious on global tech.

Fixed Income: Underweight but we have been increasing. We have added duration in the fixed income portfolio via US Treasury and add to a new manager that focusing on generating absolute return in Asia credit. This new inclusion dovetails with our view that global growth is stable and therefore conducive to Asia's assets but with spreads tightening, search for returns in the bond space must come from a more bottom-up approach.

FX: Downgrade to Neutral. We exited our long Euro which we have advocated since start of the year and with a flattish view of USD in the medium term, we do not see much opportunities in the FX space.

Commodities: Neutral with Gold as an inflation hedge and still looking for levels to buy Oil.

Alternatives Investments: We have trimmed our AI exposures in Asia and global equities as they have failed to perform better that ETFs.

Cash: Raising cash level the highest in last 9 months.

Featured Picture/Quote: So unnecessarLee.

This is a storLee,
About a house in Oxlee,
It belongs previously to an elder Lee,

Tear it down when I am gone eternaLee,
I don't need it as a memorLee.

Now that he is gone, his children cannot settle it properLee.

Two say bring it down and obey respectfuLee
One says let's see if we deal with it diffrerentLee.

Why does the whole world needs to know the whole storLee,
When actually is matter of their own famiLee.

As the elder Lee, shakes his head sadLee,
I can't help but ask you guys cannot let him go peacefuLee.

David Tan Kok Kheng

Edward Lim, CFA

Chief Investment Officer