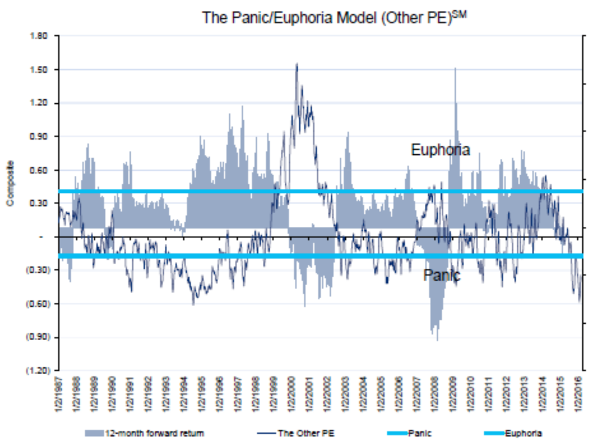
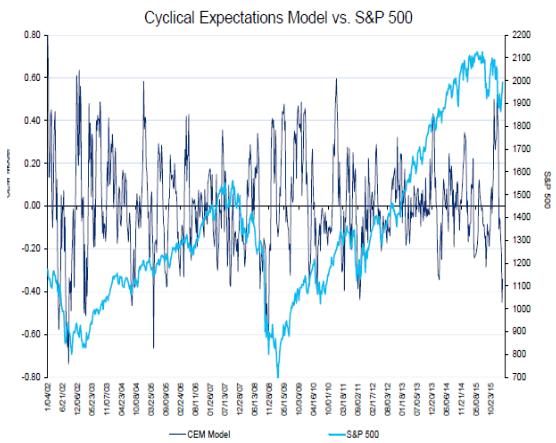
The Month Ahead Mar 2016: From Fear to Feh to Faith

Throughout this wanton fear to feh, our investment prognosis has been consistent advocating for faith. Faith that lower oil price is an income dividend for global consumers. Faith that there are still monetary tools left in the central bankers' arsenal. Faith in the improvement of global employment and ensuing rise in wages will underpin consumption and drive economic growth. Faith in the convergence of robust consumption and anaemic manufacturing will happen. Faith in our firm's underlying investment philosophy that there is price to everything. Even fear has its price.

Since our last month's write up where we have advocated adding more equity and oil-related risk, equity markets and oil have rebounded 8% and 19% respectively. We attribute much of this bounce as a reversal of uber-bearish sentiment and our oft use Panic/Euphoria index has again proven its predictive prowess pricing fear at its extreme. Despite the jump in risk assets, the model remained in Panic territory. In addition to our JPM Nowcaster model we have used for a long time, we are also introducing another model from Citi in our attempt to identify inflexion points in an economic cycle. The Cyclical Expectation Model (CEM) has finally bottom and started to turn up after 6 consecutive months of decline. It is normally a 3 weeks lead indicator of US economic momentum.



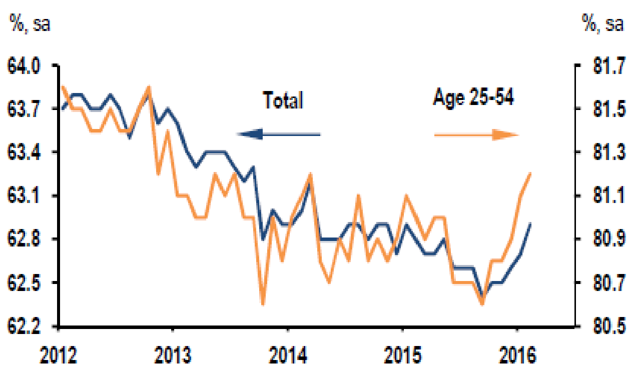
Source: Haver Analytics, Fact Set, and Citi Research – U.S. Equity Strategy



Source: Haver Analytics, Fact Set, and Citi Research – U.S. Equity Strategy

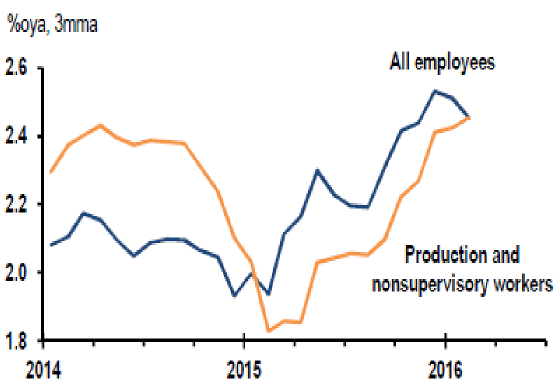
Key tenet to our sanguine view has always been that an improving labour markets in DM support consumption. Latest data on both fronts continues to collaborate with this view with US payroll employment up 242,000 in February exceeding consensus expectation of 195,000 and January's 172,000. Average hourly wages for the first two months of 2016 is up 2.4% vs 2.1% same time last year despite an increase in participation rate.

Rising number of people rejoining work force



Source: BLS

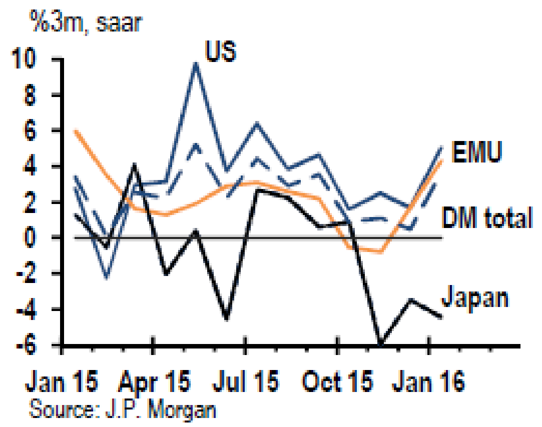
On the back of rising wages



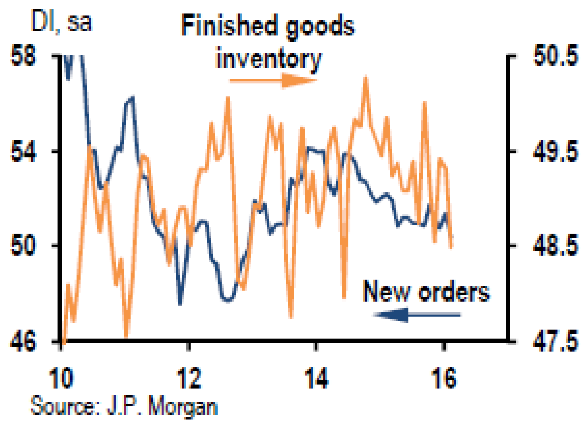
Source: BLS

DM sales volume is accelerating from last quarter with volumes increased at 3.6% ar in three months through January. While February global PMI new order did decline from 51.5 to 50.2, the larger decline in inventory of finished goods has led to three consecutive months of improving new orders/inventory PMI measure. If our consumption thesis continues to hold up, the past 3 months of inventory adjustments should presage a rebound in manufacturing in 2Q16 and this will go a long way to assuage investors that the global manufacturing engine is not dead.

DM Retail Sales improving except in Japan



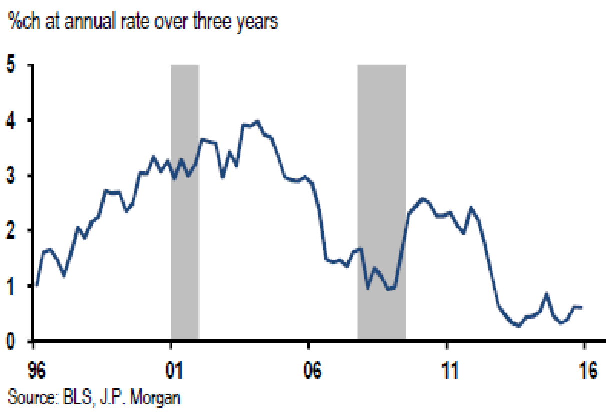
Continuous decline in finished goods



Hence, we retain our contrarian perhaps bordering on bonkers view that 1Q16 GDP is on track to be higher than 4Q15 and will accelerate further in 2Q16. We are looking at global GDP of 2.4% in 1Q16 in contrast to 4Q15 1.7%, which was a large 1.1% ppt drop sequentially and a further improvement of 2.9% in 2Q16. 1Q16 growth will be driven largely by DM's consumption strength while 2Q16 by rebound in global manufacturing and EM, particularly China.

Before our readers designate us to the "perennial hopeful" mental asylum, which also goes by the moniker, Fools Club, we take this edition to highlight one structural concern that can impinge on global growth potential and another fact that convolutes this issue. Some of you may recall we wrote about how weak productivity is posing a risk to long term growth potential during our 2016 Investment Outlook commentary published in January but have also argued traditional measures of productivity could be arcane. We take US as a case study given its longer history and swathe of data that can be mined. US labour productivity has fallen precipitously. In fact, productivity growth is at its weakest since 1996 and confounding weakest at this stage of an economic recovery. An analysis of G10 mirrors that of the US as well with productivity growth in the last ten years materially slower than the previous ten years.

Precipitous drop in US productivity



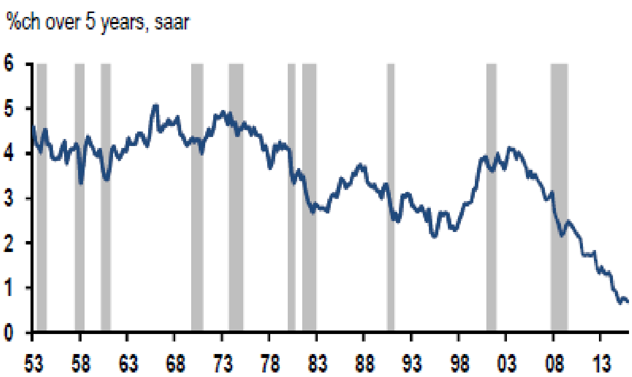
Same trend observed in G10 countries

	1997-2004	2005-2014	change
Sweden	2.8	0.5	-2.3
United Kingdom	2.4	0.4	-2.0
United States	2.7	1.0	-1.7
Netherlands	1.8	0.4	-1.4
France	2.0	0.7	-1.3
Japan	1.9	0.8	-1.1
Belgium	1.2	0.4	-0.8
Germany	1.5	0.8	-0.8
Canada	1.5	0.9	-0.6
Italy	0.5	0.0	-0.5
Switzerland	1.0	0.9	-0.1

Source: OECD, J.P. Morgan

The slumbering productivity growth has many profound implications. First, it lowers growth potential. JPM estimate that if current dismal productivity trend continues, the potential US growth rate could be only 1.7% in the foreseeable years.

Estimate of potential growth in the US is lowered



Source: BLS, J.P. Morgan

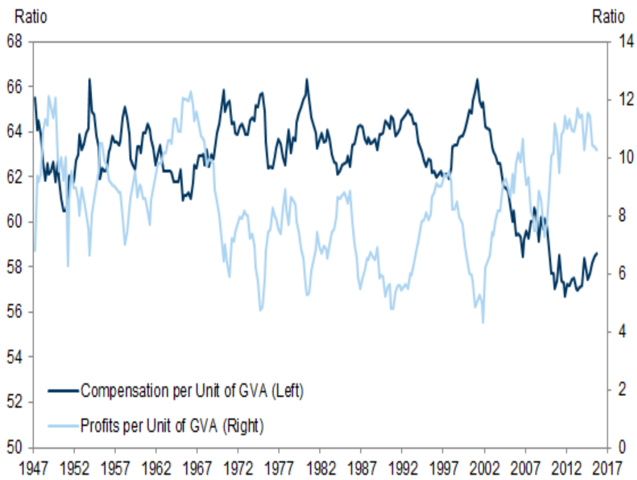
US growth potential has been downgraded over time

Period	Average realized potential	Labor force	Labor quality	Capital services	TFP
'75 to '94	3.3	1.2	0.3	1.2	0.6
'95 to '04	4.4	0.7	0.3	1.4	2.0
'05 to '15	1.8	0.4	0.3	0.8	0.3
Forecast	1.7	0.3	0.1	0.8	0.5

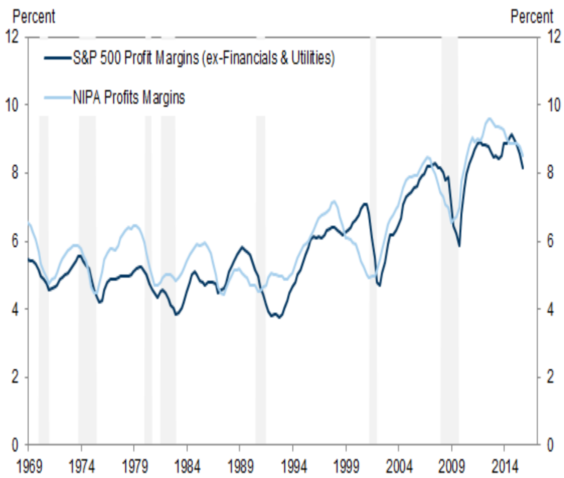
Source: San Francisco Fed, J.P. Morgan

Second, as labour market tightens as it is now and without a commensurating rise in productivity, profit margins could be squeezed. Declining profit margin normally presages recessions.

Rising wages reduces corporate margins



Declining margins presages recessions



However, just to perform mental acrobatics, this writer chance upon a Mckinsey report that supports his assertion that is easier these days to find a wanton mee stall in Kathmandu due to the proliferation of smart devices and its accompanying data wizardry. According to the report, even as flow of finance, good and services have slowed falling from 53% of global output created in 2007 to only 39% in 2014, the flow of digital information has more than doubled from 2013 to 290 terabytes in 2014. By its own calculation, such new form of globalization, let's called it digital data globalization, has created an extra of US2.8 trn of value to the global economy, almost similar size to global trade in goods in 2014! This digital data evolution extends beyond smartphones, apps and streaming services but also encompass JIT management and even 3D printing technology. The collective use of such information means it has brought markets closer to good producing companies than even before. In fact, in a separate report, IMF has remarked that the arrival of this digital data evolution has shorten global supply chain and could even contributed to as much as half of post-crisis slowdown in trade. Digital data evolution has a profound impact to the way businesses are transacting with each other, value is added and new inventions are created which we believe can aid productivity and for now are poorly documented by current measurements.

<u>Asset Allocation Strategy:</u>

Over the past month, we have been adding back risk first by taking off our hedges and adding safer upside optionality rather than outright cash investment. Over the coming week as we navigate tricky central bankers meetings with ECB starting this Thursday followed by Fed and BOJ next week, we will look for opportunity to increase our equity exposure should the market corrects.

Equities: Upgrade to Overweight from Neutral (Europe and Japan – Overweight, US – Neutral and Asia/EM – Underweight looking to move to Neutral)

We will be monitoring carefully our view that 2Q16 global GDP will be driven by EM markets, particularly China. If we have another month of collaborative data, we will be looking to remove our partial hedge in Asia and look to add LATAM on valuation grounds.

Bonds : Downgrading from Overweight to Neutral (no change)

We will be looking to add duration risk rather than wholesale changes to our current barbell approach of capturing yield in EM and capital structure and positions in high grade and govies.

Commodities: Underweight no change.

Exiting our contrarian long Oil trade as it has reached our near-term target of $40. Added Gold as a diversifier and tail-risk trade should market questioned again the efficacy of unorthodox monetary directives.

FX: Exiting our contrarian long EUR/YEN trade but retain consensus short CNY(H)/USD

Both Yen and Euro have performed well up 4.5% and 0.6% respectively. A gradual depreciation of the RMB is expected over the next 2 years and we are forecasting RMB to depreciate to 7.00 by year end. But a return of Jan-Feb 2016 capricious dislocation is unlikely to be repeated.

Alternatives Investment : Increasing for non-correlated to market returns

We have added a quantitative manager that has very low correlation to both stocks and bonds in addition to our allocation to US and Asia L/S managers.

Cash: Reducing cash.

Featured Picture/Quote:

"A good name is more desirable than great riches; to be esteemed is better than silver or gold."
Proverbs 22:1