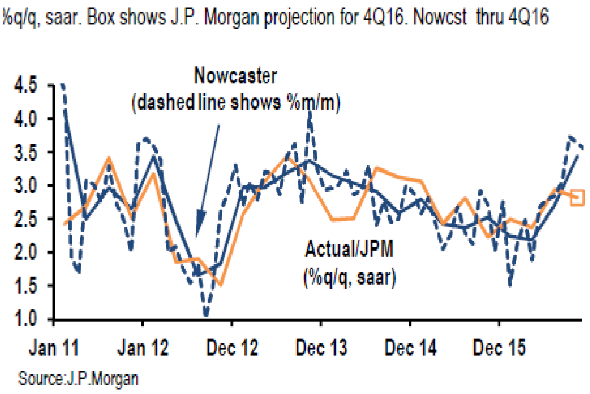
The Month Ahead Nov 2016: A Time of Syncretism

Unlike, Brexit where we felt the risk for UK to elect to leave is high, the margin of lead into the last day of US presidential election still shows Clinton ahead with comfortable margin. However, not only Trump won the electoral votes, his share of the popular votes was similar to Clinton's. So, begins the process of syncretism. We ask ourselves what are the impacts to macro-economics and to risk assets in the coming months.

1. **Macro-economic**: **Little impact in the near term** as the growth reflation thesis we have espoused continues to strengthen with incoming data. We continue to observe growth picking up across the globe with global PMI released in October showing broad improvements for both manufacturing and service components. The global manufacturing PMI jumped 1.6pts to 53.6; a level normally consistent with IP running at a strong 3.5% for 4Q16; higher than 3Q16 1.9%, 2Q16 1.0% and 1Q16 1.6%. The global October services PMI also moved 1.6pts higher to 53.2 Therefore, the composite index (manufacturing and services PMI) aligns to a 2.9% official 4Q16 consensus forecast, which would be the best quarterly GDP growth in last three years.

Nowcasting forecasting model is highest since Dec 2013



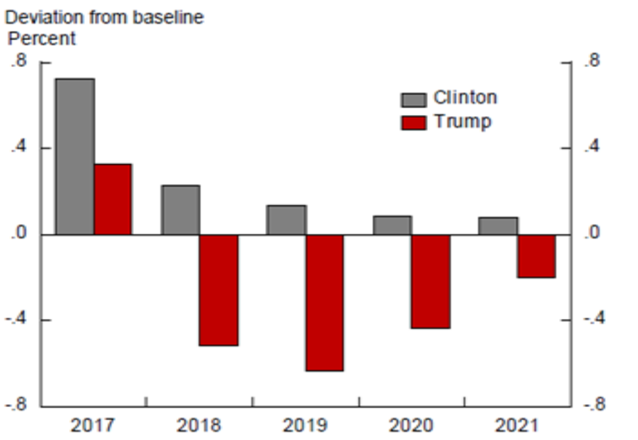
PMIs improved m-m, retails sales remain strong

%ch over previous period, sa (ar for quarterly). PMIs are levels.

	3Q16	4Q16	Sep 16	Oct16	Nov16	Dec 16
PMI, mfg	52.0	53.5	51.9	53.6	53.5	53.4
PMI, serv	51.4	53.3	51.6	53.2	53.3	53.5
IP	1.9	4.6	0.3	0.4	0.4	0.4
Retail sales	2.2	3.3	0.3	0.3	0.3	0.3
Auto sales	16.8	13.2	3.8	-0.4	0.6	0.4
Cap. orders	4.6	6.9	0.4	0.7	0.7	0.6
Nowcast	2.7	3.4	3.1	3.7	3.6	3.5

Note. Shaded values show forecasts computed by the Kalman filter estimates from the dynamic factor model. Underlined values are our estimates based on available data and our judgment.
Source: J.P. Morgan, Markit, and national statistical agencies.

We have mentioned in our previous publications a Trump or Hilary victory is good for fiscal stimulus. This is the only matter both candidates can agree on. According to Nomura Research, the fiscal boast for a Trump victory is a lift of 0.4% to GDP in Fy17; a 20% increase from current forecast of 2.1% growth for next year. The impact of Trump's economic policy in subsequent years subtracts from baseline growth largely because of drags induced by decline in immigration numbers. However, noticeable is Trump's tax cuts which should provide at the least a support to consumption growth and at best, a fillip to consumption.



Note: Based on simulations of the Federal Reserve's FRB/US Model. Source: Nomura

Clinton

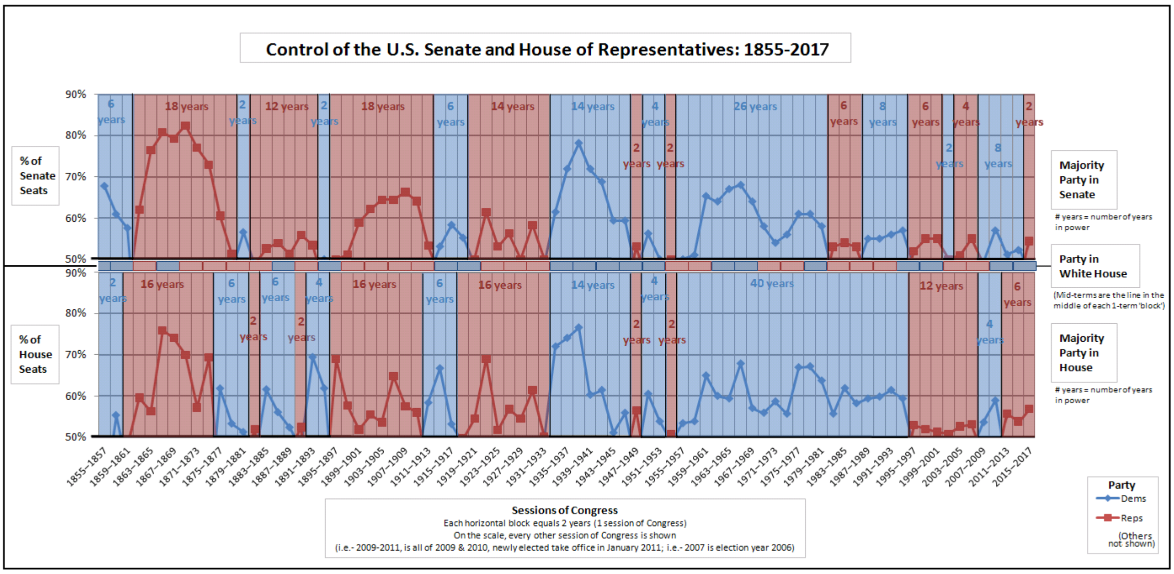
- Government spending ($ tn., over 10-yrs)
  - Consumption: +$1.2
  - Investment: +$0.4
- Taxes ($ tn. over 10-years)
  - Personal: -$0.8
  - Business: -$0.2
- Immigration
  - +2.5 mil over five years

Trump

- Government spending ($ tn., over 10-yrs)
  - Consumption +$0.5
  - Investment* +$0.5
- Taxes** ($ tn. over 10-years)
  - Personal: +$2.2
  - Business: +$0.8
- Immigration
  - -2.5 mil over five years
- Trade
  - Import prices +15%
  - Export prices +15%
  - Core PCE prices*** +1.8%

Primary source for spending and tax estimates is Committee for a Responsible Federal Budget (CFRB).

It is important to highlight as well we should have lesser risk of political gridlock going forward as the House, Senate and Presidency are now controlled by Republicans. This has not happened in the last ten years.



The longer-term impact is of greater concern for us living in Asia, for emerging markets and for trade in general given Trump's has campaigned for greater protectionism in trade and a withdrawn military pressence in the rest of the world. However, we can't ascertain with any clarity what will be the eventual outcome towards trade agreements, military involvement and immigration until Trump reveals his policy in the next 100 days.

Asset Allocation Strategy:

From an asset allocation strategy, the near-term impact will be significant and we believe emerging market equities will be most hit. The impact to risk assets stems not from macro-economic factors which are conducive for risk but from rising risk premia associated with Trump's presidency.

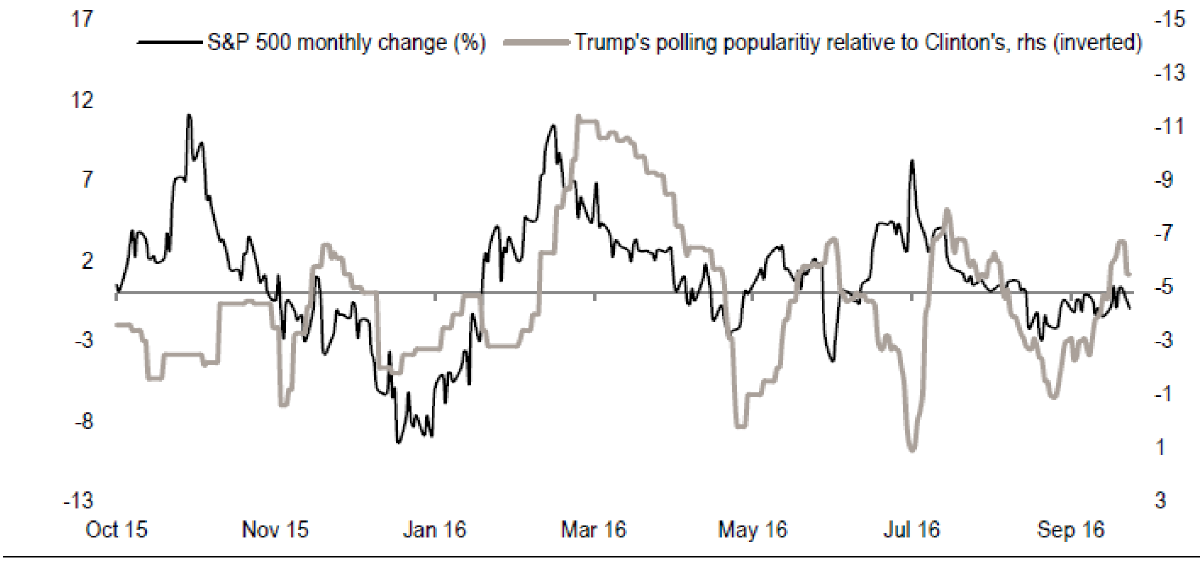
Fixed Income: Maintain Underweight. We maintained an underweight in Fixed income based on three key reasons. First, we remain constructive on growth and in fact a Trump victory is reflationary in the short-term due to his fiscal spending plans and tax cuts especially on personal taxes as detailed above. Furthermore, his immigration policy will stoke wage growth higher against a labour market that has already tightened and are showing signs of sustained wage increases. Foreign-born workers have accounted for 28% of employment growth since 2010 and US has 11.1m undocumented migrants constituting 6.9% of the labour force. Second, we believe the Fed will maintain its independence and their language in November meeting has communicated clearly its intention to raise rates. As we believe data will continue to strengthen from here, the case for Fed to hike should remain. It is also interesting to learn from UK example, the Bank of England estimated the uncertainty surrounding the lead-up to the EU referendum reduced output by 0.7% over preceding 12 months but post Brexit, the economy has done better than expected with less than expected decline in hiring and industrial activity. Yellen has only two-three windows to raise rates before Trump assumes his presidency and exert undue pressure on the Fed. It must also be noted Trump has favoured higher rate deriding Fed's uber easy monetary policy as the cause of inflationary bubbles. Lastly, a heightened political risk should also translate to higher risk premia.

We remained constructive on spread compression trades deriving from better growth prospects, increased exposure in financials and commodities bonds but continue to avoid holding too long a duration and government bonds.

Equities: Maintain Overweight.

Our equities strategy has certainly been complicated by Trump's victory. We believe the short-term impact could be a drop of SPX by another -5% (see chart below) and EM markets by -10 % to -12% in the coming weeks. But it will likely be short-lived as the over-riding issues remain that of growth and earnings prospects.

SPX mom change to Trump's popularity prior to election ranges from -10% to -3% and is spuriously correlated.



Source: Thomson Reuters, Credit Suisse research

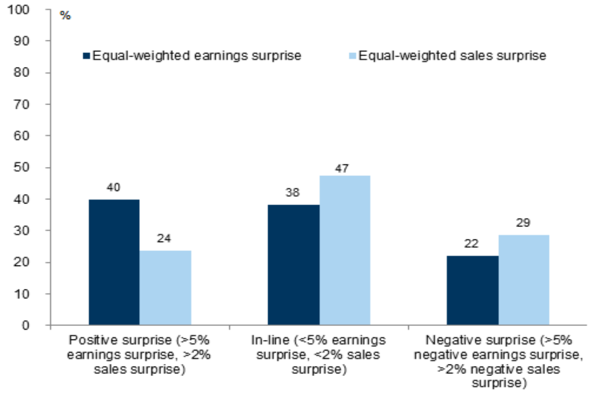
We have already enunciated our pro-growth views in our musings, http://www.covenant-capital.com/wp-content/uploads/2016/07/The-Month-Ahead-Oct-2016-Dog-Days-Are-Over...for-now.pdf and http://www.covenant-capital.com/wp-content/uploads/2016/07/The-Month-Ahead-Sep-2016-Lets-Get-Fiscal-Fiscal.pdf. We focus our intention on earnings instead. Earnings for US, Japan and Europe for 3Q16 were unanimous in its scope of positive surprises and granularity of sectoral surprises. Financials, IT, Energy and Basic materials were key surprises for both regions.

	Number of Companies			EARNINGS: Std Dev Surprises (a)			EARNINGS: Absolute Surprises (b)		EARNINGS: Avg 3Q	REVENUE: Std Dev Surprises (a)		REVENUE: Avg 3Q
S&P 500 EQUAL-WEIGHTED	Reported	Total	% of Co's	Positive	Negative	In-Line	Positive	Negative	Surprise	Positive	Negative	Surprise
Information Technology	52	66	79%	75 %	4 %	21 %	88 %	6 %	11 %	52 %	10 %	1 %
Financials	63	64	98	65	5	29	87	11	6	43	14	2
Consumer Staples	27	37	73	59	15	26	78	19	5	15	33	(3)
Utilities	27	28	96	59	11	30	74	26	7	11	22	(4)
Health Care	50	59	85	50	16	34	64	22	4	32	14	0
Industrials	63	69	91	49	19	32	67	27	2	11	37	(1)
Consumer Discretionary	50	82	61	40	12	48	60	28	6	26	30	0
Energy	34	36	94	38	12	50	59	35	11	18	15	2
Materials	23	26	88	35	22	43	57	39	10	9	39	(2)
Real Estate	28	28	100	25	7	68	50	21	1	29	7	1
Telecom Services	5	5	100	20	20	60	40	20	(1)	0	60	(1)
S&P 500	**422**	**500**	**84%**	**51 %**	**12 %**	**36 %**	**70 %**	**22 %**	**6 %**	**27 %**	**22 %**	**(0)%**
S&P 500 ex. Energy	388	464	84%	53 %	12 %	35 %	71 %	21 %	6 %	28 %	23 %	(0)%
Comparative Data (full earnings season)												
2Q 2016				49 %	13 %	39 %	69 %	22 %	5 %	28 %	19 %	(0)%
1Q 2016				45	11	45	69	23	5	26	22	(1)
4Q 2015				44	12	45	67	24	5	22	26	(1)
3Q 2015				46	13	41	64	26	5	21	33	(1)

In the US, the % of companies that have surprised on the upside in earnings both on standard deviation and absolute basis is higher than past four quarters reporting season. We observe the same trend in Europe. Basic resources reported the largest earnings surprise, reporting average surprise of +23%. Banks was the 2nd largest at 17% better than expectations. The level of earnings surprises for Europe is far higher than historical averages as well. In Japan, there have been more positive earnings surprises than negative with financials supporting much of the upside as well. Hence, we are expecting earnings revision to trend higher

Better than expected 3Q16 earnings for Europe.

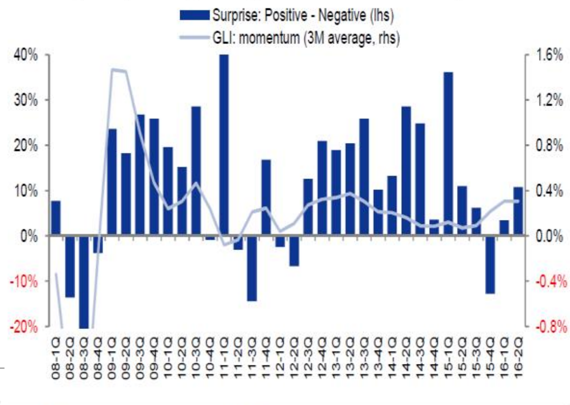
	STOXX 600: Equal-weighted avg (%)	STOXX 600: Cap-weighted avg (%)
Earnings surprise	3.7	3.2
ex Financials	0.3	1.0
Sales surprise	0.0	0.0
ex Financials	-0.7	-0.6



Same for Japan.

A: So far in 2Q results, positive surprises have outweighed negative surprises

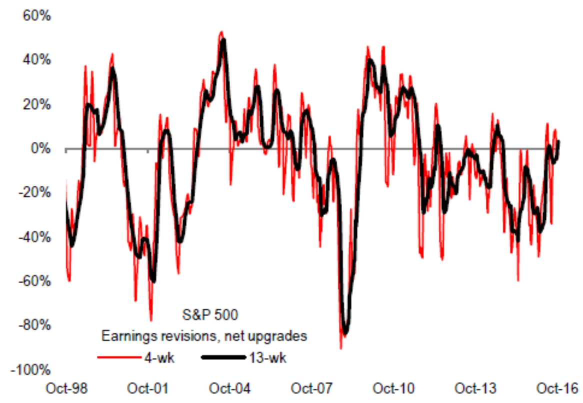
TSE1 companies (Feb/Mar year-end), that have announced results, as of Nov 2



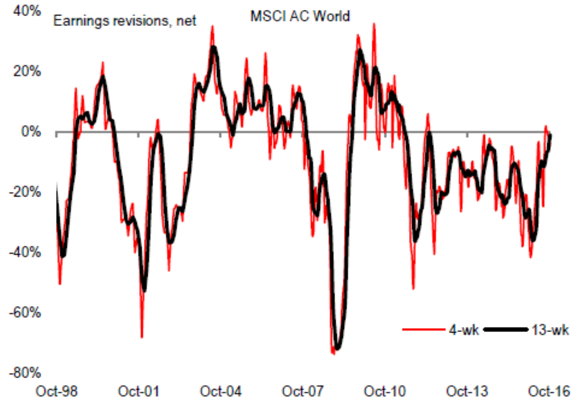
Source: IBES, FactSet, Goldman Sachs Global Investment Research

Earnings upwards revision sentiment remains bullish for US and globally while positioning remains against equities. Hence, the easy part of our equities allocation is to be overweight cyclicals such as financials, commodities and industrials. All the sectors that should benefit from a Trump's presidency. The complications in our equities strategy is in emerging markets and Japan, where we have been most overweight. The nexus of our concern is Trump's purported policy against trade and lesser American military involvement in Asia. We reserved our judgement in this part of our portfolio until we have a clearer policy direction from Trump. For the time being, stronger growth tends to benefit Japan and EM more than other regions while earnings revision momentum is improving for Japan and EM.

Earnings revision remains bullish across the world



Source: Thomson Reuters Datastream, Credit Suisse research



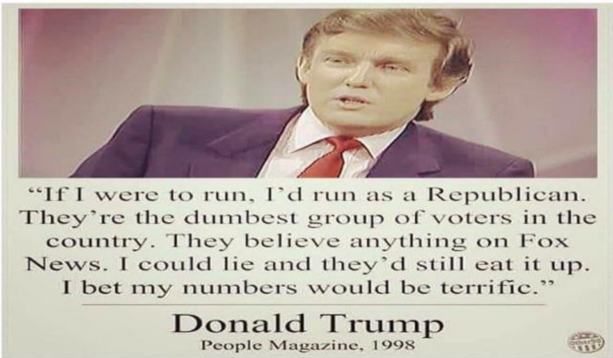
Source: Thomson Reuters Datastream, Credit Suisse research

Commodities: Maintained Overweight. Our view of copper is reinforced as fiscal stimulus in the US becomes a reality with a Trump victory and both congress and presidency controlled by Republicans. It has now become our preferred commodity play as well as our investment in a specialist fund investing in commodities space.

FX: No change in view maintained Long USD view though we decided to trim our short Yen exposure due to risk off attitude.

Alternatives Investments: Increasing for non-correlated market returns. We continue to like non-correlated strategies like our quantitative trend follower manager, long/short equities managers in the US and Asia. We have also been very bullish about real estate particularly in Europe and Japan and look to introduce more private equity real estate managers.

Featured Picture/Quote: The year of underdogs.



Could then be the year for my team.

Edward Lim, CFA

Chief Investment Officer