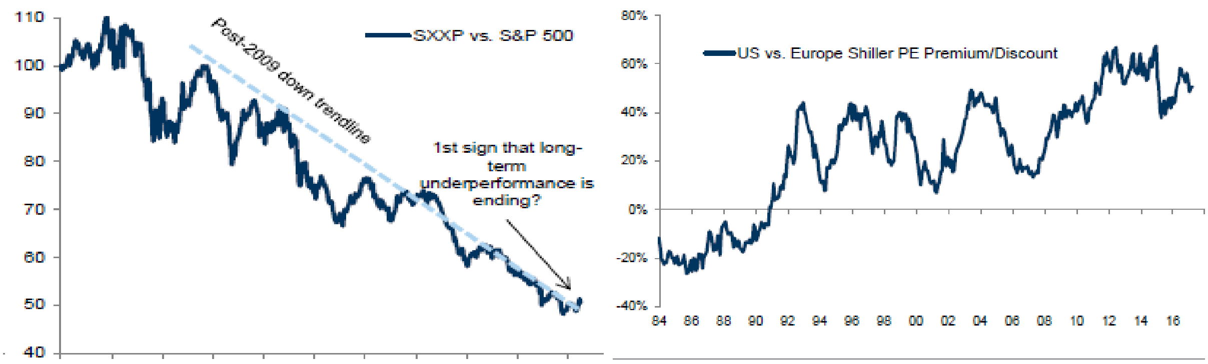
COVENANT CAPITAL

The Month Ahead May 2017: Le Pen is not mightier than the sword.

The first gift this writer received from the opposite sex was a pen. A gift from my first relationship that was to inspire my penchant for literature and writing. She decided to place the pen into a nicely wrapped box with these inscriptions on top of the box "THE PENis MIGHTIER THAN THE SWORD". Cheeky and certainly an indelible gift till this day. We have deliberately refrain from writing about Le Pen and Macron in the past few weeks despite the brouhaha promulgated by the popular media. Part of our reticence to write on the French election is because we don't think the outcome would alter the strong economic momentum that is already entrenched in the last 9 months. Moreover, our muscle memory has been trained that the impact of politics is far less than feared as we have witnessed market and economic reactions post Brexit and Trump victories. We prefer to ground our asset allocation decision on sound macro-economic analysis, valuations support and technical positioning than to speculate or fear the gerrymandering of politics. The other reason why we have not written much about French politics is we have concluded that the risk of a negative outcome of a Le Pen victory is significantly lower than Brexit and Trump. As shown in one of our graphs in last month's musing, Dont forget to breathe, the margin of swings votes in the month preceding Brexit and US Presidential elections was very close within +/-2% for the former and less than +/-5% for latter. In contrast, the Macron has a consistent lead over Le Pen of over 20% heading into the 1st round and his lead widen post the 1st round. We thus stuck to our guns to remain overweight European assets since December last year and in fact added a long EUR/USD position last month ahead of the election.

That has proven to be the right call with European equities up 3.5% in last 1 month outpacing the MSCI World Equities +2.7% and SPX 1.9%, French credit spreads halved while EUR currency rallied 2.9%. We believe the case for European equities and EUR remain bullish despite this recent run-up. Since the GFC in 2008, European equities (in fact all regional markets) have underperformed US Equities. The European existential crises wrought upon the malaise of the PIGS countries in 2010 accentuated the underperformance of European assets resulting in a 50% underperformance in equities that is trading at 45% discount to US valuation versus 20% normally.

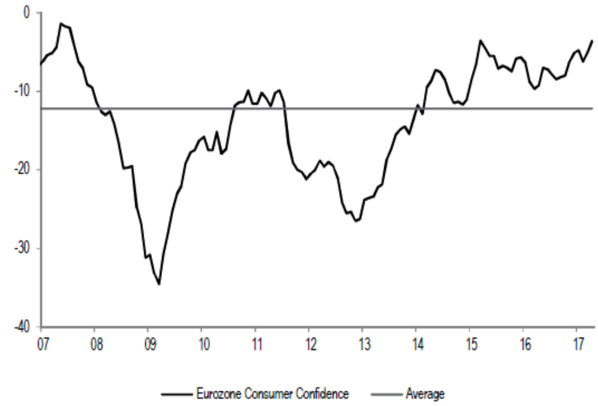
The Ugly Duckling Trade (UDT*) copyright with a client



Source: Shiller, Goldman Sachs Global Investment Research

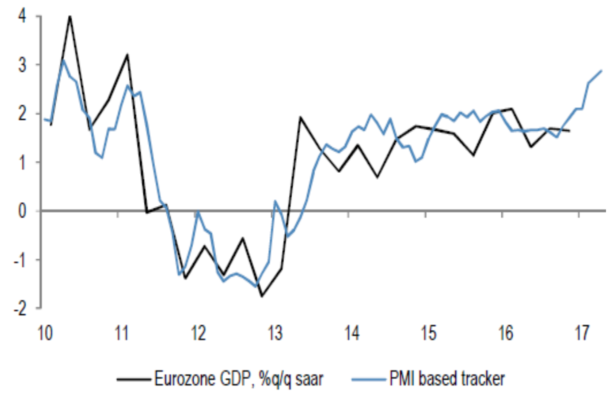
Despite the cacophony of experts calling the demise of Eurozone, the actual economic performance of Eurozone has been very resilient. Eurozone consumer confidence index is now at its pre-2008 level high reflecting much-improved employment dynamics with unemployment rate fast approaching its NAIRU level (NAIRU is the level of unemployment rate below in which inflation will start to rise). Among the major economic blocs, this area has seen the biggest magnitude of GDP upgrade since the start of the year. JPM PMI-tracker is now looking at a potential GDP growth close to 3% for 2017; 50% higher than current consensus and ECB forecasts.

<u>**EU consumer confidence all time high**</u>



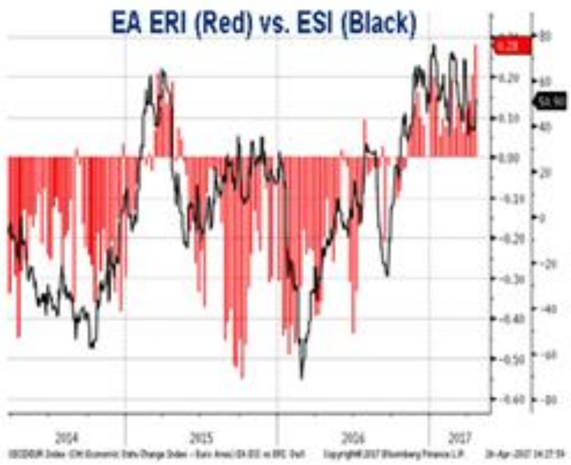
Source: EC

<u>**PMI is tracking GDP of 3%, double that of consensus**</u>



Source: Markit, J.P. Morgan Economic Research

The momentum in economic and earnings improvements for Europe is finally outpacing the US. As shown in the graphs below, the US economic surprise index (ESI-Black) has turned negative while its earnings revision momentum (ERI-Red) is slowing down after the surge in Feb 2017. In contrast, Europe's ESI and ERI remain in positive territory with earnings revision momentum actually accelerating in recent months.



Source: Citibank.

The stronger earnings revision momentum for Europe versus the US extends beyond 2017 into 2018. **Since the November last year as the reflationary view gains traction among the investment community, Europe has seen EPS revised higher for 2017 and 2018 whereas for US its 2017and 2018 EPS has been lowered slightly.**

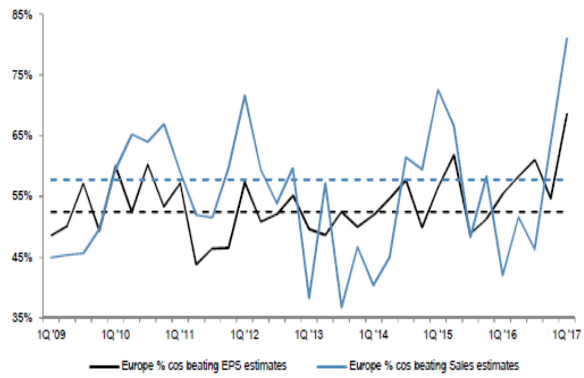
Stoxx 600 2017 and 2018 revised upwards but SPX 2017 and 2018 revised lower.

Source: IBES, Goldman Sachs Global Investment Research

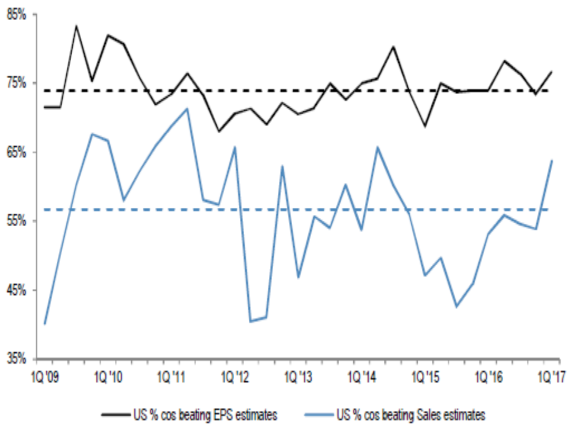
Source: IBES, Goldman Sachs Global Investment Research

1Q17 reporting season, which is underway, reiterates the message that Euro equities are reporting better than expected EPS and sales growth and they are coming in at levels above its historical norm. They are also registering far stronger EPS growth of 26% yoy in 1Q17 compared to 13% for SPX. When calibrated against its full year forecast, Stoxx 600 Europe 1Q17 actual results of 26% yoy is surpassing its full year forecast of 14% whereas SPX 1Q17 +13% EPS is in-line with its full year forecast of 11%.

Stoxx 600 larger beats than SPX and higher than historical norms

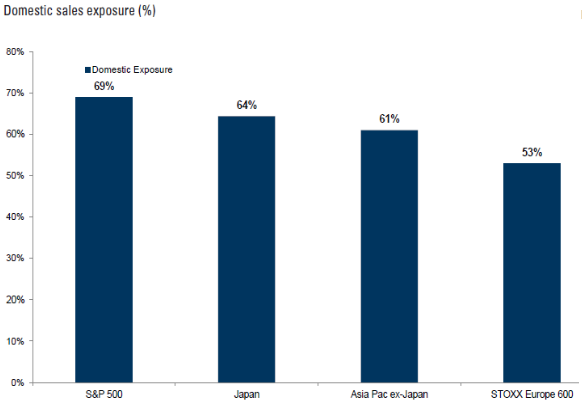


Source: Bloomberg, J.P. Morgan, dotted lines denote median EPS and Sales beats



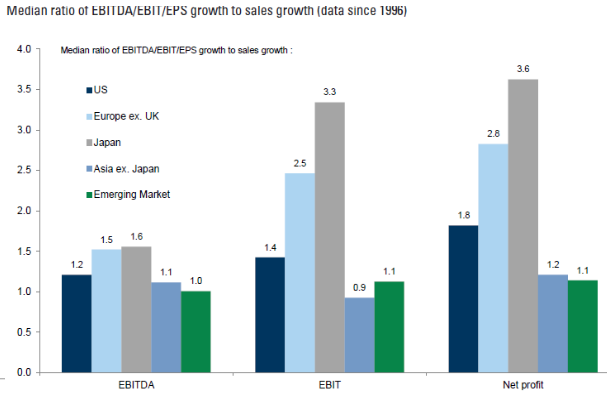
Given our view that global economy has finally reached terminal velocity in 2017 with global GDP forecasts revised upwards from 3.2% at start of the year to 3.4% for 2017 and from 3.3% to 3.4% for 2018, **Europe equities markets are more leveraged to global growth than the US.** 47% for Stoxx Euro 600 Index are exposed to external environment while it is only 31% for the US. A simple sensitivity analysis from Goldman Sachs illustrates the impact of a 1% improvement in top line growth has a 1.5% increase in European companies' EBITDA, 3.3% to EBIT and 3.6% increment to net profit; double the magnitude of the US.

Europe equities more sensitive to external growth



Source: Goldman Sachs Global Investment Research

Europe's net profit 2x higher leveraged than US



Source: Datastream, Goldman Sachs Global Investment Research

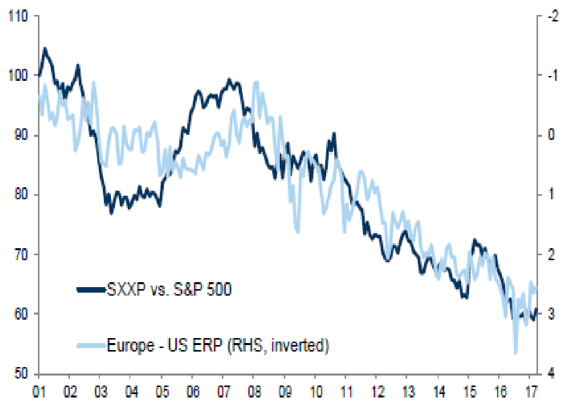
Moreover, from an index weight representation, the weight of cyclicals sectors such as Energy, Materials, Industrials, Financials, Real Estate excluding IT, is higher for Europe at 54.5% vs US 36.1%. With the French election behind us and the German and Italian elections not due till October 2017 and May 2018 respectively, the elevated level of risk premium associated to European assets should also fall concomitantly as growth trajectory affirms.

Europe stock market has larger cyclical weights than US

GICS Sector	U.S.	Europe	Japan	APxJ	The World
Energy	6.4	6.8	0.9	4.4	6.4
Materials	3.0	8.2	6.3	6.8	5.0
Industrials	9.7	13.3	20.4	7.5	11.4
Consumer Discretionary	13.0	10.9	20.2	8.2	12.5
Consumer Staples	9.3	14.1	7.9	5.3	9.9
Health Care	13.8	12.8	7.6	3.2	12.2
Financials	13.8	20.4	13.5	27.4	17.5
Real Estate	3.2	1.4	4.4	6.6	3.3
Information Technology	22.3	4.4	11.1	22.7	15.5
Telecommunication Services	2.4	4.1	5.7	4.5	3.1
Utilities	3.2	3.5	2.0	3.4	3.2
Total	**100**	**100**	**100**	**100**	**100**

Source: MSCI, FactSet, Goldman Sachs Global Investment Research

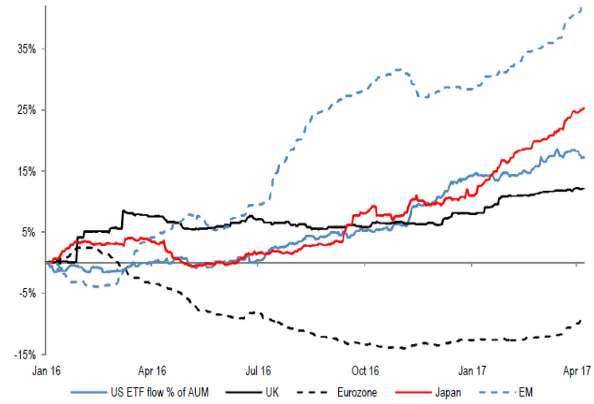
All time high risk premium to Europe should reverse



Source: Datastream, Goldman Sachs Global Investment Research

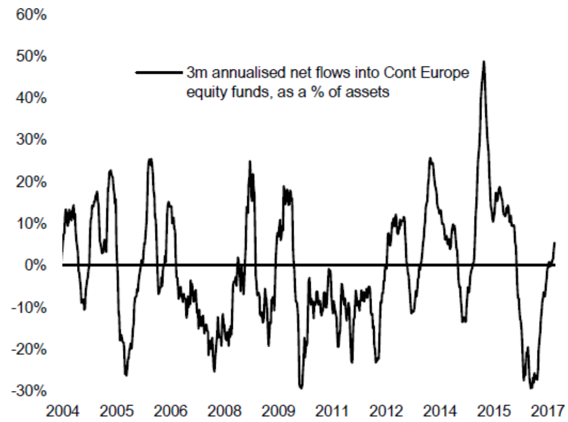
Finally, **from positioning and valuation points of view, Europe equities are also more attractive than the US.** Looking at passive flows into ETF since Jan 2016, Eurozone is the only region that has not reversed its outflow in contrast to the inflows every other regions have experienced. We believe this is set to change. Recent data since the start of 2017 shows investors are nibbling back into European equities. We believed it is still at its infant stage of recovery if you consider that a net outflow of USD23bn occurred in 2016 that reversed 2/3 of the inflows the region has seen since Nov 2014!

EU only region still seeing net outflows



Source: Bloomberg. *Based on the 25 biggest ETF's with a mandate to invest in that particular region

But is changing. Since start of 2017, seen net inflows



Source: EPFR Global, Credit Suisse research

From a valuation perspective, Stoxx Europe 600 valuations are not stretched in contrast to the US, which is trading close to its historical percentile across many metrics.

Stoxx600 Europe is trading above its historical norm but US is trading close to its historical highs

Data since 1998 for all metrics other than PEG ratio (2002) and free cash flow yield (2006)

Valuation Metrics	Aggregate index		Median Stock	
	Current	Historical %ile	Current	Historical %ile
P/E to growth (PEG)	1.4	64%	NA	NA
EV / Sales	1.5	88%	1.9	87%
EV / EBITDA	9.0	79%	9.4	91%
Price / Book	1.8	50%	2.0	86%
Forward P/E	15.1	74%	16.0	92%
Free cash flow yield	5.4	33%	5.2	21%
Cyclically adjusted P/E	17.4	63%	NA	NA
Median		64%		87%

Source: Goldman Sachs Global Investment Research

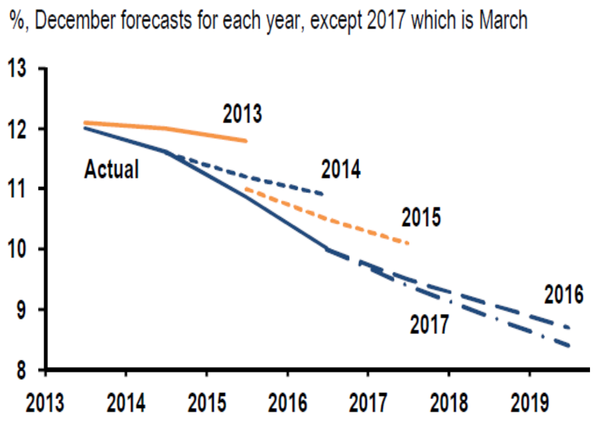
Data since 1976 for all metrics other than PEG ratio (1982) and free cash flow yield (1990)

Valuation Metrics	Aggregate index		Median stock	
	Current	Historical %ile	Current	Historical %ile
P/E to growth (PEG)	1.5	97%	2.0	100%
EV / Sales	2.2	95%	2.8	100%
EV / EBITDA	11.7	89%	12.1	100%
Price / Book	3.1	83%	3.4	99%
Forward P/E	18.1	90%	18.4	98%
Free cash flow yield	4.1	55%	4.5	43%
Cyclically adjusted P/E	25.0	87%	NA	NA
Median		89%		100%

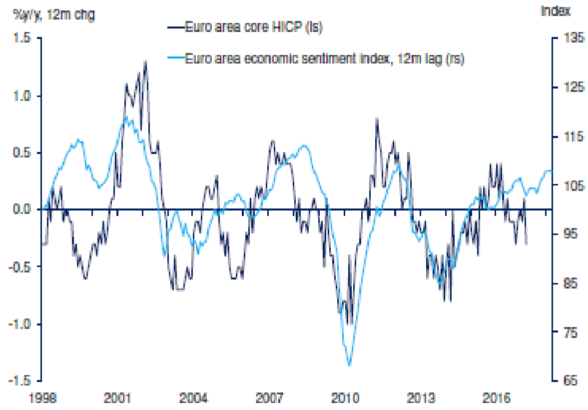
Source: Goldman Sachs Global Investment Research

The last point we want to address in conjucntion with our bullish views of Europe's economy and equities is **the risk of market under-estimating Europe's inflation**. The biggest source of inflation risk lies with the assumption when will Europe hits its NAIRU of 8.5%. Based on the last 5 years relatonship between growth and ensuing decline in unemployment rate, if current GDP forecasts of 1.6% in 2017 and 2018 are achieved (as a reminder PMI data points to 3% GDP while we our forecast is above 2% in both years), Europe will hit NAIRU at the end of this year or early 1Q18. This is a good 1-1.5 years ahead of ECB's forecast. We believe our view on NAIRU is likely to be right as ECB has had the history of wrongly forecasting their unemployment rate by 0.5-1.0 ppt each year since 2013. Importantly, we believe as Europe's unemployment rate lowers and tends toward NAIRU, it will exhibit similar characteristic in the US where the covexity of Philips curve kicks in as the gap between actual and NAIRU narrows and sharply steepens once unemployment rate falls below NAIRU. In other words, wage inflation acclerates as the economy tends towards is NAIRU state of employment. In addition, other contributory factors to Eurozone inflation are also rising. Unprocessed food has risen to 3% since start of 2017; a good 1-2 ppt higher than last 2 years average. The pass-on through to processed food prices in coming months is expected to be acute. Reent survey results on price expectations are collarborating with this view as well.

ECB's forecast on unemployment has been wrong. NAIRU by 1Q18 and HICP rises to 2% by end 2Q18



Source: ECB, Eurostat, J.P. Morgan



Source: Eurostat, Haver Analytics, Deutsche Bank Research

Hence, we are far more sanginue that Europe will see inflation rising quicker in the next 2 years than it has in the past five years and will achieved ECB's inflation target of 2% by end of 1H18; a good one and half year ahead of ECB's forecast. This conviction have profound implications. Firstly, QE tapering will have to end earlier than current intention of end 2017. We think this June meeting, ECB may bring forth a few months ahead of QE ending and if not, its rhetoric will be more hawkish. We also expect them to chart it first increase in reference rates by end of the year or early 1Q18 signalling a possible increase in rates by 2Q-3Q18; a good 1-2 quarters ahead of market's view. This view on the path of inflation and ECB's reaction fucntion are some of the reasons why we are overweight European equities, particularly banks and insurers, Euro currency and are weary of European sovereigns and investment grade bonds as ECB QE comes to an end.

Asset Allocation Strategy:

Equities: No change still Overweight with preference for Europe equities over US and neutral for EM (prefer China in EM) and Japan. As we have commented in 2017 strategy piece, The Year Ahead 2017:Its the end of QE as we know it (And I feel fine), 2017 marks the year of EPS growth synchrony in every major stock markets; an occurrence we have not had since 2010.

So far for 1Q17 earnings season, many companies are surprising both on the top and bottom lines and all regions are recording 1Q17 EPS growth that is higher than their full year forecast. In the US, 77% of the 76% of total listed companies have reported EPS that were higher than consensus. They delivered 6% positive surprise with growth of +13% yoy. 10 out of 11 sectors are delivering positive EPS growth. The proportion of companies raising revenue guidance stands at 37%, the highest since Q4'13. In Europe, 69% of 62% of total listed companies beat EPS estimates, surprising positively by 11% and delivering +26% yoy EPS growth. This is the strongest growth in nearly 7 years. Top-line growth is robust too, at +12% yoy with 81% of companies beating sales estimates. This reinforces the messages we have written above that Europe is higher leveraged to global growth nuances than the US. Japan reporting season has only started with 30% of companies reported as of last week. 58% of the companies reported beat EPS estimates, delivering growth of +28% yoy the best since 1Q14. In Asia, 43% of the companies have reported and have subsequently seen their EPS upgraded by 2.7% post results.

One of the best reporting season in years

Q1'17 Results snapshot

	SPX	SXXP	SXXE	TPX
% cos reported	76%	62%	59%	30%
% cos beating EPS	77%	69%	66%	58%
EPS %y/y	13%	26%	20%	28%
% cos beating Sales	64%	81%	85%	54%
Sales %y/y	8%	12%	10%	4%

Source: Bloomberg, J.P. Morgan

Europe and Japan seeing largest ppt increase in EPS

	2017e EPS Growth, %		2018e EPS Growth, %	
	Current	Jan '17	Current	Jan '17
MSCI World	12.6%	12.8%	10.9%	10.9%
S&P 500	10.1%	11.6%	12.2%	11.9%
Stoxx 600	14.6%	13.6%	9.7%	10.1%
Euro Stoxx	15.2%	12.8%	10.5%	10.5%
FTSE 100	21.1%	20.8%	8.0%	9.6%
Topix*	15.8%	11.6%	8.3%	8.4%
EM	19.0%	14.1%	11.2%	11.8%

Source: IBES, * for Year Ending March 2018 and March 2019

Fixed Income: Underweight. No change in view except we are highlighting our concern on European credit especially sovereign and investment grade credits. The trinity of QE ending earlier than expected, rates rising faster than thought and heavy positioning puts these two fixed income asset classes at most risk in the coming quarters. Moreover, we believe Europe tightening cycle has only just begun while the US path of normalization has been effectively communicated by the Fed.

FX: Getting Longer EUR/USD and USD strength in last stage. No change to our view of liking EUR/USD but we believe USD strength could get another kick towards June as the likelihood of Fed raising rate has increased to 100% and as growth rebounds from 1Q17 tepid rate of 1.9% in the US to 2.4% in 2Q17 and maintained above 2.2% throughout the year.

Commodities: We have zero industrial commodities exposures since we downgraded Oil in January and took profit on Copper in March. We keep our call to buy Gold made in March 2017 as we are far more bullish on global inflation. The precipitous drop in oil price in recent weeks is presenting an interesting opportunity for us to re-enter the trade in the long side but our focus will be on the equities of high dividend paying oil majors rather than crude itself.

Alternatives Investments: We have trimmed our AI exposures in Asia and global equities as they have failed to perform better that ETFs. Moreover, we can capture stronger returns via cheaper alternatives as growth strengthens, volatility of price movement reduces and risk of correlation convergences diminishes.

Featured Picture/Quote: Who is scarier than Trump? Trump Jong-Un.

Edward Lim, CFA

Chief Investment Officer

(PS for those of you who have not met me, this is not my picture)