May 2016 Investment Newsletter

It's complicated

1. Reflections and thoughts on a sizzling month

"When all is said and done, the weather and love are the two elements about which one can never be sure."
- Alice Hoffman

The sun has been sizzling in this part of the world; April is apparently the hottest month of the year in Singapore and last month the heat broke records, with the highest temperature of 36.7 °C (98.1 °F) recorded on 13 April 2016. Yet blowing hot and cold, the day frequently ended with an afternoon shower.

For many days in April, the financial markets were so green that it was dazzling, although by the end of the month the returns fizzled out. Here is last month's performance of the S&P 500 Index, which enjoyed a great run-up at exactly the same time the sun was hottest:

Chart 1: S&P 500 enjoying a great run up in the middle of the month and gave back returns in the last two days.

Overall, the major equity indices (S&P 500, Eurostoxx, Nikkei, Shanghai Composite) were flat for the month, although when we look beneath the surface quite a few things were happening. Specifically, the energy sector has been enjoying a strong rally.

Before we get to that, of special note is the low level of volatility in the US market. We are trading back at levels before the RMB depreciation event in August 2015:

I keep hearing a lot of anecdotal stories of interest in

Chart 2: The VIX Index, a measure of volatility for US equities, is trading back at levels before the RMB depreciation event in August 2015.

buying volatility and in shorting US equities, and yet somehow as the S&P approached its all time high again, the volatility has been remarkably low. Buyers of volatility would have their hearts somewhat broken by now. Now that the earnings season is nearly over the focus will likely shift to the possibility of June rate hikes. In the meantime the weak dollar is providing to a boost to risky assets.

The real sizzle last month came from energy stocks, which enjoyed a strong rally. Oil has stabilized and has slowly moved up:

Chart 3: Crude oil prices enjoying a strong rally last month. The generic WTI crude oil futures is shown here.

Chart 4: Enterprise Product Partners, which does oil pipelines and storage – 'toll collector'. Dividend yield of 6%. Long history of dividend growth (going back for more than a decade).

In mid April, a summit in Doha, Qatar involving oil-producing nations ended without an agreement to freeze oil production. The Doha talks initially generated a lot of news and volatility; oil gapped down when the markets opened after the talks failed, but eventually the market looked through the talks as slowly increasing demand catches up with slowly decreasing supply.

Chart 5: Williams Partners, which focuses on natural gas pipeline and storage, has a dividend yield of 11%. Its share price was hammered in January/ February when one of its major clients appeared to be on the verge of bankruptcy. So far the firm continues to run its operations steadily and continues to secure contracts to build new pipelines, and recently maintained its dividend.

The following two energy midstream names are examples of sizzling rallies: Enterprise Product Partners and Williams Partners, who build pipelines for oil and natural gas in the US. They are more volume driven than price driven, so operating results should be steady as long as humans still need oil and natural gas, and dividends can still be paid out. In fact, this is exactly the case as the firms continue to maintain or increase dividends. Moreover, with oil stabilizing at a higher level, markets are less concerned about their clients defaulting and the uncertainty that would generate.

Meanwhile, the heartbreak story of the month goes to Mitsubishi Motors, which also serves as a cautionary tale.

Its shares traded limit down for 2 days in a row after admitting to cheating on fuel-economy tests for years. It was down 33% over two days. Limit down means that the shareholder cannot sell the stock even if he or she wants to. It was a truly horrific time to be a shareholder of Mitsubishi Motors. This also poignantly highlights the need for diversification in single stock purchases.

Chart 6: Mitsubishi Motors was down 47% in April after admitting to cheating on fuel-economy tests for years.

2. Where are the opportunities now?

It is hard to imagine equities not having another mini-blow up in the near future, so if one is positive on the fundamental picture/ long-term outlook, waiting for a pullback would be a better time to add to equities.

In the meantime, if one really wants to get in, I think there could be opportunities in beaten down areas such as China and Japan.

Is China's bust behind us?

Perhaps you have read the comments from Bob Bishop, a former chief investment officer at Soros Fund Management who runs $2.2 billion hedge fund Impala Asset Management. A lot of prominent hedge fund managers (for example, George Soros) are talking down China, likening it to the U.S. in 2007/ 08, when credit markets froze and triggered a global recession, and that its banking system is increasingly unstable.

Bob is of the opposite view. He said, "China already had the crash...It bottomed at the end of 2015. It's going to feel like a much better economy in China over the next two years than people seem to think it will be."

He cited rising infrastructure spending, steel production and demand for metal and heavy duty trucks are signs of improvement for the nation's industrial and manufacturing sectors.

Trading opportunities in Japan

A Japanese fund manager told me recently this curious fact: Japan has been experiencing poor growth for the past 15 years, but the equities market and industry are alive and well. Perhaps we should take a trading approach to Japanese equities, selling when they are high and buying when they are low. We also note that the government has become a major buyer of stocks and they are likely to come in when prices are attractive enough. The Nikkei 225 Index is one of the worst performers at negative 15% for the year and could be due for a rebound soon. Once the Golden Week holidays in Japan are over we will get a better picture.

Data sources: Bloomberg

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