ATLAS
ASSET MANAGEMENT PTE. LTD.

November 2016 Investment Newsletter

Market Outlook

1. Staying the course

I find the US elections riveting, not least because of the ramifications on financial markets, but also because it has been polarizing, disconcerting and disturbing.

There are many lessons to be drawn from the presidential elections process; for example, do not ever send explicit texts or images* to *anyone* (especially strangers!), especially if you intend to be a public figure. However, the one lesson that speaks out to me is about staying the course.

Staying the course in the working world

Donald Trump has frequently veered off-topic in his rallies and debates — he comes across as unfocused, taking precious time out to attack his accusers, to attack Clinton, essentially picking fights with everyone, instead of focusing on national issues and what he can do for the nation. For example, Trump told the crowd in a recent rally that he would "love" to take on Vice President Joe Biden in some fisticuffs. Maybe this was just a minute-long barb in the middle of an hour-long speech. But he should know better. The damage was done and the media pronounced that this was "maybe the first time a national political figure has brought up the possibility of violence involving a sitting vice president since Aaron Burr shot and killed Alexander Hamilton in 1804."

Are Trump's policies any good? A number of voters are so turned off that they probably do not care anymore. Objectively speaking, the policies are likely to be thoughtful, given the phalanx of technical experts involved in crafting them. The lesson for me is that in meetings, we need to stay focused and deliver the messages we want to get across, and not to get sidetracked by negative/ controversial remarks whoever might inadvertently spout. He did not stay focused. We need to stay focused and keep the long term goal in mind.

Staying the course in relationship management

It is the same in relationship management. Supposed you decide to meet someone again after a 6-month break, and the last time you spoke it ended on an acrimonious note. First of all, what is your objective in meeting him/ her again? We need to stay focused and keep the long term goal in mind. You do not want to be throwing tantrums. You do not want to start accusing each other. You do not want to bring up past quarrels and arguments. You want to focus on making her laugh, making her feel comfortable and making her feel secure. Have the end goal in mind—you want to win the hearts and minds of the people you are with, not to prove you are right and they are wrong.

Staying the course in investing

We need to stay the course for our investments too. What are important issues and what are noise? There are many news and market rumors everyday — if we get too drawn into it and trade in and out rapidly, we will end up with a hefty commission bill from our brokers.

* otherwise known as sexting

1. Staying the course (continued)

Investors need to stay focused and keep the long term goal in mind. Many investors move in and out of investments at precisely the wrong time. They will jump into stocks at what turns to be a period of good performance, and they rush out after a period of poor returns, only to find out that they have sold at the bottom. It is extremely difficult to pinpoint turns in the market. Many people panic during a falling stock market. Investors fortunate enough to exit a market drop often missed out on significant returns that followed because of under-investment.

Dodge & Cox did the following research: Morningstar observed that because of poorly timed buy and sell decisions, over the ten years ending December 31, 2014, the average U.S. equity investor and international equity investor earned 1.0 and 1.2 percentage points less, respectively, per year than the average mutual fund's published return. Another study, "Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies," also found that the returns investors actually earned were much lower than the return they would have earned buying and holding their funds through the 22-year period under analysis. In fact, this held true across all fund types. Over the last 20 years, mutual fund investors appear to have given up approximately 2% per year because of ill-timed buy and sell decisions.

Having patience and maintaining a long-term investment horizon are essential to achieving long-term investment success in any market.

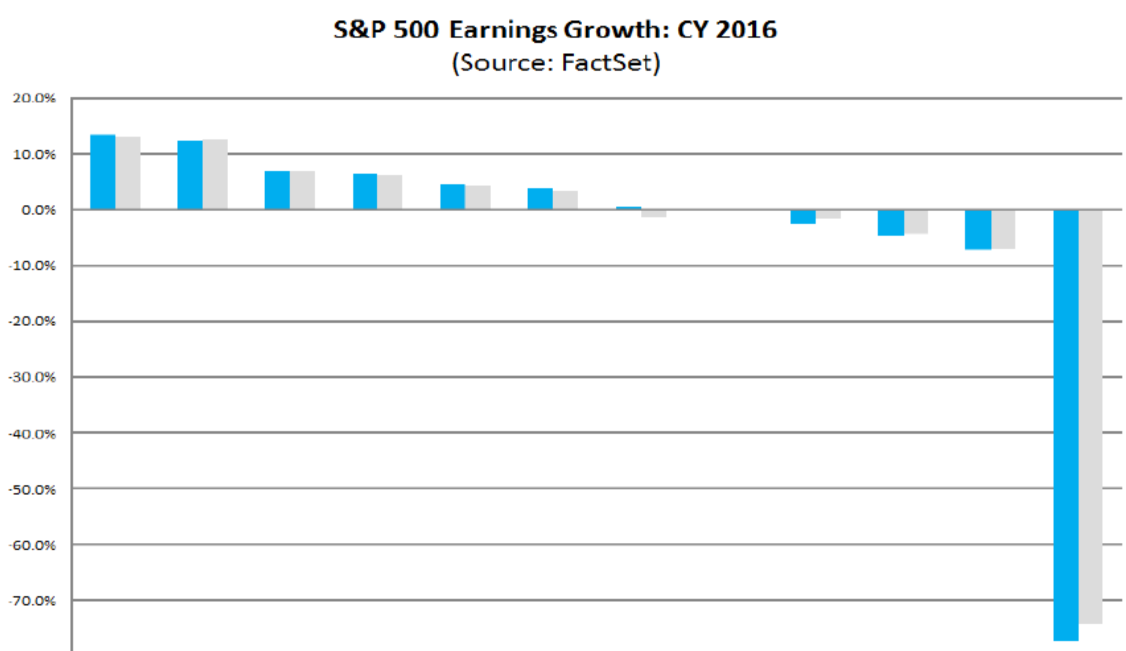
There can be an overwhelmingly number of factors to consider, but if I focus on the big picture the macro view still seems pretty positive to me, so I see no reason not to stay the course. Let's touch on some of the big topics that are likely to impact assets over the short-term and medium-term: Earnings, Oil, US elections and China.

2. Earnings and Energy

October was earning seasons again, and some people are bearish about the US market because the S&P 500 is on track for six straight drop in year-over-year earnings. However, we will see that if we strip out energy, the picture looks pretty decent.

Why are earnings important? As we know, when we buy a stock, we are looking for capital appreciation and/ or dividend income/ growth. Now all these good stuff cannot happen without earnings, and thus you would not expect price growth and dividend growth without earnings growth. Of course, you can expect a lot of smart people trying to game the earning systems as management is paid in stock anyway. It has become an expectations game since it is human nature that management will attempt to under-promise and over-deliver on earnings. In fact, the market expects this sort of behavior such that stocks will be heavily punished to an earnings miss. Also, in our ultra-low rates environment companies are borrowing money to buy back shares to boost earnings per share. But is that really wrong? Intuitively if we know that deposits are paying us zilch we move to higher yielding assets, so I see stock-buyback as simply the mechanism by which low rates lead to higher asset prices. Now that we have a brief appreciation on some of the pitfalls with earnings, let us proceed to look at earnings growth across the sectors.

Chart 1 says it all. The blue bars show the earnings growth by sector for the year as of 21st Oct 2016. Other than energy, the picture is not that shabby. This also gives us encouragement that sector selection and stock picking are not meaningless exercises.



	Real Estate	Consumer Disc.	Health Care	Utilities	Consumer Staples	Info. Technology	Financials	S&P 500	Materials	Industrials	Telecom Services	Energy
Today	13.3%	12.4%	6.8%	6.4%	4.3%	3.8%	0.4%	0.1%	-2.6%	-4.8%	-7.2%	-77.1%
30-Sep	12.9%	12.5%	6.8%	6.2%	4.2%	3.4%	-1.6%	-0.2%	-1.7%	-4.4%	-7.1%	-74.1%

Chart 1: S&P 500 earnings growth for current year 2016. The blue bar shows the earnings growth by sector as of 21st Oct 2016. (The grey bar shows the earnings growth by sector for 30th Sep 2016.)

2. Earnings and Energy (continued)

Energy stocks have in fact staged a mighty recovery from the lows of February 2016 and also from a year-to-date perspective, which coincides with the oil price recovery. In fact if we look at the S&P 500 Energy Index and Brent Crude visually (see Chart 2) we can see that they track each other really well. In other words, if oil prices rise further we would expect energy share prices to rise further.

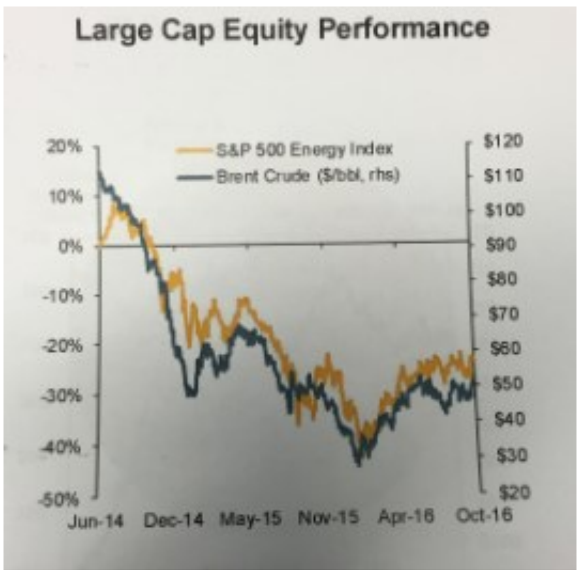


Chart 2: S&P 500 Energy Index and Brent Crude. Source: Bloomberg, CreditSights

Will oil rise further from the $40-$50 level we have here? Odds are good that we will see $50-$60 oil over the coming year, so I am not in a hurry to reduce my energy portfolio. Global spare production capacity is at multi-year lows and the supply/ demand outlook is beginning to look more favorable for oil prices (see Chart 3). The futures market is also currently pricing WTI prices in 2017-2020 to be around the $50-$60 region.

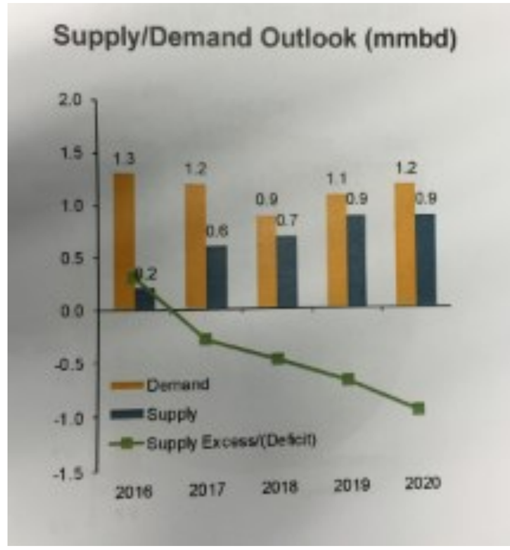


Chart 3: Oil supply/ demand outlook. Oil is set to be on a supply deficit over the next few years. Source: Bloomberg, CreditSights

Meanwhile, the S&P 500 earnings growth outlook for 2017 for the energy sector is 357% (see chart 4). This seems a little crazy high for me, although I note that we are coming off a low base. The risk here for someone who is long energy would be an earnings disappointment on the seemingly rosy expectations.

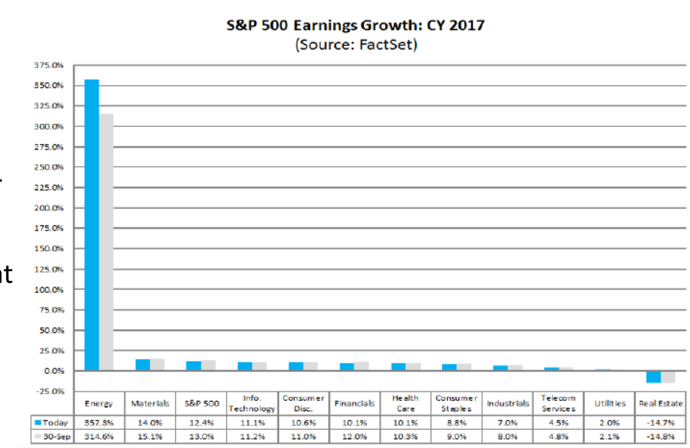


Chart 4: S&P 500 Earnings Growth outlook for 2017. The energy sector (left most bar) is expected to grow earnings by 357%.

3. Impact of the US elections on financial markets (including gold)

The past few days have given us a preview of what is to come. Initially, with what was looking then as a likely Clinton win, markets were remarkably stable. A Trump victory is likely to result in considerable volatility.

The prevailing thought used to be that a Clinton win would result in a mini-selloff on buy the rumor sell the news scenario. However, the legacy of the Brexit referendum surprise from June suggests there would likely be some relief that the opinion polls have not given the markets a false signal once again. Not only that, the turn in the events in the past few days have made a Clinton win less of a sure thing than say 2 weeks ago. Therefore, with a Clinton win we are likely to see a relief rally of sorts.

A Clinton win would mean going with status quo and therefore a likely reduction in economic uncertainty. This should mean trend GDP growth and inflation, a low-for-longer Fed, all of which should be broadly positive for US equities. Now the Senate and House of Representatives are controlled by the Republicans. If the Democrats seize control of both houses we would expect fiscal measures to be pushed through easily, which would be positive for risky assets. However in such a scenario monetary policy is likely to be tighter which would a drag on valuations, acting as a counterweight.

A Trump win is likely to see a spike in volatility given that it could result in a significant departure from current economic policies. Given Trump's preference for tighter immigration and import laws, we could see import prices rise and immigration labor force contraction, all of which sound bad for US equites.

Gold

Gold might be a beneficiary here, especially as it has come off a little recently . In addition to economic and financial events, gold is sensitive to geopolitical and even social developments. This US election may be particularly important in setting the course of US economic policy and foreign policy and hence for gold prices. A Trump win should be bullish for gold, given the uncertainty he would generate and thus gold's 'flight-to-quality' attributes will come into play. A Clinton win might not have a huge positive impact on gold but given that the dollar is likely to be subdued, I do not expect gold prices to plunge either. Also, if the Democrats gain control of both houses, gold should perform more bullishly given that there should be more inflation and larger budget deficits from being able to run more aggressive fiscal policies and to redistribute wealth.

The Federal Reserve will probably go slow on increasing interest rates and therefore the dollar is likely to remain subdued, buoying bullion demand. Mohamed El-Erian, chief economic adviser at Allianz and former CEO of PIMCO, thinks that gold is increasingly part of the solution in our ultra low interest rate world. The key is the importance of sizing one's portfolio allocation in a manner that enables it to stomach considerable mark-to-market price fluctuations, or face the risk of "doing the wrong thing" during periods of unsettling market volatility. This is a concept I have repeatedly touched on over the past year. El-Erian thinks a 5% strategic allocation is appropriate.

4. China

Meanwhile, China seems to have done a pretty good job so far in stabilizing its economy. The Chinese government seems to be like a Lebron James, scoring, assisting, stealing, blocking and generally being all over the court on offense and on defense.

For one, total debt at China-listed companies excluding financial firms has dropped to 86 percent of their common equity from 122 percent in 2007, based on a market-capitalization weighted average of latest filings. According to Bloomberg, "the deleveraging we are seeing today is a result of policy measures and credit that has helped boost commodity prices in China and allowed excess-capacity-sector companies to generate higher earnings and service debt," said Raja Mukherji, Hong Kong-based head of Asian credit research at Pacific Investment Management Co. "It looks all good today but the leverage risk is clearly being pushed out." Sounds like a plan to me. Kick the can down the road and grow your way out of the problem in the meantime. Big-bang approaches can be seriously traumatic for everyone.

China also started controlling the sale of wealth management products. The People's Bank of China is tightening its monitoring of the banking sector's off-balance sheet activities by including wealth management products in its newly formed "macro-prudential assessment" framework. High-yielding investment products will be subject to capital and other regulatory requirements. This is an area of concern for many China analysts and thus the action by the Chinese authorities should be viewed as positive development.

Meanwhile, we are seeing evidence of an economic bottom for China. 3Q GDP figures of 6.7% on-year growth was reported for a third consecutive quarter.

On-year growth statistics do not capture turns, so we should look at sequential growth, which rose for a third consecutive quarter. Now at 7.2% (QoQ, saar) growth is the fastest in three years (see chart 5).

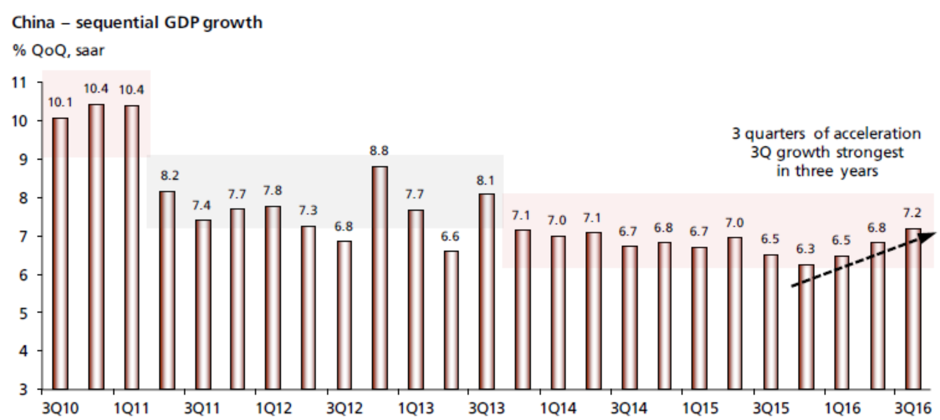


Chart 5: China quarter-on-quarter GDP growth. 3 quarters of acceleration 3Q growth strongest in three years. Source: DBS Research

Consumption is driving the growth, in line with the plan to transition to a consumption economy. Retail sales grew by 10.7% on-year in September, up from 10% in May. In the first nine months of the year, consumption accounted for 70% of GDP growth, nearly twice as much as the 37% share contributed by investment.

Given the importance of China, a cyclical bottom as good for the rest of Asia as it is for China itself.

4. China (continued)

The positive GDP data is being corroborated by higher frequency data. For example the manufacturing and service sector PMIs both bottomed in late-2015 / early - 2016 and have risen steadily since. The manufacturing sector PMI returned to 50+ territory three months ago from 48.5 at the start of the year. The service sector PMI is now running just shy of 53, up from 52-and-change nine months ago.

Of course, we cannot have a discussion on China without discussing the renminbi (RMB). The RMB against the USD has weakened to 2010 levels; we were glad to watch this unfold from the sidelines as we have gotten out of RMB exposure in early December 2015. I believe depreciation will continue, with capital outflows as a result of easy monetary policy and real interest rates too low to prevent capital from seeking returns abroad. The government is likely to allow the gradual depreciation of the RMB versus the basket: inflation is still low and the weakening RMB certainly will not hurt exports. As a result, they are likely to continue losing reserves to manage the pace of depreciation, but the pace of reserve loss should remain low and tolerable relative to the stock of reserves. The key here is that we are now less likely to see a disorderly RMB depreciation unlike the havoc in August 2015.

In spite of its 15% fall versus the dollar, euro and yen over the past 18 months, the BIS estimates that the RMB has still risen by 40%-45% in trade-weighted terms since 2005 (chart 6). The drop since mid-2015 helps to offset the unwelcome rise the year before.

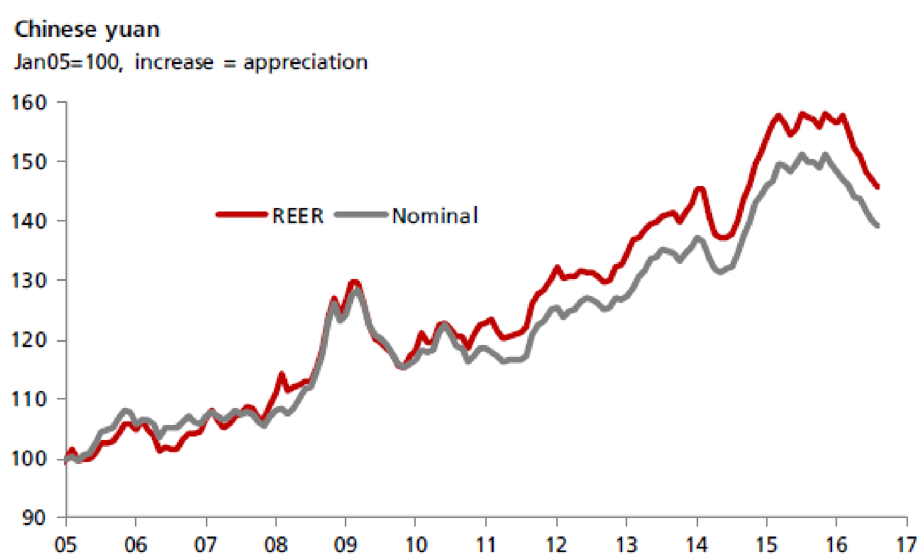


Chart 6: The Chinese yuan in nominal and REER. The real effective exchange rate (REER) is the weighted average of a country's currency relative to an index or basket of other major currencies, adjusted for the effects of inflation. The base is set to Jan 2005 = 100. Source: DBS Research

5. Conclusion

Taken together, the macro picture looks positive, with projected earnings growth, stabilization of oil prices, still a Clinton win on the cards and stabilization of the Chinese economy.

Technically speaking, as I have mentioned in August, LGT Research thinks that S&P 500 is now emerging from the narrowest two-year sideways pattern since mid-1990s. They have this to say:

"Despite the occasional volatility outbursts, the S&P 500 has been trading within an exceptionally narrow range in historical terms over the past two years. Such a prolonged sideways pattern last occurred in the two years through December 1994 — which was also during which US monetary policy was shifting from easing to tightening. The Fed had begun to raise rates in March 1994, after cutting them by 675 basis points between 1989 and 1992. Once investors realized that the tightening would not hurt the economy and earnings, equity prices soared, and we had the great dot-com boom."

In addition, the US Federal Reserve's policy intentions have recently moved in line with markets' expectations, making disruptive monetary policy surprises less likely than only a few months ago.

Data Sources:

- Bloomberg
- Dodge & Cox, 'Staying the course in value investing', April 2016
- HSBC Global Research, 'US Election Strategy', 26th Oct 2016
- DBS Group Research, 'China: cyclical bottom', 19th Oct 2016
- Mauldin Economics, 'Earnings ex-Losers Look Great', 30th Oct 2016
- Factset, Earnings Insight, 21st Oct 2016
- LGT Beacon, Global Market Update, 26th Oct 2016

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