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December 2016 Investment Newsletter

Wake me up when December ends

1. A multiple asset class approach makes sense

Rip Van Winkle fell asleep and fortuitously escaped some tumultuous times. When he awoke he was advanced to a timeline where he was free of his nagging wife, had avoided a terrible war, and became loved and supported by his grown children. In many ways, one cannot really do much better than sleep through 2016, which has been a heck of a ride. As of time of writing, the dollar remains the currency to have and to hold, and US equities still prove to be one of the best performers. If we had capitulated at the lows during the tumultuous times in February, during Brexit and during the US elections, we would likely be worse off.

What will 2017 bring? I think we will continue to see a gradual return to lower correlations amongst asset classes, where the world is no longer simply divided into risk-on and risk-off assets, and where asset allocation matters and having a multiple asset class approach works.

For example, I don't want to be 100% allocated to equities and I don't want to be 100% allocated to bonds, and I don't want to be 50% allocated to equities and 50% to bonds either. I want to flesh out my asset allocation with alternatives such as private equity, hedge funds, commodities and insurance linked strategies, etc.

First, a word on Trump and then onto some market thoughts.

Trump emerges triumphant

I was glued to my seat, witness to the market carnage during Asian hours. Like many others, I was surprised by the outcome of the US elections. The market is a great place to learn about humility and to understand humans' tendency to overestimate certainty.

I would say Trump's reconciliatory speech after being elected president made the difference. Before that the market was in upheaval as it was positioned for a Clinton win. You could say that the average investor, if he/she were to stay in the USA, will likely be living it up on either the east or west coast, where Trump lost the vote by a substantial margin. Anyway, after the calming speech the market was very relieved and by the time the US session ended US equities were up strongly and bonds were selling off.

As they say, history is written by the victors. It is quite interesting to see how suddenly there are more people praising Trump (or more closet Trump supporters coming out?) and now Trump is even credited with bringing 'animal spirits' back to trading (!). Well, the cold hard truth is that if Trump puts more cash into everyone's pockets as markets continue their upward trend and as employment rises, there are going to be a lot more people praising him than cursing him.

Which leads us to our next point— where do US equities go from here?

2. Still sanguine on US equities

Where does it go from here? Is the rally in US equities credible? The rally happened because the markets really believes the reflation trade now, reflation being the stimulation of the economy by easing monetary conditions or by reducing taxes, seeking to bring the economy back up to the long-term trend. So this hinges on whether the Trump administration can deliver on its promises to significantly reduce taxes and to undertake large infrastructure projects, whereby the Trump victory can be viewed as the unexpected easing of US monetary conditions.

I think it is possible because with the Republicans having control over both chambers of congress, the gridlock scenario is over and the administration should be able to push through policies effectively. Republicans are also known to be supportive of government expenditure and tax cuts. The Federal Reserve will be there to tighten monetary policy to ward off inflationary pressures, but my sense is that they will not try to get ahead of the curve.

The expected fiscal boost has given a boost to US equities, and the common view is that it will be tempered by rising US bond yields and a strong dollar. I actually think all these developments sound positive for US equities. People expect the dollar to get stronger, so they will want to shift more assets into the dollar. Now if they also think bonds are going to do poorly, where will they place their money?

We also want to see more diversity of views and not more consensus views. At the start of the year when I was positive about US equities some people were telling me the US markets were over-valued and it would crash. Some even laughed in my face. I love that kind of talk and that is what we want to hear. We should start to get extremely worried when everyone feels so positive about US equities.

I sense that the tone is still rather cautious and no one seems to be over-allocating to equites at the moment. Thoughts on equities are generally refrained, with words/ phrases like ‘constructive’, ‘don’t chase the market’ being strewn all around. The downside is that it seems like every house is recommending financials, healthcare, energy and industrials, which makes you wonder if that has become a crowded trade.

Are US equity valuations really expensive?

The often heard warning against US equities is that it is over-valued. Chart 1 shows various valuation metrics by RBC research. According to different metrics, while the market can indeed be viewed as expensive, it can also be viewed as reasonably valued or even slightly inexpensive.

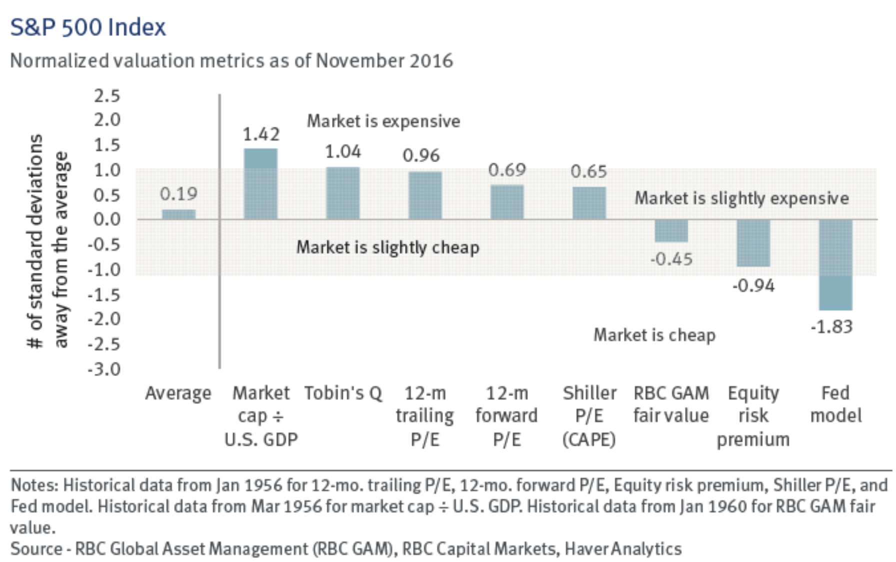

Chart 1: Various valuation metrics for the S&P 500.

3. Bond yields could back up but should not blow up

Bonds corrected sharply after Trump's victory. Gundlach (famous bond investor of Doubleline Capital) reckons 10-year bond yields could reach 6% in 4-5 years. US 10-year treasuries currently trade at 2.4%, from around 1.8% before pre-election. During the 2013 Fed tantrum, yields backed up to 3%.

I think that a 6% bond yield is probably too good to be true. I would imagine there would be a lot of bond buyers at that stage. A 6% risk-free rate sounds like heaven in these times. The truth is probably somewhere in the middle. While rates will trend higher other forces will keep a lid on the increase. The administration is cognizant of the fact that high rates will put a dampener on the housing market, borrowing and consumption. With other liquid low-risk government bonds yielding so low there should also be a fair bit of demand for US Treasuries as its yields get juicer.

The following charts show the historical yields for 10-year Japanese Government Bonds (JGBs) and 10-year German Bonds (Bunds) for the past 5 years. JGBs currently yield 0.02% while Bunds yield 0.22%. At some point you would think the Bank of Japan and European Central Bank will start tapering and then their respective bond yields may spike up. So why not sell the JGBs and Bunds to fund the buying of US Treasuries?

Chart 2: 10-year Japanese Government Bonds yields from 2012-2016. We are looking at 0.02%...

Chart 3: 10-year German Bonds yields from 2012-2016. It recently yields 0.22%.

If we look at the 10-year US-JGB interest rate spread, we are looking at around 220bps (2.20%), which is at top of the range since the 2008 financial crisis.

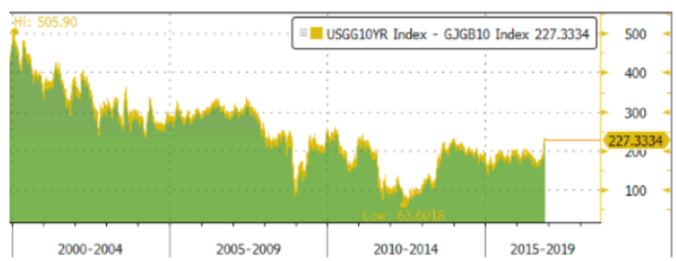

Chart 4: This shows the interest rate spread between 10-year US Treasuries and 10-year Japanese Government Bonds yields from 2000-2016. The current spread is 227bps or 2.27%.

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