ATLAS ASSET MANAGEMENT PTE. LTD.

March 2017 Investment Newsletter

Market Outlook

1. First, the bad news

Let's start with the bad news—all the things that can go wrong. The S&P 500 is up around 6% this year and about 10% since the US elections. Is the end near?

Goldman Sachs thinks so. In a recent report, the firm says the surge in confidence following Donald Trump's November victory is reaching an inflection point. Investors counting on tax cuts and an economic boom to fuel a surge in corporate profits are getting ahead of themselves, according to the bank. The "S&P 500 Index will give back recent gains as investors embrace the reality that tax reform is likely to provide a smaller, later tailwind to corporate earnings than originally expected."

Moreover, rising interest rates ahead will pressure the U.S. dollar higher, which also could hamper market values. With just over two weeks to the next Fed meeting on the 15th March, it is noticeable how all the Fed speakers continue to stress that March is indeed a live meeting. Will the potential rate hike in March and potential hawkish rhetoric be the final straw that breaks the camel's back?

The S&P 500 now is also considered richly priced by various valuations measures. For example, according to Ned Davis Research, the S&P 500 Median P/E ratio is over 1 standard deviation overvalued compared to historical standards. So we are talking about equity valuations being expensive in a context of rising interest rates and heightened political risks.

The longest cyclical bull market move lasted nine years (October 1990 to March 2000). The current cyclical bull market is in its eighth year. The cyclical bull market post the 2000 market peak lasted five years. Therefore, the current bull run is indeed aged and richly priced.

Meanwhile, a number of European nations are having elections this year, namely Germany, France and the Netherlands. Political risk is a key driver of market moves in Europe at the moment. The Dutch are having their elections on the 15th March, while the French have two rounds of elections in April and May. Germany will have their elections later in the year. The French elections are the one to watch, with populist leader Le Pen planning to do things very *differently* if she is elected. Le Pen has been gaining momentum: the election is very open at this stage increasing investor nervousness as markets hate uncertainty.

Now, onto the more uplifting news.

2. Something uplifting

Now, with all that said, the trend is still your friend. We have to let the trend run and investors who do not do so tend to leave a lot of money at the table… How to determine trend exhaustion? That is a billion-dollar question—a simple rule of thumb used by legends such as Paul Tudor Jones is the 200-day moving average. And despite the concerns (overpriced and aged bull market) the current weight of evidence (risk appetite, GDP growth) remains bullish for equities; developed markets benefit from high sentiment indicators (highest since 2004) while emerging markets are boosted by China's credit increase. Risk appetite indicators suggest that investors are optimistic but not euphoric. Regarding valuation levels, we are not at *extreme* overvaluation levels and markets can stay in overvalued states for an extended period (just as they can stay in an undervalued state for an extended period.) Besides, while the index may be considered overvalued this is not so for individual stocks. Take the S&P 500 median P/E ratio being overvalued as an example. Median means that while 50% of the stocks in the index are above that number, 50% are below that number too. So there are stocks out there that are undervalued.

Meanwhile, Warren Buffett's annual newsletter came out over the weekend. The legendary investor reminded us that "babies born in America today are the luckiest crop in history". In many ways, if you are reading this, and if you are not reading this from North Korea, this phrase applies to you too. The early Americans, "were neither smarter nor more hard working than those people who toiled century after century before them." Many of us readers can identify with this statement and be thankful for the foundations our pioneers built for us, enjoying the fruits of their labor where we were neither smarter nor more hard working than them.

Regarding stocks, Buffett has this to say: "American business – and consequently a basket of stocks – is virtually certain to be worth far more in the years ahead. Innovation, productivity gains, entrepreneurial spirit and an abundance of capital will see to that." People have said that stock markets always go up in the long run. Well, actually it is the *US* stock market that always goes up. "Americans have combined human ingenuity, a market system, a tide of talented and ambitious immigrants, and the rule of law to deliver abundance beyond any dreams of our forefathers." The American system, warts and all, have indeed been working well and thus we see the S&P 500 moving ever higher over time. Some countries are mired in recession, deflation, wars and governmental deadlock. If the nation's economy is stuck then you can bet that their stocks will be stuck too. Bottom-line: US stocks will go up in the long run, as long as the American system is in place.

Buffett also serves up a good point that we cannot really predict market moves. Panics will come and there will be opportunities. "Widespread fear is your friend as an investor, because it serves up bargain purchases" What is important is to be ready when the time comes. There will be dips and there will be opportunities. This is what investors live for. Stay solvent to be there when that rain of opportunity comes along. Make sure to take a "washtub out rather than a teaspoon" when it is raining opportunities.

Apple and the scuttlebutt method

We spoke about undervalued stocks in previous paragraphs. By definition, this is what Warren Buffett buys, for if the stock is overvalued he would exit it. Buffett had nearly quadrupled its Apple stake from 15.2 million shares as of end September to 57.4 million shares on December, making it a Top 10 holder in the tech company. Not only that, in a recent interview with CNBC in end February, Buffett said that he more than doubled his holdings in Apple yet again between the start of 2017 and the tech company's most recent earnings report. At this point, Buffett owns $17 billion worth of the tech giant's stock, making him a Top 5 holders of the stock. The purchases that Buffett revealed give Berkshire Hathaway about 2.5% of the outstanding Apple shares. It also made Apple one of Buffett's company's largest holdings, second only to Coca-Cola. Buffett likes the consumer-retaining power of Apple. "Apple strikes me as having quite a sticky product, and an enormously useful product to people that use it," Buffett told CNBC.

Buffett said that a book by famed investor Philip Fisher called "Common Stocks and Uncommon Profits" inspired him to research how consumers feel about Apple products. "He talks about something called the 'scuttlebutt method,' which made a big impression on me at the time, and I used it a lot," Buffett said. "[It's] essentially going out and finding out as much as you can about how people feel about the products that they [use.]"

Scuttlebutt method

I am a firm believer of the scuttlebutt method although I am cognizant that personal biases can get in the way as well. What is the scuttlebutt method? It is about inquiring and asking questions to all the people involved with the company. This would mean vendors, customers, suppliers, the competition, etc. It refers to combining all these qualitative information with the technical and fundamental analysis to assess an investment. It is about the personal observations and insights that investors get by going out and kicking the tires.

That is why I am a firm believer in Apple. I personally use Apple products and I can see why consumers are snapping up Apple products and why the consumers are loyal, creating a formidable sticky ecosystem. I can also see why personal biases can get in the way of investing. My colleague is a big Blackberry fan; he swears by Blackberry and he thinks Apple phones suck. So true to form he has been bearish on Apple and never bought Apple shares as it rose. My personal bias has also gotten in the way of investing in great stocks. For a long time I think Facebook (FB) as an app is a joke since I am not a big social media user, so that's why I did not really buy into FB shares, which has been a multi-bagger.

And therein lies the danger of an over-reliance on extrapolating personal experiences. I might not feel the same way about FB, but I would be unwise to make an investment judgment on my experience alone. Yesterday my research desk just pushed out a recommendation on L Brands. L Brands' major business is Victoria's Secrets. So, just because I do not use the products does not mean I will tear it apart — I will review this recommendation seriously, and will start by paying a visit to the flagship store round the corner.

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