



From the desk of Amit Lodha

January 2019

Welcome to 2019

The message for 2019 that we should take away from the volatility of 2018 is that it is going to be a year of divided outcomes. In most years, there are always enough reasons to worry, but one can also invest with a bottom-up mindset without spending too much time on the macro. Unfortunately, 2019 is unlikely to be one of those years. Trade policy (what kind of agreement the US and China reach), global central bank policy (driving US dollar liquidity) and a potential US fiscal stimulus will be important drivers of earnings and hence stock price performance. One needs to believe that these macro drivers will shift positively to take a positive view on the markets.

To jump to the conclusion: In a nutshell, I believe the probabilities are in our favour and am feeling more positive – at least tactically. Don't get me wrong, there remain (as there always are) enough reasons to run for the hills. But below are a few reasons why I am positive tactically (but still cautious structurally) on global equities.

Clearly, 2018 was one of the worst years in terms of performance across asset classes. There was literally

no place to hide. All investor worries around the macro (slowdown), trade wars, oil, China, and dollar seem to have been reflected in equity market performance.

And 2019 seems to have begun on the same volatile note, with the first four days bringing a poor Chinese PMI print, Apple's first negative preannouncement in 16 years, a mini flash crash in the currency market and the worst ISM drop since October 2008. We concluded the week with a \$74 billion pharma mega-merger (which left most people scratching their heads!), the largest payroll beat of the cycle and the US Fed governor, who did everything he could do to appear 'flexible' and 'patient' (almost dovish versus his comments in early October, which were interpreted as being quite 'hawkish').

The good thing amongst all this volatility is that almost every worry that we worried about in the past now seems to be in some part discounted by the markets. In fact, one could argue that the market has tried to discount the potential of a 2020 recession in the month of December 2018 – talk about Christmas pudding indigestion!

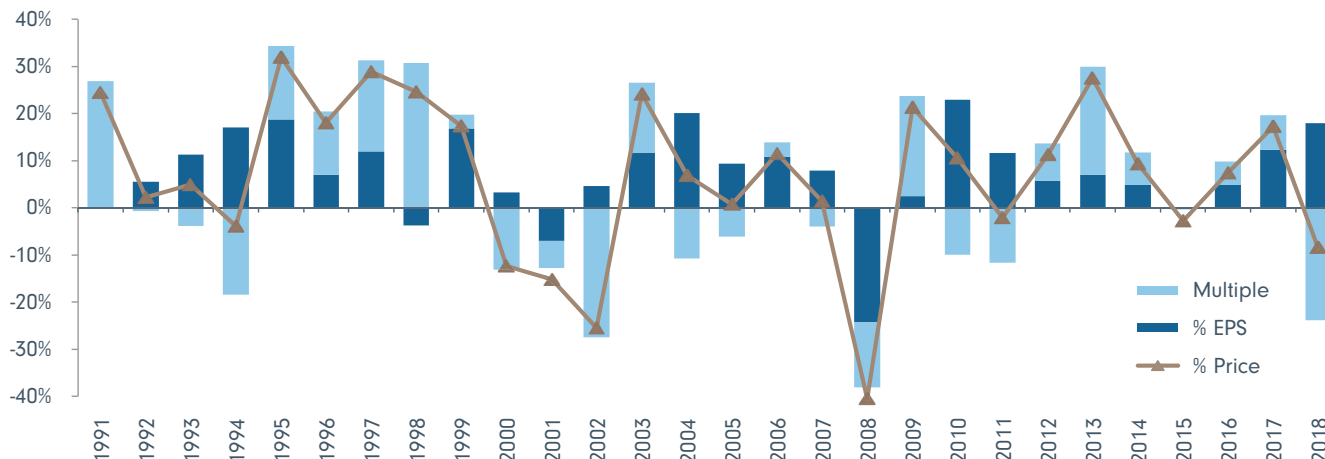
Table 1. Fewer asset classes are beating inflation than in 2008

Ranking	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1	REITS	MSCI EM	MSCI China	MSCI China	US 10Yr	MSCI EM	REITS	US 10Yr	MSCI China	Russell 2000	REITS	MSCI Japan	Commodities	MSCI China	REITS
2	MSCI EM	Commodities	REITS	MSCI EM	US 2Yr	MSCI China	Russell 2000	Inflation Bonds	MSCI Europe	S&P 500	S&P 500	REITS	Russell 2000	MSCI EM	S&P 500
3	MSCI Europe	MSCI Japan	MSCI Europe	Commodities	US Agg. Bond	Global HY	Commodities	EM\$Sov Credit	Global HY	MSCI Japan	US 10Yr	US 10Yr	US HY	MSCI Europe	US 2Yr
4	Russell 2000	MSCI China	MSCI EM	MSCI Europe	EM Local Debt	US HY	MSCI EM	US IG	REITS	MSCI Europe	MSCI China	EM\$Sov Credit	Global HY	MSCI Japan	US HY
5	MSCI Japan	EM\$Sov Credit	Russell 2000	Inflation Bonds	US IG	Commodities	MSCI Japan	US Agg. Bond	MSCI EM	US HY	US IG	S&P 500	S&P 500	S&P 500	US Agg. Bond
6	Inflation Bonds	REITS	S&P 500	US 10Yr	Inflation Bonds	MSCI Europe	US HY	REITS	EM\$Sov Credit	Global HY	EM\$Sov Credit	US 2Yr	MSCI EM	Russell 2000	Russell 2000
7	Global HY	MSCI Europe	Commodities	US 2Yr	EM\$Sov Credit	EM\$Sov Credit	S&P 500	US HY	Russell 2000	MSCI China	US Agg. Bond	US Agg. Bond	EM\$Sov Credit	EM Local Debt	Commodities
8	Commodities	S&P 500	Global HY	US Agg. Bond	US HY	REITS	Global HY	Global HY	S&P 500	REITS	Russell 2000	US IG	REITS	Global HY	US 10Yr
9	EM\$Sov Credit	Russell 2000	US HY	EM\$Sov Credit	Global HY	Russell 2000	EM Local Debt	S&P 500	US HY	US 2Yr	Inflation Bonds	MSCI Europe	US IG	EM\$Sov Credit	Global HY
10	US HY	Global HY	EM\$Sov Credit	S&P 500	Commodities	S&P 500	EM\$Sov Credit	US 2Yr	EM Local Debt	US IG	US HY	Global HY	EM Local Debt	REITS	US IG
11	S&P 500	EM Local Debt	Inflation Bonds	US IG	MSCI Japan	US IG	US 10Yr	10/01/19	US IG	US Agg. Bond	US 2Yr	Russell 2000	Inflation Bonds	Inflation Bonds	Inflation Bonds
12	US IG	US HY	MSCI Japan	EM Local Debt	Russell 2000	EM Local Debt	US IG	Russell 2000	Inflation Bonds	MSCI EM	Global HY	US HY	MSCI Japan	Commodities	EM Local Debt
13	US 10Yr	US Agg. Bond	US Agg. Bond	Global HY	S&P 500	Inflation Bonds	US Agg. Bond	Commodities	MSCI Japan	Inflation Bonds	MSCI EM	Inflation Bonds	US Agg. Bond	US HY	EM\$Sov Credit
14	US Agg. Bond	US 10Yr	US IG	US HY	REITS	MSCI Japan	MSCI China	MSCI Europe	US Agg. Bond	EM Local Debt	EM Local Debt	MSCI China	MSCI China	US IG	MSCI Japan
15	EM Local Debt	US IG	US 2Yr	Russell 2000	MSCI Europe	US Agg. Bond	MSCI Europe	MSCI Japan	US 10Yr	EM\$Sov Credit	MSCI Japan	EM Local Debt	US 10Yr	US Agg. Bond	MSCI Europe
16	MSCI China	US 2Yr	US 10Yr	MSCI Japan	MSCI China	US 2Yr	Inflation Bonds	MSCI EM	Commodities	US 10Yr	MSCI Europe	MSCI EM	US 2Yr	US 10Yr	MSCI EM
17	US 2Yr	Inflation Bonds	EM Local Debt	REITS	MSCI EM	US 10Yr	US 2Yr	MSCI China	US 2Yr	Commodities	Commodities	Commodities	MSCI Europe	US 2Yr	MSCI China

Source: Bloomberg, Morgan Stanley Research. Note: We compute annual returns minus US headline inflation. Green means returns (in USD) beat inflation, and red means returns trailed inflation. 2018 data as of 21 November 2018.

Figure 1. Significant multiple contraction during the year

P/E vs EPS growth (biggest multiple contraction since 2002 despite biggest EPS growth since 2010)



Source: Baird Research, Bloomberg, January 2019. The chart shows the performance of the S&P 500 each year and its attribution from EPS growth and P/E expansion/contraction. The brown line is the % change in the S&P 500 price each year. The dark blue bars represent the % change in forward EPS estimates (estimates are 18% higher than they were 12 months ago) and the light blue bars represent the difference between this and % market performance.

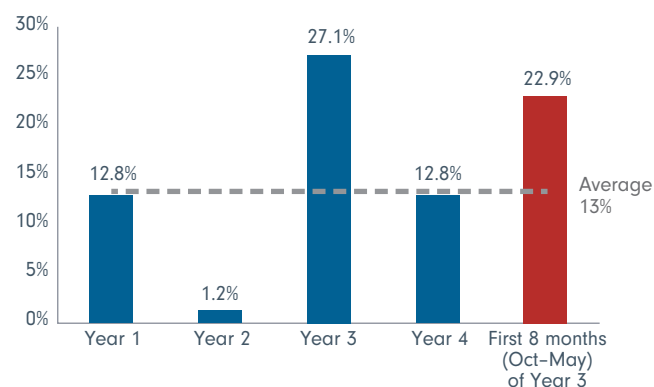
So, here are my reasons to be positive:

- (a) **Valuations:** Equities have taken quite a multiple de-rating – earnings in 2018 will be up anywhere between 15 and 17% –with the US leading the charge at a +20% year, driven by the tax cut. Yet equities around the world were down in 2018. For 2019, Fidelity equity analysts expect this to be a slow growth year – only 4.5% earnings growth, a shade below consensus. However, with the valuation de-rating, this suggests to me that for the first time really since 2016 we are getting paid to take risk intelligently. See Figure 1 for the S&P 500 multiples since 2002, with performance broken up into EPS growth versus multiple expansions.
- (b) **Sentiment** seems quite washed out after the poor Q4, especially in the technology bellwethers. The crowding that we saw in the markets, particularly with a narrow part of the market (the FANGS) doing well, has been cleared out. At least from a market structure perspective, this is positive.
- (c) **The third year of the US presidential cycle delivers the best returns historically.** In fact, the US market hasn't given you negative returns in the period between November and April since 1946 in the third year of the presidential cycle (see Figure 2). Jeremy Grantham from GMO has done some great work on the US presidential cycle returns. So if you are betting on a bear market, you have some serious history to contend with – it may be different this time, but just worth heeding the message of history!

But most importantly on a fundamental basis, the poor stockmarket performance of 2018 also increases, in my view, the probability of:

- (a) a trade deal between US and China
- (b) a more dovish Fed and possibly ECB, and Japanese and Chinese central bank
- (c) a follow-through fiscal stimulus bill which drives capex spending in the US.

Figure 2. Presidential election cycle returns (1928–2012)



Source: CRSP, Stan Clark Financial Team

Putting all this together, a base case would suggest that central bank policy would be more accommodative, as the FED Chair hinted in his comments of 4 January, driving the strong rally in the US markets, and with the prospects of a trade deal between US and China, the markets can breathe a sigh of relief – moving from discounting an outcome of worse to 'less bad' (which is incidentally where a lot of money can be made).

However, before you think I am suggesting that we go all in, it is worth pointing out that reasons to stay structurally cautious haven't disappeared:

- (a) Financial markets remains addicted to central bank policies of capital subsidisation and insolvency prevention – maybe we have one last hurrah (new market highs) but everything from the social and political order to the economic make-up of markets is changing. The investment environment of the next decade will be clearly different from the past and we will need to at some point contend with high levels of debt which we have built up in this cycle across both corporates (primarily in the US) and federal debt levels (China, US). A new playbook still needs to be written!

- (b) From a more tactical perspective, we have all the hallmarks of a late cycle, with low unemployment, peak earnings, declining multiples, yield curve near inversion, etc.
- (c) It is quite possible that the Fed could make a policy mistake and continue to talk dovish, but not follow through with real action, in which case the downside in equities could be significant. Earnings typically fall at least 10% when the yield curve (2-10) inverts and this is no way discounted in estimates. This would paradoxically be quite positive from a longer-term perspective (in getting rid of zombie companies), but the attendant social and political upheavals, and also the asset price deflation which inevitably comes with a recession, could be quite significant. This is the bifurcated other side of no trade deal and a hawkish central bank with downside greater than 20-30%.
- (d) So, what we are hoping for is that global central banks follow through their dovish talk with action, i.e. expansion of central bank balance sheets, else the developed market credit pyramid will continue to exhibit higher signs of instability and volatility, which could push the global economy into a synchronised recession. (Note as per Jim Grant's estimates in Q4 2017, the Fed, ECB, and BOJ combined asset purchases were \$100 billion per month; this dropped to zero in late 2018 and in Q1 2019 will turn negative to a roughly \$20 billion per month withdrawal - the direction of this flow must change!)

Signs to look out for that this is not happening would be:

 - i. High yield spreads and the performance of the corporate debt market (for example, no high yield issuance in December is a clear amber light).
 - ii. Emerging market currency and dollar performance.
- (e) China's balance sheet remains a worry and, while they can stimulate, marginal return on credit seems to be deteriorating (i.e. more and more credit required to create the same impact on GDP growth). To investigate this further, I am in Shanghai this week and will report back on what I learn.
- f) Geopolitics will continue to have an increasing (not decreasing) impact on markets - the wealth divide remains significant and more Pandora's boxes like Brexit will be opened around the world. For example, before the end of the year, we need to navigate the uncertainty of Brexit, a new ECB governor, possible political change across Europe, consumption tax increases in Japan besides the trade/tariff issues between China, US and the rest of the world.

Tactical positioning

My view is that the economic and earnings data in Q1 is going to make it tough to be unabashedly positive. Further, as Apple showed in profit warning, the economic and trade-related issues are having a real impact on company earnings (which is why macro is so important for 2019). Given trade-related worries, it is likely that a lot of pre-ordering happened in Q3/Q4 2018 - this makes comparisons for 2019 difficult and also increases the amount of inventory in the system. From Fedex to Apple,

everyone is singing from the same hymn sheet of trade-related troubles.

Putting this together: Q1 earnings guidance is likely to be muted, and with margins likely to be under pressure due to both operating leverage (rising labour costs) and financial leverage (rising rates), it is unlikely that CFOs will have the same confidence in guiding for 2019 earnings as they did in the heady tax stimulus days of January 2018.

Consequently, while I am looking to be tactically positive, it is only after making sure we have a high degree of margin of safety in the companies we hold or are looking to buy. This means a margin of safety both on valuations of the stocks we are buying, as well as their forecast earnings and cashflow in various market scenarios. It is clear, bottom-up stock picking is more important, but equally important would be how one navigates volatility and does not get whipsawed and connects the dot on a global basis (for example, focusing on the Taiwanese supply chain made sure that Apple was amongst our largest underweights).

It is not going to be easy, but invest with a long-term view and continue to reevaluate the investment thesis with diligence and higher-than-normal regularity and flexibility.

Areas we like, or where we think we can find value (coincidentally risk on sectors)

- (a) Emerging markets.
- (b) Energy stocks.
- (c) Technology (selectively - and yes, even some of the FANGS, as I think the market will differentiate between them).
- (d) Cyclical (US/European interest rate sensitives in the scenario that the US President and Congress negotiate a good fiscal stimulus program).
- (e) Companies in any sector which have their own company-specific factors driving earnings (restructuring, product cycles, market growth, etc.).
- (f) Stocks where the market has discounted an outcome which is very bad but where we think there is a lot of upside if things are just OK (I daresay European cyclicals, especially financials, fall into this category).

Areas we would be cautious on would be stocks/sectors where expectations and valuations are high. While scarce growth will still trade at a premium, however if these companies miss expectations the stocks risk a double whammy of both decline in multiples and earnings expectations - potential for significant capital loss.

One last point is on volatility, and that we should also be cognisant of the change in the structure of the equity markets. The rise of ETFs/algorithmic investing on the one hand versus the decline in importance of the broker dealer/prop desks (who provided liquidity in times of stress but can't do so now due to regulatory capital constraints), means programmatic trading/machines are a lot more in control of the short-term gyrations of the markets.

This has also meant that historical signals/tools are no longer providing the early warnings as moves across asset classes are becoming a lot more correlated. (My fixed income colleagues tell me they are looking at the equity market for direction, just as we look at them for guidance!)

The only way to look for uncorrelated return will be found in the mundane: doing the work on a stock-by-stock basis with a focus on valuations based on earnings and cashflows under various market/macro scenarios.

So, in summary, the message is that in the near-term, markets are now offering selective good value. Use the Q1 earnings season to deploy cash in high-quality companies available at good valuations taking a longer-term view. However, continue to reevaluate the investment thesis periodically, don't forget to have a good margin of safety, and make sure you protect capital!

And if trade policy or central bank policy go the other way versus base case, or the credit markets fall out of bed, make sure you have your running shoes on – after all, it's January!

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