GavekalResearch

May 2017

Structuring A Globally Diversified Portfolio

Louis-Vincent Gave

Is money management about picking winners? Or avoiding losers?

Top-ten market by market cap: how often do winners stay on top?

1980	1990	2000	2010	2017
IBM	NTT	Microsoft	Exxon Mobil	Apple Inc.
AT&T	Bank of Tokyo-Mitsubishi	General Electric	PetroChina	Alphabet (Google)
Exxon	Industrial Bank of Japan	NTT DoCoMo	Apple Inc.	Microsoft
Standard Oil	Sumitomo Mitsui Banking	Cisco Systems	BHP Billiton	Amazon.com
Shlumberger	Toyota Motors	Wal-Mart	Microsoft	Facebook
Shell	Fuji Bank	Intel	ICBC	Exxon Mobil
Mobil	Dai iIchi Kangyo Bank	NTT	Petrobras	Tencent Holdings
Atlantic Richfield	IBM	Exxon Mobil	China Construction Bank	Johnson & Johnson
General Electric	UFJ Bank	Lucent Technologies	Royal Dutch Shell	JP Morgan Chase
Eastman Kodak	Exxon	Deutsche Telekom	Nestlé	Ali Baba Group

Prominent beliefs :
Peak oil,
US businesses are just better run

Underweight the US
Underweight energy

Prominent beliefs :
Japan will take over the world

Underweight Japan
Underweight banks

Prominent beliefs :
It's different this time; US is a big TMT boom winner

Underweight USA
Underweight TMT

Prominent beliefs :
Peak oil,
China taking over the world

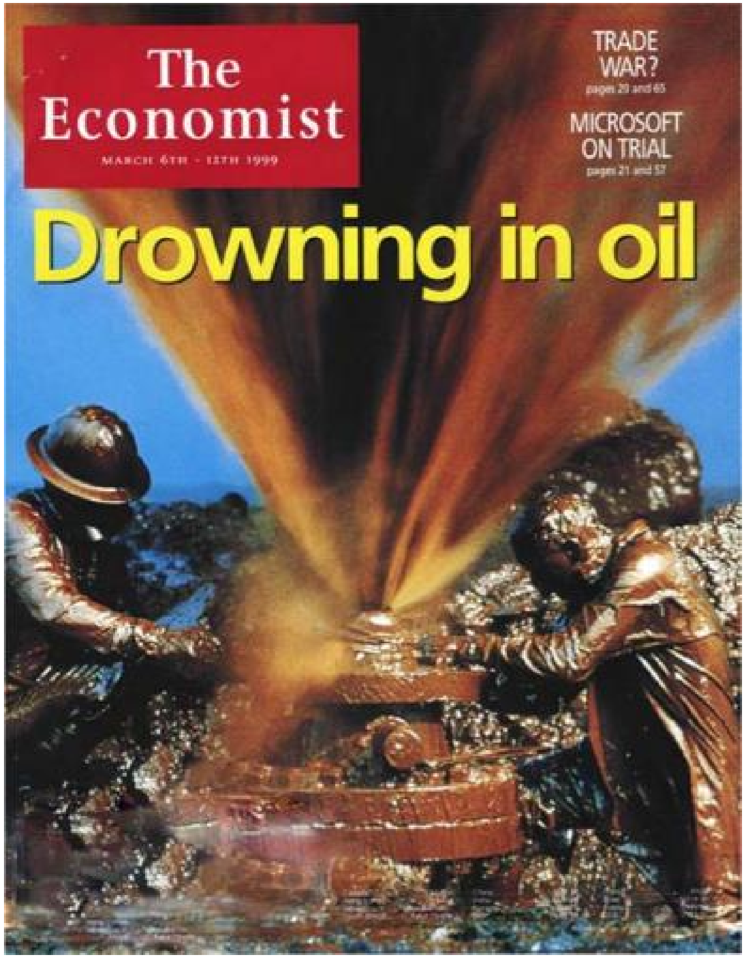
Underweight China
Commodities

Hey, it's not yet the end of the decade & we may still have time to dance?

Good thing there is no common thread among the above names…

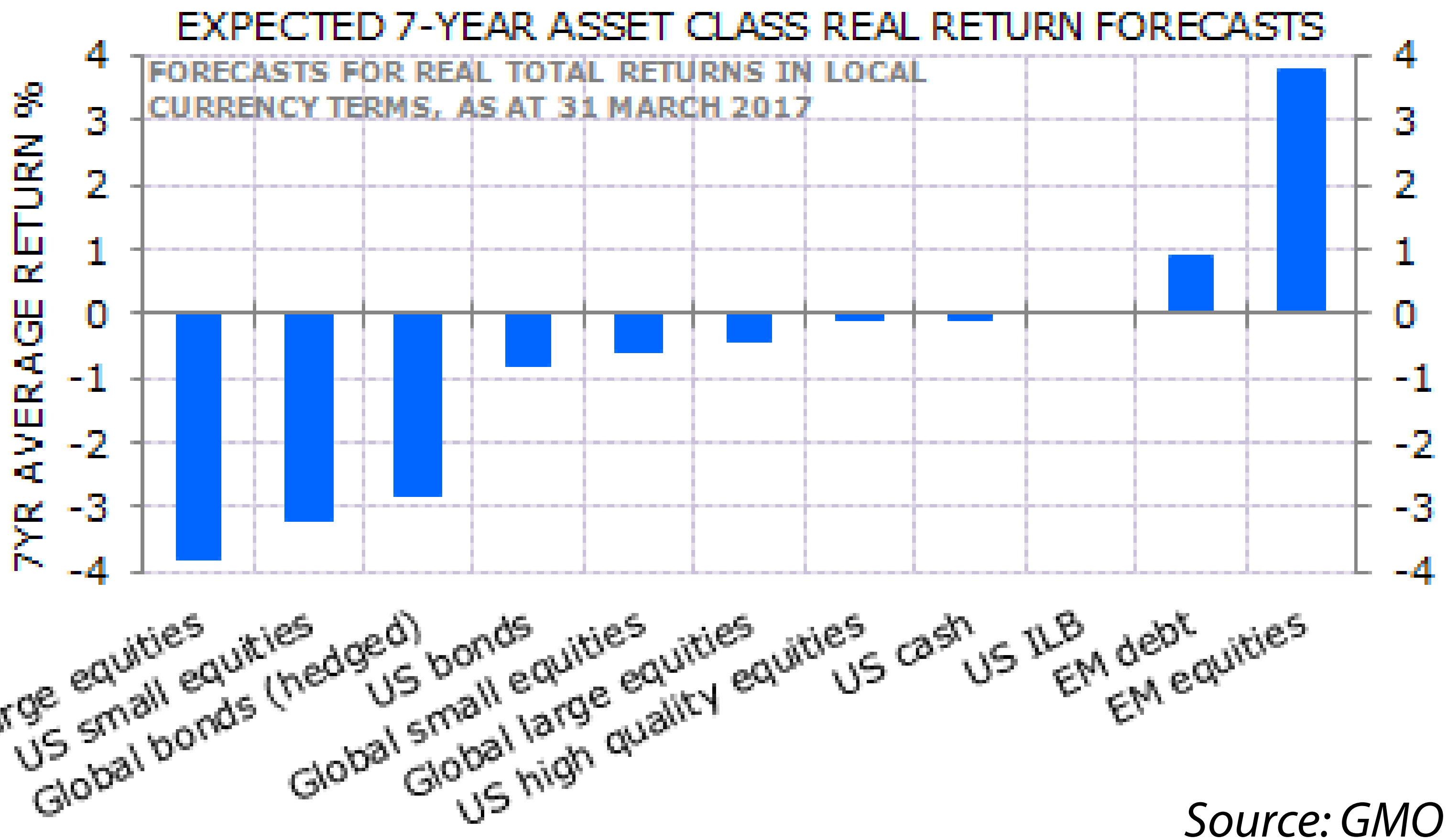
Nothing to worry about, it's not like US tech keeps making magazine covers…

March 1999—oil hit US$10/bbl, a low not seen since



May 2017— 7/10 biggest companies are tech companies

Latest GMO asset class forecast paints a tough picture for US large caps

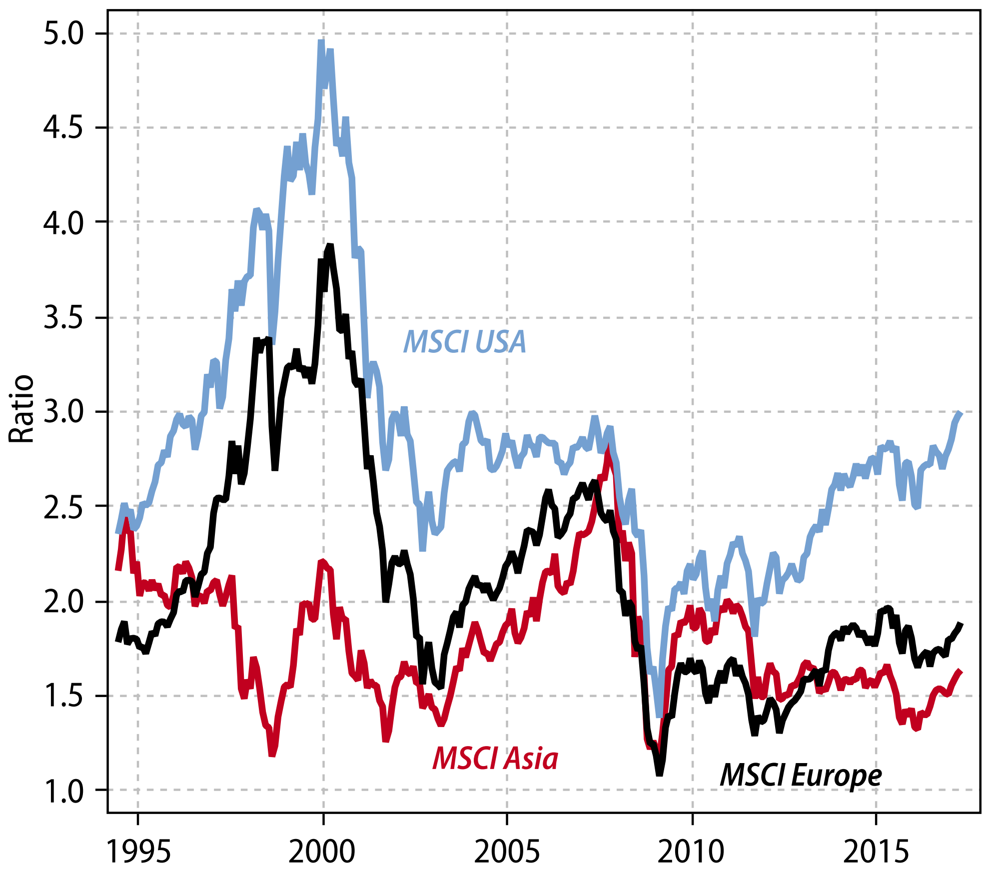


Source: GMO

1 — Is underweighting US equities once again the slam dunk trade?

Valuations would point that way

Price to Book in Asia, USA, Europe



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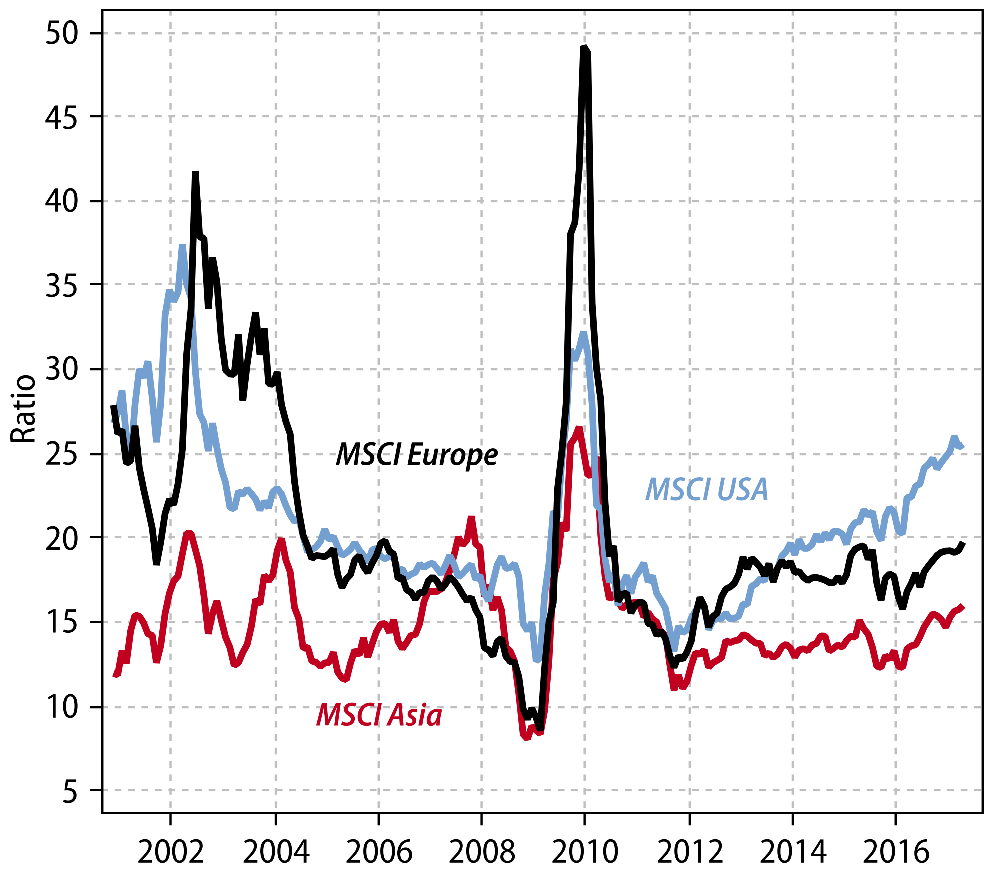
PE ratios in Asia, Europe, USA



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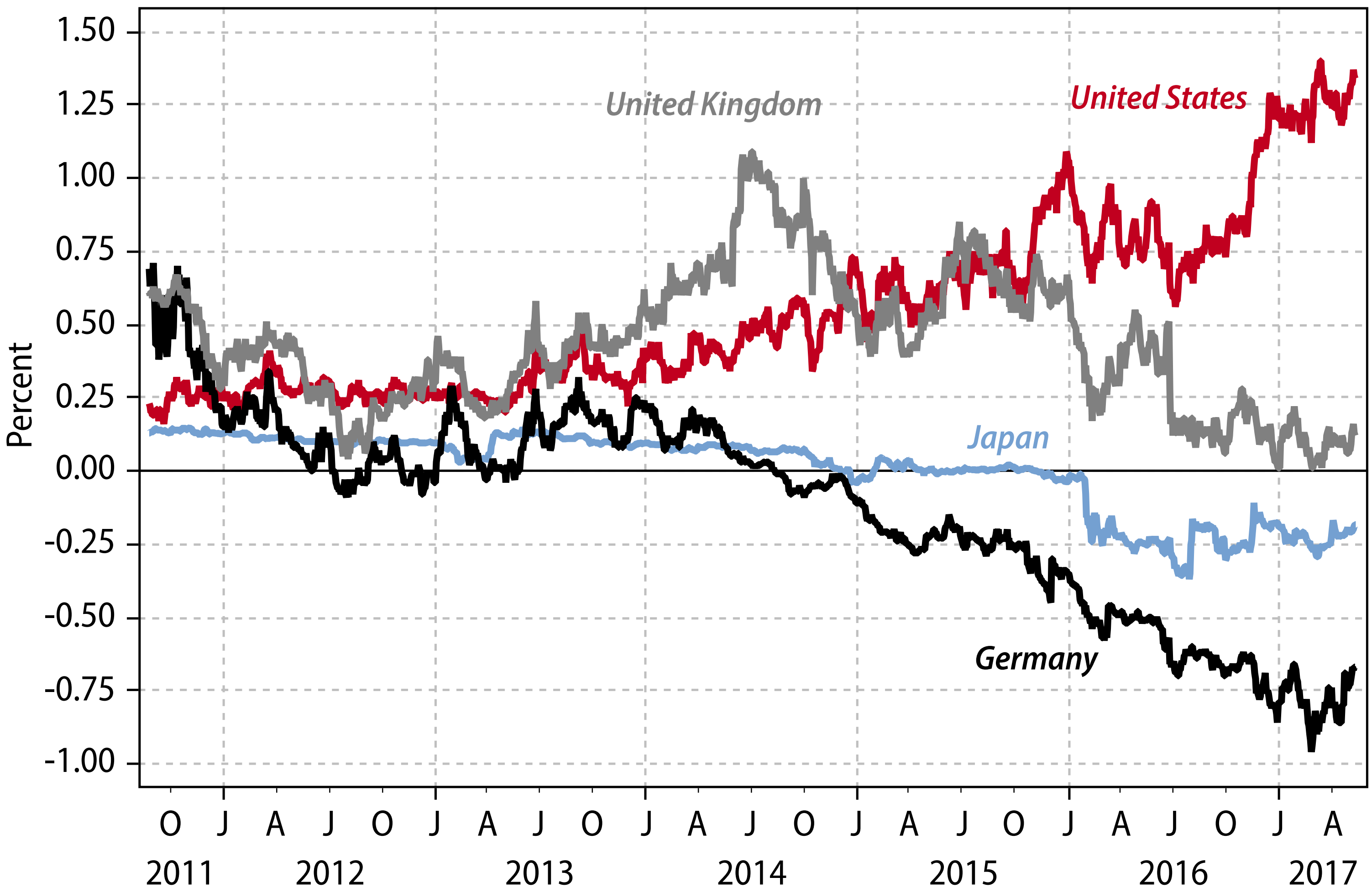
As would the diverging monetary policies

Two-year government bond yields



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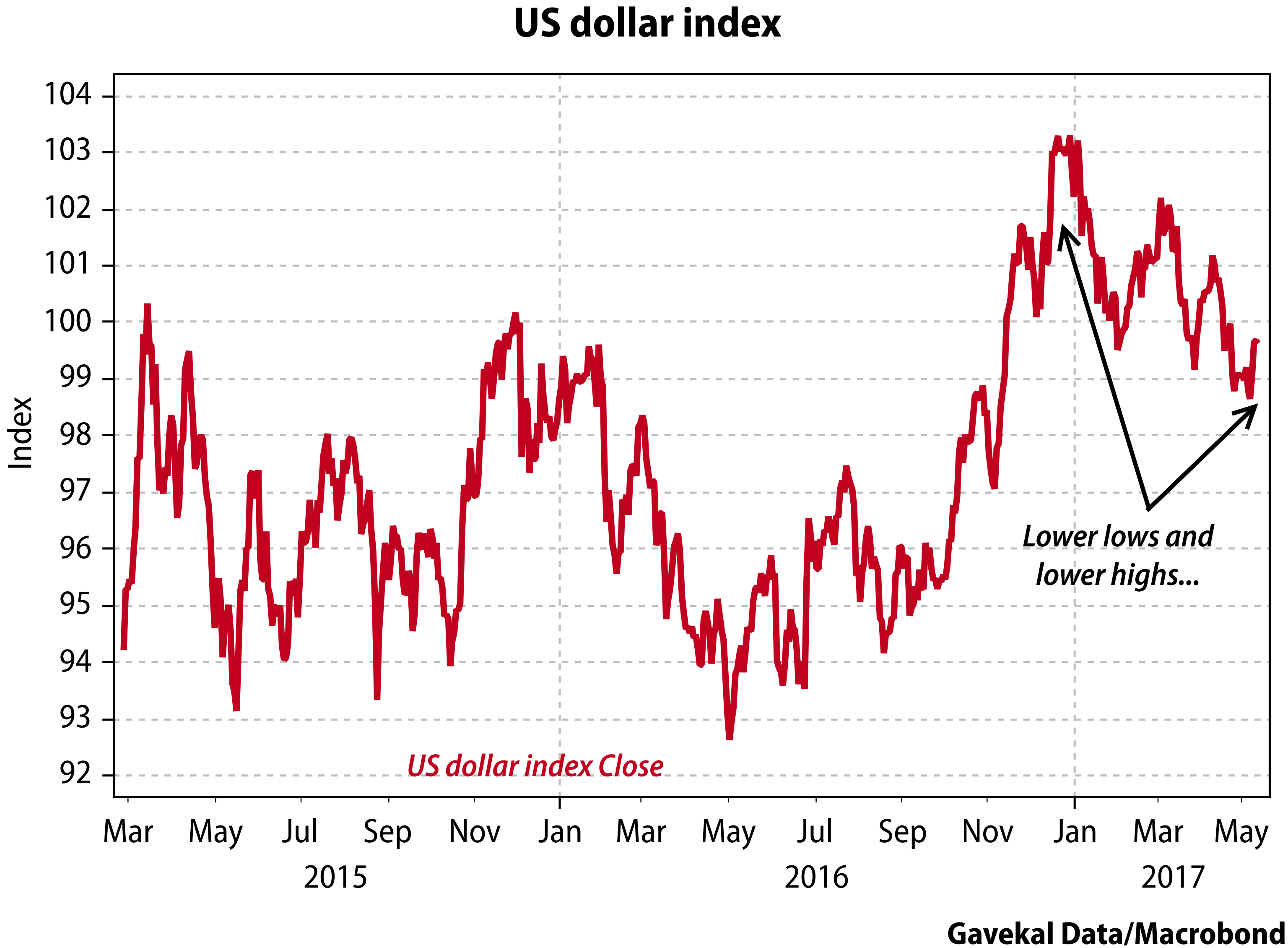
US$ range-trading while the Fed raises rates: a sign of extreme positioning?



The five variables driving investment: where does the US compete today?

Entrepreneur

Cost of capital

This used to be a significant comparative advantage for the US.

But today, cost of capital is low everywhere.

And availability of capital has also much improved.

Cost of government

The cost of government in the US could be the highest in the Western world.

Massive healthcare costs/ uncertainties + frivolous lawsuits + aggressive regulators = high cost.

Cost of labor

The US used to be cheap, but the rise of the US$ means that US workers are no longer very competitive.

Especially when one takes into account healthcare and other indirect costs.

Cost of energy

Five years ago, this was by far the US's biggest comparative advantage.

But today, almost everyone has access to cheaper energy.

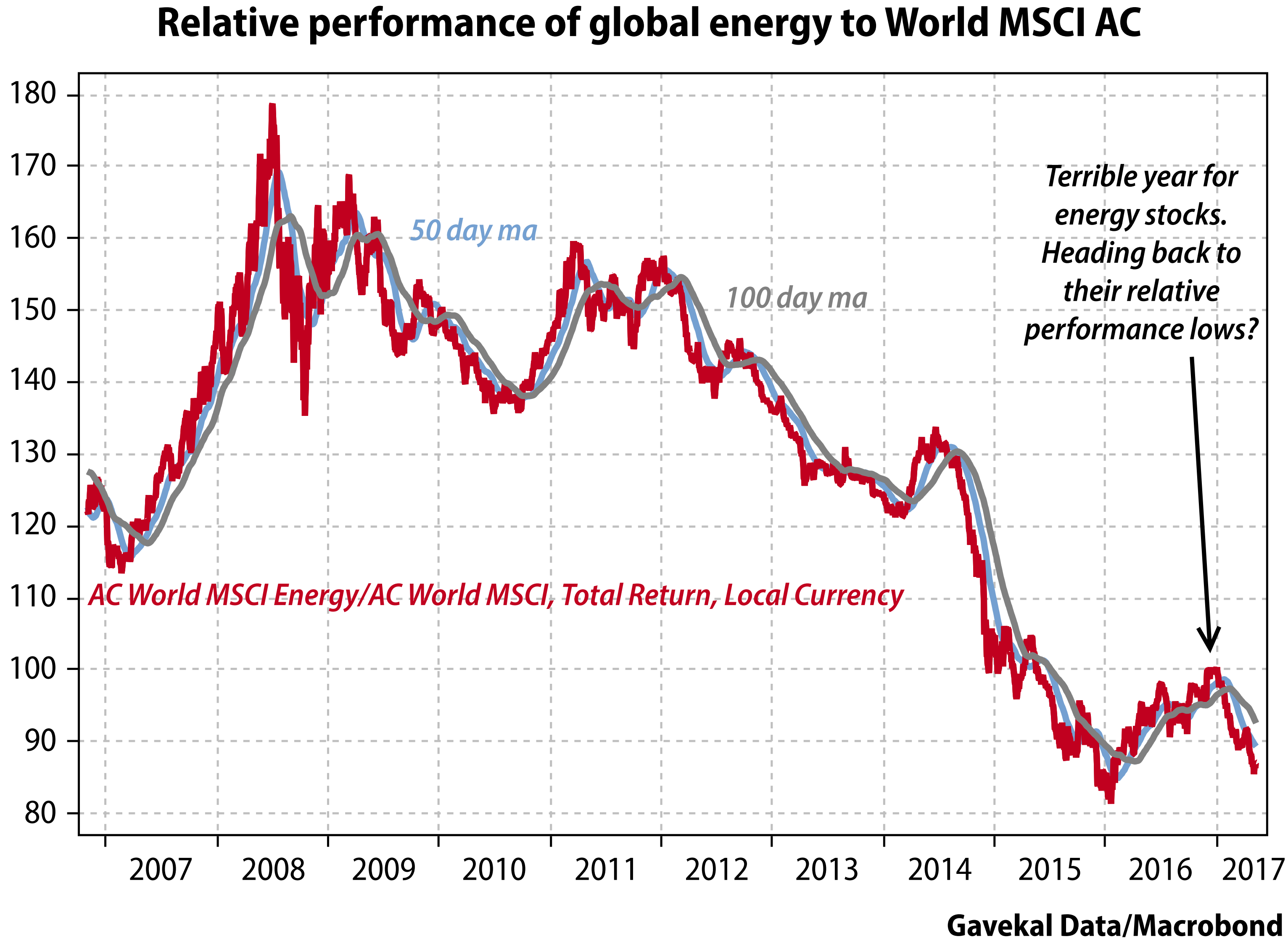
Energy may no longer be a key decision driver.

Cost of land

Land and real estate remains cheaper in the US than in most other countries.

To maximize land productivity, a high level of infrastructure spending is necessary. Will it happen?

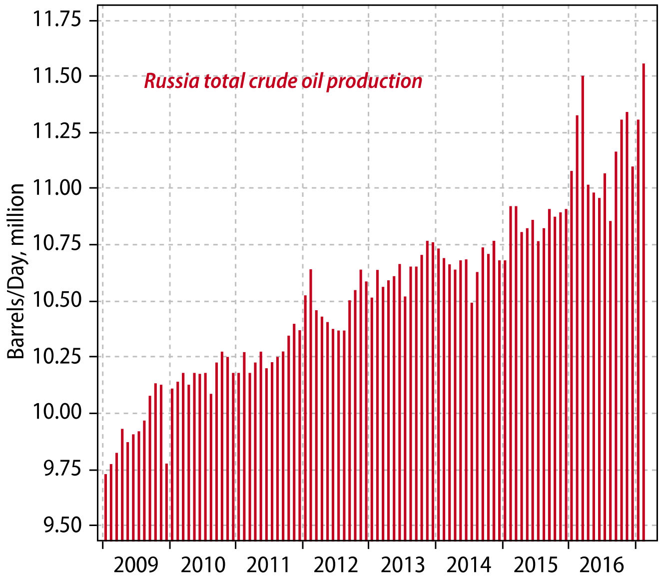
Energy has undeniably been a dog



Saudi Arabia: between a rock and a hard place

- The "peak-oil" premium has by now been thoroughly squeezed out of global energy markets. Instead, oil prices are likely now stuck in a US$30 to US$50/bbl range.
- We fear that we may be heading to the lower end of that range in the very near term for geopolitical reasons. Basically, Saudi Arabia is on the ropes, having to fund three wars (Syria, Yemen, Iraq), a large welfare state, some client states (most notably Egypt) and of course the lifestyles of 3000+ princes. To fund all this, Saudi is trying to sell the crown jewel, namely, Saudi Aramco, at a punchy valuation (a US$2trn market cap).
- This is why Saudi did all it could to try and keep the oil price around US$50/bbl.

Russia total crude oil production



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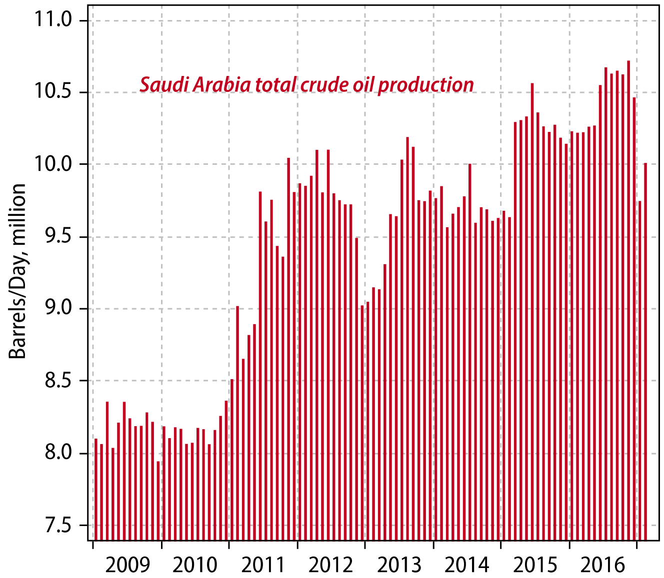
Saudi Arabia total crude oil production



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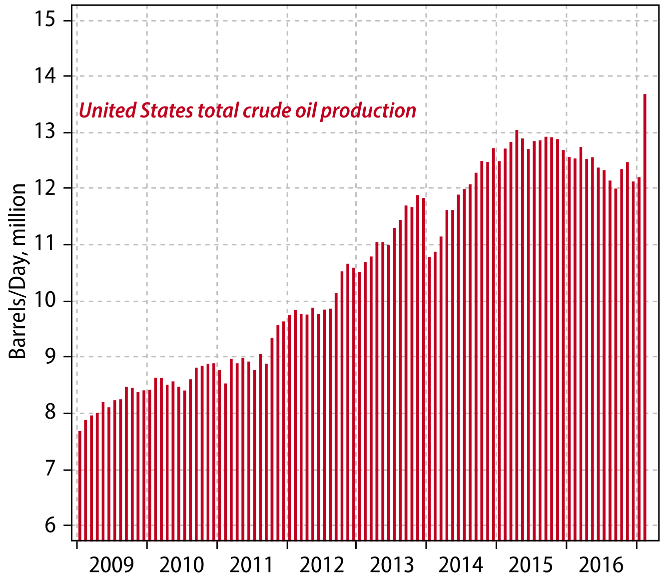
United States total crude oil production

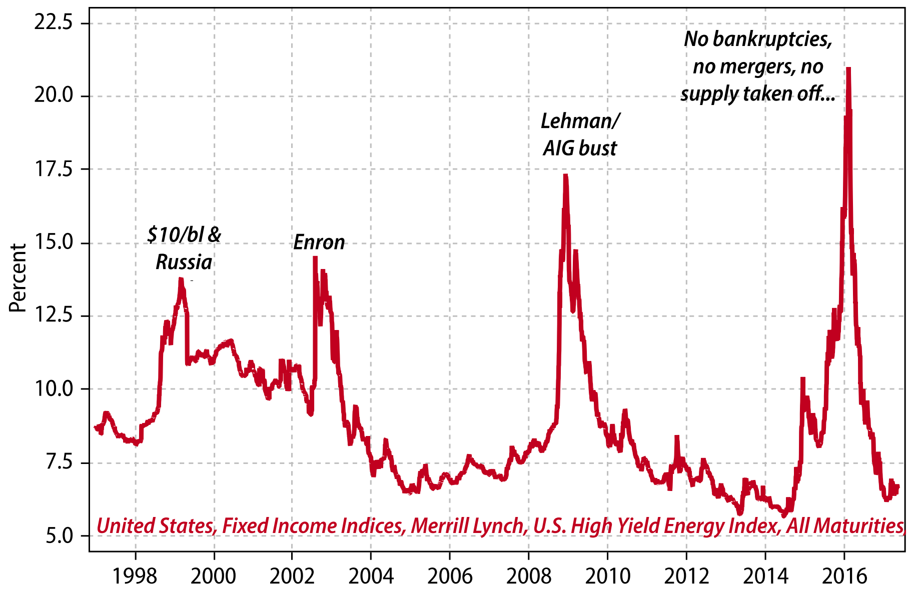


Gavekal Data/Macrobond

Could the falling price of energy be a problem for the US market?

- The obvious answer should be "no". After all, the energy sector has already fallen from 12.5% of the S&P 500 (in 2011) to 7.5% today… The energy sector's recent underperformance is pushing it into gradual irrelevance.
- But, at the same time a lot of capital was invested in energy between 2005 and 2015; whether in the form of debt, private equity, bank loans, etc. So much so that, when oil was plummeting in early 2016, the correlation between bank share performance and the oil price moved to 1:1. The fears of energy company bankruptcies in turn triggered fears of banks' derivative exposure.
- Which brings us back to the fact that "demand-led" cycles usually end because of a policy mistake (rise in interest rate, tax hike, protectionism…) while a "supply-led" cycle usually ends when large amounts of capital have been misallocated and the returns on capital fall below their cost. Could the US economy struggle with energy write-offs?

Merrill Lynch US high yield energy index yield



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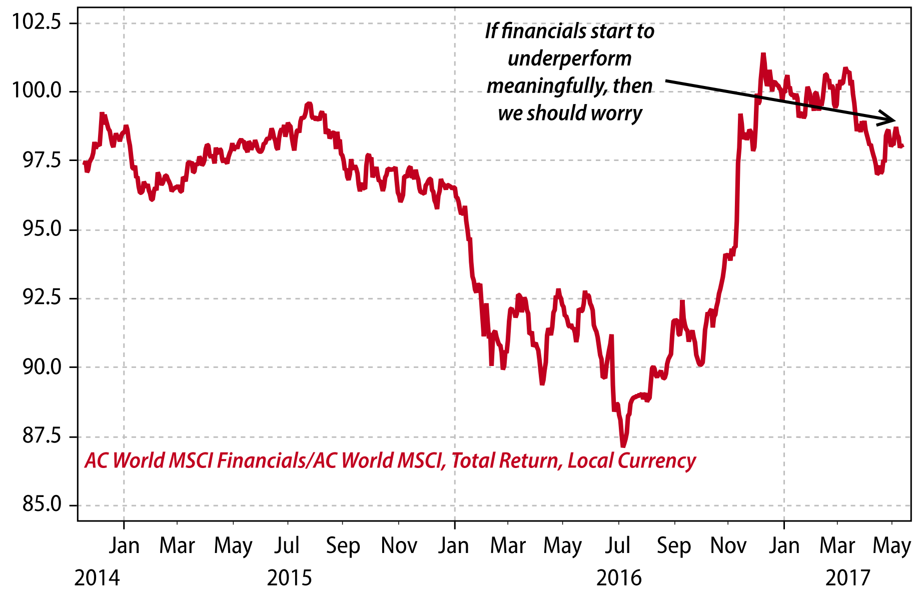
Relative performance of Global Financials to World MSCI AC



Gavekal Data/Macrobond

2 — The return of emerging markets

Contrary to widespread belief, there was no EM balance sheet crisis

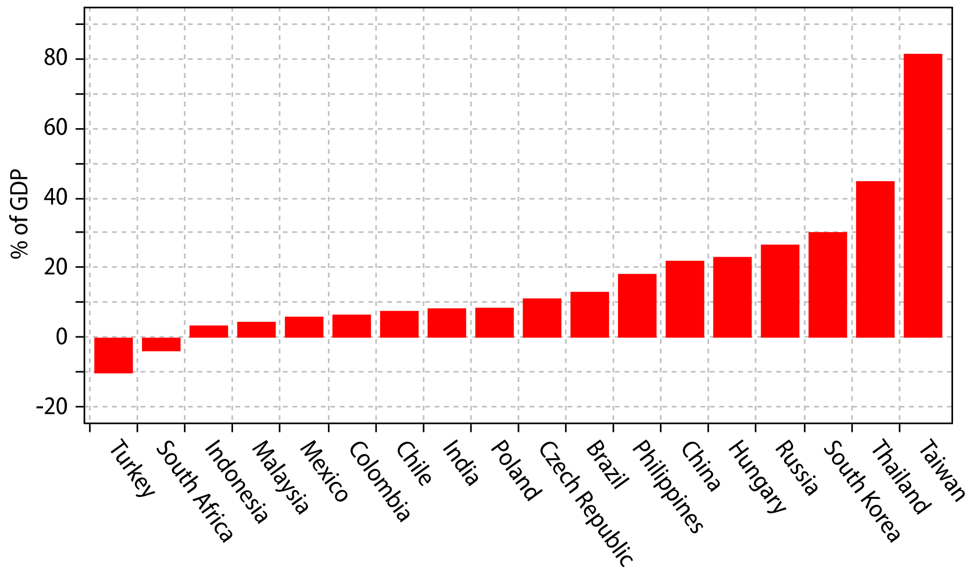
The depreciation of EM currencies does mean that the system faces stress

Major EM currencies, excluding oil-countries Russia, Mexico and Malaysia, equally weighted

Gavekal Data/Macrobond

EMs mostly have a solid foreign currency reserve buffer

(FX reserves - ST external debt) + 2 years C/A Balance, % of Trailing 12M GDP [Monthly data]

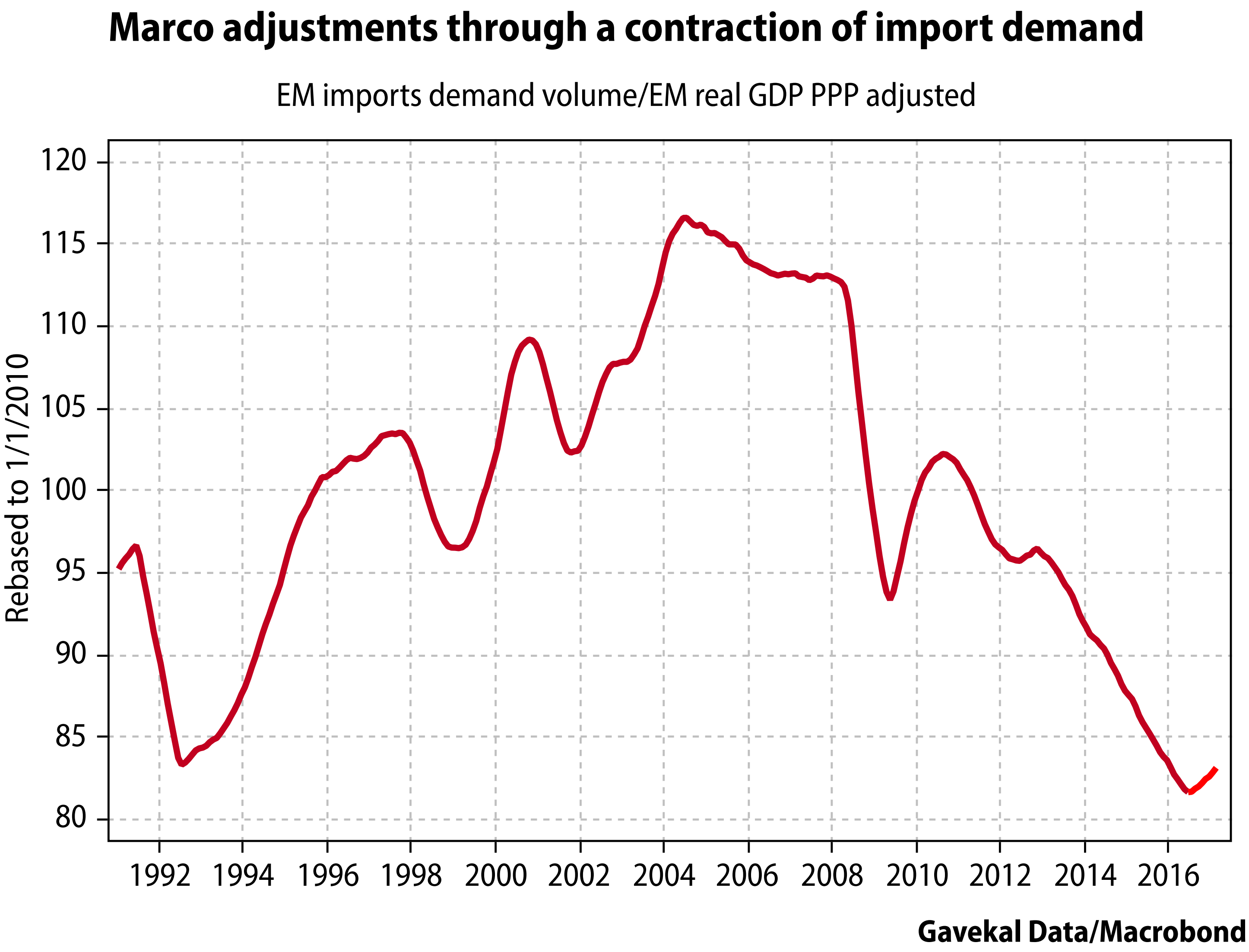


Gavekal Data/Macrobond

Investors' biggest fear about EMs is their ability to repay foreign currency debt. This burden has been a particular concern in the aftermath of a currency devaluations, when EM borrowers have struggled to repay debt from (devalued) domestic cash flows. The good news today is that emerging economies have less of an asset-liability mismatch than in previous economic cycles.

Since the Asian financial crisis of the late 1990s, EMs have accumulated sizeable foreign exchange reserve buffers and pools of public wealth through sovereign funds. This has given them a liquidity buffer and also the flexibility to pursue a rebalancing via a currency depreciation without incurring the immediate risk of a debt default.

Macro adjustments are more than half way through

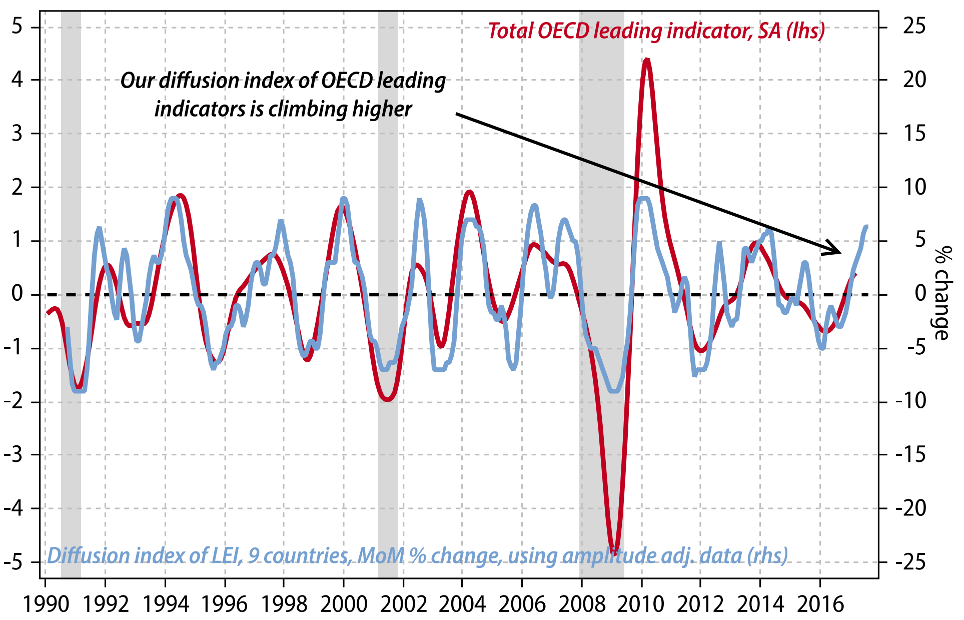


After the 2013 "taper tantrum" and 2014 commodity bust, many EMs saw their external position sharply worsen.

What followed was a belt-tightening adjustment that crimped imports. As a result, the import-to-GDP ratio across EMs has fallen to a level not seen in 25 years. That process seems to have run its course.

A synchronized global recovery benefits exporters

The diffusion index of leading indicators is climbing higher



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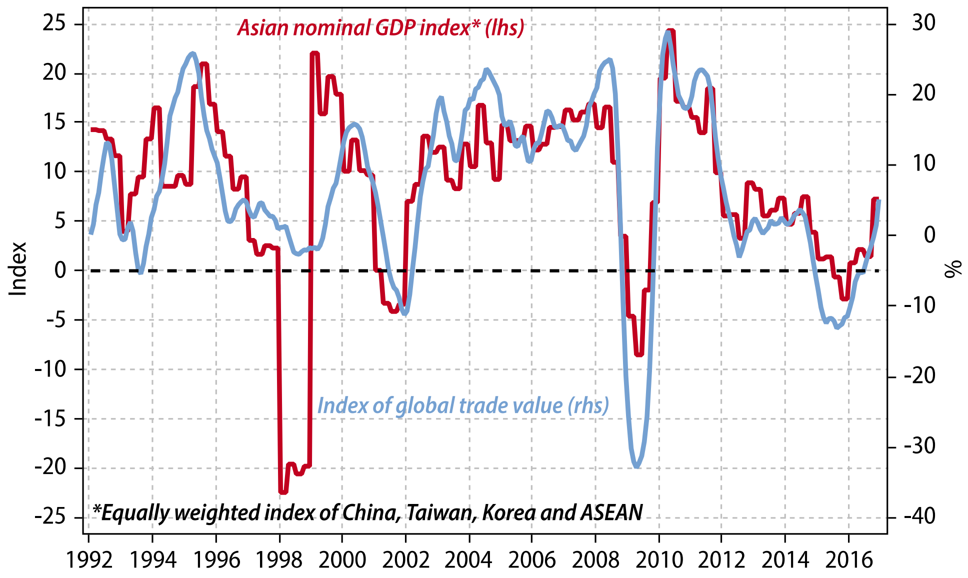
The EM Asia growth cycle is synchronised with the global trade cycle

EM Asian GDP growth index vs global trade, YoY % change



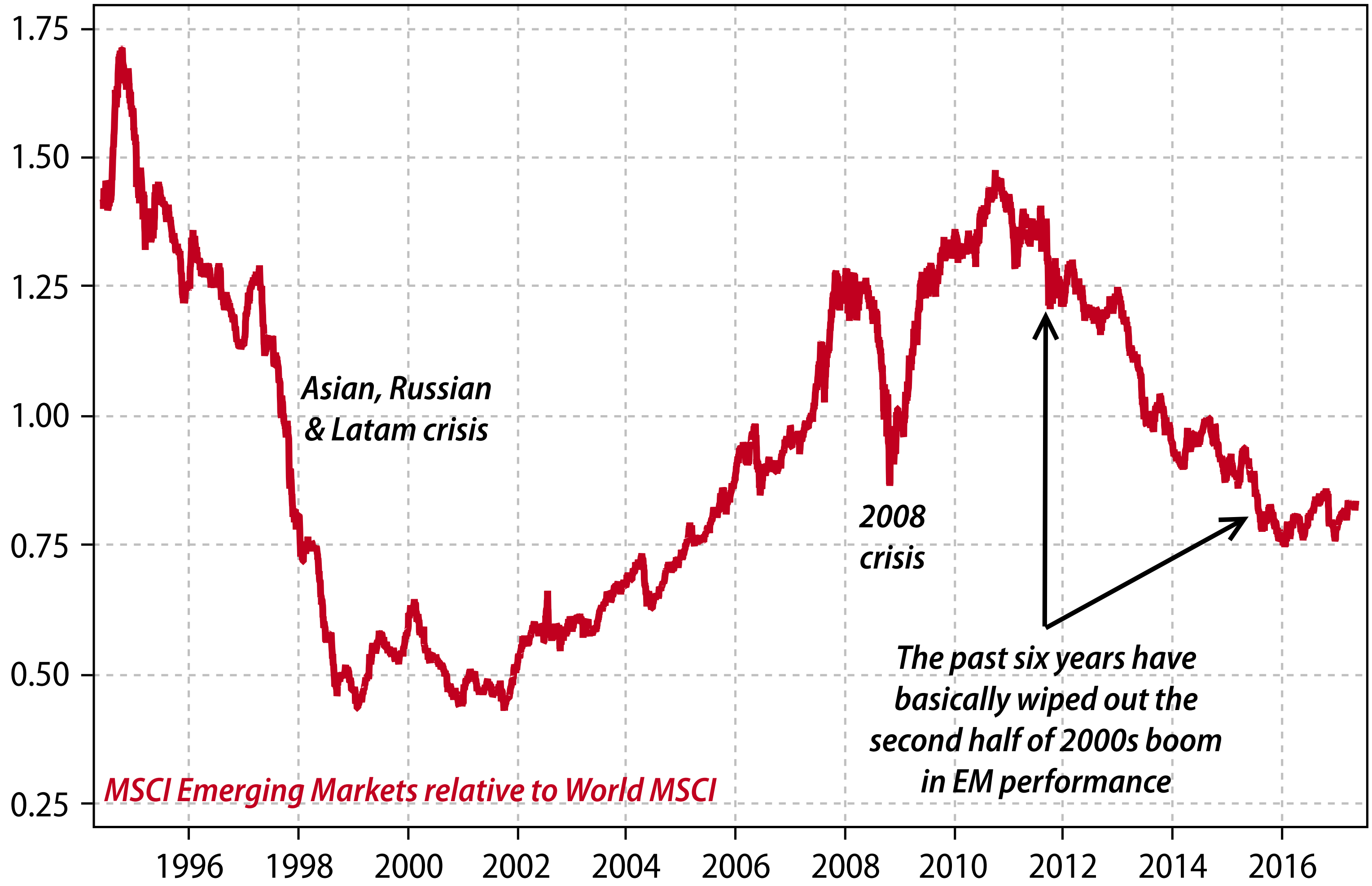
Gavekal Data/Macrobond

Cyclical growth measures have picked up as shown by the OECD's latest composite leading indicator. Historically, such an upturn in the developed world has been a reliable signal for identifying turning points in Asia's growth and profits cycle.

Economic growth in EM Asia (measured in nominal US dollar terms) has historically tracked world trade growth closely. Since Asian firms typically have high operating leverage and work in globalized supply chains, their earnings and investment cycles are disproportionally impacted by changes in global demand.

And sure enough, right on time, EMs are done underperforming

After six years of underperformance, are EMs set for a structural upturn?



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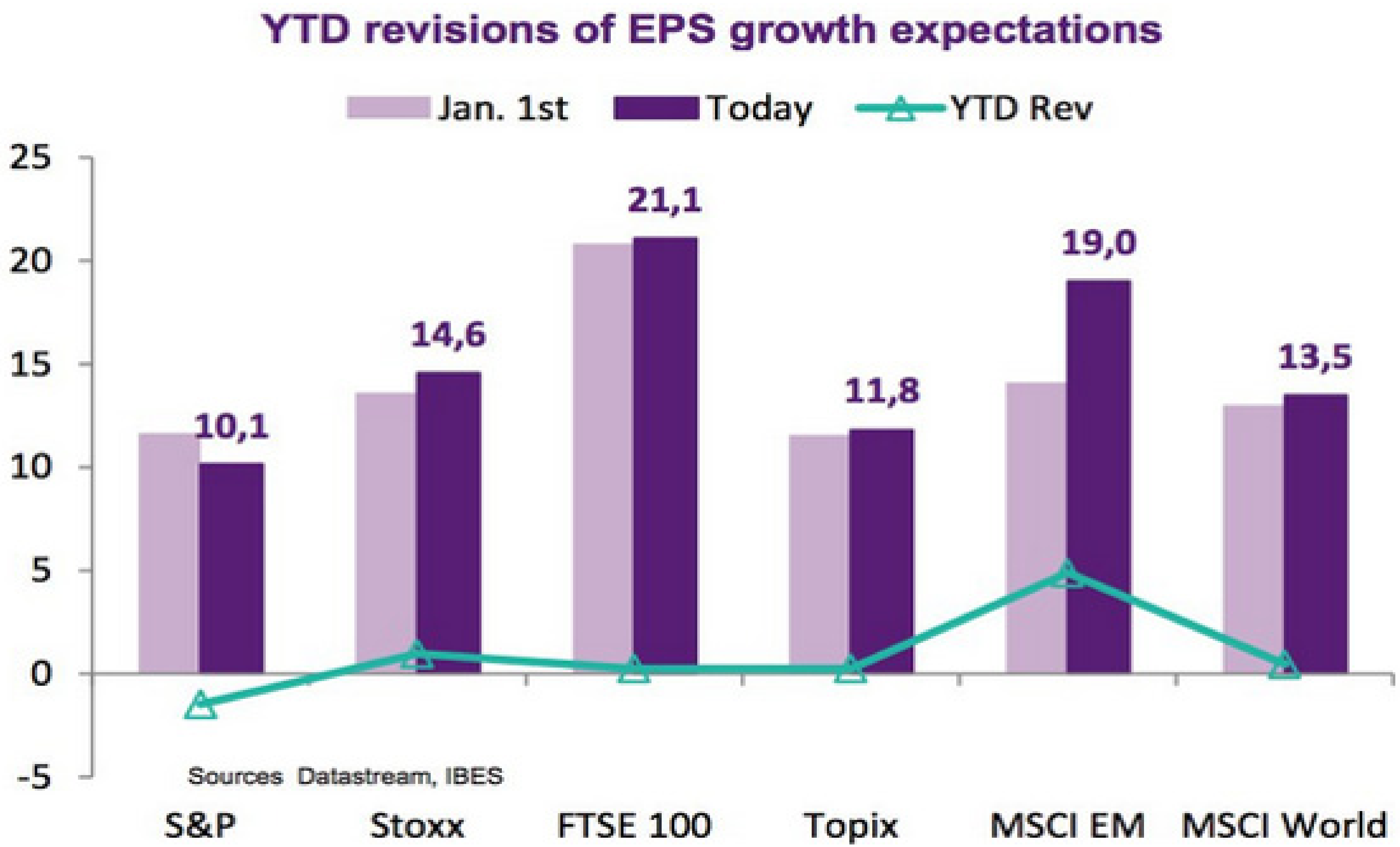
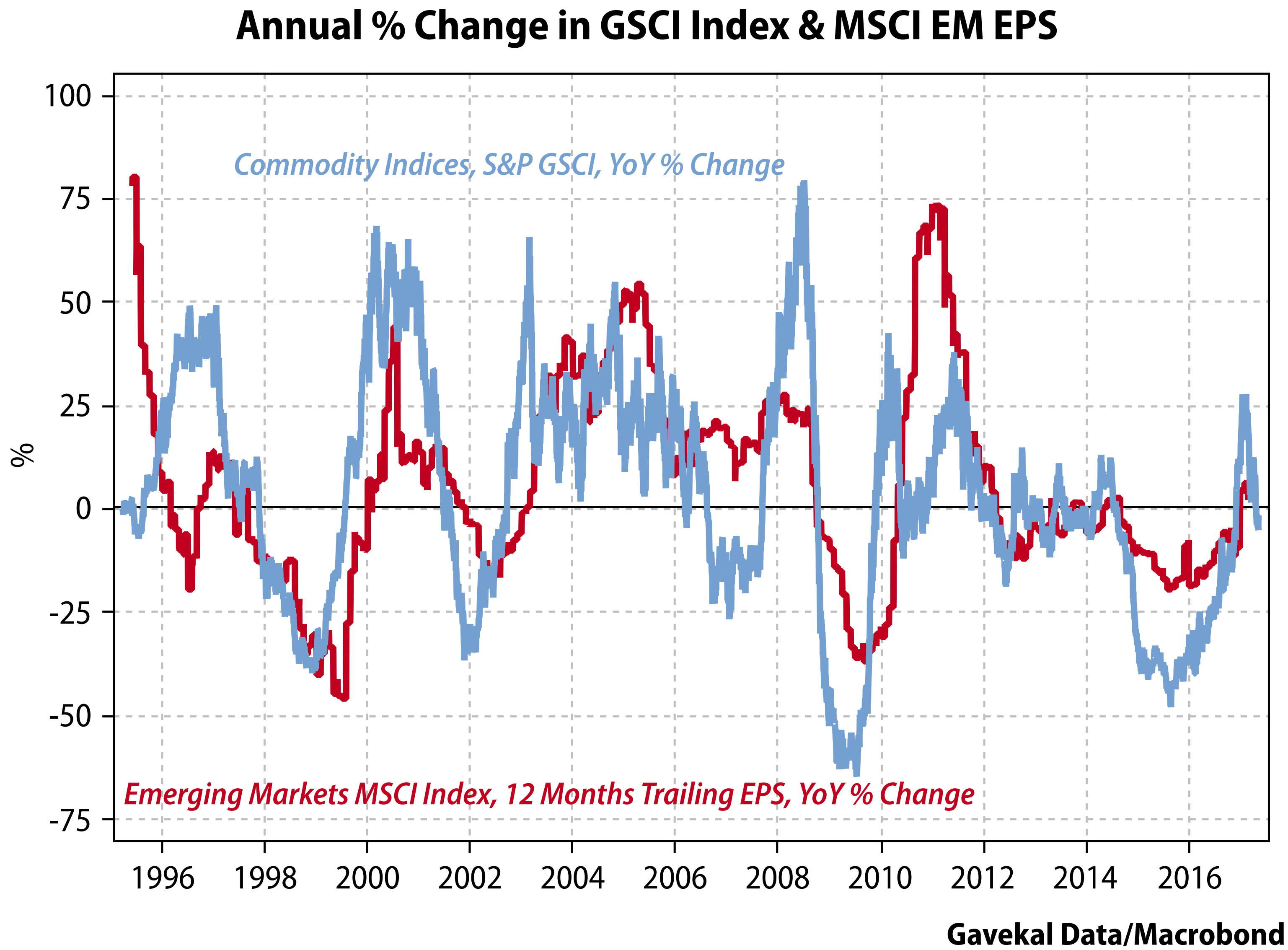
The EM rebound reflects not only the weaker US$, but an EPS growth reality

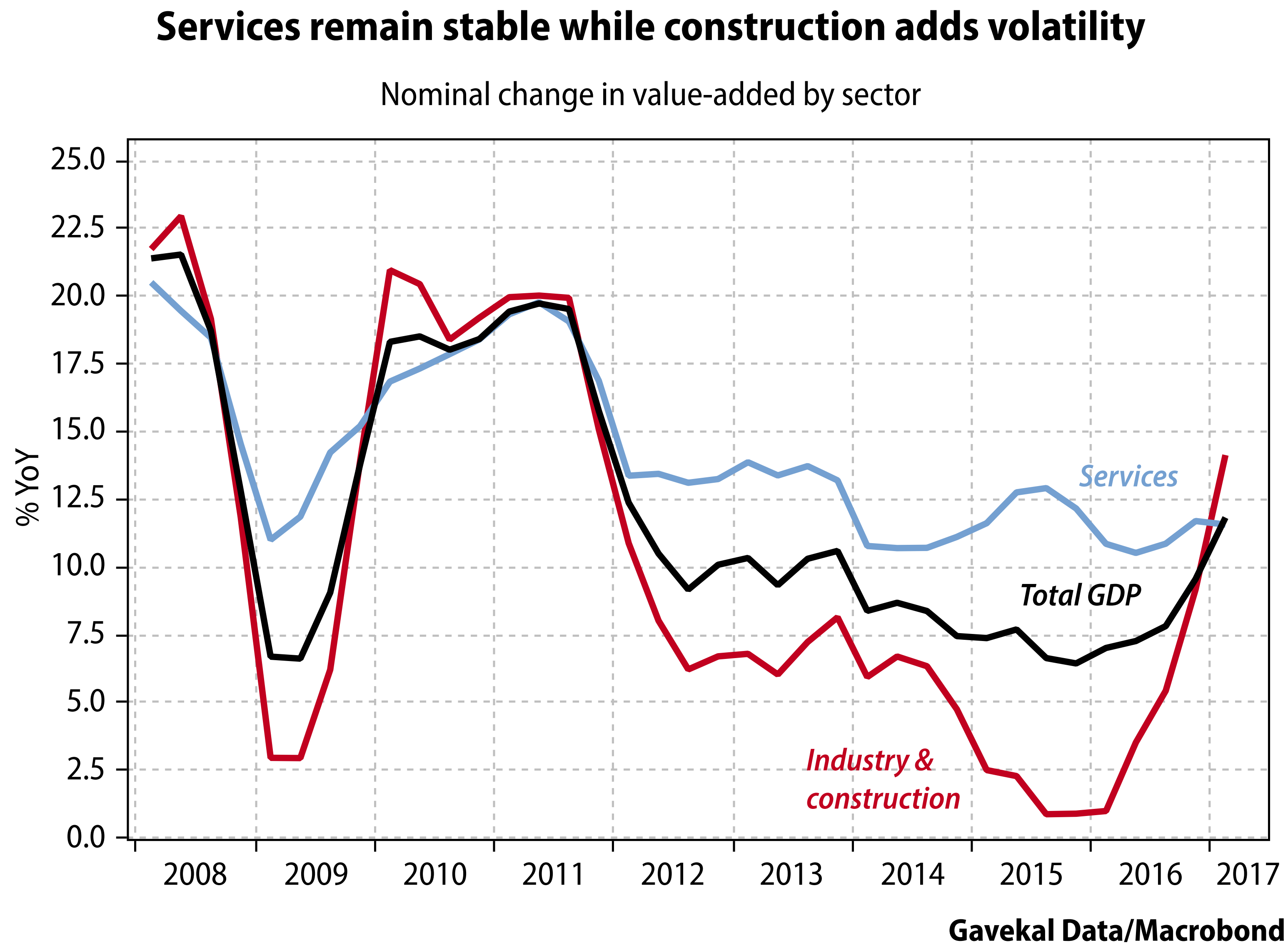


Source: Natixis, WSJ

But how much of the EM EPS rebound is linked to rising commodity prices?



And how much of the commodity rebound is linked to China's 2016 stimulus?

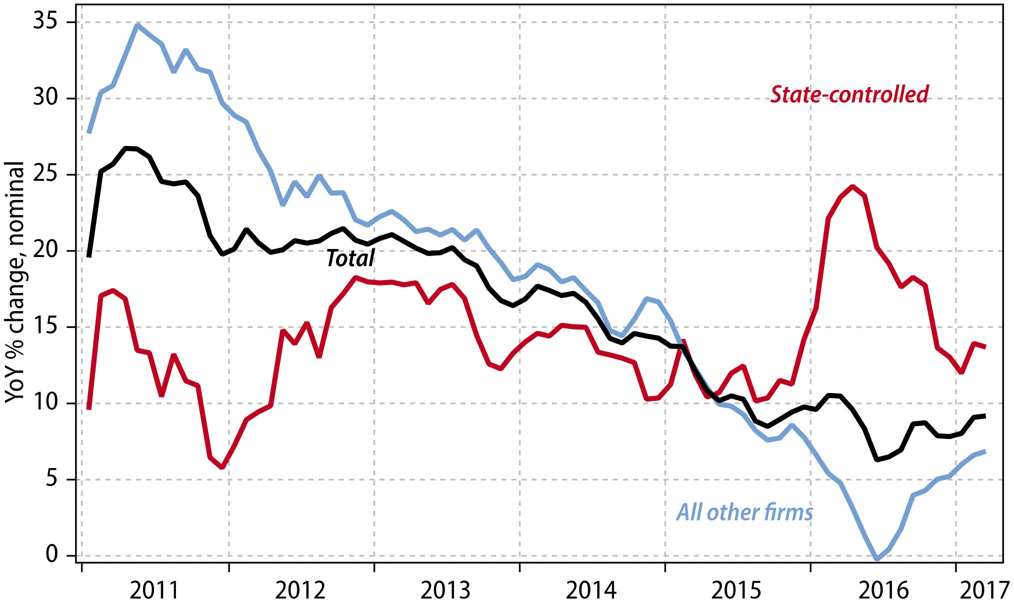


In a year full of surprises, the big 2016 surprise was China's reflation

But the reflation was done through SOEs

Investment growth has stabilized recently as SOE spending picks up

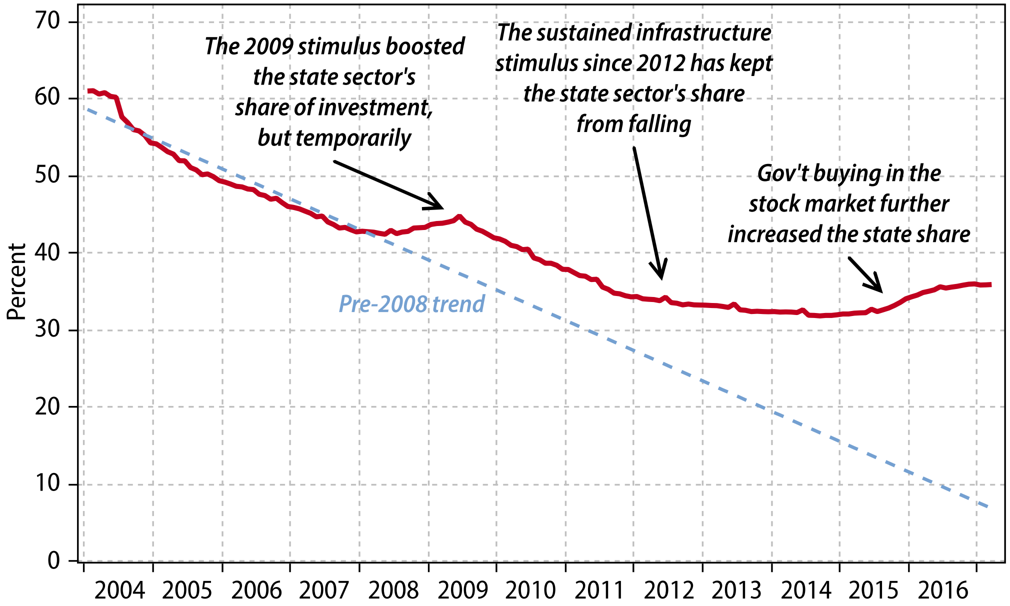
Fixed-asset investment by ownership of firm, 3mcma



CEIC, Gavekal Data/Macrobond

The retreat of the state sector has ended

State-controlled firms' share of fixed-asset investment, 13mcma

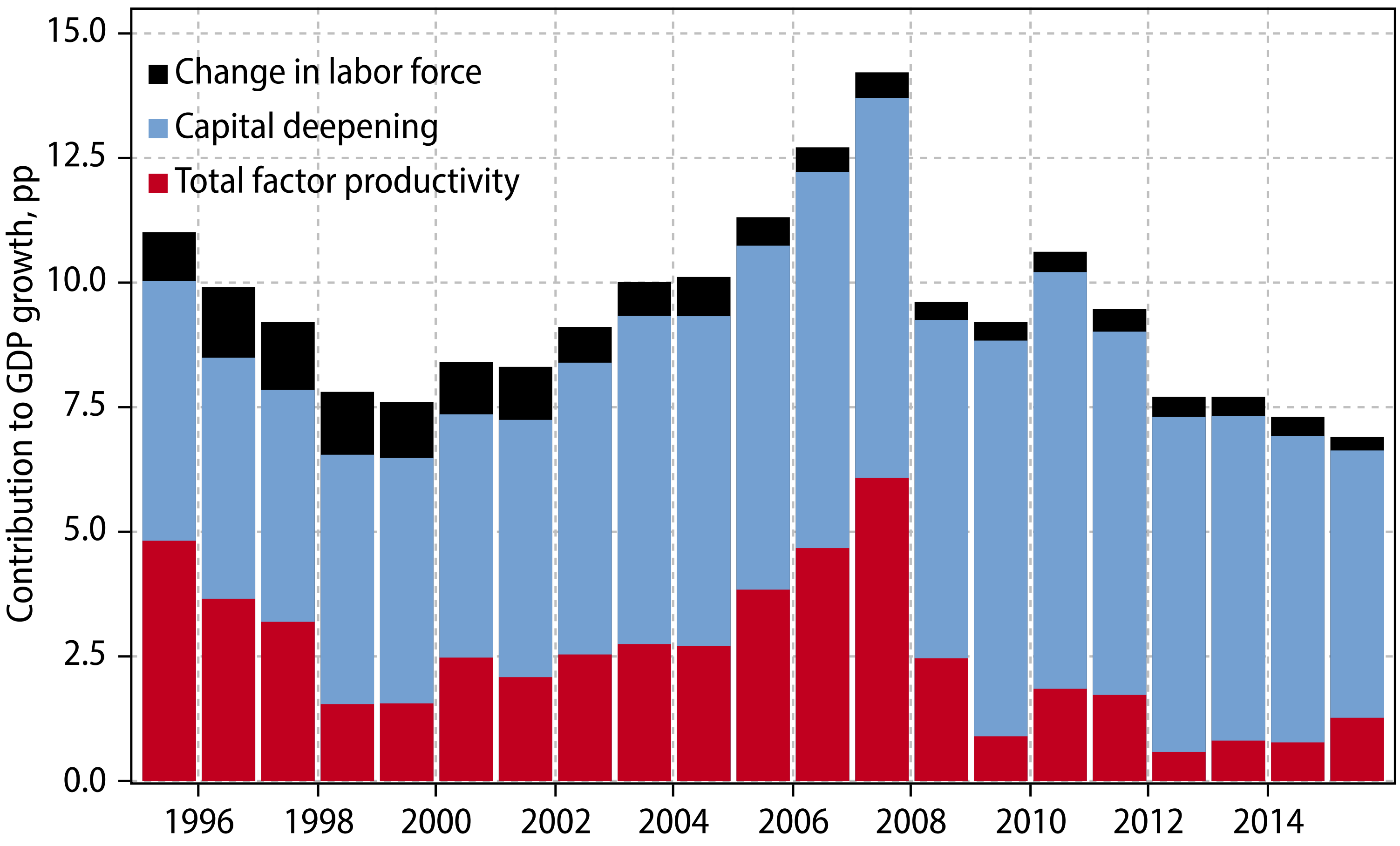


CEIC, Gavekal Data/Macrobond

Which hurts productivity growth

China's productivity growth has deteriorated sharply

Conference Board estimates, using GDP at PPP



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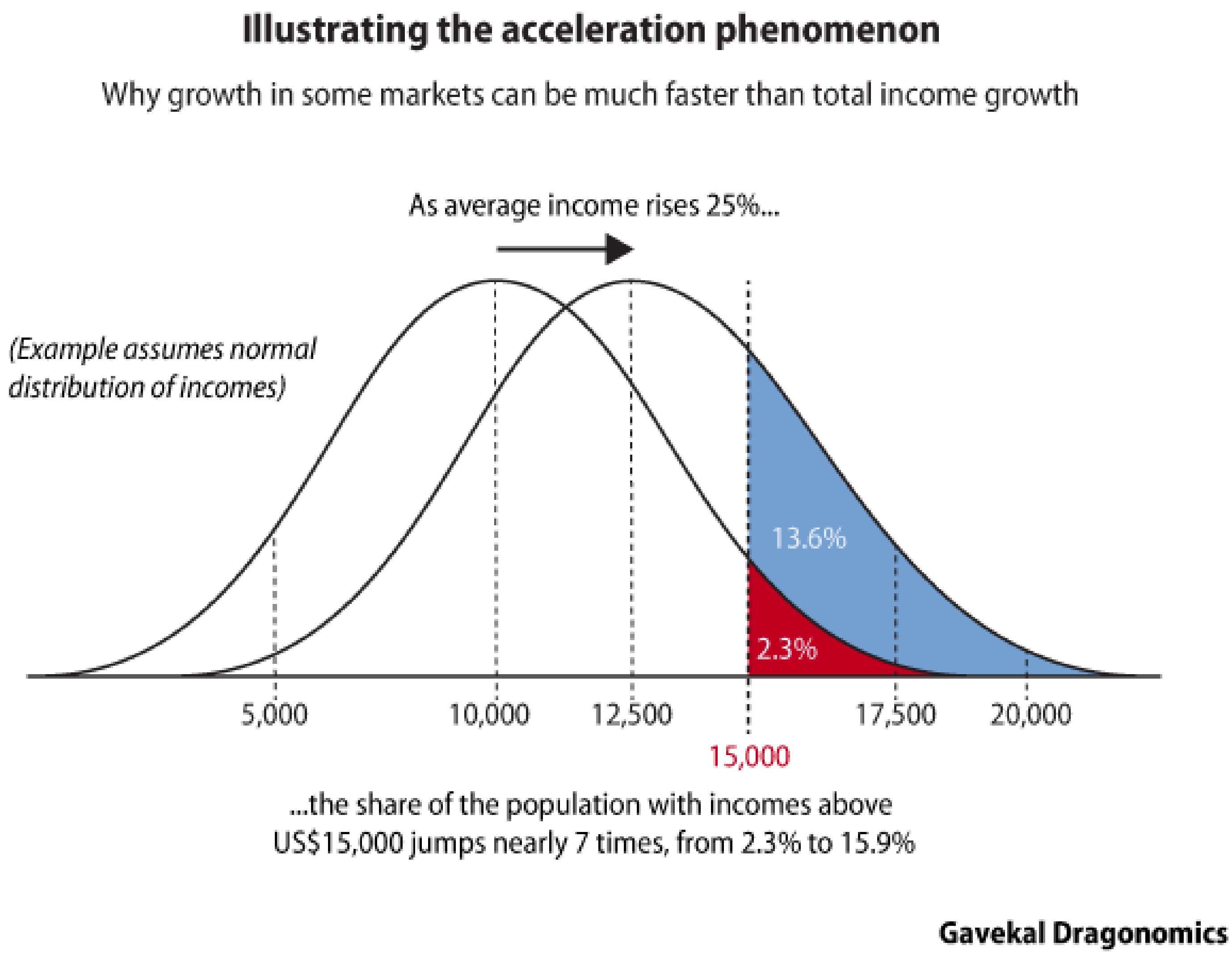
And needless to say, capital misallocation isn't that great for returns on capital

But growth will not implode as the "Acceleration Phenomenon" kicks in



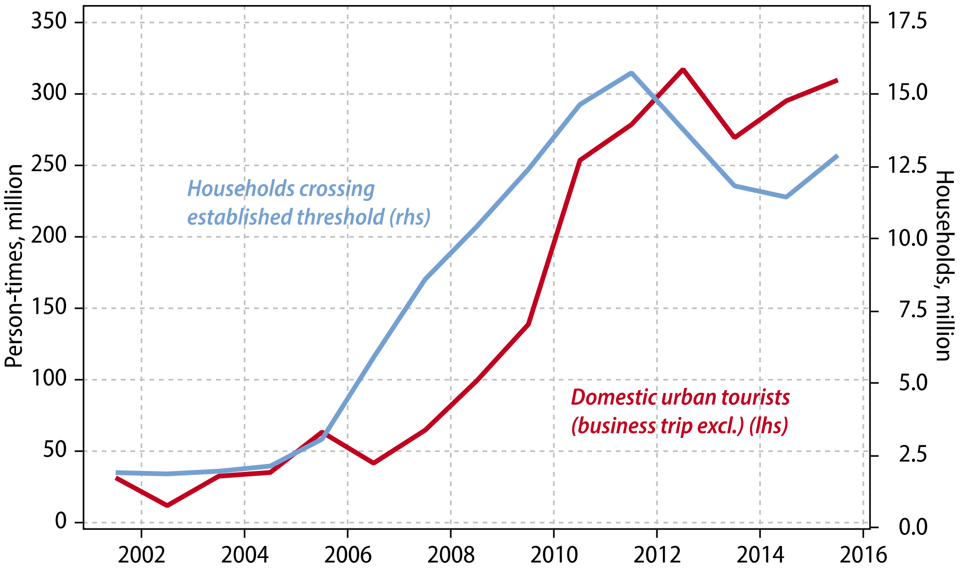
Our framework for identifying winners and losers in the consumer market is the "acceleration phenomenon": the fact that spending on particular goods and services accelerates sharply when lots of households cross the appropriate threshold of affordability.

As the diagram illustrates, markets for individual goods and services can grow many times faster than average income when lots of households are crossing the right threshold. In markets like China, or India, the number of consumers going through thresholds can be massive.

The acceleration phenomenon in Chinese tourism

Domestic tourism has plateaued along with established households

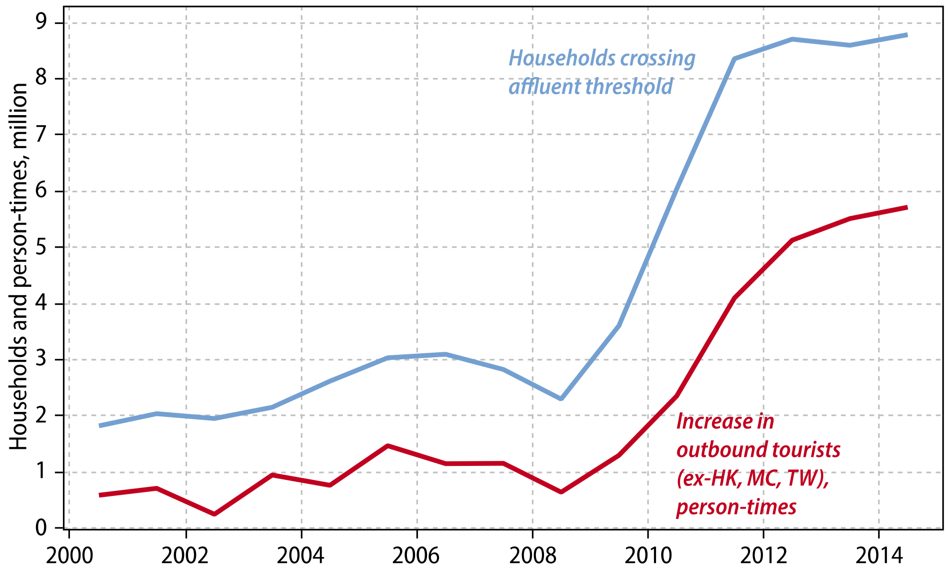
Annual increase of tourist visits vs. households crossing thresholds, 3ycma



Wind, Gavekal Data/Macrobond

Affluent households driving recent surge in Chinese overseas travel

Annual increase of tourist visits vs. households crossing thresholds, 3ycma



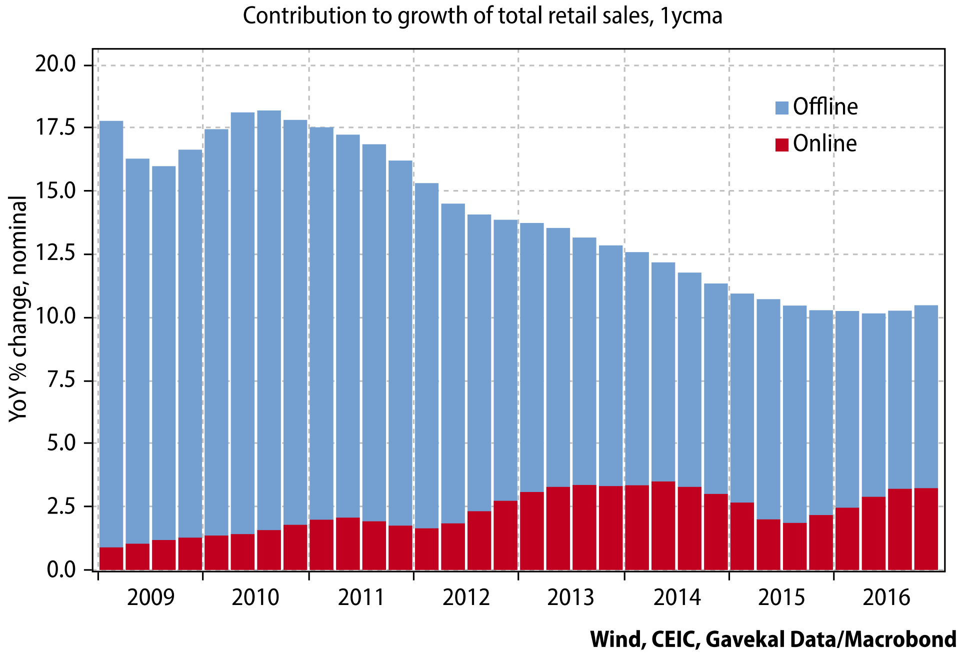
UNWTO, Wind, Gavekal Data/Macrobond

Domestic tourism excluding business trips was about 500mn trips a year in 2005, and then increased by 40-60mn trips a year to 2008. Then growth in domestic tourism exploded as the number of established consumers also accelerated. But since 2010, growth in the number of established households has stopped accelerating, and so has growth in domestic tourism.

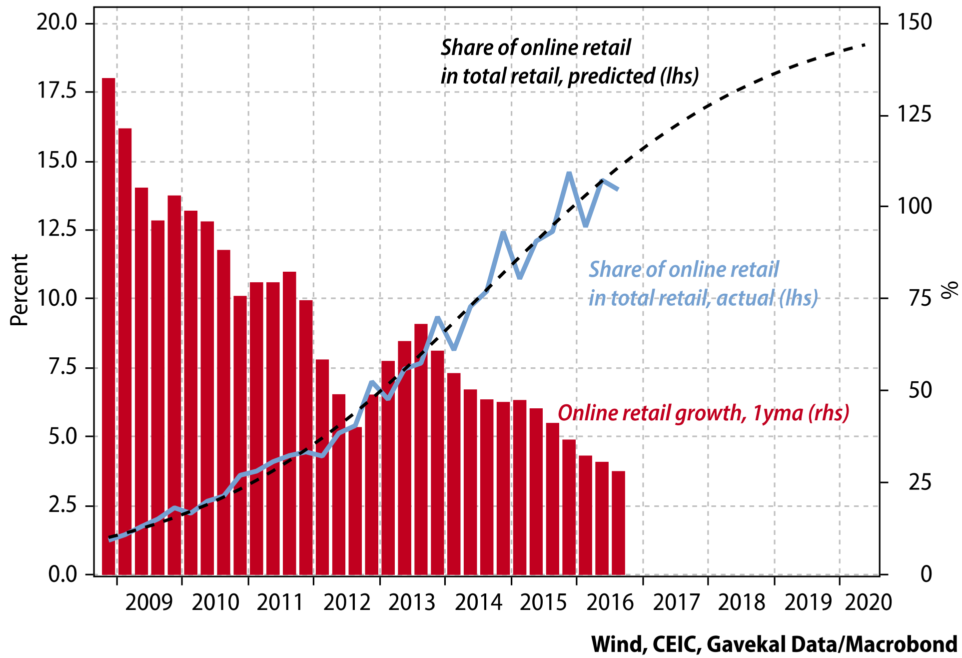
The acceleration phenomenon is now strongest for affluent households, who seem to thirst for the new experience of foreign travel. As households crossing the affluent threshold surged from around 2mn in 2008 to over 9mn since 2012, the annual growth in foreign tourists also surged from 0.6mn to nearly 6mn. The trajectory of the acceleration phenomenon should mean that foreign tourism has a few more years of rapidly accelerating growth before it starts to cool down.

Online shopping is a big growth driver, but it is also slowing

Nearly one-third of retail growth comes from online shopping



Online retail is also shifting onto a slower growth trajectory



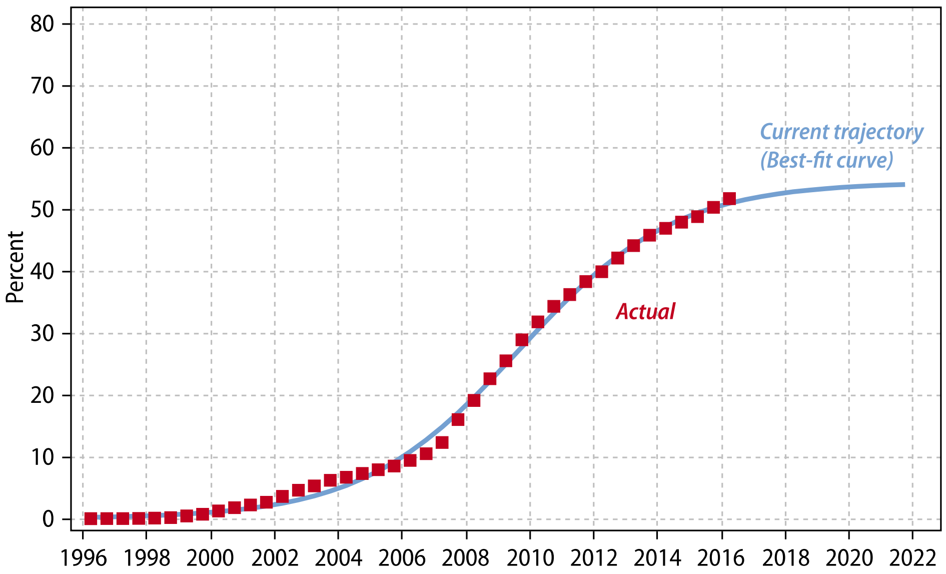
The boom in online shopping is the most significant new growth story to emerge during the gradual slowdown of consumer spending. Total retail sales growth has come down to around 10% currently from over 15% in the early 2010s; over this period the growth contribution from online retail has doubled. By 3Q16, nearly one-third of the growth in total retail sales came from online. E-commerce in China now has both enormous scale and still quite fast growth rates.

Yet online shopping is increasingly mainstream and mature. Growth in online retail has slowed down to 20%-30% YoY over the past year, from 50-75%. That growth trajectory indicates that online retailing has likely reached the second half of its S-curve, where growth slows rather than accelerates. The share of online retail sales in the total is 12-14% today, and the curve that best fits the historical data indicates it will reach a ceiling of 15-20% in the next few years.

The internet economy is already very mature in urban China

China's internet penetration rate is no longer rising rapidly

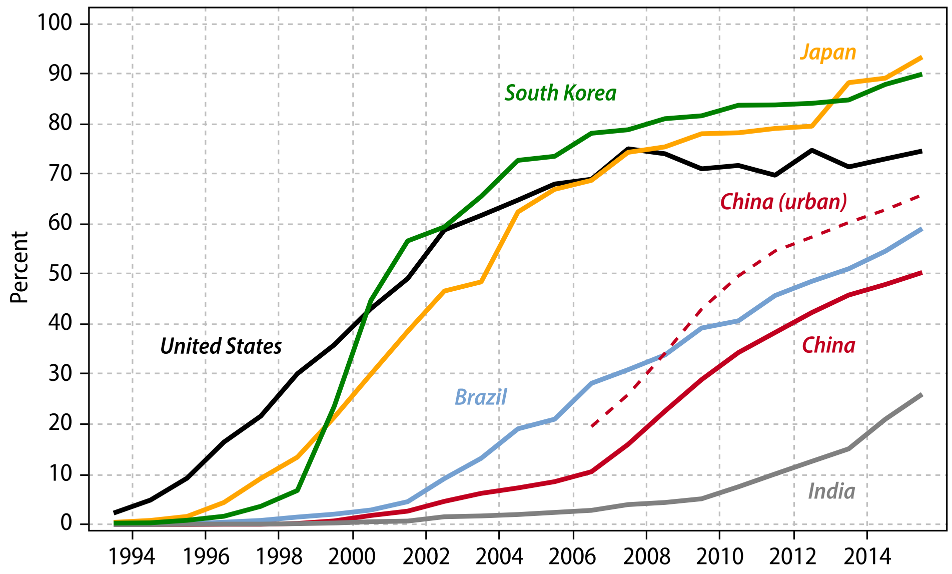
Share of internet users in total population



Wind, Gavekal Data/Macrobond

China's urban internet penetration rate is comparable to other countries

Share of internet users in total population

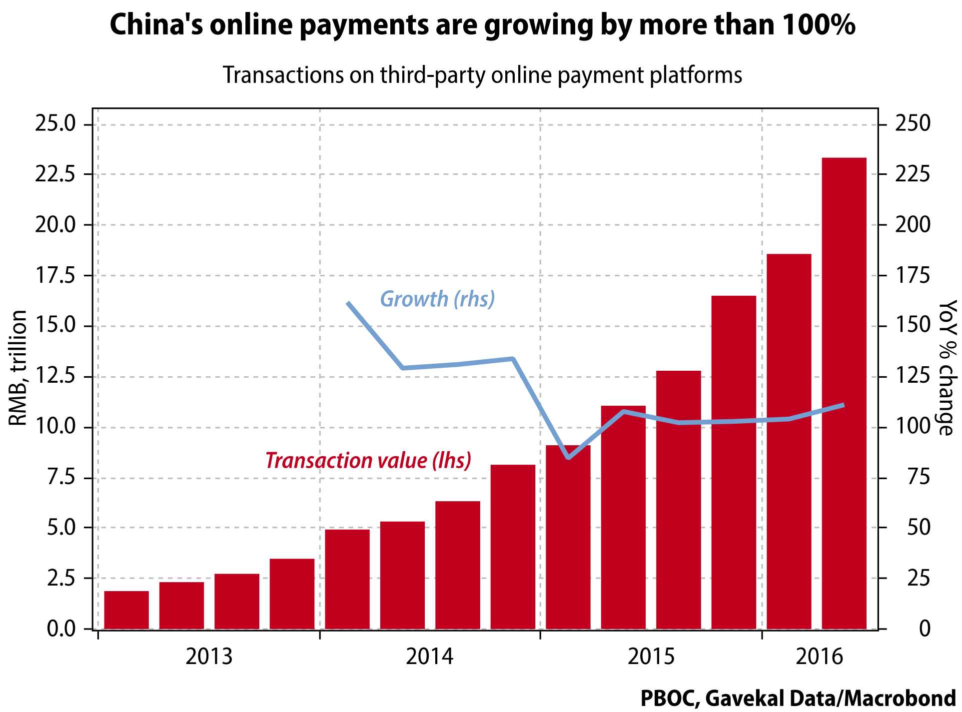


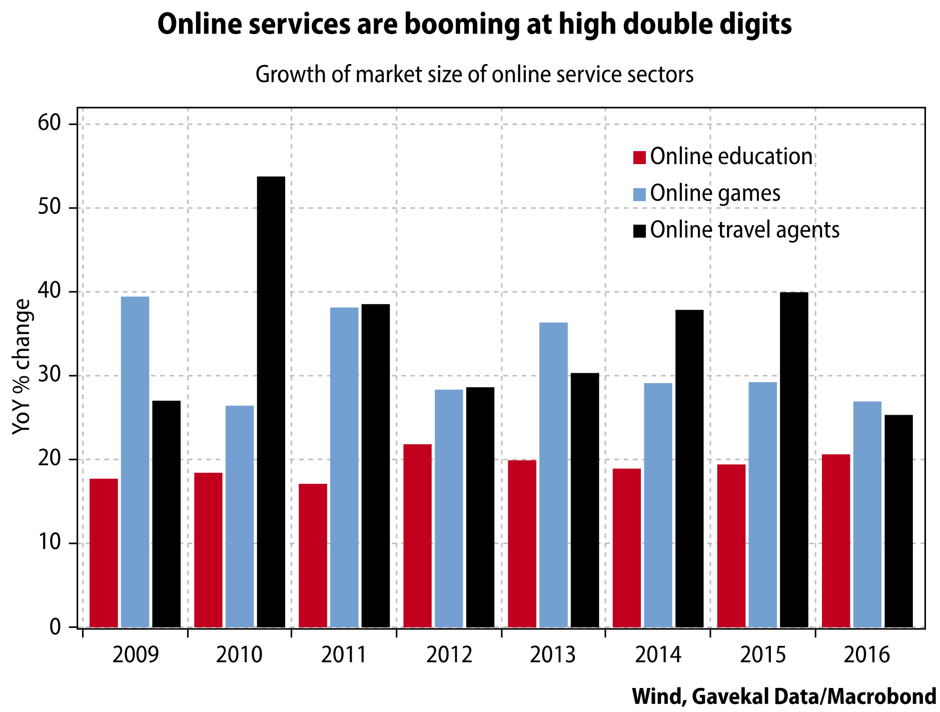
World Bank, CNNIC, Gavekal Data/Macrobond

One of the fundamentals behind the slowing growth of online sales is a slowdown in the spread of internet use. As the internet penetration rate has passed 50%, the growth in the number of new users has also slowed; again, the second half of the S-curve has been reached. Much of the remaining Chinese population that is not online are either urban elderly or rural people with low education levels, and these groups will not go online quickly without technological changes that further lower barriers to internet use.

The internet penetration rate of China's urban population is in fact quite high at 67%, near the 70% where the US and Japan plateaued for a while in the 2000s. This reinforces the (fairly obvious) point that Chinese cities have a large and mature internet economy where most people are accustomed to doing things online. With internet penetration slowing down, future growth in online businesses will come from ever-more intensive use by existing urban internet users rather than a new boom in rural e-commerce.

Services are the fastest growing part of the internet economy





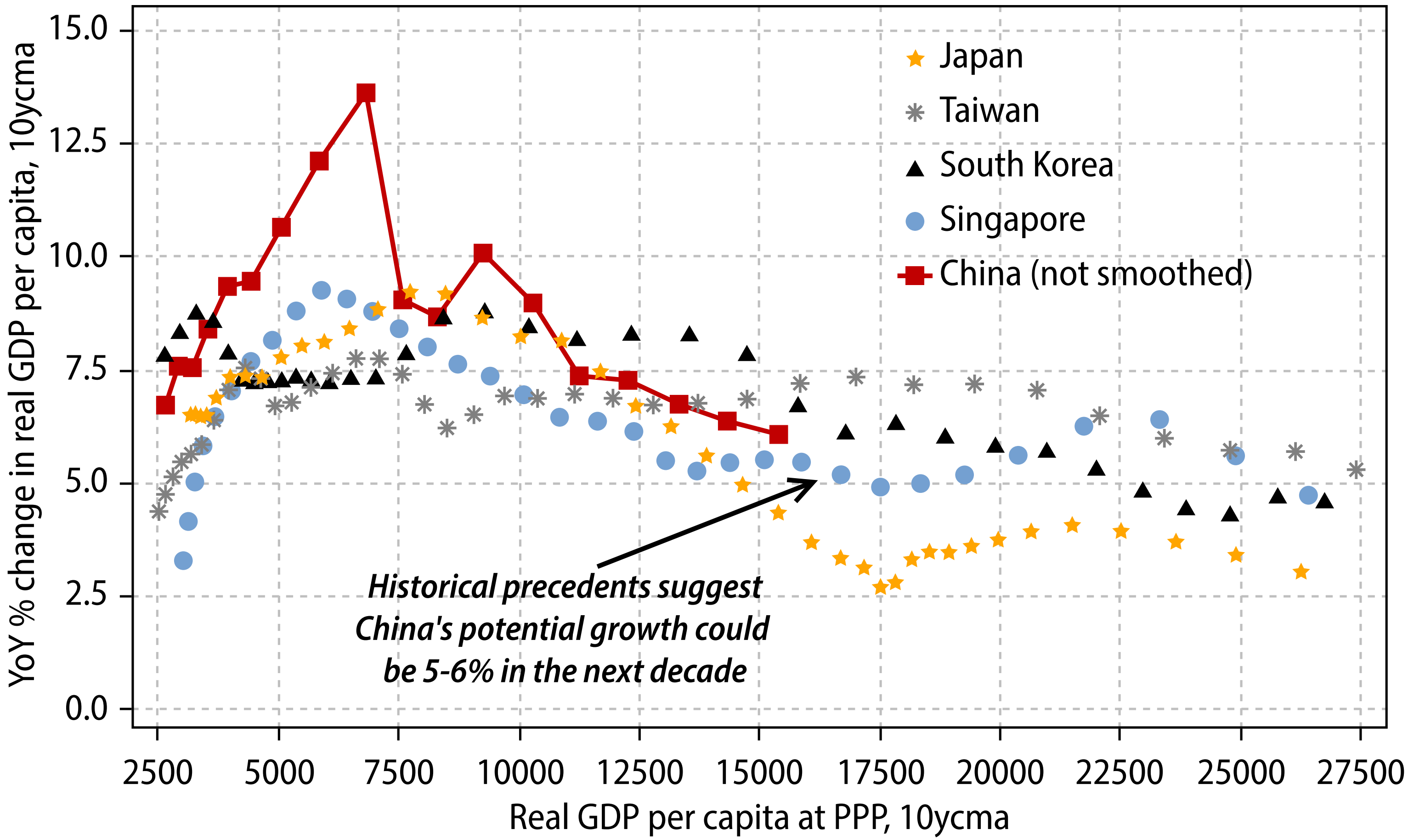
The slowdown of internet penetration and online retail sales does not mean that growth in the total internet economy is weakening, as new applications are allowing more and more transactions to move online. For instance, PBOC data shows that transactions through online non-bank payment platforms are growing by more than 100% annually. Internet companies are already reorienting their investments toward finance and services, focusing their attention on these super-high-growth sectors rather than more mature ones.

There is also clearly explosive growth in new services like ride-hailing apps and online games, and traditional businesses such as movie tickets and trip planning are rapidly transitioning online. The pattern of growth areas in the internet economy thus in some ways mirrors that in consumer spending overall: the fastest growing areas are those catering to the needs of the more affluent and more technologically savvy, and not in sales of basic mass-market goods to lower-income households.

However one cuts it, China's growth rate will weaken in coming years

As China gets richer its growth will keep slowing

Trend growth rates and level of development for successful Asian economies



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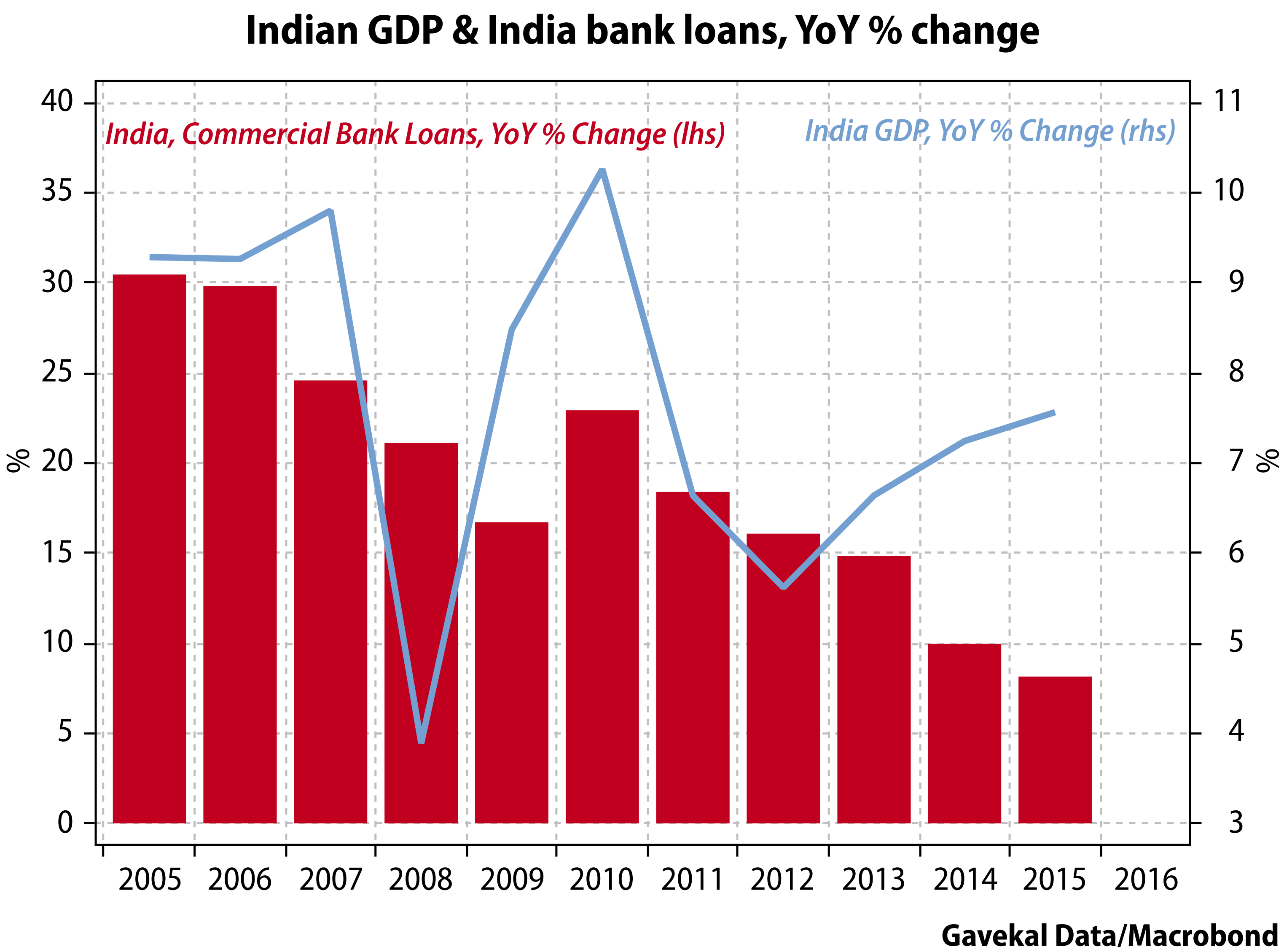
Can India pick up the slack?



Ability to bounce back quickly, and stronger, from own-goals is encouraging

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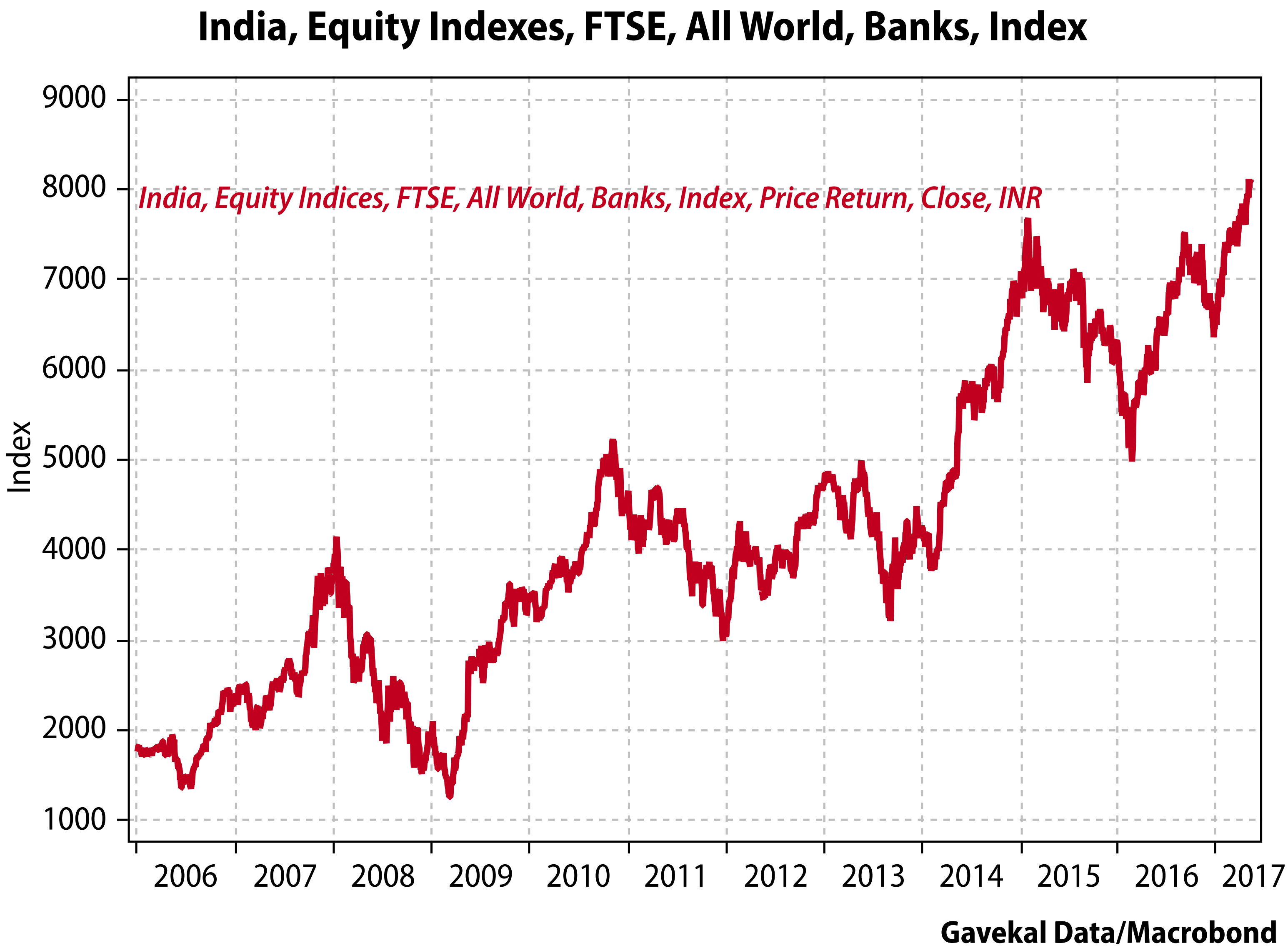
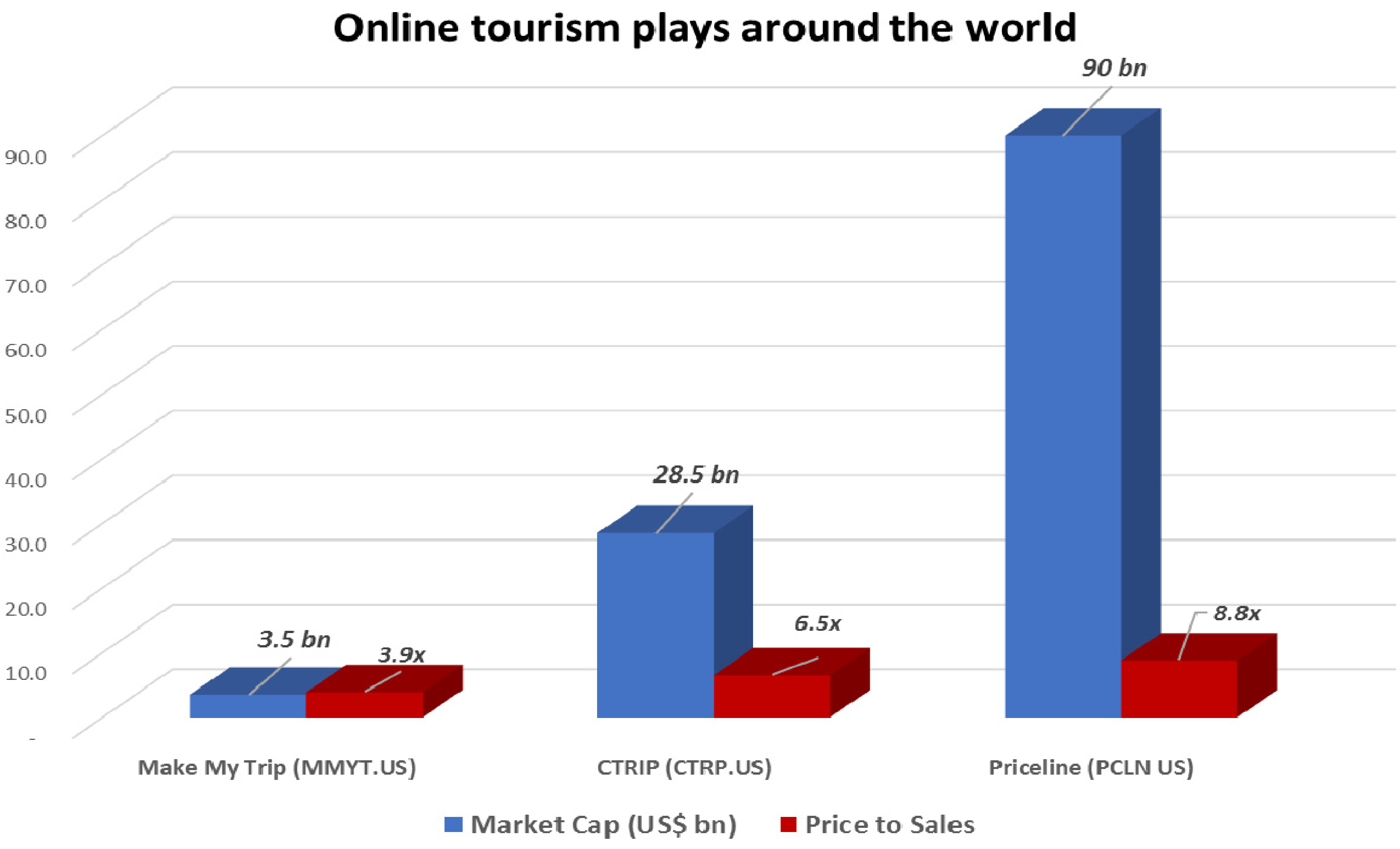
Indian bank reform is very important for India, and possibly for EM!



Do valuations really reflect India's long-term growth trajectory?



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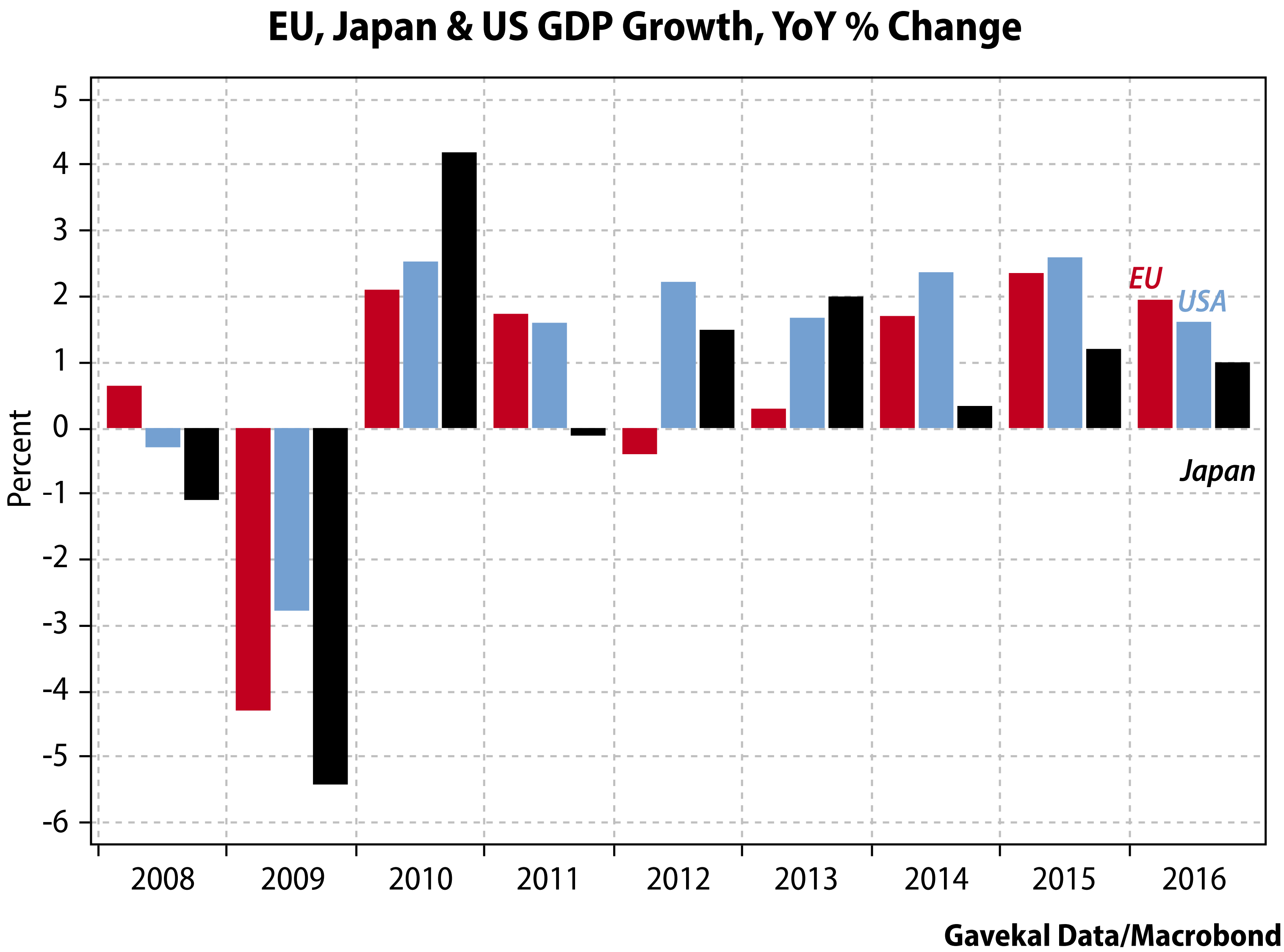
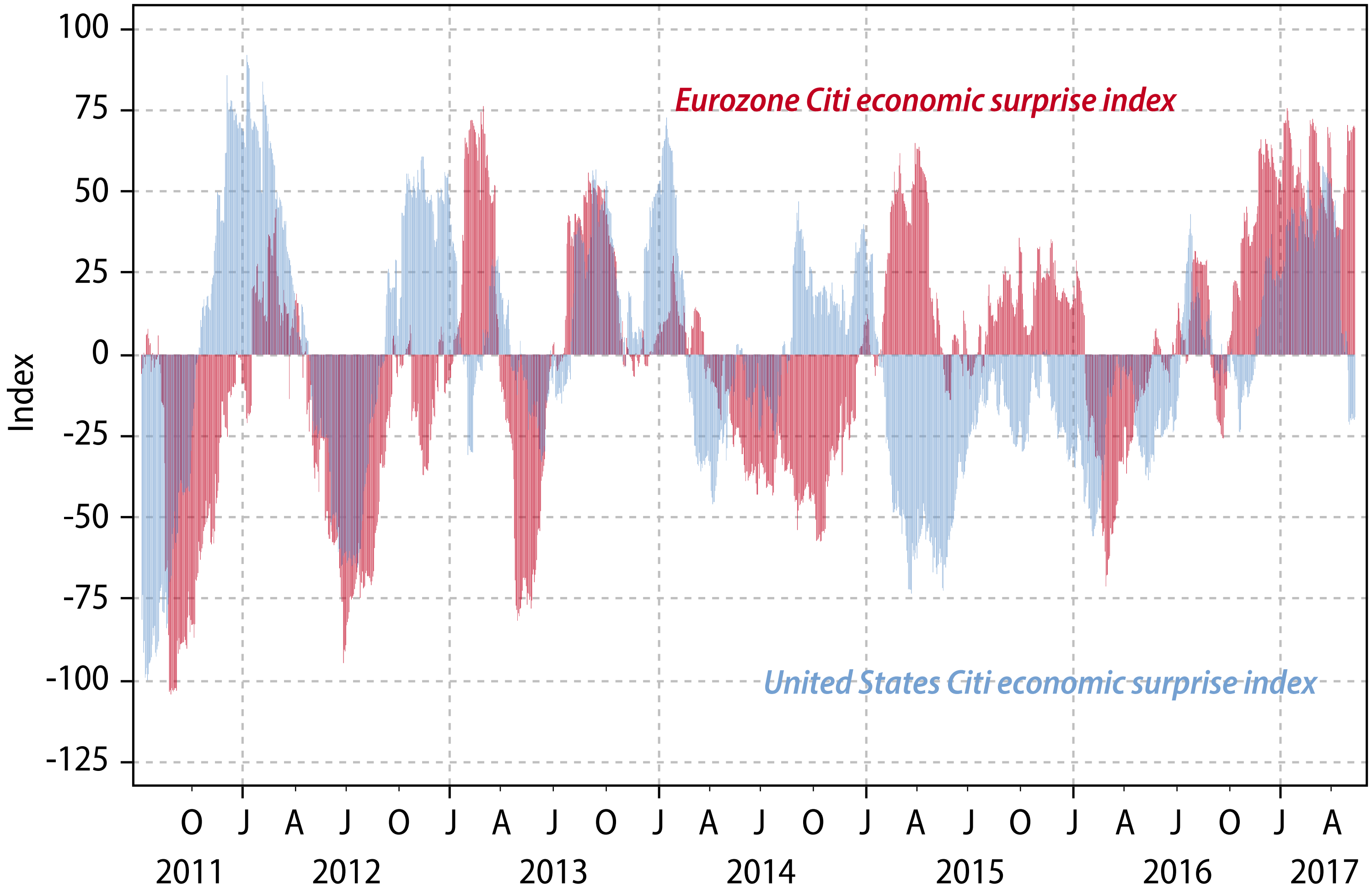
3 — Europe: the world's genuine coiled spring

In 2016, European growth actually outpaced US growth



And recent economic tailwinds continue to favor Europe over the US

US now delivers negative economic surprises; Europe surprises on upside



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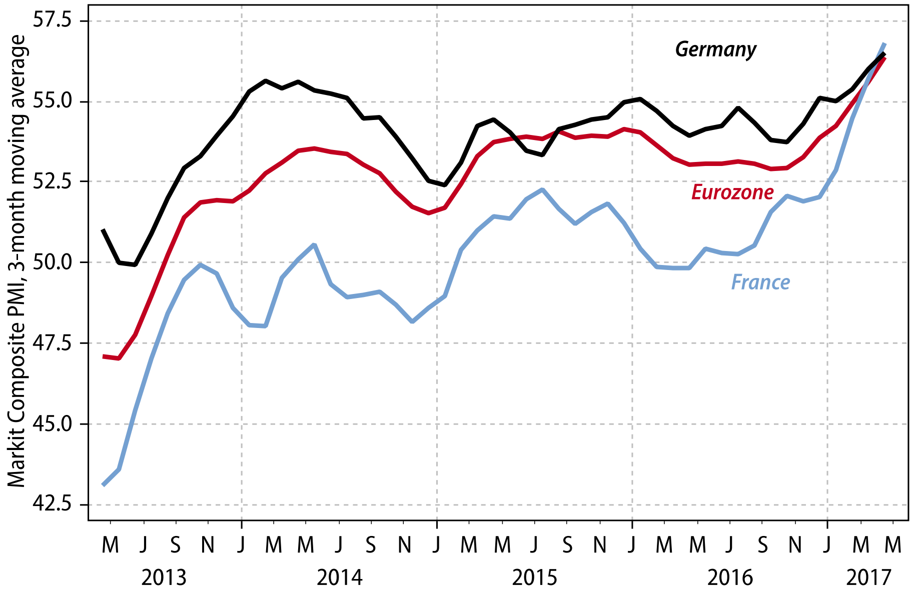
The eurozone recovery is becoming self-sustaining

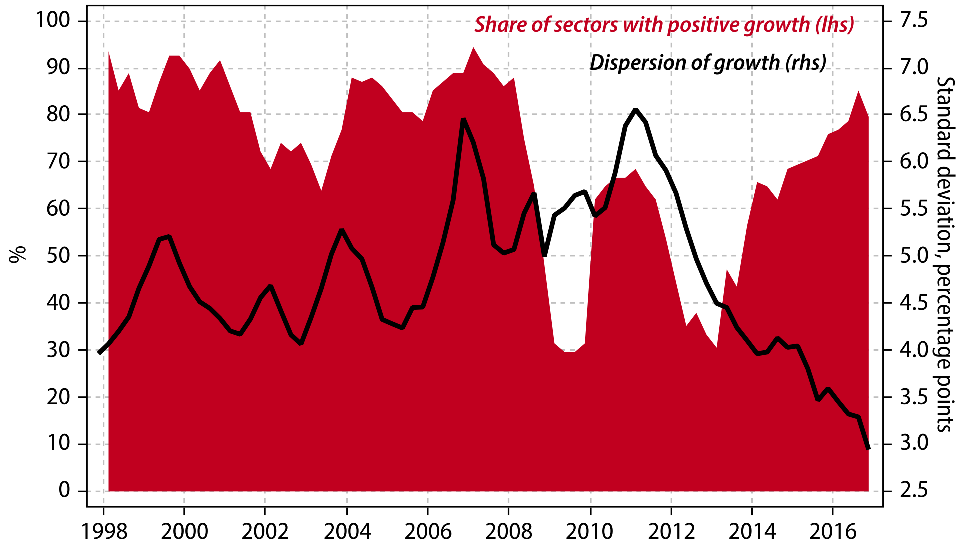
The French economy is finally catching up



Gavekal Data/Macrobond

Growth is spread more evenly across sectors than in years

Using broad economic sectors for the 12 largest EZ countries



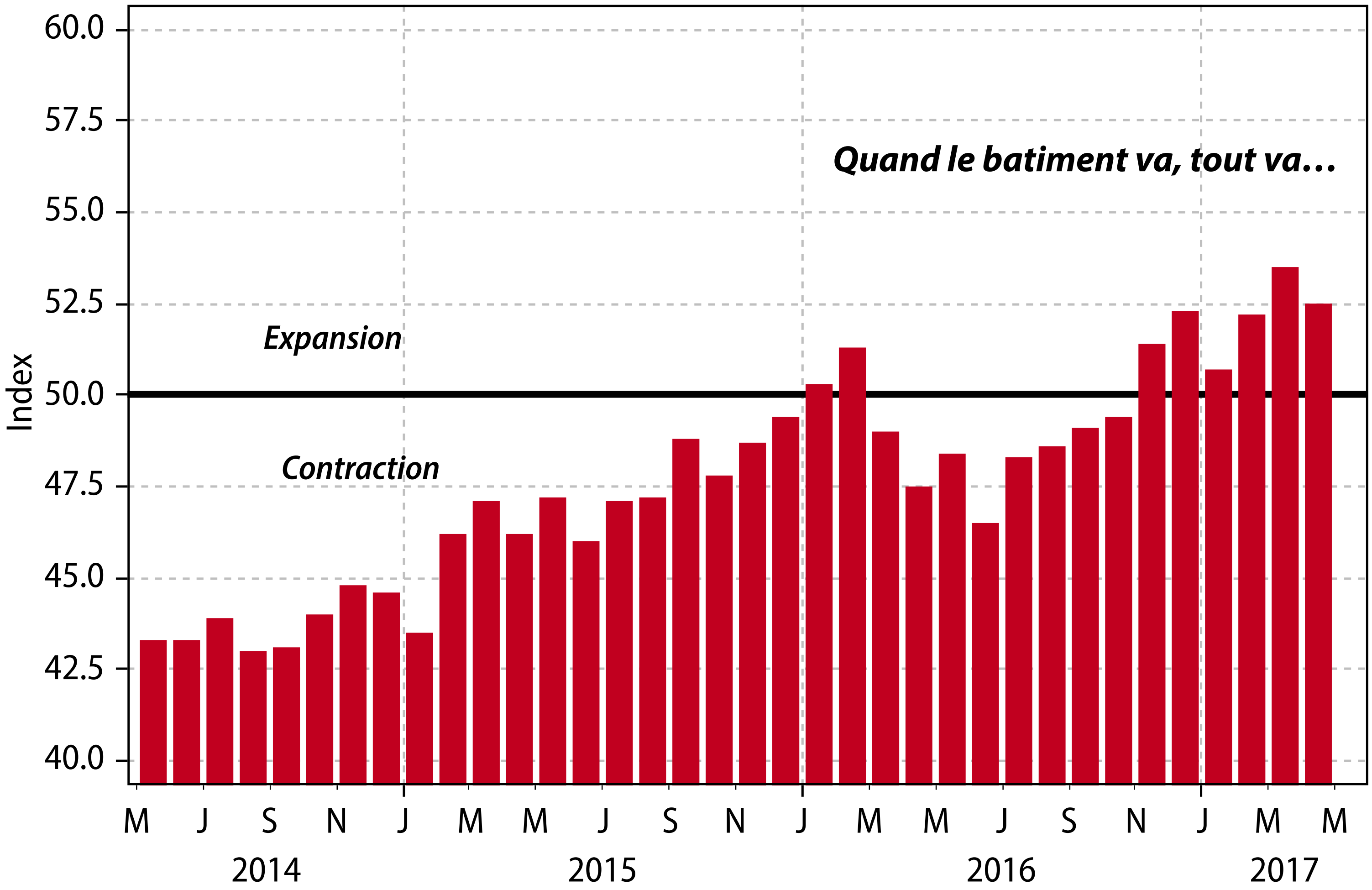
Gavekal Data/Macrobond

- The French economy is finally catching up after years of lagging the rest of the eurozone.
- Rebound is led by the construction sector, restored corporate margins and solid lending growth.
  - ➢ Supports job creation and stronger investment.
  - ➢ Eurozone now firing on three of its four main cylinders—solid growth in Germany, France and Spain, only Italy trailing.

- **Broadening recovery** across economic sectors (see **The Eurozone's Silver Lining**).
  - ➢ Variation in growth rates across sectors is the lowest since the introduction of the euro.
  - ➢ Growth is increasingly spilling over from country to country and sector to sector.
  - ➢ Spillover effects will drive a self sustaining economic expansion.

Construction had been the big drag on growth but this is now over

Eurozone construction PMI



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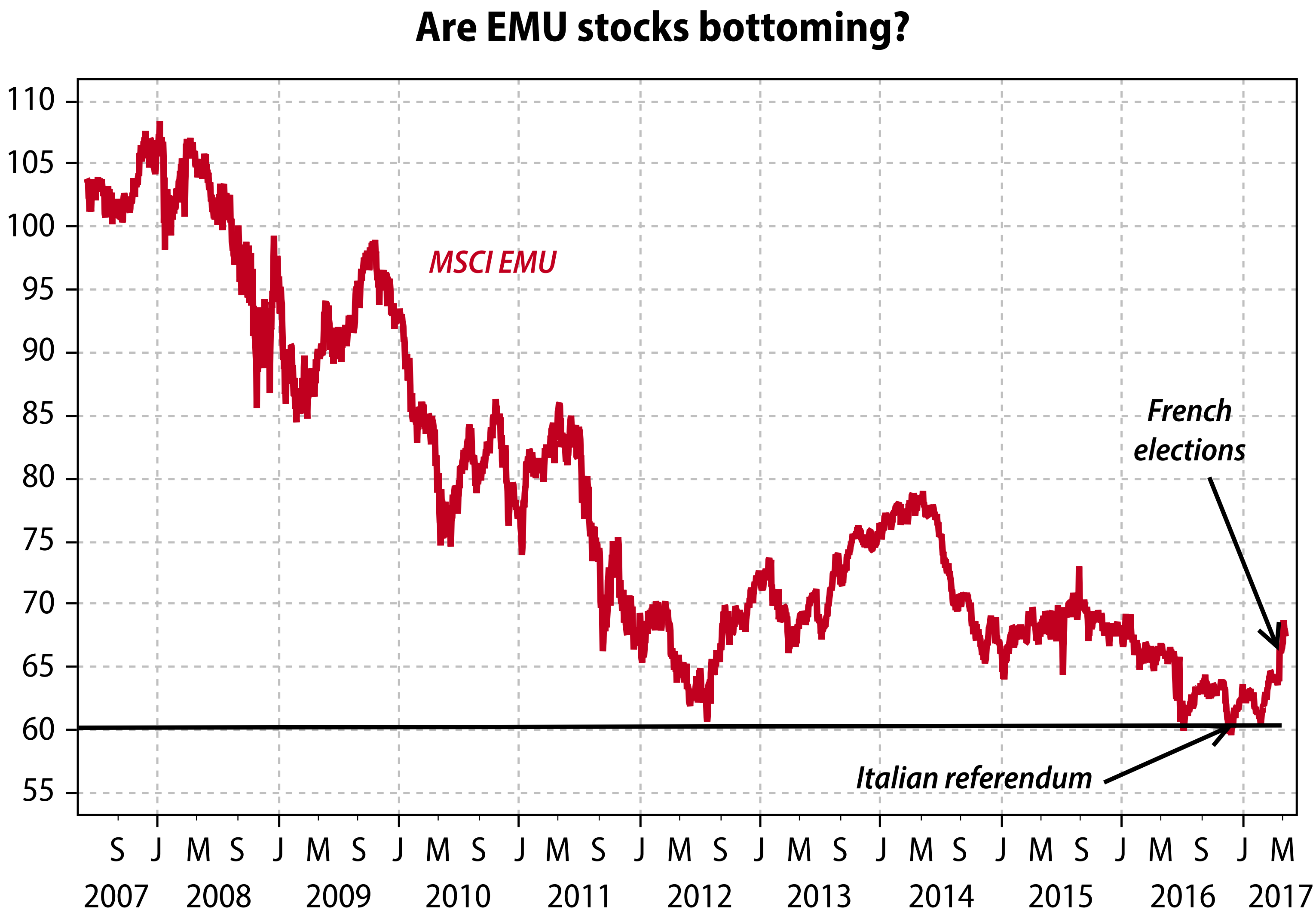
Europe's triple bottom?



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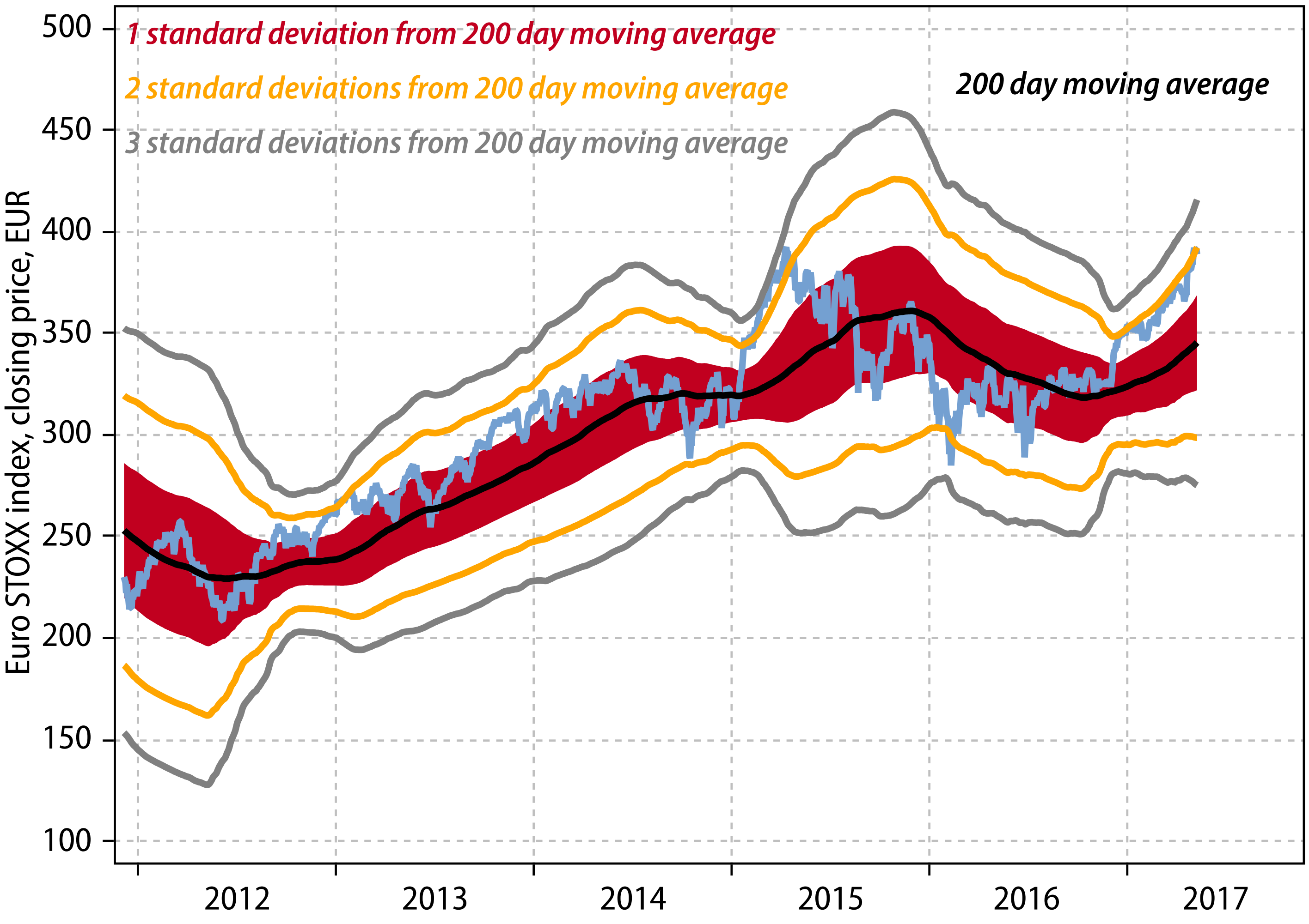
Wait for a market correction to add to bullish trades



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- Strong momentum and good political results have sent European stocks to two standard deviations above their 200-day moving average.
- This is usually a signal of an impending correction.
- To be sure, the market's reaction to the French election may be somewhat overdone.
- Not that the French election isn't a big deal…

The French election allows European integration to re-launch

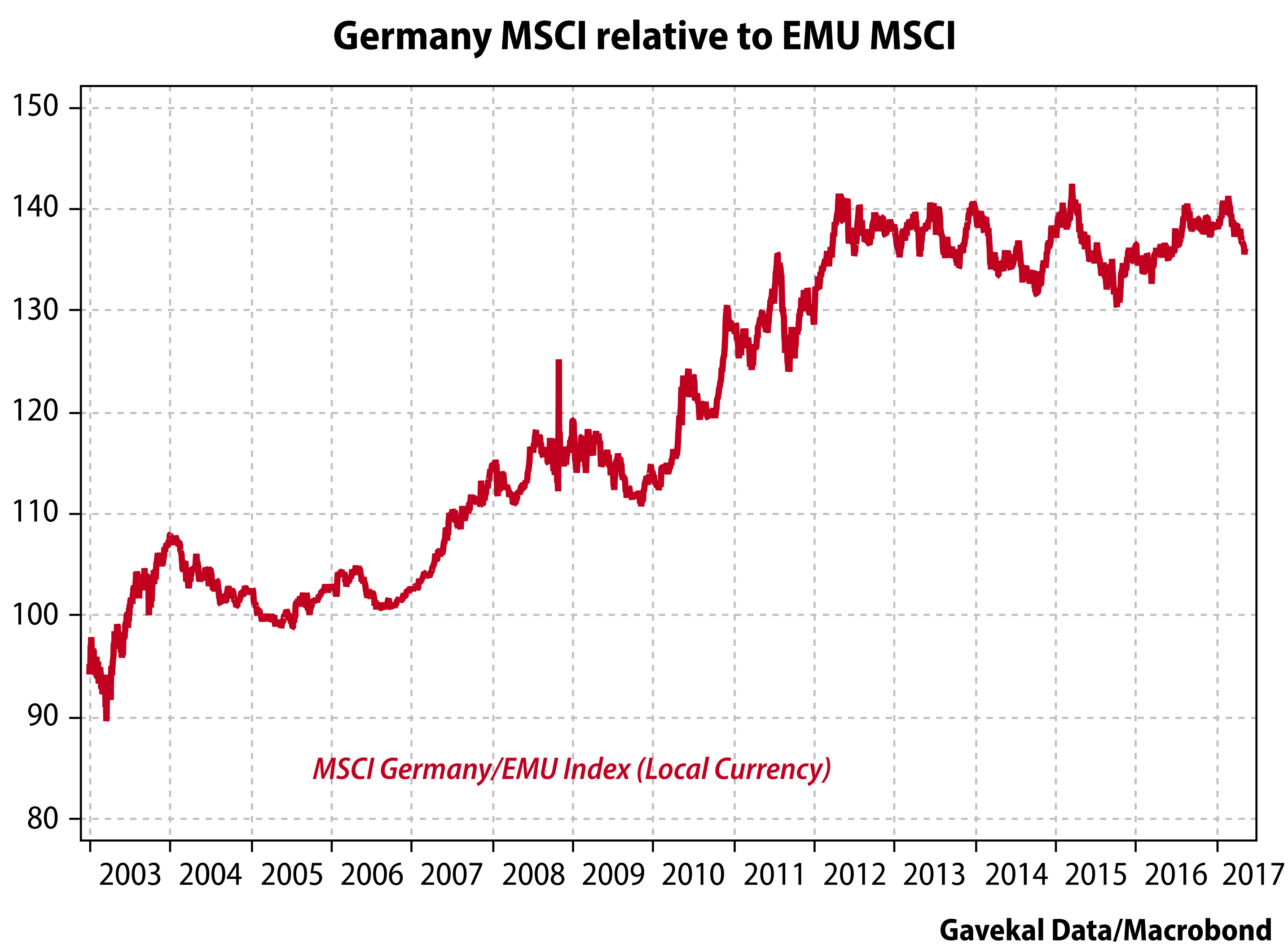
Reforming France + Rebalancing Germany

=

Strengthened Franco-German axis

- **France**
  - *Baseline scenario* — Emmanuel Macron pushes through some (even modest!) reforms of France's excessively onerous labor code.
  - At the same time, there will most likely be an increase in defense and law and order spending (to combat the FN's appeal).
- **Germany**
  - *Baseline scenario* — A reforming France enables Germany to soften its opposition to fiscal easing and further European integration.
  - With Eastern Europe (Poland, Hungary…) looking further right, and with Brexit, Germany has little choice but to turn back towards France, provided France makes the right noises.

Is Germany now condemned to underperformance?



- If, as seems likely, the euro survives for the coming years, then Southern Europe will likely outperform Germany.
- Meanwhile, if the euro ever breaks up, then:

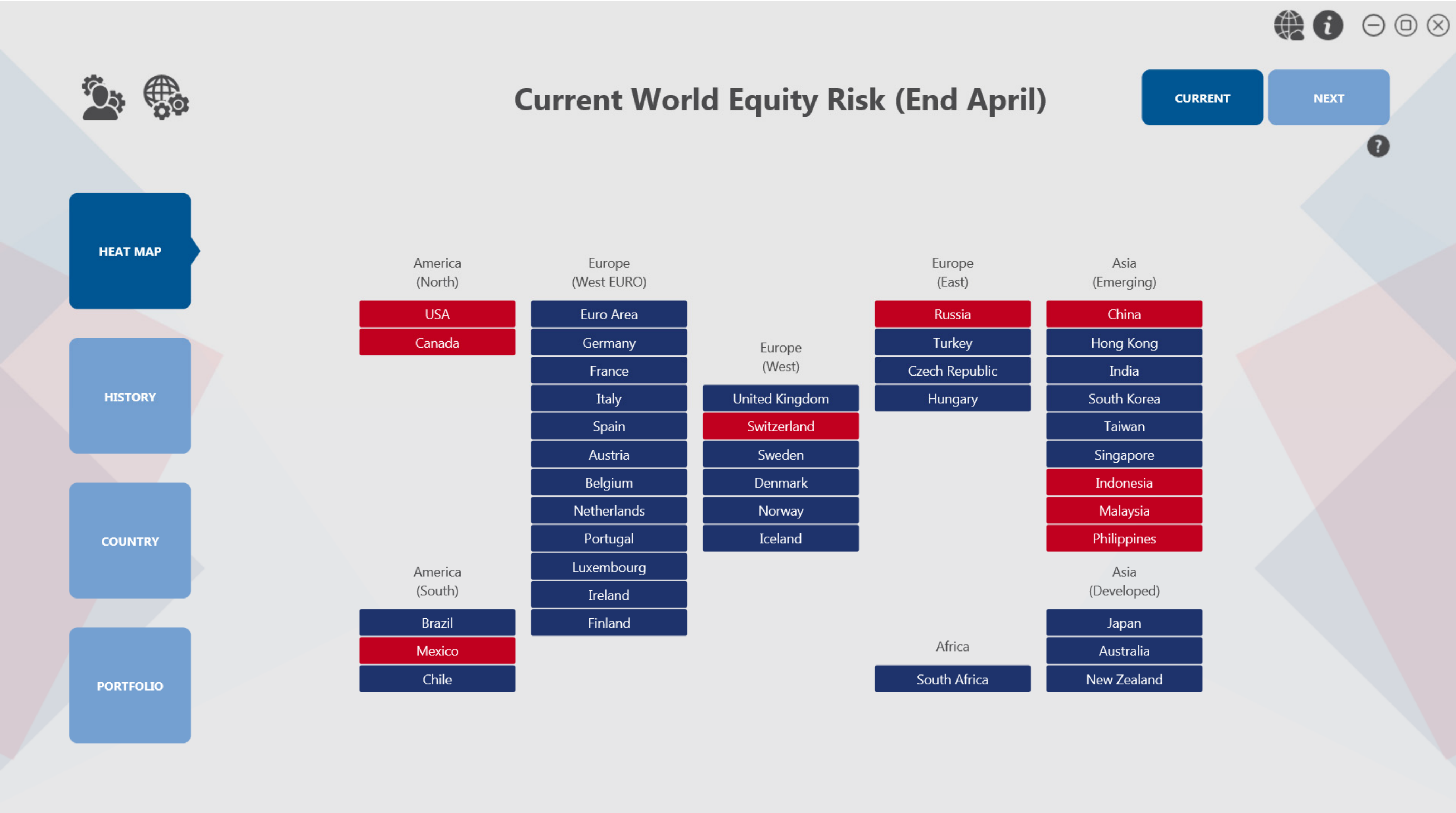
a) The entire Germany financial sector (banks, insurance companies, pension funds…) will need to be re-capped.

b) The German manufacturing industry, which operates on tight margins, will be wiped out.

- With that in mind, one is better off overweighting Spain, Italy and France and underweighting Germany within European positions.

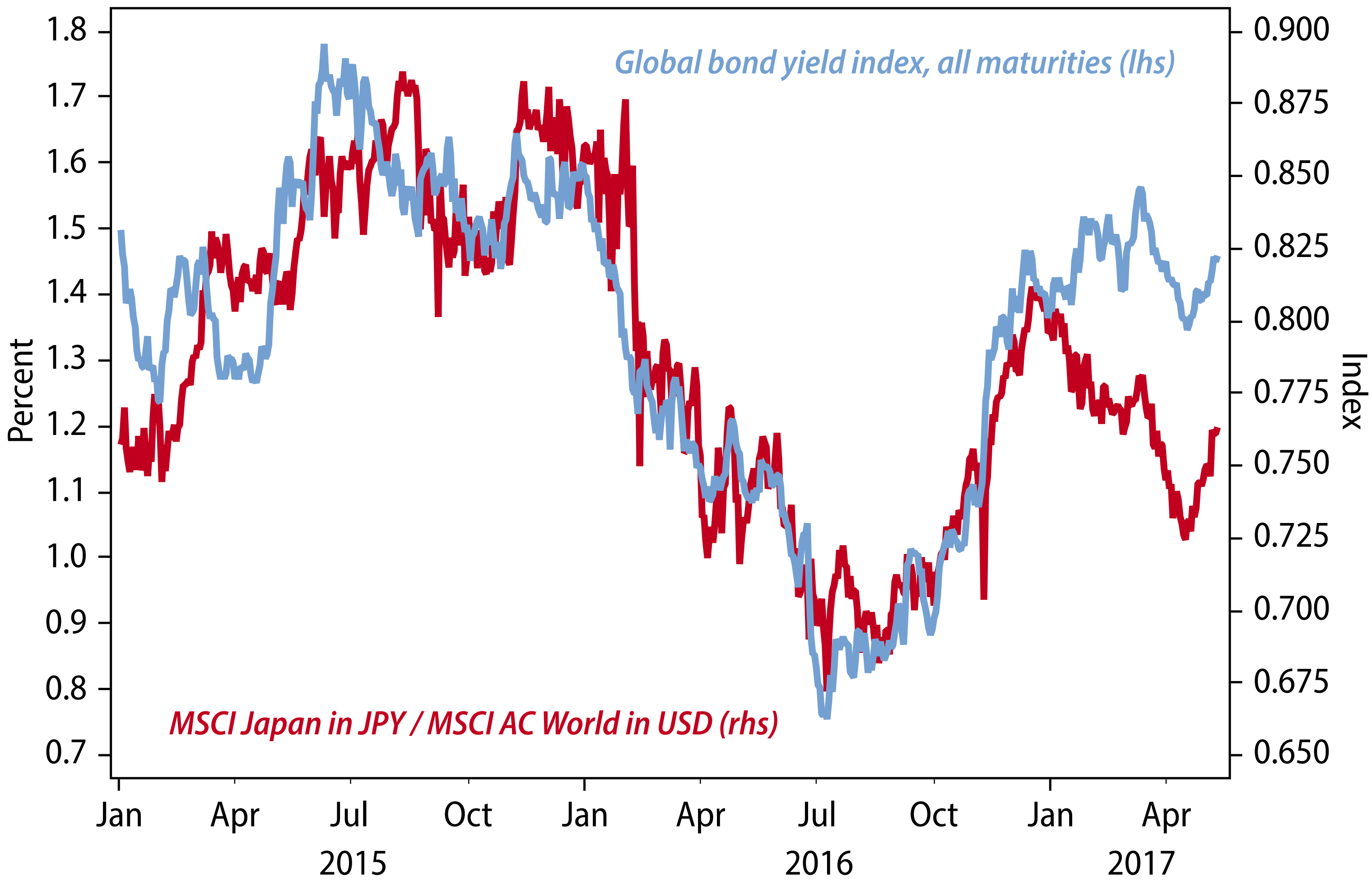
4 — Japan, the red-headed stepchild everyone has forgotten

Japan, like most of Asia and Europe, is flashing a buy



To some extent, Japan has been yet another 'reflation trade'

Japan as a global reflation trade?



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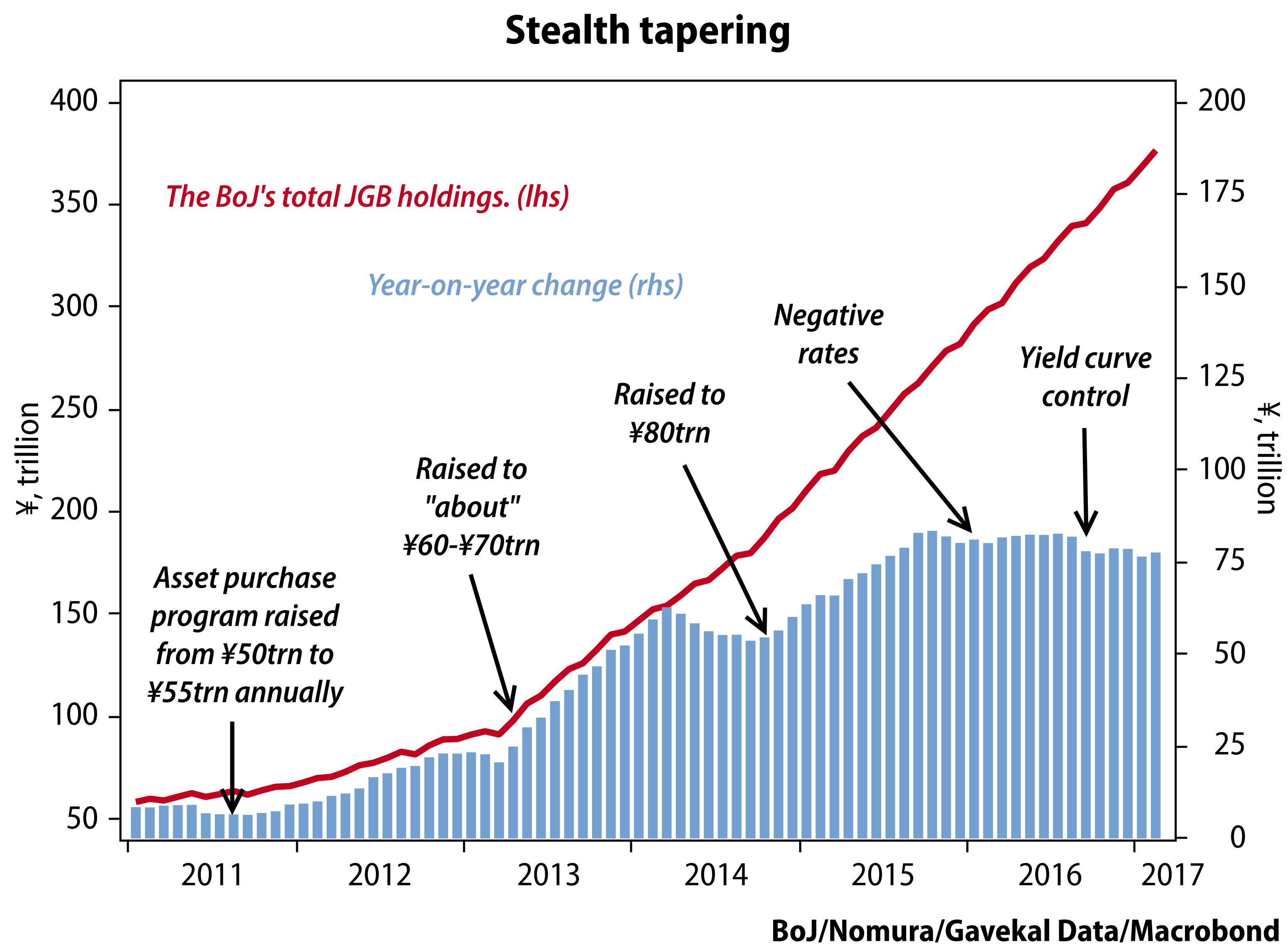
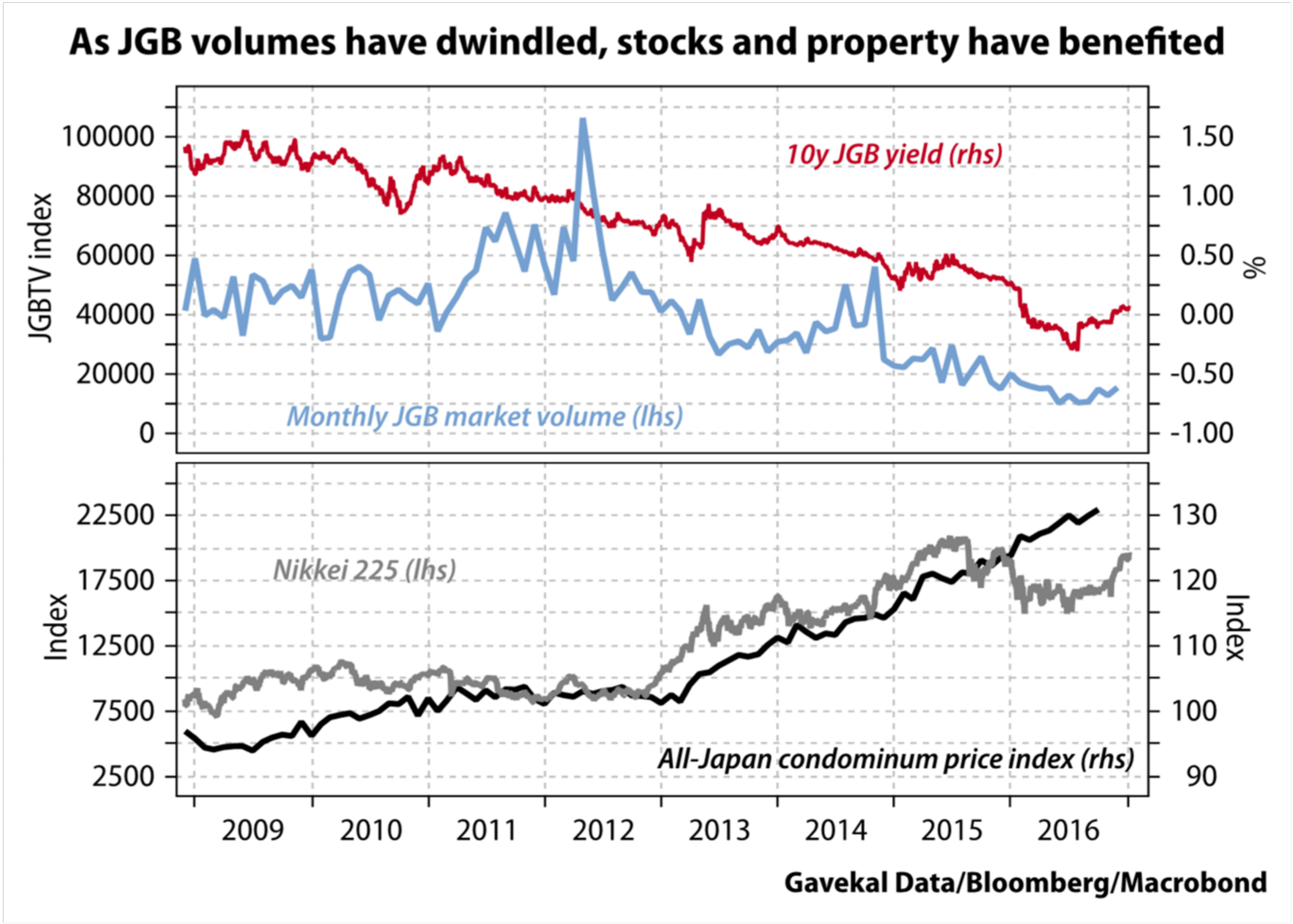
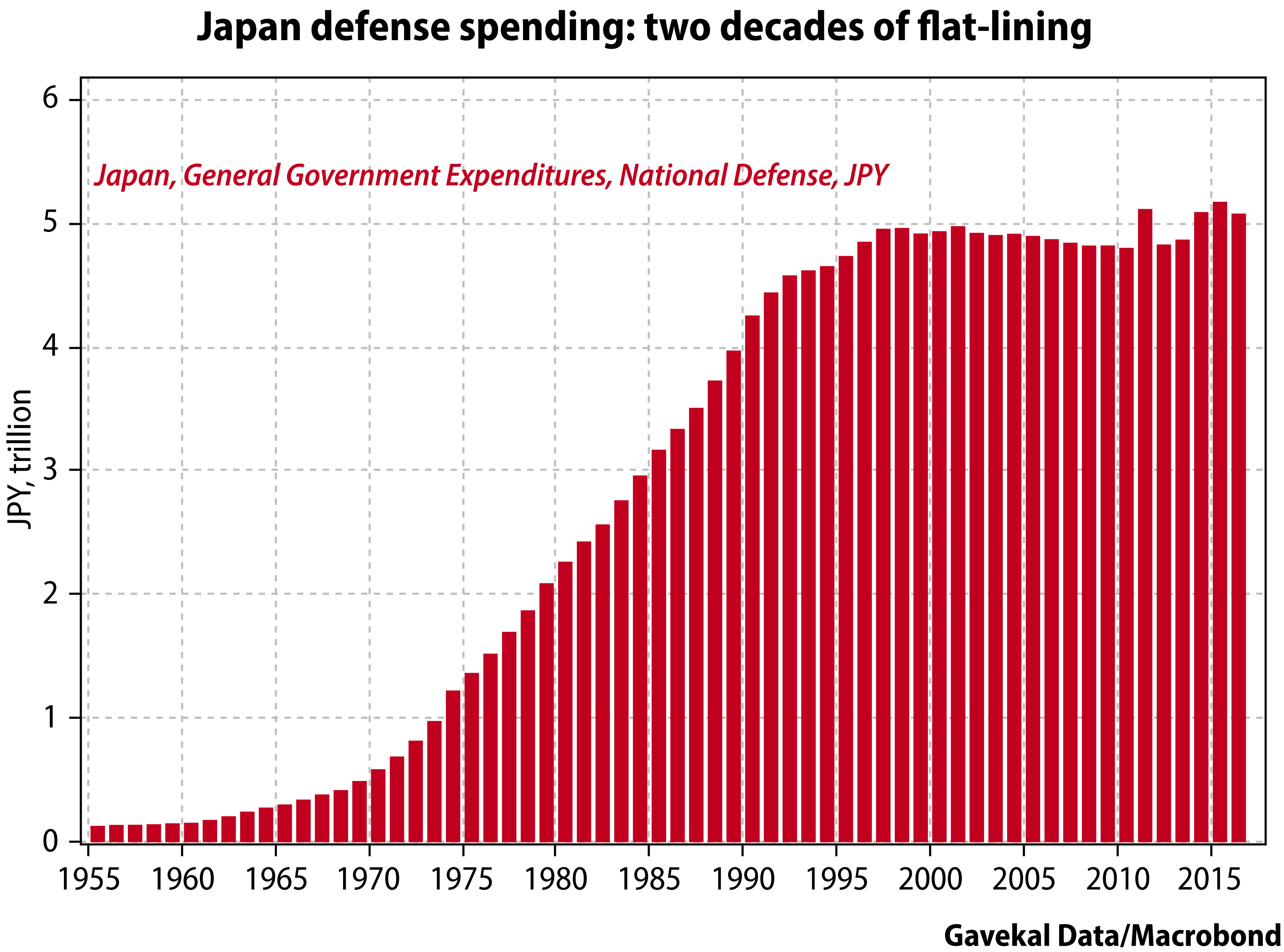
Given the continued expansion of the BoJ balance sheet, this is not surprising



The BoJ is running out of bonds to buy!



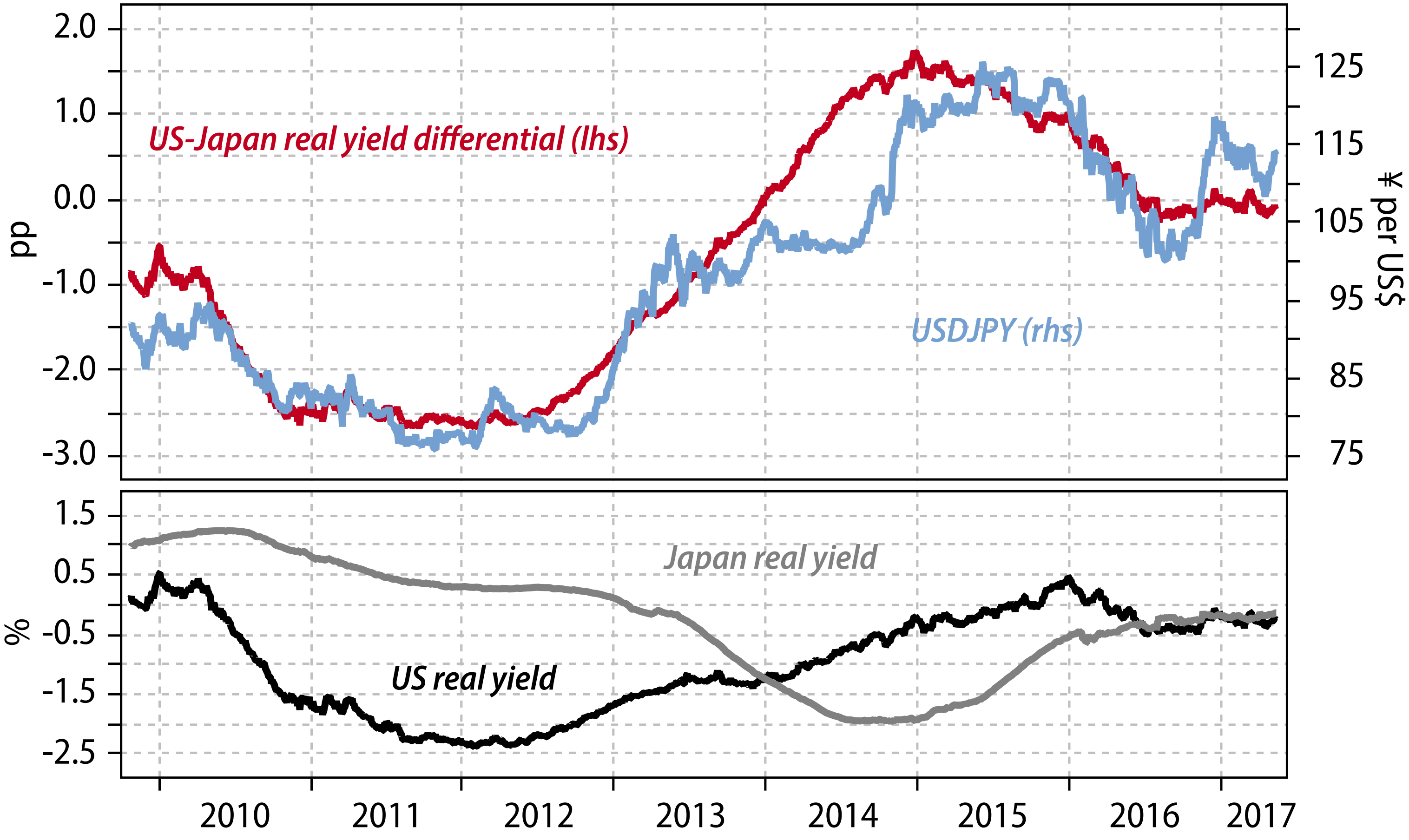
But Prime Minister Abe is not running out of ideas to spend money!



With the 'guns & butter' policies, it is hard to be bullish on the yen

Real yield differentials drive the US dollar-yen exchange rate

Real yield = 2y govt bond yield - 2yma of CPI



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Simple thoughts on Japan

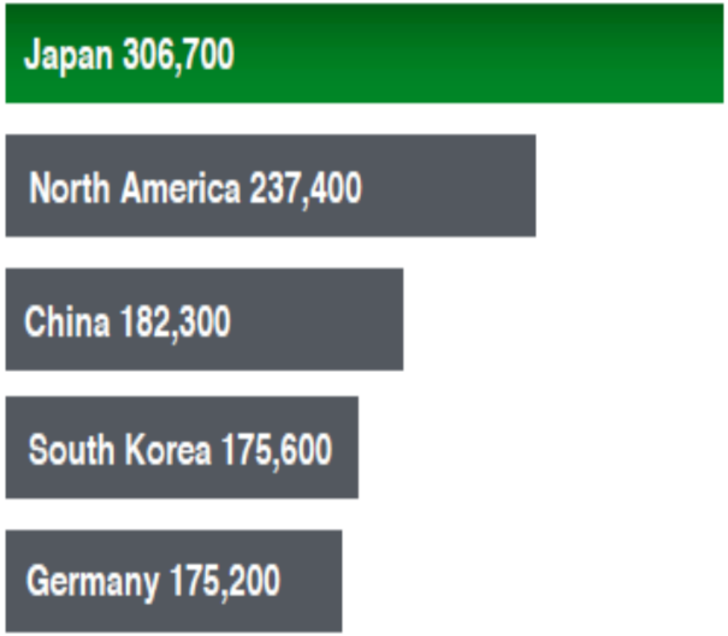
- The BoJ will most likely be the very last central bank in the world to tighten. Instead, the BoJ is more likely to be the easiest central bank around for quite some time. At the same time, Prime Minister Abe seems little inclined to reduce government spending. Far from it! Instead, Abe is trying to change the constitution to dramatically increase defense spending.
- With this in mind, the path of least resistance is likely lower for the yen from here on out.
- As it turns out, the correlation between the yen (lower) and Japanese equities (higher) has been strong in recent years. And as long as this correlation holds, it is hard to be too bearish on Japanese equities.
- Beyond defense stocks, it obviously makes sense to buy yen sensitive assets in the sectors where Japan has a clear comparative advantage: robotics, aerospace, inbound tourism (a growing destination for Chinese tourists), machinery and other industrials.
- Incidentally, robotics stocks are probably a decent hedge on the world going full-on protectionist. **After all, the factories may well come back, but the manufacturing jobs won't!**

Japan has a clear edge in robotics

Almost half of the largest robotics stocks are in Japan

Bellwether Companies	GICS ® Sector	Country
ABB LTD	Industrials	SWITZERLAND
ACCURAY INC	Health Care	UNITED STATES
AEROVIRONMENT INC	Industrials	UNITED STATES
AMANO CORP	Information Technology	JAPAN
COGNEX CORP	Information Technology	UNITED STATES
DAIFUKU	Industrials	JAPAN
FANUC CORP	Industrials	JAPAN
FARO TECHNOLOGIES INC	Information Technology	UNITED STATES
HARMONIC DRIVE SYSTEMS	Industrials	JAPAN
HIWIN TECH CORP	Industrials	TAIWAN
HOLLYSYS	Industrials	CHINA
INTUITIVE SURGICAL INC	Health Care	UNITED STATES
IROBOT CORP	Consumer Discretionary	UNITED STATES
KEYENCE CORP	Information Technology	JAPAN
KRONES AG	Industrials	GERMANY
OCEANEERING INTERNATIONAL	Energy	UNITED STATES
OMRON CORP	Information Technology	JAPAN
NABTESCO	Industrials	JAPAN
RAVEN INDUSTRIES	Industrials	UNITED STATES
ROCKWELL AUTOMATION	Industrials	UNITED STATES
YASKAWA ELEC CORP	Information Technology	JAPAN
YUSHIN PRECSN EQPT	Industrials	JAPAN

Japan has more industrial robots in operation than any other country



Source: www.roboglobal.com

5 — Putting it all together

The important currency regime change

- On the currency front, the single most important development of recent months is the fact that the US dollar is no longer rising. This has triggered a steady outperformance of emerging market currencies. We see no obvious reason why EM currencies should start underperforming.
- Usually, buying currencies that start with an "R" is a bad idea (rupees, rand, rupiahs, rubles, ringgits…) but given today's valuations and yield differentials, R-currencies (including the renminbi!) look attractive.
- At stake is whether the dollar remains the currency hegemon over the next decade(s). With more Saudi-China and Russia-China trade moving to renminbi, could the ability of the US economy to keep funding massive twin deficits at zero cost may start to be undermined?

Investment strategy — Momentum trades

Among possible momentum trades, these stand out:

1. **Robotics stocks.** Trump may succeed in bringing back manufacturing to the US, but any company that relocates there will prefer to install robots rather than hire costly and unreliable workers.
2. **Asian consumption.** The structural demand growth from EM households, especially in China, is unstoppable. Higher-end food products, tourism plays, luxury goods and financial services all benefit.
3. **Financial services, IT & infrastructure spending in India.** Since Modi took power 270mn Indians have opened bank accounts; his recent "war on cash" will drive further growth in financial assets.
4. **Tech, but maybe outside of the US?** The momentum around technology remains all-powerful. But at current valuations, perhaps finding the tech juggernauts outside of the US makes sense? The risk on US large-cap tech has to be that an end of index fund inflows triggers a dearth of new buyers.

Investment strategy — Return-to-the-mean trades

Several return-to-the-mean trades look attractive:

1. **Eurozone stocks.** On a relative basis they are not far off their 2012-2013 crisis lows. Rising nominal growth will boost earnings. Utilities, infrastructure spending and domestic consumption plays should be favored. Along with business & IT services.
2. **Financials.** These should be supported by easier regulations, fewer fines and slowly rising interest rates.
3. **The pound.** The pound is still ultra-cheap: one standard deviation below its long-run mean against the euro.
4. **Hong Kong stocks.** They are cheap, tend to do well when the US$ rolls over, and sentiment will strengthen on the July replacement of the current unpopular chief executive.
5. **Mexico**. The ultimate "anti-Trump" trade?
6. **Defense spending in Europe and Japan**

Investment strategy — Yield plays

Given the growing uncertainty, and possibility of US growth disappointments, adding some yield protection into portfolios may well make sense.

Still, we would look to add yield through high dividend yield paying stocks (preferably in undervalued currencies) rather than government bonds at this stage. Specifically:

1. **Consumer staples across the OECD**
2. **Utilities across emerging markets**
3. **Healthcare stocks everywhere**

As mentioned above, EM debt and EM currencies also remain an interesting potential yield diversification for portfolios.

Investment strategy — Hedges

Gold miners & long-dated UST: two different plays on a dovish Fed?

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- Over the past few quarters, an uncanny correlation has emerged between long-dated bonds and gold miners.
- To some extent, this makes sense for, at this juncture, both are a play on the Fed not being as aggressive as the market expects.
- The one big difference is that gold miners have a very high beta. Thus, owning a tiny bit of gold miners is not a bad way to hedge portfolios against bad events that would trigger renewed dovishness from the Fed.
- **Another attractive hedge today would be wide straddles on the US$.**

Contact and disclaimer

Thank you!

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