February 21st, 2017

A favorable risk/reward set-up in Emerging Markets vs. Developed Markets…

Over the past couple of years the consensus thought has become more engrained in the view that it is the U.S. acting as the engine that has been pulling the rest of the world along with it. However, given the economic data over the last year it appears as though a potentially sustainable transition is afoot, where the Rest of the World has taken the global growth leadership baton and is now pulling the U.S. along for the ride. The latest Flash PMI readings from Markit Economics suggests as much, with the Eurozone composite PMI firming to 56.0 in February from 54.4 last month, representing a six-year high. This reading is consistent with 2 – 2.5 % real GDP growth for Q1 out of the Eurozone which is a pace that has not been seen in almost six years and challenges the latest estimate from the Atlanta Fed for U.S. GDP to expand by 2.2%.

The strong PMI readings out of Europe were led by the German manufacturing PMI hitting a 69 month high of 57.0 and France's combined PMI came in at 56.2 from 54.1 which also marked a 69 month high.

Also helping to calm investor anxiety in the Eurozone was some progress in the impasse between Greek creditors, where talks for a deal have resumed and this caused yields across the curve for Greek debt to come in quite a bit (two-year note yields plunged 129 basis points to 7.4%, the sharpest one day drop in seven months). Then there is the upcoming French elections where Marine Le Pen's anti-EU platform has grabbed the headlines, and while she has experienced a bump in her poll numbers over the last couple of weeks her chances of ultimately emerging victorious are fairly unlikely with little upside to her current 27% polling results. It's the second round of the elections where she just doesn't have the numbers, with the latest poll results showing her trailing by a large margin in one-on-one runoffs against either Francois Fillon (56% to 44%) or Emmanuel Macron (58% to 42%).

Those who are nervous about a potential Brexit redux fail to understand that there are very few parallels to draw between France and Britain when it comes to the EU (keep in mind Britain has always been a drastically different animal when it comes to the EU arrangement, with one foot in and one foot out).

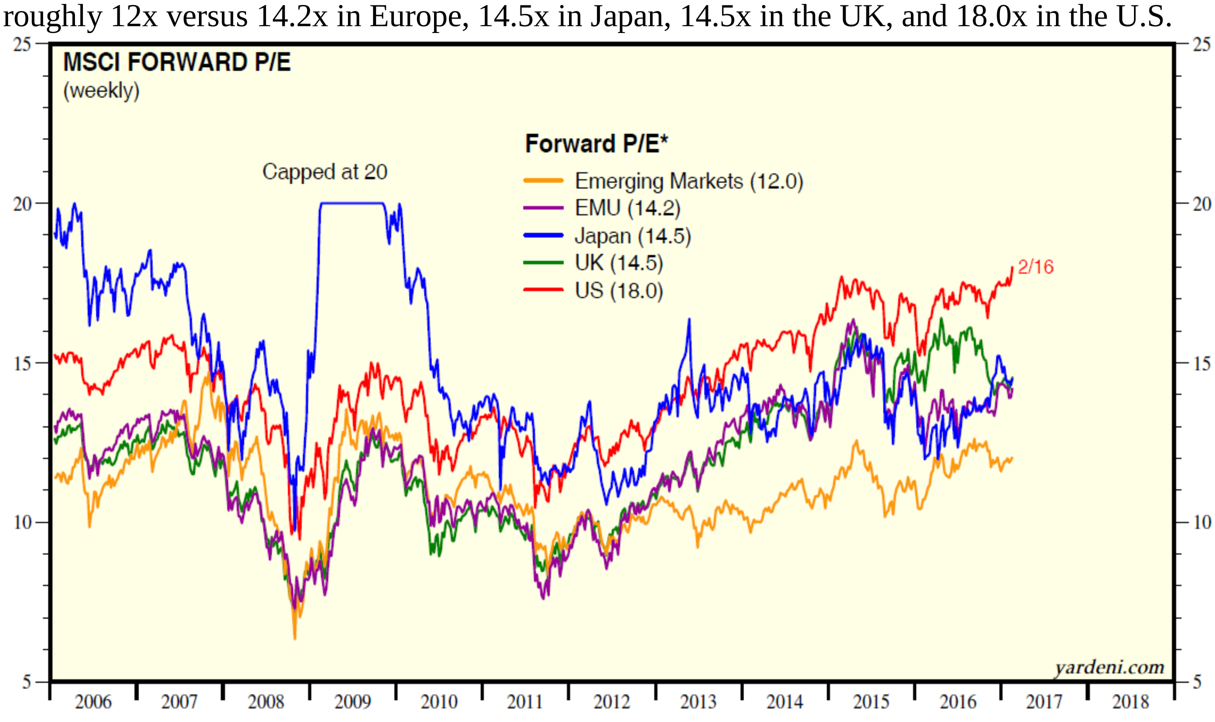
The preliminary PMI data out of Japan was also very strong as it jumped to a 35 month high of 53.5 in February from 52.7 in January. Japan remains an under the radar investment region with foreign investors being net sellers over the past twelve months while local Japanese investors have been net buyers. Usually it's the local buyers that have superior knowledge of the value that exists in their home market. In addition to the contrarian sentiment on the Japanese equity market, long-term investors have the tailwind of an extremely accommodative central bank policy where Governor Kuroda has no other option to offset a massive government debt load and unfavorable demographics than to pin the yield curve at zero, inflate asset prices by buying stocks and bonds, and weaken the Yen to improve the international competitiveness of its manufacturing industry. With this set-up investors also get the kicker of cheaper equity valuations relative to what is becoming a very richly valued U.S. equity market.

Coming into this year I've held the view that foreign equities represented a more favorable near-term and long-term risk/reward trade-off relative to U.S. equities. Thus far, and it's early days, but U.S. equities are up nearly +5% on the year while the MSCI All-cap World Index ex-U.S. is up +6.5% with Emerging Markets well out in front of both with gains nearing +11%.

On a general and basic big picture frame work, Emerging Markets will suffer less than Developed Market regions from the headwinds of eroding demographics and unsustainable debt loads. Demographics and debt are two meaningful constraints that will slow GDP growth, limit productivity, and make it more challenging for their Developed Market economies to generate an adequate return on capital. This isn't to say that these constraints don't exist in the Emerging Market economies of the world, but on a relative basis they will present a much more subtle headwind.

Moreover, we are also seeing more Emerging Market economies approaching key inflection points as they transition from a manufacturing led economic model to a consumption based model with a potential demand base from a middle class consumer segment that the world has never seen before. Take China for example: by 2020 the number of middle class consumers is projected to exceed 470 million people which is roughly the combined adult population of the U.S. and Europe. This stands in stark contrast to the Developed Markets where every day for the next fifteen years there will be 10,000 people turning 65 years of age, which will act as an anchor for these regions to generate much in the way of sustainable inflation or a robust pick-up in economic growth.

What also stands out between Emerging Markets and the U.S. is the divergence in performance, where through the end of 2016 Emerging Markets (using the EEM ETF as a proxy) were still more than 35% below where they peaked in October 2007 (just before the Global Financial Crisis) while the S&P 500 was more than 40% higher than its October 2007 peak. This has opened up a significant gap in terms of valuations with EM as a group being one of the cheapest major asset classes in the investing universe with a forward P/E of roughly 12x versus 14.2x in Europe, 14.5x in Japan, 14.5x in the UK, and 18.0x in the U.S.



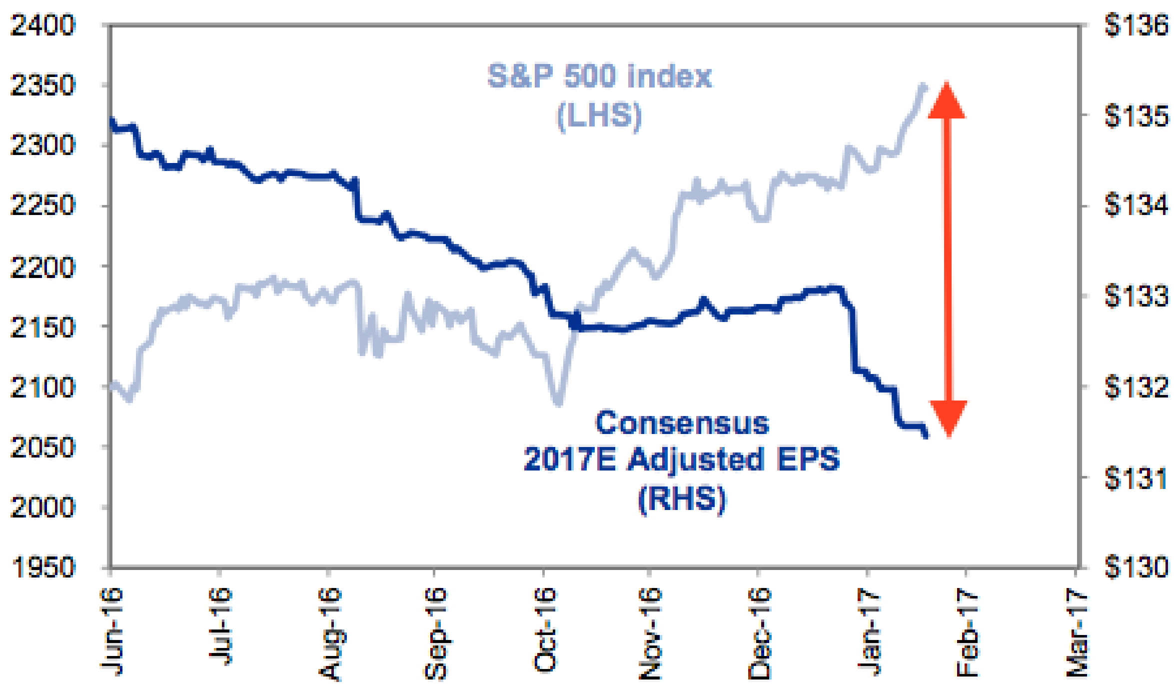
* Price divided by 12-month forward consensus expected operating earnings per share.
Source: Thomson Reuters I/B/E/S.

The icing on the cake is that the cheaper relative valuations of EM are accompanied with much higher earnings growth rates. Keep in mind this favorable set-up does not make this investment thesis immune to risks, volatility, and/or problems in DM's as there are many sound reasons for investors to be skeptical of near-term challenges (dollar denominated debt, rule of law, inflation, under-developed financial markets…). But for investors with a long-term investing horizon, my guess is that the next seven years will be more representative of the 2003 – 2010 period where Emerging Markets drastically outperformed Developed Markets than the 2011 – 2016 period where DM's outperformed EM's.

It's becoming increasingly difficult for me to get excited about the U.S. equity market at this time with almost any momentum metric one can fathom registering off the radar readings in terms of it being overbought. In addition to the euphoric, herd like price action, a bevy of near-term sentiment indicators are screaming extreme complacency is at play:

- NYSE Put/Call Ratio: 0.80x
- The equity market volatility index (VIX) ending last week at 11.49 and its 65-day rolling volatility level just reached a record low
- Investors Intelligence Sentiment: 68% bullish
- The 14-day relative strength index has moved to 77.4 – above the 70 level that is widely viewed as being an overbought threshold
- The S&P 500 has traded higher in 11 of the 13 trading days so far in February and has gone 89 sessions without seeing so much as a 1% decline
- And, valuations just continue to get stretched further into expensive territory with earnings estimates going in the opposite direction of price (see chart below)

Exhibit 1: S&P 500 rallied as consensus adjusted EPS was revised down
as of February 16, 2017



Source: FactSet and Goldman Sachs Global Investment Research.

This brings to mind the following thoughts from the legendary trader Jesse Livermore:

> "*I believe that the public wants to be led, to be instructed, to be told what to do. They want reassurance.*
>
> *They will always move en masse, a mob, a herd, a group, because people want the safety of human company.*
>
> *They are afraid to stand alone because they want to be safely included within the herd, not to be the lone calf standing on the desolate, dangerous, wolf-patrolled prairie of contrary opinion".*

None of this means that stock prices cannot continue to climb from here, but at some point rational thought, fundamental due diligence, and actual policy details (rather than hope) will "Trump" the prevailing herd mentality. After all, the S&P 500 is up some 25% from where it was a year ago while earnings are up some 5% – that sort of gap is rather uncommon folks, but we are continuing to find more and more of these anomalies in this era of unprecedented monetary policy experimentation. We are talking about P/E multiples on the S&P 500 that on a trailing earnings basis have expanded to 21.4x at present versus 17x a year ago, and on a forward multiple basis have grown to 18x today versus 15.5x at this time last year.

Investor confidence has not been relegated to just stocks, as credit spreads have tightened dramatically and are now approaching a three year low in the high yield market with spreads versus Treasuries compressing to 390 basis points. In the investment grade space spreads have tightened to just 130 basis points and are approaching their 2014 cycle lows.

It's been sacrosanct to question the one-way street U.S. equities have been on since the start of the year as any suggestion of adhering to prudence and risk management has caused you to get stampeded by the crowd, but there are a growing number of non-confirmations forming in that volume has been declining and breadth has been deteriorating.

Perhaps the most glaring disconnect is that even with inflation readings approaching their cycle high, the blow-out in animal spirit sentiment surveys, the numerous comments from Fed members that 3 to 4 rate hikes this year appear likely (Harker and Mester being the latest), suggestions of huge infrastructure spending, and commodity prices surging, the yield on the 10-year Treasury bond has not been able to sustain a move above 2.5%. Even if the 10-year yield were to break above the 2.5% level that in the near-term appears to be a ceiling, it still is not a challenge to my thinking until it sustains a move north of 3%.

So, not everyone is drinking the Kool-aid and for students of history it's usually the Treasury market that gets the story right. Seeing gold being able to hold its ground around the $1,225 -1,250/oz level in the face of what has been a fairly resilient level in the U.S. dollar index is an interesting development and perhaps speaks to investors flocking to an asset that is expected to act as a safe-haven in times of heightened geopolitical uncertainty, mounting global debt loads, and massive global central bank liquidity.

Look, I've become more open minded to the potential outcome that the pro-growth reflationary agenda of the new administration could ultimately work, but this has not blinded my thinking towards adequately assessing and evaluating the probabilities of several less favorable outcomes. Once again this thinking isn't rooted in political bias, but more so on history and fundamentals. I still see too many late cycle indications that I cannot blindly or willfully overlook on the auspice that government policy can overcome the daunting secular forces of decaying demographics and burgeoning debt.

Hope remains high that the much anticipated tax policy will be announced within the next several weeks and this will be the first real release of something tangible that investors can analyze – rather than just going off of colorful adjectives such as “phenomenal” or “massive”. What we know at this point is that the ‘border adjustment tax’ is all but dead and this was one of the few (if not the only) levers that could be pulled to raise enough revenue to make any needle moving (in terms of economic growth) tax reform policy somewhat budget neutral. And let’s not forget that while the Republicans have a clear cut majority they are a long way from the 60 votes needed to make any legislation filibuster proof. This is why I continue to have many doubts that anything meaningful can get done on the policy front – unless we witness a break-through in terms of compromise and unity that crosses party lines.

Because without the likelihood of meaningful legislation to support asset prices that have moved well in advance of this expectation, then investors are looking at an economic expansion that is long in the tooth with growing signs of peaks being reached in autos, housing, commercial real estate, capex, and exports. You could add stock and corporate bond prices to this list if hyped up hopes on the policy agenda end up being just that – hype and hope.

Nevertheless, I know I’ve been penning this for the last couple of weeks and it’s been wrong given the move in the equity market, but I continue to be of the view that it is warranted to be patient before deploying any new capital at current levels until we get some details over the ensuing couple of weeks on the policy front.

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