Gavekal Research

The Gavekal Monthly

Shall We Dance?

August 2016

The Gavekal Monthly – August 2016

Joyce's Take

Shall We Dance?

Joyce Poon

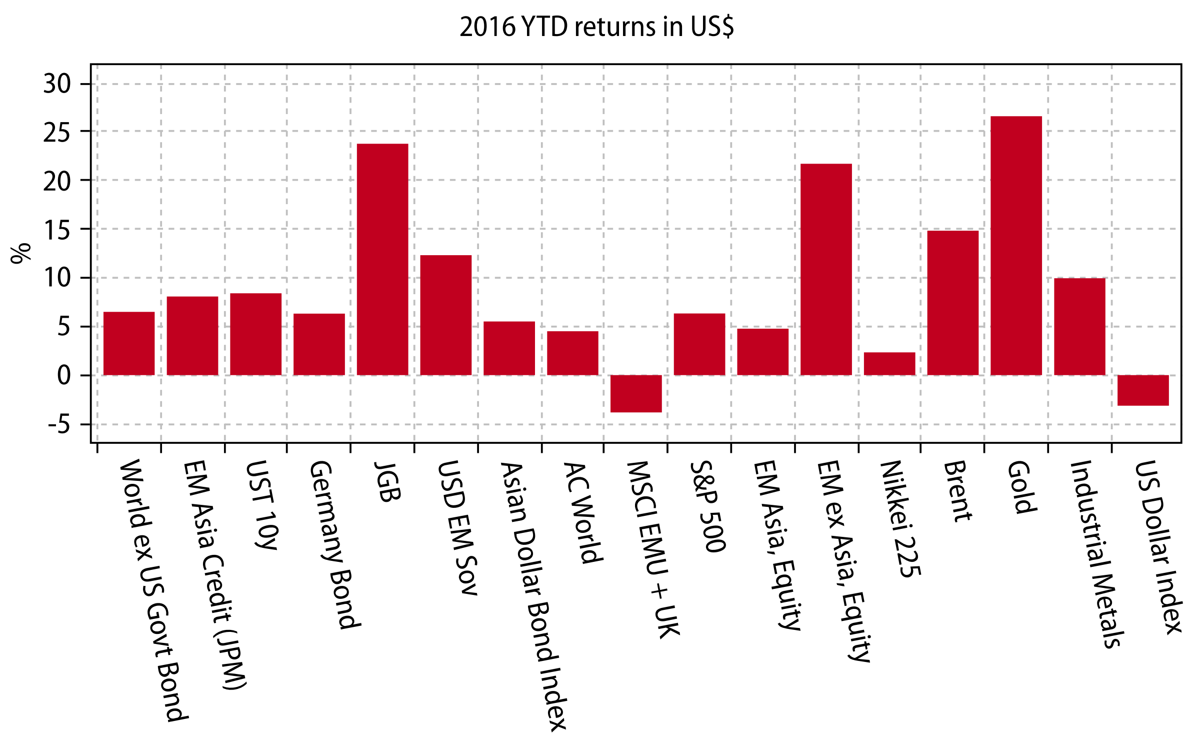
jpoon@gavekal.com

Joyce's Take The easy-listening music is still playing

"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

Chuck Prince, Former Citigroup CEO, July 10, 2007

Virtually every investment has worked in 2016



Gavekal Data/Macrobond

Investors today face a similar dilemma as Chuck Prince did back in 2007. Even with the benefit of hindsight, they are joining the dance floor, as Chuck did, on the belief that the party will go on and they can get out before the music stops.

Unlike 2015 when nothing performed except for the USD*, almost everything has worked well so far this year (except for the USD and ex-US DM** equities).

In this market, good news is good, and even bad news (like Brexit) turns up the music of central bank easing.

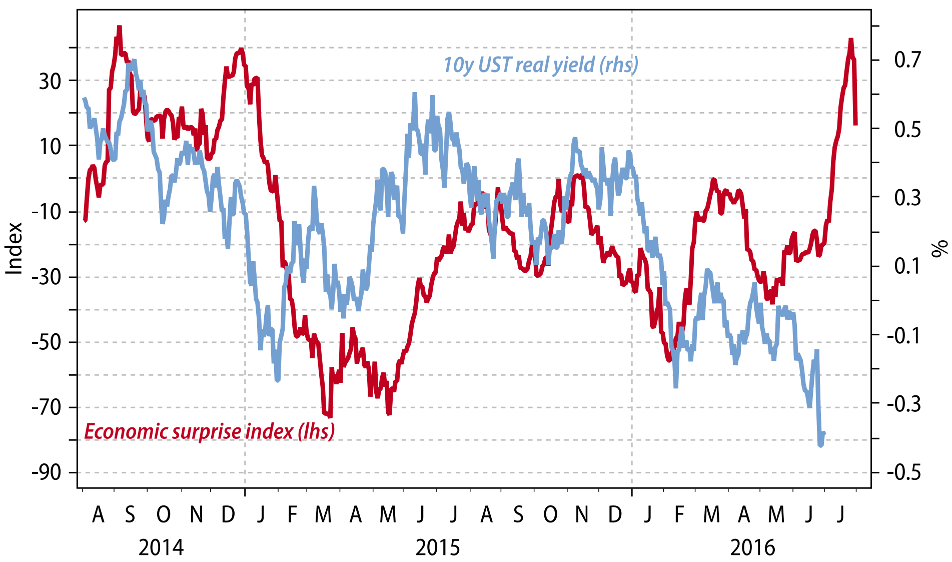
*US dollar

**Developed market

Mistake, or virtuous cycle?

Diverging messages from bonds and economic data

10y UST real yield (deflated by core CPI) vs Citi Economic Surprise Index



Gavekal Data/Macrobond

Total assets of G20 central banks, excluding China

YoY % change; in US$

Gavekal Data/Macrobond

The epic run in US treasuries (USTs) began when equity investors saw the US economy slowly inching towards a cyclical upturn. While the US economic surprise index spiked to a one-year high, real rates fell to 4-year lows. Are equity investors too optimistic about the economy? Or are bond investors too pessimistic?

Or should we see the development through an entirely different lens?

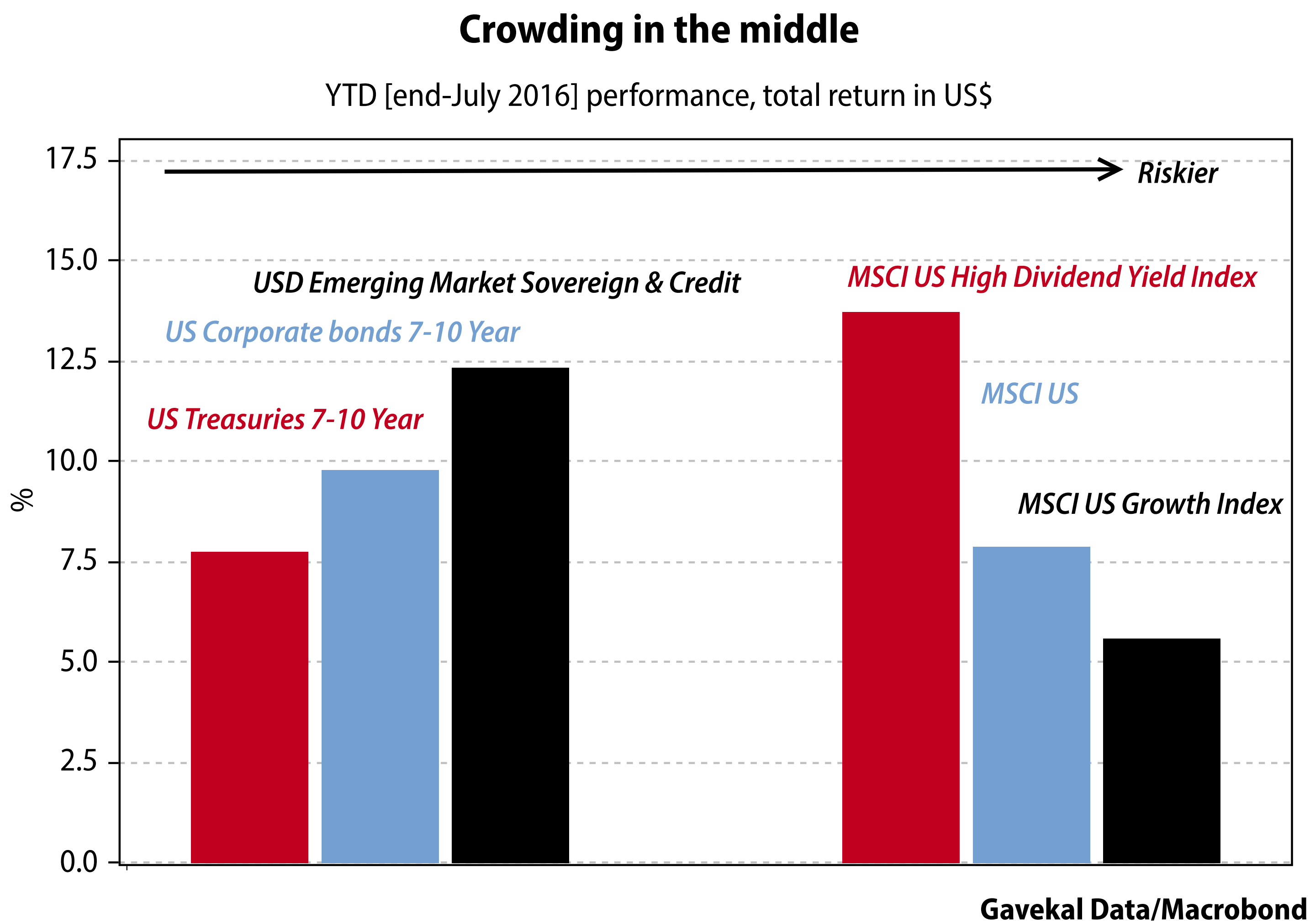
The Fed wants to dispel deflationary fears, so will ensure its rate hikes stay behind the inflationary curve (see **The Fed Throws Ems* A Lifeline** and “US Rates: Lower For Not So Long,” pp. 11-14 below). This supports equities. And as other central banks push more non-US yields negative, yield-hunting foreign investors will pour into USTs.

The US bond and equity markets reflect the same positive feedback loop.

Gavekal Research

*Emerging Market

Joyce's Take The middle of the risk spectrum is crowded



But the vote for "the party never ends" is half-hearted. Rather than going into full risk-on mode, investors are crowding the middle of the risk spectrum, chasing yields and cash flows.

Bond investors moved out of negative-yielding issues and into hard-currency EM sovereign and corporate bonds.

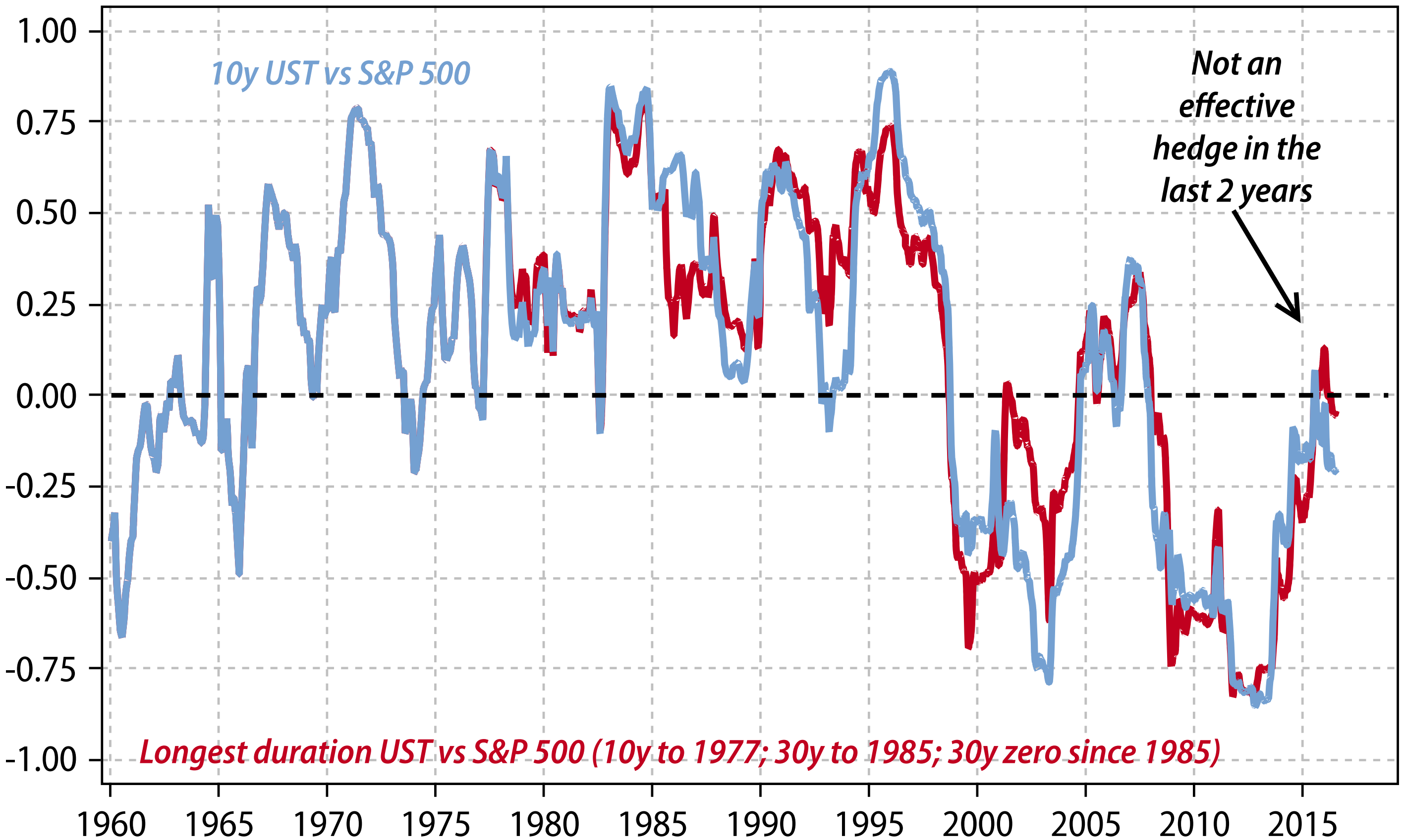
Meanwhile, stock investors lacked conviction and poured into high dividend yield stocks.

As yield plays have been handsomely rewarded, is it time to add or reduce risk?

Joyce's Take Safe-haven bonds: not so safe

The correlation of equities and bonds has risen

2-yr rolling correlation of QoQ total returns in equities vs bonds



Gavekal Data/Macrobond

In an era of hyper-stimulus, safe-haven bonds now offer low or negative returns with rising volatility risk.

Hence, safe-haven bonds are losing their ability to hedge the volatility of equity portfolios.

In a standard 50/50* portfolio, 10y UST yields must go to zero to compensate for a -10% equity market fall. Even the long-duration safe-havens are no longer as negatively correlated with stock prices as two years ago.

If the pool of effective hedges is shrinking, the knee-jerk reaction for investors would simply be to cut risk.

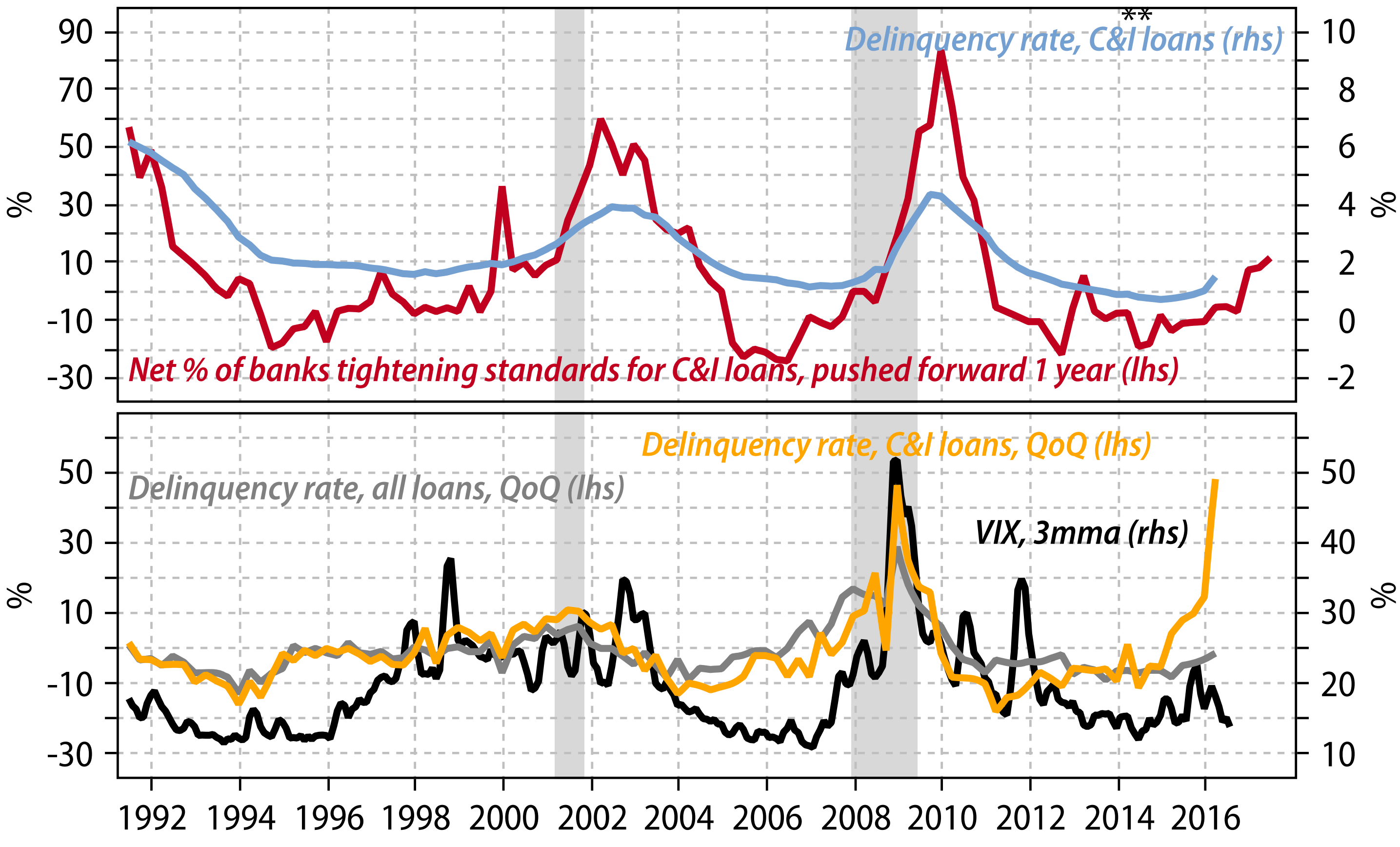
Gavekal Research

*I.E., a balanced stock/bond portfolios.

Volatility, the enemy to risk-on

Is volatility heading for an upward spike?

Loan delinquency rates vs the VIX *



Gavekal Data/Macrobond

If investors do indeed cut back risk because of the lack of hedges, market volatility could rise—leading to more pressure to cut back risk.

Meanwhile political risks, which are difficult to hedge, are mounting everywhere around the world.

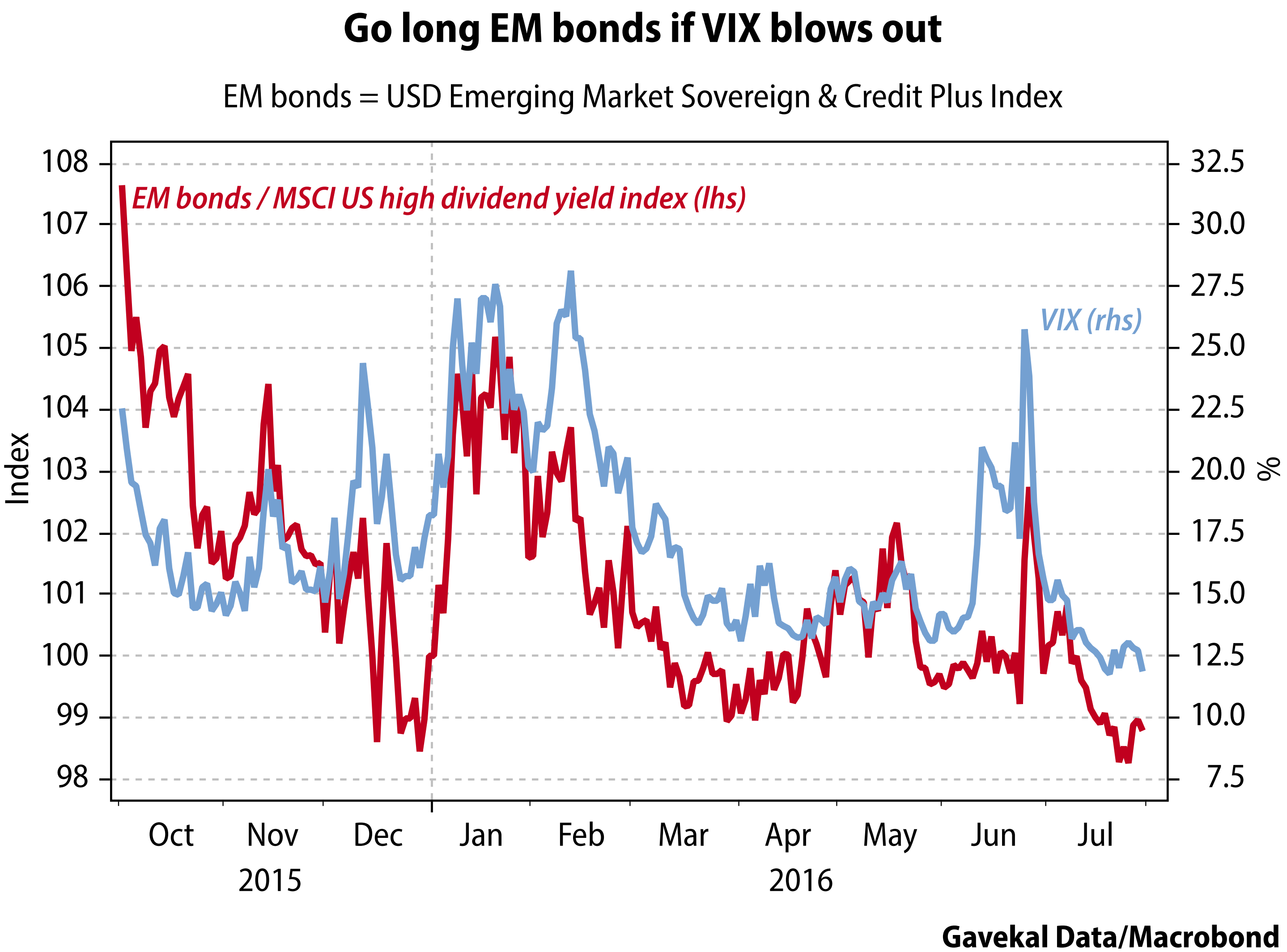
A worsening delinquency cycle also tends to lead market volatility with a moderate lag. The US is now facing the threat of a default cycle.

The VIX may be near its all-time low, but this is scant comfort given the many reasons why volatility could rise in the coming months.

*VIX = volatility index

**C&I loans = Commercial & Industrial loans

Prefer EM bonds over dividend stocks



How to play this environment? Yield plays now offer limited capital gain upside, but there are few decent alternatives given the heightened volatility risk. I suggest:

- In anticipation of the return of volatility, **de-risk yield portfolios by shortening duration.**
- For those who can tolerate volatility and look for higher yields, **EM US-dollar bonds look less vulnerable to shocks than US dividend plays** (see more details in "Chase That EM Yield, Cautiously," pp. 19-22 below).

Joyce’s Take ‘Certainty plays’ worth a higher premium

Tailwinds for UK exporters

UK non-financial exporters to non-Europe (50% rule), index constant weights

Gavekal Data/Macrobond

Fiscal stimulus plays should pay off

Infrastructure index performance vs IMF* advanced economies govt spending

Gavekal Data/Macrobond

Another tactic is to identify “certainty plays.” In an environment of heightened uncertainty, investors value most the assets that look like a “sure thing.”

One “sure thing” right now is that UK exporters should continue to see the benefits of currency competitiveness outweighing domestic risk as sterling has become a structurally weak currency.

Another “sure thing” is that governments are mulling a policy shift from monetary easing towards fiscal stimulus to jump-start growth. Calls for fiscal expansion, especially on infrastructure, will only intensify.

Whether infrastructure investment will actually aid growth is debatable—but infrastructure plays will certainly benefit from fiscal stimulus.

*International Monetary Fund

US Rates

Lower For Not So Long

Tan Kai Xian

ktan@gavekal.com

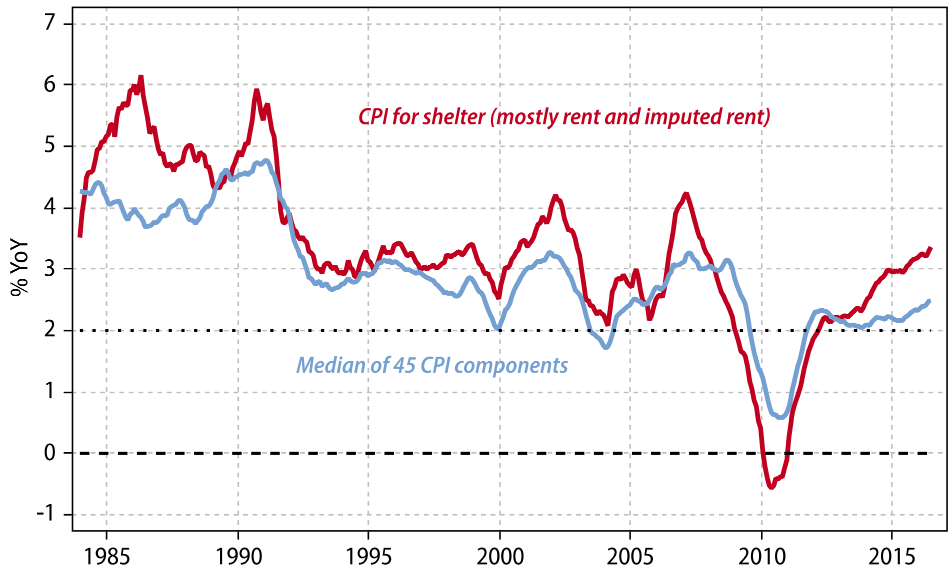
US Rates Lower For Not So Long

What's happening	What it means
Markets rallied strongly after the UK's Brexit vote, with the S&P 500 setting a record high	• Many investors were unsure whether the rally was a "sell the rumor, buy the fact" rebound, or prefigured a fresh round of liquidity creation by the world's big central banks, and so missed out (see **The Post-Brexit Rally: Head Fake Or Game-Changer?**).
With over half the S&P 500 having reported, both sales and earnings remained weak in 2Q at -1% and -3.8% YoY respectively	• **Rising wage pressures and inventory overhang will continue to squeeze US corporate earnings** (see **The State Of US Profits**). • In addition, the flattening of the yield curve is making it harder for US banks to deliver earnings growth. • The weak outlook for earnings suggests that **the post-Brexit rally has been driven by liquidity**—and the expectation of additional liquidity—rather than by improving fundamentals.
The Federal Reserve left interest rates unchanged in July	• The Fed tightened its language, leaving the door open for a rate hike before the end of the year. • The market puts a probability of a move this year at less than 50%. • Inflation pressure is mounting, especially in housing. **Investors may be underpricing the chance of a rate hike this year. But even with a hike, real interest rates will remain low.** • This means any resumption of gradual rate hikes will inflict little damage on the real economy.

US Rates Lower For Not So Long

Rising rents are supporting the median CPI at just above 2%

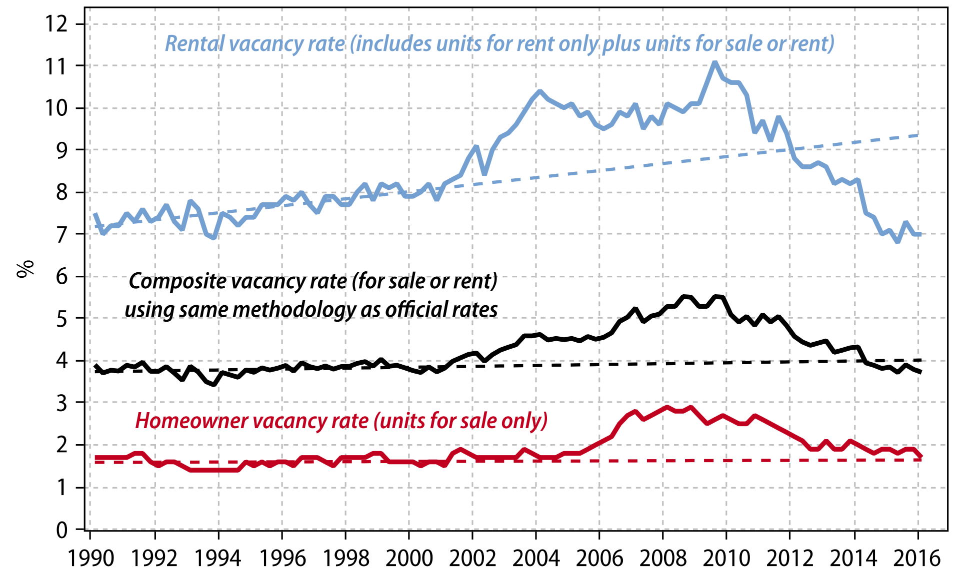
3 month exponential moving average



Gavekal Data/Macrobond

Vacancy rates have normalized and are likely to fall further

Compared with the trend from 1990-2000



Gavekal Data/Macrobond

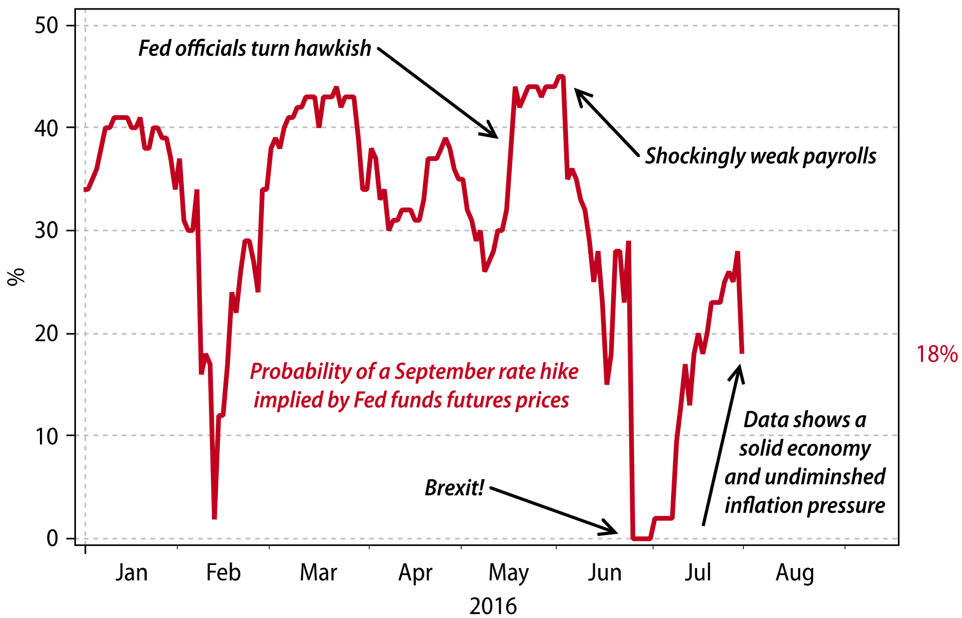
US inflation pressures are mounting. Solid domestic demand, rising consumer credit, and the relative stabilization of oil prices all point to higher inflation.

By themselves these factors are unlikely to cause a rapid acceleration in price rises. The factor that could really cause inflation to gather pace is housing costs, now rising at their fastest rate since 2007.

The failure of homebuilders to keep up with solid demand from homebuyers and tenants is pushing up both rents and property prices. The imbalance is unlikely to reverse any time soon, as tighter standards on bank loans to the construction sector point to a further slowdown in building (see **US Homebuilders Hit A Speed Bump**). As a result, vacancy rates are likely to fall further, adding to the upward pressure on rents and imputed rents.

US Rates Lower For Not So Long

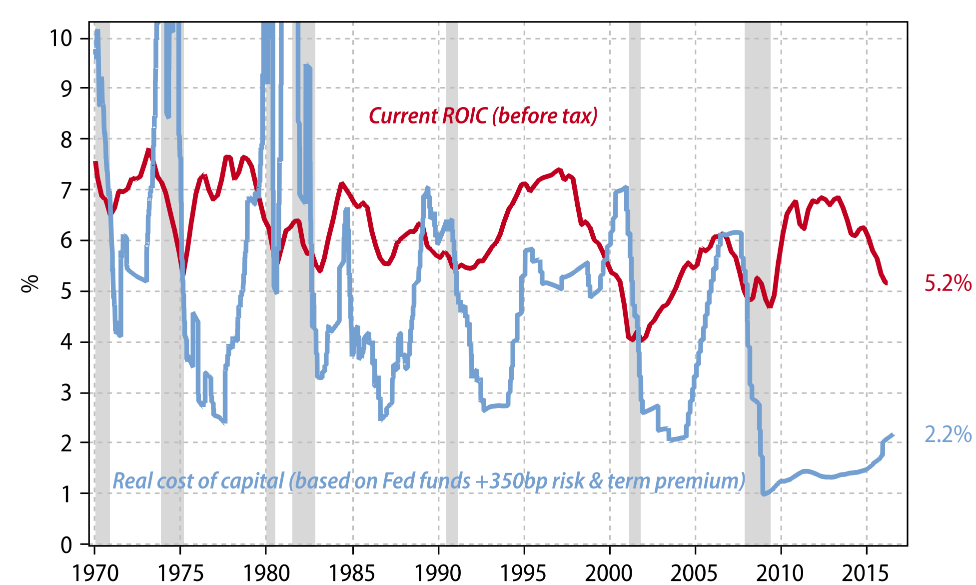
In July investors revised up their expectations of a September rate hike



Bloomberg, Gavekal Data/Macrobond

With real short rates well below ROIC,* near term recession risk is low

Current ROIC = EBIT**/ invested capital at current cost (domestic non-financial corporate sector)



Gavekal Data/Macrobond

With weights of 32% in CPI and 15% in the personal consumption expenditure index, rent and imputed rent have a significant effect on US inflation.

As a result, any further acceleration in shelter costs will likely lead investors to price in a higher probability of a September rate hike—especially now it is clear that the UK's Brexit vote is not going to trigger a financial crisis in the near term (see **Beyond Brexit, A More Hawkish Fed**).

The prospect of early Fed rate hikes prompted by rising inflation may lead to heightened volatility in the equity market. Investors should not be overly concerned. The Fed shows no inclination to get ahead of the curve on inflation, which means real interest rates will stay low. With the real short rate well below returns on invested capital, the likelihood of a Fed-induced recession is low (see **There's No Need To Fear A Tighter Fed**).

Gavekal Research

*Return on invested capital
**Earnings before interest & taxes
***bp = basis points; 100 basis points equals 1%

Japan

The Shrinking Japanese Government Bond Market

Neil Newman

nnewman@gavekal.com

Japan

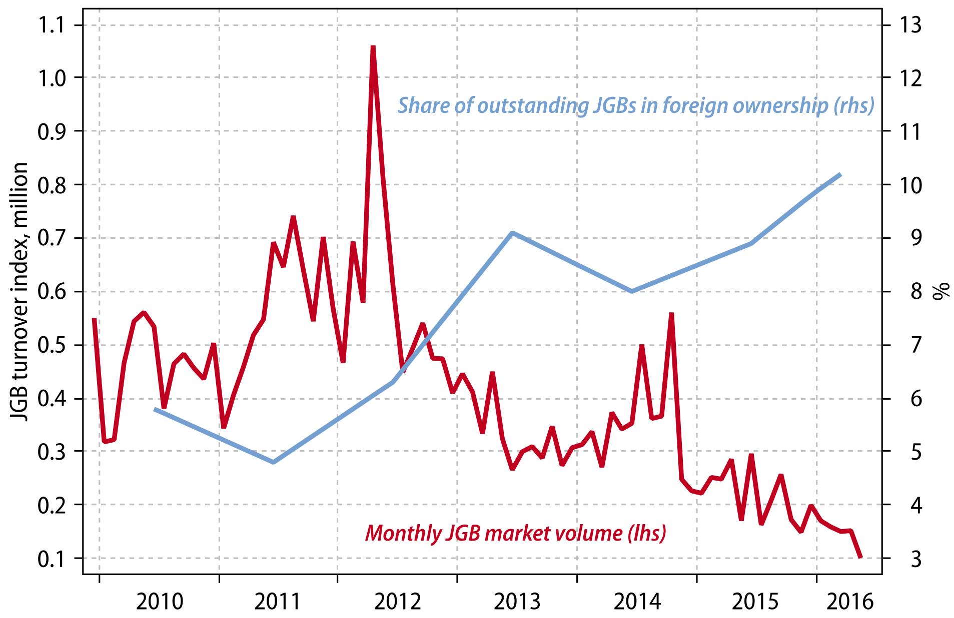
The Shrinking JGB* Market

What's happening	What it means
The Bank of Japan (BoJ) is buying between ¥8trn** and ¥12trn** of Japanese government bonds each month	• In its attempt to hit a 2% inflation target, the BoJ has pledged to expand Japan's monetary base by ¥80trn a year, largely by buying JGBs in the secondary market. • By the middle of next year, the BoJ will own half of all outstanding JGBs.
The BoJ has given no indication of any exit strategy	• With BoJ purchases of JGBs exceeding new issuance, at current rates the pool of tradable JGBs will be exhausted within three years. • As the BoJ's holdings of the tradable float have grown, market liquidity has become increasingly tight. Turnover in the JGB market has fallen -80% over the last four years.
As the pool of JGBs shrinks, Japanese institutions are looking to foreign markets	• In recent months Japanese flows into foreign bond markets have hit new highs. • Currency hedging costs wipe out any yield pick-up on US treasuries, so Japanese life companies prefer US mortgage and corporate debt. • Japanese holdings of peripheral eurozone sovereign debt are rising.

*Japanese government bonds
**Roughly $80 billion and $120 billion USD.

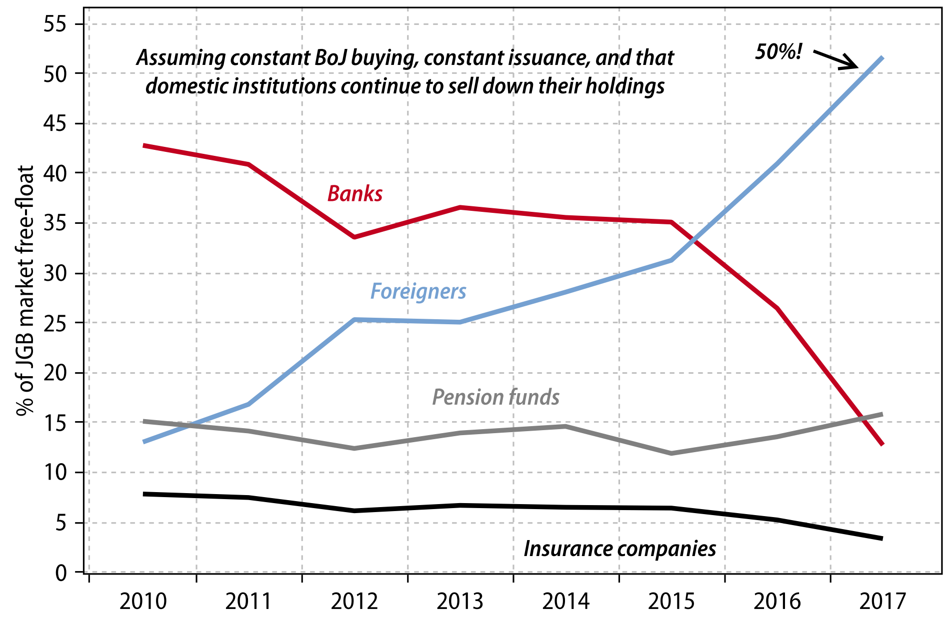
The Shrinking JGB Market

As JGB turnover has collapsed, the share held by foreigners has risen



JSDA, Gavekal Data/Macrobond

On current trends, foreigners will soon own half the free-float



Gavekal Data/Macrobond

Turnover in the JGB market has slumped since the BoJ started quantitative easing. With the tradable float and turnover shrinking, domestic players have withdrawn from the market. In July Bank of Tokyo Mitsubishi, Japan's largest bank, quit the market as a primary dealer.

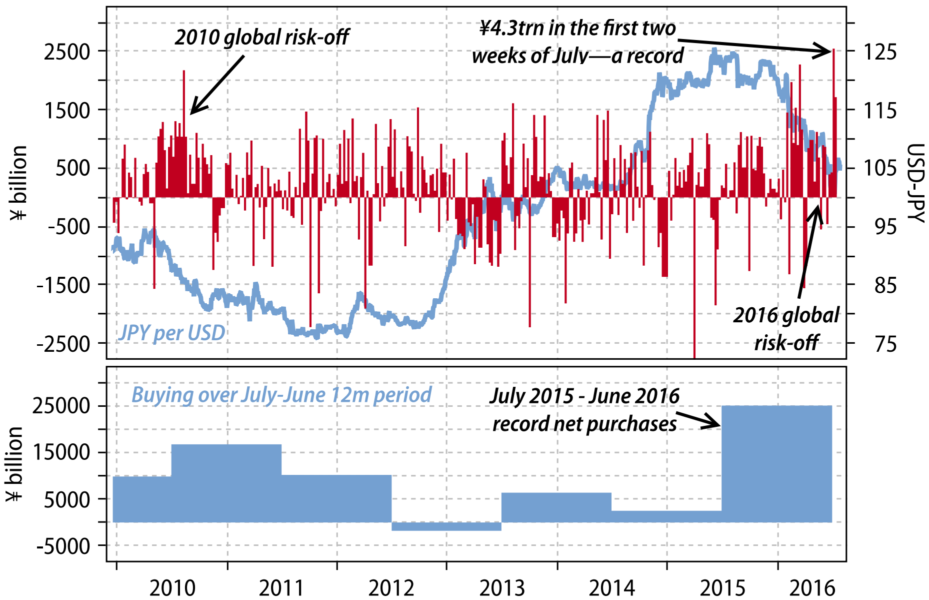
As domestic participation has fallen, the share of the market owned by foreign investors has risen: foreigners now own more than one-third of the JGB free float.

Japanese pension funds keep much of their portfolios locked up in JGBs held to maturity. This effectively removes them from the market, and reduces the JGB free float.

If the BoJ continues to buy at its present rate, the diminishing participation of domestic institutions means that foreign investors could soon own half the float, which could leave them exposed to an eventual BoJ endgame.

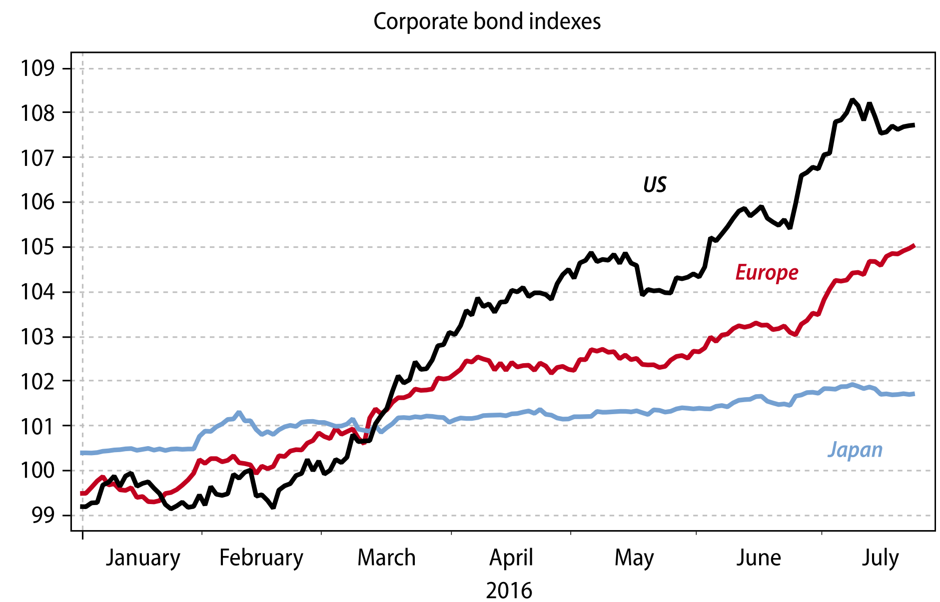
Japan The Shrinking JGB Market

Japanese net buying of foreign bonds has hit record levels



Ministry of Finance, Gavekal Data/Macrobond

International bond markets have outperformed Japan



Gavekal Data/Macrobond

As they exit the domestic market, Japanese institutions are moving into international bond markets. With domestic yields so low, the JGB market is of little use for Japanese institutions seeking to manage how they meet future liabilities, so they are taking advantage of periods of yen strength to buy into higher-yielding markets abroad.

In the first two weeks of July, net purchases of foreign bonds hit a record ¥4.3trn.

Thanks to persistent low yields, Japanese corporate bonds have underperformed relative to European and US markets.

As a result, the tsunami of pension money flowing out of Japan will continue to support international markets and further suppress yields around the world.

Yield hunting will become more creative, with riskier securitized loans and mortgage bonds seeing demand.

Emerging Markets

Chase That EM Yield, Cautiously

Udith Sikand & Joyce Poon

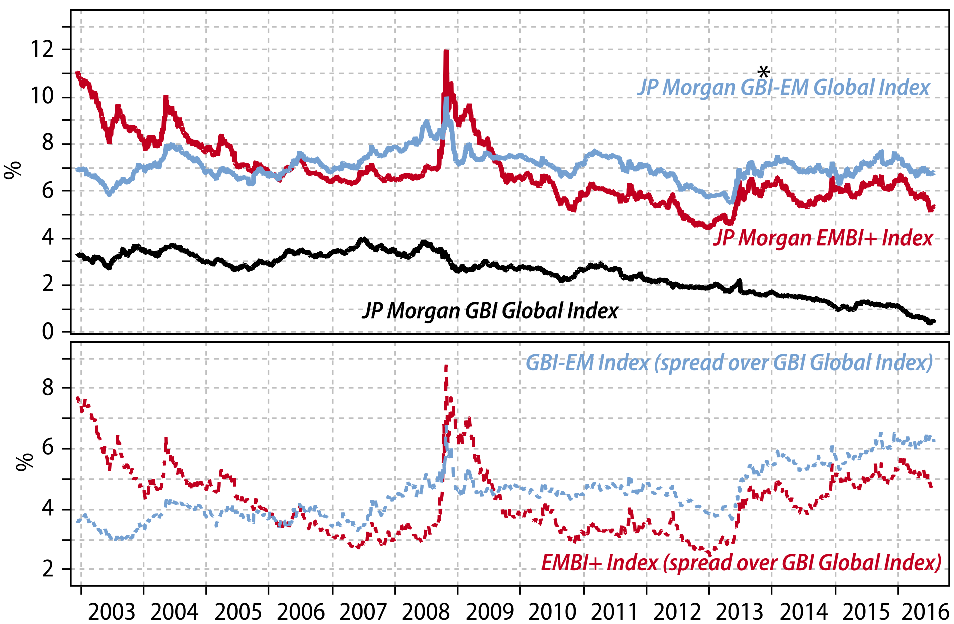
usikand@gavekal.com, jpoon@gavekal.com

Emerging Markets — Chase That EM Yield, Cautiously

What's happening	What it means
EM equity and debt portfolio inflows rose US$33bn in 2Q (IIF data)	• After three straight quarters of outflows, investors have bid up EM assets on the back of subdued expectations of US rate hikes and the hunt for yield. • EM equities are usually a high beta play on "risk-on" sentiment. The YTD outperformance of both hard currency and local currency bonds over EM equities suggests **investors are still cautious about the EM growth outlook.**
Malaysia, South Korea, Turkey and Russia have cut rates	• EMs have shrugged off the headwinds stemming from the Brexit vote, giving EM policymakers room to be more supportive of growth. • With EM currencies still resilient against the USD, **more rate cuts are likely to follow**—especially in countries with relatively high real rates: Indonesia, Russia, India.
Global trade volumes rose 0.8% YoY in May, driven by a surge in EM Asia import volumes (4.2% YoY)	• The commodity rebound is being stoked by China's housing stimulus. • Even if Chinese stimulus hits domestic constraints in 2H16, commodity prices stabilizing around current levels will alleviate the stress in EM balance sheets.

Chase That EM Yield, Cautiously

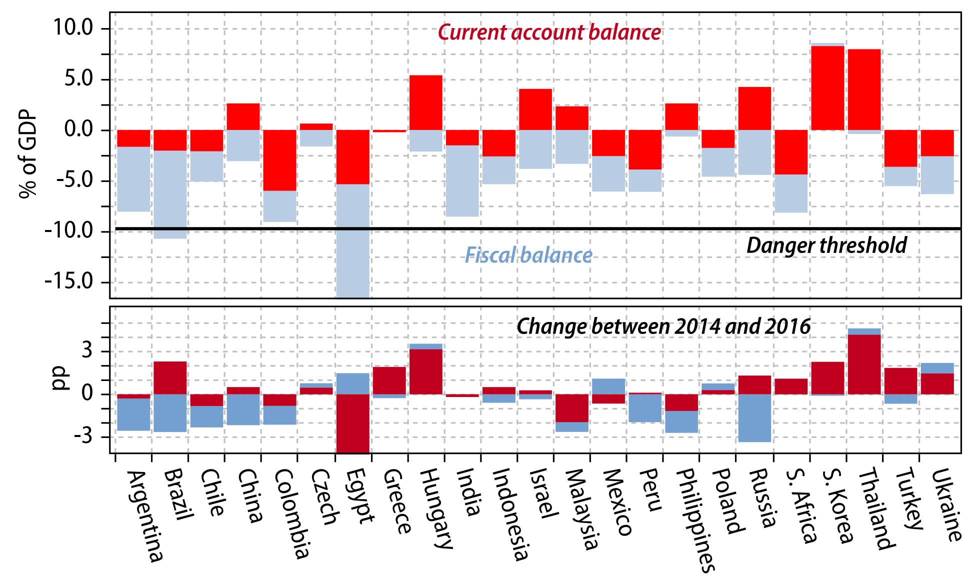
Despite the recent rally, EMs still offer a substantial carry over DMs



Gavekal Data/Macrobond

Twin balance (fiscal + current account) for EM countries

2016 IMF forecast; Fiscal balance = overall govt balance



Gavekal Data/Macrobond

The EM rally is underpinned by the commodity rebound. EM equities have outperformed their DM peers by over 5pp this year, returning around 10%.

This stellar performance of equities has been eclipsed by EM bonds, which have delivered gains of around 15% over the same period, with much lower volatility. With the yield differential between EM and DM still near record highs, the ongoing rally in EM bonds still has legs.

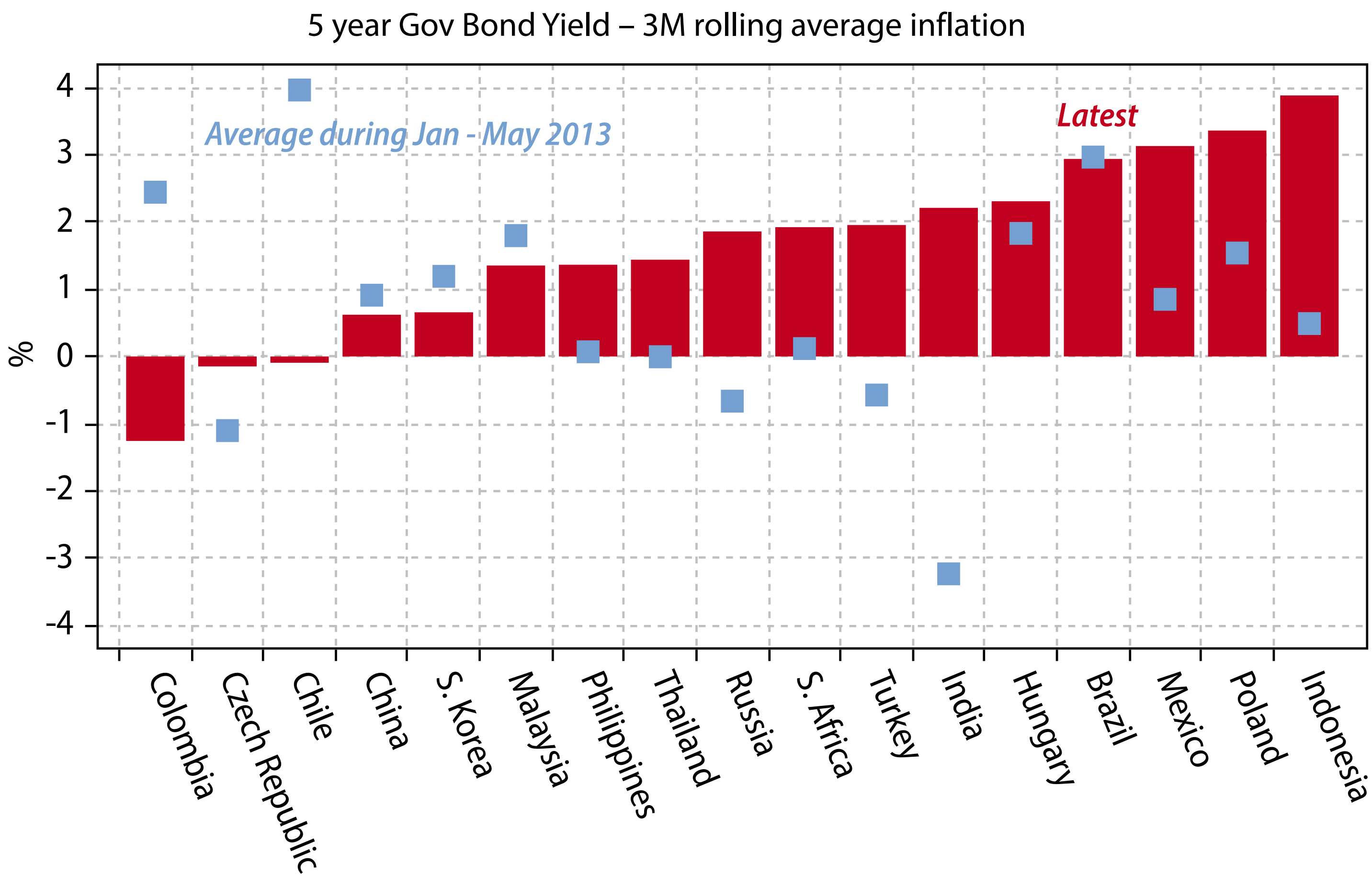
The question is whether to chase the lower yield in hard currency EM debt or to embrace currency risk and chase higher yields on local currency debt.

Although still attractive relative to DM, EM hard currency debt yields are near their record lows in absolute terms. EMs have spent the last two years reducing their external imbalances. Growth imperatives could compel policy easing that would put pressure on local currency yields.

*GBI = Global Bond Index

Chase That EM Yield, Cautiously

High real interest rates offer room to ease policy



Gavekal Data/Macrobond

Real rates are much higher than they were before the 2013 taper tantrum. This means EM policymakers have plenty of scope to cut rates.

We prefer countries with high real and nominal yields, justifying currency risk. Top picks: Indonesia, Russia and India.

Brazil and Turkey would also fit, but their twin deficits are still too high. Turkey carries high political risk and should be avoided altogether. Brazilian risks stem largely from domestic fiscal policy. Brazilian hard currency bonds, now yielding 5% and backed by US$350bn in FX reserves, look attractive.

Our Views In Brief Economies

Region	Analyst	View	Read more
United States	Will Denyer/Tan Kai Xian	Consumers must drive growth, as the strong USD has eroded tradable sector competitiveness	The Consumer Alone Can't Avert A US Recession
United States	Will Denyer/Tan Kai Xian	Tight labor market suggests stronger wage growth, which should support consumption	The Dissonance In Jobs
China	Andrew Batson	The property rebound is losing steam and private capex is weak, but 2016 GDP will still grow 6.5%.	The Growth Trade-Off Gets Harder; The Housing Cycle Is Aging Rapidly
Eurozone	Nick Andrews	Brexit will hurt growth. Expect policymakers to shift towards fiscal stimulus.	Towards A Fiscal Union By Stealth
Japan	Joyce Poon/Neil Newman	Abenomics has not succeeded in reviving confidence; expect more drastic policies	The Next Monetary Move; Japan: Twice Bitten, Thrice Shy
India	Tom Miller/Udith Sikand	"Competitive federalism" and infrastructure spending make India a compelling growth story	Why India Can Move Faster; Bridging India's Financing Gap

Our Views In Brief Markets

Market	Analyst	View	Read more
Global asset allocation	Charles Gave	The best hedge for *Ursus Magnus**: a balanced portfolio of 40% equities (US and UK) and 60% 7-year UST zeros.	**US Bonds As A Hedge: It's Complicated**
US asset allocation	Will Denyer	The narrowing spread between return on capital and cost of capital suggests reducing risk.	**Wicksell's Portfolio**
US corporate bonds	Will Denyer/Tan Kai Xian	Spreads are likely to widen as corporate profitability is weakened by the strong USD and rising wages	**The Next Move In US High-Yield**; **High Yield Worries**
Emerging markets	Louis-Vincent Gave	With the USD done rising, and EM earnings least hit by Brexit, EM/DM risk premium differentials should fall.	**The Flow Through To EM Equities**
Emerging market bonds	Joyce Poon/Udith Sikand	High quality EM yield plays should be part of a core portfolio in a world of rising tail risk	**The EM Equity Question**
Renminbi	Chen Long	A strong USD could continue to put pressure on the renminbi, but this is unlikely to spook markets	**The Renminbi Falls; No One Cares**; **Reduced Chance Of Renminbi Storms**

*I.E., severe bear market

Our Views In Brief Themes

Topic	Analyst	View	Read more
Political risk	Anatole Kaletsky, Charles Gave	The Brexit vote is symptomatic of a new era of political risk in which voters reject the elite	**Everything Just Changed**; **Trump And The Prisoner's Dilemma**
Negative interest rate policy (NIRP)	Louis-Vincent Gave, Joyce Poon, Nick Andrews	By accident or design, NIRP will kill bank profits and prove ineffectual/counterproductive	**NIRP: Machiavellian Design?**; **Japan's Point Of No Return**
The low-rate fallacy	Charles Gave	Zero rates are destroying productivity and leading to a deflationary recession	**Vertigo And The US Economy**; **The Bloodhound And The Swedish Economist**
Oil: lower for longer	Anatole Kaletsky	Abundant supply means US$50/bbl is a ceiling price	**Oil: Lower For Longer**; **Oil's Busted Flush**
China reform risk	Arthur Kroeber	Xi Jinping's preference for political control over market reform could lead China into Japan-style stagnation	**Making Sense Of The Economic Policy Mess**; **Powerhouse, Menace Or The Next Japan?**
Renminbi internationalization	Louis-Vincent Gave	Beijing's drive to globalize its currency to continue despite market turmoil	**The Crocodile Mouth About To Close**; **The New Way To Think About China**

www.gavekal.com

Gavekal Ltd Head Office
Suite 3101 Central Plaza
18 Harbour Road
Wanchai, Hong Kong

Tel: +852 2869 8363
Fax: +852 2869 8131

Gavekal Capital, LLC
370 17th Street
Suite 4930
Denver, CO 80202

Tel: +1 303 763 1810
Fax: +1 303 763 1811

Gavekal Dragonomics China Office
Room 2110, Tower A
Pacific Century Place, 2A Gongti Beilu
Beijing 100027, China

Tel: +86 10 8454 9987
Fax: +86 10 8454 9984

For inquiries contact sales@gavekal.com