RHarding@maybank-ke.com.sg

OVERNIGHT 20/10/17

Bloomberg --

U.S. stocks eked out a gain to finish at a fresh all-time high as gains in defensive shares offset declines sparked by Apple Inc. Treasuries rose and the dollar extended losses after a report from Politico that President Donald Trump is leaning toward Jerome Powell as the next Fed chairman.

The S&P 500 wiped out a slide of 0.5 percent to close higher for a fifth straight day. The Nasdaq Composite Index fell the most in three weeks with Apple pacing declines after a report that the iPhone maker was dialing back orders. The Cboe Volatility Index held above 10, but trimmed a jump of more than 15 percent. Ten-year Treasury yields fell to 2.31 percent and gold approached $1,290 per ounce.

American traders awoke to find the S&P 500 headed for its biggest drop since August as a host of negative headlines snapped a risk-on sentiment that had dominated in recent days. Investors sought the safest assets, from the Swiss franc to gold, amid concern over politics in New Zealand and Spain, a sharp drop in Hong Kong shares and the bad news from Apple. That sentiment faded as the U.S. day wore on, amid the prospect for higher corporate earnings and data showing firmness in the American labour market.

Here are the main moves in markets:

Stocks

- The S&P 500 Index rose less than 0.1 percent at the close in New York.
- United Continental Holdings Inc. fell the most in eight years after the airline’s profit outlook disappointed investors.
- EBay Inc. fell the most in two months after giving a lackluster profit forecast for the holiday quarter.
- The Stoxx Europe 600 Index dropped 0.6 percent.
- The MSCI Asia Pacific Index dipped 0.2 percent.

Currencies

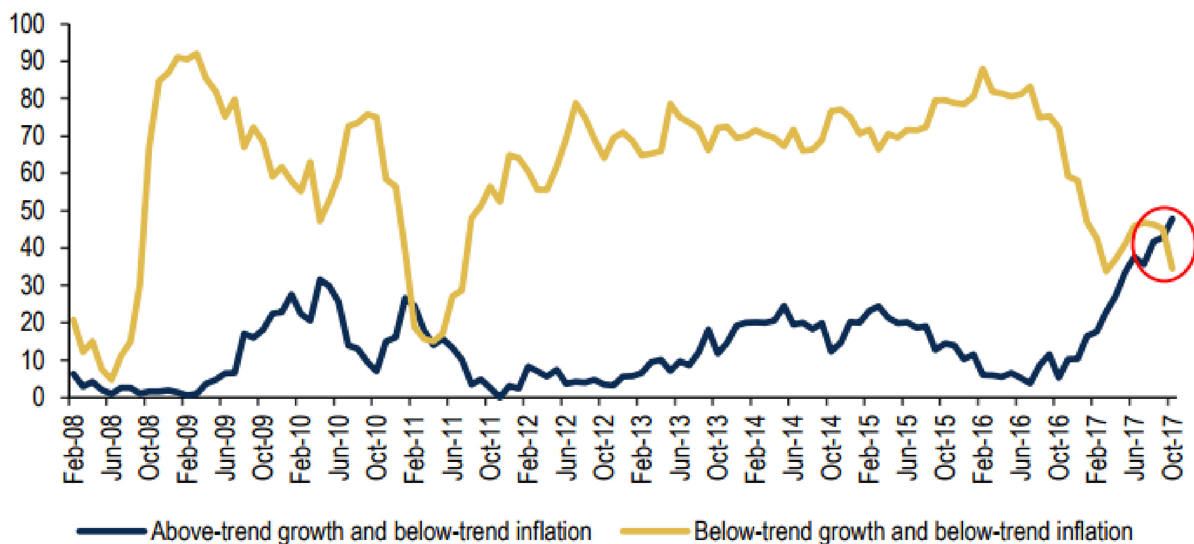
- The Bloomberg Dollar Spot Index lost 0.2 percent.
- The euro climbed 0.4 percent to $1.1833, the strongest in more than a week.
- The British pound slipped 0.4 percent to $1.3156.
- The Japanese yen rose 0.3 percent to 112.56 per dollar.

FUND MANAGERS' EQUITY ALLOCATION HITS SIX MONTH HIGH

By Rupert Hargreaves ,Valuewalk

For the first time in six years, fund managers believe that the outlook for the global economy is looking up, and fund managers are upping their equity allocation as a result.

According to Bank of America's monthly Global Fund Manager Survey, 48% of respondents (up 5%) believe that over the next 12 months the global economy is heading into a "Goldilocks" period of above-trend growth and below-trend inflation. 34% of respondents believe that the economy will face below-trend growth and inflation.



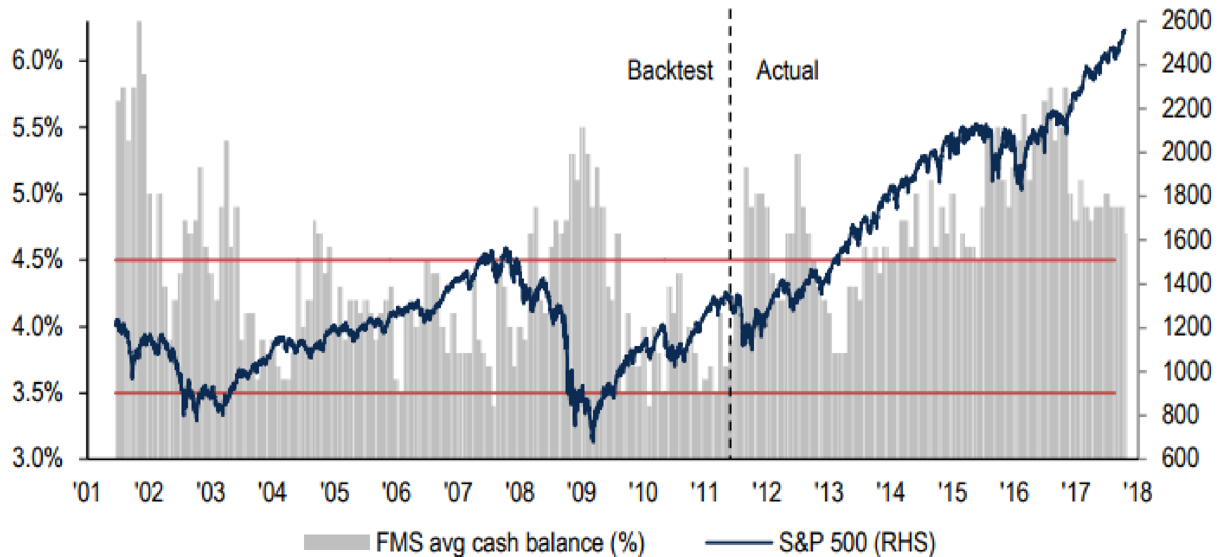
Fund Managers' Equity Allocation Hits Six Month High

A total of 207 panelists with $585 billion in assets under management participated in the Bank of America survey. Overall, the mood among fund managers surveyed seems to be positive and managers are buying equities once again.

According to the survey, the average cash weighting has fallen to 4.7%, the lowest in two-and-a-half years, and well above the October 2016 peal of 5.8%. The reduction in cash balances since the peak has coincided with an $18 trillion increase in global equity market cap according to the report.

The overall allocation to equities ticked higher in October to net 45% overweight, the highest in 6 months. The current equity allocation is 0.7 standard deviations above its long-term average.

Exhibit 5: Global FMS average cash balance (%)



Source: BofA Merrill Lynch Global Fund Manager Survey, Bloomberg; Disclaimer: The indicators identified above as BofAML Bull & Bear and BofAML Global FMS Cash Rule are intended to be indicative metrics only and may not be used for reference purposes or as a measure of performance for any financial instrument or contract, or otherwise relied upon by third parties for any other purpose, without the prior written consent of BofA Merrill Lynch Global Research. These indicators were not created to act as a benchmark.

However, while managers are bullish on equities, they're bearish on bonds. Just 3% of respondents said global bond yields will be lower in the next
12 months and 82% said bond yields will rise. A record 85% of investors declared that bonds are overvalued at current levels. The overall allocation to bonds declined to net 60% underweight, the lowest allocation in 7 months. The current equity allocation is 0.9 standard deviations below its long-term average.

On the topic of tax reform, two-thirds of investors expect some tax cuts in 2018 but they also believe that these actions will have a limited impact on risk assets. Two-thirds expect a tax reform bill in Congress in Q1 2018.

Other notable trends from the survey include:

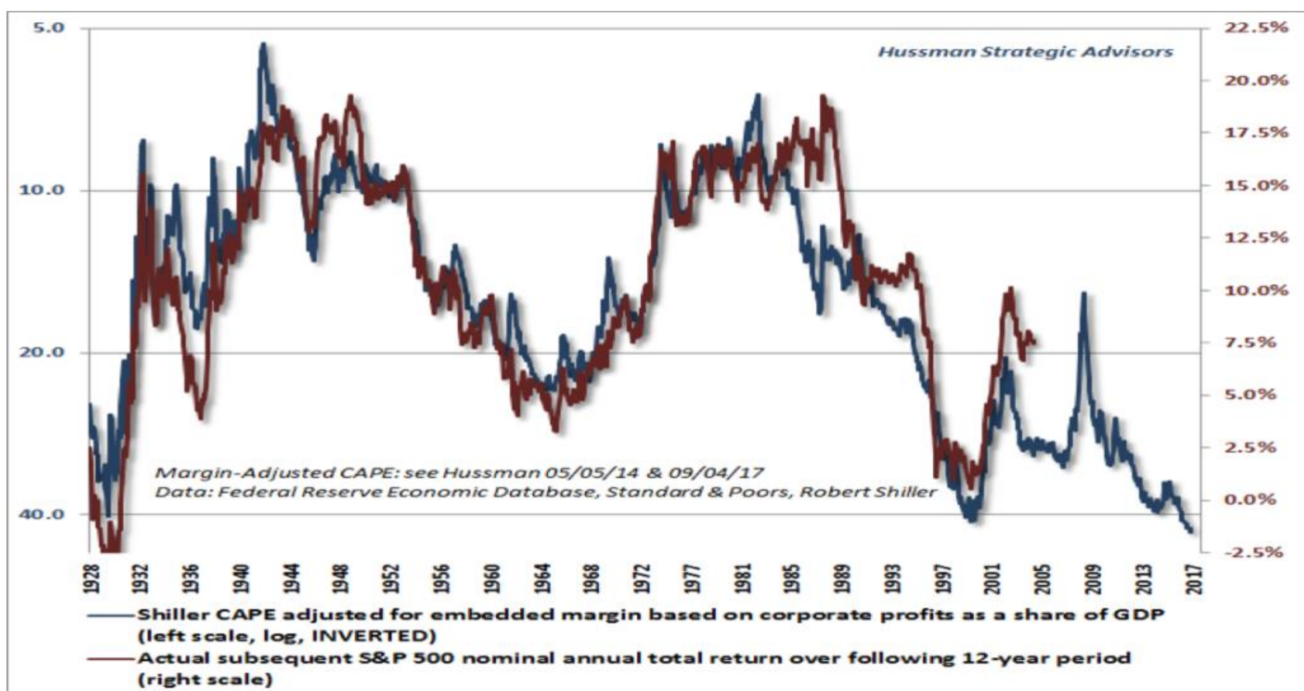
- Investors who think US$ undervalued falls to net 20% (from 23% in September, the highest since Dec'14).
- Fear of a policy mistake by the Fed or ECB returns to the top tail risk spot in October.
- "Long Nasdaq" the most crowded trade for the 5th time this year.

EQUITY MARKET VALUATIONS: WE HAVEN'T BEEN HERE BEFORE

By Baijnath Ramraika, CFA and Prashant Trivedi, CFA, AdvisorPerspectives.

As the equity bull market has entered its ninth year, market participants have voiced concerns over elevated valuation levels. John Hussman has been one of the more prominent who have sounded the warning bells about low expected returns and elevated risks embedded in equity valuations. In his recent note, Hussman stated that few investors recognize that one of the reasons why valuation multiples were so rich in 2000 is that profit margins were actually below historical norms at the time. The benefit of normalizing the embedded profit margin comes not just from muting margins that are above historical norms, but also from normalizing margins in periods where they are below historical norms.

In the chart below, Hussman plotted the margin-adjusted cyclically adjusted price to earnings ratio (CAPE) on an inverted log scale along with actual subsequent S&P 500 nominal average total returns over the subsequent 12-year period. There are two points that are worth noting about this chart. Firstly, the fit between observed valuation levels and subsequent long-term returns is tight, suggesting that the valuation model employed is robust. Secondly, valuations based on this metric are in the same territory as the 1929 high and the tech bubble, zones that resulted in poor subsequent investment returns.



Source: Weekly Market Comment, John P. Hussman, Hussman Funds, October 2, 2017

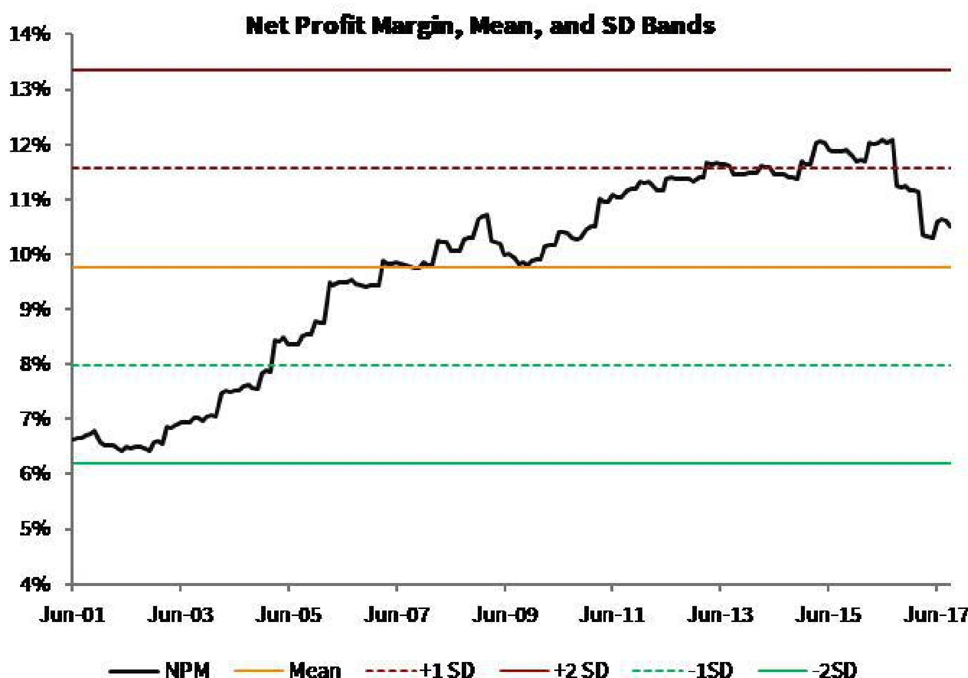
Maybank Kim Eng

At our firm, we are focused on a much smaller sub-set of businesses; that of high-quality businesses with durable competitive advantages. Accordingly, our concerns around market valuations are largely related to the valuation of this sub-set of businesses. Our target sub-set performed well over the last few years with a significant portion of that performance driven by the broader equity bull market. The important question that we face at this juncture is whether the sub-set of high-quality businesses is as overvalued as the broader markets and whether that is likely to bode ill for our future investment returns.

To effectively answer that question, we built a bottom-up model of the companies in our investment universe; the Global Moats Index. Our analysis covers 120 unique companies over the last 16 years with 110 of these companies being a part of our investment universe currently. In the discussion below, we take a deep dive into the profitability of these businesses as a group, levels of leverage employed, business reinvestments and share buybacks, and business valuations.

Profitability – troughs and peaks

As is seen in the charts below, profit margins, net profit margin as well as operating profit margin, started from a low level in 2001 and peaked in the 2013 to 2016 period. Since then, profit margins for the Global Moats Index have pulled back towards the mean of the past 16 years.



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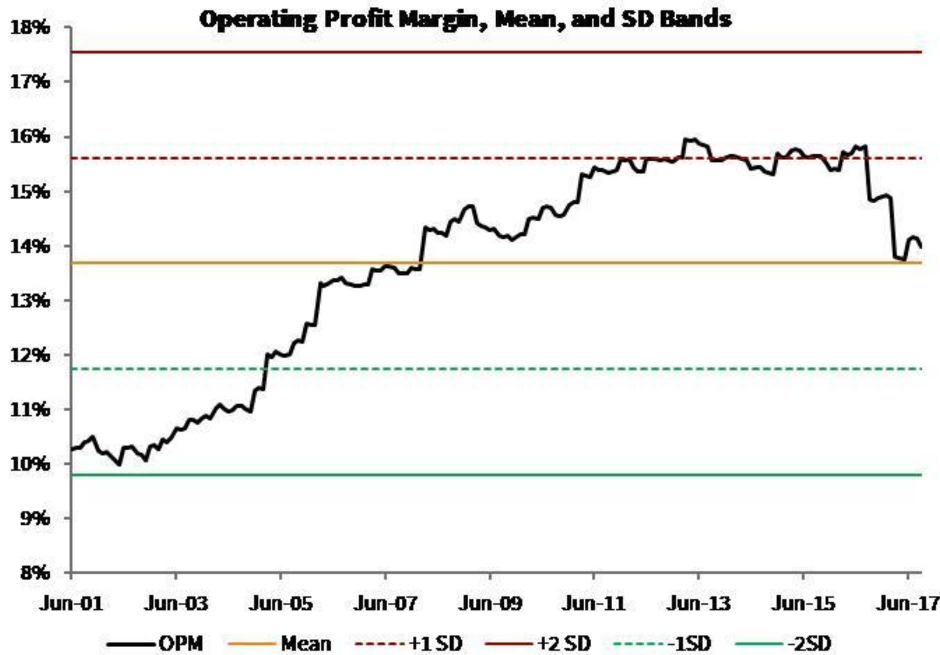
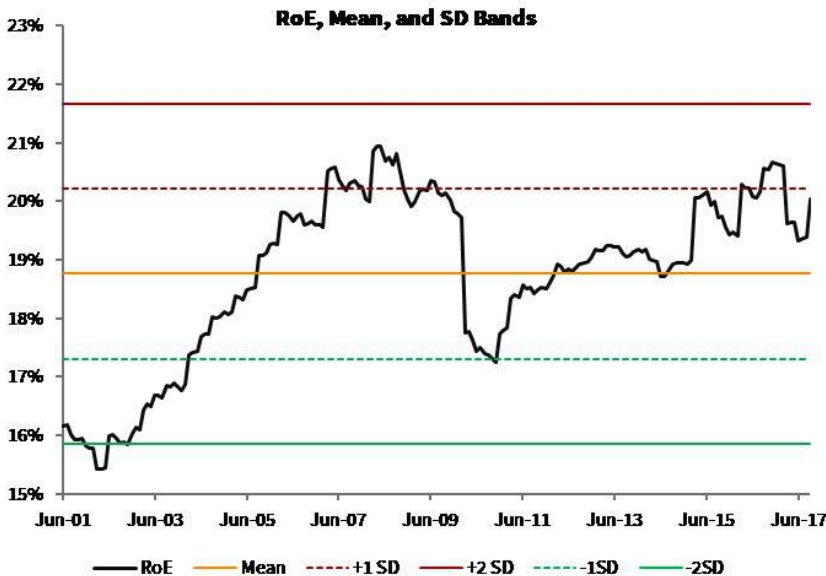
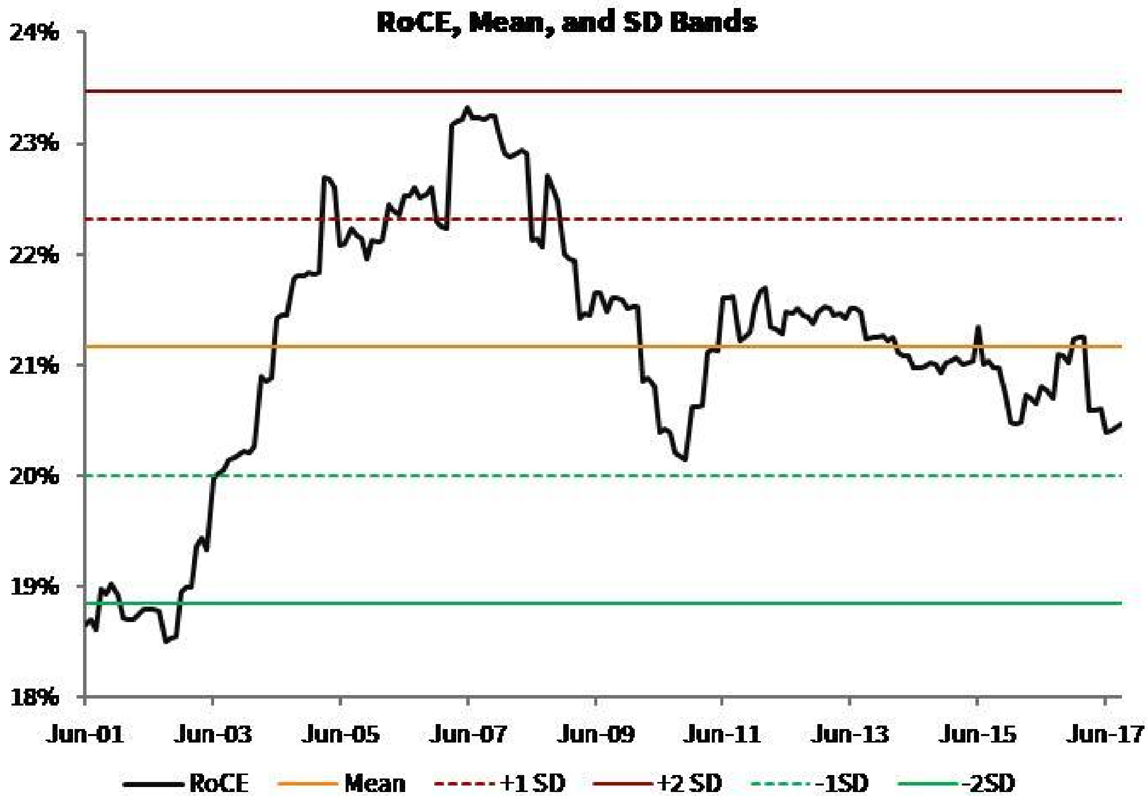


When we measure profitability in terms of returns on capital, a somewhat different picture emerges. For one, the range of returns on capital has been fairly tight when measured in terms of return on equity[1] as well as return on capital employed[2]. Additionally, while returns on capital persistently increased between 2001 and 2007, since then we have had much more of an oscillating behavior.

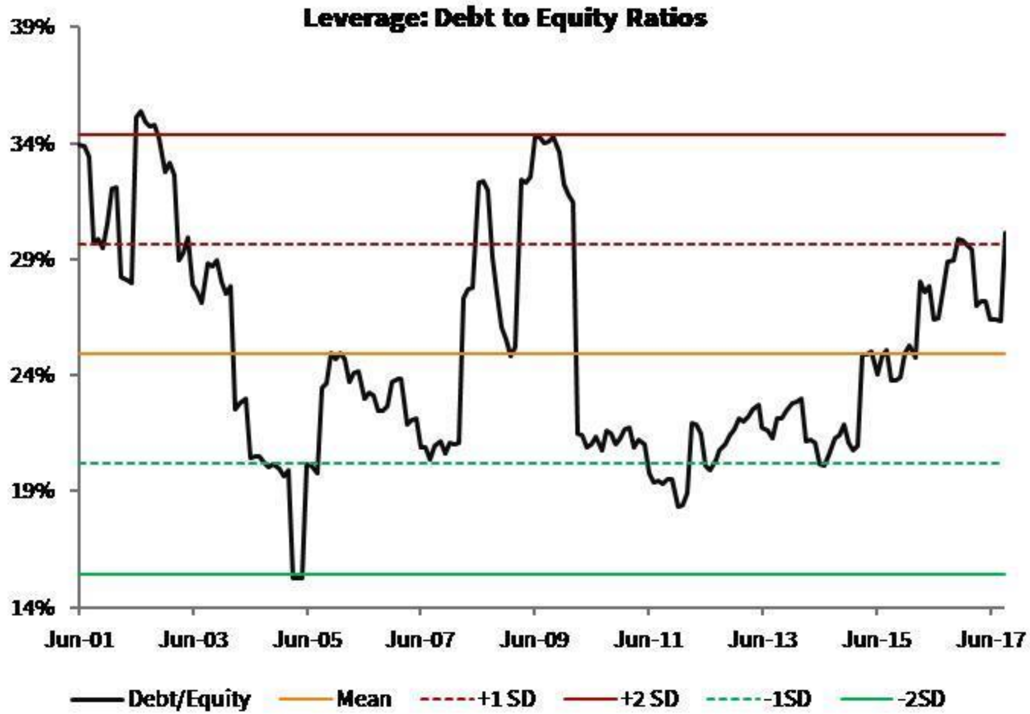


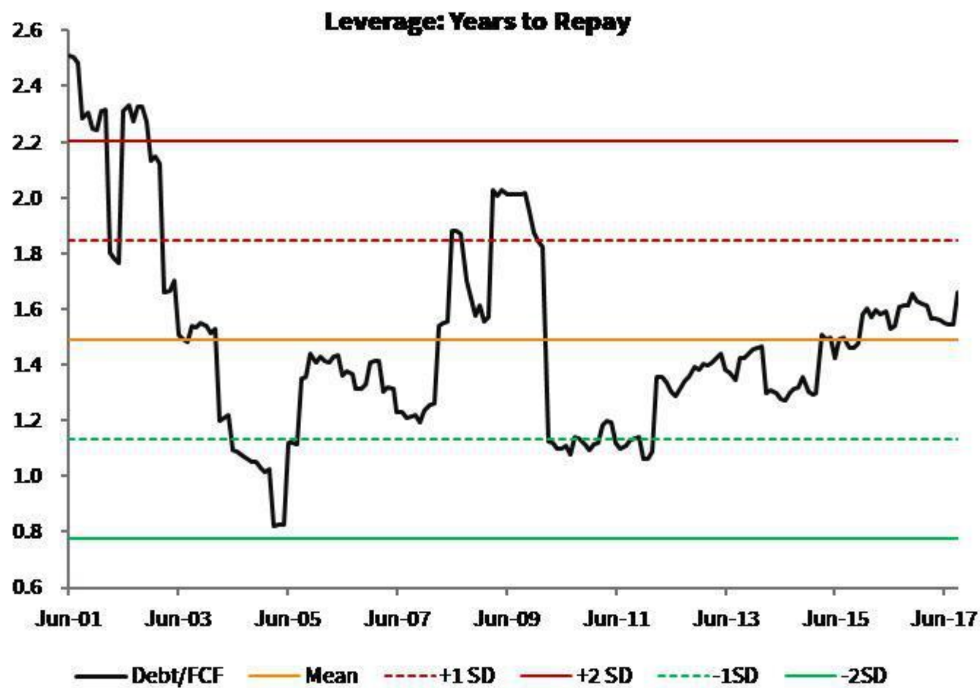


Leverage – capital structure and years to repay

The last few years have seen a significant increase in employment of leverage at corporate levels driven by low borrowing costs and lax lending standards, factors that have created an environment ripe for levered speculation. We have no affinity to levered engagements and accordingly we avoid leverage.

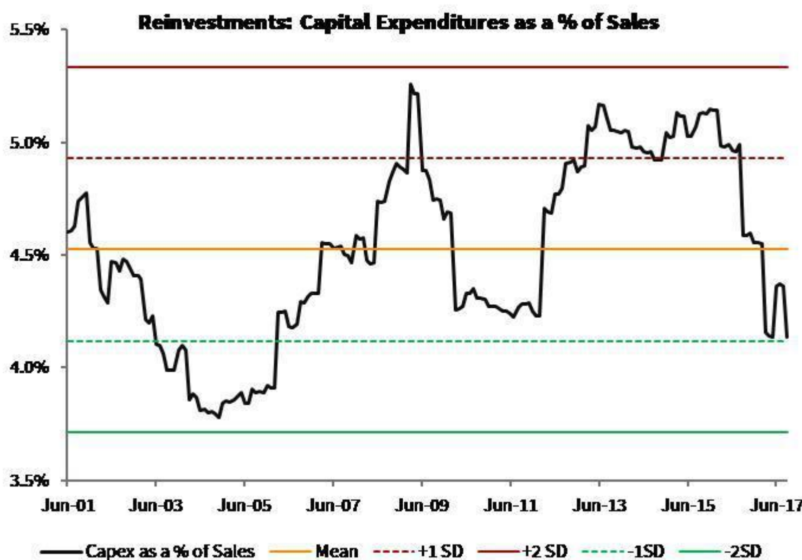
As the charts below show, leverage embedded in our businesses remains well controlled. Years to repay debt as measured by total leverage *divided by* free cash flows has stayed below two years.

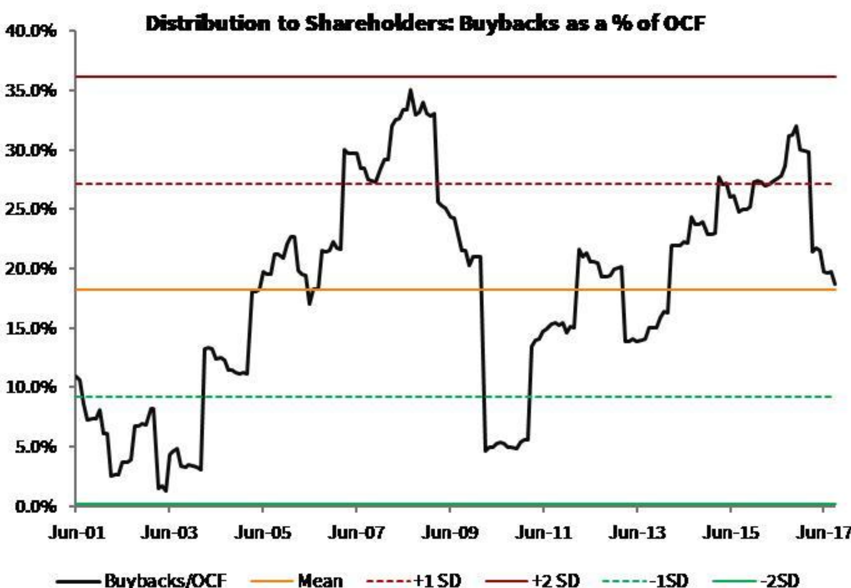

Leverage: Debt to Equity Ratios
39%
34%
29%
24%
19%
14%
Jun-01
Jun-03
Jun-05
Jun-07
Jun-09
Jun-11
Jun-13
Jun-15
Jun-17
Debt/Equity
Mean
+1 SD
+2 SD
-1SD
-2SD


Leverage: Years to Repay
2.6
2.4
2.2
2.0
1.8
1.6
1.4
1.2
1.0
0.8
0.6
Jun-01
Jun-03
Jun-05
Jun-07
Jun-09
Jun-11
Jun-13
Jun-15
Jun-17
Debt/FCF
Mean
+1 SD
+2 SD
-1SD
-2SD

Usage of cash – reinvestments and distribution to shareholders

While the economic recovery since the global financial crisis has continued at a slow pace, reinvestments by companies have declined. Additionally, companies have increasingly engaged in buying back their own shares by borrowing at low interest rates. Interestingly, this behavior hasn't been as pronounced among our high-quality businesses. Indeed, reinvestment rates as measured by capital expenditures as a percentage of sales has stayed around its mean. While buybacks did take up a larger share of the operating cash flows, they have since declined towards the mean.

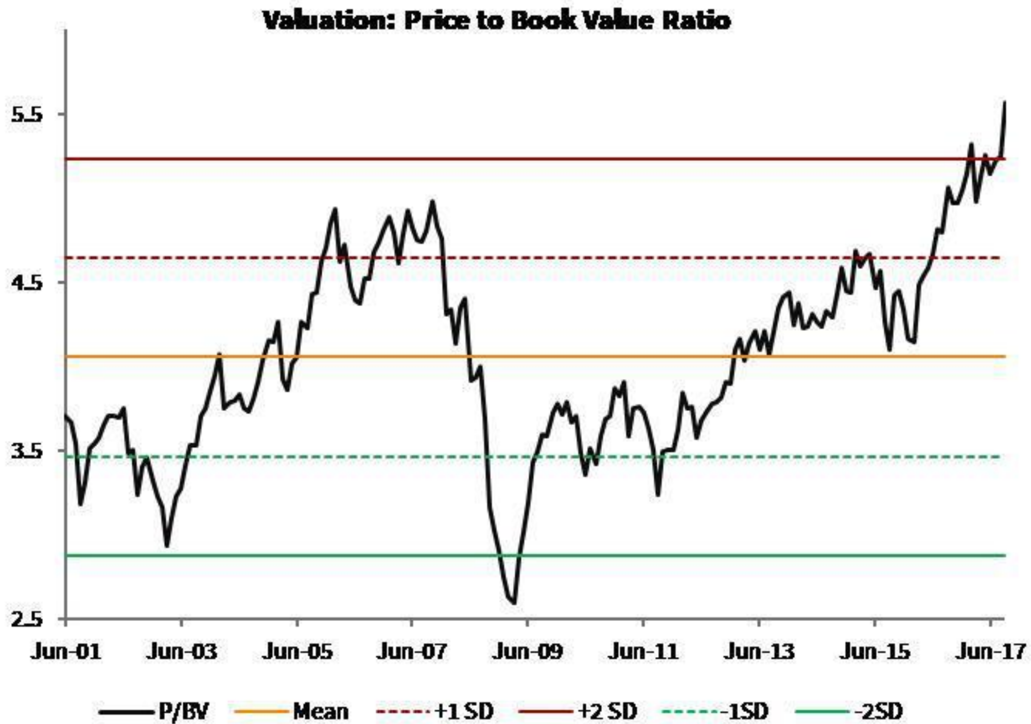


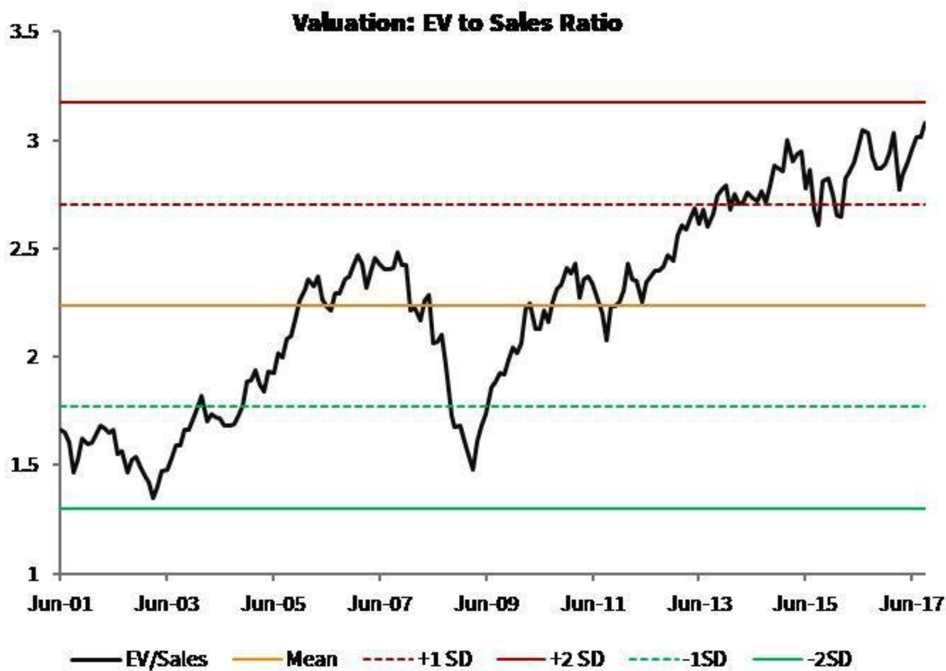


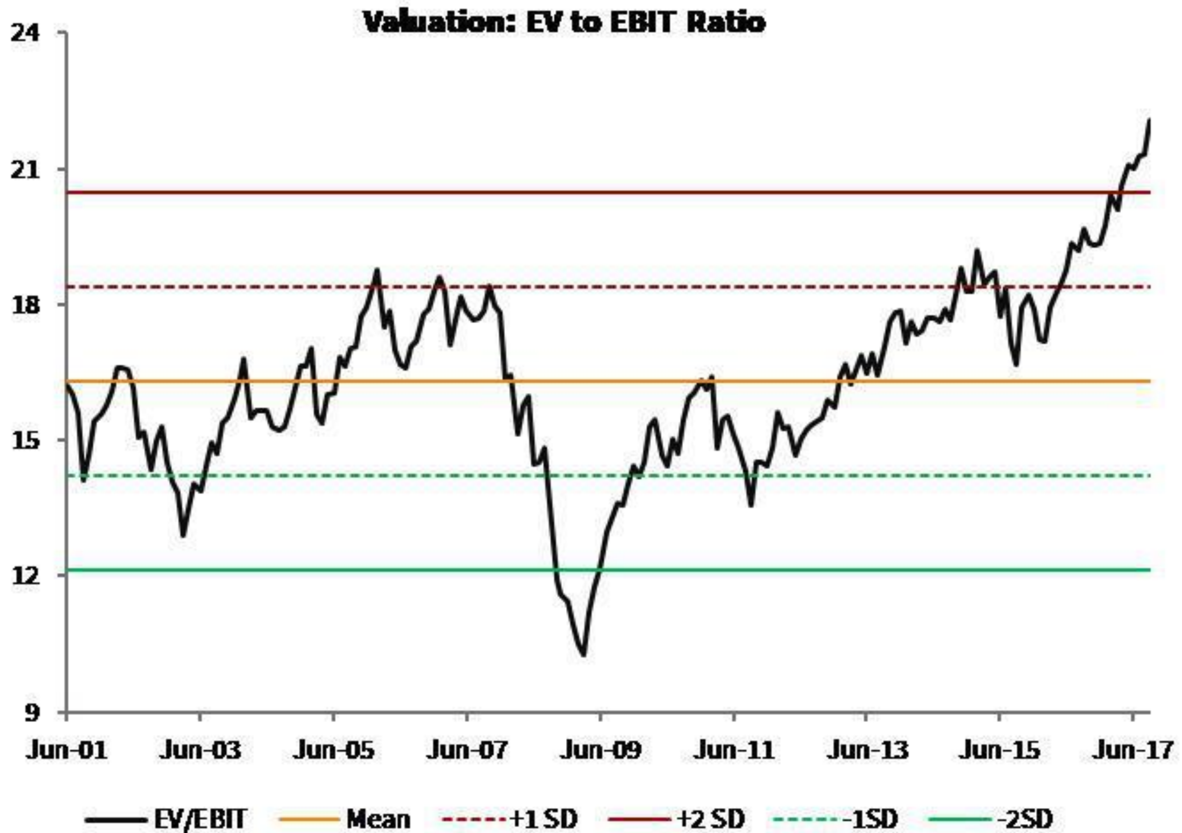
Valuation – uncharted territory as measured by conventional valuation tools

Much as the work of Hussman suggests for the broader equity markets, a similar picture emerges regarding valuations for the Global Moats Index. Valuations are in a zone where we haven't been before.

Below, we show valuations for the Global Moats Index based on four conventional valuation tools, namely the price to earnings ratio, the price to book ratio, the enterprise value to sales ratio, and the enterprise value to earnings before interest and taxes (EBIT) ratio. In each one of the cases, valuations are the highest they have been over the last sixteen years.


Valuation: Price to Book Value Ratio
5.5
4.5
3.5
2.5
Jun-01
Jun-03
Jun-05
Jun-07
Jun-09
Jun-11
Jun-13
Jun-15
Jun-17
P/BV
Mean
+1 SD
+2 SD
-1SD
-2SD

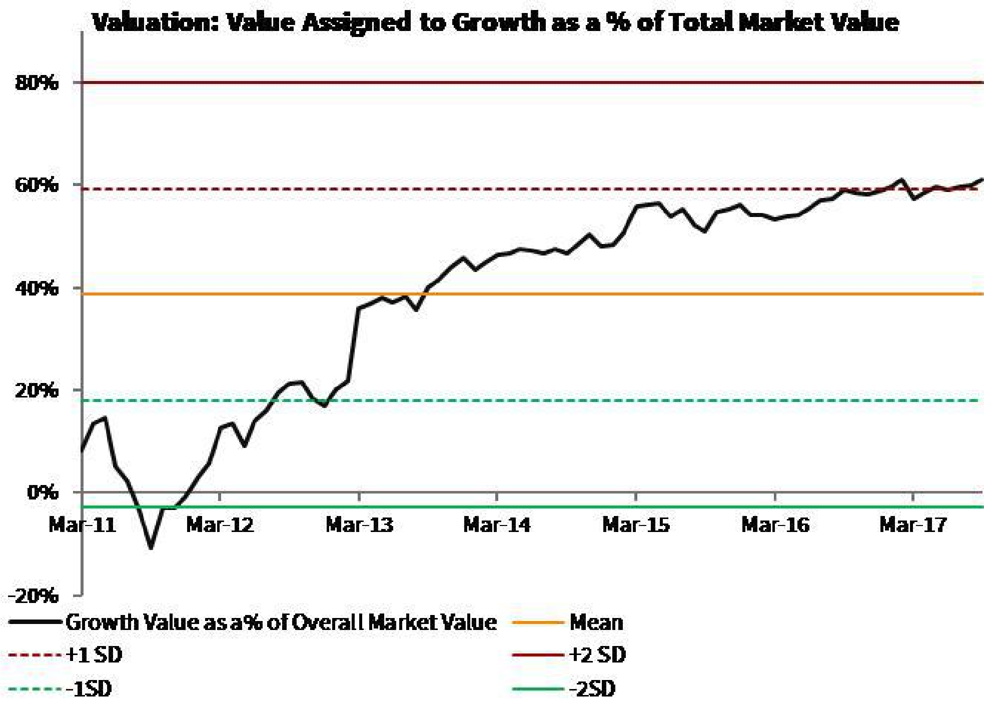

Valuation: EV to Sales Ratio
3.5
3
2.5
2
1.5
1
Jun-01
Jun-03
Jun-05
Jun-07
Jun-09
Jun-11
Jun-13
Jun-15
Jun-17
EV/Sales
Mean
+1 SD
+2 SD
-1SD
-2SD



Valuation – absolute valuations are suggesting overvaluation too

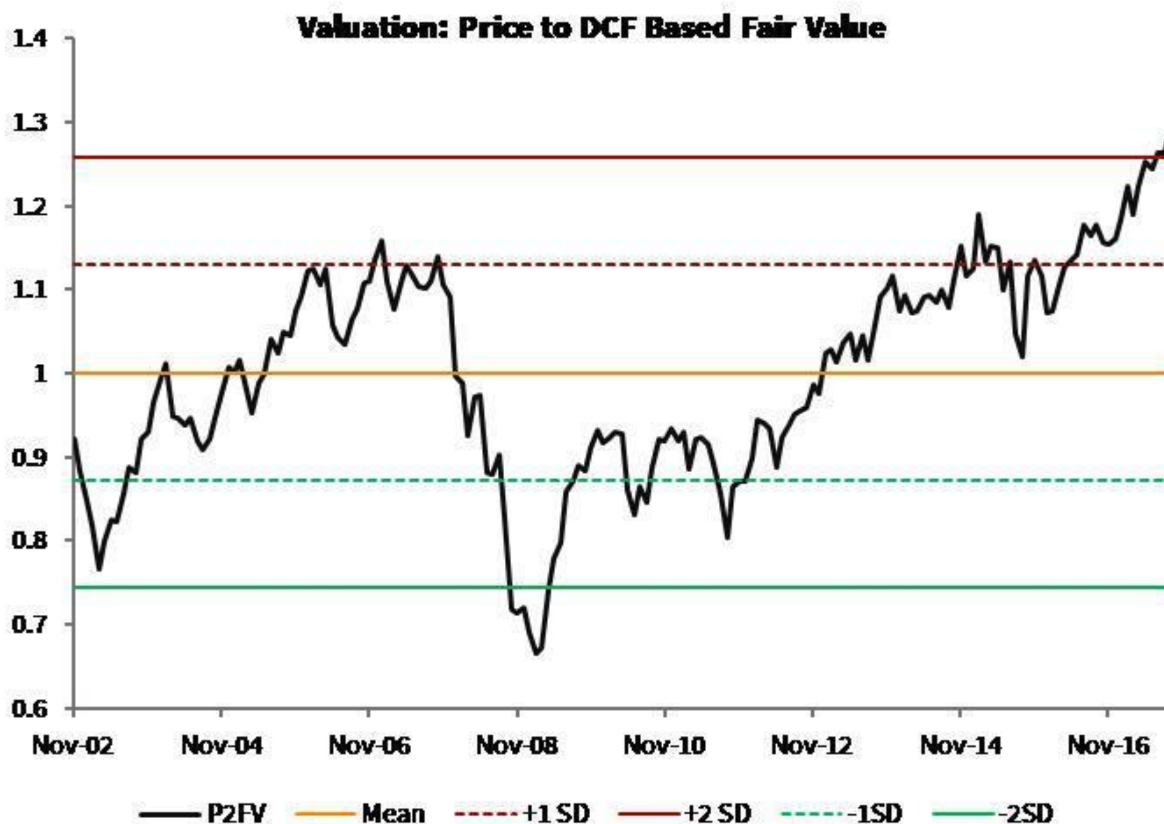
As Benjamin Graham posited, shares are not mere pieces of papers. Instead, they should be thought of as part ownerships in a business. As part owners of businesses that we invest in, we look to understand the value of what we own. One of the valuation metrics that we find quite useful is the value of the current business franchise of the business, i.e., the current earnings power value of the business's moat. This is the value of a moat business if it were to have zero growth. Assessing the value of current earnings power of the business allows us to segregate the overall market value between the current earning power's value and the percentage of market value that is ascribable to future growth of the business.

Valuation: EV to No Growth Value
3
2.5
2
1.5
1
0.5
Mar-11
Mar-12
Mar-13
Mar-14
Mar-15
Mar-16
Mar-17
EV/NGV
Mean
+1 SD
+2 SD
-1SD
-2SD


Valuation: Value Assigned to Growth as a % of Total Market Value
80%
60%
40%
20%
0%
-20%
Mar-11
Mar-12
Mar-13
Mar-14
Mar-15
Mar-16
Mar-17
Growth Value as a% of Overall Market Value
Mean
+1 SD
+2 SD
-1SD
-2SD

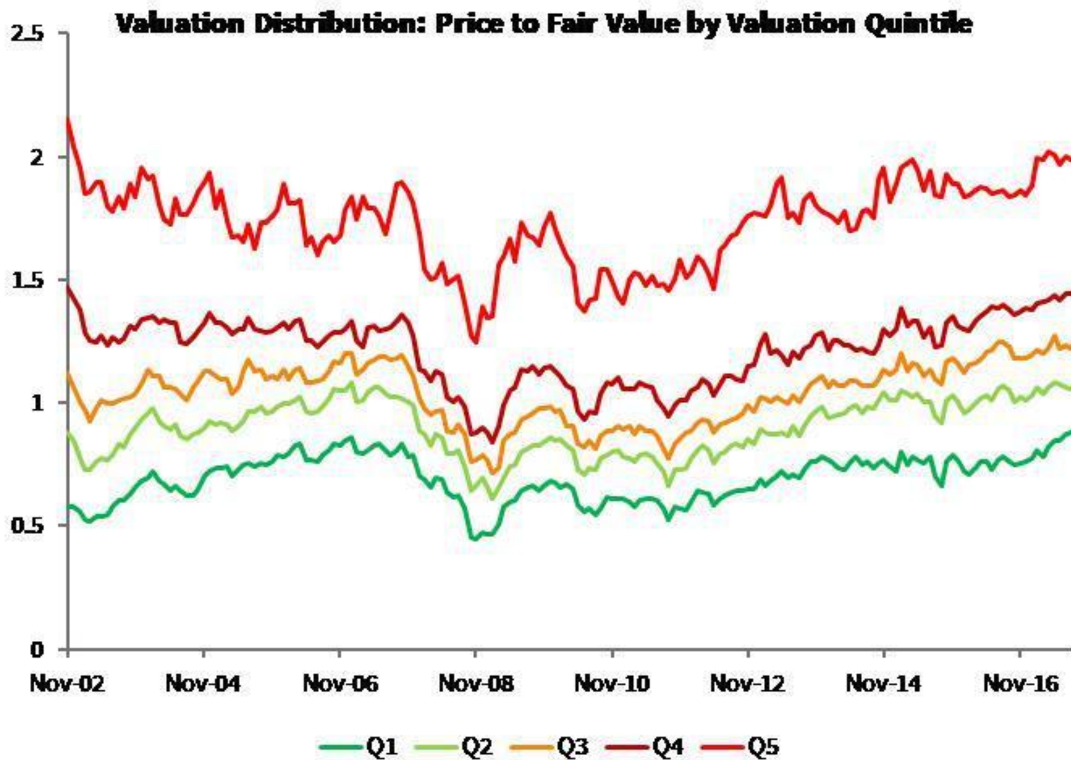
As is seen in the charts above, the Global Moats Index went from selling at just about the franchise value in 2011 to selling at more than 2x the franchise value currently. The result of this valuation rerating is that market participants went from assigning almost no value to the growth of our businesses in 2011 to assigning nearly 60% of the current market value to future growth.

A similar picture emerges when one looks at the pricing of the index in relation to appropriately calculated discounted cash flow based business value. As is seen, we are indeed in uncharted territory.



Valuation distribution – ability to buy businesses at meaningful discounts to fair value

As active investors, our ability to add value depends not only on the level of valuation across the target investment universe, but also on width of the valuation distribution. As is seen in the chart below, the valuation distribution continues to be wide affording us an opportunity to selectively build portfolios that have superior expected prospective returns. However, it is important to note that even the cheapest quintile is close to valuation levels that were observed in 2007.



Expected returns

Over extended periods, we expect our investment experience to be largely driven by the change in underlying per-share business values of the businesses in our portfolio. Accordingly, the key factor in our assessment of expected returns is the expected business value growth.

Over the past 16 years, businesses within the Global Moats Index observed a growth of about 13% in their intrinsic value with about 2% of the business value growth driven by margin expansion, i.e., core business value grew at about 11%. The Index's results were further aided by valuation multiple expansion which added another 2.5% to the index's returns.

Both these factors, margins and valuation multiples, are likely to be sources of negative returns over the next seven years. Assuming that profit margins and valuation multiples normalize over a course of seven years, they will contribute -1% and -4% respectively to the index's returns. Further assuming that core business growth rate stays at similar levels as observed over the past 16 years and a contribution of 1.5% from dividends, we will expect our high-quality business universe to generate annualized investment returns of about 7.5% over the next seven years (11% -1% -4% +1.5%).

Clearly, our expected investment returns from hereon are well below the returns that we expect to generate over full business cycles. However, when looked at in relation to other investment avenues, our sub-set of businesses will likely serve as one of the best potential investment avenues over what promises to be a low-return period for equities.

There are two factors that support our opinion. Firstly, as we have shown above, we estimate prospective returns for the Global Moats Index to be 7.5% nominal. This estimated return is significantly better than the negative nominal return expectation for the broader equity markets as estimated by Hussman. Secondly, as the valuation distribution chart above shows, the valuation distribution within our investment universe continues to be wide. This affords us an opportunity to selectively build a portfolio of businesses that will likely generate investment returns that are superior to that of the Global Moats Index.

Summary

The Global Moats Index is depicting similar overvalued conditions as observed around the broader equity markets. Such elevated valuation levels have historically resulted in poor long-term investment returns. This time is not likely to be any different and prospective returns will be significantly lower than the returns over the last few years.

However, the superior quality of businesses in our investment universe results in business value growth that is significantly greater than publicly traded benchmarks. While valuation factor will likely affect our investment returns negatively, higher business value growth generated by our businesses means that our forecast of expected investment returns is significantly higher than that of the broader markets. Additionally, the width of valuation distribution within our investment universe affords us the opportunity to selectively build a portfolio of businesses that will generate excess investment returns over and above that of the Global Moats Index.

LOW FOR LONGER DUE TO WEAK ECONOMIC GROWTH AHEAD

Lance Roberts,Seeking Alpha

As stocks rang new highs last week, there were several disparate stories that caught my attention.

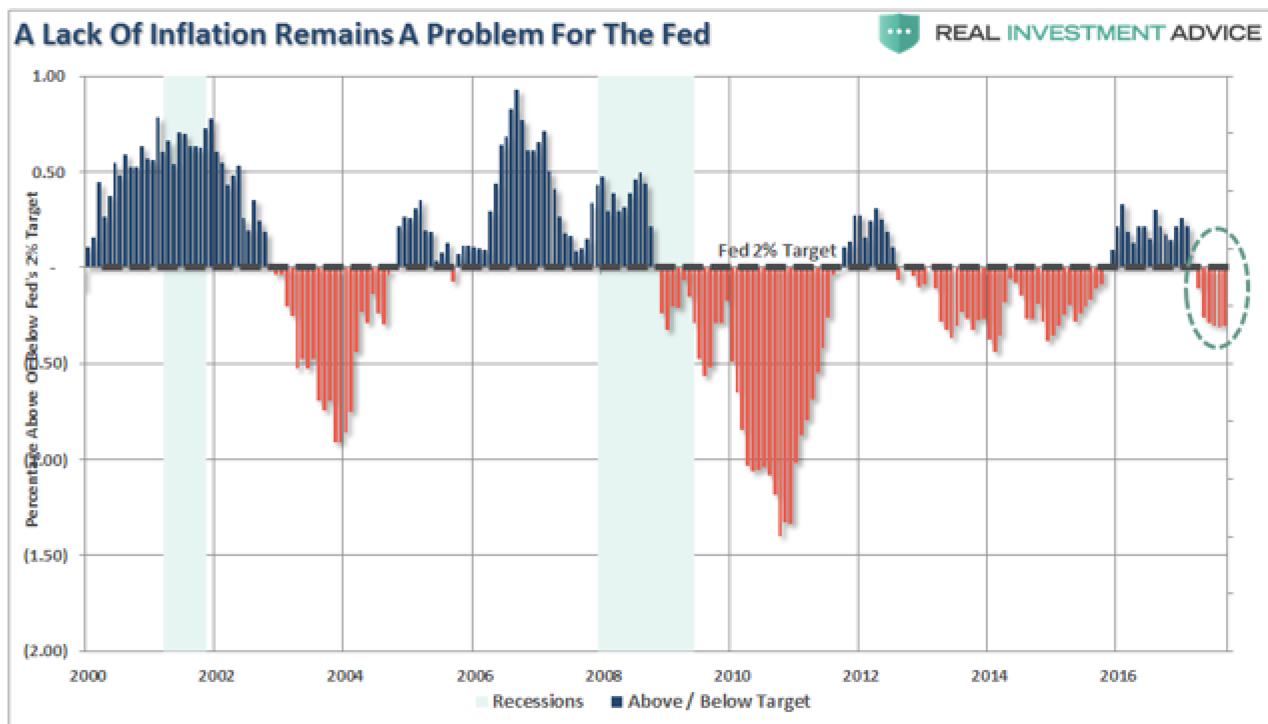
Individually, each story is nothing to be overly concerned about, and are regularly dismissed by investors.

However, when you begin linking these stories, a picture is beginning to emerge that suggests investors may be ignoring the evidence at their own peril.

Story 1: CPI Remains Weak

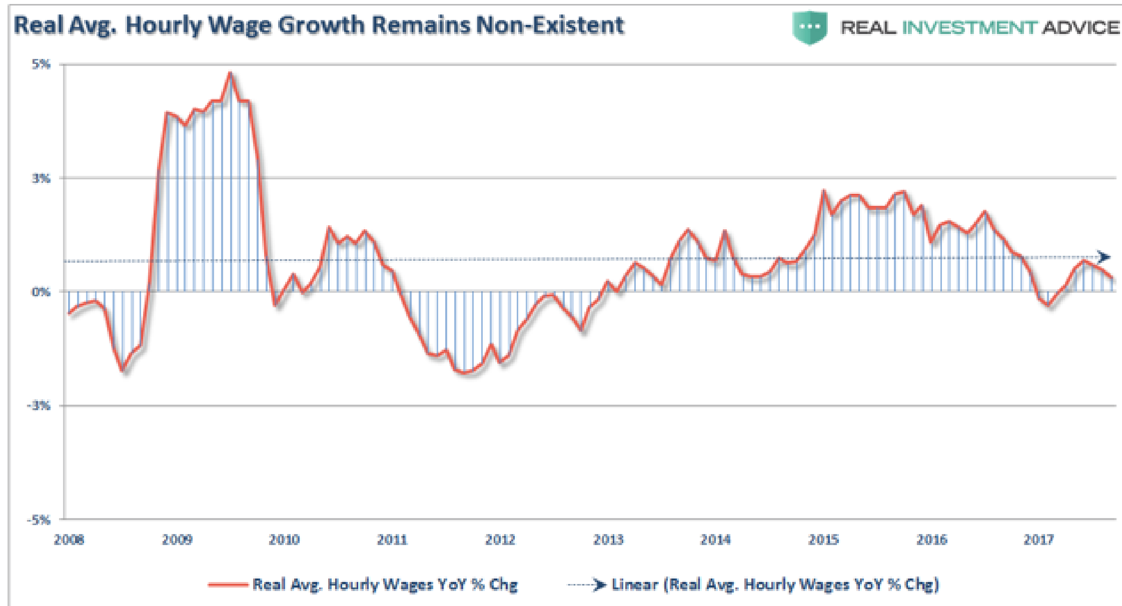
Despite three hurricanes and wildfires over the last couple of months, core CPI *(ex-aircraft)* failed to register much inflationary pressure. One would have expected given the surge in demand for goods and services needed to rebuild destroyed communities.

However, despite the Fed's hopes for a surge in inflationary pressures to justify further hikes in interest rates, inflationary pressures have been on the decline for the last several months.

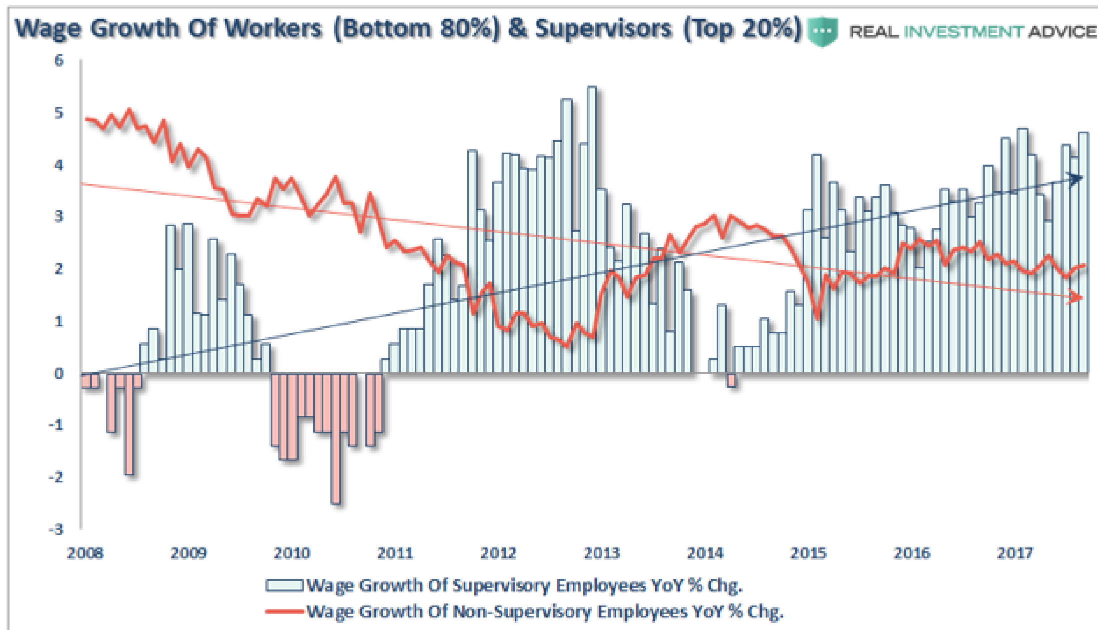


Story 2: Real Wage Growth Slumps Along With Employment

Of course, the lack of inflation leads through to a decline in inflation-adjusted wages. While the chart below only goes back to 2008, wage growth has been non-existent since 1998.



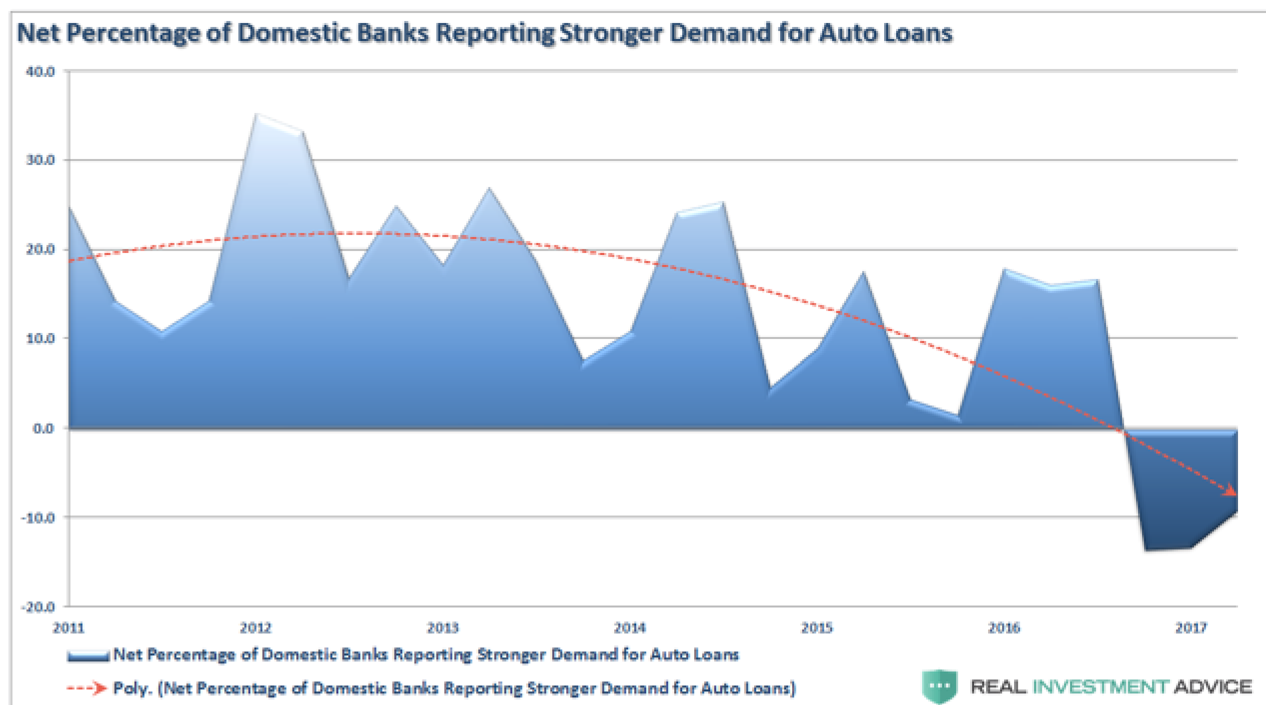
But as I discussed previously, even those wage numbers are skewed by the top 20% of income earners versus the bottom 80%, which continue to see wages decline.



Story 3: Auto Originations Crash

As Wells Fargo (NYSE:WFC) announced this past week, **the decline in auto loan originations continued tumbling 47% Y/Y to only $4.3 billion, the lowest print since the bank started disclosing this item back in 2013.**

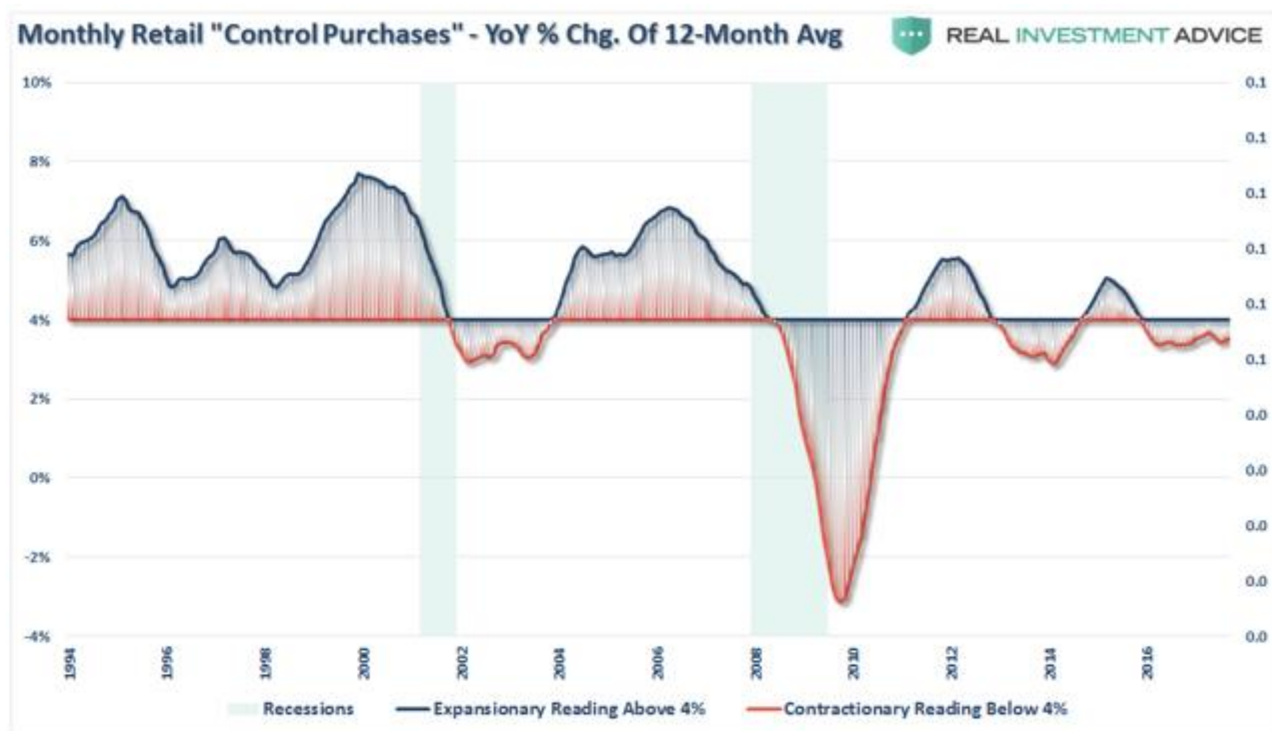
The problem is that it is not just Wells having this problem, but all banks. As shown in the chart below, the number of banks reporting strong auto loan demand has been in decline for quite some time.



Story 4: Retail Sales Continue To Lag

It isn't just auto either. Retail sales account for roughly 40% of personal consumption expenditures, which makes up 70% of the economy. **With wages stagnant, and the real cost of living on the rise, it is not surprising that with roughly 80% of Americans living paycheck-to-paycheck that retail sales continue to wane.**

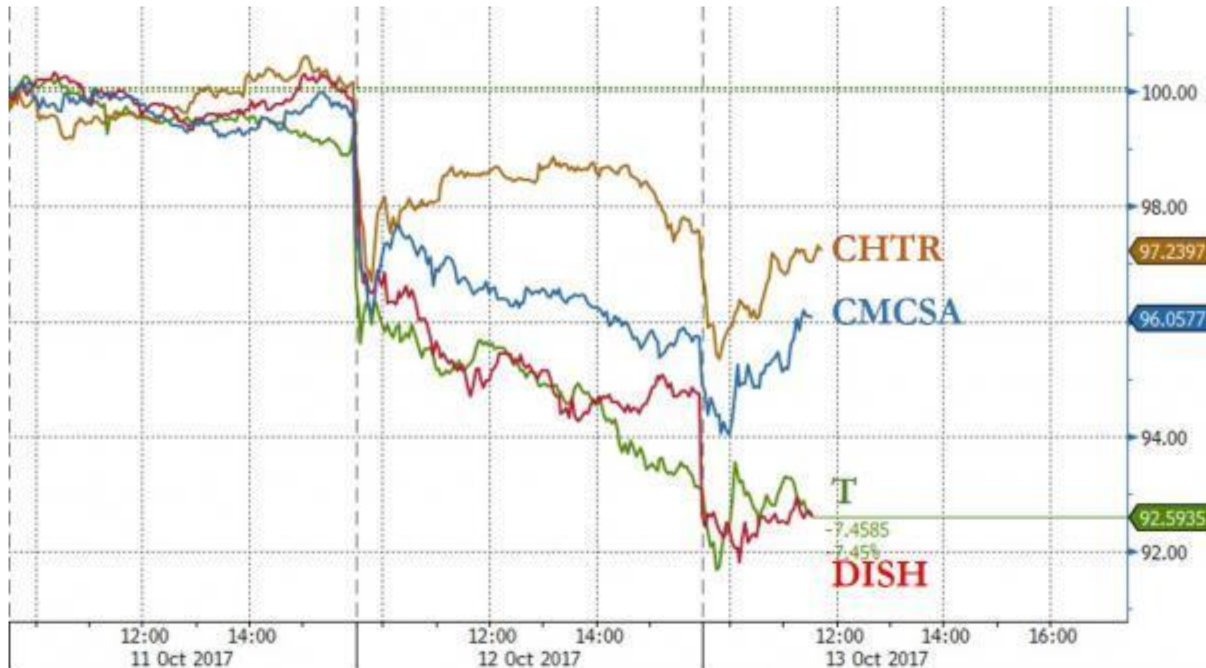
The chart below is the annual percent change in the 12-month average of *"control purchases."* These are the items that consumers buy with regularity and shows why retail struggles aren't just related to the *"Amazon effect."*



Story 5: Pay-TV Customers Decline

While *"cutting the cord"* may be a *"thing,"* this is much more a story about consumers being faced with a choice between making their mortgage payment or paying for cable. With budgets strained, consumers are actively seeking choices where they can get access to programming at much cheaper costs. From Bloomberg last week:

"Barring a major fourth-quarter comeback, 2017 is on course to be the worst year for conventional pay-TV subscriber losses in history, surpassing last year's 1.7 million, according to Bloomberg Intelligence. *That figure doesn't include online services like DirecTV Now. Even including those digital plans, the five biggest TV providers are projected to have lost 469,000 customers in the third quarter."*



At least all the *"low budget"* films are getting a shot at a whole new audience. So sit back, grab some popcorn and take in *"Galaxina"* or *"Cannibal Women From The Avocado Jungle."*

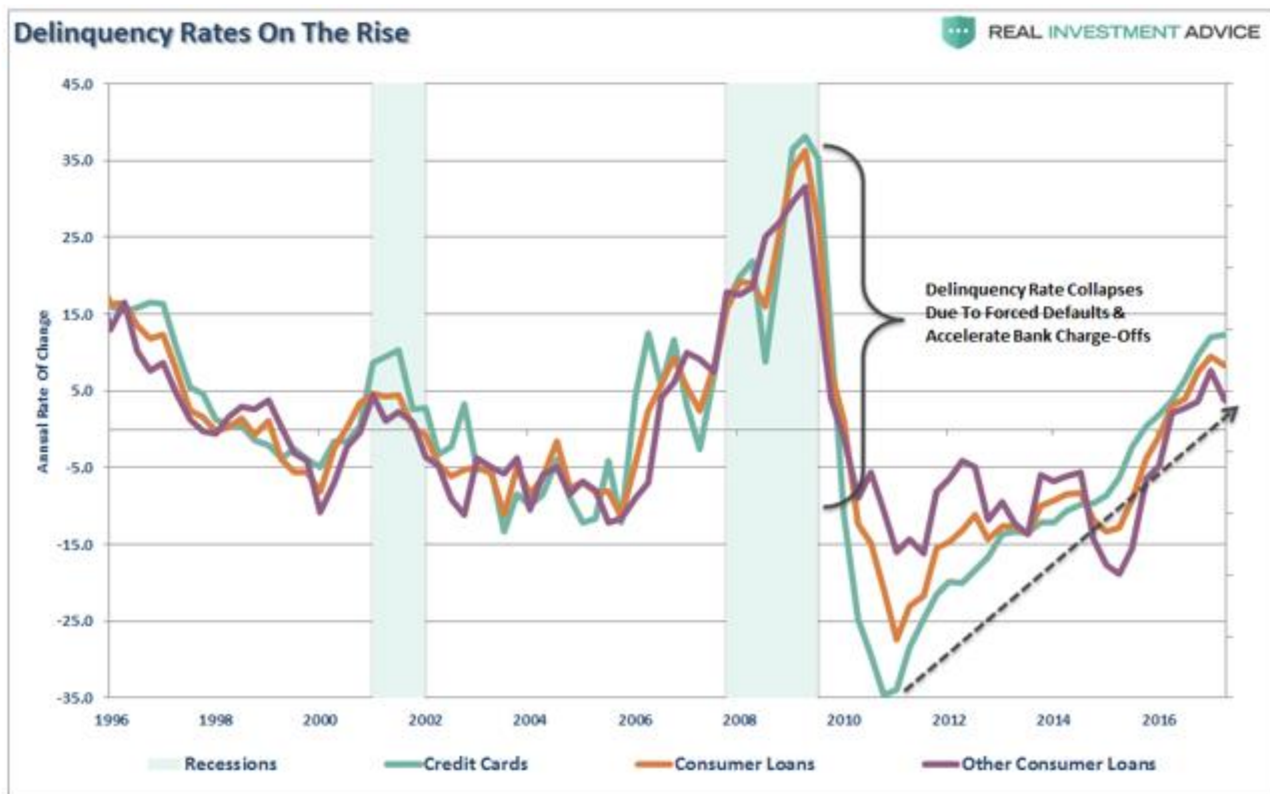
Story 6: Banks Ramp Up Loan Loss Reserves

In another interesting note this week, **Citi (NYSE:C), JPMorgan (NYSE:JPM) and BofA (NYSE:BAC) all boosted their *"loan loss reserves"* by the most in 4 years.** Banks don't boost reserves unless there is a rising risk of defaults on the horizon. From Zerohedge:

"Four months ago, when looking at the latest S&P/Experian data, we first reported that credit card defaults had surged the most since June 2013, a troubling development which ran fully counter to the narrative that the economy was recovering and the US consumer's balance sheet was improving.

*The troubling deterioration prompted Moody's to pen its own report titled 'Spike in Charge-off Rates Indicates a Slide in Underwriting Standards' and as Moody's analyst Warren Kornfelf wrote, **the steep increase in credit card charge-off rates in 1Q'17 and 4Q'16 was the largest since 2009**, and indicates that 'strong underwriting standards in place since the financial crisis have deteriorated, potentially rapidly.'"*

Of course, the following chart might just suggest why they are doing that.

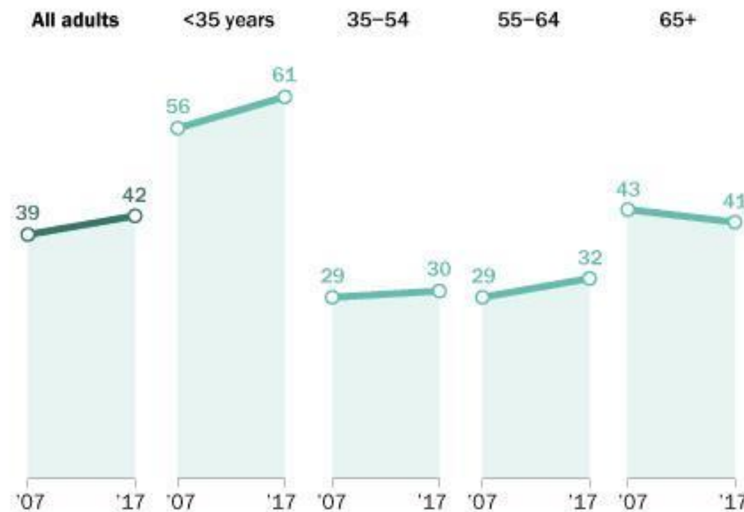


Story 7: Millennials Are Delaying Marriage Because Men Aren't Earning Enough

As reported by The Hill this past week, more Americans are living alone today has risen sharply.

"The number of Americans living with a spouse or partner has fallen notably in the last decade, ***driven in part by decisions to delay marriage in the wake of a recession that hit new entrants into the workforce especially hard.***

Forty-two percent of Americans live without a spouse or partner, up from 39 percent in 2007, *according to the Pew Research Center's analysis of U.S. Census Bureau figures.* ***For those under the age of 35 years old, 61 percent live without a spouse or partner, up 5 percentage points from a decade ago."***



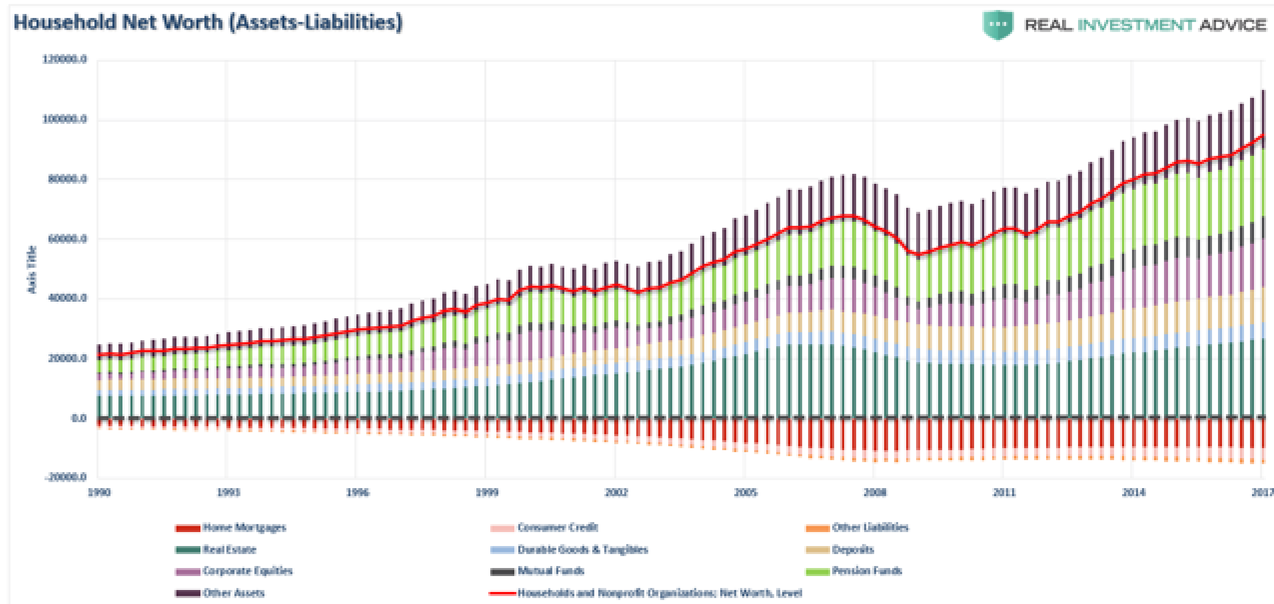
With more multi-generational families living together, the aging of the baby-boomer generation and a significant fall-off in birth rates, the huge demographic headwind is gaining momentum. The economic ramifications, as well as for the financial markets, is going to be extremely problematic.

Tying It All Together

As more clues become available, the risk to the financial markets becomes clearer.

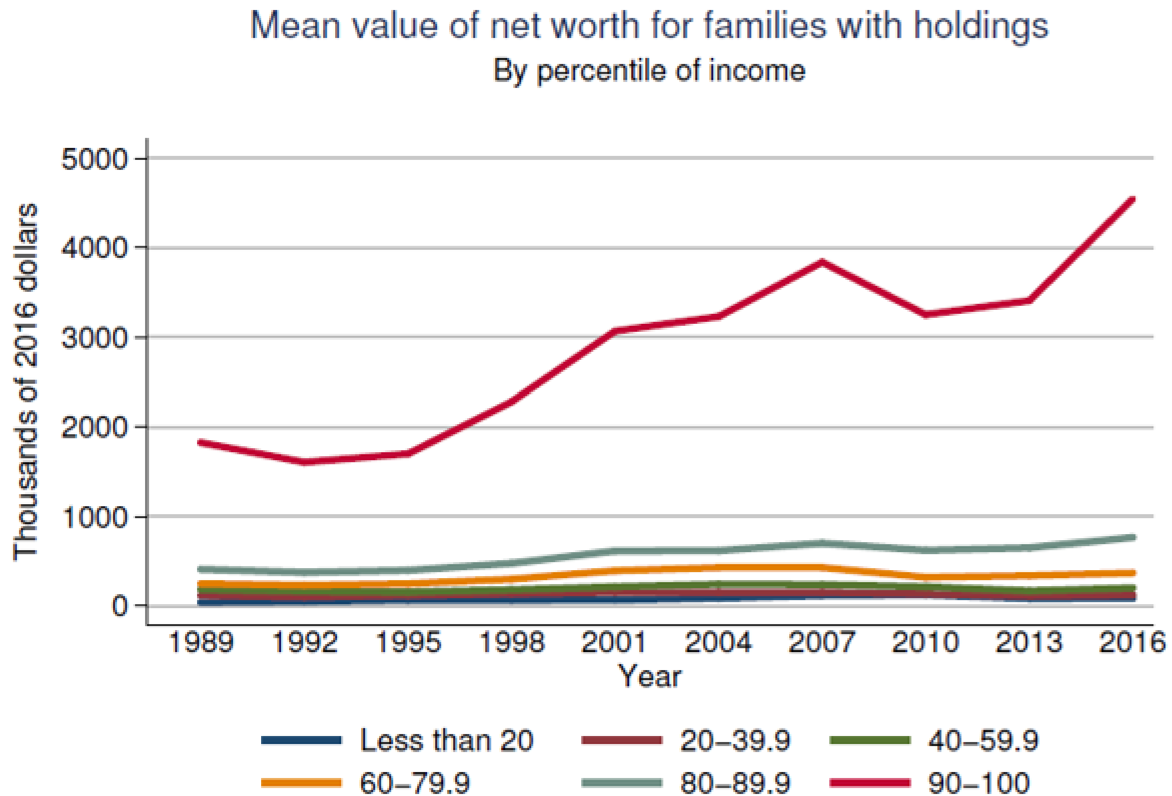
All of these stories have a common thread - **the consumer.** While stocks continue to ratchet to all-time highs on expectations of tax cuts and reforms leading to stronger economic growth, the stories here all suggest something much more telling is happening beneath the surface.

Yes, household net worth has recently reached historically high levels. However, **The majority of the increase over the last several years has come from increasing real estate values and the rise in various stock-market linked financial assets like corporate equities, mutual and pension funds.**



But, once again, the headlines are deceiving even if we just slightly scratch the surface. Given the breakdown of wealth across America, we once again find that **virtually all of the net worth, and the associated increase thereof, has only benefited a handful of the wealthiest Americans.**

As the Federal Reserve just recently reported, while the mainstream media continues to tout that the economy is on the mend, **real *(inflation-adjusted)* median net worth suggests this is not the case overall.** As stated, the recovery in net worth has been heavily skewed to the top 10% of income earners.

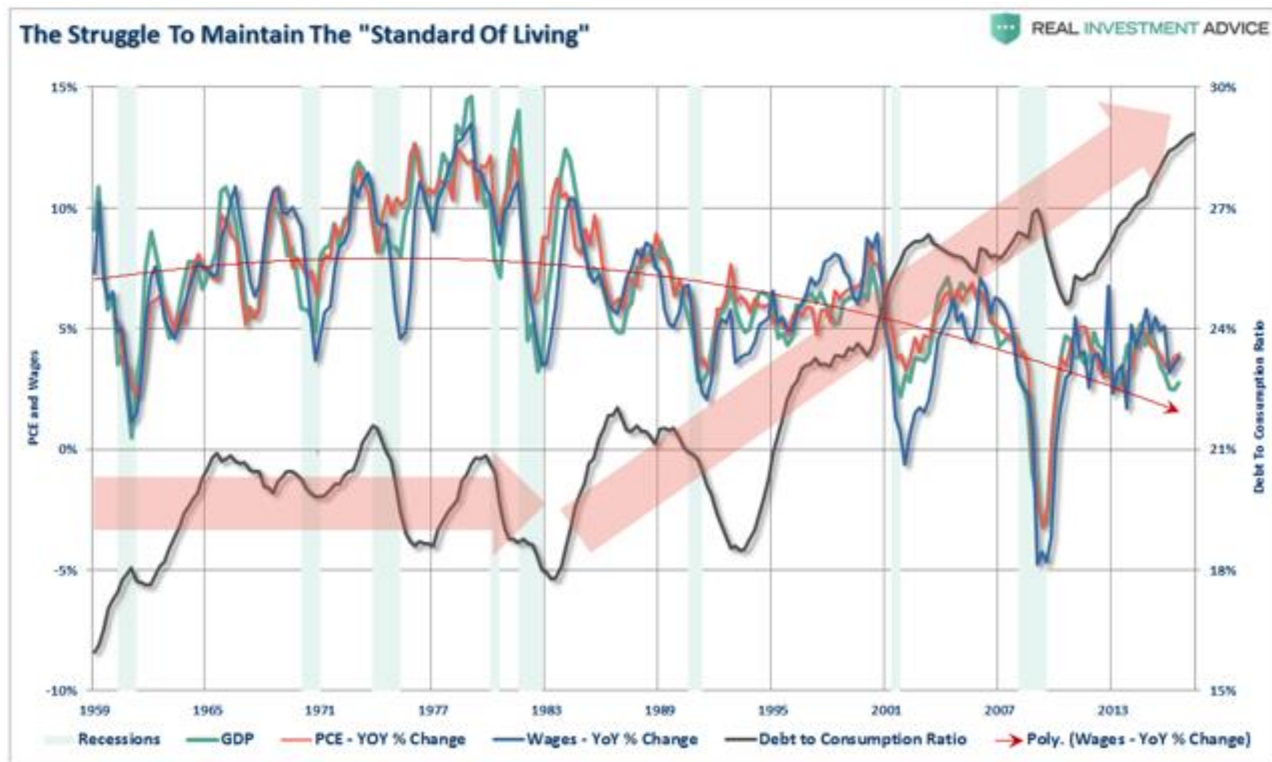


Of course, this explains why the largest number of the population over the age of 65 is still employed as they simply can't afford to retire.

The multi-generational households are on the rise, not by choice but by necessity. These are long-term headwinds that suggest economic growth will remain weak, **and the rise in delinquencies, slow-down in auto demand, and weak retail sales all suggest consumers may have reached the limits of the debt-driven consumption cycle for now.**

In other words, individuals are ratcheting up debt, not to buy more stuff, but just to maintain their current *"standard of living."*

RHarding@maybank-ke.com.sg



The disconnect between the stock market and real economic growth can certainly continue for now. **Exuberance and confidence are at the highest levels on record, but the underlying stories are beginning to weave a tale of an economy that is very late in the current cycle.**

Importantly, these are not short-term stories either. The long-term picture for the economy and the markets from the three biggest factors *(Debt, Deflation, and Demographics)* continues to build. **These factors will continue to weigh on economic growth, and market returns, during the next generation as the massive wave of baby-boomers shift from supporters to dependents of the financial and welfare system.**

As an investor, it is important to pay attention to the clues and the weight of the evidence. The success, or failure, of catching the end of the current bull market and economic cycle will have important implications to your long-term financial goals.