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Markets Research

Asia

Strategy

The Investigator

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Strategy Update

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Could margins surprise positively? Yes

After spending time in northern Ethiopia, visiting the rock-hewn churches in Lalibela and living in a Mongolian *Ger*, we are back to grapple with the enduring madness of markets. A few things stand out.

First, the fourth quarter in a US Presidential election year is normally positive for stocks. What markets need is a clear direction for policy, with less of a logjam, whether in the US (where political polarization is close to a 100-year high), Europe (a classic creditor-debtor debate), or China (policy transition). We think on all three fronts, things are likely to get less bad.

Second, policy uncertainty has been high since the global financial crisis – the two Presidential candidates in the USA offer starkly different policy directions; whatever the outcome, less policy uncertainty would be a potential positive for decision-making, and for stock-picking – stock correlations with the benchmark have moved exceptionally closely with a quantifiable measure of policy uncertainty. Life might just get easier for stock-pickers with less policy uncertainty.

Third, Asia's terms of trade, which LEAD Asian margins, are picking up. Bottom-up analysts are unaware of this, or don't seem to care. This year, their (almost perpetual) no margin change view was violated to the downside, leading to sharp downward EPS revisions. In most Asian markets, except China, the terms of trade/margin proxies are rising, potentially setting us up for positive margin and EPS surprises.

Fourth, Risk-Love is in now in mild euphoria from a mild panic in late May, but the US economic surprise index and cyclical/defensive stock performance have only hit neutral from extreme lows in late May. We believe there is still juice in this stealth global equity bull market.

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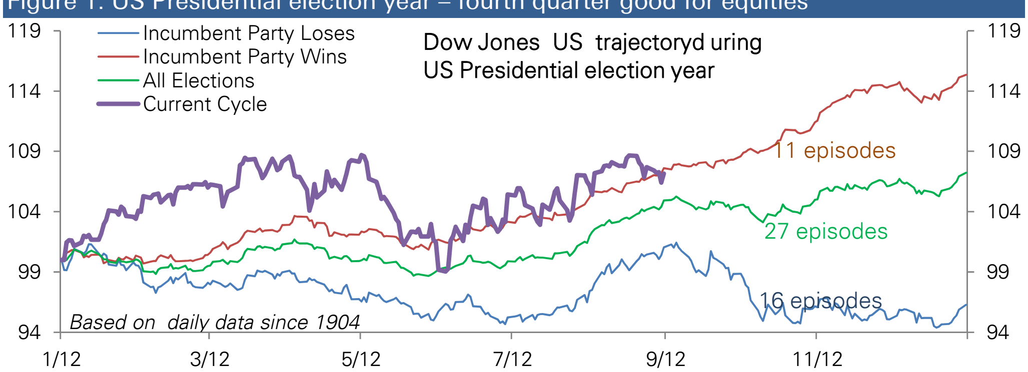
Policy uncertainty, margin surprises and risk-on

After spending time in northern Ethiopia, visiting the rock-hewn churches in Lalibela and living in a Mongolian *Ger,* we are back to grapple with the enduring madness of markets. A few things stand out. First, the fourth quarter in a US Presidential election year is normally positive for stocks. Second, policy uncertainty has been high since the global financial crisis. The two Presidential candidates in the USA offer starkly different policy directions; whatever the outcome, *less* policy uncertainty would be a potential positive for decision-making, and for stock-picking – stock correlations with the benchmark have moved exceptionally closely with a quantifiable measure of policy uncertainty. Life might just get easier for stock-pickers. Third, Asia's terms of trade LEAD Asian margins. Bottom-up analysts are unaware of this, or don't seem to care. This year, their (almost perpetual) no margin change view was violated to the downside, leading to sharp downward EPS revisions. In most countries, except China, the terms of trade/margin proxies are rising, setting us up for positive margin and EPS surprises. Fourth, Risk-Love is in now in mild euphoria from a mild panic in late May, but the US Economic Surprise Index and cyclical/defensive stock performance have only hit neutral from extreme lows in late May. We believe there is still juice in this stealth global equity bull market.

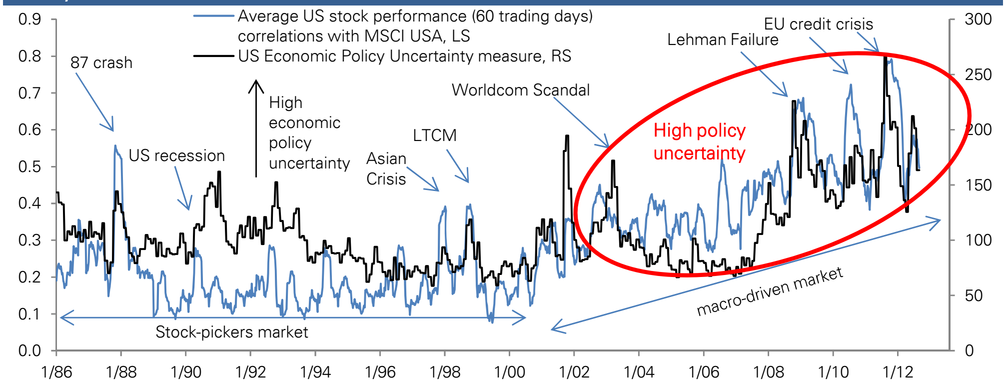
Figure 1 shows the trajectory of the US equity market in Presidential election years. When the incumbent party wins (16 out of 27 times in the past 100 years), the market responds well. (See Deutsche Bank global strategist Binky Chadha's recent notes on markets and politics: *Asset Allocation: Staying Constructive,* published 5 September 2012 and *Asset Allocation: The 2012 US Elections,* published 4 September 2012). Of course, this time could be different. What markets need is a clear direction for policy, with less of a logjam, whether in the US (where political polarization is close to a 100-year high), Europe (a classic creditor-debtor debate), or China (policy transition). We think on all three fronts, things are likely to get less bad. Why is this important? Figure 2 shows an index of policy uncertainty in the US – it has been elevated in the past four years, and correlates well with individual stock correlations with the benchmark. If, and this is a big if, the US elections and the Chinese political transition lead to less policy uncertainty, the elevated equity risk premium could drop a bit, as could stock correlations with the benchmark, making life less challenging for stock-pickers.

Figure 1: US Presidential election year – fourth quarter good for equities



Source: Deutsche Bank, Bloomberg Finance LP

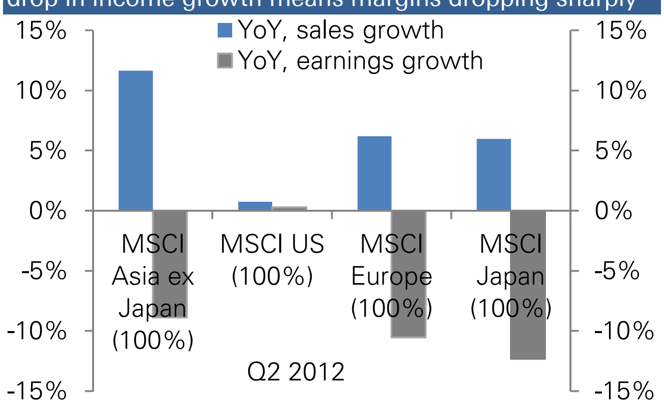
Figure 2: US policy uncertainty elevated since financial crisis – will the election bring clarity?



Source: Deutsche Bank. Stock correlations with MSCI USA based on rolling 60-day daily returns on a broad universe of stocks covering the top 95% of total market capitalization (i.e.1,053 to 2,684 stocks from 1985 to 2012). For more on the "Economic Policy Uncertainty Index", go to the website http://policyuncertainty.com. According to the authors, "To measure policy-related economic uncertainty, we construct an index from three types of underlying components. One component quantifies newspaper coverage of policy-related economic uncertainty. A second component reflects the number of federal tax code provisions set to expire in future years. The third component uses disagreement among economic forecasters as a proxy for uncertainty."

It seems to us that the default option some analysts use when forecasting margins generally involves plugging in the same margin number for the next year. This is why we get margin (and EPS) surprises, especially in Asia's cyclical markets. This year, for example, the margin and EPS surprises have been quite negative. In the recent reporting season, as Figure 3 shows, while Asia's company revenue growth has been decent, profit growth has been a disaster. The gap is largely driven by atrocious margin declines. A similar story could be told for Japan, and Europe. The US sails through with the best earnings growth, despite the lowest revenue growth – US firms don't have the margin declines the others suffer from, even though we hear a lot about "peak" US margins. As Figure 4 shows, the US had the highest percentage of positive earnings surprises, Asia was a damp squib. Little wonder that the US market is beating the rest of the world. See: *The Investigator, The Supremacy of Earnings Power,* published 6 August 2012, in which we wrote about the importance of earnings, rather than valuations in this low-growth environment.

Figure 3: Asia ex-Japan – good revenue growth but sharp drop in income growth means margins dropping sharply



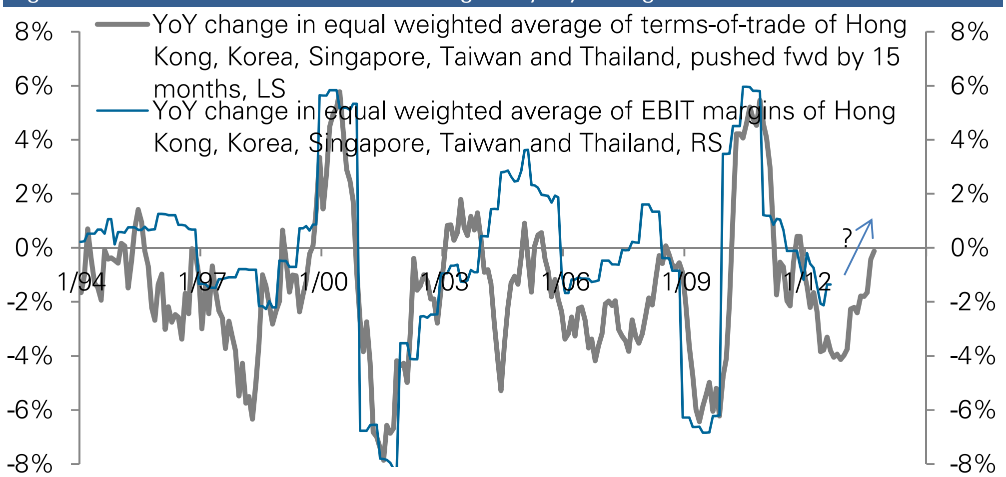
Source: Deutsche Bank, Number in parenthesis is % age of companies which have reported their Q2 2012 earnings.

Figure 4: US – huge positive earnings growth surprises, driven by margin surprises

Source: Deutsche Bank, Number in parenthesis is % age of companies which have reported their Q2 2012 earnings.

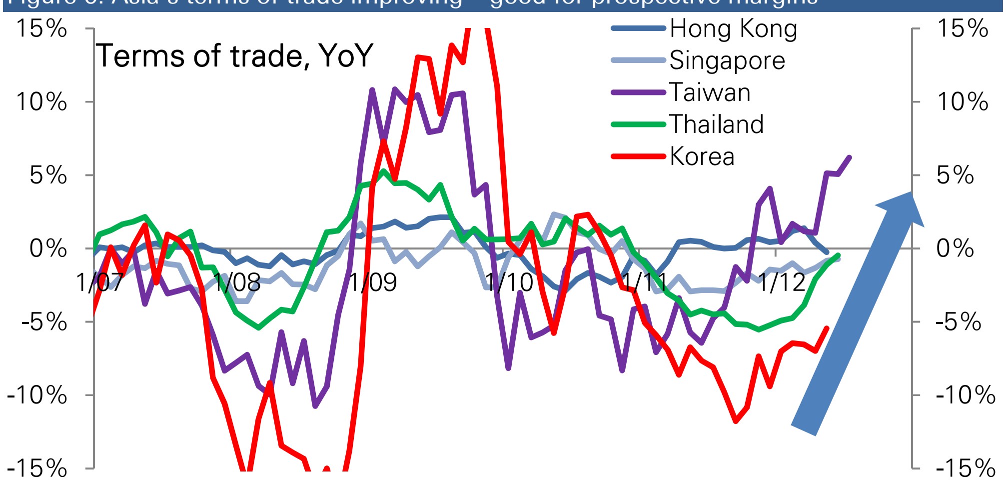
As Figure 5 shows, the terms of trade (export prices divided by import prices) LEAD Asian margins by about a year for the five countries that report these data – Hong Kong, Singapore, Korea, Taiwan, and the Thailand. (See Figure 6 for the individual terms of trade data.) This indicator foretold the attenuated margins we are seeing in the recent reporting season – it is also foretelling a pick-up in margins in these five countries in the coming year. Analysts! Please pay attention. The exception is China. We wrote about the secular decline for China's margins in our last note, in which we worried about past mal-investment and a super-strong currency (See: *The Investigator, Are Chinese Equities Expensive? Maybe,* published 22 August 2012). On a *cyclical* basis, the gap between the corporate price deflator and a proxy for unit labor costs (wage growth less industrial production growth) is looking worrisome – see Figures 7 and 8. China has a near-deflation problem for its corporate sector, and with its high national leverage and demographic turning point, some serious challenges for equity investors lie ahead.

Figure 5: Asian terms of trade LEAD margins by a year – good news ahead



Source: Deutsche Bank, CEIC, MSCI, Bloomberg Finance LP. Terms of trade is the ratio of a country's export price index to its import price index.

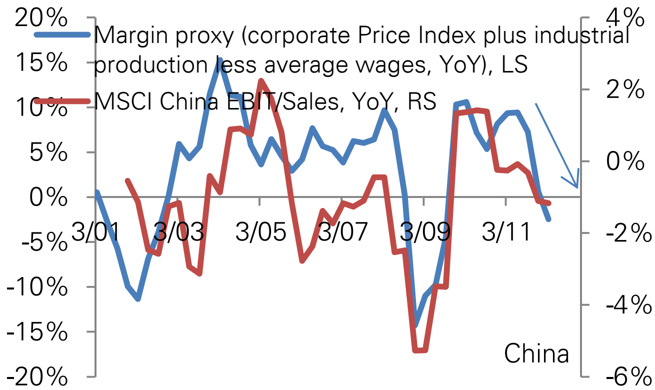
Figure 6: Asia's terms of trade improving – good for prospective margins



Source: Deutsche Bank, CEIC. Terms of trade is the ratio of a country's export price index to its import price index.

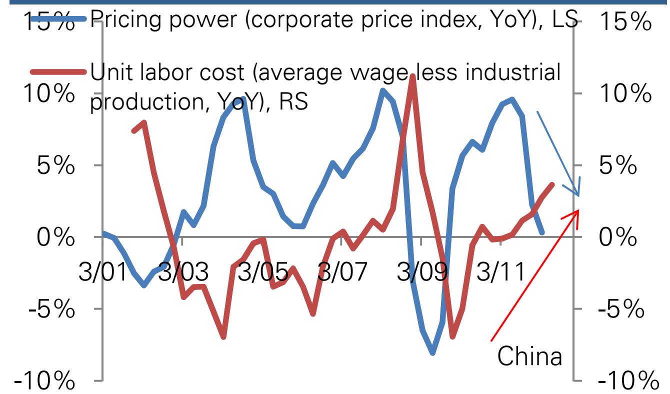
Lastly, we are tracking three charts for the "risk-on, risk-off" trade. See Figure 9. First, Risk-Love (or sentiment) has gone from a mild panic to mild euphoria. This is a mild worry. Second, US Economic Surprises have gone from exceptionally negative to neutral. We will worry more when they get to exceptionally positive levels. Third, cyclicals have gone from very poor relative performance versus defensives in late May to just about neutral levels. Again, when this mean-reverting series hits much higher levels, we will worry more. For now, the stealth bull market is in place.

Figure 7: China's margin proxy in decline…



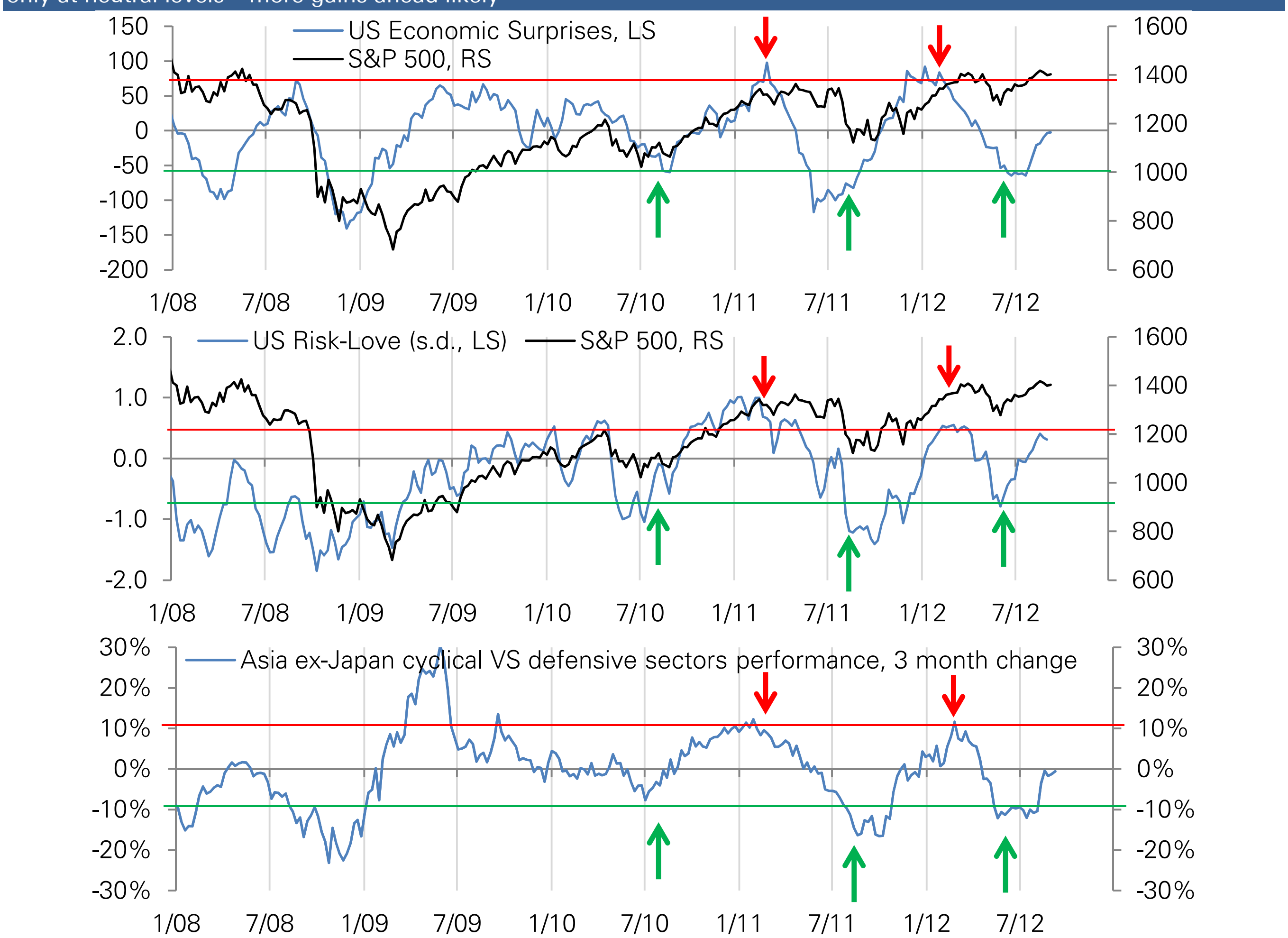
Source: Deutsche Bank, National Bureau of Statistics, The People's Bank of China. CEIC

Figure 8: … as corporate pricing power collapses, while unit labor costs rise



Source: Deutsche Bank, National Bureau of Statistics, The People's Bank of China. CEIC

Figure 9: While Risk-Love is in mild euphoria, US economic surprises and cyclical/defensive relative performance are only at neutral levels – more gains ahead likely



Source: Citigroup, Deutsche Bank, MSCI, Bloomberg Finance LP. Defensive sectors represent equal weighted index of consumer staples, healthcare, utilities and telecommunications while cyclical sectors represent equal weights index of energy, materials, industrials, consumer discretionary and information technology.

Appendix 1

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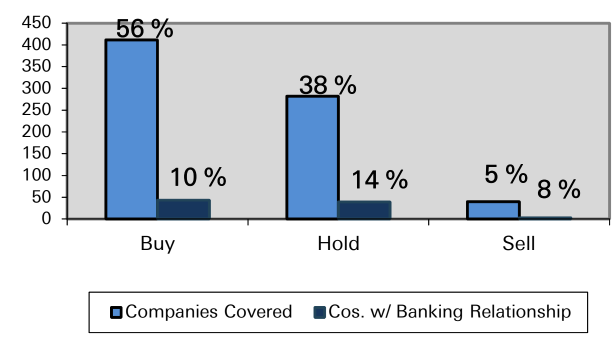

Asia-Pacific Universe

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