

Quarterly Strategy Chartbook

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# **The Big Questions For The Rest Of The Year**

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June 2014

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# Introduction

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In 2008-09, stock pickers were made to look like fools; as everything collapsed in unison, the relative worth of one company against another simply did not matter. Instead, it was the golden age of the macro investor.

Fast forward to 2014 and we are currently experiencing the mirror image of that period, one in which usual macro relationships have simply broken down. For example, 2014 has so far witnessed undeniable weakness from China (*part 1, pages 4-13*) lackluster growth from Europe and North America... And yet commodities have done well and the Australian dollar has been among the best performing currencies YTD!

Just as awkwardly for a number of macro investors, inflation has rebounded by more than 150bp in Japan on the back of the BoJ's aggressive reflationary policies, but JGB yields have remained anchored to the floor and Japanese reflation plays have been among the world's worst performing trades (*part 2, pages 14-22*). But at least, JGB yields have not come down noticeably, which has been the case in the US despite a notable pick-up in domestic inflation (*part 3, pages 23-29*).

So could the US and Japanese low yields find their explanations in the bond market rally in euroland, itself a result of lackluster domestic lending and the promise of more ECB action (*part 4, pages 30-36*)? And if so, does that make for a stable investment environment going forward (*part 5, investment recommendations, pages 37-51*)?

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# Testing the reformers' resolve in China

# China is slowing, but a crisis is unlikely

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## **China's growth in 2014 will slow more than policymakers anticipated**

It is almost a dead certainty that China will fail to hit the government's 7.5% GDP target in 2014. By year-end the run rate of GDP growth will probably be below 7%, and in 2015 a further slowdown to 6-6.5% is possible.

The slowdown was prompted by a weak property market, which will lead to slower construction and heavy industry activity. Nationwide, we expect housing completions will fall about -5% in 2014 to 10mn units, and then stabilize; prices in most cities could correct down by 5-10% but probably not more.

On the bright side, the government has already eased monetary policy and most cities are now free to end house purchase restrictions. So a stabilization of credit and housing sales is likely in 2H14.

Moreover, the labor market remains very tight and exports are solid, so household consumption and the external sector should provide support for growth, making a big stimulus unnecessary.

There is little risk of a property collapse or financial crisis.

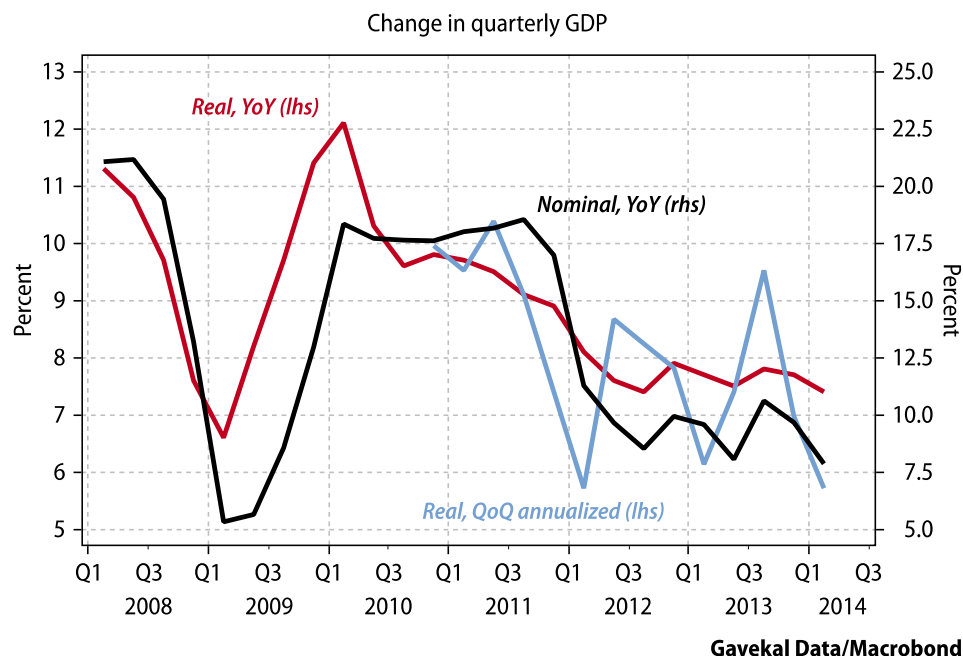
## **How soon will we see gains from structural reform? And what is the impact of the anti-corruption drive?**

Financial sector reform is proceeding smartly: a more flexible exchange rate since March is a prelude to liberalization of deposit rates within two years. Other reforms (fiscal, SOE and urbanization) are proceeding more slowly.

The anti-corruption campaign has struck far more broadly and deeply than anyone expected. This could be a good thing, if it eliminates vested interests opposed to reform. But it could also be counterproductive by paralyzing the government and undermining business confidence.

# GDP growth continues to slow, especially inland

## China's growth threatens to slow down again

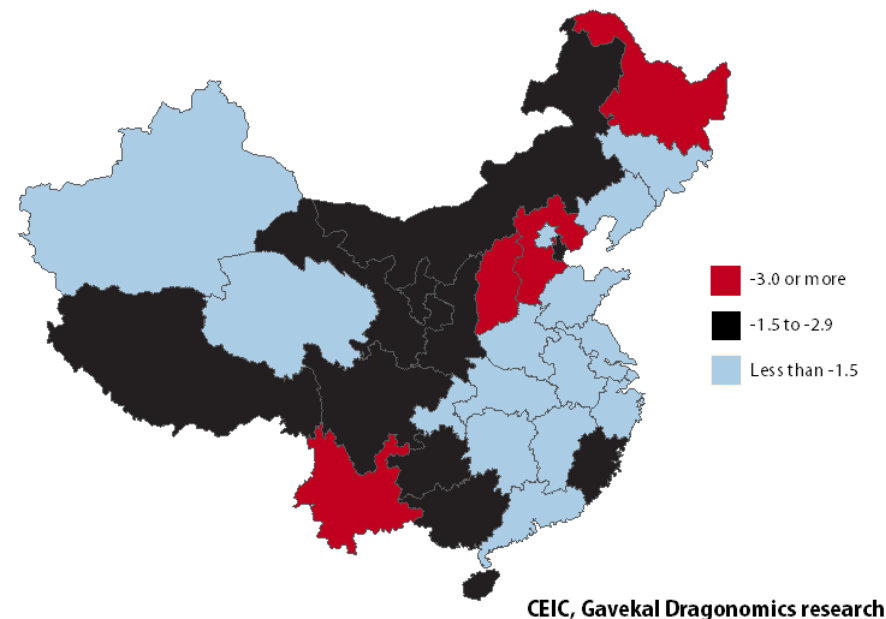


Since 2012, China's headline GDP growth has stayed in a relatively narrow range of 7.4% to 8.1% YoY. The slowdown in Q1 means growth is already back to the low end of this recent range.

But since momentum is deteriorating rather than accelerating, a further slowdown to a new recent low looks inevitable. The government may have wrongly assumed that growth would stabilize at 7% without policy intervention.

## China's inland provinces are the hardest hit

Slowdown in real provincial GDP growth in 1Q14 from 2013, in percentage points

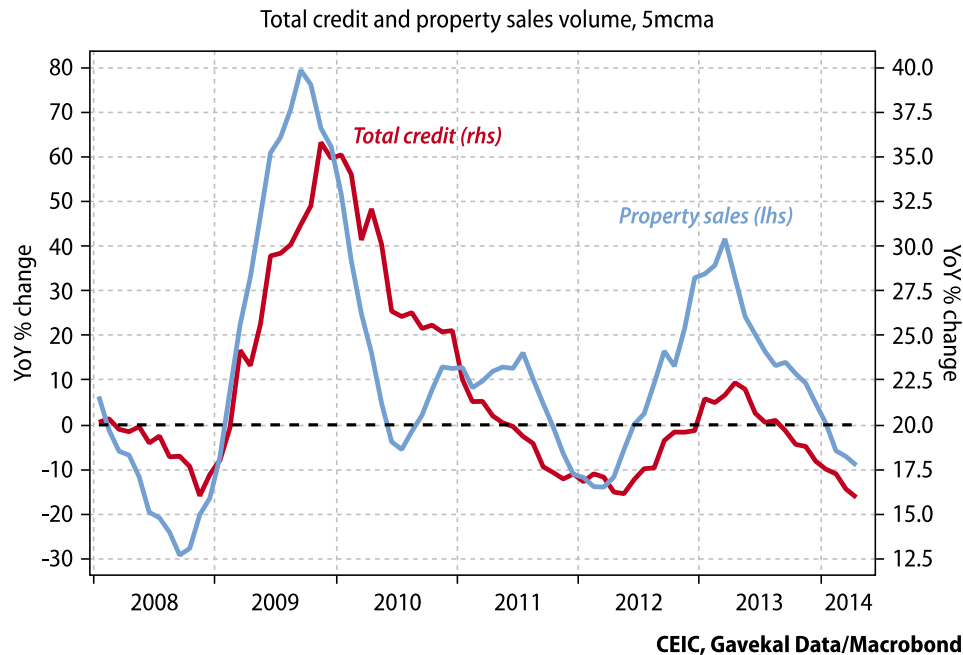


The slowdown in some parts of China—particularly inland provinces dependent on heavy industry and government infrastructure projects—is even more severe.

Hebei, the province surrounding Beijing that is home to much of the steel industry, saw GDP growth collapse to 4.2% in 1Q14 from 8.2% in 4Q13. Shanxi, China's primary coal producer, similarly saw its GDP growth fall to 5.5%.

# Economic cooling is led by a weaker property market

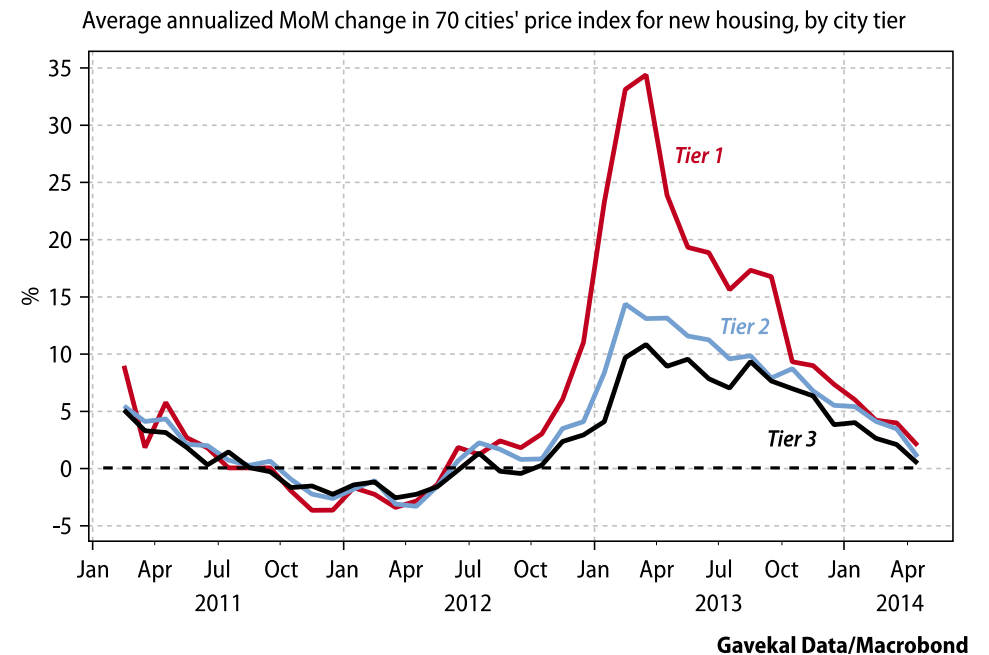
## Housing sales and credit growth have cooled in tandem



Property sales started slowing in 2013 after a surge early in the year, caused by front-loaded purchases on fears of a tax change. The slowdown continued later in the year as credit growth slowed, but sales have actually been weakest in larger cities—against the consensus view that small cities are more vulnerable because of larger supply.

Sales growth slowed more sharply in March and April 2014 as price cuts sapped sentiment and led buyers to wait for a better opportunity.

## Housing price growth has slowed across all Chinese cities

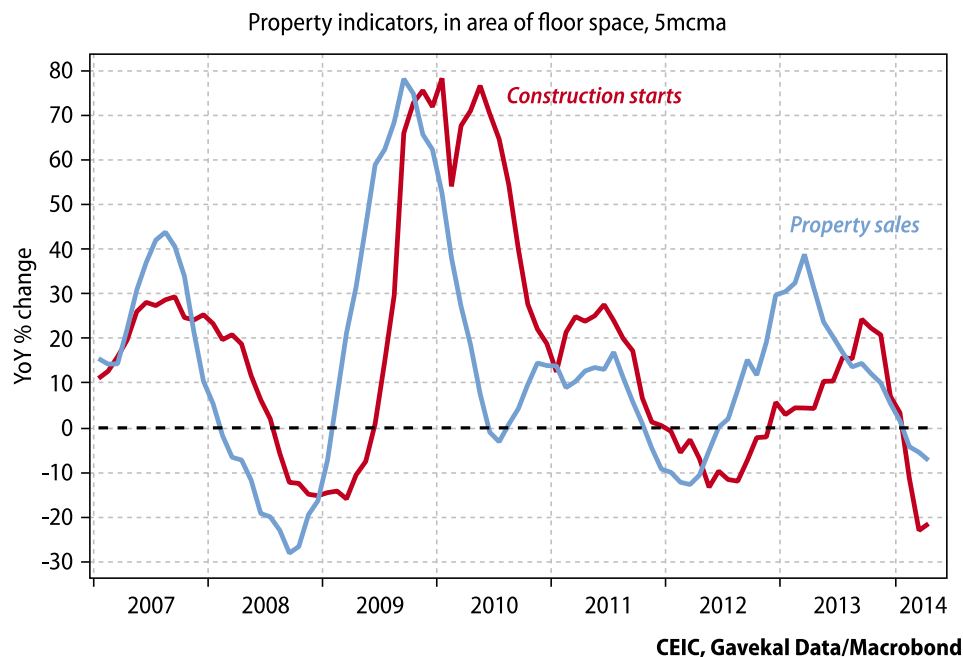


As sales declined, property prices also cooled off. The price adjustment was much faster in the large Tier 1 cities (Beijing, Shanghai, Guangzhou, Shenzhen), as these cities saw the biggest price hikes in 2013 and affordability is much worse than in smaller cities.

Price cuts accelerated in early 2014 as the sales decline and tight credit led to cash flow problems for developers, and with sales momentum now weakening, price indices look to be heading into negative territory soon.

# The construction downturn hurts heavy industry

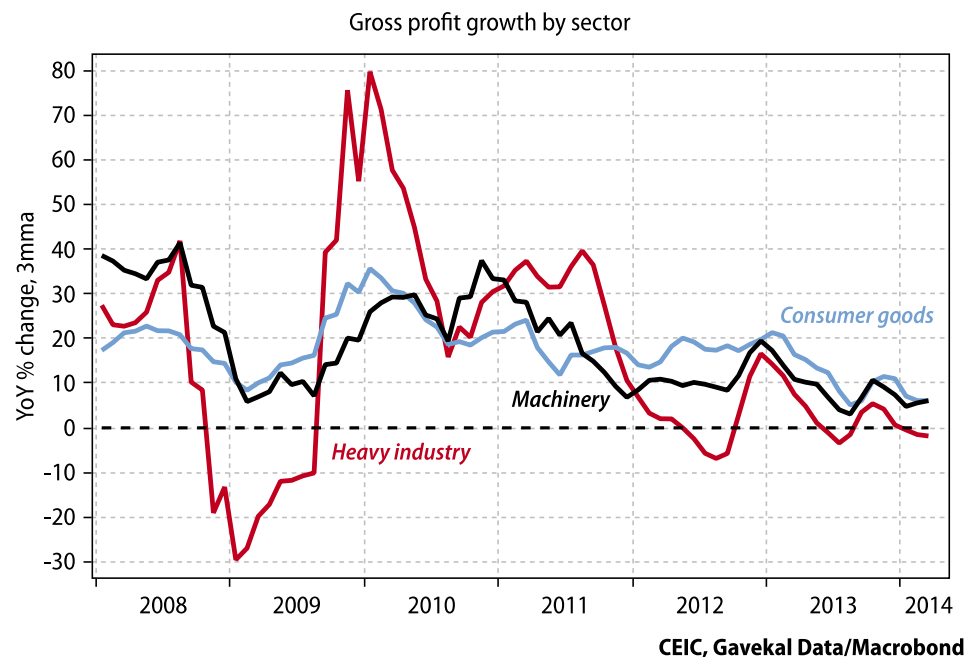
## The correction in construction has been worse than in sales



While sales have been slowing gradually for most of 2013, the adjustment in construction did not come until early 2014 and was extremely sharp. The growth of new construction starts has fallen to a seven-year low, strongly affecting steel and other materials sectors.

The cutbacks reflect developers both trying to control expenses as their cash flow is squeezed, and reassessing future growth prospects in light of oversupply.

## Heavy industry has dragged on corporate profits for some time



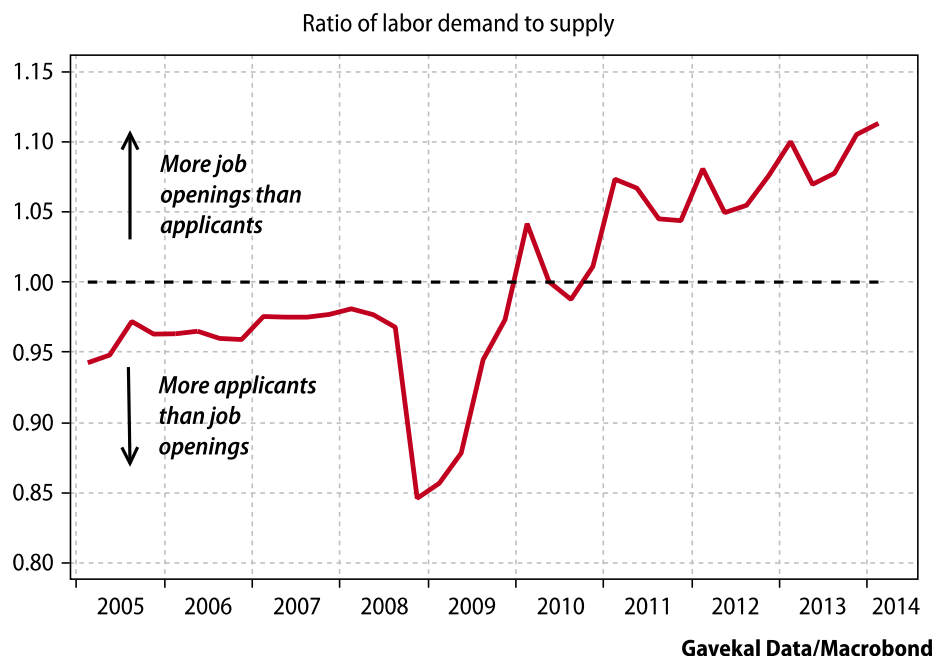
The property slowdown hit heavy industry (metals, materials, energy and chemicals). Profit growth in this sector is now negative and margins are low.

But the picture in other industrial sectors is somewhat better: machinery, which follows export growth, still enjoys positive profit growth and margins, as do consumer goods sectors. If these trends continue, the growth slowdown should contribute to economic rebalancing.



# The labor market is still tight, and exports are a bright spot

## China's job market continues to tighten despite slowing growth



Despite slower GDP growth, the labor market is holding up well and wages continue to rise quite rapidly. This reflects structural constraints on the supply of labor from changing demographics and the slowing of rural migration.

As a result, even if China misses the GDP growth target, the urban jobs creation target of 10 mn is almost certain to be met (13 mn new jobs were created in 2013). While wage growth may slow as the economy cools, consumption momentum seems solid.

## China's underlying export growth is better than the headline figures



Headline export growth slowed down quite dramatically in Q1, but much of this is a statistical artifact due to overstated exports to Hong Kong in 2013 (a way to bring capital into China in breach of capital controls).

After excluding exports to Hong Kong, export growth looks better. The headline number will start to improve more after May as the over-invoicing effect diminishes and US growth continues to strengthen.

# Monetary policy is not tight, but another credit boom is not likely

## Credit growth continued to slow down due to high base

Growth in stock of outstanding credit, by type

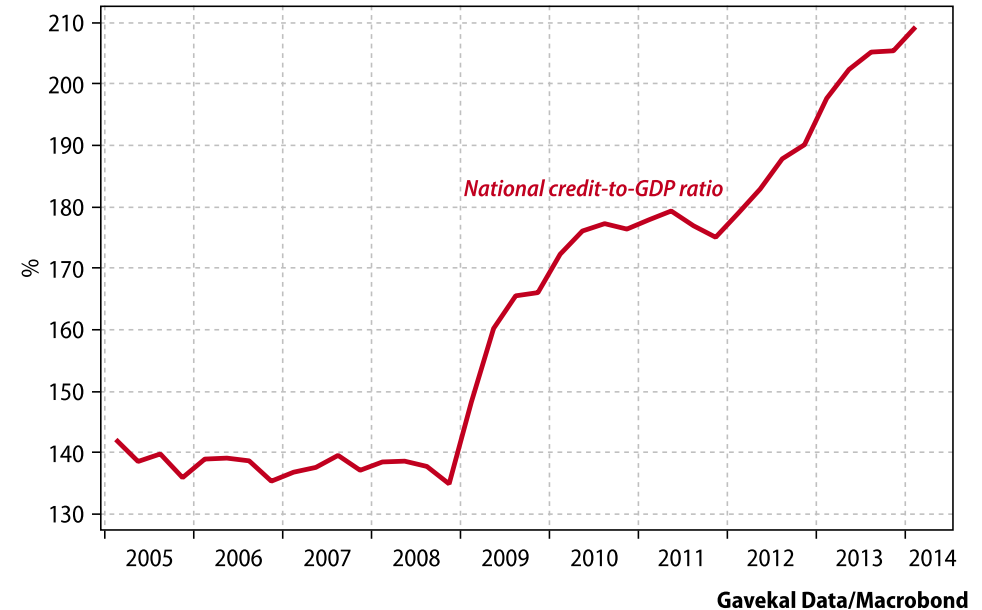


Credit growth has continued to slow down this year, but since liquidity is not tight this largely reflects the effect of the high base in 2013. Most of the slowdown was in shadow finance which has seen its share of total credit fall.

But in sequential terms, credit growth is already accelerating, and in YoY terms it should stabilize and start to pick up after June. However the acceleration in credit will be fairly modest as new flows are already extremely large.

## China's leverage ratio is rising again as growth weakens

Credit to nonfinancial sectors (including gov't), ratio to annualized GDP

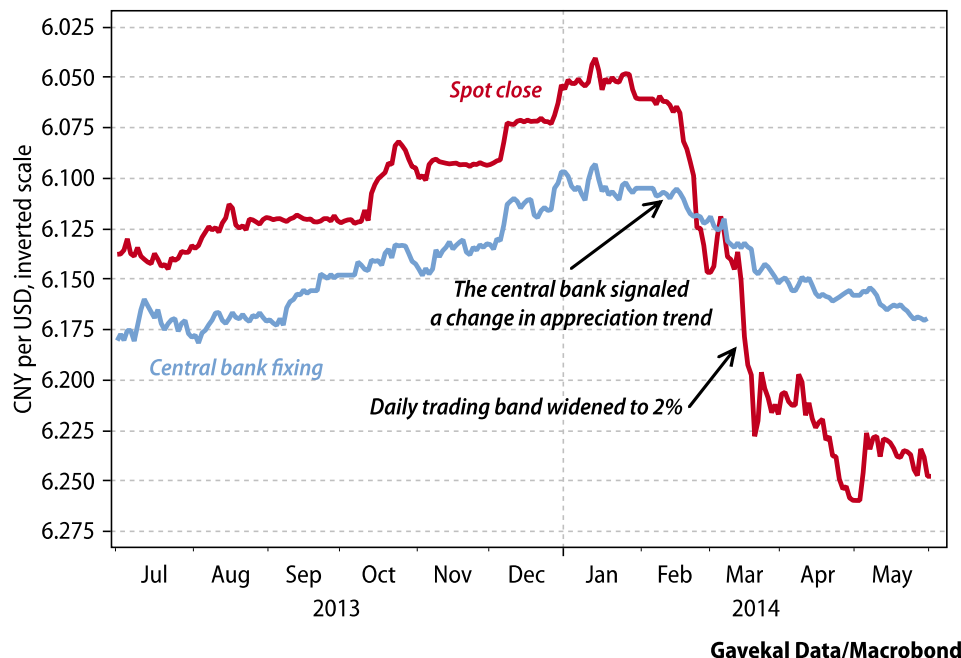


The limited response of credit policy to the current slowdown reflects objective constraints: total credit to GDP has risen to 210% of GDP, led by the expansion of corporate sector whose debt is already 130% of GDP.

While China's debt ratio is still lower than some developed economies, it is already extremely high by emerging-market standards. Current policy points to slower growth in total leverage, but not yet a stabilization or decline in leverage.

# End of the road for the one-way RMB bet

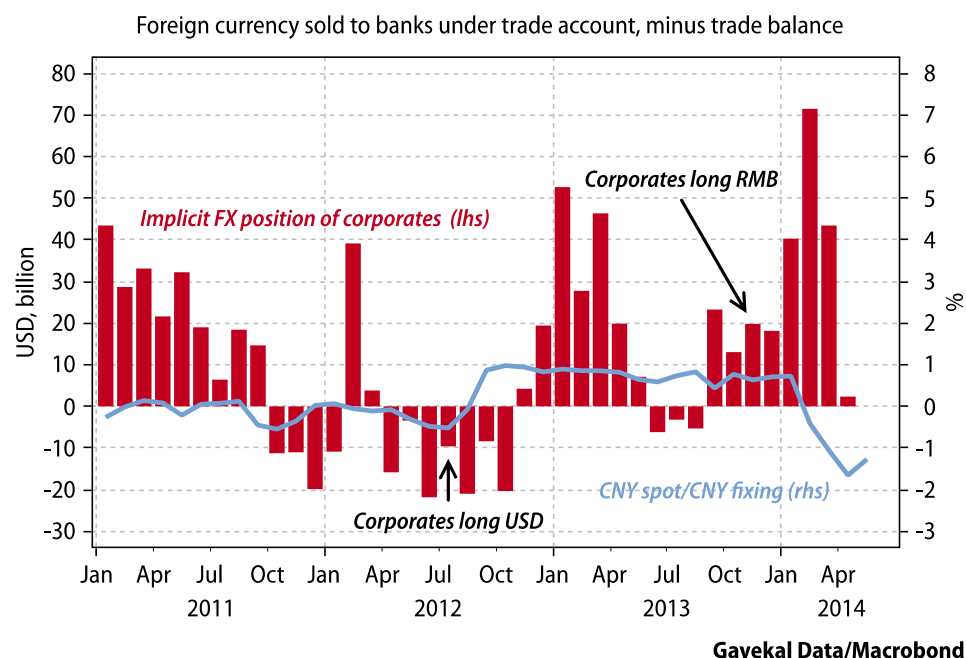
The central bank pushed back against appreciation expectations



The consistent appreciation of the RMB over the last few years entrenched expectations of its future rise. As a result, even though the current account surplus has narrowed, capital inflows continued, pushing up FX reserves by more than \$400 bn in 2013.

The central bank was increasingly uncomfortable with this pattern, and in February and March signaled a change in its stance through movements in the daily fixing and intervention in the spot market. It also widened the daily trading band as a signal of more market volatility to come.

China's currency move aims to counter firms' bets on a rising RMB



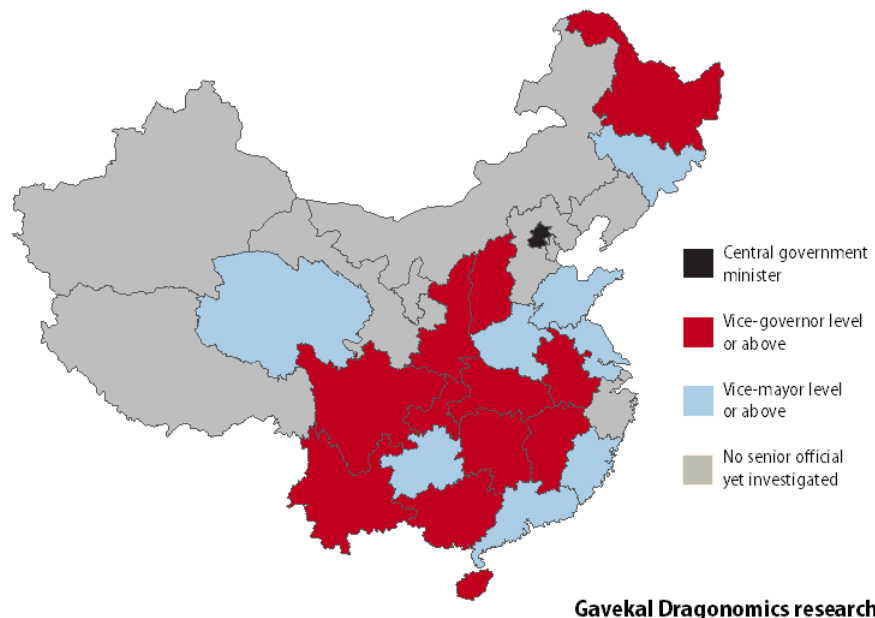
While capital controls limit short-term portfolio investment in and out of China, significant capital flows occur through exporters' and importers' currency positioning. As of April, the central bank's moves appear to have caused companies to significantly scale back their implicit bets on a rising RMB, reducing capital flows from this channel.

This suggests the central bank won't need to further devalue the currency to achieve its goals, but it also will not return to the steady appreciation of the past.

# Other policy moves: anti-corruption and SOE reform

## Xi Jinping's anti-corruption drive has cast a wide net

Corruption investigations into government officials, by seniority

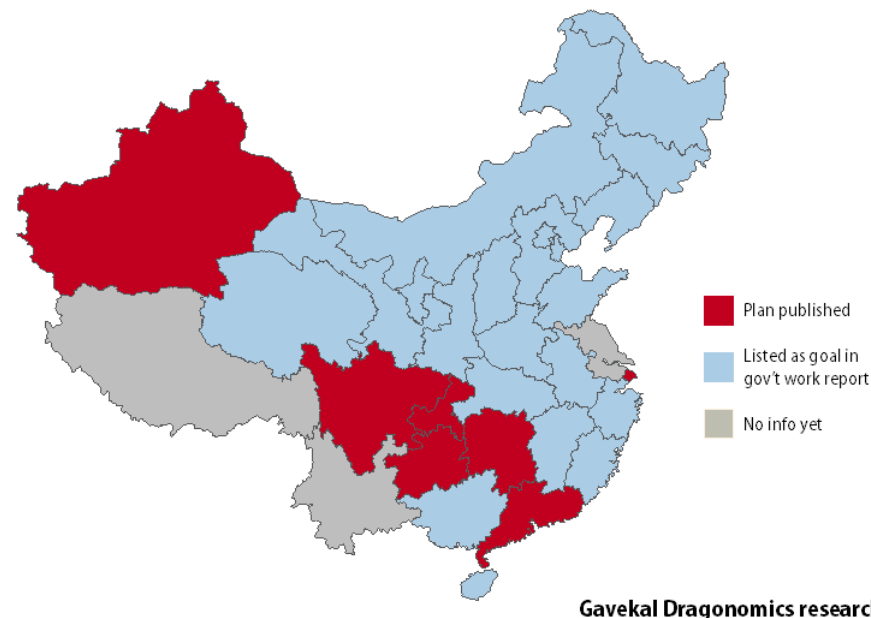


Xi Jinping's anti-corruption crackdown has turned out to be tougher and more widespread than almost anyone expected. Senior officials at central ministries, provincial governments, municipal governments and large SOEs have all been investigated.

The campaign gets rid of the vested interests who are opposed to change. But it is also beginning to undermine government efficiency and business confidence, as officials and investors are too scared to move. Careful calibration of the anti-corruption drive will be needed.

## China's provinces are moving on state enterprise reform

Status of local state-owned enterprise reform, by province, as of May 2014

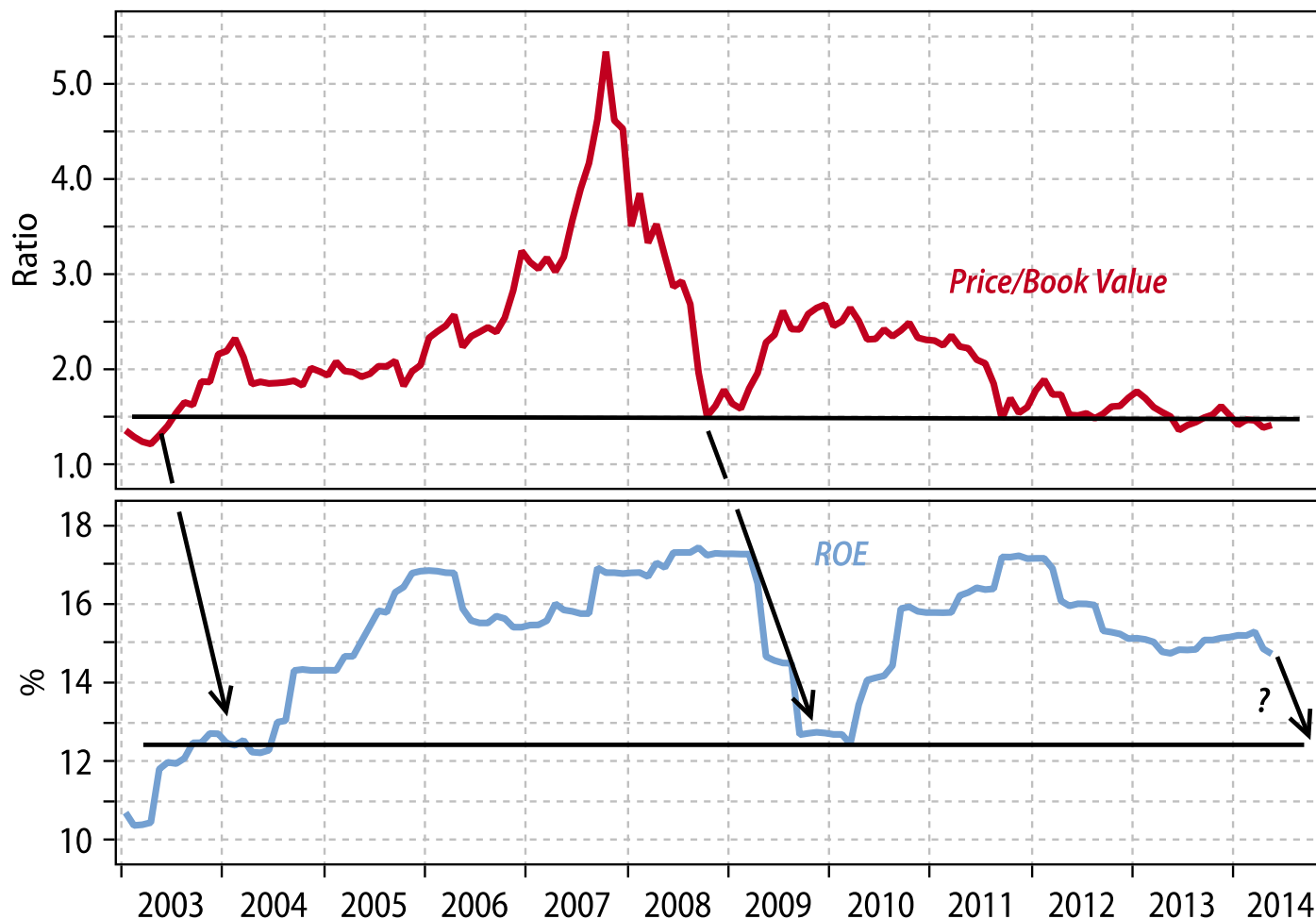


One of the surprising parts of the new government agenda is the revival of state-owned enterprise reform, which many observers had deemed too sensitive.

But the central government has endorsed "mixed ownership" (code for partial privatization), and local governments seem enthusiastic about pushing it forward. Many local SOEs are underperforming, and indebted local governments will find asset sales a tempting way to raise cash.

# Chinese equities are priced for a catastrophe that won't happen

## Current valuation of Chinese equity assumes a collapse in ROE



Gavekal Data/Macrobond

If (as we believe) perceptions of systemic risk in China are overblown by a general media always feeding off sensationalism, and if (as we also believe) Beijing's commitment to reform is under-appreciated, then Chinese equities are today offering a compelling risk-reward proposition.

Indeed, even as nominal GDP growth remains constrained by high leverage, Chinese equities are now priced for catastrophe. There is thus plenty of room for a significant upward re-rating should the central government's reform efforts persuade investors that Beijing can successfully manage the trade-off between growth, restructuring and monetary prudence.

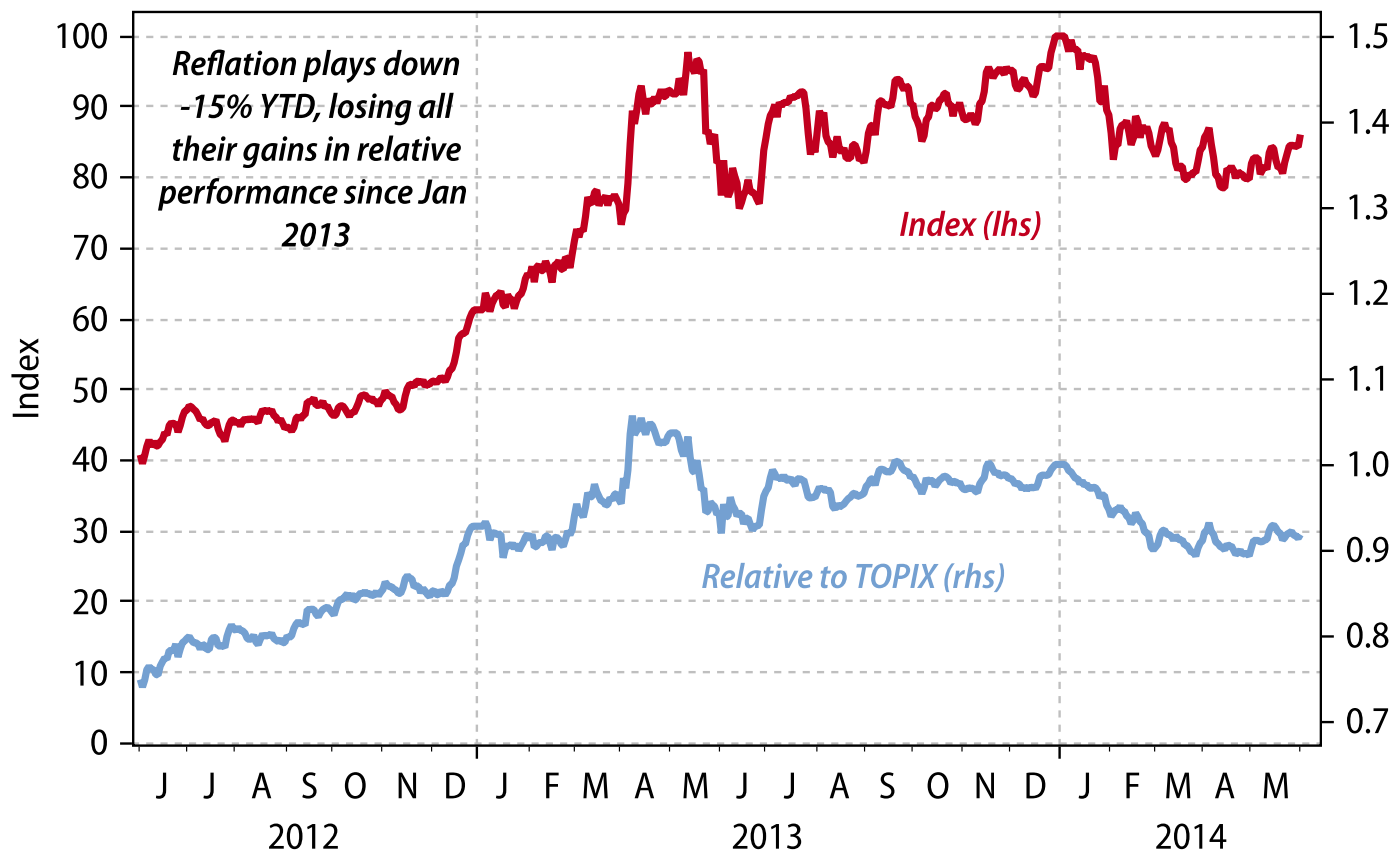
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# Can Japan regain its reflationary mojo?

# A hard-pressed Japanese government?

## Sell-off in Japanese reflation plays

Reflation plays = financials and real estate industries, equally weighted



Gavekal Data/Macrobond

Japanese reflation plays have had a rough ride this year, reflecting investors' fading confidence in Prime Minister Shinzo Abe's reflation efforts.

Under these circumstances, the Japanese government will face difficulty fulfilling its commitment to raise the sales tax from the current rate of 8% to 10% by late 2015.

In order to regain support, the Japanese government may look to announce corporate tax cuts or push for a more aggressive BoJ (see [After The Repositioning](#)).

Can we expect new market-friendly policies out of Tokyo in the coming months?

# A concern not shared by the bullish BoJ

## The BoJ's forecasts

All YoY % change

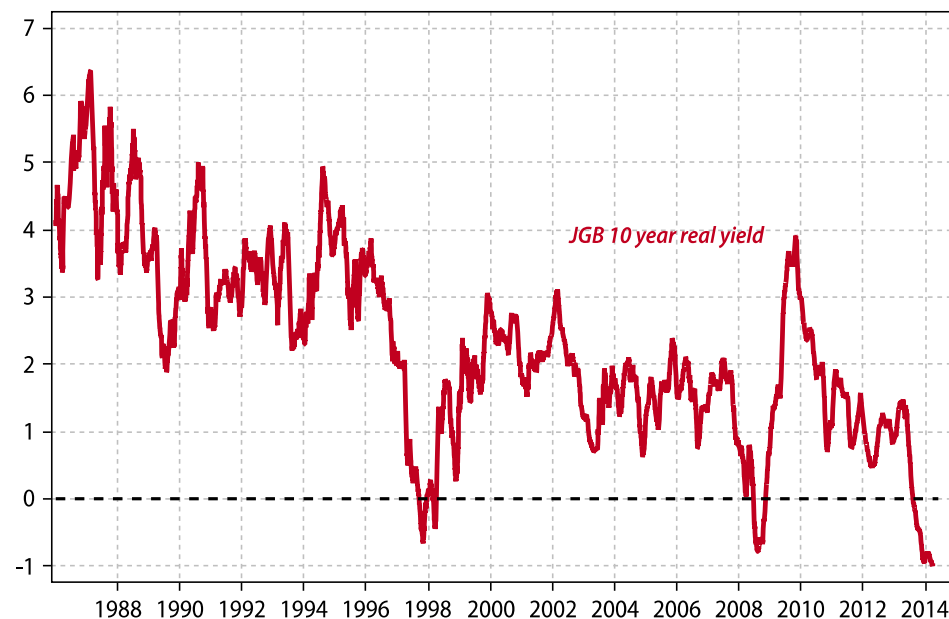
	Real GDP	CPI (all items less fresh food)	CPI (CPI less fresh food and excluding the effects of consumption tax hikes)
FY 2014	+1.1	+3.3	+1.3
FY 2015	+1.5	+2.6	+1.9
FY 2016	+1.3	+2.8	+2.1

BoJ's Outlook Report, April 2014

In its *Outlook Report* published at the end of April, the BoJ predicted success in reaching its 2% inflation target in FY2016.

This implies that the BoJ may feel that it has done enough and that any moderate pull-back of inflation in the next couple of months can be discarded as a one-off impact of the sales tax hike.

## Victory in repressing real yield



Gavekal Data/Macrobond

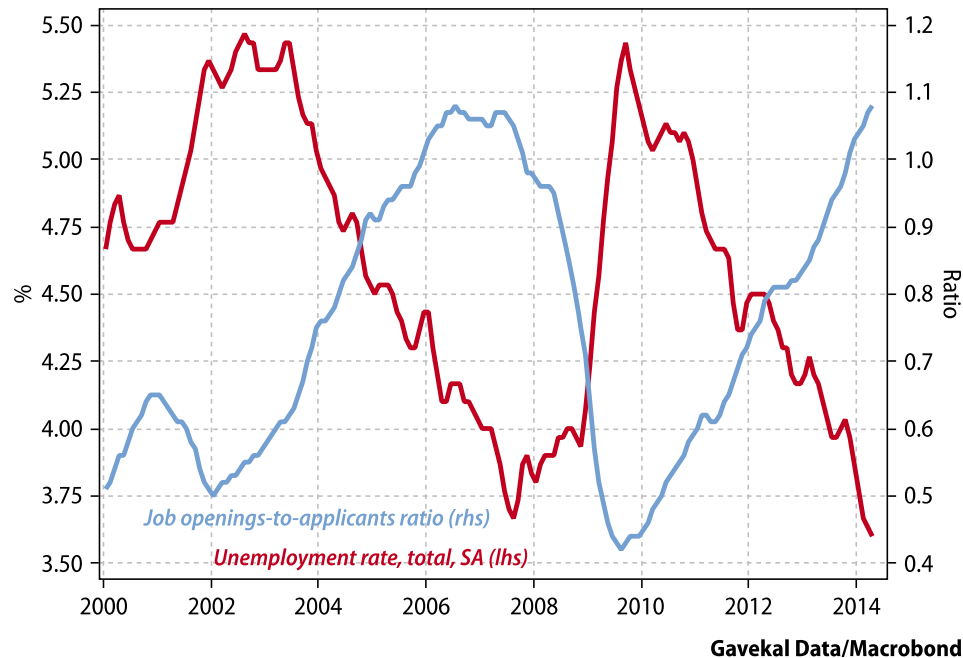
The BoJ sees the lowering of real interest rates as the most important factor in QE's transmission channels.

By this measure, the BoJ has never before been so successful, and in the BoJ's own view it is only a matter of time before the impact feeds through the system and stimulates demand in the real economy.



# The risk is that the BoJ takes a back seat

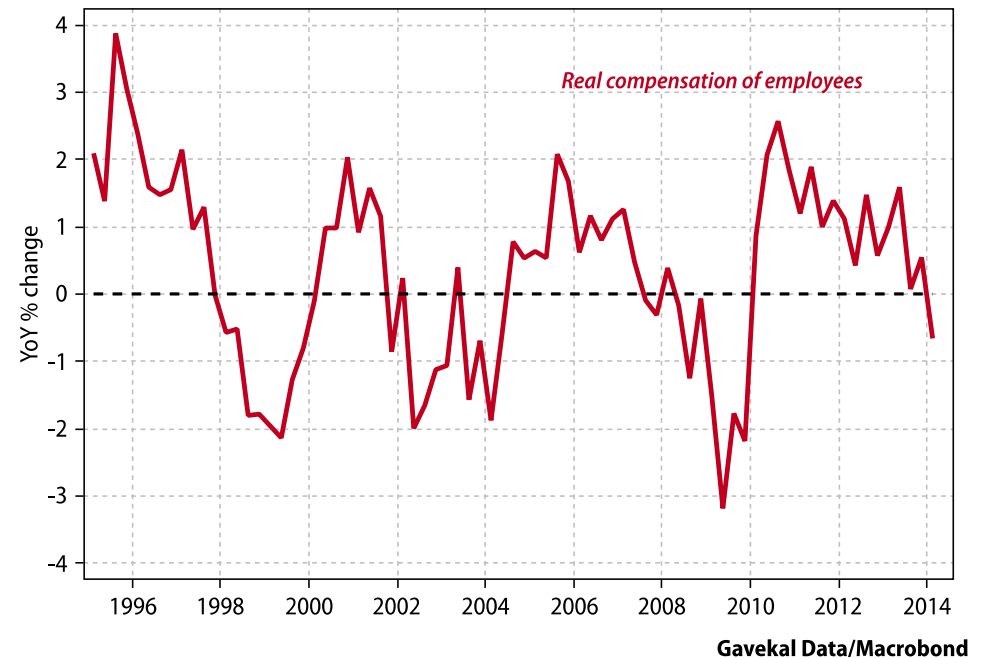
## Japan's tighter labor market



The BoJ's confidence in its inflation projection rests on a view that inflationary pressures in Japan are coming less from the cost-push effect of a weaker currency, and more from a domestically generated demand-pull phenomenon.

The general idea is that labor market conditions have tightened and the output gap has narrowed.

## Negative real income growth in Japan



However, at least half of the increase in domestic demand, and much of the new hiring, has been driven by public spending. Given Japan's fiscal consolidation plans, this is not a sustainable source of demand.

In addition, with inflation approaching 3% following April's sales tax increase, achieving real wage growth to support aggregate demand is getting more difficult.

# The importance of the wealth effect may have been underestimated

## The wealth effect of a weak yen



In the absence of real wage growth, wealth effects have supported a rising marginal propensity to consume.

Our fear is that the BoJ may underestimate the impact of yen weakness on equity prices, household net worth and consumer confidence during the transitional period.

Thus, by letting the weak yen policies take a back seat in driving future reflation, the BoJ risks falling behind the curve.

But could investors get some help from the fiscal side?

# Considerations for corporate tax cuts

## Global Corporate Tax Rates Compared

	2013	2014
Japan	38.0	35.6
Asia average	22.5	21.9
EU average	22.8	21.3
OECD average	25.3	24.1
Global average	24.1	23.5

KPMG

Japan's effective corporate tax rate stands at ~35%, more than 10pp higher than regional and global averages.

According to some estimates, a 10pp reduction of tax rate would boost GDP growth by 0.5pp (from the original 0.9%) thanks to productivity gains.

However, to eliminate primary deficits by 2020 (another key goal of Abe's economic plan), the Diet would need to make up the tax revenue lost either by further hiking the sales tax (from the expected 10% in 2015) or by broadening the tax base.

This could prove politically controversial since in effect it would be asking consumers to subsidize corporate earnings.

# The impact of corporate tax cuts is also highly uncertain

## Cash hoarding by Japanese corporations

Flow of funds, nonfinancial corporations, currency & deposits



There is also no guarantee that a tax cut would trigger a significant increase in capital spending. Risk-averse Japanese corporations may just hoard any benefits from a tax cut.

Since the 2008/09 global financial crisis, Japanese corporates have steadily built up cash reserves, suggesting a deep-rooted caution on the sustainability of recovery.

Having said that, success in implementing a tax cut would still be an encouraging sign of a government that can “walk the talk.”

# Japan's fork in the road

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The tax ayatollahs at the Japanese Ministry of Finance are committed to raising the sales tax by the end of 2015. However, with the Nikkei now among the worst performing major equity markets, and with the air having gone out of Japanese reflation trades, the Diet will be hard-pressed to increase the consumption tax unless one of two things happens:

- A reduction in the corporate income tax rate, which would hopefully lead to more Japanese companies being managed for profits (today, some 80% of Japanese companies pay no corporate income tax). Needless to say, such a development would be very bullish for Japanese equities .
- A new and more aggressive round of quantitative easing from the BoJ. The challenge is that the BoJ has lately made noises about its concerns over the impact of QE on the JGB market (admittedly, the BoJ could buy Japanese equities or REITs instead of bonds). Either way, a new round of QE would likely lead to another leg down for the yen.

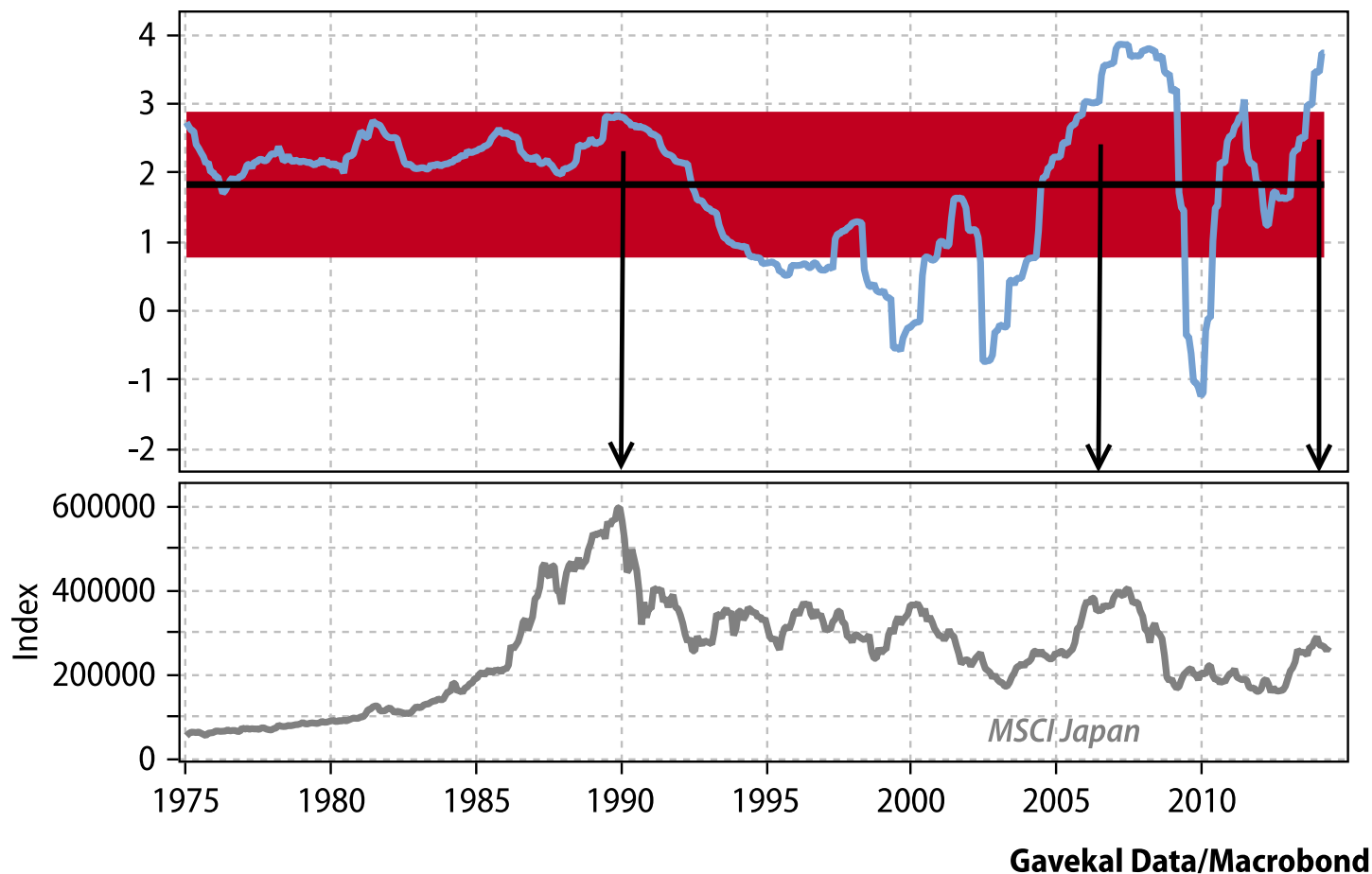
However one cuts it, the decision-tree on Japan is pretty simple: the planned consumption tax hike will likely be a non-starter unless the Abe government announces a corporate tax cut, or the BoJ becomes more aggressive.

If we were asked to give odds on upcoming Japanese developments, we would argue that there is roughly **a 60% chance that the BoJ becomes more aggressive** before the end of the year in order to pave the way for the next consumption tax hike, **a 10% chance of a corporate tax cut** as a quid pro quo for a consumption tax hike and **a 30% chance that, instead of either, Japan does nothing and continues to slowly drift into irrelevance?**

# A tactical boost or a structural re-rating in Japan?

## Earnings share of GDP peaking in Japan?

MSCI Japan EPS over GDP 12 mma; all in JPY



If Japan delivers a pause in sales tax hikes, or more QE, it will boost market sentiment but nothing fundamental will change.

In this case, the historical relationship, where equity market peaks tend to coincide with a topping out in the EPS-to-GDP ratio, is likely to hold.

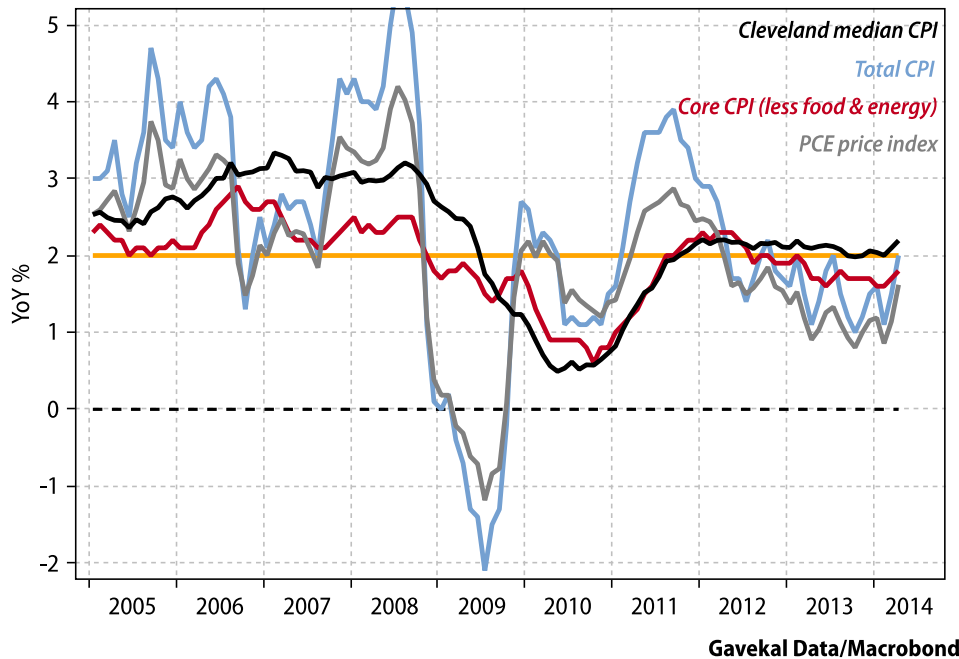
But if Tokyo delivers a corporate tax cut, it will raise hopes that Japan's growth trajectory could be on a different path, possibly overcoming a peaking in the EPS-GDP ratio.

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**Is inflation set to accelerate in the US?**

# US inflation is bouncing back

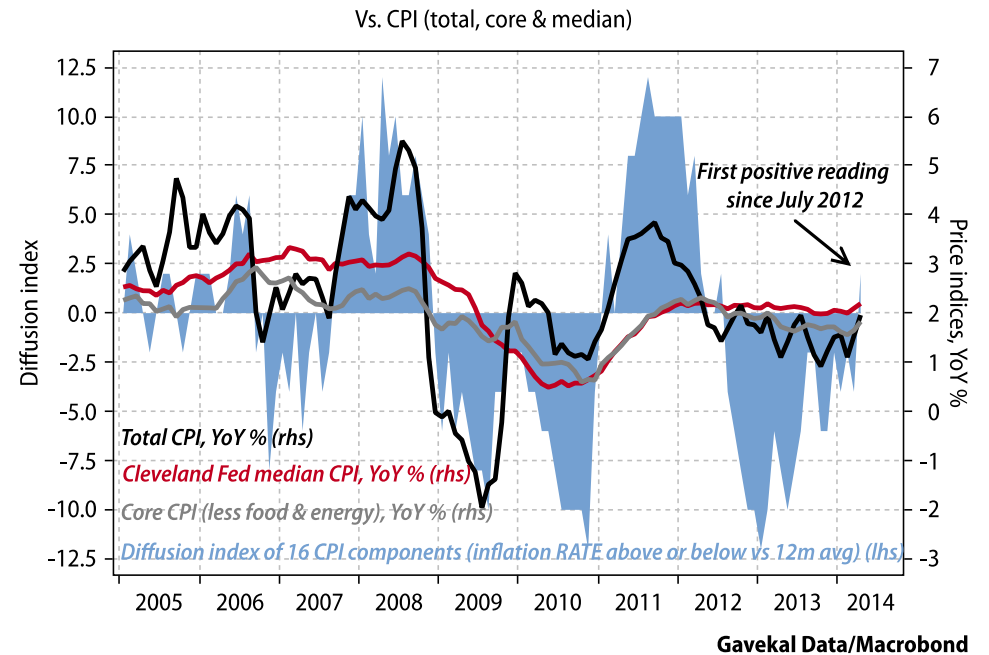
Inflation measures are on the rebound



Most inflation measures have spent the last two years well below the Fed's now explicit 2% inflation target (with the notable exception of the Cleveland Fed median CPI).

Today, all measures are on the rebound. And for the first time since mid-2012, our diffusion index shows more CPI components accelerating than decelerating.

Diffusion index of 16 CPI components - accelerating or decelerating



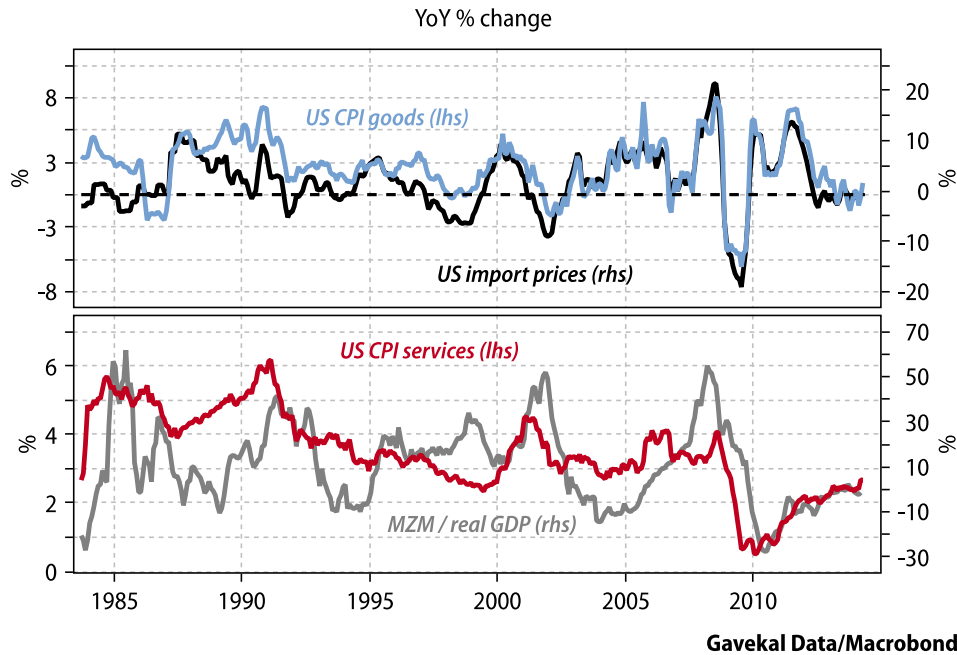
This raises a few important questions:

1. Where are inflationary pressures coming from?
2. Should we stop worrying about deflation and start worrying about stagflation?
3. Will the Fed be forced to tighten sooner and more aggressively than expected?
4. Would this kill the housing market?



# Inflationary pressures are home-grown

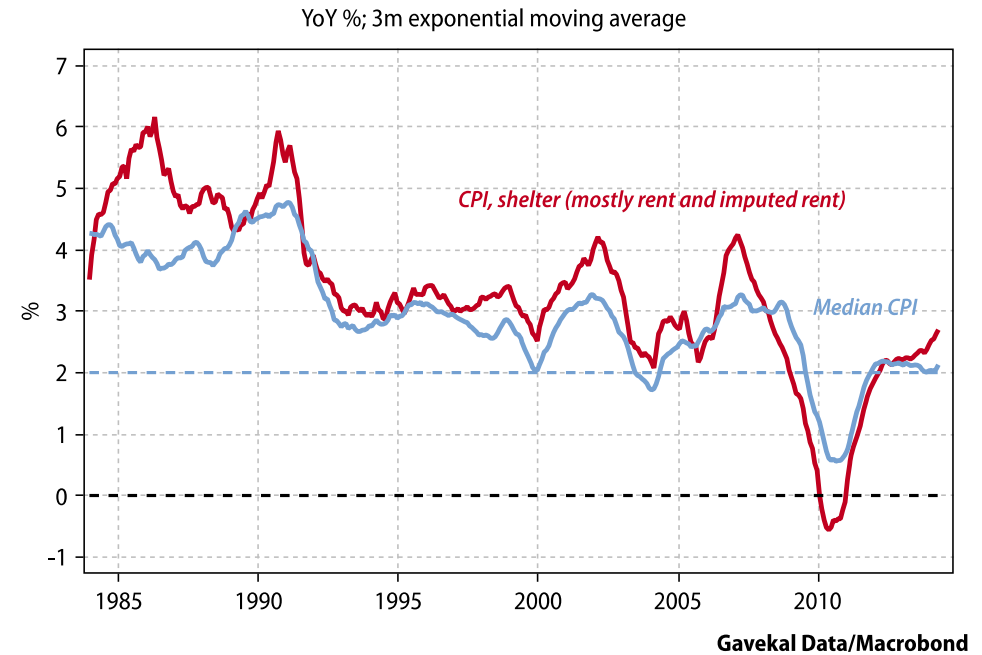
## Goods inflation is imported; services inflation comes from within



Goods prices in the US are largely a function of import prices. For the last two years, neither measure has shown much price change.

While we have started to see some life in commodity prices, a sustained pick-up seems unlikely given the slowdown in China and the coming on stream of additional capacity, especially in the energy sector. Simply put, global commodity production capacity does not appear to be very tight today.

## Rising rents supporting median CPI at just above 2%

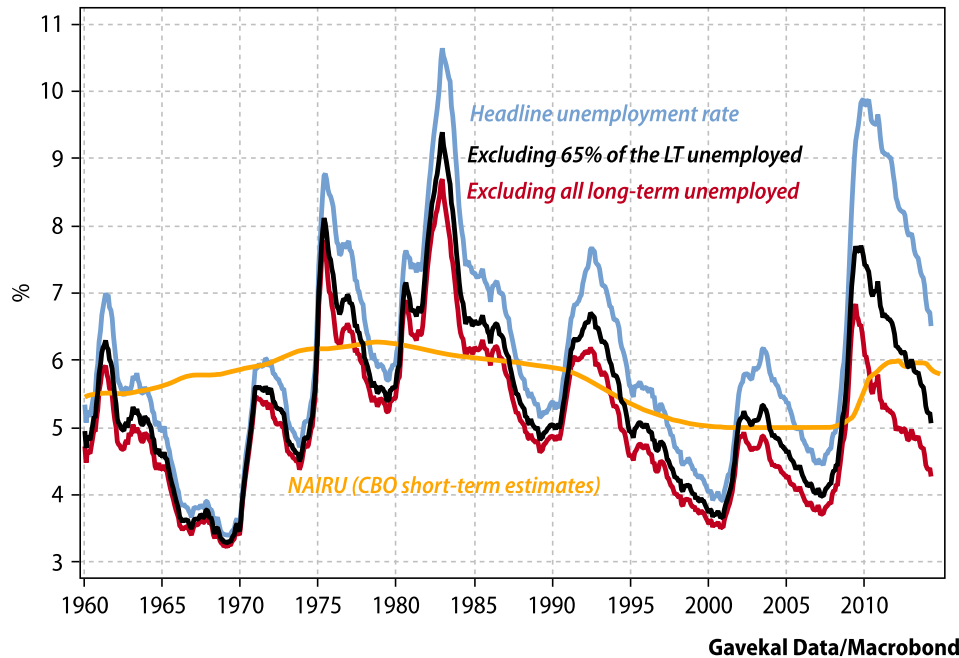


However, the Fed has succeeded in producing inflation at home. Service prices are much more a function of domestic factors—such as the supply of money (we use MZM here) versus economic activity (real GDP).

The ratio is far from perfect (as is the money supply and GDP measure) but the point is that domestic factors are bidding up the price of services—especially rent.

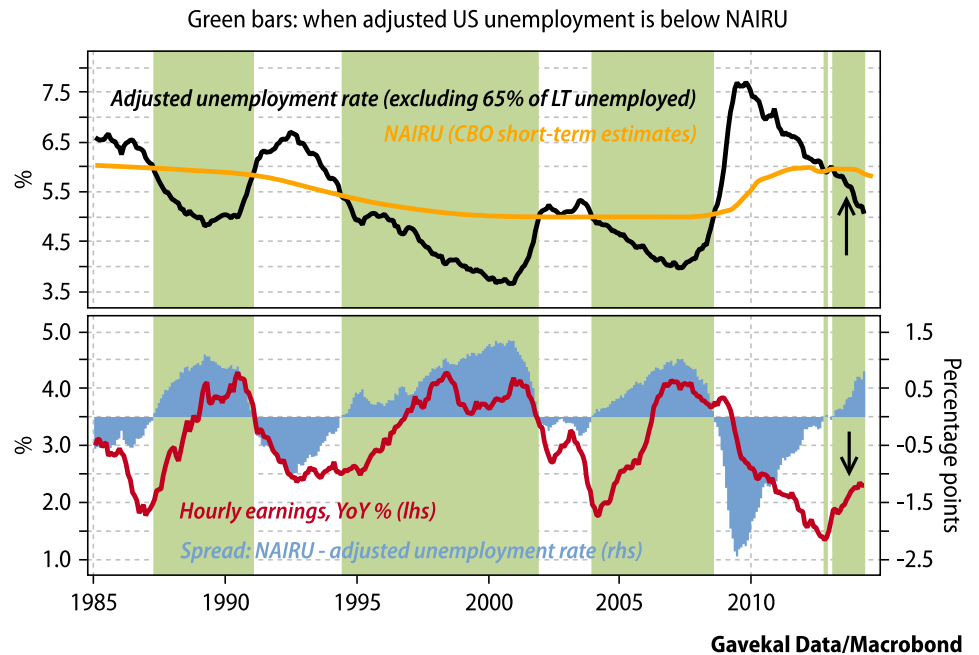
# Wage growth is accelerating as labor slack abates

US unemployment rate: headline & excluding long-term unemployed



Rebounding wage growth is a big part of the domestic reflation story. One might ask why wage growth is accelerating (and in fact has been since the end of 2012), when unemployment is still well above the estimated NAIIRU (non-accelerating inflation rate of unemployment, see [The Round Peg](#))?

Wage growth makes sense if we exclude a portion of the LT unemployed



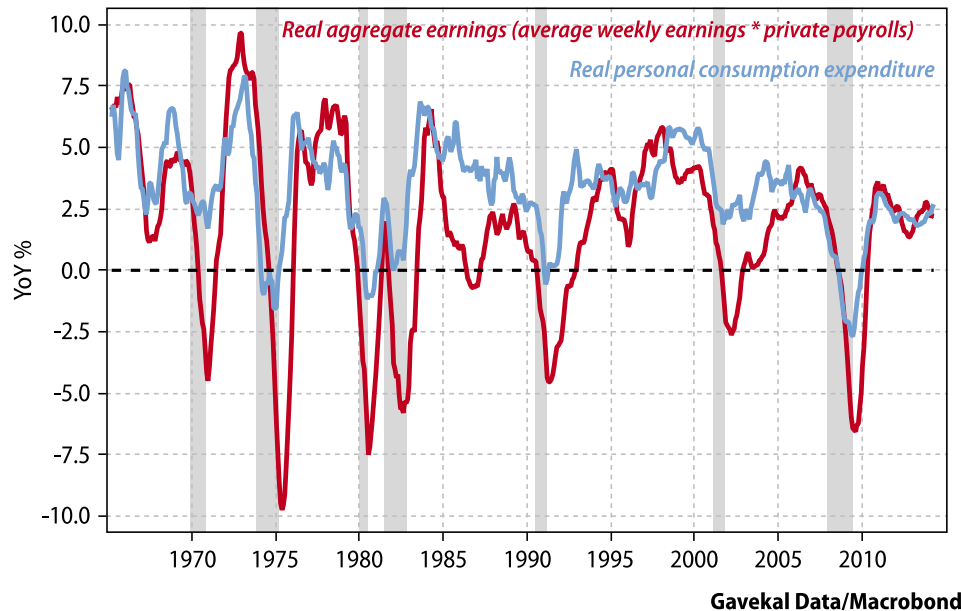
Our view is that a good portion of the long-term unemployed are not easily re-hirable. By trial and error, we find that the standard NAIIRU works a lot better if we compare it to an unemployment rate that strips out 65% of long-term unemployed.

By this adjusted measure the US labor market has a lot less slack in it than the headline numbers suggest, which perhaps helps explain the accelerating wages.

# So long as wages & employment are growing, stagflation will be avoided

## Inflation is not a threat to consumption yet

Earnings for production & nonsupervisory private employees; 3m moving averages

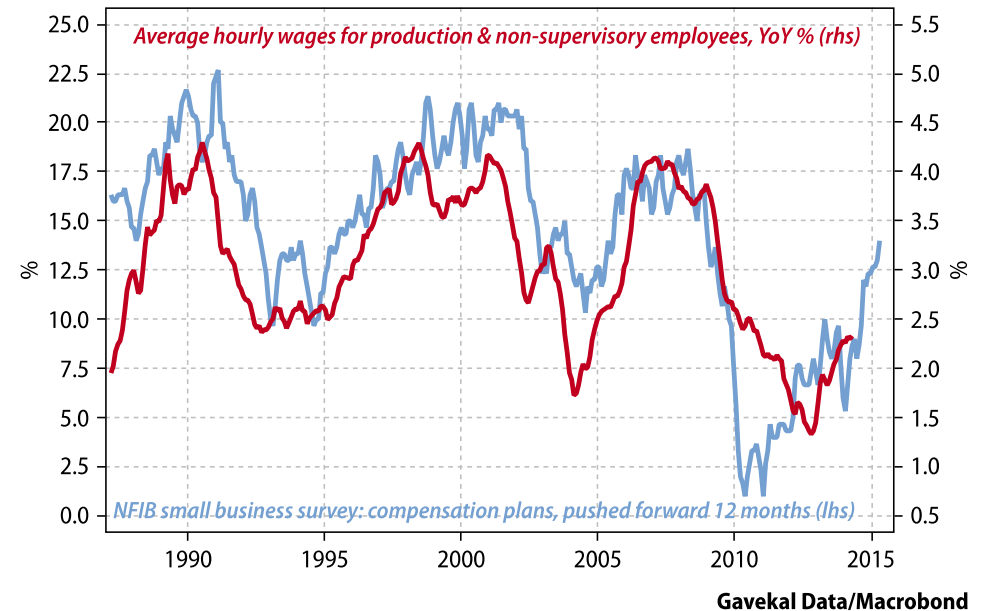


In 1Q14 the US economy performed terribly, contracting at an annual rate of -1%. Meanwhile, inflation is on the rebound. So, understandably, concerns are emerging that stagflation could be around the corner?

Given the completely unprecedented monetary activism of recent years, we cannot dismiss such fears out of hand. But for now at least, there are few signs of stagflation brewing in the data.

## NFIB small business survey indicates that wage growth will accelerate

3-month moving average



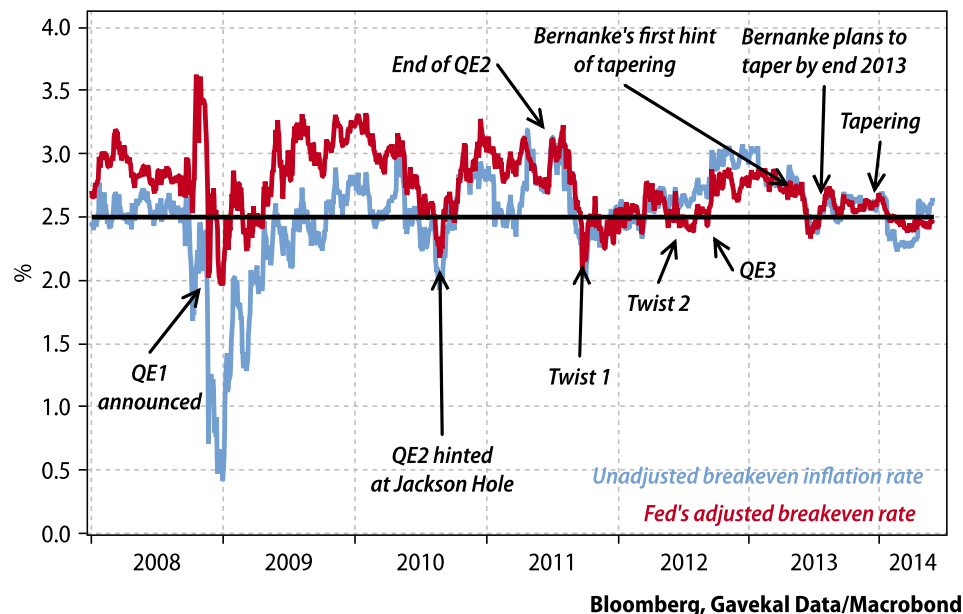
Earnings growth is keeping pace with inflation. Add in decent payroll growth, and the aggregate purchasing power of US consumers is still on the rise in real terms. This is not what stagflation looks like.

Better still, the NFIB survey reports that small businesses are planning to increase compensation to employees, so more wage growth acceleration is on the horizon.

# Will rising inflation usher in tighter monetary policy?

## Inflation expectations (5-10 years forward) remain "well anchored"

On Bloomberg: USGG5Y5Y Index & FED5YEAR Index



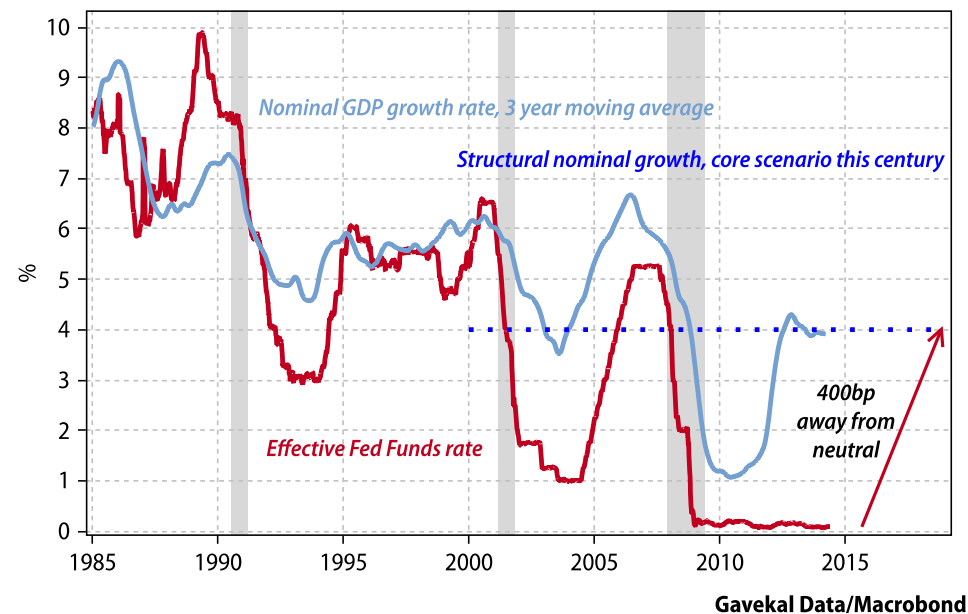
QE is being tapered out of existence this year, but ZIRP is expected to be with us for at least another twelve months, maybe more.

Could rising inflation bring forward short rate hikes? Perhaps. But there are a couple of things that investors should keep in mind:

Firstly, inflation expectations remain "well-anchored", to use Fed-speak. As long as this is the case, rate hikes are likely to come only gradually, and not until next year.

## The Fed has a long way to hike rates before they get restrictive to growth

Core growth scenario: Demographics suggest ~2% real growth + 2% Fed inflation target = 4%



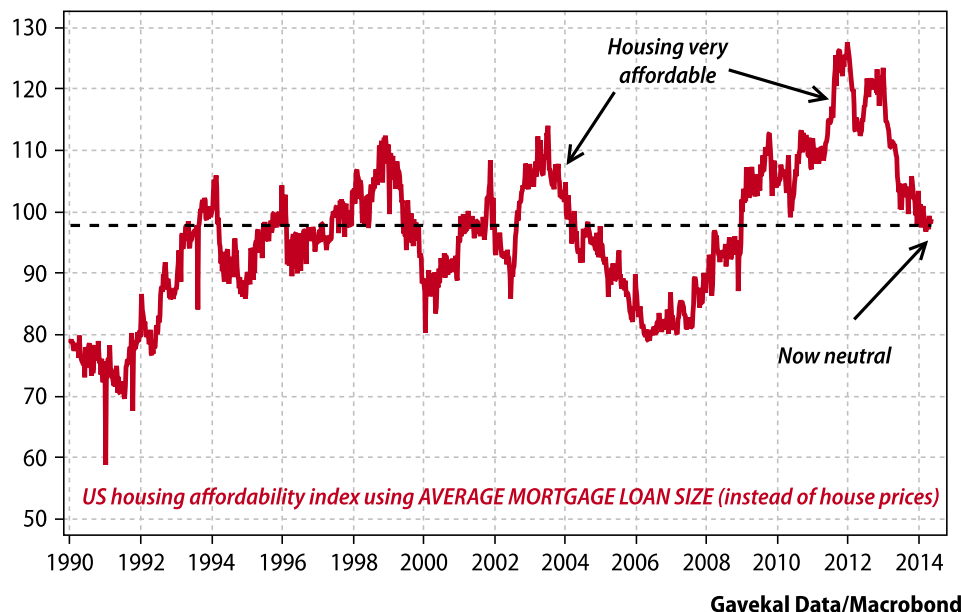
Secondly, short rates will not start to restrict growth until they encroach upon the structural growth rate (at around 4% in nominal terms, now and in our core scenario going forward). So we have 400bp of rate hikes to go before policy is really "tight".

Of course, assets whose valuations depend on extraordinarily easy monetary policy may struggle. We get to equity valuations in the final section. The other significant valuation issue taxing investors is on US housing.

# Will rising inflation = higher rates = housing market bust?

## US housing affordability back at neutral levels

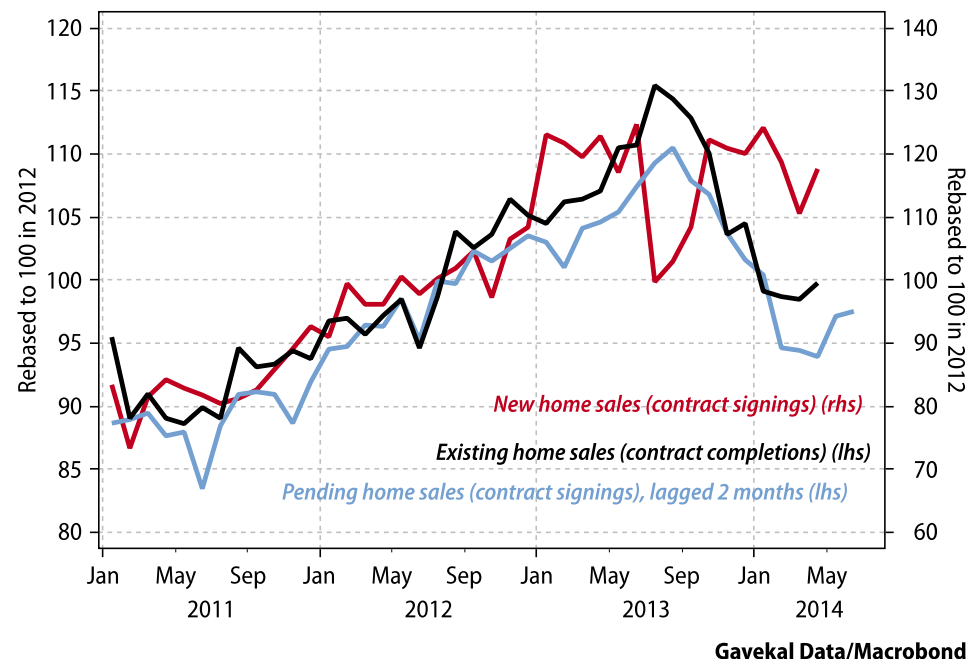
Dashed lines = mean of 1993-03 (10y period of stable affordability)



After benefitting from a strong housing recovery in 2011, 2012 and the first half of 2013, the US economy has seen negative contributions to GDP from housing construction in the last couple of quarters.

The 4Q13 decline was due to the rise in mortgage rates in mid 2013 which, along with the rise in house prices, took the affordability tailwind out of the housing market. Clearly, the higher interest rates hurt housing activity.

## Housing market remains sluggish after affordability normalized



Then 1Q14 brought extreme weather which hit construction activity hard. Signs are appearing that housing activity may be coming back, but if the overall housing sector remains lackluster.

Housing (in terms of construction or price appreciation) is unlikely to come back strongly this year; but it is also not going to go bust. Affordability is still reasonable, and the US consumer has deleveraged and is now seeing wage growth.

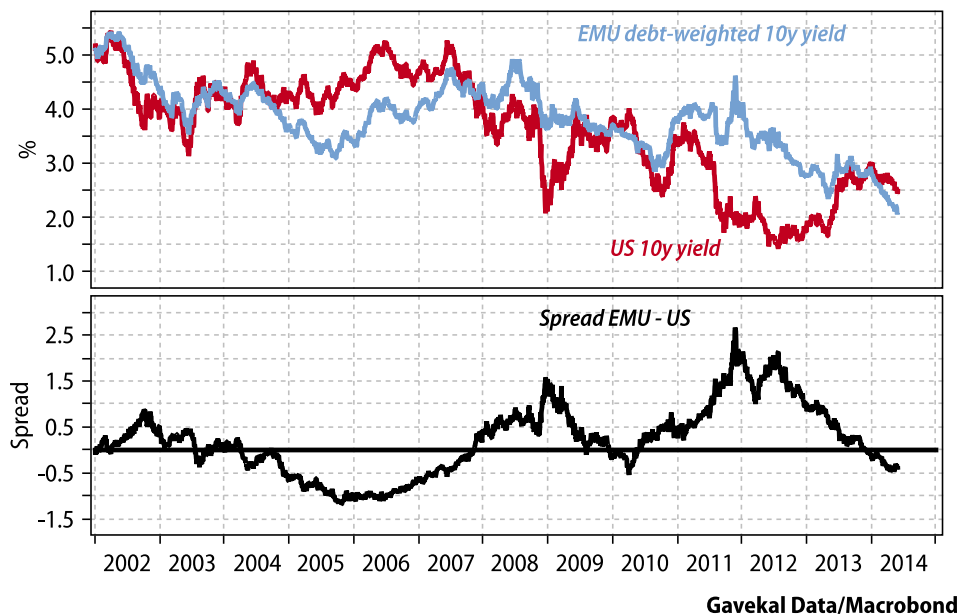
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# What can we expect from European reflation?

# Europe has seen a strong improvement in financial conditions

## EMU weighted average 10-year bond yield vs US

EMU debt weighted excludes Greece, Portugal and Ireland

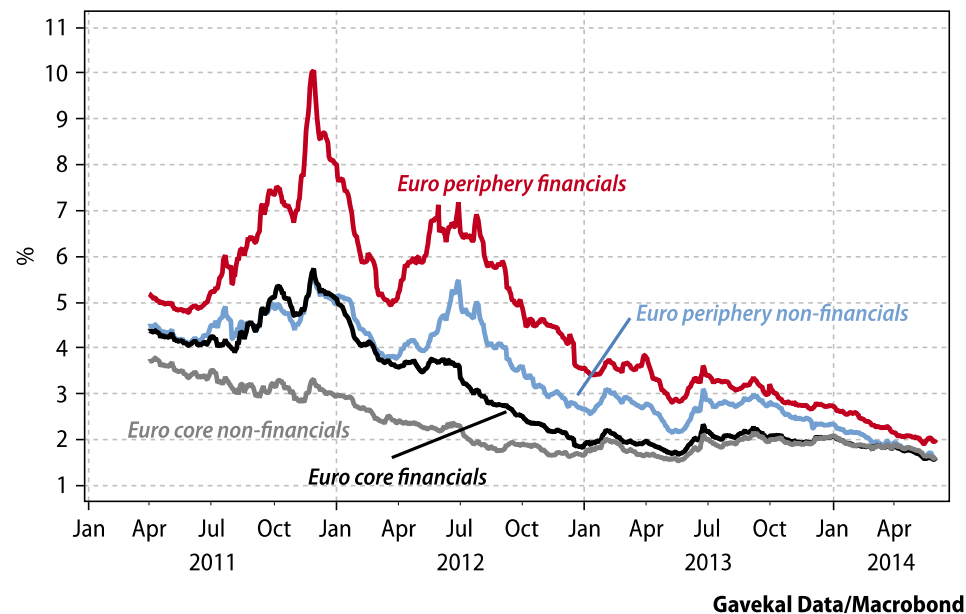


As we highlighted in our last [Quarterly Strategy Chart Book](#), despite precious little real action from the European Central Bank, financial conditions in the eurozone have improved markedly.

In fact, we are now at a point where most of the big eurozone economies can issue sovereign bonds yielding less than their US counterparts.

## Record low yields and shrinking divergences

Corporate bond yields



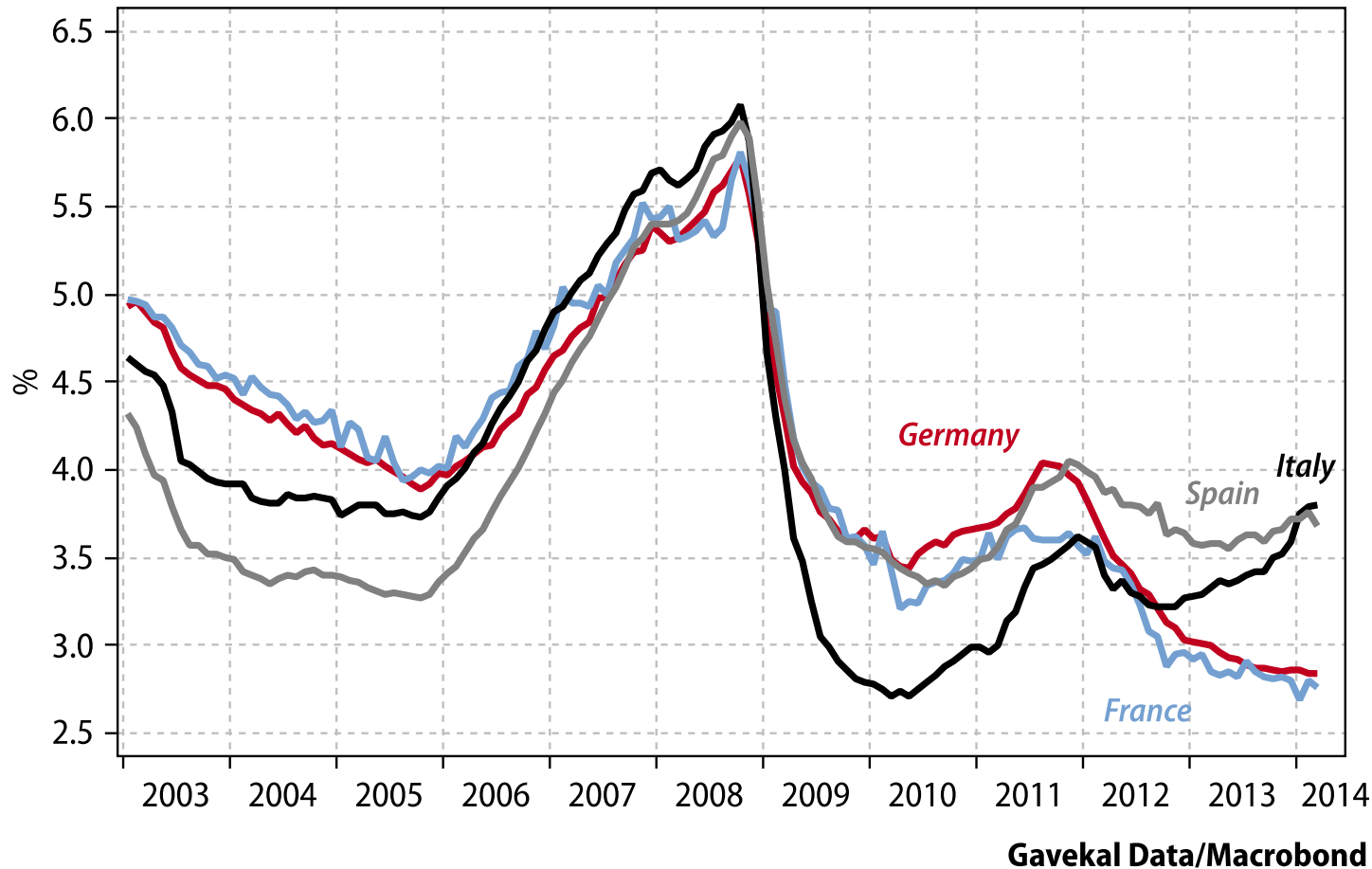
Falling bond yields have also been great news for large European businesses that have access to the EMU corporate bond markets.

Unfortunately, the vast majority of small and medium enterprises in Europe are still very dependent on bank lending, and here the data is less encouraging.

# But eurozone bank credit is still lagging badly

## Bank interest rates to non-financial corporations

On 1-5 year loans



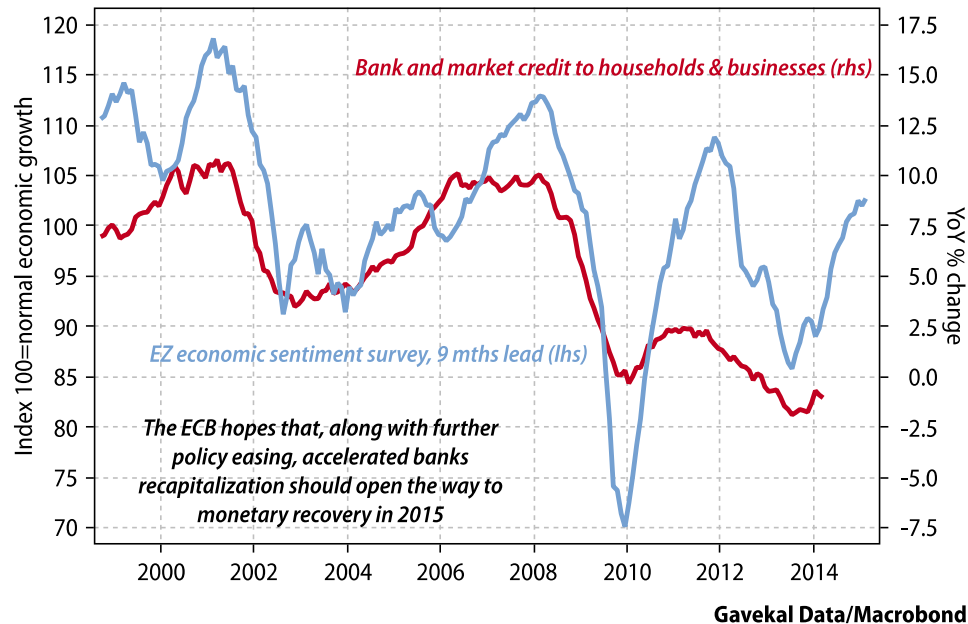
Despite the impressive fall in sovereign and corporate borrowing rates, bank lending in Europe has remained anemic.

As a result, capital is now quite scarce for the areas in the eurozone that need it the most: small and medium businesses in Italy and Spain.



# Some light in the eurotunnel

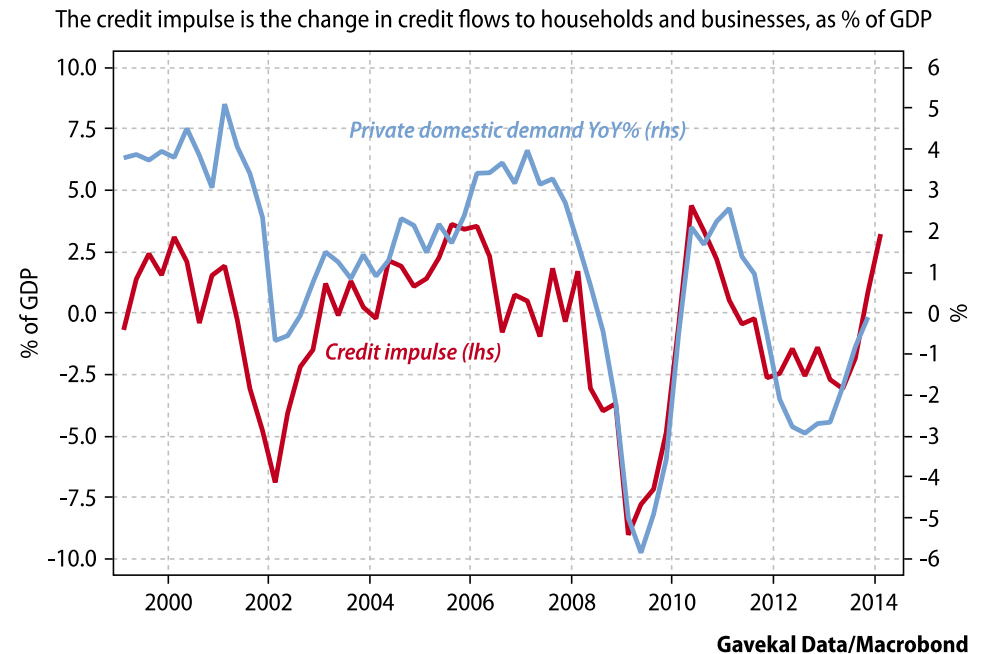
## Euro Area credit growth lags the business cycle, but has remained negative so far



One argument is that credit growth tends to lag economic activity and hence poor lending activity is a result of weak economic performance of the past few years.

And now that fiscal policies have started to tilt to growth, that lackluster banking activity will take care of itself?

## The credit impulse has turned up

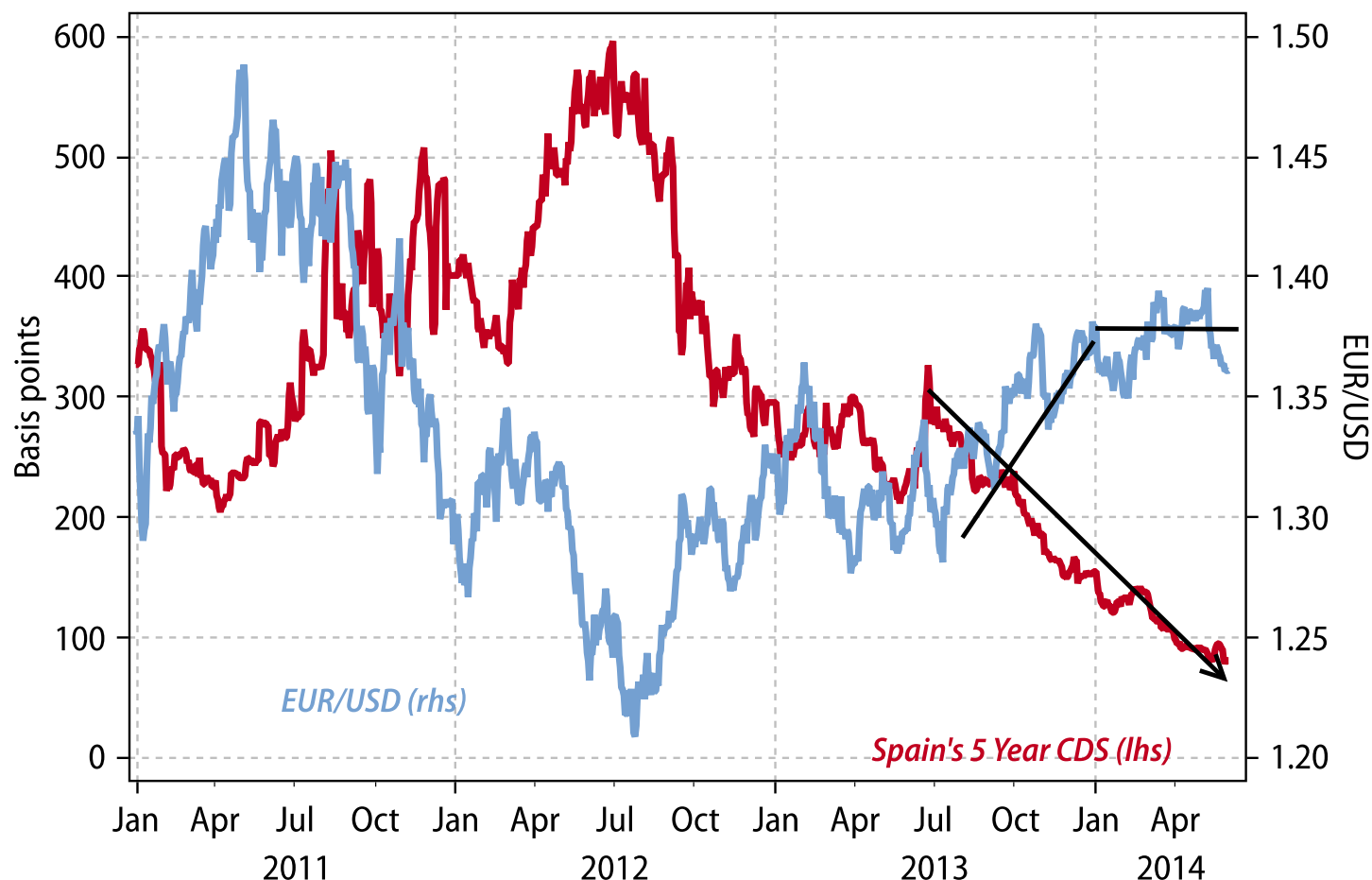


After all, forward-looking indicators such as the “credit impulse” (which measures the change in credit flows as a share of GDP) have shown a marked improvement of late.

In addition, it appears that the appreciation track of the euro has at least temporarily been broken.

# The euro looks to be losing steam

## The collapse in GIPSI risk premia pushed the euro higher - but no longer



Gavekal Data/Macrobond

Ever since financial conditions started to improve in Europe, the euro has drifted higher against most major currencies.

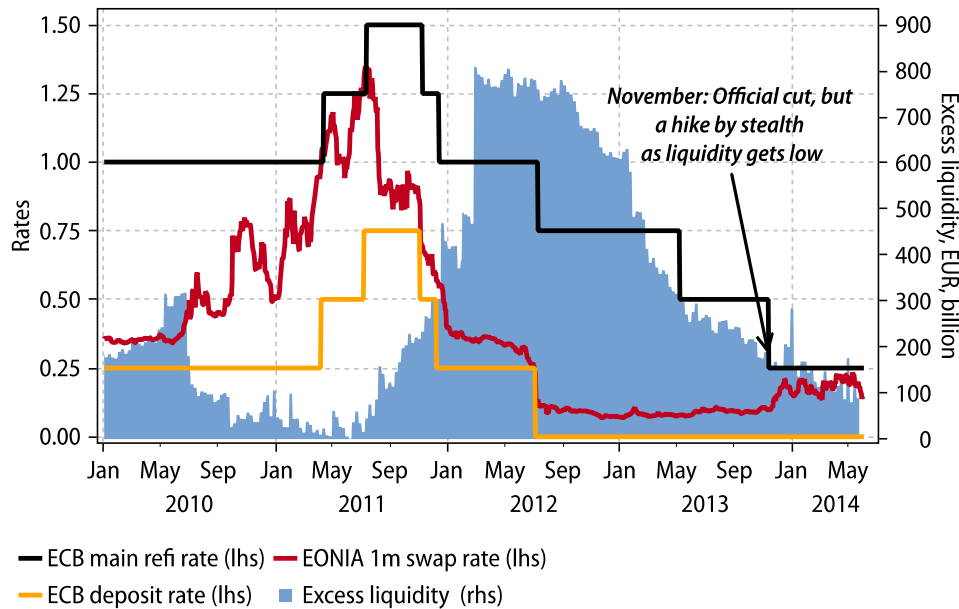
This negatively impacted the profitability of small and medium exporters in the eurozone which were already struggling due to the constrained availability of credit finance.

Fortunately, it appears the euro has topped out. This new weakness of the single currency is linked to market expectations of an easier ECB.

But will the ECB deliver and meet the market's ever loftier expectations?

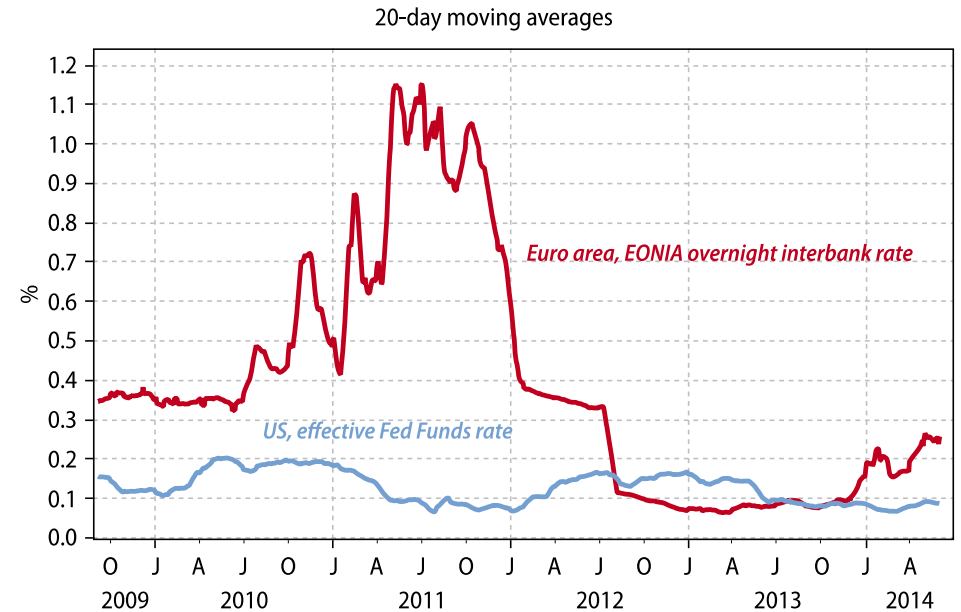
# How to make sense of ECB actions: excess liquidity & policy rates matter

**LTRO repayments = less excess liquidity = stealth rate hikes**



Gavekal Data/Macrobond

**Short rates in euro rise while ZIRP holds in the US**



Gavekal Data/Macrobond

ECB policy rates establish the corridor in which euro short rates can trade; the amount of excess liquidity in the system determines where in that corridor those short rates trade. In this system, strange things can happen. And they did last year!

In November, the ECB cut its headline policy rate, the main refi rate, from 0.50% to 0.25%. But the facts on the ground were quite the opposite. Short rates were already at about 0.1%, but soon after the official rate cut, rates started to rise, not fall.

This was because the decision by banks to repay LTRO disbursements made by the ECB had reduced excess liquidity to such an extent that interbank rates faced upward pressure (this point appears to be between €100-200bn).

With the US still committed to ZIRP, even the most moderate of stealth rate hikes in the euro area put some upward pressure on the euro.

With this in mind, we consider the possible outcomes of the much-anticipated ECB meeting in June, on the next slide.

# The likely consequences of various ECB policy actions

This Quarterly was written a few days before the ECB's June meeting, but regardless of what the ECB does or does not deliver, it is worth considering the likely consequences of possible policy actions—because if the ECB does not deliver on the options below at this meeting, it may do so in the future. Below are possible actions, and a few likely consequences:

- **Negative deposit rate—not enough.** If this is all the ECB delivers, expect the euro to rise and equities to fall. Why? As we explained, declining excess liquidity has put upward pressure on short rates and in turn the euro. A negative deposit rate risks making matters worse. If the ECB starts charging banks to hold excess liquidity, banks won't rush to lend out excess reserves resulting in a surge of velocity (as some hope); instead, banks will just return excess reserves back to the ECB. In Europe, liquidity is “borrowed” from the ECB, not “owned” (i.e. not created through open market operations). Thus, with negative deposit rates, expect to see more LTRO repayments and/or less money rolled over at upcoming refinancing operations. Either way, the eurozone will see less excess liquidity. At best, this will do nothing more than keep short rates where they are, up near the main refi rate; thereby keeping upward pressure on the euro. At worst, tighter liquidity might cause spreads to widen. Either way, equity markets would be disappointed. The only way a negative deposit rate might provide a lift is if it is paired with a major long-term liquidity provision.
- **Stop sterilizing the SMP—temporary relief.** The Securities Markets Program from years ago was meant to target troubled areas of the European credit market; it was not meant to add general liquidity. Thus the purchases have been sterilized ever since. If the ECB quit sterilizing those purchases, it would release about €150 billion into the system. That would push short rates down and provide temporary relief. But that would only buy the ECB time and would, on its own, likely disappoint markets.
- **Cut the main refi rate—negative for the euro, positive for equities.** This is the simplest way for the ECB to reverse the stealth rate hikes that have occurred since November. This would remove a support for the euro, which much of Europe would welcome, and it would likely be cheered by equity markets.
- **New LTROs, QE or some other liquidity provision—positive.** In the past, the ECB has only been able to embrace aggressive actions when a crisis was already underway. Will this time be different? And if the ECB delivers, will the banks participate? The terms will have to be attractive enough for banks to participate in the absence of a crisis. We are skeptical, but if the ECB does, the euro will likely sell off and equity markets will rally.

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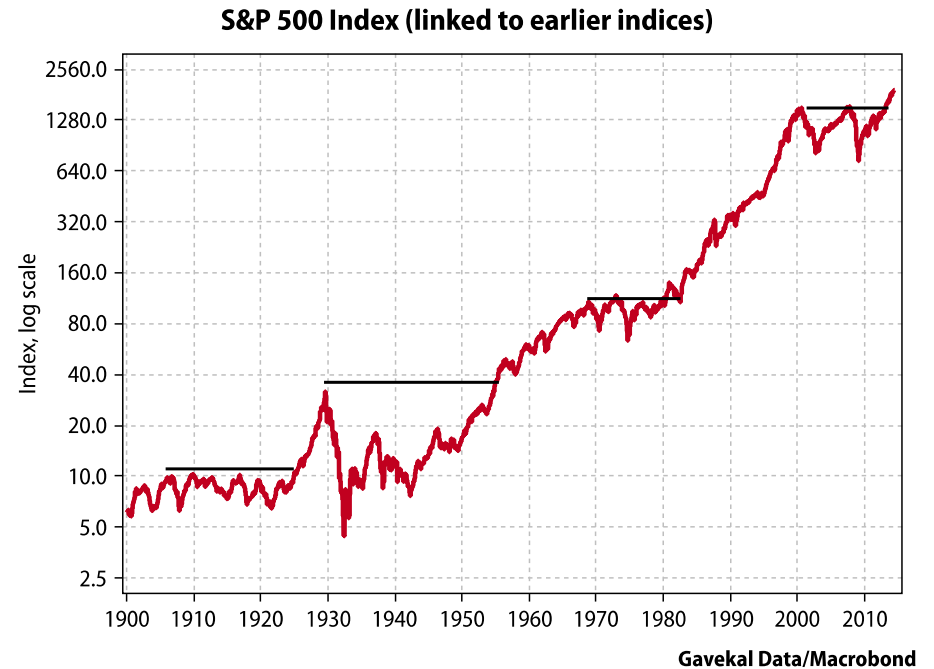
**Is a market dislocation ahead?**

# Top of the range or a new structural break-out?



Bearishly inclined investors will probably look at the above chart and feel a shudder go down their spine. Indeed, modern equity rallies tend to last around five years, which coincidentally is just about the duration of the current rally.

Combine that with some anecdotal evidence on the record number of profitless companies launching their IPOs, Shiller PEs looking stretched, margins at all time highs... and one might conclude that a defensive portfolio is the way to go.



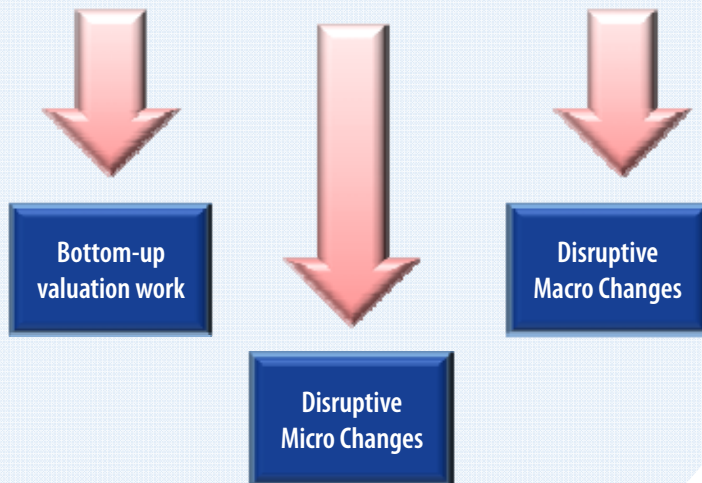
The alternative view is the one presented by the chart above and the idea that we are finally leaving behind a 20-year trend of sideways trading on global equity markets?

We will not know the definitive answer to this question for quite a few more years. However, as the rally is undoubtedly maturing, we would advocate the use of a balanced portfolio, while remaining focused on short-term risks and the pursuit of value.

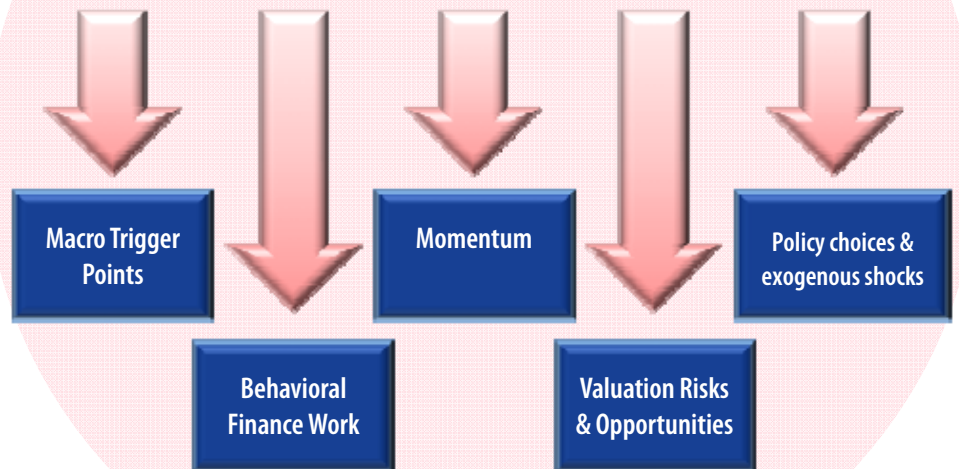
# Beating the long-term returns offered by global equities

Returning to the idea that the past year has not been the year of the macro investor, we should note that there are two ways to beat the long-term returns offered by equity markets: by **identifying individual stock or market inefficiencies**, or by **identifying periods of market dislocations and avoiding equity market draw-downs**. In recent quarters, it has been more productive to focus on the former, but will this change?

## Identifying Market Inefficiencies



## Identifying Market Dislocations

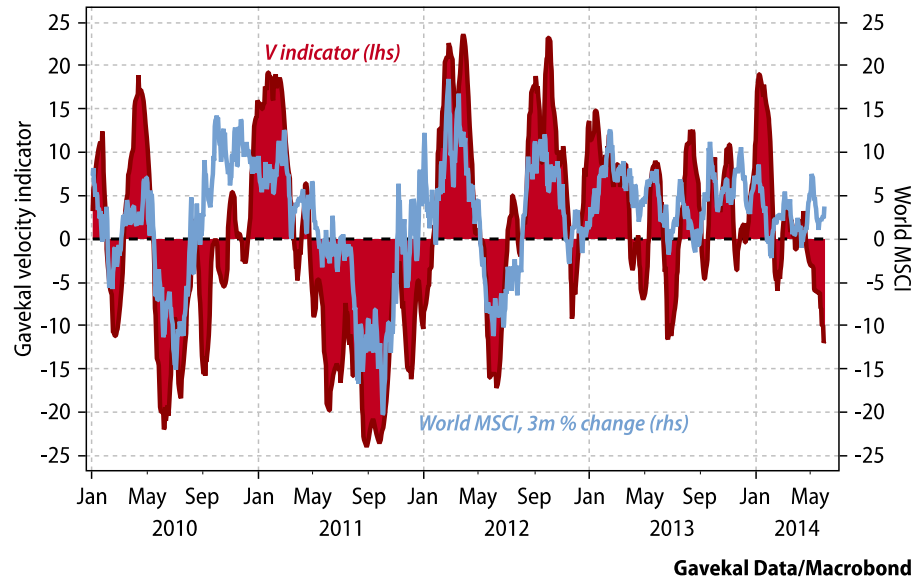




# Macro risk #1: our velocity indicator is flashing red

## Gavekal velocity indicator

Combination of market-based spreads & fundamental data aimed at estimating risk appetite

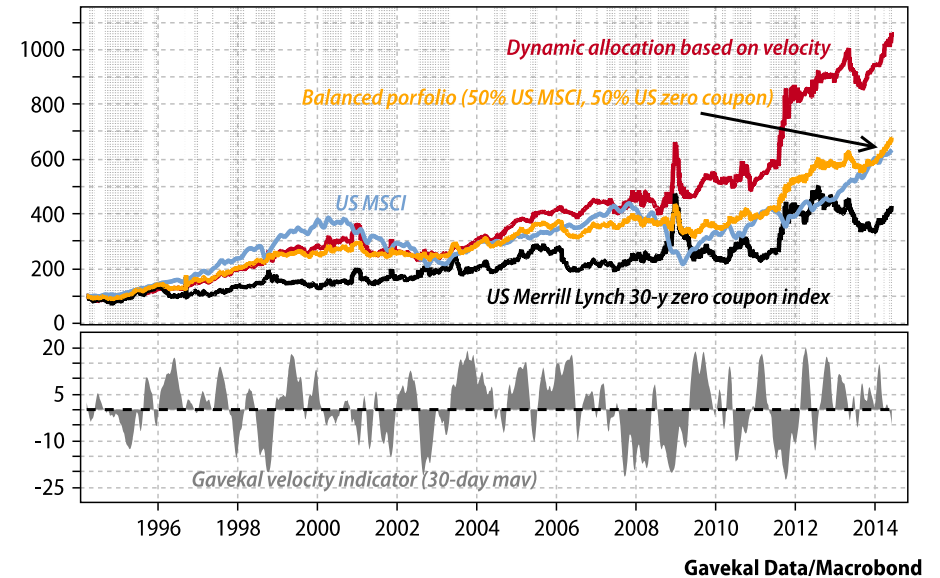


As regular readers know, we pay a lot of attention to the global economy's velocity of money. To measure this "propensity for risk", we have put together our own velocity indicator, made-up of various market spreads and fundamental data. Over the years this has become one of our more trusted indicators.

Worryingly, as shown in the chart above, our velocity indicator is now firmly in the red.

## Velocity based asset allocation strategy

All portfolios rebased at 100 in January 1994, shaded periods = negative velocity



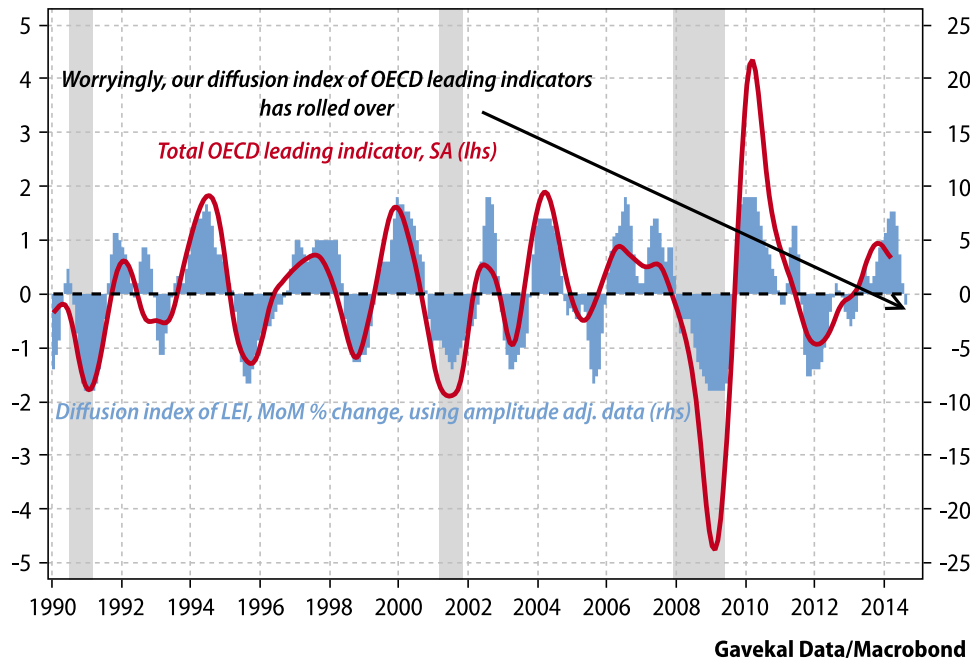
In the chart above, we look at a dynamic allocation strategy which applies a 70% weight in equities and 30% weight on bonds when velocity is above zero. By contrast, when velocity is negative, the portfolio is moved to a 70% weight in bonds and 30% in equities.

As is plain to see, this active allocation yields very strong results. We are not suggesting that this is a silver bullet of an investment strategy. Simply that paying attention to velocity pays off. Thus, a cautious approach on risk assets and a general focus on value is probably recommended.



# Macro risk #2: could we face some disappointing growth numbers?

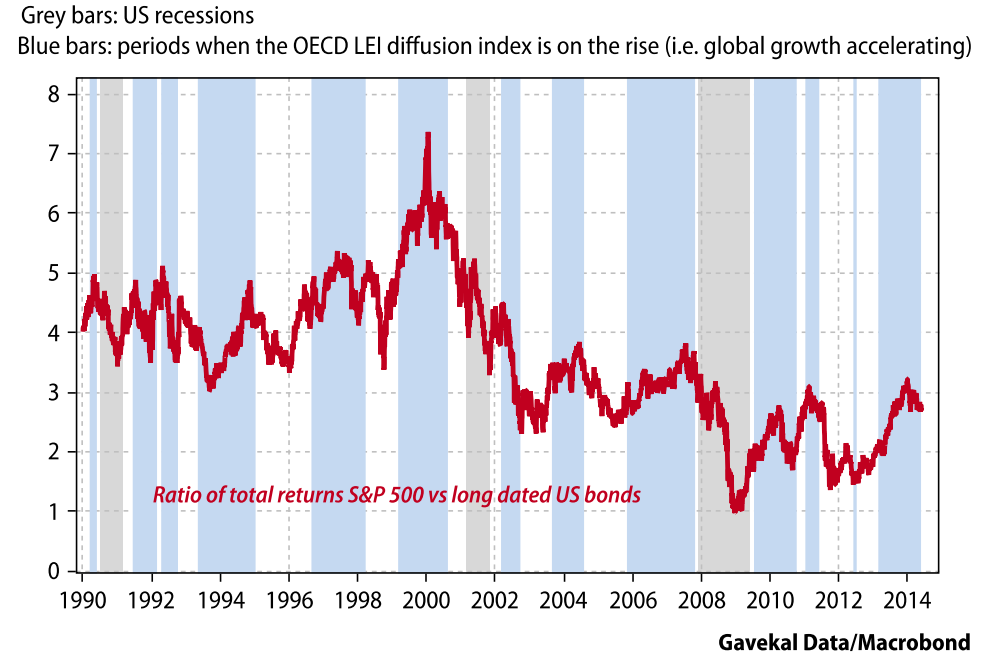
Leading the OECD leading indicators



Our diffusion index of OECD leading indicators has now turned negative – given the low rates, steep yield curves and aggressive monetary policies all around the world; this is discomforting.

Also, right on cue, as the diffusion index of OECD leading indicators moved into negative territory, long dated bonds started to outperform equities.

Indicators are finely balanced



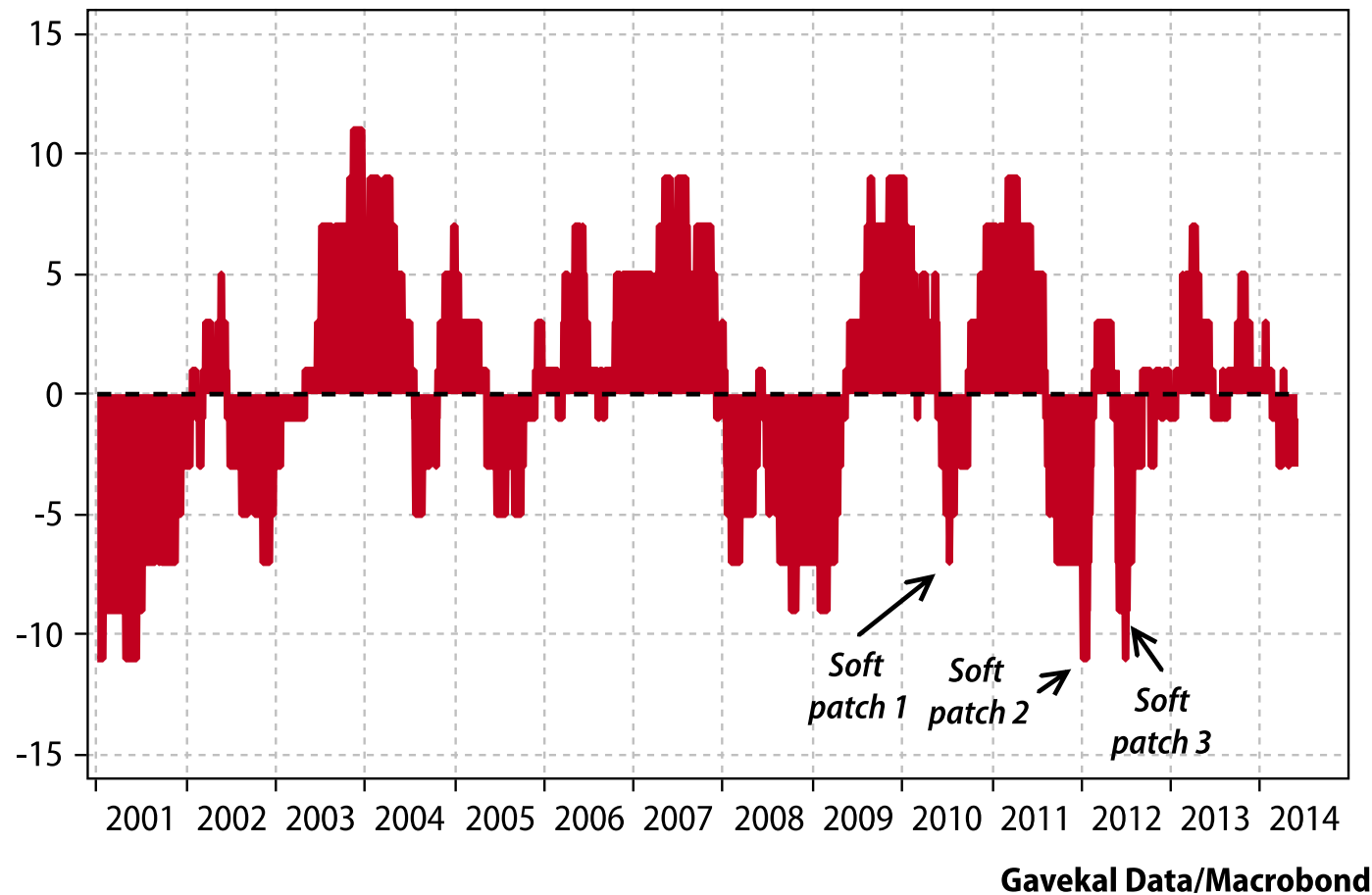
So far in 2014, it seems that growth has come in on the softer side, and bonds have out-performed equities. Of course, this does not mean that these trends are now set in stone.

Nonetheless, with overall OECD leading indicators seemingly stalled, any growth disappointment going forward could have a magnified impact on global equity market returns.

# Our diffusion index of economic sensitive prices is very soft

## GaveKal global diffusion index of economic sensitive prices

A daily series of various market prices that indicate global growth



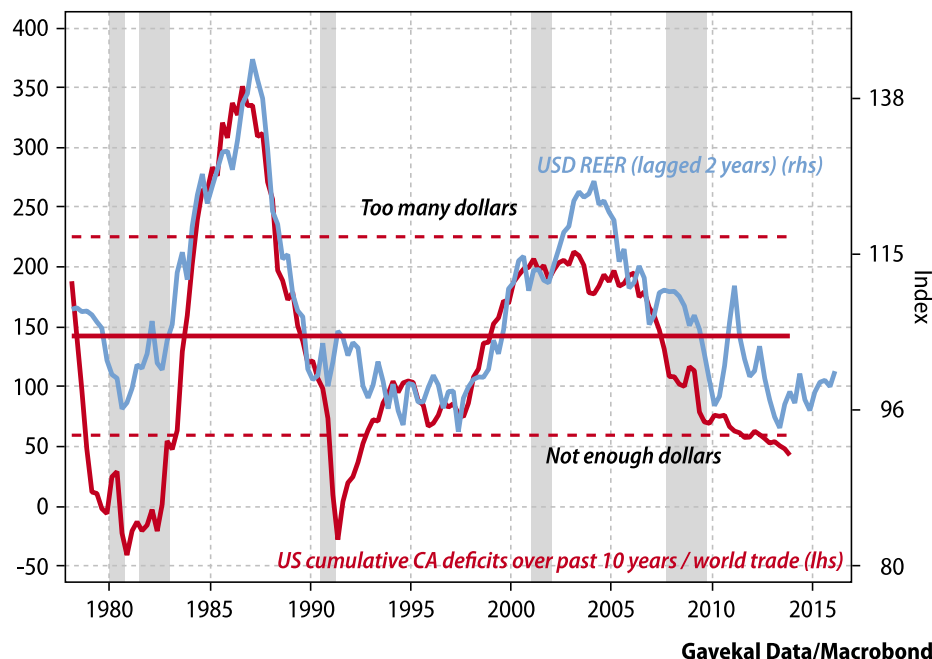
The roll-over in OECD leading indicators seems to be confirmed by our own diffusion index of sensitive prices.

But perhaps the problem is that this indicator, built as it is on market data prices (Dram prices, copper, Baltic dry index, relative performance of cyclicals vs non-cyclicals etc.) may be disproportionately sensitive to the Chinese slowdown?

Then again, if China slows down meaningfully, this will likely have a global impact.

# Macro risk #3: could tightness in US dollar be hampering global trade?

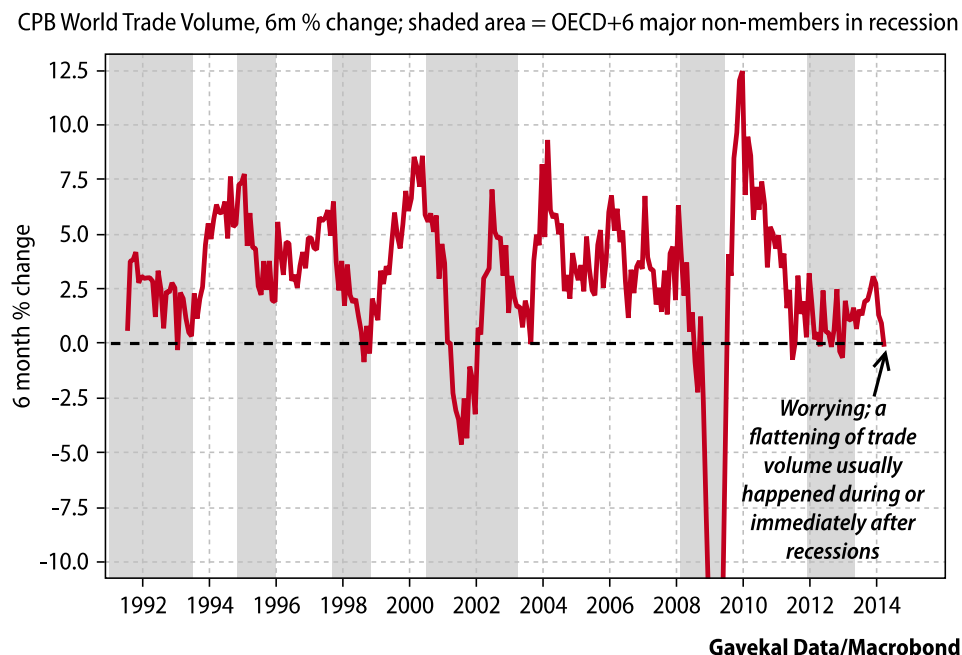
Ratio US cumulative current account deficit / world trade



As the US trade deficit continues to improve, the US exports fewer and fewer US dollars abroad.

Meanwhile, global trade needs dollars to expand, or someone finds themselves cut-off (see our previous [Quarterly Strategy Chart Books](#) for more on this issue).

Trade volume stopped growing again

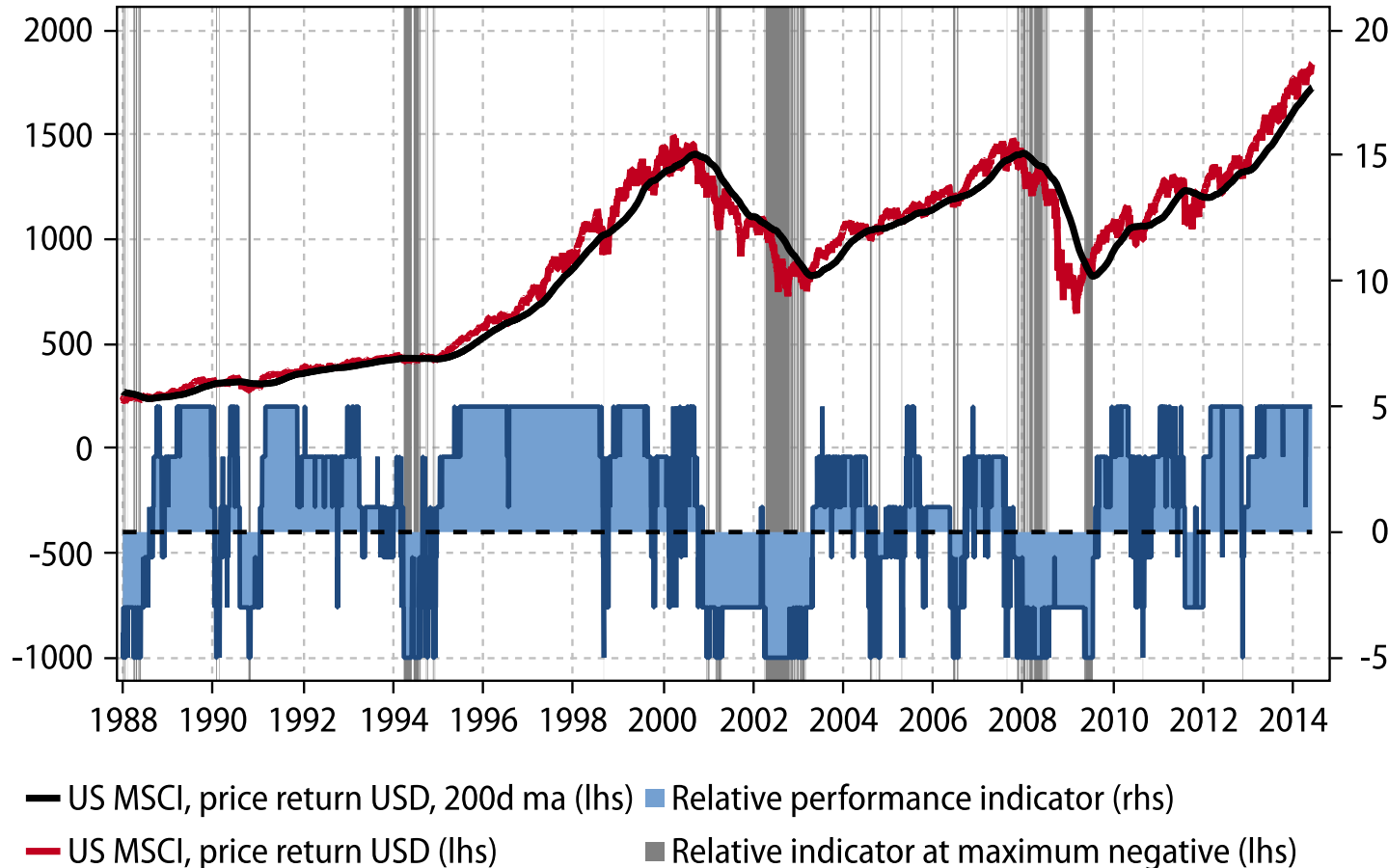


Worryingly, global trade seems to be stalling. This typically occurs at times of recessions.

Is it a direct consequence of the China slowdown? Of the structural US manufacturing renaissance? Of last year's emerging market hiccup? Regardless, it is hard to imagine a lasting bull market in an environment of contracting global trade.

# Momentum: very positive on most markets

## US equities & the relative performance indicator



Gavekal Data/Macrobond

Comparing each market against its own moving average or the returns delivered by cash, gold, domestic bonds, international bonds, or global equities, it is clear that most Western equity markets are still registering 'positive momentum' readings.

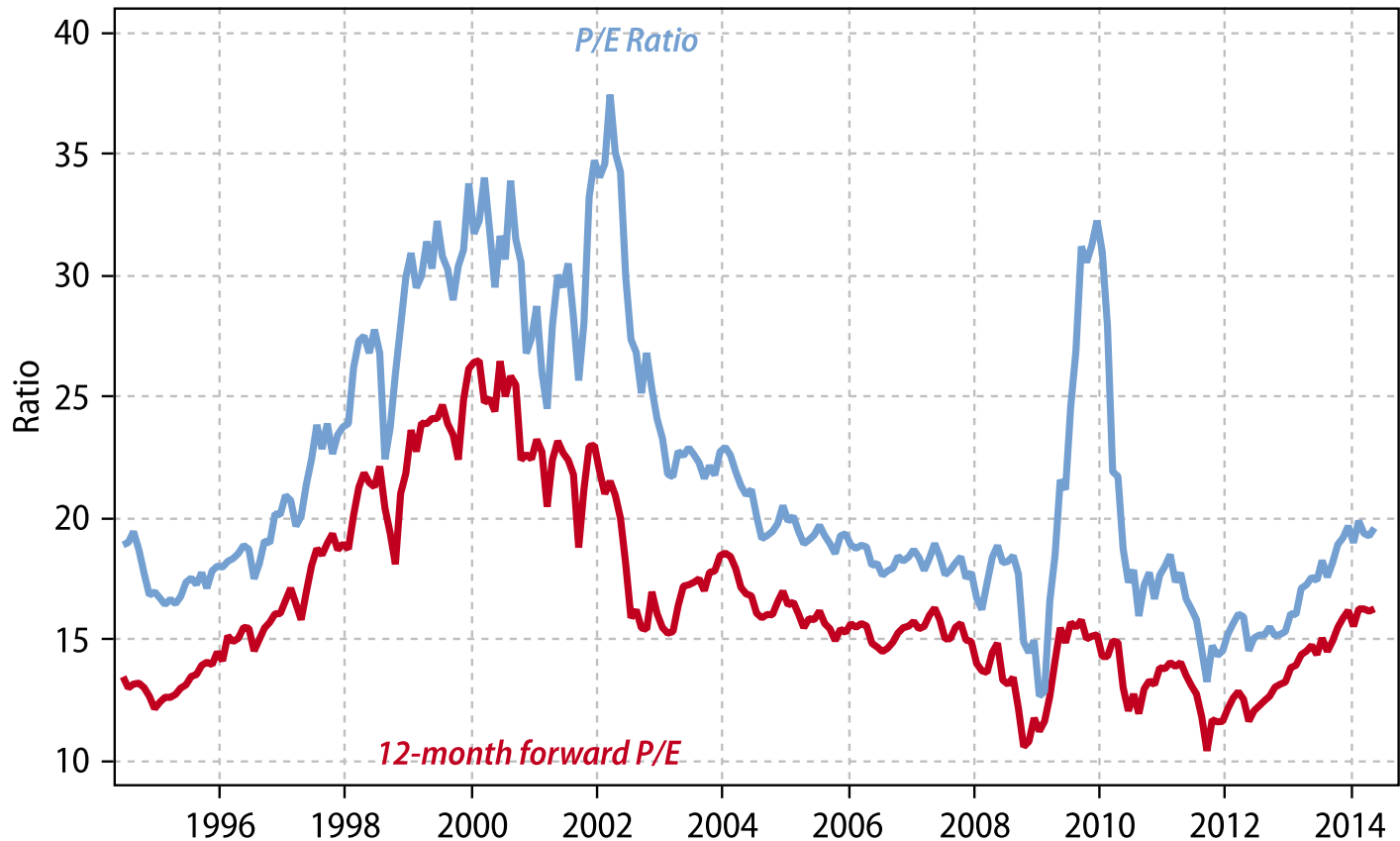
Of course, this could change if bonds deliver another quarter of solid outperformance.

Still, for now, the average retail investor will be broadly happy with his or her equity exposure.

# On most non-EM equity markets, valuations are broadly fair

## US 12m current and forward P/E

MSCI IMI (large, mid & small cap) index



Bloomberg, Gavekal Data/Macrobond

With price/earnings ratios roughly back to their 'post TMT bubble' highs, equity valuations are no longer dirt cheap.

In fact, on the rule of 18 (i.e.: market PER + CPI = 18), the market seems to be broadly fairly valued.

# With wide valuation disparities within markets themselves

## Valuation of consumer discretionary sector is looking stretched

S&P 500 sector indices; price to book value ratio deviation from mean since 1990



US equities saw an incredible multiple expansion in 2013. Consumer discretionary was the poster-child of the 2013 bull market. Unsurprisingly, this sector got hit hardest in the 'growth to value' rotation of March and April.

Meanwhile, cheaper sectors such as energy and utilities benefited from the rotation to value.

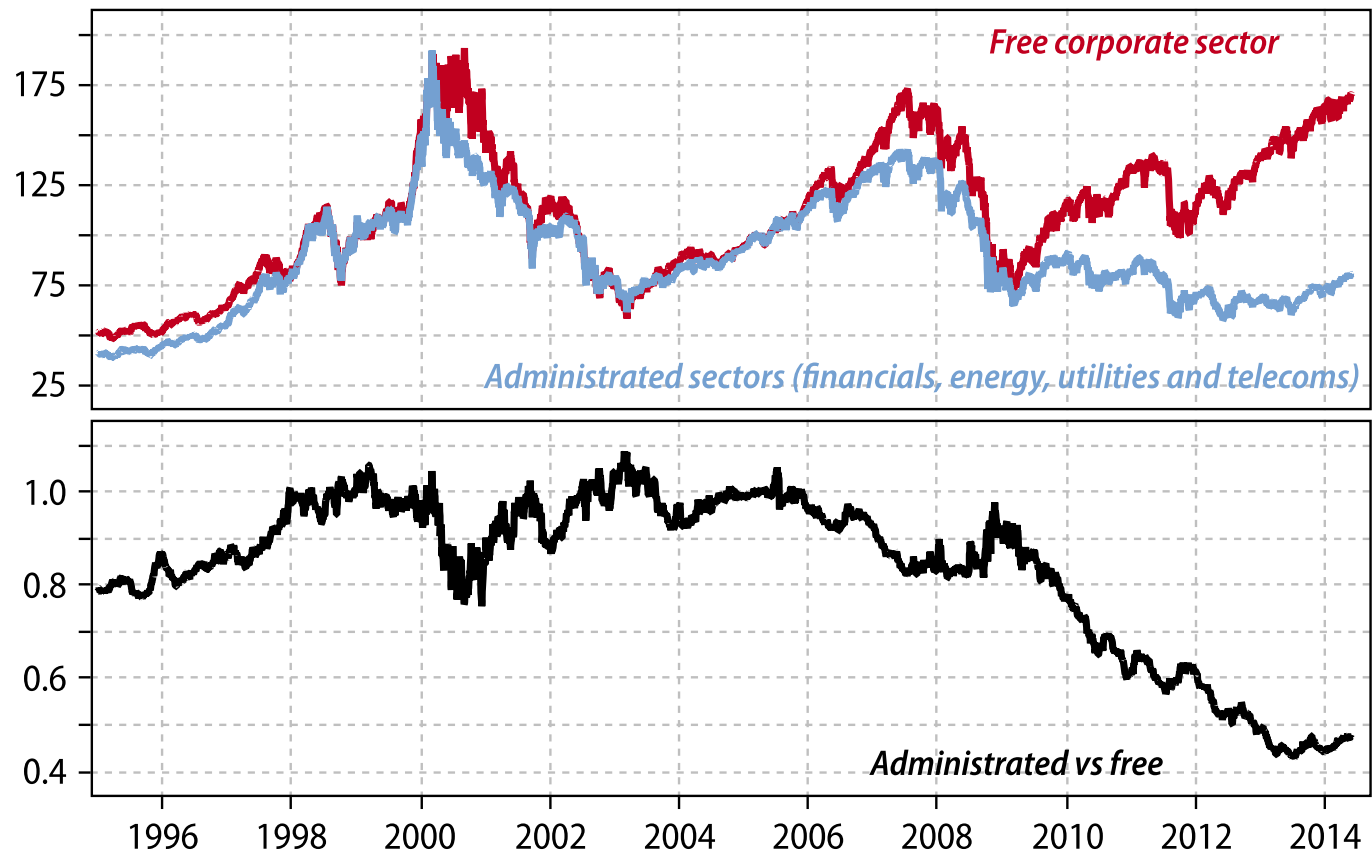
That rotation has partially reversed in recent trading sessions, but we would remain cautious of buying richly-valued stocks.

While we are relatively constructive on the outlook for the US consumer, the discretionary sector as a whole appears to have run well ahead of fundamentals.

# In Europe, it is time to rotate towards domestic sectors

## Euro area - free vs administrated equity sector performance

Market cap weighted price performances based on MSCI sector data



Gavekal Data/Macrobond

We have long advised investors to avoid those European sectors dependent on public largesse and too heavily regulated. Instead, we have recommended overweighting eurozone companies in the free sectors and especially strong European exporters.

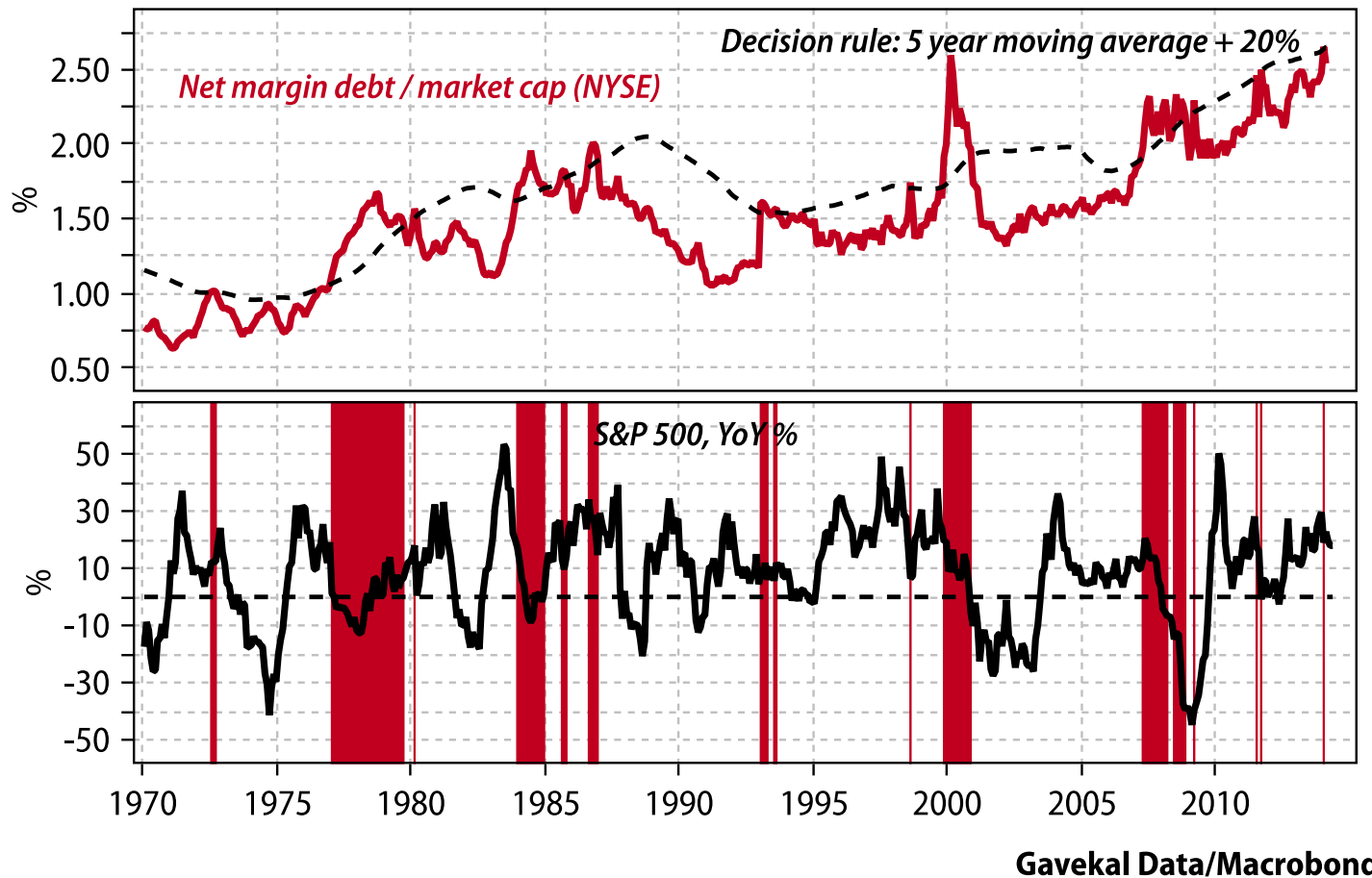
However, the valuation gap has become so large that we wonder if it is time to reverse the trade.

Politically, with aggressive reflationary policies in the eurozone's pipeline (on the back of the Democratic Party's election victory in Italy, Manuel Valls' new government in Paris etc...) the timing for such a switch seems about right.

# Behavioral: broadly fine, with possible exception of margin debt

## Margin debt decision rule, now flashing red

Red areas: margin debt exceeds decision rule



From a behavioral finance perspective it is probably too early to conclude that markets are over-stretched and set for a major correction.

After all, we have just witnessed a significant correction in specific pockets (biotech, social media, Chinese internet stocks...) with few repercussions for the broader market.

That said, one interesting data point to consider is the record high level of margin debt. Usually, a roll-over in margin debt is a significant headwind for equities.



# Going through the equity grid – an overall positive environment

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**On the growth side:** potentially, this is where the biggest concerns might rest. To take the positive view, most recent data out of the US tends to show that the weak start to the year was an anomaly. Other bright spots include Japan and the UK. Unfortunately, the data out of China points towards a significant slowdown in the rate of growth, which in turn could affect emerging markets which have done so well in riding China's coattails. Another concern is that data out of Europe (especially France) remain lackluster at best.

**On the valuation side:** the equities where valuations look stretched are US consumer discretionary, eurozone exporters, Chinese internet and gaming stocks, and Asian staples and healthcare stocks. Beyond these sub-groups, however, valuations of most equity markets do not raise alarm bells.

**On the policy front:** central bank policies (at least out of the Fed, BoE and BoJ) have been remarkably supportive of asset prices for the past year. Will they become even more so as the ECB, and perhaps the BoJ again, decide to act? Or will they become less so as the BoE and the Fed start clawing back some of the excess liquidity injected into the system in recent years?

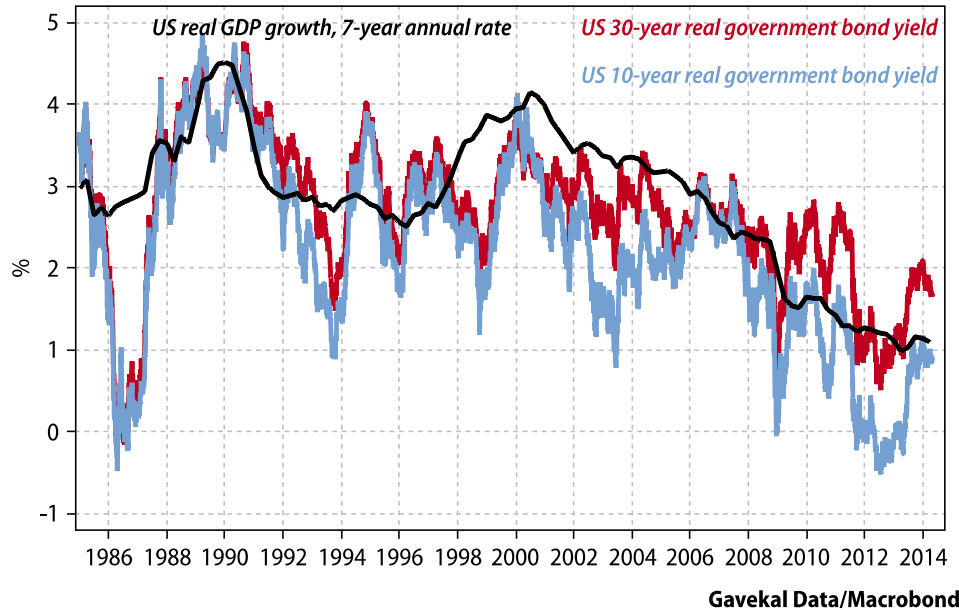
**On the momentum side:** the wind still seems to be in the sails of most equity markets, bar China, Japan and Korea.

**On the behavioral finance front:** the recent sell-off was rather healthy, with the market drawing a clear distinction between the non-profit making and more speculative sectors (biotech, social media, Chinese internet) and that of the broader market.

# Still staying hedged with 30 year US treasuries makes sense

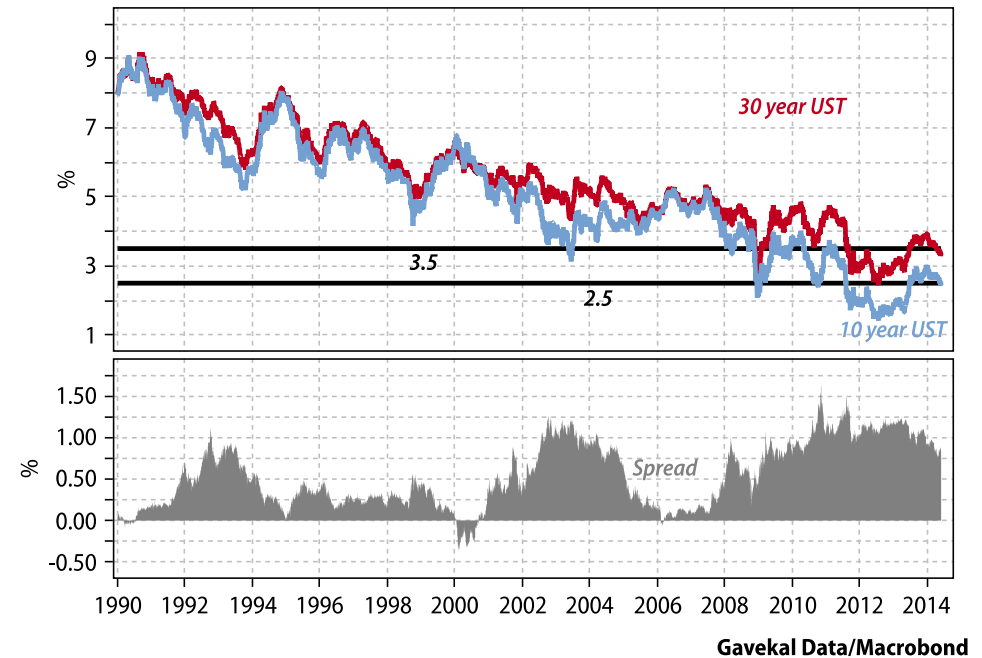
## 30 year UST yield is more likely to decline to US structural growth rate

Bond yields are deflated using core CPI



In a balanced portfolio, the main reason to hold bonds is to hedge against the risk that the structural growth rate of the US economy keeps falling—contrary to our core scenario of future trend growth of around 2-2.5%.

## The 30-10 year UST yield spread continues to narrow

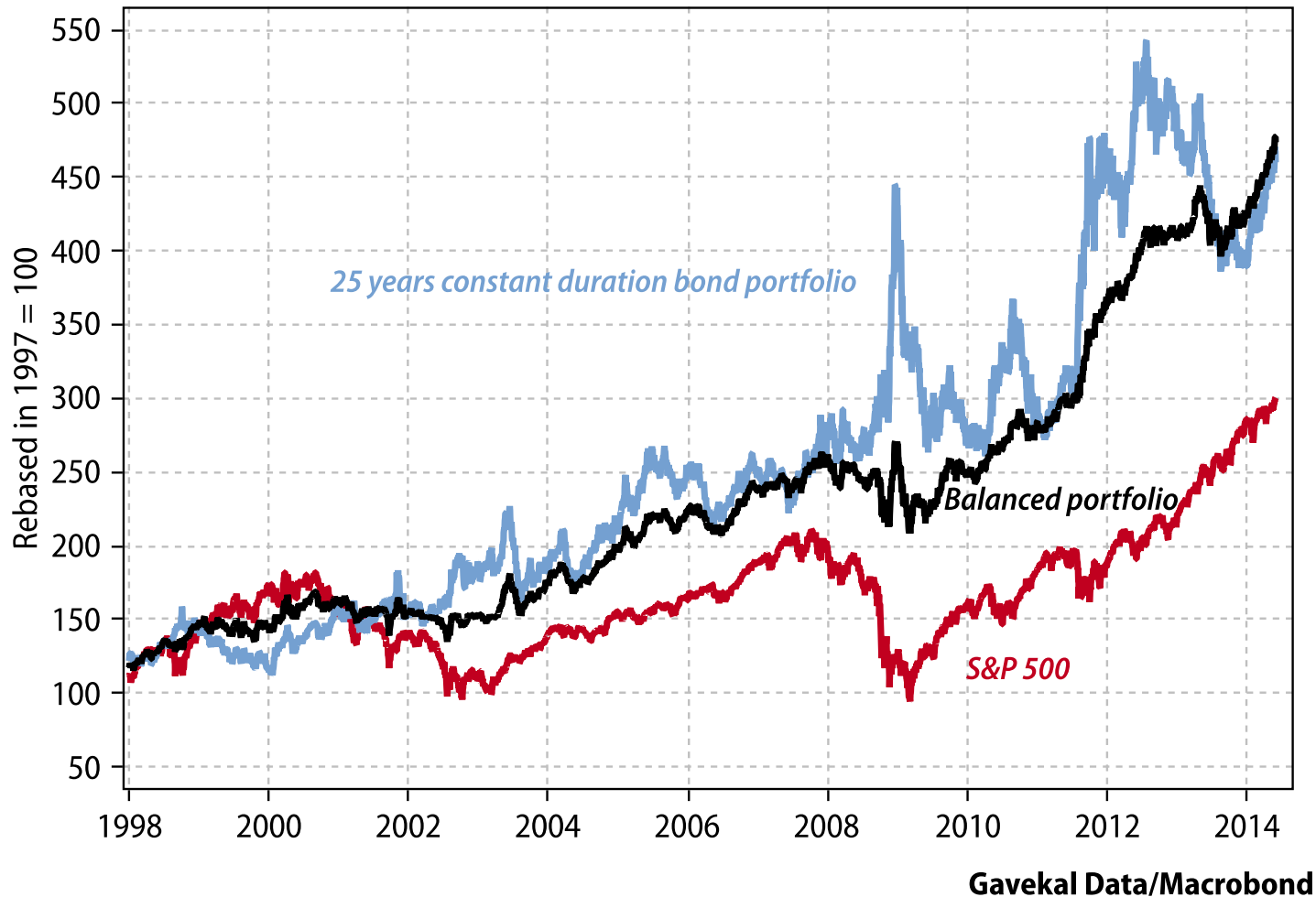


We like 30-year bonds over 10-year bonds because they offer better value. While the spread has narrowed from its extreme level last year, it is still wide by historical standards.

If growth falters, both bonds will offer protection. If growth turns out to be decent, the yield curve will normalize and investors will lose less on a 30-year treasury hedge than a 10-year treasury.

# Implying that a balanced portfolio remains the way to go

## A balanced US portfolio has outperformed since 1997



Bonds are now far less expensive than a year ago, while the potential for disappointments on growth remain (as is the likelihood that the US structural growth rate is now probably lower).

With that in mind, we have in recent quarters recommended a balanced portfolio (see [Portfolio Building In The Time Of Disinflation](#)).

History suggests that a portfolio invested 50% in equities and 50% in long bonds (rebalanced as needed) should outperform pure equity or pure bond portfolios over the medium to long-term in periods of deflation (see our book [Too Different For Comfort](#)).

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