Investment Themes and Considerations for 2019

"Every man is the smith of his own fortune." – **Iranian proverb**

"Time is like a sword: if you don't cut it, it cuts you." – **Arabic proverb**

Contents

Note: Our comparable piece from 2018 can be found here.

Global Liquidity

As we reflect back on 2018, the year, in a capital markets context, was defined, in our view, by the charging and retarding forces acting upon global liquidity. On the one hand we had the tax reform driven liquidity enhancers, on the other a host of liquidity depressants, including monetary policy driven tightening, pseudo-capital controls under the guise of anti-graft measures, rising interest rates and high oil prices.

In the words of Thomas Joplin, the nineteenth century British banker and merchant, "A demand for money in ordinary times, and demand for it in periods of panic, are diametrically different. The one demand is for money to put into circulation; the other for money to be taken out of it".

Last January, with global stock markets off to their best start in more than three decades, the world was in the midst of demand for money to be put into circulation far outstripping demand for it to be taken out of circulation. From October through to the end of the year, as markets witnessed a sharp sell-off, demand to take money out far outweighed the demand to put it back. While in the intervening months between January and October, dominance waxed and waned between the two opposing forces.

Enhancers

One of the leading sources of liquidity in 2018 was US companies' accelerated contributions to their respective defined-benefit pension schemes. The Republican Party's tax reforms gave American corporations till mid-September of last year to benefit from the higher 35 per cent corporate tax rate when deducting their pension plan contributions from their tax bill. US Companies making contributions through mid-September and deducting them from the prior year's tax return is not new. The difference last year was that the value of the deduction fell to 21 per cent following the mid-September deadline.

Pension plan contributions by companies in the Russell 3000 Index are estimated to have topped US dollars 90 billion through mid-September last year – more than 10 times the contributions made the year before.

The other major source of liquidity was also motivated by US tax reforms. The reforms, by subjecting US corporations' offshore profits to a one-time tax of 15.5 per cent on cash and 8 per cent on non-cash or illiquid assets, eliminated the incentive to keep money offshore. In response, US multinationals are estimated to have repatriated more than US dollars 500 billion last year, a significant portion of which went toward share buybacks. The flow of money was not evenly spread throughout the year, however. Corporations repatriated the vast majority of the funds in first half of the year with the amount of cash being brought back dropping off sharply in the second half of the year.

Depressants

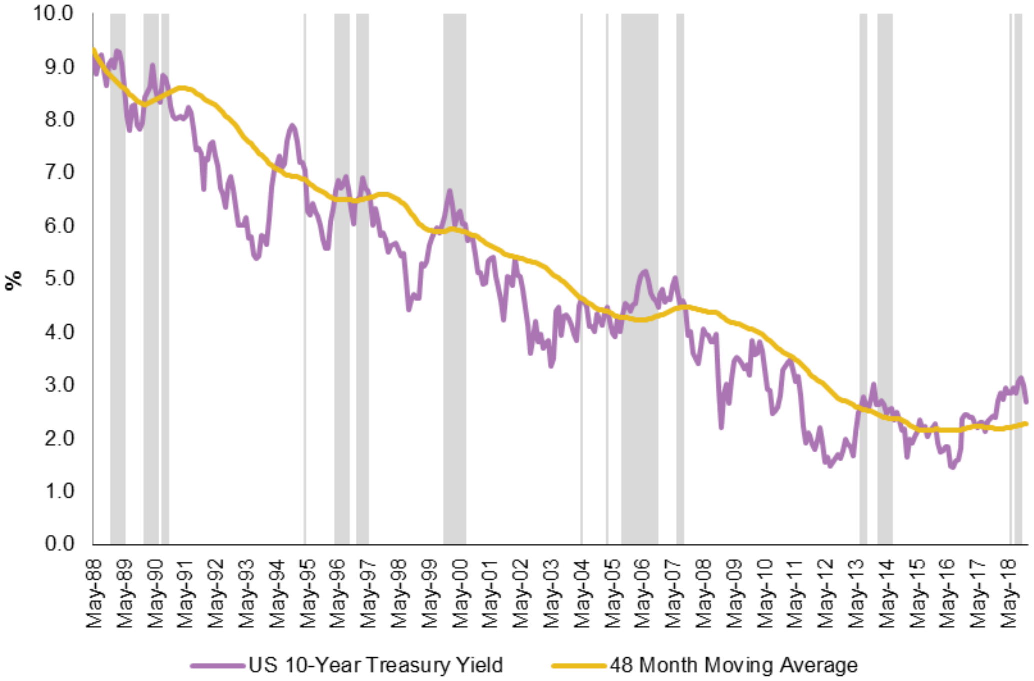
There were many forces working to suck liquidity out of and impede the flow of capital through the global monetary system.

1. Oil and US Interest Rates

Arguably the US dollar and oil are the two most important ‘commodities’ in the world. One lubricates the global monetary system and the other fuels everything else. Barring a toppling of the US dollar hegemony or till such time when the dominance of oil as the world’s primary energy resource diminishes meaningfully, the global economy is unlikely to enjoy prolonged and synchronised economic growth in an environment in which US interest rates are rising and oil prices are high.

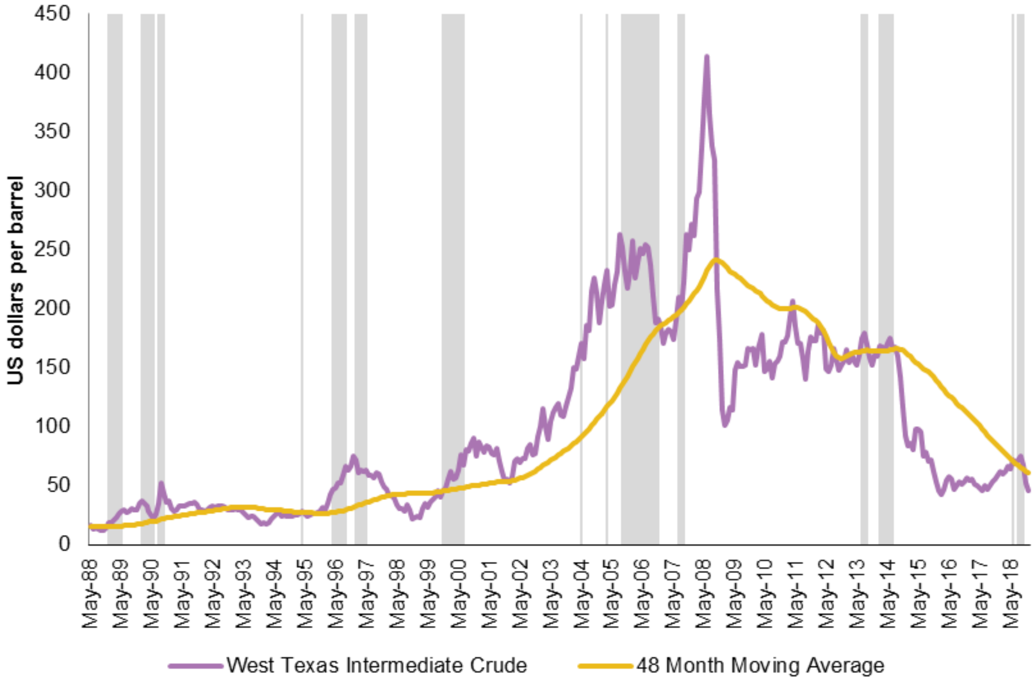
In the more than 30 years between end of May 1988 through December 2018, the US 10-year treasury yield and the oil price have simultaneously been above their respective 48-month moving averages for less than a fifth of the time. And only on six occasions have the two prices remained above their respective 48-month moving averages for 5 or more consecutive months. (The periods when both prices are about their respective 48-month moving averages are highlighted in grey in the two charts below.)

US 10-year Treasury Yield



Source: Bloomberg

West Texas Intermediate Crude Price per Barrel



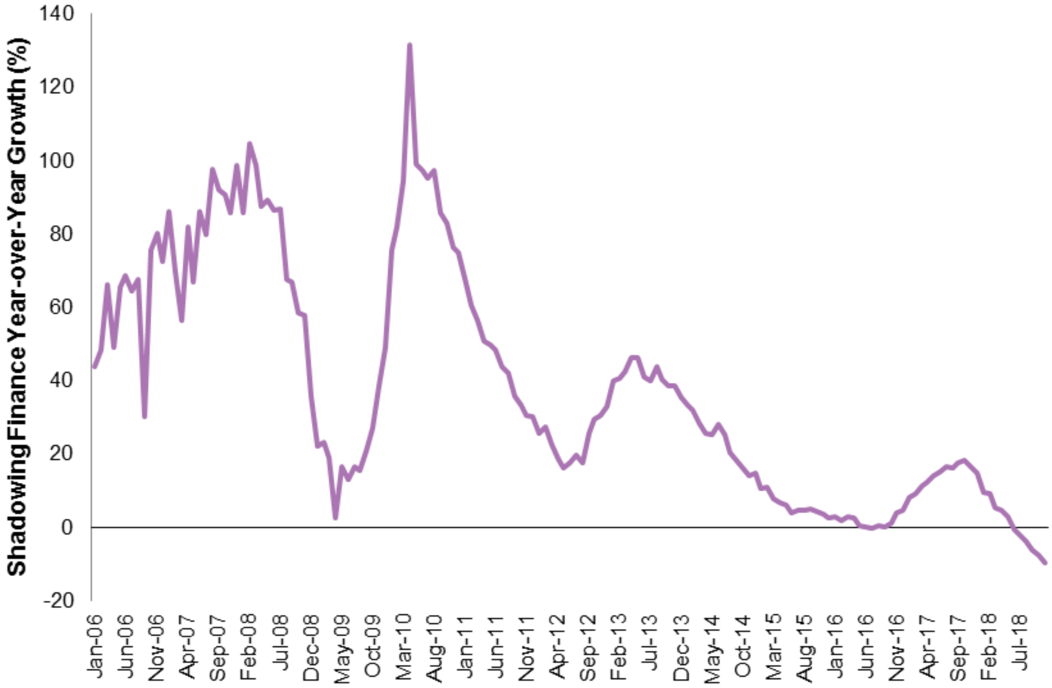
Source: Bloomberg

2. Policy Driven Tightening

The two dominant liquidity centres of the world, the US and China, moved in 2018 to rein in animal spirits and tighten monetary conditions.

In China, the Communist Party's, in a bid to bridle systemic risks, clamped down on shadow finance. The tightening of credit conditions, however, has thrown up an interesting twist: interest rates, as opposed to increasing as would be expected, have declined.

China Shadow Financing Growth Year-over-Year



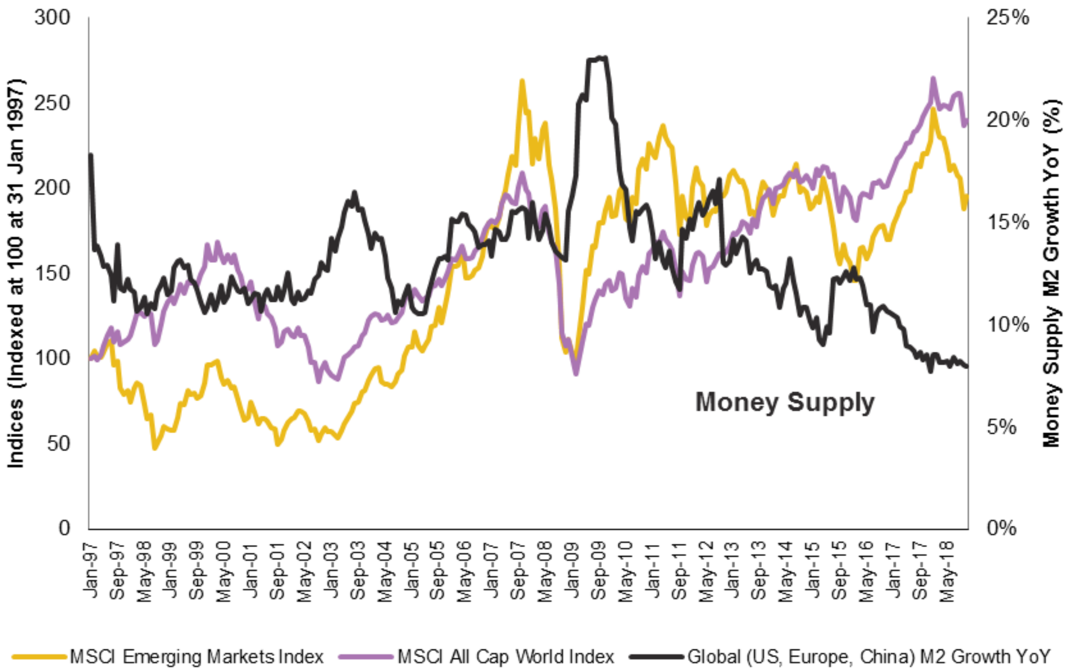
Source: Bloomberg

In the US, the Treasury upped issuance of short-term debt to replace maturing long-term bonds just as long-term issues were being worked off the Fed's balance sheet through quantitative tightening.

The potential ramifications of quantitative tightening and increased Treasury bill issuance bubbling under surface are difficult to assess. In a monetary system governed by the hitherto untested Basel III framework and the many policy tweaks enacted by the Fed, such as money market fund reform and setting the interest on excess reserves below the upper band of the feds fund rate, following the Global Financial Crisis, it is difficult to grasp what, if any, hiccups there will be in the transmission of monetary policy as the Fed continues to drain reserves from the banking sector.

Nonetheless, the tightening policies employed by the Fed and the People's Bank of China, have squeezed global liquidity. Using year-over-year growth in money supply (M2) across the US, China and Europe, as a proxy, we can see global liquidity growth fell to multi-decade lows in 2018.

Global Money Supply Growth vs. MSCI ACWI and EM Indices



Sources: Bloomberg, European Central Bank

3. Anti-Graft

A number of governments across the world have, in recent years, taken drastic measures to crackdown on corruption and the outflow of illicit funds from within their borders. We share a few examples below.

India

In 2016, in a bid to curtail corruption and weaken its shadow economy, the Indian government announced the demonetisation of all Indian rupees 500 and 1,000 banknotes. It also announced the issuance of new Indian rupees 500 and 2,000 banknotes in exchange for the demonetised banknotes. What transpired following the announcement was as, if not more, surprising than the government's demonetisation scheme: an estimated 93 per cent of the old notes made into the banking system.

With most of the notes flowing into the banking system, they were now unsullied, legal tender. And little need for capital to now flow out of India illegally through the hawala system to be held out of reach of the government remains.

Saudi Arabia

In November 2017, the Saudi government famously rounded up, amongst others, wealthy Saudi businessmen, government officials and members of the royal family in the glitzy Ritz Carlton hotel in Riyadh as part of its anti-corruption campaign. Little of what transpired within the boundaries of the five-star hotel has been confirmed by official reports. We do, however, know that billions of dollars of assets moved from private asset pools to the Saudi government's coffers.

China

China, under the leadership of President Xi Jinping, has been pursuing a far-reaching campaign against corruption. Since the campaign started in 2012, Chinese authorities have investigated more than 2.7 million officials and punished more than 1.5 million people, including seven national-level leaders and two dozen high-ranking generals.

As governments across the world have cracked down on corruption and elicited the support of regulators across global financial centres, price insensitive bids for real estate across New York City, London, Sydney and Vancouver have started to dry up. The best gauge of the liquidity impact of the anti-graft measures described above, we think, is Dubai. Long a magnet for Russian, Chinese, Indian, Saudi and Iranian capital, amongst others, Dubai had one of worst performing equity markets globally in 2018.

Dubai Financial Market General Index

Source: Bloomberg

In summary, as the forces propelling global liquidity petered out over the course of last year, the squeezes on liquidity overwhelmed global financial markets taking down one market after the other, culminating with the dramatic end to the long-running US equity bully market in December.

Investment Themes

Infrastructure Diplomacy: The Answer to the Rest-of-the-World's Under Performance?

One time series that has intrigued us over recent weeks and months is that of the ratio of MSCI All Cap World Ex-US Index (RoWI) to the S&P 500 Index (SPX). The chart below is a plot of the month-end ratio of the two indices from December 1987 through December 2018. (A rising line indicates the RoWI is outperforming the SPX while a falling line indicates the SPX is outperforming the RoWI.)

Superimposed on the chart are the Fibonacci projection levels based on the relative high of the RoWI, occurring in July 1988, and cyclical low of the ratio recorded in October 1992. (You can learn more about Fibonacci projections here.)

Source: Bloomberg

From a long-term perspective, the drastic underperformance of equity markets in the rest-of-the-world relative to the US equity market is obvious. Looking at the above chart, however, we cannot help but feel that a cyclical upturn for the rest-of-the-world is due.

The question then is: What would prompt a correction in the secular trend? We think the answer is a ramp up in global infrastructure investment led by infrastructure diplomacy programmes.

The most marketed, and some might say most notorious, infrastructure diplomacy programme is China's Belt and Road Initiative. The initiative encompasses the construction of two broad networks spanning four continents:

- The "Silk Road Economic Belt": A land based transportation network combined with industrial corridors along the path of the Old Silk Road that linked China to Europe; and

- The "Maritime Silk Road": A network of new ports and trade routes to develop three ocean-based "blue economic passages" which will connect Asia with Africa, Oceania and Europe

The Belt and Road Initiative, however, is not the only global infrastructure investment program in existence today. In 2015, worried by China's growing influence in Asia, Japan first unveiled its "Partnership for Quality Infrastructure" initiative as a US dollar 110 billion investment programme targeting Asian infrastructure projects. In 2016, the initiative was expanded to US dollars 200 billion and to include Africa and the South Pacific.

In October 2018, the US Senate joined the US House of Representatives in passing the Better Utilization of Investment Leading to Development bill (or Build Act), a bipartisan bill creating a new US development agency – the US International Development Finance Corporation (USIDFC). The passing of the Build Act is being hailed by many as the most important piece of US soft power legislation in more than a decade.

The USIDFC has been created with the goal of "crowding in" vitally needed private sector investment in low and lower-middle income countries. The agency, endowed with US dollars 60 billion in funding, is being positioned as an alternative to China's Belt and Road Initiative, which has at times been described as nothing more than "debt trap diplomacy".

We think if the three distinct initiatives propel infrastructure investment across the developing economies and help them integrate into the global economy, create jobs and gain access to much needed hard currency, the rest-of-the-world can once again enjoy a prolonged period of outperformance.

Investors, particularly those with an investment horizon of at least three years, should gradually reduce exposure to the US and reallocate it to the rest-of-the-world.

US Dollar: What Will the US Treasury Do?

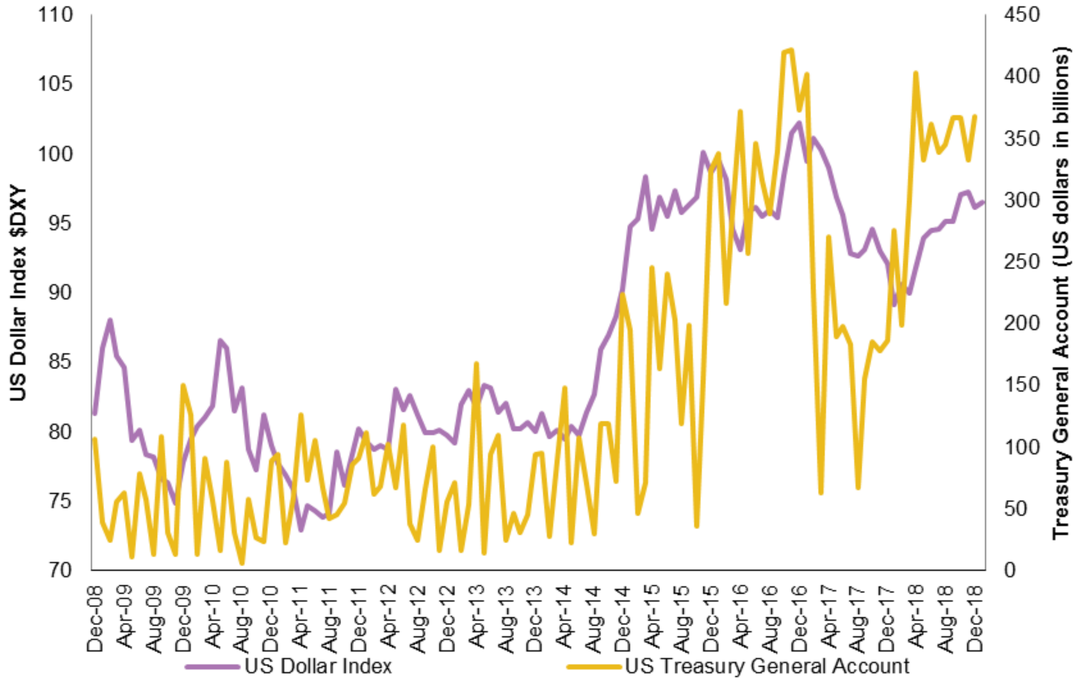
When the US Treasury issues bills and increases its cash balances in the Treasury General Account at the Federal Reserve Bank of New York, it inadvertently tightens monetary conditions in the global banking system.

For the period starting September 2017 through April 2018, the US Treasury did just that. It increased cash balances with the Fed from under US dollars 67 billion at the end of August 2017 to US dollars 403 billion by end of April 2018. (At the end of last year, cash balances with the Fed stood at US dollars 368 billion.)

The increase in the US Treasury's cash balances was offset by the loss of an equivalent amount of reserves and / or deposits by the US banking system. Thereby tightening monetary conditions and reducing the availability of US dollars.

The last time the US government faced the prospect of a shutdown, the US Treasury started drawing funds from its cash balances with the Fed to pay for entitlements and other government expenditures. The US Treasury's Cash balances held with the Fed went from US dollars 422 billion at the end of the October 2016 down to US dollars 63 billion by the end of March 2017. The release of US dollars into the global banking system provided much needed relief, stimulated global risk appetite and weakened the greenback.

US Treasury General Account vs. US Dollar Index $DXY



Sources: Bloomberg, Federal Reserve

With the US government shutdown triggered by President Trump entering its third week and with little sign of progress in talks between the Democrats and the Republicans, the US Treasury may once again have to draw down on its cash balances with the Fed. If this does transpire and is similar in scale to the previous draw down, it could again stimulate risk appetite and weaken the US dollar.

We are bearish on the near-term (six to nine month) prospects of the US dollar.

China: Incrementally Better, Not Worse

The year has barely started and the People's Bank of China has already announced the first reserve ratio (RRR) cut of the year, a full percentage point reduction. Unlike previous RRR cuts in 2018, the latest move is a two-step reduction, effective on January 15 and January 25.

This RRR cut will release approximately Chinese yuan 1.5 trillion in liquidity, part of which will replace maturing medium-term lending facilities during the first quarter. On a net basis, the cut is equivalent to Chinese yuan 800 billion in easing.

On the fiscal stimulus side, the government has already approved new rail projects amounting to US dollars 125 billion over the course of the last month. Beijing refrained from stepping up fiscal spending in 2018. With a slowing economy and the on-going trade dispute with the US, however, the government appears to be have greater willingness to loosen the purse strings in 2019.

Beijing, in a bid to shore up credit creation, is even allowing local governments to bring forward debt issues.

Manufacturing data coming out of China is likely to get worse before it gets better – a hangover from US companies' accelerated orders to build inventories ahead of the initial 1 January deadline for tariff increases. Nonetheless, given that the official policy stance has now tilted towards easing, we expect Chinese economic activity to improve, not worsen over the course of 2019.

Throw in the prospect of MSCI quadrupling the inclusion factor of Chinese A-shares in its emerging markets index and there is a strong possibility Chinese A-Shares break out of their bear market in 2019.

Emerging Markets: Relief Not Reprieve

A sharp drop in oil prices, a pause in the US dollar rally, signs of increasing fiscal stimulus in China and retreating long-term Treasury yields are providing emerging markets much needed relief. While the structural challenges, particularly on the funding side, faced by many of the emerging economies are unlikely to be resolved soon, the welcome liquidity relief can certainly provide tradable opportunities for investors.

Moreover, as we noted in December, emerging markets have been outperforming US markets since early October, which may well provide further impetus for asset allocators to re-consider exposures and potentially exchange some of their US exposure in favour of emerging markets.

Ratio of the MSCI Emerging Markets Index to the S&P 500 Index

Sources: Bloomberg

The simple play is to be long the iShares MSCI Emerging Markets ETF $EEM. And in times of either euphoria or despair, it can prove to be the right choice as there can often be little to distinguish between constituent level returns. Nonetheless, with the rise of China's tech giant, we think $EEM has become both too tech and too top heavy.

For broad-based exposure we prefer being long dedicated emerging market asset manager Ashmore Group $ASHM.LN. In terms of country selection we prefer being long Russia $ERUS and Indonesia $EIDO. We would also like to be long Hungary, opportunities for direct exposure to the country are, however, limited and is instead better played with some exposure to Austria $EWO.

Semiconductors: Led On the Way Down, To Lead On the Way Up?

We were bearish on the prospects of semiconductor stocks for the better part of 2018. With technology at the centre of China's trade conflict with the US, and no technology more critical than semiconductors, our thinking was that production capacities, led by China, would rise faster than the market was pricing in.

While China has made headway in gaining market share in the more commoditised segments of the semiconductor market, it has failed to catch up with the leading chip companies in the world. The top-end of the semiconductors remains tightly controlled by a handful of players.

The Trump Administration's security hawks and a slowing China, however, have, we think, had a far greater impact on the sharp drop in chip prices than increases in production capacities.

With valuations for the constituents of the Philadelphia Stock Exchange Semiconductor Index $SOX having corrected significantly and a lot of doom-and-gloom reflected after Apple's guidance cut, we think semiconductors are well-placed to surprise to the upside in 2019.

Philadelphia Stock Exchange Semiconductor Index Trailing 12 Month P/E Ratio

Source: Bloomberg

Moreover, if there is to be a favourable outcome to the trade related negotiations between the US and China, we suspect China will pony up to reduce its trade surplus with the US by offering to buy more chips.

Saudi Arabia: Emerging Market Indices Inclusion

Ignoring the human rights grievances, the fallout from the murder of *Washington Post* columnist Jamal Khashoggi, and the sharp drop in the price of oil, we weigh the opportunity of investing in Saudi Arabia based purely on a technicality. That technicality being the inclusion of Saudi Arabia into the FTSE and MSCI emerging market indices in 2019.

Based on broker estimates, passively managed assets of greater than US dollars 15 billion are expected to flow into the Saudi equity market on the back of the inclusions. The vast majority of these passive flows are set to materialise during the first half of 2019. Given the size of flows relative to average daily traded values of less than US dollars 1 billion, the passive flows can move the needle in a market with few other positive catalysts.

We remain long the iShares MSCI Saudi Arabia ETF $KSA.

Outsiders for Outsized Returns

Here we discuss investment ideas that we think have an outside chance of generating outsized returns during 2019. We see these opportunities as cheaply priced out-of-the-money call options that may warrant a small allocation for those with a more opportunistic disposition.

Triunfo Albicelestes

Argentina, to put it mildly, has a chequered history when it comes to repaying its creditors. It has defaulted on its external debt at least seven times and domestic debt five times in the 202 years since its independence.

Argentina first defaulted on its sovereign debt in 1827, only eleven years after gaining independence from Spain. It took three decades to resume payments on the defaulted bonds.

The Baring Crisis, the most famous of the sovereign debt crises of the nineteenth century, originated in Argentina – at a time when Argentina was a rich nation and its credibility as a borrower had been restored. Argentina had borrowed heavily during the boom years of the 1880s and Britain was the dominant source of those funds. The flow of funds from Britain was so great that when Argentina defaulted on its obligations in 1890, the then world's largest merchant bank, Baring Brothers & Co., almost went bankrupt. Had it not been for intervention by the Bank of England, the British lender would have been long gone before Nick Leeson came along a century later.

In 1982, Argentina once again failed to honour its external debt obligations and remained in default for almost a decade. Its emergence from default was made possible by the creation of Brady bonds – a solution proposed by then US Treasury Secretary Nicholas Brady as a means for debt-reduction by developing nations.

In the 1990's Argentina kept piling on debt until it finally defaulted on around US dollars 80 billion of obligations in 2001, which at the time was the largest sovereign default ever. The government managed to restructure 93 per cent of the defaulted debt by 2010; however, Paul Singer's Elliot Management famously held out and kept Argentina exiled from international debt markets for a further six years. Argentina returned to the bond market in 2016 after settling with the hedge fund and bringing to an end a long-running saga, which saw Paul Singer take extreme measures such as convincing Ghanaian courts to seize an Argentinian navy vessel so it could collects on its debt.

The lessons from Argentina's history of defaults, however, were quickly unlearned by capital markets. In little more than a year after its return to the bond markets, Argentina successfully pulled-off the sale of a 100-year bond in 2017. The good times did not last very long, however. In August 2018, Argentina was heading to the IMF cap-in-hand requesting the early release of a US dollars 50 billion loan. By end of September the IMF had increased the debt-package to US dollars 57.1 billion – making it the biggest bailout package ever offered by the IMF.

After running through Argentina's history of debt defaults and at a time when it may appear that its future is bleak, we are here to tell you that Argentina has the foundations in place to surprise to the upside.

The days of "Kirchnerismo", the legacy of Cristina Fernández de Kirchner's and her late husband Néstor's twelve years in power, defined by the concentration of power, unsustainable welfare programmes and fiscal profligacy shrouded under the guise of nationalism, are gone. President Mauricio Macri's willingness to chart a new course, armed with a robust IMF bailout package, we think, can help revive the Argentinian economy.

What is transpiring in neighbouring Brazil, too, has potential spill over effects on Argentina. If newly elected president Mr Jair Bolsonaro remains true to his word, Brazil is likely to pursue a reformist economic agenda that liberalises the economy from the statist policies that were the mainstay of the Workers' Party's rule. If the economic reforms spur growth in Brazil, Argentina should benefit – Brazil is, after all, Argentina's largest trading partner.

President Bolsonaro's external agenda is also likely to diverge from that of his predecessors. He has openly criticised China – Brazil's largest trading partner – and expressed a desire to forge closer ties with the US. If Brazil pivots towards the US, Argentina, as South America's second largest economy, is likely to be wooed aggressively by China. China's ambition to dilute the US's influence in Latina America is an open secret. In China's bid to acquire influence, Argentina is well placed to attract investments from Beijing.

There are many ways to play this theme be it through the bond market, the currency or the equity market. For the average equity market investor the easiest way to gain exposure is probably through the Global X MSCI Argentina ETF $ ARGT.

Data Driven Dystopia: "The monetization of every move you make"

From *The New Yorker*'s article "How the Artificial-Intelligence Program AlphaZero Mastered Its Games":

"David Silver, the head of research at DeepMind, has pointed out a seeming paradox at the heart of his company's recent work with games: the simpler its programs got—from AlphaGo to AlphaGo Zero to AlphaZero—the better they performed. "Maybe one of the principles that we're after," he said, in a talk in December of 2017, "is this idea that by doing less, by removing complexity from the algorithm, it enables us to become more general." By removing the Go knowledge from their Go engine, they made a better Go engine—and, at the same time, an engine that could play shogi and chess."

As the leading tech companies have ramped up investments in developing their artificial intelligence – or machine learning, if you prefer – capabilities, what has started to become apparent is that data not algorithms hold the keys to success. The companies that collect the most and best data, not the ones that develop the most sophisticated algorithms, are likely to reap the greatest rewards from investing in artificial intelligence.

One, much maligned, 'wearables' company that has been tracking and collecting data on its users' movements for many years, with little to show for it, is Fitbit Inc. $FIT. The company has fallen out of favour amongst investors ever since the launch of the Apple Watch – particularly after Apple's health and fitness pivot following the launch of Series 2.

We think $FIT is a viable acquisition target for Amazon.

Amazon, through the Echo, is already collecting data at home and could close the data loop with an acquisition of $FIT. $FIT's wrist bands and watches can be integrated with Alexa and with a little investment be upgraded to better compete with the Apple Watch. Moreover, Amazon could feature $FIT's products front and centre on the most valuable retail real estate in the world – Amazon's homepage.

Books

Five We Have Read and Recommend

1. *Monetary Regimes and Inflation: History, Economic and Political* Relationships by Peter Bernholz
2. *Time to Start Thinking: America in the Age of Descent* by Edward Luce
3. *Thinking in Bets: Making Smarter Decision When You Don't Have All the Facts* by Annie Duke
4. *The Art of Execution: How the world's best investors get it wrong and still make millions* by Lee Freeman-Shor
5. *Adaptive Markets: Financial Evolution at the Speed of Thought* by Andrew W. Lo

Five from Our 2019 Reading List

1. *Crashed: How a Decade of Financial Crises Changed the World* by Adam Tooze
2. *The Volatility Machine: Emerging Economies and the Threat of Financial Collapse* by Michael Pettis
3. *Efficiently Inefficient: How Smart Money Invests and Market Prices Are Determined* by Lasse Heje Pedersen
4. *The Goal: A Process of Ongoing Improvement* by Eliyahu M. Goldratt and Jeff Cox
5. *These Truths: A History of the United States* by Jill Lepore

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