

The US Economy. Growth Strong but Not Fast. Trade Expressions.

The US economy remains the most important and vibrant in the world. China is fast catching up but for market depth and liquidity, for corporate governance and clear and well defined regulations, the US is the prime market for fixed income and equities.

Trade Expression:

1. Long term buy US equities.
2. Long term overweight USD.
3. Underweight exporters.
4. Medium term buy US non agency RMBS.
5. Medium term buy US high yield via loans and bonds.
6. Medium term buy US 30 year long bond.
7. Medium term short US 2 year bond.
8. Medium term cautious US investment grade.
9. Short term cautious US equities.

Economy:

1. Long term growth is stable. US continues to enjoy a technological advantage over the rest of the world, especially developing markets.
2. Long term growth rate has been chronically over-estimated. This creates mis-estimation of cyclical highs and lows.
3. US is intentionally becoming less reliant on outsourcing of manufacturing as well as importing oil. The result is a more self-reliant economy.
4. Outsourcing manufacturing implies importing finished product.
5. The US trade balance is likely to move towards balance over the long term.
6. The housing recovery remains on track although it is a mature recovery. Affordability and house hold balance sheet recovery will support the stability of this recovery.
7. Healthier tax receipts and reduction of military footprint is reducing the budget deficit.

Policy:

1. The Fed wants to raise interest rates for a host of reasons.
2. The delay is because it cannot raise interest rates, not because it doesn't want to.
3. The rate hike trajectory will be very gentle.
4. The Fed is not independent, it considers the debt service costs of the US treasury in its calculations.

Risks:

1. The Fed balance sheet is acutely inflated. At some stage the balance sheet will need to be shrunk.
2. Equity market valuations are being supported by low interest rates, access to credit, share buy backs and ample liquidity.
3. Earnings growth is not accelerating. Bloomberg estimates historical PE at 18.4, current PE at 17.8 and next year PE at 16. This implies earnings growth of 3.6% in 2015 and 11% in 2016.
4. Domestic politics. The US election will take place Nov 2016. At this early stage in the process many unexpected things can happen.
5. Geopolitics 1. A strong USD can destabilize the dollar bloc economies. It can disrupt non-dollar bloc economies as well as currency hedging costs enter the calculus for sovereign funding. The net currency hedged yield for owning a long dated BRL or IDR bond may be less attractive than owning a US treasury for example.
6. Geopolitics 2: A more self-reliant US has implications for its strategic and economic allies. Witness what self-reliance in energy has done for the political stability has done for the Middle East as American strategic assets are gradually tapered from the region.

Rationale for trade expressions:

1. Long term buy US equities.
 - I like US equities for all the reasons under Economy. The economy is robust but growing moderately.
 - I am cautious for reasons Risk 1, Risk 2 and Risk 3.
 - Absolute valuations are not cheap. Valuations relative to treasuries are cheap. Therefore valuations are very dependent on rates. The ultra-long duration nature of equities may lead to underperformance in a rising rate environment.
2. Long term overweight USD.
 - Economy 3 and Economy 4 above point to slowing imports and thus a lower supply of USD. This supports

not only the USD level but will likely raise the actual cost of funding in USD internationally.

- The safe haven status of USD makes it attractive as other regions are relatively weaker or more risky than the US.

3. Underweight exporters.

- For the simple reasons that we expect a strong USD and greater trade protectionism in the world.

4. Medium term buy US non agency RMBS.

- Economy 5. Housing data has on balance been strong. We advocate the more direct and targeted exposure to US housing which is via the non-agency RMBS market than the more volatile house builders where company management introduces idiosyncratic risk.

5. Medium term buy US high yield via loans and bonds.

- A slow but positive and durable growth environment is ideal for high yield corporate debt.
- There are two trade expressions here: loans which carry little duration and will be very useful in the early stages of the rate hike cycle and bonds which carry more duration.

6. Medium term buy US 30 year long bond.

- Economy 6, Policy 3 and Policy 4 support investing in the long end of the US curve.
- Economy 6, the US budget. The congressional budget office estimates that the total and primary budget deficits will improve from now but trough in 2018.
- Policy 3 and 4. The US federal reserve and indeed most central banks have in recent times shown themselves to be not independent of their government's funding needs. They have either monetized debt by buying treasury bonds or they have suppressed debt service costs by keeping rates lower longer than they needed to. That the US treasury began issuing 2 year FRNs in Jan 2014 only creates a direct alignment between low short term interest rates and the debt service of the US treasury.
- The consensus view on the US 30 year bond is that it will fall (yield will rise). However, given the safe haven nature of the bond (investors buy it in crises) and the fact that the US treasury market has priced in the rate hike cycle, we advocate having a small position in a balanced portfolio as a form of portfolio catastrophe insurance.

7. Medium term short US 2 year bond.

- Rate hikes will most impact the front end of the curve.
- Yield difference between 2 year and 30 year US treasuries. The curve is likely to flatten as the current economic cycle matures towards the next recession.
- If one expects the 30 year to outperform we must by inference expect the 2 year to underperform.

8. Medium term cautious US investment grade.

- I am cautious about the 2 to 7 year sector of the USD term structure. Investment grade corporates issue mainly in this sector of duration which we seek to avoid. The credit spread is insufficient in our view to surmount the duration in a rising rate environment.
- Investment grade issuers are likely acquirers in the current M&A environment so there is significant event risk.

9. Short term cautious US equities.

- Absolute valuations are unattractive. Relative valuations, however, are better. This, however, makes US equities sensitive to the coming rate hike.
- I think that the market may be underestimating the immediate and short term effect of a rate hike which may introduce volatility in the market.