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INVESTMENT MANAGEMENT

Facts, Damned Facts, and Alternative Facts

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Against a backdrop of positive economic “facts,” worrisome “damned facts” and a slew of confounding “alternative facts,” investors can be forgiven for being confused. We suggest that investors focus on realities—good and bad—and, if necessary, be prepared to ride out short-term turbulence.

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Facts: Global economy is growing…

Underpinned by healthy fundamentals, economic growth has been improving in most regions, with the U.S. at the forefront among developed markets. This positive global macroeconomic backdrop has pushed volatility levels below long-term averages and equities to near historic highs.

For the past several years, the economy has been running on consumer spending largely fueled by cheap energy and loose monetary policy, but without a business fixed investment leg—despite plenty of cash and low interest rates. Fortunately, that is changing: business fixed investment is starting to pick up.

…and business spending is set to rise

Since the economic downturn in 2008, businesses have reduced investment in fixed assets as a way to preserve margins and keep profitability high. Over the short term, there are no immediate consequences of low capital investment: equipment gradually depreciates and becomes obsolete, but still keeps running.

After years of underinvestment, though, productivity growth is languishing. At the same time, rising wages are starting to squeeze company margins. New restrictive immigration policies will likely exacerbate this wage increase. Building a wall, or any other large infrastructure project, combined with a big shortage of legal, skilled workers will drive wages up even faster.

Shortly after the election, Bloomberg reported that 'With as many as 20% of construction workers composed of undocumented immigrants, Trump's plan to deport them could cause wages to double within a few years. Unemployment in the construction sector is already about 2% and even lower for some skilled tradesmen.'"[1]

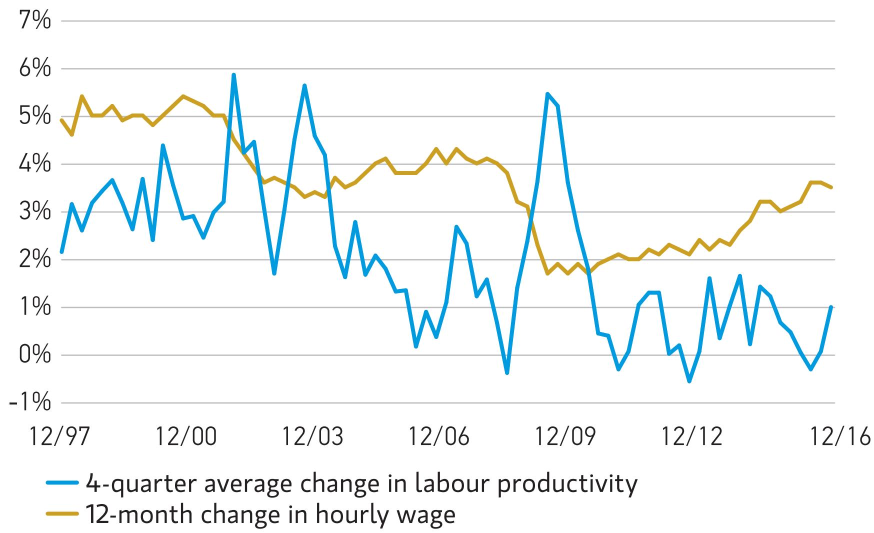
In this environment of low unemployment and rising wages, businesses can more easily make the case for undertaking capital projects to boost productivity. With a strong underlying economy and financing costs that are still low, the environment for capital investment is near perfect.

Business fixed investment is thus likely to be the next leg in economic growth. The long-awaited resurgence in capital spending could also give legitimacy to the recent stock market rally—despite some notable economists saying "the markets and the economy are most likely enjoying a sugar high that will not last a year."[2]

There is evidence in the latest preliminary GDP numbers, that business fixed investment is rising. The latest release from the Bureau of Economic Analysis shows that fixed investment, quarter-on-quarter, was up by 4.2% in the fourth quarter, after three tepid quarters of -0.9%, -1.1% and +0.1%. Likewise, nonresidential fixed investment was up 2.4% last quarter, after three quarters of -3.4%, +1.0% and +1.4%.[3]

DISPLAY 1

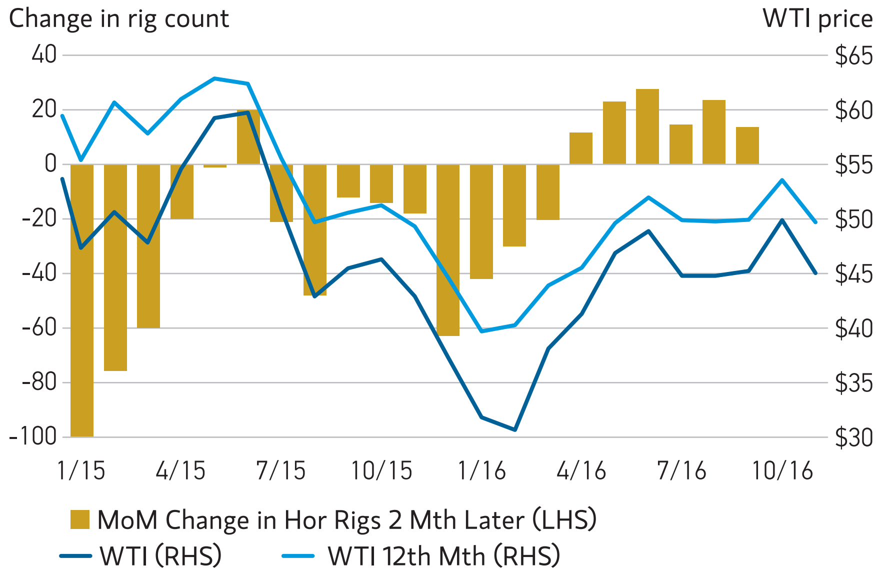
Case for capital investment: Rising wages and low productivity



Source: Bureau of Labour Statistics, Atlanta Fed. Data as of 31 December 2016.

DISPLAY 2

Shale oil rig count: Tangible evidence of capital investment



Source: Bloomberg, Baker Hughes, Morgan Stanley Commodity Research

[1] Mark Boud, chief economist at Washington-based research company Hanley Woord quoted in https://www.bloomberg.com/news/articles/2016-11-10/build-that-wall-pledge-has-companies-bracing-for-labor-shortages

[2] Larry Summers, Economist, President Emeritus and Charles W. Eliot University Professor of Harvard University, Financial Times, http://blogs.ft.com/larry-summers/ as of 29 January 2017.

[3] U.S. Bureau of Economic Analysis (BEA), News Release: Gross Domestic Product: Fourth Quarter and Annual 2016 (Advance Estimate), 27 January 2017. www.bea.gov

In the oil and gas sector, there is also tangible evidence of an upturn in business fixed investment. Energy companies that survived the sharp decline in oil prices did so thanks to improved efficiency and now stand to benefit from a stabilisation in oil prices. We see that with oil prices back in the $50-plus range, horizontal rigs used by shale, a proxy for oil and gas fixed investment, are starting to be built again.

Utilities are also making investments to shift from coal-produced energy to natural gas, which is competitively priced and environmentally preferable. Large solar arrays in desert regions have also become competitive, so we are likely to see continued investment in this type of infrastructure despite the Trump administration's sceptical position on climate change.

This all provides further evidence that conditions are favourable for capital investment, which is an important component of sustained economic growth. Confirming investors' optimism is the drop in volatility in the options market, except in options with higher strike prices that are profitable if the market rises. There the prices seem to be high, suggesting that investors see upside potential in the market and are ready to pay for it.

Damned facts: Risks of inflation and policy contradictions

On the "damned facts" side, inflation appears to be picking up. We are seeing this not just in the United States, but also in Europe and in Japan. Although positive in the sense of avoiding a deflationary or recessionary environment, the problem with inflation is that it is very difficult to control once it takes hold. It remains to be seen if the expected three Fed hikes in 2017 will be sufficient to prevent runaway inflation.

Inflation also leads to significant increases in bond yields, which have already risen in the U.S. and have started to rise in Germany and even Japan. If damned facts like this go too far, they can become damaging to the economy in the long term.

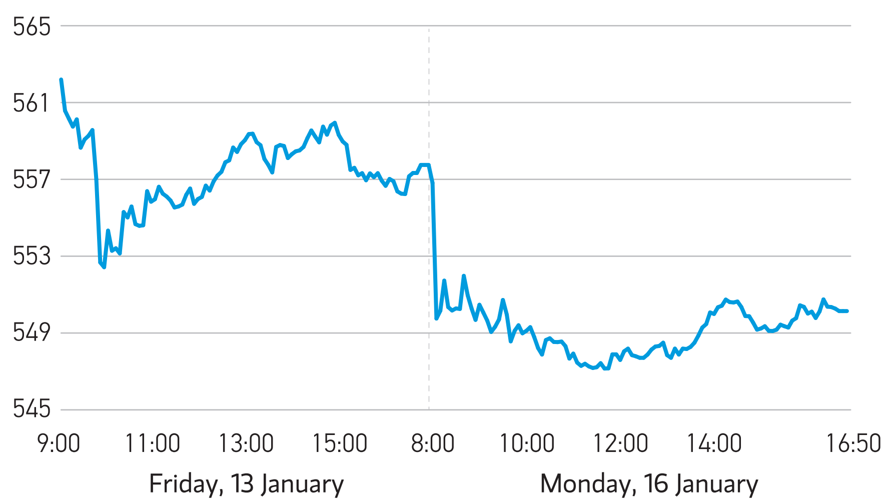
Another related damned fact, depending on perspective, is that U.S. unemployment is below 5%.[4] The trick with unemployment is to keep it low enough to fuel growth, but just above the inflection point at which it sparks inflation. The current low level of 5% makes one question the wisdom of additional stimulus that could push unemployment to an even lower level that would unleash inflation. If that were to occur, it could force the Fed to raise interest rates in an effort to cool the economy. The contradictory policies—

DISPLAY 3

"Trump Twitter Turbulence" causes sharp moves in financial markets

SPR S&P Biotech ETF

STOXX Europe 600: Automobiles & Parts



Source: Bloomberg, SPR S&P biotechnology data as of 7 December 2016, STOXX Europe 600 Automobiles & Parts data as of 13-16 January 2017. This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

[4] Bureau of Labor Statistics (BLS), 31 January 2017.

that of the Trump administration's stimulus and the Fed's hikes to curb inflation—could be a source of volatility and concern for investors.

Alternative facts: Presidential tweets and other frictions

This is where we get to the alternative facts. President Trump continues to believe that the U.S. economy is in need of significant protection, that it is not growing at a sufficient pace and that U.S. workers are suffering due to a lack of jobs. The evidence suggests otherwise—which is what makes it an alternative fact—leading to the possibility of overstimulus.

Alternative facts that have no direct connection to the economy—such as inauguration crowd size—also create noise, concern and political uncertainty. "Trump Twitter Turbulence"—the president's practice of spontaneously tweeting without regard to hard facts-has been a source of market jitters on numerous occasions. On 7 December, the president sent biotechnology shares lower as he promised to bring down drug prices. Similar comments on 16 January about imposing a 35% border tax on vehicle imports caused prices to fall sharply and Trump's 17 January tweet, that the U.S. dollar strength against the yuan "is killing us," caused the dollar to trade low against a slew of currencies.

Finally, there is the potential for conflicts between the president and Congressional Republicans. They disagree on many issues, including Russia, trade, deficits, immigration and the details of changing the tax code. If these conflicts and alternative facts continue, they could stymie meaningful political initiatives while leading to some significant headlines and volatility.

Europe: Political season

Politics are again a factor in Europe, with the potential for significant political instability and volatility. Brexit is hitting a critical moment as Parliament is voting to give the Prime Minister authority to invoke Article 50, leading potentially to considerable volatility as we approach the final stage of the process. On top of that, elections in France and the Netherlands promise to be exciting, while Italy may also face an early election due to a change in the law.

Given that concerns about Europe are mainly political rather than economic, the associated volatility may provide opportunities to buy in rather than sell out.

China: Improved export-to-GDP ratio

As with the developed markets, the economic facts in China are largely positive. Its export-to-GDP ratio has fallen to historic lows, making it less sensitive to international trade and providing insulation from Trumponomic shocks. Currently at 20%, it is in line with India's export-to-GDP ratio of 19%[5] —the comparison is interesting because India is normally considered relatively immune to trade flows and China the opposite, and indicates that China is no longer as sensitive as it has been in the past.

On the political front, however, the administration's suggestions that China is protectionist combined with tensions created by Trump's direct communications with Taiwan, breaking the longstanding mutual agreement to sidestep the sensitive Taiwan issue, raise some concern about Trump triggering a trade war with China.

Rest of Asia: Risks of protectionism

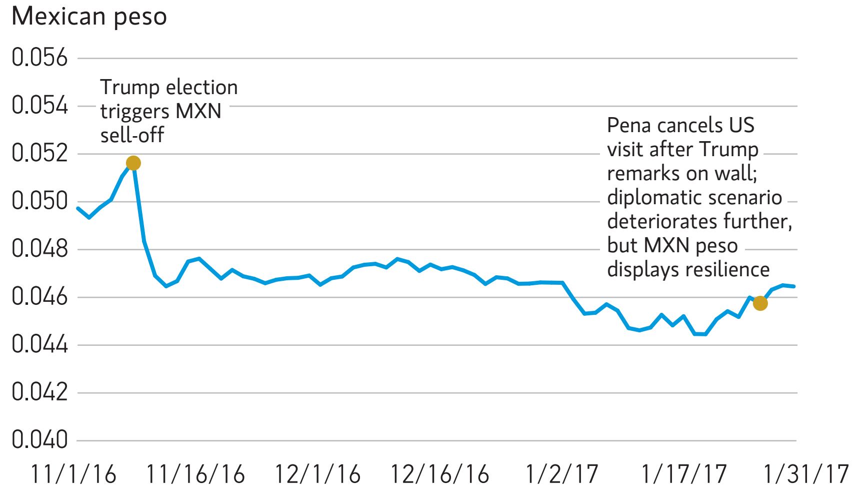
If the U.S. relationship with China deteriorates into some form of trade war, then Asian countries that are linked to China could also suffer. Many of those countries export manufactured goods rather than raw material and would thus be hit harder by any protectionist policies in the U.S. For the moment, global economic growth still makes the outlook positive, but with a hint of geopolitical caution.

EMEA emerging markets: Still volatile

Although some investors have been optimistic about EMEA emerging markets, we remain neutral. Even though the president himself may wish to be

DISPLAY 4

Peso takes it on the chin, bounces back



Source: Bloomberg; as of 31 January 2017

[5] Financial Times, 23 January 2017.

more accommodative, there is good evidence that there was some Russian interference in the election and a great deal of scepticism in Congress about becoming friendlier with Russia. At the same time, other emerging markets, such as Turkey, continue to be quite volatile in economic terms.

Latin America: From overreaction to opportunity

The Mexican peso is interesting. It was knocked down by the anticipation of negative Trump policies, but with the latest spat over President Peña Nieto's U.S. visit, the peso actually stopped dropping. There's tentative evidence that maybe the market overreacted to the negative implications for Mexico of some of Trump's policies.

Latin America as a whole could continue to be an interesting area despite the negative outlook towards trade, simply because it already reacted very sharply and now seems to have stabilised. Many of the Latin American countries tend to be exporters of raw materials, which are unlikely to be affected by protectionist policies in the U.S. and are likely to benefit from a growth in global economic activity. With exceptions like Ecuador, most of their currencies are not tied to the dollar, which means interest rate increases won't automatically be transmitted to them. The outlook for Latin America seems quite good.

Conclusion: Just the facts, please

Investors have reasons to be confused. Although President Trump has shown resistance to accepting facts as they are, alternative facts have a tendency to be resolved by real facts at some point. We believe investors need to shift their focus from alternative facts to the real facts and possibly the damned facts. For now, the strength of the underlying global economy and strong signs of a rebound in capital investment give investors plenty to cheer about.

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