

JANUARY 16, 2020

MONTHLY



*Global Investment Letter*



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## INTRODUCTION

The decade is starting on a positive note for investors, with most global equity markets ending 2019 on a bullish note. Supporting further upside for markets is, as we have discussed in these pages, an apparent commitment by central banks and governments as they implement both monetary and fiscal measures to support the global economy and postpone the next recession.

There is a great deal of concern by central banks about the potential severity of the next recession/bear market, given the fragile underpinnings of the global economy. We can, therefore, expect strenuous efforts to forestall the next recession and unprecedented measures to mitigate its effects once it inevitably occurs. While the decade has begun on a relatively benign note for investors, it will most likely prove to be volatile, in sharp contrast to the general lack of volatility characteristic of the past decade.

On the geopolitical front, the New Year started with the American assassination of an Iranian general, which escalated tensions and threatened military conflict. The tensions appeared serious, causing us to delay writing this issue for several days until the direction of events could be discerned. Somewhat surprisingly, both parties have stepped back from military escalation. Capital markets took the events in stride. It is just a matter of time before Iran returns to the headlines.

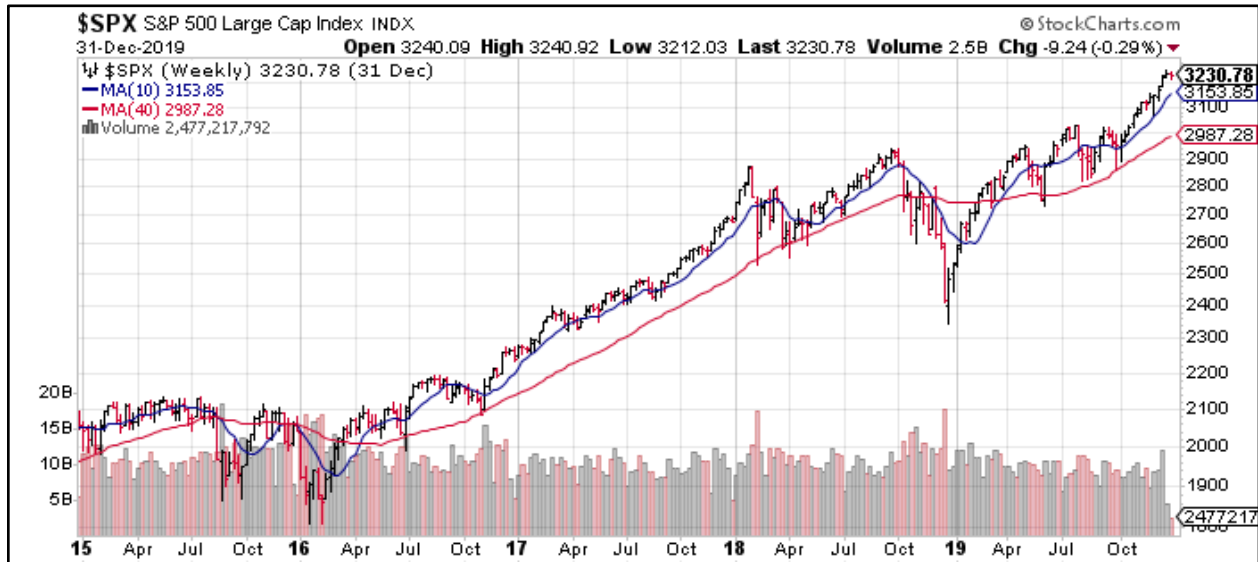
An additional boost to markets will come on January 15<sup>th</sup> as China and the United States sign what is purported to be “phase one” of a comprehensive trade agreement. The signing of an agreement does serve to, at least temporarily, reduce trade tensions between the nations. The deal cancels the imposition of threatened additional tariffs on Chinese imports while committing China to buy more American goods, especially agricultural products. Importantly, the deal leaves substantial earlier tariffs in place on both sides. It does not constitute a return to free trade. It is also worth noting that the recent deal is not definitive; new tariffs can be threatened or imposed at any time by the United States given the right pretext. We can expect trade to again be a point of contention between China and the United States as they wrestle for global influence.

This is the year of Brexit, though we still don’t quite know what that means. The terms of Britain’s separation from the European Union are still unresolved. The most important issues, such as dealing with the Northern Ireland border, remain unresolved. Though we are resigned to Brexit occurring, we remain of the view that it is not in the U.K.’s best interest. The economic fallout of Brexit will be negative for Britain, and the loss of one of its key members is a blow for the European Union. We continue to believe that the economic and geopolitical challenges facing the E.U. will result in a change in the nature of the organization.

We live in an investment environment dominated by macro factors that are likely to produce periods of extreme volatility in the coming decade. There will be risks and opportunities. It will be important not to become wedded to long-term assumptions and to be prepared to respond to change.

EQUITIES COMMENT

S&P 500 (WEEKLY)



Our bullish stance on equities, and US stocks especially, remains intact following a continued rise in December. In addition, both the subdued adverse reaction of the S&P 500 to the escalation of tensions with Iran in early January 2020 and its quick rebound are very bullish indeed.

Equities are moving higher on a host of positive factors. As we have discussed, there appears to be a concerted effort by central banks and governments to forestall the next recession with a combination of monetary and fiscal policy. How long this will work remains to be seen, but this powerful stimulative cocktail should buy the economic expansion more time. Other factors providing a tailwind for equities is the traditionally positive seasonal tendencies of this time of year. Economic indicators are suggesting that the recent slowdown in growth has been halted and that the economy may be re-accelerating, albeit at a modest pace. It will take subsequent reports to confirm that the American economy has caught a second wind.

Though we remain bullish, the probability of a market pullback is increasing. Volatility remains at a level that suggests complacency, which will be discussed more fully in the next section. In addition, the very sharp ascent of the market over the past couple of months usually produces a corrective phase before continuing higher.

In sum, we remain bullish of equities until evidence suggests a change. However, we must recognize that the odds of a pullback are rising and are not insignificant. Our view is to defer major new capital commitments to equities until a buying opportunity is presented by a pullback. In addition, or as an alternative, one might wish to purchase volatility as a hedge, as discussed in the following section.

VOLATILITY TRADE

S&P 500 VOLATILITY INDEX (VIX) (DAILY)



The volatility index spiked modestly in late December and early January around the assassination of the Iranian general and associated tensions before settling back to levels that suggest fairly comprehensive complacency.

In addition to general investor complacency, an additional factor that is acting to subdue the VIX of late is the selling of volatility by pension funds and related parties in a bid to pick up income that the current low-interest-rate environment is denying them.

This wholesale selling of volatility has not ended well for the sellers in the past and has typically been a sign that a period of elevated volatility (i.e. declining equity markets) is growing near.

**iPATH SHORT-TERM VIX FUTURES ETN (VXX) (DAILY)**



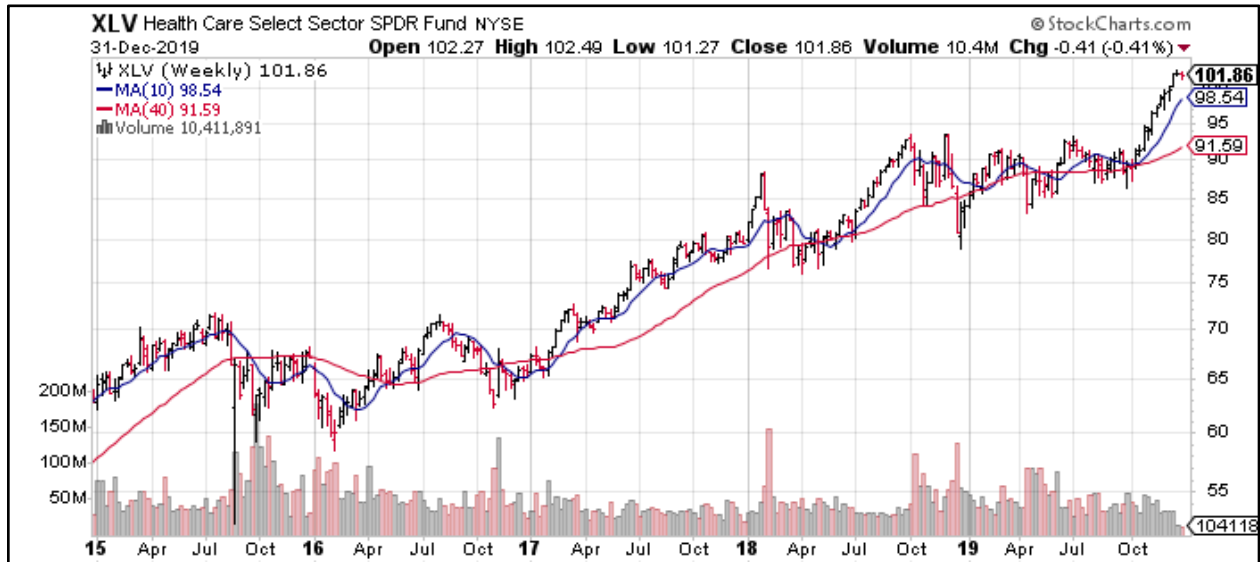
Our long volatility position using the VXX was showing a profit at year-end but we are maintaining our position in anticipation of a much larger upward move in the VIX.

The VIX remains at levels well below long-term averages, which suggests a reversion to the mean will produce a very attractive return. The timing of the rebound in volatility is uncertain but we can be confident that it will eventually occur.

As we have discussed previously, exiting this trade is a matter of interpreting the behaviour of the S&P 500 and the VIX when the market pullback does occur. The 100-day moving average is a starting point in calculating a price target but all relevant factors should be weighed in the decision.

**U.S. HEALTHCARE TRADE**

**HEALTHCARE SPDR ETF (XLV) (WEEKLY)**



The long position idea in the U.S. healthcare industry is off to a positive start following our initial comment in the December 2019 issue.

Our preferred vehicle to gain diversified exposure to the sector, the Healthcare SPDR ETF, did pullback back somewhat in very early January due to the Iran issue, before moving to new highs at time of writing.

The prospects for the XLV remain bullish given its relatively attractive valuation versus historical norms and the positive technical aspect of its recent breakout from an extended base.

XLV would, of course, be vulnerable to a retracement in a general market correction. We would maintain our bullish view as long as XLV traded above the circa 90 level. A move lower than that would constitute a failed breakout and should be construed bearishly.



**FTSE 100 (DAILY)**

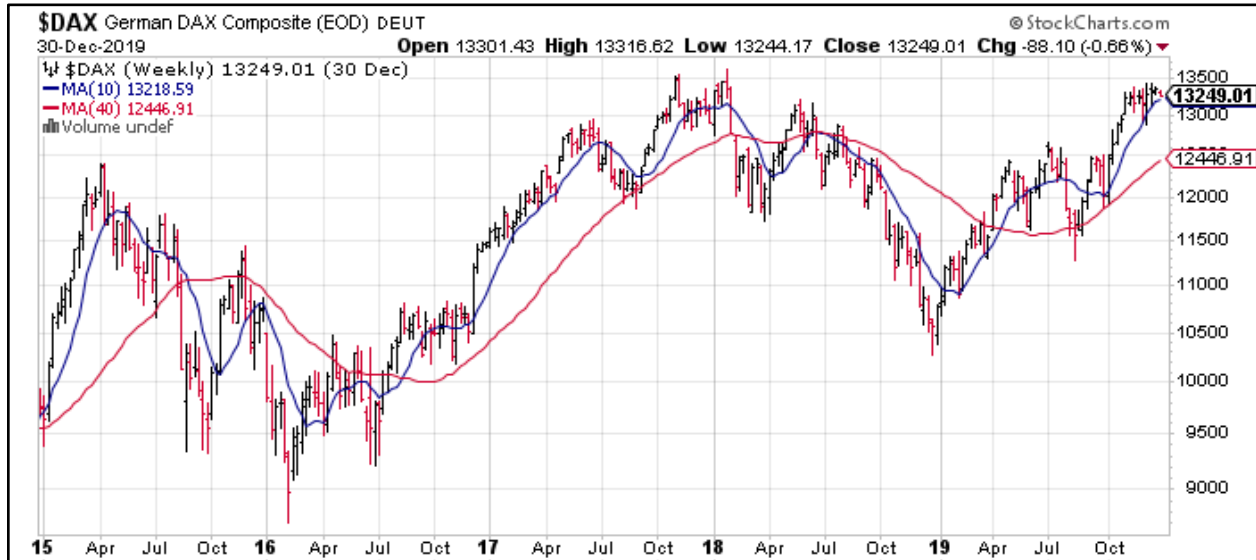


We maintain our cautious view of the FTSE despite the resolution of the issue of whether Brexit will occur or not. Another issue looms that will have a significant impact on the British economy and the FTSE. What is at issue is the agreement that codifies the terms of Britain's departure from the European Union. The Brexit deal remains in negotiation with major issues, such as the Northern Ireland border, still unresolved.

We would avoid broad exposure to U.K. equities until the terms of Brexit are confirmed. As well, Brexit will likely encourage Britain to devalue the pound as an offset to its negative economic consequences, making pound denominated assets relatively less attractive.

We will continue to wait for a sentiment-driven move in the FTSE following the announcement of the terms of a Brexit deal. We anticipate trading against such a move if it is extreme. That scenario could produce an attractive risk/reward trade opportunity.

**DAX INDEX (WEEKLY)**



Our cautious view of the DAX remains unchanged as its recent rally stalled in December. We expressed concern in recent issues about entering the DAX when it is so close to major resistance (i.e., it's 2018/19 high). This type of significant resistance often serves to reverse uptrends, making the purchase of the DAX an unattractive risk/reward trade. On a technical basis, it is best to wait for a clear breakout above the 2018/19 high, which would indeed be bullish.

Notwithstanding technical considerations, we continue to have reservations with the DAX. The German economy continues to soften, and it is the European nation that would be most impacted by American trade tariffs. We think some type of increased protectionist trade action against the European Union is probable in 2020.

## CAC 40 (WEEKLY)



Our bullish view of the CAC 40 continues to be rewarding. It is our favourite European market, both from a technical standpoint and for the relatively lower exposure of France to protectionist trade practices of other nations.

We will maintain our bullish view, with the caveat that a fall below the 5600 level would consider a failed breakout and reverse the bullish trend.

**NIKKEI INDEX (WEEKLY)**



The Nikkei is in a similar situation to the DAX in that a recent rally has brought it near to important resistance at the circa 24,500 level. A breakout above what is essentially a double top would be very bullish and would signal a new bull market from a technical standpoint.

However, as with the DAX, such major resistance points also often serve as formidable barriers that reverse uptrends.

We will await a clear breakout before becoming bullish of the Nikkei, which has been trading sideways in a broad channel for the past two years.

**SHANGHAI COMPOSITE (WEEKLY)**



The Shanghai Composite has been trading in a relatively tight consolidation range since its sharp rally of early 2019. The status of trade relations with the United States certainly contributed to the sideways movement of this market while investors waited for evidence of de-escalation of trade tensions.

The signing of “Phase One” of an agreement on January 15<sup>th</sup> constitutes a lessening of tensions, albeit tariffs remain in place and there may well be no “Phase Two.” At least things did not worsen, and the agreement provides more certainty for investors than existed previously.

As such, we are again becoming bullish on the Shanghai market. The chart pattern is technically bullish, and the tight consolidation pattern suggests a spike in volatility that could produce a sharp move higher. In addition, there is growing evidence that the economic stimulus efforts of the Chinese are having an effect.

Our newfound bullish posture would end should the Shanghai trade below 2800, which would be significantly bearish.

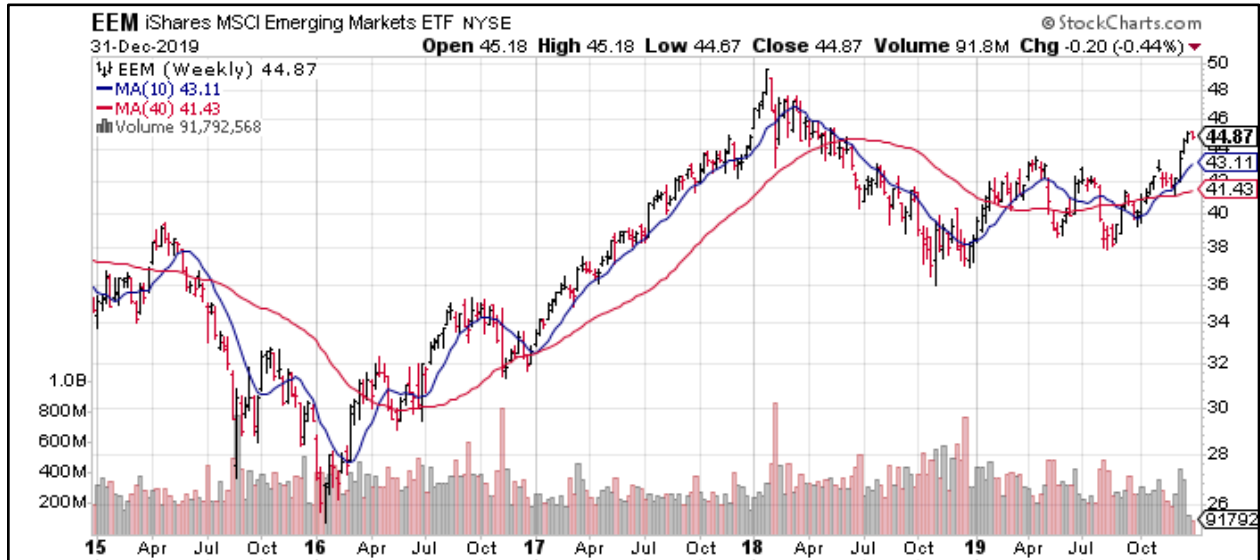
**SENSEX (WEEKLY)**



We remain bullish of the Sensex, which continued to perform well in December. The surprise tax cut of 2019 along with general strength in global equities is helping the Indian market move to new highs.

We will maintain our bullish stance unless the Sensex trades below the circa 40,000 level, which would constitute a failed breakout with attendant bearish implications.

**EMERGING MARKETS ETF (EEM) (WEEKLY)**



We turned bullish on emerging markets, through our proxy EEM, at year-end as it closed above our previously published purchase trigger price of 44.50.

A number of factors have combined to benefit emerging markets of late. The recent weakness of the American dollar and the announcement of a first step in easing China/ United States trade tensions have positive ramifications for emerging markets. An easing of protectionist sentiment would serve to reinvigorate global trade and clearly benefit emerging markets, which typically depend heavily on trade. The general strength in stocks in December also played a role.

While we have turned bullish, we remain cautious as a number of factors could reverse the bullish tone of these most vulnerable of markets. For example, renewed strength in the U.S. dollar must be watched carefully for its effect on emerging markets. A move back below 44.50 would cause us to return to a neutral stance, as the breakout attempt would have failed.

FIXED INCOME COMMENT

10-YEAR US TREASURY NOTE (WEEKLY)



The pullback in 10-year Treasuries continued in December, following the very sharp rally of 2019. The pullback is certainly a normal consolidation of a sharp move but also reflects investor concern that the cycle of interest rate cuts has been halted and that the US economy has found a second (or perhaps third) wind. It is also worth noting that the consolidation began near a major resistance point on the chart, the 2016 high. It is not unusual for more than one attempt to be required to move through such a price level.

We continue to believe that the path of least resistance for interest rates is lower, though the timing of the next interest rate cut will be determined by economic reports. The recently reported economic measures suggest that the U.S. economy has firmed somewhat, so the next rate cut may not be imminent. However, given that central banks and governments seem determined to get ahead of economic weakness to postpone the next recession, we can expect the Fed to resume cutting rates at the first plausible justification. That this is an election year is not irrelevant. Though the Fed is meant to be independent, there is reason to believe that President Trump’s enthusiasm for lower interest rates is having some influence.

We, therefore, remain bullish on 10-year Treasuries, although a break below the 127 level would be a bearish development and cause us to reconsider our view.



CURRENCY COMMENT

US DOLLAR INDEX (DXY) (WEEKLY)



The weakness in the US Dollar Index in the fourth quarter of 2019 accelerated in December. The Index ended the year on a bearish note, trading below both its 10 and 40-week moving averages.

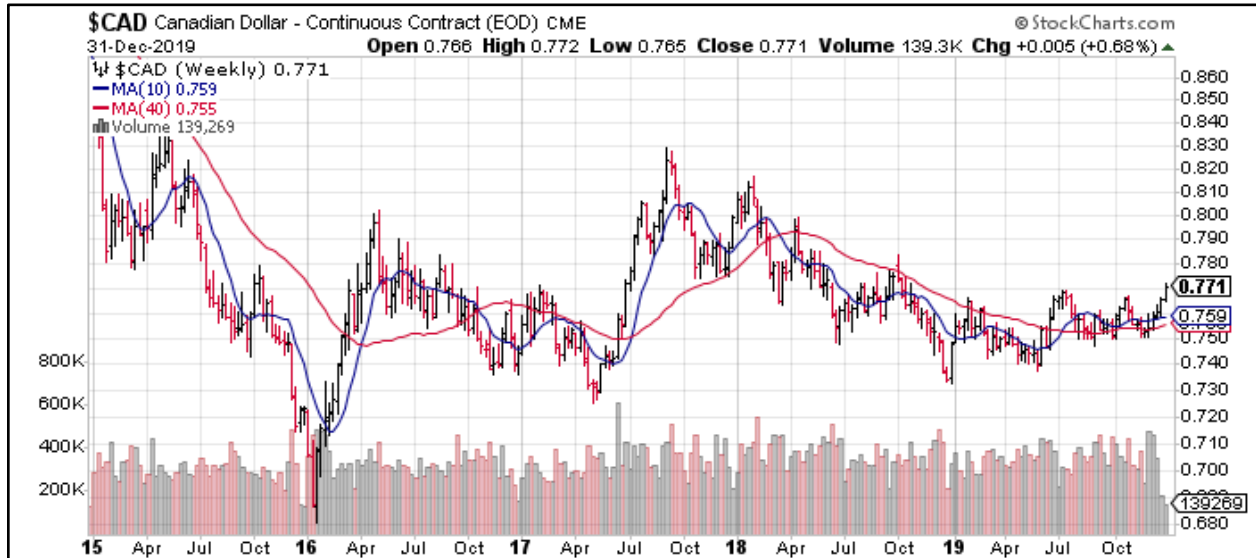
While we pay great attention to moves above and below the long-term 40-week moving average, we are not as yet prepared to change our bullish view to bearish.

In our view, a move below the 95 levels would be very bearish and cause us to adopt a bearish view. The 95 level is noteworthy because it has acted as support a number of times in the past year.

Our reluctance to turn bearish on the dollar stems from our inability to identify a compelling alternative, given America’s role as a geopolitical safe-haven and the strength of the U.S. economy. As well, the dollar still enjoys a significant positive interest rate differential versus other major currencies such as the euro and the yen.

In summary, we maintain our bullish view of the dollar contingent on the Dollar Index continuing to trade above 95.

**CAD/USD (WEEKLY)**



The Canadian dollar strength against the U.S. dollar in late 2019 owed much to a rising oil price, with which it is highly correlated. The reluctance by the Bank of Canada to match Fed interest rate cuts in 2019 played a secondary role. The price of oil is by far the biggest influence, with the Canadian dollar being a de-facto petro currency,

Our ongoing bearish long-term view of oil, combined with the Canadian dollar trading at a major resistance point at circa .77, suggests that the Canadian dollar has much more downside risk than upside potential at these levels.

Our negative view of the Canadian dollar remains largely a function of our view on oil, but also because we believe that the Bank of Canada views a weaker dollar being in Canada’s interest for trade purposes. The soon to be signed China/United States trade agreement will likely have some negative effect on Canada, as China is committed to increasing its spending on American goods by \$200 billion, which presumably will entail lower purchases of goods from other nations.

## EUR/USD (WEEKLY)



The euro strengthened against the U.S. dollar late in the year, which likely owes more to softness in the dollar than the attractiveness of the euro.

The euro finished the year trading very close to its 40-week moving average. That level acted as an effective barrier to a euro rally attempt earlier in 2019.

We will defer changing our bearish view of the euro until a clear move above the 40-week average is apparent. We remain cautious of the euro give the strongly positive interest rate differential of the dollar and the challenging geopolitical and economic issues of the European Union.

**POUND/USD (WEEKLY)**



The pound reacted positively in the fourth quarter to political machinations that finally produced a certainty that Britain will leave the European Union. A good measure of the strength was likely short-covering ahead of the December 12<sup>th</sup> election as it became more apparent that the Conservative Party would win a majority.

It is worth noting that despite the election and short-covering, the pound still failed to end the year at a 12-month high.

A good deal of uncertainty remains, given that the terms of Britain’s withdrawal from the European Union remain unknown. Substantial economic risk remains. It is difficult for us to see how Britain will be better off economically post Brexit. The potential political fallout re Northern Ireland and Scotland is not inconsequential.

We remain cautious on the pound, with a long-term expectation of a lower pound intact. One of the ways that Britain will cope with a post-Brexit world is through currency devaluation.

In the shorter term, we remain watchful for a trading opportunity on the announcement of the terms of Brexit. We would trade against a sentiment-driven move produced by the announcement, should one occur.

**YEN/USD (WEEKLY)**



The recent weakening of the yen versus the dollar was halted in December, largely due to the general weakness of the dollar against other major currencies.

A case can be made for the yen to strengthen. The yen stands as the major, if flawed, alternative to the dollar. The Japanese economy is the third-largest in the world and Japan is seen as a relative safe haven, especially by Asian investors.

However, the yen is a distant second choice as a repository for capital given the negative interest rate environment in Japan. Japan is also less attractive as a geopolitical refuge, given its proximity to China. Lastly, a stronger yen is not in Japan's interest given its reliance on exports.

The yen remains essentially trendless, so we maintain our neutral stance.

## YUAN/USD (DAILY)



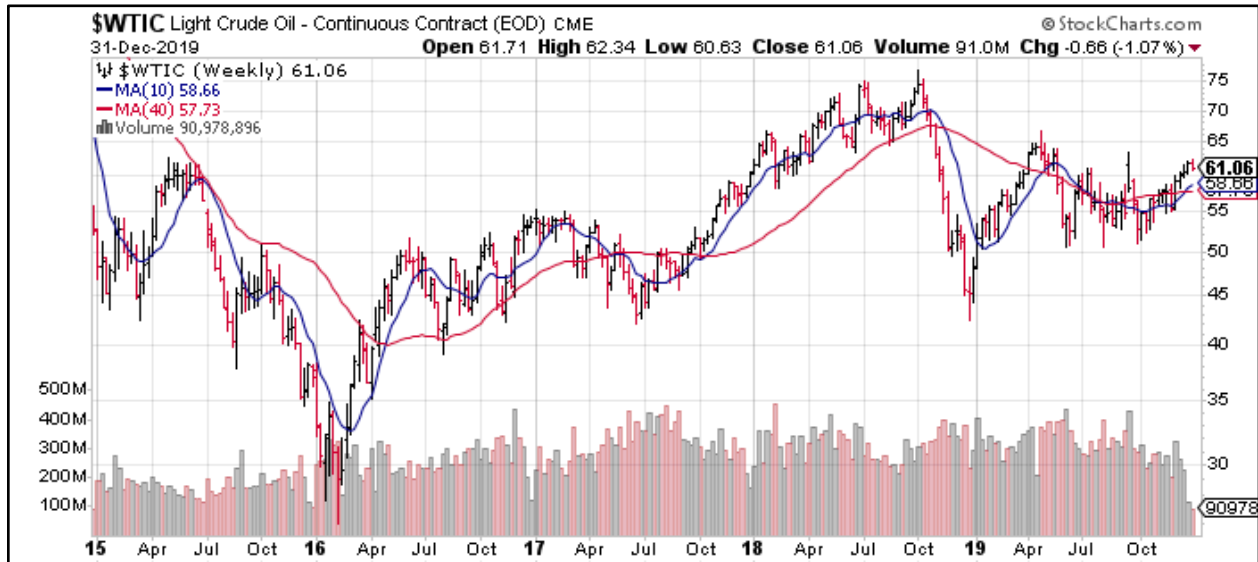
The yuan has retreated to the important 7 to the U.S. dollar level, which reflects subsiding trade tensions between the two nations as the signing of Phase 1 of a trade accord approached on January 15<sup>th</sup>.

We expect the yuan to trade at the circa 7 level for some time as that seems to represent a price that both China and the United States can tolerate. However, renewed trade tensions could see China move to weaken the yuan in response.

Therefore, given the asymmetric nature of the trade probabilities, we do not favour unhedged exposure to the yuan.

OIL COMMENT

CRUDE OIL (WTI) (WEEKLY)

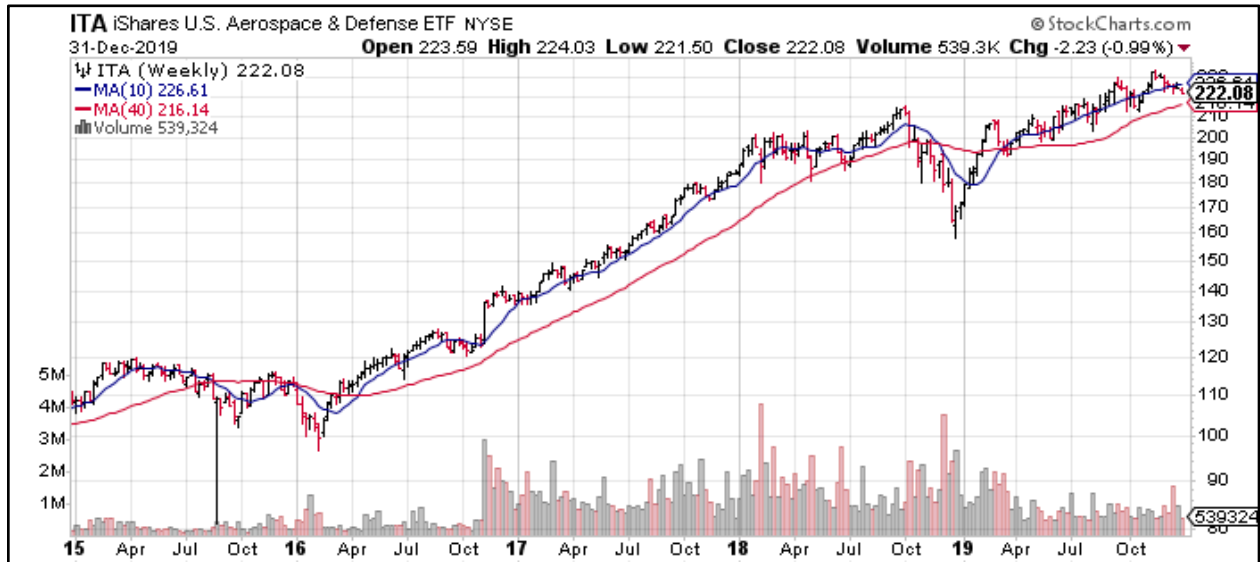


We remain bearish on oil, with the failure of the price spike of early January attesting to the weak underpinnings of the price of oil. We must repeat our oft referred to bromide that markets that behave bearishly when they should be acting bullishly are in a very bearish situation indeed. The failure of oil to retain its price gains following the assassination of the Iranian General is profoundly bearish.

As we have elaborated in previous issues, the fundamental supply/demand balance for oil does not suggest higher prices. We repeat our caution, however, that oil is not a market we would short sell given its tendency to spike on adverse geopolitical developments.

DEFENCE SECTOR COMMENT

US AEROSPACE & DEFENCE ETF (ITA) (WEEKLY)



The recent escalation of tensions between Iran and the United States has served as a reminder of the deteriorating global geopolitical environment. In addition to the always contentious Middle East, North Korea remains undeterred in its nuclear ambitions while the United States and China can be expected to remain rivals for global influence for the balance of the century. A major beneficiary of these disturbing circumstances will be the global defence industry. Selected defence stocks will continue to benefit from the combination of two major factors, geopolitics and the evolution of technology.

Other geopolitical considerations are serving to boost defence spending aside from the major factors mentioned above. The absence of leadership among Western nations, combined with President Trump’s skeptical view of NATO, will encourage European nations to become more self-sufficient in their defence capabilities. Russia’s annexation of Crimea and activities in the Ukraine have served to focus European nations on defence matters. In Asia, China’s rapid growth in defence spending and provocative presence in the South China Sea has created unease among neighbours such as Japan and Taiwan.

The changing geopolitical landscape has influenced defence spending. In 2019, the Stockholm International Peace Research Institute (SIPRI) published a study suggesting that global defence expenditures in 2018 were the highest in 30 years. The Trump administration has already announced the largest defence spending program in American history of some \$700 billion. The United States alone accounts for more than a third of global defence expenditures. In addition, China is rapidly increasing its military spending as is Saudi Arabia.



In addition to geopolitics, technology can also be expected to propel defence spending higher in the next decade.

Warfare has always attracted the latest technology and spurred technological innovation. The rapid pace of technological change in the 21<sup>st</sup> Century is creating significant gaps in military capabilities among nations that will require enormous expenditures to address. One current example is the lead in the development of hypersonic weapons by Russia and China over the United States and other Western nations. Hypersonic weapons are missiles that travel at speeds greater than 5 times the speed of sound. There is currently no effective defence against such weapons. The Russian Avangard missile is said to travel up to 20 times the speed of sound. Russian Defence Minister Sergei Shoigu stated that the first regiment of Avangard missiles was deployed in the Urals region of Orenberg late in 2019. The United States is said to be two years behind in the development of hypersonic technology and is spending accordingly.

In addition to hypersonic weapons, Artificial Intelligence (AI) is playing a major role in the evolution of weapon systems. AI is a particularly important factor in the development of unmanned weapon systems. Autonomous aircraft (e.g. drones) and ships have been in development for some time. Major advances have also been made in the development of robots that may eventually replace human soldiers.

The combination of changing geopolitics and technology has placed unprecedented pressure on militaries around the world to update and expand their defence capabilities in the coming decade. These pressures have been reflected in the performance of defence stocks and we expect this trend to continue.

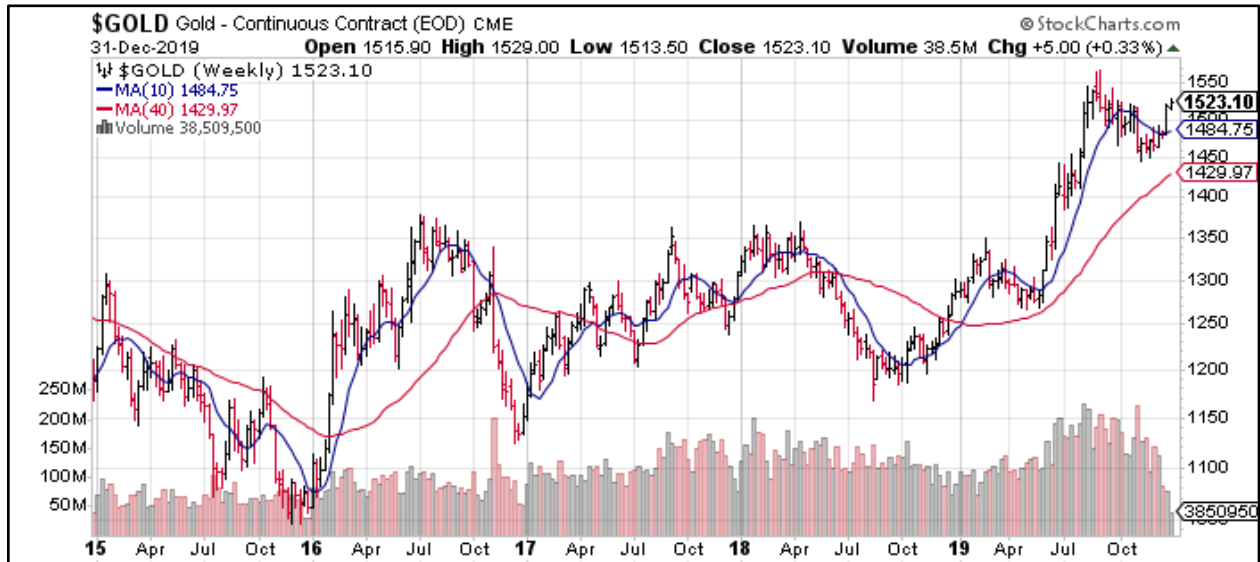
Since first being discussed in the February 2017 issue of the Global Investment Letter, the defence sector (using the U.S. Aerospace and Defence ETF (ITA) as a proxy) has gained 62% versus an approximate 45% gain in the S&P 500. In the past year, the ITA has risen 29% versus a gain of approximately 26% in the S&P 500. The ITA ETF is an efficient means of gaining exposure to the defence industry and offers the benefit of diversification.

We especially favour the aerospace companies that produce products incorporating the highest technology. Investors who prefer individual stocks may consider Lockheed Martin (LMT), Northrup Grumman (NOC), Raytheon (RTN), and General Dynamics (GD), among others. Foreign defence contractors such as Airbus (France) BAE Systems (U.K.), Rolls-Royce (U.K.) and Thales (France) may also be considered as they offer geographic diversification, which may be desirable in an era of shifting alliances.

The strong tailwinds provided by geopolitics and technology suggest global defence spending will rise for the foreseeable future. Aside from general market risk, the major risk for the defence sector is a decline of global tensions, which sadly seems unlikely.

**GOLD COMMENTARY**

**GOLD (WEEKLY)**



We remain bullish on gold. It continues to trade bullishly above key moving averages, suggesting that the uptrend remains intact.

Gold’s consolidation phase appears to have ended, with a significant price move higher in December. Weakness in the U.S. dollar may have played some role, but we interpret the upward move last month to a continuation of an established bull market.

### ABOUT THE EDITOR

The Editor and Publisher of the Global Investment Letter is Jonathan Baird CFA. Prior to founding the Global Investment Letter, Jonathan spent more than 25 years as an award winning money manager in Canada, most recently winning a Lipper Award in 2010 for managing the #1 Global Equity Fund in Canada. Jonathan managed several #1 ranked funds over the course of his career as a money manager, investing in all major industries, asset classes and markets. Along with his interest in the world of investment, Jonathan has been a lifelong student of history and uses the lessons of history to help interpret and provide context to current events. Jonathan no longer invests money for others, managing only his own account. The Global Investment Letter represents his personal thoughts and opinions.

Jonathan well understands the difficulty of the investment process, and the essential role that quality information and opinion play in successful investing. Each monthly issue will contain comments on major markets, economics, geopolitics as well as investment ideas. There may also be discussion of investment philosophy or practices and reviews of books deemed of potential interest to readers.

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