

## MRP THEMES: REVIEW OF NEW AND OLD THEMES

Joe Mac's Market Viewpoint: March 29, 2018

The U.S. capital markets have been undergoing rapid changes. Interest rates which had been low for so many years are rising: the fed funds rate is up by 150 basis points (bps) from its cycle trough and the 10-year treasury is up 140bps. Equities, after being in a seemingly unstoppable bull market for almost 9 years, have stalled since late January and volatility has surged with the CBOE Volatility Index (VIX) jumping from a low of 9 to 25 in just a few months. It is indeed possible that the great bull market will not be able to endure in the face of rising rates and growing uncertainty.

Only time will tell.

In the meantime, professional investors would be well-served to focus on themes. It is the identification of change-driven themes that is our mission at MRP. So, in the face of the recent market turmoil, a review is in order. Since October we have added 3 new themes and also eliminated 3. Currently, we have a total of 19 themes that are active. A review of all those active themes follows.

### THEMES FOCUSED ON COUNTRIES OR REGIONS

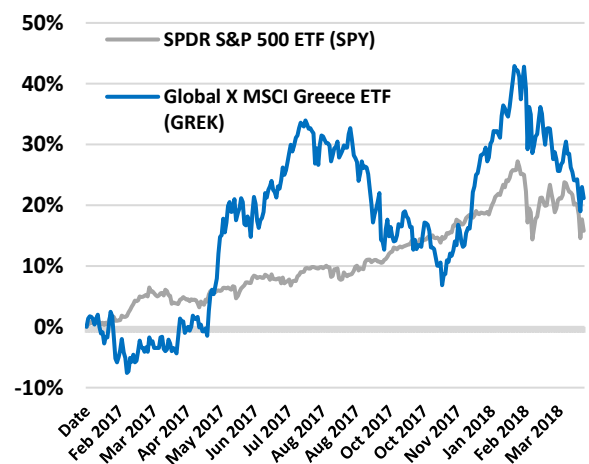
#### ASEAN – Long

The Association of Southeast Asian Nations (“ASEAN” bloc) has emerged into an important economic bloc thanks to its strong growth, rising urban population, favorable demographics, growing middle class, and geographic proximity to China and India. Although ASEAN produces more than 7% of the world's exports, it accounts for just 3.3% of global GDP. However, that is likely to change in the future, as the bloc now has four key elements that should pave the way for ASEAN to become emerging Asia's new low-cost manufacturing hub.

New and disruptive technologies are impacting almost every industry and creating the sort of dynamic business environment that is conducive to an economic boom.

ASEAN market valuations are still relatively cheap and earnings have so far lagged the underlying macro momentum. **Launched March 28, 2018.**

Greece (GREK) vs S&P 500 (SPY)  
Year to Date, 2017



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## FRANCE – Long:

France has finally emerged from a decade of low growth and weak job creation that left nearly 3.5 million people out of work. The country is experiencing its strongest pace of job growth since the 2008 financial crisis, and President Macron's pro-business agenda is already having a positive effect on GDP. Last year, the economy expanded at a rate of 1.9% versus growth of 1.1% in 2016. It is projected to grow 2.5% in 2018.

Macron's efforts to revamp France's labor laws last summer went better than expected. He has now taken on a greater challenge which could define his legacy as president. Macron's proposals to abolish jobs-for-life at the state-owned SNCF railway company have set his administration on a collision course with France's powerful labor unions which have organized nationwide strikes.

The strikes affect rail and air transportation, and could last for months, disrupting the economy. We will be monitoring this development closely. **Launched June 14, 2017.**

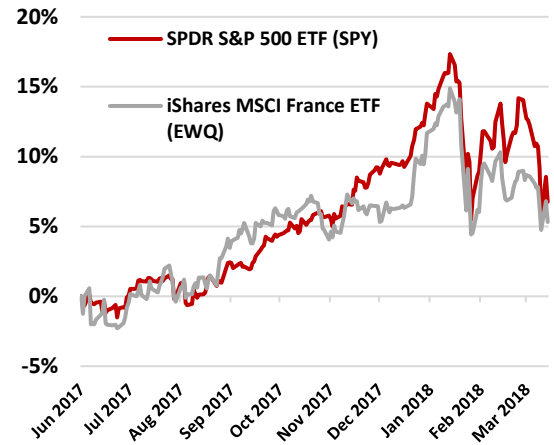
## GREECE – Long

Greece is on track to finally exit its bailout program this year. Kalin Anev Janse, a board member of the euro zone's bailout fund, noted: "They have pushed through unprecedented levels of structural reforms and are one of the few countries in the euro zone to run a fiscal surplus along with Netherlands and Germany".

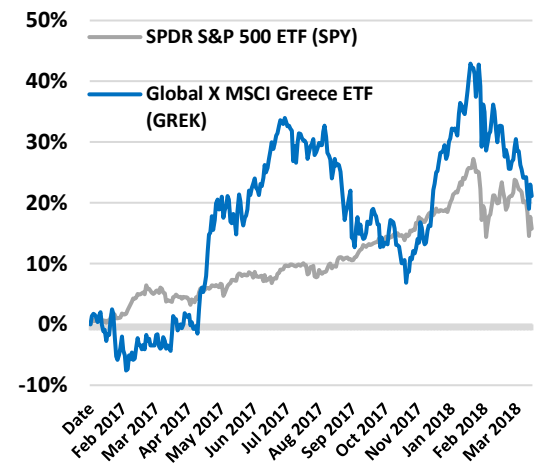
The European Commission sees the economy expanding by 2.5% in 2018 and 2019, up from 1.6% growth in 2017 and negative growth in 2016. An EU-sponsored investment of 8 billion euros into the recovering economy should help spur further growth as restrictions on banks are also eased.

Greece's stock index is still 40% below its previous high, but should get a boost as earnings improve. **Launched January 19, 2018.**

France (EWQ) vs S&P 500 (SPY)  
June 2017 - March 2018



Greece (GREK) vs S&P 500 (SPY)  
Year to Date, 2017



## THEMES FOCUSED ON SECTORS

### AUTOS – Short:

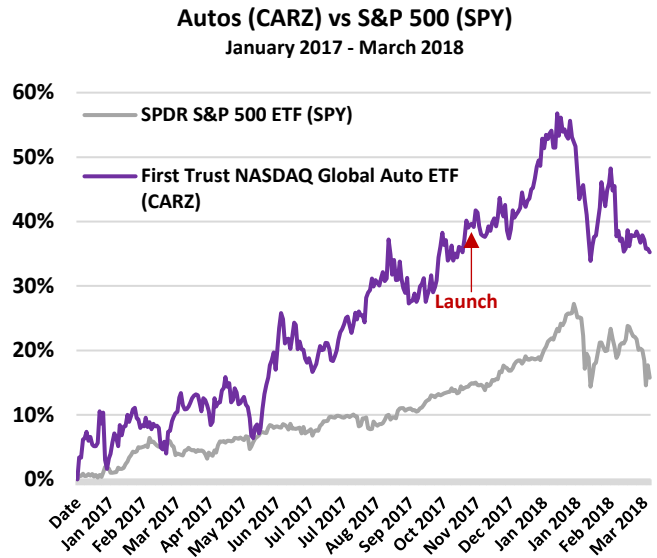
Auto sales have slipped in the first two months of 2018. February saw a YoY decline in sales of 2% and this pace could begin accelerating from here on out. Auto loan interest rates are now at levels not seen since

2010 – an average of 5.2% in February, compared with 4.4% in February 2013. That means higher monthly

payments regardless of whether one is buying or leasing. The average new-vehicle retail transaction price to date in February is \$32,237, a record for the month, surpassing the previous high for the month of \$31,302 set in February 2017.

Inventories are still taking very long to clear as it currently takes an average of 70 days before a dealer is able to sell a new vehicle – just off from 75, which was the highest level since 2009.

Outstanding motor vehicle loans are at an all-time high at the same time, auto loan debt has climbed 14% since the beginning of 2016. Delinquencies on auto loans also threaten to bring down the car market as the percentage of 90+ Days Delinquencies made up by auto loans has increased by 15% over that same span. Auto loans are the second fastest growing loan type, behind only student loans, that are entering delinquency. **Launched October 12, 2017.**

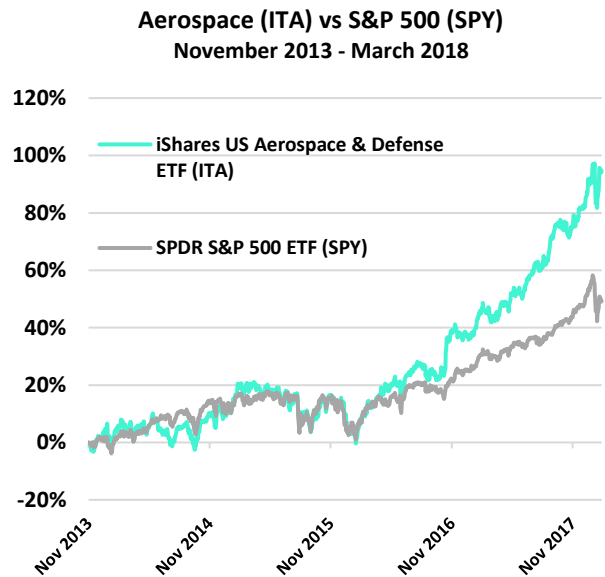


**DEFENSE - Long:**

The recently passed \$1.3 trillion spending bill includes \$650 billion for the U.S. Defense Department, dramatically increasing funding for the military by almost 10%.

The Missile Defense Agency will get \$393 million to speed up Boeing's modernization of the kill vehicle in 20 Ground-Based Midcourse Defense System interceptors. There are also funds for three more Boeing KC-46 tankers, on top of the 15 the Air Force requested. The Army will get \$577 million for 17 Boeing AH-64E Apache helicopters, and the Navy will get \$501 million for three more Boeing P-8 maritime surveillance aircraft.

The proposed budget also includes \$165 million for more Lockheed Terminal High Altitude Area Defense interceptors along with \$178 million for Raytheon (RTN) SM -3 interceptors and \$137 million for another test of Raytheon's SM-3 Block IIA missile. Both interceptors are for use in Lockheed's Aegis Ashore system. Along with an increase in F-35s, Congress approved \$84 million for six more Northrop MQ-8 Fire Scout unmanned helicopters. **Launched November 27, 2013.**



## ELECTRIC UTILITIES - Long

Electric utilities are on the cusp of a renaissance powered by four major forces: the electrification of transportation, the proliferation of digital data from IoT and cloud computing, the digitization of money, and advances in energy industry technologies. These shifts are heavily influencing how money is being deployed on infrastructure, which will transform the electric grid from traditional to "smart".

A U.S. household with an electric car could see a 50% increase in its electricity usage. Meanwhile electricity consumption from data centers and IoT should rise as because wireless technologies consume more energy than wired technologies such as fiber, cable or DSL. And, cryptocurrencies, whether privately-issued or government-issued, will still need to be mined which requires a lot of power.

These seismic shifts will result in higher electricity demand and a more dynamic business model which have not been fully priced into the stocks of electric utility companies. **Launched November 20, 2017**

## U.S. FINANCIALS & REGIONAL BANKS – Long

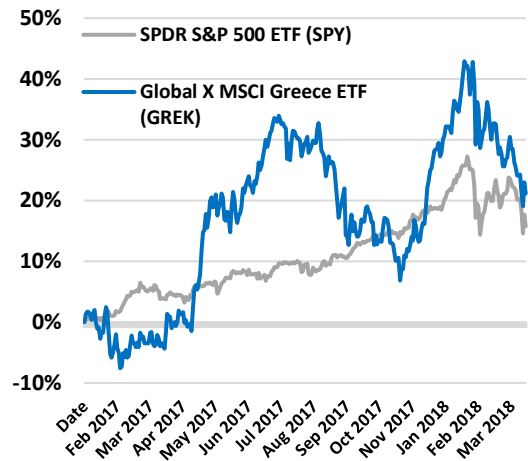
While interest rates are rising, a good sign for the financials sector, an impending trade war between the US and China is creating shaky footing. The consensus view, as of now, is that long-term growth expectations are not keeping pace with short-term growth, flattening the yield curve.

However, as Trump has already granted multiple countries exemption to new metal duties, and is preparing to negotiate with Chinese officials on tech tariffs, it remains to be seen if GDP growth will actually be negatively impacted in the long term.

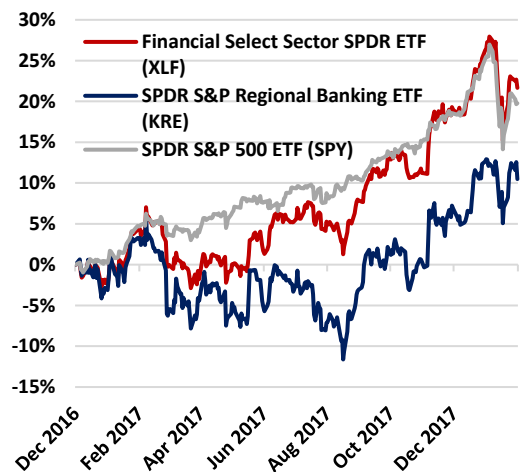
Outside of international tensions, things are looking up for banks. Overall net-interest income for U.S. banks rose 8.5% in the fourth quarter from a year earlier – a gradual jump from the 7.6% increase in Q4 2017. Along with this, the average rate on a one-year certificate of deposit, or CD, rose to 0.49% last week, the highest level in more than seven years. Even higher rates could be on the way, spurring more deposits and saving.

On the regulatory front, midsize banks are set to benefit from new legislation that rolls back Dodd-Frank, raising the threshold at which banks face tighter oversight to \$250 billion in assets from the current \$50 billion. For a long time, banks have purposely restricted their assets to remain below the \$50 billion mark to avoid enhanced oversight. With the new legislation in place, a wave of M&A could be the way for expanding regional banks. **Launched December 23, 2016.**

Greece (GREK) vs S&P 500 (SPY)  
Year to Date, 2017



XLF (Financials) vs Regional Banks (KRE)  
vs S&P 500 (SPY)  
December 2016 - March 2018

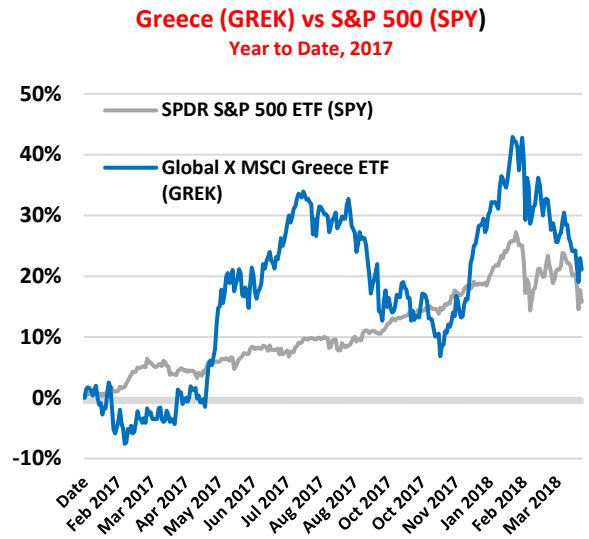


## US HEALTHCARE PROVIDERS – Short

Lines are being redrawn in U.S. healthcare as the \$3.3 trillion industry undergoes an unprecedented transformation. Hospitals are wading into drug manufacturing, pharmacies are merging with insurers, and corporate America is experimenting with customized solutions that bypass traditional stakeholders.

Reimbursement cuts, lower patient volumes, and pressure to provide more care in outpatient settings are forcing health systems, such as hospitals, to rethink traditional barriers and business models.

This is just the beginning of a restructuring of America's healthcare industry which is also under significant regulatory strain. The share prices of healthcare services companies will likely underperform under these conditions. **Launched October 16, 2017.**

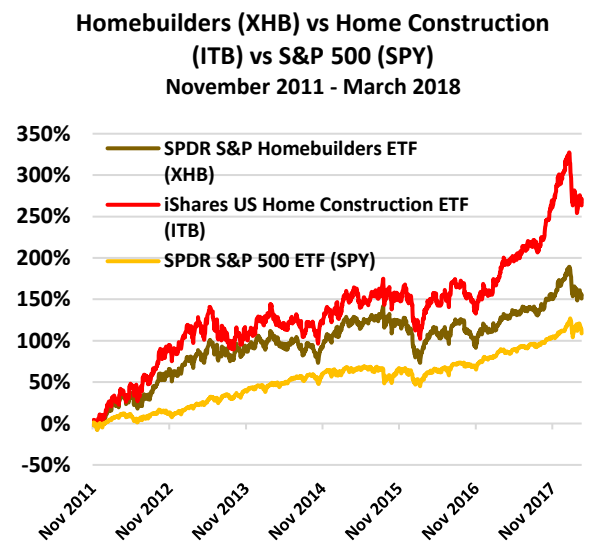


## U.S. HOMEBUILDERS & HOME CONSTRUCTION – Long

In February, MRP reaffirmed our Homebuilders and Home Construction theme in Beyond the HOUSING HEADWINDS. Although total housing starts slipped gain in February, it was largely dragged down by a decline in multi-family units. Single-family housing starts increased 2.9% from 877,000 in January to 902,000 in February. New home sales slowed while existing home sales increased in the month.

The data initially seems neutral, however homebuilder sentiment still remains high with the National Association of Home Builders/Wells Fargo Housing Market Index at 70, well above 50, considered to be the baseline for a positive reading. Although home prices continue to rise, the estimate of new houses for sale at the end of February was 305,000, the highest since March 2009.

The pressure of rising mortgage rates should continue pushing prospective home buyers to lock in purchases before rates increase even more in the long run. According to a recent survey by Redfin, 94% of respondents would not cancel their search for a home altogether because of rising rates, and 21% of that cohort said rates passing 5% would increase their urgency to buy a home. **Launched November 3, 2011 / Reaffirmed in the Spring 2012 / Updated August 5, 2016.**



## INDUSTRIALS & MATERIALS - Long

The basis of this theme was our expectation that President Trump's policies would unleash a national infrastructure rebuilding program and improved corporate cash flows, both of which would spur a boom in private sector and non-residential construction outlays. This in turn would lead to substantial increases in demand for industrial materials and machinery. The country is still waiting on the President's supposed \$1 trillion infrastructure project; thus far, he has only signed an executive order to speed up approval of projects.

Despite this, capital expenditures in general have exhibited strong year-on-year growth, with the industrial side recovering from largely negative figures in 2015 and 2016. The industrials XLI has kept pace with the S&P in 2017, returning about 14% since the theme launch. The Materials XLB has done slight better, returning almost 17% over the same period. Launched on December 23, 2016.

Launched December 23, 2016.

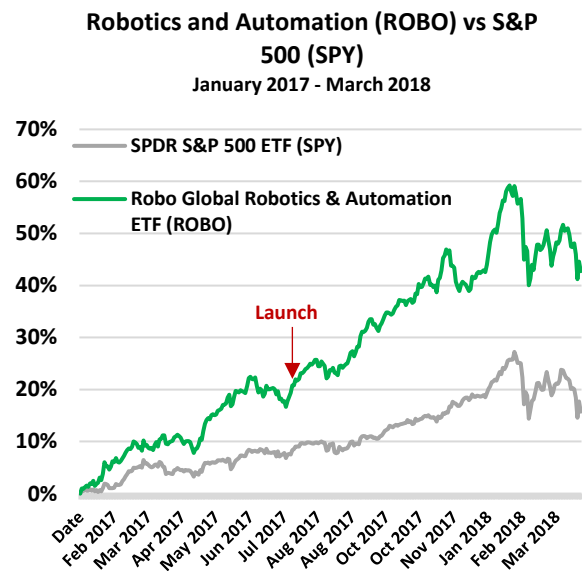
## ROBOTICS & AUTOMATION - Long

As with many technologies, China is taking a leading role in automation. Their growing dominance in AI research is leading the charge as The number of industrial robots put to work there reached record levels in 2016, and installations are projected to swell at an annualized pace of between 15% and 20% in China through 2020. The pace is unlikely to slow as fears of steep unemployment and growing poverty in China have proven completely unmerited. Humans aren't displaced for very long. They're retrained, even if informally, to oversee more and more output, with much of that output growth the result of automation.

In the US, automation is continually growing. Low unemployment rates are leaving a lot of manufacturing firms without human labor to staff factories, accelerating the pace of automation. Only about 12.4 million factory workers were employed nationwide last year, a decline of almost 2 million industrial jobs in a decade and 5 million since 1997. However, output as a share of GDP continues to hold steady, indicating that robotic technologies are picking up the slack.

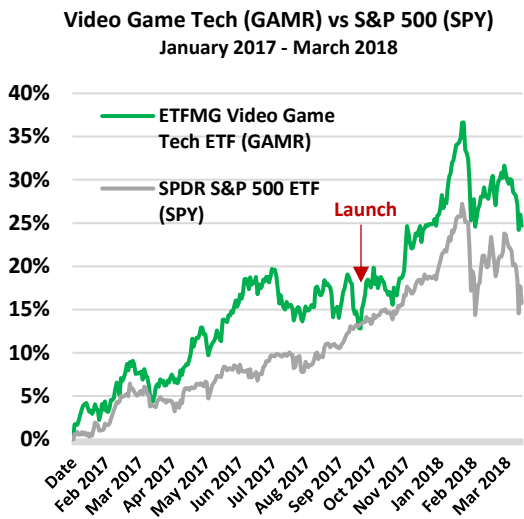
Last year 27,294 robots worth \$1.47 billion were ordered in the first nine months for installation throughout Canada, Mexico and the United States. This was a record sales mark for any three-quarters period in any year. The average price was approximately, \$54,000 per unit, an affordable level for most manufacturers.

**Launched July 20, 2017.**



## VIDEO GAMING – Long

Gaming is experiencing a large-scale shift to the cloud. Microsoft, one of the longtime hardware producers of

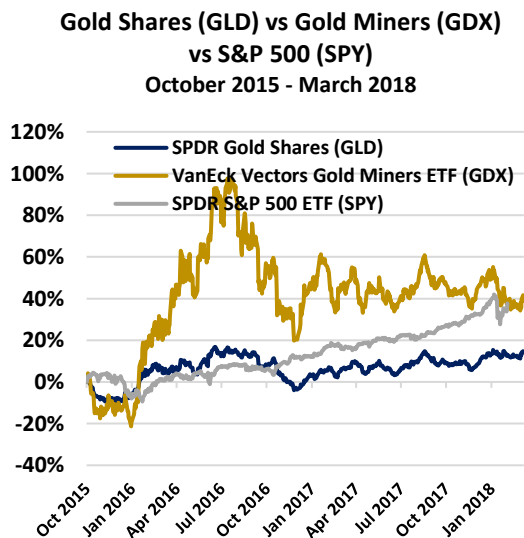


the industry and manufacturer of the Xbox, has recently broken new ground in the industry by introducing a “Netflix for Gaming” based on its cloud service. Further, more than 90% of the world’s largest game companies are now utilizing Amazon Web Services, the megacorporation’s cloud computing arm, which offloads online gaming infrastructure tasks to Amazon’s giant cloud computing resources. Amazon has said that top games from Activision’s Destiny 2 to Supercell’s Clash Royale rely on its cloud infrastructure to handle the ebbs and flows of demand on cloud-connected data centers.

Steam, the world’s largest gaming platform, had a record year in 2017 with \$800 million in growth from 2016. Consumer spending worldwide on game consoles and hardware related services last year reached its highest point since 2011, recording an 18% YoY increase – the first YoY increase since 2014. **Launched October 19, 2017.**

## THEMES FOCUSED ON COMMODITIES

### GOLD & GOLD MINERS – Long



Gold has been stronger in 2018 as a result of a consistently weak dollar and volatility creeping back into the market. Inflation is also trending back up, threatening to push gold even higher. While the Fed is still treading their path to higher interest rates, a 50 basis point increase for the rest of the year is still dovishly cautious and does not pose a huge threat to gold.

Rising instability is always a catalyst to watch and with some of President Trump’s latest moves, tariffs on Chinese tech products, and the appointment of war hawk John Bolton to the position of National Security Advisor, gold could continue an upward trend.

Further, the S&P 500 is still overvalued and has been in a bull market for more than 8 years. MRP highlighted the extended market valuations that have been running rampant for some time now in The Gathering Storm. If the perfect storm has finally reached the shore, safe haven assets such as gold may be on tap for an eruption. **Launched October 21, 2015.**

## LITHIUM – Long

Lithium has been the central catalyst of the battery revolution this past decade. It already plays a large part in our daily lives through our smartphones, laptops, and almost all other rechargeable electronics. The market for lithium-ion batteries alone was \$31 billion in 2016 and is expected to reach \$67 billion by end of 2022. A lot of that growth will come from the electric vehicle and utilities sectors. All the major auto makers have frontloaded their electric car plans, and lithium-ion batteries are the fuel source of choice for most of them. Electric power generation companies are also increasingly using batteries to store solar energy during daylight hours, and these energy-storage sites feature large lithium-ion batteries.

Lithium has faced some headwinds, chief among them, a Morgan Stanley report that forecast rising supply to decrease prices by 45% over the next 3 years, a prediction that contrasts with most analyst expectations. Industry executives also dissent from this opinion, stating that Morgan Stanley underestimates strong demand and how complicated it is to process and mine.

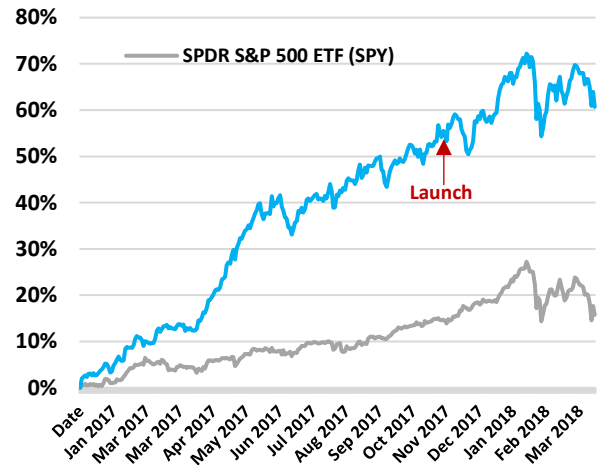
Forecasts of oversupply also fail to take into account previously unforeseen externalities. Firstly, President Trump's tariffs were not just all about reducing dependence on foreign aluminum and steel, but all "critical minerals". In his executive order, Lithium was named as one such mineral. Eliminating the importation of cheaper lithium from economies like Bolivia and Chile, could continue to sustain the current high prices of lithium. **Launched October 2, 2017.**

## OIL, US ENERGY – Long

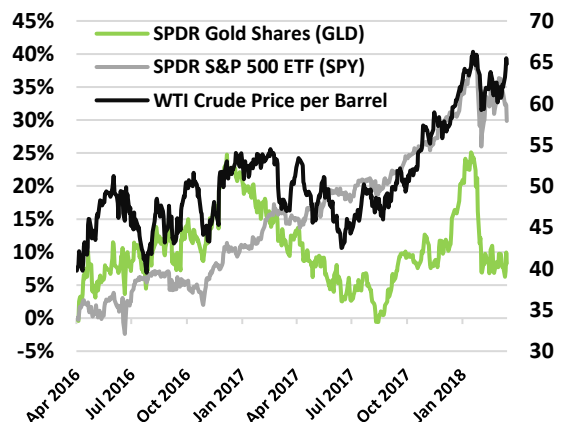
Oncoming US tariffs on steel and aluminum - crucial components of energy infrastructure – could create a significant effect on oil markets. US oil and gas executives are skeptical that the US steel industry has enough capacity on its own to supply future infrastructure expansions, especially since some projects require specialized steel that is not produced by American companies and must be imported. Steel needed for 26-inch pipelines, for instance, is manufactured in three countries, none of which are the U.S. A study by AOPL last year showed that a 25% increase in pipeline costs could increase the budget for a typical project by \$76 million.

If the cost to build pipelines increases, the price of crude must be higher to incentivize oil companies to invest in their

Lithium & Battery Tech (LIT) vs S&P 500 (SPY)  
January 2017 - March 2018



US Energy (XLE) vs WTI Spot Price vs S&P 500 (SPY)  
April 2016 - March 2018





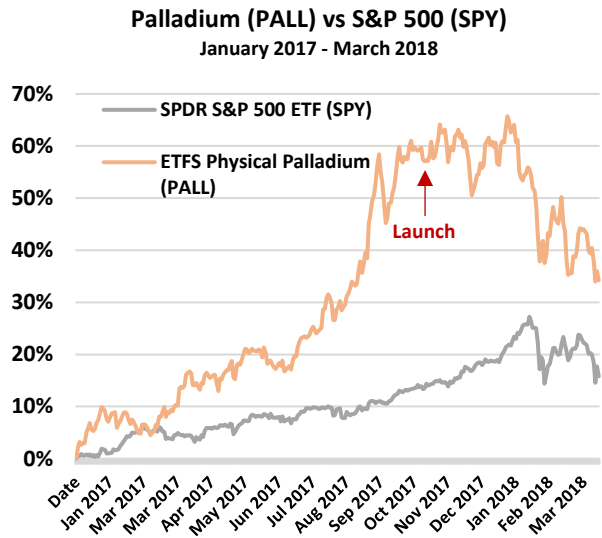
construction and expansion. If US pipelines are not expanded, thereby eroding American export capacity and upstream investment in new projects, importers would simply have to find oil elsewhere. OPEC would be the most likely candidate to fill that demand, guaranteeing they maintain reasonable power over prices.

The OPEC-Russia cartel, whose output cuts have become deeper than planned, with total compliance reaching 149% in February, may now extend the restrictions into 2019, according to Saudi Arabia's Energy Minister Khalid al-Falih. This, while instability and the resulting decrease in production is still plaguing some key producers like Libya, Angola, and Venezuela. **Launched April 8, 2016.**

### PALLADIUM – Long

Shortages sent prices to a record US\$1,139.68 an ounce in January. While the price has slipped a bit lately, the rest of 2018 is expected to see production continue to trail.

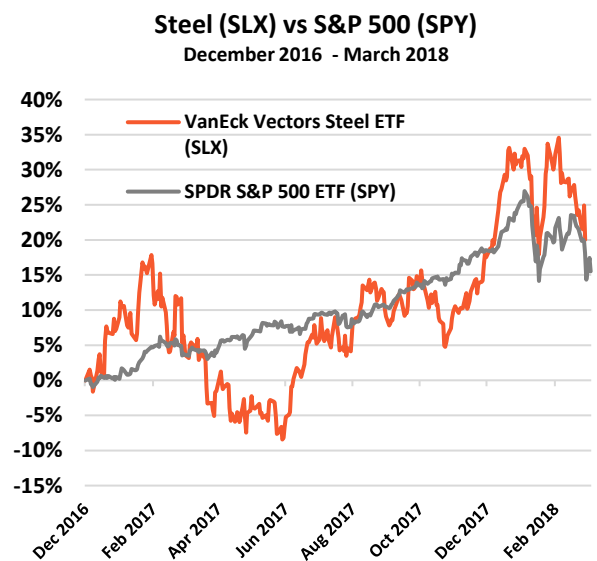
Palladium is a key emission-controlling component of catalytic converters in gasoline engines, whereas platinum is used for that purpose in diesel engines. Along with restrictions and outright bans on diesel-powered vehicles throughout Europe decreasing the market for platinum, palladium is benefitting from the shift to cleaner, but still gasoline-based, hybrid engines. **Launched October 9, 2017.**



### STEEL - Long

Enthusiasm for US steel and aluminum companies was very high when US President Trump announced sweeping 24% tariffs on all foreign steel. However, as seems to be Trump's negotiating style, he begins slamming an issue with a sledgehammer and then, later, dialing it back. In this case Trump has already granted the European Union, Brazil, Mexico, Argentina, Australia, Canada and South Korea temporary exemptions from duties on steel.

It is important to note, though, that the US steel industry will still benefit from tariffs on other producers like Russia and China. These specific exemptions will even further bolster certain parts of the US steel industry. Companies like California Steel Industries Inc. don't produce the raw steel used for their sheets and pipes, but rather buy whole slabs from Mexico and Brazil.



China, the world's biggest steelmaker, is now expected to continue production cuts beyond the winter heating season as the nation presses ahead with a campaign to reduce air pollution, and simultaneously recuing a supply glut. Hebei province, together with several other areas of northern China, ordered cuts of as

much as 50% on steel production during the winter heating season, and the country as a whole plans to eliminate 30 million tonnes per year of production capacity in 2018. This goal should be reached comfortably, opening the door to even further cuts coming later in the year. **Launched December 23, 2016.**

Outstanding motor vehicle loans are at an all-time high at the same time, auto loan debt has climbed 14% since the beginning of 2016. Delinquencies on auto loans also threaten to bring down the car market as the percentage of 90+ Days Delinquencies made up by auto loans has increased by 15% over that same span. Auto loans are the second fastest growing loan type, behind only student loans, that are entering delinquency. **Launched October 12, 2017.**

## THEMES FOCUSED MARKET CYCLES

### TIPS (Long) / LONG-DATED UST (Short)

In November's Market Viewpoint report, Beyond the BOND BUBBLE, MRP highlighted four major disruptions that would, in our opinion, depress bond prices in 2018. These included the Fed's balance sheet shrinkage, rising interest rates, the acceleration in global growth which could usher in higher inflation, and a changing of the guard at the Federal Reserve that could culminate in a more hawkish central bank. Indeed, Jerome Powell's Fed raised is already projecting three rate hikes in 2019, up from the previous projection of two.

Now, there are external headwinds in the form of waning demand from Japan and China's possible scaling back of its US treasuries purchases.

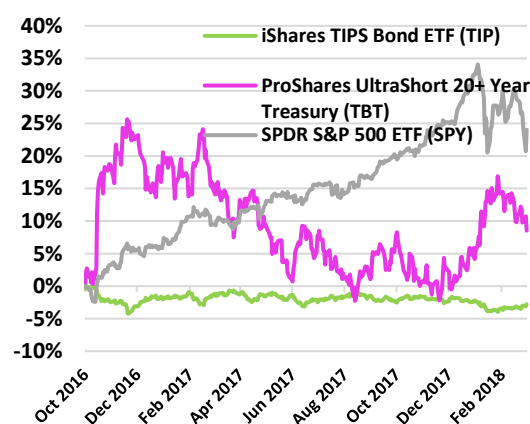
Moreover, MRP believes bond yields may soon start moving in the direction of the US' nominal growth rate, which itself may be about to accelerate. If the administration hits its real GDP growth goals and the Fed were to hit its inflation target, nominal GDP growth of 5-7% would, in time, suggest a more than doubling in the level of the 10-year yield.

As we've noted before, longer-term bonds perform poorly in rising interest rate environments, so now would be as good a time as any to short long-dated U.S. treasuries. **Launched October 26, 2016.**

### VALUE OVER GROWTH – Long

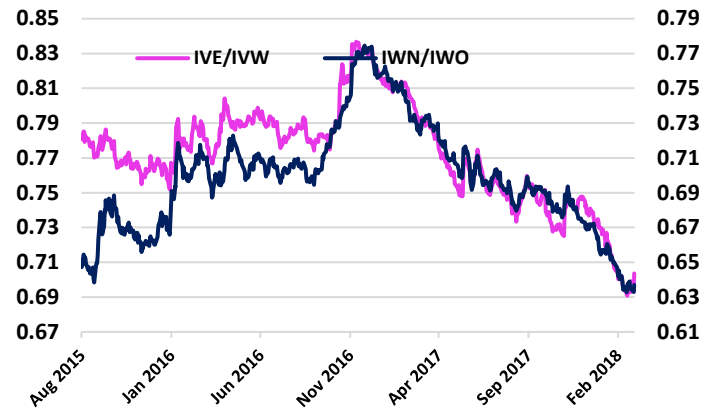
According to the Fed, 2 more interest rate hikes are on tap following this month's decision to hike the fed funds rate from 1.5% to 1.75%, the highest level since the Great Recession began. On top of this, they are now increasing the rate at which they'd like to continue raising rates, plotting a path to 3 rate increases in 2019 instead of the previously forecasted 2. This is significant for earnings-dependent growth stocks as the present value of an asset is its expected future stream of cash flows discounted back to present value.

**TIPS (TIP) vs Ultrashort Long-Dated Treasuries (TBT) vs S&P 500 (SPY)**  
October 2016 - March 2018



In other words, when interest rates rise, future earnings are subject to discount. Growth stocks have performed well in a long-term environment of zero or near-zero interest rates and easy money via QE. Now that the Fed is squarely focused on tightening, the market landscape will undoubtedly shift and, if history is any indication, the initiation of higher rates will be followed by a reversal of an earlier trend of growth outperforming value. Perhaps not right away, but eventually for sure. Launched August 28, 2015.

S&P 500 V/G vs Russel 2000 V/G (IWN/IWO)  
August 2015 - March 2018



*Joe Mac*