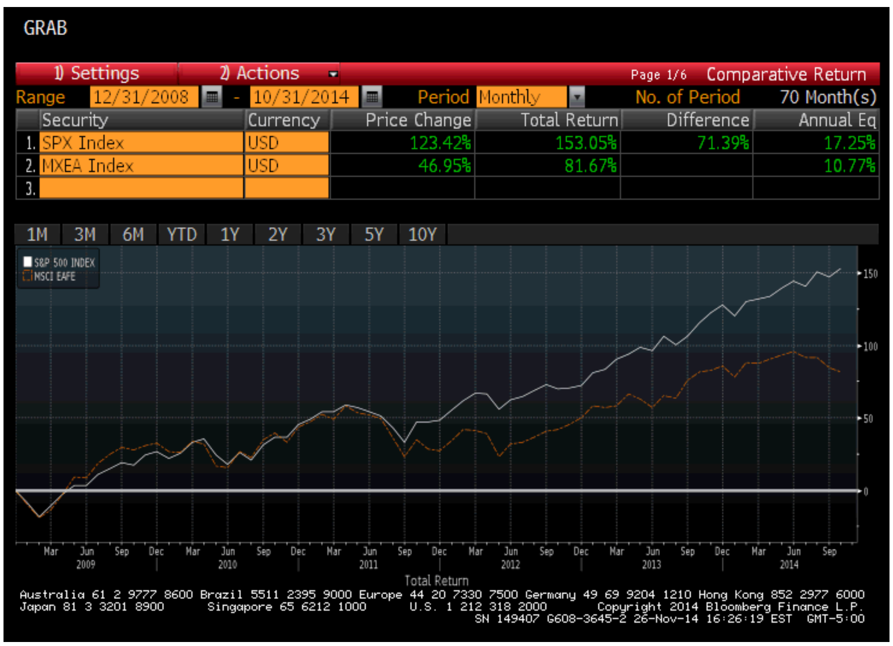
COMMENTARY

November 28, 2014

Dear clients and colleagues,

Markets have been on an upward trajectory since mid-October. In the US, the rally is driven by Mega Cap Technology names like Apple which has now reached US$700B in market capitalization, an all-time record for a company. The S&P500 is now selling at 18x earnings and 11x ebitda while the Nasdaq is selling at 24x earnings, both their highest level since 2007. The US weight in Global equity indices is at an all-time high. With both, valuations and relative performance much higher than the rest of the World, the US recovery and the US dollar strength is already priced in the US market in our opinion. Especially given that the US Fed will probably be the first Central Bank to raise interest rates next year. The chart below shows the performance of the S&P500 vs. the MSCI Eafe (ex-US) index. A similar chart would hold true for the small cap indices.



Source: Bloomberg

We remain positive for equity markets, however, we believe that markets outside the US may outperform in the next 12 to 36 months, especially with US rates rising and strength of the US dollar affecting results at large US multinationals. While markets outside the US still benefits from Central Bank easing and a lower currency.

Qing travelled to Korea and China early November while Robert was in Singapore and Hong Kong during that same period. Their trips coincided with the Hong Kong / Shanghai link, which was discussed in last week's comment.

It also coincided with China lowering interest rates for the first time since July 2012, in response to slowing growth.

China is still in transition from fixed investment and export-led economy to a consumer and service driven economy. It is following the same trajectory that Japan and Korea followed. Using those two economies as a guide, there should be another 7 to 10 years of above average growth in China, before slowing down to more normal growth rates. The faster growth continues to be driven by China's urbanization drive. Between now and 2020, China will have another 200 million people moving to cities. At that time, it will have more than 200 cities of more than 1 million people. That compares to 35 in Europe and 9 in the US. The level of debt taken to finance this massive infrastructure build is a major risk facing China, one that we closely monitor.

One thing that we noticed again during our trip to Singapore and Hong Kong is how these two countries have become expensive. The relative advantage they had in terms of labor costs, utility costs and other overhead costs has all but disappeared. A major diversification of their economy is required.

Similarly, we had many discussions with Chinese mainland companies that are relocating production to lower cost countries, particularly Vietnam. They highlighted labor costs that are less than half of those in China, energy costs that are about 75%, lower corporate taxes, etc.

During our trip to Asia, we had a chance to meet many of our Japanese and Hong Kong holdings. We came away extremely encouraged by their outlook for 2015.

Have a great weekend.

The Global Alpha team