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Flash Notes
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# *Can the S&P keep hitting new highs in 2020?*

When strategies are more talked about than implemented, it's time to ditch the drama. Last week, President Trump signed the Hong Kong Human Rights and Democracy Act. Beijing announced countermeasures. Needless to say, the traditional string of morbid journalists were out in force, spontaneously marching to the cry of "The end trade negotiations is nigh!" I don't intend to take any risks talking about politics, but when events affect your day-to-day decisions (as in my case), you have no choice. So let's take a closer look.

I believe I'm not mistaken in thinking that all your doubts are summed up in a simple question, the one suggested by the title of this article: Can the S&P keep hitting new highs in 2020? I think it can. In what follows I will briefly—but, I hope, convincingly—explain why.

1. As regards the signing of the act, once the bill had unanimously passed both houses of Congress, Trump had no choice but to sign it. Nevertheless, the act's significance will be determined solely by the response from Beijing—which seems more focused on achieving a pullback on certain tariffs.

2. I have no idea what Beijing's response will be, but I do know Beijing has a big incentive to take the heat off HK and avoid disproportionate measures: (1) In January there are elections in Taiwan and only a situation of calm in HK could improve the Kuomintang party's limited chances (this party is against the island's independence). (2) An excessive response from Beijing that compromised judicial independence in HK would lead to an unfavorable review of the city's autonomy by the US and would meet the criterion set out in the new act for revoking "official status". That would pose a serious threat to Beijing's financial ambitions. Why? Because in its *"Great Plan"* for the future, Beijing knows it needs a global, credible and functioning financial center, and it also knows that, as of today, neither Shanghai nor Shenzhen meet the requirements (as evidenced by the fact that Alibaba chose Hong Kong for its second listing, despite Beijing's insistence that it list on the Shanghai market). You can't build a reliable financial center just with skyscrapers and broadband. You need a culture, freedoms, universities, schools, galleries, theaters, law firms, etc.—all the things you have in Hong Kong. Thus, without this major new financial center up and running, Beijing can say goodbye to its *"Great Plan"* of becoming a global financial leader.

In its "Great Plan" for the future, Beijing knows it needs an international financial center. But for the time being, neither Shanghai nor Shenzhen fit the bill.

3. China's Communist Party (CCP) may be whatever you like, but there's no denying it's a master at achieving its long-term objectives through the silent virtue of patience. There have been two recalcitrant areas in the western part of mainland China (Tibet and Xian Jiang), whose majority population has always been hostile to Beijing. The CCP's strategy to solve this problem has been to encourage mass migrations of Han Chinese (93% of the population) into these areas, so as to dilute the opposition groups' power base. Today, I'm told, the

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migratory flows from the mainland to Hong Kong are massive and are accelerating, with some of our local collaborators suggesting that “the demographic makeover may be complete within a decade”. Whether this is fair or unfair, moral or immoral, is beyond the scope of this analysis, but it does seem to be a strategy which, given the CCP’s customary patience, could bring it closer to its goals. Knowing this, I would venture to say Beijing will not jeopardize short-term trade negotiations for something which, given time, it expects to be able to control.

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Leaving China aside and focusing on other aspects of the market, I detect a degree of concern following a rally in the S&P that has NOT (all caps, please) been followed with a rise in profit’s growth. In the third quarter, the corporate results in the S&P showed QoQ growth of +1.3%, but -1.9% YoY, and for some people that is a worry. As I see it, the situation could carry on like this (gains in the index with no evident growth in EPS) throughout 2020. Here’s why:

1. Earnings growth is unexciting but appears to be sufficient. After-tax ROIC fell from 4.8% to 4.3% (50bp) in the year, but the Cost of Capital (CoC) fell even further (116bp at the long end, and 66bp at the short end), so American companies are still able to make profitable investments (a situation measured by the ROIC-CoC spread). I have evidence for all this, as reflected in how US companies continue to seek skilled personnel, despite the lack of growth in earnings.

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2. US producers may be getting ready to set up their machinery. The inventory-to-sales ratio has stabilized (starting a downward trend) and, as often happens, the recent cuts by the Fed will probably lead to a revival of the housing sector, which very likely will push up new production (as 60% of all US manufacturing production is related to housing and the demand for related goods). This is the clear message we seem to be getting from the market, with the performance of the cyclical sectors improving already.

3. I accept that the rally was due to multiple expansion (which is sub-optimal). But although the S&P may be expensive compared to cash, it seems obviously cheaper than bonds (with the 10Y UST offering a yield of 1.75%, while equity offers a yield of 5.26%, as measured by the inverse of the PER).

In any case, I hope I’ve answered the question satisfactorily.

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