Investment Update & 2022 Outlook

January 2022

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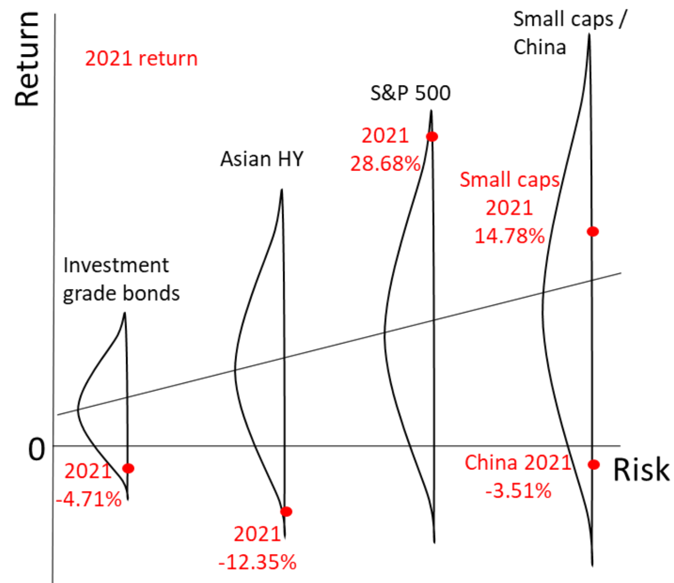
Market Review 2021

It was a challenging year for investors like us who focus on fundamentals and valuation. The S&P 500 topped return charts with gains of 28.68% (see the chart below), hitting 68 record highs even after it reached record highs at the end of 2020. This happened as the US led other markets in the economic cycle, which we positioned for via small caps. Actually US small caps kept pace with the S&P for most of the year with gains of 24.63% until mid November when growth scares emerged. Again, this volatility around the expected return is "expected". If anything, **the S&P might have overshot on the upside**, and forward returns are expected to moderate. Hence, **while small caps may have lost ground in recent months' battles, we expect them to prevail in the war.**



Source: Bloomberg. Investment grade bonds: Bloomberg Global Aggregate Index, *Asian HY: Bloomberg Asia USD High Yield Bond Index, Small caps: Russell 2000 Index, China: CSI 300 Index. For illustrative purposes only and not drawn to scale.*

The Bloomberg Global Aggregate Index is arguably the most popular index investment for fixed income investors. Accordingly, many bond funds are benchmarked to it, and investors have also taken to just investing in it for their fixed income exposures. While that might have worked out reasonably well before, this approach faced a reckoning in 2021 with losses of -4.71%. **The last time the Global Agg (as it is commonly known) had a loss of similar magnitude was 2005, so investors can be forgiven for not remembering that bonds can have losses.**

The chart shows that while the expected return for Global Agg over the next 5 years from the start of 2021 was 0.83%, its associated volatility resulted in 2021's losses of -4.71%. Those who have been following us might ask "Aren't starting yields a predictor of return for fixed income?. As we elaborated in our Oct 2020 investor letter, the experienced return will vary from the expected return in the interim periods. If there is volatility around the expectation of 0.83%, why losses and not gains? This was driven by one of the major headwinds facing bond investors that we have been highlighting for a while: that of rising rates. **Unfortunately, the prospects for investment grade bond investors are worse going forward, as we will cover in the next section.**

2021 also saw the bifurcation between Developed and Emerging Markets (DM and EM). That can be summed up in one word: China. China experienced a double whammy of slowdown (which we expected and reduced China equity exposures) and government clampdown (which we could not foresee but have taken advantage of subsequent dislocations). Accordingly, EM credit and equity markets were on the lower end of the volatility band, with Asian High Yield credit down 12.35% and China A equities down 3.51%.

Can EM markets bounce back from the stresses of 2021? Let's see what is in store for 2022.

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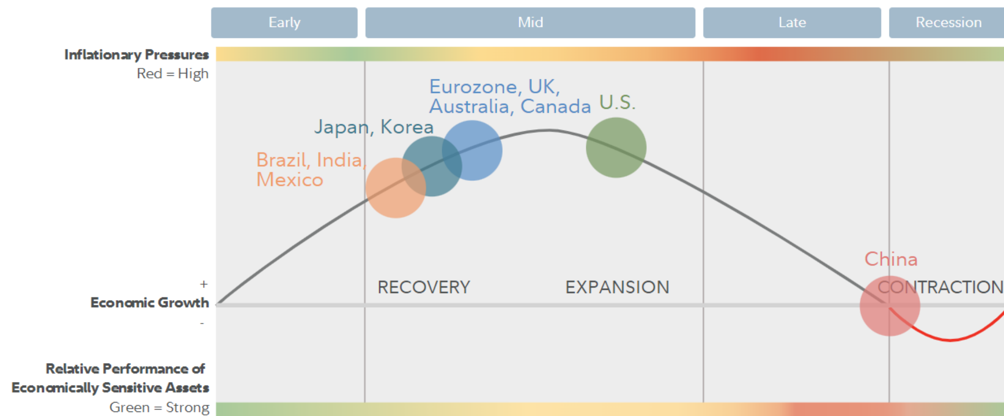
What’s In Store For 2022? (1/2)

As markets take turns to perform, divergent transitions this year across major economies are expected to create volatility and throw up varied opportunities.

Economic cycle progression: Divergence transitions across major economies



Source: Fidelity Business Cycle Update Q4 2021

While the US led in the economic expansion in 2021 and benefitted, other economies including Europe lagged but are expected to catch up. Indeed, one of the benefits of this non-synchronous growth is it creates an ongoing series of opportunities for investors.

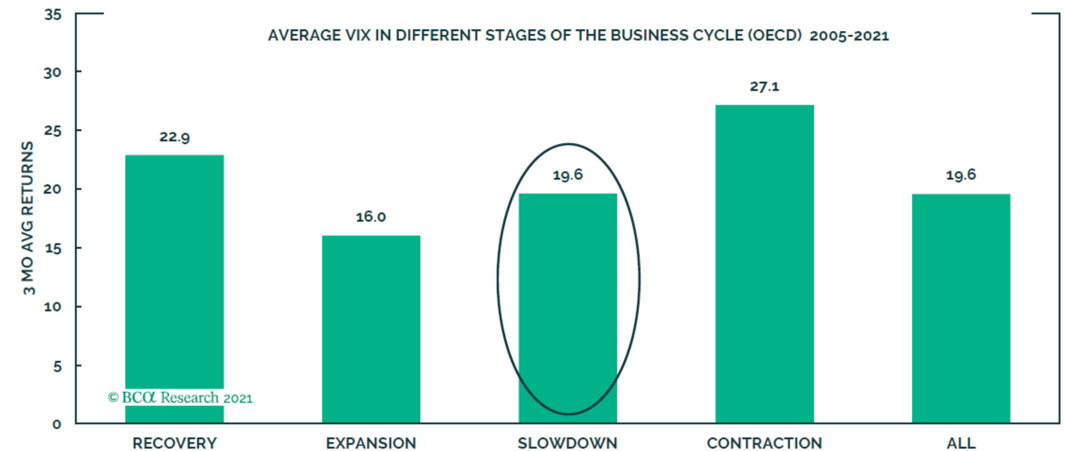
China stands out for being asynchronous in its economic cycle progression, having managed covid well and grew ahead of other economies, but found itself facing contraction due to the aforementioned slowdown and government clampdowns. We reduced China equity exposures in mid 2021 at the peak of China’s cycle and averted greater losses from the downside volatility.

Today, we find that **the Chinese economy may be bottoming as last year’s deleveraging has taken its course**. This means that while credit conditions were adverse last year, they are expected to improve and that has been seen in the PBOC’s (People's Bank of China) easing of monetary conditions. Though we are positive on longer-term prospects, we want to observe conditions turning more supportive for growth (and corporate profits) before adding onto existing China allocations.

At any point in time, we are allocating to an area that is positioned to do well in its respective place in the cycle, while not putting all our eggs in one basket.

Higher Volatility from phase transitions

Quite a number of considerations lead us to expect higher volatility this year. First, higher volatility is to be expected as economies transition from one phase to another. In particular, volatility rises moving from Expansion to Slowdown.



Source: BCA Research

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What's In Store For 2022? (2/2)

While the expansion phase tends to be the longest compared than other phases, we should expect slowdown to happen in due course. To which investors would naturally ask "When?" and expect a date as an answer. The thing about markets is they are measured by events not time, so anyone who says "so-and-so will happen [insert date]" with conviction is probably lying.

To be clear, while we are not able to call these transitions in terms of timing, we know what is on the horizon and steer the portfolios to be prepared for those outcomes.

Higher volatility from economic phase transitions is part and parcel of the cycle. A non-typical aspect contributing to higher volatility is covid. While economies are set on their economic growth pathways, covid's own cycle of transitioning from pandemic to endemic can throw a spanner into the works. Which is why we always ask "what if we are wrong?", and in this case, what if growth gets delayed or derailed.

To that end, **healthcare is suitable in the current environment where growth and earnings in other sectors moderate** and become less exciting, and healthcare's steady earnings profile do not look as boring in comparison.

Another transition contributing to higher volatility is the change in interest rate regime, which stands to be one of the significant market events in the foreseeable future.

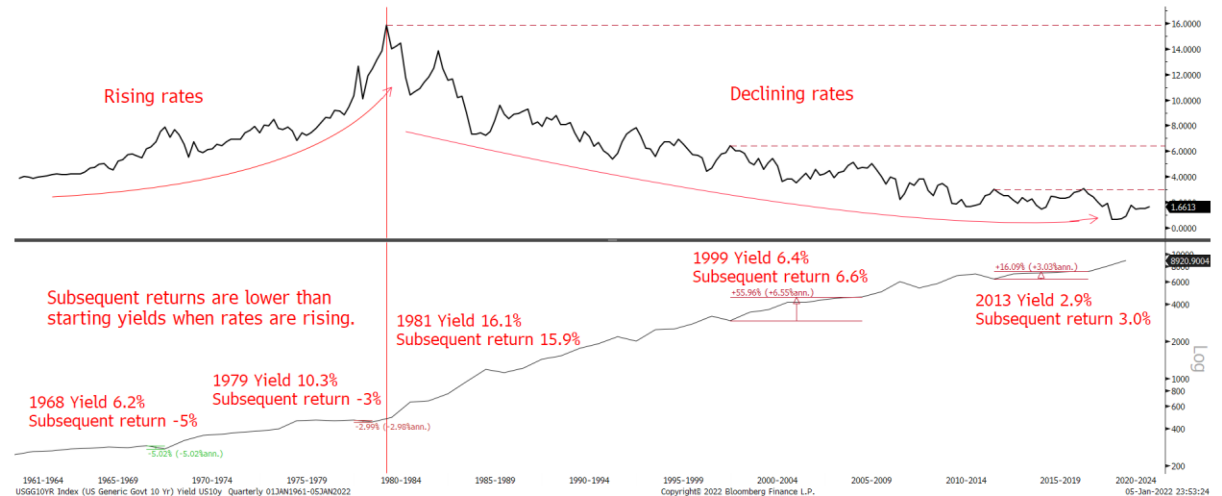
When to hike rates?

Why do central banks exist? So that an economy has a function to regulate economic fluctuations, such as reducing interest rates to stimulate and increasing rates to prevent overheating.

After years of low rates to stimulate economic activity post the 2008 Great Financial Crisis, the Fed is getting the growth and inflation that it was seeking to embark on tightening measures. While they do not want to overreact and end up triggering a recession, tightening is a case of when not if.

Amidst the backdrop of low rates, fixed income investments that have served investors well before are no longer expected to do as well as their expected returns are at multi-decade lows. Hence, one needs to look elsewhere for returns.

Second, the prospect of rising rates will threaten many bond portfolios as we have seen in 2021's losses. The chart shows that in a cycle of rising rates, investors' returns are lower than starting yields, and today's low starting yields don't leave much margin for error.



In the following section, we discuss the key themes we have in our portfolio to address the conditions above: 1. Positioning for Economic Growth, 2. Stability Amid VUCA, 3. Search for Yield.

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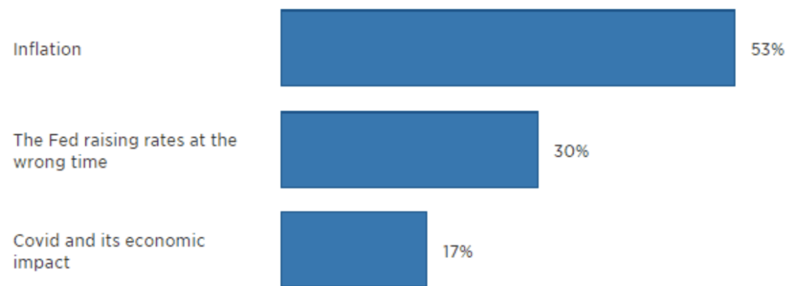
Key Themes: Positioning For Economic Growth

Surprisingly, while the Omicron variant may top the list of worries for some investors, this was not the case amongst the majority of Wall-street insiders, as per a poll conducted by CNBC. Here are the results:

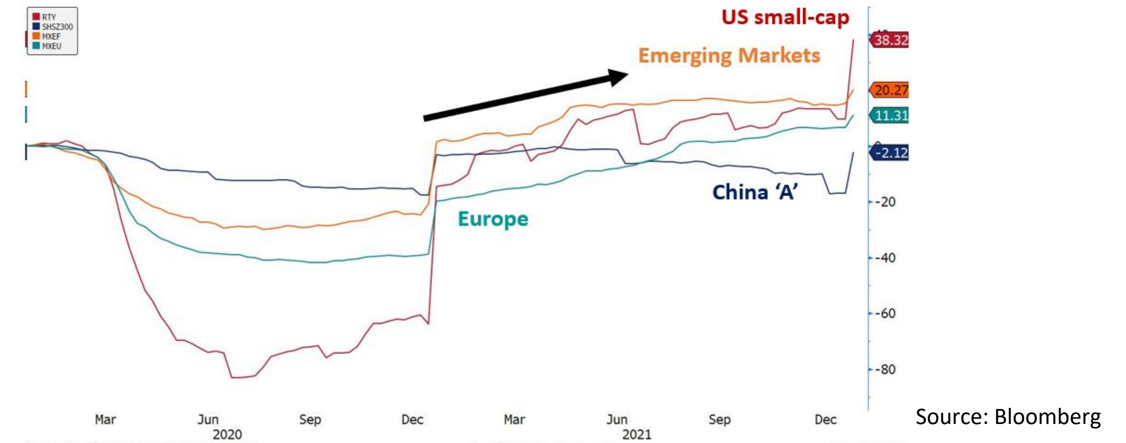


Inflation-related worries topped the list for more than half of investors surveyed. Perhaps this should not be surprising as inflation compels governments to impose cooling measures which adversely impacts economic growth (and weakening our "positioning for economic growth" thesis). It would also lead to pressures on corporate profits, and ultimately jeopardising the market and our portfolios.

We do not think we are in this bad scenario just yet, with our recovery positions showing resilience amid the current environment: The chart on the following page shows that earning's estimates for our recovery positions have actually marched upwards through 2021 despite rising inflation and sporadic covid restrictions.

*https://www.bloomberg.com/news/articles/2021-12-27/fed-s-first-rate-hike-won-t-derail-equity-rally-crossmark-says?sref=EnJawTd3

Recovery Positions: Earnings have recovered and continued to grow



Source: Bloomberg

While inflation concerns have not translated to a hit on corporate profits, we also do not turn a blind eye to risks and continue to monitor our economic signals for warning signs. Till then, we expect the gradual recovery to continue. The only exception where estimates have worsened is China. However, this was largely due to a credit slowdown and regulatory crackdowns as mentioned before - these pressures are expected to ease going forward. In fact, we may even look to add to our position should conditions turn more favourable in the coming months.

As for the economy cooling due to an overtightening by the Fed; this is not yet a foregone conclusion. Tightening may very well secure an optimal balance between economic growth and curbing inflation. **Crucially, stocks have tended to continue rising following the first rate hike*** (the first hike is expected in the coming months). In the meantime, we utilize our 'FVT' process to allocate to markets expected to do well alongside the broader ongoing recovery, and with sufficient margin of safety so that we are more confident riding through short term noise and concerns.

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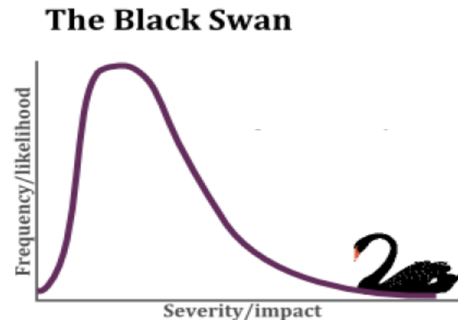
Key Themes: Stability Amid *VUCA*

VUCA is used to describe environments with **Volatility**, **Uncertainty**, **Complexity**, and **Ambiguity**

Proponents of Nicholas Nassim Taleb's Black Swan theory would be the the first to urge you not to over concentrate your bets, regardless of how convincing the existing set of facts stack up in your favour. After all, history has been disproportionately defined by unlikely Black Swan events that were, prior to occurring, difficult to predict and beyond the realm of normal expectations.



To ignore possibilities simply because they stand outside the current corpus of knowledge is a quintessential form of hubris. For it would only be a matter of time before one were caught unaware by a Black Swan event, meeting one's eventual demise.

One manner of preparing for Black Swan events would be to diversify and cater to a range of outcomes, even if some of these outcomes do not seem plausible or probable at the current point of time. The wisdom of doing so is apparent from the following comparison:

It is the year 1938. The possibility of World War Two breaking out is furthest thing from the mind of affluent investor A. Seeing no immediate reason why he should diversify, investor A decides to invest purely in apartments in Paris, France. Eventually, WWII breaks out and this investor finds no way of monetizing these assets. He becomes a displaced, impoverished refugee.

In contrast, there is affluent investor B. Like investor A, investor B has no reason to think that WWII is imminent. Despite so, she decides to diversify and builds a global apartment portfolio instead. When WWII breaks out, she finds herself safely ensconced in her apartment in Sydney, living on income from a second rental located in Thailand. She waits out the war in relative comfort and stability.

Hopefully, the narrative above has sufficiently illustrated the essential nature of diversification and why we incorporate diversification into portfolio construction. In fact, we incorporate more than geographical diversification and strive for the most robust form of diversification possible. This means: **(1) diversification across asset classes** (equities, bonds and alternatives), **(2) sectors and industries** (finance, consumer goods, healthcare, etc) and **(3) geographies** (China, Europe, US, etc).

As we head into an environment of rising volatility and eventual slowdown (while expansion is typically the longest phase, it also cannot last forever), it is even more important to ensure proper diversification. In our portfolios, we have recovery positions that are expected to do well as global economies continue to recover. We also diversify into Healthcare, which does not depend so much on economic growth to do well - **healthcare is primarily driven by secular trends such as an aging global population and enjoys stable and growing earnings, regardless of the general economic climate**. Ultimately, we may not be able to predict the next Black Swan event, or when the impending slowdown would happen exactly. However, if we prepare ourselves judiciously via robust diversification, then perhaps we can ride it out in relative comfort and stability like investor B.

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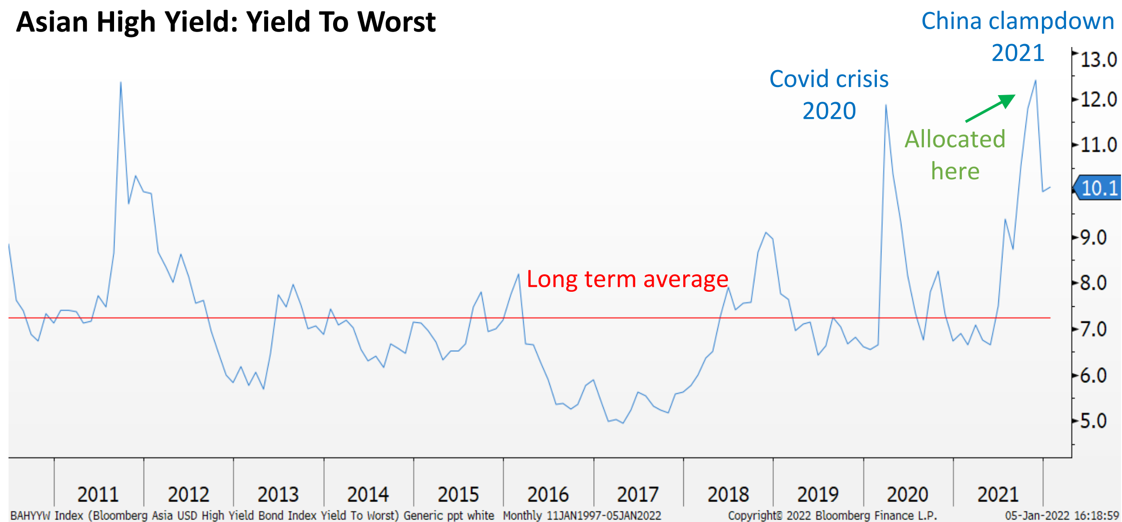
Key Themes: Search For Yield

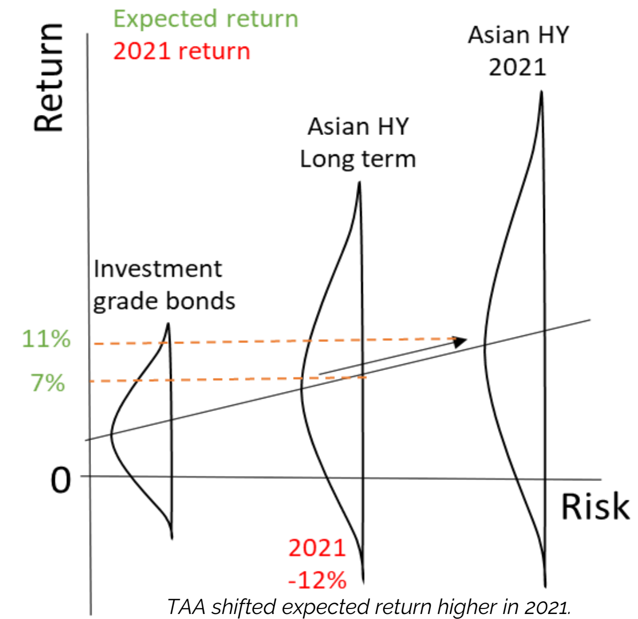
Where are we positioning for better returns in 2022? Actually we sowed the seeds for that during the China market stress in 2021. In October we allocated to Asian High Yield as markets were pricing in so much bad news as if it was the covid crisis in 2020. Indeed, the mood then was most pessimistic; This is exactly how we add value through our **TAA** (tactical asset allocation)

Asian High Yield: Yield To Worst



Source: Bloomberg. Bloomberg Asia USD High Yield Bond Index

How does our TAA add value? By taking advantage of market dislocations and allocating when others are fleeing, we have shifted expected returns for Asian high yield from the long term average of 7% to 11% going forward. Would returns overshoot on the upside? They potentially will as we saw how the S&P 500 did in our market review. Since yields peaked in March 2020 during covid, the subsequent one year return was 21%. A strong rebound from current conditions is also likely. Our base case is still 11% going forward but look to crystallize higher gains if opportunities present themselves.



TAA shifted expected return higher in 2021.
Source: Bloomberg. For illustrative purposes only and not drawn to scale.

How do we have confidence the return will happen? Recall in our previous commentaries that starting yields are a good predictor of future returns (202109 Commentary under 'Search for Yield')

Indeed, at current yields for Asian High Yield, investors who extrapolate Asian high yield's 2021 losses downwards will miss out. The table shows the yields of various bond markets. Where would you go for higher returns today?

Global Investment grade	Asia IG	US High Yield	Asia HY
1.37%	4.13%	4.33%	10.08%

Yield to worst of bond markets as at 5/1/2022. Source: Bloomberg. Global Investment grade bonds: Bloomberg Global Aggregate Index, Asia IG: Bloomberg Asia Credit, US High Yield: Bloomberg US Corp High Yield, Asian HY: Bloomberg Asia USD High Yield Bond Index

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Key Themes: How Are We Positioned?

Positioning for Economic Growth	Stability Amid *VUCA*	Search for Yield
China 'A' equities	Health Care equities	Asian High-yield bonds
Emerging Market equities		Emerging Market Short Duration bonds
US Small-cap equities		
Europe equities		
Quality Value		

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Asset Allocation Strategy

Equity: Regions	--	-	=	+	++	Allocation strategy
United States						**US Small-caps** as relative valuations attractive and are expected to benefit as economies recover. **Healthcare** as earnings are more stable and less dependent on broader economic cycle. **Quality Value** as valuations attractive, and expected to benefit as economies recover. Quality bias to avoid potential 'value traps'
Europe						Relative valuations are attractive, and expected to benefit as economies recover.
Japan		0%				Maintaining no exposure as they are less attractive compared to other opportunities.
Asia Pacific ex Japan						Maintain **China 'A'** slight overweight as deleveraging cycle has taken its course, with credit conditions expected to improve.
Emerging Markets						Neutral as valuations attractive relative to developed markets, but where earnings tend to be less resilient.
Fixed Income	**--**	**-**	**=**	**+**	**++**	**Allocation strategy**
Global						Focus on currency-hedged government bonds and unconstrained credit to buffer portfolio volatility during periods of stress.
Investment Grade Corporate	0%					Maintaining no exposure as low incremental yield and long duration credit exposure are less attractive than other segments.
US High Yield		0%				Maintaining no exposure due to relative poorer valuations.
Asia						Attractive yield across major fixed income markets with room for capital appreciation and better fundamentals.
Emerging Market Debt						Hard currency short duration focus as a more defensive credit investment amid low rates.

Notes: - - Underweight - Slight Underweight = Neutral + Slight Overweight + + Overweight

Current Previous

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Market Index Returns

Equity Regional	MTD	QTD	YTD
Global	4.02%	6.75%	19.02%
United States	4.47%	11.02%	28.68%
Europe	5.44%	7.64%	25.82%
Japan	3.45%	-1.74%	12.75%
Asia Pacific ex Japan	1.89%	-0.77%	-2.90%
Emerging Markets	1.81%	-1.36%	-2.47%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	-0.14%	-0.67%	-4.71%
Global Aggregate (Hedged)	-0.41%	0.04%	-1.39%
High Yield	2.13%	0.70%	4.51%
Asia	-0.10%	-1.29%	-2.09%
Emerging Market Debt	0.98%	-0.52%	-1.65%

Currencies	MTD	QTD	YTD
USD/SGD	-1.22%	-0.64%	2.03%
EUR/SGD	-0.91%	-2.42%	-4.97%
JPY/SGD	1.69%	3.41%	11.46%

Commodity	MTD	QTD	YTD
Gold	3.08%	4.11%	-3.64%
Oil (WTI Crude)	13.64%	0.24%	55.01%

Equity Markets	MTD	QTD	YTD
Australia	2.76%	2.26%	18.65%
Brazil	2.85%	-5.55%	-11.93%
China “A”	2.24%	1.61%	-3.51%
China “H”	-1.57%	-5.60%	-21.25%
Hong Kong	-0.31%	-4.69%	-11.84%
India	2.11%	-1.32%	23.23%
Indonesia	0.86%	5.00%	12.46%
Korea	4.91%	-2.95%	4.15%
Malaysia	3.68%	2.46%	0.33%
Russia	-1.67%	-6.38%	21.88%
Singapore	2.91%	1.75%	13.55%
Taiwan	4.68%	7.74%	26.92%
Thailand	5.68%	3.40%	17.70%

Equity Sectors	MTD	QTD	YTD
Gold	2.18%	10.58%	-9.37%
Energy	3.08%	7.89%	54.39%
Technology	2.61%	13.30%	30.14%
Healthcare	7.40%	7.98%	20.34%
Financials	3.28%	4.52%	34.87%

Total return in local currency terms as of **31 December 2021**
Source: Bloomberg

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