Monthly Investment Update
August 2019

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Market Review: Fixed Income

Last week's Straits Times headline "Singapore shares fall amid global plunge after Trump tariff blow" succeeded in causing concern among investors. The "fall" in question was a decline of 1.34% for the STI (Straits Times Index) on Thursday.

Over the past 10 years (or 2508 trading days), the STI index had 130 days worse than 1.2%. This means that for 5.2% of the time, or once every 19 days, there were some worried investors. This is in the context of the **STI returning 5.6% per annum while global equities returned 9.4% per annum** (we have little exposure to Singapore stocks as we manage our home bias). That means an investor who was on the way to compounding their wealth had (or chose to have) a panic attack about every month.

This is not to trivialize the fact that markets are volatile, and do drop. One needs to take risk to be compensated; this is true for business, investments, even relationships. The tricky thing is investing as an activity is innocuously doable by anyone, as opposed to say, medicine i.e. a layperson will more likely feel they can be successful at investing compared to carrying out surgery. This is despite studies* that show the average investor earns much less than what fund performance reports suggest.

Just like in other industries, **we are conditioned to take the stress associated with our profession**. It is not a stress that we wish on our investors; it should be delegated to us.

*https://thereformedbroker.com/2017/12/28/investors-underperforming-their-own-investments-2/
https://www.dalbar.com/QAIB

That does not mean ignore your investments. Our investors have long term horizons, and should not be stressed by short term effects. Do read our April investor letter where we discuss less stressful ways to monitor your portfolio and achieve investment goals.

Some investors asked if it was appropriate to go to cash after the strong performance in the first half of the year. Markets responded by rising further in July. **Currency-hedged bonds** gained 0.79% while **unhedged bonds** declined -0.28%. This was amidst the backdrop of markets previously pricing in too many rate cutes by the Fed, resulting in July losses for those who bet excessively on bonds and against the USD.

On the credit front, **global high yield bonds** returned 0.45-0.58%, which is in line with our expectations that returns from these segments would be driven by coupon as opposed to capital appreciation. **Emerging market bonds**, which have been profitable but lagging earlier this year (3.4%), played catch up to close the gap with their developed market counterparts with gains of 6.5%. This shows that while **it is not possible to pinpoint when the returns will show up, they eventually will so long as the investments are selected using a robust framework as shown below.**

Yield and YTD return for high yield and emerging market bonds

	US short duration high yield	Emerging market short duration debt
Yield at 31 Dec 2018	8.2%	5.6%
YTD return as at 31 Mar 2019	5.7%	3.4%
YTD return as at 31 July 2019	7.6%	6.5%

Source: Bloomberg

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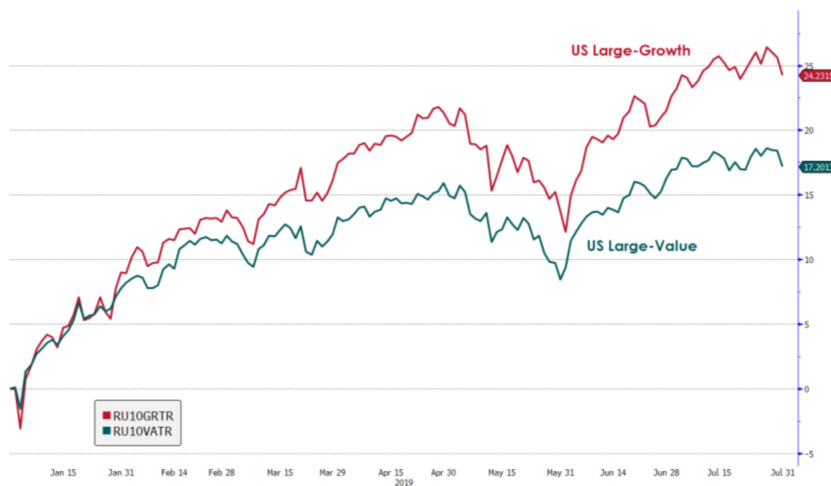
Market Review: Equities

US corporates report better earnings than consensus estimates

***S&P 500 Earnings Surprise** as of 2 Aug 2019	
% Positive Surprise	73.3%
% Negative Surprise	23.2%

Our Growth-bias outperformed meaningfully YTD



Source: Bloomberg

Equity markets eked out small gains in July as the tug-of-war between weaker economic growth and supportive central bank policies continued to drive markets. **Our portfolios benefitted as growth-stocks extended their outperformance over value-stocks YTD, vindicating our early assessment that economically-sensitive companies (a large part of value indices today) would face headwinds in a slower growth environment.**

US equities continue to lead gains over the past month, spurred on by a generally positive earnings reporting season*. A few tech-related stocks saw strong gains; with Apple (+7.6%), Google (+12.5%), and Microsoft (+1.7%) contributing meaningfully to overall benchmark returns.

European equities gained marginally in July, as the economically-sensitive financial sector detracted from returns. Euro-area manufacturing data fell further into contractionary territory in July, increasing bets on more accommodative ECB policy going forward (the tug-of-war we were referring to). **We maintain the view that the divergence in slowing economic activity, with increasingly rich market valuations have reduced the risk/reward proposition in the region, having already exited our European equity exposures in June.**

Japan did better over the past month, though still lagging the other major markets YTD. Even as Japanese equities remain attractively-valued, we are increasingly wary of the impact of slower growth on corporate earnings and are closely monitoring developments here.

China 'A', where we are overweight, managed modest gains even as the broader Asian market was down 1.65% in the past month. Notably, China 'H' (Chinese companies traded on the Hong Kong Stock Exchange, and a large part of Asia ex. Japan) did much worse, declining 1.9% over the same period. Emerging Market stocks underperformed as the USD strengthened, which is typically a headwind for EM companies that borrow in USD e.g. loan principal and interest payments go up.

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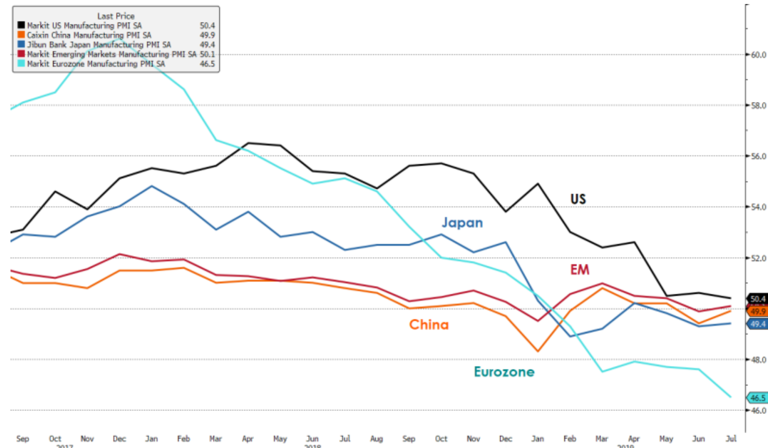
Key Themes: Slowing Growth

Global manufacturing activity is contracting…



…though investors tend to get rewarded for staying invested

US S&P 500 performance 12 months after initial contraction	
Average gains	9.6%
% positive returns	72%

Contraction defined as the initial month after the ISM Manufacturing PMI falls below 50, since 1980.

Source: Bloomberg

We mentioned last year that even though the economies were in late stage growth, strong but volatile gains could still lay ahead. If investors took profit when global manufacturing activity began to contract at the start of the year, they would have missed out of the strong gains YTD. Rather than rely on just a few observations, we were guided by our FVT (Fundamental, Valuation, Technical) framework to stay invested. Similarly, a manufacturing contraction may not be too much of a concern on its own– in the past, the S&P 500 has gained more than 9% on average in the following 12 months after a contraction. That said, weakening fundamentals would likely lead to more volatility going forward. **Though a recession is not our base case, we place a stronger emphasis on investments with higher earnings predictability that would hold up better in a less favourable economic environment i.e. Quality-Growth and Health Care companies.**

We continue to prefer US large-growth companies versus the other segments. With increased uncertainty we look to invest in quality businesses with low debt, stronger earnings, and overall healthier balance sheets; which make them more resilient in a slowdown. As growth slows in a late cycle economy, we prefer not to invest in cyclical businesses that may find it challenging to grow their earnings.

China 'A' equity valuations remain reasonable even after a 27% gain YTD. Though not as cheap as earlier this year, they are still hovering around their historical average. Earnings growth have also held up well despite the US-China trade tensions. Going forward, the Chinese government is expected to continue with additional policy stimulus to support the economy and markets amidst a more uncertain backdrop.

Our allocation to Japan was expected to outperform with attractive valuations, and on growth picking up. However, growth has remained lacklustre, and profit margins deteriorating. For now, we maintain our slight overweight on attractive valuations. That said, if the growth dynamics deteriorate even further, we would look to adjust our positions.

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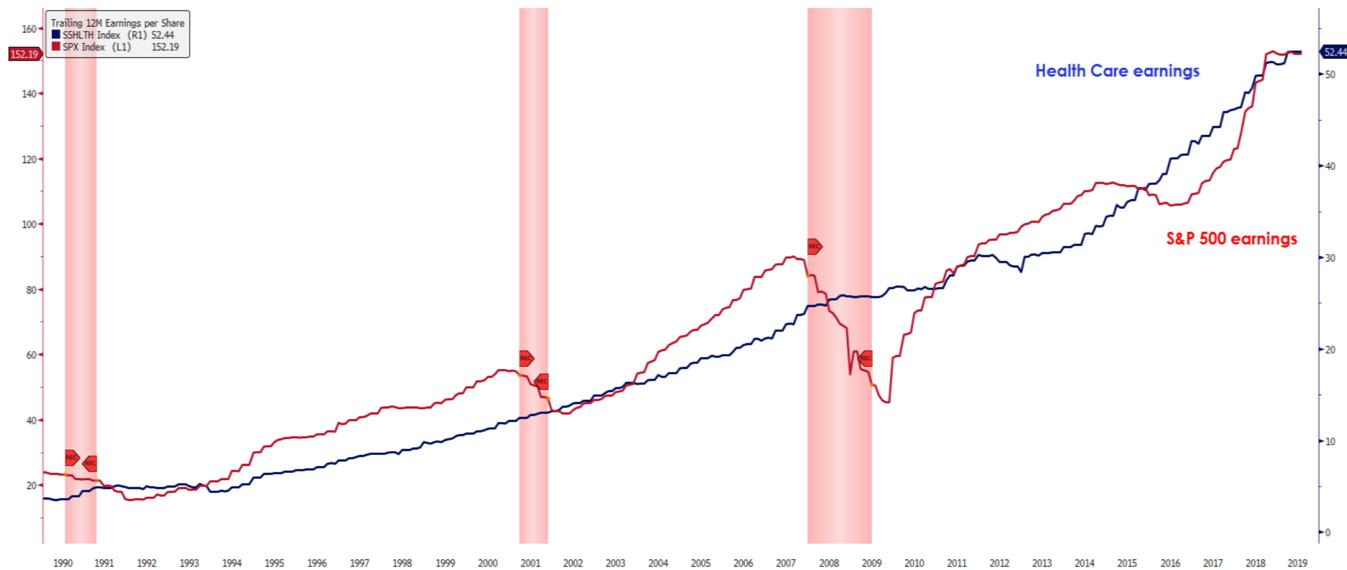
Key Themes: Slowing Growth

Last month, we re-allocated our European equity exposures (effectively bringing holdings to zero) into the Global Health Care sector, where earnings are generally less correlated to the broader economic cycle i.e. Health Care earnings are resilient during recessions whereas earnings for the broader market decline. Health Care valuations are also broadly in line with historical average, which means that we are not overpaying to be invested here.

European equities have done well YTD despite an outsized slowdown in economic activity, which make it a more challenging risk/reward for investors going forward i.e. upside is limited if the economy recovers, and there is greater downside if the economy continues to slow. Valuations for European large-growth companies continue to be expensive relative to the broader market, with earnings moderating. On the other hand, cheaper value stocks have a large cyclical component which are similarly unattractive as growth slows; the latest euro-zone manufacturing data showed further contraction in July. Neither heads (expensive large-growth companies) nor tails (cheaper value stocks facing strong headwinds) are attractive in Europe, and we choose to avoid such investments altogether.

Health Care earnings are more resilient than the broader market in an economic downturn



Shaded areas indicate recessionary periods.

Source: Bloomberg

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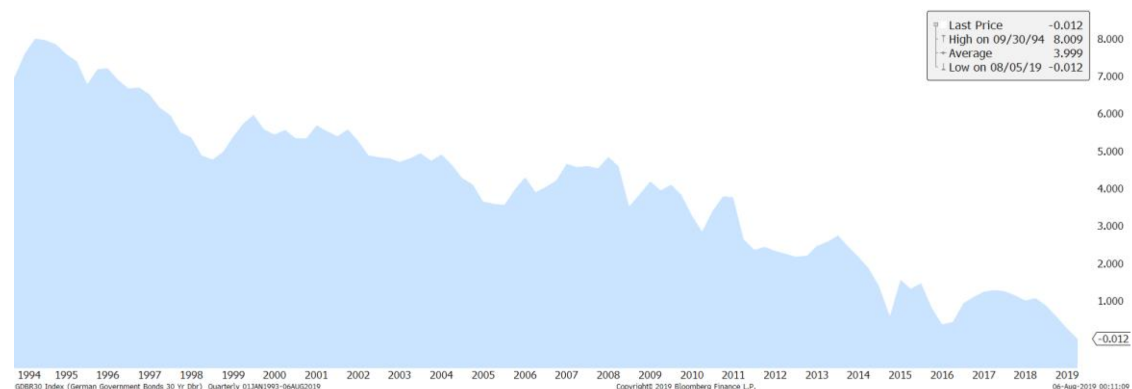
Key Themes: Central bank easing?

Imagine driving a car that is accelerating non-stop on a highway. One would instinctively slow down by tapping on the brakes. This was the series of interest rate hikes since 2016 to prevent the economy from overheating. During this period, it was obvious to maintain short duration due to the clear hiking policy.

Last month, we said that it's tough to predict what a central banker is going to do. Accordingly, this theme has been phrased as a question because it is precisely so: **central bank policy is not clear**. Despite the Fed's first rate cut in a decade, the jury is out on whether it is politically motivated, caving in to market expectations, or a short term policy response (the jargon "insurance cut" being used liberally recently). Is the recent cut a tap on the accelerator to get the car out of a slow corner back onto the growth highway, or will it be a few more pumps on the accelerator to prevent the economy from grinding to a halt?

Fundamentals help us to filter opportunities with potential, and **we increase likelihood of turning this potential into profit by assessing valuation to determine what is already priced in**. We were recently asked, if we look at valuation, does that not mean we are value investors? No, we are not value investors in the textbook sense nor would a style analysis identify value as a significant structural exposure in our portfolios. However, all opportunities across fixed income and equities have their own "valuation" metrics which help us determine which are more or less attractive in different environments.

Sovereign bonds: Sovereign bonds are the safe-end of our portfolio barbell. We try to optimise this safety against its cost/benefit. For the most part, investors in longer-dated bonds tend to get low positive yields i.e. one gets a positive return on safe assets. **This changed recently as yields in 30-year German bonds went negative (refer to chart below) i.e. investors are paying to park their money with the German government for 30 years.** Despite the obvious negative return expectation, certain benchmark-constrained investors still need to invest in such assets. We do not have such constraints. The portfolios' currency-hedged sovereign bond exposures have modest positive return expectations while serving as a flight to quality asset.



Short duration: We emphasise the short duration exposures on our credit exposures i.e. high yield and emerging markets. Just like those who advocate investment grade bonds with the intention of tilting the portfolio more defensively, **short duration credit is expected to drop less during stress.** The difference is until that happens, investors continue to be rewarded for taking credit risk in high yield and emerging markets while those who do so in investment grade corporate debt have reduced their downside but also precluded themselves from much upside despite taking credit risk.

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Key Themes: Search for yield

Asian High Yield, US & EM short duration provides attractive yields

	31 Jul 2019
Asia HY	**6.6%**
US HY short dur. bonds	**5.6%**
US HY bonds	5.8%
EM short dur. bonds	**4.6%**
EM bonds	4.8%
Global investment grade corporate	2.4%

Much more attractive than what bank deposits offer today

SGD 1Y deposit	1.7%
USD 1Y deposit	2.4%

Source: Bloomberg

One might wonder why we have been showing the yields of credit investments alongside deposit rates; clearly the risks are different. Is it a fair apples to apples comparison? Bonds have been largely split into "investment grade" and "high yield" (used interchangeably with "junk bonds"). Implicit in this is that investment grade bonds are better and safer, while junk bonds are not. **When we recently reviewed the yield for global investment grade bonds, it seemed like there was something wrong with our data. Global investment grade corporate bonds with maturities of 9 years were yielding 2.4%, the same as 1-year deposits**. Yes, investment grade bonds tend to be issued by better known companies but investors are now not getting paid much to take extra risk in such "better and safe" corporate bonds. Turns out there was nothing wrong with our data. This is why we pay attention to valuation as it is an important determinant of whether we profit rather than just pick what is "better".

US High Yield: Our thesis for short duration is not just about getting comparable yields to the longer duration counterparts. **Short duration credit exposures are expected to more defensive in a downturn**, which is in line with our strategy of creating a more robust portfolio for this stage of the economic cycle.

EM bonds: Again, while we position the portfolios to capture return, we do it in areas where we have greater confidence in the underlying risks. In a period of slowing growth, **it is prudent and appropriate to seek returns from hard currency bonds** instead of taking excessive emerging currency exposure via local currency bonds.

Asian High Yield: While we expect most credit returns to be driven by coupon, Asian High Yield **is one of the segments globally that has room for capital appreciation**. We do see some isolated instances of companies not being able to meet loan payments, and are watching for signs of worsening conditions and potential contagion to reduce risk in the portfolio.

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Key Themes: How are we positioned?

Slowing Growth	Central Bank Easing	Search for Yield
US Quality Growth equities	Short duration bonds	Asian High-yield bonds
Health Care equities		Emerging Market short duration bonds
Japan equities		
China 'A' equities		

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Asset Allocation Strategy

Equity Regional	--	-	=	+	++	Allocation strategy
United States			■			Large cap growth to capture late business cycle growth, and where large caps are more resilient to rising financing and wage costs. Health Care as earnings are less dependent on the broader economic cycle.
Europe	■					Maintaining no exposure as economic activity is slowing meaningfully, and as valuations are rich.
Japan				■		Slight overweight as economy is supported by corporate reforms, and equities at attractive valuations.
Asia Pacific ex Japan				■		Slight overweight to China 'A' as valuations are attractive and supported by earnings growth.
Emerging Markets			■			Weaker-stable USD may help to support equities in the region.

Fixed Income	--	-	=	+	++	Allocation strategy
Sovereign			■			Focus on currency-hedged global government bonds to buffer portfolio volatility during periods of stress.
Investment Grade Corporate	■					Maintaining no exposure as low incremental yield and long duration exposure are less attractive than other segments.
High Yield			■			Maintain short duration which provides better yield to broad market with less sensitivity to interest rate changes.
Asia				■		One of the most attractive yields across major fixed income markets backed by policy support and sentiment.
Emerging Market Debt				■		Range-bound USD eases downward pressure on EMD which adds to portfolio diversification.

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

Current Previous

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Market Index Returns

Equity Regional	MTD	QTD	YTD
Global	0.17%	0.17%	15.07%
United States	1.31%	1.31%	18.89%
Europe	0.23%	0.23%	14.25%
Japan	0.90%	0.90%	4.76%
Asia Pacific ex Japan	-1.65%	-1.65%	8.81%
Emerging Markets	-1.69%	-1.69%	7.38%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	-0.28%	-0.28%	5.28%
High Yield	0.45%	0.45%	11.34%
Asia	0.58%	0.58%	8.11%
Emerging Market Debt	1.00%	1.00%	10.48%

Currencies	MTD	QTD	YTD
USD/SGD	1.57%	1.57%	0.84%
EUR/SGD	-1.10%	-1.10%	-2.61%
JPY/SGD	0.75%	0.75%	1.62%

Commodity	MTD	QTD	YTD
Gold	0.32%	0.32%	10.25%
Oil (WTI Crude)	0.19%	0.19%	29.00%

Equity Markets	MTD	QTD	YTD
Australia	2.93%	2.93%	20.65%
Brazil	0.84%	0.84%	15.84%
China "A"	0.26%	0.26%	27.39%
China "H"	-1.90%	-1.90%	5.44%
Hong Kong	-2.68%	-2.68%	7.48%
India	-4.86%	-4.86%	3.92%
Indonesia	0.50%	0.50%	3.16%
Korea	-4.98%	-4.98%	-0.81%
Malaysia	-2.23%	-2.23%	-3.30%
Russia	-0.95%	-0.95%	15.62%
Singapore	-0.63%	-0.63%	7.56%
Taiwan	0.87%	0.87%	11.27%
Thailand	-1.06%	-1.06%	9.47%

Equity Sectors	MTD	QTD	YTD
Gold	4.57%	4.57%	27.38%
Energy	-1.87%	-1.87%	9.06%
Technology	2.83%	2.83%	29.42%
Healthcare	-1.17%	-1.17%	7.48%
Financials	2.30%	2.30%	18.58%

Price returns in index currency terms as of 31 Jul 2019. Source: Bloomberg

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