Monthly Investment Update
September 2019

finexis

Market Review: Fixed Income

The summer months from June to September represent a time for holidays and conjure up images of a relaxing day at the beach. Where this relates to investments is that many market participants also head off for long vacations, resulting in less efficient price discovery and leading to volatile moves away from fair value. A summary of the S&P 500 quarterly performance over the past 30 years indicates that the third quarter is both more volatile and has a higher proportion of negative returns.

S&P 500 Index	Q1	Q2	Q3	Q4
Annualised Volatility	13.71%	13.14%	**16.22%**	16.95%
Percent negative returns	33%	37%	**37%**	21%

There is a similar effect for emerging markets, albeit with even larger spike in volatility. Perhaps that is due in part to the Western "tourist" investors who have shifted their attention from the markets to the beach?

MSCI Emerging Markets	Q1	Q2	Q3	Q4
Annualised Volatility	18.24%	24.57%	**28.44%**	27.27%
Percent negative returns	27%	53%	**53%**	34%

Source: Bloomberg, Quarterly returns of S&P 500 and MSCI Emerging Markets index from 1990 to 2019.

We've been highlighting that volatility is expected to increase at this stage of the economic cycle. Imagine this cyclical increase together with the seasonal rise above. Clearly that can be discomforting for investors who have been experiencing smoother rides earlier. But as we come to understand (and embrace?) these as the natural ebb and flow of the markets, such changes in volatility will be less uncomfortable.

After a record rally in the first half of the year, August saw risk aversion and a correction that was more acute in emerging markets. We construct the portfolio using the range of tools (weapons) at our disposal. In a negative month, the USD-centric exposures performed as expected. Currency-hedged bonds are the shield in the portfolio, gaining 2.3% while unhedged bonds rose 2.03%.

August was trickier for our credit investments. In the context of a correction, yields tightened and benefitted longer duration exposures, while credit spreads widened slightly, affecting credit investments. The absence of a larger widening of credit spreads typical of stressed conditions meant that short duration credits underperformed. As an illustration, short duration high yield bonds were flat while the broader high yield market was up 0.51%.

Asian high yield bonds were one of the worst performing credit segments in August, down 1.02%. As an overweight exposure, Asian high yield has been offering the best risk-adjusted returns year to date with returns of 10.02% and volatility of 2.3%, whereas global high yield returned 11.91% with volatility of 3.7%. Of course, we could not have forecasted this superior risk-adjusted return at the beginning of the year. But what we did was to identify and invest in credit segments with better valuations and lower risk (lower duration), then have a higher probability of getting better outcomes.

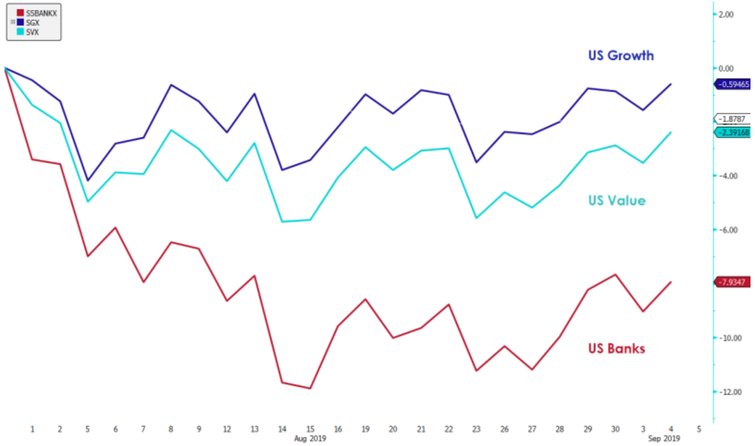
Emerging markets experienced some drama due to large declines in Argentina's currency (-26%) and USD bonds (-38%) arising from political uncertainty. Is it because of the reduced investor participation due to the summer lull, or is it a canary in the coalmine?

Market Review: Equities

An escalation in US-China trade relations, coupled with an inversion of an important part of the yield curve (historically a precursor to recessions) led to more risk-averse markets in August. Subsequently, economically-sensitive stocks declined the most. In contrast, certain high growth market segments (e.g. US Growth) were more resilient alongside other more traditional defensive Healthcare and Consumer Staples sectors. In general, market participants continued to weigh the continued deterioration in economic data against expectations of more accommodative central bank policies, which are expected to support economic growth and risk assets.

Source: Bloomberg

As recession concerns rose, cyclical sectors saw the sharpest declines

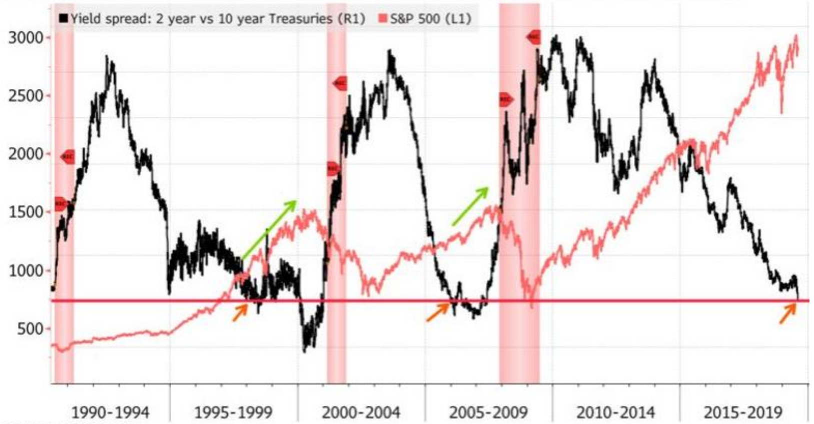


Our preferred exposures held up well in a turbulent August

Overweight (We prefer)	**Underweight** (Minimal to 0% exposure)	**1M Relative Performance** (Measured in USD)	**Market Observations**
US Growth	US Value	**+2.2%**	As economic indicators continued to moderate, growth stocks extended their outperformance over value stocks in a choppy August. US financials, a large component of 'value', saw outsized declines as interest rates fell even further (lower rates are typically bad for bank profitability). Within the US growth-segment, our preferred *higher quality* companies were even more resilient.
Global Healthcare	Europe	**+2.7%**	Our rotation out of European equities and into Healthcare in July proved timely, as European equities fell 1.6% in the past month. Unhedged-dollar investors got the short end of the stick, as currency effects further exacerbated equity declines by another 1 percent. Global Healthcare stocks outperformed as they were roughly flat for the month.
China 'A'	Asia ex. Japan	**-0.1%**	Even as US-China trade tensions dominated news headlines the past month, our overweight allocation in China 'A' equities have performed in line with the broader Asia ex. Japan equities markets, when measured in USD terms. Year-to-date, the China 'A' share market is up 23.9%, in contrast to the more modest 6.3% gain in the broader Asia ex. Japan market.
Japan currency-unhedged	Japan currency-hedged	**+2.0%**	Our portfolios are deliberately exposed to movements in the JPY, as we seek out its its safe-haven characteristic during market stresses. i.e. our Japanese equity exposures are not currency-hedged. This has helped to offset portfolio losses as volatility rose in August - JPY gained 3.4% and 2.4% against SGD and USD respectively.

Key Themes: Slowing Growth

While yield curve inversions have preceded recessions, stocks tend to keep rising



Source: Bloomberg

We have showed before that deteriorating economic indicators (manifested as economic slowdowns in newspaper headlines) do not necessarily lead to negative returns. Indeed, 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. Similarly, we know that the occurrence of **a yield curve inversion alone should not be taken as a signal for investors to take money off the table. While investors should expect more volatility, history tells us that there may still be some time for astute investors to harvest more gains from the market.**

That is not to say we ignore these economic indicators. Each one is not necessarily helpful for investment decisions, but we lean on a combination of Fundamental (such as manufacturing activity, or yield curve inversions), Valuation and Technical 'FVT' inputs in guiding us to be positioned in areas with higher probability of gains. Over the course of the year, these inputs have led us to be invested into markets which are more resilient in the face of slowing growth, or where we see compelling value:

We continue to prefer US quality-growth companies versus the other segments. With increased uncertainty we emphasis on 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. Quality growth outperformed in August, as markets were more volatile.

China 'A' equity valuations remain reasonable even after a 26.2% gain YTD. Though not as cheap as earlier this year, they are still hovering below their historical averages. 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.

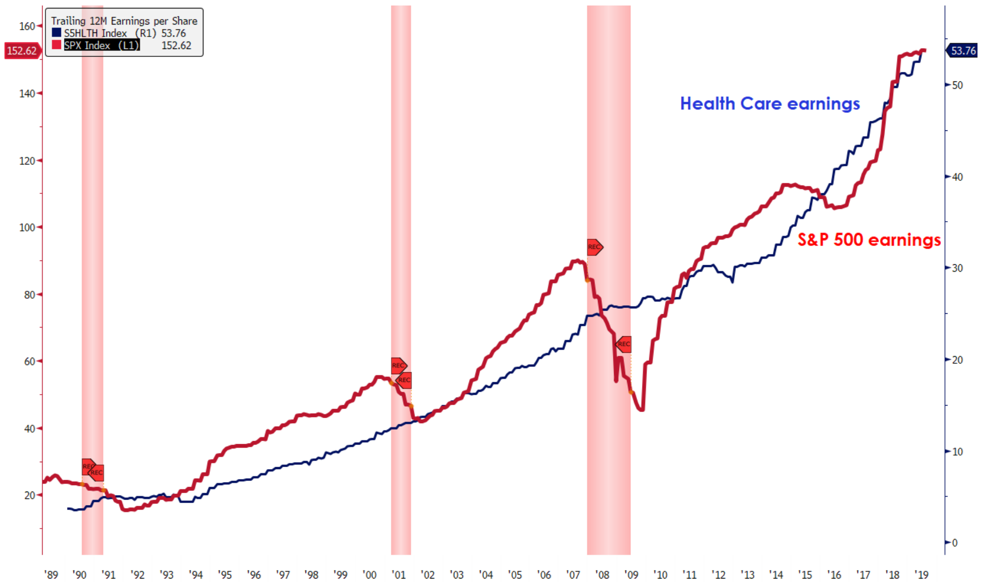
Our allocation to Japan was expected to outperform with attractive valuations, and on growth picking up. However, growth has remained lacklustre, and profit margins deteriorating. For now, we maintain our slight overweight on attractive valuations. We also expose our portfolios to the JPY currency, which acts as a safe-haven during market stresses. That said, if the growth dynamics deteriorate even further, we would look to adjust our positions.

Key Themes: Slowing Growth

In July, we re-allocated our European equity exposures (effectively bringing holdings to zero) into the Global Healthcare 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. Our rotation proved timely, as Healthcare outperformed European equities by 2.7% (USD terms) in August.

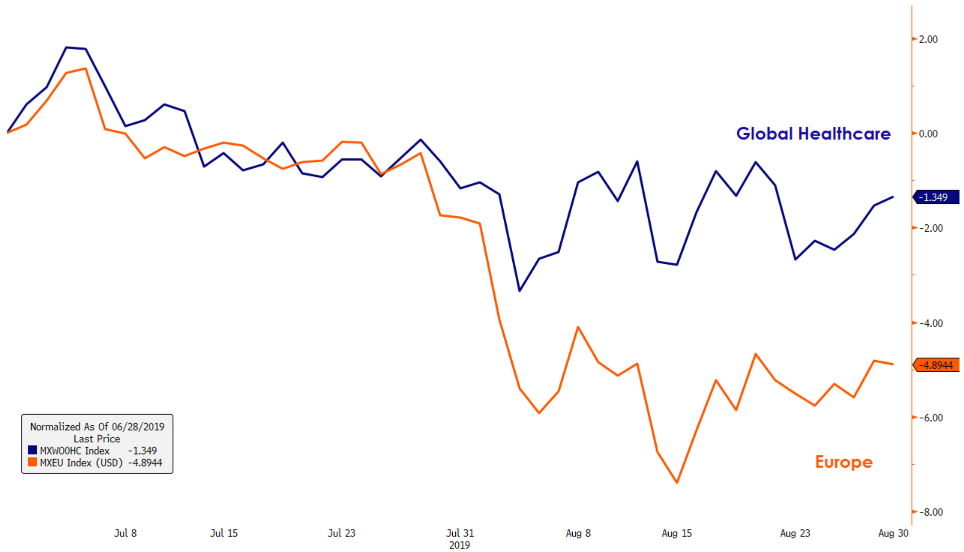
European equities have done well YTD despite an outsized slowdown in economic activity, which make it a more challenging risk/reward for investors going forward i.e. upside is limited if the economy recovers, and there is greater downside if the economy continues to slow. Valuations for European large-growth 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 in an economic downturn



Shaded areas indicate recessionary periods.

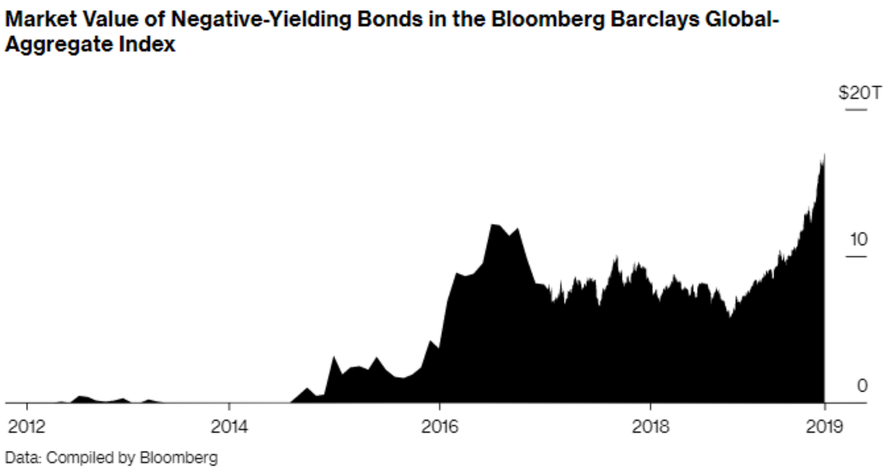
Global Healthcare stocks held up better in last month's market decline



Source: Bloomberg

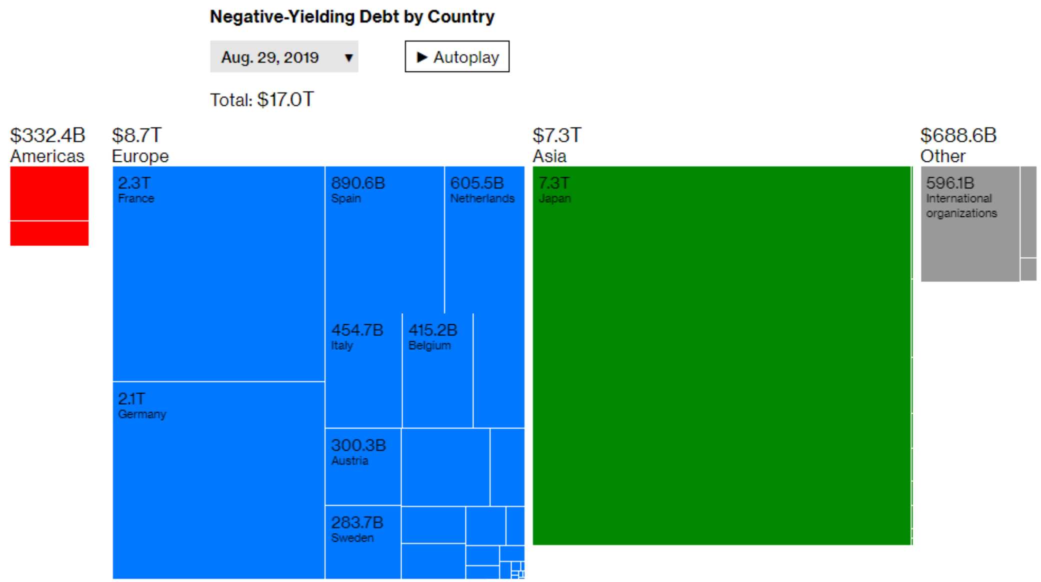
Key Themes: Central bank easing?

Since the start of QE, bond investors have gone from a low yielding world to a negative yielding world. Last month we showed how 30-year German bond yields went negative i.e. investors are paying to park their money with the German government for 30 years. In terms of opportunity set, investors have been facing an expanding universe of negative yielding bonds in the recent years. This is expected to worsen if the Fed starts to ease and reduce rates further.



Recently a fund manager was interviewed on one of the leading financial media and effectively said that in the current environment, fixed income managers are seeking areas where they would lose less. Certainly, benchmark-constrained managers find their hands tied when their investment universe is increasingly filled with negative return expectations.

Sovereign bonds: European and Japanese bonds currently dominate the set of negative yielding bonds globally. Even though sovereign bonds are the safe-end of our portfolio barbell, we are not compelled to accept the negative yields. The portfolios' currency-hedged sovereign bond exposures have modest positive return expectations while serving as a flight to quality asset.



www.bloomberg.com/graphics/negative-yield-bonds/

Short duration: For our credit investments i.e. high yield and emerging markets, the short duration nature is analogous to a sword that can be used for defense, whereas longer duration credit is more like an attacking focused sword. Short duration credit is expected to be more resilient than longer duration credit in a large sell-off e.g. 2008 Global Financial Crisis, and that is how the portfolio has been structured for this phase of the economic cycle.

Key Themes: Search for yield

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

	30 Aug 2019
Asia HY	**7.2%**
US HY short dur. bonds	**5.6%**
US HY bonds	5.6%
EM short dur. bonds	**5.0%**
EM bonds	4.9%
Global investment grade corporate	2.1%

Much more attractive than what bank deposits offer today

SGD 1Y deposit	1.6%
USD 1Y deposit	2.1%

Source: Bloomberg

US High Yield: Investors who have followed our positioning might note that we have favored high yield (junk bonds) tactically, while seemingly never liked investment grade corporate bonds. Does that mean we are risk-seeking junkies who always invest in bonds with lower ratings in order to get returns? Last month, we discussed how Global investment grade corporate bonds had similar yields as 1-year deposits, which means investors are not getting compensated to take on extra risk in bonds of blue-chip companies. This phenomena continues to persist in August; global investment grade corporate bonds with maturities of 9.5 years are yielding 2.1%, the same as 1-year deposits. We do not eschew from investment grade corporate bonds and will invest in them when the risk-reward is attractive. It's just that for quite some time they present limited upside and quite a bit of downside; not our type of investment.

Asian High Yield: This segment has been delivering one of the best absolute and risk-adjusted returns this year. Nevertheless, it is important to note that credit investing (or any investing) is not without risk. Markets have been able to digest the isolated stresses; bond defaults have not caused systemic concerns. Valuations have actually improved and Asian high yield continues to be one of the few credit segments globally with room for capital appreciation. We are monitoring for signs of worsening conditions and contagion such as more companies struggling to repay debt and defaulting.

EM bonds: A few investors may remember that a good number of crises were linked to emerging markets e.g. the 1998 Russian bond crisis, 1994 Mexico Tequila crisis, and 1997 Asian crisis following the Thai baht devaluation. Such crises are actually more frequent than we think. Last year there was the Turkey crisis where Turkish government USD bonds dropped 15.3% and were up 21.5% thereafter. All in, investors in Turkish bonds have been compounding at 8% annually. We do not profess to have the ability to sell before the drops and buy at the bottoms. What we do is structure the portfolio to capture upside while managing the risks. Currently, the emerging market exposures are more conservative in the form of hard currency short duration debt.

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		

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			■			Maintain neutral allocation as valuations are at historical averages, and where earnings have moderated.

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 with room for capital appreciation.
Emerging Market Debt				■		Hard currency short duration focus as a more defensive credit investment for the late-stage economic cycle.

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

Current Previous

Market Index Returns

Equity Regional	MTD	QTD	YTD
Global	-2.57%	-2.40%	12.12%
United States	-1.81%	-0.52%	16.74%
Europe	-1.63%	-1.40%	12.39%
Japan	-3.40%	-2.53%	1.19%
Asia Pacific ex Japan	-4.71%	-6.29%	3.68%
Emerging Markets	-5.08%	-6.69%	1.92%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	2.03%	1.75%	7.42%
High Yield	0.51%	0.97%	11.91%
Asia	1.44%	2.03%	9.66%
Emerging Market Debt	0.25%	1.25%	10.75%

Currencies	MTD	QTD	YTD
USD/SGD	0.94%	2.53%	1.78%
EUR/SGD	0.11%	-0.99%	-2.51%
JPY/SGD	3.38%	4.15%	5.06%

Commodity	MTD	QTD	YTD
Gold	7.53%	7.86%	18.55%
Oil (WTI Crude)	-5.94%	-5.76%	21.34%

Equity Markets	MTD	QTD	YTD
Australia	-3.06%	-0.22%	16.96%
Brazil	-0.67%	0.17%	15.07%
China “A”	-0.93%	-0.68%	26.20%
China “H”	-5.55%	-7.34%	-0.41%
Hong Kong	-7.39%	-9.87%	-0.47%
India	-0.40%	-5.23%	3.51%
Indonesia	-0.97%	-0.47%	2.16%
Korea	-2.80%	-7.64%	-3.59%
Malaysia	-1.39%	-3.59%	-4.64%
Russia	0.02%	-0.93%	15.65%
Singapore	-5.88%	-6.48%	1.23%
Taiwan	-1.90%	-1.05%	9.16%
Thailand	-3.33%	-4.36%	5.82%

Equity Sectors	MTD	QTD	YTD
Gold	11.60%	16.70%	42.16%
Energy	-8.73%	-10.44%	-0.47%
Technology	-2.29%	0.47%	26.46%
Healthcare	-0.18%	-1.35%	7.29%
Financials	-5.07%	-2.89%	12.57%

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

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