JULY 2023

THIS TIME IS DIFFERENT...OR IS IT?

Monthly Investment Update

Foreword

During last year's unprecedented bond market and equity declines, it paid off to be truly diversified as we benefitted from exposures to alternatives and avoiding overvalued markets.

This year, in what Blackrock calls "an unusual equity market", 7 stocks essentially propped up the markets they were in, the tech-heavy Nasdaq in particular. In contrast, the Dow Jones index, which represents the broader US economy, is flat.

A small number of stocks rising while others are not is called a narrow rally. To some, a rally is a rally, it does not matter how or why. Others may even wonder "Is diversification dead?"

This rally has left many who missed the boat with a conundrum: Should they stay out of the game, or should they chase the narrow tech rally?

However, there is good news. Our positions are poised to provide meaningful return without having to worry about whether there will be catastrophic losses following a sharp rally.

The four most dangerous words in investing are "this time it's different". I have seen so many investment portfolios lose money because of this. Investors trust us with their assets, the last thing they want is for anyone to jeopardize their nest eggs by going "all-in".

Alvin Goh
Chief Investment Officer

Finexis Asset Management

MARKET REVIEW

Last year saw one of the fastest rate hike cycles in decades, resulting in unprecedented declines in popular bond markets, with immediate impact on investors with traditional fixed income exposures.

More than a year on, the real economy impact of the rate hikes are manifesting. Financial institutions that were not managing their risk well (e.g. SVB, Credit Suisse) found themselves out of business. Highly acquisitive property investors are being hit with a double whammy of declining rental income, and facing a refinancing cliff as the low rates they enjoyed before are expiring.

Even up to a month ago, many were worried about the debt ceiling and bank blow-ups. Yet amid this challenging backdrop, widely followed markets such as the S&P and Nasdaq have rallied this year, driven by a small segment of tech stocks. In the blink of an eye, the market is transfixed on a group of stocks called the Magnificent 7: Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA and Tesla.

Essentially, in order to make money from the Magnificent 7, at the start of the year one would have had to:

1. Ignore the fact that the US economy was lacklustre, and
2. decide to plough their investments into 7 stocks out over 90,000 globally.

Clearly that was very hard to do before these stocks rallied. Now with the benefit of hindsight, **the question that investors have would be "should I buy these winners?"**

Blackrock described this year's rally as "an unusual equity market". It is unusual but not unprecedented. The chart below shows how much the top stocks are as a percent of total market capitalization over time. The key observations are:

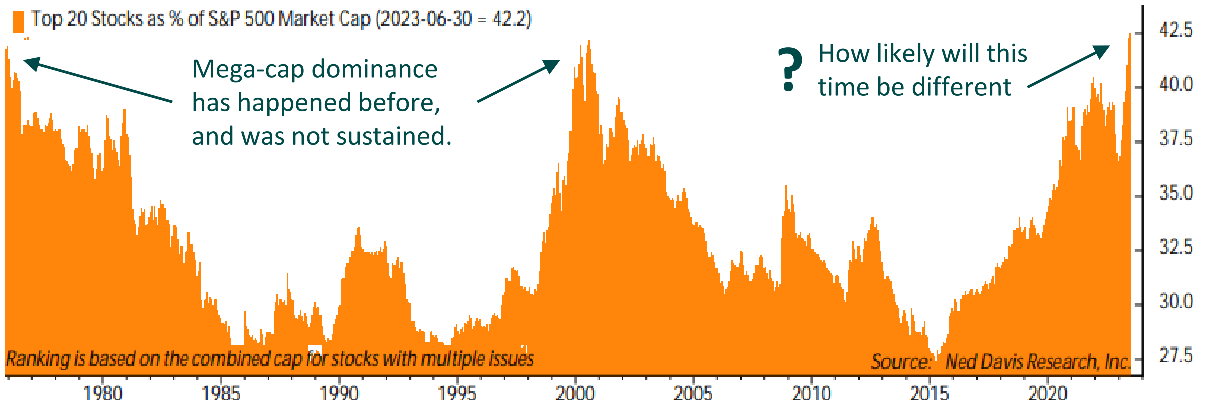
- Such dominance has happened before, but is uncommon, having only occurred twice before in the past 50 years.
- **Such dominance was not sustained**. What followed from each extreme dominance was the mega-cap percent of total market cap dropped. There are only two ways for this drop to happen, **either the prices for mega-caps drop or other stocks rise.**

The Magnificent 7 companies are not inherently bad. It's just that at current valuations, they are not for the faint hearted. There is a saying "never pay 10x sales unless you are comfortable with 80% drawdowns."

The last time mega-caps were so dominant was in 2000. What happened after that? An investor who bought into the Nasdaq then would have made about 5% p.a. in the 23 years since. This is assuming they did not sell because soon after they bought in, the stocks plunged 80%.

Conversely, any investor who was both patient and gutsy enough to buy in after the 80% plunge would have made over 1700% till now (about 15% p.a.).

Clearly, buying the winners under such stretched conditions makes for poor risk-reward. Maybe this is where investing is similar to poker; there is no point betting on the winner after the cards have been revealed.



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POSITIONING FOR RECOVERY

The widely followed S&P 500 and NASDAQ are up this year, leaving many feeling that a real recovery is underway. This reinforces the notion that equity markets do bounce back after a sell-off like what happened last year.

However, this recovery has been led by a small segment of mega-cap stocks in what can be described as a narrow rally. While these mega-caps do get bigger in absolute terms, such as Apple's recent milestone as the first $3 trillion company, we see from the earlier chart that they subsequently drop relative to other companies. *This is where the opportunity is for investors today.*

Returns broaden out after a narrow rally

Goldman Sachs studied prior periods of narrow leadership since the 1980s and found that subsequent equity gains eventually broaden out. Meaning other parts of the market do better. Imagine the narrow rally as the tip of the iceberg, with subsequent returns broadening out to other parts of the market.

Where will the broadening extend to?

In this regard, history is on our side. The table shows that small caps practically outperformed all the time one year after periods of narrow leadership.

Coupling this with our prior research which shows that small caps tend to rebound strongly during the recovery phase, surpassing the performance of large-cap stocks by 30% on average.

In short, the combination of being positioned in small caps for recovery and the recent narrow rally have improved the odds of our recovery theme working out.

This shows that with work and patience, there are other opportunities that have strong return potential without sky-high valuations.

In a separate report, Goldman* identified the next potential Magnificent 7 based on the characteristics of rapid and consistent sales growth. Among the names were Enphase and Solaredge, which are small-cap stocks found in our portfolios.

Hence, one can achieve meaningful returns while still being diversified.

*Source: Goldman Sachs "Rule of 10: Screening for S&P 500 stocks with secular sales and net income growth greater than 10%"

Russell 2000/1000 Ratio Performance After Percent of S&P 500 Stocks Outperforming Index in Last Three Months Falls Below 30%

Date	21 Days Later (%)	63 Days Later (%)	126 Days Later (%)	252 Days Later (%)
3/27/80	3.2	6.6	20.0	26.2
12/11/80	1.6	5.5	15.5	7.6
9/10/99	-1.3	-0.2	27.6	6.3
3/21/00	-7.5	-3.8	-4.0	5.8
8/31/20	0.3	11.3	27.3	11.7
4/5/23	-0.6	N/A	N/A	N/A
Mean	-0.7	3.9	17.3	11.5
Median	-0.1	5.5	20.0	7.6
% Positive	50.0	60.0	80.0	100.0
All Periods Mean	0.0	0.1	0.2	0.4

Three months = 63 trading days. Repeat signals over 126 trading days screened out.
Sources: S&P Dow Jones Indices, FTSE Russell.

Small caps have outperformed large caps after narrow rallies

Source: Ned Davis Research

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LATE CYCLE STABILITY

The following describes a few mega-cap stocks:

- game changing technologies that will change how people work
- dominate the market and lead the Nasdaq to its all time high
- valuations and equity positioning at extremes

This is an apt description of the Magnificent 7. In reality, this was used to describe the 4 Horsemen of the 2000 internet era: Microsoft, Intel, Cisco and Dell.

The rally observed so far has led some to believe that economies are out of the woods. Some even believe that the Magnificent 7 will propel economies to the next level.

As we have mentioned before, "a good company may not be a good investment". In the same report on high-growth stocks, Goldman found that starting valuations do matter, even for the fastest growth stocks.

The table shows what happened to the 4 Horsemen since their peak dominance of markets in the year 2000.

Company	Gain/loss 1 year prior to peak market dominance	Subsequent drawdown	Gain/loss from peak dominance 2000 to 2023
Microsoft	68%	-63%	+832%
Intel	122%	-79%	-15%
Cisco	182%	-86%	-4%

Source: Bloomberg as at 4/7/2023

Note: Dell is excluded as it has been privatized.

Some key takeaways

- The stocks dominated the markets because of massive gains before, not after.
- Even though **the companies continue to dominate their fields more than 20 years later, investing in their stocks after peak dominance would still lose money** on two out of three names.

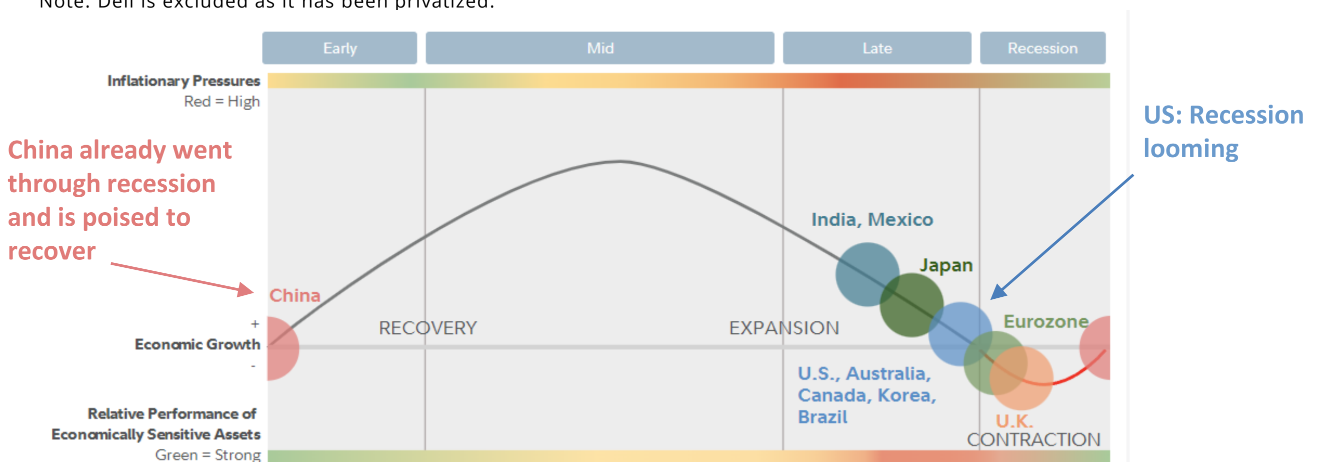
Hence, we should not be surprised if 20 years later, the likes of Nvidia have shaped the world with its AI technology but an investor buying in today is still underwater simply because they did not pay attention to starting valuations.

What caused the 4 Horsemen to drop, and can cause the Magnificent 7 to do the same? A recession and significant market decline.

The chart below shows that major economies are in the late stage of their economic cycle, with recession looming. Today, recession is practically a given, particularly on the heels of the supernormal growth experienced during the post-covid recovery. More importantly, this recession is not being priced into many markets.

The only exception is China which has already gone through its recession and is poised to recover (we are positioned for this in our recovery theme).

The question is just how severe the recession is, and how one prepares for it. This is why we maintain our stability exposures in Healthcare equities for now.



Source: Fidelity, Business Cycle Update as at Q2 2023

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CAPTURING HIGH YIELDS

People may not relate to monetary policy and interest rate hikes but the fact is we are all part of this giant "social experiment".

Where has this been most obvious? The dash for cash. Where we used to spend, spend, spend, the thinking now is "I'll buy it later, in any case, I'm getting a 4% return on my cash". Multiply this across the population and viola, the central bank has succeeded in sucking liquidity out of the system, reducing demand, and easing inflationary pressure.

There is some downside to cash despite the current higher return. The first is that the **higher cash return is still not beating inflation**. This is something we have discussed at length and will not belabor here. The second is that the **high return on cash is only a short-term phenomenon**. The moment interest rates start dropping, cash and money market returns will drop as well.

So how can one capture higher returns for the next few years even if interest rates drop? Today, investors have more options than they used to as shown in the table.

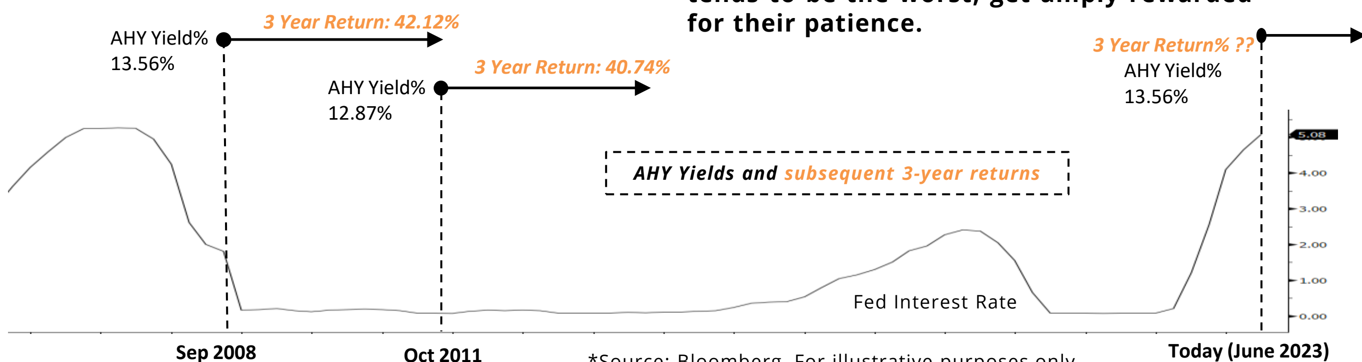
Fixed Income Market *	Dec 2021	Jun 2023
Fed Interest Rates	0.09%	5.08%
Global Investment Grade	0.83%	3.84%
Global High Yield	4.94%	9.24%
Asian High Yield	6.98%	13.56%
Emerging Market Debt	5.99%	11.16%

Of course, anything other than cash comes with larger price swings and is only suitable for investors with a longer investment horizon.

Asian High Yield stands out as having the best opportunity. Yet it also sticks out for the wrong reasons as dark clouds seem to linger in the form of a lackluster property recovery in China. This has been affecting sentiment for the Asian High Yield market. To that, we remind ourselves and investors to not miss the forest for the trees. On balance, there continue to be reasons for maintaining a preference for AHY:

- **Asian High Yield is not just about China property**. China makes up about a quarter of the AHY market, with China real estate an even smaller proportion. While we do not want to trivialize the significance of the China property, concerns on it relating to the AHY market may indeed be overblown.
- **Other markets with 'stronger' economic growth have entered the AHY universe**. For instance, India's weight in the market has doubled over the past two years. AHY investors have retained the yield and return potential, with less reliance on China property to drive performance.
- While China's property sector has not recovered as quickly as expected, things are also not deteriorating. Amid the sensationalized headlines, what was overlooked was that Moody's had upgraded China's property sector to 'stable' from 'negative'. With the **re-opening of the economy and continuous supportive policy measures**, there is reason (not just hope!) to expect better times ahead. Nevertheless, we monitor developments closely and will adjust as necessary.

Despite these favourable factors, some may ask "Will the return ever come?" The below chart shows previous instances where AHY yields were high and their subsequent 3-year return. While history does not repeat itself, it certainly rhymes. **Those who invest through periods of high yield, when the sentiment tends to be the worst, get amply rewarded for their patience.**



*Source: Bloomberg. For illustrative purposes only.

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HOW ARE WE POSITIONED?

Positioning for Recovery	Late Cycle Stability	Capturing High Yields
China 'A' Equities	Healthcare Equities	Asian High-Yield Bonds
Emerging Markets Equities	Government Bonds	Emerging Markets Short Duration Bonds
US Small-Cap Equities		

The 'Positioning for Recovery' positions are expected to do well as the economy and markets gradually work through current shorter-term volatility, while the complementary Stability and Yield positions provide effective diversification to the rest of the portfolios.

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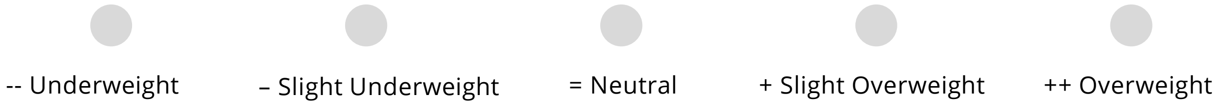
ASSET ALLOCATION STRATEGY



-- Underweight | – Slight Underweight | = Neutral | + Slight Overweight | ++ Overweight

Equity: Regions

United States (Neutral)

US Small-caps as relative valuations are attractive and expected to benefit as economies recover. **Healthcare** as earnings are more stable and less dependent on broader economic cycle.

Europe (Slight Underweight)

Lower risk/reward after previous attractive value translated to strong performance over the past year. Potential for earnings disappointment as global growth slows.

Japan (Slight Underweight)

Maintaining no exposure as they are less attractive compared to other opportunities. Valuations have also become less attractive.

Asia Pacific ex Japan (Overweight)

China 'A' overweight as deleveraging cycle has taken its course. Tailwinds steadily building up in the form of improving credit conditions and economic activity.

Emerging Markets (Neutral)

Neutral as valuations are attractive relative to developed markets, but where earnings tend to be less resilient

Fixed Income

Global (Slight Underweight)

Focus on currency-hedged government bonds to buffer portfolio volatility during periods of stress.

Investment Grade Corporate (Underweight)

Maintaining no exposure as low incremental yield and long duration credit exposure are less attractive than other segments

US High Yield (Slight Underweight)

Maintaining no exposure due to relative poorer valuations.

Asia (Overweight)

Attractive yield across major fixed income markets with room for capital appreciation and better fundamentals.

Emerging Markets Debt (Overweight)

Hard currency short duration focus to focus on return from credit while limiting exposure to emerging market currencies and interest rate risk.

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MARKET INDEX RETURNS

Equity Regional	MTD	YTD	10Y	20Y
Global	5.84	14.26	9.35	8.76
United States	6.61	16.88	12.85	10.04
Europe	5.14	13.66	6.68	7.66
Japan	4.11	11.35	5.68	5.85
Asia Pacific ex Japan	3.09	3.02	4.49	8.49
Emerging Markets	3.83	5.02	3.32	8.53

Equity Markets	MTD	YTD	10Y	20Y
Australia	4.98	2.94	6.66	10.41
Brazil	15.89	18.69	1.44	8.84
China “A”	0.13	-4.47	6.24	8.52
China “H”	5.20	-3.47	-0.33	7.71
Hong Kong	4.42	-3.19	2.35	7.02
India	4.41	8.09	10.70	13.93
Indonesia	1.53	4.49	1.58	13.35
Korea	0.18	10.10	3.69	8.37
Malaysia	-1.67	-11.25	-2.94	6.25
Russia	-5.08	10.68	3.53	8.28
Singapore	1.82	0.20	3.27	8.40
Taiwan	2.15	20.02	11.38	10.99
Thailand	-3.48	-9.94	2.22	10.88

Equity Sectors	MTD	YTD	10Y	20Y
Gold	-2.48	4.72	3.28	1.89
Energy	6.65	-5.55	4.35	8.95
Technology	6.18	39.06	19.78	13.12
Healthcare	3.22	1.09	10.88	9.49
Financials	6.69	-0.53	10.07	4.91

Fixed Income	MTD	YTD	10Y	20Y
Global Aggregate	-0.01	1.43	0.20	2.47
Global Aggregate (H)	-0.06	2.96	2.11	3.20
High Yield	1.80	5.46	3.98	6.45
Asia	-0.12	3.18	3.18	2.79
Emerging Markets	1.49	3.30	2.73	5.83

Note: (H) Currency Hedged

Currencies	MTD	YTD	10Y	20Y
SGD/USD	-0.05	-0.95	-0.64	1.33
EUR/USD	2.06	1.91	-1.75	-0.27
JPY/USD	-3.44	-9.14	-3.68	-0.93

Commodities	MTD	YTD	10Y	20Y
Gold	-2.21	5.23	4.51	8.94
Energy	3.75	-11.99	-3.08	4.34

As of 30 Jun 2023. Source: Bloomberg. ***Total return in USD****.*
10 and 20 year returns are annualized.

"In investing, what is comfortable is rarely profitable.“

Rob Arnott

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