JUN 2023

THINK DIFFERENTLY
TO GET DIFFERENTIATED RESULTS

Monthly Investment Update

Executive Summary

In May, the US debt ceiling garnered significant attention in the media, sparking concerns about the government's ability to meet its financial obligations and the potential consequences of a fallout. However, all the drama ultimately ended with anticlimax – with minimal impact on bond markets. Comparatively, the 'Big Reset' in bonds where interest rate rose from practically zero in 2022, had a more significant impact, leading to a 15% drop and highlighting the relative insignificance of the debt ceiling issue. This underscores the practicality for investors to focus on fundamentals and valuations that can help one position for large moves that make an impact. This is a much better way than trying to second guess events like the debt ceiling.

Notably, this year's market recovery has been uneven. The strong performance of the S&P 500 index this year is largely attributed to the surge in a few mega-cap tech stocks, driven by excitement about Artificial Intelligence (AI). Although such rallies can tempt investors to jump in hastily, history has shown that making investment decisions solely based on the fear of missing out (FOMO) often leads to negative outcomes. For example, investors who entered the energy sector following last year's impressive rally would be facing painful losses. A more prudent approach would be to focus on investing in overlooked areas that offer more predictable returns. One such opportunity in which we are invested is China 'A' equities, which offers promising opportunities for future returns.

Amid uncertainty over the US debt ceiling, some investors may consider selling investments to mitigate risks. However, this market-timing approach entails trading costs and a whole lot of stress, all to avoid a relatively small decline of about 1%. Not to mention potentially missing out of subsequent gains - unfortunately, market-timing expose investors to the risk of missing out on the market's best-performing days which significantly impact overall returns. Instead, disciplined investors can harvest attractive returns over the long-term by looking beyond short-term price fluctuations and ensuring proper portfolio diversification.

In light of the "Big Reset" in bonds, there are now promising opportunities for investors to secure higher levels of income in the years ahead. In particular, high-yield (HY) bonds stand out as an attractive investment option. These bonds offer the potential for high returns amid price levels that have only been witnessed three times in the last 15 years. Past instances of such price levels have reliably presented excellent investment opportunities. Notably, while HY bonds can be volatile during stressed periods, they have the potential to deliver impressive 1-year returns exceeding 30% coming out of each downturn.

MARKET REVIEW

Unless one was living on a remote island with no internet, the biggest thing last month was the US debt ceiling debate.

Just as one would be drawn to an accident on the expressway, the media and market commentators were fixated on what looked like a slow-moving car crash. Throw in sensational possibilities like a default of the world's largest economy and catchy names like an "X date", and this makes for drama that captured popular imagination.

US on track for June 1 default without debt ceiling hike, Treasury says

By David Lawder and Andrea Shalal

May 16, 2023 3:44 PM GMT+8 · Updated 20 days ago

Wall Street was not immune; one could not look at a research report or podcast list without seeing something on the debt ceiling. As the days rolled closer to the X date like a ticking time bomb, media channels piled on the drama.

Yellen issues new potential date for looming default, calling 911 can be fatal: 5 Things podcast

Taylor Wilson USA TODAY

Published 11:08 a.m. ET May 27, 2023 | Updated 11:13 a.m. ET May 27, 2023

And then literally the next day, it all went away. This was not the nail-biting, down to the wire finish that many were conditioned to expect. In fact, an agreement was announced on 28th May, well before the initial deadline. All that build-up ultimately ended with anticlimax.

The debt ceiling was introduced with the original objective of reducing red tape so that Congress would not have to keep approving debt issuance. What was good intentions backfired as politicians used the debt ceiling debates as opportunities to engage in brinksmanship, literally blackmailing the other party in a game of chicken to fulfil their own agendas.

Credit Suisse investment bank noted in a research report (yes, they are still functioning) that they "had very few client questions about the debt ceiling". Evidently, not as many investors were concerned about the debt ceiling despite the media coverage.

How were markets reacting? Throughout the month, US bond yields* (which are a gauge of the country's creditworthiness) moved a total of 0.5% i.e. it cost the US 0.5% more to borrow money.

This translated to a decline of about 1% in bond prices. This was small compared to the bond market declines of 15% in the past year. Basically, **markets were saying the debt ceiling is nothing compared to when bond markets 'reset' from a very overvalued status in 2022.**

The large move in 2022 was what we would call a Big Reset, one that investors should position for. Why?

- These are large moves that make an impact. Would you rather capture/avoid a 1% or 15% move?
- It is easier to position for these large moves compared to trying to second guess events like the debt ceiling.

Easier to position does not mean easier to hold. Markets can stay cheap or expensive for a long time, which can test investors' patience. Until under or overvalued markets start moving like bond markets did in 2022, there is no validation. The fact that the media focuses on market-moving events does not help. It's so much easier for an editor to publish "Bond markets tumble" in 2022 than rehash "Bond markets are expensive" in the years before that.

The direct and immediate impact of the Big Reset registered on the bond markets last year. However, **the ramifications on other markets are only showing up recently.**

Defaults are happening in the US commercial property space. What has this got to do with the Big Reset in interest rates? Asset owners such as Brookfield and Pimco found themselves with higher mortgage payments when they needed to refinance. Faced with lower rental income due to low occupancy rates, defaulting was a pragmatic choice. Fortunately, such properties are a small part of these giants' portfolios but they remind us that paying attention to fundamentals and valuation help to deal with whatever markets throw at us.

*Source: Bloomberg. US 10-year bond yields.

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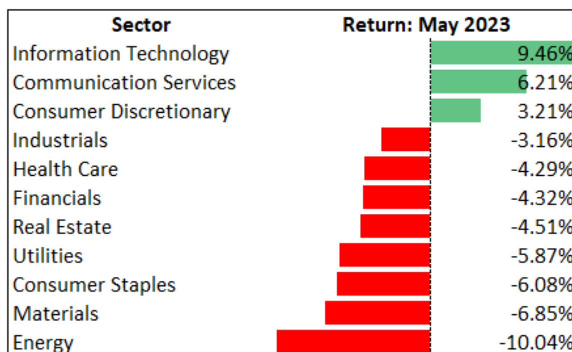
POSITIONING FOR RECOVERY

This year's market environment is likely to be frustrating for many investors. Amid slowing economies and a highly anticipated recession, markets have remained volatile and unpredictable in the short-term. Furthermore, certain market segments have also delivered strong gains ahead of others.

By itself, positive performance is not unusual amid periods of uncertainty (remember that markets can still deliver a positive return in a recession). What's more unusual is the unevenness of the 'recovery' with only a small handful of sectors positive in May:



Sector	Return: May 2023
Information Technology	9.46%
Communication Services	6.21%
Consumer Discretionary	3.21%
Industrials	-3.16%
Health Care	-4.29%
Financials	-4.32%
Real Estate	-4.51%
Utilities	-5.87%
Consumer Staples	-6.08%
Materials	-6.85%
Energy	-10.04%

Source: Bloomberg

Tech stocks sit at the top of the performance table amid the recent frenzy around Artificial Intelligence (AI); with a blistering rally of 9.46% in May. The performance is even more stark considering that the bottom-performing sectors are down by up to -10% (almost a 20% difference!).

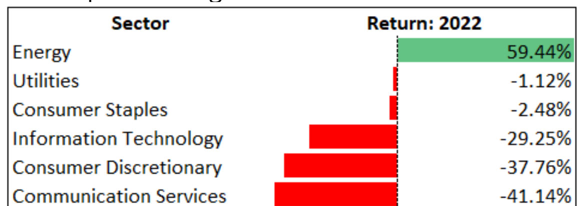
This is also the reason for the strong performance of the US S&P 500, which has more than 27% in tech – practically all their gains this year are made up of that one sector.

Any investor not exposed to the handful of mega-cap tech stocks would have had a hard time, with many feeling like they have 'missed the boat'. Some may be tempted to give in to *FOMO* (the fear of missing out) and buy into the strong rally.

FOMO-Fueled Tech Rally Steamrolls Over Pile of Earnings Warnings

- Bulls have been undeterred by weak earnings results so far

It must be emphasized that FOMO-investing is a common emotional reaction leading to irrational decisions that do more harm than good. Looking at the earlier performance table; can you guess which were the top and worst-performing sectors of 2022?



Sector	Return: 2022
Energy	59.44%
Utilities	-1.12%
Consumer Staples	-2.48%
Information Technology	-29.25%
Consumer Discretionary	-37.76%
Communication Services	-41.14%

When it comes to investing, it often does not pay to bet on today's winner for tomorrow's return. Likewise, betting on Energy after the spectacular rally last year would have been a bad idea. Today, tech valuations continue to be very aggressively priced even before recent gains – Nvidia, the current poster child for the AI rally is trading at *38 times* last year's revenue.

We prefer more predictability in our portfolios than trying to chase after temporary gains. Such predictability can be found in overlooked markets with returns ahead rather than behind them.

Alongside US small-caps and Emerging Markets, **China 'A'** is one of those overlooked opportunities today. After rallying 59% from the lows in October to the highs in January this year, they have since lagged major markets in the past few months. Should investors be concerned? The fact is that markets became overly exuberant on news that the country was ending their covid-zero policies but were subsequently disappointed when the economic recovery did not turn out to be as good as expected – April's data showed the economic recovery to be uneven and bumpy. To be clear, the economic recovery *is happening,* with China's economy growing 4.5% in the first quarter. Unsurprisingly, we've instead seen experts and individual investors alike shunning the market following a period of disappointing performance.

We believe that the combination of extreme pessimism mixed with attractive valuation is a powerful cocktail for our recovery positions to rebound strongly. All that's left is patience.

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STABILITY AMID VUCA

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

The weeks leading up to the US debt ceiling deadline saw a lot of drama and many sensationalized news headlines, and then also went away without much drama as the government passed a bill to suspend the debt ceiling.

A global equity investor who wanted to avoid the uncertainty leading up to the debt ceiling would have gone through all the trouble to avoid a mere -1.01% in May. As mentioned earlier, the anticipated event turned out to be a non-event. **Markets rallied shortly after the event, leaving those who have gotten out wondering when to get back in.** By trying to time the market, what's guaranteed is trading costs incurred and a whole lot of stress.

It is common for equity investors to expect 8-10% returns over a long-time horizon (at least 10 years). **Through history, such returns are almost assured if we can take a disciplined approach to investing.** Why risk losing out on attractive long-term returns for a chance at some short-term comfort? The chart below shows that missing just the 10 best days in the market can reduce your annualised returns drastically.

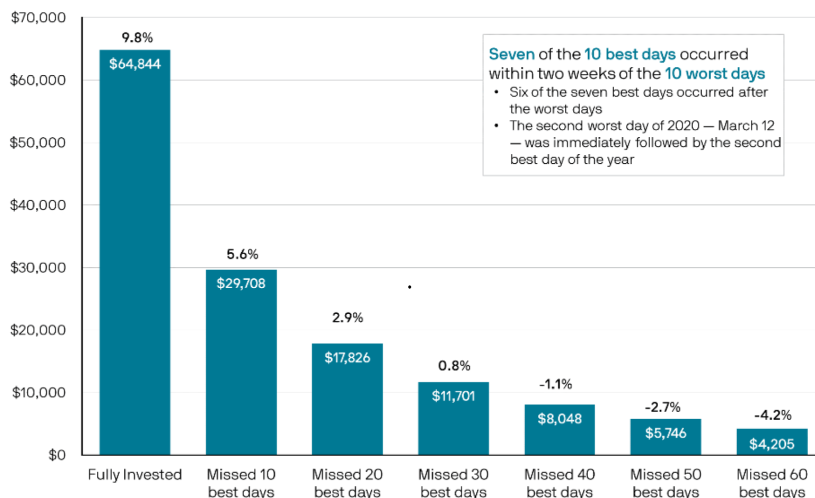
Of course, many indicators continue to point towards a more challenging economic environment in the coming months - **the effects of higher interest rates and overall tightening of financial conditions are still working their way through the economy.**

While this may not mean negative returns, it does mean that we should expect continued volatility and uncertainty.

If you turn back at every sign of danger, you will never reach your destination. A better way is to build a strong ship that can withstand the storms that you will encounter along your journey. In today's context, this means not letting large price swings throw you off your long-term financial goals. The foundation of a strong portfolio is of course; diversification.

Why diversifying is hard: It requires an investor to recognize that their best idea may not work out immediately. A better way is to have a few good ideas that are complementary to each other, but this requires more work than just finding one best idea. But by doing so we can improve the portfolio risk/reward.

Why diversifying is important: we do not know what we don't know. Even after doing thorough research, markets may go through black swan events that can destroy whole investment portfolios. Diversification ensures the longevity of your investment portfolio so you can harvest the attractive returns that are offered by markets over time.



Source: JP Morgan Asset Management as of 31 Dec 2022

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SEARCH FOR YIELD

For over a decade before last year, income investors had few compelling options due to near-zero interest rates. This meant savers were getting nothing from bank deposits, and speculators could leverage by borrowing at extremely low costs. This meant savers who would otherwise have kept money in the bank were compelled to invest to get a minimal return, and speculators did not have to think too much if an investment could cover their low-interest costs. In short, there was a lot of indiscriminate money in the markets, making already overvalued bonds even more expensive.

The music kept playing for a while but ultimately ended in 2022. Bond markets buckled under unsustainable low rates, resulting in their largest-ever declines. This led to levels of bond volatility not seen since the Global Financial Crisis.

This explosive combination of historic declines and volatility represented the Big Reset that was long overdue. Out of this Big Reset was the transformation of "return-free risk" to risk-free return. Savers who do not have the risk tolerance can now get a decent recent on money market funds (some banks have yet to raise deposit rates). Speculators now have to think twice, three times before leveraging as they need to cover borrowing costs before the investment return kicks in.

The exit of savers and speculators means less indiscriminate money is competing with investors for returns. Combined with higher yields across the board, **the current environment offers opportunities for investors to lock in higher levels of income for years to come.**

High-yield bonds currently offer the following characteristics that make them attractive investments.

<u>Higher return potential</u>
High-yield bonds have historically generated higher returns for investors with higher risk tolerance (as shown in the table).

Money Market Funds *	Investment Grade Bonds	High Yield Bonds
2.68%	4.67%	7.64%

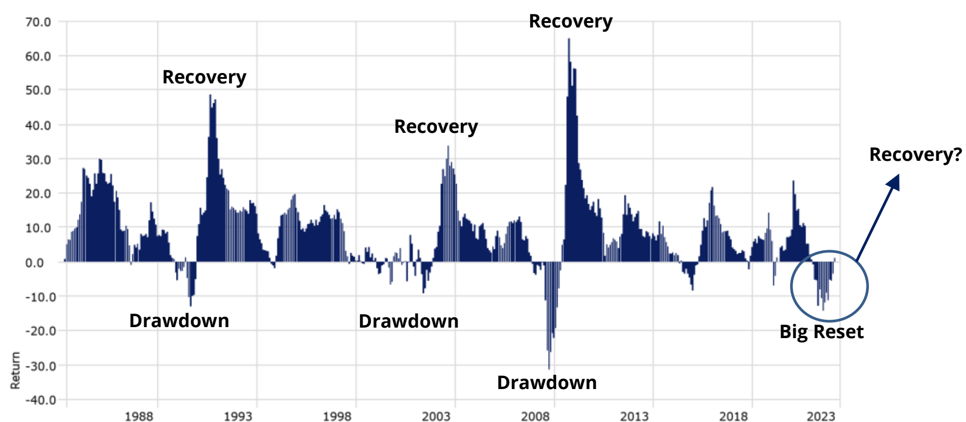
Today's yields have only been so high three times in the past 15 years, and each time was a great opportunity to invest.

<u>Recovery characteristic</u>
High-yield bonds seem to get a bad rap from their other name: junk bonds. They are more volatile during periods of stress, which may deter some investors. Yet, high-yield bonds have demonstrated their ability to recover losses (and more) throughout past crises. The chart below shows the rolling 1-year return for high-yield bonds through the years.

During crises, the drawdowns can be meaningful. However, **each drawdown was followed by recovery periods, with the potential to hit 1-year returns of over 30%.**

2022's Big Reset is circled in the chart below. If history is any indication, the prospects for high-yield investors are very favourable indeed.

*Source: Bloomberg. 31/1/1990-31/5/2023. Money market fund: Vanguard Federal Money Market Fund, Investment grade bond: Bloomberg Global Agg Index, High Yield: Bloomberg US Corporate High Yield Bond Index



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HOW ARE WE POSITIONED?

Positioning for Recovery	Stability Amid VUCA	Search for Yield
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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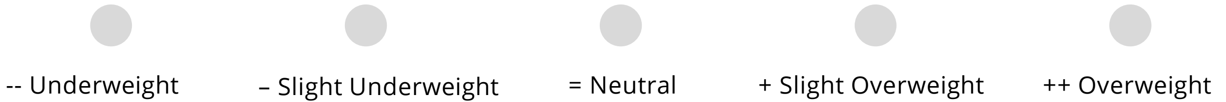
ASSET ALLOCATION STRATEGY



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

Equity: Regions

United States

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

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

Japan

Maintaining no exposure as they are less attractive compared to other opportunities

Asia Pacific ex Japan

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

Fixed Income

Global

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

Investment Grade Corporate

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

US High Yield

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 Markets Debt

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	-1.01	7.95	8.41	8.56
United States	0.43	9.64	11.98	9.75
Europe	-5.79	8.10	5.63	7.45
Japan	0.86	6.95	5.40	6.01
Asia Pacific ex Japan	-2.35	-0.06	3.54	8.61
Emerging Markets	-1.66	1.15	2.26	8.63

Equity Markets	MTD	YTD	10Y	20Y
Australia	-4.61	-1.94	5.36	10.38
Brazil	1.80	2.41	-1.62	8.06
China “A”	-8.22	-4.60	4.55	8.14
China “H”	-7.70	-8.25	-1.78	8.02
Hong Kong	-7.63	-7.29	1.32	6.84
India	1.66	3.53	9.48	14.50
Indonesia	-5.40	2.91	0.80	13.44
Korea	3.90	9.90	2.83	8.73
Malaysia	-5.22	-9.74	-2.99	6.51
Russia	4.05	16.61	3.61	9.06
Singapore	-3.94	-1.58	2.54	8.62
Taiwan	6.36	17.49	10.89	11.29
Thailand	-1.12	-6.70	1.59	11.79

Equity Sectors	MTD	YTD	10Y	20Y
Gold	-8.56	7.38	1.62	2.02
Energy	-10.04	-11.44	3.47	8.55
Technology	8.21	30.97	18.66	12.81
Healthcare	-4.03	-2.07	10.39	9.48
Financials	-4.32	-6.77	9.18	4.59

Fixed Income	MTD	YTD	10Y	20Y
Global Aggregate	-1.95	1.44	0.08	2.41
Global Aggregate (H)	-0.39	3.03	1.98	3.18
High Yield	-1.12	3.60	3.50	6.52
Asia	-0.42	3.30	2.81	2.79
Emerging Markets	-0.75	1.78	2.11	5.77

Note: (H) Currency Hedged

Currencies	MTD	YTD	10Y	20Y
SGD/USD	-1.28	-0.90	-0.67	1.24
EUR/USD	-2.99	-0.15	-1.94	-0.49
JPY/USD	-2.18	-5.90	-3.21	-0.77

Commodities	MTD	YTD	10Y	20Y
Gold	-1.37	7.61	3.53	8.78
Energy	-11.32	-15.16	-2.96	4.26

As of 31 May 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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