AUG 2023

THINK DIFFERENTLY

TO GET DIFFERENTIATED RESULTS

Monthly Investment Update

Executive Summary

The previous narrow market rally driven by Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla (collectively known as the Magnificent 7) broadened out in July. This is in line with historical patterns which indicate that narrow rallies do not continue for long. The broadening of the rally benefited our investors, with our recovery positions like small-caps and emerging markets posting strong gains. Last month's performance reminds us that while some things do change, certain fundamental market characteristics remain constant. To benefit from this, we have to study and understand historical market patterns and have the discipline to stick to a strategy when markets are volatile.

Nevertheless, patience is required to realize the gains up on offer in the market. Understandably, skepticism exists around investments that have declined, and when they are surrounded by pessimistic news flow day in and day out. But history has shown that markets bottom when sentiment is at its worst.

Investors in Asian High Yield bonds have asked when, how much, and even if recovery will happen. A review of the Eurozone debt crisis shows that even for the most basket case markets, not only do they recover, but they recover in spectacular fashion.

As for equities, the stars seem to be aligning for our recovery positions. Small caps gave a glimpse of their potential in July. Meanwhile, the Chinese government, whose tough policy stance has been putting pressure on 'A' shares, has dramatically shifted its tone.

The question of whether it is the right time to add more risk and reduce stability positions arises, given the dynamic and uncertain economic environment. While the potential for a U.S. recession has eased slightly, developed economies remain in a late-cycle phase. Making binary decisions based on recession forecasts is not advisable, as such predictions are often inaccurate. Markets can perform well even during a recession, and investors should think in terms of probabilities across various outcomes to manage their investments effectively.

As we approach a potential inflection point, our strategies focus on stability to endure short-term challenges while capturing the medium to long-term return potential of markets. Additionally, we remain prepared to seize opportunities should the environment shift unexpectedly.

Finexis Asset Management

MARKET REVIEW

Last month, we discussed how past narrow market rallies (periods of gains driven by only a handful of stocks) do not last. We saw that **returns eventually broaden out to other parts of the market, with small-caps tending to outperform.**

Fortunately, our investors did not have to wait much longer for that to happen. The S&P 500 was up 3.21% in July, while the Small-cap Russell 2000 index was up 6.11%.

This reminds us that **while some things may change, certain fundamental market characteristics stay the same**. However, it is hard to remember these characteristics for two main reasons:

1. As shown in the study cited in last month's commentary, these characteristics can only be identified after studying decades of market behaviour.
2. The strong recency effect of out-or-underperformance by any market will cause investors to overlook historical patterns.

Having said that, this does not mean that small-caps will continue to outperform every month; the journey to recovery is not a straight line up.

Across the other side of the world, Emerging Markets were up 6.28%. For some investors, it may look like the narrow rally has indeed broadened out. For others, they may remain skeptical about the potential of Emerging Markets especially when their experience in recent times has been very poor.

Over the last two years, investors in Emerging Markets have been dealt cards such as the unprecedented clampdown by the Chinese authorities on capitalism. China 'A' share investors would have had a more challenging time, being more directly impacted.

To say that investors are downbeat would be understating it. While the worst may have passed, the lack of any visible progress translating to sustained recovery has frustrated investors who are likely at the end of their patience.

Questions of "When will it recover?" and "How much will it recover?" have turned into "Will it come back at all?" It is natural to have doubts after going through such environments. Who would not be doubtful if they are inundated with pessimistic news flow day in, day out? But it is also true that during market bottoms, news flow tends to be the worst.

Let's take a look at a market that has been hitting the news lately.

Hot New Play in Stock, Bond Markets: Greece Is Suddenly Booming

The country is back on investors' radar after a decade in the wilderness.
July 19, 2023 at 10:00 PM EDT

Greek Stock Market 2023 Is Among the World's Best – Bloomberg

The Greek equity market bottomed in May 2012 during the Eurozone crisis. But it is only now, more than 10 years later, and more crucially, after the market has rallied 218%* that it is hitting the news. What if you were told that over the same period, Greek government bonds were up 998% for an annual return of 24%? Indeed, bonds can outperform equities, but only in exceptional circumstances.

Why should Greek markets matter to our investors? Today, they are firmly on investors' radar after significant gains over the past decade. Crucially, It's worth remembering that there was a time when they were written off as a basket case market.

Which market is being considered a basket case today? *China equities and bonds*. Indeed, sentiment towards these markets is poor, yet **history has shown that markets bottom when sentiment is at its worst.**

The path to outperformance is fraught with uncertainty which will test the patience of even the most seasoned investors. In this commentary, we will try to share how patience under the most challenging circumstances is necessary for investors who want to want to grow their wealth.

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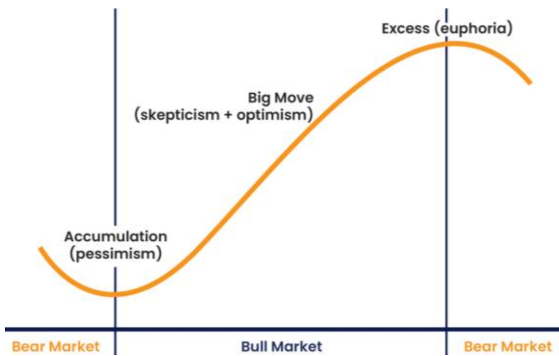
POSITIONING FOR RECOVERY

"Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria."



Source: finexy.com

Where do you think the best opportunities can be found?

As alluded to earlier, the fact is that **markets tend to bottom when things are looking their worst and when investors are the most pessimistic**. For sure, it isn't easy to invest at that point, especially when the news headlines are also likely to be spewing doom and gloom. But **this is when some patient investors start accumulating for long-term returns**. Warren Buffet does this very well, often seeing value where others don't. What gives him the confidence? It is being able to buy a good investment at attractive valuations, giving the investment room to grow to their fair value.

By the same measure, we have accumulated a portfolio of recovery positions with attractive valuations and the potential for strong gains as markets recover.

Small-caps is one such recovery theme. We mentioned earlier that the small cap market was up 6.11% vs the S&P 500's 3.21% last month. If we look under the hood of these markets, the best stock in the Russell was up 163% in July compared to that of the S&P 500 which was up 42%. This shows that small companies are far from down and out, and can outperform large caps meaningfully.

This also shows that despite arguments that the big (such as the Magnificent 7) will get bigger, small caps can provide much better return for investors.

Nevertheless, an investment can also take some time to play out. When it comes to investing, market developments tend to move at a slow pace, testing investors' patience until a tipping point is reached. Then, seemingly out of nowhere, markets bottom and embark on the next bull market. Have we reached such a tipping point in China 'A' equities?

"Property is for living in, but not for speculation"

At each Politburo meeting of China's top leaders chaired by President Xi since 2019, this mantra has been repeated every year to reflect the government's policy stance. At last month's Politburo meeting, the above statement was unusually left out.

Indeed, there has been a clear shift in tone from Chinese policymakers.

On 3rd August, the state-owned newspaper *Economic Daily* or *经济日报*, published an article 'tying stock market fortunes to improving growth'.

7 财金 2023年8月3日 星期四

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Snippet from经济日报 with the headline 'Promoting consumption, let capital markets help!'

As also reported by Bloomberg, "the newspaper, which is affiliated with the State Council, stressed the need to 'enable households to make money from investing in stocks and funds, so their intention to spend can translate into the ability to spend.'" If anything, recent developments suggest that the government has swung its tone to basically do what it takes to get both the economy and markets on firm recovery.

We are also making sure that it is not just rhetoric. While we view recent developments as encouraging for our Emerging Markets and China 'A' positions, we continue to monitor developments closely to see how it will translate to actual improvements in the data and in corporate earnings of our positions.

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LATE CYCLE STABILITY

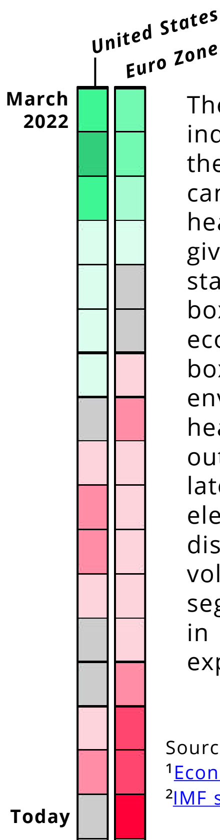
We ushered in 2023 with gloom across economies and markets. Back in December, 70% of economists polled by Bloomberg expected a U.S. recession within the next 12 months[1].

Fast forward to today, the sentiment seems to have shifted. The number of economists predicting a recession has fallen to 58%. It's far from conclusive, but there's a glimmer of hope that we may avoid a severe economic downturn, also known as a 'hard landing'. Indeed, there have been early signs that the economy is holding up better than expected:

US economy grew faster than expected in Q2

Data shows sustained strength in domestic demand while inflation subsided considerably last quarter.

The dynamic and uncertain environment poses a tricky question for investors: is it time to add more risk? Should we be adjusting our stability positions? It's a delicate balance, especially when developed economies remain firmly in late cycle.



The left-side illustration gives an indication of business conditions in the US and Europe over time. We can think of each box as a monthly health check for the economy, giving useful information about the state of economic health. A **green** box is a positive sign that the economy is improving, while a **red** box signals a more challenging environment. The most recent health check shows that we are not out of the woods just yet. Being in late-cycle, the US and Europe face elevated risks of earnings disappointment and bouts of volatility particularly in market segments that have rallied strongly in the past few months on lofty expectations.

Source: Bloomberg. PMI data.
[1]Economists place 70% chance for recession
[2]IMF shows poor record at forecasting recessions

With that said, investing is not about making binary decisions i.e. making all-in bets on whether or not we are heading for a recession. There is good reason for that:

- Studies show that recession forecasts are often wrong[2].
- Markets can still deliver positive performance over a recession. This is because markets may already start declining before a recession, and start to go up before the end of one.
- Investing is about surviving the long-game. Betting it all on a single outcome can permanently destroy portfolios if the unexpected outcome happens.

Rationally, investors should be thinking in terms of probabilities across a range of outcomes, and the potential impact on their investments if each one happens.

With that in mind, it would seem like we could be getting close to an inflection point, especially if the data continues to improve going forward. **As more positive signals appear, we expect to be allocating more to our recovery positions as the probability of hard landing goes down.**

And what about the other (less likely?) scenario where the data goes from bad to worse? As mentioned earlier in this report, it turns out that the best opportunities tend to reveal themselves when things are the most bleak. That is one superpower a long-term investor has; to be able to strengthen their long-term position when others are capitulating in the short-term.

This is how our strategies are positioned today: stability to withstand some bumps and bruises, while allowing investors to remain invested to capture the medium to long-term return potential of markets. And if the environment changes unexpectedly, we are also in good position to capture opportunities.

Fitch Downgrades America

On a side note: we published an update earlier this week on news of Fitch's downgrade of US to AA+ (**read here**). The event was a good reminder that the unexpected can and will happen, and emphasizes the importance of having a strategy when investing.

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CAPTURING HIGH YIELDS

"Will it come back?" "How much will it come back?" "How long will it take?"

These are some of the pressing questions being asked by Asian High Yield investors as they try to make sense of the volatility they have experienced in recent times.

Let's take a look at Greece, which was the poster child of the Eurozone debt crisis more than a decade ago.

The Eurozone debt crisis started in Aug 2009, where lack of confidence in the Greek financial system led to bond yields rising from 5% to 30%. Correspondingly, Greek bond prices crashed (remember that bond prices drop as yields go up, as global investors experienced in 2022).

"Will it come back?"

Despite being written off (and maybe because they were written off), Greek bonds did come back. Greek bond markets bottomed in 2012, and have compounded at 24% from then till today. This was what the news flow was like at the bottom of the market in 2012.

EUROPE'S DEBT CRISIS

Europe's debt crisis: 'No clear end in sight'

By Ben Rooney @CNNMoneyInvest January 6, 2012: 5:17 AM ET

The parallel for us is the Chinese property sector which is the poster child for the Asian high yield markets today. AHY markets saw a bottom in November 2022, after which they also rallied strongly. This was what the news flow was like at the Nov 2022 bottom.

China property crisis enters new phase as once-safe developers face bond distress

Source: Singapore Straits Times, 1 Nov 2022

This reminds us that during market bottoms, sentiment is usually at its worst.

"How much will it come back?"

Despite crises, the basic rules of markets apply. An investor who bought into Greek bonds at the top of the market in Aug 2009 still would have made money based on the yield at which they entered, which was 5%. Of course, such an investor who bought at the top would have to endure a very volatile journey along the way.

Fast forward to today, that investor would have compounded at 5% if they held on to their position. Hence, **even an investor who buys in at the top of a "basket case" market will get their yield if they hold on.**

Similarly, investors who entered Asian high yield at the top should expect to get the yield they entered at, provided they don't throw in the towel.

"How long will it take?": How long did it take for an investor who bought in at the top of the basket case market that nearly brought down the European Union?

It did come back but they had to be patient. After markets bottomed, they had to go through 21 months of gains before breaking even. But this scenario is for the worst case of an investor who got in at the top. What can one do to shorten the wait? By entering when yields are higher.

Imagine an investor who bought into Greek bonds at the bottom. They would have annualized more than 30% (equivalent to the peak yield at the bottom of the market) over the next 10 years. We don't expect to buy at the bottom but **anyone who did not buy at the top would have compounded anywhere between 5-30% depending on the yield they entered at.**

Today, AHY yields are at 13%. For the patient investor, this presents an opportunity to capture high yields going forward.

Source: Bloomberg. Greek bonds: Bloomberg Greece Govt All Bonds Total Return. Asian High Yield: ICE BofA Asian Dollar High Yield Corporate Constrained Index

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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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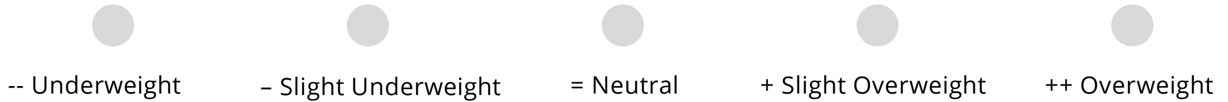
ASSET ALLOCATION STRATEGY



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

Equity: Regions

United States

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. Valuations have also become less attractive.

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	3.69	18.49	9.23	8.84
United States	3.21	20.64	12.64	10.11
Europe	3.00	17.07	6.23	7.72
Japan	3.07	14.78	5.91	5.83
Asia Pacific ex Japan	5.76	8.96	4.86	8.54
Emerging Markets	6.28	11.65	3.84	8.54

Equity Markets	MTD	YTD	10Y	20Y
Australia	3.75	6.80	6.70	10.64
Brazil	4.32	23.81	2.03	9.01
China "A"	6.99	2.21	6.88	8.85
China "H"	9.74	5.93	0.23	7.62
Hong Kong	7.70	4.27	2.59	7.11
India	2.64	10.94	11.23	13.72
Indonesia	3.20	7.84	2.69	13.62
Korea	5.96	16.93	3.87	8.29
Malaysia	9.75	-2.59	-1.81	6.51
Russia	7.55	19.03	3.99	8.97
Singapore	7.09	7.31	3.78	8.37
Taiwan	1.43	21.74	11.31	10.48
Thailand	7.18	-3.48	3.21	10.99

Equity Sectors	MTD	YTD	10Y	20Y
Gold	4.54	9.47	2.73	2.11
Energy	7.40	1.43	4.58	9.48
Technology	2.72	42.85	19.57	12.94
Healthcare	1.33	2.43	10.42	9.63
Financials	4.85	4.30	10.02	4.93

Fixed Income	MTD	YTD	10Y	20Y
Global Aggregate	0.69	2.13	0.14	2.65
Global Aggregate (H)	0.03	3.00	2.08	3.31
High Yield	1.39	6.93	3.90	6.60
Asia	0.26	3.45	3.09	2.80
Emerging Markets	1.18	4.52	2.73	6.06

Note: (H) Currency Hedged

Currencies	MTD	YTD	10Y	20Y
SGD/USD	1.72	0.75	-0.45	1.41
EUR/USD	0.81	2.73	-1.88	-0.11
JPY/USD	1.41	-7.85	-3.67	-0.83

Commodities	MTD	YTD	10Y	20Y
Gold	2.38	7.73	4.02	8.94
Oil	15.80	1.92	-2.47	5.05

As of 31 Jul 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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