OCT 2023

THINK DIFFERENTLY

TO GET DIFFERENTIATED RESULTS

Monthly Investment Update

Executive Summary

The roller coaster ride that investors have experienced this year reinforces the point that financial markets have shifted from straight roads to winding paths. Drawing inspiration from the quote “Straight roads are for fast cars, turns are for fast drivers“; investors should ask themselves if they are prepared for the journey ahead. Indeed, the prolonged era of easy money and low-interest rates has ended, ushering in a period of greater uncertainty and volatility. Today, two potential outcomes loom: a soft landing that propels the US economy to its next growth phase, or a hard landing that could push the economy into a recession. The question is: what should investors do amid such uncertainty?

The foundation of long-term investment returns rests on two ingredients: growth in earnings growth and valuations. While these principles are well-known, emotions often get in the way of the long-term investment objective. A study from Morningstar in 2023 highlighted that emotional investing led to investors missing out on about one-fifth of their fund investments’ average returns over the prior 10 years. This year exemplifies the challenges of staying invested, with mega-cap stocks like the ‘Magnificent 7’ driving performance, while the benefits of positions backed by attractive valuations and improving fundamentals have not yet materialized. That said, potential catalysts in the form of stabilization of economic activity could indicate better times ahead. Yet, beyond any potential catalysts, perhaps there is a third key ingredient required for long-term investment returns: patience.

Over the past quarter, we have remained cautiously optimistic even as the consensus increasingly settled on a ‘no recession’ view. A few indicators suggest that the effects of higher interest rates are still working their way through the economy: tightening lending standards, diminishing pandemic-era savings, and rising delinquency rates underscore the need for a resilient portfolio that can help investors stay invested so that they do not miss out on the subsequent recovery.

The end of the ‘free money’ era also has important implications for fixed-income investors, who can now get 5% from USD money market funds (from 0% just over a year ago!). However, to truly gain an edge in purchasing power, investors must look beyond money market or cash. Credit markets are one segment with higher return potential, especially where investors are compensated e.g. Emerging Market High Yield. As the Fed signals the end of its aggressive rate hikes, history indicates that such transition periods present a more fertile hunting ground for opportunistic credit investors.

As we stand at the crossroads of potential market outcomes, it's crucial to focus on the long-term drivers of returns: fundamentals, valuations, and perhaps most importantly, patience. While the journey may be turbulent, investors can navigate the market's twists and turns and reach their desired financial destinations if they are prepared.

Finexis Asset Management

MARKET REVIEW

"Straight roads are for fast cars, turns are for fast drivers" - Colin McRae, World Rally Championship winner.

When it comes to driving, it is quite easy to tell if one is a fast car or fast driver: The fast car is the one that crashes at the turn.

When it comes to markets, it is much less obvious. In fact, the fast car may be convinced they are a fast driver, especially when the roads have been straight for a long time.

If the pattern of volatility in recent months is any indication, the era of straight roads has come to an end. **Whatever worked in an era of free money will not work amid today's new regime of high interest rates.** Which is why like a fast driver, we are prepared for twists and turns in the new regime.

While financial markets had an immediate response to rate hikes last year, the medicine is still working its way through the system. Higher rates are supposed to reduce inflationary pressures on the community by curbing demand.

However, the war on inflation is far from painless. The rate hikes are now weighing on economies as intended. Central banks have the unenviable job of steering their economies into a controlled descent/crash. The constant question on investors' minds is "Will it be a hard or soft landing?"

What is the market's response? It depends on when you ask. The chart below shows that **markets are currently feeling extreme fear. Just a month ago, the sentiment was greed. A year ago, it was fear.**

Why such drastic swings in sentiment?

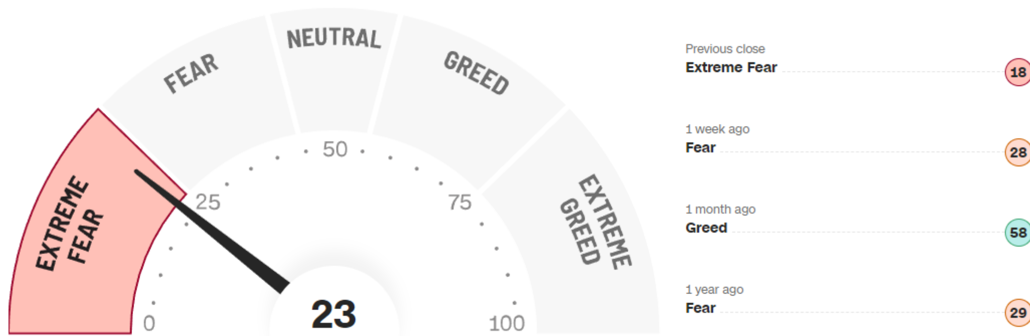
Humans don't like change. With each twist and turn in markets, fear alternates with relative calm. Market participants are responding to every new data point. Every green shoot is extrapolated to a recovery, while any sign of economic weakness leads to pessimism.

Indeed, there may be no more 'long straight roads' ahead. In fact, there are two potential turns ahead, and the jury is still out in terms of which will materialize. It could either be:

1. A soft landing that sets the US economy up for the next growth phase; or
2. A hard landing resulting from the Fed being behind the curve, and hiking the economy into a recession.

These are not hypothetical scenarios. The strong gains of the S&P 500 belie the fact that the US economy is not out of the woods. The Dow Jones index, which is one barometer of the U.S. economy's overall health, is flat for the year. If scenario 1 pans out, most markets would rally strongly, closing the gap with the S&P 500, if not surpassing it. If scenario 2 pans out, the gap will also close, but more from the S&P 500 reverting to where other markets are.

In the following sections, we elaborate on how our portfolios are positioned for the turns ahead. Trying to predict or react to the short-term events is counterproductive. Instead of swinging from greed to fear month on month, focus on the destination and the key factors that drive long-term market returns.



Source: https://edition.cnn.com/markets/fear-and-greed

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POSITIONING FOR RECOVERY

In recent meetings, we find ourselves re-emphasizing two key ingredients that ultimately underpin long-term investment returns: growth in earnings (fundamentals) and valuations – which of course makes up the 'F' and 'V' of our FVT framework.

The two ingredients are far from being a secret. They are extensively studied and almost undisputable in being the recipe for investment success. So why is it that most investors cannot just follow the recipe to get rich?

Many studies have confirmed the fact that on average, investors get far less than the returns offered by the market. A 2023 research by Morningstar found that investors missed out on about one-fifth of their fund investments' average returns over the previous 10 years. The reason: investors mistiming their buys and sells due to emotional investing; they get greedy (and buy) only after strong performance, and fearful (and sell) after investments go down. It turns out that investments are unpredictable and noisy in the short-term, with the full benefits of the two ingredients only appearing for those who invest with a longer time horizon.

Of course, many investors would believe that they can remain invested through the ups and downs. But ask any seasoned investors who have experienced multiple market cycles (multiple booms and busts!) and they would tell you that staying invested for the long-run is never easy.

One only needs to go through the first 9 months of 2023 to understand why it can be challenging.

The strongest returns this year have been from mega-cap stocks; benefitting markets and portfolios that hold them e.g. S&P 500. Indeed, the seven largest companies in the S&P 500 (now known as the 'Magnificent 7') made up almost all of the US market return year-to-date. In fact, the above graph shows that the average stock is flat for the year.

Likewise, our recovery positions i.e. US small-caps, Emerging Markets and China have not revealed their potential. Remember that they are underpinned by 1. attractive valuations 2. expectations of better earnings growth (the two ingredients for long-term returns) but this does not mean that it will surely lead to a better outcome in shorter periods.

In contrast, valuations of mega-cap stocks like the Magnificent 7 are stretched, to say the least (a recipe for long-term poor performance). What about the fact that their earnings growth is indeed…magnificent? An often-overlooked point is that their earnings are *expected* to be magnificent going forward, which lies the risk. If the reality falls short of the lofty expectations, the combination of high valuations and disappointment in fundamentals would result in a severe impairment of their stocks.

What would it take for our recovery positions to rally? We may not need to wait too long especially if the Fed sticks a soft landing, in which case US small-caps is poised for an upswing. Similarly, we monitor recent encouraging economic data from China closely; which may also signal a better environment for our China 'A' positions.

Yet, beyond any potential catalysts, perhaps there is a third key ingredient required for long-term investment returns: patience.

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LATE CYCLE STABILITY

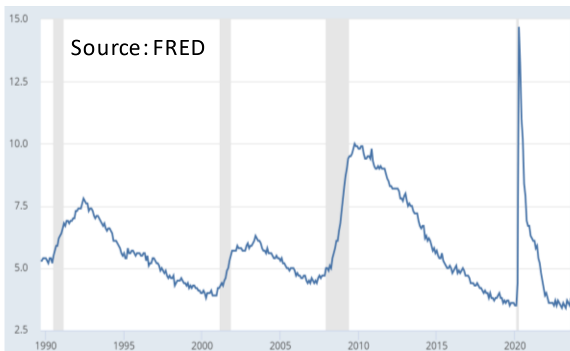
The S&P 500 being up this year has led to some calls that the much desired soft landing has been achieved. That would be a case of not seeing the wood for the trees.

In the recent quarter, as the consensus increasingly settled on 'no recession', it is interesting to note that instead of going up, markets have gone nowhere or even down.

While it is still possible that a soft landing can be achieved, **there exists some risks of potential hard landing which indicate the US economy is not out of the woods**.

Strong employment data is actually bad

Unemployment is at a record low. At face value, this is good news. Low unemployment should have benefits to the economy and society. In reality, low unemployment tends to indicate that the economy has peaked, from which there is only one way to go: down. The chart shows how record-low unemployment has tended to precede recessions (indicated by grey-shaded areas).



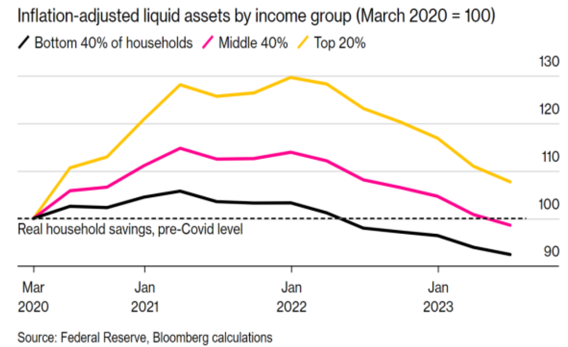
Credit squeeze setting in

According to the Federal Reserve Senior Loan Officer Survey, more than 40% of banks say that they are tightening lending standards.

Lending standards are being tightened, which means businesses cannot borrow as easily as they used to. Together with higher costs of borrowing, this tends to slow down business growth and hiring. By the way, this is what tighter monetary policy is supposed to achieve. But if overdone, can lead to recession.

The US consumer may not be as healthy as it seems

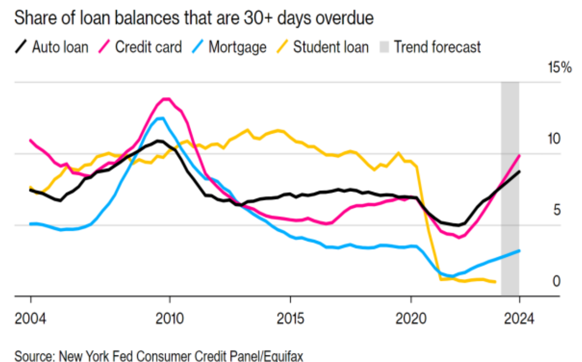
Pandemic-era related savings from stimulus cheques which drove the post-pandemic recovery are running out. The following shows how 80% of the population have less cash on hand than they did before COVID-19.



Recent alternative data that analyses retail spending patterns indicates that more consumers were seeking bargains during the recent back-to-school shopping season, pointing to weakness in household budgets.

Low delinquency rates starting to climb

Low delinquency rates are positive; it's when they start to rise that creates concerns as rising delinquencies tend to precede recessions. In another sign that higher borrowing costs are starting to filter into the real economy, the chart shows how low delinquency rates have been rising.



While the Fed may indeed achieve the elusive 'soft-landing', history informs us that we need to remain on guard. It is key to consider how significant the risks are and have stability positions to improve the resiliency of our portfolios. This way, one is sure to have a fast driver instead of a fast car when it comes to navigating the potential turns.

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CAPTURING HIGH YIELDS

Thanks to the Fed's inflation-fighting interest rate hikes, one can now get 5% from USD money market funds. The fact that this was 0% over a year ago in March 2022 shows how the era of free money is behind us.

Since the start of the Fed hikes last year, more than $1 trillion has poured into money market funds*. If one can get 5% risk-free, why should they consider other investments? After all, 5% today compared to 0% is "higher yield".

But think about it: if just about everyone can get 5% risk-free, the "higher yielding" **money market fund does not give one better purchasing power than the next person.**

For those who want greater purchasing power, credit markets offer higher yield over cash. ...How much more?

Credit spreads are a measure of how much more one can get compensated to take more risk over cash. The table below shows the current credit spread for investment grade and high-yield bonds. In general, investors expect to get higher returns by investing in high yield compared to investment grade.

Additional Returns over Cash	5 year		
Credit spread %	Current	Median	Percentile
Investment Grade (IG)	**+1.32**	+1.29	55%
High Yield (HY)	**+4.81**	+4.74	58%

Does this mean that investing in credit always gives a higher return? If only investing was that simple. The practical answer is: In the long run, yes. But in the short-medium term, no. There are certain environments where investing in credit is more rewarding, and certain environments where it is less.

How can one tell when it is a more favourable environment? This is where the Valuation part of our FVT process comes in: **the risk of IG or HY markets does not change much over time, but how much one gets compensated varies meaningfully over time.**

* Investment Company Institute data

Source: Bloomberg. Money market fund: Vanguard Federal Money Market Fund, IG: ICE Global Corp Index, HY: Bloomberg Global High Yield Index. From 31/10/2018-30/9/2023.

The spread is not a fixed number; it increases and decreases. When it is high, investors are compensated more to take credit risk. When it is low, investors are compensated less for similar credit risk. For example, high-yield spreads tend to move in a range from 3% to 8%. **Hence, one should be greedy when the spreads are higher, and fearful when spreads are lower.** In reality, the opposite tends to happen, which makes Warren Buffett's quote "Be Fearful When Others Are Greedy and Greedy When Others Are Fearful" ever more relevant.

At over the 50th percentile, current spreads for developed market credit are marginally higher than the median over the past 5 years, indicating fair value, not expensive or cheap. With spreads of 6.81% that are much higher, one can do better with Emerging market high yield bonds.

Furthermore, we are in a part of the monetary policy cycle that offers higher return for those willing to take credit risk. While the war on inflation is not complete, the Fed has telegraphed that most of the hikes are done, potentially needing only the last hikes of this cycle. As monetary policy cycles go, after the last hike is a transition period followed by a first cut.

Why is this relevant to high yield? The following shows that **such transition periods have been good for high-yield investors**, with median and mean annualized returns of 9.6% and 13.6% respectively.

Last Hike	First Cut	Distance	Spread (OAS) Change	Periodic Return	Annualized Return
Feb '89	Jun '89	4 Months	n/a	3.1%	9.5%
Feb '95	Jul '95	5 Months	n/a	9.3%	23.8%
May '00	Jan '01	8 Months	171	3.9%	5.9%
Jun '06	Sep '07	15 Months	84	12.1%	9.6%
Dec '18	Jul '19	7 Months	(140)	10.7%	19.1%
	Median	7.0 Months	84	9.3%	9.6%
	Mean	7.8 Months	38	7.8%	13.6%

Amid the current macro crossroads of hard or soft landing, such yield opportunities allow investors to get additional returns over cash, while balancing against the heightened volatility in equity markets.

Source: Skyharbor, ICE Data Indices, BofA Merrill Lynch, Bloomberg, Credit Suisse, Federal Reserve.

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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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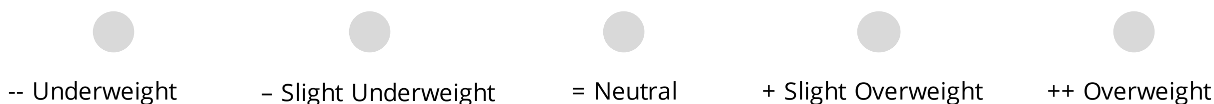
ASSET ALLOCATION STRATEGY



-- 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	-4.10	10.49	8.14	8.30
United States	-4.77	13.06	11.90	9.71
Europe	-4.01	7.88	4.75	7.16
Japan	-2.21	10.12	4.82	4.75
Asia Pacific ex Japan	-2.71	-0.45	3.40	7.65
Emerging Markets	-2.61	2.07	2.44	7.66

Equity Markets	MTD	YTD	10Y	20Y
Australia	-3.03	-0.84	4.94	9.78
Brazil	-0.71	12.09	-0.10	7.51
China "A"	-2.49	-7.83	4.76	8.73
China "H"	-2.12	-5.35	-1.59	6.61
Hong Kong	-2.42	-7.17	0.89	5.85
India	1.04	8.90	11.29	12.62
Indonesia	-1.77	5.29	4.27	12.49
Korea	-5.85	3.00	1.67	7.59
Malaysia	-1.45	-7.18	-2.33	6.14
Russia	-3.85	15.31	2.77	7.76
Singapore	-1.48	1.29	3.09	7.72
Taiwan	-2.59	13.97	10.21	9.69
Thailand	-9.83	-14.29	2.14	9.06

Equity Sectors	MTD	YTD	10Y	20Y
Gold	-8.13	-5.69	1.93	1.36
Energy	2.63	5.99	5.03	9.53
Technology	-6.79	30.67	18.05	12.11
Healthcare	-3.22	-1.60	9.87	9.46
Financials	-3.14	-1.65	9.64	4.64

Fixed Income	MTD	YTD	10Y	20Y
Global Aggregate	-2.92	-2.21	-0.44	2.20
Global Aggregate (H)	-1.72	1.09	1.84	3.12
High Yield	-1.34	5.81	3.77	6.31
Asia	-1.53	1.11	2.82	2.68
Emerging Markets	-2.28	0.91	2.35	5.60

Note: (H) Currency Hedged

Currencies	MTD	YTD	10Y	20Y
SGD/USD	-1.11	-1.96	-0.84	1.18
EUR/USD	-2.49	-1.23	-2.43	-0.49
JPY/USD	-2.56	-12.22	-4.10	-1.45

Commodities	MTD	YTD	10Y	20Y
Gold	-4.72	1.35	3.36	8.16
Oil	8.56	13.12	-1.19	5.84

*As of 30 Sep 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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