FEB 2024

THINK DIFFERENTLY

TO GET DIFFERENTIATED RESULTS

Monthly Investment Update

Executive Summary

Most of the activity in January centered around the stock markets. Most fixed income markets ended flat amid volatility arising from speculation that rate cuts were not so forthcoming. Asian High Yield credits were an outlier with notable gains despite the ups and downs in their stock markets.

Government bonds now serve two functions: offering modest returns and acting as a buffer against the volatility of higher-risk assets. For those looking to generate greater income, traditional and alternative markets offer opportunities not seen in years.

While it is not clear when rates will be cut, it is clearer that rates will be lower. The implications are that investors will start to shift capital out of money market funds as they face a combination of push (lower money market fund returns) and pull factors (higher yield from government bonds and credit).

Recent data points to a resilient economy, providing momentum for the soft landing phase that started last year. Accordingly, exposures such as small caps and Europe have benefitted from this context. Nevertheless, the soft landing journey will not be a straight highway due to volatility arising from interim speculation that rate cuts are not so forthcoming. The upcoming US elections will increasingly register on investors' minds. It is key to note that market performance has generally been positive over time, irrespective of the political party in the White House, underscoring the importance of looking beyond immediate political events to the broader, long-term market trends.

We've reduced exposures to China to capitalize on more immediate opportunities such as Vietnam which have already started to make a difference. Nevertheless, we are still mindful of the considerable long-term prospects in China, recognizing that the timeline for these potentials is marked by considerable uncertainty. Amid immense volatility, it is possible that an opportunity to engage more meaningfully will emerge in the near future.

Finexis Asset Management

MARKET REVIEW

Most of the action last month was in equity markets. In fixed income, Asian High yield credit stood out with strong gains despite volatility in their equity markets. In this section, we highlight a few key market observations and thoughts from January.

US x Tech x Magnificent 7: The US equity market is currently intertwined with the technology sector given that the Magnificent 7 make up the top 10 largest stocks in the S&P 500. The US S&P 500 was up 1.68% in January, driven by the 6 of the Magnificent 7 which exceeded sales expectations in Q4.

Exceeding expectations is certainly a way for stock prices to rise, but the bar to beat is raised each time. In their latest note, Goldman Sachs said that the fate of the Mag 7 (and the S&P 500) would hinge on their ability to deliver rapid growth this year. Indeed, current expectations are for the Mag 7 to grow 4x more than the rest of the 493 companies in the S&P 500.

What about the 1 member of the Mag 7 that did not meet expectations? In a reflection of what happens when expectations are not met; Tesla dropped 25% in January. It's like one gets a little pat on the head for exceeding expectations but receives a shelling when they don't. In this environment of asymmetric market response, investors should ensure that they are not overly exposed to such risks in their portfolios.

Small caps were down 3.89%. This may seem disappointing but to put this in context, US small caps rallied 23% in just over 2 months at the end of 2023. More importantly, we are currently in a soft-landing environment that is generally conducive for small caps.

In our 2023 review, we mentioned that China's pace of recovery was disappointing and that we would approach China from a more opportunistic standpoint. With the overhang persisting, we reduced exposure to China as negative sentiment took hold. Contrary to expectations of a pre-Chinese New Year rally, China equities dropped 6%. This reduction in exposure does not mean we have given up on China. As an indication, the Magnificent 7 group is now worth more than China's entire market cap.

Will it still be like that in 5 or 10 years time? Therein lies an opportunity for long-term investors to capture going forward.

Vietnam, a recent introduction to our portfolios, was up 2.51%. This is a reflection of how an allocation to Vietnam truly diversifies an equity portfolio. We elaborate on the above as well as other markets in the following sections.

Fixed income investors are expecting between mid to high single-digit returns across rates and credit markets this year. Yet they were largely flat in January. The common driver was price volatility arising from markets pricing in a lower probability of rate cuts. Does this mean that one should expect flat returns in fixed income going forward?

Recall that yield is the major contributor to fixed income return over the long haul, but is affected by interim price swings. One should not extrapolate short-term performance, especially if it is the result of price volatility. To get some perspective, the past year's return for fixed income investors across investment grade to high yield has ranged from 4.5-9.6%, and this was amidst volatility in fixed income markets not seen in the past 15 years.

The outlier in January was Asian High yield, which was up 2.62%. Over the past three months, AHY has gained about 10.17%. Of course, the recent gains serve to make up for the prior period where AHY's return did not meet the expected yield before. That is why fixed income is not called fixed return; the return will ultimately come but certainly not in a straight line. If the recent performance is any indication, AHY markets are looking to make up for lost time going forward.

Bonds: Small caps: Russell 2000, Vietnam: Vietnam Ho Chi Minh Index, Asian High Yield: Bloomberg Asia USD High Yield Diversified Credit Total Return Index

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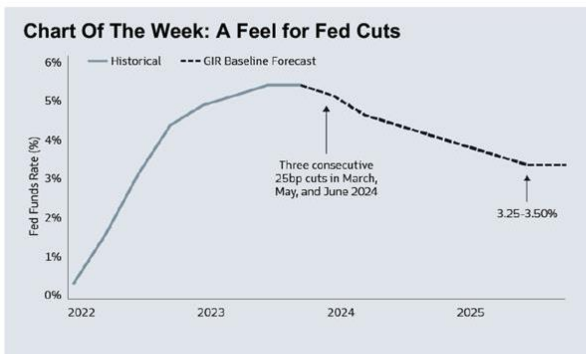
BONDS ARE BACK

We mentioned that bonds are back, and it looks like it. Government bonds are providing a dual role of low return while providing a buffer against other risk assets. Investors who seek higher income can look to clip coupons from credit markets.

How to position in rates
One question that is frequently asked is “when will interest rates be cut?” That sounds like a proper question for a market participant. The reality while a rate cut is likely this year, trying to figure out exactly when it is at best a tricky proposition, and at worst a fool’s errand.

The chart from Goldman Sachs shows that the Fed would cut rates 5 times this year from March for a total reduction of 1.25%. Already, recent strong data indicates an economy that is stronger than expected, creating volatility in rates markets, and affecting markets in the short term. With such resilience the Fed can afford to be patient on cutting rates, which may end up pushing out when rates would be cut. For those focused on figuring out when cuts will happen, it can be a nauseating journey.



Source: GS GIR and Goldman Sachs Asset Management. As of January 12, 2024.

Are the experts wrong then? In all fairness, Goldman is doing these forecasts based on the information they have now. The reality is things can happen in the interim to affect when the events will happen. The problem is investors who assume these forecasts will pan out without considering what happens along the way. So instead of asking when the cuts will be, it is more relevant to ask where rates will likely end up, which is a more rewarding exercise.

What is the Fed targeting? 2% inflation rate. With rates at 5.5%, they have managed to get inflation to stop rising and even slow down. At some point, rates have to come down so that the Fed does not end up over-cooling the economy. It may be a 1.25% cut, maybe more maybe less, but lower rates are the destination. In a twist from the popular saying, when it comes to investing, it is the destination not the journey that matters.

What are the implications?
For one, investors who poured $1.5 trillion into money market funds after the rate hikes will rapidly find their money market returns dropping. So investors who are able to ride out any short term volatility can consider investing in longer duration assets such as government and corporate bonds. These have the dual advantage of locking in higher yields, and opportunity for capital appreciation when rates really drop.

Opportunities for income
Readers who have been following us will know that we have exposures to Asian High Yield. Accordingly, recent announcements on the liquidation of Evergrande, the poster child for everything bad in China property, raised concerns.

On the surface, the liquidation may seem disconcerting but this represents progress in the whole restructuring process. That AHY went up amidst this is a sign that credit markets are ready to move on from the troubles of the property sector. Another thing to note is that the portfolios are dynamic. The AHY market has evolved to be less dependent on property, while not losing out on the income potential.

Not only did investors in alternative income benefit from double digit income last year, they did not have to sit through the volatility that traditional income investors had to bear with. Currently, alternative income yields are still at multi year highs. This means the stage is set for another year of high income that is not impacted by traditional equity and bond markets.

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EQUITY: SOFT-LANDING RECOVERY

Good news: the latest data continues to point towards a resilient economy.

Robust employment figures (NFP) released over the weekend aligns with other data suggesting that the American economy remains robust, reducing the likelihood of an impending recession. Indeed, unemployment remained stable at 3.7% with wages continuing to rise. The manufacturing sector is also rebounding, with PMI activity expanding for the first time in nine months. By most measures, the US economy look to be on track for a soft landing.

Why didn't we get a broad-based rally in in January? Instead, 'soft landing' positions like US small-caps took a breather over the past month. But It is important to note that they rallied 23% in just over 2 months at the end of 2023 as soft landing became more likely - when markets get overly excited in the short-term (the Fear & Greed Index was flashing 'extreme greed'!), they need to come back down slightly to gain momentum for the next new high.

Similarly, European equity performance paused in January after gaining 15% over 2 months at the end of 2023. This has happened alongside a better fundamental picture: sentiment indicators have broadly improved, with economic activity set to be on an upswing in the coming months. Historically, such trends have coincided with periods of positive returns for Europe's market, but once again, they do not go up in a straight line.

The soft-landing journey is not expected to be on a straight highway. January was a case of "too much of a good thing" as continued indications of strength in the consumer prompted concerns that interest rates would not come down as quickly as investors expect. The saying "two steps forward, one step back" indicates that reaching a goal is not a straight path. In the case of the *recovery* theme, this was a case of many steps forward, one step back.

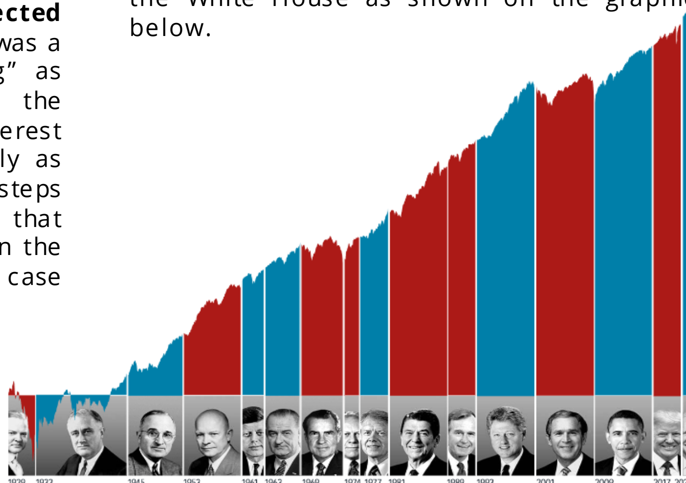
What is the outlook for recovery positions going forward? Let's recap two of the prominent market drivers today:

- Interest rates: Central banks i.e. Fed and ECB have telegraphed that it has either peaked or may cut, either of which is conducive for recovery positions like small caps.
- Economic growth: Our preferred undervalued recovery markets are expected to do well in an environment that does not entail recession, or high growth that prompts further rate hikes. The current soft-landing scenario with moderate growth is the sweet spot.

The past month is a reminder not to be swayed by market noise and focus on fundamentals that ultimately drive returns for investors. As of now, we focus on investing in the best opportunities for the likely soft-landing scenario.

This reminder is also particularly timely given the upcoming elections in the US later this year, and which has been gradually creeping onto the list of investors concerns. This is not surprising, given the increasing number (and increasingly extreme) of news articles and social media coverage as we get closer to actual day.

In times like this it is important to step back and take guidance from history. In this case, investors can take comfort from nearly 100 years of data that show a consistent trend: that markets go up regardless of who is in the White House as shown on the graphic below.



Source: Dimensional

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EQUITY: EMERGING OPPORTUNITIES

China has been a pain point for global investors. While there are signs that the worst is already behind us, the unpredictable regulatory environment and slow pace of recovery have been disappointing. Today, negative sentiment around China is at extreme levels, with performance declining even further over the past month.

Our decision to reduce exposure to China earlier this year helped to offset some volatility over the past weeks (refer to last month's outlook report where we outlined our approach to China). Today, we maintain a smaller exposure that offers investors a more limited downside with the potential for a stronger upside from the subsequent recovery.

While we have reduced positions in favour of more timely opportunities, we remain cognizant that China retains immense long-term potential – just one with a highly uncertain timeline. We continue to monitor the market closely; to identify better points to buy and sell opportunistically and also as China remains an important growth engine for the rest of the world.

So, what happened in January? Since the beginning of 2024, China's CSI 300 index declined by around 6% as of February 1st despite the PBOC's bigger-than-expected RRR cut as well as property policy easing in several top-tier cities.

Why did cheap get cheaper? In one word, snowballs.

No, we are not reminiscing about winter. Snowballs are financial products that were very popular with Chinese investors which promised steady returns from equity markets (how's that for an oxymoron?).

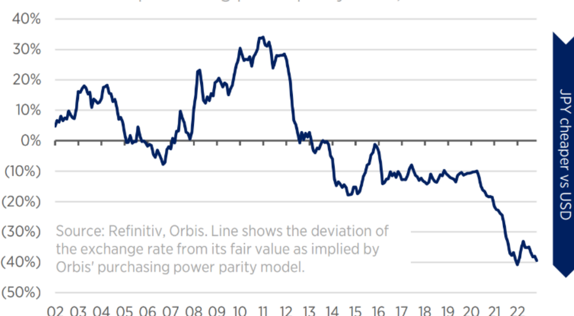
The catch was that if equity markets hit certain levels, the steady returns would turn into capital losses. Ironically, investors' short-termism and desire for instant gratification eventually led to what they feared the most: large permanent capital losses.

There are reasons why the recent declines should not concern long-term China investors:

- The sell-off looks to be more 'technical' in nature i.e., due to the forced unwind of investors who were not able to accept the inherent market volatility
- Credit markets typically drop with equities if there is real stress. Not only did China credit markets not show any panic, but they were also one of the best-performing segments globally across asset classes

A single month does not make a trend, but we are encouraged by the performance of our recent investment into Vietnam equities. As we can expect of a market with its own distinct economic trajectory, Vietnam was up 2.5% in January, one of the few markets that ended the month firmly in the green. This was on the back of attractive valuations and expectations of a rebound in corporate earnings as economic activity improves going forward; which ensures that we are at the start of a long runway ahead.

Another market that did well in January was one we have little exposure to: Japan. We've been assessing Japan as a potential emerging opportunity but are cautious about near-term headwinds facing the market. For one, valuations are no longer as cheap today after last year's gains. Importantly, there is a risk of a stronger JPY going forward: Japanese equities have tended to fall (rise) when their currency strengthens (weakens). A weaker JPY was one of the key reasons for the strong performance last year and over the past month. True enough, the Japanese Yen is one of the worst-performing major currencies in 2023 and in the first month of 2024. But with the Yen currently trading at multi-decade lows, we'd rather go to Japan for a holiday than invest aggressively in their financial market.



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HOW ARE WE POSITIONED?

Equity (Green) **Bonds (Blue)**

Key Themes	
Positioning for Recovery With the end of the rate tightening cycle and soft-landing as the current base case; there is a good window of opportunity for undervalued markets to lead the recovery. Maintain a preference for higher quality segments that still offers strong recovery potential.	**US small-cap equities** **Europe equities**
Emerging Opportunities Financial markets operate in cycles. The end of the easy money era means looking beyond popular markets that did well during the previous broad-based growth to find tomorrow's winners. Focus on high-growth markets driven by their own distinctive economic trajectories and coupled with attractive valuations.	**China 'A' equities** **Emerging Market, and Vietnam equities**
Late Cycle Stability With interest rates remaining at higher levels compared to the past decade, there continue to be signs that economies and businesses are adjusting to the new regime. e.g. tight labour markets and slower growth.	**Healthcare equities** **Government Bonds**
Capturing High Yields The combination of high interest rates with the end of the Fed interest rate tightening cycle means that bonds should place prominently on investors radars. Position in higher yielding markets that can provide a good buffer to their higher volatility profile.	**Asian High-Yield bonds** **Emerging Market bonds** **US High Yield Bonds**

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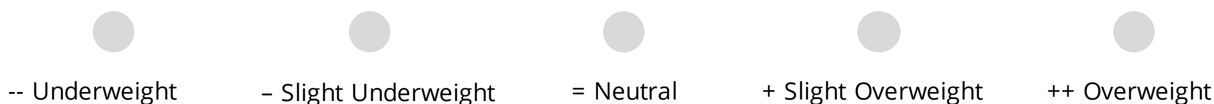
ASSET ALLOCATION STRATEGY



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

Europe's pro-cyclical industrial base to benefit from economic recovery as it becomes clearer a severe recession is not on the cards.

Japan

Maintaining no exposure as they are less attractive compared to other opportunities. Valuations have also become less attractive, with the prospect of a stronger JPY posing a risk to Japanese equities.

Asia Pacific ex Japan

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

Emerging Markets

Preference for high-growth markets at attractive valuations i.e. Vietnam

Fixed Income

Global

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

Investment Grade Corporate

Maintaining no exposure as we run a barbell strategy combining defensive government bonds and high income credit.

US High Yield

Maintaining no exposure due to relative poorer valuations and risk of defaults as economies remain late-cycle.

Asia

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

Emerging Markets Debt

Hard currency bias to focus on return from credit while limiting exposure to emerging market currencies.

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MARKET INDEX RETURNS

Equity Regional	MTD	YTD	10Y	20Y
Global	0.61	0.61	9.01	8.08
United States	1.68	1.68	12.60	9.68
Europe	-0.47	-0.47	5.43	6.66
Japan	3.75	3.75	6.23	4.94
Asia Pacific ex Japan	-4.79	-4.79	3.98	6.85
Emerging Markets	-4.64	-4.64	3.22	6.75

Equity Markets	MTD	YTD	10Y	20Y
Australia	-2.36	-2.36	6.82	9.57
Brazil	-6.30	-6.30	2.76	6.43
China "A"	-7.17	-7.17	4.36	7.40
China "H"	-10.04	-10.04	-2.71	3.89
Hong Kong	-9.25	-9.25	-0.10	4.25
India	-0.38	-0.38	11.60	11.67
Indonesia	-3.09	-3.09	4.89	11.33
Korea	-8.96	-8.96	2.24	6.74
Malaysia	0.97	0.97	-1.78	5.79
Russia	3.92	3.92	4.90	7.64
Singapore	-4.04	-4.04	3.76	6.99
Taiwan	-2.44	-2.44	11.46	9.59
Thailand	-6.98	-6.98	3.12	7.70
Vietnam	2.51	2.51	8.65	9.04

Equity Sectors	MTD	YTD	10Y	20Y
Gold	-9.83	-9.83	3.11	1.64
Energy	-0.38	-0.38	4.07	8.27
Technology	4.03	4.03	19.43	12.31
Healthcare	2.72	2.72	9.78	9.28
Financials	3.04	3.04	10.74	4.73

Fixed Income	MTD	YTD	10Y	20Y
Global Aggregate	-1.38	-1.38	0.13	2.31
Global Aggregate (H)	-0.20	-0.20	2.25	3.38
High Yield	-0.16	-0.16	4.07	6.33
Asia	0.00	0.00	3.25	2.99
Emerging Markets	-0.56	-0.56	3.00	5.69

Note: (H) Currency Hedged

Currencies	MTD	YTD	10Y	20Y
SGD/USD	-1.49	-1.49	-0.48	1.19
EUR/USD	-2.16	-2.16	-2.21	-0.68
JPY/USD	-4.14	-4.14	-3.60	-1.66

Commodities	MTD	YTD	10Y	20Y
Gold	-1.14	-1.14	5.06	8.45
Oil	5.86	5.86	-2.48	4.24

*As of 31 Jan 2024. 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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