APR 2024

THINK DIFFERENTLY

TO GET DIFFERENTIATED RESULTS

Monthly Investment Update

Executive Summary

The first quarter of the year was a picture of two halves. January's risk aversion quickly turned into gains starting in February, cheered on by a resilient economy and supportive corporate earnings. It was a conducive environment for risk assets like Emerging Market high-yield (EM HY) bonds, EM equities, and US small-cap equities which extended their gains. Asian high yield, in particular, reminded us once again that yesterday's underdogs are often today's champions.

Is the shift from 'bust to boom' sustainable? Indeed, the gains were supported by data. For now, it looks like economic expansion is back on the table, signaled by manufacturing PMI activity crossing into optimistic territory. As the broader economy gains strength, investors are venturing beyond the familiar mega-caps, seeking growth in new segments of the market.

Indeed, popular markets like US equities shouldn't overshadow the burgeoning potential elsewhere. As we face crossroads in economies and markets, now is the opportune moment to embrace diversification. We are finding a few select Emerging Opportunities, with their attractive valuations, fundamental resilience, and reasonable expectations ripe for positive surprises.

For fixed income investors: cash returns may be higher than prior years, but they will still lose out to inflation over time. With interest rates peaking and poised to come down eventually, cash's allure will also eventually fade. Those that have turned to credit markets for their higher return potential have already enjoyed a much stronger performance in recent times.

The stage is set for more returns in 2024. Amid today's uncertainties and signs of shifting leadership, investors who are flexible enough to look beyond the obvious winners can capitalize on the next phase of growth in the market.

Finexis Asset Management

MARKET REVIEW

Q1 was a picture of two halves. The year started with a volatile January. This risk aversion did not last as markets rallied from February as investors shook off their prior concerns on the back of favourable corporate earnings.

This meant a conducive environment for risk assets, with markets that led in February e.g. emerging market high-yield bonds (EM HY), EM equities, and small-cap stocks extending their lead.

The journey for EM HY was not as smooth but overall, investors cannot complain. EM HY markets held up during the volatility in January, then gained about 5% in the next two months. This is running above the yields at the start of the year due to investors getting more confident about EM, resulting in capital gains for those already positioned.

Asian high yield stands out so far this year. Not only did it hold up in January, it started the year strong and the momentum built to close the quarter up over 6%. Indeed there is a sense that the laggards of yesterday have become the leaders of today.

What caused this change in market direction? Does this rally have legs? These are important questions for any investor, and perhaps more so for our investors.

The short answer is the recent gains are more likely to persist, due to what we call “rotation supported by data”.

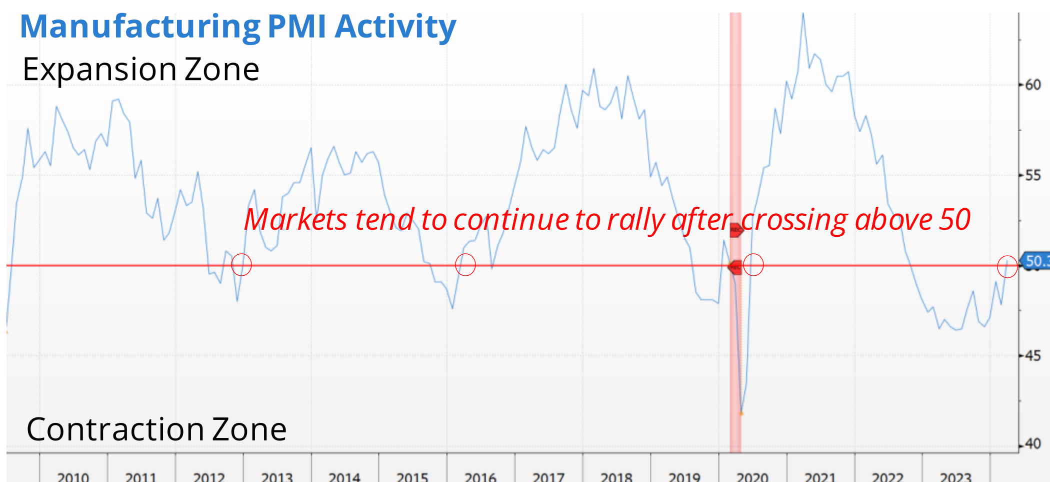
There is a saying in markets that “fundamentals tend to lag prices”. The rallies starting in February have been followed with data showing that after contracting since 2022, economies have started to expand. This is indicated by the chart of manufacturing PMI data shown below which crossed into expansionary zone (more than 50) in March.

If fundamentals lag prices, then why bother looking at fundamentals? One interesting observation over time is that when PMI crossed above 50, markets tended to continue to rally. Recall that improving fundamentals is one of the key drivers of market returns. Hence the shift from contracting to expanding economies is providing support to the market rally.

More crucially, **this shift paves the way for a meaningful rotation**. Investors were jittery when economies were still contracting and the effects of higher interest rates were uncertain, leading them to crowd in a narrow segment of mega-cap equities.

Improving economic data means other segments are likely to benefit as less jittery investors will start to look outside of the mega-caps for opportunities and broader economic growth will flow through to other segments of the markets in the form of better earnings.

*Source: Bloomberg. EM HY: Bloomberg Emerging Markets High Yield, Asian high yield: Bloomberg Asia USD High Yield Bond Index



Source: Bloomberg. ISM Manufacturing PMI.

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CASH IS NOT TRASH, BUT…

…CASH IS NOT KING EITHER.
There are a number of headwinds facing those still sitting on cash.

Despite cash returns being the highest in years, many are finding that cash returns are not covering basic price increases, much less modern needs such as education and healthcare costs. This may worsen as **interest rates have peaked, and are expected to decline, meaning even lower cash returns going forward.**

Cash has fewer defensive properties than bonds. Some investors may question this statement as they may recall that cash did well in 2022 when bonds did not offer much defence. The key difference in 2022 is the macro backdrop. Back then, central banks held rates low and bonds did not have defensive properties. Today, we have higher rates and central banks that are pondering rate cuts down the road. Which means that investors in bonds are paid coupons, plus the potential for capital appreciation when rates drop. Hence, the environment is more conducive for bonds as a defensive allocation compared to cash.

Cash is crowded. The chart below shows how investors have ploughed into money market funds in recent years, literally forming a mountain of cash. This is justifiable as interest rates were rising. But as interest rates peak and cash returns start to lag, one by one, those in that mountain of cash will start moving elsewhere.

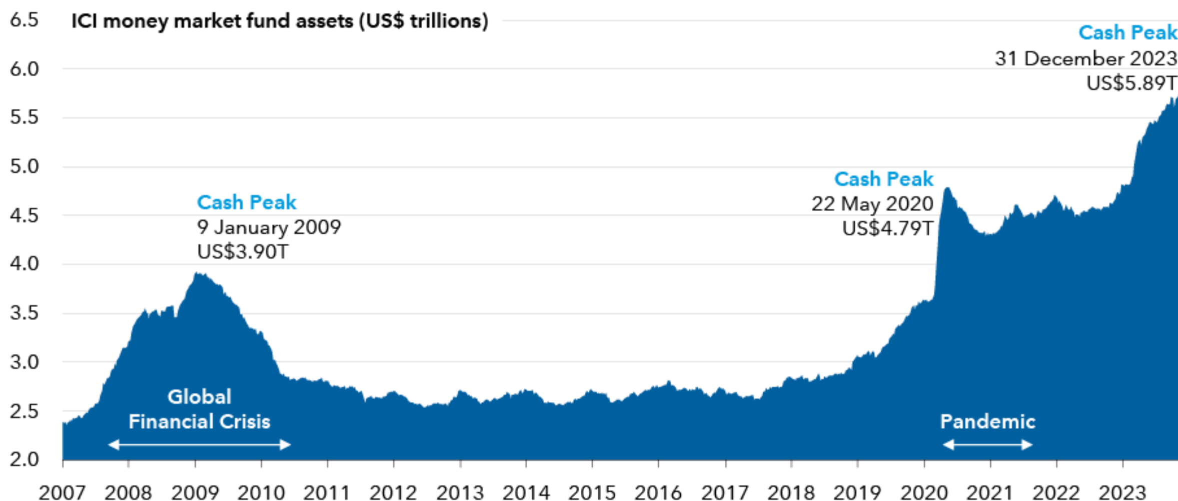
Where will they go?
Some flexible investors may make the move to equity to benefit from an equity rotation. But for many cash investors, the most natural path is into credit markets which are money market funds' "next door neighbour".

In the review section, we discussed how credit markets have provided meaningful return this year from coupon and capital appreciation. The table below shows the performance of various fixed-income segments in just under the past six months.

MMF	DM IG	DM HY	EM IG	EM HY
2.41%	9.14%	12.08%	11.70%	16.71%

At some point, cash investors will start to notice the performance and wealth gap, and contemplate shifting. The good thing is current macro conditions are supportive of credit markets to provide stable yields going forward. We must remind investors that credit markets are not without risk. But for those still with ample cash on hand, perhaps they are taking a different kind of risk that will be more onerous down the line.

Source: Bloomberg. MMF: Vanguard Federal Money Market Fund, DM IG: Bloomberg Global Aggregate Corporate Index, DM HY: Bloomberg Global High Yield Index, EM IG: Bloomberg Emerging Markets Hard Currency Aggregate Index, EM HY: Bloomberg Emerging Markets High Yield Total Return Index Value from 18/10/23 to 31/3/24.



Source: Bloomberg, Capital Group, Investment Company Institute

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ROTATION TO FUNDAMENTALS

For most of 2023, investors were jittery about markets as they were digesting the impact of high rates and slowing economies. But they were not jittery enough to get out of equities. Hence, what they did was to crowd into a narrow segment of mega-cap stocks.

This led to strong returns in mega-caps, primarily from valuation rerating, meaning investors were willing to 'pay more' to own the same names. Research from JP Morgan shows more than 2/3 of the 2023 return for the S&P 500 was driven by the market becoming more expensive.*

We've always said that market returns are driven by two key ingredients: valuation and fundamentals. So one might ask "What's wrong with valuation re-rating giving me most of the returns?" The key is valuation re-rating returns need to be backed by fundamentals.

The chart below shows that over the long-term valuation has contributed to half of equity returns. That means at some point fundamentals have to 'catch up' to valuations, or returns from valuation re-rating need to come back down.

*Source: JP Morgan, Guide to the Markets 2Q

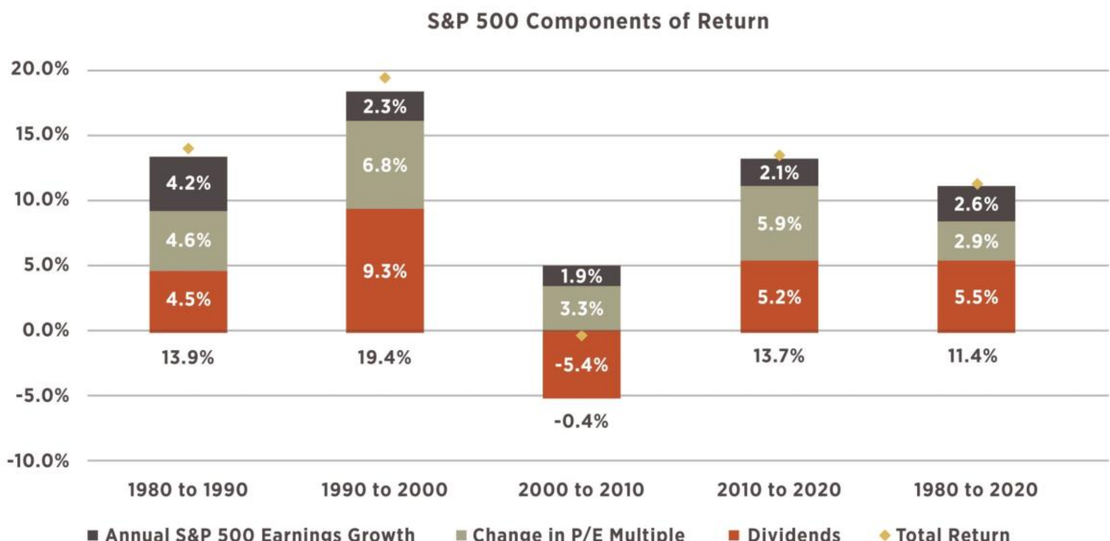
Increasingly, there are doubts that the mega-caps can deliver on the earnings. Morgan Stanley's CIO recently said that "it's hard to justify the higher index level valuations based on fundamentals alone, given that 2024 and 2025 earnings forecasts have barely budged over this time period."^

Just look at Tesla. No one's really talking about it in the same breath as the Mag7. The stock is down 30% in Q1 as sales disappointed expectations. As such, 2024 will be a show me the numbers market where companies that deliver better-than-expected revenue or earnings will be rewarded, while those that disappoint will be punished.

So where are the sources of better-than-expected revenue or earnings?

The latest economic indicators and the broadening market performance are showing improving risk appetite and growth expectations. Under such conditions, pro-cyclical segments that are highly responsive to growth shifts and have significant operational leverage like smaller caps tend to benefit. With expectations so low now, it would not take much of a revenue or earnings rebound to result in further gains in these segments.

^https://www.businesstimes.com.sg/companies-markets/wall-street-bears-say-stock-rally-will-end-if-



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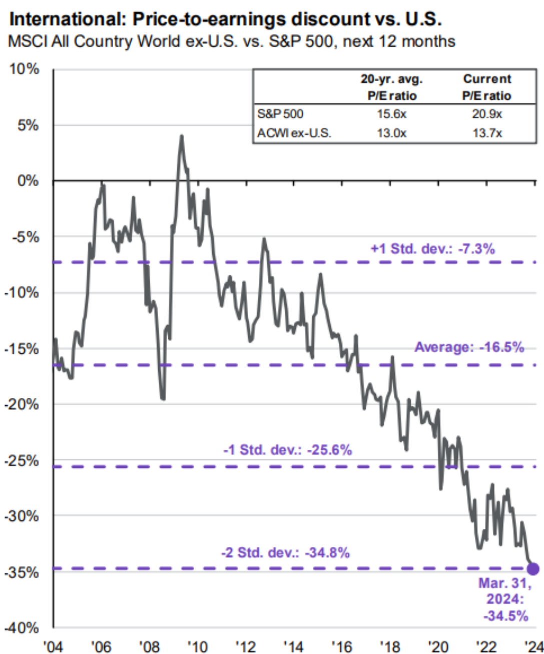
EMERGING OPPORTUNITIES

The S&P 500 is undisputedly the most popular market and investment in recent years. It also has the honor of the largest ETF in the world: 'SPY' ETF, with assets of close to $500 billion.

It is perhaps no surprise then that the trajectory of the US economy is front and center of many investors radar. This is for good reason as many investment portfolios will be affected. But whether or not they get a soft or hard landing, or if the Fed cut interest rates in June, July, or the end of the year; today is the right time to consider diversification. Historic high valuations of the US relative to the rest of the world supports this view:



This does not necessarily mean the US is a bad investment today – it remains an important part of our portfolio. But it means that investors should at the very least start to diversify into Emerging Opportunities with the potential to be tomorrow's winners. Think of it as a hedge to secure your returns in the years ahead.

The Emerging Opportunities theme is likely one of the most important themes for investors going forward. Vanguard, which manages hundreds of billions of dollars of funds tracking the US markets, has also urged investors to consider diversifying outside of the US[1]. Vanguard's research also indicates that international stocks will outperform the US in most of their outcome simulations in the next decade!

[1] Vanguard: Making the case for international equity allocations.

Today, we are finding good Emerging Opportunities across Asia and Emerging Market equities. They stand out as a good diversification opportunity, given its (1) attractive valuation, on both relative and absolute basis (2) promising long-term growth, which is fundamentally less correlated with the economic development and policies in the developed world, and (3) being a fertile ground for companies that have time-proven resilience against macro adversities (i.e. runaway inflation, high interest rate) as demonstrated over the past cycles.

Of course, Emerging Opportunities may be perceived as facing more uncertainties. Take China, which is currently at crossroads: have they finally turned the corner or is there more downward pressure ahead? As a result, investors are staying on the sidelines to see how these economic puzzles develop, by large preparing for the worst. What a contrast to the investors' attitude towards US markets, anticipating the best!

When it comes to 'show me the numbers'...
Seasoned investors like to say: 'There are no good or bad numbers, only the numbers above or below expectations". Considering the very realistic expectations for Emerging Opportunities like China and Vietnam today, investors will likely be rewarded as their economic indicators continue to improve.

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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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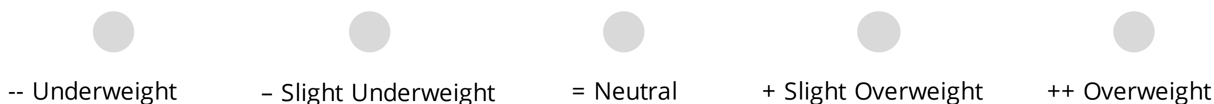
ASSET ALLOCATION STRATEGY



-- 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

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	3.19	8.32	9.24	8.41
United States	3.22	10.55	12.94	10.15
Europe	4.14	5.23	5.34	6.98
Japan	3.44	9.86	6.98	4.51
Asia Pacific ex Japan	2.60	2.08	4.06	7.06
Emerging Markets	2.50	2.41	3.32	6.83

Equity Markets	MTD	YTD	10Y	20Y
Australia	3.88	0.86	5.95	9.43
Brazil	-1.42	-7.42	1.37	6.24
China "A"	0.14	1.37	5.83	7.45
China "H"	2.39	0.55	-1.89	4.27
Hong Kong	0.68	-2.72	0.49	4.83
India	1.01	1.93	10.39	11.69
Indonesia	-0.10	-1.44	3.54	11.61
Korea	3.52	-0.46	2.85	6.92
Malaysia	1.07	4.34	-2.00	5.43
Russia	1.10	4.89	5.64	6.84
Singapore	2.63	-2.19	3.25	7.05
Taiwan	5.94	8.51	12.20	9.99
Thailand	-0.37	-7.47	1.98	8.02
Vietnam	1.97	11.46	8.89	8.10

Equity Sectors	MTD	YTD	10Y	20Y
Gold	19.61	1.27	4.22	2.23
Energy	10.60	13.69	4.69	8.78
Technology	1.71	12.35	19.80	12.98
Healthcare	2.47	7.66	9.73	9.65
Financials	4.77	12.45	11.01	5.10

Fixed Income	MTD	YTD	10Y	20Y
Global Aggregate	0.55	-2.08	-0.07	2.19
Global Aggregate (H)	0.90	0.01	2.21	3.31
High Yield	1.20	1.27	3.97	6.40
Asia	0.81	0.28	3.08	3.01
Emerging Markets	1.72	1.53	2.90	5.65

Note: (H) Currency Hedged

Currencies	MTD	YTD	10Y	20Y
SGD/USD	-0.27	-2.15	-0.70	1.09
EUR/USD	-0.14	-2.26	-2.41	-0.66
JPY/USD	-0.91	-6.81	-3.75	-1.85

Commodities	MTD	YTD	10Y	20Y
Gold	9.08	8.09	5.67	8.62
Oil	6.27	16.08	-1.98	4.31

*As of 31 Mar 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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