

THINK DIFFERENTLY TO GET DIFFERENTIATED RESULTS

Quarterly Investment Update

Executive Summary

In a move reminiscent of Black Monday in 1987, Japan equity markets experienced a dramatic 12% drop on August 5th, wiping out its gains for the year. Reversals in US interest rates, the Japanese Yen, and equities prompted margin calls and the unwinding of trades which were dependent on a weak Yen. Recent moves show how seemingly different investments are correlated, emphasizing the need for investors to look beyond the surface rather than relying solely on recent trends.

Contrary to expectations, markets sold off sharply following US Fed Chair Jerome Powell's signal for a likely September rate cut. Weaker US economic data quickly shifted investor focus back to fundamentals, underscoring the difficulty of predicting or reacting to sudden market reversals. A better strategy is to be prepared - in anticipation of potential twists and turns in the second half of 2024, we adjusted our portfolios to improve their resiliency while looking to capture a higher quality recovery going forward. This strategy has proven valuable in maintaining resilience through recent market volatility.

Claudia Sahm, known for the 'Sahm Recession Rule', recently stated that she is not currently concerned about an imminent recession despite her rule triggering. While the July employment report was weaker than expected, other high-frequency indicators, such as restaurant bookings and air travel, suggest the economy continues to be humming along. Although a recession is *inevitable* at some point, current data do not indicate that it is *imminent*, especially with current corporate earnings trends indicating the potential for market gains in the months ahead.

Fixed income markets have shown resilience amid recent volatility, well-suited for income investors with lower risk tolerance. However, even resilient income markets are not immune to declines, and generating returns above inflation means being selective on segments with better valuations and fundamentals. Our approach continues to focus on maintaining a well-diversified portfolio of such attractive positions while watching to see how economic and market trends evolve to make timely adjustments.

MARKET REVIEW

In echoes of the Black Monday of 1987, Japan was down 12% on Monday 5 August, the largest down day in about 40 years. If not for the circuit breakers triggering, who knows how much the decline would have been? The sell-off propagated across Europe and US equity markets, showing a sea of red across our market monitors.

In mid-July (just not too long ago!), Japan equities were up 13% year-to-date. **A few months worth of gains were then wiped out in just a few days, reminding us of the adage ‘markets take the stairs up and the elevator down’.** For those who have been bullish on Japan for reasons such as structural corporate reforms and renewed growth in wages and capex, this is a great chance to invest. For those not adding to their positions, now is a good time to reflect on whether they truly believed in those reasons. The events that unfolded in the past two weeks serve to remind us how easy it is to find reasons to justify any rally, and how painful it is when things don't play out according to expectation.

The chart below shows that across different asset classes and markets, there were simultaneous reversals in 1. US interest rates, 2. Japanese Yen (your holiday just got a bit more expensive), 3. Japanese equities, and even 4. Magnificent 7 stocks in the US.

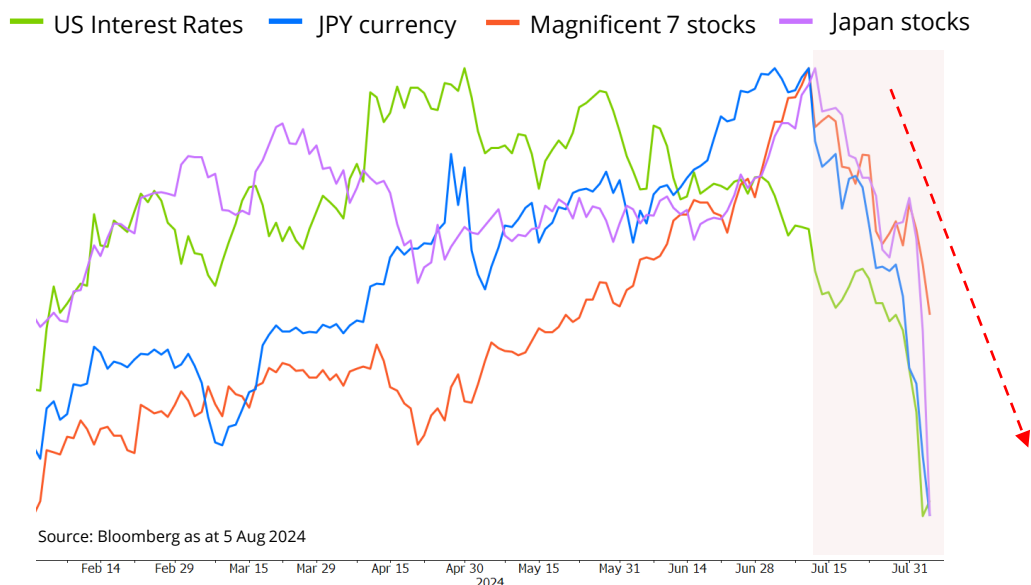
Why is this happening?

If there is a reason for the moves in Japanese currency and equities, one can find it 10,000km away in the US. In July, markets finally started to take US interest rate cuts seriously. In contrast, the Bank of Japan (BOJ) surprised markets with a rate hike from 0.1 to 0.25%, leading to a stronger JPY – more than 10% in a month, reversing a weakening trend that many took for granted. Those who had been borrowing and counting on continued cheap + weakening JPY to invest elsewhere are now facing margin calls and causing the unwind of crowded positions globally, which is what has been happening in the past week or so. Such “status quo” trades tend to work well until they don't.

Implications for investors going forward

The recent moves serve as a reminder that different positions have common risks and that this time is never different. After the fastest pace of rate hikes by the Fed, markets are on the cusp of another regime shift (rate cuts amid softening economic activity) as recent patterns threaten to break down.

Investors cannot count on markets to be as one-sided as they were in the past. With economies and markets at potential inflection points, investors need to consider and be positioned for different scenarios.



Source: Bloomberg as at 5 Aug 2024



WATCH OUT FOR TWISTS & TURNS

What happened to the Fed saving the day? Instead of markets rallying as many had expected, markets saw violent sell-offs across markets even as the US Fed Chair, Jerome Powell, gave the all clear for a September interest rate cut.

As outlined earlier, **the combination of higher rates in Japan, and expectations of lower rates in the US, coupled with weaker economic data triggered sell-offs across global markets over the past week.**

It is unlikely that anyone could have predicted that things would have played out according to the recent sequence of events, much less the timing of it. The past week or so showed that the twists can come both *suddenly* and *sharper* than most people expect, once again reminding investors that it is better to be prepared rather than trying to predict or react to such moves.

Last month, we cautioned investors to ‘watch out for twists and turns’ for the second half of 2024. As a recap, we highlighted a few key risks over the next few months to watch out for, such as:

- Deterioration in economic data
- US presidential election
- Disappointment in corporate earnings

Amid the more uncertain backdrop, we adjusted our portfolios in mid-July to improve the resilience of our portfolios while positioning to capture a higher quality recovery with economies firmly in late-cycle. This was reflected through a reduction in economically sensitive positions such as small-caps in favour of higher quality large-cap segments like Healthcare.

Recent market movements have asserted the growing concerns that our process has led us to be positioned for:

Japan equities went from one of the best-performing to worst-performing markets in just a few days. We have been cautious and avoiding Japan equities in our portfolios due to extreme levels of the JPY currency – much of the previous outperformance has been driven by a weaker JPY. Likewise, it should not be a surprise to see Japanese equities underperform as JPY strengthens.

We are watching closely how the market and fundamentals evolve which may prompt us to change our positioning in Japan going forward, especially if the volatility presents us the opportunity to invest at a good price.

US equities: Expectations were high leading up to the Fed meeting last week, as cooling inflation data meant that the US central bank could finally start to cut rates. Though rate cuts are expected to benefit market segments like small-caps which are more sensitive to high borrowing costs, they ended up being fragile in recent declines. Small-caps tend to shine when rates are low and economic growth is stable. While rate cuts are now incoming, markets are focusing on weaker economic data which would challenge the more economically-sensitive segments of the market.

With signs of economic softening, we are positioned to capture a recovery through higher-quality large-cap segments such as Healthcare. Healthcare equities were particularly resilient in the past month, as expected of their stable earnings profile regardless of the economy’s strength.

Government bonds are once again effective shields for portfolios in today’s high-interest rate environment. As market declines accelerated, government bonds delivered positive returns which helped our portfolios offset volatility and further losses.

Recent market moves remind investors that it is usually too late to react to shocks that can come unexpectedly. Portfolio protection such as government bonds or other hedges gained alongside market declines, becoming more expensive for investors who are only now looking to have some protection in their portfolios. Similarly, some investors may be tempted to reduce their equity exposures in an attempt to protect against further losses and pain. This is also a risky move as they may end up getting out at the lows.

A better way is to prepare by maintaining a well-diversified portfolio of holdings that are of good fundamentals and valuations. This has put us in a good position to navigate the markets in the coming weeks and months ahead with confidence.



ECONOMIC GROWTH TO CONTINUE

Claudia Sahm, creator of the recession signal, recently said that she is not concerned about a recession today. While we do not ignore the historical accuracy of the recession indicator, we also do not focus on one indicator to guide our portfolio positioning. Sahm herself indicated as much:

“Certainly, when I make a call on the economy - where it is, where it’s headed - I look far beyond the Sahm Rule.” [1](#)

One must not fall into the trap of making a conclusion first, then finding data points to justify that conclusion. Investing is easy to do but hard to do well. So many aspects of it require us to resist how humans are inherently wired to think.

At first glance, the recent July employment report was softer than expected, creating concerns that a recession was afoot. That said, there were also reports to attribute some of the weaker employment to poor weather with Hurricane Beryl causing a few power outages. If so, we would want to see a stabilization of data going forward rather than further signs of deterioration.

Likewise, other higher frequency data like restaurant bookings, air travel activity, hotel demand, and box office receipts are only indicating a slight decline. **Overall, this reflects an economy that is still broadly humming, and that investors should not overreact to one or two weaker-than-expected jobs data.** If anything, one can be forgiven for suspecting that the weaker jobs data was due to people taking time off for leisure.

That said, we are not perma-bulls with an unreal view of economic and market cycles. To be clear, a recession is a matter of when, not if. One must be careful to leave the party early, but not so early that a lot is left on the table. This is a fine balance to strike, and we do not presume that anyone get it right most of the time.

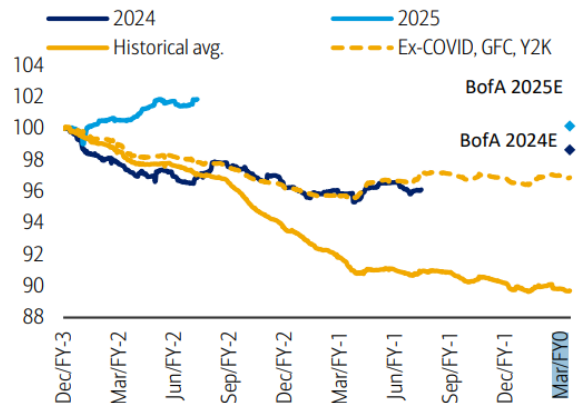
Instead, we have started to position our portfolios more defensively in response to the uncertainty, leading to positive outcomes during the recent sell-off as discussed in the previous section. At the same time, we continue to be positioned for further gains as indicated by continuing growth in the economy and corporate earnings – albeit at a slower pace.

The silver lining from the current bout of volatility and corrections is that a lot of excessive optimism that we saw has been relieved. Investors are no longer as strident in their beliefs which had been reinforced for a long while until recently. For example, there is now a healthy dose of scepticism relating to AI capex and results where it was purely based on hope and speculation before. In short, more are paying attention to fundamentals to guide market performance going forward.

Inevitably, matters such as Fed rates and elections have overshadowed corporate earnings in investors’ minds. When it comes to fundamentals such as corporate earnings, it would be a mistake to overreact to one or two bad data points – we focus on trends that will help guide our positioning.

The chart below shows that earnings are trending in a way that is consistent with a non-recessionary year. This gives support for markets to resume their (bumpy) uptrend as long as growth does not meaningfully deteriorate from here.

2024 Earnings trends (blue line)... following a typical non-recessionary year



Source: BofA Research, FactSet. Historical average based on 2001-2023. S&P 500 historical forward earnings revisions vs 2024-2025 consensus as of 8/1/2024



FINDING TRULY DIVERSIFIED INCOME

While equity investors were facing volatility and declines (which is what equity investors should expect from time to time), the table below shows that **fixed-income markets including high yield have been relatively resilient.**

This also meant that **income investors who tend to have a lower tolerance for volatility could better sit through headlines such as “Japanese stocks crash in biggest one-day drop since 1987 as global market rout intensifies”.** This is crucial as the reality for investors is that they need to stay invested to pocket the gains at the end of the day. The other reality is that many abandon ship halfway when they are underwater amid turbulence, and lock in losses.

Looking at the table, it is easy to conclude that one should just invest in income markets and get comparable or even higher returns than equities, and with fewer worries (declines). Equity investors who focus on capital growth might even think about shifting their investment strategy from growth to income.

Before making any such decision, one has to ask if they are getting into a doom loop of chasing returns.

For investors with aggressive profiles, one must think back how they felt in mid-July when global equities were up strongly for the year, and how they feel now. Are they only excited when there is up volatility, and panic when they are down? Volatility cuts both ways but when the going is good, the bad is forgotten. If they are thinking about shifting to income strategies, perhaps they did not have that risk tolerance in the first place.

More conservative investors should also think about how they felt when equity markets were up mid-teens in mid-July while income markets were in the single digits. Were they contemplating changing investments from income to capital growth to get better performance? Imagine doing that and running smack into an equity decline.

The resilience of income markets so far does not mean that they will not suffer declines. Getting a higher return than cash to provide passive income and beat inflation is not riskless. While only Alternative income is truly uncorrelated as shown in the table, many income opportunities commonly available to investors need economies and markets to do well to generate more consistent income.

Some liken the economy to a ship that takes a long time to turn after the captain starts turning the wheel. After two years since the fastest pace of rate hikes to tame inflation, the signs of a slowing economy are starting to show. Will these lead to a soft landing or a deeper recession? Is the recent volatility a buying opportunity, or the beginning of a bigger bear market? For now, the weight of evidence points to a more orderly economic slowdown that would support a continued bull market in the coming months.

In life and especially in investing, being early also means that one is wrong. We are monitoring the ongoing data releases so that we can be more active and timely in making adjustments to our portfolios.

Investment	16/7/2024-5/8/2024	Year to date 5/8/2024
Global equities	-8.27%	6.18%
Developed market high yield	-0.39%	4.86%
Emerging market high yield	-0.49%	6.89%
Asian High Yield	-0.16%	12.14%
Alternative income	+0.97%	5.50%

Source: Bloomberg as at 5 Aug 2024. Global equities: MSCI World, Developed market high yield: Bloomberg Global High Yield Index, Emerging market high yield: Bloomberg Emerging Markets High Yield Total Return Index, Asian High Yield: ICE BofA Asian Dollar High Yield Corporate Constrained Index. Finexis Asset Management. Alternative Income: Based on NAV until 30/6/2024 and estimates until 5/8/2024.

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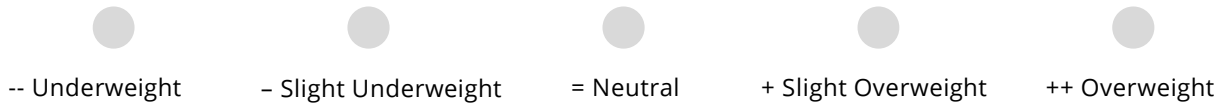
HOW ARE WE POSITIONED?

Equity (Green) Bonds (Blue)

Key Themes	
<p>Positioning for Growth</p> <p>With the end of the rate tightening cycle and economies continuing to grow; there is a window of opportunity for capital appreciation in equity markets. Maintain a preference for higher quality segments that offer growth potential while being more resilient in the event of slowdown.</p>	<p>US equities</p> <p>Europe equities</p>
<p>Emerging Opportunities</p> <p>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.</p>	<p>Emerging Market and Vietnam equities</p>
<p>Late Cycle Stability</p> <p>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.</p>	<p>Healthcare equities</p> <p>Government Bonds</p>
<p>Capturing High Yields</p> <p>The combination of high interest rates with the end of the Fed interest rate tightening cycle means that bonds should figure prominently on investors radars. Position in higher yielding markets that can provide a good buffer to their higher volatility profile.</p>	<p>Asian High-Yield bonds</p> <p>Emerging Market bonds</p>



ASSET ALLOCATION STRATEGY



Equity: Regions

- United States**
● ● ● ● ● **US Quality** as relative valuations are attractive and expected to benefit as economies grow. **Healthcare** as earnings are more stable and less dependent on broader economic cycle.
- Europe**
● ● ● ● ● Europe's pro-cyclical industrial base to benefit from economic growth so long as severe recession is not on the cards.
- Japan**
● ● ● ● ● Maintaining no exposure as continued Japanese equity performance needs JPY to weaken further whereas both BoJ and Fed policies point to a stronger JPY.
- Asia Pacific ex Japan**
● ● ● ● ● Tailwinds for China building up in the form of improving credit conditions and economic activity but confidence remains low. Participate in China via broader exposure to Asia.
- 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	1.64	13.42	9.32	8.81
United States	1.22	16.69	13.14	10.54
Europe	2.31	8.53	5.71	7.19
Japan	6.26	11.76	6.38	5.13
Asia Pacific ex Japan	0.16	8.65	3.74	7.90
Emerging Markets	0.36	8.03	3.00	7.75

Equity Markets	MTD	YTD	10Y	20Y
Australia	1.96	4.35	5.70	9.83
Brazil	1.55	-18.23	-0.85	5.75
China "A"	1.25	0.98	4.49	8.73
China "H"	-2.02	9.14	-2.44	5.12
Hong Kong	-1.08	5.09	-0.11	5.36
India	3.13	13.56	10.04	13.02
Indonesia	3.35	-2.94	2.71	11.59
Korea	-0.39	-1.00	2.04	7.94
Malaysia	5.03	14.14	-1.48	6.24
Singapore	5.10	8.05	3.46	7.65
Taiwan	-3.79	17.46	12.15	11.52
Thailand	4.90	-8.37	0.81	8.28
Vietnam	1.51	7.56	8.28	8.74

Equity Sectors	MTD	YTD	10Y	20Y
Gold	10.91	21.64	5.13	3.17
Energy	2.11	13.27	3.82	8.18
Technology	-2.05	22.65	20.05	14.00
Healthcare	3.30	11.87	9.70	9.91
Financials	6.46	17.28	11.39	5.56

Fixed Income	MTD	YTD	10Y	20Y
Global Aggregate	2.76	-0.49	-0.06	2.42
Global Aggregate (H)	1.93	2.07	2.19	3.46
High Yield	1.91	4.39	4.20	6.51
Asia	1.98	3.00	3.04	3.14
Emerging Markets	1.85	4.11	2.72	5.91

Note: (H) Currency Hedged

Currencies	MTD	YTD	10Y	20Y
SGD/USD	1.49	-1.18	-0.68	1.27
EUR/USD	1.05	-1.93	-2.10	-0.52
JPY/USD	7.26	-5.97	-3.71	-1.48

Commodities	MTD	YTD	10Y	20Y
Gold	5.19	18.64	6.68	9.60
Oil	-4.45	8.74	-2.28	2.92

As of 31 July 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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