

# THINK DIFFERENTLY TO GET DIFFERENTIATED RESULTS

## Quarterly Investment Update

### Executive Summary

Equity markets began September on a weak note, with the S&P 500 and China equities falling about 4% - seemingly continuing the third quarter's volatility and in line with September's historically poor seasonality. However, mid-month brought about a stark shift in sentiment. The US Fed delivered an outsized 0.5% rate cut, which helped to push US equities up 2% to hit new highs. Meanwhile, China equities experienced a dramatic reversal, rebounding strongly after the Chinese government surprised everyone by unleashing large-scale stimulus measures.

The past month has made it clear that central banks are committed to supporting economic growth, which could prolong the current expansion. We are cautiously optimistic that this environment is supportive of risk assets and continue to maintain a well-balanced portfolio: a combination of higher quality positions like Healthcare to mitigate volatility in late-cycle, alongside growth-oriented positions like Emerging Markets (e.g. China, India, Vietnam) to capture upside in a soft-landing scenario. Within fixed-income markets, there continue to be opportunities that offer investors attractive high income of 3-5% above cash for those who can tolerate some volatility. Higher-quality segments may be a better fit for those seeking smoother returns, especially if economic conditions unexpectedly worsen.

With that said, the broader economic environment remains in late-cycle phase, marked by slowing growth. Although easing financial conditions has reduced the likelihood of an immediate downturn, the risk of recession remains - we are staying vigilant for signs of further deterioration and are prepared to make portfolio adjustments as necessary based on how the data unfolds in the coming weeks and months.

## MARKET REVIEW

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### What happened in September?

Equity markets started the month on a weak note. Both S&P 500 and China equities were down 4%, seemingly in line with weak seasonality – historically, September has been the worst month for markets on average. What happened next is a reminder that averages are just that – *averages*. Of course, making any major decisions based on a single factor is not prudent as it can ruin one's market-compounding journey.

### US Fed cuts rate after their hiking cycle

On 19<sup>th</sup> September, the Fed finally initiated its first rate cut with an outsized 0.5% adjustment. Markets cheered the move, with US equities rising 2% in September and hitting new highs.

### 'A' China melt up

It was a different story on the other side of the world. China did not hit a new high; the initial 4% decline meant that China equities hit a new multi-year low. Then Chinese markets rebounded strongly over the remainder of September to end the month up more than 20%, as the government surprised everyone with a bazooka of a policy. Our Emerging Market positions (with China being the largest component) benefitted as market participants rushed to cover their shorts, or closed out their China underweights.

### Could anyone have known?

In hindsight, it is tempting to think if one could position ahead of the big move. But let's rewind the clock to 13<sup>th</sup> September when China was down -5.4% year-to-date, in contrast to double-digit gains in other major markets. Fundamentals had continued to deteriorate, and the Chinese government resisted calls for any sort of sizable stimulus measure. A continuation of that status quo would have likely led to disappointing performance and giving up on returns elsewhere.

At this point, some market commentators would say that after the strong rebound, the "easy money has been made". In reality, this was probably the hardest money to make; as it would require one to endure record lows with no end in sight even as recent as mid-September.

### This melt-up is not just a China thing.

It is nothing new and has happened in many other stock markets throughout history. Melt-ups happen in the throes of a market crisis when policymakers react forcefully with strong measures. The same thing happened to US equities during the 2008 Great Financial Crisis. The combination of extreme pessimism and element of surprise makes the move very powerful, which is what happened here.

It is at such bottoms when most investors capitulate to remove their pain and positioning is the lightest. This is human psychology at work, but it means many are unable to participate optimally most of the time in stock market appreciation.

### Opportunities abound

Having said that, there are still opportunities abound. The fundamental backdrop globally is that of economies in late-stage growth, which requires delicate manoeuvring from the Fed to execute a soft landing. Interestingly, the China stimulus may benefit other economies as it provides much needed support for global growth as other economies face slowing growth. Capital growth (equity) investors just need to brace themselves for greater volatility as economies go through these transitions. Amid all the focus on markets, investor concerns such as the US presidential elections have been relegated but may also come back to the fore.

Income (bond) investors have not been left out of the party as they enjoyed both income and capital gains in September. With further interest rate reductions on the cards, the risk-reward of the average income investment will decrease. However, there are still plenty of opportunities for investors willing to explore beyond the typical markets.

# CENTRAL BANKS ACT

## Central banks talk, markets listen.

Central banks play an important role in financial markets. They control interest rates and money supply, which in turn influences the economic and business cycle. A tighter policy environment like what we got in the past two years (higher rates!) is akin to stepping on the brakes, while more accommodative policy (rate cuts?) is like pressing on the accelerator pedal.

### 2022-2023: Rapid rate hikes

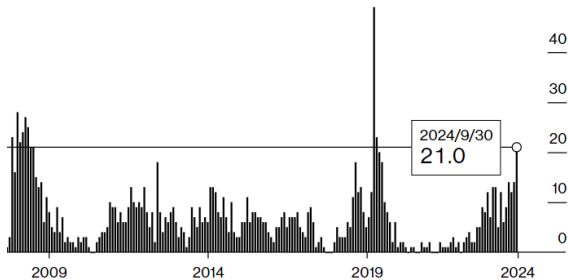
Tighter policy i.e. higher interest rates over 2022-2023 was crucial in the fight against high inflation, but it also led to a general slowdown in economic conditions. This has led to concerns that the world will fall into a recession down the road (see next page).



### 2024: Inflation cooled, room for rate cuts!

The good news is that with inflation coming down convincingly over the past year, central banks now have the tools at their disposal to try and prevent a more meaningful downturn. Indeed, policy easing has been accelerating across global central banks, apart from a few exceptions like the Bank of Japan.

### No. of Rate Cuts (Across 100+ Central Banks)



Source: BofA Global Investment Strategy, Bloomberg

## Don't fight the Fed...and China

There is a common saying in Wall Street: 'Don't fight the Fed'. This is used to say that it is usually a bad idea to position against the Fed's policies – don't take too much risk when the Fed is trying to cool the economy or be too bearish when they are trying to support growth. Of course, it is important to look at other fundamental and valuation drivers too, but the Fed's policy is not one to ignore.

The Fed's rate cut in September had likely encouraged other central banks around the world to also start cutting as well. The chart on the bottom-left of this page shows the biggest month of easing since April 2020 (when central banks eased during the Covid-19 pandemic), with 21 rate cuts observed across global central banks in September.

Surprisingly, the biggest central bank action in the past month came out of China. For most of the past 2 years, the Chinese government had been reluctant to embark on any meaningful stimulus that would risk overheating the economy. But as we now know, it was insufficient to trigger a sustainable recovery in their economy or markets. Perhaps that is why Chinese policymakers finally gave markets what they wanted to see: starting September 24<sup>th</sup>, the government has announced a barrage of policies that covered both fiscal and monetary easing in what some commentators have called a US-style stimulus.

We agree that recent actions have led to a window for a tactical recovery in Chinese-related assets from their low valuations. This has benefitted our existing positions in Emerging Market and China. Going forward, we remain tactical as we see how announced measures can extend to the real economy e.g. resolving China's housing crisis.

**Importantly, China's easing may also support a continued global expansion at a time when the US growth is slowing. The widespread easing across central banks globally should not be underestimated and can prolong the current up-cycle for a while longer.** While this is positive for risk assets, this is also not the time to go 'all in' as we discuss in the next section.

# NEARING CROSSROADS

Interest rates, elections, valuations, geopolitics. These are some of the common issues that investors worry about today.

**But being overly focused on these issues can distract us from the 'true drivers' of market returns that help investors compound their wealth over the medium-long term.**

One key driver is the earnings growth of the markets and companies that we invest in. The other is valuations, but we focus today's discussion on earnings for now.

In the chart below, we show how equity earnings have grown over time. This is not a price chart, but it can easily be mistaken for one as their overall pattern is similar. This is not a coincidence. As investors (or 'business owners' as Warren Buffet likes to say), we receive a share of a business's profits and as the earnings potential grows, so will their stock price. We highlight two observations:

- Earnings grow as economies and businesses develop, driving equity prices higher over time.
- Earnings experience sharp declines during recessions as economies and businesses suffer, which is why markets perform poorly over these periods.

It can be painful to hold through periods of earnings recession – global equities saw declines of between 34% to 59% around the past three recessions highlighted below, so it is worth preparing for such a scenario when risks are elevated.

**Are we headed into a recession?** After all, the effects of higher interest rates over the past 2 years have continued to be felt throughout the economy today. According to the Fed's 'Beige Book' review of economic conditions, more districts reported flat or slowing activity in August. This is consistent with recent PMI manufacturing activity in September which showed continued contraction (but not yet in dire conditions).

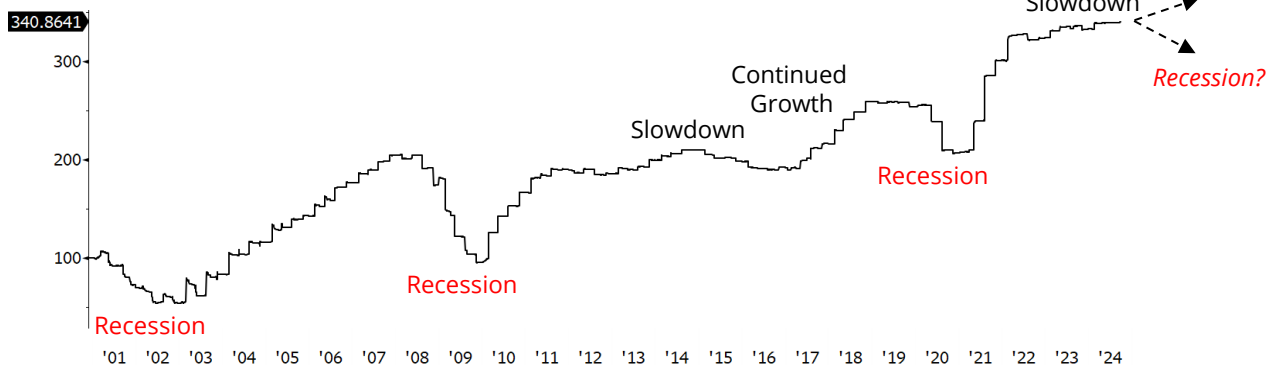
The labour market is also one worth watching closely, as any further deterioration may lead to a recession. Again, the data points towards some cooling of labour market conditions, but also not yet indicating an imminent recession.

All-in, we remain in a late-cycle environment characterized by slowing (but not collapsing) growth. We have seen some earnings pressure amongst the more economically sensitive market segments, but the economy continues to be holding up otherwise.

The Fed's recent *jumbo* rate cut looks to be a pre-emptive move to ensure that the slowdown does not morph into a painful recession. This is supportive for risk assets...but we remain on high alert as mentioned earlier.

We remain cautiously optimistic going into the end of the year, balancing higher quality segments such as Healthcare which tend to be more resilient during a slowdown, with positions like Emerging Markets which have better upside in a recovery scenario. Amid current crossroads, we remain ready to adjust our portfolios as the data informs us of the most likely path going forward.

## Earnings Growth: An Important Driver of Returns



Source: Bloomberg. Trailing Earnings Per Share for Global Equities as of 30 September 2024.

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# FINDING THE RIGHT INCOME

## Fewer, higher-yielding Government bonds

With the Fed having embarked on its cycle of rate cuts, it means the supply of bonds to meet income investors' needs will reduce. And this is happening across major bond segments.

Just four months ago, US government bond yields were practically 5%. Fast forward to today, they are yielding just over 3.5%. An income investor parking in US government bonds just saw their income reduce by 30% in a matter of months!

Yields were already declining before the Fed starting cutting. Now that they have actually started cutting, there will be more pressure on yields to decline further. Which is why we've been 'locking-in' higher income in our portfolios even before interest rates came down.

Nevertheless, for income investors with low-risk tolerance, lower-yielding government bonds may still be the appropriate place to be in today as the likelihood of permanent capital loss is remote. Of course, there will still be volatility (so make sure to pick the right investment to match your risk tolerance and time horizon!) but it is fair to say that the worst volatility in government bonds from two years ago is behind us.

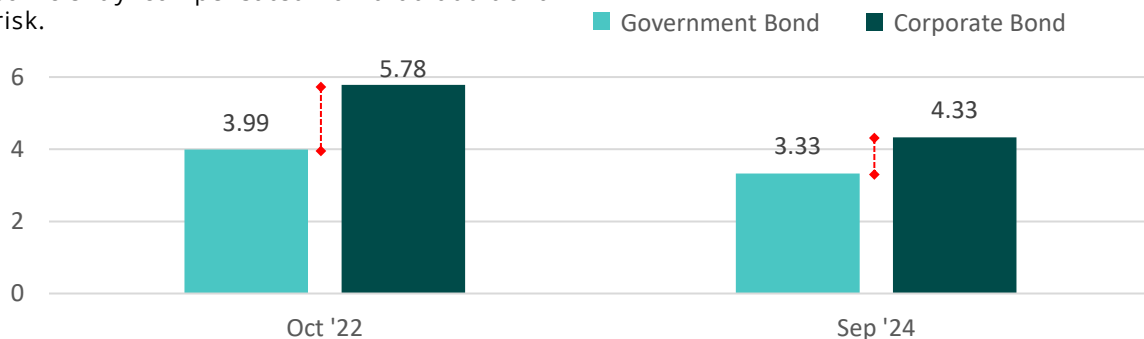
**Income investors who want higher passive income can typically find that in corporate bonds which usually provide more income than government bonds.** However, the reduction of supply in higher yielding government bonds is having a similar knock-on effect on corporate bonds, which means that it is important to ensure that one is sufficiently compensated for that additional risk.

Over the past two years, businesses have been able to pay lower additional yield (compensation) to investors as shown in the chart below (extra 'compensation' marked out in red dotted line). This means that the average corporate bond investor is getting lower return for every unit of corporate credit risk they are taking.

**The good news is that there are still opportunities for investors to find better income before yields come down even more.** In the current environment, active strategies with the flexibility to invest beyond the vanilla corporate bonds can offer the potential for higher income without taking undue risk. For example, Asset-Backed Securities (ABS) is one segment within IG that may offer that marginal extra return over government bonds comparable to IG corporates, and may be more resilient in times of stress.

Investors who seek higher income and have the risk tolerance will also face increasing challenges of a reducing opportunity set in the broad high yield markets. Similarly, there remain high-yield markets such as segments of Emerging Markets that offer opportunities for investors who want 3-5% more income than cash today.

Of course, higher-yielding markets usually outperform in the context of a soft landing where economies and companies continue to chug along – in our portfolios, we look out for to signs of stress that would prompt adjustments into higher-quality segments that may offer better resilience during periods of volatility.



Source: Bloomberg. Yield to Worst data as at 20 October 2022 and 30 September 2024, respectively. Government bond: Bloomberg Global Aggregate Index. Investment Grade Bond: Bloomberg Global Aggregate Corporate Index

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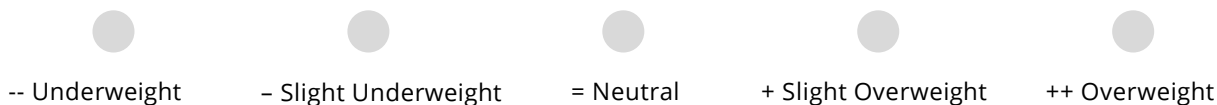


# HOW ARE WE POSITIONED?

Equity (Green)    Bonds (Blue)

Key Themes	Allocation
<p><b>Positioning for Growth</b></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><b>US equities</b></p> <p><b>Europe equities</b></p>
<p><b>Emerging Opportunities</b></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><b>Emerging Market equities</b> (e.g. China, India, Vietnam)</p>
<p><b>Late Cycle Stability</b></p> <p>The effects of high interest rates are still working its way through the economy. 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><b>Healthcare equities</b></p> <p><b>Government Bonds</b></p>
<p><b>Capturing High Yields</b></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><b>Asian High-Yield bonds</b></p> <p><b>Emerging Market bonds</b></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

Recent stimulus measures announced by the Chinese government provides better tailwinds for Asia to catch-up. Participate in Asia and China via broader exposure to Emerging Market.
- Emerging Markets

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

# MARKET INDEX RETURNS

Equity Regional	MTD	YTD	10Y	20Y
Global	2.36	19.08	9.97	8.92
United States	2.14	22.08	13.36	10.70
Europe	0.57	13.32	6.53	7.18
Japan	0.50	12.30	6.74	5.24
Asia Pacific ex Japan	7.87	19.95	5.48	7.98
Emerging Markets	6.68	17.13	4.40	7.66

Equity Markets	MTD	YTD	10Y	20Y
Australia	6.01	15.17	7.89	9.88
Brazil	0.69	-12.34	0.94	5.62
China "A"	22.38	21.72	5.93	9.65
China "H"	19.93	35.99	0.48	5.87
Hong Kong	18.74	29.90	2.76	6.06
India	2.49	17.21	10.25	12.67
Indonesia	0.49	8.11	4.24	11.72
Korea	-1.33	-3.33	2.33	7.04
Malaysia	4.44	30.97	0.16	6.84
Singapore	6.01	19.36	4.94	7.86
Taiwan	0.92	22.51	13.08	11.26
Thailand	12.68	11.64	2.25	9.26
Vietnam	2.05	14.35	8.77	9.19

Equity Sectors	MTD	YTD	10Y	20Y
Gold	3.07	28.44	7.76	3.29
Energy	-2.68	8.36	3.94	7.56
Technology	2.20	27.18	20.19	14.30
Healthcare	-2.95	14.57	9.51	9.97
Financials	-0.55	21.90	11.40	5.64

Fixed Income	MTD	YTD	10Y	20Y
Global Aggregate	1.70	3.60	0.57	2.46
Global Aggregate (H)	1.16	4.38	2.33	3.48
High Yield	1.50	7.68	4.58	6.46
Asia	1.40	5.83	3.28	3.28
Emerging Markets	1.76	8.17	3.18	5.82

Note: (H) Currency Hedged

Currencies	MTD	YTD	10Y	20Y
SGD/USD	1.69	2.75	-0.07	1.36
EUR/USD	0.79	0.87	-1.25	-0.55
JPY/USD	1.77	-1.81	-2.66	-1.32

Commodities	MTD	YTD	10Y	20Y
Gold	5.24	27.71	8.11	9.64
Oil	-7.31	-4.86	-2.86	1.60

As of 30 Sep 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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