COVENANT CAPITAL

The Month Ahead Apr 2017: Don't forget to breathe.

In last month's musing, **Focus on your core**, we attached a video on how to exercise your core. The key when exercising your core is to control your breathing and not to indulge in gym-rat crunches of 200 sit-ups in a minute. Controlled breathing accentuates the core muscle group you want to work on whereas copious repetitive sit-ups aggravates your back as it pushes the curvature of the spine beyond its natural state. Like in many things in life, one needs to take a breather every now and then, slow things down, regroup, recharge before forging ahead.

That's how we see the markets now. The growth acceleration story we have espoused since we wrote in Oct 2016, Dog days are over...for-now, needs to take breather and transition to a stable growth phase. This is an important distinction we must ascertain as the two different stages of growth alter our asset allocation preferences. In an accelerating growth phase, which we witnessed in 3Q16 till recent, we saw economic growth indicators inflecting from its nadir, economists upgrading their economic growth and inflation forecasts and yet incoming data kept surprising on the upside. In this environment, equity and commodities rallied significantly while the yield curve shifts upwards and steepen which is detrimental for Fixed Income. The appropriate asset allocation is to shift aggressively towards equity particularly in markets and sectors which are more sensitive to growth nuances (Emerging market, financials, commodities and basic materials), underweight fixed income, shorten bond duration dramatically and add into underlying commodities such as oil and copper. Our portfolios have benefitted from this allocation settings in the last 7 months.

However, **a change in asset allocation is required if we judge that momentum has slowed in economic and earnings upgrades, incoming data are no longer surprising** and is at risk of disappointing elevated expectations, fiscal impulses are well documented or worse at risk of disappointing (US comes to mind) while the price actions of several assets classes are exhibiting signs of exhaustion. In an environment like this where growth is still evident but the delta of improvement is slowing down, a less aggressive portfolio positioning in equities vs fixed income is appropriate. Equities remains an overweight but less aggressive and in its place, we should raise cash for opportunities to buy into any weakness, add risk-off hedges in fixed income via sovereign bonds while trimming commodities exposures. This is what we have done since late February.

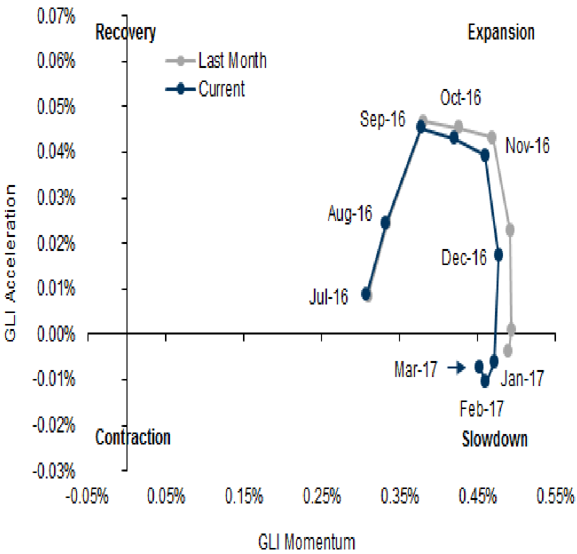
Stable Growth Phase	Accelerating Growth Phase
Economy is strong but growth acceleration has stalled	Economyic momentum accelerating
Main argument: Hampered by post-crisis instilled caution in corporates, consumers and governments. Weak capex and weak productivity alongside ageing demographics phenomenon	**Margin agrument:** Animal instincts take over, new capex cycle resumes and productivity moves into typical cyclical lifts
Yield curve steepening plateau or flattens	Yield curve shift upwards and steepen
Earngings revision plateau	Earnings revision accelerates
Inflation stable	Inflation picks up

Stable Growth Phase	Accelerating Growth Phase
Favoured asset allocation	
More balanced asset allocation with slight tilt towards equties	Overweight equities, significantly underweight Fixed Income
Raised cash for opportunities	Leveraged portfolio
Within equities, shift back to Growth, Big Caps and Neutral commodities	Prefer Value, small caps and commodities
Neutral regional weights	Take active bets on regional views, Europe seems strong
Equities with income	Equities for capital appreciation
Subdue inflation therefore should put back on US Treasury as a hedge and carry	Down the credit curve and stay with EM, HY credits
USD strength stalls	USD strengthens

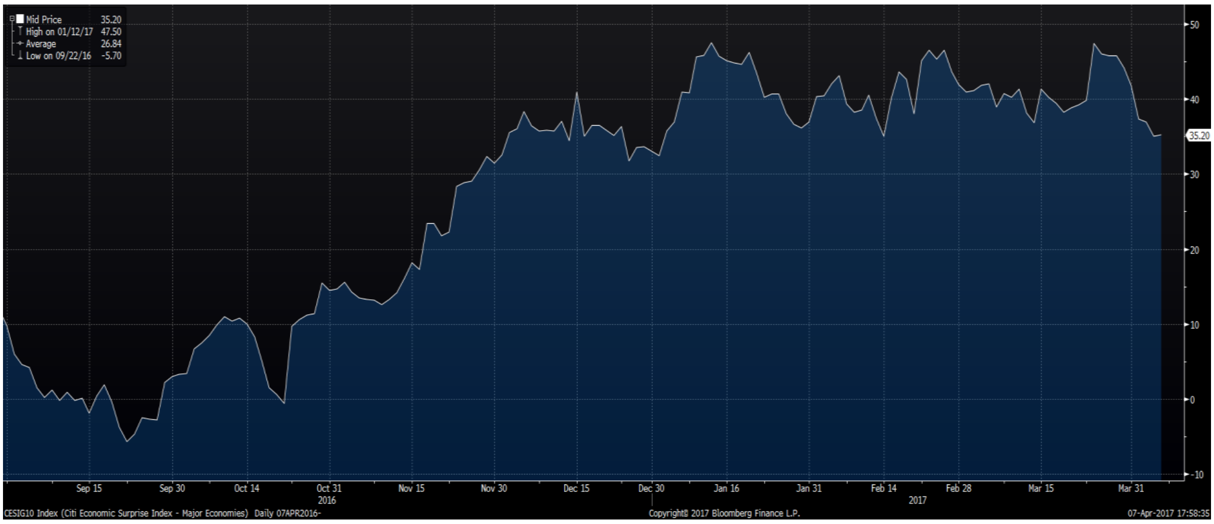
In recent weeks, we have noticed several key markers we are watching moving away from the growth acceleration into the stable growth phase. Economist upgrades in economic forecast have stalled in recent months. Another gauge we often use to measure economic momentum is Goldman's Global Leading Indicator Swirlogram which have been quite prescient in identifying inflexion points. The indicator has moved from expansionary phase since Jul 2016-Dec 2016 but has now moved into the slowdown phase since Jan of this year. We often monitor Citi's Macro Surprise Index which measure macro-economic data surprise relative to market expectations. That gauge has also peaked in Mar and have started to move lower.

Upgrade in economic forecast slowing down, GS GLI in "Slowdown" phase

	GDP Forecast 2016	Chg MoM	GDP Forecast 2017	Chg MoM
At Aug 2016	2.3		2.6	
Sep-16	2.5	0.2	2.7	0.1
Oct-16	2.6	0.1	2.8	0.1
Nov-16	2.6	0	2.9	0.1
Dec-16	2.6	0	2.9	0.0
Jan-17			2.9	0.0
Feb-17			2.9	0.0
Mar-17			2.9	0.0
Source: Bloomberg				

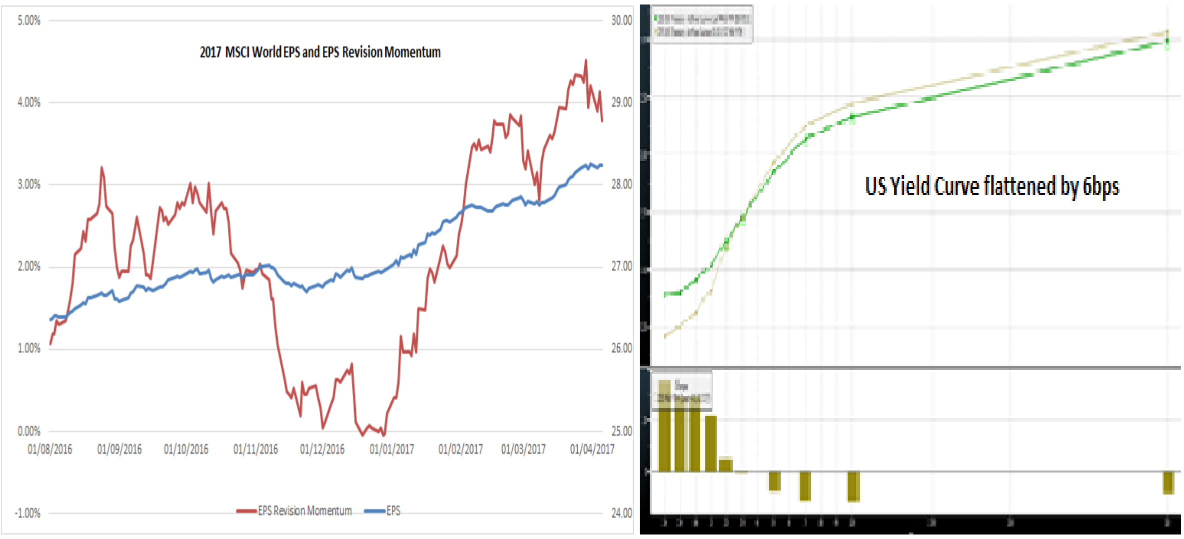


Citi Global Macro Surprise Index moved lower from peak in March 2017



Consensus earnings revision was accelerating at the start of the year but has since rolled over. The biggest EPS revision downgrade came from US specifically in the energy sector which have seen the duality of poorer-than- expected 4Q16 result announcements and slide in oil prices year-to-date. The yield curves for all major economic blocs have flatten in the past month. The short-end of most sovereign curves have moved higher in tandem with several central bankers tightening their rates, notably Fed and PBOC, but is the long end of the curve that has moved lower that worries us more. We maintained our view that central bankers are under-estimating inflation risk as output gaps tighten globally and commodities push inflation kicks-in as evident in rising PPIs. We contend markets are we poorly prepared for a steeper rise in rates.

EPS Revision Momentum slowing; US Yield curve steepen initially but since start of year has flatten

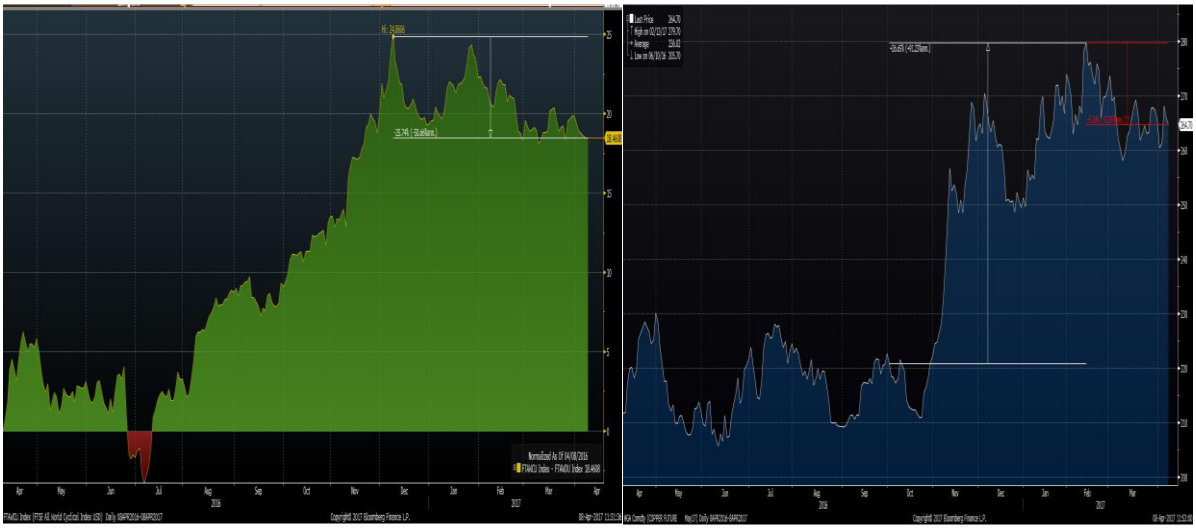


Source: Bloomberg

Nonetheless, there is a thin distinction between intellectual obstinateness and astute foresights. The market disagrees with our views that in the longer-term, global growth will achieve escape velocity and inflation will come to ruse. Their key arguments are that demand remains hampered by post-crisis instilled caution in corporates, consumers and governments, elevated debt levels in sovereigns, weak capex and productivity gains alongside an ageing demographics in many developed economies. A persuasive argument no doubt, in contrast to what we have argued that a healed employment backdrop, alongside improved profitability has brought out animal instincts to spend and to capex as we moved into the next stage of the economy.

Beside the flattening of the yield curve at the longer-end, other market metrics are also inferring that we have entered a stable growth phase. The global cyclical versus defensive index has retraced 26% from peak back in Dec last year after its substantial rally from Aug. The contraction of this spread is another sign the market is dialling back their expectations that growth will accelerate in the coming months. We often view copper prices as a key lead indicator of global industrial activity given it is the most widely used base metals for industrial production. We have advocated a contrarian buy on copper back in Sep 2016, **Lets Get Fiscal, Fiscal**, and it has rallied aggressively up 26% until Feb this year. Since then, the price of copper has retraced 5% from its Feb peak and has stalled despite more than expected supply disruptions that has happened this year. Another market signal that is telling us we need to take a breather.

Cyclical vs Defensive Index and Copper price have stalled.

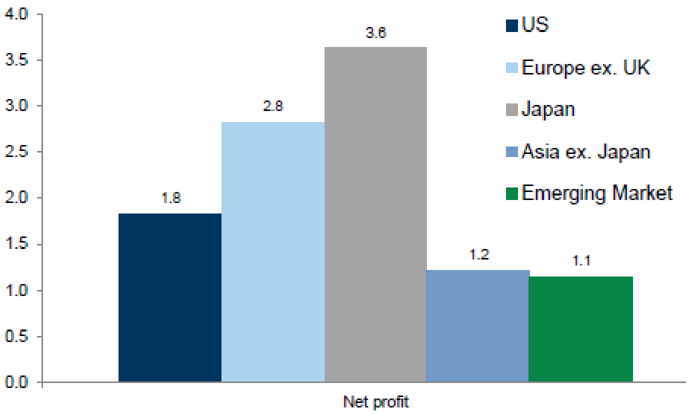


Asset Allocation Strategy:

Considering the built-up of evidences that we have moved away from an accelerating growth to a stable growth phase in the economy, we have made a few changes in our asset allocation. Notably, we trimmed further our equities exposure to just slight overweight in contrast to the past 7 months where we have run aggressive equities risk. We raised cash level to capitalize on any opportunities to buy on weakness and are eyeing European assets. We reduced our underweight in Fixed Income and have added US Treasury as hedges, Emerging market debt in Global Anchor mandates to earn carry.

Equities: Reduced further to slight Overweight. We remained underweight the US due to valuations and policy disappointments. We have trimmed our technology exposures in US as well. We are neutral EM equities largely due to technical reasons as the run up in their share prices in 1Q17 have accounted for all its EPS growth driver for the rest of the year. We have weighed the opportunity set between over-weighting Japanese or European equities but decided to sell down our Japanese equities exposures to raise cash instead. If we are right that the global economy has moved past the growth acceleration into stable growth phase, Japanese equities are the most vulnerable to this transition. Goldman postulates that a 1% swing in sales leads to a 3.8% correspondingly directional swings in EPS for Japan more than Europe's 2.8%. Japanese equities remained subservient to JPY movements with high beta correlation to each other. Whereas European equities trades less sensitive to EUR and in fact has had negative correlation.

<u>Japan has highest operating leverage and is very sensitive to its own currencies</u>

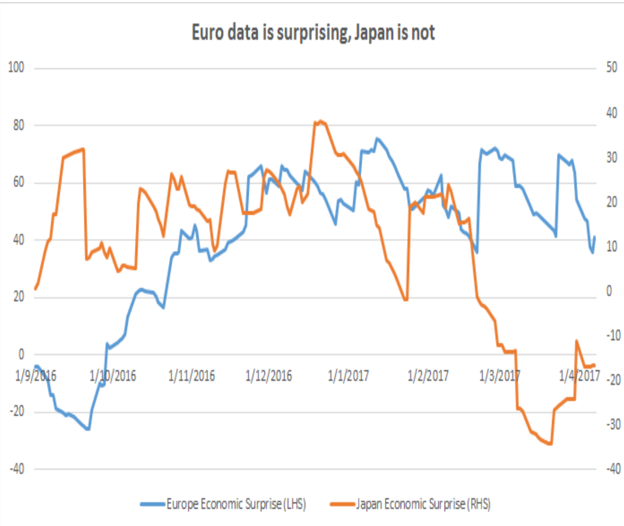


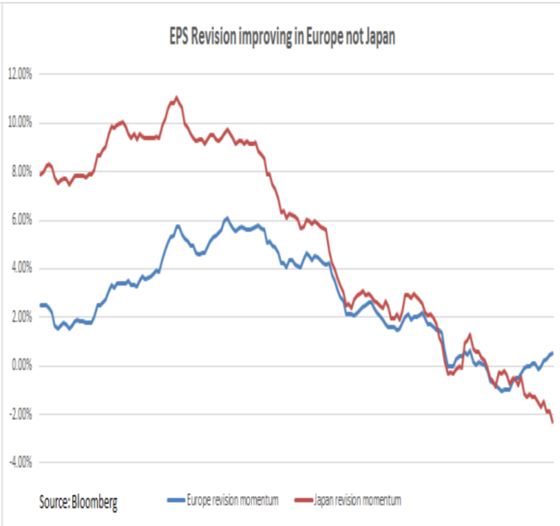
Source: Datastream, Goldman Sachs Global Investment Research

Beta	Yen	Eur	Dollar Index
Nikkei	0.953		
Stoxx 600		0.149	
SPX			0.09
Source: Bloomberg 2015 - current			

Moreover, economic data surprises and earnings revisions momentum are stronger in Europe vs Japan. Japan have seen both of its earnings revisions momentum and economic surprises declining since the start of the year in sharp contrast to improving earning revision for Europe and relatively high and stable set of data surprises for Europe.

<u>Contrasting trends of economic surprises and earnings upgrades between Europe vs Japan</u>





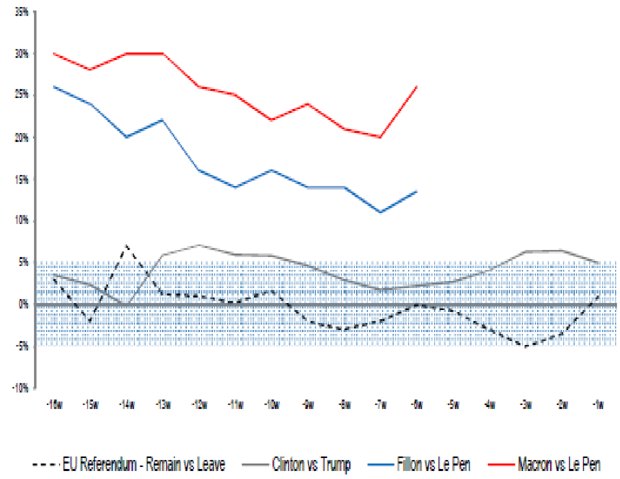
We acknowledge the risk of an anti-EU French election will have significant impact to European assets, hence we are simply raising cash for now and will monitor closer to end of April if the risk dissipates to add.

Fixed Income: Reduce Underweight (No change). We are running a more balanced portfolio in light of above views and added US Treasury and EM/plus Asia credit for carry and for capital gains resulting in a slight increase only in duration to the overall bond portfolio but higher yield profile.

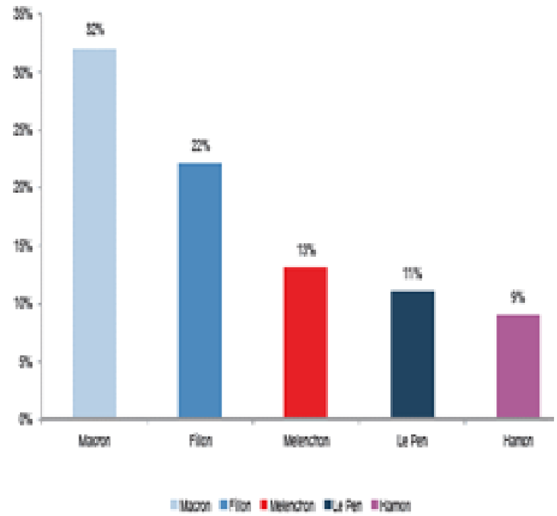
FX: Long USD and Long EUR. We have added a small long in EUR ahead of French election in part because we believe positioning is heavy against EUR and that market could be mis-pricing French concerns amidst a very resilient European economy and the increasing prospect of earlier than expected tapering of ECB asset purchases. Some commentators have compare the French election to the risk of Brexit and Trump victories. We do not agree as the margin of error for Brexit and Trump-

Hilary was extremely tight. The risk of Le-Pen victory over the preferred candidate, Macron, is low given the large spread of more than 10% favouring Macron vs Le-Pen in contrast to less than 5% margin error for both Brexit and Trump elections. If we hold on a simply view that at the end of the day, voters biggest disgruntle is really about the economy, recent poll ranked Macron a clear leader in having the best economic plan 32% ahead of FIllion 22% and Le Pen, a distant 11%.

<u>French election isn't quite analogous to the risk of Brexit and Trump victories. Quite far from it.</u>



Source: J.P. Morgan, various polling agencies, using the latest available poll at the end of each week



Source: BVA, La Tribune poll released on 23rd March

Commodities: No change zero positions, waiting for better entry level in copper.

Alternatives Investments: 1H17 will be period of reviewing our AI strategies.

Featured Picture/Quote: Hasta la vista, baby

[5 white-collar jobs that robots already are taking away]

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