The Navigator

COVENANT CAPITAL

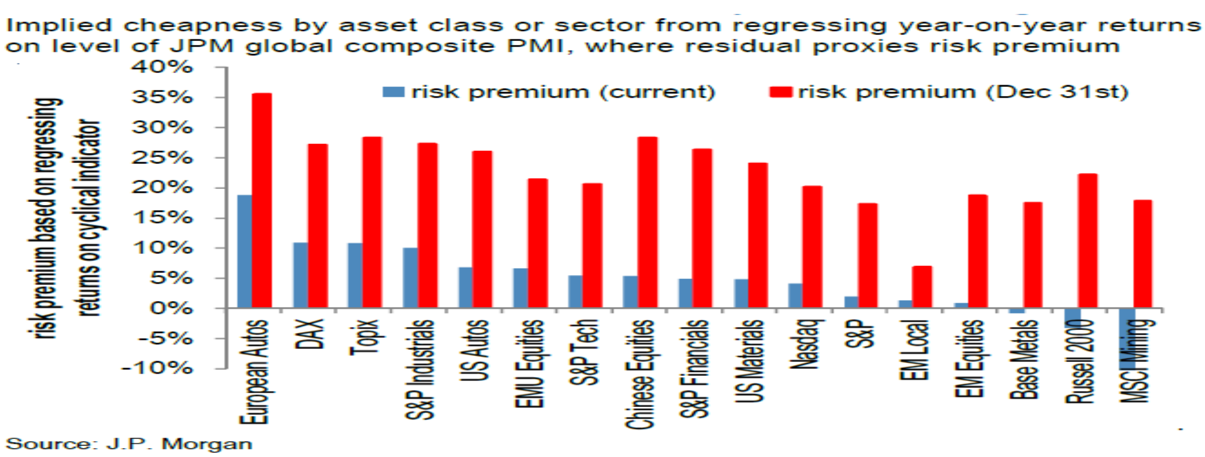
March 2019

Show Me The Money

Since the start of the year, we have posited the markets have discounted too much risk of an impending recession in the coming 12 months. We even quantified the markets are misaligned to economic realities by as much as 20% for some asset classes. We have urged investors to keep their calm and add more risk, particularly in equities, specifically in emerging markets. Our bullish stance was obviously bolstered by Fed's capitulation in late January towards a dovish tilt. As expected, all our mandates have performed well year-to-date as we have kept our tilt towards overweight in equities, reduce our long-standing underweight in fixed income by adding more EM local and hard currencies debt and initiated a small short in USD.

However, with all asset classes having rallied and cross-asset correlations are now uncomfortably low, we are urging caution. Using JPM analysis of comparing current valuations versus historical and regressing to the level of economic activity as measured by PMI surveys, the risk premiums for many asset classes have reduced significantly, in other words markets are pricing in-line with current economic realities. For example, in the chart below, investors were according up to 20% risk premium for S&P500 back in Dec last year, but the 12.6% rally this year and the decline in economic momentum in the US has now dwindled the risk premium to almost none. Even our favored EM equities and debt are now trading close to fair value. Only European Autos, DAX Index and TOPIX are trading at more than 10% risk premium.

<u>JPM valuation metric shows risk premiums have dwindled for many asset classes</u>



Valuation for most equities, as well as US High Yield and EM Debt, are now within its recent high. Year to date, the 11.6% rally in global equities has put its forward PE at 15.2x, just 3% below its 30 years average.

Furthermore, earnings revision momentum (ERM) in the past 3 months have been negative. In fact, the only major market that has seen an upgrade in ERM is in China. However, we are tapering our bullish view in China as valuation is now just 3% lower than its historical long-term average. It is the same picture for most credit. EM High yield debt spread has compressed by 135bp to 465bps. At 465bps, it is merely 150bp higher than its historical low back in Jan 2018 when the EM fervor was at its peak and is significantly lower than its post-2009 average spread of 663bps wide; not quite skewed asymmetrically to the downside but certainly not as attractive as the start of the year. US High Yield year-to-date performance of +6.8% total return is on track for the best two-month performance in almost 20 years.

Nothing is cheap now though many is fairly valued

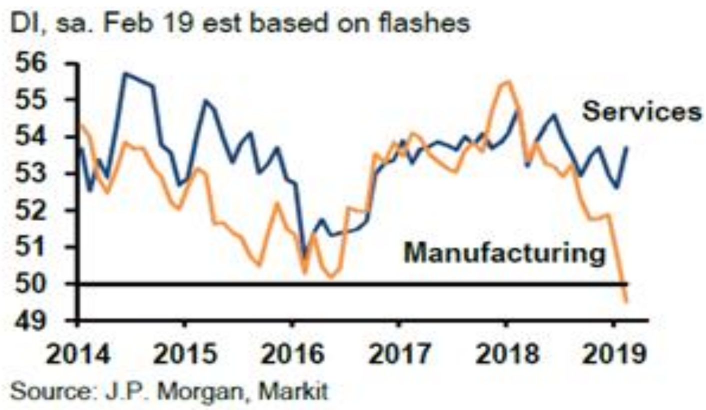
Equities	Return Year-to-Date	Current PE FY19	PE FY19 (Dec '19)	PE re-rating (Past 3mths)	30 years PE Average	Current to 30yrs PE	ERM (Past 3 mths)
World	11.6%	15.2	13.2	Higher	15.6	-3%	-1.60%
US	12.6%	16.9	14.7	Higher	15.0	13%	-1.40%
Europe	12.8%	14.1	12.4	Higher	13.0	8%	-0.70%
Japan	7.8%	13.4	11.7	Higher	19.0	-29%	-2.50%
EM	10.3%	12.5	10.5	Higher	12.0	4%	-3.12%
China	17.1%	12.1	10.4	Higher	12.5	-3%	1.45%

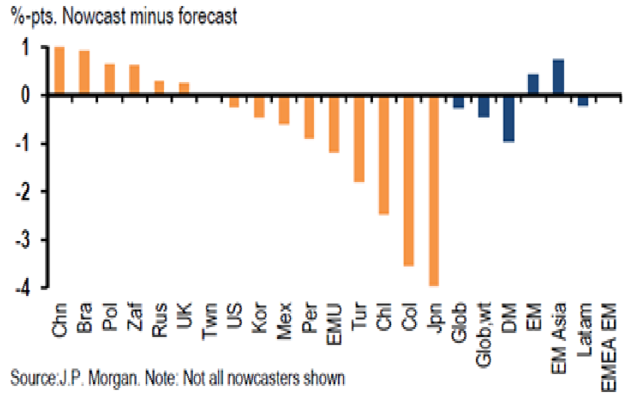
	Return Year-to-Date	Current Spread(bps)	Spread (Dec '19)	Spread Compressed
US High Yield	6.8%	395	530	-135
US Investment Grade	3.5%	127	162	-35
European HY	4.9%	391	506	-115
EM HY	5.4%	465	600	-135

Source: Bloomberg

Complicating matters, the economic momentum has worsened in the past 3 months, particularly in the manufacturing and capex data points. The most recent PMI for manufacturing is now in contraction at 49.5 while the forward-looking new orders have worsened to 48.8. At these prints, it is the lowest readings since the European existential crisis of 2012. The capex story evident throughout 2017 and into 3Q18 have all but now disappeared. The latest capex proxy is tracking zero growth which we attribute much of the sudden drop to poor business sentiment conflated by US-China trade tensions and overall slowing global economy rather than th decline in profitability or the means to increase capex. JPM nowcaster for 1Q19 has now edged to 2.5% ar. At this level, the global economy is growing below its long-term trend and is tracking far behind consensus full-year forecast of 3.1%. (We have taken the liberty to adjust for forecast error now from current forecast of 3.3%). The bright spot is services remain strong, in fact, a nudge higher than last month resulting in overall composite PMI still in expansionary level. We have seen such economic environment before when the slump in manufacturing and capex is juxtaposed with resilient consumer spending back in 2015. It was also the year quantitative tapering 2 begun as Fed ended its QE program and hiked its interest rates for the first time since the crisis in December. That year equities return was negative at -7.6% and traded with a large volatility range of 16% from peak to trough.

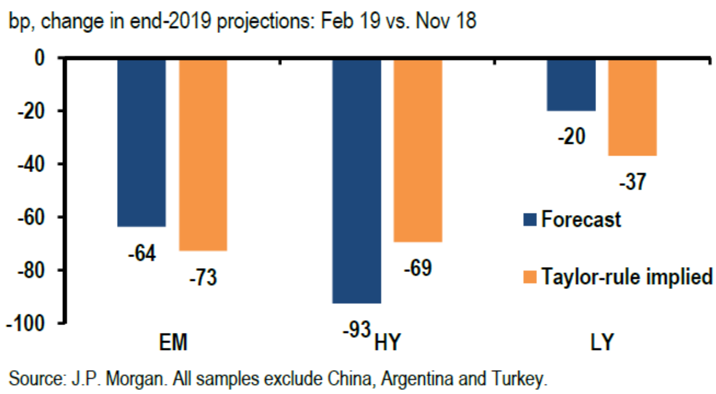
Incoming data ain't great with Manufacturing weak but Services holding up. GDP tracking behind forecast



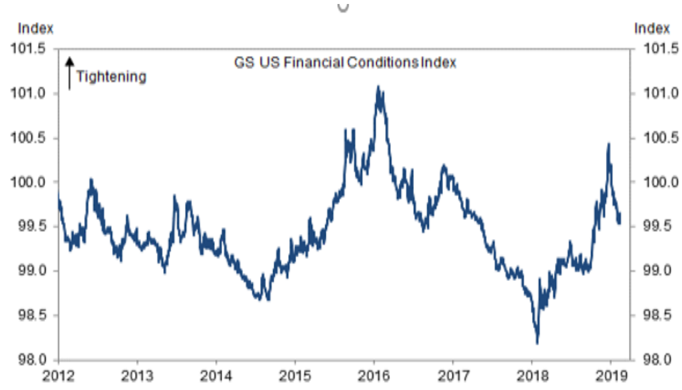


The equipoise to a worsening economic trajectory and fair valuations are global central bankers have become more dovish and positioning is still relatively light. In early December last year, the market was still pricing 2 hikes in 2019, but the latest Fed Fund futures is now indicating zero hikes in 2019 and 40% chance of a 25bps cut in January 2020. The other central banks have taken lead from the Fed with BOJ being the latest to reiterate their easing stance. EM markets have been the biggest beneficiary of Fed's patience while in the US Financial Conditions Index has erased all its tightening bias in 4Q18.

Fed's patience provided reprieve globally

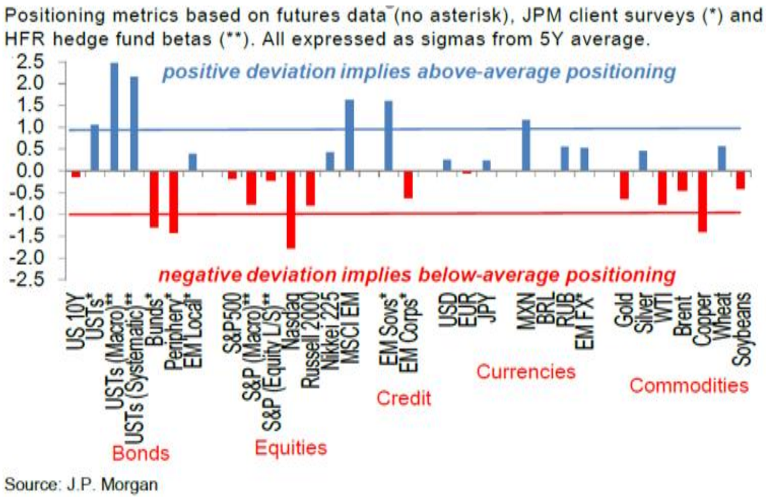


US Financial Condition eased all of 4Q18 tightening

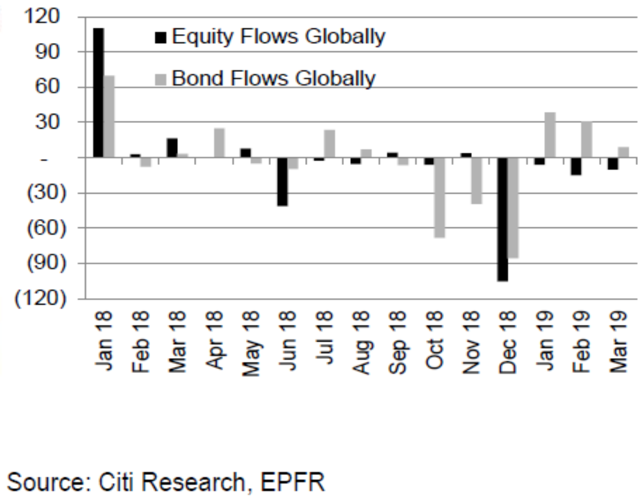


Positioning for equities is not heavy despite the rally we had. In fact, global equities are still seeing a net outflow of -$31bn year to date and on top of its -$100bn large outflows seen in Dec 2018. Cyclicals continue to see the sharpest outflow in contrast to improving flows into defensives. Interestingly, EM Equities have seen an inflow of $23bn while DM Equities continued its trend of 2018 with an outflow of -$54bn. China attracts the most of EM inflows with $35bn coming in largely via passive ETFs. We believe the trend of further flows into China, particularly in the A-share market will continue into 2Q19 as the market weighs in on China's inclusion in the MSCI World Index. However, the positioning in government bonds in both developed and emerging markets are now quite heavy indicating investors prevalent "flight to safety" mindset. Positoining in commodities are under-represented in tandem with general concern on global growth trajectory. Latest fund managers survey in February indicated cash level is the highest since January 2009 with over 44% of respondent indicating they are overweight cash.

Positioning light in equities and commodities, not in fixed income



Equities outflow continues, Bond inflows



Asset Allocation Strategy

Equities (Downgrade from Overweight to Neutral): Valuation has been the key bedrock in our investment decision and with valuations for most regional markets at fair value, we have been taking down risk in the last 1.5 months. While the market may continue to rally as positioning is light, we are at the stage of "Show Me the Money" as the trade-off between policy stimulus versus growth weakness is skewed to the latter getting worse while the former is already well discounted by the markets. We have reduced our overweight in EM Equities to Neutral but have kept our overweight stance in Japan largely due to valuation and positioning differences between both regions. Europe remains underweight, but we are keeping a close eye on potential recovery in its manufacturing and export sectors. In the US, our macro clock dedicates defensive sectors such as utilities and healthcare. Cheaper valuations, relatively low positioning and high probability of a tech demand bottoming in 2Q19 leads us to be in tech sector particularly focusing on large-cap techs and semiconductor stocks. In fact, across the regions, we are well represented in the semiconductor space from IDMs, foundries to passive components. Given the benign rate environment, we are relooking at global REITs manager for our total return asset allocation mandate whilst our income mandate already has a respectable portion in Asian REITs.

Fixed Income: Neutral and we continue to add Government Bonds in developed markets and selectively quasi-sovereign debt in emerging markets to deploy our excess cash as well as act as a hedge to our equity portfolio in the event that macro data continues to worsen. We continue to favor EM credits over Europe and are more constructive in US credits. For our total return asset allocation mandate, the preference is for benchmark agnostic and total returns-oriented managers, whilst our income-oriented mandates are bar-belled with holding longer duration high-grade credits coupled with shorter term high yield credits that allows us to enhance our overall portfolio yield.

FX: Expect USD to weaken as US exceptionalism fades and Fed pauses.

Commodities: Neutral. Gold has retraced from its recent high and is re-exhibiting its usefulness as a hedge. Oil is ranged bound at $55-65 restraining us from expressing an outright view preferring to own high dividend paying oil majors.

Alternative Investments: We are exploring a non-correlated events manager and will update further.

Cash: We intend to hold larger than normal cash level. Any bullish expression will likely be done via options. Volatility is cheap now to be long options but at the same time cross-asset volatility is too complacently low and warrants some volatility hedge in the portfolio.

Featured Picture/Quote:

A fantastic book to read and you are assured to expand your repertoire of bombastic words. "World Order" by Henry Kissinger.

"Islamic legal rulings stipulate that a treaty cannot be forever, since it must be immediately void should the Muslims become capable of fighting them." What these treaties did not imply was a permanent system in which the Islamic state would interact on equal terms with sovereign non-Muslim states: "The communities of the dar al-harb were regarded as being in a 'state of nature,' for they lacked legal competence to enter into intercourse with Islam on the basis of equality and reciprocity because they failed to conform to its ethical and legal standards." Because in this view the domestic principles of an Islamic state were divinely ordained, non-Muslim political entities were illegitimate; they could never be accepted by Muslim states as truly equal counterparts. A peaceful world order depended on the ability to forge and expand a unitary Islamic entity, not on an equilibrium of competing parts."

— **Henry Kissinger**

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