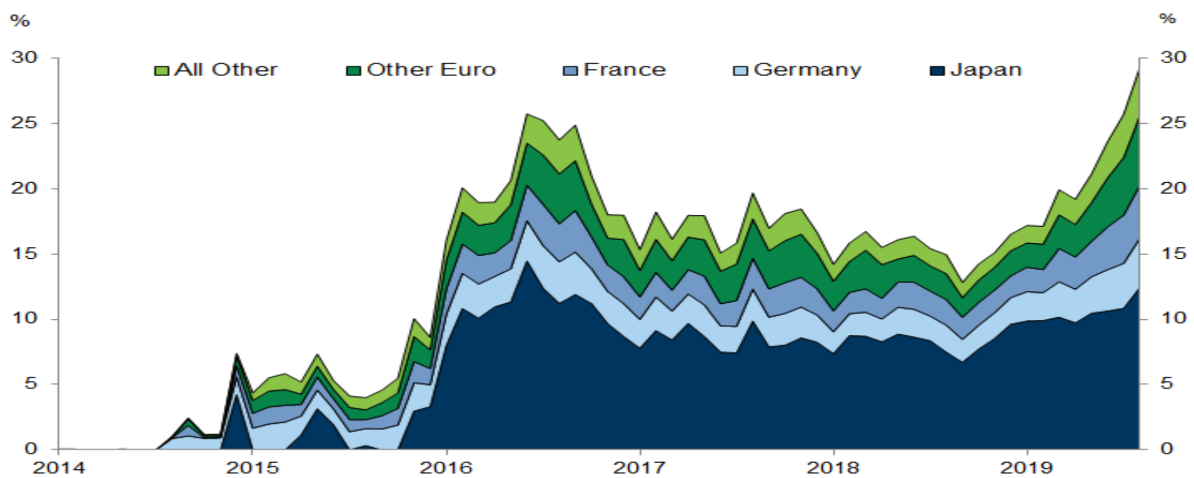
This is the world we live in

This is the world we live in. Of instant gratification, of bellicose rhetoric that reeks of schadenfreude. This is the investment world we live in. Of **uber low yielding environment driving investors to look for capital gains when buying bonds, dividend yields when buying stocks and super-normal profits in private equity that are illiquid and opaquely valued.** But this is the world that we live in where the traditional financial concepts of return and risk have been reversed as a decade long of unorthodox monetary policies and equally to be blamed imprudent financial policies rewrite investment behaviors. In last month's Navigator, I see Yield, you see me, we cautioned reading too much into the predictive value of an inverted yield curve, argued that the current inversion is driven more by the herd mentality of market participants than economic fundamentals, but remained cautious on risk assets.

The mad, mad world of negative-yielding assets



Source: GS

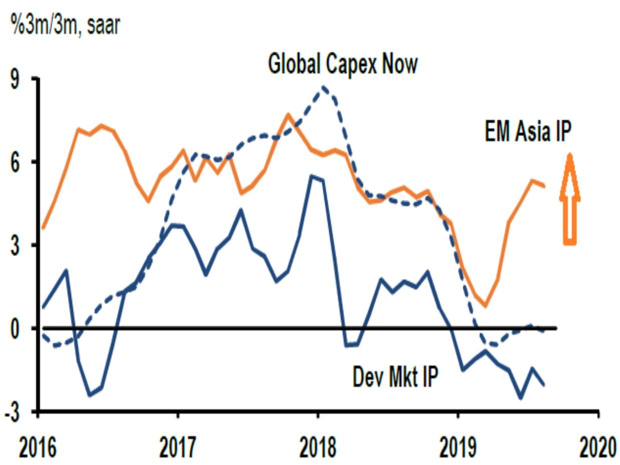
Early weeks of September has brought some relief for markets with a slew of positive developments. Since March, we have identified the slowdown in the global economy is emanating mainly from the manufacturing sector wrought upon by the US-China showdown. However, as the manufacturing accounts for 31% of the global economy, we do not believe the weakness could trigger a global recession, but we acknowledge the manufacturing sector has always been the swing factor of economic momentum. Nonetheless, we did caution that if the manufacturing recession is prolonged, it could potentially spill over into the services sector and possibly triggering the much fear recession many have been waiting for as this economic expansion is now the longest in modern history. **In the past**

few weeks, the data for the manufacturing sector appears to have bottomed and the prospect of improvement is probably the highest we have witnessed since the start of this year. The Global PMI data for manufacturing edge back to an expansionary level of 50.1 with investment goods and intermediate goods improving month on month. These 2 segments are critical to watch as they are analogous to both future capex and outputs, especially for the former which has been sluggish since the start of the year and is tracking close to zero growth year-to-date. The PMI surveys of Output and Employment have also improved month on month collaborating with the improvements in capex (Investment goods) and outputs (Intermediate goods).

We have also seen Japan and European industrial production figures improving month on month and if we compare to their forward-looking manufacturing surveys, they are also indicating improvements in future output. We are quite confident that in the coming months the manufacturing sector for China should sequentially improve predicating this view from the recent State Council meeting in September where the emphasis on "six stability" (employment, trade, financials, FDI and general expectations) is highlighted as key policy initiatives. Like Japan and Europe, China's NBS manufacturing survey saw an increase of 0.5pt in August back to an expansionary level of 50.4, led by the output, employment, and export orders. The recent RRR cut, the recent revision to the Loan Prime Rate which will lower overall funding costs, and the increase in TSF (aka monetary creation which jumped to RMB1.98bn; an RMB100bn increase over the average of last 6 months) should support this view of a turnaround in China's manufacturing sector. As the region that is the nexus of the manufacturing hub of the world and has borne the largest brunt of the trade wars, the past few months pick-up in industrial production activity in EM-Asia augurs well for a reversal in cyclical drags. However, the US manufacturing sector continues to weaken with both outlook and employment surveys deteriorating further. It is finally reeling from the impact of the numerous trade conflicts Trump has initiated in the past year. Perhaps, this is the reason in recent weeks it has brought a more reconciliatory tone for the administration in dealing with their trade partners.

Some signs of manufacturing bottoming

Global PMI Manufacturing	April	May	Jun	Jul	Aug	
- Consumer goods	53.9	52.0	51.6	53.1	53.0	Worsen
- Investment goods	48.3	48.4	49.2	48.1	48.2	Improved
- Intermediate goods	49.6	49.7	48.1	47.4	49.0	Improved
- Output	50.6	50.1	49.5	49.4	50.1	Improved
- Employment	50.6	49.9	49.8	49.2	49.6	Improved
Global Industrial Production						
US Industrial Production	0.7	1.7	1.2	0.5		Worsen
Europe Industrial Production	-0.7	-0.8	-2.4	-2.0		Improved
Japan Industrial Production	-1.1	-2.1	-3.8	0.7		Improved
China Industrial Production	5.4	5.0	6.3	4.8		Worsen
Source: Markit, government sourcces						

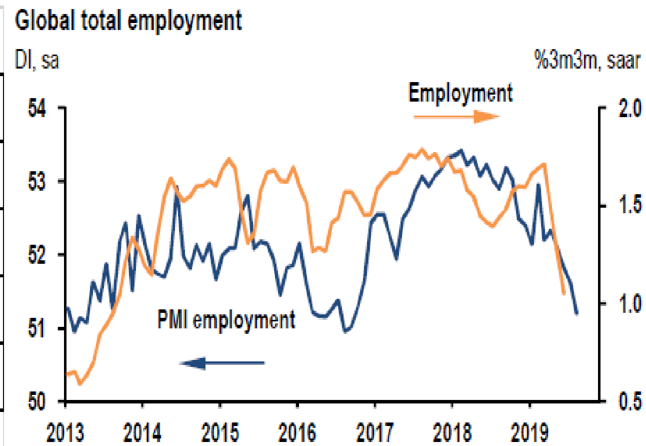


Source: J.P. Morgan

While our base case scenario is for the service sector to provide the ballast against a weakening manufacturing sector, we have also mused in June's Navigator, Conflated, Confused, hopefully not Concussed, **there are incipient signs that the manufacturing recession is spilling over into the consumer sectors. The August's PMI for Services fell to its lowest level since 2016 at 51.8 with all 3 segments of consumer, business and financial** declining, particularly the financial segment falling a significant 2.4bps probably due to market volatility and several mass layoffs in the banking sector in the past few months. Consequently, the outlook for employment in service sectors fell as well to its lowest since 2016. We need to monitor this development carefully given its inordinate significance to the global economy. Fortunately, the latest US consumer data in August including actual spending and sentiment survey remain robust with retail sales up 4.1% yoy/0.1% mom. Jobless claims continue to trend lower with 204,000 initial claims. But the strength in retail sales is largely confined to the US, with Europe, Japan, and China retail sales remaining sluggish.

Services and Employment outlook beginning to feel the bite

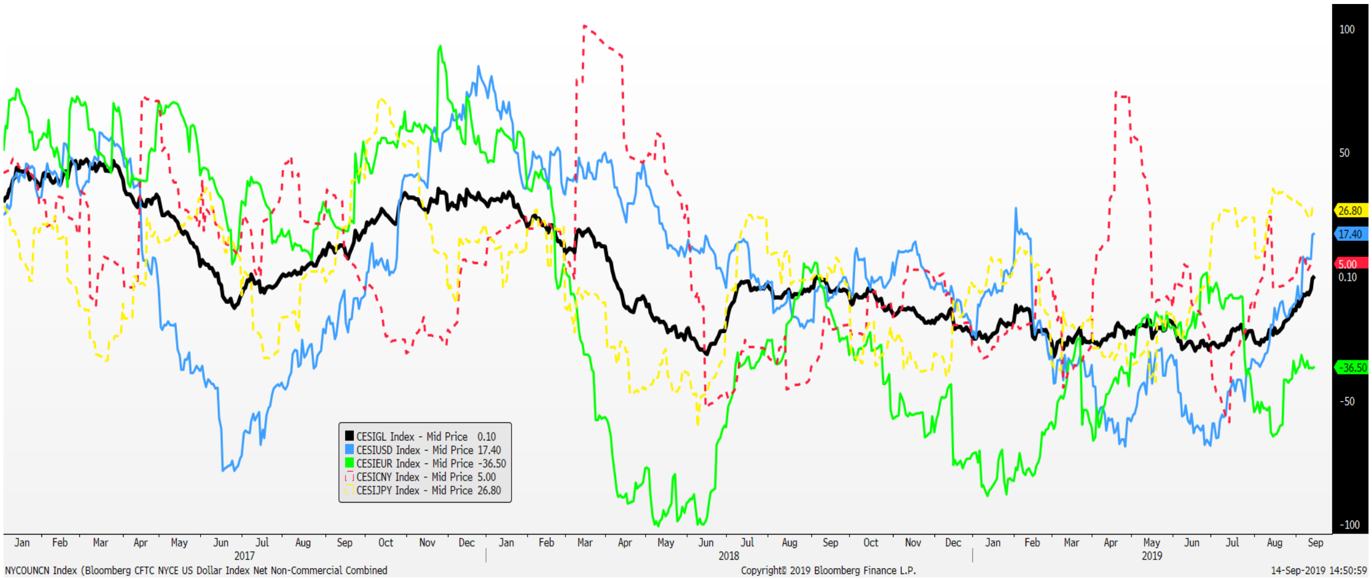
Global PMI Seervices	April	May	Jun	Jul	Aug	
- Consumers	51.7	51.6	52.7	51.4	50.9	Worsen
- Business	52.7	51.3	51.3	52.4	52.0	Worsen
- Financial	54.1	52.6	53.1	54.2	51.8	Worsen
- Global Services Composite	52.7	51.6	51.9	52.5	51.8	Worsen
- Employment	52.3	52.3	51.9	51.9	51.2	Worsen
Source: Markit						



Source: J.P. Morgan

On balance, we are tweaking our bearish view we have held since March. Several reasons are underpinning this less negative view. This includes our expectation that data in the manufacturing sector should show incremental improvements and when contrasted to low expectation by the investment community, any improvement in data can swing risk appetite rapidly. As a matter of fact, the **Citi Global Economic Surprise Index (Black) has registered month-month improvements since August** and it is at the highest level since Apr 2018. Drilling into various regions, we have incoming data in China, the US and even Japan surprising on the upside from dour low expectation with only Europe still surprising on the downside.

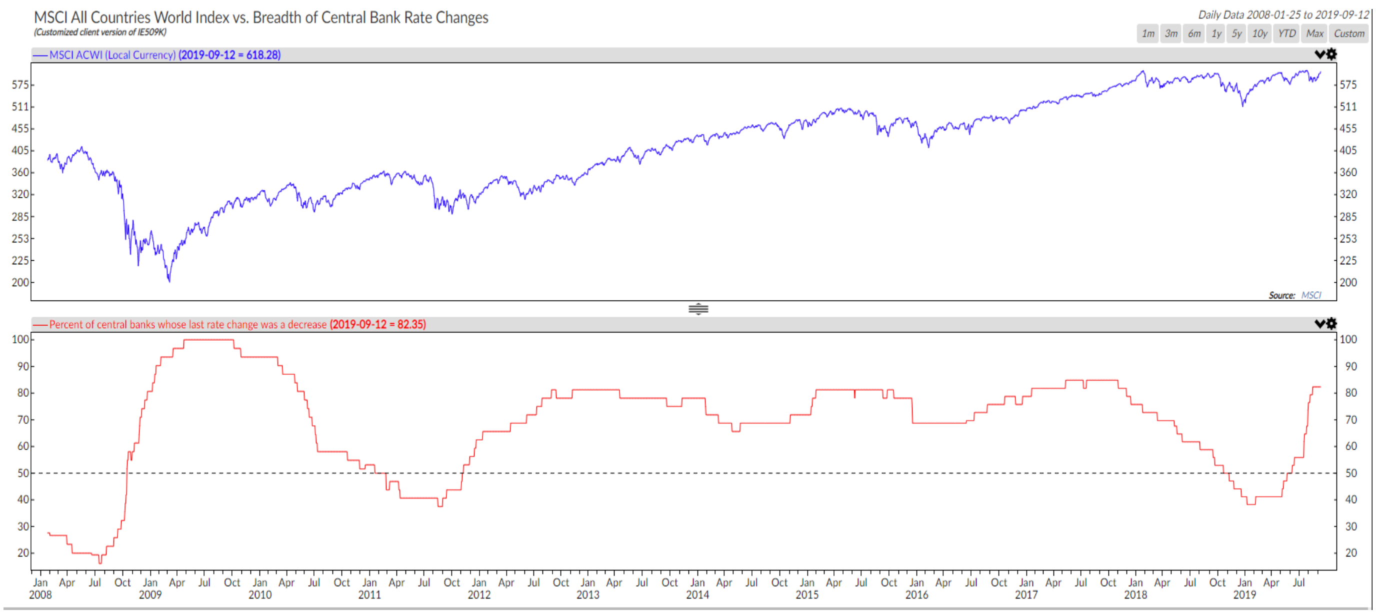
Incoming data are surprising on the upside versus very low expectations.



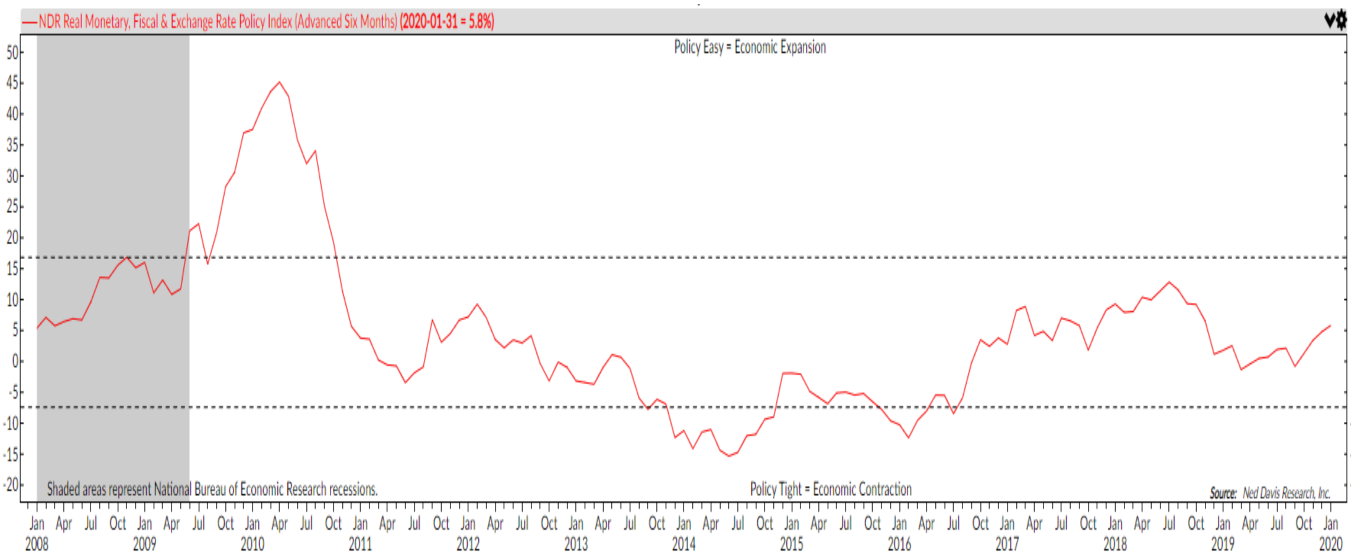
Source: Citi

The other reason is the **powerful and coordinated easing of monetary policies globally.** In fact, in the last 3 months, the percentage of central banks in the world that has lowered their policy rates stands at 83%! The last time we had more central banks easing than now was back in GFC. We expect further cuts in the coming months, including next week for the Fed, England, Brazil, China and maybe even Japan following ECB's new QE program announced last week. We are also witnessing more government announcing fiscal programs to address the weak external economy as tracked by NDR easing/tightening index.

83% of the central banks in the world has cut their policy rates in the last 3 months!



Slew of governments have announced expansionary fiscal policy in the last 3 months



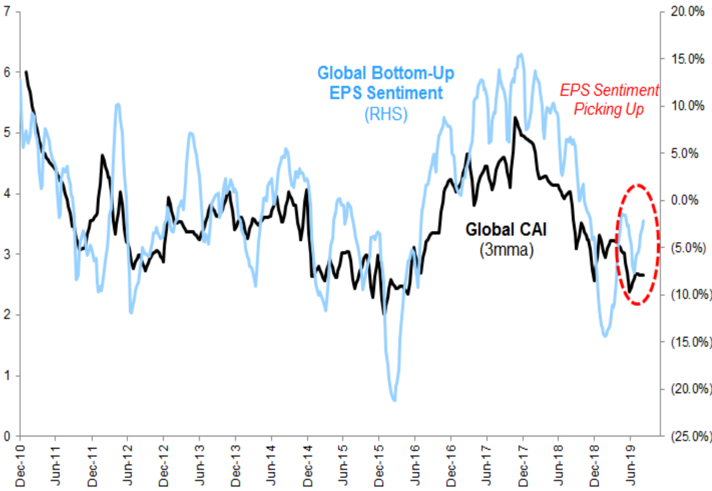
Source: NDR

Asset Allocation Strategy

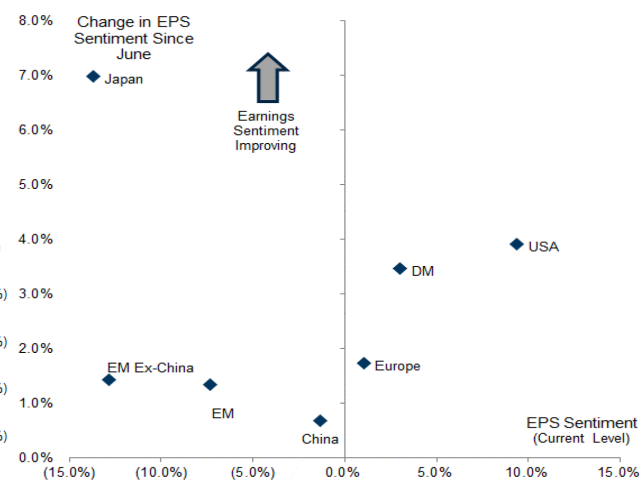
We are making subtle changes to be less bearish upgrading Equities to Neutral from the cautious view we have held since March. While we have used global treasuries as a portfolio hedge in the past few months, the surprise drop to a low of 1.43% in UST10 in early September was clearly an overshoot especially against our views that the global economy that is bending but not breaking. We lifted our US Treasuries hedge alongside our risk-off Gold trade early part of the month.

Equities: Upgrade to Neutral. While we have not turned full-on bullish, there has been a few geographical and sector representational tilts to reflect the current more optimistic view. The US remains the largest weight in our Equity exposures although it is still Neutral to benchmark because of its comparatively more expensive valuation and crowdedness. We have increased our financials exposure in the US (and EM) and has added to our tech exposure, which is the largest sectoral representation, as a form of expressing this cyclical tilt. The former is due to valuation and a tactical beneficiary of an overshot in rates while the latter remains very much bottom-up focused. We have added call options to Japan which by far is the cheapest vol among the developed market indices and often are the key beneficiaries from an upswing in manufacturing sentiment alongside other markets such as Brazil and South Korea. But the key tilt we made is to upgrade EM Equities to Overweight as we have observed data improving the most in this region alongside an accommodative fiscal and monetary policies. Since June, we are also witnessing an uplift in earnings sentiment (ie more upgrades than downgrades) across all regional blocs with the US and Japan seeing the biggest improvement.

EPS Sentiment improving

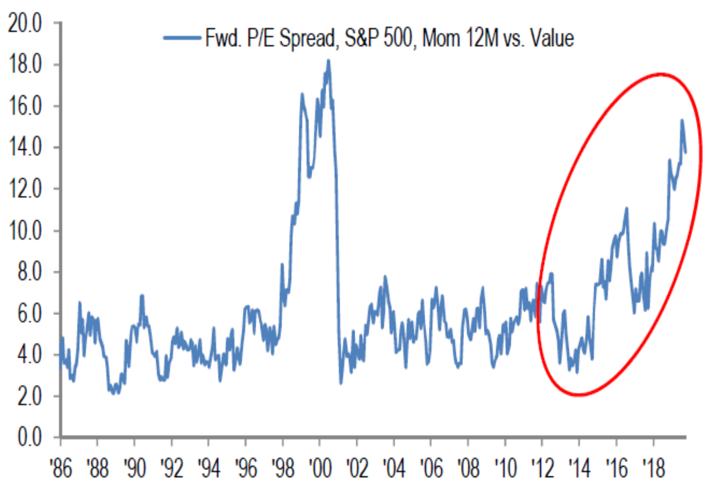


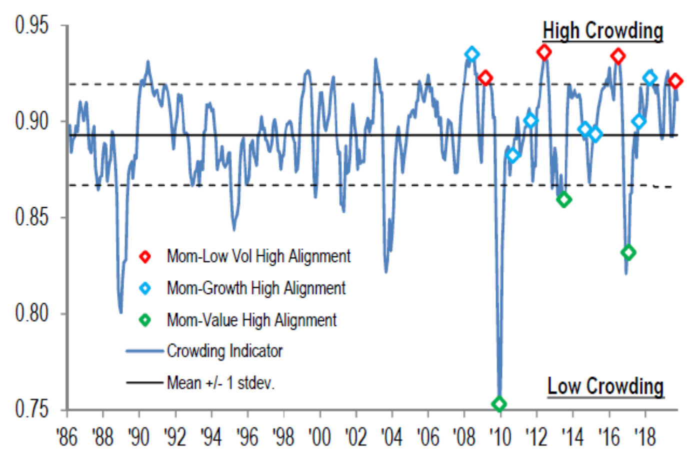
US, Japan and DM the most, but EM getting less negative



If data continues to improve, we will be looking to shift towards value vs momentum as the PE spread between these two styles are alarmingly wide while momentum trades are very crowded. Nonetheless, there is still a focus on obtaining dividends across all our mandates that has equity exposures via REITs, consumer staples and lower volatility stocks.

Value is extremely cheap and not crowded compared to momentum and risk of rotation to value is high





Source for all on page: J.P. Morgan US Equity Strategy and Quantitative Research

Source: JP Morgan

Fixed Income: Neutral. We have reduced our duration risk substantially in the past 2 months when rates were heading lower. As mentioned in last month's Navigator, we do not subscribe to the market view of rates heading to zero in the US! Alongside the reduction of duration, we have also increased the credit quality of our fixed income portfolio by increasing our investment grade exposures and carefully monitoring our high yield exposures. One beneficiary of ECB's renewed QE would be European banks AT1 and CoCos; we have also increased our exposure in this space.

FX: Neutral. With all key central banks reducing rates we doubt there will be any significant move in the DXY in the coming months besides the risk of Trump initiating the Treasury to label everyone a currency manipulator; though it is a plausible risk.

Commodities: Neutral exited our Gold hedge but we remain skeptical of buying oil on the back of our more constructive macro views due entirely to our medium-term view of large incoming supply from the US.

Alternative Investments: No change

Cash: We should be reducing our cash level pending confirmation of better data.

Featured Picture/Quote: How do you control inflation?

By KuiChwee-ing it

Edward Lim, CFA

Chief Investment Officer
edwardlim@covenant-capital.com

Risk Disclosure