The Navigator

COVENANT CAPITAL

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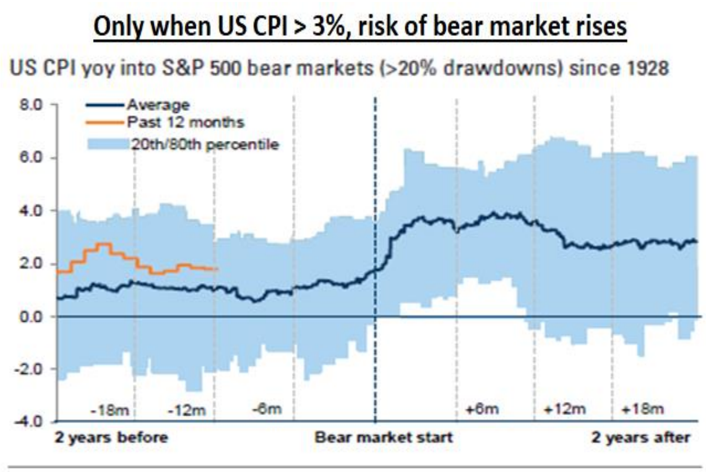
Hachiko – The dogged tale of faithfulness and loyalty

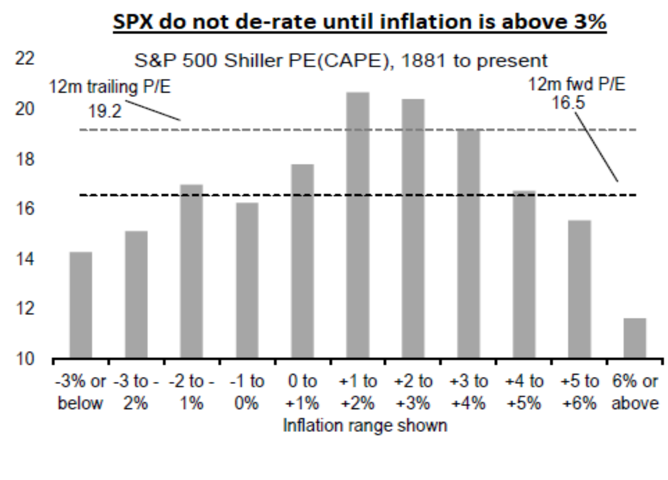
Most of us who have travelled to Tokyo would have seen the fabled Hachiko dog in Shibuya station. As the tale goes, this faithful and loyal Akita dog waited for his master everyday at the train station in their daily commute. Even after his master's death, the iconic dog continued to preserve waiting for 9 years, 9 months and 15 days until its own death. It is has become a national sensation since and are told in Japanese schools to emphasize the principles of faithfulness and loyalty. This author hopes he doesn't need to wait that long to affirm his key thesis of a continuation in the bull market and that rates are not quite there yet to have a pernicious impact to risky assets.

Our quick note, Don't Worry Be Happy, published days after what has been the most dramatic correction in US and global markets, surpassing the GFC of 2008 in terms of points dropped, affirmed the views global economic momentum remains strong, earnings revision continues to post new highs and there are plenty of empirical data to support we are not there yet in terms of inflation and concomitant rise in yields that will have negative impact to risk assets. But as we have written extensively in our 2018 investment outlook piece, Eat Drink Man Woman, we contended that inflation risk is the 2nd largest elephant in the room that we need to monitor carefully. We also provided clear goalposts at what level of inflation and yields will have negative impact to equity and bond markets.

Let's remind all the goalposts. **We said only when CPI is above 3%, the risk of bear** market rises (ie defined as more than 20% drop in S&P). At one-point last week, SPX did drop -12% at its low from its highest peak but it is still not quite at bear market territory yet. **Valuation multiple doesn't de-rate to below 16x until CPI is above 3%.** In fact, this dataset from 1881 to present (a real long time) indicates that when CPI is at the 1-2% range (which is were actual and forecast data is for 2018), valuation multiple accorded to equities is at the highest above 19x trailing PE.



Source: Bloomberg, GFD, Goldman Sachs Global Investment Research

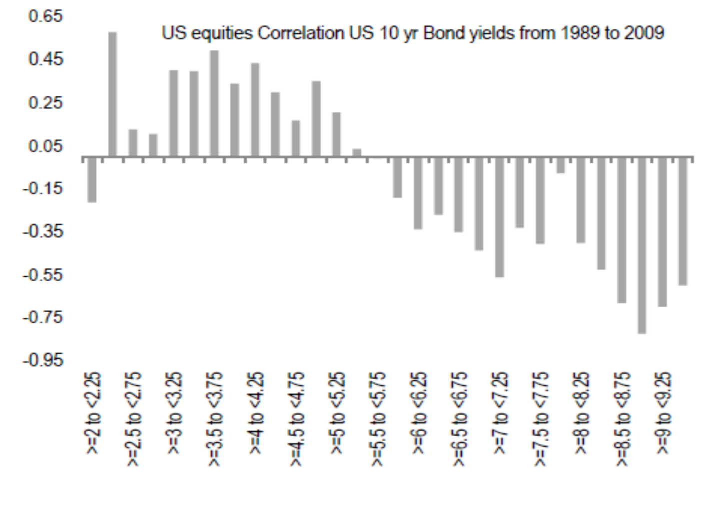


Source: Thomson Reuters, Credit Suisse research

We add on to our arsenal of data to identify where is the inflexion point. Data set from 1989 to 2009 before the world embark on QE tells us **only when US10 yields is above 5.5% equity markets will be detrimentally affected** as inflation and higher rates erode earnings power and curtail investment through higher cost of capital. We have written as far back as Sep 2017 in The Epitpah of QE and His Mates that term premia is way too low and market participants are too complacent. Hence, if we add three more Fed rate hikes of 25bps each to current policy rate of

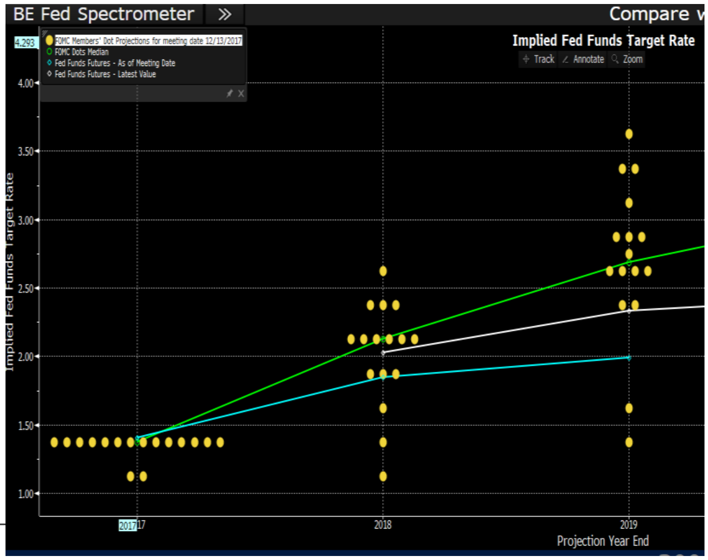
1.25% and add back the normal 30 years historical term premia of 100bps to US10, we arrive at US10 yield at 3%. This has always been our fair value where US yields should be trading at by end 2018 in contrast to our often-mentioned market's misalignment. At the start of the year, the market still had US10 at 2.40% and was pricing only one rate hike for 2018! In short-period of less than 2 weeks, market is now aligned with Fed's dots and have moved yields up 45bps to 2.80% currently. This is the first time since Fed hiked rates in 2015 that the market is aligned with Fed's intentions. A reminder this data tells us that at this level of **US10 2.80% to eventual 3%, rising yields are beneficial for equity markets.**

Only when US10 >5.5%, -ve correlation to equities



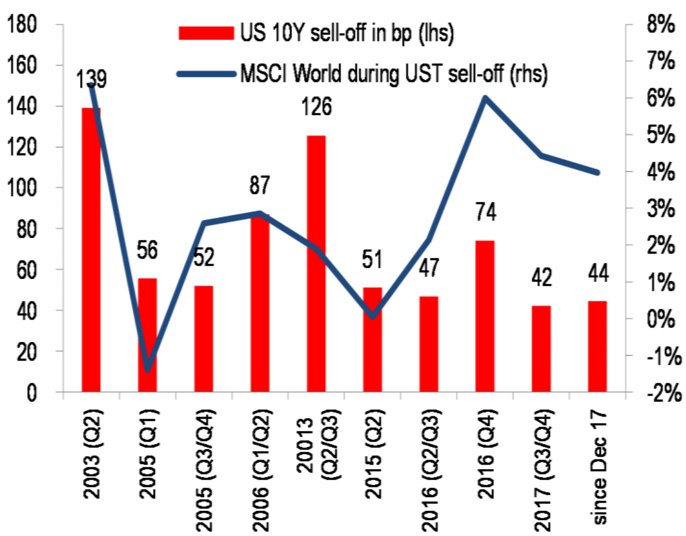
Source: Thomson Reuters, Credit Suisse research

Now market is finally aligned to Fed's dots

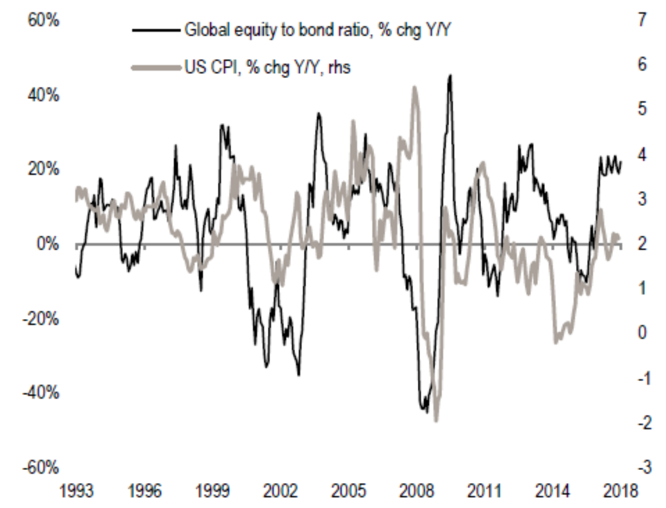


We remained faithful to history and history tells us **past sharp increase in yields, 9 out of ten times, equities registered positive return 1 month after with average returns of 3%.** History also tell us equities outperform bonds when inflation accelerates. **Only when inflation is above 3%, equites cedes performance to bonds as flight to safety ensues.**

Past sharp rise in yields, equities mostly up

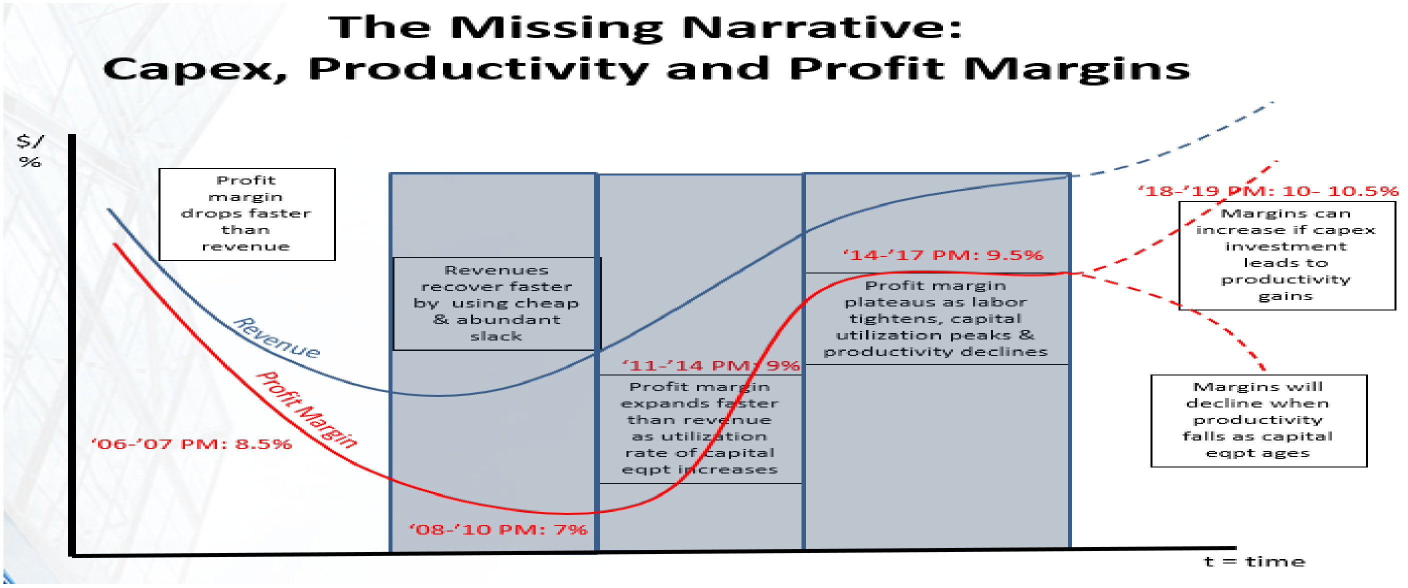


Equities outperform bonds when inflation accelerates



Source: Thomson Reuters, Credit Suisse research

One final point on global macro is our new-found narrative for this current cycle is the return of capex and the expected improvement in productivity capex brings forth. This author had the brusque, rude and yet funny comment from a fellow practitioner in this industry saying "Edward, the market is !)(@*$% crapping out and you want to tell me about capex and productivity" Fair point for an insolent ticker watcher but is a big deal for corporates who think about in terms of years and not seconds on how their profits will and can be made. As we have presented in our Jan 2018 outlook dinner, [Eat Drink Man Woman Outlook Dinner Presentation](), the narrative of capex is profound. Not only are capex cycles long in duration, they are often associated with positive EPS growth, positive equity markets and most importantly increase in capex provides the buffer to inflation pressure therefore sustaining profit margins for corporates. As we have mused on many occasions in our 2018 write-up and dinner event, earnings matter most.



Source: Covenant Capital

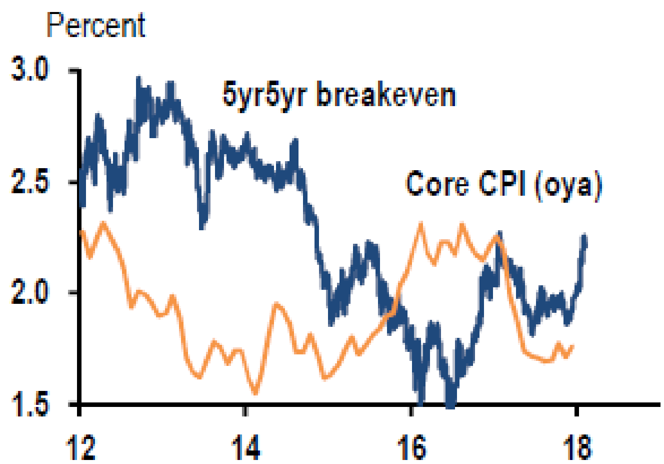
Asset Allocation Strategy

We categorized past 2 weeks market gyration as a classic correction in a bull market. A few of you would have received a warning form us 2 weeks ago that market is way overbought with many asset classes trading above RSI 80. For our discretionary accounts, we removed some risks before this market tumult and added put protections as well. This correction is analogous to 2013 taper tantrum correction when the market was dealt a surprise announcement by then Fed Chairman Ben Bernanke to end QE. This time round the market had to align themselves to the twin concerns of rising inflation and policy normalization. During 2013 in taper tantrum, market corrected by 7% but US10 yield jumped a whopping 72bps from 2% to 2.73% within 2 months. However, it took only a month for market to recalibrate before moving higher to close 17% higher from its year trough or 10% from its earlier peak of the year. Interestingly, trailing PE back in 2013 was also 17x similar to current year but EPS growth then was only 7% in contrast to 14% forecast for this year. We believe this current correction will be short-lived now that market is attuned to Fed's prescribed tightening. There shouldn't be any source of dislodgement emanating from this concern unless the new Fed communicates otherwise or inflation surprise even higher than expected.

As to adjustment in inflation expectation, the market has gone from blasé view to quickening pace. We think market is again wrong here and we are calling from a moderate rise in inflation with long-term structural impediments like ageing demographics, weak labour market pricing, technology induced efficiency and our all-important medium-term narrative of capex/productivity growth capping wage and goods inflation. Market is now pricing inflation at above

2.3%; a good 0.30% ppts higher than actual and forecast even into 2019. It is ridiculous that market was calling for a continual of low-inflation for extended period throughout last year into mid-Jan 2018 and then to swing to concerns of inflation within 3 weeks.

Market now pricing inflation higher than actual?!



Source: J.P. Morgan

Feb 2018 is typical non-recession correction

Start	Bottom	Trading days to Bottom	Trading days to Recover	Price change Correction	Price change +3-mo.
Sep-76	Mar-78	367	367	(19)%	15 %
Oct-79	Nov-79	24	50	(10)	16
Feb-80	Mar-80	31	75	(17)	18
Nov-80	Aug-82	431	59	(27)	36
Oct-83	Jul-84	200	126	(14)	13
Aug-87	Dec-87	72	415	(34)	19
Jul-90	Oct-90	63	89	(20)	7
Oct-97	Oct-97	15	29	(11)	10
Jul-98	Aug-98	32	60	(19)	23
Jul-99	Oct-99	65	23	(12)	17
Mar-00	Oct-02	638	1197	(49)	19
Nov-02	Mar-03	70	44	(15)	25
Oct-07	Mar-09	356	1022	(57)	39
Apr-10	Jul-10	50	88	(16)	12
Apr-11	Oct-11	109	100	(19)	16
May-15	Feb-16	189	99	(10)	6
Overall median (16)		71	89	(18)%	17 %
Recession median (5)		356	89	(27)	19
Non-recession median (11)		70	88	(15)	16

Source: FactSet, Goldman Sachs Global Investment Research.

A typical non-recession correction has market falling -15% from peak, we had -12% already. the market recovers 16% within 3 months post these corrections while they typically last 70 days. Our asset allocation strategy is unchanged. Underweight bonds but Overweight Equities and Commodities and in fact have added some risk this week.

Equities: This recent sell-down has presented us the perfect opportunity to increase our equities allocation adding more options and buying core ideas we never managed to buy due to run-away prices. We have grouped our ideas into a few buckets. Cyclicals with strong growth and high dividend, oversold cyclicals, structural with high growth and oversold. The only addition to our equities overweight is to hedge via outsized put options from time to time in recognition that volatility will increase from hereon.

	2 yrs EPS Growth	FY18 Dividend Yield	PE -18	PE -19	9day RSI	2 weeks peak - trough price change	Expected Target Return
Cyclicals - Strong growth and High Dividend							
Allianz	14%	4.63%	11.9	10.8	29	-9%	14%
Bank of Chiina	16%	5.40%	5.9	5.6	45	-15%	24%
CNOOC	44%	5.40%	12.4	8.8	27	-17%	37%
Cyclicals - Strong growth and Oversold							
Ping An	44%	1.91%	16.2	13.2	40	-19%	21%
Lam Research	63%	1.07%	10.4	10.6	40	-24%	47%
OIH - ETF	33%	1.94%	41	24	27	-19%	32%
Keppel Corp	28%	3.30%	14.8	13.5	35	-12%	19%
Structural - Strong growth and Oversold							
Broadcom	29%	2.86%	12.3	11.9	50	-13%	31%
BABA	80%	0%	34.2	26.5	38	-15%	31%
Vodaphone	48%	6%	20.9	19.3	26.5	-15%	22%
British American Tobacco	22%	4.56%	14.4	13.2	30	-13%	27%

Source: Bloomberg, Covenant Capital. Please consult your banker for appropriate risk and return objectives.

Fixed Income: Underweight. No change expecting second year of negative returns for most sovereign bonds, barbell approach with yields and carry in EM debt, capital securities and preferred securities while expecting only carry in investment grade credit. However, we will be embarking on a more proactive duration hedging especially into 2H of the year.

Commodities: Overweight. Continue to like oil, copper and their derivatives in the form of equities and bonds.

FX: Neutral. Dollar strength in short-term but medium-term dollar bear is only into 2nd year of a typical 7 year bull/bear cycle. The tax reform, fiscal budget and impending infrastructure plan is expected to be dollar negative in the medium term as well.

Alternatives Investments: Most of our L/S strategies are now in the fixed income space rather than equity. We are also exploring a few non-correlated strategies such venture capitalists/PE funds focusing in South Asia's technology and consumers and fund managers that rely solely on AI and big data analytics in their investment decisions.

Cash: Cash maintained 0-5%.

Featured Picture/Quote : Woof, Woof, Woof to all our readers this CNY

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Risk Disclosure

Investors should consider this report as only a single factor in making their investment decision.

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