The Navigator

COVENANT CAPITAL

October 2018

Simi ci 7th innings?

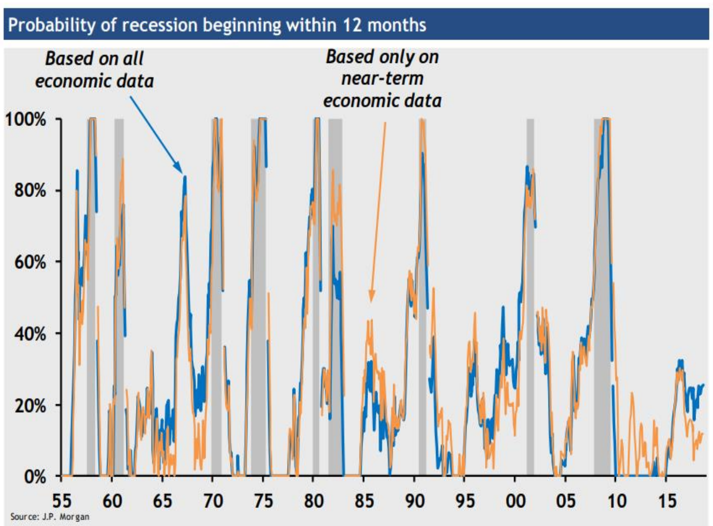
As a Singaporean growing up listening to Martin Tyler's effluent commentaries of English football (yes to our American readers it is football, not soccer because it is played with the foot and your football should be called handball, running with the ball or clashing each other without the ball), I have no perception of the urgency of time when every prominent stock market commentators says we are in the 7th innings of this bull market cycle. I suppose the equivalent football analogy is the 70th minute of a football game when the managers must make bold substitutions to win the game. So, I set off to understand that there are 9 innings in a baseball game and what a 7-9th inning of the game looks like in equity market parlance. In analyzing the last bull market cycles since 1932, **the last 7-9th innings typically reap 24% average returns and constitute 16% of the total cumulative bull market returns.** The lowest return during this late stage of a game is 8.4% while the highest is 49%, which occurred in the longest bull cycle of Oct 1990 to Mar 2000. The 7-9th inning game can also last quite long, on average of 13 months with the shortest lasting 6 months. Therefore, the 7-9th inning playbook is one of meaningful returns and can last quite a while

That's what a 7-9th inning of a bull market cycle looks like? Meaningful and long returns

	Duration of past bull cycle (mths)	Return of past bull cycle	Duration of 7-9th innings of bull cycle	Return of past 7-9th innings	Contributed % of Total Bull Market Return
Oct 1966 - Nov 1968	26	48.0%	6	9.8%	20%
Oct 1987 - Jul 1990	31	70.5%	7	10.1%	14%
Jun 1970 - Jan 1973	32	73.5%	7	11.9%	16%
Jul 1962 - Feb 1966	44	79.8%	10	8.4%	11%
Oct 1957 - Dec 1961	50	86.1%	11	18.6%	22%
Jul 2002 - Oct 2007	60	101.7%	13	11.1%	11%
Oct 1974 - Nov 1980	73	124.9%	16	34.6%	28%
May 1942 - May 1946	48	156.8%	11	27.6%	18%
Jul 1982 - Aug 1987	59	230.0%	13	34.6%	15%
Jun 1949 - Jul 1956	84	262.6%	19	47.0%	18%
Jun 1932 - Feb 1937	57	323.8%	13	29.5%	9%
Oct 1990 - Mar 2000	114	427.3%	25	48.9%	11%
Mar 2009 - current cycle	113	321.71	????		
Average	**56.5**	**165.4%**	**13**	**24.3%**	**16%**
			Min return	**8.4%**	
Source: GS and Bloomberg			**Max return**	**48.9%**	

While the allure of holding up for the last leg of this market looks tempting given its substantial return prospect, the critical question to answer is "Are we already past the 7th, maybe in the 8th or worse, we are already in the 9th inning?" since we know S&P peaks on average 7 months ahead of recession. Particularly prescient to analyze given this month's purge in equity markets. We attempt to frame this critical question with two approaches. First, we look at recession prediction models used by various firms such as JP Morgan. The caveat is with any modelling, the risk of black swans' triggers can never be foretold nor model into. Nonetheless, we use what past correlations have given us and at the least, this approach is systematic rather than some vacuous premonitory. Based on JP Morgan, as well as several others this author is tracking, **the probability of recession in the next 12months whilst have increased to 25%, it still within their 2 years average probability of 17% and it is nowhere near >50% probability trigger to act.** Quantifying this probability is important not only to pinpoint are we already in the 7-9th innings but it is also a critical asset allocation signal to shift to maximum cash and treasuries.

JPM model says only 25% risk of recession in 12mths



J.P.Morgan

S&P peaks 7 months ahead of recession

Economic peaks and market peaks

US economy peak (NBER)	S&P 500 peak	Lead of S&P to economic peak (months)
Aug-57	Jul-56	13
Apr-60	Aug-59	8
Dec-69	Nov-68	13
Nov-73	Jan-73	10
Jan-80	Jan-80	0
Jul-81	Nov-80	8
Jul-90	Jul-90	0
Mar-01	Mar-00	12
Dec-07	Oct-07	2
	Average:	**7**
	Min:	**0**
	Max:	**13**

Source: J.P. Morgan

The other approach we have outlined in Melt up Nov 2017 and at the start of the year, The Navigator Year Ahead 2018: Eat Drink Man Woman is to understand at what point inflation and commiserating 10-year yields often coincide with bear markets and using the predictive power of a negative yield curve in foretelling recessions. **Using data as far as back as the 1900s, the analysis tells us bear markets often happen when inflation is above 3% versus 2.3% currently and the UST10 yield needs to exceed 4% (3.16% now) for a bear market to commence. Furthermore, only when the yield curve turn negative, does a recession starts based on data from 1980 onwards**. **We are not there yet on these 2 counts.** Even when the yield curve inverts, there is an average lead time of 9 months (the shortest is 3 months) before S&P peaks. The current yield curve has flattened but it isn't negative, yielding a 31bps spread between the 2s10s of US treasury.

We have established is the probability of recession is still low in the next 12 months and other market indicators are not flashing corroborative signal that a recession is imminent which should not put us deep into the 7-9th innings of a bull market, implying there is still considerable returns to extract. Nonetheless, recession and market peaks still weigh heavily on our mind and we are reminded in our piece back in Sep 2017, The Epitaph of QE and his mates, it doesn't pay to exit ahead of a bull market. Even if we are wrong that a bear market has already commenced, it is not too late to sell as the first 3 and 6 months of a bear market cycles typically fall -5% and -6% respectively but constitute a smaller part of an average -31% decline in bear markets.

Doesn't pay to exit ahead of a bear market and never too late to sell into the start of a bear market

Bear Market			Performance before the start		Performance after the start	
Start	Length (m)	Performance	- 3m	- 1m	+ 1m	+ 3m
Dec-61	6	-28%	7%	2%	-2%	-6%
Feb-66	8	-22%	2%	1%	-1%	-2%
Nov-68	18	-36%	10%	4%	-4%	-9%
Jan-73	21	-48%	11%	1%	-1%	-10%
Sep-76	17	-19%	4%	5%	-5%	-4%
Nov-80	20	-27%	15%	10%	-9%	-13%
Oct-87	2	-32%	8%	4%	-3%	-7%
Jul-90	3	-20%	7%	2%	-2%	-7%
Jul-98	1	-19%	6%	7%	-7%	-5%
Mar-00	30	-49%	5%	12%	-11%	-5%
Oct-07	17	-57%	4%	8%	-7%	-4%
Apr-11	5	-19%	7%	3%	-3%	-6%
Median	**12**	**-28%**	**7%**	**4%**	**-4%**	**-6%**
Average	**12**	**-31%**	**7%**	**5%**	**-5%**	**-6%**

Source: Bloomberg, Goldman Sachs Global Investment Research

What about catching the last up wave of an otherwise torrid 2018? What does seasonality tell us? Over the last 30 years, 4Q return is always the strongest with an average return of 4.8%; 2.5x more than first and 2 quarters while 3 quarters is typically the worse quarter, hence the axiom "Sell in May and go away". The probability of positive return in 4Q is also high at 80% with only 4 occasions, the performance in the fourth quarter is negative. Three of such years occurred in the recession years of 2008, 2009 and 2001and the other was in 2012 when QE1 ended and European existential crisis was developing with the PIGS under severe duress but ECB incapacitated itself from rescuing them. We find a similar seasonality effect for EM equities with an average 4Q return of 4.7% and is always the best quarter in a year albeit the probability is lower at 68% of a positive return. What about the other adage "Black October"? This adage must be strongly refuted! The average return of S&P is October is positive 0.70% in the last 30 years, marking it the 7th best performing month in the year. The probability of October being a negative month is only 33% over the last 30 years. Its overinflated importance probably stems from the fact that it has on the record the worst S&P monthly return in 30 years down -17% during the depths of 2008 GFC, the 1987 flash crash as well as the onset of 1929 Great Depression which is considered the biggest monthly decline in S&P history.

<u>4Q is the best quarterly return with 80% probability of positive return for S&P</u>

	Q1	Q2	Q3	Q4
25 Yr Trailing Avg(2018)	1.64	2.25	-.17	4.79
2017	5.53	2.57	3.96	6.12
2016	.77	1.90	3.31	3.25
2015	.44	-.23	-6.94	6.45
2014	1.30	4.69	.62	4.39
2013	10.03	2.36	4.69	9.92
2012	12.00	-3.29	5.76	-1.01
2011	5.42	-.39	-14.33	11.15
2010	4.87	-11.86	10.72	10.20
2009	-11.67	15.22	14.98	5.49
2008	-9.92	-3.23	-8.88	-22.56
2007	.18	5.81	1.56	-3.82
2006	3.73	-1.90	5.17	6.17
2005	-2.58	.91	3.15	1.59
2004	1.29	1.30	-2.30	8.73
2003	-3.60	14.89	2.20	11.64
2002	-.06	-13.73	-17.63	7.92
2001	-12.11	5.52	-14.99	10.29
2000	2.00	-2.93	-1.24	-8.09
1999	4.65	6.71	-6.56	14.54
1998	13.53	2.91	-10.30	20.87
1997	2.21	16.91	7.02	2.44
1996	4.80	3.89	2.49	7.77
1995	9.02	8.80	7.28	5.39
1994	-4.43	-.34	4.15	-.74
1993	3.66	-.25	1.86	1.64

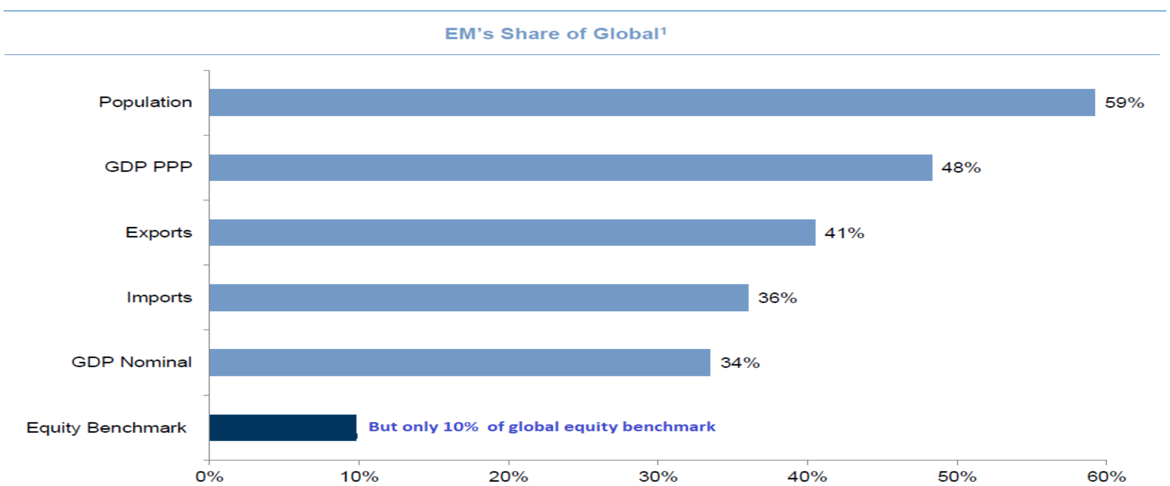
<u>Bad October is a myth, 67% is positive in Oct and is the 7th best performing month in the year.</u>

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
30 years Average Return	0.64	0.41	1.39	1.6	1.09	-0.18	1.19	-0.86	-0.39	0.75	1.05	1.89
30 yrs High/Lo Returns	13.2/-8.6	7.0/-11.0	9.7/-6.4	9.4/-6.1	9.2/-8.2	5.4/-8.6	8.8/-7.9	6.1/-14.6	8.8/-11	10.8/-21.8	7.5/-8.5	11.2/-6.0
Probability of +ve return	60%	67%	63%	77%	73%	50%	53%	53%	50%	67%	70%	80%

Source: Bloomberg

Nonetheless, these empirical facts provide scant comfort for us as we have held our overweight stance in EM Equities since the start of the year to much chagrin and pain. **We remind investors it is not unusual for EM to fall more than 10% from a peak within a calendar year. In fact, there have been 22 occasions in the last 20 years EM has fallen more than -10% within a year.** The only time EM equities didn't fall more than -10% in a year was in 2003, 2005 and of course 2017 where many of us established our reference bias heading into 2018 with an overweight call on it. We also want to remind investors why are bullish on EM Equities over the long term. Emerging market represents 59% of total world population, 48% of global GDP, 41% of exports but its equity markets only represent 10% of global equity benchmark.

<u>Why we are long-term bullish EM Equities; It is a significant part of global economy and yet poorly represented</u>



[1] Source: MSCI, IMF WEO, Thomson Reuters Datastream, HSBC. All data as of 2016. Equity Benchmark: MSCI ACWI. EM definition includes 24 markets in MSCI EM Index. The economic and market forecasts presented herein are for informational purposes as of the date of this presentation. Please see additional disclosures at the end of this presentation.

Can EM Equities have negative returns despite it growing above its medium-term growth potential? Unfortunately, it can. There have been 6 years when EM Equities returns are negative while it was growing above its potential. The six years were in recession years of 1997 in Asian Financial Crisis, the dotcom boom-bust of 2000 and 2002, end of QE1 in 2011which also coincided with US posting a significant slowdown in growth, 2014 where global commodities were in a stage of meltdown and of course now in 2018! This current drawdown is now officially the longest on record lasting 251 days, surpassing 143 days during1998 AFC, 185 days for 2008 GFC and 232 days during 2014 commodities collapse. **The 2018 underperformance in EM equities is the only time it has existed in a non-recessional year for EM economies or for other developed economies that could impart contagion.** If we have the clairvoyance to predict that Sep marks the trough for EM Equities for 2018, past post-trough analysis of its performances, is quite propitious for investors who stay the course. Over one, three and six months after a trough, EM Equities rebound 11%, 16% and 20% respectively with 100% probability of positive return one and three months out and 84% for six months later.

Unusual -ve EM equities return in a year EM GDP is strong

Real GDP growth	United States	Emerging market and developing economies	MSC EM Yearly Returns	
1994	4.0	3.1	-8.7	Growth potential > 4%
1995	2.7	3.9	-6.9	
1996	3.8	5.1	3.9	
1997	4.5	4.7	-13.4	
1998	4.4	2.3	-27.5	
1999	4.7	3.5	63.7	
2000	4.1	5.8	-31.8	
2001	1.0	3.6	-4.9	
2002	1.8	4.6	-8.0	
2003	2.8	7.0	51.6	Growth potential > 6%
2004	3.8	7.9	22.4	
2005	3.3	7.2	30.3	
2006	2.7	8.0	29.2	
2007	1.8	8.5	36.5	
2008	-0.3	5.7	-54.5	
2009	-2.8	2.8	74.5	
2010	2.5	7.4	16.4	
2011	1.6	6.4	-20.4	
2012	2.2	5.4	15.1	
2013	1.7	5.1	-5.0	
2014	2.6	4.7	-4.6	Growth potential > 4.5%
2015	2.9	4.3	-17.0	
2016	1.5	4.4	8.6	
2017	2.3	4.8	34.3	
2018	2.9	4.9	-13.6	

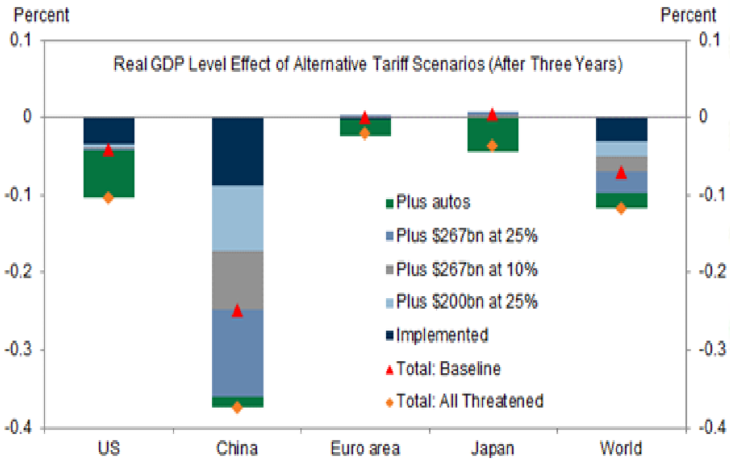
If only we can predict trough, forward returns are lucrative

21-Apr-98	11-Sep-98	143	-46.22%	11.3%	21.2%	25.7%
5-Jul-99	19-Oct-99	105	-10.33%	11.0%	27.0%	29.0%
10-Feb-00	23-May-00	103	-23.2%	7.7%	4.9%	-17.9%
17-Jul-00	30-Nov-00	136	-28.4%	2.3%	5.4%	1.5%
1-Feb-01	4-Apr-01	62	-21.4%	11.0%	7.1%	-15.2%
8-Jun-01	3-Oct-01	117	-26.2%	11.3%	32.0%	43.0%
19-Apr-02	10-Oct-02	174	-29.9%	14.9%	18.9%	11.3%
12-Apr-04	10-May-04	28	-17.0%	3.3%	2.5%	19.1%
10-May-06	13-Jun-06	34	-24.3%	10.4%	15.3%	31.7%
23-Jul-07	16-Aug-07	24	-17.7%	15.8%	30.2%	19.3%
19-May-08	20-Nov-08	185	-62.8%	25.4%	8.2%	62.8%
6-Jan-09	2-Mar-09	55	-21.8%	29.0%	67.5%	74.9%
12-Apr-10	25-May-10	43	-17.8%	10.8%	12.5%	28.5%
1-Aug-11	4-Oct-11	64	-27.6%	19.1%	12.8%	24.8%
29-Feb-12	1-Jun-12	93	-17.2%	7.0%	6.6%	12.7%
9-May-13	24-Jun-13	46	-16.7%	9.4%	14.4%	12.7%
22-Oct-13	4-Feb-14	105	-12.1%	4.2%	9.1%	16.5%
24-Jul-14	13-Mar-15	232	-13.1%	10.8%	3.3%	-14.0%
28-Apr-15	29-Sep-15	154	-27.2%	9.0%	3.0%	5.0%
16-Oct-15	21-Jan-16	97	-20.4%	8.2%	24.0%	26.5%
8-Sep-16	14-Nov-16	67	-9.5%	4.0%	11.3%	20.4%
26-Jan-18	30-Jul-18	251	-21.6%			
	Average	105	-23.3%	11.2%	16.1%	19.9%
			Probability +ve return	100%	100%	84%

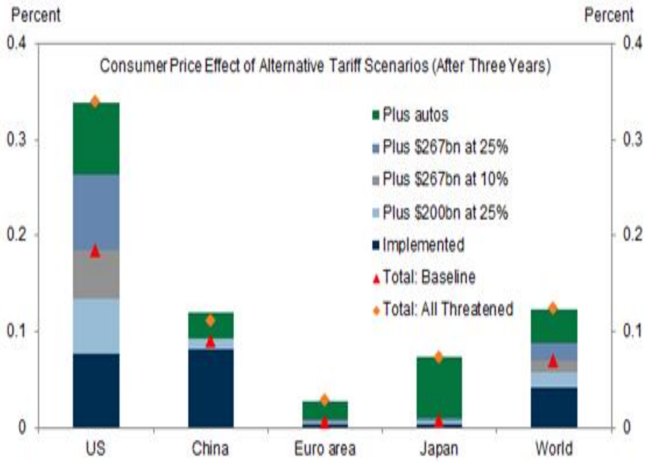
Source: Bloomberg and Covenant Capital

What then is the explanation for EM Equities' abhorrent performance in 2018 given that it existed in a year where its GDP is still growing above the potential pace of 4.9% and with no major developed economies in the recession? We think a large part of its underperformance is due to US "exceptionalism" on many fronts; from its solid growth to its unilateral schism is has created with its trading partners, particularly China. With regards to trade wars, we mark to market the impact to US, China, and global growth with the latest iterations of $200bn at 10% for 2018 and moving to %25% in 2019 by the US on China, China's additional $60bn on US as well as the resolution of US-Mexico-Canada new trade pact. The impact to growth is lesser than our previous promulgations with a 0.1% ppt shave off in global growth. However, if we model the worst-case scenario of another $267bn at 25% tariff US have threaten China with and add on global auto tariffs especially on Europe and Japan bilateral auto-trade dependency with US, global growth could be reduced by 0.20% ppt with China bearing the biggest brunt of -0.4% ppt decline. In the US, the impact to growth is manageable based on this worst-case scenario at -0.1% ppt but **the most determinantal impact for US is on inflation with Goldman forecasting that will lift US inflation by 0.35% ppt. This will likely push US CPI pass 3% requiring Fed to increase its rates more than current forecast and beyond what market is able to absorb.**

Trade wars impact to growth is particularly bad for China



But most pernicious to US on inflation

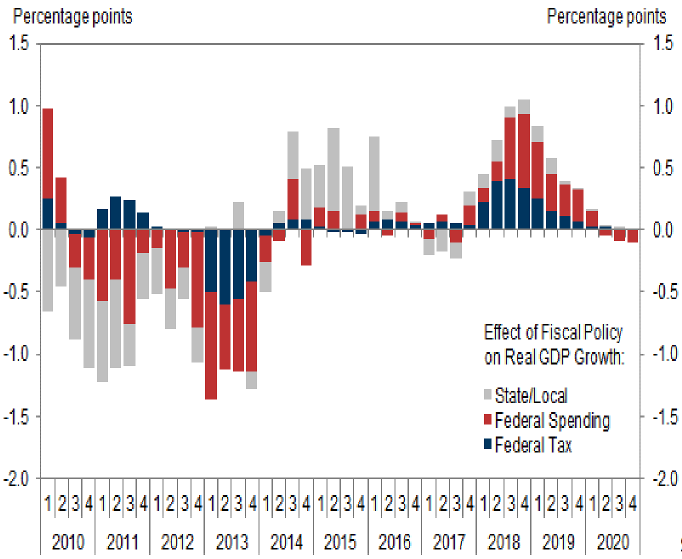


Source: Goldman Sachs

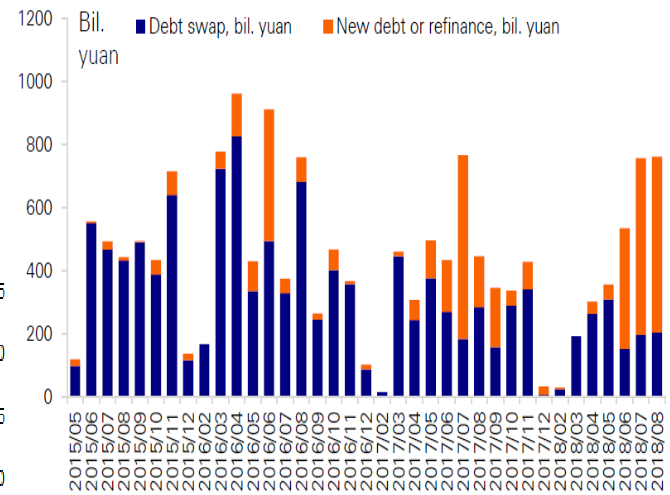
However, this worst case is still not our base case scenario. We draw comfort from various outcomes including a new USMCA trade pact, an extension of the deadline for Europe's autos and ongoing negotiations with Japan. Last week apparent instruction by President Trump to initiate the highest-level talk with himself and Xi with the apparent entourage of Nixon's grandson lead as to believe the eventual outcome is a renegotiated trade deal with less adverse impact than feared and priced into markets.

The other incident of US exceptionalism is of its stronger GDP growth and earnings outlook when compared to EM that has emerged from February of this year. **We believe this aspect of US exceptionalism is likely to reverse or at the margin become less pronounced when stacked against EM.** We overlay a few critical points to determine if US growth exceptionalism versus EM is about to reverse. First, the impact of US fiscal stimulus enacted in late 2017 and early 2018 will patter out by 2Q19. On the other hand, we expect China fiscal and monetary policy to be more aggressive and pro-growth in the coming months as witnessed by the recent RRR cuts, acceleration in government bond issuance, increased in infrastructure project approvals as well as stronger than expected starts in property constructions. In last month Navigator, we noticed that economic surprise index for EM is now exceeding that of the US, [O Captain! My Captain!]; an important precursor for EM equities to re-establish its growth proposition.

US stimulus impact wanes from 2Q19 onwards



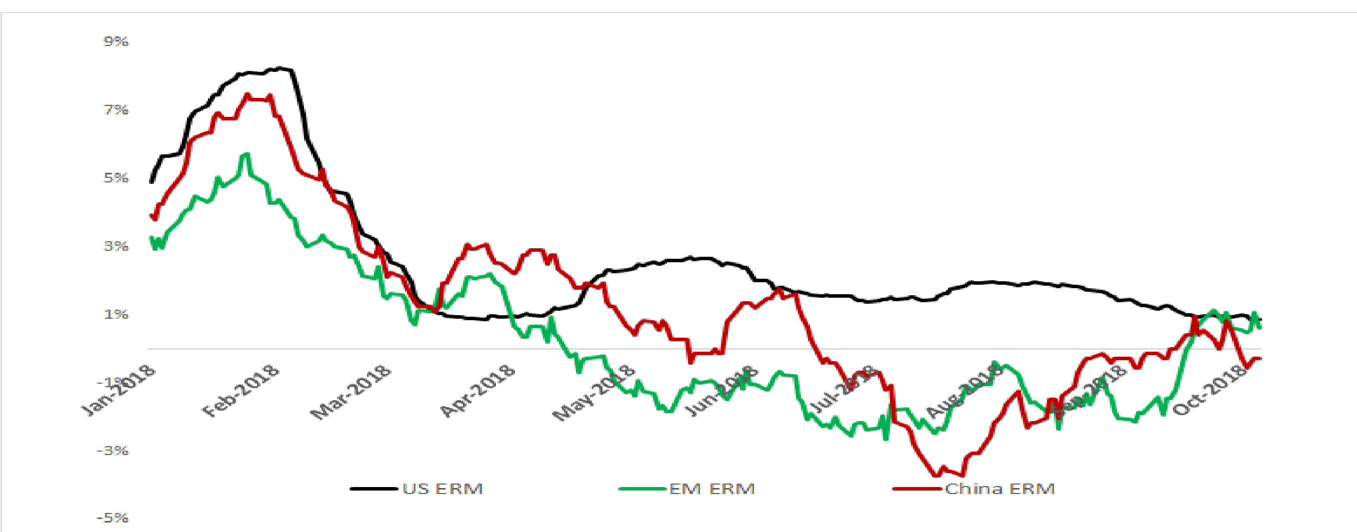
While China has stepped up the liquidity train



Source: Deutsche Bank, WIND

Second, we expect earnings momentum to wane in the US but strengthen for EM, particularly in China. We expect US growth to peak due to the trifecta of rising interest rates, higher labor wages, and eventual feed through of tariffs into pricier goods and raw materials in the US. We have seen several top-down earnings forecasts modelling a possible decline in consensus EPS estimate of +9% in 2019 to as low as +3% if the worst-case scenario is applied. If this comes to past, it means US EPS growth would have peaked this year. In EM, especially in EM-Asia and LATAM, earnings in 1H18 were largely in line with expectations moderating the sharp decline in earnings estimate that has been particularly pronounced since the onset of US trade wars in April. We are now witnessing EPS revision momentum revised upwards to slightly positive in the past month after a precipitous drop in since Feb.

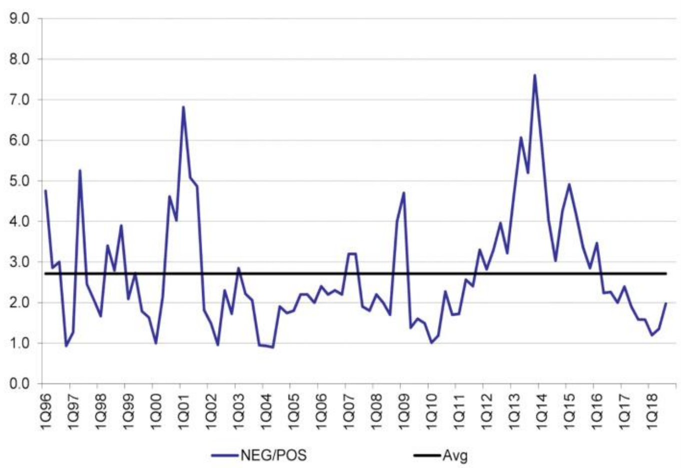
EM and China ERM bottomed in Aug and are trending higher while US is at risk of downgrade



Source: Bloomberg consensus estimate ERM=Earnings Revision Momentum tracks consensus forecast of 12mth forward earnings.

Equities: Overweight. We retain our overweight in EM Equities, but the portfolio has lesser cash representations now with our upside optionality expressed through lower-risk call options. We are also adding our exposure in Asia long/short equities and are planning to add long/short equities manager in Japan in the coming months. However, given our views of diminishing US exceptionalism coupled with expensive valuation and heavy positioning in a few narrow sectors in the US, we **have downgraded US equities from Overweight to Underweight** with asignificant part of this cautiousness expressed via put options in the US. We have also seen a pickup in pre-earnings negative announcements in the US; an occurrence that has not happened since 1Q 2016. We believe many US corporates will take this earning season to guide down to set a lower bar to beat in coming quarters in light of heighten uncertainty from both exogenous and endogenous factors. Looking into 2019 earnings, consensus forecast for US looks less superior when compared to its large differential between the rest of the world in 2018. In 2018, S&P is expected to post the highest normalized EPS growth in the region with its EPS growth spread between US and EM at a whopping 16% apart. But for 2019, the current forecast is for EM to post the largest EPS growth among the major blocs and re-asserting its stronger growth profile when compared to the US.

Seeing increase in -ve pre-earnings announcement in US



S&P earnings exceptionalism wanes in 2019

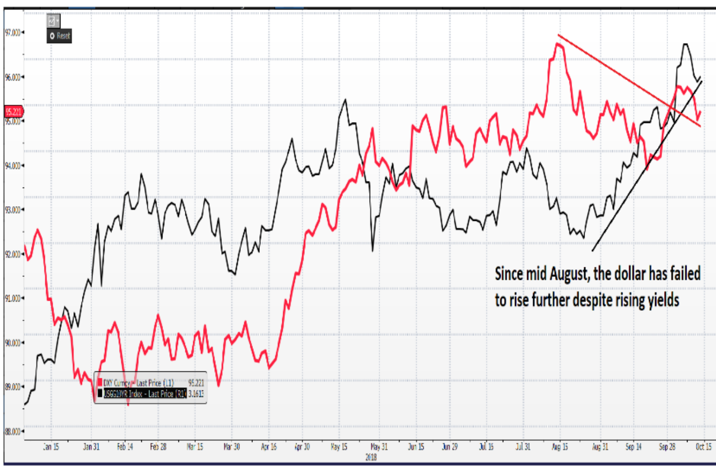
	EPS Growth forecast				
	FY2018	FY2019	ERM 1mth	PE FY18	PE FY19
S&P500	21.5%	10.2%	0.46%	17	15.4
MSCI World	15.9%	9.5%	0.47%	5.5	14.2
MSCI EM	5.5%	11.1%	0.90%	11.3	10.2
MSCI China	10.3%	16.0%	0.20%	11.3	9.7
MSCI Latam	9.5%	17.9%	6.95%	13.4	11.4
MSCI EMEA	10.4%	3.4%	5.83%	11.5	10.4
Euro 50	5.0%	10.8%	-1.56%	13.2	11.9
Topix	34.4%	7.8%	0.33%	13.2	12.3

Source: Bloomberg consensus estimate

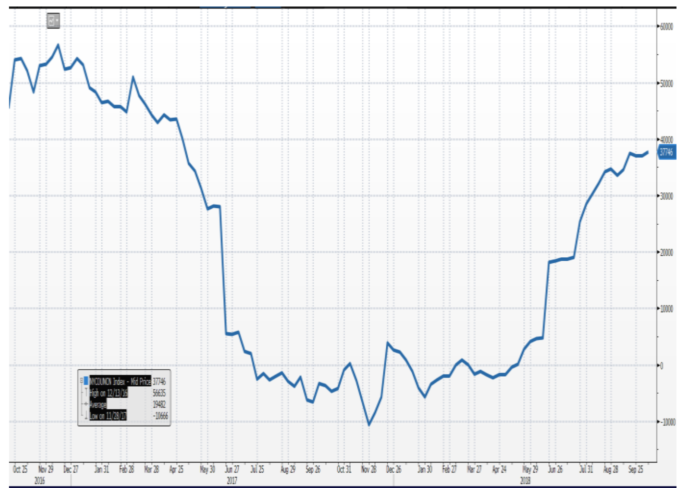
Fixed Income: Underweight. While we believe there will be another 3-4 more hikes from here on till end 2019, we believe much of the rates risk is already discounted in the market. Our base case view is for US10 to reach 3.50% - 3.60% by 2019. If we look at past history, every Fed hike cycle since the early 1990s has delivered a peak in 10Y rates around the cycle high in the Fed funds rate, which is another way of saying that restrictive policy flattens the curve as a precursor to its eventual inversion. So to reach 4% and above, which empirically portends to a sharp decline in S&P, will require a 4% or 5% terminal cash rate, compared to the highest Fed dot of 3.3% in 2020 and OIS forwards that peak at 3% in 2020. With spreads now widening to fair value for some bond classes (US Financials IG) and possibly outright cheap for others (Indon and China IG property developers bonds), we have been increasing our bond allocation albeit it still remains an underweight. We remain careful not to trade too much credit risk for yields pick-up and having a bar-bell approach within the fixed income holdings allow us to achieve that.

FX: Neutral. We believe in the near-term the 6 months long strength is USD has ended as US exceptionalism wanes while downside risk of the Fed's policy has abated as Fed has communicated well to market and markets already pricing in much of Fed's intentions. Despite the move of US10 year to its cycle high of 3.26% in the last week, we noticed the DXY didn't trade higher and in fact is -1% off from its recent peak. With net non-commercial USD net longs still at its two-year high, the risk of further speculative USD longs unwind remains elevated.

Since Aug, dollar has retraced despite higher rates



Dollar speculative longs are still at 2 years high



Commodities: Downgrade to Neutral as growth outlook clouds and likely to slow further in coming 1-2 quarters with only positive on oil. We retain the view that oil price will range between $70-80 till 1H19 when the US shale gas distribution bottleneck is resolved. Our preference to express this sanguine oil view by investing in high dividend paying oil majors and service providers whose earnings are inflecting higher.

Alternative Investments: There are plans to increase our long/short equity managers as in recent months there have been several standouts managers in this space.

Cash: Cash level is significantly higher as we trade of upside risk with call options. Cash level is now 15-20% and will tactically deploy when opportunities arise. We see opportunities in the equities space in payment system, China internet and education sectors and in Indonesia post recent corrections.

Featured Picture/Quote:

Why America isn't the greatest country in the world anymore. [The Newsroom]

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Risk Disclosure

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