The Navigator

COVENANT CAPITAL

July 2021

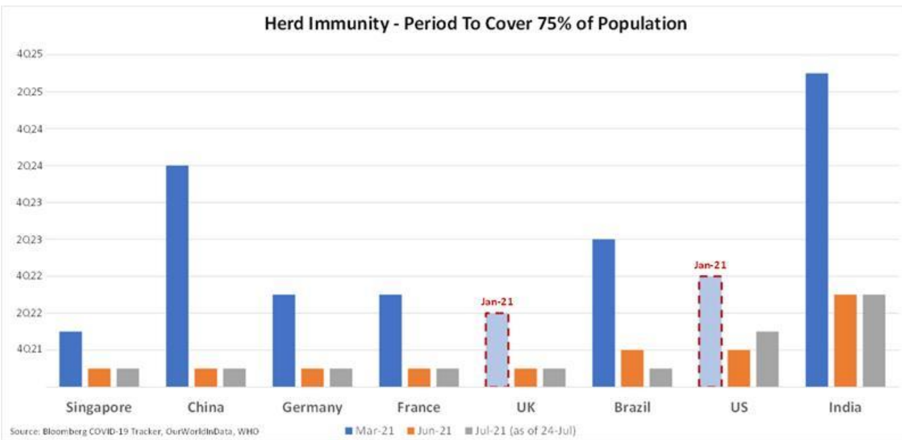
Courage on the blocks

As the Tokyo Olympics commence from its much-maligned stupor, there have been many uplifting moments this event has brought to millions of viewers. One of which I fondly recall is Eric Moussambani nicknamed “Eric the Eel”. Eric is a swimmer from Equatorial Guinea and was able to gain entry to the Olympics without meeting the minimum qualification requirement through a wildcard admission that was designed to encourage participation by developing countries that lack full training facilities. Self-taught to swim freestyle, he trained in his native country in a 13meter hotel pool that he has limited access at 5am to 6am for three days in a week. For the rest of his training, he swam in the rivers and lakes and his instructors were the fishermen around the area. The first time he has ever seen a 50meter competition pool was when he arrived in Sydney for the 2000 Olympics itself. He would recount “When I saw the swimming pool. I was so scared. The pool was so big for me. I wasn’t sure. I didn’t have experience how to dive and how to start. I had to ask people how to do it”

Adding to this colourful story of courage, he had to swim the 100metres all by himself as the two other swimmers in his heat were disqualified for false starts. “I was so scared the people (spectators in the complex) were going to laugh at me. But something came in my mind that I could do it.” For the first 50metres, he started strongly although not with the most elegant technique. However, at the turn, fatigue set in, and his poor form exacerbated his pace and soon the cheers in the crowd turned into consternation that he could drown with lifeguards on full alert to rescue him. But The Eel soldiered on, failing, and approaching closer and closer to the lane ropes. Resisting the urge to stop and hang onto the ropes, which will lead to an automatic disqualification, he pushed on and completed the event at 1:52:72, a good 1minute 4 seconds slower than the eventual winner of the 100metre freestyle event. Eric the Eel is truly a reflection of a human’s indomitable spirit. **The courage to dream, the discipline to train against all odds, and the tenacity to finish what one has started.**

As the third wave of Covid swarms through the globe, it is understandable one could be cowered by the current and be disenchanted by the failures so far. But if we look back 17 months ago, it took a team of scientists willing to dream and explore the realms of messenger ribonucleic acid and what role it may play in human biology. Their work started mainly to treat medical conditions like spinal cord damage, Parkinson's, and cancer. Before Covid, none of their prescribed mRNA therapies worked. But they continued their revolutionary work and when Covid was breaking out in China in Dec 2019, they were able to design a vaccine within 14 days after the virus’ gene was sequenced on 10 Jan 2020 and by the next month, they were able to deliver the vaccines for trials. As they say, the rest is history “still” in the making. Since the vaccines were rolled out at the start of the year, we have been tracking how long will it take for several key countries to achieve herd immunity (defined as full vaccination of 75% of the population). **Back in January this year, it would have taken the US till 4Q22 to achieve herd immunity, but at the current pace of vaccination (albeit the pace has slowed lately), the US will achieve by 1Q22 instead.** We see a similar trajectory for India when in March, India was not expected to reach herd immunity until 2Q25 but now, they are en route to achieving it by 3Q22. China is another case in point where their approach has been containment and tracing but not mandatory vaccination. In March, it was expected to achieve this status in 2Q24, but the recent surge of the delta variant has prompted many citizens to vaccinate coupled with the imposition of mandatory vaccination at local levels have bought forward this timeline to 3Q21. We are also expecting the supply of vaccines to increase significantly next year. Moderna and Pfizer/BioNTech are expected to ramp up from 20mn and 50mn doses this year to 600mn-1bn and 1.3bn respectively this year. If we include Astra Zeneca and Novavax, these four vaccines based on three different technologies will be able to supply 5.9bn doses next year.

Availability and willingness to vaccinate have accelerated expected herd immunity for many



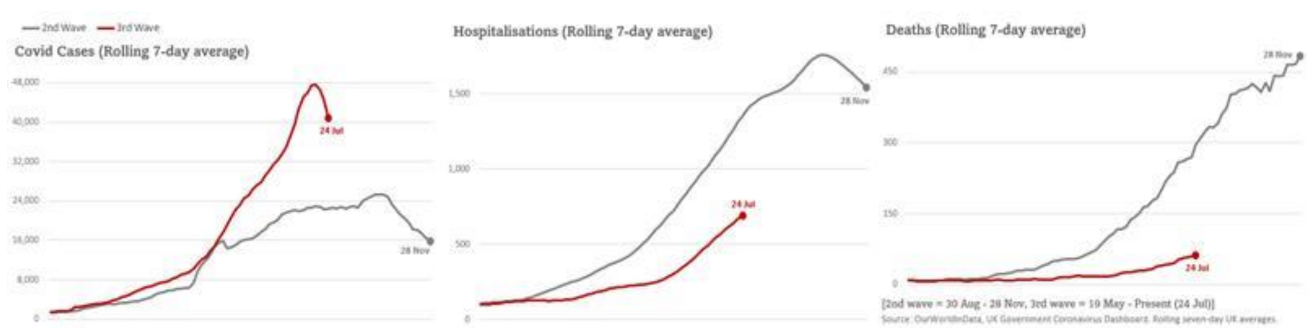
Worldwide Capacity

Company	2020 Doses (in millions)	2021 Doses (in millions)
Moderna	20	600-1,000
BioNTech/Pfizer	50	1,300
AstraZeneca	700	>2,000
Novavax		>2,000
Sanofi/GSK	100-600	>1,000
Sanofi/TBIO		90-360
JNJ		>1,000
Curevac		405
Inovio		>100
Arcuturus	<10	>100
Kentucky Bioprocessing		50-150
Clover Biopharma		>100
Medicago		100
Sinovac		100
Total	**>900**	**8,800-9,700**

Source: Company Reports; J.P. Morgan Research.

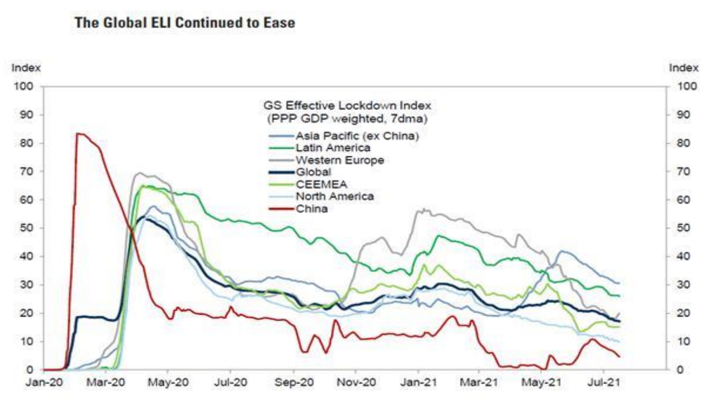
The level of vaccination is important as it is a prerequisite for reopening. Based on current data, vaccination reduces the risk of a commensurate rise in hospitalization and deaths. The UK is a good example with 55.2% people full vaccinated or 69.7% receiving one dose already, the current 3rd wave that is sweeping the country has already seen caseloads higher than their 2nd wave in Aug-Nov of last year. Yet, hospitalization and deaths rates while rising are far lower in this delta variant instigated 3rd wave. According to the UK Imperial College, the ratio of hospitalization-to-cases and death-to-cases is two-thirds lower and 10 times lower respectively in the current wave compared to the second wave simply because of higher vaccination level and most importantly the still high level of efficacy of the current vaccines.

The UK is a good example; vaccinations work in reducing hospitalization and deaths.

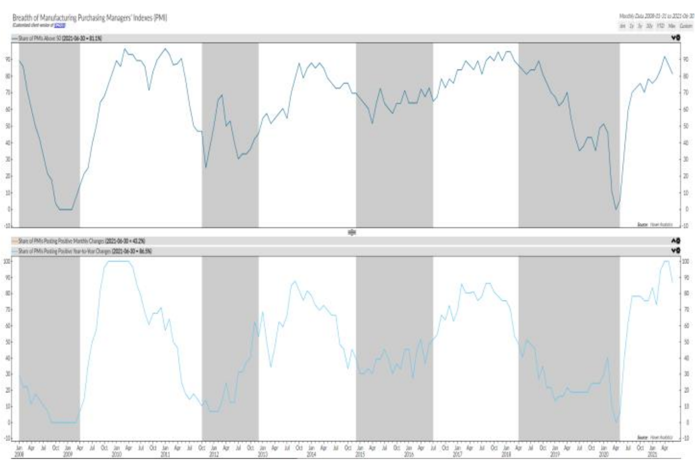


The trifecta of the level of immunization, availability, and efficacy of vaccines will determine the extent of business continuity, social mobility, and consumption of the services sectors. It is important to note that while headlines grabbing, the restaurant industry is only 4% of the US GDP and the proliferation of online ordering and delivery of food during the pandemic has lessened the impact this industry's precarious fortunes have on the overall economy. It is the travel industry that has a greater adverse spillover effect as it is estimated to contribute 7-10% of the US economy. Early in the pandemic, we have used alternative data to great effect in understanding the trajectory of the global economy, Never let a good crisis go to waste. We continue to monitor many of them and two of such alt-date we used are the Google Mobility Index (google/covid19/mobility/) and Oxford Stringency Index (covidtracker). Using a combination of these 2 indices, Goldman Sachs can track the extent changes in mobility and stringency have on the economy. As we see from the chart below, we are nowhere near the 1st and 2nd waves of restriction and lockdown. On PPP GDP weighted basis, we are in effect at the easiest conditions since the crisis has erupted. When we look at our trusted forward indicator, PMI, 81.1% of countries are reporting PMI above 50 aka expansionary and 86.5% of countries are reporting better year on year comparison. Nonetheless, we are expecting the delta variant to reduce the GDP forecast for 2H21 but it is unlikely to be material.

The impact of lockdowns on the economy has had diminishing impact to the global economy

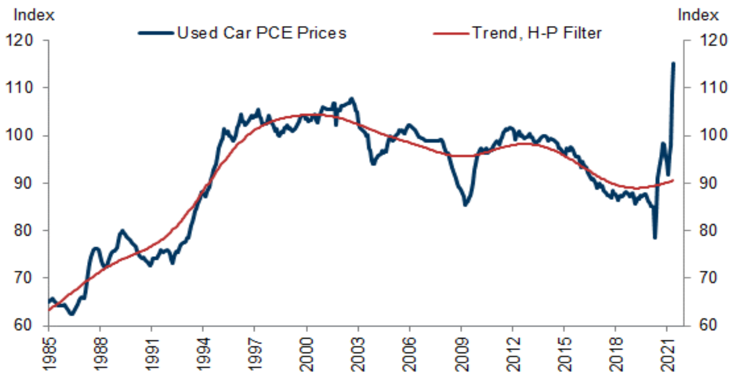


Source: Goldman Sachs Global Investment Research, University of Oxford (covidtracker.bsg.ox.ac.uk), Google LLC "Google COVID-19 Community Mobility Reports"



We are watching attentively the stickiness of this surge in inflation and the possible ensuing impact it has on monetary policies. As we have mused in our January 2021 outlook, After the storm, what comes next, and the subsequent Navigator, Low and slow, the greatest risk for this year in our view is if inflation runs hotter than the markets are expecting clashing with the central bankers' gambit of continuous easy money. Our central premise since the start of the year was for inflation to accelerate in the first half, peaked in the current month or two, and trend towards 2% to 2.5% within the tolerance of the Fed's inflation target. The jump in the first half is simply a case of easier yoy comparisons driven by the reopening of the economy unleashing pent-up consumption for goods and services while exacerbated by bottlenecks in some parts of the supply chain. However, data released so far and anecdotal comments from companies that we follow on a bottom-up basis suggest inflation could rise further and hotter. For example, used car prices have risen 38% yoy in May, the highest ever on record and a good 25% above the long-term trend. News of travelers in the US and UK unable to find rental cars during their holiday as the pandemic has forced many car-rental companies to sell their fleet last year to stave off bankruptcy. These companies are now scrambling to replenish their depleted stock. Semiconductor shortage for automobiles is unlikely to resolve till the end of the year leading to several automakers cutting their supply forecasts, pushing buyers into the secondhand market keeping second car prices elevated for longer.

<u>Used car prices surge could last longer</u>



<u>PCE, CPI and wages are rising more than expected</u>

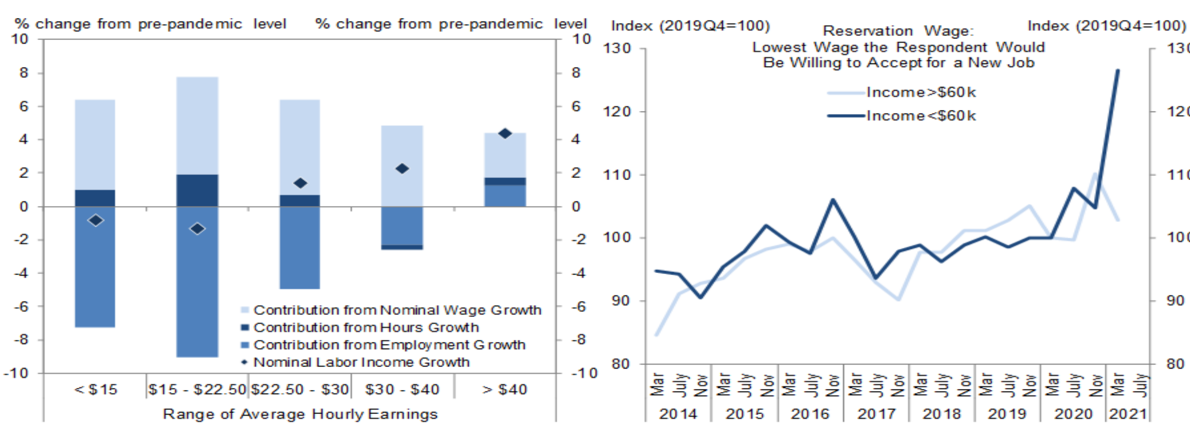
Key Changes Since Last FOMC Meetings

Indicator	Units	As of June FOMC	Latest
Prices			
Core PCE (and GS tracking)	%y/y	3.31	3.50
Core CPI	%y/y	3.80	4.45
Average Hourly Earnings	%y/y	2.0	3.6
Atlanta Fed Wage Tracker (overall weighted)	%y/y	3.3	3.4
GS Composition-Adjusted Wage Tracker	%y/y	3.3	3.4

Source: Goldman Sachs

Another component driving the recent inflation surge in the US came from the low-wage earners. The current rise in overall hourly earnings at 3.5%yoy is already an outliner when compared to other episodes when the economy emerges from a recession. But it is the low-wage earners that are of greater interest to us as they have a knock-on effect to end prices. Even though low-income wages have risen by 8% from the pre-pandemic level, more than double of the average, a recent survey by the New York Fed suggests that workers earning less than $60,000 per year say they would need a 26% higher wage than pre-pandemic level to accept a job. Combining past academic studies of the impact of minimum wages, sectors that has large component of low-wage labour will pass through nearly all their higher labour costs to end prices. It is highly conceivable using Singapore's context where the wages for cleaners. waste disposal personnel, security guards and construction workers have demanded higher wages and rightfully granted as part of the populist movement globally. These increases are unlikely to reverse back even as the pandemic eases.

<u>Increase in wages could be stickier than initial thought and unlikely to reverse post-pandemic</u>



Source: Goldman Sachs

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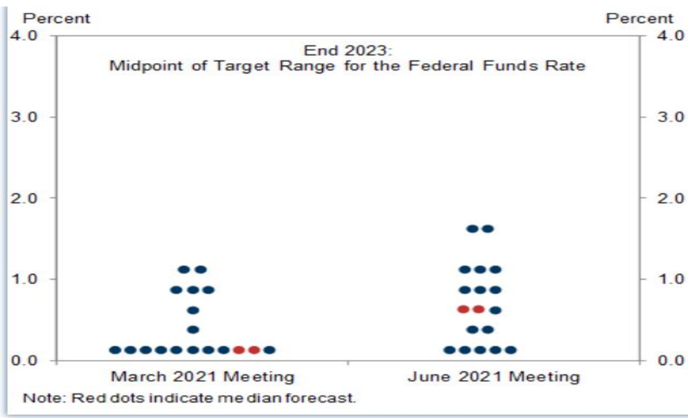
This brings us to the risk quantitative tapering occurring earlier than expected. Already Bank of Canada is halfway through its bond tapering, there is pressure on the Bank of England to reduce its purchase as well while a host of EM economies including Brazil, Russia, and China have been tightening monetary conditions in the past 6 months. The Fed in their last FOMC surprised the market with a disclosure that they have started talking about quantitative tapering. Before the June meeting, the market expectation was for the Fed to slow down their asset purchase only in mid-2022, begin tapering in 2023, and hike rates only in 2024. Back in March, the Fed dot graph shows most participants coalesce around a zero hike in 2023, but in the June release, 13 out of the 18 participants expect rates to range from 0.50 to 0.75 in 2023, or a 1 to 2 rate hike in 2023. Moreover, tapering could begin as early as the end of this year and if we use 2013 Quantitative Tapering sequencing, the first hike could happen in 1Q2023, much earlier than the 2024 assumption market had prior to the June meeting. The market is starting to reflect that with the Fed fund futures indicating a 73% probability of a first hike in Dec 2022.

Fed dots have shifted to hikes in 2023



Source: Federal Reserve Board, Goldman Sachs Global Investment Research

Market starting to believe they will

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate
12/15/2021	-0.037	+3.3%	-0.009	0.090
01/26/2022	-0.048	-1.0%	-0.012	0.087
03/16/2022	-0.007	+4.1%	-0.002	0.098
05/04/2022	+0.015	+2.2%	+0.004	0.103
06/15/2022	+0.138	+12.3%	+0.034	0.134
07/27/2022	+0.192	+5.4%	+0.048	0.147
09/21/2022	+0.382	+19.0%	+0.096	0.195
11/02/2022	+0.429	+4.7%	+0.107	0.207
12/14/2022	+0.732	+30.3%	+0.183	0.283
02/01/2023	+0.826	+9.3%	+0.206	0.306

Asset Allocation Strategy

We expect a challenging second half of the year. The market will genuflect between economic growth that might be short-circuited by an emerging and even more virulent strain to that of pent-up demand stonewalled by supply chain bottles that could drive a transitory inflationary pressure to become more permanent. Overlayed with the herculean balancing act by central bankers to calibrate the correct monetary policy that promotes growth and full employment without stoking inflation and asset price bubbles.

Equities: We downgrade our view to Neutral back in May, When it peaks, citing concern that economic growth momentum has peaked and an earlier than expected onset of QT could dampen sentiment. However, as earnings season over the first quarter and second quarter of 2021 so far are proving the be one of the best earnings seasons in a while. Consequently, earnings have been revised higher supporting our view to be advocate equities over fixed income. The overall contours of our equities preferences have not changed much. Preferring Europe and Japan over the US and EM, small-mid caps over large-caps, and reopening and pent-up demand beneficiaries. The only change we have made switching back to growth from value.

Fixed Income: Underweight. There are very few changes to our portfolio except we have taken duration risk even lower. We think the current 10year yield of 1.23% does not accurately reflect our shifting view that inflation could run hotter and longer. The main reduction in the duration risk is carried in our investment grade portfolio and have used the capital to deploy more into financial institutions' debt. We deem such debt as a key beneficiary of a rising rate as higher rates are positive for banks earnings, an expanding economy should lead to higher loan demand, furthermore, most of such debt is structured as fix-to-float rates.

FX Neutral: We are not expressing significant tilt hedging back to the reference currency of the portfolios we managed.

Commodities: Still bullish on copper as our main expression of the rising inflation and re-opening theme.

Alternatives: Exploring a long/short European equities manager.

Featured Picture/Quote:

[Eric the Eel!]

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