The Navigator

COVENANT CAPITAL

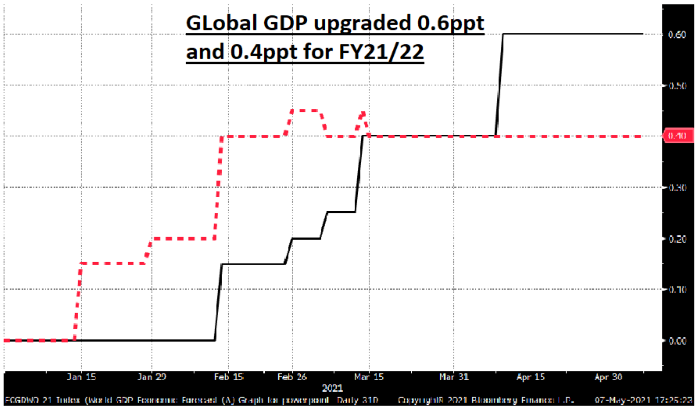
May 2021

When it peaks.

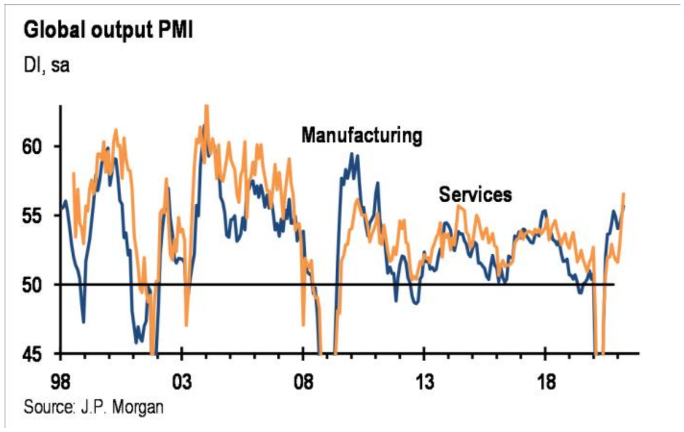
After spending a year watching Youtube and researching from the net, I have decided instead to engage a proper coach to train me. The self-design training regime I have improvised with has often led to unfamiliar injuries, fatigue, dispirited, and worst of all my performance has peaked. I hope through a professional coach and his structured training backed by performance analytics, I can improve just a little bit and not be the customary last few finishers in the race. The app that we are using is called TrainingPeaks. It contains a plethora of information and data analytics. To an untrained eye like me, the swathe of information can lead to a case of paralysis by analysis. But for the coach, it provides insightful information to my level of fitness, fatigue, and form enabling him to tailor a program specifically for me to achieve my goal; though I suspect my goal has somewhat morphed to his goal of "attempting to not finish as the last few is not a goal". The relevance to this personal anecdote to capital markets is we are soon approaching the peak of economic growth. What happens past this peak?

Even as the heart-wrenching news of several developing economies experiencing a debilitating 2nd/3rd wave, the health of the overall global economy has strengthened further since our last Navigator in Mar 21. **Since the start of the year, the forecast for global GDP growth has been upgraded by 0.6 ppt and 0.4ppt to 5.8% and 4.1% for 2021 and 2022 respectively**. Beyond the upgrade, it is also important to remind readers of a few key points of this forecast. This pace of GDP growth for the next two years is a heady 1 to 3ppt higher than the deemed long-term growth potential for the global economy. Based on this trajectory, by 2022 the world would have added another $5trn output higher than in 2019, which is the size of the third largest economy in the world, Japan. Our trusty forward-looking "soft-data" indicator, the PMI series, are at a decade or further highs now. The current PMI composite reading of 56.3 in April implies not only a strong economy but also an acceleration in activity in the coming months. Critically, the broadening of the economy is also evident in that the PMI-Services, which has been languishing around 51-52 level in the past four months, has now surged to 56.6 and for the first time since the pandemic erupted is higher than Manufacturing PMI. New orders for Services stand at 56.2, Future Output 67.1, and Employment at 53.4, all of which are record highs in recent times. This crisis is unique in the sense it has hit the often more resilient service sectors harder than the manufacturing sectors. **Alongside a boomy PMI-Manufacturing indicator, the strong readings across the series of Services PMI in April anchor our belief the economy is on a much stronger footing as that service sectors account for more than 60% of the global economy.**

Global GDP growth upgraded for 2021/22

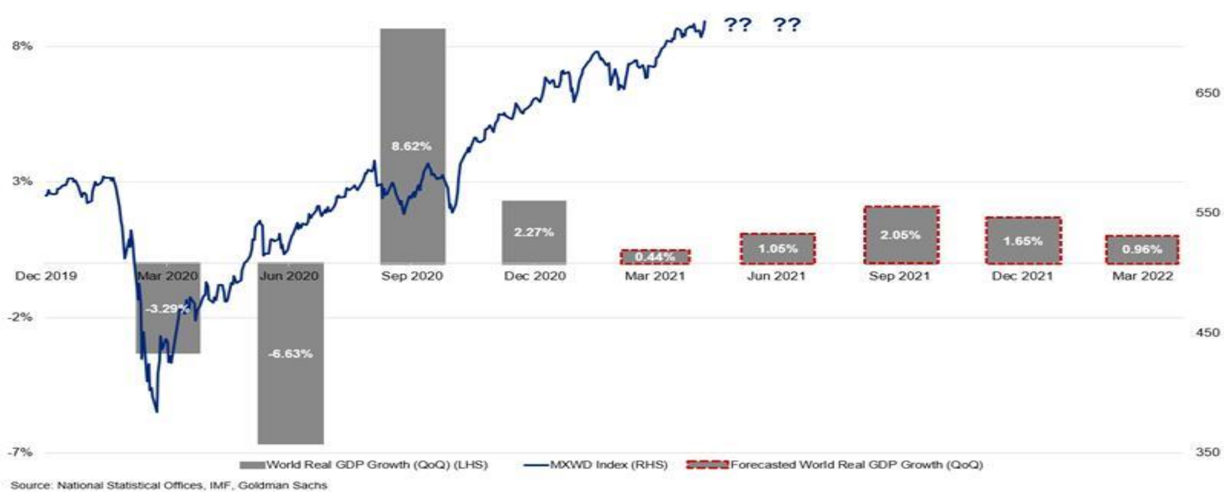


Forward indicators points to boomy growth ahead



However, the market is a forward-looking machination. Recall in last April Navigator, Never let a good crisis go to waste when we upgraded Equities from Underweight to Overweight. A stroke of clairvoyance as the market bottomed then and staged a 33% rally three to four months ahead of the economy bottoming in July/August 2020. Subsequently, the equity market stalled from September-November 2020 as investors digested the news of the 2nd wave of infections swarming parts of the developed economies and reflecting the impact of slower growth in the quarters of 4Q20 to 1Q21. However, it resumed its rally post the vaccine news and US election in November-December electing to look past the slowest quarter of growth in 1Q21 since the economy trough and instead choose to focus on the particularly strong quarters ahead in 2Q-3Q21.

Market always looks ahead of the economy. Economy peaks in 3Q21, market peaks in 2Q21?



But global growth is likely to peak in 3Q21 and is forecast to post slower quarter-on-quarter growth hereon into 2022. We are also expecting forward-looking indicators to peak in the next 1-3 months. Against this backdrop, we expect the prevailing market narrative to shift from the halcyon growth periods to the peak of growth momentum even as the quarterly print remains a large positive absolute number. **Does that translate to the equity market peaking in June-July given the common adage market looks forward 1-2 quarters ahead of the economy?**

Historical data does portend to this risk. When we tracked back PMI data as far back as 1950, future returns are often subpar when PMI is as elevated as they are now. When PMI readings exceed the 95th percentile high (ie above the reading of 64.0), the average forward returns in the 3, 6,12 months periods are 0.14%, -0.20%, and 1.32%; measly return profile. Furthermore, the incidence of positive returns is not overwhelming as well with 44%, 56%, and 56% of the time for the 3,6,12 months periods, respectively.

On average, future returns subpar when PMI is this high

S&P 500 change when ISM PMI >= 95th percentile (screened 100 days)

Event Date	PMI	3-Months	6-Months	9-Months	12-Months
4/30/1950	68.1	-1.3	8.1	19.9	24.1
8/31/1950	75.8	5.9	18.3	16.8	26.4
12/31/1950	67.1	4.9	2.7	14	16.5
2/28/1955	67.8	3.1	17.5	23.8	23.3
7/31/1955	66.2	-2.7	0.7	11.2	13.5
12/31/1955	65.6	6.6	3.3	-0.3	2.6
1/31/1959	64.4	3.9	9.2	3.8	0.3
5/31/1959	68.2	1.6	-0.7	-4.4	-4.9
12/31/1961	64.2	-2.8	-23.5	-21.4	-11.8
3/31/1965	64.9	-2.4	4.4	7.3	3.6
1/31/1966	65.8	-2	-10	-13.7	-6.8
9/30/1972	65.1	6.8	0.9	-5.7	-1.9
1/31/1973	72.1	-7.8	-6.7	-6.7	-16.8
5/31/1973	64.8	-0.7	-8.6	-8.3	-16.8
10/31/1973	66.2	-10.8	-16.6	-26.8	-31.8
10/31/1983	64.4	-0.1	-2.1	-7.9	1.6
3/31/2021	64.7				
Mean		**0.14**	**-0.2**	**0.11**	**1.32**
Median		**-0.38**	**0.78**	**-2.32**	**0.95**
Number Up		**7**	**9**	**7**	**9**
Number Down		**9**	**7**	**9**	**7**
All Periods Mean		**2.18**	**4.4**	**6.65**	**8.86**

Ned Davis Research Inc. T_HOT202104161.1

The recent torrent of suggested tax hikes from the corporate, personal, and capital gain in the US to a unified international minimum corporate tax rate further weighs on the investors' sentiment. We expect the development in the US with regards to Biden's revised tax regime to be fluid. In the coming months, we will have a clearer idea if President Biden can execute these campaign promises. Below is the summary of Biden's recent policies overtures:

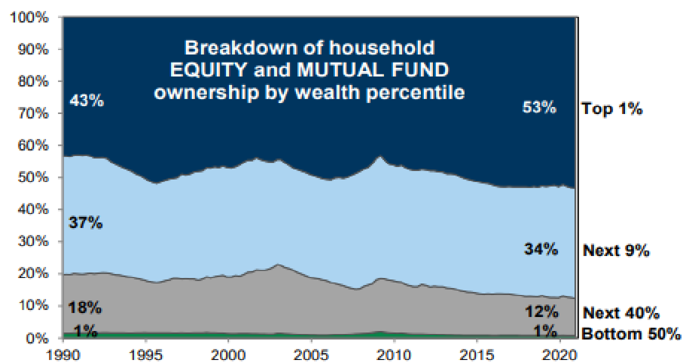
(1) $2trn plus infrastructure plan to be spent over the next 8 years with the bulk committed to improving ageing infrastructure ($986bn), expanding quality and affordable elderly care and individuals with disabilities ($400bn), implement various clean energy initiatives ($320bn), and invest in new technology and high-speed broadband coverage ($220bn).

(2) It will be funded by corporate tax increase from 21.5% to 28% and a complicated personal tax increase from 23.8% to 43.4% for its highest bracket earners. The tax increases will help offset the spending in 15 years resulting in a neutral outcome to the budget.

Based on various estimates, the corporate tax increase to 28% can reduce EPS growth by 6-9 ppt in 2022 resulting in flat earnings prospects for next year. We doubt he will be able to win enough support for this as there are already some camps within his party that have pushed back against such a large increase. We think a 25% corporate tax rate is more likely, which still is a negative for market. The tabled personal tax increase will another wall of worry to climb as it might lead to a substantial sell down in equities ahead of the tax increase. The last personal tax increase, which also included a hike in capital gains tax, was in 2013. We can draw several possible outcomes from that episode. In 2013, wealthy households sold off 1% of their equity holdings ($120bn) a month ahead of the hike. **The**

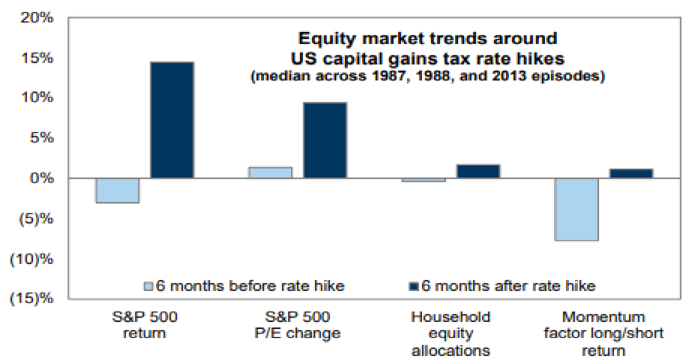
impact to the market was negative but not as deleterious as fear. It was short-lived (much of the decline happened in the month before the hike) and the market fell -5%. Goldman estimates that the wealthiest households now hold 53% of the US26trn US equities and if they sell down 1% as they did in 2013, this will equate to $260bn of selling which is 1.5x of average daily trading value in all of the US exchanges. They also estimate that these households have an approximate $1 to 1.5trn of unrealized capital gains. Selling all the gains will have a bigger adverse impact to the market as it equates to 9 trading days. The 6 months post such episodes of rate hike has generally led to 15% returns but is contingent on macro fundamentals beyond a spurious causation of a post-hike buying euphoria.

Top 1% holds 53% of US equities



Source: Federal Reserve Board and Goldman Sachs Global Investment Research

Last episodes of tax hikes -ve but manageable

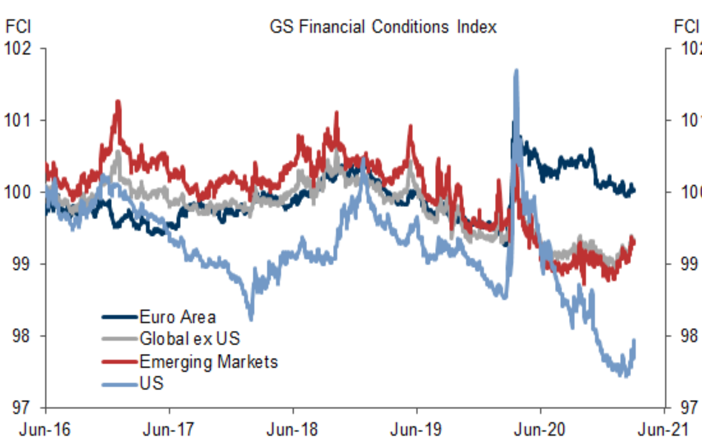


Source: FactSet, Federal Reserve Board, and Goldman Sachs Global Investment Research

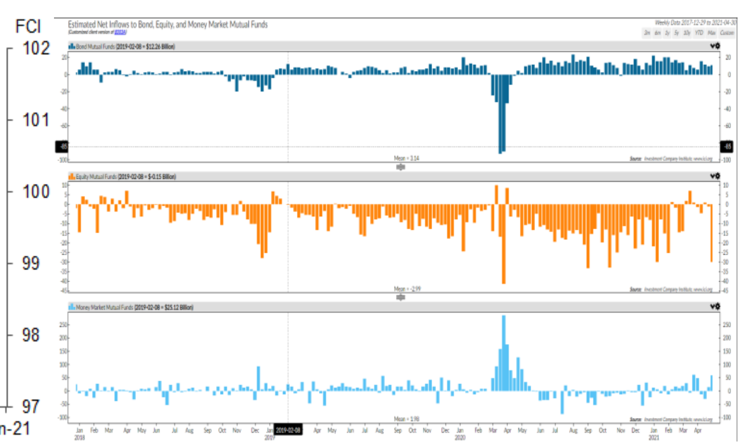
Asset Allocation Strategy

The tax hikes issue is topical and difficult to ascertain in what form will it be passed. Mutant strains are unavoidable and manageable if political will and sensible citizenry co-exist, while the current vaccines have so far demonstrated high efficacy against them. We think these two sources of consternation are still manageable. Growth forecasts are often subjected to revision but at the current juncture, we doubt the economy is going to get any better than it is though we are not suggesting a steep precipitous decline thereafter. Buttressing these concerns remain the highly accommodative central bankers keeping financial conditions easy and relatively low positioning in equities as an asset class in comparison to flows into bonds and money market funds.

Financial Conditions remains very easy

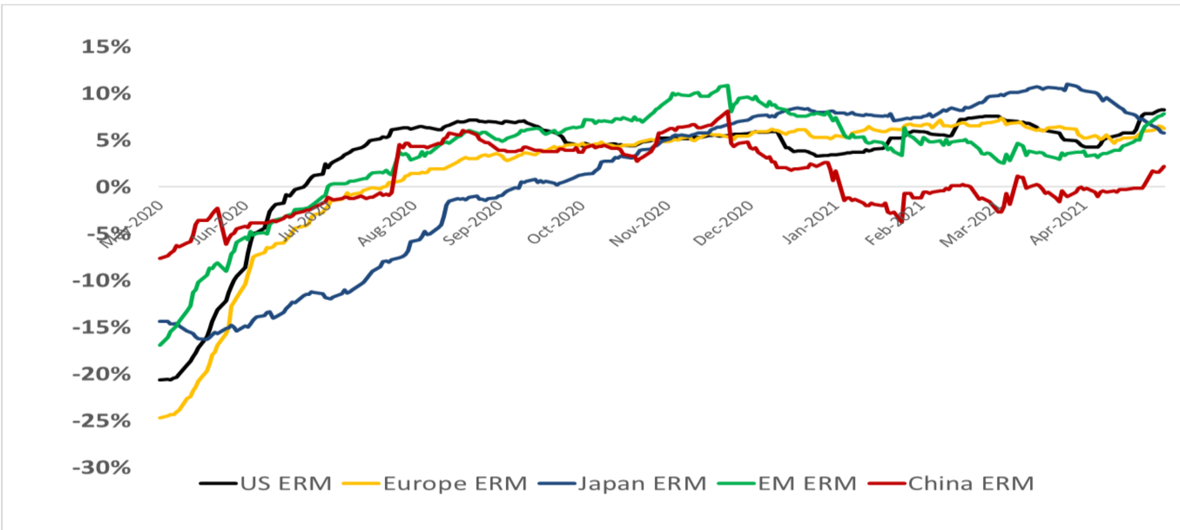


Equity still seeing outflows contrasting Bond/MMF inflows



Equities: Downgrade our Overweight to Neutral with favourable positioning, easy monetary stance ,and still positive earnings revision momentum (ERM) keeping us from an outright downgrade. As we have commented in various publications before, neither an expensively valued market or negative GDP or EPS growth are good predictors of expected returns. In fact, a positive ERM and an improving ERM are far more reliable indicators to future growth. So far, ERM remains conducive to owning equities with upgrades seen in all regions.

Every region experiencing positive earnings revision momentum



Source: Bloomberg consensus

A common refrain we have been hearing is "markets have already rallied so much, the risk of a negative return year after a stupendous year before should be in the cards". However empirical data does not support that. The analysis by NDR suggests the 2nd year after a cyclical bull market bottom still yield positive returns 77% of the time with a median return of 11% and with the 2nd-year best returns at 25.3% (1987) and worst return of -13.8% (in 1980). Small caps outperform large caps significantly at a median return of 17% with a range of -17% to +43% return profile. The Financials, Industrials, and Materials have higher absolute returns within the sectors and have a higher incidence of positive returns than the overall market. Technology surprisingly performed the worst in absolute return and incidence of positive returns.

Year 2 returns after a bear-market rebound are overwhelmingly positive and material

	Median Return (%)	% of Year 2 +ve return	Year2 Return less than Year 1
S&P 500	11.1	77%	83%
Russell 2000	17.0	77%	82%
Industrials	16.6	92%	
Financials	16.5	92%	
Materials	14.4	78%	

Energy	10.3	69%
Technology	2.9	54%
Healthcare	7.6	62%
Consumer Discretionary	13.4	77%
Consumer Staples	8.5	85%
Communication	12.7	77%
Utilities	12.7	77%

Source: NDR

	Higher return than market
	Higher positive incidence than market

Our portfolio is positioned along these lines with an underweight in technology, overweight in financials and industrials, with copper as a representation of our materials tilt. Mid-small cap stock and focus managers account for a larger part of our total portfolio. We have also been increasing our equity Hedge funds weight. From a regional perspective, we prefer Europe and Japan over the US and the EM in part due to Europe and Japan exhibiting greater sensitivity to an accelerating global economy and also our concern with an increasing regulatory risk within China.

Fixed Income: No change still Underweight with subtle changes keeping a high-grade portfolio and opportunistically trading US treasuries. We have been increasing our non-US treasuries exposure, particularly in China while keeping our relatively large exposure in the US inflation linkers. After a few high-profile credit events in China, we believe the concern of escalating default in China is misplaced and we have added to our select Asia and China bond managers.

FX Neutral: Has been a choppy year for the dollar genuflecting alongside interest rate parity and risk on-off modes. We have decided to be neutral for now despite our long-term view dollar is on its 7-year decline.

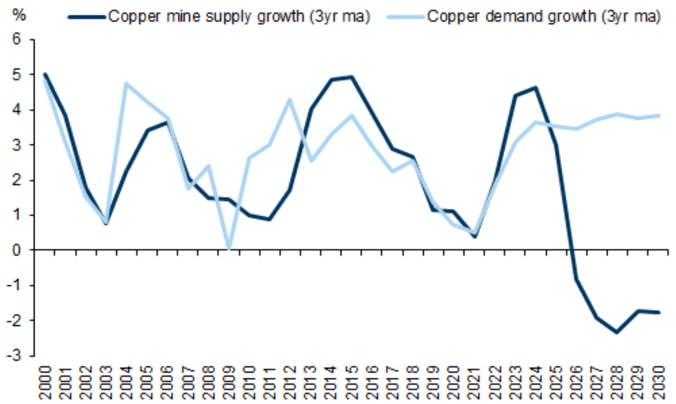
Commodities: After holding Gold as either an inflation hedge, risk-off diversifier, or as an alternative to the debasement of the US dollar since 2018, we finally exited this trade. Gold in the past ten months has exhibited very poor price reaction to all of the above reasons why one would hold it. It seems to be reverting to its post-GFC to 2018 dull performance period. Instead, we have replaced it with crypto assets as an alternative to the bearish US$ and copper as an inflation hedge and using the US and China government bonds as risk-off diversifiers instead.

Copper is experiencing another resurgence of interest. Beyond Mr Copper as a leading indicator of economic cycles, there is increasing focus on copper witnessing a new and sustainable demand driver from the efforts to de-carbonize the global economy. Citi estimates just on Biden's green efforts, an additional 202k of annual copper demand will be required. That is 7% of global incremental new demand for this base metal. Supply constraints is another tailwind. Copper is a long-cycle commodity as it takes 2-3 years to expand production of an existing mine and 6-8 years to develop a greenfield project. Copper supply peaked in 2013 and in the last three years, the supply growth has lagged the demand growth. Based on current greenfield and brownfield projects, the supply is expected to contract from 2026 onwards in sharp contrast to demand increasing 3 to 4% per annum. Goldman Sachs estimate for the supply gap to rebalance, the copper price needs to rise $15,000 per tonne to induce the starting of new mines. That is another 40% upside even though copper has already risen 39% year to date.

New driver for copper demand: Go Green

	Budgeted spend (Bn)	5yr Avg Copper intensity (kt per Bn USD)	Implied total demand (8 years)	Avg per annum
Building & Construction (ex power)	550	0.17	96	12
Power	100	6.88	688	86
Transportation (ex-EV's)	446	0.81	360	45
EV's* - Federal Fleet + Charging	174	-	59	7
EV's* additional sales	-	-	415	52
Total	1270		1618	202

Massive shortage of copper. More mines needed.



Source: Citibank and Goldman Sachs

Alternatives: Exploring a alternative credit manager.

Featured Picture/Quote:

Top trending archaic word in Singapore: Umbrage

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Risk Disclosure