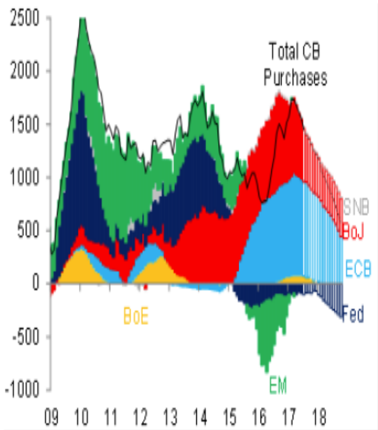
COVENANT CAPITAL

The Month Ahead August 2017: And the three bears never saw her again.

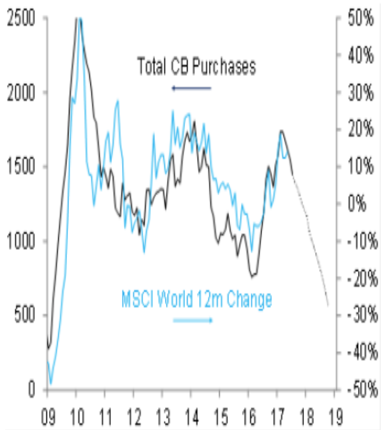
Never did like the story of Goldilocks and the three bears. The story displays two facets that doesn’t appeal to this author. First, it is a story of narcissism as Goldilocks self-invited to the bears’ home while the bears are away and then went on a spree of not once but three transgressions and indulging thrice for each one of them. Second, the story suggests the best solution is the in-between choices. The best is the not-too hot or cold porridge, the not-too big or small chair and the not-too hard or soft bed. The best athlete, the best leader and the best manager are not those crafted in moderation. The best in their fields are often those who operates in extreme dichotomies. In financial parlance, the equivalent of “moderation is the best” is the often-used oxymoronic phrase “Cautiously Optimistic”. This author thinks this is the worst kind of advice an advisor could dispense to their clients. You are either cautious or you are optimistic; you can’t be both at the same time.

As some of our long-time readers may have noticed since our April 2017 musing, Dont forget to breathe , we have steadily pared down our maximum bullish view of equities espoused in October last year Dog Days Are Over...for now, to just slight overweight and in the process raising the highest cash level in a year by now. We highlighted our concerns that momentum for global economy has peaked and is turning negative, the risk of QE ending is still not well understood while valuations across many asset classes are +1 to +2 standard deviations from its long-term average. **In this month musing, we add to the litany of concerns we are noticing and warn that the Goldilocks period of 1H17 where nearly all asset classes generated positive returns is about to end.**

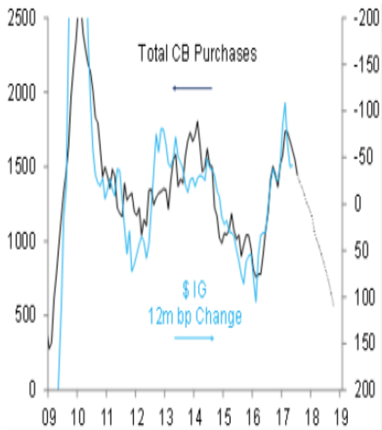
Central banks’ balance sheet shrinking and its ensuing impact to equity and bond prices



Source: Citi Research, National Centrals Banks, Citi Research. EMFX Reserve changes are FX-Adjusted

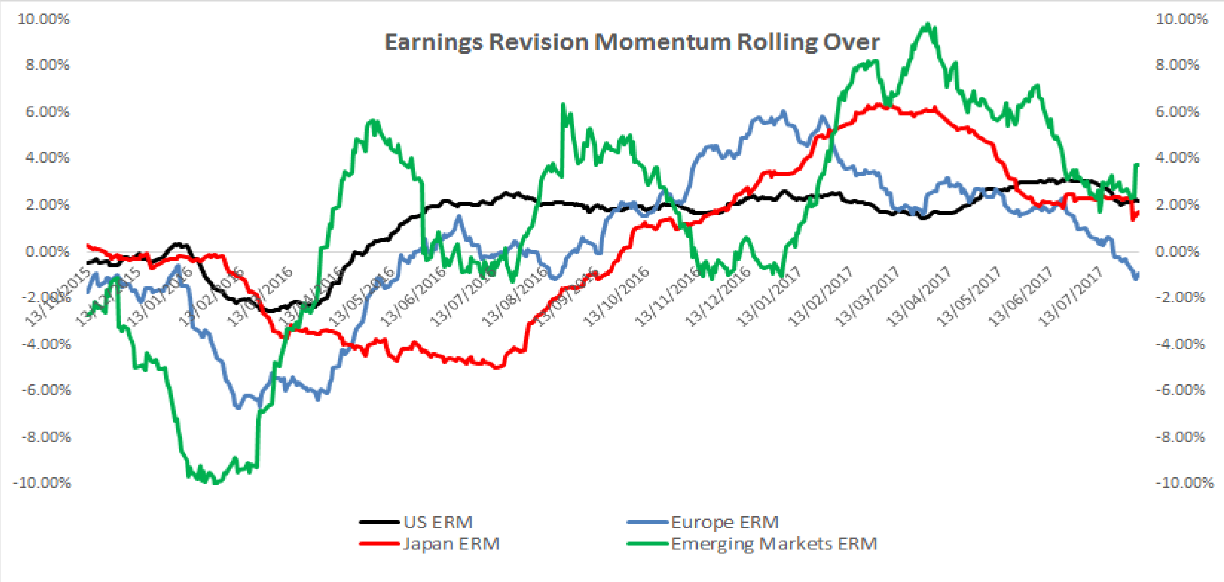


Source: Citi Research, National Centrals Banks, Citi Research.



Source: Citi Research, National Centrals Banks, Citi Research, Yield Book.

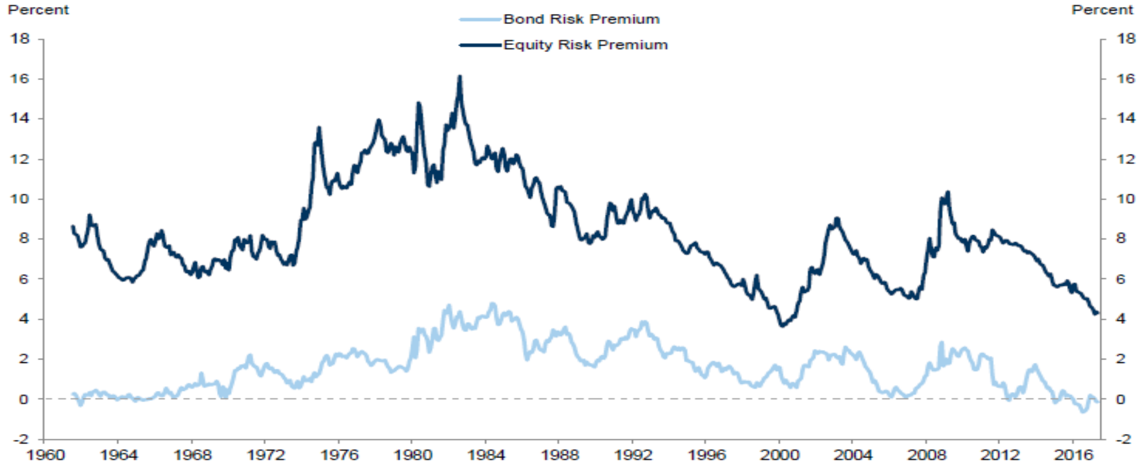
Despite a strong 2Q17 earnings season, **earnings revision momentum has now turn decisively lower.** Earnings revision momentum seems to have peaked around April for Japan, Europe and Emerging Markets and June for the US. For example, the 12month forward EPS for Emerging Markets was revised up to 10% in April but has since receded to 4%, albeit still a positive revision YTD in sharp contrast in the last 4 years where we have negative revisions throughout the year. The same can be observed for Japan when positive earnings revision momentum has halved since April. This recent observation on downgrades in earnings revision momentum is significant. In June 2017 musing , [Clairvoyance](), we highlighted that equity markets have risen a lot in the last 12 months bringing valuations for many markets above its +1sd 10 year average PE. We articulated that with no valuation multiples expansion expected, earnings are the only driver of returns going forward. With upward revisions earnings now reversing, we have but stripped off the last engine driving future returns.



We are also noticing a growing list of irrational exuberance in markets behaviour. One way of analysing the level of investor's complacency or fear when they invest is to look at the risk premium investors are according to what they are investing. We look at two primary indicators, Equity Risk Premium (ERP - yes is akin to a charge much like our increasingly ubiquitous Electronic Road Pricing) and Bond Risk Premium (BRP). These 2 indicators are the risk premiums that an investor wants to be compensated for to earn the extra return above risk-free rate for owning an equity (ERP) or a bond (BRP). The lower the ERP/BRP means investor is demanding lower risk premium on their investment implying they are confident, sometimes complacent, of the low risk of owning the assets. Inversely, a higher ERP/BRP means investor is very fearful of owning a bond or equity and demands a higher level of protection.

But the Bond Risk Premium is now close to 0% according to GS and it is at its historic low dating back to 1960. A good example of the irrational exuberance in the bond market is the recent $2.5bn 100 years bond issued by Argentina. The bond attracted close to 4x the size and eventually close at 8% yield to maturity. 8% return for a country that has defaulted 5 times in the last 100 years, has an average inflation rate of 200% in the last 60 years (current is inflation rate is 21%) and charges average of 20% interest rate to consumer in the last ten years. Still, spread has compressed and is now trading at 7.7% yield. **The Equity Risk Premium is only 4% which is at levels lower than 2007 before 2008 GFC and close to its pre-dotcom bust of 2000.** Closer to home, Razer, the Singapore homegrown gaming accessories company, was rumoured to have recently filed for US$400mn IPO in HK. Based on press releases, the company has 2 consecutive years of net losses of US$59.7mn in 2016 and US$20.4mn on revenues of only US$392/320mn in FY16/15. It also commented that it may continue to post losses. In other words, it hopes to raise 1.0x price to sales and on negative earnings for a company which is largely a hardware company. These two cases of irrationality in the desperate hunt for return necessitate the emoticon and they are not isolated cases. 

According to GS, bond and equity risk premiums are near all-time low. Reeks of complacency



Source: Robert Shiller, NY Fed, Haver Analytics

Another measure of investors' complacency is to monitor the Volatility Index (VIX). We have a complete different application of the VIX in contrast to popular newsfeed which uses VIX to gauge fear/ confidence. Consensus think that low level of VIX implies confidence in markets and higher chance of making money and the inverse implication and consequence of a higher VIX. Our own application and empirical evidence suggest that when VIX is low, the risk of losing money is higher instead. When VIX is below the lower threshold of 12, 63% of the time the SPX generated negative returns in 2 months out with average negative return of -3%. Inversely. When VIX is elevated, 100% of the time the returns are positive in 2 months with average return of 5.45%! **VIX is now at near all-time low of 9.8 at the start of this week; it says, "SELL now!". It is a classic greed and fear "where fools rush in where angels fear to tread" contrarian indicator.**

Just to take the absurdity level one notch higher on the issue of investors' complacency. Recently, this unknown stock in **China A-share, Fangda Carbon New Material, became the 11th most traded stock in the world above JP Morgan**. A total of US$1.5bn was traded in a single day in August more than JPM US$1.34bn. What is most astounding is that the market capitalization of Fangda is US8.4bn versus JPM's US$330bn. In another perspective, 18% of its market cap exchanged hands in a single day!

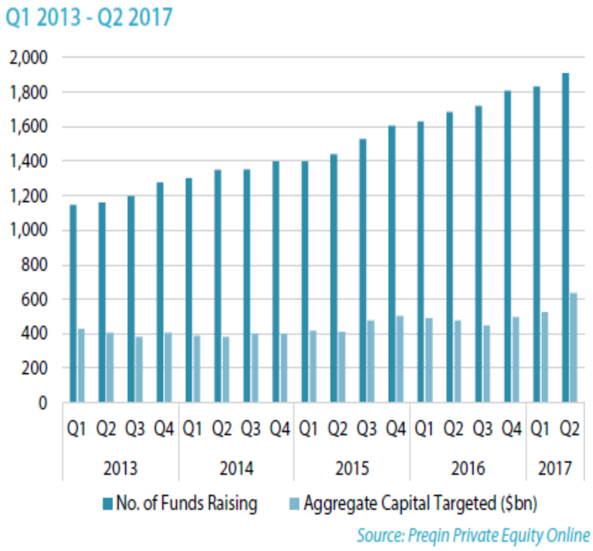
VIX is a good contrarain indicator; it says sell now!

# occurrence VIX < 12	17			
	% of -ve Returns	Average Performance	Avg Positive Perf.	Avg Negative Perf.
1st Month	59%	-0.62%	1.62%	-2.19%
2nd Month	63%	-1.15%	1.94%	-3.00%
# occurrence VIX > 20	6			
	% of +ve Returns	Average Performance	Avg Positive Perf.	Avg Negative Perf.
1st Month	67%	2.53%	3.98%	-0.37%
2nd Month	100%	5.45%	5.45%	0.00%

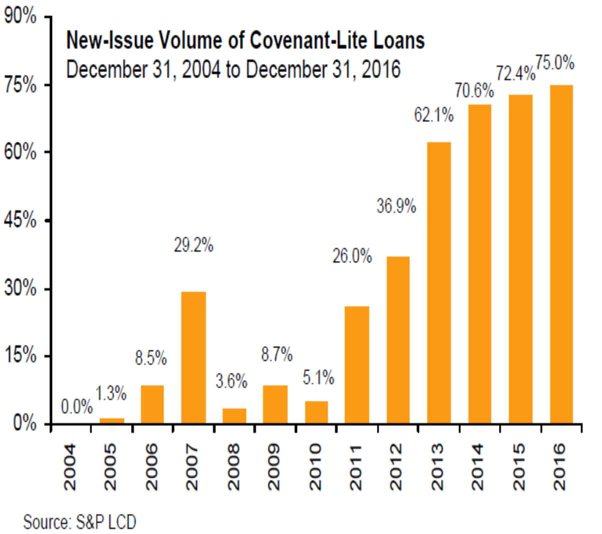
Fangda who?

Other examples of irrationality is in the private equity and leveraged loan space. According to private equity specialist, Preqin, **a total of US$244bn was raised in the first half of 2017, which is even higher than the total raised in 2008 of US$221bn when asset prices were so depressed. This bring to total an estimated of US$1.8trn of dry powder**. If we apply a reasonable debt/equity, this add up to USD3.6trn of money looking for a place to invest or the ability to buy up 2 of Steve Jobs, Apple. The penultimate example of the voracious appetite of investors is Softbank recent launch of its Vision fund which raised US$100bn. What is more intriguing beyond the fact is the largest PE fund ever raised is the structure of the fund. The structure is such that Softbank puts up 28% of the capital of the fund and rest are from outside investors but Softbank will own 50% of the equity of the fund. If you add management and carry fees, the 28% of skin in the game by Softbank may give them 60-70% of the fund's economics. From another perspective, outside investors are putting up 62% of the capital for a company to leverage up to buy into tech companies where valuations are already stretched and to earn only 30-40% of the eventual pay-out.

Record high private equity dry powder



75% of leveraged loan issuance is covenant-lite

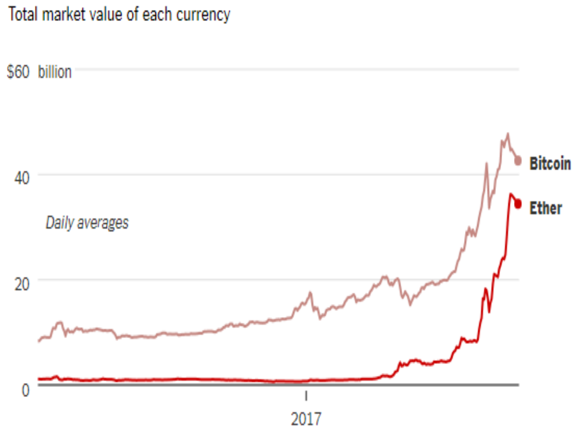


In the leveraged loan space, investors are investing in loans originated by banks for non-investment grade borrowers. Sounds familiar? The structure does provide seniority of these investment as the loans and are often pledged with a first lien of borrower's cashflow and assets. However, this asset classes are floating rate loans which are reset every 45-60 days and is not very actively traded at around US$500bn annually only. In the last three years, we have noticed that the percentage of newly issued senior loans with light covenants have been increasing to an alarming level. 75% of new issuance last year were loans that have little or no maintenance covenants. The benefit of having maintenance covenants it affords the investor the first right to negotiate with the borrower before any other parties in an event of a breach. **Covenant-lite leverage loans now account for 70% of the market; a jump from less than 20% in 2007-2010 and less than 5% pre-GFC.** Investors are lapping up paper issued by non-investment grade borrowers with lesser covenants that protects them while assuming the risk of debt serviceability is unchanged despite the facts that these loans are short-tenured and floating rate in nature.

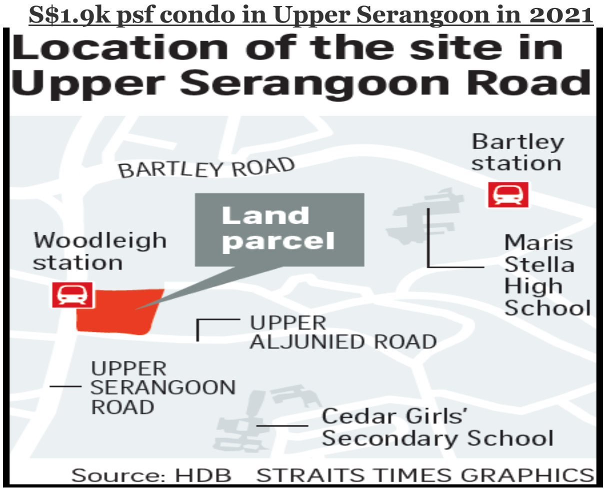
One final segment of crazy assets prices that makes no economic sense. The **best investment in the last 24 months have been in bitcoins and ethereum which have risen by 1000%!** But what are they? They are digital currencies created by unregulated exchanges. To earn them you need to solve complex math puzzles in the case for bitcoins and for Ethereum, a mathematical 19-year-old geek issues it?!?! Howard Marks, Chairman of Oaktree Capital, one of the largest money manager puts it best on digital currencies with little subtlety. “People tell me these currencies are solid..**But they are not real**”, “Bottomline: You can use the imaginary currency to buy other imaginary currencies, or to invest in new companies that will create other new currencies”, “the outstanding Bitcoin and Ether are worth more than Paypal and almost as much as Goldman Sachs”. I don’t know about you readers; this author would rather pay an overpriced Paypal or Goldman Sachs than a currency created based on the hope that it can be exchange for something in the virtual world. Maybe I am just too old to comprehend but this reek of the 17th century Tulip bubble; at its height 40 tulip bulbs was selling at 100,000 Florins while a ton of butter cost 100 florins and eight pigs costs 240. We can’t eat tulips neither can we buy substances with digital currencies.

Closer to home, SPH and Kajima recently paid S$1,166 psf for land of a mixed residential and commercial site in Upper Serangoon. That is 50% higher than a nearby site sold in 2014. For the them to make 10% margin, they **must sell the Serangoon property in 3 years’ time at S$1,900 psf, which are prices never heard of in the vicinity, is 50-70% higher than secondary prices around that area and is 30-40% more expensive than the Berth at Sentosa.** Is this consortium therefore thinking that Singapore property will rise 50-70% in three years’ time?

Metoric rise of Bitcoin and Ethereum

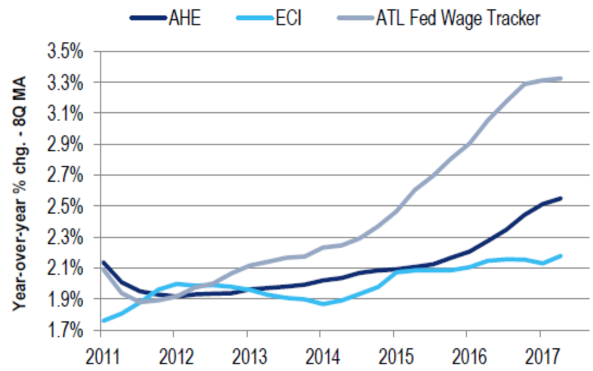


S$1.9k psf condo in Upper Serangoon in 2021



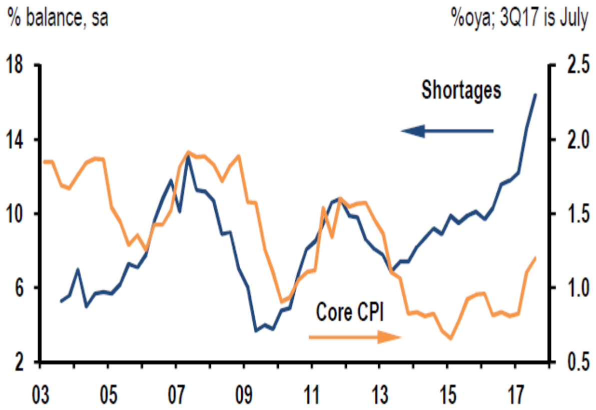
What then can trigger all these excesses to unwind? We have been consistent that the key risk is the market is overlooking the tightening of labour markets and its commensurate impact on inflation. The under-pricing of future paths of interest rates in the US and Europe have widen even further in the last 2 months exacerbating our concern that market is too complacent. The market is now pricing zero rate increase in the US for 2017 against Fed’s most recently communicated message of another 25bps hike. Market participants are expecting the next hike only in Mar 2018 and no more hikes thereafter in contrast to Fed’s three more hikes in 2018. In Europe, the first hike will only come in Dec 2018 according to interest rate futures probability. However, in our extensive of readings from various scholars of the Philip’s curve, we hold our belief that as unemployment rate edges closer to NAIRU, Philip’s non-linearity relationship will be amplified ie wages will increase much faster as unemployment rate falls below this level, Non-Linear Phillips Curves with Inflation Regime-Switching by Federal Reserve, Washington. US is already below its NAIRU of 4.5% at 4.37%, while Europe’s NAIRU is 9.1% in June and given the 2.5% GDP growth forecast 2.2% in FY17, NAIRU should fall to 8% by end of the year; a good 0.5% pt below its estimated NAIRU.

Forward wage indicators US point to wage accelerate



Source: BLS, BEA, Atl Fed, Citi Research

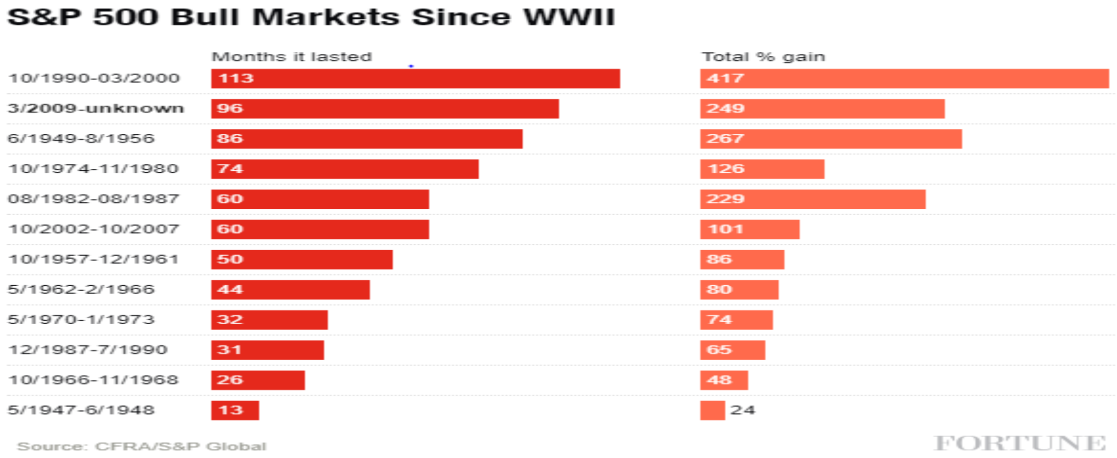
Labour shortages in Europe will drive higher CPI



Source: J.P. Morgan

Asset Allocation Strategy:

The current bull market is already into its 8th year, which will make it the second longest bull market in modern times and the 3rd biggest return of the bull cycles (we define a bull market as advances without a 20% decline with a year). Fortune hilariously try to quantify the age of a bull market in human years, this current cycle would then be 133 years old.



The common adage that "market can stay irrational, longer than you can stay liquid" pervades our mind. Too early to sell, you look like a fear monger; too late you look, well like a fool. We choose the former over the latter label.

We envisage trading conditions will be volatile in the coming 6 months where the risk of unwinding consensus trades is high and returns could be negative. In Covenant Capital, we have seniors PMs that have managing money for both institutions and high net worth private clients for more than 20 years on average. Our senior PM and myself have managed money since Asian crisis in 1997. We have demonstrated our capability to navigate this volatile environment in our past careers. Beyond capability and experience, all our mandates that we managed for our clients are imbued towards total return objective and all accounts are endowed with instruments to manage downside risk like using options, futures and investing in long/short fund managers or non-market correlated managers like quant trend-follower. We have been stress-testing our portfolios to ascertain down-side risk, granulate the source of risks and been following up with our 3rd party managers to keep abreast of their positioning and putting on hedges to minimize these risks.

Covenant Capital extensive experience and track records in managing difficult environment

Track record of Senior PMs at Covenant Capital	Global Financial Crisis (Jan - Dec 2008)	European Sovereign Crisis (Jan - Dec 2011)	Taper Tanturm and first Fed Hike of 2015	China selldown 1H16	Trump Victory Nov - Dec 2016	Years of investment experience
Global Balanced Portfolio - Senior PM	-21.0%	0.3%	-4.0%	-3.2%	NA	28
Global Anchor Portfolio - CEO	Not incepted yet	-------------------------	1.6%	-6.1%	5.3%	17
Global Income Portfolio - CIO	-------------------------	-------------------------	Not incepted yet	-------------------------	3.2%	20
Asia Long-Short Equities - CIO	1.5%	-1.1%	4.8%	1.2%	2.1%	

Global Indices	Global Financial Crisis (Jan - Dec 2008)	European Sovereign Crisis (Jan - Dec 2011)	Taper Tanturm and first Fed Hike of 2015	China selldown Jan-Feb 2016	Trump Victory Nov - Dec 2016
MSCI World Equities	-43.5%	-10.0%	-3.3%	-6.5%	3.6%
JPM Global Bond Aggregate Index	7.2%	6.5%	-2.7%	3.2%	-4.1%
50:50 Blend Global Equities/Bond	-18.2%	-1.8%	-3.0%	-1.7%	-0.3%
MSCI Asia Pac ex Japan Equities	-52.6%	-20.3%	-12.0%	-8.6%	-5.2%

Source: Past performance does not guarantee future results and other calculation methods may produce different results. Performance data are compiled from segregated managed account/s or from the dedicated funds. Some of them are audited, others are derived from audited or bank statements.

Raising even more Cash: As we have mentioned in last month's musing, As we estivate, we contemplate ahead, expensive markets is never the sole reason to sell everything, but it surely tells us not to invest further and to take profits as the rally continues. We are selling and raising our first line of defence "Cash" further to 15-25%.

Equities: Downgrade to Neutral with significant downside protection via options. We reduced Emerging markets last month to neutral sharing with our readers the empirical evidence foretelling the probability of EM equities staging another positive return in the next three months is remote after a stellar 6 consecutive months of positive returns. We are now underweight EM alongside the US. We have added significant optionality downside protection in Europe via options and futures as we acknowledge the adverse impact on Europe growth due to a rising EUR. For every 10% appreciation in Europe, it will knock of -60bps of growth in the first year and -30bps the next year. This can be quite large since FY17/FY18 Euro GDP forecast is 2.2% and 1.6% respectively. The EUR has appreciated 12% year to date. In our stress test scenarios when rates rise, Europe, Japan and Emerging Markets equities tend to fare worst.

Europe, Nikkei and EM Equities perform poorly during surprise rate hike scenarios

	End of QE1	End of QE2	End of QE3	Taper Tantrum	Fed hike	China sell down	Trump
JPM Global Bond Aggregate Index	0.3%	1.9%	1.0%	-2.0%	1.3%	2.9%	-3.6%
MSCI World Equities Index	0.0%	-1.7%	-3.3%	10.7%	-8.8%	-4.6%	2.7%
S&P500	1.1%	-2.1%	-2.5%	15.2%	-7.7%	-3.2%	3.5%
Euro Stoxx 600	-1.5%	-2.8%	-1.2%	9.8%	-10.9%	-7.0%	6.4%
Nikkei	-0.4%	0.2%	-7.9%	19.0%	-12.5%	-12.3%	17.6%
HSCEI	-1.9%	-1.6%	-8.8%	-0.5%	-17.2%	-13.7%	0.2%
MSCI Emerging Marekts Equities	1.1%	-0.7%	-6.5%	-3.4%	-10.1%	-3.6%	-2.0%

Source: Bloomberg

Fixed Income: Underweight. We have lengthened duration by adding US Treasury and preferred securities. We continue to explore adding more to total-return bottom up bond managers as well as long/short credit managers as there is little value to be found in both sovereign and corporate credits.

FX: Neutral. EUR has tested our year-end target already at 1.17. Time to take profit. We think the opportunity to be contrarian and go longer the USD for a tactical short-term trade has presented though admittedly we were wrong on long USD at the start of the year.

Commodities: Raising from Neutral to Overweight. We are in the late stage of the economic cycle that should favour commodities. We have re-added Copper a month ago and is expressing our sanguine view of oil via the high dividend paying oil majors.

Alternatives Investments: Our AI exposures have been reduced to a low delta exposure US equities manager and non-correlated global trend follower.

Featured Picture/Quote: Come as you are but Buffet reminds us not to stay too long in Nirvana. We would strongly suggest to clients and readers to know who among their investments outside of Covenant Capital are in bathing suits. We can help them identify the risk in their portfolios much like we have done for your mandates with us and mitigate the incoming risks. Please speak to your wealth manager in you need to discuss further.

Edward Lim, CFA

Chief Investment Officer