COVENANT CAPITAL

The Navigator October 2017

Are we there yet, Minsky?

Dr Hyman Minsky is a renowned professor of economics specializing in understanding the genesis of a financial crisis. His works lead to the famously coined "Minsky Moment" which is a sudden collapse of asset values after long periods of prosperity as more speculative investments are made using borrowed money. He posits that the longer the period of prosperity the worse the upcoming crisis will be. We want to remind investors that we are already heading into the 9th year of a bull market in both equities and bonds on the back of an unbridled increase in central banks' balance sheet, which is set to unwind. What worries us is the unintended consequences of QE, which has led to the export of an ultra-loose monetary policy meant for dysfunctional economies to functioning economies. We term it the great debt transfer from indebted consumers and corporates to government and rich consumers. It is in Asia that has "benefitted" the most from QE and as QT (Quantitative Tapering) begins, this writer is reminded of his early days as an investment professional when the Asian miracles unwound in 1997 with significant economic costs as well as grave political dislodgement and social upheavals.

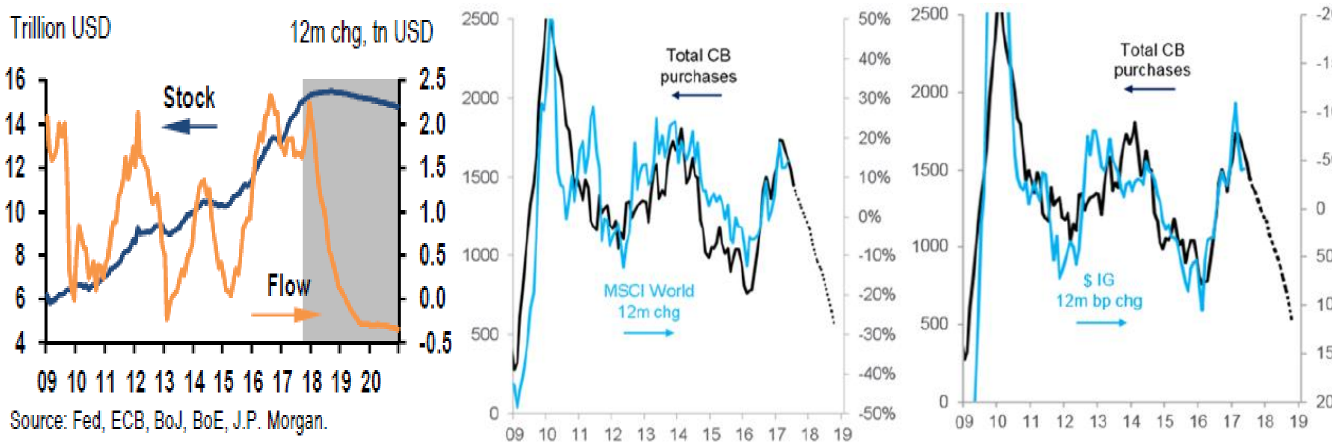
The Great Debt Transfer

Government Debt to GDP	2007	2016	Household Debt to GDP	2007	2016
Japan	183%	250%	Switzerland	182%	211%
US	62%	106%	South Korea	143%	173%
Canada	67%	92%	Norway	72%	102%
UK	50%	89%	HK	52%	68%
EU	58%	83%	Singapore	38%	61%
China	29%	46%	China	19%	45%
Source: Trading Economics					

Since GFC, the G4 central bankers have conducted $8trn worth of QE which is equivalent to 13% of their GDP; half of that increase occurred in past two years. From here on, QT will accelerate and by mid-2018 their balance sheet will outright contract. The unwind is precipitated by FED's declaring to unwind its QE in October, followed by ECB's planned announcement this week to taper its net asset purchases. BOJ is already effectively tapering endogenized by its yield control policy. This will be the first time since GFC the world will witness a synchronized reduction in the balance sheet by all G4 central bankers. In June's edition, Clairvoyance, we highlighted **our concern that as QT begins in earnest, the consequence of a reduction in liquidity in the financial systems is largely unknown beyond the circumstantial**

evidence that changes in the flow of QE have an impact on asset prices and theoretical expectation that bond yields in G4 will rise by 40 to 80bps by end of next year.

Flow seems to matter more to asset prices than the level of CB's balance sheet



We noted the rhetoric and policy actions in the last few months have shown central bankers' resolve and confidence to delink the unwinding of their balance sheet and policy rates. The FED has stayed firm in their commitment to unwind QE by 2017 while delivering what should be three rate hikes by end of the year in line with their communique in1Q17. Both Bank of Canada and Bank of England have already begun unwinding their balance sheet while hiking rates several this year. We expect ECB to announce that they will taper this week as well during their scheduled meeting while assuring markets that policy rates can remain low beyond the end of net asset purchases. This new-found confidence is critical as we have often argued the right policy tool to address growth concerns is the supply of money. With global growth already surpassing its potential in 2Q17 and 3Q17 GDP print is likely to be as strong as 2Q17, the global economy does not need such abundance of supply of money. In fact, we fear the longer excess money supply stays in the system it brings us closer to the Minsky moment of truth and pain.

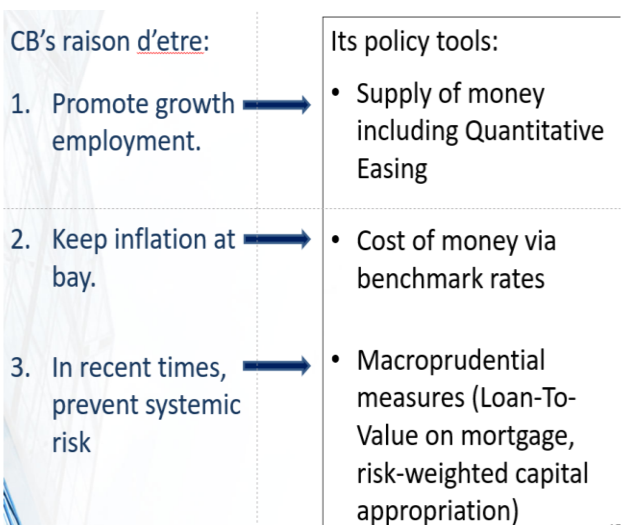
Global growth stronger than we expected

%ch, sa (ar for qet). PMIs are levels. Conf is st.dv from 2010-pres avg

	2Q17	3Q17	Jun 17	Jul 17	Aug 17	Sep 17
PMI, mfg	53.4	53.6	53.2	53.1	53.7	53.8
PMI, serv	53.8	53.9	53.8	53.7	54.1	54.0
IP	4.1	2.8	0.3	-0.2	0.7	0.4
Retail sales	5.7	3.1	0.3	0.3	0.0	0.4
Auto sales	-2.9	24.1	1.1	1.9	0.5	4.7
Cap. shpmnts	7.9	9.3	0.3	-0.1	3.2	-0.5
Cap. orders	4.1	15.4	0.3	1.7	2.5	-0.3
Cap. imports	11.1	16.1	0.2	0.9	1.9	0.7
Bus conf	1.0	1.2	1.1	<u>1.1</u>	<u>1.2</u>	1.2
Cons conf	1.5	1.6	1.6	1.6	1.7	1.6
Nowcast	3.4	3.4	3.3	3.2	3.6	3.5

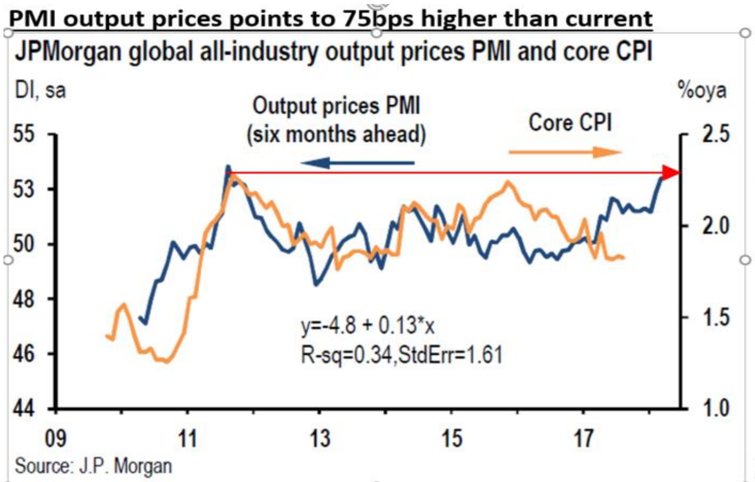
Note. Shaded values show forecasts computed by the Kalman filter estimates from the dynamic factor model. Underlined values are our estimates based on available data and our judgment.
Source: J.P. Morgan, Markit, and national statistical agencies.

The right tools for the job

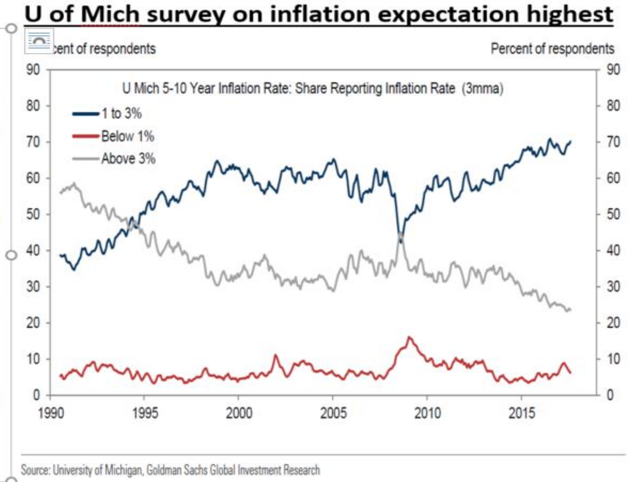


On the other hand, as inflation risk was benign in the first half of the year, it was appropriate for central bankers to calibrate their normalization of rates slowly. But this is all set to change. Data on inflation in the next few months will be critical to assess the pace of interest rate normalization. We are more concerned about the pace of interest rate normalization than the pace of QE unwinds. The pace of QE unwind can be tweaked if the economy slows down or financial conditions tighten more than what central bankers can tolerate or the economy can withstand. But inflation is an animal when unleash is far harder to tame and history has guided us only a large and continuous increase in policy rates can rein inflation. What concerns us most is the blasé expectation of the market that Philip's curve is dead and the belief has driven term premia to its all-time low as mentioned in last month's, The epitaph of QE and his mates. Inflation expectations are so low that investors are willing to be compensated close to nothing for holding a longer tenured ten-year US government bond versus one-year. **Many forward indicators we are monitoring are pointing to an acceleration in inflation both core and overall CPI across the globe in the coming months.** Global PMI surveys on output prices are now near all-time since 2011. In 2011, when the reading of PMI – Output Prices is similarly high, the corresponding read of Core CPI was 2.35%; 75bps higher than the current level. Readers are reminder PMI readings are usually 3-6 months forward indicators ahead of eventual print. In the University of Michigan Consumer Survey on inflation, the percentage of respondents expecting inflation to range from 1% to 3% has trended to its highest reading since 1990.

PMI output prices points to 75bps higher than current

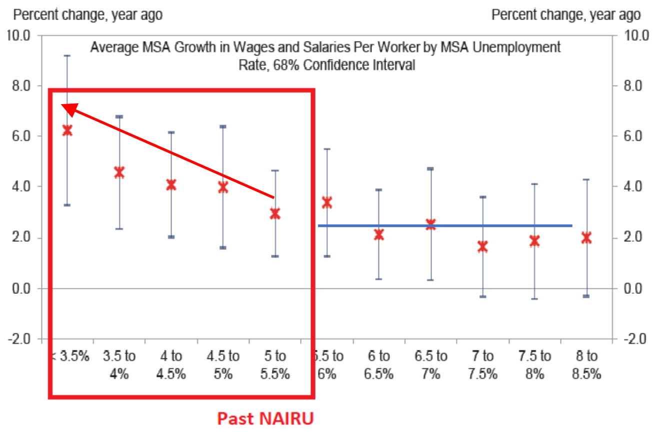


U of Mich survey on inflation expectation highest

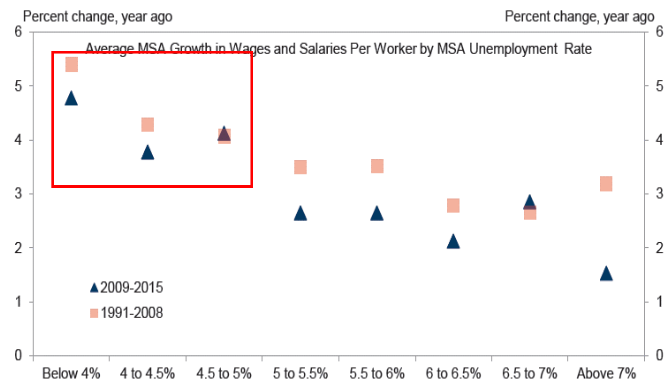


And for those naysayers that Phillip's curve is dead, we caution the adage "This time is different" because often is always the same. We rely on GS and JPM in-depth analysis of Philip's curve which they have decomposed regional as well as countries (particularly useful when we analyzed Europe given is diaspora) employment data to provide a granular view if this economic concept still works. We believe this is a far more robust approach that taking national or economic-bloc wide data. The read of their works is very clear. **What it clearly found is that Philip's curve exhibits non-linearity. As the labour slack diminishes close to NAIRU or exceeds NAIRU, wage pressures are accentuated**. The further away from NAIRU, Philip's curve relationship to wages and employment flattens out. Their research points to the US, individual countries in Europe and Japan exhibiting the same non-linearity relationship as well.

Wages accelerates closer and past NAIRU



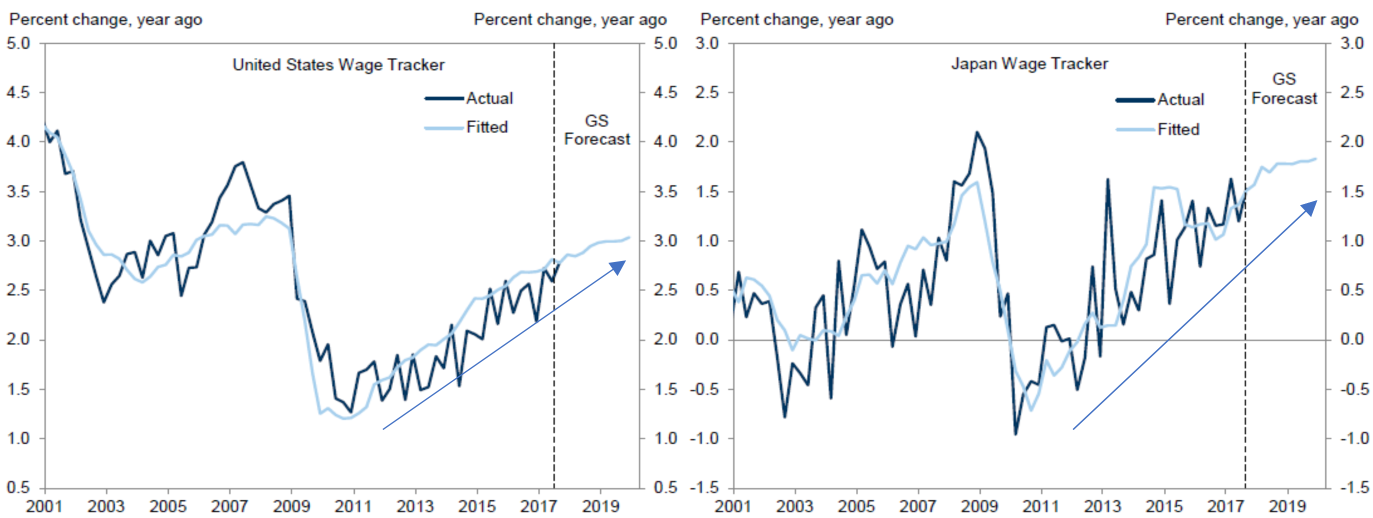
Differences narrow pre/post-GFC when closer to NAIRU



Source: Bureau of Labor Statistics, Department of Commerce, Goldman Sachs Global Investment Research

Beyond theory, **GS trackers on wages are already pointing to such an increase.** In Q317, US wages have increased by 2.8% in Q3, levels not seen since GFC. Even in Japan, wages have trended to a 1.5% increase. In countries like Spain and Italy which have seen the largest improvement in employment among the larger European countries, wages have started to trend higher as well albeit still a long way to their pre-crisis growth stature.

Real-time wage data shows increasing wages for advanced economies



Asset Allocation Strategy

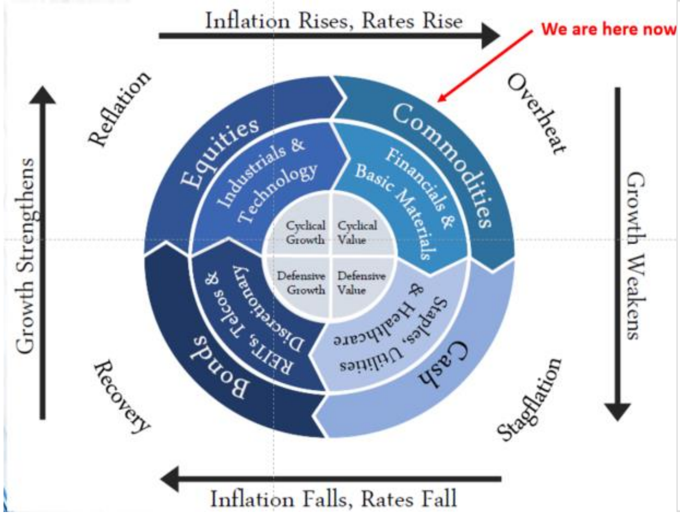
While we have been sounding the cautiously call since June, we are reminded of in last month's piece that it doesn't pay to exit ahead of a bear market assuming if you have the clairvoyance of predicting accurately one. Further, it is never too late to sell when a bear market begins as well. The risk-reward of missing the last hurrah and avoiding the start of the bear run is symmetric 1 and 3 months to the commencement of a bear market. Bear markets normally last 12 months and fall an average of -31%. If we sell 1 or 3mths into the start of the bear market when we realized one has already begun, we will still be able to avoid a large part of the overall decline.

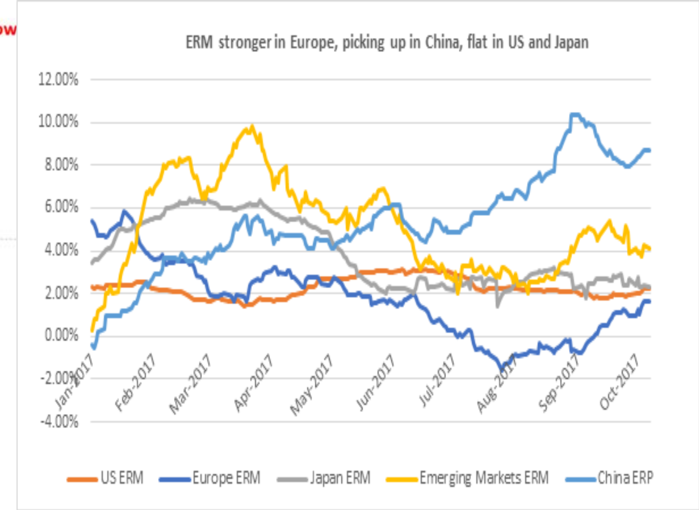
Doesn't pay to exit ahead of a bear market and never too late to sell into the start of a bear market

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

Equities: Neutral but with many upside optionalities build in via options. Valuations are expensive just about everywhere. Hence much of how we are positioned depends mainly on where we are in the investment clock and earnings revision momentum (ERM) of sectors and regions. As we are now in the overheating cycle, our biggest exposures are in commodities, financials and selected technology. Global ERM has declined in recent months hence we are focused on relative improvement and positioning with respect to regional preferences. We remain overweight Europe the most with rest of the other regions marginally indifferent to benchmarks. We have recently increased our exposures to basic materials via European building materials ETF as well as European financials. We have been trimming our weights in Emerging markets preferring EMEA than to EM Asia through our exposure to MSCI Russian ETFs while selling China-heavy EEM ETF. Rest of EM equities portfolio is focused on picking alpha trades in Asia. We have also increased our small-cap exposures with representation in all regions now either via ETFs, active managers or single stocks. Where options are available and cheap, we have increased our option exposures via a combo of cash underlying + upside calls, selling puts or even risk-reversal trades. We believe this strategy is appropriate as we are attempting to participate in the last hurrah but without committing too much capital at risk when the market turns.





Fixed Income: Underweight. We have been built up our case that market is under-estimating inflation and mispricing interest rate risk in the many past editions. Moreover, term premium is so out of whack even if you assume lower longer-term equilibrium rates associated with aging demographics and debt overhang. We have decided to reduce our duration of the portfolio significantly exiting our UST 20 years, which often served as a risk-off hedge and even opted to buy puts on US Treasury yields. We believe shorting the longer end of UST curve for alpha is increasingly looking like one of the best trade in the next 6 months. In tandem with this over-arching negative view on long duration and sovereign credits, we are adding to total-return bottom up bond managers as well as long/short credit managers. In the past months, we have been reviewing with our fixed income managers to better understand how they are positioned.

(Note: last month's comments on fixed income was erroneous, it should communicate as above as we have shortened duration further and adding more total return managers)

FX: Neutral. Our call to long USD/SGD is panning out well. Given our view that US will have to normalize rates faster while QT will add pressure on US Treasury yields, we plan to add more USD long against other currency pairs.

Commodities: Overweight. We are long oil producer, basic materials companies and have increased exposure in a fund manager that specialized in industrial, commodities and discretionary spending.

Alternatives Investments: We are planning to add more credit fixed income hedge funds.

Cash: We continued to hold larger than normal amount of cash from 15-20%.

Featured Picture/Quote

As we approached the 9th year of the bull market, which already is the 2nd longest in modern day history, we are reminded to be cautious than wanton. [10 billionaires who lost all of their money]

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