

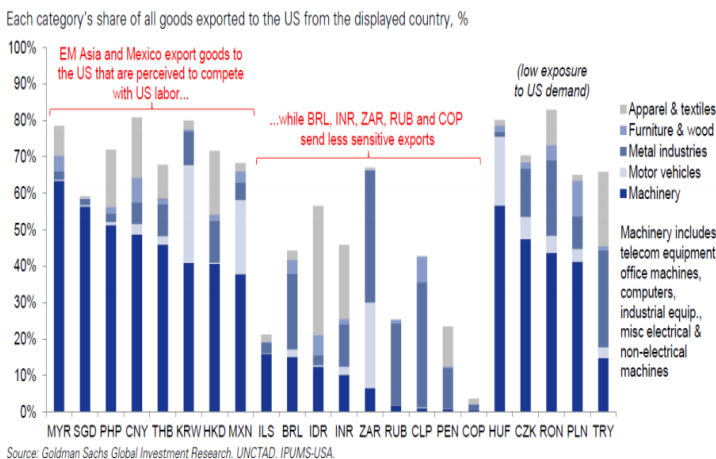


Bye, Bye, Miss American Pie

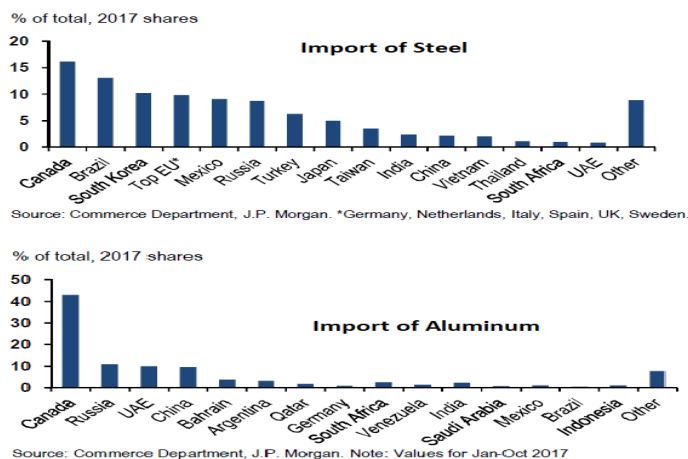
This author grew up listening to this song but never really knew the deeper meaning of its lyrics until he is much older. It was an 800 words song written by Don McLean, released in 1971. McLean left many generations guessing what this song really meant until 2015 when he auctioned off his original manuscripts and open up to the inspiration and undertones of the song. In his own words, “it was an indescribable photograph of America (in the 50-60s) that I tried to capture in words and music; I wanted to make a whole series of complex statements. The lyrics had to do with the state of society; Basically, in American Pie, things are heading in the wrong direction; It has become less idyllic; It is a morality song.” A 1971 song that is apt to the 2018 Trump presidency. I will take the latitude offered in this musing to doctor part of its lyrics to reflect recent news “Bye Bye Miss American Pie. Hit the Chevy with a levy, tax the whiskey and rye” in light of Trump’s tariffs on steel, aluminum, washing machines and solar panels imposed this year. We wrote last year, [it's complicated \(Feb 2017\)](#), attempting to analyze what will Trumpnomics be like in coming year concluding that the broad contours of his campaign promises will be good for the US economy and the stock market especially his tax cuts and expansionary fiscal plans. However, the actual impact of these 2 pro-market plans could be complicated by his stance on immigration and protectionist trade policy with Canada, Mexico and North Asia including China at the greatest risk to lower growth should a trade war ensue. Emboldened by his passage of healthcare changes and more recently his tax and fiscal policy plans, Trump has solidified his positions as the #1 global opprobrium by violating WTO established rules of engagement as well as by-passing his own party congressional branches by imposing these recent tariffs under the guise of national security.

This event has certainly added uncertainty and induced volatility in already fragile risk markets that are still grappling with the dynamics of a possible faster than expected rise in inflation and Fed policy responses alongside an evidently slowing global growth momentum, albeit still at a solid pace of expansion.

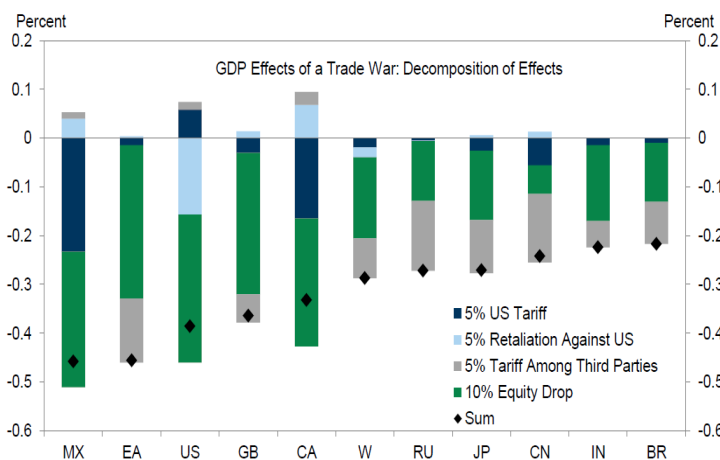
EM Asia, alongside Canada and Mexico more vulnerable



Canada, Brazil, South Korea steel and Al most at risk



On trade wars, we marked to mark the latest guesstimate (at this juncture it is just an estimate given we do not know what other products could be affected and the retaliatory actions of US trade partners against the US or with each other). According to Goldman Sachs, while the current goods affected by the new tariffs merely affects less than 3% of total goods imports by the US and less than 5% of total exports of their most affected partners of Canada, Brazil and South Africa, is the prospect of further escalation that could shave off -0.3% of global GDP, -0.4% of US and -0.5% of Europe in 2019. This is assuming global trade wars with each economic blocs, tariff increasing to 5% from current blended tariff of 1.5% and the negative feedback loop of a -10% drop in global equity markets feeding into the global economy. While these outcomes will not lead to global economies tipping into recessions, it does reduce a material amount of growth forecast in 2019. A slightly less malignant outcome where the trade war is focused only in the US and its trading partners and an accompanying increase in tariff by 5% will reduce global growth by -0.1%, US -0.1% and Europe -0.2%. We believe the latter is more likely to happen than the former of an all-out trade war. While the outcomes do not seem too egregious, it is nonetheless an unwelcome development. As seen in the chart below, much of the growth shocks will come from how equity market responds to this development (green bars) and we know investors reaction can sometimes be a beast to contain vacillating from greed to fear within a day.



Source: Goldman Sachs Global Investment Research

Potential impact to GDP 2019

	GDP FY19E	Scenario A	Scenario B
Current Global GDP forecast	3.6	-0.1	-0.3
Current US GDP forecast	2.4	-0.1	-0.4
Current Euro GDP forecast	2.0	-0.2	-0.5
Current China GDP Forecast	6.2	-0.2 *	

Source: Bloomberg, GS, UBS

Scenario A: US focused trade war with tariffs rising by 5% but RoW do not engage with each other

Scenario B: A global trade war with tariff rising to 5% and global equity markets falls 10%

* UBS estimate based on 10% tariff on all Chinese electronics/tech export to US

We are expecting further measures from Trump's in the coming weeks. The announcements so far have the biggest adverse to impact Canada and Mexico but do little to his main target China. We think Trump will likely target China on intellectual properties, tech and telco exports. His recent decision to block Broadcom acquisition of Qualcomm due to national security concern that China might upstage the US in the telecommunication space is a harbinger. The US imports 57% of its telecom and sound record equipment from China. Office machinery and automation data processing is the second most prominent import to the US from China. These two items represent 44% of the US trade deficit to China amounting to USD 164.7bn in contrast to steel and aluminum only \$2.9bn of which China only has 5% and 10% market share in these 2 items. According to UBS, 43% of Chinese exports to the US are electronics/tech imports, a 10% tariff on these products may lead to a 4.3ppt drop in exports to US and 1ppt drop in China's total real exports. But export as a % of China's GDP has fallen over the years to less than 25% of China's GDP,

thus the overall impact to China GDP is small at -0.2%. We do not subscribe to the risk of a full-on trade war between these 2 countries as we believe Trump's sabre rattling rhetoric is meant to bring China to the negotiating table and China, especially with the recent constitutional changes empowering Xi to President indefinitely, has the luxury of time to tire out Trump's antics and will elect not to objugate but to negotiate. Some compromises will be reached in the form liberalization of market access to some sectors for US companies in China earlier than the Chinese had planned.

US and China import/export dependency

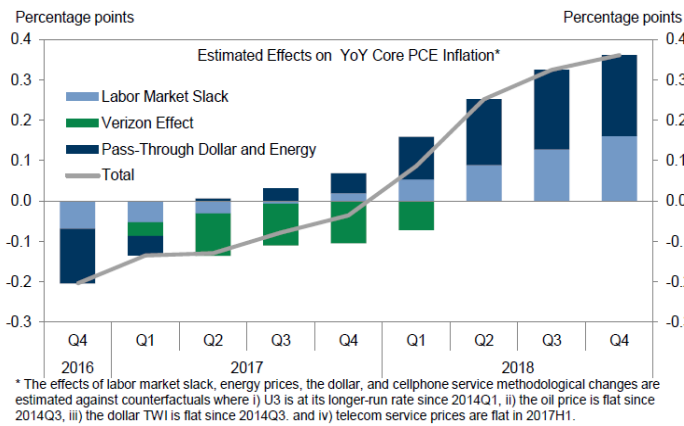
Key sector of US imports from China (2017)	US Imports (\$ bn)	Trade balance (\$ bn)	China's market share (%)	(2017)	US exports to China (USD bn)	Trade balance (USD bn)
Telecomm, sound record & reproduce equipment	96.4	-94.3	57%	Other Transport Equipment	16.3	15.5
o/w Telecom equipment (cellphone, etc.)	82.7	-80.7	60%	o/w Aircraft and Associated Equipment	16.3	15.8
o/w TV receiver	11.5	-11.4	47%	Road Vehicles	13.2	-1.4
Office machinery & Automatic Data Processing	72.7	-70.4	59%	o/w Motor Cars for Transport Of Persons	10.6	8.9
o/w ADP machine (computer, etc.)	50.5	-49.1	60%	o/w Parts and Accessories for Motor Vehicles	2.3	-7.1
o/w Office machines & parts	15.3	-14.7	68%	Oil Seeds and Oleaginous Fruits	12.4	12.4
Manufactured articles	56.0	-53.7	46%	o/w Oil Seeds, Oleaginous Fruits: Extraction	12.4	12.4
o/w Toys & baby carriages	26.3	-26.1	81%	Professional Instruments	6.4	-1.1
Electrical machinery & appliance	47.0	-36.3	27%	o/w Measuring, Checking & Analysing Instruments	4.0	0.0
o/w Electrical machinery	14.1	-13.3	35%	o/w Instruments & Appliances for Medical Purposes	1.8	-0.5
o/w Household equipment	10.4	-10.3	53%	Petroleum, Petroleum Products	5.8	5.1
Apparel & clothing	30.8	-30.7	35%	Metalliferous Ores and Metal Scrap	4.8	4.7
Furniture & parts	24.4	-24.2	49%	o/w Nonferrous Base Metal Waste & Scrap	2.9	2.9
Industrial machinery & equipment	22.6	-18.3	23%	General Industrial Machinery & Equipment	4.3	-18.3
o/w Heating & cooling equipment	4.4	-3.8	25%	Specialized Machinery	4.2	-1.7
Manufactures of metals	20.6	-19.5	39%	Plastics In Primary Forms	4.0	2.9
Footwear	14.3	-14.1	56%	Pulp and Waste Paper	3.4	3.4
Road Vehicles	14.6	-1.4	5%			
o/w Auto parts	9.4	-7.1	14%			
Textile fabrics & articles	11.6	-10.9	41%			
Other selected sectors						
o/w Iron & steel	1.9	-1.4	5%			
o/w Aluminium	1.8	-1.5	10%			

Source: CEIC, UBS estimates

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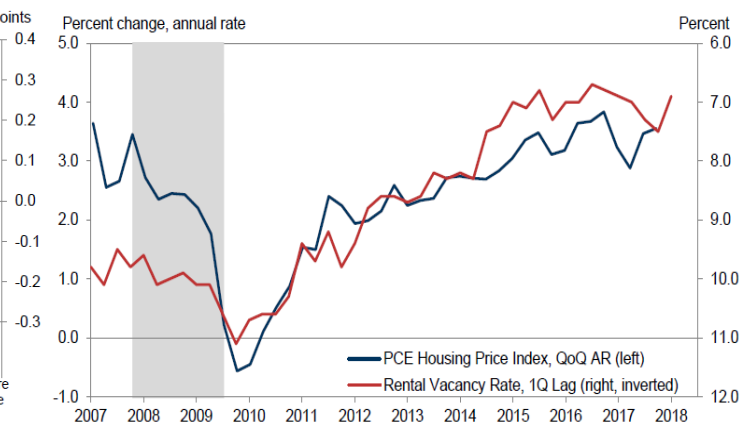
Our key concern in the markets over the last 6 months has always been inflation risk and market under-pricing inflation and policy rates. Last month's dramatic re-alignment has at least alleviated the risk; the follow-up question to ask is do we expect inflation to move higher to the point it becomes pernicious to both bonds and equities? We do not expect inflation to rise above 3% anytime till pass 2019 but the optical trend is for CPI to increase every quarter over the next 4 quarters and into 2019 as well. There are several reasons for the consecutive quarterly increase in 2018. First, the dollar has depreciated 3% YTD and is 6% lower than the average from 2Q-4Q17. The weaker dollar and the potential of higher input costs due to the recent tariffs announcements should feed into higher import costs. Second, there is an idiosyncratic issue of the sharp decline in telco prices that had a disproportionate impact on inflation in 2Q17 which will fade away. Third, we are firm believers of Philip's curve. With the unemployment rate in the US already 0.5% below its NAIRU, wages increase is a foregone expectation. Fourth, the under-supply of housing continues and will exacerbate rental increase and ownership prices. The structural impediments that are restraining inflation from accelerating beyond 3% remains that of an aging demographics, technological improvements especially in the era of price-comparison consumerism and globalization. The additional factor that we are monitoring assiduously is the swing impact of rising commodities prices.

Weak Dollar and tight labour pressuring CPI



Source: Goldman Sachs Global Investment Research

Rise in home price to extend due to insufficient supply



Source: Department of Commerce, Goldman Sachs Global Investment Research

Over the last few months publications, we have elucidated several trigger points on inflation and US yield that will guide us when will inflation become detrimental to risk assets. The trigger points are back by empirical data over a very long-time period. We tabulate these again and for deeper discussions on them please refer to [Melt Up \(Nov 2017\)](#), [The Year Ahead 2018: Eat, Drink, Man, Woman](#) and [Hachiko - The dogged tale of faithfulness and loyalty \(Feb 2018\)](#).

Inflation and Yields trigger points to watch

Trigger points	Outcome
CPI > 3%	S&P valuation multiple derates from 20x trailing to 16.5x
CPI > 3%	Bear markets commences
UST10 > 5.5%	Negative correlation to equities
Yield curve < 0%	100% chance of recession. Lead time 9 months to market peak

Source: Covenant Capital

Current and forecast key triggers

	Current reading	FY18F	FY19F
Core CPI	1.80%	1.80%	2.00%
CPI	2.20%	2.30%	2.20%
UST10	2.86%	3.04%	3.42%
Yield Curve	0.55%	0.44%	0.41%
PE		17.4	16

Source: Bloomberg

Asset Allocation Strategy

Nonetheless, we dust out our inflation playbook. A playbook that any investment professional under 35 years old would not have seen before because we have not seen a steady rise in inflation since 2004 nor a rate hike cycle of the likes of 2004-2007. There is a need to distinguish good inflation versus bad inflation. Good inflation is when inflation rises from its nadir and advances at a moderate pace. It reflects a healthy and strengthening economic expansion with higher utilization of labour and economic inputs. Moderate inflation also absconds the “Paradox of Thrift” as espoused by the famous economist Milton Keynes as higher prices encourages consumer and corporate spending as the purchasing power of a dollar today will be higher than that of tomorrow. This leads to a virtuous cycle of increased spending, higher utilization and more investments benefitting some risk assets more than others. However, as the

economic cycle ages and output gap shrinks, pressure on prices of labour and economic inputs increase. This leads to eroding power of purchase, reduces real income earned and can hurt competitiveness of a country. Corporate and consumer spending takes a hit as well as risky assets. During period of high inflation, it also has a larger regressive effect on lower income families.

How disruptive inflation can be for markets depends on the asset classes. Rising inflation always triggered a Fed progression from loose to neutral to restrictive monetary policy. Bonds returns decline, underperforming Cash but Inflation-linked bonds beat nominals. Credit suffers on duration losses and eventually spreads widens due to the concern of weakening credit metrics. Equities benefit in the early to mid-cycle phases of inflation acceleration and only suffer during the latter cycle as rising input prices (wages, commodities) eats into margin alongside slowing demand and higher financing costs due to higher interest rates. Commodities, which is often an accompanying contributor to inflation, perform well during this stage as well. EM assets and high yield credit tend to perform better in the early-mid cycle stages simply because rising inflation reflects the strength in economic momentum. They only performed poorly, in fact will be the worst performer, when bad inflation steps in as Fed tightens aggressively leading to a flight to safety capital outflow from EM back to DM/US. As to the US dollar, the relationship to inflation has been tenuous, unfortunately. It is worth mentioning during an acute change in velocity of inflation or inflation expectations, all asset classes suffer. Last month's developments and Taper Tantrum of 2013 were such cases where Bonds declined -1%, Equities -4.3%, Commodity index - 4.7%, even Gold was down -1.9% even against the backdrop of strong macro and still benign inflation print.

We are still in the early cycle of inflation increase even though we are late in the economic cycle. Hence, we retain our preference in Equities and Commodities over Bonds.

Commodities: Overweight. The three core tenets underpinning our relatively large overweight in commodities are strong economic forecast, supply discipline and resulting high free cashflow for companies operating in this space. Latest PMI readings in Feb, while have softened from its torrid high, remains expansionary. PMI manufacturing and services are tracking at 55 in the latest 3 months, level higher than 2H17. Our capex renaissance story remains intact with JPM capex proxy at 10.6% also higher than 2H17 and higher than their 1H18 forecast. While retail sales are tracking lower in last 3 months versus 2H17 due to the impact of rising oil prices, it is still a healthy clip of 3.6% and upside risk is evident as the tax impact in the US will be felt more keenly in 2Q18 onwards. Industrial activity trend is similar to PMI and capex, which is above 2H17 strength leading to JPM Nowcaster forecasting a 3.8% global GDP growth, 0.40 ppt higher than 2H17.

Supply discipline for commodities has never been more compliant. Furthermore, China push towards a greener society has also seen attrition in capacity especially in industrial metals and coal. While capex is set to rise till 2020, the absolute level is 50% lower than its peak in 2012/2013. GS expects less than 5% increase in supply for many commodities over the next 3 years. Free cash flow is increasing significantly while net debt is falling fast leading to the probability of higher dividend payouts for many these miners.

Nowcasting indicating stronger 1H18 than 2H17

%ch ar, PMI avg level

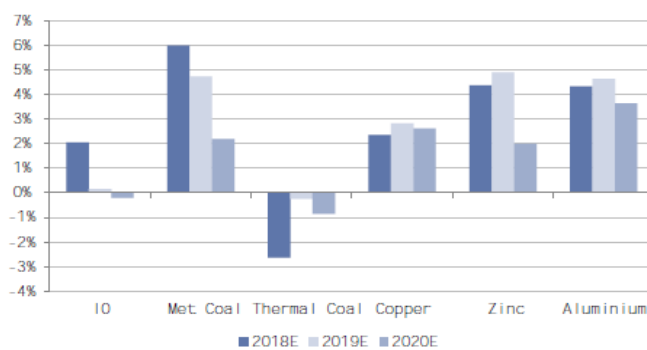
	2016	1H17	2H17	1H18	Latest*
GDP	2.9	3.5	3.4	3.6	3.8
Mfg output	2.3	3.8	4.1	3.3	5.4
Retail sales	3.9	4.3	4.3	3.0	3.6
Capex	-0.2	5.3	9.7	8.0	10.6
PMI mfg	51.8	53.7	54.2	53.4	55.0
PMI srv.	52.0	53.7	53.8	55.4	55.0
DM core CPI	1.9	1.9	1.9	2.3	2.1

*Latest %3m, ar est thru Jan. GDP nowcst(ar)/PMI Feb ests.

Source: JP. Morgan

Limited supply of key commodities next 3 years

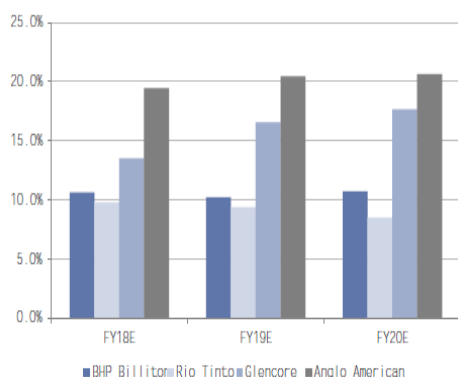
New supply coming online (as a % of 2017 supply)



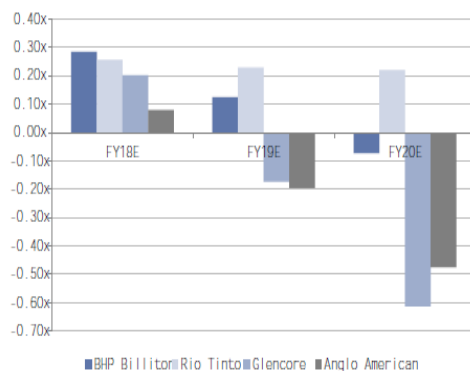
Source: Goldman Sachs Global Investment Research.

Significant improvement in cashflow and dividend payouts

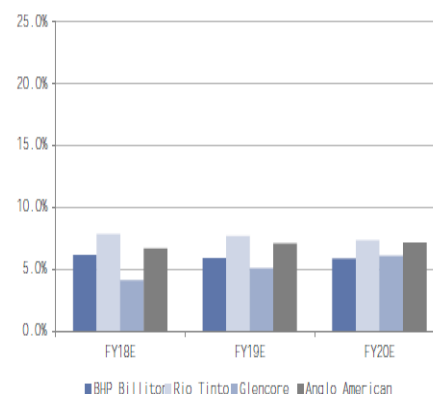
FCF yield (%) at spot



Net debt/EBITDA (x)



Dividend yield (%)



Source: Goldman Sachs

In terms of physical commodities, we like copper and oil and are invested in their physicals and their 1st derivatives such as equities of oil service providers or bond of multi-commodities producers. We also have our long-standing investment in a commodities/industrial sector specialist equities fund manager.

Selected commodities price forecasts

	Spot	FY18F	FY19F	Expected 2yrs Return
Copper	6800	7625	7800	15%
Oil	64	70	72	13%
Palladium	978	1019	1050	7%
Aluminium	2086	2125	2200	5%

Source: Covenant Capital

Equities: Overweight. Our equities exposures are triangulated on three key pivots. Earnings momentum, beneficiaries of rising inflation, growth/small cap style. At the country level, our preference is for US and EM largely because earnings momentum is the strongest there even against relatively expensive valuation for the US market. We overlay our equities portfolio with sectors that will benefit from rising inflation. Sectors such as financials, industrials, materials, discretionary

and tech have shown strong and positive correlations to rising rates. Growth and small cap stocks and fund managers tend to perform better during such periods. This style is well represented in our investments in small-cap managers in Japan, Europe and Asia.

GICS Level 1 Sectors ⁽³⁾	Median Sector Performance by Macro Environment			GS Investment Profile Factors ⁽⁴⁾	Median Factor Performance by Macro Environment		
	Rising Inflation Breakevens ⁽¹⁾	Rising 10YR UST Yields ⁽²⁾	Last 6 months		Rising Inflation Breakevens ⁽¹⁾	Rising 10YR UST Yields ⁽²⁾	Last 6 months
	Top Quartile Move: >25 bps	Top Quartile Move: >30 bps	Breakevens: +25 bps 10YR UST: +61 bps		Top Quartile Move: >25 bps	Top Quartile Move: >30 bps	Breakevens: +25 bps 10YR UST: +61 bps
Technology	5.0%	4.1%	5.1%	Growth (High vs Low)	3.0%	2.5%	(1.3%)
Materials	3.4%	2.3%	1.9%	Value (Cheapest vs Richest)	4.0%	2.8%	(3.3%)
Discretionary	2.9%	1.0%	5.3%	Financial Returns (High vs Low)	(3.1%)	(1.9%)	2.1%
Industrials	2.8%	2.3%	0.0%	Integrated/Quality (High vs Low)	3.0%	2.4%	0.6%
Energy	1.2%	0.1%	(3.4%)	Balance Sheet (Strongest vs Weakest)	(1.5%)	(0.5%)	0.6%
Financials	0.5%	1.0%	3.6%	Size (Largest vs Smallest)	(7.5%)	(5.8%)	(3.4%)
Healthcare	(5.4%)	(2.4%)	(2.4%)	Volatility (Lowest vs Highest)	(9.8%)	(6.5%)	(4.4%)
Staples	(6.0%)	(3.6%)	(8.7%)	Momentum 6m (Leaders vs Laggards)	(3.1%)	(1.9%)	2.0%
Telecom	(8.2%)	(7.0%)	(8.6%)	Short Interest (Lowest vs Highest)	0.8%	0.8%	(0.2%)
Utilities	(8.5%)	(9.0%)	(15.7%)				
S&P 500 Value / SPX (Ratio)	0.7%	0.2%	(2.2%)				
S&P 500 Growth / SPX (Ratio)	(0.7%)	(0.3%)	2.0%				
Russell 2000 / SPX (Ratio)	4.1%	3.1%	(0.1%)				

Fixed Income: Underweight. Post Feb trial run of what it will be like for bonds as inflation and interest rate normalized, we decided to rethink our entire Fixed Income portfolio as almost none of our fixed income portfolio managers or bonds had positive returns in Feb. While the approach will still be barbell oriented with earning carry on low risk instruments while eking capital gains via credit selection on the higher risk spectrum of fixed income, we decide to de-risk even further our low-risk fixed income portfolio. We are repositioning some of our lower risk investment credit into cash alternatives and improved our credit profile in our floating rate position to investment grade credit risk versus previously just a secured market. We are exploring ways to reduce duration and rates risks associated with the US in our higher risk part of our fixed income portfolio, trading off some yield for less sensitivity to US rates. The overarching stance on fixed income will continue to eschew Treasuries, to prefer high yield over investment grade due to spreads pick-up, to EM and Asia credit over development markets and selected few absolute return-oriented managers.

Various fixed income performances during rate rise cycles

Rising rate time period	Change in interest rate	Non-traditional bond	Bank loan	High yield bond	Multi-sector bond	Short-term bond	Inflation-protected bond	Traditional core bonds	Intermediate-government bond	Long-government bond
8/86 - 10/87	+3.31	-	-	1.64	2.31	2.98	-	2.41	1.83	-2.48
9/93 - 11/94	+2.86	-	6.29	0.83	-1.16	-0.16	-1.65	-3.03	-3.93	-7.87
9/98 - 1/00	+2.63	8.48	6.23	5.71	3.33	2.01	1.67	-0.61	-1.36	-6.47
5/03 - 6/07	+2.19	5.31	6.13	8.97	5.94	2.29	2.70	2.94	2.09	1.29
Average	+2.75	6.89	6.22	4.29	2.60	1.78	0.91	0.43	-0.34	-3.88

Source: Blackrock

FX: Neutral especially so given its inconsistent correlation to inflation.

Alternatives Investments: Given where we are in the cycle, we prefer to keep our investments simple, transparent and liquid. Hence, we have little exposure to AIs in the complicated or hard to comprehend strategies.

Cash: Cash increased 5 to 15% preferring to hold higher cash to buy into dip especially post March FOMC.

Featured Picture/Quote : Can't elaborate because I still want to travel to China. [Go Google.](#)



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