The Navigator

COVENANT CAPITAL

November 2019

When you wish upon a star…

This author was invited to Bloomberg to discuss our previous Navigator, This is the world we live in, where we opined a contrarian and constructive stance on risk upgrading equities to Neutral after months of underweighting this asset classes. I was asked by the newscaster about my views about the upcoming US-China trade negotiations and I could only muster the hope that a partial deal is done, We hope to see a partial deal between US & China says Covenant Capital's CIO. Much to everyone's surprise, it does seem like the US and China are working towards a phase-in deal; a better choice of word than "partial". However, our upgrade in equities did not rely on this appetent hope, but rather on the empirically backed expectation of a lift in economic momentum as well as a cushioning impact the concerted easing of monetary policies by many central banks has on potential financial shocks.

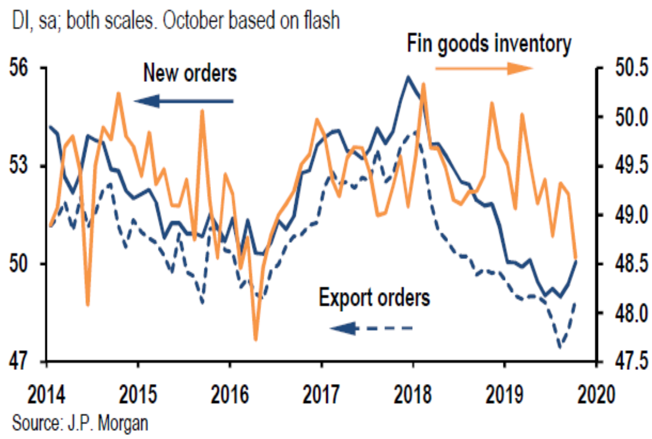
Heading into the next few months, the broad contours of our views will involve the lifting of the manufacturing sector from recession into recovery, albeit a shallow one, while the services sector will continue to expand at a moderate pace. Financial conditions will remain easy although the expectation of future rates cuts across the globe should be tapered as the economy improves. Expansionary fiscal policies announced in the past 6 months will continue to work its way into the economy in the upcoming quarters reinforcing the lift in consumption. The US-China will continue to bridge their differences enough to stabilize their economies and for Trump to declare a victory, but a truly comprehensive deal will remain elusive until the next US president takes over. We are not sure what will happen to Brexit but since we had the leprechaun charm of wishing for a partial US-China deal, we wish the United Kingdom to stay in the EU.

The recent slump in PMI-Manufacturing has been the longest since the 1990s having peaked in Mar 2018 but remarkably that has not induced a global recession. **The latest manufacturing PMI data affirmed our view of a turnaround with the output surveys registering 3 consecutive month-month improvements and has stayed above the expansionary level.** The critical triumvirate of PMI indicators, New Orders, New Export Orders, and Inventory, that best predicts future growth trajectory, are all pointing to a sustainable improvement in the near term. They have all registered two consecutive months of improvement with the New Orders survey increasing 0.6 pt to 50, New Export Orders by 0.9 pt to 48.9 while Inventory is being worked down with -1.1 pt decline.

PMI Manufacturing back into an expansionary level

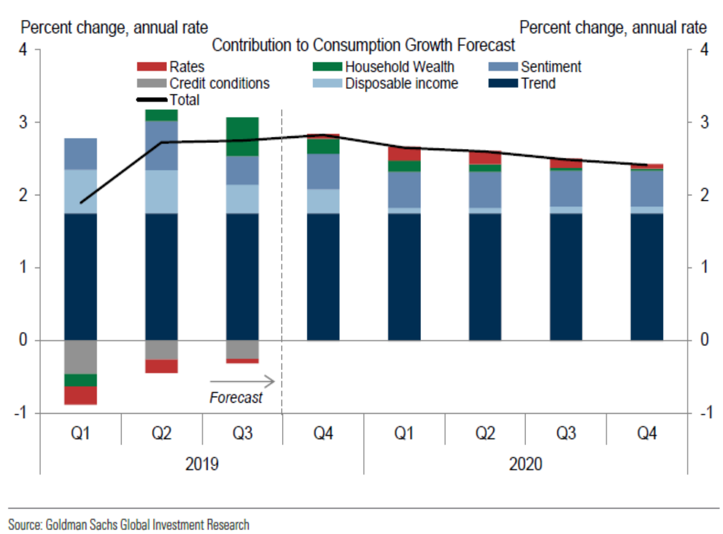
Global PMI Manufacturing	April	May	Jun	Jul	Aug	Sep	Oct	3mths trend
- Output	50.6	50.1	49.5	49.4	50.0	50.1	50.3	Improving
- New orders	50.1	49.5	49	49.2	49.0	49.4	50.0	Improving
- Export orders	49.0	49.0	48.8	48.3	47.4	48.0	48.9	Improving
- Inventory	49.5	49.1	49.4	48.8	49.3	49.2	48.1	Improving
- Employment	50.6	49.9	49.8	49.2	49.6	49.5	49.2	Worsen
Source: Markit PMI								

The important triumvirate is inflecting

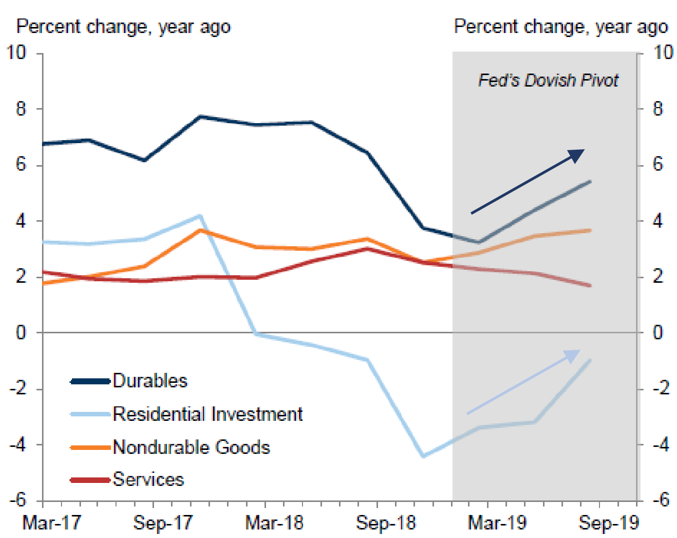


Tempering our bullish view is the continuous slide in the service sector survey which fell another 0.1pt in October for the fourth consecutive months of slide though it remains in at an expansionary level of 51.5. While the slide warrants scrutiny in the coming months **we do not subscribe to the view that the weakness in manufacturing has permeated irreversibly into the service sector.** Several reasons underpinned this positive view on consumption including the healthy clip of job creation in the US which is now the longest positive payroll on record and the increase in wages in the US and China at 2-3% and 8-10% pa respectively. These two countries account for a large part of the global services sector. GS believes **US household wealth has increased aided by the rise in housing prices and stock markets, which in turn should support consumption. Further, the Fed's policy pivot in Jan 2019 and a decline in oil price have also increased disposable income**. Consequently, they are forecasting above-trend consumption growth in the US of 2.7% in 2020. Evidence of this household strength can be seen in recent pick up in the housing market and consumption of durables goods consumption.

US consumption forecast to be above trend for 2020

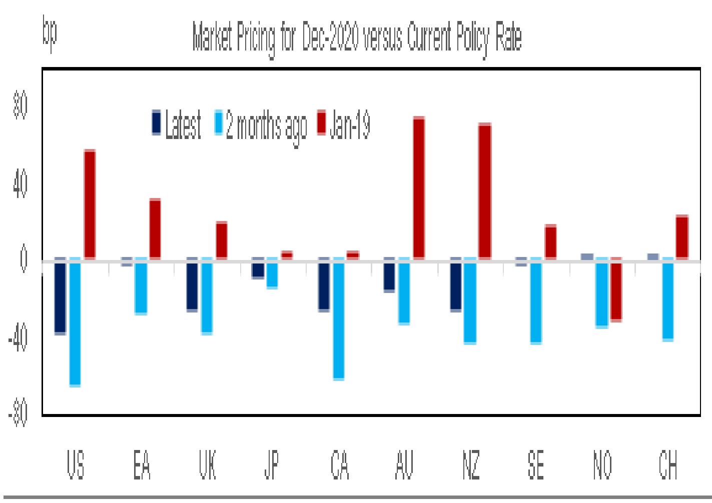


Evident in pick up durable and housing activities

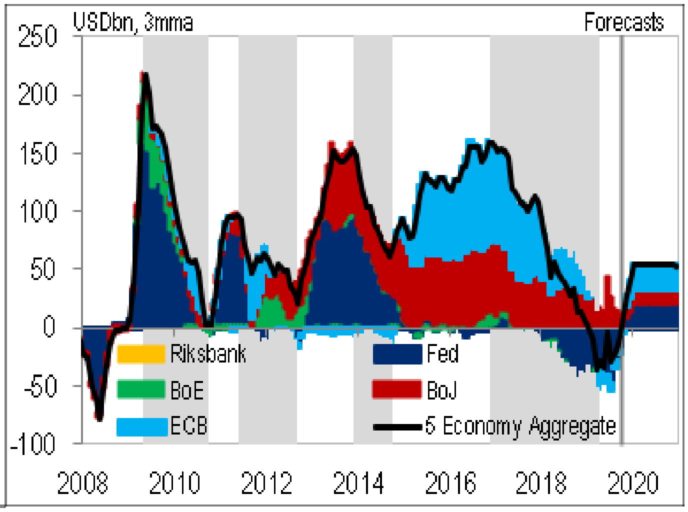


Monetary accommodation comprised of two parts: the quantity of money and the cost of money. We have seen 83% of central banks cutting rates in the last 4 months, the highest level since the onset of GFC, but we believe the pace for further lowering of the cost of money will slow. Insurance cuts have already taken place and most central bankers will abide time to assess how the policy filters into the real economy. A case in point is Fed's most recent signal that it has completed its mid-cycle adjustments of three 25bps cuts since the start of the year. However, **the quantity of money is expected to increase reversing the 2016-1H19 trend of central bankers' contracting their balance sheet**. While the announcement of ECB's QE2 was expected, the Fed intervention to supply liquidity in the T-Bill markets in mid-October when repo rates spiked was unexpected. What was more surprising is that it has kept the commitment to supply $60bn per month into 2Q20 even the stress in the repo market has abated.

Stark contrast: Tightening at start of year to easing now



Central banks balance sheet set to increase into 2020



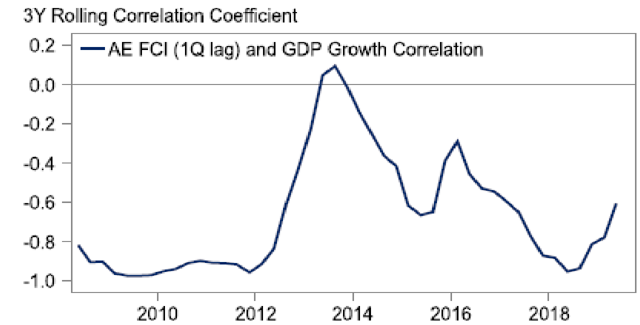
Source: Citi Research

While central bank dovishness has peaked, the liquidity they are supplying to the market is set to increase keeping financial conditions loose for the next 2 quarters. However, an accommodative financial condition whilst can provide the buffer to financial shocks, is less effective in addressing economic shock emanating from trade wars. A study by Citi Research shows the correlation between financial conditions index (FCI) to GDP growth has weakened since the onset of tariff imposed by the US against many of its trading partners. Simply put, more cheap money doesn't offset the higher cost of end-products nor reduce uncertainty to induce future investment. Leading to our last point, let's hope we have a "real-partial deal", the oxymoron of such a term. The impact of US-China saber-rattling has put the global economy perilously near the tinder box of recessions and war. No amount of central bank easing will rescue us from this conundrum.

FCI eased materially especially in China

Source: Bloomberg

But FCI impact to growth has weaken recently

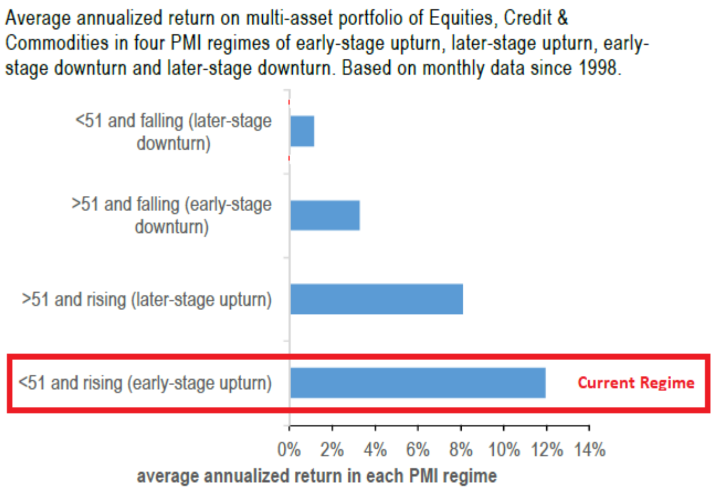


Note: FCI is moved forward 1Q. GDP growth is %YY.
Source: Bloomberg, Macrobond, National Statistical Offices, IMF and Citi Research

Asset Allocation Strategy

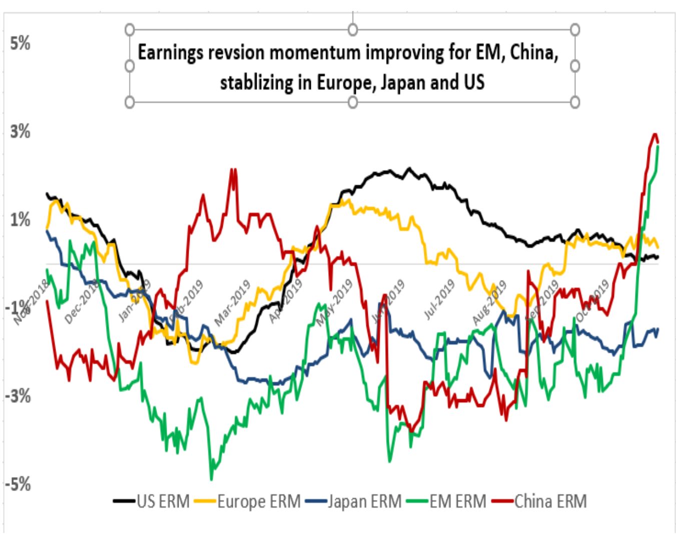
Equities: Another Upgrade from Neutral to Overweight. Our confidence in the view that the manufacturing sector is inflecting has grown with both soft and hard data collaborating this trend reversal. With history as our guide, the return profile of an early stage turnaround in PMI (below 51 and improving) has the highest return generating close to 12% for a multi-asset portfolio with equities and commodities registering the highest returns. Furthermore, as mentioned in our last Navigator, our EPS tracker continues to move higher driven by China, EM and with revision in Europe better than the US. In the past 2 months, we have already engineered a tilt in our Equities portfolio buying cyclicals and selling defensives and trimming growth for value. We added to commodities producing companies but reduced consumer staples. Financials are now as large as our tech exposures. At the regional level, we reduced our US equities and bought more international equities including more EM and Japan call options.

Best return regime is when PMI< 51 and rising



Source: J.P. Morgan

ERM improving supporting OW in Equities

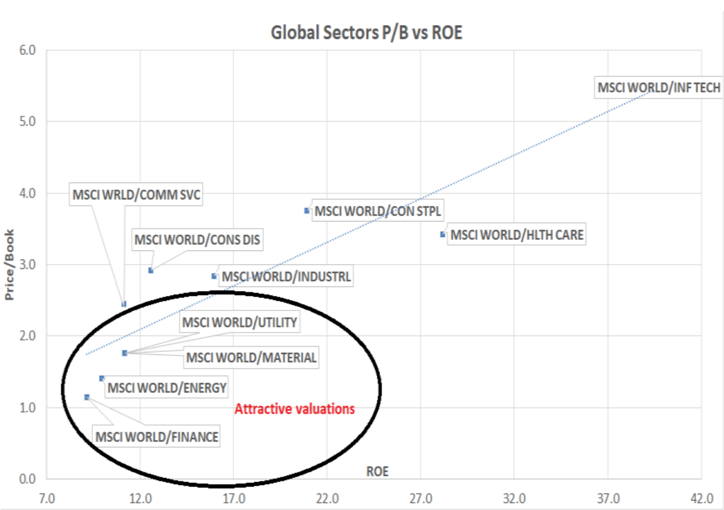


Fixed Income: Neutral. We continued to keep our duration short as we believe the market is still pricing too many rate cuts for 1H20. Any extension of duration will be within investment-grade credit to earn carry while opportunistically shorting treasuries to keep an overall duration low. Improving the credit quality of the portfolio remains key and across all mandates, high grade debt will be 20-30% more than high yield debt. Most of our high yield exposures will be via fund managers with a diversified portfolio approach and have navigated 2018 higher rates regime better than their peers. We have made little changes to our key FI managers but have been selling down our US rates risk in the last 3 months and any rates exposures are in the belly of the US curve or other developed markets government debt as a form of hedge to the overall portfolio.

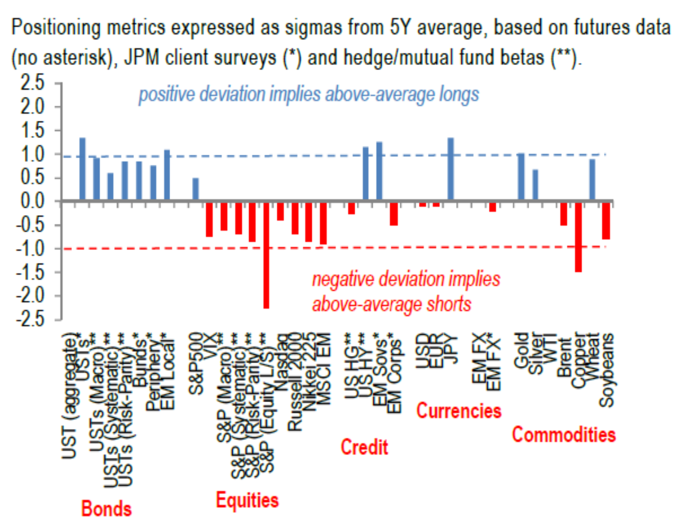
FX: Neutral. With all key central banks on an easing path, we doubt there will be any significant move in the DXY. The key to understand USD move is to monitor GDP growth differential in the coming quarters of 2020.

Commodities: Upgrade to Overweight although the preference to capitalize on this improving manufacturing view in the commodity space will be buying the equities of commodities producers as their valuations are quite compelling compared to other sectors. Physical copper and energy are the most under-positioned in the commodities space, while Gold positioning is very heavy. We have already sold our Gold exposure several months ago in sync with the development of our constructive view of the global economy.

Equity of energy and materials companies are attractive



Positioning in copper and energy is light, Gold is heavy



Alternative Investments: No change

Cash: Cash level reduced as we deploy more into equities and commodities.

Featured Picture/Quote: Bubble gum ban = PMD ban? Draconian and paternalistic.

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Risk Disclosure