Lighthouse Canton Monthly Investment Memo

August 2023

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2022 ASIAN PRIVATE BANKER AWARDS FOR DISTINCTION
BEST INDEPENDENT WEALTH MANAGER ASIA PACIFIC

PRIVATE BANKING AWARDS 2023 ASIAMONEY
RISING STAR, SINGAPORE

2021 ASIAN PRIVATE BANKER AWARDS FOR DISTINCTION
BEST INDEPENDENT WEALTH MANAGER WEALTH PLANNING SERVICES

GLOBAL Private Banking INNOVATION AWARDS 2022

2021 ASIAN PRIVATE BANKER AWARDS FOR DISTINCTION
BEST INDEPENDENT WEALTH MANAGER INVESTMENT ADVISORY

OUTSTANDING DIGITAL TRANSFORMATION IN COVID 19 BY A FAMILY OFFICE

BEST FAMILY OFFICE – MIDDLE EAST

BEST FAMILY OFFICE – UNITED ARAB EMIRATES

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SpotLight

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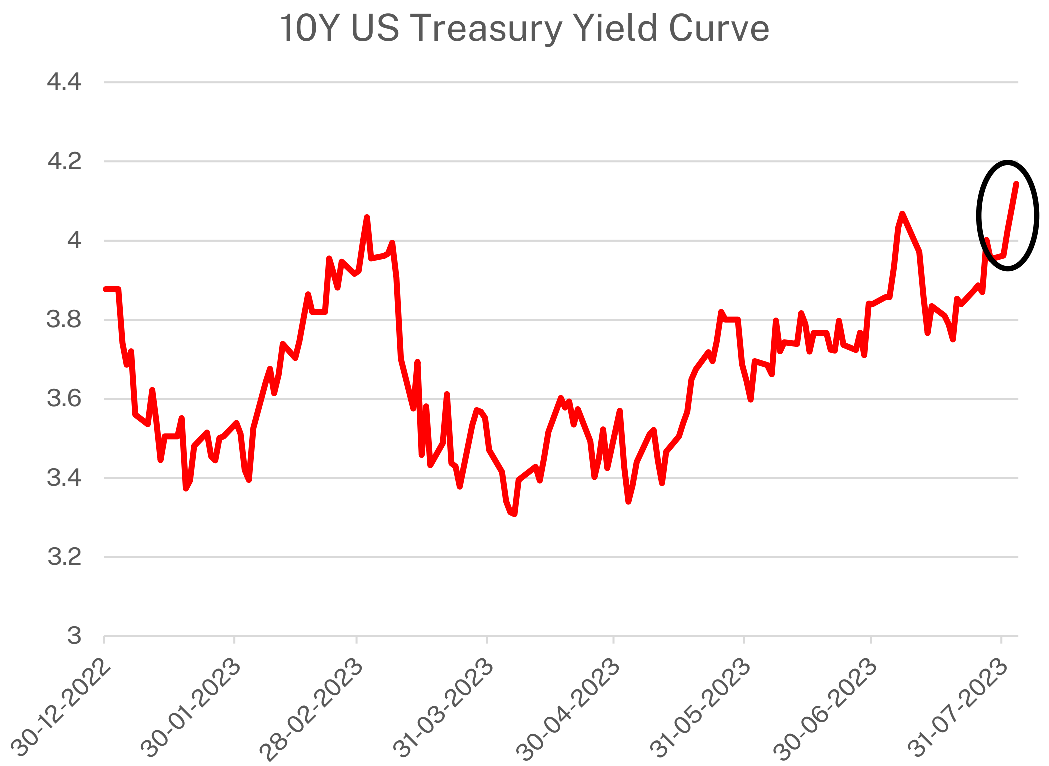
10Y Yield Back Above 4% and at YTD High

Treasury auctions, BoJ and strong labor data have been key drivers of the move up this month



- The 10- year yields have crept up from its regional bank crisis lows this year.
- Auction program also termed as Treasury Refunding, announced on 2nd August surprised on the upside, both on size of the auctions as well as nominal coupons. That put upward pressure on the yield and has been the key driver this week.
- Tight ADP jobs data added fuel to fire.
- BoJ's flexibility on the YCC (Yield Curve Control) increased the opportunity cost of holding US Treasuries thereby spiking up yields.
- While core inflation has trended lower YTD, the persistent tightness of the labor market will likely keep rate cuts at bay and put upward pressure on yields.

Source: Bloomberg, August 2023

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Market Updates

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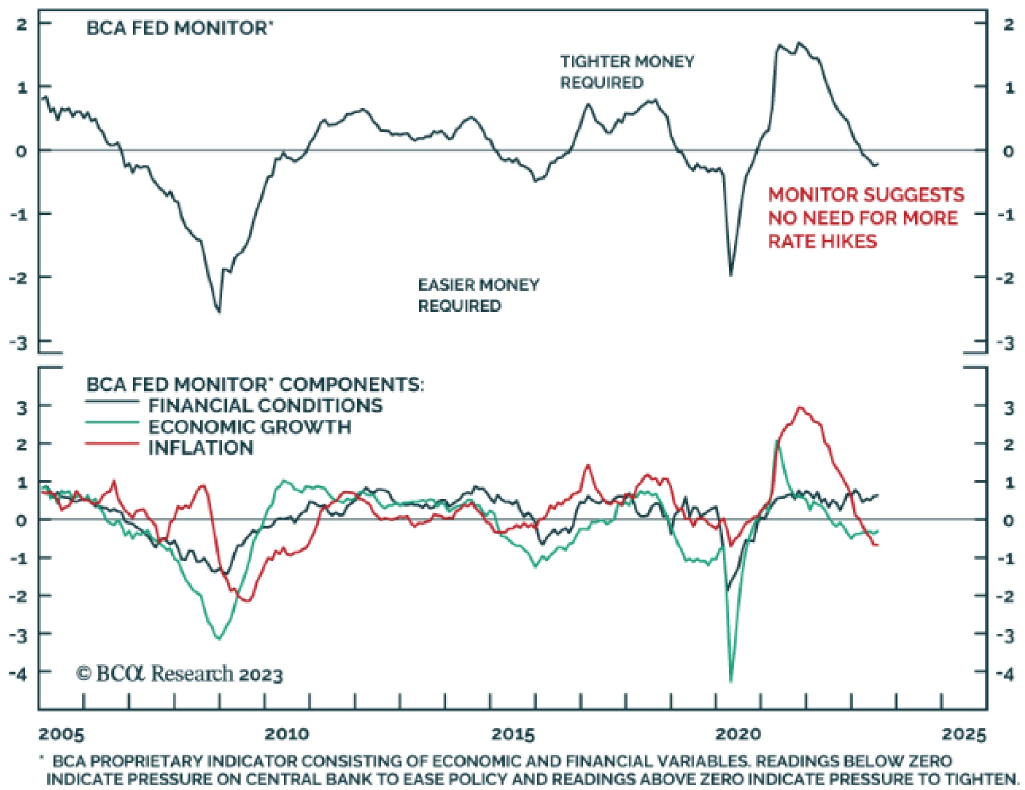
Balanced to Hawkish Tone at Jackson Hole

Pivot to Rate Cuts is Not Imminent

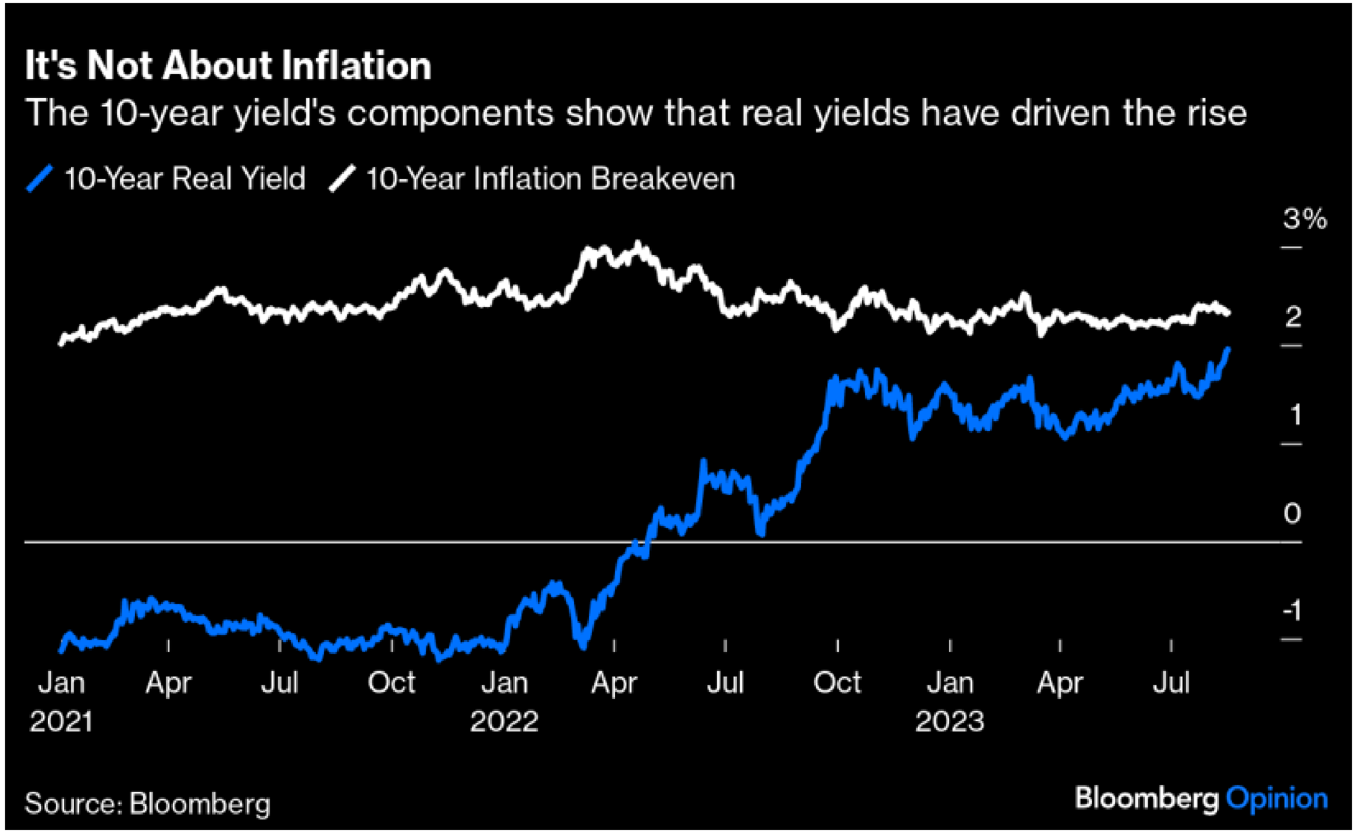


- Last Friday Fed Chair Powell’s Jackson Hole speech was relatively tame. 10Y yield ended the day broadly unchanged, while 2Y yield rose by 5.5 bps.
- On policy outlook, he said that the process of bringing down inflation “still has a long way to go” and the Fed is “prepared to raise rates further if appropriate, and intend[s] to hold policy at a restrictive level until [it is] confident that inflation is moving sustainably down toward [its] objective.”
- According to BCA, there is a possibility that falling inflation will keep the Fed on hold over the remainder of the year; and yet the US has not experienced the full effect of the monetary tightening cycle. And the tone of Powell’s speech suggests, unless there is a meaningful deterioration in the economy, a pivot to rate cuts is not imminent.

 Source: BCA, August 2023

Investors are Poised for the Fall in Yields

But is it Happening?

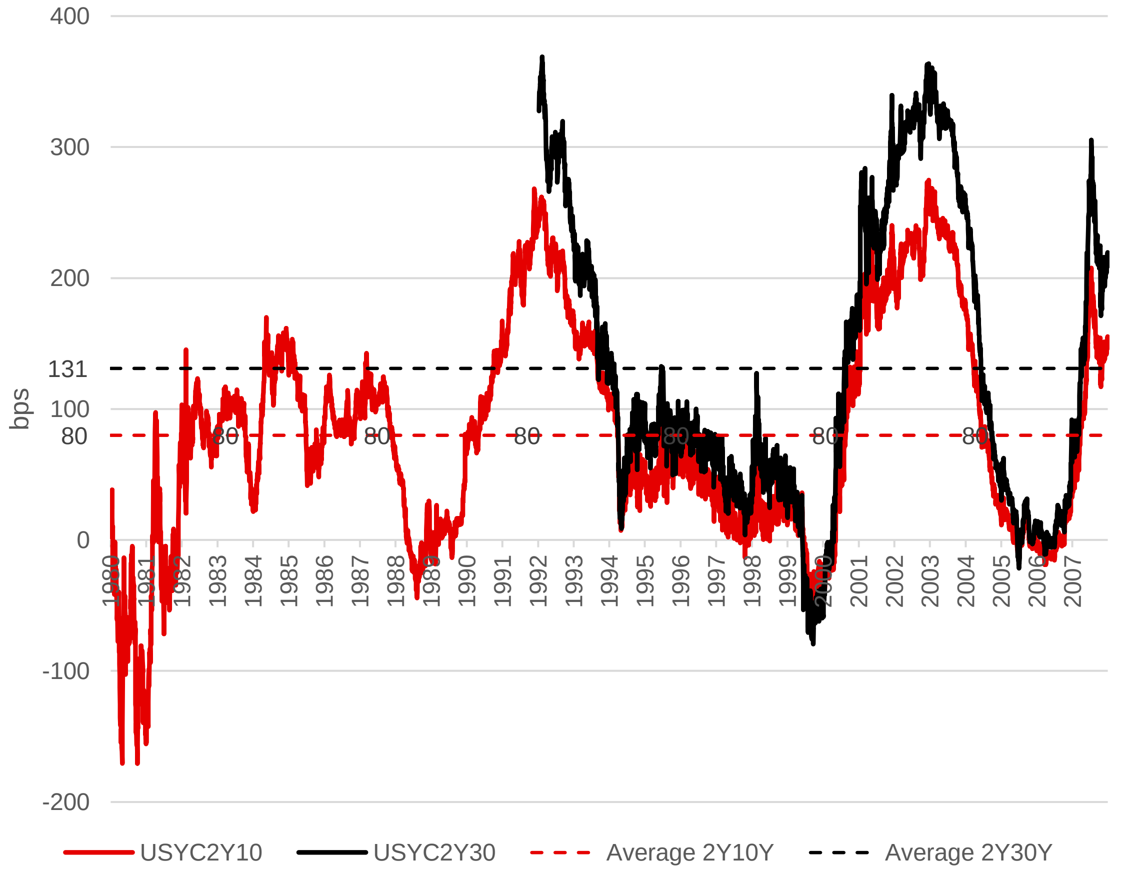


- Breaking the 10-year yield into its components 1) implicit expected inflation in the next 10 years (10Y inflation breakeven) 2) real yield, we find that shifting projections for the price levels have had more or less nothing to do with it.
- The push to higher real yields looks set in play and shows a likely structural shift away from the GFC-era levels is underway, and a spread of 2% or greater above inflation expectations makes sense for the 10Y UST.
- Reason for rising real yields could be the belief in a resilient economy in which minimal post-GFC interest rates will no longer be appropriate.

 Source: Bloomberg, August 2023

Keep Duration Below 10 Year

Extending Duration Beyond Might Not Pay-Off



- Market is pricing in 4-5, 25bps rate cuts next year and a pause for 2023. At current 5.25% lower bound of Fed Fund rate, if one is to price in 5 rate cuts, Fed Fund rate would be at 4%.
- Looking at UST2Y10Y from 1980-2008, gives us an average of 80bps and 131bps for UST2Y30Y. Therefore, one could assume that if 2Y UST is at 3.5%, 10Y UST would be around 4.3% (current 4.35%) and 30Y UST at 4.81% (current 4.45%). In other words, 10Y and 30Y might not move much from these levels.
- Even if the US managed a soft landing or no landing, where no rate cut is expected, in a normalized upward sloping yield curve where the economy is resilient, one would expect the 10Y and 30Y UST yields to rise, and not fall, from here.

 Source: Lighthouse, August 2023

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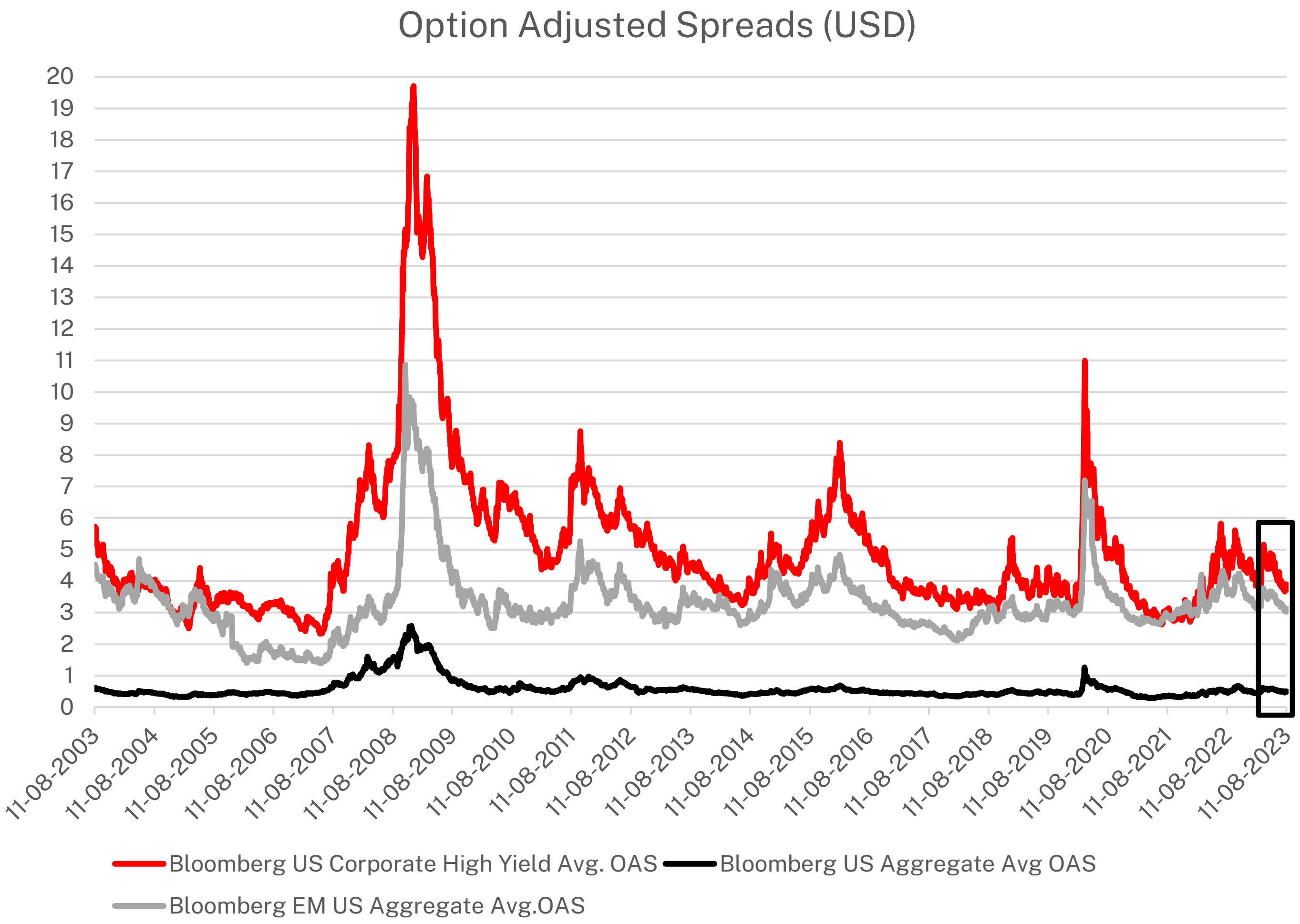
Valuations expensive across the board

Spreads trading at lows despite higher rates.

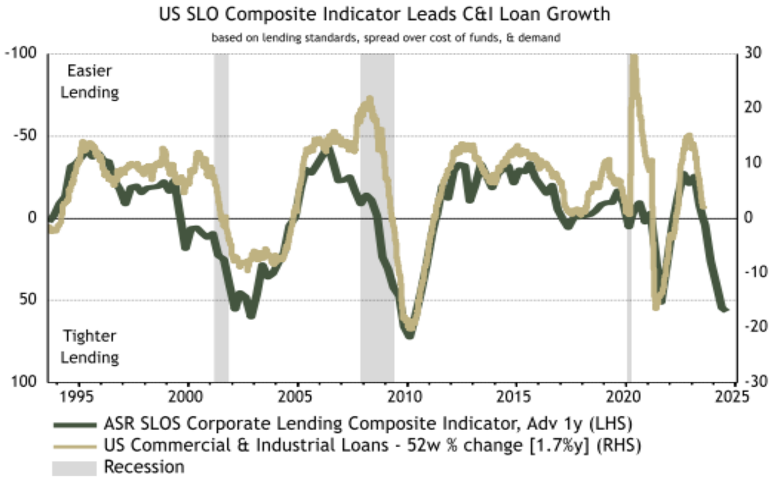


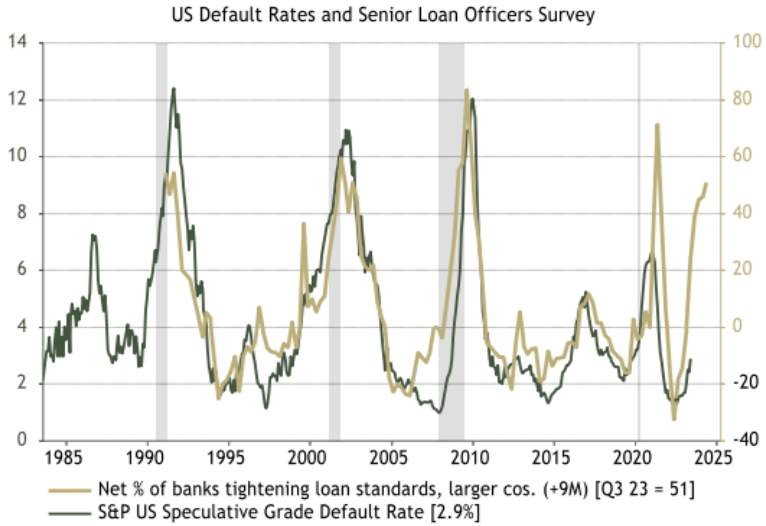
- Option adjusted spreads in USD credits have seen sharp declines since their pandemic highs.
- Return of risk appetite on back of expected soft landing most likely is the primary reason behind the compression.
- HY credits have seen the sharpest spreads compression on back of tighter supply.
- On a fundamental perspective, spreads do not reflect enough of risk premium for deteriorating credit conditions.

 Source: Bloomberg, August 2023

US SLO Survey Warns of Potential Credit Crunch

Expect Higher Default Rates and Rising Bankruptcies



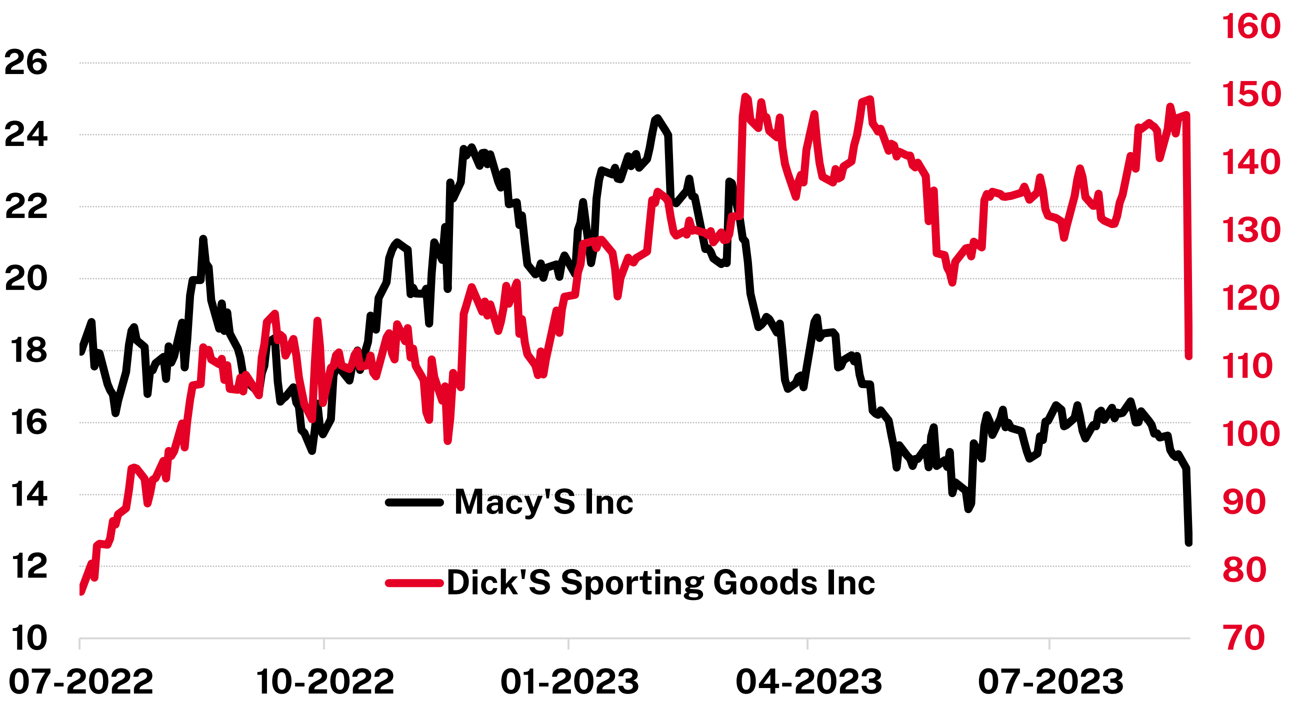


- One reason why the market for risk assets has stayed stronger for longer is because Credit has continued to grow. But that could significantly change over the coming year, with the SLO Survey at levels consistent with a 10-15% contraction in C&I lending.
- On the lower chart, its shows that the SLO Survey has been a reliable leading indicator of the speculative default grade. Rating agencies are now upgrading their default projects and this chart suggests, through an extrapolation, a default rate as high as 8% a year from now.

Source: ASR, August 2023

Signs of Slowing Consumer Spending

Retailers are now encountering a more discerning consumer, resulting in reduced revenue and profitability



Source: Bloomberg, August 2023

- Retailers like Macy's and Dick's sporting goods have started to flash warning signs on US consumer spending. Macy's reported a decline in sales primarily caused by markdowns to clear inventory, for the June quarter and noted rising credit card delinquencies. On the other hand, the sporting goods retailer missed Q2 earnings expectations; slashed its full year outlook and posted elevated inventory numbers. Both shares corrected by 14% and 24% respectively, on Tuesday.
- Nike posted a record 9 day losing streak as of 22nd August, on the back of sluggish Chinese consumer spending recovery and elevated inventory levels, which have continued to weigh on profitability.

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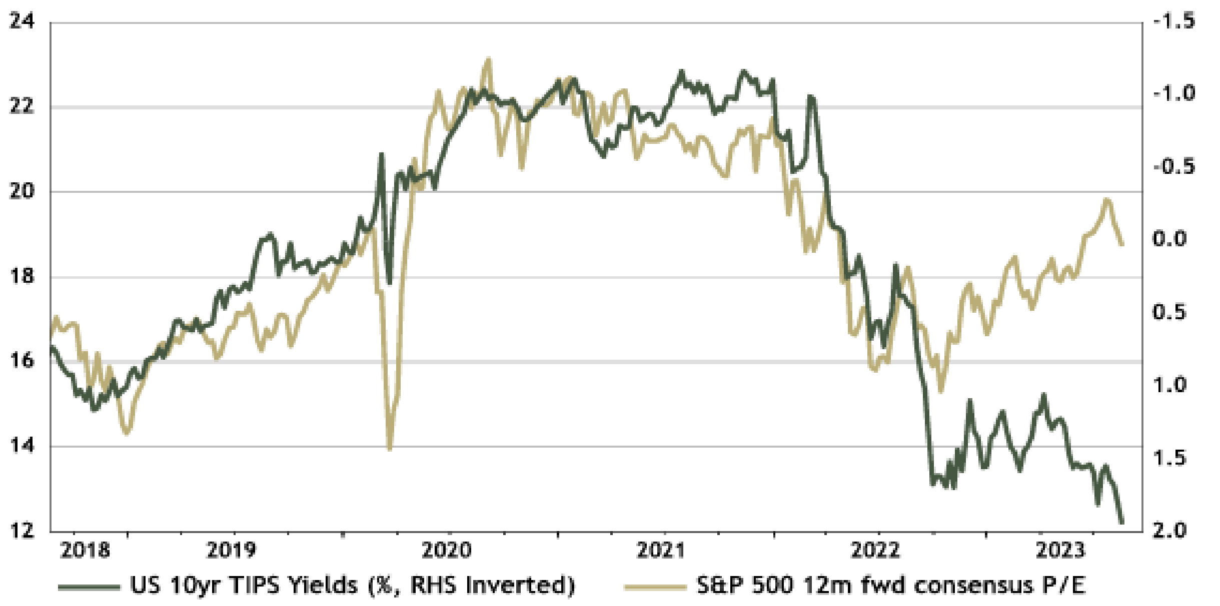
Divergences Between Stocks and Real Yields

Multiple expansion at risk of fading should real yields continue to rise

Chart 7: S&P 500 12m fwd P/E vs US 10yr Real Yield (Inverted)



- The recent rise in real bond yields poses a risk of equity contraction over the next year due to high valuations.
- Unless there's a significant drop in real yields, probably from inflation expectations revised lower, equities could continue facing downward pressure.
- Sectors sensitive to longer durations, especially those linked to growth, seem particularly at risk and may lag behind.

Source: ASR, August 2023

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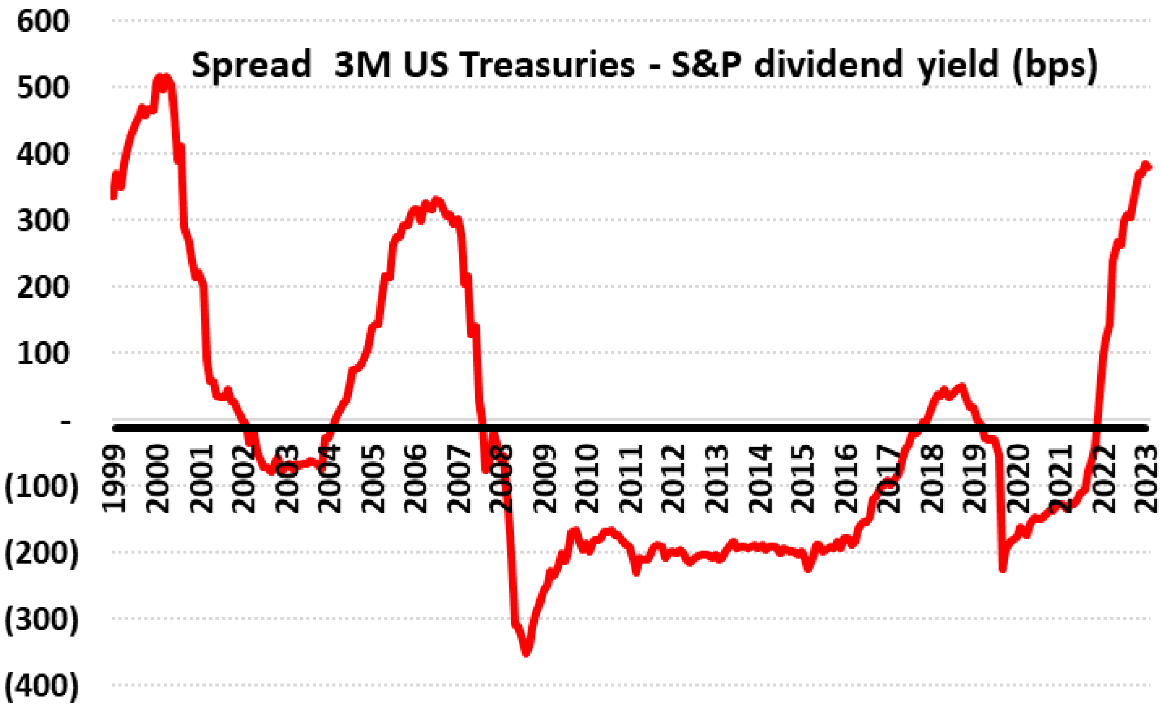
R.I.P. T.I.N.A.

TINA era is over

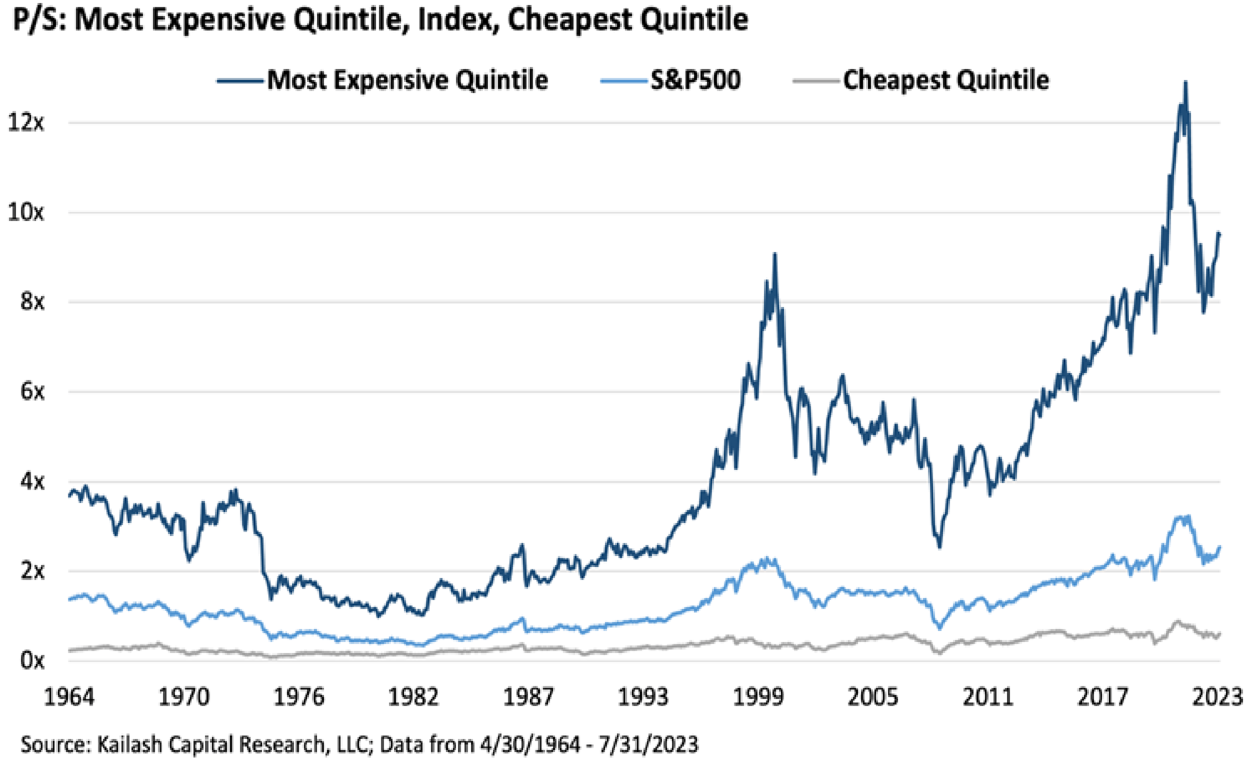


- The divergence between the yield of 3-month US Treasuries and the dividend yield of the S&P 500 has surged to a significant 400 basis points, a threshold not observed since the dot-com bubble. This notable shift signifies the conclusion of the TINA (There Is No Alternative) era, a period characterized by near-zero interest rates that essentially compelled investors to turn to equities for returns.
- With a spread of 4% favouring bonds, we reiterate our stance to strategically allocate to fixed income while maintaining a cautious stance towards equities. It's worth noting that such a wide spread occurred in 2000 and 2007, both of which were followed by pronounced corrections in the equity markets.

Source: Lighthouse Canton, August 2023

US Equities: Forewarned Is Forearmed

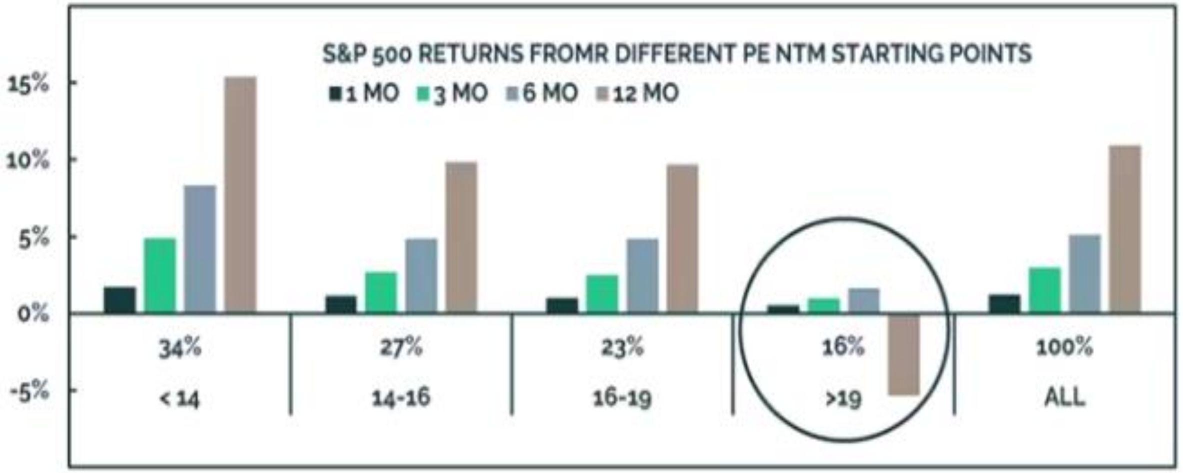
The top 20% of the S&P 500 index are (most likely) overvalued, mirroring dot-com era levels.



- Navy Blue Line: the price-to-sales ratio of the 100 most expensive stocks in the S&P 500 (quintile)
- Light Blue Line: the price-to-sales ratio of the entire S&P 500
- Gray Line: the price-to-sales ratio of the 100 cheapest stocks in the S&P 500 (quintile)

Expensive Multiples Return Lower Profits

Forward P/E at 18.5x for S&P 500: is now the right time to buy equities?



Source: BCA, August 2023

- Contrary to typical investor behaviour, where equities are purchased during the late stages of bull markets and sold at a loss during corrections, adopting a contrarian approach to stocks yield higher returns.
- BCA Research shows that the greatest returns, inclusive of both price appreciation and dividends, are achieved when buying equities at a low valuation, i.e. when the S&P 500 index Price-to-Earnings (P/E) ratio is 14 or below.
- Conversely, returns tend to be negative over a 12-month period, when purchasing stocks with a fwd. P/E ratio of 19 or higher. Since the P/E currently sits at 18.5x, investors should wonder whether this is a good time to add equities in a portfolio.

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