Investment Playbook
Weekly Update

14th to 18th August 2023

LIGHTHOUSE
CANTON

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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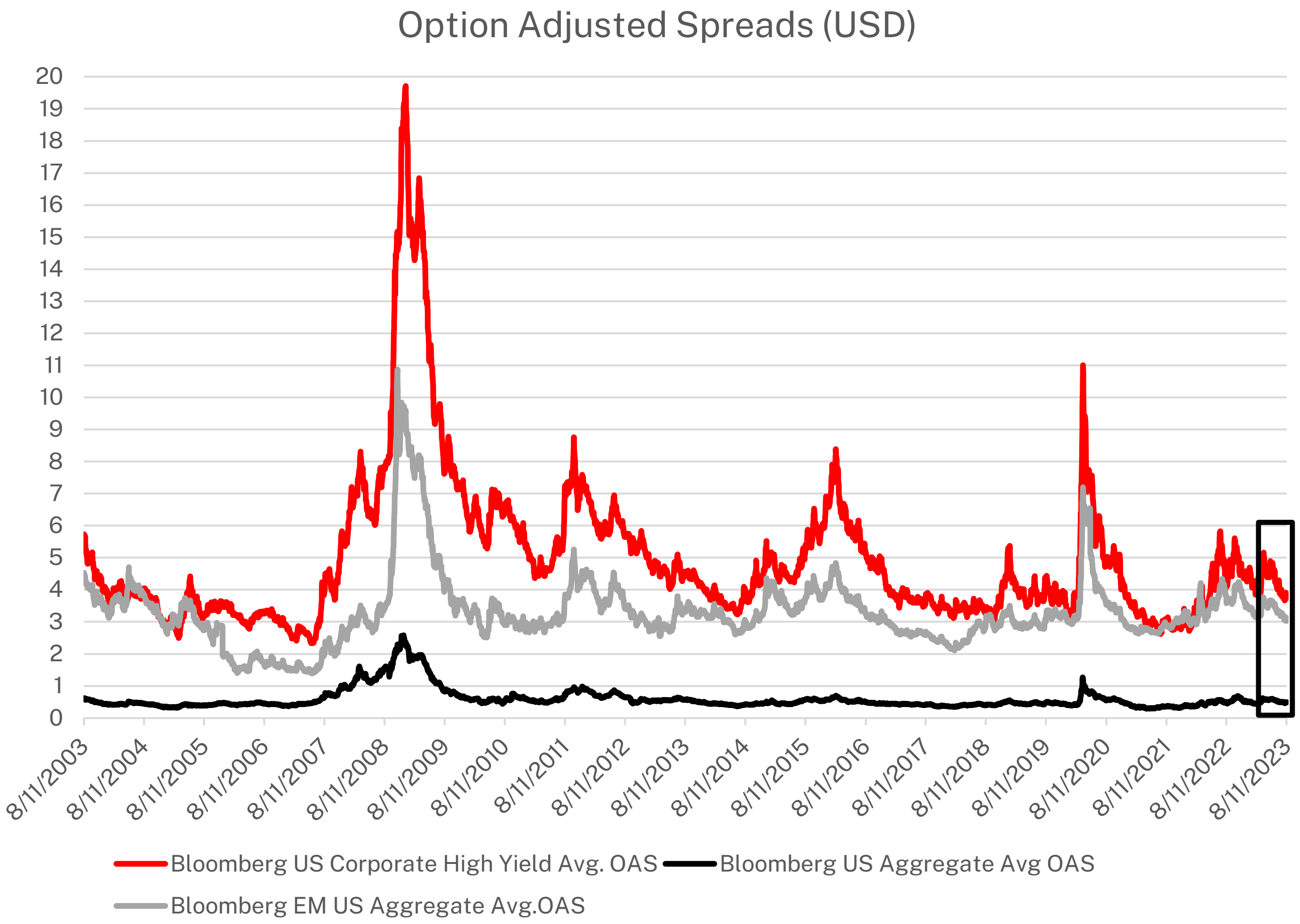
Charts of the week

1

Valuations expensive across the board

Spreads trading at lows despite higher rates.



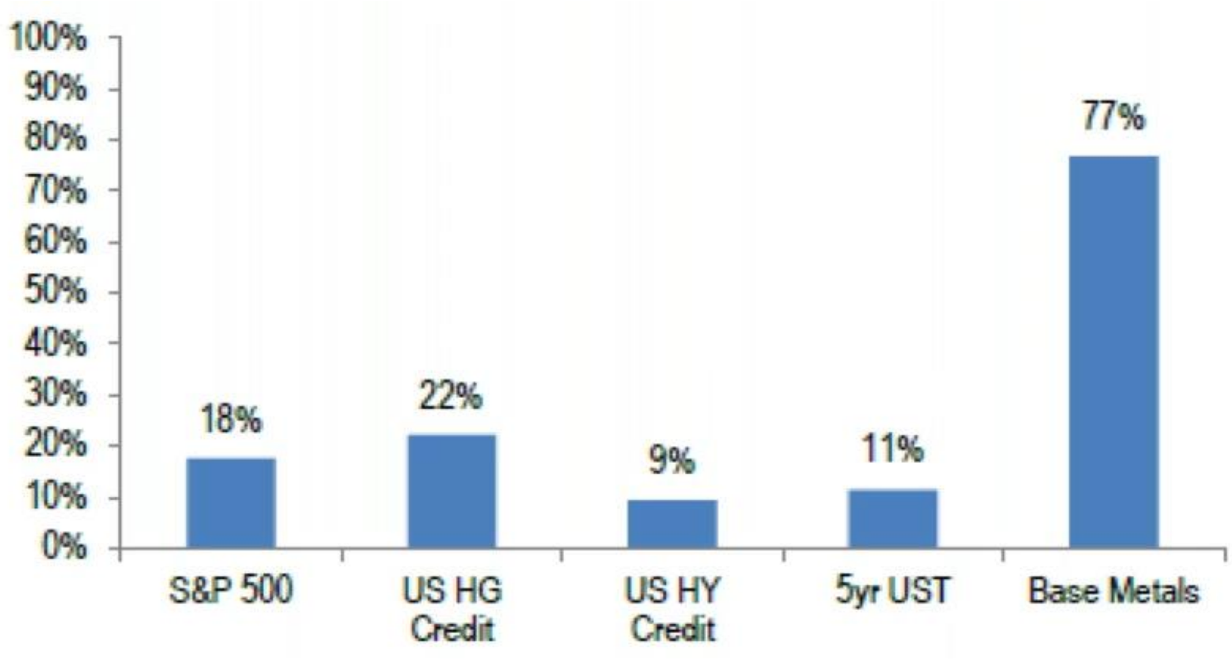
Source: Bloomberg, August 2023

- 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.

Divergent Recession Expectations Across Markets

US High Yield Implied Probability Seems Most Optimistic

Figure 1: Probability of recession priced in across US asset classes based on JPM calculations.



Source: JPM, August 2023

- As a continuation from the previous slide, the chart on the left marries well with our view that credit markets seem to be leaning more towards a no landing / soft-landing rhetoric.
- On the other end of the spectrum, cyclical base metals markets seem to be pricing in a more bleak outlook on the US economy.
- Without getting into which market is right, we think the risk/reward of risk assets in the next 12 months are not favourable especially given the elevated valuations (both on credit and equities) relative to deteriorating fundamentals.

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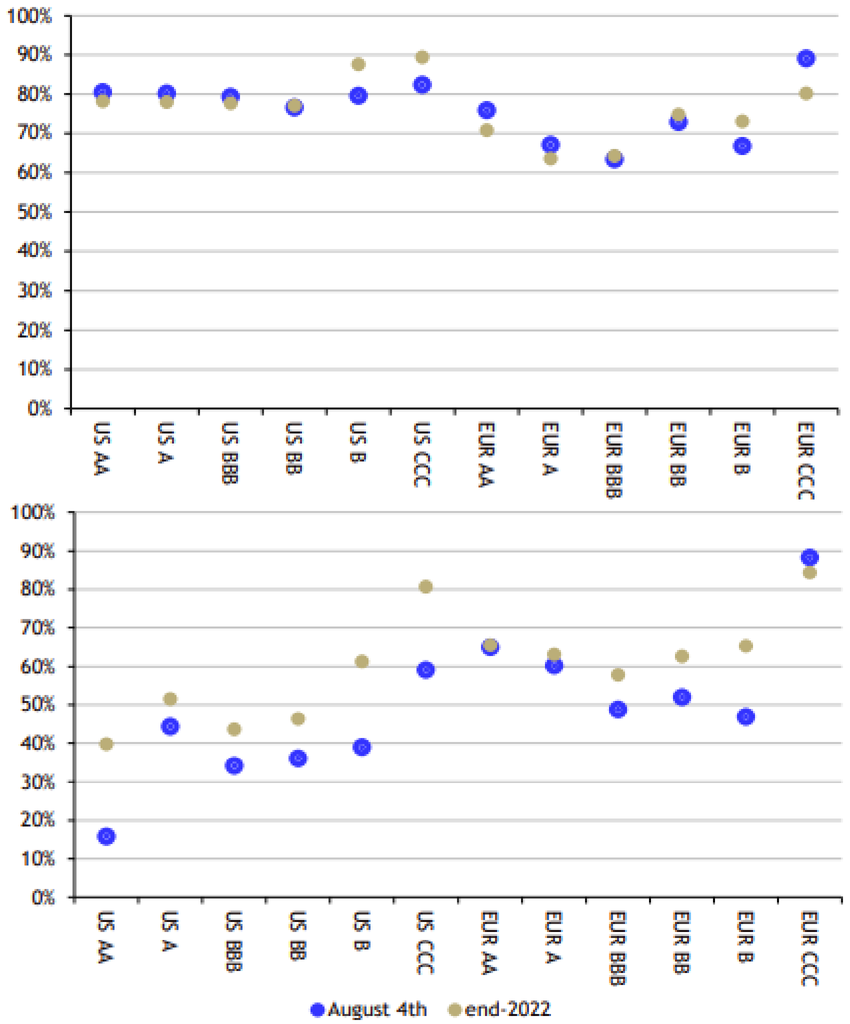
Yields are Still at Elevated Levels

But Spreads are Tight



Source: ASR, August 2023

- All-in yields are still elevated in terms of post-2005 percentiles – more so in the US (77th – 82nd percentiles) than EUR (see top chart).
- However, spreads are much less elevated in an historical context (see bottom chart).
- From a fundamental perspective, they do not reflect enough of a risk premium for deteriorating credit conditions.

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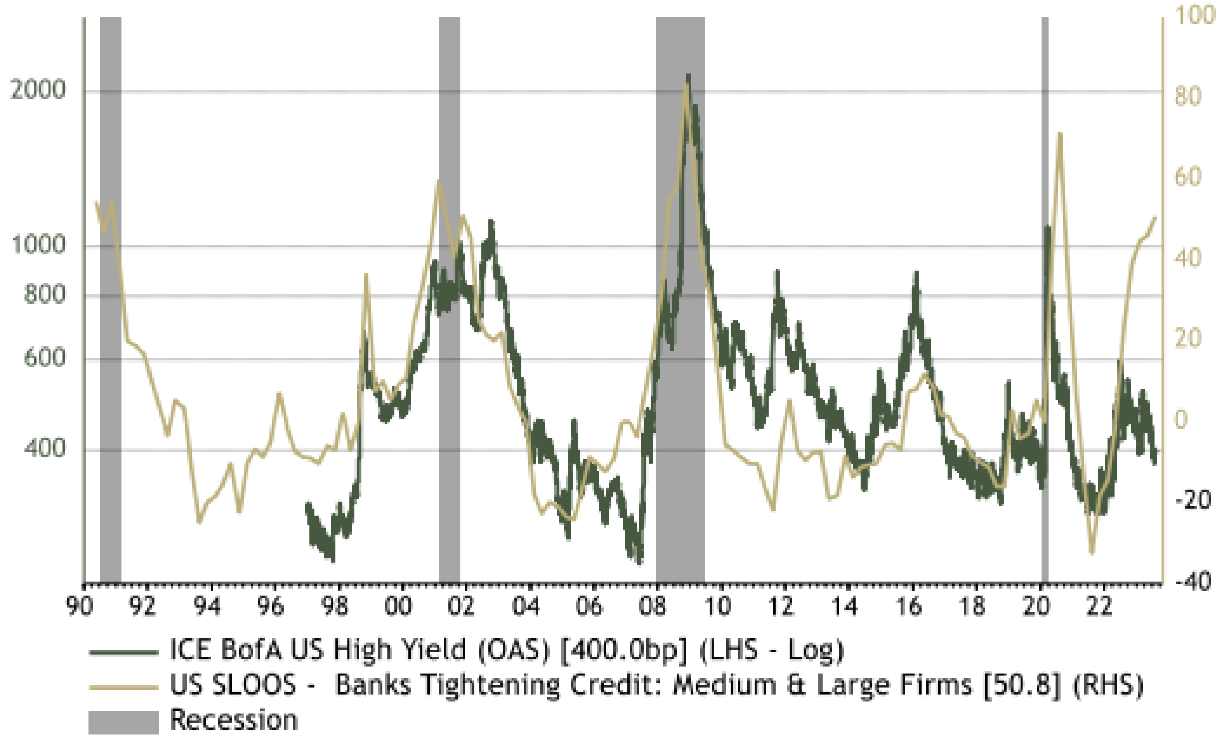
Risks of Spreads Widening

Remain Selective in High Yield Bonds



Source: ASR, August 2023

- The recent narrowing of spreads, particularly in the High Yield sector, looks incongruous against the backdrop of another tightening of banking lending standards in the Senior Loan Officer Opinion Survey (SLOOS).
- This suggests risks are skewed towards wider spreads.

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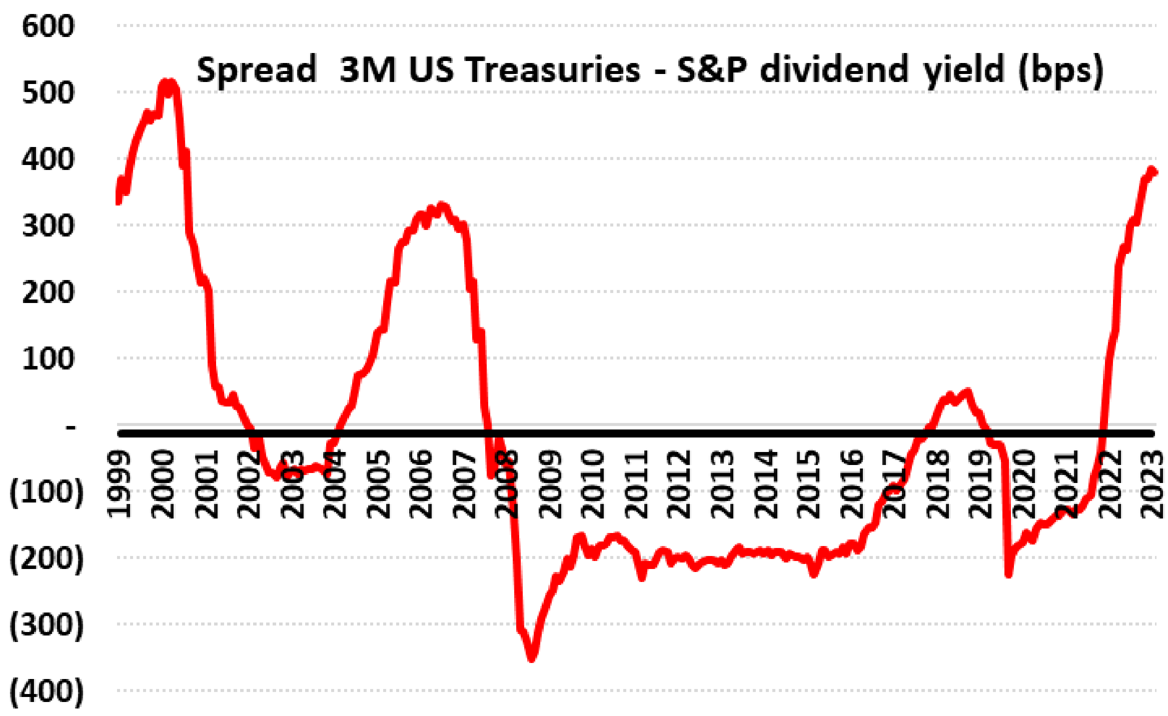
R.I.P. T.I.N.A.

TINA era is over

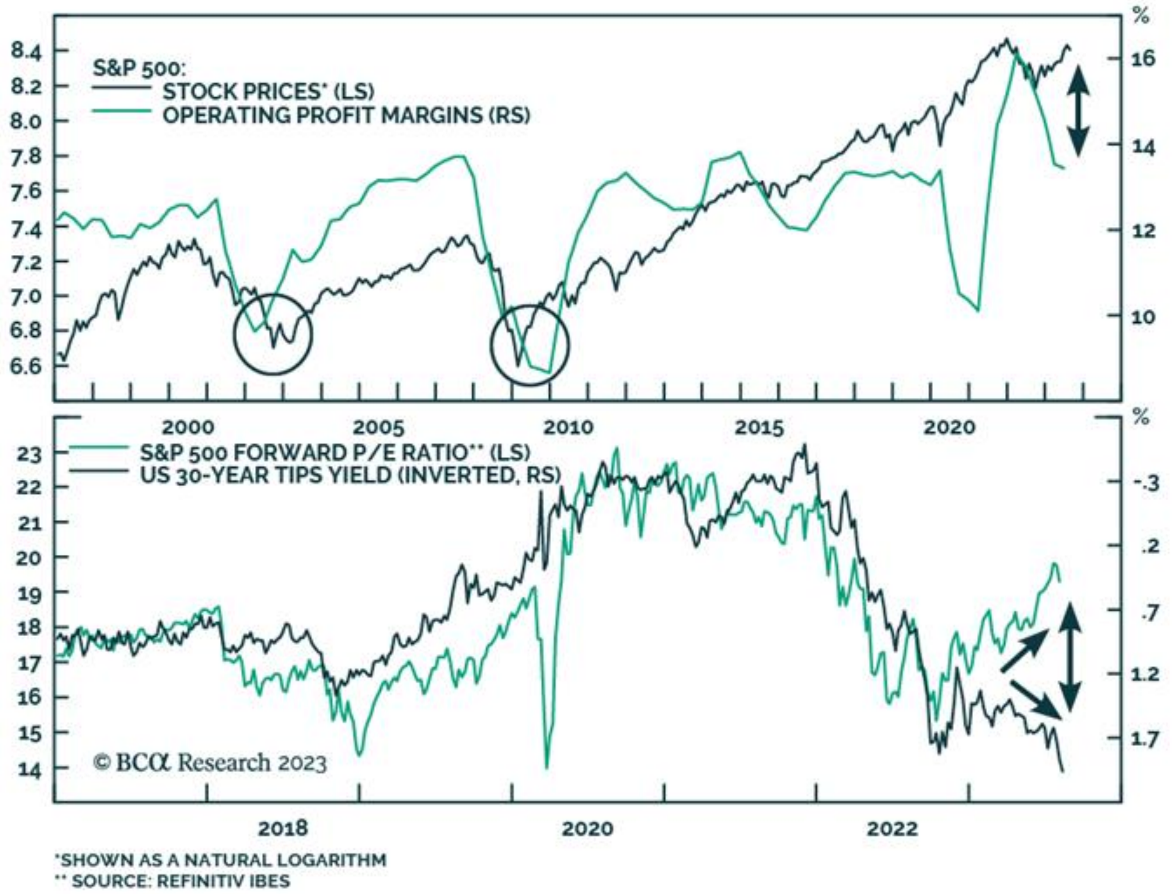


Source: Lighthouse Canton, August 2023

- 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.

Unsustainable Divergences

According to BCA research, two divergences are pointing to lower US equities going forward



Source: BCA Research, August 2023

- The gap that has formed between the S&P 500 price and its operating profit margins, as well as the divergence between the S&P 500 Forward P/E ratio and the 30-year TIPS yield are unsustainable according to BCA research.
- Indeed, faster growth in unit labour costs than in corporate prices will exert more downward pressure on company margins. To prevent profit margins from shrinking, companies would have to hike prices faster than the pace of increase in unit labour costs. If they do so, the outcome will be enduring inflation. In this context, the divergence between rising US TIPS yields (shown inverted) and the S&P 500 P/E ratio is especially puzzling.

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Are higher yields good for stocks?

The inverse correlation between the 10-year treasury yields and stocks has not been holding, since May 2023

Source: BCA Research, August 2023

- Theoretically, higher treasury rates (risk free rates) are supposed to have a negative impact on stocks, primarily in the form of higher discount rates being utilized in valuation exercises.
- The last time we saw yields cross 4.2% (back in October 2022) the S&P500 was trading at 3,600 points, 900 points below current levels and we see this to be yet another sign of markets being overly optimistic.
- We expect higher yields to be especially negative for high growth stock, given that lot of their value is derived from their future earnings power, which are now going to be discounted using higher rates.

LC Views - Summary

2

LC Views Summary (1/2)

Sub-Asset	Recommended Positioning
Rates	• The Federal Reserve hiked 25bps in July FOMC as widely expected. The lack of substantive changes to the policy statement suggests most officials still want to keep the door open to another rate hike. But Chair Powell's somewhat dovish performance at the news conference suggests a willingness to skip a hike at the September meeting, provided inflation data continue to be soft. He indicated that real rates are well above neutral and already restrictive, several times characterized June's soft CPI report as "better" than expected, said credit conditions are tight and getting tighter. Market participants are now pricing in a very low probability of a rate hike in September and 5 rate cuts next year. However, we urge against complacency as Powell continued to stress the Fed's determination to bring inflation back to the 2% target. Hence, we would not rule out another rate hike this year.
Credit	• We continue to favor investment grade bonds to build a strong foundation for the portfolio and seek to compliment the latter with selective high yield bonds for yield enhancement. While we recommend to allocate a larger portion of the portfolio in short duration bonds due to the elevated yields, we are actively extending duration (in IG credits) into the 5-10Y space with the spike in treasury yields. Due to the challenging economic outlook ahead, we see further opportunity in special situations bond funds, which could provide asymmetric returns in a prolonged distressed and disruptive credit market.
Equities	• Although present economic data doesn't point towards a substantial GDP contraction for 2024/25, higher rates will inevitably dampen corporate earnings. Equity valuations appear to be overlooking potential earnings contraction in the coming quarters, a misstep in our view. While some valuations, like Microsoft and Google, seem reasonable, a plethora of stocks, including Nvidia and Tesla, appear largely overvalued. Of note is the growing gap between the yield of 3-month US Treasuries and the dividend yield of the S&P 500, which has widened to an alarming 400 basis points. Such large differentials were previously observed in 2000 and 2007, both preceding significant equity downturns. Given these inflated valuations, any unfavourable news could catalyse swift profit-taking by investors. Additionally, it's worth highlighting to our clients that the last time US 10-year yields hit 4.2%, the S&P 500 stood at 3,600 – a stark 900 points beneath today's figures. Consequently, we maintain our cautious outlook on equities for the next six months and recommend (in order of preference) Long/Short managers, options (FCNs or Puts), and quality stocks.

LC Views Summary (2/2)

Sub-Asset	Recommended Positioning
Currencies	• **Currencies** are expected to remain volatile throughout 2023. Given higher recessionary risks, the USD may strengthen over a short-term tactical horizon but for longer term investors, we continue to hold the view for a bearish USD. Exposure to JPY, EUR and GBP could be increased over time to benefit from the recent lows and a peak in dollar's strength driven by peak policy rates. We also recommend adding active managers (Macro funds) to monetize opportunities in currencies and rates.
Commodities	• Our long-term view for a bearish USD is likely to be supportive for Gold. We also like the yellow metal for structural reasons: diversification benefit, inflation hedge, geopolitical risk and de-dollarization trend. • Oil is likely to remain highly speculative this year as witnessed in March. On one hand, recessionary fears should temper demand. On the other hand, the production cut by OPEC+ members and already low oil inventories will support prices in the near term.
Real Estate	• Tightening financial conditions have started to cause sharp repricing in property prices globally and threaten rental growth rates. The risk of further correction in real estate prices should not be underestimated. There will be opportunities to pick good REITs cheaper next year. • With the recent banking turmoil, Commercial Real Estate exposure is increasingly at risk given the large exposures the smaller banks have to the sub-sector. Clients holding on to any related exposures should consider removing them.

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