LC Investment Playbook Weekly Update

22 April 2022

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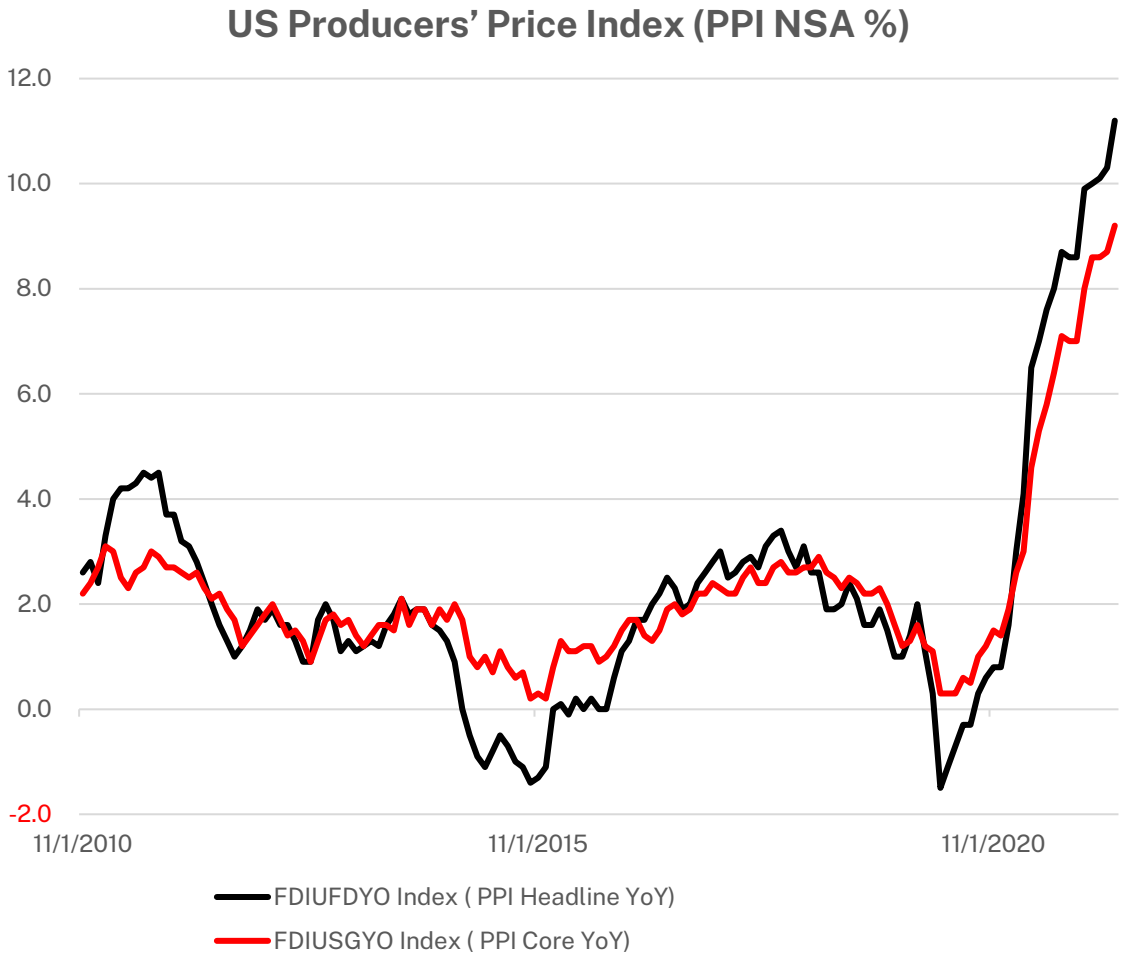
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Macro Highlights

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Red hot US Inflation

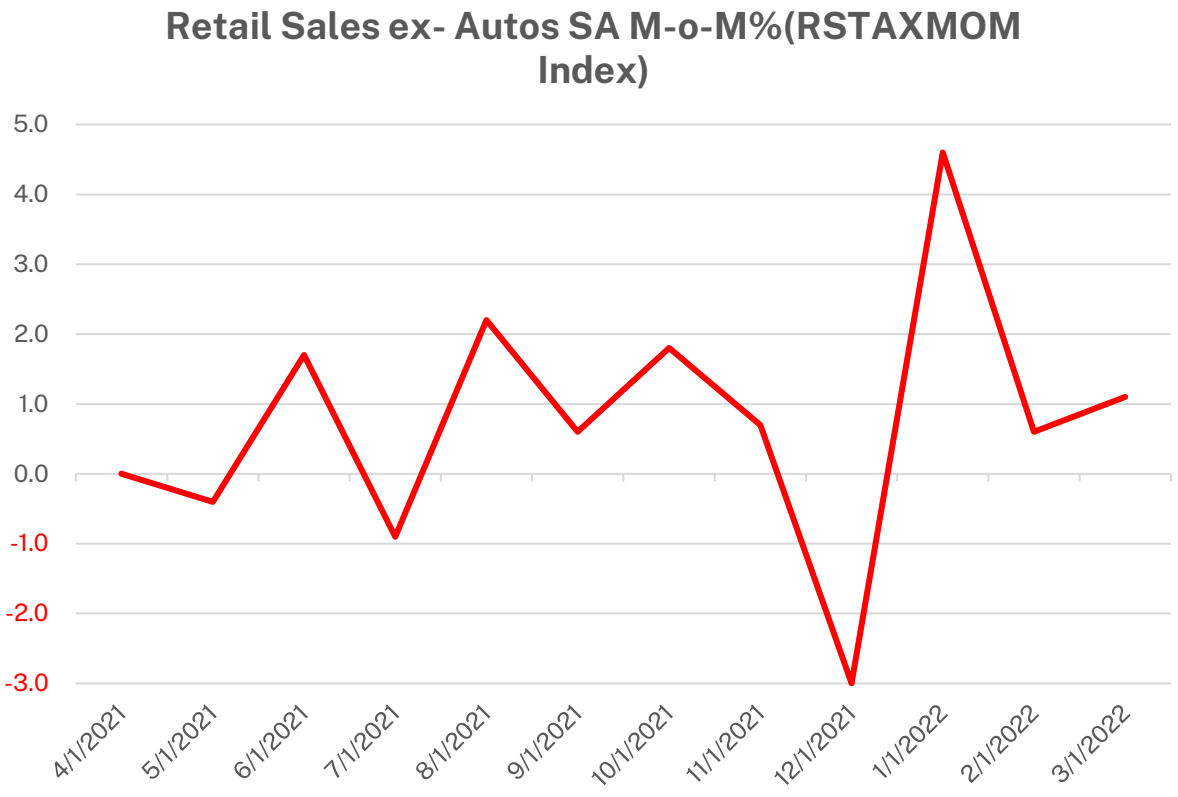


Source: BLS, Lighthouse Canton, Bloomberg dt. 15th April 2022

- US Headline PPI YoY came in at 11.2%, highest in last 4 decades. This was against a prior reading of 10%. This data is starting to show the impact of higher energy costs owing to the war in Europe.
- Core PPI YoY came in at 9.2% against a consensus of 8.4%. This was against a prior reading of 8.4%. This is perhaps a sign that inflation in the US may be peaking as also mentioned by Fed's Bainard yesterday.
- Prices of transportation (freight costs and airfares) and warehousing services spiked to record high levels .
- Increase in PPI will most likely be passed on to consumers, at least partially, thereby increasing the likelihood of higher CPI readings in future and the theory of peaking Core CPI vanishing in thin air.

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Resilient Consumers despite Inflation

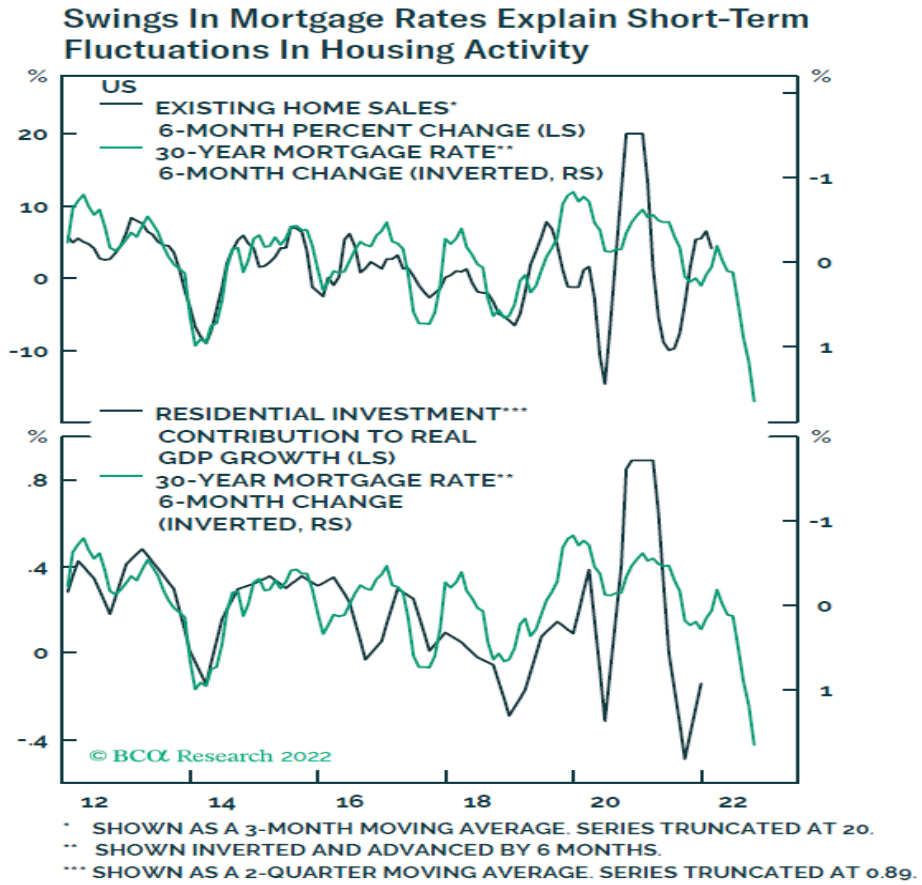


- Retail sales ex-autos in US grew by 1.1% on month-on-month basis against prior reading of 0.2%. University of Michigan's sentiment survey showed households grew more upbeat (reading of 65.7)
- While energy prices pushed retail sales up, discretionary spends in apparel and restaurants far outstripped inflation. This is largely attributed to easing restrictions.

Source: US Census Bureau, Lighthouse Canton, Bloomberg dt. 15th Apr 2022

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Housing is Key to Fed's Hawkish Limit



Source: National Bureau of Economic Research, BCA, 18th Apr 2022

- According to a 2007 research paper published by the NBER, 65% of weakness leading up to recessions are driven by the consumer side, and not business.
- Prior to commencement of recession, the first item to soften and the first to turn back up is residential investment, followed by consumer durables, consumer nondurables and then services.
- The Fed therefore, would be cognizant in ensuring the degree of hawkishness does not jeopardize housing activity in the US
- The US housing market has started to cool, but remains in reasonably good shape despite rising rates. It supported by rising incomes and near record low home vacancies. Furthermore, changes in mortgage have not reached crippling levels, yet.

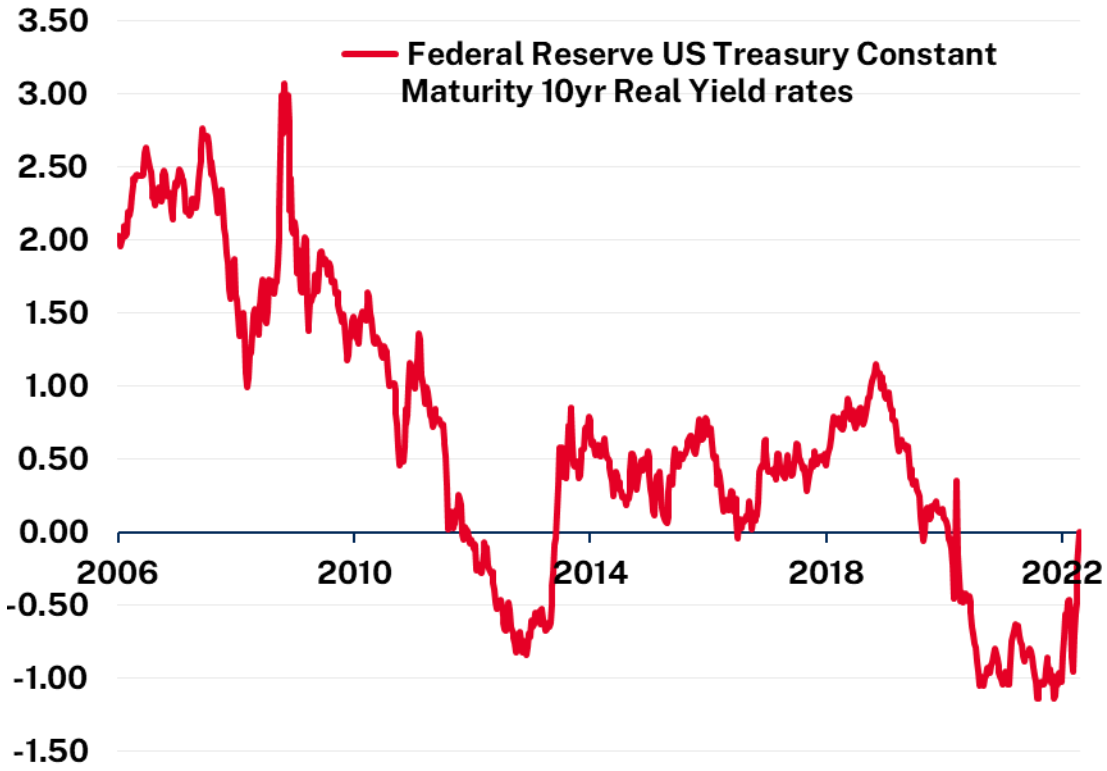
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Fixed Income Highlights

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US Real Yields back in positive territory



Source: Bloomberg 20th Apr 2022

- Treasury yields rose as expectations of sharp Federal Reserve policy tightening to damp price pressures hardened. Chicago Fed President Charles Evans said interest rates will probably exceed the neutral level.
- As a result, U.S. 10-year real yields turned positive for the first time since 2020, which is good news since nominal rates are supposed to be at least compensating against inflation.
- 10-year real yields are calculated as the difference between 10-year breakeven inflation rate (currently at 3.0%) and 10-year Treasury Yield (also at 3.0%).

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Fixed Income – Executive Summary

- **The US Treasury Yield curve steepened after higher than consensus PPI figures. Core PPI also came in higher-than-expected.** Higher PPI is likely to translate into higher CPI readings as producers will tend to pass the rising cost on to consumers. **So, the rhetoric of Core CPI peaking is perhaps little early.**

- **BoJ promises unlimited bond buying as yield approach the limits set** .

- **ECB President Christine Lagarde mentioned that the rate hikes could come "some time after" the Asset Purchase Program ends.** This leads to possible hike(s) perhaps in Q4 of this year**.**

- **PBOC cuts Reserve Requirement Ratio (RRR) but keeps Loan Prime Rate (LPR) unchanged.** Their stance is supportive but will be more structural in nature than clear rate cuts.

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Equity Highlights

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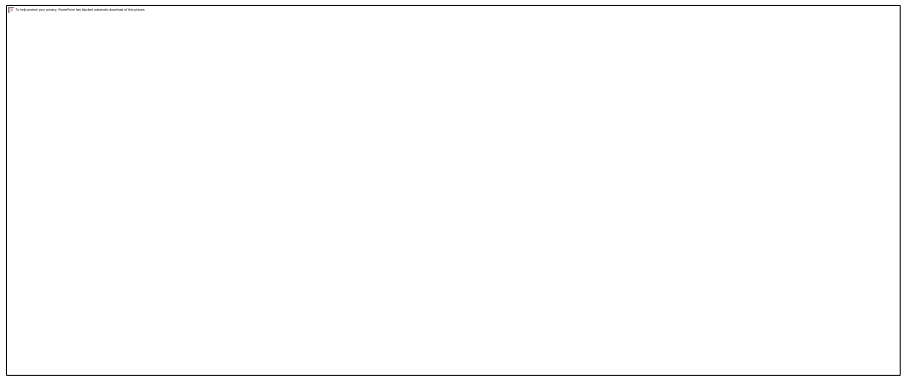
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JP Morgan “bad” quarter

Return on equity, per cent

Division	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022
Consumer & Community	54	44	34	32	23
Corporate & Investment	28	23	26	21	17
Commercial	19	23	22	19	13
Asset & Wealth Management	36	32	33	31	23

Source: Company reports

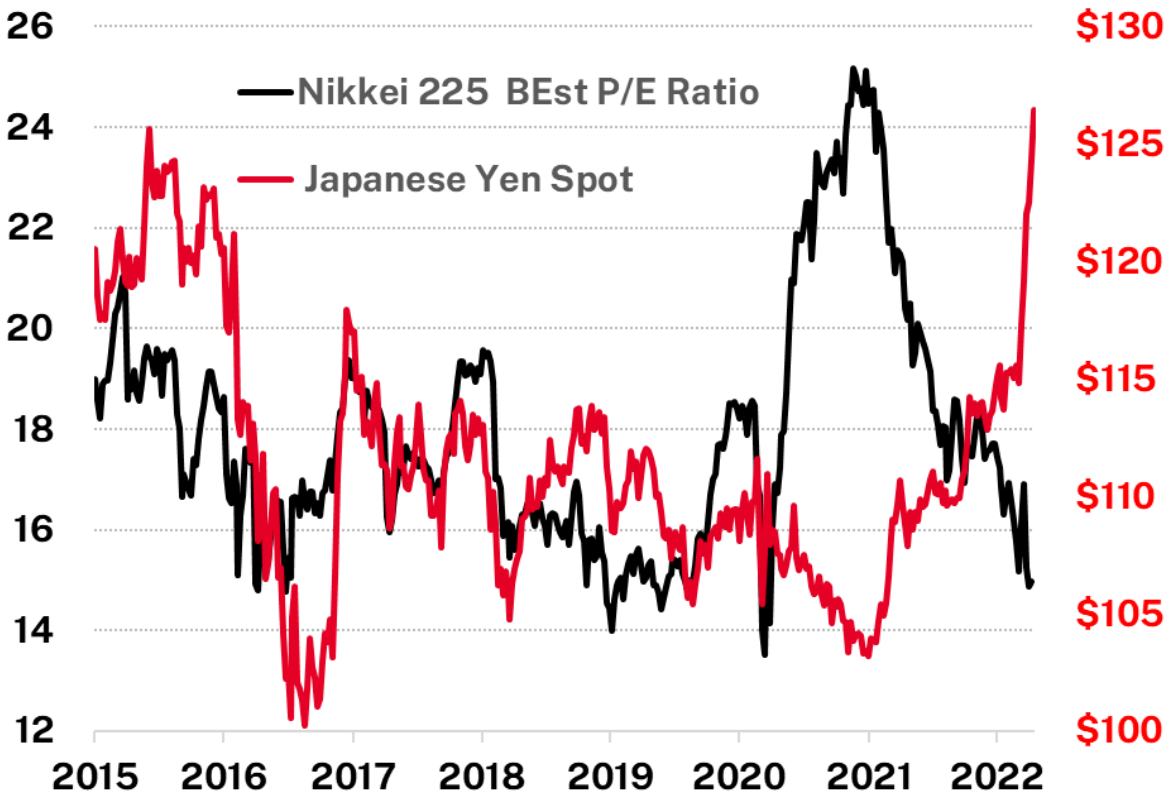


Source: Financial Times April 14th, 2022

- JPMorgan Chase is the most important bank on Wall street and consequently a good gauge for the US/World economy, and Q1 numbers are not looking good.
- As highlighted by The Financial Times, the Return on Equity for each of its four business segments have been declining sharply compared to the previous quarters. More concerning, provisions for credit losses have turned positive (which is bad news for banks) for each of its business segment and explain why JP Morgan share price is now trading -23% from its September 2021’s peak.
- While higher rates are supposedly positive for banks, a flat US yield curve is not really helping (banks are borrowing short-term and lending long-term). If/when a US recession is confirmed in the coming quarters, shares are likely to trade even lower.

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Japanese Stocks start looking attractive

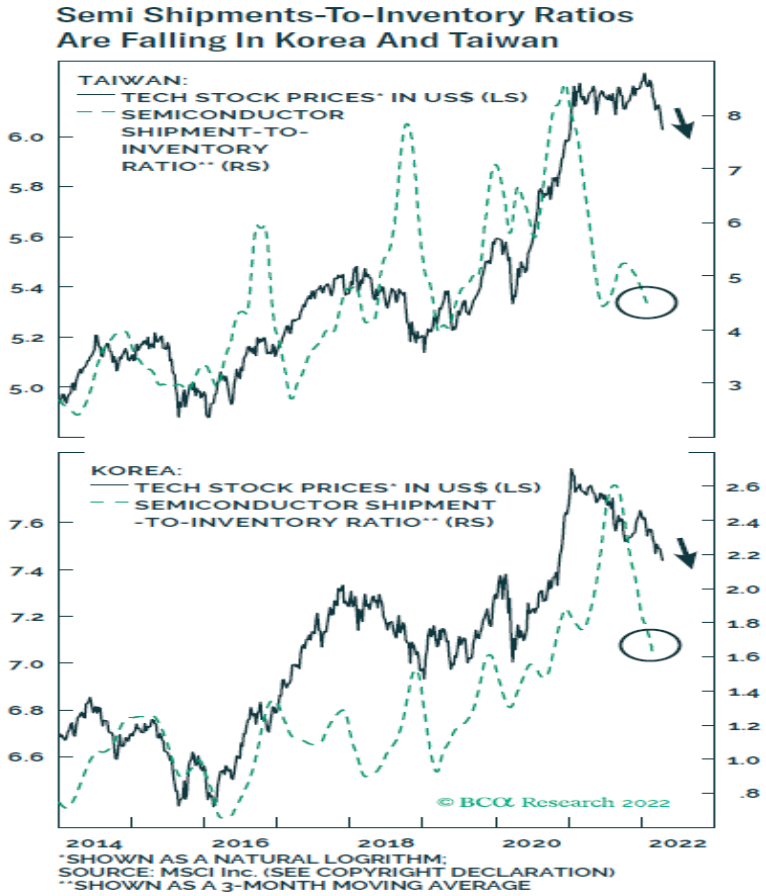


- The yen has weakened considerably recently. It is down nearly 9% vis-à-vis the USD since the beginning of March. This continues a longer-term trend that brings the yen's decline since the start of last year to 18%.
- Historically, there is a negative relationship between the yen and Japanese equities. A weaker yen is positive for the profits of Japanese exporters which become more competitive and earn revenues in foreign currencies while incurring domestic costs in yen.
- Heightened global growth fears amid the war in Ukraine and Chinese lockdowns may dampen the performance of Japanese stocks over the near-term. However according to BCA Research, the Nikkei may enjoy a catch-up phase later this year as it benefits from cheap valuations.

Source: Lighthouse Canton April 19th, 2022

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Semicon likely to underperform



Source: Financial Times April 14th, 2022

- The global semiconductor sector has entered a cyclical slump dragged down by demand. Stock prices are vulnerable to the downside over the next three to six months
- The pandemic boom in goods (ex-auto) consumption in developed economies is likely over.
- In China, ongoing lockdowns are depressing household income, which will limit their discretionary spending
- Valuations remain fairly expensive and markets have not fully priced in the expected deceleration in revenue and profits
- We suggest avoiding direct long only exposure and wait for better entry point.

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Equities – Executive Summary (1/2)

- **The 1Q earnings season started with major US banks reporting lower revenues and net income, as tight liquidity has significantly reduced financing activities. Moreover, extremely high inflation started to show its negative impacts on corporate profits.** Consumer discretionary sector has been hit quite badly, with Netflix reporting losing subscribers for the first time. The company's stock price plunged nearly 40%. Consumer staples is the relatively more resilient sector. However, as inflation is still at a high level, the Fed will likely raise interest rates more hawkishly. **Higher market volatility and further price correction are expected. Investors are advised to gradually reduce direct exposures and switch to long/short strategies.**

- **We also expect European equities to remain under pressure as the situation in Ukrainian deteriorates.** The lose/lose situation is unlikely to be solved quickly. Moreover, the ECB continued to tighten monetary policies to tame inflation. Although European benchmarks already discount a significant portion of the negative news. **Investors are recommended to avoid taking large long only positions in European stocks given the high degree of economic uncertainty and extremely depressed sentiments in the region.**

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Equities – Executive Summary (2/2)

- China's 1Q GDP growth beats consensus expectations, but the quarterly retail number was disappointing. With prolonged Covid lockdown in major cities like Shanghai, market sentiments remain depressed. The **PBoC cut the reserve requirement ratio** by another 25 bps, releasing liquidity of CNY 530 billion. In addition, it also **announced 23 supportive measures** for infrastructure projects, the struggling property sector and industries hit hard by the pandemic. However, these stimulus policies will certainly take a length of time to show effects. We will continue to use a higher equity risk premium and lower multiples for Chinese stocks. Long term investors could consider to buy the dip on some fundamentally strong names.

- The yen has weakened considerably recently and is now down 18% over the last 12 months. **Historically, a weaker yen is positive for the profits of Japanese exporters which become more competitive and earn revenues in foreign currencies while incurring domestic costs in yen.** While heightened global growth fears amid the war in Ukraine and Chinese lockdowns may dampen the performance of Japanese stocks over the near-term, **we believe the Nikkei may enjoy a catch-up phase later this year as it benefits from cheap valuations.**

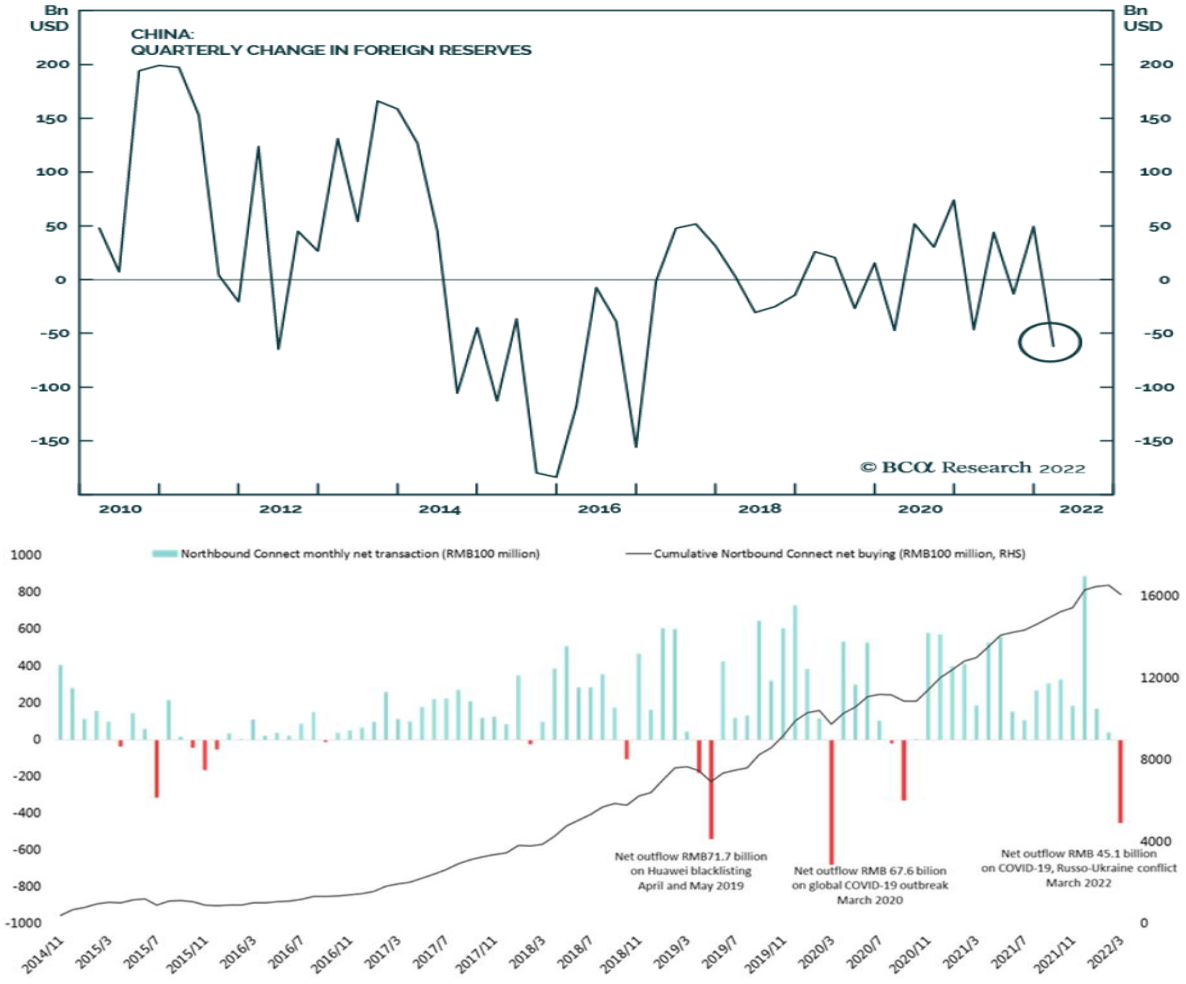
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Currencies & Commodities

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China's FX Reserves

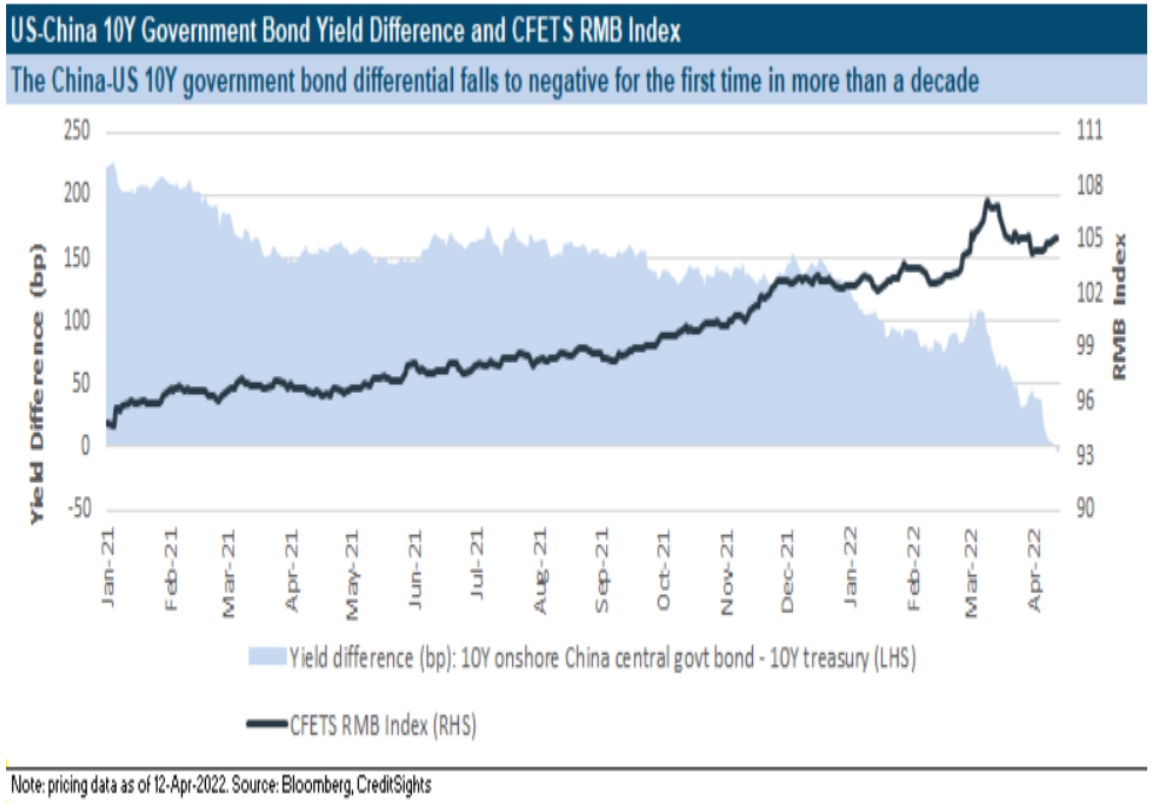


- China has accumulated around USD 3.3 trillions of forex reserves with years of trade surpluses. In 1Q22, China continued to enjoy quarterly trade surplus of USD 163.8 billion. But its forex reserves declined by USD 62 billion.
- BCA suggested that the fall in forex reserves could be a result of capital outflow as Chinese asset prices had been under pressure.
- Although foreign investors did sell a record USD 6 billion worth of Chinese equities in 1Q22. It is not enough to explain the situation.

Source: BCA, April 14th 2022
China Securities Index Co., Ltd., Wind, Springs Capital, April 15th 2022

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CNY vs USD



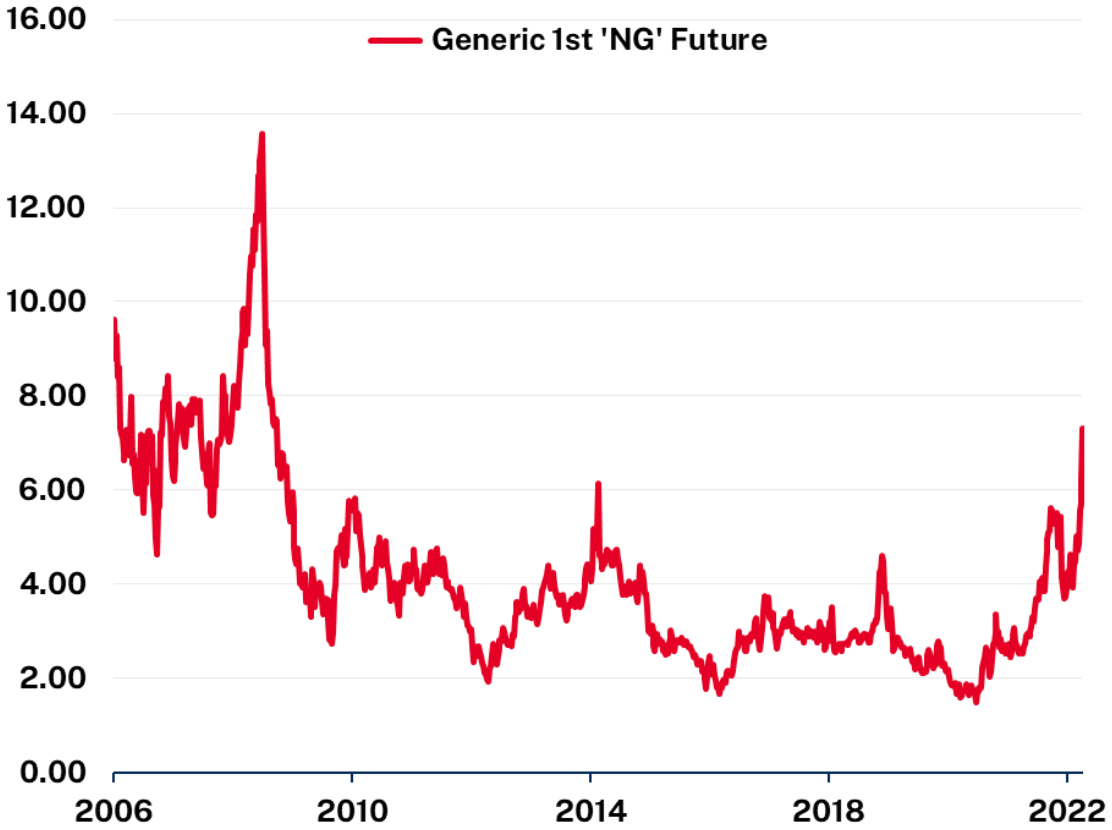
Source: CreditSights, April 12th, 2022

- In the past few quarters, the China-US 10Y government bond yield spread narrowed rapidly from more than 200 bps to slightly negative. However, the exchange rate of **CNY will likely have room of appreciation** in the coming quarters for the below reasons.

- BCA suggested that China might use its forex reserves to purchase real assets in other emerging markets to expand its sphere of influence, which would be **negative for USD and US Treasuries**.

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Natural Gas at highest price since 2008



Source: Bloomberg April 20th, 2022

- The European Union and Russia are at risk of triggering a de facto embargo on Russian gas after the bloc's lawyers drafted a preliminary finding that the mechanism President Vladimir Putin is demanding for payment in rubles would violate EU sanctions.
- If Russia follows through on its threat to cut off gas supplies to buyers that don't comply, it poses a serious threat for the EU, which gets 40% of its gas from Russia. The bloc is scrambling to find alternative energy sources as it comes to terms with the outsize leverage Moscow has over its security, but the transition will take time.
- This adverse news flow caused Natural Gas price to surge above 7$ / MMBtu, a level last seen in 2008.

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Currencies & Commodities – Executive Summary

In case you missed it

Commodities

- **Commodities are likely to remain highly speculative throughout 2022 on the back of an extremely fluid geopolitical environment**. We recommend outsourcing the trading of commodities to well establish managers with strong risk-management culture and have the ability to take non-directional views

Forex

- According to BCA Research, **the dollar has tended to decline 3-to-6 months after the Fed starts hiking interest rates**. This has been true since the mid-1990s and the average decline after six months has been 5.3%. Combined with the largest trade deficit on record, this is **supportive for the EUR which is now looking attractive (below 1.10) for investors with a long term horizon**.

- Despite having relatively higher real rates and productivity growth potential, the CNY is trading cheap from its PPP fair value. **We remain supportive of the CNY for all investors with a long-term view**. That said, there could be near-term headwinds for the Yuan with COVID-19 restrictions and expectations for looser monetary policy.

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