Lighthouse Canton Monthly Investment Memo

July 2023

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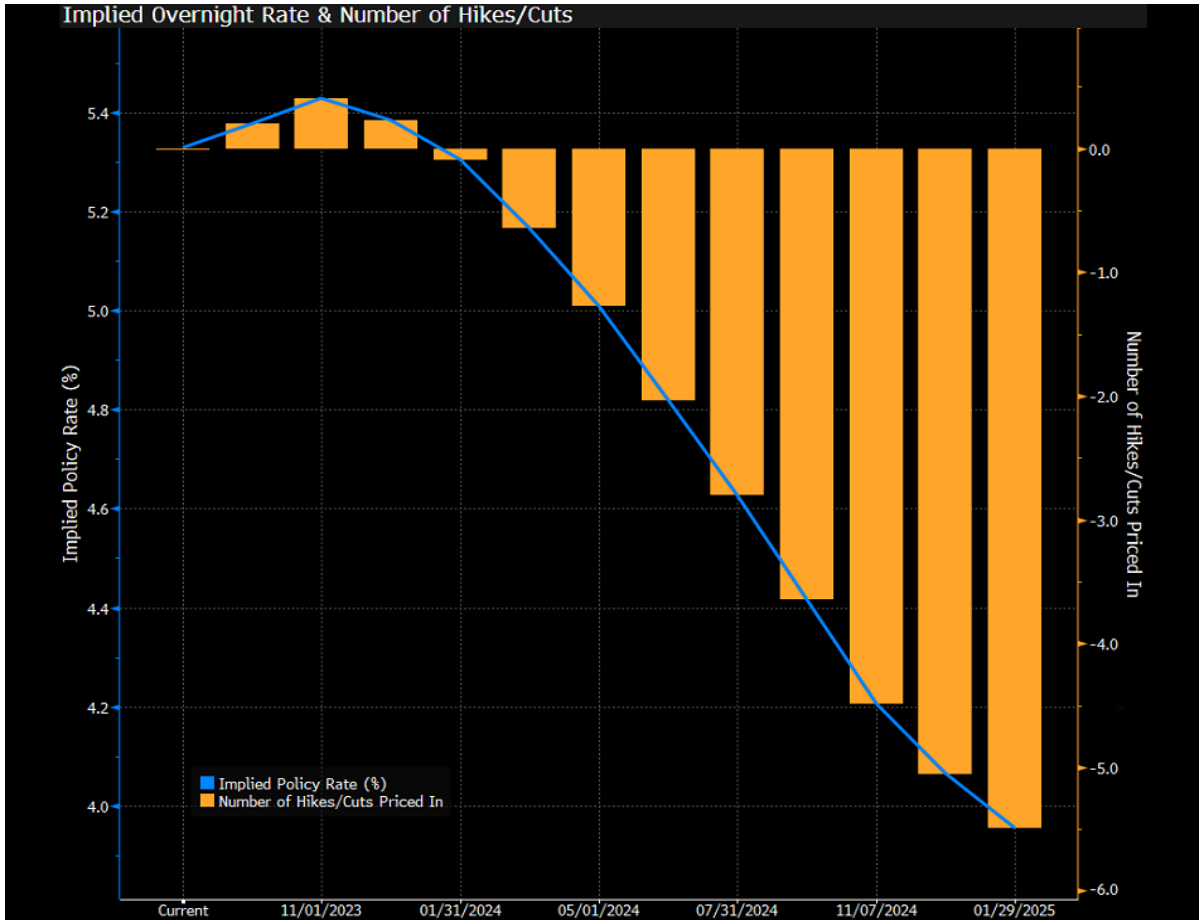
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Markets Pricing in 5 Rate Cuts Next Year

Probability of a Rate Hike in September Fell



Source: Bloomberg, July 2023

- The 25bp hike at the July FOMC meeting was as expected.
- Chair Powell's tone was somewhat dovish, suggesting a willingness to skip a hike at the September meeting, provided inflation data continue to be soft.
- Markets currently priced in a pause in September and 5 rate cuts next year.
- However, Powell continued to stress the Fed's determination to bring inflation back to the 2% target, hence, we urge against complacency in assuming this hike would be the last of this cycle.

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Market Updates

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US Yield Curve Most Inverted Since 80s

Fed tightening points to future economic weaknesses



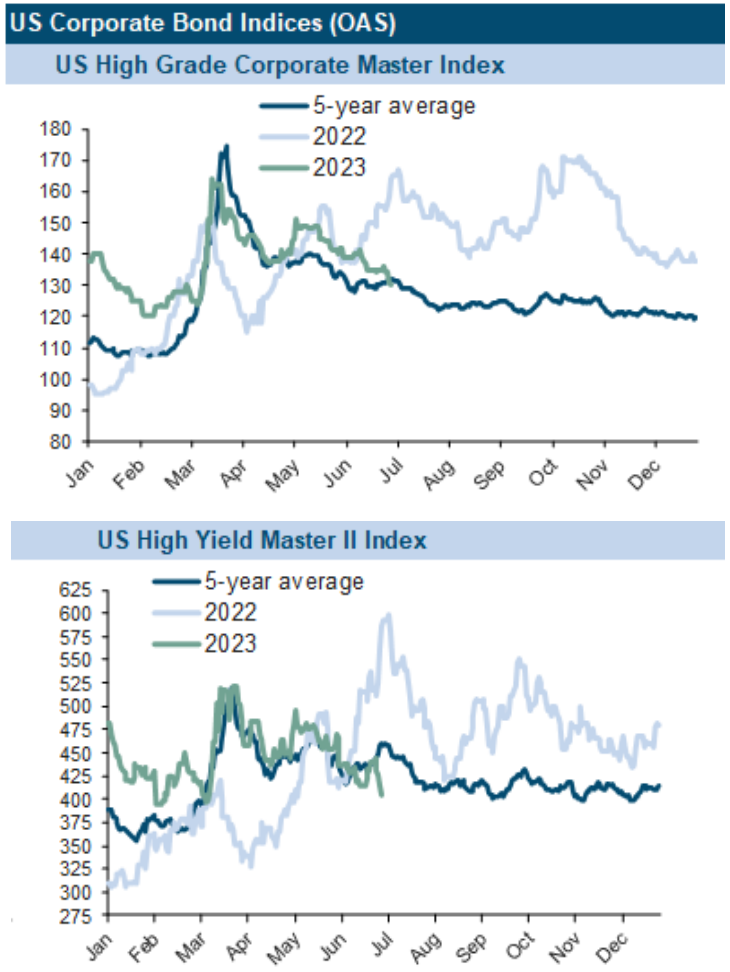
Source: Bloomberg, July 2023

- In the US Treasury market on Monday, a significant yield curve inversion occurred, reflecting traders' expectations of tighter Federal Reserve policies. Yield curve inversions happen when long-term bond yields, like the 10-year note, fall below short-term bond yields, such as the two-year note. This is uncommon since investors typically demand higher returns for longer-term investments due to increased risk. Inversions indicate anticipated economic weakness or future central bank policy easing. The two-year note yield exceeded the 10-year rate by a noteworthy 110.8 basis points, nearing the peak of 110.9 basis points in March, last observed in the early 1980s according to Bloomberg data.

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US Corporate Bond Spreads Grinding Tighter

Caution in the Junk Bond Market is Warranted



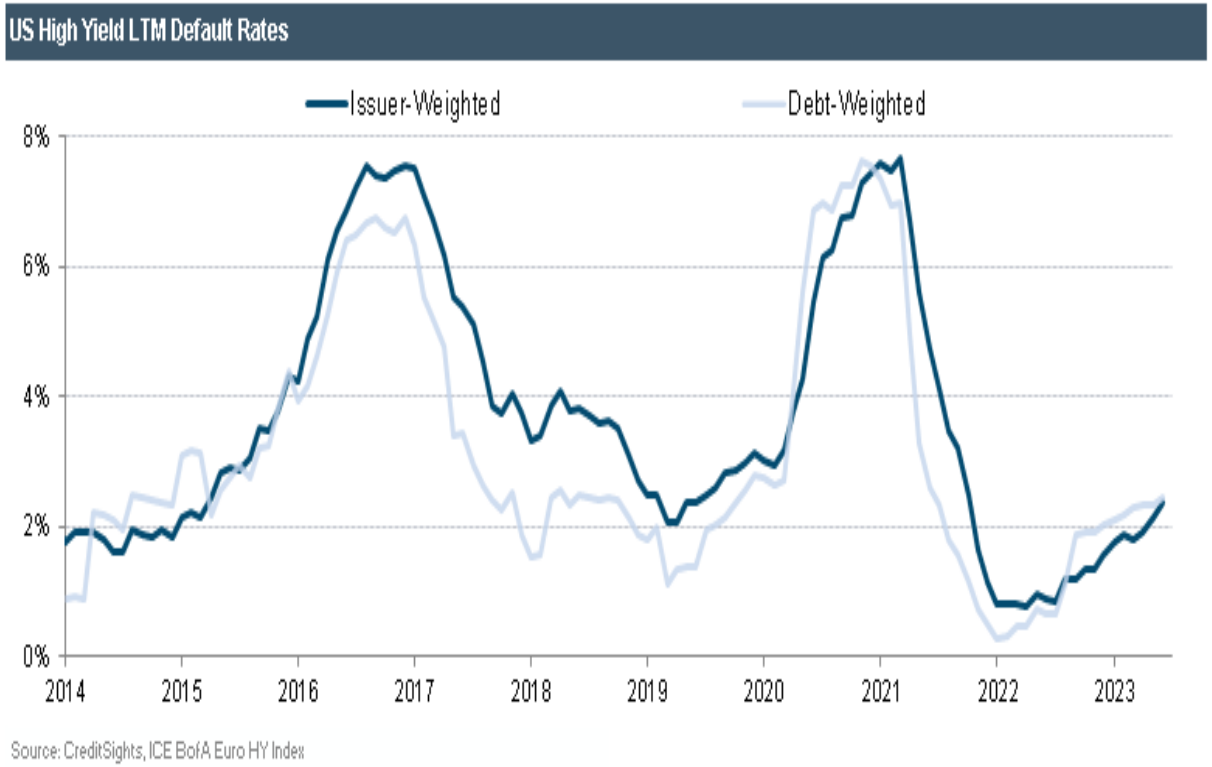
- Despite concerns over the health of the US economy, HY spreads (average 410bps as of end June) have fallen since highs last autumn and have been tightening in recent months.
- One reason could be the scarcity of supply, following a dealmaking frenzy during the height of pandemic, when companies took advantage of ultra-low interest rates to borrow cheaply and push out payment dates.
- We remain cautious and selective in HY bond issuers, as we expect the HY market to “normalize” and eventually reflect macroeconomic reality.

Source: CreditSights, July 2023

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US Default Rates inching higher

Healthcare and Retail Sectors Most Vulnerable



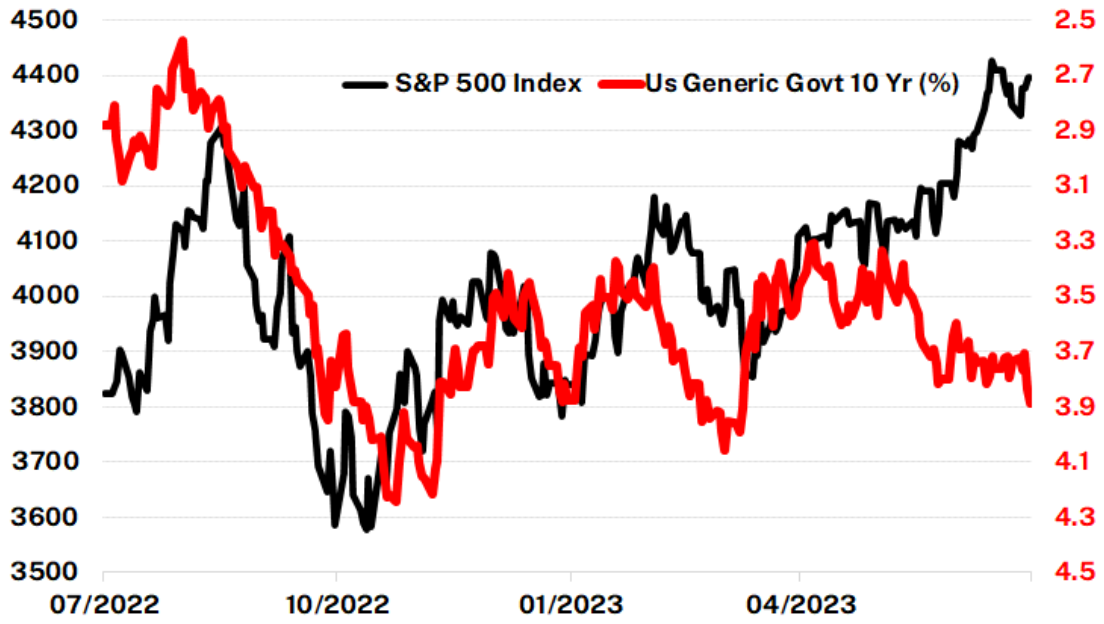
- US HY issuer–weighted default rate went up to 2.4% from May's 2.2% while the debt-weighted default went up to 2.5% as well.
- US HY distress ratio was at 11% . Distress is defined as bonds trading at OAS of over 1000 bps.
- Healthcare remained the most vulnerable with debt-weighted default rates of 13.8% followed by Retail at 4.3%. Healthcare had reported 14% default rates in May 2023 as well.

Source: CreditSights, July 2023

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Rates And Equities On Different Pages

Caution Warranted on Equities



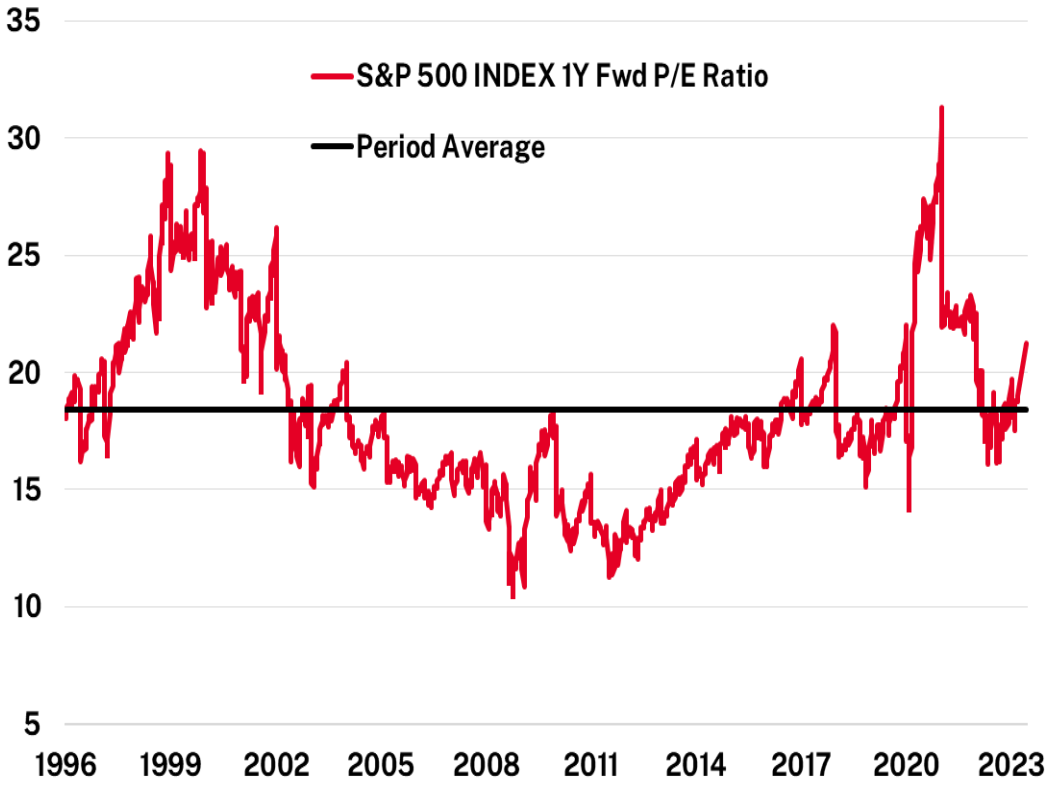
Source: Bloomberg, July 2023

- Over the past year, US rates and US equities have maintained a compelling inverse relationship, notably seen between July 2022 and May 2023.
- However, recent developments have seen these trends starkly diverge. In the last two months, the US 10-year yield has spiked 60 basis points from 3.3% to 3.9%, while the S&P 500 surged from 4100 to 4400 points, driven by AI-fueled tech stocks.
- We maintain a cautious stance on equities based on expensive valuations, the specter of another rates hike and the fact that 80% of the S&P 500 performance in 2023 is only explained by few stocks.

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Price/Equity Ratio Back To Expensive Territories

Caution Warranted on Equities



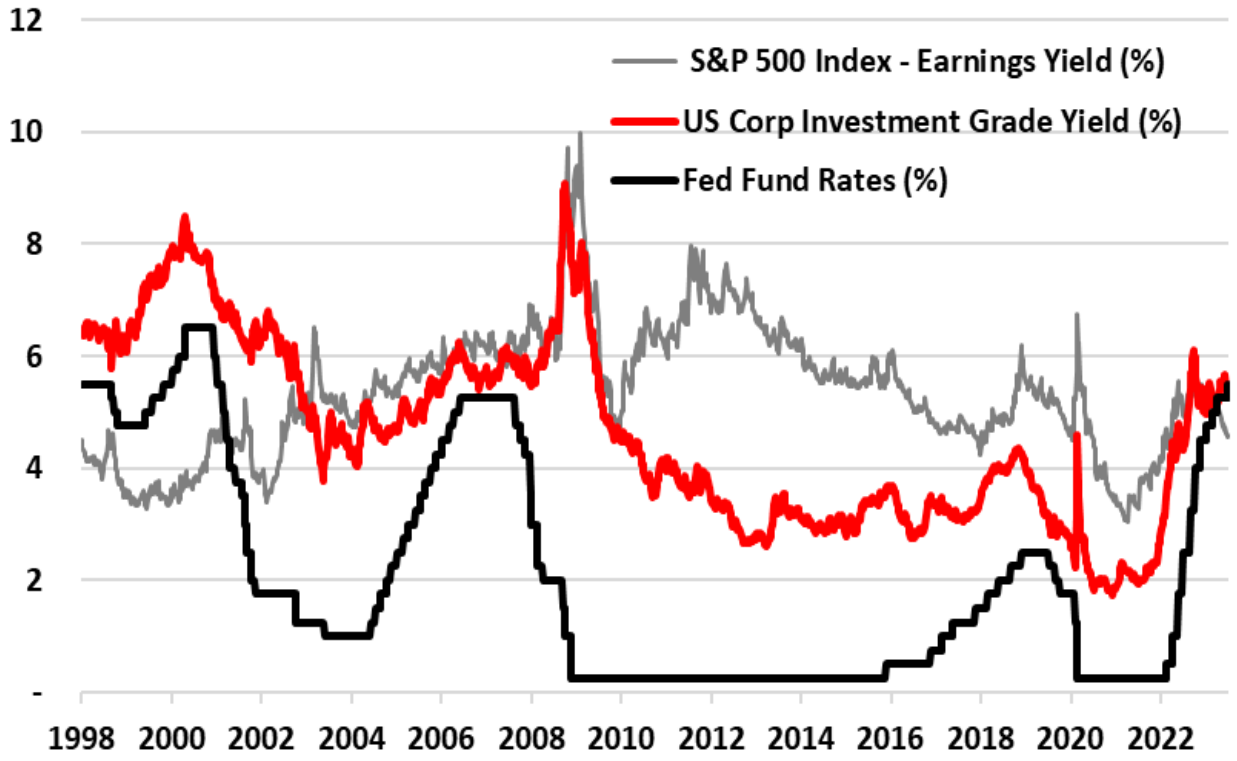
Source: Bloomberg, July 2023

- The current forward price-to-earnings ratio has surged to 21.2x, nearly 3 points above its 25-year average of 18.4x. Investors are willingly paying a premium to hold equities, indicating potential complacency in light of the anticipated recession next year, as suggested by fixed income investors.
- Although a goldilocks scenario, characterized by a robust economy and declining inflation, remains a possibility, the current rates, now at a 22-year high of 5.5%, are likely to exert an eventual slowdown on the economy.

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Equities & Bonds Yield Less Than Treasuries

Little to no reward in buying equities



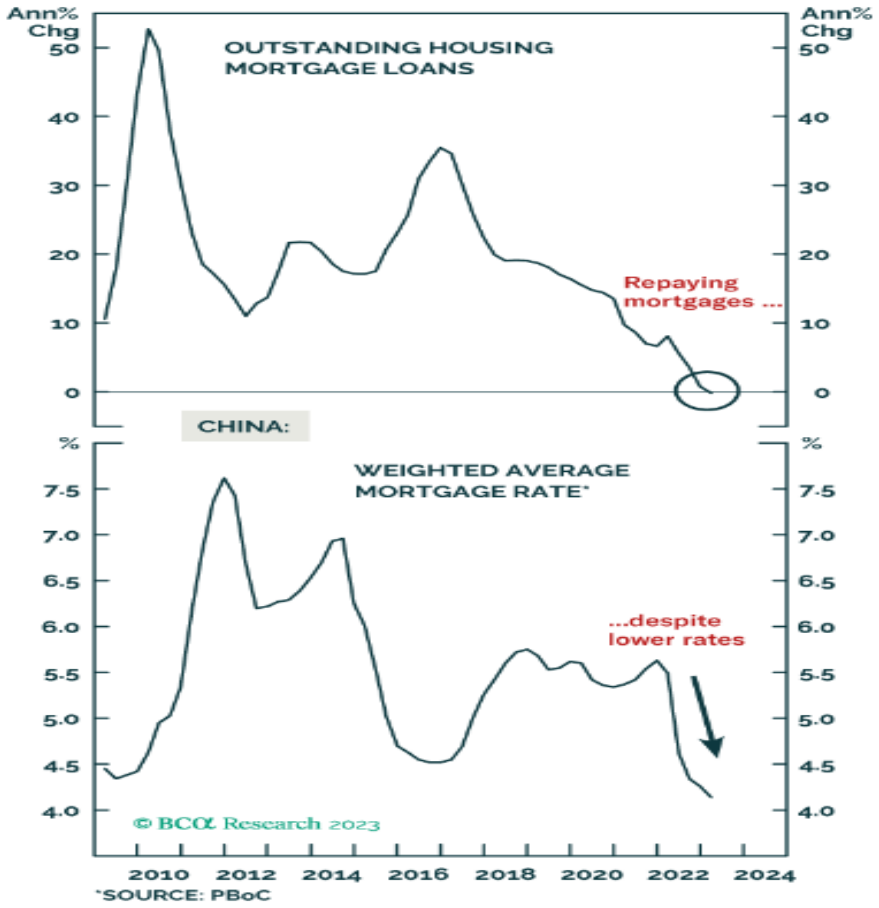
- As of yesterday, the earnings yield of US equities, represented by the S&P 500 index, stands at 4.5%. While equities historically have been a favorable asset class, it's important to note that the current earnings yield falls well below the yields offered by investment grade corporate bonds ETFs at 5.4% and the Federal Fund Rates at 5.5%.
- Considering risk-adjusted returns, equities offer limited reward. Our preference order: cash (fixed deposits), bonds, alternatives, and equities.

Source: Bloomberg, July 2023

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China in a Liquidity Trap

Credit demand is weakening despite falling borrowing costs



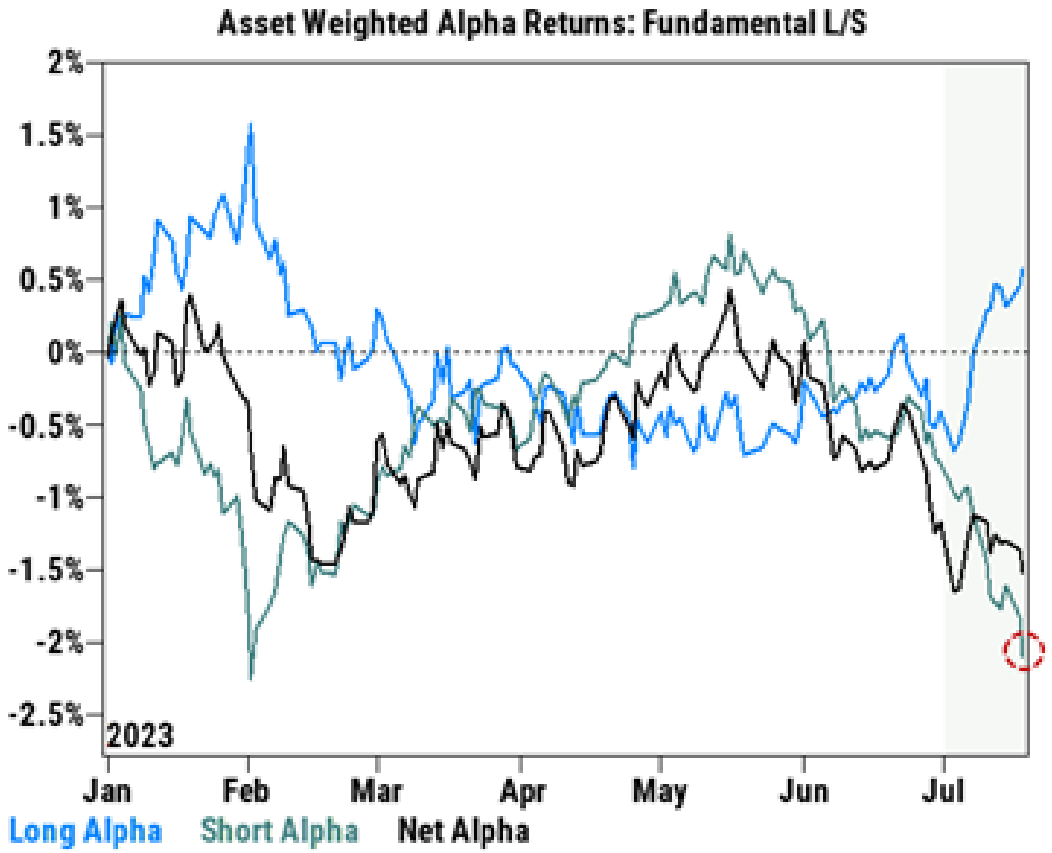
- Despite lower interest rates, credit demand has collapsed from households
- In fact households have been paying down mortgages.
- This is a symptom of a liquidity trap where households are unwilling to spend which points to a lack in conviction on the underlying economic strength today
- While policy stimulus is expected, BCA is of the opinion that the current liquidity trap issue will likely water down any stimulus multiplier until a confidence is restored in the real estate sector.
- China's investing landscape could remain rocky and therefore we think an actively managed approach to the region would be a much more sensible one.

Source: BCA, July 2023

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Equity L/S Managers Have Lagged the Market

Defensive positioning and negative short alpha have been key contributors



- According to GS Prime, Fundamental L/S managers have not been able to keep up with the YTD market rally despite generating positive long alpha.
- Most of this can be explained by negative short alpha. However, this is not the only contributor to poor YTD net alpha.
- Since fundamental managers take bottom up approach to portfolio construction, most were positioned for a weak economic scenario and earnings deterioration coming into the year.
- As the overall rally has been driven mostly by thematic (non-fundamental) trends, it is unsurprising that the vast majority did not participate in the AI rally.

Source: Goldman Sachs, July 2023

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