# Investment Playbook Weekly Update

12th May, 2023

LIGHTHOUSE CANTON



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# Weekly Spotlight

1



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# Bond Spotlight: AON 8.205 01/01/2027

## Bond Details

| | |
|---|---|
| ISIN | US037389AK90 |
| Security | AON 8.205 01/01/27 |
| Issuer | AON CORP |
| Country | US |
| Sector | Financial |
| Rank | Jr Subordinated |
| Currency | USD |
| Issue Size | 701,995,000 |
| Outstanding | 521,039,000 |
| Min Piece | 100,000 |
| Series | * |
| Liquidity Score | 32 |
| Issue Date | 25/06/2009 |
| Maturity Date | 01/01/2027 |
| Year to Mty | 3.65 |
| Mty Type | AT MATURITY |
| Next call Dte | |
| Next call Px | |
| Mod. Duration | 3.1 |

## Parent Company

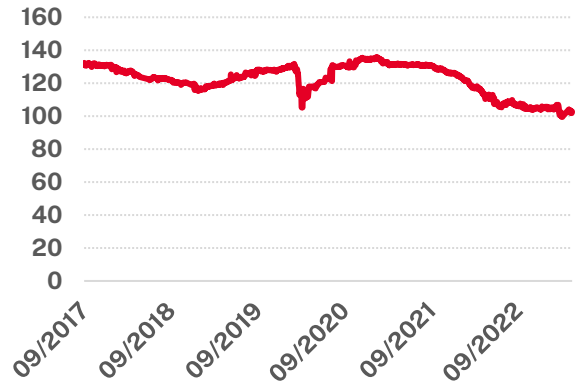
| | |
|---|---|
| Equity Ticker | AON US |
| Parent Company | Aon Global Holdings |
| Ultimate Parent | Aon PLC |

## Leverage (Issuer level)

| | |
|---|---|
| Net Debt / Mkt Cap | 0.2 |
| Net Debt / EBITDA | 2.7 |
| Liabilities / Assets | 1.0 |

## Bond Price

Source Bloomberg




## Product Risk Rating 2.0

| | |
|---|---|
| Current Price (Ask) | 102.91 |
| Yield to Worst (Ask) | 7.3% |

## Rating (Bond)

| | |
|---|---|
| Moody's | Baa3 |
| S&P | BBB |
| Fitch | BBB- |
| | BBB- |

## Liquidity (Issuer level)

| | |
|---|---|
| Current Ratio | 1.0 |
| Quick ratio | 0.2 |
| Interest Coverage | 9.0 |

## Profitability (issuer level)

| | |
|---|---|
| Return on Capital | 26% |
| Return on Equity | |
| Altman ZS | 2.1 |

## Coupon

| | |
|---|---|
| Cpn rate | 8.21 |
| Cpn Type | FIXED |
| Cpn Freq. | 2.00 |

## Default Risk

| | |
|---|---|
| Default BBG | 0.0% |
| CDS (%) | 0.6% |

## Price Change (bond)

| | |
|---|---|
| 1M | |
| 3M | -1.7% |



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# Bond Spotlight: Investment Rationale

- **Issuer Description:** AON Corporation provides insurance and brokerage services. The Company offers risk management, insurance and reinsurance brokerage, human resource consulting, outsourcing, and workforce productivity solutions. AON serves clients worldwide.

- **Investment Rationale :** AON benefitted from rising P&C premium rates which is supportive of brokerage revenues and margin expansion while the consulting wing has more than recovered from a brief pandemic driven decline. Ongoing economic recovery has been supportive of AON's consulting business, which is levered to project-based work. COVID did disrupt the business temporarily, however revenue growth in recent quarters have been stronger than expected. The only risk to the consulting arm is an economic slowdown. We are happy to take the incremental spread it offers despite quality earnings profile.

# Fund Spotlight: Ironshield Credit Fund

## FUND INFO

| | | | |
|---|---|---|---|
| **Asset Type** | Fixed Income | **Fund AUM (m)** | 76 |
| **Investment Geography** | E.U. & U.K. | **Inception Date** | Apr-20 |
| **Strategy** | Special Situations/Event-Driven Credit | | |
| **Currency** | EUR | | |

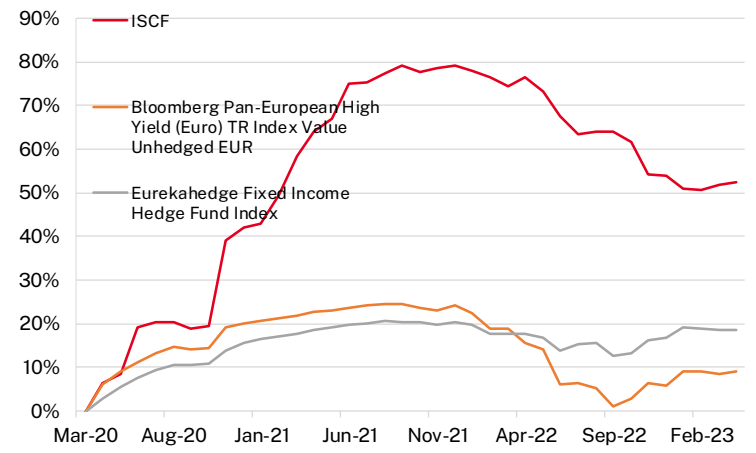
## PERFORMANCE STATISTICS

| | ISCF | Bloomberg Pan-European High Yield (Euro) TR Index Value Unhedged EUR | Eurekahedge Fixed Income Hedge Fund Index |
|---|---|---|---|
| **Annualized Return** | 14.63% | 2.87% | 5.81% |
| **Annualized Volatility** | 13.04% | 7.86% | 4.35% |
| **Annual Sharpe Ratio (Rf)*** | 1.08 | 0.30 | 1.22 |
| **Annual Sortino Ratio (vs Rf)*** | 3.38 | 0.44 | 2.30 |
| **Max Drawdown** | 16.01% | 18.94% | 6.51% |
| **Correlation to Global Equities** | 0.42 | 0.87 | 0.80 |
| **Correlation to Global IG** | 0.10 | 0.65 | 0.60 |
| **Correlation to Global HY** | 0.38 | 0.95 | 0.92 |

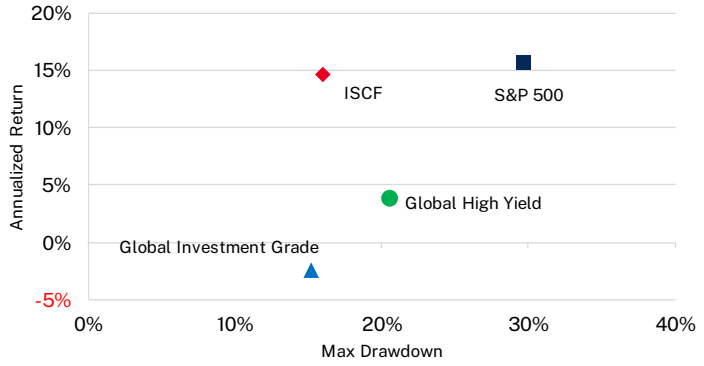
## ANNUAL PERFORMANCES

| | | | |
|---|---|---|---|
| **2022 Return** | -1.06% | 3.20% | 1.43% |
| **2021 Return** | -14.13% | -14.83% | -3.03% |
| **2020 Return** | 26.21% | 3.43% | 4.22% |
| **2019 Return** | 42.06% | 2.29% | 5.66% |

## HISTORICAL CUMULATIVE RETURNS




## RETURN VS MAX DRAWDOWN SINCE FUND INCEPTION




## STRATEGY SUMMARY

-The fund runs a long/short event driven strategy focusing on European credits, in a UCITS format.

- Its objective is to achieve high absolute returns by exploiting periods of market mispricing caused by operational and capital structure changes in corporates.

- The team uses a probability and scenario driven approach to evaluate opportunities and assess risk.

- Credit selection and position sizing are based on in-depth analysis and due diligence of a select group of corporates that the team typically tracks over a multi-year period.

- The fund can take up to 25 to 35 long and short positions with an average position size of 4%. 100% of the portfolio can be liquidated within 1 week.

- Gross exposure can range between 100-150% with a very dynamic net.

- All positions are sized appropriately for the risk so that in our downside scenario, the credit wouldn't detract more than 2% of NAV.



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# Fund Spotlight: Investment Rationale

- The fund offers a liquid way to gain exposure to a multi-year opportunity set in event driven credit where we are entering a more prolonged distressed and disruptive credit environment which is generally the best for the fund to deliver strong asymmetric returns (+42% in 2020 and +26% in 2021).
- 100% of its portfolio can be liquidated in a week which is achieved by investing in the most liquid part of the HY market (BBs to CCCs)
- Short to medium term event-driven approach provides a relatively lower volatility and uncorrelated return stream compared to the underlying credit markets.
- Highly experienced team with the longest track record amongst the European based competitors in special situations credit
- The fund has with a proven track record of protecting capital in challenging markets. Since pre-GFC, the manager has only had 6 positions that lost more than 2% of NAV.
- This gives us the comfort in the ability for fund to identify and monetize high payout event driven opportunities that are often complex and tricky to navigate.



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# Charts of the week

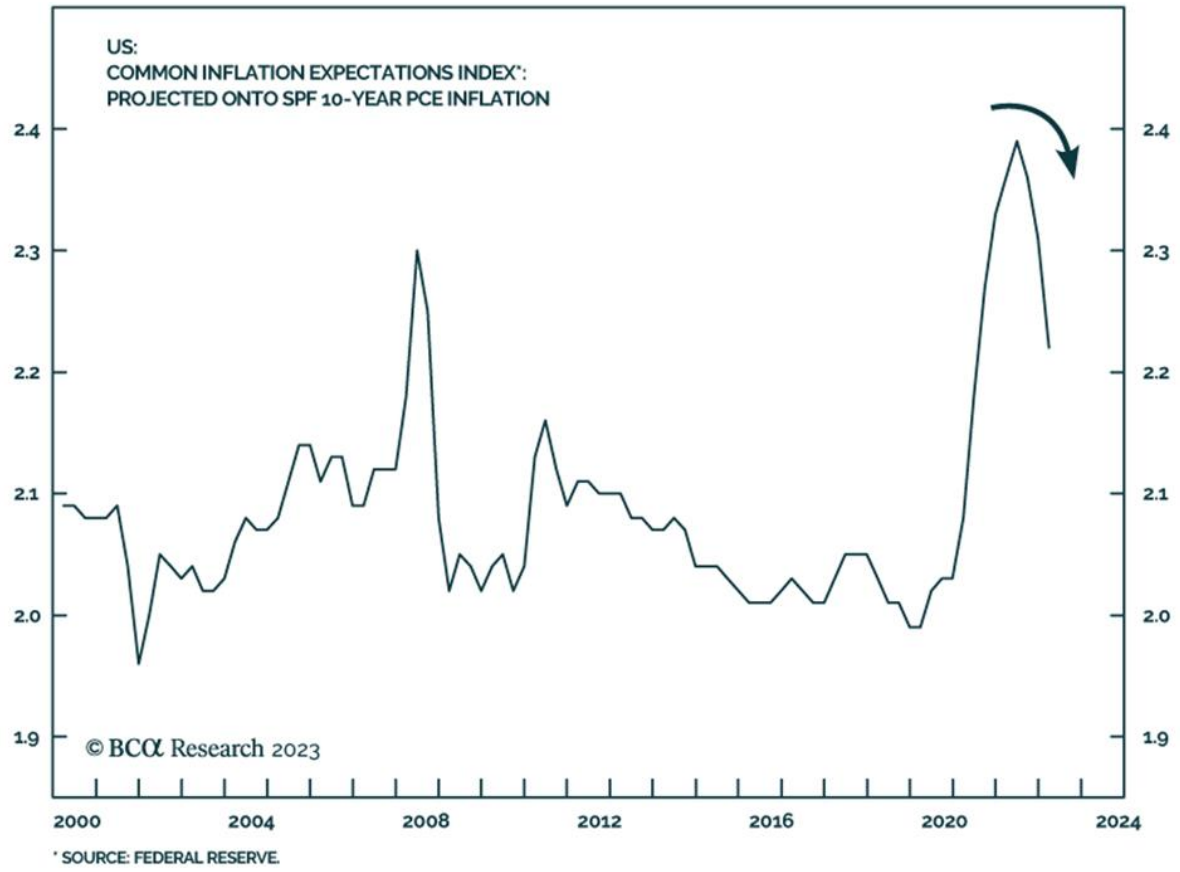
2



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# Receding Inflation Expectations

## Fed's index of common inflation expectations declined for the 3rd consecutive time in Q1




- The Fed's Index of Common Inflation Expectations confirms that there is reduced pressure on the central bank to tighten monetary policy further. The quarterly release shows the index declined for the third consecutive time in Q1.
- The index is a comprehensive measure of consumer, business, as well as market-based inflation expectations, aggregating information from 21 indicators.
- A continued decline in inflation towards the 2% target is needed to prevent expectations from breaking out again. While inflation is moderating, at 4.6% core PCE is still too high.

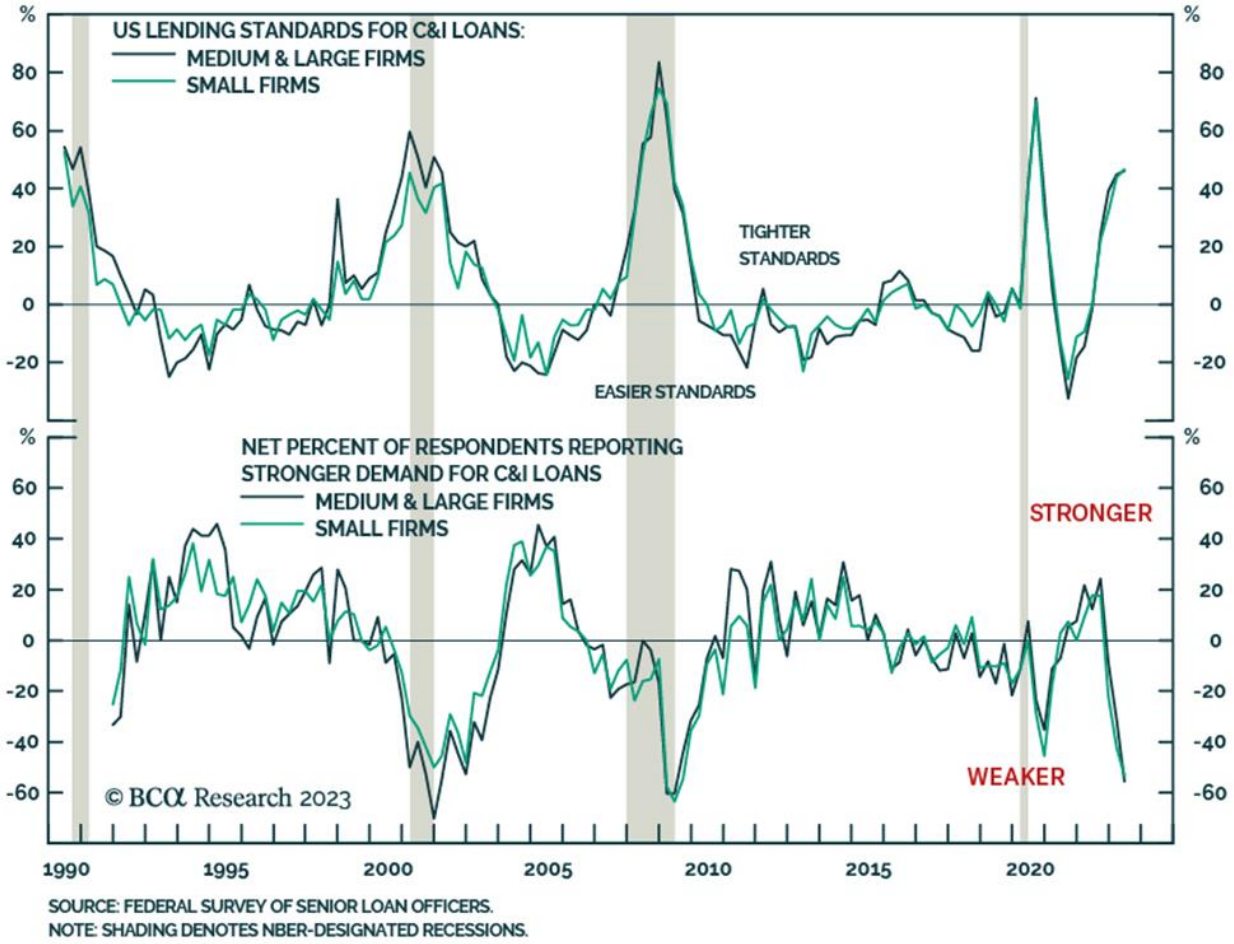
Source: US Federal Reserve, BCA Research , May 2023



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# US Loans: Tighter Standards, Weaker Demand

**Weaker lending growth is ultimately a headwind for the US economy**




Source: US Federal Reserve, BCA Research , May 2023

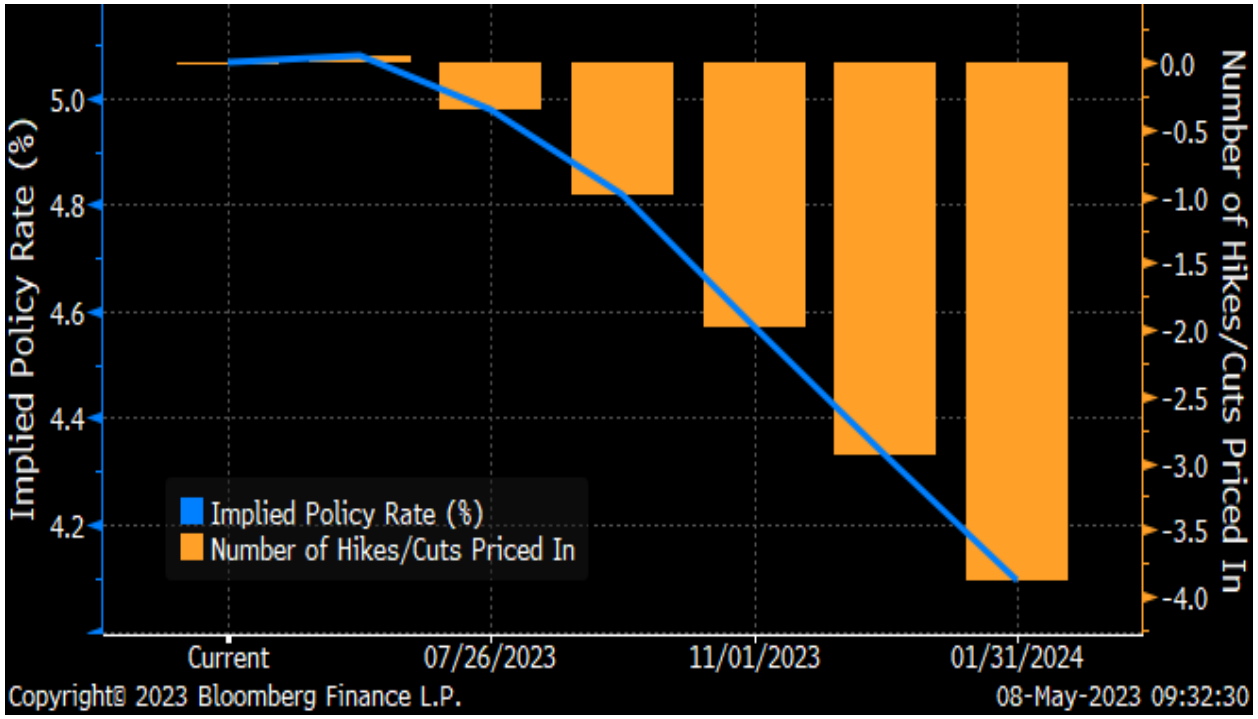
- The US Federal Reserve Senior Loan Officer Opinion Survey shows that US commercial banks continue to tighten lending standards across nearly all categories. Among the top reasons cited for the expected tightening in standards this year are a deterioration in the credit quality of their loan portfolios and in customers' collateral values, reduced risk tolerance, worries about bank funding costs, bank liquidity position, and deposit outflows.
- The continued tightening in lending standards and pessimistic outlook ultimately underscore the impact of the 500bps of rate hikes delivered by the Fed since the start of the tightening cycle last March as well as the effect of recent bank stress.



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# Fed expected to decrease rates by year-end

**Bond traders are all over the place on a potential Fed shift.**




- Friday's surprisingly strong US jobs data washed out most bets on a July cut, but rate derivatives continued to anticipate a 25-bp reduction by September and three by year-end.

- The five-year Treasury yield moved up or down 15 bps in a day three times last week, falling to as low as 3.20% before ending around 3.41%.

Source: Bloomberg, May 2023



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# A History of Asset Returns Post Last Fed Hike

**Peak rates could be supportive for long duration over 3-6 months during inflationary periods**

| | Average return after the last rate hike | |
|---|---|---|
| | 3-mo | 6-mo |
| Inflationary period - 1970-1988 | | |
| UST 30-year | 7.4% | 7.3% |
| US IG bond | 5.7% | 6.0% |
| Dow Jones | (4.5%) | (6.4%) |
| Gold | (12.6%) | (11.4%) |
| US $ | 4.7% | 6.0% |

*Rate hikes: May'74, Mar'80, May'81, Jan'82, Aug'84*

- 30-year treasuries show positive returns 9/10 times with average returns of ~7% over a 3m and 6m period
- IG bonds, which typically have high duration, have delivered positive returns 9/10 times with an average return of ~5% over a 3m and 6m period.
- As growth starts to slow during later parts of the hiking cycle, this is typically reflected in long term yields which are growth sensitive.
- We continue to hold the view that the US economy is likely to decelerate further this year which could make an overweight position in duration favorable.

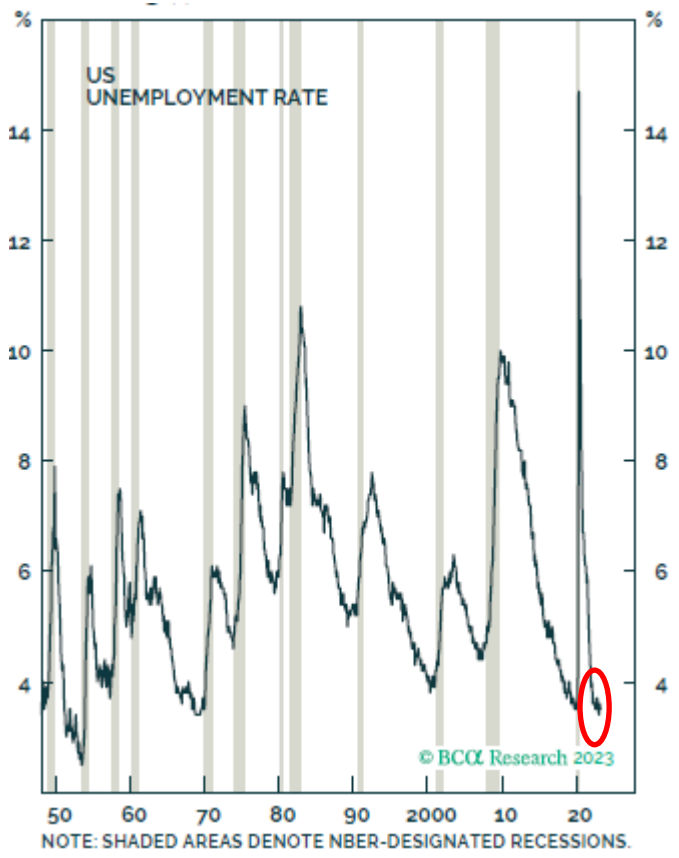
Source: Bank of America, May 2023

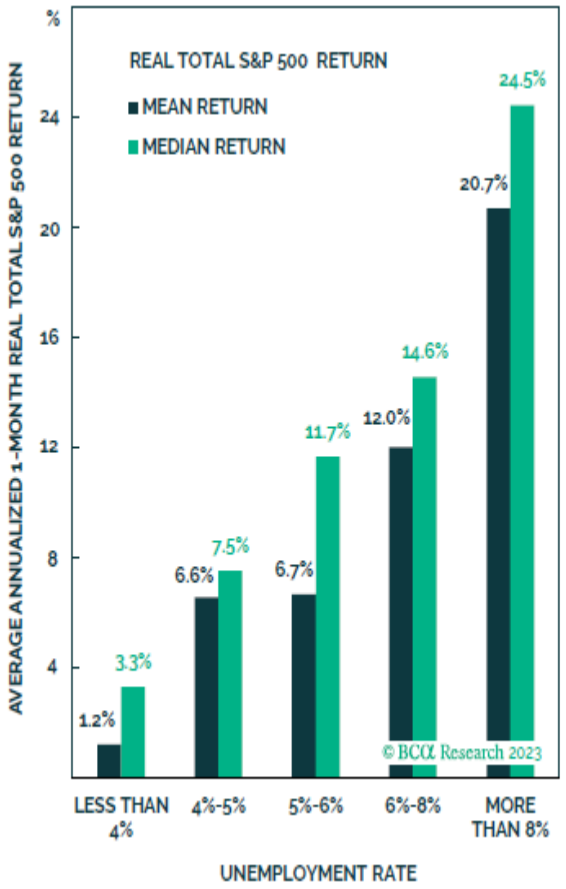


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# Stocks and Unemployment

## Stocks usually do poorly when Unemployment is low




- US unemployment rate printed 3.4% last week. Lowest in decades.
- Unemployment rate rarely moves sideways as can be evidenced from the chart on the left and very low unemployment rate has always preceded recessions.
- Hence equity returns have been suppressed every time the unemployment rates fall to very low levels as is the case now. The bar chart on the right explains the phenomena.

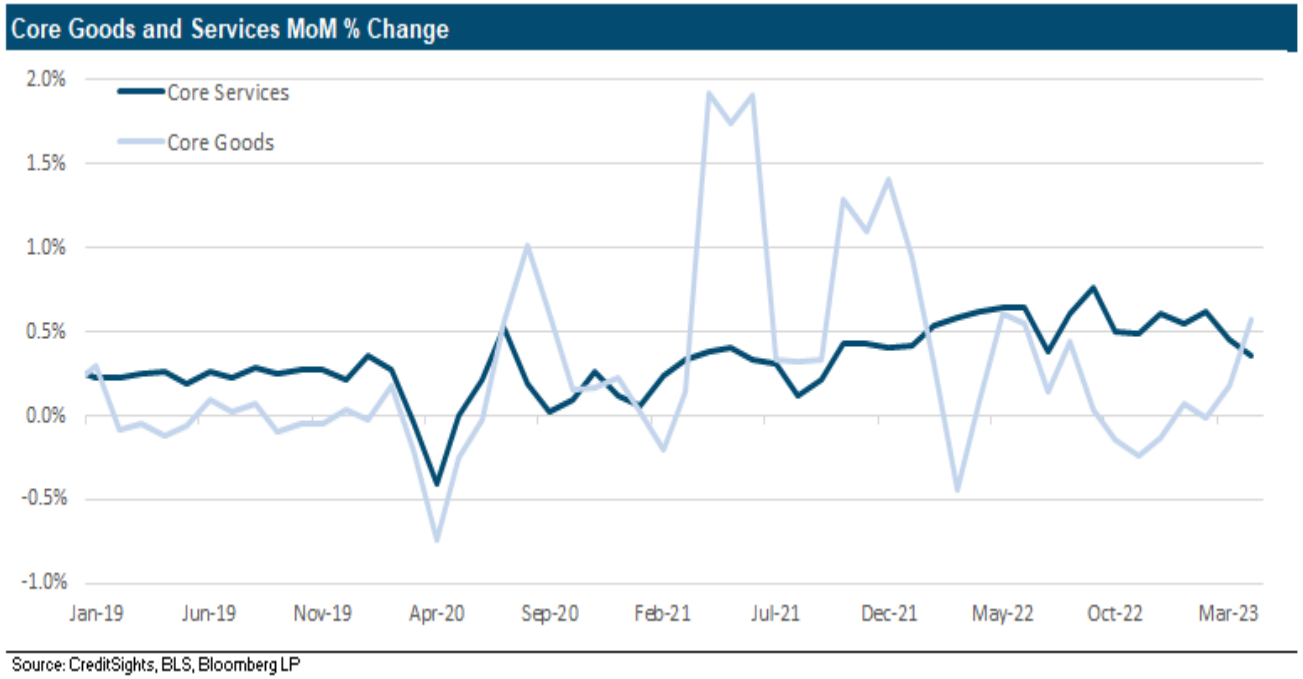
Source: BCA Research, 10th May 2023



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# US CPI: A case of rotation

## Rotation in terms of drivers of core inflation: to Goods, away from Services




- Core services decelerated to 0.36% MoM, the slowest since September 2021. YoY it grew by 5.5% down from 5.6% reported last month.
- Core goods on the other hand rose 0.6% MoM, the fastest since May 2022. Motor vehicles and parts were the key drivers.
- While inflation growth rate is slowing ,it remains extremely high relative to the Fed's 2% target.

Source: CreditSights, 10th May 2023



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# LC Views - Summary

3



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# LC Views Summary (1/2)

| Sub-Asset | Recommended Positioning |
|---|---|
| **Rates** | • Post May FOMC, the Fed had hiked by 25bps as widely anticipated. It also signaled a pause, citing that policy will be more data dependent. Meanwhile bank lending standards have tightened further on back of banking stresses, with headline CPI at 5.1% and core CPI at 5.6% nowhere near the Fed's long-term average of 2%. The Fed will likely be challenged with balancing inflationary risks and containing any further deterioration to financial stability. That being said, we feel policy rates have likely peaked and markets are expecting cuts to start materializing early next year – this makes longer duration positioning more favorable. |
| **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 seeking to extend duration into the 7-10Y space as opportunities arise. Due to the challenging economic outlook ahead, we see further opportunity in special situations bond funds, which provide absolute portfolio returns with no correlation to the overall economic cycle. |
| **Equities** | • The benchmark S&P 500 rose 7.8% year-to-date after dropping nearly 20% in 2022, while gains across technology stocks have pushed the Nasdaq 100 up 22% since the start of January. Equity valuations do not appear compelling once adjusted for the shortfall in corporate earnings, and equities do not seem attractive relative to bonds when using a 3-year Z-score Bond-Yield to Earnings-Yield ratio. 452 members of the S&P 500 have reported earnings till now and on a consolidated basis they have reported a 4% drop in earnings and modest 4.3% growth in sales. We expect earnings to continue deteriorating on the back of tighter credit conditions as the US banking crisis continues to unfold and contrary to the consensus estimates, do not expect a strong rebound in earnings in the back half of the year. Consequently, we maintain our bearish outlook on equities for the next six months and recommend (in order of preference) Long/Short managers, options (FCNs or Puts), and quality stocks. |



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# 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.<br>• 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 will inevitably support prices in the mid-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.<br>• 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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