Investment Playbook Weekly Update

12th to 16th June 2023

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Charts of the week

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US May CPI – Still sticky beneath the surface

While Headline CPI printed slightly below consensus, Core CPI came in a little stronger than expected.

Consumer Price Index Heat Map (MoM% Ch

	Weight	May '22	June '22	Jul '22	Aug '22	Sep '22	Oct '22	Nov '22	Dec '22	Jan '23	Feb '23	Mar '23	Apr '23	May '23
Headline CPI	100%	0.9%	1.2%	0.0%	0.2%	0.4%	0.5%	0.2%	0.1%	0.5%	0.4%	0.1%	0.4%	0.1%
Shelter	35%	0.6%	0.6%	0.6%	0.7%	0.7%	0.7%	0.6%	0.8%	0.7%	0.8%	0.6%	0.4%	0.6%
Food	13%	1.1%	1.0%	1.1%	0.8%	0.8%	0.7%	0.6%	0.4%	0.5%	0.4%	0.0%	0.0%	0.2%
Medical Services	6%	0.4%	0.7%	0.4%	0.7%	0.8%	-0.4%	-0.5%	0.3%	-0.7%	-0.7%	-0.5%	-0.1%	-0.1%
Vehicles & Parts	8%	1.2%	0.5%	-0.1%	0.4%	-0.2%	-0.5%	-0.7%	-0.6%	-0.7%	-0.9%	0.0%	1.5%	1.5%
Educ./Comm. Svcs	5%	0.2%	0.1%	0.0%	0.2%	0.2%	0.2%	1.0%	0.3%	0.5%	0.2%	0.3%	0.1%	-0.2%
Energy	7%	3.4%	6.9%	-4.7%	-3.9%	-1.7%	1.7%	-1.4%	-3.1%	2.0%	-0.6%	-3.5%	0.6%	-3.6%
Transportation Svcs	6%	1.6%	1.8%	-0.4%	1.0%	1.9%	0.6%	0.3%	0.6%	0.9%	1.1%	1.4%	-0.2%	0.8%
Recreation Services	3%	0.5%	0.3%	0.5%	0.0%	0.2%	0.8%	0.9%	0.3%	0.7%	1.2%	0.0%	0.7%	-0.1%
HH Furnishings/Supplies	4%	0.2%	0.6%	0.6%	0.9%	0.5%	0.0%	0.4%	0.3%	0.5%	0.8%	0.4%	-0.4%	-0.4%
Apparel	3%	0.4%	0.7%	-0.1%	0.3%	0.0%	-0.2%	0.1%	0.2%	0.8%	0.8%	0.3%	0.3%	0.3%
Recreation Goods	2%	0.1%	0.4%	0.1%	0.6%	-0.1%	0.8%	-0.3%	0.1%	0.1%	0.4%	0.2%	0.3%	0.0%
Medical Goods	1%	0.3%	0.4%	0.6%	0.2%	-0.1%	0.0%	0.2%	0.1%	1.1%	0.1%	0.6%	0.5%	0.6%
Core (Ex Food & Energy)	80%	0.6%	0.6%	0.3%	0.6%	0.6%	0.3%	0.3%	0.4%	0.4%	0.5%	0.4%	0.4%	0.4%
Core Services	58%	0.6%	0.6%	0.4%	0.6%	0.8%	0.5%	0.5%	0.6%	0.5%	0.6%	0.4%	0.4%	0.4%
Core Goods	21%	0.6%	0.6%	0.1%	0.4%	0.0%	-0.1%	-0.2%	-0.1%	0.1%	0.0%	0.2%	0.6%	0.6%

Note: Shows select MoM price change per CPI category, sorted by weight in the headline index.
Category labels abbreviated from official titles. Seasonally Adjusted. Intra-category color scheme.
Source: CreditSights, Macrobond, BLS

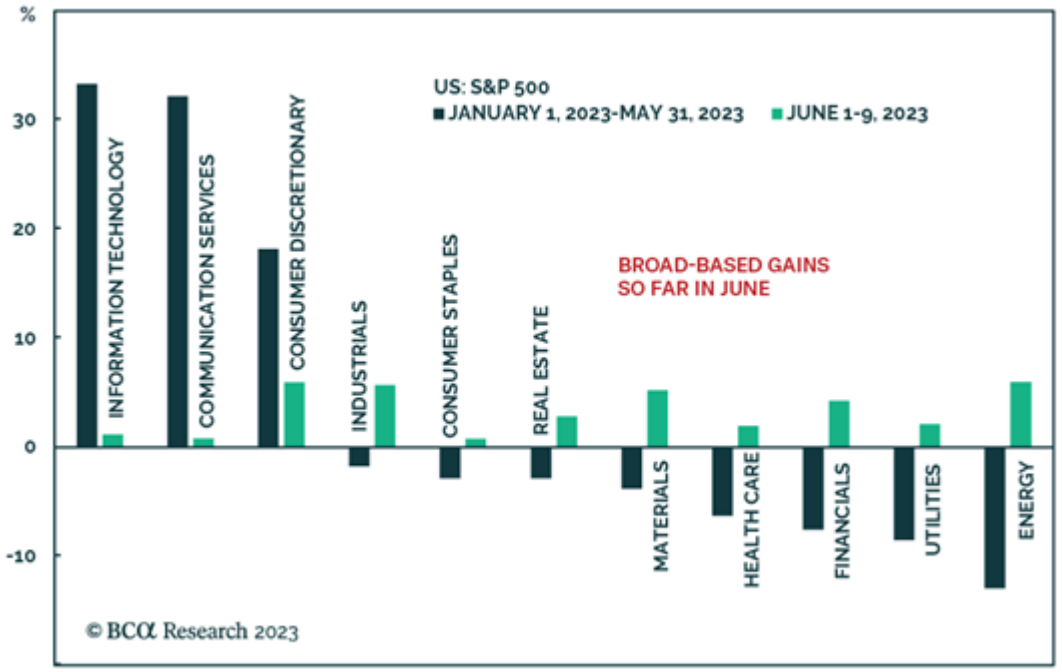
Source: CreditSights, June 2023

- The CPI data for May 2023 while continuing its downward trajectory could be viewed as mixed.
- Headline CPI came in at 4% YoY against expectations of 4.1% **BUT** Core CPI came in at 5.3% slightly beating the consensus of 5.2% .
- Shelter has been the biggest contributor on MoM basis and by virtue of its weight in the index will continue to drive the stickiness of the prints.
- Core Goods as highlighted below also has been maintaining the growth momentum on a MoM basis.
- This might force the Fed to hike in its July meeting and then will most likely HOLD the rates for the rest of the year.

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Will The Equity Rally Broaden?

While equities may experience a short-term rally, a cautious approach is advisable for the long-term



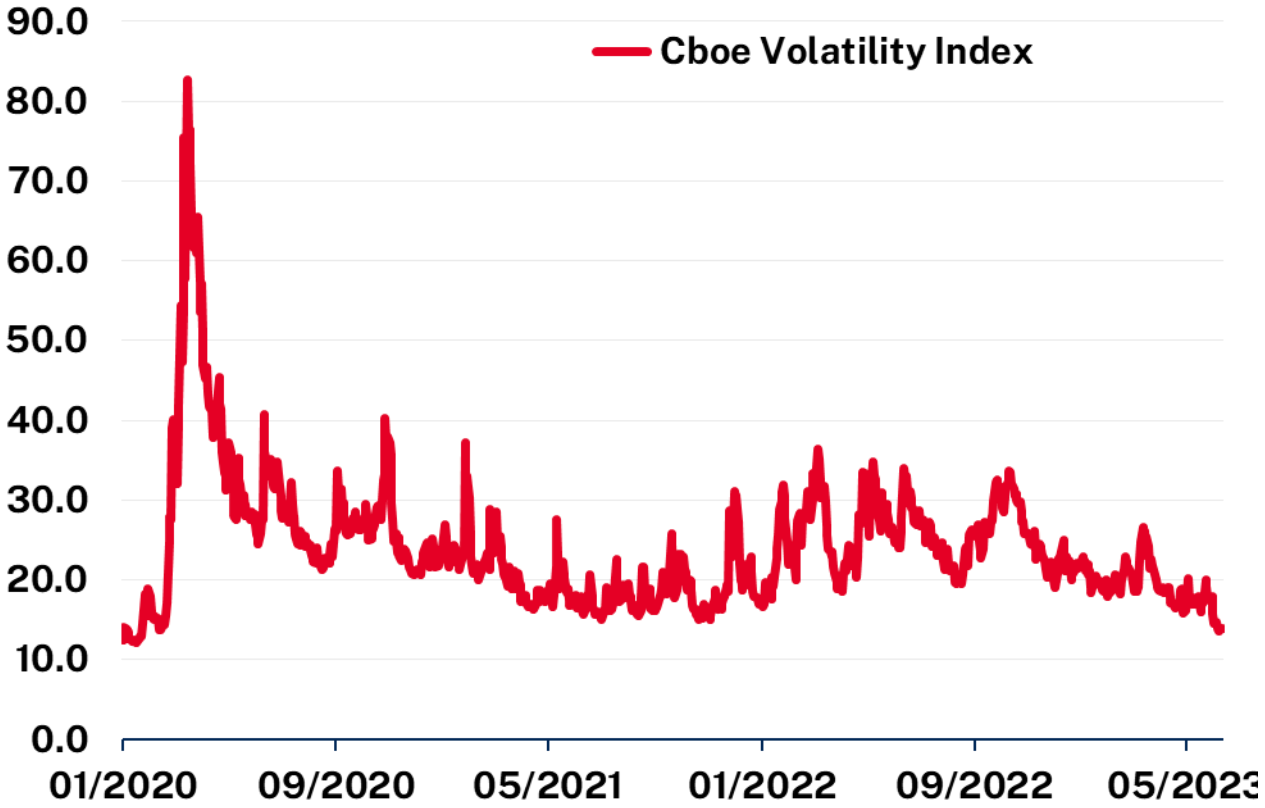
- The market outlook is mixed. On one hand, the rally may continue as investors who missed out on AI-driven gains reenter the market, and investor sentiment has improved.
- On the other hand, caution is warranted due to the weak manufacturing sector and potential negative impacts from the Federal Reserve's tightening campaign.
- With expectations of a recession within a year and valuations not particularly cheap, a cautious stance is favored, overweighting defensive sectors.

Source: BCA, June 2023

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Equities Volatility Falls To Pre-Pandemic Levels

Another sign of complacency, following the recent collapse of several US regional banks.



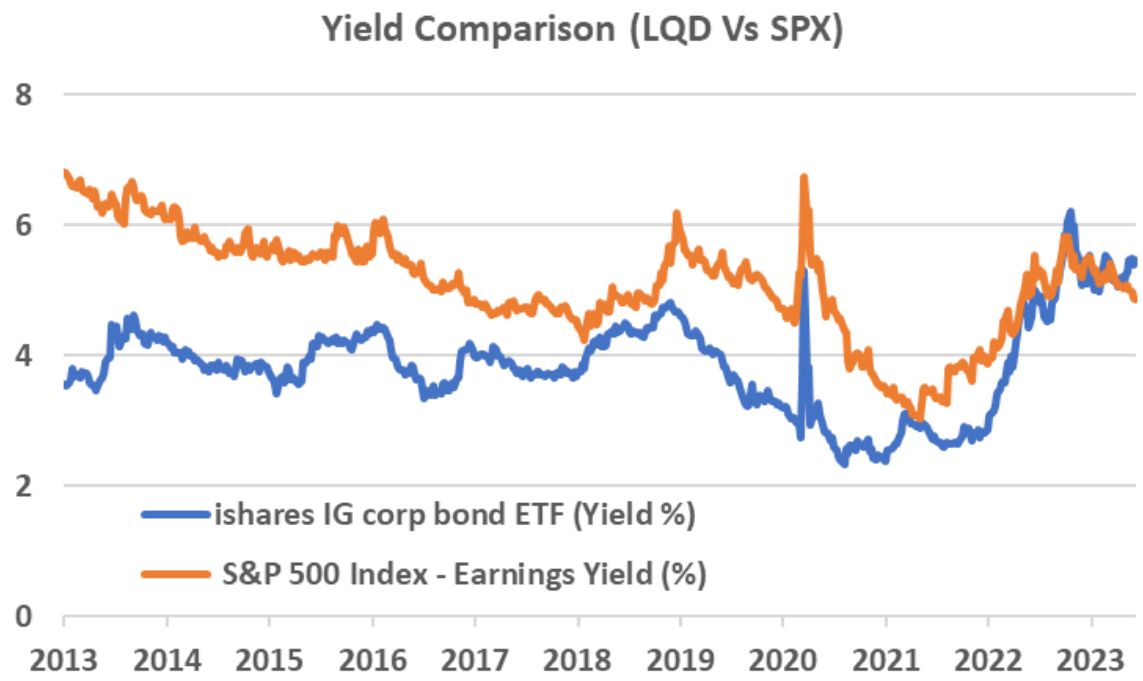
- The VIX index, a measure of US stock market volatility, has reached its lowest level since the beginning of the pandemic, even as investors fret over the direction of interest rates and inflation.
- The index fell to 13.5, the lowest since January 2020, despite rising interest rates, the collapse of several US regional banks in March and widespread uncertainty over the future path of inflation, which remains far above the 2 per cent target set by many central banks on either side of the Atlantic.

Source: FT.com, Bloomberg, June 2023

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Equities Earnings Yield Drops Below That Of Bonds

Whether we head towards a recession or a soft landing, equities valuations appear stretched



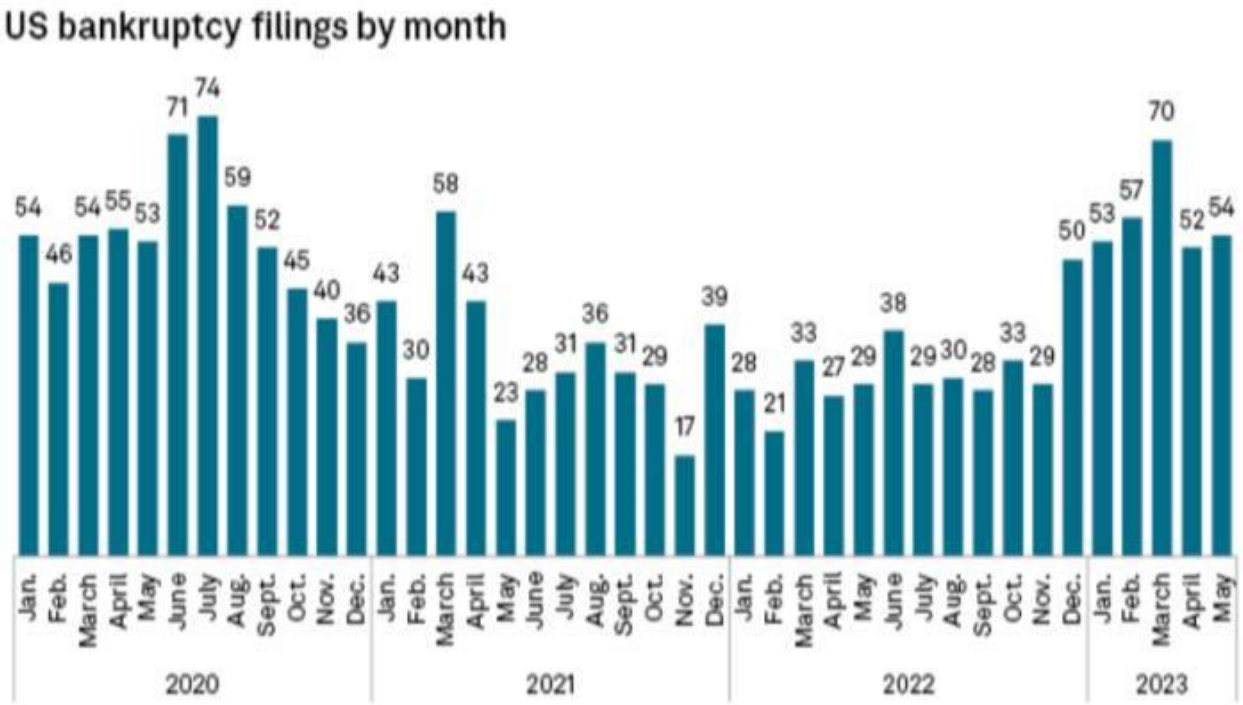
- The S&P 500 index currently has a PE ratio of 20.57x, resulting in an earnings yield of 4.86%. Interestingly, this falls significantly short, by 60 basis points, of the yield that investors could obtain by investing in Investment Grade bonds. For example, the iShares iBoxx IG Corporate Bond ETF offers a yield of 5.45%.
- Although investor sentiment towards equities has been improving, the earnings yield on equities remains significantly lower than that of bonds, indicating a worrisome level of complacency, particularly in a decelerating economy. Whether we are headed towards a recession or a soft landing, valuations once again appear stretched.

Source: Lighthouse Canton, June 2023

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Stress At The Edges

We have not seen the full impact of higher rates yet



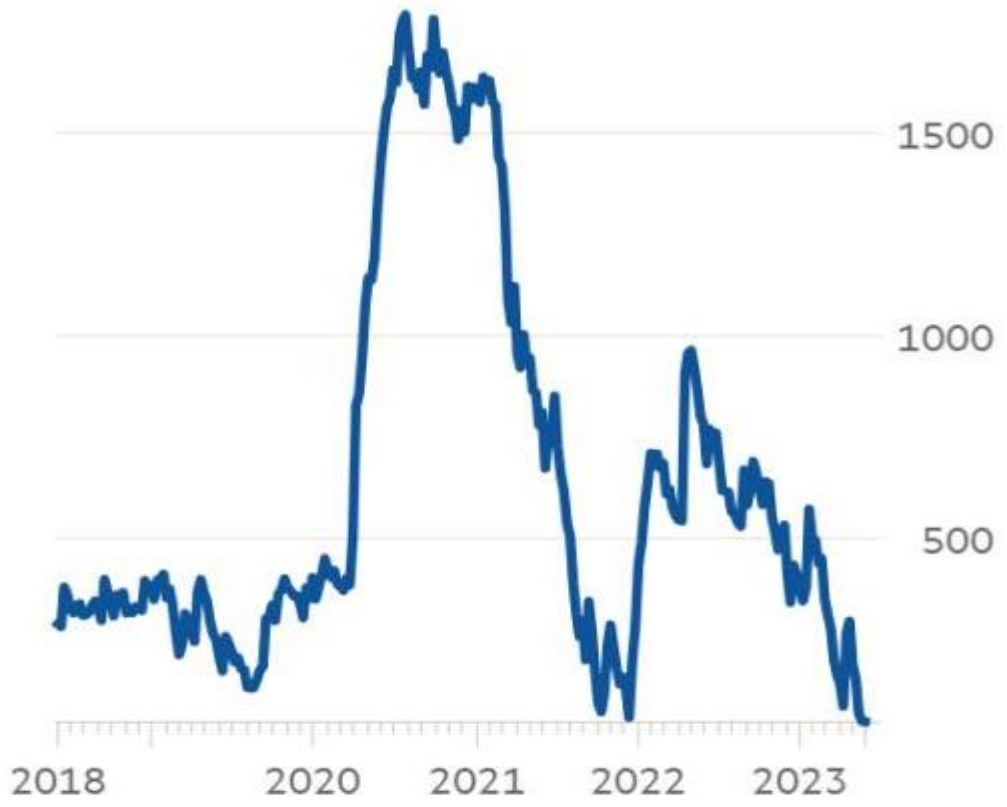
- There is growing concern over increasing US bankruptcy filings. Leveraged loans defaults (floating rates) are rising quickly and provide insights into potential future defaults on (fixed-interest) bonds. The commercial real estate sector is particularly worrisome, with approximately $1.5 trillion in commercial mortgages due within the next three years. Over the past five years, over three-quarters of loans in commercial mortgage-backed securities have been interest-only, adding to the challenges faced by building owners struggling to refinance their debt due to lower occupancy rates and building values.

Source: S&P Global , FT.com, June 2023

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Will Markets Have A Liquidity Crunch?

We have not seen the full impact of higher rates yet



Source: Federal Reserve, FT.com, June 2023

- In the run-up to the debt ceiling deadline, the US Treasury could not issue new debt, so it funded its spending by running down its checking account (known as the Treasury General Account). Now the TGA, standing at just $50bn or so, needs to be rebuilt. The US Treasury said it was aiming for a balance of $600bn by the end of September. That's the government taking cash out of the system by selling debt and not replacing it with spending; a cash drain.
- There are two related worries about the liquidity decline: The first is that it will lower the level of bank reserves, leaving banks less able to deal with market turbulence. The second worry is that withdrawing liquidity from the financial system makes risky asset (equities, bonds) prices fall.

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LC Views - Summary

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LC Views Summary (1/2)

Sub-Asset	Recommended Positioning
Rates	• The Federal Reserve is currently evaluating whether the rate hikes are complete or not. In order to avoid surprising investors soon, Powell emphasized that two rate hikes are still being considered. The revised Summary of Economic Projections indicates an increase in the median projection for the federal funds rate by the end of 2023, from 5.1% to 5.6%. This implies that there may be an additional 50 basis points of rate hikes this year. The Fed's assessment of the necessary extent of further tightening to bring inflation back to the 2% target will be guided by factors such as the cumulative tightening, the delayed impact of monetary policy on the economy and inflation, as well as economic and financial developments. According to the CME Fed Watch Tool, market participants currently assign a 60% probability of a rate hike in July, which is a significant increase compared to the 10% probability assigned just a month ago.
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	• Having maintained a cautious perspective has been an unpleasant experience. Despite the lack of justification based on weak breadth, fear of missing out (FOMO), and the hype surrounding artificial intelligence, the remarkable price action cannot be disregarded. While we are not yet ready to fully embrace the market frenzy, we must reevaluate whether the S&P 500 (SPX) can successfully defend the 4325 level. Although investor sentiment towards equities has been improving, the earnings yield on equities remains significantly lower than that of bonds, indicating a worrisome level of complacency, particularly in a decelerating economy. US Equities (S&P 500 Index) have been surprisingly resilient so far in 2023, but 95% of the performance is explained by 7 technology stocks only. The path of least resistance for stocks seems to be on the upside for now, although the rise in valuations along with our view that a recession is looming, does call for cautiousness. 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.

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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. • 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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