Lighthouse Canton Monthly Investment Memo

May 2023

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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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SpotLight

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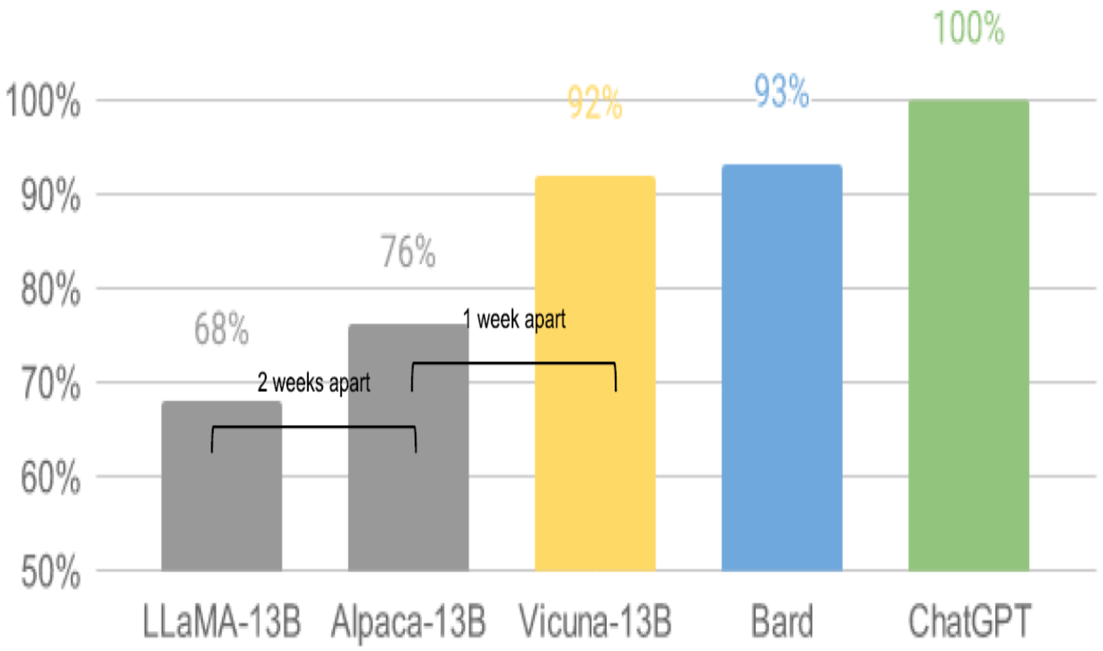
Google “We Have No Moat, Neither Does OpenAI”

Leaked Internal Google Document Claims Open-Source AI Will Outcompete Google and OpenAI



Source: https://vicuna.lmsys.org, April 2023

- Open source developments have surpassed OpenAI in various areas.
- Foundation models can be run on a smartphone at a high token rate and personalized AI can be finetuned on a laptop in a short time.
- Art models with no restrictions and unrestricted text models are widely available.
- Open-source models are faster, customizable, private, and highly capable.
- The value proposition of restricted models (Bard, ChatGPT) may diminish compared to free alternatives.

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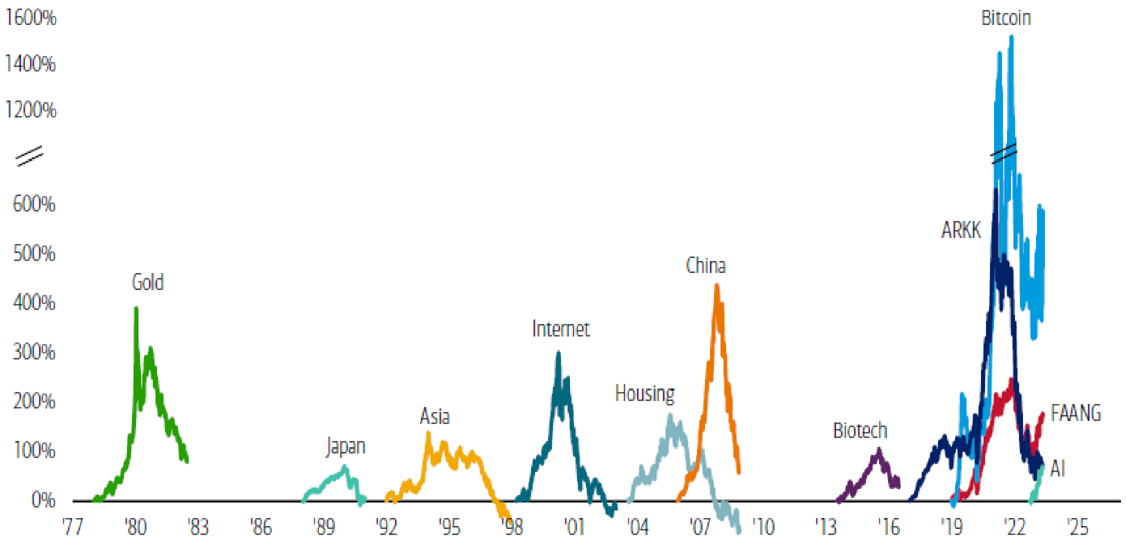
Artificial Intelligence a "Baby Bubble" For Now

US stock market rally continues to be underpinned by weak tape, underpinned by big tech.

History of asset bubbles



Source: BofA Global Investment Strategy, Bloomberg (AI = NVDA + MSFT)

- The Big 7 US Tech stocks are now up +61% YTD and are trading on 30x P/E, This is versus 17x for the rest of the market

- BofA strategist Michael Hartnett said he would be selling the market here and now as the combination of $220 EPS at a 20x PE with 200bps Fed cuts priced will be "as good as it gets".

Source: BofA, May 2023

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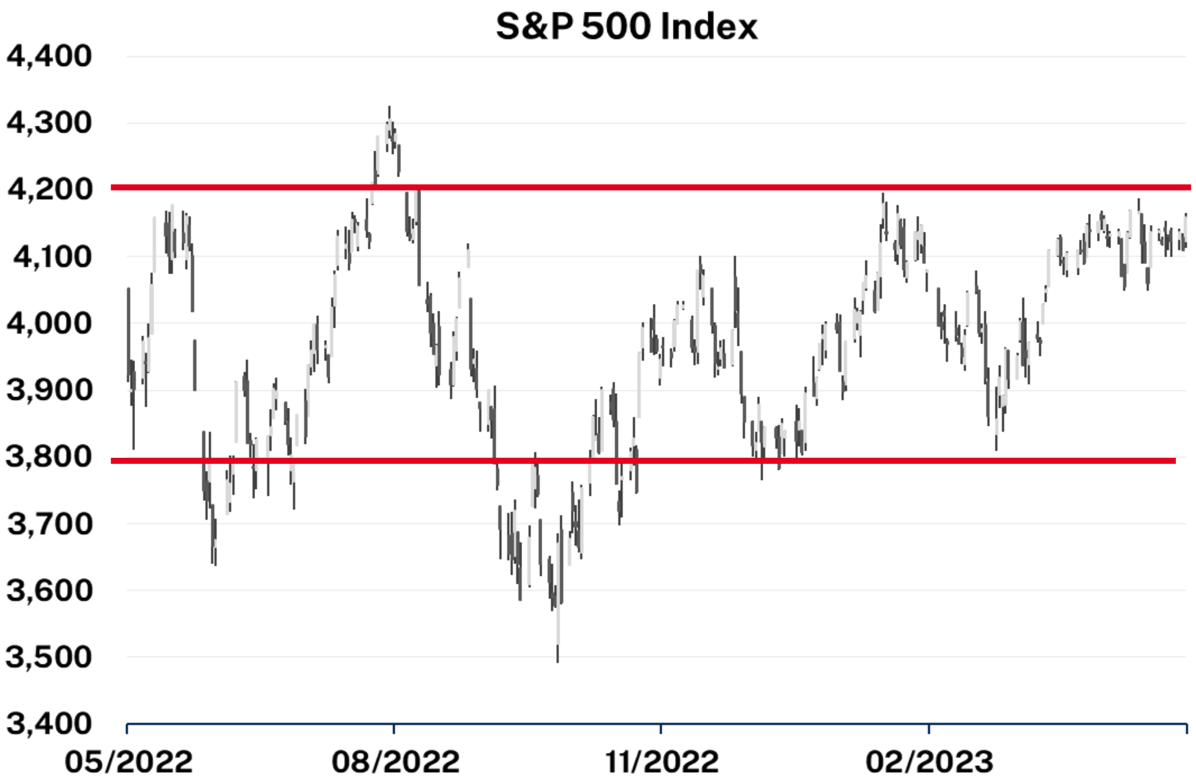
Market Updates

2

US Stocks Remain in a Narrow Trading Range

Indecisiveness has persisted for an entire year and may endure further



Source: Lighthouse Canton, May 2023

- Over the past year, the S&P 500 index, representing US stocks, has consistently traded within a relatively tight range. Out of the last 254 business days, the index has been actively traded for 204 days, accounting for approximately 81% of the observed period. During this time, the S&P 500 has fluctuated between 3800 and 4200 points, representing a relatively narrow range of just 10%.
- The current state of the stock market is characterized by a lack of a definitive catalyst that could provide a clearer direction for investors. Factors such as tighter financial conditions and a slower pace of economic growth contribute to an increased downside potential, from our perspective.

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S&P 500 Equity Risk Premium At Decade Low

Equities' premium over bonds is at its lowest in about a decade

Source:Bloomberg, FactSet, May 2023

The equity risk premium (ERP) can be determined by taking the difference between the earnings yield of the S&P 500 (estimated earnings for the next twelve months divided by the current price) and the yield of the 10-year Treasury bond.

Currently, with an ERP of less than 200 basis points and 150 basis points below its 20-year median, the low level of the ERP suggests that equity investors are exhibiting a high degree of complacency. This could potentially have negative implications for equity returns in the near future.

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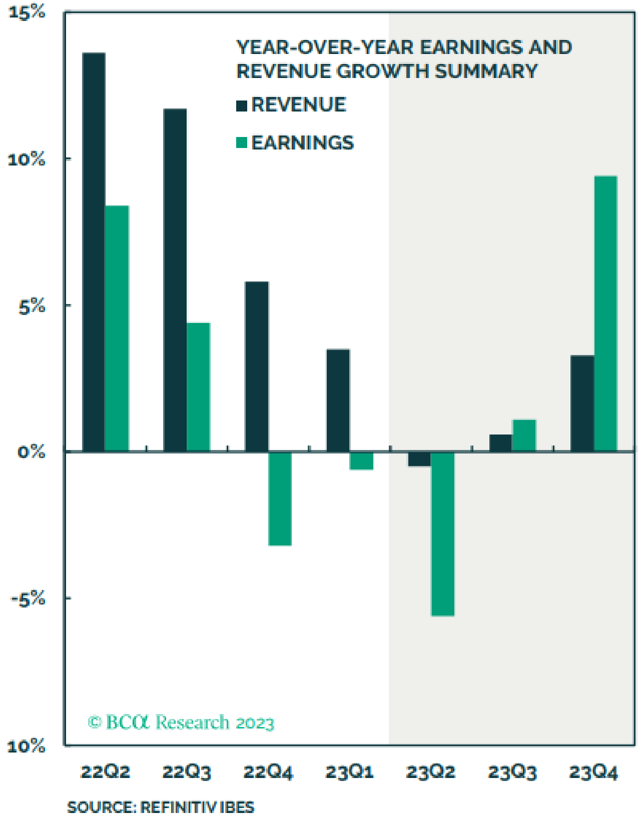
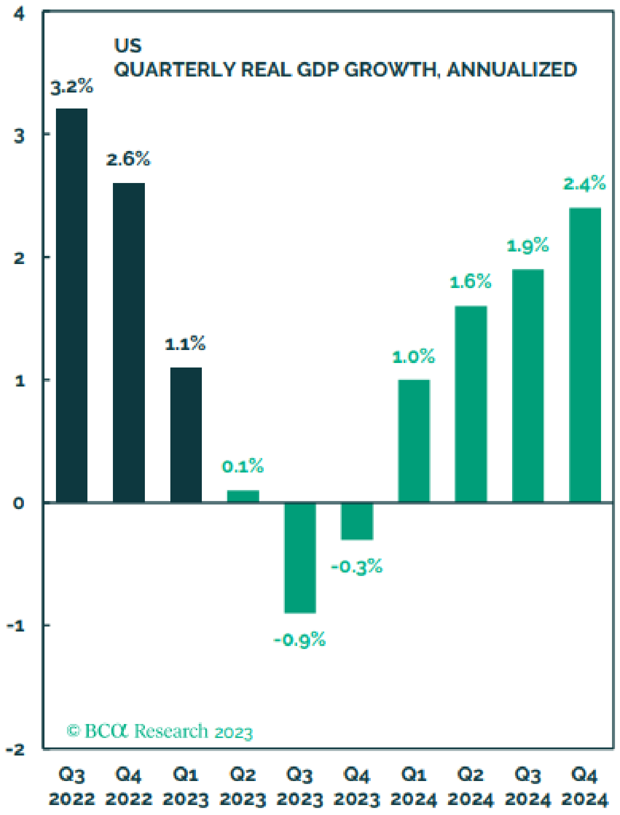
Q1-2023 Earnings: The Good News Is In

The earnings picture is fragmented and inconsistent across companies and sectors.

Analyst Expect Earnings Recovery Later This Year...



...While Economists Expect A Recession!



- Analysts expect earnings to rebound into the second half of the year (left chart), which is at odds with the economic consensus that expects a 2023 recession (right chart) and rate cuts.
- Analysts' projections imply margins will remain above their pre-pandemic level of roughly 9-10%. However, for most companies, the ability to raise prices is now curtailed and their pricing power is declining.
- Prevalent uncertainty about the trajectory of economic growth, inflation, and rates explains why the S&P 500 oscillates in the 3,800-4,200 range.

Source: Refinitiv, Bloomberg, May 2023

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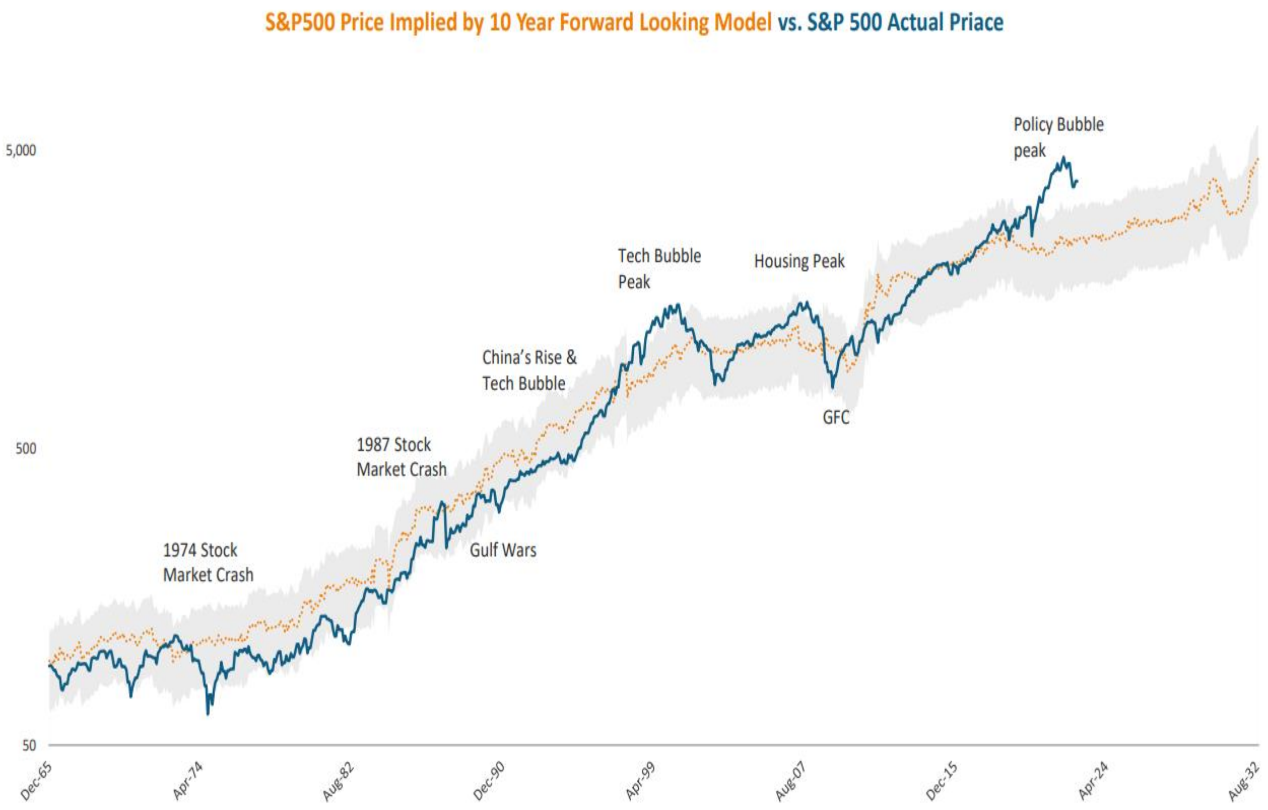
Equity Returns Could Be Flat For Next 10 Years

S&P 500 is trading well above its long-term implied valuation, according to Latitude Capital



Source: Latitude Capital, May 2023

- According to Latitude Capital's analysis, their model, which combines the Cyclically-Adjusted P/E ratio, US household stock investments, and Tobin's Q, suggests that returns on S&P 500 equities may remain stagnant or experience minimal growth over the next 10 years.

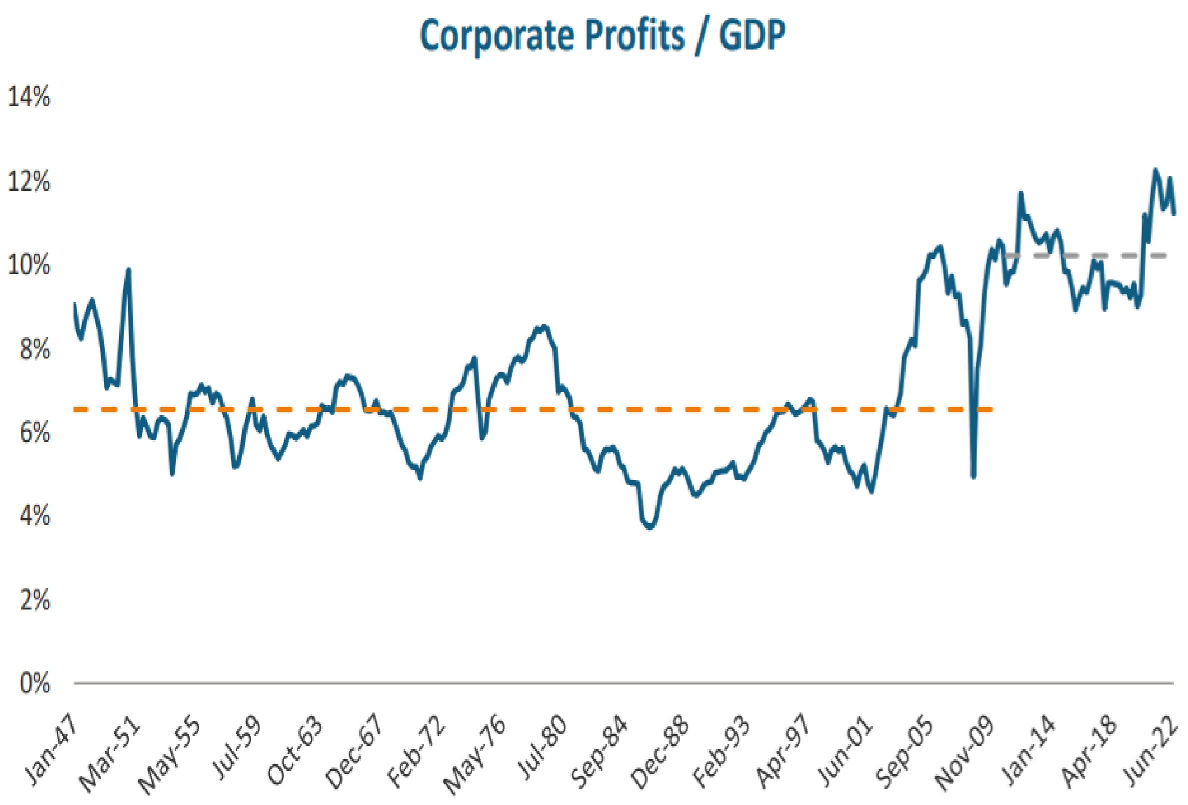
The cyclically adjusted price-to-earnings (CAPE) ratio is a valuation metric used to assess the long-term earnings potential and relative valuation of a stock market or an individual stock.

US household stock investments represents the portion of individuals' financial portfolios that are allocated to stocks.

Tobin's Q is a financial ratio that measures the market value of a company relative to the replacement cost of its assets, an indicator of whether a company is over/under valued.

Corporate Profits Are Likely to Mean-Revert

Wages, taxation and competition will play their part in the long term

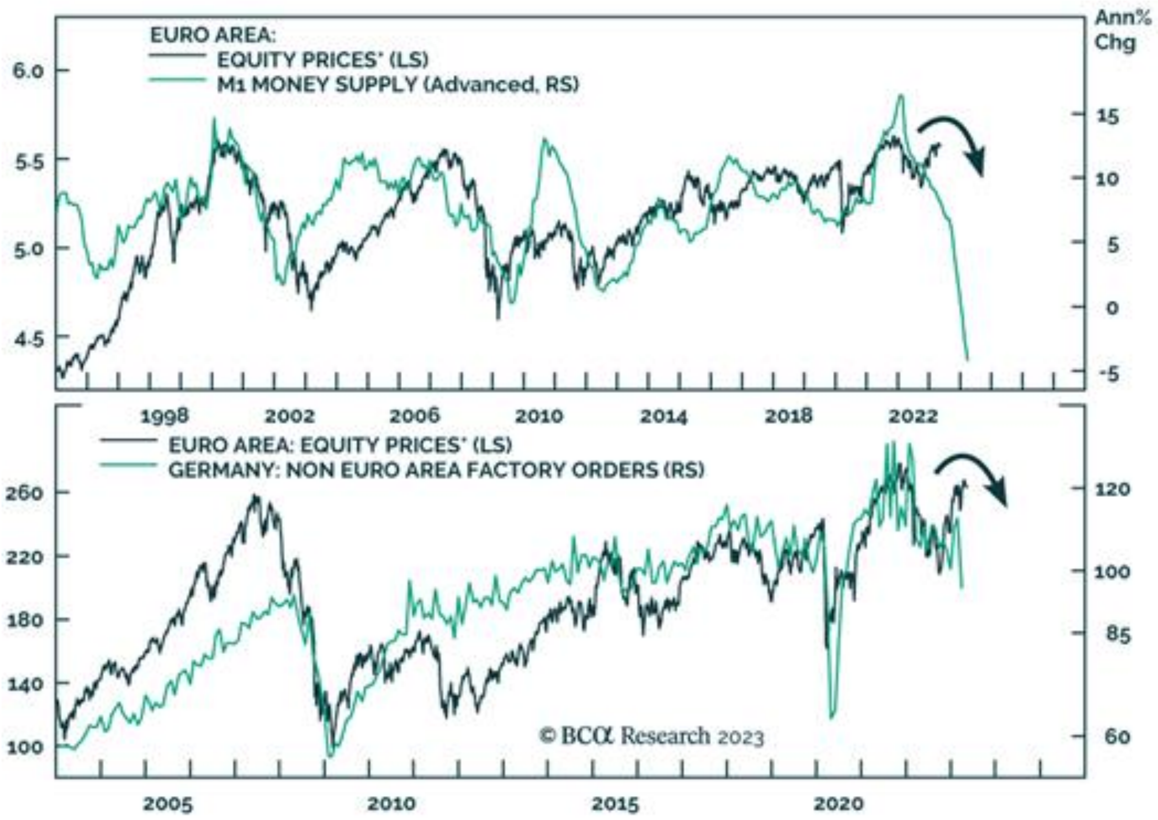


Source: Latitude Capital, May 2023

- Latitude Capital's analysis suggests that corporate profits, which currently stand at 11.3x, are expected to revert to around 10x in the upcoming years due to factors such as intensifying competition, challenges in attracting talent, and changes in taxation.
- The long-term impact of these factors may be particularly significant for tech stocks, as the advancement of AI could potentially facilitate technology transfer, further influencing their performance.

Potential Correction for European Equities

Tight credit standards and subdued loan demand further indicate looming economic troubles.



Source: MSCI, BCA Research , May 2023

- BCA Research's indicates the likelihood of a correction in European stocks in the coming months. The decrease in Euro Area M1 and the curtailment of earnings revisions are key factors contributing to the decline in Eurozone equity prices.
- The correlation between European credit standards, credit demand, and economic troubles is evident, albeit not as strong as with money supply. The presence of tight credit standards and weaker loan demand signifies an upcoming period of economic challenges.

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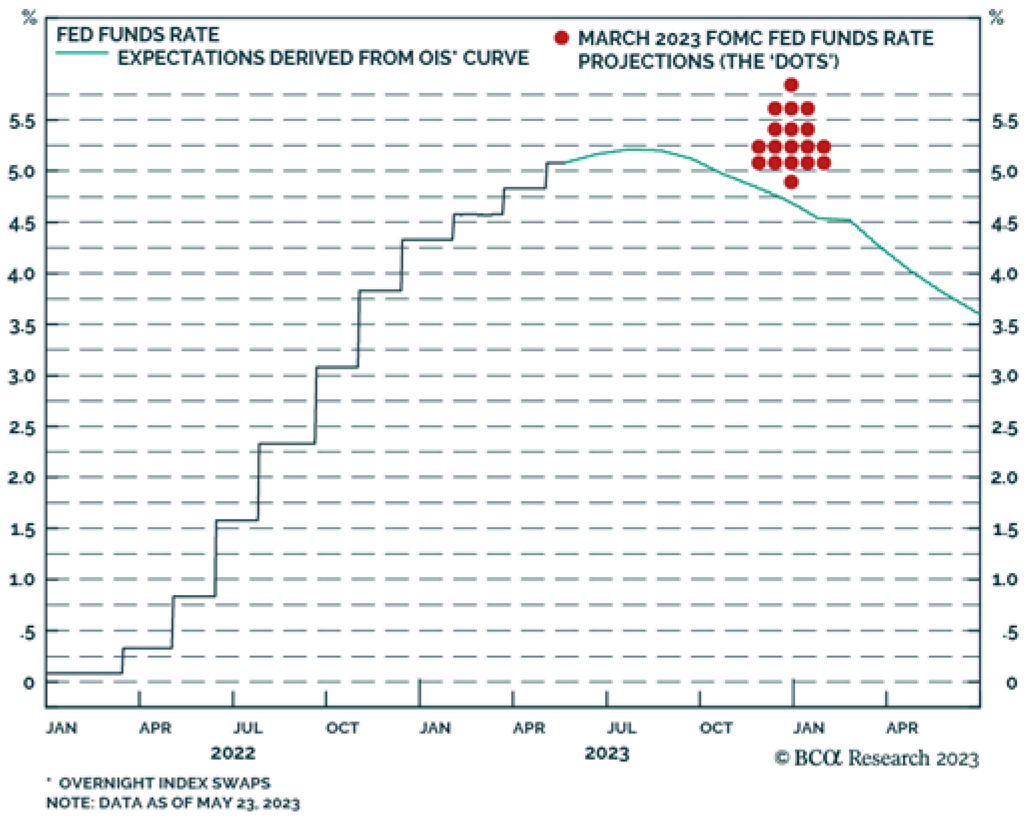
The Holds Still Have It

Recent Fed commentary suggests that the Fed is more likely to keep rates on hold

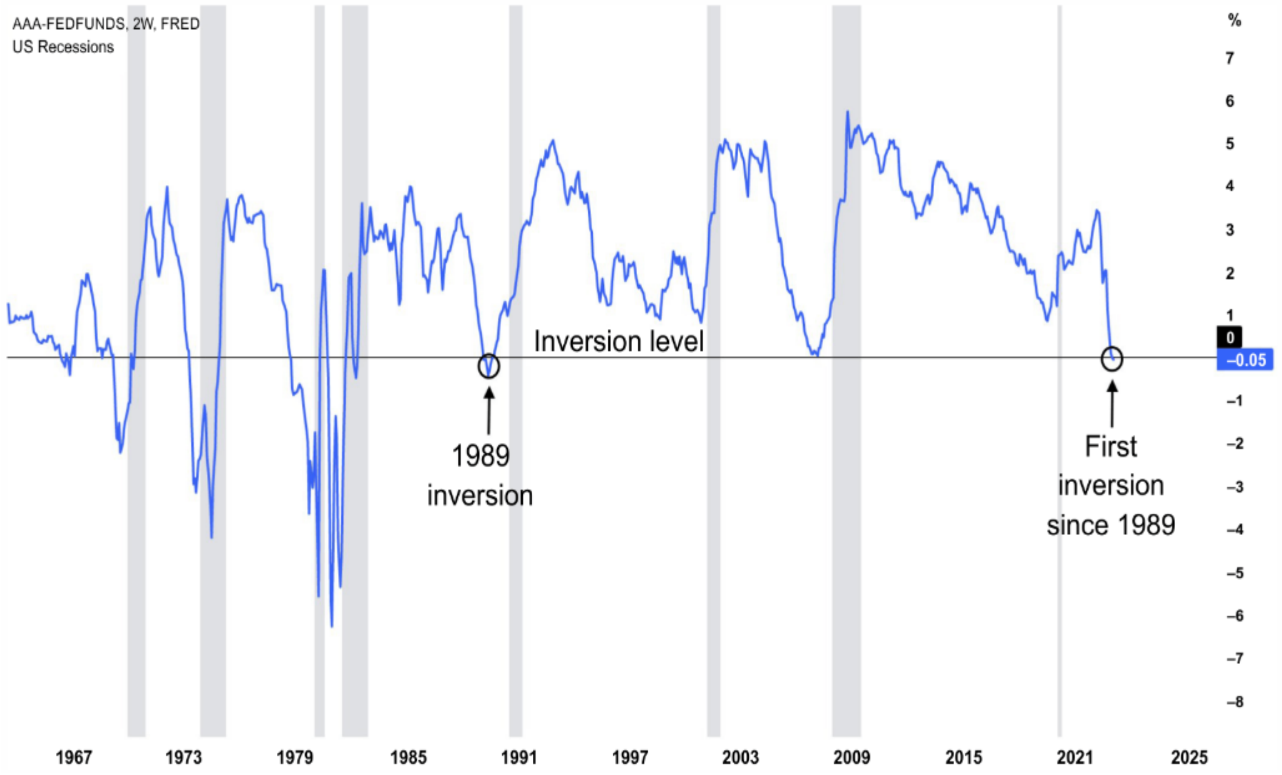


Source: BCA Research , May 2023

- According to BCA Research, recent statements from the Federal Reserve and the minutes from the May FOMC meeting indicate that the Fed is expected to maintain interest rates at their current level during its upcoming meeting next month.
- Although there is a possibility of rate hikes later in the year, BCA Research believes that such increases would only occur if core inflation begins to rise significantly, which is not their baseline expectation.
- On the other hand, the anticipated rate cuts priced into the market for 2023 seem to be misaligned with the current outlook.

Another Potential "Yield Curve Inversion"

Investment Grade bonds are now yielding "as much as" the Fed Funds Rate, a red flag.



Source: MSCI, BCA Research , May 2023

- Yields on Investment Grade corporate bonds appear poised to exceed the effective Fed Funds Rate (FFR) for the first time since 1989.
- Notably this indicator signaled the July 1990 to March 1991 U.S. recession as well as the 2008 Great Financial Crisis.
- Indeed, the effective FFR is now at 5.08%, whereas the yield-to-maturity of the iShares IBoxx IG Corporate Bond ETF (LQD US) is dangerously close, at 5.4%, as of May 24th.

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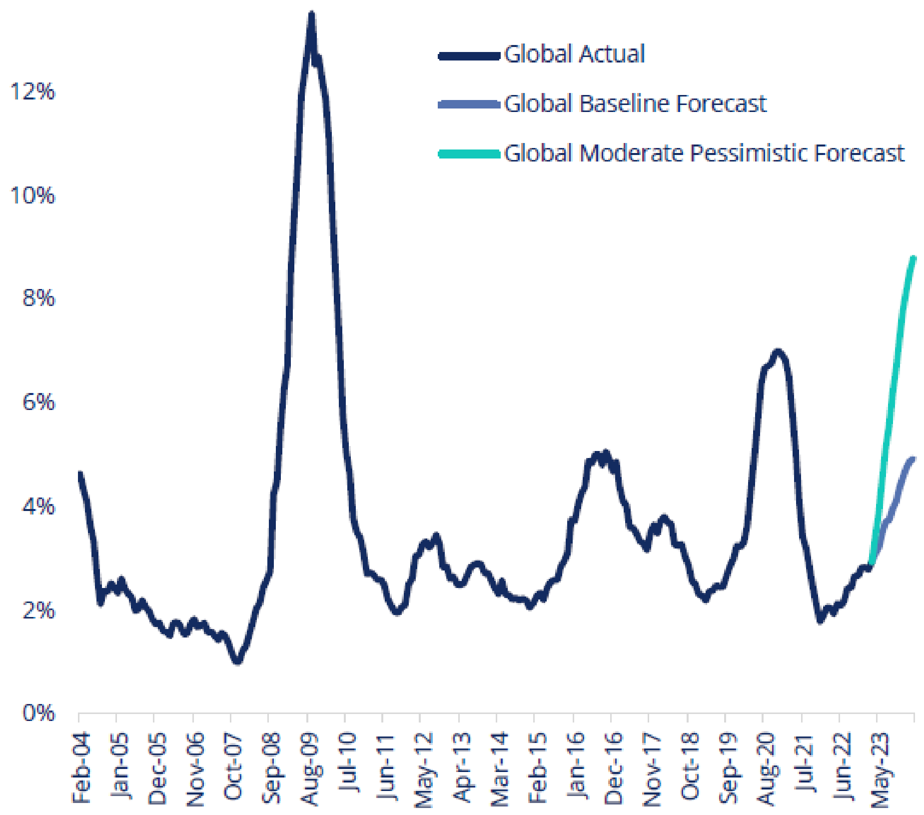
Current Conditions Augurs Poorly For HY

Junk bonds default rate is expected to increase



Source: Cheyne Capital, May 2023

- The combination of stricter lending standards and a contracting High Yield bond and leverage loan market does not bode well for the lower end of the High Yield spectrum. Additionally, liquidity in low-quality credits is already deteriorating, as evidenced by the 7.8% of companies with SGL-4 liquidity scores (Moody's lowest) representing an increase of 110 basis points year-on-year.
- Of greater concern is the significant amount of debt coming due soon, with $265 billion of High Yield debt maturing over the next two years. According to Cheyne Capital, Moody's predicts that High Yield default rates could reach nearly 5% within the next 12 months (or as high as 9% in a pessimistic scenario).

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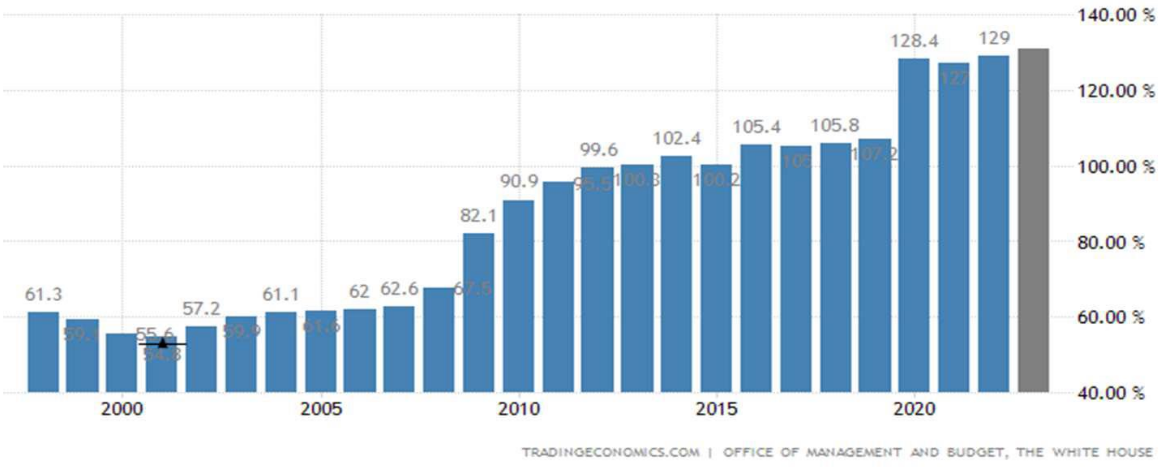
Persistent Increase in US Budget Deficits

Increasing US government debt and budget deficits are a cause of concern



- There has been a significant increase in the US Government Debt/GDP ratio, which currently stands at 129%. This rise has been particularly prominent, surpassing the pre-pandemic level of approximately 100% and doubled from the pre-Great Financial Crisis (GFC) levels.
- Furthermore, the budget deficit for the year 2022 remains elevated at 5.7%, exceeding the pre-GFC range of 1-3% and the post-GFC range of 2-4%.
- These statistics highlight the need to pay closer attention to the growing debt burden and persistent budget deficits in the United States.

Source: Tradingeconomics.com, Office of Management and Budget, The White House, May 2023

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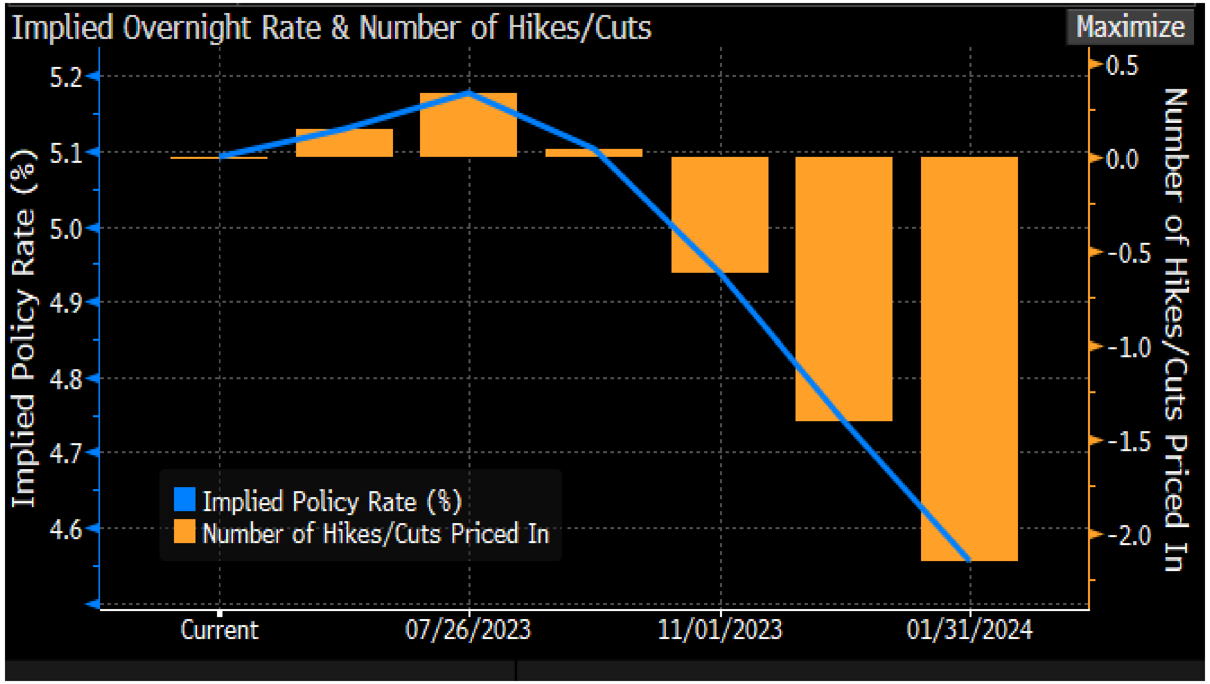
Fed Expected To Decrease Rates By Year-End

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



Source: Bloomberg, May 2023

- Surprisingly, strong US jobs data washed out most bets on a July cut, but rate derivatives continued to anticipate a 50-bp reduction by Q1 2024.

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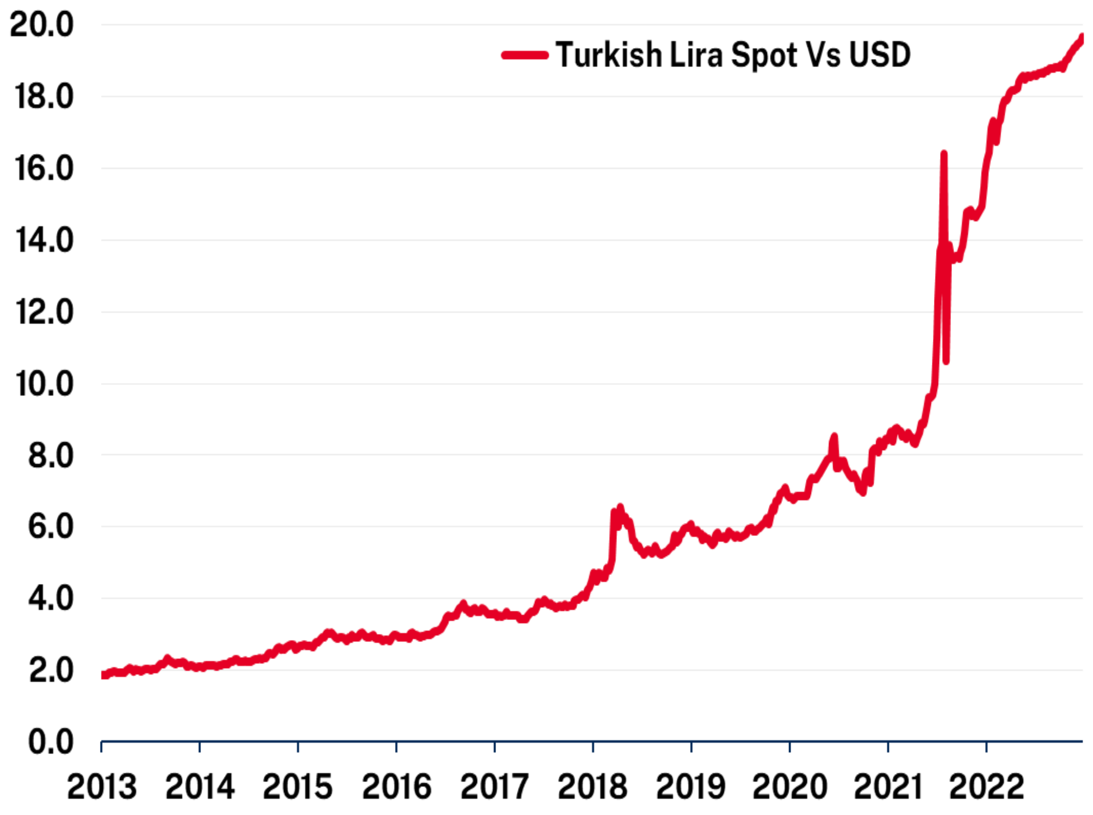
Turkey Slides Deeper Into Crisis

Erdogan's political momentum puts Turkish democracy to the test



Source: Bloomberg, May 2023

- Turkish assets (stocks, bonds and currency) slid as the nation heads for a runoff election on May 28th.
- Stronger-than-expected support for Recep Tayyip Erdogan — who garnered 49.5% of votes — wrongfooted investors who'd bet on a quick end to his unconventional economic policies.
- Stocks and bonds dropped, and the cost of insuring the government's debt against a default spiked.

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