Investment Update

July 2021

finexis
ASSET MANAGEMENT
汇信资产管理有限公司

Market Review

We discussed inflation in the past two months and markets seemed to be taking such concerns well, being in risk-on mode in June. Global equities were up 1.35%, with energy and technology sectors leading the charge. As a reflection of the strong risk sentiment, gold prices took a steep drop of 7.17%, dragging the gold mining index down 13.59%. This is a reminder that **while gold is seen as safe-haven play, investing in gold or gold companies has volatility that investors might not expect with its "safe-haven" status.**

Energy equities continued to propel upwards, buoyed by higher oil prices as OPEC dithered on raising supply and US shale production has not ramped up sufficiently. **Why do we still monitor energy markets when we have cut our direct exposures to the sector?** This is because different segments of the market are more intertwined than they seem. Oil prices surpassing pre-covid highs and benefitting equities has implications for fixed income investments. This is because governments use policy tools to manage economies through the control of interest or currency exchange rates.

Global economies have bounced back from the depths of recession and are headed on a path of strong growth. At the same time, US Fed Chair Jerome Powell says that "interest rates are as low as they'll ever be". Typically, there are three recommendations used in finance: Buy/Hold/Cut. With rates at such lows, these three options turn into two likely scenarios: Hold (if interest rates stay low) or Cut (if they go up). With governments still erring on the side of caution through continued stimulus, pouring too much money into the system may force central bankers' hand to raise interest rates.

Rising interest rates in turn have implications on equity markets. This is driven by the first principles of asset valuation. Ask an equity analyst, CFO, or independent company valuer and they will tell you that interest rates form a key assumption in their company valuations.

This interconnected and feedback loop is crucial in the functioning and price discovery in capital markets. This is where **our multi-asset approach helps to inform analysis of different asset classes that are actually intertwined.**

Crucially, this approach means we are much less prone to cognitive biases that afflict investors who tend to focus on a single asset class or region or style. It means **we are not pressured to stay invested in a particular area as we assess that there are headwinds against it**. This means we have better chance to get into the right place at the right price to enjoy better upside with reasonable margin of safety.

We have been vocal about the challenges facing the average fixed income investor. Unhedged global investment grade bonds resumed their downtrend with losses of 0.88% in the month, and -3.18% for the year. Global investment grade bonds have seen four of the first six months of year in the red as markets tussled with the low rate environment. There are a handful of years where IG bonds were in the red, and if the pattern persists, this year might be another.

Emerging market debt served its purpose in June with gains of 0.7% as emerging market equity was practically flat amid choppy markets.

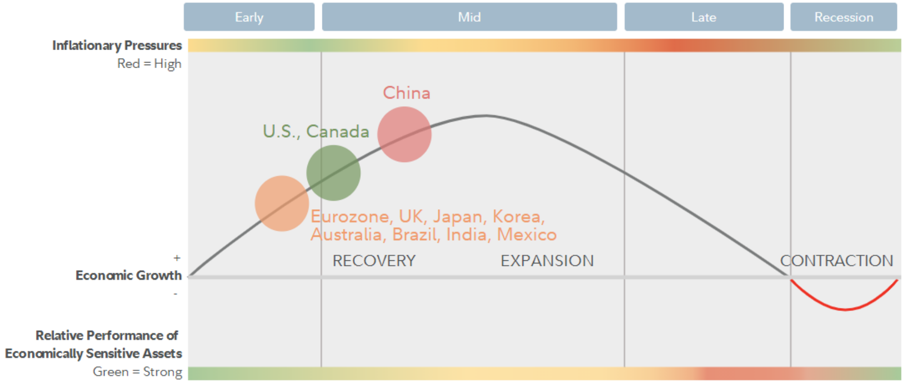
Trend following broke its streak of positive months this year (something equity and fixed income did not have), taking losses as expected when prevailing trends in commodities and currencies reversed. Nevertheless, their diversification proposition is intact.

References: Global equity: MSCI AC World Index, Gold companies: NYSE Arca Gold Miners Index, Global investment grade bonds: Bloomberg Barclays Global Aggregate Index, Emerging market debt: Bloomberg Barclays Emerging Markets Hard Currency Aggregate Index

Key Themes: Positioning For Recovery

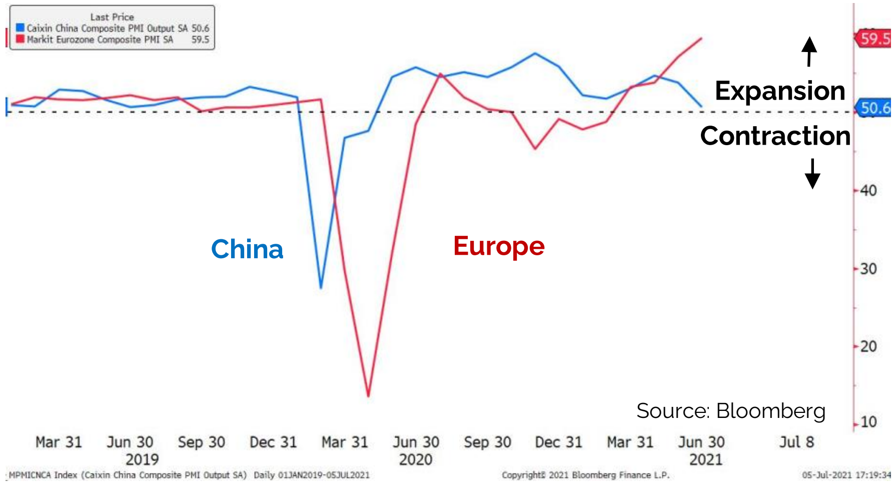
It has been almost 1 year 4 months since Covid-19 was declared a pandemic by the World Health Organization. While the battle against Covid-19 is still far from over, economies and markets have come a long way since the depths of the crisis – global growth has rebounded, and many markets have delivered strong double digit returns in the past one year.

'What's next?' is probably a question on many investors minds today. As we track the global recovery into the second half of 2021, we do not think it will be a case of 'rising tide lifting all boats'. According to Bloomberg, 'regions with the highest incomes are getting vaccinated more than 30 times faster than those with the lowest', and have unsurprisingly seen a quicker path to normalization. **Do we just invest in areas where the virus is largely under control? Again, investing is never so simple as many of these markets are already priced in a recovery, pushing down prospective returns for investors.** In the case of China, which is further ahead in the recovery (as shown in the below chart), economic activity has moderated as policy makers withdraw some of the earlier 'crisis stimulus' - we've been closely monitoring developments here and will adjust our allocations as we identify more attractive opportunities.



Source: Fidelity Q2 Business Cycle Update

PMI Composite: Europe's economy is quickly catching up



Source: Bloomberg

Our process allows us to hone in on areas with more favourable tailwinds; which had previously guided us to invest more heavily into China 'A' early last year when fundamentals and valuations were more attractive, and which subsequently delivered attractive returns for our portfolios. Going into the second half of the year, we favour opportunities with more room to recover and with good 'FVT':

Emerging Market and Europe equities are two laggard plays with the potential to do well as the recovery broadens. In particular, Europe's recovery has gained traction since we allocated last quarter (see above chart), with Euro area PMI (Purchasing Manager's Index) showing a rapid growth in economic activity. Their valuations are also attractive to other developed markets, providing a better margin of safety for investors. **We also continue to favour US small-caps as they trade at a discount to large-caps, and are expected to grow their earnings more quickly alongside the recovering economy.**

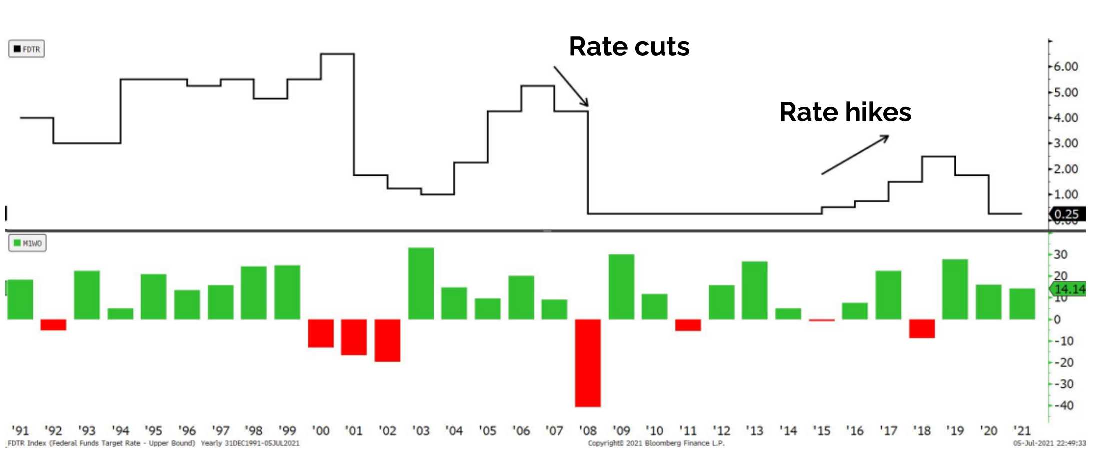
Key Themes: Stability Amid *VUCA*

VUCA is used to describe environments with **Volatility**, **Uncertainty**, **Complexity**, and **Ambiguity**

It seems like we added a new player to the VUCA team in the past month, if the news headlines are any indication. We are of course referring to the US Fed press conference, where Fed Chair Jerome Powell talked about the prospect of raising interest rates. Consequently, the market conversation immediately turned into concerns of tighter policy that may be coming sooner than expected. **Another news headline read 'The Federal Reserve Will Taper, But Don't Freak Out'..but should we actually freak out?**

The important thing to remember is that policy tightening is (usually) done in response to stronger economic growth. This time is no different, as the US is on its way to reopen their economy on the back of a successful vaccination drive. If a growing economy is generally supportive for corporate earnings growth, can we also expect equities to do well even as policy starts to tighten? We can quickly look back to history to see how global equities have fared in previous rate hike cycles:

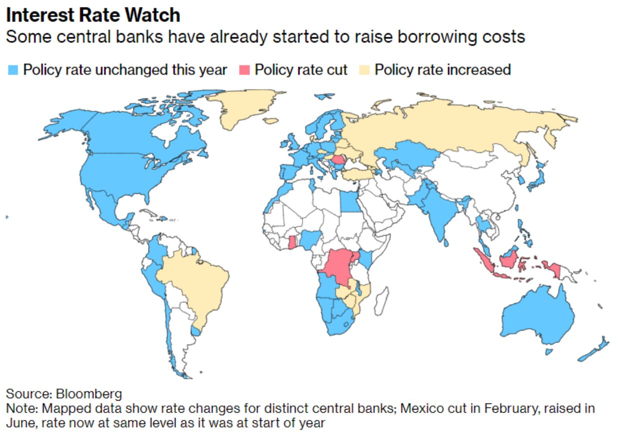
Yearly Equity Performance (bottom) and Fed Funds Rate (top)



Source: Bloomberg. Top: Fed Funds Rate. Bottom: MSCI World Equity Index

It turns out that global equity performance tends to be mostly positive in the years where the Fed first embarked on a new tightening cycle.

While not so much of a concern today, changes in Fed's policy have real implications on the economy and markets e.g. by influencing economic growth, interest rates, and inflation. Though not the base case, a sudden, unexpected change in policy can also lead to bouts of volatility that may lead to market declines e.g. 2013 Taper Tantrum. **For now, we add 'prospect of policy tightening' to the list of things to watch out for in the current VUCA environment.**



Source: Bloomberg

Our differentiated themes have served us well over the past few months as different segments took turn to outperform. As mentioned on the previous page, we have exposures to various recovery plays that are expected to do well as economies continue to recover. **We also continue to be diversified into healthcare, whose earnings are underpinned by secular tailwinds rather than being dependent on recovery to do well.**

Key Themes: Search for Yield

The low rate regime is not just jargon that one uses to impress or obfuscate. **Low rates have profound impact in many areas.**

One benefit is that mortgage servicing costs are so low that people feel compelled to stump up for a big ticket property, or even buy a few for investment. That's absolutely fine provided one is able to continue to service the mortgage payments when interest rates rise, or face the prospect of being foreclosed.

However, low costs for borrowers means low returns for lenders. And this is manifested largely in fixed income markets where prominent managers have cited headwinds for bond investors (refer to last month's commentary). This low return regime struck home recently when local insurers lowered their projected investment returns.

"Life insurers lower range of projected investment returns for policies" https://www.todayonline.com/singapore/life-insurers-lower-illustrative-caps-projected-returns-participating-policies

Year	Upper Bound	Lower Bound	MAS Government average 15 year bond yield	Lower bound - MAS Government bond yield 15 year
July 2021 onwards	4.25%	3%	1.81%	1.19%
July 2013 to June 2021	4.75%	3.25%	2.33%	0.92%
2001 to June 2013	5.25%	3.75%	3.10%	0.65%

Table 1 Illustrative rates for participating policies and MAS Government 15 year bond yield
Source: Bloomberg, https://www.singsaver.com.sg/blog/effects-of-reduced-illustrative-par-policy-rates

SGD bond market	Number of SGD bonds outstanding	Sample issuers
Total	653	MAS, LTA, HDB, Capitaland, NTUC
Yield 3%-4.25%	31	SIA Convertible bonds, Perennial Holdings, SPH
Yield > 4.25%	25	ASL Marine, Aspial, Fragrance Group, KrisEnergy, Oxley

Table 2 Universe of SGD bonds as at July 2021
Source: Bloomberg

Table 1 shows that compared to 2001-2013, insurance portfolio managers in the past 8 years had to take more risk to get a higher return over Singapore government bonds (0.92% vs 0.65%) in order to meet the lower bound of their projected returns. Despite the recent downward revision of projected returns, manager have their work cut out for them as they have to find opportunities yielding 1.19% more than MAS 15 year bonds in order to make the lower bound projected return of 3%.

What does one need to invest in to get 3% or 4.25% in the SGD bond market today? Table 2 shows that **out of 653 SGD bonds currently outstanding, most are yielding less than 3%.** Bond investors targeting to at least hit the lower bound can choose from 31 bonds issued by some blue chip companies. In order to target the upper bound of 4.25%, local bond investors have to go further out the risk spectrum into 25 bonds from smaller property, offshore, and energy companies.

This is a simple assessment of the opportunity set and is not intended to be an actuarial study. Nevertheless, it is intended to illustrate the challenges of the search for yield when the scope is limited. **Fortunately, our asset allocation universe allows us to seek out a wider opportunity set such as global and emerging market high yield in order to achieve the objective of the search for yield.**

Key Themes: How Are We Positioned?

Positioning for Recovery	Stability Amid *VUCA*	Search for Yield
China 'A' equities ⬇	Health Care equities	Asian High-yield bonds
Emerging Market equities		Emerging Market Short Duration bonds
US Small-cap equities		
Europe equities		
Quality Value		

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Asset Allocation Strategy

Equity: Regions	--	-	=	+	++	Allocation strategy
United States		→				**US Small-caps** as relative valuations attractive and are expected to benefit as economies recover. **Healthcare** as earnings are more stable and less dependent on broader economic cycle. **Quality Value as valuations attractive, and expected to benefit as economies recover. Quality bias to avoid potential 'value traps'**
Europe						Relative valuations are attractive, and expected to benefit as economies recover.
Japan		0%				Maintaining no exposure as they are less attractive compared to other opportunities.
Asia Pacific ex Japan					←	Maintain **China 'A'** slight overweight as relative valuations continue to be reasonable, and supported by a recovering economy. **Reduce overweight as economic activity has moderated.**
Emerging Markets						Neutral as valuations attractive relative to developed markets, but where earnings tend to be less resilient.

Fixed Income	--	-	=	+	++	Allocation strategy
Global						Focus on currency-hedged government bonds and unconstrained credit to buffer portfolio volatility during periods of stress.
Investment Grade Corporate	0%					Maintaining no exposure as low incremental yield and long duration credit exposure are less attractive than other segments.
US High Yield		0%				Maintaining no exposure due to relative poorer fundamentals.
Asia						Attractive yield across major fixed income markets with room for capital appreciation and better fundamentals.
Emerging Market Debt						Hard currency short duration focus as a more defensive credit investment for a recessionary environment.

Notes: - - Underweight - Slight Underweight = Neutral + Slight Overweight + + Overweight

Current Previous

Market Index Returns

Equity Regional	MTD	QTD	YTD
Global	1.35%	7.51%	12.55%
United States	2.33%	8.55%	15.24%
Europe	1.54%	6.76%	15.78%
Japan	1.17%	-0.42%	8.89%
Asia Pacific ex Japan	-0.30%	4.01%	6.84%
Emerging Markets	0.17%	5.08%	7.43%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	-0.88%	1.31%	-3.21%
Global Aggregate (Hedged)	0.49%	0.98%	-1.52%
High Yield	1.21%	2.44%	3.02%
Asia	0.35%	1.13%	-0.05%
Emerging Market Debt	0.72%	2.99%	-0.59%

Currencies	MTD	QTD	YTD
USD/SGD	1.79%	0.04%	1.76%
EUR/SGD	-1.29%	1.12%	-1.20%
JPY/SGD	1.40%	0.35%	7.61%

Commodity	MTD	QTD	YTD
Gold	-7.17%	3.65%	-6.76%
Oil (WTI Crude)	10.78%	24.19%	51.42%

Equity Markets	MTD	QTD	YTD
Australia	2.26%	8.46%	13.50%
Brazil	0.46%	8.72%	6.54%
China "A"	-1.48%	4.27%	1.01%
China "H"	-1.34%	-1.48%	0.67%
Hong Kong	-0.65%	2.75%	7.42%
India	1.29%	6.49%	10.59%
Indonesia	1.22%	1.34%	1.63%
Korea	2.90%	7.69%	14.88%
Malaysia	-3.01%	-1.73%	-3.76%
Russia	3.55%	10.77%	19.44%
Singapore	-1.06%	0.08%	11.84%
Taiwan	4.31%	8.41%	21.08%
Thailand	-0.36%	0.89%	11.46%

Equity Sectors	MTD	QTD	YTD
Gold	-13.59%	4.94%	-5.60%
Energy	4.50%	10.13%	42.37%
Technology	6.83%	11.34%	12.69%
Healthcare	2.92%	8.78%	9.06%
Financials	-3.10%	7.93%	24.50%

Total return in local currency terms as of **30 June 2021**
Source: Bloomberg

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