

Folly of the Crowds

By Edward Lim
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Have you ever paid a few hundred dollars to see your favorite artist perform live only to have the occasion marred by fellow revelers holding up their phones to record the entire concert and blocking the view of everyone else including themselves? You ask yourself should I follow the crowd and record the moments, or should I ignore and live in the moment? What kind of concertgoer are you? It is carpe Diem for me.

At the start of the year, in [The Indomitable Human Spirit](#) Navigator, our central thesis for overweighing Treasuries and high-grade debt centers on our view that inflation will fall precipitously. But central bankers' tunnel vision to restore their lost cred in fighting inflation will push the global economy into a recession, and they will have to pause their tightening by 2Q-3Q23 and reverse course by the end of the year or early first quarter of next year. We were looking to reverse our long-standing underweight in equities sometime in 2Q23 following the contours of our view of inflation and policy rates but have caveated this decision with the global economy not slipping into a severe recession. However, the view to overturn our underweight in Equities was truncated by the US banking crisis in March and the dissolution of Credit Suisse in the same month.

We opened in [Down in the valley to pray in March](#) and [Everything, everywhere, all at once](#) in April that these developments will likely tilt the US from a mild-moderate recession into a moderate-severe one. We were surprised that there are still more than 4,000 banks in the US and even more shocked that the smaller banks in the US have enjoyed regulatory arbitrage for so long. This has allowed them to grow significantly faster than the GSIB banks like JP Morgan or Bank of America and they have played an outsized role in providing credit to the US economy. For example, smaller banks with assets below \$250bn hold 80% of the commercial real estate loans in the system. Furthermore, we reiterated our long-standing view that decades of easy money have led to a colossal bubble in real estate and this bubble is global in nature. We collated our months-long discussions with various fund managers and companies spanning across different real estate asset classes from publicly listed REITs to a mezzanine financier in commercial real estate in Germany and they reinforce our view this bubble is bursting in many arrays.

With this backdrop of a slowing economy riddled with more bank bankruptcies to come accompanied by fraying real estate, it has become even more exigent to determine the probability of a recession and the kind of recession we might be in. Of course, predicting a recession, let alone the severity of one, is a career suicide job. If you are wrong, you are called an alarmist and if you are right, you will be fired. As we have highlighted in various Navigators, our approach to predicting a recession is multi-prong. First, we look at the consensus economic forecast. The consensus is expecting a recession in the US to commence in 3Q23 and last till the end of the year. But they are expecting only a mild one with a cumulative decline of just 1.0% contraction from the peak in 2Q23.

Consensus economic forecast expects a mild US recession to commence hereon

Real GDP (YoY % Change)	2023	2023	2023	2023	2023	2023	2023	2024	2024	
Source: Bloomberg	-0.6	-3.2	2.6	3.3	0.6	-0.3	-0.4	0.8	3.6	3.9

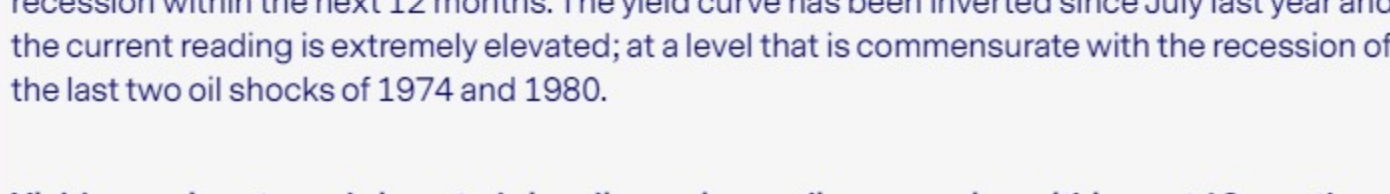
The second method is to look at the Nowcasting model which considers current economic data to estimate what is the current state of the economy. The Nowcasting model tells us the global economy is already growing below 3.0%, which is the threshold between growth and recession. Developed markets are already in negative growth reinforced by the recent news that the Eurozone has entered a technical recession. Emerging markets are barely growing above its potential and China will pose a significant drag in the coming quarters for the region and the globe. Its recent policy responses have been measured and targeted but they are not enough to lift its growth back to its target of 5%; at best we think China will grow 3-4% this year.

Nowcasting says we are already in a global recession



The third method is analyzing Forecasting indicators which attempt to predict the state of the economy in the coming 1-2 quarters. However, forecasting indicators are conflicting with the OECD G7 Indicator indicating zero growth in the coming quarters for the grouping but the more widely followed PMI shows services and manufacturing powering into expansionary phase after miring in contractionary levels for much of the second half of last year.

Forecasting indicators are contradicting each other



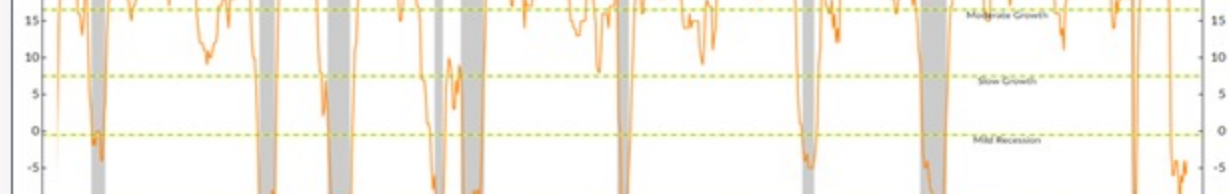
The fourth method is to rely on market indicators. The most reliable market indicator is the shape and duration of an inverted yield curve. This market signal has an impeccable record of calling a recession within the next 12 months. The yield curve has been inverted since July last year and the current reading is extremely elevated; at a level that is commensurate with the recession of the last two oil shocks of 1974 and 1980.

Yield curve is extremely inverted signaling an impending recession within next 12 months



Four and half of the barometers we use are signaling an impending recession for the US and by implication likewise for the global economy as well. Critically, what kind of recession matters more as we will demonstrate later. Based on the consensus economic forecast detailed above and Net Davis Research economic timing model, the upcoming recession is assumed to be a mild one.

Seems like it is going to be a mild-moderate recession in the US



Given the overwhelming evidence that a recession is inevitable, we are managing our portfolios with this as the base case. From a cross-assets perspective, very few asset classes generated positive absolute returns during a recession. Only the US Treasury, investment-grade debt, gold, and ironically the USD have positive returns.

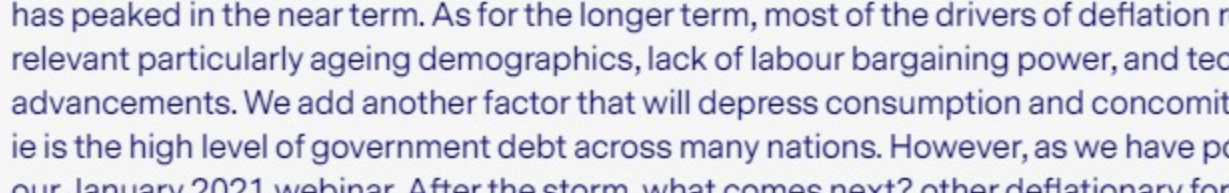
Hiring has peaked and job cuts increasing. More jobs lost than openings available

Recession	US Large Cap	US Mid Cap	US Small Cap	Emerging	US Corporate IG	US Treasury	EMD Yield	ICE BofA Fixed Rate Securities	ICE BofA US Capital Markets Index	US MBS						
Recovery	15%	21%	10%	20%	50%	5%	1%	4%	11%	7%	18%	15%	13%	3%	4%	7%
Expansion	18%	22%	24%	18%	21%	1%	4%	11%	7%	18%	15%	13%	6%	9%	3%	3%
Decline	6%	4%	3%	3%	3%	4%	2%	4%	6%	6%	4%	5%	4%	4%	2%	2%
Contraction	-8%	-1%	-1%	-2%	-2%	13%	1%	11%	-2%	-2%	-4%	-10%	-12%	7%	7%	7%

Source: Principal Asset Management

The weight of evidence supports our view that inflation should fall across all the major drivers in the next 6 months. This leads us to believe the positive correlation between equities and bonds has peaked in the near term. As for the longer term, most of the drivers of deflation remain relevant particularly aging demographics, lack of labour bargaining power, and technological advancements. We add another factor that will depress consumption and concomitantly inflation, ie is the high level of government debt across many nations. However, as we have pointed out in our January 2021 webinar, after the storm, what comes next? other deflationary forces are reversing. Presently, we stated that globalization has peaked and is replaced with friend shoring which should lead to higher prices. China becomes the net exporter of inflation instead of deflation as its costs level up. The cadence of the e-commerce penetration should slow from hereon, while the adoption of ESG will be expensive in the near term.

Gold and the USD generally post positive returns during recession



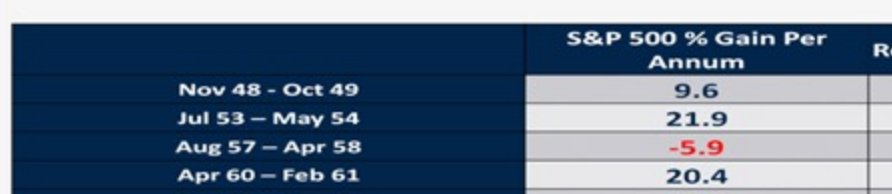
Equities: Remains Underweight. We have alluded to what kind of recession is critical and nowhere is more apparent than in equities. When we analyzed the performances of the S&P500 during a recession since 1948, we found that on average the S&P performance was unchanged. We also found that half of the time, S&P generates positive returns and when returns are positive, it is skewed better than when returns are negative. The average positive return is +13% in contrast to average losses of -11%. However, the most important conclusion from this analysis is that **when the recession is mild to moderate ie less than 2.0% contraction from the last peak, S&P returns are almost always positive.** Of course, anyone with simple arithmetic logic will know whilst return can be positive, the point-to-point transverse can be a lot hairier.

S&P performances during recession are equally split between positive and negative returns

Recession	S&P 500 % Gain Per Annum	Real GDP Contraction %
Nov 48 - Oct 49	9.6	-1.5
Jul 58 - May 58	21.9	-1.9
Aug 57 - Apr 58	-5.9	-3.0
Apr 60 - Feb 61	20.4	-0.7
Dec 59 - Nov 70	-5.8	-0.2
Nov 73 - Mar 75	-10.0	-3.1
Jan 80 - Jul 80	13.6	-2.2
Jul 81 - Nov 82	4.3	-2.5
Jul 90 - Mar 91	8.2	-1.4
Mar 01 - Nov 03	-2.7	-0.1
Dec 07 - Jun 09	-26.8	-3.8
Feb 20 - Apr 20	-8.2	-8.5
Average	1.6	-2.4
Median	0.8	-2.0

Source: Bloomberg

How can S&P generate positive returns as it runs counterintuitive to a dreadful economy? We venture two reasons. First, the stock market is not the economy. As shown by the charts below. The two largest constituents of the S&P500 are technology (31%) and Healthcare (14%) but from a GDP breakdown, Financials are the largest at 20% of total GDP in contrast to its 9% representation in the stock market. While the narrower definition of technology in GDP definition as IT, which is 6% of GDP but is 31% in the stock market.



Source: Bloomberg

The second reason is the stock market is forward-looking. It tends to peak 6-7 months before the start of a recession, though 2 months after a recession has started, and by the time the recession ends, the market has rebounded 9% from its bottom.

Stock market is forward looking. Peaking before a recession starts and troughing before it ends



From a style perspective, Growth, Quality and Large-Cap perform better. As expected, Consumer Staples performs the best as the sector offers defensive earnings quality, though surprisingly Financials and Consumer Discretionary offerings are close to consumer staples. Healthcare is the other sector that performs well because of its recession-proof business model.

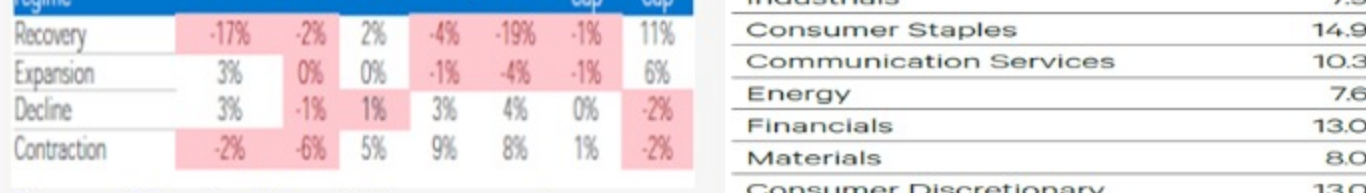
Opting for Quality, Larger Cap, Growth and Consumer Staples, Healthcare stocks

Style Returns by Regime	Momentum	Global	Growth	Quality	Mid-Vol	Large Cap	Small Cap
Recovery	17%	2%	2%	4%	19%	-7%	11%
Expansion	3%	0%	0%	1%	4%	-1%	0%
Decline	7%	1%	1%	3%	4%	0%	2%
Contraction	-2%	6%	5%	9%	0%	1%	2%

S&P 500 Sectors	Performance
Health Care	11.2
Utilities	10.2
Industrials	7.9
Consumer Staples	14.9
Communication Services	10.3
Energy	7.6
Financials	13.0
Materials	8.0
Consumer Discretionary	13.0
Information Technology	3.4

Since the start of the year, EPS for 2023 and 2024 have been revised downwards by 2-3% for both years leaving EPS growth of -1% for 2023 and 9% for 2024. With the S&P500 up 14% in the first half, this implies the entire driver of performance was due to valuation multiple expansion, not earnings momentum. This leaves valuation very rich with S&P trading at 25x trailing PE and 20x 1-year forward PE. These levels are higher than their long-term averages of 17x. And if a recession is the base case, S&P500 has historically traded at 14x trailing PE. These facts underpinned our preference to remain underweight equities given that there is no room for disappointment. Accentuating the risk is the narrow market rally with the top eight stocks now accounting for 28% of total market capitalization which is a record high and is higher than in Jan 2021 when the current bear commenced.

Valuations are more expensive now than at the start of the year as earnings forecasts have been reduced



The underweight in equities have been reduced compared to the start of the year where the general construct is to be underweight US, Europe and now China and with Japan as our only meaningful overweight. For our growth expressions, we have also substituted our tech exposure to a covered call expression on NASDAQ given its substantive performance YTD while augmenting with single names like turnaround tech names in the semiconductor space and in Japan electronic manufacturing ETF. Our growth expression extends to our holding in an environment-focused equities manager. For Quality expression, we have adopted an active and systematic ETF that focuses on Quality. We are still keepers of large US banks on valuation grounds and European and Japanese banks given their high earnings sensitivity to their central banks' policy actions. The larger part of our equities expression remains in fundamental long-short equities managers across the US and Asia.

Fixed Income remains overweight in US Treasuries and Investment Grade given they have historically performed better both on relative and absolute basis during recessions. Furthermore, there is no ambiguity to the path of Treasuries yields in contrast to equities when recessions happen. US yield falls all the time as the economy enters a recession with an average decline of 256bps in yield from the start to the end of a recession. Moreover, US yields generally peak ahead of a recession and drift lower even as the recession has ended as the bond market participants are more conservative than equities investors in pricing a recovery.

US Treasury Yields often peak before start of recession and always decline during one

RECESSION START	RECESSION END	BOND YIELD	BOND YIELD	BOND YIELD	BOND YIELD	DECLINE (BPS)	PEAK MONTHS BEL TO START OF RECESSION	MONTHS BEL TO END OF RECESSION
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Apr-57	Jan-58	4.8	3	-100	6	2		
Apr-60	Feb-61	5	4	-101	3	3		
Dec-69	Nov-70	Dec-69	Dec-71	5	6	-199	0	13
Nov-73	Mar-75	Sep-75	Jun-77	8	7	-128	2.2	27
Jan-80	Nov-82	Sep-81	Feb-83	16	10	-557	20	3
Jul-90	Mar-91	Apr-90	Sep-93	9	5	-364	-3	3
Mar-95	Nov-95	Jan-90	Sep-92	7	4	-305	-14	10
Dec-07	Jun-09	Jun-06	Dec-08	5	2	-290	-18	6
Feb-20	Apr-20	Oct-18	Jul-20	3	1	-260	-16	3
MEDIAN						-260	-3	3
AVERAGE						-256	-1	10

Source: BCA Research

With interest rates at this level, bond convexity has now skewed an asymmetric return for holding Treasuries. Even if the Fed continues to raise policy rates by another 50-100bps and Treasury yield does a parallel shift of 50-100bps too (which never happens at this late stage of a hiking cycle), the forecast 12 months loss of holding a 10-year government bond will be -4% to -7%. But if yield moves lower by 50-100bps, the forecast gains will be 7 to 11% and if history repeats with a 250bps decline in yield from the start to the end of a recession, the gains will be material at 19-23%. That is not our base case though and we believe 10y yield will settle in the range of 3.0 to 3.5% translating to a respectable gain of 4 to 7%.

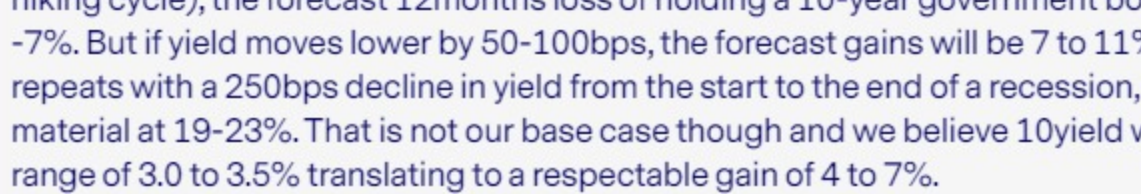
Bond convexity is skewing asymmetric returns outcome for holding even Treasuries

IMPLIED 1-YEAR RETURNS (%) OF A 10-YEAR US GOVERNMENT BOND BASED ON DIFFERENT YIELD LEVELS	IMPLIED 1-YEAR BOND RETURNS (%)
6.0%	-16
5.5%	-12
5.0%	-8
4.5%	0
4.0%	7
3.5%	13
3.0%	19
2.5%	25
2.0%	31
1.5%	37
1.0%	43
0.5%	49
0.0%	55
-0.5%	61
-1.0%	67
-1.5%	73
-2.0%	79

Source: Fed Saint Louis

The credit spread for investment-grade debt is fair for now. We think it might widen by at least 50bps from the current level if we have a mild-moderate recession. This will be offset by at least 80-100bps decline in Treasury yields that we are expecting. There have only been 20% of the time since 2009, investment-grade debt yields higher than the current 5.7%.

Investment grade yield of 5.7% now have rarely been higher since 2009



Source: Fed Saint Louis

Alternatives: We continued to build out a multi-manager and multi-strategy hedge fund sleeve that comprises systematic as well as fundamental-driven long-short equities managers, a macro CTA manager that is centrally strong in fixed income and commodities markets to diversify our larger sleeve of equities-centric hedge funds. We also own a relative value option trader and a multi-strategy hedge fund replication manager. We have also expanded our alternative credit managers to include a litigation finance manager on top of our trade finance specialist.

FX: No change and expecting the US dollar to weaken marginally. The key risk to this view remains the escalation of geopolitical risk and the classic USD hegemony should the global economy sink into recession even if the source of stress is coming from the US itself.

Commodities: Remain bullish on oil in the intermediate term.

Cash: Cash holdings have been reduced to less than 10% since high-grade debt such as government bonds and investment grade debt yield are attractive and their valuations are not demanding.

Featured Picture/Quote:

Charlie Chaplin made 82 films in his long 75 years of movie making and he only spoke in 5 of them. The first time he ever spoke was in his critical and commercial success, The Great Dictator. Click to watch Charlie Chaplin, The Great Dictator Speech

"To those who can hear me, I say - do not despair. The misery that is now upon us is but the passing of greed - the bitterness of men who fear the way of human progress. The hate of men will pass, and dictators die, and the power that took from the people will return to the people. And so long as men die, liberty will never perish." CC

And these days there are too many dictators.

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