14 Robinson Road, #09-01
Far East Finance Building, Singapore
048545

Tel/Fax +65 6819 0860
Web covenant-capital.com

The Navigator

March 24

The last mile

By Edward Lim, CFA

Before every race, I have a standing appointment with my cardiologist, thanks to the strict regulations imposed by the household's chief health officer—the wife. The doctor will always give me the same spiel: the last mile is where most amateurs bite the dust. He advises against any last-minute heroics or a mad dash to the finish line, reminding me that after 5 to 6 hours of pushing my limits, my body isn't exactly craving for more punishment. Plus, trying to outpace my shadow in the final stretch won't exactly rewrite the race's result, certainly not for this amateur athlete. It is the same wisdom of pacing and patience that I am advocating to our readers as we navigate towards the 2% inflation target in the US.

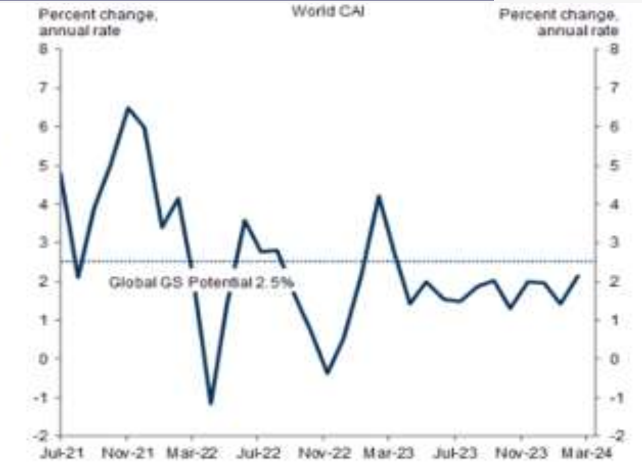
We sent our key assumptions in our January 2024 strategy, How difficult is it to sink a US aircraft carrier?, expecting a Goldilocks period of trend-like growth and the continuation of disinflation leading to a set-up for rates to be lowered across many economies. While valuations across many asset classes are not cheap and at best fair, we countered that positive revisions in GDP and earnings will drive price appreciation. We also note that market concentration in "Magnificent 7" (perhaps should be renamed Magnificent 4 since Apple, Tesla, and Google are down for the year) is a risk, but the broadening of earnings profile across more sectors alongside significant money on the sidelines do recommend a risk-on posture. We have dived deep into the reasons why the global and the US economy escaped a recession in 2023 and concluded those drivers of strength should prevail in 2024. There are ambient risks that may temper this constructive view such as the US election and transnational conflicts that might affect oil prices, but the biggest risk we believe would be a resurgence in inflation more than a recession.

The global economy, including the US, is finding its equilibrium, neither too hot nor too cold, with the service sector continuing to drive growth. The resilience of the service sector is evident in the Global Purchasing Managers' Index (PMI) for services. Both the Output and New Orders for Services indices remain in an expansionary phase, marked by readings of 52.4 and 52.0, respectively. These figures have shown consistency over recent months, underlining the sector's steady contribution to economic activity. A recent noteworthy development comes from the manufacturing sector, which after enduring several quarters of contraction (indicated by PMI readings below 50), is showing signs of revitalization. In February, the New Orders for Manufacturing climbed to a 50.4 reading, crossing the threshold into expansion. This rebound has been complemented by the sustained expansionary levels in Manufacturing Output and

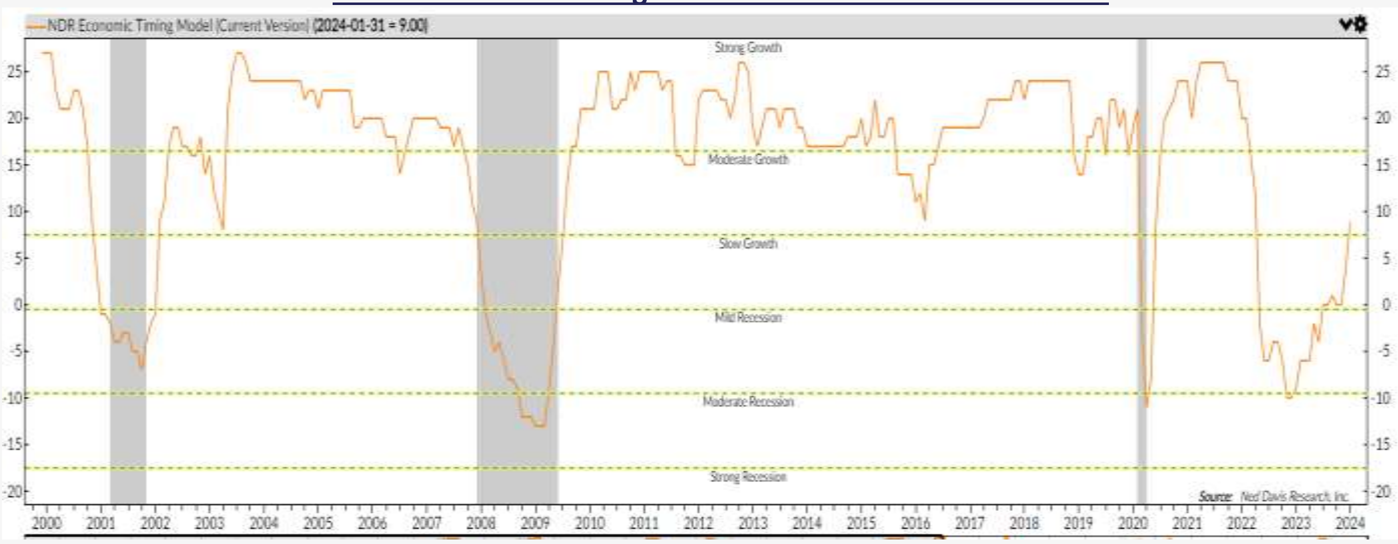
Future Outputs, while Output Prices have turned, hinting at a recovery in demand and pricing power within the segment of the economy.

The consecutive improvements in the global PMI over the past four months reinforce our assumption of a trend-like growth and one of avoiding a recession, as this data extrapolates to an annualized global GDP growth rate of approximately 2.9%. Goldman Sachs' nowcasting model projects a slightly more conservative growth rate of 2.1%. Furthermore, the Net Davis Research economic timing model suggests a transition out of "Mild Recession" into the "Slow Growth" phase, implying the risk of recession has abated further.

Forecasting and Nowcasting indicators are collaborating a trend-like growth



NDR Economic Timing Model is in Slow Growth Phase



While the recent two months of higher-than-expected inflation prints challenge one of our key views, we caution against the consensus view that disinflation has stalled. The correlation between inflation and growth is a well-established fundamental. Robust growth fuels inflationary pressures, and conversely, a slowdown tempers them. Given the anticipation of global growth slowing down to its long-term trajectory post the exceptional surge in 2023, the prospect of a sustained inflationary resurgence seems improbable. The post-pandemic landscape had many unique challenges—supply chain disruptions, labor market imbalances, and housing supply mismatches— some of which continue to exert episodic pressure on inflation but should reflect fundamentals of demand and supply over time. Keeping a restrictive monetary policy stance for too long can have detrimental effects on the economy and expose unintended and hidden vulnerabilities that can be systemic. We already have two recent examples from last year; the bankruptcies of five regional banks in the US and the near collapses of many UK pension funds as they suffered significant mark-to-market losses on their government bond holdings. History has shown the Fed cut rates even before their inflation target is achieved as recession looms and unknown systemic appears. Lastly, the latest Fed dot reaffirms their view that the long-term neutral rate should be 2.6% not 5.5% currently.

FED rarely pauses nor cuts rates until inflation is under control

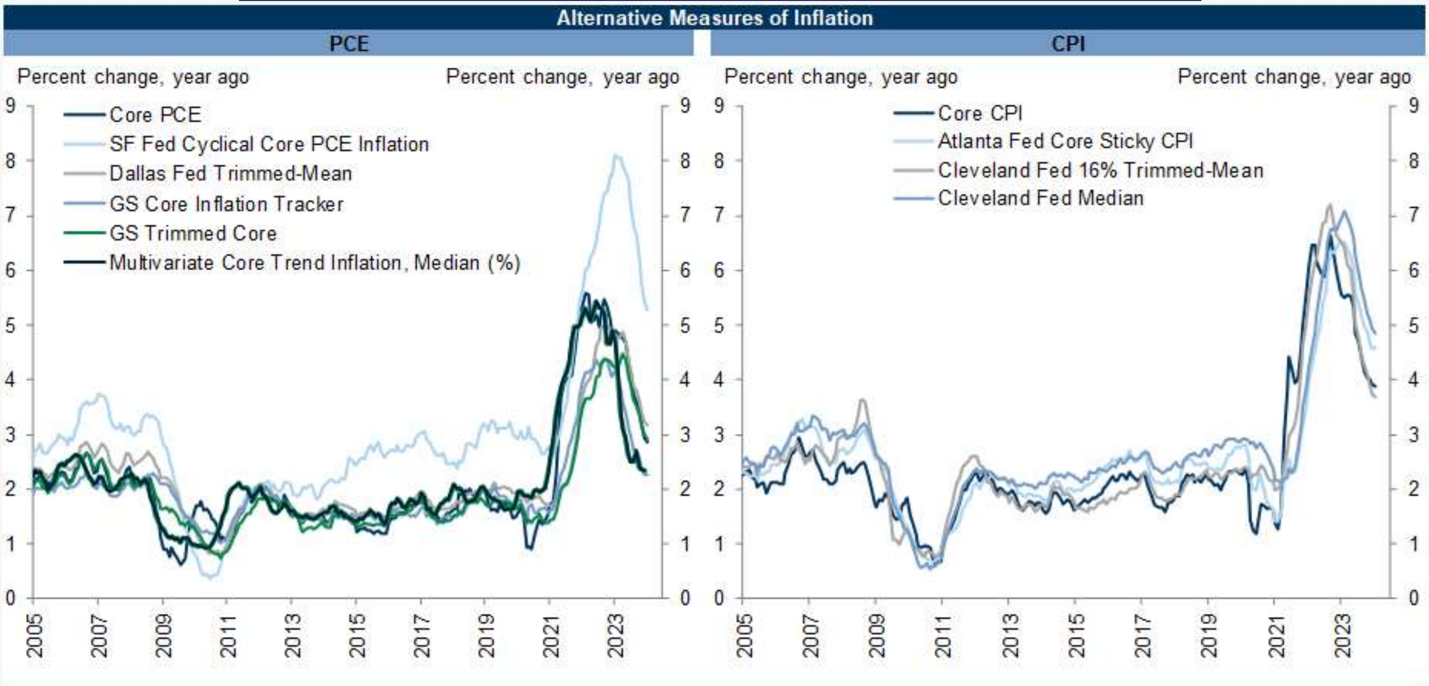
Fed Last Hike	
Date	**Inflation rate (%)**
Sep-71	4.1
Sep-73	7.4
Jul-74	10.4
Feb-75	11.2
Apr-80	14.7
Aug-84	4.3
Jun-90	4.7
Jul-00	3.7
Feb-07	2.4
Jan-19	1.5
Average	6.4%
Median	4.5%
Current Headline CPI	3.2%

Fed Cut Rates	
Date	**Inflation rate (%)**
Oct-71	3.8
Oct-73	7.8
Aug-74	10.9
Mar-75	10.3
May-80	14.8
Oct-84	3.2
Oct-90	6.3
Jan-01	3.4
Aug-07	2.0
Aug-19	1.6
Average	6.4%
Median	6.0%
Current Headline CPI	3.2%

Source: Federal Reserve, Bloomberg

After stronger than expected inflation prints in the US in January and February, market expectations shifted significantly, scaling back from predicting five to six interest rate cuts down to just three, and delaying the anticipated first cut from March to June. Contrary to market sentiment, **we stated in our 2024 global macro outlook podcast in January on Spotify, How difficult is it to sink a US aircraft carrier? that is too aggressive and expects a 75-100bps cut over 12 months commencing sometime in 2Q24.** Inflation in the US rose notably at 0.3% month-on-month increase in February's Core CPI, following January's 0.39% rise. However, we dismissed January's stronger-than-expected print as annual start-of-the-year price adjustments, while the Feb strength was driven largely by energy and housing.

Too early to say disinflation has stalled. The trend is still for lower



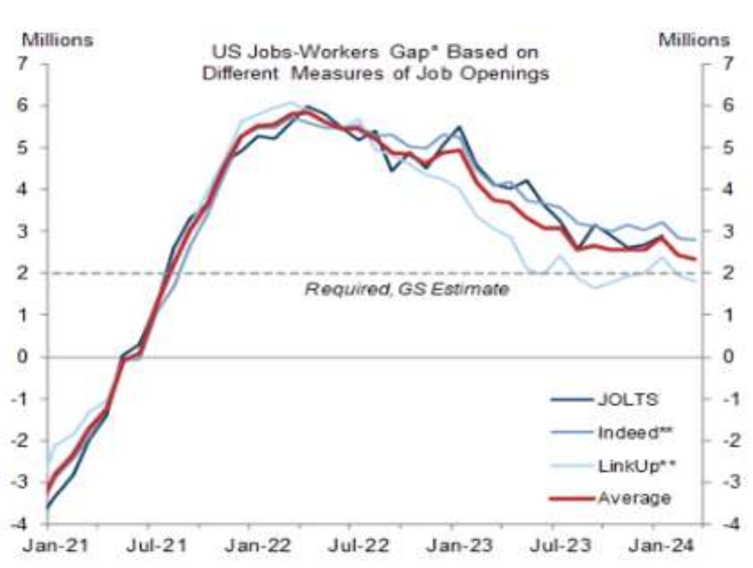
Latest Readings

Indicator	Month	% change, year ago	Indicator	Month	% change, year ago
Core PCE	Jan	2.85	Core CPI	Jan	3.87
SF Fed Cyclical Core PCE Inflation	Jan	5.26	Atlanta Fed Core Sticky CPI	Jan	4.60
Dallas Fed Trimmed-Mean	Jan	3.16	Cleveland Fed 16% Trimmed-Mean	Jan	3.67
GS Core Inflation Tracker	Jan	2.28	Cleveland Fed Median	Jan	4.85
GS Trimmed Core	Jan	2.92			
Multivariate Core Trend Inflation	Dec	2.34			

Source: Goldman Sachs

We fade the oil impact for now, moreover it is core inflation that the Fed will focus on. **We have mentioned before among the various key drivers of inflation, wages, and house prices are the most important to monitor. We expressed confidence that wages will slow towards trend growth by 2H24 and are monitoring the gap between job openings versus availability of workers, jobless claims, and wage surveys.** According to Goldman Sachs, the jobs-workers gap needs to fall to 2mn to be consistent with a 3.5% wage growth, which translates into a 2% inflation print. The gap is very close to that level now. The surge in immigration has also eased the workers shortage in blue-collar jobs and this segment was responsible for the largest increase in the wage composite. The latest wage surveys corroborate this view as wages have moderated to 3.5% in February.

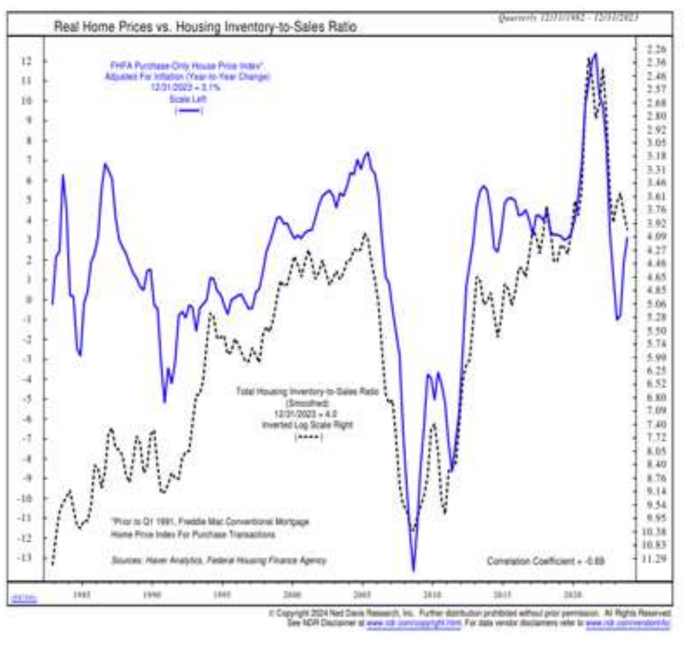
Wage pressure is waning and is close to level where inflation moderates to 2%



Source: Goldman Sachs

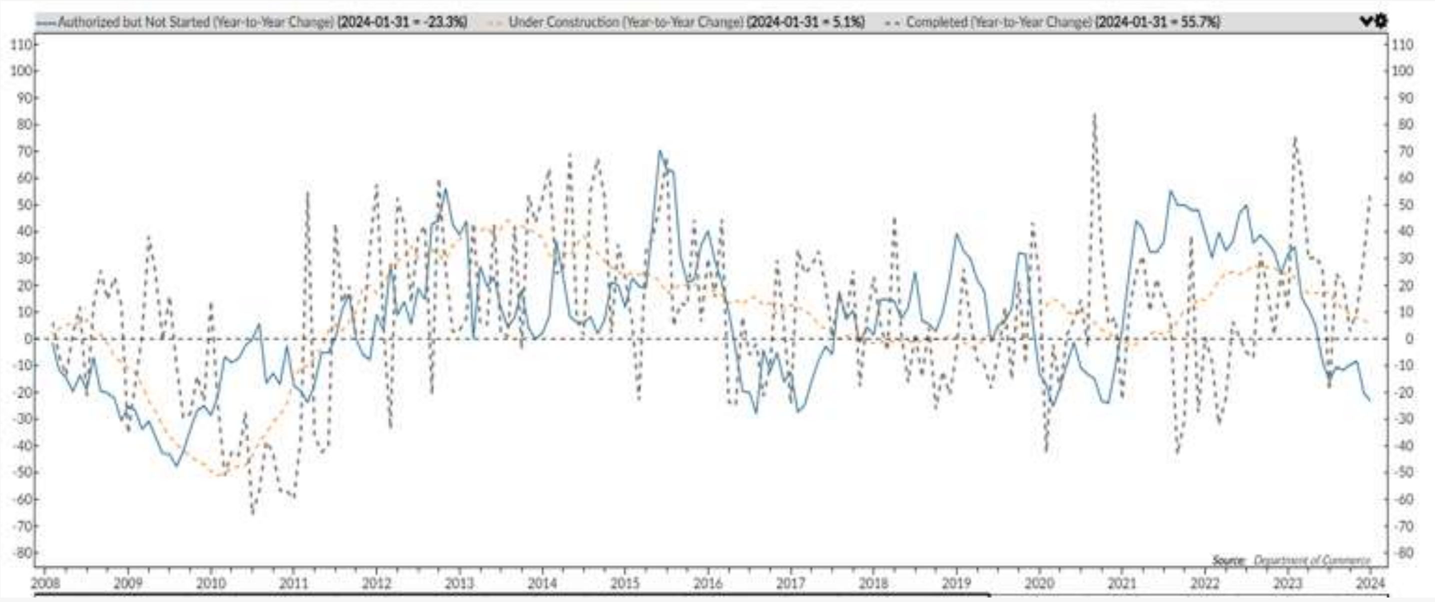
As we have communicated in our bond webinar held in October 2023 (please ask your wealth manager if you like to listen to that recording) **we believe housing represents the greater risk to our disinflation call. Furthermore, house inflation is by far the largest weight in both PCE and CPI calculations.** The latest high-frequency indicators of rents continue to support the view of housing inflation will moderate in the coming months. But on the other hand, the chronic shortage of housing, especially at the localized levels, does present an upside risk in the longer term.

Rental rates have stalled but longer-term undersupply pose upside risk



At the national level, the US needs a sales-inventory ratio of 6 months to ease price pressure. Currently, it stands at 2 months short and that has not changed post-GFC aftershocks to developers' psyche. Recent construction data presents a mixed picture. On a positive note, there has been a significant year-over-year increase of 55.7% in completed housing projects, yet this optimism is tempered by a noticeable slow and declining in the volume of ongoing constructions (only growing +5% yoy) since the start of 2023. This downturn is further exacerbated by a worrying -23% year-over-year drop in the initiation of new projects, as indicated by the permits for yet-to-be-started constructions. Such trends portend a prolonged undersupply of housing. Housing is not within the remit of the Fed's policy tools, so for now, **we cautioned against the current view that inflation is sticky and about to surge and reiterate our view for patience and for inflation to reach the Fed's last mile by late 2H24 with a caveat to watch housing sales and construction data.**

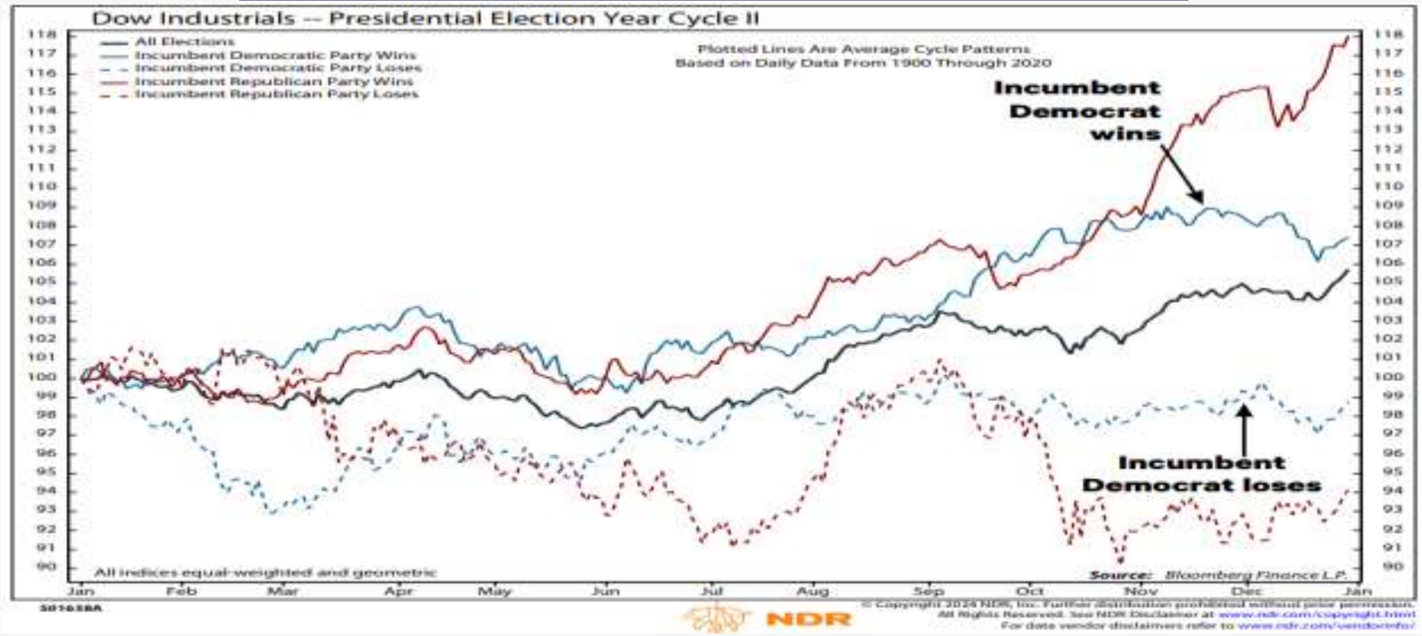
Mixed outlook on housing supply suggesting continuous price pressure



Source: Net Davis Research

Even though we are not experts in US politics and often find it more entertaining than enlightening, it's hard to ignore discussions about the US elections. What we can do is to look at data with regard to this risk. **Looking at data since 1928, we note that market tends to be choppy in the first half of an election year. We also note that when a Democrat incumbent President wins, the market performance is the best rallying ahead and post-election. However, if a Democrat incumbent loses it is 2nd worst outcome** after the loss of a Republican incumbent, chopping around negative returns throughout most of the election year. These are fun facts, but they could also be spurious and ultimately as they said during Bill Clinton's campaign against senior George Bush. "It is the economy, stupid."

Best outcome has been for incumbent Democrat President to win

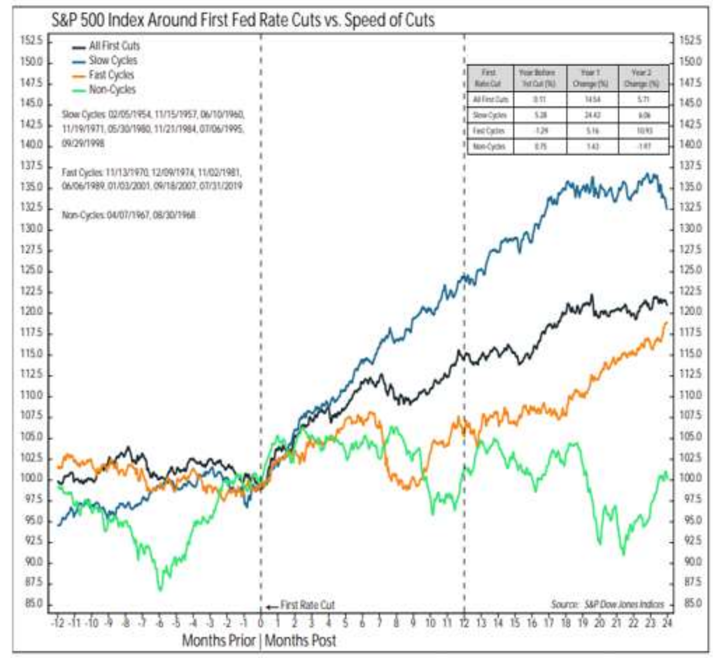


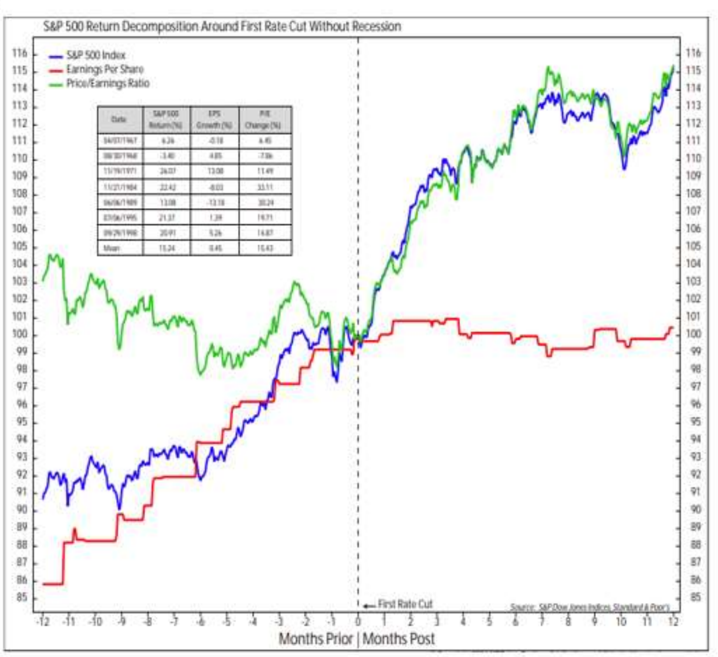
Asset Allocation Strategy

While the macro set-up continues to be constructive, the debate has shifted from aggressive cuts to slower cuts. We looked at the difference in asset price performances in an environment where rate cuts are shallower, which has been our base-case scenario since the start of the year anyway.

Equities: Overweight. For equities, a slower rate cut cycle (defined as 4 cuts or less within a year of the first cut), is better than an aggressive one. Using data since 1954, it shows that in a slower rate cutting scenario, **S&P rose 5x more than in an aggressive cutting cycle returning 24% a year after the first cut.** The logic is simple. If a rate cut is shallower, it therefore implies the economy is resilient and avoids a recession. In this scenario of a shallower rate cut, the driver of price appreciation comes from the dual combination of PE multiple expansion (15% increase in PE ratio in a year out) and stable EPS growth. In contrast, if the Fed must cut rates aggressively it would mean a recession has occurred and/or a systemic risk has risen. Return drivers rest solely on PE multiple expansion which increased by 37% during this period while EPS collapsed on average of -16%.

Slower rate cuts are better for equities **Driven by PE expansion & stable earnings**



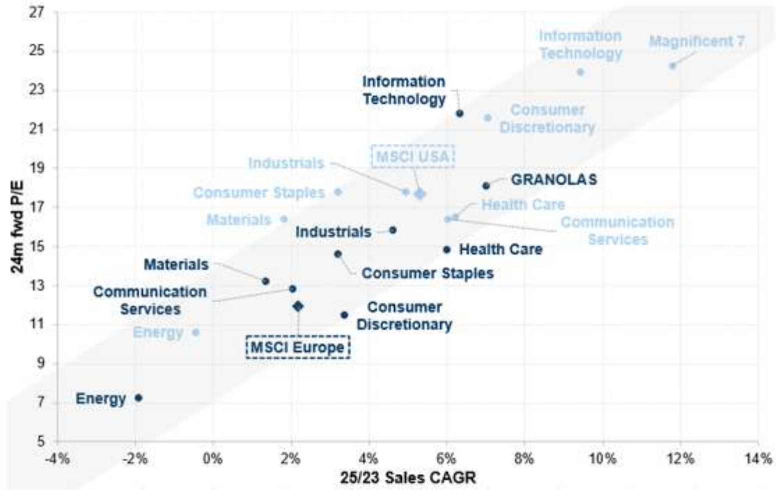


Source: Net Davis Research

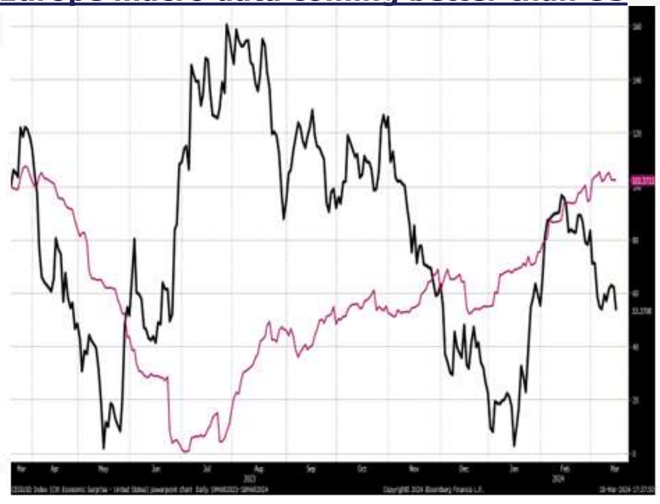
However, **we note that since Oct last year, the S&P500 has risen by 25%** and its PE has rerated by 32% to 21x forward earnings (23% if we consider EPS growth). **This expansion has already exceeded history when rate cuts were shallow. It makes sense to lighten some positioning in the US and in tech where valuations are steep and to look for cheaper quality growth alternatives.**

We fancy European equities. European equities are highly leveraged to global economic momentum, particularly in manufacturing, which plays well to our view that global growth for 2024 broadens out. We also have higher confidence that the ECB will cut rates earlier and more than the Fed, while its Chair has already provided a timeline for the first cut in June. In the last few months, the delta of surprises in economic data has also been better for Europe than in the US. On valuation, MSCI Europe equities trade at a cheaper multiple with a 12x forward PE and EPS growth of 8% while MSCI US equities trade at 37x PE with 10% EPS growth. Europe is still trading below its long-term PE of 15x, but the US is trading close to its +1sd average. On a relative PE basis and even after adjusting for ROE differences, the US is trading at its highest over Europe in the last 20 years.

Europe scores well on valuation and growth



Europe macro data coming better than US



Source: Goldman Sachs and Bloomberg. Light blues are in Europe and dark blues are US. Black line is US economic surprise index and Red is Europe economic surprise index.

In scenarios of shallower rate cuts, the S&P 500 delivers a better performance with an 18.3% rise, whereas sharper cuts lead to meagre gains. The US small caps often outperform large caps a year post-cut by 5%. Within sectors, performances also vary by the depth of rate cuts. Post a shallow cut, sectors like Healthcare, Communication Services, Financials, and Industrials perform better with returns of 21.7%, 21.3%, 20.7%, and 15.7% respectively in six months. In contrast, aggressive cuts favor defensive sectors like Utilities and Consumer Staples. We are reducing our Tech exposure due to high valuations and aligning our US equities portfolio with these anticipated market shifts through newly established exposures in Healthcare and Industrials ETFs while keeping our Financials investments unchanged. The communication services sector is excluded due to the high concentration of Meta and Google, where we have a neutral view, and its valuation is not attractive as well.

Shallow rate cut is better for equities and cyclical perform better than defensive

	Sector Leadership Following First Rate Cuts - Fast vs Slow Cycles			
	Slow Cycles		Fast Cycles	
S&P 500 Sectors	Six Month Returns (%)	Case Outperforming(%)	Six Month Returns (%)	Case Outperforming (%)
Utilities	6.9	25.0	7.2	83.3
Consumer Staples	10.7	25.0	6.6	66.7
Health Care	21.7	50.0	8.5	66.7
Real Estate	5.9	0.0	2.3	50.0
Communication Services	21.3	75.0	3.0	50.0
Industrials	15.8	50.0	2.3	50.0
Consumer Discretionary	9.2	25.0	1.8	50.0
Information Technology	18.0	50.0	-2.2	50.0
Materials	4.5	0.0	2.8	50.0
Energy	11.4	50.0	-4.7	50.0
Financials	20.7	75.0	0.9	33.3
S&P 500 Index	**18.3**	**N/A**	**1.5**	**N/A**
Cyclical Growth Median	**18.0**	**50.0**	**1.8**	**50.0**
Defensive Median	**10.7**	**25.0**	**7.8**	**66.7**

Slow Cycles: 05/30/1980, 11/21/1984, 07/06/1995, 09/29/1998

Fast Cycles: 12/09/1974, 11/02/1981, 06/06/1989, 01/03/2001, 09/18/2007, 07/31/2019

Sources: Ned Davis Research, Inc, S&P Dow Jones Indices

The current consensus view is that an exit by the Bank of Japan from the world of NIRP is positive for Japanese equities. We do not think it is so simple. Back in April last year, we contented the mother of all QE is by the BOJ, Everything, everywhere all at once, and the ramifications of their unwinding are multi-folds and complicated. There is the impact of higher rates on the fiscal position of the government coffers when it already has the distinction of having the highest debt-GDP of 218% amongst OECD countries. Financial institutions' balance sheets will be adversely impacted by mark-to-market loss similar to what happened to Silicon Valley Bank and UK Pension funds debacle but can be counterbalanced by higher profitability in their loan books. Another big unknown is the impact on the global economy and stock markets when domestic investors start to sell down their overseas holdings and repatriate back onshore as the Yen appreciates. It is the largest foreign holder of US treasuries (4% of total US treasury stock) and many other countries such as Australia (15% of stock), Sweden (13%), New Zealand (10%), and France (8%). Japan is also consistently the biggest FDI investor in this region. Furthermore, the appreciation of Yen is negative for Japanese earnings. For every 10 Yen appreciation, earnings will be cut by half. Lest we forget, there is a carry trade unwind making the domestic equities negatively correlated when the Yen appreciates.

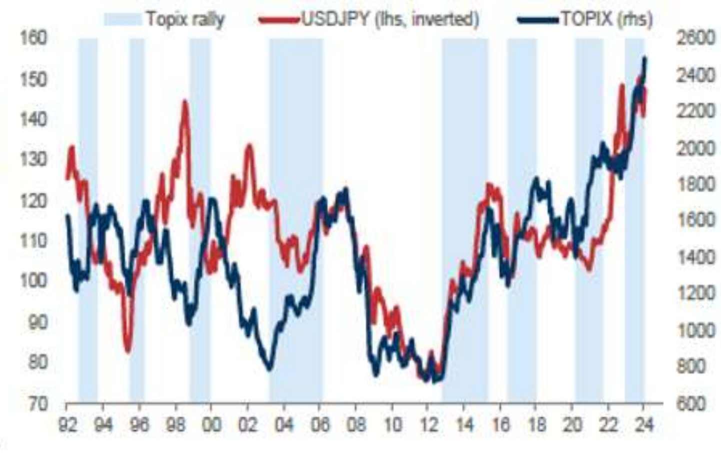
Stronger Yen is negative for earnings

FY2024 TOPIX EPS Sensitivity

USDJPY	120	125	130	135	140	145*	150	155
FY24 EPS growth	-0.6%	1.1%	2.9%	4.6%	6.4%	8.1%	9.9%	11.6%
FY24 EPS (¥)	160	163	166	169	171	174	177	180

Source: Goldman Sachs Global Investment Research

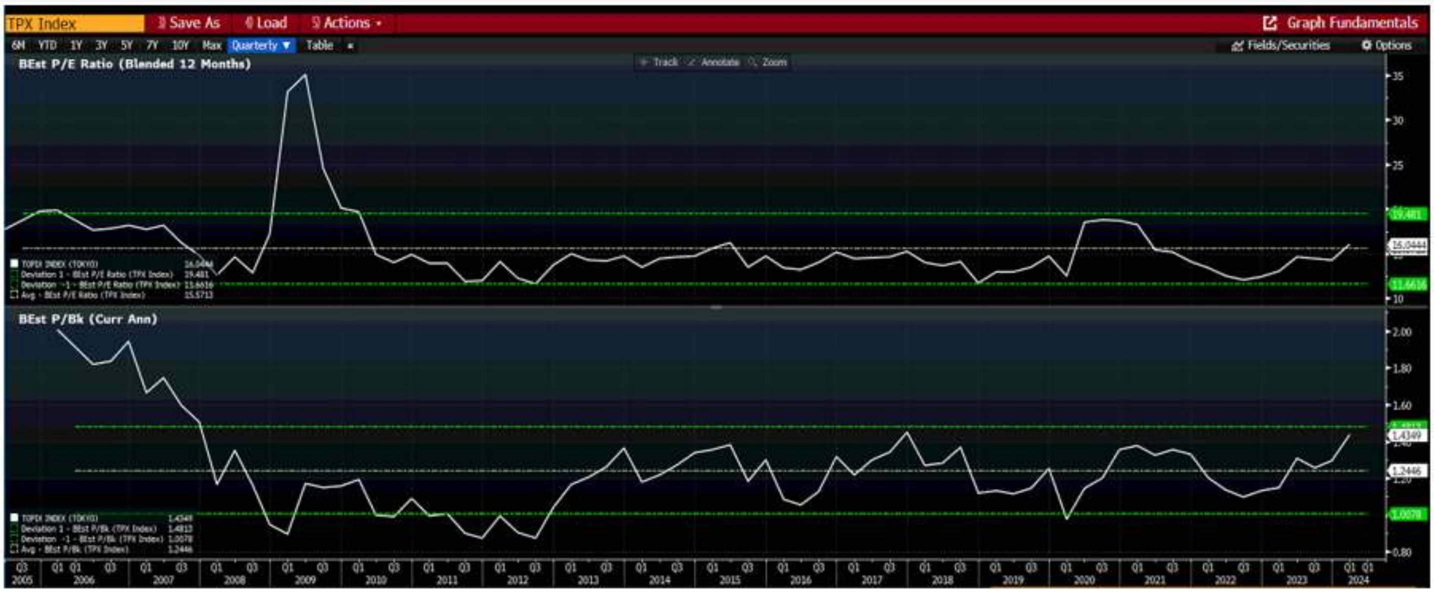
Negative for Topix too



Source: Bloomberg

Valuations are no longer cheap. Topix now trades at 16x forward Price/Earnings, in-line with its 25-year average, and 1.41x Price/Book it is above its 25-year average. We have been early advocate of the improvement in corporate governance and ensuing restructuring themes in Japan but that will take time to improve its ROE of 8%, which is much lower than Europe's 14% and the US 20%. Reducing beta in Japan and retaining our expressions in activism and ROE enhancement themes.

Japan equities are no longer cheap



Source: Bloomberg

Fixed Income overweight in US Treasuries and Investment Grade. No change as we are expecting 75-100bps cuts in the next 12 months in the US Fed fund rates. Working off this 75-100bps cuts, we use our four-prong approach of using market participants forecast, forecast from economists, history as a guide, and theory as an anchor, we believe US10 yield should trade with the range of 3.70% to 4.20% in 2024. With bond convexity working in our favour now that yields are high, a 50bps move lower in US10 yield can generate a total return on investment-grade bonds in excess of 7%. But should yield rise by 50bps against our expectation, our sensitivity shows our bond portfolio can still generate a total return of 2%.

Where should US10 yield be?

	Current	2024	2025
Market Expectations	4.00	3.79	3.62
Economic Forecaster		3.75	3.58
History		3.80	3.00
Term Premium		3.61	3.31
Average		**3.73**	**3.37**

Source: Bloomberg, Fed, NDR

Regardless of the depth of cuts, US 10 years Treasury yields fall ahead of the first cut, though it tends to fall more in a shallower cut scenario. Post-cut and in shallow cut episodes, US10 yields are largely unchanged for the first 6 months but rose by the 12th month as investors comes to grip that the economy is strong. However, the yield curve always steepens post cuts and steepens more when the cuts are shallow. Hence, we are positioned in the front end of the curve rather than the back end. Happy to clip attractive 5+% coupons with the possibility of generating capital gains with low volatility from this allocation even as valuations are at best fair.

Bond yield fall more pre first rate cut and stay stable post cut in shallow episodes

Bond yields around and after First Rate Cut

10-Year Treasury (First Cut)

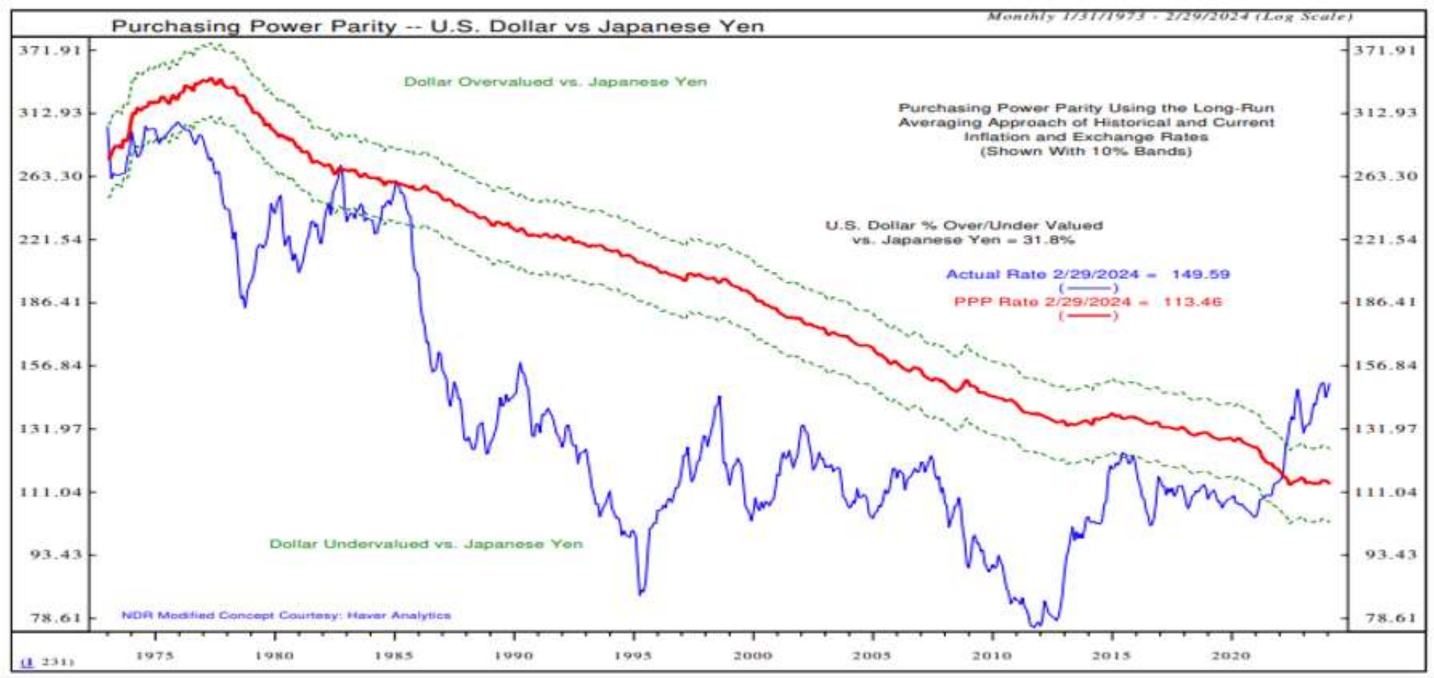
First Cut Date	Value (%)	BP Change					
		12 months before	6 months before	3 months before	3 months after	6 months after	12 months after
1970-11-13	7.00	-13	-80	-71	-89	-43	-123
1971-11-19	5.79	-69	-70	-69	27	31	45
1974-12-09	7.40	69	-8	-64	18	37	79
1980-05-30	10.25	120	-9	-247	164	247	321
1981-11-02	14.57	211	-12	-38	-10	-70	-401
1984-11-21	11.39	-20	-233	-130	37	-75	-181
1989-06-06	8.36	-66	-77	-90	-17	-54	11
1995-07-06	6.05	-125	-183	-107	7	-40	73
1998-09-29	4.59	-151	-108	-85	12	66	138
2001-01-03	5.14	-135	-85	-73	-20	30	-4
2007-09-18	4.50	-30	-6	-59	-30	-112	-109
2019-07-31	2.02	-96	-68	-50	-18	-45	-147
Median	6.53	-48	-74	-72	-1	-41	4
Median for shallow cuts	8.15	-73	-59	-119	25	13	106

Source: Federal Reserve Board

Alternatives: No change with 25% to 30% of the budget allocated to our multi-strategy and multi-manager hedge fund strategy. It has demonstrated the ability to generate high-single digit return with a volatility budget that is less than one-third of equities and half of bonds. Its returns are also less correlated and have a low beta relative to the traditional stocks and bonds asset classes. If you would like to find out more about this mandate, please also reach out to your wealth managers.

FX: The rather dour price reactions after BOJ announced the end of its decades long unconventional monetary policy did not sway our bullish stance on the Yen for this year. BOJ provided no clear signal for an immediate policy lift-off and rightfully should adopt a cautious and data-driven strategy given the complexities we have raised above. Nonetheless, we believe the Yen is poised to appreciate as the interest rate differentials between the US and Euro versus the Yen are expected to narrow, largely due to diverging policy directions from their central banks. While the Fed and ECB are anticipated to initiate rate cuts in June, with projections of a 100bps reduction by the end of 2024, the BOJ is likely to tighten with a potential 20bps hike in either October or December. This contrast in monetary approaches underpins our optimism for the Yen to strengthen.

Yen is very undervalued but the path to 110 will be gradual



Source: Net Davis Research

Commodities: We continue to favour Gold. It has several investment theses running for it. A play on the long-term risk of de-dollarization, it is inversely correlated to bond yields and the USD. There is a need for emerging market economies to diversify their USD holdings and increase their gold reserves. Gold as a percentage of central banks' reserve is still very low even excluding the early tumultuous decade post Bretton-Woods exit.

Cash: Rasing some cash from equities but mostly fully allocated to high-grade debt, alternatives and gold.

Featured Picture/Quote: Watching the Bank of Japan pivot from NIRP is as exciting as watching an AMSR of trimming a bonsai plant. Enjoy.

Breathtaking and exhilarating video of trimming a bonsai tree. A must watch. Click to watch video

Edward Lim, CFA

Chief Investment Officer

edwardlim@covenant-capital.com

Risk Disclosure