Covenant Capital

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

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

The Navigator

July 2024

Now I know when I must retire

By Edward Lim, CFA

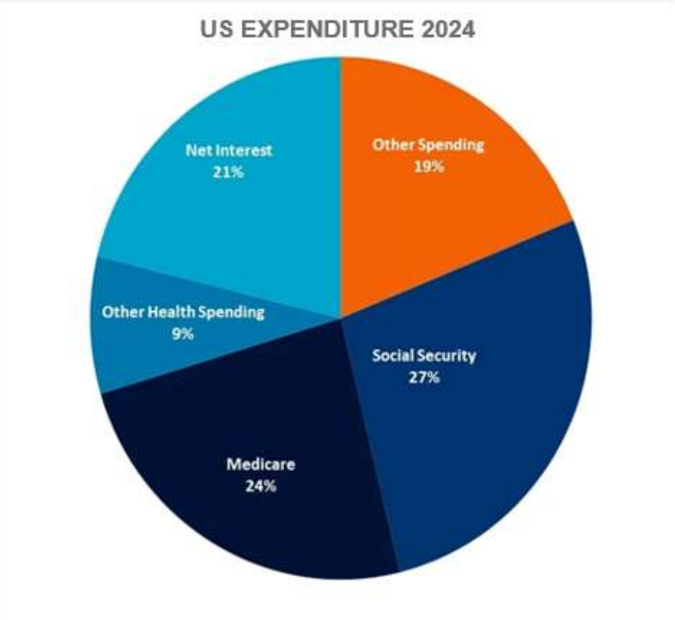
I have asked ChatGPT to rank the greatest football transfers of all time and it responded with Cristiano Ronaldo's transfer from Manchester United to Real Madrid back in 2009 as the greatest. Back then, it was a world record transfer and in his tenure in the Bernabeu, he scored a prodigious 450 goals in 438 matches. Simplistic math equates to one goal per game. He also won two league titles, four Champions League titles, while picking up the Ballon d'Or on four occasions. It is a hard fact for a rival team supporter to accept but if I apply my investment acumen while suppressing my inherent bias as a fan of his rival team, the title of the greatest transfer will still be Mr CR7. Adjusted for inflation, Ronaldo will cost £113m in 2023 terms ranking him only the 10th most expensive transfer of all time. His success far eclipsed that of Neymar's move from Barcelona to Paris Saint-Germain for £229 million (inflation-adjusted), or Mbappe's transfer from Monaco to PSG for £185 million. During Neymar and Mbappe time together in PSG, they only won some trophies in the minor league of world football.

Back in the 2020 strategy piece, The Four Horsemen of the Apocalypse, we delineated the challenges government will face in the coming decades, especially in the developed world. An aging demographics, the end of neoliberalism economics, the rise of state-sponsored enterprises, the ascendance of the vox populi, and the emergence of a new world order. These developments portend significant complexities and threats to both the financial system and the system of governance. Four years on, and we have indeed witnessed the intensification of these issues. The opprobrium generated by the woke culture contributed somewhat to the rise of the Far-right movement. The redux of Trump versus Biden, and the bipolar schism between Western style system of governance and all other forms of governance against a plethora of issues from wars to climate challenges. A good example is how the state has sponsored the success of China's EV cars and the ensuing trade barriers enacted against them are a microcosm of the trends we have raised in 2020.

The most salient encapsulation of all these issues is the greatest transfer of debt from the consumer and the corporate sectors to the government. In the US, Federal debt-GDP rose from just under 59% pre-2008 to more than 100% now. At $34trn of debt, it is a peacetime high and only 6ppt lower than its record high right after the end of World War 2. According to the US Congressional Budget Office, in the absence of any major policy changes, US federal debt-GDP will reach 170% by 2050. Already the US is spending $870 billion in net interest servicing which is equal to their defense budget and will soon surpass it.

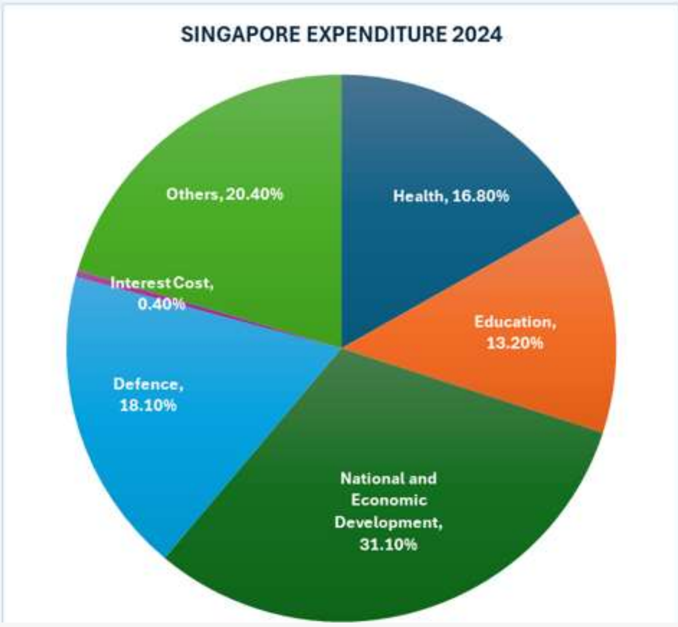
Government incurring debt is not inherently deleterious. If the debt is use for productive purposes, it propels future growth and keep the debt ratio at bay. However, if the debt is to finance consumption rather than investment, it is borrowing from the future to fund the present and that is exactly what is happening in many developed countries. Take the US for example, social security (27% of fiscal budget), Medicare/Mediaid (24%), and net interest payments (21%) constitute the three largest parts of its budgetary allocations, and they are all consumption-related spending. In contrast, Singapore investments-related expenditure such as healthcare, education, and various national and economic development programs account for 58.1% of the national budget, and interest cost is only 0.4% of our budget.

US: Borrowing from the future to spend now



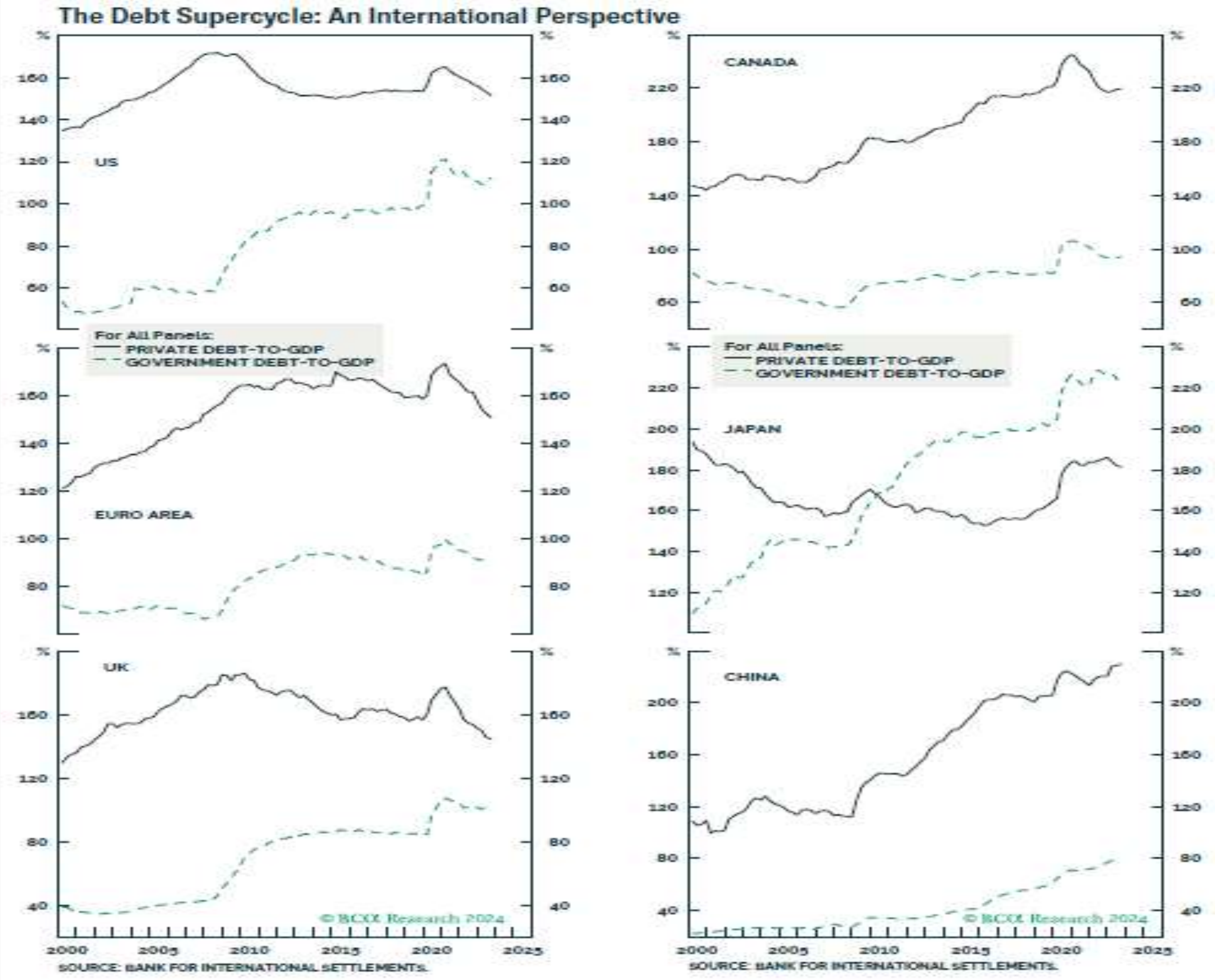
Source: Congressional Budget Office

Singapore: Investing in the future to spend later



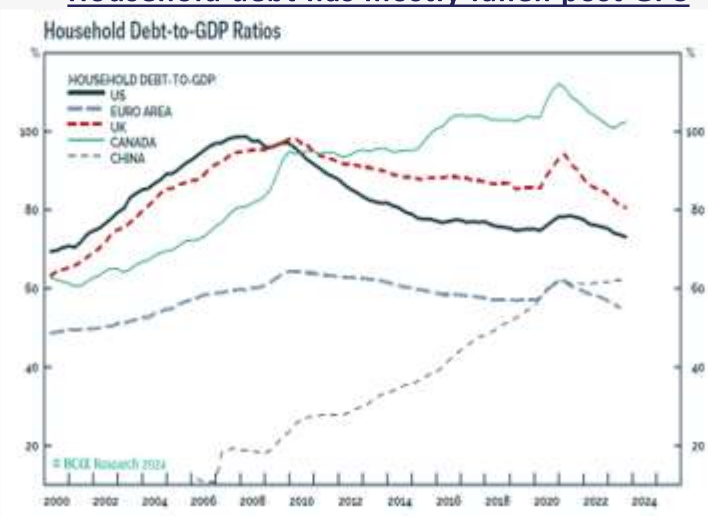
Source: Ministry of Finance, Singapore

As detailed below, **the ballooning of government is not just a US occurrence. It is prevalent in all the major economic blocs, even in China, which is late in the development cycle, has seen their government debt risen rapidly.**

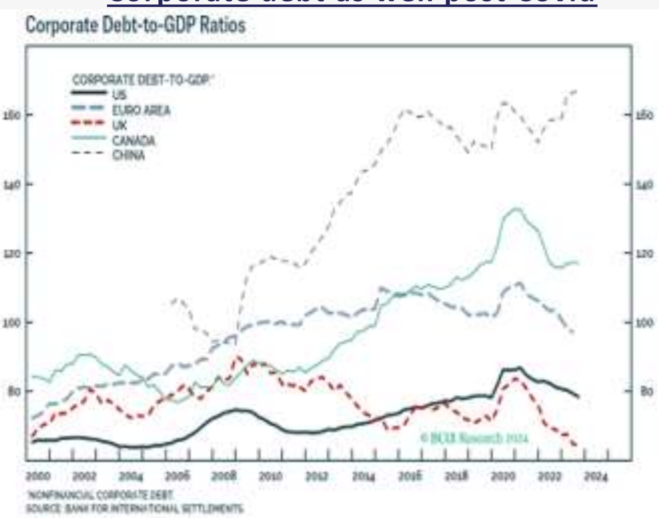


Conversely, the US private sector debt-GDP (which includes both household and corporate) fell from a high of 170% pre-2008 to less than 150% now. Aside from China and Canada, household debt to GDP has either stabilised or trend lower post 2008. Corporate debt- GDP has also fallen steadily in countries like US, UK and the Euro Area post covid.

Household debt has mostly fallen post GFC



Corporate debt as well post Covid

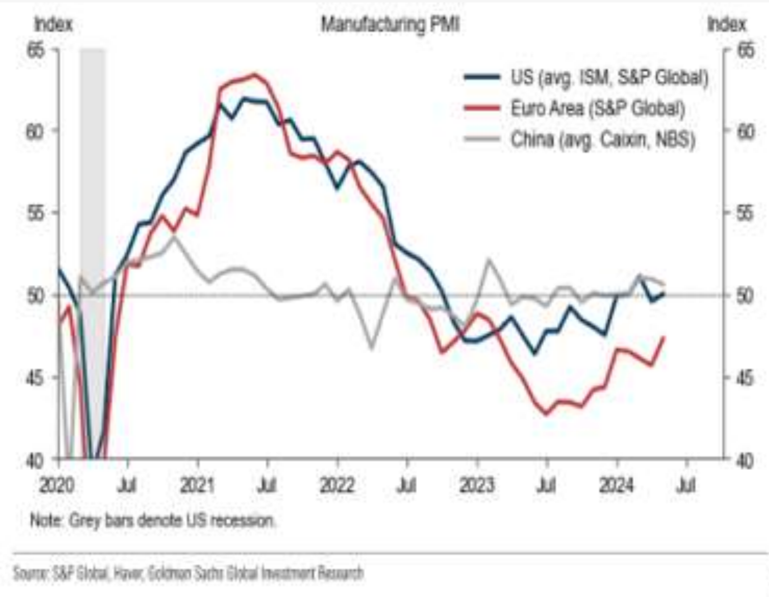


While the transfer of debt from the consumers to corporates does reduce the risk of the next recession originating from these segments, it means **the next global recession could be triggered by bond vigilantes revolting against further funding of profligate governments**. In a classic private sector recession fuelled by intolerable debt levels, defaults rise, lenders suffer, and a destructive cycle of retrenchment in profits, employment, and GDP growth ensues until sufficient resets are achieved. However, in a public debt default scenario, yields spike, dragging down capital markets, financial institutions that are large holders of government debt go under, and currency devaluation occurs. This pushes inflation up as growth struggles and the country moves into the dreaded stagflation. If it is Argentina that we are talking about, the world brushes that aside. If it is the US, I think it is time to retire.

Asset Allocation Strategy

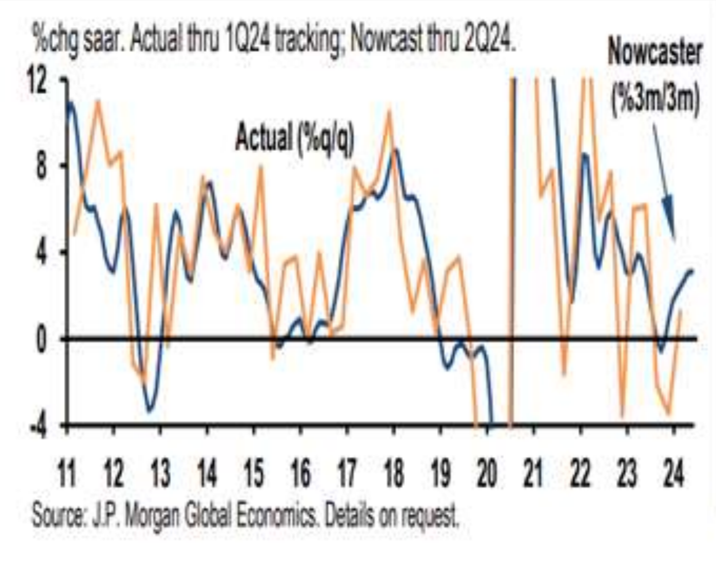
In our 2024 outlook, [“How difficult is it to sink a US aircraft carrier?"], we moderated our concerns about an imminent recession in the US. Our analysis of the strength of US consumer and corporate balance sheets led us to conclude that both are remarkably healthy, supporting our view that a recession is not on the horizon. We anticipate a deceleration in global GDP, driven by a moderate slowdown in the US but mitigated by growth in other regions, thus preventing the risk of a synchronized global recession. We are also expecting the driver of growth to transition from the services sector, a post-Covid bulwark, to the manufacturing sector. The latest global output PMI, which rose for the seventh consecutive month in May, is collaborating with this view. Furthermore, we give considerable importance to the sectoral and regional details, and those sets of data point to a global expansion that is increasingly independent of the US demand.

Balanced growth driven by several regions and by both manufacturing and services

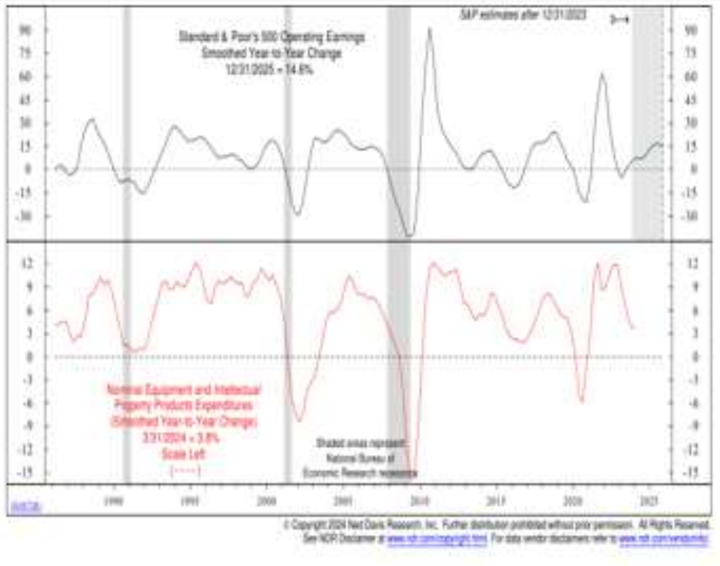


Another promising facet of the current economic cycle is the **resurgence of capital expenditure (capex) fueled by robust earnings and the promising applications of artificial intelligence (AI)**. The latest high-frequency data points to an acceleration in Capex with the nowcasting model suggesting sustained momentum in the coming few quarters. Critically, the pick-up in intermediate goods reinforces the trend. We can link this resurgence in capex to the virtuous cycle of better-than-expected corporate profits that is inspiring greater confidence to further invest. Such an up-cycle in capex has historically been accretive to GDP and earnings growth. As we wrote in 2017, Melt-up, capex cycles have been pivotal for equities performance as they typically yielded higher returns driven by positive earnings revisions and multiple expansions.

A renewed Capex cycle is underway



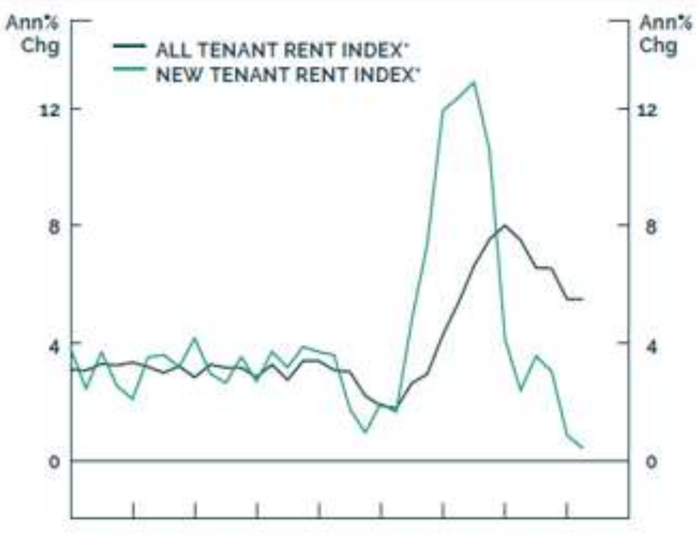
Higher capex portends to stronger earnings



At the same time, **we cautioned against the widespread belief of substantial central bank rate cuts** arising from a smooth disinflationary trend. In our 2Q24 outlook, The Last Mile, we counsel patience for inflation in the US to fall to the Fed's target and cited the biggest risk on our disinflation call has less to do with oil nor wages but with housing, which the US is suffering from a chronic shortage post-2008 trauma. Given that inflation prints since our 2Q24 publication have only edged slightly lower and our main concern, housing disinflation has fallen slower than we have anticipated, we move our first rate cut to 3Q-4Q24, with the earliest possibility being in September and the latest by November. Nevertheless, we retained the view that the Fed will execute 3-4 cuts over the following 12 months after the first cut.

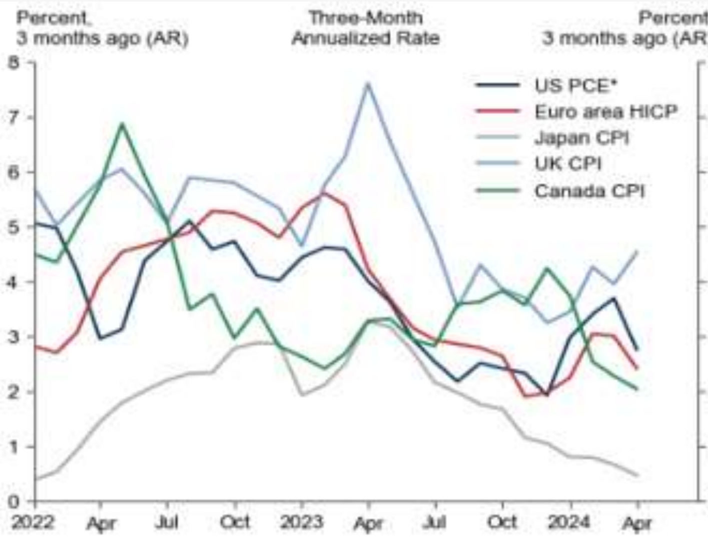
Decline in rent indicators have slowed

But new rents are falling faster than existing

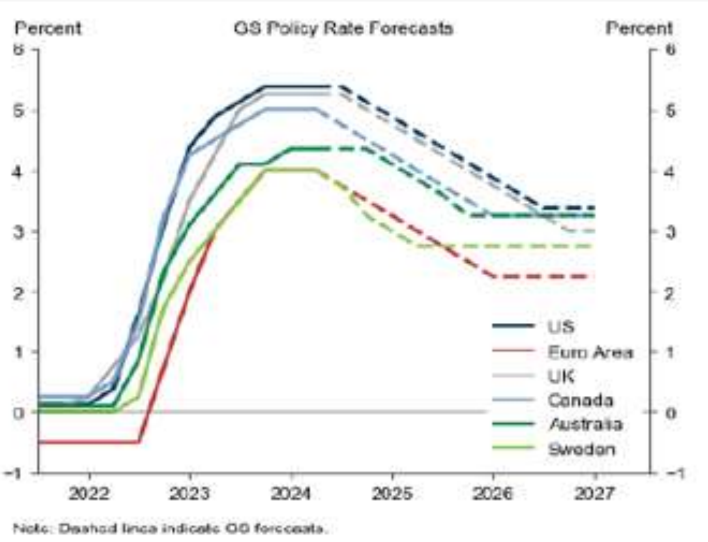


There are nuances in our inflation and rates view as well where we expect the ECB to cut ahead of the Fed and they did (For the data geek, this is the first time the ECB has ever cut its rates ahead of the Fed), followed by BOE in 3Q24. Since the start of the year, we have already seen the central banks of China, Brazil, Mexico, and Switzerland reducing their policy rates, hence, we remain confident we are at the start of a global easing cycle, not one of higher for longer rates. But we are suspending our view that BOJ will be raising theirs in the near term and has written extensively about the dilemma Governor Ueda faces in raising rates, Everything, Everywhere, All At Once. We believe BOJ could wait for Fed to cut first before they increase theirs as that would have a more pronounced impact to arrest the "excessive" depreciation of the Yen that they so detest.

Inflation has side-line in past months



Doesn't change our view we are in easing mode



Source: Goldman Sachs

It is important to highlight our portfolio strategy is assuming that the forthcoming easing cycle will be a shallow one, with four or fewer reductions, akin to those seen in 1980, 1984, 1995, and 1998.

Equities: Overweight. When we triangulate the three aspects of valuation, growth and positioning, Europe stands out on cheaper valuation, and lower positioning, while both the US and Japanese equities are expensive on valuation and already well-favored. We have further reduced our weights in the US equities in favour of Europe and Japan as Neutral after significantly trimming positions in the last two quarters. The lift in global manufacturing bodes favourably for Europe more than for the US as well as its economy and stock market constituents are more geared to global momentum. China is cheap on all three measures, but we remained cautious as we do not believe the current policy actions are enough to stem the multi-dimensional and multi-year restructuring process it must address as stated in this Navigator, High and Dry.

Instead, we are quite happy to represent our views in EM Equities via our key long/short managers and they have continued to deliver. Many of **our core managers and ETF expressions have continued to generate better risk-adjusted returns than their respective indexes.**

Core Equities – Mostly delivering better risk-adjusted returns

US Core Equity	Trailing 1yr Return (USD)	Volatility	Return/Vol
Long/Short Quantamental manager	11.6%	5.1%	2.26
In-house Global Equity mandate	23.7%	17.6%	1.35
Technology ETF	31.4%	27.7%	1.13
Alpha seeking ETF 1	10.7%	23.1%	0.46
Alpha seeking ETF 2	12.8%	21.2%	0.60
S&P 500 Index	**25.8%**	**20.9%**	**1.23**
Europe Core Equitiy			
Environment focus manager	15.4%	24.6%	0.63
Stoxx 50 Index	**19.8%**	**21.5%**	**0.92**
Japan Core Equity			
Japan Activism Fund manager	26.2%	8.0%	3.28
Topix Index	**11.7%**	**19.3%**	**0.60**
Emerging markets Equity			
Long/Short Asia manager 1	7.5%	8.7%	0.86
Long/Short Asia manager 2	33.9%	9.3%	3.62
EM Equities Index	**7.6%**	**22.5%**	**0.34**

Source: Managers, Bloomberg

For the **active component of our US equities allocation, we have constructed around two intersecting characteristics. We like sectors that will outperform in a shallow-cut cycle** such as healthcare, financials, and communication services as shown below. We also want to be in **sectors that will exhibit higher growth potential, have better valuations, and are not overly crowded**, such as Utilities and Technology sectors.

Sector leadership in a shallow cut; stronger earnings profile and lighter positioning

	6 months returns after first cut in Shallow cut cycles	% Outperformed S&P	2yrs EPS CAGR	PEG 2025	3mths EPS Revision (2024)	ETF flows ($ mn) YTD	ETF flows % of AUM YTD	Performance YTD
Healthcare	21.7%	50%	15.1%	1.16	-6.1%	-795	-2.01%	3.20%
Communication Services	21.3%	75%	27.6%	0.64	4.0%	-220	-1.18%	4.40%
Financials	20.7%	75%	12.2%	1.20	1.3%	1346	3.45%	5.10%
Technology	18.0%	50%	29.8%	0.88	3.0%	1597	3.65%	15.20%
Industrials	15.8%	50%	10.2%	1.90	-2.3%	1802	18.11%	8.10%
Energy	11.4%	50%	-1.6%	-6.97	2.5%	-1472	-3.97%	10.80%
Consumer Staples	10.7%	25%	10.2%	1.92	-0.1%	-819	-5.29%	-1.00%
Consumer Discretionary	9.2%	25%	19.0%	1.16	0.9%	-614	-3.27%	3.30%
Utilities	6.9%	25%	21.0%	0.75	0.7%	-1172	-8.31%	13.50%
Real Estate	5.9%	0%	10.1%	1.69	2.1%	377	1.19%	-1.60%
Materials	4.5%	0%	5.2%	3.55	1.2%	501	8.67%	5.30%
S&P 500	18.30%		17.4%	1.11	0.10%	- 15,167	-2.82%	6.20%

Source: NDR and Bloomberg as of 10 Jun 2024

Sectors that outperforms during Shallow cut cycles

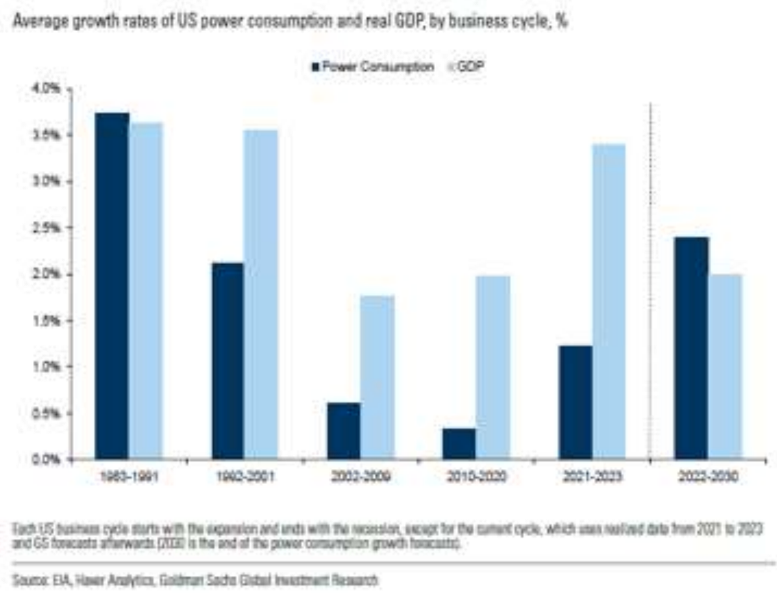
Sectors that have stronger EPS growth, better EPS revision momentum, relative cheaper valuation

Sectors will relatively lighter positioning

Take the Utilities sector for example. We call it the 2nd derivative of AI play aside from the semiconductor and software plays we have in the portfolio as the underlying, and data centres as the 1st derivative. According to a study by Goldman Sachs, **it will be the first time in three decades that power demand in the US will outpace GDP growth**. It is estimated power demand in the US will grow at 2.4% CAGR up until 2030 in contrast to the past 2 decades' growth of less than 0.5% pa. The proliferation of data centres is expected to drive 650 TWh of incremental power or at 15% CAGR during this period. It is expected to account for 8% of total power demand by 2030 up from only 3% currently. At least $95bn of annual capital investments will be needed just to deliver power to data centre in the US.

Over in Europe, the demand surge is even more pronounced. Electricity demand in Europe since 2008 has declined cumulatively by nearly 10% through a combination of exogenous financial shocks and ongoing greening of their economy. But Goldman Sachs forecast power demand from Europe will reverse this trend rising 3.6% CAGR over the next decade. In Europe, in addition to supporting data centres, there is also the added impetus coming from the electrification of their household and transport systems. The power demand for data centres is forecast to grow 8% CAGR in the next 10 years or addition of 150 TWh of extra power needed. Furthermore, it is estimated that Europe needs $800bn of spending on transmission and distribution especially given that their grid is the oldest in the world with an average grid life span of 45-50 years versus North America's 35-40 and China's 15-20 years.

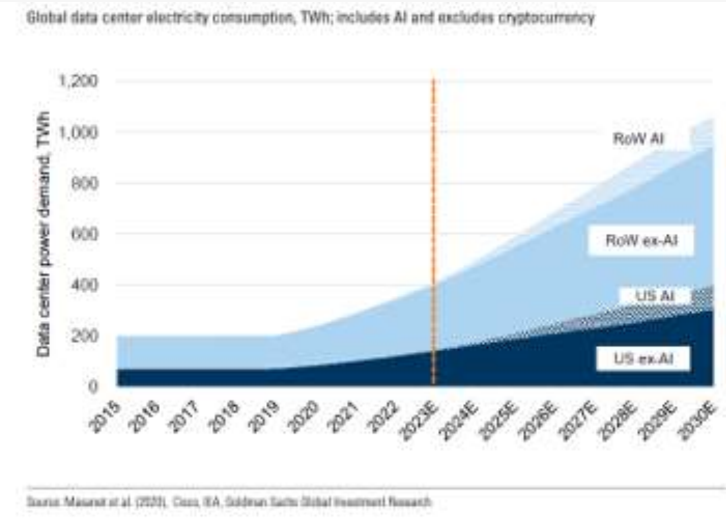
US power demand to outpace GDP in 20 years



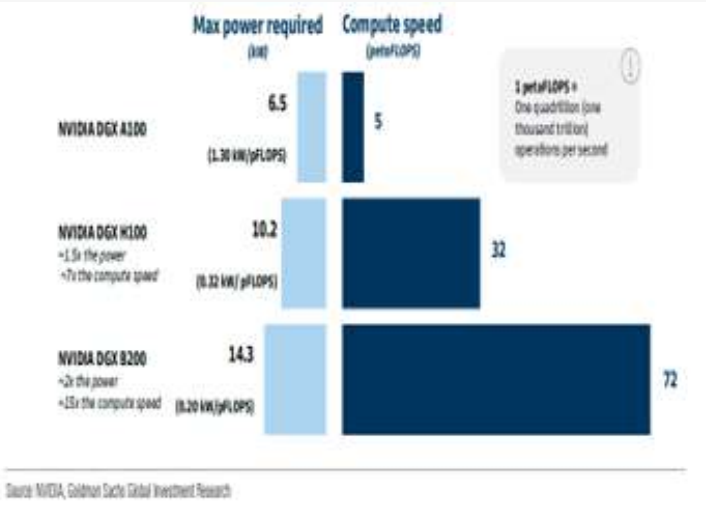
Europe power demand inflect to growth

Globally, the power for data centre is expected to accelerate significantly from 2023 onwards from 200 TWh of power to more than 1000 TWh by 2030. This is driven not only by the increase in demand for AI data centres but also by the difference in power intensity between traditional hyperscalers and AI data centres. For example, ChatGPT itself requires 10x more power than a normal Google search. The upcoming Nvidia Blackwell chip will require 2.2x more than the first GPU used in AI data centre and 40% more than the current chip that is being used.

Data centre power demand set to grow 5x



More advanced GPU needs more power



Distilling all of these factors, the **EPS for Utilities ETF in the US is forecast to grow 21% CAGR over the next 2 years, outpacing S&P by 3ppt**. The last time this industry grew at such healthy clips is way back in 2004-2007. It currently trades at a discount to S&P on a PEG basis and at 15.7x 2025 earnings is just trading at a slight premium to its long-term PE. Between 2004-2007 when it exhibited double-digit growth, the sector traded at an average of 17x PE to a high of 21x. Moreover, for the first time since the GFC of 2007, the sector is forecast to generate ROE above 11%. This sector is also sensitive to interest rates given utilities are highly leveraged companies, which should also benefit from our view of an easing cycle in the coming months.

2nd derivative play on AI: Utilities, the search for more power

Fixed Income downgrading to Neutral. We are in the camp the easing cycle will commence this year and our range of US 10 yield has not changed looking for a fair value trading band of 3.70-4.20% in 2024 and 3.30-3.70% in 2025 versus the current level of 4.32%. However, we are downgrading Fixed Income to Neutral as we believe better returns could be generated by allocating to equities and hedge funds. We continue to like Developed Markets Treasuries and Investment-Grade debt as they can generate asymmetric returns given the current level of bond convexity. Furthermore, as past analysis shows that fixed deposit rates always fall 6 months before the first cut and 12 months after, we believe there will be a hunt for carry shifting flows from fixed deposits to other relatively safer assets such as higher yielding Treasuries and investment-grade debt. Speak to your wealth managers if you want to find out more about our Fixed Maturity Investment-grade offering that is currently yielding more than 5.5%.

100bps move in Treasuries can generate material capital gains due to convexity

Estimated one-year Bloomberg Global Aggregate Index total return under various scenarios:

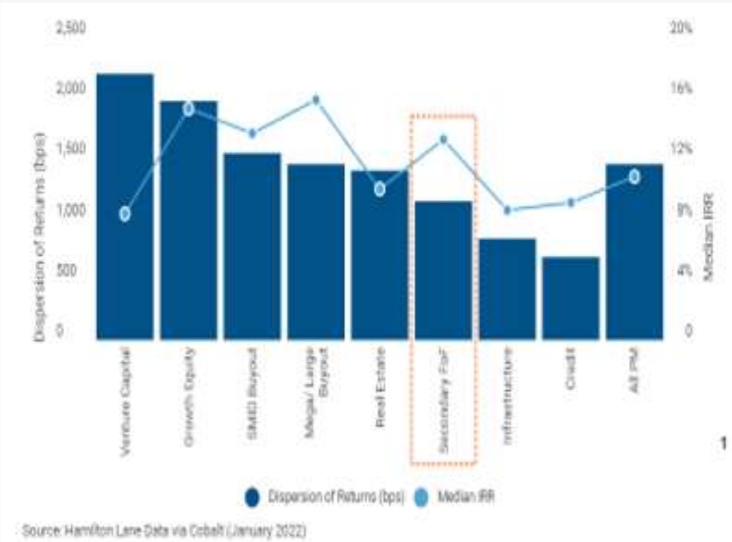
Change in US Rates (bps) \ Change in US IG Spreads (bps)	-50	-25	0	25	50	75	100
-100	12.0	11.0	10.1	9.2	8.3	7.5	6.8
-50	9.5	8.6	7.7	6.8	6.0	5.3	4.6
0	7.1	6.2	5.4	4.6	3.8	3.1	2.4
50	4.9	4.0	3.3	2.5	1.8	1.1	0.5
100	2.7	1.9	1.2	0.5	-0.2	-0.8	-1.3

Source: PIMCO

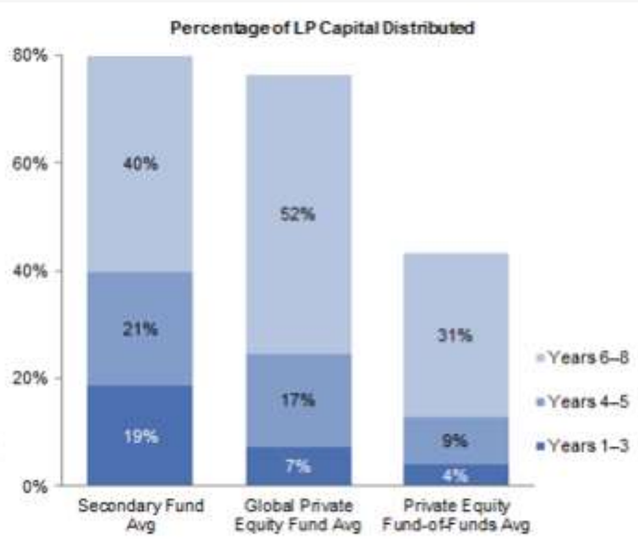
Alternatives: We have never agreed with the consensus view that Private Equity is a great diversification strategy that should warrant anything more than 15% of your portfolio. This asset class has hidden behind a flood of cheap money and away from the realism of mark-to-market profit and loss. Even when they are mark-to-market, the vagaries of how they are valued and the inherent conflict of the auditor marking a client's book is just too obfuscating.

Our skepticism towards private equity has been validated, as noted in the Financial Times article, "FT: Private Equity bosses warn of further losses". However, in the realm of investments, everything has its price—whether in periods of euphoric pandemonium or manic depression. We believe that in the coming quarters, the reset in private equity valuations will become more pronounced, potentially presenting an opportune moment to acquire PE secondaries. Historically, returns from PE secondaries have closely matched those from venture capital seeding and growth equity but with lower return dispersion. More importantly, given our firm's emphasis on liquidity, PE secondaries typically return capital much earlier than other private equity formats.

Secondaries' IRR is good and lower dispersion



Secondaries return money faster



Source: Cambridge Associates

Instead, we have advised clients to allocate a larger chunk of their alternative bucket to hedge funds. They have far better liquidity (typically within 6 months you will get your money back) and if the hedge funds are dealing with the public markets, valuations are easily discoverable. Our multi-strategy and multi-manager hedge fund strategy continues its stellar performance generating good returns on low volatility and remains lowly correlated to equities and bonds. If you would like to find out more about this mandate, please also reach out to our wealth managers.

GARP continues to generate good returns with low volatility and correlation

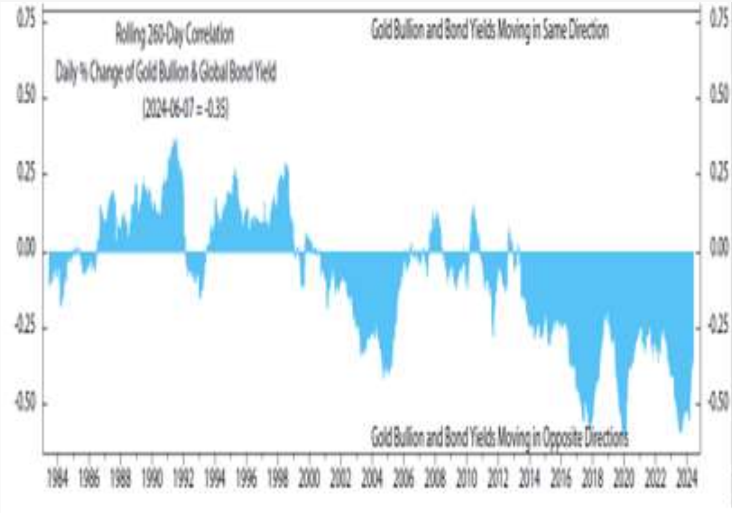
	YTD (May)	Annualized Volatilty (%)	Corr/Beta to Equities	Corr/Beta to Bonds
L/S Equity				
Global L/S	7.05%	5.6%	(0.57/0.22)	(0.21/0.27)
US L/S	0.50%	17.2%	(0.31/0.31)	(0.14/0.33)
European L/S	9.50%	10.6%	(0.33/0.2)	(0.08/0.12)
Asia L/S 1	6.14%	10.0%	(0.61/0.36)	(0.47/0.65)
Asia L/S 2	22.00%	11.0%	(0.33/0.22)	(0.03/0.05)
Multi-Strategy				
Platform manager	5.30%	3.4%	(0.07/0.01)	(-0.09/-0.04)
Quant-driven	4.27%	10.4%	(-0.07/-0.04)	(-0.31/-0.45)
Macro	1.91%	4.1%	(0.05/0.01)	(0.19/0.1)
Event				
Japan	20.20%	8.8%	(0.58/0.3)	(0.12/0.15)
Europe-centric	4.50%	8.0%	(0.53/0.24)	(0.23/0.25)
Relative Value	5.61%	4.6%	(-0.07/-0.02)	(-0.27/-0.17)
Alternative Credit				
Trade Finance	2.80% (Apr)	0.5%	(0.02/0)	(0.06/0)
Litigation Finance	5.23% (Apr)	1.1%	(-0.1/-0.01)	(-0.1/-0.02)
Covenant Capital HF Solution (GARP)	7.1% *	4.10%	(0.56/0.13)	(0.19/0.11)
Bloomberg Global Hedge Fund Index	6.80%	6.20%		

Source: Managers, Covnenant Capital and Bloomberg *estimated

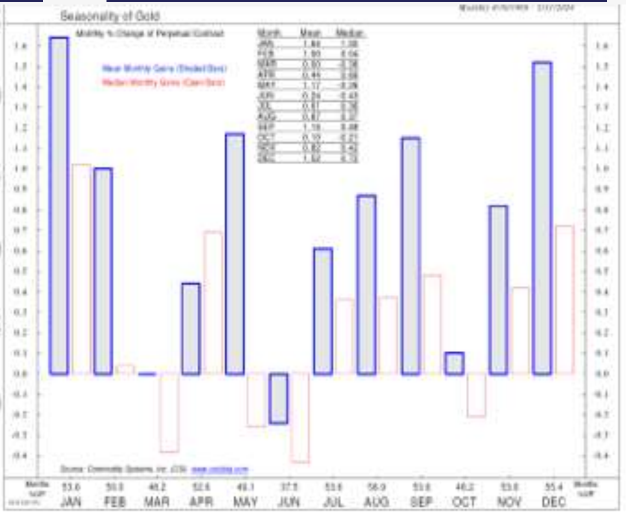
FX: We expect the Yen to appreciate as the interest rate differentials between the US and Euro versus the Yen are expected to narrow, largely due to diverging policy directions from their central banks. ECB has already cut, and we expect the Fed to ease sometime between August-November this year. However, we think it is more likely that BOJ will initiate their hike after the Fed has eased theirs. The contrast in monetary approaches underpins our optimism for the Yen to strengthen, albeit gradually.

Commodities: We continue to favour Gold within the commodities space. It has several investment theses running for it. In the short term, gold is inversely correlated to bond yields and the USD. Seasonality is also favourable for gold heading into the second half of the year.

Gold price and Bond Yield are negatively correlated

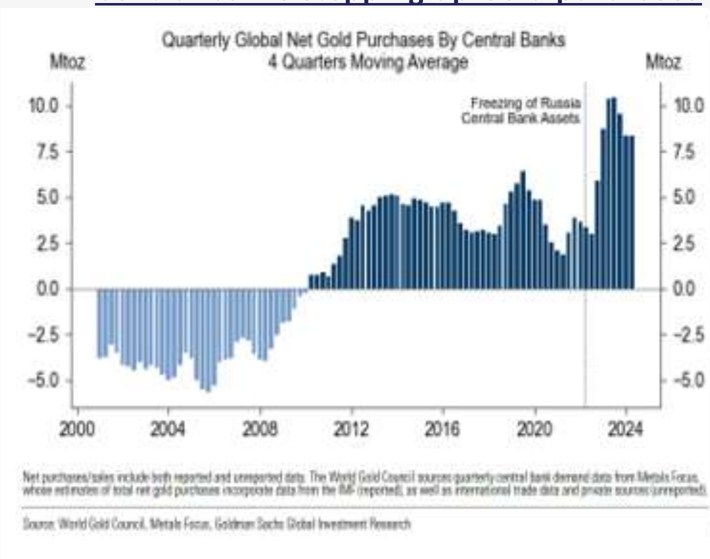


2nd half seasonality good for Gold

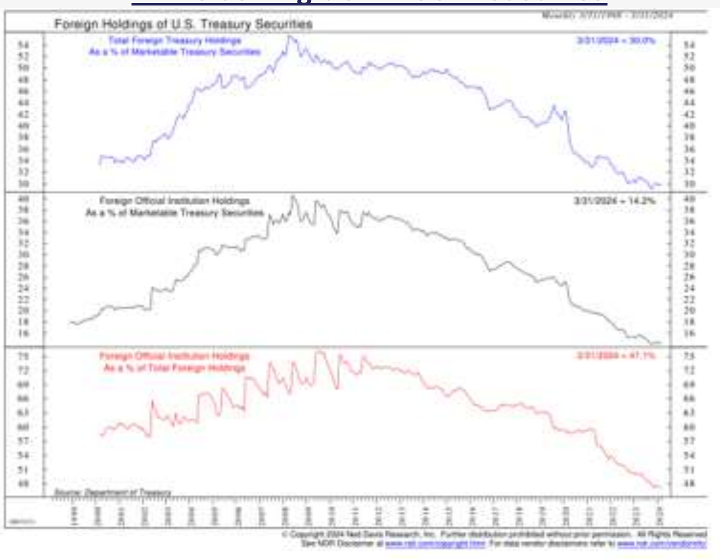


In the longer term, the dollar hegemony we have known since post-WW2 is increasingly being called into question. The blunt force of locking Russia out of the international financial system is as brute as Russia's attack on Ukraine. The multi-national move to cut off Russia has caused consternation amongst many governments, especially among emerging market economies. Compounding their concern is that US is on a path of unsustainable fiscal profligacy and the day of reckoning when foreigner buyers' revolt will have serious repercussions to the status of the USD.

Central banks stepping up Gold purchases

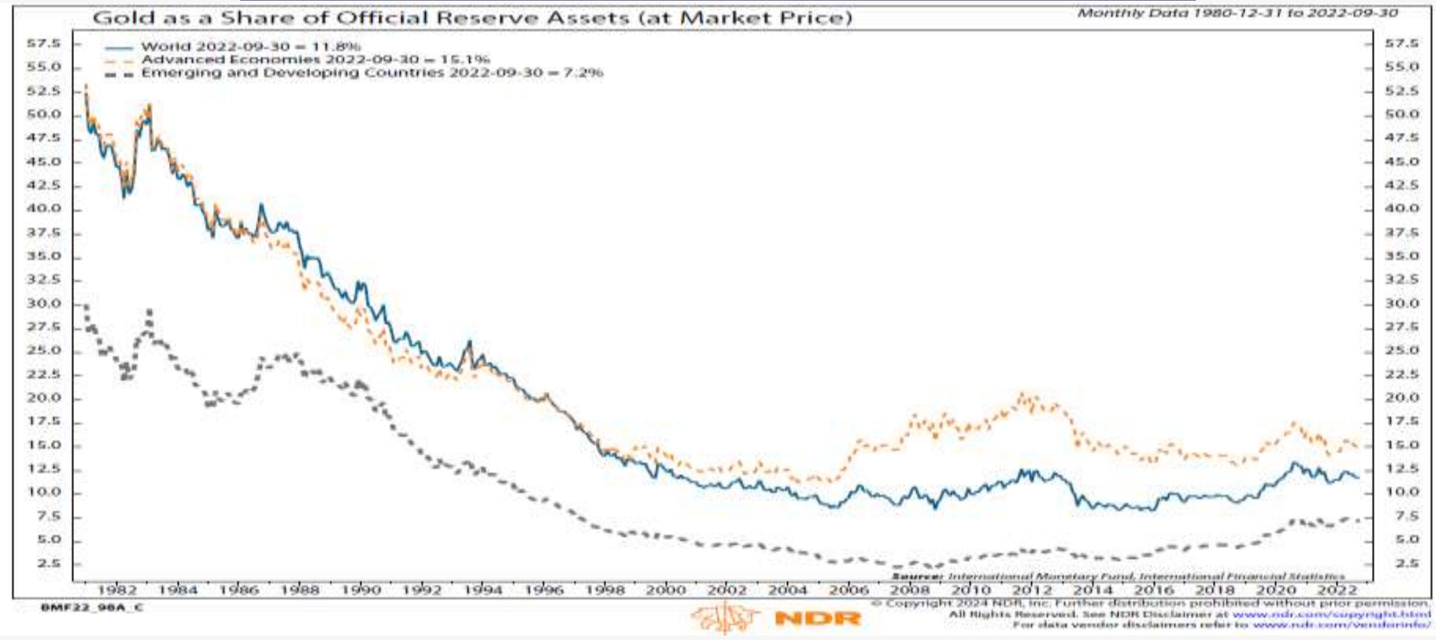


while selling down US Treasuries



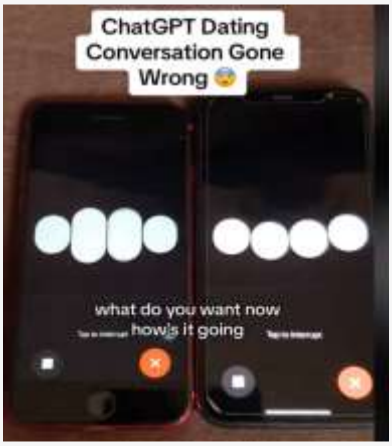
How much more can these central banks be substituting US Treasuries for Gold? Currently, emerging and developing countries hold 7.2% of their reserves in gold, which is more than 3x they held at the bottom in 2008. Post 2008, when the developed market central banks threw away conventional monetary policies and opted for an unorthodox world of QE and helicopter money, there has been a perceptible increase in their holdings in Gold. If we look at their gold reserves back in the 1980s, they averaged 22% of their reserves and between 1990-2007, the average was approximately 11-12%. The same trends can also be seen for advanced economies; a noticeable pick up in Gold post-2008 and gold reserves that were substantially higher back in the 1980 right up to 1999 when the other reserve asset, the Euro, debuted. In other words, there is still room for them to add more gold and diversify away from USD. We can also slide copper as the 3rd derivative of AI data centre boom.

There is still more room for Gold to rise in central banks' reserves



Cash: Cash 3 to 5%

Featured Picture/Quote: ChatGPT dating gone wrong. Thank God I am married.



https://www.tiktok.com/@thechattinghour/video/7371150343163350305

Edward Lim, CFA

Chief Investment Officer

edwardlim@covenant-capital.com

Risk Disclosure