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The Navigator

October 24

When bad news is bad news

By Edward Lim, CFA

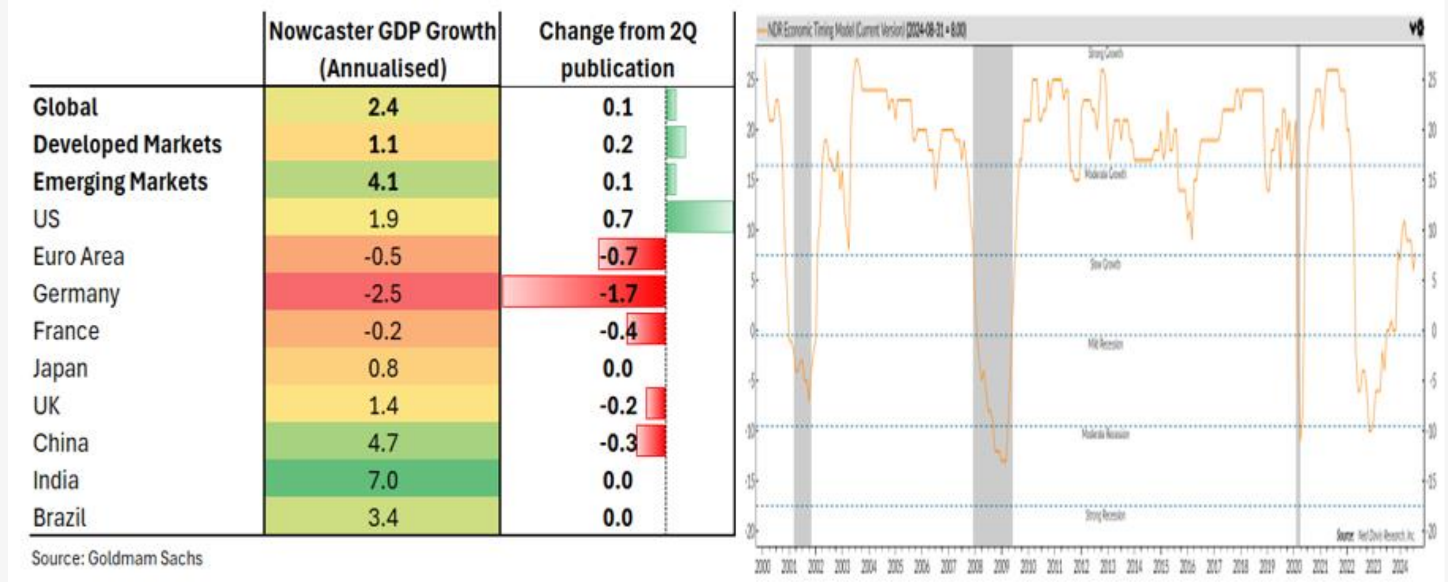
Singaporeans are not known for their good sense of humour. Let alone trying to put our brand of humour into the 30-second format of a TV commercial advertising for a state-sponsored radio station. But this commercial is an all-time classic, please click to watch before you read further. Gold 90.5: Hear only the good stuff. In our Navigator, we never shy away from telling our readers the bad stuff; call a spade a spade and in the case of this advertisement, call a dud a dud.

For a good part of the first half, our macroeconomic contours involve the global economy slowing down but do not fall into recession, therefore inflation moderates, and central bankers globally can commence their easing cycles. We also nuanced that even as the global economy slows, the impetus of growth shifts away from the US towards the rest of the world with Europe and Japan as the key drivers of this momentum while China economic activity stabilizes. Furthermore, we were expecting the transition of growth from the stalwart service sectors that have helmed global growth for much of the last two years to manufacturing sectors aided by state-sponsored investments in critical manufacturing and technological capabilities, as well as corporates with their strong profits plowing back to capex expansions. Even as the street has swung from extreme bull to bear on the path of inflation, we have been consistent and have argued for patience towards the path of disinflation, The Last Mile. The decline in inflation will therefore enable central banks to cut rates. This favourable macro setup bodes well for all asset classes particularly growth stories in equities.

Even when there is bad news about growth, participants have traded the market higher because they believe bad news is good news as it means Fed needs to cut early and cut hard. **However, we believe that going into the next few quarters, bad news about the global economy will be regarded as bad news**. While we are still in the camp the Fed has achieved the immaculate soft landing, we are humble enough to know this assumption needs to be continuously marked to market. We will also admit discerning a slowdown versus an impending recession requires clairvoyance we do not possess. We also humbly state we are wrong that US exceptionalism in the last two years gives way to a broader recovery by all actors nor have the manufacturing sector took over the growth baton.

Working through our three-axis macro framework for asset allocation, on the growth axis, **Nowcasting models such as Goldman's shows the US economy has strengthen from our last publication, but weakness in Europe is pervasive outside of the bright-spot in UK. China growth is deteriorating, and Japan remains at its inconsequential torpid pace**. Net Davis economic timing model has also dipped in the past few months falling from "Moderate Growth" phase back to "Slow growth."

Nowcaster shows lopsided growth | **NDR Economic model slip to Slow Growth**

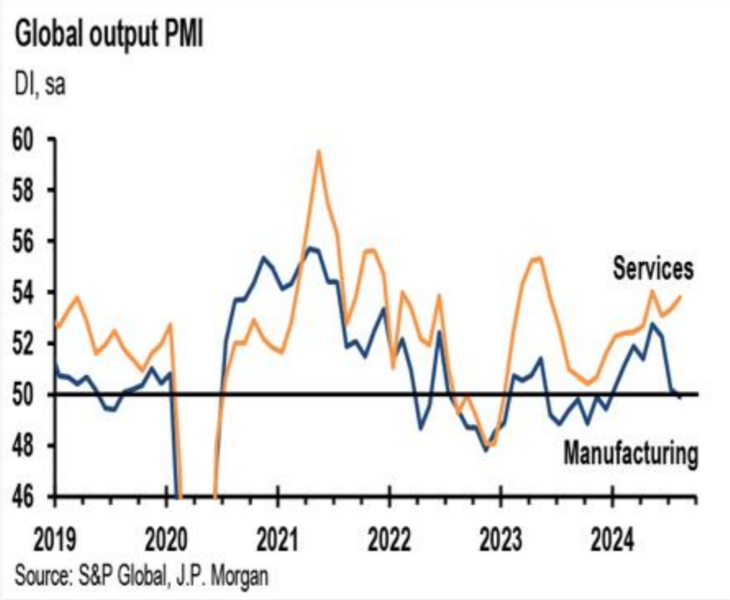


	Nowcaster GDP Growth (Annualised)	Change from 2Q publication
Global	2.4	0.1
Developed Markets	1.1	0.2
Emerging Markets	4.1	0.1
US	1.9	0.7
Euro Area	-0.5	-0.7
Germany	-2.5	-1.7
France	-0.2	-0.4
Japan	0.8	0.0
UK	1.4	-0.2
China	4.7	-0.3
India	7.0	0.0
Brazil	3.4	0.0

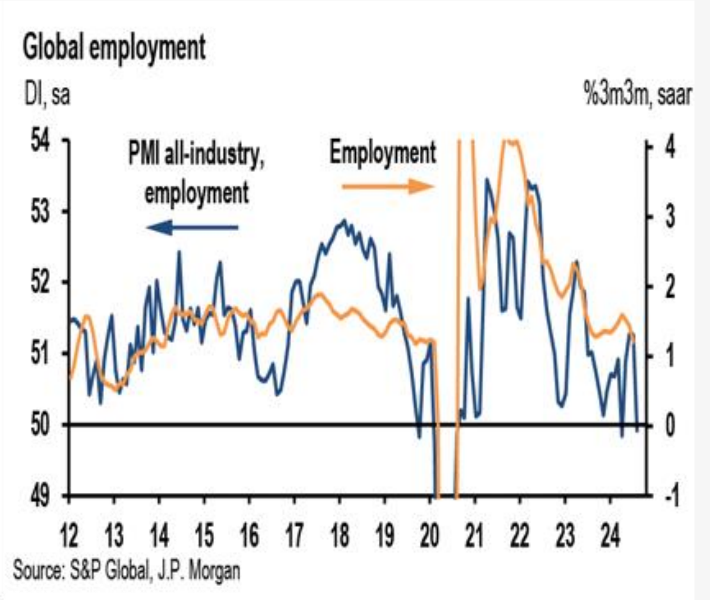
Source: Goldmam Sachs

Forecasting tools like PMI shows service sector remains the key ballast of growth but the pickup in manufacturing and industrial production we saw in 2Q24 has now retraced in the last few months. A combination of fading fiscal impulses, automotive inventory overhang, China and Germany woes, and consumer pulling back as their saving has depleted have led to a reversal in PMI-Manufacturing dipping below 50 again. More worrisome is when we look at the forward-looking series on employment, employment prospects have now fallen below 50 and that does not bode well for vitality of the service sectors in the coming quarters.

Manufacturing PMI weaken again



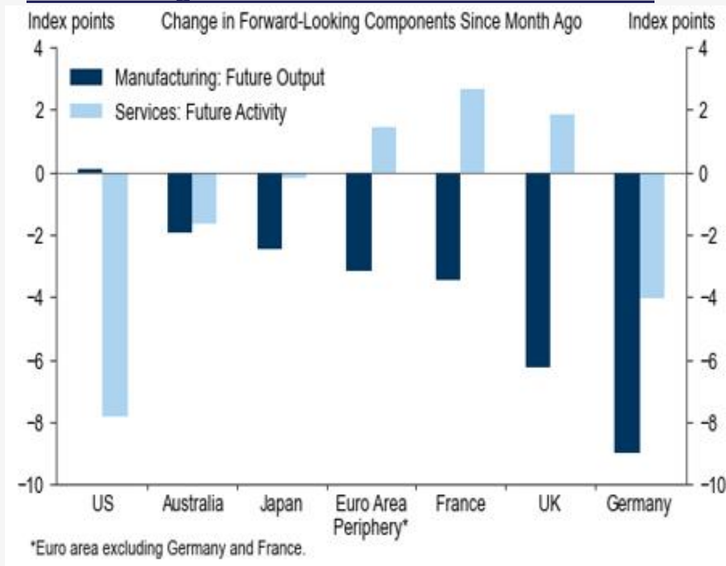
Diminishing prospect in employment



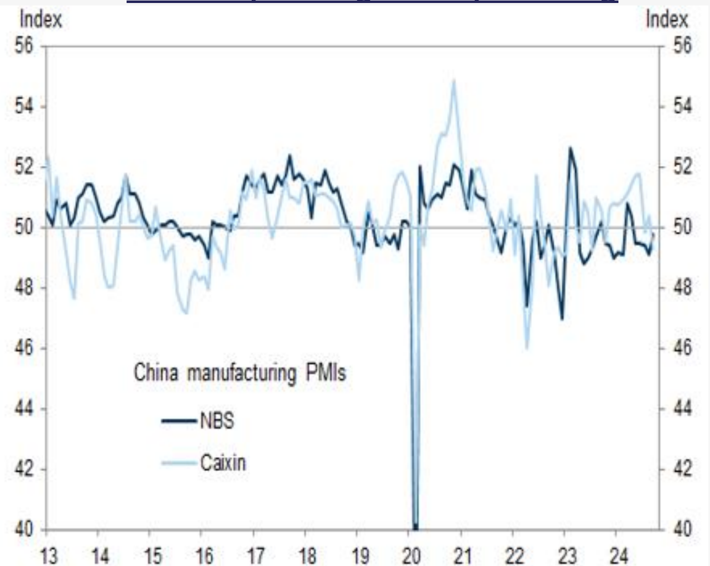
At the national level, the latest PMI data shows a greater swathe of economies posting lower forward-looking components from a month ago. For eg. the manufacturing PMIs for all major economic blocs have declined from few months ago. For services PMI, there is the sharp drop in future expectation in the US which needs careful monitoring and three of the six countries in the table have seen a deterioration in services. The US, Australia, and Germany services sector accounts for 24% of total global GDP.

Depending on which PMIs in China you want to use (NBS or Caixin), both underscored a weak manufacturing prospect. The NBS manufacturing index, which has larger SOE enterprises as their sample, has remained below 50 for five consecutive months. The Caixin manufacturing (skewed towards more private enterprises) has hovered around 50 for much of last 4 months too. Neither are the services PMI from both series exhibiting any strength over the last 5 months. The export sector has been a significant contributor of growth for China contributing more than half of its 1H 4.1% at 2.3ppt, but there are clear signs that is faltering now with New Export Orders falling to 47.5 from 48.7 in previous month and lead times are increasing and price deflation continues to persist.

Forecasting tool such as PMI have softened



China export engine is spluttering



Source: Goldman Sachs

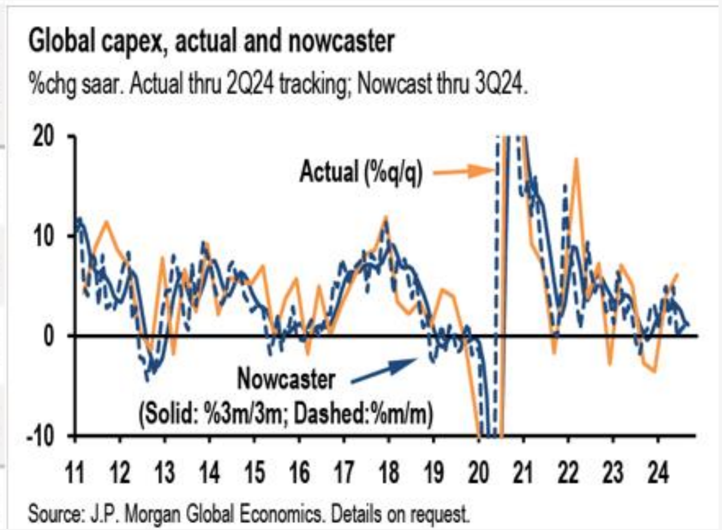
AI capex has been one of the bright spots and our global equities colleague remains optimistic about AI The 70/30 strategy and Gen AI. **I am more skeptical in the short run doubting the hundreds of billions spend so far on AI can generate any meaningful return on investment for these companies in the medium term.** It is estimate that over $400-500bn has already been spent on AI in the last 18 months and another budget of $500-600bn will be spend in the next two years. This stacks against what many believe revenue run-rate derived from AI adoption is only $10bn currently. Even if we generously extrapolate the cadence of AI-revenue which has jumped from less than a $1bn to $10bn in 12 months, AI revenue could be $100bn by 2025, the return of AI investment is less than 2.5% pa over the four years period. No technology spent can argue that a cumulative 10% ROI in four years is a great investment. You can only argue it is “Build and they will come” foray. Therefore, I expect the pace of AI capex investment should slow down in the coming quarters as the market calls time on these companies to show-me-the-money for the hardware investments that they have been made or is going to make. Do not take my word for it. Read the eminent VC expert, David Cahn of Sequoia Capital, commentaries about capex on AI, AI $600bn question and Game Theory of AI Capex or veteran tech analyst from Goldman Sach, Jim Covello, Generative AI: Too much spend, too little benefit?

The global capex renaissance we were expecting has also moderated in the last few months. Using JP Morgan Capex tracker, global capex is now merely annualizing 1% growth. Perhaps this softness in recent months is merely corporates delaying until US elections are over as there are significant ramifications between Trump versus Kamala economic policies.

$600bn AI revenue needed to justify capex

	Q4 2023 ESTIMATE	Q4 2023 ACTUAL	Q1 2024 ACTUAL	Q4 2024 ESTIMATE
NVDA Data Center Run-Rate Revenue	$50	$74	$90	$150
Data Center Facility Build and Cost to Operate	50%	50%	50%	50%
Implied Data Center AI Spend	$100	$147	$181	$300
Software Margin	50%	50%	50%	50%
AI Revenue Required for Payback	$200	$294	$363	$600

Global capex tracking only 1% ar growth.



Source: Sequioa Capital

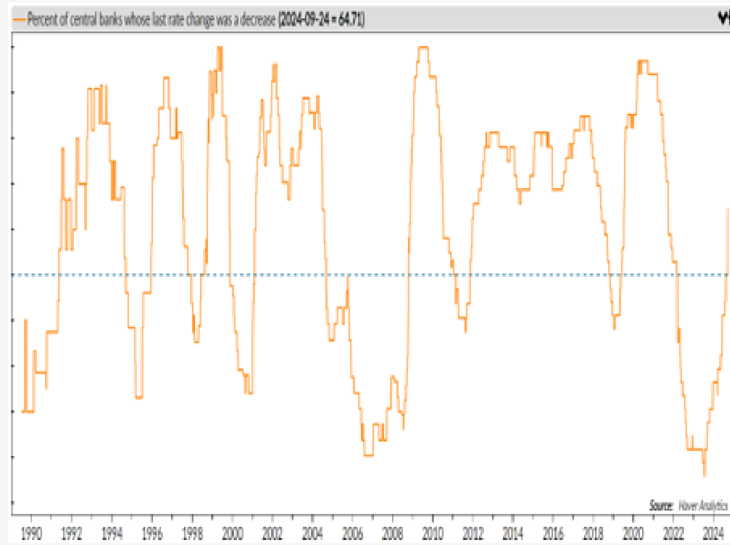
However, we are not suggesting the economy is slipping into recession as the Nowcasting is still pointing to an annualized growth pace of 2.4% and global PMI level extrapolates to forward growth of 1.9%, but the drivers of growth are narrowly concentrated in fewer countries and segments and therefore is susceptible to shocks. We must remind readers investment is not just a matter of magnitude but more importantly it is a porous game of deducing the size, direction, and inflexion points. We are positing that in terms of magnitude of GDP growth it remains in a sweet spot, but the direction of change has started to turn negative.

Delta of change has turned negative: All major regions Economic Surprise Index is -ve

Source: Bloomberg

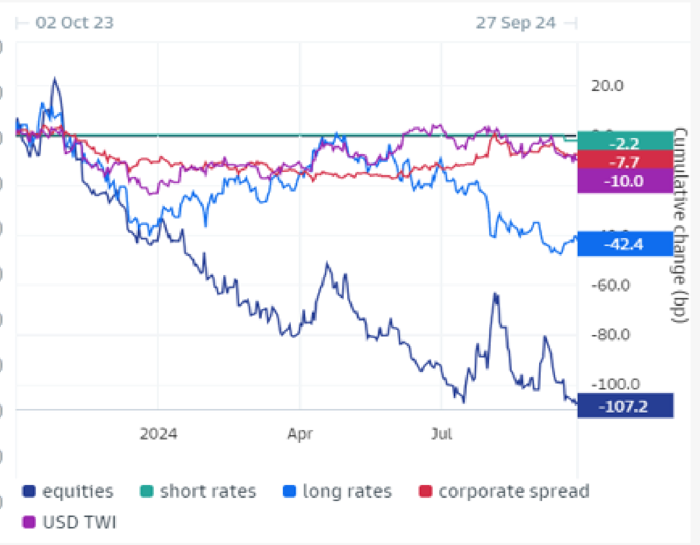
We shift now to our second axis of inflation and central banks' reaction function to that. Inflation has come within developed market central banks threshold and the balance of risk for them to judge now has tilt towards growth concerns rather than sticky inflation. Hence, **65% of central banks have reduce their policy rates at their latest meetings and we expect more easing to come over the next 12 months** and the most important of them all is the Fed. The resultant lower long-term yield, compression in credit spread, higher equities prices have pushed global Financial Conditions to the lowest level since the Feb 2022. It is worth mentioning that the Fed latest dot-plot is indicating another 50bps cut before the year ends and another 100bps into 2025. This would constitute an aggressive cutting cycle against our long-held view since end of last year of a shallow easing. We will be spending the remaining part of the strategy differentiating the outcomes of a shallow versus aggressive easing cycles.

65% of central banks lowered rates



Source: NDR

Global FCI has eased to lowest since 2022



Source: Goldman Sachs

Which brings us to the last element of our macro-economic asset allocation framework which is valuations. **Valuation of US equities and credit are not cheap by any definition** and in an environment where bad news is treated as bad news, markets can be volatile. There has never been a calendar year when US equities returns are negative, and the rest of the world churn out positive outcomes.

US equities and credit are not cheap, except for Treasuries.

	Equity					Government bonds				Credit				
	S&P 500	Stoxx 600	MXAPJ	Topix	MSCI EM	US 10y	German 10y	Japan 10y	UK 10y	US IG	US HY	EUR IG	EUR HY	EM ($)
Valuation metric	12m forward P/E ratio					Yield				Spread				
Current:	21.1x	13.3x	13.0x	13.2x	11.6x	3.7%	2.1%	0.9%	3.8%	109bp	339bp	134bp	361bp	385bp
Expensiveness (last 10y percentile):	*84%*	*25%*	*41%*	*33%*	*34%*	*16%*	*18%*	*4%*	*14%*	*86%*	*84%*	*45%*	*63%*	*40%*
3M change:	0.1x	0.0x	-0.6x	-1.4x	-0.6x	-0.6%	-0.3%	-0.1%	-0.3%	2bp	10bp	-1bp	6bp	-10bp
Average:	18.2x	14.4x	13.3x	13.9x	12.1x	2.4%	0.6%	0.2%	1.8%	143bp	440bp	136bp	404bp	-2bp
95th:	22.1x	17.4x	16.2x	17.3x	14.8x	4.3%	2.5%	0.8%	4.3%	192bp	693bp	203bp	583bp	509bp
5th:	15.5x	11.9x	11.6x	12.0x	10.5x	0.7%	-0.5%	-0.1%	0.3%	101bp	316bp	96bp	279bp	292bp

Note: GSDEER is our fair value macro model for exchange rates. US IG spread is from iBoxx. EM ($) is JPM EMBI.

Source: Datastream, I/B/E/S, iBoxx, Goldman Sachs Global Investment Research

Asset Allocation Strategy

This leads us to our portfolio construction. **We are clearly in the anti-consensus call of a risk-on appetite. We are downgrading Equities to Neutral**, for **Fixed Income are Neutral** and our exposures are in high-grade credit that should perform relatively well if the economy slows more than expected. We **retain our position in Yen and Gold Yen** given the differentiated path of monetary policy for the former and coincidentally both of them serve well as a risk off trades. We continue to favour hedge funds given they have demonstrated their ability to generate positive returns with low correlation to the broader equities and bonds markets.

The differences in the path of returns and the probabilities of positive returns can vary significantly if the easing cycle was a shallow one (aka no recession) or an aggressive one (recession or a systemic risk occurred). For example, 12 months after the Fed first cut, the average return in a shallow cut cycle is 21% and all the time, the SPX returns were positive. However, in an aggressive cut, the average return turn to losses -1.4% and only 60% of the time the returns are positive, and the maximum losses can be material at -24%. US10 yield compressed 80% of the time in an aggressive cycle but credit spread widens most of the time. Risk off trade like Gold works returning 11% return on average and 80% of the time made positive return.

Significant variations in return prospects in a shallow versus aggressive easing

	12 months returns after first cut in Shallow cut cycles	12 months returns after first cut in Aggressive cut cycles
Change in US10 (Average)	87.8	(130.0)
% Spread Compressed	25%	80%
Max Compression	(181.0)	(401.0)
Change in Credit Spread (Average)	(15.5)	41.8
% Credit Widen	75%	80%
Max Credit Spread Widen	(79.0)	90.0
SPX Return - Average	20.9	(1.4)
% Returns Positive	100%	60%
Maximum Loss	NA	-23.91
Gold Return - Average	(4.1)	11.0
% Returns Positive	25%	80%
Maximum Loss	(12.9)	(5.3)
Dollar Strengthens	5.0	1.6
% Returns Positive	25%	40%
Maximum Loss	(12.9)	(5.3)

Source: Bloomberg

Equities: Downgrade from Overweight to Neutral. While we are still in the company of a US soft landing even as the rest of the world looks precarious or at the margin absent of growth catalyst, we note that can be significant dispersion from the average returns when the Fed commences its easing cycle. As we have detailed in last quarter Navigator, Now I know when I must retire, S&P delivered an impressive returns of 18.3% 6 months after a first cut if the follow-on easing is a shallow one (defined as four 25bps cuts of less). Healthcare, Communications Services, Financials outperformed the S&P, and Technology in-line. However, in an aggressive cutting cycle, it implies that the economy has deteriorated meaning fully, S&P only returned 1.5% and sector leaderships clearly shift toward defensive ones like Healthcare, Utilities and Consumer Staples of which we already own healthcare and utilities.

Sector leadership and market performances: Shallow vs Aggressive easing cycles

Shallow Cycles

	6 months returns after first cut in Shallow cut cycles	% Outperformed S&P
Healthcare	21.7%	50%
Communication Services	21.3%	75%
Financials	20.7%	75%
Technology	18.0%	50%
Industrials	15.8%	50%
Energy	11.4%	50%
Consumer Staples	10.7%	25%
Consumer Discretionary	9.2%	25%
Utilities	6.9%	25%
Real Estate	5.9%	0%
Materials	4.5%	0%
S&P 500	18.30%	

Aggressive cycles

% Outperformed S&P	6 months returns after first cut in Aggressive cut cycles	
67%	8.5%	Healthcare
83%	7.8%	Utilities
67%	6.6%	Consumer Staples
50%	3.0%	Communication Services
50%	2.8%	Materials
50%	2.3%	Industrials
50%	2.3%	Real Estate
50%	1.8%	Consumer Discretionary
33%	0.9%	Financials
50%	-2.3%	Technology
50%	-4.7%	Energy
	1.50%	S&P 500

Source: Bloomberg

We **exited our long-standing position on US Financials** as our base-case economic scenario downshifts from our start of the year bullish calls. JPM CFO comments in the past few weeks are a negative harbinger for the sector. They downplayed consensus estimate of just low single digit growth in Net Interest Income as “overly optimistic” and warned that cost would increase more than market is estimating. The sector is trading at 1.52 PEG and is 15% more expensive than what is already an expensively valued S&P at 21x PE in 2025. On a P/B basis, financials trades at 2.3x far higher than its ten-year average of 1.7x and is at +2 sd. Instead, **we swapped that position to consumer staples ETF in the US on grounds that it performs well during aggressive rate cut cycles delivering 6.6% return and outperforming S&P 67% of the time**. The sector trades at 21x 2025 PE in-line with the broad market and is forecast to generate 2 years CAGR of 9%. In the last 3 months it has the biggest inflow of money into the ETF at 2.4% of its asset under management while we have seen outflows seven out of thirteen sector ETFs.

US sectors valuation, Earnings Revision Momentum, and ETF flows

	2yrs EPS CAGR	PE2025	PEG 2025	1mth EPS Revision (2024)
Healthcare	14.4%	18.4	1.28	4.6%
Utilities	20.5%	18.2	0.89	-0.2%
Consumer Staples	7.6%	21.0	2.77	-1.0%
Consumer Discretionary	16.9%	25.1	1.48	2.5%
Technology	33.6%	27.0	0.80	0.2%
Communication Services	24.4%	18.1	0.74	-0.2%
Financials	13.8%	16.0	1.16	2.6%
Industrials	9.9%	21.7	2.20	0.1%
Energy	-14.7%	12.3	-0.84	-5.5%
Real Estate	8.5%	20.3	2.38	-11.5%
Materials	19.0%	20.6	1.08	0.3%
S&P 500	**15.8%**	**20.8**	**1.32**	**1.00%**

Category	21-Day		Year-to-Date	
	Asset Flows($mil)	% to Total Assets	Asset Flows($mil)	% to Total Assets
Consumer Disc	-468.79	-1.24	-1,173.55	-3.11
Consumer Staples	692.53	2.42	-77.22	-0.27
Energy	-1,418.85	-2.17	-3,825.65	-5.86
Financials	-2,335.10	-2.47	2,937.17	3.10
Health Care	-91.58	-0.10	-2,706.40	-2.85
Industrials	-555.20	-0.93	4,265.57	7.15
Information Tech	5,454.69	0.50	94,284.08	8.61
Materials	-168.53	-1.36	-582.55	-4.69
Real Estate	1,133.78	1.58	3,627.37	5.04
Communication Services	-307.95	-1.27	-1,663.67	-6.85
Utilities	210.68	0.67	1,624.22	5.19
Leveraged/Inverse	1.57	5.84	25.33	94.30
Total	**2,147.25**	**0.13**	**96,734.70**	**5.99**

Source: Bloomberg

Outside of the US, we only made two trades. **The first to switch out of our Stoxx 50 Europe to increase our exposure to MSCI Europe + UK ETF to gain exposure to the UK market.** Economic momentum in the UK have surprised on the upside relative to their European cousins. The new UK Prime Minister's economic doctrine of responsible fiscal restraint versus past governments' years of profligacy could augur a new economic paradigm for UK versus the rest of Europe. UK constitute 22%% of the ETF while the switch also provided us a defensive bend with 21% in defensive sectors in contrast to Stoxx 50 ETF of 11%. Both ETFs trades at same level of 13x next year, but the ETF with UK blend has 4ppt higher EPS 2yrs CAGR.

The other trade we did was to **re-enter our Topix Banks ETF trade post the remarkable sell-down in late August** when the Yen strengthen aggressively. But the fact is Japanese banks benefits from a stronger Yen because of their overseas lending activities which on average is about 30% of their total lending for the four major banks. Every 10 Yen appreciation adds 3% to their net income. Moreover, the banks have commented they are not sensitive to US rates as its net interest margin did not expand when US rates was going up simply because their USD lending are funded in USD too. In fact, they are key beneficiary of rising Japanese yield with every 15bps increase in local yields can add 6% to their net income.

Rising Japanese yield and appreciation of Yen are all positive for Japanese banks

(JPY bn)	USDJPY assumption for FY3/25	Profit impact from ¥1 move in USD/JPY (weak yen)				Net income (FY3/25CoE)	% post-tax impact to net income
		Revenue	Expense	Net business profit	Net income		
MUFG	¥140			8.5	7.0	1,500	0.47%
SMFG	¥140			4.5	2.5	1,060	0.24%
Mizuho	¥135	7.0	-3.5	3.5	2.5	750	0.33%
SMTH	¥140	1.0	-0.5	0.5	0.4	240	0.15%
Resona	n/a				0.0	165	0.00%
JPB	n/a				0.0	365	0.00%
Aozora	n/a				0.0	18	0.00%

	Change in Policy rate 0.15%		
	Net Income Impact	Current Consensus Net Income FY 26	% of Accretion
MUFG	127.5	1738	7.3%
SMFG	60	1220	4.9%
Mizuho	67.5	842.7	8.0%

Source: Company and Goldman Sachs

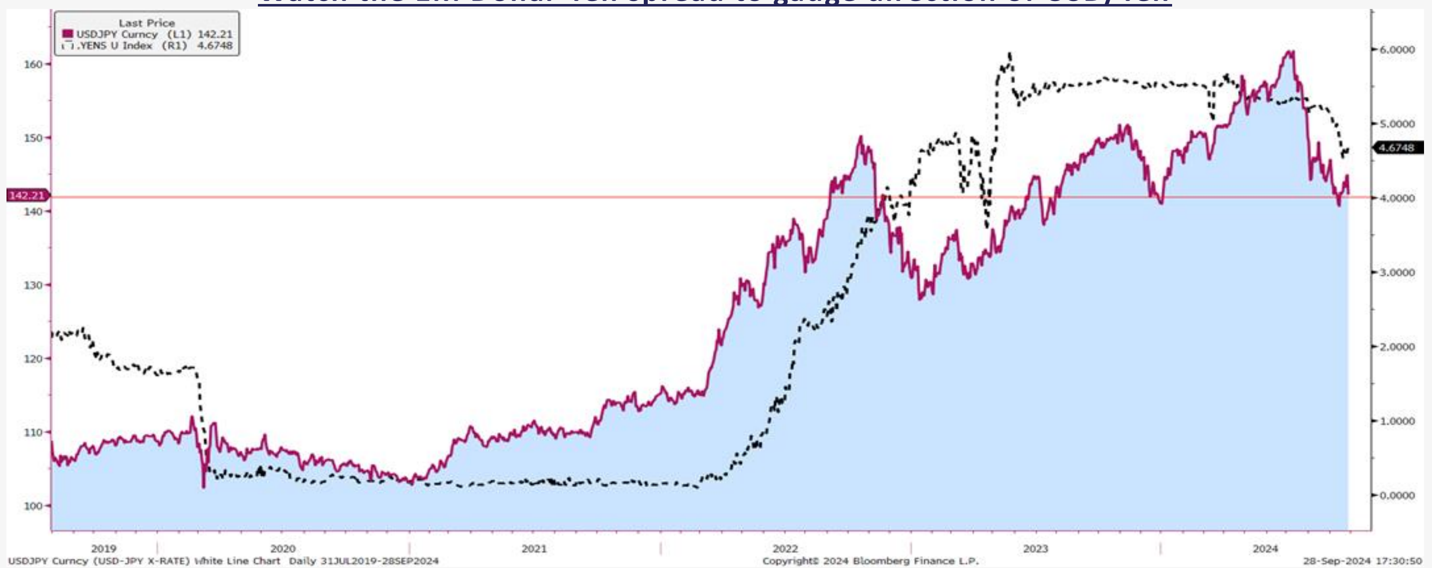
The trade we avoided was to catch the bounce in China. We have written extensively in 2023 in High and Dry and in our Spotify podcast China Real Estate where we drew many similarities of Japan's lost decades and China's current moribund state of affairs. The latter part of the quarter easing by PBOC and all related financial bodies of China is not enough to get it out of its funk. China is in a balance sheet recession, no amount of cheap and more money will unhinged it. Japan has already provided them a template of what not to do and it befuddles me why the Chinese refused to learn from them, a misplaced nationalism? China needs a fiscal stimulus targeting not its export sectors but the domestic consumption.

Alternatives: Given our prescribed macro dynamics, hedge funds should form a large asset class in our portfolio, and it currently stand at 30% at the upper threshold of our limits. I have just completed a European trip visiting our hedge fund managers and speaking to other MFOs there. The skeptical view I have shared in the last Navigator on private equity and the advice I have given that one should have more hedge funds than private equity as their alternative assets were corroborated with the MFOs I have met. One large MFO told me they have 70% of their alternatives in hedge funds and 30% in private equity. He shared on average his experience has been PE managers do not deliver superior returns when adjusted for liquidity than their hedge funds managers or even public markets. 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. In the month of August where there has been violent unwind of Yen carry trade, growth equities, momentum strategies, only three of the twelve managers in GARP were down with the largest being our activism Japan manager that was down 2.6% only.

Fixed Income: Neutral. Current level of US 10 yield does not reflect our more cautious view of the US and global economy, and we will be looking to add to our current long-dated duration when it trades within our US10 yield ranges of 3.70-4.00% for the remainder part of 2024 and 2025 range of 3.30-3.70% in 2025 as we have successfully done so in the past. No change in views as we continue to like Developed Markets Treasuries and Investment-Grade debt in sync with our macro views. There is asymmetry of returns from current level of bond convexity, but quality of credit matters materially as the economic cycle slows. **Speak to your wealth manager about our Global Investment-grade bond portfolio as well as our fixed-maturity global IG bond portfolio.**

FX: No change holding long Yen for its under-valuation and risk-off characteristic. For Yen to move convincingly lower below 140, we will be monitoring the 1-month forward interest rate differential between US and Japan as it has often served as good barometer of direction. If it cracks below 4%, that trigger the next resistance level of Yen 130.It currently stands at 4.67%.

Watch the 1M Dollar-Yen spread to gauge direction of USD/Yen



Source: Bloomberg

Commodities: No change holding Gold as debasement of fiat currencies trade, the slow demise of USD hegemony, and risk off trade. We will be reassessing our 2025 gold target towards the year end and would be happy to ride it past our 2024 target of $2,700.

Cash: Cash has increased meaningfully to 10-15%.

Featured Picture/Quote:

Me in the loo in Amsterdam. “I wondered if they come with a complimentary ladder?”

Edward Lim, CFA

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