Covenant Capital

16 Raffles Quay, #41-02
Hong Leong Building, Singapore 048581

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

The Navigator

October 25

The Rare Ones

By Edward Lim, CFA

Arne Slot has etched his name indelibly among the legendary “Rare Ones” of English football. Since the establishment of the English Football League First Division in 1888 only eight managers have ever won the league title in their very first season at a club. Slot is part of an even more exclusive group: just three managers who not only lifted the English title in their debut campaign but also arrived as reigning champions from their previous league. He now stands alongside José Mourinho, who won back-to-back Primeira Liga titles with Porto before guiding Chelsea to the Premier League crown in 2004–05, and Antonio Conte, who came to Chelsea as a Serie A winner and delivered the Premier League in 2016–17.

If Slot’s Liverpool side can defend their crown this season, he will match the remarkable feat of Mourinho—winning a domestic league before arriving in England, claiming the English title at the first attempt, and then retaining it the following year. Such an achievement would enshrine Slot’s legacy as one of the two “Really Rare Ones” in a league with a history stretching back 138 years.

Rarity is not confined to sports. In the history of the Fed’s easing cycle dating back to World War 2, there has only been seven times that the Fed has halted for 6 months or more before commencing another round of easing. The 2024-25 easing cycle will be the eighth of such rare ones. Each episode was shaped not by the familiar rhythm of boom and bust alone, but by complex undercurrents that demanded constant policy recalibration. The 1976 pause, for example, provides an instructive parallel to the current one.

Back in 1971, US has just abandoned the Bretton-Woods Accord that has served in effect devaluing the USD and resulting in higher import prices amongst many other consequences. The prior decade of proxy wars against communism including the humiliating defeats in Korea and Vietnam coupled with enlarged social programs have also led to higher spending and eventually fiscal deficits in contrast to two decades fiscal discipline. Geopolitical miscalculations in the Middle East led to the oil embargo on the US in 1973 which further stoke inflation. The ensuing years saw inflation tripling to 12% by late 1974 and concomitantly, the Fed had to increase rates for much of 1972-1974 from a low of 3.50% to 13%. The economy crumbled and unemployment rate started to rise and by the middle of 1975 the unemployment ratio has more than doubled to 8%. The Fed had to reverse course slashing rates in late 1974 but by 1976, they had to pause their easing because inflation has re-emerged. Furthermore, there was politicizing of the Fed under Governor Arthur Burns as he was criticized for being too accommodative in his earlier tenure. The pause in easing of 1976 was also partly calibrated to demonstrate Fed's independence.

Our investment process is anchored by economic theories and empirical data. We need to glean from history **what might happen next even more so when faced with such rare outcomes when Fed paused for so long before resuming another rate-cutting cycle:**

1) Of the seven occasions, **only twice in 1982 and 1990 did the economy eventually slip into recession**. The 1982 and 1990 episodes were also the only time four or more subsequent cuts were delivered after the pause in recognition of recession risk. More about why this distinction of more or less rate cuts is important in the asset allocation segment.
2) **For equities, the skew is positive. S&P returned a median/average of 11 and 17% respectively twelve months later after they resumed their cuts.** Even in 1982 episode that was accompanied by a recession, the market was up 58% twelve months later. Only in the later easing of 1976 was a negative return over the next twelve months at -9% as the Fed had to wrestle stagflation.
3) But **we should expect volatility as six of these episodes did saw material drawdown** on average of -19% (range from -5% to -36%) and the recovery generally took several months.

Therefore, while the skew is for further upside in the next 12 months as Fed resumes its rate cuts, there are important features to note including risk of large drawdowns and the recoveries often took several months.

The Rare Ones of > 6 mths pause Fed easing cycles

# of cuts after long pause	Episodes	S&P Return 12 mhts	Worst Drawdown	Recovery period	US 10 Yield	Yield Curve	Credit Spreads	USD
Three or few cuts	19/1/1976	23%	Nil	NA	-48	22	-72	5
Three or few cuts	22/11/1976	-9%	-23%	36	39	-99	-12	-36
Four or more cuts (recession)	20/7/1982	58%	-10%	2 months	-212	38	-115	7
Four or more cuts	7/3/1986	11%	-5%	1 month	-73	6	-30	-13
Four or more cuts (recession)	13/7/1990	10%	-36%	7 months	-19	70	-6	6
Two or few cuts	6/11/2002	9%	-19%	7 Months	36	7	-41	-11
	Average	**17%**	**-19%**		**-46**	**7**	**-46**	**-7**
	Median	**11%**	**-19%**		**-34**	**15**	**-36**	**-3**

Source: Bloomberg, Fed, NDR

What about the other asset classes? How did they behave 12 months after a pause and a resumption of rates cut? 10-year yields mostly decline on average/median of -46 and -34 bps and only on two occasions it rose (1976 and 2002). Yield curve steepens by an average/median of 7 and 15bps and only in the 2nd episodes of 1976 yield curve inverted as stagflation took hold. Credit spreads always narrow on average/median of -46 and -36bps.

The outcome of the USD is less conclusive with 50% chance of rising or falling. The average/median decline are moderate at -7% and -3%. Again, it is the case of 1976 under the disastrous Fed governor Arthur Burns, USD experienced the largest decline of -36%.

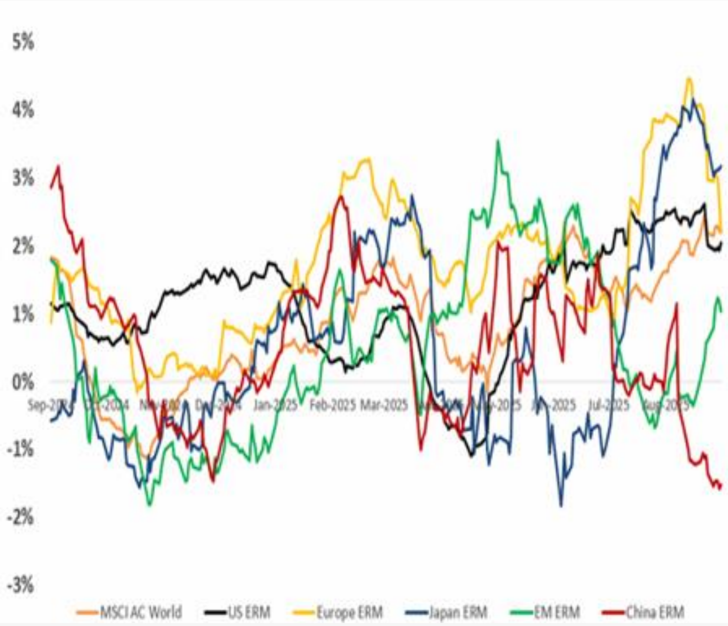
Asset Allocation Strategy

We started the year with the narrative of robust but uneven growth supported by strength in the US and recovery in China driven by their highly stimulative policy but stifled by fragility in Europe and Japan continues. While Trump's 2025 agendas on immigration and tariffs are the biggest negative swing factors, his pro-business and deregulation stances can counteract the pernicious impact of tariff and mass deportation. Even as growth is strong and inflation is abating, the expected increase in tariffs kept us cautious in our positioning with Neutral in equities but with a view of neutralizing our underweight in US equities when opportunity presents. But we downgraded Fixed Income to underweight eschewing developed market government bonds particularly in the long-dated govies on concerns of their elevated level on indebtedness written in 3Q24 strategy, Now I know when I must retire. We instead opt to add more investment-grade credit and hedge funds instead in anticipation of volatility as tariffs noise amplifies. Gold featured prominently in our allocations due to expected increase in central banks' buying as they look into ways to hedge their decades long overallocation into USD denominated assets.

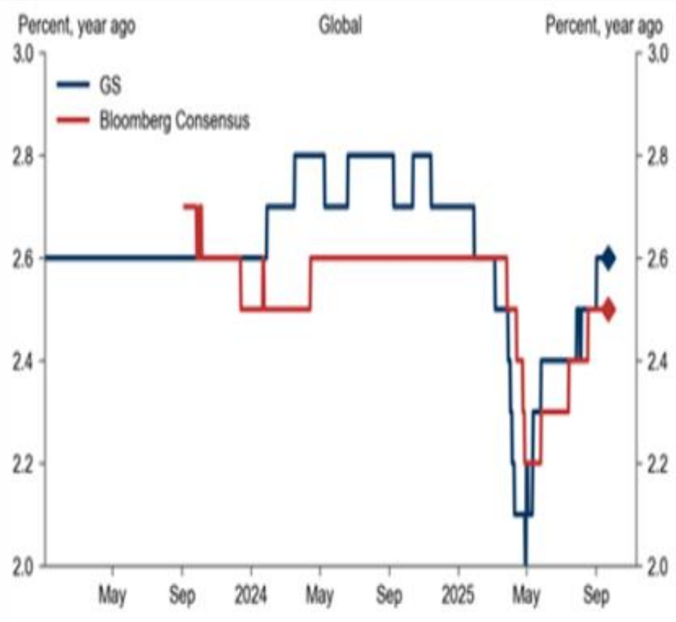
By the second quarter, our worst-case tariff risks scenario outlined at the start of the year has now become our base case with the effective rates of 15–17% established as the new baseline. This higher tariff regime led to downward revisions in US growth forecasts, with GDP projected at 0.8–1.2% for 2025, while our dis-inflation trajectory was pushed out by two quarters into the end of 2025 instead. Still, we believe higher inflation pressures will be transitory, and the Fed should look pass this bump and resume its cuts to less restrictive monetary zone (sub 4%). Crucially, AI-led capex, data-centre buildouts, and grid upgrades emerged as powerful counterweights—supporting earnings revisions and allowing equities to advance even at fair valuations.

By the third quarter, the growth drag and price pressures from tariffs proved milder than feared, with upward revisions to earnings and GDP following Liberation Day.

Most regions' earnings are revised higher so has Global GDP forecasts



Source: Bloomberg

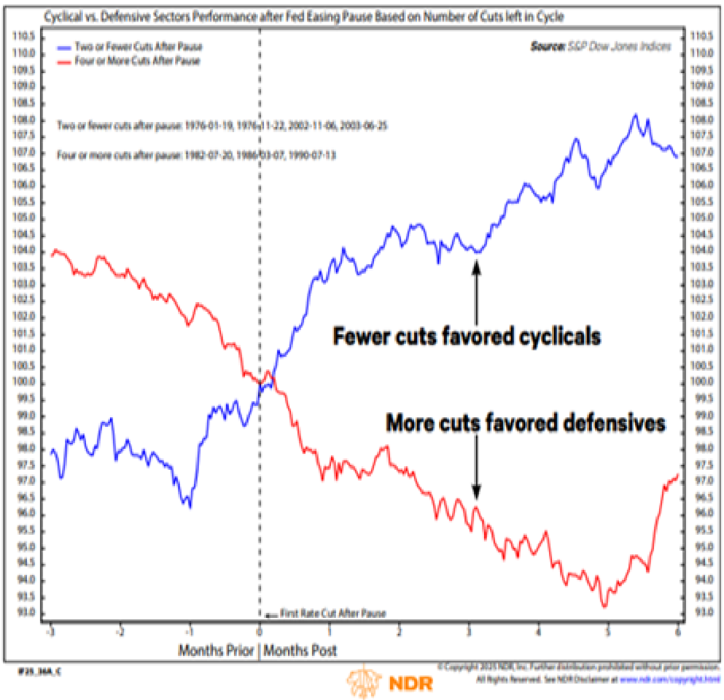


Source: Goldman Sachs

We pivoted the portfolio to risk-on: We recalibrated with high beta, growth expressions added including more AI themes, China tech, and global financials which should benefit from our view of a steepening yield curve. The theme of curve steepening was also incorporated into our fixed allocation focusing on shorter duration mandates. We also added more EM credit as USD weakness is a tailwind for EM economies. The penultimate risk-on expression was our addition to Bitcoin ETF after months of consultation with our clients explaining the legitimacy this asset class has achieved post the establishment of clearer regulatory frameworks. It is also as an alternative to the prevailing view of USD losing its hegemonic status alongside our preference to hold Gold.

Equities: Upgrade to overweight. As detailed above, Equities has historically performed well when Fed resumes its easing cycle after an extended pause though leadership styles differ between shallow (defined as three or fewer cuts) versus more aggressive cuts (four or more). In a shallow easing cycle, cyclicals outperformed defensives, Industrials, Financials, and Tech outperformed the broader market and have high incidence of outperformance too.

Fewer subsequent cuts favors Cyclicals



Financials, Industrials and Tech do well

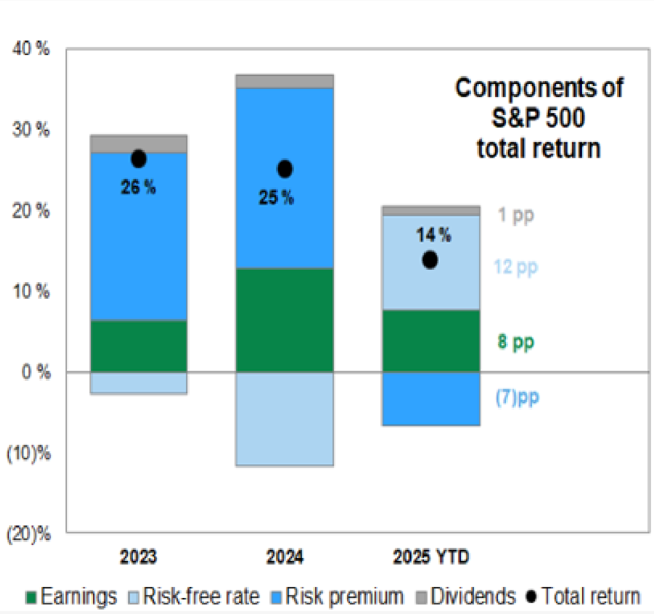
	3 or less cuts		4 or more cuts	
	Median Gain (%)	% case Outperforming	Median Gain (%)	% case Outperforming
Industrials	9.4	100	1.5	33
Financials	6.4	100	-0.2	33
IT	6.4	75	1.6	33
Energy	6.4	75	18	67
Real Estate	6.2	50	9.6	33
Communication Services	4.8	50	14.2	100
Utilities	4.2	50	14.6	67
Materials	3.4	50	11.4	67
Consumer Discretionary	1.8	50	6.4	33
Healthcare	0.1	0	20.3	67
Consumer Staples	-2.8	0	19.9	67

Source: NDR

We believe the market is too dovish in expecting the Fed Fund rate to reach 3% (i.e. 4 cuts) by 3Q26, and we will present that in our view in the fixed income segment. Our equities portfolio is positioned for a shallower cut outcome. 50% of our equities portfolio is positioned in tech, financials, and AI-related plays. Nonetheless, we are cognizant that those rare episodes often come with significant drawdowns averaging -19%, hence we have another 45% of our equities in core long/short, event-driven hedge funds and lower beta expressions. In terms of geographical views, we are overweight the US and China and Neutral in both Japan and European equities.

We have argued in T2025: I'll be back – US equities are not expensive and instead are fairly valued. We commented the key condition for the market to generate positive returns hereon will be driven by earnings growth alongside positive earnings revision momentum. Year-to-date S&P performance of 14% has been driven by earnings growth which accounted for 44% of the advance, dividend 5%, multiple expansion 38% while rising equity risk premium subtracted 33%. S&P earnings for 2025 have been revised upwards by 3ppt since the start of the year. Looking forward, these positive catalysts should remain for the 1-2 quarters. Consensus estimates for S&P and Nasdaq are for EPS to grow by 8%/12% and 13/17% respectively in 2025-26 and there is no reason to expect negative revision momentum.

Earnings and dividends drove YTD returns



Source: Goldman Sachs

3mth ERM most positive in US markets

	EPS Growth 2025	EPS Growth 2026	2yrs EPS CAGR	PE 2025	PE2026	PEG 2026	3mth EPS Revision (2025)
MSCI World Equities	7%	13%	14.0%	20.1	17.8	1.27	0.5%
S&P 500	8%	12%	14.8%	23.4	20.9	1.42	2.8%
NASDAQ	13%	17%	22.2%	31	26.4	1.19	9.2%
Stox Europe 600	5%	13%	11.2%	15	13.3	1.18	-2.0%
FTSE 100	3%	13%	9.8%	13.4	11.9	1.22	2.2%
TOPIX	3%	11%	8.5%	16.5	14.8	1.75	3.2%
MSCI China	2%	17%	10.2%	14	12.0	1.18	-5.0%
MSCI Emerging Markets	7%	16%	14.9%	14.7	12.6	0.85	-3.2%

Source: Bloomberg

Source: Bloomberg

Fixed Income: Underweight. Shallow versus aggressive cutting cycles matter distinctly for bonds too. In shallow cycles, 10 year yields tend to be broadly unchanged, curves flatten, and credit spreads narrow modestly, leaving risk adjusted prospects more compelling in equities than owning bonds as the combined effect of yield and credit spread compression is expected to be mild, especially when considering credit spreads are near or at all-time lows across investment-grade and high yield bonds.

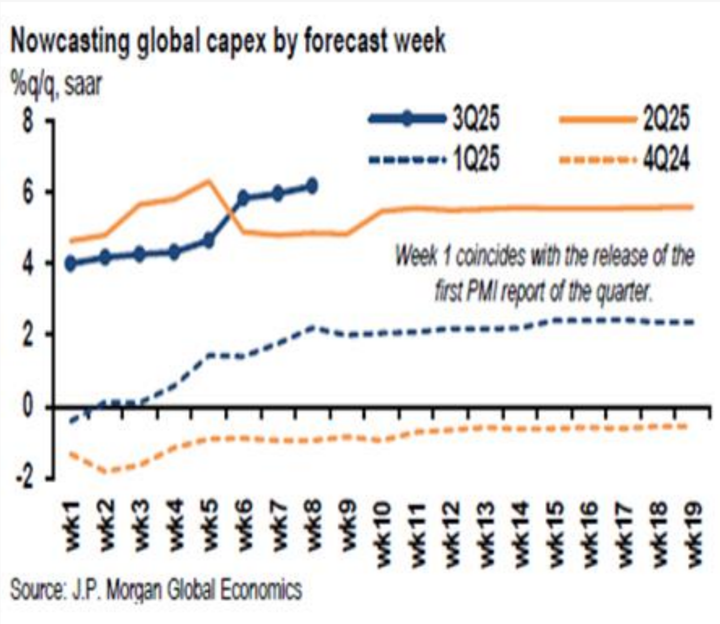
The Rare Ones of > 6 mths pause: Shallow vs Aggressive subsequent cuts

	S&P Return 12 mhts	Worst Drawdown	Recovery period	US 10 Yield	Yield Curve	Credit Spreads	USD
Three or few cuts	8%	-21%	22	9	-23	-42	-14
4 or more cuts	26%	-17%	3	-101	38	-50	0
Source: NDR							

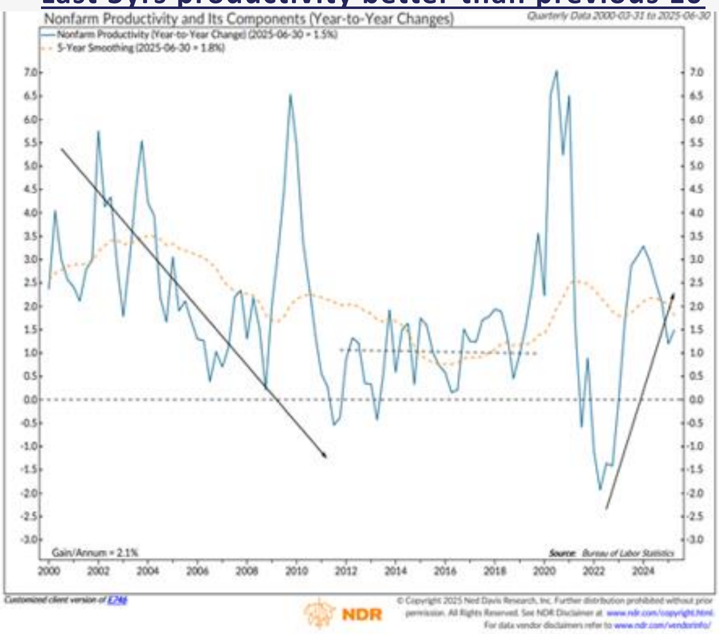
Our conviction that this cycle will be a shallower cut lies with assumptions that GDP growth will be resilient into 2026, while inflation will abate but is unlikely to retreat to the Fed's level of 2% through a combination of stronger growth and residual effect of tariffs. The global GDP nowcasting model we tracked currently stands at 2.3%ar, which is not far behind its long-term growth potential. The latest PMI reading in Aug of 52.9 portends to trend-like growth of 2.1%ar in global GDP in the next two quarters. Much like the nowcasting model, global PMI has risen for four consecutive months. Looking further out, the consensus full year GDP growth forecast for 2025 and 2026 is for 2.9%; certainly not a stall-speed pace.

One of the main pushbacks to a benign growth outlook has been the stagnation in the labour market in the past few months. We believe the current conundrum between a weak job market, but a strong GDP can be explained by a combination of improvement in productivity and higher capex. As profits increase, we believe the current lag in employment will likely be reversed over the next few quarters. All these factors point to a measured response from the Fed. The current Fed dot-plot indicates three more cuts by 2026 while the market is expecting four more cuts by middle of next year. We will not be surprised if there are only two more cuts left; hence, we made no material changes to our fixed income strategies: keeping duration short, preferring Investment-grade and EM credits and staying with our private lending activity in trade finance.

Global capex growing at 6%



Last 3yrs productivity better than previous 10



Commodities: No changes, just keeping gold and bitcoin futures. Gold feels extended based on the positioning we have seen in Gold ETFs and future contracts and is already above our 2025 target price of $3,500. We introduce of our 2026 target price at $4,000 for Gold. Bitcoin medium term target price of $125k remains and fast money positioning is not as heavy as in Gold. So, from a risk-reward perspective, we prefer Bitcoin over Gold for this quarter.

Alternatives: No change with 30% allocation to hedge funds. Our fund-of-hedge-funds strategy (GARP) has shown its worth in providing low-correlated returns to bond and equities, while generating a 10.7% return since inception on volatility of less than 4%. Speak to our wealth advisor to find out more.

Cash/FX: Cash is kept at the minimum.

Featured Picture/Quote:

“Always take your job seriously, never yourself.” — Dwight D Eisenhower

Edward Lim, CFA

Chief Investment Officer

edwardlim@covenant-capital.com

Risk Disclosure