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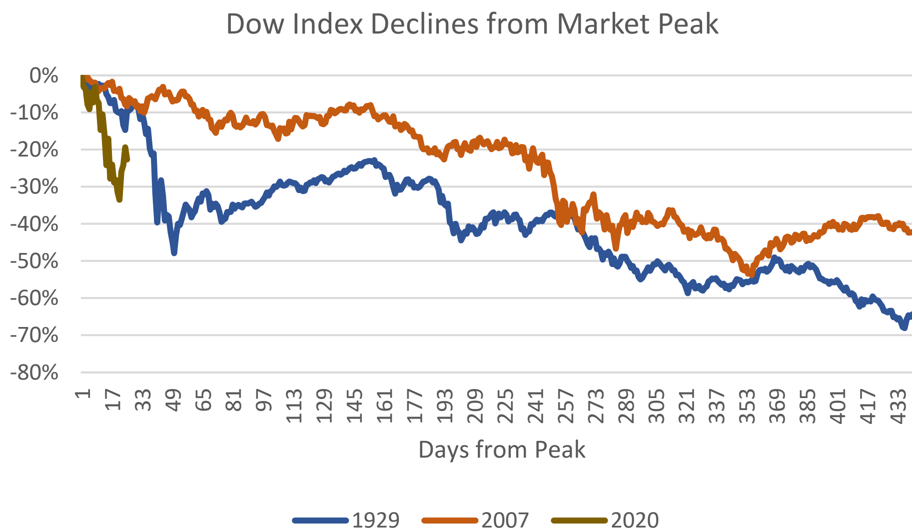
Creating Value through Innovative Financial Solutions

LC Monthly Investment Memo : March 2020

March 2020 will be remembered for witnessing one of the steepest declines in financial history, beating both 2008 and 1929 so far as shown on Chart 1 below. The rapid spread of Covid-19 globally has forced most countries to close their borders and impose stay-at-home notices for its residents with no firm end date. We believe the bottom will be in sight once both the pandemic is contained and economic activity restarts. While we hope that spread of Covid-19 will be contained in next few weeks, the scale of damage to the economies is yet to be ascertained.

<u>Chart 1</u>

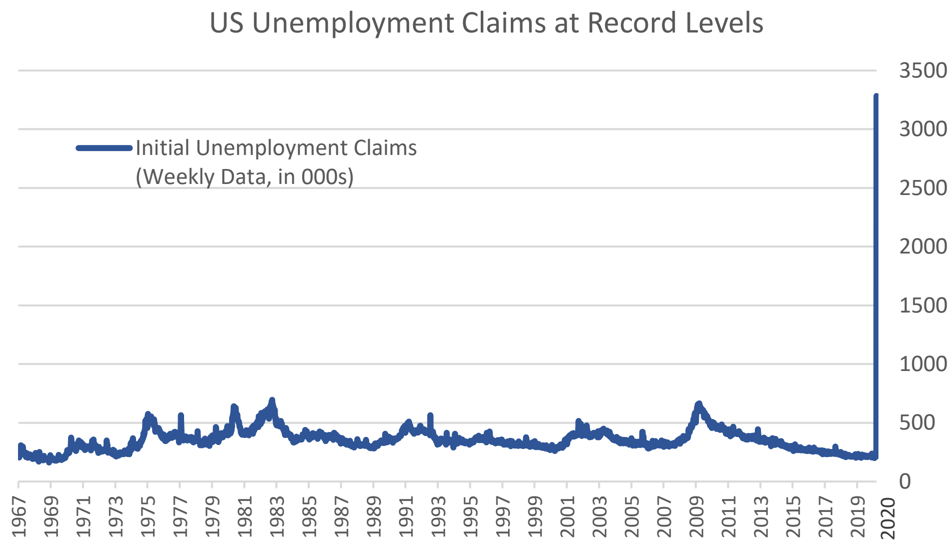


Source: LCPL, Bloomberg

We expect airlines, tourism, hospitality, retail and energy, just to name a few sectors, will be hit the hardest. The job losses in these sectors are already reflected in the recent jobless claims numbers in the US as shown on Chart 2 below. Referencing back to the experience during the GFC in 2008, authorities were quick to react in their support for the weakest links through generous stimulus. The success of the stimulus packages will depend on the speed of their implementation. SMEs which tend to be more sensitive to such situations than larger companies, will bear the brunt of this lockdown.

Since SMEs account for a large share of countries' economies (about 70% of GDP in the US) redundancies and bankruptcies are likely to surge in the coming months globally. According to James Bullard (Fed of St Louis), unemployment in the US could surge to 30% and GDP plunge 50% in the next quarter.

<u>Chart 2:</u>



Source: LCPL, Bloomberg

The financial mayhem has resulted in sharp dislocation during the month. Gold and US Treasuries, which are considered safe havens during stress periods, were dumped during the equity rout due to forced selling as investors scrambled for liquidity. For the first time in history, 1M and 3M T bills yields (US government short dated bonds) are now below 0%, officially joining the club of negative yielding assets that Europe and Japan has been part of. Oil dropped by 55%, its worst monthly performance since the Gulf war and is back to its long term trend in the 1980s of $20/barrel as shown on Chart 3. Many currencies also have fallen to all-time lows (ZAR, TRY, NOK, RUB, BRL, IDR, ARS, COP, MXN, etc.) while others are within reach of their 20-year lows (GBP, EUR, SEK, AUD, CAD).

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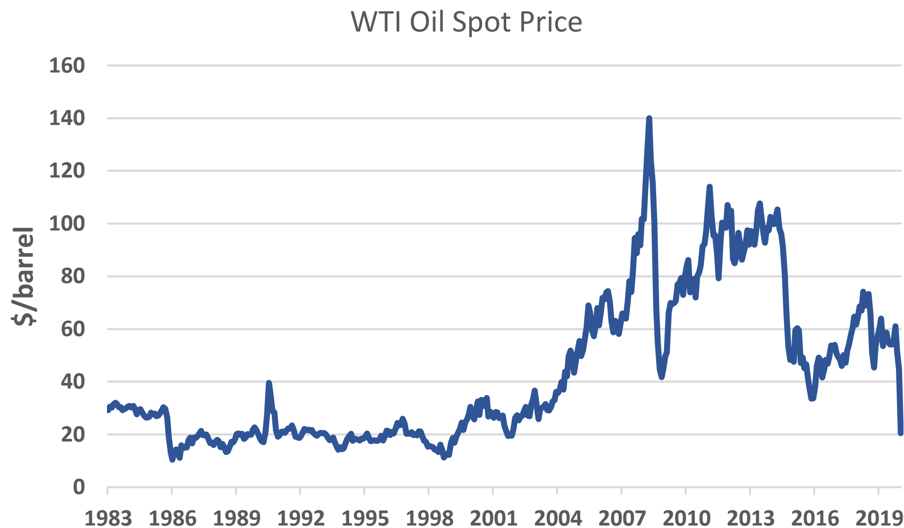
Chart 3:



Source: LCPL, Bloomberg

For investors who view this economic disruption to be relatively short-lived, markets currently offer good buy opportunity. For more conservative investors, reducing risk and sticking to high quality assets is a more sensible option, should the recession be prolonged. At Lighthouse Canton, we anticipate financial markets to remain volatile and challenging till the Covid-19 situation is tamed and should be approached with caution and with long-term horizon in view.

Fixed Income: Quality issuers will benefit from low debt issue costs (at all time low level when positive), supported by the Central Banks unlimited QEs. Expected income for US Dollar investors will consequently be as low as the debt in Japanese Yen or Euro. With the expectation of economic deterioration, many low investment grade issuers will be downgraded to junk, which according to Financial Times, could potentially add US$1tn worth of bonds to junks category. Even without considering an increase in defaults, the higher number of issuers joining the high yield club will push the spreads higher simply because of the mismatch between supply (higher) and demand (stable or decreasing due to defaults happening). This is also likely to weigh negatively in portfolio returns going forward.

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Equities: We continue to favour stocks with strong fundamentals in the form of high profitability, growth, cash in the balance sheets, predictable cashflows and good corporate governance. We would like to reiterate our view for investors to avoid cyclical sectors (e.g. tourism, transportation, retail) as well as those that are highly sensitive to commodity prices (e.g. Oil and gas, metals and mining). Companies in distress will have to recapitalize by issuing new shares at lower prices. This could potentially be highly dilutive for investors that have invested too early. We prefer more defensive sectors like healthcare, utilities, e-commerce and consumer staples amid the ongoing uncertainties in the market.

Because uncertainty has rarely been so high, we reiterate that a diversified portfolio that includes quality names and a large allocation to non-correlated strategies (i.e. non-directional) offers the best possible investment alternative and should be part of a portfolio's core allocation. Our conviction in uncorrelated strategies has proved its mettle with our own in-house strategies, LCV Trade Finance Fund and LC Beacon Global Fund which have successfully delivered positive performance both in February and March despite high volatility in the market. These Funds have continued to provide the much-needed diversification benefit and stability to the portfolio in these testing times. We have been recommending our clients to consider having these funds as an integral part of their portfolio.

All these tie-in with the essence of our investment philosophy which is to deliver stable risk-adjusted returns over multiple business cycles.

Yours Faithfully,

The Lighthouse Canton Team

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