Creating Value through Innovative Financial Solutions

Dear Friends,

In an increasingly uncertain market environment, where the disconnect between macro and fundamentals has become more apparent, the investment horizon seems to have been shortened to quarterly period. We have observed that one of the approaches that many investors have been taking in response to this is to piece macro events together to form an investment thesis. At Lighthouse Canton, we view this as a short-sighted approach to investing and is not sustainable if an investor is looking to create long-term wealth. We believe that a well-designed portfolio constructed with disciplined investment process and risk management should be able to generate competitive risk-adjusted returns, regardless of market conditions – an approach we strongly adhere to.

With year-end approaching, we would like to take this time to reflect on 2019, share our outlook for 2020 and discuss how our portfolios are designed to deliver the risk-adjusted returns to investors.

Looking back at 2019

This year, the financial markets were primarily driven by two factors: (i) the Sino-US trade war, which is increasingly seeming like a soap opera, and (ii) the new round of easing – a complimentary service from Central Bankers.

As a result of the two aforementioned factors, equities markets globally rebounded sharply from their 2018 lows and are on track to delivering their best annual performance since the Global Financial Crisis (GFC). Case in point is the US equities, which owns the largest share of Tech companies, breached new high in Q4 2019, with the S&P 500 index settling well above 3,100 points.

At the beginning of 2019, market consensus was a forecast of 2 rate hikes. Instead, we witnessed the FED having to cut rates by 25bps not once but three times in a row in their effort to avoid a complete inversion of the US yield curve. Falling interest rates were obviously supportive for bonds portfolios, especially those with long duration and/or low credit quality.

Referring back to our CIO Memo that was shared at the beginning of 2019, we shared our expectation that markets would remain uncertain and volatile. The view was based on our forecast of slowing economies as well as monetary normalization (end of easing policies), which was purported to be delivered through gradual interest rate hikes.

While we have rightly distanced ourselves from the normalization of monetary policies and considered the inversion of the US Yield Curve as highly likely, the market proved us wrong on our prediction of equities returns to look like a “bell curve” (with H1 supported by monetary easing and H2 impacted by lower earnings expectations). This exhibits the unpredictability of policy makers and market’s temperament even though our outlook was based on traditional economic theory.

LIGHTHOUSE
CANTON

2020 Outlook

With what transpired in 2019, how is the stage set for next year?

In our view, markets should be prepared for slower growth. According to *The Economist,* while Asia is likely to grow at 5.2% (excluding Japan, Australia and New Zealand), the rest of the world is expected to slow down. For instance, it is stated that growth is anticipated to be 1.4% in Western Europe, 1.6% in North America, 1.2% for LatAm and 0.4% for Japan (despite hosting the Olympic games) in 2020. The drivers of this slowdown includes a mix of both local and global geopolitical factors.

While the initial move by President Trump against China's deliberate fixing of the CNY against USD (pretty much a de facto levy on US goods) appeared justifiable, the on-going rhetoric and untimely tweets seem counterproductive in the long run, as it weighs on business sentiments and capex spending. This is bad news in the context of slowing economies.

Geopolitics will continue to be in the forefront for at least the first half of 2020, especially with the upcoming elections in the US and Asia Pacific, Brexit and trade wars just to name a few. With elections in sight, populism is likely to rise worldwide with threats coming from both the left (Corbyn) and right (Trump, etc.) wings. Such mentality could potentially undermine GDP growth, as mentioned earlier, rather than solve long term problems due to lack of reforms and competitiveness in western economies because of an undervalued CNY.

The synchronization of economies ranks high in our 2020 catalysts. The fact that China, LatAm, India, the UK, Germany and South Korea are slowing down simultaneously should be worrying considering how intertwined these economies have become. Fiscal and monetary policies would have to be a more concerted effort at a global scale in order for these to be effective.

Below are some of the key catalysts we have identified that could influence the direction of the market in 2020:

1. US - China relationship (Deal Vs trade war, South China sea, depreciation of CNY)
2. Synchronized Economic Slowdown
3. Rising corporate defaults (China, LatAm, Europe)
4. US elections
5. Brexit implementation
6. Hong Kong political tensions
7. Rising tensions between US & Europe (digital tax, NATO spending)
8. Political instability in Europe (France, Italy, Spain)
9. Denuclearization (Iran, North Korea)
10. Latin America (Venezuela, Argentina, Brazil, Chile)

LIGHTHOUSE CANTON

Equities

Even though the equity markets appear stretched (based on the inflated valuation), we feel that there are still opportunities present within listed equities space, although we would advise investors to be extremely selective. Out of the 505 members of the S&P 500 index, based on discounted cashflow valuation, we estimated that roughly 10% currently present an upside, whereas the rest either offer no real upside or are grossly overvalued. The fact that 80% of 2019's IPOs were linked to companies with negative EBITDA, a level last seen in 2001 during the dotcom bubble, clearly illustrates investors' complacency in an interest-free risk environment.

Levered balance sheets (Energy, Banks), cyclical companies (retailers, autos) and those being disrupted (for which revenue has decreased over the last 3 years) should be avoided, as their valuations are likely to go lower if or when an economic slowdown is confirmed.

We would also recommend for investors to be cautious with their investments in traditional PE/VC funds at this stage of the cycle. Free money (central banks) and large pockets investors (SoftBank) have pushed valuations through the roof. In our opinion, the illiquid and black box nature of these investments in addition to these being highly charged funds present a less attractive investment opportunity.

Fixed Income

Central banks are expected to keep policy rates lower for longer which implies that returns on cash, when positive, will hardly compensate for inflation.

At this stage it is worth mentioning that we do not see any value in holding bonds with negative yields, which rules out most of the G10 currencies, except USD. This seems obvious but since this concern one third of all outstanding debts globally, many of which held by professionals, we think it is worth reiterating.

We expect US rates to trend lower in 2020 as recession fear resurfaces. Consequently, we see very limited value in Investment Grade credit after factoring in approximately 2% inflation. We would recommend taking profit now and avoiding High Yield credit going forward, as this remains highly vulnerable to downside risks owing to the impending global slowdown and the overutilization of leverage both at company (balance sheet) as well as investor level (loan to value).

Commodities

With the US reducing their dependency on imports and an expected global economies slowdown, we expect that oil prices to go lower in the next 12 months. A further decrease in production from OPEC members or a supply disruption from a large exporter could reverse that trend, but this is not our base scenario.

Thanks to the defensive nature of gold, it might perform well in the coming quarters although will remain highly speculative. Guessing where gold will be trading at the end of next year is like shooting in the dark. Should the economic or geopolitical situation deteriorate rapidly, gold could easily revisit 1,800 points or even trade higher. Otherwise, gold could easily trend lower, even in a bearish scenario.

Stepping into 2020

We believe that a well thought portfolio should continue to generate attractive risk-adjusted returns across different market cycles, without causing undue stress to investors.

In an (almost) "interest-free" world, where bonds barely compensate for risk and equities present asymmetric returns (limited upside with unlimited downside), we believe that a decent risk-adjusted return is still achievable through careful stock and/or manager selection. A well-diversified portfolio with risk capital efficiently allocated between selective equity strategies whose investment philosophy is based on solid long-term fundamentals; and absolute return strategies that offer a strong downside protection or low correlation to traditional asset classes is key. In addition, we would recommend keeping the correlation low amongst the different strategies as well as gradually reducing exposure to bonds and equities with weak fundamentals.

No one can truly predict or guarantee how market will turn out. At Lighthouse Canton, we remain vigilant of the possible bumps on the road ahead and strive towards a disciplined and well risk-managed approach to investing – putting our client's best interests at the forefront. We strive to achieve this for our clients every day and watch markets closely, so that you don't have to. This is the philosophy we will continue to adhere to.

The Lighthouse Canton team would like to sincerely thank you for your support and confidence in us and we look forward to growing in strength with you. We wish you Happy Holidays and may 2020 bring much success, happiness, wealth and joy to you and your loved ones.

IMPORTANT DISCLAIMER: This document is based on information from sources which are reliable, but has not been independently verified by Lighthouse Canton Pte Ltd and its subsidiaries ("LC"). The contents of this document may not be reproduced or referenced, either in part or in full, without prior written permission from LC. This document, provided as a general commentary, is for informational purposes only and is not to be construed as an offer to sell or solicit an offer to buy any financial instruments in any jurisdiction. This does not constitute any form of regulated financial advice, and your independent financial advisor should be consulted prior to taking any investment decision(s). Information contained herein are those of the author(s) and does not represent the views held by other parties. LC is also under no obligation to update you on any changes made to this document. LC has taken the reasonable steps to verify the contents of this document, and accept no liability for any loss arising from the use of any information contained herein. This document is prepared by Lighthouse Canton Pte Ltd, which is regulated by Monetary Authority of Singapore("MAS"). MAS has no responsibility for reviewing, verifying and approving the contents of this document and/or other associated documents.