Creating Value through Innovative Financial Solutions

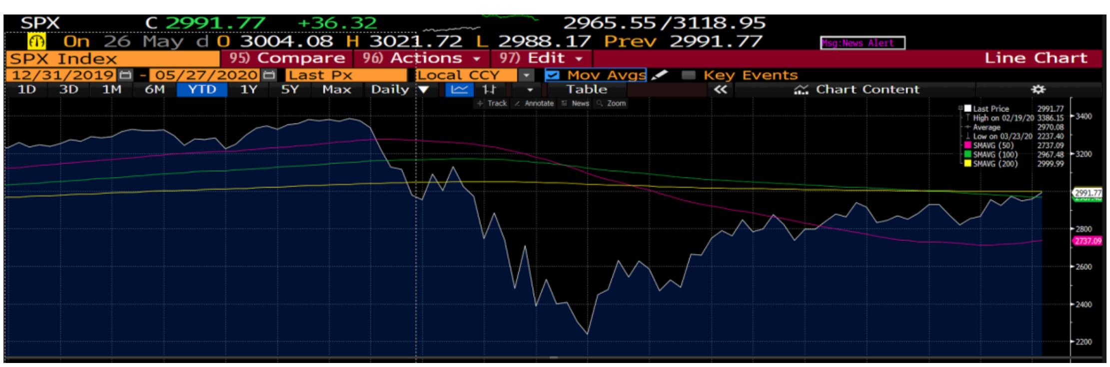
LC Monthly Investment Memo : May 2020

It has been two months since the world began scrambling into the "Great Lockdown" to slow the spread of COVID-19. The month of May marked the phased easing of these restrictions globally. While some countries have managed to contain the virus somewhat successfully, the push for easing restrictions and lockdowns has been largely driven by economic factors in most instances. Countries such as Germany, New Zealand and South Korea have demonstrated strength in their ability to combat the virus while emerging markets such as Brazil, India and Indonesia have begun to ease lockdowns despite rising infection numbers, amidst pressure to re-open businesses and curb rising poverty. Though the fear of a second wave remains, the easing of restrictions and hopes for a vaccine have provided some respite.

Soaring Equity Markets

The markets have been reacting strongly to every bit of positive news, such as the announcement of stimulus packages, the promising results of initial vaccine tests by Moderna or the announcement of easing lockdown in various countries. As shown in Chart 1 below, this optimism has led the S&P 500 index tracing the 3000-point mark and pushing beyond its 200-day moving average, leaving many investors concerned that the equity market is moving ahead of the real economy. Though this does lead to some skepticism, part of this can be explained by the growing strength of Mega Cap firms in the Technology and Healthcare sectors that have thrived during this period, with every member of the FAANG complex returning positive in 2020. On the other hand, the median stocks in the US and Europe still sit approximately 30% below their 52-week peaks. With countries re-opening and the concerted efforts put forth by Central Banks to avoid pullbacks, markets are looking towards a "catch-up" by stocks outside these Mega Cap firms for a broader market rally. Bargain-hunting in the other segments where price rally has been limited may present much value to investors.

Chart 1: S&P 500 Movement 2020 YTD

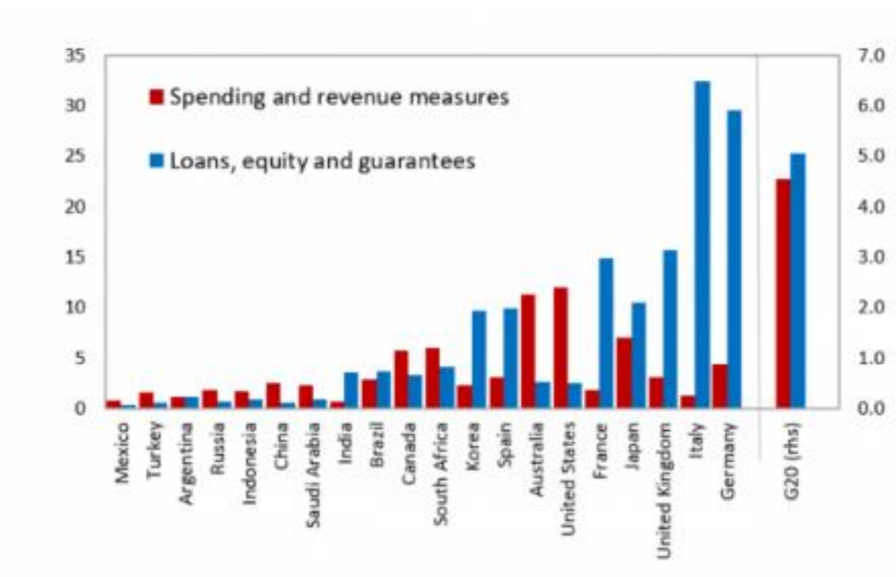


Source: International Monetary Fund (IMF), World Economic Outlook (April 2020)

Massive Scale of Monetary/ Fiscal support

The positive move in equity market started with the announcement of overly generous stimulus packages to tide over the economic effects of the pandemic. To-date, countries have deployed a total of $9 trillion to help people and businesses get through the crisis. The breakdown is as follows: direct budget support is currently estimated at $4.4 trillion globally, and additional public sector loans and equity injections, guarantees, and other quasi-fiscal operations (such as non-commercial activity of public corporations) accounted for the remaining $4.6 trillion. As of April 2020, the G20 advanced and emerging market economies accounted for the bulk of the global fiscal support, standing at $8 trillion. As highlighted in Chart 2 below, the total revenue and spending measures for G20 countries account for 4.5% of their GDP on average, larger than during the Global Financial Crisis. This has been the stabilizing factor primarily responsible for the soaring markets subsequent to the market mayhem witnessed in March.

Chart 2: Fiscal measures announced in G20 countries as % of GDP



Source: International Monetary Fund (IMF)

Escalating US - China Tensions

For most of 2019, fear of an escalating trade war between US and China had kept investors at the edge of their seats. By year end, President Trump gave the markets a reason to cheer by announcing “Phase 1” of the trade deal which pushed equities to record highs.

While the implementation of the agreement was not expected to devoid of complications in an election year, the COVID-19 pandemic has brought about an even more undesirable twist to the situation. It has led to further souring of the relationship, with Trump being increasingly vocal about China's response to the outbreak.

He has also announced possible measures which include, amongst others, breaking off trade ties, restrictions on investment flows and reducing the reliance of supply chains in China. The blame game continues to play out amidst sweeping measures and initiatives announced by the US and China. One such example is the new legislation approved by the Senate on 20th May 2020 that could bar some Chinese companies from being listed on US stock exchanges. These tensions could potentially add to short term market volatility.

Oil Supply Glut - Fear Abated

The oil market regained confidence much faster than anticipated. Production cuts in North America and the Middle East, combined with signs of swiftly recovering oil demand, alleviated fears about an overflowing oil market. The market sentiment has improved, reflecting slightly bullish views. Current oil price of $35 should likely result in the revival of the shale sector.

Opportunities Present Given this Context

Interest rates are slowly converging towards their long-term anchor level of 0%. UK just issued a 3-year bond at negative yield, joining several other developed countries that were already in the negative rate territory. With traders speculating on negative rates in the US as early as 2021 and the FED "thinking very hard" about targeting specific yields on Treasuries, it is just a matter of time before the US yield curve slides further down. With debt levels skyrocketing around the globe (both at corporate and government level), Central Banks must now ensure that borrowing costs stay at rock-bottom levels.

We reiterate our view that companies with strong balance sheets can issue debt at very attractive prices (i.e. unattractive yields for investors) while challenges lay ahead for weaker issuers, as illustrated by the High Yield spreads which are settling well above 500 bps. We do not anticipate value in fixed income currently given that solid issuers are paying close to nothing while weak ones present a hugely negative asymmetry in terms of risk and reward.

In this current low return, high risk environment, we tend to favour managers with actively managed strategies which offer an alternative to fixed income. Strategies such as our LC Beacon Global Fund and LCV Trade Finance Fund fit in that bucket as they continue to display low correlation to the more traditional asset classes and strategies as seen through their steady and stable returns this year, despite the market volatility. These are strategies which we would view as good diversifiers to an investor's portfolio.

For equity markets, on the other hand, despite the volatility and disconnect with real economy as we are witnessing currently, we hold a view that it still present long-term opportunities. This is particularly so for fundamentally driven managers whose strategies are focused on investing in fast growing and profitable businesses (i.e. low debt, surplus cash levels, high earnings growth and ROE). Adverse mark-to-market should not dampen an investor's long-term perspective and therefore, potential gains. For managers like Sageone India Growth Fund, whose portfolio companies in India have earnings compounding at an average of double-digit rate quarter over quarter, it is just a matter of time before valuations rebound to reflect fundamentals. In such a volatile market which is still driven by macro sentiments, trying to time the market could result in either large losses or lost opportunities when market participants revert their attention to fundamentals.

In conclusion, we feel that the current market environment is primarily driven by headlines around the development of this pandemic and lifelines extended by the governments in the form of generous stimulus packages in their effort to save the economy. This will continue to drive the euphoria in the financial markets, at least in the short-term. However, we believe that once the dust settles, the focus on fundamentals will resurface and hence it is important for investors to keep a long-term horizon in their investment decisions.

Yours Faithfully,

The Lighthouse Canton Team