LIGHTHOUSE CANTON

Creating Value through Innovative Financial Solutions

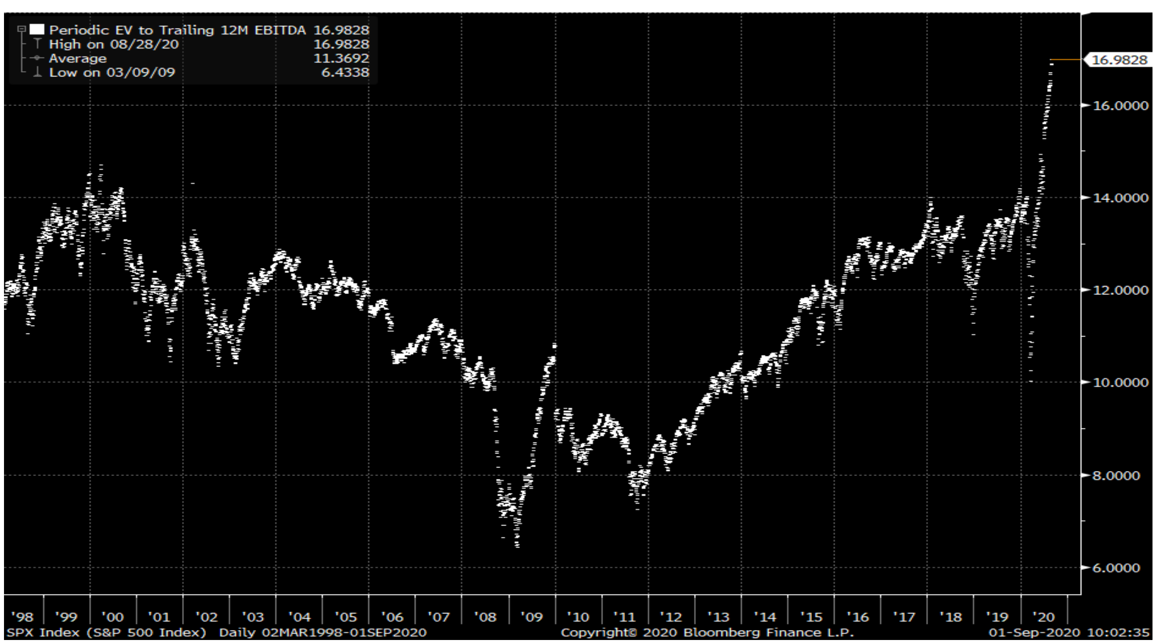
LC Monthly Investment Memo : August 2020

As this tumultuous year progresses, investors are now turning their attention to the next big catalysts and the implications these pose on their investments. At the top of the list sits the US elections and its potential impact on taxes, antitrust regulations and of course the US-China relationship. Second on the list is the resurgence of Covid-19 cases. With Hong Kong reporting the first case of Covid-19 reinfection (raising questions on immunity from the coronavirus), and the autumn season around the corner in the northern hemisphere, experts fear a surge in new cases in the coming months. For instance, schools reopening is bound to send the number of new cases higher in the coming weeks. Germany and France have already announced that they would not lock down their economies again but contact tracing and stay-at-home notice will inevitably slow down the economic recovery.

Equities

Considering that the S&P 500 has reached its all-time-high (3514.77 pts) on 31st August, we feel that the upside now looks somewhat limited. This is even clearer when looking at valuations like the Enterprise Value to Trailing 12M EBITDA ratio, which at 17x, is well above the levels seen during the 2000 Tech bubble.

Chart 1: S&P 500 Index – EV / Trailing 12M EBITDA multiple since 1998



Source: Bloomberg

This rally in equities is not supported by fundamentals such as strong earnings but is largely driven by investors' complacency and desperation. The phenomena of "Fear of Missing Out" and "There is No Alternative" among investors continue to fuel this rally.

The technology sector, and its overly optimistic assumptions, is a source of concern for us. The "Awesome 8" stocks (Amazon, Apple, Facebook, Google, Microsoft, Netflix, Nvidia, and Tesla) have gained on average +120% year-to-date primarily based on technical factors such as retail flows, lockdown speeding up the digitalization process as well as falling interest rates which are supportive of valuations.

Netflix, Tesla and Apple are great illustrations of the current euphoria. There are certain questions that one should consider when evaluating these names:

- If someone did not bother to purchase a Netflix subscription in March or April, how likely is it that they will subscribe for the first time in September?
- Apple shares have rocketed 34% since it announced a stock split on 30th July, which allowed for broader access to the shares causing retail investors to pile into the stock. A stock split is a cosmetic change in the number of outstanding shares a company has issued and does not change the value of a business. Hence its worth questioning whether such a strong upside is justified.
- Elon Musk tweeted on 30th April that Tesla, at $170, looked overvalued. What should we make of the shares trading at $498 four months later (after a 5 to 1 stock split!)?

This is not to say that everything is bleak on equities - there remain pockets of opportunities that are not overpriced and can create value for investors. China is still an interesting play for investors with a long-term investment horizon, especially with technology and consumer-oriented stocks. China's uniquely V-shaped economic recovery along with a potential decoupling from the US is likely to create market leaders in the nation which are still underrepresented in portfolios worldwide.

Fixed Income

Global debt issuance reached a record high in the first eight months of 2020 and issuers are taking advantage of current conditions to extend maturities. The average IG duration for developed markets hit a historical record of 8 years, while Asian IG durations is just below 6 years.

Credit risk remains elevated as illustrated by credit spreads trading 20bps (US IG) to 80bps (US HY) wider than their January 2020 level. UBS predicts that US HY defaults will rise to 10% by end of 2020 and up to 18% in 3 years. The same can be seen in Asia, with Goldman Sachs anticipating that Asian HY default rate could reach 5.2% by end of next year, its highest level in 20 years. More interestingly, BCA Research shows that US and EU HY credit spreads were no longer compensating for potential losses, given the expected default rates further.

For investors looking for compelling risk adjusted returns, BCA concludes that investors should focus on EM bonds. We agree with this view and have reviewed and rebalanced our portfolios to favour selected Asian bonds, as they offer better valuations and stronger fundamentals.

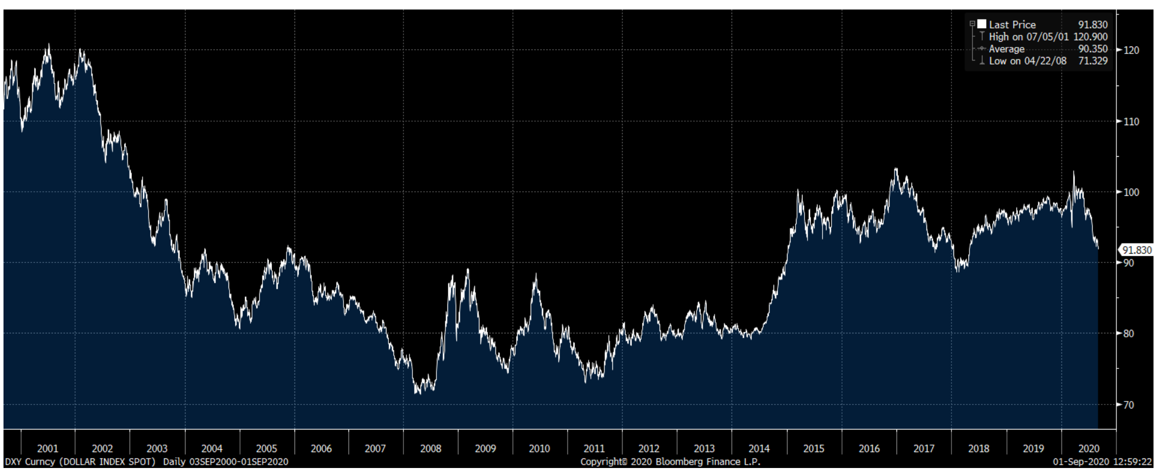
The 2020 edition of the Jackson Hole meeting is likely to be considered as an important shift in Central Banks policies. Chairman J. Powell has prepared markets for a "financial repression" whereby inflation could increase and even overshoot its 2% target without systematically implying higher interest rates. In other words, unemployment comes first and inflation second as determining factors in FED's decision to adjust interest rates. Since the financial repression is the easiest way to reduce indebtedness, we consider such a shift as positive. That said, fixed income investors and savers are bound to suffer in such an environment.

Foreign Exchange

A dovish stance by the FED, higher potential inflation and poor management of the Covid-19 situation have caused the US dollar to be weaker this year with it depreciated by 4.7% YTD so far. While forecasting where the USD will be trading by year-end is impossible, we would not be surprised to see cambists re-test the 2018 lows, when the USD dollar index was trading at 88.25 (-3.6%).

The slide in the US dollar so far this year is a reminder in the importance of currency diversification to a portfolio. A weaker US dollar and larger Central Banks balance sheets are however supportive for assets like Gold. We hold a favorable opinion on the precious asset which could go higher in case of a change in market sentiment, when the risk-off sentiment kicks in.

Chart 2: US Dollar Index (DXY Index) since 2000



Source: Bloomberg

Way Forward for Us

As we attempt to make sense of the current market conditions every month, our conclusion inevitably ends up being the same – a need for investors to reduce their Beta and leverage exposures. While the irrational markets today may appear to offer a potential upside to investors, the fundamentals do not justify the market rally, leading us to be cautious when buying equities or high yield credit, especially at record high level.

We continue to be prudent in our selection of bonds and equities, only holding quality assets where the valuations are supported by fundamentals.

More importantly, the need to effectively manage downside risk has become even more critical now. Therefore, when evaluating a fund, we review and place a lot of emphasis on not just their past performance but also on their risk mitigation and downside risk management measures to understand how they have weathered down cycles. To insure our portfolio against undue surprises or benefits from markets dislocation, we have been focusing on niche and differentiated strategies, such as Relative Value Strategies, that have traditionally had a low correlation to the traditional markets.

Yours Faithfully,

The Lighthouse Canton Team