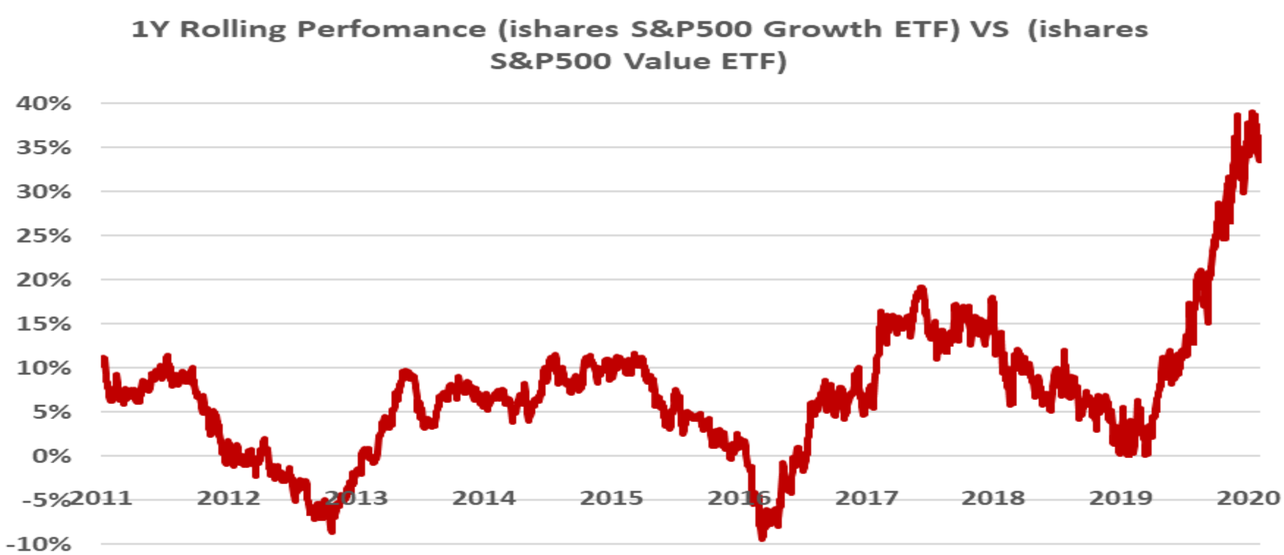
Creating Value through Innovative Financial Solutions

LC Monthly Investment Memo: October 2020

Following what was a very broad-based selloff in September, October was another negative month for risky assets. Global equities were in the green until mid-October, before selling off meaningfully in the final few days on the back of strong resurgence of Covid-19 cases in UK, Europe and US which had left the governments with little choice but to re-enforce a lockdown. This in turn depressed investors' sentiments on the speed of economic recovery and with the impending US Elections, investors were seen to take profit.

More interestingly, "priced-for-perfection" equities have started to decrease, sometimes very sharply as seen with Twitter Inc. and SAP AG (third-largest independent software supplier worldwide and the largest producer of standard enterprise-wide business applications for the client-server software market), both of which plummeted by more than 20% on their respective earnings date. These are good reminders that overly optimistic valuations (i.e. on the back of inflated growth and profitability assumptions) are unsustainable. Ironically, investors focusing on tangible cash-flows can find good bargain in the value space. For example, companies like Imperial Brands (Tobacco), Danone (Food & Beverage), Molson Coors (Beers) or Bayer (Pharmaceuticals) which have been left on the sides by investors have now reached very attractive valuations (and dividend yields). We consider the latter as attractive opportunities for investors with a 2 to 3-year horizon, especially since the gap between value and growth stocks has never been this wide over the last decade as shown on Chart 1 below.

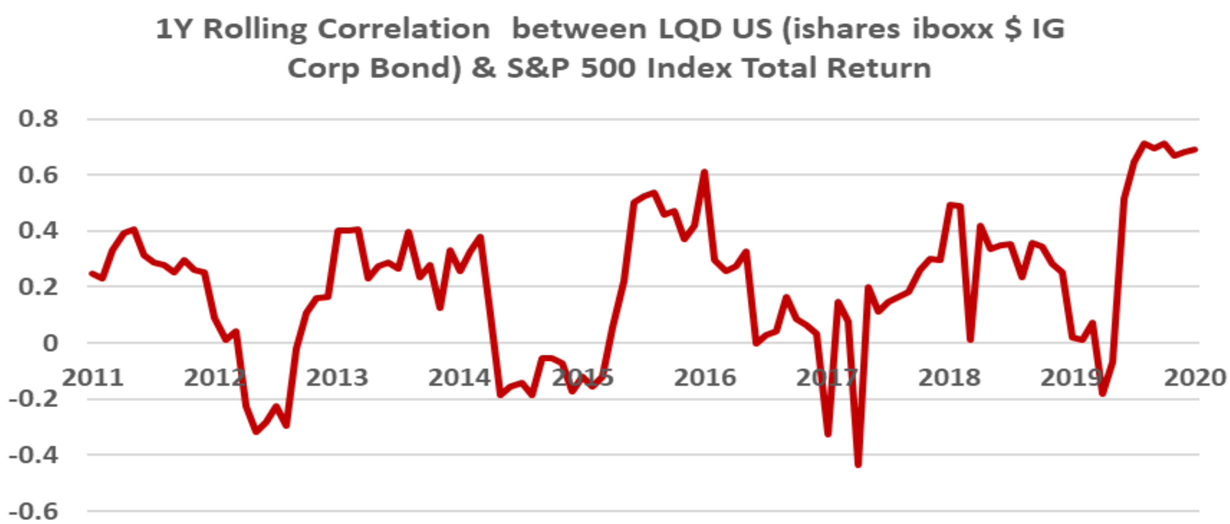
<u>Chart 1: Rolling 1 year spread between IVW (iShares S&P 500 growth ETF) and IVE (iShares S&P 500 growth ETF) total returns indices</u>



Source: Lighthouse Canton, Bloomberg

In a profound shift from the relationship that asset allocators have come to rely on (i.e. lowly correlated), both stocks and bonds experienced negative returns in October. The Fed's commitment to allow a temporary overshoot of 2% inflation has been perceived by many investors as the last dovish arrow in the Fed's quiver, and appears to have marked a shift in the correlation between stock prices and bond yields as shown on Chart 2 below.

Chart 2: Rolling 1-year correlation between LQD US (iShares iBoxx $ IG Corp Bond) & S&P 500 Index Total Return

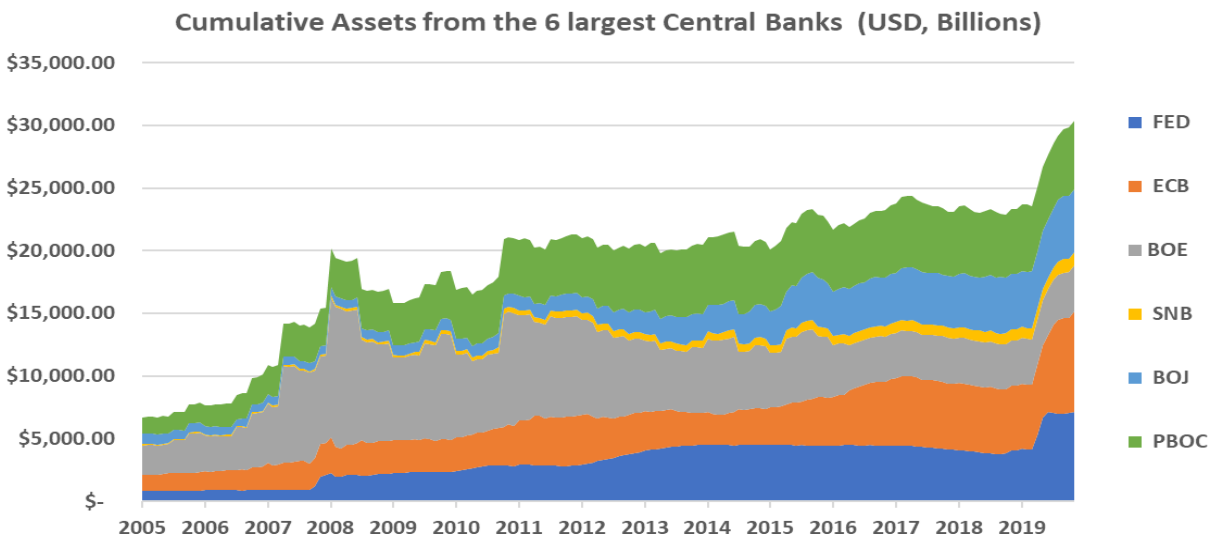


Source: Lighthouse Canton, Bloomberg

With a correlation above 0.6 between bonds and equities, we reiterate that a 60/40 allocation or even a risk-parity approach are bound to take investors by surprise, especially during periods of stress like we have seen earlier this year. The true diversifiers are to be found in strategies that have a low correlation to equities such as trade finance, life settlements, true alpha generating long/short managers, and select global macro funds.

We also think that this decade is likely to be remembered as one where investors started diversifying away from the US dollar. A currency like the Chinese Renminbi ought to benefit from this move as China's GDP eventually overtakes both US and Europe, and this would subsequently flow into the fixed income and equity markets. An allocation to gold is also a smart and effective way to reduce the risk of Central Banks' balance sheets expansion, which are de facto weakening their currencies. With the balance sheets of the 6 largest Central Banks having grown from US$6.6 trillion to US$30.3 trillion over the last 15 years (CAGR 11%!), according to Bloomberg data, the risk of currencies debasement should not be underestimated.

Chart 3: Top 6 Central Banks cumulated assets in USD since 2005



Source: Bloomberg

At the time of writing, with the US election almost out of the way, investors would have to identify the next catalysts to determine the course of their investments. Considering the inflated valuations on both equities and bonds (on average), the high correlation between these asset classes and real economies that are still in recovery, we believe investors will have to be increasingly selective to keep attractive returns going forward.

With no clear progress on the Covid-19 front and the markets continuing to remain uncertain, we maintain our stance on favoring non-correlated strategies (relative, value, global macro) and equity strategies with variable net to generate alpha on the long and short sides.

Yours Faithfully,

The Lighthouse Canton Team