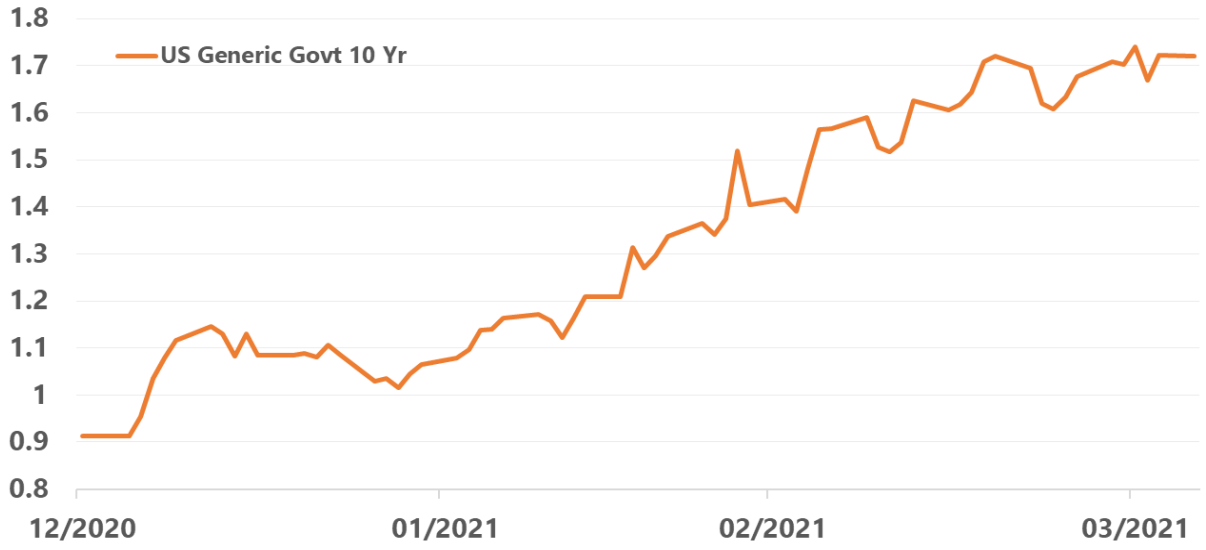
Creating Value through Innovative Financial Solutions

LC Monthly Investment Memo: March 2021

The sudden collapse of Archegos and Greensill Capital, along with the associated unwinding of their positions, stole the headlines in financial markets during the past month. Similar to 2008, several financial institutions have been left nursing losses amounting to several billion dollars due to use of excess leverage and poor risk management – both on the part of the manager and investors. While these 2 downfalls appear to be more of a storm in a teacup, the discussions around US stimulus and fiscal spending remain much more significant in terms of the medium-term economic ramifications. On 11th of March, President Biden signed the $1.9 trillion "Coronavirus relief package" which was followed by the announcement of another $2.25 trillion "American Jobs Plan", to be disbursed over the next 8 years. Economy re-openings are anticipated to further improve the jobs growth number in the next few months on the back of an unexpectedly strong US Jobs report announced on 2nd of April, which showed non-farm payrolls rising by a whopping 916,000, far outpacing the 660,000-consensus gain. With consumers now flushed with cash, economists expect pent-up demand to spur economic activity in the coming weeks.

Graph 1: US 10-Year Government Bond Yield (%)



Source – Lighthouse Canton, Bloomberg

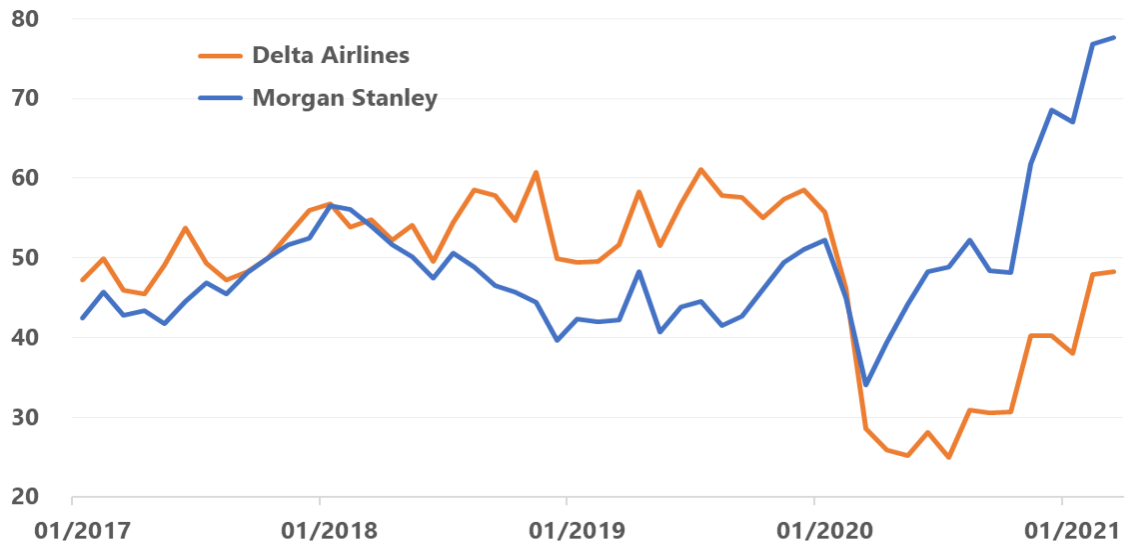
Higher growth expectation coupled with the Fed announcing that they are comfortable with inflation temporarily overshooting 2%, have fueled concerns around the rate at which inflation will settle in the coming quarters. As illustrated in Graph 1, the US 10-Year Government bond yield has almost doubled over the first quarter of 2021 from about 1% in January 2021 to 1.7% currently. Interestingly, this inflation fear seemed to have impacted the short-term rates much more than long-term rates – which is rather counter-intuitive. This is exhibited by the forward break-even inflation rates (which is a measure of expected inflation derived from Treasury Constant Maturity Securities) in the US on Graph 2 below. The latest value implies that market participants expect the average inflation to be higher in the next 5 years (2.6%) than in the next 30 years (2.28%) and hence resulting in an inverted curve.

Graph 2: US Inflation Expectations (%)

Source – Lighthouse Canton, Bloomberg

Higher bond yields seemed to have little impact on equities, most of which have benefited from the reflation trade. In fact, we observed that a majority of indices globally such as S&P 500, DAX or Nifty are trading at or close to record highs. In fact, many stocks in cyclical industries/sectors, such as Banks, Mining and Airlines, have rebounded sharply from their recent lows, generally back to pre-Covid levels as seen in Graph 3 driven by the inflated optimism of economic recovery boosted by the very generous "Covid Recovery Rescue Packages".

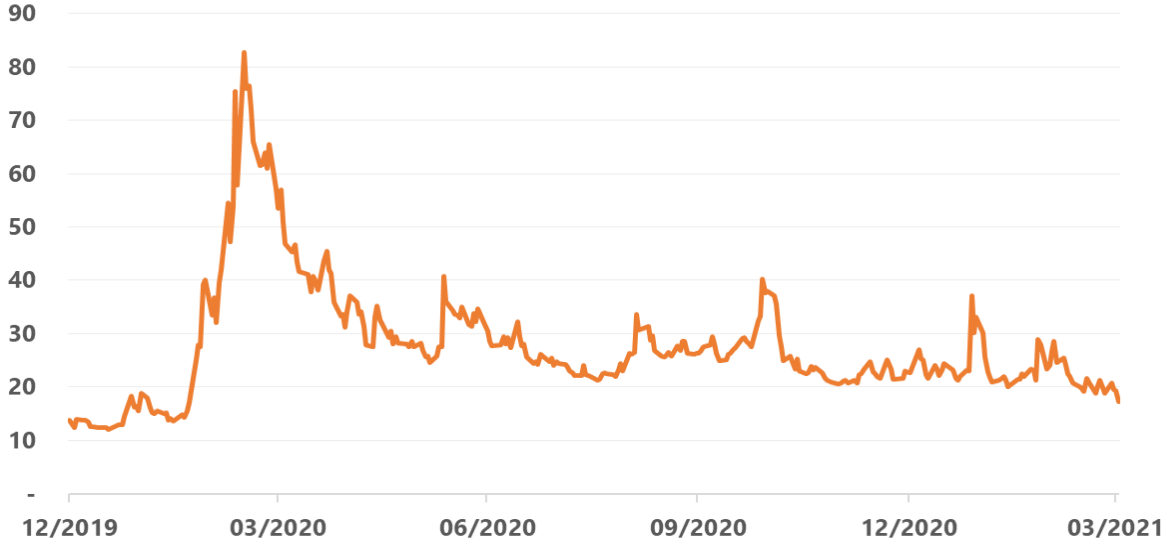
Graph 3: Share price of Delta Airlines and Morgan Stanley since 2017 (in $)



Source – Lighthouse Canton, Bloomberg

Investors also do not seem to be unnerved by the fact that US fiscal packages will be paid for by the reversal of former President Trump's signature 2017 tax cuts. Despite the current talks surrounding higher US corporate taxes (back to 28% from 21%) which would typically send equities temporarily lower. The VIX index, often called the "fear index", instead fell to 17, a level last seen in February 2020 as shown on Graph 4 below.

Graph 4: VIX Index since December 2019



Source – Lighthouse Canton, Bloomberg

The developments over the last month have not convinced us to deter from our investment approach and portfolio allocation which we have shared over the last few months. Exuberances around names like GameStop or SPAC deals not being approved because a vast majority of voters are not showing up during the vote are just illustrations that prices are currently set by retail investors. Keeping in mind that the US government bond yields (10-Year maturity) are currently returning 1.7%, we reiterate our view to allocate generously to strategies that are lowly or uncorrelated to traditional asset classes like bonds or equities. Managers who are long optionality (risk limited to premiums, unlimited gains) should be favored in all asset classes. A well-diversified portfolio across complementary strategies that keep the portfolio beta (0.2 or lower) and correlation low, should be increasingly favored in our opinion. In this rather unprecedented market, which can retreat as quickly as it rallies, selecting the managers who have a proven and robust risk management is paramount.

Yours Faithfully,

The Lighthouse Canton Team