

# LC Investment Playbook

Weekly Update

**April 08<sup>th</sup> 2022**

**LIGHTHOUSE  
CANTON**

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# Macro Highlights

# 1

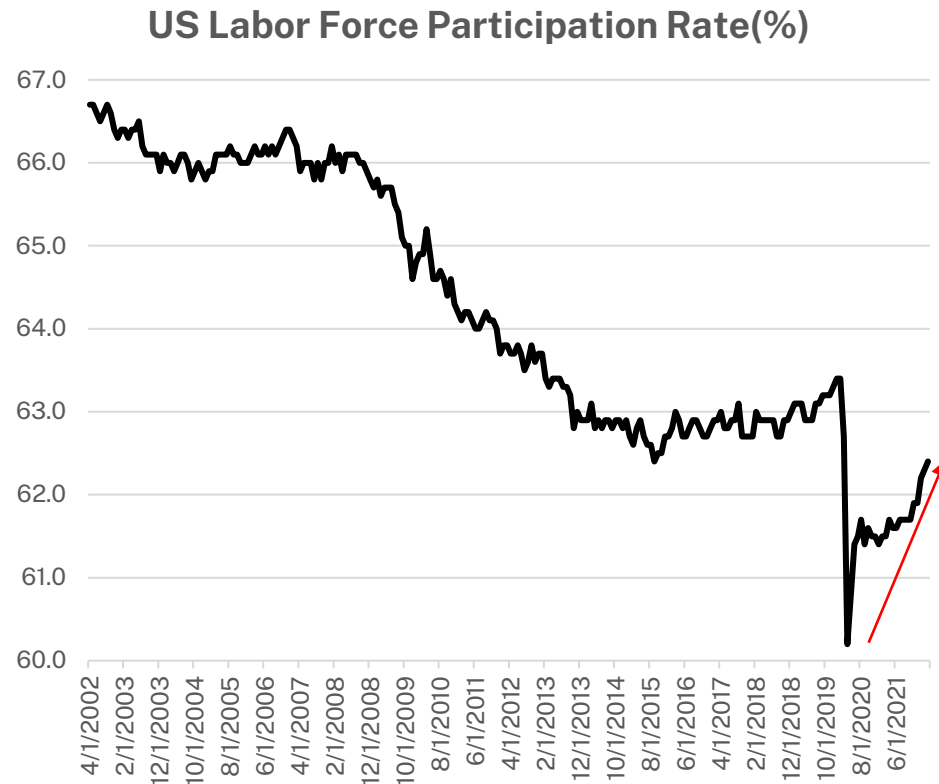
# Improving Labour Market in US (1/2)



Source: BLS, Lighthouse Canton, Bloomberg dt. 03<sup>rd</sup> April 2022

- US Unemployment rate came in at 3.6%, one of the lowest in last 2 decades. The lowest being 3.5% pre pandemic. This was against a prior reading of 3.8%
- US NFP Change came in at 431,000 for the month of Mar 2022 as against a consensus of 490,000.

# Improving Labour Market in US (2/2)

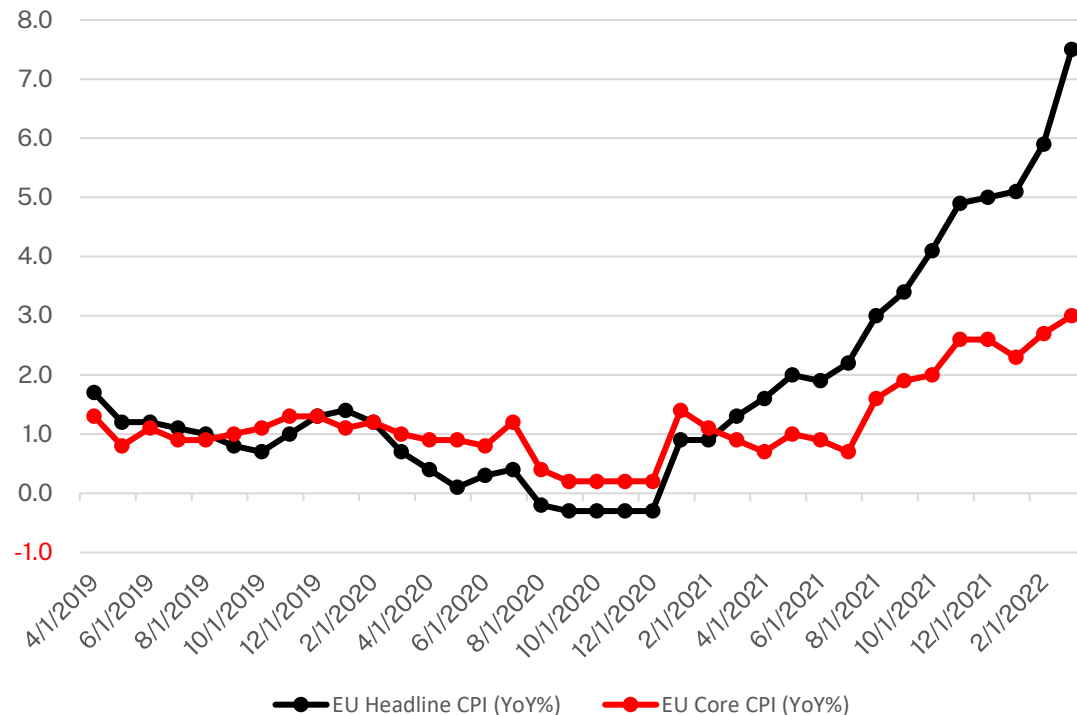


Source: BLS, Lighthouse Canton, Bloomberg dt. 03<sup>rd</sup> Apr 2022

- Average hourly earnings MoM for March showed a growth of 0.4% MoM. YoY printed a 5.6% growth against a prior reading of 5.1%.
- Labour force participation improved to 62.4% in March 2022. Prior reading was also 62.3%.

# EU CPI inching upwards

EU CPI YoY (%)



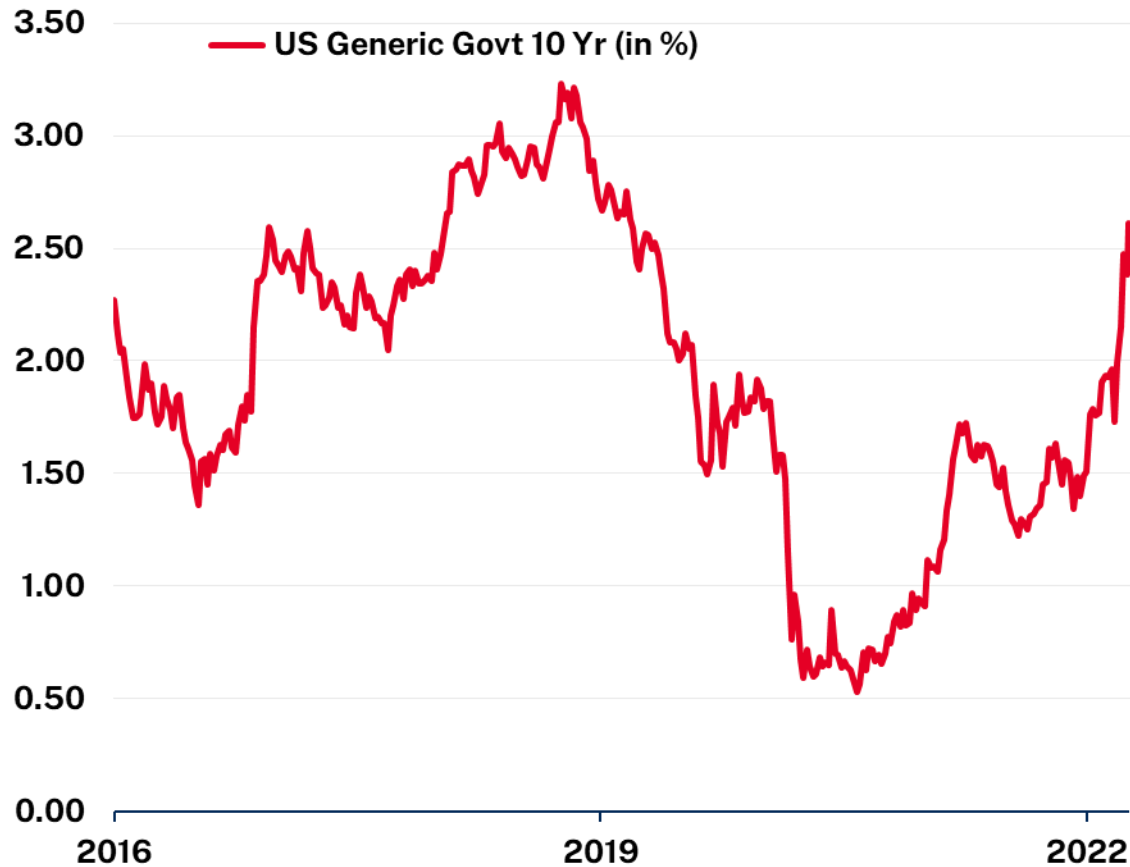
Source: Eurostat, Bloomberg & Lighthouse Canton 03<sup>rd</sup> Apr 2022

- EU Headline CPI came in at 7.5% against a survey estimate of 6.7% and prior reading of 5.8%. This is primarily owing to high energy prices in EU.
- Core CPI came in at 3% against a survey estimate of 3.1% and prior reading of 2.7%.
- The differential between Headline and Core CPI highlights the impact the war is having on inflation.
- The above reading is setting the stage for ECB to start raising rates. However, the ECB might be observing the Core CPI more closely to determine the number and quantum of hikes.

# Fixed Income Highlights

# 2

# Fed to begin balance sheet reduction



Source: Bloomberg & Lighthouse Canton 5<sup>th</sup> Apr 2022

- Rates are surging incredibly fast in the US. A statement by Lael Brainard (Fed's Vice Chair) on April 5<sup>th</sup> sent the yield on 10Y treasuries 20bps higher to 2.61%.
- Lael Brainard suggested that the US central bank was prepared to take 'stronger' action on raising interest rates and that it would begin a rapid reduction of its \$9tn balance sheet as soon as next policy meeting in May.
- Surprisingly, some investors were caught 'off guard'.



# Fixed Income – Executive Summary (1/3)

## Recession fears

- **The war in Ukraine injects further uncertainty** into an already highly uncertain situation, raising questions about the pace of real activity and the availability and price of energy, food and other critical raw materials.
- **The Fed will start reducing its \$9 trillion balance sheet "at a rapid pace" as soon as next month, Lael Brainard predicts. Whether the U.S. will hit a recession next year as the Fed jacks up rates is the most debated question amongst economists.**
- **European bond markets are now pricing in an economic slowdown**, and we would recommend reducing positioning or completely steering clear from European equities and HY credits for the time being.
- **EM portfolio managers facing steep losses on their Russian debt holdings**, with no market liquidity available to exit Russian positions, they will likely need to sell other bonds in their portfolio to manage risk, thereby creating contagion for all of EM debt.

# Fixed Income – Executive Summary (2/3)

## Interest Rates

- **The swaps markets are pricing in six quarter-point hikes from the Fed this year.** Fed's Quantitative Tightening is likely to shift the U.S. yield curve higher in the coming quarters (by an estimated 3 bps / month for the US Yield Curve). JPMorgan predicts up to 9 hikes by the Fed to keep inflation under control. We anticipate the US 10Y yield, currently at 1.97%, to end the year between 2.00% and 2.25%.
- **The ECB delivered a hawkish surprise on March 10<sup>th</sup>.** It announced a faster exit from its APP bond-buying plan. Monthly net purchases will decline from EUR 40 billion to EUR 30 billion in May and to EUR 20 billion in June. Net purchases in Q3 will ultimately depend on the medium-term inflation outlook: unless it weakens, then net purchases will end in Q3. The ECB also raised its 2022 inflation forecast to 5.1% from the December projection of 2.6%.
- The PBOC is the only large Central Bank easing, which **illustrates that the Chinese economy is slowing down.**

# Fixed Income – Executive Summary (3/3)

## Coco's

- The ECB seeks to review its stance on AT1 instruments in response to the European Commission's call for advice.
- In summary it would like to make AT1s more equity-like by making coons more likely to be suspended, removing hard triggers for principal write downs and increasing permanence of AT1s by reducing callability.
- Its argument is that AT1s no longer fulfill their purpose of being loss absorbing instruments on a going concern basis.
- It is not clear if any of the ECB's recommendation will be adopted, but if they are, it will shake up the AT1 market.
- Investors should consider **reducing CoCo exposures** as risk reward is highly skewed to the downside due to **heightened regulatory risk**.

# Equity Highlights

# 3

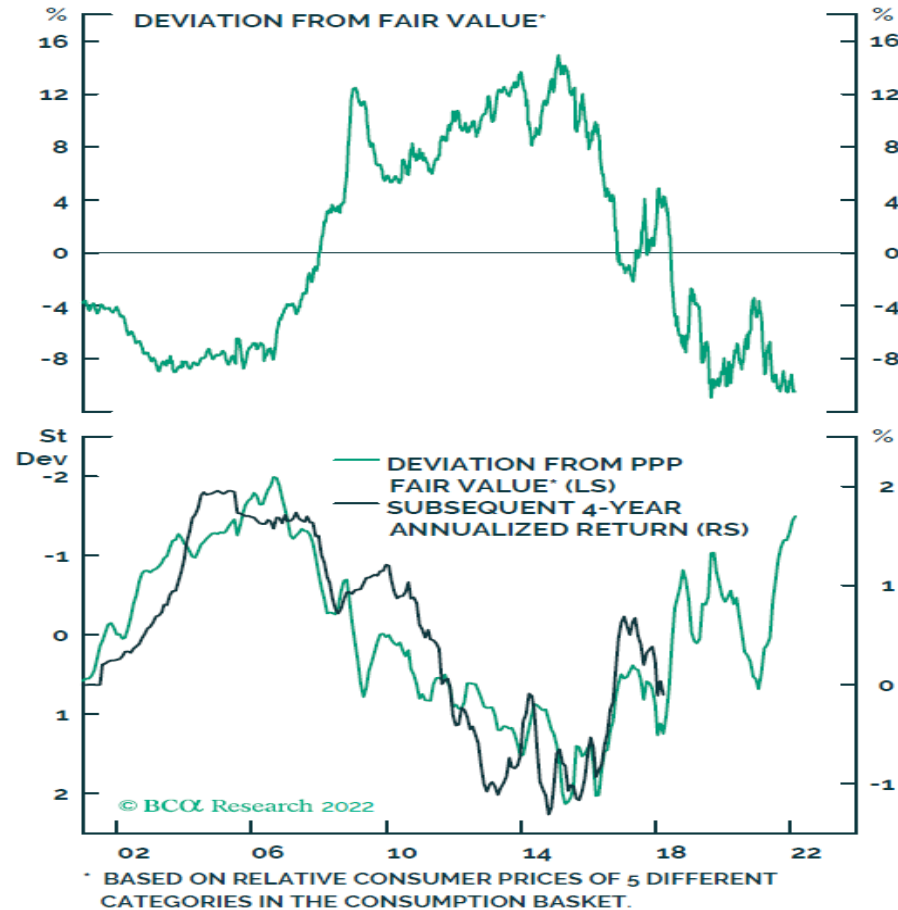
# Equities – Executive Summary

- **Equities remain highly dependent on the news flow:**
- A statement from Lael Brainard (Vice Chair of the Fed) mentioning that **“the Fed will start reducing its \$9 trillion balance sheet at a rapid pace as soon as next month”** sent the Nasdaq Composite Index 2.3% lower on April 5<sup>th</sup>. The Nasdaq Composite index has returned -9.2% so far in 2022 and is likely to remain volatile throughout the year.
- We also expect European equities to remain under pressure as the situation in Ukraine deteriorates. **Allegations of war crimes by Russian troops in Ukraine are forcing European leaders to take a new round of sanctions against Russian companies and Oligarchs, putting more pressure on their own economies. The lose/lose situation is unlikely to be solved quickly.**
- The structural nature of the Chinese crackdown justifies a higher equity risk premium and lower multiples for Chinese stocks. **The threat by US authorities to delist Chinese ADRs from US exchanges is another roadblock for Chinese stocks on the short term.**

# Currencies & Commodities

# 4

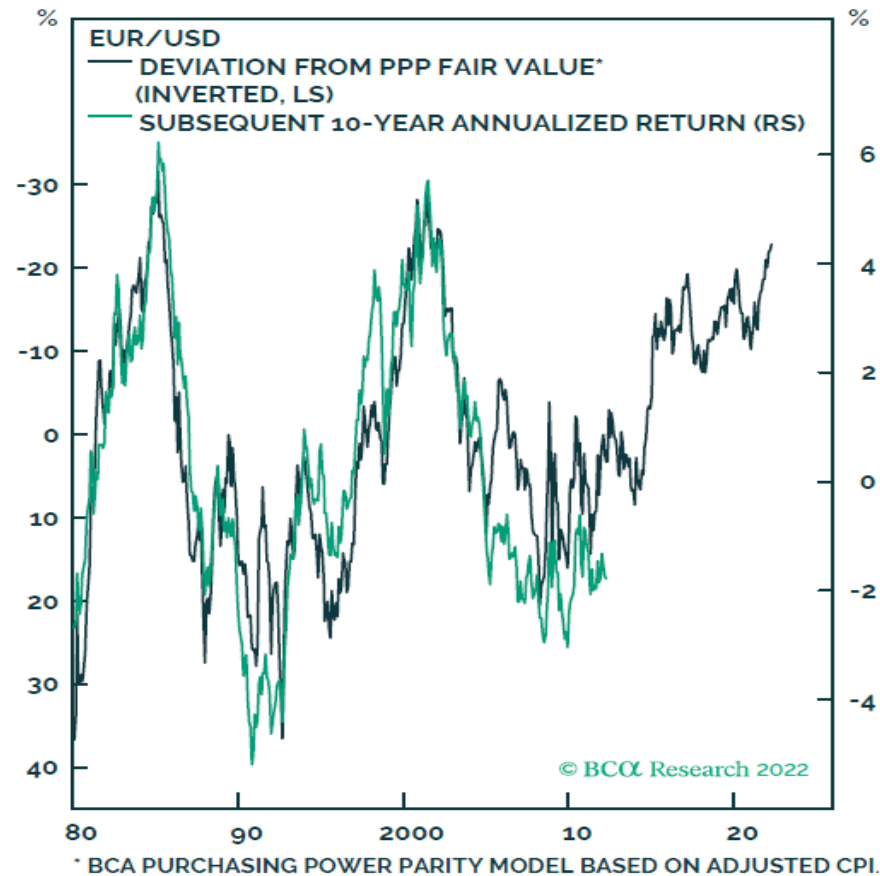
# RMB presents medium term upside



Source: BCA, April 1<sup>st</sup> 2022

- Higher real rates have supported the RMB in recent months
- Despite its strength, BCA thinks the currency is undervalued by at least 10% from its PPP fair value
- Considering China's relative higher productivity growth when compared to most other countries and an increasing likelihood of it wanting to start diversifying its dollar holdings, we believe the RMB could continue to remain resilient over the near to medium term.

# USD is significantly overvalued (1/2)

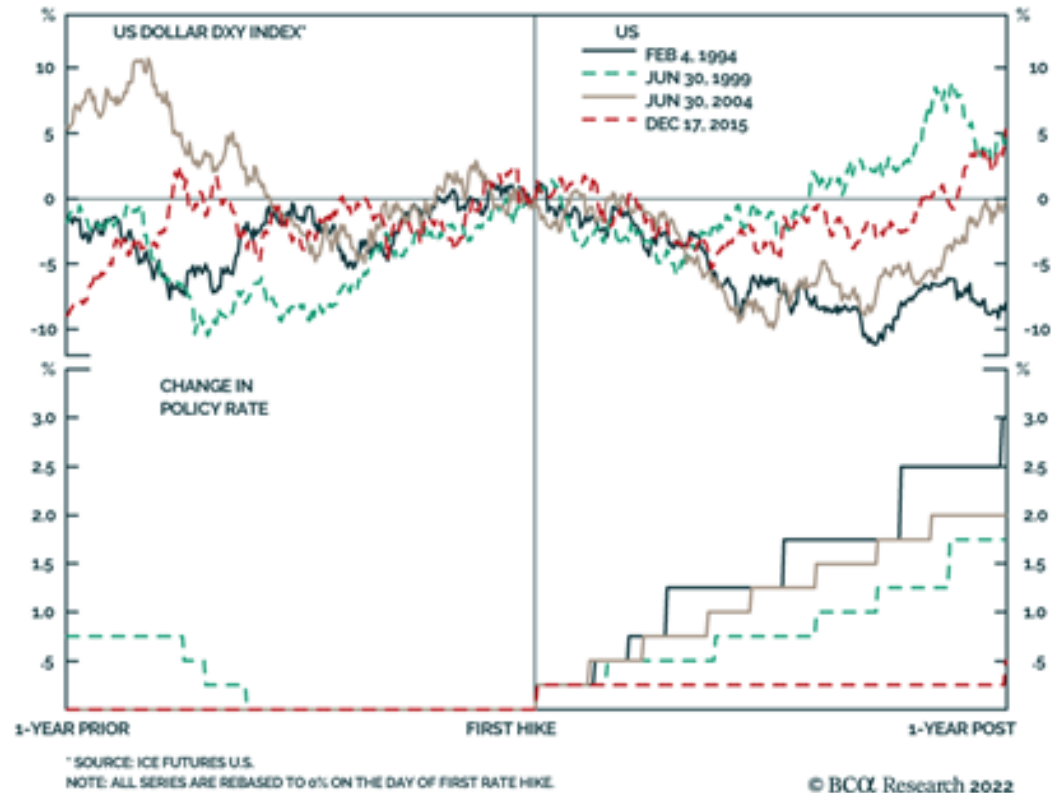


Source: BCA, April 1<sup>st</sup> 2022

- BCA thinks the currency is overvalued by more than 20% from its PPP fair value
- Strong equity inflows have funded its deficit so far but this has started to ebb significantly in face of poor sentiment with US tech stocks
- Considering the US is experiencing its largest trade deficit on record, the long-term outlook for the currency remains weak and is likely to reverse course barring any recessions.



# USD is significantly overvalued (2/2)



Source: BCA, April 6<sup>th</sup> 2022

- According to BCA Research, the dollar has tended to decline 3-to-6 months after the Fed starts hiking interest rates. This has been true since the mid-1990s and the average decline after six months has been 5.3%.
- Historically, the Fed has usually been the first to start the process of hiking interest rates globally. It has also been the central bank that has lifted rates by the most. This history of credibility has nudged forward markets to grow accustomed to anticipating the Federal Reserve to be ahead of the curve. As of now, US policy rates stand at 0.25% but the two-year yield is at 2.5%.

# Currencies & Commodities – Executive Summary

- **Gold will remain volatile because of opposite forces.** On one hand, a stronger USD and rising rates are making Gold less attractive to investors. On the other hand, geopolitical instability is positive for the precious metal. With almost no correlation to US Equities (0.09 between March 2016 and March 2022, Monthly observations), we consider Gold as a good diversifier but not as a good hedge.
- As the Chinese economy becomes the world largest, **we remain supportive of the CNY for all investors with a long-term view.**
- **Below 1.10, the Euro start looking attractive** for institutional investors, with a long-term horizon (5-10Y). For investors with a shorter investment horizon, we recommend waiting for the EUR/USD to trade closer to 1.05 before adding European equities.
- **Commodities are likely to remain highly speculative throughout 2022.** We recommend outsourcing the trading of commodities to well establish managers with strong risk-management culture.

# Thematic Spotlight

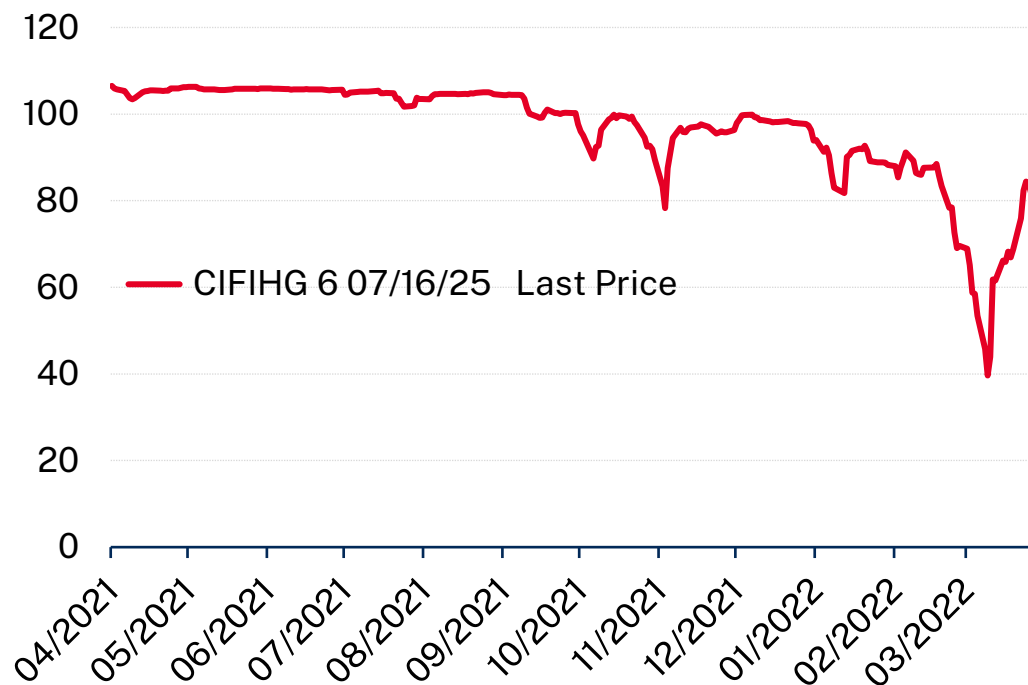
# 5

# Logan Updates

- The company released unaudited 2021 annual report on the night of 1<sup>st</sup> April, specifically “for bondholders’ references only”.
- According to the unaudited report, Logan still had CNY 38.2 billion of cash and equivalents as of 31 Dec 2021; its total bank loans and senior notes due in 2022 were CNY 22.7 billion; other current liabilities were CNY 13.1 billion.
- Logan’s debt-to-equity ratio was 82.1% (up from 60.8% in the 2021 semiannual report); liability-to-asset ratio was 71% (up from 69%); cash-to-short-term-debt ratio was 1.07x (down from 1.85x).
- Despite the abovementioned deteriorations, the company’s financial metrics still did not breach any of the Three Red Lines (TRL). The company is still categorized as Green in the TRL system, which is also the reason why it was allowed to issue new ABS and convertible bonds in Dec 2021 and Jan 2022 respectively.
- The company’s cash equivalents are not all that liquid. It has CNY 18 billion of mortgage funds from property pre-sales that are still under bank supervision, and CNY 12 billion of uncollected funds from property sales, which are mainly from the low turnover business of urban renewal.

# Liquidity crisis caused by bad governance

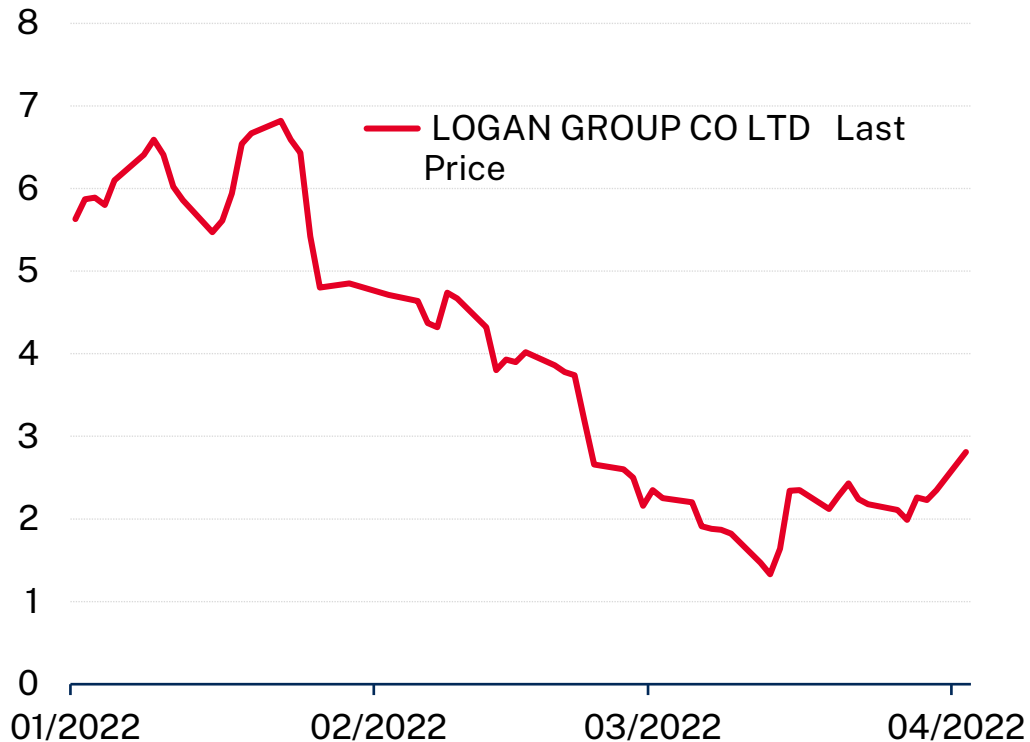
- CIFI learnt the lesson from Logan:



Source: Bloomberg, April 4<sup>th</sup> 2022

- Logan initially denied the rumor that it has around USD 3 billion of off-balance-sheet private debts but subsequently acknowledged to have USD 1 billion private debts in an investor conference call.
- S&P and Moody's downgraded the company's ratings due to lower financial transparency scores, which triggered early repayments of a few bonds.
- Another developer, CIFI Holdings, learnt from Logan's mistake. When it was reported by UBS to have similar off-balance-sheet private bond commitments of CNY 60-90 billion. It quickly made a full disclosure that it is only responsible for around CNY 25 billion of private debts owned by some joint ventures, of which the company only held minority shares. As a result, the company has not been downgraded; its bond price rebounded in just a few days.

# Lesson learned



Source: Bloomberg, April 4<sup>th</sup> 2022

- Fundamental analysis is still the key. A developer, financially weaker than Logan, would likely have already gone bankrupt facing similar financial pressures. But Logan managed to make all onshore and offshore interest payments and obtain investors' approvals for extensions of onshore CNY bonds and ABSs. Its stock price has increased by 111% from the mid-March trough.
- However, as international investors are spooked by the Chinese real estate sector, analysis should also extend to proper governances of the bond issuers to avoid any unnecessary paper losses for a prolonged period of time.

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