LC Investment Playbook Weekly Update

29 March, 2022

LIGHTHOUSE CANTON

BEST INDEPENDENT WEALTH MANAGER
WEALTH PLANNING SERVICES

BEST INDEPENDENT WEALTH MANAGER
INVESTMENT ADVISORY

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Fixed Income Highlights

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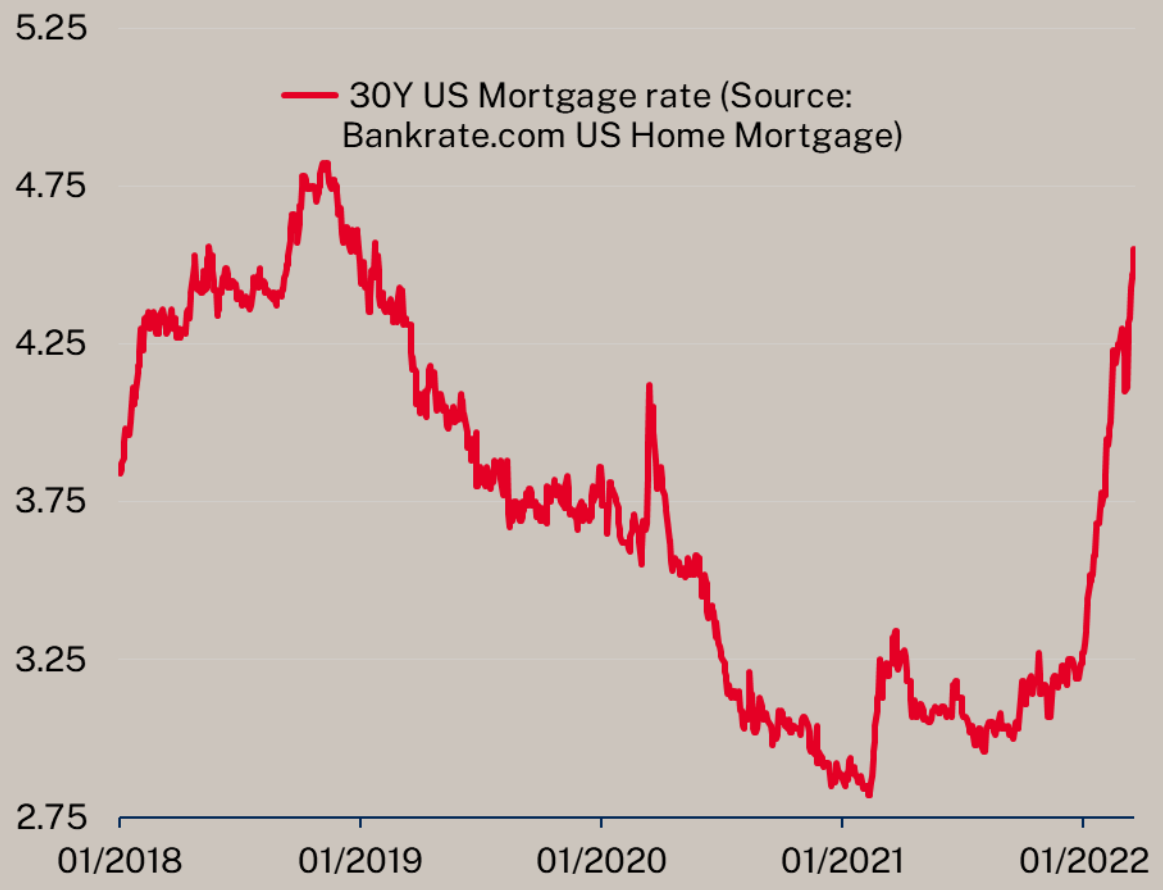
US Mortgages are more expensive

February data from the National Association of Realtors NAR) found existing-home sales falling 7 per cent month-on-month. According to Lawrence Yun, head economist at NAR “Housing affordability continues to be a major challenge, as buyers are getting a double whammy: rising mortgage rates and sustained price increases. Some who were previously qualified at a 3 per cent mortgage rate were no longer able to buy at the 4 per cent rate”



Source: Bankrate.com, March 21st 2022

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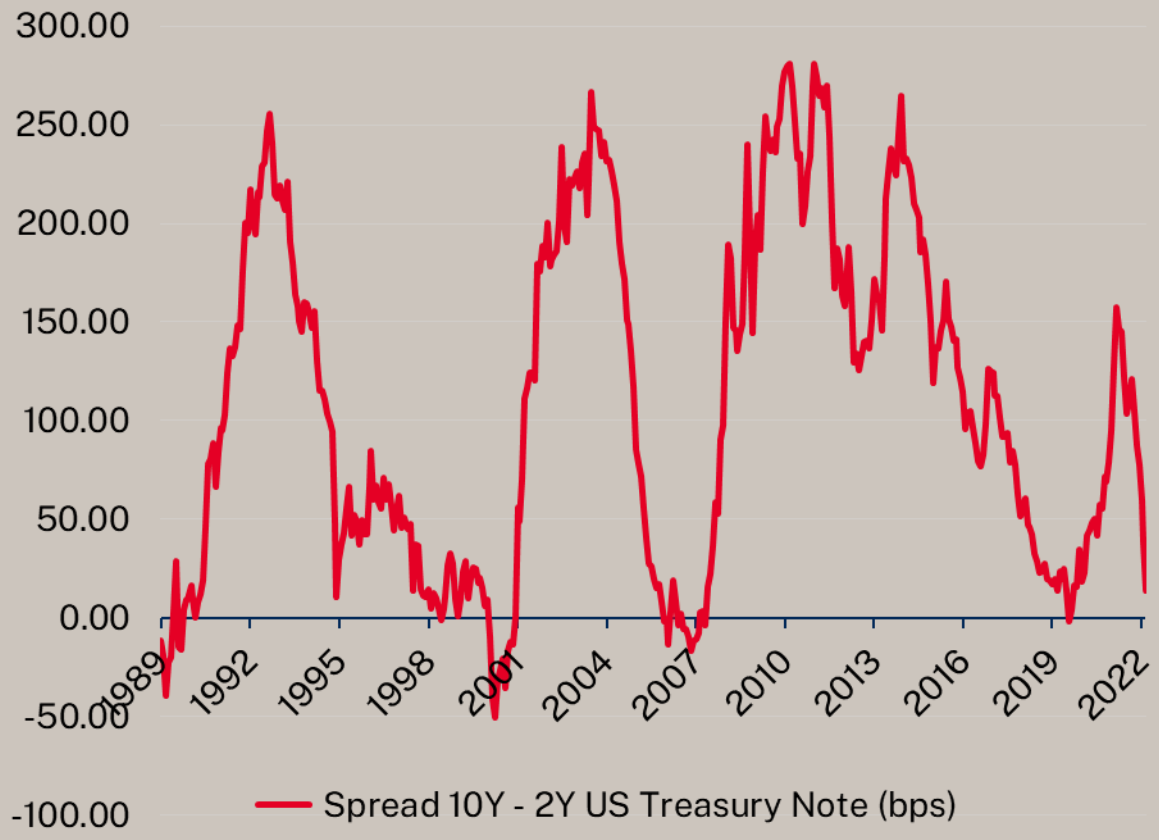
US Yield Curve is likely to invert soon

Every US recession since 1960 has been preceded by an inversion of the US Treasury curve, with shorter-maturity yields rising above longer-maturity ones. Currently, the yield spread between the 10-year and 2-year Treasuries is at a meager 22bps.

Since the spread between the 10Y & 2Y US Treasuries is often considered as a leading indicator, an inverted yield curve raises the question of a looming recession.



Source: Bloomberg, March 14th 2022

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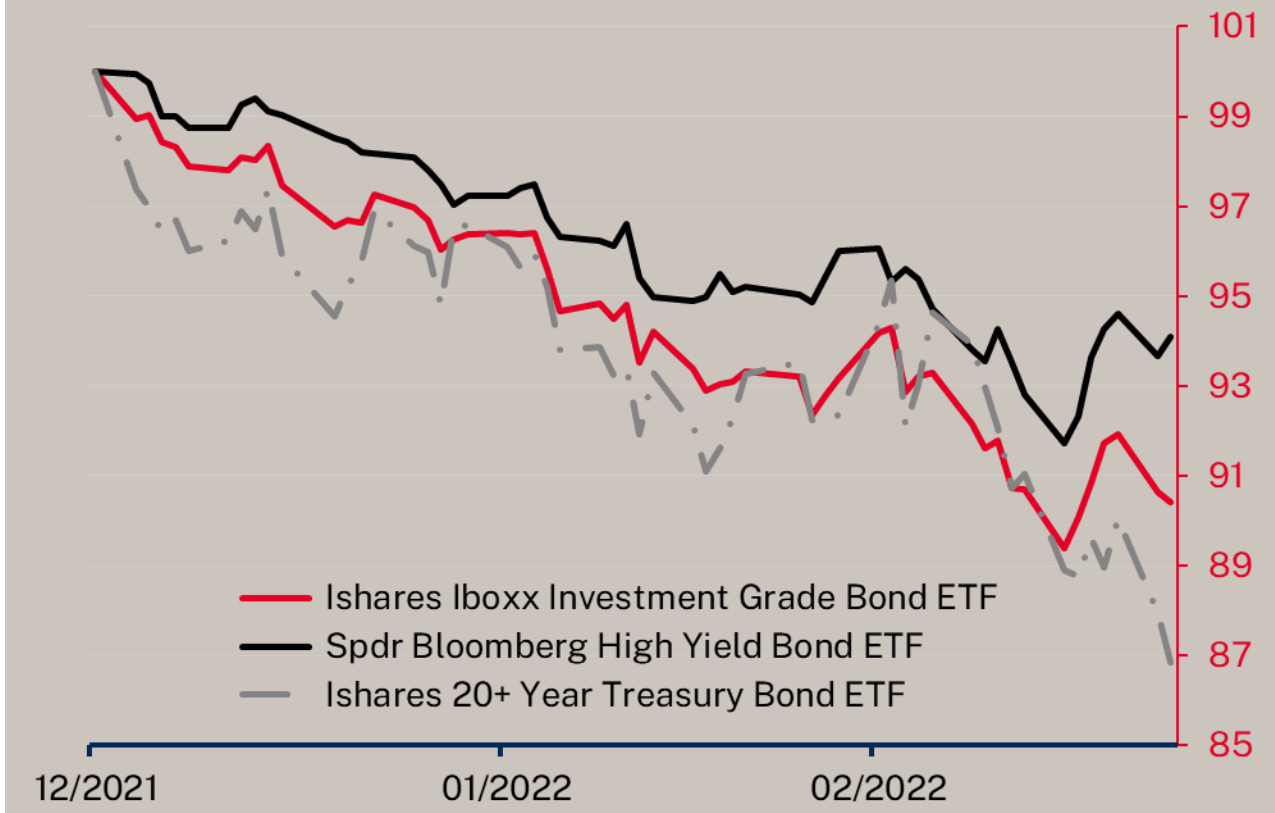
Raising Yields are detrimental for Bonds

- Global bond losses accelerated to the most on record, with the Bloomberg Global Aggregate Index tumbling 11% from its 2021 high. All indices are in the red so far this year with LQD US (ishares Investment Grade Bond ETF) down 9.3% and JNK US (Spider High Yield Bond ETF) down 5.8% year-to-date.

- Duration Bonds are suffering even more as illustrated with ishares 20+ Year Treasury Bond ETF down 13.1% so far this year.



Source: Bloomberg, March 23rd 2022

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Fixed Income – Executive Summary

- **The People's Bank of China (PBOC)** did not cut policy rate again on Tuesday, 22nd March, as expected, as the China-US 10-year treasury spread had narrowed to 42 bps, the lowest level since Feb 2019. But more **easing** is expected in the coming months, as the central government vows stronger support for the economy.

In case you missed it:

- **The Fed kicked off its tightening cycle with a 25 bps hike and signaled six more increases this year**. The new dot plot projects rates ending the year at 1.9%, and then rising to about 2.8% by the end of 2023. What is already considered as "the most aggressive policy campaign in decades" will be watched closely by investors who fear that a hawkish policy might derail growth as soon as next year. Indeed, every US recession since 1960 has been preceded by an inversion of the US Treasury curve, with shorter-maturity yields rising above longer-maturity ones. Currently, the yield spread between the 10-year and 2-year Treasuries is at a meager 22bps.

- **The European Central Bank (ECB) delivered a hawkish surprise on March 10th**. 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.

Equity Highlights

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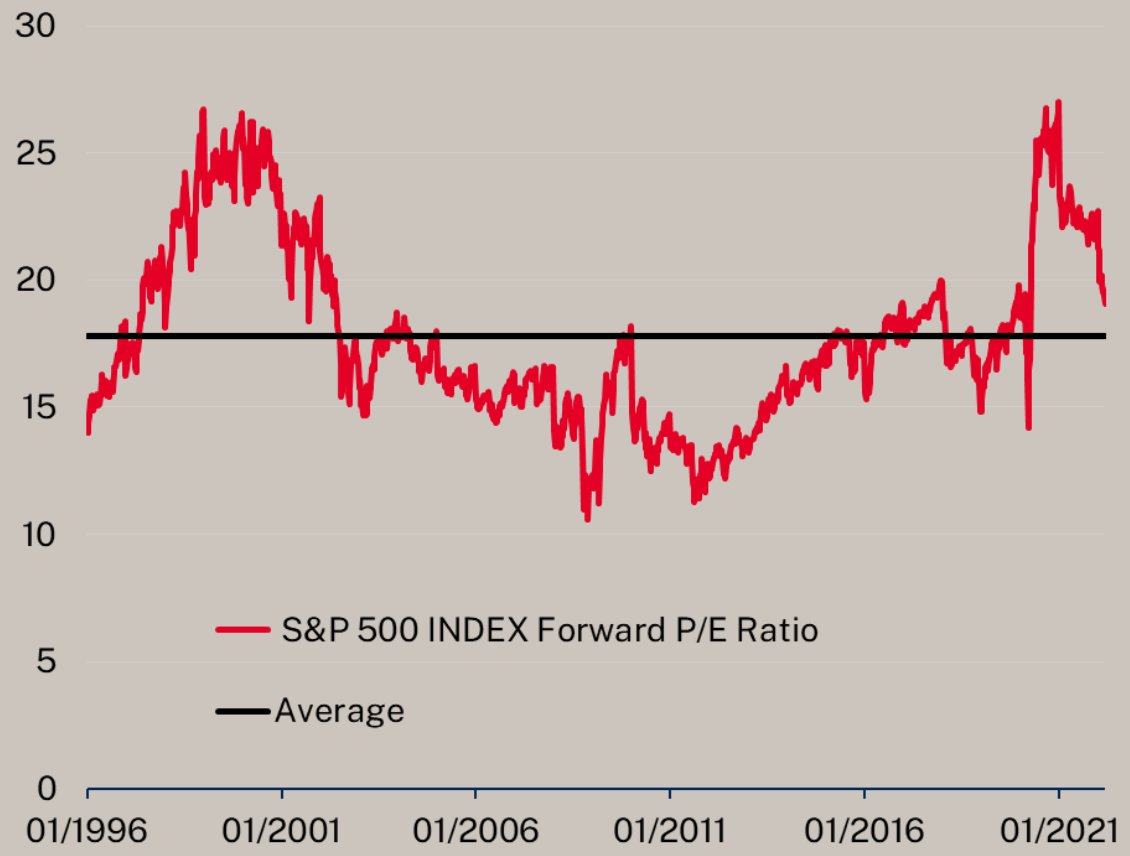
U.S. Valuations are getting less expensive

- Should economic growth forecasts and earnings growth estimates be downgraded because of the Russia-Ukraine crisis, U.S. equities would likely face near-term headwinds.

In case you missed it:

- The forward P/E ratio for the S&P 500 index has dropped to 19.8x, which is still 2.5 point above its long-term average of 17.3x.

- While U.S. equities are not considered "cheap" just yet, we are less concerned with their valuations.



Source: Lighthouse Canton, March 10th 2022

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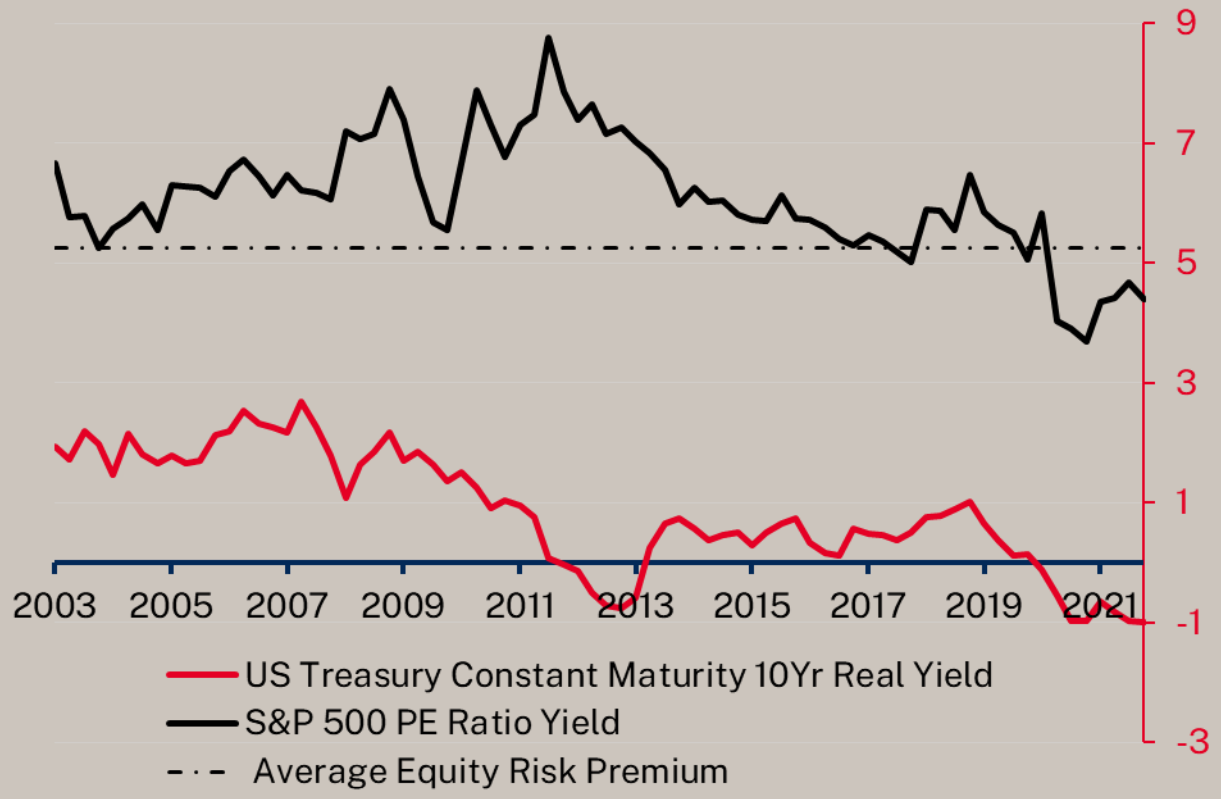
Equity Risk Premium and Valuations

- According to BCA Research there is a close inverse relationship between real bond yields (nominal rates minus inflation) and the P/E multiple. As long as real bond yields remain relatively stable, they will not be a headwind for equity valuations.

- A risk to equities will emerge if the Fed attempts to hike interest rates in a way that will also push up real yields. Since the Fed's hawkish pivot reflects an attempt to maintain its credibility in the face of inflationary pressures, rather than to slow economic growth, BCA research concludes that such a scenario is, for the moment, unlikely.



Source: Lighthouse Canton, March 22nd 2022

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Equities – Executive Summary

- Thanks to the Q1 2022 correction, **US equities are beginning to look "fairly" priced**. We expect US equities to remain extremely volatile throughout the year, in the context of quantitative tightening and interest rate hikes on the one hand and speculators "buying the dip" on the other. Economic growth forecasts and earnings growth estimates are likely to be downgraded by year-end which could also act as a near-term headwind to global equities. A risk to U.S. equities will emerge if the Fed attempts to hike interest rates in a way that will also push up real yields.

In case you missed it:

- **We recommend reducing or completely steering clear from European equities for the time being**. Indeed, bond markets are now pricing in an economic slowdown in Europe and the quantitative tightening, announced by the ECB to tackle inflation, does not bode well for European equities in the coming weeks.

- The recent announcement by Liu He (China's Vice Premier) that Authorities would take "measures to support the economy and financial markets" suggests that policymakers are deeply concerned with the recent market rout. **We believe beaten-down Chinese stocks offer a good entry point for long-term investors.** We also believe that China's regulatory clampdown is not over yet, which justifies a higher equity risk premium and lower multiples for Chinese stocks.

Currencies & Commodities

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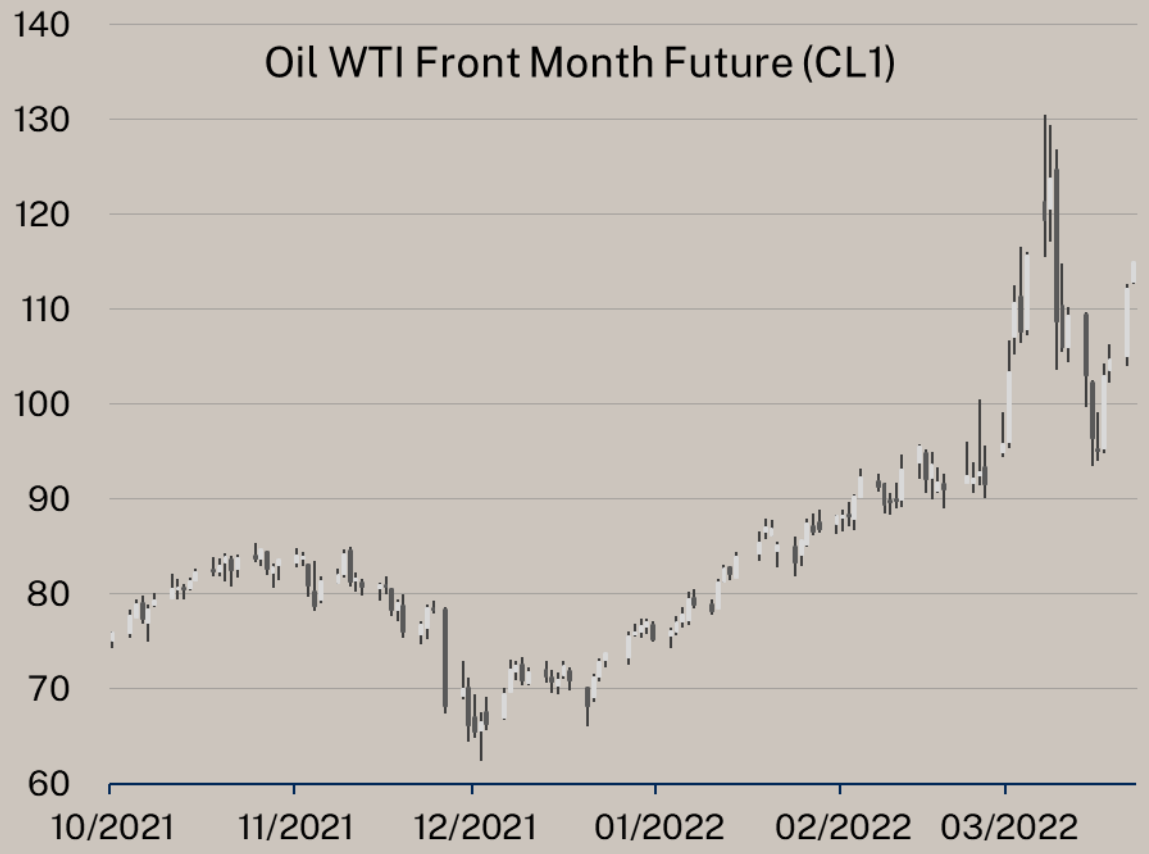
Europe moving away from Russian supply

- The price of a barrel of WTI oil climbed more than 7% to $116 on March 21st. The big move highlights how geopolitics continues to inject supply uncertainty which is driving up the risk premium priced into oil markets.

- A deterioration in the situation in Ukraine will accelerate Europe's efforts to diversify away from Russian energy supplies over the long-term. The LNG deal between Germany and Qatar agreed on March 20th is a case in point.



Source: Lighthouse Canton, March 22nd 2022

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Currencies & Commodities – Executive Summary

In case you missed it:

- **Commodities are likely to remain highly speculative throughout 2022**. We recommend outsourcing the trading of commodities to well established managers with strong risk-management.

- **Gold will remain volatile because of opposite forces**. On one hand, a stronger USD and raising 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 would suggest using gold as a good diversifier to one's portfolio rather than allocating to gold as a hedge.

- As the Chinese economy becomes the world largest, **we remain supportive of the CNY for all investors with a long-term view**. Reports showing that Saudis are considering selling Oil to China in Yuan is also representative of the international shift in favor of the Chinese currency.

- **Below 1.10, the Euro starts 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.

Thematic Spotlight

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US Sanctions & Delisting of Chinese Companies

- Possible sanctions include:

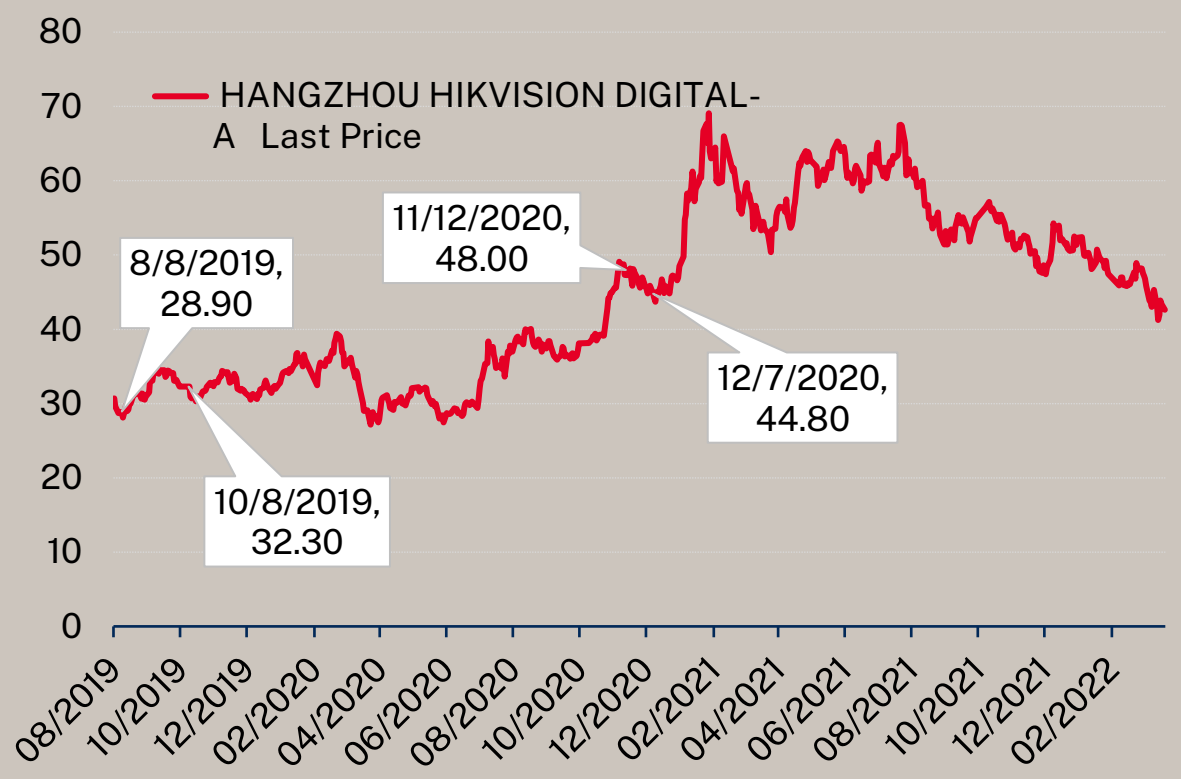
1. Banning companies from receiving federal government contracts.
2. Barring firms from buying components from U.S. companies without U.S. government approval.
3. Prohibiting any American company or individual from owning shares in such companies.
4. Requesting the companies' ADRs to be delisted from US markets.

- Besides sanctions, delisting of Chinese ADRs could also be a result of non-compliance of the audit requirements of the Holding Foreign Companies Accountable Act. The outcome of delisting include:

1. Some companies may fully buy back their ADRs before the delisting; this will be an easier settlement for ADR-holders, but the buyback prices will not be so good.
2. If the company also has Hong Kong shares listing, its ADRs could be cancelled in exchange for delivery of H shares.
3. If no buyback and no H shares are available, ADR-holders could still opt to hold the shares, which can no longer be traded on the exchange but can still be traded over-the-counter; but because of the much lower liquidity, it will become more like a PE investment.

Case Study 1: Hikvision (002415 CH)

- In August 2019, the U.S. government banned Hikvision from receiving federal government contracts due to security concerns.
- In October 2019, Hikvision was formally placed on the Entity List by the U.S. government for its role in surveillance of Uyghurs in Xinjiang and of other ethnic and religious minorities in China.
- In November 2020, U.S. President Donald Trump issued an executive order 13959 prohibiting any American company or individual from owning shares in companies that the United States Department of Defense has listed as having links to the People's Liberation Army, which included Hikvision.
- In December 2020, Hikvision was removed from FTSE Russell.



Source: Lighthouse Canton, 21/03/2022

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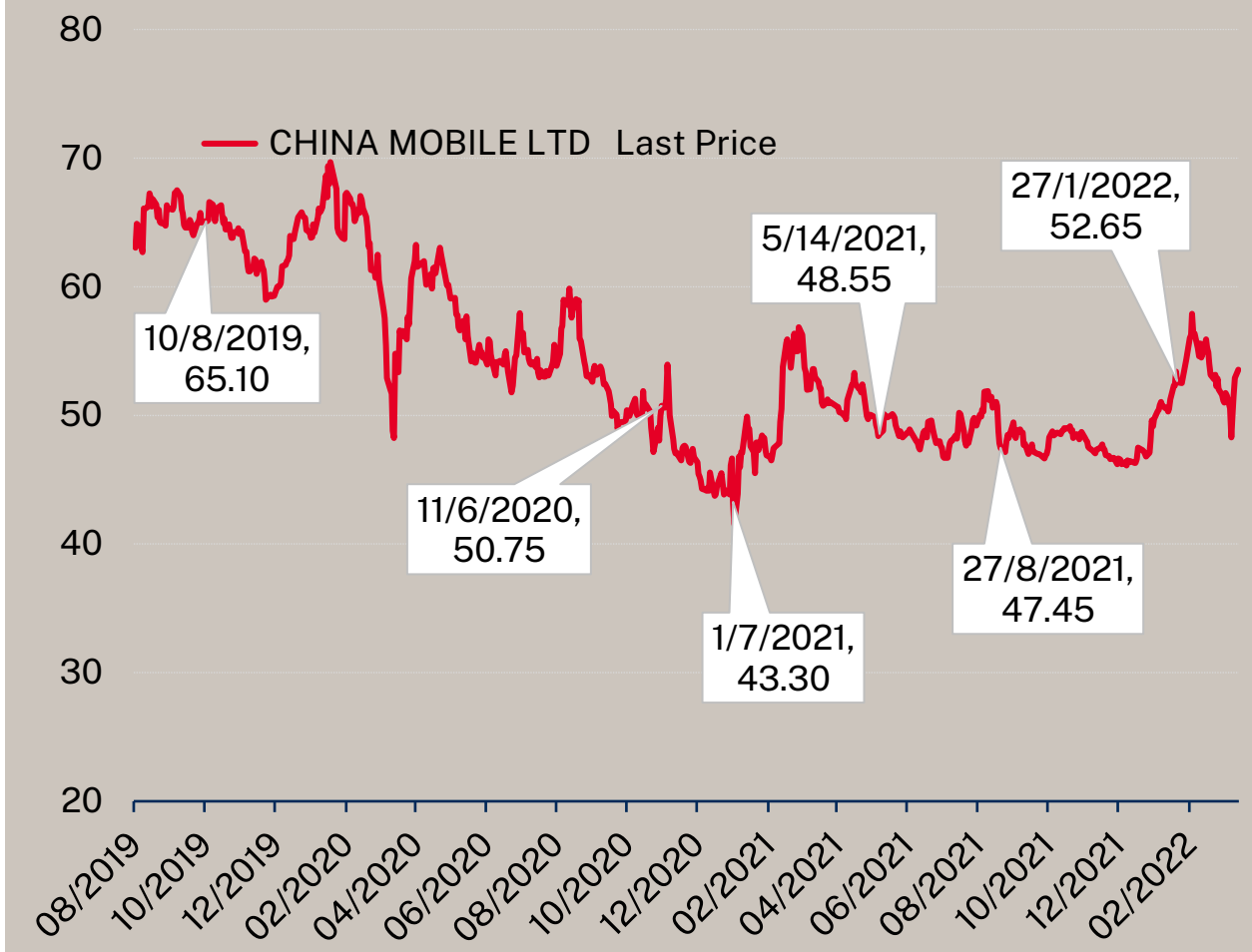
Case Study 2: China Mobile (941 HK)

- In October 2019, China Mobile was also formally placed on the Entity List by the U.S. government for potential links to the People's Liberation Army.
- In November 2020, U.S. President Donald Trump issued an executive order 13959 prohibiting any American company or individual from owning shares in the company.
- In Jan 2021, NYSE finalized the delisting decision of China Mobile, the company was removed from MSCI, SPX and FTSE Russell indices.
- In May 2021, China Mobile officially delisted from NYSE. Its ADR holders can cancel each ADR for delivery of five ordinary shares of the Company, which are listed for trading in Hong Kong.
- In August 2021, the company announced its Shanghai IPO plan, which was done in Jan 2022.



Source: Lighthouse Canton, 21/03/2022

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Case Study 3: Didi (DIDI US)

- Didi has not been sanctioned by the US.
- But it was requested by the Chinese government to delist, as it failed to comply with China's pre-foreign-listing requirements.
- The main reason is that the geolocation data held by Didi are deemed sensitive and related to the national security of China. It will never allow Didi to disclose data to the US.

Source: Lighthouse Canton, 21/03/2022

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Conclusions

1. When Chinese companies have limited international exposures and are listed on the onshore A share market, US sanctions will have a very limited impacts on their operations and stock prices (e.g., Hikvision).
2. Companies with H shares and/or ADRs will have their stock prices directly negatively impacted by US sanctions;
3. Chinese onshore funds will only buy the dip on Hong Kong market when the US delisting is finalized (e.g., China Mobile);
4. Last week, the two countries' regulators made some progresses on the audit info disclosure requirements. However, companies holding sensitive data may still not be allowed by China to disclose to the US (e.g., Didi);
5. Therefore, investors should only consider Chinese companies which are unlikely to be sanctioned by the US, and do not hold data that may be deemed sensitive by China. Moreover, companies that have only A and/or H shares are preferred. Companies with both H shares and ADRs, H shares are preferred but will likely remain undervalued for a prolonged time, until ADR delisting is finalized or completely ruled out. Companies with only ADRs are better to be avoided for now.

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