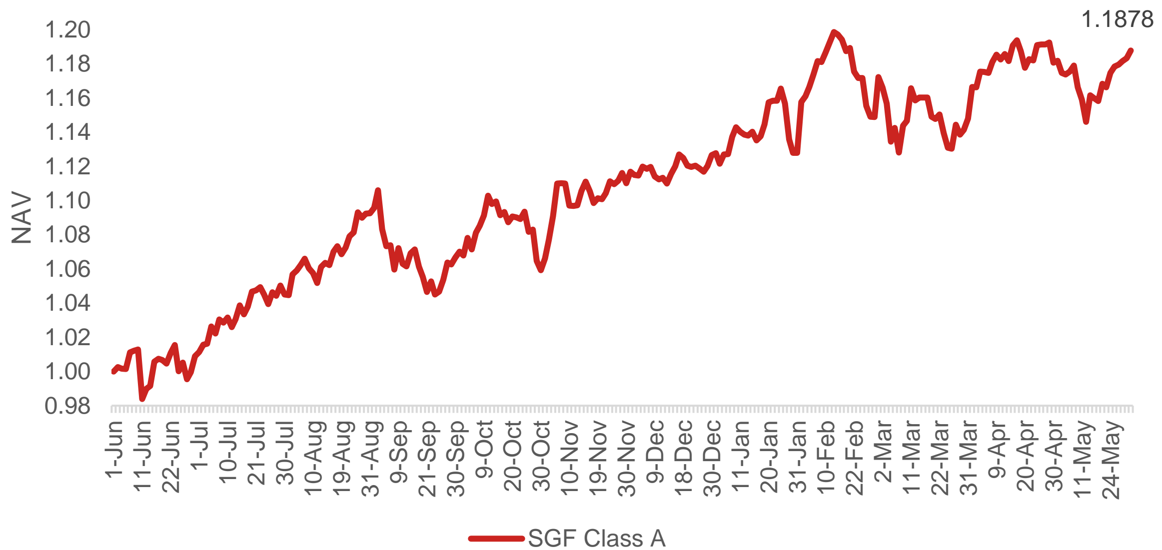
Global Strategic Thoughts #17

NOMURA

Nomura Global Shariah Strategic Growth Fund (SGF)

Dear SGF investors and friends,

This month marks the 1 year anniversary of SGF (fund was launched on the 2nd of June 2020). First and foremost, I would like to thank all the investors who have embarked on this investment journey with us. Before I start with the usual commentary, I would like to share the performance of SGF Class A over its first 12 months. Class A total return for the first 12 months (2nd june 20 to 1st june 20) = **+18.78%**



As we approach the mid-point of this year, it would be a good time to take a step back and review the fund and market performance this year to date and how our strategy is changing into the next half of 2021.
Avid readers of our SGF letters would be familiar with the analogy that was drawn last November, about flying through some turbulence. A short extract is shown below.

"*Simply put, think this could be a good opportunity to add more exposure to Global Equities into FY21, Doing so on any pullbacks from here, would of course be ideal.*

Flight Path Redux: As such, our strategy has shifted to increase our equity exposures significantly into the year end. Having brought down equity exposure slightly as the market hit an all-time high, we are once again looking to add back exposure, which will accelerate if we do hit any dips in the market.

(Source: Canva)

"*The most beautiful skies comes after the worst of storms*"
From SGF Letter #9

Expertise to Exceed

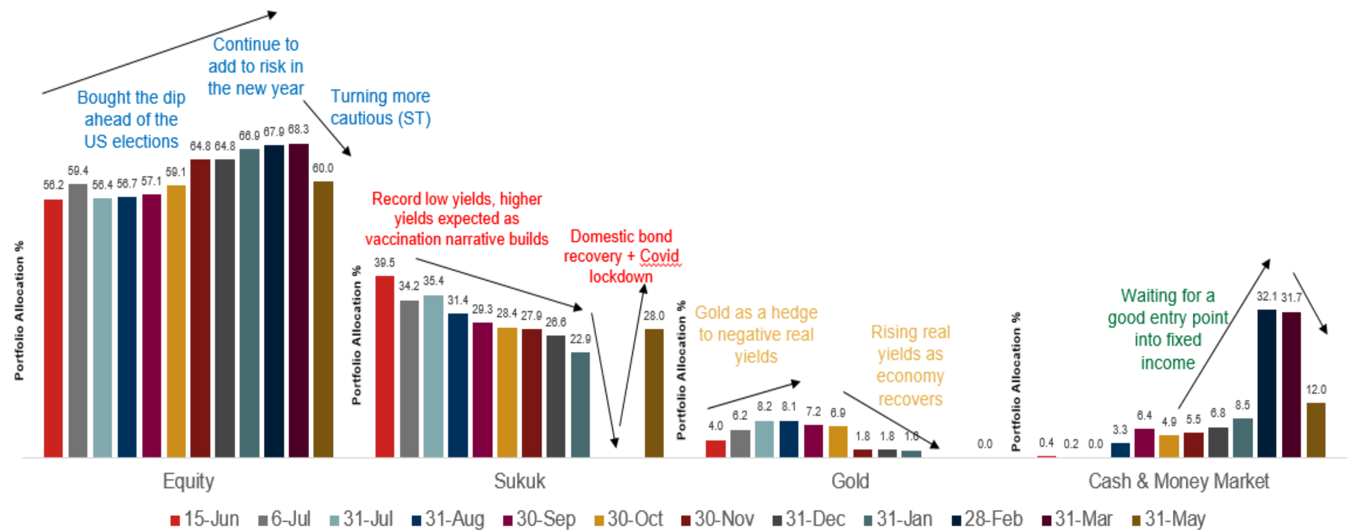
It would seem that our predictions of a turbulent or volatile market did turn to reality. A quick glance at the funds' performance chart this year evidences this. As we transition into the second half of this year, we lay to rest the turbulence analogy as it would seem that we have reached our "destination" (New York JFK if memory serves me). Post landing checks a.k.a. the performance of the fund, for the **year to date to 31st of May** is shown below.

- SGF Class A = +4.92%
- SGF Class B = +4.79%

From here, we are shifting gears slightly into the seasonally quieter summer months. Not because of the headline grabbing "sell in May and go away" but because short term indicators signals to us that the market is overbought in the near term. In other words, it would be difficult to get incremental buyers into this market hence risk reward near term may not be as favourable. As such we have reduced our equity exposure (a barometer of risk taking) by c10% to 60% of the portfolio, as we wait for better entry points. The catalyst for the next leg for the market (whether higher or lower) would be the Federal Reserve's announcement on taper (ending QE) in late August, likely at the Jackson Hole event. Our portfolio strategy is likely to change again as we get closer to the event date and as the narratives in the market becomes clearer.

Portfolio Allocation Mid-Year Review

To give investors a clearer view as to what we have done in terms of the funds allocation, we show the chart below that tracks the allocation to the different risk assets over time.



Equity – "Risk On" asset class

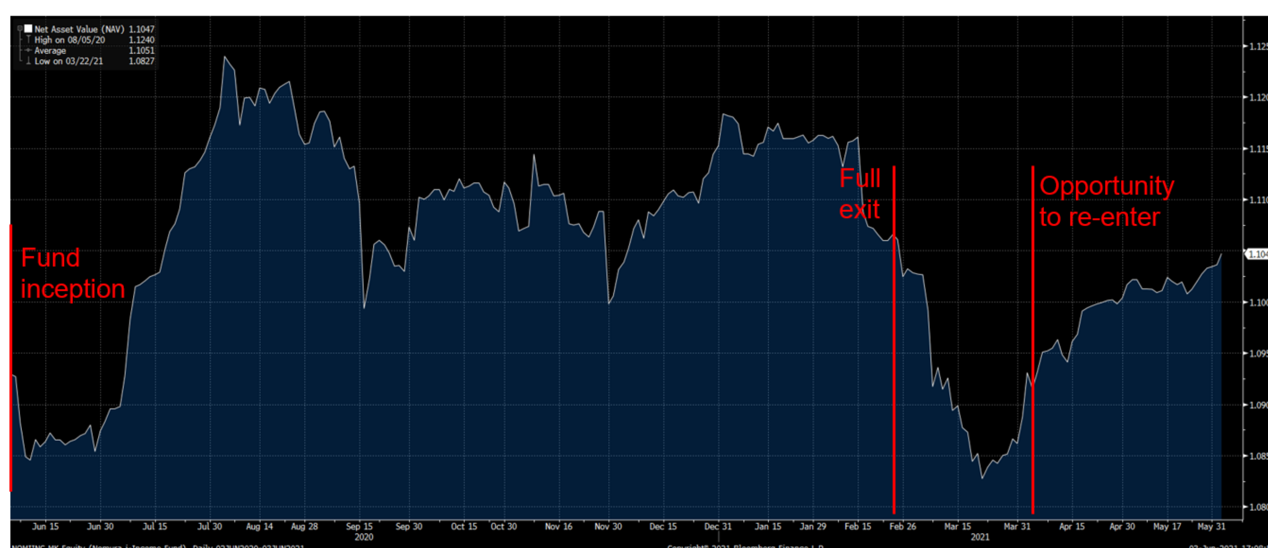
As mentioned in our analogy, we decided to increase the risk taken in the fund at the back end of last year. Hence the allocation to equities was increased starting from November last year, and more so into this 2021. With the markets continuing to make new highs this year, we believe this strategy was indeed the right one. Note that the Equity allocation peaked at c70% of the portfolio. The Equity allocation trend is shown by the columns on the left in the chart above.

At the end of April, we started to bring down our equity exposure and by the first few days in May, equity allocation was down to c60% of the portfolio. This reduction in risk taking in the portfolio aligns with our more defensive view in the near term. Our strategy now is to buy meaningful dips in the market as the outlook into the year-end still looks attractive. It's just that tactically, we think that the market needs to work off some of the excess positioning here and some sort of reset (which is expected to be shallow) is likely going to be good for the market.

Sukuk / Fixed Income – "Risk Off" asset class

The chart shows that the allocation to sukuk (via our Nomura i-income fund) has trended down since the launch of the fund and we made a full exit earlier in February this year. US yields were expected to move higher and global yields to follow. As such, the risk reward of owning domestic bonds was not favourable and we waited for a better entry point.

The opportunity to re-enter presented itself in early April as domestic demand started to rise, and we re-allocated into sukuk (via our Nomura i-income fund). Additionally, domestic bonds continued to perform in May as concerns of another Covid lockdown started to rise. We plan to continue to invest in this asset class over the near term and will re-assess as we get closer to the potential taper announcement by the Federal Reserve in the fall. Chart below shows the performance of our Nomura i-income fund and the points of our exit and re-entry.



Cash and Money Markets

We continue to hold a relatively high allocation in cash of c12%, as we wait to increase our risk exposure via our equities book.

Gold

The fund does not currently hold any investments in Gold. With real rates likely to move higher as the gap between nominal yields and inflation breakeven narrows (usually with nominal yields moving higher), it would be difficult for gold to outperform, as it has a negative correlation to real yields. In other words, gold is a good inflation hedge, however, it tends to work best in a risk off environment. With vaccination and global recovery underway, we are in a general "risk on" mode, which makes it difficult for gold to outperform. We view Gold as a "hedge" asset and we will only own it at specific times in the market where we think it can serve its purposes of hedging against market risks.

Foreign Exchange Derivatives

As ringgit investors investing in foreign currency assets i.e. global equities, we are exposed to FX risks, which can beneficial at times (when ringgit weakens) or could be a headwind for returns (when ringgit strengthens). By entering into FX forward contracts (a type of derivative), we are able to hedge the FX risks, i.e. not suffer a loss caused by FX if the ringgit were to strengthen. We continue to apply this hedge throughout the year but at differing degrees, depending on our views on FX – as discussed in previous letters.

Dynamic Asset Allocation

We hope that the commentary above gives investors some insights to the inner working of SGF's dynamic asset allocation over the past 12 months as well as how we are positioned for the next half of 2021.

Depending on our view of the market and the outlooks of the different asset classes, we perform the asset allocation on behalf of our investors, who may not have sufficient time. The hope is of course, that our actions would optimise investors long term returns.

Final Words

Thank you again to our investors and friends of SGF for your trust and for helping us reach our first anniversary. In keeping with our promise to deliver full transparency with our investors, we hope this edition of the Global Strategic Thoughts finds you in good health. Thank you for investing with SGF.

Sincerely,

Hisham Hamzah

For investors who want a technical explanation on what to expect over the next few months, I've included a detailed view below.

Near Term Outlook (Summer)

We are likely to see a push and pull between growth and policy. Markets are getting concerned about higher inflation, and whether it is transitory or permanent. Some investors and the Federal reserve believes that we should not worry much about inflation as it is transitory, i.e. because of Covid related supply chain issues combined with a strong recovery in demand from the reopening of the economy, prices will be squeezed higher for a short period. However, as supply chains and demand normalizes, we inflation will start to cool. There are other investors who believe that we are in an inflection point for inflation. After decades of low and falling inflation, we are at a point where globalization has peaked (therefore imported deflation will be less) and $2.3 trillion of accumulated consumer savings from the pandemic would drive pent up demand and prolonged growth in consumer spending, which would lead to higher inflation.

My sense right now is that inflation is likely to be higher than where it was pre pandemic, however it is unlikely to be “runaway” inflation. i.e. medium term inflation will be positive but closer to the Fed’s target rate of 2%, not 3-5%. Few reasons for this. 1) Tech led deflation has not gone away, if anything, digital adoption will likely accelerate post pandemic. 2) Yes consumer savings are high, but it might not come down as quickly given the mix or inequality of savings. 3) The Japan experience shows us that it is not easy for inflation to be sustainably high in a developed economy. Even though unemployment was low, wage inflation was not high and private sector savings remains high.

That said, as the debate continues with inflation and employment data published over the next 3 months, we could see knee-jerk reactions in the market, similar to the one we saw in May, when the April CPI print came in significantly ahead of expectations.

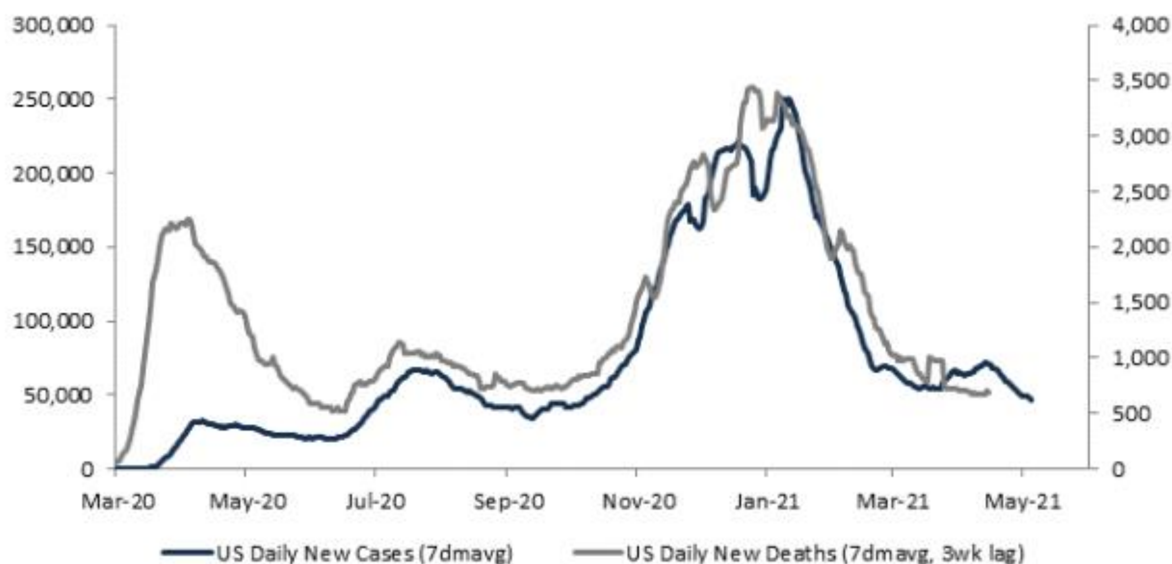
Because of this growth policy debate, we take a more defensive view over the next 2-3 months. Combined with the near term indicators suggesting that the market remains overbought and positioning and leverage at all-time highs, being tactically defensive here makes sense. However, given that the set up for the second half of the year is still attractive, we refrain from taking down the equity allocation by a significant amount, as the current view is any selloffs in the market is likely to be shallow dips.

Mid Term Outlook

In summary, we still think the equity market is likely to move higher sometime at the back half of this year, driven by ample liquidity, higher bonds yields making equities the better alternative, and the Fed keeping rates lower for longer (i.e. taper talks likely to start sometime near the fall but no rate lift off this year). That said, we do think that some caution is warranted in the near term given strong performance in recent months and markets are looking technically overbought.

There are 3 key drivers for the market at the moment.

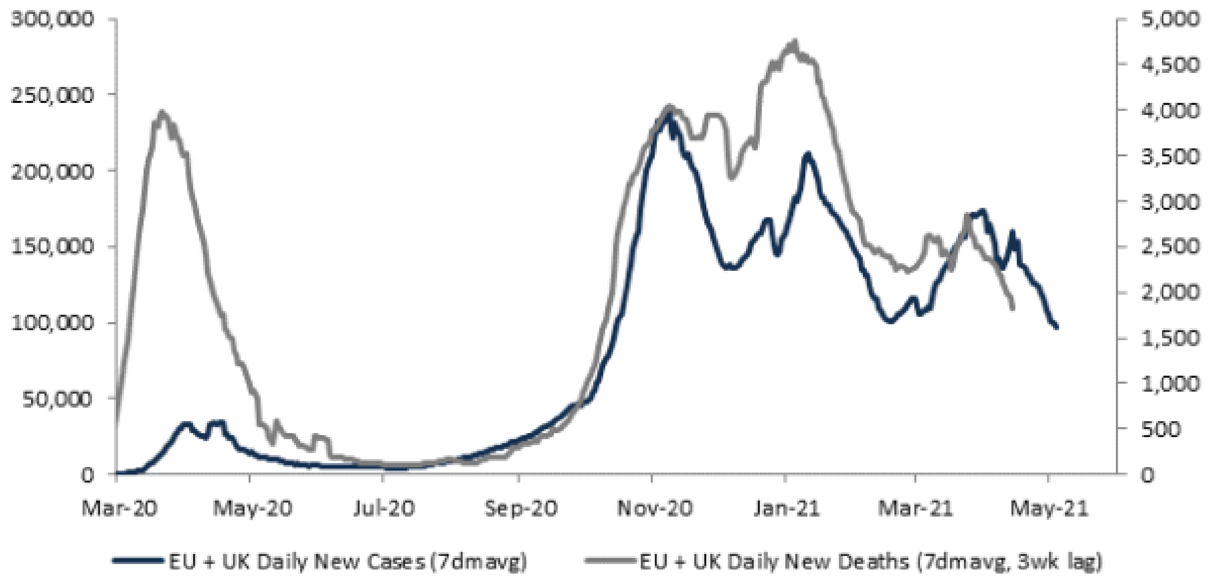
1) Pandemic Developments – Regional Allocation Considerations



Source: Evercore ISI Research

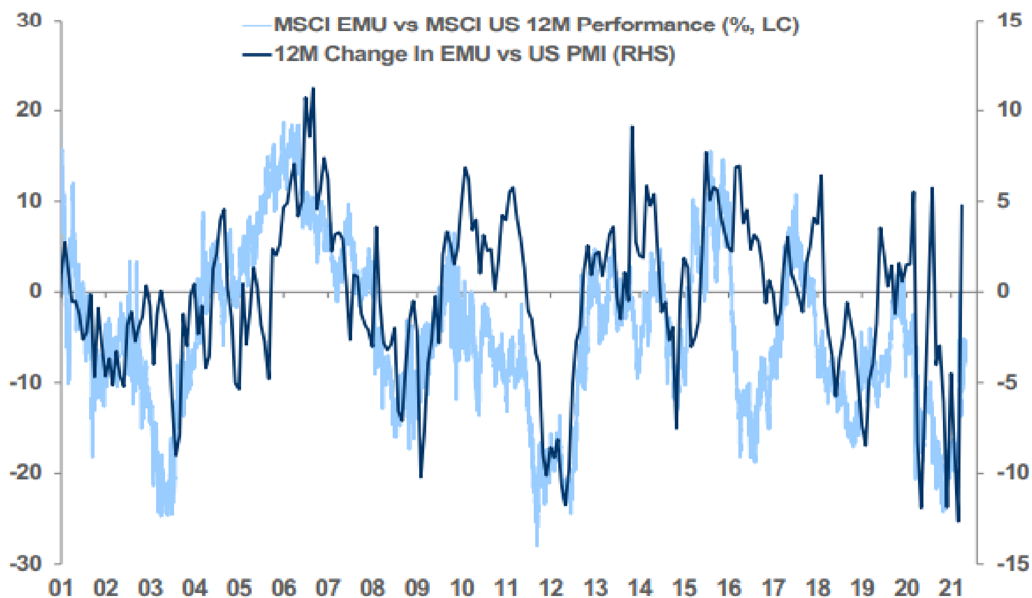
Cases in the US have started to roll off as the pace of vaccination has surprised positively with the new Biden administration. We think that the US economy should re-open successfully in the summer as herd immunity is achieved and the warmer weather should help with transmission rates. Mobility has been improving and we expect this to continue.

Some delays in the vaccination rollout in Europe has led to renewed lock downs and concerns but looks like things are back on track right now. As such, Europe is likely to follow the path of US re-opening, with perhaps a 2-3 month delay.



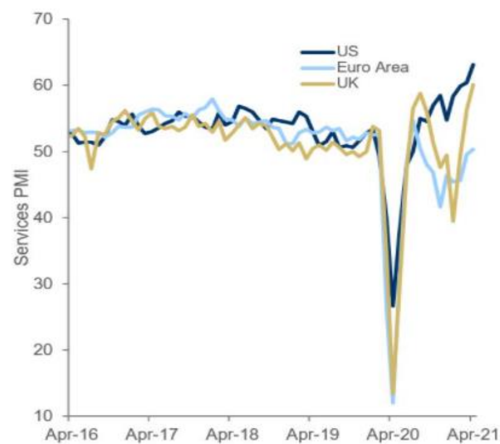
Source: Evercore ISI Research

We think of this as the passing of the baton. US economic data has been strong and is expected to continue to be strong in May (likely the peak either this month or next). As such, we are likely to see the same wave of strong economic data for Europe next. As such, it is likely that Europe can outperform the US markets for the 2nd half of this year. The chart below shows that Europe tends to outperform the US when the PMI starts to outperform as well. Additionally, the EU Recovery Fund starting in H2 is likely to further contribute the strength of the recovery.



Source: MSCI, Haver, Morgan Stanley Research

As such, we have made some small changes in the portfolio with regards to this. First to shift some allocation to Europe and to increase exposure to the service sectors in Europe that would benefit from the re-opening. At the same time, we are taking some profits on the European capital goods sector, which has done well and valuations are no longer cheap. The chart below shows that whilst manufacturing PMI in Europe has recovered, Service PMIs still lag. Hence our focus on the services sector (Caterers, Offices, Leisure, Restaurants and Retail).



Source: Haver, Markit, Morgan Stanley Research

2) Easy Monetary Policy remains

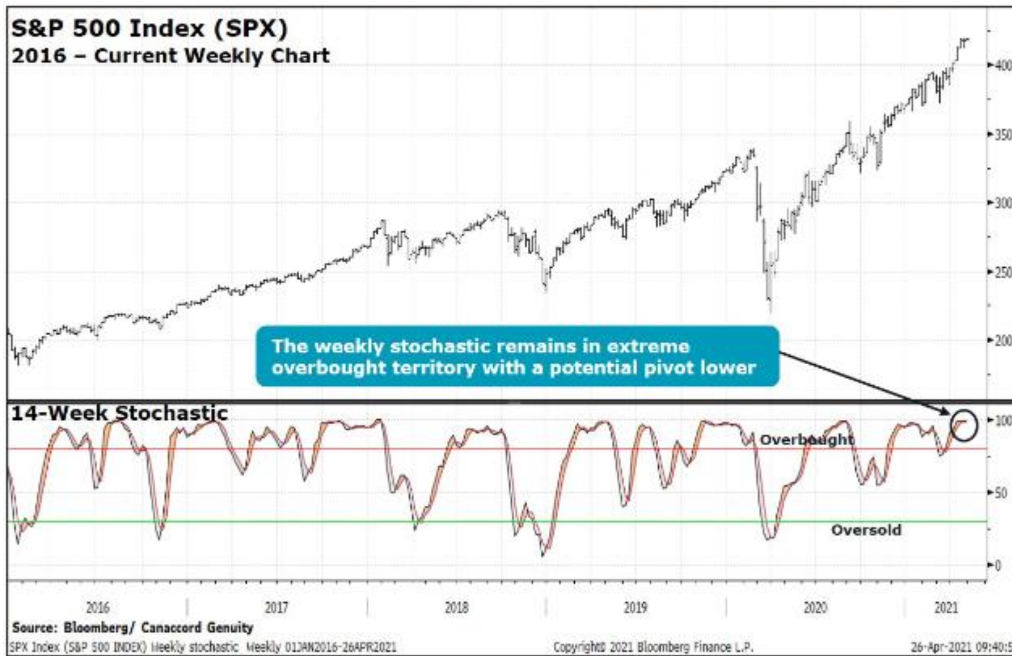
We are not expecting Fed to start tapering this year, but start to communicate taper sometime in the fall. As such, rates should remain lower for longer and the backdrop for monetary policy remains easy. Recent Fiscal stimulus plans should be a benefit but is likely to be offset by tax increases, both on the corporate level and on personal income. Even though we expect the tax increases to be watered down given insufficient support for a majority at the Senate, it should still lead to mid-single digit headwinds to earnings growth next year. More importantly, despite the increase in taxes, US EPS is still likely to be up mid to high single digits next year. So long as the yields do not increase significantly above what market is expecting (somewhere in the 1.9% to 2% range by year end), the set up for equities into FY22 should still be favourable.

Developments on taper and tax increases is likely another contributing factor on why Europe can outperform the US in the 2nd half, given that the ECB is further behind the Fed on rising rates and Europe does not have a tax headwind.

3) Market Positioning – Near Term Overbought

At this stage, all sentiment or short term indicators are likely going to show that the market is currently overbought, having gone up close to 10% this year.

Figure 1: SPX weekly stochastic in extreme overbought with potential pivot



A short term correction should not come to a big surprise, given various instances in the past as shown in the charts below. Think market could trade sideways or perhaps consolidate some here as we enter into a seasonally quieter summer period.

Figure 1: The "Dot-com crisis" market recovery

Figure 2: The "Great Financial Crisis" market recovery

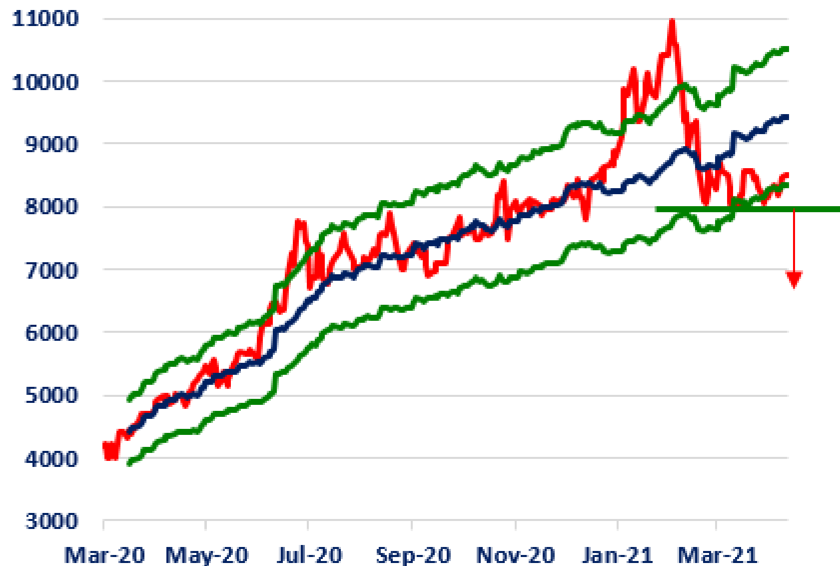
More importantly, we do think that any dips are likely bought, absent of new market narratives. According to JP Morgan's Prime Brokerage data, market positioning is no longer as stretched as it was in April. Q1 earnings season saw one of the strongest upside surprises yet price action was very weak as hedge funds and active fund managers pared back risk, more so within the technology sector.

4) Market Positioning - China / EM for H2

From an attribution perspective, the portfolios allocation to EM or China specifically has been a drag to performance this year. MSCI China and HSTECH, a proxy for China Internet stocks have lagged behind MSCI ACWI. Whilst the analysis on why this is can be rather difficult to pin down, majority of market observers would point to the reversal in mutual fund inflows from China. In September to December last year, domestic China mutual fund sales was running at $25bn per month, peaking at $58bn in January this year (before Chinese New Year). However a change in the Government tone on support for the equity market (indirectly liquidity) triggered the selloff, with the net inflow falling to $4.4bn in April.

We think the worst could be over and on shore new money flows should get better from here. Despite the strong EPS beats vs. consensus, the China markets remain close to the lower bound of the trading range, measured by central bank liquidity (See chart for HSTECH below).

Chart 2: HSTECH At Cheap End Of Band But Can Overshoot



Source: Citi Trading Strategies

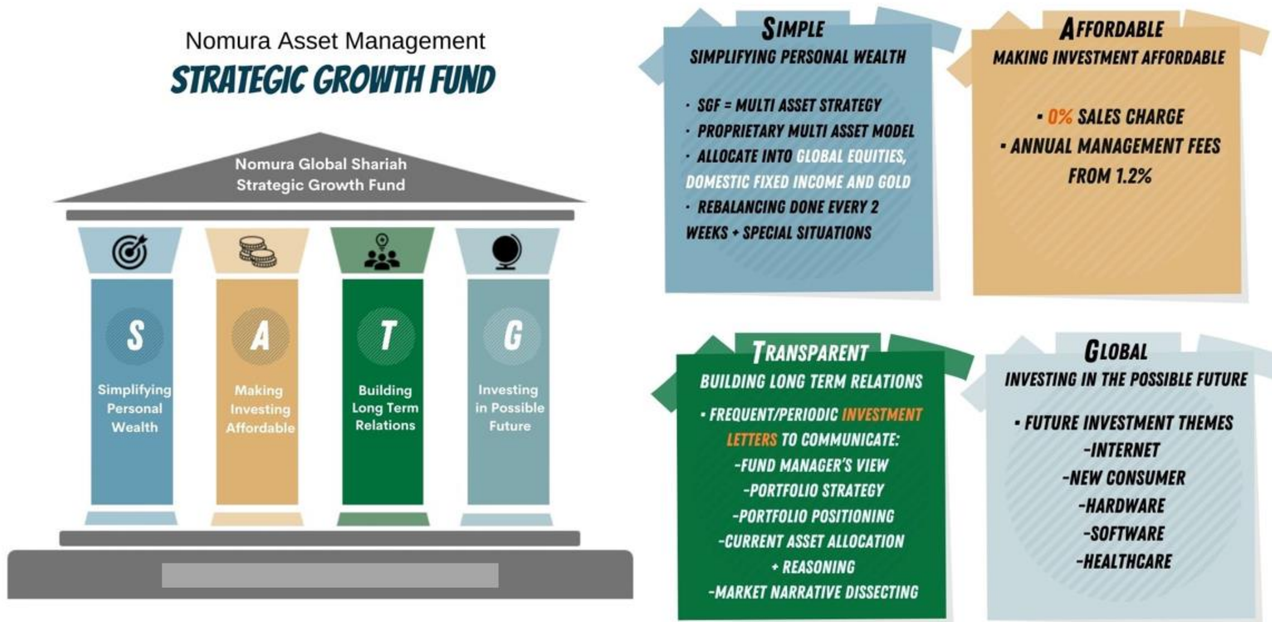
Moreover, the reversal in flows coincided with heightened anti-monopoly regulatory concerns, which are starting to come to conclusion, with Ali Baba already fined and the remaining e-commerce players pledging compliance to the new rules. We think that over the next few months, investigations on Food Delivery company Meituan and reviews on the Fintech arm of Tencent is likely to conclude, ahead of the 100 year Party Anniversary of the Communist Party.

Risk reward starts to look very attractive here, as further declines in the China market is likely going to see the government step in for support. This has historically been decisive turning points in the market.

Additionally, if we take the analogy above on the baton passing, after the recovery in Europe, Emerging Markets is going to be next. Whilst the pandemic development is mixed right now in EM, with India getting worse, Brazil and Turkey off the highs but countries like Singapore faring better, as vaccination rolls out progresses and supply of vaccines continue to improve, EM recovery should follow the developed markets. This should be supportive for the China Internet companies where the portfolio continues to maintain an exposure to.

Sincerely,

Hisham Hamzah



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