LC Monthly Investment Memo: May 2021

Sell in May and go away. This is once again proven to be the right strategy, especially for speculative assets. As an illustration, Bitcoin has retraced more than 20,000 pts, from 56,814 pts on 30th April to 35,320 pts on 24th May, due to "legitimate" concerns raised by Elon Musk on Bitcoin's high energy consumption equating to Switzerland's consumption in one year. A coincidental crackdown on digital coins signaled by the Chinese regulators last week also added pressure on cryptocurrencies prices.

Graph 1: Bitcoin Price (USD) since December 2019

Source: Bloomberg

Interestingly, what should have been an isolated phenomenon in the world of digital coins has spread to other asset classes. In the commodity space, Lumber, which doubled in price year-to-date (from 873pts on 4th January to 1711pts on 10th May), tumbled 30% (10th May to 19th May) before settling around 1450 pts. On the equities front, Ark Innovation ETF, which focuses on innovative disruption (i.e. fast-growth, loss-making companies) which quadrupled its performance between March 2020 and February 2021, also fell by 12% month-to-date (as of 24th May), trading 34% below its peak in February, primarily driven by the general market sell-off.

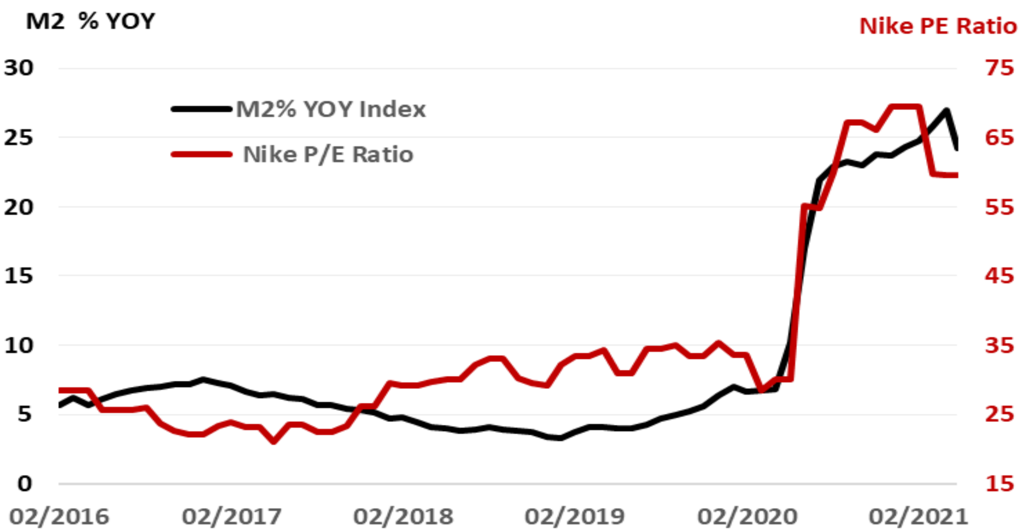
Graph 2: Ark Innovation ETF (USD) since December 2019

Source: Bloomberg

As explained in the previous investment memo, the surge in valuations across all asset classes is a function of loose monetary policy by central banks around the world. Since we believe most valuations have been artificially inflated by excess liquidity, we welcome the current correction on speculative assets, as it probably would reduce the possibility of an eventual market crash. As central banks' policy focuses on inflation and unemployment, we consider their main challenge for the coming quarters is a timely and effective tapering without having a major negative impact on risk assets.

As an illustration, Nike P/E ratio traditionally trades around 30x, it has increased more than double in Q2 2020 to 72x, which coincides with the 20% growth in M2 (measure of the money supply that includes cash, checking deposits, and easily convertible near money) over the same period. Since the same pattern is observed for other asset classes (equities, bonds, commodities, cryptos), we believe current prices are often not justified and ultimately not sustainable.

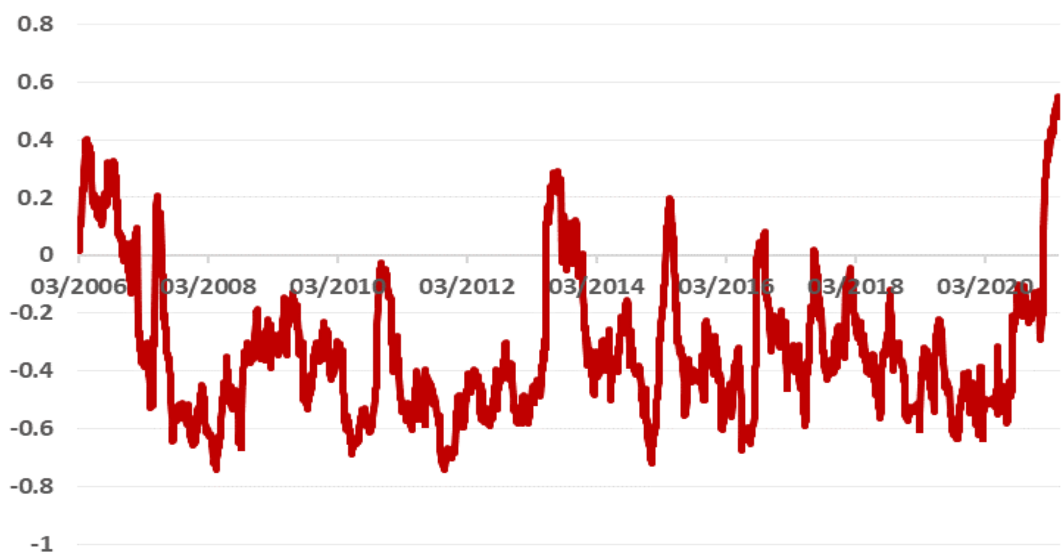
Graph 3: Comparison between Nike Price-to-Earnings Ratio and M2 in the USA since 2016



Source: Bloomberg

What was a necessary short-term fix to prevent a financial meltdown during the Covid-19 crisis has been considered a “Fed put” by speculators, i.e. an implicit guarantee that central banks would do whatever it takes to prevent deflation. In our opinion, this is alarming for investors who have not noticed that correlation amongst asset classes have drastically changed. As an example, with reference to Graph 4 below, the 60-day rolling correlation between US equities (S&P 500) and US treasuries, historically in the negative territory at -0.35, has inverted and is now at +0.48 - a level never seen over the last 15 years!

Graph 4: 60 Day Correlation between S&P 500 index and 10-year Treasury Futures since 2006



Source: Bloomberg

Treasuries also seemed to have lost their longstanding role as portfolio insurance since it has become positively correlated with equities as the inflation narrative has emerged as a key investment theme in 2021. Many US employers are reporting labor shortages despite raising wages, which is a clear indication of a tight labor market, not a loose one. US employers only added 266,000 jobs in April 2021, far below the 916,000 (nonfarm payrolls) registered in March 2021. To crown it all, excess liquidity has obliged commercial banks to start returning cash to the central banks. As an illustration, reverse repo transactions at the Fed are now accounting for $400bn (*Source: US Federal Reserve*), a level last seen in 2017. Once again this is not an indication of liquidity scarcity but rather too much of it.

With a cyclically adjusted P/E of 37x for the S&P 500 (*Source: Yale University, Robert Shiller*), US equities have never been this expensive over the last century, except during the dot.com bubble (1999-2000). We reiterate our view that the excess liquidity is distorting financial markets and have led to multiple bubbles. If history is of any guide, rising rates are likely to be the trigger for the next market correction. Should the Fed be right, and inflation being temporary, then exuberant valuations could remain the norm for an extended period. Otherwise, the correction could happen sooner than many investors predict.

As uncertainties remain around valuations, holding a diversified portfolio would be the wiser approach in reducing the downside risk should market corrects more extensively. In our view, strategies with low correlation to equities, such as relative value and trade finance, should have a higher allocation, while equity and bond strategies with deep, fundamental approach and have exhibited track record across past market cycles should be preferred over a more trading-oriented strategies especially in a market environment where irrationality prevails.

Yours Faithfully,

The Lighthouse Canton Team