Silverdale Fund Management

PROUDLY FROM SINGAPORE

Silverdale Funds

EMERGING MARKETS | USD BONDS | ASIA TILT

Helicopter View

November 2022 was one of the best months for fixed income markets in past 35 years with Silverdale Funds out-performing most of the relevant indices. Positive market sentiment was driven by the trilogy of Fed's expected slowing down of rate hikes, China's change in policy tone, and Ukraine issue taking back-seat.

Peak Inflation & Slowing Rate Hikes

October'22 witnessed further slowing down of Headline Inflation from peak of 9.1% (in June'22) to 7.7% (against est. of 8%) with Core Inflation at 6.3% (est. 6.5%).

The markets celebrated the positive CPI surprise with 3-year treasury yields falling by 24 bps in Nov'22 to 4.20% and 10- year treasury down by 37 bps to 3.68%. The markets are now pricing Fed to slow the pace of rate hikes starting from next month with peak Fed rate of circa 5% in 1H-2023.

Looking ahead

The largest component of Core Inflation is Shelter (c. 32% weight), which is expected to remain firm into 2023 because the way it is constructed (the sample data is collected only every 6 months) hence lags rents by about 8 months). However, stripping out Shelter, Core CPI fell 0.10% month-on-month in October 2022 (first decline since May 2020).

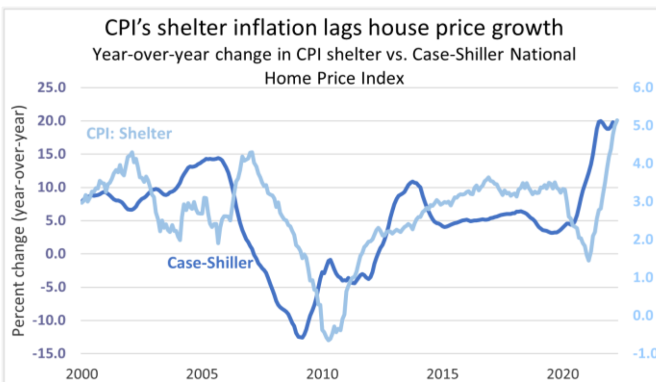

Figure-1 CPI's shelter component lags housing market indicators[1]

Further, the money supply (M2) has also slowed down significantly at levels consistent with 2% inflation, albeit with marginal increase in money velocity.

Figure-2 US Money Supply decreased 1.5% over the last 7 months[2]

The strong dollar making imported goods 'cheaper' and the base effect of elevated Core CPI (almost 0.6% month-on-month during Oct'21 - Feb'22) will provide headwinds to current Core CPI figures.

Labour market showing signs of cooling

Labour market is cooling down with 3-month average non-farm payroll addition dropping from 600k (Q1-2022) to 280k (Oct 2022). However, in the past 16 Fed rate hiking cycles since 1954, the average unemployment rate at the time of Fed's last rate hike has been about 5.7% (currently, 3.7%). *Hence, the ride to normalcy is likely to be longer than usually expected.*

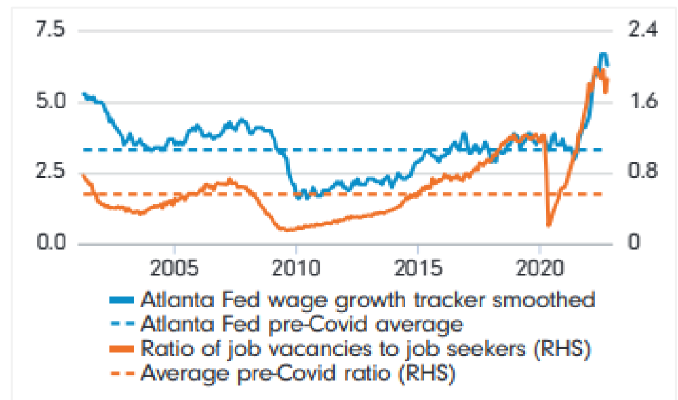

Figure-3: Job market and wages have peaked but remain elevated[3]

Consumer & Corporate remain strong

Household debt service ratio (debt-to-disposable income) is near historic lows; read with robust corporate fundamentals (*see* Silverdale October 2022 Commentary), the default rates are low and are likely to remain lower than previous rate hike peaks.

[1] Source: Bureau of Labor Statistics; S&P Cash-Shiller
[2] Source: Compound Capital Advisor
[3] Source: Fidelity Asia

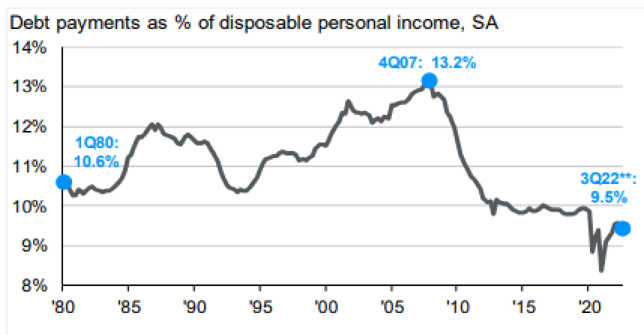

Figure-4: Household debt service ratio[4]

China: Change in policy

On 11/11, China announced 16-point comprehensive plan to support property sector and then backed it up by almost CNY 1 trillion of bazooka credit lines and cutting of bank reserve requirements (RRR) by 25 bps. Additionally, China started relaxing its ZCP (Zero Covid Policy) by avoiding the wholesale city-wide shutdowns while preparing for expected surge in Covid cases (targeting 10% of hospital beds to be ICU beds). The markets cheered the move with Shanghai index up circa 7% and China HY USD Bond Index up about 15% MTD.

With reopening, China reported highest ever Covid cases, while still low at cumulative rate of 0.02% as against global average of 8.1%. This is likely to be followed by a sentimentally bad surge in mortalities. *Hence, China re-opening is likely to be slow and bumpy.*

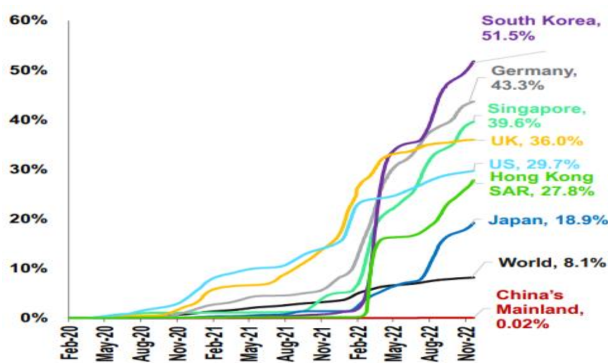

Figure-5: China's cumulative infection rate is very low[5]

Nov'22 Performance: Out-performance

As the tides started turning, the quality and resilience of Silverdale portfolios shone. For November 2022, the Bloomberg Emerging Markets Asia USD Corporate Total Return Index was up by about 6.8% (YTD -19.1%); while our flagship Silverdale Bond Fund NAV increased by 7.49% (YTD -22.3%) and various fixed maturity funds increased between +2.5% to 7.7%.

The Takeaway: Goodbye TINA, welcome BOB

Since 2009, 91%[6] of the time, the Fed rates were below 2%, as a result the investors has to accept TINA (There Is No Alternative) and embrace riskier assets. Currently, the bond yields are higher than S&P Equity Dividend yield. Hence, savvy investors are calling on BOB (Bring on Bonds) resulting in one of the highest inflows into US bonds in Oct'22.

In 2023, as market focus shifts from economics of rate hikes to politics of rate hikes (govt treasury bearing the MTM losses and interest burden) and as recession starts biting, the fixed income asset class will outshine other asset classes (see Silverdale August Commentary)

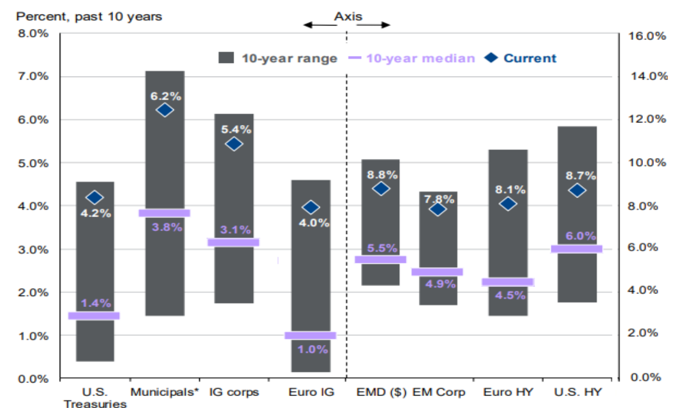

Figure-6: Yield-to-worst across fixed income sectors[7]

Our flagship Silverdale Bond Fund (SBF), continues to be positioned to take advantage of high carry offered by quality bonds, with 76% high quality Investment Grade bonds, duration of 1.57 years; yet, providing leveraged YTM of 18%, pointing to higher potential returns to investors. FMP2026 points to low double-digit net leveraged returns, and FMP August2024 targeting high single digit net leveraged returns.

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[4] Source: JPMorgan Research
[5] Source: Standard Chartered Research
[6] Source: Edward Jones Investments
[7] Source: Bloomberg, JPMorgan Research