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2019 MARKET OUTLOOK

A RITE OF PASSAGE INTO A MULTIPOLAR WORLD

BY VIRGINIE MAISONNEUVE

Virginie Maisonneuve is the Chief Investment Officer overseeing all asset classes at Eastspring Investments. Below she discusses the three factors which will likely shape the investment landscape in 2019.

2018 was a challenging year for investors. A stronger US dollar led to heavy selling across Emerging Markets; political volatility unnerved investors and asset markets repriced to take into account rising interest rates. The global economy experienced significant currency volatility, as well as a de-synchronisation of growth between the US and the rest of the world.

The reach of the US political agenda into trade dampened growth expectations in several trade dependent regions including Asia and Europe. The China-US trade dispute notably puts the two largest global powers at the table of a difficult negotiation.

In 2019, three factors will likely shape the investment environment. Each could have a major impact on asset markets as they could trigger a shift in market leadership. The factors are:

- A peak in US interest rates (which has implications for the US dollar);
- A re-synchronisation of global growth;
- The ongoing trade war between the US and China ('Clash of the Titans').

In addition, long-term trends such as climate change, sustainability, and artificial intelligence (AI) seem on track to grow in importance also reshaping the investment landscape.

In short, 2019 could easily be a transition year marking the start of a new era in the post Global Financial Crisis world.

A PEAK IN US INTEREST RATES

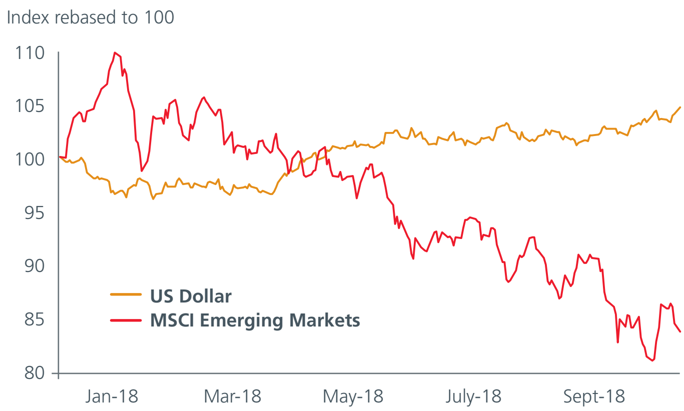
The US equity market outperformed in 2018 as benefits from tax cuts and share buy-backs contributed significantly to corporate earnings growth. On the other hand, US interest rate normalisation led to a stronger US dollar, which in turn weighed on the Emerging Markets (See Fig.1).

This normalisation, combined with changes in US tax rules on offshore profit repatriation, also created a tight offshore dollar lending environment.

Looking into 2019, the market is facing an important inflection point either when the Federal Reserve (Fed) signals that it has tightened sufficiently or when investors start anticipating the end of the US interest rate cycle.

When this happens, the US dollar – relative to other major currencies – should stabilise and even weaken, if the economic environment in the rest of the world remains stable. This would challenge consensus investment positioning possibly as early as the first half of 2019.

Fig. 1: A stronger US dollar is associated with selling in Emerging Market equities[1]



A RE-SYNCHRONISATION OF THE GLOBAL ECONOMY

A re-synchronisation of global growth is likely in 2019 as the US economy slows. A 'hybrid' congress in the US will likely find it difficult to agree on either massive infrastructure programmes or new tax cuts.

As the impact of the 2018's tax cuts fades, we are likely to see softer yet still healthy US economic growth. Outside the US, China and Europe are expected to slow, although at a moderate pace (See Fig.2).

For China, the slowing economy has already spurred a series of accommodative measures to help support GDP growth at around 6%. Such measures, historically, have been supportive of Emerging Market performance.

In 2019, the major central banks will likely shift from quantitative easing (QE) to quantitative tightening (QT). The combined balance sheets of the Fed, the Bank of Japan (BoJ), the European Central Bank (ECB), and the Bank of England (BoE), are expected to shrink by 4% by end 2020.

Although QT is an important development and a source of volatility for asset markets, the tightening process is expected to be gradual and liquidity will likely remain sufficient.

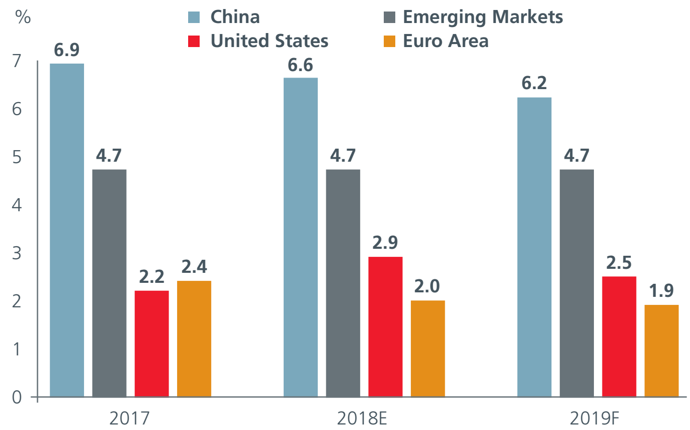
TRADE WAR: 'CLASH OF THE TITANS'

The trade war between China and the US is important to investors given its potential impact on global trade and, in turn, global economic growth. This war, we believe, will have varying degrees of impact on Asia.

That said, its true impact will likely be revealed in 2019 and may not be all negative. There may be, for example, a redistribution of trade and investment activities throughout the region, potentially benefiting the technology sectors in Taiwan and Korea, as well as the manufacturing companies in Malaysia and Vietnam.

In addition, the 'Clash of the Titans', we believe, may accelerate China's efforts to reshape its domestic economy and increase its commitment to open its domestic markets. This would reflect a maturing of China's economic development.

Fig. 2: US economic growth to slow in 2019[2]



Since the beginning of the trade war, China has lowered import tariffs, which will make US products cheaper for Chinese consumers and companies. Furthermore, China seems unlikely to retreat from its policy of raising its technology profile, potentially differentiating itself from the US.

It is very interesting, for example, to note that the Shanghai Stock Exchange, in November 2018, announced that it will set up a science and technology innovation board with a pilot registration process. This new trading platform should make it easier for Chinese high-tech companies to access funding[3].

We believe that technology is very much at the heart of this ongoing 'Clash of the Titans'. Given the rise of China's economic power, the trade war is representative of today's multipolar world and an acknowledgement of China's importance.

China's GDP today, in purchasing-power-parity terms[4], is 120% of that of the US. The trade war is a competitive race of sorts between the two largest world powers. This is likely to have an impact on access to technology and marginal competitiveness in the next global 'race' of technology and AI.

Given its ambition to be an AI world leader by 2030, China has developed rapidly in this field, and is creating a new world order with the US (as discussed in my previous article 'Geopolitical Darwinism in the Age of Artificial Intelligence').

In such a dynamic world, investors cannot afford to ignore the impact of AI. This ongoing trade war goes beyond trade. Its economic consequences will be very important to investors.

CLIMATE CHANGE AND SUSTAINABILITY

Long-term themes such as environmental, social and governance (ESG) should continue to make inroads in 2019. As the impact of climate change becomes more pronounced and regulations evolve, companies' environmental awareness will likely increase, as the associated risks become clearer.

With millennials growing their marginal share of the investor wallet, sustainable/ESG investing will increasingly be in the spotlight. Technology again will be an enabler – providing greater transparency – and a determinant in resolving ESG-related issues by helping raise energy efficiency, productivity and more. This will likely challenge executive management teams on their vision and resolve to tackle long-term challenges.

STAY ACTIVE AND AGILE IN 2019

While sustainability – as it continues to reshape the investment environment – will be at the forefront for investors in 2019, the 'rite of passage into a multipolar world' will also be a key feature.

Given the potential shifts in market and currency leadership, and the ongoing 'Clash of the Titans' for economic and technological dominance, volatility clouds the horizon.

Volatility, however, is not a bad thing. According to **Ben Dunn**, our Head of Quantitative Strategies, low volatility strategies thrive in choppy markets.

Ultimately, selected risk assets should stand out as volatility edges higher. Exposure in selected Asian equities and fixed income can provide attractive returns in 2019. In a slower growth environment, investors should need to pay closer attention to valuations. As such, investors could also include contrarian value equity strategies in their portfolios.

An active allocation to different asset classes and styles holds the key to more efficient diversification and superior risk-adjusted returns. Investors can diversify by combining factors that are relatively uncorrelated with each other. Income and outcome oriented multi asset strategies will be key in helping investors ride through this transition year.

ASIAN INSIGHTS. GLOBAL EXPERTISE.

Navigating dynamic markets requires diverse views and a deep understanding of local nuances.

At Eastspring, the diversity of our investment teams and our culture of open communication bring out high conviction views that underpin our best investment ideas.

We asked our CIOs based in Singapore, China, Indonesia, Malaysia, Korea, Taiwan and Vietnam to share their views for 2019. The following highlights the opportunities and challenges that our CIOs consider to be at the forefront in the new year.

From a multi asset perspective, **Kelvin Blacklock** (CIO, Global Asset Allocation) and **Colin Graham** (CIO, Multi Asset Solutions), expect a positive environment for risk assets in 2019; higher volatility will unlikely derail asset markets. Both CIOs are overweight US equities and US high yield bonds, as corporate earnings remain supportive. Asian high yields which trade at attractive valuations are on Colin's radar. Both Kelvin and Colin are cautious about Europe and the Emerging Markets.

Value stocks have finally turned in the third quarter of 2018 after a difficult period starting end 2016. The turnaround presents more opportunities for **Kevin Gibson** (CIO, Value Equities). He is finding value opportunities in Asian financials given their attractive valuations and healthy capital ratios. He remains cautious on Japan in general but sees attractive opportunities from a bottom-up perspective.

Low Guan Yi (CIO, Fixed Income) believes that Asian high yields are oversold as the broad fundamentals have not deteriorated. She is, however, avoiding those Chinese property companies that are aggressively expanding their land banks despite tightening credit conditions. For currencies, she expects the Indonesian Rupiah and Indian Rupee to outperform.

FROM THE GROUND UP

At the country-wide level, our country CIOs provide not only their local expertise but also unique perspectives, which are crucial to our global investment decision making.

For example, the Chinese government has begun implementing easing measures, such as tax cuts, to limit the downside risks associated with the ongoing trade war.

Based in Shanghai, **Michelle Qi** (CIO, China) sees growth opportunities in the A shares market despite concerns over China's slowing economy. She is focusing on those industry leaders with convincing growth, good earnings visibility and reasonable valuations in the 'new economy' area, including technology, high-end manufacturing, new energy and new consumption areas.

Elsewhere in Asia, **Ari Pitoyo** (CIO, Indonesia) prefers Indonesian bonds over equities. With a yield of 8%, Indonesia's 10-year government bond offers an attractive spread over inflation. He notes that Indonesian corporates may face tighter borrowing conditions given the elevated bank loan-to-deposit ratios. Over in Malaysia, **Doreen Choo** (CIO, Malaysia) believes the current account surplus makes the domestic market more resilient; she thinks select consumer staples and oil and gas exporters are likely to stand out. **Simon Liu** (CIO, Taiwan) is cautiously optimistic. With the launch of the next generation of mobile internet connectivity, he prefers to focus on companies in the 5G supply chain.

Woong Park (CIO, Korea), on the other hand, prefers to focus on the more defensive sectors and quality growth equities as earnings and economic momentum decline. Within fixed income, he favours shorter duration bonds as the increasing interest rate gap between the US and Korea will likely put pressure on domestic rates.

While the ongoing China-US trade dispute remains a risk for many Asian economies, **Ngo The Trieu** (CIO, Vietnam) believes Vietnam could benefit if international corporates shift their production facilities out of China. With strong earnings growth, attractive valuations and a stable currency, The Trieu is confident that Vietnam will continue to attract more foreign investor interest.

Sources: [1]Bloomberg, from 29 December 2017 to 12 November 2018. US dollar spot rates are represented by Bloomberg Dollar Spot Index (BBDXY) against euro, Japanese yen, Canadian dollar, British pound, Mexican peso, Australian dollar, Swiss franc, South Korean won, China offshore spot, and Indian rupee. [2]International Monetary Fund | October 2018: World Economic Outlook: Challenges to Steady Growth. E stands for estimate. F stands for forecast. [3]Bloomberg News: China to Create Stock Venue in Shanghai for High-Tech Companies, 5 November 2018, citing the China Securities Regulatory Commission. [4]Gross domestic product (GDP). Purchasing power parity adjusts a country's GDP by relative price basis, hence to measure the actual purchasing power of a country for comparison purposes.

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