Outlook 2019

CIO's Letter

By Jeffrey Lee, MD & CIO of Phillip Capital Management

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Dear Investors,

Here's wishing you a Happy & Prosperous New Year!

A few themes stand out for me amidst this challenging investment environment. First, the withdrawal of liquidity has been a prime catalyst of the market correction. Given the attractive valuations of risk assets, a reversal of these conditions in 2019 may spark a sharp relief rally. Next, as the multi-decade-long property market cycle in Asia ages, financial instruments (especially income-focused products) will increasingly complement residential investments as the key component of portfolio wealth. With concerns of peak globalisation and margins, the focus on dividends, quality, and protection of principal makes sense in this environment. Finally, investors may want to consider sustainable investing as a way to reduce risk and improve returns.

THE MARKET CORRECTION

The market correction at the end of 2018 was primarily liquidity driven; the Fed's determination to unwind its quantitative easing policies drained liquidity from markets, while the Chinese government's attempts to reduce shadow banking and reform bank balance sheets caused a decline in lending and a reduction in overall monetary growth. Because this liquidity-induced growth slump was created by governments, the solution is also policy-driven. China's recent move to reduce the reserve requirement ratio is a sign that its regulators have begun to loosen its monetary policy, as growth rates must be sustained to create sufficient jobs to absorb the rapidly urbanising population. The Fed is also having second thoughts about raising rates too quickly for fears of crimping the domestic economy at a time when key indicators (wage growth, manufacturing activity, auto sales, house prices) have started to slow. After a painful December, bruised investors are now excessively bearish towards markets and have fled to safe-haven assets. Any incremental improvement in economic data or a pause in the Fed's rate hikes is likely to lead to a sharp and decisive rebound in risk assets such as equities.

Valuations of stocks, especially in Asia, are attractive suggesting favourable risk-reward. In our experience, Asian markets go through phases of extreme sentiment swings. When markets are bullish and risk-taking sentiment is high, Asia becomes the bastion of global growth, and investors pay a premium for these assets. When markets are bearish and risk-aversion is prevalent, such as today, the flaws of Asian assets are highlighted - such as poorer corporate governance, currency risks, low liquidity, high volatility. This is despite the fact that Asian companies have strong balance sheets and adequate buffers to ride out a slowdown in demand. Debt levels in Asia are half of the levels during the 1997 Asian Financial Crisis, as companies have learnt their lessons from taking on too much leverage.

Market (Index)	Total Return (p.a.)	P/E Ratio (2000-2009)	P/E Ratio (2010-2018)
Asia-ex-Japan (MSCI AEJ)	8.8%	16.4	12.6
US (S&P 500)	5.6%	19.6	17.5
Japan (Nikkei 225)	3.9%	37.1	19.7

Source: Bloomberg

Figure 1: Market returns from Dec-2000 to Dec-2018

As seen in Figure 1, long-run total returns (9%) have been remarkably stable in Asia and superior to the rest of the world, but negative sentiment to the region has seen its earnings multiple derate to a large discount to the US and other developed markets. Institutional investors we talk to have been adding quietly and gradually to Asian and emerging market assets to capitalise on this valuation discount.

END OF THE PROPERTY MARKET BOOM

In addition to slowing economic growth, another theme we witness in Asia, is the end of a multi-decade long housing boom. House prices have started to fall after decades of extraordinary returns, with significant corrections in Australia, Hong Kong and smaller drops in Singapore, Malaysia, China. One reason for this reduction in property prices is the aforementioned liquidity crunch, reducing available financing for investment properties. However, in our view, the main reason for house price corrections is falling demand due to declining affordability. For example, in Shenzhen, it takes the average worker 35 years of wages to purchase a property. Compared to China, Singaporeans have it relatively easy due to the availability of public housing, with an average of 5 years income required to purchase a HDB flat. We do not think this property correction will have a huge impact on financial stability, as Asian banks have been conservative with loan-to-value buffers while having ample liquidity and high deposit liquidity. The exception is Australia, given its banks' large exposure to mortgages and high levels of leverage due to tax policies (such as negative gearing), which have encouraged excessive risk taking.

We are also less bullish on Singapore residential property. Cooling measures imposed by the Singapore government on the domestic residential sector combined with higher interest rates have negatively affected both public and private house prices. Although the strength of the Singapore dollar and the stability of our political/legal system will continue to attract global investors, fundamentally we sense that the local supply-demand balance has shifted. With declining immigration numbers and slowing population growth, demand for local property is likely to fall and we think investors will not see the same magnitude of returns in property as enjoyed in the last few decades. Investors interested in real estate may wish to consider REITs instead. Singapore REITs deliver on average a dividend yield of about 5% as compared to residential rental yield of 2-3%.

DIVIDENDS AND QUALITY MATTER

While the US-China trade war dominates today's news, watchful observers would have noticed major shifts in the political climate over the past few years, evident from events such as Brexit and the Trump presidency. Experts call this phenomenon "peak globalisation", as citizens subjected to globalisation's pernicious consequences are reducing their support for free trade and embracing isolationism. This will cause labour costs to rise, and coupled with higher financing costs from rates rise, will crimp profit margins of companies around the globe. In this late-cycle environment, investors must safeguard their portfolios by focusing on dividends and quality. A stream of dividends will be a steady component of portfolio returns even as capital returns remain volatile, providing a buffer during downturns while supplying income. Dividend stocks do well in bad markets: our dividend-focused Phillip SGX APAC Dividend Leaders REIT ETF and Lion-Phillip S-REIT ETF were resilient despite the sharp market correction in October 2018. High quality companies that have low debt and sustainable earnings also outperform during a risk-off, flight-to-safety mentality. Combining these concepts of dividends and quality, our recently launched Phillip SING Income ETF - comprising familiar names that provide essential products and services such as supermarkets, healthcare, banking and telecommunication services - was well-received by investors looking for yield as well as downside protection.

CASH IS NO LONGER TRASH

The expected risk-adjusted returns from cash has improved considerably as compared to that of equities. The spread between S&P 500's earnings yield and the yield of three-month T-bills has declined from a peak of 7.5% in 2009 to the current spread of 3.3%. As the spread may tighten further following potential rate hikes, holding cash provide attractive risk-adjusted returns for conservative investors. Switching to liquid assets such as the Phillip Money Market Funds which have comparable returns have increasingly been an attractive proposition amid the current market volatility.

SUSTAINABLE INVESTING

In response to client requests, we are also exploring products that provide income as well as a tilt towards towards quality companies that score high on environmental, social and governance (ESG). We see growing demand for sustainable investing in Asia. Globally, both institutional managers and individual investors are trying to affect change in the world by aligning their investment dollars with their values. The foundation of sustainable investing is simple: it is about risk management. A company's approach towards climate change, gender diversity and labour practices has a material impact on the business risks it faces and subsequently, the long-term growth trajectory of the firm. With studies which have shown that sustainable investments deliver better risk-adjusted returns in mind, we urge our investors to consider environmental, social and governance factors in their investments.

We wish you all the best for 2019. **The stormy markets will pass but our focus on quality, dividends and sustainability will not.**

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