Singapore | Malaysia | Hong Kong | Thailand | Indonesia

Phillip Capital Management

2015 Market Outlook & Funds Review

Asian Values   Asian Focus   Asian Expertise

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January 2015

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Plotting the course for 2015: The Big Picture

A new year is upon us and we enter 2015 with we dare say, more cause for optimism than we did 2014. To start, we hold a positive view on equities stemming from key factors such as the accommodative monetary policies from central banks, an improving US economy, and low commodity prices. In response to the financial crisis in 2007, the US Federal Reserve had launched three rounds of quantitative easing (QE) that started in the fall of 2008 and has finally come to a close in October 2014. Naturally what has prompted the conclusion of the US QE is an ever improving US economy.

This is evident in an unemployment rate that fell to post-crisis low of 5.8% in November 2014 from a peak of 10% in October 2008 and the corresponding strong GDP growth registered in the US economy during the period. But whilst we are seeing a rosy picture of growth in the US, growth is faltering in other parts of the world. The major economic bloc of the Eurozone, China and Japan are showing a contrasting outlook from the US. The Eurozone is seen to be at risk of slipping back into recession whilst China has embarked on restructuring the economy as well as clamping down on years of excesses which has led to declining rate of economic growth. In Japan, early fanfares of Abenomics are giving way to the reality of persisting sub-par growth as it slipped into recession in the 3rd quarter of 2014. In response to the weak economic conditions, the European Central Bank (ECB), Bank of Japan (BOJ) and more recently the People's Bank of China (PBOC) have announced its respective stimulus measures, and we do believe there will be sustained efforts on the part of the central bankers to ensure a positive outcome, if we take US as the precedent example. So although the US Federal Reserve is ending its liquidity tap, elsewhere liquidity is still gushing.

The vast amount of liquidity injected into the financial system has fueled a 6-year bull rally in the equities market. The MSCI World Index has more than doubled in value from a low of 688 in March 2009 and so the pertinent question on everyone's minds is "Will the rally be coming to an end?"

We do not think that it is. As mentioned earlier, we still see abundant liquidity in the system. However as that liquidity cannot flow forever, therefore the second leg to the bull rally has to be earnings-driven. We see this happening in the US now, with the GDP growth rate improving and translating into better corporate earnings. We are hopeful that the rest of the major economic blocs will follow the same route. Another beneficial factor is the low commodity prices. The low oil and industrial metals prices are making investments attractive to corporates which should drive up return on equities (ROE), rather than keeping money on the balance sheet and hence we are seeing the entire economic cycle moving up again.

So we are positive on equities. How then for bonds? One mitigating factor for bonds is the US interest rate hike cycle which is expected to begin in mid-2015. A US rate hike has worldwide implications since the USD is the world's reserve currency and many countries are holding onto US treasuries. We are expecting the short end of the yield curve to move up as the US Federal Reserve starts to increase interest rates and so, would pay particular attention to bond tenors when buying bonds. Having said that, despite the widely anticipated interest rate rises, bonds have and may continue to outperform investors' expectations given the continued quantitative easing from the various central banks.

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We are also positive on real estate which we feel will continue to be supported by the ample liquidity in the system and recovering economic growth particularly in the US boosting effective demand. The high profile purchases of commercial property by strategic investors such as Government of Singapore Investment Corporation (GIC) and Norwegian Government Pension Fund during the year too could be viewed as a bellwether for the asset class.

Finally we are neutral on commodities although it must be said that this asset class, well known for its volatility, can always spring a surprise on investors despite the current bearish backdrop. The recent drop in crude oil price is largely attributed to the supply-side. So if the scenario of a recovering global economy continues to play out, the demand-side may yet balance out the supply-side glut. However we do not see this scenario happening in the near-term and in the meantime, we will busy ourselves with identifying the gainers of the current situation. Meanwhile, gold often is viewed as a safe haven asset however with a strengthening USD, we do not see much upside on gold prices.

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Spurring Asia on in the Year of the Goat:

In general, there are some catalysts we can look forward to which may propel Asian markets in 2015. Firstly, Japan with its USD 1.14 trillion pension monies and its plan to double the target allocation to domestic and international equities to 25% each should provide a boost to its equity markets. Add to that the most recent round of monetary easing under Abenomics and we expect to see regional markets benefit through Foreign Direct Investments and fund flows emanating from Japan.

December saw the launch of the HK-Shanghai Stock Connect which grants investors in Hong Kong and mainland China mutual access to stocks in each other's markets. As the through-train program matures in implementation and acceptance in 2015, investors will benefit from the higher liquidity in both markets. The Chinese stock market also stands to gain from the continued weakness in the property market as retail investors start to divert their funds into equities.

For the ASEAN region, 2015 should prove to be a momentous year as it will see the establishment of the ASEAN Economic Community. This framework, much like the framework from which the European Union emerged, targets regional economic integration with the objective of transforming ASEAN into a region with free movement of goods, services, skilled labour and capital. As a result, the countries will see tremendous opportunities in the development of manufacturing hubs, financial integration and infrastructure linkages, all these adding to the attractiveness of the region to global investors.

With all this in mind, our funds are broadly positioned to favour Asia given the continued influx of liquidity with a particular focus on companies poised to benefit from a recovering US and the growing affluence of the Asian consumer.

Finally what risks are we mindful of? Well the main one to potentially derail the markets closer to home could be a disorderly exit of capital from Asia due to faster-than expected US interest rate rises. This could trigger a domino effect of currency weakness in Asia and all-round volatility in the various credit and stock markets. Another risk that cannot be ignored is geopolitical risk notably continued tensions between a rising China and a pro-US Japan. Further away from home, there is the Russia-Ukraine debacle which could prove to be a wild-card if not delicately contained.

Here's wishing everyone a year of successful investing ahead!

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Phillip Asia Pacific Growth Fund

The fund rose +4.05% for 2014 versus a 2.4% gain in the MSCI AC Asia Pacific index in a year which saw a general rebound of Asian markets as foreign funds flowed back into selective beaten down markets such as the ASEAN countries, India and then China in the later part of the year.

The fund benefited from the overweight of the regional markets as Philippines, Thailand and especially Indonesia having performed extremely well through the likes of Surya Semesta and Ciputra Property. In Japan and Korea, our holdings outperformed the broad market where in Japan, we focused on the beneficiaries of the weak yen such as Kawasaki Heavy and Daiwa House Industry. Over in Korea, our attention on value worked well and we saw SK Telecom which was trading under 10x PE when we initiated a position, deliver strong returns for the fund. Exposure to the semiconductor sector and names such as TSMC and Advanced Semiconductor which rose 30% for the year were also the top contributors to the fund's performance.

On the other hand, our key underweight market had been Australia due to our negative view on commodities and Australia has ended the year underperforming most other markets in the region.

India was another miss for the fund given its high twin deficits; its national budget deficit and its trade deficit which posed some concern to us. However India ended 2014 being a bright spark for many investors as the markets rose over 40%. The China A-share market also had a good run in the last quarter of 2014 and although the fund has exposure to China through the Hong Kong market, these "H-shares", Chinese stocks listed in Hong Kong, have not done nearly as well as the "A-shares" (China stocks listed in Shanghai & Shenzhen). Going forward, we will explore investing into A-shares through the new "HK-Shanghai Stock Connect" but we will be cautious in picking an entry point given the more volatile nature of the A-shares market.

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Phillip Asia Pacific Growth Fund

Looking ahead to 2015, the fund will focus on Asian exporters with links to global recovery and particularly to US demand. These would include Japanese industrial equipment and automobile-related exporters, Korean electronics exporters, ASEAN industrial estate developers and Asian financial names. We also be paying attention to the beneficiaries of cheaper oil prices such as transportation and logistics players. On a whole, it is good to note that Asia-Pacific is in general, a net beneficiary of the low oil prices we currently see.

Sectors the fund will continue to overweight are those which benefit from the long-term Asia consumption theme such as ASEAN infrastructure-related companies. The big push for infrastructure construction by new Indonesian president Joko Widodo and Thailand's government should lead to the building and upgrading of ports, roads and train lines. Within the property sector, we like companies that have stagnated for long periods such as Japanese and Singapore property developers. Stock exchanges will also be key beneficiaries of the increased linkages within Asia by virtue of higher trading volumes and new markets offering new financial products

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Phillip Singapore Real Estate Income Fund

For the year 2014, the total return for the fund was +14.8% versus a +9.2% gain in the benchmark (FTSE ST REIT index). Careful management of the dividend income and coupon income received by the portfolio has meant that the fund has successfully paid its investors a quarterly distribution amounting to a 6.3% yield in 2014.

Initially, the investment sentiment surrounding the Singapore Real Estate Investment Trust (REIT) sector was rather negative in late 2013 due to the imminent end of quantitative easing. However, this showed some signs of recovery in the first few months of 2014, as investors started to recognise that the concerns surrounding quantitative easing taper had already been priced into S-REITs. Hence in mid-2014 we saw a resurgence in the sector and this can be attributed to the US Federal Reserve's forward guidance that interest rates were likely to stay low "for a considerable time". So for the rest of 2014, Singapore REITs stayed relatively resilient apart from a mild correction in Sep-Oct which it bounced back from strongly.

Throughout 2014, the fund had been positioned towards Commercial REITs, both office and/or retail, over Industrial REITs. This overweight in Office REITs such as Capita Commercial Trust and Suntec REIT has done well due to the broad market realization that office supply was tight. Therefore office rentals are likely to have a strong rebound after the several weak years as experienced after the Global Financial Crisis.

Amongst the Retail REITs, stock picking was key and REITs with strong portfolios such as Mapletree Commercial Trust did well for the fund. Our underweighting of Industrial REITs due to concern about regulatory tightening after the significant rise in industrial property prices benefited the fund as the majority of them underperformed the market.

On the other hand, Keppel REIT albeit an Office REIT, did not benefit as much from the recovery in the office segment as we expected. Going forward however, we are optimistic about the holding since the capital-raising for purchasing Marina Bay Financial Centre 3 has already taken place.

Looking ahead to 2015, the fund will continue to be overweight Office REITs as office supply remains constrained thus supporting office rentals. In fact, recent office rental lease renewals are being done at double-digit increases over existing rates. Hospitality REITs have been under considerable gloom in 2014 with the MH17 incident and China's clampdown on corruption impacting tourist arrivals in the region. However, we may have seen a turning point in regional tourism with indicators such as Changi Airport passenger traffic rising year on year and Thailand's tourist numbers turning positive.

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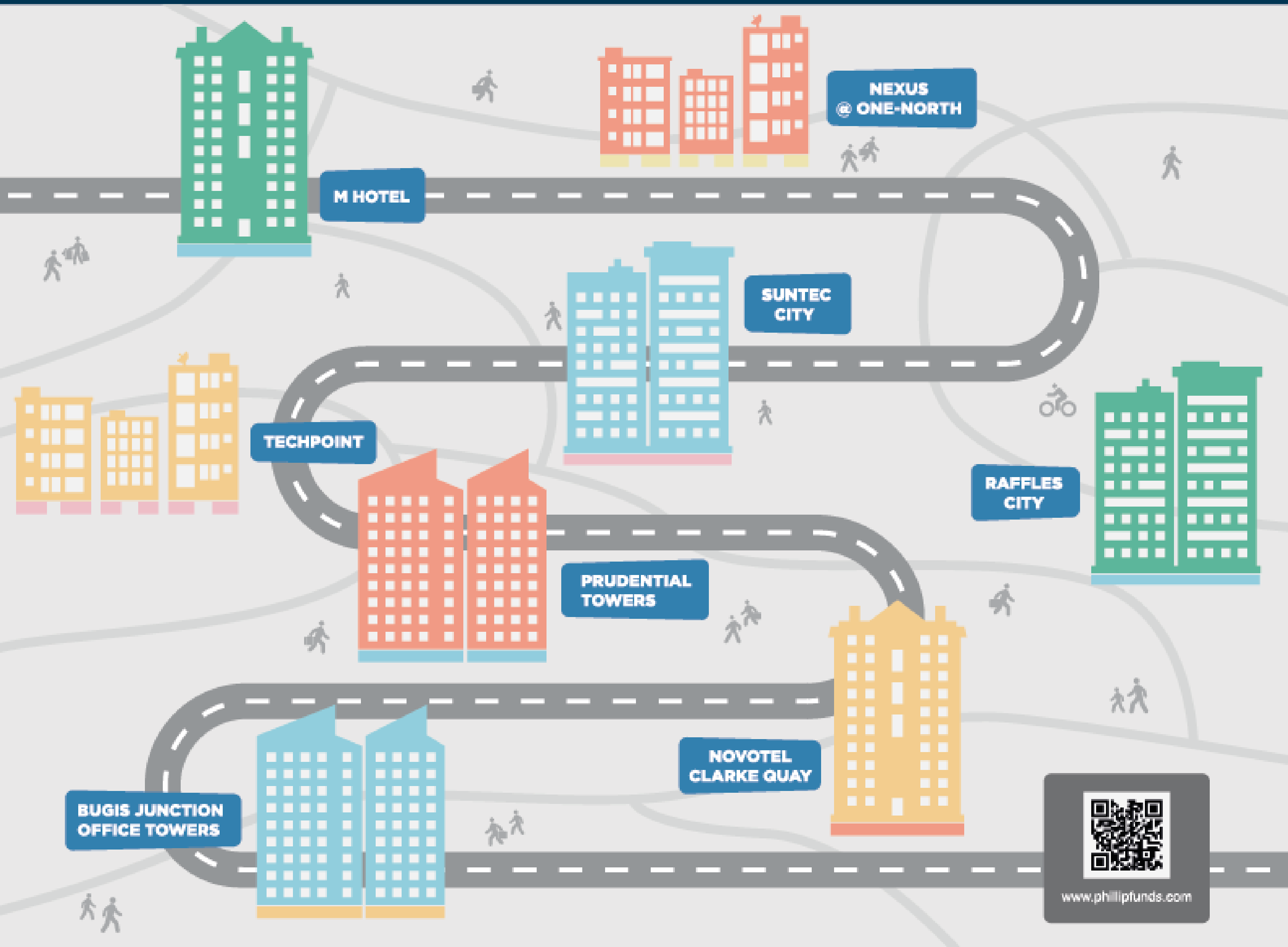
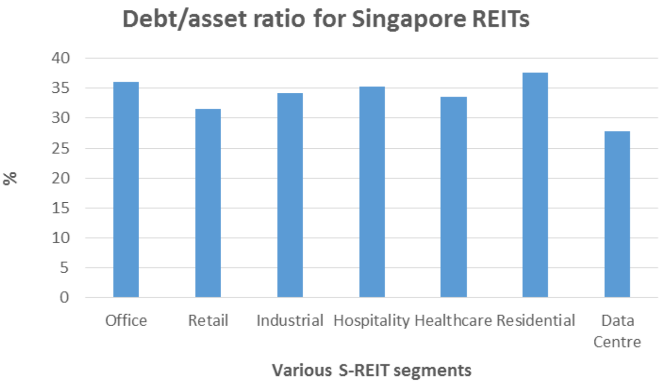
Phillip Singapore Real Estate Income Fund



We are neutral on the all-mighty Retail REIT sector with the latest retail sales figures remaining flat year on year whilst tenants face challenges stemming from the labour crunch and the popularity of online shopping to name a few. The fund is likely to continue to underweight Industrial REITs seeing the large supply of leasing space coming onto the market in 2015, a time of relatively subdued industrial production growth. We do like Healthcare REITs which possess strong underlying fundamentals however we will wait for attractive entry points as sector valuations are too high at the moment for our liking.

Lastly, we are ever mindful of the looming interest rate rises expected for 2015 and fortunately, so are our invested REITs. Most have made necessary preparations such as fixing borrowing costs several years out and buffered up their balance sheets to keep gearing ratios at relatively comfortable and manageable levels post the Global Financial Crisis as can be seen in the chart beside.



Sources: PCM and Bloomberg (Jan 2015)

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Income Opportunities Global Perspective

For the year 2014, the total returns for the fund was +5.8% for the year outperforming the fund's composite benchmark which rose +4.6%. Careful management of the dividend income and coupon income received by the portfolio has meant that the fund has successfully paid its investors a semi-annual distribution amounting to a 4.5% yield in 2014.

The fund has a global mandate however throughout 2014, the fund remained overweight the Asian markets in both its equity and fixed income allocations. Asia continues to benefit from the vast amounts of liquidity as a result of easy monetary policies maintained by the major central banks whilst underpinning the Asian corporates is the rise of the Asian middle class with its ever increasing consumption levels. The fund favoured equities able to offer and more importantly, maintain attractive dividend yields and hence sector-wise, the fund had a bias towards financials, real estate as well certain utility sub-sectors. In particular focus were REITs in Singapore which offer steady income and backed by high quality underlying property such as Capitamall Trust and also large Chinese Banks like Industrial & Commercial Bank of China (ICBC).

With regards to the fixed income holdings, the fund benefited not only from the selection of high quality bonds for its portfolio but also from our careful attention to the currency exposure of its holdings as 2014 saw high volatility in many currencies such as the rupiah, ruble and euro just to name a few. Instead, the fund gained significantly from its appreciating USD and CNY-denominated bond holdings.

One such example is Finansbank AS, a mid-sized bank in Turkey enjoying strong profitability and robust growth with 650 branches offering 5-year bonds with attractive yields. Its high credit quality led to a significant gain for the fund after a 6-month holding period. China Travel Services Corp Ltd is another example of a high quality credit holding as the company is one of the largest PRC state-owned travel enterprises present in 11 countries and the fund has already profited significantly from its ten-year bond issue purchased in October 2014.

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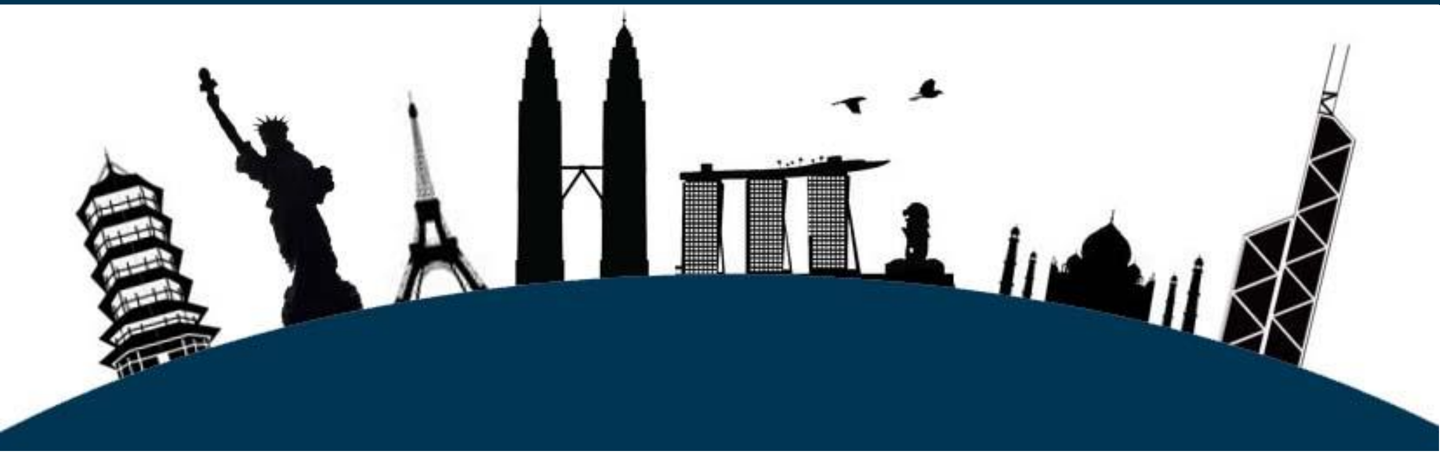
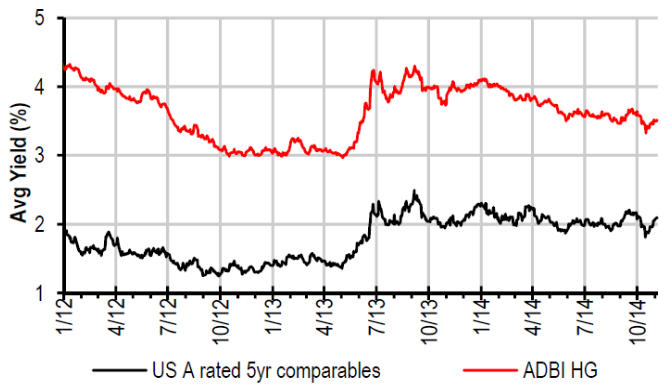
Phillip Income Fund



Looking ahead to 2015, it is widely expected that the US Federal Reserve will be raising interest rates most probably in the latter half of the year. This will likely lead to a re-pricing of risk assets especially bonds at the shorter end of the yield curve hence we have and will continue to closely manage the interest rate (duration) risk and look to maintain the duration of the portfolio at approximately 5 years. Having said that, the central banks of Europe and Japan are likely to continue their quantitative easing given their weak economic outlook and hence posing far less interest rate risk to Euro and Yen-denominated bonds.

The fund will continue its preference for high-yield Asian equities and quality Asian bonds in 2015. We believe Asian credit spreads still offer value as opposed to US domestic bonds of comparable standing as seen in the graph beside(ADBI = Asian USD Bond Index).

5. ADBI High Grade vs US High Grade



Source: Bloomberg, HSBC

At the same time, we also expect default rates in Asia to remain low with Asian high-yield default rates at 1.5% for 2014 and consequently even lower, for investment grade bonds.

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Phillip Money Market Fund & Phillip USD Money Market Fund

Throughout 2014, the SGD Money Market fund continued to offer attractive yields and meet the liquidity needs of all its investors.

The assets under management remained stable and ended the year at approximately S$ 800 million, and so the fund continues to be the largest SGD retail money market fund available in the market. The fund is usually allocated between money market instruments and fixed deposits about equally and to ensure ample liquidity, the manager diversifies across fixed deposit tenors as well as bond maturities. The weighted average maturity of the fund remained below 90 days for much of the year whilst the credit ratings of the underlying bonds were rated A on average.

As a result of the significant size of the fund, the manager gained access to several high quality Singapore dollar private placements on offer by highly rated institutions at attractive yields.

The Philip USD Money Market fund also had an excellent year which saw assets under management grow to a high of US$ 108 million. With the end of quantitative easing in October, we expect to see short-term interest rates rising leading to higher yielding bond issues and an appreciating USD which makes the fund an ideal vehicle for any investor holding US dollars.

Likewise, the outlook for the Singapore dollar remains positive as MAS maintains its policy stance of modest SGD appreciation going forward.

Both funds have a conservative risk profile and the stringent selection of credit investments have meant that neither fund has ever seen a default of its underlying credit holdings.

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