# Quarterly Investment Outlook
# Second Quarter 2018

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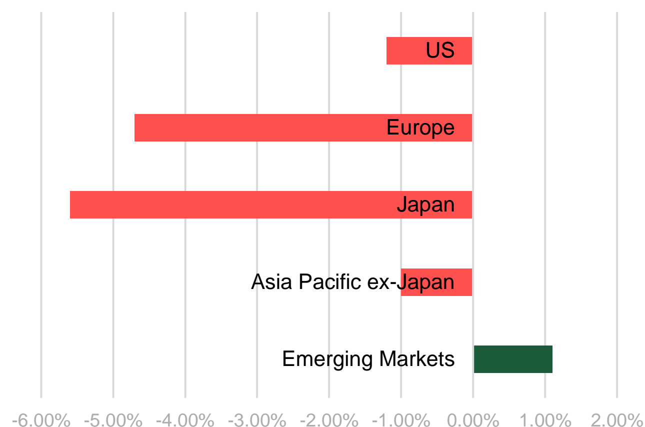
## REVIEW: EQUITY MARKETS

*The record-breaking streak of consecutive monthly gains came to an end in spectacular fashion. Equities closed January with 5.8% before reversing over the next two months. Markets have undoubtedly entered a higher volatility regime as volatility spiked to levels not seen since 2015. Daily moves of more than one percent have become almost ordinary, as speculators reacted – sometimes dramatically – to any hints that the bull market may be finally coming to an end.*

*The fear of higher interest rates was followed by a US-China trade skirmish. Rate sensitive utilities initially declined as interest rates rose but turned up as markets turned their focus to a potential trade war. Tech and financials led declines in recent weeks, after leading gains in the early part of the year.*

**Global Equities -1.4% (QTD, USD)**




**Source: Bloomberg**

**United States -1.2% (QTD, USD)**

Investors shunned tech stocks, the embodiment of last year's momentum-driven rally, on increased regulatory scrutiny, and on worsening trade relations. Facebook fell 20% from its peak, as it faced a privacy crisis on the handling of sensitive user data. Despite this, tech is up 3.5% over the quarter even after the recent rout. Defensive utilities gained over the past month as markets went into risk-off mode, clawing back some of their earlier losses. Small-caps benefitted as they were perceived to be less vulnerable amidst trade concerns.

**Europe -4.7% (QTD, EUR)**

The Italian election was largely a non-event, as the non-mainstream parties did not emphasise on their initial populist agenda. Global trade tensions and slowing – but still positive – economic activity led eurozone equities meaningfully lower. The outsized weight of financial stocks in European markets exacerbated losses as the sector underperformed. A stronger euro helped offset some losses for our currency-unhedged positions over the quarter.

**Japan -5.6% (QTD, JPY)**

Japan saw outsized declines. The safe-haven yen rose 5.6% in Q1 as markets went into risk-off mode, benefitting un-hedged foreign investors. A stronger currency, with mixed economic data, boded ill for the region even though there continued to be structural improvements observed in corporate Japan. The financial and industrial sectors (known as 'value' sectors) underperformed.

**Asia Pacific ex Japan -1.0% (QTD, USD)**

**Emerging Markets +1.1% (QTD, USD)**

The healthcare and information technology sectors were the only two with decent positive returns for Asia. Semiconductors were the main contributor for the information technology sector - Taiwan Semiconductor gained more than 10% over the quarter on growing demand for their chips, and on the back of development in next-generation technologies such as AI. Telecom and consumer discretionary stocks underperformed, with the former facing a structural decline of consumers moving away from traditional revenue sources such as land lines and cable television.

Firmer commodity prices and a weaker dollar were positive tailwinds for the emerging countries. Russia gained more than 7% over the quarter despite geopolitical pressures and sanctions. Brazil also saw gains of about 12%. Notably, the upward trend in oil prices and base metals have mirrored growth in emerging markets.

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## REVIEW: FIXED INCOME MARKETS

*The shift to government bonds in Q1 paid off as they closed the quarter flat while most risk assets were in the red. The bond market started the year on weak footing as inflation fears emerged in the US. Subsequently, trade concerns and the ensuing risk aversion saw investors flocking into safe-haven sovereign bonds. Riskier fixed income asset classes (non-sovereign bonds), suffered as credit spreads widened. The US Fed increased interest rates by another 0.25%, in a move largely expected by markets.*

**Sovereign bonds rose as equities declined**

**Source: Morningstar Direct**

**Sovereign bonds** fell sharply at the beginning of the year, spooked by higher inflationary data in the US and strong growth in the Euro area. The subsequent moderation in growth momentum in the US and Euro area, coupled with the equity rout triggered a flight-to-safety response. Sovereign bonds rallied as investors flocked to safe-haven assets.

**Investment Grade (IG) bonds** were among the hardest hit within the fixed income segments. An overall rise in interest rates led to lower bond prices. In addition, already-tight IG credit spreads also widened, delivering a double blow to IG bonds. As one of the most liquid risky assets within the fixed income market (there are ready buyers and sellers at any point in time), IG bonds became an easy target for profit taking when market sentiment turned cautious.

**Asian bonds** corrected in line with movements in the global bond markets. Hard currency (dollar) bonds suffered from higher interest rates and as credit spreads widened. Local currency bonds fared better on a weaker dollar over the quarter. Indian bonds were the star performer, as it rallied strongly after India's government announced a drastic cut in borrowings for the first half of FY 2019 – under normal circumstances, a smaller bond issuance would support bond prices.

**Emerging Market (EM) debt** also declined across the board. There was little differentiation in performance among the regions of Asia, Latin America, Europe, Middle East and Africa. Venezuela debt was one exception in the global sell-off: extremely high coupon (caused by an earlier extreme sell-off) managed to absorb the negative impact from higher interest rates and credit spread widening. Brazilian bonds also outperformed on stronger economic growth and benign inflation. Our position on short duration EM debt benefited as declines were muted relative to broader EM debt.

**High Yield (HY) bonds** performed relatively well as the supposedly riskiest segment of the fixed income market, even as it declined over the quarter. The relatively high coupon offered by these high yielders managed to compensate for some of the losses from higher interest rates (lower bond prices) and wider credit spreads. To add icing on the cake, our exposure to short duration high yield bonds were one of the few markets above water.

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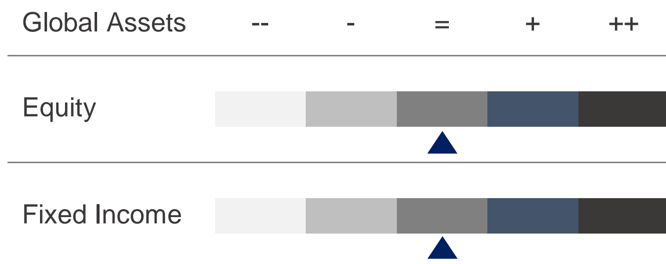
## OUTLOOK AND ASSET ALLOCATION STRATEGY




Note:
--: Underweight | -: Slight Underweight | =: Neutral | +: Slight Overweight | ++: Overweight

**Equity: Neutral**

The threat of a trade-induced slowdown, at a time where major central banks are looking to withdraw their accommodative policies, has gotten markets on the edge. That said, global growth is still robust, with earnings expected to stay strong – these numbers are the ones to watch out for in the coming months.

More recently, growthier tech stocks have come under greater scrutiny from regulators, though the jury is still out if this would lead to a more permanent structural consideration - this could very well be another driver for a rotation out of growth into value stocks. Our assessment of these drivers, including monetary policy, valuations, and sentiment, indicate that the current environment is not ripe for such rotation. Generally, economic and corporate fundamentals have remained strong, providing support for the growth thesis.

**Fixed Income: Neutral**

Global growth is expected to remain on track after a softer first quarter. Rising inflation remains a risk for the US Fed to hike rates more aggressively than market expectations. The European Central Bank (ECB) could also become more hawkish as it looks to begin its tightening of monetary policy. Short of a full-blown trade war, the baseline scenario is for risk assets to come back into favor over the coming months. In general, these headwinds continue to pose a challenge for fixed income assets.

We continue to identify favorable risk/reward propositions, while utilising the defensive properties of fixed income assets to hedge against a more volatile market. We further tilt our portfolio to the shorter duration to reduce sensitivity to interest rates.

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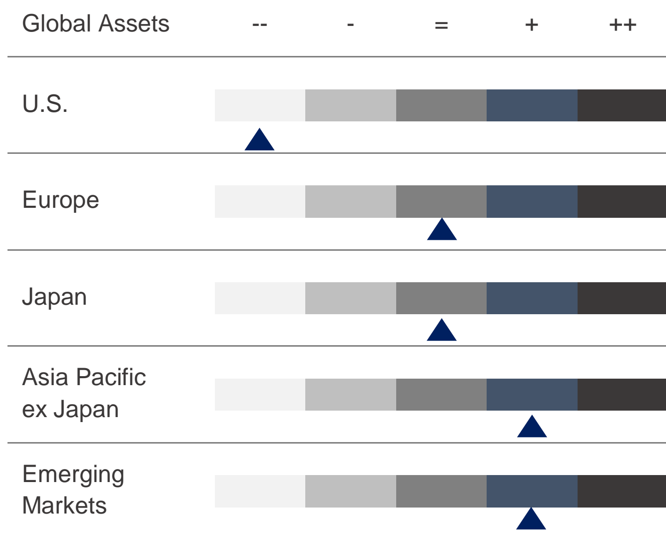
## EQUITIES

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### United States: Underweight

We maintain our small-cap growth bias as we watch how trade rhetoric will unfold. Smaller companies tend to derive the bulk of their earnings domestically and may be less insulated to restrictions on trade. While valuations are still stretched, there was a pick up in earnings reported for Q4 2017.

Tech companies are still expected to post strong earnings this quarter, but the potential of regulatory restrictions – amidst rich valuations – threatens their blistering pace of growth. Financials continue to look attractive on a valuation perspective, though trade concerns have weighed on the outlook for the economy.

Continue to underweight US equities as they remain richly valued even after the recent correction, while we focus on identifying favorable segments, e.g. small cap growth and financials in the current environment.

### Japan: Neutral

Japanese companies continue to report a growth in earnings, and rising margins. Structurally, corporate Japan is in the midst of a positive transformation, though markets have not yet responded in kind. Valuations continue to be attractive on a relative and historical basis.

Equities were hit particularly hard as the yen rose, tampering future earnings expectations. Trade worries came to the forefront, as it was reported that Japan was not exempted from US steel and aluminum tariffs.

**We remove the currency-hedge to gain exposure to the Japanese yen.** As a safe haven currency, this would further cushion our portfolio in event of global tail risk. Additionally, the Bank of Japan has recently been seen posturing the markets on its eventual tightening of their accommodative policy; supporting the thesis for yen appreciation.

### Europe: Neutral

The European economy saw mixed economic data; with growth and low unemployment holding, but with a slight moderation in the manufacturing sector as measured by the Purchasing Manager's Index (PMI).

Our currency-unhedged positions meant that we benefitted from a firmer euro, though it has not rallied strongly since January. The European markets are light on Tech stocks relative to the US, which contributed to some of the underperformance. Going forward, the more economically-sensitive market may catch up if the trade skirmish can come to a swift resolution.

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### Asia Pacific ex Japan: Slight Overweight

The region is potentially the biggest loser from a trade induced slowdown. International trade has been a key fundamental driver for Asia’s economy; not just in China. While the implications of a full-blown trade war are not something to take lightly, commentators are expecting cooler heads to prevail - China has said before that they are open to negotiation.

Valuations have moderated (particularly for China A shares) over the quarter, making markets relatively attractive. Earnings trajectory continues to be intact, though we continue to monitor for developments arising from the current stage of the global growth cycle; or if trade policy derails such growth.

### Emerging Markets: Slight Overweight

The global macro landscape is now a more uncertain one. Robust economic activity and positive growth outlook has been tempered by rising protectionism and geopolitical risks.

Barring a sudden slowdown in global growth, we expect commodity prices to remain firm. Oil prices have continued to be supported by OPEC's commitment to curb production. There is also potential for supply-side disruptions in Venezuela and the Middle East on increased tensions. We continue to maintain our slight overweight to the emerging markets as valuations remain less stretched, and as a play on commodities.

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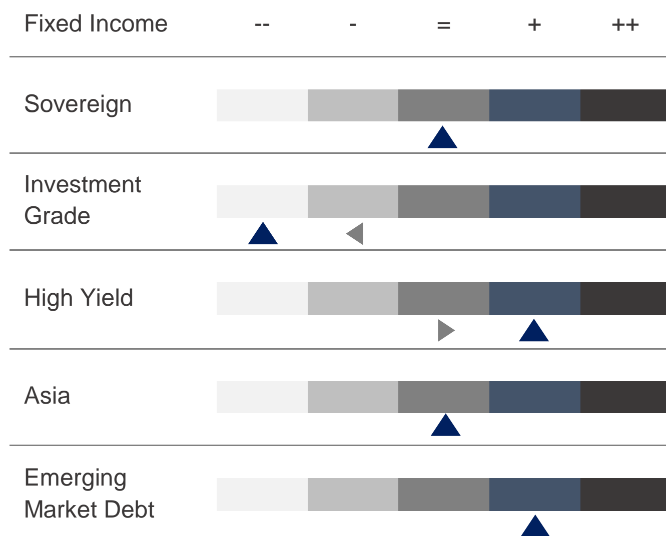
## FIXED INCOME

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### Sovereign: Neutral

Sentiment for equities turned down over the quarter. By moving our sovereign bond allocation from underweight to neutral in January, we were more prepared and benefitted when the riskier asset classes declined.

Trade fears aside, we believe that markets will eventually refocus their attention to the tightening cycle of the major central banks. Improving economic fundamentals and worsening bond supply/demand dynamics are expected to send interest rates higher. We will look for opportunities to reduce the exposure to sovereign bonds that face the most headwinds.

### High Yield: Slight Overweight

We had reduced exposure in Q1 as spreads were historically tight, making HY bonds an expensive proposition – this turned out to be a timely decision as we took profits before the subsequent sell-off.

Spreads have widened since then, offering us a slightly higher margin of safety. Strong corporate earnings, and a generally low default environment, have also continue to be positive for this asset class. Coupled with the relatively high coupon offered, with low interest rate sensitivity (through our short-duration bias), **we take the opportunity to increase exposure to a slight overweight.**

### Investment Grade: Underweight

Investors (particularly those constrained to investment grade mandates) have been piling into IG bonds in the quest for yield. This has resulted in corporate yields being pushed to marginal levels above their respective government bonds.

Essentially, investors are not being rewarded for taking corporate credit risk, while being exposed to the downside of corporate defaults. The defensive properties typically associated with owning IG bonds is also diminished. We saw this play out in Q1 as investment grade corporate bonds sold off as much as high yield. With higher short-term interest rates, the higher cost of hedging could also dampen demand from foreign investors. **We view these headwinds as unattractive, and hence reduce our exposure to underweight.**

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### Asia: Neutral

Asian bonds are subjected to uncertainty from the risk of a trade war escalation in the near term. Both the US and China has unveiled their list of $50 billion worth of goods to target, though these are still up for review and negotiation.

Market sentiment in Asian bonds, mainly dominated by Chinese issuers, is likely to be jittery in the meantime. The market will turn back its attention to fundamental factors if US-China tensions can be resolved, but we remain highly vigilant on developments on this front.

### Emerging Market Debt: Slight Overweight

Emerging market growth tends to accelerate in the advanced stages of the growth cycle. Domestic growth and corporate earnings are picking up, with low levels of inflationary pressure. Firm commodity prices have also been underpinning emerging market economies. We continue to favour this segment on stronger fundamentals and cheaper valuation, with an emphasis on shorter duration bonds to mitigate interest rate risks.

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## RETURNS AS AT 31 MARCH 2018

| Regional Equity | MTD | QTD | YTD |
|---|---|---|---|
| Global | -2.4% | -1.4% | -1.4% |
| US | -2.7% | -1.2% | -1.2% |
| Europe | -2.3% | -4.7% | -4.7% |
| Japan | -2.9% | -5.6% | -5.6% |
| Asia Pacific ex-Japan | -2.4% | -1.0% | -1.0% |
| Emerging Markets | -2.0% | 1.1% | 1.1% |

| Fixed Income | MTD | QTD | YTD |
|---|---|---|---|
| Global Aggregate | 1.1% | 1.4% | 1.4% |
| High Yield | -0.7% | -1.2% | -1.2% |
| Asia | 0.0% | -1.2% | -1.2% |
| Emerging Market Debt | 0.1% | -1.5% | -1.5% |

| Currencies | MTD | QTD | YTD |
|---|---|---|---|
| USD/SGD | -1.0% | -1.8% | -1.8% |
| EUR/SGD | 0.1% | 0.7% | 0.7% |
| JPY/SGD | -0.6% | 4.0% | 4.0% |

| Commodity | MTD | QTD | YTD |
|---|---|---|---|
| Gold | 0.5% | 1.7% | 1.7% |
| WTI Crude | 5.4% | 7.5% | 7.5% |

Source: Bloomberg.
All returns in index currency terms.

| Country | MTD | QTD | YTD |
|---|---|---|---|
| Australia | -4.3% | -5.0% | -5.0% |
| Brazil | 0.0% | 11.7% | 11.7% |
| China “A” | -3.1% | -3.3% | -3.3% |
| China “H” | -3.1% | 2.5% | 2.5% |
| Hong Kong | -2.4% | 0.6% | 0.6% |
| India | -3.6% | -3.2% | -3.2% |
| Indonesia | -6.2% | -2.6% | -2.6% |
| Korea | 0.8% | -0.9% | -0.9% |
| Malaysia | 0.4% | 3.7% | 3.7% |
| Russia | -0.5% | 8.3% | 8.3% |
| Singapore | -2.6% | 0.7% | 0.7% |
| Taiwan | 1.0% | 2.6% | 2.6% |
| Thailand | -2.9% | 1.3% | 1.3% |

| Sector | MTD | QTD | YTD |
|---|---|---|---|
| Gold equity | 1.7% | -6.6% | -6.6% |
| Energy equity | 1.6% | -6.6% | -6.6% |
| Technology | -3.7% | 3.2% | 3.2% |
| Healthcare equity | -2.4% | -1.8% | -1.8% |
| Financial equity | -4.5% | -1.4% | -1.4% |

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