# Quarterly Investment Update
# Q3 2019

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# Market Review: Fixed Income

With the ongoing deluge of news and data, many are trying to predict and respond to every twist and turn in the market. This is akin to wrestling a bull; we get upset that we cannot predict its moves, and even if we can, do not have the ability to counter its bucking and threshing.

Hence it is rare for a person who is always reacting to the market to feel happy all the time as it seems nothing goes as intended and things are out of control. How can one be happy? An ex-Googler put forth a formula which is quite elegant.

Happiness ≥ Your perception of the Events of your life − Your Expectations of how life should behave

www.solveforhappy.com

This formula proposes that happiness is reflected less by how well things are going, but more by how well things are doing better than expected.

To be clear, we have high expectations, but we also discern between realistic and non-realistic expectations. Real-time news and data is a double-edged sword. We leverage on selected content to improve our decision-making and filter out other content that is counter-productive. In this way, **we choose to fight the battles that we are better equipped for in order to win the war**.

When it comes to investment happiness, having the right expectations is crucial. The obvious downside is perpetual unhappiness; more subtle (and hazardous to outcomes) is inappropriate response that derails the investment journey.

After a decline in May ended 2019's winning streak, markets bounced back with a vengeance. Practically all the equity and bond markets we monitor gained, with the exception of Indian equities showing a small loss. Accordingly, all holdings in our portfolios were profitable.

Markets took the cue that major central banks were being more accommodative and would reverse monetary policy by lowering rates, resulting in positive sentiment across all asset classes. A clear negative outlier was the USD, which declined against other currencies and commodities.

In a month where a rising tide floated all boats, currency-hedged bonds gained 1.4% while unhedged bonds rallied 2.2%, which meant our defensive posturing in flight-to-quality bonds made less than other segments. Nevertheless, the currency-hedge bonds are doing what they are expected to do: lead when markets are down such as in May, and lag in rallies like June. After all, **defenders are not expected to score goals but hold up when the team is stressed**.

June was more about markets being driven by general risk sentiment rather than specific regional dynamics. Consequently, there was not much differentiation in terms of performance across the portfolios' credit exposures in high yield and emerging markets, with gains in the range of 1.48-1.58%.

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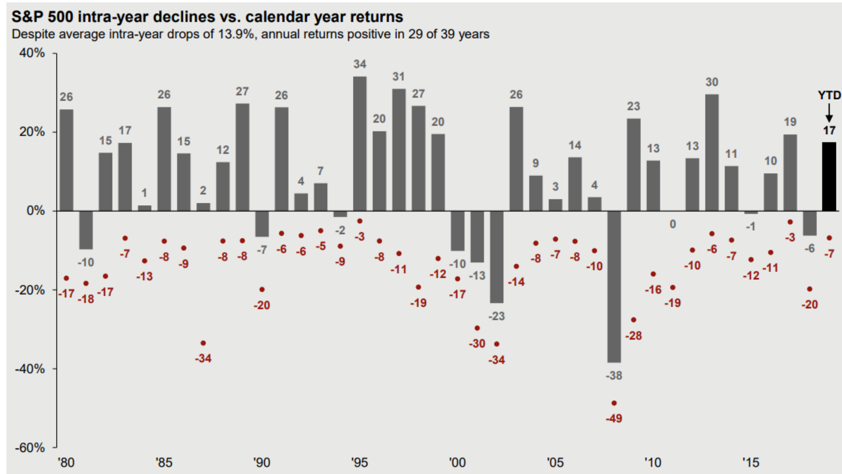
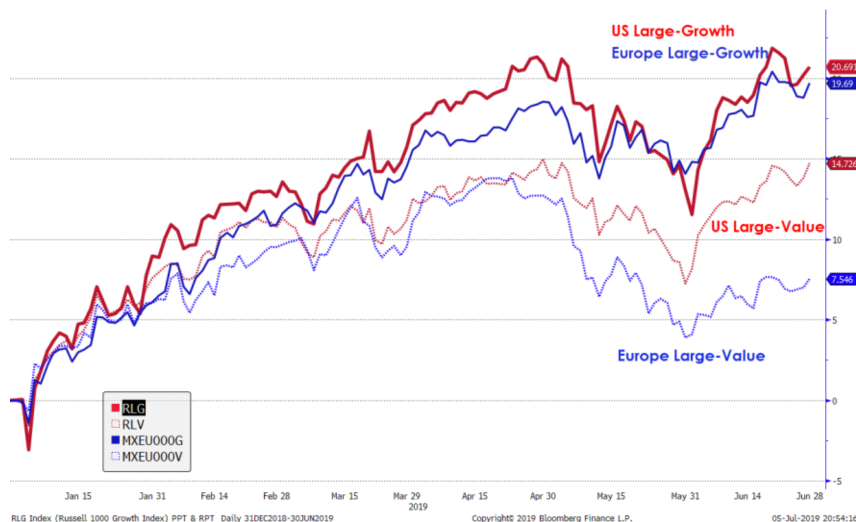
# Market Review: Equities

**Large intra-year drops are common within a positive year**




Source: J.P. Morgan Asset Management

**Our Growth-bias outperformed meaningfully YTD**




Equities rebounded strongly over the past month, spurred on by expectations of more accommodative central bank policies. For those who were spooked by the drop in May, the rapid turnaround in performance reminds us that markets do not go up (or down) in a straight line; in fact, large intra-year declines are common within years of strong gains.

US equities continued their leadership over the major regions in June, extending YTD gains by another 6.9%. In contrast to the previous month, the defensive utilities and consumer staples sectors lagged in such a risk-on environment, while the energy and technology sectors led with gains of more than 9%. Technology stocks remained the best performing sector YTD, with gains of close to 30%, and benefitting our tech-heavy growth exposures.

**Our growth bias in US and Europe performed well over the first half of 2019, with growth outperforming value by 6% in the US, and an outsized 12.1% in Europe.** In a slowing growth environment, we avoid the more economically-sensitive sectors that tend to be more dependent on the economy to do well. As a case in point, the economically-sensitive European financials sector (a large component of European value indices) are up a mere 6% including dividends, or about 1/3 of the broader market.

Emerging markets and Asia rebounded close to 6% over the past month, making up for some of the declines in May. Emerging markets were additionally supported by firm commodity prices and a weaker dollar; which are tailwinds for the region. **China 'A' equities – where we are overweight – added to their strong gains YTD, retaining its position as one of the best performing markets in the first half of 2019.**

Japanese equities, where we are also overweight, lagged regional markets in the first half of 2019. A softer growth environment, and generally disappointing corporate earnings in Q1 did not help, resulting in a drag on portfolio performance.

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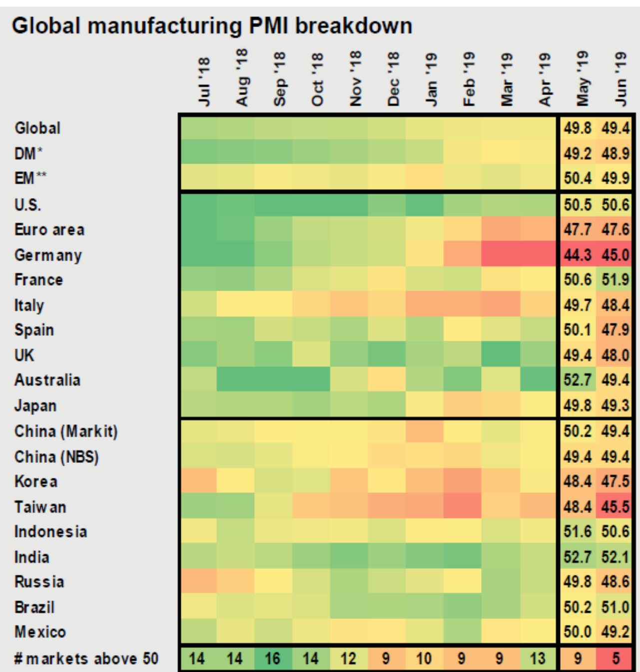
# Key Themes: Slowing Growth

**Global manufacturing activity is contracting…**




Source: J.P. Morgan Asset Management

**…though investors tend to get rewarded for staying invested**

| US S&P 500 performance 12 months after initial contraction | |
|---|---|
| Average gains | 9.6% |
| % positive returns | 72% |

Contraction defined as the initial month after the ISM Manufacturing PMI falls below 50, since 1980.

Source: Bloomberg

We mentioned last year that even though the economies were in late stage growth, strong but volatile gains could still lay ahead. Investors looking only at strong YTD returns may be surprised to know that global manufacturing activity started to contract at the start of the year. Rather than rely on just a few observations, we were guided by our FVT (Fundamental, Valuation, Technical) framework to stay invested. If we went to cash just based on manufacturing activity, the portfolios would have missed out on the strong YTD gains. Similarly, a manufacturing contraction may not be too much of a concern on its own– in the past, the S&P 500 has gained more than 9% on average in the following 12 months after a contraction. That said, we acknowledge weakening fundamentals that may prompt more volatility going forward. Though a recession is not our base case, we place a stronger emphasis on investments with higher earnings predictability that would hold up better in a less favourable economic environment.

**We continue to prefer US large-growth companies versus the other segments**. Large-growth companies tend to have low debt, stronger earnings, and overall healthier balance sheets; which make them more resilient in a slowdown. Additionally, growth tends to outperform value in the few months following an initial Fed rate cut (which may happen this year), giving us added confidence that they can continue to extend their outperformance even further.

**China 'A' equities remain attractive even after a 27% gain YTD.** Our overweight was prompted by attractive valuations going into 2019, which was further supported by high earnings growth. Today, valuations are not as cheap, but are still around their historical average. Earnings growth has also held up well despite the US-China trade tensions. Going forward, the Chinese government is expected to continue with additional policy stimulus that would support the economy and markets.

Our allocation to Japan was expected to outperform with attractive valuations, and on growth picking up. However, growth has remained lacklustre, and profit margins deteriorating. For now, we maintain our slight overweight on attractive valuations. That said, if the growth dynamics deteriorate even further, we would look to adjust our positions.

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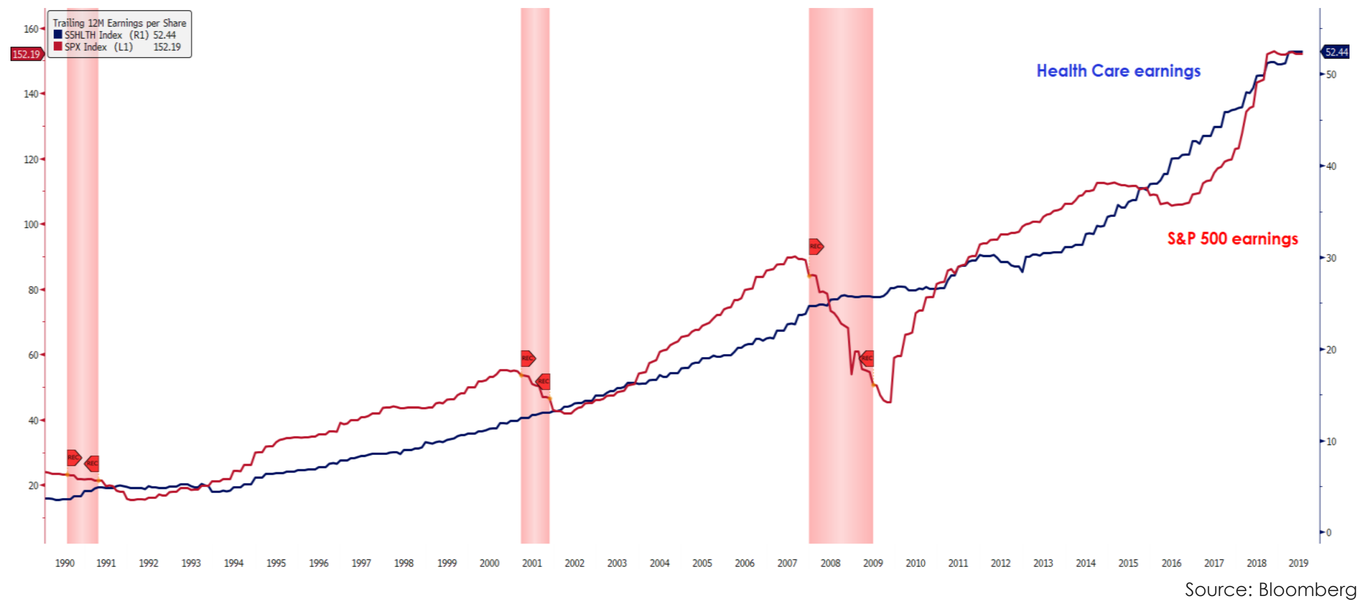
# Key Themes: Slowing Growth

**We are less constructive on Europe, which has done well YTD despite an outsized slowdown in economic activity.** It is fair to say that markets may have gotten ahead of fundamentals, making it a challenging risk/reward for investors i.e. upside is limited if the economy recovers, and there is greater downside if the economy continues to slow. Valuations for European large-growth companies are expensive relative to the broader market, with earnings moderating. Value stocks with a large cyclical component are similarly unattractive without a clearer pick-up in growth. **The good thing is that we are not forced to choose heads or tails when both options have clear headwinds; and move Europe equities to maximum underweight (0% exposure). We re-allocate our European exposures to the Global Health Care sector which is generally less correlated to the broader economic cycle** i.e. healthcare earnings are resilient during recessions whereas earnings for the broader market decline. Health Care valuations are also broadly in line with historical average, and further supported by earnings growth.

**Health Care earnings are more resilient than the broader market in an economic downturn**




Source: Bloomberg

Shaded areas indicate recessionary periods.

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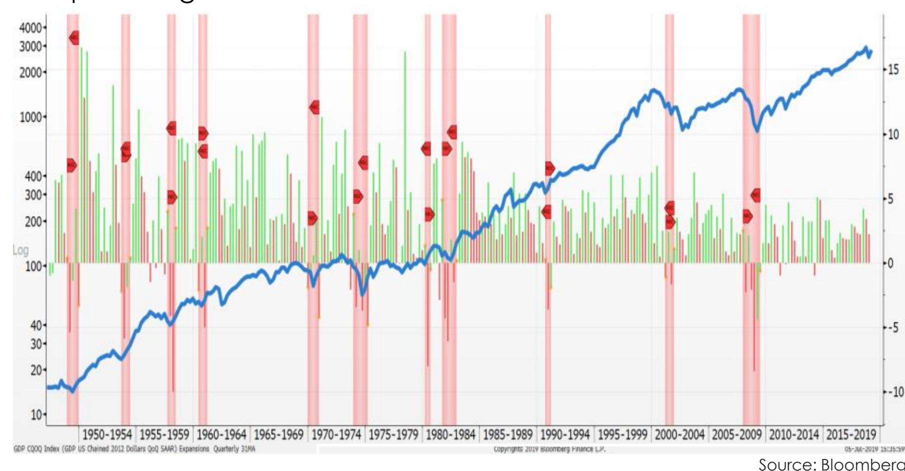
# Key Themes: Central bank on hold?

As of 2nd July, the current post-2009 economic expansion is the longest on record. The coordinated growth among major economics has moderated i.e. growth is still positive but at a slower rate. Looking deeper in, manufacturing sectors have started to contract.

While slowdowns and contractions have a negative connotation, they are part of economic cycles. The chart below shows economic expansions and recessions (shaded in red), with the corresponding S&P 500 index performance. It is important to note that going through these cycles do not mean that markets stop compounding over time.



Source: Bloomberg

At this juncture, there are three potential scenarios: Resurgence of growth, continued moderation, or contraction leading to recession.

Our central scenario is continued moderation, but not because it is middle ground. Indicators from the real economy and financial markets are not signalling recession. Conversely, a growth resurgence is not likely as it would take a lot of stimulus to turn this slow down around.

With more volatility and more uncertainty, we bias towards investments where sources of return are more certain e.g. cash flows, as opposed to capital appreciation predicated on optimistic extrapolation of growth.

**Sovereign bonds:** It is a tough time to be a central banker, and a tougher time to predict what a central banker is going to do. Our sovereign bond exposures have positive but modest return expectations. They **are also intended to, and have, shown gains when equities are down (though this does not happen on every equity down day or month).** We maintain exposure to currency-hedged sovereign bonds as a flight-to-quality investment with higher yield compared to Euro-denominated bonds. Sure, the portfolios would miss out on gains from the Euro if markets rally, but we expect to more than make up for it through the other risk assets.

**Short duration**: Long duration bonds have rallied more than short duration this year as markets raced to price in rate cuts. Nevertheless, our short duration credit investments were able to extract returns from higher coupon and capital appreciation. Will we be late to the game if we wait for the noise to reduce, and for a clearer signal to increase duration? Our studies show that even if duration was increased only when the central banks actually cut rates (which they have not), there are still returns to be made. In this way, we try to increase probability of gains, rather than looking at potential gains in isolation.

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# Key Themes: Search for yield

### Asian High Yield, US & EM short duration provides attractive yields

| | 31 Dec 2018 | 28 Jun 2019 |
|---|---|---|
| Asia HY | 8.9% | **6.4%** |
| US HY short dur. bonds | 8.2% | **5.5%** |
| US HY bonds | 7.9% | 5.8% |
| EM short dur. bonds | 5.6% | **4.6%** |
| EM bonds | 6.1% | 4.9% |

### Much more attractive than what bank deposits offer today

| | |
|---|---|
| SGD 1Y deposit | 1.7% |
| USD 1Y deposit | 2.3% |

Source: Bloomberg

In an environment of increasing volatility and uncertainty, investors tend to focus on more certain sources of return. In the case of credit investments, we focus on coupon returns more than capital appreciation.

**US High Yield**: Much has been said about rotating to investment grade corporate bonds as government yields have reduced so much that they are not worth holding. That is true if an investor had to choose only between sovereign and corporate bonds in the investment grade space. Being able to allocate to high yield bonds allows us to optimize across the entire credit spectrum. Our base case return expectation for US high yield bonds is around 5%. Most of this return is expected to come from coupons, with limited interest rate risk. While there is potential for capital appreciation, valuations are more likely to hold steady rather than provide much upside. So long as the slowdown does not cause corporate fundamentals to deteriorate to the extent of mounting defaults, borrowers are expected to be able to keep up with coupon payments to creditors.

**EM bonds**: We are sounding like a broken record on EM bond exposures. EM hard currency bonds offer higher yield to EM local currency bonds, without taking on currency risk. When we are more firm on the upside of emerging market currencies and the associated volatility, the portfolios will naturally see local currency exposures in the bond space.

**Asian High Yield**: Asian high yield continues to be one of the most attractive segments among global bond markets. Coupons are attractive, and there is room for capital appreciation based on current valuations. There are also encouraging signs that the credit environment is improving in China, which bodes well for borrowers and their ability to service their interest.

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# Key Themes: How are we positioned?

| Slowing Growth | Central Bank on Hold | Search for Yield |
|---|---|---|
| US Large-Growth equities | Short duration fixed income | Asian High-yield bonds |
| ~~Europe Large-Growth equities~~<br>Global Healthcare | ~~Currency-hedged European equity~~ | Emerging market short duration bonds |
| Japan equities | | |
| China ‘A’ equities | | |

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# Asset Allocation Strategy

| Equity Regional | -- | - | = | + | ++ | Allocation strategy |
|---|---|---|---|---|---|---|
| United States | | → | ■ | | | Large cap growth to capture late business cycle growth, and where large caps are more resilient to rising financing and wage costs. **Health Care as earnings are less dependent on the broader economic cycle.** |
| Europe | ■ | ← | | | | **Reduce to no exposure as economic activity is slowing meaningfully, and as valuations are rich.** |
| Japan | | | | ■ | | Slight overweight as economy is supported by corporate reforms, and equities at attractive valuations. |
| Asia Pacific ex Japan | | | | ■ | | Slight overweight to China 'A' as valuations are attractive and supported by earnings growth. |
| Emerging Markets | | | ■ | | | Weaker-stable USD may help to support equities in the region. |

| Fixed Income | -- | - | = | + | ++ | Allocation strategy |
|---|---|---|---|---|---|---|
| Sovereign | | | ■ | | | Focus on currency-hedged global government bonds to buffer portfolio volatility during periods of stress. |
| Investment Grade Corporate | ■ | | | | | Maintaining no exposure as low incremental yield and long duration exposure are less attractive than other segments. |
| High Yield | | | ■ | | | Maintain short duration which provides better yield to broad market with less sensitivity to interest rate changes. |
| Asia | | | | ■ | | One of the most attractive yields across major fixed income markets backed by policy support and sentiment. |
| Emerging Market Debt | | | | ■ | | Range-bound USD eases downward pressure on EMD which adds to portfolio diversification. |

**Notes:** - - Underweight - Slight Underweight = Neutral + Slight Overweight + + Overweight

Current | Previous

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# Market Index Returns

| Equity Regional | MTD | QTD | YTD |
|---|---|---|---|
| Global | 6.37% | 2.93% | 14.88% |
| United States | 6.89% | 3.79% | 17.35% |
| Europe | 4.28% | 1.52% | 13.98% |
| Japan | 2.57% | -2.54% | 3.82% |
| Asia Pacific ex Japan | 5.89% | -0.26% | 10.64% |
| Emerging Markets | 5.70% | -0.31% | 9.22% |

| Fixed Income | MTD | QTD | YTD |
|---|---|---|---|
| Global Aggregate (Unhedged) | 2.22% | 3.29% | 5.57% |
| High Yield | 2.60% | 2.55% | 10.84% |
| Asia | 1.34% | 2.73% | 7.48% |
| Emerging Market Debt | 2.71% | 3.75% | 9.39% |

| Currencies | MTD | QTD | YTD |
|---|---|---|---|
| USD/SGD | -1.59% | -0.20% | -0.73% |
| EUR/SGD | 0.23% | 1.19% | -1.53% |
| JPY/SGD | -1.14% | 2.53% | 0.87% |

| Commodity | MTD | QTD | YTD |
|---|---|---|---|
| Gold | 7.97% | 9.07% | 9.90% |
| Oil (WTI Crude) | 9.29% | -2.78% | 28.76% |

| Equity Markets | MTD | QTD | YTD |
|---|---|---|---|
| Australia | 3.47% | 7.09% | 17.22% |
| Brazil | 4.06% | 5.82% | 14.88% |
| China "A" | 5.39% | -1.21% | 27.07% |
| China "H" | 4.76% | -4.37% | 7.48% |
| Hong Kong | 6.10% | -1.75% | 10.43% |
| India | -0.80% | 1.87% | 9.22% |
| Indonesia | 2.41% | -1.70% | 2.65% |
| Korea | 4.35% | -0.47% | 4.39% |
| Malaysia | 1.29% | 1.73% | -1.09% |
| Russia | 3.77% | 10.76% | 16.74% |
| Singapore | 6.54% | 3.38% | 8.24% |
| Taiwan | 2.21% | 0.84% | 10.32% |
| Thailand | 6.80% | 5.60% | 10.64% |

| Equity Sectors | MTD | QTD | YTD |
|---|---|---|---|
| Gold | 19.07% | 14.34% | 21.81% |
| Energy | 9.07% | -3.71% | 11.13% |
| Technology | 8.60% | 5.57% | 25.87% |
| Healthcare | 6.67% | 1.11% | 8.76% |
| Financials | 6.56% | 7.43% | 15.92% |

**Price returns in index currency terms as of 28 Jun 2019. Source: Bloomberg**

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