



Outlook 2019

CIO's Letter

By Jeffrey Lee, MD & CIO of Phillip Capital Management

Date: 9 January 2019

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 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.**

Important Information: This material is provided by Phillip Capital Management (S) Ltd ("PCM") for general information only and does not constitute a recommendation, an offer to sell, or a solicitation of any offer to invest in any of the exchange-traded fund ("ETF") or the unit trust ("Products") mentioned herein. It does not have any regard to your specific investment objectives, financial situation and any of your particular needs. You should read the Prospectus and the accompanying Product Highlights Sheet ("PHS") for key features, key risks and other important information of the Products and obtain advice from a financial adviser ("FA") before making a commitment to invest in the Products. In the event that you choose not to obtain advice from a FA, you should assess whether the Products are suitable for you before proceeding to invest. A copy of the Prospectus and PHS are available from PCM, any of its Participating Dealers ("PDs") for the ETF, or any of its authorised distributors for the unit trust managed by PCM. An ETF is not like a typical unit trust as the units of the ETF (the "Units") are to be listed and traded like any share on the Singapore Exchange Securities Trading Limited ("SGX-ST"). Listing on the SGX-ST does not guarantee a liquid market for the Units which may be traded at prices above or below its NAV or may be suspended or delisted. Investors may buy or sell the Units on SGX-ST when it is listed. Investors cannot create or redeem Units directly with PCM and have no rights to request PCM to redeem or purchase their Units. Creation and redemption of Units are through PDs if investors are clients of the PDs, who have no obligation to agree to create or redeem Units on behalf of any investor and may impose terms and conditions in connection with such creation or redemption orders. Please refer to the Prospectus of the ETF for more details. Investments are subject to investment risks including the possible loss of the principal amount invested, and are not obligations of, deposits in, guaranteed or insured by PCM or any of its subsidiaries, associates, affiliates or PDs. The value of the units and the income accruing to the units may fall or rise. Past performance is not necessarily indicative of the future or likely performance of the Products. There can be no assurance that investment objectives will be achieved. Any use of financial derivative instruments will be for hedging and/or for efficient portfolio management. PCM reserves the discretion to determine if currency exposure should be hedged actively, passively or not at all, in the best interest of the Products. The regular dividend distributions, out of either income and/or capital, are not guaranteed and subject to PCM's discretion. Past payout yields and payments do not represent future payout yields and payments. Such dividend distributions will reduce the available capital for reinvestment and may result in an immediate decrease in the net asset value ("NAV") of the Products. Please refer to www.phillipfunds.com for more information in relation to the dividend distributions. The information provided herein may be obtained or compiled from public and/or third party sources that PCM has no reason to believe are unreliable. Any opinion or view herein is an expression of belief of the individual author or the indicated source (as applicable) only. PCM makes no representation or warranty that such information is accurate, complete, verified or should be relied upon as such. The information does not constitute, and should not be used as a substitute for tax, legal or investment advice. The information herein are not for any person in any jurisdiction or country where such distribution or availability for use would contravene any applicable law or regulation or would subject PCM to any registration or licensing requirement in such jurisdiction or country. The Products is not offered to U.S. Persons. PhillipCapital Group of Companies, including PCM, their affiliates and/or their officers, directors and/or employees may own or have positions in the Products. This advertisement has not been reviewed by the Monetary Authority of Singapore.