Phillip Capital Management

US Interest Rates: We have lift off!

23 DECEMBER 2015

The event most anticipated by the global financial community has finally taken place. The US central bank has raised interest rates a quarter percent (currently at 0.5% from 0.25%) and has pledged a gradual rise. Our fund managers present their views on the rate hike.

The Federal rate decision was clearly anticipated by the market over the last few weeks, as recent speeches and guidance by the US Federal Reserve governors have clearly signalled the intention.

We think it is likely the recent broad market correction in 3rd quarter 2015 has probably taken out many marginal sellers who are fearful about the imminent rate hike. And so in Asian trading before the rate hike on 16 December, the MSCI AC Asia Pacific index was up 2.2%. On 17 December (the day after the rate hike), the index was up 0.8%.

"Federal Reserve seems to think that likely future economic growth is stronger than the market believes…"

Do we agree with Fed guidance?

FOMC projections for the rate hike cycle in 2016-17 appear to be quite aggressive relative to current market pricing, and this is one point we will monitor as it implies the Federal Reserve seems to think that likely future economic growth is stronger than the market believes. The following factors however may convince the Fed to slow down the pace of increases should economic circumstances require it.

- The impact on US corporations of a slowing external global economy characterized by tepid demand and a stronger USD resulting in lower repatriated earnings and competitiveness of exports.
- Slow wage growth and declining consumer inflation expectations exerting a downward pressure on inflation statistics which may compel the Fed to readjust the pace of rate rises to ensure that inflation does not significantly fall below the target of 2.0%.

Impact of rate hikes on the markets

We think equity markets generally see the Fed rate hike as a benign event. The focus has now shifted to exactly when the next move will happen.

- Yellen's statement contained no big changes from the points that had been in recent weeks, with the emphasis being on gradualism in the rate hike path in 2016 onwards.
- Monetary tightening intention had been signalled as early as 2013 during Bernanke's time, and fund and capital outflows from "fragile economies" (mainly emerging markets) have had plenty of time to adjust themselves, such that we see less possibility of sudden big destabilising capital withdrawals going forward.
- Most importantly, the beginning of normalisation reflects confidence in the US, and probably the global, economy's recovery and conviction that it will be able to withstand a gradual increase in interest rates going forward.
- It is worth pointing out that the general equity market performance during the last two rate hike cycles, the 1999-2000 and 2004-2006 Fed rate hike cycles actually coincided with uptrends in the MSCI Emerging Markets. (Fig 1)

How the Singapore economy will be affected

- The Singapore economy is expected to grow 2.2% in 2016, up from the 1.9% in 2015 and so, rises in local interest rates would likely be gradual as MAS adopts a more accommodative stance in view of the sluggish economic growth and subdued inflation.
- Based on historical trends, the benchmark 3-month interest rates (SIBOR) typically exhibit a high correlation with US rates, given that Singapore is open to capital inflows/outflows.
- The Fed has predicted the US rates to eventually rise to the 1.375% at the end of 2016 whilst local (cont.)

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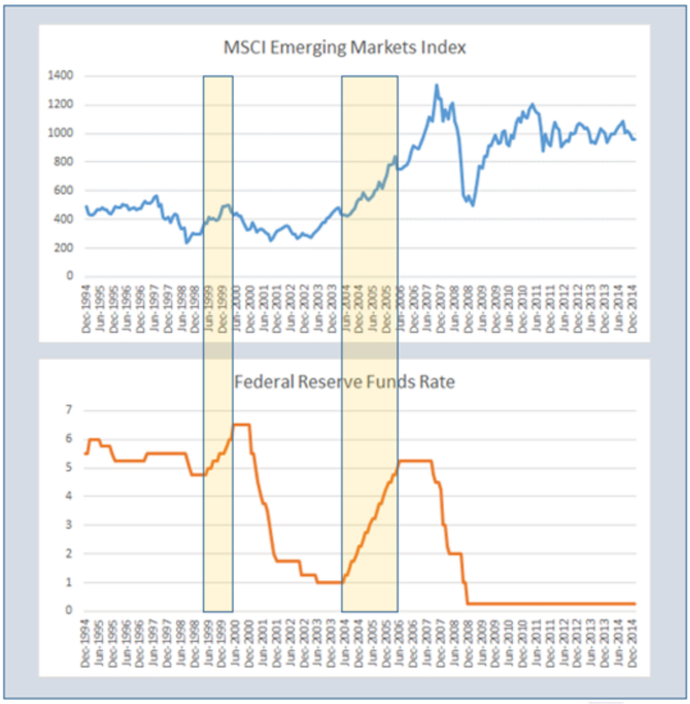

Fig 1: MSCI EM Index against Federal reserve Funds Rate

banks have forecasted the 3M SIBOR to reach 1.5% towards the end of 2016 from the 1.1% at present.

- Theoretically, higher rates imply liquidity tightening, which would mean sectors whose demand is debt-financed is likely impacted. Property is one of the key sectors, given high local debt levels. Worth noting though, that property equities are well priced for this (with many trading 20-50% discount to book value).

> *"…as Singapore is an open economy, its fortunes would be driven by global economic trends …"*

- We would emphasise that although the US has started tightening, the rest of the world, namely European and Japanese central banks, continue with quantitative easing, hence the impact is cushioned somewhat.
- We expect that both the US and Singapore dollars are likely to appreciate as rates move up with the SGD expected to strengthen particularly versus regional peers though not as much as the USD. A stronger SGD will see loss of export competitiveness. This includes incoming tourism which could see continued weakness.
- Banks should benefit as they can earn higher lending spreads; the largest local banks tend to have a large deposit base whose rates are stickier compared to lending rates. Electronics demand may see recovery in-line with global demand (typically, the tech sector is one of the early beneficiaries in a classic recovery cycle), though as mentioned, those that are based out of Singapore will face cost difficulties.
- In general, as Singapore is an open economy, its fortunes would be driven by global economic trends which all in all, appear to be on the path to recovery. As we observe, other entrenched trends are

- Structural weakness in commodity prices impacting Singapore's non-oil ex-electronics exports, specifically the transport engineering segment which includes oil rigs and shipbuilding.
- China's slowdown resulting in a gradual RMB depreciation will in turn affect export competitiveness of its Asian neighbours, while simultaneously its demand for their products may slow down.

As we know, Singapore too is going through an economic restructuring phase ("productivity-driven, Singaporeans-first, inclusive growth"), which leads to country-specific issues outside of the US rate hike. These other entrenched trends may have similar or an even greater degree of impact on Singapore than the US rate hike itself.

How the rate hike affects our portfolios

All in all, a mixed bag of opportunities abound so we want to invest in those companies which can raise themselves out of the low-productivity trap and/or have pricing power for their products, as this allows them to escape the drag of a strong SGD, and also derive relative competitive advantage against local peers.

In Phillip Asia Pacific Growth Fund, we hold QAF which owns the Gardenia bread brand that dominates Singapore & Malaysia, and has significant product segmentation catering from budget buyers to health-conscious premium buyers. We also hold ST Engineering, a key supplier of local armed forces' demand in addition to a strong aviation maintenance base in US; Del Monte Pacific which markets the well-known Del Monte vegetable, fruit and beverage brand in the US, Philippines South America, India plus the S&W brand globally.

For the Singapore REIT market, it is widely known that interest rate rises affect REITs negatively as a result of higher interest costs associated with their borrowings whilst more expensive financing could mean reduced demand from end buyers and so, the sector has softened accordingly in anticipation of rising rates. However, most REITs have been preparing for the change in their operating environment and have shored up their balance sheets in the process, so as to ensure that the impact of rising rates is kept to a minimal. It is these REITs that we seek out for inclusion in the Phillip Singapore Real Estate Income Fund; REITs that are able to continue paying out attractive dividends in the face of rising interest rates. Tellingly, the fund ended the week positively despite the announcement of higher interest rates.

In the new environment of rising interest rates, we are naturally very mindful of managing the duration risk of our fixed income portfolios. As such, our Phillip Money Market fund and Phillip USD Money Market fund both maintain a shorter maturity profile which would allow the opportunity of achieving higher rollover rates during reinvestment. Currently, the funds have a dollar weighted average maturity of 118 days and a higher allocation to financials in order to capitalize on higher interest margins. As always, the credit quality of our invested issuers is our foremost concern and much of our due diligence centers on assessing the issuers' cash flow and liquidity profile to ensure the safety of capital.

the Phillip Income fund with its balanced asset allocation and focus on income generation has a weighted average maturity of 4.7 years and yields an attractive 5.26% annually even whilst approximately 65% of its bonds are rated investment grade. The fund will likely maintain a shorter duration of under 5 years to mitigate interest rate risk and avoid US Treasuries going forward in the expectation that they will likely underperform other sovereign bonds for instance Singapore, Malaysia, Australia and New Zealand currently.

Conclusion: Nearing Normalisation

The Fed has spent a good time preparing the markets for the eventual normalization of interest rates and we at Phillip Capital Management have strived to best position our portfolios for the next rate rise cycle. Of course, after 7 years of near zero interest rates, we fully expect some volatility in the market as the world weans itself off cheap money. But overall, we are optimistic about the opportunities in the market as rising rates itself imply a growing world economy. We will merely continue to do what we always do which is to identify the best companies able to thrive in the coming 'new normal' market environment.

(Source of all statistics are either Bloomberg or Phillip Capital Management (S) Ltd as at 22 Dec 2015)

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