Phillip Capital Management

OUTLOOK 2022

CIO's Letter

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Salient Points:

- *Inflation Risk and High Valuations*
- *China's Experimentation on Self-Reliance*
- *Towards Net Zero*
- *Stick to the Quality Theme to Ride Out 2022*

At the beginning of 2021, we wrote about the vaccine-led recovery in global economies and stock markets. Since then, world markets have returned around 20%, and the US market more than 25%, surpassing the expectations of most investors. Omicron is currently making the rounds, after the Delta variant, and it has yet to be seen how governments plan to respond to new variants in the future. 2022 will be marked by inflation concerns, uneven economic recovery, and moderate equity gains (coupled with negative bond returns) amid heightened volatility in financial markets. The world economy will transition from the recovery boom fuelled by ultra-loose monetary and fiscal policies to steady-state growth and Fed monetary tightening...(continued)

The Spectre of Inflation

Inflation warnings have been sounded since last year, but the Fed persisted with its ultra-stimulative policies. The tide has changed, however, and the Fed, alarmed by recent data, has announced the accelerated conclusion of the Treasuries and mortgage-backed securities purchasing programme by March 2022, and are expected to start raising interest rates thereafter. This could rock stock markets and stymie recovery in the short term, but will also arm the Fed with some leeway to fight any potential downturns in the future.

Indeed, there could be continued trouble in the global economy with persistent inflation. Today's inflation is partly driven by supply-side factors, and Omicron has further disrupted supply chains and contributed to labour shortages. Moreover, China, whose ports and related industries are an intrinsic part of global manufacturing and transport networks, is doubling down on its zero-Covid policy, and recent city-wide lockdowns and increasingly onerous measures at ports are adding to existing strain in the system. Hence, it is likely that small interest rate hikes will do little to curb such strong supply-side inflationary pressures. Hopefully, 2022 will end with inflation levels down from the current 7%, and close to target levels of 2%, but it would be prudent to prepare for another huge miss.

On the bright side, precedent suggests that the Fed will be flexible if the policy changes prove to be ineffective at dampening inflation or if they excessively hamper recovery. In 2018 and 2019, the Fed increased rates multiple times, but reversed course very quickly when stock markets plunged. This underpins our case for modest equity returns.

High Valuations, Insider Selling, and Declining Breadth

US stock valuations are high at present, with a current CAPE ratio (cyclically adjusted price-earnings ratio which compares share prices with the average corporate earnings of the past 10 years) of around 40; a record high since the peak of the dot com bubble in 1999 at 43.8. Generally, high valuations mean low returns in the future, a rule that CEOs and corporate insiders might be taking note of as many of them sell extraordinarily large amount of their stock holdings. Such insider sales are estimated to reach over US$69 billion this year, up 79% from the 10-year average, with the top sellers including Tesla's Elon Musk, Amazon's Jeff Bezos, Walmart's Walton family, and Facebook's Mark Zuckerberg. On the other hand, retail investors are continuing to buy, which is unfortunately reminiscent of the phenomena leading up to the 1929 stock market crash. Since insiders have a reputation for selling at the peak, while retail investors buy, it follows that a decline might occur next.

There is an obvious danger in that, if the markets were to face a substantial correction, severe outrage amongst retail investors might culminate into populist backlash. There is a lot at stake for a lot more people, after all. Millions of novice retail investors flocked to new trading apps during the 2020 lockdown. More than 50% of American adults own stock, and net margin debt is now equivalent to about 2% of GDP. Indignation at being left "holding the bag" (a phrase popularised by Reddit threads) is highly probable when it looks like "the 1%" have used unfair advantage to "cash out" at the expense of "the little guys".

In addition, high valuations and high investor interest and demand are not evenly distributed across the stock market. Observably, breadth is declining as a smaller proportion of stocks are performing well relative to those that are performing poorly. While, this is not always a sign of an upcoming market correction, it can be concerning to have a market being so reliant on the good performance of a few stocks.

China

Across the Pacific, China is reining in its private sector, from tech companies straddling one industry too many, and recent or aspiring US stock market debutantes, to debt-ridden property firms. This has created some turmoil in the short term, while the debt problem in its property sector (which accounts for up to 25% of the Chinese economy) remains gargantuan.

However, China is signalling an interest in promoting investment. The new Beijing Stock Exchange, opened November 2021, aims to help small and medium-sized enterprises raise capital, which is in keeping with Xi's push for "Common Prosperity". That is not to say that the Chinese government has turned on its largest companies; rather, it can be said that (in addition to concerns about data and national security) China wants investors to buy shares of companies like DiDi on the HKEX instead of the NYSE.

There is a lot to watch in the world's second largest economy. The effects of Xi's pivot to self-reliant, sustainable, socially equitable growth after decades of rapid development and dependence on international markets will be tough to predict. Coupled with their strict zero-Covid strategy, the reportedly lower efficacy of Chinese vaccines, rising tensions with the US, and the threat of

commercial and technological decoupling, it is perhaps safe to say that a nimble and cautious stance for 2022 will be best.

ESG Imperatives

We are embarking on our strategic Environmental, Social and Governance ("ESG") plan, prioritising countries and companies aligned to a just, nature-positive transition to net zero. It is guided by the adoption of the United Nations-supported Principles for Responsible Investment ("PRI") and application of the Taskforce for Climate-Related Financial Disclosures ("TCFD") framework. Phillip Capital Management is now an official signatory and supporter of these two initiatives. Our approach emphasizes primary independent research, which we have always favoured, rather than sole reliance on an ESG rating provider. Furthermore, the way a company manages ESG issues reflects its quality and ability to compete successfully. Companies that perform better in addressing these issues can increase shareholder value by properly managing risks, anticipating regulatory action, accessing new markets, lowering costs of capital, and contributing to the sustainable development of the communities around them.

What Should Investors Do?

It is worth remembering that, in the long run, stocks are almost always a buffer against inflation. Over the last century (which includes the inflationary episodes in the US that followed the two world wars), stocks have returned 10% per annum, or close to 7% after adjusting for inflation. This is not surprising as stocks represent real assets, which in the long run appreciate with the inflation rate. Overweight Quality companies (e.g. Coca-Cola) have pricing power, strong balance sheets, and the ability to grow free cash flow. They are well-represented in the Phillip Global Quality Fund, which was launched in February 2021, and has since returned around 20%. Quality is the most important factor that we consider when designing our Funds, and Quality companies are best able to address sustainability issues while keeping profit margins intact.

Globally, REITs have been the best inflation-adjusted asset class for the past two decades. US REITs' dividend growth has outpaced the annual inflation rate every year except 2002 and 2009. In Singapore, the Lion-Phillip S-REIT ETF has returned more than 5% annualised since its inception in October 2017, outpacing the average inflation rate of 0.5% and the STI's 1.9% for the same period. Over the last two years, our S-REIT ETF has attracted more than $100 million of inflows. We expect these inflows to continue amid the current inflation and interest rate concerns in the market as REITs have weathered previous tightening cycles well. This is because the underlying real estate values and rentals will increase along with rising prices and outweigh the negative impact of rising interest rates. In addition, the sector will benefit from the recovery and reopening of Singapore as well as the quest for scale through mergers and acquisitions.

Investors in need of a steady income stream should also consider the Phillip SING Income ETF, which has a steady dividend yield of 5%. The underlying Quality constituents in the Singapore Equity universe, generate sustainable dividends, and include utilities, supermarkets, essential service providers, and the banks (which also benefit from higher interest rates).

In conclusion, we are looking at a year of transition in terms of Fed monetary policy, on whether inflation would prove persistent, on signs of a mid-cycle correction in the stock markets, and any significant political and economic changes in China. Nevertheless, we are confident that prudence and staying invested in Quality stocks and REITs will position us well to ride out the volatility in 2022. Of course, we will consider ESG factors every step of the way, as we believe that the best investments are those that are ethical and sustainable. Happy New Year!

Sincerely yours,

Jeffrey Lee
January 03, 2022

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