Phillip Capital Management

OUTLOOK 2023

CIO's Letter

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Salient Points:

- Dramatic correction predicted by high stock valuations, insider selling and Fed tightening as pointed out in our letter at the start of 2022
- US stocks still overvalued but the ongoing correction will sow the seeds of the next bull market
- Buckle up but stay focused on quality stocks and investment grade bonds

3rd January 2023

Look Back to Connect the Dots Forward

To prepare for 2023 and beyond, it is critically important to review what happened in the past and to draw the right parallels from it.

In our letter on 3rd January 2022, we pointed out that the high stock valuations, heavy insider selling (especially from technology leaders), declining stock market breadth, and Fed tightening could rock stock markets and stymie recovery.

To recap, US stock valuations were at a record high (since 1999 – of around 40x early last year), based on the CAPE ratio (cyclically adjusted price-earnings ratio which compares share prices with the average corporate earnings of the past 10 years)

Since then the S&P 500 index was down by almost a quarter at its lowest point last year, erasing more than US $10 trillion in market value. The CAPE ratio has now derated to around 27x but still well above the average of 20x or 1 standard deviation above the modern-era average. After a painful correction last year, the US stock market is still in overvalued territory considering that the earnings outlook is murky. However, this derating process will provide better entry points for investors and sow the seeds of the next bull market. Do not forget the big picture that over the last century (which includes the inflationary episodes in the US followed by the two world wars) stocks have returned on average 10% per year and 7% adjusted for inflation. Government bonds, usually a shelter from stocks, have not been a safe haven in this storm either. Treasuries are heading for their worst year since 1949.

Hangover From a Long Party

House prices are falling globally from Canada to Australia. Cryptocurrencies have crashed, and so have some of the platforms they are traded on. Gold and commodities have been relatively resilient, partly because of the war in Ukraine. The correction was made worse because investors had become used to low inflation and low volatility. However, this shock was not unpredictable. Long periods of low volatility predict both rapid credit growth and incidence of crisis many years into the future. After the global financial crisis of 2007-09, central banks cut interest rates aggressively to avert a meltdown of the financial system. As interest rates fell and stayed down, asset prices surged and a "bull market in everything" took hold. The S&P 500 rose seven-fold from its low in 2009 to its peak in 2021. Venture funding was widely available to a wide range of start-ups. Private markets across the globe – private equity, as well as property, infrastructure and private lending – quadrupled in size to more than US $10 trillion.

Last year's dramatic reversal was triggered by rising interest rates. The Fed has tightened more rapidly than at any time since the 1980s and their example has been followed by other central banks. Across the developed world, consumer prices are rising at their fastest annual pace in four decades.

These efforts may not yield the desired result of quashing resurgent inflation in the near term. There are, after all, underlying factors (such as food and fuel shortages) that cannot simply be solved by changing government or central bank policy. The war in Ukraine has dragged on for longer than many foresaw, and we are heading into a long, dark winter. Despite energy bills caps, it is estimated that the current energy prices will drive deaths in Europe far past the historical average. In addition, the (partial) loss of Russia and Ukraine as major contributors to the global food supply chain has hurt the most economically disadvantaged countries and individuals. We might not freeze in Singapore, but can feel the chill wafting over.

What History Tells Us About Fed Rate Hikes

Today's Fed is well aware that the hikes would raise unemployment and slow the economy but took the view that failure to restore price stability would mean far greater pain later on. The outlook is gloomy but there have been gloomier days before. The last time severe inflation tested the mettle of the Fed was the era of Paul Volcker. When he took office in August 1979, inflation was 11% and surged to 15% in March 1980. He managed to bring it under 4% by 1983, albeit at the cost of 2 recessions, high unemployment and

extreme volatility in financial markets. The Fed Funds rate peaked at 20% in June 1981. The Fed drove the economy into one recession and when it failed to curb inflation sufficiently, into a second. Inflation fell to 6 to 7% in September 1982 and the economy contracted sharply. The extraordinarily high interest rates in the US spread globally, aggravating a debt crisis in Mexico, Argentina and the rest of Latin America. In the US, major banks were under considerable stress. The Penn Square Bank in Oklahoma was declared insolvent in July 1982 and had a devastating effect on the US banking system. The Fed decided it was time to provide relief and lower interest rates in August 1982. It pivoted and the S&P 500 gained 15% within the same year and kept rising. That was the start of a bull market that continued for 40 years. In short, buckle up as the Fed continues to hike. It will pivot only when inflation is tamed or the financial markets seizes up.

What Should Investors Do?

What comes next, will be a complete reversal of the conditions that prevailed for much of the past 40 years. No more easy money, optimistic borrowers and asset owners. Bond investors and lenders are now better positioned for higher returns and creditor protections. Investors can now buy investment-grade corporate bonds offering 5 to 6%, which are attractive relative to government bonds and stock dividends.

Amidst the volatility in stocks and bonds, investors have sought the shelter of our Singapore (2.6% p.a.) and US dollar (3.1% p.a.) money market funds. They are well-positioned to benefit from rising rates and side-stepped the debate on how high the Fed Funds terminal rate will be. In short, cash will no longer be trash in these uncertain times.

Although gold has not glittered so far, it has performed well last year relative to stocks and bonds, as expected. Remember gold does its job when stocks and bonds fail investors. Over the past 50 years, gold has returned more than 8% per year which includes periods of high and low inflation.

How long will the turbulence last? In Volcker's time, when it seemed that the pain would go on forever, there was a remarkable turnaround. He inflicted pain when he entered in August 1979 and the situation looked gloomy but quickly reversed when investors sensed the improvements in August 1982. By the time he stepped down in August 1987, the Fed had vanquished inflation and brought prosperity that would last four decades.

In the meantime, go for quality stocks (such as Coca-Cola) which have a sustainable moat, pricing power, strong balance sheets and have outperformed the broad markets. They are well-represented in the Phillip Global Quality Fund and have been a refuge for equity investors. For growth investors, the recent launch of our HK Newly Listed Equities Index ETF is timely. It capitalizes on the dynamic IPO market in HK and the myriad investment opportunities such as the next Alibaba or Tencent.

Amidst the carnage, the Lion-Phillip S-REIT ETF has not been spared. However, it has performed well relative to the sharp declines in REITs globally. This can be attributed to the quality of the S-REIT market and its resilient dividends which will show a modest increase going forward. This will be led by the hospitality sector arising from the successful reopening of Singapore and the eventual resumption of outbound travel of China tourists amidst an unsteady start of China's relaxation of the zero-Covid policy. Additionally, income-seeking investors can look forward to a steady dividend yield of 3.5% from the Phillip SING Income ETF. This will be underpinned by the quality constituents in the Singapore equity universe comprising utilities, supermarkets, essential services providers and the banks.

Happy New Year and Happy Investing!

Jeffrey Lee

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