# Monthly Investment Update
# February 2019

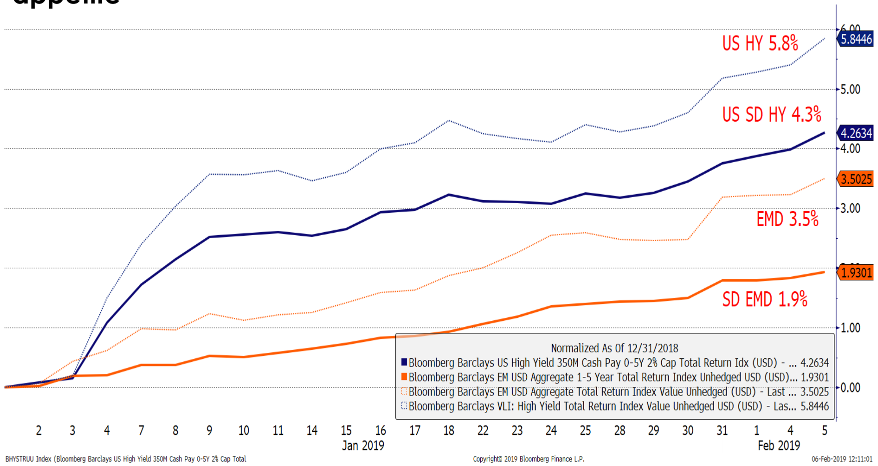
finexis
ASSET MANAGEMENT
汇信资产管理有限公司

# Market Review: Fixed Income

What a difference a month makes! The double whammy to fixed income and equity markets in 2018 seemed like a distant memory as practically all major asset classes staged a strong recovery in January. In a single month, global bonds edged into positive territory erasing 2018's losses while global equities came within 2% of making up for 2018's decline.

While we do not want to read too much into a single month, the silver lining mentioned in last month's commentary; that a repeat of losses for both asset classes is unlikely, seems to be playing out.

**Short duration debt lagged broad market due to bounce in risk appetite**




**Source: Bloomberg**

One key catalyst was the US central bank signalling that it was taking a pause on rate hikes to be more accommodative rather than reining in growth. This had the effect of improving sentiment and expectations of continued economic growth.

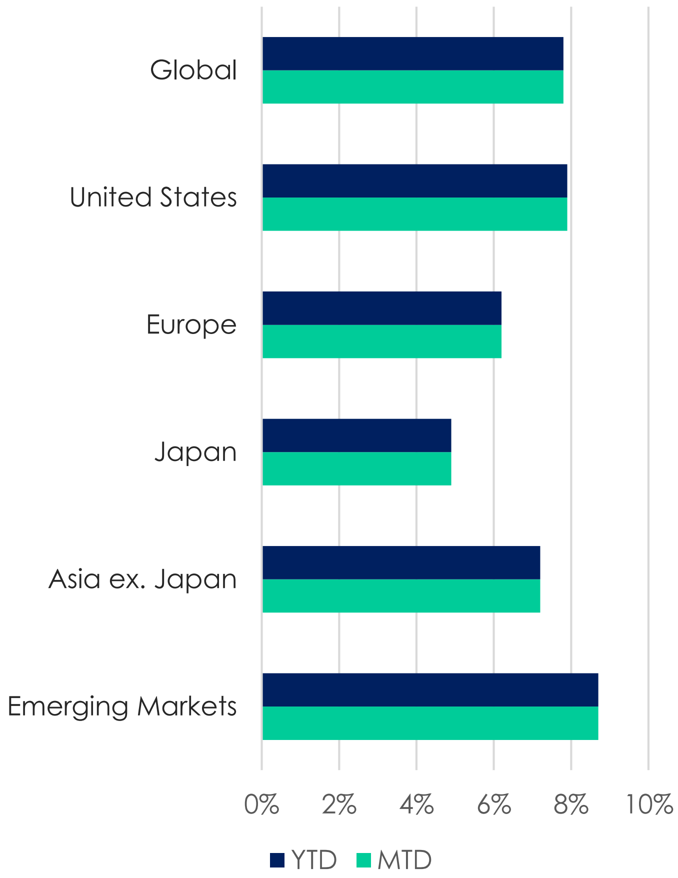
All segments of the bonds markets ranging from safe-haven sovereign bonds to riskier corporate credits were positive. Currency-hedged investment grade bonds gained 1.06%, lagging unhedged investment grade bonds which gained 1.52%. Short duration credits in high yield and emerging markets gained between 1.9% to 4.3% but also lagged their respective markets (as shown on the chart). All in, our relatively defensive positions in fixed income underperformed in such a bullish environment. Nevertheless we are not perturbed because the portfolios' attacking (equity) and defensive (fixed income) positions did their job.

Investors with short memories might be inclined to invest only in equities (you could get 7% in a month by randomly choosing any market), or adopt an investment rule of "just buy on dips". This would be analogous to switching to an attacking formation (the attacking-minded teams score the most goals but they tend to concede the most goals as well). There are also investors with long memories who remember the dot.com and 2008 market crashes, and stayed out of the market. When one steps on the brakes permanently, it's fair to say they will not get anywhere. As tempting as it may be, one should not forget portfolio discipline.

Years of low rates have created a low return, low volatility world which have frustrated investors. As we break out of this low return environment, expect volatility to rise as central banks reverse monetary policy amid this mature stage of the economic cycle. Fortunately, markets have been kind to investors by easing them into rising volatility in the form of a correction rather than a market crash.

# Market Review: Equities

**Regional Equity Performance**




**Returns in index currency terms as of 31 Jan 2019**
**Source: Bloomberg**

Global equities rallied strongly from their lows in December, as markets took a more sanguine view around some of the key issues concerning markets last quarter. Alongside a more accommodative US Fed, there were also signs of progress in resolving the ongoing US-China trade tensions; all of which contributed to the positive market sentiment.

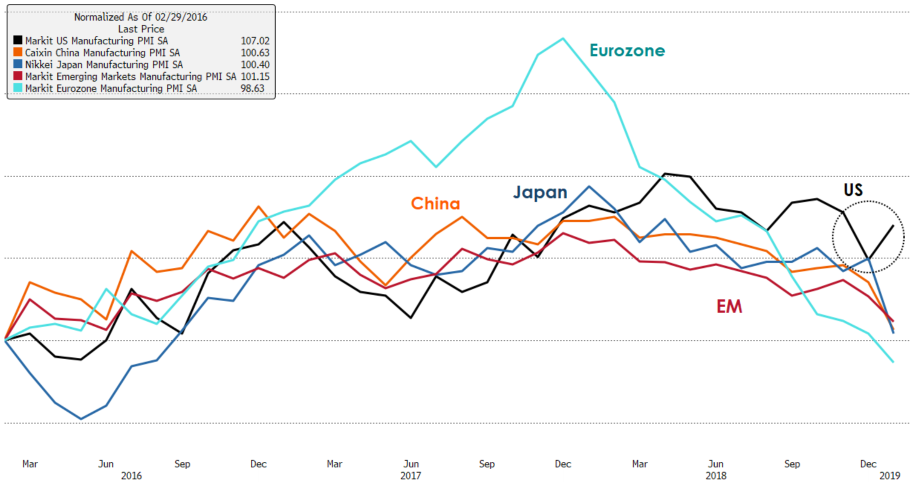
US equities outperformed other developed markets (Europe and Japan). January was also when companies began to report their 2018 Q4 earnings results. Perhaps the lack of any further negative earnings surprises beyond what was already priced in before, helped to sustain gains over the past month i.e. earnings were not as bad as what people initially thought. Against this backdrop, cyclical sectors contributed strongly to performance, while the defensive utilities, healthcare and consumer staples sectors underperformed the broader market.

The financials sector – which we reduced earlier in the month – also saw strong gains alongside the broader market. Were we too cautious in reducing the financials exposure? We are not keen to make investment decisions based on just one good month of performance or data. More importantly, it is still prudent to tilt our portfolios away from areas that are increasingly challenged by the slowdown in global growth, and favour those with clearer tailwinds.

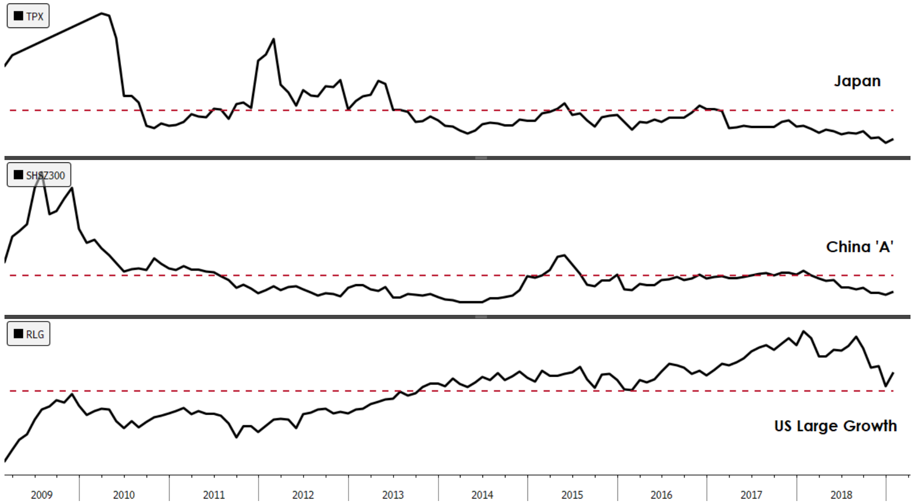
Emerging Market (EM) equities were the best performing region in January. Not surprisingly, sentiment around China benefited from continued trade negotiations with the US. We also saw greater willingness by the Chinese authorities in implementing more stimulus to support a slowing economy. In general, a stable dollar, and relatively more attractive valuations supported the strong gains in EM equities.

# Key Themes: Peak growth

**Clearer slowdown in manufacturing activity outside the US**




**China & Japan cheap enough? P/E ratios below their 10 year average**




**Source: Bloomberg**

We entered the new year with an environment vastly different from just one year ago. At the end of 2017, there was immense optimism that the synchronized growth environment would propel risk assets much higher. Since then, global growth has slowed considerably, with recent numbers even pointing towards a contraction for a few economies. Which then prompts the question: if growth has peaked, how should we invest in such an environment?

The US economy is more of a mixed bag as opposed to clearer signs of slowdown elsewhere. After falling sharply in December, the rebound in US manufacturing activity in January was encouraging. That said, other economic indicators such as weaker new export orders, were less resilient to weaker economic activity abroad. In such an environment we continue to maintain our bias to US large-growth companies for their strong earnings, low debt, and overall healthier balance sheets. These characteristics make them more resilient in a slowdown, or in a less accommodative environment; in short, less at the whim of central bank policy.

Global growth has slowed considerably in other regions, but they also come with more attractive valuations. Valuations for both Japan and China 'A' (we have a slight overweight in both markets) are historically attractive, and relative to other regions such as the US. Corporate earnings have also held up well considering the uncertain economic (and political) environment. While it is true that 'cheap can get cheaper', these areas present interesting opportunities for us, especially when a lot of the bad news are already priced in. We pay close attention to any meaningful deterioration in corporate earnings that may detract from the upside scenario.

# Key Themes: Central bank tightening

One of the most drawn out rate hike cycles is being put on hold as the Fed is trying its best not to snuff out growth in its attempt to prevent the economy from overheating. However, taking a pause on rate hikes should not be misconstrued as backing off plans to tighten over the long term. The Fed still wants to tap on the brakes, just not prematurely.

Fixed income investing amid a rate hike cycle is like paddling upstream. The speed of the current has essentially stopped as markets are not expecting further hikes due to the central bank's response to prospects of slowing growth (as shown in the table). While the headwinds to fixed income markets in the form of rate hikes have dissipated, tail winds in the form of rate cuts are not evident.

**Odds of further US rate hikes have diminished significantly**

| Date | Probability of a Fed interest rate hike at next meeting |
|---|---|
| 30/11/2018 | 79.20% |
| 18/12/2018 | 69.60% |
| 19/12/2018 | 2.10% |
| 31/12/2018 | 0.00% |
| 31/01/2019 | 0.00% |

**Source: Bloomberg**

Meanwhile, the central banks in Europe and Japan are in no hurry to raise rates given that economic growth is abating. The European and Japanese central banks found themselves in a tricky situation where they were inclined to raise rates but could not find the opportunity to do so. This means that they are hampered in the ability to cut rates to stimulate the economy in the event of a slowdown. Hence, our base case is one where central banks are tightening over the long term, pauses notwithstanding.

**Short duration**: Rather than just judge on fundamentals alone, we also look at what the markets are pricing in. The US high yield short duration market is yielding 7.0% vs the broader market's yield of 6.7%. Similarly, short duration emerging market debt is yielding 5.1% with the broader market at 5.5%. Given similar yield, similar credit risk, and less sensitivity to interest rates, this is one of the examples in investing where we can have our cake and eat it too.

**Sovereign bonds:** Despite the January market rally, the heightened uncertainty arising from the combination of inflection in monetary and economic cycles persists. Furthermore, trade friction and over-levered businesses present additional risk. We adopt a barbell approach as we maintain exposure to currency-hedged sovereign bonds as an anchor for the portfolio while extracting returns from the riskier assets.

For a long time, investors had to "pay" to hold safe haven assets due to low and steadily rising interest rates (which eat away at bonds' capital values). The current environment is more conducive as sovereign bonds provide higher coupon income than before and the pause in rate hikes significantly reduces the impact on bond prices.

# Key Themes: Search for yield

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

| | 31 Dec 2017 | 31 Jan 2019 |
|---|---|---|
| Asia HY | 5.6% | **7.8%** |
| US HY short dur. bonds | 5.7% | **7.0%** |
| US HY bonds | 5.5% | 6.7% |
| EM short dur. bonds | 4.0% | **5.1%** |
| EM bonds | 4.5% | 5.5% |

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

| | |
|---|---|
| SGD 1Y deposit | 2.1% |
| USD 1Y deposit | 3.0% |

**Source: Bloomberg**

Imagine two kinds of property investors: One persistently buys fundamentally good Orchard Road property even when rents are declining and prices are high (leading to lower rental yield). The other investor searches across all regions to invest in property with stable or rising rents, and where prices are relatively lower (leading to higher rental yield). When it comes to fixed income investing, we are like the second investor.

There has been an increasing chorus that coupon payments will be the largest contributor of fixed income returns this year whereas capital gains are more uncertain. While there is more market uncertainty, our strategy does not need to change. Instead, the strategy adapts to markets by searching for bonds where we get coupon income, and with potential for spread compression backed by fundamentals.

**US High Yield**: Low default rates continue to underpin market fundamentals. After price declines in Q4 2018 (rising spreads), high yield bonds saw meaningful price gains (spread compression). Spread compression is a show of confidence and optimism by the market. As mentioned in the previous section, short duration yields of 7% make for a compelling choice as one gets similar return potential for reduced sensitivity to interest rates.

**EM bonds**: As the Fed holds off on rate hikes, the USD is expected to be range-bound, which reduces downward pressure on emerging market assets. Short duration EM debt offers comparable yield to the broad index while being more insulated from interest rate risk.

**Asian High Yield**: Our entry point into Asian high yield has been rewarded as investors bought into the market, driving yields from 9% to 7.8%. There is still ample room for price appreciation, and even if that does not happen, investors are able to clip 6.4% in coupons. Chinese high yield bonds, which form a large part of the market, are backed by policies to sustain growth. A key risk will be further deterioration in the Chinese economy affecting the ability of corporate borrowers in the real estate and industrial sectors to repay or refinance, triggering a chain reaction of defaults.

# Key Themes: How are we positioned?

| Peak Growth | Central Bank Tightening | Search for Yield |
|---|---|---|
| US Large-Growth equities | Short duration fixed income | Asian High-yield bonds |
| Europe Large-Growth equities | | Emerging market short duration bonds |
| Japan equities | | |
| China 'A' equities | | |

# Asset Allocation Strategy

| Equity Regional | -- | - | = | + | ++ | Allocation strategy |
|---|---|---|---|---|---|---|
| United States | Current | Q4 2018 | | | | Large cap growth to capture late business cycle growth, and where large caps are more resilient to rising financing and wage costs. Underweight driven by higher valuations relative to other markets |
| Europe | | Current | | | | Slight underweight as valuations are on the higher end, and as economic activity continues to moderate. |
| Japan | | | | Current | | Slight overweight as economy is supported by structural growth arising from corporate reforms, and equities at attractive valuations. |
| Asia Pacific ex Japan | | | | Current | | Slight overweight to China 'A' as valuations are attractive and supported by earnings growth. |
| Emerging Markets | | | Current | | | Earnings are expected to slow, though a weaker-stable USD may help to support equities in the region. |
| **Fixed Income** | **--** | **-** | **=** | **+** | **++** | **Allocation strategy** |
| Sovereign | | | Q4 2018 | Current | | Focus on currency-hedged global government bonds to buffer portfolio volatility during periods of stress. |
| Investment Grade | Current | | | | | Maintaining no exposure as low incremental yield and long duration exposure are less attractive than other segments. |
| High Yield | | | Current | | | Maintain short duration which provides better yield to broad market with less sensitivity to interest rate changes. |
| Asia | | | | Current | | One of the most attractive yields across major fixed income markets backed by policy support. |
| Emerging Market Debt | | | | Current | | Range-bound USD eases downward pressure on EMD. Maintain short duration to mitigate rate hike impact. |

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

Current | Previous

finexis ASSET MANAGEMENT 汇信资产管理有限公司

# Market Index Returns

| Equity Regional | MTD | YTD |
|---|---|---|
| Global | 7.8% | 7.8% |
| United States | 7.9% | 7.9% |
| Europe | 6.2% | 6.2% |
| Japan | 4.9% | 4.9% |
| Asia Pacific ex Japan | 7.2% | 7.2% |
| Emerging Markets | 8.7% | 8.7% |

| Fixed Income | MTD | YTD |
|---|---|---|
| Global Aggregate | 1.5% | 1.5% |
| High Yield | 5.2% | 5.2% |
| Asia | 2.0% | 2.0% |
| Emerging Market Debt | 3.2% | 3.2% |

| Currencies | MTD | YTD |
|---|---|---|
| USD/SGD | -1.3% | -1.3% |
| EUR/SGD | -1.4% | -1.4% |
| JPY/SGD | -0.6% | -0.6% |

| Commodity | MTD | YTD |
|---|---|---|
| Gold | 3.0% | 3.0% |
| Oil (WTI Crude) | 18.5% | 18.5% |

| Equity Markets | MTD | YTD |
|---|---|---|
| Australia | 3.9% | 3.9% |
| Brazil | 10.8% | 10.8% |
| China "A" | 6.3% | 6.3% |
| China "H" | 9.0% | 9.0% |
| Hong Kong | 8.1% | 8.1% |
| India | 0.5% | 0.5% |
| Indonesia | 5.5% | 5.5% |
| Korea | 8.0% | 8.0% |
| Malaysia | -0.4% | -0.4% |
| Russia | 6.4% | 6.4% |
| Singapore | 4.0% | 4.0% |
| Taiwan | 2.1% | 2.1% |
| Thailand | 5.0% | 5.0% |

| Equity Sectors | MTD | YTD |
|---|---|---|
| Gold | 7.5% | 7.5% |
| Energy | 11.0% | 11.0% |
| Technology | 7.7% | 7.7% |
| Healthcare | 5.1% | 5.1% |
| Financials | 8.6% | 8.6% |

**Returns in index currency terms as of 31 Jan 2019. Source: Bloomberg**

# Disclaimer

To the best of its knowledge and belief, Finexis Asset Management Pte. Ltd. (Finexis Asset Management) considers the information contained in this material as accurate only as at the date of publication. All information and opinions in this material are subject to change without notice. No representation or warranty is given, whether express or implied, on the accuracy, adequacy or completeness of information provided in the material or by third parties. The materials on this material could include technical inaccuracies or typographical errors, and could become inaccurate as a result of subsequent developments. Finexis Asset Management undertakes no obligation to maintain updates of this material.

Neither Finexis Asset Management nor its affiliates and their respective shareholders, directors, officers and employees assume any liabilities in respect of any errors or omissions in this material, or any and all responsibility for any direct or consequential loss or damage of any kind resulting directly or indirectly from the use of this material. Unless otherwise agreed with Finexis Asset Management, any use, disclosure, reproduction, modification or distribution of the contents of this material, or any part thereof, is strictly prohibited. Finexis Asset Management expressly disclaims any liability, whether in contract, tort, strict liability or otherwise, for any direct, indirect, incidental, consequential, punitive or special damages arising out of, or in any way connected with, your access to or use of this material.

This material is not an advertisement and is not intended for public use or distribution. This material has been prepared for the purpose of providing general information only without taking account of any particular investor's objectives, financial situation or needs and does not amount to an investment recommendation.

The information contained in this material does not constitute financial, investment, legal, accounting, tax or other professional advice or a solicitation for investment in funds managed by Finexis Asset Management, nor does it constitute an offer for sale of interests issued by funds that are managed or advised by Finexis Asset Management. Any offer can only be made by the relevant offering documents, together with the relevant subscription agreement, all of which must be read and understood in their entirety, and only in jurisdictions where such an offer is in compliance with relevant laws and regulatory requirements.

Simulations, past and projected performance may not necessarily be indicative of future results. While there is an opportunity for gain, any investor is at risk of loss of 100% of its investment when investing in funds managed or advised by Finexis Asset Management.

The information on this material is not intended for persons located or resident in jurisdictions where the distribution of such information is restricted or unauthorized. No action has been taken to authorize, register or qualify any of the Finexis Asset Management funds or otherwise permit a public offering of any Finexis Asset Management fund in any jurisdiction, or to permit the distribution of information in relation to any of the Finexis Asset Management fund in any jurisdiction.