Quarterly Investment Update
Q4 2019

finexis
ASSET MANAGEMENT
汇信资产管理有限公司

Market Review: Fixed Income

September was a month where investors forgot the pain of August, and increased their risk appetite. Safe assets (bonds) declined while risk assets (equities) rallied. Just imagine investors brandishing their swords and throwing away the shields.

Bonds have had a remarkable year with returns well above expectations: September was the first down month for currency-hedged bonds, our preferred bond exposure, while unhedged bonds had a see-saw journey as shown in the color-coded table below.

Date	Unhedged bonds	Hedged bonds
Jan-19	1.52%	1.06%
Feb-19	-0.58%	0.12%
Mar-19	1.25%	1.79%
Apr-19	-0.30%	0.06%
May-19	1.35%	1.44%
Jun-19	2.22%	1.40%
Jul-19	-0.28%	0.79%
Aug-19	2.03%	2.27%
Sep-19	-1.02%	-0.46%
Total return	6.30%	8.76%

Source: Bloomberg, Monthly returns of Bloomberg Barclays Global Aggregate Bond Index Unhedged and Hedged from 31/12/2018 to 31/09/2019.

Unhedged bonds fluctuate more than hedged bonds as they bear more risk in the form of currencies. Recall that currencies account for around 40% of risk in bonds. If more risk means more returns, do the higher returns from hedged bonds with less risk present a contradiction?

Rather than just more risk, more return, we think about more *better* risk, more return. To do that, we apply our FVT process to be selective about the risk that we expect to be rewarded for, rather than just blindly taking risk. This led us to the hedged USD-centric exposures that have paid off though they have "less" risk than unhedged bonds.

In our last commentary, we used the summer lull to discuss volatility associated with seasonality. The monthly see-saw movements in unhedged bonds are associated with events that do not help us in making informed investment decisions e.g. speculation on interest rates. Sometimes, choosing the appropriate segment to be in reduces the noise that we are exposed to.

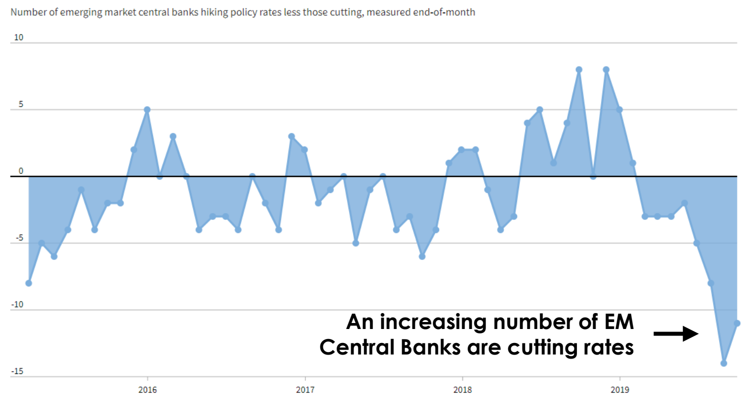
Credit investments had their chance to shine in September where investors were selective about which segments of credit to reward. **Our preferred exposures to Asian high yield and short duration emerging market debt had the strongest gains among major credit markets.** Asian investment-grade credit, which we do not have exposure to, was the only major segment in the red, dragged down by duration exposures that also caused losses in global investment grade bonds. Hence, this is an illustration that the credit investments have a return expectation while being differentiated from other parts of the fixed income portfolio (what we call lower correlation).

Emerging markets shook off some of the drama in August; Argentina's currency and USD bonds rallied 3.2% and 10.4% respectively. Despite this, we are monitoring markets for deterioration that may prompt changes in allocation.

Market Review: Equities

Source: Reuters Graphics

Global Central Banks trying to stimulate economic activity



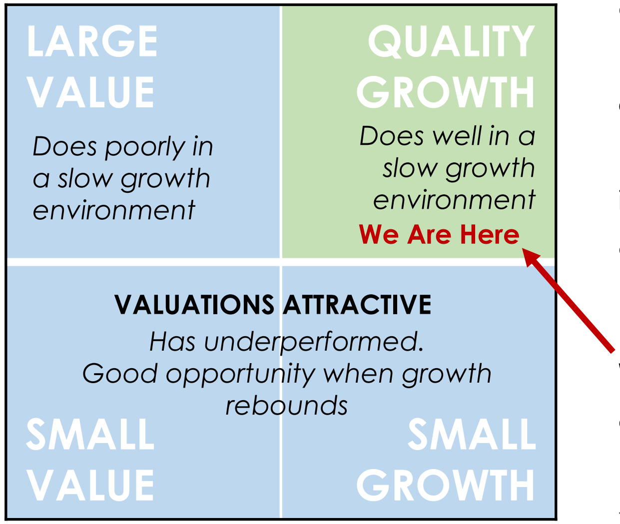
Note: Central banks of the following 37 economies are included: Azerbaijan, Belarus, Brazil, Bulgaria, Chile, China ex-Hong Kong and Macau, Colombia, Costa Rica, Czech Republic, Egypt, Georgia, Hungary, India, Indonesia, Iraq, Ivory Coast, Jordan, Malaysia, Mexico, Morocco, Namibia, Nigeria, Pakistan, Peru, Philippines, Poland, Qatar, Romania, Russia, Serbia, South Africa, South Korea, Sri Lanka, Taiwan, Thailand, Turkey, and Ukraine
Source: Refinitiv Datastream, Reuters calculations

Market expectations for more accommodative central bank policies were largely met as global central banks cut interest rates to support economic growth. Over the past month, we witnessed a momentary switch to "risk-on" mode across the board, as investors were encouraged by more accommodative policies to combat deteriorating economic data. The prior month's worst performers rebounded strongly – the economically-sensitive financial and energy sectors gained 4.5% and 3.6% in September, making up for some of their earlier losses. By and large, developed market equities ended Q3 on a positive note, though EM and Asia markets ended in negative territory.

Areas of Interest	Market Observations
US Large-Growth US Small	**Year-to-date, our preferred US large-growth market (+23%) maintained their wide lead over the other market segments, providing greater resilience over this period of increased market uncertainty.** In Q3, large-growth stocks also had smaller and shorter drawdowns versus the other segments i.e. Large-Value, or Small-caps, resulting in a less stressful experience for investors. In contrast, US equities with small-capitalization 'Small-caps' emerged one of the worst segments in the market; returning 14.2% year-to-date, or about a 9% underperformance. Our long-time readers would remember when we moved out of Small-caps in 2018 Q4, when the segment was deemed to be expensive, and as their earnings were more at risk in a growth slowdown. Today, Small-caps are much more attractively-valued, and could be an interesting opportunity for us when economic condition improves from here.
Europe	Europe equities trudged higher in Q3, even as the economy fell deeper into contractionary zone. Investors continued to focus on accommodative European Central Bank (ECB) policies, rather than the deterioration in economic fundamentals. We do not think that the divergence in deteriorating fundamentals and rich valuations make for an attractive investment, and chose to avoid investments in this area. That said, we pay close attention to the risk drivers in Europe for selective opportunities that may present themselves when there are clearer signs that the growth slowdown is bottoming.
Japan	Patience in Japanese equities, which we still consider attractively valued, paid off in the past month (+5.9%). On a total return basis, Japan equities managed to outperform the other major markets over Q3 (+3.3%), and benefiting our overweight. Even as attractive valuations improve the risk/reward in Japan, the strongest returns are likely to materialize when global growth improves. Likewise, we would look to adjust our positions if the growth dynamics deteriorate even further from here.

Key Themes: Slowing Growth

Which markets to invest into?



The strong YTD gains across our portfolios have vindicated our earlier decision to stay invested even as some economic indicators started to moderate at the start of the year (manifested as economic slowdowns in newspaper headlines). At the same time, **we have been on high alert for a more meaningful deterioration in economic data that would lead to a much less happy outcome** – in the form of a global recession, which would likely be accompanied by a bear market (declines of more than 20%). Today, we have a few fundamental indicators such as the *yield curve* flashing warning signs, but when we assess the markets across our combination of Fundamental, Valuation and Technical 'FVT' inputs, they are telling us to keep the door open to risk-assets moving higher for potentially some time longer.

We believe that US quality-growth companies are well positioned for a slowing growth environment. These quality businesses have low debt, stronger earnings, and overall healthier balance sheets; which make them more resilient in a slowdown. In the past quarter, US quality-growth stocks performed well in drawdowns relative to cyclical value-stocks that may find it more challenging to grow their earnings in a slow growth environment.

We have always said 'prepare, don't predict'. For us, this means knowing which markets to get into in different environments. As growth slowed YTD, we progressively turned more defensive in our positioning, preferring markets that are more resilient or with supportive valuations. **With clearer signs of a recession, we would further increase exposures to safe assets to protect against sharp declines. That said, we also entertain a scenario where accommodative policies lead to a rebound in global growth.** In this scenario, there are segments that may benefit tremendously (see graph); and where we are prepared to invest opportunistically. Japan equities are expected to do particularly well when growth rebounds. Even though growth is still lacking, we maintain a slight overweight on attractive valuations and favourable risk/reward. Indeed, Japan equities did particularly well in September (+5.9%).

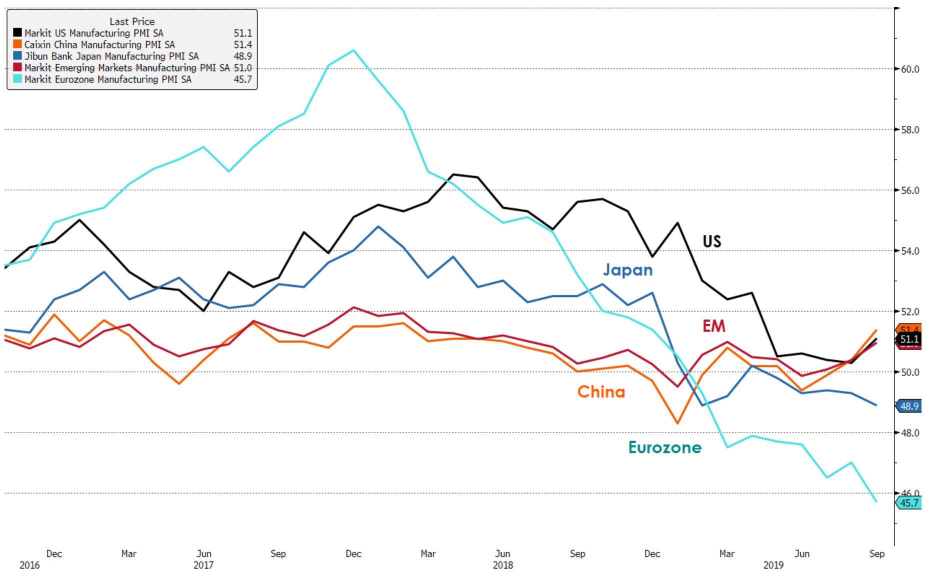
China 'A' equities continue to be an interesting proposition, offering investors access to a high growth market without overpaying – valuations are currently attractive below their historical averages. Even with all the uncertainties of the US-China trade tensions, China 'A' is one of the top performing markets YTD (+29.5%), and a meaningful return contributor for our portfolios. The Chinese government is also expected to embark on policies that will support the economy and markets.

Key Themes: Slowing Growth

Earlier in July, we re-allocated our European equity exposures (effectively bringing holdings to zero) into the Global Healthcare sector, where earnings are generally less correlated to the broader economic cycle i.e. Health Care earnings are resilient during recessions whereas earnings for the broader market decline. Health Care valuations are also broadly in line with historical average, which means that we are not overpaying to be invested here.

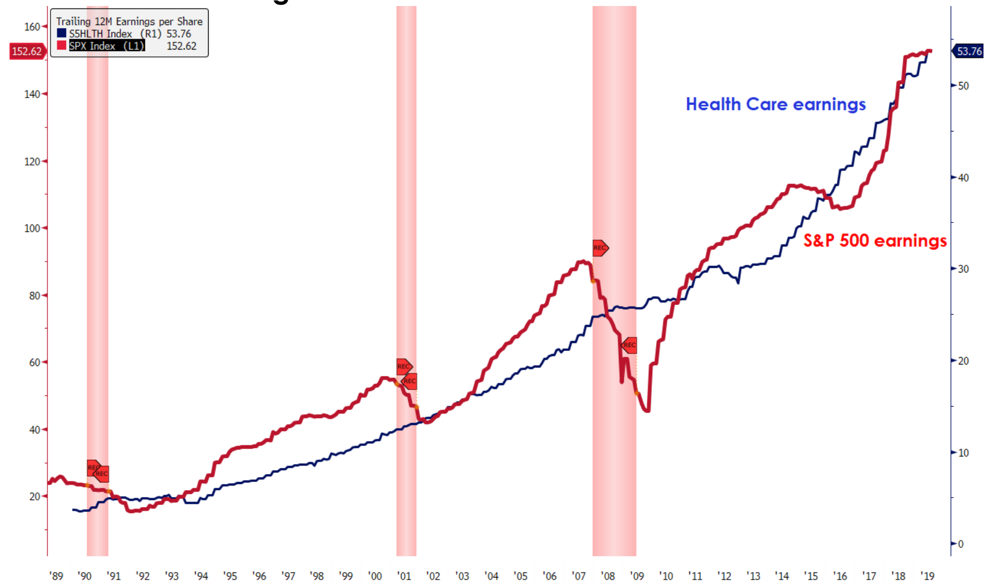
European equities have done well YTD despite an outsized slowdown in economic activity, which make it a more challenging risk/reward for investors going forward i.e. upside is limited if the economy recovers, and there is greater downside if the economy continues to slow. Valuations for European large-growth companies are expensive relative to the broader market, with earnings moderating. On the other hand, cheaper value stocks have a large cyclical component which are similarly unattractive as growth slows; the euro-zone manufacturing data has continued to contract. Neither heads (expensive growth stocks) nor tails (cheap value stocks) are attractive in Europe, and we choose to avoid such investments altogether. **As the European Central Bank (ECB) has embarked on additional stimulus measures to support the economy, we pay close attention to a potential growth rebound (which has yet to materialize) that would present an opportunity for us to allocate into in the more attractively-valued parts of Europe's equity market.**

Europe's manufacturing has fallen deeper into contraction



PMI above (below) 50 represents an expansion (contraction) compared to the previous month

Health Care earnings are more resilient in an economic downturn



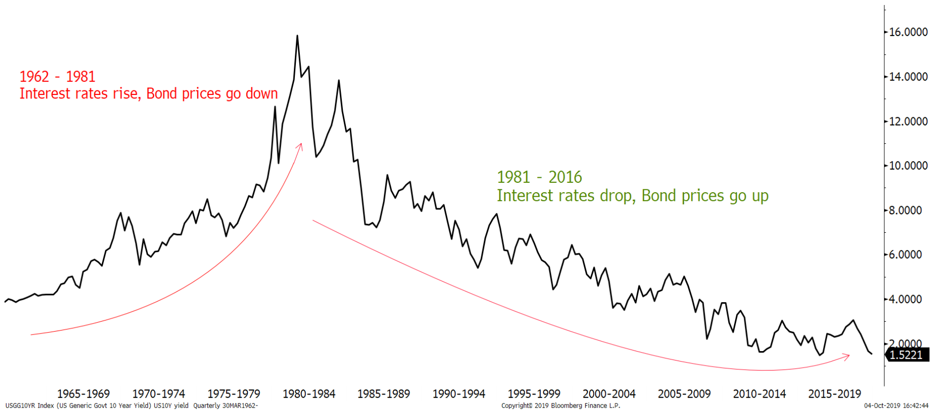
Shaded areas indicate recessionary periods.

Source: Bloomberg

Key Themes: Central Bank Policy

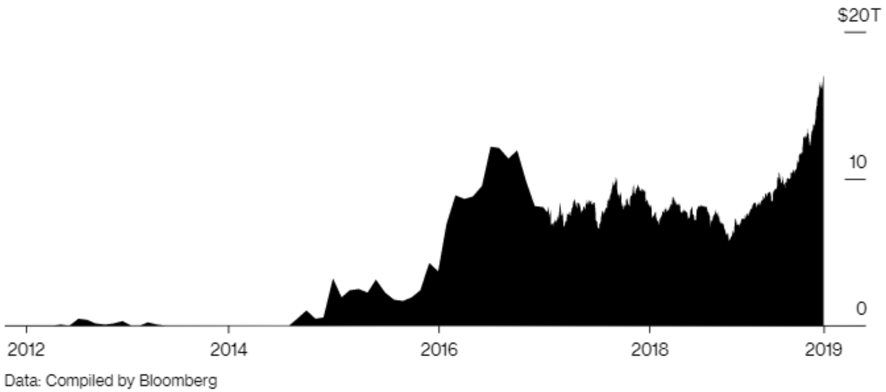
There are investment strategies that are premised on megatrends. In the past, these would be exemplified by peak oil or gold fever. In recent times, some trends include blockchain and ESG (Environmental, Social, and Governance). These trends can be painful because they are inherently extremely volatile e.g. gold had five declines of more than 40% since 1975. Such volatility inflicts two kinds of pain: psychological pain which tests the investor's conviction, and pain of opportunity lost by not investing in other opportunities with better risk/reward.

In fixed income, we have seen two megatrends since the 1960s. It would seem obvious to just invest in bonds from 1981 as investors enjoyed returns from both coupon and yield compression. But is it the best strategy going forward when yields today are at multi-decade lows? **The prospect facing bond investors is: earning 1.5% by locking in their capital for 10 years, and every 1% increase in rates can cause the value of the bond investment to drop by 9%.**



Sovereign bonds: In recent months, we have highlighted how the universe of negative yielding bonds has been increasing.

Market Value of Negative-Yielding Bonds in the Bloomberg Barclays Global-Aggregate Index



www.bloomberg.com/graphics/negative-yield-bonds/

Lately, there were articles on how certain investors have been able to benefit from negative yielding bonds. https://www.bloomberg.com/news/articles/2019-09-10/some-investors-actually-make-money-on-negative-yielding-debt

Investors who have heard us going on and on about currency-hedged bonds since 2016 will be pleased to know that this (currency-hedged) is how their portfolios have been positioned to benefit in a world of negative returns. This allows the safe-end of the portfolio barbell to provide some modest returns while serving as a flight to quality asset.

As they say, nothing lasts forever. We are clear about the source of this opportunity and how it may erode. If the Fed reduces rates further, this source of returns is expected to diminish, prompting investors to look for other opportunities. This would lead to the unwinding of currency hedges, and long European and Japanese bond positions, causing volatility in currency and bonds markets.

Key Themes: Search for Yield

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

	30 Sep 2019
Asia HY	**7.0%**
US HY short dur. bonds	**5.5%**
US HY bonds	5.6%
EM short dur. bonds	**5.0%**
EM bonds	5.0%
Global investment grade corporate	2.2%

Much more attractive than what bank deposits offer today

SGD 1Y deposit	1.7%
USD 1Y deposit	2.1%

Source: Bloomberg

The portfolios extract yield from credit investments i.e. high yield and emerging markets with short duration. Short duration credit is expected to be more resilient than longer duration credit in a large sell-off e.g. 2008 Global Financial Crisis, and that is how the portfolio has been structured for this phase of the economic cycle.

US High Yield: Not much has changed in terms of the key proposition for short duration high yield bonds. They offer meaningful returns for the credit risk taken, without taking too much interest rate risk. Default rates remain contained though we are more alert to signs of deterioration. High yield bond volatility has increased by 50% this year compared to 2018, which is expected for the current stage of the economic cycle.

Asian High Yield: This segment continues to deliver one of the best absolute and risk-adjusted returns this year. Asian high yield was one of the best performers in September, as investors recognised the improved valuations in August and credit spreads tightened. Markets have been able to digest the isolated stresses; bond defaults have not caused systemic concerns. Valuations continue to be attractive, with no signs of "cheap getting cheaper". We are monitoring for signs of worsening conditions and contagion such as more companies struggling to repay debt and defaulting.

EM bonds: At the beginning of the year, we mentioned that credit returns would be driven more by coupon than capital appreciation. This has been true for emerging market bonds. Despite some potential stress points in emerging markets, EM bonds have held up. Emerging market bonds are also attractive in that they are less correlated to other investments. Furthermore, for the first time this year, valuations are at a more attractive level, with room for capital appreciation. Currently, the emerging market exposures are more conservative in the form of hard currency short duration debt.

Key Themes: How are we positioned?

Slowing Growth	Central Bank Policy	Search for Yield
US Quality Growth equities	Short duration fixed income	Asian High-yield bonds
Health Care equities		Emerging Market short duration bonds
Japan equities		
China ‘A’ equities		

Asset Allocation Strategy

Equity Region	--	-	=	+	++	Allocation strategy
United States			■			Large cap growth to capture late business cycle growth, and where large caps are more resilient to rising financing and wage costs. Health Care as earnings are less dependent on the broader economic cycle.
Europe	■					Maintaining no exposure as economic activity is slowing meaningfully, and as valuations are rich.
Japan				■		Slight overweight as economy is supported by corporate reforms, and equities at attractive valuations.
Asia Pacific ex Japan				■		Slight overweight to China 'A' as valuations are attractive and supported by earnings growth.
Emerging Markets			■			Maintain neutral allocation as valuations are at historical averages, and where earnings have moderated.

Fixed Income	--	-	=	+	++	Allocation strategy
Government			■			Focus on currency-hedged global government fixed income to buffer portfolio volatility during periods of stress.
Investment Grade Corporate	■					Maintaining no exposure as low incremental yield and long duration exposure are less attractive than other segments.
High Yield			■			Maintain short duration which provides better yield to broad market with less sensitivity to interest rate changes.
Asia				■		One of the most attractive yields across major fixed income markets with room for capital appreciation.
Emerging Market Debt				■		Hard currency short duration focus as a more defensive credit investment for the late-stage economic cycle.

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

Current Previous

Market Index Returns

Equity Regional	MTD	QTD	YTD
Global	2.14%	0.09%	16.72%
United States	1.87%	1.70%	20.55%
Europe	3.71%	2.69%	20.32%
Japan	5.92%	3.28%	8.66%
Asia Pacific ex Japan	1.81%	-3.81%	8.25%
Emerging Markets	1.90%	-4.16%	6.14%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	-1.02%	0.71%	6.32%
High Yield	0.27%	1.24%	12.21%
Asia	-0.19%	1.84%	9.46%
Emerging Market Debt	0.04%	1.28%	10.79%

Currencies	MTD	QTD	YTD
USD/SGD	-0.38%	2.14%	1.39%
EUR/SGD	-1.16%	-2.14%	-3.64%
JPY/SGD	-2.11%	1.96%	2.85%

Commodity	MTD	QTD	YTD
Gold	-3.15%	4.47%	14.81%
Oil (WTI Crude)	-1.87%	-7.53%	19.07%

Equity Markets	MTD	QTD	YTD
Australia	2.02%	2.79%	23.90%
Brazil	3.57%	3.74%	19.18%
China “A”	0.48%	0.85%	29.56%
China “H”	1.58%	-5.01%	4.55%
Hong Kong	1.87%	-7.49%	4.30%
India	3.57%	-1.43%	8.29%
Indonesia	-2.52%	-2.85%	1.80%
Korea	4.84%	-3.17%	1.53%
Malaysia	-1.04%	-4.24%	-3.68%
Russia	0.62%	2.38%	22.76%
Singapore	0.48%	-4.72%	5.30%
Taiwan	2.23%	4.12%	16.02%
Thailand	-0.89%	-4.64%	7.53%

Equity Sectors	MTD	QTD	YTD
Gold	-10.01%	5.01%	27.92%
Energy	3.56%	-7.25%	3.08%
Technology	1.52%	2.00%	28.39%
Healthcare	-0.24%	-1.58%	7.04%
Financials	4.46%	1.44%	17.59%

Total return in index currency terms as of 30 Sep 2019. Source: Bloomberg

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