

OUTLOOK 2018

CIO's Letter


Jeffrey Lee
MD and CIO
Phillip Capital Management



Dear Investors,

2017 has been a great year for investors, especially in Asia. Global stock market performance as measured by the MSCI All Country World Index, gained 22% in 2017, closing at a record high. Asia ex-Japan equities have rallied 30-40% on average driven primarily by record inflows and a return of optimism among investors. With valuations supportive versus developed market equities and the earnings upgrade cycle in full bloom, the rally has continued into 2018..

(Continued)



Gardens by the bay, Singapore. Newer attractions like this has brought in tourists helping the hospitality REITs flourish. Photo by [Miguel Sousa](#) on [Unsplash](#)

Equities trump Bonds

Since 1981, US bond yields have trended down primarily because inflation has been low. Inflation is currently under 2% versus 14% in 1981. Disruption, disintermediation and the rapid technological advancement has been deflationary. When inflation is low, central banks can afford to tighten gradually, and the synchronised global recovery can co-exist with low-interest rates and meagre bond yields. Corporate profits have been strong, and a return of confidence and greed will continue to fuel the stock market rally. It is worth remembering that since 1927, the average increase in the final year before the end of a bull market has been around 17%. Missing these periods would have lowered the long-term annualised returns on the S&P 500 from 9% to just 7%. However, long duration bonds will be impacted most by rising interest rates from central bank tightening.



Singapore retail REITs like Plaza Singapura has been more resilient against the Amazon threat. Picture Source: capitaland.com

Secular Demand for Income

The theme of sustainable dividend income will remain relevant. Interest rates will remain low just like in the period spanning the Great Depression and World War II because debt levels were high relative to growth. The current high debt burdens globally, as well as a rapidly ageing demographic landscape, will keep a lid on long-term interest rates. We continue to favour Asia-Pacific REITs and investors can gain exposure through the Phillip SGX APAC Dividend Leaders REIT ETF. It offers a higher dividend yield (>4% last year) relative to bonds and is trading at a reasonable price to book valuations of around 1.1x versus their past which have exceeded 1.5 times at its peak. Additionally, REITs today are far more resilient to rate hikes, having learnt lessons from

the troubles they faced during the Global Financial Crisis. They have not only locked in low-interest rates for a longer time horizon but also have selectively de-gearred their balance sheets. Given ample global liquidity, the shortage of funding from capital markets, which they experienced a decade ago is unlikely to repeat.

SREITs offer attractive returns

Among global REITs, we continue to favour Singapore as yield spreads are among the widest globally. This spread was minimal in the run-up to the Global Financial Crisis. Singapore retail REITs have proven to be more resilient against the Amazon threat than those in the United States given domestic shopper preferences for the in-store experience and in-mall entertainment. Singapore office REITs are on a cyclical uptrend, and hospitality REITs will outperform in 2018 amidst the return of

Chinese tourists to the region and the tightening of hotel room supply. Another source of return for global investors in Singapore REITs is the long-term strength of the Singapore dollar (SGD). Over the last thirty-one years of my investment career, the SGD has appreciated by 1.6% per annum against the USD from 2.20 SGD/USD in 1986 to 1.30 SGD/USD today. The MAS monetary policy of targeting gradual currency appreciation to offset inflation has made the SGD a safe haven amidst competitive devaluation by global central banks and increased the appeal of SGD-denominated assets such as Singapore REITs. Since its inception in 2002, Singapore REITs have returned more than 10% per annum.

Yield is not enough

Dividend growth is another enduring theme that we favour in the current environment. Companies that have grown dividends over long periods of time (often decades!) have proven to be excellent investments for shareholders, as dividend growth highlights the ability of the company to continually reinvest their cash into projects that increase earnings per share. Many of these “dividend aristocrats” also operate in non-cyclical businesses with good returns on capital, high free cash flow generation and low leverage. Examples of dividend

growth companies listed in Singapore include Thai Beverage and Jardine Cycle & Carriage, which have handily outperformed the markets and created wealth for stockholders. We are exploring new products that will allow investors to access this theme through ETFs. Investment returns vary from year to year

and are uncertain but lowering costs will certainly improve returns. Our low-cost ETFs are actively designed and built to outperform broad market exposures. For example, our recently-launched Lion-Phillip S-REIT ETF's (AUM S\$127 million) weighting emphasis towards Singapore REITs with high quality and strong financial health is favourably positioned in a rising-rate environment.

Our likes for 2018

Given our expectation for a synchronised global economic recovery, we continue to favour financials which benefit from higher interest rates and more robust loan growth. The Japanese and European stock markets will be underpinned by rising employment, capital expenditure and wage growth while China continues to deleverage and pursue quality growth.

Southeast Asia remains attractive in our view. North Asia has greatly outperformed South Asia in 2017 as regional growth has been propelled by a rebound in trade and exports. Over the next decade, we should see better growth in domestic demand-biased markets. Structurally, the best domestic demand growth economies are likely to be India, Philippines, Indonesia and Vietnam, given wage growth and favourable demographics. Thus, we should expect these markets to outperform if the cyclical tech-driven earnings momentum fades and investors return to focus on the

non-cyclical drivers of growth for Asian economies.

We continue to be positive on commodities and energy which typically do well in the late stages of economic expansion. Non-energy commodities will do even better since they have no equivalent to shale, and mining companies cannot increase production quickly in

response to rising prices. In the mining sector, margins are improving, orders and new investments are gaining momentum.

Potential Risks

Ironically, a key risk to the stock market rally is if the US economy booms. Most economists are still sceptical that growth will stay above 3% even with the tax cut. So if the US economy enjoys a good, old-fashioned boom, it will eventually be bad news for markets. Inflation above the 3% level has historically been a challenge for US bonds and equities. Also, a stronger US currency arising from strong economic growth would be a headwind to emerging markets and US stocks which had a major boost from overseas earnings.

Technology, in particular, internet and semiconductor stocks, have been the stellar performers in 2017. There



Companies with growing dividends like Thai Beverages have served the investors excellently. Photo Source: Changbeer.com

is still long-run upside for internet stocks given structural earnings growth potential, high scalability in business models and the huge network effect of incumbents but a short-term correction arising from more regulatory scrutiny and disruption will not be surprising in 2018. The sustainability of this semiconductor rally – although supply discipline is prevailing is questionable. History has shown that new supply will come to the market soon and thus affect pricing. Given many semiconductor and related-equipment stocks are already pricing in a benign, secular-growth environment, we do not see good risk-reward in these investments. If history has taught us anything, it is that proclamations that “this time is different” should be taken with a large pinch of salt.

Be Disciplined

Going forward, our advice for investors remain unchanged: (1) Stay

invested in Equities and REITs. (2) Choose investment strategies that are sustainable and generate both

income and capital returns. (3) Purchase asset classes, which have underperformed in the short run but will do well in the long run!

On behalf of Phillip Capital Management, I would like to wish you a happy and prosperous new year.

January, 2018



We won the award for the Most Innovative New ETF from SGX for our Phillip SGX APAC Dividend Leaders REIT ETF in 2017.

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