Phillip Capital Management

# Yearly Review 2015 and Outlook 2016

# CIO's Letter

January, 2016

Dear Investors:

The new year is upon us and indeed 2016 is shaping up to be a challenging year. The expected increase in market volatility, rising US interest rates, an ageing US bull market that is six and a half years old (being the fourth–longest on record), and the repercussions of a weak oil price will continue to dominate our attention.

To navigate these challenges, we require discipline and a contrarian approach which has served us well over the years. 2015 was difficult for most investors as major asset classes- stocks, bonds and commodities- saw heightened volatility and negative returns. Our decision to exit from China's bubble when euphoria was at its peak in the middle of last year and to shift funds towards Greater India was a lonely and contrarian call but eventually served our clients' well.

## The end of emerging markets? Depends on which markets..

Financial headlines proclaim the death of emerging markets. As long term participants of markets over various cycles, we have observed that when commentators are the most bearish on an asset class, it is also the best time to be contrarian. Today, emerging market equities not only trade at a discount to their developed markets peers but also at a discount to their own historical levels. The price to book of the MSCI-Asia-ex-Japan index is currently below 1.2x, a level not seen since the 2009 and 1997 crises. In these two previous crises, price to book levels rebounded after approximately 6-9 months at the bottom- giving us confidence that Asian markets will similarly recover in 2016. Why do favourable valuations create the highest long-run adjusted returns? This is because markets only price in negative developments and ignore a potential uptick in the cycle. For instance, companies across the manufacturing and commodity industries are reducing capex spending to adjust to the new normal- for this reason we expect overall returns on capital to rebound and valuations to follow.

## Asia still attractive

The longer term story for Asian markets continues to be compelling relative to the rest of the world, with growing consumption supporting good returns. Despite global growth moderating since 2010, many Asian economies continue to grow above 5%, and high corporate profit growth (a long run driver of investor returns) is still intact in many of the region's companies. This suggests that fears over a Chinese slowdown appear to be overblown. A comparison between India and Brazil highlight the stark divergence in emerging countries' fortunes. Brazil is facing a shrinking economy, a widening budget deficit, a plunging currency and mounting political turmoil. In contrast, India's new Prime Minister Narendra Modi is enacting tough reforms to reduce its subsidy burden and restart public spending. A lower current account deficit has underpinned a relatively resilient rupee. Additionally, given India's historic position as a net importer of oil, the falling oil price has created an estimated US$47b windfall for the Indian government, allowing them to spend more on much needed infrastructure projects. Bond flows into India have accelerated in recognition of these favourable tailwinds, and will continue to underpin its stellar performance.

Crude oil benchmarks are trading at levels below the Great Financial Crisis in 2008. We are cognizant of the near term challenges facing the industry given that incremental supply most recently from Iran, has hit the market just as demand weakened. However, at current crude prices, nearly half of the world's estimated oil projects are operating at a loss. This means it is a matter of when, rather than if, supply discipline is re-instated. Our view is that while the drop in oil is mostly finished, the geopolitical and financial effects of it are not. However, given that the consensus in the oil market is deeply pessimistic, there will be more opportunities to buy rather than sell .

Where will growth come from

The major themes that will drive the global investment space will be a stronger US economy which will help the world recover from the deflationary effect of a Chinese slowdown. However, one side effect of the Fed rate rise is greater inflows and higher demand for the American currency, buoying the US dollar. With the euro weakening relative to the dollar, we expect European companies to gain market share with more competitively priced exports. Another counterbalance to tighter American monetary policy is looser policy leanings across Asian central banks. Japan's economy is only 30% of the US but the Bank of Japan has undertaken a quantitative easing on the scale of the Fed, which has been positive for corporate profits and government tax revenues. China will continue to ease and stimulate its economy, countering the end of a huge property-based, debt-fueled boom and strong devaluation pressure on the yuan which will continue to be the key challenges for China and its trading partners. And under central banker Raghuram Rajan, aided by favourable commodity tailwinds, India has successfully tamed inflation and thus has sufficient room to cut rates.

Given favourable yields, stocks are considerably more attractive than bonds after the recent significant correction. The global hunt for yield is also likely to continue in companies with resilient pay-outs, favouring REITS at the expense of MLPs (energy and pipeline related trusts) and commodity stocks. As interest rates rise, our Money Market Funds will also see better returns and asset inflows. Overall, despite its challenges, we look forward to 2016 as a year where we can excel and prove our mettle as guardians of your capital.

*Jeffrey Lee, CFA*

*Chief Investment Officer*

*Phillip Capital Management*

**"..India is poised to drive growth for emerging markets as Mr. Modi enacts tough reforms…and restart public spending…"**

# Asian Equities Review and Outlook

Asian markets had a volatile year in 2015. While early 2015 saw strong gains for Asian markets, with a generally benign macro environment and optimism over lower oil prices and accommodative monetary policies in many countries outside the US, a variety of concerns led to a broad market correction across most markets starting in August. Generally, the year saw the weakest performances from the ASEAN, Taiwan and Australia stock markets, while Japan was an outperformer. The stock drama of the year belongs to the China domestic markets' though, with the domestic A-share markets swinging from wild exuberance in the first half of 2015 (when they were the best performing in Asia) to a dramatic selldown in the second half (with the Shanghai Composite index collapsing over 40% from peak to trough), as a clampdown on margin loans by the authorities led inadvertently to a domino effect of panic selling.

Our flagship fund, the Phillip Asia Pacific Growth fund with a major allocation to Japan, its performance was cushioned by the relatively stronger performance of Japan. Despite the weakness of the markets in the second half of the year which pulled many Asian markets into the red, the fund was able to end the year with positive returns, up 1.2% for 2015, its fourth straight year of positive returns for unitholders.

Key risks as we see it

What is the outlook for 2016? At the time of writing, the markets have corrected sharply in the first few weeks of 2016. Therefore we shall start by observing a few key event risks that have transpired in late 2015 which will have had a bearing on the weak market start in 2016.

First of all, the US Federal Reserve rate hike cycle is finally in motion. We don't expect this to be as great an overhang as feared, as markets have prepared adequately for this the last three years, whilst the US Federal Reserve should conceivably be more cautious in considering subsequent hikes.

Secondly, the collapse in oil prices has started to weigh on the balance sheets of even the strongest oil economies such as Saudi Arabia, leading them to potentially look at repatriating some of their overseas assets to support their domestic economies. Of course the silver lining is that cheap oil acts as a cost subsidy for oil consuming economies around the world, though this point seems to be overshadowed at the moment by worry over what the low oil price portends.

Thirdly, an unexpected devaluation of the renminbi in August 2015 and continued weakness in manufacturing data for China sparked widespread concerns about the China economy. This has continued into 2016, with concerns over a possible hard landing for the China economy as well as a currency war sparked by continued yuan depreciation. This is probably the biggest worry, as China has been a key global growth driver, and competitive currency devaluation yields no eventual winners.

We note, however, that markets are forward-looking. As mentioned, valuations in the Asia Pacific are close to the lows in 2011 during the European fiscal crisis, with the MSCI AC Asia Pacific (including Japan) index at 1.27X price-book, compared to about 1.2X during the European crisis. One may argue that Europe is as important as China to the world on a GDP contribution basis, and far more interconnected to the world's financial system compared to China. We are of course, some way from the lows hit in the 2008 financial crisis (about 1.0X price-book), but that was because it was a systemic global crisis originating from the center of finance, the United States.

Not all doom and gloom

So, indeed, we are of the view that we are nowhere near a systemic crisis that warrants crisis valuations, though perhaps a slowdown is a likelihood. We will now highlight some positives that we see. Firstly, if we take a more sanguine view the US Federal Reserve finally hiking interest rates, the beginning of normalisation reflects confidence in the US, and probably global, economy's recovery and a belief that it will be able to withstand a gradual increase in interest rates going forward. It is instructive to look at the general equity market performance during the last two rate hike cycles. The 1999-2000 and 2004-2006 Fed rate hike cycles actually coincided with uptrends in the Asian stock markets.

Within Asia, medium-term trends that we have highlighted previously continue on track, and that may be a catalyst for a market rebound. Japan continues to pull itself out of a multi-year slump through Abenomics, with some signs that business and consumer confidence are recovering. China continues to open up, with its currency now officially an IMF reserve currency, and a Shenzhen-Hong Kong through-train program set to follow after the 2014 implementation of the Shanghai-Hong Kong through-train program. China reform may be a dirty word to financial markets now as it seems to imply a slowdown, but we think it will put China on a more sustainable growth path and that must be viewed optimistically as progress in the long term. And in ASEAN, the ASEAN Economic Community officially came into effect on 1 January 2016. The combined 2014 GDP of ASEAN countries makes it the 7th largest economy in the world worth $2.6 trillion. There are expected to be opportunities in manufacturing and financial integration, as well as building of infrastructure linkages.

<u>How the fund is positioned</u>

What does this mean for our Fund positioning and strategy? We continue to be focused on companies in the Asia-Pacific with growth momentum that can do well in a rising rates environment. Ideally, such companies are riding on secular trends, whether it is online retail, rising tourism in Asia or construction of much-needed infrastructure linkages. In view of weak markets, this is a good time to buy such companies at discounted valuations. Top-down country-by-country selection may not be an appropriate framework in thinking about the portfolio allocations. Markets seen as vulnerable from US rate hikes especially emerging ASEAN have already adjusted in their valuations to price this in over last 2-3 years. For instance, Indonesia moved to below its 10-yr mean in price-earnings and price-book terms whilst Singapore is at a 5-year low in price-book terms and so any recovery in sentiment and reversion to mean would mean a strong rebound.

Conversely, we think it is equally important in such a volatile environment to avoid certain types of companies, namely over-leveraged companies, especially if they are borrowing in foreign currencies particularly the US dollar. These are clear losers from US dollar strength, which we expect to persist with the US on a rate hiking path whilst many other economies continue to be on accommodative monetary policies.

Two points that we would like to emphasize: one about the markets, the other about a specific feature of our fund. Firstly, it is an attractive time to buy into Asia now, and that should be apparent to anyone with a long-term perspective and a sense of history.


"Japan cushioned our performance in 2015 and likely to support us through 2016"

Secondly, for those want to buy into Asia but who are a bit jittery about China having too big an allocation in the fund, the Phillip Asia Pacific Growth Fund includes Japan in its investment mandate (unlike many Asia-Pacific equity funds which are ex-Japan) and therefore has Japan as a major allocation, with China including Hong Kong occupying a much smaller portion. The Fund has already benefited in 2015 from its Japan allocation, as Japan was a strong outperformer vis-à-vis the rest of the Asian markets.

# Phillip Money Market Funds Review and Outlook

In 2015, the Phillip SGD Money Market Fund ("PMMF") continued to offer attractive yields and fulfil the liquidity needs of all its investors.

The assets under management remained stable over the duration of 2015 and ended off the year at S$650 million, retaining the fund's status as the largest SGD retail money market fund available on the market. The fund divides its allocation between money market instruments and fixed deposits in approximately equal proportion, and ensures ample liquidity through diversification across fixed deposit tenors and bond maturities. The weighted average maturity of the fund is kept below 120 days over the year, and credit rating of underlying bonds remained high at an average of A- while maintaining diversification across countries, sectors and issuers. By sector allocation, the banking sector currently accounts for the largest share at 30.7% of the portfolio. Within a rising SIBOR rate environment, the fund has maintained both higher liquidity levels and a shorter maturity profile which enables it to roll over investments at higher prevailing yields thereby enhancing overall returns.

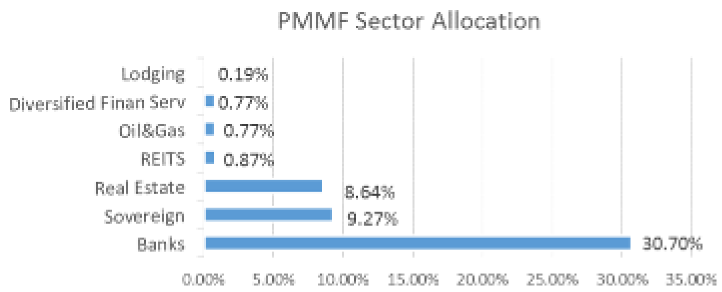
The significant size of the fund facilitates the fund manager in accessing several high quality Singapore dollar private placements on offer by highly rated institutions at attractive yields.

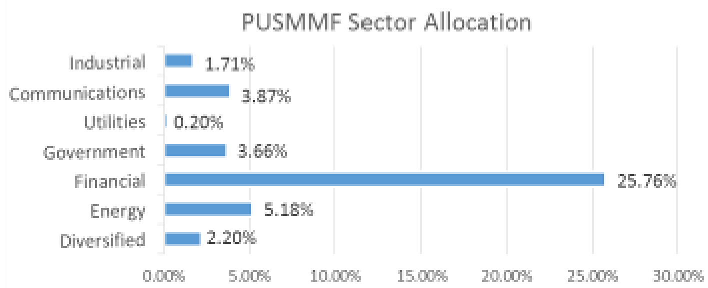
The Phillip USD Money Market Fund ("PUSMMF") oversaw assets under management growth to US$148 million, capping off a positive year. The fund is overweighed on the financial sector based on its sector allocation at 25.76% of its portfolio. As the US Federal Reserve transitions towards a tighter monetary policy, we expect the higher yielding bond issues and appreciating USD within a rising interest rate environment to be conducive for the fund's performances, and consolidating the fund's status as a vehicle of choice for investors with US dollar holdings. By keeping liquidity high and the average maturity profile low, the fund is well positioned to deliver value through rolling over credit investments at higher yields.

Similarly, the outlook for the Singapore dollar against regional peers remain stable despite the SGD being pegged against a basket of currencies which includes the USD. Given the weaker domestic economy and its reliance on exports, MAS would be keen to avoid excessive SGD appreciation against regional peers.

As of 31 December 2015, both the PMMF and PUSMMF

displayed positive growth in their respective current 1-month annualized* yield. PMMF's yields increase from 0.53% a year ago to 0.92% while PUSMMF's yields is at 0.44%. The higher yields reflect the recent hike in the US Federal Fund rates and the resultant rise in SIBOR rates. Within the span of 1st to 31st December, the US Federal Fund Rate had risen from 0.11% to 0.25% while the 3M SIBOR increased from 1.08% to 1.19%. The 3M SIBOR is expected to maintain its upward trend as the US Federal Reserve is poised to continue tightening its monetary policy. (*annualized yields are quoted with a 365 day count convention).




Both funds have a conservative risk profile and the stringent selection of credit investments have ensured that neither fund have experienced a default on its credit holdings.

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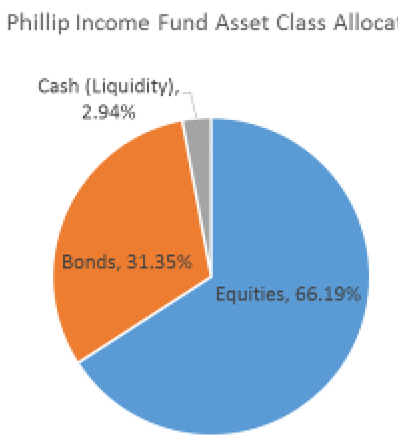
# Phillip Income Fund Review and Outlook

For the year of 2015, the total returns of the fund was -1.53% for the year. Careful management of the dividend income and coupon income received by the portfolio enabled the fund to provide investors with two semi-annual distributions amounting to an average 4.70% yield in 2015.

Despite its global mandate, the fund continue to identify value within the Asian markets and remaining overweight on both equities and fixed income allocations. Asia continue to benefit from high liquidity through accommodative monetary policies adopted by regional central banks, which is expected to be supportive of domestic consumption. The fund favoured equities able to offer and maintain attractive dividend yields, while affording entry at favourable valuations. Based on these criteria, the banking sector accounted for the highest proportion of the sectoral allocation at 20.97%, together with significant exposure to both sovereigns and REITS. Over the course of the year, the fund seek to optimise returns through increasing its REITS allocation to better capitalise on the stability of dividend yields.




With regards to the fixed income allocation, the fund benefited from the selection of high quality bonds for the portfolio while remaining highly conscious of monetary policy changes implemented by the central banks. Due to significant exchange rate fluctuation from currencies such as the CNY and the MYR, currency volatility exposure continues to be a key consideration for the overall portfolio. The fund registered gains on its appreciating USD-denominated bond holdings, while staying poised to benefit from the upswing associated with bond investments entered previously at favourable foreign exchange valuations.

The fund recently acquired Australian, New Zealand and Malaysian government bonds on longer term tenors at attractive yields. Based on the steepness of the interest rate curves and the anticipation of interest rate reductions by the respective central banks, the fund is on course to benefit from capital appreciation on the bonds.

Over the duration of the year, the fund managed to achieve significant returns on its equity investment in Mizuho Financial Group and CK Hutchison Holdings Ltd of 30.98% and 33.12% respectively. Mizuho Financial Group is the second largest financial services group within Japan, offering a diverse range of financial services such as banking, securities, trust and asset management services, while having more than 68,000 employees across 30 countries. CK Hutchison is among the largest Hong Kong-listed companies with a global commercial interest within port operation, retail, infrastructure, energy, telecommunications and aircraft leasing. On the fixed income front, the fund managed to obtain a 12.22% return on a 30-year bond issued by Perusahaan Listrik Negara. Perusahaan Listrik Negara is an Indonesian utilities company with core business activities based on generating, transmission and distribution of electricity.

**Outlook**

Much of the economic outlook for 2016 is centred on the pace and extent at which the US Federal Reserves would hike interest rates, subject to prevailing global economic conditions. Contrary to the US, the central banks of Europe and Japan are adopting a more accommodative monetary policy in a bid to stimulate demand and economic growth by increasing the magnitude and duration of their respective quantitative programmes, alongside the transition into negative interest rates for central bank deposits. Given the favourable conditions in play, we would expect a reduction in interest rate risks for our Euro and Yen-denominated bonds. Similarly, the fund would be preferring the USD-denominated tranches for foreign bonds, in view of higher liquidity and visibility within the secondary markets.

The fund will also be turning its investment focus towards REITS assets given its higher resilience to negative macroeconomic externalities, alongside conducive conditions such as low inflation and attractive entry valuations.

*All data presented in the report is updated till 31 Jan 2016. Source: Phillip Capital Management and Bloomberg*

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