Phillip Capital Management

REVIEW 2016
OUTLOOK 2017

CIO's Letter

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Dear Investors,

At the beginning of 2016, we predicted that oil and equities, especially those in emerging markets, would do well. Our predictions have indeed played out according to plan. Crude has rebounded from its $26 low in February to its current level of above $50/barrel. Equities have performed well for investors in 2016, returning between 8-12% across the globe. We also said that we thought that bond markets were exhibiting signs of extreme optimism, given US long-term bond yields were below 1.5% amidst an improving economy and rising wages. Indeed, bond markets have had a terrible second half in 2016. Our contrarian decision to underweight long-duration bonds has served us well.

Markets and investors could not have expected a more

(Continued)

exciting 2016 than the one that transpired. The world witnessed not one but two 'black swan' events; 'Brexit' in June then the Trump win in November. Markets around the world have already reacted quickly to the potential effects of a Trump administration. His rhetoric to implement restrictions on trade and to pass a US$1 trillion domestic spending package on infrastructure is stoking fears that inflation will rise. The parallels between today and 1895 are uncanny; after a long period of deflation and globalisation in the prior two decades, the next twenty years was marked by a shifting political consensus towards protectionism. Tariffs were raised, resulting in higher prices (as production shifted to higher cost domestic centres) and more frequent geo-political tensions. Today the same forces are hastening across the globe- as many commentators have pointed out, Brexit foreshadowed the Trump victory, representing a marked shift towards the right of the political spectrum and the increasing weariness among many towards globalisation.

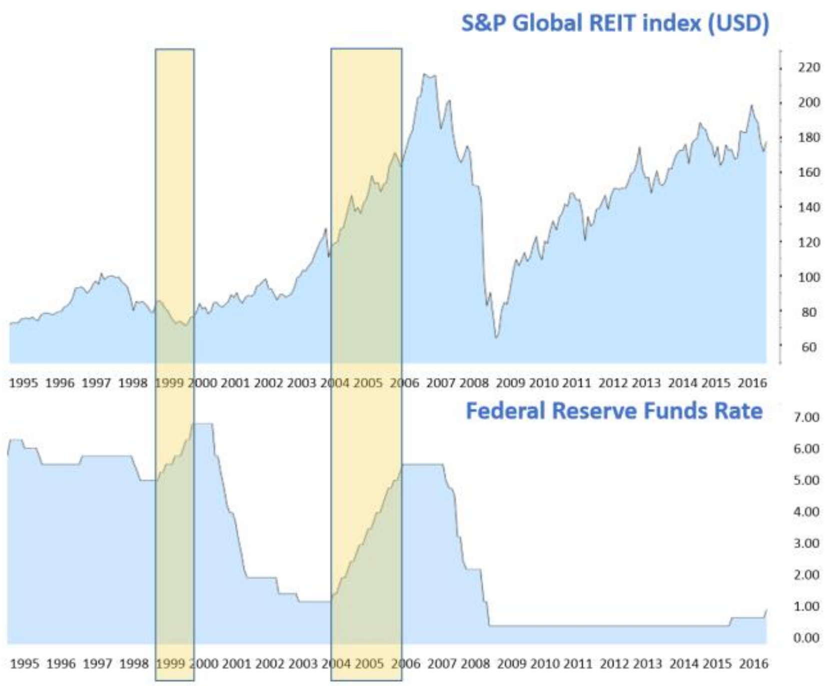

Fig: Impact of past two Federal Reserve Rate hikes on global REITs (Source: Bloomberg)

So how should investors position their portfolios in response to these moves? The winners from these trends are seemingly clear, but are the losers as evident? In the case of the current sell-off in sectors such as consumer staples, utilities and REITs, we think that it may be a case of the market getting ahead of itself, unreasonably punishing these stable companies and pricing in very optimistic growth in financials and cyclicals. However, we feel that for many of the companies in the defensive sectors, the combination of the companies' fundamental strength, their stellar history of dividend increases and attractive valuations currently is not worth abandoning just yet.

For instance, in the case of Real Estate Investment Trusts (REITs), while the market has clearly priced in the downward force of higher capitalisation rates on REIT valuations, the market is ignoring the fact that higher US growth usually comes alongside higher rates. A strong American economy is good for global growth and favourable for leasing demand, improving supply-demand dynamics and allowing landlords to raise rents. Although we think that directionally interest rates may continue to move up, the speed at which they will rise will be very moderate as rapid upward moves will be difficult for the global economy to digest given the divergence in political and economic states of the major markets. Ageing demographics, high public and private debt burdens and rising wages will also keep a lid on long-term interest rates.

Looking back at the last two US rate hike cycles in 1999 and 2005, global REITs fell initially but rose to hit new highs subsequently. It is not entirely surprising to see REITs continue to deliver attractive returns in a steadily rising interest rate environment because high-quality REITs possess the ability to grow their dividend distributions and thus provide a degree of interest rate resiliency. An inflationary environment is also likely to lead to rising rents. We believe that as the pace of rate hikes is likely to be gradual; the REIT asset class will quickly regain its attractiveness as an investment option after an initial period of volatility which will greatly benefit our REIT-focused strategies; the Phillip SGX APAC

Dividend Leaders REIT ETF and the Phillip Singapore Real Estate Income Fund. Additionally, higher interest rates will benefit our Phillip Money Market funds as short-term paper can be roller over into higher yielding instruments. Already we see the yields on our SGD and USD Money Market funds at attractive levels and rising, offering investors 0.74% and 0.72% overnight respectively.

An artist's impression on Trump Presidency reflecting the main-stream media's view during the campaign. We all know now how that turned out.

Trump and Asia

What of Trump's impact on global trade and Asian economies? In comparison to domestic policies, trade is an area in which a US president has significant autonomy. Presidents have the authority to raise tariffs on goods and withdraw from trade agreements without congressional approval. However, we think that the potential impact on Asian economies will possibly be less than what the market expects. China and India's share of world consumption projected to rise to 27% by 2035 from 12% currently. In addition to the rapidly growing middle class in the rest of Asia notably South-east Asia, we note that increasingly, Asian economies are more levered to growth within the Asian region; in particular to China and greater India. Another driver of regional trade will be the development of more manufacturing capabilities outside of China as can be seen successfully taking place in Indochina especially Vietnam and India.

Thus, on our Asia-Pacific equities positioning, we adopt a combination of positioning on both what we see as "defensive" and "offensive" fronts. The certainty of return would be important, and we seek to achieve it through an emphasis on companies that can grow their dividends. Stock exchanges and power grid operators are examples of such companies. And we also take "defence" literally, by investing in companies that produce defence equipment. Current trends involving a possibly isolationist US under Donald Trump, combined with a more assertive China, are likely to spur defence spending in the Asia-Pacific due to a potential power vacuum.

Domestically and regionally focused economies and commodity exporters will outperform, including the Greater India and the Cambodia, Laos, Myanmar, Vietnam (CMLV) regions. India, the seventh largest world economy is projected to grow at 7.6% in 2017 despite short-term turmoil from policy reform such as the recent 'demonetisation' event. The continent indeed offers the Phillip Greater India Equity fund unique investment opportunities such as the flourishing pharmaceutical sector in Bangladesh. With its GDP per capita soon to pass the US$ 1000 milestone, we may see consumption and expenditure take off like it did in India. Pakistan is also another standout market having been long written off as a terror-ridden outpost for investment; the Pakistan market has soared back to life, not only because of its recent inclusion in the MSCI Emerging Markets index but more so driven by its balance of payments stability and sustained investments from China. Another region we are positive about is the Cambodia Myanmar Laos Vietnam (CMLV) market, as infrastructure spending and foreign direct investment is set to explode spurred by China's "one-belt-one-road" initiatives.

The various "black swan" events of 2016 such as the election of Donald Trump reminds us of an important lesson in investing– we must expect the unexpected. The polls and the financial markets were almost unanimous in predicting a Clinton win. Similarly, a few months ago, nobody believed that Britain would leave the European Union. Markets can be very humbling and demonstrate this time and time again, with the most unlikely of outcomes becoming a reality.

At this point, despite the widely acknowledged political and policy risks expected in 2017, we see the CBOE VIX index close to its historical lows implying a high level of complacency in the market. Hence, we remain very watchful of certain indicators that may be a harbinger of another economic crisis, the first of which is an inverted yield curve. Yield curve inversions have been consistent in predicting the last seven recessions including the Global Financial Crisis and we think it will present itself before the next crisis. Valuations also bear watching closely with valuations of some markets looking stretched; one instance being US stocks which are more expensive now than they have been 90% of the time. Certainly, this drives home the need for a more alpha-focused approach to investing especially true when interest rates are no longer at rock bottom. We continue also to pay heed to top line revenue guidance from corporates on which crucially depends, a continued and sustainable economic growth trajectory for the world.

In the case of our investment strategies, we focus on knowing our invested companies best so we can position our portfolios for positive outcomes as ultimately, our objective remains, simply, to reduce the risk of capital while maximizing returns for our investors.

Finally, on behalf of everyone at Phillip Capital Management, I would like to wish you happy investing in the new year of 2017.

Despite setbacks, South and South-east Asian economies are gathering pace and are looking to be exciting prospects. (A snap from rural Cambodia, Source: Pixabay)

IMPORTANT INFORMATION