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2020 MID YEAR OUTLOOK – STAYING AHEAD

GLOBAL PERSPECTIVES FROM AN ASIAN LENS

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While COVID-19 has delivered a sharp and deep economic shock, activity should recover rapidly as containment measures are relaxed. Ooi Boon Peng, Head of Investment Strategies and Kelvin Blacklock, Head of Investment Solutions share their views on what is in store for the markets in the next 12 months. Highlights include:

- **The surfeit of global liquidity looking for yield and stable returns**
- **Attractive equity valuations, especially in Asia**
- **Tech disruptors' continued market leadership**
- **Increasing importance of Environmental, Social and Governance considerations in differentiating winners**
- **USD's fading appeal as economies reopen successfully**
- **Heightened market volatility from new COVID-19 outbreaks, geopolitical tensions, rising government debt levels and Japanification fears.**

1 WHAT IS YOUR OUTLOOK FOR GROWTH AND INFLATION OVER THE NEXT 6-12 MONTHS?

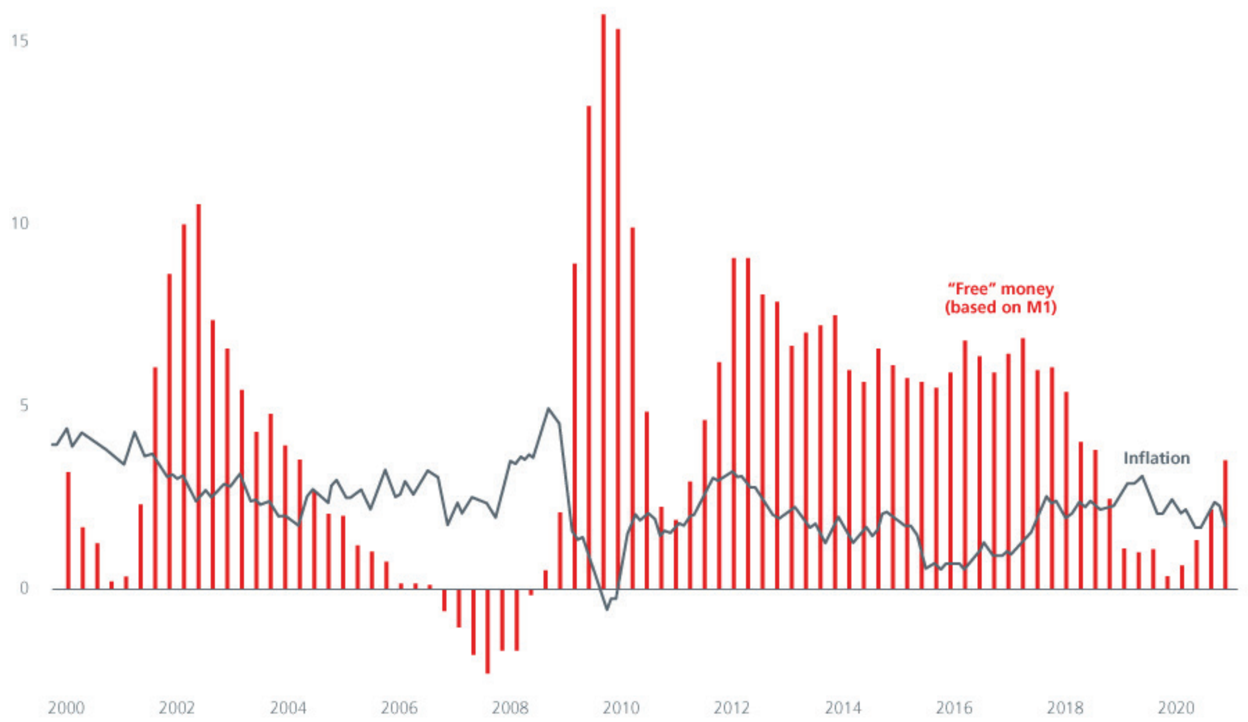
Ooi Boon Peng: Economic activity is likely to resume as lockdown measures ease and economies reopen, albeit cautiously. Already, activity indicators are showing early signs of picking-up at the point of writing.

While trying to effectively bring down the number of new infections and minimise deaths, governments around the world are also mindful of the economic costs of a protracted lockdown which has caused surges in unemployment and risks long-term damage to businesses. With persistent containment efforts and a downdrift in the number of infections, my base case is for economic data to rebound strongly in the third-quarter or fourth-quarter after a dismal first half in 2020. The economic outlook can improve quickly if a vaccine is found and mass-produced which would allow the common view of an asymmetric global recovery to play out. Premised on a vaccine being found and mass-produced by the first half of 2021, I expect some economic activity to be lost when measured over 2020 and 2021. The shock to businesses in the first half of 2021 would cause a significant drag on economic activity going into 2021.

The fallout from the pandemic has disrupted consumption. As a result, inflation is expected to decline on the back of falling demand, the recent drop in oil prices and the ballooning labour market slack. Demand-driven disinflationary pressures are likely to more than offset any rise in inflation brought about by supply constraints. Looking further out, structural forces such as ageing demographics and technological disruption will exert greater deflationary pressures if the global economy fails to revive. If this comes to pass, it would be difficult for interest rates to normalise. I expect interest rates to be markedly lower than in previous cycles. See Fig. 1.

Kelvin Blacklock: The coronavirus pandemic has delivered a sharp and deep economic shock. Market moves were reminiscent of the darkest days of the Global Financial Crisis (GFC), but I don't think this is a repeat of 2008. Stringent containment and social distancing policies have brought economic activity to a near standstill and will lead to a sharp growth contraction in the second quarter. However, bold and rapid policy actions including drastic health measures to stem the spread of the infection, and significant monetary as well as fiscal measures have been taken to bridge households and businesses through the shock. Total fiscal stimulus announced has been larger than what was pledged during the GFC but compressed into a shorter timeframe. Activity should recover rapidly as the containment measures and social distancing measures are relaxed. It is probably more important to watch economic activity indicators than daily new cases from this point, as the latter only matters if it triggers new lockdown measures. As Boon Peng mentioned, high frequency data such as mobility trends and credit card spending is showing evidence of a pickup in activity although it will take time to reach a full recovery.

Fig 1: Inflationary pressures may remain low from muted demand despite the liquidity boost



Source: Refinitiv Datastream as of April 2020. OECD "Free" money and Inflation. "Free" money is calculated as the % YOY change in M1 - % YOY change in nominal GDP as at Q1 2020.

Beyond the initial recovery, it is likely that policy makers will be slow to pull back on the fiscal stimulus applied during the crisis. In my view the longer-term impact of this stimulus is binary. If fiscal easing continues, it could break the decade-long disinflationary cycle, and lead to higher yields and steeper yield curves. In contrast, as with the GFC, if governments are subsequently forced into austerity, the era of low rates and low inflation will continue for the foreseeable future.

2 WILL THERE BE A CHANGE IN MARKET LEADERSHIP?

Kelvin Blacklock: The COVID-19 lockdowns have accelerated technological shifts that were already underway prior to the crisis and are likely to cause some permanent changes in human behavior. The shift to online entertainment, working, studying and shopping suggests that disruptors within the tech sector will likely continue to benefit post the pandemic. While the healthcare sector has also benefitted from the outbreak, there are emerging opportunities in the consumer and cyclical sectors as economies re-open.

The outlook for Developed versus Emerging Markets (EM) is more nuanced but investors would need to be selective in some EM countries where depreciating currencies and rising bond yields severely limit policy response to the pandemic. Meanwhile, the price to book valuation for the US market is currently hitting expensive territory but the uncertainty surrounding the upcoming US presidential elections may heighten market volatility. On the other hand, Asian equities appear attractively priced with the price to book valuation for MSCI Asia Pacific ex Japan equities near its historical low. See Fig. 2. and Fig. 3.

Fig 2: US equity valuations are hitting expensive territory

Source: Refinitiv Datastream as at 29 May 2020

Ooi Boon Peng: Value stocks have underperformed growth stocks for almost a decade. Ironically, the long period of underperformance and substantial valuation divergence help establish some of the pre-conditions needed for value to work. There is still merit to buying quality companies that are undervalued relative to the sustainability of their cashflows and earnings. For example, the Global Emerging Market and Regional Asia Equities team is overweight large cap and liquid banks in China which have high provision levels and healthier balance sheets than during the 2008 financial crisis. Likewise, the team is overweight selected technology names having found many attractively valued stocks in Korea, Taiwan and China. The divergence between value and growth stocks can narrow, although it may require greater certainty about a broader recovery in global economic activity.

On a different note, Environmental, Social and Governance (ESG) considerations will become even more important in differentiating winning companies. The fall in pollution resulting from the lockdowns has established a clear link between business activity and the environment. The outbreak has also increased focus on the social impact of companies and whether they are treating employees, customers and suppliers fairly.

Improving ESG disclosures in terms of scope, volume and materiality is needed for better ESG integration although Asia is making progress on this front. Hong Kong's Securities and Futures Commission has made it compulsory for listed companies to disclose all their sustainability credentials. China has also required all listed companies to report their ESG risks from 2020. In Singapore, efforts are underway to make the information in the mandatory sustainability reports more useful[1].

Research suggests that the marginal improvement in ESG ratings contributes most to alpha generation. As such, while Asia's ESG standards may currently lag those in the US and Europe, there is significant potential for ESG integration to add value to investors and the society in Asia.

Fig 3: Asia Pacific ex Japan equities are at very attractive levels

Source: Refinitiv Datastream as at 29 May 2020

Source: [1]https://www.businesstimes.com.sg/companies-markets/investors-to-see-more-useful-data-in-mandatory-sustainability-reports

3 HOW HAS COVID-19 CHANGED RISK AND RETURN EXPECTATIONS AND WHAT ARE THE ASSET ALLOCATION IMPLICATIONS?

Kelvin Blacklock: Markets, in my view, will ultimately settle down if three conditions are met: 1) visibility on the ultimate scale of the coronavirus outbreak and evidence the infection rate has peaked over the long-term; 2) deployment of credible and coordinated policy packages; and 3) confidence that financial markets are functioning properly. Once we better understand the scale and impact of the outbreak, the policy response is setting the stage for an eventual –and strong –recovery. The Investment Solutions team believes that investors should take a long-term perspective. For some investors, this may include rebalancing back toward benchmark weights, as the scale and rapidity of market moves have likely left many portfolios effectively overweight bonds and underweight equities.

The broad cheapening in global valuations enhances the case for equities. Following the rally in mid-March to May, investor sentiment has turned to neutral from extreme bearishness. At the point of writing, we are overweight equities and underweight duration on expectations that the fundamentals are bottoming. We are also positive on US tech sector may be neutral relative to the broader US equity market, its return on equity is much higher.

Sovereign bond yields in the developed markets have collapsed in the flight to quality, and as investors priced in slower growth as well as lower inflation. Against this backdrop, credit may offer better value especially since spreads have stabilised following the US Federal Reserve's intervention in the US Investment Grade and High Yield bond markets. With developed market central banks becoming active buyers of their corporate bonds and much of the stimulus targeted at preventing defaults, this should help to underpin the credit bond market. These bond buying programmes are also unlikely to end anytime soon, thus preventing any sudden rise in bond yields. We see potential in Emerging Market Bonds where spreads are at historical levels. That said, caution is also warranted as the asset class is dominated by Latin American issuers that are suffering from both depressed economic activity and low oil prices. We have turned more cautious on Treasury Inflation-Protected Securities (TIPS) after a huge decline in rates, though we still see value in the long-term.

We emphasise portfolio resilience through a benchmark allocation to government bonds, quality equities, cash and sustainable investing. We prefer geographies with the most policy space – these currently include the US and China in both equities and credit, and favour quality exposures.

Over a longer horizon, this pandemic adds to the trade tensions in compelling companies to rethink their global manufacturing footprints. This combination of supply shocks could weigh on growth, increase production costs, pressure profit margins and drive up inflation.

4 WHAT IS THE OUTLOOK FOR ASIAN FIXED INCOME AND ARE THERE RISKS FROM RISING GOVERNMENT DEBT?

Ooi Boon Peng: Asian fixed income markets should be supported by a gradual resumption in economic activity, as well as by the surfeit of liquidity looking for yield and stable returns. I expect inflation in Asia to remain low and ease even further. Even though Asian currencies have depreciated between 2.7% to 6.3%[2] year to date , the risk of higher imported inflation due to weaker currencies is probably limited by the sharp drop in oil prices. Low inflation means that Asian real government bond yields will remain high.

The massive fiscal stimulus and monetary accommodation announced by Asian governments and central banks are likely to

Source: [2]Bloomberg. As at 27 May 2020.

remain in place well beyond the end of the pandemic to ensure that the recovery is self-sustaining. Despite the substantial fiscal stimulus measures in many Asian countries, government debt levels remain generally manageable. Notably, the government debt levels of Asian economies were lower than their developed market peers going into this crisis, giving them more fiscal room to underpin economic growth. As such, Asian governments can provide economic support for an extended period.

Against a still challenging macro backdrop, the skill in credit differentiation will be key and high-quality bonds will be a more defensive bet whilst providing a decent yield. While the all-in yields of Asian Investment Grade (IG) bonds are not particularly high relative to history, Asian IG credits still offer an attractive yield pick-up over other risk-free assets. Slower economic growth will impact the fundamentals of Asian IG names, but the risk of credit defaults and downgrades is expected to be manageable given that Asian issuers had been prudent in their debt expansion and have strong funding access. In addition, a number of these firms are either state-owned or have strong parental support. Currently, 60% of the Asian IG universe is rated Baa1 or better[3]. Asia IG's lower beta within EM should provide investors with more stable credit spreads and overall returns.

The liquidity-driven selloff of Asian High Yield (HY) bonds has driven their credit spreads to historically very attractive levels. See Fig. 4. Given low Developed Market government bond yields, Asian HY's wide credit spreads suggest that the sector offers good value whether assessed from an overall nominal or real yield basis. Since 2005, investors who have entered the Asian HY bond market at spread levels of above 800 bps, would have enjoyed an average total return of 16% on a rolling 3-year basis. In view of the current high economic stress however, the Fixed Income team is paying greater attention to the viability and sustainability of HY

Fig 4: Asian high yields are attractively valued versus US high yields

Source: Bloomberg, JPMorgan, ICE Benchmark Administration Limited (IBA), 29 May 2020 (daily data); JPMorgan Asia Credit Index – B sub-index; ICE BofAML US High Yield B Option-Adjusted Spread retrieved from FRED, Federal Reserve Bank of St. Louis; August 1, 2018. HY: High Yield. *Spread differential between Asian HY B rated and US HY B rated. Please note that there are limitations to the use of such indices as proxies for the past performance in the respective asset classes/sector. The historical performance or forecast present in this slide is not indicative of and should not be construed as being indicative of or otherwise used as a proxy for the future or likely performance of the fund.

companies' business models, cash flows and ability to access capital markets in order to avoid defaults in our Asian HY portfolio.

5 WILL US DOLLAR STRENGTH PERSIST? WHAT IS THE OUTLOOK FOR ASIAN CURRENCIES?

Ooi Boon Peng: The US dollar (USD) is currently living out the Dollar Smile theory[3] in which investors tend to rush for safe, liquid assets. The twin demand and supply shocks induced by this pandemic have resulted in dollar hoarding; countries and corporates with dollar liabilities have rushed to stock up dollars as dollar revenues fall on the back of the collapse in global economic activity.

Still, given the significant economic packages, I think investors can make a first phase move to "risk-up" in buying Asian and EM currencies even though we do not have the "all-clear". The release of liquidity is already being manifested in the lift to global stocks, credit markets and EM currencies amidst a still uncertain outlook. The Chinese economy is the first to stage a comeback which provides a positive backdrop for Asian currencies. From a longer-term perspective, EM currencies are generally undervalued against the USD. See Fig. 5. That said, holders of Asian and EM currencies must be prepared to weather bouts of market volatility.

Kelvin Blacklock: Year-to-date, the USD has been appreciating against all G10 currencies except the Japanese Yen. As investors continue to assess how the pandemic will play out, the USD may remain well bid amid risk-off episodes over the coming months.

In the second half of the year, if countries can successfully reopen without fresh waves of new infections, investor sentiment may turn positive and away from risk havens like the USD. Moreover, the USD has lost its carry attractiveness since US treasury

Fig 5: Asian currencies have declined to 15-year lows vs USD

Source: Bloomberg as at 31 May 2020

Source: [3]Put forward by Morgan Stanley strategist Stephen Jen.

yields dropped. Another key event that will drive market direction would be the outcome of the US elections.

The path of USD versus Asian currencies depends on a) how quickly Asian economies can kickstart activity; b) developments on US-China trade tensions particularly for the export-oriented economies and CNY; and c) evolution of fiscal spending and impact on bond yields particularly for those with USD borrowing. Overall, in line with the Investment Solutions team's broad USD view, we would be overweight USD against the Asian currencies. Countries that are reliant on USD borrowing and have announced aggressive fiscal stimulus, can expect their currencies to remain particularly under pressure. Currencies considered safe havens in Asia (JPY, TWD) may continue to outperform their Asian peers amid the uncertain environment.

6 WHAT ARE THE KEY RISKS FOR THE MARKETS IN THE NEXT 12 MONTHS AND BEYOND?

Ooi Boon Peng: As countries ease their lockdown restrictions, they risk a second round of infections which will cause lockdowns to be re-imposed. The successful discovery of a vaccine is needed for the global economy to fully normalise, failing which the world will operate in a new-normal of lower potential growth. Second or even third round COVID-19 outbreaks would lead to permanent losses in economic activity and business. In that scenario, consumers and corporates will continue to restrain spending despite the massive policy support. The deflationary impulse will be exacerbated, and global interest rates could stay low permanently. Taking a leaf out of the 2008 GFC experience, the massive policy stimulus that was pumped into the system then did not cause inflation expectations to normalise even as economic growth picked up. In fact, inflation and wage growth stayed subdued. Do recall that even as the US economy was chugging along in May last year, US inflation continued to undershoot its 2% target.

A prolonged economic downturn will eventually cause the number of corporate bankruptcies to increase globally. The historic drop in oil prices is already distressing oil and gas companies. With hospitality and services severely impacted, there is a greater risk of rising credit defaults spreading to these sectors. This in turn has implications for banks' profitability and ability to lend. Refinancing difficulties can lead to a repeat of the 2007 credit crisis although this is not my central scenario.

I also see heightened geopolitical risks in the coming months. This pandemic has highlighted the fragility of the European Union, triggered a rise in nationalism and a desire for self-sufficiency, as well as increased tensions between the US and China. While trade frictions may rise and fall, I do not expect a material escalation in tensions, despite a recent increase in rhetoric from the Trump administration. With the US elections just months away, the Trump administration is keen to see the US economy rebound and is unlikely to risk retaliatory tariffs on China that will have negative repercussions on its own economy. Recently, a recommitment towards the trade agreement from key trade representatives also gives hope that both sides desire a positive outcome.

Even as I discuss these risk factors, I am mindful that these are not fresh concerns. We could see markets climb this current wall of worry and perform very well with the aid of policy action. By monitoring market sentiment indicators, we can be more alert to the possibility of a surprise turnaround.

Kelvin Blacklock: Like Boon Peng, I see geopolitics as the key uncertainty for markets for the rest of the year although the situation remains under control for now. Meanwhile, financial markets have benefitted from the massive policy boost and pledges of unlimited support from the US Federal Reserve. The assurance of policy backing is causing the delink between Wall Street and Main Street even as economic data over the coming months is likely to reveal a bleak picture.

History shows that equities can rally even during stresses like the World War II. Investors need to be prudent amid the uncertainties posed by this crisis and yet acknowledge the potential market upside that can come about from the fiscal and monetary stimulus – a difficult balance. Given that there is no precedence to this crisis, the duration, extent and effectiveness of policy measures will continue to be debated.

While fiscal policies boost economies, too much of a good thing can be bad as seen post the 2008 GFC. Then, as now, monetary and fiscal policies were unleashed to prevent a deep recession. Two years later, the spotlight fell on the amount of public sector debt and the solvency of governments. Austerity measures subsequently kicked in to deal with the excessive debts. We seem to be taking a similar path. Even before the COVID-19 crisis, growth was slowing across major economies with Latin America chalking the slowest growth. Weak oil prices and a strong USD are tipping the region deeper into a recession. The countries with already stretched public finances face sovereign rating downgrade risks.

Another consequence of this pandemic is the Japanification of the world where bond yields decline steadily and remain low. Japan's "Lost Decade" in the 1990s began with low growth that eventually led to a banking crisis in 1997. The rest of the developed world experienced its own financial crisis in 2008. In both cases, bond yields were already in decline beforehand. Compared to Japan, the decline in the developed world's yields has been much faster. Asset allocation and diversification amidst a low yield environment will become even more challenging.

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