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2019 MARKET OUTLOOK

AN INTERVIEW WITH LOW GUAN YI

Low Guan Yi, Chief Investment Officer of Fixed Income, discusses why she is increasingly positive on duration based on her view of well-anchored inflationary expectations. Asia's divergent interest rate cycles and valuations also present opportunities.

Q For the past few years, your strategy has been to 'tactically' trade risk. Is this strategy still appropriate heading into 2019?

After a year of intermittent volatility, 2019's investment environment is shaping up to be more stable. The reduced focus on global themes should facilitate the emergence of individual country themes, which in turn should enable us to target strategic allocations (based on fundamental and valuation indicators), rather than pursue tactical opportunities arising from market technicals.

Some of the uncertainties that fuelled 2018's volatility have either been discounted or removed. Monetary policy tightening, for example, will be less of a headwind against a backdrop of a slower-paced expanding global economy. The outcome of the US midterm elections also removes another source of market uncertainty.

While the risk of political gridlock has increased, we do not expect US growth to be derailed; domestic growth drivers should hold up even without the boost from the additional tax cuts and other fiscal measures proposed by President Trump.

Q Could the US Fed hike rates faster than projected given recent concerns of rising input costs and tariffs fuelling inflation? How would this impact your positioning?

We are increasingly positive on duration and have reduced our underweight duration exposure significantly. This reduction is based on our view that the Fed tightening cycle is well advanced and inflation expectations remain well-anchored; while the US has seen healthy payroll gains, for example, the pressure on wages remains low. At the same time, excess labour capacity and reduced earning power should restrain inflation globally.

Should the Trump administration raise tariffs on all Chinese imports, beyond the proposed 25% on USD200bn, a knee-jerk reaction could trigger a spike in front-end yields as the market prices in accelerated Fed tightening. The impact on long-end yields is questionable, however as recession fears may come to the fore.

But for now, any further rise in yields would present good entry levels to increase our duration exposure.

Q Given that the consensus points to further US dollar strength, at least for the first half of 2019, what could trigger a change in your overweight stance in the Indian Rupee and the Indonesian Rupiah?

2018's weakness in India's Rupee and Indonesia's Rupiah was more than a strong US dollar story. The spike in oil prices, which resulted in current account deteriorations, was a key reason for currency underperformance versus other Asian currencies. A stabilising oil price as production increases in response to higher prices, should ease pressure on both current accounts.

As such, we see a lot of room for 2019 outperformance when the 'dust settles' and investors refocus on the fundamentals.

Structural improvements over the past few years, for example, have better anchored inflationary expectations, while both economies possess adequate foreign reserves coverage ratios. With both currencies having fallen over 2018 to 20-year lows, current account and debt servicing fears seem adequately discounted, leaving valuations looking attractive.

We would reassess our overweight stance should the fundamentals deteriorate materially. For now, we are comfortable with our positions.

Q Fears of slowing growth, possible policy missteps and the impact of a prolonged trade war have taken a toll on the Chinese Renminbi. What is to stop the currency from getting cheaper?

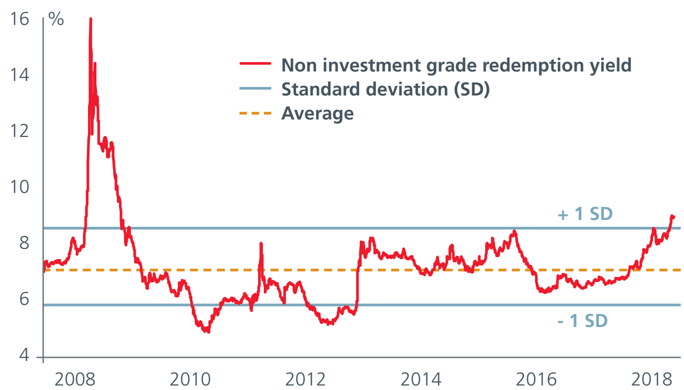
Chinese policymakers have consistently emphasised that they will not 'weaponise' their currency in any US-China trade conflict as they remain committed to the internalisation of the Renminbi.

The door has been left open, however, to any currency weakness resulting from a deteriorating external balance as the currency responds to market forces.

While a weaker Renminbi is a natural shock absorber in the event of a prolonged trade war, the outlook for the Renminbi will ultimately reflect China's growth potential.

Chinese policymakers are proceeding with tax reforms to stimulate private economic enterprise. Equally, the development of economic hubs and investments in infrastructure to support greater urbanisation will continue to be growth engines.

High redemption yields suggest investor fears are discounted in good measure[1]



Q Earnings estimates for Asian corporates are on a downtrend at a time when liquidity is shrinking. Given this, what is driving your overweight conviction on Asian high yield corporates?

We view Asian high yields as being in oversold territory given that the broad fundamentals for the companies (especially Chinese property) have not deteriorated.

That said, we are starting to observe that the refinancing cycle for Asian high yield corporates is getting shorter; many companies are only able to refinance into 3 years or shorter tenors, reflecting investors' duration concerns. We see some Chinese property companies scaling back their land bank purchases as funding becomes more difficult.

For this reason, we must be selective and invest in companies that can refinance in the next 2–3 years. We draw comfort from the fact that some of these companies have good land banks, projects which they can either pledge or sell to secure funding, as well as good access to loan markets.

We would turn more negative if these companies were to aggressively resume expansion amidst tight liquidity conditions. In fact, we are avoiding individual companies that behave in this way.

Q What factors should investors consider when deciding between Asian US dollar or local currency bonds. Where do you see the opportunities?

Asian US dollar bonds yield a steady risk/reward profile and are particularly suited for investors looking for income generating assets.

Some of our top picks, for example, lie within the Chinese Asset Management companies (AMCs). Spreads of these companies have widened on supply concerns and tighter onshore borrowing requirements, let alone the scrutiny on the chairman of one of the largest AMCs. These spreads have widened to levels that we feel sufficiently justify taking on the risks.

While some of the AMCs seem set to undergo internal restructuring, not excluding possible management change, the top AMCs are systemically important to the country and will continue servicing their debts despite the above-mentioned headwinds.

Local currency bonds will also likely present selective total return opportunities.

Asian currencies, for example, could fare better if US dollar strength fades as the growth differential between the US and Emerging Markets narrows. Structural factors, such as the US twin deficits, could also emerge, thus undermining dollar strength.

Asia's divergent interest rate cycle and valuations also present opportunities; we are positive on Indonesian, Indian and Philippines local currency bonds. Indonesian and Indian real yields are amongst the most attractive in the region. Our expectation of a more stable macroeconomic backdrop in 2019 could lead to a compression in risk premium, while the pressure for further rate hikes should ease. In contrast, we think the Philippines is closer to the end of its rate hike cycle; bond yields appear to have discounted the remaining rate hikes.

Sources: [1]JPM JACI Non Investment Grade Index from Thomson Reuters Datastream as at 15 November 2018.

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