Capricious Equity Markets in 2019

Dear Investors,

After a dreadful 2018, we take stock of events that could unfold in the first part of this year and their implications for our portfolio.

US

We do not expect a recession, though US corporate earnings growth in 2019 is expected to slow to single digits. This would reflect higher credit costs, wages and trade-tariff-induced inflation.

The effect of the tariffs will boomerang to raise input costs, thereby reducing the cost-competitiveness of US manufacturers and raising inflation for consumers. This corrals the Fed's ability to meet Trump's repeated demands for holding back rate increases. Hence, we still expect at least two interest-rate hikes in 2019.

As a large oil producer, the sharp decline in oil prices in 4Q18 did not bode well for the US. Major oil producers have vowed to cut their production from Jan 2019. It is yet unknown if they will stick to this. Low oil prices, combined with the plunge in US equity markets, could hurt domestic consumption, which accounts for more than 70% of the US economy.

Investigations into Trump, who might be indicted by Special Counsel Robert S. Mueller III for Russian involvement in his presidential campaign, might rock the US market. We are underweight on the US market.

CHINA / HK

De-escalation of the trade war is a welcome breather. But regardless of whether the US and China reach an amicable settlement in early Mar 2019, trade and manufacturing diversions to other Asian countries have begun. We think they will only gain pace.

To counter the impact of the tariffs and lower consumption spending in the country, China has introduced tax breaks for childcare, healthcare and aged care from 2019. It is also prodding its banks to lend more to SMEs. Still reeling from China's deleveraging campaign that decimated their fixed-asset investments, the banks would loathe to load on risks as economic growth slows.

One development that could cause Trump to soften his stance against China is the pending renewal of casino licences in Macau. US casino operators are behind 60% of Macau's gaming income. Sheldon Adelson, Chairman of Las Vegas Sands, is the biggest Republican donor. He controls Sands China, which runs two casinos in Macau, whose licences are due to expire in 2022. Two other licences currently held by Macau-based operators, SJM Holdings and MGM China, will also expire in 2020 and are up for grabs. Sands China may be interested.

Although China has downplayed its Made in China 2025 ambition, it is fast closing its technology gap with the West. Alibaba is expected to launch its first computer chip tailor-made for artificial intelligence in 2H 2019. Dubbed "Pingtouge" in Chinese, after the Chinese nickname for the fearless honey badger, Alibaba aims to use this to reduce China's dependence on foreign silicon for its electronic products.

Before that, we expect a year of slower growth for China. With trade relations hanging in the balance, we stay underweight on China and HK.

EUROPE

The ECB ended its quantitative easing (QE) at end-2018, though it may not raise interest rates anytime soon. We believe the ending was poorly timed. The Eurozone has barely come out of years of easy money that had cultivated complacency and poor spending discipline by some EU nations. If the global economy slows down further, it will have little option left. The ECB, with a balance sheet at 41% of the Eurozone's GDP and ultra-low interest rates, has exhausted its monetary ammunition.

Brexit's exit, whether hard or soft, will mostly be negative for the Eurozone, though there might be some positive spillover for countries such as Spain, the Netherlands and Czech Republic. Companies with operations in the UK are relocating ahead of the UK's exit to these countries. We are underweight on the Eurozone.

ASIA

Slower Fed tightening will allow Asian countries to catch up in interest rates. It would also take some pressure off Asian currencies and stem fund outflows from Asia. In fact, we expect flows from developed markets to reverse back into emerging Asia. Emerging markets appeal with their burgeoning middle class and strong infrastructure needs.

Japan: In spite of an impending rise in its sales tax in Oct 2019 from 8% to 10%, we see more positive economic momentum for Japan, from construction spending ahead of the 2020 Olympics. The country is easing restrictions on the employment of foreigners, which should help to raise productivity.

Singapore: Singapore has been over-de-rated, from anxieties that the trade war could drastically weaken its GDP growth. At 4.5%, Singapore has one of the highest yields in Asia. And a price to book ratio of about 1x has also made some of its listed companies attractive M&A targets.

We are bullish on banks with established operations in HK and China, as they should continue to surf credit growth in China. With risk aversion demanding a higher cost of equity, banks are trading at yields of above 5%.

Malaysia: Malaysia is taking longer to get back on its feet after its May elections that swept the Pakatan Harapan coalition into power. Its Ministry of Finance is said to be reviewing a number of public-private-partnership projects started by the old government. Revelations that Lembaga Tabung Haji, the savings fund for Muslim pilgrims, has been mismanaged have also rattled the market. The fund owns substantial stakes in Malaysian-listed companies. We are underweight on Malaysia.

One sector that stands out is glove manufacturing, which is enjoying low rubber prices, ringgit weakness – products are sold in US$ - and weaker energy prices. Malaysian glove makers listed in Singapore trade at lower valuations than those listed in Malaysia and still offer value at <1x PEG multiples.

Indonesia: Indonesia's current account and inflation could improve with the downtrend in oil prices, as it is a net importer of oil. Any peaceful presidential elections in April 2019 that return President Joko Widodo to power would be a positive catalyst. Jokowi has channelled savings from lower fuel subsidies to more infrastructure spending. We like Indonesian banks. The country has a low penetration rate for financial services. Less than 40% of its vast 260 million population owns a bank account.

Thailand: Thailand and Vietnam are starting to benefit from the relocation of manufacturing out of China. Thailand will hold its long-awaited general elections in 1H 2019. Consumer sentiment is expected to get a boost, going by past traditions.

CONCLUSION

We expect weak 4Q18 earnings to weigh on equity prices in 1Q19. Markets will also be consumed by trade negotiations between China and the US in early March and the Brexit settlement at end-March. We believe value stocks will lead an eventual market recovery and have positioned our portfolio for this.

We are thankful for your support!

Best regards,

Peggy Mak
Head & Chief Investment Officer
peggymakbm@phillip.com.sg

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250 North Bridge Road
#06-00 Raffles City Tower
Singapore 179101
www.phillip.com.sg

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