Areté | CAPITAL ASIA

ARETE CAPITAL ASIA GLOBAL OUTLOOK 2018

WELCOME TO 2018

Many of the big financial institutions invest considerable effort to compile a forecast for the year ahead. It is maybe not so surprising that these views tend to overlap. The most salient parts of these reports are generally related to where these houses make their own investment recommendations.

As an independent advisor, we have decided it is not such a good idea to add to this already substantial volume of opinion. Rather, we would summarize the broad consensus views, highlight areas where there are different opinions and then list some of the investment ideas that have been put forward – all in a few pages!

To add a little more rigour to this exercise, we have made a compilation of views from both the buy-side and the sell-side.

We hope you enjoy this brief read and can apply a few of these views to your own portfolios – of course we are willing to discuss these with you when you are ready.

Regards

TERRY LEEWORTHY

CHARLIE LUCHANGCO

BROAD CONSENSUS IN BIG PICTURE …

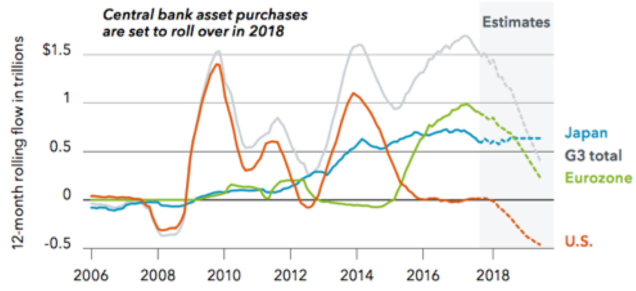
INVESTMENT CLIMATE

- The investment landscape continues to be dominated by Central Banks but the scale of Central Bank support is set to diminish in 2018.
- If the system is destabilized for any reason during 2018/19, there is a high degree of confidence that the Central Banks would take action to contain the event.
- The Fed has clearly moved on to cautious tightening, while EU and Japan will continue with easy money policies. The BoJ is approaching policy exhaustion and will remain super-accommodative.
- A note of caution: the world now carries a huge debt burden – a significant increase over the last decade.

SUSTAINED EXPANSION

- The breadth of global expansion is widening and indicates a longer lifespan of this expansion.
- Expect global growth to be nearer 4% than 3% in 2018. Most houses project 3.6-3.8% for global growth.
- Consensus US growth is 2.4-2.6%. **JPMAM** argues that US economy cannot sustain growth above 2% beyond 1H18 (limited employment growth & lack of investment spending has hurt efficiency)
- EU growth consensus is 2.0-2.3%. **UBS** estimates slightly below at 1.9%
- EM Asia growth consensus is 6.0-6.5%.
- The economic expansion in the US is the longest on record, but economic growth and corporate profit growth will fall back later in 2018 following a few quarters of excellent gains.
- Global capital expenditure is recovering, particularly in the EU. The EU, with unemployment at 8.8%, still has plenty of capacity for above-trend growth

G3 central bank net asset purchases, 2006-2018



INVESTMENT CLIMATE

'Our base case scenario in the US is that above-trend pace of growth will continue in 1H18, but is likely to slow down to 2% or lower later in 2018 and beyond' **JP Morgan Asset Management (JPM AM)**

SUSTAINED EXPANSION

'We see no change to the big picture of global expansion chugging along at an above-trend pace' **BlackRock Investment Management (BLRCK)**

'Strong profitability and still supportive financing conditions should support capital spending in 2018' **Credit Suisse (CSuisse)**

Expect 5.0% growth across emerging markets in 2018, but large swathes of EM – Mexico, Turkey, S Africa, Saudi Arabia and India – will grow below potential.. **Bank of America Merril Lynch (BAML)**

BROAD CONSENSUS IN BIG PICTURE …

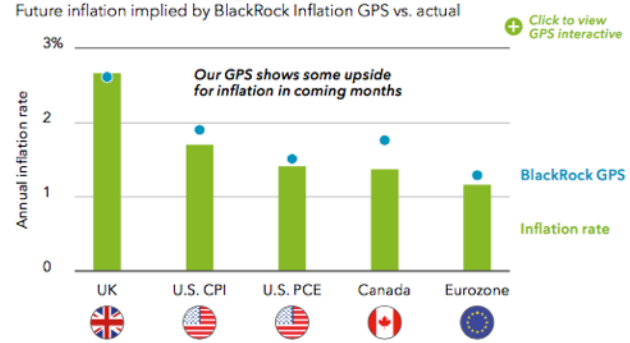
INFLATION

- Resurgent inflation is probably the biggest recognised risk given the leverage in the global economy., Although the likelihood of inflation rising is low, the cost of getting this wrong is high.
- Inflation in the US is expected to rise nearer 2%, giving rise to rate increases from the Fed.
- Core inflation in the EU will be at much lower levels, and the ECB will be more cautious about reducing QE.
- The structural drivers of low inflation look set to continue: globalization should continue to put downward pressure on prices, technology plays it's part, and services disinflation is also on the horizon given the rapid development of AI.

> 'Just the possibility of inflation developing could shake the credit markets, given the high debt levels and asset prices'
> **Macquarie Investment Management (McQ IM)**

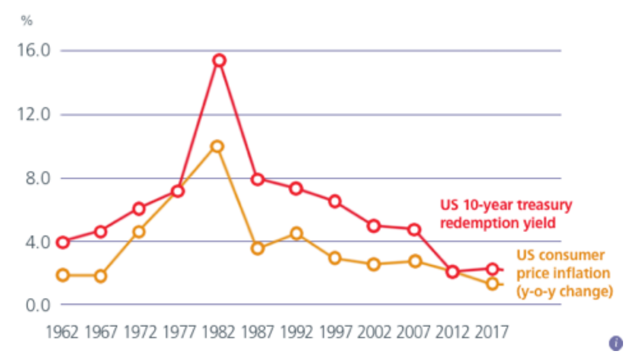
Inflation's demise exaggerated

Future inflation implied by BlackRock Inflation GPS vs. actual



Sources: BlackRock Investment Institute and BlackRock Scientific Active Equity group, with data from Thomson Reuters, September 2017. Notes: The BlackRock Inflation GPS shows where the core (excluding food and energy) Consumer Price Index (CPI) for each economy may stand in six months' time. U.S. PCE shows core personal consumption expenditures price inflation.

Bonds took a long time to price in low inflation



DEVELOPED MARKET EQUITIES …

Equity markets around the world have continued to experience buoyancy in 2017. Of course, risks exist in 2018, but we believe there are reasons for a range of relatively optimistic outlooks

US EQUITIES

- Longer term investors concerned by valuations (PE over 25.0 vs historical average of 15.7). Market appreciation in 2017 has made the market more expensive.
- Consensus is for S&P to deliver mid-single-digit total returns in 2018. With US tax reforms being passed, **Deutsche Bank (DB)** considers S&P will be 13% by year end
- Several houses are underweight US equities vs Europe

DEVELOPED MARKETS EQUITIES

- There is broad consensus favouring selected European countries and Japan. **Morgan Stanley (MStan), State Street (SStreet), McQ IM, Eastspring Investment (ESpring)**,
- Many houses strongly favour European equities over US equities. **UBS** Generally overweight EU equities – particularly domestic demand stocks and banks
- The EU area has many supporting arguments, but equities in Germany (equities still cheap and monetary policy loose) and Spain (cheap exposure to a recovering banking system) **CSuisse**

S&P 500 Index cyclically adjusted P/E ratio

Source: Robert Shiller, International Center for Finance at Yale School of Management, and S&P Dow Jones Indices (all via Ned Davis Research, www.ndr.com).

'Unless someone makes the case that 10y Treasuries are poised to rise, or that recession is looming, I don't see why investors would not be looking, selectively, for stocks' **McQ IM**

'In MSCI's DM indices, PE ratios have declined in countries as diverse as Australia, Germany, France, UK and Japan. EU area and Japan have low enough valuations to support price gains before reaching historic norms. **McQ IM**

CONTRARIAN VIEW

'We are bullish US equities, more so with tax reforms. Eurozone equities outlook is more cautious where we are neutral since some drivers that have provided support will fade next year'. **DB**

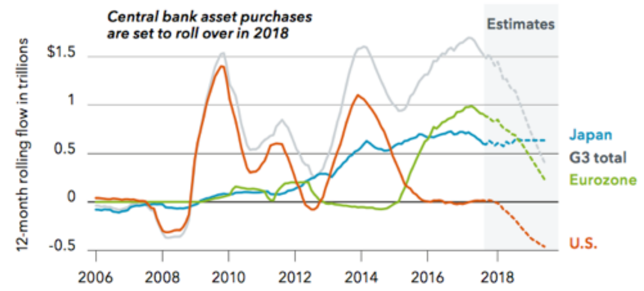
EMERGING MARKET EQUITIES …

Many houses have a positive view on emerging market equities, many in Asia – most recommend selective investments. The technology sector offers opportunities for many. Some more selected views…

EMERGING MARKET EQUITIES

- China is moving rapidly up the economic value chain through innovation and product differentiation. Several houses have highlighted China equities as an opportunity in 2018. **SStreet, McQ IM, ESpring. Citi** is neutral. Some houses indicate weak sentiment for China. **CSuisse**,
- Chinese banks look extraordinarily cheap. **CLSA, CSuisse**
- We at Arete prefer selected tech, banks and healthcare..
- In Brazil, inflation has been reined in, which should be supportive of growth there, if sustained. **McQ IM**
- Russia is in the early stages of recovery, and inflation has moderated. **McQ, ESpring, CSuisse**
- In India, we expect the governments priorities to refocus on growth **McQ**
- Equities in Malaysia are interesting **CSuisse**
- Korean equities look cheap. **Citi, CSuisse**,
- A few Taiwanese stocks offer good yield. **CSuisse, Citi**,

G3 central bank net asset purchases, 2006-2018



'Our preference is for EM small caps, that have lagged the large cap rally in 2017. We prefer EM consumer stocks'. **CSuisse**

'Low volatility at the markets surface can conceal great dispersion, and opportunities, in individual stocks beneath' **BLRCK**

'Looking behind the headlines, the reality is that 2017's rallies were driven by EM rather than DM (reversing the pattern of previous years) and dominated largely by one sector in one country – internet in China'. **ESpring**

NON-CONSENSUS VIEW

'There is potential for short-term vulnerability and relative under-performance, but we remain a long term bull on India'. **CLSA**

DEVELOPED MARKETS FIXED INCOME …

Consensus expects steady fixed income markets, with modestly higher bond yields given the global economic momentum while structural forces continue to exert a cap on inflation and interest rates. 2018 is likely to be a year of moderately positive bond returns.

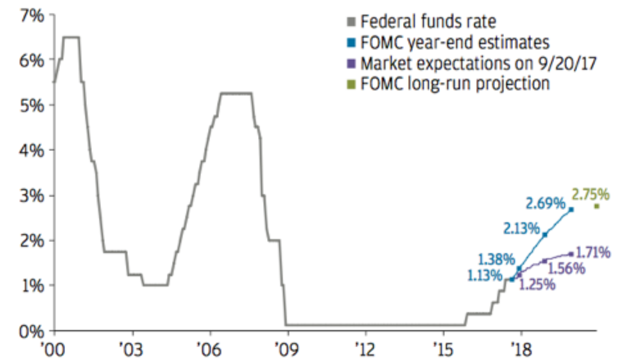
Consider inflation linked bonds in EU and US. **Allianz SE (Allianz)**

US MARKETS

- Consensus view is that most measures of the economy are quite healthy, there is not a lot of upside. Expect UST 10y to remain range-bound 2.0-2.6%
- Bond investors should clip the coupon and brace for some small negative movements in bond prices.
- Credit spreads should widen. There is limited value in US high yield. **UBS**

DEVELOPED MARKETS BONDS

- Non financial corporate bond valuations in the EU are rich. Subordinated bank and insurance bonds are fairly priced, should benefit in a period of growth.
- Investors might want to avoid Spain and Italy due to the stresses in their own financial systems.



Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.

'The world cannot handle significantly higher rates and we see a strong case that rates remain lower for longer' **McQ IM**

'Parts of the investment grade market are likely to see negative returns overall. The outlook for investment grade corporate bonds is only slightly more promising, but the end of QE demands more selectivity. Euro HY spreads are too low to compensate for the risk'. **UBS**

TWO NON CONCENSUS VIEWS

'**MStan** are recommending to lower exposure to credit on the basis of moderating growth (in the US and China) and higher inflation (which may remain below target). They expect UST 10y to be closer to 1.95 at the end of 2018'.

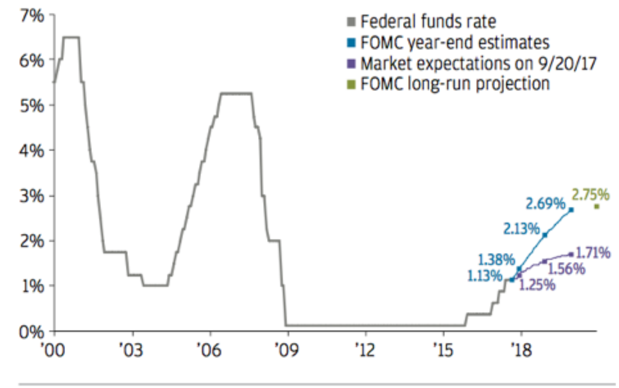
Fed will increase rates 4 times in 2018. **DB**

EMERGING MARKETS FIXED INCOME …

Most houses see expensive bonds in EM, but they also vary in terms of where they see the better value to invest.

GENERAL

- EM corporate bonds are expensive, sovereign bonds in hard currencies have low return potential. **CSuisse**
- EM debt returns are likely to be positive, just lower than history. **JP Morgan Investment Management (JPM IM)**
- Many EM govt's have room to cut rates amid steady growth and subdued inflation, so expect EM debt to outperform. **BLRCK**
- The global environment should still support EM business and credit cycle and investors can find value in selected EM credits. A blend of sovereign and corporate bonds could yield around 5%. **UBS**
- Asian credit spreads are tight (around 220bp vs 10yr avg of 304bp) but we still see value in Asian credits and EM local currency bonds. **ESpring**
- Select opportunities in EM debt, particularly in Europe. **Allianz**
- We do have a constructive view on a few EM currencies. We suggest money market instruments in TRY, MXN, ZAR and MYR. **CSuisse**
- High yields and reasonable currency valuations support local currency bonds in Russia and Indonesia. **MStan**



Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.

Emerging market and Asian local currency bonds offer longer term value – the trick to successfully navigate this world will be to remain nimble and "tactically" trade value opportunities as and when they appear'. **ESpring**

'Parts of the investment grade market are likely to see negative returns overall. The outlook for investment grade corporate bonds is only slightly more promising, but the end of QE demands more selectivity. Euro HY spreads are too low to compensate for the risk'. **UBS**

SELECTED INVESTMENT THEMES … 1 of 2

Several investment themes are based on technological development or disruption primarily born from the same

TRANSFORMATIONAL TECHNOLOGIES

Companies playing a role in technological disruption can outperform – we favour US technology and investing in automation, robotics, digital data and smart mobility. **UBS**

EMERGING MARKET EQUITIES

This year emerging market rally in equities was driven by larger caps. We prefer EM small caps, particularly consumer stocks given robust domestic demand. **CSuisse**

CORPORATE DISRUPTION

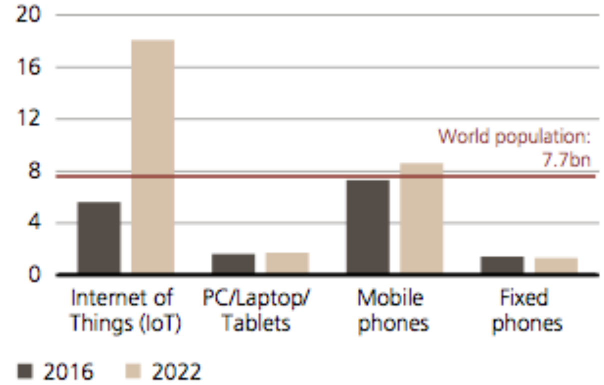
A small group of companies are being rewarded for reinventing industries and pushing existing business to the side. Interesting things are happening in finance, healthcare and technology. (IT valuations are much better outside the FAANG's)

EUROZONE REAL ESTATE

Favour underlying and listed real estate markets (on fundamentals and quality of listed portfolios). Residential in Portugal, Spain and France deliver the greatest rental yield above mortgage rates **CSuisse**

More IoT devices than people

Units in billions



Source: Ericsson, UBS

CORPORATE DARWINISM

'Corporate Darwinism I set to accelerate in a world where sector boundaries are blurred. This will be powered by technology advancements, including AI, and these will create new competitive forces'. **ESpring**

Today's technology giants do not require the same labour resources to generate high profits: Google's 2017 profits were 7.5x higher than those of GM at its peak (in 2017 dollars) with only 9% of the workforce!'

'Bullish on innovation and China'. **Hermes Investment Manager (HERMES)**

SELECTED INVESTMENT THEMES … 2 of 2

CORPORATE INVESTMENT

Companies have large sums of cash, but have been not spending to invest. They are now having to invest in production processes, IT security, etc Companies facing disruption must acquire to merge. Invest for a pick up in M&A and beneficiaries of capex - infrastructure related industrials and B2B. Favoured sectors include media and software. **CSuisse**

GEOPOLITICAL RISKS

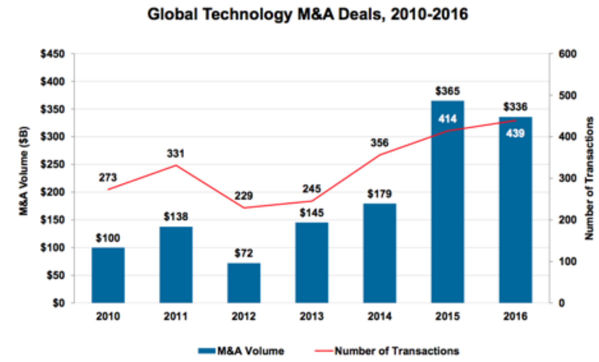
UBS has identified two strategies that could benefit if geopolitical risks escalate: 1) Overweight gold and silver against base metals. 2) Overweight Chinese stocks against Taiwanese stocks.

TECHNOLOGY TRENDS

The tech field has several fields that are close to producing real world impacts: voice enabled speakers for homes, semi-autonomous vehicles, augmented reality, robotics.
The world is only just starting to feel the impact of AI.

INFRASTRUCTURE INVESTING

At this stage of the economic cycle, listed infrastructure assets perform well - focus on LNG (production and pipelines). Also real assets like airports, ports, roads and storage (oil for instance) should perform well. **McQ IM**



'Today's technology giants exhibit some winner-takes-all characteristics that come with digital dominance. Their growth rates accelerate as they grow, not slowed'.

INDEX VS STOCK SELECTION

'Owning the benchmark is a poor decision – We are in a moderate growth economy where investors need to distinguish between companies that can deliver and generate cash in a flat revenue environment vs companies that have to deliver substantive growth to meet debt obligations.' **McQ IM**

'41% of all stock assets are in passive investments, and growing. More people realise Wall Street firms have been getting an outsized portion of the value created. It will become clearer investors need to get the return first before the vultures '. **Vanguard (Vngrd)**

THE FLAGGED RISKS – KNOWN UNKNOWNS

MARKETS AND CENTRAL BANKS

- The two most mentioned risks are the return of inflation and the possibility that Central Banks mis-handle a given situation
- Investors should beware volatility spikes and liquidity shortfalls given that the G3 Central banks own 1/3 of the tradable bond market,
- Market volatility is low, but there is a lot of money in volatility products, normally to gain an extra yield. No-one is sure how this plays out if markets change
- China may mis-manage its rising debt

GEOPOLITICS AND PLAIN OLD POLITICS

- While economic growth has helped Europe. Brexit and Italian elections and a public pushback against immigration (nationalism) could cause major tensions. 'Regionalisation' is also of concern (Catalonia, Corsica, etc)
- There is widespread angst over the ascendancy of China and US efforts to limit this. This could spill over into trade friction, hostilities over NKorea and/or the S China sea, sanctions, etc
- Less reported, but in a similar vein, Japan has its own discomfort with its bolder neighbor
- Oil is generally under-represented in portfolios. A few petro-states are in unhealthy positions: Nigeria, Venezuela, Qatar. On a different tack, but related, Saudi now has the world's 4th largest military budget
- US tensions with Iran (nuclear proliferation, supporting terror) are quite divergent from the European view of Iran, which might give rise to some surprise repercussions

POTENTIAL TECH FALLOUTS

- Regulatory scrutiny of tech firms in the US could put in doubt their extraordinary growth rates and valuations. Tax enquiries could have a similar effect
- Investigations of China's own tech giants could change situations very quickly

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