ACAL 2019 YEAR AHEAD OUTLOOK

AN OUTLOOK IN VOLATILE MARKETS

Last year, we prepared a market outlook that outlined the consensus view, amongst buy and sell side, and then incorporated some interesting outlying views. We received a lot of positive replies for that nice summary (it did save a lot of time if you were thinking about reading the views of a few banks!). We had it in mind to repeat that exercise with views for 2019.

Many institutions had published their views by end November. Although not a precise science, the market gyrations in December alone, have cast more doubt over these predictions. The fact that markets have turned 'risk on' in the new year, we are calling this unique year end experience the 'year-end valley' (in reference to the more frequently experienced 'year-end rally'!).

This 'V' (or valley) can be seen in many charts over the year end period, some more pronounced than others. The one exception has been gold, which looks to be coming to life amidst the global uncertainty.

EXERTING OUR INDEPENDENCE

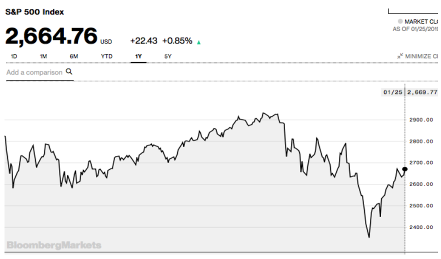
We at Arete Capital are truly independent financial advisors, using our 'freedom of selection' to source a few innovative solutions that have been incorporated into client portfolios to provide good growth potential and simultaneously have defensive qualities when the downturn comes.

Charlie and I really have the capability to offer the better solutions amongst several providers – we will advise the solutions most suitable for our clients.

We have recently made several good investment recommendations and many of them are on our website. We encourage you to go take a look and see for yourselves what a truly independent adviser can offer. www.arete-asia.com

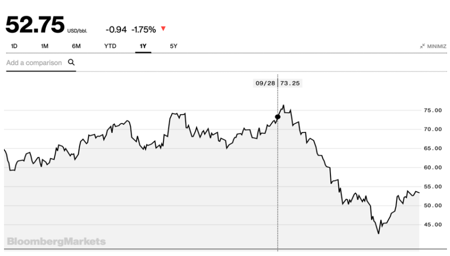
All people with some wealth are impacted by the movement of markets, some more directly than others. This year has brought more than a few unexpected scenario's and many asset prices declines. We write this article that includes some pertinent, interesting views from the world of investing.

S&P



Nikkei

WTI



US10y

JGB10y

Gold

A QUICK LOOK BACK

At the end of 2017, the broad outlook for 2018 was a continuation of the broad economic synchronized expansion that we experienced in 2017. This obviously did not come to pass. After 2017, where nearly every asset class appreciated, this last year's best performer is cash! With most securities suffering declines.

One thing overlooked, although was flagged quite clearly, was the extent to which the US has been more strident in 'looking after its own interests' around the world - with changes of the US stance being imposed on NAFTA, Middle East, NATO, Russia… along with a few military excursions in parts of the world. The 'world' view is a lot less harmonious that was the case 12 months ago.

Last year we did highlight a risk of a fallout in tech stocks – in the US and in Asia/China. Recognising the value created in the tech sector, we favoured more sober calls in Microsoft and Google (staying away from Nvidia and Netflix). The sectors valuations are now not so extra-ordinary, but still very significant.
The world is beginning to appreciate the not so favourable attributes of these giants (winner takes all, exploiting personal data collected, etc) and we believe more action on this front will take place this coming year.

> The US believed once China secured more wealth, it would embrace Western values. The Chinese thought Trump was a deal maker and they could adjust at the margins. Both misread. Tom Donilon, Blackrock

CONSENSUS ECONOMIC VIEW

There is a broad consensus expecting global growth to slow from 3.8% in 2018 to 3.5% in 2019. With the US economy looking more durable than the rest of the world, slowing from 2.9% to 2.2-2.6%.

Japans potential GDP growth rate has stabilized (with more foreign workers boosting potential GDP) expecting a slight pick-up in GDP growth from 0.8% to 1.0%.

For the Eurozone, consensus expecting 2019 growth to slow from 1.9% to 1.4-1.7%, many quoting the slowdown as a fallout from a world moving toward de-globalization in a region that is heavily dependent upon exporting manufactured goods.

China growth slow towards 6%, constrained by US tariffs, sluggish manufacturing investment and slowing consumption growth. However, there is some skepticism of numbers from China.

Morgan Stanley Real GDP Growth Forecasts

	2018E	2019E		2020E	
	Morgan Stanley	Morgan Stanley	Consensus	Morgan Stanley	Consensus
Global	**3.8**	**3.6**	**3.6**	**3.5**	**3.6**
G10	**2.2**	**1.9**	**2.0**	**1.6**	**1.7**
U.S.	2.9	2.3	2.6	1.9	2.0
Euro Area	1.9	1.6	1.6	1.5	1.5
Japan	0.8	1.3	1.0	0.6	0.4
UK	1.2	1.3	1.5	1.6	1.6
EM	**4.8**	**4.7**	**4.7**	**4.8**	**4.8**
China	6.6	6.3	6.2	6.1	6.0
India	7.7	7.6	7.3	7.5	7.5
Brazil	1.3	2.3	2.3	2.5	2.5

Source: Bloomberg, IMF, Morgan Stanley Research forecasts;
Note: Aggregates are PPP-weighted.

2018 ASSET PERFORMANCE

(%)	1Q17	2Q17	3Q17	4Q17	2017	1Q18	2Q18	3Q18	4Q18	2018
Global Equities	6.5	4.2	5.0	5.6	23.1	-1.1	1.9	5.1	-13.3	-8.2
US	6.1	3.1	4.5	6.6	21.8	-0.8	3.4	7.7	-13.5	-4.4
Europe	6.3	1.2	2.8	0.6	11.2	-4.0	4.3	1.3	-11.5	-10.3
Asia	13.4	8.4	6.7	8.3	42.1	0.6	-5.3	-1.5	-8.8	-14.4
Japan	-0.3	6.1	2.4	12.0	21.3	-4.9	4.1	9.0	-16.9	-10.4
Hong Kong	10.1	8.5	8.6	8.8	41.3	0.9	-2.5	-2.5	-6.7	-10.6
China A	4.4	7.0	5.8	5.1	24.3	-3.3	-9.0	-0.9	-12.4	-23.6
Emering Markets	11.5	6.4	8.0	7.6	37.8	1.4	-7.9	-1.0	-7.6	-14.5
Global IG	0.9	1.8	1.1	1.0	4.9	-1.7	-0.7	0.6	-0.2	-1.9
US HY	2.4	2.0	1.9	0.5	7.0	-0.7	1.1	2.4	-4.7	-2.1
EM Sovereigns	3.7	2.1	2.5	0.7	9.3	-1.8	-3.7	2.1	-0.7	-4.2
Gold	8.9	-0.6	3.1	1.8	13.5	1.7	-5.5	-4.9	7.7	-1.6
Oil (Brent)	-7.0	-9.3	20.1	16.2	17.7	5.1	13.0	4.1	-35.0	-19.5
Dollar Index	-1.8	-4.7	-2.7	-1.0	-9.9	-2.3	5.0	0.7	1.1	4.4
EURUSD	1.3	7.3	3.4	1.6	14.1	2.7	-5.2	-0.7	-1.2	-4.5
GBPUSD	1.7	3.8	2.9	0.9	9.5	3.7	-5.8	-1.3	-2.1	-5.6
AUDUSD	5.8	0.8	1.9	-0.3	8.3	-1.7	-3.6	-2.4	-2.4	-9.7

Source: Bloomberg L.P., as of Dec 31, 2018; Returns are total returns

RECENT SHIFTS

There have been a few fundamental shifts in the last quarter:

1) FED HAS SPOKEN, BUT IS NOW DATA DRIVEN:

In the second half of '18, the Fed was clearly flagging future rate increases. In December, the US stock swooned on a well publicised quarter point increase in the Fed fund rate. This was a little surprising - the stock market maybe believed that the Fed would come to the rescue of asset prices again (repeating the actions of the last decade) after soft markets in Nov/December. The Fed stood their ground! We think there are a few trains of thought around this scenario.

1) The Fed recognises it has few tools in their armoury with such low interest rates at this time in the economic cycle, so is building some room to manoeuvre.
2) The Fed needs to let some air out of the asset bubbles, that have been created by low rates, without stating it.

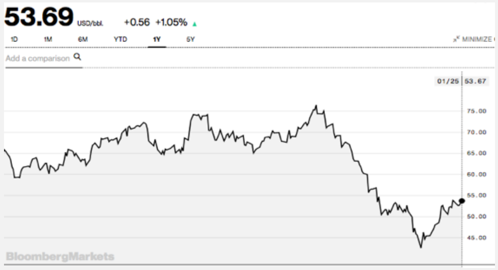
The Fed are probably doing what they should be doing - despite the noise in the press about mistakes and political pressure. Future rate rises will be those that are possible without bringing the house down.

2) OIL PRICES CONTAINED FOR NOW:

Iran has been a thorn in the side of US globalism for many years. The US administration has painted themselves into a corner by so publicly not renewing the existing nuclear arms treaty with the intention to impose new embargoes that would certainly impact oil supplies and prices (and imposing these on the rest of the world).

The very real threat of higher oil prices if these sanctions were fully imposed, resulted in the US administration allowing many exceptions to the pending oil embargo. The US blinked! Oil was trading around $76 at the beginning of October and now at $53.

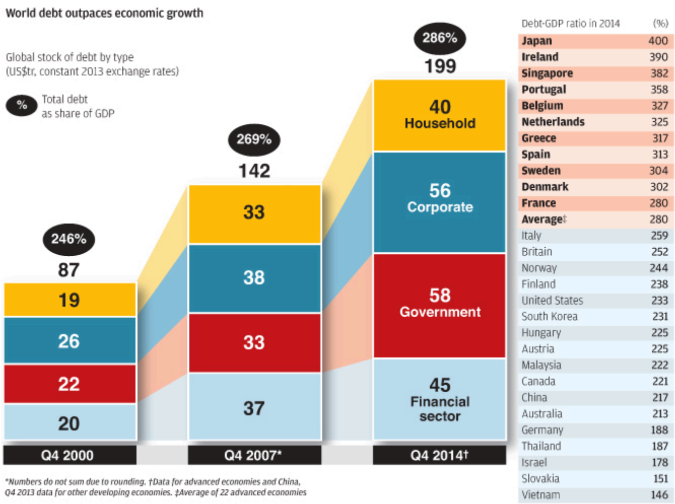
WTI



RECENT SHIFTS (CONT.)

3) WORLD IN DEBT:

We have reported several times about the huge build up in debt around the world over the last decade - government, corporate, personal debts are all huge, in absolute size and also huge relative to the size of today's economies. The lack of accountability, also in evidence in the usually more prudent developed countries, is all too obvious when political parties across the spectrum, are all advocating policies that will certainly grow deficits. ….. all displaying an attitude of spend today and worry about the consequences later!



Corporates have done exactly the same. US corporates in particular have been borrowing big time to fund share buy backs.

The bond markets have taken this huge and growing debt pile in their stride - until the end of 2018. The shift to 'risk off' at the end of 2018 has drawn a reaction from the bond market. We have witnessed credit spreads widening, this is significant given the credit markets indifference to many scares through last year.

4) FROM QE TO "QT"

We are already in an established trend towards **'Quantitative Tightening'.** One of our favorite market watchers, Mohamed El-Erian has written that investors may assume that while the World Central Bank's feature a systematic plan for a removal of stimulus while global economies reflate, the reality is much more complicated. The issue is to determine the impact on asset prices now the stimulation is being withdrawn – in a less harmonious world.

In the developing new world order, China and US are the two dominant countries and they have become uneasy bedfellows. They know one another well, there is no outright superior and each knows the other's strengths and weaknesses. They each recognize that if they cause pain to their partner, the partner is able to strike back. There are many chapters to come in this story.

A MORE ASSERTIVE US

For many years, the US has forced its own agenda onto other jurisdictions. The US reasoning that it is the 'guardian of the world' was reluctantly accepted by G10 allies and other nations. But alongside the demonization of the current president, a pushback of sorts is starting to emerge from many quarters. The most testing resistance to many of these US advances emanates from China. My view is that this power struggle between the US and China will play out for many years to come – trade, financial, militarily, scientific research, technology, space, etc. The Huawei headlines could be taken as the new normal!

This US/China dual is more complex than the cold war since Russia's main threat was their military. With the US and China, their symbiotic relationship really reveals a need to work with each other for their own economic prosperity – hence the reluctant bedfellows.

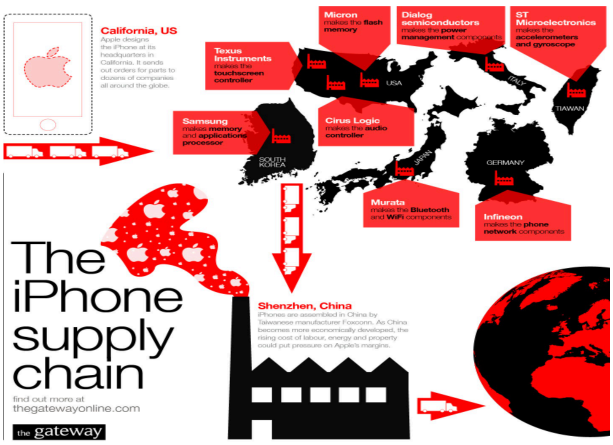
The US is fundamentally shifting its position toward China, from the 'constructive engagement' of previous administrations toward 'strategic containment'. SStreet

Corporate America is still expected to deliver strong profit growth at a healthy 10.7% for 2019. We are positioned for an extended late cycle and would not exclude the possibility of a mini rally. ESpring

The US expansion looks more durable than most commentators suggest. Schroders

A quote: The biggest expected change in 2019 will be the fading of US economic exceptionalism'. JPM

The US /China trade dispute will force a redesign of many global supply chains. Look at Apple



CHINA TAKES IT'S PLACE:

Many world issues cannot be addressed without considering China – equity indices, shipping in Asia, technology, global trade, AI, supply and demand in commodities, military build-ups, financing infrastructure, etc. China is taking its place on the world stage, ready or not, and this is changing the relatively stable world order of the last few decades.

In investment terms, we believe China equities have had a torrid time in 2018. The falls have been broad and there are certainly pockets of value to be found.

Current valuations in China's equity market are attractive and we see many opportunities in which to invest.
UBS

There are a few sectors where you can now buy 'growth at a reasonable price'….internet, healthcare and consumer.

We believe investors have devalued the region too harshly, and perhaps prematurely. Although China will likely slow in 2019, there are still potential opportunities especially among defensive sectors. MacQuarie

With reform and regulatory pressure on China banks, we do not own any China banks. We also avoid companies with USD debt ie. China property developers.

Some institutions see China in such a unique position that they suggest creating a distinct portfolio with exposer to China (rather than considering China an influential part of emerging markets)

Whether you have a negative or positive view, China is now so influential in the world, that a distinct approach to China is warranted.

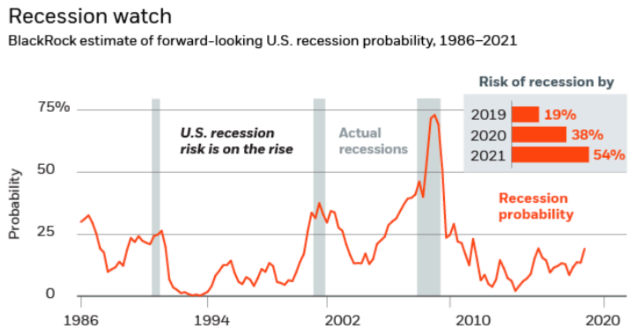
RISKS:

Many houses identify the two big major risks being the fallout from a US and China trade war, and secondly, the risks to European stability.

We do believe both China and the US will reach some form of agreement before March when additional tariffs kick-in.

In Europe, both Brexit and Italy have major differences with the ruling elite in Brussels. But the underlying views inherent in these two situations are not unique and are certainly reflected amongst many EU citizens. The more recent election swings make this something increasingly difficult for the EU to ignore (but they will probably try).

Most commentators have the view a recession is not far away (given we are near the end of one of the longest economic expansions) but only one see's a recession in 2019.



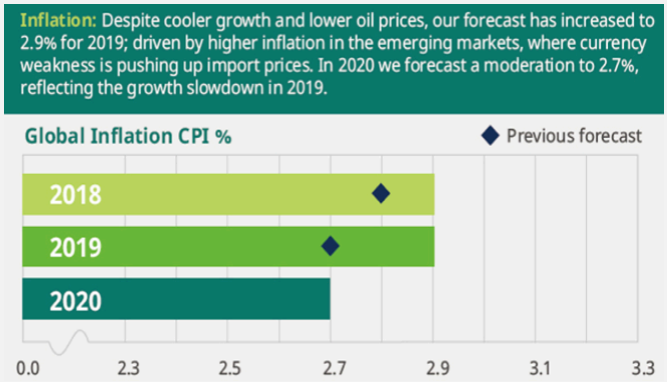
A few houses have identified a few other risks:
Shrinking liquidity is the biggest risk in 2019. A liquidity issue could arrive via two paths
a) Central Banks take a quantitative tightening misstep, or
b) repatriation of US dollars creates a global liquidity crunch
ESpring

The largest risk to markets would be the combination of more aggressive Fed policy coupled with widening credit spreads. Janus Henderson Funds

INFLATION:

The few areas of the world that have been affected by rising inflation can at least draw a breath for air at this point. Oil producers have great difficulty coordinating production cuts to bolster prices. Inflation forces are likely to remain subdued for the time being.

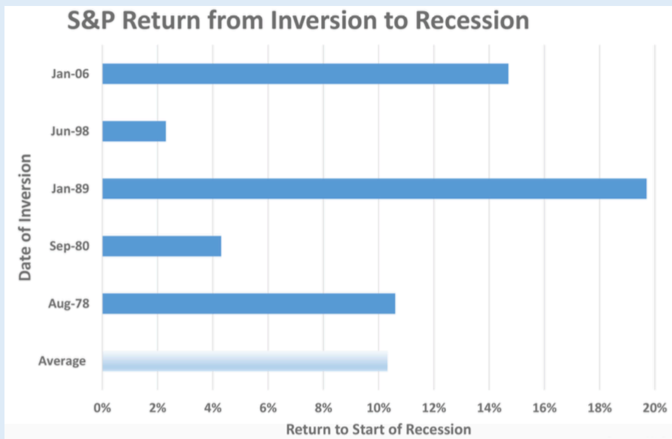
From Espring ….. while the inflation outlook appears subdued, many developments could change it.
No bond investor will want to get this one wrong!



Global inflation is creeping higher but remains contained. In 2019, we expect price pressures to build gradually in major economies: even 10yrs after the financial crisis, upside risks to inflation are still only really evident in the US. HSBC

RECESSION EFFECTS

From a US yield curve inversion, there is an average of 18m before recession hits. Equities generally do quite well in this period.



EQUITIES:

Consensus View -
The strong performance of US equity markets over the last 2yrs, up to December, has rewarded many investors for being in the US. However, softer earnings, price declines and a less benign outlook have given international investors a need to look elsewhere.

Our conviction is that diversification into non-US equities is a prudent response to the worlds uncertainties. MacQuarie

The chart, produced in mid-Dec, incorporates some of the fall in the US market in Dec. US equities were expensive at the beginning of the third quarter. They are now a lot more reasonably prices with S&P trading at 15 forward earning PE. (Below the high of 17x in Jan18 with the 10yr avg being 14x)

Five valuation Measures For Global Stock Markets
15-year average shown in brackets

	CAPE	Forward P/E	Trailing P/E	P/B	DY
UK	14 (13)	11 (13)	14 (14)	1.6 (1.9)	4.7 (3.7)
US	29 (25)	15 (15)	19 (18)	3.1 (2.8)	2.1 (2.0)
Europe ex UK	18 (16)	13 (13)	15 (16)	1.7 (1.8)	3.6 (3.2)
Japan	23 (25)	12 (14)	12 (17)	1.2 (1.4)	2.4 (1.8)
EM	12 (16)	10 (11)	12 (14)	1.5 (1.8)	2.9 (2.6)

Source: Schroders, Thomson Reuters Datastream, MSCI, Robert Shiller. Data is as at 14 December 2018.

Figures are rounded and are shaded dark red if they are >10% expensive compared with their 15yr average and dark green if >10% cheap, with paler shades for those in between.

The US market has enjoyed a decade of uninterrupted growth, with interest rates now rising and unemployment near all-time lows has driven international investors to look elsewhere……

Europe and Japan continue to benefit from ongoing stimulative monetary policy and low-capacity utilization. Corporate earnings are improving and valuations are not expensive. There are compelling investment opportunities.

EQUITIES (CONT.) :

Equities should continue to outperform on the back of robust earnings growth. CS

The ROE of Asia-Pacific ex Japan equities currently stands at 12.1% and the improvement has been broad-based.

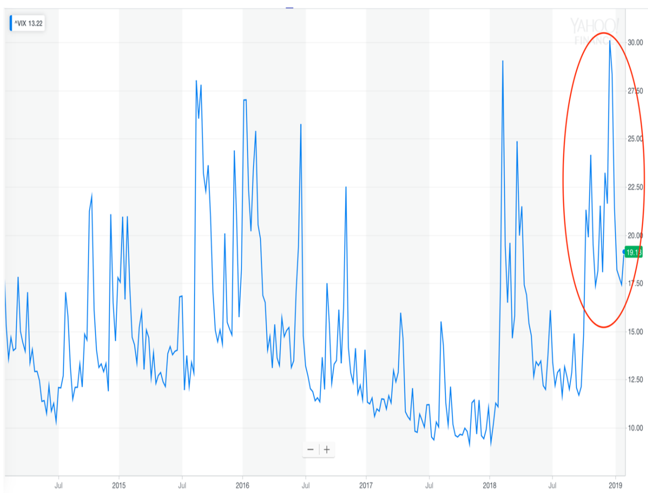
Asia-Pacific ex Japan equity market, as it continues to trade at a significant discount to other global markets. On price-to-book terms, the discount is 34% versus developed markets as of the end of October. HSBC

In the UK, equities remain a lose-lose proposition in 2019 as Brexit looms. JPMorgan

In the equity market, EM stocks are expected to deliver double-digit appreciation, with Brazil, Chile, Indonesia and Russia as top overweight picks. JPMorgan

Profit growth for 2018 is projected to be a hefty 24% for the US market, although this is partly down to the Trump administration's tax reductions. UK and emerging markets are also both forecast to deliver double-digit earnings growth. Schroders

Below is the VIX Index blow in 2018 relative to previous Years.



BONDS:

Consensus View -
Most analysts predict a modest increase in interest rates in all parts of the world except Japan. There will be no dramatic increases in developed countries.

If the dollar remains strong, emerging economies may have to respond by increasing rates to defend currencies and domestic issues.

JPM stands out for calling an inversion of the US yield curve in 2019…. And we know this is a very good indicator for a recession

The bond market has turned on a dime this last 2 months, the 10yr US Treasury was yielding 3.24% on 8th Nov and now around 2.75%. The turnaround has been quite breath taking. The predicted number of Fed rate increases in 19 is under scrutiny and credit spreads have started to widen.

In Europe, 2019 will be better than 2018, with German 10yr yields expected to hit 1.0%.

In 2018, we have seen a significant re-pricing of US fixed income assets. Our measure of the US 'bond risk premium' (the future reward for owning bonds over cash) has increased during the year and is now slightly positive, while we think short-duration US bonds now offer attractive risk-adjusted prospective returns.

Outside of the US, the risk premium on global government bonds remains very negative. HSBC

Mindful of credit risks, we intend to emphasize modest position sizes in issuers with steady free cash flow and a commitment to deleveraging, while avoiding companies issuing debt to create shareholder value. Janus

Asian high yield bonds are attractive and with higher coupons. Many bonds are now over-sold even though broad fundamentals (especially Chinese property) have not deteriorated. ESpring

Credit spreads are near tights, so we see very limited upside across interest rate assets, with emerging markets as the possible exception. MacQuarie

INVESTMENT THEMES:

Many houses do not give specific investment ideas, but chosen to advise on 'investment themes'…. Broad outlines of sectors or developing industries that appear interesting.

ESG has been often mentioned. But the righteousness of the theme is the subject of a few negative articles recently, referring to the sector as self-fulfilling with related indices attracting fees.

There are several good articles on super trends – akin to the rising middle classes in Asia. The trend is undisputed, how to make smart investment decisions in the theme is another matter.

We list some of the more interesting themes we have come across, many of these from CSuisse.

Population aging: Old age diseases, health & life insurance, senior lifestyle, senior housing and facilities

Millennial values: Sustainable business, clean energy, digital natives, fun health and leisure.

Emerging Asia: Vietnam, Bangladesh

Technology servicing humans: Digitalisation, AI, Healthtech, 5G,

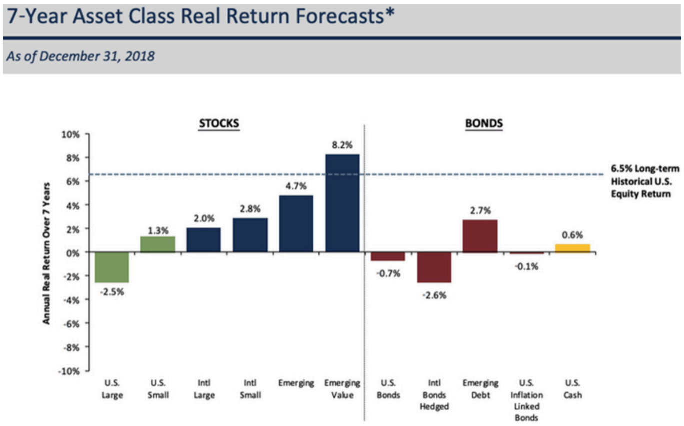
Infrastructure: Energy & water, affordable housing, telecoms infrastructure, transport

China A: With the market declines last year, particularly in dollars, there are most certainly pockets of value in China.

Angry Societies: Cybersecurity, security & defence, national brands.

INVESTMENT IDEAS:

To set expectations, I include a chart from Jeremy Grantham (GMO) on real returns.



The 7yr outlook for returns on US stocks is not bright. And in contrast, they see better opportunities in select emerging market bonds and equities.

We have seen institutional investment recommendations only cover high level views - suggesting a sector or class of securities. This is understandable since their research is for their clients (that are directly or indirectly paying for it). Throughout our Outlook, we have incorporated several such recommendations.

We are all aware the press sensationalises news – same with financial commentators – it sells stories. Here we include a few ideas where we suggest clients keep at a very safe distance …….

Recent headlines have glorified unicorns; start-ups that have attained incredible valuations. Some of these companies have investors that are clearly willing to accept growth as a metric for value! We believe this year will likely test the sustainability of their current funding model and also the financial reality they are living in. Not all unicorns are bad, but a few names that could face reality include Palantir, WeWork, Didi Chuxing, Netflix.

The Korean market has generally lost its edge, with shipbuilders and car makers losing market share. Unbelievably, a third of total corporate profits in Korea are derived from DRAM - not a comfortable place when China is looking to build a manufacturing base at home.

ICO's (Bitcoin, etc) …… WE SAY NO MORE!

CONCLUSION:

To conclude this outlook, we have listed several more specific investment ideas, a combination of our own efforts and from a few houses that went into detail….

ASIA EX-JAPAN EQUITIES:

Stocks in Asia ex-Japan have good ROE's over 12%, and a PB trading at a 34% discount to developed markets. We suggest a small portfolio overweight China and India and underweight Australia.

INDO BONDS:

Indonesian high yield bonds have suffered through reduced demand and offers good relative value with better clarity on the pending presidential elections in April - with Widodo currently looking quite hard to beat.

Asian high yield bonds are attractive and with higher coupons. Many bonds are now over-sold even though broad fundamentals (especially Chinese property) have not deteriorated. ESpring

COMMODITIES:

Scarcity of commodities is not a new theme. We do like Cobalt following a decline last year. But if you believe the demand for batteries will continue, China Moly is worth a longer term position.

COMMODITY PRODUCERS:

Positive on countries that export commodities. Russia has suffered (due to sanctions and lower commodity prices) and looks like an opportunity. Kazakhstan is in a similar position. Brazil and Mexico are now attractively values, also from an FX perspective.

MacQuarie

GOLD:

The curve will invert in 2019, the expansion will slow and expectations of Fed easing will build. At this juncture, expect real rates to move lower and gold's fortunes to reverse, as gold tends to benefit from consistent drop in real yields during the lead up to recessions and thereafter. JPM

A weaker dollar will also help the gold story.