

Rising above volatility

Investing in 2015 remains a challenging endeavour. Against this backdrop, our panellists give their take on profiting from the most promising themes for the year

Falling oil prices, muted economic growth, and a resurgent US... Investment is a challenging puzzle. But here we round up the investment experts to give you a sense of what they see as the most promising themes for 2015 and how you can profit from them.

Genevieve Cua: What themes do you expect to play out in 2015, and how should investors position themselves?

Lim Say Boon: The most important theme likely to shape financial and asset markets in 2015 is what we call “unfinished business”. That is, the unfinished business of battling the global tendency towards slow growth and deflation.

The global economy has recovered from the Great Recession of 2008-2009. But that recovery has been patchy and below historical averages. Indeed, the euro area had dipped back into recession once since then, and is still fighting against the threat of yet another recession and deflation. Similarly, Japan had also dipped back into recession and is still fighting a multi-decade battle against deflation. Even China – the so-called economic powerhouse of the world – is also fighting slowing growth and disinflation.

All this suggests policymakers around the world will likely continue to keep money cheap for longer. While the Federal Reserve could raise interest rates in 2015, the increases will likely be modest. Meanwhile, rates will likely come down further in other economies, including China and Australia.

Meanwhile, quantitative easing has rotated from the US to Japan. And it seems likely that it will also rotate to the euro area by middle of 2015.

As a consequence of cheap money and ample liquidity, stock prices are likely to push higher, albeit with wide regional variations. This is not “irrational exuberance”. There is nothing irrational, for example, about continuing to buy US equities, even at these heightened valuations, when dividend yield of around 2 per cent compares against the cash rate of not much above zero.

In a sense, asset price inflation is the flipside of consumer price deflation or at least disinflation. And monetary policy intervention – through declining or even zero interest rates and monetary expansion – is the link between the two.

Marie Owens Thomsen: We see a most unusual constellation take form in the world economy in 2015: that of a deflationary expansion. This event is so unusual that it does not even have a name of its own. We proceed to call it “transflation”, a term that describes the transformational events that allow falling inflation/prices and accelerating GDP (gross domestic product) growth to occur simultaneously.

The world has not seen any notable transflation since the 1800s when it was present over long periods. Today, what lies behind the transflation is not only the shale revolution, which sent energy prices falling even before the sharp drop in oil prices since November, but also the advent of the Internet with the ensuing rise in global competition, as well as productivity gains in agriculture that have caused food price deflation.

All of these structural forces will limit inflation and/or depress prices irrespective of any cyclical monetary policy. It is undeniably good news for the world economy, in particular for consumers and oil importers. We thus predict stronger growth, lower inflation, and still loose monetary policy in mature markets. This is a firmer underpinning for equity markets than anything we could imagine only a few weeks ago. It also allows for some residual value in bond markets, thanks to the drop in inflation, arguably until the Fed makes its first move.

It also means that pursuing an inflation target of 2 per cent is rather nonsensical. This target should be abandoned, or at least given a long holiday, in favour of a full-employment target (which the Fed has, but the European Central Bank or ECB does not have). The greatest threat to the major economies is clearly unemployment, not inflation, and official policy should reflect this in an explicit and unambiguous way. Such a policy strategy would allow disen-

chanted voters to regain some confidence in the political system.

Didier Duret: International diversification is the key phrase for 2015, as opportunities in bonds are limited due to the low yields offered. Equities are the main engine for portfolio returns, but investing in the national champions of an investor’s home

country exposes him to risks relating to the home country, such as political and even geopolitical risk.

Therefore investors should look towards having a broad-based equity exposure in companies with solid earnings momentum in sectors such as IT in the US, global healthcare, as well as European world leaders in consumer staples that would benefit from the undervaluation of Euro-

pean stocks. Finally, don’t forget a decent exposure in emerging Asia with a preference for China as well in the portfolio.

Matthew Colebrook: In 2015, heightened volatility is expected. We expect a divergence in growth expectations for different economies and also in monetary policy globally. The tightening of US monetary policy, which could lead to the first interest rate hike since the global financial crisis, is a major macro event going forward especially for emerging markets. For investors, a well-diversified portfolio is essential to capture opportunities across asset classes.

Genevieve Cua: What are your most important asset allocation (strategic and tactical) calls for 2015?

Say Boon: We remain overweight equities. Global equities should continue their uptrend although there will be wide regional differences. Within equities, we favour developed market equities – particularly US and Japanese stocks, the latter with a short yen hedge.

US equities will enjoy resilient profit margins. Meanwhile, the uptrend in the US purchasing managers’ indices suggests that revenue growth will strengthen, supporting earnings growth in 2015. In Japan, USD/JPY correlation with the Nikkei will continue to

be the dominant theme. We see a much weaker yen in 2015 – hence a stronger Nikkei, boosted by companies’ foreign earnings currency translation gains.

Emerging market equities will struggle under the weight of a stronger dollar, weaker commodity prices and the constant threat of contagion from a financial crisis in Russia. So for emerging markets, we favour those markets whose home economies enjoy current account surpluses; which are net commodity importers rather than exporters; and those with strong buffers against uncertainties through deep value. China stands out in this regard.

We remain underweight bonds, with a repeat of our warning from September 2014 to lighten up on Asian high yielders. Such is the nature of double tops and double bottoms in markets that metaphorically, the postman always rings twice. I believe we have seen the bottom in Asian high yield credit spreads for this cycle. The market got a little fright late in 2014 when liquidity dried up. Conditions have eased somewhat since then. But I believe we have heard the postman ring once.

Finally, the US dollar should continue its ascent against most currencies. The US economy is the strongest of the developed market economies. It is past the most accommodative stage of its monetary cycle.

Japan is in the midst of furious monetary expansion. The European Central Bank will also likely undertake quantitative easing this year. The Reserve Bank of Australia will likely cut rates further this year. China will likely also try to stimulate its economy through monetary measures. Elsewhere in the emerging markets, slowing growth calls for weaker, rather than stronger, currencies.

Marie: As regards geographic asset allocation we have long favoured the champions of structural reform. In a world where monetary policy no longer can deliver much impetus and fiscal policy has been largely exhausted, structural reform was the only avenue left to boost growth in output, jobs and incomes. The drop in the oil price now makes such reforms less urgent (which is both a boon and a bane). Nevertheless, we continue to favour the reformers, minus the oil-exporting reformers. This downgrades Mexico and the Middle East in our recommendations while leaving our positive calls regarding China, the eurozone and Japan intact.

India and Indonesia are also potentially significant reformers. The US also benefits

THE BUSINESS TIMES' WEALTH ROUNDTABLE

Genevieve Cua, BT Wealth Editor poses questions to four wealth experts for their views on the outlook for 2015.



Lim Say Boon is Chief Investment Officer at DBS Group Wealth Management & Private Banking. He has held senior positions in banking

and finance and the financial media. He has a lifelong training in martial arts and has been training since 15 in various forms including Wing Chun, taekwondo and the Filipino weapons art of Arnis.



Marie Owens Thomsen is Chief Economist at Credit Agricole Private Banking. She has worked for over 15 years as chief strategist and

economist for major international banks such as HSBC and Merrill Lynch. For about 10 years, she ran her own company selling made-to-order manufactured goods. Outside of economics, her number one interest is horses. She enjoys skiing, running, reading literature, and mentoring young people.



Didier Duret is Chief Investment Officer, ABN Amro Private Banking. He manages a team of 44 analysts worldwide and has more than 20 years’

experience in finance. His favourite pastime is trekking in Switzerland with his family. As an active member of the Chopin Foundation, he helps to organise concerts and master classes for young talented musicians.



Matthew Colebrook is Head of Retail Banking and Wealth Management at HSBC Singapore. He has over 28 years of experience

in financial services industry and has held senior executive roles in the UK and the US within HSBC Group, including UK Head of Direct Banking, prior to leading the business in Singapore. He is an active and accomplished pilot holding UK, European and US pilot licences.



‘A “too low” oil price adds to the picture of rising global instability... Political dysfunction and weak legislative capacity will weigh on the world’s most peaceful regions.’

**Marie Owens Thomsen,
Chief Economist,
Credit Agricole Private Banking**

from our buy recommendation because we expect the economy to accelerate by one percentage point in 2015. We also recommend core holdings of quality economies in order to mitigate the risks elsewhere in the world. These include Switzerland, Germany, Scandinavia (except for Norway), Hong Kong, Singapore and New Zealand.

In terms of currencies, we are bullish structurally speaking, on currencies of countries that run current account surpluses. These are the euro, the Swiss franc and the Singapore dollar. The US is running a current account deficit, which makes us less bullish on the US dollar than the perceived consensus. Any exposure to the Japanese market should be hedged.

Didier: After several disappointing years, we expect the earnings of European stocks to relink to the pace of those in the US. Hence, we are overweight European stocks, which is supported by the renewed momentum in world trade. Recovery is already visible in peripheral countries. Although we are underweight bonds, bonds can still be used as a diversification instrument during periods of equity market corrections. We favour peripheral European bonds – high yields that have a good chance to achieve positive real returns and Asian corporate bonds.

Matthew: Corporate assets – equities and corporate bonds, particularly in Asia – remain attractive in 2015 as corporates in the region continue to record strong profitability and offer good valuations. We expect the market environment to remain broadly positive for risk assets and investors are likely to be rewarded by being overweight equities over bonds and cash in a diversified portfolio.

While volatility is likely to increase in 2015, there are still attractive long-term opportunities in the equity market. Stock selection based on corporate profitability and valuation remains the key to outperformance in this environment.

Within Asia, HSBC favours equities in North Asia including China, the cheapest market in the region and also one of the cheapest in the world on a valuation basis. Reform implantation in China remains one of the most important drivers for Chinese equities. The Chinese government is expected to continue using targeted policy measures to push forward the reform agenda to ensure growth remains within a reasonable range.

We also prefer Korean and Taiwanese equities as they are still at low valuations.

From a sectoral perspective, cyclical stocks such as energy and financials continue to look cheap compared to defensive stocks such as consumer staples and healthcare, as these corporates record stronger profitability while still trading at low valuations.

For bonds, we expect corporate bonds in Asian emerging markets to provide higher risk-adjusted returns than “safe-haven” developed market government bonds over the long term. Despite investors’ concerns over the

US interest rates hikes, the Asian bond market still presents selective opportunities to investors who are searching for yield in the current low interest rates environment. Credit selection for attractive yield carry will be the investment focus going into 2015.

Renminbi bonds are of growing significance on a global scale. With the opening up of China’s capital markets, the Chinese bond market will become too big to ignore.

Genevieve: What major risk could upend your base investment case for 2015, and should investors hedge themselves against this?

Say Boon: The outbreak of an uncontrolled currency war could throw all asset classes and currencies into confusion. Up until now, the logic of relative economic strength and monetary policy cycles has dictated relative currency strength and weakness. And that is as it should be.

The tail risk is that the aggressiveness of yen depreciation – which hitherto appears well tolerated by the US – spills over into more rapid depreciation of other Asian currencies via the Korean won. If that occurs, US market tolerance for a strong dollar might be stretched to its limit. That could have ramifications beyond the currency market.

Gold and other commodities could get a respite. But equities could be destabilised by the uncertainties thrown up. The yen could then appreciate – as it does during times of volatility – taking the Nikkei down.

Another risk is contagion from the financial crisis in Russia spreading to other emerging markets. This would likely hurt emerging markets with current account deficits, which depend on external dollar funding for their economic growth.

These are not dangers clear and present. They are tail risks. And the problem of hedging for tail risks is the cost. A perpetual hedge through the course of the year for these two events would not only be costly but contradictory. You might want to hedge for potential emerging market volatility through a more aggressive long dollar position. That’s not what you would necessarily want in a currency war scenario.

The only realistic answer is to be alert. Watch the volatility indices. When they start attempting to break out of ranges, be nimble and quick: Go long volatility and buy put options. But there are costs. Be prepared to pay the premiums for the portfolio insurance and close the positions out when the storms subside.

Marie: The major risk is the deteriorating political environment. Whatever one might think of the US, it is easier to run the world with one largely undisputed leader than it is to understand the shifting allegiances among three potential contenders for the world’s top dog position.

What we have to look forward to over the next few years is in all probability a more complex and dangerous world political context in which the countries with effective governments and legislative capacity to conduct structural

forms will emerge as the “winners”. Those without these attributes will be vulnerable to social unrest and deteriorating political and economic conditions.

A “too low” oil price adds to the picture of rising global instability. It could starve some extremist groups of funds and as such be very positive, but it could also provoke desperate actions in some quarters. It is nigh impossible to predict the next crisis, but we can already identify the high-risk zones: North Korea, Russia, Ukraine and the Baltics, Israel and Palestine, Iran, Venezuela, Nigeria, Libya, Syria, Sudan and South Sudan, and China’s maritime claims are the world’s most obvious hot spots.

In addition, political dysfunction and weak legislative capacity will weigh on the world’s most peaceful regions. The US will have a completely divided government starting January 2015; Sweden failed to produce a stable government – the first such mishap since 1958 – and will go to the urns again in 2015; Greece’s political outlook is uncertain; and the UK holds elections in May 2015 as will Poland, Mexico, Argentina and Spain.

The gap between the “haves” and the “have-nots” is likely to widen, and that will increase discontent around the globe. The way to protect investment portfolios against such risks is to concentrate holdings on quality countries.

Didier: No major risk is perceived, but rather, a variety of risks that can create short-term nervousness and price corrections that will open the gate for entry points. Geopolitical factors as well as disappointing growth in the eurozone remain possible risks. The former is a very low risk with high consequences, while the latter has low risk and moderate consequences, mitigated by the effect of a strong US dollar and low oil prices.

We do not tag low oil price as a deflationary risk, as consumers and goods producers alike will benefit from a higher purchasing power and low input price. The risk of slower growth in China is moderate as a pace of around 7 per cent will clearly place China in the world growth league, and also bearing in mind that Chinese firms are climbing the value chain.

Matthew: We see a few key risks that investors should be aware of in 2015.

US monetary policy risk and foreign exchange (FX) volatility: There is uncertainty over both the pace and scale of US monetary policy tightening that will take place in 2015 and its impact on asset prices. The process of asset prices adjusting to tighter policy after six years of near zero interest rates is likely to result in market volatility and concerns over whether the economy can sustain higher interest rates. It could also result in volatility in FX markets in particular, leading to a process of competitive depreciations by exporter economies and eventually de-stabilising financial markets.

Eurozone deflation risk: With headline inflation in the eurozone just above zero, there is a risk that the region could slip into deflationary territory should the ECB not act aggressively enough.

China “hard landing” risk: The current policy-engineered slowdown in the Chinese housing market becomes much worse and negatively impacts the banking system.

Genevieve: How are you guiding investors’ expectations of investment returns for 2015?

Say Boon: In a word, moderate. Returns will be much more modest than in past years. And investors have to be moderate in their expectations.

In equities, seek a combination of value and income. That is, go for stocks which have yet to hit valuation peaks and which generate cash and pay decent dividends. In equities, spreads are wafer thin for corporate credits. Don’t expect further spread tightening.

Not exciting. But still better than near zero returns from cash.

Marie: 2015 will see a new and rare context in the world economy; transflation, that is, a deflationary expansion. This will entail higher GDP growth and lower inflation/prices in oil-importing countries and pose severe challenges to oil-exporting regions. Monetary policy will remain loose, but possibly not as loose as many market participants are currently hoping for.

Volatility is likely to be greater in 2015 as markets struggle to come to terms with this new environment. Investors who dislike marked-to-market fluctuations would need to adjust their allocations to the new environment.

Globally speaking, we expect investment returns in the high single digits and in line with corporate earnings. These could surprise on the upside if we have underestimated the growth impact of the lower oil prices. They could also surprise on the downside if one of the crisis-prone areas in the world turns into something more sinister.

Didier: For global equities and bonds offering positive real yields, we expect a low single digit return for 2015. The risk of being wrong on the economic scenario is mitigated by being aware of the alternative scenarios, and portfolio risk is identified and assessed through a sensitivity analysis. As the bull market is rather mature, a larger choice needs to be presented to our clients to ensure effective diversification. 2015 calls more for a diversified exposure rather than concentrated bets.

Matthew: We believe that in 2015 investors may feel less secure than in the past few years because the cycle is maturing in the US and therefore, monetary policy will be less supportive.

Markets will also be confronted with more risk coming from contradictory forces: economic expansion on one side and tighter monetary conditions on the other. The net effect, however, should remain positive. ☐

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