

Against the odds

Investors are finding the search for yield a challenge in a 'lowflation' environment. Against this backdrop, our panellists share their insights on the asset classes most likely to do well

Investing in a "lowflation" backdrop poses some challenges particularly if interest rates creep up amid slower economic growth. We ask experts their view on the asset classes most likely to fare well in this environment, and the challenges in obtaining income.

Genevieve Cua: Inflation has been on a downtrend and there are concerns today about deflation, particularly in China and the eurozone. What is your outlook in terms of growth and inflation/deflation for Asia over the next 12 to 24 months?

Marie Owens Thomsen: There are important structural causes for the lower price increases (that is, lower inflation also called disinflation) and outright price drops (deflation) that we see around the globe today. These are:

- The Internet which increases global competition and puts downward pressure on goods prices.
- Productivity gains and innovation in agriculture which help lower food-price inflation.
- The shale revolution which is disrupting the world's energy sector and has contributed to the drop in the oil price.

If countries were to liberalise their service sectors and trade in services, there would be disinflation/deflation also in this sector. All of this is very positive for consumers everywhere, and very supportive of output growth. This is why we prefer talking about "transflation", a term that we use to describe the simultaneous occurrence of low inflation/falling prices and accelerating output growth. We believe that we are in this kind of context today, and we do not subscribe to the "deflation = depression" interpretation of current events.

Globally, we expect oil importers to grow by 0.5 to one percentage point more this year than if oil prices had remained above US\$80 per barrel. Oil exporters, on the other hand, will suffer a hit to their GDP (Gross Domestic Product) growth rates of similar magnitudes. Headline inflation rates are likely to continue to fall almost everywhere in the first half of this year. Inflation looks set to pick up towards the end of the year because of the base effect and the anticipated stabilisation in oil prices.

In 2016, we cannot expect the same boost to GDP or drop in inflation unless a new

disruptive force comes into play. The Trans-Pacific Partnership (TPP) could be such a force. It is a proposed regional free trade agreement being negotiated between the US, Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam. China shines with its absence.

We have only to look at the transformation of China's economy that followed the country's accession to the World Trade Organization in 2001 to know the power that freer trade has to lower global prices and increase growth in output. Hence, the current "transflation" could be a transitory phenomenon set to abate in 2016, or a more durable one if countries embrace change and reform.

Steve Brice: We are not excessively worried about the inflation outlook. While deflation fears have been increasing – technically both Europe and the US are in deflation at the moment – we see this as a transitory phenomenon caused, to some extent, by the sharp fall in oil prices. The world economy is likely to continue recovering in 2015-6 with lower oil prices supporting this recovery.

The US economy is, at last, achieving very healthy growth rates. In recent times, we have seen data disappoint slightly, but growth of around 3 per cent still looks achievable this year, which would be the strongest pace since 2005.

Europe contributed more to the acceleration in global growth last year than any other region as the economy went from a full-year recession in 2013 to modest growth in 2014. The

key question is whether Europe can build on this performance in 2015. We believe it can, although the acceleration bolstered by easing credit conditions and monetary stimulus may take some time to come through. Over time, this should ease deflationary pressures. However, weak oil prices will make a quick rebound difficult to achieve.

Finally, we see China's policy easing as much targeted at helping to manage the default risks associated with the huge rise in debt levels as it is aimed at supporting growth. Therefore, a further modest deceleration in Chinese growth is likely in 2015 with inflation remaining very benign.

This paints a mixed picture for Asia. The expected acceleration in US/Europe growth is supportive, while China continues to be a headwind. The good news is inflation pressures in the region are muted and this allows the authorities to maintain loose monetary policies intended to stimulate domestic demand. Given excess capacity in the global economy and weak commodity prices, there appears to be little to suggest the trend for loose(r) monetary and fiscal policy settings will reverse any time soon. This should allow for a modest acceleration in economic activity in Asia ex-Japan/China in 2015.

We expect Thailand to lead the way with pent-up investment demand expected to lead to a sharp acceleration in economic growth. At the other end of the spectrum is Malaysia, where lower oil prices are likely to result in a slight deceleration. Developments in India will be closely watched, but we expect reforms to gather pace and lead to a more favourable economic climate over the coming 12 to 18 months.

Sean Taylor: Disinflation pressures have been persistent and widespread, led by China – a number of Asian economies are currently facing PPI (Producer Price Index) deflation and have been for the last two, some three years.

Downward commodity price pressures and loss of corporate pricing power mean that a large portion of the PPI basket is in deflation suggesting widespread overcapacity pressures, particularly in China.

Those most impacted have been South Korea, Singapore and Taiwan which have a significant portion of their trade with China. China's growth slowdown is exacerbating the entrenchment of PPI deflation while this has further weighed on the consumer through Asia's CPI (Consumer Price Index) inflation and is also transmitting into weaker GDP deflator growth for the region. For China, we expect 2 per cent CPI for 2015, one per cent in Japan with growth rates of 6.8 and 1.2 per cent respectively.

Eurozone year-on-year inflation rate has been in negative territory for three months since December 2014. These moves are mainly due to the strong decrease in energy prices. Looking at recent movement in the oil price and our overall assessment of eurozone growth – 1.3 per cent for 2015 and 1.6 per cent for 2016, we expect inflation to move back into positive territory in 2015, reaching above 0.5 per cent level at the end of the year. 2016 inflation is expected to move above one per cent.

Genevieve: What do you see as the biggest investment challenges in this environment? What asset classes and themes are most likely to do well in the backdrop that you expect?

Marie: Lower inflation will allow nominal interest rates to continue to fall

(although not necessarily real interest rates which have risen in the US for example). This means that there is still value in some bonds, at least until we get closer to the date at which the Fed is likely to raise the Federal Funds rate (possibly end-2015). Quantitative easing (QE) by the ECB (European Central Bank) and negative policy rates in some European countries (Switzerland, Denmark and Sweden) will continue to push investors to search for yields elsewhere.

We are particularly optimistic on Chinese bonds in this context and expect the dim sum market to continue to expand. However, there is a risk of a reversal of capital flows when a tighter Fed policy materialises. This, in turn, favours safe haven markets and the US dollar in particular. Low inflation and low interest rates provide a positive backdrop for equity markets. These are likely to outperform bond markets and we are looking for high single-digit returns as a world average for stock markets this year.

Within stock markets, we favour the countries that embrace change and implement structural reform – that is China, Japan, Europe, and also arguably Indonesia and India (although the latter's reforms have been slow to come). The US is a core market in spite of the country's political impotence, and there we like the Nasdaq in particular.

Steve: From an investment perspective, we continue to prefer equities, particularly in developed markets. However, we expect volatility to increase as we head towards the first US interest rate hike since 2006. Volatility has generally been relatively benign in 2012-2014 and we expect that to change in 2015. The key challenge here relates to portfolio construction.

Normally, investment-grade bonds would be used to provide a "hedge" within portfolios and reduce volatility. However, low yields mean this can be viewed as an expensive and risky hedge. Meanwhile, as we saw from the taper tantrum in 2013, an environment where monetary policy is being tightened can push the correlation between equities and investment-grade bonds higher, reducing the effectiveness of the hedge.

Of course, we should not forget that higher volatility can create significant opportunities that either allow investors to buy assets cheaper than they have been for some time, or seize on relative value opportunities that often occur during such periods of dislocation. Therefore, we would recommend investors ensure their exposure to equities is not excessive to their risk tolerance and use leverage judiciously.

Sean: 2015 could turn out to be one of the lowest inflation years for Asia in history. The development of most concern within a backdrop of lowflation is that the figures reflect more than energy-related supply side developments. There are concerns that the lack of upward inflation pressure also reflects demand deficiency worldwide, which is a key risk to Asia and global growth forecasts.

Furthermore, PPI deflation transmitting into weaker CPI inflation and GDP deflator growth, as well as slower nominal GDP growth, are pushing real rates higher. In this environment, along with an increase in leverage in terms of debt to GDP seen over the last six years, further challenges are added to the management of the region's debt profile.

We have a preference for equities over bonds given globally low bond yields encouraging a shift towards higher-return assets, as well as an abundant, central bank driven liquidity environment which nurtures a positive environment for equities. Within Asia, we have a preference for China, India and Philippine equities.

European equities may present some interesting opportunities in the coming months, as we are getting more evidence that earnings are starting to turn around and valuations look attractive. European economic data is also starting to improve. US equities are more expensive and much will depend on continued US corporate earnings growth, which could face a headwind from US dollar strength.

Genevieve: There is still a strong demand for income. What investments do you recommend for investors who want an ideal combination of a stable and high income?

THE BUSINESS TIMES' WEALTH ROUNDTABLE

Genevieve Cua, BT Wealth Editor poses questions to three wealth experts for their views on investing in a "lowflation" environment.



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.



Steve Brice is Chief Investment Strategist, Group Wealth Management at Standard Chartered Bank.

Mr Brice is an expert on the world economy and global markets, and has had more than 15 years financial markets experience in senior positions. He is an ardent sports fan focusing on cricket, rugby and Liverpool FC.



Sean Taylor is Regional Investment Head APAC and Head of Emerging Markets, Deutsche Asset & Wealth Management.

He joined the firm in 2013 and has more than 20 years of industry experience. He has a strong track record of consistently good performance and of creating cutting-edge emerging markets investment products. He is very keen on sailing.



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Marie Owens Thomsen, Chief Economist, Credit Agricole Private Banking

PHOTO: ISTOCK

Marie: We talk a lot about Sharpe ratios, that is the volatility adjusted return (return divided by volatility). We think that today's environment is one in which investors should seek to maximise Sharpe ratios rather than maximising returns. This is because we expect volatility to rise on the back of high geopolitical risk and the likely shock to markets of a US policy rate hike. Protecting investment portfolios becomes crucial in this context and this is best done by keeping a close look at Sharpe ratios.

Markets with regular returns and relatively low volatility are for instance the Swiss market, which was a clear buy a few weeks ago, but remains a buy even at these levels. Basically, quality assets are likely to have higher Sharpe ratios, and also a higher price tag, naturally. It makes sense to increase the portfolio allocation to such assets in today's markets, while adding calculated exposure to higher-volatility options in the appropriate size in order to try to boost overall returns.

China remains a key call of ours for such purposes, preferably via H-shares for international investors. What we are describing here is a strategy that arguably will mean that the investor has to accept a lower overall return. For a given return objective, investors will have to tolerate more risk and volatility today. If that is not an option, the return target has to be revised down – there is simply no other way.

Steve: Diversified income has made it onto our shortlist of key investment themes for the fourth consecutive year in 2015. The challenge for investors is that traditional sources of income, namely bonds, are offering very low yields. This not only reduces the income generated, but also increases the risk profile of such assets. Therefore, we continue to recommend a more diversified approach to income investing. Naturally, this includes high-dividend equities, particularly in Europe where yields and expected returns are higher.

We have also added two key themes in 2015. First, covered calls (the simultaneous purchase of stocks and the sale of a call option on the same stock). This strategy generally performs better than a pure equity investment when stock market returns are more muted and volatility rises – exactly the scenario we expect to develop in 2015. Second, Indian rupee and Chinese yuan bonds, where we see the yield on offer attractive relative to the currency risks involved with local currency exposure.

Sean: For those seeking high income we prefer to take a more conservative approach through emerging market (EM) hard currency over local currency debt given EM currency headwinds. The demand for relatively safer yield following eurozone/Japan QE should extend to EM hard currency debt with strong credit quality. We have seen spreads rise in recent months, pricing in oil-price downgrades, political noise and potential default risk in Argentina/Venezuela. Furthermore as oil prices stabilise and rise into the year end (our forecast is US\$68 by FY15) then we expect spreads to narrow.

Developed markets high-yield debt may also appeal in this context. Lower oil prices have hurt US oil high-yield issuers, but demand for US high yield overall remains decent and default rates are expected to remain low. We are also positive on European high yield, which has also been experiencing strong fund inflows recently.

Genevieve: In today's environment where countries such as Japan, Europe and even Singapore favour a slide in their currencies, investors' portfolios with global

exposures are impacted. How necessary is it to hedge currency exposures of global portfolios?

Marie: Firstly, we would like to stress that no true competitiveness is ever built on a weak-currency policy. Weak currency = weak economy – that general rule still holds. Only the US can live with a trend-depreciating US dollar and still attract investors because of its status as the issuer of the world's reserve currency. The effect of the exchange rate on the real economy is greatly exaggerated in most market participants' minds.

We also guard against over-reacting to bilateral exchange rates when it is global trade-weighted exchange rates that matter for a country's overall competitiveness. Moreover, there are always both winners and losers in the wake of any exchange rate move. Which will dominate depends on the relative import and export intensities of the economy and the firms within it.

Countries with high import shares gain if their currencies appreciate. Countries with high exports in the production of which not many imports are used are the ones that would benefit from a weaker currency – that is essentially commodity exporters, although such countries often import a lot of basic products. A weak-currency strategy only makes sense if it is to create a window of opportunity during which to implement structural reform. This is arguably the case in Japan.

In any case, in terms of investment strategy, we favour strong and appreciating currencies, and cite the Chinese yuan as a case in point. Countries with weak-currency strategies should perhaps not be included at all in investors' portfolios. Where they are, because we still believe in the country's economic policies in spite of the depreciating currency, they would need to be hedged. Which ones they are depends on the base currency.

A simple guide to strong-currency countries is to look at the current account. Countries with large current account surpluses should hedge their exposure to countries with large current account deficits. We also highlight that the eurozone is running a current account surplus while the US is running a current account deficit.

Steve: We believe monetary policy divergence – whereby the US Federal Reserve starts to hike interest rates while the majority of the world remains in easing mode – will continue to push the US dollar (USD) higher in the coming months. Against this backdrop, we are recommending investors be very selective in terms of their non-USD bond allocations and also hedge the currency exposure implied by investments into our two preferred equity regions – namely Europe and Japan.

In Asia, currency weakness is expected to be more muted, although depending on the hedging costs involved, it may be pertinent to hedge the currency exposure in Singapore, South Korea, Malaysia and Taiwan.

Sean: For USD denominated investors invested in Europe and Japan, and for those who are able to hedge out the depreciation in EUR vs USD and the yen vs USD we would recommend doing so. We expect 1.05 EUR/USD and 125 yen/USD by 2015E which will offset positive USD equity returns unless investors have currency overlays embedded into their portfolios. ▣

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