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# In sync with market trends

Our panellists share insights on understanding key trends and tuning out market noise in a volatile environment

**UNCERTAINTY abounds this year as global growth slows and markets remain volatile. We ask our panellists how they help investors discern between investment trends and noise.**

**Genevieve Cua: What are the major trends that you see over the next six to 12 months that will drive investment decisions and asset allocation shifts, as opposed to market "noise"? How are you implementing these in client portfolios?**

**Marc Van de Walle:** The first two months of 2016 were perplexing for investors as they tried to decipher how much of the market gyration was a signal of underlying problems and how much was just noise that would fade.

At that time, we assessed that the global economy was not as bad as markets perceived it to be, and recession fears would eventually recede.

In February, we were convinced that the discrepancy between an economically solid world and an overly bearish market presented a lucrative investment opportunity. We encouraged our clients to tactically raise their equity allocation to "overweight". Since then, equity markets have rallied significantly as the global recession scare proved to be a false alarm.

As calm returned in March, we saw a shift in market tides as the US Federal Reserve delayed its hiking cycle, creating a pause in the dollar rally and a renewed interest in emerging market (EM) assets. Against such a backdrop, we upgraded Asian equities to "overweight" as we assessed Asian corporate earnings growth to have bottomed and valuations remain at attractive levels.

Now that financial conditions are back to where they were before the Fed first hiked rates in December 2015, we expect growth to pick up in the coming months. There are a few trends that will have ramifications for investment portfolios over the next six to 12 months:

i) China's cyclical rebound: China's recent policy measures to stimulate growth appear to be bearing fruit, allaying fears of an economic hard landing. Rising house prices have sparked new activities, pushing up construction and demand for raw materials. A somewhat stronger Chinese economy should also take the pressure off the authorities to significantly depreciate the renminbi, giving some support to global risk assets.

ii) Stabilisation in oil market: US crude oil production has recently been declining. Lower oil output increases the odds that the inventory overhang will diminish. Encouragingly, oil market sentiment shrugged off Opec's (Organization of the Petroleum Exporting Countries) failure at their recent Doha meeting to agree on a production freeze. Going forward, we expect the tight relationship between oil and risk asset prices to fade as global trade picks up, with oil prices settling into a trading range.

iii) Recession fears diminish with resilient corporate earnings: The recession scare in early 2016 has proven to be a false alarm. The rebound in US and Chinese manufacturing surveys confirmed that underlying economic conditions are resilient, which will support global corporate earnings. In particular, US earning upgrades are looking more plausible in the coming months as the drag from energy and the prior strong dollar wane.

**Ken Peng:** After intense market distress at the beginning of the year, major global central banks appear to have agreed to shift policy easing towards internal credit creation and minimise exchange rate impact. For

## THE BUSINESS TIMES' WEALTH ROUNDTABLE

**Genevieve Cua**, BT Wealth Editor poses questions to wealth experts for investment ideas that have worked well for portfolios so far in 2016.

**Marc Van de Walle** *is Bank of Singapore Global Head of Products.* Marc has responsibility for the product platform on which all wealth management solutions are built. He also has responsibility over the bank's investment strategy, research, discretionary portfolio management, trading advisory, wealth planning and trust services. Marc is an avid golfer and skier. He also has a keen interest in wine.

**Ken Peng** *is Citi Private Bank Investment Strategist for Asia Pacific.* Ken is responsible for formulating investment views and strategies for Asian markets across asset classes. He is also a member of the bank's global investment committee. He enjoys reading, skiing, wine and whiskey, and is a *Game of Thrones* fan.

**Norman Villamin** *is Union Bancaire Privee (UBP) Head of Investment Services.* Norman has over 20 years of experience managing wealth both on an advisory and discretionary basis. Since relocating to Switzerland, he enjoys travelling in Europe with his wife and four children.

**David Pinkerton** *is Falcon Private Bank Chief Investment Officer.* David has over 30 years of experience in private equity and hedge funds. He was previously a managing director in the alternative investments group at AIG Investments in New York. He is passionate about photography, culture and history and also enjoys the outdoors and nature.

the Fed, that meant scaling back tightening and thus weakening the US dollar (USD). This has helped asset prices in the US, emerging markets and commodities, while reversing much of the stimulus effects of European and Japanese monetary easing.

However, this has not resolved the problem of weak growth. Inflation and interest rate expectations remain very low as a result. The growth improvements seen in emerging markets are likely to be temporary. Japan faces significant downside economic risks from the stronger yen. Yet, aside from the seasonal weakness in Q1, the US economy remains on more solid footing than most of its trading partners.

As a result, many economies outside of the US are likely to see additional easing. For the US, even though there is no rush, we believe that the Fed is still on track to gradually normalise monetary policy. This is likely to become more apparent in the summer and into the second half 2016, when we expect the USD to re-assert its strength. That said, we believe that the trend of USD strength is in its eighth inning, because the US business cycle is also at a late stage.

In equities, this is likely to encourage rotation into more yield generating sectors such as utilities, or into those with sustainable growth prospects such as IT, consumer and healthcare, particularly those that have lagged the market. The energy sector is likely to benefit from improved supply-demand dynamics. On the other hand, the materials sector still faces headwinds from overcapacity, partly because China stimulus has restored local supply. Banks also continue to be weighed down by the leverage problem.

In fixed income, we expect the low rate environment to largely remain in place. Investors should hold a well-diversified bond portfolio to limit exposure to credit event risk.

**Norman Villamin:** Though the policy transition from quantitative easing (QE) to rate hikes in the US has been in the spotlight, more broadly, it is increasingly clear that European, Japanese and to a certain extent, Chinese policymakers are likewise in the midst of policy regime transitions. These transitions have introduced renewed volatility into asset markets which investors will need to navigate in the year ahead.

As policy shifts from quantitative easing to credit easing in Europe, we expect carry strategies to continue to be well bid as spreads, though having narrowed from the wide levels of Q1, compensate investors well in a period of increased volatility. Investment-grade credit, both developed and emerging market look particularly attractive on a risk-adjusted basis. Spreads in US high yield remain fair given the outlook for defaults. However, the relative illiquidity of the sector mitigates the benefits of the relatively wide spreads in the sector.

With earnings growth remaining challenging across many geographies, we prefer a value-oriented approach to stock selection in the US and Europe in particular. As the outperformance of growth stocks relative to value stocks approaches the extremes seen in 1999-2000, we expect value stocks' underperformance to end in the months ahead.

As seen in the first half, the transition in global policy regimes should likewise mean that alternative strategies including minimum-variance, hedge funds and volatility carry strategies should be helpful in enhancing what we expect to be modest total returns looking ahead.

**David Pinkerton:** We are much more tactical in our asset allocation now than we have been in the past. More volatility is expected as uncertainty increases and valuations of equities are driven by earnings divergences in industries and markets. In the past, our approach to equities was based more on a recognition that the equity markets were being driven by QE policies (that is, top down). Now, it is more bottom up.

Industries that are still dominating growth such as healthcare and technology are still growing, whereas industries such as oil and manufacturing are in transition and transforming. Accordingly, our portfolios underweight equities. But upon shorter-term selloffs, we expect to again rotate towards an overweight allocation. We also favour gold and other asset classes that are beneficiaries of slower growth.

**Genevieve: There are some views that emerging markets may have reached a trough in valuations, particularly in the context of a maturing US bull market. What are your views and have you begun to advise an allocation to the asset?**

**Marc:** Since late March, we saw that the stars – rising oil prices, rebound in China data and a more dovish US Fed – were in alignment for emerging markets. The Fed's dovish guidance was the game changer. A push-back in a US interest rate hike meant that the dollar rally would likely take a pause, reducing China's devaluation pressures and pushing commodity prices higher. This calmer macro condition induced a resurgence of fund flows into emerging markets searching for higher returns and yields.

Before the Fed restarts its hiking cycle, we believe that there is a window of opportunity for emerging markets to do well, especially for the second quarter of 2016. Therefore, in April, we upgraded our tactical call on Asian equities to "overweight". At the same time, we remain positive on EM high yield bonds, which we think will benefit from a broadly benign macro environment.

**Ken:** EM prospects have improved this year on the weaker USD, bottoming of oil prices and expectations on China's ability to engineer another soft landing. However, there are still growth hurdles for emerging markets and there should be differentiation within them.

While many idiosyncratic factors are at work, the most important single driver of EM valuations is still the USD. When the USD is weak, capital leaves the US to seek higher growth and returns in emerging markets, and abundant funding produces yet more investment and growth. This allows emerging markets to borrow cheaply, which often runs into excess. Then, capital leaves emerging markets, cuts off foreign funding for growth, while a stronger USD makes EM debt harder to repay, causing recessions and often political change. USD strength often ends at the nadir of recession and EM outperformance restarts because investors see greater value and opportunity for growth in emerging markets again.

Currently, the world is close to but not yet at the nadir. China has become the biggest marginal driver of EM and global demand. The recent growth stabilisation is welcome, but may be difficult to sustain due to its dependence on credit. The borrowing boom in Q1 has increased leverage, delayed capacity reductions and likely elevated credit risks in the coming years. Hence, China's growth remains in a trend slowdown. It is unlikely that the rest of the world can pick up the slack that China is creating.

That said, improving oil supply-demand balance could differentiate prospects for EM oil producers versus consumers. US and other non-Opec production of crude oil has started to decline, while Opec (ex-Iran) output is stabilising at near capacity. This suggests stable to falling overall supply, while demand remains steady. Therefore, oil prices likely saw the cycle bottom in February. This should reduce default risk in the sector, particularly large producers with government backing.

Latin America (LatAm) financial markets have been plagued by the precipitous fall in oil prices, which exacerbated other political and economic troubles. A more constructive outlook for oil could help to stabilise the region, alleviate fiscal tightening and reverse some earlier financial underperformance.

By contrast, Asian emerging markets, due to their oil importer status, have been much more resilient during the oil price decline. In fact, stronger fundamentals and external positions have allowed Asian emerging markets to increase borrowing much more than their LatAm counterparts. This makes leverage a much bigger overhang for Asia, which would likely weigh on regional asset prices.

For emerging markets in general, the next global business cycle downturn still looms as a key hurdle. Even though the current global recovery has been slow and unsatisfying, it is still in its seventh year and real global growth has averaged a 2.5-3.0 per cent clip. The amount of monetary policy easing it took to get us here has been staggering. As a result, it is difficult to imagine great growth without first seeing some pullback in policy and economic activity. This is likely to take place over the next two to three years in our view, which is also why we remain cautious on broad EM prospects.

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**Norman:** Some measures of valuations in EM equities have long been attractive, with the asset class trading at 1-1.5x book value (levels seen near the troughs in 2008-09) for much of the past three to four years. However, the underperformance in the asset class has been persistent since 2010 as policy tightening in China, combined with a sharp decline in commodity prices and domestic issues in large markets including Brazil and Russia, weighed on returns, while weak earnings has similarly been a headwind to both absolute and relative performance in the asset class.

The recent turn in emerging markets comes as Chinese policy becomes more aggressively expansionary. Commodity prices have firmed and progress is being made towards a political resolution in Brazil just as US and Japanese growth and policy momentum have waned. While Chinese policy momentum may continue, the challenges for Brazil extend beyond resolving the current political quagmire. In addition, despite some positive signs from the macro picture, from a bottom-up perspective, the negative earnings momentum in the broader EM universe still has not yet reversed.

As a result, with a weak earnings picture and policymakers likely needing to remain accommodative in the months ahead, we prefer to access the EM space via hard currency EM debt where investors can benefit from the same economic drivers while exposing themselves to much lower levels of volatility and more attractive income relative to standalone direct equity exposure.

**David:** Yes, we believe that the tide of improving performance to certain but not all emerging markets is changing. This is mostly because of the slowing momentum of persistent USD ascendency and domination. EM equity markets receive a catalyst of upward price momentum once their currency seeks and/or finds a bottom relative to the USD. Some of these countries show five-year lows in valuations and have had massive currency depreciations relative to the USD. They are positioned to receive external capital flows from international investors because their economies have strong demographics and the potential of more rapid economic growth.

**Genevieve: Having reached the six-month mark, what investment ideas (including hedges) or allocations have worked well for portfolios so far in 2016, and what risks are you most mindful of?**

**Marc:** We witnessed how unpredictable markets can become in the first two months of the year and the recent calm should not be taken for granted. The delay in the Fed hiking cycle will give risky assets some breathing space, but this calm is unlikely to last for the remainder of 2016. Market volatility will return especially with the UK referendum slated for June 23 and the Fed restarting its hiking cycle towards the second half of 2016. One product that has worked well for us was the Lion-Bank of Singapore (BOS) Asia Income Fund. The fund was launched under extreme market stress earlier this year. Since inception, it has recorded 4.8 per cent return as at end-April. The fund's unique covered call writing strategy – or "target-selling" as we termed it – contributed significantly to its performance as it allows the fund to exploit market volatility and convert it to better yields and returns.

On asset allocation, we are constructive on the outlook for global economic growth, and thus recommend a moderately pro-risk positioning stance for portfolios. We maintain our "overweight" call on equity and EM high yield bonds, which will benefit from the broadly benign macro environment. However, the pace of the current risk rally is likely to be more modest than in the two past months, with periodic setbacks


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and heightened volatility. More recently, as markets enter a consolidation phase, we are proposing rebalancing trades such as switches out of "old economy" and into "new economy" stocks that are better positioned to capture future growth opportunities.

We have provided the following asset allocation calls and key investment themes to help clients plan their portfolios for the second half of the year:

*Theme 1 – Innovation:* Investing in innovation provides opportunities for alpha returns over the long term. The challenge is to identify investable opportunities in innovations which have the potential to change our world. We have created a robust framework to identify innovative companies: Using a systematic methodology and relying on the deep understanding of each company's fundamentals of over 100 equity analysts, we sift out around 50 companies (from a universe of over 1,400 companies) that are best positioned to benefit from the key themes in innovation.

In particular, Big Data analytics is showing enormous potential to unleash new waves of productivity growth and consumer surplus. Gene sequencing and neurochemistry are enhancing the quality and longevity of human life. Nanotechnology, energy systems, robotics and 3D printing have the potential to disrupt traditional industries and change the world we live in.

*Theme 2 – Brexit:* The most probable outcome of the June 23 referendum is for the UK to stay in the European Union (EU). Hence, for investors with very little UK and Europe exposure, the Brexit uncertainty may result in good opportunities to selectively build positions in UK and European equities. However, the possibility of Brexit cannot be brushed off. The volatility of UK and European assets is set to rise ahead of the UK's vote, especially in the days leading up to June 23, just like during the 2014 Scottish referendum.

Currently, the volatility of the euro remains subdued and significantly lower than that of the sterling. If Brexit were to happen, the euro, together with the sterling, will experience a sharp spike in volatility, with the euro likely to play catch-up to the sterling. To take advantage of the uncertain binary outcome of Brexit, BOS introduced a volatility swap to capitalise on a rise in euro volatility, without taking a directional view. Volatility swap is typically an institutional play, but we successfully introduced it for our high net worth clients in a simplified warrant form.

*Theme 3 – Reprieve for emerging markets:* They should outperform in Q2 2016 due to the delay of the Fed's tightening cycle and the pause in the dollar rally. The Fed's dovish guidance has eased the pressure on indebted EM economies that faced rising costs in their dollar-denominated debts.

We think EM high yield bonds should benefit from the resurgence of funds in search of attractive yields. In this respect, we leveraged our fixed income expertise in the emerging markets and helped clients gain access to new bond issuances of high-yielding supranational organisations such as the West African Development Bank.

*Theme 4 – Persisting low yields:* Given the downward pull of negative rates in Europe and Japan, long-dated US bonds will likely remain well bid in the next few months. Hence, bond duration risk may matter less in Q2 2016.

*Theme 5 – Asian equities:* Asian corporate earnings growth expectations seem to have bottomed and valuations remain undemanding despite the recent rebound. Asia's macroeconomic growth outlook is stabilising with the bulk of the adjustment to China's slower growth phase largely done. Also, a pick-up in economic reforms and policy support have started to provide much needed catalysts.

**Ken:** Throughout 2015, we have gradually reduced risk exposure in our asset allocations, which was borne out by the progressively larger corrections that we experienced last summer and early this year. In February, we retained the small overweight in global equities despite intense market distress because we believe that the global recovery had not finished. After the February-March rebound, we took another step towards selectively reducing risk, which included shifting from Asia to LatAm to reflect the more sanguine view on oil prices. Going forward, we would expect to continue to reduce risk as we approach the end of the business cycle.

Currently, markets again face headwinds due to uncertainty over policy and politics, but we expect these to be temporary and may generate interesting opportunities in the summer. The policy risks are mainly from Japan, China and the US. Our expectations are for Japan to ease both fiscal and monetary policy in the coming month or two and for the US Fed to stick to the current stance. China may need to clarify the extent of the recent credit defaults, but should largely still be benefiting from earlier easing, so the policy risk is slightly tilted towards the upside.

The political risks include UK's referendum over EU membership, another round of Greek debt negotiations, and the US presidential election. Although our base cases expect favourable outcomes in all three situations, there may still be noises ahead of the events.

With accommodative policy, the key undercurrent of slow global economic growth should continue. What provides us some comfort, compared to the peak of spring 2015, is that investor positioning is far more conservative and cautious, with much larger cash balances and short-risk hedging positions.

**Norman:** Bonds continued the trend of the second half of 2015, outpacing equities globally as the European Central Bank embarked on credit easing to complement its QE programme launched late last year. Carry strategies were rewarded in the first half with investment grade, high yield and EM credit all outpacing sovereign counterparts.

Equities continued to struggle as earnings momentum remains absent across the developed world. In local currency terms, EM and US equities generated modest positive performance while European and Japanese equities lagged. Currencies, however, were a big driver as the USD weakened against the yen, euro and EM currencies, leaving common currency performance of developed market equities roughly flat, while EM equities benefited from the strengthening in currencies to date.

Commodity and commodity-related themes performed strongly as the rebound in underlying commodity prices combined with hopes/expectations of a rebalancing in supply-demand particularly in the energy sector.

While market attention may shift focus temporarily towards concerns such as Brexit or the upcoming US presidential elections, a key risk is that years of QE and a lack of inflation consequences have numbed investors to inflation risks. Official inflation rates are soft and financial instruments that forecast inflation are very correlated with movements in asset markets as opposed to long-term economic data. All that it will take to deliver higher inflation is a revival of commodity prices or a higher than expected increase in wages paid to US employees. Fixed income, foreign exchange markets, and to a certain extent equity markets have discounted this scenario aggressively. Should it materialise, strategies that take advantage of short-term interest rates going up will gain if interest rates do go up quicker than expected, while holding long-dated government bonds would lose money under these circumstances.

**David:** Credit has done well year-to-date because it got aggressively oversold towards last year in tandem with the selloff in oil. The credit markets were worried about many companies that had exposure to the oil industry, but now there appears to be an unfreezing of the credit markets towards energy and the restructuring process is underway. Credit in general is also a bottom-up asset class right now, meaning that the buyer must understand the ability of the company to repay its debts based on its cash flows rather than purely investing on the premise that weak credits will be bailed out by a refinancing as they were in the past.

We are also cognisant that currency devaluations are the continuing strategy of many economies and central banks, and we lean towards currencies that have real interest rate spreads over others. W