We have a secret ingredient that makes all the difference
PMBINVESTMENT
An Islamic Fund Management Company (IFMC)
03 2785 9800
www.pmbinvestment.com.my

COVER STORY

INVESTING IN 2018

BY **KUEK SER KWANG ZHE** AND **KHAIRANI AFIFI NOORDIN**

The robust growth seen in the global economy this year is expected to spill over into 2018. Therefore, individuals should stay invested and maintain a risk-on mode next year as growth continues to pick up, say private wealth bankers and local fund managers.

"We have had such a friendly environment this year, and this is expected to extend into next year as the global economy is still improving. Investors have made money in various asset classes this year ... For instance, the MSCI All Country World Index is up 24% in US dollar terms this month. Bonds, which we have been more cautious about starting this year, have also generated 8% returns," says Standard Chartered Bank Malaysia Bhd head of managed investments and product management Danny Chang.

He adds that global economic growth this year was largely supported by the US economy, which is expected to continue to expand next year, judging from the low unemployment rate, stronger corporate earnings and gradually rising salaries.

In October, the International Monetary Fund forecast that the global economy should grow 3.6% this year and 3.7% next year, compared with 3.2% in 2016. The World Bank has forecast that the global economy will grow 2.7% and 2.9% this year and next year, up from 1.7% last year.

While China has maintained its path of slower growth, the European Union (EU) has seen unemployment rates trending downwards as corporates have shown healthy earnings under the European Central Bank's (ECB) bond-buying programme. Japan, the world's third largest economy, has grown for a seventh consecutive quarter, the longest streak in nearly two decades.

Apex Investment Services Bhd CEO Clement Chew says, "Our central view is that this is not the time for investors to bail out of their investments. The global economy is growing above-trend. The momentum is expected to extend into the first half of next year. Maybe it will ease off a bit in the second half, but it is still a very robust environment. Our projection is that global growth in 2018 should be about 3%."

More importantly, he says, global growth this year is well supported by strong corporate earnings, providing a solid foundation for next year's growth. Based on the MSCI All Country World Index, corporate earnings globally this year are generally positive, a stark contrast with 2016.

"Just by looking at the world's two largest economies — the US and China — their corporate earnings are good and analysts are revising [forecasts] upwards. This is supportive for higher share prices [globally] going forward," Chew says.

> Overweight equities, underweight bonds

> Northeast Asia is expected to outperform. Go for technology and semiconductor stocks in the region.

US GROWTH EXPECTED TO CONTINUE NEXT YEAR

Despite the positive news, investors are concerned that the global economic growth cycle is close to its peak. The US economy, which is now supporting global growth, could be edging towards a downward cycle sooner than expected. This would drag down global growth and send negative sentiment across the global markets.

After all, the US economy has experienced the third longest expansion in its history, lasting for 100 months since 3Q2009. The longest expansion period so far was from March 1991 to March 2001, which lasted for 120 months. The second longest was from February 1961 to December 1969 that lasted for 106 months.

"If the current US economic expansion continues until the second quarter of next year, it will be the second longest expansion streak in its history. If it lasts until the second quarter of 2019, it will be the longest," says Danny.

The US stock market, meanwhile, is at its all-time high. As at Dec 14, the Dow Jones Industrial Average hit 24,585.43 points, up 24% from the beginning of the year. The Nasdaq Composite Index has appreciated 26% from the start of the year.

In response, asset management firms in the US, such as Crescat Capital, are taking a short position on US indices. In its third-quarter investor letter posted on its official website, the firm says that the valuation of the US market is at its highest, based on several financial ratios — including price-to-sales, price-to-book and price-earnings.

However, other industry players, like Apex's Chew, differ. He says there are broad indicators showing that the US economic cycle might still have legs. He points to two commonly used indicators, the yield curve of the two-year and 10-year US treasury notes.

"To put it simply, a US recession usually happens when the yield curve flattens or becomes inverse. This has happened in the last seven recessions in the US, so this indicator works pretty well.

"It is still an upward slope for now, even though it has slightly flattened recently. The two-year note's yield is 1.8% while the 10-year yield is 2.3%. There are still about 50 basis points in between," Chew says.

Another indicator is the core inflation rate, which is equal to the federal funds rate minus inflation. The core inflation rate in the US rose more than 1.9% in previous recessions, he says. "It is now at negative 0.5% and I don't see it rising to that level next year."

US high-yield bond prices are another useful indicator. StanChart's Danny says these usually experience a correction six to nine months before the end of their economic cycle, but this has not happened so far. "Yes, the prices have come off slightly but it is not a massive sell-off. It subsequently rebounded."

These indicators might give investors more confidence and comfort in the US and the global economy going forward. However, Chew and Danny say investors should keep an eye on these indicators next year.

US TAX REFORM COULD TAKE GLOBAL ECONOMY TO THE END OF THE CYCLE

A key event moving forward is the proposed US tax reform that aims to cut corporate tax from 35% to 21%, a significant reduction that could cause the US and global economies to heat up at a much quicker pace. This could lead to a higher-than-expected inflation rate if commodity prices trend upwards as well.

In addition, if President Donald Trump were to follow through with his plans and implement infrastructure spending, it would inject a huge amount of capital into the

Danny
HARIS HASSAN/THE EDGE

From a shoestring budget to a king's ransom, we provide comprehensive investment solutions

PMBINVESTMENT
An Islamic Fund Management Company (IFMC)
03 2785 9800
www.pmbinvestment.com.my

US economy and speed it up. More importantly, it could be a catalyst that causes the US and global economies to overheat.

"This [overheating] is a typical sign that the global economy is much nearer the end of its cycle. We are getting closer to that point. It might be a 2019 story, not next year's. That is our view at this juncture," says Danny.

He says another risk is that central banks of the largest economies are expected to unwind their quantitative easing programmes and embark on a rate hike cycle following in the footsteps of the US Federal Reserve. This could reduce market liquidity and cause an inflationary environment. "The Fed is now alone in unwinding its QE programme and hiking its rates. But the EU and UK are already on the verge of embarking on the same cycle. Japan might take a while longer, but certain parts of Asia are already preparing to hike rates. This includes Malaysia."

Amid a tightening cycle, the market's main concern now is Europe, not China, says Danny. When the ECB starts to tighten its monetary policy, will the EU economy continue to recover? Or has it become a "drug" that the economy cannot do without?

While he says he does not have the answer, Danny remains optimistic. "The EU's unemployment rate has started to come down. Consumer spending is beginning to go up and corporate profitability is rising. Its economy is starting to fire up."

Meanwhile, the Chinese government has been doing well in slowing down its economy, says Danny. "The markets have already seen what the government has done. The Chinese government is tackling shadow banking and is allowing default rates to slowly go up. It means non-profitable companies and industries may not be able to refinance their loans. They are doing the right thing."

The risk associated with China is that its government could "overdo" its tightening policy and trigger a series of defaults. This would create market volatility, which would see Asian high-yield bonds impacted the most as Chinese companies within the mining, property and other sectors issue about 40% of these bonds, says Danny.

'OVERWEIGHT' ON EQUITIES IN A GROWTH AND REFLATION ENVIRONMENT

Given the broader context, equities remain the key asset class that investors should focus on next year. Danny and Chew are "overweight" on equities.

In the case of Apex, Chew says the firm has deployed more funds into the markets this year and now has a cash level of 10%.

Danny adds, "Investors should lean towards slightly more risk-on. If you are still investing conservatively, like heavily into bonds, you should consider adding a small allocation to equities." Danny expects a reflation environment next year, which will drive investors to place their monies in risk assets (such as growth stocks) as company earnings are expected to improve, resulting in higher stock prices.

> Pick bonds, such as emerging market hard currency corporate ones, which could have more legs

The StanChart 2018 outlook report, released on Dec 8, has a 40% probability for the reflation scenario to play out next year. This is compared to a 35% probability for a muddle-through scenario (structurally slow growth and low inflation); 15% for the global economy being too hot (sharp growth with rising inflation); and 10% for the global economy being too cold (slower growth and lower inflation).

CIMB-Principal Asset Management chief investment officer Patrick Chang says the rotation of money will continue towards the equity markets. "For most of the next 12 months, we will continue to be positive on equities versus fixed income. As long as earnings continue to deliver, we will continue to see growth. It wouldn't surprise me if at some point, there is some disappointment on the earnings side. There may be some corrections, but I think this is a natural occurrence in a bull market."

UOB Asset Management Bhd CEO Lim Suet Ling agrees with Patrick. After all, global economic indicators, such as the Purchasing Managers' Index, are showing good signs, she says.

"We are still 'overweight' on equity as the numbers shown by economic indicators are not slowing down. The price-earnings ratio of global equity is now around 16 times, so the earnings yield that you can get from the stock market is 6.25%. Meanwhile, the yield you would get for a two-year US bond, for example, is only 1.8%. If you are 'overweight' on equity, there is no doubt that you are taking a risk, but the risk-reward is skewed towards equity."

NORTHEAST ASIAN COUNTRIES TO OUTPERFORM

Private wealth bankers and local fund managers favour Asia-Pacific when it comes to equities, in particular the Northeast Asian countries, such as China and South Korea. The technology sector is a key driver in these countries and companies in the sector are expected to benefit from synchronised global growth.

"We split Asia into two markets. One is a more domestic-oriented market such as India, Indonesia, Thailand, the Philippines and Malaysia. The other is a non-domestic-oriented markets such as China and South Korea, which are more exposed to exports.

"The latter are also countries that are strong in the technology sector. You have Alibaba Group Holding and Tencent Holdings in China and Samsung Group in South Korea. The earnings of these companies have been strong in the Asia technology sector and it is where the future growth is," says Patrick.

Suet Ling, agrees, saying, "We are positive on China and South Korea. We are now waiting for a market pullback [as it has rallied a lot since the beginning of this year and there is more buy-in]."

She favours China's technology sector as its economy is transitioning from an old to a new economy. The trend is more than obvious. "Banks used to be the majority of the MSCI China Index at over 40%. Today, this has shrunk to about 20% while technology is about 40%. The technology sector in China is a force to be reckoned with."

Also on Suet Ling's radar screen are some Chinese companies within the consumer staple, healthcare and insurance sectors, which are expected to benefit from the continued growth of the country's middle-income group.

Affin Hwang Asset Management Bhd portfolio manager Lim Chia Wei likes South Korea's technology sector. He is keeping a close watch on some of its "internet companies and semiconductor producers".

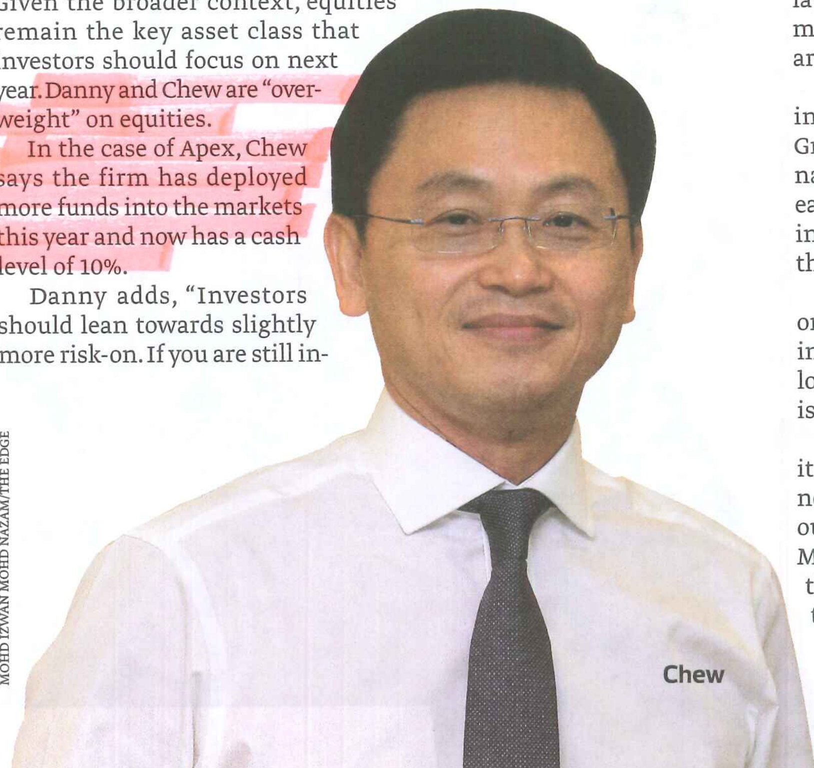
He says the profits and earnings of some companies have been affected by the Chinese government's recent ban on Chinese tour groups visiting South Korea. In addition, the Chinese boycott of South Korean products has affected sales.

The boycott and the ban were implemented because South Korea decided to host the Terminal High Altitude Area defence, a US anti-ballistic missile defence system, amid rising tension with North Korea. The Chinese government sees this as a threat to its national security, explains Chia Wei. "However, in the past weeks, we have observed that China has softened its tone. There is even talk that the travel ban will be lifted. We will see how this affects the share prices of South Korean companies."

StanChart's Danny says Southeast Asian countries are less attractive compared with Northeast Asia, but they are still expected to perform well in a continuing global growth environment.

Patrick is "overweight" on Indonesia next year as its markets have started to price in potential pump-priming by the government prior to the country's 2019 general election. He favours the infrastructure and consumption sectors as the government is expected to make announcements that could spur the economy and put money back into people's pockets.

"There were a lot of political noises in the first half of this year. Consumer consumption is weak and government infrastructure spending has been subdued. However, we think President Joko Widodo knows that he has to be more populist in order to win the next election. Thus, more announcements are expected prior to the election ... I think we are seeing nascent signs of a recovery in consumption and that will drive an improvement in the Indonesian market."



MOHD IZWAN MOHD NAZAM/THE EDGE

Chew

MOHD IZWAN MOHD NAZAM/THE EDGE

Suet Ling