COVER STORY

LATE-CYCLE INVESTING PLAYBOOK

BY TAN ZHAI YUN

The global economy is in its late cycle, which is characterised as a period of increased volatility and slowing growth. But some observers have pointed out that this late cycle is distinct from other such periods in the past, especially with unique geopolitical events such as the ongoing US-China trade war and uncertainties surrounding Brexit.

Under the current circumstances, investors should be mindful of these trends and manage their portfolios accordingly, say the fund managers interviewed by *Personal Wealth*.

One reason this late cycle is different from the others is the extent of growth in economic powerhouses such as the US, according to a report by Deutsche Bank Wealth Management. The world's largest economy is now officially in its longest period of expansion, with its GDP having grown for the last 121 consecutive months as at July.

However, investors should not be worried that this long period of expansion means a recession is imminent, says Stephen H Dover, executive vice-president and head of equities at Franklin Templeton Investments in the US. "It is true that the expansionary phase of the current US economic cycle has been running longer than what is typical. It has been more than 10 years since the last trough in 2009. But Australia has the record for the longest expansion of more than 20 years," he adds.

Investors should consider that the nature of the economy is different now, says Dover. "Historically, when the US economy was manufacturing-based, recessions happened when inventories got too big. Over the last 20 years, as the US has moved into a more service-based economy, there isn't that same inventory dynamic. So, I do not think we can conclude that a recession is imminent just because the current expansion is longer than it has been in the past."

For context, there are four stages of the economic cycle. The early cycle refers to a recovery period, when the economy is coming out of a downturn and central banks are easing monetary policies. The mid-cycle is the expansion period and the late cycle is when economic activity slows and interest rates peak. The end of the cycle occurs when a recession is imminent.

Typically, economic growth hits its peak during the late cycle. According to the report by Deutsche Bank Wealth Management, unemployment is low and central banks are forced to raise interest rates to deal with inflation. But this time around, inflation remains low globally and some countries are still experiencing weak growth. While the expansion period has been long, it has also been weak.

Growing uncertainty due to factors such as the trade war is causing central banks to lower interest rates instead of normalising their monetary policies.

"Investors are hoping that slow economic growth will translate into an extended cycle. To rephrase Lao Tzu, 'the flame that burns half as bright, burns twice as long'. Even as many investors fret about the late cycle, we are not seeing some of the typical signs associated with the late cycle, like overheating economies and inflationary pressure," says Francis Eng, chief investment officer at UOB Asset Management (M) Bhd.

According to fund managers, the US-China trade war is something that investors should pay attention to as it will continue to affect the economy. Other potentially influential events include a hard Brexit.

"The US-China trade war will have an impact on financial markets. While most have focused on the direct impact of tariffs on economic growth, less attention has been given to the second order impact, such as how the uncertainty from the trade war could dampen the future capital expenditure and investments [of companies]," says Eng.

"We are expecting the trade war to be protracted. Thus, it could affect economic growth over the medium term."

Irene Goh, head of multi-asset investing (Asia-Pacific) at Aberdeen Standard Investments in Hong Kong, does not foresee a quick resolution to the trade dispute. The increased political uncertainty will continue to be a feature of the economic landscape, which will negatively impact trade volumes and business investments.

"All these have critical implications for monetary policies. The response from policymakers is a key reason why we are forecasting broadly flat — rather than deteriorating — global growth over the next two years, albeit at a rate well below the post-crisis average. This implies that corporate earnings are likely to grow in the low to mid-single digits," says Goh.

Against this backdrop, experts suggest having a balanced portfolio of equities and bonds. For instance, an Asia-focused moderately aggressive investor should have the biggest exposure to equities (46%), followed by fixed income (41%) and alternative strategies (12%), says Standard Chartered Bank managing director and head of wealth management Sammeer Sharma. In terms of asset classes, he suggests that the highest exposure (20%) should be to North American equities, followed by stocks in Asia ex-Japan (12%) and alternatives (12%).

An Asia and global-focused conservative investor should hold 75% in fixed income, 15% in equities and 10% in cash, with no alternative strategies, says Sammeer.

Patrick Chang, chief investment officer for Malaysia and Asean equities at Principal Asset Management Bhd, says investors should build a globally diversified portfolio that focuses on income and dividend flows. He recommends that investors hold an equal amount of stocks and bonds via balanced funds. Investors can also look at real estate investment trusts (REITs), which could provide income and dividend flows.

"These comprise real estate equity that can be viewed as 'equity with yield' combined with bonds such as fixed-rate commercial mortgage-backed securities (CMBS). REITs will provide both the growth element and yield while CMBS will provide a steady flow of income. A REIT, especially one that is global in nature, would fulfil our recommendation."

OPPORTUNITIES IN US AND EUROPE

Equities can benefit from a low interest rate environment and slowing growth in the global economy. Even if a recession were to occur, returns could still be positive initially, says Eng.

"Historically, an inverted yield curve has been a good predictor of recessions. From the first point when the yield curve inverts, it takes over a year on average before the economy turns into a recession. [During that time,] the S&P 500 can gain more than 20% on average, with the mar-

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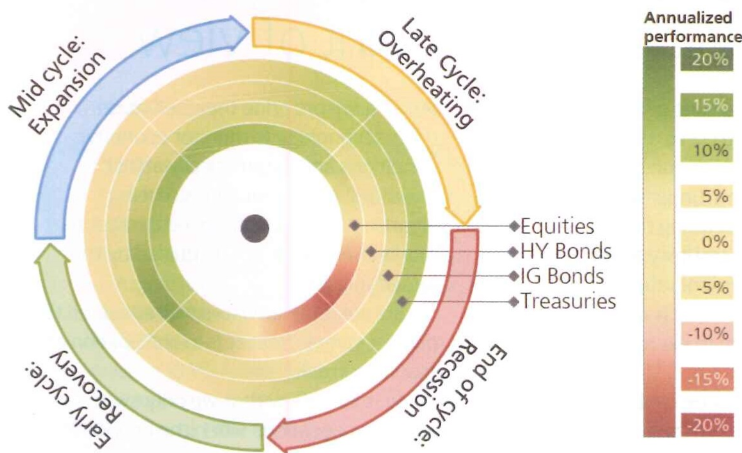
> We view the current moderation as a cyclical slowdown, with the global economy having been on a positive trend since recovering from the 2008 global financial crisis. > Chang

Summary of asset returns by business cycle stage



Note: Approximate total returns on asset classes by business cycle stage, annualised, based on historical observations over the past 30 years and expert assessments

ket peaking 1½ years later, based on historical evidence," he adds.

According to a report by UBS Global Wealth Management, stocks tend to continue performing in a late cycle as long as earnings growth remains strong, although the risk-adjusted returns will moderate.

The key yield curve (the difference between the yield of the 10-year US Treasury note and that of the 2-year note) inverted last month.

Eng recommends that investors hold some cash to take advantage of the volatility in the equity markets. "The volatility will present opportunities to investors who are disciplined. For instance, the S&P 500 initially weakened when the US imposed tariffs on some of China's imports in May or June last year, only to rebound to new highs in the subsequent months," he points out.

Eng likes the US market for its comparatively healthy corporate earnings outlook. He also likes the more domestic-centric markets such as Asean (excluding Singapore) as the countries are expected to fare relatively better amid the US-China trade war.

Sammeer sees the rate cut cycle as being supportive of risk assets. It is a similar situation to when the US Federal Reserve made "pre-emptive" cuts in 1995 and 1998, and a recession did not occur in the next 12 months. The central bank reduced rates as an insurance against a weakening economy, even though it did not expect a recession.

"Bond yields and equities fell sharply before the cuts [in those two years]. Twelve months after the cut, however, equities and high-yield debt delivered exceptional returns, although higher-quality debt offered muted returns," he says.

"Within equities, we prefer US stocks, given the country's strong economic backdrop. However, emerging-market assets also tend to do well in insurance-cut scenarios."

On the other hand, Goh's team is tilting its global equities exposure to developed markets over emerging markets. In her view, if the trade tensions worsened, the fallout could be worse for emerging-market equities. The team has already reduced its equity exposure in the light of certain external risks.

"On the back of a strong rally in the face of weakening global growth, we reduced our equity exposure in late July to its lowest level this year. This helped us navigate the subsequent market drawdown following US President Donald Trump's tariff escalation and the renminbi's abrupt depreciation," says Goh.

According to Fidelity's Viewpoint article, "How to invest using the business cycle" at end-June, in general, stocks show somewhat better performance on some metrics in the late cycle and cash tends to outperform bonds. But it also adds that "the indefinite frequency and magnitude of relative performance warrant more neutral allocations relative to the benchmark portfolio".

European markets tend to perform in a late cycle due to their high exposure to inflation and rate-sensitive sectors such as commodities and financials. Dover notes that European companies have been vastly under-earning their US peers. "These stocks are trading at historical valuation discounts, offering scope for both profit improvement and multiple expansion as policy conditions normalise," he says.

What about Malaysia?

Malaysian equities and bonds could benefit from the low interest rate environment and its defensive nature, say fund managers. Bonds in particular are attractive for their yields and low volatility.

Francis Eng, chief investment officer at UOB Asset Management (M) Bhd, says local bonds offer attractive yields relative to those in developed markets with the potential of monetary easing.

"The risk for Malaysian bonds is if these are excluded after the FTSE index review later this year, which could potentially trigger some bond portfolio outflows. Our base case assumes that the country will continue to be included in the index," he adds.

Kevin Chan, head of fixed income investments at Apex Investment Services Bhd, observes that the local bond market is not expected to see too much volatility going forward. Given the shift by central banks to ease monetary policy to reflate the global economy, it is currently a good environment for fixed income.

"Given this backdrop, actively managed bond portfolios provide the flexibility to move across sectors and durations. This can be advantageous to investors in the later stages of the economic expansion," he adds.

The dovish shift to Bank Negara Malaysia's monetary policy also supports the local bond markets, says Chan. "In particular, local corporate bonds still offer attractive spreads in our view and we believe these have more legs to run despite the recent rally, although we are cautious of companies with exposure to the US-China trade tensions."

Within fixed income, Eng prefers corporate debt for the better yield. "But I would exercise caution in credit selection given that we are in a late-cycle environment," he warns.

The Asian Development Bank says in its Asia Bond Monitor — June 2019 report that Malaysia was one of the emerging East Asian countries whose local currency bond markets continued their expansion in the first quarter of this year despite moderating global growth and trade conflicts.

Malaysian equities have underperformed their regional peers this year. As at Sept 10, the FBM KLCI had recorded a drop of 5.6% year to date and 8.42% over a 12-month period. By comparison, equities in Singapore, Thailand and Indonesia recorded positive gains during the corresponding period.

Going forward, local equities could benefit from their defensiveness amid all the uncertainties, says Eng. Some of the sectors he likes are consumer, manufacturing, technology and oil and gas.

"In a late-cycle environment, we would focus more on defensive and quality companies. We also expect stocks that offer high dividend yields to perform relatively well under the low interest rate environment," he adds.

Sammeer Sharma, managing director and head of wealth management at Standard Chartered Bank, and Patrick Chang, chief investment officer for Malaysia and Asean equities at Principal Asset Management Bhd, are neutral on Malaysia.

Like Eng, Chang prefers corporate credits over Malaysian government securities. As for stocks, he prefers large-cap defensive names with the ability to pay dividends.

"Meanwhile, we are kicking the tyres to look for turnaround plays and new opportunities. That is because the government has started to implement some of the previously suspended major infrastructure projects," says Chang.

Sammeer expects Malaysia's interest rates to fall by 25 basis points by the end of this year, which could benefit local bonds and local bond proxy assets such as high-dividend-yield stocks and real estate investment trusts. "[But] relative to Asian equities, Malaysian stocks continue to trade at premium valuations. Coupled with lower corporate earnings expectations, this makes Malaysian equities less attractive," he says.