Investment Insights

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One week, Two speeches, A World of Differences

The paradox of Trump and Xi


Source: Gettyimages.com

In the middle of January, China President Xi Jinping gave his opening address at the World Economic Forum (WEF). A few days later, newly elected President Donald Trump delivered his inauguration speech.

The two speeches bore stark contrast and the irony of the role reversals did not escape notice. At Davos, President Xi, the leader for a country which had at a point in history isolated itself, defended trade and globalisation. In the White House of a country that championed freedom and openness, President Trump blamed the same items for the loss of jobs and damages to the US economy, painting a picture of a better "America First" future.

Selected excerpts on trade and globalisation

President Xi Jinping, at WEF Annual Meeting 2017	President Donald Trump, Inauguration address 2017
There was a time when China also had doubts about economic globalization... But we came to the conclusion that integration into the global economy is a historical trend... We have had our fair share of choking in the water and encountered whirlpools and choppy waves, but we have learned how to swim in this process.	We've made other countries rich while the wealth, strength, and confidence of our country has dissipated over the horizon. One by one, the factories shuttered and left our shores with not even a thought about the millions and millions of American workers that were left behind.

As the two world leaders set their eyes in opposite directions, Asia, caught at the intersection, could be in for a ride as new policies and initiatives filter through.

Inside

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Changing ties ▶▶

The gears of change were quickly set in motion by a fast-to-act US leader. Shortly after his inauguration, President Trump rolled out a series of executive orders, of which two were pertaining to trade. The first was to renegotiate North American Free Trade Agreement (NAFTA) and the second, withdrawal from the Trans-Pacific Partnership (TPP) deal.

His actions raise questions for the traditionally trade-dependent Asia. While TPP has never actually materialised and hence would have limited impact on current trade landscape, the message that US is turning inwards is almost certain. How the potential changes could affect Asia's development seems less apparent.

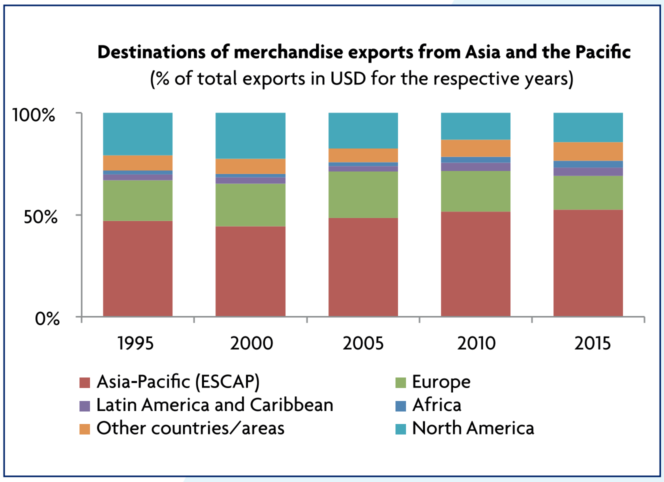
Drilling deeper, Asia Pacific's trade relationships with its partners have changed significantly. In 1995, North America[1] accounted for 21 per cent of the total merchandise exports, but it now contributes only 14 per cent (as of 2015). In comparison, intra-Asia Pacific trade has risen modestly over the years.

[1] Including United States, Canada, Greenland, Bermuda and Saint Pierre and Miquelon.

A barometer for trade flows is Singapore, an open economy with exports totalling over 170 per cent of GDP in 2015 (Bloomberg, 02 February 2016). The country has enjoyed a 9.5 per cent year-on-year growth in exports last December. Furthermore, top contributors to non-oil domestic exports growth were China, Taiwan and Hong Kong. Other Asian countries like South Korea, Taiwan and Japan also posted strong export growth in recent months.

Combined, the growth in inter-Asia trade and gradual shift away from US makes Asia less susceptible to trade shocks from US than in the past.

Fig 1: Evolution of trade relationships for Asia Pacific over 20 years



Source: United Nations ESCAP, based primarily on data from the International Financial Statistics of the International Monetary Fund (IMF), last updated as of 11 April 2016

Modern Silk Road ▶▶

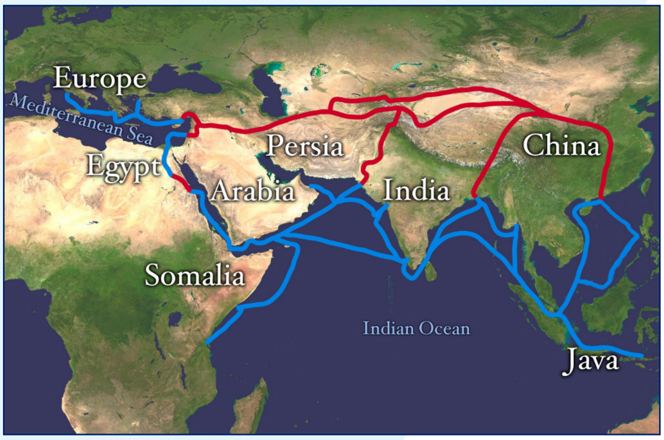
In January this year, a China Railway Express train left Yiwu in China and journeyed across Asia and continental Europe to conclude its 18 day trip in London.

While the rail freight service is the first direct rail link between China and the UK, the route itself was actually part of the old Silk Road which began around 200 BC which China is reviving as part of its "One Belt, One Road" project.

Other countries are chipping in to China's grand scheme to invest in infrastructure across Asia. The Asian Infrastructure Investment Bank (AIIB) has garnered a total of 57 signatory countries and approved 9 projects totalling $1.7 billion in 2016. The project represents a commitment of Asian countries to further interregional ties.

Fun Facts
The Silk Road was a network of trade routes that linked Eurasia through both land and sea, dating back to the Han dynasty in China. It derived its name from the lucrative Chinese silk carried out along it, though other merchandise also passed through. Chinese silk has been found in places like Egypt and Rome, places faraway from its origin.

Fig 2: Old Silk Road



Source: Wikipedia

Conclusion: US continues to remain an important trade partner for Asian economies and President Trump holds the wild card. However, even with the "America First" rhetoric, President Trump may not be necessarily looking to shore off the US economy, but could be instead looking towards bilateral trade agreements which give US better advantage. Intraregional trade flows within Asia Pacific could also help mitigate potential declines in trade with US.

What it means to Investors
Asian Equities, the Asset Class to Own in the Year of Rooster ▶▶

Uncertainties surrounding Trump's protection policies have weighed on the prospects on Asian equities. However it is worthwhile to remind investors that Asia is no longer a manufacturing and export story, but more of the economy driven by consumption. Urbanization and consumption upgrade patterns have the potential to generate a robust domestic demand to offset any likely negative impacts of a more insular US.

In addition to the intact long term fundamentals, we have identified three near term catalysts that potentially can lead Asian equities higher in 2017.

Fun Fact
2017 is a Year of the Fire Rooster. Back in 2005, the Year of Wood Rooster, the markets were in a similar economic cycle to the present situation, i.e reflation and revaluation.

In 2005, Asia ex-Japan equities registered + **19.3%**. The fiery question is "Will we see similar returns in 2017"?

1. Stabilizing growth in China

- The supply side reforms from China should help ease the downward pressure on China growth. The inventory situation of some traditional industries, such as coal and steel, has improved while prices have rebounded. See Figure 3.
- Furthermore, consumption and services, accounting for more than half of China GDP, continue to be resilient. Retail sales increased 10.9 percent year-on-year in the latest December 2016 data release.
- In view of a stabilizing "old economy" and steadily growing "new economy", we believe China's growth is likely to stabilize at 6.5 percent this year, providing a constructive backdrop for Asian equities.

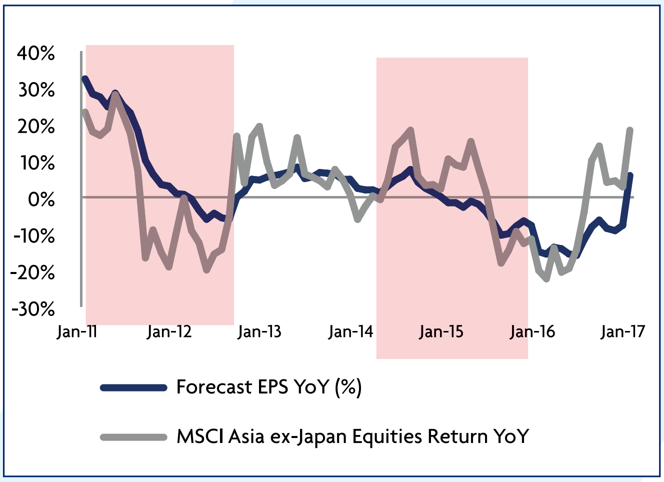
Fig 3: Industries that are in overcapacity, such as steel, are in better shape.

Source: Bloomberg, UOB PFS Investment Strategy, 02 Feb 2017

2. Positive earnings revisions

- Deteriorating earnings caused Asian equities to underperform against developed market equities in recent years.
- 2017 is likely to mark a return to positive earnings growth for Asian equities. The forecast earnings growth turned positive in January 2017, a breakaway from the negative trend for the last two years. See Figure 4.
- The drivers for better earnings forecast are improving bank earnings due to generally better economy and upward revisions for Industrials and Materials.

Fig 4: Earnings are projected to grow in 2017, after years of disappointing performanc.



Source: Bloomberg, UOB PFS Investment Strategy, 02 Feb 2017

3. Valuation gap with developed market equities is likely to narrow

- Asia ex-Japan equities are generating double digit return on equity (ROE). This region is currently trading at a large valuation discount to developed markets like the US, Europe and Japan. See Figure 5.
- We believe that Asian equities are at a better starting point for investors who want to take advantage of the more attractive entry valuations for potentially handsome medium to longer term returns.

Fig 5: Asia ex-Japan equities are trading at large discount to the DM peers.

Equity Market	Return on Equity (%)	Forward Price to book (X)	Forward Price to Earnings(X)
Asia ex-Japan	**10.6**	**1.4**	**12.5**
US	12.8	2.7	17.4
Europe	7.3	1.7	14.4
Japan	7.0	1.3	13.7

Source: Bloomberg, UOB PFS Investment Strategy, 02 Feb 2017

Position Asian equities through a Low Volatility Strategy

Although we are constructive on Asian equities, we are mindful that anti-globalisation comments and decisions from political leaders could create market jitters – resulting in a bumpy and potentially scary ride. It may then be prudent to start the journey through investing in lower volatility Asian stocks and a portfolio that is dynamic and more domestically oriented. This could help to cushion any downside shocks, whilst setting the long term goals of being invested in this attractively valued asset class.

Key Risks to Asian equities

We have identified two main risks for our call on Asian equities.

1. Earnings turn-around does not materialise

Earnings turn-around underpins our conviction call of Asian equities. There are many factors that can affect earnings, such as inventory costs. Investors ned to be vigilant on companies' earnings and managements' financial guidance.

2. Heightened geopolitical risks between the US and China

Other than trade, geopolitical tensions could arise over sensitive political issues, such as "One China" policy and territorial rights in the South China Sea. Matters can become more complicated as the Trump administration could be at times provocative and China exercises the need to exert greater regional leadership. Any escalated conflicts between the two super powers may dampen investors' risk sentiments in the region.

Market Outlook ▶▶

We started 2017 with our investment outlook based on a global reflation theme. Years of global accommodative policies have helped to support the global economy. However, recent developments are redefining the investment landscape that leads to potential higher inflation and growth.

1. Shift from monetary to fiscal policy
2. Rise of Populism
3. Confluence of Supply and Demand Factors.

We feel that in a reflationary backdrop, investors should tilt their portfolios towards equities and to reduce interest rate sensitivity in their bonds portfolio. Details of the strategies are reflected in the table – Investment Perspective – February 2017.

The key risks for 2017 are the following

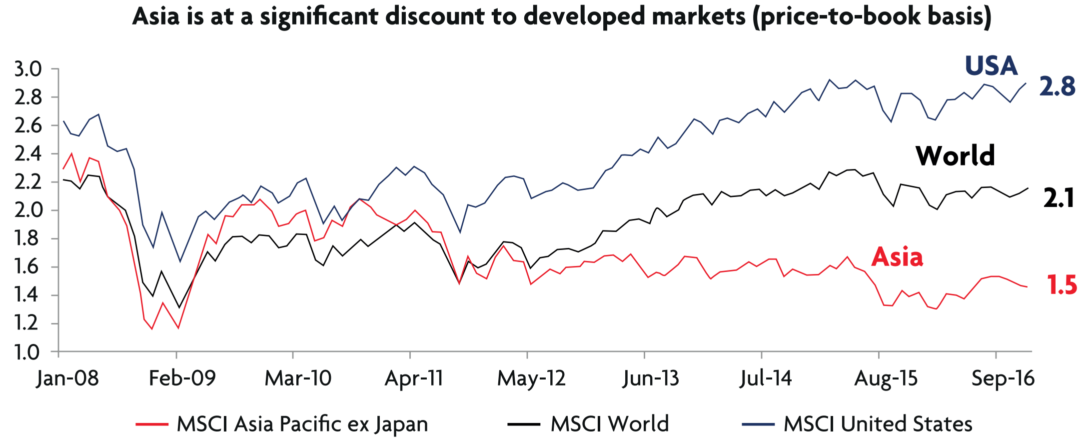
1. "Hard" Trump scenario where the new president rushes through protectionist policies that could hurt global trade.
2. European Politics where upcoming elections in France, Netherlands and Germany could trigger unexpected swings in the markets.
3. Inflation overshoots too fast, causing the central banks to tighten monetary conditions.

Investment Perspective – February 2017

Equity	Focus on Asia ex-Japan equities, but with a low volatility approach. Selective on US equities. Focus on Industrials and Financials.
Fixed Income	US short duration high yield. Subordinated bonds of high quality issuers. Hybrid credits that allow for reset at call date, with a preference for bonds with a high reset spread.
Alternative	Structured notes that allows participation to the equity markets through a customised payoff structure
Currency	USD faces temporary downside pressure but overall uptrend remains. Expect AUDSGD and AUDUSD to consolidate GBPUSD to remain under pressure as Article 50 draws closer.

PRICE TO BOOK OF MARKETS

ASIAN VALUATIONS ARE VERY ATTRACTIVE



Strategy for the month of February

- Fixed income investing should be assessed with consideration of interest rate sensitivity (duration risk) to achieve better total return. This is approached with selecting shorter maturity bonds and/or bonds that offer higher coupon buffer.
- Growing protectionism sentiments, especially from the Western developed countries raise concerns of how global trade will evolve.
- Financial markets are taking a breather from the long Trump rally since last November.
- Investors can consider adding to Asian equities (on dips) where the valuations are attractive both compared to other regions as well within itself by historical measures.

Strategies ▶▶

Strategy		Analysis
1 Position for higher rates through short duration high yield bonds and subordinated bonds. **Heightened Interest Rate Risks**		**Short Duration High Yield Bonds**
	Value	Albeit spreads have narrowed due to recent outperformance, **the yields are attractive** compared to US Treasuries.
	Trend	Investor fund inflows have been **supportive**, but the asset class may be overbought in the near term.
	Activity	Economic outlook should remain **positive** in the medium term.
	Risk	Strong economic momentum and governments' efforts to boost growth will **keep default rates at low levels**.
		Subordinated Bonds
	Value	**Yields are attractive** compared to senior bonds of investment grade companies
	Trend	Technical indicators point to **sideways movements**.
	Activity	Inflation may pick up. **Higher yields could cushion negative impacts on prices**.
	Risk	**Default risk is likely to stay low** for companies with strong balance sheets.
2 Asia remains attractive but a conservative stance is warranted. **Tap on Asia Value**		**Asia Ex-Japan Equities**
	Value	Price to earnings (P/E) for Asia Ex-Japan equities at 14.5x remain **attractive relative to developed markets equities** at 22.4x. Current P/E levels are fair versus long-term historical average.
	Trend	**Price has rebounded** since 5-year low in January this year and recovered from the panic sell-off following US elections.
	Activity	In particular, structural reforms in India and Indonesia could boost domestic growth. Business activities and consumer sentiments are buoyant.
	Risk	**Possibility of constricted trade channels** under a "Hard Trump" scenario could dampen prospects in the traditionally trade-dependent region.
3 Invest in US through sectorial plays on Financials and Industrials. **Selective on US sectors that are likely to benefit from Trump's policies**		**US Financials**
	Value	**Earnings per share growth is poised to pick up** with improved net interest margins on the back of steeper yield curve.
	Trend	**Momentum is positive.** Trend has been strong since the US elections.
	Activity	**Business and consumer sentiments are positive.** Federal Reserve is still likely to raise rates gradually.
	Risk	Due to current high earnings growth expectations, **investors may be prone to disappointments**.
		US Industrials
	Value	Expectations from fiscal stimulus (infrastructure spending) may help to improve future earnings
	Trend	**Momentum is positive.** Strong upward trend established since US elections.
	Activity	**Business sentiments are improving.** Higher fiscal spending may boost additional demands.
	Risk	A **delay in the fiscal spending** could result in re-pricing of the sector.
FX USD remains bullish for the longer term on rate hike expectations. **US interest rate policy divergence from other central banks**		• USD faces downward pressure after Trump's inauguration • We expect AUDSGD and AUDUSD to consolidate • GBPUSD remain under pressure as deadline for triggering of Article 50 draws closer

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