GLOBAL OUTLOOK: A RETURN TO DIVERSITY

Smoother sailing ahead for international markets on the back of increased diversity in views and assets held, with strong earnings growth for equities and US dollar-denominated bonds.

By **Alift Yusri**

International markets are seeing a return to diversity following a decline in Q1 2018 as indicated by homogeneous investor positioning and pronounced 'groupthink' trends among brokers and asset managers, according to Standard Chartered Bank in its 2H 2018 Global Market Outlook brief, while emerging markets (EMs) face tightening liquidity and fund outflow from a strengthening US dollar.

The sentiment comes in spite of escalating trade war tensions between the United States and China, which show no signs of cooling down following US President Donald Trump's 26 July announcement of a three-part US$12bil plan to subsidise American farmers hard-hit by retaliatory Chinese duties on soybeans, beef, pork and fruit, among other agricultural products.


Danny Chang

"This correction in global market view presents a different set of opportunities as we move forward into the second half of the year, with no better illustration of this diversity than onshore, in Malaysia. If you look at the KLCI, domestic funds are buying and foreign funds are selling," says Danny Chang, Head, Managed Investment and Product Management, Standard Chartered Bank.

Looking to the West

Key opportunities in 2H 2018 include US dollar-denominated government bonds in EMs, as well as global equities, with the US as a preferred market, according to Standard Chartered. As a whole, the global economy continues to grow above expectations, though expansion has moderated in Europe, Japan and China.

This is balanced by expectations that the US Federal Reserve will hike interest rates twice more in 2018, leading to inflation surges as a key risk in that market, with the European Central bank likely to end bond purchases by December. Meanwhile, the Bank of Japan has maintained an accommodative stance in terms of monetary policy amid low inflation, while the People's Bank of China balances domestic-driven growth with structural reform.

"Global bonds have been the worst-performing asset class since mid-December 2017, which is unusual as they are typically a safer place to be than equities. This is attributed to a combination of storms in 1H 2018 in the bond market as yields went up and corporate bonds suffered disproportionately," says Manpreet Singh Gill, Head, Investment Strategist, Standard Chartered Bank.

Despite this, the bank remains bullish on bonds due to their defensive nature, with 10-year yields expected to rise to the 3.0-3.25% range over the next 12 months. EM US dollar-denominated government bonds are favoured due to attractive yield and stable credit qualities, though government bonds denominated in local currencies have underperformed as the US dollar strengthens in the short term.

Consensus earnings growth for the MSCI All Country World index was reported at 16% for 2018, making equities the preferred asset class for investors this year, with the US driving growth on the back of tax cuts and increased corporate margins. Earnings growth expectations for the market are as high as 21%, with technology, energy and financials as key sectors.

"Global stocks and bonds perform differently at various stages of the Fed's interest rate hiking cycle. Right now, we think we're at a point where growth is strong and inflation is normalising, and equities tend to do well in this operating environment. While a lot of risk and volatility remains out there, it could prove expensive not to be invested in global equities," says Manpreet (refer to Chart 1).

"However, as markets move from the later points of the cycle to the end of the cycle, the returns start reversing, with equities making almost nothing, whereas high quality, low-yield bonds are where all the returns come from. Unfortunately, it's difficult to forecast exactly when the cycle will shift, which is why diversification in investment strategy is important."

Diverse Points of View

Meanwhile, US dollar strength is projected to peak on the back of softening growth momentum for non-US economies, as well as the short-term effects of the Trump administration's international trade policy. However, the currency's rally is expected to return to its long-term structural decline, driven by narrowing global growth and an anticipated focus on the US's budget and trade deficits, according to Standard Chartered.

Chart 1: Asset Class Performance vs Fed Policy Cycle

Source: BCA Research, MSCI, Bloomberg Barclays, Standard Chartered

"The US dollar is a macro variable with significance beyond just foreign exchange investment, because if the dollar goes up, Asian and EM equities go down, with associated currency and bond markets following suit," says Manpreet.

Domestic Perspectives

This is reflected in the capital outflow affecting Malaysia, with domestic players such as online unit trust distributor Fundsupermart.com (FSM) echoing Chang's sentiments regarding foreign sell-offs, though it notes that the trend is attributable to larger regional currents.

"We saw record levels of investment in January, but subsequently saw a lot of clients selling off in June, with losses of up to 16% for those who invested earlier in the year. In the global context, however, I would like to highlight that investors aren't exiting Malaysia because of the recent change in government. This selling is taking place across the board with regard to Asian funds, including Indonesia and Thailand, and Malaysia isn't the worst off in this regard," says Wong Weiyi, General Manager, FSM.

However, in contrast to Standard Chartered's US-centric investment strategies, FSM favours Japanese capital markets as a dark horse alternative to US equities and dollar-denominated government bonds, banking on fundamentals such as the East Asian nation's affluent, mature demographics, who have largely invested locally, as well as the prevalence of globally-aligned large-cap businesses in the country.

On the domestic front, Chang shares that the primary global risk factor affecting Malaysian markets is the escalating US-China trade conflict, given that the US drives some 35% of the world economy, as well as localised jitters following the defaulting of at least 20 corporate bonds in China up to May this year.

"With regard to foreign selling, if you look at 2017 and the year to date in 2018, about 70% of net inflow last year has already gone out. Some of the remaining capital is tied up in Malaysia-dedicated funds, so one way or another, we're closer to the end of the selling trend. The other question on everyone's mind is how Malaysia's fiscal deficit will be funded. The expectation here is that this gap will widen, and I think that transparency and the information being disseminated by various ministries, notably the Ministry of Finance, will be the key to managing expectations from a foreign perspective," he concludes.