FULLERTON FUND MANAGEMENT

MARKET UPDATE

Our Views on the Escalating Trade Situation

7 August 2019

In Brief

- Trade and geopolitical tensions are complex. We do not expect the US-China trade dispute to be resolved in the near term.
- Central banks globally would shift more markedly towards easier monetary policies. We currently do not expect the CNY to weaken significantly.
- In equities we have reduced our exposure to certain sectors vulnerable to rising tariffs and a depreciating CNY, in favour of names with more resilient earnings momentum.
- In fixed income we are into lower beta sectors and higher quality bonds demonstrating greater refinancing flexibilities. We see opportunities where policies are likely to lead rates lower.

Following uncertainties with Fed's policy path and a surprise tariff hike on Chinese imports over the past week, equities and emerging market currencies have retreated as investors flocked to cash and safe-haven assets such as German bunds, US Treasuries and Japanese Yen.

Asian USD credits have suffered in tandem with the broad market sell-off, with spread widening on both the investment grade and high yield bonds. Investment grade bonds held up thanks in part to the strong rally in US Treasury yields. Asian currencies have suffered, led by the Korean Won, Indian Rupee (in addition to the CNY). A bright spark was the onshore Chinese government bond markets which got a boost as expectations of more policy easing rose.

The Hong Kong equity market is also experiencing prolonged weakness. Already affected by weak global demand and its exposure to the Chinese economy, the social discourse have hurt economic activities and further dampened business sentiment.

All taken into consideration, inflection points are essential features of the financial markets. As fundamental investors, we recognise that changing market sentiment can translate into investment opportunities. The key to invest through market cycles is to have a disciplined approach that focuses on the fundamentals and risks underlying each investment opportunity, and to package quality ideas into a diversified portfolio to make the most out of sold-down assets with strong long-term fundamentals.

Investment Strategies

While China equity valuations remain attractive, earnings visibility however is limited. Earnings visibility (dependent on US-China trade war resolution) remains central for any market re-rating.

In view of the above, we have been cautious on the outlook of Chinese equities since 2Q19, particularly following threats of 25% tariffs on virtually all imports of Chinese goods in May. To this end, we have been trimming our China equity exposure across our equity portfolios, with current positioning being neutral to underweight (versus the benchmark). We have reduced exposure primarily in names across sectors such as consumer discretionary and IT, which have exhibited higher vulnerability to rising tariffs, and of late, in names within the real estate sector with downside exposure to a depreciating CNY.

We remain invested in select defensive, quality compounders in the financials and communication services sectors. We retain our exposure to companies within the more domestic-driven consumer and industrials sectors, which are well positioned to benefit from stimulus measures being implemented by the government.

Broadly across our fixed income strategies, we are turning more defensive, rotating out of higher beta sectors into lower beta ones; taking some profits off the table in bond holdings where valuations were stretched or in crowded, consensus trades which have benefitted from the strong rally this year.

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Within Chinese credit, we are also shifting towards a more cautious posture, by rotating into higher quality bonds in the Chinese property sector; industry leaders with greater refinancing flexibilities to weather any downturn in the property markets. Within Hong Kong, we have turned more cautious in the sectors more exposed to the current political situation, such as the retail sector.

Within Asian local currency strategies, we are looking to selectively extend duration in local bond markets such as in onshore China where expectations of more policy support have risen. Singapore and Thailand rates are also looking interesting, given their weaker fundamentals and warrant a closer look on market corrections. We have been keeping to a long US dollar bias versus Asian currencies given the weakening growth backdrop and slower export momentum, and have also put in place currency hedges to weather any near-term market volatilities. That said, we are mindful of the risk of a US currency intervention which for now, remains a tail risk event.

In terms of risk management, our starting point is to diversify as much as possible in the setting of our asset allocation and selecting of securities within the equity and fixed income portfolios. Additionally, we apply downside risk management dynamically to shield the portfolio against tail risk events. Our strategy includes inexpensive hedges using futures and options.

Market Outlook

There was much mischaracterisation of Fed Chair Powell's "mid-cycle adjustment" comment. In our view, the Fed will act if the data warrants it, and would not materially tighten financial conditions during a weak market cycle.

The outcome of the additional tariff on Chinese imports, however, is harder to predict. The PBOC had on Monday allowed the CNYUSD to weaken past the symbolic 7 dollar mark, prompting the U.S. to name China as a currency manipulator, then allowed the yuan to strengthen the next. The standoff between the disputing parties could quickly get a reprieve (as seen in the case of Mexico), or on the contrary, stay protracted. Market expectation is for a trade deal by end 2019/early 2020, nearer to Trump's re-election campaign, though developments remain fluid.

Looking ahead, the escalation of the US-China trade tension will pose some headwinds to global growth and corporate earnings recovery. We do not expect a quick resolution in the trade dispute and there are likely to be many false starts.

We believe that China will step up its fiscal stimulus and adopt a proactive monetary policy to support economic growth as the importance of the "six stabilisation" policy was mentioned at the July Politburo meeting (following its removal at the April meeting). Similar actions will be seen from central banks globally, providing strong positive offsets. However, the stimulus measures are likely to have a lag effect. As such, we expect Chinese and global GDP to worsen qoq in coming quarters.

While the CNY may be highly volatile, we currently do not expect China to engage in aggressive competitive devaluation. A currency depreciation will help to cushion the additional 10% tariff announced, but a steep devaluation could stoke a capital flight and put strain in Chinese corporations, something Beijing will be keen to avoid.

Please do not hesitate to contact us if you require further clarification.

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