FOR SOPHISTICATED INVESTORS ONLY

Nikko Asset Management

2019

OUTLOOKS

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GLOBAL INVESTMENT COMMITTEE OUTLOOK 2019: TEMPERED POSITIVE VIEW

Global Growth Should Be Moderately Good

So many developments have occurred since we last met in September, but the major ones were the surprising collapse in oil prices mostly due to geopolitical factors, the U.S.-China trade and BREXIT conflicts becoming increasingly intractable, and that aspects of the global economy showed occasional signs of moderation. The major market debate is whether the 3Q GDP data weakness in various countries was mostly a function of temporary factors or a sign of a major downturn. Of course, everyone has long known that 2019 will be slower than the heady pace of 2018 and that central banks were slowly normalizing, but markets lost confidence very quickly when clear signs of such appeared. Indeed, there is a generalized concern about being at the end of an economic cycle, but we all know that this cycle is very different than all the others, so it is very difficult to predict. We, however, come down on the side that economies will not falter in 2019 and that the markets have over-reacted. Many on our Global Investment Committee think that the balance of potential risks is to the downside, but not strong enough to produce a significantly negative view. BREXIT plays a large role among these risks, and none of us are truly confident about the result, which would have major global implications, but assuming BREXIT does work out without major disruption, the G-3 and Chinese economies should grow decently through December 2019, approximately in line with the expectations of major economists, while we expect central banks to reduce their accommodation similarly to consensus expectations. With such as the backdrop, we expect bond yields to rise mildly, the USD to be flat in the 1H, but decline in the 2H, and equity markets to rise further, especially as we forecast that the multitude of other geopolitical risks will also remain under control. Clearly, there are significant downside risks, but obviously upside risks as well.

Through November 30th, MSCI World fell 5% from our September meeting date vs. our +6.9% expectation (although our targets were for end-December, so much depends on the coming weeks' news), defying our bullish stance at the time. We plainly did not accurately forecast the development of political and economic fears. All regions undershot their targets with negative returns in USD terms so far during the period. 10-year Bunds and JGBs moderately undershot our December target but Treasuries slightly exceeded our target. Our currency calls were basically correct, with the EUR and JPY only slightly weaker than we expected.

Despite the market conniptions, our GDP forecasts for 4Q18-1Q19 were relatively good, albeit from 3Q levels that were disrupted in Japan by weather disasters and in Europe by German auto production dysfunction. Relative to current consensus, the U.S. forecast was on target and Europe and Japan now have consensus estimates moderately lower than our forecast for 4Q18-1Q19, but our 2Q19-3Q19 forecasts match the current consensus. As for China, consensus now is just barely below our forecasts. Looking forward, U.S. GDP, at a 2.5% Half on Half Seasonally Adjusted Annualized Rate (HoH SAAR) in 1H19 and 2.0% in 2H19, should match economist-consensus expectations. Growth should come from increased personal consumption and fixed asset investment, while net trade will likely be a very volatile factor, especially in the 1Q. Meanwhile, the Eurozone's and Japan's GDPs will likely both grow at 1.7% on a HoH SAAR basis in 1H19, and 1.8% and 0.6%, respectively, in 2H19, both also approximating consensus expectations. Japan's forecasted weakness in the 2H is due to the VAT hike scheduled in October. Lastly, China's official GDP should be approximately 6.0% and 6.4% HoH SAAR in the 1H19 and 2H19, respectively. Here too, personal consumption will likely lead the way, while fiscal stimulus will begin providing more support, as well. Overall, these results should re-assure risk markets, and corporate profit estimates should continue to show decent growth through 2019.

As for geopolitical issues, we still believe that such will be handled without crisis due to the strong economic incentives of all major players, but there are many situations that bear close monitoring, especially regarding China, the Middle East and BREXIT. Trade disputes with the U.S. and Europe, Canada and Mexico have settled down, but that with China has proven quite intractable. We assume 25% US tariffs on the $200BB tranche of Chinese exports to the U.S. will occur in the 1H but that the global economy can withstand such without too much dislocation. The conflict, however, has metastasized into sanctions and arrests related to national security, and into the real possibility of a break in supply chains and technological standards, which would be a large disruption to the world economy. This also increases the possibility that North Korea could become a hot issue again. In Europe, the Italian budget conflict has been ameliorated for now, but promises to be an occasional disruption in the future due to populist anger at slow economic growth, poor wealth conditions and immigration problems, neither of which are likely to be solved. France is suffering from these issues too now and the violence there is likely striking fear in governments throughout Europe. Lastly, the U.S. internal political situation is too difficult to predict, and while market uncertainty related to impeachment and recriminations by both sides may rise at times, the chance of a major political upheaval remain slim.

Central Banks: Normalization except Japan

Our Fed call for 25 bps hikes in both September and December certainly seem correct, although our forecast for a pause in the 1Q, followed by hikes in the 2Q and 3Q is unproven, though not too far to current economist consensus. We now expect 4Q, 1Q and 2Q hikes and then a pause. As we expected, the ECB still intends to end QE in December. We retain our call for quarterly 20 bps hikes starting in 3Q19, but there is a decent chance that such could be pushed into 2019. We also add that moderate-sized TLTROs will be issued in the 1H. In September we expected the BOJ to remain on hold except that it would taper ETFs, but clearly this latter factor is off the table for a while. We still do not expect any BOJ hikes for the next four quarters due to the VAT hike in October 2019. As for inflation, we expect U.S. Core CPI to be 2.2% YoY in June, and 2.1% in December 2019; and as we expect the Brent oil price to be $66 and $68 at those periods, we expect the headline CPI to be 2.2% and 2.3% respectively, which are basically perfectly on target for the Fed. Overall commodity prices should also move mildly upward in 2019, primarily led by a recovery in oil due to OPEC regaining better control of the market. Although global growth should keep global commodity demand quite firm, investment speculation in commodities should diminish.

Flat USD in 1H, weaker in 2H and Low G-3 Bond Yields

Given our scenario, we expect G-3 bond yields to continue rising slightly in the next few quarters. For U.S. 10Y Treasuries, our target for end-March is 3.15%, while those for 10Y JGBs and German Bunds are 0.15% and 0.40%, respectively. For June-end, we expect 3.15%, 0.15% and 0.50%, respectively, and in the 2H, the U.S. should decline to 3.0%, while JGBs should remain flat and Bund yields rise slightly. This implies (coupled with our forex targets) that including coupon income, the Citigroup WGBI (index of global bonds) should produce a -1.2% unannualized return from our base date of November 30th through June in USD terms, and -1.3% through December. Thus, we continue to maintain an unenthusiastic stance on global bonds for USD-based investors. For Yen-based investors, the WGBI index in Yen terms should be -0.1% and -3.5%, respectively, and as for JGBs, we target the 10Y to have a -0.6% total unannualized return in Yen terms through June and similarly through December.

Regarding forex, although Fed policy will tighten faster than the BOJ and ECB, global worries about U.S. budget and trade deficits, coupled with an uncertain U.S. political situation, should restrain USD enthusiasm, so we expect the Yen and Euro to be basically flat through June from our base date levels of 114 and 1.13, respectively. The Yen and Euro should, however, strengthen to 111 and 1.16 at end-December. Meanwhile, our call for the AUD:USD is for 0.72 at end-June and 0.74 at end-December.

Moderately Positive on Global Equities

Our new scenario is positive on global equities (as it has been for us during virtually the entire period since the Global Financial Crisis), as decent economic growth should bring good corporate earnings growth, while mildly rising interest rates should not curtail valuations much. The increasing realization that the Fed will pause, if not halt, its hiking cycle in the 2H, should help all equity markets. Meanwhile, relief on BREXIT and the U.S.- China trade war would also be a major positive for markets. Aggregating our national forecasts from our base date of November 30th, we forecast that the MSCI World Total Return Index will increase 6.6% (unannualized) in USD terms through June and 11.6% through December. Clearly, this suggests a reasonably positive stance on global equities for USD-based investors (and Yen-based investors, as well).

In the U.S., decent global economic growth, coupled with accelerating corporate operational efficiency, should more than offset the headwinds from mildly higher interest rates and political uncertainty, so the equity backdrop is positive, especially as SPX CY18 and CY19 EPS estimates have risen by another 1% since our September meeting and the PER based on 12-month forward EPS has fallen to 15.8 times from 16.8. A continued high level of share buybacks also will help support the market. Given all of this, we expect the SPX to hit 2884 (5.6% total unannualized return from our base date at end-November) at end-June, and 2957 at the end of 2019 (9.2% return).

European equities have been quite disappointing for the last three quarters, especially in USD terms. Some European macro economic data, especially exports and auto production, are still showing signs of deceleration, but GDP should be reasonably solid going forward, especially by mature-country standards. Political risk continued to haunt the markets, but fears of an Italian crisis have greatly decreased in recent days and better BREXIT conditions would greatly boost investor sentiment. Continued low interest rates and decent earnings increases from global economic growth should help its equity market rebound. Notably, rising oil and commodity prices, to which UK and European corporations are highly geared via multinational companies, should also boost corporate earnings after a very negative 3Q trend for such. Furthermore, the European PER on next-12-months EPS is low at 12.8 and will likely rise somewhat, so we see the Euro Stoxx index rising to 375 and the FTSE to 7500 at end-June, and to 380 and 7800 at year-end, which translates to 10.7% and 16.8% unannualized MSCI Europe returns in USD terms for those periods. Consensus EPS for CY18 and CY19 decreased 2% since our last meeting, but YoY growth for CY19 remains solid at 10% with a high dividend yield of 3.5%.

Japanese equities have also disappointed, falling significantly in USD terms during the reporting period, but now valuations are very low, at 12.5 times next 12-month EPS, and EPS growth is still looking positive ahead. Indeed, although consensus EPS for CY18 and CY19 decreased 2% since our last meeting, YoY growth for CY19 remains very good at 9%, with a dividend yield of 2.3%. Global trade disputes likely have played a key factor in reducing investor sentiment regarding the country, with Chinese demand for Japanese capex goods declining significantly. Japan’s domestic economy also suffered from natural disasters in the 3Q, but the 4Q should rebound nicely. Companies still have high operational gearing to continued global economic growth, so our expectation for improved sentiment for the latter should lead to greater interest in Japanese equities. Meanwhile, corporate governance continues to improve (despite a few hiccups), with share buybacks continuing to be very supportive, so we expect TOPIX at end-June to be 1752 with 1862 through December for total returns of 5.1% and 16.8% in USD terms, respectively. There is some uncertainty about how volatile economic sentiment will be in the lead up to the proposed VAT hike in October 2019, as the last hike caused major disruption, but we think the bumps should be quite mild this time as the economy is now on much sturdier ground and consumers realized that they over-reacted the last time.

As for the Developed Pacific-ex Japan MSCI, it too has been disappointing due to trade fears, but we expect Hong Kong and Australian equities to perform well ahead, leading to an 8.4% unannualized return in USD terms through June and 18.3% through year-end. Better confidence in global growth, reasonable equity valuations, decent earnings growth and continued low global interest rates all play major roles in these expected returns. Hong Kong property prices are likely to decline, but this is greatly discounted in share prices already and any sense of an impending pause by the Fed should especially help sentiment there. Once again, the major risk is trade disputes, particularly between the U.S. and China, but that risk is greatly priced into the markets by now and the topping out of sanctions at 25% on the $200BB tranche would be a major positive for these markets.

Investment Strategy Concluding View

There is no doubt that geopolitical tail risks remain quite large, but the Global Investment Committee remains moderately positive because the net impulses for global economic growth and corporate profits continue to improve. Thus, similar to our meetings of the last decade, this justifies a positive stance on global equities. Meanwhile, global bond yields should rise slightly, so we maintain an unenthusiastic stance on global bond returns, especially compared to U.S. short term fixed income rates. Clearly, there are significant downside risks to global risk markets in 2019, but many upside risks as well.

ASIAN CREDIT OUTLOOK 2019

Summary

The macroeconomic backdrop for Asian countries should remain broadly neutral for credit performance in 2019. GDP growth is expected to moderate across the key economies, although we don't expect any hard landing scenarios to materialize.

We expect fiscal policy to remain supportive of growth in most Asian economies, notably China, and act as a stabilizer to weakness in external and private domestic demand. Given the national elections in India and Indonesia, some fiscal slippage is to be expected, although the broad fiscal consolidation trend in these countries remain intact and is likely to resume in coming years. Last but not least, with inflation remaining subdued, we expect monetary policy to stay neutral to accommodative across most Asian economies.

In 2019, the focus will be more on credit selection across countries and sectors. Credit with a strong management and track record of operating through tough business and funding environments will be preferred. We generally still prefer shorter-dated credit, both in Asia IG and HY. Within China HY, we have a preference for short-dated property bonds over industrial.

2018 Market Review

2018 turned out to be a year of high volatility for Asia credit. A strong rally in January, prompted by optimism on the global economy, proved to be short-lived. Subsequent firmer inflation readings and rising oil prices triggered heightened expectations that the Fed could accelerate monetary policy tightening, leading to a spike in UST yields, as well as an exodus of funds from EM including Asia. US trade policy took center stage soon after, with the US getting embroiled in a tit-for-tat trade battle on several fronts. Notably, US President Trump's hard line stance on trade was most pronounced against China. Uncertainty over the outlook for global trade provided a cap for UST yields. Meanwhile, idiosyncratic concerns in Turkey and Argentina adversely affected investor sentiment for risky assets. The resulting sharp falls in some EM currencies including the Indian Rupee (INR) and Indonesian Rupiah (IDR) added to investor concerns and pushed credit spreads wider. Bank Indonesia (BI) lifted interest rates by a total of 175bps so far in this cycle, largely as a policy response to stabilize the rupiah.

In addition to intensifying trade tensions, there were concerns that China's deleveraging efforts have started to tighten financial conditions onshore and further weigh on domestic growth, particularly on the investment and consumption fronts. With the domestic slowdown looking to be worse than expected, Chinese policymakers started rolling out (both monetary and fiscal) easing measures. The loosening of policies in China provided a lift to sentiment in July and August and reversed some of the spread widening since February 2018. However, the Asia credit market succumbed to a sell-off anew in September and October, as disappointing earnings results from US companies caused a significant correction in global equities, prompting USTs to rally. Toward the end of the year, the market tone turned more constructive on expectations that the Fed is close to ending its cycle of rate hikes, and news that the US and China have re-opened negotiations to ease trade tensions.

Over the year, a shift in supply and demand dynamics provided yet another headwind for Asia credit, particularly for the high-yield space. Tighter liquidity conditions in the onshore Chinese market caused offshore bond supply to remain heavy, but simultaneously moderated demand from onshore investors. Overall, the JACI Composite returned -1.63% year-to-date. Asia high-grade lost -0.95%, with spread widening 48bps to 206bps. Asia high-yield corporates lost 3.92%, underperforming as spreads widened 164bps to 620bps.

Key risks to watch for in Asia credit next year include:

1. **Trade and US-China relationship**: The US and China are in negotiations to resolve the trade conflict, with a tentative deadline of 1 March, 2019, to reach a deal. Failure to come to a compromise, on trade and other strategic issues, will likely be negative for credit spreads and the broader risk environment.

2. **China**: A sharper-than-expected slowdown in China due to weak external demand and tight onshore funding conditions could weaken investor sentiment significantly.

3. **Commodity prices**: While current account deficit countries that are net oil importers would benefit from lower crude oil prices, a sharp and abrupt fall could lead to greater uncertainty and damper investor risk appetite. Lower commodity prices also affect the credit fundamentals of upstream companies in the Oil & Gas and Metals & Mining sectors.

4. **Rise in risk-free rates**: Despite the pervasive dovish sentiment in the US Treasury market at the end of the year, a sharp rebound in UST yields due to higher-than-expected wage and price inflation remains a key risk for 2019.

5. **Supply**: Demand for Asia credit is expected to stay decent despite a more challenging EM hard-currency flow environment. The gross supply of new issues should remain strong, especially if higher onshore funding costs and/or more limited availably of credit onshore causes Asian issuers to turn more toward the USD credit market. However, with sizeable redemptions in 2019, net supply should be manageable.

2019 Asian Credit Outlook

Fundamentals

Macro

The macroeconomic backdrop for Asian countries should remain broadly neutral for credit performance in 2019. GDP growth is expected to moderate across the key economies, although we don't expect any hard landing scenarios to materialize. Export growth is likely to slow as the impact of existing tariffs began to be felt more forcefully. However, import growth is likewise expected to moderate, especially if commodity prices remain broadly stable to moderately lower on global growth concerns. The contribution of net exports to GDP growth is therefore expected to be only slightly less supportive relative to 2018. Countries with large current account deficits will continue to be the focus for credit investors and remain vulnerable to spikes in the USD, US interest rates and crude oil prices.

We expect fiscal policy to remain supportive of growth in most Asian economies, notably China, and act as a stabilizer to weakness in external and private domestic demand. Given the national elections in India and Indonesia, some fiscal slippage is to be expected, although the broad fiscal consolidation trend in these countries remain intact and is likely to resume in coming years. Last but not least, with inflation remaining subdued, we expect monetary policy to stay neutral to accommodative across most Asian economies. This is particularly relevant in China where the tightening in onshore financing conditions had exerted negative pressure on the performance of both onshore and offshore USD credit in 2018. With the recent policy focus on ensuring adequate financing to the private sector and provincial public infrastructure projects, we expect credit conditions in China to improve next year.

With 2019 expected to be a year of moderation for GDP growth and other sovereign credit metrics, we anticipate little change in Asia's sovereign rating outlook.

Credit

We expect Asian corporate credit fundamentals to remain broadly stable. We expect broadly stable credit profile for Asian banks, underpinned by still solid economic condition, strong capitalization, and stable asset quality. The ability and willingness of banks to extend credit remain firm. In China, efforts continue to strengthen the regulatory framework governing the major banks, which helps to mitigate systemic risk in the overall financial system despite tighter liquidity and rise in onshore corporate defaults from low levels.

The investment grade (IG) corporate sector in Asia has shown improvements in leverage and debt servicing ratios over the last few years. While the deleveraging trend is not likely to stretch much further with the neutral macro backdrop resulting in slower earnings growth and higher funding cost, we expect no significant deterioration in the credit profile of Asia IG corporates. Ratings bias is therefore expected to be broadly stable through 2019.

On the high-yield (HY) side, there will likely be greater differentiation, both between and within sectors. The China property sector will likely see slower growth in 2019. However, strong contracted sales achieved in 2018, lower land-banking activities, and less acute onshore funding conditions should help to mitigate the risks. Larger developers will undoubtedly fare better than smaller ones given their better access to financing and greater array of saleable resources. Credit metric trends for China HY industrials will be more credit specific, although still tough onshore financing conditions will exert pressure across the sector. The Asia HY metals and mining sector could see some pressure given the expectation of weaker commodity prices from 2018 average.

We believe refinancing risk remains manageable overall, although the Asia HY default rate is likely to remain elevated, relative to its history, in the 2% to 3% range due to tough operating environment and still tight credit availability affecting select issuers with tight liquidity.

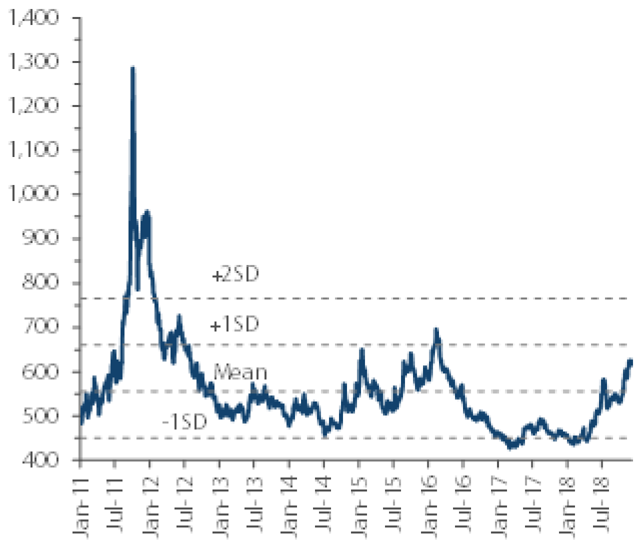
Valuations

Both high-grade and high-yield spreads have cheapened over the course of 2018. High-grade spreads at 206bp are near the historical post global financial crisis (GFC) mean level. With the high-yield underperformance in 2018, high-yield corporate spreads at 620bp have cheapened to a level last seen in 2016. With the sell-off in UST yields, high-grade yields have risen to a more attractive level of 4.9%; a level last seen during the taper-tantrum in 2013. Similarly, the high-yield corporate yield has risen to 9.05% -- a level last seen in 2012 after the European crisis.

Chart 1: Asian High-Grade Spread

Source: J.P. Morgan, Bloomberg, as of 6 December 2018

Chart 2: Asian High-Yield Corporate Spread



Source: J.P. Morgan, Bloomberg, as of 6 December 2018

In 2018, against US credit, Asian credit broadly underperformed despite some late retracement in spread differentials in late 2018. Lower rated credit underperformed more than those in the higher rated segment. In 2018, the spread differential between Asian and US A-rated ended 3bp tighter, despite underperforming for most of 2018. BBB-rated differential widened by 18bp to 72bp. Asian HY underperformed with BB-rated and B-rated widening by 122bp to 156bp and by 238bp to 240bp. At this point, there is more value in the BBB- category for high-grade and in the high-yield segment where the spread differential is at the wider end of the recent historical range.

Technicals

The technical backdrop for Asia credit is likely to remain lacklustre into 2019. The external flows into EM funds should remain muted given on-going macro concerns and tighter monetary policy environment. Indigenous demand for Asia credit should also remain intact as seen from the take-up in primary issuance despite the weak backdrop for most of the year. However, with onshore liquidity still tight, in particular for Chinese high-yield issuers, USD issuance is likely to weight on secondary spreads.

Gross supply is likely be around USD226bn, as seen in 2018. This should be manageable, with a sizeable amount due to redemptions of existing issues of around USD149bn.

Return Expectations

Asian credit returns are likely to be subdued in 2019, reflecting a continuation of a tighter US monetary policy, heightened macro-headwinds from the China-US trade tensions, while acknowledging that valuations, in particular for high-yield, have improved. Risk-free rates are expected to continue rising, albeit at a slower rate than that in 2018. For Asian IG credit, the expectation is that credit spreads will end 2019 with a small widening on the back of the various macro risk factors, offset by spreads that have cheapened and higher starting all-in yields. Bond carry will again be the main driver of returns as the continued rise in UST yields will continue to negatively impact returns. We expect modest positive returns for Asian IG bonds in the low single-digit range.

Asian high-yield spreads could end 2019 marginally wider from the current 620bp. In 2019, Asian HY is expected to outperform IG due to the shorter duration and higher carry. Comparing IG corporates to HY corporates, the spread ratio of 2.81 higher than the mean of around 2.50, also suggests a tilt towards HY corporates.

Strategy

In 2019, the focus will be more on credit selection across countries and sectors. Credit with a strong management and track record of operating through tough business and funding environments will be preferred. We generally still prefer shorter-dated credit, both in Asia IG and HY, where valuation has been become dislocated relative to fundamentals for some credit due to the broad market weakness, especially towards end-2018. Within China HY, we have a preference for short-dated property bonds over industrial.

In terms of yield curve positioning, we remain underweight duration relative to benchmarks given the risk of widening credit spreads in the longer-end of the curve, as well as the risk of UST yields rebounding from end-2018 levels.

We remain overweight financial subordinated debt in countries with strong banking systems such as Singapore and Hong Kong. We continue to like China infrastructure and the stronger segments of China quasi-sovereign, while remaining wary of technology due to sector headline risks. We remain underweight Philippines sovereign and South Korea credit on valuation. We are neutral Indonesia in IG, but are overweight the sovereign sector versus quasi-sovereign and other sectors.

Country & Sector Outlooks

Countries

China

Chinese economic growth is poised to slow further in 2019, prompted largely by the lag effect of credit tightening. However, the economy will avert a hard landing, as authorities have begun to recognize the degree of pessimism within the real economy and onshore financial markets. The trade ceasefire with the US has reduced the urgency for China to introduce large scale fiscal measures. Nonetheless, the Politburo's recent declaration of the need for timely measures to counter growing downward economic pressure, signals that the government stands ready to roll out significant fiscal and liquidity support for the economy. Meanwhile, monetary policy has clearly shifted toward an easing bias.

We expect the recent rebound in inflation to be temporary and expect overall inflationary pressure to remain manageable in 2019, on the back of our expected moderation in growth. This, together with supportive monetary policy from the PBoC, should put a cap on interbank rates and limit the rise in government bond yields that may result from an increase in the fiscal deficit.

India

In 2019, the economy is likely to continue to register robust growth, helped in part by increased expenditure by the central government ahead of the general elections in April/May, and an improving investment climate. Meanwhile, we think inflation has peaked in India, as food price inflation is likely to moderate/remain stable. Nonetheless, we anticipate the headline number to remain close to 4% on a year-on-year basis. Hence, in the absence of a seasonal shock to food prices, we expect the RBI to maintain its monetary policy unchanged. On the general elections due in April/May 2019, we expect the current ruling party to remain in power, albeit possibly with a slimmer majority.

Indonesia

For 2019, GDP growth is likely to moderate, as BI's cumulative 175bps rate hikes this year filter through the broader economy. Moreover, the postponement/cancellation of some investment projects point to domestic investment likely being sluggish in the coming year. Despite these factors, we expect growth to remain firm. Government policies to keep inflation stable and provide targeted assistance to households, together with election-related spending ahead of the April presidential elections, are likely to support private consumption.

We expect inflation to remain fairly anchored next year, given the pre-emptive hikes taken by BI. Improvement in the government's efforts to enhance food supply management across the country will also ensure that inflation remains manageable in the coming year. Against such a backdrop, our base case is for the Indonesian central bank to leave interest rates unchanged in 2019, barring a further sell-off in EM currencies.

Politics have started to take the spotlight, as campaigning for the presidential elections in April 2019 has gone full swing. We expect the elections to be relatively uneventful, with President Joko Widodo being re-elected for a second term.

Sectors

Financials

We expect broadly stable credit profiles for Asian banks, underpinned by still solid economic conditions, strong capitalization, and stable asset quality. In China, the regulators have made progress in reducing systematic financial risk by curbing shadow banking and interbank lending activities. We expect larger Chinese banks to be in a better position to tide over the challenging macro conditions. In Hong Kong, we believe banks have sufficient capital buffer to withstand a potential property market correction. In South Korea and Singapore, we see stable operating environments boding well for capitalization, profitability and asset quality.

Therefore, we are overweight subordinated debt from China, South Korea, Hong Kong and Singapore. We believe capital instruments from these countries still offer attractive valuation compared to their senior papers, although supply is likely to pick up next year given that subordinated debt issued by Chinese banks back in 2014 will likely be called and refinanced.

We are positive on China Leasing companies senior debt with the leasing to bank senior pickup widen to ~40bps from the tights of ~25bps. These bank affiliated leasing companies are expected to receive timely support if required from their parent banks with explicit liquidity/capital support under the articles of association of leasing companies. China asset management companies' (AMCs) saw regulators introducing rules to encourage them to refocus on their traditional distressed assets business and to deleverage. We view AMC's shift back to core business of traditional asset management as credit positive. With China's slower economic growth in the coming years, their systemic importance will increase. Therefore, we continue to like the AMCs from a medium story perspective.

Oil & Gas

Oil prices declined significantly in 4Q 2018. Brent was down 30% after hitting its peak of $86 per barrel in October. It is currently hovering around $60 per barrel. Despite the sharp decline, Brent has averaged around $70 per barrel in 2018, which is still 25% higher than the year before. Upstream oil companies are still expected to report a significant full-year growth in earnings for 2018. Downstream companies will benefit from lower oil prices due to lower feedstock costs. Working capital needs will also be lower and margins will improve as a result. In the near term, downstream companies are likely to report some inventory losses due to the large swings in oil prices. These will largely be one-off impacts that do not alter the long-term credit fundamentals of these companies.

Looking toward 2019, the oil futures market indicates expectation for prices to remain range-bound at the current level of $60 per barrel. Saudi Arabia and Russia recently agreed in the G20 meetings to extend cooperation towards production cuts into 2019. This will help to stem further declines in prices.

At current price levels, we expect Asian oil & gas companies to have a stable credit profiles with little to no impact to their credit ratings. Oil majors in Asia are mainly represented by national oil companies that enjoy strong support from their respective governments. Therefore, despite the lower profitability from lower oil price, we expect the credit fundamentals for these companies to remain strong and resilient.

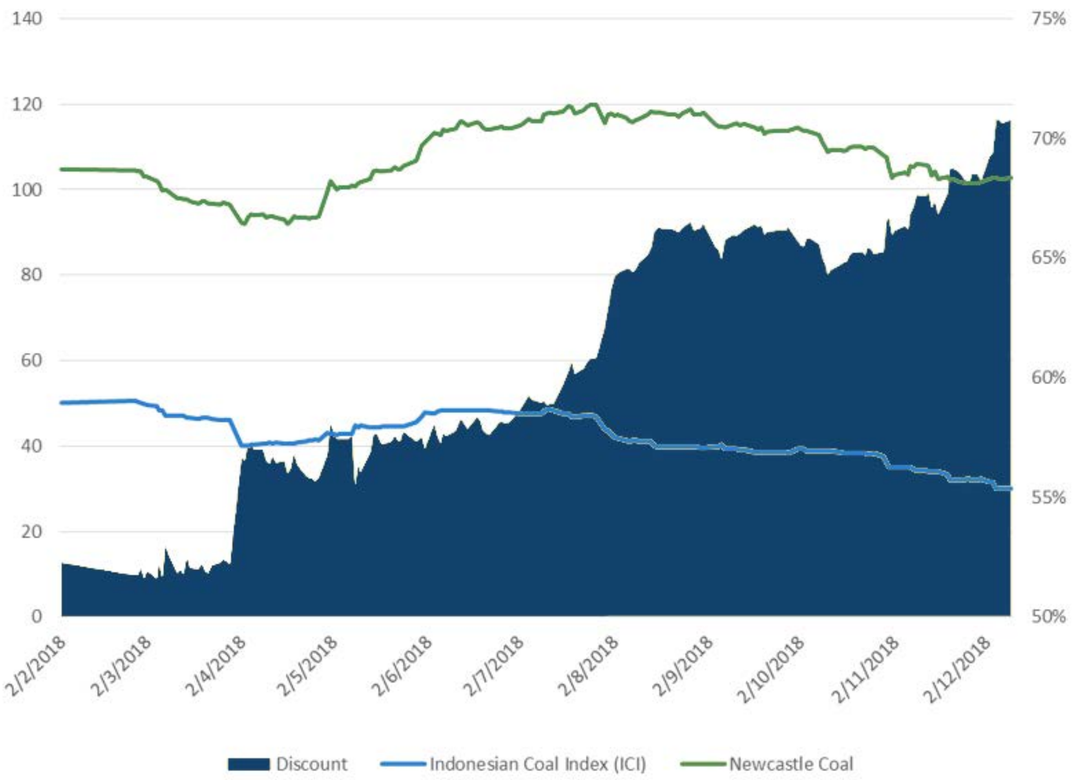
Coal & Mining Services

China's economic growth is expected to slow in 2019. Lower economic activity will drive down energy demand, and impact coal prices. In mid-November, China's NDRC imposed port restrictions on both metallurgical and thermal coal. As a result, seaborne coal prices have been under intense price pressure.

The impact of the import restriction is most pronounced on low-grade coal, which mainly originates from Indonesia. This is seen in the diverging price trends between the Newcastle coal index and the Indonesian Coal Index. While Newcastle coal price remains above $100 per tonne, Indonesia's 4200kcal ICI index has fallen almost 40% from its July peak and is trading near $30 per tonne. Should low-grade coal prices persist at these levels, some of the smaller Indonesian coal miners are likely to come under pressure. As for contract mining services companies, we expect a marginal deterioration of their credit profiles. They have better earnings visibility with less correlation toward coal prices, compared with upstream mining companies.

Overall, we expect credit profiles for companies in this sector to weaken in 2019, driven mainly by weaker coal prices. However, the deterioration will be buffered by the improved capitalisation, following two years lofty coal prices. Refinancing risks will be minimal as well, as there are no notable bond maturities over the next twelve months.

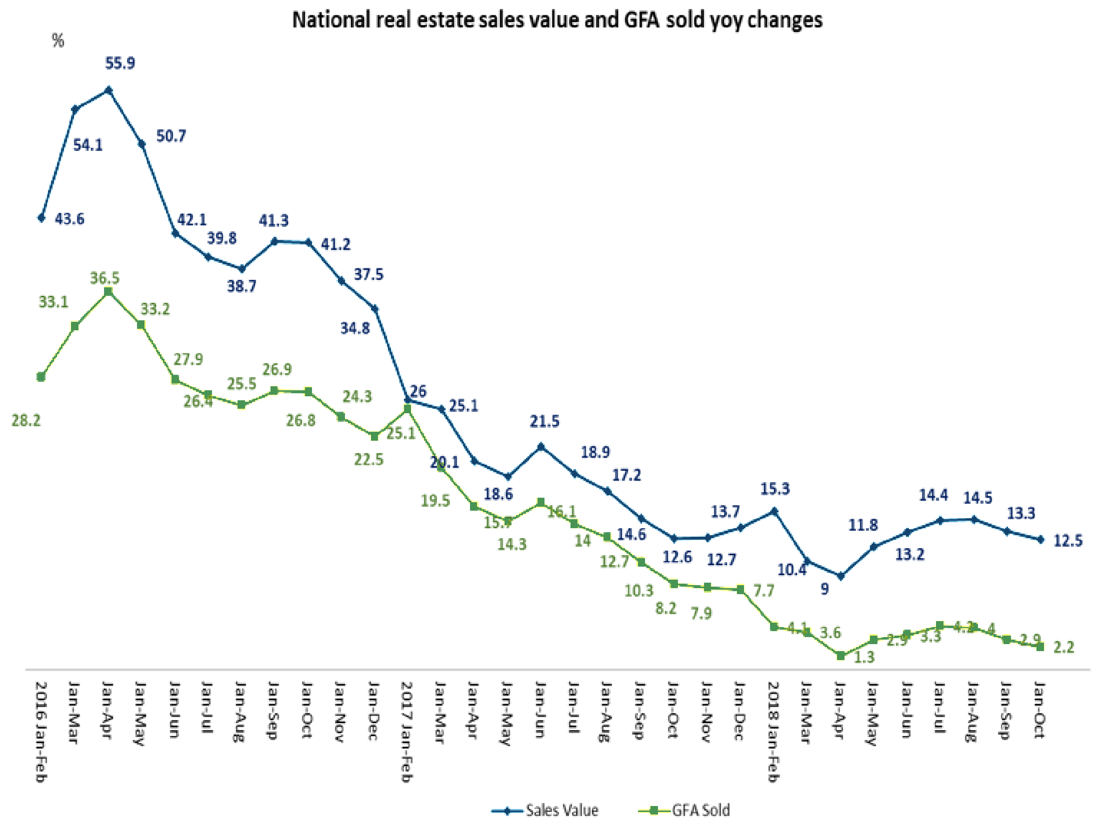
Chart 3:



Property

2019 should be a year of stabilisation after approximately two years of continuous tight government policies. Fine tuning of policies has begun in certain cities and more will follow suit if market sentiment worsens further. The consolidation pace for the sector to pick up as credit policy toward the sector remains tight. 2018 has been one of the best years for property developers with the national residential sales amounting close to CNY 12trn. However, we expect the national residential sales to decline moderately as volume decreases, while prices remain stable in 2019. The volume decline will come mainly from Tier 3 and lower cities, as shanty town redevelopment slows after the successful inventory de-stocking efforts. Talks about the implementation of a real estate tax have been ongoing for the past few years. The probability of implementation in 2019 is unlikely, but more likely a 2020-2021 event. However, the impact from the real estate tax is likely to be minimal if one takes reference from the Shanghai and Chongqing trials, as we await further details from the central government. As the NDRC imposes restrictions on the usage of bond issuance, that of property developers should also be lower in 2019. The total refinancing need for 2019 is approximately USD 25.5bn, comprising USD 14.7bn of maturing bonds and USD 10.8bn of callable bonds. We are cautiously optimistic on the sector as we enter 2019. We prefer the short-dated bonds from quality developers who have demonstrated financial prudence over the various cycles, while staying away from highly leveraged smaller issuers.

Chart 4:



Technology

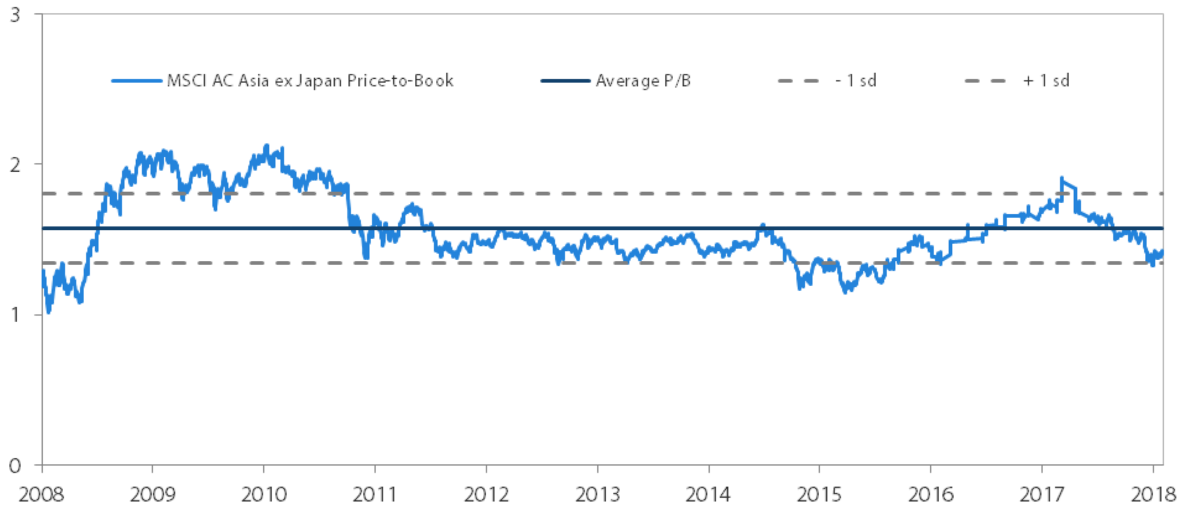
We expect the Chinese Internet companies to have healthy revenue growth in 2019, but at a slower pace versus last year. Profit margins will continue to moderate due to increased investments in new business initiatives, and higher spending on contents, customer acquisition and customer retention. On the fundamental front, we expect credit profiles of Internet companies to be stable due to their strong cash balance, and their investment activities to be within cashflow generation capability. On the valuation front, the Chinese Internet sector looks increasingly attractive versus similarly-rated Chinese SOEs, and US technology companies. On the technical front, sentiment for the sector is very weak given heightened key executive risks, regulatory clampdown, and continued US-China trade tension, which could take a long time to resolve.

On the fundamental front, we think US-China trade tension to have less direct impacts on the operating performance of China Internet companies, and more impacts on the hardware tech companies. Valuation of hardware tech companies is now very attractive comparing to historical levels and peers, but this could stay for sometimes until the US-China trade tension eases. Hence, we have underweight recommendations for both the Internet and hardware technology sectors.

ASIAN EX-JAPAN EQUITY OUTLOOK 2019

One thing is for sure, 2019 will not be a dull year. We expect more headlines and drama on trade but would pay more attention to underlying policy direction at both the Federal Reserve and Chinese authorities, as bigger markers for improved fortunes across Asian markets. At the local level, almost half our markets have general elections next year and although most are expected to yield investor friendly results, these can present undesired surprises. Against this uncertain backdrop, focusing on the first principles by investing in quality franchises benefiting from structural tailwinds is the way forward. Valuations remain extremely attractive across large swathes of the Asia ex-Japan universe, particularly in China, Indonesia and select areas within India.

Figure 1:



December 2018 marks the 40th anniversary of Deng Xiaoping's famous reform drive, finally opening up China to the world and setting the country on a path to greater development and prosperity. Despite some slight easing on the ongoing deleveraging campaign, we expect the current regime's push for quality over quantity to persist, with some support to consumers. A number of sub-sectors have endured regulatory headwinds this year which has resulted in some very attractive valuations in what should be structural growth areas. We would also highlight the possibility of accelerated A-share inclusion to major global indices next year as another potential catalyst for investors. The Fund has added software to other core long-term holdings of insurance, healthcare and select consumer sub-sectors.

India, as always, remains a story of contrasts. The macro narrative remains tepid, with slowing growth, persistent core inflation, and rising political risk, even as the companies themselves are singing a more bullish tune. We retain our structurally positive view, given a number of reforms in recent years, but have tempered our positions on account of stresses within the financial sector, rich pockets of valuation and growth uncertainty in the run up to national elections. We remain focused on strong private sector banks and the real estate sector, where we believe regulatory led consolidation will yield huge opportunities for the strongest players.

In South Korea, President Moon's approval ratings are languishing, even as conciliatory moves toward the North show some progress, owing to a lacklustre domestic economy. Furthermore, the government's populist policies remain a concern. The move to increase minimum wages has in part been responsible for the uptick in unemployment rates. In addition, the politically driven crackdown on chaebol, via an extraordinarily hawkish stance on the economy's promising nascent industries, could have further negative ramifications on the economy in the long run. In the tech sector, trade issues together with waning demand growth and capacity expansion are likely to lead to further downside in both the memory and hardware sectors, which are large components of the Korean and Taiwanese markets. Hence, we remain selective across both markets with a focus on healthcare, some niche technology companies and electric vehicles.

ASEAN offers dichotomous paths. Incipient consumption recovery and potentially easing political torpor in Indonesia offer promise, while the opposite is true in Malaysia, which we continue to observe from the sidelines. Delayed monetary tightening in the Philippines is yet to work its way through the economy, which warrants a wait-and-watch approach. On the other hand, signs that Thailand might hold elections next year, even as a healthy balance of payments will allow it to handle macro headwinds in the form of a stronger USD or lower oil prices, makes it a good candidate for further investment.

DEVELOPED MARKETS OUTLOOK 2019

Shakespeare once said, "present fears are less than horrible imaginings." As we come to the close of 2018, we have observed equity markets turn double-digit returns to losses, an aggressive rise in interest rates and a modest increase on the perception of escalating tensions surrounding the world's two largest economies. The fact remains that the US in on the verge of its longest post WWII expansion in history, with an underlying backdrop of positive global GDP growth as well. While we expect central banks to moderate either the pace of hikes or the tone of guidance, the increased volatility toward the year-end has re-introduced a more robust risk-premium into the market. We believe this will provide a catalyst for increased potential for returns in 2019, on the backdrop of wider credit spreads and lower equity prices. Additionally, we think the resilient economy will continue to provide headwinds for longer-term interest rates, albeit at a relatively moderate pace compared with last year's normalization of interest rates.

Europe Outlook

Political risk in Europe will remain a continuing theme into 2019. The elections to the European Parliament will take place in mid-2019 and will potentially be seen as a market event for the first time. Several national elections will also take place for EU member states in 2019. Populism has been and will remain an ongoing force for European elections. Populists will further contribute to risk premiums in European markets, limiting reform efforts on deficit reduction and the banking sector, while promoting increased segregation in lieu of integration. The risk of snap elections will remain a persistent threat to market stability, with several fragile coalition governments at risk to populist agendas.

Elsewhere, Brexit stills weighs heavily on the outlook for the UK, where the implications of the UK leaving the European Union have yet to be settled. The position of Theresa May as PM seems confirmed for now, however what is yet to be confirmed is the nature of the exit, and whether the deal May's government agreed with the EU will pass in the UK Parliament. We expect a deal to eventually come to pass but there will be more challenges along the way. The chances of a delay in leaving on 29 March will increase until she is able to get the number of votes needed to pass in Parliament and additionally a second referendum could transpire. With the assumption of a deal, we expect there to be upside in Pound Sterling, which could reach 1.40 GBP/USD. But if there were to be an exit with a no deal, the range will be 1.15 or lower.

The fluctuating Brexit negotiations make it harder to make a prediction on the course of the BOE. If a deal is agreed, we look for two further hikes in May and November 2019, making the Bank Rate 1.25%. The obvious risk is if Brexit negotiations collapse and economic growth stalls, that would prevent any rate hike and the potential need for further stimulus from the central bank. Conversely, a clear Brexit deal could bring a positive spillover to the economy and bring forward the timetable.

On a much broader view, we think the Eurozone will continue to generate moderate growth with subdued inflation. We note that Mario Draghi's term as president of the ECB ends in October 2019, and there is no clear favorite for his replacement. Whomever the successor, they will likely have to maintain a dovish tone with no expectations of a rate hike until 2020 at the earliest. While the end of QE will occur as 2018 closes, we think the ECB will be apt to maintain its balance sheet for the foreseeable future, akin to the Fed's four-year balance stability that ended in October 2017. Given the large maturity concentrations, especially within the ECB's holdings of German assets, we expect the ECB needing to focus on diversification, as it reinvests maturing in bonds. We think it more likely that the ECB will institute an operating twist, spurring continued flattening in core and semi-core curves.

US Outlook

Across to the US, we think the Fed will likely move away from its regimented quarterly tightening pace, driven by increased data dependency and tempered by political risk from the US-China trade-war, as well as moderating economic growth. We think the US yield curve will likely approach inversion in the first half of 2019, based on slowing inflation data and growth outlook, but expect the curve to steepen in the second half of 2019, driven by a pickup in energy prices and the knock-on effects of the capex spending pick-up in 2018. The resurgence of volatility and data dependency will continue to define the US market going forward as the Fed will become increasingly cautious given growing uncertainty surrounding its economic outlook. The main risk here is that either the Fed, or market is wrong on the terminal Fed funds rate, our confidence lies in the market.

The US economy is enjoying the second-longest growth cycle in history and is on the way to becoming the longest on record. The duration of this cycle has surfaced the debate regarding when it will end. The Fed has raised interest rates eight times since December 2015 in an effort to normalize monetary policy from the emergency levels set after the financial crisis and this has added to the debate about when the current growth cycle may end. Although there are some imbalances appearing in the US, we see more positive signs that support a continued growth cycle than we do risks of recession over the next 12 to 18 months. The NY Fed's own recession probability model has risen in recent years but stands at 14.5%, which is relatively low, given historical levels ahead of actual recessions.

The flattening of the yield curve in the US has added to concerns about the economic cycle. The 2's 10's spread has declined from 260bps in 2014 to around 25 basis points. Recessions tend to be preceded by a Fed hiking cycle and an inverted yield curve. The Fed has downplayed this concern recently owing the low level of longer term rates due to a lack of term premium caused by quantitative easing and demand for duration. We agree with this view however, we think the potential for the curve to steepen or at least stabilize and not invert has increased recently. The current supply dynamics in the US, reduced demand caused by the ECB's intention to stop balance sheet expansion at the end of this year and the BOJ's recent decision to reduce QE purchases should put pressure on the long end of the curve. The combination of these events may influence investors to demand a higher term premium and therefore we may see longer duration underperform and a steeper curve.

There are many reasons to believe recession risk is low and for continued growth momentum in the US economy. Some of the key factors are the current strength in the labor market, very strong capex investment, and moderate inflation. Furthermore, despite the Fed's tightening cycle, broader financial conditions remain very easy in the US. Additionally, on the fiscal side of the equation government spending has increased and the regulatory environment continues to improve. While these conditions are supportive of growth they are also the reason US corporate leverage is now at record levels over $9 trillion, on the other side, corporate revenues have never been stronger. While we have observed spreads widen in the corporate space towards the end of 2019, we think this provides an opportunity to add to credit risk as spreads have now approached levels commensurate with positive long-term excess returns. With a limited probability of recession, we think the added carry offered by the corporate sector will defray some of the risk of higher underlying yields in the US.

EMERGING MARKETS OUTLOOK 2019

2018 review

Since performing well in the first quarter of the year, emerging market fixed income had a difficult time over the remainder of 2018. It looks highly likely that all the major segments of the asset class will end the year in negative territory in USD terms. At the time of writing this outlook, local debt was the worst performing segment in EMD (down ~8.7% - JPM GBI-EM GD), followed by external debt (down ~4.8% - JPM EMBI GD) and corporate debt (down ~2.0% - JPM CEMBI BD).

This marks a sharp turnaround in the fortunes of emerging debt, which performed strongly over the previous two years. So what exactly caused emerging bonds to fall for most of the year?

It all started off with the ongoing strength of the US economy. While we were optimistic about emerging debt's prospects in our 2018 outlook, we did point out that Fed hikes were a risk to the asset class, and this is exactly what panned out. As it became clear that the US economy was growing stronger than other global economies, thanks to President Trump's tax cuts and increased government spending, the markets priced in further rate hikes by the Fed, leading the USD to appreciate and emerging market currencies to fall.

In addition, a combination of robust US demand and higher geopolitical risks including the war in Syria, Iran nuclear deal and Venezuelan crisis, led to a surge in oil prices, with Brent briefly topping $85 per barrel in October for the first time in four years. Higher oil prices saw a marked re-acceleration in the pace of headline inflation this year. But they also lead to a significant erosion in the terms-of-trade for major oil importing emerging markets, adding further downward pressure on emerging market currencies, as their balance of payments positions deteriorated. This created a "perfect storm" for some of the most troubled emerging economies, as the growing need for external financing coincided with rising costs and declining availability.

Many central banks in emerging markets were forced to hike rates in response. The most vulnerable eventually succumbed to full-blown currency crises, including Argentina (which raised interest rates to 60%) and Turkey (which saw the lira plunge to its lowest-ever level). There were fears that similar crises would develop elsewhere in the emerging world. Investors suddenly reawakened to the risks of South Africa sliding toward full junk status, disappointing growth in Brazil and the need to tackle the budget deficit, and another round of sanctions looming over Russia's head. All of which contributed to deteriorating sentiment, investor outflows and general market weakness.

Aside from a number of idiosyncrasies, emerging markets also faced various other external shocks throughout the year. Balance sheets of the G4 central banks finally started to contract and the gradual removal of their massive bond-buying programmes began to have an impact. Emerging markets have benefited greatly from quantitative easing, as their higher economic growth and relatively high interest rates have made them attractive destinations for hot money flows. But as global liquidity tightens, they're vulnerable to capital outflows. President Trump's aggressive rhetoric about trade was another headwind for the asset class. Indeed, any full-blown trade war with China would impact growth across the emerging universe, and the president didn't just focus on China, he also singled out a number of other emerging countries including Mexico and South Korea, for what he called "unfair" trading practices.

Going into 2019…

The consensus outlook for emerging markets in 2019 is much less optimistic than it was as we entered this year. The general expectation is that the major central banks will continue to tighten liquidity through rate hikes and/or balance sheet reduction throughout next year. As we've seen, tighter liquidity is a major headwind to emerging market assets, not least because emerging market government debt stands at its highest level since the 1990s. What's more, private sector credit in China remains a concern.

However, we see a glimmer of hope that could come from a moderate growth slowdown of developed economies. Indeed, growth in emerging economies, which is more dependent on China, could start to look more attractive on a relative basis. Furthermore, the slowdown in China, which is slowly feeding its way through the emerging world, is already well accounted for.

In addition, we have to consider the eventuality of a prolonged trade war. But China would be able to mitigate its impact initially via a combination of monetary and fiscal stimulus, helping offset the impact of tariffs to a certain extent.

There are also country-specific issues to consider. As a result of its problems this year, Argentina is now under an IMF programme that has forced the government to put in place aggressive fiscal policies. While the government seems committed to follow through, the market is sceptical that the programme is sustainable, especially with a general election coming up at the end of October 2019. We are convinced that Argentina will stick to the programme and continue to receive support from the IMF, underpinning its economy.

There are also concerns about Turkey due to the country's highly uncertain political backdrop, weak currency and double-digit inflation. While the Turkish central bank responded late to the crisis it faced this year, many investors are concerned that the measures it has taken are not enough. We believe Turkey will be able to manage the impact of its slowing economy on its corporate and banking sector.

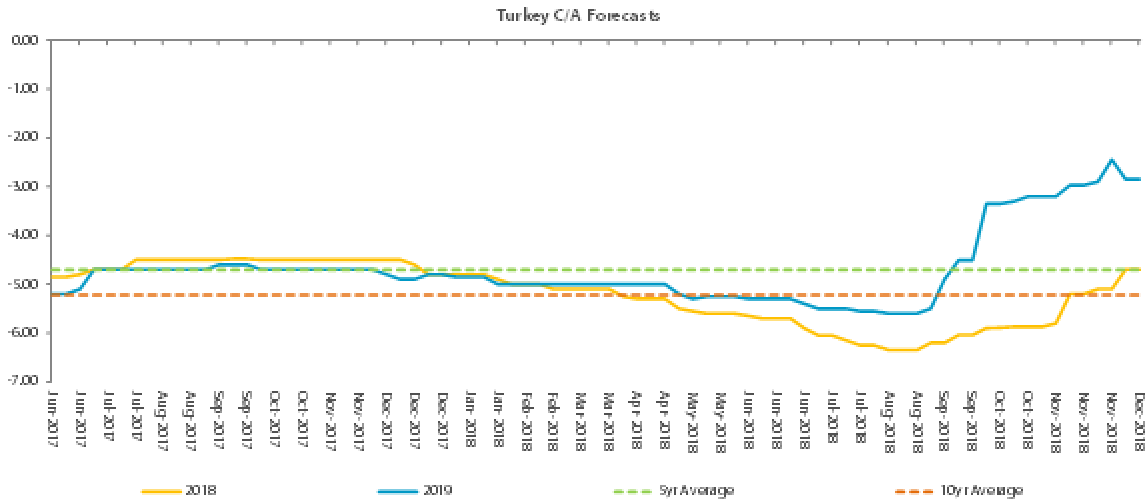
Meanwhile, South Africa now has in place a more business-friendly new president and is determined to regain its full investment-grade rating. Brazil, for its part, finally has a strong, if somewhat controversial leader, but time is running out and pressure is mounting for it to implement reforms in order to reduce its fiscal deficit.

Finally, there's another heavy election calendar next year, and these always create a certain level of uncertainty. The main votes to watch are in Indonesia, India, the Philippines, Thailand (if the military sticks to its promise), Argentina and South Africa. In general, we predict continuity, but upsets can never be ruled out.

A more constructive view

While the consensus view might be bearish, we strongly believe that individual emerging markets will be able to cope better next year. Most importantly, we think that there will be fewer US rate hikes than expected, as attention could turn to the possibility of a recession in the US in 2020 as we progress throughout next year. Fewer US rate hikes would be excellent news for emerging bonds. Neither do we believe that a full-blown trade war between China and the US is a likely outcome. President Trump has been flexing his muscles all year, but at the G20 meeting in November he agreed to a temporary truce with President Xi, suggesting that he may well be willing to compromise. It would be in the interests of both countries, and the rest of the world, if they were able to reach a deal. With its economy slowing, China can't afford an economic war with the US, so it is likely to make concessions. Of course, it's important to remember that emerging fixed income isn't a homogenous asset class. While some countries may suffer next year, that needn't be reflective of the asset class as a whole. More than ever, active management will be crucial to navigate through the volatility.

Glimmer of hope: forced current account rebalancing in Turkey



Sources: Bloomberg, IMF

GLOBAL CREDIT OUTLOOK 2019

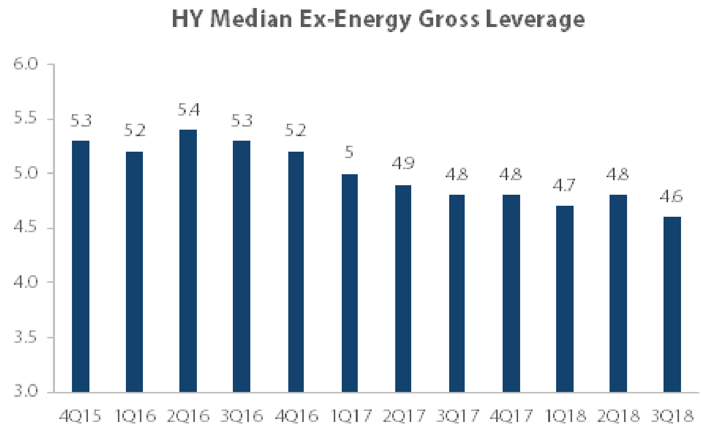
The year after the correction

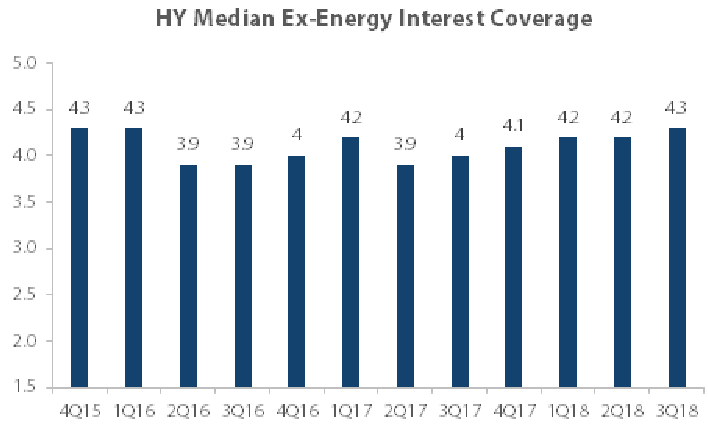
Credit markets didn't perform in line with the expectations we set at the beginning of the year and disappointed most investors. We have critically reviewed the past couple of months and have defined the intended path for 2019.

In terms of excess returns, 2018 has been the third worst year on record over the past 10 years, only beat by 2008 and 2011. In both of those years, the major developed economies were in or near a recession. In addition, these led to increased default rates in those years. Therefore, investors had good reason to reduce their credit exposure and demand higher premiums.

However, what about 2018 and potentially 2019? Neither Europe nor the US are close to a recession, not even after global leading indicators have weakened over the past couple of months. Furthermore, weakness in the latter hasn't found its way into corporate fundamentals. For example, in US HY we saw significant price weakness in Q418, and this sector of the market continued its multiple year path for lower leverage and higher interest coverage ratios **(Figure 1)**.

Figure 1:





Source: Credit Suisse as at 30 September 2018.

Given the healthy level of macro as well as micro fundamentals in the US, it's hard to justify the valuation correction that we have experienced in 2018. Nevertheless, it would be too easy to conclude that the market is now just cheap. As a result, a deeper and more defined analysis into the driver of the correction becomes necessary. By looking through the ups and downs of the credit market this year, it becomes clear that there wasn't a single culprit that caused the weakness, but rather several idiosyncratic events, which drove it. Some of them were more important than others.

Top of this list has been the trade war that has dominated the headlines for most of 2018. This was sparked by the Trump administration and now is mostly focused on the future trading relationship between the US and China. However, the introduction of automobile import tariffs would also have negative implications for Europe. Further down on the list in politics, uncertainties in Italy and the U.K. have also unsettled the market in 2018.

The trade war and political difficulties have created follow-up problems extending the list of drivers for this year's credit market weakness. One of these has been weakness in the cyclical sectors. In particular, car manufacturers and industrials, such as General Electric, have been vulnerable.

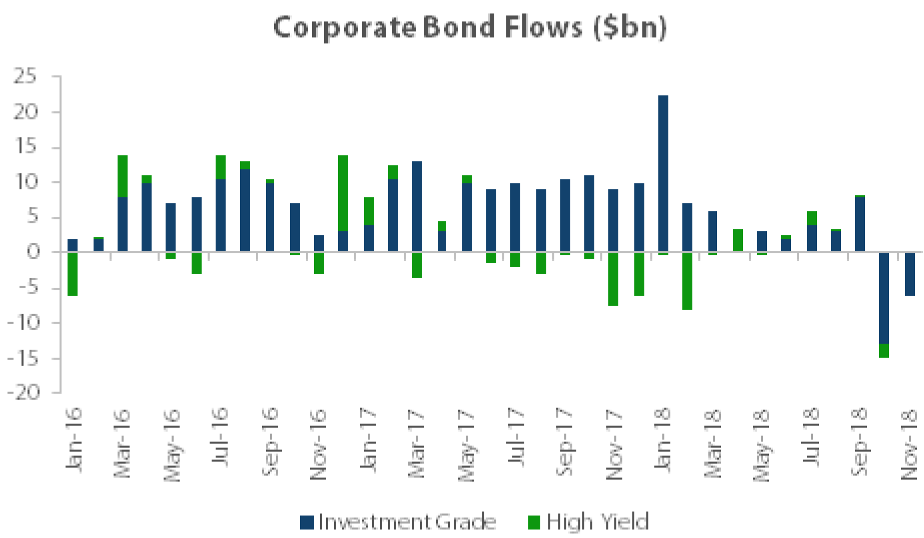
Another spillover effect has been credit outflows, with some credit markets, like EUR credit as well as US HY getting hit harder than others. The outflows combined with central bank monetary policy tightening have heavily weighed on credit market liquidity. Furthermore, the recent decline in oil prices caused pressure on spreads in the energy sector.

The crucial question for investors over the coming months will be how to reconcile the still sound fundamentals with the long list of negative credit drivers. Our answer would be to rank all drivers by importance and assess how interlinked they are, and to evaluate our investment themes and their interaction with the drivers.

We take the view that the most important driver going forward for credit will be the implications of the trade war. Although the truce reached between the US and China at the G20 summit in December is supporting credit markets, erratic communication from both sides will keep volatility elevated. We would advise an increase in the use of derivatives as the most cost-efficient tool to combat trade market volatility, as well as underweighting the auto and industrial sectors, which have a greater proportional impact because of the trade war.

We also see vanishing liquidity as a major problem. Central banks have tightened liquidity globally and investors have pulled money from credit markets **(Figure 2)**. However, we would think that central bank action should be priced in. With regards to credit outflows, it isn't obvious where the money has gone. For US investors, money markets have become an attractive option. However, this option doesn't exist for EUR and JPY investors and therefore, we would expect some of the outflows to return to the credit market in 2019.

Figure 2:



Source: Credit Sights, ICI

Finally, we would like to highlight continued heightened political risk. Although the situation in Italy is improving as the government signaled a willingness to comply with EU budget rules, the situation in the UK remains highly uncertain and we would refrain from taking significant exposure in either market.

Market drivers

As outlined above, market drivers still need to be reconciled with our investment themes to define the strategy going forward. In order to do so, we will gradually replace some of our 2018 investment themes, to be more focused and relevant to the ever changing environment in global credit markets.

Going forward, we will be more active in the use of CDS indices for portfolio construction and risk management, in order to facilitate higher volatility and lower liquidity in credit markets. We will also reduce our position in rising stars and HY, and thereby underweight the auto and industrial sectors, and stay cautious with credit exposure in Italy and the UK.

Out of the last seven years, six (except for 2016) have seen more rising stars than fallen angels. We view it as prudent to take profit and focus on the identification of fallen angels, rather than rising stars. Additionally, we are going to reduce our HY exposure, although not leaving it entirely, as the fundamentals still look solid. In recent years, it has been a theme that more traditional Investment Grade investors have increasingly sought HY names in order to enhance returns. We envisage the risk that these investors will exit in 2019 as we approach the end of the credit cycle. This theme started in 2018 and will probably continue next year. Both reductions will lead to a more conservative sector allocation and imply reduced exposure to cyclical companies, i.e. auto and industrial.

Although we're going to change some of our investment themes, we will keep others. We still like the short end of the US credit curve and think that yields of over 3.6% offer solid compensation. Furthermore, European hybrid bonds and financial bonds remain high on our buy list. In addition, A-to BBB-rated Chinese SOEs on the front end of the curve look attractive.

Investment themes

For 2019, we anticipate low to mid-single digit returns. We expect the rate sell-off of 2018 to moderate considerably as we are closer to the end of the Fed's hiking cycle. Moreover, spreads in credit markets, which were pushed up significantly this year, offer risk compensation and moderate prospects of excess returns going into 2019.

But what are the other risks to credit besides our rather benign expectations for 2019? The main one is the trade war. If the truce between the EU and China doesn't last and the US continues to impose tariffs, this will certainly have an impact on inflation. The Fed might be forced to accelerate its move toward higher rates, which will also increase finance costs for the corporate sector. At the same time, higher import prices due to the tariffs will hit companies' P&L's. The finance costs, as well as higher import costs, will weaken micro fundamentals, which is one of our main rationales for remaining credit bulls. Another risk factor will be market liquidity, and in particular how the market copes with the end of the ECB buying program and the Fed's balance sheet reduction.

In order to be sure-footed in 2019, we will shorten our investment horizon from 12 to three months and become, like the Fed, more data dependent. As a result, financing and input price inflation will be our focus, as well as market liquidity.

GLOBAL EQUITY OUTLOOK 2019

The potential hangover from the monetary binge of QE continues to weigh on global equity markets as we head towards 2019. The turning of the calendar will do little to change this. Politicians have generally done little to help either. Irrespective of these risks, our focus remains to seek companies that deliver superior returns over the longer term, and we do this by picking companies that meet our Future Quality criteria.

Markets are – as ever – expending a lot of effort Fed-gazing in an attempt to work out how much US interest rates are likely to go up over the next 12 months. As bottom-up investors, we have no strong view, though we suspect that the majority of tightening has already taken place. Mortgage rates are ticking higher, the stimulative effect of US tax cuts will wear off next year and – despite this stimulus – inflationary pressures still appear relatively well contained.

Regardless of the future path of rates, the market has lost its mojo – particularly if you exclude the Information Technology sector. This has been the case ever since the Fed started to trim its balance sheet.

Figure 1:

Source: Bloomberg

Part of the problem for global markets has been the divergence in economic momentum between the US and its trading partners in the second half of the year. This has doubtless been partly driven by short-term phenomena, including US tax reforms, at exactly the same time that China is deleveraging and Europe remains beset by political problems. Part of this also speaks to confidence levels regarding the ultimate 'winners' of any trade war.

Figure 2:

Source: Bloomberg

Foreign exchange markets have been quick to reflect the differing activity levels noted above and the likely expected path of interest rates. As a result, the USD has continued to rally. The resultant increased cost of US exports has drawn a predictably aggressive response from President Trump's Twitter account, commenting that he sees the Fed as "a much bigger problem than China." Developing economies with USD denominated debt likely aren't enjoying this much either.

European politics have proven an unwanted source of uncertainty this year – impacting consumer and corporate confidence, even though employment remains reasonably firm and balance sheets relatively strong. Brexit, German politics, disquiet over French reforms and the Italian budget saga remain sources of risk until the end of Q1 at the earliest.

That is not to say that economic bust is inevitable, or even our base case – just because this economic expansion has lasted longer than most (shortly entering its 10th year). The well-known adage that bull markets don't die of old age, but rather they are killed by the Fed, speaks to exactly where we are now. If the beneficial impact of tax breaks fades in 2019 and wage inflation remains restrained by rising participation rates, it is not obvious to us why Chairman Powell would want to raise interest rates above a neutral level, threatening growth in the US. If expected rate rises fail to materialise and the pressure from USD appreciation on some emerging economies eases, 2019 could still be a good year for equity markets. This would be particularly true if global trade fears recede and (arguably more fancifully) if Europe's politicians could get their house in order.

Irrespective of the economic situation, our focus remains looking for companies that fulfill our Future Quality criteria. For instance, 'Quality of Management' is a key attribute of the companies that we look for. At times like these, when the path between a slowdown in economic growth or an inflationary boom looks pretty narrow, tight control over your cost base and prudent capital allocation are imperative. Our recent acquisition of Danaher is a great example of these characteristics. Management here have a long track record of reducing costs and reinvesting the savings made in investments in research and development (to accelerate organic growth) or in acquisitions. The business also generates extremely strong cashflow and enjoys a strong balance sheet, both of which are critical late in the economic cycle.

It is always important to separate cyclical factors from those that are more secular in nature and have a clear view of the relative valuation that you are willing to pay for these sources of growth. This is especially true where valuation multiples are elevated relative to history and investor positioning crowded. Despite profit-taking this quarter, the Information Technology sector remains the most glaring example. Our portfolio is only slightly overweight relative to the index, partly because of these considerations. History suggests that when the economic tide goes out on the cyclical parts of the sector, the performance impact can be significant, and we are seeing that play out in the semiconductor sector. We continue to prefer recurring revenue profiles on offer in software names like **Red Hat**, **Microsoft** and (to a lesser degree) **Accenture**.

With economic expansion looking more threatened than in the recent past, wage costs rising and debt servicing becoming more pricy too, 'doing more with less' is becoming increasingly important. We continue to like companies whose products or services make processes more efficient as a result. Within Healthcare, for instance, we continue to like managed care organisation **Anthem,** which remains well placed to help deliver necessary reform in US healthcare, paying only for treatments that actually benefit the patient. In IT, **Hexagon**'s sensor technology and data management make construction much more cost effective. Finally, there is **Ecolab,** whose products are all about increasing the water and energy efficiency of their customers.

As always, careful stock picking and a disciplined approach to valuation remain key for maximising returns across global equity markets.

JAPAN EQUITY OUTLOOK 2019

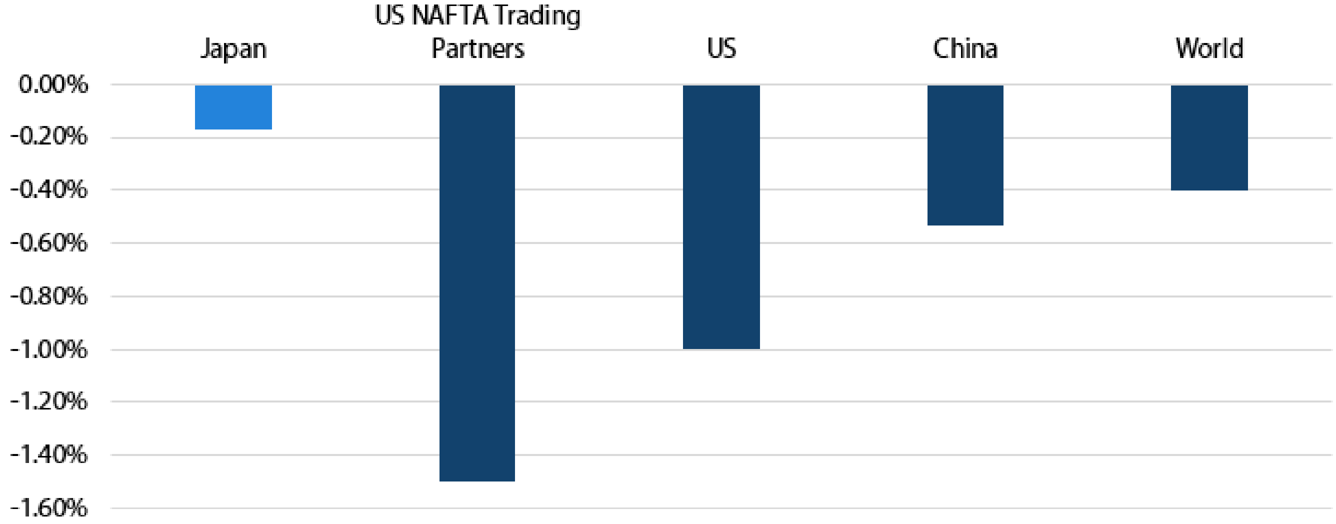
As we reflect on 2018, we would all agree that Trump and his trade policies dominated the conversations and dictated some of the major moves in the financial markets around the world. While the US midterm elections are behind us, we think it is likely that the world will continue to face protectionist moves by the largest economy, given the sheer size of its trade deficit and the continued Republican control of the Senate.

Japan isn't immune from global trends. However, we believe the country offers a unique opportunity set for global investors looking to enhance investment returns while benefiting from diversification.

Trade tension and Japan

In October, the IMF ran several scenarios for how the trade tensions will play out in the global economy in its latest World Economic Outlook. In the worst case, the long-term negative economic impact for Japan could be "just under 0.2%," with "almost 1%" for the US, and China "just over 0.5%." US NAFTA trading partners could see a 1.5% decline, and the world, "roughly 0.4%" **(See Exhibit 1)**. While there will certainly be sector winners and losers from the tensions, we believe Japan, as a market, is better positioned than others to stand firm against any moves to slow down global trade.

Exhibit 1: IMF estimates of trade tension impact on Real GDP



Source: Nikko AM based on IMF World Economic Outlook (October 2018)

One of the interesting developments unfolding behind the headlines on US-China trade tensions is that Japan is taking steps to accelerate its free trade policy. In July 2018, Japan signed an EPA (Economic Partnership Agreement) with the European Union, which is expected to take effect in February 2019. The two markets together account for as much as 1/3 of world GDP and 40% of global trade.

Furthermore, the 11-member TPP (Trans-Pacific Partnership), which the US withdrew from in the early days of Trump's presidency, is now scheduled to take effect on Dec. 30, 2018. The group will initially be made up of Japan, Canada, Mexico, Singapore, Australia and New Zealand, followed by Vietnam, Malaysia, Chile, Peru and Brunei. Thailand and the UK have also shown interest in joining. One of the key drivers that led to these developments to promote free trade at a time when protectionism is on the rise, is the strong political leadership in Japan.

Political safe haven

Japan is currently facing few obstacles to push through agendas and implement policies, as Prime Minister Abe and his ruling party control a majority in both houses of parliament. We believe this substantial political capital can be leveraged to withstand any headwinds, whether it be trade tension or other event risks to the economy.

One such event risk we foresee in 2019 is the VAT hike (from 8% to 10%) scheduled for October 2019. Having learned from its previous experience with a VAT hike in 2014, the government is said to be considering ways to smooth out any impact this time. Specific measures such as tax cuts and subsidies to ease the burden on households and to boost consumer spending on durable goods are said to be considered, in addition to keeping the tax rate on food, beverages and other consumer staple products at 8%. Burdens will also be lessened as approximately 1/3 of additional tax revenue (JPY1.7tn out of JPY5.6tn) is to be used for childcare and other subsidies for households. Moreover, a large-scale fiscal stimulus package, which includes spending on public works to strengthen infrastructure and support the economy, is also expected to be announced ahead of the VAT hike. We believe it is good timing to implement the VAT hike as consistent policy support can ensure a smooth transition.

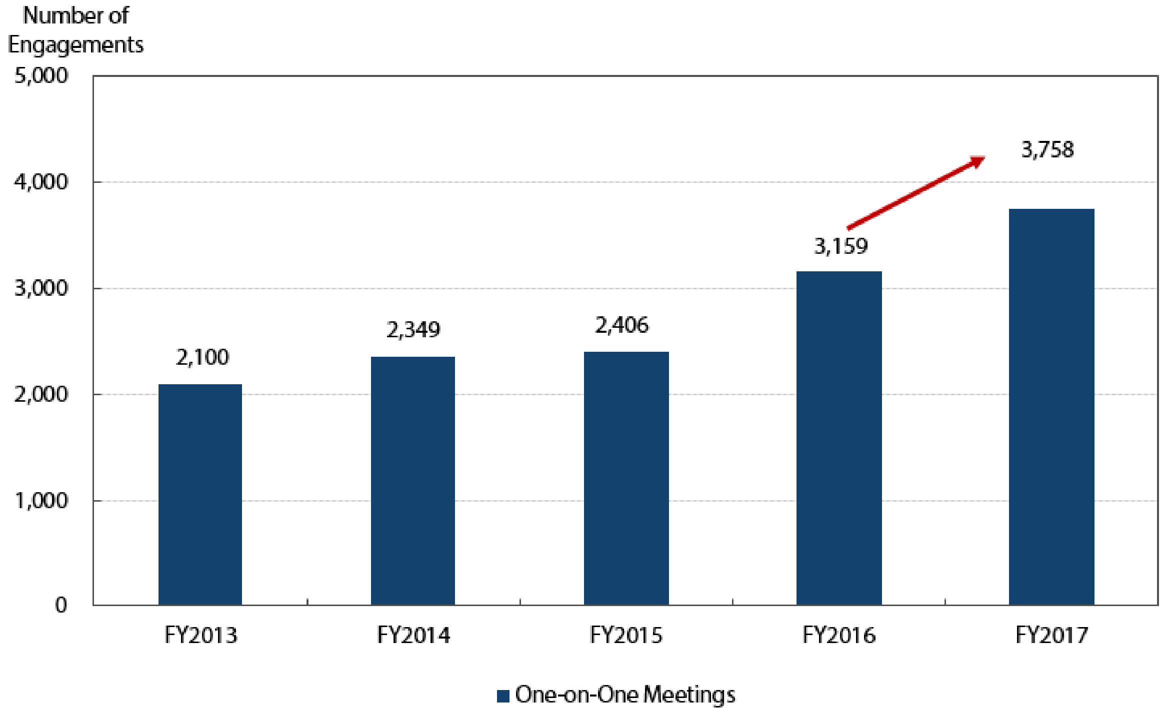
On the monetary side, BOJ governor Kuroda was re-appointed in April 2018 for another five-year term. In the latest monetary policy meeting statement (released Oct. 31), the BOJ stated explicitly that it is committed to continue its accommodative monetary policy for an "extended period of time," to cope with any uncertainties (including the upcoming VAT hike). The policy accord between the government and the BOJ (from 2013) on their inflation policy is still in effect and thus, we can expect to see consistent policy coordination.

Inflection point in Corporate Governance reform

Another area in Japan where we see uncorrelated alpha opportunities with the rest of the world is the ongoing corporate governance reform.

Under Abe's leadership, Japan's Stewardship Code was introduced in 2014, followed by its Corporate Governance Code in 2015, together calling for companies and institutional investors to engage in constructive dialogue to enhance shareholder value. In May 2017, the Stewardship Code was revised, urging the disclosure of detailed proxy results. Institutional investors and asset owners are required to assume a higher level of fiduciary responsibility, with the aim of enhancing their investee companies' return on equity (ROE). **(See Exhibits 2 and 3 for Nikko AM's recent stewardship activities)**.

Exhibit 2: Nikko AM - Engagements with Firms



Source: Nikko AM

Exhibit 3: Nikko AM – Proxy Voting Results (July 2017 – June 2018)

Company-Generated Proposals

	Proposal	Yea	Nay	Subtotal	Nay ratio
Proposals on company functions	Election/Dismissal of directors	14,183	2,934	17,117	17.1%
	Reference: In terms of no. of firms	1,252	832	2,084	39.9%
	Election/Dismissal of corporate auditors	1,568	162	1,730	9.4%
	Reference: In terms of no. of firms	893	135	1,028	13.1%
	Appointment/dismissal of accounting auditors	40	0	40	0.0%
Proposals on executive renumeration	Executive remuneration amount	699	73	772	9.5%
	Retirement benefit payments	162	26	188	13.8%
Proposals on capital policy (excluding proposals on articles of incorporation)	Appropriation of surpluses	1,374	135	1,509	8.9%
	Restructuring	43	11	54	20.4%
	Introduction/renewal/abolishment of anti-takeover measures	0	62	62	100.0%
	Other capital policy proposals	110	8	118	6.8%
Revision to articles of incorporation		510	41	551	7.4%
Other		0	1	1	100.0%
Total		18,689	3,453	22,142	15.6%

Shareholder Proposals

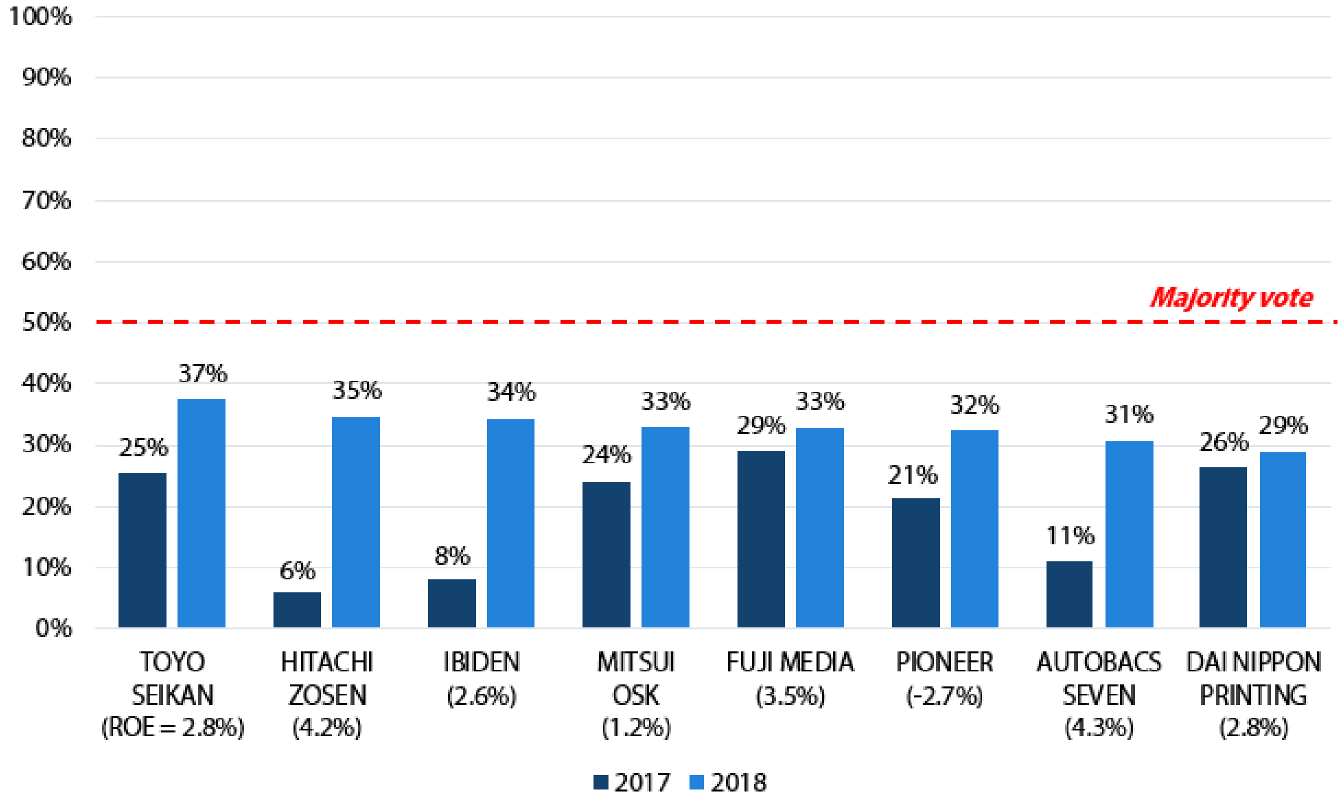
	Proposal	Yea	Nay	Subtotal	Yea ratio
Total		25	139	164	15.2%

Source: Nikko AM
Note: The ratio of votes against company proposals increased significantly after we signed the Stewardship Code.

Three years after the Corporate Governance Code was introduced, the revised version was announced by the Tokyo Stock Exchange and took effect on June 1, 2018. The core of the revision is an unwinding of cross-shareholdings, enhanced board committees and mobilizing Japan's corporate pension funds toward greater engagement. Companies are now under strict scrutiny by investors and must justify their stock holdings and therefore, boards will annually assess whether or not to hold each individual cross-shareholding. They're examining whether the purpose of each holding is appropriate and whether the benefits and risks cover the company's cost of capital. Japanese companies' ROE is around 9%, lagging that of the US, which is consistently in the mid-teens, so there is still work to be done.

We believe that corporate governance reform can't be done overnight as it is a continuous effort by management teams to change their practices. But we also believe that the aforementioned codes have started to have a meaningful impact on companies. For example, many companies that have low ROEs are increasingly facing "No" votes against the re-election of their top executives (CEO/Chairman) at their annual general shareholder meetings **(See Exhibit 4)**. We think an inflection point is just around the corner, and believe it is only a matter of time before we see top executives being ousted by unhappy shareholders due to weak operating results. Corporate governance reform is creating this pressure and investors are well positioned to reap the benefits from proactive actions taken by the companies to enhance shareholder value.

Exhibit 4: %Votes against re-election of top executive at AGMs vs. ROE

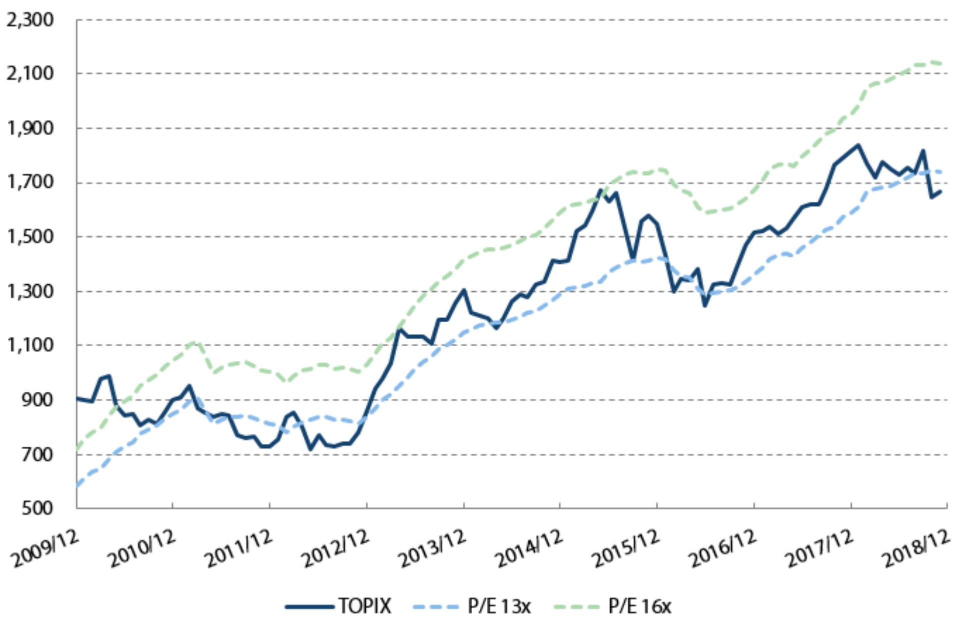


Source: IR Japan and Bloomberg. ROE is 5-yr average adjusted ROE.

Excessive pessimism

We believe the market is at an attractive level if you are a fundamental investor. The TOPIX index P/E (12-month forward) is hovering at around 12.8x (at the time of this writing on Dec. 13, 2018), falling outside of the trading range of 13x -16x since the start of Abenomics **(See Exhibit 5)**. We believe excessive pessimism and fear about the trade war are to be blamed for the recent drawdown, which was then exacerbated by non-fundamental investors such as quants or risk-parity funds.

Exhibit 5: Valuation outside of the Post-Abenomics trading range



Source: FactSet. As of end-November 2018.

The new era

Japan will step into a new era in 2019. The Heisei period (1989 – present) is scheduled to come to an end on April 30, 2019, after Emperor Akihito abdicates the Chrysanthemum Throne. There will be various festivities throughout the year including an abdication ceremony in April and the enthronement ceremony in October to celebrate the ascension of Crown Prince Naruhito. There will also be a one-time, 10-day public holiday at the end of April through the beginning of May, and the country will be in a mood of celebration throughout the year, likely boosting consumption. Inbound tourism (up from 6.2mn in 2011 to 28.7mn in 2017) is also expected to continue to soar with the help of major sporting events such as the World Cup Rugby in September and the 2020 Summer Olympics. The city of Osaka was also elected in November 2018 as the host city of the World Expo 2025.

In sum, Japan today has several aspects that offer attractive uncorrelated investment opportunities to global investors looking to enhance performance with diversification benefits. It has a unique position in the global trade scene, political stability, corporate governance reform, and attractive valuations. We expect 2019 to mark the start of a new era with more investors (and tourists) showing ever more interest in Japan.

About the Japan Equity Team

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Investment Director

SINGAPORE EQUITY OUTLOOK 2019

The Rise of Resilience

We believe 2019 will be an important year for active selection or alpha and our focus will be on delivering on stock selection returns by picking quality companies who are resilient in growth amid a rising risk environment.

We foresee a more challenging macro backdrop for Asia in 2019 as compared to the previous years. Concerns over rising trade tensions and global protectionism, as well as tighter financial conditions arising from domestic policy tightening and rising global bond yields, will likely dominate as key investor concerns as we move into a new year. We expect this to translate into slower growth for corporate earnings in 2019. On a more positive note, equity markets have already begun to price in these growth concerns and earnings risks. Since April 2018, the Singapore equity market has already fallen by almost 20% as a result. Valuations are now looking attractive, with P/B multiples close to retesting its trough, last seen in 2015.

We believe these factors set up an interesting backdrop for performance for Singapore equities in 2019. While we are cautious on the rising macro headwinds, our bottom-up view on stock selection is looking more constructive and we see good opportunities in quality value and oversold growth cyclicals. Notwithstanding further major cuts to EPS growth in 2019, we believe stocks could find a bottom over the next 12 months. Another key observation is that the earnings growth trajectory in Singapore is increasingly bifurcated and dispersed. In 2019, we have witnessed much wider sector and company dispersion. Industrials are offering a combination of good value and earnings resilience, as well as growth optionally, should there be some relief in resolution of trade tensions. Other sectors appear to showing vulnerability in exhibiting further downside in earnings revisions and deterioration in returns in capital. This makes us bullish as stock pickers, and we believe 2019 could potentially hold one of the best hunting grounds for relative return strategies and active selection.

Reflections in 2018 and 2017

To gain a better perspective of 2019, we review our previous strategy pieces in 2018 and 2017 to tie in our thought process in Singapore and also provide insights for the coming year.

A review of 2018: Beyond Expansion, Focusing on Sustainability

Our 2018 outlook piece argued for the need to focus on sustainable growth and defending returns as returns would moderate into 2018 on the back of rising growth risks, tighter liquidity and less attractive valuations. Equity markets peaked in April 2018 and have retraced by close to 20% on these concerns. We also argued that with a maturing economic outlook, greater bifurcation will ensue, and relative returns becomes a lot more important. Industrials (Capital Goods) and Consumer sectors were looking attractive in our report last year. As of end-October 2018, we note that Industrials and Consumer have topped the 2018 best performers list, with 8 of 10 best in the two categories. Industrials such as ComfortDelgro and ST Engineering and Consumer names such as Wilmar and Dairy Farm were among the year's better performers.

In 2019, growth resilience will become a more defining feature in stock selection. We believe Industrials in Singapore depict late-cycle economic cyclicals, whose earnings are better equipped to cope with rising interest rates, while Consumer typically fare better than when we move from disinflation to inflation.

Best Performers in Singapore

Name	Market Capitalisation	Return	Sector
JAPFA LTD	1,273,432,192	31.75	Consumer Staples
M1 LTD	1,943,675,392	26.68	Telecommunication
SHENG SIONG GROUP LTD	1,623,819,904	20.63	Consumer Discretionary
KEPPEL TELECOM & TRANSPORT	1,034,358,400	20.53	Industrials
COMFORTDELGRO CORP LTD	4,806,305,792	18.97	Industrials
DAIRY FARM INTL HLDGS LTD	11,957,656,576	17.84	Consumer Discretionary
HAW PAR CORP LTD	2,811,066,368	15.30	Consumer Discretionary
SINGAPORE TECH ENGINEERING	10,606,702,592	13.73	Industrials
WILMAR INTERNATIONAL LTD	19,739,045,888	5.65	Consumer Staples
MAPLETREE COMMERCIAL TRUST	4,619,387,904	5.03	Property REITS

Note: Market Capitalisation >SGD1bn
Source: Bloomberg

A review of 2017: The Year of Expansion

2017 was a year of expansion where we witnessed a trinity of market drivers in earnings, valuations and liquidity all moving positively in tandem. We believed the Singapore equity market was well supported by the expansion of earnings momentum, valuation multiples and policy conditions. In 2017, earnings expansion or revision momentum was accelerating for the first time since 2013. Valuation multiples were also attractive and had room for multiple expansion as ROEs were improving. Finally, liquidity conditions were accommodative, which would allow for risk assets to perform better. The Singapore equity market registered a gain of 25.5% in 2017, as measured by MSCI Singapore Total Return index, its best since 2012.

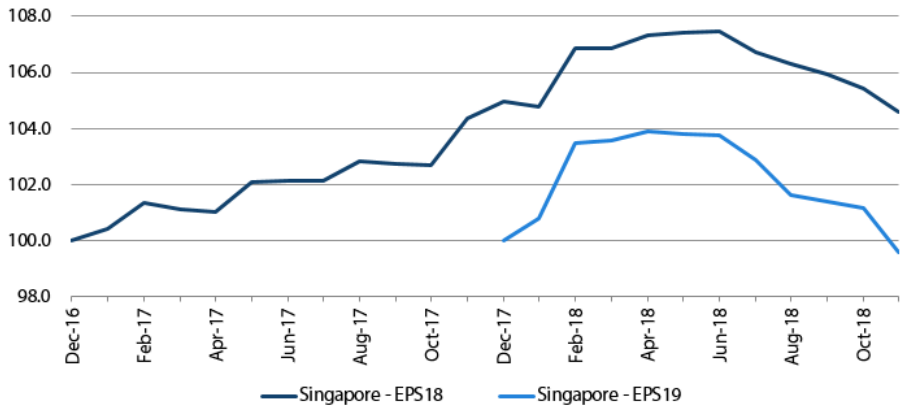
In 2019, we will revisit the same three drivers in Singapore. The conclusion is balanced. The most positive indicator is derived from valuations, where we find equity price-to-book valuations attractive at close to -1 standard deviation of its mean and almost back to trough valuations experienced in its last low in 2015. Earnings however, look less positive with momentum having stalled since late 2017 and trending lower for most of 2018. Earnings will likely pose a headwind for equity performance. We find 2019 momentum generally challenging, with potential downside risk in interest-rate sensitive and economic-sensitive sectors. Finally, liquidity indicators which have been tight through most of 2018 due to domestic policy adjustments are now looking relatively more balanced following the rise in interest rate in 2018 and capital market outflows.

2019 Market Outlook

Earnings

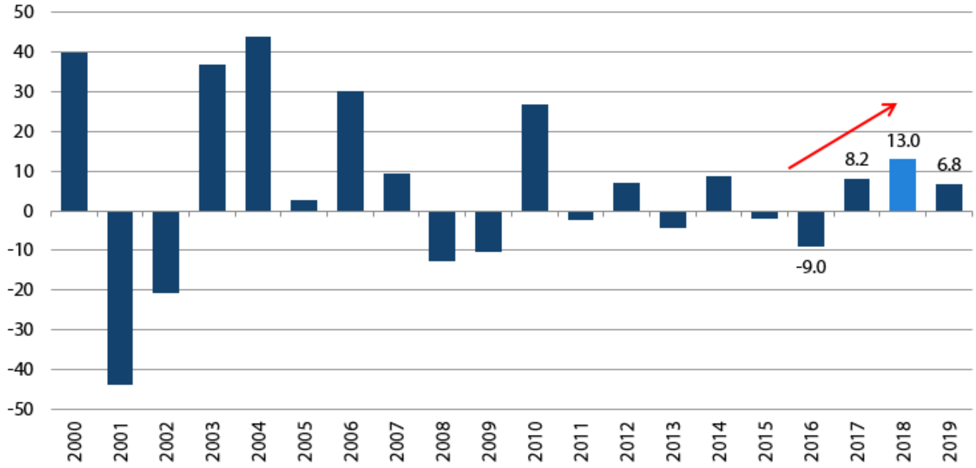
Earnings revisions have reversed after its positive growth trajectory in 2017. Consensus expectations for corporate earnings growth in 2018 peaked in April 2018 and has been cut by 3-4% since. Likewise, the outlook for 2019 corporate earnings growth has moderated with a potential slowdown in growth expected for 2019. Currently, corporate earnings growth is expected to slow from 13.0% in 2018 to 6.8% in 2019 (source IBES, Credit Suisse)

Figure 1: Consensus 2018 and 2019 EPS cut by 1.3% and 1.8% respectively, post results



Source: I/B/E/S

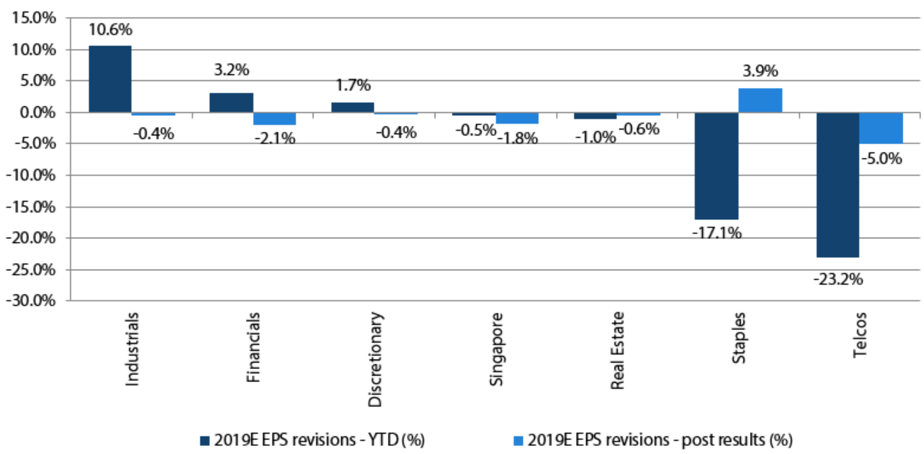
Figure 2: Singapore EPS growth expected to slow to 6.8% in 2019 from 13% in 2018



Source: I/B/E/S

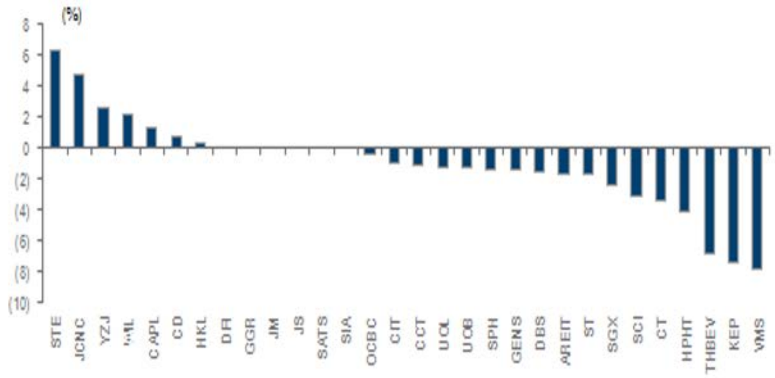
While the general trend of earnings revisions have been negative in 2018, we have witnessed a more pronounced bifurcation across sectors. Positive revisions in selective industrials, financials and consumer sectors are seen in 2019, while telecommunications have been largely negative. Dispersion has also been equally pronounced at the stock level with a sharp dispersion in 2019 EPS revisions within the Singapore universe. We note that stock and sector dispersion is also reflective of a late stage of the equity market cycle, where sector and stock selection typically play a greater importance in driving returns.

Figure 3: Most sectors saw EPS cuts post-results, with Telcos having most significant cuts



Source: I/B/E/S

Figure 4: 3-month consensus 2019 EPS revisions for STI constituents



Looking forward, we expect earnings growth to moderately positive at 3-5% in 2019, but see the continuation and greater dispersion in returns. Against a backdrop of slowing growth, sector selection will be key and we expect sector and stock selection may offer better return opportunities at a time of growth scarcity. We overweight selected industrials where we find good valuations and cyclicality upside in growth. We also overweight selected consumer sectors where we find stronger earnings resilience and quality growth.

Valuations

Price-to-Book valuations have turned attractive (Trailing Price-to-Book of 1.2X) with the close to 20% correction witnessed since April 2018. We believe a further 10% correction from current levels would retest previous 2015 and 2008 GFC lows, where we can be reasonably confident equity markets will recover over a 12-18 month view. Forward Price-to-Earnings are also starting to look more attractive following the earnings downgrades, tracking close to 11X forward Price-to-Earnings ratio.

While valuations are attractive for Singapore, we believe a positive catalyst either in terms of macro conditions or a stabilisation in earnings downgrades is needed to raise our convictions to positive. We continue to monitor this over the next 6 months. In the interim, our primary focus remains on earnings resilience and quality growth in the current environment, despite attractive valuations.

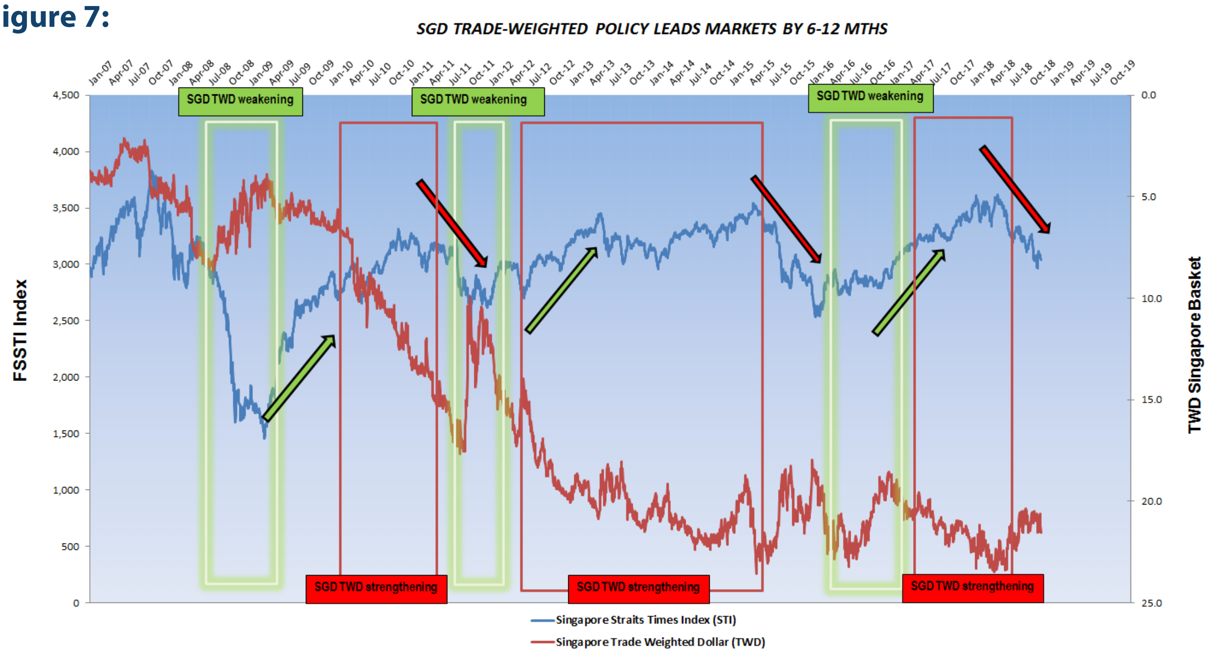
Figures 5 and 6:

Liquidity

Liquidity conditions in Singapore has tightened in 2018 with the global tightening and rise of interest rates. Domestically, liquidity was also impacted with the introduction of macro-prudential measures targeted towards property in July and the policy decision by the Monetary Authority of Singapore to maintain its bias for rising SGD dollar against its trade-weighted basket in October. We have witness a tightening move in our proprietary leading liquidity indicator (see chart), which we believe underlie tighter liquidity conditions in 2018, challenging local equities to perform.

Looking ahead in 2019, our liquidity indicator is looking more balanced suggesting some normalisation in liquidity conditions. While as interest rates might continue to move higher and tighten liquidity further, conditions appear to have stabilised which could be supportive for equity markets.

Figure 7:



Bullish on Alpha in 2019 – stock selection to make all the difference

With a sanguine outlook for macro, we believe stock selection or alpha to exert itself prominently in what could be a low beta environment in 2019. We centre on the theme of resilience – stable earnings growth, high and sustainable dividend yields and strong balance sheets. We believe that against a backdrop of rising interest rates, tighter liquidity and higher risk premium, cost of capital will increase, posing risk for asset-heavy and interest rate sensitive sectors not well backed by cash flows.

On the flip side, allocation of capital will become more efficient in valuing quality companies with strong cash flow returns and who are able to deliver resilience and sustainability in returns. Equity returns and performance are likely to better correlate with company's returns on capital and cash flows as we move away from low interest rate environment. We also expect earnings delivery, transparency and quality to feature prominently together with valuations in driving performance at the stock level. This investment backdrop is very conducive for bottom-up company selection and we expect alpha and active returns to dominate in the next 12 months.

Our biggest convictions for 2019:
1. Focus on earnings resilience, consumer and industrials poised to outperform
2. New Singapore –the search for tomorrow's service eco-system winners continues
3. Dividends to dominate returns and dividend growth to outperform in a rising interest rate environment

Focusing on Earnings Resilience

We are more positive on stock selection in Singapore and particularly in industrials and consumer sub industries. We are selective within financials and underweight property and telecommunications.

We are selective in financials and underweight interest rate sensitive sector such as property developers. Within REITs, we are also more cognisant of the sustainability in earnings or dividend growth (DPU) as well as financial leverage in a rising interest rate environment. We believe domestic policy risks and rising interest costs could pose challenges over the next 12 months.

We are selectively more positive on industrials and the consumer sector in 2019. Industrials in Singapore represent a broad categorisation of conglomerates, transportation and marine offshore companies but most have earnings linked to the latter part of the economic cycle and who benefit from a recovery in the real economy i.e. capital expenditure (capex). We also find valuations in some industrials cases are attractive, close to multi-year valuation lows and deeply discounted to their book values. Other industrial and consumer stocks have strong quality franchises, are poised to have sustain earnings growth in 2019 and are able to maintain and improve on their return on capital amid challenging growth environments.

This is most prominently seen in earnings expectations for 2019 and 2020 where industrial and consumer staples lead in terms of earnings growth expectations. Also, notice increasing bifurcation in earnings growth for 2019 and 2020 and believe this will lead to greater dispersion in returns from sector selection.

Positive fundamental change (Growth) and Sustainability in Returns to come from Consumer and Industrials in 2019

EPS Growth (consensus)	CY18E	CY19E	CY20E
Banks, Diversified Financials & Insurance	10%	7%	7%
Consumer Discretionary	11%	(2%)	–
Consumer Staples	3%	**13%**	**9%**
Industrials (Conglomerates)	12%	**6%**	**7%**
Industrials (Offshore Marine)	(1%)	**16%**	**15%**
Industrials (Transport)	(1%)	**10%**	**0%**
Real Estate Developers	9%	4%	3%
Real Estate Investment Trusts	(2%)	3%	5%
Technology	10%	5%	5%
Telecommunications	(12%)	(2%)	(2%)
Healthcare, Utilities & Others	(932%)	(51%)	(103%)
TOTAL	**8%**	**7%**	**7%**

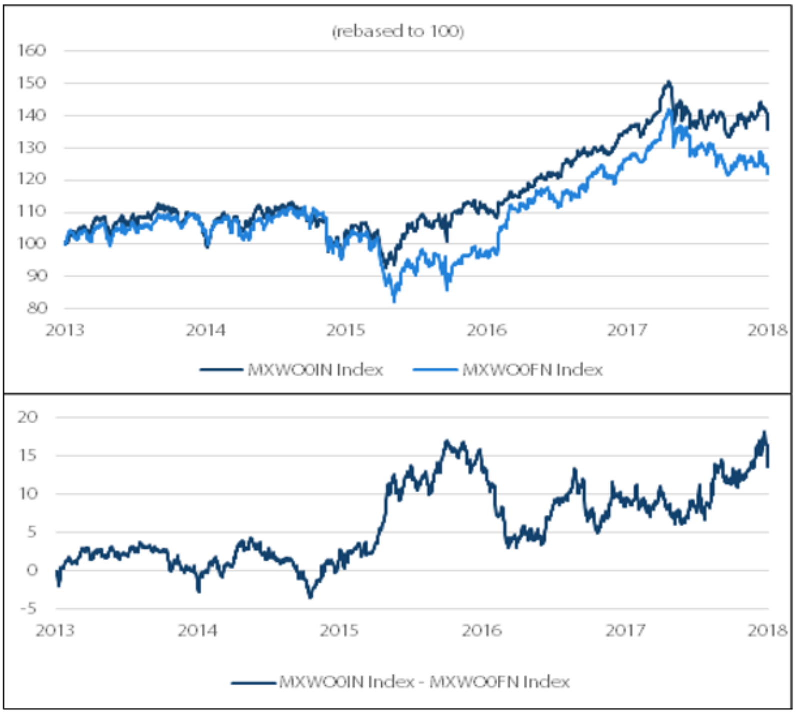
Source: dataCentral, Bloomberg

Industrials to perform better in a rising interest rate environment

As more signs point towards the latter or closing stages of the economic cycle, we believe industrials could be set for better performance in 2019. Industrials are typical late cycle economic sectors and usually associate with the corporate capex spending cycle linked to job creation and the real economy. With the rise in interest rates correlating with the rise of economic activity and corporate spending associated with improved business confidence, industrial equities tend to perform better during this stage of the economic cycle.

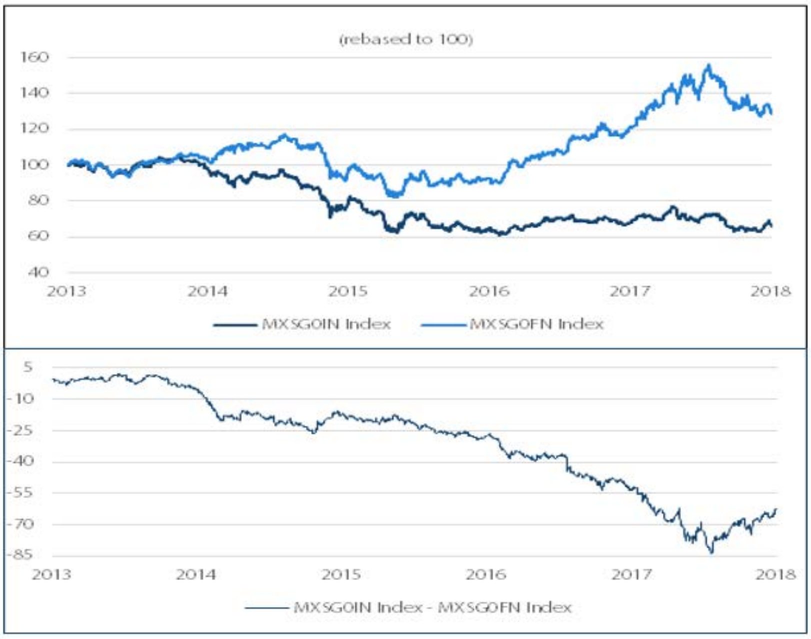
MSCI World Industrials, a broad measure of global industrial companies, have outperformed the MSCI World Financials index over the past 3 years, as economic conditions improved and interest rate conditions tightened.

Figure 8: Relative Performance of MSCI World Industrials/MSCI World Financials



The case for Singapore Industrials however has been starkly different, where MSCI Singapore Industrials have underperformed MSCI Singapore Financials significantly over the past 3 years. This has started to reverse over the past 3 months as sector earnings revisions within industrials have improved and valuations have also remained supportive. Meanwhile, sector revisions in the financials have moderated due to tighter liquidity conditions and domestic policy tightening on the property sector. We believe the backdrop for industrials to build on its recent outperformance against financials remains supportive.

Figure 9: Relative Performance of MSCI Singapore Industrials/MSCI Singapore Financials

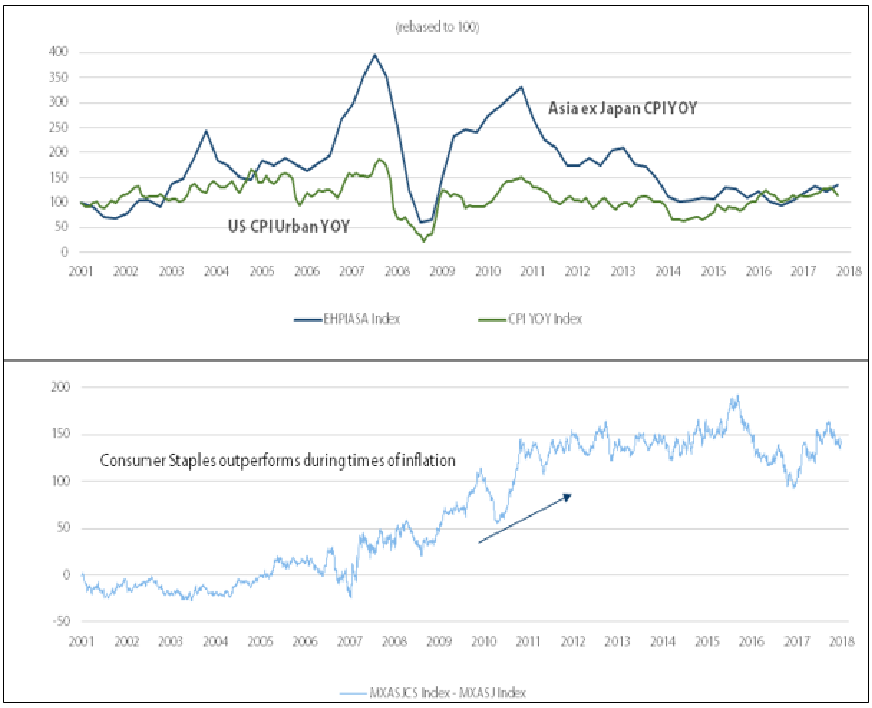


The return of inflation a potential tailwind for Consumer Staples

We believe consumer staples and food sector also represent a compelling investment proposition for 2019. The broad earnings backdrop for consumer staple is supportive, as sales (prices) are typically positive correlated to inflation and staple demand (volumes) is also less elastic and more resilient in a growth slowdown. We continue to have a positive structural thesis on Asia consumer staples riding on the rise of the middle class and trend of consumerisation in Asia. We also view consumer staples within the food supply chain as defensive in a slowing growth environment and relatively well placed in its ability to improve pricing margins as inflation rises. One example of this is that in 2018, we have noticed select consumer staples in Asia benefiting from potential trade dislocations and new market opportunities resulting from the current trade tension between US and China.

We also look back to the periods of 2004-2008 and 2009-2010 where inflation rose and find consumer staples typically outperform in these periods.

Figure 10:



New Singapore to remain in focus in 2019

New Singapore continues to represent the new Singapore economy and companies within the service economy which is riding on innovation and restructuring to better compete in the new economy. We continue to like sectors such as technology services, data centres, healthcare, logistics, tourism and consumer services within Singapore which we believe are part of the service eco-system. We believe these sectors have long term structural growth drivers and are poised to outperform the economy in terms of growth in the coming years.

Restructuring has also been evident in industrials who are recalibrating their growth engines, fine-tuning their corporate and capital structures and building a bigger push towards services. A most recent example would be Keppel Corp's privatisation of its data centre and logistic subsidiary Keppel T&T, consolidation of its telecommunication operations in MobileOne and growth initiative in Keppel Infrastructure via acquisitions.

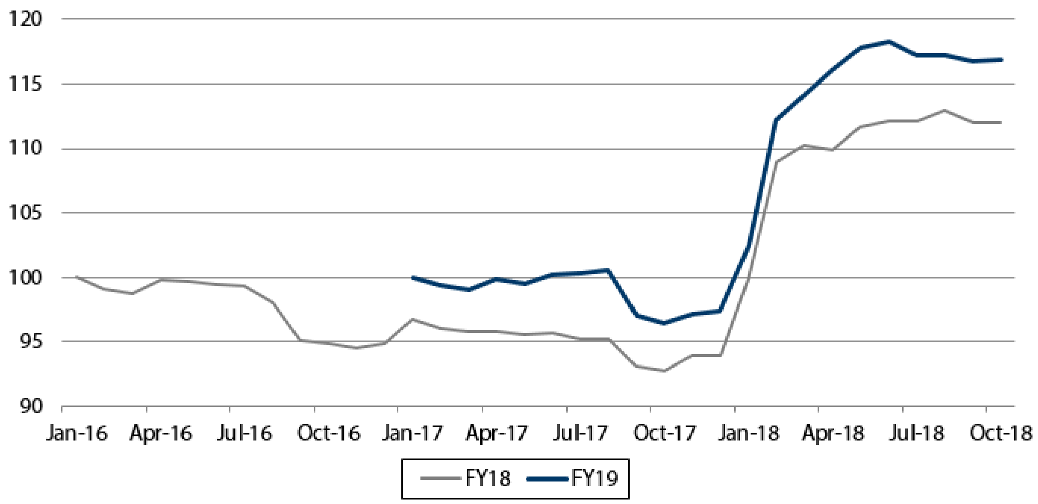
We continue to like these sectors who offer growth exposure in companies well plugged into these service eco-systems as well as restructuring opportunities through companies reinventing their business models and/or restructuring to better compete in the current environment. We are currently overweight select companies in the healthcare, technology service and tourism sectors.

Dividend Investing to Outperform

Singapore remains a defensive proposition for investors in uncertain times, with a resilient economy, a stable currency and most importantly, an attractive market dividend yield of 4-5% backed by high free cash flow, strong pay-outs and defensive balance sheets. In a low beta or low return market environment, dividends will continue to feature strongly in driving returns. We expect a highly convictive dividend strategy encompassing both yield and growth is most well placed to outperform in today's rising interest rate environment.

Dividend yields in Singapore are now very attractive having now risen to 4-5%, one of the highest in the Asian region. This has come from a combination of lower equity prices, the sustainability of dividend pay-outs and dividend upgrades from the banks. This has led to a scenario where dividend yield expectations have actually risen in 2018 helping to counter balance the weaker trend on earnings revisions. This is encouraging which supports our view that dividend yields will help support the market on the downside and Singapore offers a defensive growth proposition in the region.

Figure 11: Dividend (DPS) expectations in Singapore resilient and rising in 2018 and 2019



Source: IBES, Credit Suisse

We continue to focus on companies who offer high and defensive yields with a steady growth in dividends. In high dividend yield sectors, we focus on selective financials, industrials and consumer companies where we see higher ROE expansion driving dividend returns as well as higher potential pay-outs from rising free cash flow and capital strength. Within REITs, we find good opportunities and like office, hospitality and industrial REITs with growth in DPU and selected infrastructure business trusts.

Summary

In summary, we believe resilience remains key for stock selection 2019. We measure resilience in the form of the sustainability of returns in earnings growth, business models and balance sheets. We believe active performance will come from companies which are able to deliver in sustaining earnings growth, have business models with defensible and quality growth and are equipped with the financial ability to take advantage of growth opportunities in the current environment of slower growth and tightening liquidity. Sustainability of Returns or resilience will be key for performance in 2019.

This makes us relatively cautious and selective on asset plays especially companies dependent on interest rates and more constructive on quality and value franchise with a good earnings growth trajectory. We see this particular in industrials, were capex conditions continue to suggest growth is continuing and late cycle capital expenditure remains supportive for earnings. Likewise, in consumer sectors, we believe companies are better able to cope with the rise in inflation and earning have room to see positive surprises from margins.

We also continue to be positive structurally on the service economy in Singapore. While many of these sub-sectors such as tourism, infrastructure and healthcare are sub-sets of industrial and consumer sectors, we believe these sectors have long term structural growth drivers and are poised to outperform the economy in terms of growth in the coming years. We see strong opportunities in companies who are re-inventing themselves to compete in the new economy and overweight select companies in the healthcare, technology service and tourism sectors.

Finally, we believe dividend investing will continue to be profitable in 2019. Dividend yields in Singapore are now the highest in the region at an attractive market dividend yield of 4-5% backed by high free cash flow, strong pay-outs and defensive balance sheets. In a low beta or low return market environment, dividends will continue to feature strongly in driving returns. We expect a highly convictive dividend strategy encompassing both yield and growth is most well placed to outperform in today's rising interest rate environment.

GLOBAL MULTI-ASSET OUTLOOK 2019

Once again, the Federal Reserve (Fed) policy has proven itself to be the key determinant of global liquidity, and 2018 was clearly tight. We endorse the notion that growth and easy policy elsewhere can help to offset Fed policy, but at least in the developed world which is still mostly what matters, policy is due to tighten there as well with the ECB ending quantitative easing (QE) by the end of 2018 and the BOJ reducing asset purchases despite its official stance in keeping policy easy.

China now too is a key contributor to global liquidity and, in 2018, reform efforts leading to a credit crunch clearly added to the global squeeze. The command economy has decidedly begun to reopen the liquidity spigots, but not in the usual form of massive government-led investment, which is positive from a reform perspective. Rather, injections to date are aimed to protect the real economy from the credit squeeze and escalating trade war. So far, the transmission has been rather weak, but we do expect authorities will ultimately get the mix right for growth to improve.

Our base case is that growth and now a slightly less hawkish Fed can overcome the slow withdrawal of liquidity across the developed world. However, tighter liquidity coupled with still high geopolitical uncertainty from trade wars to BREXIT and beyond, volatility will remain elevated. But like any late cycle, gains from risk assets can still be quite meaningful before the cycle ends. We remain anchored in our outlook but data dependent with firm signposts that look through volatility to either confirm our view or suggest a different path. Following are some of the key themes that we are currently following for 2019:

Key Themes

Stabilizing dollar:

Outsized US growth owing to fiscal stimulus and steady Fed tightening figured prominently during 2017 in driving the dollar higher and risk assets in the rest of the world lower. Now, with stimulus-induced growth waning in the US and the end of Fed tightening within sight, the dollar is likely to stabilize and perhaps weaken at the margin, lending relief to risk assets and emerging markets (EM) in particular. The main risk to this thesis is ever-tighter liquidity that risks a deeper dollar shortage if dollar borrowers are forced to deleverage.

China stimulus begins to lift growth:

Through fine tuning, China is likely to find the right policy mix to lift growth in Q1, but more derived through local demand, given the emphasis on consumption and less on infrastructure investment. Improving growth in China is positive for EM and commodities, but less pronounced than earlier stimulus. The principal risk is that trade wars escalate once again, and/or that rising defaults damages confidence to the point that stimulus transmission continues to be hampered. China property is also important to watch, as deterioration could also weigh on growth.

Tariff war morphs to tech cold war:

Despite the ongoing bluster, Trump knows tariffs are sure to inflict pain in the US, so cutting a deal is clearly a better set up for the 2020 election. The deal would fall short of dismantling 2025 as China deems this point as non-negotiable. So we will likely see more one-off targeted policies and attacks on certain tech companies like ZTE and Huawei. China will respond in kind, and tensions will remain high. Supply chains will continue to reconfigure to protect local technology, data and IP. The outlook is not positive but, on balance, better than the alternative driven by escalating tariffs.

European outlook is less certain:

BREXIT and Italy will continue to simmer, though we think both of these points of stress will avoid worst case scenarios. More worrying in Europe is the ailing banking system, such as Deutche Bank and the Italian Banks. As the ECB removes QE, we see the potential for further stress among banks and slower credit expansion keeping growth disappointing. The ECB is likely to re-start programs such as the TLTRO to rollover loans coming due under prior programs, so there are unlikely to be imminent flashpoints.

Liquidity tight, explosions continue:

Steady removal of liquidity by central banks will continue to add stress to those most dependent on external sources of liquidity. Turkey and Argentina could return to instability, but there macro vulnerabilities elsewhere and poor fundamentals in corporates such as GE and other lower quality credits that may begin to struggle to rollover debt on weaker cash flows. Banks in the US are much healthier than they were in 2008, but European banks are a still a risk.

On balance, we remain constructive on growth, albeit less strong in the US as stimulus wears off. Liquidity is tighter, but still healthy growth in the US, a more stable dollar and positive momentum in China can nevertheless help to lift broad money in global terms. However, as we enter this late stage of the cycle, it is important to distinguish risks and vulnerabilities to be avoided or hedged accordingly. Mistakes can and will happen, so close monitoring is essential.

Asset Class Outlook

Equities:

Equity market valuations vary quite considerably with the US still showing the most expensive against the rest of the world. The balance of risk factors discussed above suggests that 2019 will deliver low but still positive returns, in the absence of any major tail risk event. The cheaper valuations on offer in Japan and parts of Emerging markets offer a good combination of higher returns upside and greater downside cover in a falling market than the more expensive markets of the US and core Europe. In spite of our value-centric investment philosophy we believe it is too early for an outright overweight of value vs. growth or defensives vs. cyclicals companies.

Value stocks are very inexpensive compared to growth stocks on a range of measures currently. However this valuation discount might be little more than false economy if it suggests owning highly geared or cyclical companies in an environment where rates and growth risks are both rising. Similar to our colleagues from the equity security selection teams, we favour owning companies with stable and growing cash flows instead. Small cap companies too may offer greater insulation from global trade risks than large cap multinational companies.

Sovereign Bonds:

While the majority of DM sovereign bonds continue to be expensive, US Treasuries are an outlier with a more neutral valuation. The tightening of US monetary policy and rising Treasury yields in 2018 led to a significant underperformance of US bonds relative to other, lower yielding markets. However, looking ahead we believe a role reversal is likely with European bond markets in particular underperforming US Treasuries. With the ECB stepping away from its buying program, European bond yields will be forced to find their own clearing level in the absence of net central bank buying. As a result, the asset class overall will struggle to generate positive returns for investors so we prefer low duration and, in a portfolio context, investment grade credit that offers a better yield with similar protection characteristics.

Credit:

US and Asia investment grade (IG) are attractive as wider spreads have improved valuations and US treasury yields have risen. In the US, we prefer high quality as the index is increasingly filled with lower quality BBBs – now more than 50% – a fair amount of which is over-levered and at risk of downgrades to junk as the stimulus impetus ebbs and cash flows deteriorate. We do not like US high yield (HY) for similar concerns on deteriorating cash flow against quite high leverage, the risk of which is still not adequately compensated for in the spread. As a result, US HY is still expensive. Although HY is priced more attractively in Asia, the bulk of the index is comprised of Chinese property developers that still suffer from poor fundamentals and potentially further headwinds, so we stay clear. Different than in the US and Asia, European corporates have used improved cash flows to actually pay down debt. However IG is less attractive due to our bearish view on European sovereigns. It is in the European HY space where value is starting to appear.

Commodities:

Fundamentals would seem to still support oil, but the outsized influence by speculators on price make movements difficult to read. The large decline experienced since early October is perplexing as fundamentals seem still supportive. The chief concern is that the fall may be associated with a demand shock which would be very negative for the global economy, so it certainly bears a close watch. Gold is attractive having proven to be a safe asset in turbulent times, despite the headwinds of a rising dollar and real yields.

Conclusion

The US is clearly late cycle and valuations are rich while the rest of the world is hampered by slower growth and increasingly tight liquidity. However, it is early to suggest growth cannot improve to extend the cycle globally. We expect conditions to improve on the back of a less hawkish Fed, averting a full blown trade war, and more constructive growth in China as efforts to stimulate take hold. Emerging markets could perform quite well in such an environment, but sticking to quality remains key as tighter liquidity will continue to take victims that suffer from weak fundamentals. Key downside risks include escalation of a trade war, a strong dollar that forces a bout of deleveraging and efforts to stimulate China growth fall flat. Europe also bears a close watch for its still ailing banks, uninspiring growth and rising populism, just as the ECB is preparing to end its asset purchasing program. Upside risks include a firmly weak dollar and strong China growth, which would add to tailwinds for risk assets across the board. Closely following signposts will remain key for capitalizing any of these trajectories.

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