23 October 2019
Fundamentals Flash

Asset Management

AFFIN HWANG CAPITAL

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Flash Points:

- Limited room for further monetary easing as central banks adopt 'wait-and-see' approach and save ammunition
- Trade tensions continue to put a drag on growth heading into US election year in 2020
- Active management with an emphasis on credit selection crucial as default risks rise in a late cycle

Global Easing Cycle Close to an End

In the following Maggie Wong, Senior Portfolio Manager of Affin Hwang Asset Management shares her views on where we are in the current interest rate cycle and outlook for Asian credits.

1) On monetary policy outlook, where are we in the interest rate cycle looking ahead?

In the past six months, we saw coordinated efforts by central banks globally to reduce interest rates in response to slowing economic growth. Total interest rate cuts delivered amounted to more than 1000bps by 26 central banks, including US Federal Reserve (Fed), European Central Bank (ECB), Reserve Bank of Australia (RBA) and Bank Indonesia (BI).

Going forward, we believe there is limited room for further monetary policy easing given already low interest rates. Central banks are more inclined to "save some bullets" for future, i.e. in the event whereby a recession materialises, as well as adopting a "wait-and-see" approach to assess impact post recent rate cuts.

In the US, the Fed will likely put rates on hold after a final cut in October (if not December), delivering a total cut of 75bps this easing round. The RBA and Bank of Korea (BoK) have also recently signalled that they have likely approached the end of the current easing cycle.

At the same time, we are also seeing a transition whereby central banks are now passing the baton to governments to prop-up growth (i.e. from monetary easing to fiscal easing). For example, there is increasing pressure on various European governments to launch fiscal stimulus. Other countries which have implemented fiscal stimulus recently include but not limited to France, Netherlands and India.

Therefore, expectations are that global interest rates are close to bottoming out in the near term. Having said that, I do not foresee central banks reverting to an interest rate hike cycle anytime soon. The biggest risks (both upside and downside) to my view would be ongoing trade negotiations and US inflation.

2) Which currencies do you think can continue to outperform against the US dollar in the year ahead?

Perhaps, the UK Sterling Pound (GBP) which has taken a big hit since the 2016 referendum, as markets factored in the risk of a no-deal Brexit. As recent developments in the UK have significantly lowered the risk of a no-deal Brexit, there could be room for the GBP to rally further.

While I think upside room for the USD is capped, there isn't any country/currency that stands out as US growth is still outperforming the rest of the world. That said in the medium term, the EUR and JPY could outperform USD as both currencies continue to trade cheaply on a real effective exchange rate (REER) basis.

Furthermore, both the Eurozone and Japan are running on a current account surplus, whereas the US is running on twin deficits (current account and fiscal account deficit). The JPY is also a good hedge against a sell-off for risky assets in a risk-off environment.

3) From a macro standpoint, which economies do you think are likely to give us cause for concern as we go forward?

Even though the risk of global recession remains low at this current juncture, among the "big-4 economies" the likelihood of Eurozone and Japan falling into recession next year is high. Germany's GDP contracted by 0.1% in Q2 and highly likely will contract again in Q3, triggering a technical recession.

In 2017, Germany accounted for 28% of Euro Area economy, followed by the UK which is going through a volatile period. Hence, it is likely that the Eurozone will dip into recession in 2020.

As for Japan, exports have tumbled given the slowdown in global growth and collapse in global trade volumes. The government has recently hiked VAT from 8% to 10% and this is expected to also weigh on growth.

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The remaining two of the “big-4 economies” i.e. China and US whilst not in recession territory yet are slowing rapidly. Ongoing trade tensions continue to weigh on corporate and consumer sentiment, dampening business and consumption spending. Uncertainty will continue to be in the backdrop and stay high going into the US election year in 2020. Hence, it is unlikely that we will see a pickup in business capital expenditure and household consumption.

5) How are Asian bond markets performing at the moment compared to the global bond market, where are the bright spots and where do you see the best opportunities arising?

Asian bond markets delivered a total return of 10.7% as of September 2019 which slightly underperformed the US bond market (12.9%) and global EM bond market (11%).

As we head into the late-cycle, active management would play an important role as default risk tends to rise. Hence, credit selection is key in navigating the current volatile environment. Within Asian bond markets, we like the Chinese property space both in Investment Grade (IG) and High Yield (HY). But we would also like to emphasise the importance of credit selection, i.e. avoiding companies with weak fundamentals.

In addition, in this kind of low rate environment, instead of going down the credit curve, we prefer going down the seniority to extract more yields. For example, we like certain hybrid bonds issued by corporate with strong fundamental and strong structure (bondholder friendly). Hybrid bonds tend to be ranked junior to straight bonds and usually yields 1.2-1.5x more than senior bonds.

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