Fullerton Insights 2019 – Highlights Part II

January 2019

Fullerton Fund Management held its flagship client seminar – Fullerton Insights – on 16 January 2019. The seminar was well-attended by around 160 guests from the institutional, private banking, wholesale and insurance segments.

Panel Discussion – Do Fundamentals Matter Anymore?
Fullerton's Asset Heads weighed in with their views on the relevancy of fundamentals in investing, in an increasingly macro-driven environment.

<u>Panelists:</u>

- Mr. Gerard Teo, Co-Head, Multi-Asset
- Ms. Shirin Ismail, Head of Alternatives
- Ms. Ong Guat Cheng, Head of Fixed Income
- Mr. Ken Goh, Head of Equities

Moderator: Mr. Lester Gray

Below are the key highlights of the discussion:

Q: Explain why bottom up, fundamental investing still matters in a world that seems to be increasingly driven by top down, global macro and geopolitical concerns.

Multi-Asset

- Geopolitical events of the last 12 months have indeed made investing more challenging. Market volatility has increased, given the need to factor in geopolitical considerations, in addition to top down, macro factors. Return to risk trade-offs have also worsened. In our assessment of the global macro and liquidity outlook, we are mindful of the potential blind spots and geopolitical risks.

- The Multi-Asset team is constantly looking at how to introduce greater diversification in the portfolios, and lower the volatility of portfolio returns, both from a top down allocation and bottom up security/credit selection perspective. We are mindful of managing drawdown risks, even as we aspire to achieve the target returns for investors over time.

Equities

- Fundamentals will prevail over the medium term. The Equities team's focus is on companies' earnings power, because earnings growth is the key driver of equity returns. This is especially pertinent in a world where there are more disruptive changes.

- Looking at the companies we analyse, we need to be open minded as the past does not necessarily reflect the future. We have to be better at anticipating changes, hopefully earlier than what the companies themselves are able to figure out. With that, we then assign the right valuation for a particular company we invest in. Having a strong conviction on the companies we invest in are crucial as well.

Alternatives

- The Alternatives team is focused on understanding three layers of fundamentals. First, to identify the macro fundamentals and with that, we can strategically position and structure the portfolios, deciding on which asset classes/types of fund strategies to include in the portfolio, and the range of beta exposures we want to have. Next layer is from the bottom up, i.e. micro fundamentals. The way our managers extract alpha is primarily extracting security alpha; this is achieved by better understanding the corporate business models and capital structures. The third layer is somewhere in between the first two layers, i.e. understanding the micro structure of the strategy that it is operating in.

- However, we are mindful that geopolitics may affect the state of the world and at times overwhelm the fundamentals of certain strategies, i.e. cross-border transactions, such as M&As. In such an environment, the focus can be shifted to domestic plays instead.

Fixed Income

- Our investment framework incorporates both top down and bottom up analysis. Top down, we analyse interest rates and currencies. Our bottom up analysis focuses on credit selection. The predictability of business cycles aids us in making projections, because there is history to fall back on. However, when one interjects geopolitical risk into economic/fundamental analysis, it becomes more challenging to navigate, because one has to assess whether the impact is short term or more sustained, and how it affects the macro drivers top down, as well as country-specific economic trends.

- In terms of credit selection – diversification is key in structuring our credit portfolios, and that is even more pertinent in an environment where the macro volatility remains high. Taking Chinese developers as an example – trade tensions have resulted in earlier than expected easing policy stance on financing for selective property issuers. This has led us to turn more constructive on selective property names. We believe it is important to pay close attention to bottom up fundamentals, and the ability of companies to repay their debt is key.

Q: Asian companies have generated a great deal of financial success in offshoring or outsourcing production and manufacturing lines. With the move towards protectionism, trade wars etc., this model might come into question. Are you paying close attention to this phenomenon?

- Asia's growth model has been changing significantly over the decades. Previously, there was cost arbitrage and the building up of the supply chain globally, with Asia, particularly China, at the heart of it. That model has run its course as it is increasingly difficult for Asian companies to create value as part of the global supply chain, as competition has heated up.

- Asian companies are looking to move beyond being only a supplier. Increasingly, they are confronted with the need to differentiate themselves in areas such as branding, distribution and product innovation.

- Specifically, China is facing a paradigm shift. China can no longer rely on being the factory of the world. China's ambition to be the R&D centre of the world is under threat, given that US policy is geared towards containing China. China will have to re-examine its own development model and how it fits into a new global order. That would have implications on the future investment opportunities in China, and whether companies are able to adapt/innovate. Those that are able to do so are the companies that would create more alpha opportunities for investors.

Q: Have Chinese equity markets fully discounted the economic slowdown and trade tensions?

- We believe that the US and China are still likely to reach an agreement on trade tariffs. The US-China trade situation has turned more constructive, with the resumption of a new round of trade talks between the two nations.

- After a lacklustre performance in 2018, Chinese equity markets rebounded strongly in January 2019, driven mainly by easing US-China trade tensions and supportive domestic policies. Chinese equities remain attractively valued, having been beaten down in 2018.

- Based on our bottom up analysis, there appears to be more weakness to come, given that growth expectations for China have come off – the topline growth for many companies remains sluggish.

- We believe companies need to find ways to improve margins by looking at new areas – for example, making use of 5G technology to drive the Fourth Industrial Revolution.

Q: Is the US credit problem likely to lead to wider credit spreads in the next 2 years?

- We are in the advanced stage of the US expansion cycle. 2018 has not been an easy year for credit investors. We have seen spreads widen, although some have been sector specific, such as the oil and high yield sectors.

- Because of the less aggressive tightening compared to last year, and from the monetary policy rate standpoint, the incremental impetus of tightening will not be as strong, compared to last year. That aside, there could be more idiosyncratic risks out there. From a corporate fundamentals standpoint, we are more constructive on Asia relative to the US.

Q: What are your economic growth assumptions for 2019?

- In our central scenario, the global economy muddles along over the medium term. Recovery struggles to gain traction.

- US growth moderates to 2-2.5% trend pace for 2019. Consumption remains resilient as consumer fundamentals are largely firm. However, investment activity remains uneven due to slower profit growth and lingering worries over US-China relations. Fiscal spending eases and turns contractionary, given the need to reduce the sizeable deficit.

- Asian governments ease fiscally so as to boost domestic demand. China will likely grow at a pace of 6-6.5%. China continues to strike a balance between sustaining growth versus pushing economic reforms. Periodically, policymakers switch to prioritizing macro stability whenever economic growth decelerates. Base case is China succeeds in avoiding a hard-landing, given ample policy ammunition in reserve.