INVESTMENT INSIGHT- November 2018

Investment Services Department

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China-U.S. Trade War + Fear of Emerging Market Crisis

Escalating trade war between China and the U.S. and the fear of emerging market crisis were the two main investment focuses in the third quarter of 2018.

In addition to the 25% tariffs on the USD50 billion Chinese goods imposed in July and August; in mid of September, the U.S. Government announced its second wave of tariffs on USD200 billion worth of Chinese goods effective on 24th September. The new tariffs would start at 10% and increase to 25% by the end of the year. Unlike the previous wave of tariffs which was mainly on industrial goods, the new action would also affect consumer products such as air conditioners, furniture and lamps. The Trump administration also threatened tariffs on an additional USD267 billion worth of imports if China retaliated, which China promptly hit back within 24 hours after President Donald Trump's decision. The Chinese Ministry of Commerce announced that it would levy tariffs of 5% to 10% on USD60 billion worth of US goods sent to China, with 5,207 individual products affected and the commencement date was on 24th September as well.

Followed the start of bilateral trade talks with the European Union ("EU") and Japan and the earlier trade deal settled with South Korea, the U.S. also reached a new United States-Mexico-Canada Agreement (USMCA) with Canada and Mexico to replace the previous North American Free Trade Agreement (NAFTA) on 30th September which was shortly before the deadline. By clearing the disputes with other trading partners, it seems that the U.S.'s bargaining power is strengthened and the U.S. is ready for a protracted economic war with China.

Since the second quarter of this year, the Chinese Yuan has depreciated almost 10% against the U.S. dollar. To a certain extent, it helped China to weather the impacts of the U.S. tariffs by making its export goods cheaper. Although the recent economic figures showed the growth momentum of the Chinese manufacturing sector has slowed down, it is believed that the Chinese Government may apply further stimulus measures including tax cut and increase in infrastructure spending while the central bank will provide adequate liquidity in the financial system so as to boost domestic demand and offset the fall in the exports to the U.S.

EXHIBIT 1: The Chinese Yuan has depreciated almost 10% against the USD since April this year

Source: Bloomberg (as at 30/9/2018)

The trade war between the U.S. and China is not a pure trade or economic issue; it is also a political tug-of-war. Up to now, it is hard to anticipate when the China-U.S. trade war will end since there is no sign of softening for both countries. The damage of the trade war is not only limited to the U.S. and China, the pain will also be felt across the globe since global economies are more and more interconnected. As warned by the IMF Managing Director, Christine Lagarde, the escalating China-U.S. trade war could deliver a “shock” to the already struggling emerging markets, the crisis happened in Argentina and Turkey may spread across the developing world.

EXHIBIT 2: The falling MSCI Emerging Market Index

Source: Bloomberg (as at 30/9/2018)

With the American economy enjoying a strong upswing, the Federal Reserve has been raising its benchmark interest rate for 8 times since 2016 and has also been unwinding its massive balance sheet. The monetary tightening caused strong U.S. Dollar and it hurt emerging markets like Turkey and Argentina, which borrowed heavily in the U.S. Dollar during the period of quantitative easing. As at the end of the third quarter, the Turkish Libra and Argentine Peso have fallen 37% and 55% respectively against the U.S. Dollar this year and the two countries' interest rate have been risen to 24% and 60% respectively so as to stop further currency depreciation. Apart from Turkey and Argentina, other emerging markets seem also have been inflected. In Asia, the Indian Rupee is now at the historical low level while the Indonesian Rupiah also falls to the lowest since 1997. At the end of the third quarter, the MSCI Emerging Market Index has dropped over 17% from its peak in January this year. The market down trend continued in the early October and entered into bear market territory.

The current U.S. economy is near full employment, economic growth and inflation are close to the targets, it is expected that the rate hike cycle will continue in the U.S. At the same time, if the trade dispute between China and the U.S. cannot be resolved, it may hinder global economic growth and also add market uncertainty. Investor should be aware that that the already-fragile emerging market economies may experience further market corrections, sharp exchange rate movements, and weakening of capital flows in the near term.

TABLE 1: Global Stock Markets Performance

	2018 Q3 Return		2018 YTD Return	
Indexes	**Local Currency**	**USD**	**Local Currency**	**USD**
Dow Jones Industrial Average	9.63%	9.63%	8.83%	8.83%
Euro STOXX 50	0.42%	-0.12%	0.04%	-3.35%
Euro STOXX 600	1.30%	0.75%	1.41%	-2.04%
DAX	-0.48%	-1.02%	-5.19%	-8.41%
CAC 40	3.36%	2.80%	6.27%	2.66%
Nikkei 225	8.81%	6.20%	7.68%	6.80%
Hong Kong Hang Seng	-2.50%	-2.24%	-4.10%	-4.26%
Hang Seng China Enterprises	1.87%	2.13%	-2.08%	-2.24%
Shanghai Stock Exchange Composite	0.32%	-3.26%	-12.63%	-17.24%
Shanghai Shenzhen CSI 300	-0.91%	-4.45%	-12.82%	-17.42%
Singapore FSSTI	1.26%	0.98%	-1.02%	-3.21%
Korea KOSPI	0.73%	1.04%	-4.66%	-7.98%
Taiwan TWSE	4.61%	4.50%	7.54%	4.66%
India SENSEX	2.63%	-3.14%	7.44%	-5.44%
Indonesia JCI	3.21%	-1.20%	-4.06%	-12.57%

Thailand SET	10.98%	13.49%	2.84%	3.68%
Russia RTS	6.30%	6.30%	8.09%	8.09%
Brazil IBOV	9.04%	4.76%	3.85%	-14.62%
S&P Pan Arab Composite	-0.88%	-0.88%	11.34%	11.34%
MSCI World	5.10%	5.10%	5.89%	5.89%

Source: Bloomberg (as at 30/9/2018)

TABLE 2: Major Currencies Performance (In terms of USD)

	Change in 2018 Q3	Change in 2018
Currencies	**In terms of USD**	
Euro	-0.68%	-2.22%
British Pound	-1.33%	-2.56%
Japanese Yen	-2.59%	-0.04%
Hong Kong Dollar	0.24%	-0.18%
Chinese Renminbi (CNY)	-3.61%	-5.27%
Australian Dollar	-2.44%	-7.06%
New Zealand Dollar	-2.20%	-6.13%
Singapore Dollar	-0.34%	-2.27%
Korean Won	0.48%	-3.48%
Taiwanese Dollar	-0.16%	-2.43%
Indian Rupee	-5.55%	-11.89%
Indonesian Rupiah	-3.84%	-8.96%
Thai Baht	2.41%	0.74%
Russian Ruble	-4.29%	-12.09%
Brazilian Real	-4.27%	-18.29%

Source: Bloomberg (as at 30/09/2018)

Review Highlights and outlook around the globe:

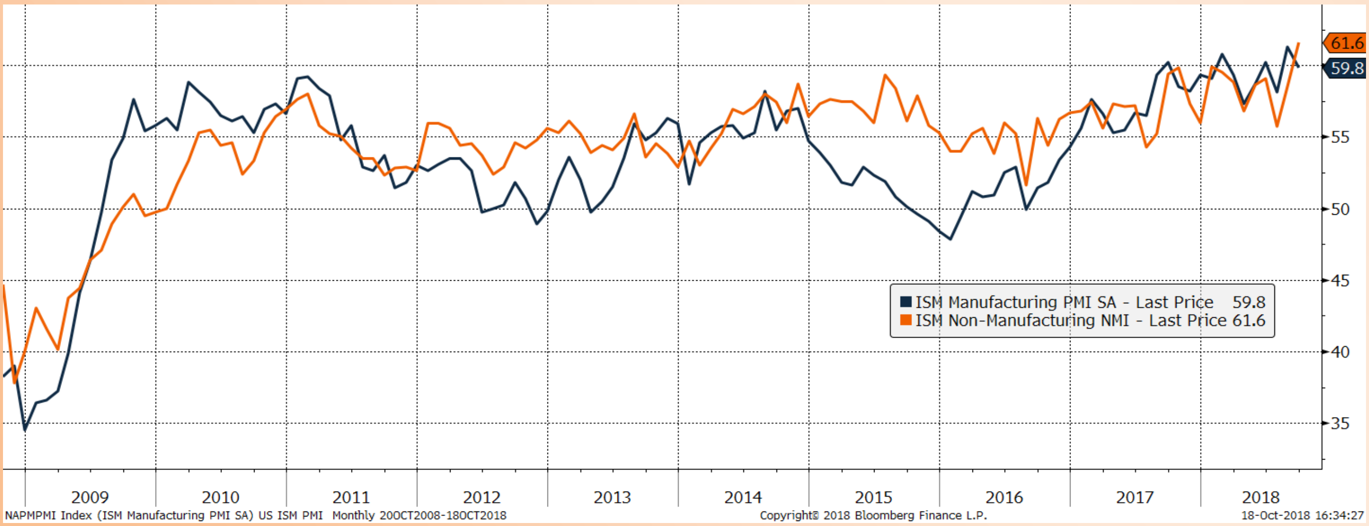
U.S.

- The U.S. economy grew 4.2% annualized rate in the second quarter which was better than the 4.1% preliminary estimation and was the fastest rate since the third quarter of 2014. Net trade made the highest contribution since the last three months of 2013 mainly due to a rise in exports of soybeans and other goods before tariffs take completely effect. Growth was also driven by the Trump administration's USD1.5 trillion tax cut package, which boosted consumer spending after it almost stalled early in the year.

- It is always important to watch the consumer confidence and consumer sentiment numbers as 70% of the U.S.'s GDP is comprised of consumer spending. According to the recent report from the Conference Board and University of Michigan, the consumer confidence in the U.S. approached to all-time high level. The consumer confidence index climbed to 138.4 in September from a revised 134.7 in August which was close to the level last seen in 2000. Besides, although the final reading of the University of Michigan's consumer sentiment index in September was revised down from 100.8 to 100.1, it was still above August's level of 96.2 and topped over 100 for the 3rd time since January of 2004.

- Apart from personal consumption, both manufacturing and non-manufacturing activities remained robust in the U.S. According to the September figures from the Institute for Supply Management (ISM), although the manufacturing index dropped to 59.8 from 61.3 in August (the highest level since May 2004), the non-manufacturing index rose to 61.6 which was the highest reading since the index was created in 2008.

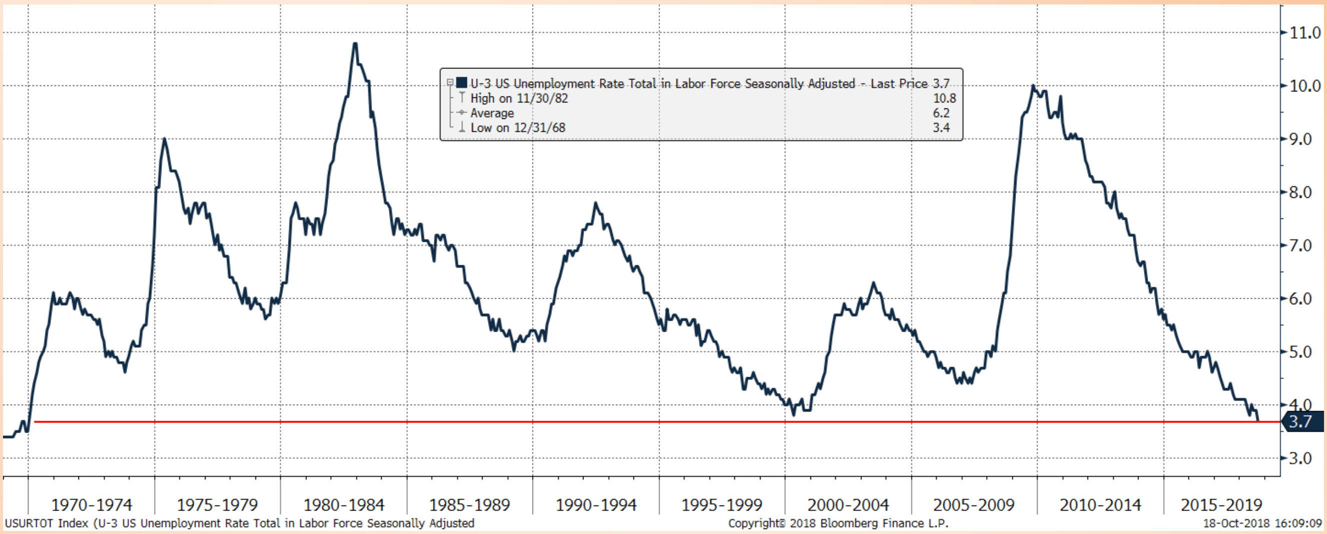
EXHIBIT 3: Robust manufacturing and non-manufacturing activities in the U.S.



Source: Bloomberg (as at 30/9/2018)

- Due to the impact of Hurricane Florence , the nonfarm payrolls of the U.S. only increased by 134,000 jobs in September, the fewest in a year. However, the unemployment rate fell from 3.9% in August to 3.7% in September, which was the lowest level since December 1969. The annual rise in wages fell to 2.8% from 2.9% in August and it is believed that mild wage growth remains sufficient to keep inflation around the Fed's 2% target.

EXHIBIT 4: The U.S. unemployment rate was at the lowest level in 49-year



Source: Bloomberg (as at 30/9/2018)

- Since the domestic economy was strong, it boosted American's purchases of foreign goods. The trade deficit expanded 6.4% from the prior month to a seasonally adjusted USD53.24 billion in August and it was the highest since February this year. In August, imports increased 0.6% to a record of USD262.7 billion while export fell 0.8% to USD209.43 billion from July's USD211.10 billion. Against Trump's expectations, China's merchandise trade surplus with the U.S. also grew in August to a record of USD38.6 billion, up from USD36.8 billion in July. The widen gap might reflect that businesses rushed to import goods from China before the tariffs in late August and September for the preparation of coming holiday shopping season.

- As widely anticipated, the Federal Reserve raised the federal funds rate 25 basis points to a range of 2% to 2.25%, back to the level in April 2008. This was the 8th increase since the Fed began interest rate normalizing policy in December 2015. In addition, the Fed also dropped the language saying that "the stance of monetary policy remains accommodative" in its statement and projected one more hike before the end of the year and three in 2019. The Fed also released a new economic forecast and estimated that the economic growth will gradually decline over the next three years from a 3.1% annual rate this year to a 1.8% rate in 2021.

- The U.S. stocks finished up for the best quarterly performance since 2013. Both the Dow and the S&P 500 were up in 11 of the last 12 quarters while the Nasdaq was up for the 9th quarter in a row. The U.S. bull market has been running for almost 10 years and it is supported by strong fundamental as the U.S. economy is booming and the corporate earnings are robust. It is hard to anticipate when the economic expansion cycle will end; however, it is believed that the U.S. stock market will be more volatile due to its high valuation. The result of the U.S. mid-term elections in November, the third quarter corporate earnings, the development of the China-U.S. trade war and the coming interest rate movement are the key factors that we should look at in the near term. Same as the last quarter, we prefer to wait for a market correction buying opportunity for a long term investment in the U.S. stock market.

Europe

- The Eurozone economy expanded 0.4% in the second quarter of 2018, unrevised from the second estimate and the same pace as in the previous period. Compared with the same quarter of the previous year, the Euro Area economy expanded 2.1% in the second quarter, slightly below the second estimate of 2.2% and the previous quarter's 2.4% growth.

- It seems that the latest trade war between China and U.S. has also weakened the factory expansion in Europe. According to the data from HIS Markit, the September Manufacturing PMI dropped to a 2-year low of 53.2 from August's 54.6 and the new export orders rose the least in the past 63 months. Not surprisingly, the European Central Bank ("ECB") lowered its Eurozone GDP growth rate forecast in 2018 and 2019.

- Political uncertainty in Italy and U.K. also heightened at the end of September. Italy's anti-establishment government has approved a draft budget to increase public spending in the coming years and announced that its deficit would reach 2.4% of GDP in 2019, 3 times higher than the target announced by the previous government. In addition, the Italian Government also did not have any plan on structural adjustment as requested by Brussels to cut down its massive pile of public debt, which was over 130% of its GDP. If the Rome Government refuses to make any change to improve its announced deficit figures, the European Commission may take unprecedented step of rejecting Italy's budget and it is believed that the impact will be serious.

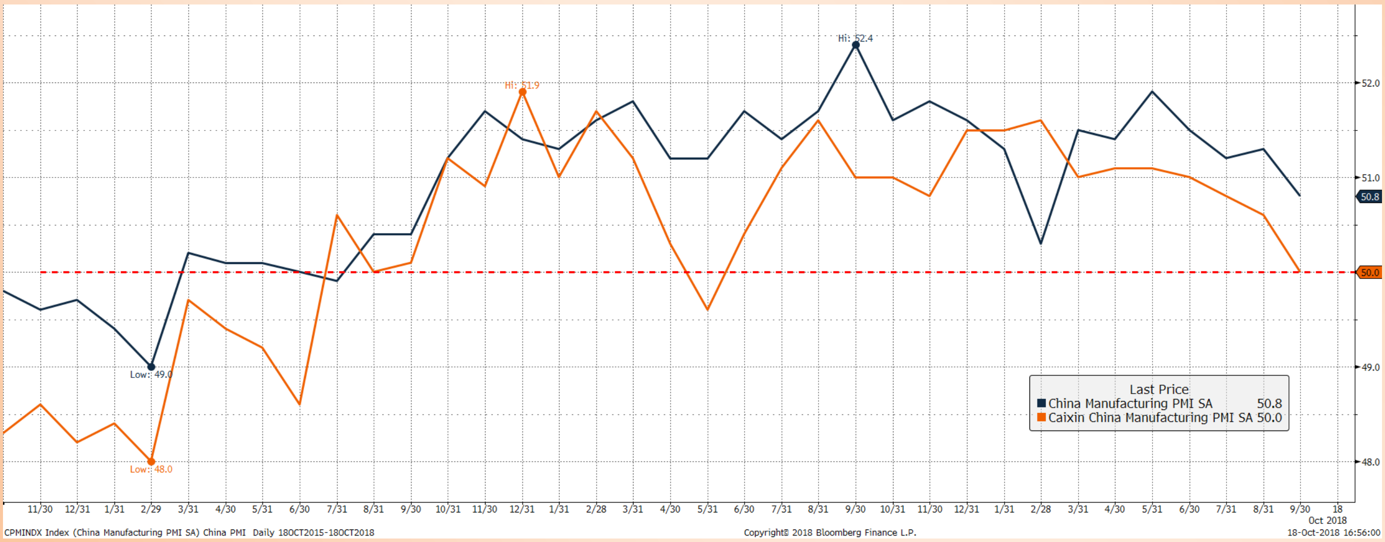
- According to the Brexit timetable, there is less than 6-months time for the U.K. to leave the EU. However, the negotiation between both parties is still in a deadlock and the chance of "No Deal" Brexit is increasing. If no agreement can be made, it means there would be no 21-month transition period, which Theresa May is currently proposing. If that is the case, the British consumers, businesses and public bodies would have to respond immediately to changes as a result of leaving the EU and it may create significant damage to the U.K. economy.

- The European investment market is filled with political uncertainty. The outcome of the Brexit negotiations is unclear and whether the Italian budget will be accepted by the EU is still an unknown. Coupled with the rise in global trade protectionism, the European economy is showing signs of slowdown. Although the valuation of European stock markets is relatively low, it is believed that there will be no breakthrough and the market will continue to consolidate in the near term.

Asia

- The impact of trade war on China's economy is now more visible. The official and Caixin manufacturing PMIs both declined much more than expected in September, with the latter falling to 50 -- the threshold separating improving and deteriorating conditions. The export orders sub-index of the official manufacturing PMI – one of the key indicators to gauge the impact of the U.S. tariffs -- tumbled to 48.0, from 49.4 in August. It remained in the contraction territory for a fourth month in a row. New export orders in the Caixin PMI also saw a sharp decline.

EXHIBIT 5: Weakening manufacturing activities in China



Source: Bloomberg (as at 30/9/2018)

- Economic downturn pressure in China has intensified. It is expected that more fiscal support from the government will come and the People's Bank of China ("PBOC") is likely to loose its monetary policy. Not surprisingly, on the last day of China's National Day holiday, the PBOC announced to cut the reserve requirement rate for most commercial banks by 100 basis points effective on 15th October. The move will inject 750 billion yuan into the banking system and it was the 4th cut in 2018.
- In Japan, the household spending jumped 2.8% in August, which was the fastest annual pace in the past 3 years, as bigger summer bonuses and steadily rising wages boosted consumption, suggesting robust domestic demand could help offset ill-effects from escalating trade frictions. Solid growth in consumption is considered crucial for Premier Shinzo Abe, who reshuffled his cabinet after winning

a ruling party leadership race last month, to proceed with a scheduled increase in the sales tax October next year.

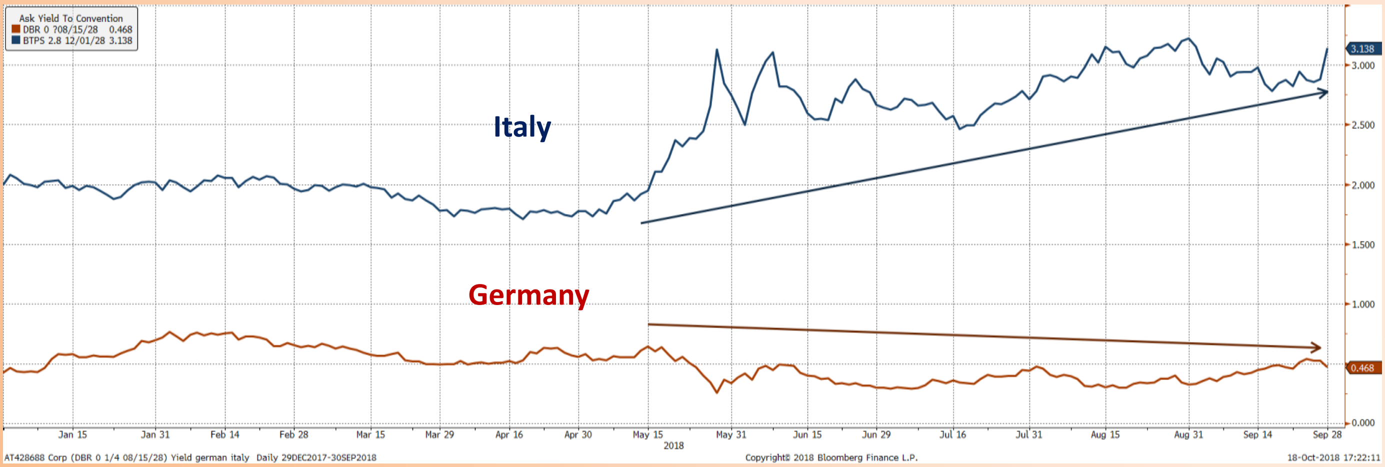
- Except China, several Asian emerging markets have delivered a pretty good performance in the last quarter. Thailand's SET Index has led the way, with its biggest quarterly jump since 2013, while Malaysia's benchmark gauge has rallied the most since 2011. However, it was not enough to prevent losses in the regional MSCI Asia Pacific Index. The index recorded the third consecutive quarterly slide, its longest streak since 2011. As there are a lot of market uncertainties, the Asian stock markets may experience further correction in the near term. However, as the stock market valuation is relatively low (especially Hong Kong and China), aggressive investor may consider accumulating Asian stocks gradually so as to capture the potential investment opportunity in medium to long term.

Fixed Income

- Due to the reason of rising optimism over the strength of the U.S. economy and further interest rate increase from the Federal Reserve, the 10-year Treasury bond yield has risen over 3.1%, the highest level since July 2011. The surge in U.S. Treasury yields has also prompted a rise in government bond yields across the globe, Japanese and euro zone bond yields rose sharply, tracking their U.S. counterparts.

- As the tension between the EU and Italian Government was lifted because of Italy's 2019 budget deficit proposal, the Italian Government debts were sold off and its 10-year bond yield rocketed to over 3% which was the highest level since 2014. The yield spread between Germany and Italy 10-year government bond also widened to the widest in around five-year time. However, the situation may worsen further since investors are worrying that credit rating downgrade from S&P and Moody's may come soon, and send Italy's sovereign debt rating closer to "junk" level.

EXHIBIT 6: The yield spread between Germany and Italy 10-year government bond



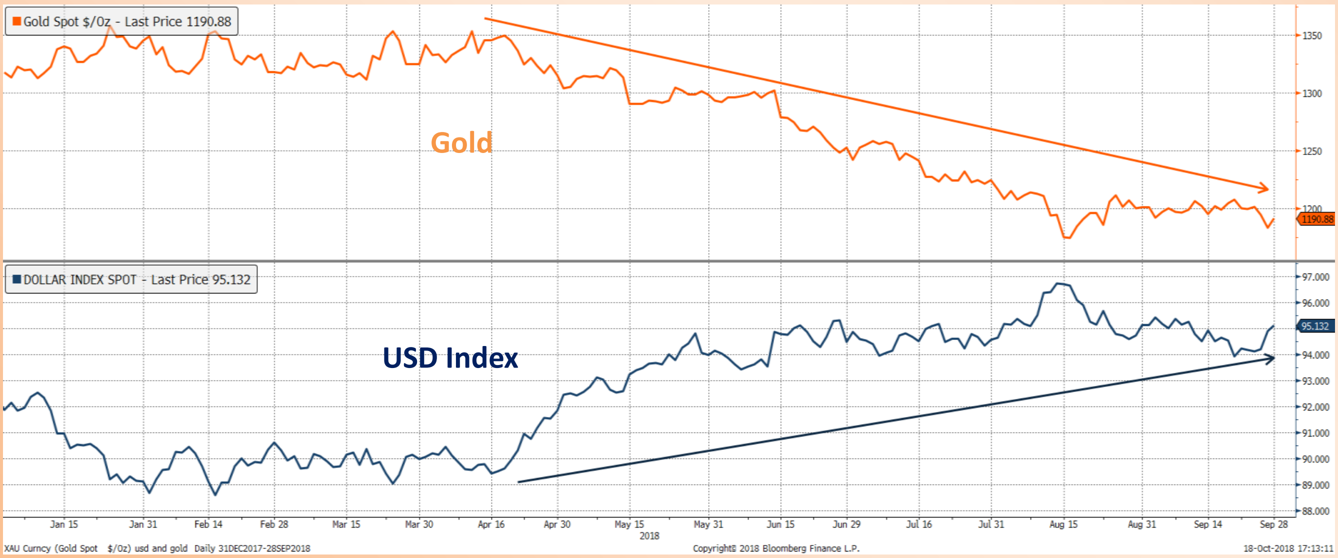
Source: Bloomberg (as at 30/9/2018)

Commodities

- Crude oil price has gained more than 20% this year and was at the highest level in 4 years. Although the OPEC and its allies' pledge to pump more oil, it may not be enough to offset losses from American sanctions on Iranian oil. Besides, the geopolitical risk in the Middle East is increasing recently; it is believed that the oil price may remain high in the near term.

- On the other hand, due to the strong U.S. dollar and the prospect of rising interest rate in the U.S., gold price recorded its sixth consecutive monthly drop in September and lost nearly 12% since mid-April. Unless there is any sudden negative event happens, otherwise, the outlook of the yellow metal may still be pessimistic.

EXIHIBIT 7: Opposite movement of gold price and the U.S. Dollar



Source: Bloomberg (as at 30/9/2018)

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