INVESTMENT INSIGHT January 2019
Investment Services Department

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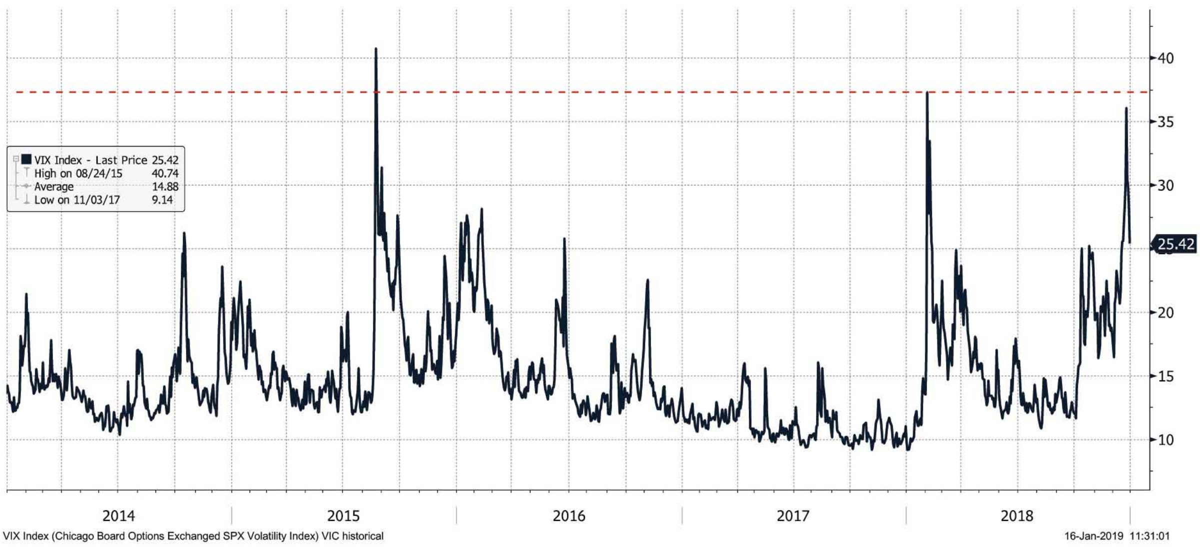
Market volatility is coming back; stable approach should be the investment direction in 2019

While 2017 was a stellar year for investors, on the contrary, 2018 was a horrible year and it has been the worst year since the 2008 financial crisis. In January 2018, several major global stock market indexes reached new record high level as investors were celebrating a synchronized upswing in global economic growth. However, due to the uplift of inflation expectation in the U.S. and the fear of more aggressive interest rate hike, the wind direction changed rapidly in February and the stock market volatility also returned from recent years' low.

EXHIBIT 1: Market volatility returned in 2018



Source : Bloomberg (as at 31/12/2018)

The interest rate hike cycle and relatively strong economy in the U.S. caused the U.S. Dollar to become one of the strongest major currencies in 2018. The strong U.S. dollar was the nightmare of emerging markets, especially to those countries with large U.S. Dollar denominated debt. During the summer time of 2018, both Argentina and Turkey experienced sharp currency depreciation (The Argentine Peso and Turkish Lira fell 51.24% and 34.69% respectively in the 2nd and 3rd quarter of 2018). Investors worried that the "crisis" would spread across other emerging market countries, but fortunately the situation did not get worse in the 4th quarter.

The escalating trade conflict between China and the U.S. was also one of the main investment focuses in 2018. The sentiment was slightly improved after the temporary 90-days trade tariff ceasefire deal was reached during the G20 Summit in early December. However, the arrest of Huawei's deputy chairwoman and chief financial officer, Meng Wanzhou, in Canada may add further uncertainty towards the relationship between the two countries.

The trade war between China and the U.S. has threatened the growth of the manufacturing sector in China, both the official and Caixin Manufacturing PMI fell to contraction zone in December. Besides, economic slowdown was also seen in many other countries, the economy in Japan, Sweden, Switzerland, Italy and Germany has already contracted in the 3rd quarter. In the 4th quarter, record-high US stock indexes also took a sharp downturn. The Dow Jones and S&P 500 Index fell almost 10% in December which were their worst December performance since the Great Recession in 1931 and their biggest monthly loss since February 2009.

While investors were excited about global synchronized economic growth in the beginning of 2018, ironically, they worried about global economic slowdown at the end of the year and the recent performance of global investment markets has reflected the pessimistic sentiment. In the past, even the financial markets were in the most difficult time, usually few major asset classes could make profit. For example, during the financial crisis in 2008, U.S. Government bond and gold could still deliver positive return. However, in 2018, it seemed "Cash is King",` no matter you invested in global stocks, government debts or commodities, you suffered loss eventually.

EXHIBIT 2: Almost every major asset class was down in 2018

Source : Bloomberg (as at 31/12/2018)

Looking forward in 2019, we believe that there are several important factors investors should pay attention. They are as follow:

The Development of China-U.S. Trade War

According to the meeting between President Donald Trump and Xi Jinping during the G20 Summit, the deadline of the trade negotiation will be on 1st March 2019. We tend to believe that both parties may reach certain agreements finally and the tension between the two countries will be lessened in the near term, however, it is thought that the trade conflict is not a pure trade or economic issue; it is also a political tug-of-war and the Sino-American relations are still full of new challenges and changes in the long run.

Global Economic Growth

Global economic slowdown is almost a general consensus. In the U.S., the impact of President Trump's tax cut policy may fade out gradually, but robust job market and strong private consumption may still be able to support the U.S. economy in 2019. It is no doubt that the recent economic data released in China were weak; however, as the Government committed to provide more stimulus measures, it is believed that the Chinese economy can still maintain at around 6% annual growth in the near term which is still a pretty good figure. On the other hand, it seems that the risk in Europe is heightened. The economy in Germany and Italy has already contracted in the 3rd quarter and the uncertainty of Brexit and rising social problems may hurt the European economy further.

U.S. Interest rate

After 9 times of interest rate increases since the end of 2015, the U.S. monetary policy looks set to enter a new phrase. According to the minutes of the Fed's December meeting, the Fed could be more "patient" on future rate hike. The end or near-end of the interest rate hike cycle may halt or even reverse the strong U.S. dollar trend that has been in place since last spring and it will be favorable to the emerging markets.

Market Valuation

We have a lot of bad news in the investment markets in 2018. However, the valuation of several major equity markets has fallen to recent years low after the correction and now they may have a more attractive risk to reward ratio.

TABLE 1: The P/E ratio of major stock indexes

	Current	5- year Average	5- year High	5- year Low
Hang Seng Index	9.82	11.48	14.18 (8 June 2017)	8.94 (2 Dec 2016)
MSCI World Index	15.56	19.45	22.65 (7 Sep 2016)	14.85 (25 Dec 2018)
MSCI Emerging Market Index	11.58	13.98	17.11 (8 June 2016)	9.84 (4 Feb 2014)

Source : Bloomberg (as at 31/12/2018)

We see both potential risk and opportunities in the investment markets but a stable and defensive investment strategy would be a more prudent and proper approach as it is believed that high market volatility will continue in 2019.

TABLE 2: Global Stock Markets Performance

	2018 Q4 Return		2018 Return	
	Local Currency	USD	Local Currency	USD
Dow Jones Industrial Average	-11.31%	-11.31%	-3.48%	-3.48%
Euro STOXX 50	-11.82%	-13.13%	-11.78%	-16.05%
Euro STOXX 600	-11.89%	-13.20%	-10.65%	-14.96%
DAX	-13.78%	-15.07%	-18.26%	-22.21%
CAC 40	-14.51%	-15.78%	-9.15%	-13.54%
Nikkei 225	-16.91%	-14.58%	-10.39%	-8.63%
Hong Kong Hang Seng	-10.55%	-10.78%	-6.73%	-6.81%
Hang Seng China Enterprises	-10.00%	-10.22%	-8.09%	-8.17%
Shanghai Composite	-11.57%	-11.69%	-22.74%	-26.91%
Shanghai Shenzhen CSI 300	-12.41%	-12.52%	-23.64%	-27.76%
Singapore FSSTI	-5.50%	-5.24%	-6.47%	-8.28%
Korea KOSPI	-12.87%	-13.29%	-16.78%	-20.07%
Taiwan TWSE	-11.61%	-11.78%	-4.95%	-7.66%
India SENSEX	-0.20%	3.90%	7.23%	-1.76%
Indonesia JCI	3.94%	6.72%	-0.28%	-6.69%
Thailand SET	-10.63%	-11.28%	-8.09%	-8.01%
Russia RTS	-9.44%	-9.44%	-2.11%	-2.11%
Brazil IBOV	10.77%	15.03%	15.03%	-1.79%
S&P Pan Arab Compositex	-1.46%	-1.46%	10.41%	10.41%
MSCI World Index	-13.31%	-13.31%	-8.19%	-8.19%

Source : Bloomberg (as at 31/12/2018)

TABLE 3: Major Currencies Performance (In terms of USD)

	Change in 2018 Q4	Change in 2018
	In terms of USD	
Euro	-1.18%	-4.48%
British Pound	-2.13%	-5.62%
Japanese Yen	3.66%	2.73%
Hong Kong Dollar	-0.05%	-0.23%
Chinese Renminbi (CNY)	-0.14%	-5.41%
Australian Dollar	-2.42%	-9.73%
New Zealand Dollar	1.51%	-5.34%
Singapore Dollar	0.30%	-1.97%
Korean Won	-0.59%	-4.05%
Taiwanese Dollar	-0.55%	-2.97%
Indian Rupee	3.90%	-8.46%
Indonesian Rupiah	3.56%	-5.71%
Thai Baht	-0.63%	0.10%
Russian Ruble	-5.97%	-17.34%
Brazilian Real	4.51%	-14.61%

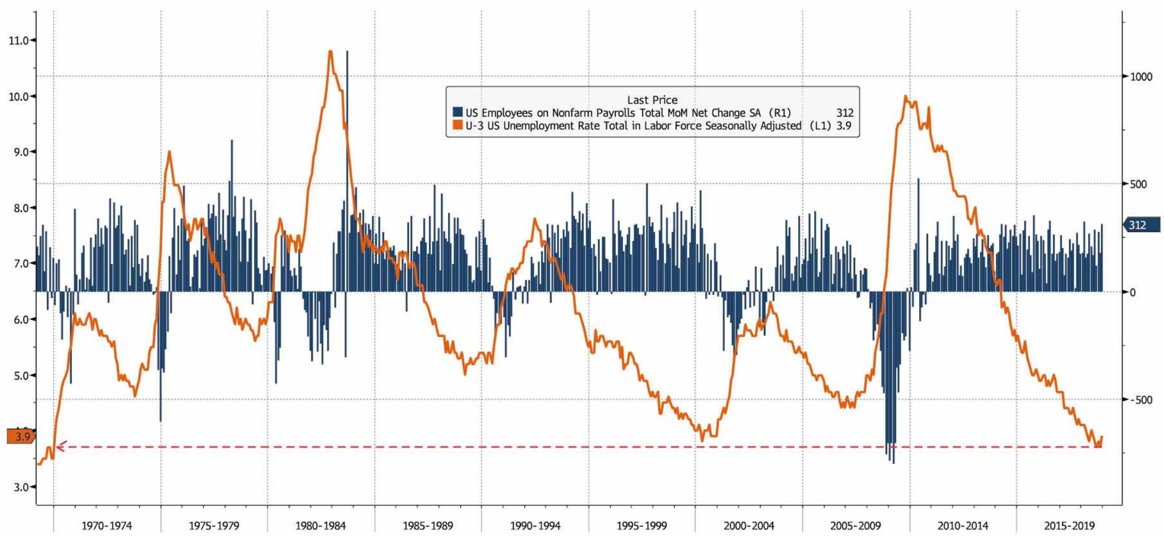
Source : Bloomberg (as at 31/12/2018)

Review highlights and outlook around the globe:

United States

- The U.S. economy slightly cooled down during the 3rd quarter; the GDP fell from 4.2% in the 2nd quarter to 3.4% but remained in line with the Trump administration's goal of achieving a 3% growth rate in each quarter. The deceleration of GDP growth was primarily attributed to a downturn in exports and non-residential fixed investments. Growth was still largely driven by President Trump's $1.5 trillion tax overhaul, which was signed into law in last December and significantly slashed the corporate tax rate, bolstering business investment and increasing consumer confidence.
- The trade war also affected the U.S. factory activities as well. As growth in new orders, production and employment slowed sharply, the December ISM Manufacturing PMI in the U.S. fell to 54.1 from 59.3 in November which was the weakest since November 2016, and missed the market expectations of 57.9. Besides, it was also the largest monthly drop since October 2008.
- On the other hand, the job market in the U.S. remained robust in 2018. The December nonfarm payroll increased by 312,000 which was much better than the last month figure and expectation. The December jobs gain pushed the total U.S. employment above 150 million jobs for the first time. The average hourly earnings rose 3.2% from a year earlier, topping projections and matching the fastest pace since 2009. Meanwhile, the unemployment rate rose from an almost 5-decade low to 3.9% while the labor force participation rate increased to 63.1% which reflected that more people were actively seeking jobs.

EXHIBIT 3: The U.S. jobless rate was almost at 50-year low



Source : Bloomberg (as at 31/12/2018)

- Despite the heavy criticism from President Donald Trump, the Federal Reserve raised the target range for the federal funds rate by 25bps to 2.25-2.5% during its December meeting. At the same time, it also lowered forecasts for interest rate hikes in 2019 amid the recent volatility in financial markets and slowing global economic growth.

- The U.S. stock market experienced a sharp correction in the last three months of 2018. At the end of 2018, the S&P 500 index was about 14% away from the peak. Except healthcare and utilities sectors which still posted 4.7% and 0.5% annual gains respectively, all other sector indexes lost in 2018. Apart from global economic slowdown and trade tension between China and the U.S., investors also worried that the U.S. corporate earnings growth might come to the peak and decline in 2019. After the recent correction of asset price, the valuation of the U.S. stock has become more reasonable and the current and estimated price to earnings ratio of the S&P 500 index were traded at around 17 and 15 times respectively, which were lower than before. Perhaps the recent market sell-off has fully reflected investors' pessimistic expectation in the future.

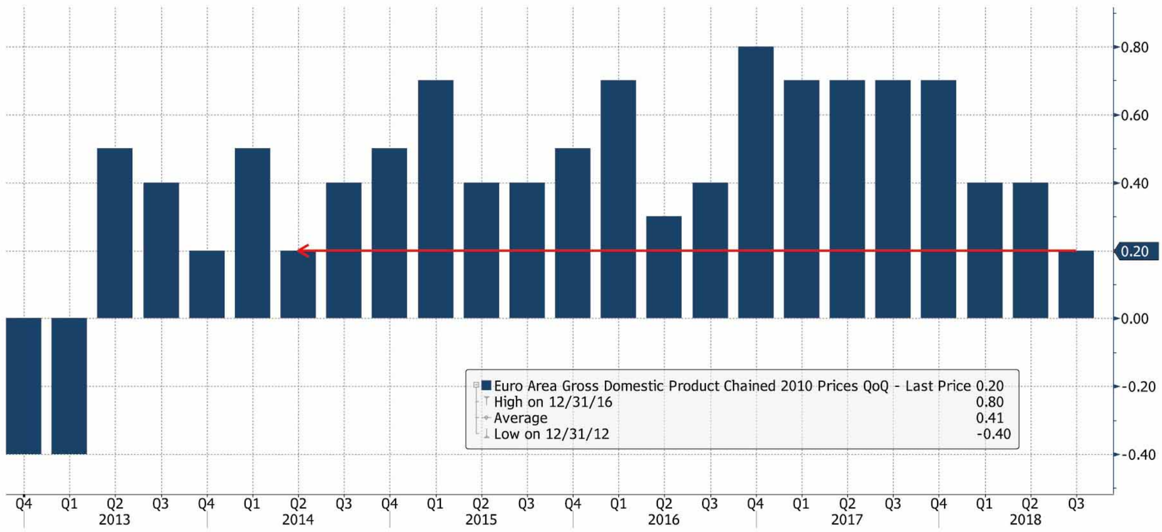
EXHIBIT 4: The Price to Earnings Ratio of S&P 500 fell to 5-year low

Source : Bloomberg (as at 31/12/2018)

Europe

- The Eurozone economy grew 0.2% quarter-on-quarter in the 3rd quarter of 2018 and it was the weakest growth rate since the 2nd quarter of 2014, mainly due to a negative contribution from external demand. Among the Eurozone countries, the German and Italian economy unexpectedly contracted in the 3rd quarter. In Germany, as the production of the auto sector slowed down, the economy contracted 0.2% compared with the previous quarter which was the first time contraction since 2015. Due to the reasons of political instability and weak domestic demand, the Italian economy also shrank 0.1%.

EXHIBIT 5: The 3rd quarter GDP of Eurozone was the weakest since 2014



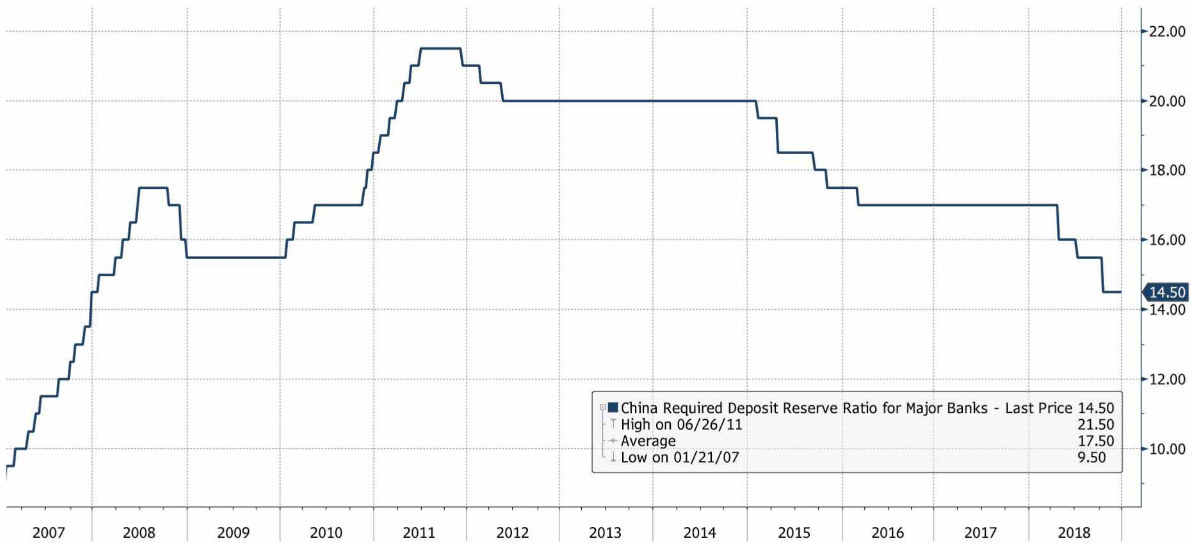
Source : Bloomberg (as at 31/12/2018)

- The economy in Eurozone may continue to slow down in the near future. The latest IHS Markit Eurozone Composite PMI in December dropped to 51.1 from 52.7 in November which was at the weakest level for over 4 years. Among Eurozone's largest economies, France's economic output fell for the first time for two-and-a-half years due to the “Yellow vests Movement”. The growth in Germany was also the weakest for five-and-a-half years. Italy output was flat, while PMI's for Ireland and Spain hit the lowest in 9 and 3 months respectively.
- Due to the weak energy price, the Eurozone inflation cooled to its weakest rate in 8 months. The region’s consumer price index rose 1.6% in December year-on-year, down from the prior month’s 1.9% and also below the market expectation of 1.8%.
- After 4 years and 2.6 trillion Euros bond purchase, the European Central Bank (“ECB”) confirmed to halt its bond buying program in 2019. However, since the inflationary pressure was still low and the recent economic growth in the region was slowing, the ECB promised to keep reinvesting cash from maturing bonds for an extended period of time and it also reiterated that the key interest rates would remain at record low levels at least through the summer of 2019.
- There are a lot of challenges to Europe in 2019. While the economy of the region has slowed down or even some countries in the region start to have contraction phenomenon, the quantitative easing has come to the end. Apart from this, the U.K. will leave the European Union at the end of March but there is still no agreement between both parties yet and the chance of “no-deal Brexit” is increasing. Besides, the rise of populism and social problems, such as high youth unemployment, the impact of refugee, etc may continue to spread over in the region. The Euro STOXX 600 fell 13% in 2008 which was the biggest annual crash since the 2008 financial crisis and has already erased the gain in the past 2 years. Currently, the European equities were traded at their lowest valuation level since 2013. However, in the context of the deteriorating macroeconomic environment and weak corporate earnings growth, the outlook of European stock markets may still tend to be bearish.

Asia

- More and more evidence showed that the Chinese manufacturing sector was decelerating. Both the official and Cainxin Manufacturing Purchasing Managers' Index(PMI) fell to contraction zone in December. The official PMI compiled by China's National Bureau of Statistics, has recorded a drop of 0.6 to 49.4, its first contraction since July 2016. The Caixin PMI, which tracks the activities of small and medium-sized enterprises, dipped below 50 for the first time since May 2017 as December's reading fell 0.5 points to 49.7.
- On the other hand, the Chinese service sector was accelerating. The official Non-Manufacturing PMI and Caixin Services PMI extended gain in December; they rose to 53.8 and 53.9 respectively. Service industries are increasingly important for China's economy and according to the figures from the National Bureau of Statistics, the service sector currently accounts for 50% of the country's GDP while the industrial and manufacturing sector accounts for 40% and the other 10% is contributed by farming.
- To avoid economic downturn, the People Bank of China ("PBOC") has cut the reserve requirement ratio ("RRR") for banks several times to 14.5% in 2018. To boost further liquidity in the banking system in advance of the 2019 Chinese New Year, the PBOC announced to cut the RRR 0.5% on January 15 and a further 0.5% on January 25. The cut will release a combined CNY 1.5 trillion of liquidity into the banking system primarily for lending to private firms and small businesses.
- Different from the previous RRR cuts, the PBOC's decision this time was announced directly at the beginning of the year, sending a strong message to the market that the Government would address prominent problems in the economy, inject confidence for entrepreneurs and lay a foundation for the stable run of the economy in 2019.

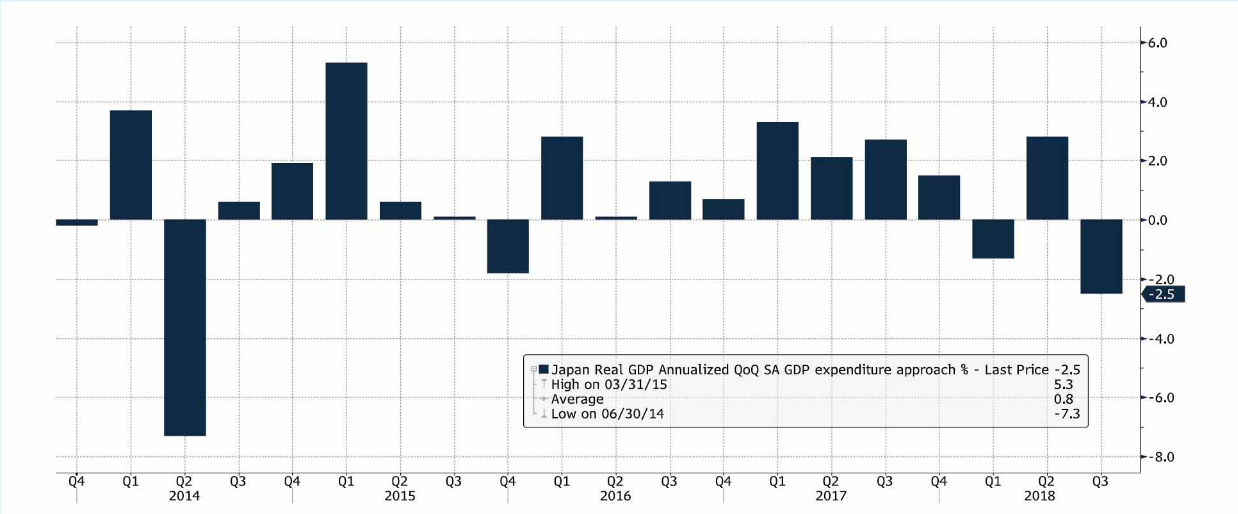
EXHIBIT 6: The current Reserve Requirement Ratio in China was the lowest since the 2008 Financial Crisis



Source : Bloomberg (as at 31/12/2018)

- In Japan, the GDP fell at an annualized pace of 2.5% in the 3rd quarter which was the sharpest contraction since the 2nd quarter of 2014. The drop was partly driven by a series of natural disasters. Severe flooding in western Japan in July, a powerful typhoon and the magnitude 6.6 earthquake in Hokkaido in September has hindered the country's exports and tourism. Besides, the biggest decrease of capital expenditure since the 3rd quarter of 2009 also explained the big slide as well. It is expected the economy would rebound in the 4th quarter as factories lifted production following the natural disasters. However, the economic outlook of Japan in 2019 would be more uncertain in the face of trade frictions, global economic slowdown and a planned sales tax hike.

EXHIBIT 7: The 3rd quarter of Japanese economy contracted at the fastest pace since 2014



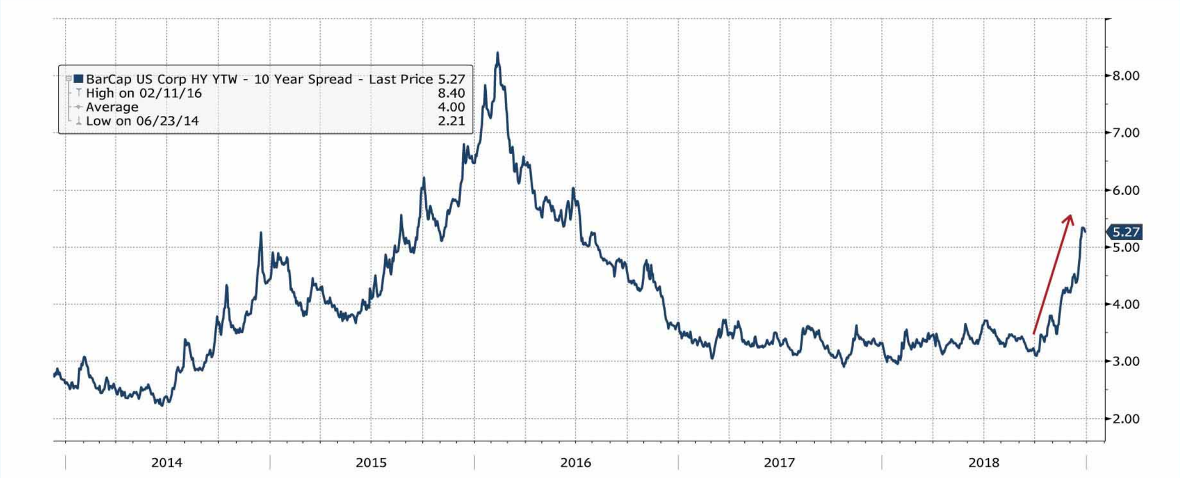
Source : Bloomberg (as at 31/12/2018)

- The Asian equity markets peaked in the beginning of 2018 and moved down gradually in the rest of the year. At the end of 2018, the MSCI Asia Pacific Index fell over 20% from the year high. Among the Asian stock markets, Chinese A-shares was the worst performing one and the CSI 300 Index dropped over 27% in terms of USD in 2018. In 2019, politics will be a key theme for the region, with different important elections will be held in India, Indonesia, Philippines and Australia. Besides, the outcome of trade negotiations between the U.S. and China remains the key risk. The current stock market valuation in Asia is relatively low and becoming more attractive, but volatility may remain high due to the market uncertainties.

Fixed Income

- An inverted yield curve is an abnormal situation in which longer-dated bonds have a lower yield than shorter-dated bonds of the same credit quality. It reflects that investors are pessimistic about the near-term prospect of the economy and expect that the interest rate will be rising in the short-term while they also believe that the interest rate will remain low in the long run. As a result, investors demand higher yields for short-term bonds and prefer to buy long-term bonds even though they receive lower yields and hold longer period of time.
- In recent years, the U.S. treasury yield curve flattened which the yield spread between the short and long-dated bonds narrowed. On 3rd December, the U.S. treasury yield curve even started to have inversion as the 2-year Treasury note was yielding slightly higher than the 5-year note and it was the first time since the 2008 recession.
- So far, the current U.S. treasury yield curve is only “partially” inverted. A more comprehensive inversion would be considered when the yield of the two-year bond rises over the 10-year bond. In the past 40 years, each time this happened, the U.S. economy entered into recession soon afterwards.
- Since the sentiment of the economic outlook has soured and oil prices plummeted, investors have withdrawn a record amount of cash from funds invested in junk-rated debt in 2018. The total outflow from U.S. high yield bond fund was over USD 60 billion, which doubled the amount withdrawn in 2014, another period when oil prices fell sharply. Affected by the fund outflow, the yield spread between the U.S. treasury and high yield bond was also widened significantly during the last quarter of 2018.
- The flattening U.S. treasury yield curve and widening credit spread always imply that the systematic risk is rising. At the same time, according to the minutes of the Fed meeting in December, the Federal Reserve would be patient about future rate hike due to low inflationary pressure and the recent investment market volatility. For the above reasons, it is believed that investors may consider a more defensive approach for their investments and high credit quality fixed income is overweighed in the current market situation.

EXHIBIT 8: The yield spread between the U.S. 10-year treasury and U.S. corporate high yield bond surged in the 4th quarter



Source : Bloomberg (as at 31/12/2018)

Commodities

- The rising interest rate in the U.S., strong U.S. Dollar and heightening concerns over international trade friction and global economic slowdown affected the overall performance of commodity asset class in 2018. The Bloomberg Commodity Index fell 13% in 2018 and most of the losses came from the 4th quarter.
- In the beginning of October 2018, the oil price was still at recent years' high. However, it experienced a painful correction afterwards. Even though the U.S. renewed the oil sanctions against Iran and the OPEC paired with Russia to cut oil output, the U.S. crude production also reached a fresh all-time high in October and fear over global economic slowdown also clouded the market. At the end of December, the oil price dropped around 40% from the peak in October which was one of the steepest oil market sell-offs of the past decades.

EXHIBIT 9: Oil price tumbled from the peak in the last quarter of 2018

Source : Bloomberg (as at 31/12/2018)

- Since the global stock market slumped in the 4th quarter, gold was treated as the hedging tool and safe haven again by the investors. The gold price rallied almost 7% during the period and recovered most of the loss in 2018.
- As mentioned previously, there are a lot of uncertainties in the investment market in 2019. As the return of gold is always uncorrelated with the stock markets, it is believed investor may consider allocating a certain portion to that precious metal in 2019 so as to diversify investment risk. Regarding the energy, the oil price should have a rebound in the near term after the heavy sell-off in the last quarter. However, the longer term outlook will depend on the global economic growth momentum.