Active is: Sharing insights

Conclusions and themes from our Hong Kong Investment Forum

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As our investment experts gathered in Asia's financial centre, our proximity to mainland China seemed particularly fitting given the US-China trade war that has been roiling the markets. Amid rising global leverage, political uncertainty and a patchy global economy, taking an active, long-term view may be investors' best approach.

Five investment conclusions

1. **Plan your future – focus on the long term**
   Given recent market conditions and concerns about recession, it's understandable that investors may be nervous that this long but lacklustre economic cycle is coming to an end. However, we don't believe it's finished just yet. So despite market corrections and volatility, investors should aim to benefit from the long-term power of compounding. Instead, look beyond the immediate news flow and political bluster to focus on balance-sheet strengths and other qualities that underpin the sustainability of investments.

2. **Actively diversify across all asset classes**
   In addition to a mix of equities, fixed-income and cash, consider alternatives – they are less correlated to traditional asset classes and may be able to help improve a portfolio's risk-return profile. Also consider supplementing a diversified approach with contrarian ideas (such as UK equities) and counter-cyclical hedges (including US Treasuries). Asian and emerging-market sovereign bonds appear to be good places to hunt for income.

Key takeaways

– Debt seems to be the biggest long-term problem facing the global economy, but politics and trade uncertainty may create the most volatility in the coming year

– A trade war could cripple current supply chains, but a "tech cold war" between the US and China could be a bigger issue, creating two competing tech eco-systems

– Our Investment Forum conclusions stress the importance of active investing, long-term planning and a counter-cyclical approach; ESG can also help identify quality, scope for improvement and potential value appreciation

Value. Shared.

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3. **Use volatility – be an active investor**
   The markets showed signs of distress in late 2018, but we think they may have overreacted. While this kind of volatility seems here to stay – due to geopolitical tensions, monetary-policy normalisation and other factors – corrections in equity and credit markets may offer opportunities for active, selective investors to move back into some risk assets. Passive investing, based on backward-looking benchmarks, may fail to capture tomorrow's opportunities while simply tracking the market's volatility. Strong rallies also could be good times to reduce positions, but investors should resist the urge to time the market.

4. **The biggest risk is to take no risk**
   Investors can be uncertain where to move in today's markets, but taking risk off the table altogether can be too risky an option. This approach has the potential to harm purchasing power over time, and it ignores the good opportunities that we think still exist. Look to mitigate necessary risks by looking for quality holdings – as evidenced by good balance sheets, healthy dividends and strong governance. Draw on fundamental research to identify the stocks, sectors and trends that offer the potential for growth and the ability to capitalise on long-term trends.

5. **Aim for an improved risk/return profile with ESG**
   Environmental, social and governance (ESG) investing is a rapidly growing area of investor interest – and with good reason: ESG provides a vital lens for identifying quality, scope for improvement and the potential for value appreciation. Companies that focus on ESG factors may be better positioned for the long term and can help improve the performance of portfolios. In emerging economies such as China, good governance is being increasingly encouraged. This can help companies grow in a responsible way and should make these markets more attractive as companies evolve their practices.

Key themes

Global growth may be patchy, but active investors can navigate recession fears

Last year was generally a challenging one for investors overall, with poor returns and renewed volatility giving global investors few places to hide, particularly as the year came to a close. The markets are wary of the growing signs of economic fatigue around the world. Late-cycle fault lines have become more visible: corporate profit growth has peaked, fiscal stimulus is waning and central banks are providing less liquidity.

Yet perhaps the biggest problem facing the global economy is leverage. The world essentially solved the last debt crisis by taking on more debt. China is one of the worst offenders – with a debt-to-GDP ratio of approximately 300% in 2018 – but many other countries have levered up as well, bringing US dollar-denominated debt outside of the US to record levels. For example, Turkish companies will need to refinance USD 250 billion in US debt in the coming years – a struggle with rates set to rise.

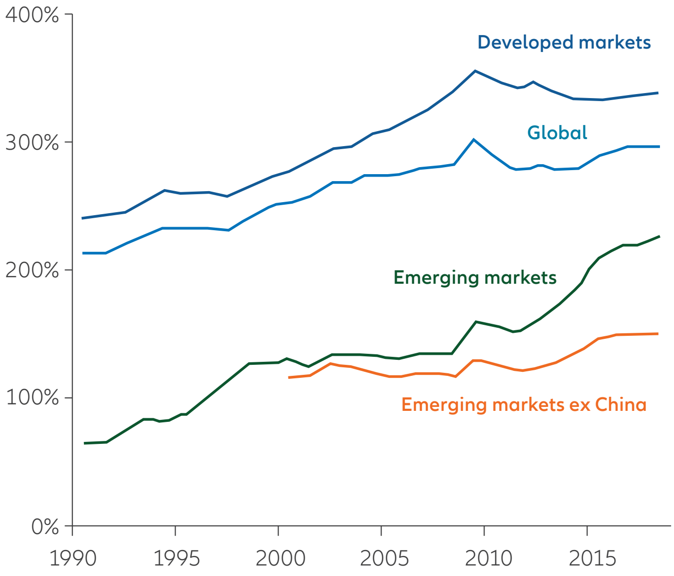
Economists can debate what constitutes a "normal" level for interest rates, but rates generally haven't normalised yet: they seem set to stay lower for longer. This makes the hunt for income all the more pressing – particularly with even low levels of inflation able to drastically reduce purchasing power over time.

So where is there yield to be gained? We are finding attractive yield potential in Asian fixed income and in high-yield bonds, though weaker growth, higher volatility and declining credit quality bear monitoring. Income can also be found in dividend yields from equities in Asia and Europe – less so in the US – and in inflation-linked bonds.

Economic growth around the world is getting patchier, and the US is slowing down amid growing fears of a recession. Yet although the US economy has the potential to deteriorate in 2019, as signalled by a flatter yield curve and weaker housing market, a recession seems unlikely this year. Even if a recession were to happen, we think active investors will still be able to find opportunities by focusing on the fundamentals – including using proprietary research.

Deleveraging? What deleveraging?

Global debt to GDP by region



Source: Allianz Global Investors, Bank for International Settlements, Datastream. Data as at Q1 2018.

Trump and Brexit aren't the only political question marks; just the ones attracting the most media and market attention

Markets no longer take geopolitical tensions in stride. Headlines about populism – and the accompanying rise of anti-globalisation sentiment – have the power to spook equity, bond and currency investors. A rolling back of globalisation may make it harder for firms to arbitrage away costs in pursuit of optimal supply chains and margins – and trade wars could make matters worse.

In the US, President Donald Trump faces a divided Congress and a renewed focus by the Democrats on providing checks and balances. Mr Trump will soon pivot to re-election mode, and to win re-election in 2020 we believe he will pull all the levers at his disposal – particularly in the area of trade policy. As such, we wouldn't be surprised if Mr Trump soon looked for some way to wind down the US-China trade war and declare victory. He may also look for common ground with Democrats, compromising on areas such as infrastructure spending or targeted health care reform – although any move to reduce drug prices may hit pharmaceutical stocks.

In Europe, Britain's exit from the European Union looks set to be a long-running theme. Whatever the ultimate Brexit "end state", more frictions in trade with Europe seem unavoidable. This appears likely to affect European Union (EU) member countries and UK sectors differently, though Brexit will be a particularly bumpy ride for UK assets.

EU Parliamentary elections, internal battles in Italy and France, Germany's weakening economy, and important elections in India and Indonesia also loom large. Yet even as investors keep an eye on these developments, they should take care not to write off opportunities at the regional or sector level. Being more granular and selective, and seeking out strong fundamentals, could be a smart contrarian approach.

A "tech cold war" could be more significant than a trade war

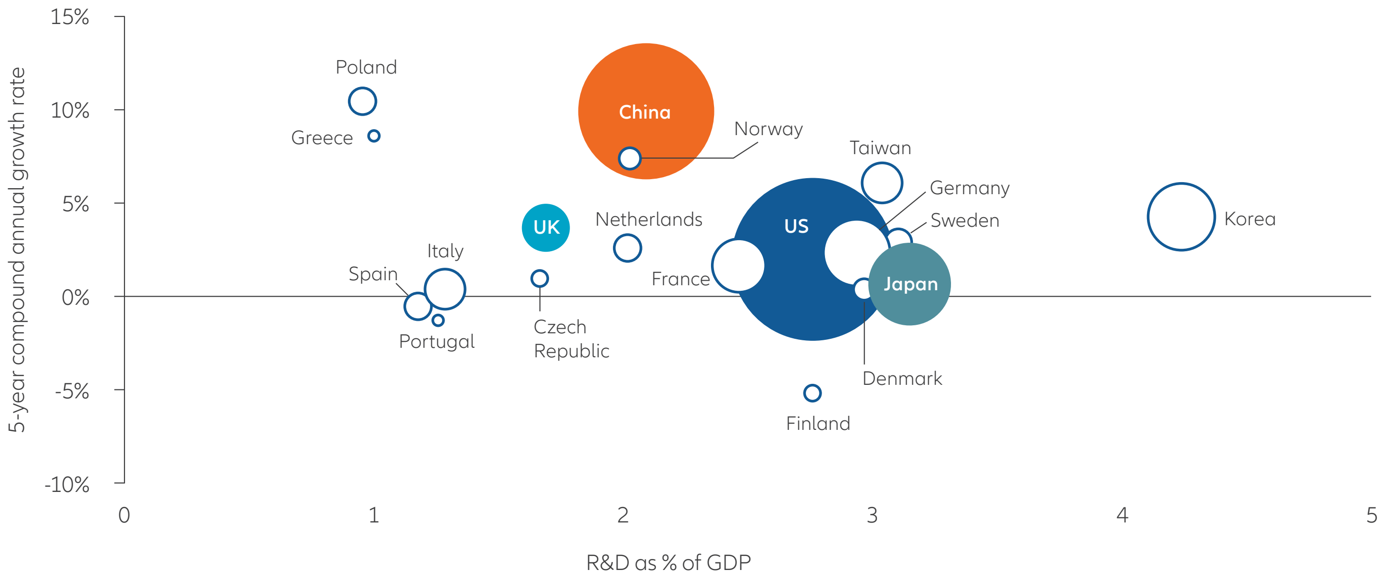
News headlines about the US-China trade war may be obscuring the potential for something more serious: a potential "tech cold war" between the world's two largest economies.

The US sees China as a strategic threat, and China wants to rely less on American technology. Both fear becoming too interdependent on shared technologies and providers, particularly now that they see how a trade war could cripple current supply chains. As a result, we fear that two competing high-tech eco-systems could emerge over time – one American, one Chinese – and the rest of the world, including China's neighbours within Asia, may be forced to choose sides. This could be damaging to business models and supply chains, particularly those of large American tech firms that invent in Silicon Valley and manufacture in Asia.

At the same time, some countries are poised to benefit from the increased competition between China and the US – particularly countries like Thailand and Vietnam, but also India and Indonesia. So while there may be losers from a tech cold war, there are still opportunities for investors to take risk to earn returns from the winners that emerge from this conflict.

In the R&D race, China has been rapidly gaining on the US

Global research and development expenditure and growth



Source: OECD data, UNESCO institute for statistics,Allianz Global Investors. US, France, Poland and Taiwan data as at 2015; all other data as at 2016. Size of the circle reflects the relative amount of annual R&D spending by the indicated country, measured by USD purchasing power parity.

Overall, we believe China and the US need each other more than they don't, which suggests a toning-down of the trade-war rhetoric before eventual reconciliation. Until that happens, we could see continued volatility and reduced growth. Along the way, investors may want to pursue strong secular high-tech themes within the equity markets – including intelligent cities, artificial intelligence and disruption.

China is an asset class in its own right

China can be a polarising subject for investors. Many believe that China's growing economic power – stemming from its focus on innovation and "rebalancing" its economy towards a consumption-driven one – is the most compelling investment story of the 21st century. Others are more concerned about China's government interference, US-China trade wars and the credit-fuelled nature of China's economic development. The local equity market, dominated by short-term retail investors, can be volatile. While we understand China's challenges, we think Beijing is well placed to handle them. China's government understands that its economy needs to reduce leverage, and that it must control the use of credit. The country's leadership is seeking to strike a balance between reform and growth, and we believe they will do what it takes to be successful.

One needs only to look at the sheer scale of the "Made in China 2025" initiative and the "one belt, one road" programme to understand China's commitment to securing its future – incurring short-term pain to secure long-term gains.

Many of our clients have a similar long-term view about China. While the ongoing trade dispute continues to be an issue, we think it will be resolved in the medium to long term. And even in the event of a tech cold war, investors would benefit from exposure to both eco-systems.

Navigating the local equity markets requires a long-term approach and a focus on fundamentals. To that end, incorporating ESG factors is critical. Indeed, as at May 2018, 86% of China's A-shares included in the MSCI had below-average governance ratings. That's a prime example of why we conduct our own ESG research – to make our own assessments of this critically important area – and why we share our insights with our clients.

China is an asset class that looks attractive to many investors – particularly with China's A-shares currently unloved by the markets, and with China's bonds a source of attractive real return potential inside a global bond portfolio. We believe that as ESG standards improve, the case for China will only improve further.

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