Investment themes & strategy

6 takeaways from our Hong Kong Investment Forum

by Neil Dwane | 26/01/2018

Summary

Our strategists, economists and portfolio managers recently convened in Hong Kong to reflect on the state of the global economy today – and its direction over the next 3-5 years. The gradual tightening of monetary policy could bring a return of volatility, especially in developed markets, but Asia in general and China in particular are bright spots.

Key takeaways

- The competing factors of geopolitical turmoil, demographic change and technological advancement will make for an interesting if uncertain investment climate in 2018
- The scale of central bank support is diminishing globally, but we expect the overall shift to be slow; income opportunities abound for investors willing to look beyond benchmark bonds
- The outlook for China and Asian markets overall remains favourable – so much so that one of the biggest risks to investors' portfolios may be an "unconscious" underweight to China
- Disruptive business models are reshaping investment opportunities across the globe; the US and Europe will need to respond to high-tech competition from China

1 Keep a watchful eye on the Fed

Central banks' use of quantitative easing and ultra-low interest rates kept Western economies from flat-lining in recent years. But central banks have begun using the language of economic expansion rather than economic recovery – which means tighter monetary policy is on the horizon, albeit at differing paces in different regions. The Fed is already starting to normalize, which could bring volatility to the financial markets – as could a loss of economic momentum. That said, new US Federal Reserve Chair Jerome Powell will likely be cautious with rate rises and should favour further market deregulation – one of the reasons why we continue to favour financials.

2 China and Asia's continuing success will favour the risk-takers

Asia remains the biggest economic story of the 21st century so far – in large part due to China's expected

transformation from an export-led economy to one fuelled by domestic consumption. In addition, China's "One Belt, One Road" plan is far more than just hype. This massive investment in infrastructure can be seen on the ground in countries throughout the region – for example, in the China-Pakistan Economic Corridor. Not every project will make sense for every nation, and debt-servicing will be an issue for some, but OBOR is delivering a significant boost to many countries. Infrastructure and construction companies should be among the other winners from this initiative.

China is not without its risks, led by a debt-to-GDP ratio that sits at a staggering 258 per cent. Yet China's high aggregate leverage ratios are likely to be manageable, given the still-moderate public leverage ratio, the high foreign-exchange reserve levels and the low share of external financing. We are also looking forward to May 2018, when the MSCI will include a small number of China's A-shares in its emerging-market index for the first time. To give some sense of scale, A-shares are approximately a USD 8 trillion market – a full 30 per cent bigger than the euro area – and may attract significant investor interest.

3 Politics are changing the global outlook for trade

US President Donald Trump has made no secret of his disdain for many cross-border trade arrangements, and he could break up NAFTA – the key trade agreement between Canada, Mexico and the US – with a simple executive order. Yet while his stated aim is to put "America first", the US could eventually cede its role of global leadership to China, which would be more than happy to take up the mantle.

More immediately, however, President Trump scored a big legislative victory in 2017 with his tax reform bill, which appears set to stimulate the US economy. It will likely benefit some companies more than others: financials and industrials have seen upwards earnings revisions, while utilities and real estate have seen their earnings downgraded. Moreover, the timing of tax reform could have been better, coming as it does at the end of the business cycle. As a result, it may trigger more monetary-policy responses than the markets have so far priced in. All told, these reforms will make stock selection even more important in 2018, reinforcing the value of active management.

The European Union is dogged by Brexit negotiations and a fragile Italian economy, though overall economic performance within the euro zone has been robust. The UK too – despite a weakened pound Sterling and falling consumer spending – has fared well in relative terms following the Brexit vote.

4 Japan is doing better than advertised, especially with its ageing population

Demographic deceleration presents a very real concern to many developed economies – particularly Japan and Germany. Globally, 900 million people are more than 60 years old, and this figure could rise to 2.1 billion over the next decade.

The good news is that Japan provides a helpful example of how to manage an ageing population and turn around a stagnant economy:

- "Abenomics" reforms are slowly working, and better labour-market participation by women and the elderly are addressing the issues of full employment and low productivity.
- The stimulative tax reforms that Japan has planned should encourage Japanese companies to increase productivity, boost capital expenditures and raise wages. If these measures ultimately stimulate private-sector spending, it would be a big improvement for Japan's medium-term outlook.
- A move towards more shareholder-friendly corporate governance has raised average returns on equity from 5 to 10 per cent in the past five years. Overall, the country is making good progress on issues related to environmental, social and governance (ESG) factors.
- The 120-per-cent cumulative gain of Japan's equity market over the last five years (as at 30 November 2017) has been supported by earnings growth and – much less so – by valuation re-ratings.

5 Disruption continues to transform industries and economies

The reach of some of today's most disruptive companies – Facebook, Amazon, Netflix and Google (the FANGs) in the US; and Baidu, Alibaba and Tencent (the BATs) in China – will continue to expand across sectors, creating high barriers to entry for their competitors. Consumers are growing increasingly enamoured of highly disruptive services such as e-payments, which in some countries are circumventing the banks – particularly in China, an increasingly cashless society. Yet despite their many successes, mega-cap tech firms are attracting increasing regulatory scrutiny due to their business practices – though the BATs may ultimately be more willing than the FANGs to align themselves with their government.

In the disruptive field of artificial intelligence, there are signs of an arms race between the US and China – and China may be more willing to invest its way to victory. China alone spends more on research and development than the entire European Union, whose lack of FANG- or BAT-type companies is starting to look like a real weakness. For its part, Europe could find itself too far behind the curve in reshaping the future of its own businesses. Emerging-market countries also need to address the disruption caused by AI, moving workers who have been displaced by AI into the service industry.

Disruption is set to be a dominant investment theme for years to come, reinforcing the need for active managers who can aim to identify the winners and avoid the losers. Focusing on ESG factors, which directly influence shareholder value, could provide investors with a way to identify the companies with the best business models.

6 Manage your risk in the hunt for income

The global economy appears to be in a "Goldilocks" phase: thanks to the efforts of central banks, growth is neither too high nor too low, and fears of inflation remain muted. But how long can this environment last? For the next one to two years, we believe that neither a recession nor a credit-cycle downturn are likely – and although inflation will likely remain static for now, we expect it to move higher within the next five years.

For many investors, the hunt for income remains a pressing concern, with benchmark bonds offering insufficient yields. Fixed-income investments in emerging markets may be an attractive option: they can offer additional spread and their economies are enjoying stronger macroeconomic tailwinds. Dividend-paying equities can also be a good source of yield for income-seeking investors.

Overall, our investment professionals expect market returns to move lower over the next 3-5 years. Although the financial markets may be somewhat complacent about this possibility, investors can find ample opportunities to take risks that can be managed with confidence.

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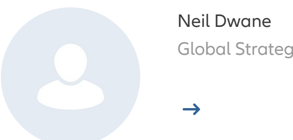

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Big tech must pitch in on social infrastructure

by Karl Happe | 21/02/2018

Summary

Today's tech giants have profited greatly from the world they're disrupting, without returning much to society save for the tax revenues they try hard to minimize. We must ask big tech to contribute more to the digital and physical infrastructure – and the functioning civil societies – upon which their profits depend.

Key takeaways

- Internet businesses should be taxed in jurisdictions where their revenue originates
- Internet bandwith as a public good should be auctioned to for-profit businesses to ensure that its benefits are shared with society, rather than privatized by a few ultra-wealthy owners
- If internet companies don't participate in the societal costs of their disruption, the infrastructure and civil society upon which their business models depend will deteriorate