

Global Fixed Income Investing - Diversification in Rising Rates Environment

The Aftermath Effect of the Post-QE Era

A decade after the global financial crisis peaked in 2008, financial markets have only just begun to correct the asset-price distortions created by the US Federal Reserve's (Fed's) massive quantitative easing (QE) program. QE was originally deployed to stabilize financial markets during the crisis, but instead of being a limited intervention to restore markets over a few years, it expanded and became an ongoing endeavor. It succeeded in pushing down bond yields and pushing up asset prices, steering many investors toward riskier assets.

In October, the US bond and equity markets declined concurrently as rates rose, which may seem anomalous. But because bonds and equities were equally propped up by Fed intervention, they have been equally vulnerable to the opposite effect as Fed policy unwinds. Investors should be prepared for concurrent price corrections in US Treasuries and other asset classes in 2019.

What Factors May Push US Treasuries Higher?

These are the three factors:

- Increased borrowing needs from the US government
- The Fed and foreign governments reduce demand in US Treasuries
- Rising inflationary pressures

The first storm is driven by increased spending by the Trump administration, along with tax cuts and ongoing mandatory spending which are projected to drive the fiscal deficit toward 5% of GDP (gross domestic product). That increases the already high borrowing needs of the government.

The second storm is diminished official buying demand, both domestically from the Fed as it unwinds QE, as well as externally from foreign governments. This leaves a large funding gap that will need to be filled by price-sensitive investors, who would need to roughly triple their current levels of buying to fill the void. Less buying volume and more supply volume means yields need to rise to find new clearing levels.

The third storm stems from inflation. Wage pressures have been rising on exceptional strength in the US labor market, increased by a lack of skilled and unskilled labor in certain sectors. The labor pool has been further constrained by restrictions on both legal and illegal immigration by the Trump administration. Sector tariffs are also expected to raise costs for consumers. Each of these conditions has inflationary implications. Given the current environment, it is expected that the Fed continues hiking rates toward the neutral rate in 2019.

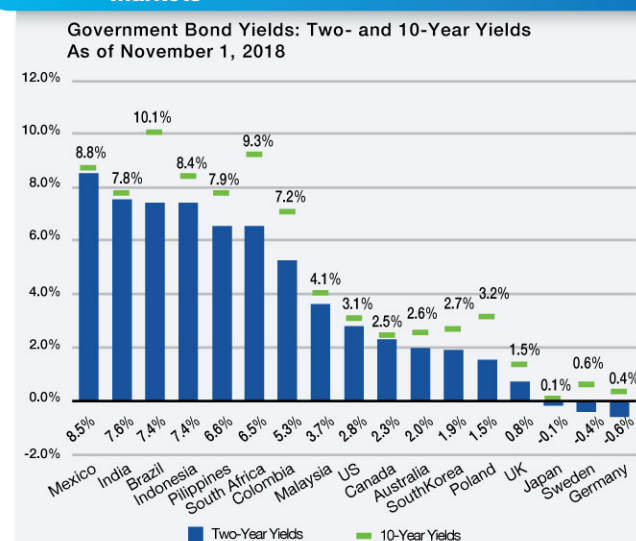
Select Emerging Markets Are Better Positioned to Absorb Rising Rates

Selective local-currency emerging markets show the highest level of undervaluation across the global fixed income markets. Individual countries are far more distinct than they were decades ago. Some countries have diversified their economies, significantly broadened their local-currency debt markets, expanded their domestic investor bases and built up resiliencies to external shocks. Others continue to have persistent structural imbalances, unreliable institutions and fragile economies.

In 2019, it will be increasingly important to identify countries that offer idiosyncratic value that is less correlated to broad-based market risks, as rising rates in the US should impact individual countries in markedly different ways. Countries with low rate environments, or large structural imbalances and economic soft spots, could be vulnerable to external rate shocks. However, countries with stronger economies, balanced current accounts and relatively higher yields should be in a stronger position to absorb rate shifts of 1% or higher.

In summary, the challenge for investors will be that the traditional diversifying relationship between bonds and equities may not hold true as US Treasuries yields rise. In 2019, it is expected that various asset classes will endure price corrections as monetary accommodation unwinds.

Chart 1: Higher Yields Available in Select Emerging Markets



Source: Bloomberg. Past performance is not an indicator or a guarantee of future performance. See www.franklintempletondatasources.com for additional data provider information.

Disclaimer: The above information is provided by Franklin Templeton Investments (Asia) Limited (the "Third Party"). The information was updated as of December 21, 2018. This document contains general information for reference only. This document is not an offer, recommendation, advertisement or invitation to buy any security or participate in a collective investment scheme. Since the above information and data in this document are obtained from a Third Party, any such information and data may be incomplete or condensed, may differ from the market environment, and is subject to change without further notice. MassMutual Asia Ltd. ("The Company") makes no representation or warranty and accepts no responsibility as to the completeness of the information and data provided herein. The Company does not warrant that the above information meets your investment needs, objectives and risk-tolerance level. Should you make your investment decision relying upon the information in this document, you do so at your own risk. Any person considering an investment should seek independent advice on the suitability or otherwise on the particular investment. Investment is subject to market and exchange-rate fluctuations and to the risks inherent in all investments. The price of investment units may go down as well as up. Past performance is not indicative of future performance and yields are not guaranteed. No part of this document may be reproduced in any manner without the prior written permission of MassMutual Asia Ltd.

2019 Market Outlook - With A Focus On Emerging Market Equities

Key Takeaways

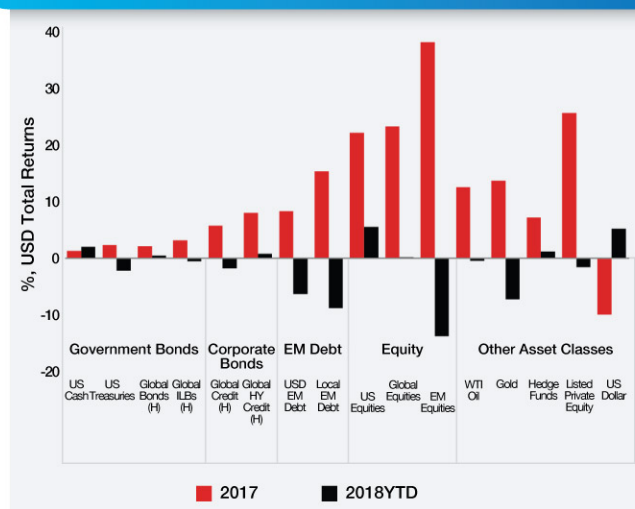
- Whilst the global economy has lost some vigor, recession risk is low and corporate fundamentals still look good
- The outlook for global equities is quite positive for 2019, and a number of interesting opportunities in some emerging markets now offer great value
- Amongst those, China offers good value. Investors are also positive on the broader Asia-Pacific ex Japan equity market

2018: A Challenging Year For Investors

The year 2018 was a difficult one for investors as most risk assets performed poorly. As the Goldilocks economic environment of 2017 gave way to a more difficult situation from around February, a series of volatility waves damaged asset-class returns, such as changes in market expectations in the number of Fed's rate hikes, a rapid appreciation of the dollar, political uncertainties, and growth worries.

In particular, performance was most disappointing in emerging markets – local currency debt was down by high-single digits while emerging-market equities were down by double digits in 2018 (albeit with significant regional variations). Other asset classes were also either flat or had delivered negative returns (see Chart 1).

Chart 1: Asset-class performance



Source: Bloomberg, HSBC Global Asset Management. All asset class returns shown as USD total returns (unhedged) from 01/01/2017 – 31/10/2018. H - Refers to currency-hedged USD total returns. Any views expressed were held at the time of preparation and are subject to change without notice.

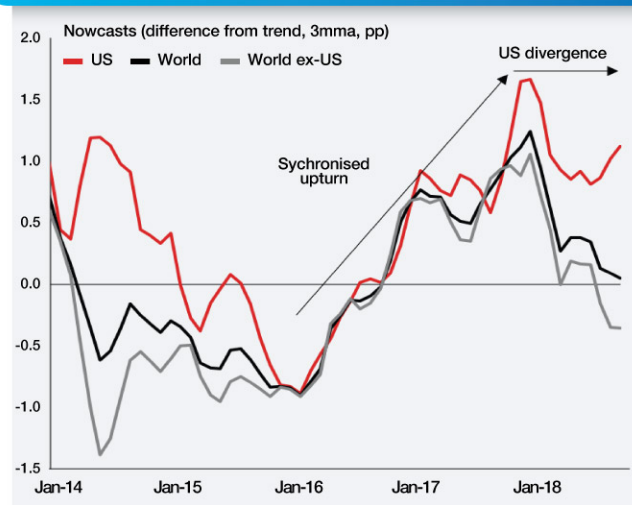
Past performance is not a guarantee of future performance.

However, investors may take comfort in the fact that a lot of what occurred in 2018 was linked to changes in the market narrative rather than to decisive shifts in macroeconomic fundamentals – from inflation fears to trade tensions, geopolitics, Brexit, and political uncertainty in Europe.

2019: Back To A More Normal Environment

The global economy has lost some vigor. Nevertheless, based on HSBC Global Asset Management's global 'Nowcast', global growth is now back to its average rate of the last five years (see Chart 2). This is hardly cause for 'doom and gloom' and, not least since the probability of recession looks low, it might be argued that we are simply returning to a more normal environment.

Chart 2: US growth outperformance



Source: Macrobond, HSBC Global Asset Management. Data as of November 2018.

Past performance is not a guarantee of future performance.

This relatively sanguine view of the outlook is reinforced by the performance of the corporate sector. Company fundamentals have remained largely unaffected by the 'noise' around the macroeconomic newsflow, with both corporate profitability and default rates evolving relatively favorably. This is important, because the weakness in markets in 2018 means that they are now discounting a more subdued and difficult environment than was the case twelve months ago.

Taken together, the return to a normal economic environment, combined with healthier valuations, should mean that financial markets, and especially global equities, may well deliver positive returns in 2019.

Certainly, the outlook is not without risk. Investors could see a continuation of some of 2018's challenges with strong growth in the US, leading to higher-than-expected inflation and, in turn, higher-than-expected interest rates, the most important uncertainty. This risk is not easy to diversify, but it will be important to enter 2019 with a balanced portfolio and this should help investors 'ride out' any noise.

The Worst Is Probably Over for Emerging Economies

Emerging economies slowed markedly during 2018, which gave rise to the feared 'doom loop' dynamics - a vicious cycle of falling asset prices and deteriorating fundamentals. However, investor concerns have calmed materially since August and September.

Looking forward, much will depend on what happens to both US rates and Chinese growth. Interestingly, emerging-market fundamentals may now improve as China economic data stabilizes and financial markets calm down. A few emerging economies have seen a surge in inflation following currency weakness, but most are only experiencing gradual increases in core inflation, from historically low levels. Importantly, the currency depreciation also seems to have gone far enough to stabilize the external position of crisis-hit economies.

Emerging Markets Look Attractive, But Being Selective Is Key

The forecast for global equities is quite positive for 2019. First, fundamentals have gotten stronger because equities are now less expensive and more profitable almost everywhere around the world. In addition, some of the macro factors by which investors have been so absorbed seem likely to be less of a focus going into 2019.

While equities across the board have corrected in 2018, investors could see a number of interesting opportunities in some emerging markets which offer great value. It is believed that emerging markets compare favorably against developed markets on a fundamentals basis. Yet it is important to note that 'emerging markets' present significant diversity in terms of economic and market conditions.

Whilst none of the key emerging markets was immune to the 'dollar shock' or other major global market events through 2018, investors have seen a fair amount of cyclical divergence from one emerging economy to the next, particularly in terms of growth and inflation.

China Has Held Up Better Than Expected

Amongst those, China could be highlighted in particular, which has been in the eye of the storm for most of the year. Chinese equities have been weighed down by trade tensions between the US and China, resulting in a series of tit-for-tat tariff increases in 2018, and in fears for growth amidst the country's ongoing deleveraging program. Despite these concerns, it is believed that, overall, the Chinese economy has held up better than expected. Going into 2019, as these concerns recede, it is expected that some of this fundamental value will be released, which could set the stage for a strong comeback by Chinese stocks.

Asia-Pacific ex Japan Equities Continue To Trade At A Significant Discount

Investors are also positive on the broader Asia-Pacific ex Japan equity market, as it continues to trade at a significant discount to other global markets. In price-to-book terms, the discount is 34% versus developed markets as of the end of October 2018, significantly larger than the long-term average discount (since 1996) of 23%. In addition, after hitting a low point in 2016, return on equity (ROE) for Asian equities has largely recovered, a factor which is often overlooked. A number of important catalysts have driven this recovery, including higher profit margins and industry consolidation. Moreover, helped by prudent and proactive policies and better macro fundamentals, regional economies have stayed resilient in the midst of an increasingly challenging external environment for emerging markets.