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CFA SINGAPORE INSIGHTS

By Pranay Gupta

Is the global equity juggernaut losing steam?

One answer is: 'Stay invested, but be prepared for a year of higher volatility and a day of reckoning'

THE billion dollar question today (as always) is "Is it too late to buy equities now?" As always, the answer is more nuanced than a simple yes or no.

Growth stability

Global growth has been on an upswing for the last decade. With US growth expected at 2.7 per cent this year, China at 6.7 per cent and India, the fastest growing large economy, at 7.6 per cent, overall global growth will be a healthy 4 per cent. Even Europe is growing at a respectable 2.5 per cent, and Brazil and Russia are emerging from their slump.

China reaffirming top-down growth estimates, the US passing a tax cut and expansionary budget, and India resuming its trajectory after demonetisation and VAT implementation, all mean that the late cycle recovery is set to sustain, even as the support from accommodative monetary policy fades. More importantly, unlike the recipe that resulted in the global financial crisis, this growth has come with relatively few economic and financial imbalances.

The inflation conundrum

The unexpected characteristic has, however, been the mild level of inflation. A modest oil price and widespread technology implementation has kept a check on wage growth and consumer prices. With the Fed expected to hike four times in each of 2018 and 2019 as the US core personal consumption expenditure (PCE) reaches 2 per cent next year, it is unlikely that they will fall behind the curve.

Arguably, with a flatter Philips curve, even with the greater demand growth that is expected, while the labour market may tighten, inflation pressures can remain contained, allowing central banks to normalise monetary policy gradually.

But we know investors are watching this like a hawk. As was evident in February, any signs of unexpected inflation will imply that the Fed needs to raise rates faster, and this will impact equity markets swiftly and substantially.

Can Abenomics continue?

Japan managed a 1.6 per cent growth in Q4, driven by strong export demand, capex and resurgence in domestic demand. But despite the modest success of Abenomics, inflation is stuck at sub-2 per cent levels. While the core consumer price index touched 1 per cent for first time since 2014, much of it was driven by oil prices and is thus less sustainable.

The crucial test, however, is yet to come. The recent yen appreciation and increasing allegations against Mr Abe, has caused a fall in business confidence. If he is unable to secure a third term as Liberal Democratic Party president in the September elections, the new administration will likely follow more populist policies and give the Bank of Japan more independence. A postponement of the consumption tax hike, and back-tracking on qualitative and quantitative easing (QQE) then become likely. The resulting tightening of financial conditions, and further yen appreciation would then cause the current revival in growth and asset prices to stutter.

Recent headlines have been dominated by the prospect of a China-US trade war. PHOTO: REUTERS

Trump, tariffs and China

Recent headlines have been dominated with the prospect of a China-US trade war. While many disagree on Mr Trump's negotiation strategy, the problems of China subsidising its industries, constraining access by foreign companies in many sectors, and the issues surrounding intellectual property rights are undeniable.

As Peter Navarro recently pointed out, over the last two decades since China joined the World Trade Organization, China's economy has multiplied 10-fold, from US$1.3 trillion to US$11.2 trillion, while its trade surplus went from roughly zero to US$422 billion in 2017.

There needed to be a reset, and it required a blunt president to pick the fight. Posturing aside, the outcome, however, is most likely to be a compromise, as it is in both sides' interest. Mr Trump sorely needs to show a China win to increase his prospects in mid-term elections, and China would be happy to throw him some scraps so they can largely pursue status quo till they are good and ready.

In any case, with a commitment to sustaining growth, buoyant retail sales and domestic demand, strong export momentum, lower fiscal deficit, healthy industrial production and real-estate investment growth and contained inflation, China has few immediate economic challenges on the horizon.

Closer to home, Asean has probably the maximum to lose in a trade-war scenario. It is inextricably linked to the global supply chain, has no bargaining power against the US or China, and has large trade imbalances. Coupled with the economic consequences, the resulting de-risking will unavoidably lead to large capital outflows from Asean economies, creating currency challenges and fall in all emerging markets. In the absence of a trade war, all Asean economies will continue to benefit from export growth and stable upward commodity prices.

Data scandal

The more important development in my opinion, however, is the Facebook data scandal. Many technology companies have relied on a business model based on eyeballs, powered by consumer data at their core.

Regulation could disrupt this. Coupled with the fact that just five companies – Facebook, Amazon, Apple, Google and Microsoft – account for a third of the market cap of the Nasdaq and 40 per cent of its increase since 2017 means that a correction can happen very easily. It may not a 2007 situation, but it could well be a 2000.

Portfolio strategy

So what does this all mean? Equity markets across the world are fully valued, if not overvalued, even though economic prospects are bright. If you have been invested in global equities till now, you have earned solid gains. It may be too early to throw in the towel, as the ride will likely continue into 2019, but the risks are mounting.

Unlike last year, this year will be the year of higher volatility, central bank policy normalisation, and geopolitical gyrations. There will be a day of reckoning – there always is – and there will be another crisis and correction in equity markets, as that is the very nature of market cycles. But no one knows what will break the camel's back and when it will happen.

For the brave-hearted, stay invested, don't get greedy and put your finger on the sell button when all hell breaks loose; for the faint-hearted, or those who have already cashed their chips and missed the recent rally in risk assets, a reasonable portfolio return can be easily achieved with a structured portfolio of emerging market corporate credit, blue-chip preferred stock and opportunistic buying of long-term growth equities.

So there is no need to rush in. Keep your powder dry, wait for the correction to happen, then steel your nerves and buy when everyone else is selling.

The only strategy that you perhaps should avoid at this stage of the market cycle, is the conventional 60-40 balanced portfolio, where you will bear the full cost of a market correction and won't be able to capitalise on buying opportunities as you are already fully invested.

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