Monthly Observations

The need to stay defensive

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Defensive Portfolio: Since June 2018, we have been advising our clients to build up a defensive portfolio due to our views on the economy, earnings cycle and geopolitical tensions around the world, which has led to an increase in volatility in financial markets. In this moment, we continue to advocate the same stance and recommend investors to build a portfolio of defensive stocks, REITS and bonds.

Market Observations:

Rising rates continue to be a key concern for many market participants given that the 2 major sell-offs in 2018 coincided with spikes in the 10Y interest rate. While market-implied rate hike odds have fallen with a more neutral stance from the Fed, a stronger than expected earnings season in Q1 could restore sentiment in equity markets and incentivize the Fed to resume its hawkish stance once again.

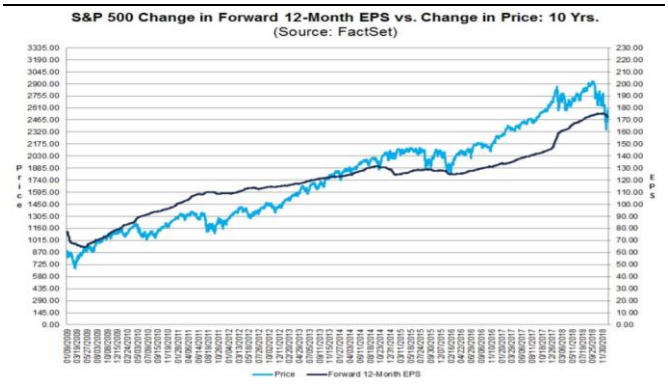
Figure 1: Target Rate Probabilities for 29 Jan 2020 Fed Meeting

TARGET RATE (BPS)	PROBABILITY(%)			
	NOW *	1 DAY 14 JAN 2019	1 WEEK 8 JAN 2019	1 MONTH 14 DEC 2018
150-175	0.1%	0.1%	0.0%	0.0%
175-200	2.0%	2.4%	1.5%	0.8%
200-225	19.8%	21.0%	17.4%	11.2%
225-250 (Current)	64.9%	62.7%	60.3%	37.4%
250-275	12.6%	13.2%	18.8%	34.5%
275-300	0.7%	0.7%	1.9%	13.3%
300-325	0.0%	0.0%	0.1%	2.6%
325-350	0.0%	0.0%	0.0%	0.3%

Source: CME Group, KGI Research

Equity markets have fallen 20% from highs in FY18 with weak expectations of the upcoming earnings season. According to Factset, the 12-month P/E ratio for the S&P 500 is ~15.1, which is below the 5-year average of 16.5 but above the 10-year average of 14.6.

Figure 2: S&P 500 Change in Forward 12-month EPS vs Change in Price

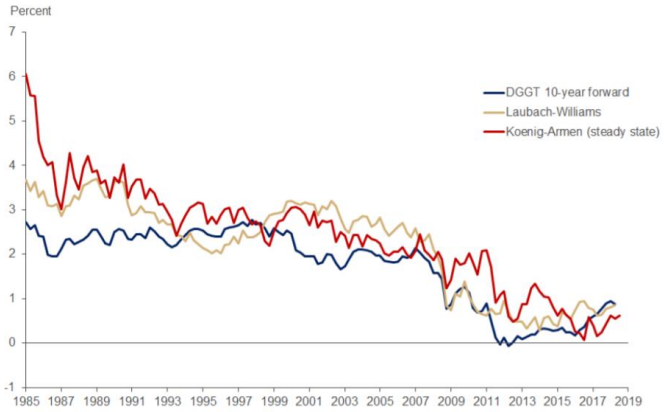


Source: Factset, KGI Research

In providing guidance for the 4th quarter, 59.7% of companies who provided guidance for 4Q18 have issued negative EPS guidance. For the first 3 quarters of FY19, consensus expectations of earnings growth are in low, single-digits.

Aggressive rate hike cycle is unlikely. One of the biggest debates surrounding fixed income investors in recent years has been the level of netural rate, which is the optimal rate where monetary policies neither stimulates or restricts economic growth.

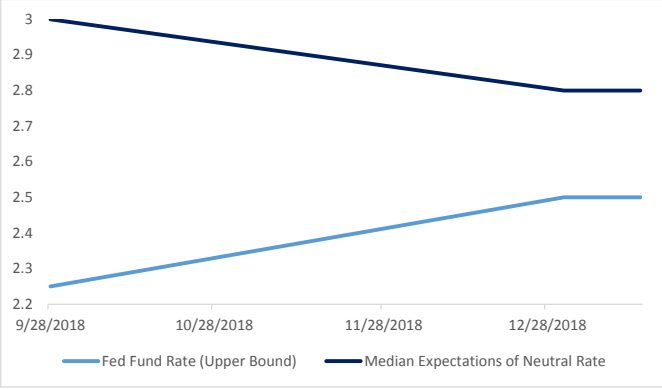
Figure 3: Estimates of the Longer-run Real Neutral Rate



Source: Dallas Fed, KGI Research

In the December Summary of Economic Projections (SEP) by the Federal Reserve, FOMC participants' median estimate of the longer-run neutral rate for the US economy declined to 2.8% from 3% in September.

Figure 4: Fed Fund Rate (Upper Bound) vs Neutral Rate

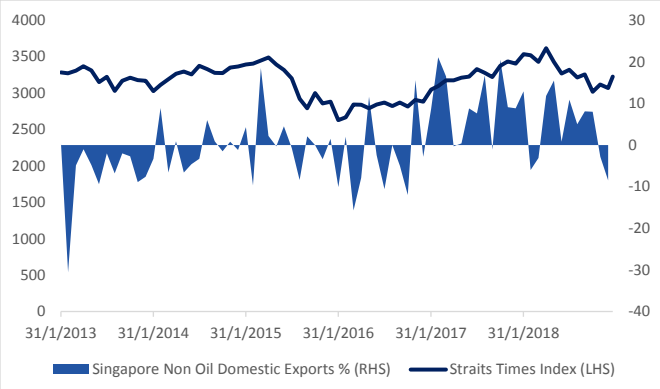


Source: Federal Reserve Minutes, Bloomberg, KGI Research

At current levels, the neutral rate is just 0.3% away from the upper end of the current fed fund target rate (2.25% - 2.5%), which suggests that the Fed could be venturing into restricting economic growth if rate hikes continue to be aggressive. We believe this is unlikely given the Fed's more dovish tone after the recent market sell-off, weaker GDP/inflation expectations, and the street's expectations of a weak earnings season in the first 3 quarters of FY19.

Singapore's non-oil exports declined 8.5% in December 2018, the worst in 2 years. On a MoM basis, non-oil exports declined 5.7% in December, after a 4.3% decline in November. This is in contrast to consensus expectations of a 2% YoY increase as trade tensions from the US-China continued weighing on importer's sentiment. If such trends persist, similar disappointments could also happen in the equity markets with earnings missing expectations, which is why we continue to advise clients to build up a defensive portfolio.

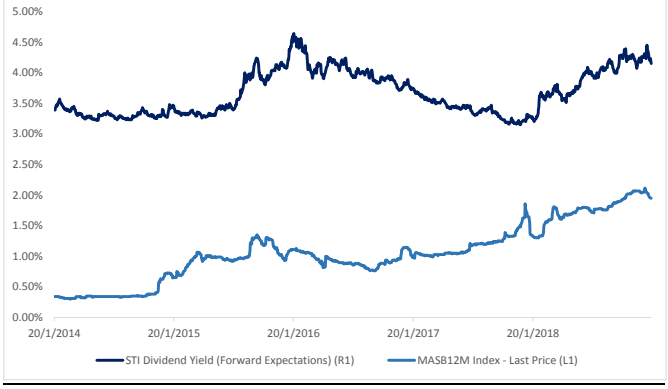
Figure 5: Singapore's Non-Oil Domestic Exports Vs Straits Times Index



Source: Bloomberg, KGI Research

Rethinking Carry (Bond Yields/Dividend Yields). Looking at spreads between expected dividend yields on the STI and 1Y government bond yields, we observe an average spread of 251bps since 2014. If 1 year implied dividend yields on the STI currently yields 4.3% and 1-year government bonds trades at 1.95%, we believe investors looking at fixed income securities in the SGD market should be targeting a carry of 2%-4% before adjusting for term premiums and credit spreads.

Figure 6: Dividend Yields Vs MAS 12-Month Yield

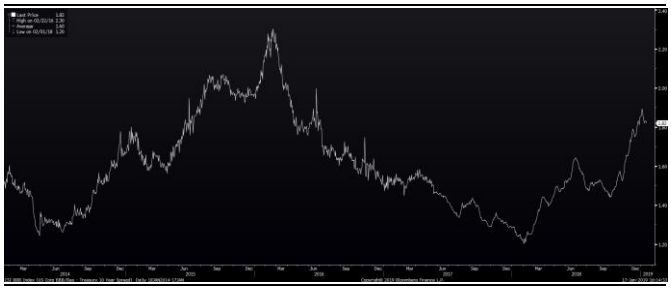


Source: Company Data, KGI Research

Currently, median expectations of the Fed's dot plots indicate a rising rate environment till 2020 before rates remain flat or decline while market expectations of SG2Y rates in 2019 and 2020 are at 2.2% and 2.4% respectively, which is well within our expectations of a 2% - 4% carry in the SGD bond market.

Opportunities are appearing as credit spreads widen after the withdrawal of liquidity from central banks. In USD corporate credits, spreads between BBB/Baa names and 10Y treasuries have widened to 1.8% from a 5 year low of 1.2% in February 2018 while spreads between the 2 and 10 year treasury yields have tightened to a low of 10.7bps in December 2018.

Figure 7: US Corporate BBB/Baa vs 10Y Treasury Spread



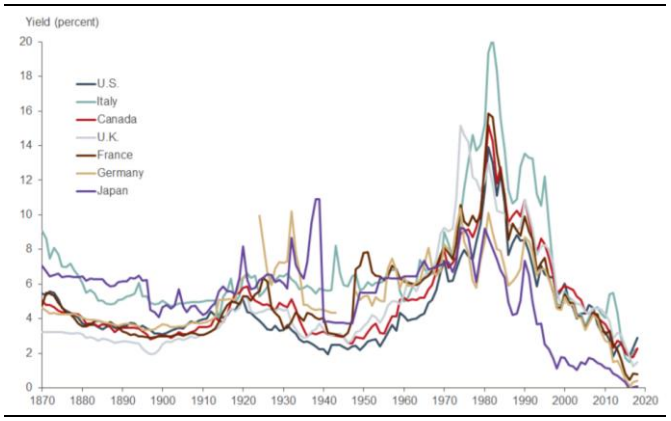
Source: Bloomberg, KGI Research

While credit tightening could create sell-offs in corporate credits, we believe there could also opportunities to pick up credits backed by strong fundamentals in a sell-off since high interest rates environments are unlikely to return.

High interest rates environment are unlikely to return but supply of top investment grade corporate credit has declined. Due to low-interest rates environment in the last decade, many investors are concerned that a rising rate environment means negative returns for bonds as textbook theory suggests. In our view, this is only true if the Fed's rate hike cycle is too steep and aggressive, which will erode returns from carry and increase the risk of an equity market sell-off.

Looking at nominal yields on long-term government bonds over the past 150 years, we can see that nominal yields have declined since the 1970s, long before the start of quantitative easing or negative interest rates policy.

Figure 8: Nominal Yields on Long-Term Government Bonds



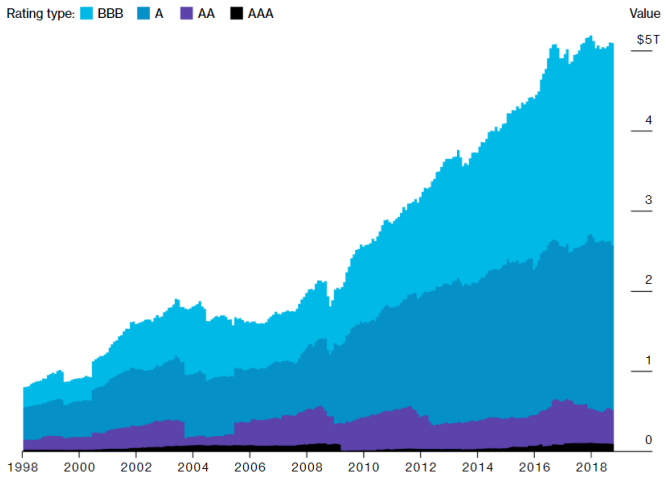
Source: Dallas Fed, KGI Research

Economists at the Dallas Fed suggests that such trends are driven by a reduction in inflation expectations due to lower rates of economic growth and worldwide demand for safe and liquid assets as the size of pension funds, central bank

balance sheets and other fixed-income investment pools have increased over the years.

While central bank balance sheets are expected to shrink in the coming years, the supply of top rated investment grade (IG) bonds have also fallen over the years, according to Bloomberg data. In the IG space today, BBB names make up 49% as compared to 27% in 1993, driven by companies looking to finance corporate acquisitions.

Figure 9: More than half of US IG index now sits in the lowest ratings tier



Source: Bloomberg, KGI Research

Looking at performances of high yield credits, IG and intermediate corporate bond returns, we can see that total returns of fixed income securities have been positive even though the Fed started raising rates in 2015, which supports our view that unless the Fed embarks on an aggressive rate hike cycle, investors should include fixed income securities as part of their defensive portfolio.

Figure 10: Returns from fixed income securities remain positive

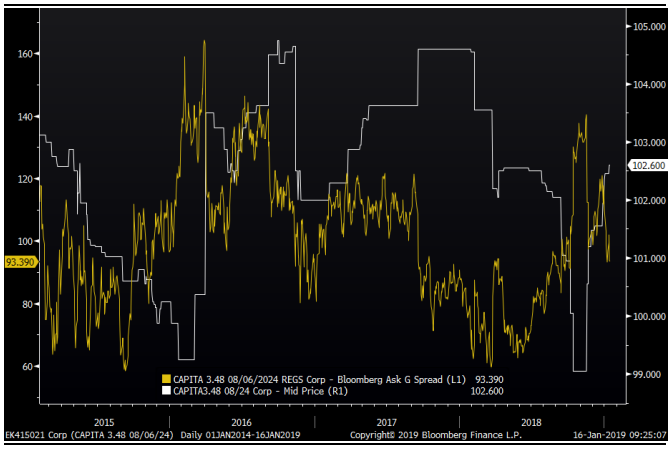
Source: Bloomberg, KGI Research

Therefore, unless interest rates expectations or the Fed's rate hike cycle moves faster than expected, we recommend investors diversify their portfolio with intermediate term corporate credits (3Y – 7Y) backed by strong fundamentals. We remain negative on high yield credits for our defensive portfolio.

Duration Vs Interest Rates. To illustrate our view on interest rates and intermediate term credits, we look at a few examples with low credit spreads in the SGD corporate bond market. As the Fed only started raising interest rates in 2015, our illustrations will show the fluctuations of intermediate term credits with low credit spreads since 2015.

CapitaLand'2024 -

Figure 11: CapitaLand'2024 vs Credit Spreads



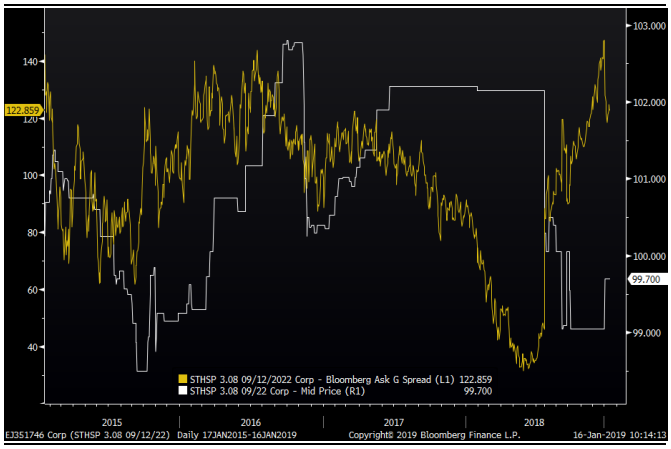
Source: Company Data, KGI Research

Company Background - CapitaLand is one of Asia's largest real estate companies. Headquartered and listed in Singapore with 40% ownership by Temasek Holdings. The group is an owner and manager of a global portfolio worth over S$92 billion as at 30 September 2018, comprising integrated developments, shopping malls, lodging, offices, homes, real estate investment trusts (REITs) and funds.

Reaction to Rising Interest Rates – Since the rate hike cycle began in Dec 2015, the bond price of CAPL'24 traded within a range of 99 and 105 with credit spreads fluctuating between 60bps and 160bps. Investors who had bought the credit on December 2015 would have made a total return of ~13% as of December 2018.

Starhub'2022 -

Figure 12: Starhub'2022 vs Credit Spreads



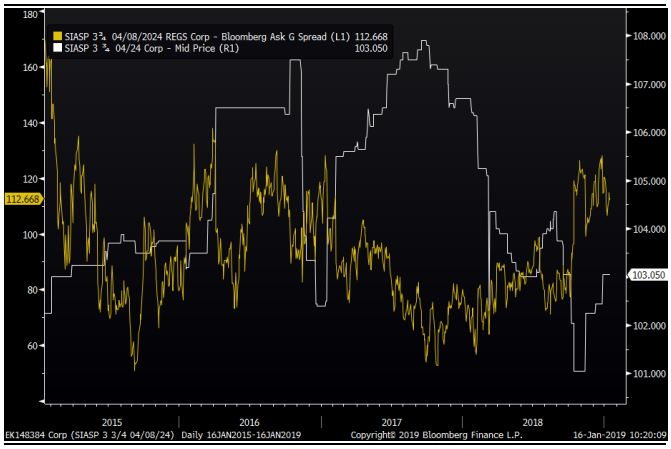
Source: Company Data, KGI Research

Company Background - StarHub is a fully-integrated info-communications company, offering a full range of information, communications and entertainment services for both consumer and corporate markets. The group operates a mobile network and manages an island-wide HFC network that delivers multi-channel pay TV services (including HDTV, Internet TV and on-demand services) as well as ultra-high speed residential broadband services. Listed on SGX, the group has a market cap of S$3bn and is 56% owned by Temasek Holdings.

Reaction to Rising Interest Rates - Since the rate hike cycle began in Dec 2015, the bond price of STHSP'22 traded within a range of 98.5 and 102.8 with credit spreads fluctuating between 31bps and 147bps. Investors who had bought the credit on December 2015 would have made a total return of ~9% as of December 2018.

Singapore Airlines'2024 -

Figure13: Singapore Airlines'2024 vs Credit Spreads



Source: Company Data, KGI Research

Company Background - Singapore Airlines is the flag carrier of Singapore and provides passenger air transportation services through various brands including Singapore Airlines, SilkAir, Tiger Airways and Scoot. The group also provides other services such as air cargo transportation and airframe maintenance through subsidiaries such as SIA Engineering Company. Listed on SGX, the group has a market cap S$11bn and is 55% owned by Temasek Holdings.

Reaction to Rising Interest Rates - Since the rate hike cycle began in Dec 2015, the bond price of SIASP'24 traded within a range of 101 and 108 with credit spreads fluctuating between 50bps and 169bps. Investors who had bought the credit on December 2015 would have made a total return of ~10% as of December 2018.

Recession fears are real but fears of an asset price collapse are not among the top worries of business leaders and policy makers. According to The Conference Board's annual survey with C-Suite executives from the United States, Asia and Europe, recession risk was rated as the top concern globally for 2019 as compared to 19th in 2018. Other key concerns include trade wars, politically instability and cyber-security.

Fiscal crises, asset price collapse and unemployment woes however, have not been ranked among the top 5 global risks by business leaders and policy makers at the World Economic Forum. According to the WEF's Global Risks Report 2019 which surveyed 1,000 experts and decision-makers, 91% of respondents believed in further economic confrontation between major powers in 2019.

Figure 14: The Conference Board's C-Suite Challenge 2019

EXTERNAL HOT-BUTTON ISSUES	CEOs Overall	US	Europe	Japan	China	Latin America	Other C-suite
Recession risk	1	3	2	1	1	1	1
Threats to global trade systems	2	4	5	3	2	8	2
Global political instability	3	6	1	1	3	3	5
New competitors	4	2	4	4	7	5	3
Declining trust in political and policy institutions	5	5	3	6	6	4	6
Cyber security	6	1	6	8	10	7	4
Currency volatility	7	11	8	11	5	2	7
Rising interest rates	8	7	9	9	11	6	10
Uncertainty in corporate tax policies	9	10	10	12	4	9	12
Income inequality	10	8	12	7	9	11	11
Impact of climate change on our business	11	9	13	5	12	10	9
Volatility in energy prices	12	13	11	10	8	12	8
Effects of Brexit	13	14	7	14	14	13	13
Terrorism	14	12	14	13	12	14	14
	N = 795	N = 132	N = 317	N = 79	N = 118	N = 31	N = 591

Source: CNBC, The Conference Board, KGI Research

Trade Ideas: In line with our defensive portfolio positioning and observations stated above, we recommend investors consider opportunities in the following asset classes to build up a defensive portfolio.

Defensive Portfolio

Equities –

Figure 15: Defensive Stocks under KGI Coverage

Company Name	Currency	Last Price	Currency Adj. Market Cap (US$ mn)	P/E (x)		P/S (x)		PEG (x)		Dividend Yield (%)
				FY17	FY18F	FY17	FY18F	FY17	FY18F	
THAI BEVERAGE PCL	SGD	0.73	13,493	23.0x	18.2x	1.9x	1.7x	2.3x	2.1x	2.81
SHENG SIONG GROUP LTD	SGD	1.11	1,228	23.8x	23.1x	1.9x	1.9x	3.0x	2.8x	2.97
COMFORTDELGRO CORP LTD	SGD	2.22	3,538	17.2x	16.0x	1.3x	1.3x	2.8x	2.6x	4.68

Source: Bloomberg, KGI Research

REITs –

Figure 16: Selected Names from KGI S-REITs Watch List

Company Name	Last Price ($SGD)	Currency Adj. Market Cap (S$ mn)	Yield (%)	Gearing (%)	P/B (x)	6M Average daily trading volume (S$ '000)	(YTD) Price Performance
MAPLETREE COMMERCIAL TRUST	$ 1.75	$ 5,055	5.20	35.2	1.2	8,786	6.1
CAPITALAND MALL TRUST	$ 2.31	$ 8,517	5.19	32.8	1.1	23,133	2.2
FRASERS CENTREPOINT TRUST	$ 2.28	$ 2,115	5.44	29.6	1.1	2,007	5.1
KEPPEL DC REIT	$ 1.47	$ 1,987	5.37	32.4	1.4	4,267	8.9

Source: Bloomberg, KGI Research

Fixed Income –

Figure 17: Selected Names from KGI Fixed Income Watch List

Issuer Name	Coupon	Maturity	Maturity Type	Ask Price	Gspread	Yld to Worst(Ask)	Duration	ISIN
CAPITALAND LTD	1.85	19/6/2020	CONVERTIBLE	98.36	107.06	3.06	1.36	XS0935605401
SINGAPORE AIRLINES LTD	3.22	9/7/2020	AT MATURITY	101.10	44.60	2.44	1.41	SG7W61959351
SINGTEL GROUP TREASURY P	3.49	8/4/2020	AT MATURITY	101.45	27.87	2.25	1.16	SG7V66955876

Source: Bloomberg, KGI Research

KGI's Ratings

Rating	Definition
	KGI Securities Research's recommendations are based on an Absolute Return rating system.
BUY	>10% total return over the next 12 months
HOLD	-10% to +10% total return over the next 12 months
SELL	<-10% total return over the next 12 months

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