BCT MARKET OUTLOOK

As of February 2020

BCT 銀聯集團

‘Black swan’ COVID-19 casts its shadow over the global market

Investment Markets	BCT’s Investment Views	Summary
Equities		
US		We remain cautiously neutral on the U.S. equities, valuations are reasonable and are supported by low credit spreads and interest rates. However, for any further upside in prices, earnings would need to grow.
Europe		We are slightly positive on European equities. Expectations of a rebound in manufacturing, low unemployment, accommodative monetary policy, fiscal stimulus, and the U.S.-China phase 1 deal support the case for European equities.
Japan		We are neutral on Japanese equities. Japanese corporate fundamentals remain solid as profits are growing and buybacks are increasing, and at the same time balance sheets remain underleveraged. However, if geopolitical risks re-emerge, Japanese companies (most of which are exporters) will be vulnerable to a rising yen.
Asia ex Japan		We are slightly positive on Asia ex-Japan equities. Diminishing trade war tensions, low interest rates, fiscal easing, and hopes of limited appreciation in the USD could support emerging markets equities in the medium term.
China & HK		We are positive on China equities and continue to maintain a preference for A-shares market, which represents the domestic sectors of the economy that should benefit the most from the economic policy stimulus. Also, flows will continue to be supported from the gradual lift of the A-share inclusion factor following the plan set by the MSCI. We are neutral on Hong Kong, one significant positive of the epidemic is the absence of the protestors, which disappeared and brought some calm in the city.
Global Bonds		
Government Bonds		The COVID-19-driven uncertainties capped the potential rebound of yields and led to the current repricing which discounts a more uncertain global macro outlook.
Credit		

Scales of weighting	Underweight	Neutral	Overweight

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U.S. EQUITIES

The U.S.'s S&P 500 made a new all-time high on 17 January but it closed the month with minor underperformance of -0.04%. The narrower Dow Jones 30 managed to underperform its big brother, recording a loss of 0.99% for the month whilst th asdaq outperformed with a +1.99% return. Growth stocks continued their recent run and out ormed value stocks in January with the former up 2.20% whilst the latter posted a 2.82% loss. The U.S.'s Q4 GDP rose 2.1% with growth in government spending (defence spending) as well as residential fixed investment and exports, making positive contributions to the expansion. Offsetting those gains were an 8.7% fall in imports, a 1.5% drop in non-residential fixed investment and a decrease in private inventory investment. The U.S. manufacturing growth slowed with the IHS Markit Manufacturing Purchasing Managers' Index falling to 51.9 in January whilst the activity in the services sector measured by the IHS Markit Service Purchasing Managers' Index rose to 53.4. The coronavirus (COVID-19) impact in January's Purchasing Managers' Index (PMI) was likely to be very limited as surveys ran at the early stages of the crisis. Domestic demand kept slowing, with investment spending hit worse than private consumption. Business climate surveys showed resilient services and still fragile manufacturing, but signs of a tentative bottoming-out are appearing. Inflation remained benign, although in the near term some upside movement materialized (2.3% core and headline inflation), yet core Personal Consumption Expenditures (1.6% year-over-year) remained close to, but below, the Federal Reserve's (The Fed) target. The Fed considered its policy stance appropriate and well calibrated to support moderate growth and resilience on the labour market. Yet, as we expect some disappointments to come on growth, we are penciling in another cut in 2020.

Real GDP growth is expected to gradually decelerate in the U.S. towards potential (we expect a 1.9% year-on-year growth for 2020), with growth driver mix becoming less broad-based. While we maintain our call for the U.S. consumer to post an "average" year, thus becoming the main engine of growth, investments will decelerate, in particular non-residential. Compared to the last update, we revised up the expectations on residential investment performance, which no longer dragged growth. We expect the Fed to deliver a 0.25% cut of the Fed Fund rates in the first half of the year as the economy continues the deceleration trend. The strong USD gives the Fed room to ease. The U.S. valuations look reasonable and are supported by low interest rates and credit spreads. Given the dovish Fed's stance of 2019, the lagged impact of low rates and other input costs should now boost earnings. In addition, around 40% of earnings in the S&P 500 depend on international operations of companies and consequently a weakening USD would have a positive impact. A majority of earnings growth would come from consolidation of these international earnings. This, in turn, would drive returns in 2020. We remain cautiously neutral on the U.S. equities, valuations are reasonable and are supported by low credit spreads and interest rates. However, for any further upside in prices, earnings would need to grow. Encouragingly, the lagged impact of low rates and input costs would indeed boost earnings. Overall, we favour value over growth and low beta names.

EUROPEAN EQUITIES

In Europe, equity markets mostly posted negative results, with the MSCI Europe down 1.66% in local total return terms. The MSCI EMU and the Euro Stoxx 50 did worse, posting returns of -1.79% and -2.66% respectively for the month. Defensive indices such as the Danish and Finnish bourses posted positive returns. In terms of macro data, the Eurozone's Q4 GDP grew just 0.1% on a quarterly basis, according to preliminary data, which was the weakest since Q1 2013, when the Eurozone economy contracted. The French and Italian economies contracted in Q4 while Spain accelerated. Eurozone's Q4 growth was up only 1.0% from a year earlier, decelerating from 1.2% gain in Q3. The bank lending survey in Q4 confirmed the relative strength of the consumer sector, with strong net demand from households across the board, but while lending conditions and standards remained broadly unchanged, lending demand from corporates remained weak in aggregate. According to preliminary data, the Eurozone's inflation rate increased to 1.4% in January from 1.3% in December. The core inflation gauge, excluding the volatile prices of energy, food alcohol and tobacco, was the lowest since October, at 1.1%.

Headline inflation was instead up to 1.4% from 1.3%, which was the highest since April. The Eurozone's unemployment rate fell to 7.4% in December from 7.5% in November, which was the lowest since May 2008. The U.K. left the European Union (EU) on 31 January after the EU gave a final approval to the process but much remains to be done to complete the Brexit with both parties hoping to agree on a new trade agreement by the end of this year.

The picture is mixed in Europe, with Germany and Italy improving the growth trend profile, after the poor 2019 performance, while France is keeping a rate of growth close to potential and Spain is slowing down. Eurozone in aggregate stabilizes at potential, with currently little signs of an accelerating momentum ahead. Indeed, manufacturing PMI still raises concerns that a turn of tide in the trade war escalation will not suffice to remove the drag on the sector. Signals of expansionary fiscal policies remain limited to country-level implementation but have not yet taken shape as a coordinated effort. A further push remains theoretically possible, in particular if the economy worsens and struggles to rebound. As inflation is supported in its very gradual upside move by growth stabilizing, we are not expecting any new easing by the European Central Bank (ECB). In the U.K., after the slowdown of last year, the U.K.'s GDP growth is projected to pick up a little in early 2020 but the future relationship with the EU is creating uncertainty on future paths. The uncertainty surrounding the future trade framework with the EU will nonetheless continue to impede investment. Overall, we are slightly positive on European equities. Expectations of a rebound in manufacturing, low unemployment, accommodative monetary policy, fiscal stimulus, and the U.S.-China phase 1 deal support the case for European equities. In addition, Europe is home to companies with sound environmental, social and governance (ESG) profiles. Given that ESG factors will be increasingly important in investor pricing going forward, this collectively boosts the case for the region's equities. Market dislocations continue to offer opportunities in cyclical value names.

JAPANESE EQUITIES

In January, Tokyo stocks posted the first monthly contraction in five months with the TOPIX falling 2.14% and the Nikkei dropping 1.91%. Geopolitical concerns at the beginning of the month and the outbreak of the COVID-19 in China thereafter, sent equity prices into tailspin for fear of the adverse impact on inbound tourism during the Chinese Lunar New Year holidays. In addition, anxieties over the disruption of global supply chains squeezed already beleaguered automobile sector. The market collapsed on 27 January as COVID-19 spread to Europe and the U.S., compounding fear for global economy. The poor corporate results in automotive electronics and construction machinery fuelled the downward streak. The market retrieved to the level recorded in November last year. The Diet approved the fiscal year 2019 supplementary budget, which contained a part of the recent sizable economic package. Meanwhile, base money growth accelerated, as the Bank of Japan (BOJ) had suspended its tapering of Japanese government bond buying since December. Japan's GDP shrank at an annualized pace of 6.3% from previous quarter in December, which was the biggest slide since a previous tax increase in 2014, according to preliminary estimate by the Cabinet Office. Consumer spending finally started to show signs of recovery from the value-added tax hike-induced weakness. Inbound tourism into Japan bore the brunt of the outbreak of COVID-19, despite that one-third of foreign visitors come from Greater China, which normally celebrates the Lunar New Year holidays. Disruption of supply chains could exacerbate problems in the automotive industry, which is already struggling with poor sales.

There have been some encouraging signs in Japanese economy, with domestic demand showing a moderate positive trend. However, the positive trend in domestic demand has been hampered by the COVID-19 outbreak. External demand is still showing weakness, with exports dropping for the 13th straight month in December. The approved supplementary budget is expected to boost GDP by 0.7% over the next two years. Our latest forecasts for the real GDP year-over-year growth are 1.2% for 2019, 0.7% for 2020 and 0.8% for 2021. The BOJ may still consider additional easing in 2020 if geopolitical risks increase again and the yen strengthens materially. We expect one 0.10% rate cut in the next 12 months on two conditions. First, a cut

in the short-term interest rate target must be accompanied by realignment of the three-tiered structure in the BOJ's current account deposit in order to mitigate adverse effects on financial institutions. Second, the BOJ will obviously keep the longer-end of the curve from declining, in order to secure the slope of the curve. We are neutral on Japanese equities. Japanese corporate fundamentals remain solid as profits are growing and buybacks are increasing, and at the same time balance sheets remain underleveraged. However, if geopolitical risks re-emerge, Japanese companies (most of which are exporters) will be vulnerable to a rising yen. The cyclical argument is in favor of Japan, but in the short term COVID-19 fears may prevail. During the SARS episode, Japan was among the latest to rebound with Hong Kong. Therefore, we maintain our neutral stance.

ASIA EX-JAPAN EQUITIES

The escalating tensions between Iran and the U.S. in the first half of the month and the COVID-19 outbreak in China hurt investor sentiment and resulted in a sell-off across Asian equity markets. The MSCI World lost 1.08% in January while the MSCI Emerging Markets and the MSCI Asia ex-Japan lost 3.0% and 4.5% respectively as the uncertainty around the COVID-19 overshadowed the optimistic outlook on global trade activity. Economic conditions in the region improved on the back of constructive export flows out of countries such as South Korea, Taiwan and China that are heavily exposed to the semiconductor sector. The region's inflation figures remained very benign, although they generally increased in December. Noteworthy December figures once again came from India and China, with a high contribution from food basket components, at 7.4% and 4.5% year-over-year, respectively. In January, Malaysia's central bank unexpectedly reduced its reference policy rate by 0.25% to 2.75%, on concerns about economic growth and the external risks to it. The spread of the COVID-19 out of China is expected to negatively impact neighbouring countries, in particular those which receive important touristic inflows, such as Thailand and Vietnam. Unsurprisingly, given the expected negative impact on corporate earnings, 2020-2021 earnings for the region were revised down by 2.6% and 2.1% over the last month. India, Taiwan and Indonesia saw modest positive earnings revisions to 2020 estimates while, Thailand, Korea and Singapore saw negative earnings revisions in the range of 3 to 9%.

Capital markets roiled for fear of the epidemic and the potential drag to global growth. It is still early to conclude any impact and we are monitoring it closely. The environment remains very fluid and it is difficult to forecast how, when and if, the disease can be contained, but the proactive and draconian measures taken by the authorities around the world provide some assurance that the virus could be brought under control. Similar to 2003, we expect China, and other Asian markets, to implement both expansionary fiscal and easing monetary measures to support growth. In India, domestic economic activity indicators started to show a mixed picture with a few green shoots in an overall depressing economic environment while inflation surprised on the upside, which will probably require a further upward revision in the Reserve Bank of India's central case and further delay any policy rate decision in the short term. We are slightly positive on Asia ex-Japan equities. Diminishing trade war tensions, low interest rates, fiscal easing, and hopes of limited appreciation in the USD could support emerging markets equities in the medium term. Unless the "elevated uncertainty" derails the global economy into a shock – which is not our assumption – excessive downward setbacks in prices could provide entry points. Diversification remains the key and stock selection is vital, we prefer quality stocks with solid fundamentals that are sold off indiscriminately along with the markets.

CHINA & HONG KONG EQUITIES

Asian equities had a generally negative month in January. The Hang Seng Chinese Enterprises (H-shares) posted a 8.31% fall. The Hang Seng Index fell 6.66% on worries about the impact of the COVID-19 in China. In addition, Moody's lowered Hong Kong's long-term credit rating by one notch citing a lack of a credible plan to address anti-government protests. Most of the Chinese economic data monitored rebounded in December (stable property sector and infrastructure investments). GDP figures for Q4 2019 were released as expected at 6.0% year-

over-year. Notwithstanding the rebound, the sudden spreading of the COVID-19 out of Wuhan posed serious downside risk to the growth in China. Headline inflation remained stable at 4.5% year-over-year in December and food prices shifted slightly. The policy mix once again proved only marginally supportive: the 0.50% cut in reserve requirement ratio at the beginning of the year, and loan prime rate on hold in January at 4.15%. Chinese authorities announced a slew of measures in late January to counter the strong headwinds from the COVID-19 and re-assure markets. These included the provision of sufficient liquidity, strengthening of credit support particularly to those regions and sectors affected by the virus, reduction of the debt burden for troubled corporations and individuals, and fine-tuning of deleveraging policies.

The viral epidemic will lead to a drop in Chinese GDP growth. Assuming a short virus longevity and a gradual easing in the lockdown measures, we lowered our Q1 GDP expectations from 5.8% year-over-year to 4.5%, taking the 2020 GDP growth to 5.6% year-over-year from 5.8%. In order to boost consumption and encourage economic activities, the People's Bank of China is likely to inject liquidity into the system by introducing at least a 0.50% cut in the banks' reserve requirements, lowering the loan prime rate, waiving fees for specific sectors, and maybe lifting the housing curbs. Overall, we are selective on our investments in Hong Kong and China. We are neutral on Hong Kong, one significant positive of the epidemic is the absence of the protestors, which disappeared and brought some calm in the city. We are positive on China equities and continue to maintain a preference for A-shares market, which represents the domestic sectors of the economy that should benefit the most from the economic policy stimulus. Also, flows will continue to be supported from the gradual lift of the A-share inclusion factor following the plan set by the MSCI. If we see a reacceleration of the virus spreading outside Hubei province, we will review our exposure towards Hong Kong and China, which could suffer, but at the moment we keep our positive bias towards China.

GLOBAL BONDS

Rising economic optimism drove the yield of the U.S. Treasuries up in the first part of the month but then investors switched to bond investments due to rising worries about the spread of the COVID-19. At its meeting on 29 January, the Fed kept interest rates unchanged as the U.S. economy looked to experience another year of solid jobs growth and steady inflation. Although the uncertainties around trade have diminished and there are some signs of global growth stabilizing, uncertainties about the outlook remain, including the COVID-19 in China. The Fed tried to normalize the repurchase market with an increase of 0.05% in the interest on required reserve but the main drivers of the curves were the recent concerns on the global growth driven by the COVID-19. The short-dated part of the yield curve saw falling yields during January with the U.S. 2-years yield falling 0.26%, ending at +1.32%. Further out the curve, the U.S. 10-years yield finished at +1.51%. The breakeven inflation rate also moved down during January, starting the month at +1.79% and finishing the month at +1.64%. European fixed income markets followed a trend similar to that of the U.S. with higher yields in the first part of the month followed by falling yields later in the month. With risks surrounding the Eurozone growth tilted to the downside, the ECB left its policy settings unchanged and kept the rate on bank overnight deposits at a record low of -0.50%. It also launched a "strategic review" of its inflation goal and tools. German 10-years bond yields fell further in negative territory to finish the month at -0.44%. Over the month, German 2-years bond yields fell 0.06% to -0.67%. One of the strongest performances came from Italian BTPs, which benefited from the reduction in political risk after Matteo Salvini's Lega party failed to win a key regional election earlier this month.

In line with market expectations, our central scenario is that the Fed will deliver another rate cut in 2020, in order to maintain accommodative financial conditions and keep the U.S. growth on track. The COVID-19-driven uncertainties capped the potential rebound of yields and led to the current repricing which discounts a more uncertain global macro outlook. The search for yield continues, specifically in the Italian curve, which is an exceptional case of attractive positive yields. Thus, we remain constructive on Italian 30-years as compared to German 30-years. In credit, while valuations are rich, the asset class continues to be supported by the current late

cycle environment and technical factors, especially in Europe (targeted longer-term refinancing operations and ECB's quantitative easing 2). We prefer Eurozone investment grade to that of the U.S. because of better leverage profile of the former. Elsewhere, benign inflation, attractive carry, dovish emerging markets' central banks, and strong relative yields all support emerging market debt (hard currency), although we recommend hedging the duration and currency risk.

From a risk/return perspective, we prefer hard currency over local currency for the time being. While the fundamental and technical backdrop will likely remain supportive of the asset class in 2020, valuations currently look tight. It is hard to see pockets of value, especially given the limited space for the Fed to loosen further and for emerging markets currencies to perform strongly in the short term. Our outlook is still moderately positive for emerging markets debt, but we believe a more cautious stance is appropriate now, as the strong performance in 2019 was behind us. We are neutral on government bonds and positive on corporate credit.

Investment involves risks. Past performance is not indicative of future performance. The value of constituent funds may fall as well as rise. For further information about the risks involved, please refer to the principal brochure of BCT (MPF) Pro Choice and BCT (MPF) Industry Choice.

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