FOR INSTITUTIONAL INVESTORS ONLY

Nikko Asset Management

INVESTMENT OUTLOOK 2021

Our investment teams across asset classes and geographical regions present their views on the outlook for the year ahead

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Global Strategy thoughts for 2021
Reflationary repair

By John Vail, Chief Global Strategist

US capitalism was built on large societal divisions, but sometimes such becomes intolerable and the majority of the population revolts. In this case, the virus accentuated the income divide and engendered even greater angst. However, during the past four years, the majority fought back in different ways and ended up fighting each other, while the wealthy prospered more than ever, with high-skill workers reaping gains while lower-skill workers struggled and were often displaced, especially after the virus. Now, with the election in Georgia, the wealthy and corporations will likely be negatively affected, especially regarding taxation, but this could be offset by increased economic and corporate revenue growth related to stimulus measures and the vaccine-led re-opening of the global economy.

Inflation hurts low income citizens the most because they allocate nearly all their income on daily necessities and rent. This tenet is often cited by central bankers and politicians for economic prudence, but in the current situation, central banks consider employment an even more important criterion, and hope that economic and price reflation will create jobs. Meanwhile newly empowered Democratic politicians are emphasising large fiscal spending, including infrastructure, social welfare policies and minimum incomes in order to help low-income citizens. While there is some debate about such, it seems that the Democrats will be able to pass major fiscal stimulus relatively soon using the "budget reconciliation" process that was used in most other major fiscal bills in the past few decades.

Such should greatly offset the weak virus-burdened underlying economy. Interest rates are being subdued by central bank purchases and multifaceted fears among bond investors, although some of these fears seem to be fading as inflation is rising faster than expected and bond market-derived intermediate-term inflation expectations are rising rapidly. Indeed, the CPI is already above pre-virus levels. Furthermore, the fact that the Saudis are cutting oil production, despite oil prices in USD terms nearly returning to pre-virus levels, is also likely related to the weaker USD, as the oil price in euro terms remains far below pre-virus levels. Any fear of continued such actions would be quite inflationary. Indeed, coupled with a weaker USD, rising food prices and distribution expenses, the US CPI could well approach 4% YoY in the 2Q and substantially exceed

"newly empowered Democratic politicians are emphasising large fiscal spending, including infrastructure, social welfare policies and minimum incomes in order to help low-income citizens"

3% throughout the 2H. Of course, part of this is due to a low base-year effect, but even on an annualised six-month basis, the CPI will likely be, unless there is a massive deceleration in measures of housing rent, 3% or higher throughout 2021, and even 4% in some months. Near year-end, the Fed may signal the tapering of purchases, but it would have to do so quickly in order to restrain inflation in 2022. Thus, a significant headwind to reflation may be bond yields rising much faster than expected.

Clearly, the political situation is very disturbing in the US, which seems to be more divided than ever, but it is calmer now in Europe. Japan and China are fairly calm too, as usual. The Middle East is even more a powder keg than usual, but President-elect Biden put the Iran nuclear deal's authors in command of the State Department, so there is hope for greater peace. It would be immensely unwise for Iran not to compromise on many issues so that its people can prosper.
Japan, Europe and a good portion of the rest of the world will also likely experience inflationary economic growth, as oil prices and housing prices continue to rise. Of course, if the USD is weak, inflation may be somewhat curtailed in other countries, but we estimate that Japan will be very active in preventing yen strength and Europe will resist euro strength to some degree too. As societal divides are lower in most of the rest of the developed world, fiscal stimulus programs such as major increases in guaranteed income levels are unlikely to be common outside the US, which may curtail inflationary fears.

> “there are many reasons to be positive about societal and economic repair via reflation reflation, but the most positive factor of all will be the widespread distribution of vaccines in 2021”

Interestingly, for all the factors that are changing rapidly, very many others remain in a long-term uptrend. ESG investment themes, including alternative energy and technological improvements, are accelerating further. Assets in ESG and new technology-related funds have continued to hit record levels and this shift in preferences is likely to shape the investing landscape for decades to come. With the support of increased regulatory focus, ESG will promote many new forms of beneficial economic growth.

Also, the global diversification of supply chains will likely continue. We have long believed that this adds to economic growth globally, perhaps with somewhat decreased efficiency, but also providing increased robustness and reliability. ASEAN will continue to be a major beneficiary of this trend, but it will be interesting to see how much the Biden Administration emphasises on-shoring. Meanwhile, Chinese companies will continue to benefit from the country's establishment of its own massive internet system and promotion of new hi-tech industries.

So, although the world remains full of twists and turns and burdened by the virus, there are many reasons to be positive about societal and economic repair via reflation, but the most positive factor of all will be the widespread distribution of vaccines in 2021.

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Global Multi-Asset Market Outlook: Expanding the opportunity set amid reflation

By the Multi-Asset Team

An overview of 2021

The year 2020 is one most would like to forget, but for markets, performance was particularly strong despite the substantial COVID-19-related economic fallout. Certainly, ample liquidity in the form of massive monetary and fiscal stimulus was a key driver of performance, but near-term optimism may also be warranted. The vaccine rollout could return demand to more normal levels in 2021 and potentially beyond, given the pent-up demand on the back of still-massive amounts of liquidity sloshing through the system.

While the overall policy response has been impressive, it is the pivot to massive fiscal stimulus that is different from anything in near-term memory. Since the Global Financial Crisis (GFC), monetary easing has been the chief stimulative agent, but fiscal stimulus was notably absent—until now. The combination of large monetary and fiscal stimulus has far more potential to generate real growth than monetary easing alone, and it is being generously applied on a global scale. With vaccines slowly releasing pent up demand in 2021, conditions are ripe for worldwide reflationary growth.

Reflation expands the opportunity set across risk assets. While we have already witnessed this in a significant rotation to COVID-19 losers, value plays such as those in Europe, Japan and emerging markets also stand to benefit from broadening global demand that is further reinforced by a weaker US dollar. The risks that lie ahead may be in the fact that reflationary growth has become a consensus trade, showing froth in portions of the market. What could go wrong? Certainly, if the vaccine proves difficult to roll out or other problems emerge, these would prove clear setbacks to the reflationary outlook that is being so firmly priced.

> "The vaccine rollout could return demand to more normal levels in 2021and potentially beyond, given the pent-up demand on the back of still-massive amounts of liquidity sloshing through the system"

A more obvious and present risk is the likely rise in long-term rates that reflationary growth typically engenders. Already rates are drifting higher, and we expect this trend to continue, particularly in US Treasuries. We are cautious on duration risk, but we are also cautious on the implications for risk assets should they rise too quickly. Growth stocks, technology in particular, are vulnerable to such moves given the high valuations that typically suffer in a rising rate environment. We still like secular growth which includes technology but prefer a bar-belled approach that includes value stocks that are less sensitive to rising rates.

Key themes for 2021

The following are some of the key themes that we are currently monitoring for 2021:

- **Normalising post-COVID-19 demand**
  Demand may disappoint in the first quarter as lockdowns continue to roll through the US and Europe, but the vaccine rollout should ultimately see a gravitation to more normal patterns of demand—albeit different than the pre-pandemic apportionment and including elements of economic scarring. Accommodative policy is set to continue to support such demand. China will tighten at the margin, but higher quality stimulus is transmitting to sustainable demand that is supporting exports from around the world.

- **Weaker dollar**
  The US Federal Reserve might well have done the most in its dovish pivot back in March, and given its new policy targeting an average inflation rate, guidance suggests that policy will remain easy for at least a couple more years. Easy policy, large twin deficits and accelerating growth in the rest of the world is a favourable backdrop for dollar weakness, which is self-reinforcing as a weak US currency tends to support global demand.

- **Reflation but no inflation (yet)**
  Strong monetary and fiscal support plus improving global demand on the back of a weaker dollar supports a reflationary outlook while still-wide output gaps distance the prospects for more negative inflationary pressures. Reflation is clearly supportive of growth assets but rising long-term rates could still be a headwind to growth assets pricing at high multiples. Also, while output gaps remain supportive of few inflationary concerns, it is possible that with the significant number of bankruptcies to date, the remaining firms with fewer competitors may have pricing power of which the market is currently unaware. In addition, large quantities of liquidity do have the potential to surprise markets with pockets of demand exceeding expectations, meaning that real assets such as gold are still an important hedging asset.

- **Less geopolitical surprise**
  After four years of enduring sudden elevations of geopolitical risk, often triggered through just one tweet, policy is likely to be more predictable—at least from the US—reducing the number of sudden "risk off" scenarios that plagued markets over the last four years. Bipartisan Washington support for continued pressure on China will remain high, but fewer surprise escalations likely mean that strained US-China relations can at least move along with fewer tail risks than experienced, say, in 2018. This bodes well not only for China assets, but also emerging markets in general that benefit from stable China demand.

- **Simmering political tensions**
  The US election delivered a positive result, averting a harsh contest or civil unrest, but the US is far from returning to the pre-Trump state of "business as usual" given that tensions have yet to dissipate. US president-elect Joe Biden has promised that he will heal the country, breaking the hard division of left from right, but it is still a tall order, leaving some wondering if it is even possible. The political divide is perhaps most obvious in the US, but it is not unique—from Europe to Latin America and beyond. Biden's win suggests a return to some sense of normalcy, but the underlying pressures of political divide remain present in varying degrees worldwide.

On balance, we remain constructive on growth among the following:

1. improving global demand on the rollout of vaccines, 2. improving and sustainable China demand and 3. continued strong and coordinated stimulus. It is late cycle, particularly for the US, but less so for the rest of the world where assets look attractive against a reflationary backdrop. Certainly, rising inflation risks that force the US Federal Reserve to turn more hawkish would be a potential catalyst for the next downturn.

Asset class outlook

Equities: The outlook for equities is positive, particularly for the proposition of normalising growth on a global scale. We still like secular growth in the US and North Asia, but we see improving demand conditions in Europe, Japan and emerging markets that show better value against broader growth. Our question in Europe is, how sustainable is the rotation? Here, we applaud the pivot from 10 years of asphyxiating austerity, but we are concerned about the banking system that remains only partially "fixed" given the still-weak state of balance sheets, high regulations and flat yield curves that make revenue growth challenging. Emerging markets could be more interesting given the adjustments to date and reforms over the last 10 years. Just rewards for years of necessary pain might be on the horizon, albeit selectively, with a focus on quality.

Sovereign Bonds: At least in the developed world, sovereigns are not well-positioned for improving growth conditions given that rates are still priced near the all-time lows set in early 2020. Asset purchases will continue, but short of yield curve control à la Japan, long-term rates should rise. In a multi-asset context, the normally "protective" asset that typically

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includes developed market bonds may just be the "risk" asset of 2021 where coupons clipped can easily be wiped out by duration risk with a sudden jerk to the yield curve. China bonds may just be the best alternative defensive sovereign asset. First, yields are healthy and, second, central bank policy is largely orthodox and less prone to sudden adjustments. Yields have already risen to reflect the V-shaped China recovery. Could they rise more? Yes, but the tether grows tighter given the yield advantage over the rest of the world and the higher yield is a risk-reducing offset to rate volatility.

Credit: Global credit markets are likely to outperform government bonds in a rising yield environment. Investment grade (IG) corporate spreads are likely to remain stable and compress as demand conditions improve. The yield premium and shorter average maturity of IG markets will shelter returns compared to sovereign bonds. This should also prove to be a reasonably attractive environment for global high yield markets as duration risk will have less of a negative impact.

Commodities: The outlook is positive owing to improving demand. This includes significant fiscal stimulus relative to limited supply, especially given the lack of investment over the last decade since the commodity bubble burst amid the GFC. Commodities demand had largely depended on China. But the demand envelope might be bigger this time given the commitment by developed markets to invest in their own infrastructure.

Conclusion

We are overall bullish to risk assets and negative on long-term rates, but this is just for the year ahead. We do take pause when considering the long-term sustainability of the combined largesse of central banks and fiscal policy because excesses eventually do have consequences. Nothing comes free. Deficits and debt levels are high, and central banks are currently helping to finance them, which makes sense in a state of emergency such as a war, but we are less convinced that such programmes can be unwound—as they eventually have to be—without other unintended consequences. Still, eventual limits are often anticipated well before they come to fruition, so we watch closely to follow the contours of what might follow next.

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Global Equity Outlook

Virus news remains dark but light at end of COVID-19 tunnel

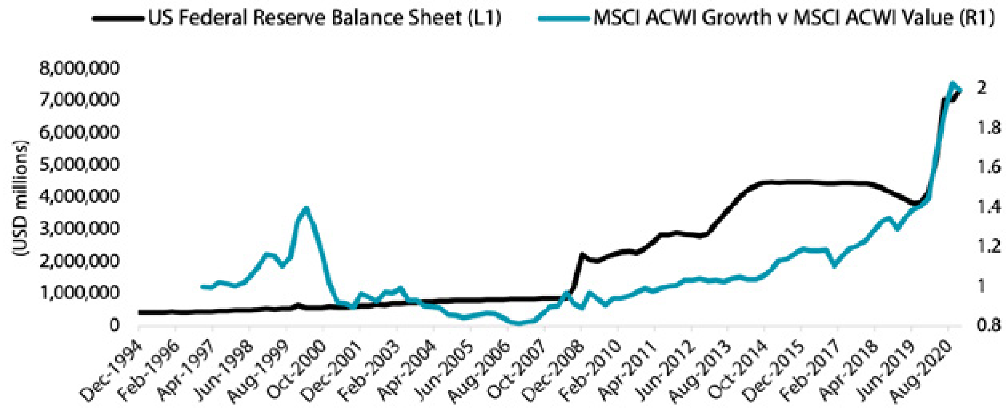
By the Global Equity Team

As the calendar turns and a new year set to begin, market commentators are once again dusting off their crystal balls. None of us, however, predicted 2020 and the inevitable hangover from 2020 makes the forecasting error associated with 2021 even higher.

Countless "Year Ahead" pieces of research routinely predict that 2021 will be the opposite of the one that just passed. In many ways, we certainly hope that this will be the case. Hopefully the various vaccines either already approved or pending approval will be as effective against any new mutations of the virus as they have been in the clinical trials carried out to date.

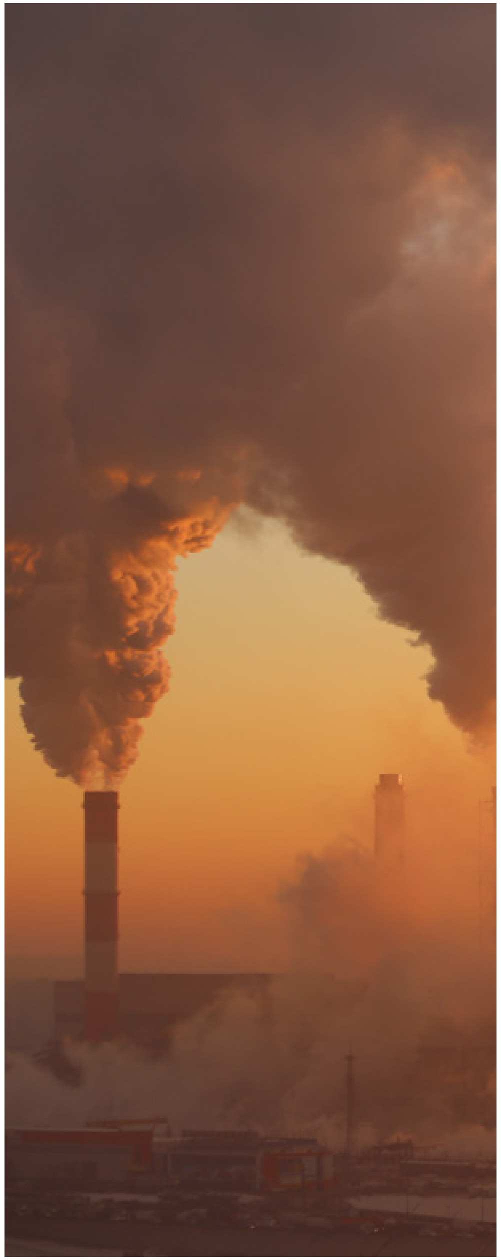
Certainly, there are grounds for optimism for the year ahead. After a year of forced abstinence, we hope that some of the experiences that we used to regard as routine will now be available for us to enjoy once again.International travel will be near the front of the queue for many of us. In a business investment sense, companies will likely feel optimistic enough to rebuild inventories that they ran down as manufacturing capacity was shuttered during lockdowns.

Once the sugar rush of returned freedom has passed, however, will things have changed much, relative to 2019? The Federal Reserve (and other central banks) are doing their bit, as ever (see chart below) but will the spurt of economic growth be strong enough to create a lasting inflationary impulse (supporting a sustainable rotation into "value" parts of the market) or will the immovable objects that are western world demographics and substantial debt burdens mean that 2022 and beyond look much like 2019? If so, investors will likely still be faced with relatively anaemic economic growth and favour those companies most able to deliver strong revenue and profit growth, borne out of sustained innovation.



Source: Bloomberg, as at 22 December 2020.

We continue to spend the vast majority of our time on company research and there are doubtless other observers better placed to predict which path that the market will go down, but it seems more likely to us that the future will look much like the pre-COVID-19 recent past. For instance, central banks have become increasingly politicised in recent years. At the same time, many national governments are more indebted than ever, having rushed through huge wage support programmes—designed to postpone a severe economic reckoning as a result of the lockdowns that they imposed. Against this backdrop, it looks unlikely that interest rates will be allowed to rise meaningfully, and this is a very real headwind for banking stocks in particular.



Our portfolio continues to own both cyclical and growth stocks, as we continue to find "Future Quality" characteristics in both camps. Recent months have seen us adding to some of those cyclicals and trimming some of our growth winners, where valuations had become extended. Most observers (including us) believe that the next few months could see a continued narrowing of the premium paid for growth stocks. Where we believe that relative valuations have moved too far, too fast, we will not be afraid to act accordingly. This could easily see us adding back to our growth stocks, but only where we believe that the business in question is continuing to improve and future cash returns on investment are likely higher as a result. In many cases, these improvements will be underpinned by products and services that help society address pressing long-term issues. Challenges such as delivering affordable healthcare or protecting our climate will demand sustained action whether growth is better than value or vice versa.

In conclusion, it is an enormous relief to all of us that the world's scientists may be about to deliver us respite from the loss and stress caused by this pandemic. For millions of people 2020 was clearly an extremely difficult year and we hope that 2021 brings better times for them. From an investment perspective, this transition from hopeless to hopeful is driving a period of reassessment. At times like this, it is easy to lose your bearings and spend all your time attempting to foresee the macroeconomic future—letting that view dictate the new investment ideas that you bring forward. This is a bit like using a telescope the wrong way round in our view. Instead, we continue to spend all our time focusing on the stock specific Future Quality attributes of the companies that we invest in for our clients.

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“Challenges such as delivering affordable healthcare or protecting our climate will demand sustained action whether growth is better than value or vice versa”

Asian Equity Outlook 2021
Crystal gazing and navel gazing

By the Asian Equities team

Tesla, Doss and Karikó

Let there be light…and there was!
In 1891, alternating current (AC) was used to light up the World's Columbian Exposition in Chicago. This was shortly followed by the installation of the first AC motor and hydroelectric plant at Niagara Falls—and the world started on its electrification journey. Then, having bulbs that light up on demand across long distances was as much as a miracle as God bringing forth light to the universe. And it was all thanks to Tesla…not the car maker that has captured the popular imagination, but the inventor Nikola Tesla who bested Thomas Edison in the battle of currents, at least. By all accounts, Tesla was brilliant, charming, and dapper; a futurist and a polyglot with eidetic memory. Edison—an introvert who worked iteratively and was involved in multiple inventions at any given time—was almost a study in contrast. Yet, Edison was the more "successful" inventor, while Tesla died in relative ignominy despite his monumental contributions. There are a couple of lessons to be learnt from their lives and their battles: patience is a virtue, as is hard work; and disruption to the status quo takes time to gain traction but once it does, it is transformative.

Fast forward roughly 50 years, and Desmond Thomas Doss became the first conscientious objector to receive the US Medal of Honor for sticking to his guns, pun intended. As a Seventh-day Adventist Christian, Doss refused to carry a weapon into battle or kill an enemy soldier, even when faced with enemy fire. The film Hacksaw Ridge brings to life in vivid technicolour Doss' story. He was wounded multiple times and had 17 pieces of shrapnel in his body at one point; yet, he refused to pick up a gun. It is hard to fathom the conviction he must have had in his beliefs. Similarly, Hungarian-born scientist Katalin Karikó persevered for more than four decades to prove the therapeutic potential of mRNA (immunogenicity of ribonucleic acid) technology despite scepticism from peers, multiple rejection of grants and the cost of career progression opportunities. Her work forms the basis for the vaccines developed by Pfizer-BioNTech and Moderna to combat COVID-19, which has infected more than 60 million people globally.

Virtually everyone knows, or knows of, someone who contracted COVID-19, and in some cases, sadly, succumbed to it. That COVID-19 has affected every aspect of life is hackneyed; thus, we will only point out that some of these impacts will likely outlast the virus. For instance, what the "office", "home", and the "third space" mean; the implication of crowd dynamics; and the increasing focus on health. One of the lesser appreciated aspects of the pandemic's long-term impact is the collective trust deficit. The "Karen" meme is one example, as is this anonymous quote:

> "When this quarantine's over, let's not tell some people"

"When this quarantine's over, let's not tell some people." To be sure, trust takes a long time to rebuild. Also, nothing drives home the ephemerality of life like death, or the fear of death; this leads one to think of legacy and one's will, both as the benefactor and the beneficiary. Perhaps, it is not coincidental that the world is suddenly rallying together to focus on the environment and sustainability.

As investors, it behoves us to spend at least as much time thinking about and practicing patience, hard work, perseverance, and taking the long view in the way we invest, as it does contemplating what China's monetary policy will be two quarters from now.

The instalment of the 2020 Annual Outlook included references to the US Federal Reserve; US President Donald Trump and the US elections; the US-China trade-war; and geopolitics affecting the price of oil. COVID-19 was conspicuously absent. In 2020, markets largely shrugged off COVID-19, with the MSCI Asia ex Japan Index up circa 21% year to date at the time of writing, bettering 2019's 18% return, although the global economy is still dealing with the aftermath of the pandemic. That we failed to predict the biggest event in 2020 and possibly the next decade is best summed up in the words of Ian E. Wilson, the former chairman of General Electric: "No amount of sophistication is going to allay the fact that all your knowledge is about the past and all your decisions are about the future." In this regard, the research papers titled "Uncertainty" and "Uncertainty II" penned by American investor and writer Howard Marks in May 2020 are recommended readings.

With that major caveat out of the way, we outline our views forthwith. Simply put, Asian countries have, by and large, handled the COVID-19 pandemic better than their western counterparts and are now emerging from that nadir. Most of these countries have plenty of fiscal and/or monetary stimulus headroom. And this superior growth and better national finances are available at a significant discount to developed markets. A languid US dollar will enhance local currency returns in these "risk assets".

Crouching Tiger, Hidden Dragon

That China is aware of the US bipartisan support for policies to straitjacket its technological progress is old news. That it is taking steps to mitigate the fallout is also not new. And given the country's track record in getting things done that really matter to it, give or take a couple of years and a few hundred billion renminbi, one wouldn't bet against it. So, the world's second largest economy will march to its own beat.
In this regard, for the first time this century, China's Five-Year Plan, its 14th, does not have an explicit economic growth target. This is as much a reflection of Chinese President Xi Jinping's consolidation of power as it is of the country's shift from "quantity to quality". The former because Xi is comfortable admitting that China's growth rate will slow structurally; the latter because there is cognizance in the corridors of power that the old model of relying on fixed asset investment to "grow" out of trouble is no longer viable. Enter the "dual circulation" strategy—at its core, China aims to remain open to the world (international circulation), while engineering a shift from infrastructure-led growth to innovation- and consumption-led growth domestically (domestic circulation).

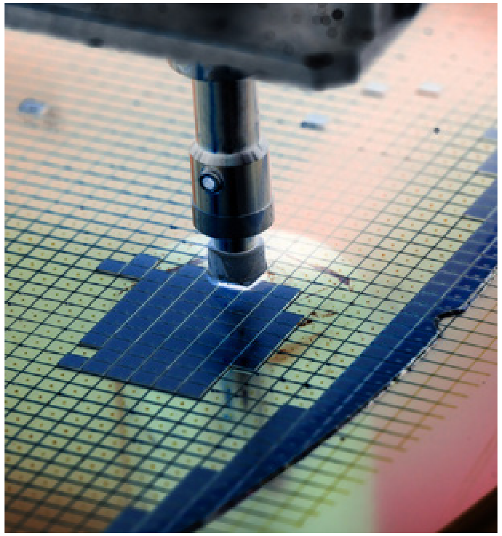
Announcements or targets in the areas of fiscal sustainability, stabilising supply chains (especially as it pertains to semiconductors), and addressing climate change via the national emissions trading scheme, will show a commitment to "walk the talk". The government's no-nonsense approach apropos corruption and abuse of power, even if the perpetrators are the giants of China's digital economy, ought to lead to a broadening and deepening of innovation.

Meanwhile, Hong Kong continues to come to terms with the reality that the "one country, two systems" is only possible if the "one country" doesn't feel threatened by the "second system". The recent arrest of activists aimed at fostering patriotism may raise hackles in the western press but will not change reality on the ground. In keeping with these views, we prefer to invest in areas of improving Chinese domestic demand, localisation and strategic industry development.

"English, August" no more?

The Indian movie (and book, before it) "English, August" is a portrayal of two different Indias—the educated, sophisticated and posh urban India; and the uneducated, inefficient, rural one—and the tensions between the two in the context of bloated government bureaucracy. But that may well be a thing of the past. Indian Prime Minister Narendra Modi's government has pushed through labour and agriculture reforms that could be transformative if executed well. Labour reforms have also relaxed onerous restrictions on lay-offs, fixed-term employment and unions, thereby boosting efficiency. The new laws significantly reduce the compliance burden, which has been a major deterrent for investments in labour-intensive sectors in much need of productivity improvements, such as agriculture. Agriculture employs some 44% of India's 450-million strong workforce but contributes only about 15% of its economic output. This sector will also benefit from the recent passage of reforms announced in May via much-needed investment in the supply chain, which makes it more efficient. We continue to focus on sub-sectors benefiting from trends such as market consolidation, formalisation, and companies that reduce the friction of doing business, namely private sector banks, digital services and logistics.

> "An enduring change accelerated by COVID-19 will be increased digitisation—of work, social media and commerce"



Beauty and the Beast

An enduring change accelerated by COVID-19 will be increased digitisation—of work, social media and commerce. And digitisation of anything relies heavily on the semiconductor industry and the technology supply chain. In this regard, South Korea and Taiwan remain well positioned, notwithstanding the rising tensions between China and the US. However, geopolitics will be a major driver of volatility. Trump's "America First" stance has already forced these US allies to take stock of their relations with China, the largest economy in Asia and one that is still growing faster than most economies anywhere. China's state media has dedicated appreciable newsprint to China's repeated incursions into Taiwanese airspace over the last month. These moves are tantamount to a warning by Beijing to both Taipei and Washington not to change status quo vis-à-vis the "One China" policy. On the other hand, President Xi's planned visit to South Korea reflects a warming of relations between those two nations, though there is no predicting how, and how quickly, that can change. Thus, we like esoteric sectors such as clean technology, content and industrial automation.

The Gods Must Be Crazy

There's a never a dull day in ASEAN. If it isn't the constant musical chairs of politics in Malaysia or the changes of government in Thailand (or threats thereof), it is the wild gyrations in the Indonesian rupiah or the Thai baht. In other developments, Indonesian President Joko Widodo passed the contentious Omnibus reforms, paving the way for greater foreign direct investment. Also in Indonesia, COVID-19 has catalysed a massive acceleration in digitisation. And Indonesia and Vietnam, in particular, are benefiting from the redesign of supply chains currently heavily reliant on China. Malaysia remains uninteresting except in niche segments. Thailand's lacklustre economy needs a sizeable fiscal impulse, one that is unlikely given ongoing political developments. Singapore's stock market remains a proxy for the region, albeit with a better governance framework. Besides continued capital inflows from Hong Kong, there is little fundamentally that excites us here. The Philippines is showing early signs of a cyclical recovery, and we are content to stay watchful for now.

The year 2020 has been an unforgettable one, the first half unpleasantly so. But as we look to 2021, it is worth noting the words of the wise Greek philosopher Socrates that "the secret of change is to focus all of your energy, not on fighting the old, but on building the new"

Best wishes for 2021, and happy investing!.

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China Equity Outlook
Optimistic prospects

By Eng Teck Tan, Senior Portfolio Manager

A review of 2020

To say that 2020 was an eventful year for China would be an understatement. Having endured an onslaught of political sanctions from the US through 2019 and beyond, China was hit early in the year by the COVID-19 outbreak. This initially seemed similar to the 2003 SARS pandemic, but turned out to be much more severe. Seemingly in denial at the beginning, China's government finally acknowledged the outbreak and rallied the nation to contain the virus. China's lockdown was far more draconian than measures imposed by most other governments, but it allowed the country to contain the virus far more effectively than the rest of the world. By the middle of the year, China appeared to have completely bounced back from the pandemic with its economy in recovery, and it could be the only major economy to register positive growth in 2020.

Despite the pandemic, markets in China were resilient and we believe that they will continue to reach new highs in 2021. Structural factors that drove the Chinese markets in 2019 and 2020 remain intact and strong leadership enabled the Chinese markets to be among the best performing (if not the best performing) markets in the world. In addition to the structural factors that we have highlighted repeatedly over the past few years, such as import substitution trends, high value-added manufacturing and deep penetration and consumption of e-commerce, new structural factors have started to emerge that stoke our optimism towards the Chinese markets.

Outlook for 2021: New structural factors

New structural factors that have emerged from the pandemic include intensifying nationalism and patriotism in China. These trends were already emerging in 2018 when China was perceived to have been bullied by the Trump administration. But the pandemic took the nationalistic and patriotic fervour to another level, as the Chinese were impressed to see their economy recovering far faster relative to other major economies, with Western nations, long revered in China, struggling to contain the pandemic.

This has led to pride in everything Chinese. Belief is growing that China's products and brands are no longer inferior to those of other major developed economies, with only a few exceptions. Chinese brands are gaining significant market share in literally all market segments. We believe that this trend has significant momentum and Chinese brands, which had dominated only the domestic markets in decades past, will gain a higher profile in international markets. This trend is no longer just being enjoyed by visible consumer brands but is also extending to industrial goods, traditionally dominated by north Asian, European and US brands. These industrial sectors are still trading at a significant discount to the market and have long-term appreciation potential.

China's manufacturing prowess

In our outlook for 2020, we repeatedly emphasised that China's manufacturing prowess deserves more attention despite the obsession with its transformation from an export-oriented to a consumer-based economy. China's manufacturing muscle did indeed shine through the pandemic and is seen as major contributing factor to the country's solid performance in 2020. Such strength was in display when manufacturers across the country rallied under the government's guidance and went into full production of personal protective equipment (PPE) needed to fight the pandemic. The manufacturers' ability to flexibly adjust their production apparatus to meet immediate demand contributed significantly to China's recovery. The manufacturing sector subsequently made a significant contribution to a surge in exports, as China became the default source of much-need goods for the rest of the world stuck in lockdowns. The manufacturing sector has been penalised strongly in the last decade as investors took the view that China's exports have peaked, but we believe that it is will come back strongly in 2021.

Five-year plan

One of the reasons that China emerged stronger from the pandemic is that the government can mobilise the nation into concerted action. At least within China (international reaction to China's handling of the pandemic has been mixed), the markets were impressed with the country's ability to absorb extreme pain and bounce back strongly.

Domestically, confidence in the government has never been stronger. It is almost impossible not to scour through the government's much quoted "dual circulation" initiative and the 14th five-year plan when trying to determine the direction of the stock market. Dual circulation could be President Xi Jinping's most talked about initiative since the Belt and Road and it could have huge implications for the Chinese economy and equity market. The initiative revolves around developing China's giant-scale consumer demand and potential domestic demand to sustain economic growth while drawing in foreign investment and trade in order to integrate the country into the international economy.

The first pillar of the dual circulation strategy has been reflected in the markets with consumer stocks trading at premium valuations. These stocks will likely remain elevated well into the next decade as the government explores more regulations to encourage consumption. Within the second pillar, we think the most important aspect with investment implications is the plan to open up the capital markets further. This would be a significant development as foreign access to Chinese capital and financial markets could open up opportunities in areas such as wealth management, pension investing, insurance investing and even in simple traditional banking products. In the longer run, this could also mean full internationalisation of China's capital markets, although the chances of that happening in the short term appear limited.

The 14th five-year plan, which established goals well into 2035, also provides good insight into the government's thinking. Two objectives that could have significant implications for the markets are anti-monopoly practices and specific renewable energy targets. Since 2018, we have repeatedly discussed the weaponisation of corporates in China—describing a situation in which the government is more lenient with private sector regulations as they need the private sector investments to tackle US sanctions. Between 2013 and 2017, during a period of very strong markets and growth in China, the government had taken a tougher stance towards the corporate sector. That changed between 2018 and 2020 as the government became locked in a trade conflict with the US and needed the private sector to be on its side. Some cracks have appeared in this cosy relationship, although we believe that a return to the 2016–2017 period is unlikely. The anti-monopoly law is the first sign that the government is uncomfortable about giving too much authority and autonomy to the private sector, but we are hopeful that the government will be selective and that the private sector can still thrive.

The renewable energy targets set by China are far more interesting than many of the rehashed goals we have seen in previous five-year plans. The targets for renewables could have far-reaching implications, potentially creating a gigantic renewable industry encompassing electric vehicles (EV); EV components and automation; solar manufacturing and utilities; offshore and onshore wind sectors; and ESG investing

Remaining challenges

China is not without its challenges though. Chief among them is the continued sanctions and restrictions that the US is placing on China's government and its corporations. The outgoing Trump administration will no longer be a threat. However, it could be difficult for Joe Biden, the next US president, to reverse the extensive executive orders signed by Donald Trump in the last few months of his presidency, as doing so could make Biden appear too pro-China. Restrictions on technology imports, removal of Chinese companies from indices, delisting of Chinese corporations from US stock markets and sanctions on individuals are some the prominent measures imposed by the US.

We, however, take a more optimistic view of these restrictions and sanctions. We believe these measures will only prompt Chinese corporations and the government to be more self-sustaining and independent of the US economy. We are also comforted by the fact that increasingly China is becoming a more important investment destination, having enjoyed record inflows from foreign investors in 2020. We believe this trend will continue despite passive outflows due to the removal of corporations from indices and a delay by MSCI to further increase its weighting of China's markets. China has handled everything that the US has thrown at

them. For example, more Chinese companies are returning home to list in Hong Kong and Shanghai; Beijing has placed reciprocal (but in comparison relatively mild) sanctions on certain US corporations and individuals; and it has penetrated new markets in Asia, aggressively finding an alternative supply chain source. We believe that China will emerge stronger in the coming years and that its relative dependence on the US economy will diminish over time.

Two other risks (or challenges) worth highlighting in China are the credit defaults that have gained media attention and geopolitical risks arising from tensions with Taiwan and India (the list could also include Vietnam, North Korea and South Korea; Hong Kong is also a potential flashpoint).

We see some positive aspects regarding credit defaults. Investors are now more aware of the risks and will no longer blindly invest in government-linked companies. The government has spent more than four years educating investors that government-linked companies are not eligible for implicit guarantees and the message finally appears to be getting across. Looking through the numbers, the defaults and refinancing needs still seem relatively manageable relative to the size of the capital market. In our view, the Chinese government is capable maintaining control.

Geopolitical developments are much more unpredictable. Our base case is that many of the regional frictions involving China have been limited to posturing, as Beijing would not want to willingly trade its prosperity for conflict. China's regional relations, however, need to be observed vigilantly as geopolitical risks can flare up with little warning. ●

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Summary

We are optimistic in our outlook for China's economy and equity markets. However, the last several years have shown that alpha can only be generated through active investing as index biases towards China's financials, cyclicals and the internet sector mean that market performance will be uneven.

China's internet sector, dominated by Tencent and Alibaba, might face challenges going into 2021. Financials still have their challenges while cyclicals remain mired in low returns. As we highlighted earlier, we have much to be positive about sectors related to renewables, semiconductors, the cloud, artificial intelligence, big data, EVs, automation and consumers.

On the economic front, China still has significant structural drivers such as urbanisation, HuKou reforms, domestic demand generation from pension reforms, saving-spending balance strategy, higher value-added manufacturing and import substitution trends. China could potentially enter a blue-sky scenario in 2021 as the low base in the first half of 2020 will make comparison easier while momentum could be prolonged into the second half of 2021 as COVID-19 vaccines may help international economies recover. We are optimistic on China in 2021.

Japan Equity Outlook
Five themes for the post-COVID 19 era

By the Japan Equity Team

We believe 2021 will be remembered as a year that marked the beginning of the end of the COVID-19 crisis as the world develops vaccines to counter the pandemic. In Japan, we expect a gradual recovery of its economy in 2021, as the pandemic's impact lessens, and economic activity normalises.

Introduction

Looking ahead into 2021, we identify five key themes in the post-COVID-19 era that we expect will positively impact companies in the Japanese market: a robust Chinese economy, deregulation, the Japanese government's bid to decarbonise, corporate governance reform and a reactivation of the pre-pandemic themes that will gain traction, such as digitalisation and addressing the country's aging social infrastructure.

China's economic recovery and Japan

The Chinese economy has been a step ahead of its pandemic-stricken peers, showing a swift recovery from the negative effects of COVID-19. We assess Japanese corporate sectors that could benefit from a robust China.

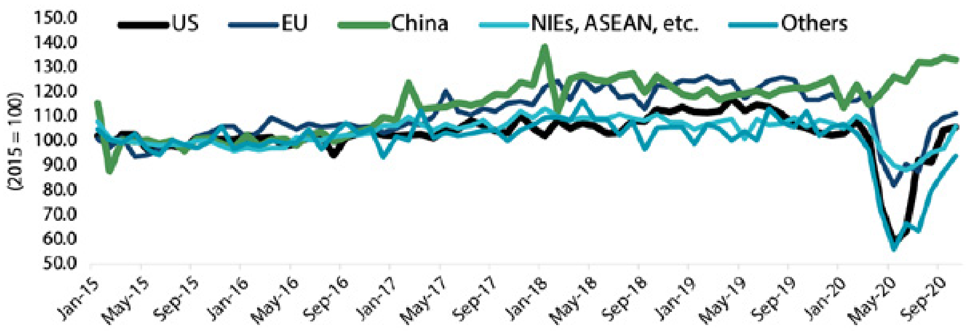
China: Japan's second largest trading partner

China is Japan's second largest trading partner, accounting for about 20% of the country's exports. Japan's exports to the US, its largest trading partner, have been unstable during the pandemic. But its exports to China have been quite resilient due to China's quick economic recovery from the COVID-19 crisis (Chart 1).

Demand for Japan's machine tools provides an example of the role a strong Chinese economy is playing. According to Japan Machine Tools Builders' Association (JMTBA), industry wide orders rose 8% year-on-year (YoY) in November 2020, marking positive YoY growth for the first time in 26 months. The growth in November was led by foreign demand (+22.5% YoY), which helped offset sluggish domestic demand (-15.2% YoY) (Chart 2). Strong foreign demand stemmed from orders that originated in China, including its infrastructure and semiconductor related sectors.

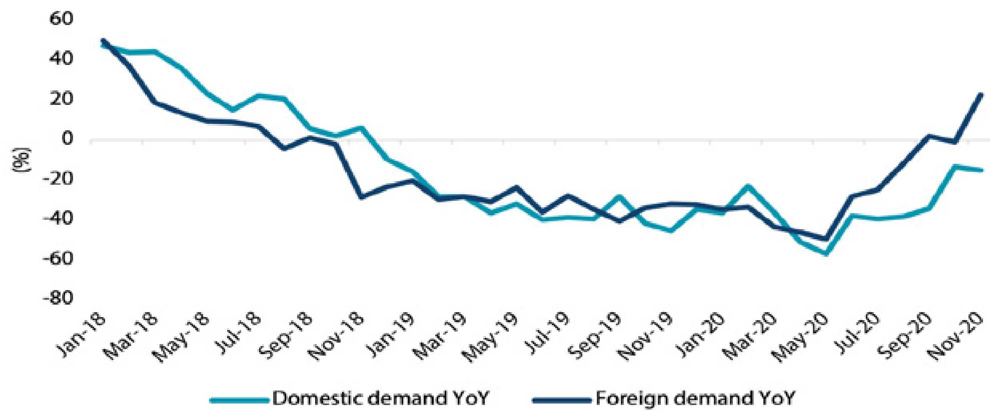
Also, it is worth noting that according to its forecast release in December 2020, the China Passenger Car Association (CPCA) expects the country's new car sales in 2021 to surpass sales in 2020. If realised, that would be the first growth in four years and mark a 4% increase compared to sales expected in 2020. The CPCA expects the sales of new cars to

Chart 1: Japan's exports by destination



Source: BOJ data compiled by Nikko AM

Chart 2: Japan machine tool orders



Source: JMTBA data compiled by Nikko AM.

increase thanks to the Chinese government's policies geared toward supporting the domestic economy.

Furthermore, China, South Korea and Japan have eased business travel restrictions between themselves ahead of other trading partners, and the measure is expected to provide a boost for businesses spanning Japan and China. Japan is also better positioned to benefit from China's growth in demand as the relationship between Washington and Beijing, which deteriorated considerably under the Trump administration, is likely to remain tense despite a change in US presidents.

Deregulation under PM Suga

PM expected to focus on populist policies
Japanese Prime Minister Yoshihide Suga, who took office in September 2020, is expected to solidify his position in 2021 in order to establish the basis for a long-term administration. Suga faces several challenges in 2021, the foremost being the pandemic, which is likely to remain the administration's top agenda item at least through the first half of the year. Suga also has a daunting political calendar to contend with in 2021: the ruling Liberal Democratic Party's presidential election in September, which he needs to win to remain premier, and a Lower House election in October, when the four-year term for the house expires.

As such, Suga is expected to focus on populist policies in 2021 to shore up his public approval rating. Some of these policies are expected to include expanding medical insurance coverage on fertility treatments, pressuring telecom companies to lower mobile phone fees and requiring the elderly to pay a larger share of healthcare costs.

Digital technology an important deregulation target
Another deregulation target for the Suga administration is digital technology, where regulations are seen to have hampered progress. Japan's public sectors have been slow to invest in digitalisation and this is a deepening concern. According to the United Nations' e-government rankings released in July, Japan was placed 14th in 2020, dropping from 10th in 2018. Japan received high marks for its telecommunications infrastructure and human capital but was rated low in areas such as online services.

The pandemic exposed how the digitalisation of Japan's public sector had fallen behind. When the government decided to provide citizens with cash handouts earlier in 2020 to cope with lockdowns, most municipalities could only process requests by paperwork, and in some cases the recipients had to wait a month to receive their handouts.

The government took the situation seriously and intends to boost the digitalisation of the public sector. Prime Minister Suga made "digital transformation" (DX) of government administration one of his key policy pillars when he took office in September. The initiative will focus on digitalising the "My number" personal identification cards and creating a unified digital administrative system for the government and municipalities. Suga plans to set up a digital agency in 2021 and its establishment will help streamline administrative procedures pertaining to DX. Suga aims to complete the digitalisation by 2025, and investments into related systems are expected to begin in earnest in 2021.

In the private sector, in an effort to lay the groundwork to attract investments, the government in December 2020 announced reform proposals for DX-related taxes; firms that invest in cloud-based systems that transfer of data between departments and companies will be allowed to take as much as 5% of the capital spending as tax credit. We believe that such a tax proposal, if enacted, will benefit a significant number of IT service-related companies.

Key Japan-related events in 2021

March	Integration of health insurance cards and "My number" cards
Spring	Revision of the Corporate Governance Code
Spring	Japan Fair Trade Commission publishes results of mobile phone market survey
July	Tokyo hosts summer Olympics, Paralympics
September	LDP presidential election
September	Government launches digital agengy
October	End of four - year Lower House term
November	UK hosts 2021 UN climate summit (COP26)

Reducing carbon emissions

Japan aims to rectify its unenviable carbon emissions record and 2021 could be a key year as it gears up to become carbon neutral by 2050. To achieve its goal, boosting hydrogen usage and production is among the steps it will take. The government is considering steps to encourage investments into decarbonisation-related initiatives through tax breaks, according to the draft outline of fiscal 2021 tax reforms. The government would allow a tax deduction of up to 10% of capital expenditures into the manufacture of products that lead to decarbonisation, such as next generation lithium ion batteries.

Against such a background, we expect hydrogen to become an important agent of change. Hydrogen usage offers an effective path towards decarbonisation. The Japanese government sharply raised its 2030 hydrogen usage target to 10 million tons from the initial goal of 300,000 tons. The ambitious goal reflects the government's desire to create a hydrogen society by encouraging technological breakthroughs in hydrogen production and by triggering a change in the demand side. We believe that such a push will benefit a wide range of industries; for example, renewable energy sectors that generate the electricity necessary for hydrogen production, infrastructure sectors linked to the production and distribution of hydrogen and manufacturers of hydrogen fuel cells.

How the government's push towards decarbonisation and the adoption of hydrogen plays out deserves close attention as Japan is home to a number of globally competitive companies with strengths in various hydrogen-related technologies. Toyota, for example, recently unveiled the second generation of its Mirai hydrogen fuel cell-powered vehicle. The second generation Mirai boasts a much longer range thanks to a redesigned hydrogen tank. Toyota also greatly improved its production capacity for the new Mirai, in a commitment to hydrogen mobility. Toyota is just one example among many Japanese companies that possess strong fuel cell battery technology in the mobility arena, and we believe they will have an extensive role to play as Japan decarbonises.

Japan's proximity to China could also play an important role in its bid to decarbonise and adopt hydrogen. China made a pledge to become carbon neutral by 2060, and the adoption of renewable energy and hydrogen could be an option the regional powerhouse could choose in order to decarbonise.

Japan's governance reform

For Japan, where reforms took a back seat in 2020 due to the pandemic, 2021 could market the beginning of "Governance 2.0". We believe that there will be two main governance-related topics in 2021: the upcoming revision to the Corporate Governance Code and the realignment of the stock markets.

Japan's Corporate Governance code to be revised again

The Corporate Governance (CG) code, first introduced in 2015, is expected to be revised for the second time in the spring of 2021. As of December 2020, the framework of the revamped guidelines has gradually become visible. Regarding the revisions, the media have focused on areas such as diversification of management and increasing the number of independent outside directors. While these are important aspects to consider, our focus rests on the fact that a groundwork is being laid towards corporate governance reform shifting from the "formality" phase to an actual "substance" phase; this brings the CG code revisions closer to their intended purpose of improving Japanese corporate profitability, which leads to higher shareholder value.

Under such a shift from formality to substance, the "practical guidelines" released by Japan's Ministry of Economy, Trade and Industry (METI) intended to reinforce the CG code deserves special attention. The guidelines have included an outline of effective group governance (June 2019) and best practice guides to business portfolio management (July 2020), and we hope that these guidelines spark lively debates between investors and corporations, providing the latter with an opportunity to reassess the role they are required to play.

Indeed, we are seeing an increasing number of "parent-child dual listing" arrangements being dissolved; recent high-profile examples include NTT's buyout of its mobile unit NTT Docomo, Sony's takeover of listed subsidiary Sony Financial Holdings and Mitsubishi Chemical Holdings taking full control of Mitsubishi Tanabe Pharma. The parent-child dual listings are unique to Japan and have come under increasing criticism as such arrangements are seen to undermine minority interests amid the ongoing CG reform. The parent-child dual listings are also part of the issues that CG reform intends to address through effective group governance and business portfolio management mentioned above.

We hope that the CG code revision fosters debates by corporations, both within themselves and with investors, and leads to actions that increases shareholder value.

Realignment of the stock markets

Along with the CG code revision, the planned realignment of Japan's stock markets is another important governance-related topic to consider.

Japan's Financial Services Agency revealed an outline of the realignment initiative in December 2019, and the Tokyo Stock Exchange has been leading plans to revamp its market segments and the TOPIX index, with the change expected to come into effect in April 2022.

Plans to realign the market segments have taken shape, with a framework revealed in February 2020 and a systematic outline of the new market framework expected to be released later. Under the proposed realignment the five current market segments—first section, second section, Mothers, JASDAQ growth and JASDAQ standard—will be reshuffled into "prime", "standard" and "growth". Companies in the prime section, which will replace the current first section, will be required to have a tradable market capitalisation of at least JPY 10 billion.

A clear definition of "tradable number of shares" is yet to be revealed; furthermore, companies that do not meet the market capitalisation requirement are expected to be granted a certain grace period. It is therefore difficult to assess what impact the realigning of the market segments could have. Still, companies, particularly SMEs, could make business decisions intended to boost their market capitalisation (and therefore shareholder value) and increase their tradable shares.

Currently, the TOPIX index consists of companies listed on the first section. But after the realignment this will no longer be the case. According to the guidelines released in February 2020, a limit will be set on the number of companies that will be eligible for selection on the TOPIX index and that these will be reshuffled regularly. Further information regarding the TOPIX index revision has been limited since. While we wait for new information, our hopes are that the new TOPIX index improves in quality both as an investment vehicle and a benchmark, and that the revision serves as an incentive for companies to improve their shareholder value.

Summary: Back to basics

For Japan, long stuck with an aging and decreasing population, 2021 could be a year to go back to the basics and improve its productivity. When the pandemic eventually ends, the market will not only be shifting its focus to post-COVID-19 opportunities but will also turn its attention back to the challenges Japan faced before the pandemic.

The pandemic served to divert attention from Japan's long-standing challenges in certain cases, but the fact remains that the country faces a myriad of issues to deal with. In fact, the coronavirus crisis may have sharpened the focus on the challenges Japan faces, and as the economy normalises and the public becomes accustomed to COVID-19, demand for these issues to be addressed is likely to increase again.

The most pressing issue, in our view, is reinforcing Japan's IT infrastructure. In a "DX report" published in September 2018, METI warned that aging Japanese IT systems could tumble off a "digital cliff" in 2025. Efforts to modernise Japan's IT systems stalled in 2020 due to the pandemic but are expected to pick up again in 2021. The pandemic increased focus on shifts to clouds and DX investments and the trend is likely to provide an incentive to bring IT systems up to date.

In addition to digitalisation, Japan is faced with several other issues, such as aging social infrastructure, the need for automation to counter labour shortages and integrating information and communications technology into education. The pandemic may have temporarily diverted attention from these issues. But these challenges only deepened during the pandemic, and we believe that they will return to the forefront in 2021. ●

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Singapore Equity Outlook
Reviving returns in the post-COVID-19 economy

By Kenneth Tang, Senior Portfolio Manager, Asian Equities

Key takeout

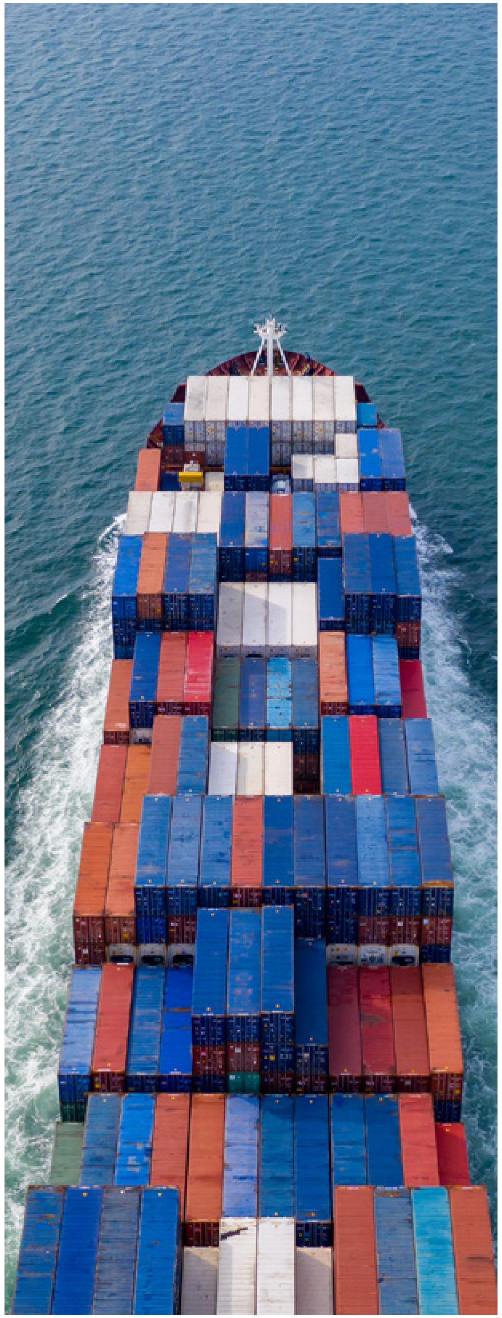
- The year 2020 was a challenge for Singapore. Its economy suffered a decline and its equity market returns were negative. But we believe that prospects for 2021 are better, with the economy poised for a recovery led by a global manufacturing-driven upturn in exports.
- In our view, 2020 was about resilience and 2021 will be about reviving returns. Much as value and cyclicals look attractive, regaining performance versus growth and quality, we believe the key to alpha is still sustainability in returns and positive fundamental change.
- The Singapore economy is on the mend. The strong recovery in exports points to positive returns, driven by a turnaround in earnings.
- We believe that the restructuring of Singapore will continue in 2021, as the country evolves as a technology, financial and investment hub and transforms its economic growth model towards innovation. We believe that the COVID-19 pandemic has accelerated innovation and created competitive advantages and opportunities for Singapore Inc.
- We look for relative growth winners in 2021, focusing on the dual theme of resilience and recovery. We are upbeat on companies which have exhibited resilience in sustainable growth and anticipate positive change in the recovery in global industrial growth and the re-opening of the economy.
- We favour industrials and technology in 2021 and are less optimistic on consumer staples. We are also selectively more upbeat on financials. We are cautious on telecommunications and property and have stronger convictions in other sectors.
- We remain positive on dividend investing. The yield spread for dividends against bond yields has improved favourably. With yields and interest rates likely to remain low, dividend yields are attractive and dividend stocks offer compelling value, in our view.

A review of 2020 and the road ahead in 2021

Singapore equity returns were among the weakest in Asia in 2020, returning -8.05%, as measured by Straits Times Index on a total return basis (STI Total Return) as of the end of December 2020. The negative economic impact arising from the pandemic—given the country's open economy coupled with the high market representation in value and disrupted sectors such as banking, property, consumer discretionary and industrials—led to its underperformance within Asia.

Following the negative performance of 2020, we believe 2021 could see better returns and a recovery. The sharp rally of 16% (STI Total Return) in November 2020, following Joe Biden's US presidential election win and positive news regarding COVID-19 vaccine developments, helped boost the market. We believe equity returns will remain supported by the re-opening of the Singapore economy and expect an improved market performance in 2021. With the backdrop of fewer global trade conflicts, accelerating exports, accommodative policy, higher return on equity and low foreign ownership, we expect the outlook for 2021 earnings to improve and that should support better market returns.

Recently, a commonly accepted approach appears to have formed: buy the laggards of 2020 and rotate into value and cyclicals, as vaccine news accelerates the rebound. While we do not disagree with such an approach, we would caution against a blanket shift in style. Instead, we continue to advocate a bottom-up strategy, focusing on picking companies with sustainable returns and positive change. These companies—those with strong competitive advantages in a new post-COVID-19 world that can sustain above market returns and have positive cyclical and restructuring catalysts in driving fundamental change—will offer the most potential for alpha in 2021, in our view. Much as performance in 2020 was about picking defensive growth, quality and resilience, we believe that 2021 will be about finding the best growth opportunities in reviving returns and embracing growth through innovation in a post-pandemic environment.



Economic rebound on track, supported by exports and fiscal policy

We believe that the recovery in the Singapore economy in 2021 will be driven by a combination of economic stimulus measures, regional improvement in trade and exports, and the normalisation of consumption and investment conditions arising from the prospects of vaccine delivery and easing of social restrictions.

The manufacturing sector has been the bright spot, with the recent third quarter (3Q) 2020 GDP surprising on the upside with a 5.8% year-on-year (YoY) decline, compared to advanced estimates of -7.0% YoY. The subsectors leading the recovery were bio-medical and electronics production, both which helped to offset weakness in the COVID-19-impacted service and construction segments.

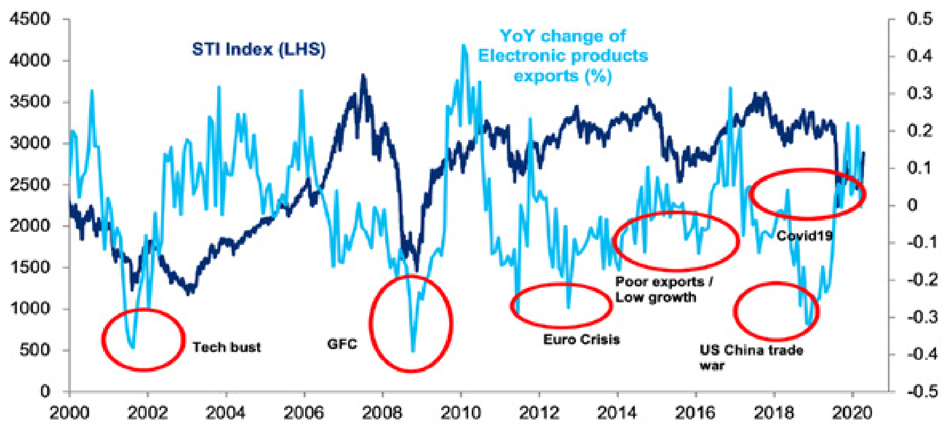
We expect the export-led manufacturing recovery to be sustainable into the first half (1H) of 2021 and that this will help broaden the economic recovery in 2021. The current revival in China's industrial and manufacturing production bodes positively for regional Asian exports, including those of Singapore. We believe Singapore exports are well placed due to the country's open economy, which will benefit from the external lift in global demand and supply chain diversification.

Growth in 2021 will also be supported by government fiscal support, which was a critical driver in buffering the declines in the domestic economy in 2020. Looking forward to 2021, fiscal support is likely to be extended on a targeted basis to sectors such as aviation, tourism and healthcare to ensure a transition back to economic normalisation.

Exports to provide a tailwind for earnings and market returns

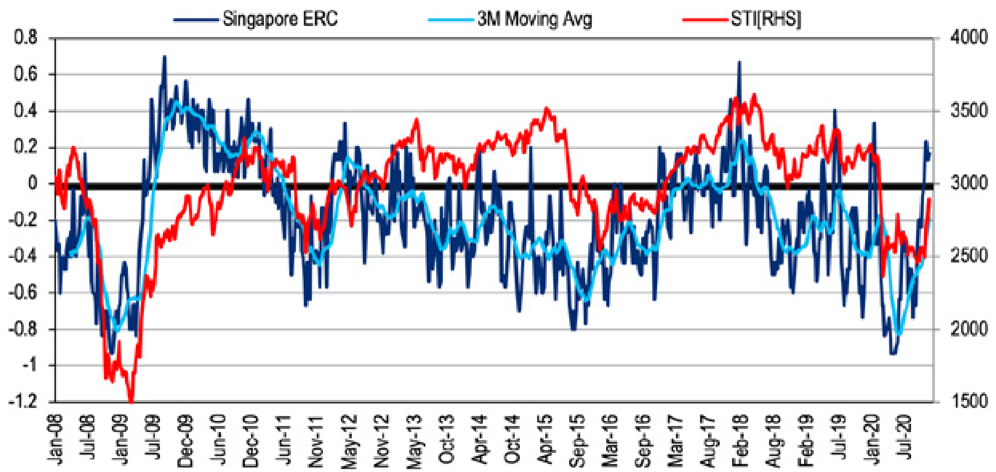
With strong export momentum in Singapore, there should be tailwinds for market returns and corporate earnings growth, based on historical trends. The previous pick-up in exports in Singapore in 2016 came amid a global industrial production recovery, which provided a strong catalyst for the equity market in 2016 and 2017 (see Chart 1). With a similar backdrop of strong export performance in 2020, the recovery in trade in 2020 and 2021 could provide strong tailwinds for equities in 2021.

Chart 1: STI performance relative to a change in exports



Source: Citi Research, Datastream

Chart 2: Singapore's earnings revision count (ERC)



Source: Citi Research, Datastream COVID-19 a catalyst for restructuring and recalibration

Corporate earnings in Singapore have fallen steeply, declining nearly 40% in 2020, accompanied by sharp negative revisions since the beginning of the year. These declines would have been sharper if not for the government support scheme. Earnings revisions, however, have started to bottom in 2Q2020, subsequently turning positive in November. We believe that the positive revision cycle in earnings, if sustained, will continue to drive equity market returns in 2021.

We believe that the restructuring of Singapore will continue as innovation transforms its economic growth model, strengthening its status as a technology, financial and trading hub. The pandemic has been a catalyst for change and an accelerator of innovation and transformation. Strong proactive government fiscal support for businesses to defray costs and the government's tight control in managing COVID-19 cases have also helped position Singapore well in the crisis. We believe the transformation of its economy will continue in 2021, and that the country is well positioned to emerge stronger and more resilient from the pandemic.

We believe Singapore corporates are also restructuring their costs and recalibrating their business models towards new growth opportunities, which should allow them to emerge stronger from the pandemic. We look for relative growth winners, focusing on the dual theme of resilience and recovery. We are upbeat on companies which have demonstrated resilience in sustaining growth during the crisis and for which we anticipate growth in the current revival of global industrial production and the re-opening of the Singapore economy.

Leading candidates in the recovery in supply chain

Singapore, as a small city state, has thrived on its success as a financial and trading hub, capturing investment flows on continued globalisation. Trade wars and deglobalisation are recent challenges that it has faced. We see evidence that Singapore has been swift in adapting to these challenges; for example, it has reconfigured its supply chains and embraced new opportunities resulting from the crisis.

We identify key economic sectors which are primed to emerge stronger as we move into a post-pandemic economy. Cross border flows are key areas of strength in Singapore's service and economic eco-system, and we see financial, manufacturing, logistics, consumer healthcare and food technology supply chains as growth opportunities when investing for transformation and positive change. The diversification of supply chains within Asia will also likely reinforce Singapore's recovery in 2021.

We highlight a few Singapore companies which have been recalibrating amid the pandemic. Companies such as in-flight caterer and gateway services provider SATS[1]; technology services, products and solutions provider Venture Corporation[1]; and Singapore conglomerate Keppel Corporation[1] are examples of corporate names that are embracing new opportunities, even as they recalibrate their growth priorities in the new post-COVID-19 environment.

SATS is fast reconfiguring its business towards growth opportunities in non-aviation food, particularly in food services, fast casual food and retail. While waiting for the aviation industry to recover, it is also expected to take advantage of opportunities in the supply chain, particularly in its airfreight capability to facilitate the handling of e-commerce and pharmaceutical products.

Keppel Corp is fast pivoting towards renewables and evolving as a sustainable developer of infrastructure and property assets. In recent months, the company has conducted a transformation plan and strategic review to consider new growth footprints in the offshore and marine, logistics and infrastructure arena.
Meanwhile, Venture Corp continues to evolve towards an advanced manufacturing and medical technology company with a growing footprint in healthcare and life science. We believe the pandemic has also positioned the company to develop its medical diagnostic capability in new revenue areas, such as test kits, point of care diagnostic tools and vaccine research equipment.

[1]Reference to any particular securities or sectors is purely for illustrative purposes only and does not constitute a recommendation to buy, sell or hold any securities or to be relied upon as financial advice in any way.

Singapore market outlook and strategy

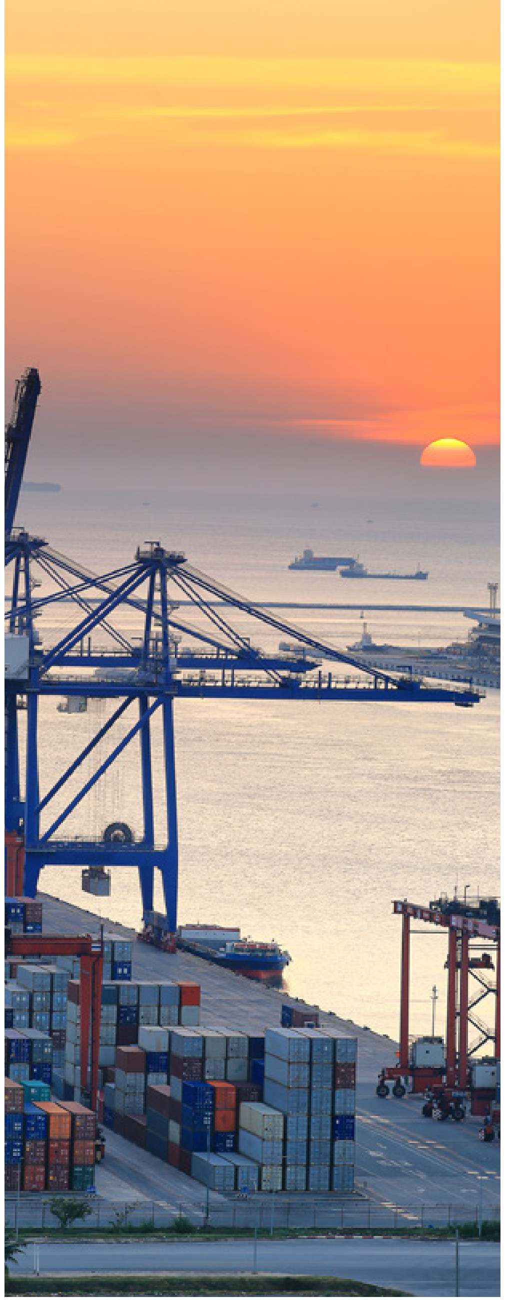
We expect Singapore's GDP to recover in 2021, with growth nearing 6% for the year, driven by a rebound in global industrial production and a revival of domestic activity, as the economy reopens and the impact of the COVID-19 pandemic starts to ease. Thanks to the positive COVID-19 vaccine news, we have seen a sharp rebound in consensus earnings since November, with steep downward revisions made early in 2020 being reversed. We expect corporates to continue making positive earnings revisions into 2021 on the back of greater optimism around COVID-19 vaccines and an export-driven recovery in GDP.

Following the sharp equity rally in November 2020, Singapore stocks no longer trade at crisis valuations, but they have not fully discounted the recovery in 2021, in our opinion.

We consider the market to be reasonably attractive on a 2021 price-to-earnings multiple of 14 times, versus its historical average of 13 times, with the potential for earnings upgrades in 2021. On a price-to-book multiple, market valuations are also undemanding at 1.1 times, which is close to the lows during the 2008 Global Financial Crisis (GFC) of 1.0 times and 1998 Asian Financial Crisis of 0.8 times. Finally, from a dividend yield perspective, the Singapore market is also moderately attractive with a prospective dividend yield in excess of 4%.
1Reference to any particular securities or sectors is purely for illustrative purposes only and does not constitute a recommendation to buy, sell or hold any securities or to be relied upon as financial advice in any way.

In terms of equity convictions, we believe returns in 2021 will be anchored by companies and sectors that can maintain resilience in growth and are well placed for a recovery in returns as the economy recovers. We remain positive on companies that rank strongly on sustainable returns, actively pursue innovation and are key beneficiaries of the Singapore restructuring story. We also like well-placed companies that benefit from cyclical tailwinds and a recovery in exports from the resumption of trade.

We favour industrials and technology most in 2021. In general, we favour stocks that are well positioned to ride the global industrial cyclical tailwinds and those that benefit from a recovery by exports within the technology supply chain. We see the potential for positive earnings surprises for both sectors as the Singapore economy recovers. We also believe they offer strong growth propositions to restore and exceed pre-pandemic 2019 earnings. We moderate our optimistic view on consumer staples, which now look less attractive. We are also selectively more upbeat on financials in 2021, as we believe the worst of the credit provision cycle is behind us. We have a cautious view of telecommunications due to the sector's less attractive growth



outlook. We also remain cautious on property, given the potential declines in property prices as well as rentals, as companies grapple with higher vacancies and defaults which arise from the failures of small- and medium-sized companies and unemployment.

Positive on dividend investing in 2021

For dividend strategies, 2020 was a good year. In particular, the strategy that focuses on resilient business franchises, which maintained dividend growth amid a backdrop of falling earnings and dividend cuts, performed well. Overall equity market returns in 2020 were negative, but dividend stocks with resilient growth prospects and defensible earnings/dividends both outperformed and delivered absolute returns.

We believe the environment in 2021 will remain supportive for dividend investing. The continued decline in interest rates and the low interest rate environment in Singapore have presented a dividend yield versus interest yield spread of more than 3%, which looks attractive against a post-GFC historical backdrop. We remain positive on high dividend- yielding stocks with good prospects to maintain and sustain their distribution per unit growth amid the low interest rate environment. We expect yield compression to drive returns for good-quality dividend moats. Sectors we are most positive on include industrial/logistics REITs, infrastructure trusts as well as selective retail REITs, which appear well positioned for the economic recovery.

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Asian Credit outlook
Poised to recover as global growth rebounds

By the Asian Fixed Income team

Summary

- We expect Asian credit spreads will tighten gradually over the coming months, supported by a solid rebound in gross domestic product (GDP) growth for most Asian economies in 2021 and stable to slightly better corporate credit fundamentals.

- Credit-supportive fiscal and monetary policies are also expected to remain in place in most developed and Emerging Market (EM) countries, even if incremental easing measures are likely to start to moderate. Progress on vaccine development and better treatment for COVID-19 cases further reinforce this positive backdrop.

- That said, valuation is no longer cheap given the sharp rally in credit spreads over recent months, and there may be periods of market consolidation amid the spread tightening trend.

- We prefer Asian high-yield (HY) credits to Asian investment grade (IG) at the start of 2021, given expectations that Asian HY will generate a higher total return during the year. There is more room for spread compression within Asian HY, which will also be less affected by rising long-end US Treasury (UST) yields given its shorter duration. Within HY, we prefer short-dated Chinese property bonds over the industrial sectors across China, India and Indonesia. Within Asia IG, we also prefer compression, favouring BBB-rated credits over those that are A-rated and above.

Fundamentals

Macro

Following a year in which global economies were ravaged by the COVID-19 pandemic and the mobility restrictions implemented to curb the spread of the virus, GDP growth of Asian economies is expected to solidly rebound in 2021, with the International Monetary Fund projecting the Emerging and Developing Asia region to expand by 8%[1]. This recovery will be driven by a gradual return to normalcy in social mobility and economic activity, particularly in the external and domestic services sectors, as well as continued support from both fiscal and monetary policies. The key to this normalisation is the gradual rollout and distribution of COVID-19 vaccines around the world, which will enable those sectors hit hardest by the pandemic, such as air travel, tourism, and restaurants, to revive from a deep slump in 2020. Manufacturing has already started to recover in most Asian economies and the recovery likely to continue in 2021. As the major advanced economies also rebound in 2021, external demand should further solidify and export growth in most Asian economies should continue to pick up, particularly if demand for commodities continues to strengthen. Private investment demand may remain subdued in the first half of the year but could gather momentum into the second half of the year as business confidence and the consumer outlook improve.

In terms of country performance, China and other North Asian economies should continue to lead, at least in the first half of the year. However, towards the second half of the year, India and Southeast Asian economies may exhibit stronger growth as

[1] *International Monetary Fund, World Economic Outlook, October 2020*

they catch up after their slower recovery thus far in 2H 2020, and as vaccine distribution may take longer in the larger economies of South and Southeast Asia. Some of these countries may also be constrained in terms of their fiscal policy space, hence their fiscal impulse may be weaker compared to the North Asian countries in the early part of 2021.

We expect fiscal and monetary policies to remain accommodative in most Asian economies. However, we may see moves to withdraw some of the extraordinary policy support as the year progresses if the growth trend improves as expected. This process is likely to be led by China. That said, with domestic inflation remaining benign, rising gently with domestic demand, and central banks in developed market economies unlikely to raise policy rates anytime soon, the room for monetary policy to stay accommodative through 2021 will likely remain intact across most Asian countries.

We expect the sovereign credit ratings of most Asian economies to remain stable in 2021.The biggest risk remains with India, given its negative credit outlook (rated Baa3 by Moody's and BBB- by Fitch). While a downgrade to non-investment grade is not our base case for India, at least in 2021, clearly much hinges on the robustness of its GDP growth recovery and the ability of the Indian government to manage the country's fiscal deficit and debt-to-GDP ratio. There is also a slight risk that S&P could follow Fitch and downgrade Malaysia's rating to BBB+ if the country's GDP growth does not recover strongly enough and enable the fiscal consolidation trend to return.

> "We expect the sovereign credit ratings of most Asian economies to remain stable in 2021"

Credit

Given the backdrop of economic recovery and continued policy measures to ensure ample liquidity and lending support, we expect Asian corporate credit fundamentals to remain stable to slightly better in 2021 with recovering earnings and broadly stable debt levels. Compared to 2020, we are likely to see fewer idiosyncratic "fallen angel" cases, although the many Indian banks and state-owned enterprises whose ratings are sovereign-linked remain a source of uncertainty. The Asian HY corporate default rate is likely to remain manageable at around 2.5% in 2021.

Despite the impact of the pandemic on earnings, overall the IG corporate sector in Asia managed to retain stable leverage and debt servicing ratios through the first half of the year. Clearly, there are some variations around this trend; for example, sectors such as retail and transportation were more adversely impacted, while those such as technology actually showed improvements due to the shift to work-from-home and changing consumer spending patterns. Furthermore, the global fall in yields likely reduced overall borrowing costs, leading to stronger debt servicing metrics for some companies as debt levels have remained broadly stable. We expect this trend of stable to mildly improving credit metrics for the Asian IG non-financial corporate sector to continue in 2021.

Asian banks could face some earnings pressure from low net interest margins, but as the majority of the banks are witnessing an improvement in repayments and a reduction in loans under moratorium, we are expecting a manageable deterioration in asset quality in 2021 when the relief measures expire. We also expect regulators to remain supportive of banks to ensure the bank lending channel is not disrupted during the nascent recovery phase.

On the HY side, the differentiation, both between and within sectors, will likely continue in 2021. The Chinese property sector will likely see stable to modest positive presales growth in 2021. Larger developers may continue to outpace the national level given their leading positions and generally stronger financial flexibility. Aggressive land acquisitions and leverage build up is unlikely in the Chinese property sector given the deadline to meet the requirements under the so-called "three red line" policy pertaining to the developers' credit metrics. As with 2019 and 2020, credit metric trends for Chinese HY industrials will be more credit specific, although the tighter onshore credit conditions may exert pressure across the sector. Tight liquidity may also pressure select HY companies in Indonesia and India, especially those facing near-term refinancing needs.

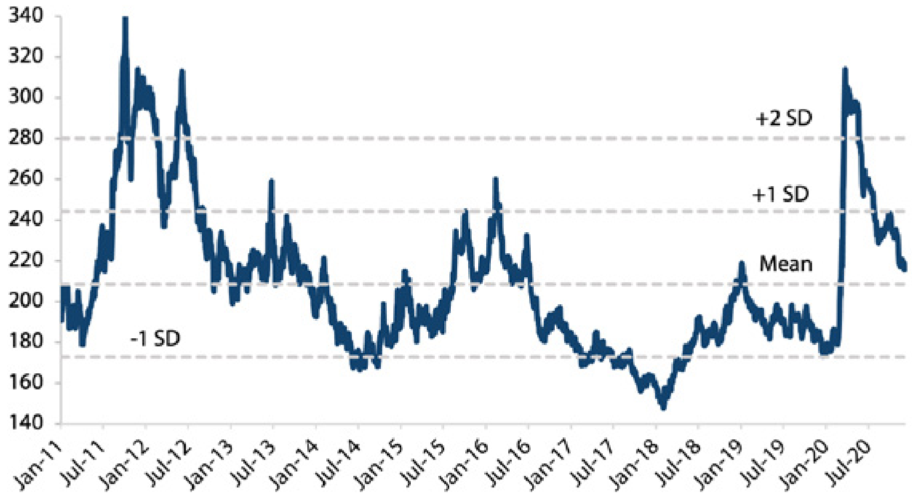
Valuations

After widening sharply in 1Q 2020 on concerns over the impact of the pandemic, Asian credit spreads have tightened significantly since end-March, although they are still slightly wider than at the start of 2020. Asian high-grade (HG) spreads currently sit at 217 basis points (bps)[2], about 40 bps wider than at the end of 2019. Meanwhile, Asian HY spreads are at 656 bps, having widened about 122 bps since the end of 2019. Both HG and HY spreads remain above their post-Global Financial Crisis mean levels.

Asian credits remain attractive compared with US credits, with the Asian IG premium over US IG currently at 85 bps[2] versus 50 bps at the start of the year. Within IG Asian credits, BBB-rated pickup over the A-rated segment is currently at 89 bps, slightly wider than 69 bps, the average level for the last five years. We thus prefer BBB-rated credits over A-rated ones for their higher pickup. Within HY, Asian credit provides a more attractive yield pickup versus its US peers. Within Asia, the single B-rated segment shows higher relative value as its pickup over the BB-rated segment has increased substantially to 471 bps[2], although credit selection remains paramount.

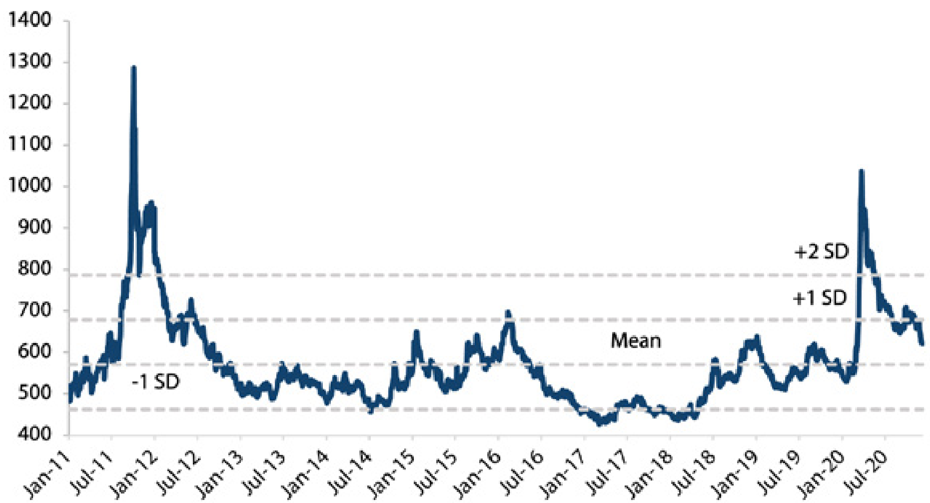
[2] *J.P. Morgan, Bloomberg, as of 8 December 2020*

Chart 1 : Asian High-Grade Spread



Source: Bloomberg, as of 8 December 2020

Chart 2 : Asian High-Yield Spread



Source: Bloomberg, as of 8 December 2020

Technicals

We expect the technical backdrop for Asian credit to remain robust. After sharp outflows in 1Q 2020, external flows into EM funds have recovered and are likely to remain strong in 2021 given the ample global liquidity and re-allocation of funds towards higher-risk assets as market and economic uncertainties subside. In addition, the low funding cost environment is likely to continue shoring up private bank demand. China-based investor demand for USD-denominated Chinese credits is also expected to remain strong, with recent onshore credit concerns impacting only some of the offshore bonds issued by weaker HY private companies and local state-owned enterprises. Gross supply is likely to remain elevated in a USD 300 billion–350 billion range after another record year of gross issuances close to USD 315 billion in 2020. A large part of the gross issuance will be for refinancing, leaving net issuance at a manageable level of around USD 100 billion. More stringent regulation will likely cap Chinese property USD bond issuances, although there could be more opportunistic issuances by IG companies to lock in the historically low yields and to fund selective mergers and acquisitions.

Strategy

We expect Asian credit spreads to tighten gradually over the coming months. High-frequency indicators suggest a recovery is underway in most Asian economies, lending support to overall corporate credit fundamentals. Credit- supportive fiscal and monetary policies are also expected to remain in place in most developed and EM countries, even if incremental easing measures are likely to moderate hereafter. Progress on vaccine development and better treatment for COVID-19 cases further reinforce the positive backdrop. The technical backdrop is also favourable with inflows to EM hard currency bond funds expected to remain robust. That said, valuation is no longer cheap given the sharp rally in credit spreads over recent months, and we expect more regular episodes of market pull-back going forward.

Given the vaccine and policy-driven reflationary expectations in the developed market economies, long-end UST yields may rise and steepen the curve in 2021. This may offset the positive impact from credit spread tightening and result in low-single digit positive returns for Asian IG credits in 2021, with carry being a more prominent driver. We expect Asian HY to generate a higher total return. There is more room for spread compression within Asian HY, which will also be less affected by rising long-end UST yields given its shorter duration. Hence, we prefer Asian HY credits over Asian IG at the start of 2021.

Within HY, we prefer short-dated Chinese property bonds over industrial sectors across China, India and Indonesia. Within Asian IG, we also prefer compression, favouring BBB-rated credits over those that are A-rated and above. In our view, the key downside risk to Asian credit in 2021 is US-China bilateral relations failing to stabilise under the Biden administration. US president-elect Joe Biden has repeatedly stressed multilateralism as a key foreign policy pillar, and there are hopes of US-China relations being reset after a tumultuous four-year period. However, the underlying technological and ideological tensions between Washington and Beijing could dash such hopes. In addition to geopolitical issues, a premature withdrawal of the accommodative fiscal and monetary policies currently in place is another downside risk that could derail the positive outlook for risk assets, including Asian credit.

Sector outlooks

Financials

As a majority of the Asian financials are witnessing an improvement in repayments and reduction in loans under moratorium, we are expecting a manageable deterioration in asset quality in 2021 when the relief measures expire. While fiscal stimulus and accommodative monetary policies could be cautiously dialled back in 2021, we trust regulators and governments to remain supportive of banks, allowing these entities to fulfil their crucial socio-economic role and prop up economic growth.

In China, Hong Kong, South Korea and Singapore, the pandemic has been relatively well controlled and economic activity has gradually picked up. While pressure on the banks' profitability will persist and credit costs could remain elevated in 2021, we see attractive risk-reward in going down the capital structure of the larger banks that are well capitalised and possess strong fundamentals, better risk management practices, and limited exposure to the weaker industries and small and medium-sized enterprises. We see minimal non-call risk for these bonds, as Asian banks continue to enjoy favourable capital market conditions and will want to avoid any lasting negative impact to their reputation. In India, the Non-Banking Financial Companies' (NBFCs) asset quality remains vulnerable despite improving loan collections. Persistent weakness amongst the smaller NBFCs will continue to weigh on the fragile sentiment toward the sector.

We continue to prefer China's asset management companies (AMCs) and the stronger bank-affiliated leasing companies over China banks seniors. For China's AMCs, the growing importance of their strategic role in distressed asset management and ongoing reduction in leverage have more than offset the rising risks in asset quality and shrinking profitability. Bank-affiliated leasing companies with a strong onshore parent bank are more profitable than their peers, aided by closely integrated business operations as well as explicit liquidity and capital support from the onshore parent bank under the articles of association of leasing companies.

Real estate

Regarding property, we favour China, have a neutral view of Hong Kong, and find Indonesia relatively unattractive. We continue to see value in Chinese property developers, driven by resilient fundamentals, attractive valuations and improving market technicals. We expect the following trends to support fundamentals:

1. *Demand for residential homes: We expect such demand to remain healthy. It is driven by household formation and urbanisation and has demonstrated resilience even during the pandemic.*
2. *Tighter macro-prudential policies: Regulators have tightened macro-prudential policies, and this will improve discipline and limit debt growth among developers, in our view. We expect policies to be implemented in a phased and manageable manner for the industry.*
3. *Better funding structure: Many developers have plans to deleverage or improve their funding structure and have shown progress in executing these plans.*

In Hong Kong, we find that wider valuations fairly reflect weakening sentiment and fundamentals, with investment property rental rates and occupancies likely to trend down. In Indonesia, we expect weak sales, as well as liquidity and refinancing concerns, to continue to weigh on the sector and see valuations as relatively unattractive.

Infrastructure & transportation

We expect engineering and construction (E&C) companies to record steady top line growth in 2021 backed by solid order book backlog. Under the newly coined "dual-circulation" strategy, the Chinese government may be less inclined to drive infrastructure investments as rigorously as in prior years. But infrastructure investments will continue to be an important pillar supporting economic growth as the economy slowly recovers from the pandemic. Most E&C companies with dollar bonds are owned by China's central State-owned Assets Supervision and Administration Commission (SASAC) and play an important role in smoothening the economy. We expect leverage on most of these companies to stay elevated due to capital needs in supporting capex and working capital investments. Overall, we still view this as manageable and have a constructive view on the sector.

Asia toll-road and port operators witnessed a V-shaped traffic recovery during 2020 as local economies eased lock down measures. We expect continued improvement to pre-pandemic levels in 2021, driven by better pandemic management and development of vaccines.

The airline sector has been one of the worst hit by the COVID-19 pandemic and is yet to see meaningful recovery. We view airline-related credits as a potential alpha source and our views may turn constructive on some relevant credits once it becomes clear that vaccines can be rolled out and air traffic begins recovering.

Technology

The Asia telecom sector's competitiveness has been curbed in some markets over the past few months and this trend could continue in 2021. The shift from voice to data and changes in data consumption habits will remain a structural trend that will pressure the industry players' margins. Hence, we expect telecom operators to retain their focus on cost management and be mindful about 5G investments in 2021. Overall, our view of the sector is neutral as we expect industry leaders to be committed to maintaining stable credit metrics in 2021.

Chinese internet players will see an increased divergence in operating performance in 2021 with leading players to post healthy top line growth at the expense of smaller players who will experience flat or negative growth. Overall, the industry will see positive but slower growth compared to previous years due to a high base effect and as competition will remain fierce. We expect the majority of Chinese internet bond issuers to maintain a stable credit profile in 2021 due to strong capitalisation and net cash positions. However, regulatory risks and impact from US-China tensions will continue to weigh on the sector in the coming year.

Some hardware technology companies have seen a decent recovery in 2020 due to industry restocking and incremental investments in 5G infrastructure and 5G phone launches. This trend could continue in 2021. However, some companies who are more vulnerable to the US-China trade tensions have lagged. We think US-China tensions will continue to impact these companies in 2021, though the upcoming change in US administrations could be a swing factor. Overall, we will remain cautious on the sector until the stance of the next US president becomes clear. We do see attractive investment opportunities in some companies that are less impacted by the US-China trade war, possess strong capitalisation and have a diversified product portfolio and customer profile.

Oil and gas

We expect the fall in oil prices in 2020 caused by the COVID-19 pandemic to weigh heavily on the profitability of oil and gas companies. Resurging virus cases and continued restriction of air travel are curbing overall oil demand, although the curtailment of oil production by OPEC+ members and major producers has greatly alleviated concerns over supply and demand imbalances. The virus could be contained some time in 2021 upon the development of much-anticipated vaccines; as the pandemic subsides, we expect oil demand and prices to recover.

Asian oil and gas companies in the upstream segment are likely to see lower profits in the near term. Most have competitive lifting costs and should still be able to generate positive cash flow despite low oil prices. These companies have sensibly lowered their capex spending and production volume guidance to conserve liquidity. The profitability of downstream segment companies will also be weak as refining margins remain soft due to poor demand. Refining spreads are unlikely to recover in the near term; furthermore, they will be weighed down by new capacity additions in the region. A robust recovery will depend on global economic conditions. Overall, we expect credit metrics to weaken in the near term. However, Asian national oil companies have strong credit profiles as most are government owned and therefore enjoy solid support. These companies are very strategically important to oil importing countries as they ensure energy security, and this will remain the case regardless of near-term oil price swings. We are neutral on the Asian oil and gas sector.

Casino gaming

As a sector heavily reliant on cross border tourism, Asia's casino operators were heavily affected by the COVID-19 pandemic. Operators in Macau and Singapore saw visits evaporate during 2Q and 3Q 2020. While Macau and Singapore have managed to bring COVID-19 cases mostly under control, visits to their integrated resorts remain well below pre-pandemic levels. Strict social distancing rules and travel restrictions continue to discourage tourism to these destinations and we expect the sector's companies to continue reporting weak results in 2021. Despite these challenges, we believe that the casino operators are well positioned to weather the downturn as they hold healthy levels of liquidity and have good access to banking credit lines. The companies have also deferred dividends and discretionary capex to preserve liquidity. As the pandemic is eventually contained and cross border travel restored, we expect the gaming sector to recover slowly and gradually. We are neutral on the Asian casino gaming sector.

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Asian Fixed Income and FX outlook
A sweet spot for Asian bonds

By the Asian Fixed Income team

A review of 2020

The year 2020 truly surprised the markets, with the COVID-19 pandemic at one point bringing global economic activity to a virtual standstill as economies shut down in rapid succession. As a result, financial markets across all asset classes, including safe-haven assets, exhibited extreme volatility. With significant disruptions to global markets, policymakers across the world raced to introduce measures to restore calm. While initially feeble and disjointed, monetary and fiscal authorities across the globe grew more coordinated and forceful by the end of the first quarter, finally succeeding in stabilising key segments of the global fixed income market. Global risk assets went on to stage a strong recovery, with US equity markets hitting record highs towards year-end.

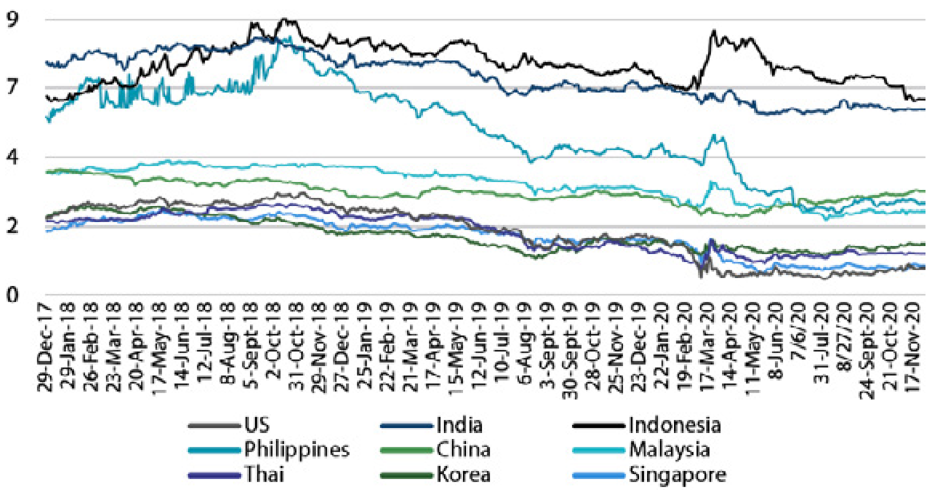
Against such a backdrop, US Treasury (UST) yields plunged 82–147 basis points (bps) across the curve. Low inflation, aggressive and broad-based policy support from central banks and concerns around the resurgence of COVID-19 infections in major economies anchored yields at low levels. In August, US Federal Reserve (Fed) Chair Jerome Powell announced a major shift in the central bank's approach to achieve maximum employment and its inflation goal, as it formally adopted a flexible average inflation targeting policy. Consequently, expectations of rising inflation caused longer-term rates to ratchet higher, although they were still at relatively low levels. The UST curve steepened after the US elections as the markets positioned for a reflation trend. A slew of positive COVID-19 vaccine trial results provided further impetus for long-end yields to rise.

In Asia, several economies experienced technical recessions on the back of the pandemic, with the ongoing recovery being uneven and partial. The decisive and unprecedented policy response from governments and central banks—both in swiftness and scale—headed off a more devastating outcome. Within the region, growth in North Asia proved to be relatively more resilient. With demand tepid, inflationary pressures fell, and annual headline consumer inflation rates in Malaysia, Singapore, and Thailand all turned negative at one point.

Overall, Asian local government bonds recorded positive total returns, with the Markit iBoxx Asian Local Currency Bond Index (ALBI) registering gains of 7.66%[1] in US dollar (USD) unhedged terms. Meanwhile, the USD weakened against most regional currencies amid the positive risk tone. On a total return basis, Indonesian and Philippine bonds outperformed regional peers, with demand bolstered by aggressive monetary easing by their respective central banks. Indonesian bonds also benefited from Bank Indonesia's (BI) liquidity support and the return of offshore capital. In contrast, Thailand markedly underperformed, as lingering political tension and a lack of tourism receipts weighed on sentiment towards Thai assets in general.

[1] *As at 30 November 2020*

Chart 1 : 2020 10-year benchmark yields, returns and FX returns



	iBoxx ALBI Indices	Currencies vs. USD
ALBI Index	**7.66%**	**2.79% (ADXY)**
China	1.85%	5.84%
Hong Kong	7.06%	0.52%
India	11.93%	-3.59%
Indonesia	12.61%	-1.80%
Korea	1.51%	4.51%
Malaysia	5.80%	0.42%
Philippines	9.72%	5.35%
Singapore	7.68%	0.32%
Thailand	1.69%	-0.97%

Source: Bloomberg, as of 30 November 2020.

Outlook for 2021

We expect global growth to grind higher in 2021, but the pace of recovery will likely be uneven among economies. In the US, renewed upticks in COVID-19 infections heading into the winter season may lead to the re-imposition of restrictions. This poses a significant headwind for growth in the fourth quarter of 2020 and the first quarter of 2021. That said, increased spending by the Biden administration is likely to mitigate some of the downside risk to economic activity. Global growth is then expected to pick up modestly as vaccine access expands.

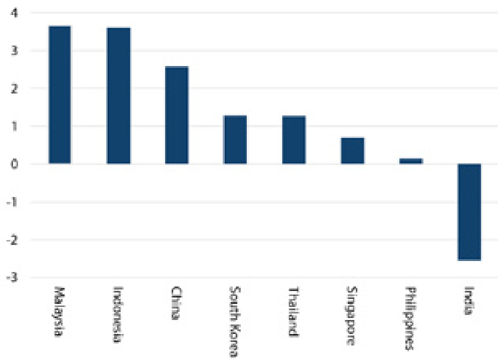
Within Asia, we expect North Asia to continue to lead the recovery (at least in the first half of 2021). But we also expect the growth divergence between North Asia and the rest of the region to narrow. Unprecedented fiscal support from governments have been pivotal to the ongoing recovery. We expect fiscal action to continue in 2021 but anticipate renewed private sector confidence as the vaccine becomes broadly available and provides a powerful tailwind to regional growth.

Meanwhile, inflation will likely rise from current low levels and remain manageable as the negative output gap is expected to persist. The Fed has embraced a flexible average inflation targeting strategy. Given our view that the US economy still has some distance to go before attaining full employment, we do not expect an interest rate hike from the Fed in 2021. These factors accord regional central banks room to further loosen monetary policy, if needed. In our view, economies which have trailed in COVID-19 containment such as Indonesia, Malaysia and the Philippines would need more support. Hence, we expect their respective central banks to announce further rate cuts in the near-term.

We anticipate the combination of growth recovery supported by vaccine availability, fiscal support and a still dovish Fed to push UST yields higher in 2021. Against a backdrop of positive risk tone, we believe Emerging Market (EM) inflows into local markets will continue to improve. We favour countries with high carry such as Indonesia, where flows have begun to return. We prefer to be patient on Indian bonds at this point, waiting for inflationary pressures to moderate. We expect Asian currencies to appreciate against the USD, with the Chinese yuan, South Korean won and Singapore dollar—being relatively more trade-sensitive—outperforming. Lingering political risk will be key headwinds for the Malaysian ringgit and Thai baht, which may cause these currencies to lag their peers.

The key downside risks to our investment thesis include a delay in vaccine developments, escalating geopolitical tensions between major countries and a faster-than-expected acceleration in inflationary pressures prompted by an upside surprise to growth.

Chart 2: Asian real rates (%) - 5-year yields vs CPI



Source: Bloomberg, as of 30 November 2020.

Individual country outlooks

China

Chinese economic growth has bounced back from initial weakness in the first quarter. The Communist Party's Central Committee recently unveiled its broad goals for the 14th five-year plan; self-reliance was a key theme and technical innovation was emphasised as vital to the country's development. Overall, few factors threaten growth at this moment, and Chinese bonds may remain weak in the near-term as the Chinese central bank does not have much reason to ease monetary policy. Until we see a more decisive turn in growth numbers, perhaps in the first quarter of 2021, bond yields are likely to continue rising gradually.

With regards to US-China tensions, we believe that Joe Biden's US election victory will not materially change Washington's rhetoric on China. However, the Biden administration is likely to engage China through proper diplomatic channels, which will reduce volatility and uncertainties in bilateral relations. This will in turn somewhat reduce risk premium in the markets.

The yuan has continued to appreciate against the USD after the US election. In October, Chinese policymakers relaxed the yuan pricing mechanism and lowered the risk reserve ratio for FX forward transactions, signalling that Chinese policymakers may tone down sizable moves from here. That said, China's growth outperformance, strong current account surplus and structural drivers of continued Reminbi (RMB) internationalisation will likely support the yuan's outperformance against its regional counterparts in the near to medium term.

South Korea

Gross domestic product (GDP) growth in South Korea has been relatively resilient relative to its peers, underpinned largely by a strong recovery in exports. In the third quarter of 2020, the economy expanded 1.9% quarter-on-quarter (QoQ), its first positive reading in 2020, as work- and study-from-home amidst the pandemic significantly boosted demand for memory chips and electronics. For the whole of 2020, Bank of Korea (BOK) expects GDP to decline 1.1%, before increasing by 3% in 2021. On expectations that US president-elect Biden will adopt a more predictable economic policy, especially in trade, business investment is likely to increase globally, which could boost growth in Korea's exports.

South Korean bonds are expected to trade in line with USTs. The BOK does not have much room to cut rates further, and concerns around financial risks, such as elevated outstanding household loan growth, will likely prompt the central bank to stand pat at the next policy-setting meeting. The BOK has, however, reiterated that it stands ready to act if necessary, and the markets have been alerted to hints of a ramp-up in bond purchases by the central bank.

Meanwhile, like China, South Korea's growth outperformance and widening current account surplus will be supportive of further won appreciation against the dollar. The increasing emphasis on 5G and the global adoption of this technology will be supportive of the tech cycle, which should support South Korean equities and thus the currency. That said, we note that rhetoric from South Korean policymakers have since turned hawkish, which suggests heightening wariness of further big swings by the currency.

Malaysia

The protracted political uncertainty is the main risk to Malaysia's recovery, with the ruling coalition having but a slim and frail majority in parliament. A general election is likely which may disrupt medium-term recovery efforts. We note that the COVID-19 resurgence has prompted re-introduction of containment measures, although they are less strict and more selectively applied in localised areas. Hence, the drag to growth will not be as severe as that in the second quarter of 2020. For 2021, the central bank expects growth between 6.5% and 7.5%, driven by a rebound in global demand and domestic investment activity. Should actual growth falter, we note Bank Negara Malaysia still has room to further ease monetary policy. The latter should provide support for faltering local bond demand from pension withdrawals.

Separately, we expect the ringgit to underperform its regional peers in the first half of 2021, as commodity price stagnation and political uncertainty, coupled with possible easing by the central bank, weigh on sentiment. The stable current account surplus should still provide a back-stop on the downside.

Singapore

The Singapore economy turned around in the third quarter of 2020, following an unprecedented decline in the April to June period. Extreme weakness on the domestic side was slightly offset by strength in exports, particularly the electronics sector. For 2020, the Monetary Authority of Singapore expects the country's GDP to contract between 6.5% and 6.0% and post above-trend growth in 2021 due to a low base. Policymakers have been pushing to re-open the borders in a gradual and safe manner. We believe that the availability of a vaccine in 2021 could slowly revive the country's position as a global travel hub.

Singaporean bonds are likely to continue outperforming USTs on the back of ample domestic liquidity and the attractiveness of the Singapore dollar (SGD). Meanwhile, we see the SGD getting a boost from a continued rebound in international trade as well as a nascent second-half recovery in air travel.

Thailand

Thailand's GDP growth bounced by a strong 6.5% QoQ in the third quarter of 2020, due partly to easing of the virus containment measures and increased government spending. The strong showing could suggest the worst is over. That said, recovery will likely be slow going forward, given the Thai economy's heavy reliance on international tourism, as governments proceed cautiously in re-opening borders. In addition, persistent anti-government protests will further weigh on the already weak growth outlook.

More rate cuts from the Bank of Thailand are possible, given the weak growth outlook, but we note that with the policy rate currently at 0.50%, it has little room to further lower rates. The potential for rate cuts would support bond demand especially as domestic liquidity is flush. On a relative value perspective, offshore investors are likely to prefer bonds which provide better risk-reward.

We also expect the baht to underperform its regional counterparts in the medium term, as lingering political tension and lack of tourism receipts weigh on the currency. The relatively large and persistent current account surplus would, however, provide it with some downside support.

India

India's economy was hit relatively badly by the COVID-19 pandemic. India's industrial growth turned positive in September, following six consecutive months of contraction, as lockdown measures eased. Other high-frequency data also suggests that recovery is picking up. On top of this, the government recently announced fresh policy measures to support the economy. Barring another surge in COVID-19 infections, the economic recovery may well surprise on the upside from here, which could reduce the urgency to further ease policy rates.

Meanwhile, the Reserve Bank of India's unconventional tools and bond-supportive measures have provided strong support for Indian bonds in recent months. Although the space provides attractive carry and would benefit from the resumption of inflows into EM, we deem it prudent to wait for a sustained moderation in inflationary pressures before turning more bullish on Indian bonds.

Indonesia

As with the rest of the region, third quarter Indonesian growth saw an improvement reflecting the impact of businesses re-opening in big cities. Government consumption growth grew significantly, consistent with improved execution of the government's support packages. The path to recovery remains fragile and uncertain. While domestic COVID-19 infection rates remain stable, they are still at high levels, prompting households and corporates to remain cautious on spending. We do expect the government to accelerate disbursements of fiscal expenditures, which should continue to be the main driver of growth in the next few months. A more meaningful recovery may only happen in mid to late 2021, when vaccines could be rolled out widely. Hence, we expect inflation to remain fairly anchored at low levels in 2021. Meanwhile, with FX stability ostensibly achieved, BI has resumed monetary policy easing after keeping rates unchanged for three consecutive meetings. Going forward, we expect further rate cuts by the central bank as focus has clearly shifted to supporting growth.

We go into 2021 with an overweight view on Indonesian bonds. As mentioned, a modest recovery in GDP growth against a low inflationary environment leads us to believe that BI will stay accommodative for at least the first quarter of 2021. Our expectation of an outperformance of Indonesian bonds on an intra-Asia basis is further supported by the higher yields offered in the space. We believe Indonesian bonds and the rupiah will also benefit from what we expect will be an increase in foreign flows into the EM debt space.

Philippines

Growth momentum in the Philippines has lagged peers. Public sector spending remains weak while the private sector's lack of confidence has led to the collapse of private spending. To shore up the economy, the Bangko Sentral ng Pilipinas has lowered its key policy rate to a record low of 2%[2].

Going forward, we foresee a much weaker pace of recovery for the Philippines vis-à-vis regional peers, in the absence of sizeable fiscal support measures. Fresh government fiscal support would in large part rely on the tax cuts via the Corporate Recovery and Tax Incentives for Enterprises (CREATE) Bill which is expected to be signed into law in 2021. Economic activity may also take time to bounce back despite the availability of a vaccine given low existing immunisation rates. Hence, we expect inflation to remain subdued for some time. Against such a backdrop, the central bank is likely to ease monetary policy further. Despite supportive monetary policy, we expect a gradual rise in Philippine bond yields in 2021 from its current historic low levels, as the markets price in recovery from the slump due to the pandemic.

Meanwhile, the collapse in imports in 2020 has supported the strong performance of the peso. As economic activity and infrastructure spending resumes, the trade deficit should widen anew, albeit at a modest pace. We hold a neutral view on the peso.

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[2] As at 30 November 2020

Core Markets Fixed Income Outlook
The curve, COVID -19 and Kamala

By Steven Williams, Head Portfolio Manager, Core Markets

> What we call the beginning is often the end. And to make an end is to make a beginning. The end is where we start from.
> – T.S. Eliot

As European Commission President Ursla von der Leyen announced the free trade agreement with the UK and the EU, she quoted T.S. Eliot: "What we call the beginning is often the end. And to make an end is to make a beginning. The end is where we start from. Well, with the end of 2020 we certainly have a new year to look forward to, but it feels we are more like in the middle of this unsettled time than at an end. With viral cases rising and the Democrats now expected to take the US Senate (at the time of writing), the landscape has changed from only a month ago when we faced a no-deal Brexit, a Republican Senate and more virus rhetoric. With new mutant, more virulent strains of the virus, we have gone from bad to worse. The help from a vaccine is on the way, but full vaccination still remains far off on the horizon. Perhaps a quick vaccination lesson from the Israelis could speed things along? USD 4.5 trillion of total fiscal and monetary stimulus between Europe and the US is primed and ready to be implemented over the immediate term and we suspect there will be more to come as the most optimistic scenarios for the pace of vaccinations falter. It took nearly 30 years to eradicate polio in the US; we certainly think the eradication of COVID-19 will be faster, but current mid-summer herd immunity projections seem optimistic.

For rates, 2021 will be all about the curve, COVID-19 and Kamala. With the Democrats now likely to take control of the Senate, we expect a bit more of a reflation trade in the first half of the year with additional stimulus, a 15-dollar-an-hour minimum wage and support for states. While the immediate concerns over Democratic leadership are those of a radical progressive agenda, the reality is that Joe Biden will likely govern with a bipartisan approach given an already fragmented Democratic party and lack of a dominant majority. We recall when Donald Trump was elected, the market was sure of the reflation trade as well. Nevertheless, we ended up with historically low interest rates. We think once the reality of low growth for longer sets in, the "Bond Vigilantes" will be forced back by the "Justice League of Central Banks" faced with taming a steepening yield curve constraining the recovery.

Inflation will certainly be an issue, and we expect some wild numbers from headline inflation as base effects will come into play versus the spring 2020 figures (e.g. how do you calculate growth off of a negative oil price?). Inflation, though, will be just an illusion as it will face the new regime of innovation, competition, debt, deficits and now zombie companies.

The record amount of US Treasury cash, USD 1.56 trillion, stands at odds with money market demand for US Treasury bills and we doubt the Federal Reserve (Fed) would want the market to dictate terms on short-term interest rates. US municipals will benefit from the push for added stimulus with likely larger grant packages coming for state and local credits and a more than likely resurgence of a Build America Bond-style program. With nearly everything looking expensive in credit, taxable municipal bonds remain a solid value standout.

We expect to see a summer lull in the virus as we observed last year, but as with the 1918 influenza pandemic, we cannot discount the impact of a potential third wave going into the 2021 autumn period, especially for emerging economies. Growth will remain suppressed throughout the year, and stimulus will remain high. We expect the USD decline to continue, but only to a point. To think the rest of the developed market economies will stand idly by and allow for the relative debasement of the USD would seem foolhardy, though quite difficult to know if there will eventually be a breaking point. Commodity currencies will continue to benefit on the road to recovery with the Australian, New Zealand and Canadian dollars and Norwegian krone benefitting from the resurgence in commodity prices, especially in a weak USD environment.

Since Trump took office in 2016, he has lost the presidency, the House and now likely the Senate. We think it is possible that the Democrats take a more pragmatic approach to the main issue at hand, the pandemic, and focus on stimulus for now. While Biden ran on taxes, the election was so close that we question the incentive to taunt the elephant given the risk of a Senate flip in 2022. As such, we are not entirely convinced of a Biden tax raise just yet. In the second half of the year the discussion of the Fed chair will become centre stage. We would make the same argument for choosing the Fed chair: why risk 2022? We think the ongoing stimulus will continue to exacerbate the wealth gap, especially increasing the number of easy-to-vilify centibillionaires, thereby leaving the Fed ripe for politicisation. Our main concern is the idea of recession insurance bonds, which are basically "helicopter money" for main street. Though enacting this would require the Democrats a solid majority, which they don't have.

"We think it is possible that the Democrats take a more pragmatic approach to the main issue at hand, the pandemic, and focus on stimulus for now"

For Europe, with USD 1.5 trillion of QE to be deployed over the course of 2021, we expect the convergence trade to continue with Italian sovereign spreads to be the main beneficiary. We expect Italian spreads to grind towards Spain over the course of 2021, as the search for yield and central bank protective put will keep volatility low and the incentive for the carry trade high. For the broader EU, we think Sweden and Denmark remain attractive alternatives given their high-quality ratings and still-high spread relative to Germany, as capital will continue to reallocate to higher yielding alternatives without sacrificing quality.

Historically, we know all pandemics end, but some linger on as chronic endemic issues. Looking back to the 1918 influenza pandemic, we know third waves and even fourth waves are possible, especially when considering the logistical challenges of rolling out a vaccine globally. However, as tough as they are, pandemics are no match for central banks. While historical recessions always incorporated a prolonged shift in asset prices, the new normal seems to have solved the asset price side of the equation, just not the general income side of it. It's become a clichéd term, but we remain cautiously optimistic for 2021. At least we can look forward to not discussing Brexit.

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Emerging Markets Fixed Income Outlook

Assessing the external drivers

By Raphael Marechal, Head Portfolio Manager, Emerging Markets

A review of 2020

Despite the devastating human and economic toll caused by the COVID-19 pandemic across the globe, and in many emerging economies in particular, emerging market debt investors were rewarded with positive returns in 2020, with local currency, external sovereign and corporate bond indices posting returns in excess of 2.5%, 5% and 7%, respectively[1]. For us, this once again exemplifies the importance of assessing the external drivers for the asset class, as well as the country-specific factors, as ultimately it was how the world responded to the pandemic that mattered to emerging market investors in 2020.

The global financial response to the pandemic was, in short, unprecedented, with an estimated USD15 trillion[2] of stimulus measures from governments and central banks combined, well in excess of what was provided in 2008. US fiscal stimulus alone has easily surpassed USD 3 trillion, while the Federal Reserve also slashed rates to close to zero and expanded its asset purchases and liquidity provisions aggressively. This abundance of liquidity allowed financial market sentiment to recover and for investors to seek out higher yields in emerging market assets, in lieu of the mostly negative real yields in developed markets.

However, we have also seen significant differentiation among emerging markets, reminding us how important it is to take a selective approach when investing in the asset class. The Turkish lira once again struggled, exacerbated by a lack of tourist revenue during the summer months. In 2020 we witnessed once again, just as in 2018, how excessively loose monetary policy ultimately caused a sharp depreciation of the lira and double-digit rates of inflation. The Brazilian real wakened significantly over the course of the year, as the fumbling of the pandemic by President Jair Bolsonaro pushed the already stretched fiscal resources of the country to their limits. Russia was also the focus of several geopolitical flashpoints, with numerous allegations targeted at the state, including the poisoning of opposition leader Alexei Navalny, bounty payments to Afghan fighters, interference in US elections and a number of high profile cyber-attacks, whilst we also witnessed protests in neighbouring Belarus and conflict between Armenia and Azerbaijan.

Fortunately, we have also seen many emerging currencies perform well. China, after locking down the city of Wuhan for 76 days, appears to have come out of the pandemic relatively unscathed, with its economy functioning almost normally. Several countries in Asia have also benefitted from the insatiable demand for technological goods during the pandemic. Finally, we have also seen a surprisingly strong flow of remittance payments despite many migrant workers suffering job losses, as direct payments from host country governments have kept the money flowing back home.

Going into 2021

It was a rollercoaster year in 2020 for emerging debt, yet the assets ultimately provided another year of positive returns. Can we expect a repeat performance for 2021? The lower starting point for US Treasury yields is, unfortunately, unlikely to bolster

[1] *J.P. Morgan GBI-EM Global Diversified Composite Unhedged USD, J.P. Morgan EMBI Global Diversified Composite, J.P. Morgan Corporate EMBI Broad Diversified Composite.*
[2] *Reuters (https://uk.reuters.com/article/uk-health-coronavirus-cenbank-graphic/15-trillion-and-counting-global-stimulus-so-far-idUKKBN22N2EP)*

the asset class to the same extent as it has in recent years. Yet sovereign spreads, despite tightening sharply in recent months, are still wider than their historical average, implying potential spread tightening as a source of positive returns. Furthermore, yields for both local currency and external debt still remain significantly higher than the developed market average, implying strong demand from yield-deprived investors elsewhere. As such, should developed market yields remain low, more capital should be deployed to emerging market fixed income assets. Finally, after a number of years of underperformance, we think that emerging market currencies remain materially undervalued in aggregate and could well boost the performance of local debt going forward.

The external factors that we consider critical to the outlook for emerging market debt in 2021, aside from valuation, include global monetary policy, fiscal policy and economic growth.

We do not expect a material change in monetary policy from major central banks in 2021 with economic activity, and hence inflation pressures, likely to remain subdued until later in the year, by which time the deployment of vaccines should start to yield a level of herd immunity. Hence, we expect the benign backdrop for global interest rates to facilitate ongoing capital flow to emerging fixed income.

While the size of fiscal policy in 2021 remains somewhat uncertain, we expect it will be expanded further in developed economies, particularly as it appears that monetary policy has been exhausted for many and additional stimulus measures are likely to be required to support individuals and businesses in the coming months. We believe that this increase in the stock of debt in developed economies is yet another factor that will keep global interest rates low and see capital flow to emerging fixed income.

Finally, the economic growth outlook looks brighter for 2021 but the timing of the recovery remains deeply uncertain and is dependent on successful vaccine deployment. For many emerging economies vaccines may not be available until late in the year. As such, the economic recovery may remain subdued and intermittent as many emerging economies continue to battle fresh waves of infections. This could be decisive for many countries which are dependent on human mobility, either directly via tourism, or indirectly via demand for energy commodities. Hence, while we remain optimistic of a recovery, we expect some delays and setbacks along the way.

Finally, we need to remain cognizant of the risks to our generally constructive outlook. As always with emerging markets, idiosyncratic factors can turn would-be winners into losers overnight. Key risks on our radar for 2021 include fiscal miscalculations, geopolitical flare-ups and social unrest.

The fiscal response has varied significantly across emerging economies, with many highly rated sovereigns with low debt burdens stimulating significantly (Central and Eastern Europe, Chile, Peru etc.) while some at risk of material ratings downgrades have acted prudently (Mexico, India, Colombia etc.), while both Brazil and South Africa are in an unenviable position of accelerating debt burdens and underwhelming growth prospects. Assessing the optimal fiscal response in 2021 to balance economic growth with financial stability concerns will remain a challenge.

Geopolitical tensions persist for many emerging countries and can often erupt without warning. US-China relations remain tense regardless of the change in US presidency, with bipartisan distrust towards China having risen significantly in the US in recent years, so this remains a potential flashpoint. Russia also appears intent on antagonizing its democratic rivals, and the risk of economic sanctions against Russia remains an ever-present threat. Meanwhile, Turkey is also riling its European neighbours by staking claims in the Eastern Mediterranean.

Finally, social tensions have gained prominence in many countries in recent years and is a risk no longer confined to low income countries, as income inequality has risen significantly, even for medium-income economies. The Arab Spring of December 2010 and riots in Chile in October 2019 both illustrate how suddenly underlying tensions can boil over. We are mindful of the risk of social unrest in a number of countries, such as Thailand, Colombia and Peru, and this heightened uncertainty may reduce their appeal to investors.

How we plan to act

Last year proved to be a year of relative winners and losers and we expect this trend to continue in 2021. As such, we maintain an active and selective approach to emerging fixed income. As a rule, we will continue to avoid exposure to countries whose economies are over reliant on commodity exports and/or excessive external financing, particularly where we do not see fair compensation for bearing such risks.

However, after several years of lacklustre performance, emerging market currencies are finally starting to grab investors' attention as valuations look highly compelling. With this in mind, we continue to follow an approach combining proprietary top-down asset allocation with a detailed country-level assessment which we believe is the best approach to deliver attractive returns to emerging markets investors in the coming years.

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Global Credit Outlook

Researching for certainty

By Holger Mertens, Head Portfolio Manager, Global Credit

> We will elaborate on why we think fiscal and monetary support, liquidity and diversification are the critical factors for investing in 2021

Researching for certainty

The last 12 months have seen a significant rotation of topics discussed at investment meetings worldwide. The agenda has moved from macroeconomic data to infection rates, hospitalization rates, vaccinations and other issues related to the COVID-19 pandemic. The shift is understandable given the impact the crisis has had on financial markets. However, it has proved difficult to forecast the path of the pandemic; experts are struggling as well as politicians and investment managers. It has been challenging to assign a higher likelihood to any of the discussed scenarios. Even with vaccination programs launching, a high degree of uncertainty remains.

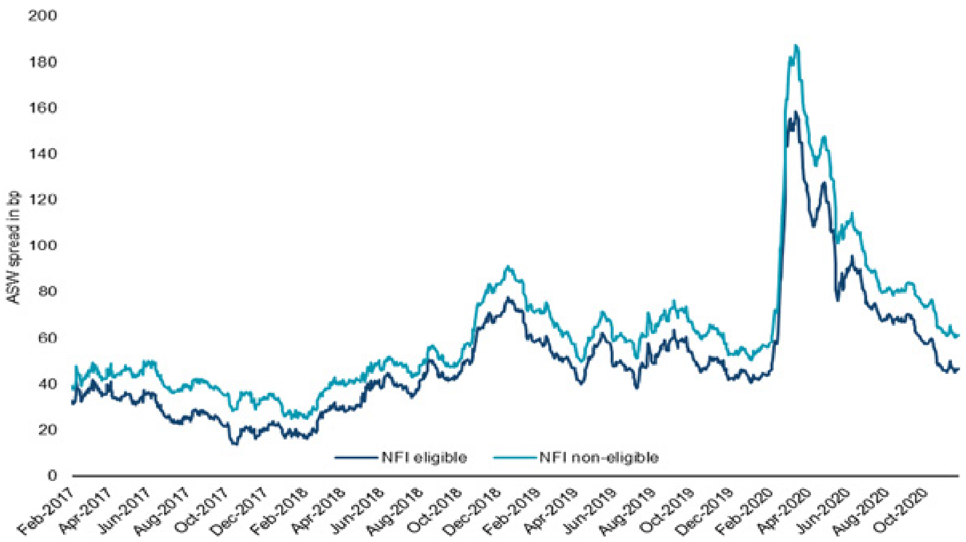
We think that it is extremely challenging to build investment cases on scenarios with low assigned probabilities. We therefore aim to focus our investments on the "knowns" rather than the "unknowns". We believe that building an investment thesis on the former improves the predictably of investment returns.

But what are the "knowns"? Firstly, we can assign a high probability to our forecast that fiscal and monetary measures will remain on an unprecedented scale and therefore support financial markets globally. Secondly, we expect liquidity for credit markets to remain difficult and thirdly we continue to believe that diversification is the only "free lunch" available to investors. All three factors will form the cornerstones of our global credit outlook and investment plan for 2021.

We will elaborate on why we think fiscal and monetary support, liquidity and diversification are the critical factors for investing in 2021.

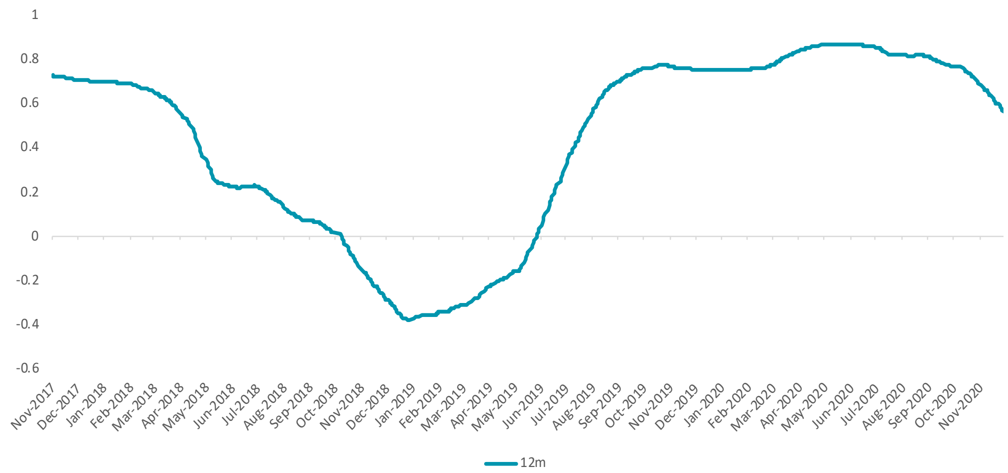
Let us start with fiscal and monetary support. With the ECB raising its PEPP (Pandemic Emergency Purchase Program) in December by EUR 500 million and extending it until March 2022, we now expect the ECB to support the corporate bond market going forward with bond purchases of EUR 10 billion per month on average. Even with a lower number of monthly purchases, the ECB was able to control volatility in the corporate bond market and spread widening was more muted for eligible bonds back in March 2020 (Chart 1). Therefore, our credit research team is focusing now on ECB-eligible bonds. Companies rated BBB or BB still offer attractive spreads but now come with reduced volatility, given the ECB support. One sector we favour in particular and where we see potential for further spread tightening is real estate. Spreads haven't returned yet to fair value and we still see attractive opportunities for our global credit strategies.

Chart 1: Credit spreads eligible vs non-eligible bonds



Source: Bloomberg, ECB, iBoxx, UniCredit Research

Chart 2: Correlation between UST 10-year and CGB 10-year yields



Source: Bloomberg, Nikko AM

The second area to single out is liquidity. Over the last decade the asset management industry enjoyed significant growth while banks had to decrease their trading books following the GFC. This situation is now creating regular imbalances in bond trading that leads to spikes in bid-offer spreads, even making bond trading impossible at times. The last time we experienced such an imbalance was in March 2020 when the COVID-19 pandemic started impacting credit spreads. We think a solution to the reduced bond liquidity is an increased use of CDS.

Our liquidity assessments of the last couple of years have shown that liquidity of CDS indices is superior to that of bonds. An increased use of CDS enables investors to change the risk profile of their portfolios quickly and efficiently when bond trading is expensive or even impossible.

Last but not least of the "known" factors is the benefit of diversification. This might not sound new and innovative and in the past we have more than once experienced asset classes that were supposedly uncorrelated suddenly move in the same direction in a crisis situation.

But extensive research has convinced us that it's possible to identify asset classes that have low to negative correlation. Often these opportunities can be found in the Asian fixed income market. For example, Chinese and US government bonds tend to have a low correlation at certain periods (Chart 2). Compared to G7 countries, China still has a higher growth rate and yields which makes its government bonds an attractive investment for a broadly diversified portfolio.

The three factors discussed above will play a pivotal role in our credit strategies for 2021.

We will also focus on lower rated companies with ECB and state support, but only after they make it through our well-defined research process. The main benefit of focusing on lower rated bonds in 2021 will be their above-market yield and the strong spread income they potentially offer.

Still, an above-market yield often goes hand in hand with an above-average risk profile for portfolios. Screening the Asian fixed income market for diversification opportunities and using CDS indices to control liquidity risk are ways to mitigate such above-average risk profiles, in our view.

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New Zealand Fixed Income Outlook
Jumping the paradox

By Fergus McDonald, Head of Bonds and Currency, New Zealand

> "Industries that have previously been the lynchpins of our economy, such as tourism and hospitality, will continue to require support and stimulus throughout 2021"

An economic outlook for 2021 and beyond

The year 2020 was a year of fear, anxiety, uncertainty and global economic defibrillation. And yet for investors and owners of assets—from art, to gold to property—it was also one of growth, prosperity and increasing confidence. This asset price pop should not have come as a surprise to anyone following our commentary through 2020, however the wider reaction has been one of disbelief.

New Zealand is still by any rational prognosis in a slump, but a far shallower one than many expected. The economy had been forecast to contract by 5.5% in 2020 and only recover to edge past its pre-COVID size by mid to late 2022. The latest data released shows the economy has already recovered from the severe contraction in the first half of 2020—however industries that have previously been the lynchpins of our economy, such as tourism and hospitality, will continue to require support and stimulus throughout 2021 and possibly beyond. So how can we explain the paradox of asset growth within a still-contracted economy? And is confidence merely illusionary or genuinely sustainable?

Confidence comes as a consequence of global economic stimulus measures, which have made money both cheap and plentiful. In this regard, nowhere is a sign of changed times more evident than in Greece, where back in 2012 the yield on five-year bonds was greater than 60%. Today these five-year bonds yield just 0.04% and the yield on two-year bonds has slipped into negative.

While confidence from low interest rates inspires consumer activity, as currently evidenced here in the residential property market (more on this later), the major beneficiaries are actually governments' balance books. Here in New Zealand, although our debt burden is forecast to rise from around 20% to 50% of GDP, the nation's interest bill will soon be significantly lower as high cost debt is replaced by low cost debt.

When a tranche of NZD 11 billion government bonds paying a 6% coupon mature in May 2021, they will likely be refinanced at around 1%, creating an annual saving of NZD 550 million. With a further NZD 700 million annual saving forecast for 2023 on the maturation of NZD 15.7 billion worth of bonds currently paying a 5.5% coupon rate, the government continues to borrow to support the economy, confident in the knowledge that it can afford to do so. And this confidence echoes beyond the beehive.

Before we get to the topic du jour, our "out of control" housing market, it's worth suggesting that those advocating that asset prices across the board may have already run their race take note of history. Since the early 1940s the average US bull market in equities saw a gain of 15% over 52 months, while the average bear market would be characterised by a 32% fall over 11 months. To put this another way, bull markets go about five times further and five times longer, so we're unlikely to have scaled any peaks just yet.

And so, to the housing market we go, where the increased buying power afforded by low interest rates and constrained supply are collectively fuelling price rises. Short term interest rates are not about to rise anytime soon, so without a heavy-handed regulatory response, it's hard to see this trend reversing until supply more evenly matches demand.

> "we can head into 2021 with a lightness of step and confidence that makes us the envy of many around the globe"

Incidentally, the dominant market influence of supply meeting demand is there for all to see even amidst the current housing boom, as house prices in Christchurch remain more stable than elsewhere in the country on the back of its large post-earthquake residential build programme.

Increasing supply has wider benefit beyond the purely economic, but as we get used to the seasonal media focus on house prices, it's worth noting that rising prices are better for the economy than falling ones. The impact of the housing market touches numerous parts of the economy and, for many, a house is a family's largest asset. In today's weakened economic environment and vulnerable jobs market, it would be devastating if a family's largest asset quickly was to become their largest liability and source of further anxiety.

As it is, generally speaking we can head into 2021 with a lightness of step and confidence that makes us the envy of many around the globe. This Christmas we will, touch wood, travel around the country in our droves, supporting local businesses of all kinds, giving further stimulus and hope of an economic revival. But how long this euphoria lasts and what the new drivers of growth will be in 2021 and beyond are questions still without satisfactory answers.

Productivity growth has always been elusive in New Zealand, and with previous drivers of economic growth such as migration, international students, cruise ship arrivals and tourism unlikely to re-emerge as a force in 2021, it would be unwise to rely on this occurring in the near term. Agriculture and horticulture are both promising, and the technology sector has been touted as the next big thing, but without a new major driver of growth, and the very real possibility of a net outflow of Kiwis once international travel bubbles emerge and the vaccine comes into play, there's no guarantee that our economic reality will match our ambition.

Leveraging New Zealand's exposure to fast growing economies such as China remains an important economic recovery strategy. But our greatest hope for emerging successfully from this period of "confident slump" is that the low and plentiful cash stimulates risk taking and productive investment activities throughout the economy, jumping the paradox and propelling New Zealand into its next phase of prosperity. ●

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