Investors entered 2018 optimistic following the stellar returns across most asset classes in 2017. However, at UBP, we cautioned that more limited – though still positive – performances were likely in 2018. As we enter the summer, despite volatility in global equity, fixed income and foreign exchange markets, equities have gained a modest 2.6% while bonds have dragged -1.4% as interest rates have risen and credit spreads widened.

Our focus on risk management in the fixed income arena has proved prudent. Insurance-linked ‘catastrophe’ bonds and structured credit have provided attractive alternatives for investors who benefitted in past years from the gains in high-yield bonds.

In equities, an earnings focus on the US has kept us positioned in global energy, which has outpaced broader indices during the first half of the year. A growth and technology bias has continued to be warranted as return prospects in more value-oriented sectors remain moderate.

With renewed volatility across asset classes, long volatility, alternative and structured product strategies helped us navigate the shifting geopolitical and economic landscape of early 2018.

As we look towards the second half, investors should take solace from the fact that both the global economy and earnings remain robust. We continue to lean on their ongoing growth stories as drivers for modest, though positive, returns until year-end. As in the first half of the year, active management will be important in mitigating risks as well as identifying opportunities.

“Despite volatility, stay focused on equities”

Later in this letter, we highlight the strategies to manage the risk of the coming quantitative easing exit by the European Central Bank (ECB) as well as the long-term opportunities presented by the opening up of onshore Chinese equity and bond markets.

As ever, we look forward to working alongside you to develop an investment portfolio that meets your needs.
The China story has been an alluring one since the market began opening up in earnest in the early 1990s. However, long-term investors in China recognise that the promise of the world’s largest country by population and the world’s second-largest economy has fallen short of expectations in many respects for equity investors. This trend looks set eventually to reverse as China begins to open up its mainland-listed bond and equity markets to foreign investors.

China’s onshore bond market is already the third-largest in the world despite offering only limited access from the outside. As they slowly open up to foreigners, China government bonds and those issued by state-backed policy banks are yielding 3.6–4.5%, representing a substantial premium to other large economies as well as other similarly A/AA-rated peers.

With local inflation running at 1.8%, investors receive not only a premium yield in nominal terms, but a positive yield adjusting for inflation. In addition, low correlation with US and European interest rate cycles means that Chinese government bonds provide added diversification against the rising rate trends seen across Western economies.

Furthermore, we expect that the government will look to pivot its policy toolkit for managing economic growth. Having relied heavily on debt-financed fiscal spending since the 1990s, the new Xi leadership will look to deleverage and lean more on liquidity management to support economic growth, much as the US and European central banks have done since 2008.

"Time to build strategic exposure to Chinese fixed income and equities"

Like in the West, where investors have benefitted from the resulting long-term decline in US and eurozone bond yields, a similar policy in China should reverse the stable yield trends seen since 2006 and also support a drop in Chinese yields for several cycles. This will be in stark contrast to our expectation of a lasting regime of rising bond yields facing US and European economies.

Within Chinese equities, investors have not been well rewarded for taking a buy-and-hold, passive approach. They have benefitted more from investing in line with Chinese government policy priorities and adjusting to them (see table).

To continue capitalising upon such a strategy, global investors increasingly need to turn to Shanghai- and Shenzhen-listed companies rather than the typical Hong Kong- or New York-listed names common in China portfolios. While investors can access Chinese industry leaders in IT, banks and telecoms offshore, new, strategic government priorities such as domestic consumption, healthcare, and advanced manufacturing are better accessed via emerging growth companies listed onshore in China.

With the opening up of Chinese markets, investors are being given an opportunity to build strategic exposure to both fixed income and equities there, to capitalise on Chinese government policy prescriptions in the decade ahead.

<table>
<thead>
<tr>
<th>5-yr plan</th>
<th>Policy objective</th>
<th>Company</th>
<th>Sector</th>
<th>Period</th>
<th>Total return (CAGR)</th>
<th>H-share index</th>
<th>Rel. perf. in foll. 5y</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986–90/1991–95</td>
<td>Increase export volumes by 36%</td>
<td>Li &amp; Fung</td>
<td>Exports</td>
<td>1992–2000</td>
<td>55.01% (10.24%)</td>
<td>(26.5%)</td>
<td></td>
</tr>
<tr>
<td>1996–00</td>
<td>More infrastructure</td>
<td>China Mobile</td>
<td>Telecoms</td>
<td>1997–2005</td>
<td>54.97% (19.88%)</td>
<td>(2.2%)</td>
<td></td>
</tr>
<tr>
<td>2001–20</td>
<td>Speed up technological progress</td>
<td>Tencent</td>
<td>Internet</td>
<td>2004–present</td>
<td>58.76%</td>
<td>13.77%</td>
<td>n/a</td>
</tr>
<tr>
<td>2006–10</td>
<td>Increase share of service industries</td>
<td>China Construction Bank</td>
<td>Banking</td>
<td>2005–2010</td>
<td>27.44%</td>
<td>22.02%</td>
<td>1.7%</td>
</tr>
<tr>
<td>2006–10</td>
<td>Increase share of service industries</td>
<td>China Life Insurance</td>
<td>Insurance</td>
<td>2005–2010</td>
<td>40.80%</td>
<td>22.02%</td>
<td>(1.4%)</td>
</tr>
<tr>
<td>2011–15</td>
<td>Rebalance towards consumption</td>
<td>Brilliance China Auto</td>
<td>Autos</td>
<td>2011–present</td>
<td>20.33%</td>
<td>8.31%</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Sources: Central Committee of the Communist Party of China, Bloomberg Finance L.P. and UBP
In its June 2018 meeting, the ECB announced that it will end its QE purchases by December, approximately one year after slowing the pace of its bond purchases, a path already followed by the US Federal Reserve in 2013 and 2014.

Despite the similarities with the US quantitative tightening strategy, the single currency area’s central bank has to navigate a much more complex risk backdrop. Shifting political winds among its member states, stalling progress towards the UK’s exit from the European Union, burgeoning trade pressures with the US, and rising geopolitical tensions all pose credible risks to current growth.

“Consider alternatives to EUR bonds”

Given the lower starting levels of both short-term and long-term rates in the eurozone as well as lower potential economic growth rates, we expect that the ECB’s tightening process may be more gradual than the Fed’s. Judging by the US experience, we anticipate that the ECB will moderate both the magnitude and speed of its exit based on the development of growth, inflation and overall financial conditions. Thus, investors should be less concerned that the change in the ECB’s policies will be destabilising for the eurozone economy.

Despite this, we expect fixed income investors in the eurozone to continue to face a more challenging environment. While German Bunds and higher-quality euro corporate credit should benefit in relative terms, their low absolute yields provide little in the way of a return prospect even if yields stay stable, and will offer only a limited cushion if yields rise slowly in the months ahead.

As an alternative, we see AAA-rated, callable Danish mortgage bonds as a liquid, comparatively higher-carry choice for risk-averse euro-referenced investors.

For investors who have sought refuge in peripheral eurozone government bonds or lower-rated corporate credit in search of higher yields, we view US dollar-denominated asset-backed securities and insurance-linked ‘catastrophe’ bonds, hedged back into euros, as well as merger arbitrage strategies, as a credible alternative to secure yields while diversifying away from the prospect of further widening in corporate credit spreads, a trend that began earlier this year. ♦

Contact us for a more detailed analysis of Europe’s quantitative tightening and opportunities in China.
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