2019 Asia Market Outlook

December 17, 2018

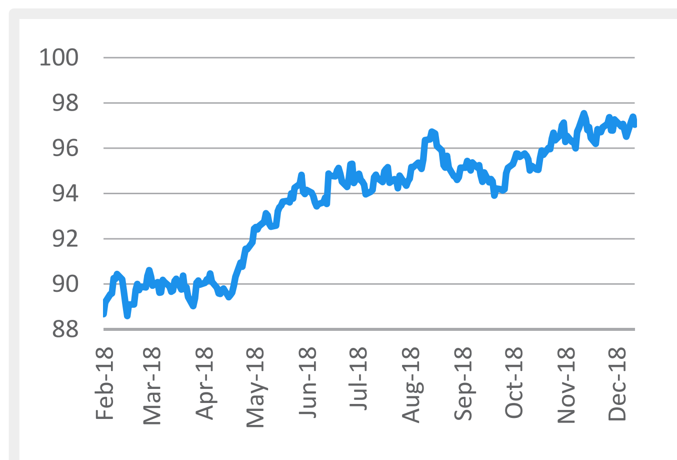
FIERACAPITAL

The CIO Perspective: *Asian Markets will Benefit from Softer Fed Policy*

At the start of 2018, emerging markets had only priced two rate hikes into the market for the year. However, Fed policy has been more restrictive than markets expected, and both Asian equity, currency, and credit markets have suffered as a result. We believe we have reached a turning point in Fed policy which will likely prove supportive of Asia-Pacific currency, equity, and select credit markets, and will result in improved capital flows to those nations.

Fed policy tends to impact Asia and emerging markets for a series of reasons. Certainly, the US is the largest trading partner for many nations in the region, and anything that slows down the world's largest economy on the basis of nominal GDP can be troublesome for them. From the perspective of currency risk, a stronger dollar makes it more expensive to pay back US dollar-denominated debt. This year, these challenges have been compounded by fears of a tariff war and the combative trade-related rhetoric launched by the US president.

The US Dollar Rose Steadily Through 2018



Source: Bloomberg, US Dollar Index as of 12/13/2018

However, midterm elections in the US, combined with softer US and global economies, may give the Fed reason to decelerate the pace of rate hikes and perhaps even pause after their hike in December. This would be a positive development for Asian equity, currency, and credit markets. In that context, this year's sell-off in emerging Asia is an opportunity for investors who are able to weather the market volatility. Valuations, cheap relative to US and European markets at the start of 2018, are especially favorable given the market correction. Additionally, if the rise in US rates has peaked in the intermediate term, we should expect US investors to renew their search for short duration yield. The rates offered by hedged direct lending strategies in Asia look particularly attractive.

- *Jonathan Lewis, CIO, US Division*

The Equity Perspective Page 2

Cautious but Constructive

- *Anindya Chatterjee, Senior Vice President and Lead Portfolio Manager, Emerging Markets Select*

The Credit Perspective Page 3

Nervous Markets Create Opportunity

- *Robert Petty, Co-CEO and Co-CIO, Clearwater Capital Partners*

Equity: *Cautious but Constructive*

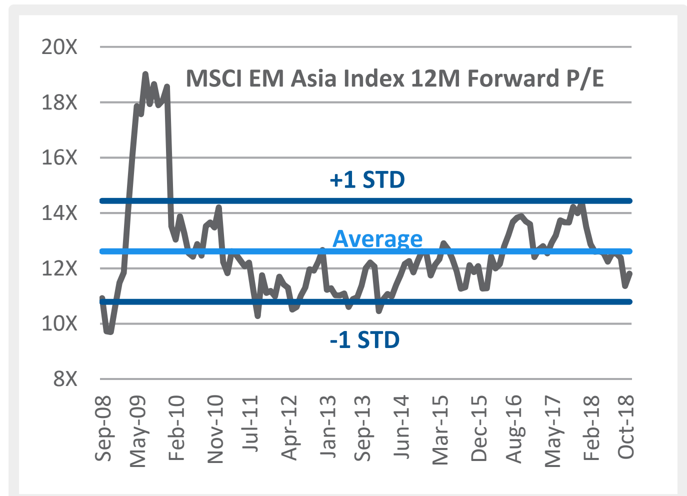
-Anindya Chatterjee, Senior Vice President and Lead Portfolio Manager, Emerging Markets Select

Triggers for a Possible 2019 EM Rally. Investors are scouring for positive catalysts for EM equities ahead, following a challenging year. A sharp decline in crude oil prices in 4Q 2018 and hints of US rate deceleration provide some fuel to rekindle investors' risk appetites. President Trump's meeting with Xi Jinping in Argentina has also raised hopes of a reprieve in trade tensions and increased scope for diplomatic dialogues and negotiations between China and the US. We won't venture to take a forward-looking view on crude oil prices, but much of EM Asia stands to benefit if they stay benign or even rangebound with modest upside. The US dollar strength in 2018 may revert as we go into 2019, further bolstering Emerging Markets. With this in mind, we consider most EM Asian currencies to be fundamentally undervalued, and a more modest ascent in 2019 US interest rates should augment these valuations. All these are credible positive triggers for EM equities - particularly in Asia.

Cause for Caution. The above silver linings notwithstanding, we expect the threat of economic slowdown in emerging markets, especially in China and India, to be of fresh cause for worry to investors. We also anticipate that markets' concerns of a US recession would continue to rise as the slow-moving expansion continues. Further, it is unlikely that US-China trade relations will see speedy resolution. This trade dispute goes beyond the large trade deficit numbers to much more complex issues of intellectual property rights, global cyber security and technology-turf dominance. We expect to see prolonged clashes between both nations, further contributing to market uncertainties, and believe the intent and objectives of the two nations are unlikely to meet any easy resolution. Geopolitics remain a wildcard. Possible tensions in the South China Sea or renewed nuclear defiance from North Korea would be cause for volatility. Further sanctions against Iran and crude oil dynamics among the recent geopolitical complexities in the Middle East would similarly serve as unpredictable but plausible threats that loom ahead in 2019.

Valuations Provide the Comfort to Stay Constructive on EM Equities. A lasting question looks to whether EM equities can perform on the back of a correction in US equities. Historical data does not provide any comfort for such hopes. Most market pundits have written off the prospects for any upside in EM equities in the event of a rollover in US equities in 2019. However small, some positive hopes for EM equities come from the comfort of valuations. EM equities have already corrected substantially in 2018. Valuations based on standard metrics like price-to-earnings and price-to-book are now well below long term averages and closer to one full standard deviation below the long term mean levels. With this recent drawdown, EM equities as an asset class have underperformed US equities over the past cumulative ten year period. *The unpredictable, as often as markets are, can happen.* **Despite these sources of caution, we are hopeful for the prospects of a continued uptick and resilience in EM equities in 2019.**

EM Asia Valuations Have Reached Compelling Levels



Source: Bloomberg as of 12/13/2018

Credit: *Nervous Markets Create Opportunity*

-Rob Petty, Co-CEO & Co-CIO, Clearwater Capital

We are in an environment where the interplay of global politics has been more impactful on the investment market than is typical. While other regions have seen their share of upheaval, Asian markets have been particularly impacted by regional and global politics over the past year and we expect to see this situation continue into 2019. One good illustration of this is how rates for Asian high yield spreads have diverged significantly from the US and Europe over the course of 2018. We see three major drivers for this phenomenon: the ongoing US/China trade war and its eventual impact on both economies and global trade, the tightening credit environment across the region, and general uncertainty of being late in the credit cycle but not knowing when or how it will end. We expect all these to keep the markets nervous for the foreseeable future, creating opportunities to invest in Asian corporate credit at attractive rates.

The trade relationship between the world's two largest economies is complex and the problems underlying the trade war that began in 2018 go back decades, so it seems unlikely that any long-term resolution will be reached during a 90-day truce. Both the US and Chinese leadership are being watched closely by their domestic audience, so the optics of how it plays out are very valuable. After years of consolidating power, Xi Jinping sits at the head of all tables in China. Any retreat at this point could be seen as a loss of face (at best) or a sign of weakness (at worst). From the US perspective, the president was just handed a mid-term defeat in the House and would like to show a win for his hardcore constituency. As both sides look for short-term gains and long-term victory, we believe that tensions will continue in the near term, even if a deal, path to de-escalation, or complete restructuring of world's most important trading relationship is eventually found.

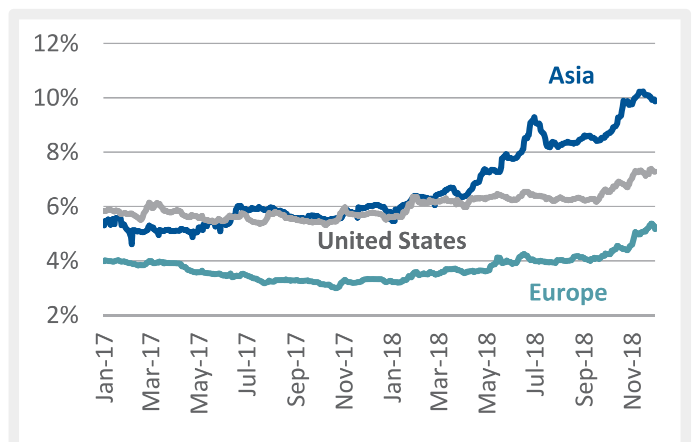
While the China-US tensions have been grabbing headlines and shaking up global markets, the longer-term story of liquidity tightening in Asia has been consistently creating opportunities to invest in credit across the region.

The industry consolidation and pullback of banks that took place in Europe and the US directly after the global financial crisis is still an ongoing phenomenon in Asia, which is leaving many strong companies without access to sufficient capital.

For the past several years, the Chinese government has been focused on cleaning up and maturing the financial sector, in part by developing a deeper onshore credit market. The credit tightening that started in 2016 and continued until mid-2018 has resulted in significant financial de-risking which was necessary to stabilize the sector. Chinese banks have been encouraged to recognize and resolve more of their non-performing loans, while the government has also focused on building out a long-term bond market and reducing the role of the shadow banking sector in onshore lending. We believe that tighter loan standards and increased oversight will continue to constrain China's ability to expand credit, especially to companies in the private sector. Banks have not built the underwriting and risk management infrastructure required to manage private sector lending, leaving the credit space underserved and undervalued in the near to mid-term, which in our estimation will allow us to find compelling investment opportunities in good companies.

This tighter credit environment, combined with the repricing the market has seen already in 2018 – with public debt markets down up to 7% year to date across Asia high yield - is creating interesting valuations even at the top of the capital structure.

Asia high yield has broken out in 2018



Source: Bloomberg Barclays as of 12/13/2018

Asia high yield has widened versus the US and Europe by over 500bps in 2018 as banks have been increasingly hesitant to lend and capital has dried up, and we believe this yield opportunity will persist in 2019 as defaults remain high and continue to reinforce the liquidity and consolidation trends. We expect to see 10-15% rates on senior secured, performing private debt in developed Asia and the offshore USD-denominated bond market. These trends create the type of nervousness and uncertainty that creates buying opportunities for credit with strong underlying fundamentals, tight security packages, and developed country law. While we anticipate that markets will continue to react to headlines, we believe that it is possible to identify long-term survivors and find compelling value with good downside protection and low correlation to developed markets.

We have always believed in developing deep sector expertise and doing in-depth analysis on our target investments. We focus on credit backed by hard assets and supported by underlying cash flows that we can diligence. We have identified a few sectors as opportunities in the coming year: energy, real estate, and infrastructure. Within specific countries, these sectors saw a relatively higher retreat of bank lenders and industry consolidation over the past year. In addition, we will be closely monitoring the distressed credit space in Asia in 2019, particularly India and China. In India, we have historically been cautious about the time to resolution (and proven right in the past years), but as we see higher rates in a weaker overall credit market we are closely watching the first credits coming through India's new bankruptcy code and court procedure. China, meanwhile, has seen more than $100 billion trade in the non-performing loan (NPL) space, and with the increase in onshore RMB interest rates we believe that market will become more interesting.

We consider China to be the anchor economy in the region. It is one of our core convictions that China not only has the fiscal capability and asset base, but also the political will to continue to support their economic priorities. With that said, we believe the markets will continue to trade at a discount to the US and Europe based on trade tension and uncertainty – which means we do not expect our set of buying opportunities to thin any time soon. With our experience investing through credit cycles in Asia, we believe the Asian credit space continues to hold diverse opportunities for yield with strong downside protection even as defaults and rates continue to rise.

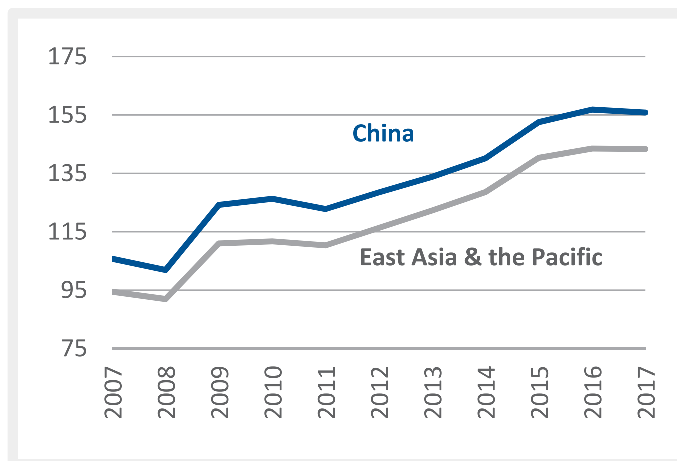
A note on distressed Asian credit as a portfolio diversifier / mitigating currency risk while building international exposure to a portfolio:

Over the intermediate term, Asia has a separate set of business cycles that do not necessarily coincide with or depend on the single dominant US Fed cycle which has been the overarching global theme for the past 1-2 decades.

With China's distinct economic cycles in particular, we expect that markets will begin to see a disassociation of correlations in Asia markets versus the rest of the world in the medium term. While global headlines will always boost correlations between country markets, country-specific headlines can create unique opportunities as capital tends to flow towards the news.

Finding opportunities that are either hedged to the US dollar or dollar-denominated can allow investors to allocate exposure to foreign markets while minimizing exchange rate volatility.

Bank Debt as a Percent of GDP



Source: World Bank as of 12/13/2018

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Bloomberg Barclays Asia ex Japan Corporate Credit High Yield Index tracks the performance of USD-denominated government-related and corporate high yield debt of the Asia ex-Japan region.

MSCI Emerging Markets Asia Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the Asian emerging markets.