alpha
WATCH

Recession risks

Uncertainty the new norm

July 2016

Contents

Executive summary	2
Introduction	3
Europe disintegrating?	3
China credit bubble burst	5
US – the next recession	8
Extreme oil prices	14
Geopolitical risks	14
Conclusion	15

Executive summary

Seven years after the Global Financial Crisis (GFC), there are concerns that the next global recession is due, as suggested by global market volatility and uncertainty.

Economic growth across Europe has been slow and uneven. The UK's vote to leave the EU has compounded the political and economic uncertainty in the region. The spread of euroscepticism, austerity measures and escalation of the banking crisis that never really went away could further derail economic growth in the EU.

As economic growth slows in China, high debt levels, rising leverage and defaults, and the risk of another housing bubble are causes for concern. Nevertheless, we do not expect a hard landing as there are ample assets and bank deposits to back up the loans, much of which are owed by state-owned enterprises (SOEs) to state-owned banks. The odds may however rise over the next few years if the debt levels continue to rise unabated and if the officials mishandle or hasten the transition reform process resulting in panic and a loss in confidence.

In the US, corporate earnings have declined and companies could be facing a credit bubble in the bond market, while there are also concerns about home prices and the stock market. Market uncertainties could pick up as the US Presidential elections in November nears. Premature increase in interest rates could dent consumer spending, a major growth engine in the US, which has been holding up and supporting economic growth.

Individually, the above risks may not be severe enough to cause a global recession, but the longer the malaise drags on, the greater the destabilising forces. Increasing geopolitical tensions and terrorism add on to the economic frailty. All it takes could be a trigger or confluence of events to spark panic and a global crisis. Governments around the world are expected to continue with loose monetary policy and fiscal stimulus to keep their economies afloat albeit at anaemic growth rates. As interest rates stay low, cap rates are likely to remain compressed. Investors will therefore have to take some risks to remain invested, but hedge against the possible global recession by investing more selectively in markets with strong fundamental growth drivers and real estate demand, and avoiding aggressive pricing and over-leveraging.

Authors

- Chua Chor Hoon
  Director,
  Research
- Wilson Liew
  Vice President,
  Research
- Lee Lay Keng
  Vice President,
  Research

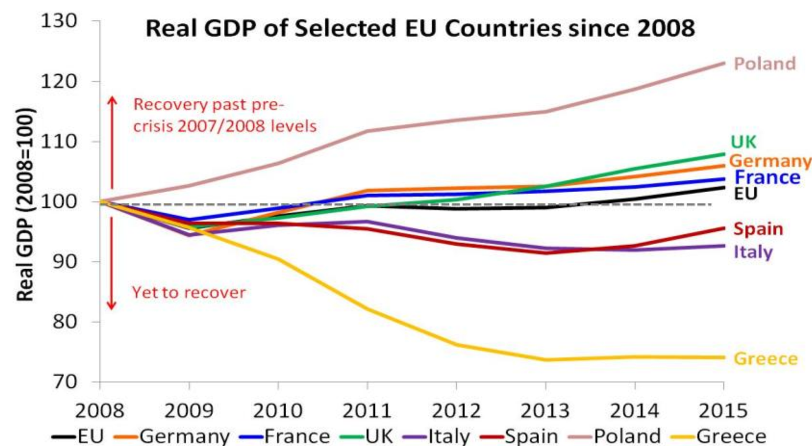
Introduction

Seven years after the GFC, concerns have resurfaced over whether the next global recession is due, as suggested by global market volatility and widespread economic downgrades. Quantitative easing has increasingly become less effective and more recently, the outcome of the UK referendum on membership of the EU ("Brexit" vote) has increased market volatility and uncertainty. This paper explores the possible risks that could precipitate another global recession and the implications on real estate investment.

Europe disintegrating?

GDP within the EU has recovered to above the pre-2008 crisis level in 2015, but growth has halved to 1.2% p.a. in 2010-2015, compared to the pre-crisis period of 2000-2007. The growth recovery has been uneven. Among the five largest economies (Germany, France, United Kingdom, Italy and Spain), which collectively makes up more than 70% of EU GDP, economic activity in Italy and Spain is still below 2008 levels, as growth was hampered by high public debt levels and austerity measures (Figure 1). The EU also faces other political and economic challenges that could further derail its growth.

Figure 1: Uneven growth recovery in EU



Source: Eurostat, AIP Research

Brexit

The UK voted 52-48% to leave the EU at the referendum held on 23 June, leading to world-wide stock market panic in the immediate aftermath and the sterling plunging by over 10% against the USD[1]. The future of the UK itself is also uncertain as Scotland has indicated that there could be a second referendum on Scottish independence, after 62% of voters in Scotland voted to remain in the EU versus the overall UK vote to leave.

The economic impact on the UK in the next 2-3 years is significant. There will be much uncertainty before the trigger (unless there is a second referendum with a "remain" result) and during the 2-year negotiations (unless extended). The medium- and longer-term economic effect on the UK will depend on the trade deals that it negotiates with the EU and other countries after its exit. Nevertheless, the UK remains an attractive business destination even without EU membership,

[1] As at 10 July 2016.

given its huge market (it is the world's 5th largest economy) and its underlying fundamentals such as strong rule of law, use of English language, skilled labour force and location in a convenient time zone between US and Asia.

Brexit on its own will not lead to a global recession. The direct impact of a weaker UK on Asia and the US is limited given the insignificant trade flows. Asia's goods exports to the UK is less than 1% of Asia's GDP and less than 4% of US goods exports are to the UK. Nonetheless, a weaker UK could affect economic activity in the rest of EU and slow down the rest of the world, as the EU accounts for more than 20% of the world economy and ~15% of the global trade in goods.

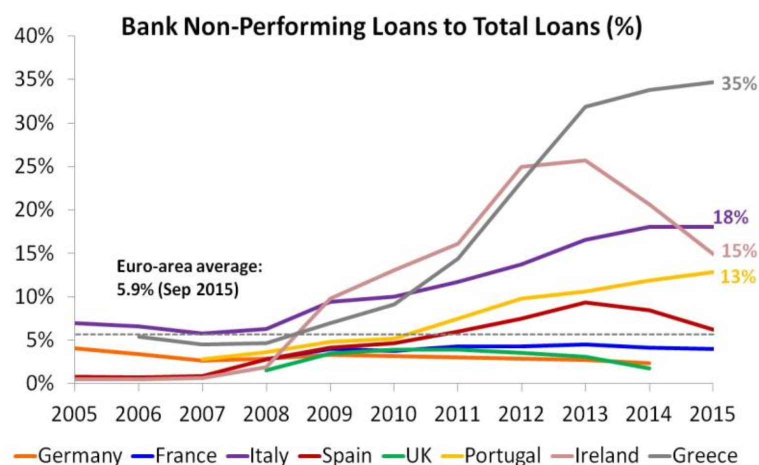
Rising euroscepticism

Eurosceptic sentiment is on the rise in other EU member states as the economic weakness exacerbated by migrant inflow and terror attacks had raised criticisms about the Schengen, one of the basic tenets of the EU, as a major security flaw. Eurosceptic parties in France, Italy and the Netherlands are already calling for referenda in their own countries. More exits from the EU will have greater ramifications for the world. However, this scenario is assessed to be unlikely as it is much harder for eurozone countries with single currency than the UK to break away, unless they are forced to the corner with inflexible and harsh EU aid requirements.

European banks under pressure

The GFC left many EU countries with high levels of non-performing loans (NPLs). The current low or negative interest rate environment and higher capital requirements have also impacted banks' profitability. Although the average NPL ratio in the EU has decreased to 5.9% in September 2015 from 6.4% in December 2014, this is still high compared to other developed countries. Besides Greece (35% at end-2015), other countries with double-digit NPL ratios include Italy, Portugal and Ireland, although the ratio has fallen steadily in Ireland (Figure 2).

Figure 2: High levels of NPLs in some EU countries



Source: IMF Financial Soundness Indicators, AIP Research

Of particular concern is Italy, which has EUR360 billion of NPLs, more than 20% of its GDP. About EUR200 billion of these NPLs are deemed "*sofferenze*", the worst type of bad loans, owed by debtors who are insolvent. Weak economic growth and

legal and institutional impediments to disposing NPLs contributed to the rise of the NPL ratio in Italy from 6% of total loans at end-2008 to 18% by end-2015. The EU aid rules requiring creditors to bail-in before government funds can be injected into the banks is hindering the clean-up as many of these creditors are retail investors, making it politically difficult to do so. Italy is the EU's 4th largest economy and the world's 8th largest economy so a financial crisis in Italy will have significant spill-over effects to the rest of Europe and the global economy.

Recession in the EU not likely in the near-term

The European banking crisis since GFC was never resolved, and the austerity programmes have stymied investments and economic growth. Notwithstanding the negative impact on growth sentiment following Brexit, a recession in the EU is not likely in the near-term. The European Central Bank will remain supportive of growth and stands ready to provide further stimulus if needed. They could expand and/or extend the quantitative easing programme beyond March 2017 or cut interest rates further, and negotiate to aid the debt-ridden countries. EU growth however is likely to remain anaemic without any major stimulus nor catalyst to boost investments and productivity, and given the limited impact of monetary easing. The risk of a recession will increase if political uncertainties snowball as there are several key elections next year in France, Germany and the Netherlands or if the banking problems escalate in the face of strict EU aid rules. These could all threaten the future existence and viability of the US$16-trillion single market, with significant impact on the global economy.

China credit bubble burst

High leverage to continue increasing

Another major global source of concern is China's high debt-to-GDP ratio, which has climbed from 170% in 2006 to estimates ranging from 250% to 280% in 2015. Corporate debt alone accounted for around 160% of GDP - twice the level as in the US. The debt level is expected to continue to rise as monetary policy is loosened, the housing market is stimulated and reforms are not happening fast enough to reduce leverage.

As economic growth slows to a 25-year low, the worry is that a credit-fuelled bubble may burst as more debtors fail to meet their debt obligations. The official NPL ratio of Chinese banks is seemingly low at 1.75% as at 1Q2016, but if we include special-mention loans, the potential bad debt ratio will triple to 5.76% of total loans, amounting to a significant ~US$700 billion[2] or 6.8% of GDP. Should there be an ensuing sharp economic slowdown in China, this could drag the world into a recession given the greater trade links that China has with the world compared to one decade ago, particularly in Asia.

[2] China Banking Regulatory Commission

Rising bad loans are manageable

As analysed in our earlier report "China: Are its debts worrisome?" we maintain our view that the Chinese government has the resources to address what is essentially a domestic problem. Most of the loans are incurred within the government system, i.e. central/local governments, SOEs, and state-owned banks. The bank loans are backed by a deep pool of retail deposits resulting from China's high savings rate, which is more stable as opposed to wholesale funding. The average loan-to-deposit ratio (LDR) in Chinese banks is at 67.0%, comfortably below the US banks' average of 79.1% (US LDR peaked at 102.5% at the onset of the GFC) and prudent level of 80-90%. The balance sheet leverage in China's banking system is also not excessive, with the current average leverage ratio (defined as Tier 1 capital divided by total exposure) at 6.4%, comfortably above the current minimum proposed under Basel III requirements of 3.0%.

In the unlikely worst-case scenario that the central government has to back-stop all local government debt and the US$700 billion potential NPL, its total debt-to-GDP would only rise to ~70%, which is still within international standards and well-covered by sovereign assets worth more than three times that[3].

The Chinese government has also been introducing new financial alternatives to address the leverage and bad debt problems. These include opening the bond market, local government debt-to-bond swaps and NPL securitisation (Table 1). The government is exploring debt-equity swaps worth US$155 billion as an avenue to further reduce NPL ratios. In time to come, the stock market is expected to undergo reform with the likely adoption of a registration-based Initial Public Offering (IPO) system in lieu of the current approval-based system. By making it easier for companies to access the equity capital markets, there can be less reliance on debt.

Rising defaults may lead to confidence crisis

We are more concerned that an increase in disorderly bond defaults could lead to a crisis of confidence, a widespread credit crunch and hence further slowing of the economy, as a result of the government attempting to deal with the leverage problem too aggressively. China's bond market has grown substantially over the years and at US$6 trillion, it is now the third largest in the world and approximately half the size of the Chinese banking system.

Despite all the global rhetoric about China's need to deleverage and moral hazard of bailing out companies, there could be widespread panic in an already jittery world when eventually there is a spike in bond defaults in China. The government has increasingly shown its preference for non-strategic "zombie companies" to deal directly with creditors for debt restructuring or face liquidation instead of being bailed out, which is in line with its supply-side structural reform. We expect the government to put more focus into reforming the SOE sector in the coming years, especially after the 19th Party Congress expected to be held in 4Q2017, where leadership renewal (with the exception of President Xi and Premier Li) will take place at China's apex of political power - the Politburo Standing Committee. When the reforms shift into higher gear, it could result in more upheavals and social unrest if not well-managed. This is especially so when creditors are more

[3] Chinese Academy of Social Sciences estimates

diversified in the bond market, as opposed to bank credit where state-owned banks could favour evergreening of SOE loans to stave off outright defaults.

Table 1: Summary of initiatives to reduce bank NPLs

Initiative	Remarks
Local government debt-to-bond swap	RMB5.4 trillion of local government debt has been swapped to municipal bonds since 2015 at lower interest costs and tradable on the bond market. As a result, local government bonds now make up 20.7% of the bond market.
NPL securitisation	The government is reportedly allowing domestic banks to issue up to RMB50 billion of asset-backed securities. In May 2016, Bank of China kick-started the process with an offering of RMB301 million worth of securities comprising RMB1.25 billion of bad commercial loans originated from Shandong. This was closely followed by China Merchant Bank's RMB233 million offering, comprising bad credit card loans worth RMB2 billion.
Debt-equity swap	Details yet to be announced, but state officials have stated that zombie companies and companies with poor credit records will be excluded from the programme.
NPL write-offs	Some banks have already actively written off NPLs, which has led to the average NPL coverage ratio declining from 212.0% in 1Q2015 to 175.0% in 1Q2016. The China Banking Regulatory Commission estimates that RMB2 trillion of bad loans have been written off the banks' books in the past 3 years.
NPL disposal	4 large state-owned asset management companies (AMCs), namely Huarong, Cinda, Orient and Great Wall, were set up in 1999 to buy bad debt from the commercial banks and subsequently dispose of them upon restructuring to maximise recovery. Since then, more than 20 local-level AMCs have also been set up to take on bad debt from their respective local governments and firms.
Bond market liberalisation	To diversify funding sources for local companies, the government has allowed foreign access to the interbank bond market since Feb 2016 and eliminated quotas for most foreign financial institutions buying onshore bonds. Requirements on overseas-incorporated Chinese companies (e.g. Hong Kong-listed Chinese developers) issuing RMB-denominated onshore bonds (also known as Panda bonds) have also been eased since 2015, giving issuers a cheaper source of funds compared with offshore bonds.
Stock market reform	The government is expected to eventually scrap the current IPO approval-based system in favour of a registration-based system, which will be more market-oriented. There are now over 800 companies waiting to go public[4].

Housing market risks overshooting

Another concern is that the housing market risks overshooting as it had in the past with the easing of housing purchase restrictions and lending policies to support growth in the economy. The government's stimulus thus far have led to increased demand filtering down to the lower-tier cities, with prices in Tier-1 cities rising despite tightening measures due to limited supply. If this continues unabated, with new unwarranted investments and fast increase in land and home prices (already seen in some cities), it could add on to more developer default possibilities in future. Residential mortgages is less of a concern right now, as the average loan-to-value ratio is estimated to be below 50%[5], while the default rate for mortgages stood at 0.38% as of 1Q2016, according to the People's Bank of China.

[4] EY Global IPO Trends, 2Q2016
[5] Fitch Ratings

Essentially the key issues for the central government to address are: 1) ensuring sufficient homebuyer demand to sustain destocking in lower-tier cities without creating a bubble; 2) concurrently allowing developers and local governments to reduce gearing; and 3) cooling exuberant demand in Tier-1 cities without causing a crash. We thus expect constant intervention in the housing market to calibrate demand and supply, and restrictions in cities with strong demand.

No hard landing

Our assessment is that a Chinese hard landing is unlikely over the next 12-18 months, although the risk will increase as the leverage rises. Given national pride, its ample resources, desire to avoid social unrest and more traction in the deleveraging reform process, we expect the Chinese government to tread carefully the tight balance between ensuring sufficient economic growth while downsizing underperforming companies or allowing them to go under at a measured pace. Nevertheless we cannot rule out implementation resistance on the ground and ill-conceived policies which can thwart the best of intentions.

US – the next recession

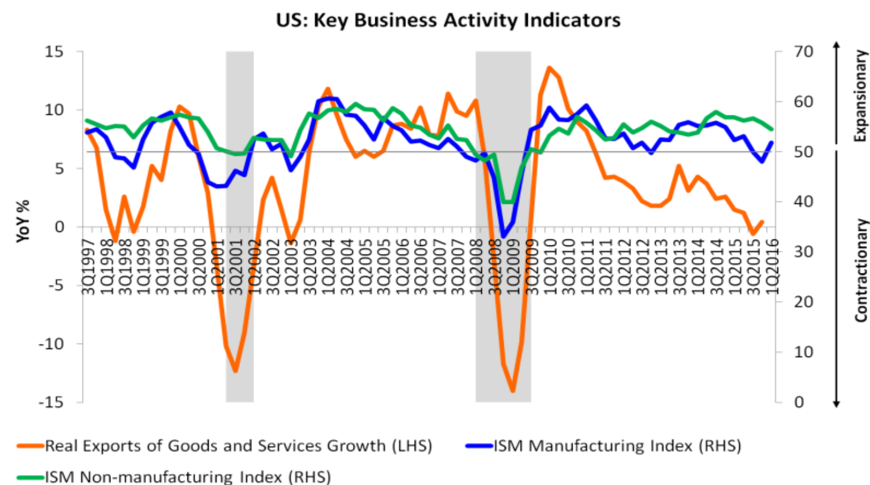
The US could be heading for a recession simply because it is overdue. Historically, recessions happened once every five years on average since 1945, but we are almost seven years into the current expansion cycle. Although the headline unemployment rate has steadily declined to 4.9% and consumption is ticking up on the back of marginal wage growth, not all indicators point to an economy in the pink of health.

Business sector slowing down

US corporate earnings are already heading for a third-straight quarter of decline in what is known as an earnings recession. According to JP Morgan, consecutive quarters of negative earnings growth coincided with a real recession 81% of the time in the last 115 years . The monthly industrial production index has been on a yoy decline since September 2015, mainly dragged down by the mining sector and an anaemic manufacturing sector. Exports of goods have been on a downtrend since 4Q2014 (Figure 3) and consequently, its share of GDP has fallen from ~9.4% p.a. in 2011-2014 to 7.7% as of 1Q2016. The Small Business Optimism Index has also been on a general downtrend since October 2015[6], and the number of corporate defaults has hit a seven-year high, led by companies in the troubled oil and gas sectors, according to Standard & Poor's.

[6] National Federation of Independent Business

Figure 3: Manufacturing remains anaemic while exports continue to slide



Source: Bloomberg, FRED, AIP Research

The labour market is an enigma with conflicting signals. The headline unemployment rate has sometimes been criticized for understating the true level of slack in the job market, because it only includes the unemployed who actively looked for a job in the preceding 4 weeks. Using the broadest measure (U-6) which includes discouraged and marginally-attached jobseekers, unemployment would read 9.6% instead, twice the headline unemployment rate and still higher than the pre-crisis levels of below 9.0%, but well below the post-crisis peak of 17.1%[7]. The Fed's Labour Market Conditions Index, which tracks 19 different labour market indicators, has been in decline since January 2016. The closely-watched nonfarm payroll data was volatile in the past few months. The unemployment rate crept up to 4.9% in June from 4.7% the month before, mainly as 414,000 new workers entered the labour force, suggesting greater confidence in the job market and people are resuming their job searches. The fact that the number of job openings have exceeded the number of hires since February 2015 while real wages have also been increasing since May 2014 suggest that the labour market has indeed tightened and the slack is partially due to skills mismatch, hence a structural issue, as alluded to by Fed Chair Janet Yellen during her most recent semiannual Congressional hearing. Hence, while there are encouraging signs of a stronger labour market, certain weaknesses remain reflecting that all's not well with the business sector.

Stock market reaches new high

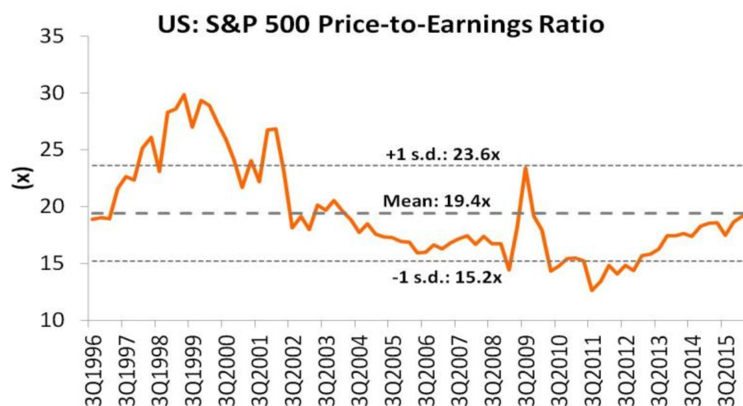
Shortly after the market turmoil caused by Brexit and in spite of the mixed local economy and corporate earnings weakness, the S&P500 once again reached its previous high water mark set in May 2015, leading to concerns that a massive correction could be in store. While it is true that corporate earnings growth remains weak and stocks are getting more expensive, we find that the market as a whole is not excessively overvalued. The S&P500 is trading close to its 20-year Price-to-Earnings Ratio mean of 19.4x, suggesting that stocks are fairly-valued (Figure 4).

[7] US Bureau of Labour Statistics

Recession risks

Uncertainty the new norm

Figure 4: S&P500 trading within 20-year mean P/E valuations



Source: Bloomberg

The two major sources of demand in the US equities market post-GFC have been corporate share buybacks and the Exchange Traded Funds (ETF) market, accounting for ~US$2.5 trillion and US$1.0 trillion of total cumulative demand respectively between 2008 and 2015. Conversely, demand from traditional equity buyers have been mostly negative, particularly households and pension funds, which had cumulatively sold ~US$1.0 trillion each over the same period[8].

Therefore, any significant sell-down on Wall Street could be short-lived, given that companies do not sell the shares they had acquired from buybacks and cheaper stocks may even prompt more buybacks. In addition, Bank of America Merrill Lynch's Global Fund Manager Survey revealed that institutional investors were holding record cash levels of 5.7% in June – the highest since November 2001. Together with record-low sovereign bond yields, any improvement in investor sentiment should lend support to the US equities market. In fact, Merrill Lynch researchers also noted that when fund managers hold more than 4.5% in cash, it creates a contrarian buy signal[9].

Corporate indebtedness up, raising risks in the bond market

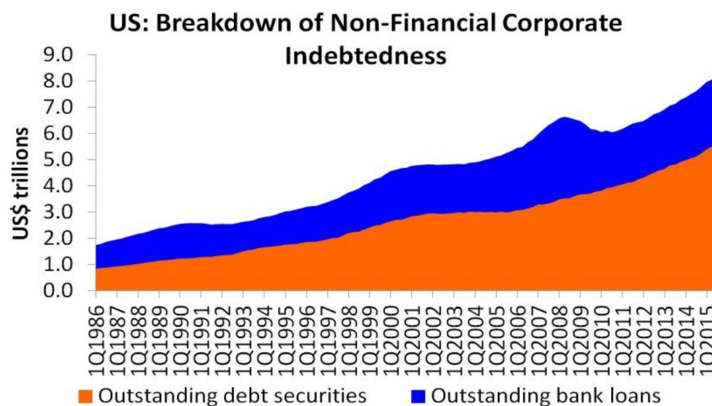
The US could face its own corporate credit bubble, as total debt held by US non-financial corporates grew by US$3.1 trillion from 2009 to 2015, while cash holdings grew by merely US$820 billion[10]. The debt binge has funded acquisitions and share buybacks, and has resulted in 99% of the corporates having a cash-to-debt ratio of 15% - the lowest in the past decade - which leaves them vulnerable to a liquidity crunch.

Nevertheless, the odds of an imminent banking system crisis in the US remain low. Bank loans as a percentage of total non-financial corporate debt declined from 47% before the GFC to just 31% as of end-2015[11], as the bond market provided most of the funding capacity (Figure 5). Although the delinquency rate for commercial and industrial bank loans has been on an uptrend since end-2014, it is still relatively low at 1.51%. The overall delinquency rate of loans at US commercial banks is now at 2.17%, way below the crisis peak of 7.4% (Figure 6). Moreover, regulatory

[8] HSBC Global Research, The Nomadic Investor, Mar 2016
[9] Bank of America Merrill Lynch, Global Fund Manager Survey, April 2016
[10] S&P Global Ratings
[11] US Federal Reserve

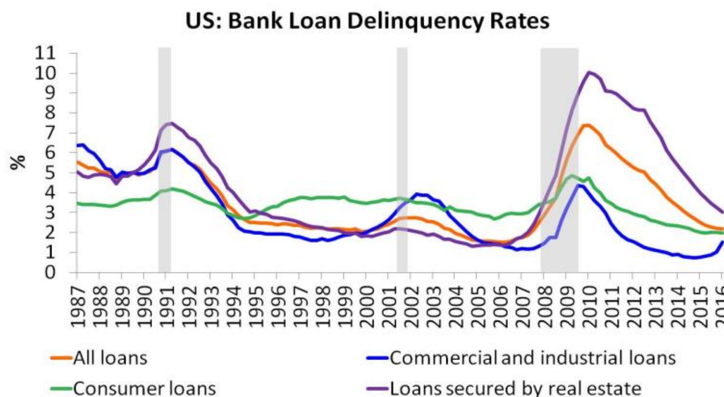
oversight of the banks has improved following the Dodd-Frank Act which took effect in 2010, under which an annual stress test[12] is required for all US-based banks with assets of more than US$50 billion. In the most recent test concluded in June 2016, 30 of the 33 banks tested passed unconditionally. Under the Federal Reserve's severely adverse scenario, the average common equity Tier 1 capital ratio would decline from 12.3% (based on 4Q2015) to 8.4% by 1Q2018, which is still well-clear of the regulatory minimum of 4.5%.

Figure 5: US non-financial corporates have been tapping on bond market



Source: US Federal Reserve

Figure 6: US bank loan delinquency rates back to pre-crisis levels



Source: US Federal Reserve

Within the US$8.3 trillion US corporate bond market, the speculative-grade (BB+ or lower) high-yield segment is likely to be the one to watch closely for signs of distress. Given their inferior credit ratings, high-yield bond issuers are most vulnerable to economic downturns and liquidity crunches. As much as 54% of the US$2.4 trillion worth of high-yield bonds will mature between now and 2020 (32% of total maturing bonds) and their issuers may face refinancing challenges, especially those in commodity-exposed sectors. Considering that, in the same period, another US$2.8 trillion worth of investment-grade debt in the US and US$5.4 trillion worth of corporate debt will be maturing in the rest of the world[13], the debt wall may make competition for funds more expensive, or unavailable, for

[12] The tests are intended to determine if the banks have enough capital and liquidity, risk management and controls to survive worst-case scenarios.
[13] S&P Global Fixed Income Research

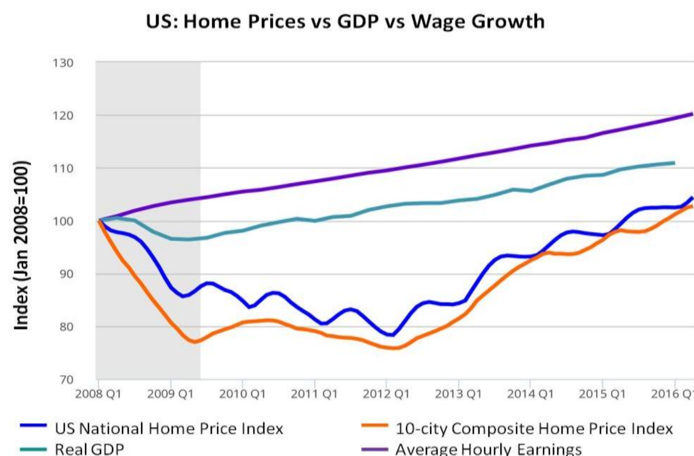
the less creditworthy borrowers, especially when the macroeconomic environment remains weak. In addition, the rise in high-yield defaults could have spill-over effects across the risk curve, pulling up borrowing costs for issuers from various sectors and with even better credit ratings.

Beginning of a new housing crisis?

US national home prices have increased by 32% since February 2012 and the Case-Shiller National Home Price Index is now just 2.7% off the pre-crisis peak registered in June 2006, spurring some concern that the US is on the cusp of a new housing bubble.

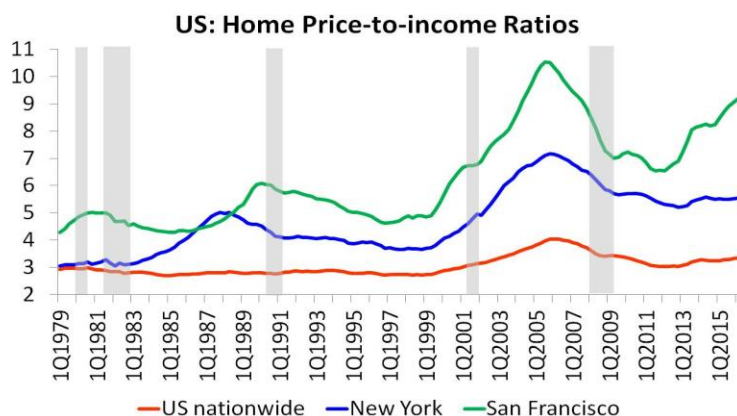
However, we think it is too early to call for a bubble as there is no widespread number of speculators betting on the rising market nor over-leveraging. The growth in housing prices is largely due to supply lagging demand and the improving labour market and income growth (Figure 7). Homes are generally not overpriced compared to pre-GFC days based on Price-to-Income measures, although rising much faster in some areas such as San Francisco (Figure 8). There is little speculative construction; housing inventory is relatively low at 5.3 months (vs 30-year average of 6.1 months; GFC peak of 12.2 months) and housing starts at 1.16m units (vs 30-year average of 1.35m units; pre-GFC peak of 2.27m units), as of May 2016.

Figure 7: Post-GFC home price increases supported by income growth



Source: US Bureau of Economic Analysis, S&P Global Indices, US Bureau of Labour Statistics, St Louis FRED

Figure 8: Home prices are still relatively more affordable than pre-GFC



Source: Zillow

However, if supply does not catch up soon enough, home prices may continue to rise faster than wage growth, pricing out even more first-time home buyers. The shock will then be significant if there is an economic recession.

What next, Mr/Mrs President?

Market uncertainties are expected to pick up in the run-up to the US Presidential and Congressional elections on 8 November 2016. The Congressional elections will also decide whether there will be more gridlock on Capitol Hill under a divided government. Questions remain over future tax reforms and government spending, which could impact business sentiments and affect corporate investment plans.

If Democratic nominee Hillary Clinton gets elected and the Democrats gain majority in the Senate, her centrist tax proposals are likely to lead to marginally higher individual and business income taxes. However, she is supportive of boosting infrastructure investment and increasing minimum wages. So there will be some pain and some gain.

If Republican nominee Donald Trump becomes president, Brookings has estimated that his tax reduction proposals[14] could add 11.5% to the 10-year GDP growth but at the expense of US$10.1 trillion in federal tax revenue, which would translate into additional national debt burden to the tune of 40% of GDP if not accompanied by spending cuts[15]. The expected economic gain however may not materialize as planned if companies hold back on investment spending and hirings in the face of economic uncertainties. At the same time, the US' public debt-to-GDP could potentially rise to 140%, pushing Treasury yields higher and increasing the debt servicing burden. Although some believe that Donald Trump would be practical and behave like the businessman that he is, there is still uncertainty if he will have his way with some of his extreme proposals thus adding on to global jitters and loss of confidence in the US.

Even without Trump, the US federal government ran budget surpluses in only 12 of the last 75 years, and in the wake of the GFC, the federal debt-to-GDP has risen from 64.3% at the onset of the crisis to 105.7% as of 1Q2016. The deficit and federal debt levels cannot keep increasing indefinitely and when demand for Treasury bonds dries up, their yields will have to rise. The impact of significantly higher Treasury yields could have global repercussions, as their risk-free status become challenged and other assets are repriced downwards due to higher discount rates.

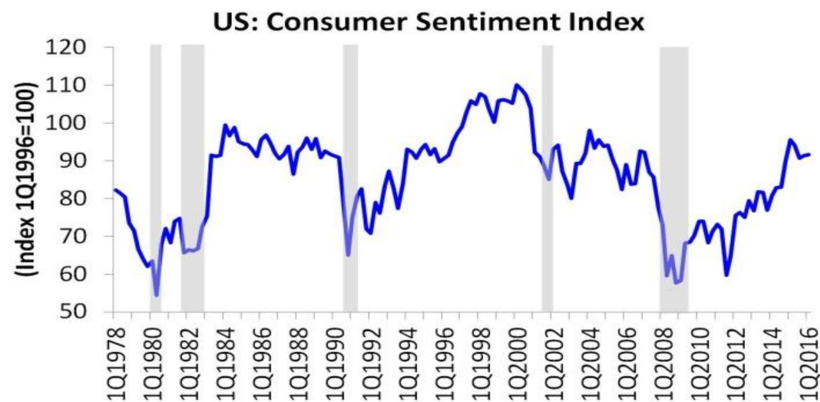
Muddling along with slow growth

Overall for the US economy, we see slow growth continuing as long as consumer sentiment remains upbeat (Figure 9) to support domestic consumption which makes up two-thirds of the US GDP. Other economic indicators show hits and misses, adding to the likelihood that the Fed will remain data-dependent and even stand pat on rates, allowing the US economy to trudge through at a low growth rate. The dilemma for the Fed lies in how much inflation it can tolerate without

[14] Trump's corporate tax plans involve cutting the high headline corporate income tax rate from 35% to 15% and introducing a one-time 10% repatriation tax on corporate cash held overseas.
[15] Tax Policy Center, Urban Institute & Brooking Institution

adversely impacting the tepid growth domestically and globally, particularly in the aftermath of Brexit.

Figure 9: US consumer sentiment remained resilient



Source: University of Michigan

Extreme oil prices

Add to global jitters

Oil prices have recovered somewhat but are still expected to remain significantly below the 2014-average of about US$100/bbl for the next two years. While the decline in oil prices has led to recessions in some major oil-producing countries like Russia or budget cuts in others such as in Saudi Arabia, this is more a blessing to other countries. However, should oil prices fall to below US$40/bbl again or rise sharply, this could spark global panic as it did in early this year. In these days of great uncertainty and volatility, all it needs is a change from status quo to spark large-scale panic.

Geopolitical risks

Triggers from accidents and miscalculations

Not only does the world have to deal with economic frailty, it is today fraught with more geopolitical tensions. The fractious South China Sea dispute continues to cast a pall over relations between China and the ASEAN claimants, particularly the Philippines and Vietnam, although the Permanent Court of Arbitration (PCA) in The Hague has recently ruled in favour of the Philippines.

Tensions are also brewing in the East China Sea between China and Japan over disputed islands, known as Senkaku in Japan and Diaoyu in China, with more scrambling of fighter jets recently by Japan to intercept Chinese warplanes over the disputed territory. Similarly, tensions are increasing in the Korean peninsula. North Korea recently fired three ballistic missiles whose range can reportedly reach all areas of South Korea, while building up capability to successfully launch longer-range ones. South Korea's decision in July to allow the US to deploy the Terminal High-Altitude Area Defence (THAAD) missile defence system in South Korea risks worsening relations with China which is worried that the system will be used against it. Similarly, Russia has also objected to the THAAD and has threatened to deploy its own missiles to counter what it sees as a security threat.

As there is much at stake in terms of trade and economic benefits, we believe government leaders will not risk war but there will be much political posturing and manoeuvres. Nevertheless, we cannot rule out any geopolitical accidents or miscalculations which can undermine business sentiments and affect regional and global trade.

The Middle East region remains a hotbed of violent instability. The fight against terrorist groups like the Islamic State within Syria and Iraq still wages on, with the threat of radical extremism spreading beyond the region and resulting in more acts of terror. Adding to the chaos, Turkey saw an attempted coup d'état fail, with President Erdogan moving swiftly in the aftermath to detain thousands of dissidents and declaring a three-month state of emergency. While direct economic impact from the instability emanating out of the Middle East has been limited and rather short-lived, there could be potential disruptions to oil supply and spike in oil prices, and more frequent and larger scale of terror attacks can have longer-term impact via reduced domestic consumption and investments.

Conclusion

Market volatility plagued by uncertainties is the new norm. We have listed a number of risks which individually may not be severe enough to cause a global recession in the next 12 months, but the longer the malaise drags on, the greater the destabilising forces. All it takes could be a trigger or confluence of events to spark panic and a global crisis; or a black swan that we have not envisaged. It is the psychological herd instinct that is most difficult to predict, especially when everyone heads for the door at once.

Nonetheless, investors should not be paralysed with fear waiting for the next global recession to come. All governments are very aware of the weaknesses plaguing their own economies and the fragile world that we are all in today, and thus are expected to continue with loose monetary policy and fiscal stimulus, manage the bad debts, and have the good sense to draw the line in sovereign disputes. Cap rates in attractive markets are likely to remain compressed as low global interest rates continue to fuel the chase for yields from quality assets. While it is necessary to take some risks, investors can hedge against the possible global recession by investing more selectively in markets with strong fundamental growth drivers and real estate demand, and avoiding aggressive pricing and over-leveraging. These include many markets in Asia Pacific which offer investors exposure to long-term secular growth which supports real estate demand (refer to our Alpha Watch published in February 2016 titled "Asia Pacific – Still the World's Beacon of Growth").

"The dangers of life are infinite, and among them is safety." - Goethe

Alpha Investment Partners Limited

Alpha Investment Partners ("Alpha") is a real estate investment advisory firm managed by a team of established professionals with proven fiduciary experience.

Equipped with a strong business network, our team of professionals aims to achieve superior investment performance by capitalizing on our unique insights into the regions property markets offering investors the competitive advantage akin to a local player. In addition to the expertise we possess in the area of investment, we establish the highest standards of corporate governance, reporting and compliance to meet investors' expectations. We strive to integrate sustainability practices into our invested assets. Our corporate culture is shaped by empowerment and trust.

Our Offices

• Singapore • Seoul • Shanghai • Sydney • Taipei • Tokyo

Disclaimer: This report is published solely for informational purposes and may not be published, circulated, reproduced or distributed in whole or in part to any other person without our written consent. No guarantee, representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein, nor is it intended to be a complete statement or summary of the markets or developments referred to in the report. The report should not be regarded by recipients as a substitute for the exercise of their own judgement and recipients should not act on the information contained herein without first independently verifying its contents. Any opinions or estimate expressed in this report are subject to change without notice and may differ or be contrary to opinions expressed by others business areas as a result of using different assumptions and criteria. Alpha Investment Partners Limited ("Alpha") has not given any consideration to and has not made any investigation of the investment objectives, financial situation or particular needs of the recipient, and accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the recipient acting on such information or opinion or estimate. Alpha is under no obligation to update or keep current the information contained herein. In no event and under no legal or equitable theory, whether in tort, contract, strict liability or otherwise, shall Alpha be liable for any damages, including without limitation direct or indirect, special, incidental or consequential damages, losses or expenses arising in connection with the use of or reliance on the information contained herein.