Investment Outlook H2 2018
Personal Financial Services

Life is a series of natural and spontaneous changes.

—Lao Tze

Contents

Editorial Team

Chung Shaw Bee
Singapore and Regional Head, Deposits and Wealth Management

Joyce Lim, CFA, CAIA
Regional Head, Funds and Advisory

Abel Lim
Singapore Head, Wealth Management Advisory

Calvin Nico Herlambang, CFA
Singapore and Regional Head, Investment Strategy and Communications

Grace Qu, CFA
Investment Strategist

Regional Contributors

Leong Wei Ji
Malaysia

Suwiwan Hoysakul
Thailand

Louis Linardo
Indonesia

Lily Huang
China

Editorial

After a buoyant 2017, we started 2018 with confidence. Synchronised global economic growth, modest inflation, and robust corporate fundamentals underpinned such confidence. We expect that equities, out of all the asset classes, to continue to offer attractive opportunities. Reflation in developed markets and structural opportunities set the stage for some sector plays, stable growth in emerging markets offered window of investment opportunities for EM assets. Quality fixed income instruments also offered good cash income and yield-enhancement opportunities.

The financial markets however experienced significant volatility in the first half of 2018, driven from various fronts – the pace of normalizing monetary policies across the world, trade war fears emanated from Trump administration's approach towards tariffs, geopolitical concerns including new leadership in Italy and Spain, and the strength of USD weighing down on EM assets.

Does this surge in volatility mean that the positive macro drivers and the strong corporate fundamentals have ended? Certainly not. In fact, the Q1 strong corporate earnings continue to suggest continued strength in global growth, further propelled by the boost from the tax-cuts in US.

As we navigate through the rest of 2018, several headwinds will put a lid on investors' sentiments. Unpredictable US administration, policy missteps in tightening interest rates too quickly, geopolitical tensions including Europe's tense political climate could further exacerbate volatility across asset classes. UOB's risk first approach weighs the risks associated with the preferred investment asset class(es). Here's a summary of our view of the world:

Earth — the macro backdrop for investments
Sifting through these concerns, the macro situation remains supportive with above trend global growth, modest inflation and still relatively accommodative monetary conditions. This backdrop is favourable for earnings.

Metal — fundamentals that underpin the strength of an economy
Heading into the second half of the year, the increasingly hawkish stance of major central banks may dampen market's return expectation.

However the fundamental drivers such as strong domestic consumption and global growth should continue to support corporate earnings growth. This enables equity earning yields, which measure the valuation of companies, to remain attractive relative to government bond yields, and provide buffer in a rising interest rate environment.

Fire — parallels to risk
Ongoing geopolitical developments and the rising interest rate environment are likely to affect the performance of financial markets in the second half. The USD could strengthen on the back of an acceleration of rate hikes and this could put pressure on EM central banks to respond. We expect geopolitical events to dominate 2018 and may impact investment decisions – the keenly watched US-North Korea Summit does suggest the start of easing tensions on the Korean peninsula, but trade tensions between the US and China have escalated.

Wood — opportunities from asset classes
We maintain our positive view on equities. This asset class should

continue to offer investors potentially attractive returns, especially since valuations have now come down to more reasonable levels.

In fixed income, we advocate selectivity, preferring instruments that are less sensitive to interest rates. In this regard, high-quality bonds now offer attractive yields following the technical correction in the first half of the year.

Water — investor sentiment and the flow of funds

Fund flows, which reflect global investor sentiment in general, remain positive towards equities compared to bonds. Flows to Japanese equities remained resilient, whereas flows to European equities have been relatively muted given the political situation in Italy. In the fixed income space, investment-grade (IG) bonds have attracted more inflows than other subclasses such as high-yield. EM assets have registered strong inflows.

Weighing the balance between the drivers of returns and the risks, selective investment opportunities are still abound at more attractive valuation levels. Thus, this is also an opportune window for one with the risk appetite to adjust their investment portfolios to meet their long-term goals.

Chung Shaw Bee
Personal Financial Services Singapore and Regional Head, Deposits and Wealth Management

2018 Mid-year Review

We review the key events that have unfolded in H1 2018 and examine the impact these events have had on the markets.

Review of H1 2018

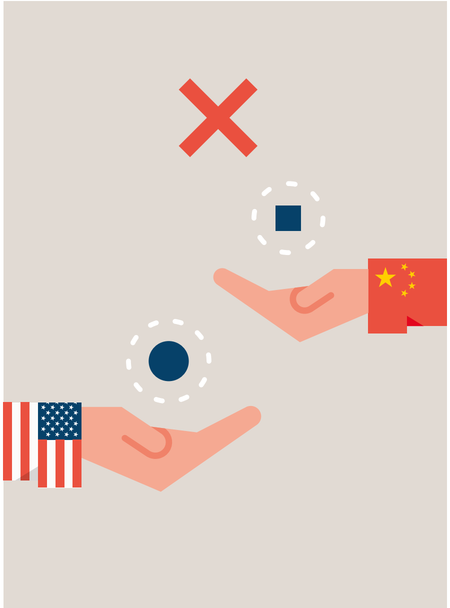
First half of the year was marked by concerns over the trajectory of interest rates, US-China trade tensions, political developments in the eurozone and the Korean peninsula, conflict in the Middle East as well as the fallout of the tech sector.

Rising US Treasury Yields

US Treasury yields, have been steadily climbing higher since the beginning of the year, with the 2-year yield topping 2.5%, the highest since September 2008. Meanwhile, the benchmark 10-year yield has hit 3%, a level not seen since 2013.

The hawkish stance of the US Federal Reserve (Fed) has been a major factor behind the uptick in yields. The Fed has been hiking interest rates on expectations of a stronger economy as well as increased inflationary pressures. Since December 2015, it has raised rates six times with the latest in March and has signaled that it could raise rates a further two times this year.

Concerns of a supply glut of US Treasuries, as the government seeks to cover a yawning budget deficit by issuing more debt, has also led to the rise in yields. Although fixed income markets came under pressure, equity markets have held up relatively well.



US-China Trade Tensions

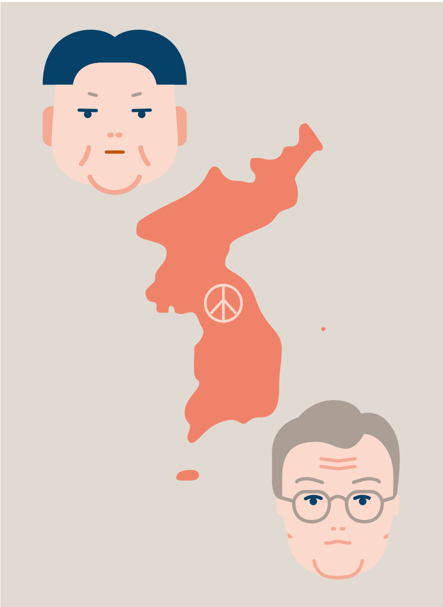
Fears of rising trade protectionism have cast a shadow on investor sentiment. The US and China has remained locked in a trade stand-off with both countries issuing tit-for-tat tariffs. Following the US' tariffs on steel and aluminium imports, it proposed further tariffs on US$50b worth of Chinese imports. It has also taken a tougher line on China's investments in US technology firms to prevent the latter's access to sensitive and critical technologies. In response, China has threatened retaliatory tariffs on US products.

The trade situation between the US and China remains fluid, with both countries open to further negotiations to prevent a further escalation of trade frictions. While a full-blown trade war seems unlikely, for now, any news of hard-hitting trade measures could trigger a knee-jerk risk-off market reaction.

European Politics

Following last year's inconclusive elections, Germany emerged from its political gridlock in the first quarter of the year. Angela Merkel's conservatives – the centre-right Christian Democratic Union and its right-wing counterpart the Christian Social Union – finally reached a coalition agreement with the centre-left Social Democratic Party. The formation of this "grand coalition" government paves the way for a more expansionary stance in Germany as well a further push for eurozone reforms.

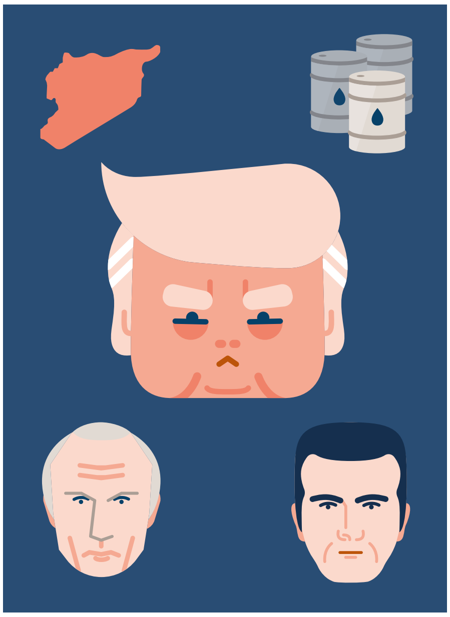
Meanwhile, Italy's deepening political crisis has put significant pressure on its government bonds and stocks. Populist far-left Five Star Movements (5SM) and the far-right League party have formed a coalition government. The new Italian government, populist in nature, is likely to take an antagonistic stance against EU.



Inter-Korea Summit

A historic inter-Korean summit between South Korean President Moon Jae-In and North Korean Leader Kim Jung Un took place in April. The meeting between the two Koreas – the first in more than a decade – concluded with a pledge for "complete denuclearisation" in North Korea. However, the declaration did not include concrete steps on how to dismantle the country's nuclear weapons and ballistic missile programme.

The landmark US-North Korea summit in Singapore concluded successfully. Both countries agreed to a broad framework for a nuclear deal even though the details of implementation were not specified. The fruitful talks between the US and North Korea could hopefully boost the security in the region and remove a key cause for the geopolitical tension. This could also pave a way for more constructive US-China trade talks.



Middle East Conflict

Middle East tensions have remained heightened due to a confluence of factors. The ongoing Syrian conflict between US-backed rebel factions and the Russian-backed Assad regime is seen as a proxy for US-Russia relations and US missile attacks on Syria in April have further strained the relationship between the US and Russia. To make matters worse, Israel has also entered into the fray by launching missiles on Iranian targets in war-torn Syria in May.

Meanwhile, US-Iran tensions have led to higher oil prices. The US' withdrawal from a nuclear deal with Iran in May and prospects of fresh sanctions on Iran could reduce global oil supplies. This, coupled with a cut in oil output by major oil producers, has caused oil prices to surge to US$70 per barrel, levels not seen since November 2014.

Tech Sector Fallout

After strong share price gains in the current bull market, tech-related companies lost some of their lustre towards the end of the first quarter. Sentiment nosedived due to data privacy concerns and this sparked a sell-off in tech stocks such as Facebook, Twitter and Alphabet (Google's parent company). Elsewhere, concerns over the safety of self-driving vehicle technology put a drag on the share prices of Uber and Tesla. In addition, US President Trump has attacked Amazon's tax practices and business methods for hurting traditional retailers.

These high-profile tech fallouts have led to calls for tougher regulations on the industry. Worries over costly and restrictive growth measures have dimmed the allure of tech stocks that were once market darlings.

Performance Review in H1 2018

Higher US Treasury yields and geopolitical tensions were the main drivers of investment markets in the first half of 2018.

Equities

Global equities have entered into a consolidation phase after the strong rally last year. Although geopolitical tensions, higher yields and tighter regulations on tech stocks led to heightened volatility, global equity markets have remained relatively resilient given strong earnings momentum. The returns for regional equities have been more divergent, unlike in 2017. US equities outperformed, as tech led the gains. European equities gave up their market leadership in the last week of May as Italian political turmoil took a toll on the performance. EM equities advanced in the first quarter but gave up their gains in the second quarter, as higher rates and a strong USD weighed on sentiment. A strong JPY put downward pressure on Japanese equities.

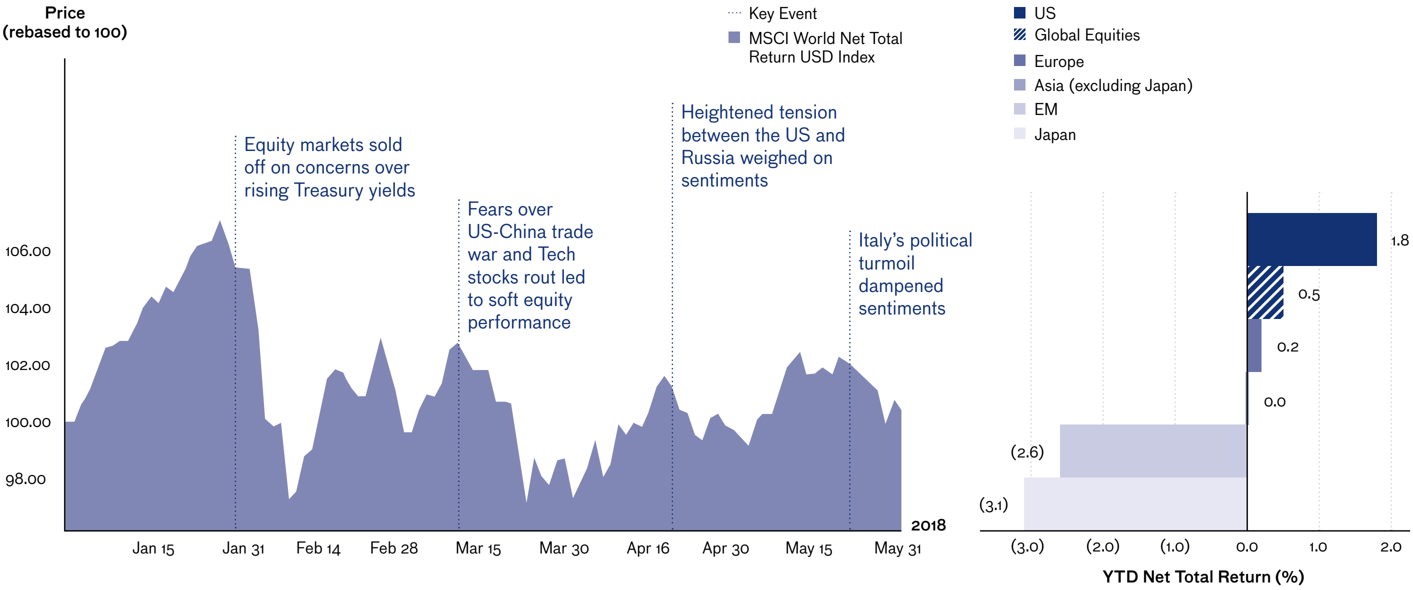
Fixed income

Perceptions of rising inflationary pressures pushed Treasury yields higher. The rise in bond yields has kept most fixed income classes under pressure. The US high-yield has weathered the recent rate rises relatively well. However, US investment grade (IG) bonds and EM hard currency bonds have underperformed due to higher yields and wider spreads.

Foreign exchange

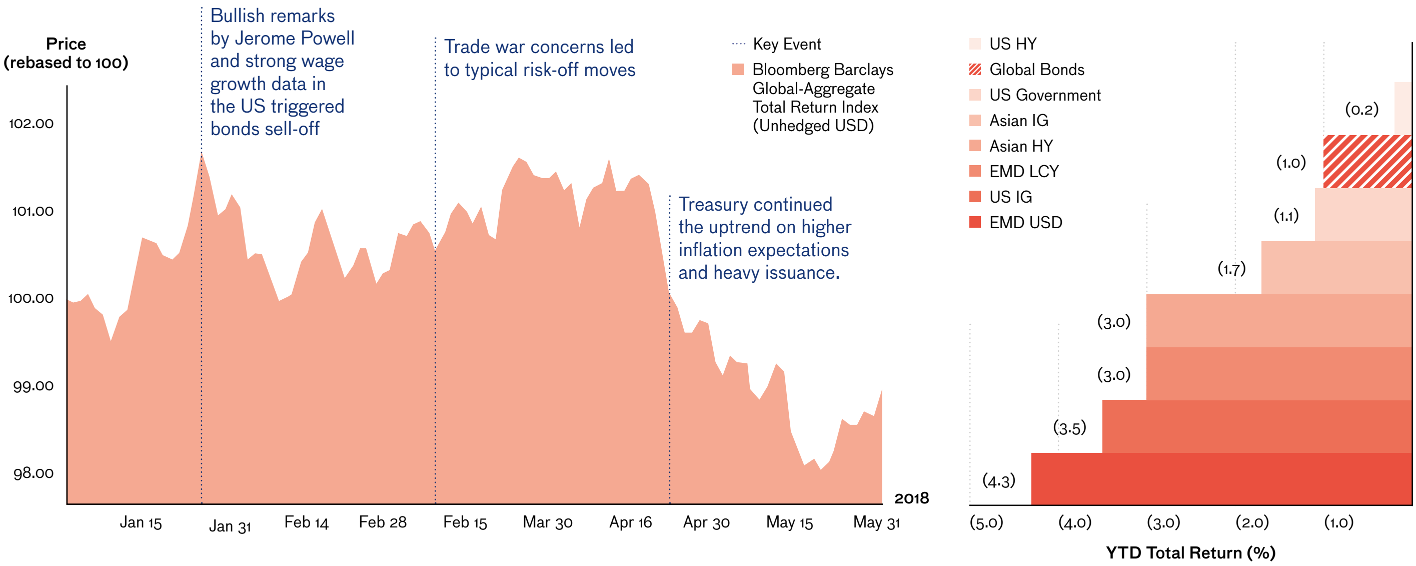
Following weakness in the first quarter of 2018, the USD bounced back on robust economic data and the unwinding of USD shorts. The easing of trade frictions between the US and China lifted pressure on the USD. Other regional risks such as the Italian political situation and uncertainty over Brexit have undermined the EUR and GBP. The AUD weakened as the Reserve Bank of Australia (RBA) stayed its hand on interest rates.

Figure 01—**Global equity markets performances YTD**



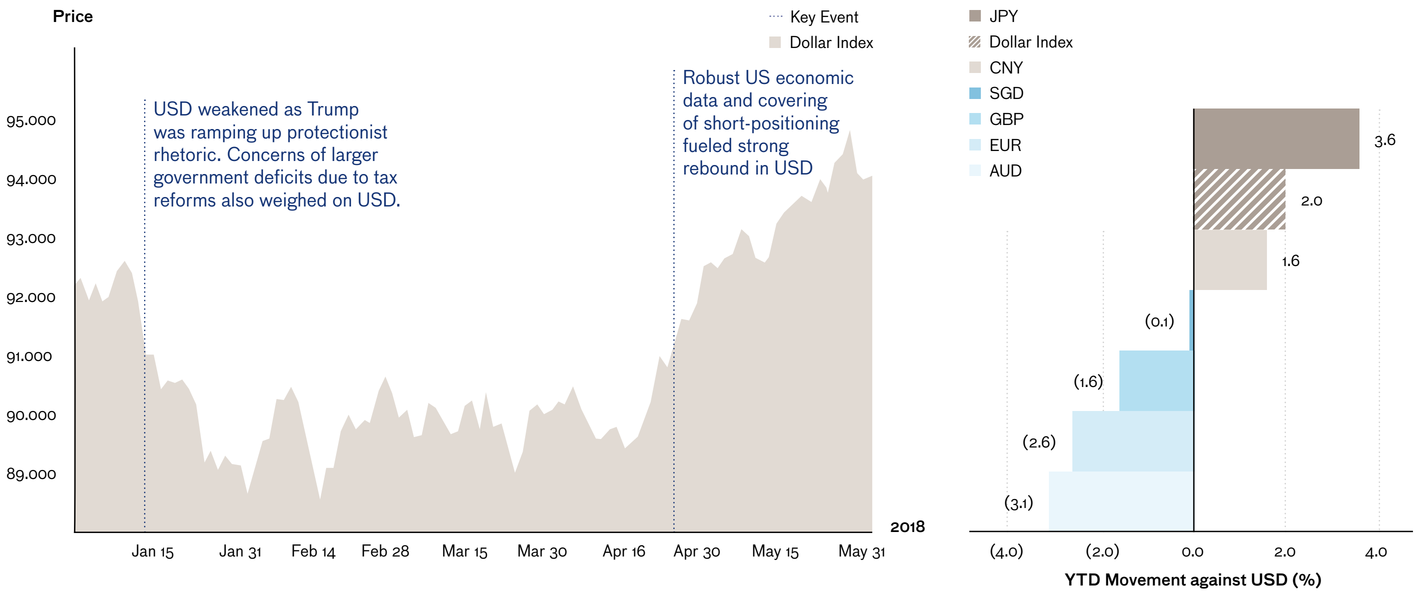
Source: Bloomberg, 31 May 2018

Figure 02—**Global fixed income markets performances YTD**



Source: Bloomberg, 31 May 2018

Figure 03—**Foreign exchanges performances YTD**



Source: Bloomberg, 31 May 2018

Calls Review H1 2018

We revisit the calls that we made at the beginning of the year and review how our calls have performed thus far.

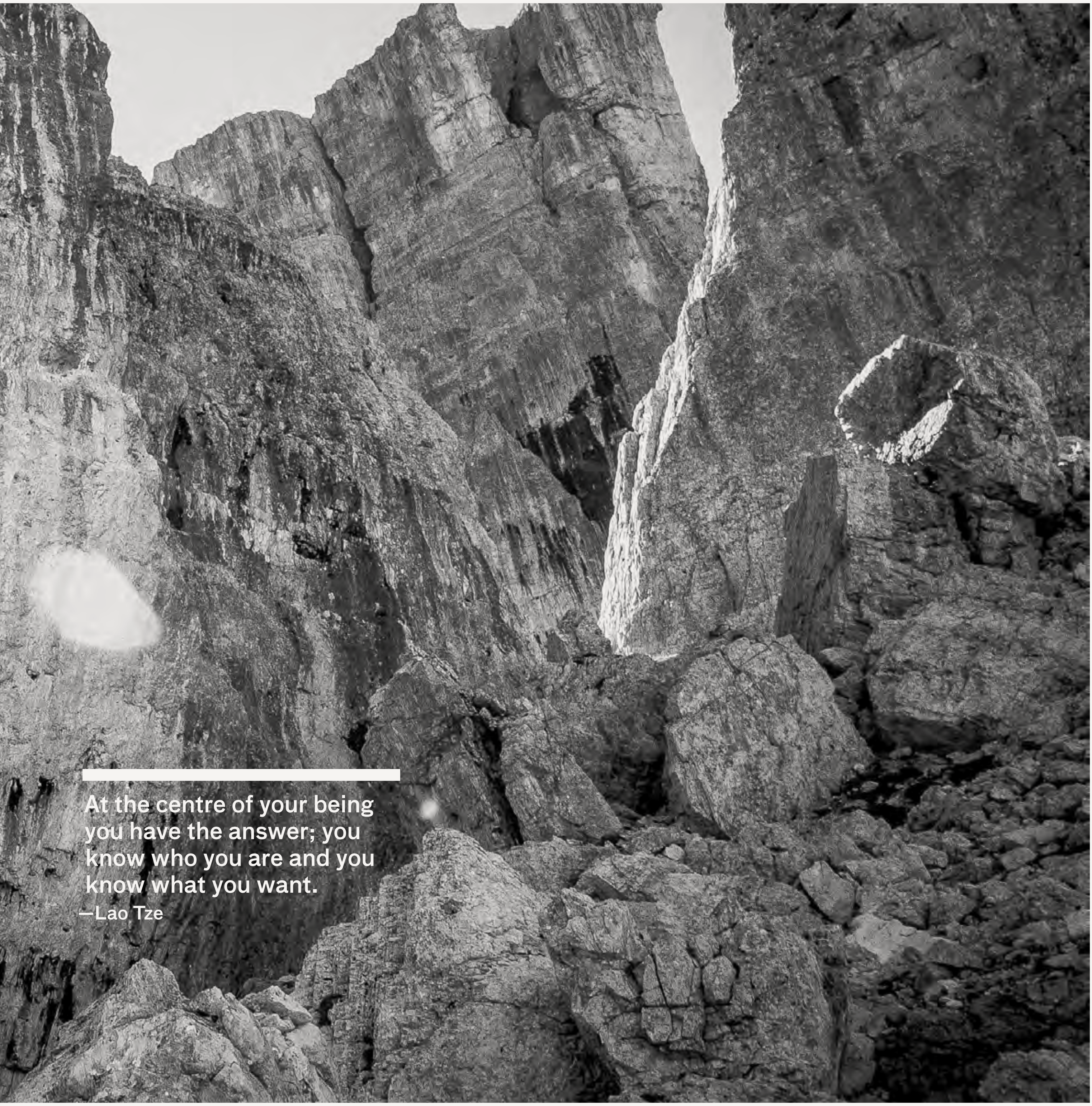
	Jan (%)	Feb (%)	Mar (%)	Apr (%)	May (%)	*YTD (%)
Theme 1: Developed Markets (DMs) Reflation Heightened valuations and reflationary impulses in DMs mean it is timely to rotate out of expensive, late-cycle markets and interest rate-sensitive sectors.	6.4	-2.8	-4.4	-0.4	-1.0	0.2
	1.6	-3.9	-2.0	4.6	0.1	1.4
	1.3	-3.7	-2.4	3.6	-1.7	-0.5
Theme 2: EM Assets Synchronised global growth provides a stable backdrop for capitalising on higher growth opportunities in EM economies.	8.3	-4.6	-1.9	-0.4	-3.5	-0.8
	4.5	-1.0	1.0	-3.0	-5.0	-4.7
Theme 3: Structural Opportunities Secular developments could drive long-term growth in specific industries, even in times of slower global expansion.	5.6	-4.5	-2.1	1.0	0.5	2.7
Theme 4: Yield Enhancer Short-duration and higher income could cushion against rising interest rates.	0.5	-0.1	0.0	0.5	0.3	1.6

Source: Morningstar, 12 June 2018
*YTD figures include returns from 1/1/18 to 12/6/18

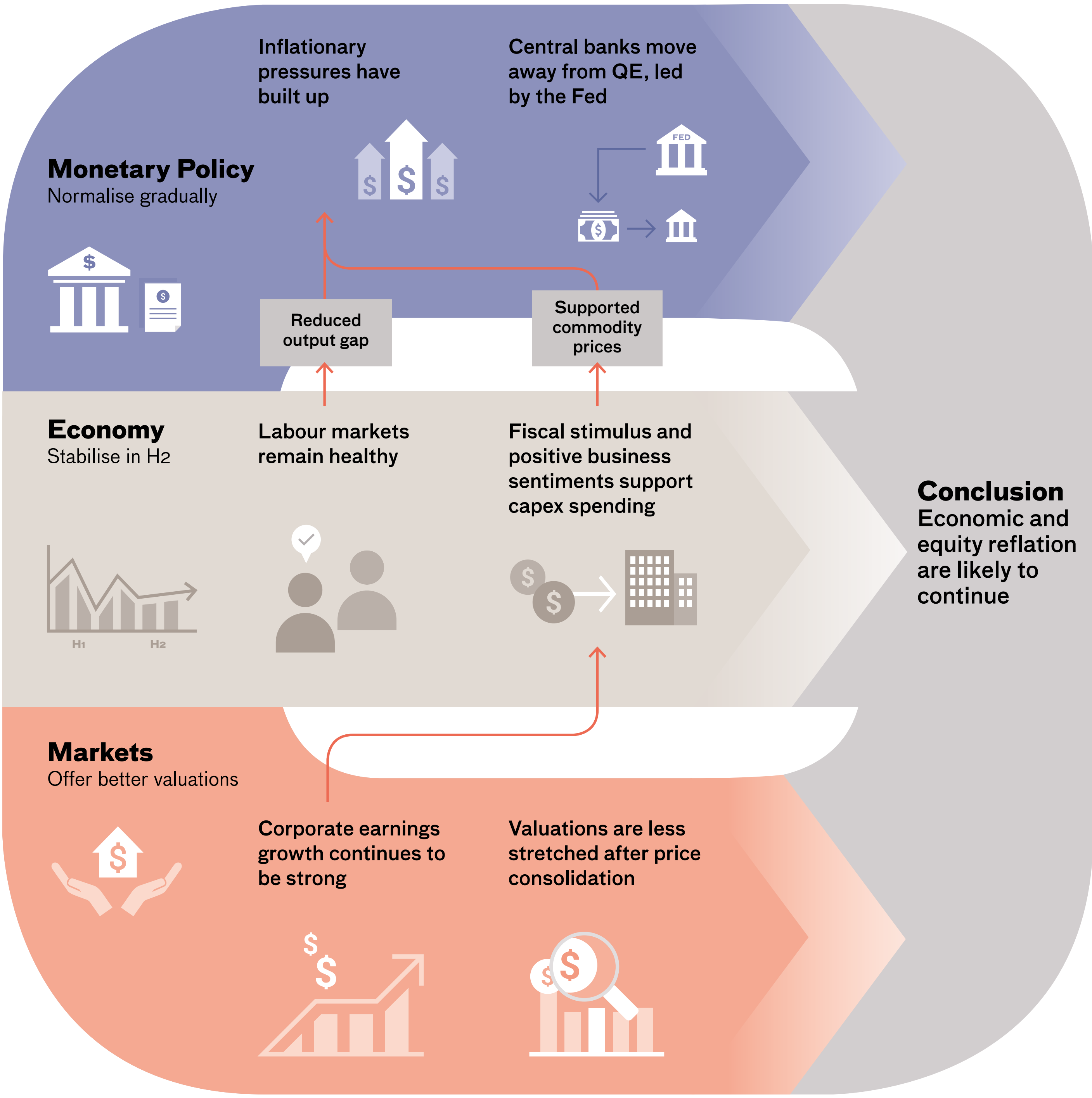
US Financials Equities	• US financials underperformed the overall US market. • Tepid loan growth in Q1 2018 and yield-curve flattening weighed on the sector’s performance. • However, credit growth has started to bottom out and net interest margins have improved as short-term interest rates continue to climb higher.
European Equities	• European equities delivered positive return YTD. Their market leadership was lost in the last week of May due to political uncertainty in Italy. • Despite the several political events over the past two years, including Brexit, European equities have been resilient and tended to recover quickly.
Japanese Equities	• Japanese equities underperformed relative to other DM markets. • Investors maintained their wait-and-see stance given domestic political issues. Strong JPY also put downward pressure on Japanese equity. • Initial basis for the call, including solid economic fundamentals, positive earnings growth and higher dividend payouts, remain valid.
EM Equities	• After a strong start in January, EM equities pulled back on a strong USD and higher US Treasury yields. This correction came after an exceptionally strong rally last year. • Given strong fundamentals and improved valuations, the sell-off looks overdone.
EM Local Currency Bonds	• Geopolitical tensions, USD strength and rising US Treasury yields remain as headwinds to this asset class. • Even though the broad EM economy stayed on strong footing, EM countries that have current account and budget deficits and are dependent on foreign funding have started to show signs of stress. • We are less optimistic on EM local currency bonds.
Global Healthcare	• Global healthcare managed to hold onto gains. • US President Trump’s plans to lower drug prices in May appear to be significantly less disruptive to the industry. After tepid trading in the last few months, the healthcare sector has started to outperform post-announcement. • M&A activities have picked up YTD, providing support to small-to-mid cap companies.
Short Duration High Yield Bonds	• While the environment for fixed income was very challenging in the H1 2018, short-duration high yield bonds managed to perform. • Credit spreads stayed tight as economic outlook remains robust. Attractive yields offset the capital loss from higher rates, resulting in positive total returns.

Macro Outlook and Risks for H2 2018

Our investment views are grounded on the understanding of the key drivers of the macro environment and identification of potential risk sources. We draw on these insights to form the basis of our strategies.



Macro Outlook for H2 2018



Key takeaways
The pace of economic growth should pick up in the H2 2018, on the back of strong consumer and business spending in developed markets and higher commodity prices in emerging markets.

Central banks are expected to gradually normalise monetary policy by hiking rates to tame inflation.

Equity valuations are now less demanding and the outlook for corporate earnings remains positive. Hence, the equity markets could be more resilient to higher interest rate scenario.

Economic growth to stabilise in H2 2018

Global economic growth momentum moderated in H1 2018, as the Global Composite PMI decreased from 54.8 in February to 53.8 in April amidst escalating concerns over a trade war between the US and China and higher interest rates. However, this is unlikely to mark the start of a downturn. The global economy has demonstrated its resilience thus far and in the absence of a significant catalyst for a recession, global growth is likely to stabilise in H2 2018.

According to International Monetary Fund forecasts, global real gross domestic product (GDP) growth is expected to inch up to 3.9% in 2018, slightly higher than in 2017, buoyed by strong consumer and business spending given solid income fundamentals.

Growth in developed markets to stabilise after slower momentum
We expect solid growth in developed markets, driven by strong domestic consumption, higher capex spending and expansionary fiscal policies.

Despite moving into the slow lane at the beginning of the year, the US economy's underlying fundamentals remain robust. Strong consumer spending, as well as a pick-up in capex spending as a result of higher fiscal stimulus, should fuel growth in H2 2018.

Europe's economy was off to a sluggish start mainly due to cyclical factors such as a shorter inventory cycle and bad weather which hit crop production. However, the core drivers of demand are likely to prop up the economy. We expect strong labour income and falling unemployment to shore up consumer spending, while healthy corporate profits and tighter capacity utilisation will provide a favourable climate for business investment.

The Japanese economy softened in H1 2018 after a peak in exports and an unwinding of inventory. Despite a stronger JPY, we expect a brighter economic outlook in the second half, given better business confidence and supportive monetary conditions.

Strengthening structural reforms in emerging markets, despite higher risks
The Chinese economy grew 6.8% in the first quarter, beating consensus forecasts of 6.7%, as strong consumer spending made up for a sluggish manufacturing sector. The economy's strong shape as well as low inflationary pressures gave the government leeway to unwind excess capacity and rein in corporate debt, even while stimulating consumption.

Other emerging markets – notably India, Brazil, Russia, Mexico and South Africa – are on track to achieve healthy growth rates in 2018. Despite worries over trade protectionism, a revival in commodity prices is likely to lift these economies, with the exception of India, which is dependent on oil imports.

While the global economy is expected to grow at a healthy clip, geopolitical risks remain. The ongoing US-China trade dispute continues to cast a pall over sentiment. Still, we are of the view that both countries will be willing to negotiate to prevent the trade row from imploding. In H2 2018, key events to look out for include the direction of

US-Russia relations, the outcome of the North American Free Trade Agreement (NAFTA) talks as well as the results from elections in Mexico and Brazil.

Central banks to adopt gradual normalisation of monetary policy

With inflation creeping up, central banks are expected to gradually normalise monetary policy by raising interest rates to quell price pressures. This is unlikely to put a major dent in the global economy.

US Fed on track to hike rates

With a tighter labour market and higher commodity prices fueling inflation, signs point to the Fed raising interest rates. The current Fed funds rate stands at 1.75%. The Fed is expected to hike rates an additional two times this year – in June and in December. In 2019, it is expected to hike rates another three times. Meanwhile, the Fed is still continuing its balance sheet reduction programme. However, in its latest Federal Open Market Committee (FOMC) meeting, the Fed has indicated that it will take a prudent approach in hiking rates so as not to put economic growth at risk.

Other central banks to take cue from Fed

Unlike the Fed, other central banks have adopted a more dovish stance so far, due to a combination of softer economic growth and low inflationary pressures. Going forward, we expect other central banks to follow in the Fed's footsteps by normalising policies, albeit at a much-slower pace.

At 1.2% as of April 2018, inflation in Europe has remained persistently low. However, it is likely to inch higher on the back of continued growth and higher commodity prices. In the third quarter of 2018 (Q3 2018), the European Central Bank (ECB) is expected to unveil its plans to scale back and eventually stop its asset purchases by the end of the year.

The Bank of Japan (BoJ) should maintain its accommodative monetary policy, as inflation is still very benign (below its 2% target).

Are worries over higher rates warranted?

The global economy has remained surprisingly resilient. The deleveraging of the US and European economies, coupled with China's shift towards domestic-driven growth, means that major economies should be able to ride out the effects of higher interest rates.

Market valuations more reasonable amidst robust earnings

Equity valuations have dropped back to more attractive levels, given good earnings growth and price consolidation. Most markets have revised earnings expectations upwards, particularly for the energy sector. Robust earnings will help to cushion the equity markets from any macroeconomic cross-currents.

Expectations of a higher interest rate environment are unlikely to cast a pall over the earnings outlook and investor confidence should remain high.

Key Risk Drivers in H2 2018

It is critical to map out key risk drivers which can take the form of both upside and downside catalysts. Understanding the impact of these risks is critical to making informed investment decisions.

Key takeaways
While the global economy continues to chug along nicely, perhaps the greatest threat that could derail the economic momentum is a sudden increase in yields. The market will also need to keep close tabs on the impact of geopolitical tensions, the results of US mid-term elections and political developments in Europe.

Spike in yields

Yields are likely to head north in H2 2018 due to a combination of factors. A tight US jobs market, rising wages and strengthening commodity prices could stoke inflation. In addition, the US government is expected to flood the market with US Treasuries to cover larger budget deficits. Any spike in yields, as a result, could spark a rout in the equities and bond markets.

Geopolitical tensions

Market sentiment remains vulnerable to geopolitical risks, particularly heightened trade tensions and a worsening Middle East conflict. An extreme protectionist stance from Washington could undermine corporate confidence though we maintain our base-case scenario that a trade war is unlikely to happen. Rising geopolitical tensions in oil-producing nations including Iran, Venezuela, Saudi Arabia, Libya and Nigeria could threaten production. Any sharp increase in oil prices could cloud the inflation outlook and dampen consumer spending.

US domestic politics

The stakes are high as the US heads into mid-term elections in November. Policy risk could rear its head should the Democrats attain the House but the Republicans retain control of the Senate. A divided Congress could lead to a policy gridlock, which could have a detrimental effect on sectors such as industrial and materials that are dependent on government spending. Failure to seal any bipartisan deal could eventually lead to pressures to tighten fiscal policy. This could, in turn, negatively impact US economic growth and market sentiment.

European politics

The worsening Italian political crisis has sparked fears of a sell-off in European markets. Even though the two anti-establishment parties managed to form a government in Italy, uncertainties still remain. The relationship with European Union (EU) could deteriorate as the new Italian government adopts a more confrontational approach. Our base case scenario is for Italy to remain in the EU as the stakes for an exit are far too high. European assets are likely to see increased volatility, until the Italian political situation has settled down.

Global Key Events Calendar

▲ Key Event

Central Banks

Political Events

July

1 Jul
Mexico General Election

July 26
ECB Meeting

30–31 July
BOJ Meeting

August

31 Jul–1 Aug
FOMC Meeting

September

13 Sep
ECB Meeting
ECB may exit the bond buying program in September.

Sep TBC
Liberal Democratic Party (Japan) leadership election
Abe Cabinet's support rate plummeted and the chances of Abe winning reelection in September looks less certain. Our base case is that Abe to remain in power for another term.

18–19 Sep
BOJ Meeting

25–26 Sep
FOMC Meeting

October

Oct TBC
Brazil General Election

Oct TBC
UK-EU exit negotiation to end with Publication of "Withdrawal agreement" and political declaration on "Framework for the Future Relationship".

25 Oct
ECB Meeting

30–31 Oct
BOJ Meeting

November

6 Nov
US Mid-term Election
Given the low approval rating for Trump, the mid-term election is likely to be rocky.

7–8 Nov
FOMC Meeting

December

13 Dec
ECB Meeting

18–19 Dec
FOMC Meeting
The Fed is expected to hike rates by 25 bps in the meeting.

19–20 Dec
BOJ Meeting

Asset Class Outlook and Strategy

To devise our asset class outlook, we focus on the wider macroeconomic picture as well as asset-specific attributes. This helps us to develop our investment strategies and identify compelling opportunities.

In the world there is nothing more submissive and weak than water. Yet for attacking that which is hard and strong nothing can surpass it.
—Lao Tze

Our Strategy H2 2018

We expect H2 2018 to be dominated by a rising interest rate environment as central banks look to hike rates. We prefer opportunities that have relatively attractive valuations and that are underpinned by robust fundamentals.

Equities

Equities remain our preferred asset class. Despite some volatility, we expect equity returns to be positive in H2 2018.

Prefer US financials
Attractive valuations and higher earnings due to rate hikes make US financials our preferred sector play in the US equity markets.

Prefer Japanese equities
We maintain a favourable outlook for Japanese equities given a strong corporate earnings landscape and progress on corporate governance reforms.

Prefer EM equities
Broad EM equities are supported by strong fundamentals and attractive valuations. Countries that have current account surpluses are less vulnerable to foreign fund outflows. We turn constructive on China.

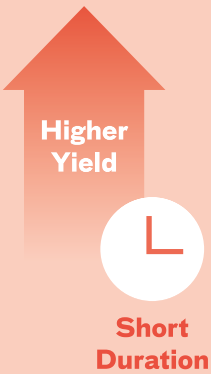
Prefer European equities
We are positive on European equities based on reasonable valuations and a robust eurozone economy that is supported by strong domestic consumption. However, political developments in Italy may dampen sentiment in the near term.

Prefer global healthcare
We expect drug approvals and an increase in M&A activity to be catalysts for a sector re-rating. Less negative announcements on drug pricing could boost sentiment.

Fixed Income

Expectations of further Fed rate hikes could lead to an increase in yields and will keep bond markets on the tenterhooks. Short-duration, high-yielding debt is the preferred option to cushion against any rate rise.

Prefer short duration and high-yielding fixed income
For better risk-adjusted return, we prefer short-duration but higher-yield fixed income instruments.



Prefer Asian IG bonds
Post-correction, valuations of Asian IG bonds have become more attractive. A sound global economy will provide support for Asian IG bonds.

Prefer floating rate bonds
Floating rate bonds are attractive in the current interest rate environment because they offer the "sweet spot" of low duration risk and attractive income levels.

Foreign Exchange

The USD is expected to soften against its Group of Ten (G10) counterparts but gain the upper hand against Asian currencies in H2 2018.

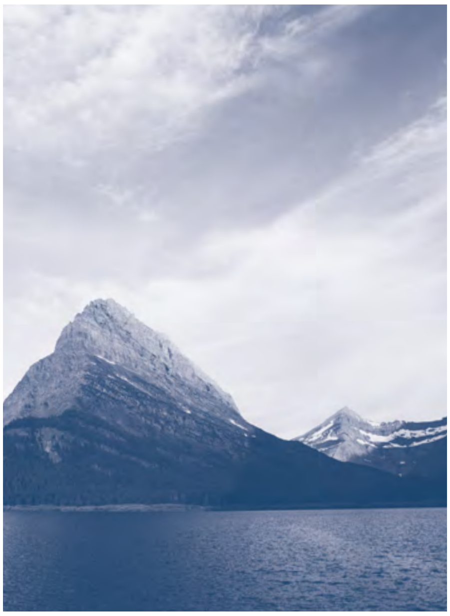
Prefer EUR
Continued monetary normalisation by the ECB and a robust eurozone economy should lead to a strengthening of the EUR.

Prefer AUD
The AUD is likely to continue to firm on the back of resilient commodity prices.

Equities

Equities remain our preferred asset class. Despite some volatility, we expect equity returns to be positive in H2 2018.

Key takeaways
Within developed markets, we are neutral on the US market, though financials offer a bright spot. We maintain a favourable view on European and Japanese equities. Undemanding valuations and a robust earnings outlook are positives for European equities while strong corporate earnings and progress on reforms should support Japanese counters. However, political concerns, particularly in Europe, may continue to hog the spotlight in H2 2018, leading to increased market volatility.



Overview

The macro environment remains constructive for equities. Despite losing some steam in H1 2018, we expect the global economy to stabilise in H2 2018. Fundamentals remain supported by central banks' relatively accommodative policies and a solid earnings outlook.

Due to corrective price pressures and continued earnings growth, valuations have become less elevated. Therefore, equities remain our preferred asset class in H2 2018.

We expect some volatility in global equity markets in the near term, given moderating global growth momentum, increasing bond yields and higher political uncertainty in Europe. Beyond that, there is room for further upside in the equity markets as the global economy should continue to thrive heading into 2019.

Regional views

Neutral on US equities, with a preference for financials

We maintain a neutral outlook on US equities for H2 2018. Despite a positive earnings momentum, relatively rich valuations and a spike in yields could put a cap on gains.

However, we are upbeat over the financial sector. Fears that weaker loan growth and a global risk spillover could hurt banking stocks are overblown.

Valuations for financials are still attractive, especially when considered over a 25-year span. Trading at a 30% discount to the benchmark, the sector's forward price-to-earnings multiple, is not elevated. Similarly, the sector's price-to-book ratio, which is trading at a 55% discount to the broader market, is undemanding.

The US Federal Reserve has shifted to a hawkish stance and is expected to hike interest rates twice more in H2 2018, and possibly a further 3 to 4 times in 2019. With short-term rates on the rise, banks will be able to lend at higher rates, providing a tailwind to their earnings.

The banking sector is also likely to get a profitability boost from deregulation, tax reform and better credit growth. Banks should be able to ride out any short-term weakness in loan volumes given their rising net interest margins, strong credit quality and tight rein over expenses.

Hopes that a positive outcome from stress test results in June could lead to increased shareholder payouts is likely to boost sentiment for financial stocks.

A key risk to financials as our top US sector pick is that the Fed turns out to be more dovish. Any delay in expected rate hikes could put a dent on the performance of US financials.

Positive on European equities, but close watch needed on political developments

We maintain a favourable view on European equities, even though the political developments in Italy could dampen sentiment in the near term. Valuations are not excessive, with European equities underpriced compared to their US counterparts. This coupled with a robust earnings outlook, means that there is still further upside for European equities.

More than half of Stoxx 600 index companies have reported stronger-than-expected earnings. This translates to a strong earnings-per-share (EPS) growth of more than 10%. In addition, top-line growth came in at a respectable 5% year-on-year.

Although the eurozone economy cooled in the beginning of the year, recent data indicate that growth momentum could still enjoy an upswing as downside surprises fizzle out. The healthy labour market bodes well for domestic consumption and this will hold up the economy for the rest of the year.

Despite the positive outlook for the eurozone, investors need to be wary of political risks in Italy. Even though the two anti-establishment parties have formed a new government, some concerns remain. The new Prime Minister Giuseppe Conte promised "radical changes", including cutting taxes and expanding welfare benefits. The new fiscal plan, if implemented, could lead to higher public debt and potential ratings downgrade. The relationship between the Italy and EU could sour if the new Italian government may take a confrontation approach against EU. Our base case scenario is for Italy to remain in the EU.

Positive on Japanese equities, with an eye on the LDP Presidential election

We expect Japanese equities to have a good run in H2 2018, with upside potential given that valuations are currently at attractive levels.

Strong corporate earnings and progress on reforms could provide the impetus for further gains. Corporate earnings will remain supported by strong domestic consumption and robust exports. Reform-minded Japanese Prime Minister Shinzo Abe's drive to improve corporate governance could also encourage companies to return cash to investors in the form of dividends or share buybacks. This will boost investor confidence.

The pro-cyclical Japanese stock market usually moves in tandem with the state of the economy. Cyclical stocks – consumer discretionary, financial, technology and industrial – make up about two-thirds of the total market capitalisation. Continued global economic expansion will sustain operating earnings and this will support Japanese equities.

Inflows into Japanese equity funds have swelled, a sign of strong appetite for Japanese shares. Inflows should remain well-supported, barring any major negative news.

Although indicators reveal that the economy hit a rough patch in Q1 2018, this is likely only a blip. Growth is likely to remain resilient in the latter half of the year. Meanwhile BoJ governor

Key takeaways
Broad EM equities remain supported by sound economic fundamentals. However, we have become more selective, given the outlook for rising yields and a possibly stronger USD. We prefer EM countries that have current account surpluses and that are less dependent on foreign funding. We are constructive on the China market and the inclusion of A-shares into the MSCI is positive for sentiment.

The healthcare sector is our preferred sector play. Increased M&A activity will increase the sector's attractiveness.

Haruhiko Kuroda's reappointment suggests that Japan is likely to maintain its easy monetary policy.

However, political risk is on the rise given dwindling support for Abe. We expect Abe to clinch a third term as leader of the ruling Liberal Democratic Party (LDP) this September. Should he fail to defend his position, his successor will still be likely to continue with pro-growth policies.

Positive on emerging market equities, selective strategy is key
EM equities continue to offer investors appealing valuations. From a price-to-book and price-to-earnings perspective, EM equities are undervalued, trading at a 25% discount to their DM peers. Consensus estimates point to EPS growth of 20% and 10% in 2018 and 2019 respectively, driven by robust global growth and rising commodity prices.

Portfolio exposure to EM equities is still relatively low, with allocation to EM equities estimated to be around 8% of total assets under management. As an asset class, EM equities show strong potential. We are likely to see further inflows and increasing exposure to EM equities, as macroeconomic indicators remain strong.

Economic fundamentals in emerging markets remain intact. Concerns over increasing trade protectionism are offset by resilient domestic consumption.

We can see several themes at play in the EM space. For one, interest rates in emerging markets are likely to mirror the upward trajectory of rates in developed markets due to central bank tapering. Rising rates will bode well for EM financial and insurance equities.

The various tailwinds driving EM growth include a pick-up in global trade as well as solid domestic growth fueled by high consumer spending power. Stronger commodity prices will continue to be a boon for EM growth and we expect EM equities to continue racking up gains, as a result.

External risks, however, remain high in H2 2018. An unexpected surge in USD strength could cause a retreat from EM equities. A stronger USD makes it more expensive for EM economies to service US dollar-denominated debt and could crimp credit capacity. A worsening of US-China trade tensions could also lead to higher market volatility.

We turn more constructive on the China market. China continues to offer stable economic growth and high corporate profit levels. The government's fresh push for more reforms to further open up the economy is positive for investor confidence. The ramping up of deleveraging and rebalancing measures will bode well for the economy in the long run.

Meanwhile, valuations of Chinese equities, in particular for H-shares, are still undemanding compared to regional or global peers. The phased addition of China's A-shares into the MSCI Emerging Markets Index this year could improve investor appetite for Chinese equities and spark further inflows into market. The inclusion is likely to lead to a re-rating of the market this year.

Risks are subsiding at the macro level. But a tightening of liquidity conditions as well as a possible slump in property sales could put a drag on the market.

Structural opportunities in healthcare

Global healthcare equities are now priced at attractive levels, having missed out of the broader market's winning streak last year. It's not too late to join the party though, given bright spots on the horizon.

The healthcare sector is trading at a discount to the long-term average price-to-earnings ratio and this offers a good entry point to gain exposure to the sector.

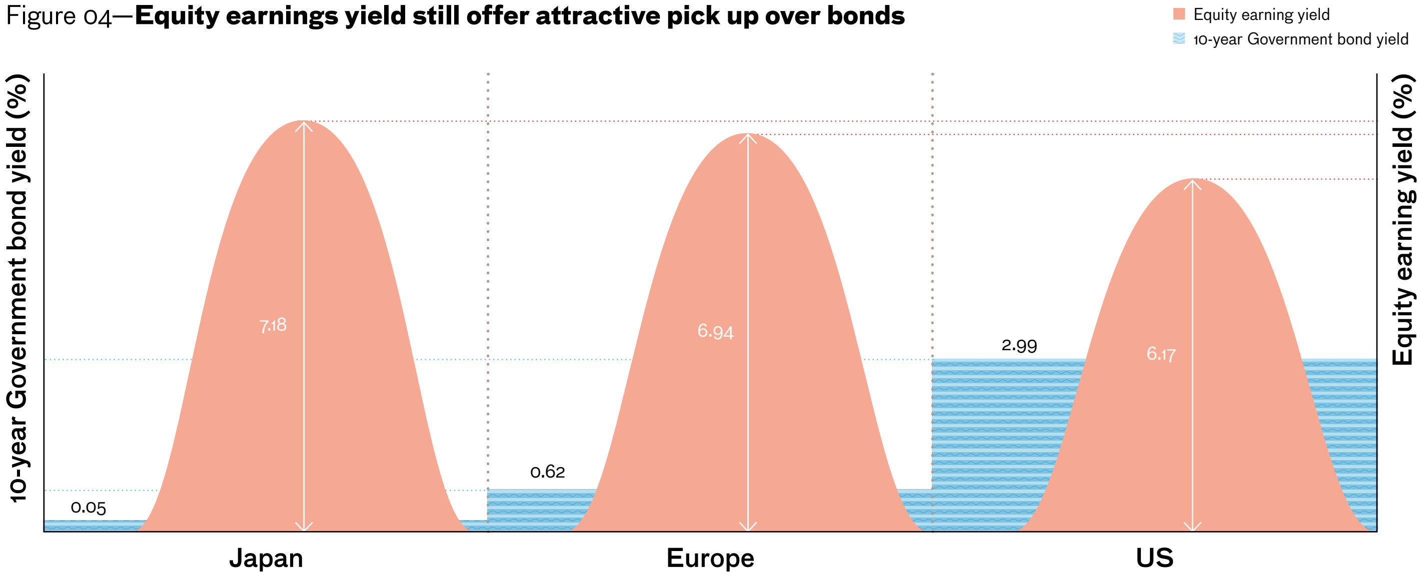
Positive news in the form of innovative drug approvals and frenzied M&A activity in the industry could drive a re-rating of the sector. Thanks to US tax reform, US corporates now have access to a stockpile of overseas cash. This could turn out to be a blockbuster deal-making season for the pharmaceutical industry. We are likely to see a ramp up in M&A activities as larger cap healthcare companies looking to repatriate cash could pour money into acquisitions.

The additional funds could also be used for dividend payments or share repurchases. This move would also boost the sector's outlook. Attractive dividend yields will sustain interest in the sector.

Policy uncertainty could weigh on sentiment for the sector, given scrutiny on drug prices especially in the specialty care areas. However, large-scale structural reform on drug pricing is unlikely, at least in the near term.

In terms of other risks, we are likely to see a continued increase in generic utilisation, with biosimilar threats flooding the market. As healthcare is a relatively defensive sector, any rise in interest rates as well as a cyclical recovery could take the shine off the sector.

Figure 04—**Equity earnings yield still offer attractive pick up over bonds**



Source: Bloomberg, UOB PFS Investment Strategy, 22 May 2018

Fixed Income

Expectations of further Fed rate hikes could lead to an increase in yields and will keep bond markets on the tenterhooks. Short-duration, high-yielding debt is the preferred option to cushion against any rate rise.

Key takeaways
Short duration high-yielding fixed income instruments offer higher yields and have lower sensitivity to interest rates.

Asian IG bonds are back to attractive valuation levels following a technical correction.

Floating rate bonds are an attractive option, providing a buffer against rate hikes without sacrificing income.

Overview

With the consolidation of US Treasury yields, headwinds to fixed income assets could moderate in H2 2018. However, the tight US labour market means that the upside for yields remains. As such, our preference is for short-duration, high-yielding fixed income instruments.

Corporate credits, in particular IG bonds, experienced a sell-off in H1 2018. Despite the weakness in the credit markets, there are still selective opportunities in USD-denominated Asian IG bonds as yields become more attractive.

Given expectations of further Fed rate hikes and rising LIBOR rates, floating rate notes offer investors the "sweet spot" with their low duration risk and attractive income levels.

Prefer short-duration high-yielding fixed income

Although duration risk remains, the outlook for US Treasuries is not as dim compared to the beginning of the year. We expect the 10-year US Treasury yield to hit 3.2% by the end of the year and continue its upward trajectory beyond that. The 10-year US bond is currently oversold and there is a lingering chill over long-term bonds. The excessive unwinding of positions could rein in upward pressure on yields – for now. However, with inflationary pressures on the rise and the dialing back of loose monetary policies globally, long-term rates are likely to trend higher over a longer-term horizon.

For better risk-adjusted returns, we prefer shorter-duration but higher-yielding fixed income instruments. After repricing, short-term corporate bonds offer a more appealing alternative than longer-term bonds. They can offer positive total returns as the income from higher yields should be able to cushion any capital losses from price decreases due to higher rates.

USD-denominated Asian IG bonds

Asian IG bonds suffered a wave of losses in H1 2018. This was due to a technical correction rather than worsening credit fundamentals. Supply from Chinese issuers outstripped demand as offshore appetite for IG bonds waned and this triggered the sell-off. Chinese issuers have turned to the offshore bond market for funding instead of tapping the onshore market given the latter's current weakness.

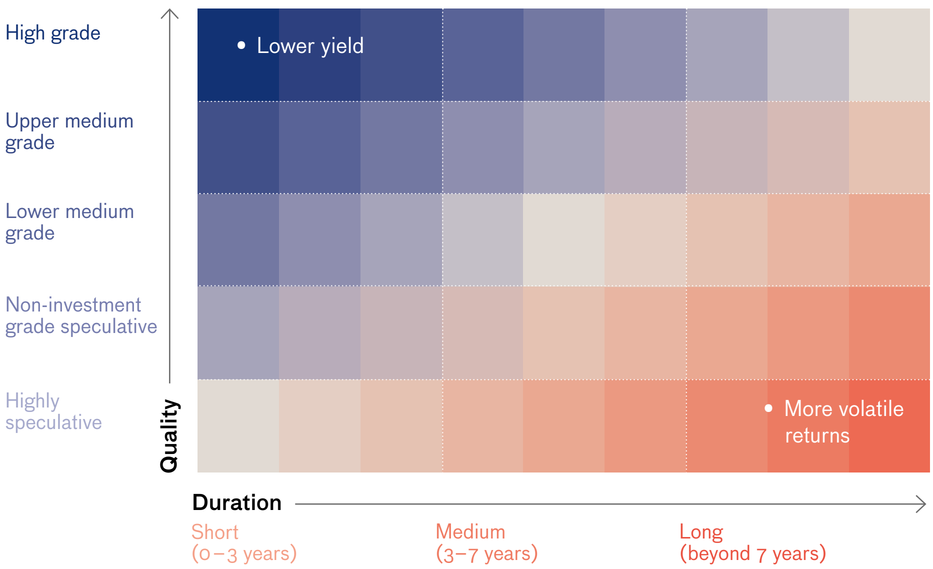
Following the correction, valuations have come down to more attractive levels in certain segments of the market. This offers an opportunity for investors to snap up selected issues at cheap prices. If the excess supply is not mopped up, technicals could remain weak in the immediate term. However, the higher yields are likely to entice investors from the sidelines and this will provide some support to the market.

The global economic growth story remains intact. And with the Chinese economy also on firm footing, the fundamentals for Asian credit are still looking bright.

Floating rate notes

Given the uncertainty over the outlook for interest rates, floating rate bonds offer protection against the effect of rate hikes without sacrificing income. A low duration fixed income security, floating rate bonds feature variable coupons that are tied to benchmarked rates such as the LIBOR. Should the benchmarked rates increase, the coupons will revised upwards accordingly, buffering investors against rising interest rates.

Figure 05—**Short duration and higher quality bonds are preferred**



Source: UOB PFS Investment Strategy, 22 May 2018

Foreign Exchange

The USD is expected to soften against its G10 counterparts but gain the upper hand against Asian currencies in H2 2018.

Key takeaways

The USD is expected to remain sluggish against G10 currencies.

The EUR should strengthen as ECB prepares to exit from quantitative easing, commodity prices could fuel gains in the AUD, while a flight to safety will keep the JPY supported. However, the GBP could weaken amidst continued uncertainty over Brexit.

Singapore's normalisation of monetary policy is likely to cast a pall on the SGD. Meanwhile, other emerging market Asian currencies are also likely to experience a mild depreciation against the USD.

Overview

The USD has bounced back from its earlier setback and a strong US economic backdrop should continue to lend support to the USD. However, the picture is mixed over the next 12 months. We expect the USD to ease against its G10 counterparts but gain ground against other EM currencies. Potential factors that could weigh on the USD include a flattening of the yield curve as well as a gradual tightening of monetary policy by major central banks, including the Fed.

G10 currencies against USD

EUR to climb on quantitative tapering

The EUR has weakened, given the moderating pace of economic growth in Europe and uncertainty surrounding Italian politics. Going forward, the EUR is likely to make further gains on the back of a strengthening eurozone economy, healthy trade and ECB normalisation. In its latest forecasts, the ECB left its growth and inflation projections largely unchanged at 2.4% and 1.4% respectively. In H2 2018, the ECB will be winding down its quantitative easing policy and is expected to end its asset purchase programme by the end of the year. This should provide support to the EUR.

AUD supported by commodity prices

Although the Australian economy has shown signs of cooling and the RBA has been keeping interest rates on hold, we believe that the AUD will continue to hold firm. Strong commodity prices should drive gains in the AUD. We see a mild strengthening of the AUD against the USD for H2 2018.

JPY buffered by safe-haven status

With the reappointment of Haruhiko Kuroda as BoJ Governor, the BoJ is likely to maintain a loose monetary policy given that Japan has yet to meet its 2% inflation target. However, any global risk aversion is likely to prompt a flight to safety to the JPY and trigger a JPY rally. H2 2018 should see increased political risks with ruling party elections and mid-term elections in Japan and US respectively. Given these events, 110 is a key resistance level for the USD/JPY pair.

GBP to soften on Brexit fears

The GBP weakened in H1 2018, amidst growing concerns over Brexit and the Bank of England's (BoE) procrastination in hiking rates. The BoE is expected to make its move in August, but continued uncertainty over Brexit, a gloomy UK economic outlook and a widening current account deficit could cast a pall over the GBP. As such, we expect the GBP to remain soft with a GBP/USD ceiling of 1.40 for the rest of the year.

Asian currencies against USD

SGD to ease on monetary policy normalisation

As expected, the Monetary Authority of Singapore (MAS) normalised its monetary policy in April, marking the first time it has tightened policy in six years. Singapore's slowing export growth coincides with the Fed's monetary normalisation policy as the US continues to increase rates gradually and unwind its balance sheet. Given this, we expect the SGD to lose steam going forward. The USD/SGD is likely to head higher for H2 2018.

Other Asian currencies to depreciate against USD

We expect most EM currencies to weaken against the USD in H2 2018.

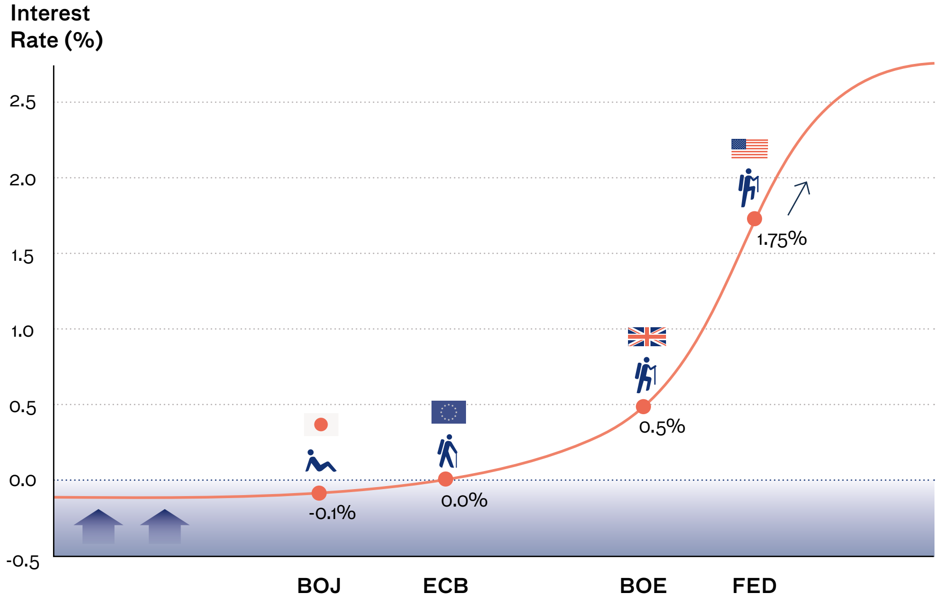
The RMB is likely to hold its ground against the USD given improving sentiment due to easing US-China trade tensions. We expect only a mild weakening of the RMB against the USD for the rest of the year.

Although the THB eased slightly against the USD, prospects for the Thai economy remain bright, buoyed by robust exports and a strong tourism sector. The Fed's gradual rate hikes could put a cap on THB gains. Given this, we expect the THB to be range bound in H2 2018.

The MYR may experience some consolidation in H2 2018. The USD's advance on the back of US rate hikes as well as uncertainty over the pace of reforms in Malaysia could cap the MYR's strength. Still, we expect the MYR to gradually strengthen as the macroeconomic situation in Malaysia improves.

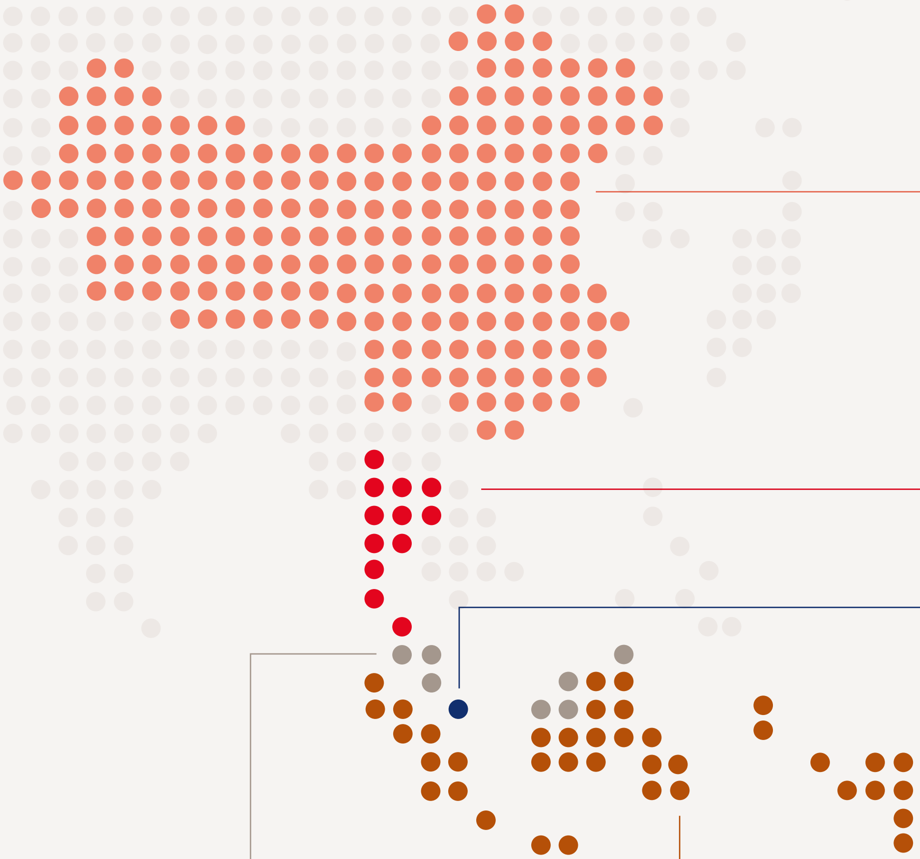
The IDR has declined against the USD as the Fed's rate hikes have dimmed the allure of Asian currencies. The IDR's slump is likely to continue given Indonesia's widening current account and fiscal deficits. The unwinding of carry trades will continue to hurt the IDR.

Figure 06—**G4 central bank rates at a glance**



Source: UOB PFS Investment Strategy, 22 May 2018

Regional Macro Summaries



Key takeaways

Generally, Asian equities should remain supported by strong economic growth and robust investor sentiment. We are positive on Singapore and China equities.

Fixed income markets should hold up but investors need to keep a close watch on the effects of the rate tightening by the Fed.

Asian currencies are likely to depreciate against the USD, given the Fed's tightening stance. Long term, we are positive on MYR as structural reforms improve.

Malaysia

Stocks

Selective on Malaysian equities. Short-lived knee-jerk reaction and increased volatility following the unexpected election results. Stocks should recover following greater clarity on government and economic policy. Selectiveness is key.

Bonds

Concerns over a larger budget deficit remain, but outflows of MYR-denominated government bonds likely contained by strong foreign reserves and robust domestic liquidity. Expect sensible macro and fiscal policy to prevail.

Foreign Exchange

Temporary weakness of MYR due to domestic uncertainties and USD technical rebound. Long-term positive due to structural reforms and efforts to improve governance, transparency and accountability.

Indonesia

Stocks

Cautiously optimistic on Indonesian equities. Attractive valuations after recent rout, above 5% GDP growth and manageable current account deficits. Lingering uncertainty from higher oil prices, negative trade balance and external headwinds.

Bonds

Headwinds from higher US rates and a stronger USD may trigger an unwinding of Indonesian carry trades. Bank Indonesia has heavily intervened in the currency and secondary bonds markets. Rate hike expected.

Foreign Exchange

The IDR may face some volatility. With current account and fiscal deficits, IDR could come under pressure as the Fed hikes rates. However, the attractive interest rate differential may provide some buffer.

China

Stocks
Positive on China equities. Improving sentiment supported by solid GDP growth, greater regulation certainty, earnings improvement, and A-share inclusion into the MSCI. Favour growth stocks in banking, consumption, healthcare and advanced manufacturing.

Bonds
Better-than-expected performance from local fixed income, driven by lower total financing demand and the People's Bank of China's neutral policy stance. Default risk remains on corporate credits. Favour high quality bonds.

Foreign Exchange
RMB may face a moderate depreciation against the USD in H2 2018, given concerns of trade frictions between China and the US, as well as the Fed's tightening path this year.

Singapore

Stocks
Constructive on Singapore equities. Valuations are fair, despite the H1 2018 rally. Rising yields, a housing recovery and higher oil prices will boost the banking, real estate and oil services sectors.

Bonds
Local rates are expected to drift higher, led by the tightening cycle in the US. However, less issuance and robust demand are likely to support the local bond market.

Foreign Exchange
SGD likely to weaken against the USD in H2 2018, amidst moderating exports and the Fed's expected moves to hike rates and reduce the balance sheet gradually.

Thailand

Stocks
Neutral on Thai equities. Economic growth supported by exports, tourism and private expenditure but downward revisions to earnings and heftier valuations could cloud the picture. Banking, commerce, and healthcare sectors to shine.

Bonds
Expected slight steepening in the yield curve, as Thai inflation shows signs of rising gradually, albeit from low levels. Volatility capped as only less than 10% of bonds are in foreign holdings.

Foreign Exchange
After recent USD strength, THB likely to be range bound. The THB should regain its footing in H2 2018 as the current account surplus improves. Expect a rate hike from the Bank of Thailand.

Important Information

The information herein is given on a general basis without obligation and is strictly for information purposes only. It is not intended as an offer or solicitation with respect to the purchase or sale of any investment or insurance product mentioned herein. Nothing herein should be construed as a recommendation or advice to transact in any investment or insurance product mentioned herein.

Although every reasonable care has been taken to ensure the accuracy and objectivity of the information contained in this publication, United Overseas Bank Limited ("the Company") and its employees cannot be held liable for any errors, inaccuracies or omissions, howsoever caused, or for any decision or action taken based on the information or views expressed in this publication.

The Company does not warrant the accuracy, adequacy, timeliness or completeness of the information herein for any particular purpose, and expressly disclaims liability for any errors, inaccuracies or omissions. Any opinions, projections and other forward looking statements regarding future events or performance of, including but not limited to, countries, markets or companies are not necessarily indicative of, and may differ from actual events or results. The information herein has no regard to the specific objectives, financial situation and particular needs of any specific person. Investors may wish to seek advice from an independent financial advisor before investing in any investment or insurance product. Should you choose not to seek such advice, you should consider whether the investment or insurance product in question is suitable for you.

This page is intentionally left blank.

RIGHT BY YOU