Investment Insights

APRIL 2018

Top 5 Messages for Investors in Q2 2018

Summary

- Underlying economy remains resilient.
- Corporate profits continue to see broad uptrends globally.
- Recession risks remain low for next 12 months.
- Equity remains the preferred asset class.
- Regime of low-volatility is probably behind us.

Snapshot of our asset allocation views in 2Q2018

	2Q2018	1Q2018	Remarks
Equities	+	+	The recent market volatility is part of correction rather than the start of a bear market
Bonds	–	–	Rates are to drift higher gradually, posing headwinds to fixed income performance but not disrupting the market
Commodities	N	N	Prices are expected to consolidate for oil and industrial metals due to a build-up in net long positioning and inventories
USD	–	–	Trade war concern could continue to weigh on the USD in 2Q18

Inside

Should you have any queries, please contact your UOB Banker for more information.

Review of Q1 2018

Global equity markets entered 2018 on a bumpy ride, after exuberant optimism in 2017. After an 18-month unabated upward trend, global equities rallied close to 5% in January, before pulling back to close the first quarter at 1.2% down.

Despite the cheer in January, equities came under heavy pressure in early February. The hawkish inflation expectations in January's FOMC meeting and higher-than-expected wage growth caused a spike in bond yields and triggered the downward movement in global equities. A tough February for investors generally, as equities, bonds and commodities were all in negative territory.

Entering into March, market's focus turned to the escalating trade war rhetoric between US and China. Amid this new tension, safe-haven currencies and bonds gained, while equities took the hit.

Figure 1: Global markets in 1Q 2018.

Asset Class	Total Return (%)			
	Jan	Feb	Mar	YTD
Global Equities	5.3	-4.1	-2.1	-1.2
Global Bonds	-0.7	-0.2	0.8	-0.1
Global Commodities	1.9	-1.8	-0.8	-0.8
USD Index	-3.2	1.7	-0.7	-2.3

Source: Bloomberg, UOB PFS Investment Strategy, 31 March 2018

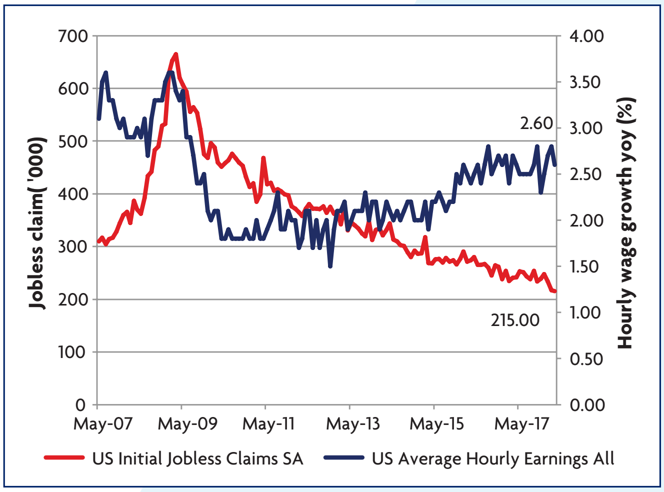
Q2 Investment Outlook – Five things you need to know

1. Resilient Global Economy

Despite global equity markets experiencing volatile movements in Q1, the underlying economy remains resilient.

US jobless claims have been below the 300,000 threshold for 158 straight weeks, indicating that the labour market is healthy. Economic growth in the Eurozone continued its moderate expansion. Even though Euro zone Manufacturing PMI has dipped from 60.6 In December 2017 to 56.6 in March 2018, the reading is way above 50 and points to ongoing economic expansion. With Asian economies also posting moderate economic growth, it continues to support investors' confidence that this latest downturn is a correction rather than a budding bear market.

Figure 2: US labour market is strong.

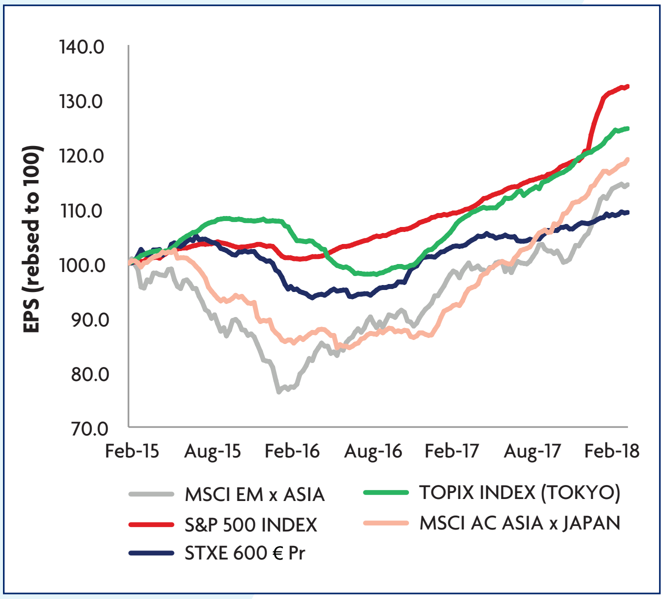


Source: Bloomberg, UOB PFS Investment Strategy, 31 March 2018

2. Upbeat Earnings Growth

Corporate profits are the key drivers for equity market returns over the longer term. Corporate profits continue to see broad uptrends across the globe.

Figure 3: Earnings continue to see uptrends.

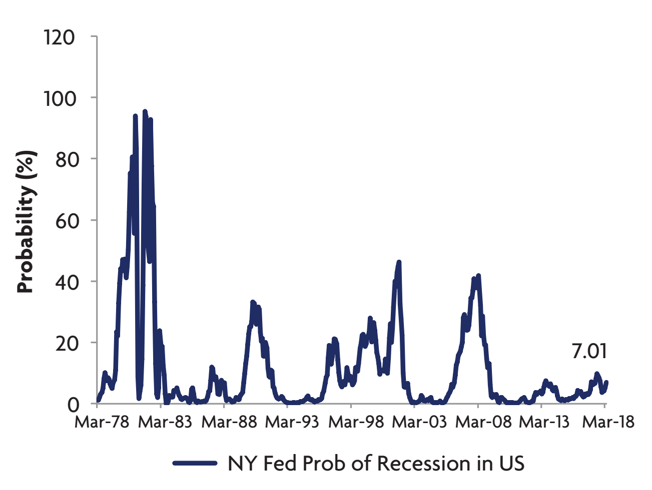


Source: Bloomberg, UOB PFS Investment Strategy, 31 March 2018

3. Low Probability of Recession

The recession indicators point to a low likelihood of recession in the next 12 months. One such indicator is the Federal Reserve's recession model that had successfully predicted the last seven recessions. This model has indicated the probability of recession in the next 12 months is at 7%, albeit the probability is trending higher.

Figure 4: The Fed's recession model shows low probability of recession in next 12 months.



Source: Bloomberg, UOB PFS Investment Strategy, 31 March 2018

4. Equity remains the preferred asset class

The latest turbulence in global equity markets should not shake investors' confidence in equities. After the sell-off, valuations of global equities have become more reasonable. As trade tensions between the US and China abate and US economy demonstrating the ability to weather the rise in US rates, the underperformance of global equities could be quickly reversed.

5. Low volatility regime is behind us

Throughout 2017, the S&P 500 Volatility (VIX) index traded around low teens. VIX index hit an intraday peak of 50.3 in February, before settling back down to its 30-year average of 19.0, closing out March at 20.0. Going forward, the volatility is likely to stay around the high-teens range, which is consistent with late cycle dynamics and higher geopolitical uncertainties. Larger price swings could also become more common.

Implications for investors ▶▶

Equities	Current pull-back is in line with a correction in the bull market rather than the start of a bear market. Resilient economy and upbeat earnings support a constructive view on equities. We continue to like **financials and ex-US opportunities** on relative valuations and growth prospects.
Fixed income	Valuations are tight for broad fixed income market. Inflation and monetary normalisation are the key developments to monitor. We **prefer Emerging market local currency bonds**, which still offer value and buffer against higher rates.
Commodities	We have **dialled down the bullishness** on commodities. Build-up in net long positioning and inventories are likely to lead to range-bound trading of oil and industrial metals in the near term.
FX	Concerns about the trade war between the US and China may continue to **weigh on USD in second quarter**. As the Fed is on track to hike 2 more times in 2018, the larger interest rate differentials could provide some support to USD in the 2H2018.
Risks	Fear of trade wars is likely to swing market sentiments. Our base case is that the probability of a trade war between the US and China remains low, as the two countries are likely to negotiate some sorts of deals to avoid the lose-lose situation. Rates and inflation data are important to monitor closely. Our base case is that inflation is expected to trend higher gradually and the robust global economy can weather the impacts of higher rates.

Market Outlook and Strategies ▶▶

Macro

Global Growth	**Global economic activities continue to firm up**. Global growth forecast for 2018 is revised up to 3.9% from 3.7%. EMs lead the improvement in growth, while the outlooks for DMs remain mostly stable.
Monetary Policy	Central banks continue to normalise monetary policy. **Fed leads with rate hikes and BSR**. ECB has started tapering. BOJ is likely to remain accommodative, but its stance could shift.
Inflation & Rates	**Inflationary pressure stay subdued but is expected to trend higher**. Forecast the Fed to hike rates **3 times in 2018**, with one done in March meeting, and **10-year Treasury yield to reach 3.2% by Q418**.

Risks

Inflation Overshoot	Yields have repriced but **tight labour markets and stable commodity prices** could feed further into wage growth and inflation. Spikes in yields could affect risk assets negatively.
China Hard Landing	Chinese government is likely to continue to strike a balance between stability and deleveraging. **But overly aggressive policies could raise default rates and hard landing concerns**.
Geopolitical & Political	**Tensions spiked between the US and China** as Trump announced 25% tariff on the imports from China. Our base case is no full-on trade war, but **headline news could cause higher volatility**.

Strategies

Tactical Strategy		Key Proposition	Key Risks
Reflation and rotation in DM	**US financials equities**	• Attractive discount versus broad US market and benefits from a reflationary environment.	• If the Fed turns out to be more dovish and hike rates less than market expected, performances of could be hurt.
	European equities	• Attractive discount versus US and tailwinds from improving economic activities.	• Strong Euro could negatively impact exporters, but the impacts are mitigated by improving domestic demand. Some political risks remain.
	Japanese equities	• Attractive discount versus other DM equities and local sentiments have recovered. Potential policy tailwinds under Abe's rule.	• A change in BOJ's monetary stance could cause Yen to strengthen. However, BOJ should remain largely dovish.
Tap into EM growth	**EM equities** *Incl. EM allocation and Asian equities*	• Offer more appealing valuations and potential tailwind from structural reforms. Stable commodity prices could provide support to earnings.	• Unexpected USD strength could be headwind, but we expect USD to stay range-bound.
	EMD LCY	• Higher yields versus other fixed income assets and benefit from improving fundamentals in EMs.	• Unexpected USD strength could be headwind, but we expect USD to stay range-bound.
Structural opportunities	**Quality equities**	• Tend to experience less drawdowns during sell-offs and outperform broad equity markets over longer investment cycles.	• Hefty valuations could increase probability of short-term corrections. However, global recession risks remain low.
	Global healthcare equities	• Attractive valuations and earnings likely to improve on higher innovative drug approvals and strong M&A activities.	• Policy uncertainties could continue to weigh on sentiments, but meaningful structural reform of drug pricing is unlikely in the foreseeable future.
Yield Enhancer	**Short duration high yield bonds**	• Lower sensitivity to interest rates and attractive yields versus Treasuries.	• Default risks could rise if economic conditions worsen, but current outlook remains stable.

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