UOB

Investment Insights

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Central banks turn dovish: time for a fresh look at bonds

Major central banks have struck a more dovish tone recently. Given the shift towards a more accommodative monetary stance, investors should reassess their existing portfolio allocations.

To avoid taking excessive equity risk, investors can consider adding bonds to their portfolios to keep portfolio volatility within a reasonable range. Locking in profit from tactical positions that are in positive territory and shifting into bonds is a strategy to protect gains.

Central bank doves spell the end of the tightening cycle?

US Federal Reserve (Fed)

- **No more rate hikes in 2019**. At its 19-20 March 2019 meeting, the Fed left interest rates unchanged and signalled that there would be no further rate hikes this year. The change in tone reflected concerns over lower growth and inflation.
- **Policy normalisation to stop**. The Fed also announced that it would end its balance sheet reduction programme by the end of Q3 2019. By winding up its tightening measures, it is set to keep monetary policy loose and increase liquidity, which should support asset prices.
- **Our house view**. Given the Fed's change in tune, we expect no further US rate hikes in 2019 and 2020, with a possibility of a rate cut in Q3 2020.

Inside

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Central bank doves spell the end of the tightening cycle?

European Central Bank (ECB)

- **Growth forecasts downgraded**. At its March 2019 meeting, the ECB revealed a big cut in growth projections. Highlighting greater economic vulnerabilities, it reduced its 2019 growth forecast to 1.1%, down from the previous 1.7% estimate the quarter before.
- **No rate hike in 2019**. In a dovish surprise, the ECB announced that it would not raise interest rates for the rest of the year against earlier expectations of rate hikes in H2 2019.
- **Fresh round of stimulus in store**. The ECB plans to inject greater liquidity into the financial system by reintroducing Targeted Long-Term Refinancing Operations (TLTROs). The move to extend cheap loans to banks is aimed at shoring up the eurozone's flagging economy.

Bank of Japan (BoJ)

- **Policies kept accommodative**. The BoJ left interest rates unchanged during its March 2019 meeting and remains committed to its ultra-loose monetary policy given the economy's delicate health.
- **External risks have heightened**. The Japanese central bank retained its view of a moderately expanding economy but acknowledged that rising overseas risks could threaten the fragile economic recovery. Slowing global growth led to a weaker export outlook.

Revisiting bonds to counterbalance equity risk

Managing portfolio volatility vital during the late-cycle stage

- **Geopolitical events have weighed on global growth**. Concerns over Brexit and the US-China trade conflict have taken a toll on growth in recent months and dampened investor sentiment up till recently. Although recent progress in US-China talks have given markets a reason to cheer, prolonged trade tensions could remain a potential flashpoint and a tail-risk which investors may want to take precautions against.
- **Late-cycle volatility**. The global economy is now in the late-cycle, which is marked by moderating growth, softer trade flows and slowing production. Fluctuations in the financial markets during this phase tend to lead to greater portfolio volatility.
- **Stabilising portfolios by increasing exposure to bonds**. While there are still opportunities in equities, investors need to mitigate excessive risk in their portfolios. To rebalance their portfolios, investors can consider locking in profits and move into investment grade bonds to balance against equity risk.

The case for investment grade (IG) bonds

- **Lower risk of default**. Typically issued by high-quality corporations, IG bonds usually carry a better credit rating, which translates into a lower probability of default.
- **Lower volatility**. IG bonds are typically less volatile than high-yield bonds and equities.
- **Reasonable yields**. With yields between 2.5% to 4.5%, IG bonds can augment investors' passive income stream.

Selecting IG bonds at reasonable valuations is key

Investors should look out for good buying opportunities in selecting IG bonds. In this space, we prefer Asian IG bonds and European bank bonds because of their attractive valuations.

Asian investment grade bonds

- **Attractive yields**. Valuations of Asian IG bonds are looking very reasonable, given that current yields are over 4%.
- **Limited impact from trade tensions**. US-China trade tensions are unlikely to greatly affect Asian IG bonds as issuers with direct US exposure only form 1.4% of total issuance, but investors still need to be wary of secondary spill-over effects should trade tensions escalate.
- **Support from Asian currencies**. Central bank monetary policy loosening in developed markets is likely to cap the US dollar's strength, giving some respite to Asian currencies. This should boost the attractiveness of Asian IG bonds.

Selecting IG bonds at reasonable valuations is key

European bank bonds

- **Well-capitalised.** European banks are generally backed by sufficient assets to meet cash flow needs, reducing default risk.
- **Strong cashflow generation**. Having generated more cashflow since 2015, European banks are more stable and better able to meet bond coupon payouts.
- **Limited new supply**. With fewer new issues expected to hit the market, current prices in secondary markets should be well supported.
- **Stimulus measures will keep interest rates low**. The ECB's TLTRO scheme and benign eurozone inflation are likely to cap interest rates. The low interest rate environment will keep bank bond prices stable.
- **Be wary of troubled issuers**. Investors should avoid bonds issued by banks which may be subject to legal procedures due to suspected wrongdoings. The resulting punitive measures could affect their credit ratings and cashflow.

Conclusion

- Major central banks have leaned towards an easing of monetary policy and this will support asset prices in general, including equities and bonds.
- To mitigate equity risk and lower portfolio volatility during the late-cycle stage, investors should review their portfolios. To preserve gains, they can consider taking profit from tactical holdings that are in positive territory and buy into IG bonds.
- In the IG bond space, the relatively attractive valuations of Asian IG bonds and European bank bonds offer an attractive entry point for investors.

Market Outlook and Strategies ▶▶

Economic Drivers

Global growth	The IMF forecasts global GDP growth to slow to **3.3% in 2019**[1] **from 3.7% in 2018**, on par with the average growth rate from 2012 to 2016. However, slower growth does not equate to a recession in 2019.
Inflation and central banks	Central banks have adopted a **dovish tone**. The Fed and ECB will not be hiking rates in 2019, while the BoJ will likely stay accomodative for the foreseeable future.
Corporate earnings	In 2019, strong personal consumption supported by a healthy jobs market should continue to drive the **positive trend** in corporate profits. Global earnings growth is expected to rise around **8% in both 2019 and 2020**.

Risks

Rising US protectionism	The US could impose more tariffs on Chinese products in 2019. **Continued trade woes** will hit Asian economies that are plugged into global value chains. Higher import prices could raise costs and lower profit margins.
Central bank policy missteps	Inflation continues to rise mildly amidst a tight labour market. **Excessive dovishness** by central banks could lead to an inflation overshoot. Conversely, if central banks are **overly-aggressive in tightening** monetary policy without high inflation, the excessive reduction in liquidity could suffocate economic growth.
Political risks	The original Brexit Day of 29 March came and went, but the UK Parliament has not accepted any Brexit proposal. Parliament has to propose new terms for EU negotiations or risk a no-deal Brexit on 12 April. As a result, financial markets could see **increasing volatility** as politicians continue to bicker.

[1] World Economic Outlook, IMF, April 2019

High Conviction Strategies

Conviction	Key Proposition	Risks
Global Quality Equities	Global quality equities tend to outperform broad equity markets over longer investment cycles.	Relatively expensive valuations could increase the probability of short-term corrections. However, the quality companies tend to better weather the economic slowdown, limiting the likelihood of large corrections in quality stocks.
Emerging Market Equities	Broad EM equities are supported by stronger fundamentals and attractive valuations.	An unexpected surge in USD strength could cause a retreat from EM equities, as seen in the Turkey situation last year. A worsening of US-China trade tensions could also lead to higher market volatility.
US Financial Equities	Attractive valuations and higher earnings due to resuming loan growth.	An escalation in the US-China trade war will hurt global growth. US banks will feel the impact directly. Increase in regulatory pressure on certain wayward banks that have been alleged of criminal wrongdoing (e.g. money laundering) will pose idiosyncratic risks.

Megatrend Strategies

Conviction	Key Proposition	Risks
Global Healthcare Equities	Healthcare is a structural growth story driven by long-term growth in an aging global population. In the medium-term, we expect drug approvals and an increase in M&A activity to be catalysts for a sector re-rating.	Policy uncertainty could weigh on sentiment for the sector. Concerns over drug pricing could place pharmaceutical companies under closer scrutiny in the near-term. This risk will likely be mitigated in the long-term as a growing silver segment should contribute to stronger increase in demand.
Chinese Equities	Chinese equities are underowned by global investors, and provide a good risk-reward and diversification benefits.	A US-China trade war remains a key risk in the near term. Negotiations are likely to be long-drawn, but both sides have shown commitment in reaching a deal sooner rather than later. Financial deleveraging could continue to put pressure on growth and lead to higher risks of policy missteps.
AI & Innovation-Driven Companies	Artificial Intelligence (AI) has the ability to drive multi-fold increases in productivity by utilising big data and powerful computing hardware to accurately and reliably solve real-world problems with little human input.	Policy and regulatory uncertainty is a key risk to watch for. As AI permeates more and more into people's daily lives, questions about safeguarding individual privacy and appropriate use of such tools will surface. Regulators may step up efforts to curb the uses and applications, while differing standards from various countries can create barriers to universal adoption.

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