UOB

# Investment Insights

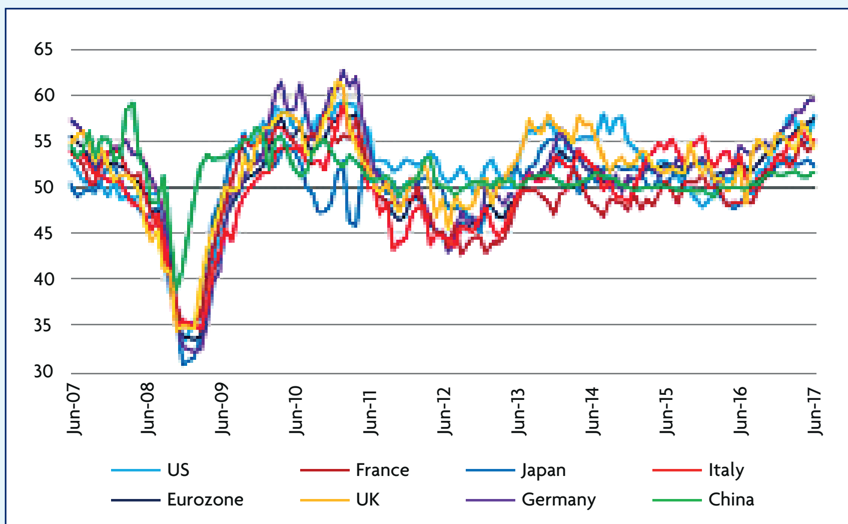
AUGUST 2017

## Focus on central banks

In the aftermath of the 2008 global financial crisis, the world experienced spouts of bleak recovery periods in different countries at different times. Today, we have come of age and finally witnessed a global synchronous growth in major developed and emerging countries (something we have not experienced since 2010). See Figure 1.

Some credit can be attributed to the ultra-accommodative monetary policies by global central banks. Unconventional tools like quantitative easing (QE) and negative interest rates were deployed by the major central banks, in an effort to stimulate growth. We believe that the three central banks - US Federal Reserve (Fed), European Central Bank (ECB) and Bank of Japan (BOJ) are at different stages in their monetary policy cycle, with their set of strategies and tools to deal with their own respective challenges.

Figure 1: Selected global manufacturing PMI indices (›50 = expansion).




Source: Bloomberg, July 2017

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## Fed faces a tug-of-war between a tight labour market and a muted inflation

The Fed has dual mandates, seeking to foster maximum employment and price stability. Whilst it has achieved amazing results in the labour market, core inflation remains stubbornly low. It is potentially risky for the Fed to take extreme paths – either to embark on an aggressive tightening stance to cool the heated jobs market or to be too accommodative, creating potential future asset price bubbles.

The Fed has raised interest twice this year, bringing the target range for the federal funds rate at **1% to 1.25%**. Expectations are for another rate hike in December this year to bring the level another 0.25% higher.

The recent announcement brings the focus to another policy adjustment, **Balance Sheet Reduction (BSR)**. The Federal Reserve has amassed its holdings of Treasury and agency mortgage-backed securities over the period of quantitative easing to the current size of USD 4.5 trillion. The plan is to reduce the balance sheet by gradually reducing its reinvestment of the principal payments in a steady and pre-announced pace. This should reduce market's ambiguity and prevent liquidity shocks. BSR is likely to commence in September this year.

By utilising both interest rates and BSR, the Fed should be able to effect a normalisation of the monetary policy whilst remaining accommodative and supporting current economic conditions.

## ECB announces intention to taper asset purchases, euro surges as an unintended result

Ever since the ECB started its QE two years ago, the Eurozone economy has found its footing and have been strengthening many areas, including employment and corporate activities. Speaking at a recent ECB meeting in Sintra, Portugal, ECB President Draghi made market participants rethink about their once negative positioning on the euro currency as it highlights the **'strengthening and broadening recovery'**. This resulted in a 9% appreciation against the USD in the last three months. Markets are also expecting a tapering in the asset purchase quantity – the first sign of a potential exit from unconventional accommodative monetary policies.

Despite the currency strength (due to market forces), ECB remains committed to providing an accommodative monetary environment and an effective transmission process. ECB has just turned the first corner and gradually moving towards some form of normalisation progress. We think that the ECB will continue the path of persistence and prudence in the near future and not risk premature killing the fragile recovery.

## BOJ is far from ending easing and reducing its asset holdings

Market expectations for the BOJ have been very dovish, with 74% forecasting it will not tighten until after the current governor Kuroda ends his term in April 2018.

The governor acknowledged last month that the annual pace of bond purchases has slowed to about 60 trillion yen (USD548 billion), from a rough guideline of 80 trillion yen. So far, the **Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control** has helped companies to borrow at low levels, thereby improving credit demand to help support business activities. In fact, the BOJ has **upgraded its assessment of the Japanese economy by using the word "expansion" for the first time in nine years**.

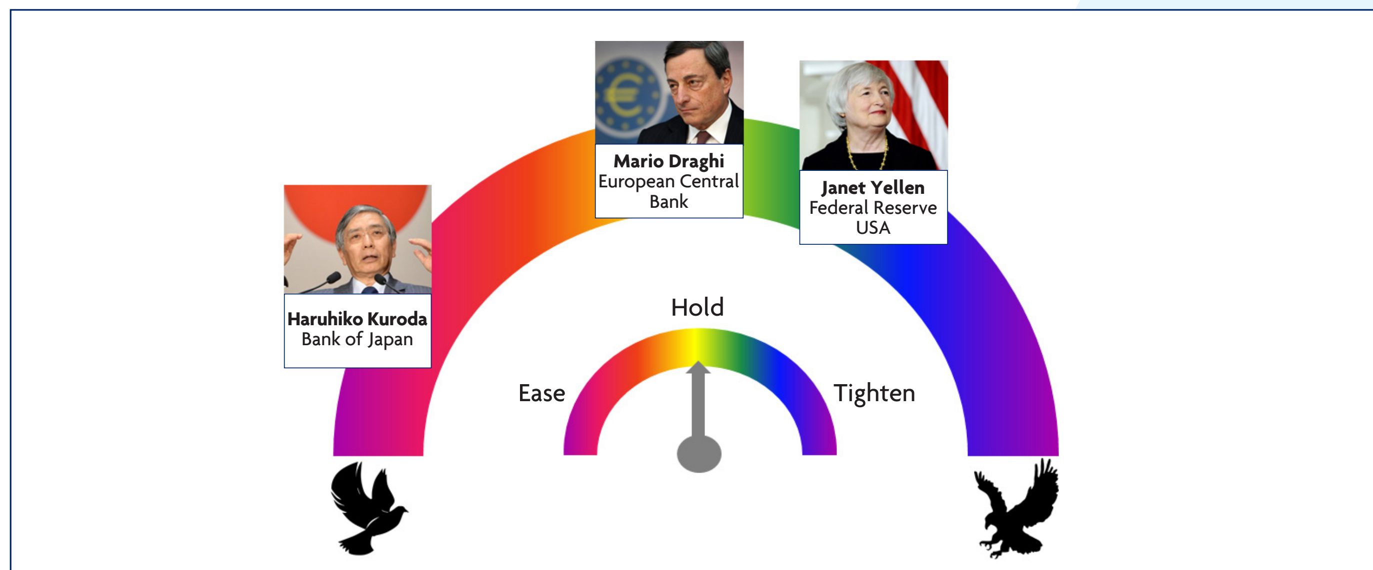
However, Japan's core inflation still hovers around the deflation line. It is now too early to discuss any exit plans until the inflation longer term outlook clears up.

## What are the likely impacts of the central bank policies?

**Overall, global interest rates are likely to trend higher**. Out of the three major central banks, two (Fed and ECB) are already taking steps towards normalisation. Government bonds yields in the US and Europe are expected to rise, albeit at a lower path than previous rate hike cycles.

**Core inflation is still kept low, with temporary factors helping**. It is worrying some economists that global inflation did not rise, despite experiencing a synchronised global growth. This can be attributed to low commodity prices and improvements in technology. Central bankers therefore are not pressured to tighten, with their lingering fear that this may stifle the nascent global recovery. However, investors should still pay attention to developments in inflation as **markets may be underpricing the risks of the upside in inflation, which may result in rising bond yields (i.e. lower bond prices).**

Figure 2: Central bankers do not seem to be too hawkish.




Source: UOB PFS Investment Strategy. August 2017

# What it means to Investors?

## Short is sweet for duration

While the Fed has delivered a relatively dovish statement, we continue to expect policy normalisation to continue, albeit gradually. Higher rates are likely having a greater impact on longer-dated bonds which is why we chose to avoid taking on excessive duration.

Below is our analysis on why US short duration high yield bonds offer investment opportunities.

### 1. Better trade-off between yield and duration

With yields at depressed levels, fixed income investors face challenges. Traditional core bonds are no longer providing the required risk reward to warrant investments.

In comparison, short duration high yield bonds offers much better trade off versus traditional core bonds. The yield to duration ratio measures the amount of duration risk investor take up for every 1% of yield they receive. Higher yield to duration ratio therefore implies better risk reward trade off.

Figure 3: US short duration high yield bonds offer attractive yield/duration ratio.

| Asset Class | Yield (%) | Duration (Years) | Yield to Duration Ratio |
|---|---|---|---|
| US Short Duration High Yield | 5.8 | 1.7 | 3.5 |
| EM High Yield | 6.3 | 3.9 | 1.6 |
| US High Yield | 5.5 | 3.6 | 1.5 |
| Europe High Yield | 2.1 | 3.2 | 0.7 |
| EM Investment Grade | 3.7 | 6.3 | 0.6 |
| US Investment Grade | 3.1 | 7.3 | 0.4 |
| Europe Investment Grade | 0.7 | 5.3 | 0.1 |

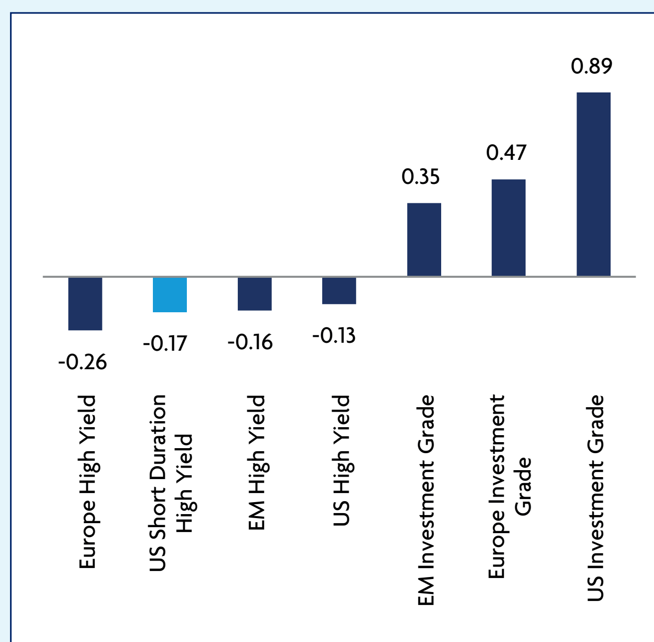
Source: Bloomberg, UOB PFS Investment Strategy, 27 July 2017

### 2. Better performance in a rising rates environment

Short duration high yield bonds tend to fare well in a rising rates environment. Historically, they have negative correlations with US Treasuries. This means that their prices tend to rise when prices of US Treasuries go down, which is usually the case when rates rise.

In addition, this characteristic could also help provide diversification to a portfolio of traditional core bonds.

Figure 4: Short duration high yield bonds are negatively correlated with US Treasuries.



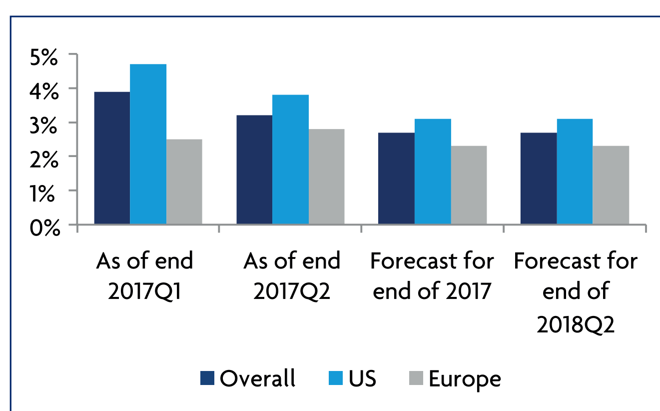

Source: Bloomberg, UOB PFS Investment Strategy, 27 July 2017

## 3. Supportive economic data and low default rates

US economy continued to show resilience. The US composite output PMI index, a leading indicator of economic activity, reached a six-month high in July. Other economic measures also remained supportive.

Meanwhile, defaults rates for speculative-grade bonds in US have generally been edging lower and forecasts also show the same trend. This development should help reduce a key risk of investing in US short duration high yield bonds.

Figure 5: **Default rates edging down for speculative-grade bonds** (Data shows 12 month trailing speculative-grade default rates)




Source: Moody's, Global speculative-grade default rate down again in Q2 2017, 13 Jul 2017, Available at: https://www.moodys.com/research/Moodys-Global-speculative-grade-default-rate-down-again-in-Q2--PR_369664

## 4. Key risks

Political risks remain a concern. While President Trump has a pro-growth agenda, we remain wary of missteps, be it in terms of trade relations or his Russian scandal, which could cause risk-off sentiments. However, the US economy has shown resilience and its strength should continue to drive high yield bond performance even if there are short term pullbacks.

**Bottom line**

Although yields are at historic lows and rates are poised to rise, there are still select opportunities in the fixed income space for investors to take advantage of.

US short duration high yield bonds are a good example. The asset class exhibits attractive trade-off between risk and reward versus peers. It also exhibits negative correlation to US Treasuries and could fare well in a rising rates environment. Furthermore, this characteristic could help provide diversification to fixed income portfolios. Lastly, as the US economy continues to show resilience, default rates for high yield bonds should remain low and encourage risk-on sentiments. These should bode well for the prices of US short duration high yield bonds.

In terms of risk, we are cautious of missteps from President Trump, who has proven to be an erratic figure in the White House. However, pullbacks due to risk-off sentiments should be short lived especially because the economy remains buoyant.

# Market Outlook and Strategies ▶▶

## Investment Perspective – July 2017

| Category | Perspective |
|---|---|
| Equity | We continue to prefer equities over fixed income. Investors can look to participate in **global equities that emphasise on generating free cash flow**.<br><br>Focus on **Asia ex-Japan** equities. To take part in Asia's growth story while mitigating risks of excessive drawdowns, we prefer lower volatility or balanced solutions.<br><br>Selective on US equities. Focus on **Healthcare** sector.<br><br>We continue to see stronger Europe data from companies' earnings and macroeconomic fronts.<br><br>Participate in **European equities** with sustainable dividends. |
| Fixed Income | **US short duration high yield.**<br><br>**Subordinated bonds** of high quality financial issuers. |
| Alternative | Structured notes that allow participation to the equity markets through a customised payoff structure.<br><br>Investors can participate in rising interest rates through **floating rate notes** structure. |
| Currency | USD is likely to be directionless into Q3. Fed may hike in September and if so USD should see some recovery but upside may be capped.<br><br>A less dovish Reserve Bank of Australia could lift AUD.<br><br>Brexit negotiations and the UK elections could weigh on GBP. |

## Investment Perspective – August 2017

| Category | Perspective |
|---|---|
| Equity | We continue to prefer equities over fixed income, but **we prefer not to blindly chase returns. NEW!** Investors can look to participate in **global equities that emphasise on generating free cash flow**.<br><br>Focus on **Asia ex-Japan** equities. To participate in Asia's growth story while mitigating risks of excessive drawdowns, we prefer lower volatility or balanced solutions.<br><br>Selective on US equities. Focus on **Healthcare** sector.<br><br>Participate in **European equities** with sustainable dividends.<br><br>We prefer to invest in stocks that exhibit Quality factor as they tend to be more resilient in uncertain times. |
| Fixed Income | **US short duration high yield.**<br><br>**Subordinated bonds** of high quality financial issuers. |
| Alternative | Structured notes that allow participation to the equity markets through a customised payoff structure.<br><br>Investors can consider participating in fund-linked note structure that can potentially offer additional participation while returning principal on maturity. **NEW!** |
| Currency | The unwinding of the "Trump Trade" has weakened the case for outright USD strength. But investors should not extrapolate USD weakness as the Fed is poised to start BSR soon. **NEW!**<br><br>Monetary policy convergence supports the EUR going forward, with EUR/USD seen targeting 1.20 as ECB prepares for tapering.<br><br>In addition, AUD/USD may sustain modest gains above 0.80, supported by recent strength in industrial commodities. |

Source: UOB Investment Insights – July 2017

## Strategy for the month of August

- We still continue to favour **Asia-ex-Japan and European equities** as both regions are supported by relatively attractive valuations and improving economic backdrop. Our preference to have exposure through lower beta solutions, such as multi-asset, dividend-paying and lower-volatility equities reflects our concerns for potential short term pullbacks. Investors should consider any near term pullbacks as opportunities for longer term investments.

- The Fed has started its policy normalisation strategy and we expect the process to be slow and gradual. Balance sheet reduction is projected to be a three to four year journey, gradually reducing the market liquidity. However, the term premium for longer dated treasuries is currently trading too low, indicating risks to an upside. We prefer to **stay with short duration and high quality subordinated bonds** to buffer interest rate risks.

- The latest US Q2 corporate earnings have been encouraging, with some sectors delivering better than expected results. **Healthcare stocks continue to outperform**.

- The unwinding of the "Trump Trade" has weakened the case for outright USD strength. With markets focusing on the odds and extent of ECB taper of their asset purchase programme, EUR/USD is seen targeting 1.20 by year end.

- In addition, AUD/USD may sustain modest gains above 0.80 by year end on recent strength in industrial metals (commodity) prices. RBA is also sounding more hawkish/less dovish in recent times.

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