Investment Insights

FEBRUARY 2018

Top 3 Questions on Investors' Minds

Inside

Over the last few months, we have received many questions from our clients about investments and the current market climate. In this issue, we will be answering some of the most popular questions investors have for 2018 and our advice for our clients.

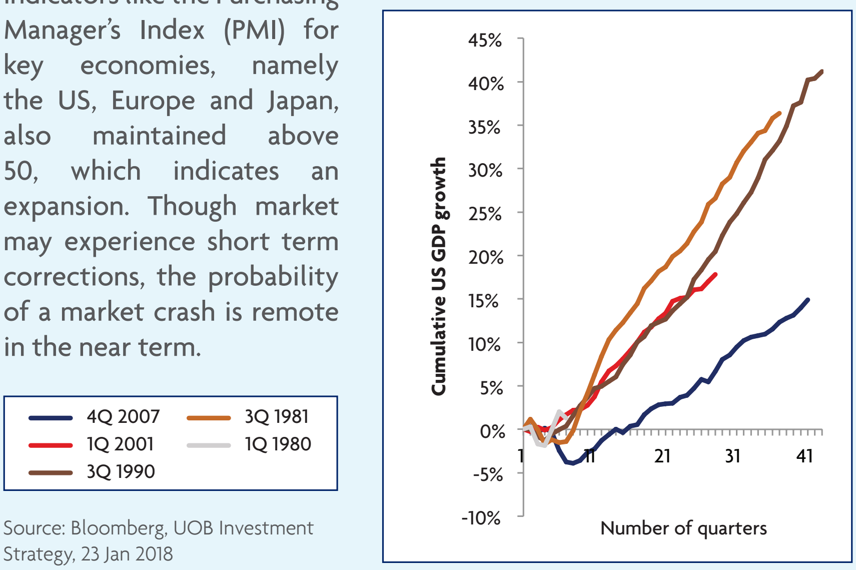
Question 1: The current bull market is almost in its ninth year, will it end soon?

The current bull market is the second longest in history and is extended from this perspective. However, bull markets do not end because of age. In the absence of a recession or systemic shock, it is unlikely for markets to crash.

The US economy can serve as a bellwether for the global environment. Although economic expansion in the US has been ongoing for almost nine years, the pace of expansion has been much slower than in the previous cycles, as shown in Figure 1. Hence, there is likely to be further scope for growth.

In addition, recent economic indicators like the Purchasing Manager's Index (PMI) for key economies, namely the US, Europe and Japan, also maintained above 50, which indicates an expansion. Though market may experience short term corrections, the probability of a market crash is remote in the near term.

Figure 1: Current US economic expansion has been more gradual versus past cycles.



Source: Bloomberg, UOB Investment Strategy, 23 Jan 2018

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

Question 2: The central banks have reached a turning point in their policies. Will this cause markets to falter?

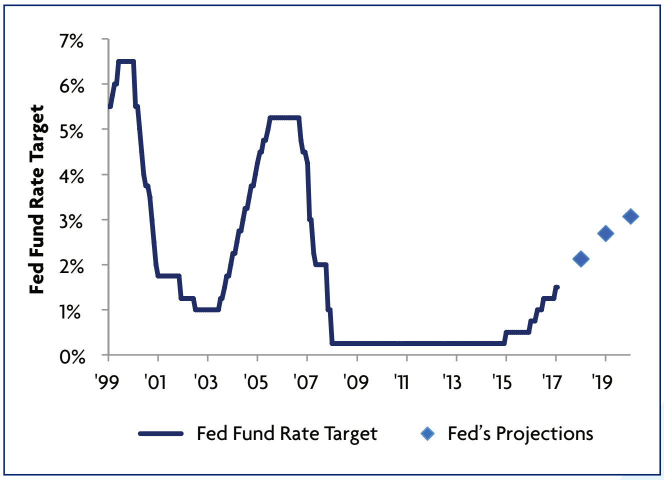
One of our key themes for 2018 relates to the normalisation of central bank policies. The Fed leads other key central banks in reducing its balance sheet and embarking on a rate hike cycle. Higher rates could increase financial stress on the economy as the cost of borrowing rises.

We see limited risks of the tightening cycle destabilising the markets due to the following reasons:

(a) current interest rates are at very depressed levels

(b) the pace of rate hike is likely to be more gradual compared to previous cycles.

Figure 2: Current rate hike cycle has been gradual and begun from a low level.



Source: Bloomberg, UOB Investment Strategy, 23 Jan 2018

The current policy normalisation might be derailed if there is a sudden increase in inflation expectations, which could cause yields to spike and re-pricing of financial assets.

The recent market correction was triggered by the upside surprise in US wage growth that causes a spike in yields and a sell off in the equity markets. However, we view the pull back as a result of technical reasons rather than fundamental weakness.

Though the strong wage data supports tighter monetary policy, we do not expect the Fed to change their policy direction drastically. There could be risk of an additional rate hike this year but the Fed is likely to be measured in their tightening, especially given that the Balance Sheet Reduction (BSR) program is still running in the background.

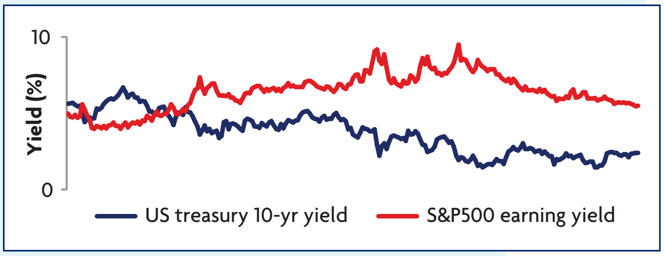
Question 3: Equity markets seem expensive, are there still opportunities?

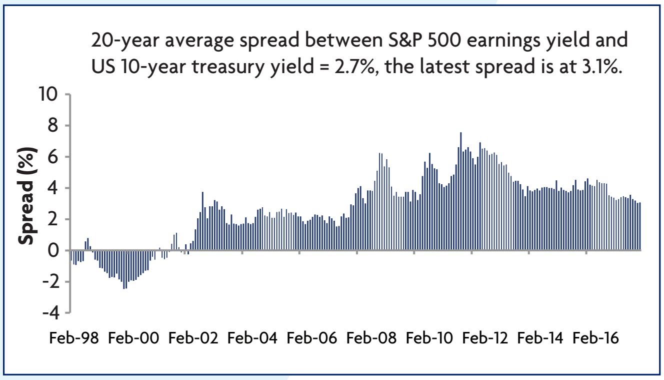
One common and very popular method amongst investors to determine if equities are expensive is to compare current price level versus historical levels. With current prices of global equities more than 40% higher than the peak in previous cycle, prices indeed look elevated.

Another commonly used method is to compare the current price-to-earnings (PE) ratio versus its historical values. Based on current PE ratio, equity markets, particularly the US markets, are expensive relative to its own history.

However, investors must look beyond valuations in their absolute terms to consider valuing equities relative to other asset classes, namely fixed income. With current low levels of yields, equities actually show good relative value versus fixed income. The current spread between forward earnings yields on US equities and US 10y Treasury yields is above historical average, indicating that US equities are of relatively better value versus US Treasuries. This spread is even wider in other developed markets such as Europe and Japan.

Figure 3: Forward S&P 500 earning yield versus US Treasury 10-year yield.





Source: Bloomberg, UOB Investment Strategy, 24 Jan 2018

Even though elevated valuations may increase the chance of market corrections, there are still opportunities for picking up good investments. As long as economic conditions are supportive and earnings growth continues to be robust, valuations could stay heightened for extended periods of time.

Implications for investors ▶▶

Our base case is for economic growth to remain robust with positive sentiments from public consumption, trades and investments in the next 12 months. Indicators such as yield curve, job markets, inflations and earnings have not raised any red flags of a possible economic downturn. Hence, we recommend investors to stay invested and mitigate risks by having proper risk management in their portfolios.

Stay invested

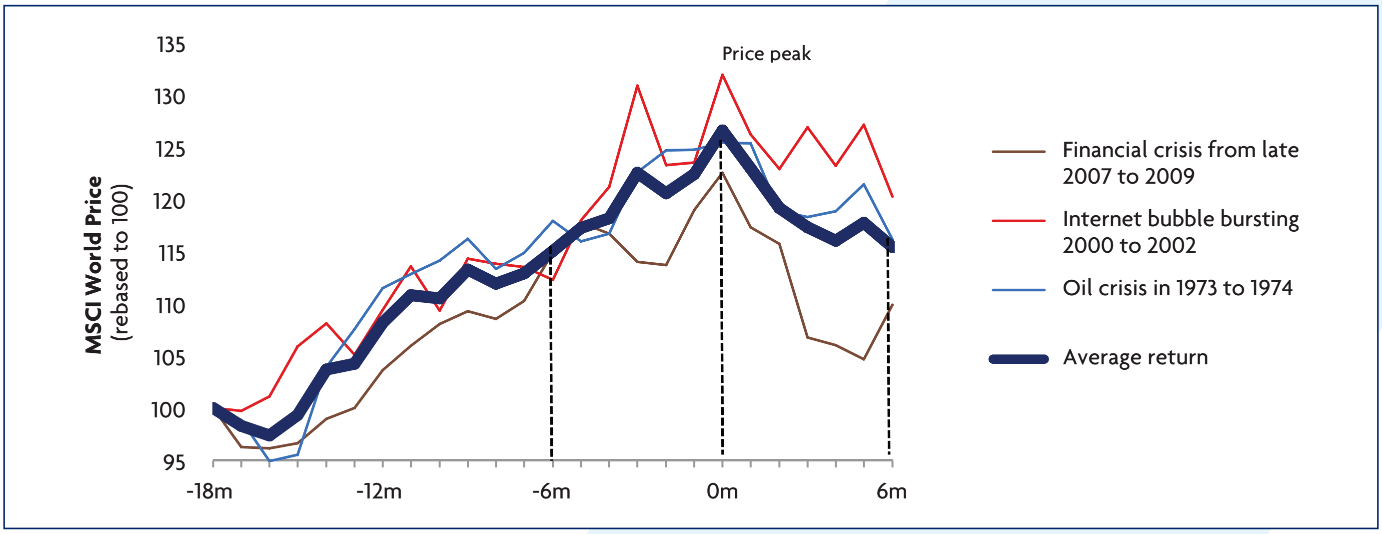
Investors tend to exit markets early in order to avoid excessive drawdowns when the market turns. Given that it is very difficult to predict the peak or trough in an investment cycle, investors often end up pulling out too early and missing out on other opportunities. On the other hand, exiting the markets after the peak may not necessarily result in lower returns versus exiting early and staying on the sidelines.

This concept is illustrated in Figure 4 below. We analysed the most severe systematic crises in the last forty years, namely the financial crisis, bursting of the internet bubble and the oil crisis. In all three instances, global equities staged strong rallies before the peak of the investment cycle. Global equities returned on average 27% and 17% in the last 18 and 12 months respectively before the equity prices peaked. Totally missing out the late-stage rally would have significant reprecussions on investors' portfolios. Meanwhile, exiting the market slightly after the market has turned may not necessarily result in large drawdowns. Based on the average of the three aforementioned crises, the price level 6 months prior to market peak and 6 months after the market peak had been similar, as shown in Figure 4. Hence, instead of trying to forecast exactly when the market would turn, a better approach would be to stay invested until a reversal in the markets is confirmed. Investors will still be able to enjoy positive returns in that phase.

Implement proper risk management

While there is no expectation of a severe market downturn in the next 12 months, we are cognizant of the exuberance in the market. In such market conditions, our UOB unique **risk-first approach** becomes even more relevant. To mitigate drawdowns, it is crucial to have appropriate allocation across a strong core portfolio characterized by lower volatility, higher income and diversified holdings. The recent rapid market rally may entice some investors to over-allocate to hot ideas in the market. It is always prudent for investors to take stock of how much volatility one can take and use the buoyant market conditions to rebalance their portfolios accordingly.

Figure 4: Price movements of MSCI World Equities in three crises from 18 months before price peak to 6 months after price peak.



Source: Bloomberg, UOB Investment Strategy, 24 Jan 2018

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 outlook for DMs remains 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 stays subdued but is expected to trend higher. The Fed upgraded its growth and inflation outlook in December FOMC. Expect 3 hikes from the Fed in 2018.

Risks

Inflation Overshoot	Markets are pricing in very low levels of inflation. However, tight labour markets and stabilizing commodity prices could feed wage growth and inflation. Yields could reprice quickly, affecting risk assets.
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 remain heightened in North Korea and the Middle East. A number of elections are scheduled to be held in the US, Europe and some emerging economies in 2018.

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.	• Expectations are heightened, but the macro environment is supportive for financials.
	European equities	• Attractive discount versus US and tailwinds from improving economic activities.	• Strong Euro could negatively impact exporters, but Euro is expected to stabilise as ECB remains cautious of currency risks.
	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.	• China slowdown could pose risks but we expect the process to be controlled.
	EMD LCY	• Higher yields versus other fixed income assets and benefit from improving fundamentals in EMs.	• Spike in USD could cause outflows, but USD is richly valued and likely to be 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.	• Repeal and replacement of Affordable Care Act (ACA) could affect outlook for industry, but we expect most provisions to remain intact.
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.

RIGHT BY YOU

United Overseas Bank Limited Co. Reg. No. 193500026Z