Investment Outlook 2018
Personal Financial Services

UOB

Nature does not hurry, yet everything is accomplished.

—Lao Tze

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Editorial Team

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

Joyce Lim
CFA, CAIA, CFP
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

Nicole Tsai
Investment Research Associate

Regional Contributors

Leong Wei Ji
Malaysia

Kitiwat Nanthawatsiri
Thailand

Erricky Soh
Indonesia

Lily Huang
China

Editorial

We entered 2017 hoping for strength in the investment world after exiting a very bumpy and challenging 2016 fraught with fears that China's economy could be headed for a hard landing, and uncertainties surrounding Brexit and the US presidential election.

Hence the theme 山重水复疑无路，柳暗花明又一村。(After endless mountains and rivers that leave doubt whether there is a path out, suddenly one encounters the shade of a willow, bright flowers and a lovely village.)

Our strategy in 2017 was to focus on equities, and here we identified opportunities in Asia ex-Japan, Europe, the healthcare sector and global quality stocks. For fixed income, the focus was on short-duration high-yield bonds.

Not only 2017 did not disappoint, the year surprised investors on multiple fronts: S&P500 +20.4%*, Euro Stoxx 600 +10.4%*, MSCI Asia ex-Japan +38.3%*, Barclays global-aggregate bonds +7.0%* and Global High Yield bonds +9.9%*. Investors who have invested and remained invested would have reaped the benefits of the buoyant global markets.

Entering 2018

As we deliberated the investment themes for 2018 after an exuberant 2017, we took inspiration from nature and the parallels between the interactions of the five natural elements—Earth, Metal, Fire, Wood, Water—and our investment strategies.

Earth, an important medium of growth, is associated with the macro backdrop for investments. Despite diverging monetary policies across central banks, we see growth in developed markets to continue albeit moderating, while growth in emerging markets likely to accelerate in 2018 led by continued structural reforms and a recovery in exports.

Metal, like earth's minerals, is akin to the fundamentals that support the macro backdrop. We expect inflation to remain benign, and consumer and business sentiments to improve, thus providing the catalysts for higher capital expenditures that would fuel economic growth further.

Fire, which can be associated with danger, is like investment risk. However, proper handling allows us to mitigate this risk. An understanding of key events that may impact one's investments allows investors to position their portfolio well without taking excessive risks. There could be continued headwinds from central banks' policies, as well as geopolitical events in 2018.

Different types of wood grow differently under the same conditions. Some may flourish while some may not. Hence, we associate wood with opportunities from different asset classes. It is important to know the potential returns of each asset class in the given environment. Equities remain our preferred asset class even though returns are expected to moderate compared to 2017.

*As of end November 2017

Finally, water. Water takes the shape of the vessel that holds it and naturally flows from higher level to lower level. Similarly, investor sentiments and fund flows that are more fluid in nature will flow out from investments with higher valuations to those at more attractive levels. Investors can consider rotating out of US equities, where valuations are higher, into Europe, Japan or emerging markets.

We believe 2018 is the year to be more selective in our investment strategy.

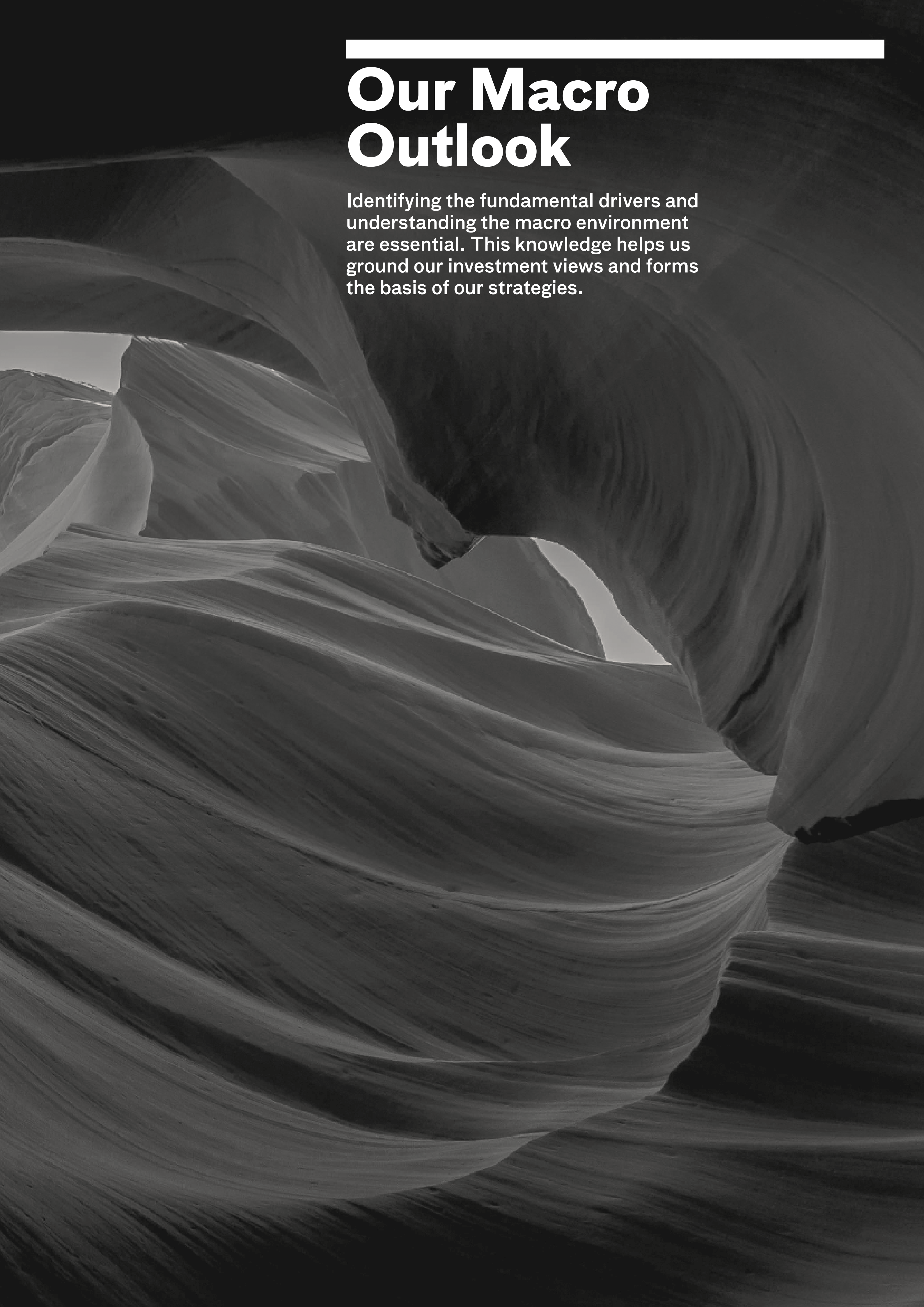
At UOB we remain right by you, taking a risk-first approach when tailoring investment advice and solutions for you. Thank you for your business and trust in us all these years. We hope you enjoy our tongue-in-cheek analogy of our 2018 outlook as much as we enjoyed putting it together for you.

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

Earth and Metal

A tower of nine storeys begins with a heap of earth.

—Lao Tze



Our Macro Outlook

Identifying the fundamental drivers and understanding the macro environment are essential. This knowledge helps us ground our investment views and forms the basis of our strategies.

Our Roadmap

The macro environment will shift in 2018. Conditions could be more challenging than before and the winners are unlikely to be the same.

Monetary Policy

Central banks are moving away from QE, with the Fed leading the way.

FED

Resilient so far

The economy took recent hikes in its stride. At the same time, diminishing output gaps and heightened asset valuations are causing concern among central banks.

Further reduction in output gap

Economy

Synchronised growth expected to continue and broaden. Political headwinds dissipated in DM while EM reforms are coming to fruition.

DM EM

Rising sentiments

Robust growth is prompting a rise in both consumer and business sentiments, particularly in DM.

Markets

A strong rally in markets have created richer valuations across bond and equity markets.

Risk assets surge

Investors, confident in the durability of the cycle, reach for higher returns. Valuation concerns become prevalent.

Continued tightening
Central banks are likely to continue tightening, especially when inflation comes through.

Inflationary pressure

Demand support for commodities prices

Continued growth
Improving sentiments are precursors for higher spending and investments, which are important for sustaining growth.

Refocus on laggards
Cheaper laggards, some of which actually have good fundamentals, finally appear on investors' radars.

Rotation

A reflationary environment is likely to benefit equities over bonds while rich valuations are likely to drive a rotation between countries and sectors.

Macro Outlook for 2018

Key takeaways
Global growth is likely to remain resilient in 2018. In DM, growth is expected to remain positive though momentum may moderate. In EM, growth could accelerate as structural reforms in key economies bear fruit.

Monetary policy is likely to tighten especially if inflation picks up. However, central banks are expected to act gradually and therefore sudden spikes in yields are unlikely.

Market valuations have become rich. While economic fundamentals have been improving, fledging signs of exuberance in certain regions and sectors are starting to appear.

Our strategy for 2018 centres around the idea of rotation. We favour investments that benefit from a reflationary environment and those that have lagged against the broader market but possess strong fundamentals.

Growth: another good year

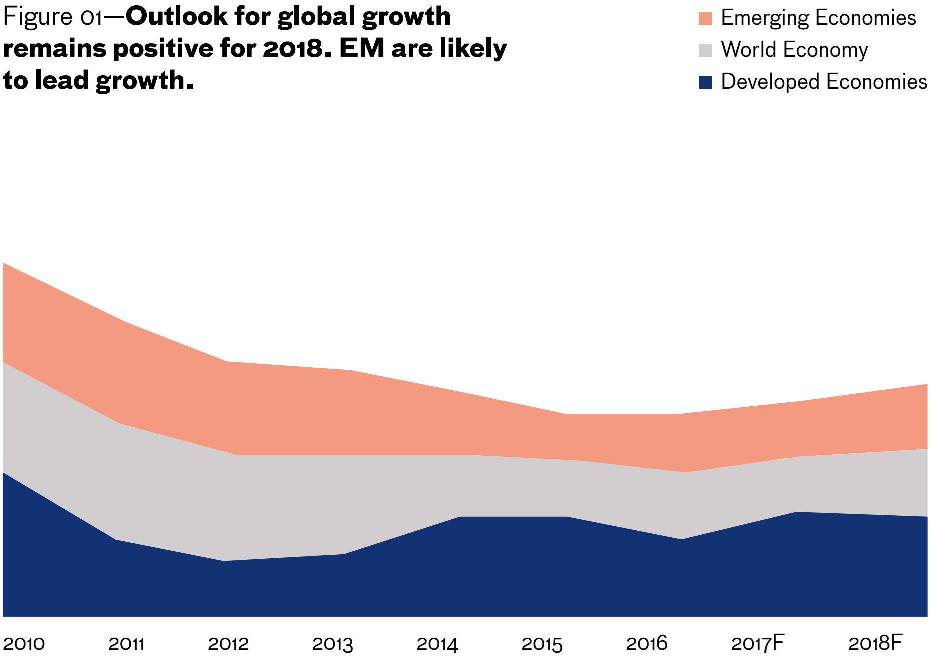
Synchronicity and low dispersion of growth were the hallmarks of 2017. Not only did overall economic expansion accelerate, both developed markets (DM) and emerging markets (EM) registered higher growth for the first time since 2010. Improved consumer and corporate confidence in DM helped spur domestic consumption and private investments. Meanwhile, a resurgence in global trade and stability in China provided a constructive backdrop for EM equities and bonds to outperform the broader market.

Heading into 2018, our outlook for global growth remains optimistic and the global economy is expected to remain resilient. (Figure 01)

DM growth remain positive but could moderate
In DM, growth is expected to hold up, underpinned by robust domestic consumption, higher corporate CapEx and stimulating fiscal policies.

Job markets remain relatively tight, as unemployment rates in the US, Europe and Japan fell to post-crisis lows. With consumer confidence and household incomes increasing at a healthy pace, domestic consumption is expected to stay robust and form the support for continued DM growth. Corporate CapEx has been subdued until recently. Higher profit margins and improved business prospects resulted in bigger CapEx investment to increase production capacity and drive productivity. Fiscal policies such as the US tax reform can further support growth in the US economy. In Europe, improving current accounts are providing governments with room for higher fiscal spending. Finally, in Japan, Prime Minister Abe's victory in snap elections is breathing life back into Abenomics and anchors

Figure 01—**Outlook for global growth remains positive for 2018. EM are likely to lead growth.**



Source: IMF World Economic Outlook October 2017, Bloomberg, 22 October 2017 expectations that easy monetary and fiscal conditions are likely to stay. While the growth outlook of DMs remains positive in 2018, the momentum may not be as strong compared to 2017. Cyclical economic indicators, such as the Purchasing Managers Index (PMI) are registering elevated levels and are setting a ceiling for upside surprises.

Structural reforms bearing fruit in EM

On the other hand, EM growth rates are forecast to outpace growth in DM and further accelerate in 2018. The improvements are likely to be driven primarily by structural reforms in key economies such as China, India and Brazil.

China is expected to continue the gradual and controlled process of rebalancing its economy. With President Xi increasing his influence during the recent 19th Party Congress, the policy direction for China is likely to remain unchanged while the pace of reform is likely to strengthen. India's economic growth is projected to improve significantly from 6.7% in 2017 to 7.4% in 2018, according to projections by the International Monetary Fund (IMF). In 2017, the Indian economy was affected by demonetisation and uncertainty related to the introduction of the Goods and Services Tax (GST). However, GST is helping to unify India's vast domestic market and set the grounds for stronger growth in 2018. Brazil is also expected to see higher growth in 2018 due to the implementation of key reforms to drive fiscal sustainability and a gradual restoration of confidence among consumers and business spending.

Central banks: readier than ever

A synchronised pickup in the global economy prompted key central banks to steer away from an accommodative stance. Leading the pack is the Federal Reserve (Fed), which began its Balance Sheet Reduction (BSR) operations in October 2017 and is projected to hike interest rates in December 2017 for the third time since the crisis. The European Central Bank (ECB), although lagging the Fed in terms of policy normalisation, has announced its schedule for tapering its quantitative easing (QE) program in 2018. Though the Bank of Japan (BOJ) remains committed to accommodation, its ownership of more than 40% of the local bond market could limit the scope for continued purchases. (Figure 02)

Subdued inflation, but trending higher

Inflation, or the lack thereof, has restrained central banks from pursuing an aggressive tightening policy. Although unemployment has been trending lower, inflation continues to remain subdued. This is particularly so for the US, where unemployment is low, at 4.1%, while inflation remains benign at 2%.

Though mild, inflation has been picking up and broadening across regions. In DMs, inflation is expected to rise from 1.5% in 2017 to 1.9% in 2018. Meanwhile, inflation in EMs is projected to remain roughly stable at 4.2% in 2017 and 4.4% in 2018. Stronger economic activities and commodity prices can eventually drive higher inflationary pressure.

Markets underpricing rate outlook

Markets are currently pricing in low expectations for rate hikes, in particular the path of rate hikes from the Fed.

Although the Fed undershot its own projections in the past, the economy has been on firmer footing and recent communications seem to suggest a lower dependency towards rate hike

Figure 02—**A slow move towards the exit from QE**

Fed	ECB	Milestones	BOJ
2008	2015	Start of QE	2011
2010	2016	Expansion of QE	2013
2013	2017	Taper talks	?
2014	2018	Tapering	?
2015	?	1st rate hike	?
2016	?	2nd rate hike	?
2017	?	3rd rate hike & BSR	?

Source: UOB Investment Strategy, 22 October 2017 decisions on inflation data. Should inflation show sustained growth, the Fed would have a stronger mandate to continue its tightening. Subsequent re-pricing of expectations by markets is likely to cause yields to drift.

Higher interest rates over time

While we have explained the reason for higher interest rates in 2018, the pace of this increase, and by extension a growth in yields, is likely to remain gradual. Barring an inflation overshoot, the Fed is expected to remain cautious, hiking rates slowly and conducting Balance Sheet Reduction (BSR) according to the announced schedule. The same should hold for European Central Bank (ECB) when it tapers its QE program over the course of 2018. Based on projections from Bloomberg, net purchases from key central banks should remain positive in 2018, thereby reducing odds of market shocks and sharp spikes in yields.

Markets: high valuations to continue climbing

Although 2017 started on a tepid note, initial headwinds, mainly political, soon faded. Growth accelerated while key central banks remained relatively dovish, providing the perfect environment for both equities and fixed income markets to perform. Strong investor sentiments further drove markets higher, causing valuations to soar.

Expensive equities, expensive bonds

As of end November 2017, the total return for US equity markets was 20.5%, outperforming other DMs such as Europe and the UK. As a result, valuations in US equities appeared to be stretched. In the fixed income markets, spreads continued to tighten on expectations of positive growth and dovish central bank policies.

While economic fundamentals have improved over the course of 2017 and earnings have been strong, there are some fledging signs of exuberance. According to surveys, a record-high percentage of investors see equities as overvalued yet cash levels are simultaneously falling. Meanwhile, high yield spreads globally are hovering at post-crisis lows, around the same levels as late-2005.

2018 strategy: Rotation

Entering 2018, our key strategy is built around the idea of rotation. With reflation in the global economy picking up, equities are likely to be favored over fixed income. Heightened valuations in the US markets could drive a switch into ex-US markets which are earlier in the economic cycle and have improving fundamentals. A lot of the focus this year has been on the technology sector. Going forward, we expect other cyclical sectors, such as financials, which could benefit from a reflationary environment to receive more attention.

Fire

The flame that burns twice as bright burns half as long.

—Lao Tze

Key Events and Risks for 2018

Anticipating key events as well as identifying potential sources of risk are paramount to strategic investment positioning.

Key Events Calendar

Knowing the timeline of events for 2018 helps guide our positioning through the year. Attention in the first half of the year is likely to be focused on central bank decisions. Political events, however, are spread throughout the year and dates remain fluid.

January

1st Quarter

22—23 Jan
BOJ Meeting

30—31 Jan
FOMC Meeting

25 Jan
ECB Meeting

ECB scheduled to reduce monthly asset purchases
Starting from January, the ECB is scheduled to reduce its monthly asset purchases from EUR 60 billion to EUR 30 billion. The asset purchase program will end in September 2018. Decisions regarding future monetary actions are likely to be data dependent.

April

2nd Quarter

26 Apr
ECB Meeting

26—27 Apr
BOJ Meeting
End of term for BOJ Governor Kuroda

TBC
IMF World Economy Outlook

May

1—2 May
FOMC Meeting

20 May
Deadline for Italy General Election
The populist party, Five Star Movement (M5S), has been running neck-and-neck with the ruling party. However, the populist stance of M5S has recently moderated.

June

12—13 Jun
FOMC Meeting

14 Jun
ECB Meeting

14—15 Jun
BOJ Meeting

October

4th Quarter

15 Oct
ECB Meeting

18 Oct
Brazil General Election

Central Banks

Political Events

Economic Events

February

3 Feb
New Fed chair
Powell is expected to be the new Fed Chair after Yellen's term expires in February 2018. Powell's appointment likely means continuity to the Fed's policies. The Fed is projected to hike rates three times in 2018.

March

8 Mar
ECB Meeting

8—9 Mar
BOJ Meeting

3—15 Mar
China National People's Congress and Chinese People's Political Consultative Conference
Confirmation of positions for new members of the Politburo Standing Committee. Successor to PBOC Governor Zhou Xiaochuan could be appointed during the meeting.

18 Mar
Russia Presidential Elections

20—21 Mar
FOMC Meeting

July

3rd Quarter

1 Jul
Mexico General Election

26 Jul
ECB Meeting

30—31 Jun
BOJ Meeting

31 Jul—1 Aug
FOMC Meeting

August

24 Aug
Deadline for Malaysia General Election

September

13 Sep
ECB Meeting

18—19 Sep
BOJ Meeting

25—26 Sep
FOMC Meeting

November

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

7—8 Nov
FOMC meeting

TBC
Thailand general election

December

TBC
UK parliamentary vote on Brexit deal (around year-end)
UK is due to leave the European Union in March 2019. If no deal is reached, the UK economy may face heightened uncertainty.

13 Dec
ECB Meeting

18—19 Dec
FOMC Meeting

19—20 Dec
BOJ Meeting

Risk Hotspots

Identifying associated risks is necessary to make informed investment decisions. Risks can represent both upside and downside catalysts. However, as we enter the late period of the economic cycle, investors should exercise more caution as tail risks loom larger.

North America

▲ Wage inflation has been rising gradually but steadily.

◣ The Fed may tighten too aggressively and cause stress to the market and the economy.

⬣ US President Trump's low approval rate may lead to a more uncertain mid-term election.

Europe

⬣ The Italian general election, due to be held by May 2018, could lead to political uncertainties.

⬣ German Chancellor Merkel continues to work out a coalition with other parties.

⬣ Brexit talks are progressing slowly. If no deal is reached, the economic and political ramifications could be significant.

▲ ECB could normalise policies too quickly and kill the fragile economic recovery.

Japan

⬣ JPY is viewed as a safe-haven asset and hence it is sensitive to risk events. A strong yen could negatively affect the Japanese equity market.

▲ Inflation overshoot

The low unemployment rates may indicate that the economy is approaching full capacity. This could soon translate to wage growth. Coupled with stablising commodity prices, inflation may surprise on the upside. As markets have been underpricing inflation, inflation surprise could cause yields to rise sharply and result in a sell-off of risk assets.

Data points: Wage growth, global Consumer Price Index (CPI), personal consumption

◣ Central bank missteps

Key central banks are beginning to wind down their unprecedented monetary experiments. Without precedence to rely on, they run a higher risk of misjudging the real impact on economy when they unwind their policies.

Data points: Central bank meetings

⬢ Geopolitical and political risks

Geopolitical risks remain heightened, particularly in North Korea and the Middle East. Although the probability of conflict is low, it has been creeping up.

Meanwhile, a number of elections are scheduled to be held in the US, Europe and some key emerging economies. The results could change the political landscape.

Data points: News flow, election polls

■ China's hard landing

China concluded its 19th Party Congress and President Xi's influence was strengthened. The country's focus on stability and deleveraging is likely to continue, but overly aggressive policies could raise default rates and hard landing concerns.

Data points: China Purchasing Managers Indices (PMIs), retail sales, monetary supply, property sales

Asia Pacific excluding Japan

■ China's structural reforms could cause short-term pains and spark hard-landing concerns.

⬢ North Korea is likely to continue with its missile and nuclear tests.

⬢ Malaysia is expected to hold its general election before 24 August 2018.

⬢ Thailand is expected to hold its general election in November 2018.

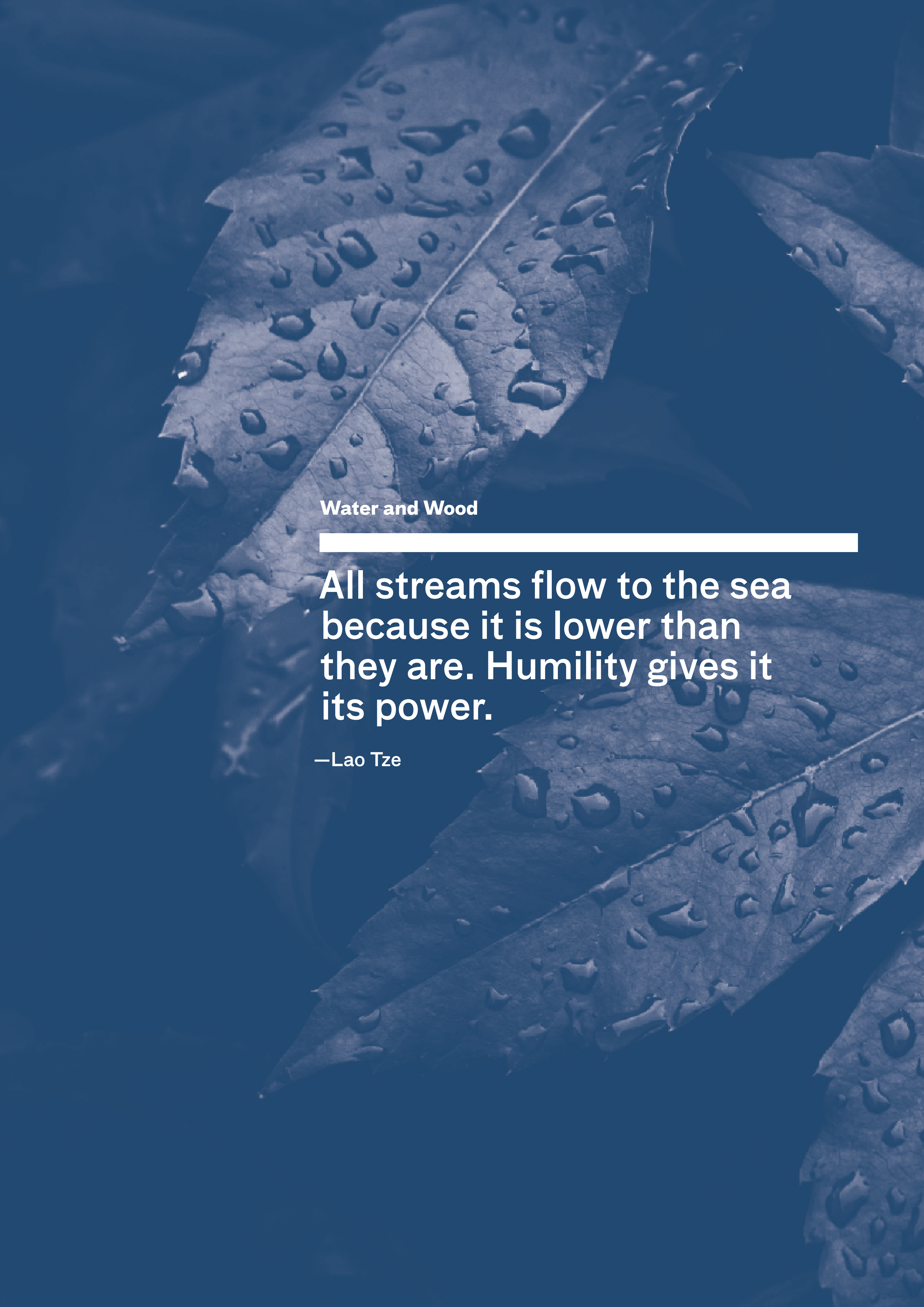
EM excluding Asia

⬢ Tensions have been rising between Saudi Arabia and Iran.

⬢ Russia is expected to hold its presidential election in March 2018.

⬢ Mexico is expected to hold its general election in July 2018.

⬢ Brazil is expected to hold its general election in October 2018.



Water and Wood

All streams flow to the sea because it is lower than they are. Humility gives it its power.

—Lao Tze

Asset Class Outlook and Strategy

In formulating our asset class outlook, we consider the macro environment as well as specific attributes of the particular asset class. This helps us to construct our investment strategies and select suitable opportunities.

Our Strategy

We expect 2018 to be dominated by a reflationary environment and heightened valuations. Hence, we prefer opportunities with attractive relative valuations and strong secular drivers that can benefit from reflationary environments.

Theme

01 Equities: Reflation and rotation in DM

Heightened valuations and reflationary impulses in DM means it is timely to rotate out of expensive, late-cycle markets and interest rate-sensitive sectors.

Strategy

Sectorial play in the US
Rich valuations and a hawkish Fed could limit the upside for equities. Focus on sectors that could benefit from a reflationary environment.

Ex-US opportunities
Focus on opportunities in Europe and Japan. Their economies are at earlier stages of economic recovery, while monetary policy is likely to remain easy.

Solutions

US bank equities
Higher rates help improve interest margins for banks. Potential deregulation in the financial sector could provide additional tailwinds.

European equities
Attractive valuations compared to the US, while recovery is firm. Cyclicals sectors like Banks and Autos could benefit from the current environment.

Japanese equities
Attractive valuations compared to DM peers. The market has been under-loved by investors but fundamentals and an accommodative policy are in its favor.

02 Equities: Tap into EM growth

Synchronised global growth provides a stable backdrop for accessing higher growth opportunities in EM economies.

Limelight on reforms and commodity plays
Focus on regions where past and ongoing reforms are coming to fruition. Stable commodity prices could also provide tailwinds.

EM equities
Structural reforms are setting the stage for higher quality growth in Asia. Ex-Asia, commodity exporters could benefit from commodity price recovery. For China, sectors that benefit from economic reforms could offer attractive opportunities.

03 Equities: Secular developments

Secular developments could drive long-term growth in specific industries, even in times of slower global expansion.

Everyone needs healthcare
The industry benefits from rapidly aging populations in DM and rising income in EM, which could drive sustained demand for its products and services.

Global healthcare equities
The sector trades at an attractive discount to the broader market. Subsectors with strong innovation capabilities could continue to see earnings growth.

04 Fixed Income & Foreign Exchange: Converging policies, but still divergent

Key DM central banks agree on the need to reduce excessive monetary policy accommodation, but disagree on the pace.

Rates are important, but so are other factors
Aside from rates, supply-demand dynamics and foreign exchange are also important contributors to absolute returns in fixed income products.

Local currency EM debt
The asset class offers yield pickup over DM debt. Better current account balances are supportive of currency strength.

AUD bonds
A less hawkish Reserve Bank of Australia (RBA) and positive commodity outlook bodes well for AUD and AUD bonds. The asset class also offers yield pickup over similar USD bonds.

Asia IG
Spreads are compressed, but yield pickup is still positive over DM debt. Reduced issuances coupled with robust demand should support prices.

Equities

Equities remain our most preferred asset class. Returns could moderate but should remain positive in 2018. Being selective is the key.

Key takeaways
Within the DM space, we prefer opportunities outside the US, such as Europe and Japan. European equities could play catch-up with their US counterparts while Japanese equities are supported by valuation and strong earnings. Although we are neutral on US equities, we see opportunities in the financial sector.

EM equities are likely to continue their winning streak in 2018. The cycle in EM equities is still early and valuations are attractive against DM equities.

Secular trends for healthcare will continue and the sector is trading at attractive discounts to the broader market.

Overview

2017 was a stellar year for equities and marks the ninth year of the equity bull run. As of end-November, global equities registered total returns of 21%. While sentiments remain generally upbeat, investors are increasingly questioning how much more the aged bull can advance. Indeed, the current bull market is the second-longest bull market on record, but a bull market cycle is not determined by its duration. Past bull markets were usually brought to an end by economic recessions or external shocks.

Looking ahead, although the 2017 growth surge may be hard to replicate, recession risks remain low for 2018. The macro environment remains constructive. Synchronised global growth, rising corporate earnings and relatively accommodative monetary policies are all supportive drivers of equity outperformance. While external risks, such as geopolitical tensions, continue to be present, they are unlikely to derail markets.

As such, equities remain as our preferred asset class. Returns could moderate but should remain positive in 2018. Given the relatively full valuations, investors need to be selective and be prepared for higher volatility in the markets.
In the DM space, we prefer markets and sectors with relatively lower valuations that are earlier in the economic cycle. Meanwhile, we continue to be constructive towards the growth story in EM.

Regional views

Neutral on US equities with preference to financials

We maintain our neutral view on US equities. Despite the positive earnings momentum and possible tax cuts, the upside could be limited by rich valuations. In addition, the Fed is poised to tighten further with BSR and three rate hikes. The combination of rich valuations and the tightening policy could cause valuation multiples to contract.

However, financials appear to be attractive and the sector trades at an attractive discount to the overall US market. Furthermore, as the Fed tightens and rates move higher, banks could see their interest margins improve. The sector also stands to benefit from potential deregulation. Finally, if tax reforms are implemented, corporate tax rates may be reduced from 35% to between 20% to 25%. This could translate to significant tax savings for financials, which currently have one of the highest tax rates, at 33%.

Constructive on European markets

In Europe, economic activities have firmed over the course of 2017 while political headwinds have receded significantly. On the policy front, ECB has stated that it would keep rates accommodative until well after its QE program ends.

Entering 2018, European equities could play catch-up with US equities, especially as markets seem to be underpricing economic growth in the European region. Fund flows moderated in recent months but remain positive and supported. On a sectorial basis, cyclical industries, for example Banks and Autos, are likely to outperform. The former could see earnings improve as interest margins widen with a pickup in yield and credit demand. Domestic economic recovery could translate to better sales for Autos. Valuations for both sectors are undemanding while prices on index levels are well below their cyclical highs.

Some risks remain for the region. Excessive euro strength could hurt earnings, but we take comfort that the currency's strength is backed by improving economic conditions. Meanwhile, we remain cautious about political risks that could threaten the EU's integrity. Finally, the European debt issue could rear its ugly head again next year when Greece's bailout program ends.

Upgraded Japanese equities after snap election

The recent victory of Prime Minister Abe in the snap election removed a crucial risk for Japanese equities. With Abe's party retaining its dominant position, Abenomics is likely to continue and BOJ is likely to remain highly accommodative. Meanwhile, the macro backdrop looks favourable, with GDP expanding for the seventh straight quarter in 2017 Q3.

Valuations for Japanese equities are very attractive relative to its DM peers, even after the recent rally. In addition, earnings could benefit from the weaker JPY, as policy divergence with other key central banks is likely to temper JPY strength even amid sporadic safe haven trades. Fund inflows have picked up strongly in recent months and look well supported. Finally, improvements in corporate governance, spearheaded by Abe, could encourage companies to return cash to investors through dividends or share buybacks. This could trigger a rerating of Japanese equities.

Japanese equities could be vulnerable, if BOJ changes its policy stance and begins tapering in 2018. Geopolitical risk surrounding North Korea lingers and could weigh on sentiments.

Positive on EM equities
After years of soft performance, EM equities finally outpaced their DM peers in 2017. A confluence of factors contributed to the outperformance, such as synchronised global growth, improving global trades, stabalisation of China economy and revival of commodity prices.

EM equities are likely to continue their winning streak in 2018. The cycle in EM equities is still early and the growth differential between EM and DM is expected to widen further in 2018. Meanwhile, valuations for EM equities are still attractive against DM equities. Fund inflows have been strong and positive, in contrast to negative to flat flows in the last four years. Key economies, namely China and India, are undergoing structural reforms, which could help set the stage for higher quality growth in the future. A number of countries, for example Brazil, Thailand and Malaysia, are holding elections in 2018 and these events could be catalysts for economic reforms. For Chinese equities, the sectors benefitting from economic reforms, particularly large banks, offer attractive opportunities.

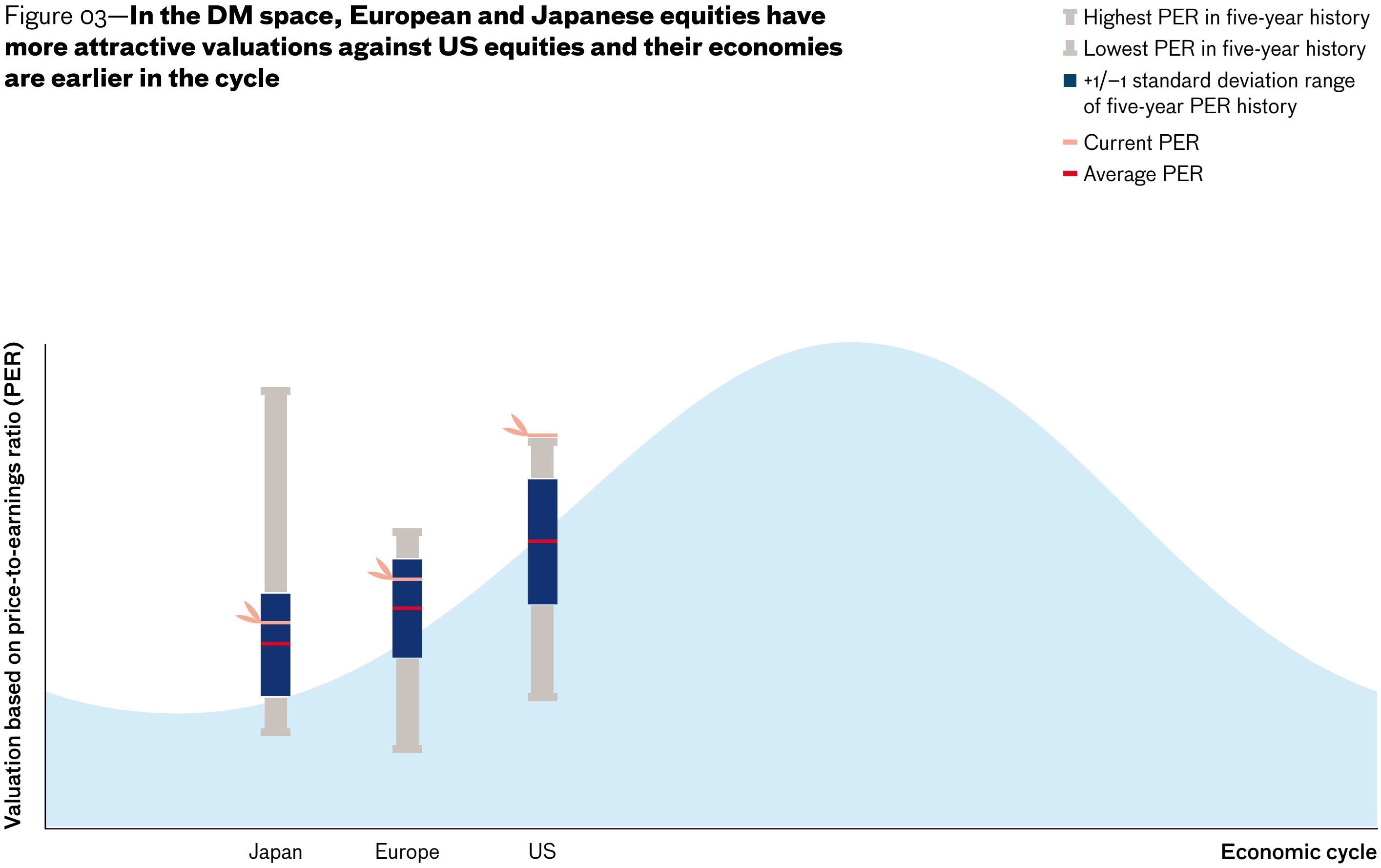
Potential headwinds for EM equities include unexpected USD strength, especially if the Fed hikes interest rates more aggressively than expected. Commodity weakness could affect EM commodity exporters, while stability of the Chinese economy continues to be a concern.

Structural opportunities

Global healthcare
The secular story of healthcare continues in the background. Rapidly aging populations in DM and rising incomes in EM could drive the demand for healthcare products and services. The sector has been trading at a discount to the broader market in the last two years, due to uncertainties surround US healthcare policy.

While policy risks remain, investors can focus on subsectors such as biopharma, which have strong innovation capabilities that could continue to propel earnings growth. The subsector has seen drastic increase in innovative drug approvals in 2017 and a strong pipeline could drive earnings in 2018.

Figure 03—**In the DM space, European and Japanese equities have more attractive valuations against US equities and their economies are earlier in the cycle**



Source: UOB PFS Investment Strategy

Fixed Income

Valuations are tight for the broad fixed income market. Monetary policy normalisation is the key development to monitor. Investors should focus on the basics of bond investment.

Key takeaways

Asian investment-grade bonds are supported by favourable supply-demand dynamics.

AUD-denominated bonds could benefit from a neutral central bank policy and improving commodity prices support the currency.

High real yield and underpriced currencies help EM local currency bonds stand out.

Overview

Credit spreads for fixed income markets have tightened in 2017. Across the US, Europe and Asia, credits spreads for both investment-grade and high-yield bonds have reached post-financial crisis lows. Although the spread compression was partially driven by improving fundamentals such as declining default rates and improving credit metrics, the extremely tight spreads offer a limited cushion in a rising-rate environment.

2017 also marks the start of monetary policy normalisation across major central banks. The Fed has already embarked on rate hikes and balance sheet reduction plans. The ECB has announced plans to taper its QE program, though any exit will remain gradual. Only BOJ is likely to continue easing.

Against this backdrop, to achieve positive total return, investors should revert back to the basics of bond investment. The factors investors should consider include finding the right balance between quality and yield, identifying issues with reasonable valuation, assessing the supply and demand mechanics, and holding bonds in currencies with appreciation potential.

USD-denominated bonds

Supply-demand dynamics support Asian investment-grade bonds

Despite the relatively tight valuation of USD-denominated investment-grade bonds, opportunities are still present. Asian investment-grade bonds shine among higher quality bonds, supported by supply-demand dynamics. The issue of Asian investment bonds has been subdued, while local demand remains strong as investors continue searching for yields. At the same time, default risks are kept low by the positive economic outlook. Although Asian investment-grade bonds are exposed to a Fed rate hike risk, their credit spreads have reflected low correlations to rate hikes in previous tightening cycles.

Non-USD denominated bonds

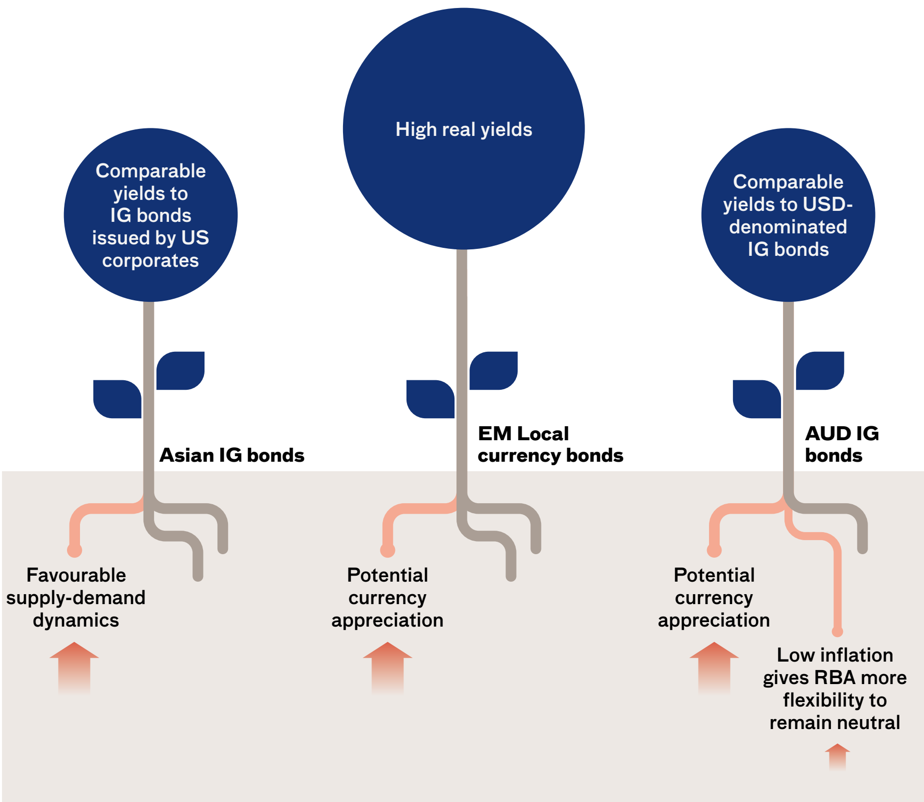
AUD bonds supported by central bank and global trades

In contrast to the Fed's hawkish bias, the Reserve Bank of Australia (RBA) is well-positioned to be in a neutral state as inflation is relatively low. AUD-denominated bonds could have the potential for capital gain should yield decline. In addition, the yield for AUD-denominated bonds is still relatively competitive compared to USD-denominated bonds. AUD is likely to appreciate against the USD, supported by recovery in commodity exports supported by recovery in commodity exports, stabilisation in China's economy, and global growth.

EM local currency bonds with high real yield and underpriced currency

Total returns of EM bonds are driven by income yield and potential currency appreciation. EM currencies are well positioned due to the improvements in the countries' current account balances and a recovery in commodity prices. Higher global trade and rising foreign direct investments have also been supportive to the inherent strength of the currencies. While EM countries have relatively higher inflation compared to DMs, it is mitigated by the high level of nominal yield. In India, Russia and Brazil, central banks may even have room to cut rates. A spike in USD is the main risk. However, we believe that USD is likely to remain sideways as the currency is expensive.

Figure 04—**Supply-demand dynamics, high real yields and potential currency appreciation will be the main drivers of total returns for fixed income**



Source: UOB PFS Investment Strategy

Foreign Exchange

Diverging returns among G10 and Asian currencies against USD in 2018.

Key takeaways

Commodity currencies are likely to strengthen against USD. AUD is supported by a recovery in commodity prices. NZD could see some upside, as the currency is oversold and the central bank's guidance suggests hawkish preference.

EUR is expected to be stable against USD with supportive economic fundamentals and a gradual normalisation of the ECB's monetary policies.

Outlook for GBP and JPY remains bearish. Dovish BOE policy and Brexit talks could weigh on GBP. JPY could stay weak as BOJ continues its accommodative monetary policy.

Asian currencies could see more mixed performances against USD in 2018 due to idiosyncratic factors.

Overview

At the start of 2017, many investors expected a stronger USD. However, it turned out to be a lacklustre year. Though the Fed kept to its plan and hiked rates three times, USD weakened against most G10 currencies. The divergence has narrowed between the Fed and other major central banks, as synchronised global growth has steered central banks such as the ECB to start normalising their monetary policies. Going into 2018, we hold a neutral view on the dollar index. Instead of a broad-based USD strength, G10 and Asian currencies are expected to deliver diverging returns against USD, influenced by the stage of the monetary cycle and the currency's idiosyncratic risks.

G10 currencies against USD

AUD and NZD likely to strengthen

AUD will likely be supported by recovering oil and industrial metals prices. With the Reserve Bank of Australia (RBA) widely expected to keep rates on hold, commodity prices are likely to be the key driver for AUD movements.

A recovery in commodities prices is expected to continue into 2018. Demand for oil has improved as global growth picked up pace, and supply is expected to be tight next year with OPEC likely to extend its supply cut beyond March 2018. Oil inventory is forecasted to decrease slowly, albeit steadily. For industrial metals, improving manufacturing activities, higher infrastructure spending and supply-side reforms in China may drive prices higher.

NZD has been volatile as a result of a change in government in 2017. After the general election in September, the currency lost 5% against USD within two months. However in 2018, NZD is expected to strengthen against USD. Growth has been robust, supported by strong global trade and a tight job market. The Reserve Bank of New Zealand (RBNZ) is to modify its mandates. As RBNZ has indicated in recent meetings that the market's interpretation about its future policy path may be overly dovish. Although political uncertainty could continue weigh on NZD, at the current level, NZD/USD is likely to see more upside.

EUR to be stable with upside bias

By the end of November 2017, EUR strengthened 12% against USD year-to-date with upside bias, and is expected to be stable in 2018. Fundamentally, economic recovery has been broad-based in Europe, with PMIs and sentiments at a multi-year high. Current account balances have improved significantly since 2011, and have already turned positive in most countries. However, a consolidation is expected in 2018 after the strong rally. Despite the ECB's reduction of its monthly purchases, the recent communication suggested a more gradual pace. Yield differential between 10-year US Treasuries and 10-year German bunds has also decreased, putting downward pressure on EUR. In addition, the speculative net long positioning in EUR/USD looks stretched and could be prone to reversion.

GBP and JPY to weaken

Although the Bank of England (BOE) hiked rates by 25 bps in the November meeting, this does not necessarily signal a new hiking cycle. The dovish statement after the monetary decision hinted at only two hikes in the future: one in late 2018 and another in 2020. Uncertainties surrounding Brexit negotiations and a weaker government further adds downward pressure on GBP.

JPY is likely to stay weak against USD. PM Abe's landslide victory in the snap election ensures the continuity of Abenomics and accommodative monetary policies. The core inflation in Japan is still below 1% and BOJ has no pressure to normalise its policies any time soon.

Asian currencies against USD

A mixed bag

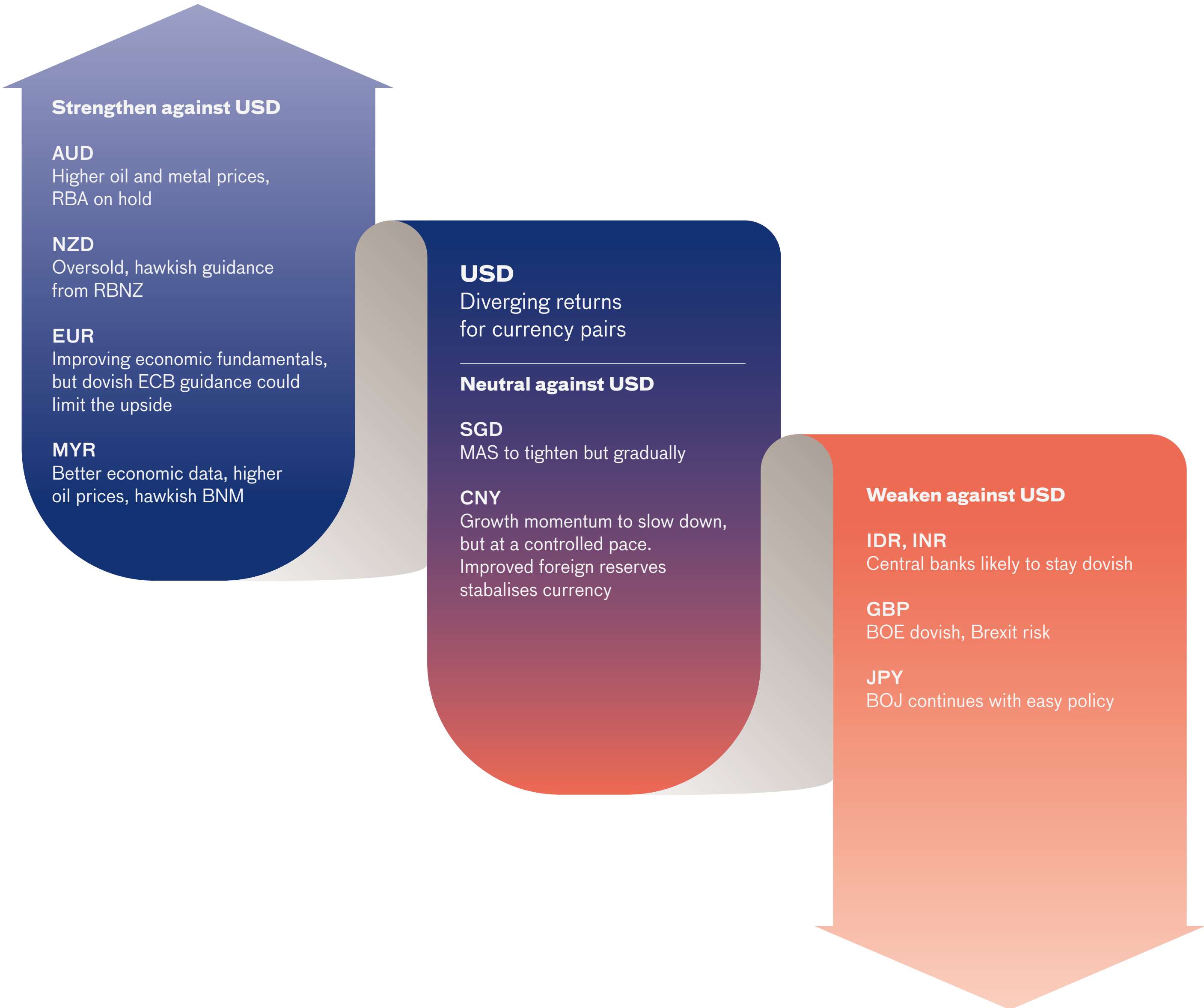
Supported by improving global trades and a stable RMB, Asian currencies have made decent gains of 5% to 10% in 2017. Going into 2018, Asian currencies could see more mixed performances.

MYR could see further gains in 2018 as economic indicators are turning increasingly positive for MYR. Bank Negara Malaysia (BNM) turned more hawkish and could hike rates by 25 bps in early 2018. Improving economic data, including better growth, higher inflation, stable current surplus and growing FX reserves, could provide a constructive backdrop for MYR to strengthen. Furthermore, the rising oil price could benefit MYR, as Malaysia remains a net oil exporter.

RMB is likely to remain firm against USD. Economic growth momentum in China is expected to soften, but at a controlled pace. Improved foreign reserves could help keep RMB anchored. SGD is expected to be stable against USD. Further tightening from the Fed could put downward pressure on SGD. However, the Monetary and Authority of Singapore (MAS) is increasingly likely to hike rates during its April 2018 meeting as Singapore's growth and activity have gathered pace.

However, some Asian currencies could face downward pressure, for instance IDR and INR. Due to lower inflation, central bank policies could remain relatively easy.

Figure 05—**Focus on total returns when investing in bonds—consider both yield and capital appreciation perspectives**



Source: UOB PFS Investment Strategy

Country Focus

Singapore
Malaysia
Thailand
Indonesia
China

Singapore

Moderating but broadening growth points to a stable economic outlook

Key takeaways
Overall, growth is likely to be more broad-based in Singapore, although headline numbers are likely to moderate. Domestic sectors in Singapore are likely to bottom out while a slowdown in China could cause a drag on global trade. A sustained pipeline of public sector projects should support economic growth.

Inflation has been picking up. MAS could tighten its monetary policy as early as April 2018. However, the flexibility of its policy tools allow for incremental adjustments and its impact should be limited.

Private home sales grew 29% year-on-year in September 2017 despite coinciding with the "hungry ghost festival". The optimism in the housing sector underscores the same confidence in the broader economy. The manufacturing sector enjoyed double-digit growth, led by a surge in global semiconductor demand. The services sector, accounting for two-thirds of the economy, also witnessed notable improvements. It expanded 3% year-on-year in the third quarter of 2017, the strongest showing since 2015.

Moving into 2018, we are likely to see growth converge between sectors. Growth in the manufacturing sector is likely to slow as semiconductor sales moderate, due to the high base effect and potential slowdown in China.

For the services sector, better sentiments and economic activities are likely to continue to support its expansion. Finally, for the lagging construction sector, a sustained pipeline of public sector projects should help to arrest any decline. Overall, Singapore's real GDP growth is expected to slow from 3.3% in 2017 to 2.5% in 2018, and headline inflation is expected to pick up from 0.5% to 1.5% in 2018.

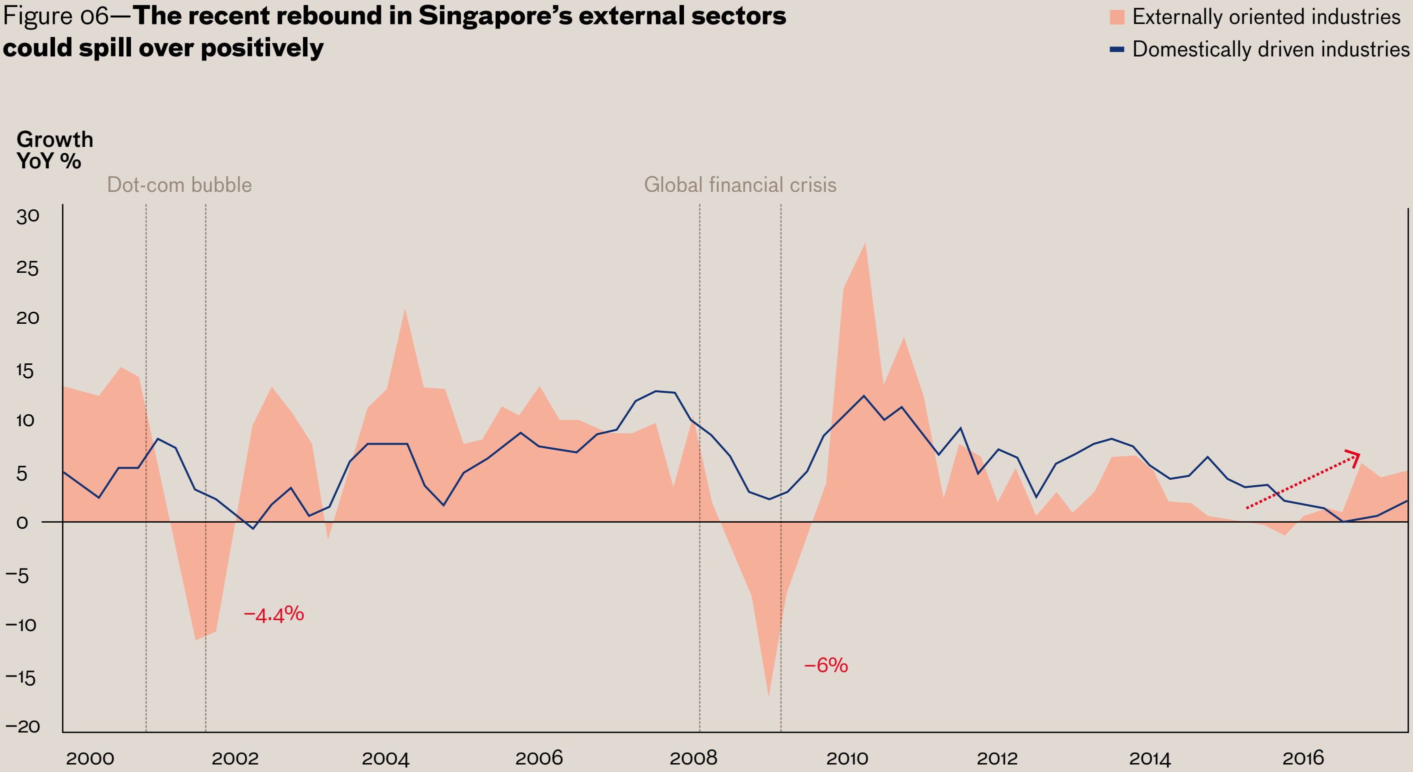
Monetary policy could be adjusted as early as April 2018, during the next MAS meeting. SGD NEER has been trading above its midpoint for most of the time this year. However, given the flexible nature of its policy tools, we expect limited impact to the economy as adjustments are likely to be incremental.

Stocks
As with the global stock market, Singapore equities also enjoyed a stellar run in 2017. The environment, however, will be more challenging going into 2018. Interest rates are poised to rise while growth could moderate in the local economy. Banks could benefit from such an environemnt, as a steeper yield curve could help improve net interest margins and support earnings. A benign environment will also support business activities and loan growth.

Bonds
Local rates are likely to drift higher, led by the tightening cycle in the US. Hence, investors are advised to avoid taking up excessive duration in their portfolios. Issuance has tapered since the series of commodity-led defaults in 2016 while demand remains robust, leading to favorable demand-supply dynamics for the local bond market. The setup is likely to continue into 2018, creating a supportive environment for local bonds despite potentially higher rates.

Foreign Exchange
SGD is likely to decline gradually against USD due to monetary policy divergence. MAS may adjust its stance in April 2018, but changes are likely to be incremental. Meanwhile, the Fed is expected to continue tightening. Singapore Interbank Offered Rate (SIBOR) is likely to drift higher alongside US London Interbank Offered Rate (LIBOR), albeit to a lesser degree.

Figure 06—**The recent rebound in Singapore's external sectors could spill over positively**



Source: CEIC, UOB GLobal Economics and Markets Research

Malaysia

Sound macro fundamentals provide a buffer against market volatility

Key takeaways

Malaysia's compelling growth in the first half of 2017 outpaced regional performance, lifted by private spending and exports. Current growth momentum is expected to sustain into 2018.

Outlook on Malaysian equities remains positive, underpinned by a strong economic backdrop, better corporate earnings, rising commodity prices, potential China investments and election-related spending.

Bank Negara Malaysia (BNM) continues to signal a neutral tone on the direction of interest rates. MYR is fundamentally undervalued over the long-term.

Malaysia's economy is on firmer footing after delivering remarkable GDP growth of 5.7% in the first half of 2017 compared to 4% in the same period last year. Following the data, Bank Negara Malaysia (BNM) said growth in 2017 will be stronger than expected. The country's growth in 2018 is expected to be further fuelled by domestic demand and robust exports. Domestic economic policies continue to be supportive, and its 2018 budget is likely to be expansionary and spur consumption growth.

Headline inflation is expected to peak in 2017 at 3.9% year-on-year and moderate in 2018 to 2.5% year-on-year as global cost factors abate. Demand-led inflation will be sustained by more robust domestic demand but is expected to remain contained.

The benchmark overnight policy rate (OPR) is expected to remain status quo at 3% in 2018, but do not rule out the possibility of a rate hike if strong GDP growth sustains and wage pressures filter into higher inflation pressures.

An undervalued ringgit, supported by positive fundamentals and higher Brent crude oil towards USD60/bbl, underpins our view that the ringgit is in a better place to strengthen assuming modest USD gains.

Stocks

Malaysian equities have been a laggard in 2017, compared with Asia ex-Japan. We maintain a constructive view supported by domestic macros, stronger foreign fund inflows and the resumption of corporate earnings growth. Key investment themes include infrastructure spending, rising China foreign direct investments, reforms among government-linked companies, a rebound in tourism and growth in commodity prices. Bottom-up stock picking strategy and profit taking from outperformers would be a prudent approach in 2018. A key risk to look out for is the country's domestic elections.

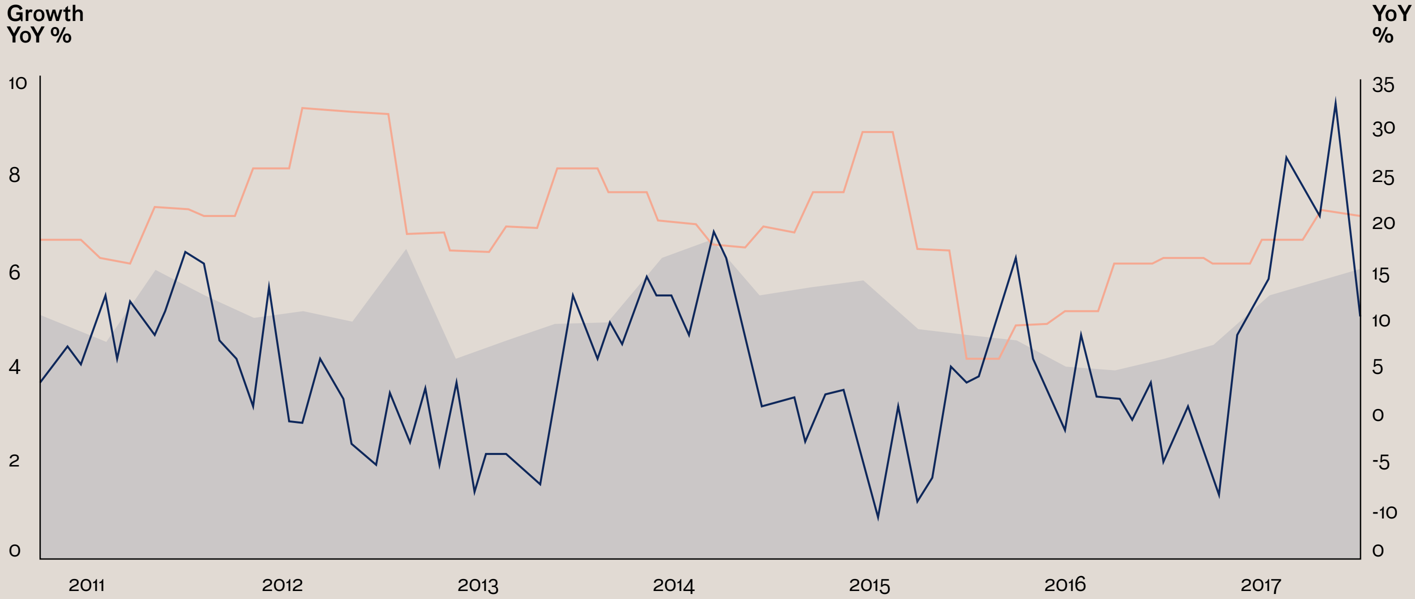
Bonds

We expect Malaysian yields to trend higher along with US Treasury yields, albeit at a moderate pace. Demand for bonds has remained resilient, supported by attractive real yields. With an improving macro backdrop and reserve adequacy ratio, the sharp foreign selling of government bonds since November 2016 has abated and the foreign holdings of Malaysia bonds should largely remain stable.

Foreign Exchange

MYR is likely to strengthen moderately against USD, although some volatility is expected. The positive view is underpinned by positive fundamentals, improving fiscal position and higher commodity prices. It is currently trading at the bottom of its historic real effective exchange rate range.

Figure 07—**Malaysia's growth is underpinned by private consumption and exports**



Source: Bloomberg

Thailand

Moderately rising economic growth driven by investment and tourism

Key takeaways
The Thai economy enjoys a healthy level of growth driven by a combination of infrastructure spending, private investments and tourism.

However, rich valuations in the local equity market could put a ceiling on further upside, especially since global rates could rise. The bond market could also be at risk due to reduced policy accommodation, although low foreign ownership in local bonds could help limit hot money flows. On the currency front, the THB is likely to weaken against USD as policy divergence widens.

Key drivers for Thailand's growth in 2018 include infrastructure spending, private investments and tourism. Infrastructure spending could pick up as many of the previously delayed projects are expected to kick-start in 2018. Higher level of utilisation in the manufacturing sector and Eastern Economic Corridor (EEC) should incentivise private investments. Meanwhile, Thailand remains one of the top destinations for tourists and the number of visitors is expected to grow by 7% to 8% to reach 38 million in 2018, from the current year-end forecast of 36 million for 2017.

Conversely, a growth in household consumption could slow in the lower-to-mid income space. This is due to a combination of a slowdown in farm incomes and continued deleveraging in households due to tighter credit card and personal loan regulations. Exports are likely to continue growing modestly, but are unlikely to be a growth driver.

The overall economic outlook remains positive for Thailand and is underscored by the Bank of Thailand (BOT) revising its GDP growth target for 2018 from 3.7% to 3.8% in September. The target may look ambitious, but it is achievable if the key growth drivers hold up.

Finally, in terms of monetary policy, BOT is expected to keep its rate unchanged at least to the second half of 2018 as slack remains in the economy and inflation looks manageable.

Stocks
Valuations in the Thai equity market are elevated. The setup reduces upside potential and leaves little room for error. Selective sectors could offer opportunities. For example, the banking sector has seen NPLs stabilised and it is also likely to benefit from increased public and private investments. The commerce sector, meanwhile, could enjoy support from tourism growth, and investors can consider buying on dips.

Bonds
A steady supply of shot-term bills and BOT's stable monetary policy outlook should keep short-term yields relatively anchored in the local market. Low levels of foreign holdings help limit volatility. As such, bonds with shorter terms are preferred, though investors could consider taking tactical positions in longer term bonds if long-term yields spike.

Foreign Exchange
Monetary divergence between the Fed and BOT, reduction in Thailand's current account surplus and potential tax reform in the US are likely to cause THB to weaken in 2018. We expect the currency to remain in the range of 33.50 to 34.50 in 2018.

Figure 08—**Tourism in Thailand continues to provide support for growth**

Source: Bloomberg

Indonesia

Resilient economy towards both internal and external pressures

Key takeaways
The economic outlook for Indonesia remains positive, however, it is clouded by potential risks such as rising trade protectionism, weakening commodity prices and an escalation in geopolitical tensions.

The 2018 regional election and 2019 presidential election may raise the domestic political risk.

The recent reduction of corporate tax for small-medium enterprises (SMEs) from 1% to 0.25% is likely to increase domestic investment from more than 56 million SMEs in the country, which accounts for 60% of GDP.

Indonesia's 2018 GDP growth is expected to improve to 5.4% from 5.2% in 2017 as set in the 2018 State Budget approved by the Indonesian Parliament. Social spending is expected to pick up as Indonesia is entering into a year of elections. This tends to have positive impact on private consumption, which accounts for more than half of the country's GDP. Indonesia's expansionary fiscal policy remains the key focus and is expected to support growth through budget reallocations in providing larger spending ceiling for public infrastructure, health and education. Although the budget deficit in 2017 widened from 2.41% to 2.92% of GDP, the government forecasts the budget deficit in 2018 to improve to 2.19% of GDP, this is with the assumption that the tax ratio is increased from the existing 10.3% to 10.9% in coming year. The country's recent upgrade by Standard & Poor's to an investment-grade rating and continued reform efforts by the government has helped accelerate capital inflows, including private investment. With inflation slowing down, the Central Bank is keeping an easing-bias with a 50 bps rate cut this year. The lower rate aims to further boost credit growth to double-digits in 2018.

Stocks

Infrastructure and structural reforms remain key priorities for the government. Ease of doing business and the low cost of funding after rate cuts of 200 bps since beginning of 2016 are expected to attract more investments from both domestic and foreign investors. Higher domestic holdings in local equities may reduce external shock should regional or global uncertainties escalate. Investment in the stock market, particularly in the consumer staples, construction and banking sectors, remain attractive as consumer sentiment rises, infrastructure spending continues and merger and acquisition activities pick up in the banking sector.

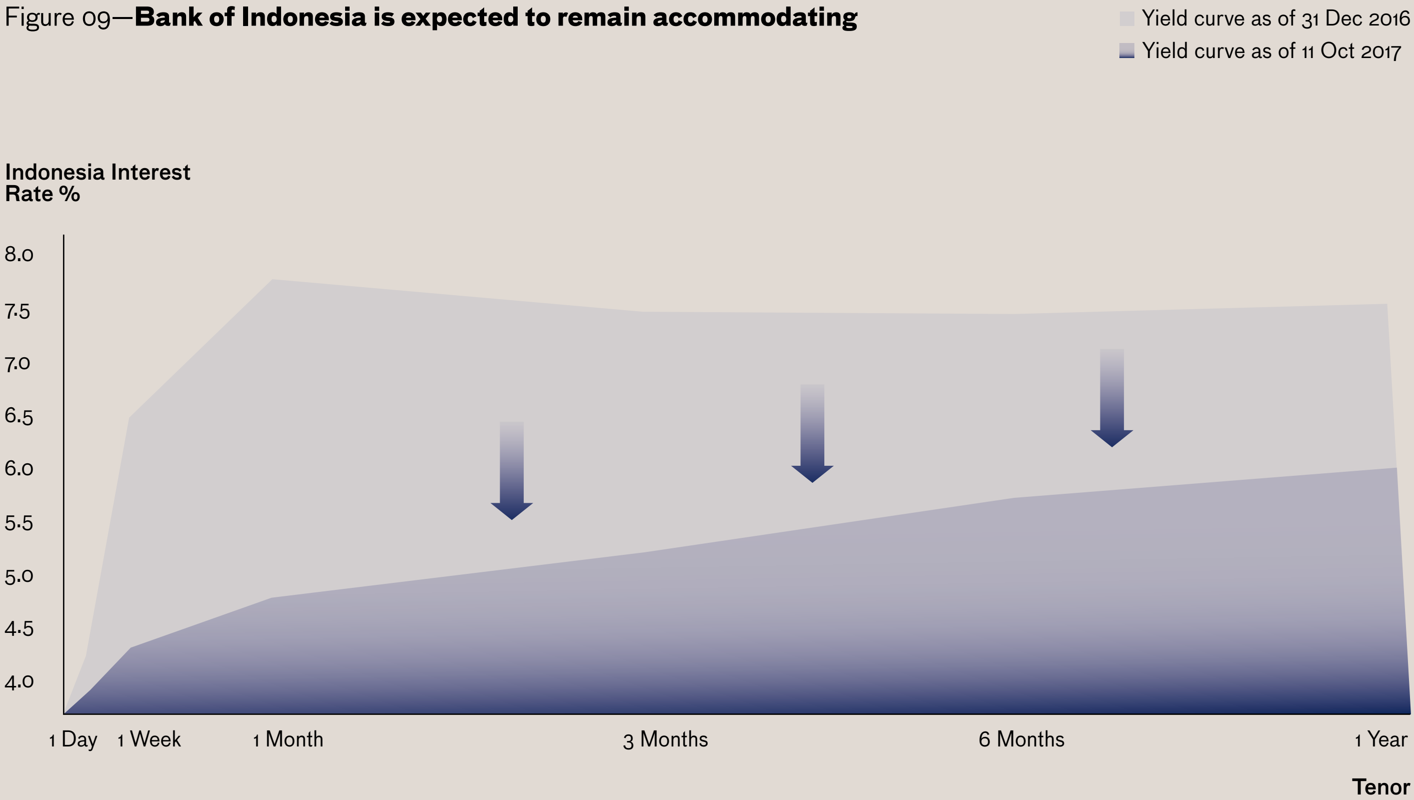
Bonds

Indonesia's government bonds offer one of the most attractive inflation-adjusted returns. Monetary policy continues to be accommodative, with the government aiming to keep inflation below 4%. Short-medium local currency government bonds are preferred over long-term ones due to a divergence in central bank views toward monetary policy, which places downward pressure on IDR. Considering the hawkish stance from the Fed, short duration USD Indonesian government bonds are the preferred asset class as Indonesia's sovereign rating has just been raised and has a positive outlook.

Foreign Exchange

IDR is expected to experience downward pressure because the central bank's view diverges from that of the Fed. The pause in policy easing signals and record-high foreign reserves allow the Central Bank to maintain the currency within the target set by the government.

Figure 09—**Bank of Indonesia is expected to remain accommodating**



Source: Bloomberg

China

Supply-side reform is still the key driver for economy growth

Key takeaways
China's economy stablised in 2017. Both manufacturing activities and consumer sentiment have improved since the second half of 2016.

The Chinese economy is undergoing structural changes. Consumption is likely to play a more important role in the economy. The government will continue to push forward supply-side reforms next year. Such measures could further improve the quality of economy and boost corporate profits.

RMB is projected to be range trading as the depreciation expectation has weakened on better growth and improved capital outflows.

China's economy has stabilised since mid-2016. Recent leading economic indicators such as China Caixin PMIs and consumer confidence have reaffirmed the momentum for stabilising China's economy. Better-than-expected corporate profits reflected more solid corporate fundamentals

Going into 2018, supply-side reform is likely to remain the top priority for the Chinese government. It could continue pushing forward reforms and the deleveraging process. Reforms may have some negative impact on the economy in the short term, as some small, inefficient and highly polluting companies are shut down. However, in the medium term, these measures could benefit the economy by improving the industrial structure, promoting corporate efficiency and increasing corporate profits. Industry leaders are likely to emerge as the winners.

The People's Bank of China (PBOC) is expected to keep its neutral monetary policy stance, as inflation is likely to stay stable. On the fiscal front, the government is shifting its policy focus from infrastructure spending to tax reduction, which will provide further tailwinds to corporate earnings.

That said, there are still some challenges in 2018. The rapid deleveraging process may cause some uncertainties, but we expect the impact to be moderate.

Stocks

Supply-side reforms have boosted product prices in the over-capacity industrials and has helped to boost company earnings, particularly the industry leaders. As a result, sentiments among both domestic and foreign investors have become more positive. Funds of foreign investors are expected to continue flowing into the Chinese equity market in 2018. We favor sectors with a better earnings profile such as the consumer and financial sectors, where strong earnings growth and attractive valuations are likely to propel outperformance.

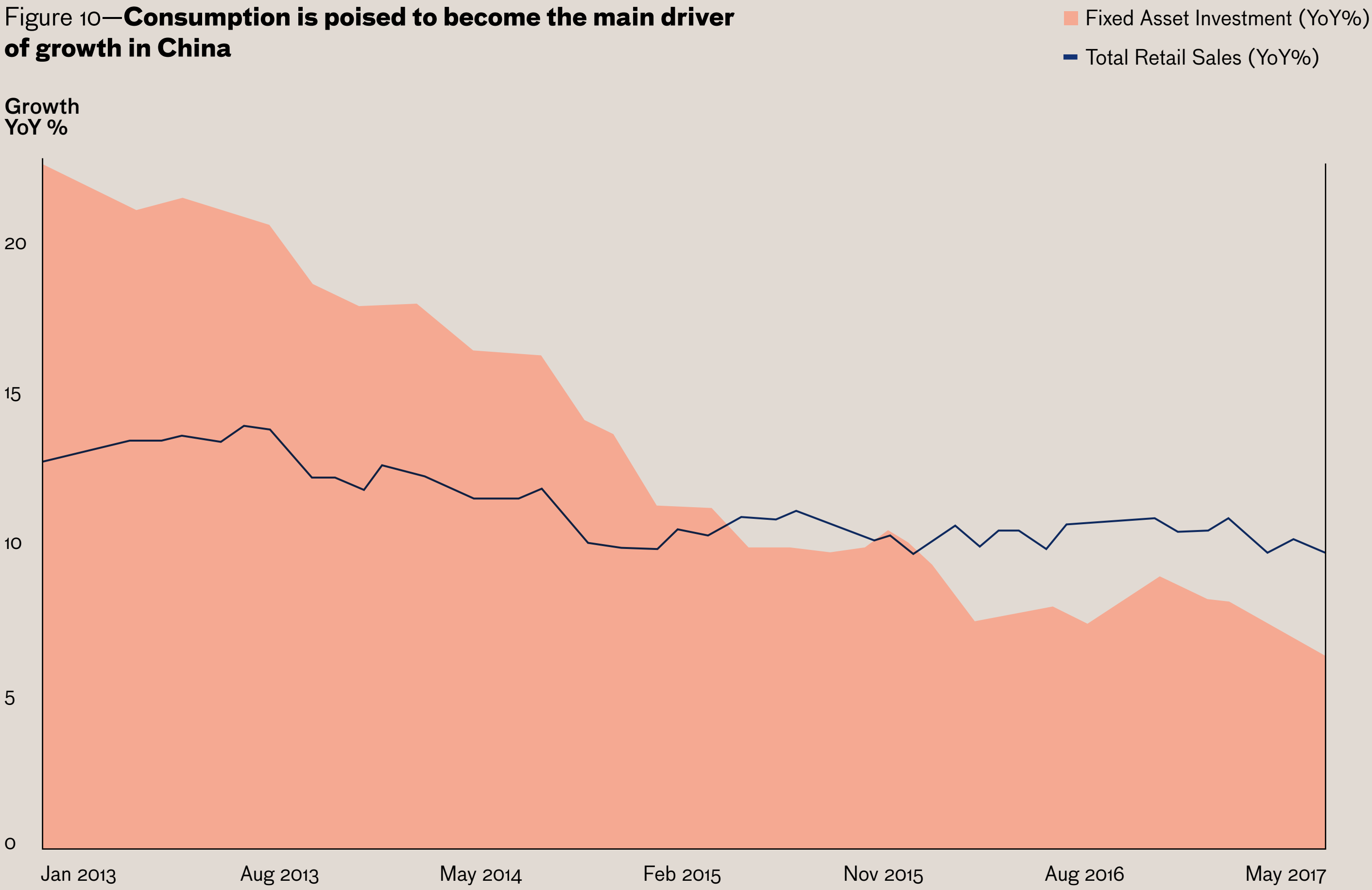
Bonds

The fixed income market is likely to stay soft owing to a better economy and tight financial regulatory environment. Tightening biases of major global central banks could further weigh on sentiments. However, a reasonable valuation may provide a good entry point for investors with a longer investment horizon.

Foreign Exchange

RMB is expected to fluctuate in the range but its volatility will be higher than before. Lower capital outflows, an improving economy and a relatively stable USD would help remove downward pressure on RMB.

Figure 10—**Consumption is poised to become the main driver of growth in China**



Source: Bloomberg

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