Investment Insights

JUNE 2017

Fair winds... for some

Changes in Europe's political scene continue to play out this year, amid some surprises. This June, the limelight refocuses on France and UK.

Surfing the waves

Newly-elected French President Macron looks to continue his momentum in the legislative elections. Exit polls for the first round on 11 June showed that En Marche! won 31.9% support, with the second party trailing at 18.9% (Source: Reuters, 11 June 2017).

For the second round on 18 June, the polls suggest En Marche! is likely to take more than 400 out of the 577 seats in the National Assembly (Source: CNBC, 12 June 2017). If Macron's party is able to win the majority of the seats, it will bode well for the implementation of his policies. We view this as a positive for the political situation in Europe.

Inside

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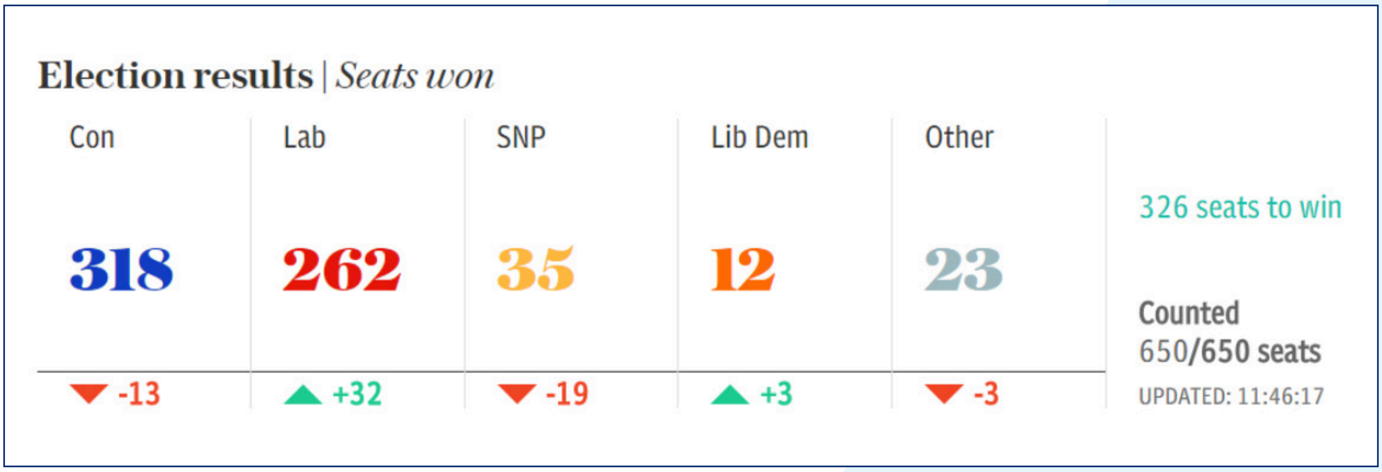
Shipwreck

Unfortunately, on the other end of the spectrum is UK Prime Minister May's situation after the snap elections on 8 June. The result is a hung parliament, where no party secured an overall majority. This makes the situation very tricky for the UK, which is about to enter formal Brexit negotiation with the Europe Union.



Source: Telegraph, 12 June 2017

Internally, it is a race against time for the Conservative Party. The first test will be the Queen's Speech, scheduled for 19 June. They will need to command a majority for their legislative agenda else face a motion of no confidence and subsequent dissolution. The Conservative is likely to form an alliance with the tiny Democratic Unionist Party (DUP), but that will only bring them to majority by three seats. This means continued challenges in passing legislations, even if they do hammer together a unified front.

Externally, the election outcome open doors for a potentially softer Brexit, as a good part of the government is made up of Labour, Scottish National Party and Liberal Democrats (parties opposing to the notion of UK leaving the EU). However, we expect the negotiation process to be lengthy and inefficient due to the fragmentation in the government.

Little England

How the UK politics and Brexit negotiations will play out in the coming weeks is unclear. We are wary of the sterling and the UK markets until a clear leadership and direction is established. However, it is likely that immediate impact will be localised and should not derail prospects in the broader Europe in the short to medium term. Hence we continue to stay constructive on European equities, while being mindful of UK markets.

What it means for investors ▶▶

European Equities still on strong footing

The UK hung parliament has introduced complication to the Brexit negotiation. It opens chances for a softer but possibly a more disorderly Brexit. However, we expect the impact to be localised to the UK markets. On a positive note, the disarray in UK may dampen the Eurosceptic rhetoric in other European countries, making the EU more unified than before.

The following factors are reasons why we remain constructive on European equities.

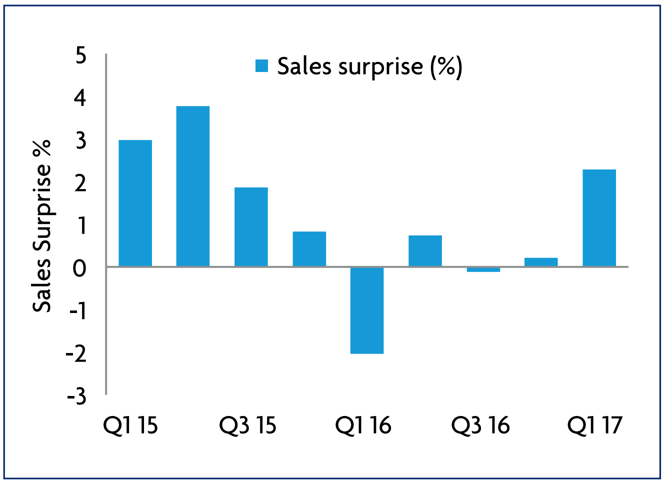
1. VALUATIONS

Q1 earnings confirm earnings turnaround

European equities reported strong sales surprises in the latest quarter, forming our basis to be constructive in this region.

On average, first quarter earnings beat consensus forecast by 13%. (Source: Bloomberg, 30 May 2017) More importantly, the strong earnings were driven by better top-line sales and not by cost cutting measures. Revenue grew at around 10% in the first quarter, beating consensus by 2.3%, the highest in almost two years. See Figure 2.

Figure 2: Sales surprises are the highest in two years



Source: Bloomberg, UOB PFS Investment Strategy, 30 May 2017

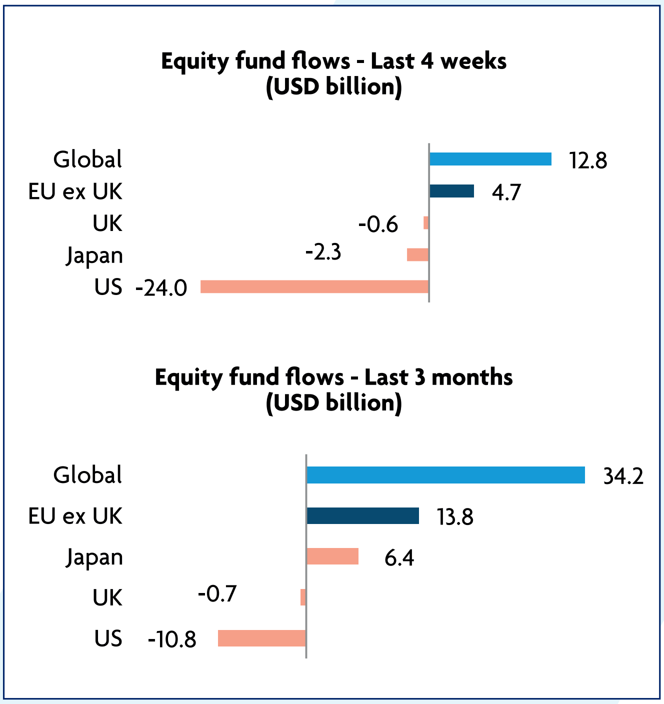
2. TECHNICALS

Fund flows continue to favour European equities

The great equity rotation is happening. In the last four weeks, fund flows favoured European equities. European equities drew the most inflows among the developed markets in recent times. See Figure 3.

The inflow came at the expense of US equities. Despite major US indices registering new highs, there were outflows from US equities, with momentum accelerating in May. We feel there is still room for investors to rotate from US equities to European equities, given the cheaper valuation, better economic outlook and the relative positioning stance from investors.

Figure 3: European equities continue to see inflows



Source: EPFR, 25 May 2017

3. ACTIVITIES

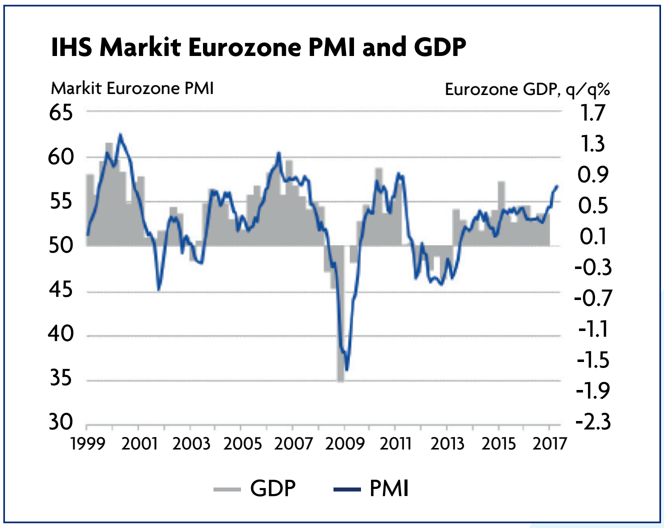
Economic data is supportive

Economic data suggests that growth in Europe is picking up. The latest Composite PMI figure indicates that the Eurozone businesses' expansion gained momentum. This is the highest levels in six years. PMI is a leading economic indicator of the economy.

A PMI reading above 50 suggests economy expansion. Furthermore, the employment situation in Europe is improving, with unemployment figures trending down. There is room for improvement in the peripheral European countries like Italy, Spain and Greece. This provides a long runway for potential growth.

Overall, the economic improvement in Europe is broad-based.

Figure 4: Eurozone PMI hold steady



Source: IHS Markit, Eurostat, 23 May 2017

4. KEY RISKS TO EUROPEAN EQUITIES

The **UK election outcome on 8 June** was not to Prime Minister May's liking, with her Conservatives party losing the initial power of a simple majority. The impact of this is likely to be localised within the UK and not spread to the broader Europe region.

French elections are in favour of President Macron and the En Marche! Party. This is likely to help seal a strong mandate to drive policies for EU's third largest economy (after Germany and UK).

The German election is next on investors' radar. The election is starting in September. Markets are likely to be less affected as both leading parties in the poll are pro-EU and pro-business. The populist party, AfD, meanwhile lagged far behind.

Bottom Line

While the headline news on political uncertainties may make some investors hold back investing in European equities, the underlying fundamentals are turning better.

European equities' earnings are projected to pick up in the near future. This should help propel the outperformance against other developed markets as it is relatively cheaper than US equities on price-to-earnings valuation.

After years of investors' outflow from European equities, the tide has finally turned in recent months, with room to catch up with US equities. This could prove to be the tailwind.

The macroeconomic backdrop is supporting the recovery, with both the consumer and business sentiments improving. This is backed by encouraging jobs data and business profitability in the large economic bloc, boosted by a conducive global growth outlook.

European equities have recently delivered strong returns and the trajectory may continue on the above factors. We believe European equities present a compelling proposition to tactically allocate within a well-diversified investment portfolio as political risks abate.

Market Outlook and Strategies ▶▶

Investment Perspective – May 2017

Equity	We continue to prefer equities over fixed income. Investors can look to participate in **global equities that emphasise on generating free cash flow.** Focus on **Asia ex-Japan** equities. Recent trade and manufacturing data suggests strong underlying growth drivers. Selective on US equities. Focus on **Healthcare** sector. The positive outcome from the French Presidential elections (i.e. pro-EU Macron won) mitigates the concern of anti-EU political fears. We continue to see stronger European economic fundamentals, suggesting a positive backdrop. Participate in **European equities** with sustainable dividends.
Fixed Income	**US short duration high yield.** **Subordinated bonds** of high quality financial issuers.
Alternative	Structured notes that allow participation to the equity markets through a customised payoff structure. Investors can participate in rising interest rates through **floating rate notes** structure.
Currency	Upward pressure on the **US dollar** is expected this month. **AUD** is expected to consolidate, risks to downside target of 0.7400. Brexit may overshadow UK election boost – **GBP** under pressure.

Investment Perspective – June 2017

Equity	We continue to prefer equities over fixed income. Investors can look to participate in **global equities that emphasise on generating free cash flow.** Focus on **Asia ex-Japan** equities. We hold the view that Asia ex-Japan equities offer longer term return potential. However, the recent outperformance run-up this year may take a breather. **New!** Selective on US equities. Focus on **Healthcare** sector. We continue to see stronger Europe data from companies' earnings and macroeconomic fronts. Participate in **European equities** with sustainable dividends.
Fixed Income	**US short duration high yield.** **Subordinated bonds** of high quality financial issuers.
Alternative	Structured notes that allow participation to the equity markets through a customised payoff structure. Investors can participate in rising interest rates through **floating rate notes** structure.
Currency	USD under pressure as Russian probe overshadows the expectation of a June Fed hike. A less dovish Reserve Bank of Australia lifts AUD. Brexit negotiations and the UK elections weigh on GBP.

Source: UOB Investment Insights – May 2017

Strategy for the month of June

- We focus on European equities this month. UK political uncertainty is unlikely to derail the broader European bloc's growth. We believe that **European equities are likely to outperform**, closing the valuation gap as compared to US equities. We are watchful on UK equities on political risks.
- The **US Fed is projected to raise interest rates by 25 bps from 1.00% to 1.25% on the June meeting**, after the short pause in May. Market has already priced in a 100% chance of a June rate hike. (Source: Bloomberg, 12 June 2017). The question now shifts to the trajectory of the rate hikes. The outlook is unclear, given that the Fed is also considering reducing its balance sheet to withdraw excess market liquidity. We think that the process is likely to be gradual and the Fed will be careful not to jeopardise US growth.
- Fear, as measured by the VIX index, continued to hover at the lowest levels in 10 years. Whilst economic data releases and earnings announcements have been positive, we **believe that markets may be complacent and short term corrections may occur**. We recommend keeping some dry powder to add positions during price corrections as the longer term outlook remains positive.
- The UK sterling is likely to remain under pressure as Conservatives try to run the government without a majority. Policies implementation is likely to take longer and the Brexit negotiations more complex as internal debates loom.

Strategy		Analysis
	Short Duration High Yield Bonds	
1 Position for higher rates through short duration high yield bonds and subordinated bonds. **Position fixed income investments defensively on increased interest rate risks.**	Value	Albeit spreads have narrowed due to recent outperformance, **the yields are attractive** compared to US Treasuries.
	Trend	Investor fund inflows have been **supportive**, but the asset class may be overbought in the near term.
	Activity	Economic outlook should remain positive in the medium term, supported by healthy labour market and improving business sentiments.
	Risk	If defaults rise due to inability of companies to refinance, this will negatively impact this asset class.
	Subordinated Bonds	
	Value	**Yields are attractive** compared to senior bonds of investment grade companies.
	Trend	Technical indicators point to **sideways movements**.
	Activity	Inflation may pick up. **Higher yields could cushion negative impacts on prices**.
	Risk	If defaults rise due to inability of companies to refinance, this will negatively impact this asset class.
	Asia Ex-Japan Equities	
2 Asian equities are attractive, given low relative valuations and supportive economic backdrop. **Tap on Asia Value.**	Value	Price to earnings ratio (P/E) for Asia ex-Japan equities at 15.2x is **attractive relative to DM equities** at 22.1x Earnings forecasts for the region has turned positive after 2 years of underperformance.
	Trend	**Trend turned positive towards earlier this year and looks to continue**. Strong gains of 13.9% since start of year.
	Activity	**Economic data are supportive**. PMI for key countries have been resilient and export growth also looks buoyant.
	Risk	**Amicable meeting between Trump and Xi helped alleviate fears of trade war**. Constricted trade flows, still a possibility, could dampen sentiments.
	US Healthcare	
3 Invest in US through sectorial play, like Healthcare. **Selective on US sectors, rather than broad market. Rotation play to be nimble.**	Value	**Earnings per share looks resilient and supported**. Relative price-to-earnings valuation is in the cheap region.
	Trend	**Momentum gained strength**, with short and long term trends in place.
	Activity	**Business and consumer sentiments are positive**. Stronger economy, more innovative medical practices and an aging population are positive.
	Risk	**Bill to replace the Affordable Care Act (ACA) has been withdrawn**, but uncertain as to whether there could be future replacements.

Strategy		Analysis
4 European equities are well supported by relatively attractive valuation and solid economic fundamentals. **Approach European equities (with dividend focus) for added stability.**		**European Equities**
	Value	**European equities are trading at wide valuation gap to US equities**. Earnings forecasts are revised upwards in 2017.
	Trend	**Trend turned positive and is at early stage of recovery**. As risk of French election moderates, the outflows since 2016 may potentially reverse in 2017.
	Activity	**Economic data are supportive**. Better PMI figures and corporate borrowings indicate that the Eurozone economy is recovering.
	Risk	**French election ended in Macron's win**. While political risks look more balanced in Europe, there are still a number of elections for this year and we remain vigilant.
5 Gain managed equity exposure through global quality stocks. **Focus on global companies that emphasise on generating free cash flow.**		**Global Quality Equities**
	Value	**Earnings per share growth remains robust** as good quality companies often operate in sectors and industries with improving fundamentals.
	Trend	**Both long-term and short-term trend are positive**. Technical indicators are trending up.
	Activity	**Stable global growth** provide a benign environment to invest in global equities.
	Risk	Global recession risk stays low. However, relatively hefty valuations **increase the probability of short-term correction**. Uncertainties still exist in the world which may suggest more volatile times ahead.
FX Continued weakness in GBP expected.		• **USD under pressure** as Russian probe overshadows the expectation of a Fed hike in June • Less dovish Reserve Bank of Australia lifts AUD • Brexit negotiations and the UK elections weigh on GBP
Rates Rising US rates expectations on the back of Fed tightening.		• The Fed is forecast to hike 3 times in 2017, with the second rate hike done on 15 June. The next hike is expected to be in September. • USD 3M Libor has increased significantly from 0.62% in January 2016 to 1.19% in May 2017. USD 3M Libor is forecasted to reach 2.04% in 2018 Q1.

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