UOB

Investment Insights

MARCH 2017

Calm market sparks concern of brewing storm

European Politics take Centre Stage

Theresa May
UK Prime Minister

Marine Le Pen
President of the National Front (FN), a political party in France

The European political calendar in 2017 is packed. The Netherlands, France and Germany will have their elections in the coming months. To make matters more complicated, Britain is set to trigger Article 50 in March which kick-starts the two-year negotiation to leave European Union (EU). Italy is also set for another round of general election, though the dates are not confirmed yet. The list goes on.

The Gross Domestic Products (GDPs) of these five countries totalled more than €1 trillion, accounting for two thirds of the economic bloc. These political events have an important impact to the future and direction of the EU.

Country	GDP in billions Euro (2015)	As % of EU GDP	Event and Date
Netherlands	676.5	4%	Dutch General Election Date: **15 March 2017**
Britain	2,577.3	17%	UK Article 50 Deadline Date: **31 March 2017**
France	2,181.1	14%	French first round election Date: **23 April 2017** French second round election Date: **7 May 2017**
Italy	1,642.4	11%	Italy Election Date: **No later than 23 May 2018**
Germany	3,032.8	20%	German parliamentary election Date: **September 2017**
Total of 5 countries	**10,110.1**	**66%**	

Source: Wikipedia, UOB PFS Investment Strategy, 22 February 2017

Inside

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French elections and Brexit negotiations ▶▶

Investors could be concerned about French election and UK's break-up terms with EU. Both France and UK are Group of Eight (G8) members – the major highly industrialised democratic economies. Changes in their political landscapes could have significant impacts on global financial markets. We now zoom into the details of the French Presidential election and Brexit to understand the respective situations.

French election – Is this another black swan?

Will the French election results follow the UK referendum, a potential "Frexit"?

The poll results, till date, do not support this outcome. While Le Pen (pro leaving EU) tops the poll for the first-round election, the probability for her to win in the final round is estimated to be only 34 percent.

When pit against another candidate in the face-off second round, her strong tilt to France's membership in the EU does not sit well with majority of the voters.

Nevertheless, a Le Pen victory cannot be ruled out. This is still early in the political run up to the final date on 7 May.

Source: Bloomberg, 22 Feb 2017

Brexit – the multi-billion dollar divorce

Just like any divorce, UK's breakup with EU is likely to be difficult. Once it formally triggers Article 50, the two years of discussion on how to terminate its 40 years membership of the bloc will then officially commence.

The first barrier is the **exit bill, ranging from €40 billion to €60 billion**. EU is likely to insist the UK to meet its financial obligation before the real talk starts. EU may be forced to adopt a hard stand to protect its own credibility. Another issue is Britain's plan to cut corporate tax after leaving EU and turn the country into a tax haven. Britain's corporate tax is projected to drop from current level of **20% to 17% from 2020 onwards** to attract business to stay within the UK. This has upset EU officials and they are mulling over inserting a clause to stop UK from doing so.

By the end of two year period, if no agreement is reached, UK may have to walk away with "no deal". It is hard to envisage what the impacts are in a "no deal" situation, but the impasse is likely to cause more harm than benefits.

No deal for Britain is better than a bad deal.

Theresa May
Prime Minister of United Kingdom
Said in a Brexit speech in January 2017

We will not allow any cherry picking.

Angela Merkel
German Chancellor
Said in December 2016 regarding UK's Brexit negotiation

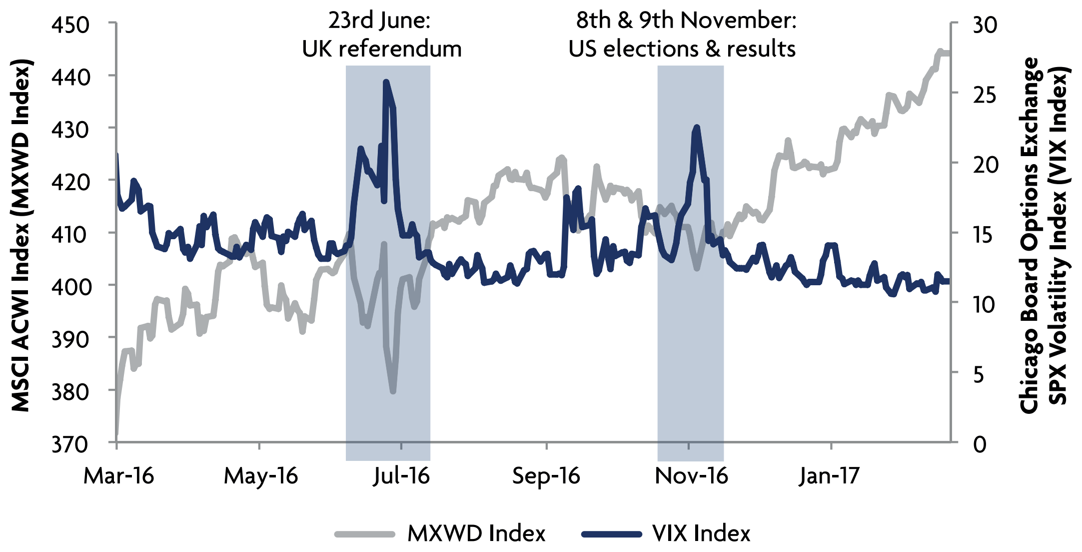
Uncertainty may be the only certainty for now

In 2016, we witnessed two political events that arguably were too close to call – UK referendum in favour of Brexit and US election in favour of protectionist policies. We learned that predicting the outcome for a political event is often difficult; forecasting the markets' reaction to the outcome is even more challenging. This lesson may also apply to 2017. Rather than betting heavily on either direction, it is advisable for investors to stay invested based on fundamentals and have a core portfolio foundation that focuses on risk management.

What it means to Investors-
Refocus on building core portfolio ▶▶

With the French elections and UK's deadline for triggering Article 50 in the horizon, we believe that markets could become event driven in the short term. Volatility may rise in the near term with the European politics driving market uncertainty.

The performance of the VIX Index (a widely accepted indicator for equity market fear) illustrates this. In the last twelve months, the VIX Index spiked on two instances, namely during the periods around UK referendum and the US elections. Correspondingly, markets have dropped significantly before recovering.



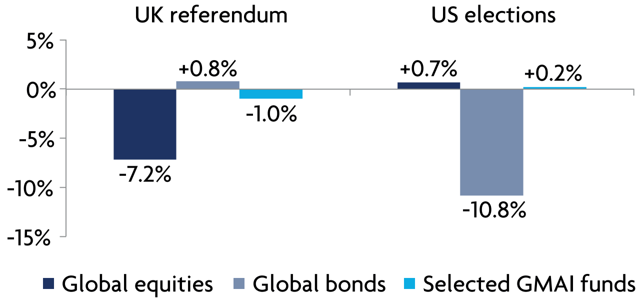
Source: Bloomberg, UOB PFS Investment Strategy, 19 February 2017

Hence, it is prudent to avoid large directional bets on the markets as such positions could sour if the outcome was not in your favour. Instead, investors may choose to allocate to diversified solutions such as global multi-asset income funds (GMAI). GMAI typically experience less drawdown than stock markets in volatile markets. This means that investors could cushion from market shocks and potentially take advantage of market price dislocations for market opportunities.

Furthermore, we believe that a passive income strategy forms an important foundation to investing. Passive income through dividends/coupons allows investors to anchor the portfolio for a more stable investment journey.

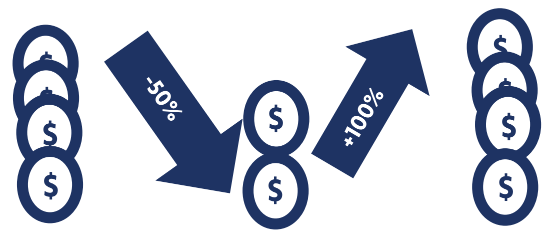
With a strong core portfolio, investors can then employ tactical strategies to take advantage of market dislocations when opportunities arise.

Performance of global indices and selected Global Multi Asset Income (GMAI) funds during periods of large drawdown



Source: Bloomberg, UOB PFS Investment Strategy, 19 February 2017

Trajectory matters because a larger increase than the initial drawdown is needed for a portfolio to recover



Market Outlook ▶▶

Investment Perspective – February 2017

Equity	Focus on Asia ex-Japan equities, but with a low volatility approach. Selective on US equities. Focus on Industrials and Financials.
Fixed Income	US short duration high yield. Subordinated bonds of high quality issuers. Hybrid credits that allow for reset at call date, with a preference for bonds with a high reset spread.
Alternative	Structured notes that allows participation to the equity markets through a customised payoff structure.
Currency	USD faces temporary downside pressure but overall uptrend remains. Expect AUDSGD and AUDUSD to consolidate. GBPUSD to remain under pressure as Article 50 draws closer.

Source: UOB Investment Insights – February 2017

Investment Perspective – March 2017

Equity	Focus on Asia ex-Japan equities, but with a low volatility approach. Selective on US equities. Focus on Financials. We think the run-up in Industrials have largely run its course and have taken the opportunity to take profit this month.
Fixed Income	US short duration high yield. Subordinated bonds of high quality issuers. Hybrid credits that allow for reset at call date, with a preference for bonds with a high reset spread.
Alternative	Structured notes that allows participation to the equity markets through a customised payoff structure. Investors should provision for more buffers or consider principal protected structures.
Currency	USD strength should return in the coming months as the Fed still sees a base case for three rate hikes in 2017. Expect AUDSGD and AUDUSD to consolidate. GBPUSD to remain under pressure as Article 50 draws closer.

Strategies ▶▶

Strategy for the month of March

- Volatility index recently printed new lows, with the US large cap (S&P 500) trading without a single day of more than 2% decline since President Trump's election victory last November.
- This suggests that markets may be a little complacent in pricing risks. We feel that markets may be due for an increase in short term volatility driven by some European politics uncertainty.
- We prefer to **refocus on building core portfolio** this month, with a keen lookout for attractive entry points should market volatility happens.
- Fixed income investing should be assessed with consideration of interest rate sensitivity (duration risk) to achieve better total return. With a 94% market expectation of a March Fed rate hike, bonds are likely to be under price pressure in the coming months.
- On the back of the reflation theme, Gold price is expected to face the dual headwinds of rising interest rates and US dollar. However, Gold is always useful as a diversifier and insurance in a portfolio. Investors can consider strategically allocating a small position in their portfolio.

Strategies ▶▶

Strategy	Analysis	
1 Position for higher rates through short duration high yield bonds and subordinated bonds. **Heightened Interest Rate Risks**	**Short Duration High Yield Bonds**	
	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.
	Risk	Strong economic momentum and governments' efforts to boost growth will **keep default rates at low levels**.
	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	**Default risk is likely to stay low** for companies with strong balance sheets.
2 Asia remains attractive but a conservative stance is warranted. **Tap on Asia Value**	**Asia Ex-Japan Equities**	
	Value	Price to earnings (P/E) for Asia Ex-Japan equities at 14.7x remain **attractive relative to developed markets equities** at 22.1x. Current P/E levels are fair versus long-term historical average.
	Trend	**Price has rebounded** since the election scare in November 2016. Trend has turned positive and looks likely to improve.
	Activity	Economic data are supportive. Purchasing Manager Index (PMI) are mostly expansionary and export growth looks buoyant.
	Risk	**President Trump seems inclined towards a hard stance on trade**. Constricted trade could dampen sentiments.
3 Invest in US through sectorial plays on Financials. **Selective on US sectors that are likely to benefit from Trump's policies**	**US Financials**	
	Value	**Earnings per share growth is poised to pick up** with improved net interest margins on the back of steeper yield curve.
	Trend	**Momentum is positive.** Trend has been strong since the US elections.
	Activity	**Business and consumer sentiments are positive**. Federal Reserve is still likely to raise rates gradually.
	Risk	Due to current high earnings growth expectations, **investors may be prone to disappointments**.
	We have taken profit on US Industrials in March 2017 as valuations become stretched on recent positive price actions. Trump's massive fiscal infrastructure spending plans still remain sketchy and future earnings are likely to only flow through earliest next year (projection).	
FX USD remains bullish for the longer term on rate hike expectations. **US interest rate policy divergence from other central banks**	• USD faces temporary downward pressure but overall uptrend remains. • We expect AUDSGD and AUDUSD to consolidate. • GBPUSD remain under pressure as deadline for triggering of Article 50 draws closer.	

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