UOB

# Investment Insights

MAY 2017

# Not yet 40

**39** – Macron's age when he was elected as the president, the youngest in French history.

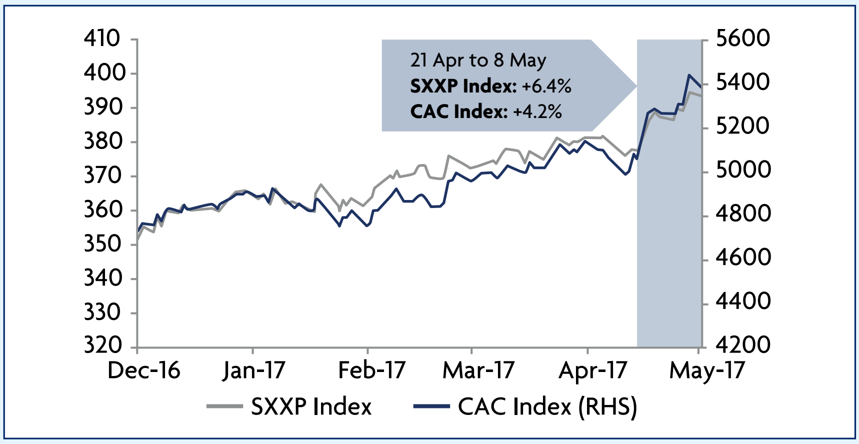
**34** – the percentage of vote secured by Le Pen in the second round of the presidential election.

**Not yet faulty** – the integrity of the European Union (EU), which has been at the crossroad of global attention since the start of year.

## A bullet dodged

On 7 May, Macron claimed victory over Le Pen in the French presidential elections. The outcome was crucial in appeasing fears of Frexit and potential instability in the EU should the outcome be in favour of Le Pen. Investors were concerned by upsets in UK referendum and US presidential elections last year. European stocks have been penalised until recently for fears of raising populism and euro-skeptics. This sentiment has improved recently. See Figure 1.

Figure 1: Key European (SXXP Index) and France (CAC Index) indices rallied on the back of reduced French political risks.




Source: UOB Investment Strategy, Bloomberg, 08 May 2017

## Inside



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The reason for market's preference for Macron is his strongly pro-business reform and pro-EU agenda, which are much less controversial and more balanced than Le Pen's anti-EU and inward looking proposals. Highlighted below are selected campaign promises relating to the economy and international relations. See Figure 2.

Figure 2: Key campaign promises from Macron pertaining to the economy and France's international relations

**Economy**

- **Reduce public spending**
  - Reduce public spending by EUR 60bn over five-year term, in part by reducing public service payroll jobs by 120,000
  - Public spending to be cut by 3pps to 52% of GDP by end of his term
- **Increase public investments and welfare**
  - Public investment spending of EUR 50bn
  - Extend healthcare cost reimbursement to full cover of dental, optical and hearing treatment
- **Cut taxes**
  - EUR 10bn reduction in local tax (taxe d'habination)
  - Cut corporate profit tax to 25% from 33%

**Europe & the world**

- **Firmly pro-EU**
- **Wants common defence funding while remaining pro-NATO and wants Eurozone governments to forge closer ties**

Source: UOB Global Economics & Markets Research, 08 May 2017

## What's next for Macron and France

The French legislative elections, due to be held on 11 and 18 June will be essential for Macron to implement his economic program. After his inauguration, Macron will need to appoint a Prime minister and win the majority in the French parliament.

Though Macron's party En Marche! does not have any parliamentary seats currently, a recent poll (Source: Reuters, Opinionway, 03 May 2017) suggests that En Marche! would lead and win between 249 and 286 seats, out of the 535 seats for mainland France constituencies. The total number of parliamentary seats in the National Assembly is 577 – of which an absolute majority is 289 seats.

This means an absolute majority is not impossible. Furthermore, Macron's agenda shares similarities with other parties and he could form coalition, absent an outright majority.

## Clearer skies ahead

Developments in France will be closely watched but the outcome of the legislative elections is unlikely to derail markets. Meanwhile, the rest of the EU is not quite out of the political woods for the year.

- Slated for 8 June are the UK snap elections. Brexit negotiations will continue to weigh on sentiments.
- Later in the year, Germany will also be holding its elections.
- Finally, concerns about Italian political risks and its banking system may come into the picture early next year.

However, the remaining key events are less contentious and lack strong anti-EU or populist undertone. Hence, we reiterate our **constructive view on Europe**.

# What it means for investors ▶▶

## A Turning Point for European Equities?

Among developed market equities, European equities have underperformed their US peers for years. **Macron's victory in the French Presidential Election may mark an important turning point for European equities.**

Thanks to Macron's victory, the probability for Frexit for next five years is estimated to be around zero. The fading political uncertainty may allow investors to stop being nervous about the survival of the European Union, and start refocusing on Europe's improving economic fundamentals and better earnings. Other than relatively attractive valuation, we highlight some key reasons that European equities could outperform going forward.

## 1. VALUATIONS

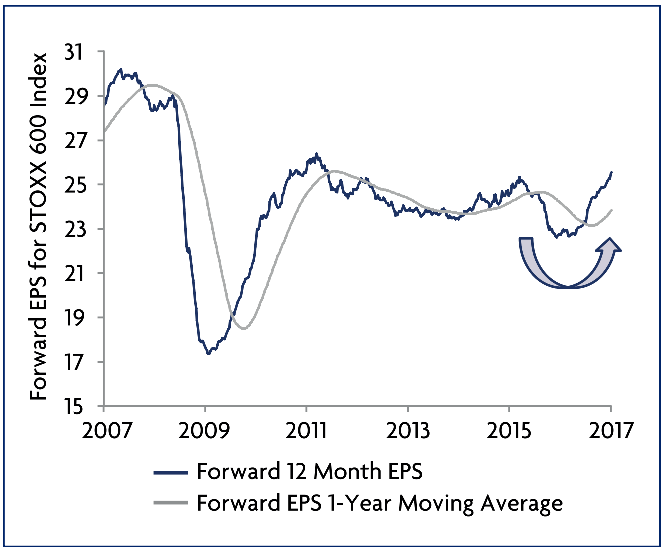
### Earnings are recovering

European equities' underperformance to US markets could largely be explained by tepid earnings growth after 2011. However the trend is changing. Consensus earnings forecasts have been picking up since second half of 2016.

The first quarter earnings of 2017 have confirmed this trend. For the 206 companies of Stoxx 600 index that had reported, 79% of those companies beat sales estimates and 69% beat earnings estimates. Overall earnings growth is 25% year-on-year (yoy). The growth rate is almost double that of S&P 500 Index (EPS growth 13% yoy). See Figure 3.

(Source: Bloomberg, JP Morgan, 05 May 2017)

Figure 3: Earnings are turning around




Source: Bloomberg, UOB PFS Investment Strategy, 09 May 2017

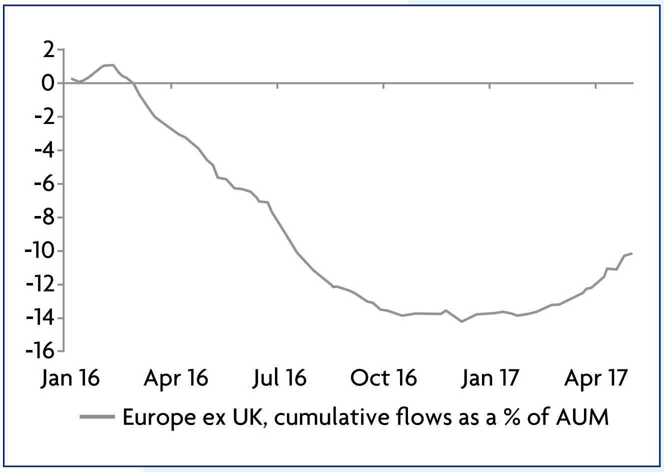
## 2. TECHNICALS

### Fund flows are back

In 2016, the net outflow represented around 15% of Asset under Management (AUM) for Europe ex UK equity funds.

**Year to date, European equities witnessed inflows of 4-5% of AUM growth. A more stable political backdrop**, combined with earnings turnaround, could drive further rotation into European equities. See Figure 4.

Figure 4: European equities witnessed recent inflows




Source: EPFR, 08 May 2017

## 3. ACTIVITIES

**Europe's economy is firing on all cylinders.**

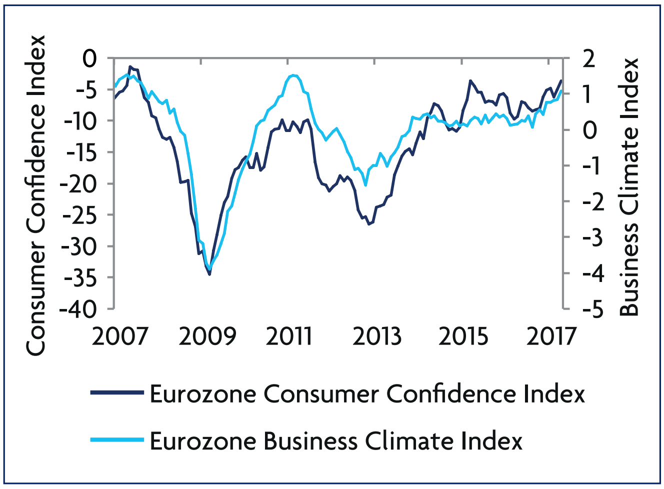
Europe's economic growth is accelerating and broadening.

European Economic Sentiment Indicator, a leading indicator to gauge GDP growth, has improved further to 109.6 in April 2017. This is the best number in 10 years. See Figure 5.

(Source: Bloomberg, 09 May 2017)

Sentiments rose in both the consumer and business space. Consumer confidence continued to trend higher, backed by better jobs markets. Business profitability and confidence (as measured by business climate index) have risen sharply since late 2016. A combination of low financing costs and higher profits is expected to support investment spending.

Figure 5: Consumer and business sentiments continue to improve




Source: Bloomberg, 09 May 2017

## 4. KEY RISKS TO EUROPEAN EQUITIES

Political risks have tamed after the French elections. Nevertheless, some political risks still remain. The next big event is the **German election**. In Germany, Schulz could give Chancellor Merkel a run for her money, with both parties polling neck to neck. That said, Schulz is pro-EU and a former president of the European Parliament. The populist party, AfD, meanwhile languished behind.

Another potential event could disrupt the market is the **UK election in June**. We expect that UK snap election to end with current Prime Minister, Theresa May, in power. She has polled around 40 percent since January and currently led Labour Party by around 19 percentage points.

**Bottom Line**

Latest outcome from the French Presidential elections relieved investors' concerns of the potential of the breakup of the European Union, as populist outcomes (like Brexit and Trump presidency win) took center stage in 2016.

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 AUM outflow from European equities, the tide has finally turned in recent months, with more room to catch up. This could help the tailwind for this region.

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 ▶▶

### Investment Perspective – April 2017

| | |
|---|---|
| Equity | Focus on **Asia ex-Japan** equities. Recent trade and manufacturing data suggests strong underlying growth drivers.<br>Selective on US equities. Focus on **Financials and Healthcare. New!**<br>European economic fundamentals continue to post strong numbers, suggesting a positive backdrop. However, investors still need to observe the political scene in France and Germany. Participate in **European equities** with dividends. **New!** |
| Fixed Income | US short duration high yield.<br>Subordinated bonds of high quality financial issuers. |
| Alternative | Structured notes that allow participation to the equity markets through a customised payoff structure.<br>Investors should provision for more buffers or consider principal protected structures. |
| Currency | USD grinds down slowly in the short term but the overall outlook remains positive.<br>Expect gradual appreciation for AUD.<br>GBP is prone to weakness on tough Brexit negotiations. |

Source: UOB Investment Insights – April 2017

### 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**.<br>Focus on **Asia ex-Japan** equities. Recent trade and manufacturing data suggests strong underlying growth drivers.<br>Selective on US equities. Focus on **Healthcare** sector.<br>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.<br>Participate in **European equities** with sustainable dividends. |
| Fixed Income | **US short duration high yield**.<br>**Subordinated bonds** of high quality financial issuers. |
| Alternative | Structured notes that allow participation to the equity markets through a customised payoff structure.<br>Investors can participate in rising interest rates through **floating rate notes** structure. |
| Currency | Upward pressure on the **USD** is expected this month.<br>**AUD** is expected to consolidate, risks to downside target of 0.7400.<br>Brexit may overshadow U.K. election boost – **GBP** under pressure. |

## Strategies ▶▶

### Strategy for the month of May

- We continue to focus on Asia-ex-Japan equities and European equities this month. As Macron won the first round earlier in April, European equities surged. This led to the outperformance of Europe vs other markets in April. We believe that **European equities are likely to outperform**, closing the valuation gap as compared to US equities.
- The **US Fed is projected to raise interest rates by 25 bps to 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, 09 May 2017). The question is now how fast is the interest rate going to rise, **rather than if** interest rates are going to rise. Stay short duration and high quality to buffer interest rate risks.
- Fear, as measured by the VIX index, traded at the lowest levels in 10 years. Whilst economic data releases and earnings announcements have been positive, we **believe that markets may be overly complacent and short term corrections may occur**. We recommend to keeping some dry powder to add positions during price corrections as the longer term outlook remains positive.
- We feel that the **USD may be supported** on the market expectations for a June Fed rate hike.
- Recent China deleveraging fears and falling commodity prices have impacted sentiments on commodity currencies, especially the AUD. The dovish RBA meeting could further **weigh on AUD**.
- We expect the **GBP/USD to remain volatile**, with risks to the downside as UK negotiates the Brexit terms with the EU.

## Strategies ▶▶

| Strategy | Analysis | |
|---|---|---|
| | **Short Duration High Yield Bonds** | |
| 1<br>Position for higher rates through short duration high yield bonds and subordinated bonds.<br><br>**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 | 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. |
| | **Asia Ex-Japan Equities** | |
| 2<br>Asian equities are attractive, given low relative valuations and supportive economic backdrop.<br><br>**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<br>Invest in US through sectorial play, like Healthcare.<br><br>**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. |

## Strategies ▶▶

| Strategy | | Analysis |
|---|---|---|
| **4**<br>European equities are well supported by relatively attractive valuation and solid economic fundamentals.<br>**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**<br>Gain managed equity exposure through global quality stocks.<br>**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**<br>Expected sideway movement before gradual upward trajectory on USD. | | • Upward pressure on the USD is expected this month.<br>• AUD is expected to consolidate, risks to downside target of 0.7400.<br>• Brexit may overshadow U.K. election boost – downside pressure. |
| **Rates**<br>Rising US rates expectations on the back of Fed tightening. | | • **The Fed is forecasted to hike 3 times in 2017**, with one hike already done in March.<br>• **USD 3M Libor has increased significantly from 0.62% in January 2016 to 1.17% in April 2017**. USD 3M Libor is forecasted to reach 2.02% in 2018Q1. |

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