UOB Investment Insights

Monthly Market Views

August 2019

Investing in H2 2019: The 5 Big Questions on Investors' Minds

With the first half of the year firmly behind us, we examine the key investment themes likely to draw investors' attention in H2 2019. For the remaining part of the year, we expect the lower interest rate environment, US-China trade tensions, the health of China's economy and risks of a recession to weigh on investors' minds.

In this issue of Monthly Market Views, we have compiled the most common questions investors have asked and weigh in with our answers to help you make your investment choices.

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Outlook for fixed income amidst lower interest rates

1. Central banks are starting to cut interests rates. In the current lower-yield environment, what should I invest in?

Central banks across the globe have started to cut rates. In this environment, fixed income tends to outperform the broader market. While fixed income has delivered stellar returns year-to-date, there is still upside potential due to strong demand from investors adopting a more defensive stance. **Asian investment-grade bonds** remain our top fixed income call. Their credit fundamentals have improved due to robust earnings and disciplined corporate spending, while the yields offered are still more attractive relative to the US government bonds.

Equity prices could get a second wind should the global economy hold up. They could also gain ground should global central banks continue to cut rates to support economic growth. Therefore, investors should resist the urge to exit the equities market entirely. However, as we edge closer to the end of the economic cycle, investors will need to consider the heightened risks of equity investing. Investors need to be highly selective in their stock picking. We prefer **global equities with stable earnings and low debt levels**.

We also retain our positive conviction in **gold**. Synchronised easing from central banks has pushed bond yields lower, reducing the holding costs for gold. When world tensions rise, investors tend to flee to safe-haven assets such as gold. Given its low correlation to other asset classes, gold has proven to be an effective hedge against **volatile markets** during uncertain times.

In terms of portfolio positioning, investors should consider adopting a prudent approach by maintaining a diversified portfolio to navigate financial risks, while accumulating returns to achieve financial goals. **Global multi-asset or balanced strategies**, which diversify their asset allocation between equities and fixed income, tend to better mitigate downside risks during market volatility.

Speak to your advisor about our **UOB Risk First Bentos**, which are diversified portfolios constructed using our award-winning Risk First methodology.

2. Bond prices have surged. Should I sell the bonds in my portfolio and buy them back later?

Geopolitical risks, concerns over the global economic slowdown and increasingly dovish central banks have driven down bond yields, resulting in higher bond prices. Heading into H2 2019, we expect these factors to continue pushing bond yields lower.

As bonds have appreciated in value, it may be tempting to sell the bonds before maturity to realise capital gains. But such investment decisions need to be carefully considered as investors may face **reinvestment risk**. After taking profit on the current holdings, the proceeds could only be reinvested at lower interest rates. This may not generate enough income to meet your needs.

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Impact from the US-China trade war

3. What are the possible scenarios for the US-China trade war? How should companies respond?

As the trade tensions between the US and China continue to intensify over the past few months, we now see our base case scenario that the US' and China's imposition of additional tariffs on nearly all bilateral merchandise trade flows will materialise and stay at least in the near-term, and there is potential for further retaliations which may involve restrictions on technology transfer and other non-trade measures. Any trade deal, if it happens, may only be in H1 2020 at the earliest.

Given the prolonged trade tensions between the US and China, companies are likely to consider moving their production out of China to skirt punitive import duties. However, many companies will still keep factories operating in China to cater to the large domestic market where goods are not subject to tariffs. Global companies can consider diversifying their supply chains by setting up alternative supply chains for other markets. ASEAN would be the preferred location given the relatively low manufacturing costs in countries such as Vietnam and Thailand.

US-China Trade Scenarios		Probability	Implications
Best Case	Protracted negotiation to lead to an eventual trade deal before end-2019. Any agreement may not remove most of the existing additional tariffs.	**5%**	• Most favourable outcome for markets as it provides clarity. • **Equities** will likely rally. • **Fixed income** prices may correct as investors shift to risky assets.
Base Case	The US and China impose tariffs on nearly all bilateral merchandise trade flows, resulting in significant uncertainties. There is potential for further retaliations, which may involve restrictions on technology transfer and other qualitative measures. If there is any trade deal, it may happen only in H1 2020 at the earliest.	**60%**	• Markets will remain volatile as uncertainty becomes the norm. • **Equities** are likely to be volatile. • **Fixed income** could benefit as investors reduce risk exposure, while supported by market anticipation of Fed rate cuts.
Worst Case	The tariff rate on the entire merchandise trade between the two countries may be increased further. The trade conflict extends into services trade and other areas, including investment restrictions and rare earth export curbs.	**35%**	• Least favourable outcome for markets. • **Equity** prices could come under pressure, especially for trade-dependent companies. • **Fixed income** will likely rally as investors seek safety.

Source: UOB Global Economics and Markets Research, UOB PFS Investment Strategists, 26 August 2019

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China's economic outlook

4. Is China's economic slowdown a key concern for investors in the next 12 months?

The July data pointed to broad-based slowdown in industrial production, retail sales, and fixed asset investments. Given moderating economic growth and external uncertainties, we expect the government to introduce more supporting measures in the second half of this year, such as **Reserve Requirement Ratios (RRR) cuts, Open Market Operations to inject liquidity, and measures to support SME financing**. These steps will help to offset the negative impact from the imposition of tariffs. In addition, 2019 marks the 70th anniversary of the founding of the People's Republic of China and the government is likely to prioritise preserving economic stability during such a milestone year. We expect China's GDP growth to moderate to **6.1% in 2019**, within Beijing's target growth rate of 6% to 6.5%.

To reduce its reliance on exports, China continues to shift towards a consumption-driven economy, supported by its vast domestic market and rising middle class. The country has made significant progress in moving up the value chain, by transitioning from its low-cost manufacturing roots to a more technologically-advanced model that embraces innovation and emerging technologies.

Risks of a recession

5. Is a recession in sight, given declining corporate earnings growth?

In the past, deteriorating corporate earnings usually foreshadow an economic recession. Lower corporate earnings tend to dampen business sentiment, which in turn affects the economy. However, in the current economic cycle, we **do not expect the earnings growth slowdown to indicate a recession** in the near term.

Firstly, US tax cuts in 2018 gave a one-time boost to earnings that year. Sluggish earnings growth in 2019 reflects the fading impact of that one-time corporate tax cut. Secondly, while earnings growth has slowed, it is still in positive territory. Global equities are expected to register earnings growth of 5.4%* and 9.0%* in 2019 and 2020 respectively.

During a recession, not all sectors are equally at risk. Historically, "counter cyclical" sectors, such as **healthcare, consumer staples and utilities**, tend to outperform during market downturns. Apart from this, investors also can tap into our **megatrend ideas** - deep-rooted, transformative forces that reshape the future of the global economy. Here, sectors such as healthcare and innovation are likely to yield benefits over a multi-year cycle.

* **Source:** Bloomberg, 01 August 2019

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Economic drivers and risks

Economic drivers

Global growth

The IMF downgraded its forecast of global GDP growth to **3.2% in 2019[1] from its earlier 3.3% forecast**, citing ongoing trade tensions as an overhang. However, a recession is still not expected in 2019.

Inflation and central banks

Central banks have adopted a **dovish tone**. **The Fed did an insurance cut of 25 bps** in July, the first rate cut since 2008. **The ECB has hinted at potential monetary stimulus measures** in September, while the BoJ is likely to stay accommodative.

Corporate earnings

In 2019, strong personal consumption supported by a healthy jobs market should continue to drive the **positive trend** in corporate profits. Global earnings growth is expected to rise around **8% in both 2019 and 2020**.

Risks

Rising US protectionism

The US-China trade tensions continue to escalate and could erupt into a full-blown trade war. Meanwhile, the US could possibly **raise tariffs on imports from other regions**, such as Mexico, India and Europe.

Political uncertainty in Europe

UK's new Prime Minister Boris Johnson has pledged to lead the **UK to leave the EU by 31 October, increasing the risk of a no-deal Brexit**. The EU Parliament elections resulted in a more fragmented parliament, which could **prolong the process of passing key policies**.

Global growth slowdown

After a 10-year economic expansion, the global economy is entering the **late-stage expansion cycle**. With effects of **fiscal stimulus fading** in the US and **escalating trade tensions**, the global economy may face a more severe slowdown.

[1] World Economic Outlook, IMF, July 2019

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Asset class views

Asset class	Subclass	Views	VTAR framework	Rationales/drivers
			● Positive ● Neutral ● Negative	
Equities	US	N	V: Neutral, T: Neutral, A: Neutral, R: Negative	Valuations are slightly expensive, prolonged trade negotiations could hurt consumer and business sentiments due to the ongoing uncertainties.
	Europe	–	V: Neutral, T: Neutral, A: Negative, R: Negative	Valuations are attractive relative to the US. However, growth is slowing and volatility is expected to remain high due to EU political instability.
	Japan	N	V: Positive, T: Neutral, A: Neutral, R: Neutral	Attractively valued, though global trade tensions weigh on business sentiments. The consumption tax hike scheduled in October remains a risk.
	Asia (ex-Japan)	+	V: Positive, T: Neutral, A: Neutral, R: Negative	Valuations are attractive. Easing of regional monetary policies and Chinese fiscal stimulus can mitigate an escalation of US-China tensions. (Prefer China).
	EM (ex-Asia)	+	V: Positive, T: Neutral, A: Neutral, R: Neutral	Valuations are attractive relative to DM peers. Expectations of Fed rate cuts and stable oil prices will sustain equity returns in 2019.
Fixed income	DM government bonds	+	V: Negative, T: Positive, A: Positive, R: Positive	Fed, ECB and BoJ are expected to remain dovish with further monetary easing in H2 2019. US Treasuries offer better value than other DM government bonds.
	DM investment-grade bonds	N	V: Neutral, T: Neutral, A: Neutral, R: Positive	IG yield spreads have narrrowed year-to-date. Supply-demand dynamics remain supportive, but credit fundamentals in BBB space have started to deteriorate.
	DM high-yield bonds	–	V: Neutral, T: Neutral, A: Neutral, R: Negative	HY offers some income buffer but default rates are projected to climb higher as the economy enters late-cycle expansion amid an uncertain economic climate.
	EM US dollar debt	N	V: Neutral, T: Neutral, A: Neutral, R: Neutral	Spreads have narrowed after the YTD rally. Easing in global central banks provides support to EM US dollar debt. Prefer Asian investment-grade bonds.
	EM local-currency debt	N	V: Neutral, T: Neutral, A: Neutral, R: Negative	EM sentiment is likely to improve as US-China trade talks resume. However, EM currencies could weaken against the US dollar, weighed down by a weaker CNY.
Commodities	Gold	+		The Fed's potential rate cuts are positive for Gold. China's reallocation of reserves into Gold will provide a support level. Gold prices could reach USD 1,650/oz by Q2 2020.
	Oil	N		Escalated tensions in Iran could provide supports to oil prices in short term. However, the upside is capped by concerns over slower global growth.
Currencies	The US dollar	N		The US dollar is expected to hold up in the near term, but could face headwinds in 2020. The Singapore dollar is expected to depreciate against the US dollar due to soft economic growth.

– – Negative – Slightly Negative N Neutral + Slightly Positive ++ Positive

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High-conviction strategies

Conviction	VTAR Framework	Proposition	Risk
Global quality equities		Global quality equities tend to outperform broad equity markets over longer investment cycles.	Relatively-expensive valuations could increase the probability of short-term corrections. However, quality companies tend to better weather the economic slowdown, limiting the likelihood of large corrections in quality stocks.
EM equities		Broad EM equities are supported by stronger fundamentals and attractive valuations.	An unexpected surge in the US dollar strength could cause a retreat from EM equities, as seen in the Turkey situation last year. A worsening of US-China trade tensions could also lead to higher market volatility.
Unconstrained bonds		A dovish stance from major central banks will keep key global interest rates low. An unconstrained bond strategy tends to enhance the return over the broad fixed income market.	An inflation overshoot will send bond yields higher, which will be the major risk to fixed income in general. However, inflation-linked securities such as TIPS will be less affected in such an event.

Megatrends

Conviction	VTAR Framework	Key proposition	Risk
Global healthcare		Healthcare is a structural growth story driven by long-term growth in an aging global population. In the medium-term, we expect drug approvals and an increase in M&A activity to be catalysts for a sector re-rating.	Policy uncertainty could weigh on sentiment for the sector. The Medicare-for-all proposed by Democrat Presidential candidate Bernie Sanders could lead to volatility, but the probability for the programme to pass is low at the present time. This risk will likely be mitigated in the long-term as a growing silver segment should contribute to stronger increase in demand.
Chinese equities		Chinese equities are under-owned by global investors, and provide a good risk-reward and diversification benefits.	The escalation in US-China trade tensions is likely to negatively impact China's economic growth. Financial deleveraging could continue to put pressure on growth and lead to higher risks of policy missteps.
AI & innovation		Artificial Intelligence (AI) has the ability to drive multi-fold increases in productivity by utilising big data and powerful computing hardware to accurately and reliably solve real-world problems with little human intervention	Policy and regulatory uncertainty is a key risk to watch for. As AI permeates more and more into people's daily lives, questions about safeguarding individual privacy and appropriate use of such tools will surface. Regulators may step up efforts to curb the uses and applications, while differing standards from various countries can create barriers to universal adoption.

V=Value **T**=Trend **A**=Activity **R**=Risk
● Positive ● Neutral ● Negative ● Not Applicable

Rates and FX forecasts

Key Currencies					Key Rates (%)				
	3Q19	4Q19F	1Q20F	2Q20F		3Q19	4Q19F	1Q20F	2Q20F
USD/SGD	1.39	1.40	1.41	1.41	**USD***	2.00	1.50	1.50	1.50
EUR/SGD	1.54	1.55	1.59	1.62	**EUR**	0.00	0.00	0.00	0.00
GBP/SGD	1.67	1.68	1.71	1.72	**GBP**	0.75	0.75	0.75	0.75
AUD/SGD	0.96	0.97	0.99	1.02	**AUD**	1.00	1.00	1.00	1.00
JPY/SGD x 100	1.29	1.32	1.34	1.34	**JPY**	-0.10	-0.10	-0.10	-0.10
NZD/SGD	0.90	0.91	0.93	0.96	**NZD**	1.00	1.00	1.00	1.00
SGD/CNY	5.00	4.99	5.04	5.04	**CNY**	4.35	4.35	4.35	4.35
					SGD	2.00	1.95	1.95	1.95

Source: UOB Global Economics & Markets Research, 01 August 2019

* Macro+FX Strategy, UOB Global Economics and Markets Research, 26 August 2019

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