OCBC WING HANG

Maintain Defensive Stance

Trump could disappoint investors

"Global risk assets have been remarkably resilient. A dovish rate hike by the Fed and a benign Dutch election outcome took away two major concerns, and allowed global risk assets to get back to an uptrend. However, Trump's failure to make significant healthcare reform is testing the strength of the risk rally. There are a number of potential near-term hurdles that could cause some market consolidation, such as economic growth momentum slowing; disappointment on the scale and timing of Trump's economic policies; and lingering European political risks. A consolidation phase is probable following the run-up, especially as risk assets looks extended in the aftermath of the U.S. election. We are not bearish on risk assets because the medium-term economic outlook remains constructive. At this juncture, we make no changes to our broad asset allocation and believe our moderately defensive investment stance remains appropriate."

Marc Van de Walle, Head, Global Wealth Management, OCBC Bank

In This Issue

As Good as it Gets?

> "It looks hard for the recent growth surge to continue to accelerate while central banks in various developed markets are preparing to signal policy tightening. Optimism over reforms in the U.S. seems to have peaked."

Richard Jerram, Chief Economist, Bank of Singapore

Key Points

- The overall macroeconomic situation looks encouraging. Growth has improved, deflation risk has fallen and the need for emergency monetary policy has faded. However, this makes it hard to see where the next incremental positive surprise might come from and as a result, this might be as good as it gets.
- Economic data has consistently surprised on the upside for several months, which has boosted investor confidence and supported strong corporate earnings upgrades over the past year. Yet economic surprise indexes are at elevated levels and may moderate in the months ahead. This means that we could be near to a point of maximum optimism on macroeconomic drivers and we could see a pause in the recent acceleration.
- In the U.S., measures of consumer and small business confidence are showing exceptional strength. However, optimism about the scale and timing of major economic policies from the Trump Administration is prone to disappointment. Overhauling the U.S. health care system has stalled. Enacting corporate tax reform and approving large-scale infrastructure programmes may run into hurdles given legislative and economic realities. An additional concern is that if Trump fails to move his economic agenda forward, then he might move backwards through the use of trade protectionism to distract attention from domestic difficulties.
- In the Eurozone, it looks like 2017 could produce the strongest growth in a decade. The transmission of monetary policy has improved in response to a healthier financial system, which is supporting economic activity. Purchasing Manager Index (PMI) readings are showing the best business conditions since before the start of austerity programmes in 2011.
- However, it might also be as good as it gets for European politics, as confidence grows that the French elections will not be disruptive. Before long, the focus will shift to Germany, and then to Italian elections which appear to involve far more hazards, with much greater support for anti-Euro parties.
- In Japan, inflation is gradually starting to lift, and the Bank of Japan is expected to start to increase its target for 10-year bond yields in 2H 2017 in response. Unfortunately structural problems remain and reform is making only limited progress. Labour markets are very tight and would benefit from reform that improves flexibility and productivity, but this does not seem likely.
- In China, a solid growth outlook for 2017 means that protectionism, rather than a burst of stress in the domestic financial system, is the greater threat to stability in China. So far the Trump administration has been surprisingly quiet on trade relations with China, compared to its pre-election rhetoric, but America's huge bilateral deficit means that tensions could easily surface.

Rebalance While the Tide is Calm

Key takeaways from the conclusion of the party congress were in-line with expectations including softer GDP and credit growth targets. This likely reflects a desire to maintain economic and financial stability amid external uncertainties and ahead of the leadership transition in autumn.

Key Points

- China H-shares performance was muted in February despite continued economic stabilisation. With 61 per cent of companies in MSCI China having reported results, the current earnings season was mixed with broadly equal number of beats and misses.
- Materials, property, healthcare and utilities underperformed while consumer, technology and telecoms outperformed.
- Although the lack of US-China trade friction thus far is positive for emerging markets, trade protectionism risks remain with President Trump turning his focus to tax reforms post healthcare reforms failure.
- Further, with producer prices and real activity growth possibly peaking, we do not see sustained re-rating with 12.4x P/E remaining extended above 3-year historical average. Investors should use the ongoing rebound to switch from old economy into new economy stocks.
- Key takeaways from the conclusion of the party congress were in-line with expectations including softer GDP and credit growth targets. Fiscal support will also be retained for infrastructure investment, including spending on renewable energy and environmental projects. This likely reflects a desire to maintain economic and financial stability amid external uncertainties and ahead of leadership transition in autumn.
- Consequently we expect policies to ease and tighten as growth fluctuates around the baseline of 6.5 per cent.
- Near-term, policymakers continued to rein in credit expansion and curb risks from financial leverage. Monetary policy remains biased towards tightening with recent interbank rates rise likely reflecting regulatory tightening besides seasonal factors. Big banks are likely to be less impacted relatively but expected slowdown in wealth management products issuance could limit fee income growth and offset bad debts stabilisation.
- Led by stronger property and infrastructure growth, fixed asset investment (FAI) rose 8.9 per cent in 2M17. Property market strength has shifted to lower tier cities, in-line with the government's aim to reduce housing inventory. However signs of slowing investment growth are emerging with new projects investment falling 8.3 per cent year-on-year (YoY) and FAI funding down 8 per cent.
- Besides potentially more policy tightening if prices continue to rise, the strong property market sentiment could prompt smaller than expected fiscal and quasi-fiscal stimulus. On the retail front, sales growth moderated to 9.5 per cent in 2M17 vs 10.9 per cent in December 2016, dragged down by auto sales which fell 1 per cent following reduction in purchase tax discount. With increasing discounts along with rising inventory, further pressure on auto stocks is likely. In HK, we also see rising property policy risks with continued price increase.
- We suggest locking in profits on developers, infrastructure constructors, and automakers.

Is the Equity Rally Stalling?

> "With nothing concrete to show as Trump approaches his first 100 days in office, the failure of the Republicans to replace Obamacare is triggering fear that the reflationary trade might not materialise as easily as the market has come to expect since November."

Sean Quek, Head Equity Research, Bank of Singapore

Key Points

- Global equities had a more difficult month in March as doubts about Trump and the Republicans' ability to push through reflationary and growth boosting policies brew. Investor sentiment continued to be underpinned by U.S. macro and political events. While the more dovish than expected Fed buoyed risk appetite, the Republicans' failure to replace Obamacare dented confidence. It remains to be seen how much longer the market's patience can last.
- We remain cautious on equities given the concerns cited above and also because of the extended valuations and the unattractive risk-reward trade off. Regionally, we continue to prefer the U.S., for its relatively defensive traits, and stay cautious on Europe, Japan and Asia ex-Japan for now.
- The Trump reflation trade will start to run out of steam unless there is clearer signs that Trump's tax reform plans, a key component of his growth boosting agenda, remains on track. Fundamentally, a stronger U.S. dollar, higher interest rates and tighter labour market suggest that corporate profit margins are unlikely to be sustained going forward. Nevertheless, given our overall cautious view on global equities, U.S. equities remain more defensive on a relative basis.
- Although firmer economic growth on loose monetary policy and fading fiscal austerity is expected to provide a boost in the Eurozone, consensus 2017 earnings growth of 16.1 per cent remains optimistic. At the same time, forward Price-to-Earnings (PE) valuation of 15.4 times, versus the 5-year historical average PE of 14.4 times, is not undemanding. Le Pen's odds of winning declined but European political risks remain, especially given the busy political calendar ahead. For these reasons we remain cautious on European equities.
- On Japanese equities we maintain our view that a sustained re-rating of the market would require more meaningful structural reforms. After China, Japan accounts for a substantial share of U.S. trade deficit and is vulnerable to potential trade pressure. Near-term, the market would continue to be driven mainly by macro factors and movements of the Yen. Valuations, at forward PE of 15.8 times versus the 5-year historical average of 14.6 times, are not undemanding.
- It would be highly negative for Asia's growth if Trump pursues his anti-trade policies, but investors seem surprisingly sanguine. It remains to be seen if the failure in healthcare reforms would push the Trump administration to accelerate its tax reform agenda or pursue trade protectionism. Coupled with the potential impact of faster-than-expected U.S. interest-rate normalisation and currency vulnerability, we remain cautious on Asia Ex-Japan.

Prefer High Yield Bonds

> “We prefer high yielding bonds where higher income can provide a cushion against rising interest rates and heightened uncertainty. High yield credit offers an interesting opportunity given the recent widening of credit spreads.”

Vasu Menon, Senior Investment Strategist, Wealth Management Singapore - OCBC Bank

Key Points

- Stronger growth brings the prospect of monetary policy tightening. This is most apparent in the U.S. where we think the Fed is set to raise interest rates six more times by the end of 2018. However, it also applies to China, which is trying to cool down the housing market, and even to Europe and Japan which are likely to be signalling a shift in monetary policy before the end of 2017. In a year's time G3 monetary policy will still be very loose, but the lengthy era of zero interest rates and abundant liquidity is slowly drawing to a close.
- There is the risk that an aggressive tax reform programme by the Trump administration may intensify concerns about overheating and drives the Fed to be more hawkish. However, the current political timetable implies that this is more likely to be an issue for 2018 rather than this year, and it is unclear whether tax reform will provide a significant fiscal boost. The collapse of healthcare reform suggests that the fiscal conservatives in the Republican Party could block policies that increase the budget deficit.
- Despite the prospects for higher interest rates we continue to be positive on high yield bonds. Bonds as an asset class arguably benefits more directly from strong underlying growth than equities. Equity markets have high growth expectations to live up to; bonds only have to remain creditworthy. That is much less of a challenge in a benign economic environment.
- Valuations on both high yield and investment grade bonds currently are rich by historical standards. However in a reflationary environment with higher rates, we believe that income from coupons will become an increasingly important component of total return. With its higher corporate spread component, high yield bonds should be somewhat better insulated from the adverse impact of higher rates. Furthermore, high yield bonds are better positioned to benefit from a decline in overall default rates in 2017 versus 2016.
- Finally, we reiterate three key things to bear in mind when investing in bond markets to reduce risk. Firstly, given the potential for higher U.S. interest rates, investors should focus on bonds with a shorter tenor (preferably five years or less) as such bonds are less affected by higher interest rates compared with longer dated bonds. Secondly, consider investing in a portfolio of bonds through a unit trust rather than buying individual bonds as many individual bonds require a significant investment outlay and can expose investors to concentration risk. Finally, it is absolutely imperative to buy only into quality bonds with decent credit fundamentals to reduce default risk.

U.S. Dollar Down but Not Out

> The U.S. dollar setback is likely to be incremental rather than acute from here, as the greenback is set to keep benefitting from the backdrop of a strong U.S. economy and further Fed tightening.

Michael Tan, Senior Investment Counsellor, OCBC Bank

Key Points

- Markets are worried that Trump will keep struggling to get any of his agenda through Congress this year following his failure to pass this healthcare bill. This has dampened expectation about tax reforms and large-scale infrastructure programs. We think the de-pricing of the Trumpflation trade is already at a mature stage and continue to expect the U.S. dollar to be "not great, not bad but just good".
- Political risks in Europe seem to be abating and the PMI indicators surprised strongly to the upside, keeping European reflation in focus. If the French election tail risk is avoided, strengthening economic momentum suggests further upside potential for the Euro.
- In the month that follows the Article 50 trigger, the EU will publish the "Brexit directives" that will set the tone for the EU negotiation. Markets will scrutinise the details to assess the probability that the trade negotiations could happen alongside the divorce deal (citizens' rights, UK's Brexit bill). It is likely that the EU will seek to limit initial talks to the latter. The market is pricing increasing probability of a Bank of England hike, which seems premature. With valuations for the currency extremely cheap and speculative positioning still short, there is a risk that Pound rallies become more frequent. But we still struggle to justify turning bullish on the Pound at above US$1.20.
- Although political risk in Europe has receded following the first French presidential debate, hopes of a gradual Fed rate hike and worries over Trump policy delays have benefitted gold price. Gold's reaction thus far should help assert its role as a portfolio diversifier and this could gain further traction should the reflationary 'Trump Trade' stall further.
- In March, concern over inventories and the supply discipline of OPEC producers sent oil prices lower, with speculative short positions increasing sharply. This is the type of moderate short-term volatility that we can expect as prices are constrained on the upside by the threat of output rising as more of the marginal producers become profitable. Meanwhile prices are limited on the downside by OPEC controls on excess supply and inefficient producers being squeezed out of the market. It looks as though the longer-term equilibrium price where supply and demand is in balance is perhaps in the US$50-60 per barrel range, which implies prices should be relatively stable around current levels.

Hong Kong's Housing Frenzy

"Lower home supply in the secondary market due to the cooling measures has posed upward pressure on second-hand home prices. In addition, lower mortgage rates and sweeteners offered by property developers have lured more homebuyers to the primary market. Furthermore, Mainland corporates have aggressively bought land in Hong Kong, in turn driving up the housing prices in the neighborhood. The Fed's dovish tone in March has also boosted housing demand further. Looking ahead, tight secondary housing supply and huge demand could alleviate the impact of increasing new home supply and higher interest rates. This indicates that housing prices are unlikely to witness any notable correction this year."

Treasury Research, Treasury Division, OCBC Wing Hang

Key Points

- Last November's housing cooling measures appeared to have merely tamed housing transactions, but failed to drag down housing prices. We believe that the major reasons behind the overheated property market can be summarized as follow. Firstly, the cooling measures push up the cost of purchasing a second residential flat. As a result, property owners are reluctant to sell their properties. This leads to lower supply in the secondary market.
- Secondly, banks' cuts in mortgage rates and property developers' offer of sweeteners have boosted demand in the primary market. In the first two months this year, transaction volume in the primary market has surged by 213.7 per cent year-on-year (YoY) while total transaction value reached its highest level compared to the same period over the past 22 years.
- Thirdly, the increase in stamp duty for high-end residential unit is relatively mild under the latest slate of cooling measures. As a result, the new measures failed to deter investment demand from local and mainland high-net-worth investors. The average price of private homes with a size over 160 square meter floor area has increased by 11.79 per cent, outpacing the price growth of other smaller flats.
- In addition, due to the lingering concern about RMB risks, Hong Kong Dollar's peg to the USD combined with China's housing cooling measures has prompted Mainland corporates to aggressively buy land in HK. As a result, housing prices escalated in the affected neighborhoods. As home prices continuously refreshed their record highs, the resultant panic-driven buying spree encouraged property developers to raise the prices of the unsold new flats.