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OCBC WING HANG

The Easy Money has been Made

Focus on Investments that Offer Yield and Stay Diversified

"With markets hitting new highs and most assets looking fully valued to us, we are sceptical that prices can continue to go higher. The rally in risky assets since the end of last year was largely due to the improvement in the economic cycle. However, with growth moderating and the increasing likelihood that President Trump cannot enact big economic reforms, it is difficult to see much market upside. Unusually low volatility and relatively rich valuations across asset markets leave little margin for error. Concerns about market valuations are likely to return to the fore, which is why we remain cautious with our asset allocation. To capture value in a fully-valued world, the investment strategy is to look for returns through carry and rotation."

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

In This Issue

Pressure on Profits

> Rising wages and poor productivity growth are combining to put pressure on corporate profit margins. Firms could try to pass on higher costs through price increases, but that would risk provoking a faster pace of Fed rate hikes.
>
> Richard Jerram, Chief Economist, Bank of Singapore

Key Points

- Despite the political turmoil, the U.S. economic recovery remains on track. However, various economic or policy indicators are showing signs of being "as good as it gets" and this also applies to profits in America. Margins are under pressure as labour markets tighten, which is normal as the economic cycle matures. Earnings at large listed firms should be more resilient, and could be helped by tax cuts, but need some attention

- The question of peak profits should be less of an issue for Europe or Japan. In Europe's case it is at a much earlier stage in the economic cycle, with more slack in the labour market. Unlike the U.S., earnings per share in Europe is still well below the previous peak. Japan's cycle is more mature, but the prospect of a slow, structural improvement in corporate governance could lead to firms squeezing higher earnings out of their business and improving returns to shareholders.

- Economic recovery in Europe has been sensitive to policy swings in recent years – both fiscal and monetary – but notably unaffected by political risk. Financial markets are relieved about the outcome of the French election – at least until they start worrying about Italy – but the economic impact seems low.

- Growth in Europe seems to fit with the theme of "as good as it gets", with composite PMIs flat-lining in May. However, the current readings are the best in six years, and this burst of growth has helped to pull the region away from the risk of deflation.

- Japan's battle with deflation continues, even four years after Governor Kuroda shocked the Bank of Japan into action. Demographic problems are biting and labour markets are the tightest in a generation, with 15 vacancies for every 10 people looking for work, but this is failing to drive any meaningful wage growth. Similarly, inflation is barely in positive territory.

- However, economic growth has been beating expectations, in part due to the benefits from the pick-up in global trade. The main blockage to faster progress seems to lie in the corporate sector, which is using healthy cash flows to further improve its balance sheet, rather than boosting investment or wages.

- A China hard-landing remains one of the key risks to the world economy, as such extreme credit expansions are typically followed by financial crisis and a sharp growth slowdown. However, most of the debt is domestic and there is significant government influence over credit allocation, which leads to expectations of a slow and disciplined work-out. The risk of a more disruptive outcome would increase if there was an abrupt shock to the economy, such as from U.S. trade protectionism. At the moment U.S. policy-makers have been relatively conciliatory, but the scale of the trade imbalance means that could change at any time.

- Most emerging markets look more resilient to the threat from higher U.S. interest rates than during the "taper tantrum" of 2013. India and Indonesia would probably no longer qualify to be members of the "fragile five" discussed at the time – with the latter recently boosted to investment grade by S&P.

- South East Asian economies continue to prosper. Reforms have pulled most of the lower income economies up the competitiveness rankings, which has helped to boost investment levels and growth. India, Indonesia, the Philippines and Vietnam stand out for their progress in recent years, and in each case this looks set to continue.

Financial Deleveraging Underway

Near-term, despite the turmoil in onshore markets, the HK market has remained resilient and southbound fund inflows could potentially support the market ahead of the 20th anniversary of HK SAR handover.

Key Points

- HK/China equities rebounded after a mild pullback at the beginning of the month. However, with China's economic growth remaining stable, financial tightening on both credit and regulatory fronts to control risks from leverage remains the key policy focus. Firm commitment by top leaders to curb financial risks suggests the deleveraging process may have finally started and would likely be a gradual, long and arduous process.
- While positive for longer term economic stability, credit conditions are expected to remain tight in coming months, keeping borrowing costs elevated and slowing credit growth. Together with declining producers' price, this is likely to cap both corporate profit margins and market upside.
- While we expect any slowdown to be moderate with the government's desire to maintain stability ahead of party leadership transition in the fourth quarter, the risk of a liquidity crunch cannot be ruled out as financial arbitrage loopholes are being closed. Nonetheless, closer coordination among regulators helps to mitigate this risk. We suggest taking profits on Chinese banks.
- On the economic front, as highlighted last month, China's economic growth has peaked with high frequency near-term data supporting a mildly slowing economic outlook. Broad credit, industrial production and fixed investment growth all moderated in April and could continue to be weighed down by ongoing credit tightening. China's property prices, sales volume, new starts and investment growth have softened, with sharper property sales slowdown likely in 2H17.
- Near-term, despite the turmoil in onshore markets, HK market has been resilient and southbound fund inflows could potentially support the market ahead of the 20th anniversary of HK SAR handover. That said, while we continue to like the long-term fundamentals of new economy beneficiaries, we think these stocks are fair to over-valued and suggest taking profit, re-entering on dips.
- Policy risks also remain alleviated in HK property with further HKMA tightening while expected higher interest rates could lower residential property demand for developers. With the market rebound in early May, we remain selective and suggest switching to stocks with strong fundamentals.
- With MSCI reviewing A-shares inclusion for the fourth year, this could be a slight positive if adopted. However, likelihood of inclusion remains low with MSCI indicating many issues remain unresolved. Assuming inclusion, the initial impact is limited with significantly reduced eligible stocks under the latest revised proposal and an inclusion weight at only 0.5 per cent of Emerging Markets Index.
- Longer-term, China remains strategically important with the market expected to account up to 34 per cent in MSCI Emerging Markets Index.

Maintain Caution on Equities

> "Global equities have done well so far this year, but given the potential disappointments amid early signs that the economic momentum has peaked, we remain cautious and prefer to hold back for a better entry opportunity."

Sean Quek, Head Equity Research, Bank of Singapore

Key Points

- Our views on equity markets remain unchanged from last month. Valuations are stretched to the point where it is pricing in more or less all the good news and this leads us to maintain our broadly cautious stance in equity markets.
- Concerns about valuation are likely to return to the fore, after the mark up in earnings estimates over the past few months. Since the beginning of the year, analysts have increased their estimates of next year's corporate earnings by almost 10 per cent for U.S. stocks, 12 per cent for the Euro Area and Japan, and a whopping 18 per cent for emerging markets. To be sure, forward earnings expectations have a dismal track record of hitting the mark, with overoptimistic forecasts often ratcheted down as the year drags on.
- Given the potential for a slowdown in the global growth outlook and disappointments on the policy and political fronts as well as limited support from the extended valuations, we prefer to hold back for a better entry opportunity.
- Another concern for equities is the impact of Fed policy. Given indications from the Fed that it would start to shrink its balance sheet towards the end of the year, the market is likely to start anticipating the timing and pace of the reduction which could cause jitters in markets.
- We are neutral on U.S. and Europe equities and underweight Japan and Asia ex-Japan. We do not see significant upside potential for U.S. equities at current valuations in the absence of a breakthrough on corporate tax reform in the U.S. Nevertheless, we tactically continue to prefer the U.S., for its relatively defensive traits.
- Diminished political risk coupled with positive economic and earnings growth outlook continued to boost investor confidence in Europe. Indicators for France and Germany suggest that the recovery is broadening. And the results season continues to surprise positively. Looking ahead, the European Central Bank is expected to be less dovish as the economic recovery gains pace. In particular, the debate on when the central bank would start to end its quantitative easing program is likely to come into focus.
- Japanese equities had another relatively muted month in May despite the positive FY2017 results season. New management's FY2018 net profit guidance came in below consensus expectations. Near-term, the market continues to be driven mainly by macro factors and movements of the Yen. Fundamentally, we maintain our view that sustained re-rating of the market would require more meaningful structural reforms.
- Asia ex-Japan equities continued to benefit from the much stronger than expected first quarter results season and elevating investor risk appetite. Looking forward, the positive economic growth momentum has started to moderate. China's growth outlook, in particular, has started to decelerate in-line with falling policy support. Asia ex-Japan could bear the brunt again as the investors start focusing on the Fed and ECB's exit plans. Also, we would not completely rule out trade war risk for the region as Trump's stance on global trade remains unclear.

Income Is Key To Returns

> "Credit markets look fully valued, which leaves us to believe that future total returns will be more modest than in past years, and will be dominated by carry – or the income component – rather than by further spread tightening."

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

Key Points

- With the U.S. unemployment rate down sharply, the Fed gradually needs to guide interest rates back towards neutral levels, even if the process takes another couple of years. Further moves in June and September are set to be followed by a pause in December when the Fed announces details of a plan to shrink its balance sheet. We see four further hikes in 2018 – much slower than previous cycles, but faster than the market expects.
- Considering that the Fed's quantitative easing (QE) programme helped to pull down bond yields, reversing QE should have an effect similar to rate hikes. We expect the Fed to drain about US$200-250 billion per year, but if it decides to move faster then it will probably see the need for fewer rate hikes.
- The Fed has not been making any big assumptions about fiscal policy when setting out its projections for interest rates. This looks increasingly prudent, as political troubles seem likely to lead to the delay, or watering down, of tax reform plans. Modest corporate and income tax cuts seem more likely than significant reform, but this might not come until 2018.
- Elsewhere, strong growth in Europe means that we expect the European Central Bank to signal tapering in coming months, with a cut-back in asset purchases in 1H 2018, followed by higher interest rates. Japan's exit from extreme monetary policy settings is less predictable due to its struggle to beat deflation, and it now looks as though a rise in the target for 10-year bond yields might be pushed into 2018.
- The bond rally in recent years has depressed long-term yields to a level that makes long-dated developed market government bonds highly vulnerable to a market reversal. Market expectations for the Fed funds rate are far too benign. This makes bond markets vulnerable to a re-rating of the path for the Fed funds rate. Investors should manage risk by lowering bond duration.
- Within riskier fixed income areas, we believe high yield bonds remain attractive for their carry and are likely to stay resilient in the early part of a hiking cycle. This is because recession risk and credit default risk remain low.
- Valuations on both high yield and investment grade currently are near post Lehman tights. However in a reflationary environment, we believe that coupon/carry 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 interest rates. Furthermore, they are better positioned to benefit from a thus far substantial decline in overall default rates in 2017 versus 2016.

Greenback is Not on a Downtrend

"It is easy to be distracted by the political noise but the U.S. Dollar may only weaken on a sustained basis if President Trump's woes hurt equities and stop the Federal Reserve from tightening monetary policy."

Michael Tan, Senior Investment Counsellor, OCBC Bank

Key Points

- Uncertainty surrounding the Trump Administration's policy agenda has undermined the U.S. Dollar since the start of 2017. However, we find it difficult to see the U.S. Dollar trending down significantly when U.S. yields are higher than the euro area's or other countries.
- Fed hikes for this year are under-priced and neither the European Central Bank nor the Bank of Japan would tighten quickly. With the possibility of no policy implementation by the Trump administration already priced by the market, the risks are tilted towards the consensus being too pessimistic on the chances for U.S. tax reform.
- Declining volatility should continue to draw investors to Emerging Market carry trades in the short-term. The recent scandal in Brazil is unlikely to impact Emerging Markets more broadly.
- The unwinding of the post-election Trump-trade, which has led to a weaker U.S. Dollar and lower U.S. Treasury yields, has supported gold's relatively strong performance this year. We also recognise that heightened political risks, ranging from speculation around a potential Trump impeachment to escalation of North Korean tension, can also give gold some temporary support.
- We are not bullish on the gold price over a 12-month timeframe. But we recognise the value of the 'hedge' trade and believe holding gold as an 'insurance policy' on global growth/geopolitical risks is prudent.
- OPEC has agreed to extend its production cuts for another nine months, but enforcing the deal could become more difficult if prices fail to respond. Inventories remain at very high levels, so even a moderate improvement in the supply/demand balance is not necessarily going to have much of an impact on prices.
- OPEC's problem is that the increased efficiency of U.S. shale producers means that the U.S. rig count has more than doubled from the lows of April 2016, and is back to levels last seen in early 2015. U.S. output has already recovered close to peak levels.
- Short-term volatility is inevitable, but 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 as long as OPEC can enforce controls on excess supply. It looks as though the longer-term equilibrium price where supply and demand is in balance is around US$50, which implies prices should be relatively stable around current levels.

Economic Growth has Peaked

"GDP growth accelerated to 4.3 per cent annual pace in 1Q 2017, the fastest pace since 2Q 2011. The rosy performance was due to resilient private consumption, strong government expenditure, public sector investments, exports of goods and private sector investments into building and construction. A low base effect also contributed to the better-than-expected growth in GDP. Due to a waning base effect and an expected deceleration of China's growth, we believe Hong Kong's growth has peaked in 1Q and will slow down gradually in the coming quarters. For 2017, our GDP growth forecast remains unchanged at 2.2 per cent on a year-on-year basis."

Treasury Research, Treasury Division, OCBC Wing Hang

Key Points

- GDP grew by 4.3 per cent year-on-year (YoY) in 1Q 2017, the fastest pace since 2Q 2011. The robust performance was largely driven by resilient private consumption, strong government expenditure and investments, buoyant goods exports and the boom in housing markets. A low base effect also contributed to the better-than-expected growth in GDP.
- The combination of stronger domestic demand on the back of the housing boom, a bullish stock market and stable labour markets pushed private consumption higher by 3.7 per cent YoY. However, with higher rates and China's slowdown likely to cool the housing frenzy in 2H, growth in domestic consumption may moderate in coming months.
- In addition, the growth of government expenditure (+3.7 per cent YoY) may decelerate as the base effect recedes. In comparison, investment by the public sector (+18.0 per cent YoY) is expected to remain strong given the government's plan to increase spending on infrastructure this year.
- On the other hand, expenditure on machinery, equipment and intellectual property products dropped significantly by 8.9 per cent YoY. This expenditure is expected to rebound in the coming quarters given a gradual recovery at home and abroad. As such, this could potentially offset the slowdown in private sector spending on building and construction (+5.3 per cent YoY) on the back of a possible housing market correction.
- Elsewhere, total exports of goods edged up 9.2 per cent YoY in 1Q. As external demand continues to improve amid the global recovery, the contribution of exports of goods to GDP growth is likely to remain significant.
- Meanwhile, exports of services increased by 2.6 per cent YoY as compared to a 1.2 per cent YoY gain in 4Q last year. As Mainland tourists have shown preference for Hong Kong to South Korea and Taiwan due to political issues, rebound in tourism activities may likely sustain and support economic growth in the coming quarters.
- More notably, the greenback may not be as strong as previously expected due to lingering political risks in the U.S. Therefore, the risk of a stronger HKD which may hit exports may be alleviated.
- In conclusion, Hong Kong's economic growth is expected to remain resilient throughout 2017. However, due to a waning base effect and an expected deceleration of China's growth, we believe Hong Kong's growth might have peaked in 1Q and will gradually slowdown in the coming quarters. For 2017, our forecast on GDP growth remains unchanged at 2.2 per cent YoY.