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OCBC WING HANG

Stay Cautious but Don't Panic

Opportunities Exist Despite Stretched Valuations

"Against a backdrop of moderating growth, markets enter into a consolidation phase. Finding value in a fully-valued market is a challenge. To ensure a safe outcome in the long run, diversification is much more important than timing the market. By holding too much cash as a defensive strategy, investors risk long-term harm by being under-invested. It is true that in turbulent times extra caution can yield positive results, but this assumes one has the ability to know when to increase cash levels, and when to stay invested. Over time, this is difficult to achieve consistently. This does not mean that we are advocating a blind insistence on staying in the market at all cost. Risk appetite and tolerance plays a role. A better investment philosophy is to look for additional sources of diversification in portfolios. Long term returns will be enhanced, without necessarily taking uncomfortably high levels of risk."

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

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Still Far from a Recession

> "Even though growth momentum is fading, the next recession is still some way in the distance. Meanwhile, policy settings are supportive for growth, with monetary tightening still in its infancy, while fiscal policy is neutral."

Richard Jerram, Chief Economist, Bank of Singapore

Key Points

- In recent months we have argued that the economic and policy news flow is "as good as it gets". However, this is far from suggesting that the world is heading back into recession. The current U.S. economic recovery began in June 2009 and is now entering its ninth year. It is already the third longest on record. Inevitably this raises questions about how much longer it can continue.
- History shows that cycles die due to policy tightening (often in response to inflationary overheating or weak government finances) or external shocks. By their nature shocks are unpredictable. Aside from geopolitics, a surge in protectionism looks like the best candidate at the moment, but news on that front has been reassuringly quiet, despite the pre-election rhetoric of President Trump.
- Geopolitics nearly always feels frightening, as we tend to lack historical perspective in remembering how uncertain things were in the past. Risks are probably higher than before, with the U.S. abandoning its global leadership role under Trump's "America First" policy.
- Policy tightening can lead to recession, but is in its early stages. America is leading the way on monetary policy, but even there it is set to be 2019 before interest rates reach neutral levels – even on the Fed's hawkish projections. Until then, the support offered to the economy will be diminishing as interest rates rise, but the impact will still be positive and should help to keep growth above trend. Central banks in other major developed economies are likely to be much slower than the Fed in tightening policy.
- Fiscal support was reversed in 2011-13 which slowed growth and led to a renewed downturn in some peripheral European countries. Government finances have now stabilised and there is no pressure for further austerity; if anything, fiscal policy might be slightly positive for growth.
- Economic recovery in Europe continues to pull down the unemployment rate and this might be contributing to the declining vote for populist parties. The jobless rate in the Eurozone is down nearly 3 percentage points to 9.3 per cent, and in Spain it has been much more striking. However, Italy continues to lag, which implies continued concern over elections that must be held by 2Q 2018.
- China remains on its "stop/go" policy path, with a liquidity squeeze in response to a solid period of growth and another surge in the housing market. Tightening credit conditions should be effective in slowing growth in such a highly indebted economy, and policy-makers will need to ensure they do not hit the brakes too hard in such a politically sensitive year.
- 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.

Big Milestone; Symbolic Impact for A-shares

Investors should continue to rotate out of the technology sector and re-enter on dips.

Key Points

- Following 4 years of consultation, MSCI has decided to include China A-shares, the second largest market globally, in the Emerging Markets (EM) Index. Inclusion will happen in 2 phases in May and August 2018. While positive for sentiment, initial market impact is limited with China A-shares accounting 0.73 per cent of the EM index based on initial 5 per cent inclusion factor. Total inflows range from USD2-3bn to USD10-12bn for passive and active flows respectively, around 20 per cent of average daily trading turnover.
- Longer-term impact is more meaningful on full inclusion which we think could take 5-10 years, with China A-shares accounting - 9 per cent of EM index and overall China (including HK-listed and ADRs) accounting up to 34 per cent.
- Against the backdrop of tight monetary and financial conditions, overall credit growth is likely to moderate further. Hence, we expect economic momentum to continue to soften into 2H despite HK/China markets edging up in June.
- With declining positive economic surprises along with weakening producer prices, earnings upgrade which had been a key driver of market optimism could fade. Investors should continue to rotate out of the technology sector and re-enter on dips. In the property space, besides new starts and land sales slowing, top tier cities have started imposing price caps which could reduce developers' incentives for new launch.
- With mortgage tightening starting to spread to lower tier cities, rising policy risks could dampen sales. Consequently, we expect sales momentum to slow in 2H and suggest taking profit on property development companies.
- In autos, May wholesale shipment fell 2.6 per cent year-on-year (YoY), reflecting front loaded sales in 2H16 ahead of purchase tax hike from Jan-17. As sales are expected to moderate in 2H on high base, we suggest switching out of auto sector proxy. With retail ex-auto sales likely to remain resilient, preferred consumer names with digital & delivery strategy expected to accelerate same store sales growth.
- Nonetheless, with policy makers' keen vigilance over market impact and liquidity through improved communications and constant policy fine tuning, this mitigates the risk of a significant credit event or liquidity freeze.
- Furthermore, while infrastructure investment growth moderated to 17 per cent YoY in May after growing 25 per cent in 1Q17, this allows room for potential fiscal stimulus in 2H17 should economic moderation jeopardise growth stability. Post the recent correction, value is emerging for infrastructure constructors.

Still Cautious on Equities

"Given the stretched valuations, on-going slowdown in global growth and potential disappointments on the policy fronts, we remain cautious and prefer to hold back for a better entry opportunity."

Sean Quek, Head Equity Research, Bank of Singapore

Key Points

- With markets hitting new highs and most markets looking fully valued to us, we are sceptical that markets can continually go much higher. The rally in risky assets since the end of last year was largely due to the improvement in the economic cycle. However, with economic growth stalling and the increasing likelihood that Trump cannot enact big economic reforms, it is difficult for markets to go much higher.
- Finding value in a fully-valued market is a challenge. To ensure a safe outcome in the long run, diversification is much more important than timing the market. By holding too much cash as a defensive strategy, investors risk long-term harm by being under-invested.
- The actual policy outcomes of the Trump presidency cannot be predicted in full – the man is just too temperamental for that – but we can make a good guess that mostly, it will fail to live up to the promises he made for bold changes.
- Infrastructure spending will likely prove to be the biggest disappointment to his support base. He has been slow to move on proposals, and it has become clear that the path to much higher infrastructure spend will be a tortuous one. It is likely that he will give up on the notion entirely once the scope of the problem becomes clear.
- The surge and recent drop in technology needs to be viewed through a prism, which is: As investors reconsider the "Trump trade," they have gone back to two investment themes, that of yield and growth. While tech valuations may not be in bubble territory, large cap U.S. technology companies are trading at the highest level since late 2007.
- We are neutral on U.S. and Europe equities. 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. In Europe, political risk was mitigated when Macron won the French presidency. We do not see much risk for markets lurking in the German election. Italian elections could be troublesome, but that is a story for next year.
- Asia ex-Japan equities continued to benefit from the positive earnings upgrades. 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' focus on the Fed and ECB's exit plans gain momentum. Also, we will not completely rule out a trade war risk for the region, as Trump's stance on global trade remains unclear.
- Japanese equities lack a catalyst. We maintain our view that a sustained re-rating of the market would require more meaningful structural reforms. Valuations, at forward PE of 14.5 times versus the 5-year average of 14.7 times, remain in neutral territory.

Will the End of QE Hurt Bonds?

> "Nine years of quantitative easing is slowly drawing to an end. The Fed will start to shrink its balance sheet before year-end, while the ECB is set to announce plans for tapering and BOJ purchases have slowed."

Johan Jooste, Chief Investment Officer, Bank of Singapore

Key Points

- The U.S. economic recovery remains on track, but the lack of inflation threatens to cause a dilemma for the Federal Reserve. The jobless rate is already well-below the Fed's estimate of full employment, so it has fulfilled half of its mandate. Job growth has been slowing in 2017 – apparently due to a shortage of workers – but is still fast enough to pull the unemployment rate even lower. The Fed's analysis is that, at some point, tight capacity will lead to higher inflation.
- However, so far prices have been slow to respond. In fact core inflation has even ticked lower in recent months, although this is partly due to technical factors. Some Fed officials are already voicing doubts about the wisdom of further rate hikes if there is no sign of inflation. There are competing explanations for the lack of price pressures. One observable trend is that firms are allowing rising costs to eat into historically high levels of profitability, rather than raise prices.
- It looks premature for the Fed to have a radical re-think of policy, so we continue to expect one more rate hike this year as well as the announcement of balance sheet reduction. Looking into 2018, we expect a gradual normalisation, with one hike every quarter until the rate hits neutral at about 3 per cent. However we recognise this would need to be reassessed if inflation does not respond or if President Trump can find a more dovish candidate to replace Chair Yellen (which looks difficult).
- Later this year, the European Central Bank is likely to respond to the stronger economic performance by setting out plans to taper its asset purchases in 2018. That would leave open the possibility of a rate hike before the end of next year. Meanwhile in Japan an exit from the current policy still looks some distance away, but asset purchases have slowed since policy shifted to focus on targeting bond yields, rather than raw balance sheet expansion. By the middle of next year it looks like the expansion of balance sheets of major central banks in developed economies will be over.
- No doubt, bond markets will face headwinds when QE among the major central banks comes to an end. Most credit markets look fully valued at this juncture. We believe this implies future total returns will be more modest than last year, and will be dominated by carry – or the income component – rather than by further spread tightening.
- Valuations on both High Yield and Investment Grade bonds are currently near post Lehman highs. However in an environment of Fed policy normalisation, 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 rates. Furthermore, High Yield bonds are better positioned to benefit from a – to date - far substantial decline in overall default rates in 2017 versus 2016.

Don’t Write Off the U.S. Dollar

> “The greenback’s weakness due to unwinding of Trump trades since the start of 2017 seems to have gone a bit too far. The Fed hiked in June and seems intent on normalising policy. This should fuel modest renewed U.S. Dollar strength.”

Michael Tan, Senior Investment Counsellor, OCBC Bank

Key Points

- The era of strong U.S. Dollar is close to an end. However, the greenback’s descent will take time to play out and will not be in a straight line. Its weakness sparked by an unwinding of Trump trades since the start of 2017 seems to have gone a bit too far. The Fed hiked in June and its intention to look through low inflation and continue normalising policy should fuel modest renewed U.S. Dollar strength.
- The markets seem nervous that the Fed is making a policy error by tightening too quickly and/or planning to reduce its balance sheet too passively and automatically, given the doubts that persist about whether inflation will rise amid weakness in oil prices. But the core Fed leadership’s confidence in inflation picking up continues to underpin our view that markets are materially under-pricing the Fed’s rate path.
- We expect gold to remain range bound in the next few months. Following the June Fed rate hike, gold retreated in response to the hawkish tilt in the Fed’s tone despite soft inflation data. Discussion around unwinding of the Fed's balance sheet likely also dismayed gold bulls. The decline in oil prices probably also drove the down move in gold by pressuring down inflation expectations and pushing up real yields.
- We are not bullish on the gold price over a 12-month timeframe. We remain relatively comfortable with the view that U.S. GDP growth will accelerate from a depressed 1.2 per cent pace in 1Q17 and the market is under-pricing the extent of Fed hikes.
- Nevertheless, we recognise the value of the “hedge” trade and still believe holding gold as an “insurance policy” on global growth/-geopolitical risks is prudent.
- On oil, supply has been dragging prices lower. OPEC seems to be fighting a losing battle in its efforts to hold down supply and boost prices. Tension with Qatar casts doubts on the ability of the cartel to maintain discipline while inventories remain at unusually high levels. To make matters worse, demand is growing at the slowest pace in over two years.
- The increased efficiency of U.S. shale producers means that they are profitable at ever lower prices. As a result 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 U$50 per barrel, which implies prices should be relatively stable around current levels.

Tighter Integration with China

> Hong Kong's integration with China is deepening in various aspects. This was also among the reasons supporting Moody's decision to downgrade Hong Kong's sovereign credit rating. However, we believe that Hong Kong is more likely to benefit than to suffer from its closer integration with China. First, tighter policies and capital controls enacted by Chinese authorities have allowed banks in Hong Kong to absorb more loan demand from Mainland companies. Second, southbound inflows under stock connects look likely to increase in the long term and support Hong Kong's stock market. Third, the upcoming launch of the bond connect may help to deepen the development of offshore Yuan market in Hong Kong. Finally, Hong Kong as a financial hub could fill the financial gap for infrastructure projects in Asia. Hong Kong companies could also share its expertise in various services with countries involved in the One Belt One Road initiative.
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> Treasury Research, Treasury Division, OCBC Wing Hang

Key Points

- Hong Kong's integration with China is deepening in various aspects. Hong Kong could welcome more business opportunities as China continues to open up its market.
- First, due to the People's Bank of China's (PBOC) policy tightening bias, loans for use outside of Hong Kong (+15 per cent YoY) registered double-digit annual growth for the third consecutive month in April. Furthermore, Mainland Chinese authorities had supported domestic corporations to raise funds in offshore market as the funds raised there could become capital inflows to onshore market.
- In addition, capital controls by Chinese authorities had forced Mainland corporates to raise funds overseas for M&A deals. Should the PBOC continue with this tightening bias, loans for use outside Hong Kong will likely expand further, hence brining more business opportunities to banks in Hong Kong. However, downside risks are still in play as Chines authorities try to tame the overseas M&A frenzy fueled by Mainland companies. Also, Mainland Chinese developers have been blocked from getting financing by issuing dollar bond in offshore market.
- Second, after the launch of the Shenzhen-Hong Kong stock connect in late 2016, southbound turnover accounted for a larger proportion of the total turnover of the Hong Kong stock market with the percentage rising steadily to over 10 per cent. Also, with southbound net inflows increasing gradually from mid-2016, Mainland investors have contributed increasingly to the stunning performance of Hong Kong stock market.
- While a stable RMB and inclusion of A-shares into the MSCI emerging market index have resulted in increased capital flows from Hong Kong to China, we believe that the high premium of A-shares to H-shares at over 20 per cent and the increasing need for asset diversification will still drive Mainland investors back to the Hong Kong stock market in the long term. This trend could be further reinforced should the HKMA launch an ETF connect and allow Mainland investors to access all H-shares.
- Third, the upcoming launch of a bond connect is likely to deepen the development of Hong Kong's Yuan market. Under the bond connect programme, foreign investors are able to access both primary and secondary bond markets in China's interbank bond market. In fact, China ranked third in the world in 2016 in terms of its total outstanding amount of bonds. However, foreign ownership of onshore bonds remained low at 1.3 per cent as of 2016, which suggests that the Mainland bond market has huge potential to welcome foreign investments.
- In addition, foreign investors will be allowed to use both RMB and foreign currency for northbound investment. However, all foreign exchange transactions will be settled in Hong Kong with either RMB clearing bank or participating bank. This means that the potential increase in northbound flows to onshore bond market will likely translate into higher demand for CNH and as a result reinforce Hong Kong's position as the largest offshore RMB market.
- Finally, Hong Kong is likely to benefit from the One Belt One Road (OBOR) initiative. Hong Kong will likely play a role as a financial hub to fill the financial gap for infrastructure investments in Asia which is estimated to be as big as US$21 trillion for the next 15 years by McKinsey. In addition, with the RMB gradually becoming a trade, investment and funding currency for countries involved in the OBOR initiative, the development of Hong Kong's offshore yuan market will likely deepen.
- At the same time, Hong Kong could share its expertise in financial services, professional services, high value-added shipping services, tourism services, and convention and exhibition services with countries involved in the OBOR initiative. Furthermore, Hong Kong could help Chinese companies to expand their businesses to these countries.

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