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OCBC WING HANG

Climbing a wall of worry

Stay defensive

"This month, markets will focus on policymakers once again. If there are serious policy missteps, we might see more market volatility. In the U.K., there will be increased scrutiny of the progress (or lack of) in Brexit negotiations. The U.S. will need to pass a budget and increase the debt ceiling so they can pay their bills. The stakes are high; without the ability to issue new debt, the U.S. Treasury's dwindling cash reserves could be exhausted by mid-October. On top of that, the U.S. Fed is widely expected to start tapering its balance sheet. There is little room for mistakes. While markets have to climb a wall of worry to go higher, the underlying conditions of stretched valuations and lofty earnings expectations make further gains even more challenging. In such an uncertain environment, we recommend maintaining a defensive portfolio stance."

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

In This Issue

A very moderate slowdown

> Even though growth momentum has peaked in 2Q 2017, the slowdown is very mild and does not involve any substantial disruption; but trade flows are moderating and that will have an economic impact in coming months.

Richard Jerram, Chief Economist, Bank of Singapore

Key Points

- The PMIs in developed economies are showing some signs of slippage, but so far it is very mild. Asia is a touch softer which is in line with the idea that trade flows are leading the slowdown. In both cases, PMIs are comfortably above 50, indicating continued expansion.
- The next recession is still too far in the distance to speculate over the timing. There are some areas of stress – such as Chinese debt or tight U.S. labour markets – but nothing that is flashing an urgent warning signal.
- The U.S. economy has experienced a sub-par recovery over the past eight years, with GDP growing an average of 2.1 per cent. This year and next are unlikely to be much different, especially as the chance of big fiscal policy changes has faded. However, even this pace of growth has been enough to bring the unemployment rate down from a peak of 10 per cent down to just 4.3 per cent, but it is hard to see how job growth can keep running at the 180,000 pace of the past year for too much longer as the pool of workers dries up.
- Political chaos in Washington also raises the danger of a government shutdown or trouble in raising the debt limit. In the past this has been resolved without much disruption, but the confrontation between President Trump and Congress implies a higher level of risk.
- The situation in Europe is starting to look like that in the U.S., albeit with a time-lag of a few years. The unemployment rate has been falling steadily and is now at the lowest level since 2009. So far, the rebound in Euro has not been much of a drag on the manufacturing sector.
- Brexit talks will warm up in coming months and the UK government has been releasing papers outlining its position on various issues. However, this has served to highlight the difficulties in reaching an agreement within the UK, let alone with the European Union. An orderly exit by March 2019 looks impossible, but even the nature of a transition period is far from clear.
- Japan's 4 per cent expansion in 2Q 2017 beat the 2.6 per cent in the U.S. and 2.5 per cent in the Eurozone. This looks like the culmination of the pick-up in global activity over the past year that is now starting to fade. This is a partial victory for Abenomics, although slow progress on structural reforms and persistent deflationary concerns limit any celebration.
- China remains on its "stop / go" policy path, as the focus swings between supporting growth and controlling the credit bubble. Moderate monetary tightening is pointing to a slower economy in coming months and the softer data for July might be an early sign of a shift in pace. Trade friction with the U.S. represents the main threat to the benign short-term outlook.
- Most emerging markets continue to look healthy, buoyed by the pick-up in global trade and commodity prices, as well as the domestic policy improvements of the past few years. Even compared to four years ago, when we saw a sharp adverse reaction to then-Fed Chair Bernanke's "taper tantrum", the situation looks much more solid.

At the cusp of a cyclical downturn

The better than expected 1H GDP growth allows policy makers to focus on structural reforms in the near-term without the need for policy stimulus. Nonetheless, we do not expect a sharp slowdown in economic growth ahead of the party plenum in October.

Key Points

- While we had been anticipating a moderation in economic growth since PPI peaked in Mar, July macro data appears to confirm the expected slowdown has since started with most data points coming in below expectation.
- Besides the official manufacturing PMI moderating further, both exports and imports reported lower sequential YoY growth, indicating both weaker external and domestic demand. New export orders fell, in-line with the decline in global manufacturing PMIs. The global economic recovery is as good as it is. This in turn dragged China manufacturing FAI growth to 1 per cent, the lowest in 13 months.
- Similarly property investment growth moderated, in-line with weakness in cement production, floor space sold and first decline in new construction starts in 10 months. With tier 3 cities recording 2 consecutive months of YoY decline in primary sales, we think the property sector may be at an inflection point.
- Given the importance of property sector to economic growth, the pace of slowdown could pose a bigger risk in 2018. Further, with producer price inflation already peaked, the decline in industrial production growth suggests industrials profits could slow too, which could be potentially negative for EPS upgrades which have been a key market driver this year.
- The better than expected 1H 2017 GDP growth also allows policy makers to focus on structural reforms in the near-term without the need for policy stimulus. Nonetheless, we do not expect a sharp slowdown in economic growth ahead of the party plenum in October.
- While the market has been positive on Chinese banks due to improving asset quality, a cyclical slowdown could reignite NPL concerns. Debt-equity swaps have been proposed to help resolve the bad-debt issue, but if banks are unable to truly scale up on a commercial basis, this could increase longer term risks through cross-holding of potential problematic assets among banks. Higher risk weight for debt-equity investments could also reduce the return on capital. Externally, trade tensions with U.S., Fed tightening with balance sheet reduction and potential interest rate hike remain key risks in 2H 2017.

Still cautious

> Given the prospects for tighter global monetary policy and extended stock valuations, we remain cautious on equities; but within the equities space we prefer the U.S. for its defensive traits and remain neutral on Europe.
>
> Sean Quek, Head Equity Research, Bank of Singapore

Key Points

- Given our view that global monetary policy environment will become tighter, even as overall growth prospects seem to have peaked, we remain cautious on the outlook for equities.
- With leading central banks owning 20 per cent of their government's total debt and the ECB and BOJ balance sheets now bigger than the Fed's, pressure is for the massive balance sheet expansion to finally come to an end. Also extended valuations provide limited support.
- In the U.S., the recently concluded 2Q2017 earnings season provided further boost to consensus earnings expectations. However, negative headlines from the White House, including the disbanding of pro-business councils, continued to mar hopes of a fiscal stimulus driven boost. Nevertheless, given our overall cautious view on global equities, U.S. equities remain more defensive.
- Consensus earnings per share downgrades for Europe finally stabilised in August, after deteriorating steadily since peaking in May, despite signs of economic strength and positive earnings surprises. With ECB balance sheet surpassing the Fed's in U.S. Dollar terms, pressure for the central bank to start phasing out its quantitative easing is mounting. Near-term, financial market movements would continue to be dictated by clues on the ECB's next move. As highlighted earlier, we see a less dovish central bank as the economic recovery continue to gain pace. Overall, we remain neutral on European equities.
- The persistently strong yen continued to weigh on Japanese equities (in yen terms) in August. This is notwithstanding the robust 2Q2017 economic growth, a relatively more positive earnings season and improving consensus EPS estimates. Fundamentally, we maintain our view that sustained re-rating of the market would require more meaningful structural reform to boost growth. To this end, Abe's fading popularity is not encouraging. Hence, we see macro factors and movements of the JPY to remain key drivers for the market.
- Asia ex-Japan equities have done very well this year, posting strong double digit gains. However the region's equities could bear the brunt again as investors' focus on the Fed and ECB's balance sheet exit plans gain momentum. Also, notwithstanding the period of unexpected calm, trade war risks, especially between China and the U.S., remains real.
- In Singapore, the equity market saw some profit taking pressure in August, with seasonal effects partly contributing to the equity market's softer performance for the month. Near term, in the absence of potential catalysts, we expect the current consolidation phase may continue. One of the brighter spots on the ground remains the improvements in the local property market, where there have been more transactions and en-bloc sales.

Be selective

> "We see more reasons to be selective within credit markets than we did at the beginning of the year as future returns are likely to be more muted compared with the recent past, and tight spreads leave little room for error."

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

Key Points

- The global monetary policy outlook, especially among the major developed markets, will have an important impact on the outlook for bond markets. In the U.S., the Fed's policy dilemma has intensified and continued low readings on inflation suggest it might opt for a break from the sequence of interest rate hikes. By some measures, no rate hike in September could be seen as a pause, but it is better viewed as providing space for the market to absorb the likely September announcement plans for balance sheet reduction.
- Strong labour markets and looser financial conditions, despite three rate hikes since last December, means that the Fed should want to continue to normalise interest rates. However, its confidence that slippage in inflation was just a temporary aberration has been undermined by a several months of soft data. It seems that the Fed might need more convincing that the underlying pressure on inflation has faded, so we expect another hike in December before a pause in March, but it could skip the year-end move. We now see three rate hikes in 2018 compared to four previously.
- If the U.S. struggles to pass a budget or to lift the debt limit to avoid the risk of a default, then we would hear talk of another ratings agency downgrade of U.S. debt. However, this typically has no impact on the performance of the sovereign debt of large developed economies. S&P cutting the U.S. to AA+ in August 2011 was soon forgotten, while Japan has seen multiple downgrades but can still issue 10-year debt at a zero interest rate.
- Elsewhere, increasing confidence about the prospects for growth means the European Central Bank is set to bring its quantitative easing policy to an end in the first half of 2018, with an announcement likely before the end of 2017.
- In Japan, inflation remains a long way from the 2 per cent target so a policy shift is still far in the future. Short-term interest rates will remain at -0.1 per cent and bond yields targeted around zero for most, if not all, of 2018.
- Overall, we see select opportunities in bond markets but returns will not be as strong as in the past. With spreads close to all-time tights, we expect modest spread tightening for the remainder of the year, which should be balanced by a modest back-up in U.S. Treasury yields. As a result, coupon income will likely drive asset class performance for the rest of the year. We recommend reducing overall portfolio duration and a move up in credit quality to reduce risk.

Remain neutral on gold

> Our view on gold is that prices will remain largely range-bound over the next 3 months, hovering between US$1,200-US$1,300 per ounce; but it could briefly break above US$1,300 per ounce in September on dysfunctional U.S. politics.

Michael Tan, Senior Investment Counsellor, OCBC Bank

Key Points

- It is possible that gold prices could briefly break above US$1,300 per ounce should risks associated with U.S. debt ceiling and the FY 2018 U.S. budget intensify as President Trump seeks to solidify support among his base to offset declining approval ratings by embracing more controversial positions.
- Barring the possibility of brief surge in gold prices above US$1,300 in September, our broader view on gold is that prices will remain largely range-bound over the next 3 months, hovering between US$1,200-US$1,300.
- We remain neutral on gold. There is an underlying appetite to hold gold as a safe haven and hedge against potential tail risks. However, this needs to be balanced against downside risks for gold from market expectations for a more active Fed, which could hike again this December and also begin tapering its balance sheet in September. We are not bullish on the gold price over a 12-month timeframe given the rising rate headwinds.
- On oil, the supply–demand balance still looks challenging. Even though consumption has picked up a little, U.S. output is close to record levels and there are concerns over OPEC's ability to maintain discipline around quotas.
- Problems with excess supply lead us to think that the trend for prices is likely to be slightly lower. As a result, we maintain our 12-month price target of US$45 per barrel. Moreover, upside is limited by output quickly rising as more of the marginal shale producers become profitable, but there is the risk of a serious break to the downside if OPEC loses control.
- On the currency front, the U.S. Dollar is expected to remain under downside pressure in September with headline risks expected to be highly evident. With no surprises from Fed Chief Yellen out of Jackson Hole, expectations of future rate hikes may remain passive, and much will rest upon the Fed policy meeting on 20 September 2017, where balance sheet tapering plans are expected to be announced. Meanwhile, uncertainty about the debt ceiling, the lack of fiscal impetus and the unpredictable nature of policy pronouncements on social media from the U.S. President could also weigh on the U.S. Dollar.
- Elsewhere, expectations about the ECB's quantitative easing ending, may send the Euro higher. The ECB has so far not expressed discomfort with the strong Euro and if it maintains this stance, this could be another factor that is supportive of a stronger Euro.
- In Japan, the central bank remains sufficiently accommodative and the yen is expected to remain a function of risk appetite fluctuations and U.S. Dollar related risks. The Pound meanwhile may continue to underperform its peers on the back of Brexit baggage as the stance from the EU continues to be less than charitable.
- China's currency has turned around in 2017 -- after three years of losses -- helped by curbs on capital outflows and Dollar weakness. If the greenback continues to remain weak, this should continue to favour the Chinese currency with positive spill over benefits for other Asian currencies.

Economic growth to slow down

“ GDP growth (+3.8 per cent YoY) in the second quarter remained resilient due to buoyant exports of goods, strong domestic demand and robust private investment on housing boom. However, GDP growth may decelerate in the second half of this year due to a fading low base effect, muted tourism, and an expected correction in housing markets. ”

Treasury Research, Treasury Division, OCBC Wing Hang

Key Points

- Hong Kong's economy expanded by 3.8 per cent YoY in 2Q2017, beating market expectations. also It is in line with our view that growth peaked in 1Q2017 (4.3 per cent YoY). The resilient growth was mainly attributed to further improvement in domestic consumption, fixed investment and exports of goods.
- Specifically, with seasonally adjusted unemployment rate reducing to a more than three-year low at 3.1 per cent in the second quarter, private consumption was well supported and grew at its fastest since 2Q2015 by 5.3 per cent YoY. Besides, housing boom and rosy performance of the stock market (Hang Seng Index climbed by 6.9 per cent in the second quarter), the resultant increase in wealth effect also underpinned consumer sentiment.
- Additionally, fixed investment (+8 per cent YoY) marked its the strongest growth since 4Q2012. Expenditure on machinery equipment and intellectual property products rebounded by 4.6 per cent YoY after falling 8.6 per cent YoY in the first quarter. This signals pickup in corporate sentiment amid recovery at home and abroad. On the other hand, private investment in building and construction increased further by 4.8 per cent YoY in 2Q2017 given the uptick in housing market momentum.
- Furthermore, exports of goods expanded by 5.6 per cent YoY on the back of improved external demand following a 9.3 per cent YoY gain in 1Q2017. Meanwhile, exports of services rose by 2.3 per cent YoY amid robust cross-border financial activities and improvement in regional trade and cargo flows.
- On the back of fiscal stimulus, resilient growth of government consumption expenditure (+ 3.2 per cent YoY) and private sector's investment in building and construction (+2.4 per cent YoY) have also contributed to the economic growth.
- Moving forward, economic growth is likely to decelerate gradually in the second half of this year due to four reasons. First, an expected correction in both the housing and the stock markets may reduce wealth effect and moderate the growth in private expenditure. Second, private investment in housing market may slow down as investor sentiment has been hit by cooling measures and prospects for higher rates and increasing supply. Third, inbound tourism (exports of travel services receded by 2.1 per cent YoY) may remain muted given an expected slowdown in China's growth in the second half of this year. Fourth, the low base effect is likely to fade away.
- Still, based on the rosy economic growth in the first half of this year, we revise our forecast on economic growth from 2.2 per cent to 2.5 per cent for 2017. However, a combination of sustained global recovery, a solid labor market and fiscal stimulus could add upside risks to HK's growth. Also, government's latest real GDP growth forecast for 2017 is revised up from 2-3 per cent to 3-4 per cent.