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OCBC WING HANG

Be Cautious – Don't chase the rally

Trump could disappoint investors

> "The macro backdrop remains constructive for risk assets, but equities are overbought at a point where there is room for a temporary pullback on policy disappointment - for instance if Trump ratchets up his anti-trade rhetoric or if he does not deliver the anticipated fiscal or regulatory reforms. However, we are not bearish over the long term, but advise investors not to add on more risk and consider rebalancing their portfolios out of sectors that are over-valued with low growth prospects, and into sectors with undemanding valuations and a strong growth outlook."

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

In This Issue

Global Monetary Policy at Turning Point

> "Faster global growth and reflation implies that the next move in monetary policy in the Eurozone and Japan is likely to be towards tightening, even as the Fed prepares to hike rates further."

Richard Jerram, Chief Economist, Bank of Singapore

Key Points

- Global economic growth continues to improve and, together with firmer commodity prices, this is reducing the risk of deflation. Headline inflation rates have picked up across the developed world, although core inflation has been slower to respond as it typically excludes the effect of higher oil prices.
- Faster growth and higher inflation spells a turning point in global monetary policy. Of course the U.S. is already tightening and various emerging markets seem to have stopped cutting rates, so the focus is on other developed markets. In 2H 2017 we can expect to see the Eurozone planning to taper asset purchases and Japan start to increase the target yield for bonds.
- In the U.S., the "America First" attitude will be a persistent risk. With the trade deficit already at 4 per cent of GDP, and set to expand due to the strong U.S. dollar and tight domestic capacity, tariff protection will be a constant threat.
- In Europe, the dichotomy continues between an increasingly solid economic performance and continued political turmoil and uncertainty. PMI readings show Eurozone business confidence at the highest level since 2011 while unemployment has been falling steadily for over three years.
- The improving economy seems to have done little to reduce public dissatisfaction with the political status quo. This should not be too much of a surprise, as the U.K. and U.S. both enjoyed a stronger recovery than the Eurozone from the recession of 2008-09, but were not immune to unexpected election outcomes last year.
- The U.K. is treading a perilous path towards Brexit and there is the danger that it leaves the European Union without securing any form of preferential access for trade relations. Large budget and external deficits limit the room for manoeuvre and leave the U.K. exposed to damage from Brexit.
- In Japan, the pick-up in regional trade has boosted Japan's exports in recent months, even before we see the likely benefits of the recent currency weakness. In turn this is driving a rebound in industrial output that will feed through to corporate profits.
- As in Europe, solid economic growth means that discussion is turning to the question of when the Bank of Japan (BOJ) might start to tighten monetary policy. Assuming that inflation picks up a little in coming months and the exchange rate remains soft, the BOJ could look at raising the target for 10-year bond yields around the middle of the year. This could bring the benefit of reducing a source of potential friction with the U.S. as well as reducing the pressure for the BOJ to expand its balance sheet so rapidly.
- In China, concern over the overheating housing market has brought some macroprudential policy tightening, as well as a slight squeeze on liquidity. This points to slower growth in coming months, but it seems unlikely to risk a serious undershoot of targets.
- Policy-makers' priorities have been clear in recent years, with the determination to deliver solid growth taking precedence over efforts to control the credit bubble. As a consequence the debt service burden is rising, bringing the risk of a rise in non-performing loans. However, most of the debts are in local currency so the government should be able to prevent abrupt systemic disruption.
- The recovery in emerging markets is threatened by higher U.S. interest rates and trade protectionism. Asia is relatively less exposed to a rise in borrowing costs, as most economies run a current account surplus, so are exporters of capital.
- Conversely, Asia is badly exposed to a reversal of the globalisation of the past few decades. Even if America's protectionist focus is on China, the rest of the region is indirectly threatened as much of the trade with China is ultimately dependent on demand from the United States.

Time for a Breather

While domestic banks had benefitted from reflation which reduced concerns over rising bad debt, we think market complacency is high on potential monetary tightening or disruption from rising inflation risks and financial deleveraging. With potentially lower fee income on tighter regulations, we suggest locking in profit on China banks.

Key Points

- China (H-shares) has been the best performing market in Asia year-to-date, gaining 12 per cent as at end-February. Benefitting from a global risk-on rally led by the U.S., improving China economic growth outlook and a stabilizing RMB in the near-term, HK/China markets were bolstered by fund inflows into Emerging Markets and increased Stock Connect southbound flows. While this led A-H share premium to fall to a 2-year low, forward PE valuations for MSCI China at 12.2x are looking stretched at 2 standard deviations above 3-year historical average.
- With the ongoing property down-cycle, we expect China's economic growth to slow from 2Q17, removing a potential catalyst for further re-rating. Consequently, we lower China to Neutral from Overweight.
- Near-term, high frequency data continues to support economic stabilization. China exports excluding HK, which better reflects underlying trend, rose 2 per cent year-on-year in January indicating slight pick-up in global demand. Imports rose 17 per cent but may have been distorted due to earlier Lunar New Year this year.
- On the other hand, inflation picked up further with consumer and producer prices rising 2.5 and 6.9 per cent respectively, both accelerating from the prior month. This led monetary policy to tilt firmly to a tightening bias with the central bank raising inter-bank rates and leading efforts among financial regulators to draft unified rules to rein in asset management risks.
- Rising interbank rates could help reduce the interest rate differential between China and U.S., alleviating capital outflows and depreciation pressure but also means southbound flows into HK may not be sustainable. While domestic banks had benefitted from reflation which reduced concerns over rising bad debt, we think market complacency is high on potential monetary tightening or disruption from rising inflation risks and financial deleveraging.
- With potentially lower fee income on tighter regulations, we suggest locking in profit on China banks. Furthermore, as the low base effect normalizes and economic growth tapers off, corporate earnings could peak in 1Q17. Industrial and infrastructure companies which had rallied could underperform.
- Potential New Economy switches include insurers which are beneficiaries of higher reinvestment returns from rising bond yields.

Cautious on Equities

> A lack of clarity about Trump's policies, Fed rate hikes, political risk in Europe and extended valuations means that the risk-reward for equities remains unattractive at this juncture.

Sean Quek, Head Equity Research, Bank of Singapore

Key Points

- Positive global growth momentum and hope of clearer U.S. fiscal stimulus and tax reform plans continued to drive global equities higher in February. The first month of President Trump's administration has been typified by drama in Washington. It remains to be seen how much longer the market's patience last. In addition, the pace of Fed interest-rate normalisation is likely to pick up and political risk in Europe remains an issue. Coupled with extended valuations, risk-reward remains unattractive. Hence, we maintain our cautious stance on equities.

- In the U.S. the stronger than expected quarterly earnings season has ignited 2017 earnings growth expectations. Looking ahead, the stronger U.S. dollar, higher interest rates and tighter labour market suggest that corporate profit margins are unlikely to be sustained. Also, the intricacies and time involved in pushing through tax reforms means that the Trump reflation trade could lose steam. Nevertheless, given our overall cautious view on global equities, U.S. equities remain more defensive on a relative basis.

- In Europe, equities underperformed other regions as concerns with political risk re-merged as hustling of the French presidential election gaining momentum, even as uncertainty hangs over U.K.'s departure of the EU market. Although firmer economic growth on loose monetary policy and fiscal austerity is expected to provide a boost, consensus CY2017 earnings growth of 13.7 per cent remains optimistic. Meanwhile, risk of political contagion remains, given the busy political calendar. Hence we remain cautious on European equities.

- Japanese equities continued to mirror movements of the yen. 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 the 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, which is expected to stay volatile. Valuations, however are not cheap.

- In Asia ex-Japan, Trump's "America First" posture does not augur well for China and the region. While it would be highly negative for Asia's growth if Trump pursues his anti-trade policies, investors seem surprisingly sanguine. Coupled with potential impact of faster-than-expected U.S. interest-rate normalisation and currency vulnerability, we remain cautious on Asia Ex-Japan.

Stay Positive on High Yield Bonds

> "Valuations on high yield bonds do not look compelling currently. However in a reflationary environment, high yield bonds should be better insulated from the adverse impact of higher rates."

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

Key Points

- U.S. bond yields have stalled as the market awaits more clarity on the direction of policy. The Fed seems likely to raise rates again, possibly by June, but uncertainty is greatest on fiscal policy where details of planned reforms are sparse.
- We continue to expect the Fed to raise interest rates three times this year and another four in 2018. The economy is at full employment and inflation is only marginally below the 2 per cent target, so the Fed should be uncomfortable with interest rates around 2.5 per cent below neutral levels.
- However, the minutes of the most recent Fed policy meeting suggests they are not worried about the risk of overshooting targets for unemployment and inflation. As such, gradual tightening still seems like the most likely scenario.
- The minutes of the most recent policy meeting also show that the Fed is preparing for a formal discussion on shrinking its balance sheet, ie quantitative tightening. Initially this will happen by ending the reinvestment of proceeds from maturing bonds and it seems likely to start in 2018. A smaller Fed balance sheet implies a higher risk premium for U.S. Treasuries and there is a risk that this has an impact akin to former Fed Chair Bernanke's infamous "tapering" remark in May 2013.
- Despite higher interest rates, we continue to see opportunities in bond markets. We stay positive on Developed Market and Emerging Market high yield bonds. The pick-up in growth bodes well for high yield bond issuers and if Trump were to enact his expansionary fiscal policies, it would be conducive for high yield bonds. Besides, oil prices are now less of a drag on the sector.
- In the face of potentially improving fundamentals and a lower default rate, the downside for high yield looks limited - even as the Fed proceeds to raise rates - given the spread cushion it enjoys. High yield bonds still offers investor good carry to tide through this period of uncertainty.
- We reiterate that there are three 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 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 bonds with decent credit fundamentals to reduce default risk.

Greenback Awaiting Policy Clarity

"Our view remains that Trumponomics will keep the U.S. Dollar good but will not make it great, especially against reserve currencies such as Japanese Yen, Swiss Franc and the Euro."

Michael Tan, Senior Investment Counsellor, OCBC Bank

Key Points

- The unwinding of post-election U.S. Dollar strength appears mature but the U.S. Dollar will likely remain difficult to trade. The greenback's struggle to rally was disappointing following slightly hawkish rhetoric from Fed officials and a solid set of upside U.S. data surprises. We expect the U.S. Dollar to move sideways until we see the greater details of the Trump fiscal plans.
- Elsewhere, oil prices remain resilient despite continued high inventory levels and signs that non-OPEC production is already rising in response to the rebound in prices over the past year. This should limit the upside.
- Oil prices have been surprisingly resilient in the face of two factors that threaten a reversal. First, inventories remain at unusually high levels, even as we start to come out of the winter season. Demand continues to grow at a steady pace around 2 per cent but it is not strong enough to make inroads into inventory levels.
- Second, supply is quickly rebounding even though prices are still relatively subdued. The U.S. rig count has almost doubled from the lows of May 2016 and production is already responding. Moreover, the Trump administration's apparent determination to reduce environmental protection implies an increase in supply of both oil and other fossil fuels.
- The combination of OPEC controls on excess supply, but the promise of non-OPEC production increasing as prices rise means that oil prices could be set for a period of relative stability. It looks as though the longer-term equilibrium price where supply and demand is in balance is lower than previously thought. It is perhaps in the US$50-60 per barrel range, which implies prices should be stable around current levels.
- European political risks (e.g. French elections) and uncertainty around U.S. fiscal and economic policy under Trump have supported buying of gold. Safe-haven buying of gold can be strong during periods of geopolitical upheaval and policy uncertainty. The higher near-term gold price backdrop is consistent with our view of gold as a valid asset to hold as a diversifier and hedge.
- The break of gold price above US$1,250 per ounce is bound to attract attention. The risk that market participants will have to play catch-up is increasing and this could extend the upside to gold. Stronger gold price is likely to attract interest out of China, where participants tend to buy into momentum. However on a twelve month outlook, we are cautious on gold given the risk of a pullback as the political risks subside and as Fed steps up rate hikes further out.

Fiscal Policy Remains Prudent

"The Hong Kong government recorded a huge budget surplus of HK$92.8 billion during fiscal year 2016-17 largely attributed to the property boom last year. However, the fiscal spending for year 2017-18 remained relatively prudent as the increase in government revenue in 2016 may not be sustainable. Given the increased spending on infrastructure and the expected improvement in domestic consumption on the back of fiscal stimulus, we revised up our forecast for 2017 GDP growth to 2.2 per cent, reflecting a rebound from the growth of 1.9 per cent seen in 2016."

Treasury Research, Treasury Division, OCBC Wing Hang

Key Points

- Due to the higher-than-expected land revenue and stamp duties on properties, the government recorded a budget surplus of HK$92.8 billion during fiscal year 2016-17, topping the forecast of HK$36.8 billion. However, the fiscal stimulus for 2017-18 did not expand significantly as expected but remained prudent as the increase in government revenue in 2016 is considered unsustainable. Even so, the surplus will be used to increase expenditure on infrastructure, education, social welfare and healthcare. Notably, the government's capital expenditure is forecasted to be around $107.2 billion for 2017-18, including $86.8 billion for capital works, allowing the construction industry to contribute 4.7 per cent to HK's GDP.
- On the other hand, the set of tax and short-term relief measures will amount to HK$35.1 billion for 2017-18, down 9.5 per cent from HK$38.8 billion last year. As economic growth has reached its cycle trough, it is reasonable for the government to offer fewer sweeteners. Indeed, the relief measures, together with other spending initiatives in the Budget, are expected to boost GDP for 2017 by 1.1 per cent. As the measures mainly support the elderly, disabled, poor and salaried workers, we expect domestic consumption to grow moderately.
- In terms of the property market, the Budget stated that the government's 5-year public housing supply target during 2016-17 to 2020-21 is 94,500 units. It also estimates that the potential land supply for private housing over the next five years will average at 20,300 units, representing an increase of about 70 per cent over the yearly average in the past five years. Additionally, the 2017-18 Land Sale Programme comprises a total of 28 residential sites, including 20 new sites, capable of providing about 19,000 residential units.
- With the primary housing market starting to dominate on the back of cooling measures, the resultant increase in property developers' demand for land is expected to drive land prices up. Moreover, any delays in new home projects will translate into slower-than-expected increase in housing supply and, in turn, offset the effects of higher interest rates and the housing cooling measures. Combined with huge demand from Mainland investors, housing prices should not see any notable correction in the near term.
- Finally, according to the Budget, the contribution of the manufacturing industry declined from 2.7 per cent of GDP in 2006 to 1.2 per cent of GDP in 2015. Therefore, the government will increasingly support the emerging IT sector, in an effort to upgrade the manufacturing industry and reduce the economy's reliance on the volatile services sector. This will also create more jobs which will lead to a stronger labour market.
- In conclusion, given the increased spending on infrastructure and the expected improvement in private expenditure on the back of fiscal stimulus, the government forecasts 2017 GDP growth at 2 to 3 per cent, compared to our forecast of 2.2 per cent.