MONTHLY **OUTLOOK**

MAY 2018

Bumpy Ride Ahead

Markets To Stay Volatile Given Elevated Geopolitical Risks And Rising Inflation

OCBC WING HANG

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BUMPY RIDE AHEAD

MARC VAN DE WALLE
Head, Group Wealth Management, OCBC Bank

"It is going to be a bumpy ride ahead for markets but this does not mark the end of the equity bull market. The global economy is still healthy and corporate earnings continue to improve. Looking ahead, two themes we have been highlighting remain relevant: keep looking for ways to diversify portfolios, and take shelter in shorter-dated credits. Diversified portfolios offer some peace of mind in these uncertain times."

GLOBAL OUTLOOK

RICHARD JERRAM
Chief Economist, Bank of Singapore

Growth outlook remains solid

"The outlook for global growth remains solid, with the healthy pace of 2017 set to continue this year and the next. Inevitably there are risks, but these do not seem any more pronounced than usual."

- PMIs both in developed and emerging markets have slipped moderately from the unusually elevated levels at the turn of the year, but not to a worrying degree.

- Trade friction is the most pressing concern, after the escalation of threats from the U.S. to China, followed by the promise of retaliation. The assumption is that this is mainly a negotiating tactic, although it is clear that the U.S. feels a genuine grievance. Fiscal stimulus into a hot economy will suck in imports and raise the U.S. trade deficit, so trade friction will remain a constant risk, irrespective of any short-term deal.

- Looking more broadly, the developed economy monetary tightening cycle continues to proceed very slowly and cautiously. Headline inflation will be impacted by higher commodity prices, but core inflation is still subdued, which means that there is no urgency to change policy, despite low unemployment rates.

United States

- After a long and slow recovery, the U.S. economy has normalised, with full employment and inflation at the 2 per cent target. Relatively low interest rates and the recently-implemented fiscal stimulus means that growth is likely to remain above trend for at least the next 18 months. In turn, this implies that capacity shortages should become more intense, with the unemployment rate falling below 4 per cent. Meanwhile inflation should rise above target, even if we ignore the impact of the weaker U.S. Dollar and stronger oil prices and focus on the core rate.

Europe

- Growth in Europe has clearly slowed from the unusually rapid pace of late 2017, but this seems partly due to temporary factors such as weather, strikes and inventory adjustment. It is hard to see a trigger for a more meaningful hit, as the policy environment is still supportive of growth and the structural reforms of recent years are starting to pay dividends.

- A further point to note is that even though indicators such as PMIs have slipped since the start of the year, they are still at relatively elevated levels. This is consistent with a strong economic performance and should provide the European Central Bank (ECB) with the necessary reassurance to wind down its asset purchase programme by the end of the year. Details are likely at the June policy meeting.

- The timing of the first interest rate hike is less clear, with the ECB's guidance that it will not come until "well past" the end of quantitative easing. That points us to expect a move in 2Q 2019, but if inflation fails to respond to the improving economy then they are likely to wait.

- Brexit inevitably continues to dominate U.K. policy discussion, but still with little clarity on the likely relationship with the European Union once the transition period is over. The lowest unemployment rate in over 40 years and above-target inflation mean that another interest rate hike is not far away, although the Bank of England (BOE) seems to be wavering over a move in May after a burst of softer data. Expectations that the BOE might hike in May have diminished considerably with the market pushing out possibility of next rate rise to August.

Japan

- Minor scandals continue to affect Prime Minister Shinzo Abe and raises serious questions about his survival. However, the economic reform agenda seems to have run out of steam, while the recent reappointment of Bank of Japan (BOJ) Governor Haruhiko Kuroda should ensure monetary policy continuity. As such it is hard to see a big impact on economic policy if Abe were to step down.

- The economy remains in good condition. Labour market tightness is extreme and is forcing companies into productivity-enhancing changes, as well as raising incentives for capital spending. Core inflation is starting to edge higher, but it is a slow process as expectations have become entrenched after such a long period of deflation. The BOJ's 2 per cent inflation target is still far in the distance and Japan seems likely to be the last central bank to emerge from current extreme monetary policy settings.

China

- Despite a strong start to the year that produced 6.8 per cent growth in 1Q 2018, policy-makers are clearly concerned about being the main target of U.S. trade policy. Reduced access to the U.S. market and to U.S. technology will hurt Chinese growth, although it is still hard to see how disruptive the barriers will be, considering the scope for negotiation. Nevertheless, we have to recognise that U.S. policy has fundamentally changed and this will involve some degree of damage to China. Concern about the hit from U.S. trade barriers might be behind signs that domestic policy is becoming slightly looser.

Emerging markets

- So far emerging markets have been resilient in the face of U.S. monetary tightening. In part this probably reflects the fact that policy settings across developed markets are still relatively loose, but it is also a testament to economic reforms in several emerging markets of recent years as well as improved current account positions. On balance, higher commodity prices help emerging markets.

HONG KONG / CHINA MARKET OUTLOOK

Underperformed despite solid earnings

MSCI China ended flat in April and underperformed the regional markets modestly on the back of rising trade frictions. This is despite solid earnings growth of 22 per cent in 2017 and a steady economic growth outlook.

- MSCI China ended flat in April, and underperformed regional markets modestly by 70bps, on the back of rising trade friction. This is despite solid earnings growth of 22% in 2017 and a steady economic growth outlook. Sectors potentially more vulnerable to trade disputes, such as Technology and Consumer Discretionary, suffered more. On the contrary, Consumer Staples, Energy and Materials outperformed. MSCI China is trading at 12.5 times 12-month forward price earnings ratio, with a forecasted earnings growth of 16-17 per cent, which we view as attractive.

- Our base case assumes no full-blown trade war, and that both countries would eventually reach a deal after negotiations, although talks could be protracted. There have been several key developments undertaken by the Chinese government, including the cut in reserve requirement ratio (RRR) by 100bps for most banks and further opening up of the Financial and Auto sectors. The RRR cut should lower the funding costs for Chinese banks and ease market concern on potential over-tightening risk. In the Auto sector, China will lower foreign ownership restrictions for joint ventures (JV) over time. We see limited near-term earnings impact with JV agreements expiring from 2027 the earliest. Following the significant share price correction from recent peak, value is emerging here.

- At the recent Politburo economic work meeting, there was particular emphasis on “consistently expand domestic demand’, alongside “structural adjustment” and “supply side reforms”. We believe it will lend further support to domestic consumption-related sectors. The education and Macau gaming are also more immune from a longer-than-expected drag in trade spats. With only 4per cent of total revenue from export sales, there should be immaterial impact on earnings even if trade tensions escalate. We maintain our cautious stance towards the IT hardware sector given the uncertainties and volatilities from ongoing trade tensions.

- In HK, the most notable issue is the widening of the LIBOR-HIBOR spread. The spread has narrowed recently from its historical peak over the past decade of 100bps+ to about 70bps and 90bps for 1-month and 3-month, respectively. The Utilities sector tends to underperform when HIBOR is on the rise. Valuation has become less attractive given rising rates.

EQUITIES

SEAN QUEK
Head Equity Research, Bank of Singapore

Supportive backdrop

"The economic and corporate earnings outlook remains solid. Valuations are less demanding after the pullback, but markets would struggle to retest recent peak earnings multiples given rising interest rates"

- Emerging signs that trade war tensions are easing gave the markets some reprieve in April, even as concerns about higher rates again weighed on investor sentiment. Talks that the Trump administration is to negotiate directly with China provided some respite. On the other hand, yields on U.S. 10-year Treasuries hitting 3 per cent for the first time since 2014 reignited concerns that higher rates would again unsettle financial markets. Also, volatility in crowded technology stocks refused to go away. It was chipmakers' turn to face selling pressure on potentially weaker-than-expected growth outlook.

- We maintain the view that robust global economic growth prospects and healthy corporate earnings outlook will continue to provide a supportive backdrop for equities. With growth staying solid, gradual rate hikes toward more neutral levels are unlikely to derail the positive stance. Valuations are also less demanding after the recent pullback although an incrementally less easy monetary environment means that market would struggle to re-test recent peak valuation multiples. Near-term, trade war threat and interest rate concerns continue to be key risks to derailing market momentum as well as the fundamental growth outlook. Further ahead, other major risks include the impending central banks' balance sheet unwinding. Overall, the unusually low volatility of 2017 is unlikely to resume. Therefore, investors should stay engaged but continue to be discerning and adopt a diversified portfolio approach.

United States

- Boosted by the impact of recent tax cuts and potential fiscal stimulus, the growth outlook for the U.S. remains upbeat. At the same time, this means that earnings expectations were getting much tougher to beat. Not surprisingly, U.S. equities struggled to outperform in April even as the latest earnings season started positively. Despite this, earnings revision has remained flat. Also reflecting the somewhat unforgiving expectations, chipmakers saw selling pressure in April. In addition to fears from the trade war impact, concerns that slower-than-expected smartphone demand would derail earnings growth led to the rout. Overall, the growth outlook remains solid but the high expectations, continues to be challenge. We maintain a neutral stance on U.S. equities.

Eurozone

- European equities outperformed in April even as headline growth numbers started to moderate and the earnings season was muted. Coupled with the flat consensus earnings revision trend year-to-date, expectations remain relatively low. Fundamentally, we expect Europe to continue to catch-up with the rest of the developed world. Valuations remain less demanding versus developed market peers.

Japan

- Japanese equities had a relatively better month in April as selling pressure from foreign investors appeared to have eased. The weak start to the earnings season did not help though. As we progress through the fiscal year earnings season in the coming weeks, corporate guidance on earnings, share buybacks, dividends and medium-term plans will remain the focus. Relative valuations are now least demanding versus Developed Market peers but a sustained re-rating of the market would require more meaningful structural reform to boost overall growth. We stay underweight and continue to see Japan as a bottom-up stock picking market for now.

Asia ex-Japan

- Asia ex-Japan has not done well so far this year because of some concerns about the region's growth prospect. Taiwan and the Philippines were the biggest losers. Singapore and India led the winners. Given its exposure to U.S. trade and technology, Taiwan succumbed to selling pressure in April. On the other hand, Singapore benefited from a positive consensus earnings upgrade trend. Although tensions seem to have eased, the trade war threat between China and the U.S. remains the key risk that could derail the bullish momentum. Looking ahead, the potential impact of the unprecedented global central bank unwinding of monetary stimulus remains a key risk, especially for smaller Asian markets.

Singapore

- Singapore equities led the region in April. While higher interest rates and trade tensions hogged the headlines, Singapore's cabinet revamp was also closely watched for indications of future leadership on the local front.
- Despite the current U.S.-China trade tensions, strong gains for the three banking stocks helped to lift the MSCI Singapore Index above its January high. Based on the current level, the MSCI Singapore Index is trading at 13.3 times FY18 earnings and 11.9 times FY19 earnings and lower than the recent average of about 14 times earnings. Price to book is at 1.3 times and dividend yield is at around 4 per cent.
- We estimate that the current proposed tariffs on Chinese and U.S. goods will have minimal impact on Singapore listed companies.

BONDS

Johan Jooste
Chief Investment Officer, Bank of Singapore

Yields heading higher

"The rise in bond yields is manageable as long as the move is not too fast. Nevertheless, higher bond yields can contribute to downward price pressure on bond markets and we remain underweight on investment grade bonds."

- This year has already provided a good example of what we can expect for the rest of 2018 and 2019, with periods of sharply rising bond yields followed by consolidation. Nevertheless this should not distract from the basic trend of rising bond yields in response to the maturing global economic cycle which will put growing pressure on inflation and, in turn, push central banks to tighten policy.

Fed should continue with slow pace of interest rate hikes

- The U.S. is furthest along the path of monetary policy normalisation, but most other developed economies are heading in the same direction. As we saw in the U.S. a few years back, the first steps towards policy tightening are very tentative and easily delayed by a patch of softer data, as we are seeing at the moment.

- Tightening in the U.S. is much more advanced, with six rate hikes and the start of unwinding the balance sheet expansion. So far, this has not been disruptive and the Fed is likely to see the need to continue to push rates higher gradually, with inflation back at target and unemployment nearly at 4 per cent. The Fed seems unconcerned about a moderate inflation overshoot, hinting at a payback after several years of undershoot.

- We expect three more rate hikes in 2018 with the probability of four more next year as the economy shows increasing signs of overheating. The Fed will eventually need to push rates past neutral levels of 2.5 to 3 per cent in order to cool down growth.

Should you worry about rising U.S. Treasury yields?

- Despite weak public finances and unstable politics, Italian debt yields are a per cent less than U.S. Treasuries, while any move away from zero in Japan is likely to be a slow process. The implicit attractiveness of U.S. debt to foreign investors should limit the scale of any sell-off and supports our 12-month target of 3.3 per cent for 10-year U.S. Treasuries yield. However, a continued rise in rates would be enough to generate poor returns on investment grade bonds, so we remain underweight on this segment of the bond market. Also, while the increase in U.S. Treasury yields should be gradual, it can contribute to some near-term equity market volatility and downward price pressure on bond markets as well.

Underweight duration and stay neutral High Yield bonds

- Generally, shorter duration bonds tend to be less adversely impacted compared to their longer maturity counterparts. For this reason, we remain underweight duration, in order to moderate the impact of higher interest rates on bond performance.

- Given the prospect of the move up in rates, we maintain our neutral rating on High Yield bonds, where credit spreads should provide some off-set to the adverse move in rates.

FX & COMMODITIES

VASU MENON
Senior Investment Strategist, Wealth Management Singapore, OCBC Bank

Will the U.S. Dollar head higher?

"The U.S. Dollar was well supported in April after U.S. 10-year Treasury yields rose above 3 per cent but looking ahead, the resilience of the U.S. Dollar depends on several factors and is not a given."

Oil

- The supply-side reaction to the prospect of more profitable production should limit the scale of the rise in oil prices, unless the geopolitical situation deteriorates significantly. In the longer term, we doubt the durability of the OPEC-led supply constraints. As a result of the supply response, we doubt recent price levels can be sustained, and see WTI at US$60/barrel over the coming year, with Brent at US$65/barrel in 12 months.

Gold

- We retain the view that gold is poised to hover between US$1,200 to US$1,380 per ounce, as the tug-of-war between bearish and bullish factors calls for neither an exceptional rally nor an aggressive sell-off. We struggle to see convincing catalysts for a rally above US$1,380 per ounce given a broadly positive global macro backdrop. On the other hand, an aggressive sell-off is unlikely as high U.S. government debt will pose a threat and only inflation can help resolve that problem.

Currency outlook

- The U.S. Dollar was well supported in April after U.S. 10-year Treasury yields rose above 3 per cent. Looking ahead, the resilience of the U.S. Dollar depends on several factors.

- If U.S. 10-year yields stay in the 2.95 to 3.05 per cent range, this may continue to support the U.S. Dollar. However, if it falls below 2.95 per cent, expect the recent U.S. Dollar rally to fizzle out and the greenback could retrace.

- Elsewhere, the ECB and the BOJ remained fairly confident of their growth and inflation outlook in April and this view may be increasingly echoed by other major central banks. Specifically, central bank rhetoric at this juncture seems to be downplaying the recent deceleration in economic momentum while focusing on the prospect of an eventual attainment of inflation targets in the medium term. If the accompanying rhetoric from non-U.S. central banks is not unduly accommodative, rate differential may not work in favour of the U.S. Dollar, which could cause the greenback to weaken.

- If trade tensions re-occur, expect the U.S. Dollar to weaken against the likes of the Euro and the Pound, while prospects for the Yen and the cyclicals/Emerging Market currencies will depend on the resultant impact on global risk appetite levels.

- On technical grounds, the U.S. Dollar index (DXY) may need to surmount the 92 level to keep the greenback afloat. However, base building behaviour within the 91 to 92 levels should suffice to provide the U.S. Dollar with support for now. Any failure to stay in this range or breakout of it on the downside could also weigh on the greenback.

- Despite the moderation of net inflows into Asia in recent weeks, the Singapore Dollar may continue to outperform the Euro, the Pound, and the Australian Dollar in the near term. Again, note that the relative outperformance of Asian currencies (including the Singapore Dollar) has been supported by better risk appetite levels; and another spike in risk aversion could well see sentiment towards Emerging Market and Asia currencies unravel rapidly.

SPECIALS

CARIE LI
Economist, Treasury Research, Treasury Division, OCBC Wing Hang

No More Soros Only Carry Trade

"After HKD touched the weak end of the band, the Hong Kong Monetary Authority (HKMA) bought HKD consecutively and reduced the aggregate balance by about 30 per cent. This pushed the 3-month HIBOR to a nine-year high. The month-end effect and worry over tighter liquidity helped tame carry trade activities and allowed the HKD to rebound. Nevertheless, the HKD may retreat again. This round of HKD weakness is different from the past as the main driver has been carry trade activities. The lack of external speculative pressure means that the size of short HKD positions could remain relatively small. In this case, the HKMA need only passively buy HKD rather than proactively guide interest rates higher. We expect aggregate balance to reduce gradually and HIBOR to edge up moderately. As such, the housing market is unlikely to take a hard hit."

- After HKD touched the weak end of the trading band for the first time since 2005 on April 12, the HKMA bought HKD consecutively to defend the currency peg system. This reduced the aggregate balance to HK$128.5 billion and pushed the HIBOR curve upwards, with 3-month HIBOR reaching its nine-year high.

- Given a 28.5 per cent reduction in aggregate balance, the month-end effect and IPO, concerns about a tighter liquidity condition propelled short HKD traders to take profit in advance. This in turn strengthened the HKD. As the USD/HKD stayed below 7.85, the HKMA may take a breather at this juncture.

- Nevertheless, after month-end balancing, the USD/HKD may tick up again towards 7.85 and prompt renewed intervention by the HKMA. On a positive note, this round of HKD weakness is different from the past as the main driver has been carry trade activities. The lack of external speculative pressure means that the size of short HKD positions could remain relatively small. In this case, the HKMA will only need to passively buy HKD rather than proactively guide interest rates higher.

- Till mid-2018, 1) a further reduction in aggregate balance, 2) dividend payment flows, 3) potential large IPOs, 4) quarter-end effect and 5) possible June rate hike by the Fed could all serve to push up HIBOR gradually and narrow its gap with its U.S. counterpart. As a result, short HKD traders may become more cautious and allow HKD to rally again. We believe that aggregate balance will reduce gradually and stabilize between HK$80 billion and HK$100 billion before mid-2018.

- After mid-2018, a further reduction in aggregate balance is possible, should more U.S. treasury bond issuance and Fed's faster tightening cause LIBOR's increase to reaccelerate and the interest rate gap to widen. Still, strong fundamentals, including sizeable foreign exchange reserve assets and twin surpluses, will allow the HKMA to maintain the linked exchange rate system well.

- All in all, we believe that carry trade activities will reduce substantially when aggregate balance reduces further to around HK$50 billion and the yield differential narrows to about 50bps. As such, USD/HKD will likely retreat to 7.83 by end of this year. In terms of local interest rates, HIBOR is expected to edge up moderately. As such, the housing market is unlikely to take a hard hit.

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