Quarterly Investment Strategy
Fourth Quarter 2018

Markets in two minds

UOB Asset Management

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Investment Strategy

We have been overweight on global equities throughout 2018 relative to fixed income even as a bullish sentiment eluded the markets. The reason for this is that the world index was driven by the US market while most other markets have underperformed the global benchmark since year-to-date.

Despite the strong fundamentals supporting the market, a bearish sentiment is weighing. Global gross domestic product (GDP) growth is above trend for 2018 and is as strong as it was in 2017. Additionally, corporate earnings growth is even stronger in 2018 compared to 2017. However, offsetting the strong market fundaments are a growing number of risks. Investors are concerned about the ageing cycle, the pressures on emerging markets (EM), trade tensions, inflation and rate risks, European politics, Iran sanctions, rising oil prices, etc.

The key call for the last quarter of 2018 is to determine which factor will ultimately get the upper hand by the end of the year – strong macro fundamentals or the growing anxiety over risk issues. Our view is that strong fundamentals will be supportive of healthy market performance. This implies that equities should continue to outperform and in an increasingly broad-based manner. Fixed income should provide positive returns through the end of the year while continuing to face headwinds from rising rates.

We continue to overweight equities, underweight fixed income, neutralise commodities, overweight alternatives and underweight cash.

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Global Asset Allocation

Sector Allocation	View	Notes
Equities	+	**Rationale:** Global GDP growth and global corporate earnings growth remain a strong fundamental pillar of support for global equities. **Risks:** Trade wars, European politics (Italy), late stage growth, and inflation could rise and trigger more rate hikes
Fixed Income	-	**Rationale:** Stronger growth leads to rising rates which will be a headwind for fixed income performance. **Risks:** Bond yield moves have already been priced in, if growth disappoints, bonds could be a surprise winner.
Commodities	■	**Rationale:** Mixed performance trends in commodities – energy is still strong, however slowing demand in China has moderated metal pricing trends. **Risks:** China's growth could slow more than expected.
Alternatives	+	**Rationale:** Equity and fixed income trends have been lacklustre which give alternatives to achieve returns on lower volatility. **Risks:** Extreme market volatility and market movements outside of individual company performance.
Cash	-	**Rationale:** We expect equity, fixed income and alternatives to all be able to achieve positive returns over the coming quarter and year at levels higher than cash rates. **Risks:** Cash rates are rising and market weakness could make it more attractive to overweight cash at some point.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Summary

It is rare for macro fundamentals to be solid alongside markets that feel bearish. Often, above-trend growth and double-digit earnings expansion would lead to a bullish year for markets. Enter 2018, and markets are caught with a mix of risk issues. This includes the ageing cycle, EM challenges, trade tensions, risks of rising inflation and rates, European politics, etc. The question remains as to which issue will prevail through the end of the year. The strong fundamentals could lead to better sentiment while prevailing risks could also drag on growth and the markets. We lean toward the former and believe fears tend to fade over time. The fundamentals still remain and history has taught us this has been a more reliable driver of market trends.

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Global Investment Strategy

Markets in two minds

So far for 2018, it has been a challenging time to articulate clear investment strategies with all asset classes being volatile. However, we continue to point out that the fundamentals for global equities remain attractive. We would also argue that the macro fundamentals for emerging markets are fairly strong. Our equity scorecards that monitor typical drivers of equity performance continues to look healthy. Leading indicators, absolute GDP growth, earnings growth, fund flows and fiscal policy all remain positive supporters of the scorecard. Valuations had previously been a negative but we have shifted valuations to neutral. As we enter the fourth quarter of 2018, global GDP growth expectations remain as high as in 2017.

The key concerns in global markets and in particular EM have largely revolved around political risks and interest rate policy divergence risks. One of the biggest geopolitical risks in 2018 has been global trade policies. While we calculate the direct effects of new trade tariffs from the US to be only slightly negative, we estimate that US$250 billion in products with new tariffs would reduce China's GDP growth by 0.4% from the consensus target of 6.6%, the threats of new tariffs create uncertainties for markets. Additionally, while the US Federal Reserve (Fed) has raised rates, the European Central Bank (ECB) and Bank of Japan (BoJ) have kept rates low, which has led to a stronger US dollar, that has historically been a headwind to emerging markets. Moreover, the US has embarked on substantial fiscal stimulus in the form of tax cuts and spending increases at the peak of the cycle. This has the effect of putting additional pressure to raise rates and thus further reinforcing global rate divergences. Historically, a strong US economy has supported growth throughout global markets, but in this cycle that has been somewhat muted in the face of trade tensions that make it more complicated for global markets to benefit from strong US growth.

> "Global equities have been held up almost entirely by the US. The divergence with other markets is rare – so will the US pull other global markets up, or will global risks drag the US down?"

While equities remain supported by above-trend growth and strong earnings growth, fixed income markets continue to face headwinds from rising interest rates. So far the US and global inflation remain in check but as the economy grows and employment in the US remains "full", the risks of rising inflation will grow in a late cycle environment. Additionally, fixed income markets saw rising credit spreads which have lowered 2018 returns. Since year-to-date, US investment grade credit spreads have widened by 15 to 20 basis points and Asia credit spreads have widened by 20 to 30 basis points. The pressures on fixed income funds have come equally from rising rates and widening spreads. Going forward, our view is that rates will continue to rise at a modest pace and spreads will stabilise, and potentially tighten which would be more in line with later market performance. While many fixed income strategies made moderate losses in the first three quarters of the year, fixed income returns appeared to be turning modestly positive and we would expect more positive returns moving forward.

There are a number of potential risks that could disrupt market performance. It appears that deals between China and the US will be harder to negotiate and the risks of disruptive trade policies are increasing. Italian politics is another issue that could trigger volatility in 4Q18 as the new leadership increasingly adopts budget policies that are at odds with Eurozone targets. US midterm elections could increase uncertainties in US policies. Brexit negotiations could break down and lead to a more disruptive exit without new trade and other policy agreements. While the number of risk issues is substantial, we recommend continuing to invest on a positive base case and monitor the risks of potential escalation.

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US Equity

Country Allocation	View	Notes
US	+	**Rationale:** US economic and corporate earnings growth continues to accelerate. **Risks:** Inflation could surprise on the upside with low unemployment and trigger fears that the Fed is behind the curve on monetary policy.

Summary

While investors may at some stage look to rotate to other regions that have lagged in performance, as of the start of 4Q18 we still would prefer US equities over other regions.

Europe Equity

Country Allocation	View	Notes
Europe Equity	–	**Rationale:** European economic growth has declined compared to 2017. Corporate earnings growth estimates are tracking at about 8% which is a little below most other regions. There are also increased political risks in Europe for 4Q18, and the slowing of accommodative policies from the ECB. **Risks:** Italian politics may get messy and increasingly hostile to the European Union. Additionally, Brexit negotiations are in their final stages which could result in increased uncertainties.

Summary

While growth is still healthy in Europe, we see better leading indicators and corporate earnings improvement in the US and Japan. European corporate profits have not recovered from the crisis in 2008 and we continue to look for signs of a strong profit recovery before weighting European equities higher. While political risks have abated, the lack of consensus in Italy will restrain much needed reforms.

Japan

Country Allocation	View	Notes
Japan Equity	–	**Rationale:** We see both signs of strong domestic economic trends with risks of weakening exports. The US may start to target its trade deficit with Japan. Corporate profit growth is lagging other regions and it is increasingly likely the BoJ slows its accommodative policies or even starts to raise interest rates in 2019. **Risks:** Structural issues such as demographic trends remain an overhang on the country.

Summary

Relative to the US, Japan corporate profit growth is slower and the economy is seeing better evidence of reflationary trends that could lead to a slowing of accommodative monetary policies.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

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Asia Ex-Japan Equity

Country Allocation	View	Notes
China	■	**Rationale:** Economic growth for 2H18 is decelerating. Compelling valuations, particularly 'A' shares means China could mitigate the trade fall-out with pro-active monetary and fiscal policies. **Risks:** Escalation to a full-blown US-China economic war beyond trade or a pronounced growth slowdown.
Hong Kong	+	**Rationale:** Continued strong demand and supply fundamentals in the property sector despite rising rates. Macau gaming sector growth continues. **Risks:** Political interference from China, any sharp spike in US rates or the Hong Kong Inter-bank Offered Rate (HIBOR).
India	■	**Rationale:** Accelerating domestic growth recovery post-demonetisation and overhang from the goods and services tax. Earnings per share revisions have bottomed out. Private investment and household consumption growth are expected to accelerate on back of fiscal expansion. Strong domestic liquidity is supporting the market. **Risks:** The rupee could weaken if oil prices or the USD strengthens, or if foreign fund flows turn negative. Valuations are still expensive.
Indonesia	■	**Rationale:** Valuations are cheap relative to historical averages. Reversal of USD strength and funds returning to EM. While ongoing inflation concerns remain, a decisive monetary tightening policy has stabilised rupiah weakness. GDP growth is expected to improve with pre-election populist policies to spur higher private & public investment spending. **Risks:** Sharp slowdown in domestic economy post rate hikes and/or currency weakness.
Malaysia	-	**Rationale:** Slowing economic growth backdrop. Robust domestic consumption likely to be supported by additional fiscal stimulus. GDP growth outlook is relatively unexciting due to slashed government expenditures (deferment of mega infrastructure projects) and slower electronics export momentum alongside weaker global growth. **Risks:** Sharp spikes in oil prices could strengthen the ringgit and lend a boost to the market.
Philippines	-	**Rationale:** Risk of further monetary tightening given rising inflation risks on back of higher oil prices, secondary impact from tax reforms and robust domestic demand. The widening current account deficit is likely to weigh on the Philippine peso. **Risks:** Continued healthy domestic demand. A reversal in USD strength could support the currency and the market.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Country Allocation	View	Notes
Singapore	+	**Rationale:** Stronger than expected economic growth and a positive beat in earnings outlook could support further market upside. **Risks:** Slowdown in 2H18 GDP growth due to US-China trade war. Continued overhang from recent tightening policies on the property market.
South Korea	■	**Rationale:** Stock market performance impeded by pessimism on earnings outlook of several large index stocks. However, semiconductors and other computing parts continue to see upward earnings revision. Valuations remain attractive and are likely to support performance as earnings recover. **Risks:** Collapse in memory chip prices, weak capital expenditure investment spending due to increased global trade tensions, subdued private consumption due to delays in fiscal spending.
Taiwan	-	**Rationale:** Downward earnings revisions. Further downside risks if handset sales disappoint. Vulnerable to potential supply-chain disruption from increased US-China trade tensions. **Risks:** Stronger than expected recovery in smartphone production.
Thailand	■	**Rationale:** Sustained strong external demand driven by exports and public investment. Acceleration in domestic demand could support GDP growth upgrades, whilst inflation remains benign and current account surplus is in a strong position. **Risks:** Market valuations on the high side. Adverse slowdown in regional exports, further delays in government infrastructure investments.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Summary

Asian markets continue to be impeded by a capital flight from the broader EM, US dollar strength and US-China trade tensions. Despite this, the earnings momentum in Asia remains steady, notwithstanding some areas of weakness (e.g. China technology). The valuations now are attractive as they trade below their 18-year historical mean (on price-to-earnings and price-to-book ratios), while the discount to global markets has widened to 28%.

Nonetheless, the increased uncertainties on Asia's growth outlook as a result of the impending US-China trade war warrant a more cautious stance. In the current market environment, we favour defensive growth sectors, where we have high conviction on earnings at inexpensive valuations.

We maintain our preference for North Asia over Southeast Asia, with a bias towards Hong Kong given its relatively defensive qualities of a stable currency, current account surplus, strong fiscal position and companies with strong balance sheets. Within Southeast Asia, Singapore is similarly better positioned to weather the current market volatility. The key upside risks to our view include a reversal in US dollar strength, driving inflows to EM, including Asia and effective China policy easing which buffers the trade war impact.

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Global Fixed Income Strategy

Sector Allocation	View	Notes
Developed Market (DM)	–	**Rationale:** DM central bank rhetoric is increasingly hawkish and we expect bond prices to stay weighed down in the coming quarter. **Risks:** The global political environment remains volatile and various idiosyncratic risks have the potential to disrupt the financial markets.
DM Government	–	**Rationale:** Yields in Europe/Japan should head higher as the path to normalisation has been paved. Yields should stay supported in the US as the Fed continues to hike rates. **Risks:** Trade or geopolitical risks could see an increased demand for DM bonds.
DM Credit	–	**Rationale:** We remain positive on corporate credits for carry against a supportive macro backdrop. **Risks:** Rate shocks and geopolitical tensions may trigger credit spreads to widen.
Emerging Market (EM)	■	**Rationale:** Pressure points such as Turkey, Argentina and weakening EM currencies are likely to keep risk appetite at bay. The case for differentiation in EM still exists, however, the period of volatility has yet to pass. Fundamentals of sovereigns with stronger balance sheets will eventually re-assert themselves leading to modest spread tightening, potentially with confirmation of improving data, rates and foreign exchange (FX) volatility normalising. Valuations have cheapened in hard currency with their fair value providing buffers, and are attractive compared to US high yield. **Risks:** Pace of US monetary tightening and protectionist measures, rapid FX depreciation, deleveraging in China, inflation surprises, and geopolitical risks.
EM Government	■	**Rationale:** Generally a more balanced policy tone emanating from EM. With the exception of Turkey, most countries have deployed both monetary tools (currency depreciation, rates) and fiscal tools (subsidy cuts, value-added-taxes) to improve their imbalances. **Risks:** Sensitivity to sharp commodity price declines and/or sharply higher USD funding costs and rapid FX depreciation. Risks such as an escalating trade war would particularly impact manufacturing exporters negatively.
EM Corporate	■	**Rationale:** EM corporate fundamentals showed improvement with defaults running at historic lows, and leverage stabilising. Overall, EM corporate credit is trading fair to EM sovereigns and quasi-sovereigns. **Risks:** Protectionist US trade policies, EM political risks, geopolitical risks. A potential recovery in the capital expenditure or mergers and acquisitions cycle would be cash flow negative.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

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Sector Allocation	View	Notes
EM Local Currency	–	**Rationale:** We are defensive due to continuing trade tensions and concerns about EM contagion, though return dispersion among countries should still be evident. Trade dependent and/or high current account deficit economies will warrant more caution. EM local currency debt valuations are less compelling against EM hard currency counterparts. **Risks:** Trade frictions are unpredictable and could take a sudden turn for the better or worse. Flexibility would be paramount.
Duration	■	**Rationale:** Long end yields should stay relatively anchored in the US compared to Europe and Japan with more upside. **Risks:** We expect long end yields to gradually move higher in Europe and Japan. However, yields could spike higher should a sharp inflation shock occur.
Yield Curve	■	**Rationale:** A flattening yield curve in the US would be counterbalanced by steepening yield curves in Europe and Japan. **Risks:** We see curve flattening as structural in the US. However, yield curves in Europe and Japan could steepen more than expected if the respective central banks adopt a much faster pace of normalisation.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Summary

The main drivers of financial markets in Q4 would be politics rather than monetary policy. The issues range from US midterm elections, trade wars, investigations with White House staff, Brexit overhangs and Italian elections. As these events continue, volatility will remain elevated, and the investment calls will almost be a binary decision. Hence it is best to remain tactical and flexible.

Across the developed markets, the shape of the yield curve is likely to be vastly different. The yield curve should flatten in the US, while it is expected to steepen in Europe and Japan. Meanwhile, credit spreads have widened particularly in the high yield space.

As global financial conditions tightened and the US dollar appreciated, poor fundamentals, such as excessive reliance on US dollar debt in a limited number of countries played a role in revealing vulnerable areas in the EM. The main question facing EM investors now is the extent to which illiquidity combined with poor technicals increases the pain for EM economies and asset prices, thereby further weakening EM sentiment. Although EM assets will face headwinds, differentiation is manifesting across the markets and risks of contagion remains low.

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Regional Allocation	View	Notes
Latin America	■	**Rationale:** External conditions have become less favourable for Latin America because the recent USD strength has discouraged capital flows into the region and tightened domestic financial conditions. Domestic political uncertainty has amplified the negative impact of less favourable external conditions on several economies in the region, such as Argentina and Brazil. Valuations in the region remain attractive, on a relative basis. **Risks:** Upcoming presidential elections in Brazil could see a return of the Workers' Party and reform fatigue. Potential unrest in countries implementing fiscal adjustments could sour reform momentum. Any failure to the North American Free Trade Agreements (NAFTA) negotiations will weigh as a risk for Mexico.
CIS/EE*	■	**Rationale:** In Russia, we see macroeconomic impact of US sanctions and the resulting market reaction as limited, with risks mitigated by Russia's low external vulnerability. In Turkey, a growth-friendly policy mix, and the status-quo creates policy uncertainty given the executive presidency system, including weakening of the central bank's independence, keeping the country susceptible to weaker external pressures. In Poland, growth is likely to moderate as household consumption normalises after a period of strong growth. **Risks:** Increasing congressional pressure by the US to impose additional sanctions on Russia, in the run-up towards US midterm elections. Weaker macro and political stability in Turkey could lead to further downgrades.
Middle East/Africa	■	**Rationale:** Economic conditions in the Africa region will likely continue to show modest improvement, supported by improving or broadly stabilising prices across key export commodities as well as easing drought conditions. Meanwhile, in the Middle East, we do not expect serious repercussions from the re-imposition of sanctions against Iran by the US due to the relatively limited financial and trade ties between Iran and the rest of the region. **Risks:** Weakening oil prices would adversely impact fiscal budgets. However Middle Eastern sovereigns have the lowest debt to GDP ratios and strong access to capital markets.
Asia	+	**Rationale:** Favourable growth from both macro and corporate levels remain positive for credit assets. Attractive bond valuations alongside an explicit easing stance from Chinese authorities will keep investors' appetite supported. Issuers are likely to pace new issuances so as to achieve a smooth refinancing pipeline. **Risks:** Any sharp escalation of global trade tussles may lead to an increase in corporate funding costs and undue pressures on certain industries. Further weaknesses in Asian currencies will add to woes.
Singapore	+	**Rationale:** Growth has remained resilient in the face of global headwinds, with core inflation ticking higher towards the upper end of the forecasted 1-2% range. **Risks:** Though Singapore has turned out to be a relatively safe haven in the region, an escalation of trade risks could yet derail the economy.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

* Commonwealth of Independent States and Central and Eastern Europe

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Currencies

FX Allocation	View	Notes
US Dollar **US$**	-	**Rationale:** We expect USD strength to have peaked in 2018, and limited room for further strength from current highs. **Risks:** The global political environment remains volatile and various idiosyncratic risks have the potential to disrupt the financial markets.
Euro **€**	+	**Rationale:** ECB would start to normalise policy in 2019 and we expect bids to enter the market well in advance. **Risks:** Political concerns could yet intensify due to an antagonistic Italian government and potential populistic policies.
Japanese Yen **¥**	+	**Rationale:** The BoJ has taken steps in normalising ultra-accommodative monetary policy and we expect this to be bullish for the JPY for the foreseeable future. **Risks:** A huge surge in risk appetite could see low yielding currencies such as the JPY liquidated in favour of high yielders.
Singapore Dollar **S$**	++	**Rationale:** SGD should outperform as the safe haven amongst EM currencies. Also, we expect the Monetary Authority of Singapore to raise the slope of the nominal effective exchange rate (NEER). **Risks:** MAS could err on the side of caution due to trade war risks and refrain from tightening policy in October.
China Renminbi **CNY**	■	**Rationale:** China's central bank is unlikely to allow USDCNY to rise above the psychologically important level of 7.00. On the other hand, trade war tensions mean chances for a sustained rebound are low. **Risks:** An all-out trade war would see the CNY depreciate further.

Maximum Overweight: ++   Slight Overweight: +   Neutral: ■   Slight Underweight: -   Maximum Underweight: --

Summary

The closer we get towards 2019, chances of the US dollar weakening gets higher as the US Treasury yield curve structurally flattens. As for the Euro, we are bullish on the currency as appreciation should be seen ahead of normalisation in 2019. However, political concerns out of Italy could yet throw a spanner into the works. The Japanese Yen should rise alongside Japanese government bond (JGB) yields.

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Commodities

Sector Allocation	View	Notes
Commodities	■	**Rationale:** Late cycle expansions could lead to healthy pricing for commodities, however, we see more headwinds. **Risks:** Further US interest rate increases could derail global growth and strengthen the USD which is negative for commodities. More protectionism or slowing economic activity in China would negatively impact demand in 4Q18.
Gold	+	**Rationale:** 4Q18 is likely to be a better environment for gold as inflation is picking up and that the gains in the USD may have peaked. **Risks:** The bullion is also vulnerable to upward moves in the USD. Non-inflationary growth and higher real interest rates would be negative for gold, which does not pay interest. Physical gold prices are also negatively correlated with the USD.
Base Metals	■	**Rationale:** Moderating China growth appears to be slowing momentum for base metals. Copper prices have declined but other metals such as iron ore have started to pick up. Better growth data from China is needed before raising metals to an overweight. **Risks:** Weaker demand as a result of slowing economic growth, particularly from China. Elevated speculation in futures markets. Country-specific risks on taxation and ownership remain a concern.
Bulk Commodities	■	**Rationale:** Chinese government supply-side reforms from 2017 and early 2018. **Risks:** Winter production cuts and seasonal strong demand is slated to whittle demand down, alongside a slowdown in China's domestic property market.
Energy	■	**Rationale:** US sanctions on Iran pose a threat to supply. Organisation of the Petroleum Exporting Countries (OPEC) supply has remained steady and we think the main incremental supply is likely to come from North American shale operations. **Risks:** Strong increases in US onshore shale production, possible breakdown in OPEC production discipline, or an early end to OPEC supply cuts. High level of speculative positions.
Agriculture	-	**Rationale:** Agricultural prices are trading at historically low levels, and trade tensions have hurt the thin profitability of many of the agricultural markets. **Risks:** Weather conditions appear more stable in the US and other major agricultural areas, which has the effect of depressing prices.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Summary

Global economic growth remains in expansionary territory, with global industrial production and purchasing managers' index (PMI) data supporting continued demand strength. Chinese demand is moderating and trade tensions are putting export commodities in jeopardy. Overall, we remain neutral on commodities until we see better price momentum.

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Alternatives

Sector Allocation	View	Notes
Hedge Funds	+	**Rationale:** Tightening liquidity conditions are hurting global growth and markets highly sensitive to any shocks. Trade war concerns and Chinese government policies also add to volatility and risk aversion. This may benefit absolute return strategies which are able to adjust their levels of exposures and fundamental focused ones that are hedged. **Risks:** Asset markets may rally due to the resolution of trade issues, strong corporate fundamentals and increasingly attractive valuations. This may lessen the attractiveness of hedged strategies.
Private Equity	+	**Rationale:** Superior return opportunities at reduced volatility makes private equity an attractive opportunity in the current volatile environment. Venture capital, private debt, big buyout and secondary funds continue to attract significant funding. **Risks:** Valuations are far from cheap in many areas after a prolonged period of inflows amid abundant liquidity.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Summary

Alternative investments are seeing a boon, as investors look for protection and returns, triggered by rising interest rates, a volatile environment and elevated valuations in the equity and fixed income asset classes.

Hedge funds have proven to be able to provide protection in periods of volatility in Asia while private equity continues to provide access to high growth businesses, superior yields and returns from active operational restructuring and improvements.

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