Quarterly Investment Strategy
Third Quarter 2015

A MID-CYCLE TEST

ASSET ALLOCATION

Remain Neutral Equities after downgrade in April, Neutral Fixed Income and Commodities

EQUITY

Remain Neutral Developed Markets and Emerging Markets with continued bias towards the US and Asia

FIXED INCOME

Remain Underweight Developed Markets and Overweight Emerging Markets with Equal Weight in all EM regions

COMMODITIES

Overall Commodities raised to Neutral with upgrade in Bulk Commodities to Slight Underweight, stay Neutral Agriculture and Energy, Overweight Base Metals and Gold

UOB Asset Management 大華資産管理

As one of the thought leaders in asset management, UOBAM regularly produces topical investment research articles and publications to help our clients stay on top of financial market developments.

Webcast – Asset Allocation Strategy for Q3 2015

In our quarterly webcast, Mr Tony Raza, Head of Multi Asset Strategy Unit, will share our asset allocation strategy, as well as discuss key issues driving developments in global markets.

View the webcast on the homepage of our website at uobam.com.sg.

INVESTMENT STRATEGY SUMMARY

After being "bullish" and overweight equities for over a year, we start the third quarter outlook with a more cautious "neutral" recommendation on the major asset classes of equities and fixed income. We have downgraded equities to neutral on 21 April 2015.

The more cautious view is based on the weaker US macroeconomic data trends, the potential risks from European politics (particularly Greece), caution over the expected near-term rate hikes in the United States and equity valuations that are increasingly expensive.

However, our allocation is not a "bearish" view. We still believe that the US economy will rebound from its soft patch and that global liquidity will remain supportive for risk assets, including equities. The key triggers that we are looking for in order to raise our equities weight again are improvements in data trends to prove that the weak US GDP data in the first quarter of 2015 was transitory, and greater clarity on the Greece debt negotiations.

For this quarter we are neutral on equities, fixed income, commodities and cash.

John Doyle
Chief Investment Officer
Equities & Multi-Assets

Chong Jiun Yeh
Chief Investment Officer
Fixed Income & Structured Investments

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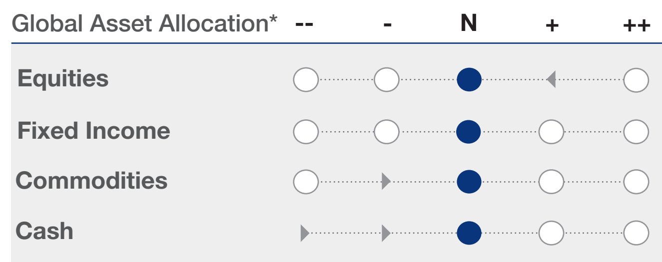
GLOBAL ASSET ALLOCATION SUMMARY

We maintain a neutral asset allocation for the third quarter of 2015, after downgrading equities from an overweight to neutral on 21 April 2015 (when we published an update report subsequent to the Second Quarter 2015 Quarterly Investment Strategy report). We downgraded equities due to weaker US economic data, political concerns in Europe, the more challenging combination of softening corporate profitability and earnings, and relatively rich valuations. While we are not bearish on the global macro environment, we view the increase in uncertainties warrants a more cautious investment approach in the coming quarter.



Notes:
*Three to six months horizon
The weights are relative to the respective benchmark(s).
'- -' denotes maximum underweight, '-' slight underweight, 'N' neutral, '+' slight overweight, '+ +' maximum overweight; arrows show change from last quarter.

Equities – Downgrade to Neutral

We maintain a base case expectation that over the longer term, equities will outperform through this period of the cycle. However, noting both macroeconomic "warning signs" and increasing pressures on corporate margins and profits, as well as relatively fair valuations, we have moderated our investment positioning over the quarter.

Fixed Income – Remain Neutral

While we had been concerned about a greater rotation of global investments from fixed income to equities, the reality is that fixed income markets continue to enjoy one of their longest cycles. We believe that inflation regimes ultimately determine asset class performance. We expect that given the continued low inflation environment accompanied by substantial global liquidity support, fixed income investments are likely to continue providing reasonable risk-adjusted returns. Hence, we maintain a neutral position in fixed income.

Commodities – Raise to Neutral

Most commodities continue to struggle. In a strong dollar environment associated with more moderate demand from China, renewed investment discipline should help to re-align supply and demand. However, the rebound in energy has proven that demand continues to exist. Other commodities could potentially be supported by China's "One Belt One Road" initiative to develop infrastructure across countries that would again raise demand for resources.

Cash – Raise to Neutral

During periods of higher risk, it is helpful to have cash on hand, especially for the potential of a modest equity correction that could represent a buying opportunity when the cash raised can be utilised.

Please refer to the last page for the important notice & disclaimer.

GLOBAL INVESTMENT STRATEGY
A MID-CYCLE TEST

We have maintained an overweight equity position for over a year but see justification for some reasonable caution in the near term. There is no evidence that the global macro trend is shifting to a downturn in our view. However, there are enough uncertainties in data trends to warrant near-term caution. Hence we view this as a "mid-cycle test" on the robustness of the economic recovery. Political events in Europe in general and Greece in particular have elevated market risks.

Investment Cycle and Inflation Regime Revisited

We have previously highlighted that the first step in our asset allocation assessment is to ascertain the global trends in inflation and the investment cycle. We have observed three major inflation regimes: 1) normal (or high) inflation, 2) deflation where prices decline, and 3) disinflation or very low and declining inflation.

1. If the inflation regime is normal (two per cent and above), we use a traditional investment clock framework in our investment allocation. As the global economy came out of recession in 2009, it stayed in a range of modest economic expansion with low levels of inflation. In a normal investment cycle, the later stages of the cycle will regularly see rising inflation. Thus our base case view is that the global cycle is still closer to the middle of the expansion phase than toward the end.

2. We have also warned that if inflation trends turn into deflation such as in Japan in the past two decades, then our asset allocation bias is to focus on fixed income as their real rates tend to outperform equities in an environment of low investment and excess savings.

3. The inflation environment of the past several years has not been either deflation or high inflation. Instead the inflation levels have been more consistent with a regime of low inflation with policy support such as quantitative easing (QE) to keep prices stable and rising. We note that in this regime we expect both equities and fixed income to perform well as the policy support boosts liquidity to keep asset prices high, while the low inflation regime makes both fixed income and equities less risky. Thus, our asset allocation recommendation for the past several quarters was to overweight on equities but not to be negative on fixed income which performs well on a risk-adjusted basis.

Over the past quarter, economic trends in Europe turned increasingly positive with signs that growth and inflation look to be normalising. At the same time, the US economy, which had appeared to be convincingly returning to "normal" growth and inflation trends, suffered a setback as GDP declined in the first quarter of 2015 (1Q 2015). Accordingly, fixed income markets were whipsawed between deflationary views in which bonds performed well and concerns that inflation was returning that triggered fixed income performance weakness.

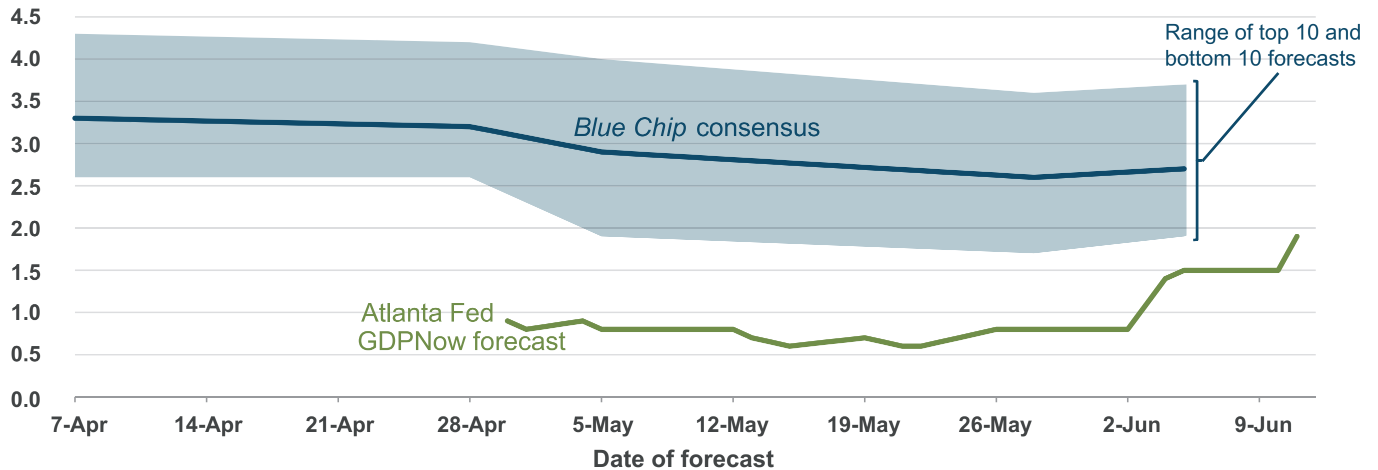
This volatility in rates and fixed income markets leaves us concerned that the volatility could spread to other asset classes. Our base case assumption is that we are still in a period of low inflation with strong policy support. However, weak data has raised the possibility that the global economy could be shifting towards a deflationary world. We thus adopt a more neutral outlook for all asset classes in this quarter.

Questionable US Economic Data

At the start of the year, US GDP consensus forecast for economic growth in 2015 was of more than three per cent. However, as we progress through the year, data has been consistently disappointing, causing consensus forecasts now dipping to 2.5 per cent. To achieve that level of 2.5 per cent growth, the forecasters are counting on a healthy rebound in the second quarter (2Q 2015) that has not yet materialised. Most economists still believe that the weak US GDP growth of negative 0.7 per cent in 1Q 2015 was due to temporary factors such as unusually bad weather and port strikes that caused economic activity to slow down. To date, the data is yet to point to a rebound in 2Q 2015.

The Atlanta Federal Reserve (Fed) maintains a GDPNow forecast that projects quarterly GDP based on data trends. To date, it has been indicating that 2Q 2015 GDP could disappoint again unless data picks up soon.

Evolution of Atlanta Fed GDPNow Real GDP Forecast for 2015: Q2 - Quarterly Per cent change (SAAR)

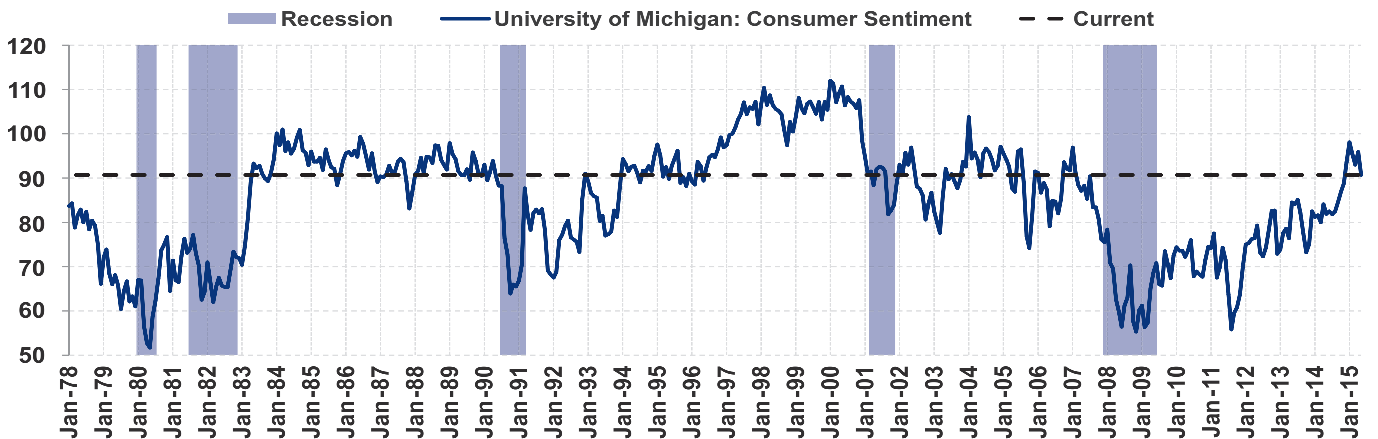


Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts

While it is justified to be cautious about recent economic indicators, our base case remains that the US and global growth will be sustained for several years. In the case of the US, the reason for being optimistic about growth is that 1) US employment and income have been improving steadily and 2) confidence and housing expansion appear to be returning to more normal levels. Housing construction activities have been stuck at recessionary levels since 2007. Residential investment can increase by 50 per cent and still be in line with normal investment levels consistent with the middle of an economic cycle.

Despite many weak data on economic activity, consumer confidence has been one key series that remained at strong levels. Our view is that the average consumer is finally more confident about the employment outlook and is increasingly likely to spend and invest in housing again, both of which can boost economic activity.

University of Michigan Consumer Sentiment



Source : Bloomberg, Jun 2015

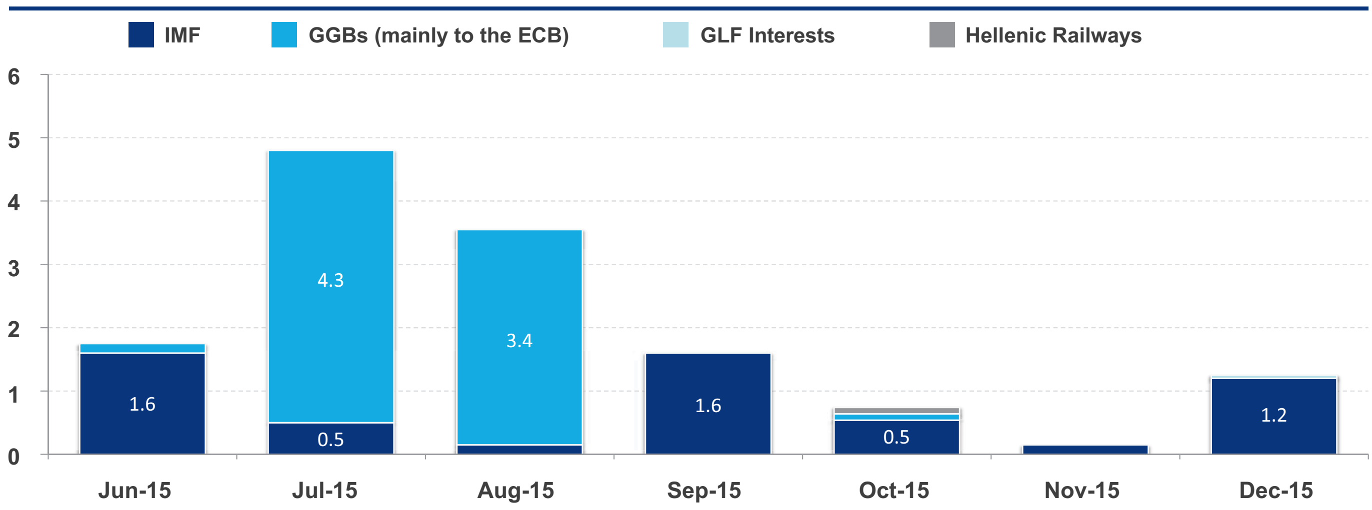
Our overall view on the economy is caution on some near-term trends but not necessarily bearish. We are of the view that economies go through "soft patches" from time to time. Investors should be prudently cautious during such periods but not outright bearish.

The Sword of Damocles with a Potential Greece Default

We continue to worry about the progress of Greece's negotiations with European authorities on funding for its debt repayment. At the heart of the issue is European authorities' concern that making exceptions for Greece would lead to the problem of moral hazard where similar concessions might need to be made for other countries. On Greece's part, its leaders represent that they have suffered enough austerity measures and need assistance at this stage. Neither side appears flexible; and the probability for Greece to default on its debts and potentially leave the Euro monetary union has increased. We assess the odds of a default and exit to be between 20 to 30 per cent. While Greece makes up less than three per cent of Eurozone's GDP, and most of Greece's debt is with the International Monetary Fund (IMF) and the European Central Bank (ECB), we still expect such a default to create volatility in financial markets around the world.

Over the coming quarter there is a series of key payments Greece has to make to the IMF and the ECB as interest and amortisation on its debts. Without some sort of agreement on new funding, Greece will not be able to make its payments. The months of June and July are particularly critical and if agreements are not made by then we would expect Greece to have no choice but to default. Once it defaults and its support from the Eurozone is damaged, we expect the odds of Greece exiting the common Euro currency to increase.

Scheduled Amortization and Interest Payments, Excluding T-bills (EUR bn)



Source : PDMA, Barclays Research

While the outlook and tone of the rhetoric so far appears quite bleak, we would note that it remains in the interest of both parties (the European creditors and Greece) to come to an agreement. Greece would suffer significant near-term chaos if it were to exit the Euro. Similarly, default losses to the IMF and the ECB (as well as other Euro project implications) will be greater than necessary in such an unstructured default. Compared to the austerity already suffered by Greece and the haircuts on debt already taken by creditors, the concessions needed to reach an agreement for continued funding are quite small.

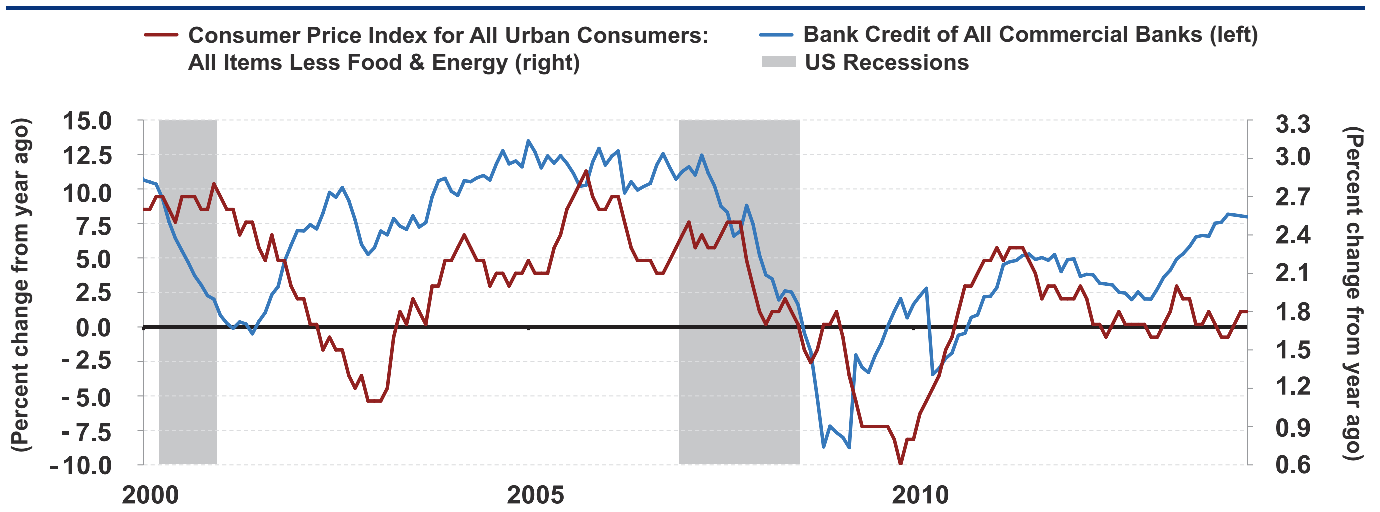
Thus we maintain an overall view of caution without being overly pessimistic. We rank it as one of the key tail risks that can affect performance but place the odds of a negative outcome at about 20 to 30 per cent.

Interest Rate Volatility

While equity volatility remained somewhat subdued over the past quarter, interest rate volatility has risen sharply. Most notably the ten-year government bond rates in Germany and the US spiked sharply in May. The US 10-year Treasury yield reached a low of 1.65 per cent earlier in the year and rose to hit 2.40 per cent in June. The German ten-year Bund rate fell close to zero per cent in early May before jumping to 0.7 per cent in early June. US short-term rates are facing close scrutiny as well with the US Federal Reserve (US Fed) inching closer to a rate hike, which we expect in the second half of 2015.

The fickle fluctuation in rates is a concern to other asset classes as volatility in risk-free rates usually transits into volatility in risk assets as well. Part of the rate volatility arose from a divergence in the economic performance of various global regions. The rates market factors in market views on growth, inflation and global risks. Adding to uncertainty was the fact that the divergence in global economic performance had not played out as expected. At the start of the year, the strong consensus view was that Europe was flirting with deflation and the US was rebounding towards normal growth levels. But economic trends have since shown that Europe is rebounding at a healthy rate while the US economy appears to have stalled. Thus, the rate market reacted to this unforeseen turn of events by pricing in a substantial jump in European and US 10-year rates.

We expect that the US economy will rebound around the middle of the year and that the US Fed will continue with its plan to increase rates. We would argue that slack in the US economy has been reduced as the unemployment rate has come down to 5.5 per cent and capacity utilisation has been approaching a critical level of 80 per cent. Money supply has been boosted by the US Fed and more critically by the banking system as loan growth has recently rebounded. The combination of loan growth, an increased US Fed money supply and rising capacity utilisation all look potentially inflationary. Thus, we suspect the US Fed will view it as prudent to at least start the rate hike process.



Source : Bloomberg, Jun 2015

Our rate forecasts are for the US 10-year yield to range between 2.5 per cent and 2.7 per cent in the second half of 2015. We expect the first US Fed rate hike in September 2015 and we expect the rate hike path to be the slowest in history with one more rate increase in 2015 and three more in 2016.

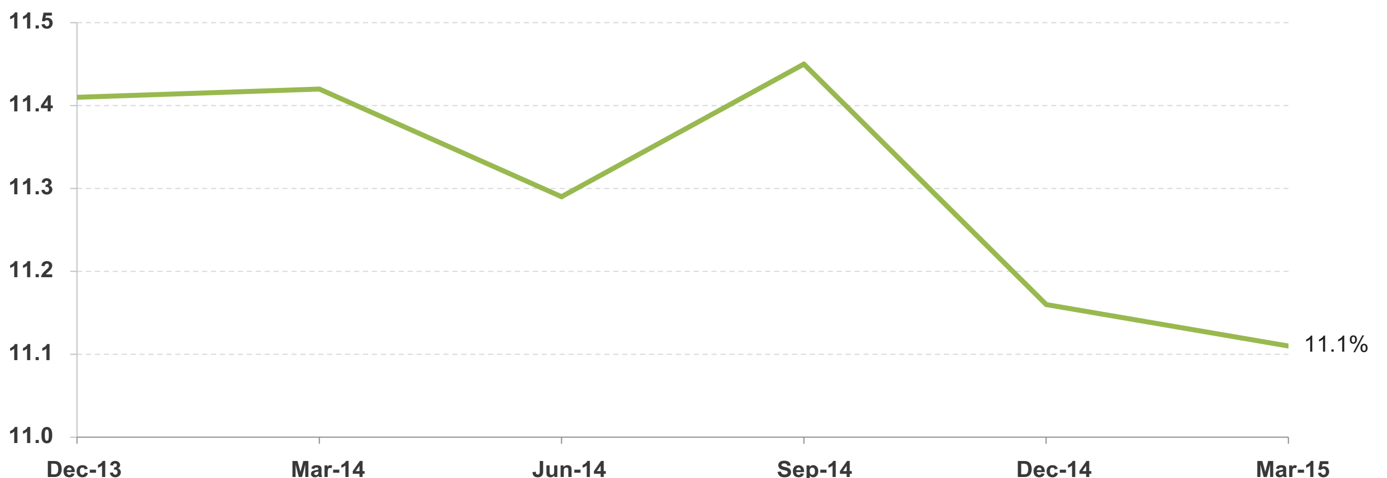
Valuations versus Earnings

Over the past six months, the equities market has started to look expensive as measured by traditional earnings-based stock market valuation methods. For most of this strong market cycle, a normal forward-looking price-to-earnings (PE) valuation has always shown US equities to be reasonably priced by historical averages. This was despite the US stock market's substantial advances and can be attributed to the strong earnings gains of US corporates. But the earnings advances have started to slow and the valuations have started to creep up over the past six months. This makes us slightly more cautious about the potential market performance over the coming quarter.

MSCI AC World 12M Forward P/E Ratio

Source: MSCI, Datastream, 30 May 2015

MSCI World Operating Margins



Source: MSCI, Bloomberg, 31 March 2015

Similar to the economic trends, we are of the view that there is good evidence that these effects can be transitory. The weaker macroeconomic growth has held back revenue growth among corporate America, while increased wages and the stronger US dollar has hurt margins. However, we expect the economy to bounce back and revenues to improve. Wages and the strong dollar may continue to be a drag, but against a backdrop of overall growth. We are of the view that this will likely result in positive equity market performance. However, till the evidence of a rebound is seen, we are more comfortable with a Neutral allocation to equities.

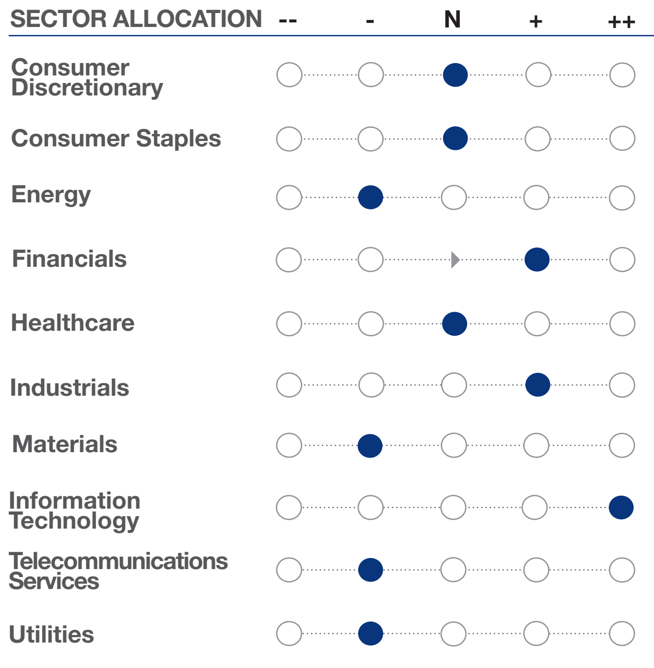
Assessment and Outlook

In summary, we are of the view that the global macroeconomic cycle is going through a "mid-cycle test". Our base case expectation is that economic data will rebound, the economy will adapt to interest rate increases in the US and that corporate revenues will resume their growth. If the cycle continues as expected, we would expect risk assets like equities to outperform other asset classes. However in the near-term, this cycle view is being tested by a weaker economic trajectory and political risks, most notably in Europe. With the increase in the range of potential outcomes and the probability of negative outcomes being raised, we are slightly more cautious and tactically neutralise our overweight on risk assets such as equities. We take pains to stress that our macro views are not bearish. Rather, our confidence in getting good risk-adjusted returns in the near term has decreased sufficiently to warrant a modest reduction in our bets on equities until we get further clarity on the data.

The key triggers to return to an overweight equity asset allocation, would be a rebound in US economic data to a range of over two per cent GDP growth, clarity in the resolution of Greece's debt negotiations and any potential correction that could normalise valuations. If the market corrected by ten per cent and we maintain our current base view of a continued expansion cycle, we would then seek an opportunity to reassign the overweight on equity which we recently neutralised. While we list the US Fed rate lift-off as a risk, we would not necessarily need or expect this issue to be resolved before September. Ultimately, we think investors will gain confidence in the US economy if the first couple of rate hikes do not slow down growth significantly.

EQUITY STRATEGY

GLOBAL EQUITY

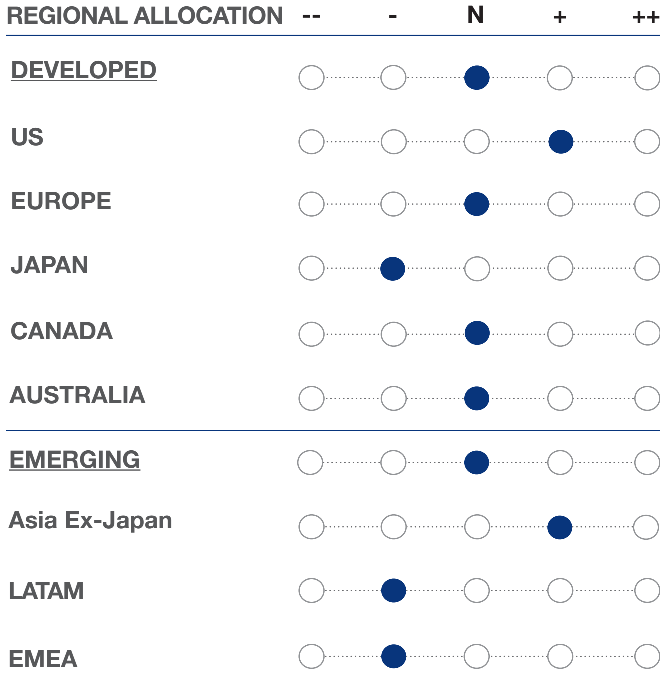


Notes:
The weights are relative to the benchmark – MSCI AC World Index.
'- -' denotes maximum underweight, '-' slight underweight, 'N' neutral, '+' slight overweight, '+ +' maximum overweight; arrows show change from last quarter.

We continue to hold a positive outlook on global equities, underpinned by improving growth in the advanced economies, modest earnings growth outlook and strong corporate profitability. Given the cyclical pick-up in demand, we are overweight on the technology sector, which should continue to benefit from rising corporate expenditure on technology hardware, software and business solutions.

With the global recovery expanding to Europe and Japan and with capacity utilisation rates improving, we remain overweight on the industrials sector. Industrials should benefit from higher utilisation rates, which should translate into margin gains. The sector's recent de-rating due to concerns over low oil prices presents an opportunity. We are keen to add weights in non-energy related names which were oversold along with the sector. We have also moved to an overweight position in financials due to attractive valuations.

Our strategy continues to be underweight on the deep cyclical sectors, such as materials, given the sub-par growth of the global economy. However, we hold the view that the energy sector is currently oversold and we look to move to a neutral position once the outlook on the oil price stabilises. We have also adopted a more cautious stance on interest rate-sensitive sectors such as utilities and telecommunication that could be impacted adversely by the impending US Fed rate increases.



Notes:
The weights are relative to the benchmark – MSCI AC World Index.
'- -' denotes maximum underweight, '-' slight underweight, 'N' neutral, '+' slight overweight, '+ +' maximum overweight; arrows show change from last quarter.

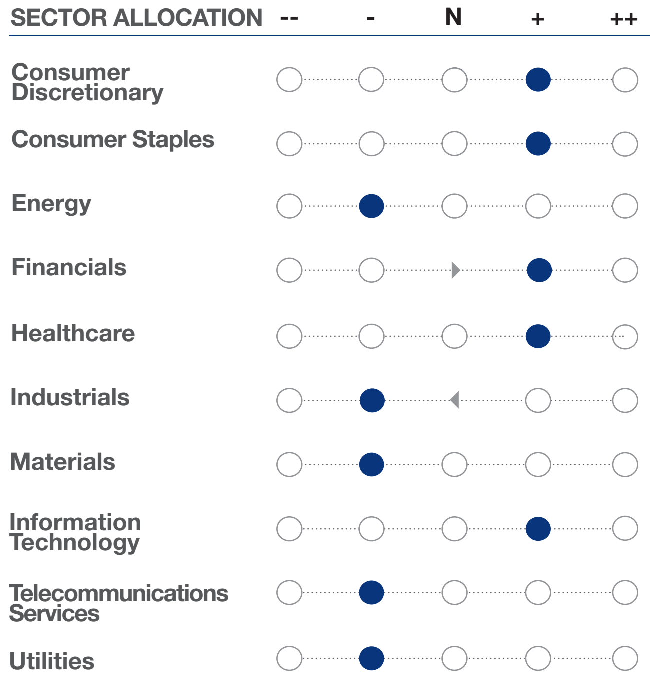
We maintain our neutral position in both developed markets (DM) and emerging markets (EM). Within DM, we have retained our overweight position in the US given our view that the recent weakness in economic data is transitory and should pick up in the latter half of the year. We recognise that a stronger US dollar is a headwind to overseas corporate profit and thus retain a preference for companies that are more exposed domestically.

We remain neutral on Europe. While a weaker Euro has helped to lift confidence, boost activity and propel the markets higher, we are mindful of the significant challenges that remain: high unemployment, political uncertainty and ongoing balance sheet deleveraging. There are some good investment opportunities despite the challenging environment, especially amongst more globally focused corporations that benefit from a weaker euro.

In Japan, concerns continue to linger over the reform initiatives. Thus far, the bulk of the heavy lifting has been undertaken by the Bank of Japan (BoJ). Fiscal reforms are slow in being implemented, which could sow the seeds of future challenges. We continue to monitor economic data over the next few months to ascertain the country's economic path. Despite the disappointments on the policy front and the anaemic economic backdrop, there are some positive developments in terms of corporate governance and corporate performance. The return on equity for Japanese companies has risen to between eight to nine per cent and continues to improve. This is creating some bottom-up opportunities.

We retain our neutral position in EM. Challenges are expected to continue due to domestic imbalances and the build-up of excess credit in the period post the Global Financial Crisis. The slowdown in China continues to weigh heavily on resources demand and prices. The abrupt shift in the resources sector has dampened investments and growth in much of the developing world and has caused many previously earmarked projects to be postponed while making others no longer viable. This shift is still playing out. Within EM regions, there are some bright spots. We remain overweight on Asia ex-Japan on the back of recent structural reforms. From a structural and macro standpoint, the EM still represents a good multi-year opportunity. From a cyclical and micro standpoint, the EM faces challenges. Growth is undershooting expectations and corporate earnings could face further downward pressures unless productivity levels can continue to be lifted. There are interesting bottom-up opportunities, but stock selection is increasingly critical.

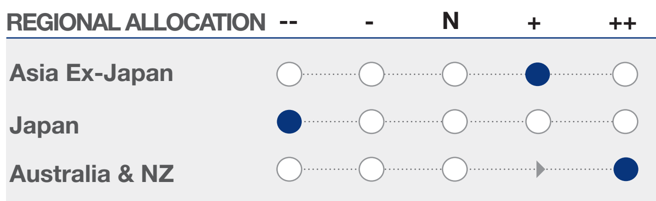
ASIA PACIFIC EQUITY



Notes:
The weights are relative to the benchmark – MSCI Asia Pacific Index.
'- -' denotes maximum underweight, '-' slight underweight, 'N' neutral, '+' slight overweight, '+ +' maximum overweight; arrows show change from last quarter.

Our representative Asia Pacific strategy is currently overweight on the healthcare and technology sectors. We are slightly overweight on the consumer discretionary and staples sectors as we see some selective value plays within the broad consumer sector. We remain positive on the longer-term trend for the consumer sector as it provides exposure to the continued strong growth of domestic demand in the emerging economies.

The strategy is underweight on the deep cyclical sectors such as energy and materials due to concerns over incremental demand from China, which is experiencing slower growth and implementing reforms.



Notes:
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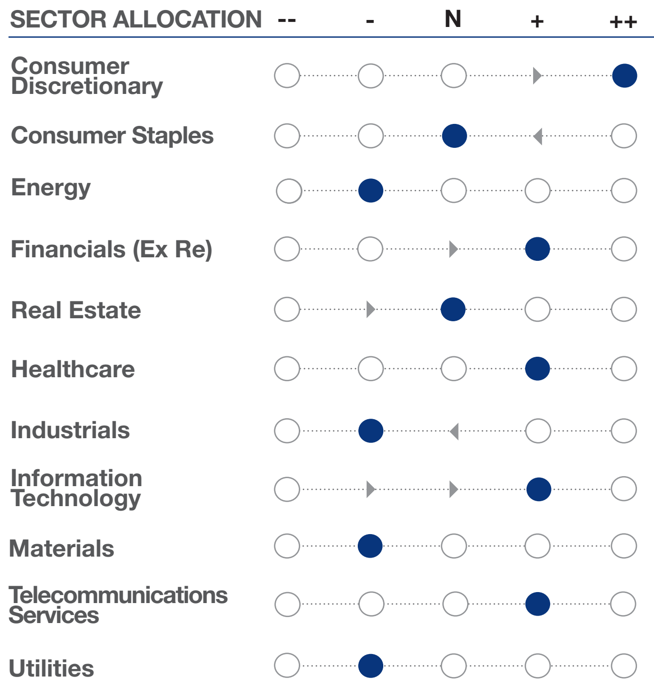
The current positioning of the Asia Pacific strategy is to be overweight on Australia and Asia ex-Japan. The position is funded from an underweight position in Japan. This is a result of bottom-up securities selection and does not necessarily reflect a view on the broader index.

For example, the overweight position in Australia is due mainly to the relative attractiveness of Australian materials and financials against the rest of the region. Similarly, the underweight position in Japan reflects our concern on the operating prospects of Japanese financials and materials companies.

ASIA EX-JAPAN EQUITY



Notes:
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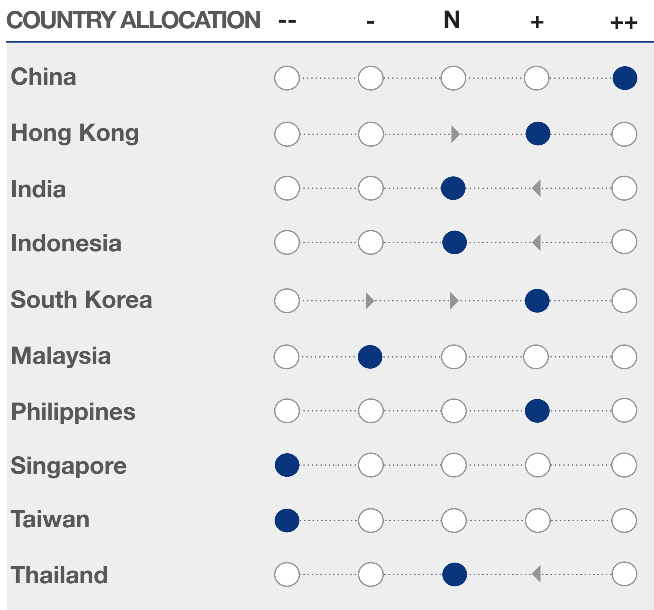
'- -' denotes maximum underweight, '-' slight underweight, 'N' neutral, '+' slight overweight, '+ +' maximum overweight; arrows show change from last quarter.



Notes:
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Growth in Asia has decelerated due to a combination of domestic and external factors. However, inflation rates in Asia have mostly declined. This has allowed central banks to continue easing monetary policy to provide support (eg. China). Higher US interest rates could be a headwind for the region as changes in US monetary conditions directly transmit into many modes of domestic monetary setting such as pegged and linked exchange rates, and/or external debt. Asia markets could also face fund outflows as a result and in this regard, we believe that the North Asia markets are better able than Southeast Asia and India markets to weather this headwind. The Asia ex-Japan strategy is positioned accordingly.

Strong liquidity in China and Hong Kong could spill over and benefit the broader Asian market. We continue to hold a cautious view of the cyclical outlook for the Chinese economy as it undergoes restructuring and reform. The reform process is both painful and difficult to execute and there is no guarantee that it can be executed without a major disruption to growth. The rally in Chinese equities seems more supported by liquidity and less by fundamentals. With further room to ease financial conditions in China, the equities market remains very supported and asset prices can move higher.

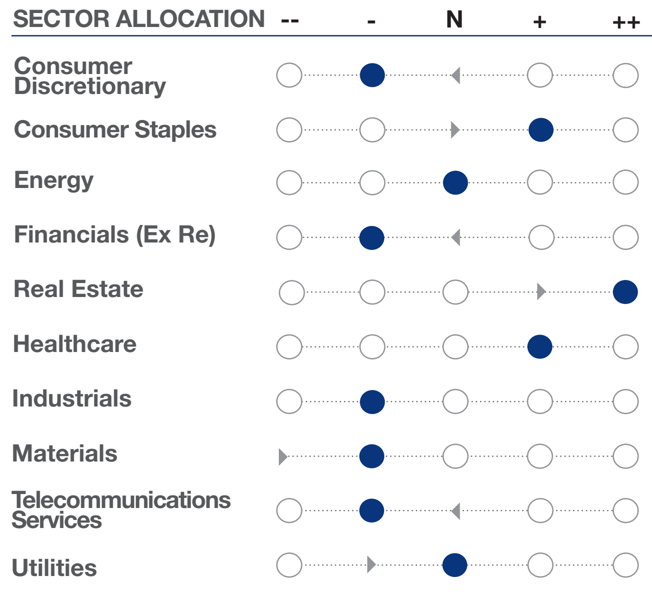
China still has overcapacity challenges that need to be addressed. The 'One Belt One Road' plan may help to mitigate some of the pressures in aligning industrial capacity with demand, but this will take some time to play out. The liberalisation of cross-border capital flows may have a positive effect on asset prices outside of China as mainland investors, over time, seek out more attractively priced investments abroad. Hong Kong's financial sector is the key conduit for this change and 'H'-shares in particular could be a significant beneficiary given that 'A'-shares currently trade at a premium of over thirty per cent to 'H'-shares.

Reforms will invariably create winners and losers and we continue to seek out more structurally attractive niches to invest in what is still a relatively high growth economy.

In other markets, we trim the weight in India as corporate earnings have yet to catch up with the positive market sentiment. Valuations have run ahead of fundamentals. We tactically reduce our positions in Indonesia and Thailand due to cyclical concerns over economic growth and concern over corporate earnings.

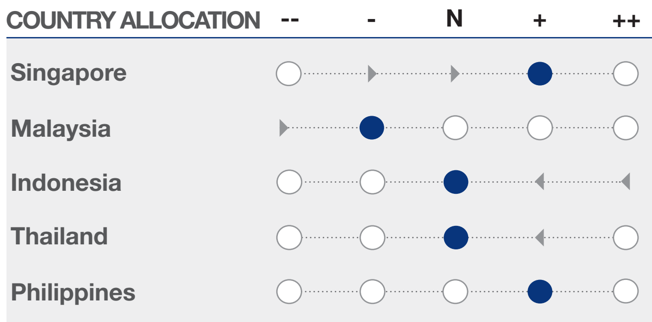
Key risks include capital outflow from Asia on the rising USD and potential US rate increases, and China domestic 'A' share market volatility.

ASEAN EQUITY



Notes:
The weights are relative to the benchmark – MSCI South East Asia Index.
'- -' denotes maximum underweight, '-' slight underweight, 'N' neutral, '+' slight overweight, '+ +' maximum overweight; arrows show change from last quarter.

Our representative ASEAN strategy is currently overweight on the consumer staples, healthcare and real estate sectors. The strategy is underweight on the industrials, materials, telecommunication and consumer discretionary sectors. The financial sector was cut to an underweight position due to weaker loan growth in both Thailand and Indonesia. We raise the utilities sector exposure to neutral given the sector's defensive earnings growth profile.



Notes:
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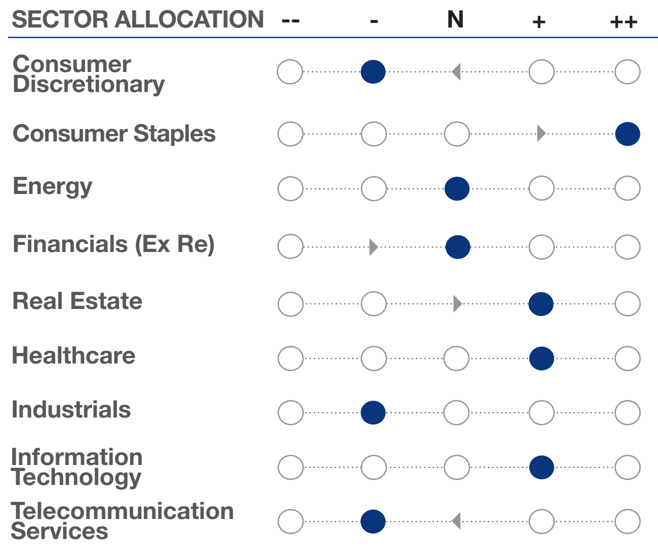
The ASEAN strategy maintains an overweight position in the Philippines. Singapore is raised to an overweight given its more defensive characteristics and relatively attractive valuations. Malaysia is maintained at an underweight exposure. In addition, Indonesia and Thailand are moved down to neutral given the macro headwinds faced by both markets in the short term.

Going forward, the pace of government spending is of crucial importance in markets like Indonesia, Thailand and the Philippines in order to drive economic growth. For the first half of 2015, the pace of spending has been below expectations leading to economic growth coming in below forecasts.

SINGAPORE EQUITY



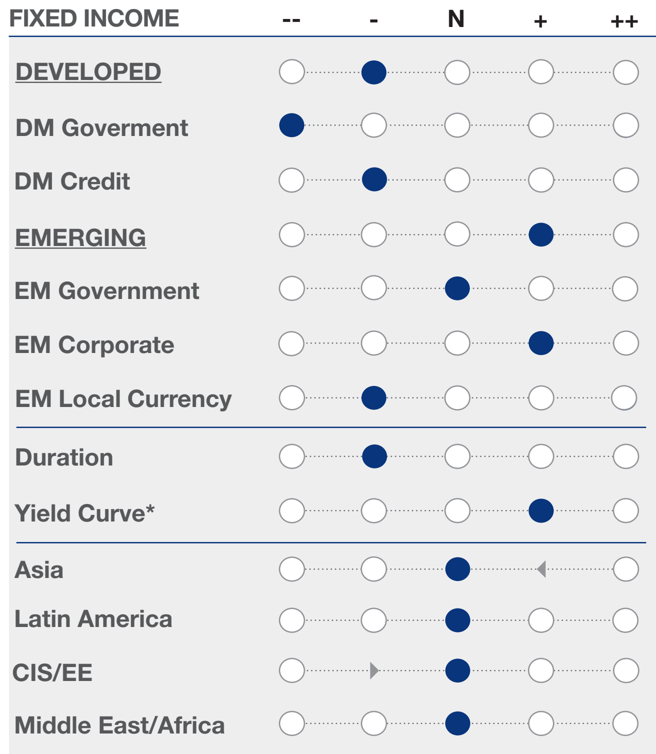
Notes:
The weights are relative to the benchmark – MSCI Singapore Index.
'- -' denotes maximum underweight, '-' slight underweight, 'N' neutral,
'+' slight overweight, '+ +' maximum overweight; arrows show change from last quarter.

The Singapore market is expected to continue to trade in a range in the quarter ahead, driven by unexciting corporate earnings offset by relatively supportive valuations.

The strategy is overweight on the consumer staples, real estate, healthcare, and information technology sectors. The financials sector is raised to neutral. We also have a neutral position in energy and are underweight on the consumer discretionary, industrials and telecommunication services.

FIXED INCOME STRATEGY

GLOBAL FIXED INCOME



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*'+' denotes Steepener and '-' denotes Flattener.

Our global fixed income strategy remains overall underweight on the DM and overweight on the EM.

In the DM, we remain underweight on government debt. We are generally positive on corporate credits particularly in the EM for carry against the gradual rising of the US Treasury (UST) yield while keeping duration short versus the benchmark. We remain cautious on high yield credits. We also remain defensive and selective in credit selection.

In the EM, we are slightly overweight. We remain neutral on EM sovereigns and slightly overweight on corporate credits. We are neutral on all EM regions, reducing our weight in Asia and raising our weight in Eastern Europe (CIS/EE). We continue to favour USD EM credits and some local currency credits selectively in Asia, CIS/EE, and Middle East and Africa.

DEVELOPED MARKETS

Review

Yields in the developed world moved higher in the second quarter led by a sharp sell-off in German Bunds. The sell-off was not entirely unexpected but its pace took the market by surprise, with the reason being more technical than fundamental. In addition, inflation returned to the Eurozone in May and the region averted a slide into deflation.

We expect growth to return to the US economy as the transitory factors that caused the weakness in the first quarter have faded. However, with a strong dollar and a moderately weak oil sector, US growth should be at a modest level.

Outlook and Strategy

With the continuous improvement in the labour market and no deflationary fears in core inflation, we expect the US Fed to start raising rates in September this year. We expect the pace of rate increases to be slow and data-dependent, and hence the term premium should rise quite gradually. We expect the two-year to five-year part of the UST curve to steepen, and the five-year to ten-year to flatten from here. With the ECB and BOJ still loosening monetary policies, the relative value trade still favours the UST. The ten-year UST should normalise to 2.50 per cent in the coming quarter but can continue to be volatile given the US Fed's data-dependency. Our medium-term view remains cautious of the structural deficiencies in the US economy which would dampen growth expectations and keep long-term rates lower than they have been historically.

In Europe, the ECB has successfully implemented its QE programme, establishing its credibility by turning around deflationary risk. We expect Germany's economy to stay supported by domestic demand, taking the ten-year German Bund yields slightly higher to 0.75 to 1.0 per cent by the third quarter (Q3). We are neutral on Bunds and French bonds with neutral duration. We are short the Euro currency, expecting it to weaken to 1.05 against the USD by the end of the quarter. In the periphery, we continue to be tactically overweight on Spain while neutral on Italy given that the current macro scenario is slightly more positive in Spain. In the UK, we believe the Bank of England (BOE) would follow the US Fed into a rate hiking cycle by the first quarter of next year. Our ten-year target for Gilts is 2.0 to 2.25 per cent for Q3.

In Japan, with the economy improving and the BOJ delaying the inflation target of two per cent to 2016, we do not expect further actions by the BOJ in the next few months. The Japanese Government Bond (JGB) yields have been capped by a home bias, given the similarly low government bond yields in the rest of the DM.

EMERGING MARKETS

Review

EM bonds rose 1.24 per cent from the end of the first quarter of 2015 (1Q15) till 31 May in USD terms as high yield bonds outperformed. UST ten-year bond yields rose during this period from 1.92 per cent to 2.12 per cent. High yield bond spreads recovered around 60 basis points (bps) after underperforming in 1Q15.

Outlook and Strategy

The recovery in EM bonds can be largely attributed to the alleviation of tail risks that were affecting the asset class since last year – falling oil prices, the Russia-Ukraine conflict, geopolitical conflict in the Middle East and fears of a China hard landing. While these risks have not totally dissipated, most of them have been re-priced by the market. This has provided a short term impetus for EM credit spreads to tighten, especially for oil-related names as prices have clearly recovered from the bottom.

The macroeconomic backdrop is not supportive as growth and inflation continue to be lacklustre. However, we argue that such an environment by itself does not warrant wider credit spreads as long as EM economies are able to navigate through this poor patch. We have already seen how oil-related credits have bounced back strongly from its low, as oil prices rebounded off the USD 40 per barrel lows. Furthermore, there appears to be some light at the end of the tunnel as European growth and inflation data improve and China eases monetary policy to support its ailing economy.

We like EM bonds at current valuations. We think that current spreads of around 340 bps, while off the recent wide of 400 bps, are still some way from recent years' tight levels of around 250 bps. We remain modestly overweight on EM high yield bonds. Credit selection will remain important and we concentrate our positions on companies which are fundamentally sound. Duration is close to neutral and we remain overweight on USD and underweight on EM currencies as growth and inflation are likely to fall further before any rebound occurs.

ASIA

Review

Asian bonds rose 0.49% from the end of 1Q15 till 31 May in USD terms as high yield bonds outperformed. UST 10-year bond yields rose during this period from 1.92% to 2.12%. High yield bond spreads recovered around 50 bps after underperforming in 1Q15.

Outlook and Strategy

Despite falling growth and inflation in China, we remain positive on Chinese credits as the government has shown that it is prepared to support the economy during this difficult period. The Chinese government continues to ease monetary policy by reducing interest rates and the reserve requirement ratio (RRR), most recently to 18.5 per cent in April 2015. To put the amount of leeway the Chinese government has in terms of monetary policy easing into historical perspective, the RRR was as low as 6 per cent prior to the Global Financial Crisis. Therefore, we continue to believe that there is room for more aggressive RRR cuts to combat falling growth and inflation. Chinese property credits were a recent outperformer, as the slowdown in the sector seems to be abating. More recently, some property developers were able to tap the onshore equity markets to raise funds.

Indian and Indonesian high grade bonds have underperformed on the back of the UST yields rising. Although the reform story for both countries remains largely intact, such structural changes take time, and in the short-term, Indonesian and Indian credits appear to have priced in too much good news. We remain more defensive in these sectors, while remaining overweight on Chinese state-owned enterprises and tactically overweight on single B-rated Chinese property names on cheap valuations. We think that the yield premium of Asian high yield over high grade is still excessive, despite the recent outperformance.

SINGAPORE

Review

We continue to see positive momentum in the Singapore dollar (SGD) corporate market in the last three months. In May 2015 alone, 28 deals worth S$3.4 billion were done, making it the second highest monthly volume since November 2013, which had 16 issues valued at S$4.3 billion. New issue activity picked up after a slow start to the year with both investment grade and high yield names performing well on the back of institutional and private bank investors' participation. The secondary market has moved higher with buyers outnumbering sellers given the limited supply. However, sentiments on oil & gas (O&G) names remained weak. Both domestic and foreign issuers have tapped the SGD corporate market due to the low funding cost. Notably, issuers from China and Indonesia have been very active in the SGD corporate market. Property/REIT issuers continue to dominate the new issue space, followed by O&G issuers.

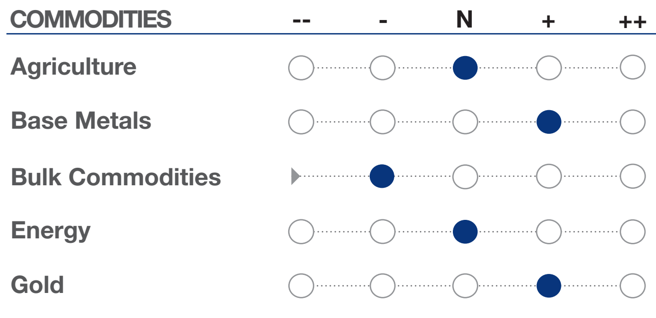
The Singapore economy grew 2.6 per cent yoy in 1Q15, outperforming expectations of 2.2%. However, the 8.7 per cent decline in industrial production (IP) for April (-5.5 per cent yoy in March) clouds the growth outlook for the second quarter. Headline inflation declined for a sixth straight month at -0.5 per cent in April while core inflation moderated to 0.4 per cent. The SGD clawed back some underperformance against the greenback to end at 1.3478 in May after weakening to an intra-month level of 1.3927 in March. This was mainly driven by a significant paring back in market expectations for further easing following the April Monetary Policy Statement, where the Monetary Authority of Singapore (MAS) made no changes.

Outlook and Strategy

With the impending US Fed rate hike, we expect both domestic and foreign issuers to continue tapping the SGD corporate bond market to lock in low funding costs, led by the O&G and property/REITs sectors. We expect overall sentiment to remain constructive in Q3. While headline Consumer Price Index (CPI) is expected to remain negative till Q3, a rebound may occur in Q4 after the base effect from low oil prices wears off.

We expect that additional changes to the SGD exchange rate policy band would only occur in the event of a significant deviation from the MAS' expectation of GDP growth of two to four per cent and CPI at -0.5 to 0.5 per cent for 2015. We expect the SGD to weaken against the USD to about 1.36-1.37 in the coming months as the US economy recovers from its winter lull. Therefore, short-end interest rates like the Swap Offer Rate (SOR) will likely rise as investors increasingly hedge their SGD exposure, leading to higher forward swap points and interbank rates. We expect the three-month SOR to rise towards the one per cent level from 0.82 per cent at end-May 2015. We continue to call for underweight positions in duration, on expectations of higher interest rates and better value seen on the two-year to five-year part of the Singapore Government Securities (SGS) curve.

COMMODITIES STRATEGY



COMMODITIES	--	-	N	+	++
Agriculture	○	○	●	○	○
Base Metals	○	○	○	●	○
Bulk Commodities	▶	●	○	○	○
Energy	○	○	●	○	○
Gold	○	○	○	●	○

Notes:
The weights are relative to the appropriate benchmark(s).
'- -' denotes maximum underweight, '-' slight underweight, 'N' neutral, '+' slight overweight, '+ +' maximum overweight; arrows show change from last quarter.

Overview

We raise our weight in the overall commodities sector to a neutral position from underweight. The key change is our increased weight in bulk commodities as prices have fallen sufficiently to offset concerns of oversupply. Economic data continues to be mixed, but the sharply lower levels of capital investment and China's launch of the 'One Belt, One Road' initiative could improve supply-demand fundamentals across a number of commodity sectors, resulting in our more balanced view of the overall sector. However, we caution that China's infrastructure plan may not provide immediate price support. In the near-term, the possibility of higher US interest rates and continued USD strength keep us cautious towards global commodity demand.

Agriculture

We remain at a neutral weight on agriculture commodities, given the strong start to the planting season – particularly soybean – in the US. Overall grain prices remain at relatively low levels, and there are no signs of production problems for corn, soybean or wheat. The only potential problem is an El Nino weather event in the Pacific, which may impact crude palm oil (CPO) production as well as crops such as sugar and coffee. However, any upward pressure on CPO pricing may be moderated by strong soybean production, given potential substitution between these oils.

Base Metals

We remain overweight on base metals given that sharply lower capital expenditure on new capacity is leading to projections of medium-term supply shortages in a number of metals. This possibility is already shown by falling London Metal Exchange (LME) inventory levels in copper and zinc. Stricter social and environmental permitting means that new mines can take up to five years to construct, at the same time that existing mines are depleting reserves.

Bulk Commodities

We upgrade to a slight underweight position in bulk commodities, given that the prices of iron ore, thermal coal and coking coal have all fallen significantly. While higher-cost producers of these commodities will struggle to stay solvent, producers in the bottom cost quartile, such as the large diversified miners, are still making healthy profits. For iron ore, recent strength in the Chinese stock market is also starting to provide a boost to construction activity, at a time when port and steel mill inventories remain low.

Energy

We maintain our neutral position in energy. Key variables for the crude oil price outlook are still the US rig count and associated US domestic production, Organisation of the Petroleum Exporting Countries' (OPEC's) level of production and the overall level of global demand. The fall in active US rigs to below 650 rigs by end-May 2015 has been much sharper than expected, but a lagged reduction in US production is still not evident. OPEC production remains above quota, and may see a further increase if Iranian sanctions are lifted this summer. The global demand outlook remains positive, but it is still unclear how much demand will be boosted by the US summer driving season. Overall, it is unlikely that crude oil prices will see a sharp strengthening in the coming quarter.

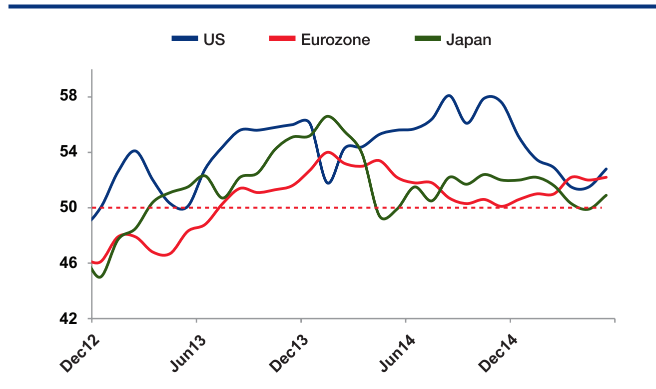
Gold

We remain in an overweight position in gold given continued strong demand fundamentals. Retail demand from China and India are at record levels, with the World Gold Council making continued sizeable upward revisions to Chinese demand figures in recent quarters. Central banks have remained aggregate net buyers, even excluding the possibility that the People's Bank of China (PBOC) has also been adding gold to its foreign reserves in the past six years. While the strong USD remains a potential headwind, a strong dollar also has the positive effect of strengthening the gold price in other currencies.

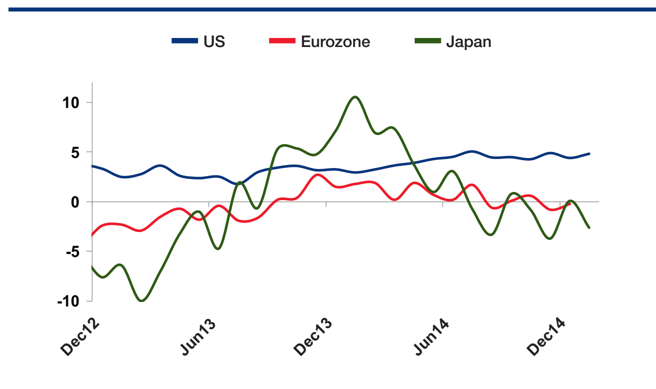
APPENDIX
ECONOMIC INDICATORS

DEVELOPED ECONOMIES

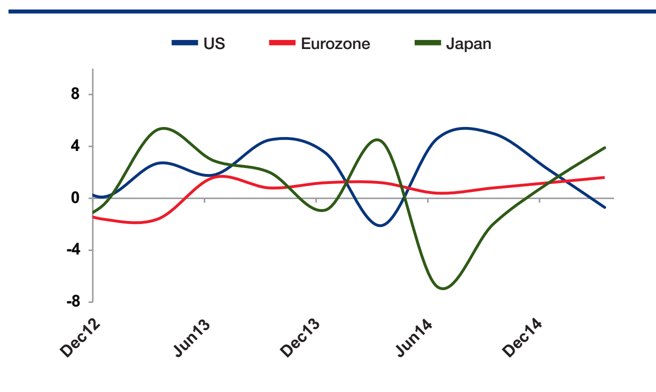
Purchasing Managers' Index



Industrial Production Growth (YoY%)

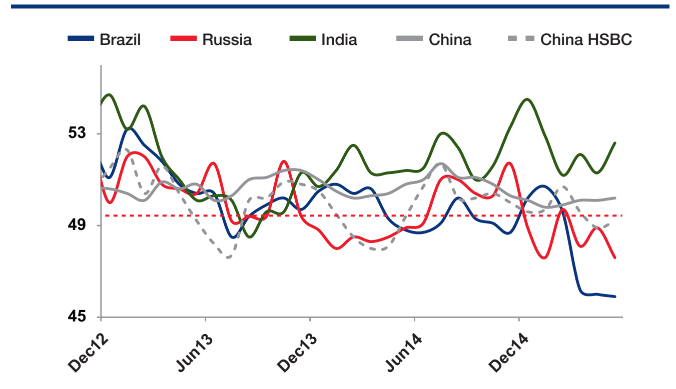


Real GDP growth (QoQ%, saar)*

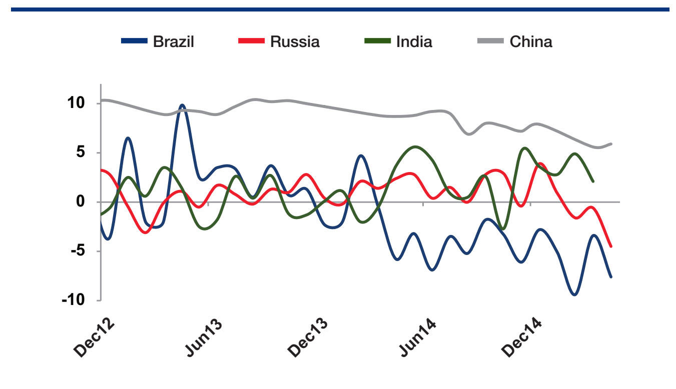


EMERGING ECONOMIES

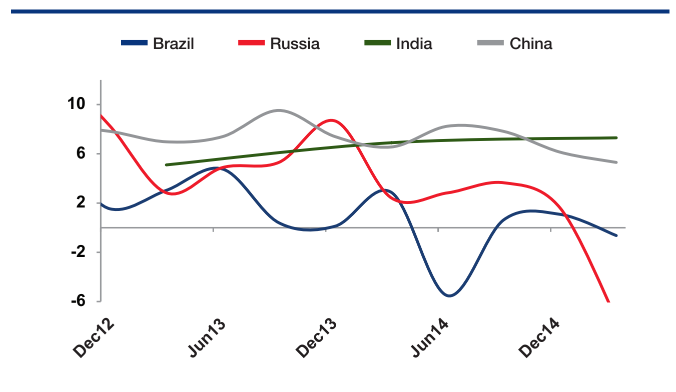
Purchasing Managers' Index



Industrial Production Growth (YoY%)



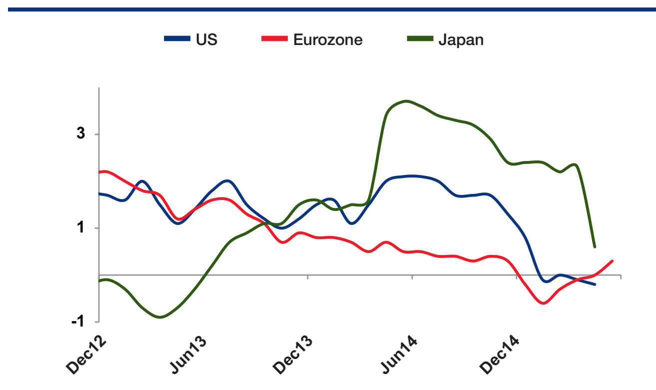
Real GDP growth (QoQ%, saar)*



*For some economies, annualised GDP data were estimated by UOBAM. For India, data are in year-on-year percentages (YoY%).
Note: All data are sourced from Bloomberg, Datastream and UOBAM unless otherwise stated, as at 9 June 2015.

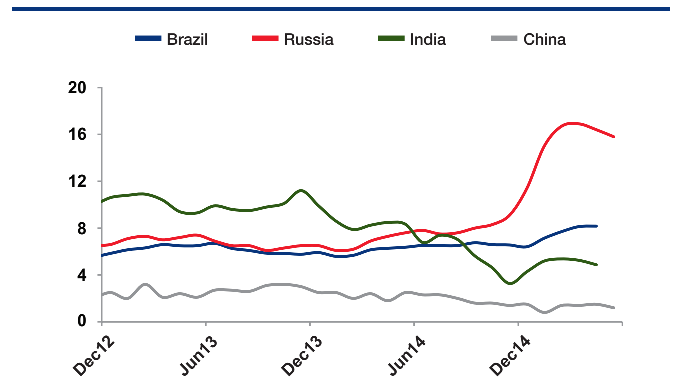
DEVELOPED ECONOMIES

Inflation - CPI (YoY%)



EMERGING ECONOMIES

Inflation - CPI (YoY%)



Note: All data are sourced from Bloomberg, Datastream and UOBAM unless otherwise stated, as at 9 June 2015.

Central Banks Interest Rates

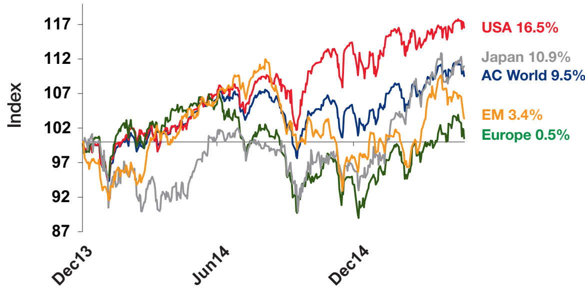
Country	Interest Rate	Current Rate (%pa)	Latest Meeting	Change at Latest Mtg (bp)	Last Change	Next Meeting
		2 Jun 2015				
United States	Fed Funds Target Rate US	0.250	29 Apr 2015	—	16 Dec 08 (-75bp)	18 Jun 2015
Eurozone	Refinance Rate	0.050	15 Apr 2015	—	4 Sep 14 (-10bp)	3 Jun 2015
Japan	BOJ Overnight Call Rate	0.100	17 Jun 2013	—	19 Dec 08 (-20bp)	—
United Kingdom	UK Official Bank Rate	0.500	1 Jun 2015	—	5 Mar 09 (-50bp)	4 Jun 2015
Brazil	Brazil Selic Target Rate	13.250	29 Apr 2015	50	29 Apr 15 (+50bp)	3 Jun 2015
Russia	Russia Refinancing Rate Announcement	8.250	13 Sep 2013	—	13 Sep 12 (+25bp)	—
India	Repurchase Rate	7.500	28 May 2015	—	4 Mar 15 (-25bp)	—
China	1 Year Benchmark Lending	5.100	—	—	11 May 15 (-25bp)	—
South Africa	South Africa Repo Avg Rate	5.750	1 Jun 2015	—	17 Jul 14 (+25bp)	23 Jul 2015

Source: Bloomberg, as at 2 June 2015

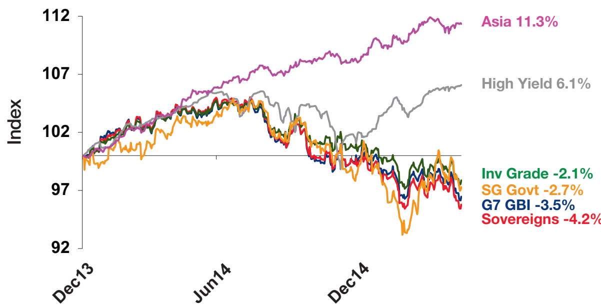
MARKET PERFORMANCE

DEVELOPED MARKETS

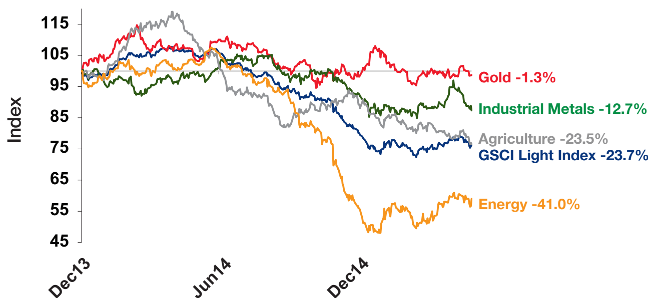
Equity Indices
(Rebased 100 on 31 December 2013)



Fixed Income Indices
(Rebased 100 on 31 December 2013)

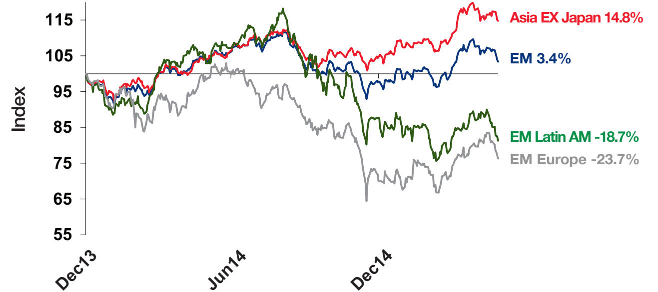


Commodity Indices
(Rebased 100 on 31 December 2013)

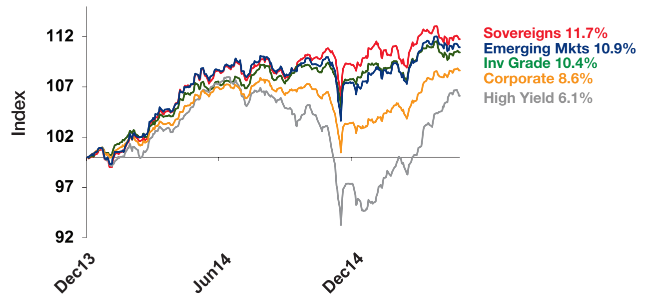


EMERGING MARKETS

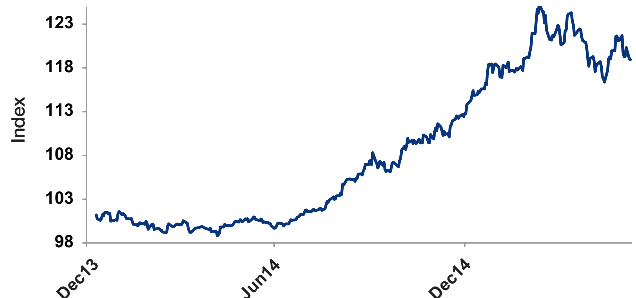
Equity Indices
(Rebased 100 on 31 December 2013)



Fixed Income Indices
(Rebased 100 on 31 December 2013)



Dollar Index Spot
(Rebased 100 on 31 December 2013)



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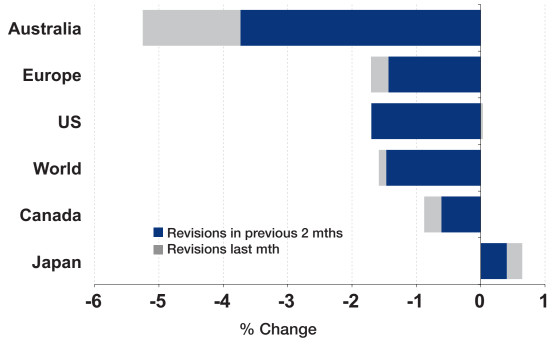
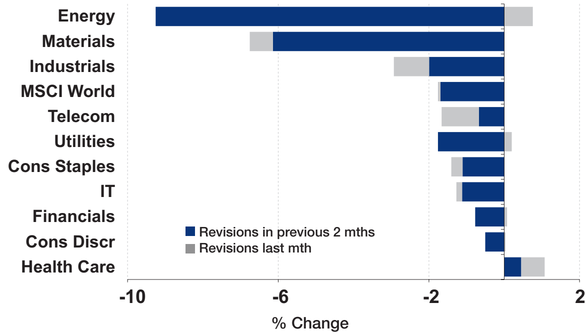
EQUITY MARKET INDICATORS

DEVELOPED MARKETS

Earnings Revision by Regions for FY2

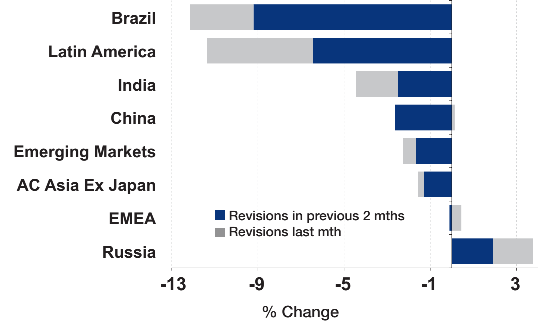


Earnings Revision by Sectors for FY2

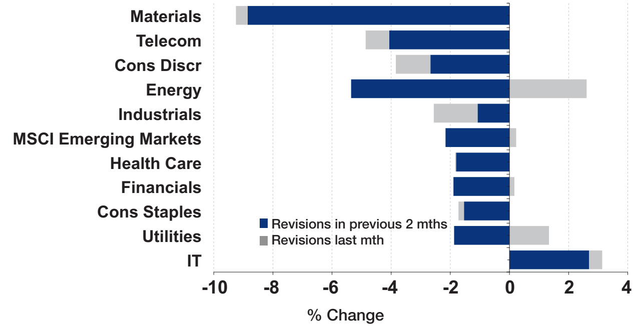


EMERGING MARKETS

Earnings Revision by Regions for FY2



Earnings Revision by Sectors for FY2

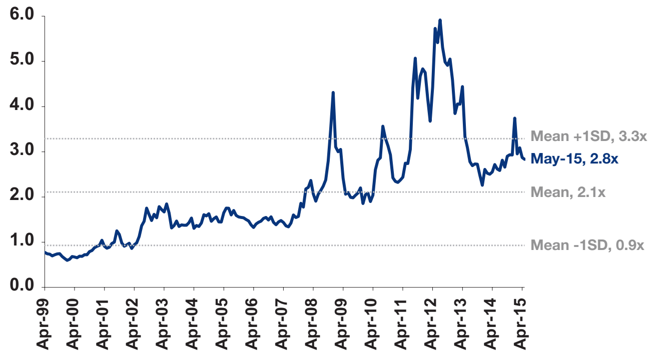


Note: All data are sourced from Bloomberg, Datastream and UOBAM unless otherwise stated, as at 9 June 2015.

Please refer to the last page for the important notice & disclaimer.

VALUATION

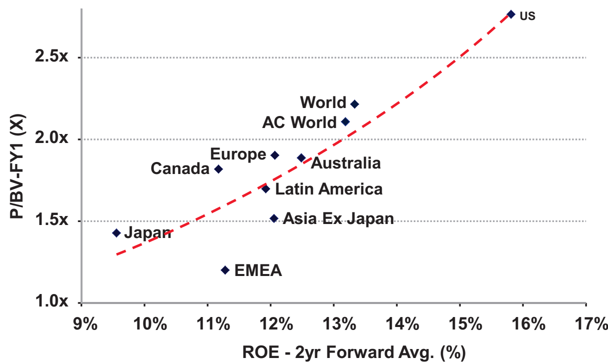
Developed Markets Earnings Yield Ratio*



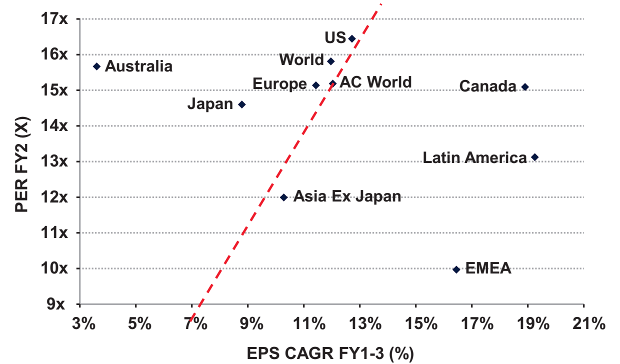
*Mean and SD are based on data from 1999.

Emerging Markets Earnings Yield Ratio*

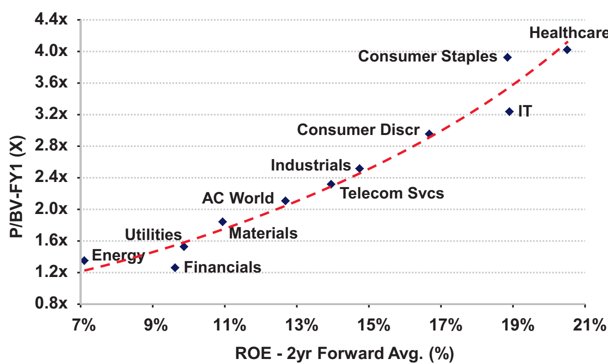
P/BV vs ROE by Region



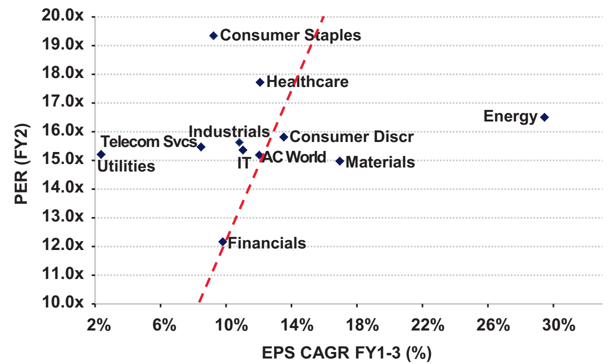
P/E vs Growth by Region



P/BV vs ROE by Sector



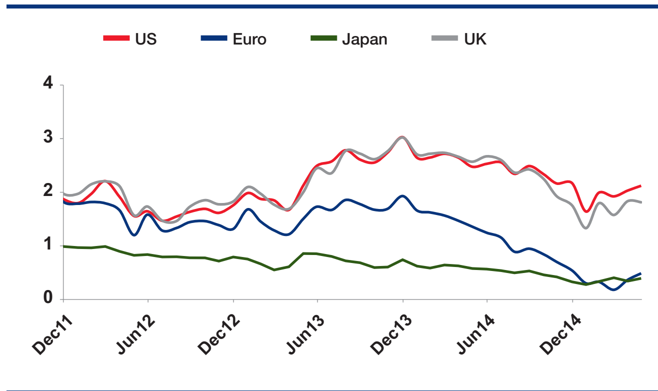
P/E vs Growth by Sector



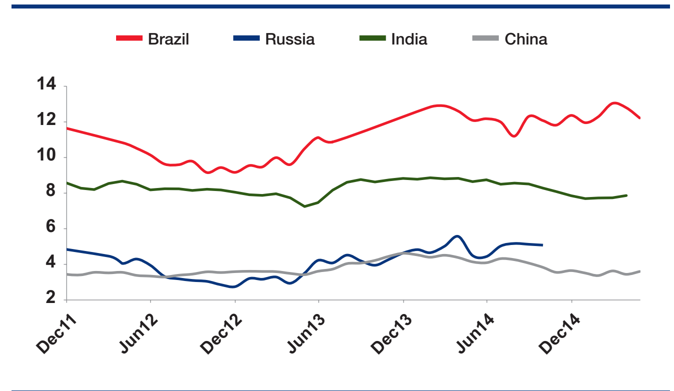
Note: All data are sourced from Bloomberg, Datastream and UOBAM unless otherwise stated, as at 9 June 2015.

FIXED INCOME MARKET INDICATORS

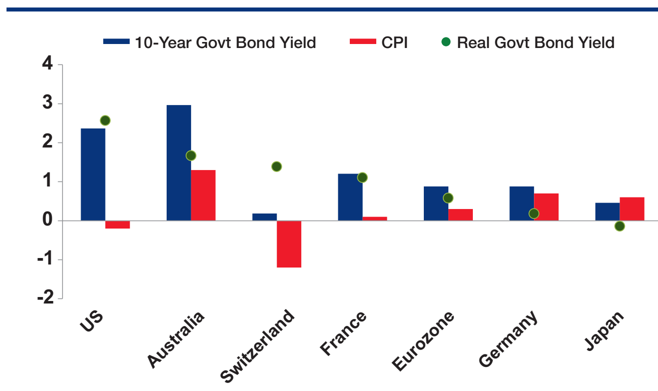
Developed Markets 10-Year Government Yield (%)



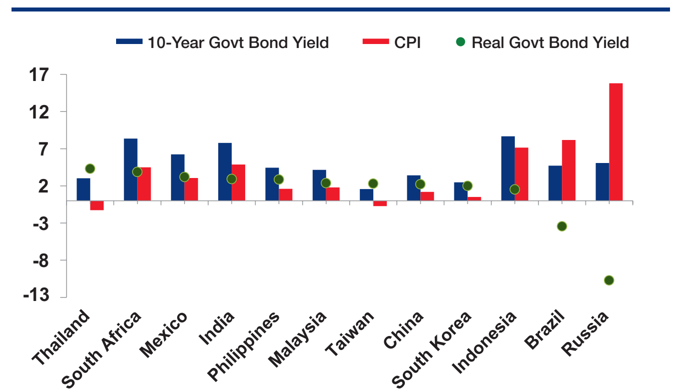
Emerging Markets 10-Year Govenment Yield (%)



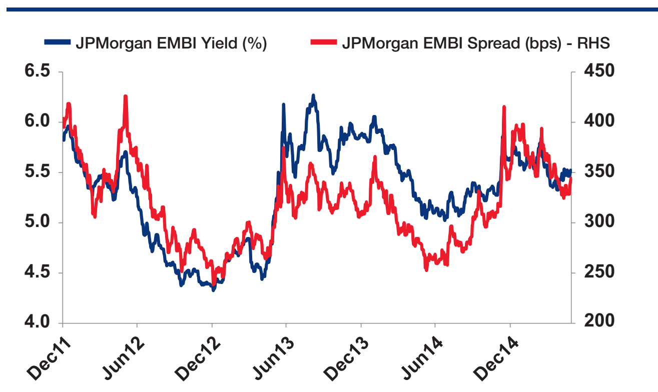
Developed Markets Real Government Yield (%)



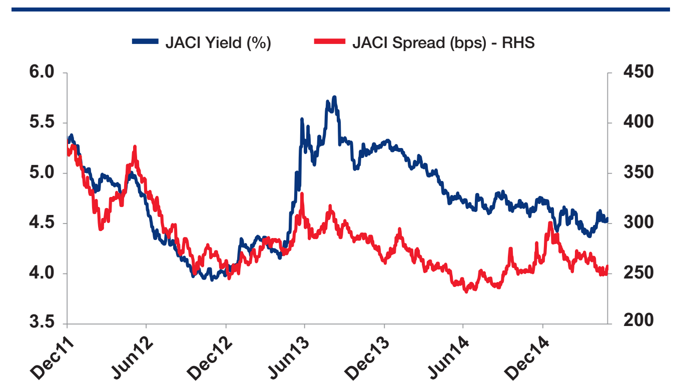
Emerging Markets Real Government Yield (%)



Emerging Markets (USD) Yield and Credit Spread



Asia (USD) Yield and Credit Spread



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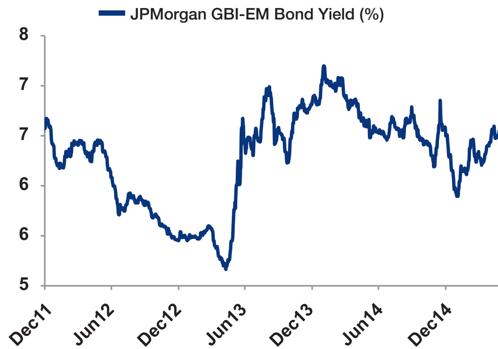
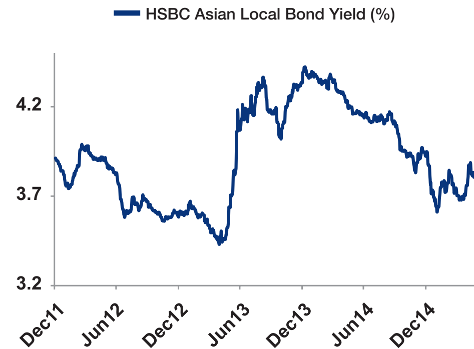
Emerging Markets (Local Currency) Bond Yield

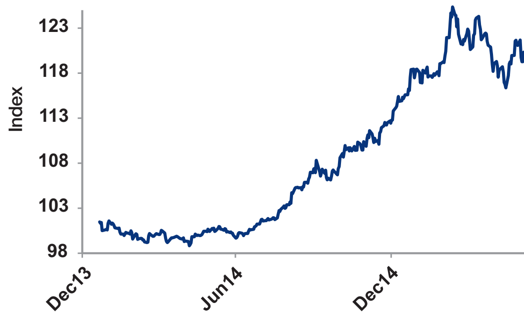


Asia (Local Currency) Bond Yield

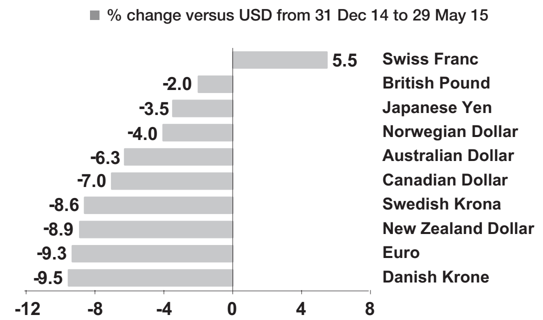


CURRENCIES

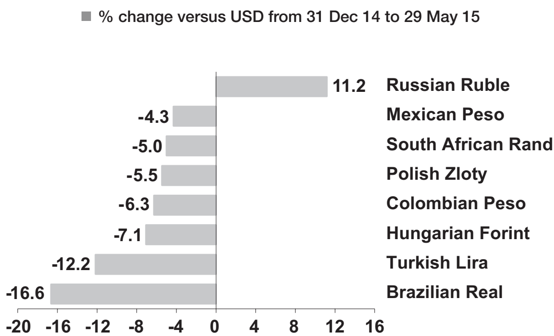
Dollar Index Spot (Rebased 100 on 31 December 2013)



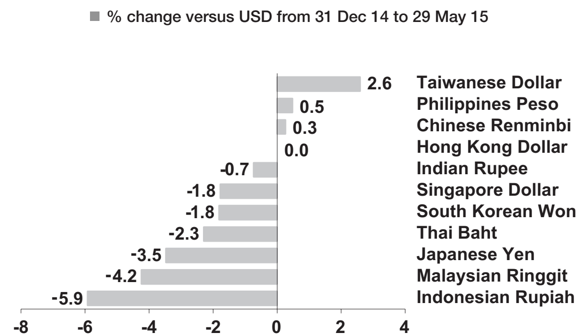
G-10 FX against US Dollar



Emerging Markets FX against US Dollar



Asia FX against US Dollar



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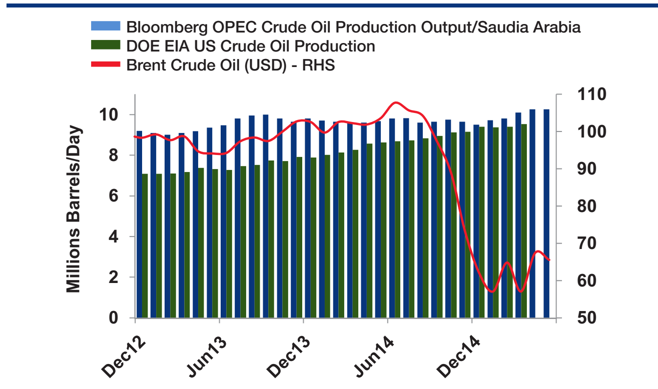
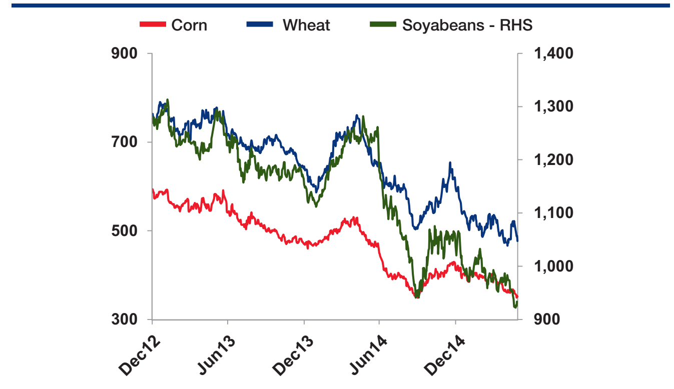
COMMODITY MARKET INDICATORS

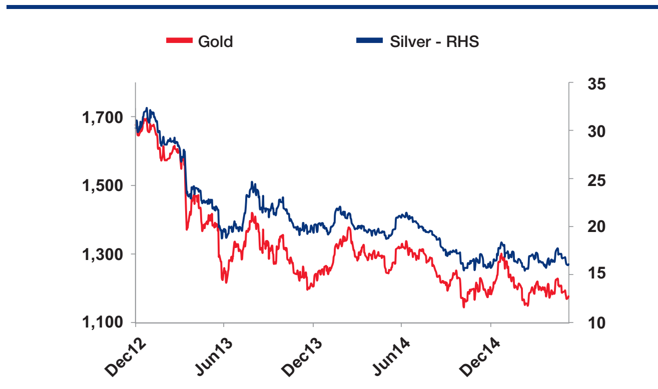
Brent Crude Oil Price and Production



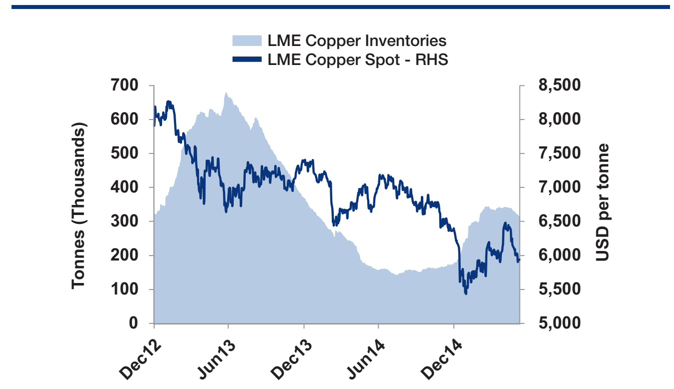
Agriculture Price (USD)



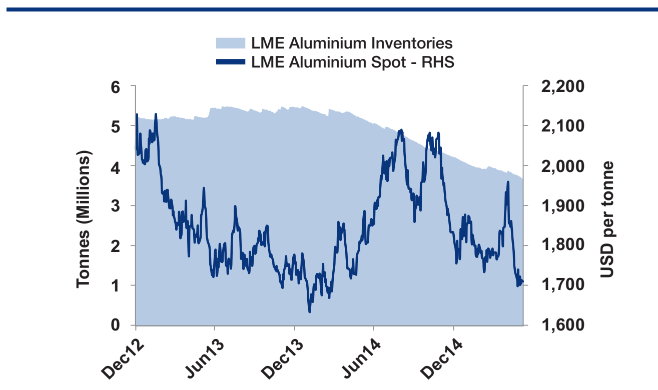
Precious Metal Price (USD)



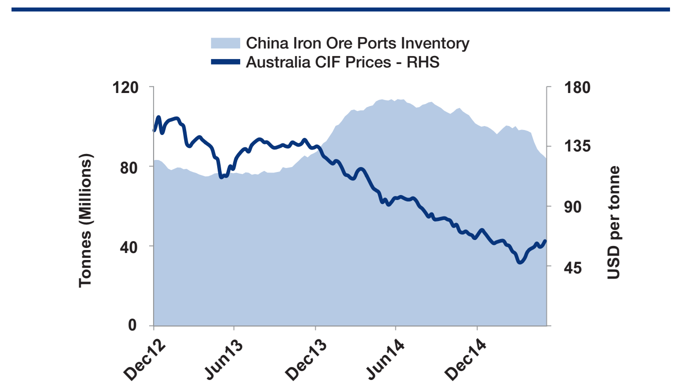
Copper Price (USD)



Aluminum Price (USD)



Iron Ore Price (USD)



Note: All data are sourced from Bloomberg, Datastream and UOBAM unless otherwise stated, as at 9 June 2015.

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The contents in this report were updated as at June 2015.

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