Investment Insights

JULY 2017

2H 2017 - Pass the Income and Quality ("IQ") test

Market Recap for 1H 2017 - Not too cold, not too hot

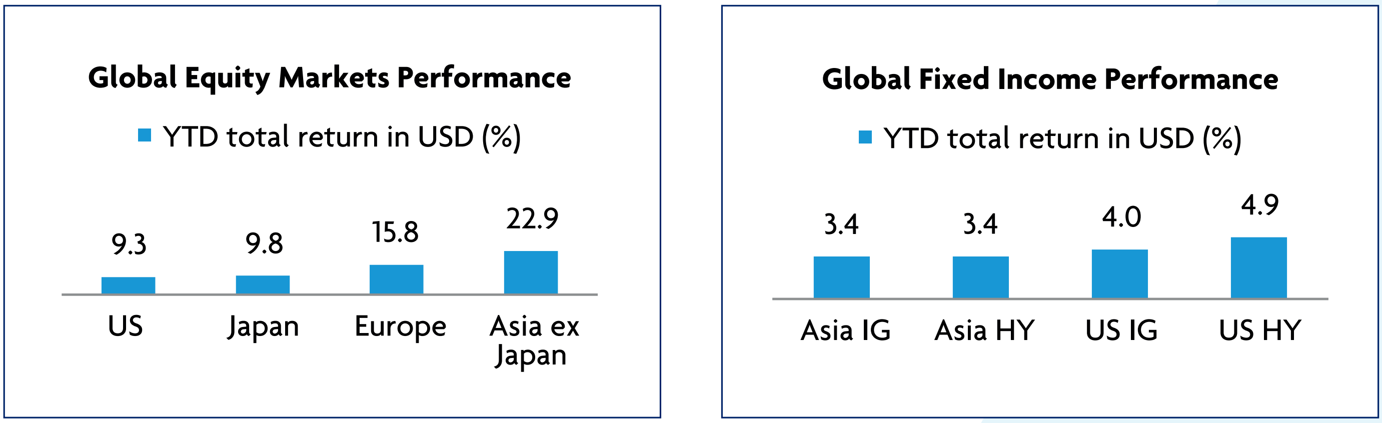
The investment climate has been positive across both equity and fixed income so far this year. Global equities and global fixed income delivered stellar returns of 11.0% and 4.4% in USD terms respectively as of end of June.

The investment environment in the first half was largely shaped by a "Goldilocks" economic condition, which means that the global economy is neither too cold nor too hot. Growth has steadied in both developed markets and emerging markets, supported by improving global trades and investments. Earnings have turned around after trending down for almost two years. Inflation overshoot, concerned by many investors at the start of the year, did not play out. Softer commodity prices and tepid wages growth have kept excessive inflation at bay, giving central banks room to normalize their policies more gradually. Such an economic backdrop has been favourable to both equities and fixed income.

Inside

Should you have any queries, please contact your UOB Banker for more information.

Figure 1: Both equity and fixed income performed well in a "Goldilocks" 1H 2017.



Source: Bloomberg, UOB PFS Investment Strategy, 30 June 2017

Outlook for 2H 2017 ▶▶

Growth to consolidate, inflation to stay benign

As we enter second half of 2017, how do we think the investment landscape would unfold?

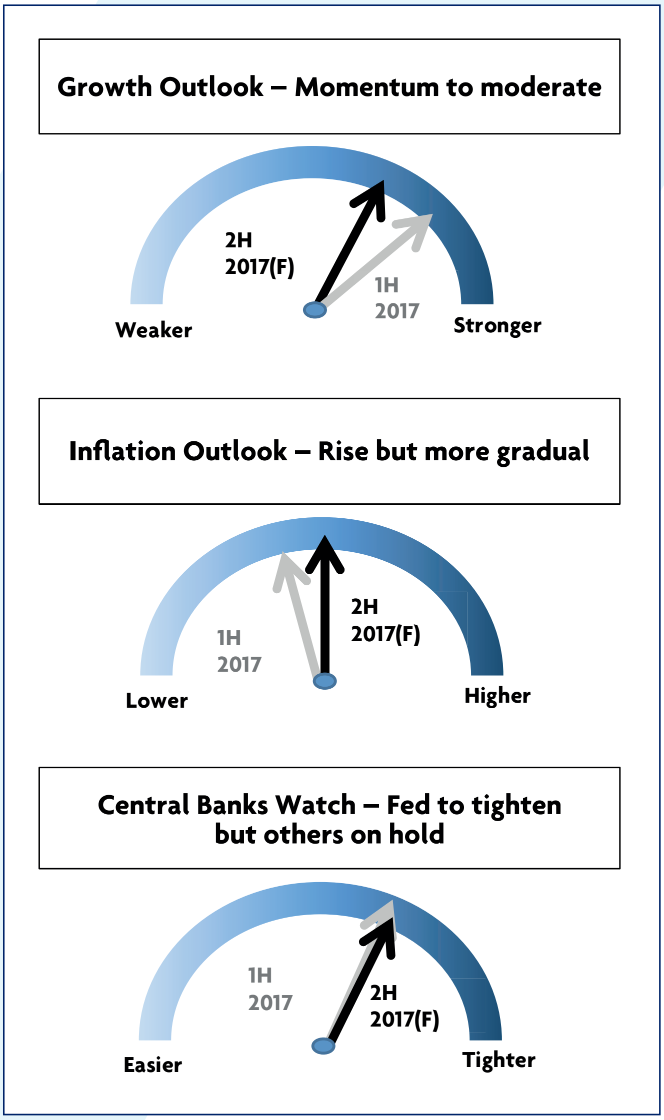
We think the **global growth** in the second half is likely to remain intact, although the **pace may moderate**. Healthy consumption, improving confidence and benign financial conditions should support growth. However, after the strong upturn, manufacturing and exports cycle could consolidate in coming months. Also, limited progress by the Trump administration to implement pro-growth policies could dampen sentiments.

Inflationary pressure softened recently, partly due to lower commodity prices and muted wage growth. Some factors leading to lower inflation could be transitory, such as oil prices. Given further labour market tightening, we believe the **core inflation would eventually trend higher albeit at much more gradual pace**.

For central banks, we maintain the **hawkish outlook for Fed**. Despite soft inflation readings, the Fed hiked rates two times separately in March and June. Going forward, the Fed is expected to hike rates again in September and announce balance sheet reduction in December. Other major central banks, such as ECB and BOJ, are likely to keep their policies unchanged for the rest of the year, providing support to asset prices.

There are several risks to watch for in 2H 2017. These include a further delay in US pro-growth policies like tax reform, China policy missteps and a persistently low inflation.

Fig 2: Macro drivers for 2H 2017.



Source: Bloomberg, UOB PFS Investment Strategy, 02 Feb 2017

Pass the Income and Quality ("IQ") Test

We continue to stay constructive on risk assets and advise investors to stay invested. Recession risk is low and the current economic expansion cycle could extend further. However, we have the view that the global growth momentum is to consolidate, and most positive factors might be priced in after the strong rally. Hence, the capital appreciation potential in the second half could be more modest. As such we put more **emphasis on downside protection** when we structure the strategies for 2H 2017.

IQ best summarize our approach for the second half. Income helps to boost the total return of the overall portfolio in times when capital appreciation is modest and quality stocks and bonds generally fare better when market turbulence surfaces.

With the overarching theme in mind, we continue to like short-duration high yield and quality subordinated bonds in the fixed income space, as both offer attractive yield pick-up. For equities, we prefer Asian and European equities. We express the view through multi-asset, lower-volatility or higher dividend yield solutions. In US equities, healthcare sector is top on our list. The sector is less sensitive to general economic condition and larger weighted companies in the indices have high return-on-equity.

Last but not least, we wish all our readers a prosperous 2H 2017!

Figure 3: Implication for Investors.

Main Theme	Prudent positioning through **Income and Quality ("IQ")**.
Fixed Income	Prefer short duration high yield and quality subordinated bonds for yield pick-up.
Equities	Prefer Asia ex-Japan and Europe on lower valuation and improving economy. Express through lower-beta solutions.
Sectors	Prefer US healthcare. Structural growth and larger weighted companies have high ROE.
Factor	Prefer quality stocks. Protect against the downside.

Market Outlook and Strategies ▶▶

Investment Perspective – June 2017

Equity	We are constructive on equities. Investors can look to participate in **global equities that emphasise on generating free cash flow.** Focus on **Asia ex-Japan** equities. We hold the view that Asia ex-Japan equities offer longer term return potential. However, the recent outperformance run-up this year may take a breather. Selective on US equities. Focus on **Healthcare** sector. We continue to see stronger Europe data from companies' earnings and macroeconomic fronts. Participate in **European equities** with sustainable dividends.
Fixed Income	**US short duration high yield.** **Subordinated bonds** of high quality financial issuers.
Alternative	Structured notes that allow participation to the equity markets through a customised payoff structure. Investors can participate in rising interest rates through **floating rate notes** structure.
Currency	USD under pressure as Russian probe overshadows the expectation of a June Fed hike. A less dovish Reserve Bank of Australia could lift AUD. Brexit negotiations and the UK elections could weigh on GBP.

Source: UOB Investment Insights – June 2017

Investment Perspective – July 2017

Equity	We are constructive on equities but have moderated our bullish stance since the start of the year. Investors can look to participate in **global equities that emphasise on generating free cash flow.** Focus on **Asia ex-Japan** equities. To take part in Asia's growth story while mitigating risks of excessive drawdowns, we **prefer lower volatility or balanced solutions**. Selective on US equities. Focus on **Healthcare** sector. We continue to see stronger Europe data from companies' earnings and macroeconomic fronts. Participate in **European equities** with sustainable dividends.
Fixed Income	**US short duration high yield.** **Subordinated bonds** of high quality financial issuers.
Alternative	Structured notes that allow participation to the equity markets through a customised payoff structure. Investors can participate in rising interest rates through **floating rate notes** structure.
Currency	USD is likely to be directionless into Q3. Fed may hike in September and if so USD should see some recovery but upside maybe capped. A less dovish Reserve Bank of Australia could lift AUD. Brexit negotiations and the UK elections could weigh on GBP.

Strategy for the month of July

- We have **maintained our calls on Asia ex-Japan and European equities** this month, as both regions are supported by relatively attractive valuations and improving economic backdrop. Lower beta solutions, such as multi-asset, dividend and lower-volatility are preferred to protect against downside risks.
- As widely expected, the Fed raised interest rates by 25 bps from 1.00% to 1.25% on June FOMC meeting. We expected the Fed to hike one more time in September and commence balance sheet reduction in December. **Stay short duration and invest in high quality subordinated bonds to buffer interest rate risks.**
- Senate's healthcare proposal left many of Affordable Care Act (ACA)'s provisions in place, and softened some cuts from the House proposal. The less aggressive proposal **boosted the sentiments for Healthcare**. We stay constructive on the sentiment for the US Healthcare industry.
- **USD could be directionless moving into Q3**. With balance sheet reduction (BSR) in the picture, the question will be how many times the Fed can hike its rate going forward. If the economic data turns soft, the Fed could hold back from further hikes. The Fed may hike in September and if so USD could see some recovery but upside may be capped.

Strategy	Analysis	
	Short Duration High Yield Bonds	
1 Position for higher rates through short duration high yield bonds and subordinated bonds. **Position fixed income investments defensively on increased interest rate risks.**	Value	Albeit spreads have narrowed, **the yields are attractive** compared to US Treasuries.
	Trend	Investor fund inflows have been **supportive**.
	Activity	**Economic outlook should remain positive**, supported by healthy labour market and improving business sentiments.
	Risk	**Default rates are expected to stay low** as economy is robust.
	Subordinated Bonds	
	Value	**Yields are attractive** compared to senior bonds of investment grade companies
	Trend	Technical indicators point to **sideways movements**.
	Activity	Inflation may pick up. **Higher yields could cushion negative impacts on prices**.
	Risk	**Default risk is likely to stay low** for companies with strong balance sheets.
	Asia Ex-Japan Equities	
2 Asian equities are attractive, given low relative valuations and supportive economic backdrop. **Tap on Asia Value.**	Value	Price to earnings ratio (P/E) for Asia ex-Japan equities at 15.4x is **attractive relative to DM equities** at 21.5x Earnings forecasts for the region has turned positive after 2 years of underperformance.
	Trend	**Trend is positive and momentum remains strong**. However, strong run-up may set markets up for short term corrections.
	Activity	**Economic data are supportive**. PMI for key economies have been resilient while export remains buoyant.
	Risk	**Watchful of potential slowdown in China**. Though the Chinese economy has done well in the first half, some manufacturing indicators have turned softer.
	US Healthcare	
3 Invest in US through sectorial play, like Healthcare. **Be selective on US sectors, and be nimble.**	Value	**EPS looks resilient and well-supported**. Forward P/E (at 16.4x vs S&P 18.8x) is relatively cheap.
	Trend	**Momentum is strong and trends are still in place**. Upward trend resumed from mid May.
	Activity	**Business and consumer sentiments are positive**. Business sentiments appear resilient for this sector.
	Risk	**Republicans are trying to repeal and place Affordable Care Act (ACA)** before summer recess in August.

<table>
<tr><th>Strategy</th><th colspan="2">Analysis</th></tr>
<tr><td rowspan="5">4
European equities are well supported by relatively attractive valuation and solid economic fundamentals.
Approach European equities (with a focus on dividends) for added stability.</td><td colspan="2">European Equities</td></tr>
<tr><td>Value</td><td>European equities are trading at wide valuation gap to US equities. Earnings forecasts are revised upwards in 2017.</td></tr>
<tr><td>Trend</td><td>Trend turned positive and is at early stage of recovery. As political risks moderate, the outflows since 2016 may potentially reverse in 2017.</td></tr>
<tr><td>Activity</td><td>Economic data are supportive. Better PMI figures and corporate borrowings indicate that the Eurozone economy is recovering.</td></tr>
<tr><td>Risk</td><td>UK elections ended in a hung parliament, opening a possibility of a softer but more disorderly Brexit. The impacts are likely to be localised hence risks remain balanced.</td></tr>
<tr><td rowspan="5">5
Gain managed equity exposure through global quality stocks.
Focus on companies that generate stable free cash flow.</td><td colspan="2">Global Quality Equities</td></tr>
<tr><td>Value</td><td>Earnings per share growth remains robust as good quality companies often operate in sectors and industries with improving fundamentals.</td></tr>
<tr><td>Trend</td><td>Both long-term and short-term trend are positive. Technical indicators are trending up.</td></tr>
<tr><td>Activity</td><td>Stable global growth provides a benign environment to invest in global equities.</td></tr>
<tr><td>Risk</td><td>Global recession risk stays low. However, relatively hefty valuations increase the probability of short-term correction.</td></tr>
<tr><td>FX
Continued weakness in GBP expected.</td><td colspan="2">• USD directionless moving into Q3. Fed may hike in September and if so USD should see some recovery but upside may be capped.
• Less dovish Reserve Bank of Australia could help lift AUD.
• Brexit negotiations and the UK elections could weigh on GBP.</td></tr>
<tr><td>Rates
Rising US rates expectations on the back of Fed tightening.</td><td colspan="2">• The Fed is forecasted to hike three times in 2017, with two hikes already done separately in March and June. The next hike is expected to be in September.
• USD 3M Libor has increased significantly from 0.62% in January 2016 to 1.30% in June 2017. USD 3M Libor is forecasted to reach 2.04% in 2018 Q1.</td></tr>
</table>

RIGHT BY YOU

United Overseas Bank Limited Co. Reg. No. 193500026Z