HOUSE VIEWS

Facing Some Headwinds

The global business cycle has continued to register above-trend growth and leading indicators suggest that conditions remain in place for further expansion of activity. The eurozone has seen growth accelerate to around a 2% pace, well above its long-term potential. In the US, the economic impact of Hurricane Harvey is likely to be contractionary in the near term, followed by a pick-up as rebuilding gets underway. In the run-up to next month's party congress in China, growth has outperformed expectations – however, we expect the focus to shift away from debt-fuelled stimulus towards more balanced growth in coming quarters.

Despite the positive macro backdrop, price pressure remains muted in the main. Unemployment is declining steadily across developed economies, reaching cycle lows in many cases, yet wage pressures are still subdued across the board. Although industrial metals prices have accelerated recently, oil prices look set to trade sideways in coming quarters, meaning little impact from this key driver of input inflation. In the eurozone, this year's strength in the single currency will keep imported inflation at bay. Finally, inflation in many emerging economies has fallen to a low single-digit pace.

Given the strong global economy, the need for exceptionally accommodative monetary policy is increasingly debatable. However, many central banks are required to formulate policy with reference to an explicit inflation target, which few have met or exceeded. In this context, we expect monetary normalization to remain gradual. In the US, another rate hike remains possible but the Federal Reserve's focus is currently on trimming its asset holdings via reduced reinvestment of maturing bonds. The European Central Bank is likely to continue its purchase programme next year, but at a scaled-back pace – higher key rates are not yet on the horizon.

More details inside...

Our views summarized

EQUITIES	BONDS	ALTERN.

Here, we present our VaMoS investment approach, combining economic, valuation, momentum and sentiment signals that help us fine-tune our views on asset classes for the coming period. The signals below reflect the latest conclusions of our Global Investment Committee. Here's how to read them:

Least preferred Neutral Most preferred Upgrades in green, downgrades in red

EQUITIES		VA Valuation	VA Fundam.	VA Macro.	MO Momentum	MO Technicals	S Sentiment	S Risk
United States								
Eurozone								
UK								
Switzerland								
Japan								
Emerging								

BONDS – EUR	Global	VA	MO	S
Govies				
Linkers				
Inv. Grade				
HY				
Duration*	Short			

USD	Global	VA	MO	S
Govies				
Linkers				
Inv. Grade				
HY				
Duration*	Short			

GBP	Global	VA	MO	S
Govies				
Linkers				
Inv. Grade				
HY				
Duration*	Short			

CURRENCIES	
EUR/USD	
GBP/USD	
USD/JPY	
EUR/CHF	
USD/CNY	
Emerging vs USD	

ALTERNATIVES	
Hedge funds	
Gold	
Oil	

Source: SG Private Banking, 8 September 2017, * Duration: short = 3-5yr, medium = 5-7yr, long = 7-10yr; HY = High Yield

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In other words

EQUITIES*	*United States*	Despite healthy earnings growth, monetary policy normalisation in the US should weigh on stretched valuations.
	Eurozone	A stronger euro will reduce corporate profits. However, eurozone equities are supported by robust economic growth and a still accommodative European Central Bank.
	UK	Slower earnings growth and Brexit uncertainty call for cautiousness.
	Switzerland	Internationally-oriented Swiss companies benefit from the global economic recovery and a weak franc.
	Japan	Japanese equities are supported by strong profit growth, improved corporate governance, and compelling valuations.
	Emerging	Neutral overall with a preference for markets undertaking structural reforms and those geared to the upswing in the technology cycle.
BONDS*	*Sovereigns*	After a recent bout of weakness, long-term yields could be supported by stronger economic momentum and an upturn in inflation.
	*Duration***	We favour the short end as the yield curve could steepen or shift upwards.
	Inflation-linked	Despite muted inflation, we remain constructive on the segment.
	Investment Grade	We continue to prefer high yield over investment grade bonds in euro-denominated portfolios, and bank issuers over industrials.
	High Yield	The macro backdrop is supportive but strong investor appetite has pushed spreads to levels which warrant a neutral stance.
	Emerging debt (hard currency)	Positive economic momentum, receding inflation and compelling real yields still attract investors towards emerging debt. However, selectivity is advised given valuations are increasingly demanding.
CURRENCIES	*EUR/USD*	The euro's recent strength seems overdone. Now that speculative positioning has reached extremes, we could see a modest correction. However, the outlook remains positive in the longer term.
	GBP/USD	A gradual slowdown in economic activity and Brexit uncertainty could drive sterling a little lower.
	USD/JPY	The yen has strengthened gradually against a weak dollar. However, we expect renewed weakness given the Bank of Japan should maintain its ultra-loose monetary policy and the interest rate differential could widen.
	EUR/CHF	The Swiss franc has lost some ground versus an outperforming euro. A further slide might be on the cards, but the downside will be limited if the central bank stops intervening on currency markets.
	Emerging	Thanks to capital inflows and attractive carry, emerging market currencies have rallied against the generally weaker dollar. We believe that these factors will persist, warranting a neutral stance.
ALTERNAT.	*Hedge funds*	This year's slide in correlations between stocks is helpful for Long / Short Equity strategies. CTA managers have built directional exposure to positive equity market trends, reducing their diversification benefits.
	Gold	Gold has benefited from safe-haven buying as tensions have risen on the Korean peninsula, providing good diversification for investors. However, upside potential is now limited.
	Oil	We still see range-trading in oil prices as rising demand is met by supply increases.

Source: SG Private Banking, 6 Sep. 2017, EM = Emerging markets, hard currency = dollar & euro, *Relative views expressed in local currencies, ** Duration: short = 3-5yr, medium = 5-7yr, long = 7-10y

Economic focus

Secular stagnation or debt deflation?

Ten years after the first cracks appeared, the drivers of global financial crisis are still hotly debated. Excess leverage, lax regulations, overly loose monetary policies all contributed to causing the financial meltdown that brought the global economy to its knees. But some countries recovered faster than others.

Some countries have recovered faster than others

- The United States has outperformed the eurozone since the crisis with GDP and corporate profits back above 2007 levels, while they still lag in most European countries. This suggests that policy response was swifter and better designed in America than in Europe.
- Many emerging markets weathered the storm pretty well thanks to unsophisticated financial systems, closed capital accounts and solid growth.
- However, with the commodity boom now over, prospects do not look as bright – robust improvements in public and corporate governance will be required to achieve economic progress.
- Asia offers better prospects than the other emerging regions in terms of investment, education and policies. Favourable demographics will be viewed as an asset in an ageing world, giving Africa an edge over other emerging regions.

But is it secular stagnation or debt deflation?

- Some pundits believe that the world economy has entered a period of secular stagnation with low growth, low inflation and low rates for the long term. Others blame the debt deflation on the slow-paced recovery and the time necessary to restore severely damaged balance sheets and revive animal spirits. This is a big difference – do we face a "new normal" or is this a passing phase?
- Public and private sector leverage has grown further since the crisis, increasing the debt burden for future generations. Low policy rates have made this debt manageable in advanced economies but risks are mounting elsewhere, especially in China. Tighter monetary policy in the United States will now begin to put Europe but also emerging economies to the test – US rates have implications well beyond the country's borders.
- Central banks are also struggling to lift inflation. Although unemployment rates have returned to historical lows in the US, Germany and Japan, inflation remains tame. Does this mean that inflation will remain structurally lower or it is just a lagged effect? In the first case, central bankers would have to replenish their tool box. In the second, inflation will eventually pick up, suggesting we should remain patient.
- More worryingly, productivity growth has been dismal in most advanced economies. This is a key policy concern as demographics and productivity are the two main drivers of long-term growth. With demographics already worsening, only better productivity prospects could give growth a welcome boost.
- However, we may in fact be witnessing the beginning of a new innovation cycle, featuring cloud computing, connectivity and robotization. It is still too early to be sure if we face secular stagnation or the early stages of a new productivity cycle – but all hope is not lost.

Fixed Income

Robust growth and central bank tapering to trigger higher yields on sovereigns

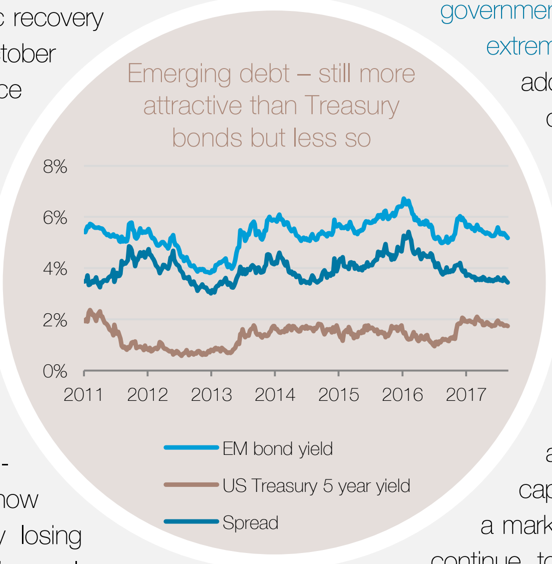
Long-term yields may soon bottom out before rising again – term premia and inflation expectations could be boosted by downsizing of the Fed's balance sheet, reduced ECB asset purchases, tighter labour markets and rising commodity prices.

Within fixed income portfolios, investors should focus on inflation-linkers and floating-rate notes rather than fixed-coupon bonds, credit rather than sovereigns, and euro-denominated High Yield rather than Investment Grade. Improving macro fundamentals argue for maintaining exposure to emerging markets.

Rates

"Stick to short-dated bonds and prefer spread products and floaters to hedge against a likely rise in long-term yields."

- Fed – trimming the balance sheet. The Fed will become less of a support to bond markets as it begins to scale back its asset holdings. The impact should be marginal at first but increase over time. Medium- and long-term maturities will be the most exposed to a repricing. Expectations for another hike in December are low but inflation pressure could revive them.
- European Central Bank – Streamlining asset purchases. ECB support has ensured economic recovery in the eurozone – September/October should see the central bank announce it will extend asset purchases into 2018, albeit at a gradually reduced pace. Benchmark yields are depressed and interest rate risks are significant with current yields well below inflation. Expect volatility spikes if bond markets adjust abruptly.
- Bank of England – on hold. Inflation concerns have eased, with the pass-through effect of sterling weakness now receding. The economy is steadily losing pace as a consequence of negative real wage growth and growing Brexit uncertainty. This should dampen inflation risks despite downside risks to sterling. The BoE may be inclined to remain on hold for a while. Long-term yields might not be immune to the global uptick but moderate growth and inflation should limit the upside.



Credit

"Improved capital adequacy will support financials while better macro will aid emerging markets."

- The macro backdrop continues to suggest a combination of steady growth, low inflation and supportive monetary policy settings. This is a favourable context for credit markets of course, given the low probability of a spike in defaults on debt obligations.
- However, this has been the case for some time and has been well-recognised by markets. As a result, the yield hunt has pushed credit spreads – the yield gap between government and corporate bonds – to extremely tight levels. Accordingly, the additional income no longer fully compensates for the additional risk inherent in such securities.
- There remain a number of pockets of relatively attractive value in credit markets. One such segment is the financial sector. Since the subprime crisis began 10 years ago, regulators have pushed banks to reduce leverage and reliance on trading and to rebuild capital adequacy ratios, thereby ensuring a marked improvement in credit quality. We continue to find opportunities in subordinated financial debt.
- Another area of opportunity is in emerging markets. Inflation is low, macro imbalances are improving, central banks have room to cut rates and the weaker dollar means financial conditions for borrowers have eased. The yield pick-up remains attractive, warranting continued exposure to this segment.

Sources: SGPB, Bloomberg (01/09/2017). IG = Investment Grade. Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

Equities

Corporate earnings growth set to lose steam

The 13.1% rise in global equities year-to-date has been driven by stronger earnings growth while valuation measures have stayed high thanks to low bond yields. The global economic recovery should keep corporate profits high in coming months. However, earnings growth should slow now that leading indicators have peaked. Moreover, above-average valuation metrics should be pressured by a gradual normalisation in US and eurozone monetary policy. All in all, we expect less positive equity returns going forward.

Eurozone and Japan still our favourites

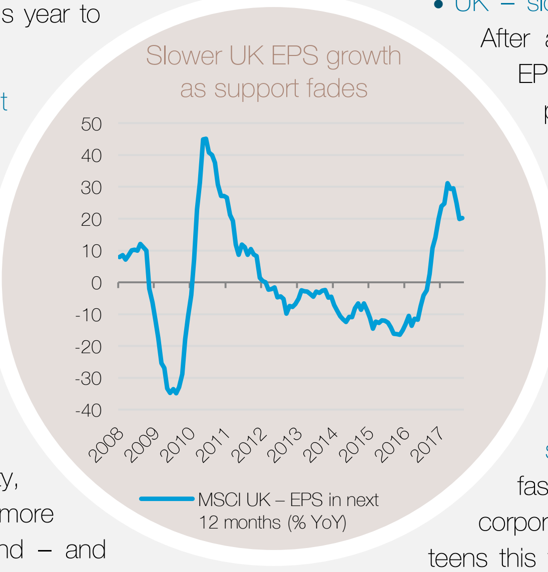
> *Recent currency moves have led to shifts in earnings prospects.*

- Eurozone – Solid growth but stronger euro starts to bite. This summer, eurozone equities have suffered from a stronger euro and analysts are now cutting their earnings forecasts for multinationals as they realise a large share of their revenues abroad. However, the ongoing economic recovery is good news for corporate profits. In addition, moderate wage growth and persistently easy financing conditions should contribute to creating a favourable environment for companies. All in all, earnings growth is expected to ease from 11.4% this year to 8.6% in 2018.
- Switzerland – Multinationals to benefit from weaker franc. Stronger business confidence, ultra-accommodative monetary policy and a weaker franc will help Swiss multinationals record solid earnings-per-share (EPS) growth.
- Japan – strong earnings growth and reasonable valuations. Japanese equities have been supported by improved profitability, strong earnings growth – thanks to more robust domestic and global demand – and attractive valuations. A consolidation in USD/JPY these next six months (see page 7) will also contain downside risks as the Japanese equity market traditionally shows a negative correlation to the yen.

We stay cautious on US and UK equities but neutral on emerging markets

> *Higher US bond yields are often associated with lower valuations, limiting US equities' upside*

- United States – limited upside. Thanks to a weaker dollar and healthy domestic demand, corporate profits are expected to grow at a double-digit pace this year. However, financing conditions should deteriorate in coming months as the Fed hikes rates and reduces its balance sheet, a headwind for highly leveraged companies. Furthermore, valuations should become less stretched as US rates increase, limiting the upside potential.
- UK – slower profit growth calls for caution. After a strong acceleration in mid-2016, EPS growth has started to slow as past positive effects from a weak sterling and higher oil prices fade. Although the recent surge in base metal prices has boosted earnings in the Materials sector, it is not enough to support the market as a whole given Brexit worries. Overall, we remain cautious.



- Emerging markets – neutral stance. Stronger global trade and faster economic growth will help corporate profit growth reach the high teens this year in emerging countries. A weak dollar and attractive valuations, especially compared to developed markets, are also supportive. However, Fed rate hikes and slower Chinese growth could act as headwinds in coming quarters. As a result, we still prefer markets undertaking structural or corporate governance reforms and those geared to the technology cycle.

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Currencies

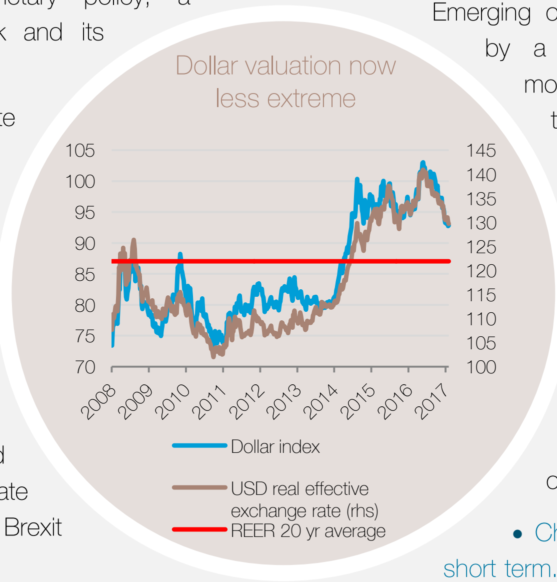
Dollar rally is over

With the White House still struggling to pass reforms, fiscal stimulus looks increasingly unlikely. The dollar has lost further ground versus developed and emerging market currencies and now looks oversold. Although It could recover somewhat if US interest rates edge up, its highs are behind us.

Euro to pause after its recent rally

The euro should reverse some of its recent gains as the Fed reduces its balance sheet.

- Euro – consolidation time. The single currency has reversed some of its gains after breaking above 1.20. The recent uptrend was caused by a shift in the perception of US political risk and heavy speculative buying of the euro. The dollar is now oversold and could recover as Fed tapering drives US rates higher. In the longer run, the euro should be supported by the ongoing economic recovery, a normalisation in the ECB's monetary policy, a strengthening institutional framework and its comparative attractiveness.
- US dollar – neutral stance. Despite recent improvement in leading indicators, US growth remains moderate and further Fed rate hikes will require a pick-up in inflation. Persistently negative short-dated real rates could also put a lid on the greenback.
- Sterling – downside risks. Sterling remains driven by Brexit talks and inflation trends. The growing rate differential with the US and Brexit uncertainty should drag it lower.
- Swiss franc – easing lower. The franc remains clearly overvalued and the central bank will continue to talk it down. In addition, in light of economic improvement and lower political risk in the eurozone, we could see lower safe-haven flows towards the franc. However, this easing of upward pressure on the currency means less need for forex interventions by the central bank, suggesting that potential downside will be limited in scope.



Still bottom-fishing, selectively

Yen heading south unlike emerging currencies

- Yen – heading south. The yen has been underpinned by its safe-haven status, a buoyant Japanese economy and broad-based dollar weakness. However, the central bank is committed to reviving inflation and expectations of a wider interest rate gap with the US should leave the yen under pressure.
- Emerging currencies – resilience as dollar risk fades. Emerging currencies should remain supported by a soft dollar, improving economic momentum, higher commodity prices, the yield hunt and robust China readings. However, in some countries, receding inflation could lead to rate cuts. This would narrow the gap versus the US and could reduce the attractiveness of emerging market bonds as the Fed further tightens its monetary policy. Selectivity remains key in emerging currency markets.
- Chinese yuan – upside risks in the short term. The currency remains supported by robust growth and tight monetary policy. Economic expansion has lead to inflows to Chinese equities. The yuan could gain further ground as the expansion in global trade bodes well for China and its trading partners. We maintain a constructive view on the yuan versus the dollar ahead of the People's Party congress in mid-October.

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Alternatives

Limited upside for oil and gold

Geopolitical tensions and a destructive storm have sent gold and gasoline prices spiking. However, we expect a return to more standard levels in coming weeks.

Thanks to weaker correlations between stocks and sectors, actively-managed hedge funds have performed well year-to-date, despite the impact of flows to passive exchange-traded funds in recent years.

Commodities

"Oil prices should return to more standard levels once the hurricane is over."

- Oil prices – not much to hope for. Hurricane Harvey has wreaked havoc on the Gulf Coast (home to 18% of US crude oil output and over 45% of oil refining capacity). The resulting surge in gasoline prices could correct in coming weeks as the US Department of Energy offsets shutdowns with releases from its strategic reserves. Meanwhile, oil demand should continue to rise gradually thanks to above-trend global growth. All in all, slow rebalancing of supply and demand could keep oil prices in a $50-55 range.
- Gold – Limited upside. North Korea's latest nuclear test sent gold to an 11-month high in US dollar terms with bullion up 10% since its July low. In the short run, gold prices could be supported by further geopolitical tensions and recent rate-driven dollar weakness. However, the upside could be limited by the Fed's intention to commence shrinking its balance sheet shortly and by the possibility of another rate hike by year-end. All in all, we expect the recent rally to be short-lived and still target $1,225 in 6 months.

Hedge funds

"Falling correlations between US equities are helpful to fundamentally-driven stock-pickers."

- Long / Short Equity. The past year has been characterized by a sharp drop in correlations between stocks – from 60% to 18% for the members of the S&P500 index, the lowest level since 2004. This has helped Long / Short funds register strong returns since early 2017. We continue to favour fundamentally-driven stock-pickers in the US and Long and Variable Bias managers in Europe and Japan.
- Event Driven. The sharp fall in correlations also benefits fundamental traders in Special Situations, as stocks respond more to intrinsic value and factors and less to macro trends. While most corporate takeover deals are completing successfully, arbitrage spreads remain tight, meaning that return potential for Merger Arbitrage has fallen along with the risk of non-completion.
- Rates / Credit. As highlighted on page 5, spreads between yields on government and corporate bonds are extremely tight. This means that return potential in Long / Short Credit is constrained. And with strong macro readings and low default risk, it is still too early to look at Distressed Debt.
- Global Macro / Commodity Trading Advisors. Momentum in equity markets remains strong (see our VaMoS framework on page 2), and CTAs have built up substantial directional exposure, which reduces their usefulness as a diversifier of risks. Our preferred area in Global Macro remains multi-asset strategies in emerging markets, given the attractive opportunities to be found.

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CA642/SEP/2017