Monthly House Views

Pace yourself

The synchronised upswing in the global economy looks set to continue in 2018. The growth outlook for the US was already for a robust ~2% before the announcement of the tax cut plan in late December provided an additional boost. Revived business confidence has shown up in capital expenditure plans, which will be key to kick-starting productivity growth and prolonging the cycle. While we anticipate a gradual slowdown in China as the authorities seek to reduce leverage in the financial system, we still believe global economic growth should be higher this year than last.

We believe that robust global growth will begin to revive household and investor expectations for inflation in 2018. However, the actual rises in prices will continue to be muted by the disinflationary forces which have developed in recent years – globalization of business supply chains, the impact of the sharing economy etc. – except in the UK where the devaluation has boosted prices of imported goods. Bottom line – inflation will rise closer to central bank targets throughout the year.

In this context, monetary policy normalization is set to continue. In the US, the Federal Reserve (Fed) will hike further and continue gradual shrinkage of its asset holdings. The European Central Bank (ECB) has already decided to slow the pace of asset purchases and is likely to announce a halt to the programme in the second half – careful communication will be key to avoiding market disruption – but we do not expect rate hikes to commence until well into 2019. Given the gradualism of policy adjustments, monetary policy will remain broadly supportive this year.

More details inside...

2 to 3 – Our views summarized

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In accordance with the applicable regulation, we inform the reader that this material is qualified as a marketing document.

Our views summarized

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:

EQUITIES

		VA			MO		S	
		Valuation	Fundam.	Macro.	Momentum	Technicals	Sentiment	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, 16 January 2018,
* Duration: short = 3-5yr, medium = 5-7yr, long = 7-10yr; HY = High Yield

In other words

EQUITIES*	United States	Despite robust profit growth, upside in US equities will be capped by Fed policy normalisation.
	Europe	Corporate earnings will remain supported by the global economic recovery but will rise at a slower pace. Political uncertainty (Brexit, Italian elections) and the ECB's cuts in asset purchases may cause investors some concern.
	Eurozone	Eurozone companies will continue to benefit from a positive economic backdrop, but weaker earnings growth than 2017 and lower profitability compared to global equities may cap the outperformance potential. We remain slightly overweight.
	UK	Despite support from a weaker currency and rising oil prices, we remain cautious. Earnings growth remains slow and the outcome of Brexit negotiations is still uncertain.
	Switzerland	Swiss multinationals should continue to benefit from a weaker franc and strong business confidence.
	Japan	A loose policy mix, robust corporate profit growth, improvement in corporate governance and attractive valuations will continue to support Japanese equities.
	Emerging	Despite a positive environment and attractive valuations, the economic context will be a little less supportive in 2018 while the strong upside momentum leaves prices in overbought territory.
BONDS*	Sovereigns	Synchronized and sustained growth is set to push yields higher, weighing on bond performance.
	Duration**	We favour the short end as the yield curve could shift upwards and steepen.
	Inflation-linked	Early signs of inflation pressure reinforce our positive stance on inflation-linked bonds.
	Investment Grade	In the US, we retain a slight preference for Investment Grade (IG) bonds over High Yield (HY). We suggest focusing on longer-dated IG bonds, which should see less supply.
	High Yield	In the eurozone, we prefer HY to IG bonds – balance sheets look healthier than in the US, the economic backdrop is supportive and the yield pick-up remains attractive.
	Emerging debt (in € and $)	Attractive yields and a supportive macro environment have underpinned performance of emerging debt.
CURRENCIES	EUR/USD	The euro is at a 3-year high thanks to a supportive environment but a short-term pullback cannot be ruled out.
	GBP/USD	Sterling has benefited from a better global economic background and a rate hike but the future looks gloomier.
	EUR/GBP	The cross rate is likely to reach or break through historical highs in 2018.
	USD/JPY	Mixed forces should keep the yen range-trading.
	EUR/CHF	Global risk appetite and a stronger euro will continue to weigh on the franc.
	Emerging	Flow and macro factors bode well for emerging currencies but beware of countries with weak fundamentals.
ALTERNAT.	Hedge funds	Market dynamics will continue to favour Long/Short Equity and the macro backdrop is also supportive for Event Driven strategies. Opportunities in Credit and Distressed Debt will remain thin on the ground.
	Gold	Sustained demand for physical gold and a rise in gold-related Exchange Traded Fund (ETF) holdings have lifted prices although the US rates outlook acts as a headwind.
	Oil	Supply disruptions, the extension of output cuts and robust demand have driven prices higher. However, the upside will be limited by an increase in US shale production.

Source: SG Private Banking, 11 Jan. 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

Treasury yields – How much upside?

- After range-trading in 2017, Treasury yields have soared in recent weeks. However, they remain well below fair value.
- Tax cuts will help boost growth while rising wages put further pressure on the Fed to normalise policy. Widening deficit and reduced Fed purchases also to put upward pressure on yields.
- These forces will be mitigated by disinflationary forces and by international flows.
- All in all, we expect yields to grind higher over 2018.

- In 2017, long-term bond yields traded in a range, as inflation prints and forecasts remained low despite further expansion in global growth.
- However, the first weeks of 2018 have seen US bond yields spike as markets feared a cutback in Chinese buying and expected faster normalization of monetary policies in the US and abroad. While there is little chance of Chinese investors dumping Treasury bonds, the recent sell-off of Treasuries reflects market nervousness.
- US yields have returned to levels last seen in early 2017 when markets still expected that swift economic recovery would push inflation much higher. They are still below fair value, which can be derived from long-term nominal growth. With potential growth at 2% in the US and the country's GDP deflator between 1.5% and 2%, fair value for bond yields would stand in the region of 3.5-4% - although yields can of course remain well below these levels for long periods.
- Looking further out, we see some other factors likely to push US yields higher and others that could limit the upside.

What could drive US yields higher?

1. *Strong growth.* US growth has been running at or close to 3% in recent quarters and we expect tax reform to give the economy a further boost. With unemployment already below its equilibrium rate, wages are likely to pick up sooner than later.
2. *Fed rate hikes.* We expect the US Federal Reserve (Fed) to hike rates further as higher wages feed into higher inflation. The market consensus remains much more cautious, and the resulting adjustments to expectations would impact longer-dated bonds through higher term premia.
3. *Further tapering.* To cut its balance sheet, the Fed no longer reinvests the full proceeds from maturing bonds. So far, the impact has been minimal but the Fed will continue to reduce reinvestment, shrinking its importance as a marginal buyer of bonds and mortgage-backed securities.
4. *A widening budget deficit.* The tax reform will deepen the long-term deficit. This will lead to heavier debt issuance, putting yields under upward pressure.

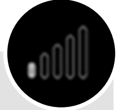
And what could limit their upside?

1. *Inflation disappointments:* Despite stronger growth, disinflationary forces may continue to quell inflation pressures, contributing to a flatter yield curve.
2. *Central bank liquidity provision:* While the Fed is cutting its balance sheet, other G4 central banks are still injecting liquidity into the market, making yields less volatile. We do not expect the aggregate balance sheet of the G4 central banks to begin to shrink before 2019.
3. *Yield gap:* Monetary policies remain ultra-loose in Japan and the eurozone, capping domestic bond yields. This encourages bond investors to chase higher yields in the US, either directly in dollars or by hedging the currency. This means that upside in US yields is contained by low yields elsewhere, which prevents the yield gap against Bunds from exceeding 2% for long.

Bottom line

- We believe that bond yields will be driven modestly higher in 2018 by strong growth and monetary policy normalization. However, we do not expect a bond crash as central banks will continue to phase out their monetary stimulus gradually and inflation is unlikely to shoot up.

Fixed Income



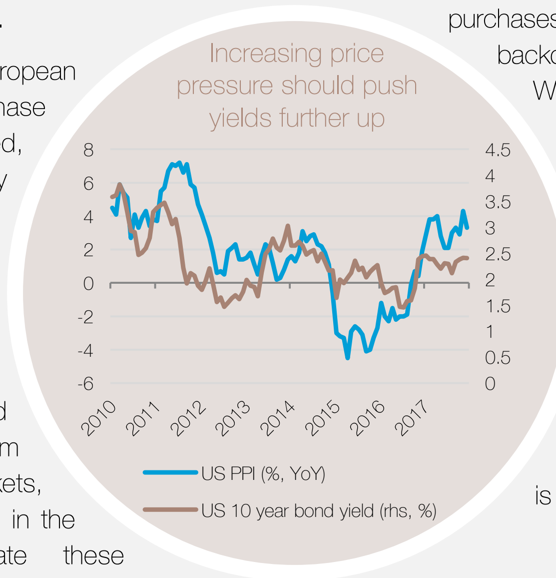
Rates on the Rise

- Rising yields mean short-maturity sovereign bonds should be preferred to longer dates.
- Inflation-linked securities should also do well.
- Tight credit spreads call for selectivity – for example, investment grade bonds in the US, High Yield in the eurozone and corporate hybrids.

Rates

"We see higher yields creating value later this year"

- The macro backdrop continues to argue for higher long-dated yields across the board.
- United States. Regarding the market in US Treasuries, the recently-decided tax cuts provide additional economic stimulus and have also begun to feed into higher wage settlements. Yields have already begun to move higher and there is further to come. This warrants a defensive stance at present, although we do see higher yields creating some value later this year.
- Eurozone. Although the European Central Bank's asset purchase programme remains open-ended, gradual normalisation has clearly commenced. We expect higher long-dated yields and continue to prefer the eurozone periphery to the core, and inflation-linkers to fixed-coupon bonds.
- United Kingdom. Gilt yields should experience upward pressure from the US and eurozone markets, although the weakness expected in the UK economy should mitigate these pressures.



Credit

"Recovery and ECB corporate purchases favour eurozone credit"

- The yield pick-up suggests modest outperformance of sovereigns by corporate bonds.
- Investment Grade (IG) credit spreads have tightened less in the US than in the eurozone, while those in High Yield (HY) have reached extremely demanding levels. Credit cycle dynamics suggest IG should be preferred to HY in dollars.
- Eurozone economic recovery and corporate bond purchases by the ECB provide a favourable backdrop to credit markets in the region. While HY should be preferred to IG in euros, opportunities remain in niches such as corporate hybrid bonds.
- Emerging debt. Macro-economic fundamentals in emerging markets have improved, and slowing inflation is enabling less restrictive monetary policies. However, spreads are tight in many markets and selectivity is advised.

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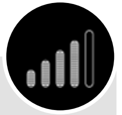
Equities



The race is not over, but mind the Fed

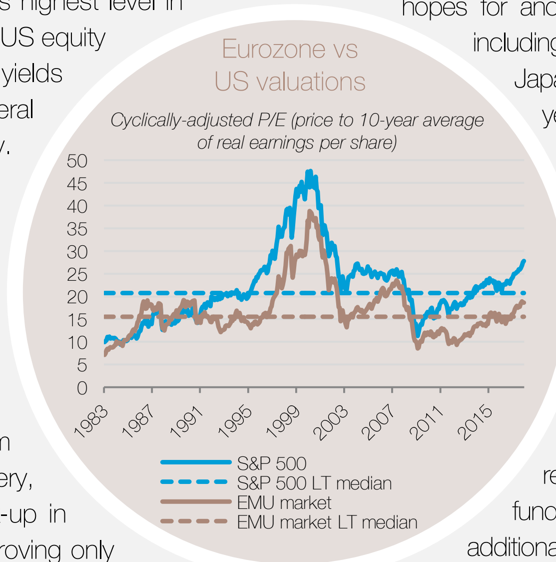
- Synchronised global economic expansion and loose financing conditions will help corporate profit growth stay robust this year and keep global equity markets well orientated.
- However, equity markets are now faced with high valuation and over-optimism. Equity returns should be less impressive than last year as declining central bank support will lead to greater volatility.
- We prefer those markets which benefit from stronger domestic demand, high exposure to the global economic and trade cycles and which are more reasonably valued, such as eurozone and Japan.

We still prefer the equity markets most exposed to the global economic cycle

> *Despite robust profit growth, US equity upside will be capped by Fed policy normalization.*

> *Favour Japan, the eurozone and Switzerland.*

- United States. Corporate earnings are expected to grow by double-digits again this year, helped by further economic expansion, tax cuts, a weaker dollar and a rebound in oil prices over the past two years. Moreover, corporate fundamentals are strong, as profit margins and returns on equity are both well above the global average. However, investors seem over-optimistic. According to the AAII Sentiment Survey conducted earlier this year, individual investor sentiment has surged to its highest level in more than seven years. In addition, US equity prices are expensive while bond yields are likely to increase as the Federal Reserve tightens its policy gradually. Any spike in bond yields could weigh on rich valuations, thus capping upside potential.
- Eurozone. European companies will continue to enjoy favourable financing conditions as moderate inflation leads the ECB to act very gradually. They will also benefit from the broad-based domestic recovery, stronger global growth and a pick-up in capital spending. Profitability is improving only slowly but top-line growth remains strong, wage pressure is tame and profit margins should improve further. In addition, Financials, the largest equity sector, will be supported by domestic economic expansion and private loan growth. Valuations are not particularly attractive in absolute terms but remain below the US.
- Switzerland. Swiss equities should benefit from a weak franc, stronger business confidence and robust growth in the eurozone, its main trading partner.
- UK. Synchronised global growth, a weak currency and the recent rise in oil prices should support the UK market given the high proportion of sales generated overseas and the significant weight of energy-related sectors. However, the economy is slowing, companies lack clarity on the outcome of Brexit negotiations and earnings are only expected up 6% this year, slower than elsewhere.
- Japan. Last autumn's re-election of Mr Abe has revived hopes for another wave of "Abenomics" reforms, including a looser fiscal policy. The Bank of Japan will stay ultra-accommodative this year with inflation still below the 2% target, although Japanese growth is already above potential. Moreover, corporate earnings growth is robust thanks to improved domestic activity and global and regional trade growth. Valuation metrics remain attractive in both absolute and relative terms. In addition, corporate governance reforms and sound company fundamentals (low leverage) will provide additional support to Japanese equities.
- Emerging markets (EM). Emerging equities should remain supported by stronger global trade, high exposure to technology innovation, higher oil prices and a weak dollar. However, the economic context will be a little less supportive in 2018 with a mild slowdown in China, rate hikes in the US and a rise in global yields in reaction to higher inflation. As a result, earnings-per-share growth should slow in 2018 but remain in double digits. Absolute and relative valuations also remain attractive. However, EM equities are now overbought after a strong rally and we would stay neutral.



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Currencies

Euro – Catching a lift

- Dollar weakness is back to the fore.
- The euro is set to firm as sustained growth, a likely shift in ECB stance and foreign investor flows are supportive.
- Higher commodity prices, global trade recovery as well as tech sector frenzy are lifting emerging currencies.

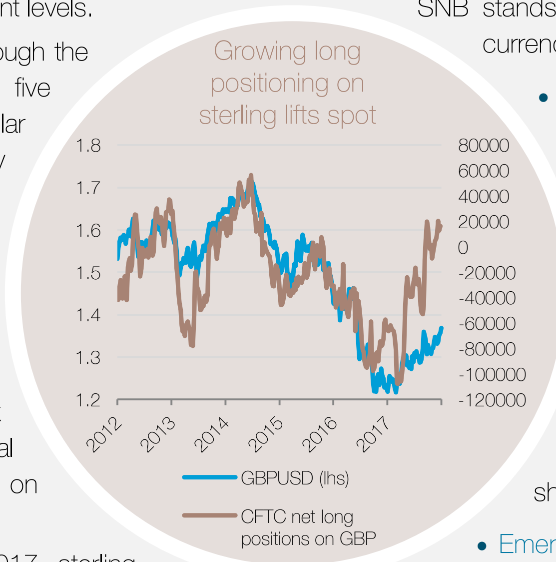
Dollar – weakness confirmed

"The euro is now at a 3-year high."

Swiss franc to shed ground

"Emerging currencies remain supported by good fundamentals and higher yields."

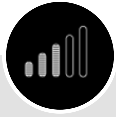
- Euro – on the rise. News of progress in German coalition talks has propelled the single currency to a 3-year high. Renewed speculation of a rise in the ECB deposit rate has also played in favour of the euro. Although upward revisions in expectations for Fed rate hikes could support the dollar, we remain quite constructive on EUR/USD. With growth above potential and no signs of weakness, the ECB is set to turn less dovish. This should give a further lift to the euro which remains undervalued at current levels.
- Dollar – weakness confirmed. Although the Fed has already hiked key rates five times and will do more, the US dollar has been losing ground since early November. The dollar index is back to late-2014 levels. In the short term, a bounce is likely as higher inflation bodes for faster monetary policy tightening. However, in the medium term, expensive valuations, high risk appetite and abundant global liquidity should continue to weigh on the dollar.
- Sterling – weakness ahead. In 2017, sterling recovered gradually thanks to the softer dollar and a resilient UK economy. The Bank of England's quarter-point rate hike in November also helped. The latest economic data point to positive growth momentum. However, we expect sterling to lose ground because of negative real income growth, flat business investment and Brexit-related uncertainty about long-term economic prospects. We expect revived weakness against the dollar and continued softening versus the euro.



- Swiss franc – slow depreciation. The franc remains on a steady downward path as risks have eased – the eurozone is doing well and most key elections are now behind us. The Swiss National Bank (SNB) is happy with the slide, as it contributes to reflation and helps corrects the currency's massive overvaluation. With interest rates likely to stay negative for long, the franc is set to depreciate albeit gradually. If risk aversion returns, the SNB stands ready to intervene again on the currency market to limit the upside.
- Yen – range bound. The yen has traded in a narrow range since early last year. The Bank of Japan (BoJ) is unlikely to intervene as this favours reflation. However, the yen has been supported lately by talk of possible action to steepen the yield curve. As the BoJ balance sheet inflates further and high risk appetite persists, the yen should remain under pressure.
- Emerging currencies – Carry on. Most emerging countries have seen economic improvement. Rising commodity prices and stronger global trade bode well for commodity-exporting countries and manufacturing hubs. The outlook remains bright for most emerging currencies given their favourable real yield gap and current valuations (fair to cheap). Selectivity remains advisable. We would prefer high-yielding currencies with positive growth momentum and solid external positions.

Sources: SGPB, Bloomberg, 12/01/2018. 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.

Alternatives



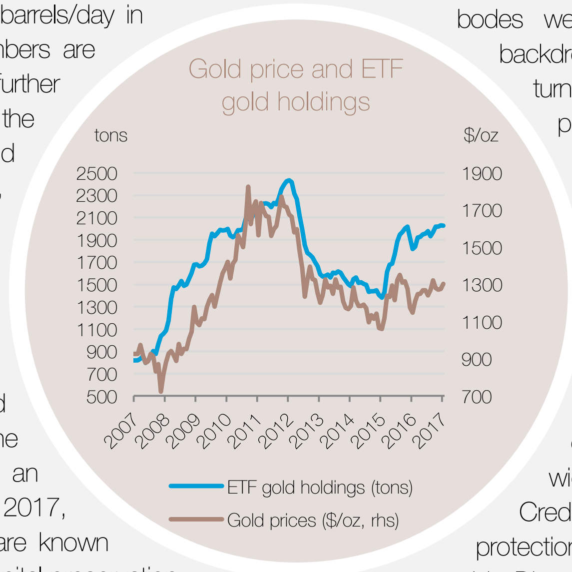
Gradual Revival for Alternatives

- Better market dynamics should continue to favour active Long/Short Equity strategies, and the macro backdrop is supportive for Event Driven managers.
- Tight spreads, low yields and the low number of defaults mean little opportunity in Credit, while Global Macro/Commodity-Trading Advisors (CTA) strategies remain heavily dependent on equity markets.
- Although there is room for further gains in the short term, we doubt the oil rally will last.

Commodities

Oil's upside will be limited by stronger US shale production.

- Crude oil. Prices are up 25% since mid-September. On the offer side, a cold winter saw US oil stocks deplete. On the demand side, appetite for oil remained strong. The decision by OPEC and Russia to extend production quotas into 2018 also supported prices in late 2017. Although there is room for further gains in the short term, we doubt the rally will last. First, at current prices, there is a strong incentive for US shale producers to step up production. The International Energy Agency expects US oil output to reach its highest annual average on record at 10.3 million barrels/day in 2018. Second, some OPEC members are not complying with quotas. Third, a further run-up in prices may not be in the interests of oil producers as it would prompt central banks to move faster, which could slow the business cycle and hence oil demand.
- Gold. Gold has been supported by revived geopolitical tension (Middle East, Korea), expectations for Fed rate hikes and renewed inflation concerns. As a result, the World Gold Council has recorded an 8.4% rise in ETF gold holdings over 2017, especially in Germany. Germans are known for investing in gold for long-term capital preservation as it combines cyclical resilience, low correlation with other assets, and immunity from credit risk. On top of that, Indian consumers have ramped up gold purchases in a context of sustained economic growth and rising purchasing power. As Asian growth is set to remain well supported, this bodes well for gold demand, which could mitigate the impact of rate rises. Although, we still expect higher US rates to be a major headwind for gold in coming months, we recognise that the recent unexpected strength reflects a shift in drivers.



Hedge funds

Tax cuts in US add fuel to stock dispersion.

- Equity Long/Short. The market backdrop for Long/Short stock-pickers remains supportive. Correlations have fallen to multi-year lows while the dispersion between stocks has risen, meaning that stocks are reacting more to idiosyncratic factors than to macro trends. The recent tax cuts in the US will add further fuel to differentiation between companies given that their impact will not be uniform.
- Event Driven. Activist managers of Special Situations funds continue to see increasing numbers of opportunities, which bodes well for future returns. The macro backdrop is supportive for corporate turnarounds. Spreads between share prices of companies launching takeovers and their prey have widened, thereby improving return potential in Merger Arbitrage.
- Credit/Distressed Debt. Yield spreads in credit markets remain extremely tight and investors should avoid funds with high directional exposure to prices, given the risk that spreads might widen – market neutral Long/Short Credit strategies provide more protection. Opportunities remain thin on the ground in Distressed Debt, with the default rate in US high yield at 4-year lows according to Fitch.
- Global Macro/CTAs. Returns from CTAs have been heavily dependent on strength in global equity markets in recent months. While the robust global expansion should remain supportive for equities, trends in other asset classes are unlikely to be sufficient for diversification purposes. Global Macro managers await the shift in fundamentals from reduced monetary policy support which should improve their opportunity set.

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