Monthly House Views

Easing the Pace

The outlook remains for sustained global growth in 2018, helped by the boost to US activity driven by tax cuts. Elsewhere, we believe that the acceleration in global activity is behind us after almost two years of regular positive surprises but growth should remain well above potential. Although growth is set to slow in China after a strong 2017, emerging economies should benefit from strong global demand and some dollar weakness.

Household and investor expectations of inflation have firmed, as witnessed by the inversion of US "breakeven" inflation expectations (calculated from bond yields) – for the first time this decade, 2-year expectations are above those for 10 years. Much will depend on wage growth, where some pressures have begun to emerge. However, we do not anticipate a spike in inflation, but rather a steady rise over 2018.

Jerome Powell – the new Chair of the Federal Reserve – gave his first testimony to Congress in late February and outlined an upbeat assessment of the US economy, thereby firming market expectations that the Fed will indeed hike rates three times this year as we anticipate. Elsewhere, normalization of monetary policy is set to continue at a very gradual pace – for example, we do not expect the European Central Bank (ECB) to hike rates before mid-2019.

The shift in investor expectations towards rising inflation, further Fed rate hikes and higher sovereign yields has led us to take advantage of the late-February rally in stock markets to recommend a tactical trim to exposure to global equities. Valuations are generally quite stretched and momentum has eased in some markets, notably the eurozone. However, the macro backdrop remains supportive and equities still represent the largest weight in balanced portfolios.

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

Source: SG Private Banking, 12 March 2018, * Duration: short = 3-5yr, medium = 5-7yr, long = 7-10yr; HY = High Yield

In other words

EQUITIES*	United States	The tax boost will help companies achieve faster profit growth this year, which is good news for US equities. However, rising rates and higher volatility may limit upside. We thus keep a small underweight.
	Europe	We expect slower profit growth than in 2017. Stronger currencies versus the dollar, Brexit uncertainty and weaker ECB asset purchases may worry investors.
	Eurozone	The global recovery and ECB asset purchases will remain a support in coming months. However, a stronger euro, slower profit growth and fading price momentum led us to further reduce our overexposure.
	UK	Stay cautious as slower EPS growth, weakening economic activity and Brexit talks remain key concerns.
	Switzerland	A weak franc and stronger trade could help Swiss multinationals record decent profit growth. However, we stay neutral as high exposure to defensive sectors may cap the upside potential.
	Japan	The outlook is favourable in the medium term with above-potential growth, a slow exit from deflation, very easy financing conditions and attractive valuations. We keep a slight overexposure despite short-term headwinds.
	Emerging	Valuations are attractive but the economic context will be a little less supportive in 2018 with Fed rate hikes, a rise in global yields and a mild slowdown in China.
BONDS*	Sovereigns	Although core yields are likely to be driven back up by US rates, we expect less upside in broader eurozone yields. In the USA, we now expect the curve to flatten as 2-year yields follow Fed Fund rates higher and still modest inflation pressure keeps a cap on 10-year rates.
	Duration**	Short maturities should be favoured as rates continue to rise.
	Inflation-linked	Signs of inflation pressure reinforce our positive stance on inflation-linked bonds.
	Investment Grade	In the US, we would refrain from adding risk – corporate leverage is high and tightening financing conditions will lead to greater risk of default. In this context, we still favour Investment Grade bonds over High Yield.
	High Yield	In the eurozone, High Yield should continue to outperform Investment Grade bonds in 2018.
	Emerging debt (in € and $)	Emerging debt remains supported by steady inflows, the soft dollar and positive growth momentum in emerging countries.
CURRENCIES	EUR/USD	We expect the dollar to lose further ground versus the euro, helping it reduce its overvaluation.
	GBP/USD	Risks are still skewed to the downside as we forecast softer growth in the short and medium term and Brexit will eventually dent foreign direct investments.
	EUR/GBP	We expect a modest correction versus the dollar but a sharper fall against the single currency.
	USD/JPY	A gradual rise in inflation should encourage the central bank to change tack, underpinning the yen.
	EUR/CHF	We expect renewed weakness in coming months as the currency remains sharply overvalued and key interest rates should stay negative.
	Emerging	We maintain a constructive view on emerging currencies. Downside now seems limited given carry remains attractive.
ALTERNAT.	Hedge funds	Increased corporate activity driven by tax reforms should support Special Situations funds. Long/Short Equity and Event Driven managers should continue to benefit from higher dispersion between stocks and generally lower correlations between markets.
	Gold	With volatility on the up in the wake of the early February stock market sell-off, gold can play a useful role in portfolios.
	Oil	Rising US output means it might overtake Russia as the world's leading oil producer. Only a price collapse similar to 2014-2015 could slow shale oil growth.

Source: SG Private Banking, 9 March 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

China – Xi almighty

- Chinese president Xi Jinping could stay in power beyond 2022 now that the two-term limit has been removed.
- The government has stepped up its efforts to curb excess leverage and tighten fiscal policy.
- Authorities will need to find the right balance between growth and reforms, and the private and public sectors, to be in a position to undertake economic reforms and achieve sustainable growth.

- The National People's Congress (NPC) has agreed to remove the two-term limit, meaning Xi Jinping controls all levers of power.
- To further tighten his grip on the economic and financial worlds, the president has also appointed close allies –Liu He will be named vice-prime minister while former anti-corruption tsar Wang Qishan is set to become vice-president. What are the government's economic priorities?

Cut leverage for greater financial stability

- Chinese growth is highly dependent on credit, putting financial stability at risk at home and abroad. Local authorities have managed to cut total foreign debt for the first time since 2007. Since early 2016, M2 growth – a monetary aggregate mirroring bank lending – has fallen from 14% to 9% YoY (source: Bloomberg, 09/03/2018).
- The recent pressure on Chinese tycoons to sell overseas assets acquired through aggressive buyouts demonstrates the government's strong grip on the economy. It also reflects the need to limit capital outflows. There is a clear will to redirect corporate investment towards domestic projects to support Chinese businesses and favour innovation.
- China's fiscal policy remains proactive and the Ministry of Finance plans to reduce public deficit from 3.0% to 2.6% of gross domestic product (GDP) in 2018.

Reduce overproduction

- Booming Chinese growth has encouraged manufacturers to over-produce in many sectors, driving prices down. The excess supply was dumped on export markets, exacerbating trade tensions between World Trade Organisation (WTO) members and prompting Donald Trump to impose 25% and 10% tariffs on steel and aluminium respectively. Excess capacities have been reduced but there is further to go.

Achieve more sustainable growth

- Although nominal GDP per capita has risen tenfold since China joined the WTO in 2001, the country is not yet considered prosperous. However, authorities want 2020 GDP to be double its 2010 level.
- One way of achieving this is through innovation. The aim of the "Made in China 2025" and "Internet Plus" schemes is to attract foreign start-ups with grants and subsidies. China is already the world leader in e-commerce – online purchases account for 18% of total retail sales versus only 8% in the US (source: Bloomberg, 09/03/2018).
- Another plan is to clear the air. Following a series of scandals, fighting pollution has become a priority – the World Bank estimates its cost at 6% of GDP. As a result, energy-efficient technologies are becoming a growing global market for Chinese producers.

Conclusion

- In the short run, President Xi's tighter grip on the economy should help achieve more sustainable growth levels and avert a hard landing.
- However, in the longer term, handing all the reins of power to a single man may not provide the hoped-for cure-all. China's economy is increasingly large and complex, and one-man rule may create bottlenecks in decision-making. Moreover, state-sponsored centralisation may run counter to Xi's plans to promote innovation and challenge the West.

Fixed Income

US yields – Time for a pause

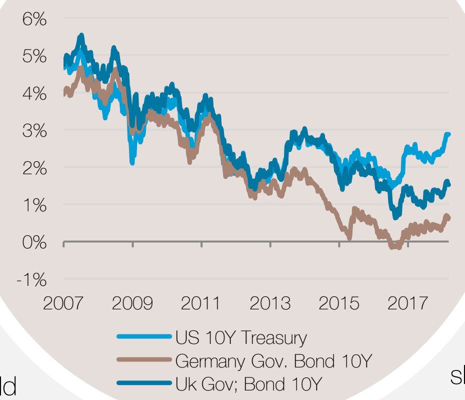
- US yields are correcting after their recent spike.
- Inflation-linked securities still provide good diversification.
- Credit spreads stood up well during the recent market sell-off.
- We still recommend short maturities.

Rates

Long-term rates to pause as price pressure eases

- United States. These last few months saw price pressure drive short rates higher – which in turn pushed longer-dated yields higher, causing some steepening in the yield curve. We now expect the curve to flatten as 2-year yields follow Fed Fund rates higher and still modest inflation pressure keeps a cap on 10-year rates. The core PCE index, the US Federal Reserve's preferred price measure, still runs at 1.5% while headline inflation hovers around 2%. The Fed should hike rates three times this year – perhaps four – as economic conditions improve. Short maturities should be favoured as they are less sensitive to upward pressure on rates from above-trend growth. Linkers remain a useful source of diversification.
- Eurozone. Core bond yields rose in the wake of the US but have turned south since. Although the core yields are likely to be driven back up by US rates, we expect less upside in broader eurozone yields. Spreads in the periphery should remain capped by ECB asset purchases and sovereign rating upgrades thanks to robust growth.
- United Kingdom. Gilt yields should rise further in the wake of the US and eurozone. However, easing price pressure will limit upside.

Government bond yields are heading north



Credit

Good resilience to recent financial turmoil

- United States. Corporate spreads touched bottom in early February before widening slightly following a spike in market volatility. This resilience in credit – which often leads other financial markets – reflects a supportive macro environment and positive earnings momentum. However, we would refrain from adding risk – corporate leverage is high and tightening financing conditions will lead to greater risk of default. In this context, we still favour Investment Grade bonds over High Yield.
- Eurozone. This year, eurozone credit will be supported by strong growth, helped by more ready access to bank loans, and heavy buying by the ECB. The central bank is expected to buy another €45bn of corporate bonds before it intends to halt purchases in September, bringing total holdings to around €190bn. The credit market will lose a key buyer when the ECB stops, making it vulnerable if growth were to start slowing. However, we still prefer the higher carry offered by corporate hybrids and subordinated financial debt, as well as selected floating rate notes. In our view, High Yield will continue to outperform Investment Grade bonds in 2018.
- Emerging debt. After breaking above 290 basis points, spreads have continued to widen moderately. Emerging debt remains supported by steady inflows, the soft dollar and positive growth momentum in emerging countries. All in all, we remain constructive on this asset class.

Sources: SGPB, Bloomberg, 05/03/2018. 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.

Equities

Catching our breath

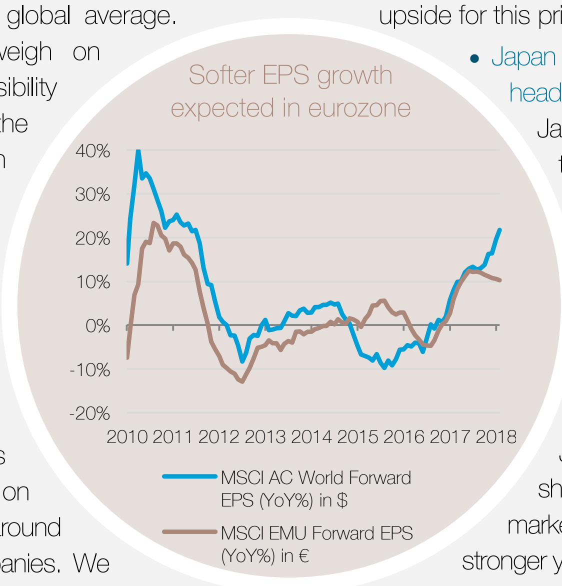
- Global equity markets have recovered from the sell-off, with the MSCI AC World up 4% since the February 8 low and 1.7% year-to-date (in USD terms). Synchronised global economic expansion and robust corporate profit growth remain supportive to global equities. However, following a recent batch of disappointing data, we believe that growth will plateau at a rather high level this year. Furthermore, rising inflation expectations, rate hikes and higher volatility will all contribute to limit upside for global equities, especially as valuations are already stretched. All in all, we have decided to temporarily scale back our exposure to global equity markets to neutral.

Global equity exposure down to neutral

"Weaker earnings growth and fading price momentum drove us to cut our eurozone exposure to a small overweight"

"US profit growth will remain strong but Fed rate hikes and higher volatility may cap valuations"

- Eurozone – reduce overexposure. Equities should continue to benefit from broad-based eurozone recovery and solid global growth in coming months. The ECB is unlikely to start hiking rates before mid-2019, inflation remains modest and financing conditions are still loose. Profitability is improving slowly and margins should expand further thanks to muted wage pressure. Earnings-per-share (EPS) are likely to grow nearly 8% in the next twelve months (IBES consensus) – a decent rate, albeit lower than the global average. Trade war concerns will also weigh on business confidence and reduce visibility on future earnings. All in all, given the likely impact of a stronger euro on corporate profits and the weaker price momentum following the sell-off, we have decided to cut our exposure to a small overweight.
- UK – stay cautious. Corporate profits are expected to grow slower in the UK than elsewhere this year as recent sterling strength is weighing on foreign sales, which account for around 70% of turnover at FTSE 100 companies. We still believe that UK equities will lag their developed market peers given the slow economic growth and Brexit fears.
- Switzerland – still neutral. A weak franc and strong business confidence should help Swiss multinationals continue to record decent EPS growth. However, high exposure to defensive sectors may limit upside.



- USA – high valuations and rising rates leave us cautious. The tax reform, a weaker dollar and robust economic growth have triggered a sharp upgrade to 2018 EPS forecasts and the consensus is now for growth in the high teens. Profit margins and return-on-equity are better than elsewhere but rising wages could act as a drag in coming months. Monetary policy normalisation and rising Treasury bond yields will act to increase volatility, capping upside for this pricy market.
- Japan – still overweight despite short-term headwinds. The outlook is positive for Japanese firms in the medium term as the economy is growing above potential and slowly exiting deflation. The Bank of Japan will stay ultra-accommodative this year with inflation still well below the 2% target. Corporate governance reforms and attractive valuation metrics will also support Japanese equities. However, in the short term, the Japanese equity market may face headwinds from a stronger yen and recent trade tensions.
- Emerging markets – still neutral. Emerging markets will be supported by the global economic expansion, high exposure to technological innovation, the bounce in oil prices since the 2016 low, a weak dollar and attractive valuations. However, the context will be a little less supportive this year with Fed rate hikes, rising global yields and a mild slowdown in China as witnessed by the worsening in manufacturing confidence these last three months.

Currencies

Reflation to push yen higher

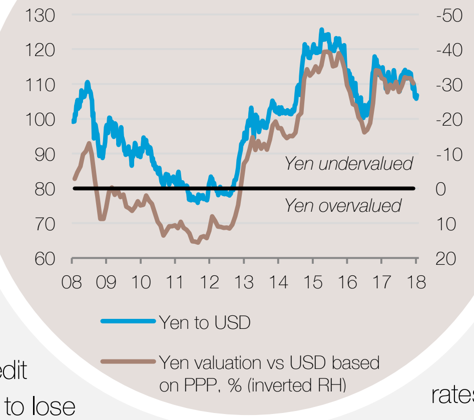
- The dollar will be supported by a Fed rate hike in the short run but the trend remains bearish.
- We expect the euro to stay range-bound in March but remain constructive in the longer term.
- Slow growth and political uncertainty will keep sterling southbound.
- High yields and robust growth should protect emerging currencies against dollar strength.

Temporary dollar stabilization

The euro will stay range-bound in the short term

- **Euro – taking a pause.** Positive growth surprises have moderated in the eurozone, encouraging the European Central Bank (ECB) to adjust its stance only gradually. After an impressive rally (+16% in 12 months), the euro is set for a period of consolidation. The new Fed chairman has sounded a hawkish note, encouraging expectations that tighter labour market conditions will lead to three rate hikes this year, if not four. With market views now converging with the Fed, the greenback has found support. However, the euro still looks slightly undervalued and the second half should see it bolstered as we get closer to the end of ECB asset purchases, political risks ease and growth remains robust.
- **Dollar – more weakness ahead.** After stabilising in early February, the dollar index has failed to rally sharply. The currency has been supported as market expectations of Fed rate hikes have risen, but there are headwinds – tax cuts will deepen the budget deficit and higher capital spending should encourage credit expansion. All in all, we expect the dollar to lose further ground versus the euro, helping correct its overvaluation.
- **Sterling – heading lower.** In 2017, sterling was supported by a softer dollar and economic resilience, to such an extent that it had recovered to pre-Brexit vote levels by early 2018. Risks are still skewed to the downside as we forecast softer growth in the short and medium term and Brexit will eventually dent foreign direct investments. We expect a modest correction versus the dollar but a sharper fall against the single currency.

Despite recent strength, the yen remains undervalued vs USD



Reflation to underpin the yen

Emerging currencies should benefit from high yields and dollar weakness

- **Swiss franc – edging lower.** As a safe haven, the Swiss franc remains highly sensitive to shifts in risk appetite and indeed it shot higher during the recent market rout. However, it returned to its downtrend as soon as market volatility eased. We expect renewed weakness in coming months as the currency remains sharply overvalued and key interest rates should stay negative.
- **Yen – further upside.** The recent market turmoil also benefited the yen. However, the currency is still cheap. A gradual rise in inflation should encourage the central bank to change tack, underpinning the yen.
- **Emerging currencies – Carry on.** Emerging currencies have been weakened by risk aversion and a stronger dollar. Downside now seems limited given carry remains attractive. Furthermore, improving fundamentals and prudent economic policies will help emerging currencies resist rising US rates. The upturn in global growth is also a positive as it implies higher commodity prices and stronger exports. Overall, we maintain a constructive view on emerging currencies.

Alternatives

A Time for Alternatives?

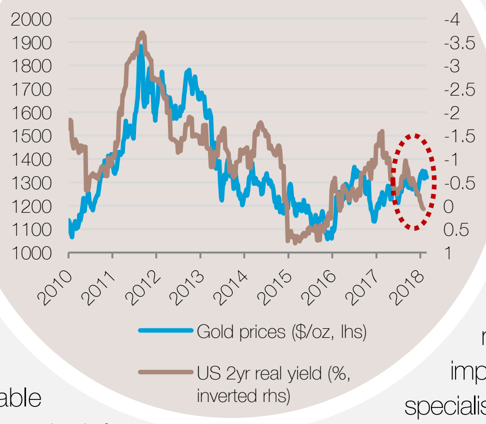
- Rising US output means it might overtake Russia as the world's leading oil producer.
- Long/Short Equity and Event Driven managers should continue to benefit from higher dispersion between stocks and generally lower correlations between markets.
- Despite turbulence in bond markets, spreads in Credit have yet to widen enough to provide new opportunities, while Global Macro/CTA managers may struggle as volatility spikes.

Commodities

With volatility on the rise, gold can play a useful role

- Crude oil. Brent prices turned south in February, falling to $65 per barrel. Further weakness is expected in March as oversupply persists. The International Energy Agency believes the USA could overtake Russia as the largest producer. Only a price collapse similar to 2014-2015 could slow shale oil growth. Also, the latest data from the Energy Information Agency (EIA) showed the US rig count at a high since April 2015. On the supply side, the EIA estimates that world inventories will grow by an average of 0.4 mb/d in 2018, the fastest rate since 2013, after shrinking by 0.6 mb/d last year. Also, US exports reached their second highest level in late February thanks to strong global growth.
- Gold. So far this year, gold has been seen as a safe haven, keeping it in a tight 1,300-1,360 range. Given gold's negative correlation to real interest rates (which we expect to rise), prices could come under some downside pressure. However, a weaker greenback will boost demand as dollar-denominated gold become more affordable in non-USD regions. Contrary to common belief, gold is a weak inflation hedge – however, it does attract inflows during spikes in equity volatility given its negative correlation to equity markets. With volatility on the up in the wake of the early February stock market sell-off, gold can play a useful role in portfolios.

Gold prices should decrease to catch up on real US yields



Hedge funds

Increased corporate activity driven by tax reforms should support Special Situations funds

- Equity Long/Short. The recent market correction saw a spike in dispersion between stocks. While this may prove short-lived, we expect dispersion to remain above the average in recent years, meaning a supportive environment for Long/Short managers. Indeed, recent performance data suggest that active managers of mutual and hedge funds have been outperforming passive strategies.
- Event Driven. The macro backdrop remains supportive for Special Situations funds, with tax cuts bolstering reported earnings and companies deploying repatriated foreign cash in corporate activity. Part is likely to find its way into increased takeover activity, improving the opportunity set for Merger Arbitrage specialists, who will also benefit from wider spreads driven by market volatility.
- Credit/Distressed Debt. The increase in Credit spreads in high yield – driven by equity volatility – which we mentioned in January and February has so far been modest and managers have limited the impact on portfolios. Distressed Debt specialists still face low numbers of defaults, which has reduced their opportunity set thus far.
- Global Macro/Commodity-Trading Advisors. As we warned last month, February's whipsaw trading in equities did indeed prove challenging for most CTAs. As a result, portfolios have been deleveraged, meaning that they are unlikely to reap much benefit from the next wave of trends. Global Macro managers have begun to recover from the abrupt change in market sentiment but still retain high equity exposure to global equities, making them vulnerable to new sell-offs.

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