Monthly House Views

Spirits level

The outlook for global economic growth remains robust. The drivers in the United States – strong business and consumer confidence, accommodative fiscal policy – remain in place, while the eurozone is now recovering from its first-half soft patch and Japan continues to outstrip its potential. We expect further escalation in trade tensions, keeping pressure on emerging economies, where weak links – Turkey and Argentina, notably – have already seen sharp devaluation of their currencies.

Core inflation in the US continues to grind higher – +2.4% year-on-year in July – with low unemployment putting upward pressure on wages and import tariffs beginning to bite. In the eurozone, the pace of price increases is markedly slower – +1.1% for core inflation in July – but the trend remains one of steady price rises. Hyperinflation has hit a number of smaller emerging economies – most strikingly Venezuela – but price pressures remain well under control in China and India.

Despite recent dovish communication, we expect that strong growth and rising inflation will keep the Federal Reserve on track to deliver two further hikes this year. The roadmap drawn by the European Central Bank is clear – asset purchases to be wound down by year-end paving the way for a first rate hike, probably in September 2019. The Bank of England is now likely to pause after lifting rates in early August – preparations for a “no-deal” Brexit are keeping a lid on corporate and household sentiment.

Strong top-line growth has bolstered corporate earnings, providing a solid underpinning for equity markets. However, this growth is also likely to push bond yields higher, capping upside for valuations. Headline risks abound – trade wars, Italy’s budget, Turkey’s crisis, talk of impeachment in Washington – keeping investors’ animal spirits in check. As a result, we expect continued modest outperformance from equities over bonds, and suggest keeping allocation levels in balance.

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2 to 3 – Our views summarized

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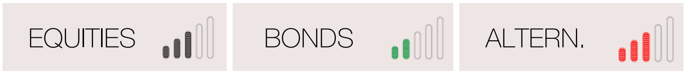
In accordance with the applicable regulation, we inform the reader that this material is qualified as a marketing document.

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 – 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
Sovereign				
Inflation-linked				
Inv. Grade				
HY				
Duration*	Short			

BONDS – USD	Global	VA	MO	S
Sovereign				
Inflation-linked				
Inv. Grade				
HY				
Duration*	Short			

BONDS – GBP	Global	VA	MO	S
Sovereign				
Inflation-linked				
Inv. Grade				
HY				
Duration*	Medium			

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

ALTERNATIVES	
Hedge funds	
Gold	
Oil	

Source: SG Private Banking, 31/08/2018, * Duration: short = 3 to 5 years, medium = 5 to 7 years, long = 7 to 10 years. HY = High Yield bonds (higher return but greater risks), Inv. Grade = Investment Grade bonds (higher quality but lower return)

In other words

Asset class		View
EQUITIES*	United States	*Strong revenue and profit growth underpin the attractions of US equities, despite worries about trade and the mid-term elections.*
	Europe	*Weak currencies and accommodative monetary policies provide support for European equities despite Brexit and Italy concerns.*
	Eurozone	*Earnings are set to grow at a high single-digit pace this year, as margins and profitability expand. However, trade tensions, Turkey and the Italian budget call for a Neutral stance.*
	UK	*Brexit uncertainty has weakened sterling, a boon for the UK's high exposure to international profits, but has also depressed domestic demand.*
	Switzerland	*The market's defensive qualities help compensate for the downward revisions wrought by Swiss franc strength.*
	Japan	*Structural reforms and central bank buying on one side and yen strength and trade war concerns on the other suggest keeping a Neutral stance.*
	Emerging	*Negative momentum has improved valuations, but trade disputes, dollar strength and rising US rates have meant downward revisions to forecast earnings.*
BONDS*	Sovereigns	*Rising yields and political concerns in Italy and Turkey do not bode well for sovereign bonds, especially in the eurozone. Caution is advised.*
	Duration**	*We still favour short maturities. UK yields should rise less than in the US or the core eurozone. If Brexit talks end prematurely with no deal, market sentiment will turn sour and the Bank of England will postpone its next rate hike.*
	Inflation-linked	*Inflation-linked bonds offer protection to bond investors.*
	Investment Grade	*We shift to neutral on US Investment Grade as upside is now limited.*
	High Yield	*Eurozone high yield remains attractive from valuation and a carry perspective but high leverage in the US warrants a more defensive approach.*
	Emerging debt (in € and $)	*Rising US rates are draining liquidity from emerging debt markets.*
CURRENCIES	EUR/USD	*After some Turkey-related weakness, we expect EUR/USD to stabilise in coming months.*
	GBP/USD	*Sterling should correct its recent drop. However, it could remain directionless afterwards.*
	EUR/GBP	*Both currencies have lost ground versus a strong dollar. However, risks are to the upside for the single currency.*
	USD/JPY	*A favourable interest rate differential will drive USD/JPY higher. However, the Bank of Japan could change tack.*
	EUR/CHF	*Risk aversion has benefited the franc. Much will depend on how the situation evolves in the eurozone.*
	Emerging	*Negative newsflow will continue to drive emerging currencies down versus a strong dollar.*
ALTERNAT.	Hedge funds	*Managers have scaled back exposures given thin summer trading volumes, suggesting reduced risk but also lower potential returns ahead.*
	Gold	*Rising US real rates have weighed on gold. We expect some bounce but upside will be capped by a strong USD.*
	Oil	*Supply and political factors will keep oil prices in check and the barrel will most likely trade in a $70-75 range.*

Source: SG Private Banking, 31/08/2018, 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

Turkey – could the domestic crisis become contagious?

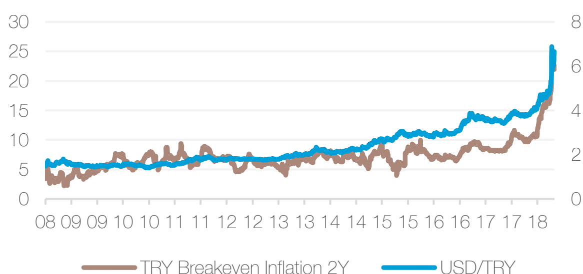
- The reduction in global liquidity is hurting the weakest links in the emerging world and Turkey is the first fuse to blow.
- Turkey's economic fundamentals are too dreadful to avert a full-blown financial crisis.
- Direct contagion has been limited so far. However, emerging markets (EM) are set to continue to feel the pinch of dollar strength, higher funding costs and trade uncertainties.

Turkey is heading for full-speed collision

- To further strengthen his grip on the country and ensure widespread political support, President Erdogan has taken serious risks with the Turkish economy.
- First, he has let credit growth surge to 35%, threatening financial stability.
- Second, spiralling inflation (15.9% in July 2018) saw the lira plunge 25% versus the US dollar in August alone, with a year-to-date trough at -45%. Such currency weakness will only generate more price pressure, which could cause a series of defaults in the banking and corporate sectors unless the government finally takes action.
- Third, high dependence on external funding to finance the current account deficit (6.3% in Q1 2018) leaves the economy exposed to sudden capital outflows and a potential loss of access to global markets.
- Against such a weak background, it is no surprise that it didn't take much – US tariffs on Turkish imports – to trigger a deep crisis in Turkey.

Turkish lira reaches historical lows while inflation flares up

2y Turkish breakeven inflation rate and USD/TRY exchange rate



Sources: SGPB, Macrobond, 31/08/2018

- However, domestic factors are not the only problem – emerging countries have also faced headwinds from abroad (a stronger dollar, rising US rates and trade war escalation). Trade tensions are hitting exporters directly and indirectly while a strong dollar is tightening financing conditions.
- Year-to-date, the MSCI EM index is down over 9% in dollar terms, while the Emerging Market Bond Index spread on hard-currency debt over US Treasuries is up 60 basis points to 390bp.

However, contagion has proved limited so far

- Healthier policies – flexible exchange rates, prudent fiscal policies – and stronger fundamentals – tighter deficits, softer inflation, large currency reserves – have helped the other emerging markets resist the Turkish crisis. However, they are not immune to potential side effects.
- Although the Turkish debacle has pushed valuations of emerging assets lower, it seems too early to buy the dips as the roller-coaster will continue in coming months.
- Trade war ceasefires, more stable growth in China and a more dovish Fed are the signs to look for before increasing exposure to emerging assets.

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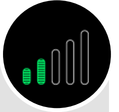
Fixed Income



Yields still heading north

- We still favour short maturities in the US and eurozone.
- Prefer long-end Spanish government bonds among peripherals until skies clears over Italy and Turkey.
- UK yields should rise less than in the US or the core eurozone. If Brexit talks end with no deal, market sentiment will turn sour and the Bank of England will postpone its next rate hike. Economic divergence between the US and the eurozone also reflects in credit spreads. We turn neutral on US Investment Grade (IG) bonds. In the eurozone, we still prefer High Yield (HY) bonds as credit conditions ease further.

Rates

Interest rates to return to their August high

- United States. Dovish talk by the US Federal Reserve (Fed) has left market participants wondering whether the ongoing trade war could convince its monetary committee (or FOMC) to revise its communiqué at the September meeting. However, strengthening GDP growth and inflation data still point to two more rate hikes this year – in September and December. We expect US yields to rise from 2.85% to 3.00%, but no higher as trade war escalation and a return of risk aversion should cap long-term yields. This means the yield curve should remain flat as it is mainly driven by the front end. We still prefer short maturities. Inflation breakevens may rise further if price pressures exceed expectations.
- Eurozone. After a peak at 0.48% in early August, the 10-year German Bund yield is now back at 0.35% as growing political concern has fed safe-haven flows. We expect the uptrend in yields to resume towards 0.50-0.60% in coming months, in line with the ECB's confidence about inflation in its latest report. In addition, 2019 budget talks are likely to be tense in Italy. We still prefer Spanish bonds, especially in the 10-year sector, given they are less risky than Italy.
- United Kingdom. The 10-year Gilt yield has been stuck in a tight 35bp range (1.20-1.55%) since the start of the year. However, yields did rise recently when it was rumoured that the BoE Governor could extend his term by one year. If Brexit talks end with no deal, market sentiment will turn sour and the Bank of England will stay accommodative a little longer. In the near term, UK yields will offer less upside potential than their US or core eurozone counterparts.

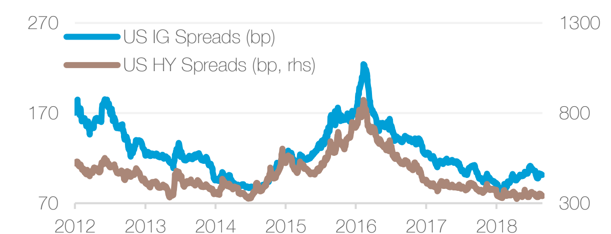
Credit

Credit spreads will widen further

- United States. US High Yield has outperformed Investment Grade recently, thanks to its additional carry for the same short maturity. We now turn neutral on IG bonds as they offer more limited upside potential at this stage of the economic cycle. We remain neutral on HY instruments as they are more sensitive to risk aversion and spread widening. We still like floating-rate notes as they offer a good hedge against rising rates and help reduce portfolio risk.
- Eurozone. Eurozone credit has become less attractive than earlier this year because of lingering political uncertainty and the first-half soft patch. The divergence with the US observed last month continues. However, eurozone credit is supported by healthy corporate balance sheets, economic recovery and ECB asset purchases. At current levels, we expect HY to outperform IG as credit conditions ease further. Alternatively, corporate hybrid bonds offer better diversification and higher yields than other credit segments, attractive qualities in a context of low interest rates. In contrast, we turn neutral on floating-rate notes, given the high proportion issued by financials which are very sensitive to Italy and Turkey.

US IG spreads are too wide compare to High Yield

US investment grade and high yield spreads



Sources: SGPB, Bloomberg, 29/08/2018.

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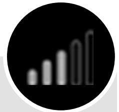
Equities



Lingering risks overshadow good fundamentals

- Global equities will continue to benefit from a supportive economic context and strong corporate profit growth, especially in the US.
- However, trade tensions, European political concerns (Brexit, Italy), geopolitical risks (e.g. Iran), rising vulnerabilities in some emerging countries (e.g. Turkey crisis) are likely to linger in coming months. Overall, risks are tilted to the downside, warranting a neutral stance.
- We keep a preference for the US and remain cautious on emerging markets.

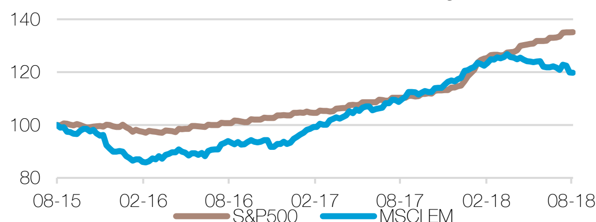
Still neutral on global equities

US equities will benefit from solid profits growth

- USA. The S&P500 hit an all-time high in late August, marking the longest run ever without a “bear market” (defined by a 20% drop). US equities benefit from the tax boost, strong growth in top-line revenues and profits, cash repatriation and growing share buybacks. In addition, the Fed will continue to hike rates only gradually, meaning that financial conditions are becoming tighter but not yet restrictive, while recession fears are overdone for now. Labour costs have remained contained so far but could start weighing on margins, and thus profits, in coming quarters. Political uncertainties are set to last until the mid-term elections. All in all, we remain positive on US equities.
- Eurozone. The Turkish crisis took its toll on eurozone equities this summer, especially banks. However, the short-term outlook has brightened with growth expected to stabilise in coming months after a weak H1. Corporate profits are expected to grow 9% in the next twelve months (IBES consensus). European companies have seen their margins and profitability expand while leverage is down since the financial crisis. Financing conditions will remain loose with the ECB staying accommodative at least until H2 2019. However, low rates for long is bad news for Financials, the largest sector weight (18%). In addition, trade tensions and uncertainty in Italy will remain a drag in coming months. All in all, we stay neutral.

Earnings – divergent expectations between US and emerging

12-month forward EPS, Index 100 = 2 years ago



Sources: SGPB, Bloomberg, 29/08/2018.

Keep a cautious stance on emerging equities

- UK. Earnings growth is expected to improve thanks to higher oil prices and weak sterling – UK large caps generate around 70% of their revenues abroad and the market has a marked tilt towards energy-related sectors (25% of the FTSE 100). However, we remain neutral due to lingering Brexit concerns, especially as we do not expect further sterling weakness or higher oil prices in coming months.
- Switzerland. Despite high valuation and significant downward EPS revisions, we stay neutral as the market’s bias toward high-quality defensive stocks could prove useful if risk aversion returns.
- Japan. Japan is a cyclical market sensitive to global trade and the yen. Trade tensions and the appreciation of the trade-weighted exchange rate since the start of the year have prompted analysts to cut their earnings forecasts. EPS are expected to grow only a modest 4% in the next twelve months (IBES consensus). Price momentum has turned negative. However, in the longer term, Japanese equities should benefit from structural reforms, better company governance, sound corporate fundamentals (higher return-on-equity, low debt leverage and high cash levels) while offering attractive valuations. All in all, we keep a neutral stance.
- Emerging markets. Trade tensions, a strong dollar and the Turkish crisis have encouraged analysts to slash their earnings forecasts and profit growth should slow in coming months due to softer global trade. Policy easing in China and potential dollar weakness in coming months will support emerging equity markets (which look attractively-valued on MSCI EM data). However, caution is advised for now as trade remains a major concern.

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Currencies

Trade war concerns hold sway

- Dollar rally is running out of steam despite robust economic confidence in the US.
- Euro to stay range-bound in the short term. More upside later.
- Brexit uncertainty still weakening sterling.
- Emerging currencies under pressure on various fronts.

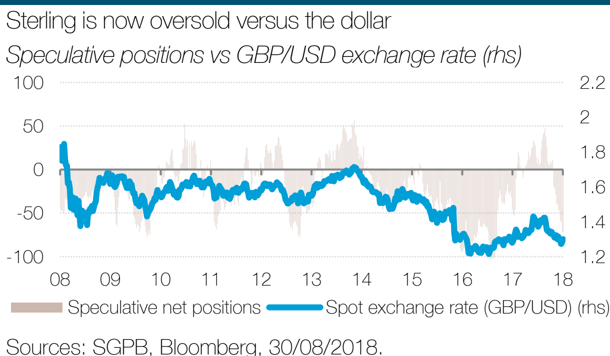
Dollar Index may have peaked

Euro to weather the Turkish crisis in the long term

- Euro – Bouncing back. The euro weakened on turmoil in Turkey and could struggle again during the coming Italian budget talks. However, in the long term, structural supports will help it withstand the deepening crisis in Ankara. Positive factors are plentiful, including a wide current account surplus, more stable growth, ECB confidence that inflation will eventually pick up, possible switches from US assets back to Europe and unwinding of forward sales of euros against the dollar. All in all, we expect EUR/USD to stay range-bound for now.
- Dollar – Plateauing. The dollar has spiked as Turkey's woes have weakened emerging currencies and trade war concerns have escalated. However, the growing US budget deficit still represents downside risk – foreign investors will be reluctant to buy Treasury bonds if they fear currency depreciation. Also, emerging market turmoil could slow global growth, reducing upward pressure on prices and encouraging the Fed to slow its planned rare hikes. All in all, we expect some dollar weakness in coming months.
- Sterling – Brexit still key. Sterling has been weakened by faltering growth, cautious Bank of England policy – despite the August hike – and endless Brexit talks. We stay neutral GBP/USD but expect some bounce from current oversold levels.

Sterling is now oversold versus the dollar

Speculative positions vs GBP/USD exchange rate (rhs)



Sources: SGPB, Bloomberg, 30/08/2018.

Trade war weighs on emerging currencies

Upside risks to the yen

- Swiss franc – bad news is good news. With heightened political uncertainty in Italy and Turkey, the franc has gone back up on safe-haven flows, ending the slow decline initiated in mid-2017. Renewed weakness would require more upbeat ECB comments, greater stability in Italy and stronger risk appetite overall.
- Yen – upside potential. Shrinking global liquidity and fading risk appetite will lead to higher volatility – a boon for the yen. The Bank of Japan's decision to widen the target range for Japanese government bond yields is likely to prompt domestic investors to stay at home rather than chase return overseas. However, monetary policy will remain ultra-loose as inflation has failed to pick up. We stay neutral although risks are clearly to the upside.
- Emerging currencies – bad weather. Emerging currencies have been hard hit by rising US rates, dollar strength, trade tensions and the recent Turkish crisis. The weakest countries – in terms of macro fundamentals and poor economic policy – have suffered the most financially and economically, although US sanctions have also played a key role. The Turkish lira did not take the plunge alone as three other currencies (the Argentinian peso, the South African rand, and the Brazilian real) have lost over 10% versus the dollar over the past three months. The focus will now be on China – the yuan has become a linchpin for the Asian monetary system and is down more than 6% vs the US dollar since May. A recovery in emerging currencies will require some appeasement in the trade wars.

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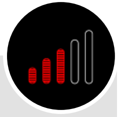
Alternatives



Pulling in horns

- Downside risks for oil prices include escalating trade tensions leading to slower economic growth and weaker demand.
- The fading dollar rally could blow tailwinds for gold.
- Equity markets are prey to political newsflow in the short term, while Event Driven strategies see more idiosyncratic opportunities.
- Event-driven opportunities in Credit Arbitrage show promise, while Macro investors find markets swayed more by politics than fundamentals.

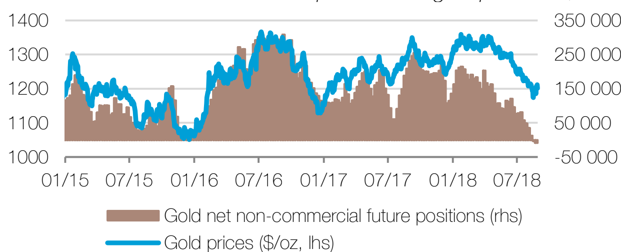
Commodities

"The fading dollar rally could blow tailwinds for gold"

- Crude oil. Prices have rallied from a 4-month low at $70 in mid-August and are now up 50% year-on-year. On the supply side, the US call for a ban on Iranian oil exports from October could stress the market, especially if combined with shortages elsewhere. However, further expansion in US output should keep the market in oversupply. Indeed, the International Energy Agency still expects non-OPEC production to grow 2m barrels/day on average in H2 2018 vs only 1mb/d for demand. Downside risks for prices include escalating trade tensions leading to slower economic growth and weaker global oil demand. Brent should stay in a $70-75 range these next 12 months.
- Gold. Oversupply and weaker supports sent bullion to a 20-month low under $1,200 in mid-August, with speculators turning net sellers for the first time since 2001. As a zero-yielding asset, gold is sensitive to its opportunity cost – rising real yields put downward pressure on prices. Metal Focus reported that central banks – mainly Kazakhstan, Russia and Turkey – had bought 193 tonnes of gold in H1 (+8% YoY), although further pressure on emerging currencies could cause some distressed selling. However, we expect the dollar to consolidate, providing some relief for gold given their negative correlation. In addition, gold remains a good diversifier and can help enhance portfolios in the long term.

Speculators turning net sellers for the first time since 2001

Gold net non-commercial future positions vs gold prices in $/oz



Sources: SGPB, Bloomberg, 03/08/2018.

Hedge funds

"Thin summer trading and idiosyncratic risks constrain hedge fund returns"

- Equity Long/Short. Managers have scaled back exposures in light of thin summer trading and the myriad exogenous risks – from trade tensions to Trump tweets. These factors have tended to sway markets in lockstep, irrespective of stocks' individual merits, making it difficult to add value through stock-picking, especially for Market Neutral funds. This being said, strong corporate fundamentals have kept the bull market in place.
- Event Driven. Despite the increased political uncertainties surrounding deals, especially those involving China, the spreads between predator and prey in takeovers have narrowed in recent months, reducing return potential in Merger Arbitrage. A shakeout might be needed to improve the opportunity set. Although recent returns in Special Situations have been boosted by the summer rally in US stocks, their activist campaigns continue unabated.
- Credit/Distressed Debt. Recent returns in Credit Arbitrage have benefited from corporate restructuring activity which has offered attractive opportunities. However, spreads remain tight, with little differentiation between issuers or between sectors, and yields are still low, constraining performance potential in this segment. Low default levels continue to hamper Distressed Debt investors as low real rates and high appetite for yield enable weaker borrowers to refinance their loans.
- Global Macro/CTAs. Markets and asset classes remain range-bound, making life complicated for systematic investors, such as CTAs, who rely on trends taking hold. In addition, there are few anomalies in correlations between markets, which detracts from this segment's usefulness for diversification. Like in Long/Short Equity, Global Macro managers are coming to terms with political cross-currents in markets holding sway over investment fundamentals.

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CA232/SEP/2018