Living, Breathing Asia

DBS

27 June 2017

INVESTMENT OUTLOOK – 3Q17

Desperately Seeking Value

Dear Valued Client,

Developed Market equities – particularly US stocks – range from fairly-valued to overvalued. And indeed, the risk of a correction, which we had expected last quarter, remains high. Yet, the global economy continues to grow with reasonable strength, interest rates remain historically very low, and political risks appear containable. All of which means a bear market is also unlikely – neither feast nor famine.

So that's the dilemma facing investors today. Staying in cash at these low rates remains unattractive. Waiting for a "big crash" to bring out your cash hoard is likely to be a long and wasteful exercise. So investing is a more delicate and discerning business today.

US equities' cyclically adjusted price-to-earnings (CAPE) ratio is now approximating two standard deviations above a 134-year average. That's dangerous overvaluation territory – a market priced for perfection. Against that, expectations of what US President Donald Trump can do for US stocks now appear unrealistic, considering that he has been politically damaged and is distracted by investigations into whether he had attempted obstruction of justice, and whether key members of his team had improper dealings with the Russians.

European equities are not cheap either. But at least, it would be more appropriate to describe them as fairly-valued rather than overvalued. And European economic data has been surprising on the upside, while it has been disappointing in the US. Meanwhile, the cost of money will remain cheaper for longer in Europe vis-à-vis the US; European Central Bank (ECB) quantitative easing will continue at least until the end of this year while the Federal Reserve could start reducing its balance sheet later this year or early next year; and political risk has eased significantly with Emmanuel Macron's victory in France.

Asian equities offer better value. Their forward price-to-earnings ratios (PE) trade in the early- to mid-teens and are in the middle of their cyclical ranges. Economic growth in Japan is picking up from the borderline recessionary conditions of 2016. Meanwhile, the continuation of a negative policy rate combined with quantitative easing should see the yen weaken anew against the dollar, helping boost corporate earnings in local currency terms. Asia ex-Japan equities could be coming into a "sweet spot", with economic growth stabilising after years of decline, inflation taming, and economists' forecasts rising since the start of the year. Corporate earnings are still at an early stage of recovery from the protracted recession that ended late last year.

So it's a mixed picture for equities globally, demanding a very discriminating approach.

For fixed income, there is a clearer, more unified theme – the end of monetary accommodation. It has started in the US, where the Fed will continue raising rates and soon start reducing the size of its balance sheet. Sometime this year, speculation over ECB tapering its asset purchase program and exiting its zero policy rate could start putting upward pressure on bond yields. Globally, inflation will continue to gradually pick up. And corporate bonds – with spreads as tight as they are at the moment – have likely seen their best.

Commodities are cheap. But global oversupply has yet to fully unwind, and sentiment remains bearish. Yet, from a longer-term perspective, this is probably a good time to take a small position in commodities. Global economic growth is strengthening, albeit modestly. And supply is being worked down, albeit slowly. So there are cycles. And commodities – particularly industrial metals and crude oil – are probably close to the bottom of their respective cycles.

In currencies, the unwinding of Trump-related expectations – particularly fiscal divergence between the US and others – may have run its course. And the next six months is likely to see a resurgence in the dollar on monetary policy divergence. Leaving aside the now ambivalent prospects for substantial fiscal stimulus in the US, economic and inflation differentials still call for higher US rates and yields against most major economies. We see a stronger dollar against most currencies.

Thank you for investing with DBS.

Lim Say Boon
Chief Investment Officer, DBS Bank

Equities

Downgrading US to Underweight, upgrading Asia ex-Japan/Emerging Markets to Overweight

Bonds

Remaining Underweight

Currencies

US dollar likely to resume strengthening

Co. Reg. No. 196800306E

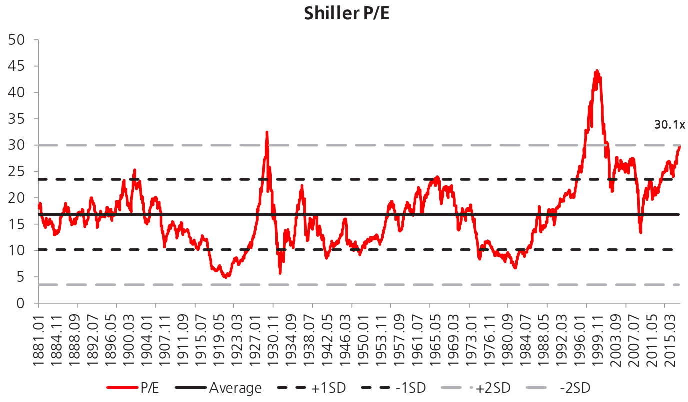
EQUITIES

Neither feast nor famine – that is the frustrating outlook for global equities. They are generally too expensive for big gains going forward. But economies and corporate earnings are growing. And rates remain low relative to history and current equities earnings yields. Hence, the spread between equities earnings yields over 10-year government bond yields is generally too large to sustain a bear.

Nevertheless, a moderate correction is a significant risk in coming months – most likely led by the United States. Technically, equities are overbought. And there is an uncomfortable complacency in the divergence between flat equities volatility and higher economic policy uncertainties.

US equities are priced for perfection – approximating two standard deviations above the 134-year average on its cyclically adjusted price-to-earnings (CAPE) ratio (Figure 1).

Fig 1: US equities are overvalued



Source: Robert Shiller, DBS CIO Office, as of June 2017

Yes, there have been occasions in the past when they have gone higher. But those ended badly shortly after. The overshoots were just before the Great Depression and the Nasdaq Crash of 2000. To be fair, the US typically doesn't go into a bear market without a recession, and the US Treasury yield curve today suggests a recession is not imminent. But history also suggests that returns are likely to be flat over the next year at these sorts of stock valuations.

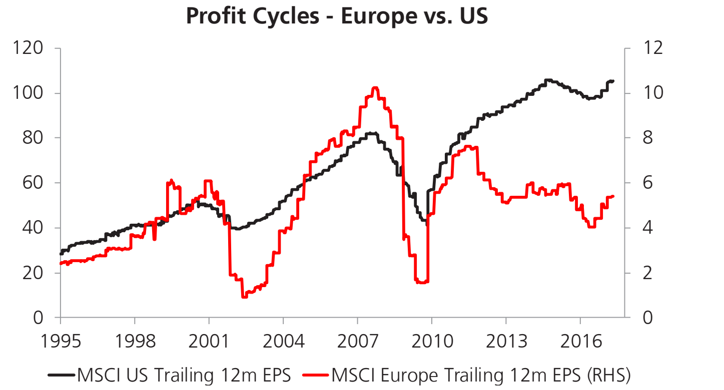
US stocks have priced in a lot of expectations of the so-called "Trump Effect" – that is, the hoped-for boost to stocks from tax cuts; the repatriation of US retained earnings held offshore, the border adjustment tax, and massive infrastructure spending/fiscal stimulus.

But US President Donald Trump is now mired in investigations into possible obstruction of justice and whether officials from his Administration have had improper dealings with the Russian government. Politically damaged and distracted, he is unlikely to deliver the promised infrastructure program and fiscal stimulus anytime soon. And there are still questions over planned tax cuts and the offsetting border adjustment tax. We are downgrading US equities to Underweight on the expectation of low or even negative returns in the coming year.

European equities are not cheap either, with its forward price-to-earnings (PE) ratio more than one standard deviation above a 10-year average. But in a low interest rate environment where people need to stay invested, the switches are likely to be between equities markets. Indeed, if equities are of poor value, bonds are of even poorer value. So in relative value terms, Europe appears more attractive than the US.

For starters, its forward PE ratio is still significantly below the US's. Growth of the denominator – earnings – has been lagging the US. But as its economic growth rate picks up momentum – which is what the leading indicators are suggesting is likely to happen – there is the prospect of European corporate earnings playing catch-up vis-à-vis those in the US (Figure 2). Also, the European Central Bank (ECB) is likely to maintain its zero policy rate and quantitative easing minimally until the end of this year, as the Federal Reserve tightens. So the discount factor for valuation should favour European stocks over their US peers.

Fig 2: European corporate earnings have "catch-up" potential



Source: Bloomberg, DBS CIO Office, as of June 2017

Asian equities are generally even cheaper, compared to US and European stocks. In Japan, equities valuation is cheap relative to its recent historical range and relative to the US. The caveat is its still-sluggish economy. But even there, economic momentum has picked up considerably from last year, with the gross domestic product (GDP) growth rate likely to end significantly higher than last year. We are maintaining our three-month Neutral weight in Japanese equities.

Asia ex-Japan and Emerging Market (EM) stocks could be heading into a "sweet spot" – a combination of stabilising economic growth; tame inflation; a strong earnings recovery; moderate valuations; and relatively tame US Treasury yields and dollar.

Global trade has been recovering, with both prices and volumes picking up since last year. This has helped stabilise Asian economic growth. Yes, rising rates/yields in the US and a stronger dollar have historically posed risks to Asia ex-Japan and EM economies. But with Trump's political stocks damaged by investigations into possible obstruction of justice and improper dealings with Russians, his tax, fiscal stimulus, and infrastructure plans will minimally be delayed. Yes, rates and yields will likely still go higher. But the pace of change will be modest, as will be gains in the dollar. We are upgrading Asia ex-Japan and EM equities to Overweight.

BONDS

The secular bull market in bonds is over. And the end is not playing out with a "bang"; it's ending with a whimper. The process is likely to be long drawn-out, choppy, with rebounds within a broad downtrend. But the returns from here are likely to be unimpressive.

A bond market rout is unlikely for a number of reasons: Ageing demographics will keep demand for fixed income high. As will the rapid build-up for private wealth in emerging Asia.

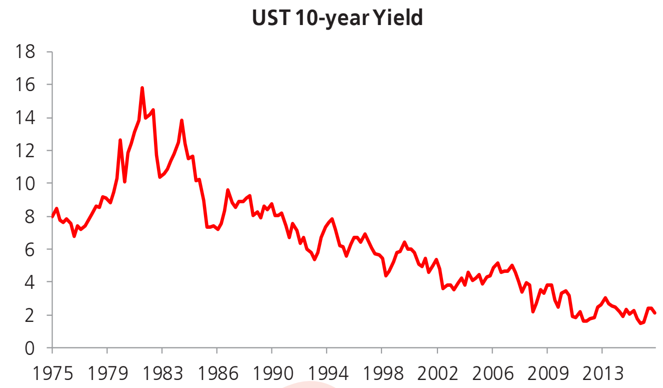
Meanwhile, the Japanese can pick up more than 200 bps in yields holding US Treasuries (UST) instead of Japanese Government Bonds. Even with currency hedging costs, it still pays the Japanese to continue buying USTs. Meanwhile, demand for USTs could return if the China continue to stabilise their foreign currency reserves in the midst of rising US rates and yields.

These are significant demand cushions against the impact of rising US rates and an eventual decline in the Federal Reserve's balance sheet.

That said, we see the decline in the 10-year UST yield from March as a pause in a bigger trend, rather than any sort of challenge to it, which is for significantly higher Treasury yields.

The second half of 2016 likely marked the end of a 35-year bull market for USTs – one which saw the 10-year yield going from nearly 16% to under 1.5% (Figure 3). And the easing back in yields in recent months was payback from the over-pricing of the "Trump Effect" on yields. That is, the market was expecting more rapid/resolute action from the Trump Administration to stimulate the economy, driving inflation expectations much higher. That has not happened.

Fig 3: The 35-year decline in the 10Y UST yield – as good as it gets?



Source: Bloomberg, DBS CIO Office, as of June 2017

But firstly, even without the "Trump Effect", the US economy is running below its non-accelerating inflation rate of unemployment (NAIRU). And the long-term trajectory of inflation is likely to be up if unemployment continues to head down. Also, there remains a possibility that President Trump's tax cuts and fiscal stimulus agenda are realised late this year and 2018, respectively, boosting rates and yields – albeit later than expected.

Clearly, the US has already ended its era of monetary accommodation – one which started when the Federal Reserve starting cutting rates in September 2007, down eventually to a lower bound of zero. Monetary accommodation was then boosted when the Fed lifted its balance sheet from under USD1t to nearly USD4.5t. Looking ahead, rates will continue rising and the Fed will start shrinking its balance sheet. A study published by the Fed suggests that quantitative easing had suppressed the term premium on the 10-year UST by around 100 bps. The point is that an end to asset purchases and maturity extension will likely push yields significantly higher.

The European Central Bank (ECB) will probably maintain dovish language until after the German Federal Election in September. Thereafter, speculation that the ECB might start tapering its asset purchases in 2018 will likely drive yields higher ahead of any such move. Plus or minus a few months, the era of monetary accommodation is nearly over in the Euro Area too.

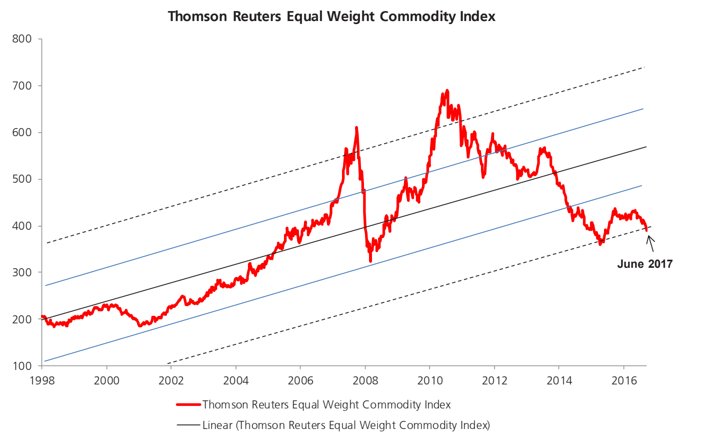
And with historically very tight corporate credit spreads, do not expect much more from the bond market. This could be as good as it gets.

COMMODITIES

The broad commodities index – the Continuous Commodity Index – had lost nearly 50% of its value from the April 2011 peak to its 2016 low. And it had given back almost all of its gains from late-2008 to its 2011 high (Figure 4).

Of course, none of the above means it can't go lower. But in markets, there are cycles. A critical part of the commodity cycle is price signalling and lagged supply responses. And generally, the price signals from a six-year bear market have pushed down supply, albeit gradually. For prices to sustain much lower, we have to assume a long-term, structural decline in Emerging Market (EM) economic growth.

Fig 4: Commodities – unloved and oversold?



Source: Bloomberg, DBS CIO Office, as of June 2017

Our belief is that the easing in EM growth is cyclical, not structural. By extension, the decline in commodity prices is also cyclical, soon to be corrected by supply responses. And firming global economic growth and inflation should support the tentative rebounds in commodities.

For example, oil market supply and demand should rebalance through the course of this year on steady growth in demand and lower Organization of the Petroleum Exporting Countries (OPEC) production. The OPEC cuts should eventually see the Organisation for Economic Co-operation and Development (OECD) stocks being drawn down towards their five-year average. This should support prices.

Similar supply-demand dynamics are emerging in industrial metals. Earlier this year, a World Bank report forecasted metals rising 16% in 2017 (after dropping nearly 7% in 2016) on "strong demand and tightening markets for most metals".

In the aluminium market, production is being constrained, new capacity growth has slowed, and production costs are rising – all of which should help prices higher.

The copper market should move into deficit this year, with the deficit rising into 2018, on the back of stronger global economic growth and demand. Critical to this, of course, is China. As Chinese policymakers tap the brakes to limit the credit expansion fall-out from recent growth, there could be some setback to demand. But we expect the Chinese to manage economic growth within a narrow band, limiting the downside risk.

Likewise, Chinese demand growth in zinc, driven by infrastructure spending in rail, telecommunications, and water management, should support prices. Global demand growth should pick up a bit compared to last year. However, on the supply side, the uncertainties are whether Glencore will extend mine shutdowns in the face of higher prices, and whether environmental regulations in China will curb production. On balance, the outlook is for slightly higher prices this year.

Nickel should also see a supply deficit this year. But the deficit is likely to be small and inventories are likely to remain high, capping prices.

CURRENCIES

Two factors weakened the dollar in April and early-May: Cautious signalling by the Federal Reserve, and a pullback in the pricing in of US President Donald Trump's ability to deliver on his agenda. But the logic of interest rate divergence between the US and other major economies should see a resumption of dollar strength.

The surge in the 10-year US Treasury (UST) yield and the dollar in the second half of last year was the market pricing in higher Fed rates and fiscal divergence between the US and other major economies. The market – as it often does – prices in advance of events, and sometimes gets ahead of itself. This was such an instance – hence the payback this year as a result of doubts over whether Trump can deliver on his promised fiscal stimulus.

But over coming months, we expect the logic of US economic strength vis-à-vis other Developed Market economies to reassert itself in higher UST yields and a stronger dollar.

DBS Bank is expecting the upper bound of the Fed funds rate to move to 2.25% by end-2Q18. Who else is raising rates? The Bank of Japan (BOJ) is likely to keep its policy rate in negative territory well into 2018. The European Central Bank (ECB) should keep its rate at zero into 2018. The Bank of England (BOE) could raise its rates, but only in 2018, and subject to the uncertainties of the impact of Brexit. In Australia, there is little risk of rate hikes, despite the red-hot housing market. It would be a crazy-brave Reserve Bank of Australia (RBA) that would raise rates in the face of dangerously high levels of household leverage.

Asia ex-Japan rates will likely stay flat in general through to 2018, with only a very few countries moving higher late-2017 or 2018.

Indeed, the risk is that the "sting in the tail" of the dollar becomes evident only late-2017 or 2018, if Trump introduces a border adjustment tax and succeeds in pushing a larger budget deficit through Congress. Never mind Trump's current political problems – the collective will of Congressional Republicans is more important.

And to reiterate, as the Fed starts shrinking its balance sheet, the reversal in the term premium on USTs could reinforce the upward pressures on their yields. Again, a study published by the Fed suggests that quantitative easing had suppressed the term premium for the 10-year UST by 100 bps. Against that, the ECB and the BOJ are highly unlikely to shrink their balance sheets anytime soon.

3Q17 Tactical Asset Allocation Strategy

	3 MONTHS	12 MONTHS
EQUITIES	**NEUTRAL**	**NEUTRAL**
United States	Underweight	Underweight
Europe	Neutral	Neutral
Japan	Neutral	Neutral
Asia Pacific ex-Japan	Overweight	Overweight
Emerging Markets	Overweight	Overweight
BONDS	**UNDERWEIGHT**	**UNDERWEIGHT**
Developed Markets	Underweight	Underweight
DM* Government	Underweight	Underweight
DM* Corporate	Neutral	Neutral
Emerging Markets	Underweight	Underweight
ALTERNATIVES	**OVERWEIGHT**	**OVERWEIGHT**
Commodities	Overweight	Overweight
Gold	Neutral	Neutral
Hedge Funds	Neutral	Neutral
CASH	**NEUTRAL**	**NEUTRAL**

*DM refers to Developed Markets

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