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CIO Insights 3Q19

Source: DBS

26 June 2019

A Changing World

Volatile, wide-ranging market in play

We expect, by year end, two rate cuts from the Fed to cushion headwinds from the ongoing trade war. The "tug of war" equity market is set to continue.

Barbell portfolio for a changing world

A changing world has profound implications to investing. Technological disruption heightens risks, but exciting opportunities abound. In this lower-for-longer rate environment, construct barbell portfolios to capitalise on secular growth themes alongside income-generating assets.

Ride secular growth themes

Amid the volatility, we see attractive levels to engage equities for the long term. Companies in e-Commerce, cloud computing, automation, and those that embrace the Sustainability agenda will be winners.

Value in income-generating assets

In a world where half the outstanding investment grade bonds are yielding 2% and less, corporate bonds and Asia REITs are prized assets. Maintain portfolios with diversified BBB/BB-rated credits, with average duration between 4 to 5 years.

Produced by:
DBS Chief Investment Office

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Contents


Source: AFP Photo

CIO INSIGHTS

1 Foreword
2 Executive Summary
3 Asset Allocation
23 Global Macroeconomics
35 US Equities
40 Europe Equities
46 Japan Equities
51 Asia ex-Japan Equities
57 Global Rates
65 Global Credit
70 Global Currencies
78 Alternatives: Gold
81 Theme I: Cloud Computing
88 Theme II: Automation
95 Special Feature I: New Defensives
101 Special Feature II: Sustainability

CIO PORTFOLIO

105 CIO Barbell Strategy

GLOSSARY

110 Glossary of Terms

Foreword

Ladies and gentlemen,

After a volatile first half of the year, I am pleased to bring you 3Q19's CIO Insights – your all-in-one investment guide to help you navigate these uncertain times. Led by our Chief Investment Office and a team of over 100 research analysts, this quarterly report provides our latest asset allocation models, as well as our high-conviction calls across various asset classes.

I'm particularly pleased to unveil a new offering from the Chief Investment Office: The CIO Portfolio. This is a global, cross-asset model portfolio based on the Barbell Strategy – with growth assets on one end, and income assets on the other. In this age of digitalisation, traditional sectors are facing unprecedented disruption. This, in turn, is redefining the investment landscape, and it is no longer "business as usual". The CIO Portfolio seeks to ride this disruptive wave of bifurcation, by focusing on the winners while avoiding the losers.

Our Discretionary Portfolio Management team takes the CIO Portfolio one step further, by constructing an actionable portfolio built around the Chief Investment Office's views. This is timely, as DBS is seeing growing interest in discretionary portfolio mandates (DPM). The uncertain market environment has driven a flight to holistic, diversified solutions that can withstand market swings. This has benefited our DPM business, which grew 50% last year, albeit from a nascent base.

Emotions can come into play when markets are jittery, and investors may be tempted to cut positions even though there may be value in staying the course. With DPM, clients can take comfort in knowing that their portfolio remains transparently invested, based on their individual risk appetites and guidelines, and that the same disciplined process applies even in such times of turbulence.

To be sure, these are unpredictable times – but I am confident that we can mine exciting opportunities together as a DBS family. I look forward to serving you even better in this new era of investing. Thank you for your support!

Sim S. Lim
Group Head
Consumer Banking & Wealth Management

Executive Summary

Dear valued clients,

Welcome to 3Q19 and the second half of the year!

At the start of this year, after a bruising 4Q18, we stood out to say this was not a start of a bear market. Rather, we said it was a "tug of war" between the bulls and the bears – and that this would result in a wide-ranging, volatile market. The markets then rallied hard in 1Q, and at the start of 2Q we argued that unless we saw a comprehensive trade deal, we would not see new highs. This roadmap has played out as said.

Where do we go from here?

While we continue to see this as a "tug of war" market, there are game-changing trends to capitalise on. This quarter, we title our publication "A Changing World".

Today, we see old business models unravelling and new secular themes emerging. For example, negative interest rates, the pervasiveness of e-Commerce, the ongoing trade war, and the Sustainability agenda will have profound implications on investing. As a result of these changes, a large chunk of the world's equity capitalisation is under siege. We first saw e-Commerce disrupting retail. Now these new technologies are disrupting the media, telecom, auto, and financial sectors.

For sure, risks abound from these changes, but there are also exciting opportunities. Should we cringe and hold cash? With near-zero rates, this surely is not going to work.

Our call is to engage markets through long-term, multi-asset, and globally-oriented portfolios. The underlying strategy is to "barbell": This entails stripping away sectors that are under siege from disruption and buying into companies plugged into secular growth themes, alongside holding income-generating assets.

In this issue, we detail exciting trends in cloud computing, automation, the New Defensives, and the Sustainability agenda.

Do enjoy the read!

Hou Wey Fook, CFA
Chief Investment Officer

Asset Allocation | 3Q19

Navigating trade war

Source: AFP Photo

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Macro Outlook

Monetary Policy

Fed to deliver two rate cuts by year end as insurance against global market risks. However, there is limited room for ECB rate cuts.

Economic Growth

US growth to stay within 2-3%, but prolonged trade war could increase stagflation risk. China's growth rate to moderate after an impressive 1Q.

Geopolitics

Escalating US-China trade war is the key risk event. Keep an eye on Brexit and ECB leadership change.

Inflation

US inflation to stay below Fed's target amid moderate energy and food prices, and limited passthrough from tariffs to consumer goods.

Fiscal Policy

Limited room for further fiscal stimulus in the US. Proposed consumption tax hike in Japan may be delayed amid rising recession risk.

Market Outlook

Equities

Given rising trade tensions, Overweight IT services over hardware within Technology. In China, prefer domestic consumption over exporters.

Currencies

Dollar to stay firm given relative US economic strength. Euro risk remains on the downside while the yuan will stay close to 7.0 on lingering trade tensions.

Rates

Trade war will weigh on G-3 rates and bond yields. ECB's policy normalisation on hold while BOJ to keep rates low through Spring 2020.

Credit

Prefer EM over DM bonds given wider yield spreads. Sweet spot is on the BBB/BB-rated buckets with average portfolio duration between 4 to 5 years.

Thematics

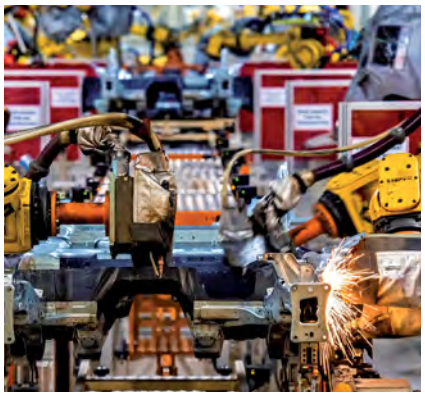
Ride the secular tailwind of Cloud Computing as data is the new oil. Benefit from the global manufacturing renaissance as Automation takes hold.

CIO Thematic Research

Cloud Computing

Data is the new oil, and cloud computing is the cornerstone of data usage, online access, and the Internet of Things. Prospects are bright given the sector's versatility amid rising demand for the public cloud.

New Theme | CIO Insights 3Q19



Automation

Global manufacturing is undergoing a renaissance as automation and "Industry 4.0" take hold. Benefit from the shift toward "smart factories" that will re-define global manufacturing.

New Theme | CIO Insights 3Q19

New Defensives

Digitalisation is leading to the disruption of traditional industries. Today, Technology and Consumer Discretionary companies offer utility-like business models. They are the New Defensives.

New Feature | CIO Insights 3Q19

Source: AFP Photo

Sustainability 2.0

As climate change outpaces society's ability to curb its mass energy addiction, a major revolution is upon us: Sustainability. In the near future, ESG investments will be part of core portfolios. Ride the wave.

New Feature | CIO Insights 3Q19

Asset Allocation

Hou Wey Fook, CFA
Chief Investment Officer

Dylan Cheang
Strategist

Navigating global trade uncertainties

True to form, global equities staged an impressive rebound during the first four months of 2019 as the timely combination of a dovish Federal Reserve and a resurgent Chinese economy reignited "animal spirits" after December's carnage. But as the saying goes, "nothing lasts forever". The high-octane rally in global equities came to an abrupt halt as US-China trade tension reared its ugly head again in May and triggered a broad-based retreat in risk assets.

Since 2018, we have maintained the view that rationality will eventually prevail with the trade war seeing a peaceful resolution. Not anymore. Recent rhetoric between the US and China suggests that the key issue at hand is no longer about trade per se. It is about the fight for strategic and technological dominance on the global stage. Even in the event that US and China reach a resolution in the coming months, the calm will only be transitory. At the end of the day, there are no easy solutions for deep-seated issues surrounding intellectual property and protectionism. Undercurrents and mistrust will linger for the foreseeable future.

Figure 1: US-China trade war – a timeline

Source: Bloomberg, DBS

So in an "all-out" trade war, what will the impact on the S&P 500 Index be?

Faced with heightened tariffs, Chinese companies exporting to the US market will try to pass on the bulk of these costs to US importers while absorbing part of it. According to DBS economists, real US GDP growth will be reduced by 0.6%pts to 1.9% in 2019. Against this backdrop, we expect:

- US capex: Based on our model-based analysis, an "all-out" trade war will bring the year-on-year 12-month trailing capital expenditure of S&P 500 companies to almost zero (vs 12% growth in 1Q19) (Figure 3).

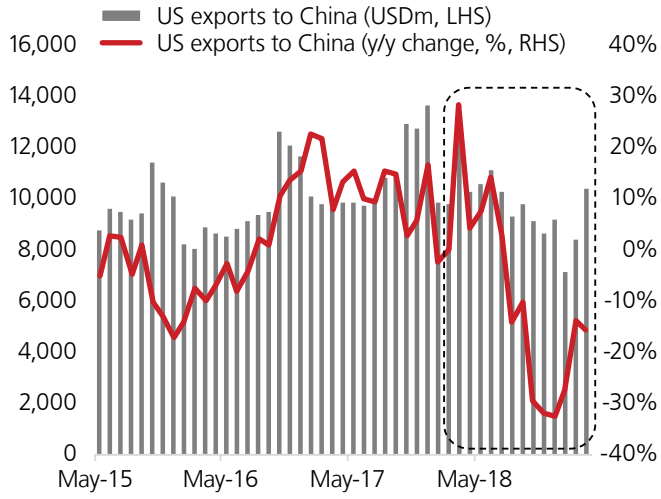
- US earnings: Based on a worst-case scenario, our model-based analysis suggests that S&P 500 earnings could be reduced by 3%pts in 2019 (Figure 4).

- US valuation: Estimating the valuation impact of an "all-out" trade war is definitely more of an art than a science. We conducted an analysis on this last year in our *CIO Perspectives – Trade war: From rhetoric to reality (4 July 2018)?*

  Back then, we drew reference on the US steel tariffs of 2002 and concluded that in the event of an "all-out" trade war, US equities could undergo correction and trade at 14% discount to its long-term median. Our view is unchanged.

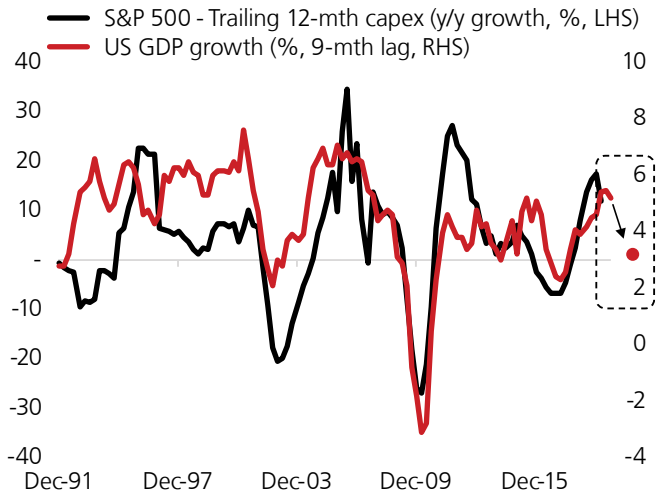
  Today, the median valuation for S&P 500 stands at 16x and a 14% discount will bring the forward P/E to 14x. As the market trades at 17x currently, this implies a valuation contraction of 17% in the worst-case scenario (Figure 5).

Figure 2: Trade War Blues I – Ongoing trade tensions have weighed on US exports to China



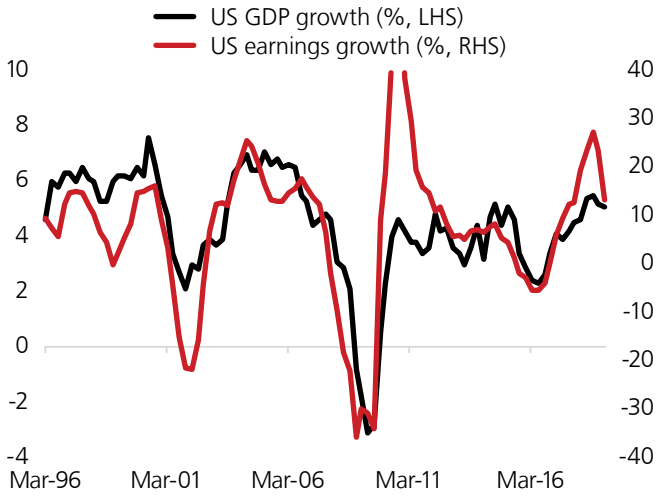
Source: Bloomberg, DBS

Figure 3: Trade War Blues II – An "all-out" conflict could drive S&P 500 company capex growth to almost zero



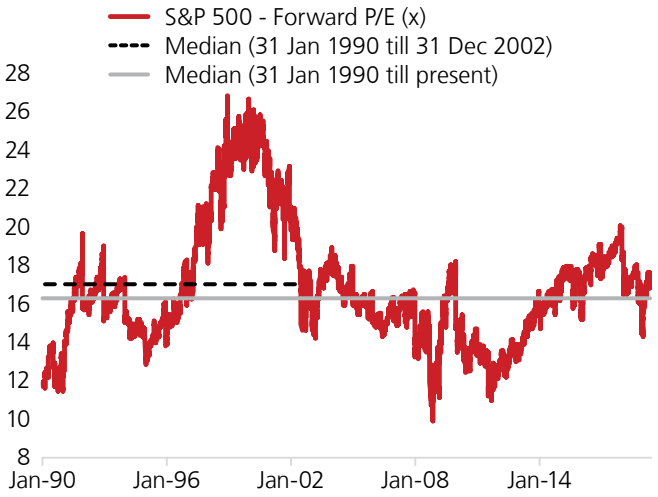
Source: Bloomberg, DBS

Figure 4: Trade War Blues III – An estimated 3%pts could be shaved off S&P 500 earnings growth



Source: Bloomberg, DBS

Figure 5: Trade War Blues IV – US valuation could contract by 17% in the "worst-case" scenario



Source: Bloomberg, DBS

Taken together, the combination of 3% earnings decline and 17% valuation contraction will bring the S&P 500 broadly back to the trough of December 2018's selldown. But this is just an analysis of an "extreme" scenario, and we are assigning only a 30% probability to it. More likely than not, we expect the market to be well-supported by the following factors during the second half, given:

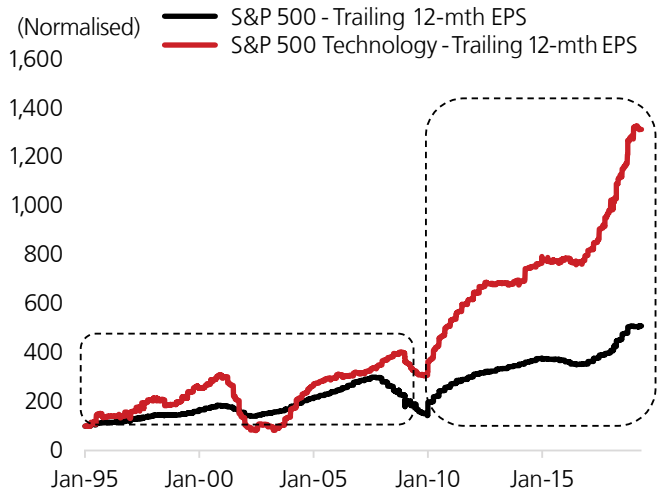
1) Valuation and growth expectations are not excessive
2) Light positioning and loose financial conditions
3) Troughing of macro and earnings momentum

Fair valuation and modest growth expectations. In our conversations with clients, a common pushback is that "valuation is no longer cheap". This, in our view, is a misconception. With the global bull market entering its tenth year, it is easy to dismiss equities as being "expensive"; in reality, however, the dynamic today is vastly different from previous market peaks.

First, the bull market (in particular the S&P 500 Index) is backed by strong corporate earnings growth. There are no signs of this abating, as traditional industries continue to face disruption – and this disruption is by technology companies which generate higher returns (Figure 6). This explains why US equities trade at 17.3x forward P/E – a level not far from its long-term average of 16.9x (Figure 7).

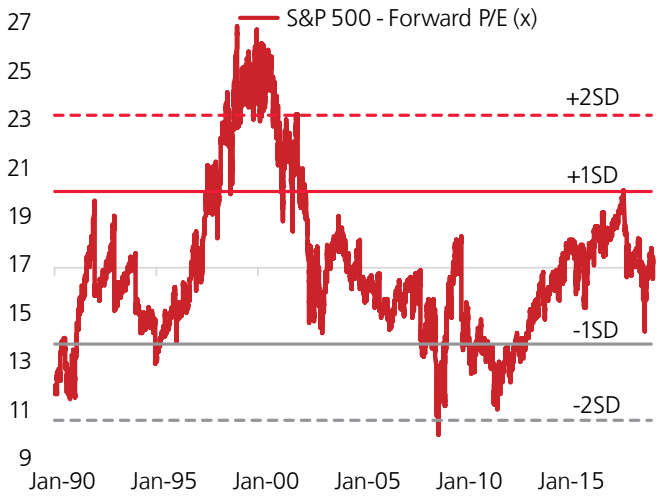
To check our blind spots on market valuation, we have constructed a two-stage Dividend Discount Model (DDM) for the S&P 500, with the following assumptions: (a) Risk-free rate proxied by the UST 10-year yield; (b) Stage one dividend growth rate based on the consensus forecast for long-term EPS growth; and (c) Terminal growth for dividends proxied by long-term average GDP growth.

Figure 6: Game changer – Technology has been a major driver of US corporate earnings, and will remain so



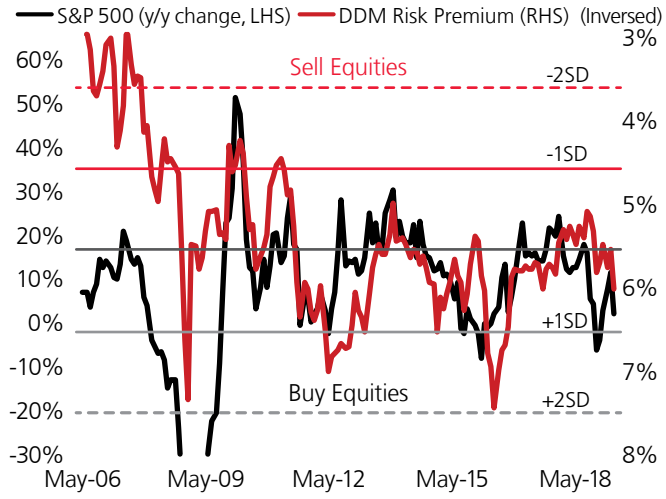
Source: Bloomberg, DBS

Figure 7: Strong US corporate earnings growth has kept the S&P 500's valuation in check



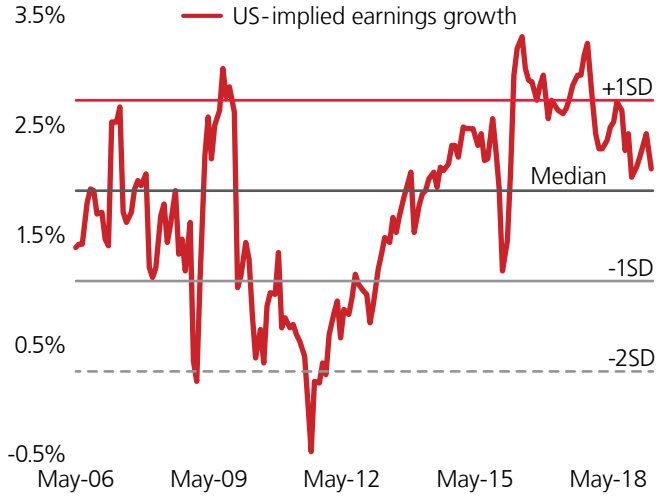
Source: Bloomberg, DBS

Figure 8: Our DDM model shows the ERP for the S&P 500 is in line with its long-term average



Source: Bloomberg, DBS

Figure 9: Current implied earnings growth for S&P 500 is modest



Source: Bloomberg, DBS

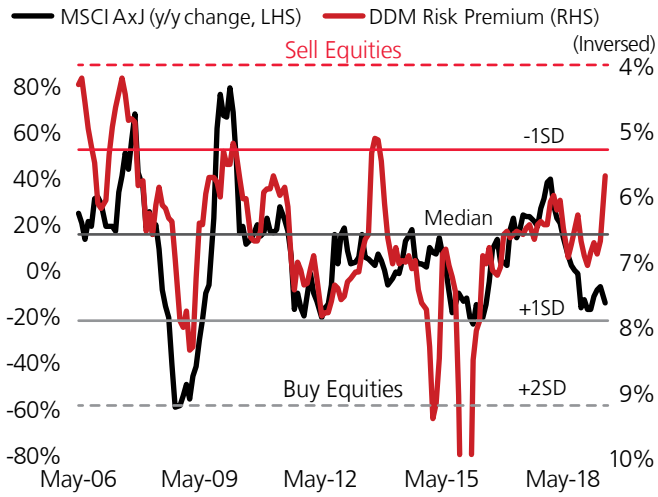
Our model shows that the market is pricing in only modest earnings growth

Based on our DDM model, the Equity Risk Premium (ERP) for the S&P 500 stands at 6.0%, in line with the long-term average. More interestingly, our model shows that the prevailing forward P/E is pricing in only conservative earnings growth of 2.1% (again, this is in line with historical trends).

All in all, the above indicators show no signs of excessive exuberance in the US equity market, at this stage.

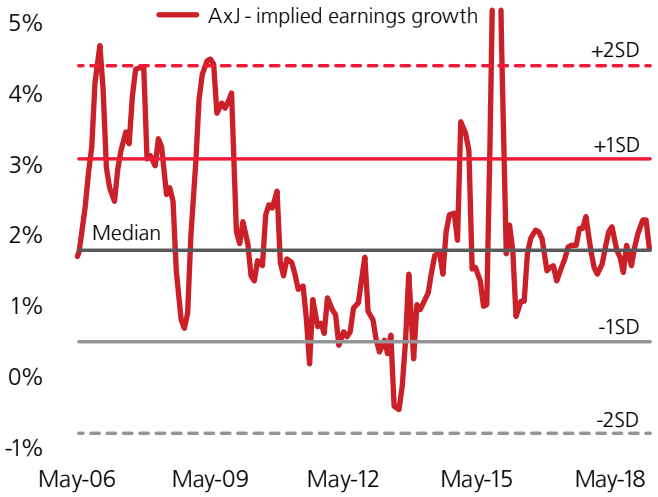
Expanding our research to Asian markets yielded similar outcomes. As Figure 10 shows, the ERP for the region stands at 5.7%, in line with its long-term median of 6.6%. At the current valuation, the implied earnings growth stands 1.6%; this is not excessive in our view.

Figure 10: ERP for Asia ex-Japan is currently in line with the long-term median



Source: Bloomberg, DBS

Figure 11: Implied earnings growth for Asia ex-Japan equities is close to zero



Source: Bloomberg, DBS

Positioning in US equities remains light and this suggests the absence of irrational exuberance

Light positioning and loose financial conditions. As we highlighted in *CIO Perspectives – An unloved bull; engage equities within barbell strategy (2 May 2019)*, our analysis of tactical indicators suggests that there remains much scepticism over the sustainability of the current market rebound.

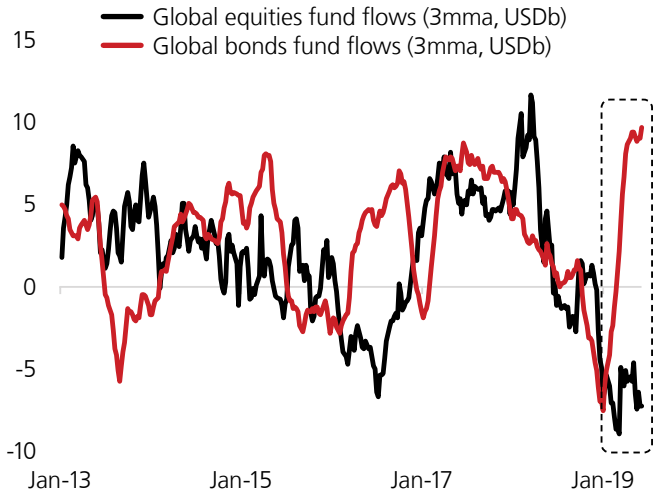
On a 5M19 basis, fund flows from EPFR Global show that USD165b flowed into global bonds, while global equities registered outflows totalling USD145b (Figure 12). The current American Association of Individual Investors (AAII) bull/bear ratio of 0.6 similarly suggests that investor appetite for equities remains lukewarm (Figure 13).

This is good news. The overall caution suggests the absence of irrational exuberance in equities. Should markets continue to rally, benchmark-based investors will be forced to play "catch-up", giving equities another leg-up.

Corporates remain the key buyer of US equities

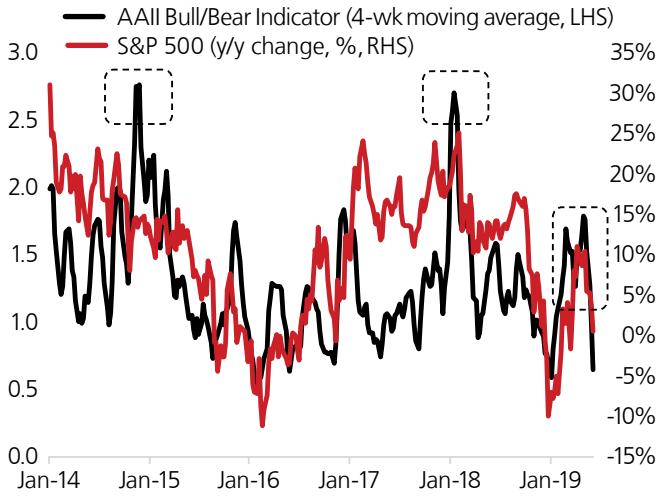
Now, one may ask: With both institutional and retail investors perceivably staying on the sidelines, who are the key buyers then? Our answer: Corporates. Corporate share buybacks remain robust, given the huge amount of cash sitting on the balance sheets. We expect this trend to stay strong (Figure 14).

Figure 12: Unlike bonds, equities remain unloved



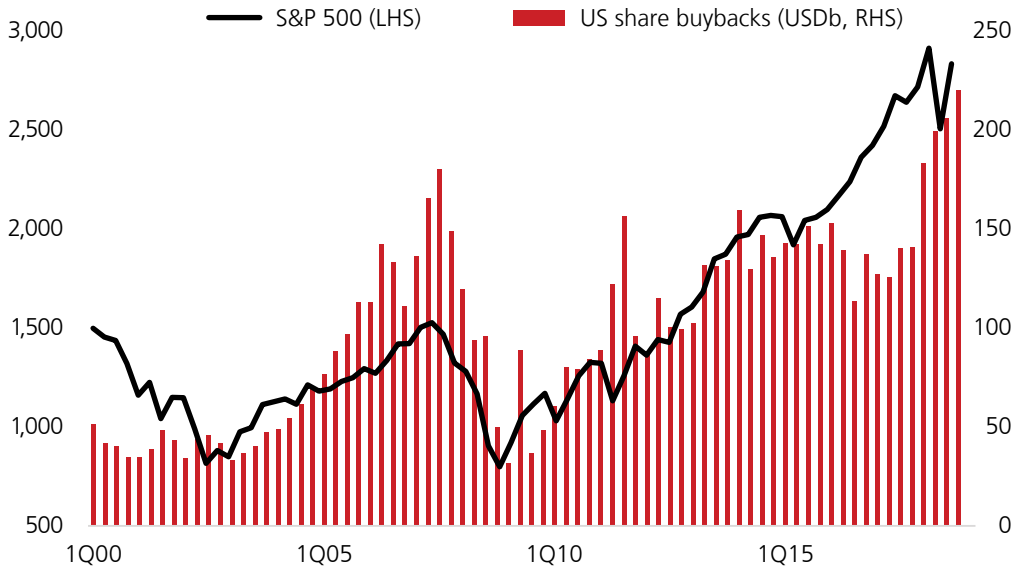
Source: EPFR Global, DBS

Figure 13: AAII bull/bear ratio stuck in moderate range, amid lingering scepticism over equity rally



Source: Bloomberg, DBS

Figure 14: Corporate share buybacks remain a significant driver of the S&P 500



Source: Bloomberg, DBS

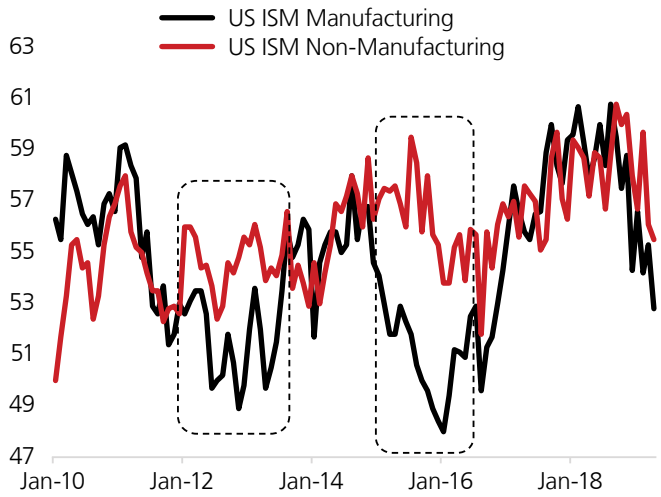
Troughing of macro and earnings momentum. The global economy underwent a broad-based deceleration for the whole of 2018, evident from the downtrend in the US ISM Manufacturing and China Li Keqiang index. But recent high-frequency data suggest a bottoming trend is in place.

Divergence between US services and manufacturing sectors

In the US, momentum has somewhat diverged for the services and manufacturing sectors, as uncertainties from trade tensions weighed on manufacturing activity. On the other hand, the services segment has remained fairly resilient, as the ISM Non-Manufacturing Index stood at 55.5 in April. As Figures 15 and 16 show, the difference between ISM Manufacturing and Non-Manufacturing (also known as the ISM differential) has historically been a leading indicator for the trajectory of GDP and corporate earnings.

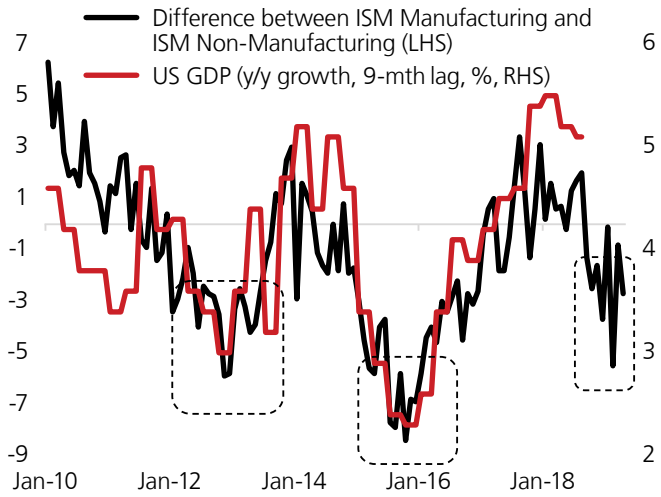
US GDP growth tends to lag the ISM differential by nine months. As such, recent weakness in the latter suggests that upcoming headline US GDP data could skew to the weaker side. Still, this is immaterial to financial markets, given the lagged nature (and hence irrelevance) of GDP numbers.

Figure 15: US ISM Manufacturing tends to catch up with the ISM Non-Manufacturing index after a lag; this time will be no different



Source: Bloomberg, DBS

Figure 16: ISM indices are signalling a softening of macro momentum in the coming quarters



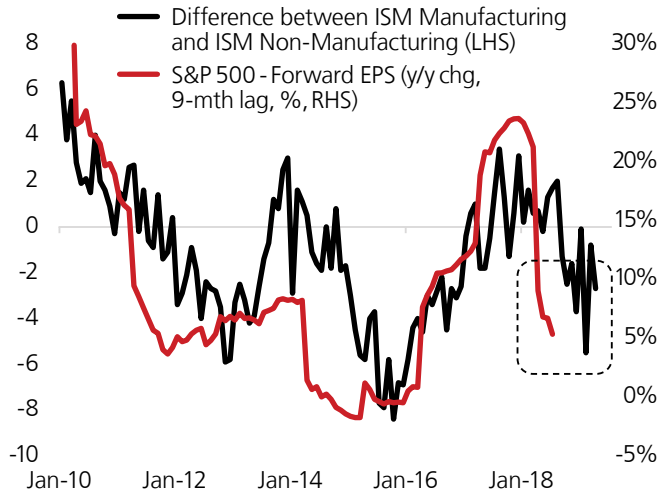
Source: Bloomberg, DBS

US corporate earnings have potentially troughed

What really matters to equity markets is corporate earnings. Figure 17 shows that earnings forecasts have already undergone a sharp downward revision in anticipation of the macro weakness. The bottoming of forecasted earnings augurs well for the outlook of the S&P 500.

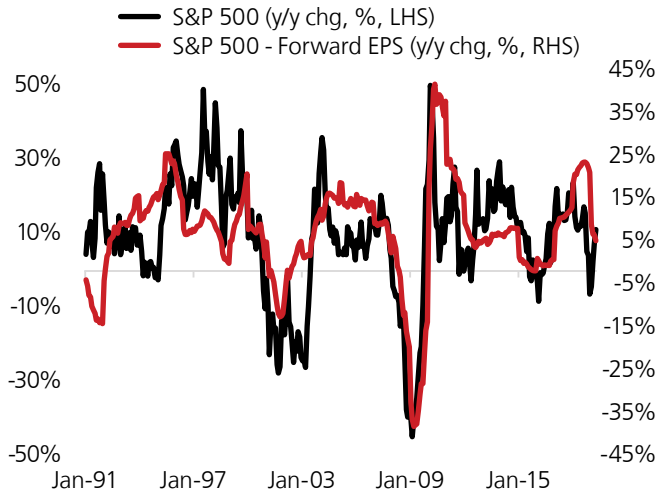
Similarly, China's macro environment is seeing early signs of a rebound, as the government pursues pro-growth policies to arrest the recent decline in economic momentum. China's manufacturing PMI seems to have bottomed in February, coinciding with recent gains in the economic surprise index (Figure 19). We believe China's macro conditions will undergo a further rebound from here, as recent RRR cuts work their way through the broader economy.

Figure 17: The looming macro weakness has already been reflected in the street's earnings forecast



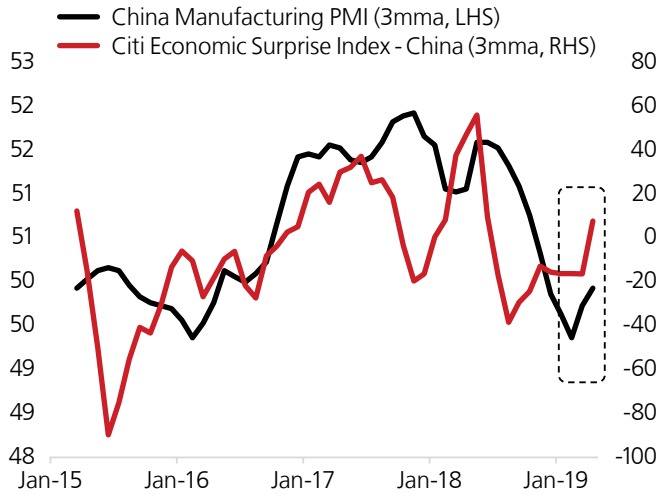
Source: Bloomberg, DBS

Figure 18: The bottoming of forecasted earnings augurs well for the outlook of S&P 500



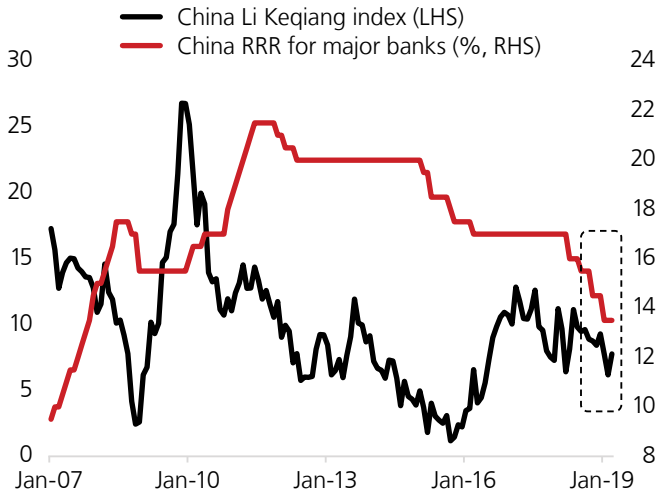
Source: Bloomberg, DBS

Figure 19: Still early days, but the Chinese economy is showing initial signs of a rebound



Source: Bloomberg, DBS

Figure 20: Chinese macro momentum is expected to improve after recent RRR cuts



Source: Bloomberg, DBS

Winners and losers in a trade war

The likelihood of this trade conflict morphing into a long-drawn affair has increased considerably, given the widening gulf between the US and China. From bilateral trade tension, the narrative has since expanded to technology and data security. Without doubt, a prolonged conflict will weigh on the global economy and in such an environment, it is prudent to seek out the relative winners and losers.

From a strategy perspective, we have been advising investors to adopt a barbell strategy in times of rising market volatility. Under this framework, we have exposure to both "Growth" and "Income" equities. Growth equities predominantly consist of exposure to US Technology, digitalisation, Millennial consumption, and China equities while on the "Income" side of the equation, it consists of REITs, dividend stocks, and BBB/BB corporate bonds.

Should the trade situation deteriorate further, one should be more discerning in their sub-sectoral/thematic allocation and our recommended strategies are:

Trade war strategies for Growth equities:

- In US Technology and the "Digitalisation" theme, prefer IT services over IT hardware
- In China equities, prefer domestic consumption stocks over exporters

Trade war strategies for Income equities:

- Trade war likely to compel central banks to cut rates further; Positive for REITs

3Q19 Asset Allocation: Equities still the best game in town

Table 2: CIO Asset Allocation (CAA) Framework – 3Q19

Categories	Indicators	Score Range	Equities				Bonds		
			US	Europe	Japan	AxJ	DM Govt	DM Corp	EM Bonds
Fundamentals	PMI	-1 to +1	0	-1	0	0	0	0	0
	Economic surprise	-1 to +1	0	-1	0	0	0	0	0
	Inflation	-1 to +1	1	0	0	0	0	0	0
	Monetary policies	-1 to +1	1	1	1	1	1	1	1
	Forecasted EPS growth	-2 to +2	1	0	0	0	-	1	0
	Earnings surprise	-2 to +2	1	-1	0	0	-	0	0
Valuation	Forward P/E	-2 to +2	0	0	0	1	-	-	-
	P/B vs ROE	-2 to +2	0	0	0	1	-	-	-
	Earnings yield - 10Y yield	-2 to +2	1	1	1	1	-1	-	-
	Credit spread	-2 to +2	-	-	-	-	-	-1	0
Momentum	Fund flows	-2 to +2	-1	0	0	0	1	0	1
	Volatility	-1 to +1	0	0	0	0	0	-	-
	Catalysts	-2 to +2	0	0	0	0	0	0	0
Raw Score			4	-1	2	4	1	1	2
Adjusted Score*			**0.21**	**-0.05**	**0.11**	**0.21**	**0.09**	**0.07**	**0.14**

*Note: The "Adjusted Score" is calculated using the "Raw Score" divided by the maximum attainable score for each category. Source: DBS

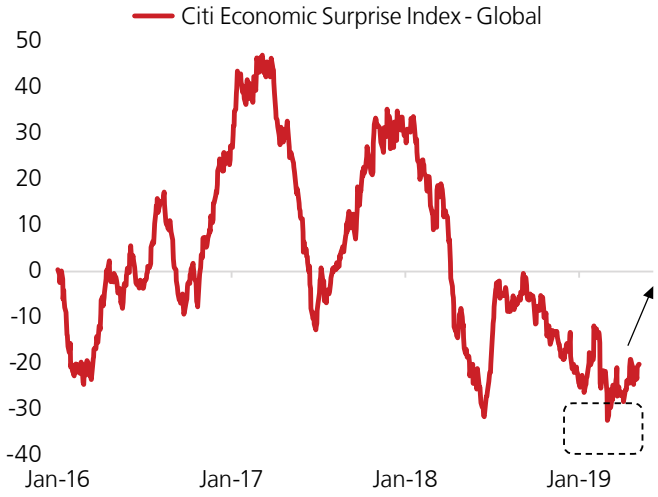
Cross Assets – Equities continue to encapsulate better risk-reward. From a cross-asset perspective, we continue to maintain a preference for equities over bonds. This view is captured in our CAA Framework, with equities garnering a higher score of 0.47 (vs bonds at 0.31).

Fundamentals: Global economic momentum is showing early signs of recovery, as seen from the uptrend in the Citi Economic Surprise Index (Global) since March. Recessionary risk for 2019 remains low and we expect corporate earnings to maintain their current momentum (Figure 21).

Valuations: On a cross-asset basis, the gap between earnings yields and treasury yields remains meaningfully wide at 3.3% (vs the historical average of 1.4%). This underlines the relative attractiveness of equities over bonds (Figure 22).

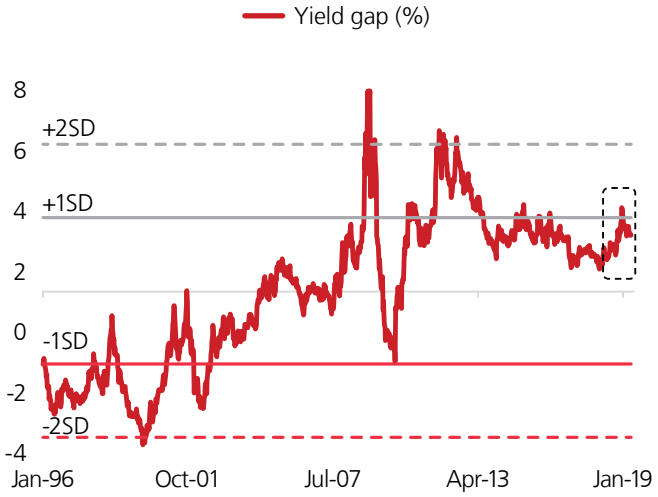
Momentum: On cross-asset flows, USD145b has exited from global equity funds this year, compared to inflows of USD165b for bond funds. The flow data suggest lingering scepticism on the durability of this equity rally. But should stock markets continue to grind higher, the pressure for benchmark-tracking investors to load up on their equity allocation will intensify.

Figure 21: Signs of bottoming in the global economic outlook



Source: Bloomberg, DBS

Figure 22: Equities encapsulate greater value than bonds



Source: Bloomberg, DBS

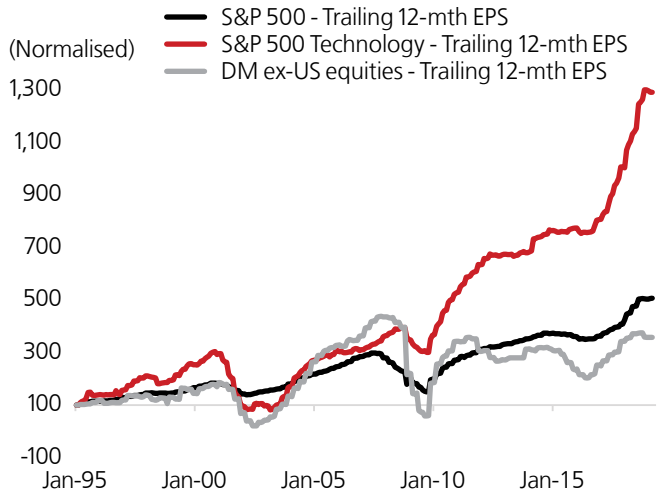
Equities: US to maintain cyclical leadership in DM; China looks attractive after the pullback. In developed markets, we continue to favour US over Europe and Japan in 3Q19 for the following reasons:

a) US equities possess superior earnings momentum, given the high representation of technology-related stocks in the index (Figure 23). The proportion of US companies reporting positive earnings surprise has been on the rise (Figure 24).

b) The strong rebound in fund flows momentum for US equities (Figure 25) suggests that benchmark investors are increasingly compelled to "chase" the S&P 500, after the strong rally this year.

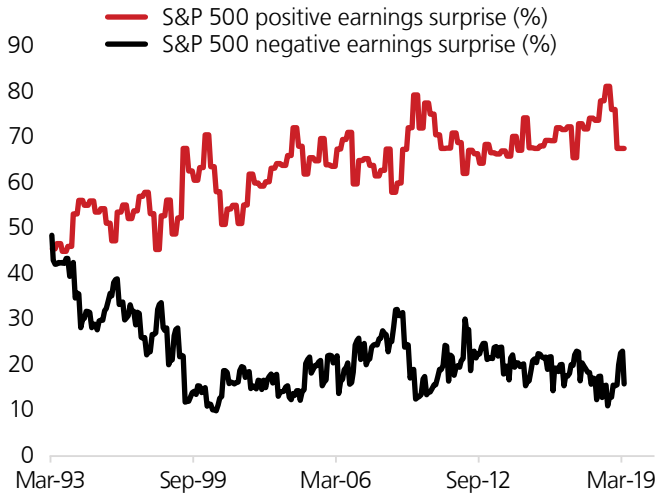
c) No signs of mean reversion, with global investors maintaining their willingness to pay a premium for US equities' stability and growth potential (Figure 26).

Figure 23: US continues to outperform other DMs, given superior earnings momentum due to huge technology exposure



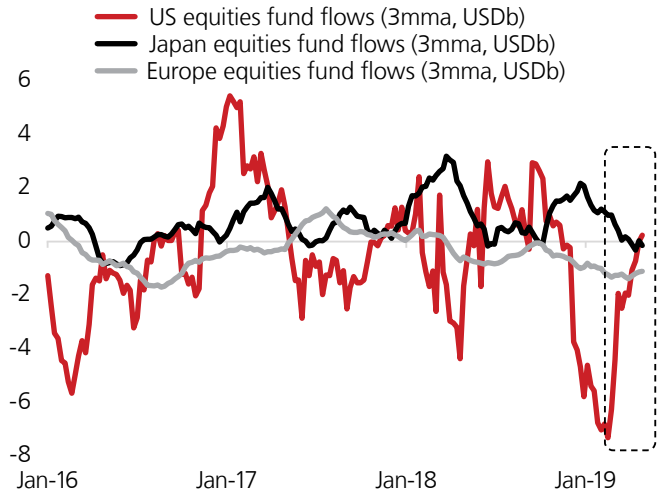
Source: Bloomberg, DBS

Figure 24: Diverging path – Proportion of US companies reporting earnings surprise on the rise



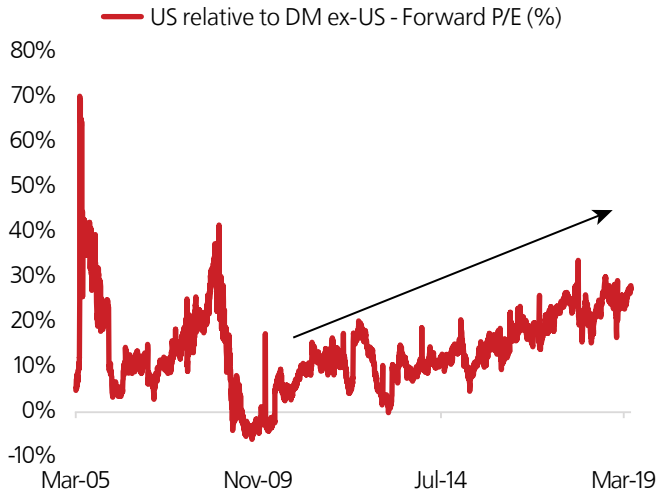
Source: Bloomberg, DBS

Figure 25: Flow data suggest that investors are incrementally allocating funds to the US, after months of outflows



Source: EPFR Global, DBS

Figure 26: The death of mean reversion? Valuation premium for the US relative to other DMs continues to grind higher



Source: Bloomberg, DBS

The sharp pullback in China equities – on renewed trade war concerns – provides an attractive entry point for investors. Indeed, post-US President Donald Trump's tweets, both H- and A- shares have corrected 9% and 5%, respectively (as of 12 June). In addition, one should take a longer-term view here. We stay positive on China equities given the following reasons:

a) The Chinese government has clearly undertaken steps to boost the domestic economy. This augurs well for corporate earnings.
b) China equities are not only cheap from a valuation perspective – they also possess huge earnings growth potential. This explains why the P/E-to-growth (PEG) ratio for China equities is substantially lower than that of global equities (1.1 vs 2.5, respectively) (Figure 27).
c) China technology stocks are looking attractive after the recent pullback. The sector trades at 2.0x P/B while ROE stands at 12.2%. Previously, when P/B was trending in this range, the ROE was approximately half of the current level (Figure 28).

Figure 27: China trades at more attractive PEG than global equities

Source: Bloomberg, DBS

Figure 28: China technology stocks are attractive on a P/B-ROE basis

Source: Bloomberg, DBS

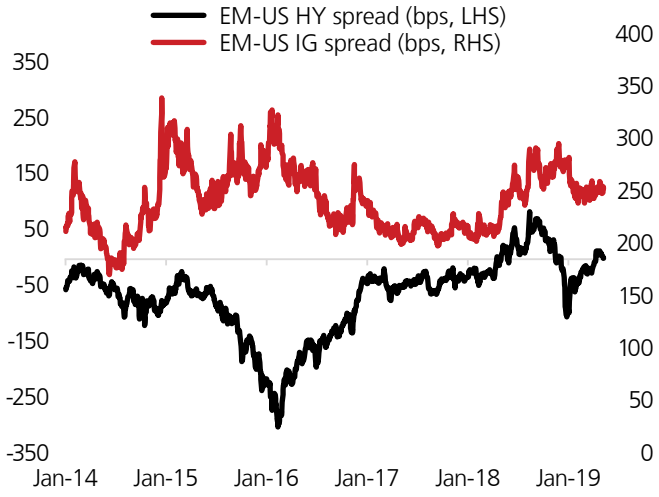
Bonds: Maintain positive view on EM bonds. In 2Q19, we upgraded EM bonds to Overweight. This quarter, we see further room for modest spread tightening as the Fed maintains its dovish policy stance (and thus extends the credit cycle). As Figure 29 shows, EM spreads tend to lag the UST 10-year yield by three months. The current level of 2.1% for the UST 10-year yield suggests that further c.20 bps of spreads tightening for EM bonds is plausible.

Meanwhile, from a relative perspective, EM bonds are not overvalued. EM spreads are now broadly in line with US high-yield (HY) (vs the long-term average difference of -66 bps), while the spread between EM and US IG is slightly wider than the historical average (Figure 30).

Figure 29: The downtrend in UST yields suggests further spread tightening for EM bonds is plausible

Source: Bloomberg, DBS

Figure 30: EM bonds are not overvalued, relative to US IG and HY bonds



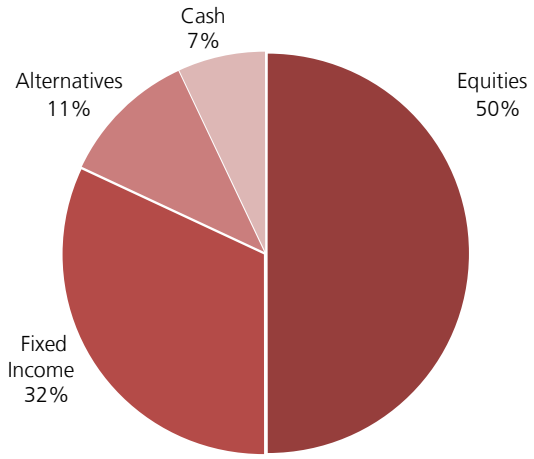
Source: Bloomberg, DBS

Table 3: 3Q19 Global tactical asset allocation (TAA)

Asset Class		
	Three-Month Basis	**12-Month Basis**
Equities	**Neutral**	**Neutral**
US Equities	Overweight	Neutral
Europe Equities	Underweight	Underweight
Japan Equities	Underweight	Neutral
Asia ex-Japan Equities	Overweight	Overweight
Fixed Income	**Underweight**	**Underweight**
Developed Markets (DM) Government Bonds	Underweight	Underweight
Developed Markets (DM) Corporate Bonds	Underweight	Neutral
Emerging Markets (EM) Bonds	Overweight	Neutral
Alternatives	**Overweight**	**Overweight**
Gold	Overweight	Neutral
Hedge Funds	Overweight	Overweight
Cash	**Overweight**	**Neutral**

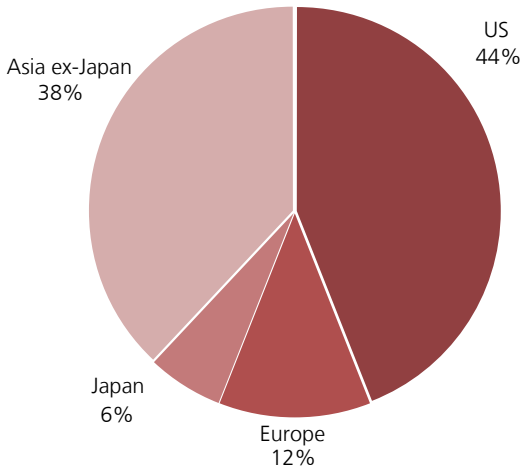
Source: DBS

Figure 31: TAA breakdown by asset class (Balanced Profile – three-month view)



Source: DBS

Figure 32: TAA breakdown by geography within equities (Balanced Profile – three-month view)

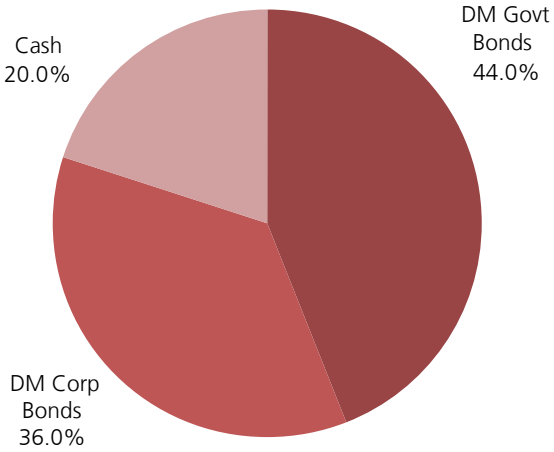


Source: DBS

Conservative

	TAA	SAA	Active
Equities	0.0%	0.0%	
US	0.0%	0.0%	
Europe	0.0%	0.0%	
Japan	0.0%	0.0%	
Asia ex-Japan	0.0%	0.0%	
Fixed Income	80.0%	80.0%	
Developed Markets (DM)	80.0%	80.0%	
DM Government Bonds	44.0%	44.0%	
DM Corporate Bonds	36.0%	36.0%	
Emerging Markets (EM)	0.0%	0.0%	
Alternatives	0.0%	0.0%	
Gold	0.0%	0.0%	
Hedge Funds*	0.0%	0.0%	
Cash	20.0%	20.0%	

*Only P4 risk rated UCITs Alternatives

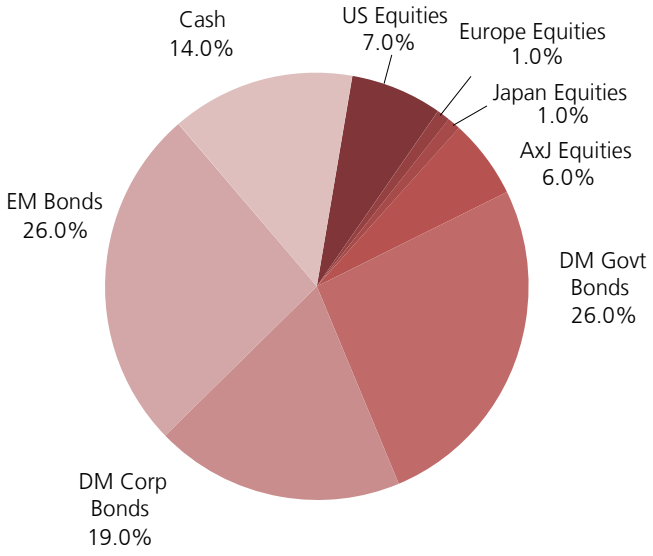


Source: DBS, Morningstar Investment Management Asia Limited

Moderate

	TAA	SAA	Active
Equities	15.0%	15.0%	
US	7.0%	6.0%	1.0%
Europe	1.0%	4.0%	-3.0%
Japan	1.0%	2.0%	-1.0%
Asia ex-Japan	6.0%	3.0%	3.0%
Fixed Income	71.0%	75.0%	-4.0%
Developed Markets (DM)	45.0%	53.0%	-8.0%
DM Government Bonds	26.0%	30.0%	-4.0%
DM Corporate Bonds	19.0%	23.0%	-4.0%
Emerging Markets (EM)	26.0%	22.0%	4.0%
Alternatives	0.0%	0.0%	
Gold	0.0%	0.0%	
Hedge Funds*	0.0%	0.0%	
Cash	14.0%	10.0%	4.0%

*Only P4 risk rated UCITs Alternatives

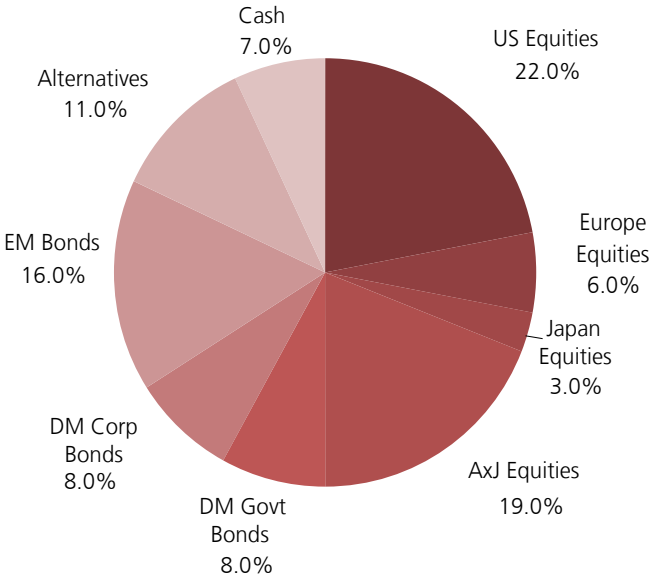


Source: DBS, Morningstar Investment Management Asia Limited

Balanced

	TAA	SAA	Active
Equities	50.0%	50.0%	
US	22.0%	21.0%	1.0%
Europe	6.0%	12.0%	-6.0%
Japan	3.0%	7.0%	-4.0%
Asia ex-Japan	19.0%	10.0%	9.0%
Fixed Income	32.0%	40.0%	-8.0%
Developed Markets (DM)	16.0%	29.0%	-13.0%
DM Government Bonds	8.0%	16.0%	-8.0%
DM Corporate Bonds	8.0%	13.0%	-5.0%
Emerging Markets (EM)	16.0%	11.0%	5.0%
Alternatives	11.0%	5.0%	6.0%
Gold	5.0%	2.0%	3.0%
Hedge Funds*	6.0%	3.0%	3.0%
Cash	7.0%	5.0%	2.0%

*Only P4 risk rated UCITs Alternatives

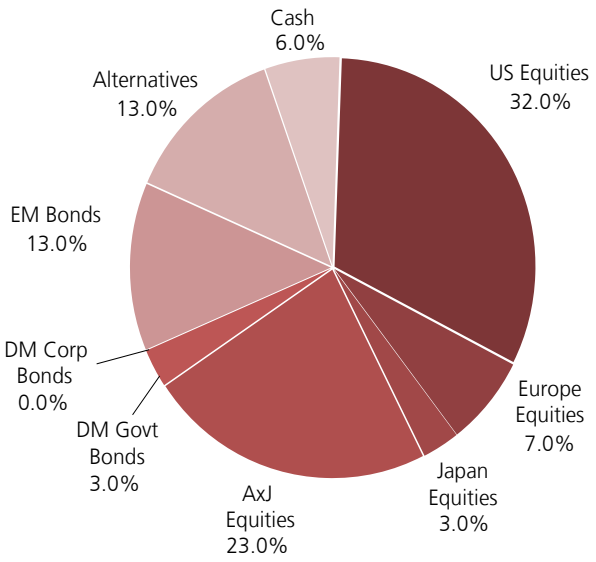


Source: DBS, Morningstar Investment Management Asia Limited

Aggressive

	TAA	SAA	Active
Equities	65.0%	65.0%	
US	32.0%	29.0%	3.0%
Europe	7.0%	15.0%	-8.0%
Japan	3.0%	8.0%	-5.0%
Asia ex-Japan	23.0%	13.0%	10.0%
Fixed Income	16.0%	20.0%	-4.0%
Developed Markets (DM)	3.0%	13.0%	-10.0%
DM Government Bonds	3.0%	7.0%	-4.0%
DM Corporate Bonds	0.0%	6.0%	-6.0%
Emerging Markets (EM)	13.0%	7.0%	6.0%
Alternatives	13.0%	10.0%	3.0%
Gold	5.0%	4.0%	1.0%
Hedge Funds*	8.0%	6.0%	2.0%
Cash	6.0%	5.0%	1.0%

*Only P4 risk rated UCITs Alternatives



Source: DBS, Morningstar Investment Management Asia Limited

Notes:

1. The above are based on three-month views.
2. Asset allocation does not ensure a profit or protect against market loss.
3. "TAA' refers to "Tactical Asset Allocation". "SAA" refers to "Strategic Asset Allocation".
4. The expected return of the SAA is based on capital market assumptions derived from Morningstar's econometric model that relies on historic, current and forecasted data on the indices highlighted below. The information is for reference only.
5. The expected risk (or expected standard deviation) of the SAA model represents the expected risk level of the portfolio based on asset class relationships (correlations) and expected volatility, based on the indices highlighted below. The information is for reference only.
6. Morningstar's SAA models started on 1 October 2010. Morningstar reviews the strategic asset allocation on an annual basis. The current Strategic Asset Allocation (SAA) is as of 1 December 2018.
7. Based on the SAA model, the Aggressive model has the highest risk, followed by Balanced, Moderate, and Conservative, with Conservative being the least risky. The risk consideration that was used in formulating the Strategic Asset Allocation was the expected volatility as measured by expected standard deviation.
8. The investor type classification for the portfolio has no direct relationship with the Financial Needs Analysis customer risk profile types and the portfolios are not assigned any product risk rating based on the bank's proprietary risk rating methodology.
9. The above SAA models are effective from December 2018 to November 2019 and are subject to change.
10. The expected return and expected risk are based on the following indices for calculation:
    - Equity: US – MSCI USA GR USD; Europe – MSCI Europe GR USD; Japan – MSCI Japan GR USD; Asia ex Japan – MSCI AC Asia Ex Japan GR USD
    - Bond: Developed Market Bonds – Citi WGBI USD; Developed Market Corporate Bond – Citi WBIG USD; Emerging Market Bonds – JPM EMBI Global Diversified TR USD
    - Alternatives: Gold – S&P GSCI Gold Spot; Hedge Fund – Credit Suisse Hedge Fund USD
    - Cash: BofAML US Treasury Bill 3 Mon TR USD

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Global Macroeconomics | 3Q19

Headwinds galore

Source: AFP Photo

DBS

Live more, Bank less

Global Macroeconomics

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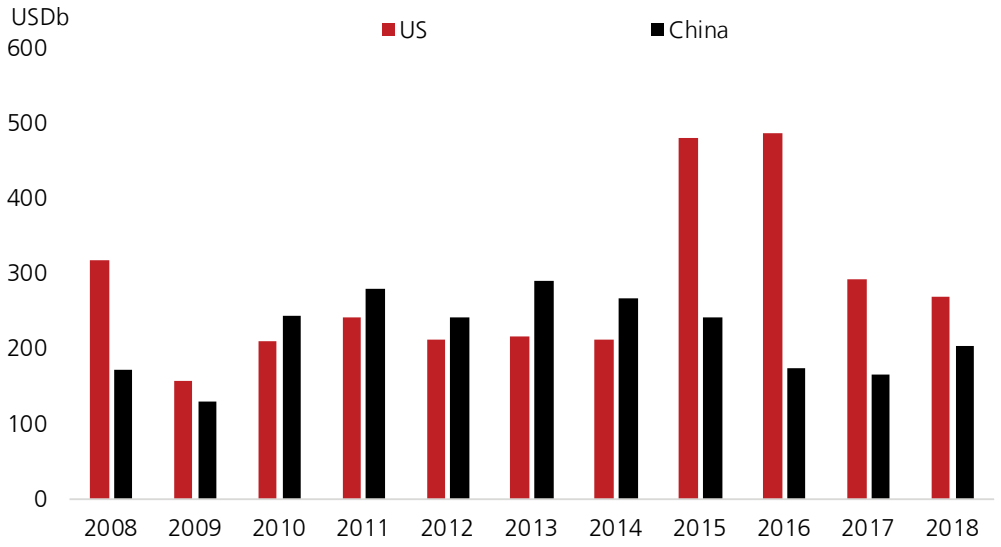
Analyst

United States

Between the unending trade war, tensions over Iran, and incessant domestic political drama, the US is the main source of volatility in the global markets these days. The economy continues to grow in the 2-3% range, with inflation well below target, and financial markets have taken the trade war escalation rather lightly. The only segment that seems to be worried about the outlook is the fixed income market, where despite a large bond supply and strong wage growth (which tends to usher in inflation), US interest rates continue to ease, pricing in several rate cuts by the Federal Reserve in the remainder of 2019 and then in 2020.

The risk is if the trade war hits investment confidence and forces producers to pass on the tariffs to their product prices. This would create a highly unwelcome stagflationary scenario for the US, hurting markets and constraining the Fed. Global investment has been on a secular downtrend since peaking in 2015, and the current situation further undermines the dynamic. Interestingly though, the data so far do not show China suffering from lower FDI. However, despite record tax cuts and other investment incentives, the US has yet to experience an uptick in investment since US President Donald Trump took office.

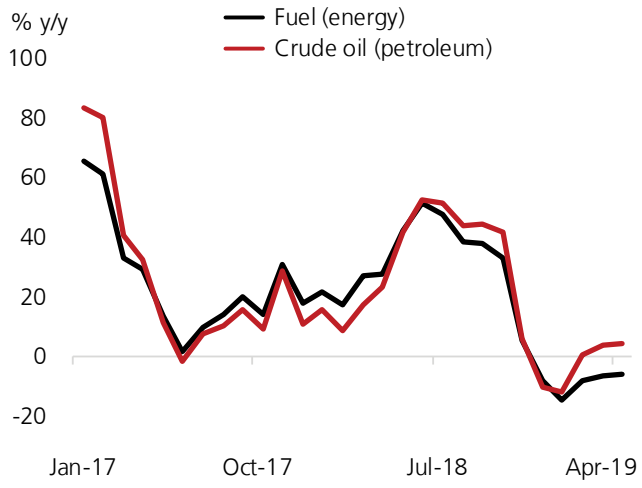
Figure 1: Inward FDI over the years



Sources: UNCTAD, DBS

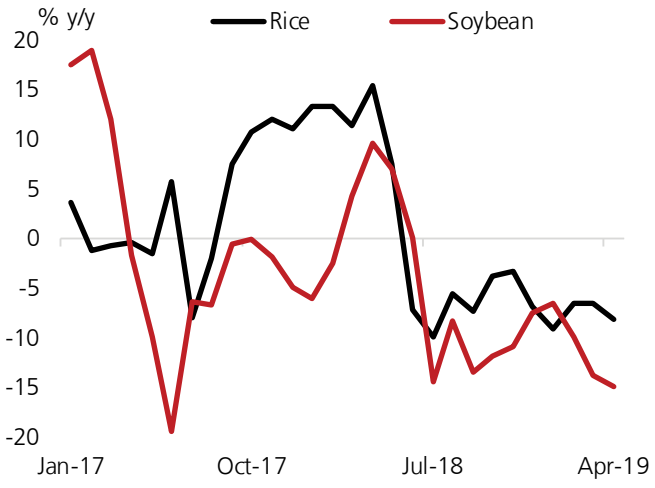
Meanwhile, US inflation rates – headline and core – remain subdued, helped by still manageable energy prices, weak food prices, and the fact that there has been barely any major passthrough from tariffs to consumer goods. With tariffs going from 10% to 25%, and the possibility of hundreds of billions of dollars worth of additional goods coming under tariffs, some inflation down the road may be unavoidable, in our view.

Figure 2: Low energy prices despite Iran tensions



Sources: IMF, DBS

Figure 3: Low food inflation is bad news for farmers



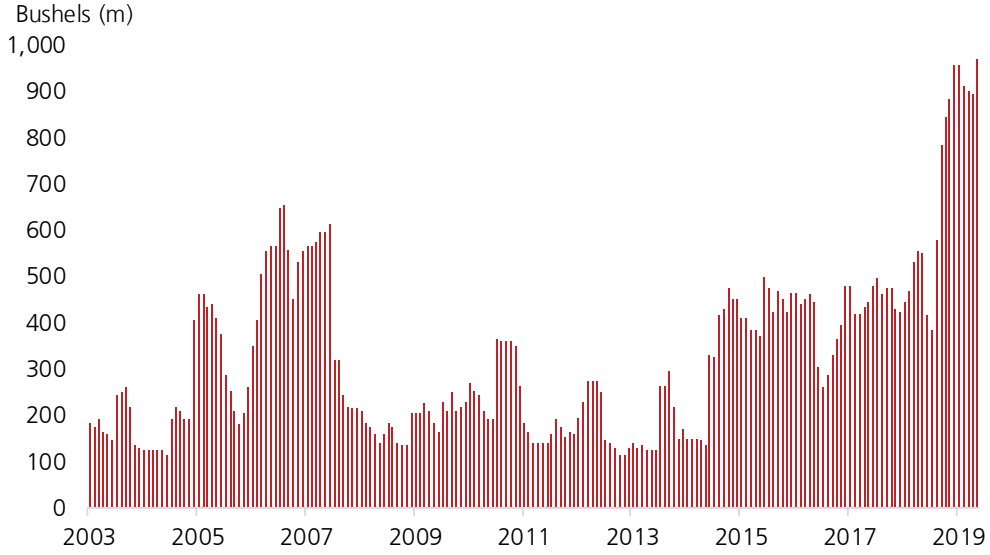
Source: IMF, DBS

Not all cases of low food price inflation are helpful

Not all cases of low prices are helpful. Low food prices hurt farmer income, for instance, and the resulting pain is evident among America's soybean producers. Since China retaliated on US tariffs by imposing duty on US soybean imports, price and demand have been affected – unsold soybean inventories have risen to record levels in recent months. In the battle of who can take more pain in this tit-for-tat game of tariffs and trade restrictions, China may seem to be on weak footing due to its large export base and reliance on US's technological inputs, but China's market is also critical to many American firms. Other than squeezing importers' profit margins, the trade war will cause an erosion of sales in China for US firms, as well as cloud the investment horizon (for both agriculture and technology).

We are approaching the middle of the year on delicate footing. The markets seem to be convinced that policymakers will work out a trade deal and provide support to the economy in case it falls through. Regardless of the outcome, the US and global investment sentiment will remain fragile, after showing nascent signs of bottoming out earlier this year. This is especially so as the US not only threatened further tariffs on China, it will also resume a hard line on European and Japanese auto exports in the coming months.

Figure 4: From trade war to spike in soybean stocks



Sources: Bloomberg, DBS

Eurozone

Eurozone growth drivers have diverged

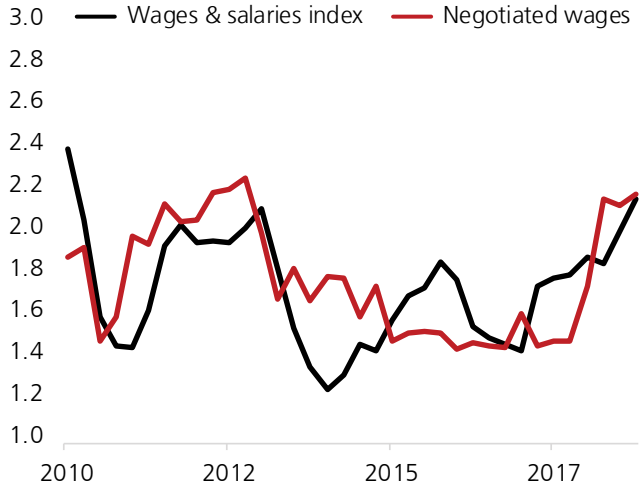
Political risks are under watch this year. Besides the French government facing pressure to ease austerity measures and Brexit uncertainty, the EU authorities and Italian government continue to disagree on fiscal rules. European parliamentary elections saw far-right factions gain ground, but not as strongly as earlier feared. While the risk of these parties forming a majority was slim considering their ideological differences, a bigger voice would have made it a challenge to reach consensus on key reforms.

Eurozone growth was a positive surprise in 1Q19, with growth at 0.4% q/q vs 4Q18's 0.2%, driven by better construction output, investments, and consumer demand. An extended phase of low rates has kept monetary conditions accommodative. The unemployment rate eased to a 10-year low, boding well for incomes and demand.

Momentum to ease for the rest of 2019

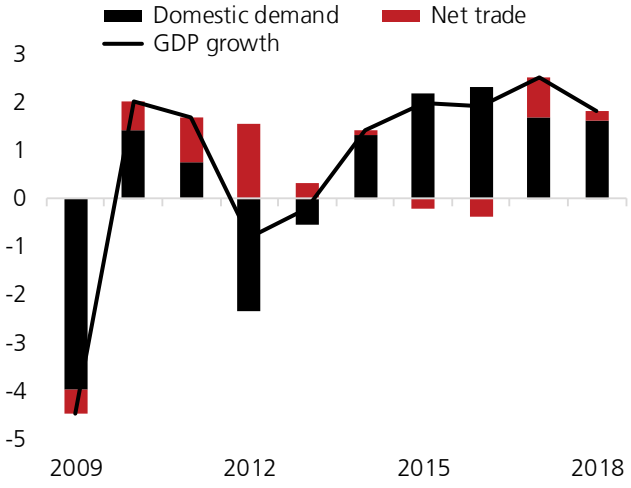
Momentum is set to ease for the rest of the year, as growth drivers diverge. Domestic demand is favourable but manufacturing/external trade data remain weak, and there are downside risks from the recent escalation in the US-China trade war. Manufacturing PMIs are below the neutral threshold as regional- and China-export growth wane. The auto sector is struggling to recover from the emission standards-led regulatory overhaul in 2H18, as production has been impacted by a global slowdown in auto production. A six-month delay in the tariffs' consideration for the auto sector comes at an opportune time. Favourable weather supported construction activity in 1Q19, which might also stabilise or soften in 2H19.

Figure 5: As unemployment rate falls, wage pressures are gradually on an uptrend



Source: CEIC, DBS

Figure 6: External sector to be a drag on growth momentum

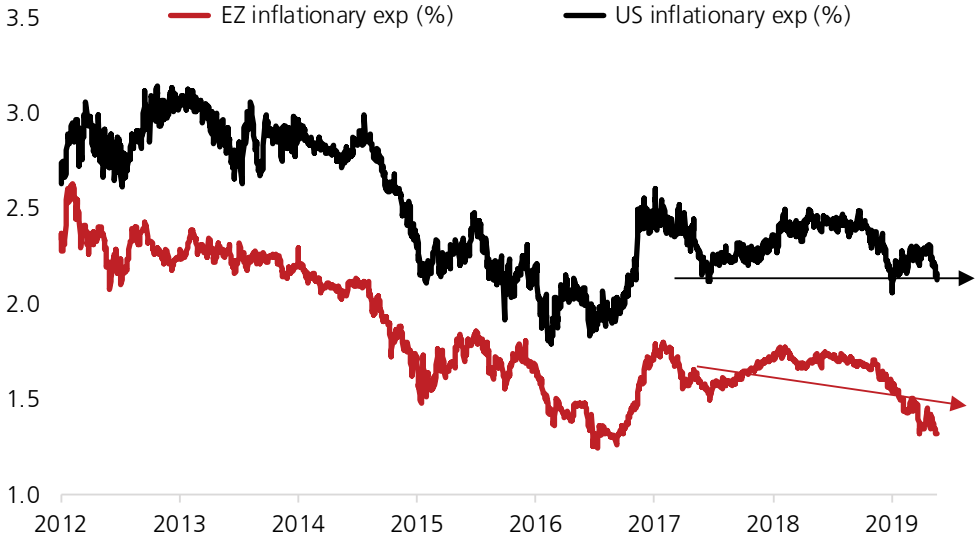


Source: CEIC, DBS

Inflationary expectations are weaker than the US, despite higher oil

Inflationary risks are benign, with the uptick in April's core inflation to 1.2% y/y seen as a one-off due to a change in Easter timings from the previous year. Headline inflation, while inching up due to base effects, is still below the 2% target. This underscores the ECB's concerns that improving wage conditions have been unable to translate into price pressures, as manufacturers are reticent to pass additional costs. Markets-based inflation indicators have corrected sharply in recent months, slipping below their US counterparts.

Figure 7: Inflationary expectations continue to soften (%)



Sources: Bloomberg, DBS

In a bid to stay ahead of the curve, ECB chief Mario Draghi offered strongly dovish guidance in June, opening the possibility of policy easing as early as July. This change in shift is underscored by the stance that they will act not only "if things worsen" but also "if things

don't get better". While sharp easing does not seem imminent, the policy toolbox includes (besides a tiered deposit facility rate) a lower deposit facility rate, negative benchmark rate, cheaper financing programmes, or as a last resort, resuming QE (with easier capital key requirements).

Japan

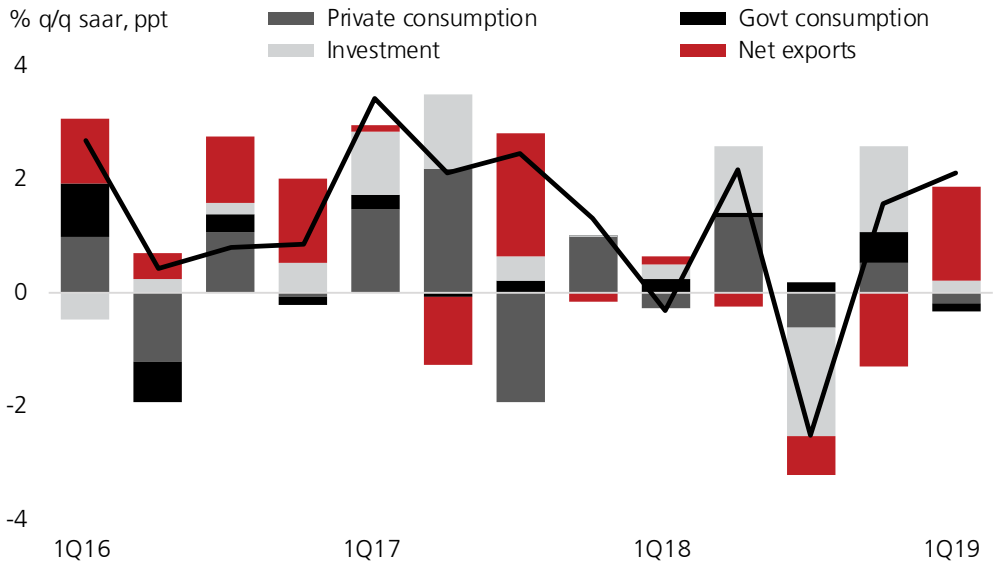
Our 2019 GDP forecast is kept unchanged at 0.7%, with risks skewed to the downside

The Japanese economy surprised on the upside in 1Q, with preliminary GDP posting an unexpectedly strong growth of 2.1% q/q saar. There is nothing to cheer about, in our view, because: 1) The 1Q rise was primarily attributed to the faster decline in imports than exports; 2) A downward revision is possible when the final GDP estimate is released in June; 3) A 2Q pullback is likely, given the increase in external uncertainties from the US-China trade war. We keep our 2019 GDP forecast at 0.7% for the time being, but see risks on the downside.

The probability of recession, consumption tax hike delay, and BOJ policy tweaking will increase in the event of a full-blown US-China trade war

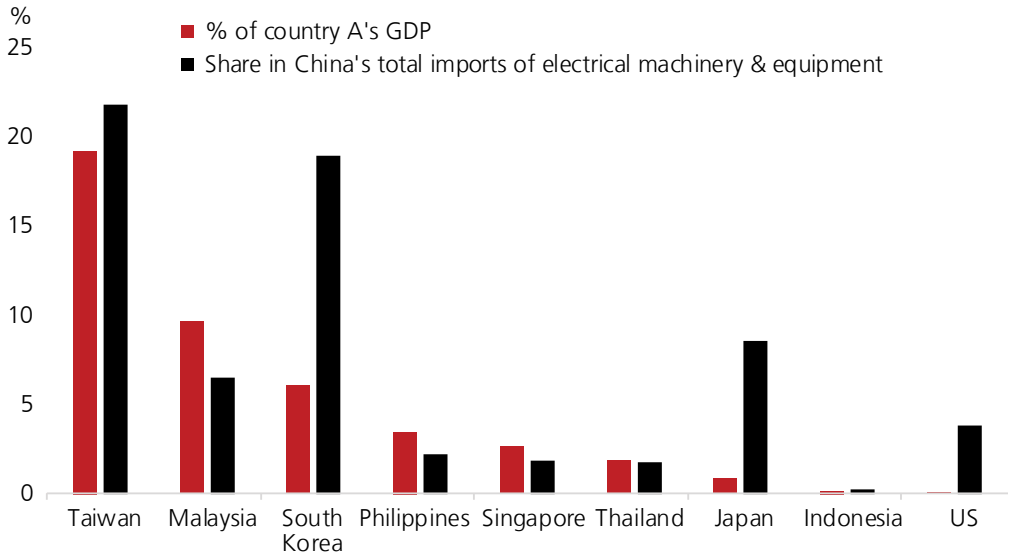
Stronger US-China trade tensions could weigh on Japan's growth outlook through multiple channels – including disruptions to the regional electronics supply chains, a delay in the 5G launch, and related tech demand being dampened. Weakening risk appetite in global financial markets would also put appreciation pressure on the yen. We believe that Japan is less vulnerable than Taiwan and South Korea to the risk of supply chain disruption, because its exposure to the China-centred electronics supply chain is relatively small. That said, given the potential double-whammy impact (both on supply chain and financial markets) and the fact that Japan's GDP growth is low to start with, we think recession risks will increase in the event of a full-blown US-China trade war.

Figure 8: GDP growth rose in 1Q19 on net exports



Source: CEIC, DBS

Figure 9: China's imports of electrical machinery and equipment from Japan, Asia, and the US



Source: CEIC, DBS

The government will raise consumption tax to 10% from 8% this October as currently planned, under our base case scenario. Japan Prime Minister Shinzo Abe has repeatedly said that the tax hike will proceed, unless Japan is hit by a shock the scale of the 2008 GFC. This, however, does not mean a tax-hike delay is impossible. Note that there have been precedents for Japan to delay the planned consumption tax hike in recent years (2014, 2016), even in the absence of a crisis-style economic shock. Should the US-China trade war escalate, recession risks increase, and Abe's approval ratings suffer ahead of the July upper house election, there would be enough justification for the government to postpone the tax hike.

The BOJ has strengthened the forward guidance on monetary policy at its April meeting, pledging to maintain the extremely low levels of short- and long-term interest rates at least through "around Spring 2020". This supports our view that the policy-balance rate and the 10-year yield target will be kept unchanged this and next year, at -0.1% and 0%, respectively. In the event of trade war escalation and a rise in recession/deflation risks, it would not be surprising to see the BOJ take more action. Policy tweaking is more likely than comprehensive easing, in our view, given the limited room for expanding asset purchases and the mounting concerns about the side-effects of a flat yield curve.

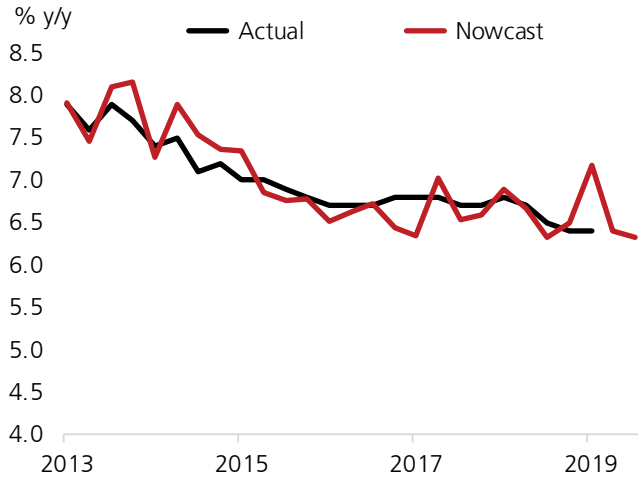
Asia

China's growth shadow returns

After an impressive stimuli-fuelled pick-up in the first quarter, China's dataflow suggests an economy heading back toward a downtrend. The NBS Manufacturing PMI fell from 50.5 in March to 50.1 in April. Advances of retail sales decelerated from 8.7% y/y to 7.2%, the slowest growth since May 2003. Industrial value-added also fell to 5.4% in April from 8.5% in March. Fixed asset investment (FAI) moderated to 6.1% y/y YTD from 6.3%, pending the effect of accelerated infrastructure spending.

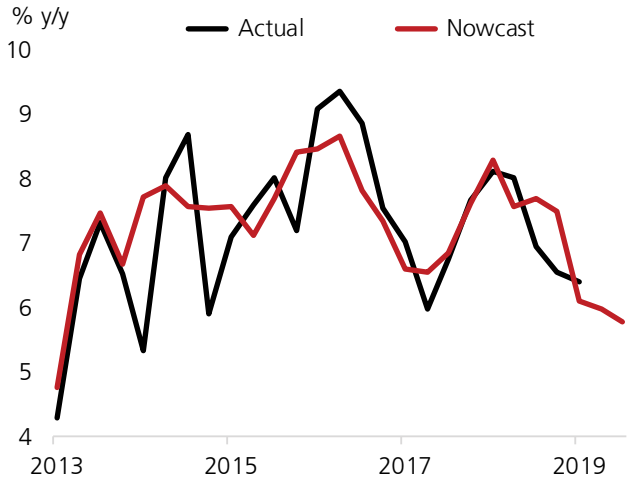
Private consumption sentiment has remained cautious. Sales performance of cosmetic, furniture, and daily use goods have been soft, along with auto sales. Consumption sentiment remains dampened by weaker expectation of future income growth alongside a weakening labour market. Industrial production fell 2.7% in April, down from an increase of 13.8% in March. Our Nowcast model suggests real GDP growth easing to below 6.5% in 2Q19 and 3Q19. Further escalation in trade wars could lead to growth heading toward 6%, in our view.

Figure 10: China's Nowcast shows growth losing momentum



Source: CEIC, DBS

Figure 11: India's growth slowdown has become more pronounced



Source: CEIC, DBS

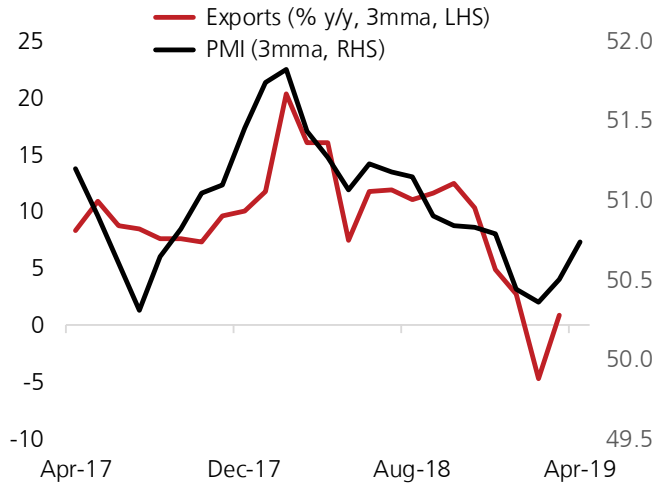
According to our estimates, 25% tariffs on USD200b Chinese exports would shave 1.0%pt off GDP growth this year. Tariff impositions on all of China's exports to the US would impact about 1.5%pts. Hence, more pro-growth policy is expected. Meanwhile, the impact from VAT cut effective in April (CNY800b corporate tax saving) and social security fee cut effective in May will feed through into growth momentum.

China's slowing momentum is mirrored by India, where despite a spike in election-related spending, consumption remains sluggish. Our Nowcast model finds growth heading toward 6% in the second half of this year, hampered by the banking and non-bank financial system facing NPLs and liquidity squeeze, a weak investment cycle, and a flat housing market. The post-election period could see some revival in animal spirits, but the risks are evenly balanced in our view as pipeline downside risks – from the squeezing of Iran as a major supply of oil for India – are lurking as well.

We see a myriad of headwinds to trade, from political to structural

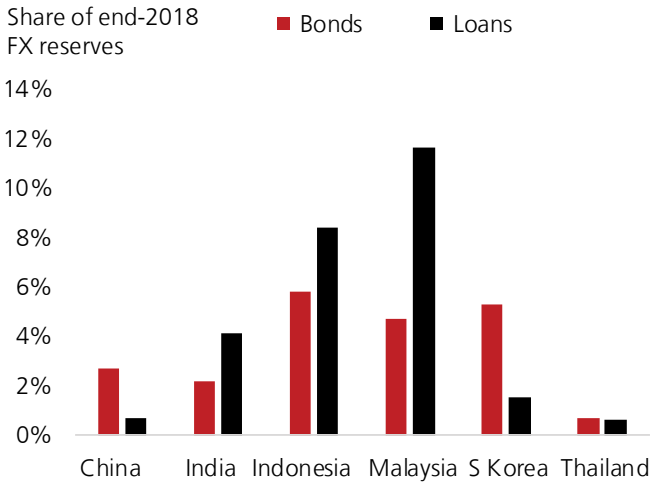
For the region, latest available data still point toward a revival in trade, but we are not particularly optimistic. Not only are trade tensions dampening the movement of goods, there is an even graver risk for trade-related investments as the US threatens to decouple from a large segment of China's electronics production network. This phenomenon may cause trade diversion eventually, but as the US has established a track record in using tariffs as a weapon, the risk is that investors will proceed very cautiously, as today's partner could well be facing a tariff barrage tomorrow. Furthermore, shipment of 5G network-related products, expected to buoy the global electronics cycle, may well get delayed because of the myriad of restrictions being imposed by the US; this will also hurt tech-related consumer spending and business investment.

Figure 12: Will exports get any better?



Source: CEIC, DBS

Figure 13: Plenty of bonds and loans falling due this year



Sources: IIF, DBS

Beyond the trade war and Iran sanctions, Asia's key headache is external funding. In the hard currency space, there is no shortage of loans and bonds falling due this year. Chinese companies, for instance, have USD107b in loans and bonds to roll over in 2019, while the corresponding figures are USD17b each for Indonesia and Malaysia, and USD27b for South Korea. Scaled by reserves, the Chinese figures do not appear to be worrisome, but given the weakness of the yuan and rising concerns about the outlook, we do not think rollover risks are trivial. For the corporates in India, Indonesia, and Malaysia, there are bound to be greater worries in the coming months, especially if global monetary conditions tighten.

Oil: Volatile days ahead

Trump's hawkish stance on Iran was a shot in the arm for oil prices, but heightened trade war rhetoric with China has somewhat spoiled the pitch

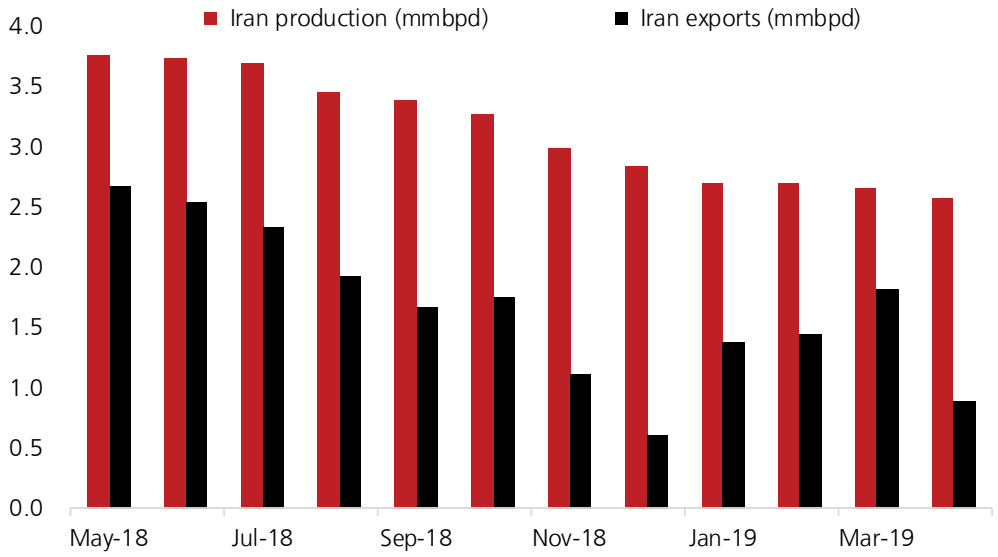
Oil prices caught between conflicting factors. Of late, oil prices have been stuck between two competing forces – 1) Tighter supply on the back of more stringent Iran sanctions filtering into the market and Middle East geopolitical tensions leading to fears of supply disruption; and 2) Demand concerns on the back of the escalating US-China trade war and other muted global economic data. Oil prices are moving either way depending on which concern seems more pressing for the day. For now, we maintain our base-case scenario for some form of trade resolution to be achieved in the coming months, and our average Brent crude oil forecast of USD70-75/bbl for 2019/20 is maintained under this base-case scenario. However, volatility could increase further in the run-up to the next OPEC meeting in early July. The key downside risk would be further escalation of the US-China trade war, and in the worst-case scenario of an ever-intensifying cold war with no resolution of trade negotiations, Brent crude oil prices could fall back to USD55-60/bbl levels in late 2019-20 owing to the perceived slowdown in global growth.

Table 1: DBS quarterly average oil price forecast

(USD per barrel)	1Q19A	2Q19E	3Q19F	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F
Average Brent crude oil price	64.0	69.5	71.0	72.5	71.5	72.5	73.0	73.5
Average WTI crude oil price	55.0	60.5	63.0	64.5	63.5	64.5	65.0	65.5

Source: DBS

Figure 14: Iran production and exports show sharp declines



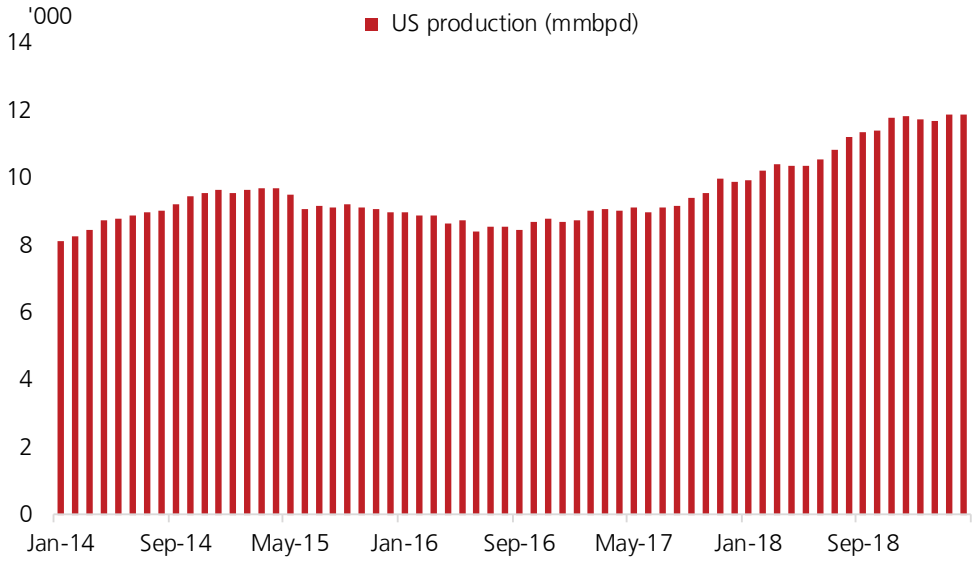
Source: Bloomberg, DBS

OPEC is not likely to repeat the same mistake of turning on the taps too wide

OPEC's stance will be keenly watched. OPEC and non-OPEC allies will meet in early-July (delayed from earlier date of 25 June) to decide the future of the six-month production cut that began at the start of 2019. Given the evolving oil price scenario, it is very likely that the production cuts may continue in some form into 2H19. While the US administration appears confident that their allies like Saudi Arabia and UAE would increase production to ensure there is no supply shock for the market after the Iran sanctions came into full force, we believe these countries learnt a hard lesson back in late 2018, when they pre-emptively increased production only for oil prices to crash following Trump's surprise decision to provide waivers on Iranian oil importers. This time, we expect OPEC to make a decision only after the full impact of Iran sanction waivers' expiration, and other ongoing factors like Middle East tensions and trade war negotiations, have been assessed.

US production remains a wild card. The pace of US shale oil production growth has slowed down significantly in the early months of 2019, thus supporting oil price momentum. This is a result of declining rig counts in the shale regions, owing to muted capex growth and a multitude of technical problems affecting productivity growth. Still, a larger-than-anticipated increase in US crude supply from 3Q19 could cap optimism, as new pipelines become operational in the Permian and ease some infrastructure constraints.

Figure 15: US production has flattened out YTD in 2019, but what lies ahead?



Source: Bloomberg, DBS

Table 2: GDP growth and CPI inflation forecasts

	GDP growth, % y/y				CPI inflation, % y/y, ave			
	2017	2018	2019f	2020f	2017	2018	2019f	2020f
China	6.9	6.6	6.2	6.0	1.6	2.1	2.3	2.3
Hong Kong	3.8	3.3	2.5	2.0	1.5	2.5	2.7	2.5
India*	8.2	7.2	6.8	6.8	4.5	3.6	3.4	3.8
Indonesia	5.1	5.2	5.2	5.1	3.8	3.2	3.6	3.6
Malaysia	5.9	4.7	4.5	4.2	3.8	1.0	1.7	1.6
Philippines**	6.7	6.2	6.1	6.1	2.9	5.2	3.1	3.1
Singapore	3.9	3.2	2.1	2.5	0.6	0.4	1.1	1.5
South Korea	3.1	2.7	2.1	2.4	1.9	1.5	1.1	1.5
Taiwan	3.1	2.6	1.9	1.8	0.6	1.3	0.7	1.0
Thailand	3.3	4.1	3.8	4.0	0.7	1.1	1.0	1.3
Vietnam	6.8	7.1	6.6	6.3	3.5	3.5	3.8	3.4
Eurozone	2.5	1.9	1.2	1.5	1.5	1.8	1.2	1.3
Japan	1.9	0.7	0.7	0.5	0.5	1.0	1.1	1.6
United States***	2.3	2.9	2.5	1.5	2.1	2.4	1.7	1.6

*Refers to year ending March. **New CPI series. ***End of period for CPI inflation. Source: CEIC, DBS

Table 3: Policy interest rates forecasts, eop

	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.25	5.75	5.50	5.25	5.25	5.25	5.25	5.25
Indonesia	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Malaysia	3.25	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Philippines	4.75	4.50	4.25	4.25	4.25	4.25	4.25	4.25
Singapore**	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95
South Korea	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Vietnam***	6.25	6.25	6.25	6.25	6.00	5.75	5.75	5.75
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
United States	2.50	2.50	2.25	2.00	2.00	2.00	2.00	2.00

*1-yr lending rate. **3M SOR. ***Prime rate. Source: CEIC, DBS

US Equities | 3Q19

Trade war blues

Source: AFP Photo

DBS

Live more, Bank less

US Equities

Dylan Cheang
Strategist

Navigate trade war uncertainties

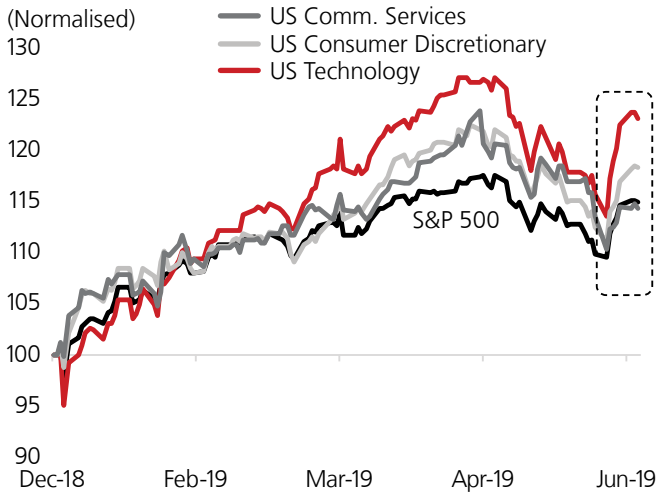
US equities have staged an impressive rebound since the start of 2019 on the back of two catalysts – a dovish Federal Reserve and China's economic stimulus. On a 4M19 basis, the S&P 500 Index notched up US-dollar-based returns totalling 18.2%, with Technology and Consumer Discretionary being the stand-out performers, gaining 27.6% and 22.3%, respectively (Figure 1). But the strong momentum was abruptly interrupted in May as US-China trade tensions suddenly re-awakened and escalated markedly.

Nothing else matters: trade war remains the wildcard for US equities. Since early last year, we have been highlighting the resilience of US equities from the standpoint of strong corporate fundamentals and relative valuation. We have not changed our views.

From a macro perspective, the Citi Economic Surprise Index suggests that US economic momentum has troughed and a rebound is on the cards (Figure 2). At the company level, US earnings have surprised investors by staying resilient despite the imposition of the initial round of trade tariffs, as demonstrated in 2Q19 earnings. The proportion of companies that reported positive earnings surprise came in at 77% and this was an improvement from 1Q19's level.

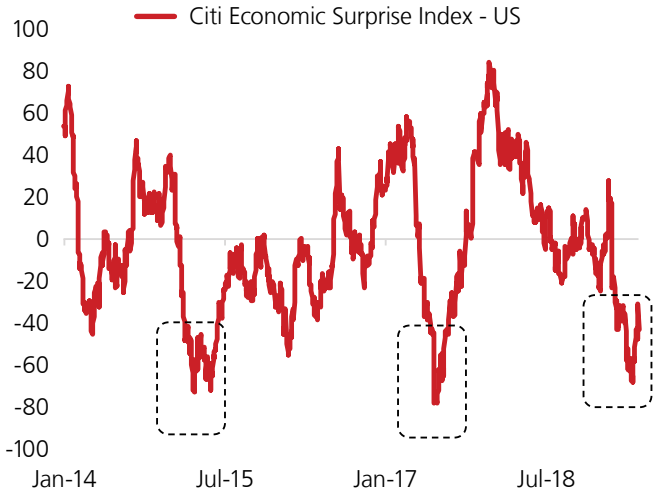
But all these positive fundamental tailwinds mean nothing should the trade war escalate in the coming months. As the recent spike in volatility shows, trade war concerns can derail the current rally and the magnitude of the fall would largely depend on whether investors believe the trade conflict is going to be transitory (Figure 4).

Figure 1: Our Overweight calls on US technology-related companies have generally outperformed YTD



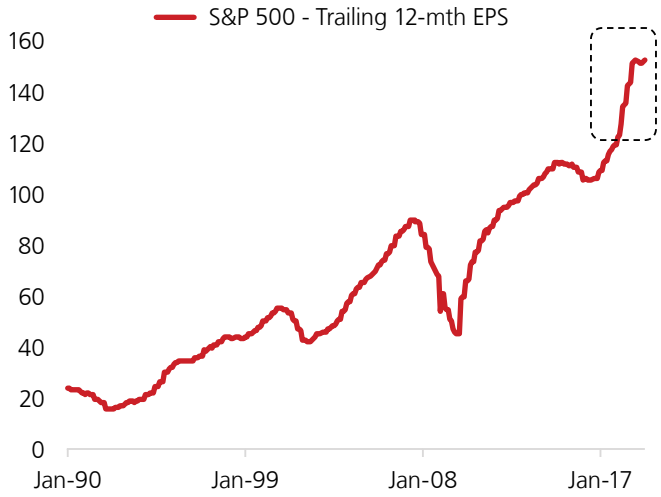
Source: Bloomberg, DBS

Figure 2: Momentum for US macro data has historically troughed at this level



Source: Bloomberg, DBS

Figure 3: US earnings maintain their upward trajectory despite trade concerns since 2018



Source: Bloomberg, DBS

Figure 4: The recent spike in volatility on trade concerns drove the S&P 500 lower

Source: Bloomberg, DBS

Keeping score: What is the impact of an "all-out" trade war? For a period of time, global investors have have acted on the premise that the US and China will reach a peaceful resolution on the trade front. But this scenario may turn out to be overly optimistic based on the most recent rhetoric. As underlying trade tensions continue to simmer, we believe it is worthwhile to run through some worst-case scenarios on what may transpire in the event of an "all-out" trade war.

- Scenario analysis (1) – Economic impact: According to our economists, in the worst-case scenario of an "all-out" trade war, real US GDP growth will be reduced by 0.6%pts, from 2.5% to 1.9%. With headline inflation expected at 1.5%, this translates to an approximate nominal GDP growth of 3.4%, which is lower than the consensus forecast of 4.5%.

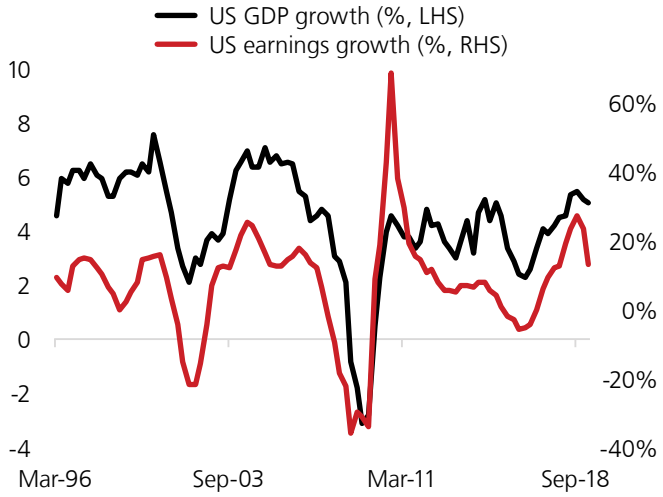
- Scenario analysis (2) – Earnings impact: Based on simple regression, a 0.6%pts reduction in US GDP growth will shave 3%pts off US earnings growth from our model-based forecast of 5.8%, to 2.8% in 2019. This is 6.8%pts lower than the prevailing consensus forecast of 9.6% earnings growth.

- Scenario analysis (3) – Valuation impact: Gauging the valuation impact of an "all-out" trade war will be more complicated. We have previously conducted research on this topic (*CIO Perspectives – Trade war: From rhetoric to reality?*) and our view remains unchanged.

Back then, we argued that comparing the current US-China trade war with the US imposition of steel tariffs in 2002 would be a relevant reference point to draw upon. To recap, the forward P/E for S&P 500 Index underwent substantial de-rating during the crisis and at its trough, it was trading at a 14% discount to the prevailing long-term median.

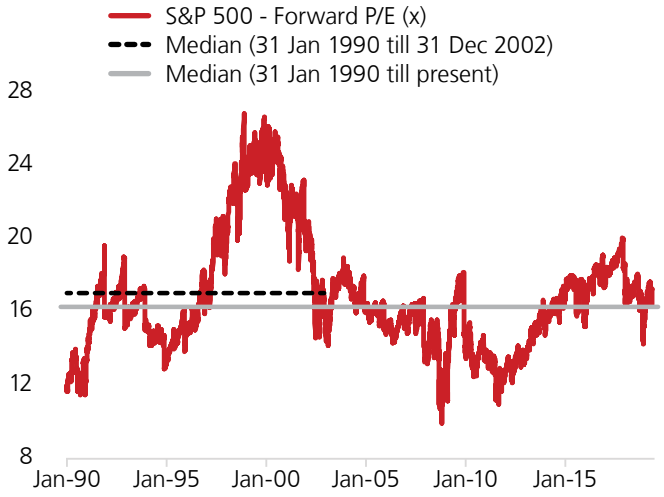
Today, the long-term median for the S&P 500 Index stands at 16.3x. A similar 14% discount to this level will bring valuation to c.14x. Given that US equities currently trade at c.17x, a 14x forward P/E implies a potential P/E contraction of 18%.

Figure 5: An "all-out" trade war will weigh on both US economic and earnings growth



Source: Bloomberg, DBS

Figure 6: A worst-case scenario of an "all-out" trade war will see US equity valuation contracting by c.18%



Source: Bloomberg, DBS

3Q19 US Sector Allocation

Trade war is no longer about trade; Undercurrents will linger in the foreseeable future. The global trade situation is expected to stay volatile in the coming months as the US and China seek to iron out their fundamental differences and try to reach a compromise. No doubt, if a deal can be reached, calm will return to financial markets. But we believe this would only be temporary, given the key issue is no longer about trade. It is really about the fight for strategic and technological dominance on the global stage. Such issues will not be resolved overnight and undercurrents will continue to linger for the foreseeable future.

Trade war strategies: Focus on services providers and avoid hardware manufacturers. We maintain a pro-cyclical stance in our US sector allocation with Overweight calls on Technology, Consumer Discretionary, and Communication Services. Our bullish calls on Technology and Consumer Discretionary are premised on our positive view of global e-Commerce, which will undergo secular growth in the years ahead. But given our expectation of lingering trade undercurrents, we would prefer service-oriented companies within the global e-Commerce space (e.g. online retailers) as opposed to hardware manufacturers (e.g. smartphone makers).

Table 1: 3Q19 US Sector Allocation

	Overweight	Neutral	Underweight
US Sectors	Technology	Financials	Energy
	Cons. Staples	Utilities	Materials
	Comm. Services		Industrials
	Health Care		Real Estate
	Cons. Discretionary		

Source: DBS

Table 2: US sector key financial ratios

	Forward P/E (x)	P/B (x)	EV/EBITDA (x)	ROE (%)	ROA (%)	OPM (%)
S&P 500 Index	19.3	3.2	13.0	13.6	2.8	13.3
S&P 500 Financials	16.1	1.4	-	8.8	1.0	20.7
S&P 500 Energy	35.3	2.0	13.2	1.3	0.6	2.3
S&P 500 Technology	19.3	5.5	14.7	22.6	9.8	22.7
S&P 500 Materials	20.6	2.9	13.8	11.8	4.6	11.3
S&P 500 Industrials	19.9	4.5	12.9	20.0	5.3	12.1
S&P 500 Cons. Staples	20.2	5.2	13.8	27.6	8.4	9.3
S&P 500 Cons. Discretionary	20.6	5.1	11.9	21.2	5.5	11.2
S&P 500 Comm. Services	11.7	2.3	6.6	16.9	3.8	18.1
S&P 500 Utilities	19.1	2.1	12.8	6.2	1.6	15.2
S&P 500 Real Estate	37.1	3.4	21.7	10.0	4.0	24.5
S&P 500 Health Care	17.3	3.9	14.2	15.3	5.8	10.5

Source: Bloomberg

Europe Equities | 3Q19

Brexit and beyond

Source: AFP Photo

Europe Equities

Yeang Cheng Ling
Strategist

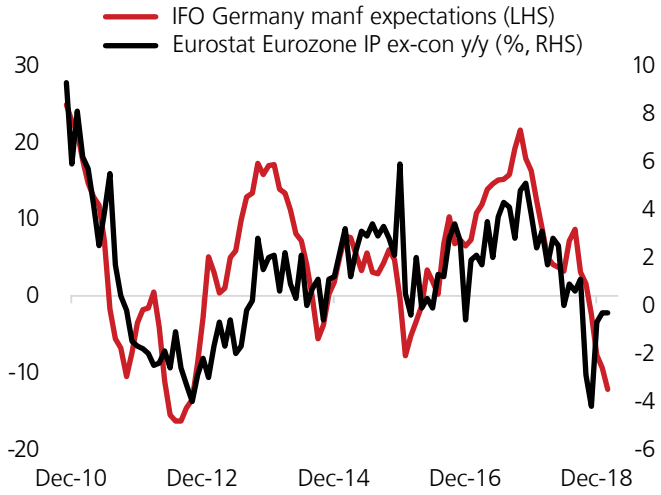
In search of catalysts

Growth in the EU stagnated on the back of the sharp drop in Germany's ZEW current economic sentiment reading (Figure 1). The manufacturing sector – among the main driving forces of the country's economy and corporate wellbeing – continued to face a downward trend (Figure 2). At this rate, the EU's largest economy could have to brace itself for a prolonged slowdown, just as it is facing Chancellor Angela Merkel's retirement in 2021.

Figure 1: Deterioration in Germany sentiment readings

Source: Bloomberg, DBS

Figure 2: Manufacturing is in a downtrend

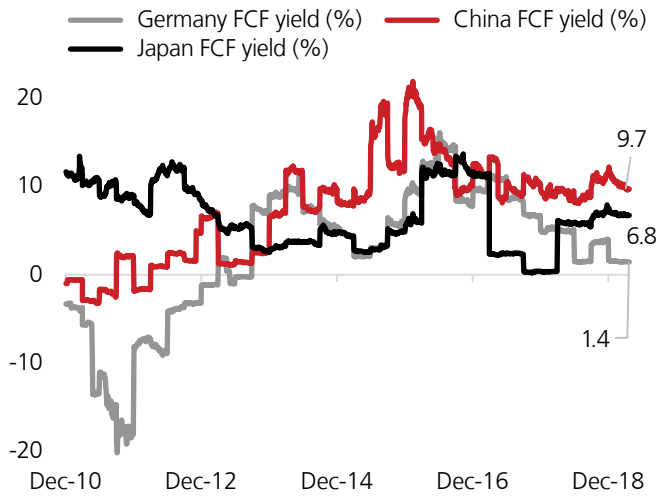


Source: Bloomberg, DBS

Not so invincible. The free cash flow yield among German corporates has worsened to 1.4% in 2Q19, the lowest level since 3Q13, extending the struggle and widening the gap with other regions (Figure 3).

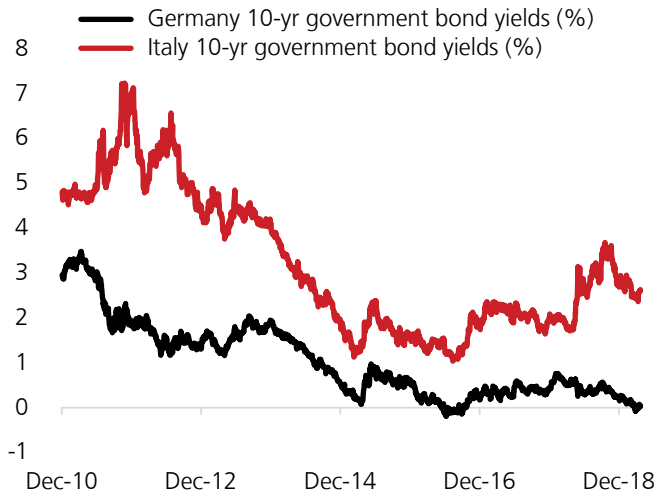
The next-to-zero yields of German Bunds further pushed the ECB into a policy bind, with little margin to negotiate new monetary easing (Figure 4).

Figure 3: Germany's corporate cash flow is inferior



Source: Bloomberg, DBS

Figure 4: Bond yields are paltry



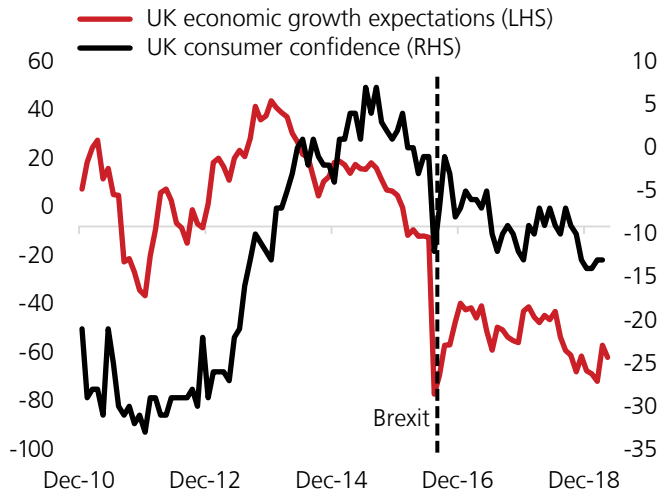
Source: Bloomberg, DBS

Brexit has become a long process with options running out. Household balance sheets need a boost

Brexit remains a headwind. Deep disagreement over the timeline and the final form of Brexit is acting against the UK's battered domestic confidence (Figure 5). Household savings have halved to less than 5% of GDP compared to three years ago while family debt remains elevated at 135% of GDP (Figure 6), stretching the household balance sheet thin.

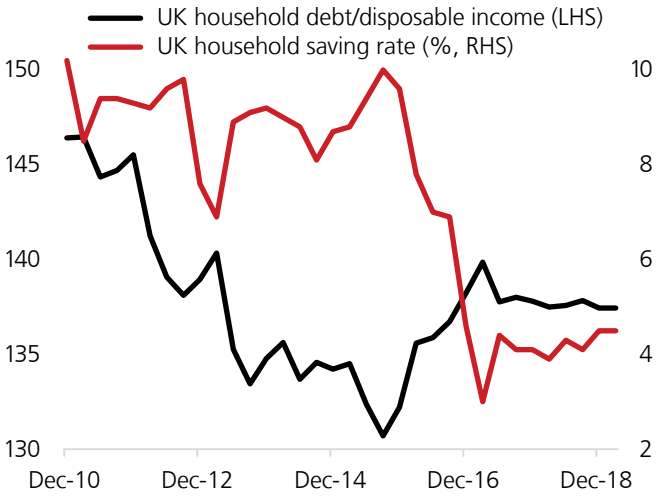
UK Prime Minister Theresa May has bought herself until 31 October to avoid an ugly, empty-handed exit from the EU, and a precious window to negotiate with opposition leader Jeremy Corbyn for a necessary palpable alternative agreement – the precursor to accepting a permanent customs union and closer alignment with EU's single-market rules when the UK finally exits from the bloc.

Figure 5: Brexit uncertainties continue to be a plague



Source: Bloomberg, DBS

Figure 6: UK households are not in the best of shape

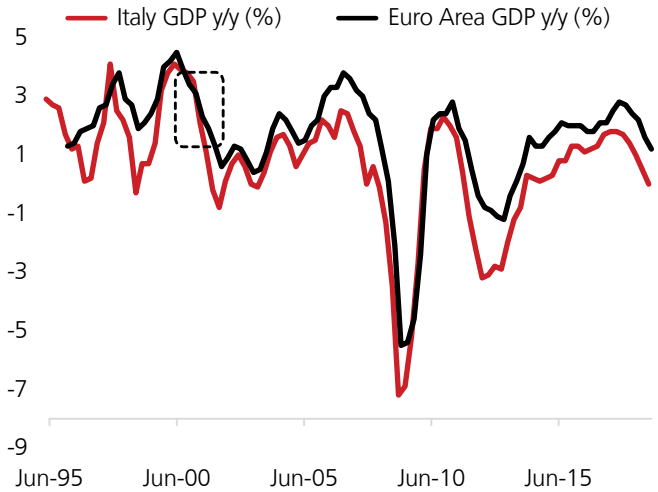


Source: Bloomberg, DBS

The land of Ferrari needs a pitstop. Italy's coalition government will have a lot of catching up to do in its policy effectiveness. The country has trailed the Euro Area GDP growth since mid-2001 and the options to steer it out of a prolonged slowdown are decreasing (Figure 7). Worse, Italy slipped into a technical recession in the final two quarters of 2018 just as the government's debt rose further to 132% of GDP. This leaves the government little room for fiscal stimulus (Figure 8).

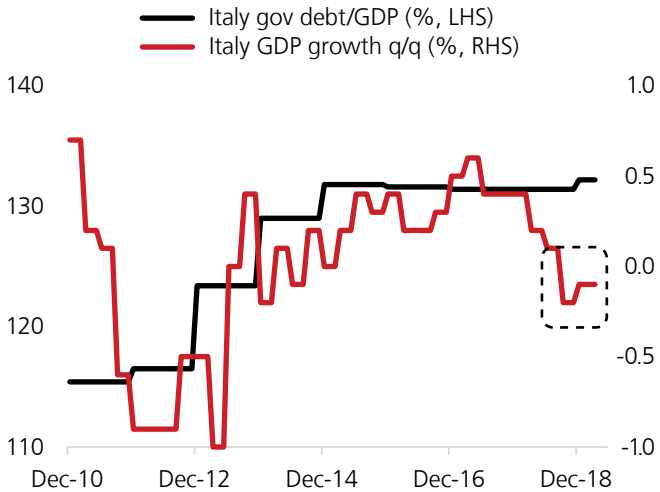
Participating in the Belt and Road Initiative (which spans Eurasia, Middle East, and Africa) and forming closer ties with China may reap some economic gains for Italy in the longer run.

Figure 7: Italy's economic problem did not happen overnight



Source: Bloomberg, DBS

Figure 8: A recession is the last thing Italy needs



Source: Bloomberg, DBS

The once-almighty auto sector could be in for a prolonged winter. Banks still lack re-rating catalysts

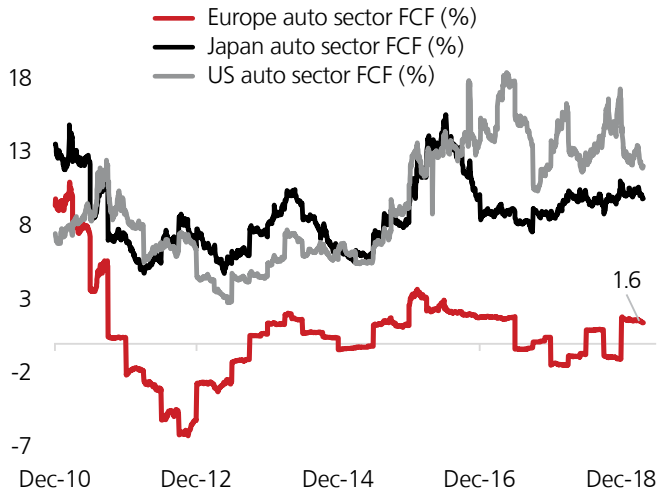
Twin blow from Autos and Banks. European advantage in manufacturing high-quality cars seems to be fading amid various looming threats. Compared to global peers, Europe's auto marques have been struggling to stay cash flow positive since the start of the decade (Figure 9). The threat of up to 25% in US import tariffs on EU autos to draw the region to the negotiation table could potentially be the last straw in plunging the sector into a cash flow famine.

Longer-term structural peril for the sector comes from:

1) Expansion in ridesharing among the younger generation for whom car ownership is less preferred;
2) Urbanisation with public transport systems becoming more efficient;
3) New ruling to reduce the use of diesel engines; and
4) Rise of electric vehicles, an area in which European brands are lagging.

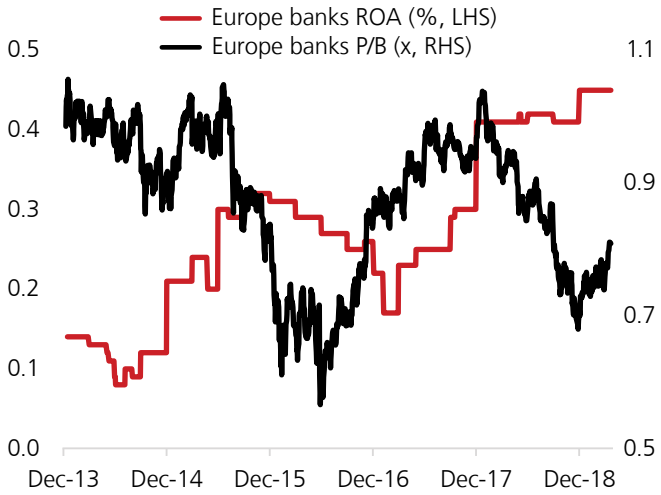
For the Banking sector, investors are unenthusiastic about the paltry ROA of 0.45%, compared to that of banks in the US and China (Figure 10). The top four US banks by market value reported ROA of 0.9-1.2%, while China's four largest state-owned banks have ROAs of 0.9-1.1%.

Figure 9: Europe's auto sector is underperforming



Source: Bloomberg, DBS

Figure 10: Europe's banks are cheap for a reason

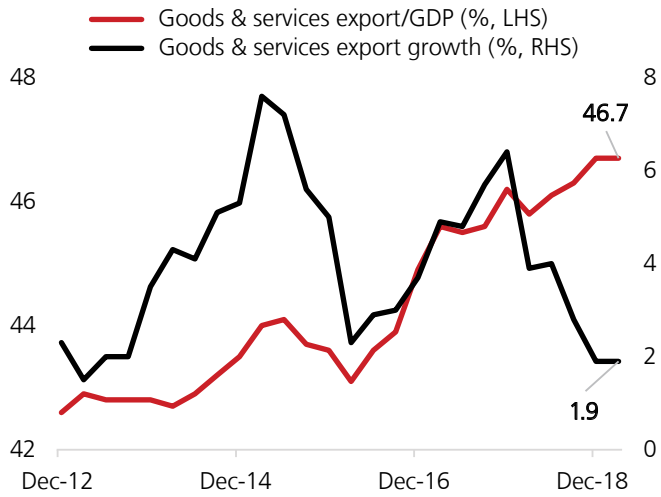


Source: Bloomberg, DBS

Equities are in search of catalysts. Economic conditions are losing momentum as the slowdown in export growth has intensified. This has impacted corporate earnings, given that external orders for goods and services account for nearly 50% of the Eurozone's GDP (Figure 11). The ECB has also attributed uncertainties over Brexit as another factor.

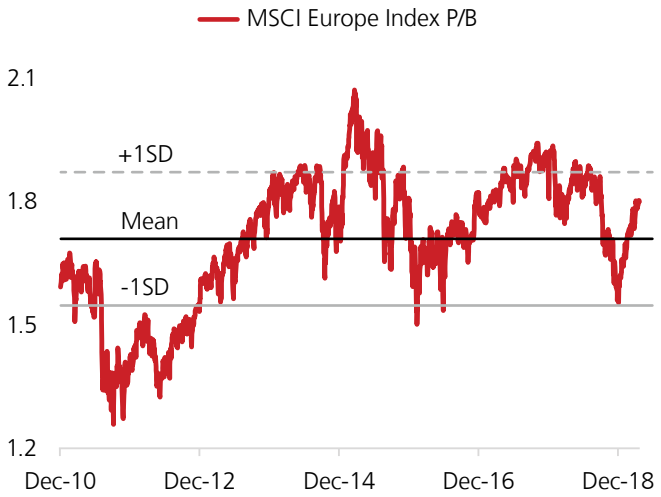
Despite the economic challenges, Europe's stock market valuation is not cheap – the P/B ratio is at 1SD above its historical mean (Figure 12). The profitability measures of OPM and ROC remain subdued vs US and Asia corporates (Figures 13 & 14).

Figure 11: Slowing export growth to be a drag on corporate earnings



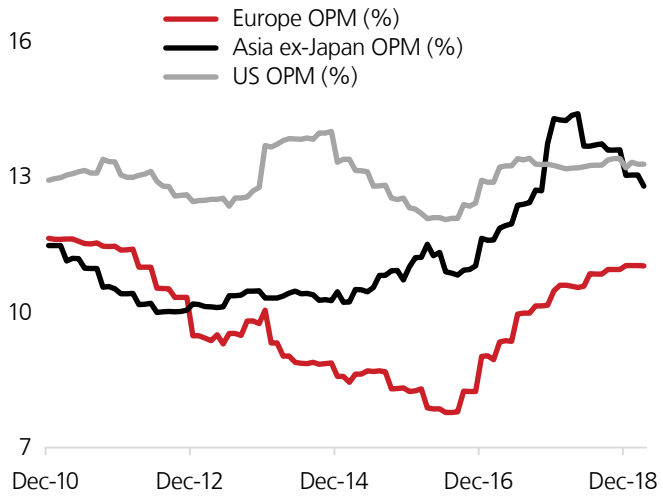
Source: Bloomberg, DBS

Figure 12: Valuation is getting stretched



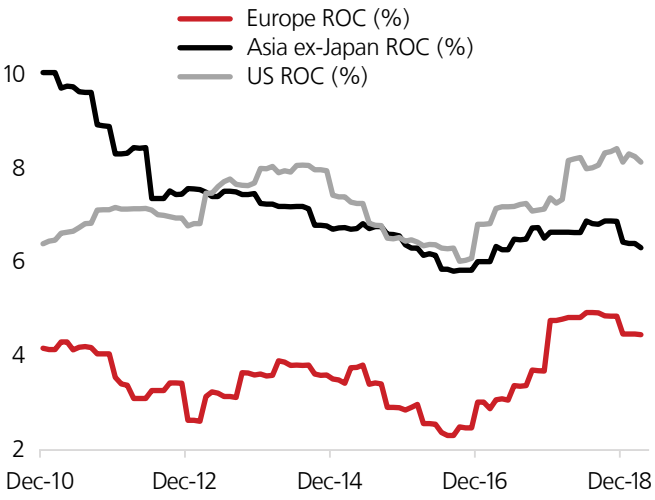
Source: Bloomberg, DBS

Figure 13: Low-key profitability…



Source: Bloomberg, DBS

Figure 14: …and subdued ROC



Source: Bloomberg, DBS

Japan Equities | 3Q19

Lacklustre outlook

Source: AFP Photo

DBS

Live more, Bank less

Japan Equities

Jason Low, CFA
Strategist

Glenn Ng, CFA
Equities

Play the video-gaming consolidation

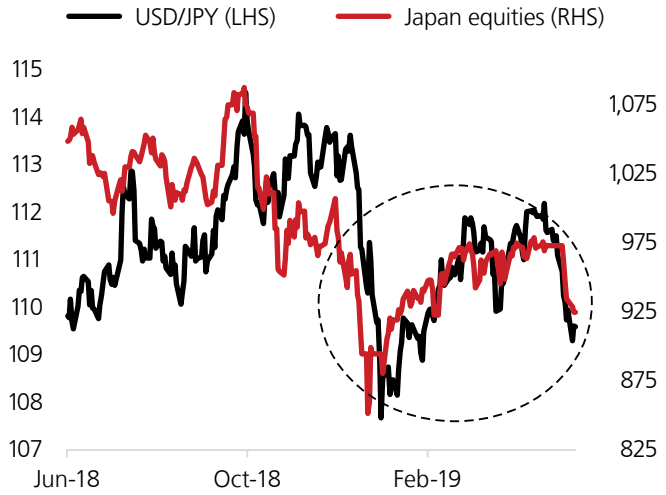
Japan equities have had a less-than-stellar performance YTD, in contrast with other major global equity markets. This was mainly due to the recent strength of the JPY, as global investors sought safe havens amid a spike in volatility driven by escalating US-China trade tensions. The BOJ has committed not to raise interest rates before Spring in 2020 as it tweaked its monetary stimulus programme. Japan equities are not expensive at 13x, but rising trade war tensions could cap their upside through weaker exports and a stronger JPY. Earnings continue to be mixed. We downgrade Japan equities to Underweight on a three-month basis. Investors should look at bottom-up opportunities in this market – we see growth opportunities in the video-gaming sector.

BOJ vows not to raise rates before Spring 2020. The Japanese central bank, for the first time, specified a date on the "extended period" for which it looks to keep rates low. Few were expecting a rate rise next year in the first place, thus diluting the BOJ's deliberate dovish messaging. The Japanese economy has deteriorated significantly since the start of 2019 amid the rapid decline in external demand and manufacturing activities. We think the economy can skirt a full-scale recession, but the soft patch in growth will stay for the rest of the year. Our full-year GDP forecast is maintained at 0.7%, but we see downside risks due to the growing global trade tensions. We see the policy rate and 10-year yield target unchanged through this year and next at -0.1% and 0%, respectively.

Escalating global trade tensions could weigh on Japan equities on two fronts. Weaker exports and a stronger JPY could cap the upside for Japan equities. Rising US-China trade tensions could, firstly, weigh on Japan's exports through disrupting regional supply chains and dampening business sentiment. It should be noted that Japanese companies derive around half of its revenue overseas. Second, they bring about volatility in financial markets, leading to investors seeking safe havens like JPY, thereby putting upward pressure on it. Historically, Japan equities are generally negatively correlated to JPY due to the large percentage of exporters in Japan (Figure 1). In fact, Japan equities underperformed major global equity markets YTD largely due to the strength of its currency and mixed earnings (Figure 2). The worry now is that the BOJ has run out of tools to combat a strengthening JPY after almost six years of massive stimulus.

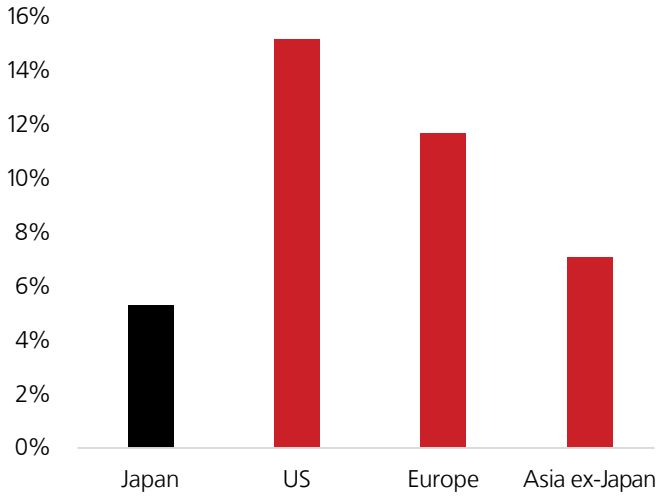
Japan has a political incentive to reach a bilateral trade deal with the US soon. US-Japan trade issues, albeit not thorny, need to be watched closely. There is motivation for Japan to achieve a bilateral trade deal with the US sooner rather than later, given the busy political agenda ahead – the G-20 Osaka Summit in June and the Upper House election in July. However, after the US trade talks with China stalled, the US will likely continue to use tariff threats on automobiles to win concessions from Japan during the ongoing trade negotiations.

Figure 1: JPY strength a headwind for Japan equities



Source: Bloomberg, DBS

Figure 2: Japan equity returns have not matched up with peers'



Source: Bloomberg, DBS

Japan equity valuations are undemanding, which should limit downside in times of trade tensions

Japan valuations are inexpensive. On an absolute basis, Japan trades at an undemanding 13x forward P/E, representing 1SD below its seven-year historical average. On a relative basis, the market trades at a 22% discount to DM – wider than the historical 15% discount (Figure 3). We believe therefore any downside to the market should be limited in a scenario of a selloff should trade tensions escalate.

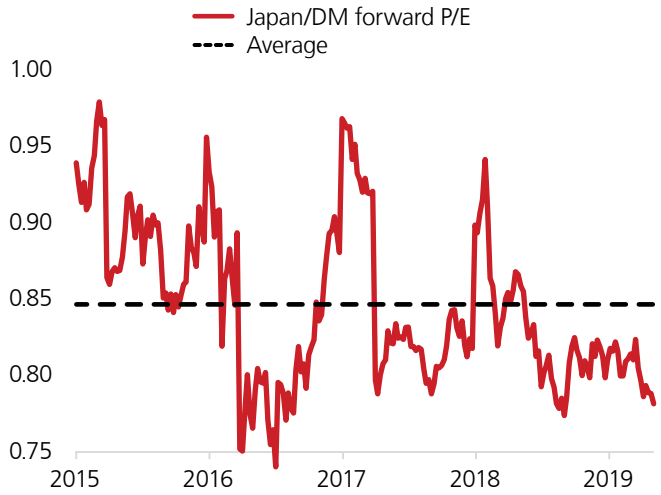
Japanese earnings are lacklustre, and the trend looks set to continue

Earnings have been less than stellar. As of mid-May, only 45% of Topix companies beat their earnings estimates while 43% of them beat their topline estimates in the latest earnings season (Figure 4). Japanese corporates have already missed earnings for two straight quarters. Among the sectors, Energy and Utilities were the outperformers with the highest percentage of earnings beats. Consensus now only expects mid-single-digit earnings growth in the next financial year, a far cry from the earnings growth in excess of 20% seen over the past few years.

Game developers to benefit from the advent of cloud gaming as well as from stronger bargaining power over distribution platforms like Xbox

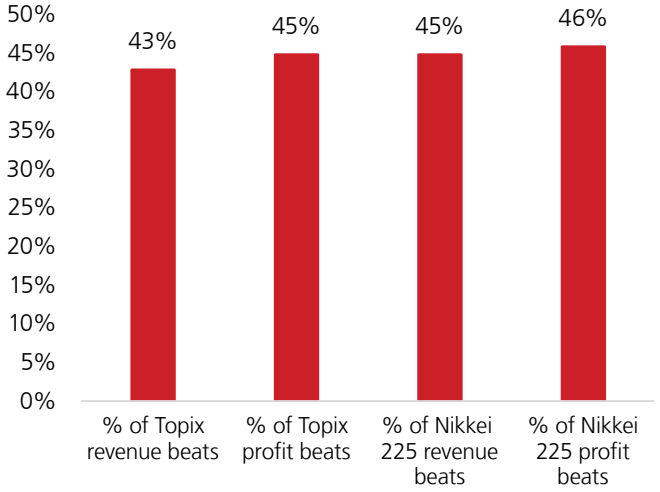
Cloud gaming a game-changer; game developers to benefit. Google's announcement that it would launch its Stadia cloud gaming platform heralds the start of a new gaming era. Cloud gaming enables the hardware-intensive computing and processing functions to be outsourced to data centres ("the cloud"), with the gamer only having to receive the final images. While the success of this remains to be seen, if actualised, it may mean that purchases of gaming-specific hardware like consoles or high-spec PCs would be a thing of the past. We are thus incrementally more negative on console players in Japan.

Figure 3: Undemanding valuations relative to DM



Source: Bloomberg, DBS

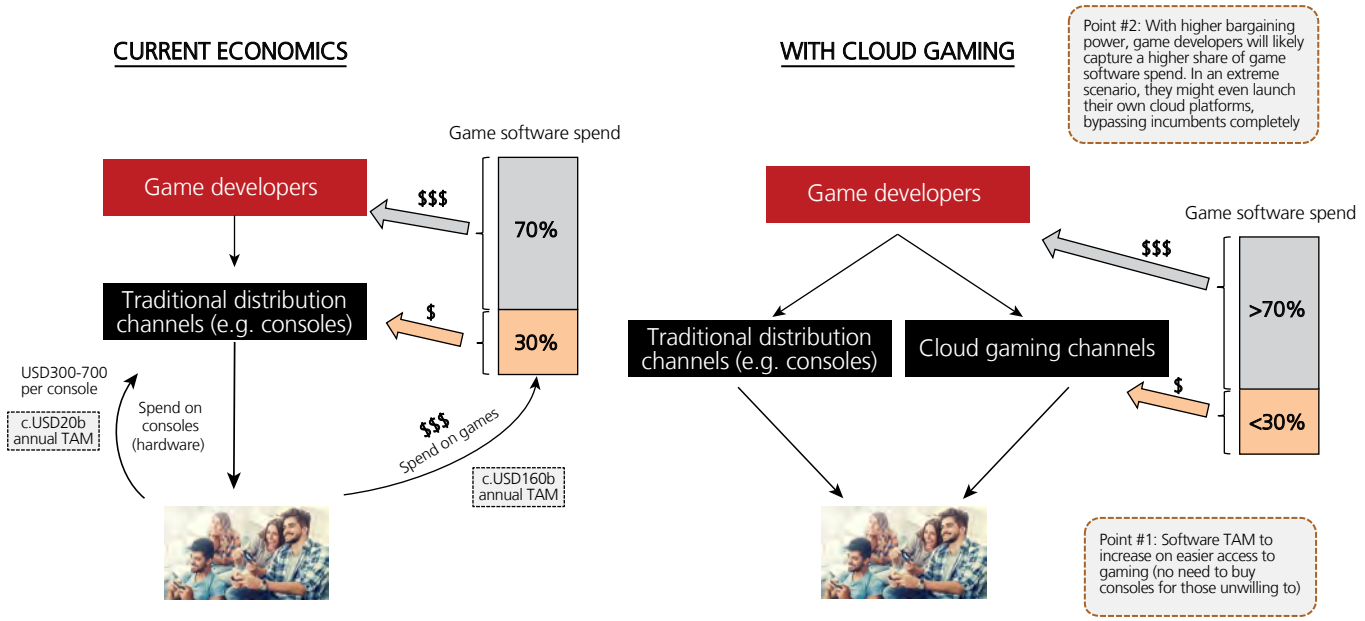
Figure 4: Less than half of Japanese companies beat earnings and revenue estimates



Source: Bloomberg, DBS

Meanwhile, cloud gaming would enlarge the gaming market, given cheaper upfront costs to access games – at least from a consumer's perspective. Also, distribution platforms like gaming consoles currently take a 30% cut of game sales. With more routes to market via the cloud, one thing is clear – the bargaining power has begun to shift from platforms to content owners (i.e. game developers), and we believe they will grab a larger share of the pie in the years ahead (Figure 5).

Figure 5: Illustrating the shift to cloud gaming – Console gaming



Source: Bloomberg, DBS

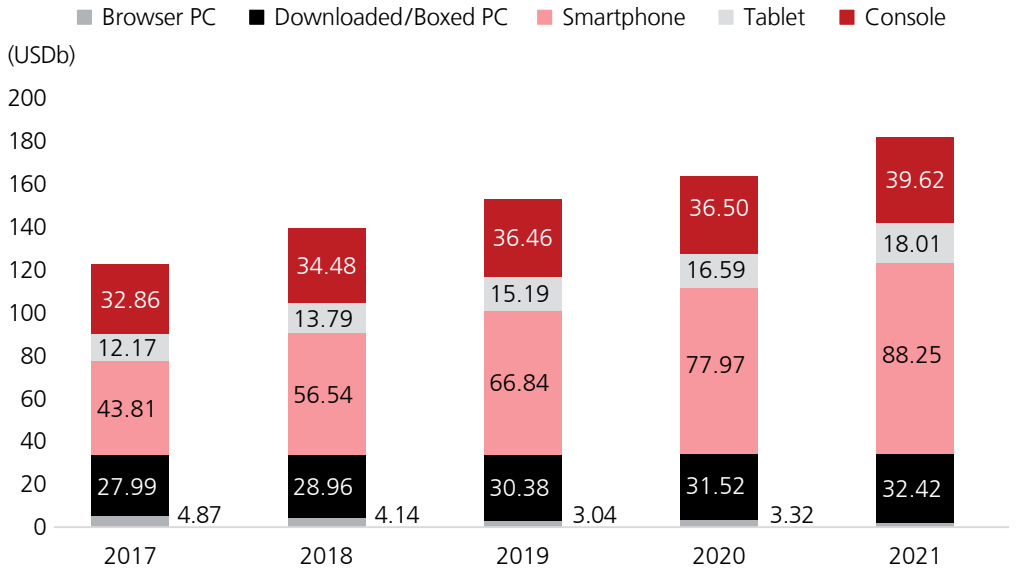
Focus on depressed developers with strong globally-recognised IP assets and strong track records

Focus on developers with strong IP and solid track record. We note the critical factors for developers' share prices are: i) Announcements of new game/expansion pack releases; and ii) Initial sales numbers of newly released games/expansions. These translate into earnings down the road, but the market tends to price in these expectations long before said earnings show up. Thus, our preference is to adopt a contrarian investment stance by investing in companies whose share prices remain depressed on a lack of visible near-term game pipeline, but have strong globally-recognised IP assets and a track record of successful game launches that can drive a future re-rating.

Developers with mobile game exposure are especially favoured, given huge growth potential

Mobile game exposure is a plus. We also think it is important that game developers have exposure to the mobile space, as that has been the fastest-growing game category, with much of that driven by Asia. Based on Newzoo estimates, smartphone gaming is expected to grow at a c.16% CAGR from 2018-21, compared to just 4-5% for PC and console.

Figure 6: Global video-game sales by medium



Source: Newzoo 2018 Global Games Market Report

Asia ex-Japan Equities | 3Q19

Opportunities amid challenges

Source: AFP Photo

DBS

Live more, Bank less

Asia ex-Japan Equities

Yeang Cheng Ling
Strategist

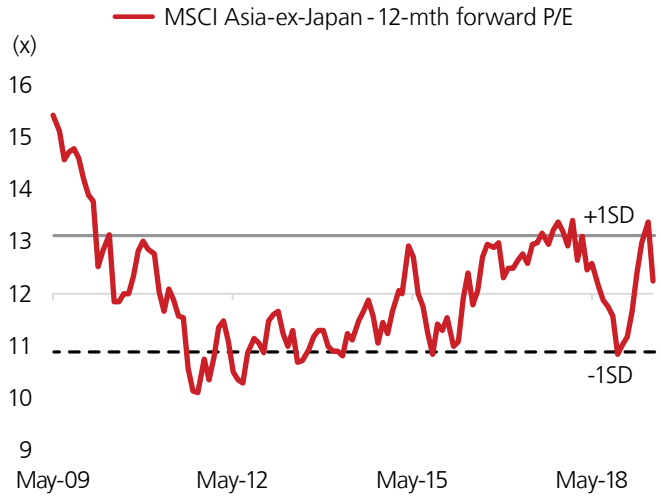
Joanne Goh
Strategist

Trade war casts uncertainties on sentiment

The intensifying US-China trade dispute was undoubtedly a negative surprise to a market that had been pricing in a resolution between the two countries. At the time of writing, a binary decision awaits the fate of USD300b Chinese exports which could be hit with further tariffs. This will have implications on Asian growth, and downside risks to CNY and Asian currencies.

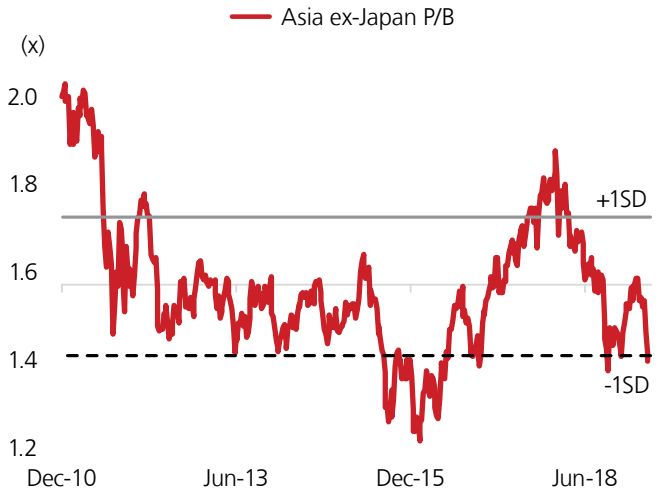
While the P/E ratio of the region's equities reached +1SD of historical mean recently (Figure 1), the P/B multiple appeared supportive after the recent round of correction (Figure 2).

Figure 1: Asia ex-Japan 12-month forward P/E valuations



Source: IBES, Thomson Reuters, DBS

Figure 2: Asia ex-Japan equities are on supportive ground

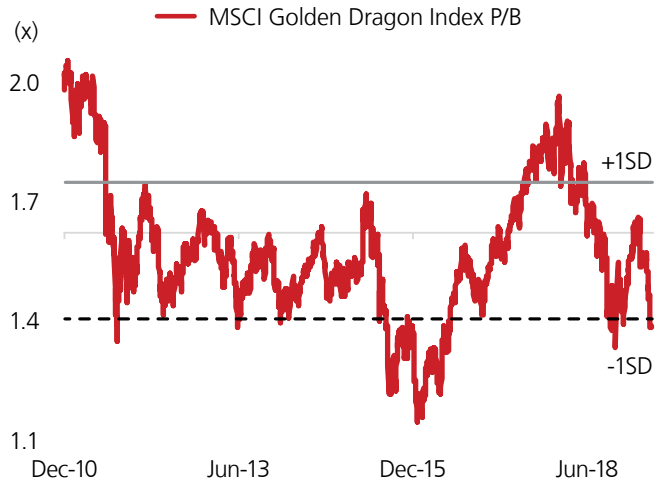


Source: Bloomberg, DBS

Correction should be shallower and shorter in duration than last year. While further adjustments to the market on the progress of trade talks remain tentative, the corrections should be shallower and shorter than last year. At this stage in markets, economic slowdown and earnings-growth downgrades are at their worst points compared to last year. But we expect policies from the US Federal Reserve and China authorities to be supportive, cushioning further downside from global risks.

The MSCI Golden Dragon Index – comprising the equity markets of China, Hong Kong, and Taiwan – traded at -1SD of the historical mean of its P/B, lending a level for downside support (Figure 3). We expect a strong rebound should there be a trade agreement between the US and China (Figure 4).

Figure 3: North Asia equities are on supportive valuations



Source: Bloomberg, DBS

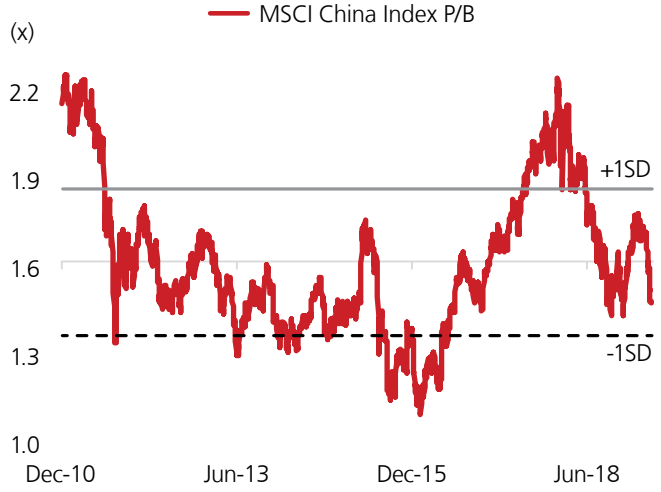
Figure 4: Recent corrections in China equities are an opportunity for long-term catalysts

Source: Bloomberg, DBS

Valuations of China equities are not excessive, backed by policy support and better balance sheet quality

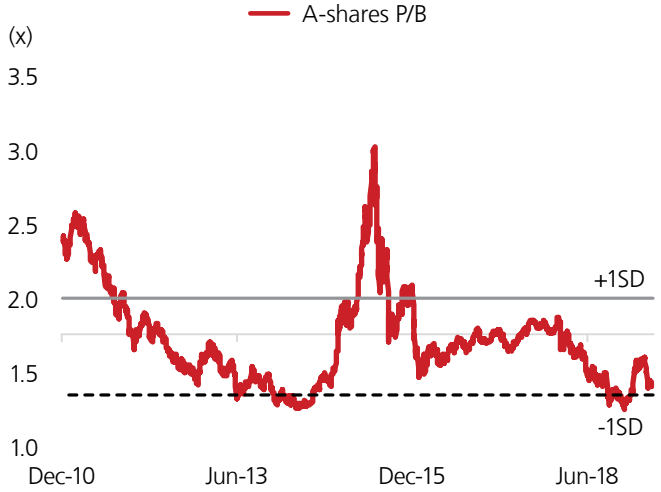
The valuations of MSCI China Index and A-shares are currently compelling, judging from their respective P/B ratios (Figures 5 and 6). Notably, domestic liquidity conditions are conducive as government authorities have room for policy stimulus including further monetary easing and fiscal reforms (Figure 7). The improvement in balance sheet quality and free cash flow yields in the corporate sector could play another principal role in weathering the external headwinds (Figure 8).

Figure 5: MSCI China equities are at mid-cycle valuations



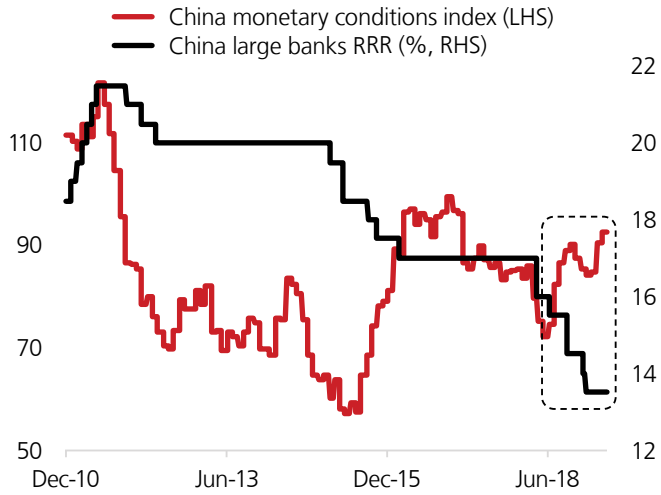
Source: Bloomberg, DBS

Figure 6: A-shares P/B is at the bottom of its historical range to the mean



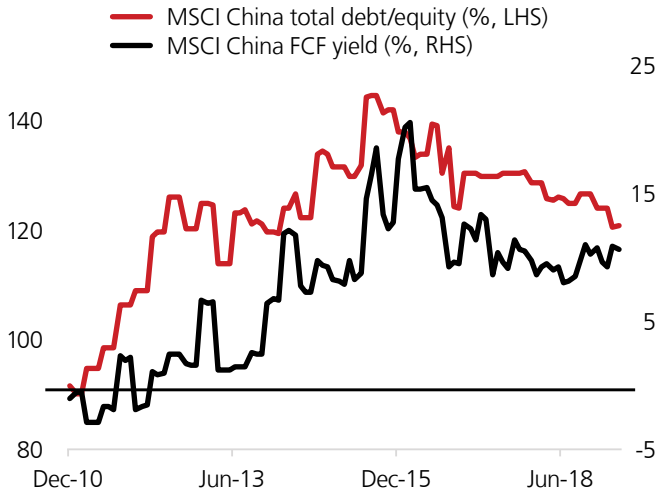
Source: Bloomberg, DBS

Figure 7: Domestic liquidity conditions are conducive with further room for policy stimulus



Source: Bloomberg, DBS

Figure 8: Better balance sheet quality and robust free cash flow yields



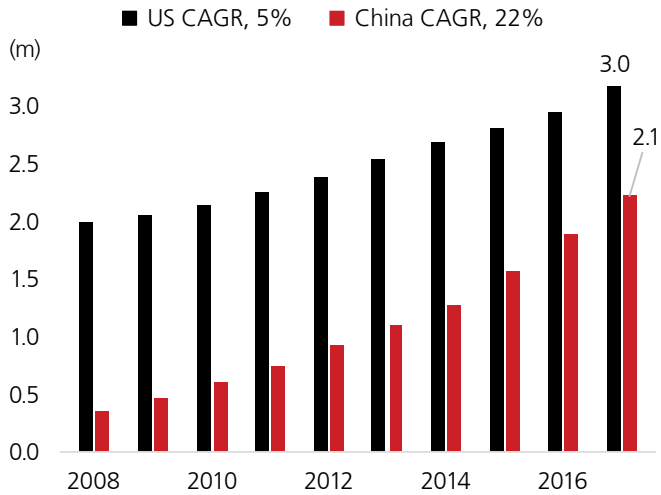
Source: Bloomberg, DBS

e-Commerce engine to support growth in domestic consumption

Development of technology and e-Commerce to continue. China has been building up an arsenal of global patents, narrowing the gap with the US over the past decade (Figure 9). We expect developments on the technology front to maintain their course despite trade war headwinds, as China inches towards its goal of technology self-sufficiency.

While China continues to face potential tariff-related disruptions to growth, the rise of e-Commerce and other supportive industries will remain important drivers to support domestic consumption growth in China (Figure 10).

Figure 9: China is fast catching up in patents in force



Source: World Intellectual Property Organization, DBS

Figure 10: Online consumption is another new force to support the domestic economy

Source: e-Commerce China, DBS

Stocks in highly cyclical and export-oriented markets such as Taiwan and South Korea may continue to see earnings downgrades, while corporate earnings in ASEAN and China should be relatively more resilient as these markets are populated with stocks driven by domestic demand (Table 1).

We see the potential of more stimulus measures among Asian countries to dampen downside risks from the trade war. For example, a dovish Fed and lower inflation have opened doors for rate cuts in many of these economies.

Table 1: Asia ex-Japan markets – Market cap exposure by economic sector

	Defensive sectors	Cyclical exposure	Global price exposure	Interest rate exposure
Hong Kong	12%	19%	12%	57%
Singapore	18%	37%	2%	43%
Thailand	28%	24%	20%	27%
Indonesia	34%	14%	14%	38%
India	18%	29%	21%	33%
Taiwan	9%	59%	15%	17%
Korea	18%	59%	11%	12%
China	16%	25%	13%	46%
Malaysia	43%	12%	13%	33%
Philippines	35%	16%	6%	44%

Source: Thomson Reuters, DBS

Opportunities in Asian markets. We continue to advocate a Barbell Strategy. On one end of the barbell, we like equity exposures in China A-shares, and the cloud computing and industrial automation sectors. On the other income-generating end, we like large state-owned China banks, as well as Singapore REITs.

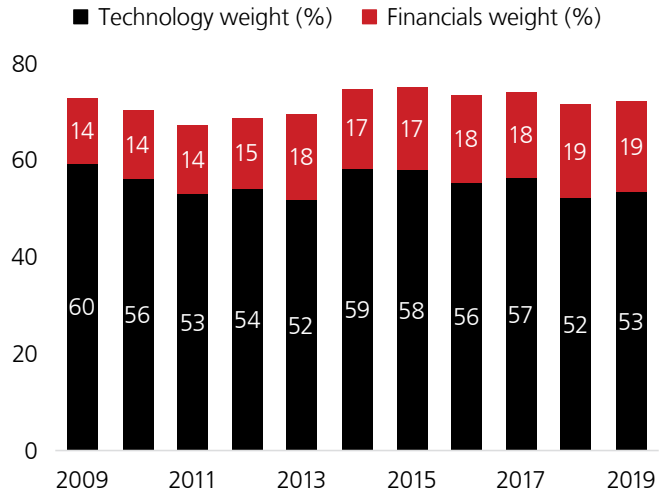
China A-shares will ride the tailwind of MSCI Inc increasing the weight of these shares on their indices over the next six months, which would eventually reach 20% in the EM universe by the year's end. This will certainly attract inflows from global funds.

We are vigilant on Taiwan, South Korea, and Malaysia

Headwinds for Taiwan, South Korea, and Malaysia equities. The Technology sector has an outsized influence on Taiwan equities (Figure 11). Hence, a prolonged trade war and slowing global smartphone demand will weigh on the earnings outlook (Figure 12).

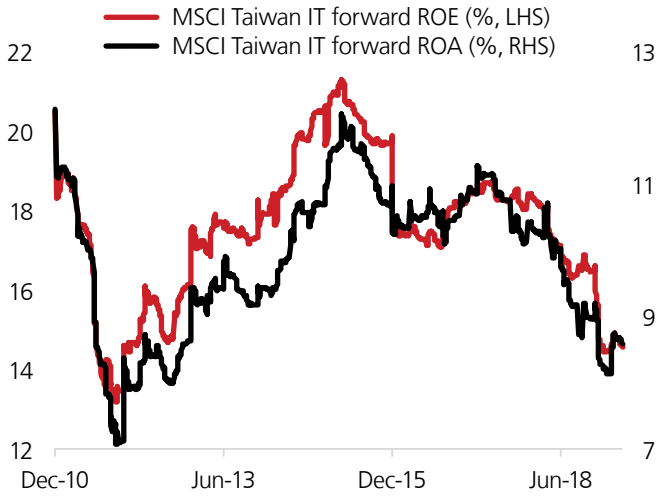
We also remain vigilant on South Korea and Malaysia equities. Like Taiwan, South Korea has a high exposure to cyclical sectors. The projected ROE remained trapped at less than 10% while the forward-looking P/E reached the higher end of its historical range despite uncertainties over corporate earnings growth. At forward P/E of 16x, Malaysia equities are exceedingly at a premium to Asia ex-Japan's average of 13x while yielding a relatively lower forward ROE.

Figure 11: Technology is the dominant factor in Taiwan



Source: Bloomberg, DBS

Figure 12: Declining asset and shareholder returns to suppress valuation multiples



Source: Bloomberg, DBS

We prefer S-REITs, are buoyant on Indonesia and the Philippines

What we think of ASEAN. We see the Singapore market trading in a narrow range on the back of support from attractive valuations. Singapore REITs remains our favoured sector as it stands to benefit from low bond yields and dovish central bank policies. Despite the 1H19 underperformance, we remain positive on Indonesia on the back of confidence placed in the BI and a stronger rupiah. Although the hope of rate cuts has diminished, we do not think the BI would hike rates like it did last year.

In the Philippines, the general election result has given a strong mandate to President Rodrigo Duterte and this has set the stage for policy continuity. So far in his tenure, the country has gained upgrades to it sovereign rating to BBB+ and we believe pro-growth policies on infrastructure spending are likely to continue.

Thailand has underperformed this year, dragged down by domestic political developments. We remain cautious as growth from export sectors could disappoint while recovery in domestic consumption may be delayed against the backdrop of a political stalemate.

In India, we expect domestic polices to support rural consumption post-election, coupled with rate cuts and increased fiscal spending.

Table 2: Outlook on Asia markets

Overweight	Neutral	Underweight
China/Hong Kong	India	Taiwan
Singapore	Thailand	Malaysia
Indonesia		Korea
Philippines		

Source: DBS

Global Rates | 3Q19

Guarding downside risks

Source: AFP Photo

DBS

Live more, Bank less

Global Rates

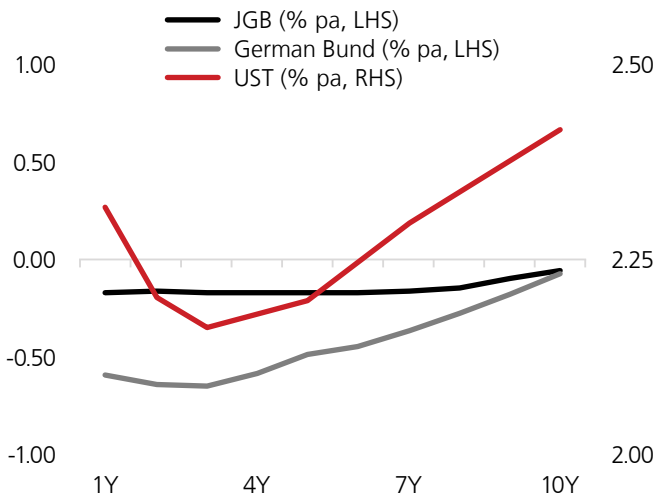
Eugene Leow
Strategist

Duncan Tan
Strategist

Guarding against downside risks

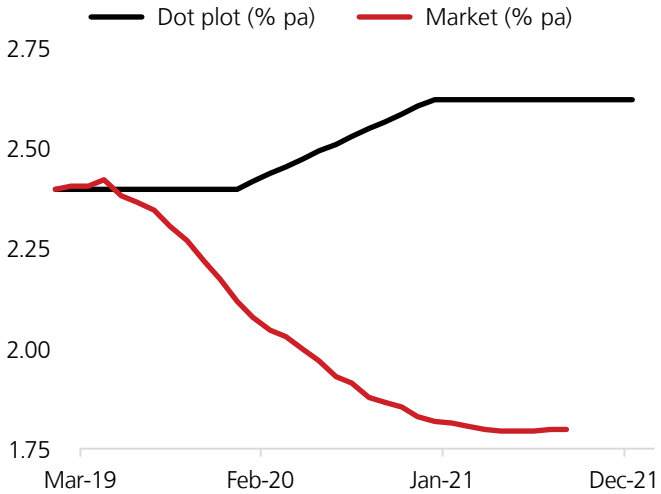
Trade and growth uncertainties will weigh on DM rates over the coming few months. Notably, US-China trade negotiations have dragged on for longer than the market initially expected. Moreover, there is an increasing chance that no deal takes place as Trump threatens further tariffs on Chinese imports. Against this backdrop, the G-3 central banks are likely to guard against downside growth risks. Notably, the ECB has already slashed its growth forecasts for the Eurozone down to 1.1% suggesting that there is no hurry to normalise policy. Similarly, the BOJ made a commitment to keep rates low through Spring 2020. Unsurprisingly, 10-year German and JGB yields are hovering below zero, keeping DM yields low in the process.

Figure 1: G-3 rates reflect pessimism



Source: Bloomberg, DBS

Figure 2: The Fed and the market diverge on rate expectations



Source: Bloomberg, DBS

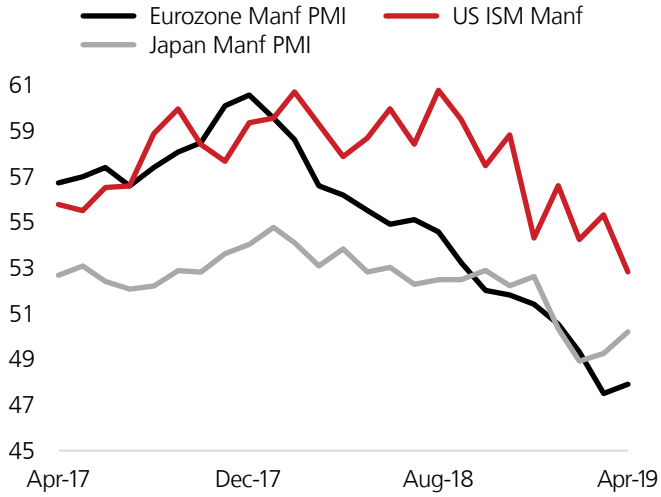
Prolonged trade tensions could prompt the Fed to take a more dovish stance. US-China trade tensions could last a lot longer than markets would have expected and there is a reasonable chance that the trade war could spread across other regions. If so, the downside risks to US growth (firm economic indicators notwithstanding) could prompt the Fed to take on an even more cautious stance. It is critical to watch the stock market. In 4Q18, tightening financial conditions, which came on the back of sliding stock indices and a stronger USD, prompted the Fed to abandon further normalisation. Similarly, if trade

tensions escalate and cause the S&P 500 Index to fall by a sizable magnitude, it would be reasonable to expect the Fed to cut rates several times. We have pencilled in two Fed cuts by end-2019.

Wary of longer-duration govvies

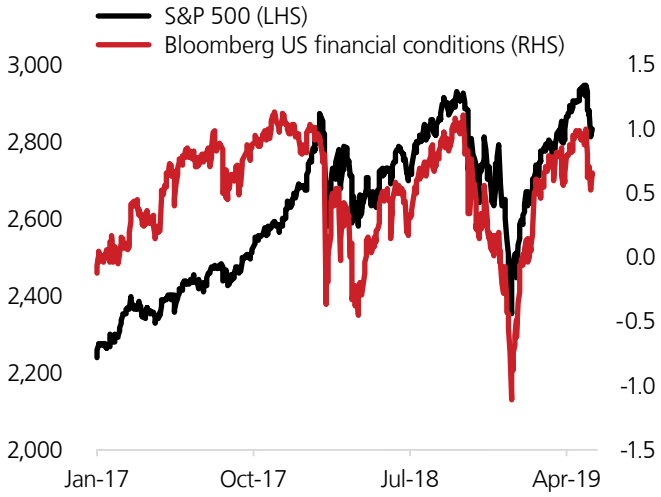
We are wary of longer-duration bonds given the extent of the rally. For the Eurozone and Japan, absolute yields are negligible (or negative) and further gains are only possible if their respective central banks reverse course and ramp up asset purchases. With much of the two curves already in negative territory, there are scant pickings. For the US, we note that 10-year and 30-year yields appear reluctant to head lower despite risk aversion, steepening the curve in the process. While trade war-related risk aversion could drive haven demand, we are worried about the structurally large fiscal deficits that the US will be running in the coming years.

Figure 3: Will a trade war scuttle the tentative recovery?



Source: Bloomberg, DBS

Figure 4: A deterioration in US financial conditions could prompt Fed to ease



Source: Bloomberg, DBS

Asia Rates

CNY rates: Trade war woes

Trade war fears will determine the direction of Chinese rates. An improvement in Chinese data after months of monetary stimulus have initially boosted equities and government yields as this led to speculation that the PBOC would pull back on stimuli. However, the positive narrative is likely to be overshadowed by escalating trade tensions. We reiterate that further RRR cuts are upcoming as the authorities strive to keep short-term interest rates low. CNY interest rates are likely to head sideways for the foreseeable few quarters. With rates already low, we suspect that equities and FX may be a lot more volatile if trade tensions escalate further.

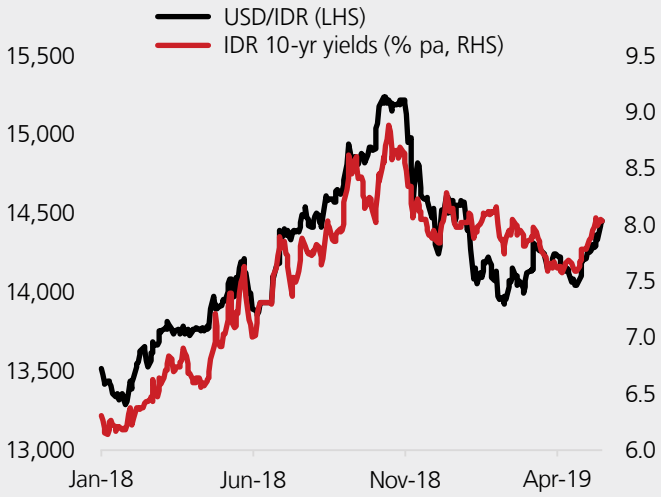
Figure 5: Trade war fears halt rise in Shanghai Composite and yields

Source: Bloomberg, DBS

IDR rates: Challenging external environment

Heightened uncertainties on the global front are likely to weigh on Indonesian govvies in the immediate few months. The appetite to take on EM debt appeared to have waned in April and Indonesia, with its high foreign ownership of assets, is vulnerable to this pullback in sentiment. Notably, USD/IDR has come under upward pressure, broadly in line with Asian peers. However, liquidity in the system has tightened somewhat, driving the 3M Jibor higher. To be sure, the move in Jibor has been relatively muted. However, the impact on government bond yields has been much larger. Ten-year yields are now above 8%, up from the low of 7.57% registered in April. Without reprieve from the rupiah, BI will be constrained from loosening monetary policy. IDR rates are already reflecting this challenging environment.

Figure 6: Rupiah weakness hurts sentiment

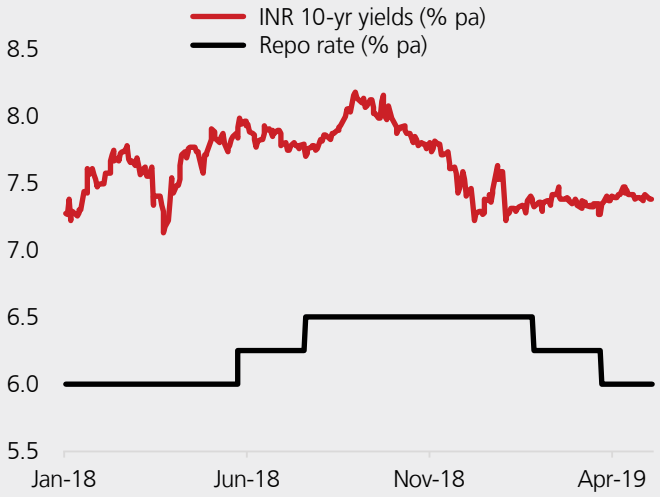


Source: Bloomberg, DBS

INR rates: Resilient

India interest rates and the INR have been relatively resilient. Since the start of the year, the OIS curve has bull steepened as market participants anticipate further monetary easing. By many macro measures, the Reserve Bank of India (RBI) should cut rates more aggressively (on top of the two already delivered this year). GDP growth has moderated below 7% while CPI inflation has dipped below 3%. Moreover, with foreign ownership of securities still relatively low, India government bonds did not face the same extent of selling pressure that buffeted Indonesia ones when the US-China trade war escalated. Relatively low exposure to global trade flows may also explain why investors appear more confident about INR assets. Accordingly, we like shorter duration India government bonds (<5-year) noting that the RBI has the leeway to lower policy rates further in the coming months.

Figure 7: A dovish RBI will support govvies

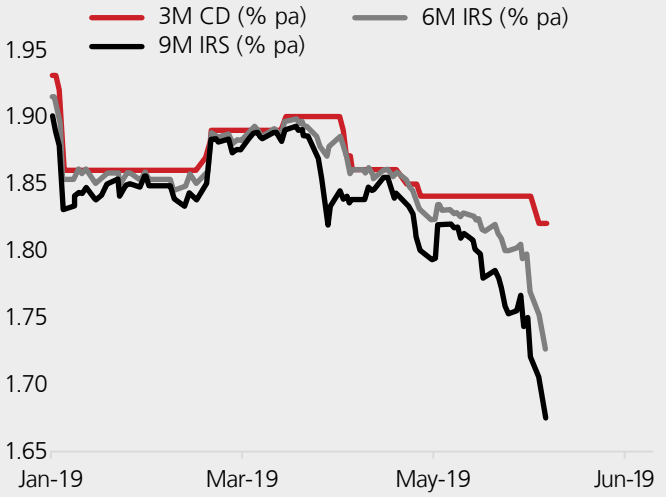


Source: Bloomberg, DBS

KRW rates: Hedge against global trade wars

BOK's reluctance to consider rate cuts is keeping markets guessing and swap pricing volatile. The case for easier policy could strengthen if economic outlook continues to worsen, global trade disputes remain unresolved, and the semiconductor cycle stays weak. Swap markets have already moved ahead of the BOK, pricing for the high probability of a 25 bps cut in 2H19. On Korean government bonds, they could offer good, broad protection against escalations in global trade disputes (beyond US-China). Korea has strong trade/economic linkages with China. Its bonds are highly sensitive to global growth/demand outlook and market volatility. Recall in 2018, Korea bonds, together with China bonds, were huge beneficiaries of elevated US-China trade hostilities.

Figure 8: Interest-rate swap markets have moved ahead of BOK, pricing for a cut in 2H19

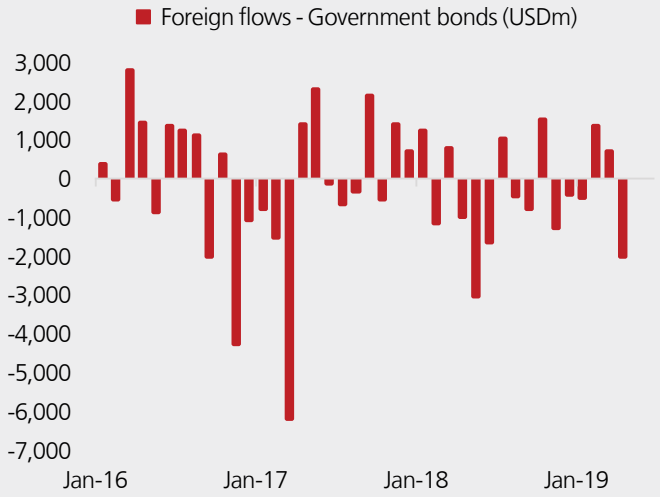


Source: Bloomberg, DBS

MYR rates: High event risks

There is some market impact risk around the outcome of two technical events, namely how the Norway sovereign wealth fund liquidates its holdings of Malaysian government bonds and whether FTSE Russell would downgrade the level of Malaysia's market accessibility at its September review (this would render Malaysia ineligible for inclusion in the World Government Bond Index). Our base case is that Norway's sovereign wealth fund would sell its holdings in a very gradual manner to limit market impact and get the best possible price. We also expect Malaysia's regulators to be in constant engagement with FTSE Russell to address issues and avert an exclusion decision at the September review (we think a retain decision is most likely). However, the elevated uncertainties and risks around future developments and outcomes would likely see Malaysian government bonds trade in a more volatile manner in the coming months.

Figure 9: Bond outflows could persist in the coming months

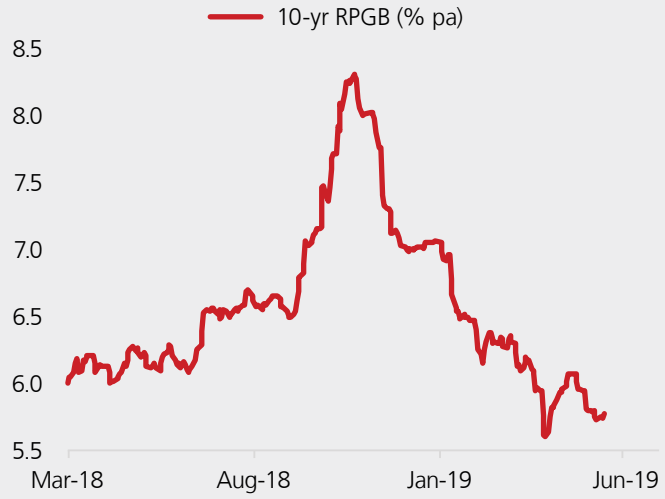


Source: Bloomberg, DBS

PHP rates: Long runway for outperformance

Tailwinds could continue driving the strong YTD outperformance. We have been constructive on Philippine local government bonds (RPGB) since the start of 2019. Several tailwinds could support their strong YTD outperformance. Inflation has continued to moderate and stabilise within BSP's 2-4% target range. S&P has recently upgraded the Philippine's credit rating to BBB+ from BBB. The central bank has been signalling that it has room to cut the policy rate and reduce banks' reserve requirement ratio. Most importantly, markets seem to be reacting quite positively to BSP's dovish stance as evidenced by an outperforming peso. Ultimately, we see scope for further capital gains. RPGBs are also attractive as a defensive play amid global trade tensions as its drivers are more idiosyncratic/domestic-driven.

Figure 10: 10-year RPGB yields have kept retracing lower

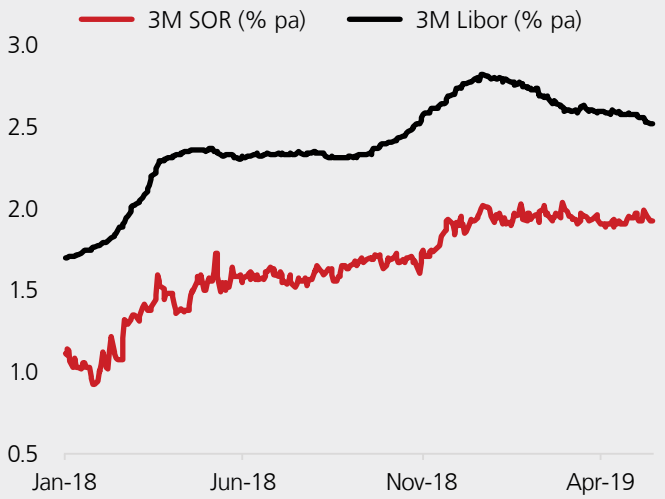


Source: Bloomberg, DBS

SGD rates: Following USD rates lower

Short-term SGD rates have come off their lofty highs. Part of this can be attributed to better liquidity conditions after a sizable maturity of SGS. Secondly, USD/SGD has come also come off as the market focused on the narrowing US-Singapore interest-rate differentials. On balance, SGD interest rates still look high compared to the US's. In the front of the curve, the USD curve is inverted as the market priced in three to four rate cuts over the coming two years. Comparatively, the SGD curve has been reluctant to factor in the same magnitude of easing. We think it would only be a matter of time before the market adjusts. Sibor and SOR will be dragged down by the two Fed cuts we see by end-2019.

Figure 11: Fed cuts will drive SOR lower

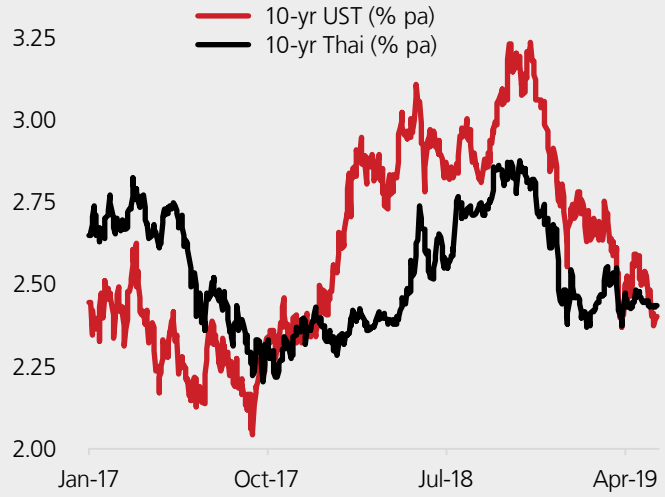


Source: Bloomberg, DBS

THB rates: BOT to stand pat

While downside risks to growth are rising (which supports the case for easier policy), the BOT remains concerned about yield-seeking behaviour and financial stability risks stemming from high household debt. On the political front, the Election Commission has announced the final results of the 24 March general elections. However, political uncertainties remain, largely around how the new ruling coalition (in the lower house) would be formed. All considered, the BOT is likely to stand pat this year. Notably, 10-year Thai government bond yields are trading above USTs' in May (after trading below for the prior 16 months). The BOT's relative hawkishness vs the Fed and peer central banks, coupled with bond outflows this year due to election-related risks, are likely keeping yields supported.

Figure 12: 10-year Thai yields have reverted to trading above USTs'



Source: Bloomberg, DBS

Table 1: Rates forecasts

		2019				2020			
		1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
US	3m Libor	2.60	2.60	2.35	2.10	2.10	2.10	2.10	2.10
	2Y	2.26	2.00	2.00	2.10	2.20	2.20	2.20	2.20
	10Y	2.41	2.05	2.10	2.20	2.30	2.40	2.50	2.50
	10Y-2Y	15	5	10	10	10	20	30	30
Japan	3m Tibor	0.07	0.05	0.05	0.05	0.05	0.05	0.05	0.05
	2Y	-0.17	-0.20	-0.17	-0.15	-0.15	-0.15	-0.13	-0.10
	10Y	-0.08	-0.15	-0.10	-0.10	-0.05	-0.05	0.00	0.00
	10Y-2Y	9	5	7	5	10	10	13	10
Eurozone	3m Euribor	-0.31	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30
	2Y	-0.60	-0.65	-0.60	-0.55	-0.55	-0.55	-0.50	-0.50
	10Y	-0.07	-0.30	-0.25	-0.20	-0.15	-0.10	-0.05	-0.05
	10Y-2Y	53	35	35	35	40	45	45	45
Indonesia	3m Jibor	7.21	7.20	7.20	7.20	7.20	7.20	7.20	7.20
	2Y	6.78	6.90	6.80	6.70	6.70	6.70	6.70	6.70
	10Y	7.63	7.70	7.60	7.50	7.50	7.50	7.50	7.50
	10Y-2Y	86	80	80	80	80	80	80	80
Malaysia	3m Klibor	3.69	3.44	3.44	3.44	3.44	3.44	3.44	3.44
	3Y	3.38	3.40	3.40	3.40	3.40	3.40	3.40	3.40
	10Y	3.77	3.85	3.90	3.95	4.00	4.00	4.10	4.10
	10Y-3Y	39	45	50	55	60	60	70	70
Philippines	3m PHP ref rate	5.55	5.30	5.05	5.05	5.05	5.05	5.05	5.05
	2Y	5.82	5.75	5.75	5.75	5.75	5.75	5.75	5.75
	10Y	5.61	6.00	6.00	6.00	6.00	6.00	6.00	6.00
	10Y-2Y	-21	25	25	25	25	25	25	25
Singapore	3m Sibor	1.94	1.95	1.80	1.60	1.60	1.60	1.60	1.60
	2Y	1.92	1.85	1.75	1.80	1.90	1.90	1.90	1.90
	10Y	2.07	2.00	1.95	2.00	2.05	2.15	2.25	2.25
	10Y-2Y	15	15	20	20	15	25	35	35

		2019				2020			
		1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Thailand	3m Bibor	1.88	1.85	1.85	1.85	1.85	1.85	1.85	1.85
	2Y	1.78	1.80	1.80	1.80	1.80	1.80	1.80	1.80
	10Y	2.43	2.40	2.50	2.60	2.60	2.60	2.60	2.60
	10Y-2Y	65	60	70	80	80	80	80	80
China	1Y Lending rate	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
	3Y	2.91	2.80	2.80	2.80	2.80	2.80	2.80	2.80
	10Y	3.36	3.15	3.10	3.15	3.20	3.25	3.25	3.25
	10Y-3Y	45	35	30	35	40	45	45	45
Hong Kong	3m Hibor	1.76	2.10	1.95	1.80	1.80	1.80	1.80	1.80
	2Y	1.45	1.80	1.70	1.75	1.80	1.80	1.80	1.80
	10Y	1.47	1.65	1.75	1.90	2.00	2.10	2.20	2.20
	10Y-2Y	2	-15	5	15	20	30	40	40
Korea	3m CD	1.90	1.90	1.76	1.76	1.76	1.76	1.76	1.76
	3Y	1.69	1.75	1.75	1.75	1.75	1.75	1.75	1.75
	10Y	1.83	1.95	2.05	2.05	2.05	2.05	2.00	2.00
	10Y-3Y	14	20	30	30	30	30	25	25
India	3m Mibor	7.42	6.75	6.40	6.05	6.05	6.05	6.05	6.05
	2Y	6.88	6.10	6.00	6.10	6.20	6.30	6.30	6.30
	10Y	7.22	6.60	6.60	6.85	7.00	7.10	7.20	7.20
	10Y-2Y	34	50	60	75	80	80	90	90

%, eop, govt bond yield for 2-year and 10-year, spread bps.

Source: CEIC, Bloomberg, DBS

Global Credit | 3Q19

Yield in scarcity

Source: AFP Photo

Global Credit

Hou Wey Fook, CFA
Chief Investment Officer

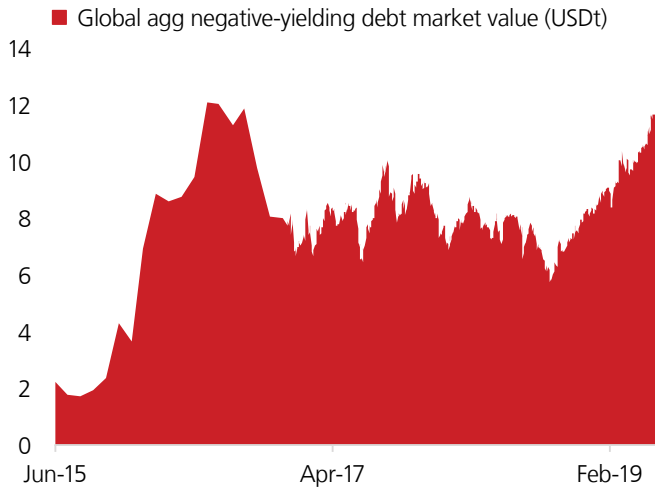
Jason Low, CFA
Strategist

Yield in scarcity

In a world where 22% of global IG bonds are negative yielding, the hunt for yield can only intensify. We remain constructive on EM bonds over that of DM given the wider yield spreads. In terms of credit rating, we prefer the BBB/BB-rated universe of bonds, also because they offer wider yield spreads. Our target duration for a bond portfolio is four years.

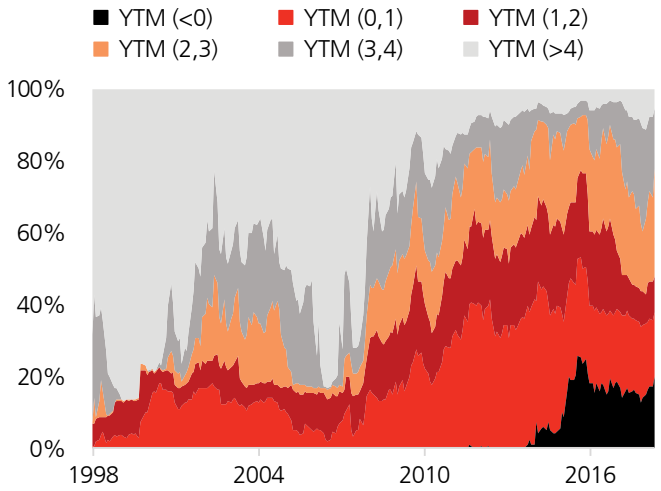
Negative-yielding bonds now make up 22% of the global IG universe. With the G-3 central banks remaining dovish, the amount of negative-yielding bonds in the world has hit USD11.7t, or, 22% of the entire global IG space (Figure 1) – the highest level since July 2016. Today, bonds that yield below 2% constitute nearly half of the global IG universe (Figure 2). Indeed, we have seen the proportion of higher-yielding buckets decreasing substantially over the years. For instance, the bucket which yielded 4% or more now makes up only 6% of the universe, compared to 87% back in 2000.

Figure 1: Negative-yielding bonds now make up 22% (USD11.7t) of the global IG universe



Source: Bloomberg, Barclays, DBS

Figure 2: IG bonds yielding below 2% now make up half of the global IG universe



Source: Bloomberg, Barclays

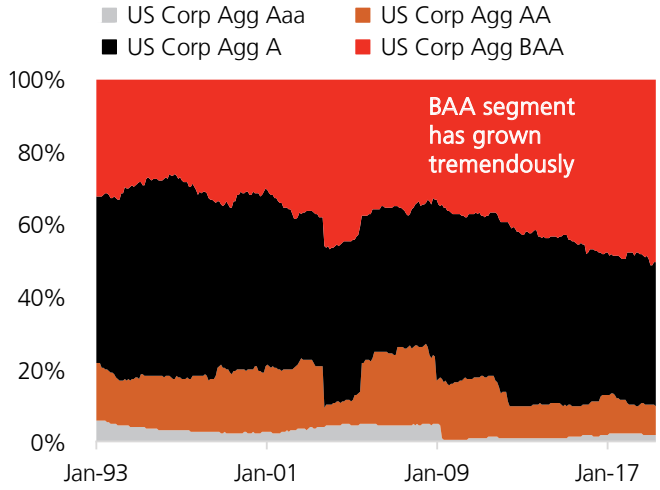
It is difficult to find value in DM, where spreads have tightened substantially

Hard to find value in DM IG space. The sharp decline in the proportion of higher yielding bonds is, in large part, due to global central banks' dovish stance since 2000. With the Federal Reserve now on hold, we do not see improvement anytime soon. Indeed, it is increasingly difficult to find value in the DM IG market. Year-to-date, US IG yield spread has tightened some 40 bps to 110 bps – a far cry from the 200 bps range right after the GFC in 2008.

The BBB segment has grown tremendously over recent years to form 50% of IG

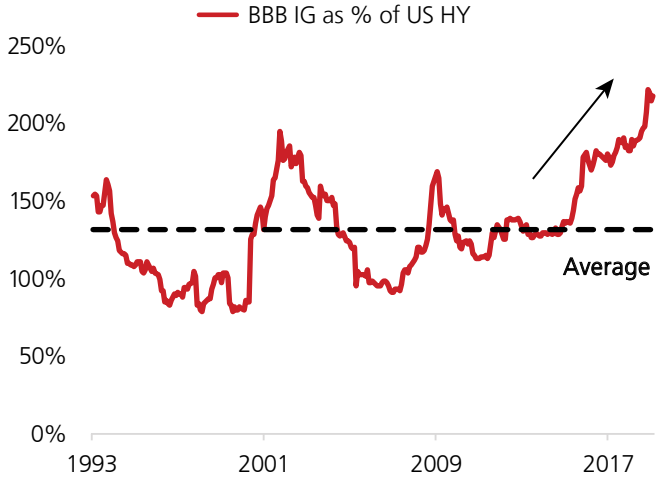
Should investors be worried about the growth of the BBB segment? In recent years, we have witnessed the tremendous growth of the US Corporate BBB segment – the lowest rung of IG rating ladder (Figure 3). Over the last 10 years, the market value of the BBB segment has tripled – far outpacing the growth of other rating buckets – to form 50% of the IG universe. The market value of the BBB USD IG segment is now more than twice that of the entire US HY universe (Figure 4). This imbalanced growth has brought a myriad of concerns among investors. One of them being, if the trade war tensions were to worsen and growth slows, would a significant portion of this BBB segment face downgrades, and thus fall into the non-IG bucket of HY bonds?

Figure 3: Proportion of US Corporate Aggregate BBB bonds has grown tremendously in recent years



Source: Bloomberg, Barclays

Figure 4: Market value of USD BBB IG now >200% of US HY universe

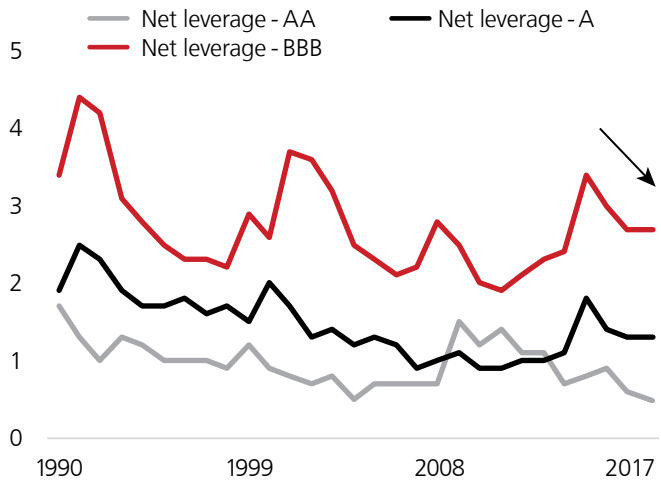


Source: Bloomberg, Barclays

We believe current credit metrics within BBB segment remain healthy and downgrade risk is manageable

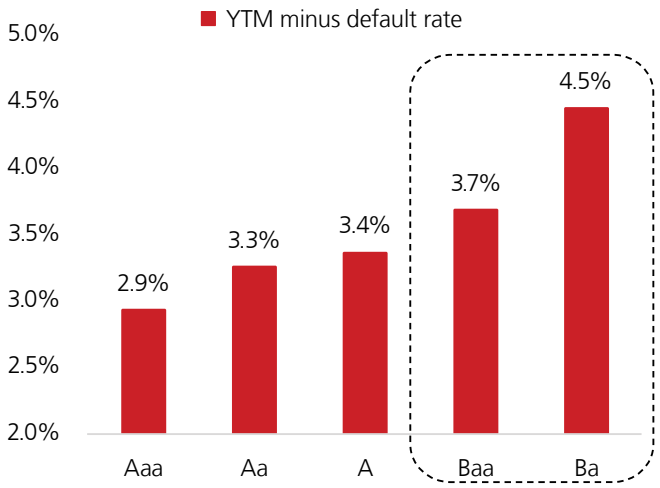
In the near term, we do not think so. While it may be uncomfortable to observe the ballooning of the lowest rung of the IG universe, the current fundamentals of the BBB bucket remain healthy. First, the credit metrics are strong as demonstrated in the declining net leverage in recent years – a trend also observed in the AA and A buckets (Figure 5). Second, since the 1920s, the average downgrade risk of BBB bucket – that is the probability of downgrade of BBB to BB – has been relatively benign at 4.5% annually (Table 1). As we are not expecting a recession, the potential downgrade of some of these BBB bonds into HY should be manageable. But we are cautious about going lower on the credit curve toward the speculative-grades of B+ or lower.

Figure 5: Net leverage of the BBB bucket has declined in recent years



Source: Bloomberg Barclays (IG), ICE BofAML (HY)

Figure 6: BBB/BB buckets offer better value, considering default rates since 1920



Source: Bloomberg, Barclays, Moody's

Table 1: Average one-year letter rating migration rates, 1920-2018

From/ To	Aaa	Aa	A	Baa	Ba	B	Caa	Ca-C	WR	Def
Aaa	86.90%	7.73%	0.79%	0.19%	0.03%	0.00%	0.00%	0.00%	4.36%	0.00%
Aa	1.04%	84.19%	7.74%	0.71%	0.16%	0.05%	0.01%	0.00%	6.06%	0.06%
A	0.07%	2.70%	85.17%	5.47%	0.63%	0.11%	0.03%	0.01%	5.73%	0.08%
Baa	0.03%	0.23%	4.16%	83.11%	**4.46%**	0.71%	0.13%	0.02%	6.92%	0.24%
Ba	0.01%	0.07%	0.48%	6.19%	74.20%	6.78%	0.67%	0.09%	10.39%	1.12%
B	0.01%	0.04%	0.15%	0.60%	5.55%	71.88%	6.14%	0.46%	12.06%	3.12%
Caa	0.00%	0.01%	0.02%	0.11%	0.49%	6.70%	67.98%	2.85%	14.16%	7.69%
Ca-C	0.00%	0.01%	0.09%	0.03%	0.58%	2.75%	8.94%	46.67%	18.26%	22.66%

Source: Moody's

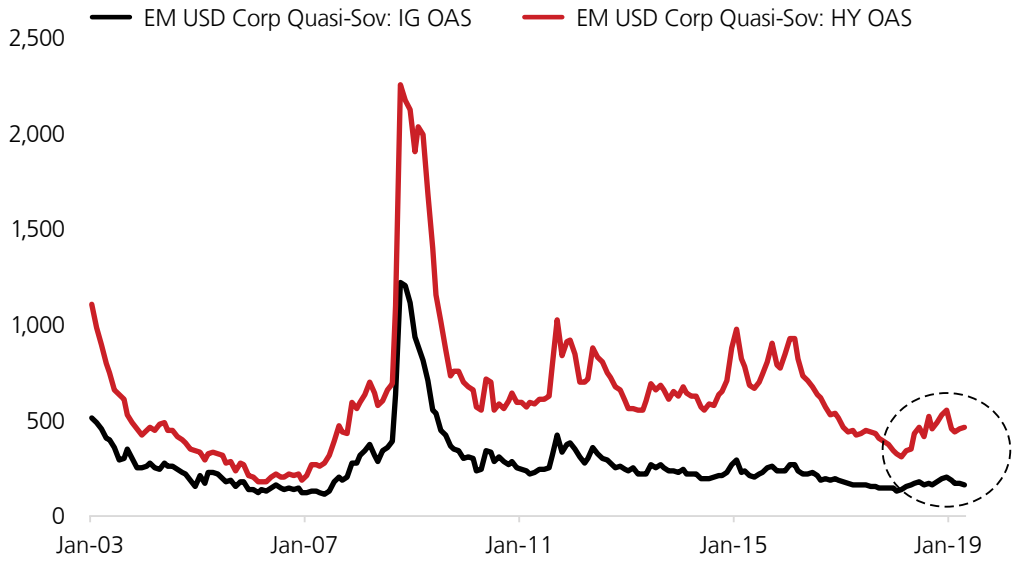
The sweet spot is in BBB/BB space as it offers better value after adjusting for default rates

The sweet spot remains in the BBB/BB space. US Corporate Baa/Ba as rated by Moody's (or the equivalent BBB/BB by S&P) currently yield between 3.9-5.5%. Historically, the average annual default rates for Baa and Ba stood at 0.26% and 1.01%, respectively. As we do not see a recession in the near term, default rates are not expected to rise substantially. If we consider the yield in relation to default rates of the various risk buckets, the BBB/BB space offers compelling value (Figure 6).

EM offers more attractive pick-up against IG as yield spreads are not as tight as before

EM offers value but stay in the BBB/BB space. There is value to be found in the EM USD space. The spread here is generally not as tight as before and EM generally offers a nice pick-up over DM bonds (Figure 7). For example, EM IG offers a 50 bps pick-up against US IG, while EM HY offers 90 bps over US HY. Here, we prefer to position in a portfolio of BBB/BB-rated bonds. We do not advise investors to go down the credit curve, given the rising incidents of credit stress, especially in China.

Figure 7: EM USD Corporates offer selective value



Source: Bloomberg, Barclays

BBB/BB bonds: An integral part of a barbell portfolio. We advise investors to adopt a barbell strategy in their portfolio construction. Heavily load superior growth stocks on one end, and stable and income-generating stocks and bonds on the other. BBB/BB bonds are an integral part of the cash-flow generating end of the barbell strategy, as it provides regular income and adds portfolio resilience. We encourage bond investors to build a diversified portfolio of 50 names or more, well spread across countries and industries.

Global Currencies | 3Q19

US dollar underpinned

Source: AFP Photo

DBS

Live more, Bank less

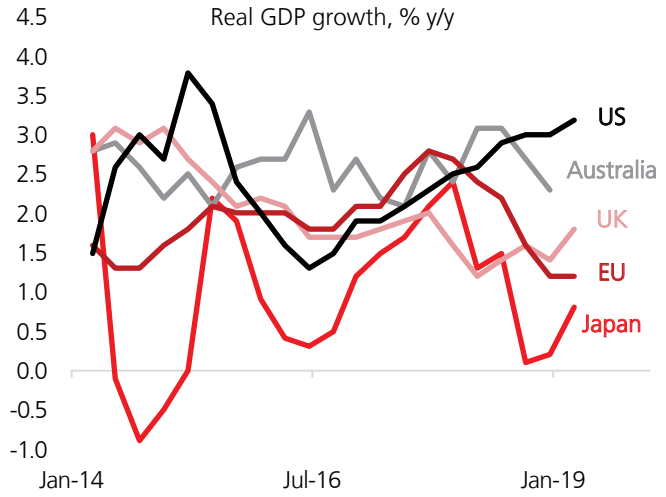
Global Currencies

Philip Wee
Strategist

USD still relatively strong

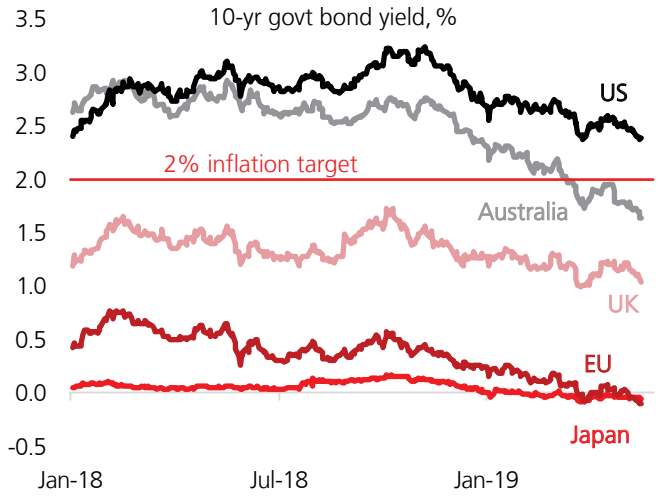
The relative strength of the US dollar has been shaken but not shattered by Fed cut expectations. The Federal Reserve believes the US economy is sound but not immune to global risks, especially those pertaining to escalating US-China trade tensions, a disorderly Brexit, and a fragile Eurozone economy. In pursuing policies that escalate global trade tensions, US President Donald Trump does not favour a stronger US dollar and prefers lower interest rates. Ironically, this has resulted in the US having the best economic growth and highest interest rates in DM. The relative strength of the US was best reflected by the UST 10-year yield holding above its 2% inflation target, and its European counterpart pushing new lifetime lows below 0%. Until these trends reverse, the greenback will be underpinned by the US's relatively strong economy.

Figure 1: US economic growth has overtaken DM peers'



Source: Bloomberg, DBS

Figure 2: The US is the only DM country with a 10-year bond yield above the 2% inflation target



Source: Bloomberg, DBS

The euro is not out of the woods and a depreciation below 1.10 cannot be discounted. Europe's 10-year bond yield has not only turned negative but has also fallen below its Japanese counterpart, a stark warning that the green shoots in the Eurozone economy could wither. The ECB staff forecast for 2019 growth has stabilised at 1.2% in June but is still well below the 1.7% projected at the start of the year. The ECB governing council needs to keep a dovish forward guidance and monitor downside risks from escalating trade tensions, a slowing Chinese economy, increased odds for a disorderly Brexit, and a potential EU-US tariff war ahead.

The British pound can revisit its post-referendum low around 1.20. Theresa May stepped down as Conservative Party leader on 7 June but remains as caretaker Prime Minister until a new leader is elected. It is doubtful that the next premier can unite the party and parliament in delivering Brexit with or without a deal. Brussels has no intention to renegotiate the thrice rejected withdrawal agreement. Withdrawing Article 50 or a second referendum are no longer palatable to the Tories after the strong showing by the Brexit Party at the European Parliamentary elections. The legal default position remains for the UK to exit the EU without a deal on 31 October. The BOE fears that corporate investment plans would be held back by another Brexit delay or abandoned on a disorderly Brexit.

The Australian dollar will depreciate further below 0.70 against USD, toward its 0.63 low seen in 2009. The RBA lowered its cash rate target by 25 bps to 1.25% on 4 June and left the door open for another cut. Real GDP growth has retreated to 1.8% y/y in 1Q19, below 2% for the first time since 2Q13. The economy is caught between weak external demand from global trade tensions and domestic demand weighed by a weak housing market and tight financial conditions. CPI inflation has fallen to 1.3% y/y in 1Q19 with no signs of a return higher into the RBA's 2-3% target range. Consumer inflation expectations hit a 30-month low of 3.3% while the unemployment rate rose to 5.2% in May from 4.9% in February.

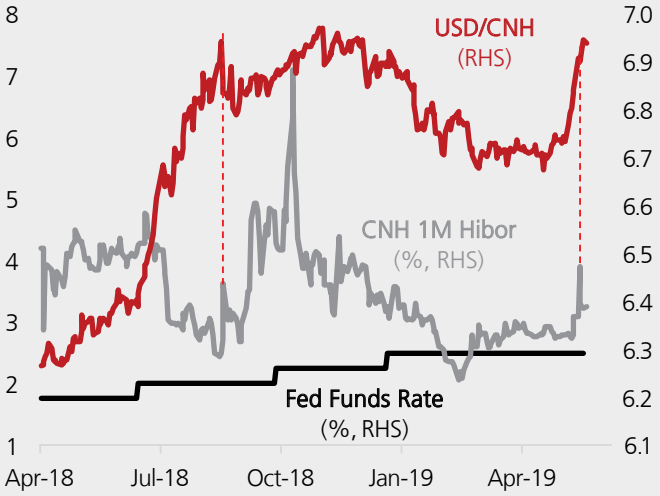
Barring global shocks, the Japanese yen will be fluctuating around 110 vs USD with a depreciation bias. The yen has, after the flash crash in January, renewed its safe-haven status during risk aversion. On the other hand, renewed US-China trade tensions have led emerging-Asia currencies to depreciate, not only against the greenback, but also the yen. Finance Minister Taro Aso expects the sales tax hike to 10% from 8% in October to proceed as planned unless the US-China trade war escalates into a Lehman-style crisis. The BOJ has refrained from providing more stimulus, and has instead, committed to keeping its ultra-accommodative policy into spring 2020. Moody's has downgraded its outlook for Japan's banking system to negative from stable in anticipation of deteriorating creditworthiness in the next 12-18 months.

Asia Currencies

CNY

The Chinese yuan will keep close to 7 on renewed trade tensions. The Xi-Trump trade truce at the G-20 Summit last December merely postponed the US tariff increase to 25% from 10% on USD250b of Chinese goods. No one expects a US-China trade deal, if any, at the G-20 Summit on 28-29 June to roll back existing tariffs. A deal, however, would hold back another 25% US tariff on the remaining USD325b of Chinese goods and vice versa. Between now and the G-20 Summit, China would probably curb the yuan's weakness at 7 to keep the door open for future negotiations and avert being labelled a currency manipulator by the US. It has done so last year by squeezing speculators in the offshore yuan market via higher CNH Hibors.

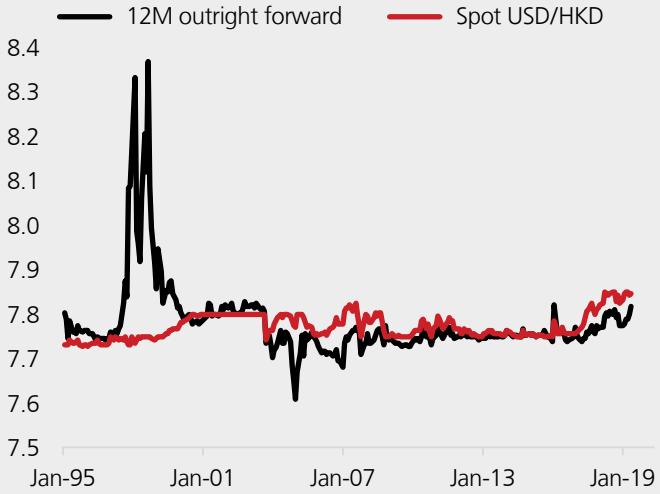
Figure 3: China prevented the yuan from depreciating past 7 last year



HKD

The Hong Kong dollar peg to USD will remain intact. The Hong Kong Monetary Authority has intervened in March and May to keep USD/HKD within its 7.75-7.85 convertibility band. The authority's war chest is large; foreign reserves totalled USD436b in April, or 117% of GDP in 2018. Portfolio capital outflows related to renewed US-China trade tensions will lead the 3M Hibor to rise and converge with the Fed Funds Rate. Unlike trade worries last year, US interest rates have stopped rising on a Fed pause stance with a dovish tilt.

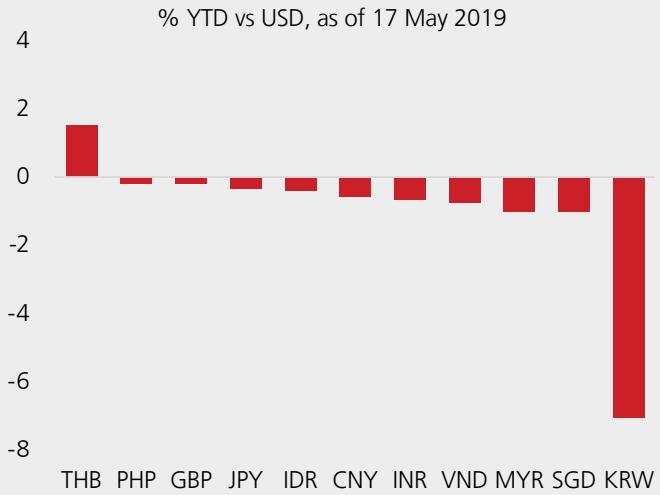
Figure 4: The Hong Kong dollar's peg to USD is intact with little signs of significant stress



KRW

The South Korean won has been the worst-performing emerging-Asia currency this year. In April, the won broke out of its nine-month range between 1,110 and 1,140 vs the USD on growth worries. The economy shrank 0.3% q/q in 1Q19, its first quarterly contraction since 4Q17, except that exports were down 8.4% y/y in 1Q19 instead of up 8.4% in 4Q17. Renewed US-China trade tensions will add more pressure on the won. Almost 40% of Korea's exports headed to the US and China in 2018. The BOK has downgraded 2019 forecasts to 2.5% from 2.6% for growth, and to 1.1% from 1.4% for inflation. Current Account surplus narrowed to 4.7% of GDP in 2018 from 4.9% in the previous year.

Figure 5: The South Korean won has underperformed its emerging-Asia peers by a wide margin

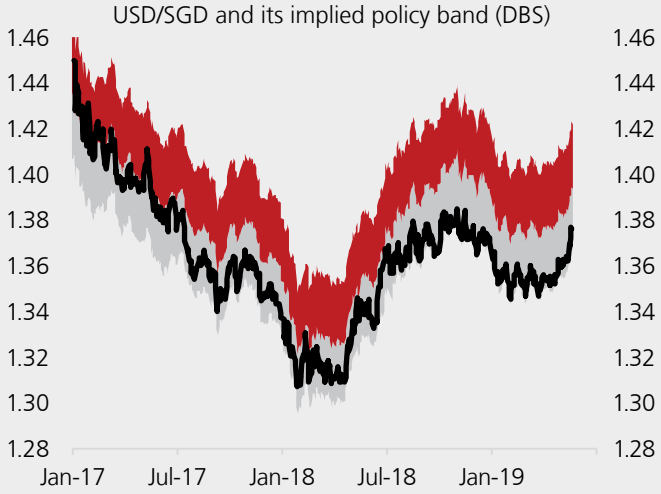


Source: Bloomberg, DBS

SGD

The Singapore dollar has depreciated into a 1.37-1.40 trading range against USD. Singapore has downgraded its 2019 official forecasts for GDP growth to 1.5-2.5% from 1.5-3.5% previously, CPI inflation to 0.5-1.5% from 1-2%, and core inflation to 1-2% from 1.5-2.5%. Globally, hopes of a recovery in the second half of the year have been dampened by renewed US-China trade tensions while central banks remain puzzled over low weak inflation. Against this background, the Singapore dollar has scope to retreat from the strongest quartile towards the mid-point of its policy band, last located around 1.39-1.40.

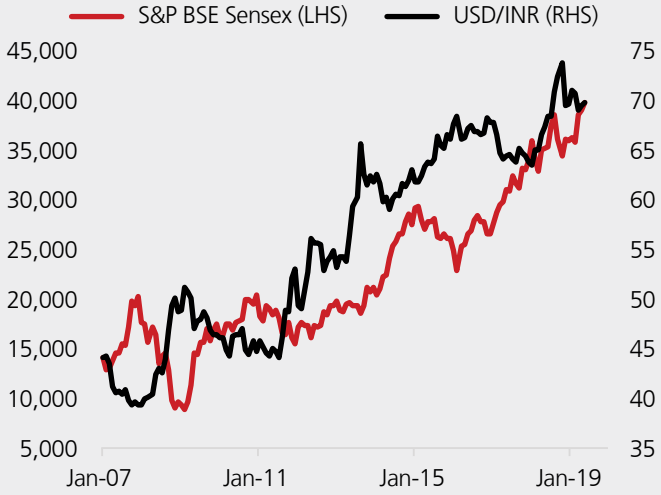
Figure 6: The mid-point of the USD/SGD policy band has been converging toward 1.40



INR

The Indian rupee is more likely than not to end 2019 weaker past 70 vs USD. Having secured a second term at the April-May general elections, the Modi government will need to reassure debt rating agencies of its plans to get fiscal consolidation back on track. Amid renewed US-China trade tensions, the burden of supporting growth will fall on monetary policy to spur domestic demand. The RBI has twice lowered its repo rate, in February and April, by a total 50 bps to 6%. Real GDP growth has slowed to 6.6% y/y in the three months ending December 2018, its slowest since the June 2017 quarter.

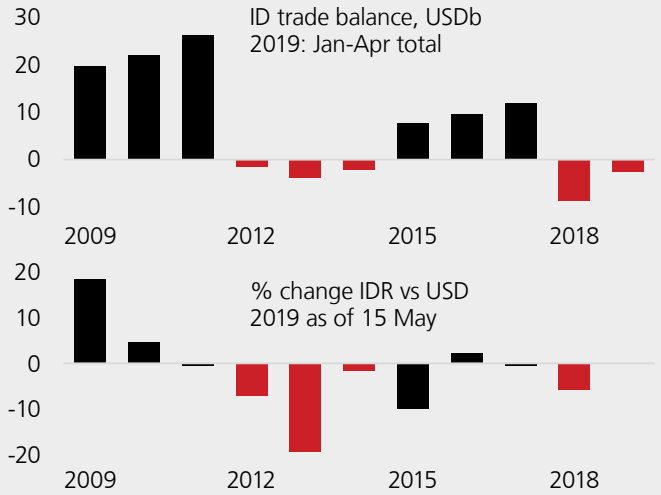
Figure 7: India's high-growth story is reflected in its stock market, not its exchange rate



IDR

The Indonesian rupiah has, in May, depreciated out of its four-month range between 13,900 and 14,300 against USD. After the GFC, the rupiah has depreciated in every year Indonesia reported a trade deficit. The USD11.8b surplus in 2017 reversed into a USD8.7b deficit last year with a USD2.6b shortfall in the first four months of 2019. The rupiah and the Jakarta stock market have, in May, returned this year's gains. Indonesia stocks have, in May, overtaken Malaysian ones as the worst performer in the region.

Figure 8: Post-GFC Indonesian rupiah depreciated in years that posted trade deficits

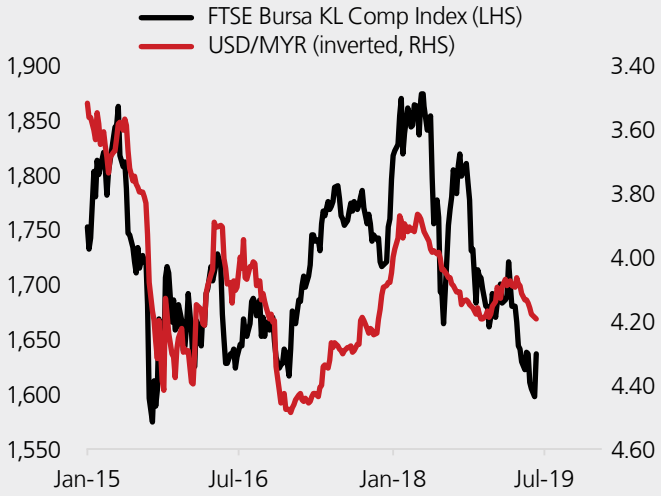


Source: Bloomberg, DBS

MYR

The Malaysian ringgit will trade into a weaker 4.20-4.25 range against USD. The ringgit has returned the year's appreciation in May. Capital outflow fears emerged after FTSE Russell warned in mid-April that it may remove Malaysia's debt from its World Government Bond Index. Malaysia has, until recently, been the worst-performing stock market this year; the Kuala Lumpur Composite Index fell almost 5% as of 17 May. The BNM has, on 7 May, lowered its overnight policy rate by 25 bps to 3%. The central bank has also downgraded its 2019 growth forecast to 4.3-4.8% from 4.9% earlier.

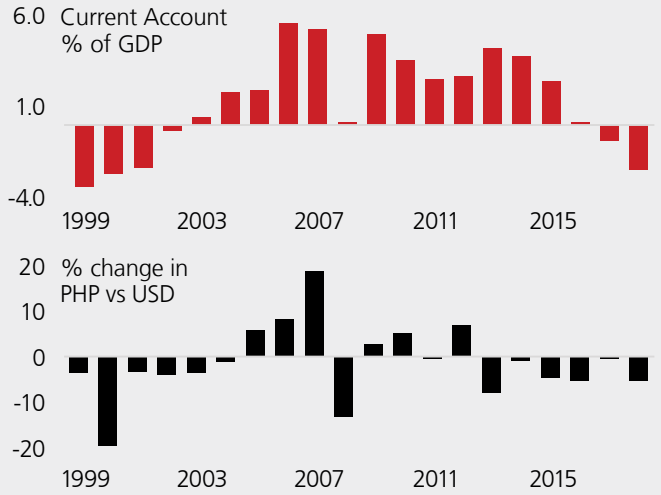
Figure 9 The Malaysian ringgit has been dragged lower by its stock market



PHP

The Philippine peso will stay, with a weak bias against USD, within its official 52-55 range this year. Overheating concerns have subsided somewhat from CPI inflation falling back into its official 2-4% target range. Trade deficits have stabilised but remained near their record wide levels. The BSP has started to ease monetary policy to support the economy. Real GDP growth slipped to 5.6% y/y in 1Q19, its weakest since 1Q15. The overnight borrowing rate was, on 9 May, lowered by 25 bps to 4.50%. RRR was lowered by 100 bps to 17% on 31 May, and will be followed by two more cuts of 50 bps each on 28 June and 25 July. The BSP is expected to make good its pledge to lower the RRR by 100 bps in the subsequent three quarters ending 1Q20.

Figure 10: The Philippine Current Account deficit will remain a drag on the peso

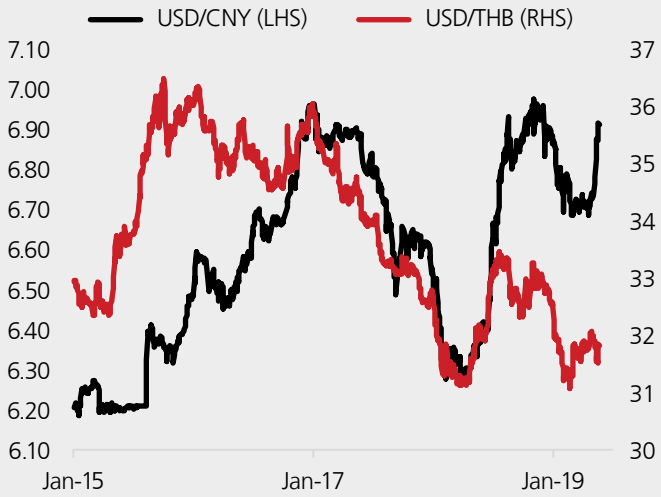


Source: Bloomberg, DBS

THB

The Thai baht will be less inclined to buck the depreciation trend in emerging Asia. Since the one-off CNY devaluation in August 2015, the Thai baht has, as of 17 May, appreciated 10% even as the yuan depreciated by 10%. Throughout the US-China trade tensions that started in 2018, the baht has been more responsive to yuan appreciation than depreciation. Thailand is not immune to global trade tensions. Real GDP growth has decelerated to 2.8% y/y in 1Q 19 from 5% four quarters earlier and CPI inflation has been unable to increase from the floor of its official 1-4% target band. The Current Account surplus has narrowed sharply from 11% of GDP in 2016-17 to under 7% last year.

Figure 11: The Thai baht has been resilient and less volatile amid the US-China trade war



VND

The Vietnamese dong will keep to its step-wise depreciation since the one-off CNY devaluation in August 2018. Vietnam's track record of ensuring macroeconomic stability has been recognised by debt-rating agencies. Standard & Poor's and Fitch have, in April-May, each upgraded the country's sovereign debt rating by a notch to BB. Vietnam has been able to achieve growth above 6% with an inflation rate below 4% and a Current Account surplus of 3% of GDP in recent years. The US has added Vietnam, its second-largest trade deficit with an emerging-Asia country, to its monitor list for currency manipulation.

Figure 12: The depreciation in the Vietnamese dong during CNY selloffs has been modest and orderly

Source: Bloomberg, DBS

Table 1: DBS currency forecasts

Exchange rates, eop								
	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
China	6.71	6.85	7.00	6.95	6.90	6.85	6.80	6.75
Hong Kong	7.85	7.85	7.85	7.84	7.83	7.82	7.81	7.80
India	69.2	70.0	71.0	71.5	71.0	70.5	70.0	69.5
Indonesia	14,243	14,300	14,500	14,400	14,300	14,200	14,100	14,000
Malaysia	4.08	4.20	4.25	4.23	4.21	4.19	4.17	4.15
Philippines	52.6	53.0	55.0	54.5	54.0	53.5	53.0	52.5
Singapore	1.36	1.37	1.40	1.39	1.38	1.37	1.36	1.35
South Korea	1135	1170	1180	1170	1165	1160	1155	1150
Thailand	31.7	32.0	33.0	32.8	32.6	32.4	32.2	32.0
Vietnam	23,189	23,400	23,500	23,450	23,400	23,350	23,300	23,250
Australia	0.71	0.68	0.64	0.66	0.68	0.70	0.72	0.74
Eurozone	1.12	1.10	1.08	1.09	1.10	1.11	1.12	1.13
Japan	111	110	112	111	110	109	108	107
United Kingdom	1.30	1.26	1.22	1.24	1.26	1.28	1.30	1.32

Australia, Eurozone, and United Kingdom are direct quotes.

Source: Bloomberg, DBS

Alternatives - Gold | 3Q19

Rising as safe asset

Source: AFP Photo

DBS

Live more, Bank less

Alternatives: Gold

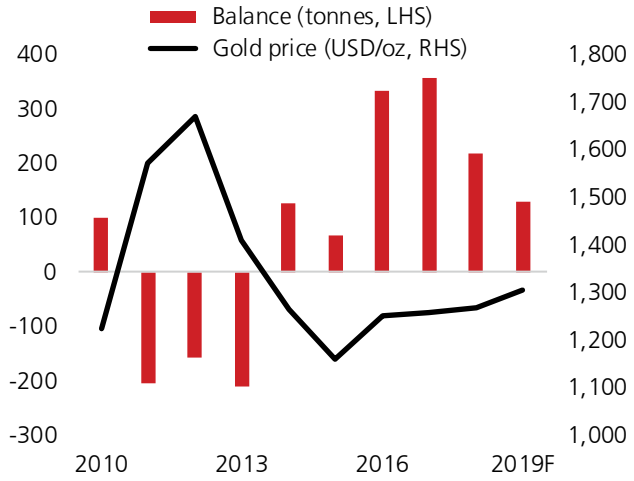
Eun Young Lee
Analyst

Expected to stay strong amid dovish Fed and weakening US dollar

Gold fell on the back of a strong US dollar in 2Q19. Despite the Federal Reserve's decision against raising rates this year, the US dollar continued to strengthen. This encouraged profit-taking from 1Q19's strong performance in gold, leading to fund outflow from gold ETFs and other financial products. The concern from the trade war between US and China fuelled the US dollar rally and dampened all asset classes, including gold.

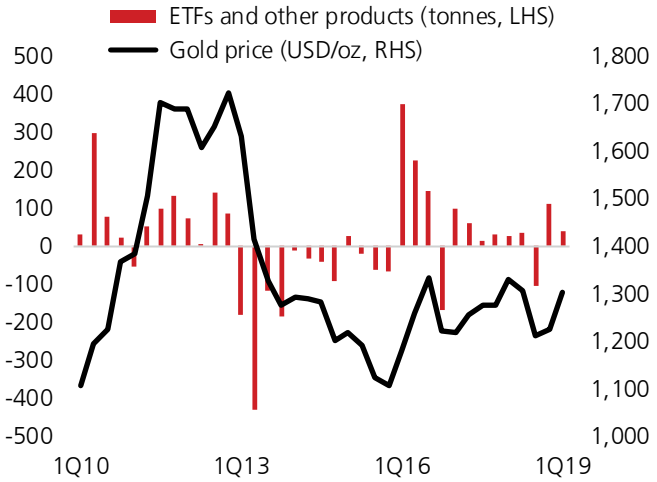
Weaker-than-expected physical demand from jewellery, bar, and coin. In 1Q19, jewellery demand grew marginally by 1.5% y/y, which is slow considering our annual growth forecast was 4% for 2019. Concurrently, demand for bar and coin saw a 1.4% y/y decline in 1Q19. This was due to weak demand from China, whose gold demand for jewellery and bar and coin declined by 2% and 8% y/y, respectively, along with its slowing macroeconomic conditions. We do, however, expect demand to pick up, as the recent gold price retreat would entice buyers to return.

Figure 1: Gold demand via ETFs and other products vs gold price



Source: World Gold Council, DBS

Figure 2: Global gold supply-demand balance and price forecast



Source: World Gold Council, DBS

De-dollarisation by central banks to persist. Central banks continued to add gold to their reserves in 1Q19, after recording a 50-year high in net purchases in 2018. Uncertainties surrounding the global economy continued to encourage gold buying by central banks. In line with the de-dollarisation policy, Russia was the largest buyer in 1Q19. We expect to see this trend persisting as Russia's head of central bank highlighted recently

that it was necessary to increase gold reserves even more, given the sanction risks. This move is in line with our view that demand from central banks would grow by a strong 10% in 2019, thus providing support to the gold price.

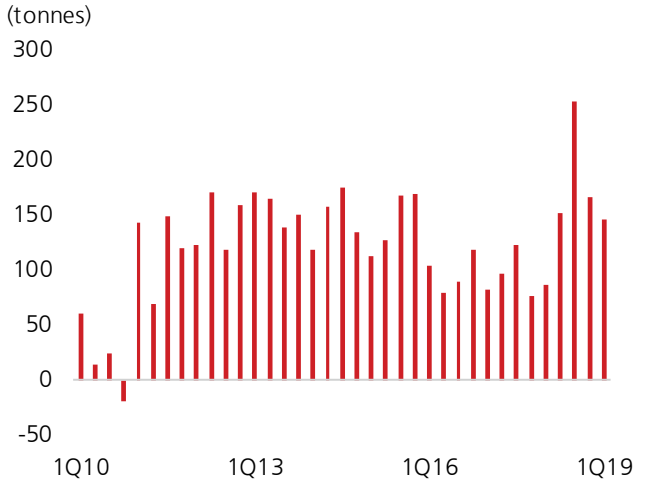
Raise our gold price forecasts. Talks of potential rate cuts, increasing fund inflows to the gold-related ETFs since mid-May, and US dollar's weakening will strengthen gold prices going forward. Also, delayed resolution of US-China trade issues and intensifying political conflicts between the US and Iran highlight gold as a safe asset. To factor in the improved environment surrounding gold, we raise our gold price forecast to average USD1,360 per ounce in 3Q19, 3.1% higher than our 2Q19 estimate of USD1,310 per ounce.

Table 1: DBS gold price forecasts

(USD per ounce)	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19F	3Q19F	4Q19F
LBMA Gold Price (average)	1,329	1,306	1,213	1,226	1,304	1,310	1,360	1,370
y/y (%)	9.0%	3.9%	-5.1%	-3.9%	-1.9%	0.3%	12.1%	11.7%
q/q (%)	4.2%	-1.8%	-7.1%	1.1%	6.3%	0.5%	3.8%	0.7%

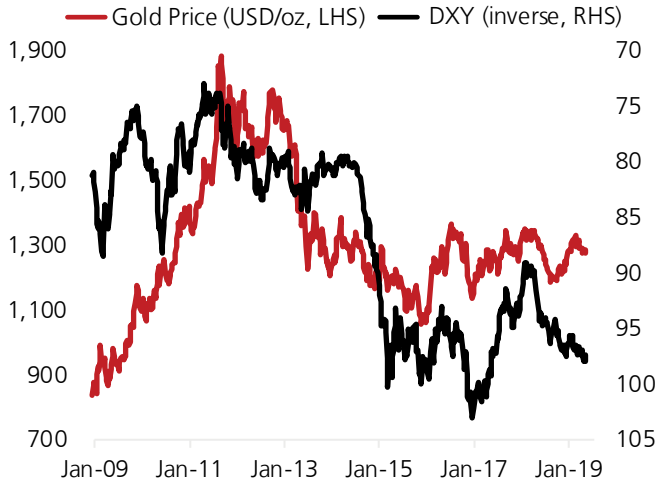
Source: World Gold Council, DBS

Figure 3: Gold demand from central banks and other institutions



Source: World Gold Council, DBS

Figure 4: Gold price vs DXY



Source: Bloomberg, DBS

CIO Thematic Research | 3Q19

Cloud Computing

Source: AFP Photo

DBS

Live more, Bank less

Theme I: Cloud Computing

Yeang Cheng Ling
Strategist

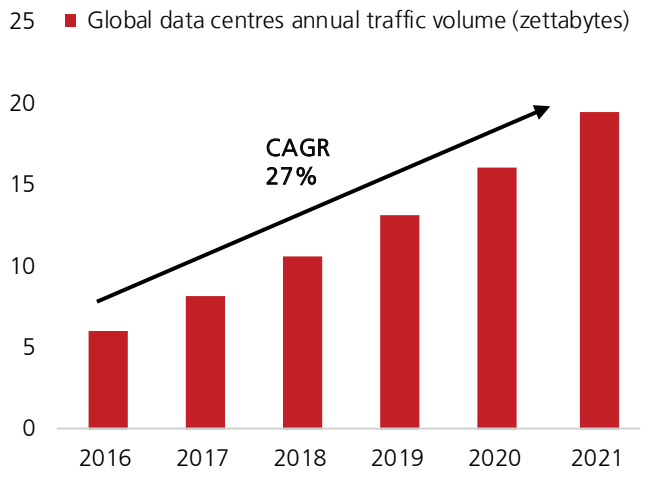
Rising, thickening, and deepening

Data is the new oil, and data management is the key for corporates to stay on top of the competition. Today, companies that operate in different jurisdictions, with distinctive structures, and have global operations can function flawlessly. Say "hi" to cloud computing that is powered by data.

Cloud computing operates by combining physical and virtual links, allowing users direct access to systems from any location. The storage and delivery of data happens via web browsers, computer operating systems, and networks connected through an Internet of Things (IOT).

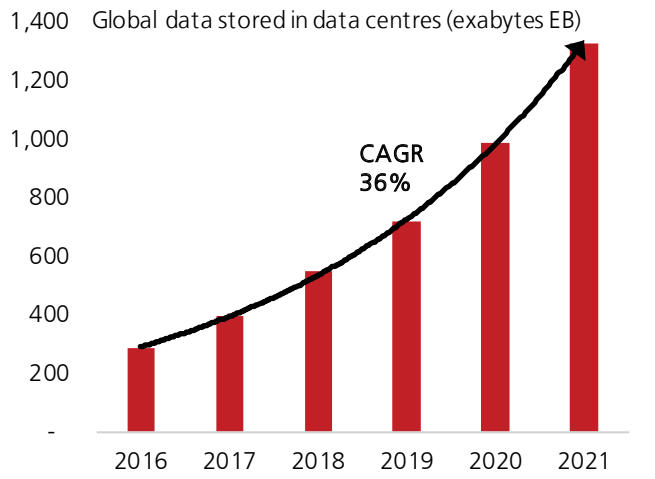
Data traffic flow (Figure 1) and storage (Figure 2) usage are anticipated to record a phenomenal surge globally, giving rise to demand for reliable cloud services. As companies expand their global footprint, they face uncompromised needs for quality and disaster recovery to prevent disruption of day-to-day operations. An effective solution for these firms hinges upon the reliability of cloud computing to dispense storage, communications, data, processes, and applications through the network.

Figure 1: Global traffic flow at data centres is projected to increase



Source: Cisco, DBS

Figure 2: Data volume is on exponential rise



Source: Cisco, DBS

Cloud usage is growing. Cloud computing covers an immense range of services. The distinction between usage and end markets are increasingly being blurred as cloud computing gets more common and blends into core operations of government agencies and corporates, as well as the day-to-day lives of individuals (Table 1).

Table 1: Areas of cloud adoption

Enterprise usage	Individual usage
Data storage and management	Video/movie streaming
Data analytics	Infotainment
Fintech	Online search
e-Commerce	Broadband communications
Medical technology	Medical records
Content services	Online gaming (e-Sports)
Industrial automation	Social networking
Publications	Personal finance
Information backup and recovery	
Financial services	
Application development	

Source: DBS

The IOT ecosystem is fast expanding thanks to the power of cloud computing, and is spurring the growth in TAM

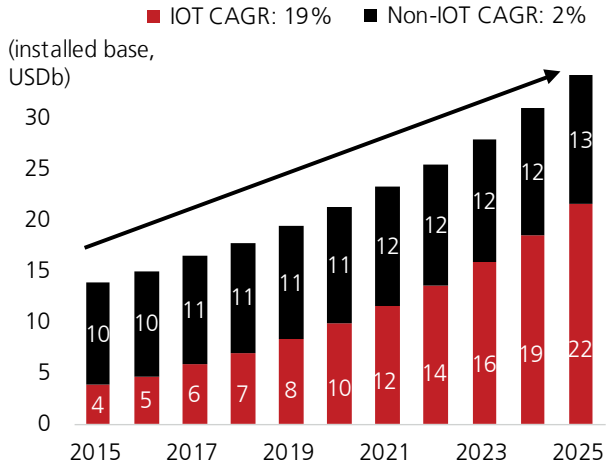
The connected world: a big market with enormous opportunities. Global spending on cloud-computing services, being an integral component of the entire IOT ecosystem, will leapfrog at an astounding pace. Growing Internet protocol (IP) traffic, data size, usage frequency, increasing on-the-go user behaviours, and format complexity have cultivated the rising adoption of cloud-computing services. Constant expansion in active connections of smart devices further supplements the development of cloud computing (Figure 3).

As a result, the IOT total addressable market (TAM) size is expected to double between 2016 and 2021 to USD1.1t, giving rise to investment opportunities in the cloud-computing space and other IT sectors (Figure 4). These include network devices, backhaul architecture, application software, as well as installation, maintenance, and other ongoing services.

Benefits of public clouds

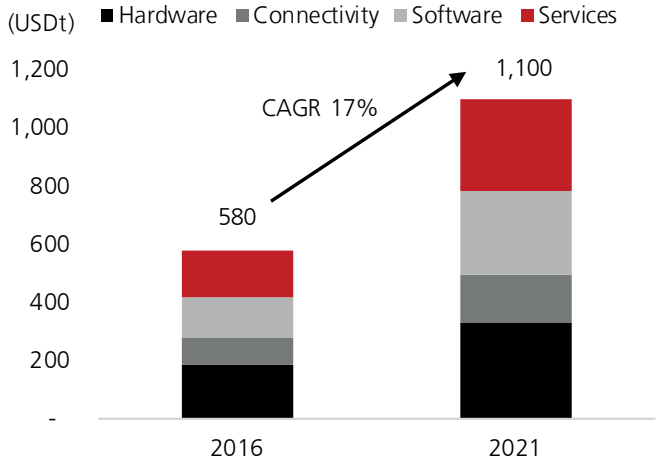
1. Flexibility: The usage, types, and scales can be customised.
2. Reliability: Providers of cloud services take full responsibility of service quality for a fee.
3. Convenience: Cloud service providers undertake all maintenance responsibilities.
4. Cost savings: Hardware and software are provided and end users only pay for the desired level of service.
5. Locations: Enables concurrent access in multiple locations.

Figure 3: Total number of global active IOT connections is on a constant rise



Source: IOT analytics research, DBS

Figure 4: Global spending on IOT capacity to double in five years

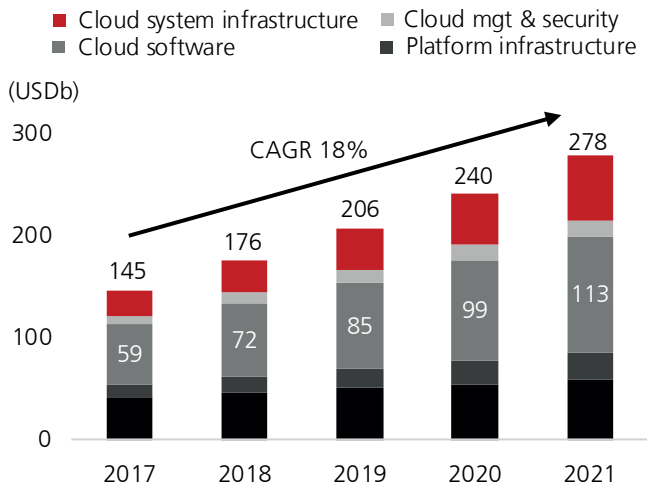


Source: Gartner, Bloomberg, DBS

Prospects are bright given the sector's versatility and rising demand for the public cloud

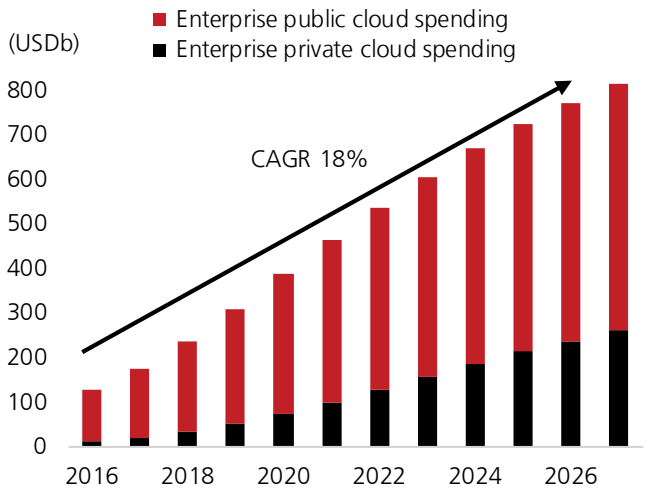
Against the backdrop of rising demand, companies providing third-party and public cloud services will see their revenue fast expanding at CAGR of 18% between 2017 and 2021 (Figure 5). Cloud-services platforms are constantly evolving and becoming interlinked, interrelated, and interdependent. This is driven by four main categories, namely: infrastructure as a service, platform as a service, software as a service, and business process as a service (Table 2). As such, enterprise spending on cloud-related services is projected to grow at CAGR of 18% from 2016-27 (Figure 6).

Figure 5: Worldwide public cloud service revenue forecast



Source: Gartner, Forbes, DBS

Figure 6: Total enterprise spending on public cloud to surge in the coming years



Source: Gartner, Bloomberg, DBS

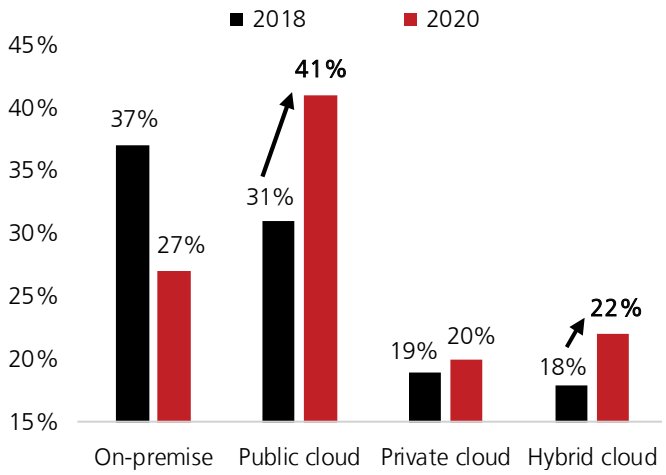
Table 2: Categories of cloud services and infrastructure

Category	Form	Function
Infrastructure as a service (IaaS)	Basic	Virtual network infrastructure, data storage, and servers.
Platform as a service (PaaS)	IaaS + operating system	Configuration and management of data base.
Software as a service (SaaS)	PaaS + on-demand software	Software installation, updates, and downloads are done via cloud network. Commonly used among corporate users for office applications.
Business process as a service (BPaaS)	Extension of SaaS	Operating of business processes on cloud platforms, coordinating the processing works on cloud.

Source: DBS

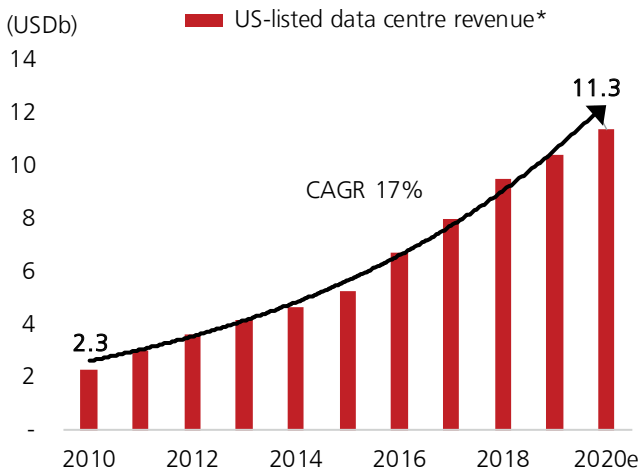
This is again augmented by ongoing migration of data workloads toward public and hybrid cloud (Figure 7) among corporates, as shown by the exponential revenue increase among the leading US-based data centre operators (Figure 8).

Figure 7: Allocation of enterprise data workloads between 2018 and 2020



Source: Logicmonitor, Forbes, DBS

Figure 8: Data centres to enjoy strong growth



*Note: This is the combined revenue of CyrusOne, Digital Realty, Equinix, and Coresite.

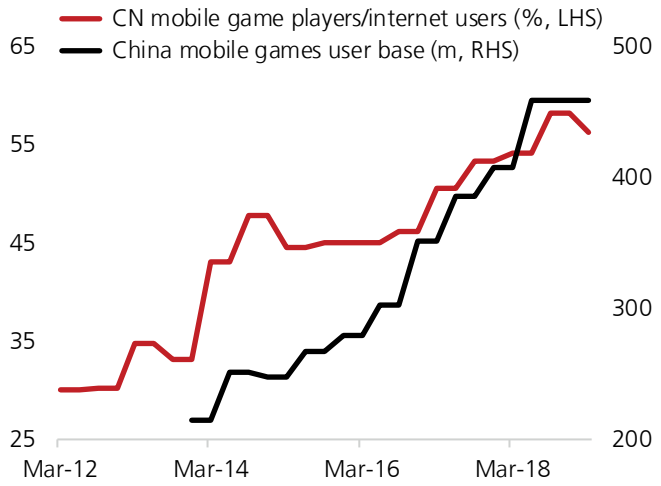
Source: Bloomberg, DBS

e-Sports: A new element. The fast-rising online- and mobile-gaming sector is emerging as another new growth driver. Microsoft's xCloud and Google's Stadia could drive the migration to cloud gaming and elevate the gaming landscape to unprecedented horizons.

Aided by the Millennial lifestyle, online gaming is another new growth driver

In China, the number of mobile-game players and penetration rates are growing steadily (Figure 9), while the monthly total hours spent playing online games and spending on massive multiplayer online games (MMOG) has consistently grown since 2010 (Figure 10).

Figure 9: China mobile-game players and penetration is on the rise



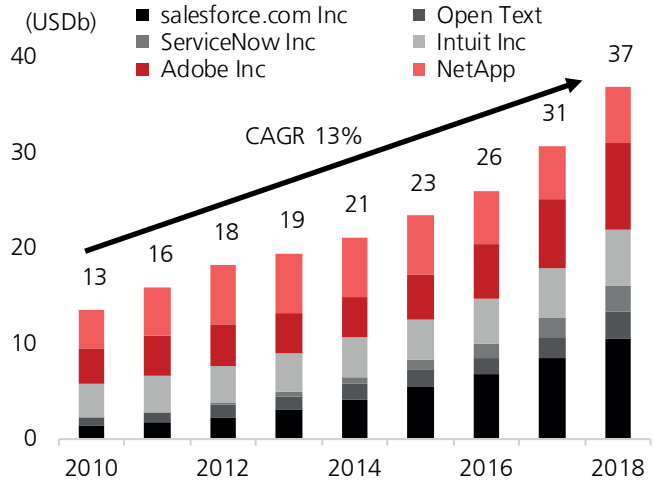
Source: China Internet Network Information Center, Bloomberg, DBS

Figure 10: China online-game industry is prospering and resilient

Source: iResearch, Bloomberg, DBS

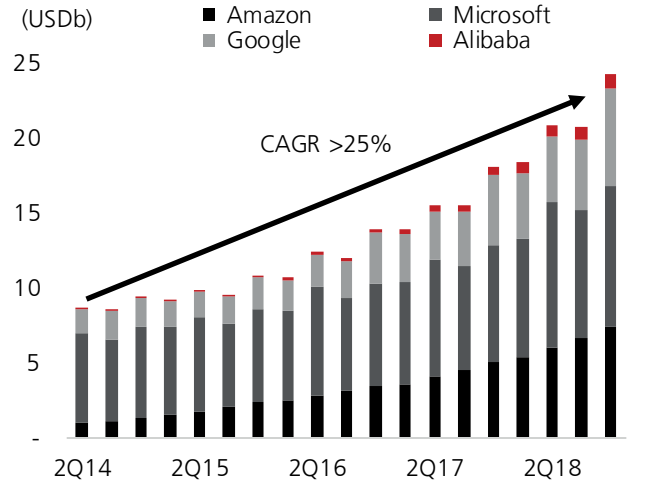
Cloud-platform growth still in its infancy. The revenue stream of companies providing cloud-based applications has been on a solid uptrend since 2010 (Figure 11). The success was achieved by riding on independent cloud platforms, which, too, have grown from strength to strength. The annual revenue of the top four cloud-platform providers has accelerated at CAGR of more than 25% since the start of 2014 (Figure 12). We believe there is potential upside in the coming years.

Figure 11: Revenue of cloud-base application providers



Source: Bloomberg, DBS

Figure 12: Revenue of world's leading cloud providers



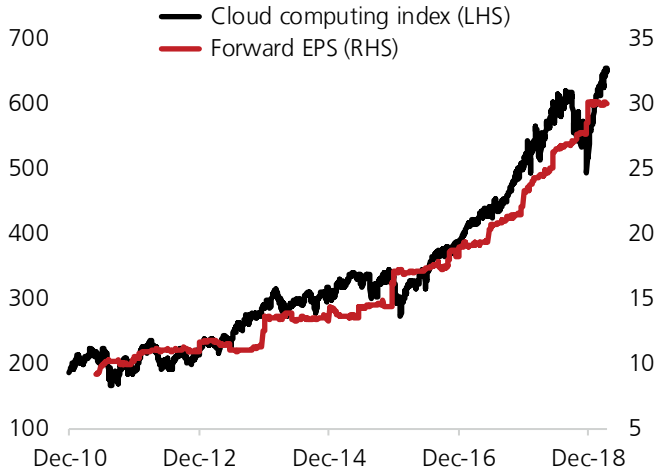
Source: Bloomberg, DBS

Solid revenue trends are evidence of the sector's growth ability. Sustainable profitability is supportive of the investment theme and outlook

Steady earnings growth and solid shareholder returns. Since the start of this decade, the sector has gone through remarkable earnings growth and this has buoyed the price performance of industry players (Figure 13). The magnitude and consistency in earnings outlook are clear testimonies of the cloud industry's superior outlook, thus capturing the attention of investors who are looking for a secular investment trend.

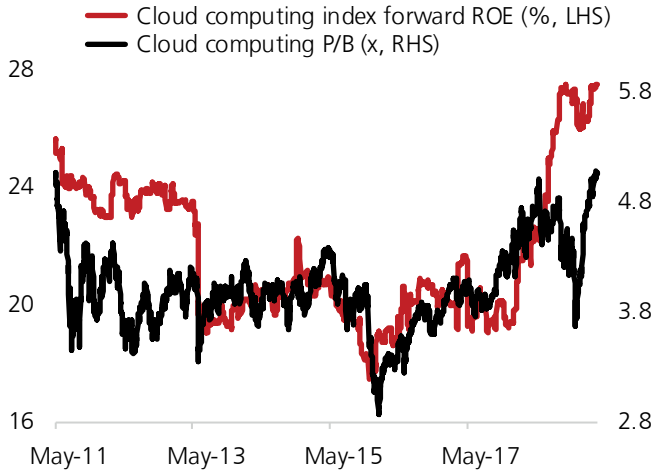
Notably, the admirable shareholder returns will reinforce the expansion in valuation multiples. Projected ROE is fast approaching 28% from 2015's low of 18%, validating our view of a sector that is being re-rated (Figure 14).

Figure 13: Strong earnings outlook to drive share-price upside



Source: Bloomberg, DBS

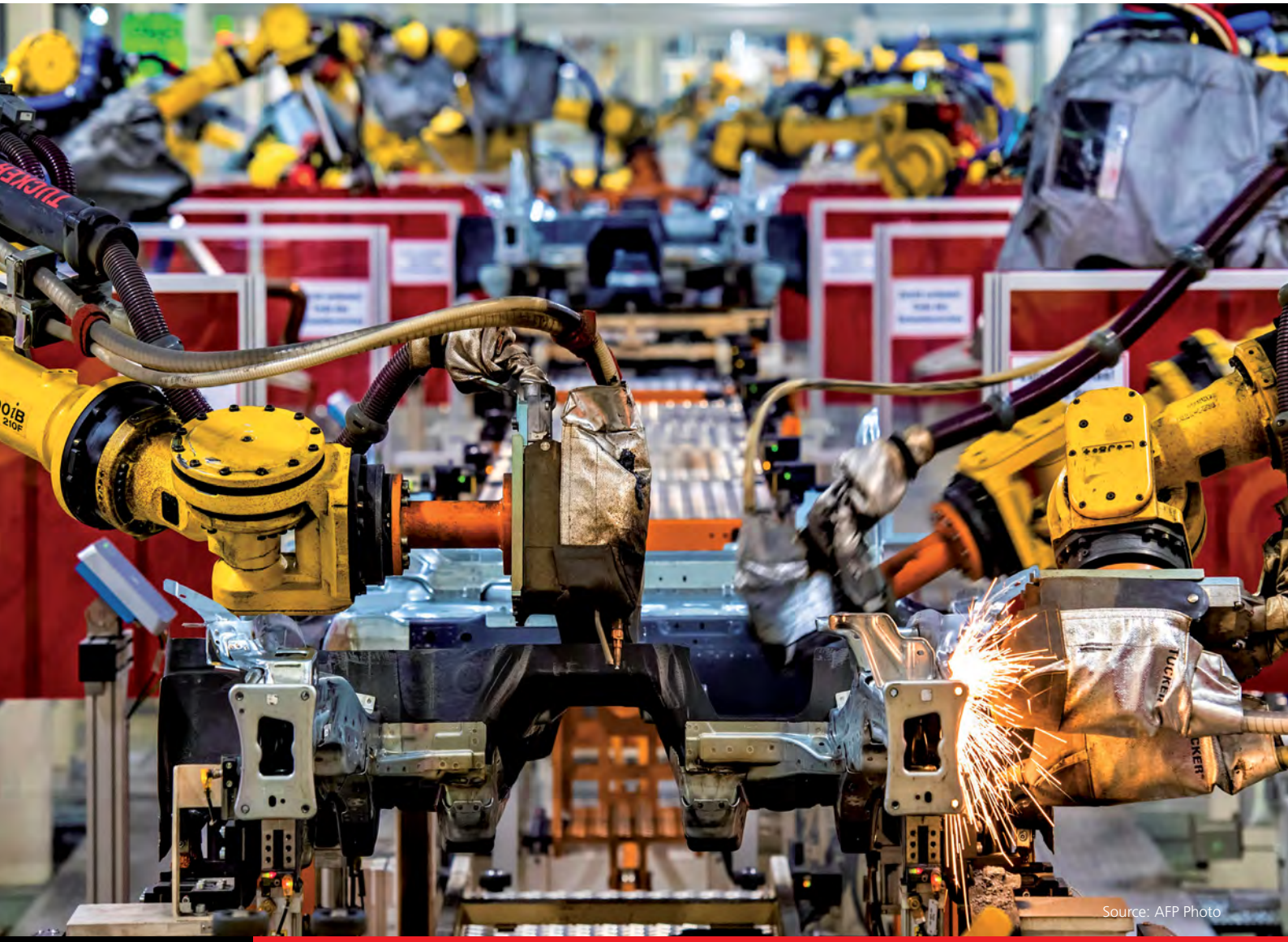
Figure 14: Strong trend in projected ROE to support the expansion of valuation multiples



Source: Bloomberg, DBS

CIO Thematic Research | 3Q19

Automation and Industry 4.0



Source: AFP Photo

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Theme II: Automation & "Industry 4.0"

Yeang Cheng Ling
Strategist

Dylan Cheang
Strategist

Global manufacturing redefined

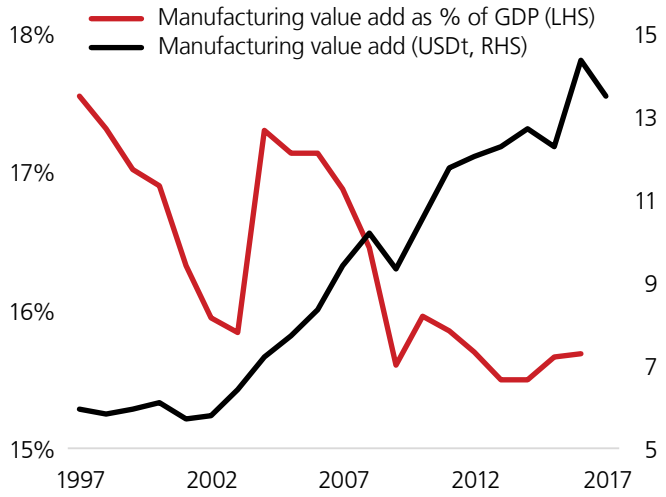
Just like how e-Commerce transformed the global retail market, automation and "Industry 4.0" are causing a renaissance in global manufacturing. What is "Industry 4.0"? Essentially, this refers to manufacturing processes that integrate automation, robotics, and the Internet of Things (IOT).

Today, we are living in a world where change is a constant and unsurprisingly, the dire need to enhance production efficiency has driven the shift toward "smart factories" which adopt data and analytics, collaborative robots ("cobots"), cloud computing, cognitive computing, and 3D printing.

These advancements have redefined the global manufacturing landscape and created the fourth industrial revolution, termed "Industry 4.0".

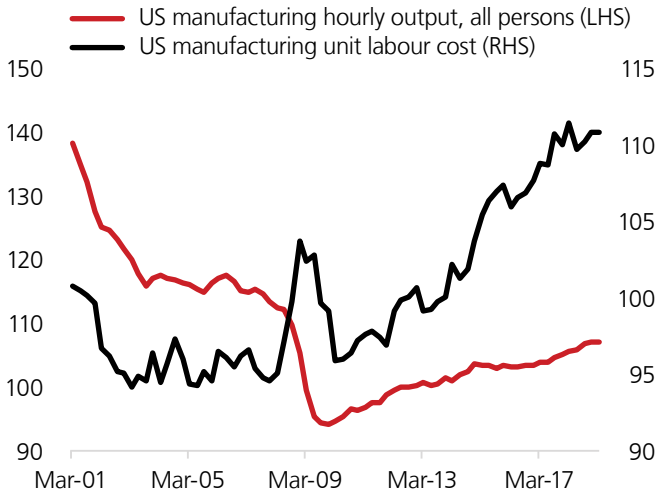
The need for speed: Automation holds the key in tackling productivity challenges. Manufacturing value-add as a percentage of global GDP has been on a downward spiral since 2003 and is now languishing in the 15-16% range amid weakness in productivity growth (Figure 1). In the US, hourly manufacturing output has also stagnated since 2010 as rising unit labour costs failed to translate into higher production output (Figure 2).

Figure 1: Global manufacturing value-add needs a boost



Source: World Bank, DBS

Figure 2: Productivity has failed to improve in tandem with wages in the US



Source: Bloomberg, DBS

Such productivity issues are likely to persist in the foreseeable future as global manufacturing faces the challenges of: (a) Rising wages; (b) Urbanisation; and (c) Changing demographics. Such headwinds highlight the need to upgrade manufacturing productivity through automation.

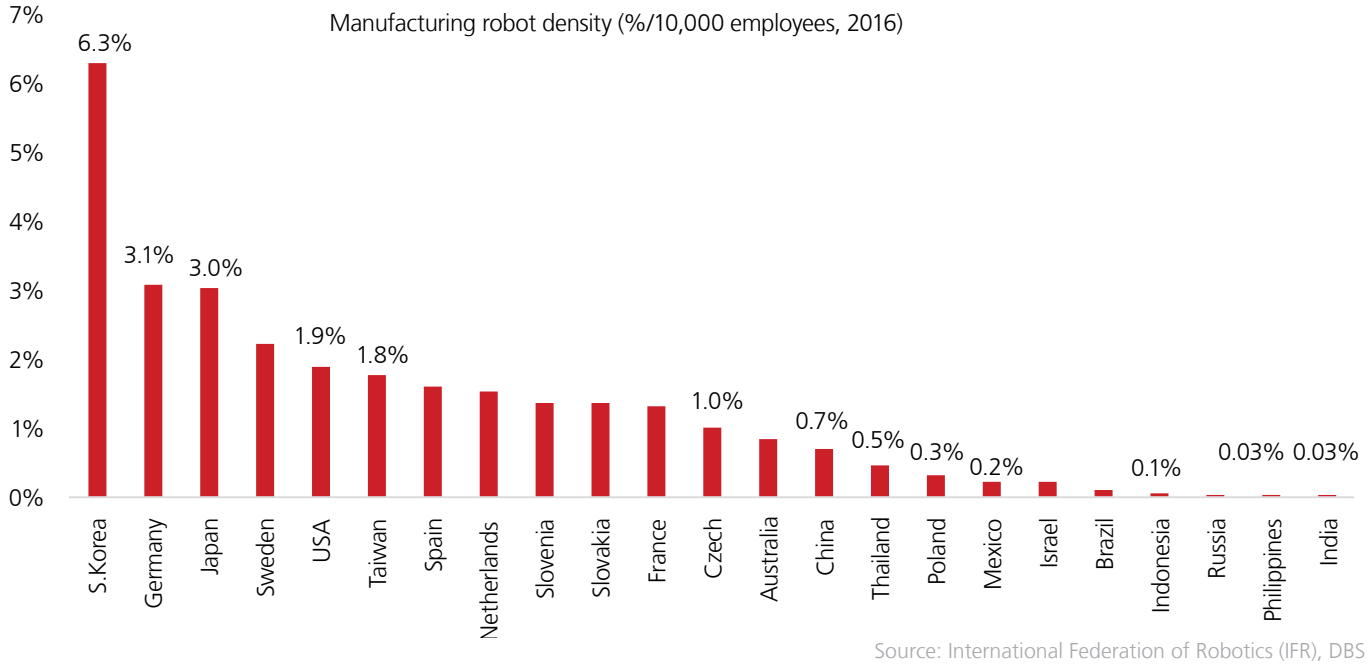
We expect adoption of automation to surge as emerging countries expand their manufacturing capabilities

The rise of the machines: Enormous growth potential for industrial robot use in manufacturing. The use of industrial robots in manufacturing is on the rise. Today, it is widely adopted in the semiconductor, technology hardware, automotive, logistics, pharmaceutical, and food services industries. Growth has been robust. Back in 2015, the ratio of industrial robots to every 10,000 manufacturing workers stood at 66. But within a short span of one year, the ratio shot up to 74 – a growth rate of 12%. Given rising needs for automation globally, the level of industrial robot usage in manufacturing will remain on a steep upward trajectory in the coming years.

South Korea has the highest robot density of 6.3% in its manufacturing sector (vs global average of 0.74%). This is followed by Germany and Japan at 3.1% and 3.0%, respectively, while the US and Taiwan have densities of 1.9% and 1.8% (Figure 3).

At the other end of the spectrum, Indonesia and India have extremely low densities of 0.05% and 0.03%, respectively. But as these countries gradually develop their manufacturing capabilities, the potential for robotics adoption in the years ahead will be enormous.

Figure 3: Huge room for robotics adoption in EM

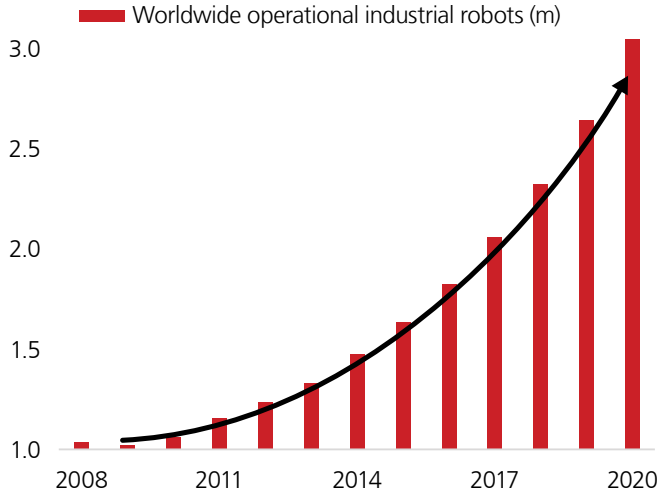


Source: International Federation of Robotics (IFR), DBS

Upward trajectory of automation to stay intact amid favourable supply-demand factors. According to the International Federation of Robotics (IFR), there will be more than 3m industrial robots operating in factories globally by 2020, double the number in 2014 (Figure 4). The upward trajectory of robotics use is expected to stay intact given favourable supply-demand dynamics.

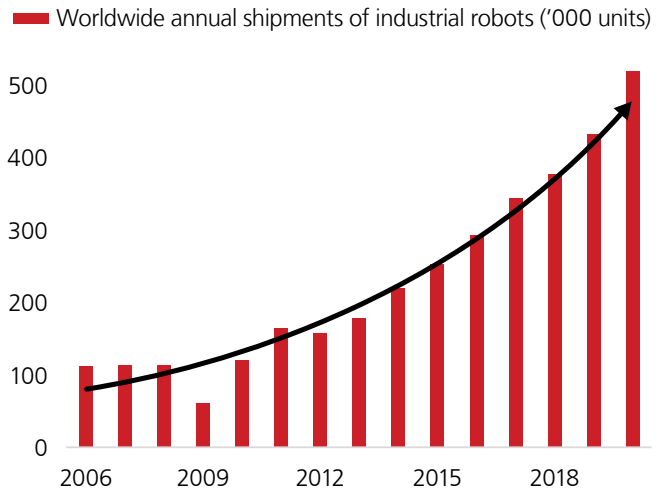
On the demand side, rising necessity for automation in various industries will drive order flows in the coming years (Figure 5). According to the International Data Corporation (IDC), up to 60% of manufacturers will utilise digital platforms to generate 30% of revenue by 2020. Additionally, about 80% of manufacturing interactions along the supply chain will be conducted across cloud-based networks to minimise disruption.

Figure 4: Global adoption of industrial robots is growing



Source: IFR World Robotics, DBS

Figure 5: Global industrial robot shipments are rising

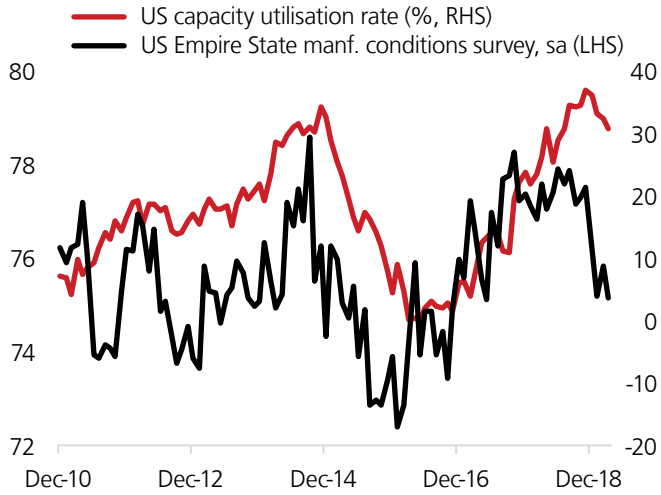


Source: IFR Statistical Department, DBS

Factory automation is the key to boosting capacity utilisation and manufacturing yields

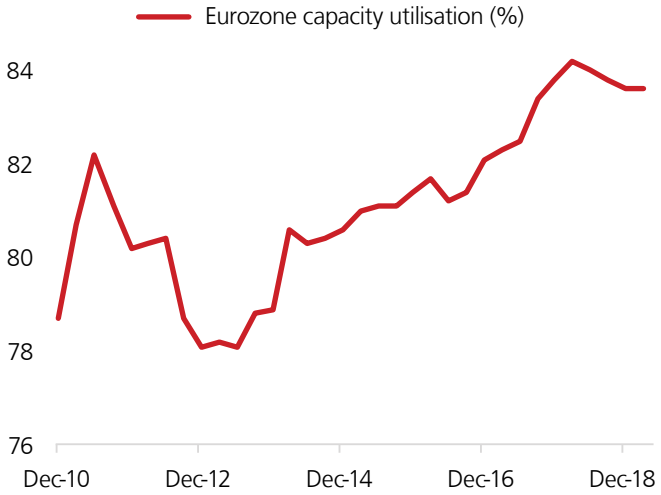
Meanwhile, capacity utilisation rate in the developed world is peaking and there is an obvious need to alleviate the bottlenecks. Despite uncertainties brought on by the US-China trade war, utilisation rates in the US and Eurozone remained high in 2018 due to the resilience in demand (Figure 6 and 7). Now, should the trade war reach a resolution, manufacturing activities will recover which would necessitate further automation.

Figure 6: US manufacturing utilisation rate is at a peak, expectations are likely to rebound



Source: Bloomberg, DBS

Figure 7: Eurozone capacity utilisation rate is on the rise too



Source: Bloomberg, DBS

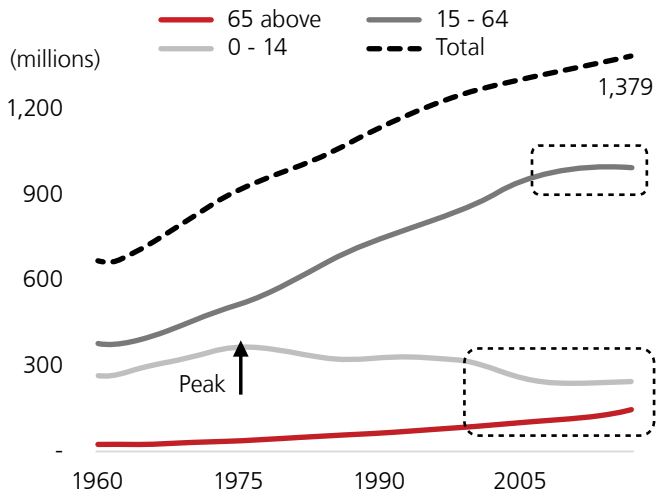
Conducive global demand backdrop for automation. The vast manufacturing sector in China is facing the twin headwinds of rising wages and an ageing population.

Rising wage pressure in China undermines the country's ability to excel in large-scale labour-intensive manufacturing (Figure 8). The world's most-populated country is ageing fast – its population aged 65 and above is rising while the number of people at productive age has peaked. Notably, the size of young population aged 0-14 peaked in 1976 and has since persistently declined, denying the country's population replacement (Figure 9). Therefore, the need for a productivity shift presents another secular tailwind driving the adoption of automation in China's vast manufacturing sector.

Figure 8: Rising wages in China

Source: Bloomberg, DBS

Figure 9: China population by age group, 1960-2017



Source: World Bank, DBS

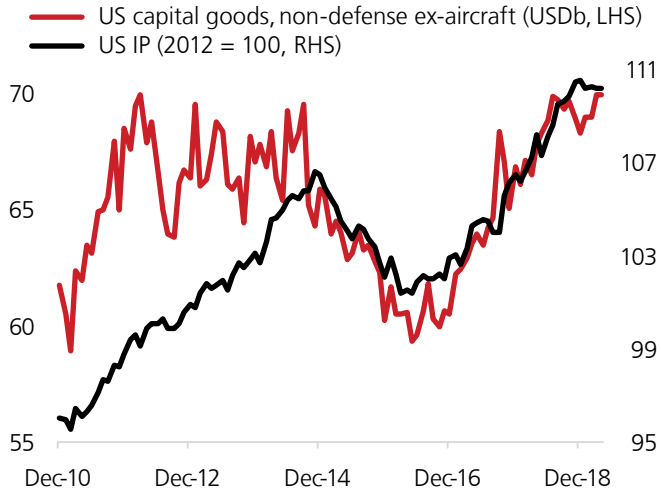
Evidence points toward robust capital spending on machinery and factory equipment

The US's new orders of capital goods (non-defence ex-aircraft), a closely-watched proxy to business spending outlook, rose to a historical monthly high of USD70b in March 2019, pointing toward improvement in corporate capital expenditure spending and capacity expansion. Industrial production similarly stayed at a historical peak (Figure 10). Across the Pacific Ocean, orders for Japan's high-tech production equipment and machinery tools demonstrated a recovery. Manufacturers in Asia and the US are loading up and preparing for an uplift in end demand, in the event of a possible trade settlement between the US and China (Figure 11).

The road ahead for automation and Industry 4.0. Industry 4.0 and factory automation will see manufacturing processes transition from legacy systems to smart components/ machines. Eventually, this will result in the formation of an ecosystem consisting data, plants, and enterprises. According to a recent study, over 45% of activities performed by humans can now be automated.

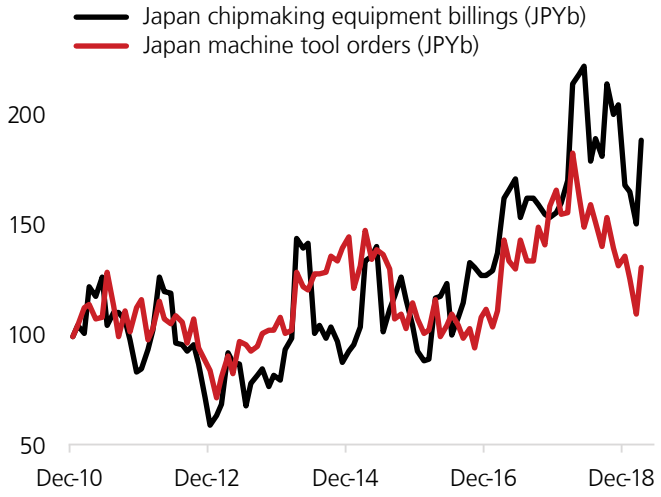
Potential for CAGR of 9%. Based on estimates from Transparency Market Research, the global industrial automation market was valued at USD182.6b in 2015 and it is expected to reach USD352.0b by 2024, constituting a CAGR of c.9% between 2016 and 2024. As global competition and customer requirements rise, manufacturers worldwide will be compelled to adopt newer technologies and solutions to enhance the efficiency of their business processes.

Figure 10: US capital goods spending and industrial production are on the rise



Source: Bloomberg, DBS

Figure 11: Japan robotics orders are on a broad-based uptrend



Source: Bloomberg, DBS

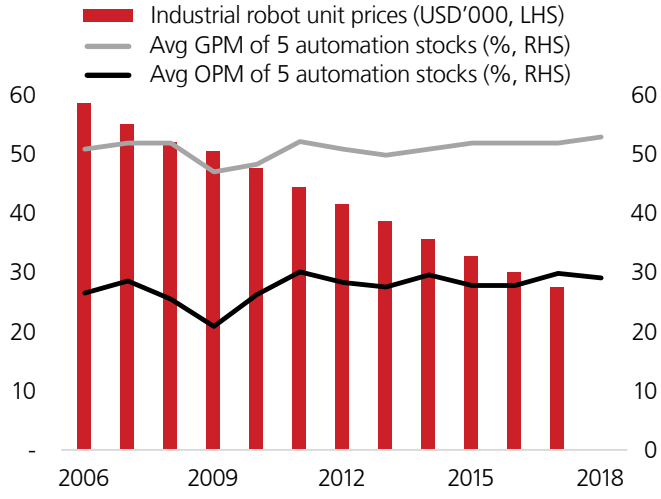
Apart from steady demand, falling equipment costs also support the growth of automation. The ASPs of standard industrial robots are getting more affordable and this drives adoption.

Resilient earnings quality to support sector re-rating and valuation upside

Interestingly, this did not translate to lower profitability for robot producers as they were able to add more functionalities to industrial robotics, such as machine learning, IOT connectivity, and AI. This underscores the sector's ability to innovate and transform, and be at the forefront of a global transition (Figure 12).

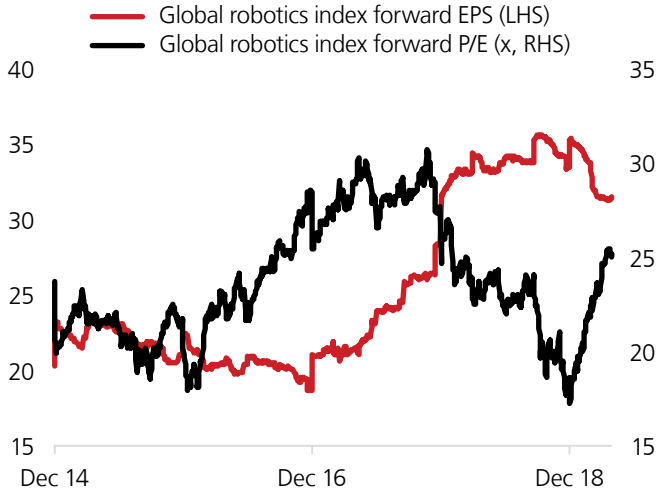
From an investment perspective, the sector's forward P/E of 25x is not excessive due to its future earnings potential (Figure 13) and expanding total addressable market.

Figure 12: The sector's profitability is unfazed by declining unit prices



Source: AKR Invest, Bloomberg, DBS

Figure 13: Strong earnings potential to support forward valuations



Source: Bloomberg, DBS

Secular developments support the sector. We highlight several recent developments undertaken by the major economies that are positive for the sector:

- Germany introduced Industry 4.0 under the "High-Tech Strategy 2020" initiative to drive the emergence of "smart factories".
- In the US, the General Electric-led Industrial Internet Consortium (IIC) is seeking to develop a US-based new manufacturing standard.
- In Japan, Fanuc is collaborating with Cisco and Rockwell Automation to jointly develop the Fanuc Intelligent Edge Link and Drive (FIELD) system capable of incorporating computer numerical control (CNC) machines, manufacturing robots and sensors in the product lines.

All in all, automation and robotics are developed to facilitate the adoption of next-generation manufacturing processes. The ultimate aim is to integrate the processes, applications, and equipment into one single platform.

In short, the automation journey has just begun and there is enormous room for it to grow.

Special Feature | 3Q19

New Defensives

Source: AFP Photo

DBS

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Special Feature I: New Defensives

Dylan Cheang
Strategist

Yeang Cheng Ling
Strategist

Based on conventional wisdom, an investor should buy "defensive" companies in a challenging economic environment. The rationale is simple. Defensive companies tend to generate stable income even when aggregate demand is falling. This can be attributed to:

1. The products the company sells are more "staple-like" (and hence, there is less elastic demand).
2. The services the company provides are deemed a necessity.

In theory, a company or sector is seen as defensive if it possesses one or more of the following traits: (1) generates stable revenue and earnings through the business cycles; and (2) provides stable dividend streams through the business cycles.

Conventional classification of defensive sectors. Traditionally, sectors that are classified as defensive within the GICS (Global Industry Classification Standard) system are: Consumer Staples, Communication Services, Health Care, and Utilities. These sectors are perceived as defensive because the end demand tends to remain resilient even when the broader economy is facing headwinds.

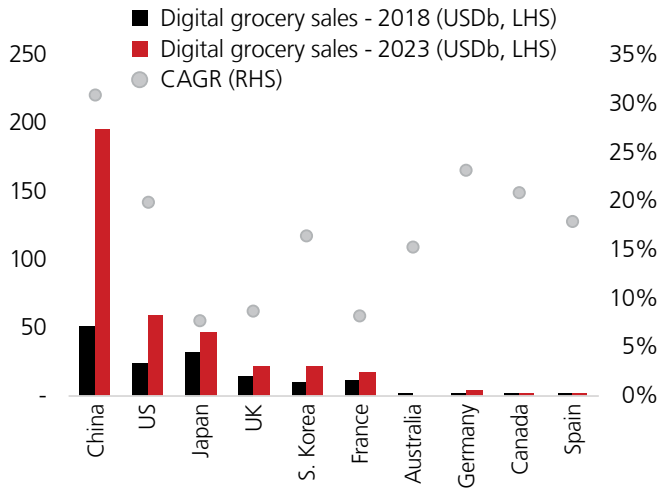
Take the Consumer Staples sector for instance. This segment consists of food, beverages, as well as personal and household products companies. End demand is resilient because regardless of the economic situation, basic necessities such as food remain essential and uncompromising in need. The same can be said for the Utilities sector. Regardless of how the economy is faring, we still need electricity and water for daily life.

Technological Disruption: The major game changer. Investors have long held on to the traditional definition of what constitutes "defensive". But with rapid technological advancements, things are no longer the same. Key industries around the world are being disrupted and the old assumptions are now facing serious challenges.

A clear case in point of disruptive technology is the hypermarket industry. Today, with the onslaught of online shopping and food delivery services, who needs to go to a brick-and-mortar store to buy household goods? Global online grocery sales is expected to register strong growth in the coming years. According to IGD, a food and grocery industry research centre, total online grocery sales for select countries is expected to increase from USD147.9b in 2018 to USD374.9b by 2023 – constituting a CAGR of 20.4% (Figure 1). On a geographical basis, China is expected to account for the largest share at USD196.3b (CAGR of 31.0%), followed by the US at USD59.5b (CAGR of 20.0%), and Japan at USD46.5b (CAGR of 7.8%).

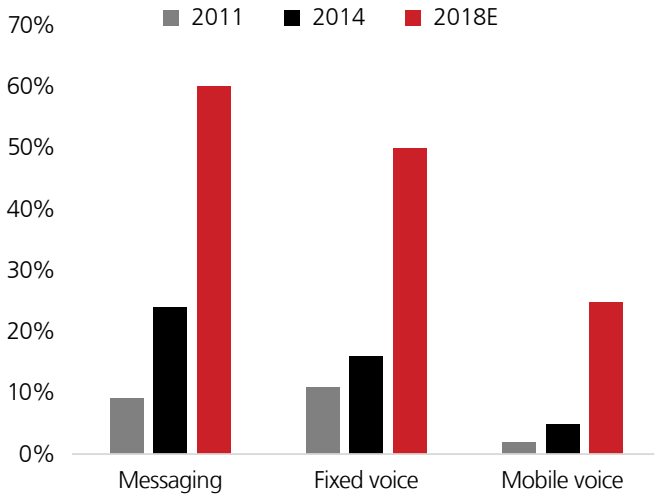
Another sector facing disruption is Communication Services. Telcos used to enjoy monopoly-like status, but not anymore. Today, they are struggling to increase their ARPU (average revenue per user) amid rising challenges from the digital wave. New OTT (Over the Top) services – such as Skype, Apple's Facetime, and Tencent's WeChat – offer more attractive and innovative communication services. According to McKinsey, the percentage share of messaging and mobile voice revenue accounted for by OTT players have increased from 9% and 2%, respectively in 2011 to approximately 60% and 25%, respectively by 2018 (Figure 2).

Figure 1: Global online grocery sales will see exponential growth in the years ahead; e-Commerce companies are geared beneficiaries



Source: IGD, eMarketer

Figure 2: OTT's share of traditional telco services



Source: McKinsey

Challenging the status quo: Technology and Consumer Discretionary are the New Defensives

As digitisation increasingly leads to the disruption of traditional industries, the business models of both Technology and Consumer Discretionary companies have evolved as well. In our analysis, we combined Technology and Consumer Discretionary into one entity termed as the "New Defensives" (Note: e-Commerce companies are classified under Consumer Discretionary while hardware companies facilitating e-Commerce/e-Payment come under Technology).

As the adoption of e-Commerce gathers pace, Technology and Consumer Discretionary sectors are increasingly exhibiting "defensive" characteristics

These sectors have traditionally been deemed as "cyclical", as their end demand highly correlates with the ebbs and flows of the global economy. When the global economic cycle is in an expansionary mode, the end demand for their products/services grows exponentially. Conversely, the reverse happens when the economic cycle turns. This differs from defensive sectors that are more "non-cyclical" in nature, given their resilient end demand.

But things are starting to change.

As the adoption of e-Commerce gathers pace, the Technology and Consumer Discretionary sectors are increasingly exhibiting "defensive" characteristics.

Defensive Characteristic (1): Resilient revenue during macro slowdown. As Technology/Consumer Discretionary companies start to entrench themselves in more "staple-like" businesses (such as grocery retail for instance), the resilience of such end demand would result in the stabilisation of revenue for e-Commerce (and related) companies. Our analysis of recent revenue data supports this view.

Figure 3: Periods where the US economy faced substantial headwinds

Source: Bloomberg, DBS

Figure 3 highlights three periods where the US economy underwent substantial contraction:

- Dot-com Crisis of 2001
- Subprime Crisis of 2008
- Recent US economic slowdown from 2015-16

Tracking the revenue per share data for both Old and New Defensives unveiled interesting results.

- Dot-com Crisis: During the Dot-com Crisis, US GDP growth moderated from 7.6% in 2Q00 to 2.1% in 4Q01. Unsurprisingly, revenue for New Defensives fell 3.3% during this period while revenue for Old Defensives grew 5.6%.

- Subprime Crisis: The Subprime Crisis in 2018 saw a similar outcome. US GDP growth moderated from 4.8% in 3Q07 to -3.1% in 2Q09. Again, revenue for New Defensives corrected 5.2% while Old Defensives gained 24.0%.

- 2015-16 Slowdown: However, the situation has reached a turning point in recent years. During the 2015-16 US economic slowdown, GDP growth moderated from 5.1% in 1Q15 to 2.3% in 2Q16. Surprisingly, while revenue for Old Defensives dipped modestly by 0.5%, New Defensives' revenue actually gained 7.1%.

Table 1: Revenue impact during periods of economic slowdown

	Dot-Com Crisis (2Q00 - 4Q01)	Subprime Crisis (3Q07 - 2Q09)	2015-16 Slowdown (1Q15 - 2Q16)
Moderation in GDP growth	7.6% to 2.1%	4.8% to -3.1%	5.1% to 2.3%
Old Defensives* - Change in revenue	+5.6%	+24.0%	-0.5%
New Defensives** - Change in revenue	-3.3%	-5.2%	+7.1%

Note: (a) * Proxied by US Consumer Staples , (b) ** Proxied by US Technology and US Consumer Discretionary

Source: Bloomberg, DBS

Through e-Commerce, Technology/Consumer Discretionary are entrenching themselves in "staple-like" industries

Interestingly, the strong showing from New Defensives coincides with the rapid growth of e-Commerce in recent years. Rising adoption of smartphones and faster Internet speed has driven consumer spending from offline to online. Through e-Commerce, Technology/ Consumer Discretionary companies are entrenching themselves in more "staple-like" industries, either directly or indirectly. This, in our view, will increase the resilience and stability of earnings in this space.

Defensive Characteristic (2): Thick margins to buffer against macro weakness. Apart from having resilient revenue streams during periods of economic stress, the Technology and Consumer Discretionary sectors are also able to generate higher profitability during those periods.

- Dot-com Crisis: In the early days, Technology/Consumer Discretionary struggled to generate profitability. When US GDP growth moderated during the Dot-com crisis, the average difference in operating margins between the New and Old Defensives were negative, at -4.0%pts.

- Subprime Crisis: By 2008, things had evolved. Despite the moderation in US economic growth, New Defensives managed to produce a slightly higher OPM (at 0.6%pts premium) than Old Defensives.

- 2015-16 Slowdown: In recent years, the situation underwent a complete change. During the 2015-16 slowdown, the average OPM for New Defensives was 6.6%pts higher than Old Defensives.

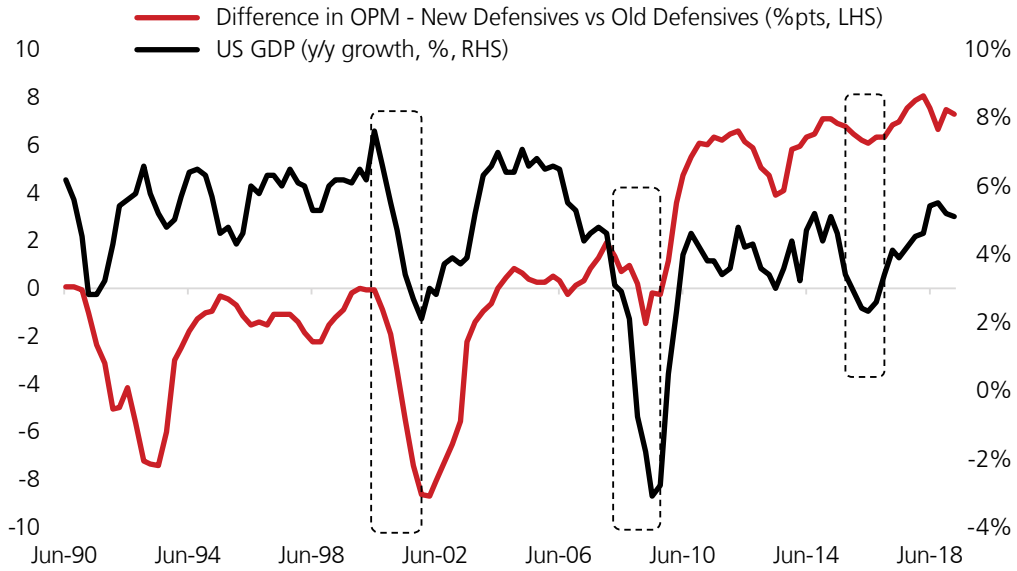
In our view, the above data highlights suggest that: (i) New Defensives are increasingly able to command higher average selling prices (ASPs) for their products/services, and this speaks well of their market positioning; and (ii) New Defensives are increasingly able to control/reduce their operating cost in pursuit of "asset light" business models.

Table 2: Operating margins during periods of economic slowdown

	Dot-Com Crisis (2Q00 - 4Q01)	Subprime Crisis (3Q07 - 2Q09)	2015-16 Slowdown (1Q15 - 2Q16)
Moderation in GDP growth	7.6% to 2.1%	4.8% to -3.1%	5.1% to 2.3%
Average difference in OPM between New Defensives and Old Defensives	-4.0%pts	+0.6%pts	+6.6%pts

Source: Bloomberg, DBS

Figure 4: New Defensives are increasingly generating higher profitability than Old Defensives



Source: Bloomberg, DBS

Time to embrace a new mindset

As the proverbial saying goes, "When the facts change, I change my mind". We concur. The changing characteristics of Technology and Consumer Discretionary companies (those directly and indirectly related to e-Commerce) warrant a re-look at how investors classify what constitutes "defensive".

In today's fast-changing world, Technology/Consumer Discretionary companies are riding on long-term secular trends and offer utilities-like business models with above-average sustainable earnings growth. The rapid proliferation of the Internet of Things (IOT), payment platforms, e-Commerce, cloud computing, and data analytics is causing a paradigm shift and we believe it is now time to embrace the New Defensives.

Special Feature | 3Q19

Sustainability

Source: AFP Photo

DBS

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Special Feature II: Sustainability 2.0

Mikkel Larsen
Chief Sustainability Officer

Jason Low, CFA
Strategist

The way forward

The Industrial Revolution began in the 18th century and took only three hundred years to etch an indelible human signature on a 4.5b-year-old planet and its systems. Today, with climate change outpacing society's ability to curb its mass energy addiction, two other revolutions are upon us – Industry 4.0 and Sustainability. One leads to the other, for without awareness brought by data and machine learning, society may not be mature enough to understand that our free-wheeling days are over.

At DBS, we recognise the urgent need to contribute and invest in sustainability and future-proof ourselves. Our Sustainability Council was formed in 2017, to oversee and coordinate bank-wide sustainability efforts. With the bank's new 2019 statement of purpose: "Best Bank for a Better World", we look to enrich lives and transform businesses by providing amazing solutions and experiences in a sustainable way. We have also chosen to focus on six of United Nations's 17 Sustainable Development Goals (SDGs) (Figure 1). The world's biggest problems are now indeed the world's biggest business opportunities.

Figure 1: DBS has chosen to focus on six SDGs

Source: United Nations, DBS

ESG investments will be part of core portfolios in the very near future, unlike its satellite status today

In Sustainability 2.0, environmental, social, and governance (ESG) investments will no longer be a niche category of investments. Instead, it will be a mainstream investment category and part of core portfolios. Currently, ESG strategies are still isolated from core investment activities, according to McKinsey, and only limited to specific asset classes. Equities have received the bulk of attention for ESG strategies, with a large body of ESG research primarily in this area; most ESG strategies have not yet expanded to other asset classes. But this is beginning to change. For fixed income investments, the use of ESG screens and integration is becoming more commonplace due to two factors: the push factor of increased client demand and the pull factor of ESG adding value to credit analysis. More frameworks have also been put in place to promote green bonds. For instance, in June 2017, MAS put in place the Green Bond Grant Scheme to promote the green bond market in Singapore.

Portfolios will increasingly be ESG-rated; clients will know their portfolio's impact on environment and society

ESG will also be increasingly integrated into portfolio ratings. As environmental awareness increases, clients will increasingly want to know the impact their portfolios have on the environment and society. Such ratings might be developed based on available public indices like MSCI, or using carbon data as required by the Carbon Disclosure Project, provided by the Task Force on Climate-related Financials Disclosures (TCFD). The progressively easy access to big data means a portfolio's carbon footprint or other environmental risks can be determined much more easily. The next logical step would be to include impact measurements into portfolios. Taken together, ESG investments can feasibly go from merely offering broad funds to consumers, to reflecting the different preferences and beliefs of individual investors. At the institutional level, active ownership can help to continually refine practices, by helping companies understand what ESG practices are most valued, and the type of disclosure investors are looking for.

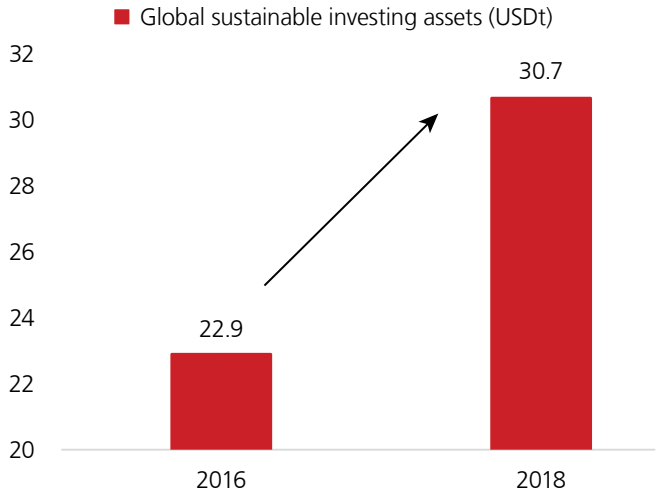
Big data will enable ESG products to be more personalised – tailoring investment portfolios with sustainable factors that matter most to each individual

Big data will enable more impactful ESG investments and greater personalisation of sustainable consumer products. With AI, big data, and fintech, the future for more impactful ESG investments looks bright. Indeed, big data and algorithms can be used to more effectively incorporate ESG factors into the management of funds, while smart algorithms allow for better interpretation of non-traditional financial information which would otherwise be resource-intensive and time-consuming. AI and big data also enable easier monitoring of impact, and allow tailoring of products for individuals, which in the past may be prohibitively costly. In fact, with data, specific sustainability could morph into personalised sustainability. Technology will enable consumers to craft their portfolios according to the sustainability factors that matter most to them. Companies will also have the data to show consumers how their sustainable factors help them.

Global sustainable investing assets have grown 34% from 2016 to 2018

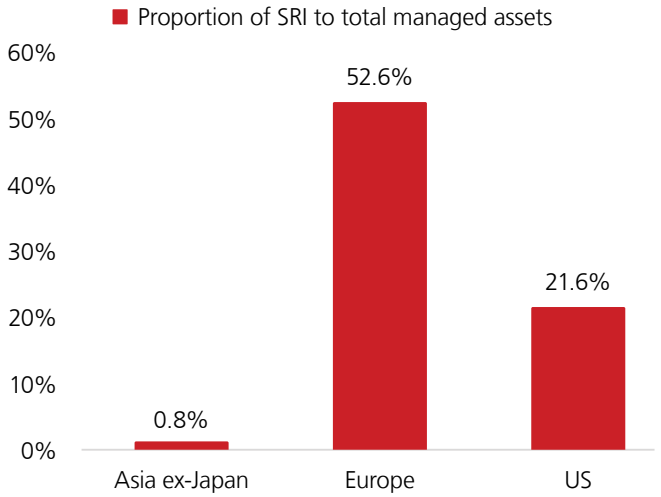
Global sustainable investing assets have grown substantially by 34% from 2016 to 2018. Global sustainable investing assets have grown 34% to USD30.7t in 2018, from USD22.9t in 2016, according to Global Sustainable Investment Alliance (Figure 2). In Asia, the Global Sustainable Investment Review revealed that there was a notable 16% increase in sustainable investment assets between 2014 and 2016. This affirms our view that the inflow into sustainable investing is structural.

Figure 2: Global sustainable investing assets grew 34% from 2016 to 2018



Source: GSIA

Figure 3: Responsible investing strategies only make up 0.8% of AUM in Asia



Source: GSIA

But the penetration rate of sustainable investing in Asia ex-Japan is still very low. Investors in Asia ex-Japan have not caught up in a big way. Assets managed under responsible investment strategies remains extremely low in Asia ex-Japan at only 0.8% of AUM in 2016. This pales in comparison to 53% in Europe and 22% in the US (Figure 3).

A window of opportunity – there is immense growth potential for sustainable investments, both regionally and globally. 66% of global consumers are willing to pay more for a sustainable brand and 73% of consumers will change their consumption habits to reduce their environmental impact, according to studies by Nielsen. In 2017, a DBS research in collaboration with the United Nations Environment Programme (UNEP) found that there was demand for an estimated USD3t of investment in ASEAN to be pumped into "green investments" from 2016-2030.

The rise of the Millennial investor is a strong tailwind for sustainable investing, especially in Asia. Sustainable investing today is still largely done by institutions, but the rise of Millennial and retail investors will drive the next phase of inflows. Globally, USD30t of wealth will be transferred from Baby Boomers to 90m Millennials over the next few decades. In Asia, about 35% of wealth will be in the hands of Millennials over the next five to seven years, resulting in the highest rate of change in any region. Millennials, based on previous surveys, are nearly twice as likely to invest in companies or funds which target specific social or environmental outcomes. In fact, 73% of millennials are prepared to pay extra for a sustainable offer, according to studies by Nielsen. Sustainable investing is becomingly increasingly compelling, given the increasing awareness among them.

Investors should future-proof by including ESG investments as part of their core portfolios. Build exposure in the form of ESG funds within the Barbell Strategy, selecting those on both ends of our Barbell portfolio – that is, superior growth-oriented ESG funds on one end, and income-oriented ESG funds on the other.

CIO Portfolio

CIO Portfolio

Strategy Description

The CIO Portfolio employs a Barbell Strategy, which entails allocating assets to the highest conviction calls from a factor-based and thematic perspective. The anchor factors which our portfolio is based on are: (a) Growth and (b) Income.

The "Growth" component consists of exposure to secular growth trends while the "Income" component consists of exposure to dividend equities, REITs, and corporate bonds.

Portfolio Characteristics

- Launch date: June 2019
- Portfolio risk rating: 3.7
- Portfolio base currency: USD
- Unconstrained strategy, benchmark agnostic
- Equity portion consists of 30-40 single stocks with different weightages assigned
- Bonds and Alternatives consist of funds and ETFs
- Performance is updated on a monthly basis

Growth Equities by Themes

Technology	20%
Millennials	15%
Insurance	5%
Health Care	8%
e-Commerce	19%
Cloud Computing	11%
Automation	12%
A-shares	7%
Tourism	3%

Income Equities by Themes

Banks	23%
Singapore REIT	54%
Dividend Fund	15%
Hong Kong REIT	8%

Initiation of CIO Barbell Strategy

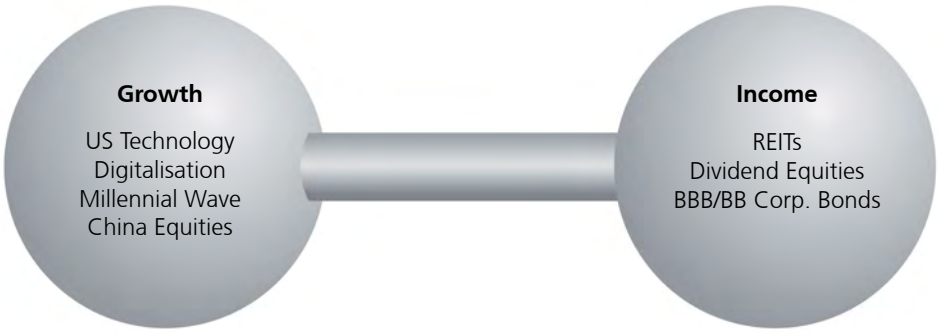
The DBS Chief Investment Office is launching a global, cross-asset model portfolio ("CIO Portfolio") based on its Barbell Strategy. In the age of digitalisation,traditional sectors are facing unprecedented disruption. As the global investment landscape gets redefined, it is no more "business as usual". Thus, the CIO Portfolio seeks to ride this disruptive wave by focusing on the winners while avoiding the losers.

Why are we different?

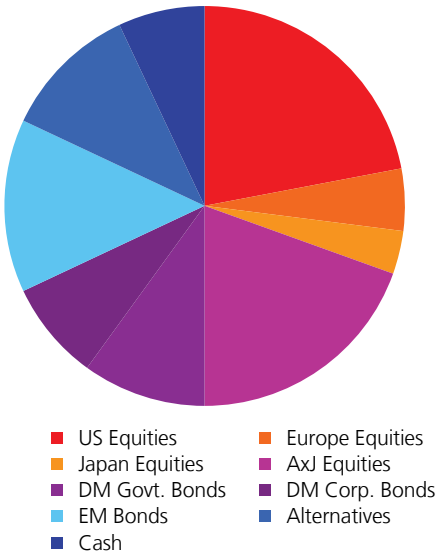
On portfolio construction, the DBS Chief Investment Office is differentiated by a three-pronged approach consisting of:

- Thematic Allocation: Our portofolio rides on secular growth trends, including technology and demographics.
- Factor Allocation: Our portfolio is constructed based on the following anchor factors: (a) Growth and (b) Income.
- Country Allocation: Our portfolio is geographically diversifisied with exposures to both Developed and Emerging Markets.

CIO Barbell Strategy



CIO Asset Allocation

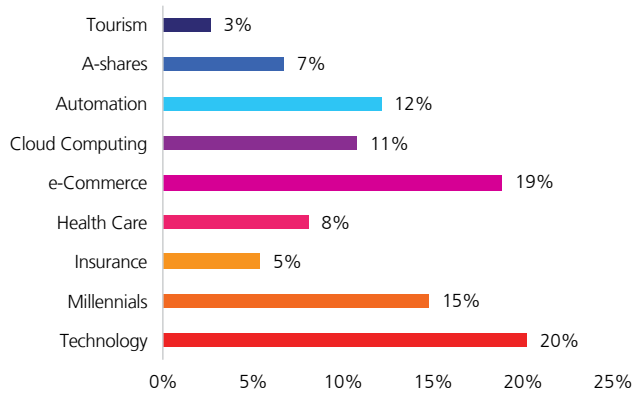


Equities	50.0%
US	22.0%
Europe	6.0%
Japan	3.0%
Asia ex-Japan	19.0%
Fixed Income	32.0%
Developed Markets (DM)	16.0%
DM – Government	8.0%
DM – Corporate	8.0%
Emerging markets (EM)	16.0%
Alternatives	11.0%
Gold	5.0%
Hedge Funds	6.0%
Cash	7.0%

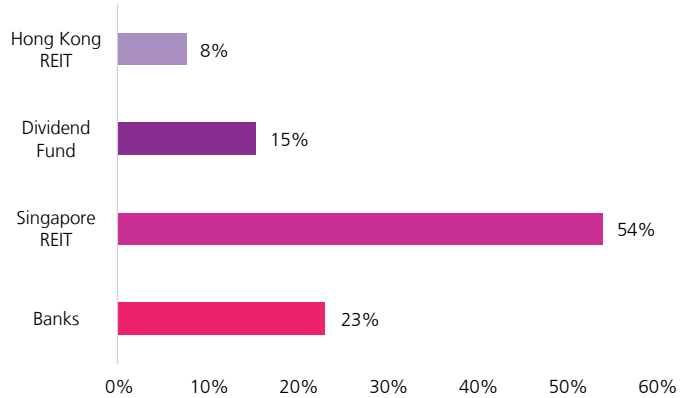
Source: Bloomberg, DBS

Portfolio Characteristics

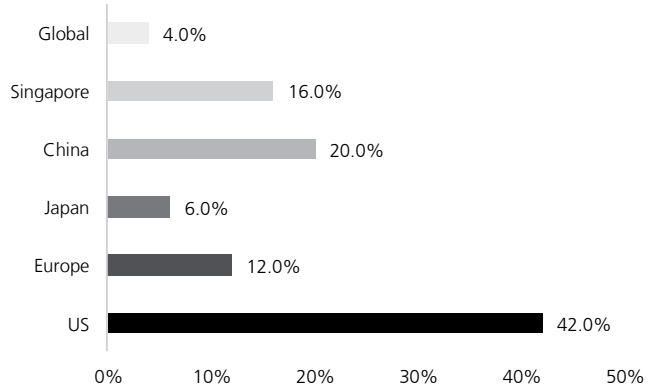
Growth Equities – Breakdown by Themes



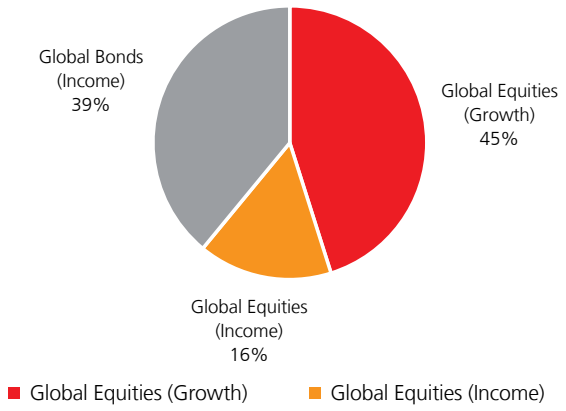
Income Equities – Breakdown by Themes



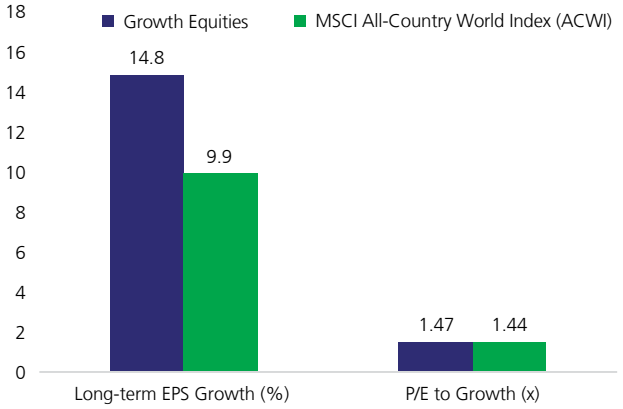
Global Equities – Breakdown by Geography



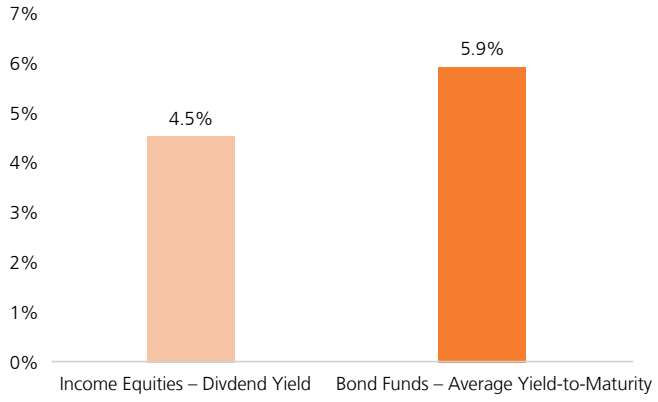
Global Equities & Bonds – Breakdown by Factor



Growth Equities vs MSCI ACWI – EPS Growth and P/E to Growth



Equity and Bond Yields



Source: Bloomberg, DBS

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Glossary of Terms:

Acronym	Definition
AAII	American Association of Individual Investors
AI	artificial intelligence
ARPU	average revenue per user
ASEAN	Association of Southeast Asian Nations
ASP	average selling price
AUM	assets under management
AV	autonomous vehicles
AxJ	Asia ex-Japan
bbl	barrel
BI	Bank Indonesia
BNM	Bank Negara Malaysia
BOE	Bank of England
boepd	barrels of oil equivalent per day
BOJ	Bank of Japan
BOT	Bank of Thailand
bpd	barrels per day
BSP	Bangko Sentral ng Pilipinas
BV	book value
CAGR	compound annual growth rate
capex	capital expenditure
CAR	capital adequacy ratio
CASA	current account savings account
CET1	common equity tier 1
CIS	Commonwealth of Independent States
CPI	consumer price index
CRM	customer relationship management
DDM	dividend discount model
DM	Developed Markets
DPS	dividend per share
DPM	discretionary portfolio mandates
DPU	distribution per unit
DXY	US Dollar Index
EBITDA	earnings before interest, tax, depreciation, and amortisation
EC	European Commission
ECB	European Central Bank
EM	Emerging Markets
EPFR	Emerging Portfolio Fund Research
EPS	earnings per share

Acronym	Definition
ERP	Equity Risk Premium
ETF	exchange-traded fund
EU	European Union
FCF	free cash flow
FDI	foreign direct investment
FX	foreign exchange
GDP	gross domestic product
GFC	Global Financial Crisis
GMV	gross merchandise volume
GRE	government-related entity
HY	high-yield
IG	investment-grade
IMF	International Monetary Fund
IP	intellectual property
ISM	Institute for Supply Management
IT	information technology
JGB	Japanese Government Bond
M&A	merger & acquisition
MAS	Monetary Authority of Singapore
mmbbl	million barrels
mmbpd	million barrels per day
NAV	net asset value
NII	net interest income
NIM	net interest margin
NPL	non-performing loan
OPEC	Organization of the Petroleum Exporting Countries
OPM	operating profit margin
P/B	price-to-book
P/E	price-to-earnings
P/NAV	price-to-net asset value
PBOC	People's Bank of China
PC	personal computer
PEG	P/E-to-growth
PM	portfolio manager
PMI	purchasing managers' index
QSR	quick-service restaurants
RBA	Reserve Bank of Australia
RBI	Reserve Bank of India

Acronym	Definition
REIT	real estate investment trust
RM	relationship manager
ROA	return on asset
ROC	return on capital
ROCE	return on capital employed
ROE	return on equity
ROI	return on investment
ROTE	return on tangible equity
RRR	reserve requirement ratio
SAA	Strategic Asset Allocation
saar	seasonally adjusted annual rate
SD	standard deviation
SGS	Singapore Government Securities
SOR	swap offer rate
SRI	sustainable, responsible, and impact investing
TAA	Tactical Asset Allocation
TAM	total addressable market
TP	target price
UCITS	Undertakings for Collective Investment in Transferable Securities
UST	US Treasury
VAT	value-added tax
VNB	value of new business
WTI	West Texas Intermediate
YTD	year-to-date
YTW	yield to worst