19 September 2017

Stay in the game

Seek opportunities in Asia and EM equities

Stay engaged in equities. Despite stretched valuations, synchronised global growth and robust liquidity conditions will underpin confidence. Continue to be Overweight on EM over DM.

Favour credit over government bonds

Government bond yields to trend higher on rising inflationary pressure, Fed balance sheet "normalisation" and potential ECB "QE Tapering". Prefer BB to BBB corporate bonds over government bonds for incremental yield.

Spot winners amid weak dollar

Headwinds for the dollar to persist on potential ECB "QE Tapering" and ongoing political dysfunction on Capitol Hill. Gain exposure to Asian dividend plays and sectors benefitting from dollar weakness.

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Executive Summary

Hou Wey Fook, CFA
Chief Investment Officer

Welcome to the inaugural "CIO Insights" publication!

The following is a summary of our investment outlook and portfolio strategy for 4Q2017.

Barring exogenous shocks – such as the escalation of tensions in the Korean peninsula – the outlook for risk assets namely equities and corporate bonds remains stable. A common concern among investors is whether the bull market led by US equities has already matured after eight years of uptrend. And are we not at the cusp of a bear market?

We do not think so. Despite stretched valuations, the fundamental backdrop of synchronous global growth with low inflation is positive. Fund flows are also supportive as global investors are flushed with liquidity and in constant hunt for investments away from record-low yielding government bonds.

Within the equity asset class, we favour Asia and Emerging Markets over Developed Markets. We believe the former's recent outperformance has a lot further to run, hence we recommend Overweight on Asia. An Asian dividend-focused stock portfolio such as Real Estate Investment Trusts (REITs) is a good strategy from a risk-return tradeoff. Corporate bonds of credit ratings of BB to BBB are favoured over government bonds for the incremental yield. The approach here is to buy a diversified portfolio of at least 40 credits and hold them till maturity.

On currencies, we believe we have now entered a period of subdued US dollar strength which based on historical trends can persist for a while yet. Such an environment has proven to be attractive for Emerging Markets and commodities in general.

You can read further the analysis that supports these views in the subsequent pages. Do enjoy the read!

Core Investment Views

Core Investment Views

Asset Allocation

- Barring exogenous shocks, the outlook for risk assets remains stable.
- Stretched valuations do not necessarily mean that a bear market is imminent as corporate earnings and liquidity conditions remain favourable.
- On a cross asset basis, we continue to favour equities over government bonds.
- Lingering dollar weakness is a tailwind for commodities and gold.

Macroeconomics

- Global macroeconomic fundamentals remain positive. Inflation stays subdued in most developed economies.
- US economic growth has become more balanced while the outlook for Europe is turning up.
- Inflation in Japan remains stubbornly slow despite recent economic revival. Asia remains the key bright spot, 'creating' a Germany every three years.

Equity

- Maintain Neutral stance as headwinds emanating from fading asset reflation theme and central banks' monetary tightening will restrict outperformance.
- Relative underperformance of US equities to persist amid political dysfunction and elevated valuations.
- Prefer Asia and emerging markets over developed markets from a valuation perspective. Gain exposure to Asian dividend plays and sectors benefitting from dollar weakness.

Fixed Income

- Expect UST 10-year yield to stay flattish at around 2.2% till year-end.
- But overall conditions remain supportive of higher interest rates on: (a) Rising inflationary pressure; (b) Fed balance sheet "normalisation"; and (c) Potential ECB "QE Tapering".
- Prefer BB to BBB corporate bonds over government bonds for incremental yield.

Currencies

- The DXY index is nearing the end of the bull cycle that began in 2011.
- Rising doubts over Trump Administration's fiscal agenda will continue to weigh on the greenback.
- Tail risks emanating from North Korea will benefit safe-haven currencies like the JPY.

Commodities

- The combination of steady global economic growth and prevailing dollar weakness will underpin commodity prices.
- Crude oil expected to range-trade with a downward bias amid firm shale oil supply from the US.
- Outlook for aluminium and copper remains positive given improving supply-demand dynamics

Asset Allocation

Hou Wey Fook, CFA
Chief Investment Officer

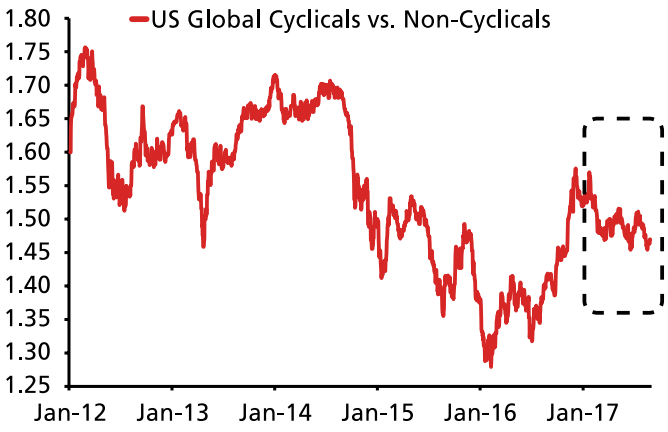
Dylan Cheang
Strategist

As we head into 4Q17, we continue to maintain a Neutral stance on equities, with a preference for Emerging Markets (EM) over Developed Markets (DM). Policy dysfunction on Capitol Hill could lead to further underperformance for the US market. Instead, we continue to see selective opportunities in Asia and EM. Meanwhile, the pullback in US Treasury yields looks unsustainable as the output gap continues to narrow. Yields will resume their upward trajectory as the Federal Reserve embarks on balance sheet normalisation in the coming months.

US asset reflation theme: Losing steam

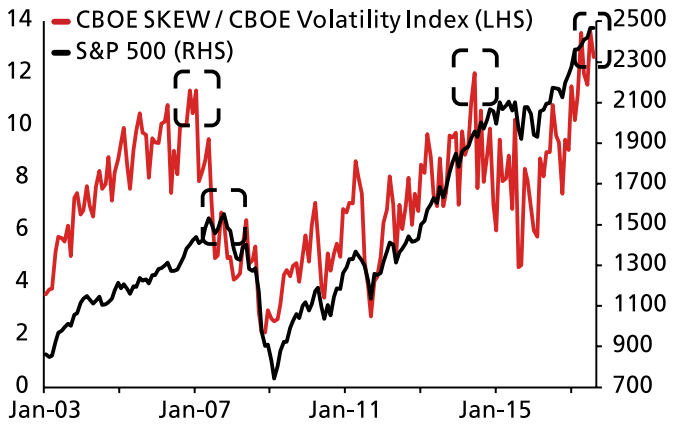
The broad risk-on trading conditions seen during the early part of 3Q17 were disrupted in August, as geopolitical concerns took centre-stage. DM equities lost 1.9% during 8-18 August, led by weakness on the S&P 500 Index as the market's rich valuations remained a going concern. The US high-yield corporate bond spread also widened 35 bps. Although US risk assets have since resumed their upward momentum, it has become clear that the post-election asset reflation theme is losing steam. This is evident from the relative performance of US global cyclicals vs. non-cyclicals since late January (see Figure 1).

Figure 1: US global cyclicals have underperformed the non-cyclicals as the asset reflation theme fades



Source: Bloomberg, DBS

Figure 2: A toppish SKEW/VIX index suggests that a US market correction is on the cards



Source: Bloomberg, DBS

SKEW/VIX index: Caution warranted

The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) has been anchored to lows as investors stay sanguine on US equities. In contrast, the CBOE SKEW Index – which consists of deeply "out-of-themoney" options on the S&P 500 – has trended higher. This suggests that despite the apparent calm as depicted by the VIX Index, investors are increasingly buying protection against major tail-risk events. The SKEW/VIX Index has historically peaked before a substantial correction on the S&P 500 takes hold, and the time lag has ranged from nine to 13 months. The current toppish SKEW/VIX Index therefore warrants caution.

Stay Neutral on Equities; Returns to stay subdued

Stay Neutral on equities as the risk-reward remains underwhelming at this juncture. Headwinds emanating from the fading asset reflation theme and central banks' monetary tightening in the latter part of the year will restrict equity outperformance.

Developed Markets: We prefer Europe and Japan over US

On a risk-adjusted basis, we maintain our Underweight view on US equities, while staying Neutral on both Europe and Japan. Investors' enthusiasm for European equities have rebounded strongly as geopolitical uncertainties in the region recede, while quantitative easing (QE) by the European Central Bank (ECB) translates into stronger economic momentum for the region. In Japan, the domestic economy is showing steady recovery while monetary conditions remain accommodative. The market trades at a 19% discount to DM, and is therefore attractive on a risk-reward basis.

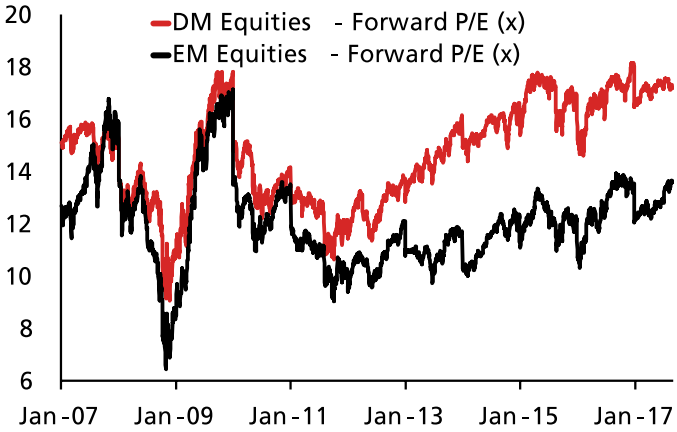
Dollar weakness: A tailwind for APxJ and EM

We stay Overweight on both Asia Pacific ex-Japan (APxJ) and Emerging Markets ex-Asia (EM ex-Asia) in view of the ongoing stabilisation in the Chinese economy. Granted, the structural imbalances and unsustainable debt level in China remain going concerns. But these are longer-term issues that take time to resolve – a point markets recognise. APxJ and EM ex-Asia – at their forward price-to-earnings (P/E) of 14.4x and 13.3x, respectively – are trading at substantial discount relative to the developed markets. The prevalence of dollar weakness will lend additional tailwinds to EM (see Figure 4).

Fed monetary tightening not a major concern for APxJ and EM

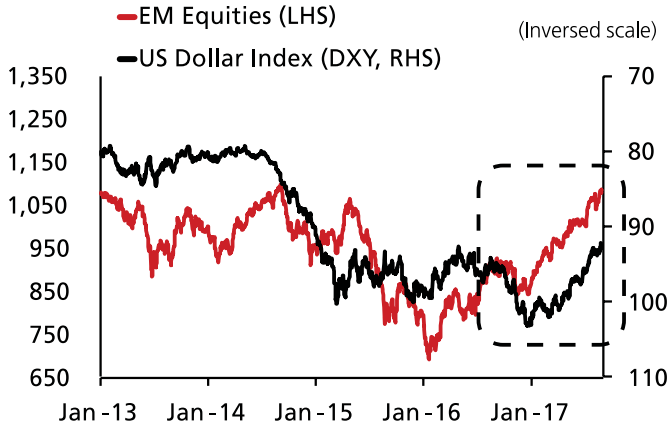
There were concerns that a more "hawkish" Federal Reserve may result in an acute outflow of funds from these regions. But such concerns are overplayed, in our view. Firstly, while central banks are expected to exit from monetary accommodation, the process will be gradual and progressive. Secondly, the economic fundamentals of these regions have improved since the days of "Taper Tantrum"; they are now better equipped to withstand monetary shocks emanating from developed economies.

Figure 3: EM valuation discount relative to DM remains substantially wide



Source: Bloomberg, DBS

Figure 4: Dollar weakness a tailwind for the emerging markets



Source: Bloomberg, DBS

The Start of Reverse QE: Headwinds for bonds

Globally, government bond yields have been held down by years of QE. But this process is about to go into the reverse direction resulting in some upward pressure on yields. We expect bond yields to trend higher on the back of rising inflationary pressure as the output gap narrows. In the US, the Fed is expected to embark on balance sheet normalisation in the coming months. Over in the Euro Area, the ECB is also expected to start scaling back its asset purchase programme for two reasons:

1. **Strong economic momentum in the Euro Area**: The Euro Area economy has been on a tear, with manufacturing activities in expansionary mode amid a continued decline in the unemployment rate. The current robust economic momentum in the Euro Area provides a small window of opportunity for the ECB to scale back its asset purchase programme.
2. **Scarcity of bonds for ECB asset purchase programme:** According to an ECB ruling, the central bank is permitted to purchase only 33% of a particular country's bonds in circulation. At the current rate, the ECB could potentially run out of German debt to purchase. This scarcity of bond supply will inevitably result in a trimming of the central bank's asset purchases.

Taken together, rising inflationary pressure and the reversal of monetary accommodation in the US and Europe will place upward pressure on rates. Stay Underweight. Within DM, we prefer credit over government bonds.

Stay Overweight on Alternatives

In Alternatives, we maintain Overweight on commodities. Our positive outlook is premised on our view of sustained dollar weakness, which will in turn buoy the outlook for commodity prices, given their historical inverse relationship. Besides, robust growth momentum in China will also be a major tailwind for the commodity complex. Lastly, we maintain a constructive stance on gold and hedge funds with Neutral weightings. Gold is a classic safe haven trade that protects portfolio downside in times of market volatility.

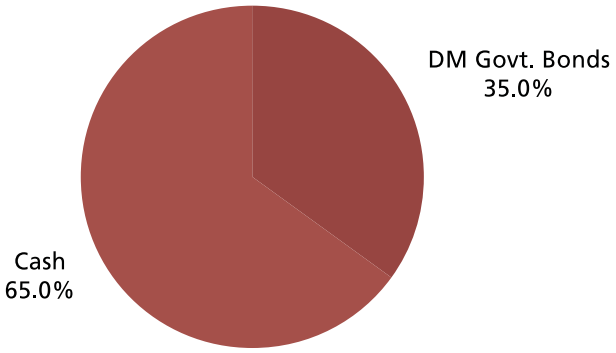
Figure 5: 4Q17 – Global Tactical Asset Allocation

Asset Class		
	3-Month Basis 4Q17	12-Month Basis 4Q17
Equities	Neutral	Neutral
US Equities	Underweight	Underweight
Europe Equities	Neutral	Neutral
Japan Equities	Neutral	Neutral
Asia Pacific ex-Japan Equities	Overweight	Overweight
Emerging Markets ex-Asia Equities	Overweight	Overweight
Bonds	Underweight	Underweight
Developed Markets (DM) Bonds	Underweight	Underweight
DM Government Bonds	*Underweight*	*Underweight*
DM Corporate Bonds	*Neutral*	*Neutral*
Emerging Markets (EM) Bonds	Neutral	Neutral
Alternatives	Overweight	Overweight
Commodities	Overweight	Overweight
Gold	Neutral	Neutral
Hedge Funds	Neutral	Neutral
Cash	Neutral	Neutral

Source: DBS Chief Investment Office

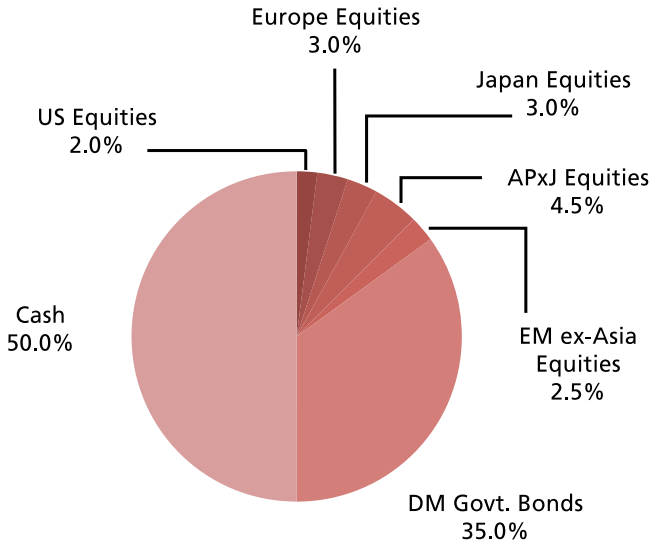
Defensive

	TAA	SAA	Active
Equities	0.0%	0.0%	
US	0.0%	0.0%	
Europe	0.0%	0.0%	
Japan	0.0%	0.0%	
Asia Pacific ex-Japan	0.0%	0.0%	
Emerging Markets ex-Asia	0.0%	0.0%	
Fixed Income	35.0%	35.0%	
Developed Markets (DM)	35.0%	35.0%	
DM Government Bonds	*35.0%*	*35.0%*	
DM Corporate Bonds	*0.0%*	*0.0%*	
Emerging Markets (EM)	0.0%	0.0%	
Alternatives	0.0%	0.0%	
Commodity	0.0%	0.0%	
Gold	0.0%	0.0%	
Hedge Funds	0.0%	0.0%	
Cash	65.0%	65.0%	



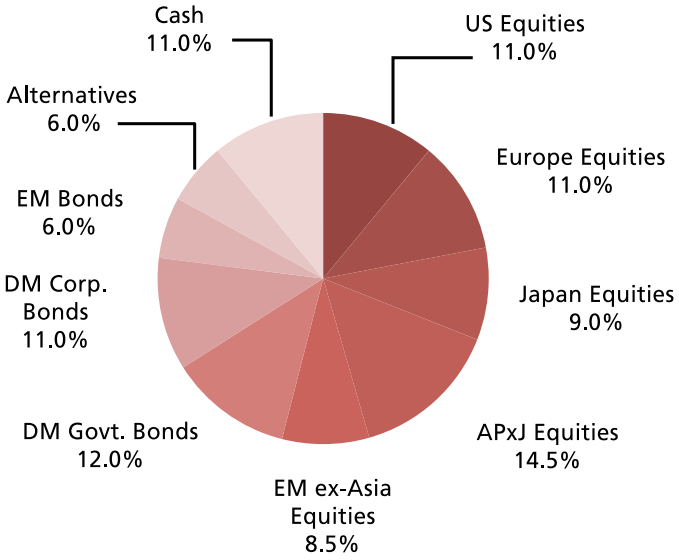
Conservative

	TAA	SAA	Active
Equities	15.0%	15.0%	
US	2.0%	3.0%	-1.0%
Europe	3.0%	3.0%	
Japan	3.0%	3.0%	
Asia Pacific ex-Japan	4.5%	4.0%	0.5%
Emerging Markets ex-Asia	2.5%	2.0%	0.5%
Fixed Income	35.0%	35.0%	
Developed Markets (DM)	35.0%	35.0%	
DM Government Bonds	*35.0%*	*35.0%*	
DM Corporate Bonds	*0.0%*	*0.0%*	
Emerging Markets (EM)	0.0%	0.0%	
Alternatives	0.0%	0.0%	
Commodity	0.0%	0.0%	
Gold	0.0%	0.0%	
Hedge Funds	0.0%	0.0%	
Cash	50.0%	50.0%	



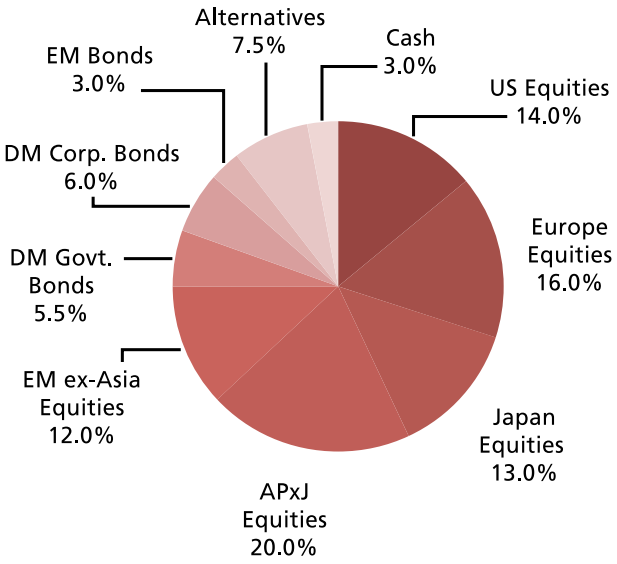
Balanced

	TAA	SAA	Active
Equities	54.0%	54.0%	
US	11.0%	12.0%	-1.0%
Europe	11.0%	11.0%	
Japan	9.0%	9.0%	
Asia Pacific ex-Japan	14.5%	14.0%	0.5%
Emerging Markets ex-Asia	8.5%	8.0%	0.5%
Fixed Income	29.0%	30.0%	-1.0%
Developed Markets (DM)	23.0%	24.0%	-1.0%
DM Government Bonds	*12.0%*	*13.0%*	*-1.0%*
DM Corporate Bonds	*11.0%*	*11.0%*	
Emerging Markets (EM)	6.0%	6.0%	
Alternatives	6.0%	5.0%	1.0%
Commodity	2.0%	1.0%	1.0%
Gold	1.0%	1.0%	
Hedge Funds	3.0%	3.0%	
Cash	11.0%	11.0%	



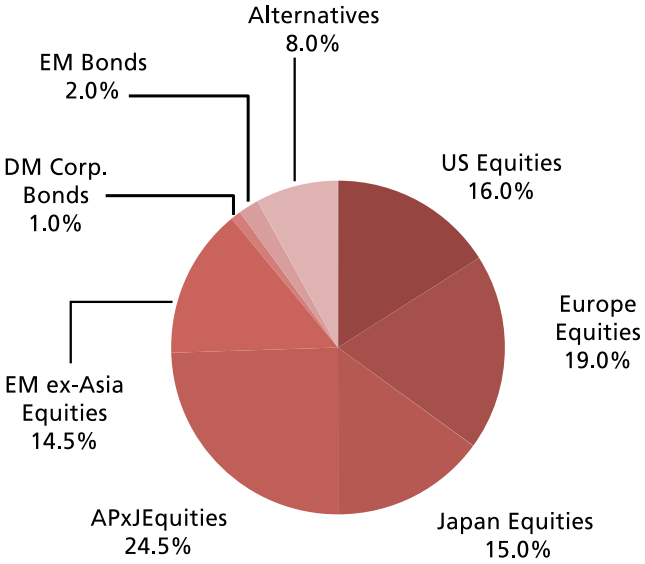
Growth

	TAA	SAA	Active
Equities	75.0%	75.0%	
US	14.0%	16.0%	-2.0%
Europe	16.0%	16.0%	
Japan	13.0%	13.0%	
Asia Pacific ex-Japan	20.0%	19.0%	1.0%
Emerging Markets ex-Asia	12.0%	11.0%	1.0%
Fixed Income	14.5%	15.0%	-0.5%
Developed Markets (DM)	11.5%	12.0%	-0.5%
DM Government Bonds	*5.5%*	*6.0%*	*-0.5%*
DM Corporate Bonds	*6.0%*	*6.0%*	
Emerging Markets (EM)	3.0%	3.0%	
Alternatives	7.5%	7.0%	0.5%
Commodity	1.5%	1.0%	0.5%
Gold	3.0%	3.0%	
Hedge Funds	3.0%	3.0%	
Cash	3.0%	3.0%	



Aggressive

	TAA	SAA	Active
Equities	89.0%	89.0%	
US	16.0%	19.0%	-3.0%
Europe	19.0%	19.0%	
Japan	15.0%	15.0%	
Asia Pacific ex-Japan	24.5%	23.0%	1.5%
Emerging Markets ex-Asia	14.5%	13.0%	1.5%
Fixed Income	3.0%	3.0%	
Developed Markets (DM)	1.0%	1.0%	
DM Government Bonds	*0.0%*	*0.0%*	
DM Corporate Bonds	*1.0%*	*1.0%*	
Emerging Markets (EM)	2.0%	2.0%	
Alternatives	8.0%	8.0%	
Commodity	1.0%	1.0%	
Gold	3.0%	3.0%	
Hedge Funds	4.0%	4.0%	
Cash	0.0%	0.0%	



Source: DBS, Morningstar Investment Management Asia Limited.

EM equity outperformance to persist

Source: AFP Photo

Global Macroeconomics

David Carbon
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4Q17 Global Economic Outlook

The global macroeconomic fundamental backdrop remains positive. Global growth is synchronised and on a surer footing in most developed and emerging economies, albeit at a low-to-modest pace. Inflation, though, remains subdued in most developed economies. In the US, the economy grinds on at around 2% pace, with growth now more balanced and labour market tight. Over in Europe, growth outlook is turning up, with manufacturing purchasing managers' index (PMIs) at six-year highs and unemployment rate falling. Likewise in Japan, where growth has expanded for six consecutive quarters. However, inflation remains stubbornly low. The bright spot remains in Asia as it is now 'creating' a Germany every three years.

United States: Better Balance

Economy grinds on

Gross domestic product (GDP) grew by 3% (q/q, SAAR) in the 2Q17, up from an unusually low 1.2% in the previous quarter, and repeating the weak/strong pattern seen in many 1Q/2Q outcomes in recent years. The average reading of the first two quarters – 2.1% – is exactly the average GDP growth figure since December 2010 and, not surprisingly, is also the growth of the past four quarters. Indeed, the economy continues to grind along at the same pace it has for the past seven years.

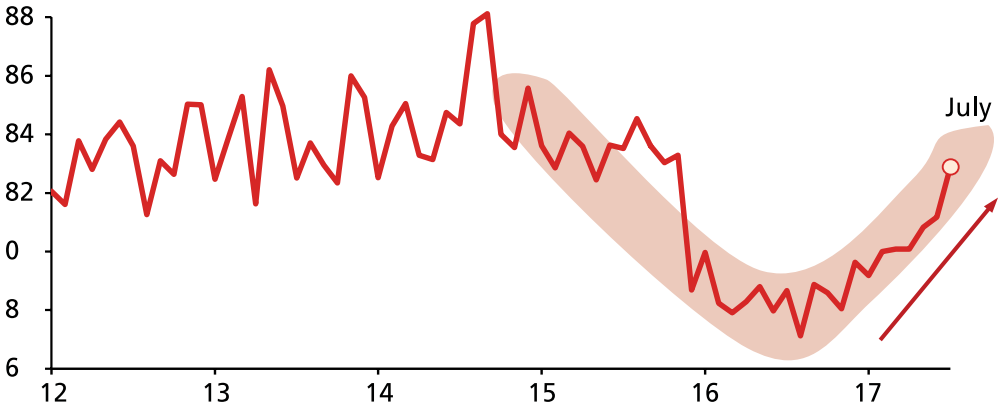
Growth is becoming ever more balanced

Business investment and consumption are taking turns in supporting US GDP. With oil prices having stabilised at USD48/USD50 per barrel over the past year, capital goods shipments turned the corner, rising sharply for nine months (Figure 1). Business investment (in the GDP accounts) has grown by 7% in each of the past two quarters and GDP overall continues to chug along at a 2% pace.

Figure 1: Capital goods shipment turned a corner

US - total capital goods shipments

US$bn/month, seas adj



Source: CEIC, DBS

Labour markets continue to tighten and inflation likely to rebound on oil price stabilisation

While August nonfarm payrolls were below expectations, many other August payrolls have looked suspect. They were either eventually revised upward or offset by stronger numbers in subsequent months. Besides, working age population growth has slowed to 0.4% per year, which means the 'natural' growth in labour force is now down to 55,000 per month. Thus with nonfarm payrolls growing by 185,000 per month on a three-month average basis, this will continue to place very significant downward pressure on the unemployment rate in months ahead. Inflation has been subdued for the past four-five months due to the 18% drop in oil prices from February to June 2017. But with crude now back at USD48 a barrel, expect to see inflation rebound in the coming months. This will likely give Federal Reserve confidence to raise Fed funds again in December and four additional times in 2018. We expect yield on US Treasuries to rise. By mid-2018, two-year yields should reach 2.25%; 10-year yields should reach 2.60%

Eurozone: A Balancing Act

Eurozone growth turning up

Broad-based Eurozone growth, coupled with a convergence among member countries have seen core-4 GDP quickened by 2.4% (q/q, SAAR) in 1H17 from 2016's 1.8%. Household spending and investment growth have been supportive, while a falling unemployment rate and lower inflation (easing to 1.5% in August 2017) have underpinned purchasing power. Wage growth remains subdued but investment growth has improved, offsetting lower support from government spending. The narrowing slack in capacity augurs well for capital formation, as utilisation rate improved to 83% in 1H17.

Revising up growth forecasts

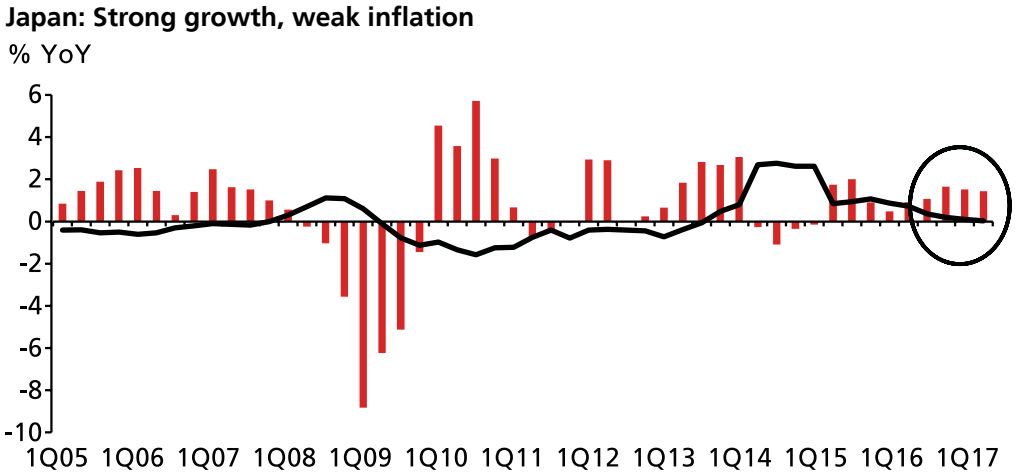
July-to-August manufacturing PMIs are at six-year highs and Eurozone investor confidence index remains at 10-year high in September despite a strong currency. Given these dynamics, we raised GDP growth estimates in 2017 and 2018 to 2.0% (from 1.7% and 1.8%, respectively). We expect yield on European government bonds to rise on a gradual basis.

Japan: Strong Growth, Weak Inflation

Longest expansion since 2005

The Japanese economy entered its longest expansion since 2005 with its sixth straight quarter of expansion in 2Q17. The 4.0% 2Q17 growth was also the strongest over the past nine quarters. Private consumption grew 3.7% in 2Q17 – the fastest rate seen since the 2014 sales tax hike. Short-term outlook remains positive, with consumer confidence improving and seasonally-adjusted jobless rate now hovering at a 23-year low of 2.8%. Exports maintained its double-digit growth in the first seven months this year at 10% y/y on average. However, inflation remains stubbornly weak (Figure 2). Consumer prices rose only by 0.4% y/y in July. Excluding fresh food and energy, core CPI remained nearly flat at 0.1%. The only consolation here is base wages are no longer falling, albeit a modest rise. We have lifted Japan GDP's forecast to 1.6% (from 1.3%) for 2017 and 1.1% (from 1.0%) for 2018.

Figure 2: Strong growth, weak inflation



Source: CEIC, DBS

Olympics likely to boost Japan investment outlook

The upcoming 2020 Japan Olympics is expected to bolster the investment outlook over the next two years. Indeed, construction on the Olympics event sites, hotels, transportation links, and other related infrastructure are already underway and will last until end-2019. According to estimates from the Tokyo city government, the 2020 Olympics will create direct economic benefits potentially worth JPY5.2t or 1% of GDP. On government bonds, we believe the speculation on Bank of Japan tapering its quantitative easing policy will reappear, driving 10-year Japanese Government Bond yield toward 0.1% from zero currently.

Asia: Enduring Myths

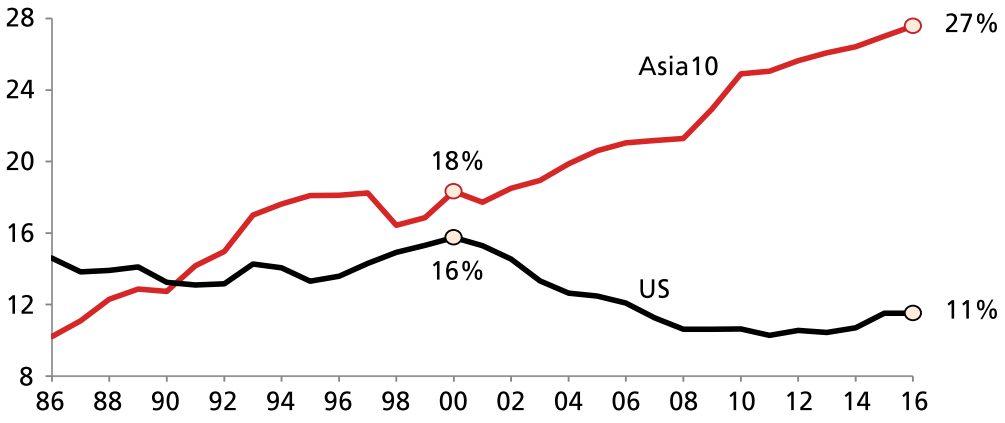
Asia is now 'creating' a Germany every three years

We highlighted 11 years ago how Asia was rapidly overtaking the US as the driver of the global economy. Nine years since the Global Financial Crisis, Asia has 'added' two Germanys' worth of GDP, while US, Japan and Europe are still nursing years of quantitative easing policies. Further, Asia's share of global trade has already surpassed the US in 1990 and now accounts for 2.5x that of the US. (Figure 3) Today Asia 'creates' a Germany every three years. Indeed, Asia is now putting Germanys on the map 3.4 times as fast as that of the US and 17 times that of Germany itself. By 2027, Asia will be adding a Germany worth of GDP every two years.

Figure 3: Asia now accounts for 2.5x US' share of global trade

Global trade shares27

% share in global 2 - way trade



Source: CEIC, DBS

US Equities

Dylan Cheang
Strategist

Political dysfunction and valuation concerns to weigh on US equities; stay Underweight

US equities have underperformed the developed markets quarter-to-date (QTD) in 3Q17. We expect the underperformance to persist given (a) The unwinding of "Trump Trade"; and (b) Valuation concerns. It is evident from the relative performance of global cyclicals over non-cyclicals that investors are unwinding their asset reflation trades, as the Trump Administration continues to flounder on its fiscal agenda. Without the economic/earnings kicker from fiscal stimulus, it is hard to justify the elevated valuation for US equities (see Figure 1). At 19.2x forward price-to-earnings (P/E), the US market is trading at premiums of 24% and 37% relative to Europe and Japan, respectively.

The key factor underpinning US equities has been the resilience of its corporate earnings. US earnings continued to stay robust with positive surprises averaging at about 78% during the first half. Much of this robust momentum, however, was attributed to the technology sector (it registered the largest proportion of earnings surprises in recent quarters). But with so many expectations embedded into this space, even slight earnings disappointments could trigger profit-taking in technology stocks, dragging the broader index lower.

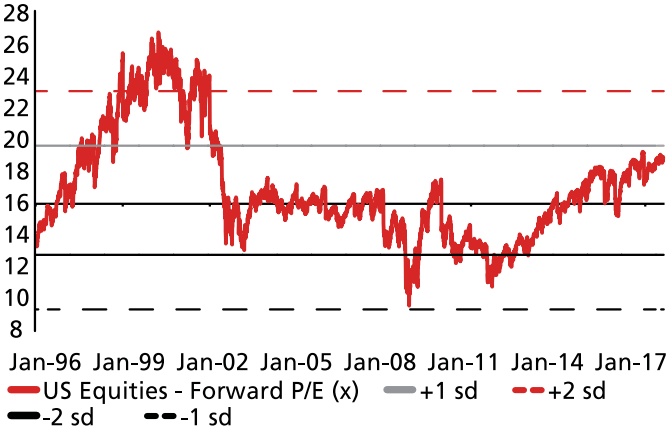
US debt ceiling can kicked down the road; complications for tax reform negotiations?

The House of Representatives, in a 316 to 90 vote, passed a bill to extend the debt ceiling and fund the government until 8 December. However, the surprise deal may result in complications for the upcoming tax reform negotiations; senior Republicans were apparently disappointed that the bill failed to tie-in reforms on spending cuts. Besides, the apparent ease of pushing through the debt deal in a Republican-dominated congress may also embolden the Democrats in upcoming tax negotiations.

Downbeat QTD performance in 3Q

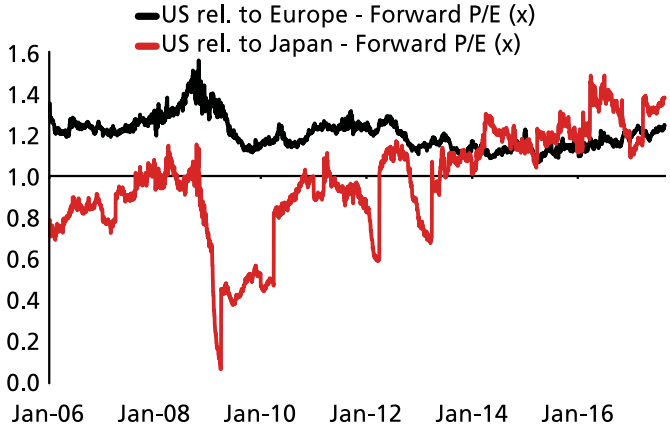
As we anticipated, the US equity market reported a subdued QTD performance during 3Q17, gaining 2.4% on a total returns basis (in USD terms). This compares unfavourably to Europe, which rose 2.9%. On sectoral basis, the key underperformers include energy (-2.8%) and consumer staples (-0.5%). The energy space underperformed substantially year-to-date (YTD) as the sector lost 15% amid weak energy prices. On the other hand, technology shares remained on a tear – partly reflecting prevailing dollar weakness, which buoyed the outcome for cyclicals.

Figure 1: US equity valuation is no longer cheap



Source: Bloomberg, DBS

Figure 2: Relative valuation premium of US equities over Europe and Japan



Source: Bloomberg, DBS

European domestic consumption plays preferred amid euro strength

Source: AFP Photo

Europe Equities

Dylan Cheang
Strategist

Euro strength will not derail Europe equities (for now); stay Neutral

The sharp rally in the euro has been a cause for concern for European equities. Since the start of the year, the EUR/USD has increased 13.2% to 1.191 (as of 31 August). According to conventional wisdom, a strong euro is typically negative for European exporters as well as companies with large non-euro denominated revenue. However, the negatives could be offset by falling political uncertainties in the region, especially after the positive outcome of the French election. The relationship between the euro and European equities has historically been unstable, and it is therefore not possible to conclude with certainty that euro strength will necessarily translate into sustained weakness for domestic equities (see Figure 1).

Sectoral Strategy: Prefer domestic consumption plays over global plays

While we believe that broad euro strength will not derail domestic equities, some sectors will perform better than others in Europe. We prefer domestic consumption plays over sectors with huge global exposures. Our preference is premised on two factors: (1) Correlations show that domestic consumption sectors like utilities, telecoms, and financials have a lower inverse relationship with the EUR/USD; and (2) Euro strength translates to disinflationary pressure domestically, prompting the European Central Bank (ECB) to maintain broad monetary accommodation. This is positive for domestic consumption plays.

Performance update: Huge divergence in performance within non-cyclical space

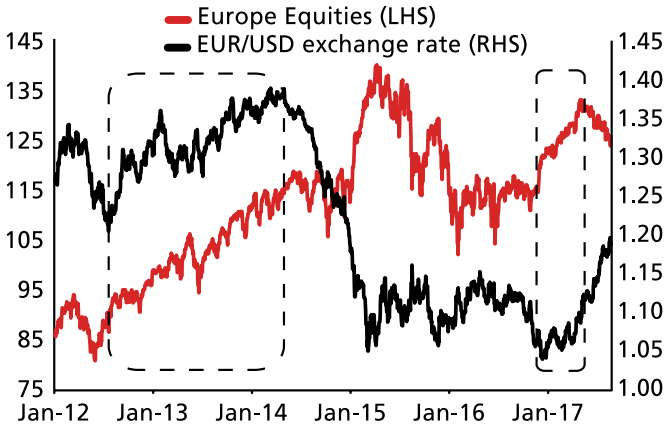
Despite recent euro strength, European equities gained 2.9% quarter-to-date (QTD) on a total returns basis (in USD terms) –the best performance among key developed markets. Among the cyclicals, materials and energy registered the largest total returns of 8.7% and 4.8%, respectively. In non-cyclicals, the divergence in performance was huge. While the likes of utilities rallied 8.8%, healthcare fell 0.9%. Geographically, Italy was the standout performer, surging 9.4%. Germany and France registered gains of 1.9% and 3.8%, respectively.

European earnings and valuation: Gradual recovery continues

Corporate profitability in Europe is on the mend as aggressive quantitative easing by the ECB works through the system. During the first half of the year, positive earnings sur-

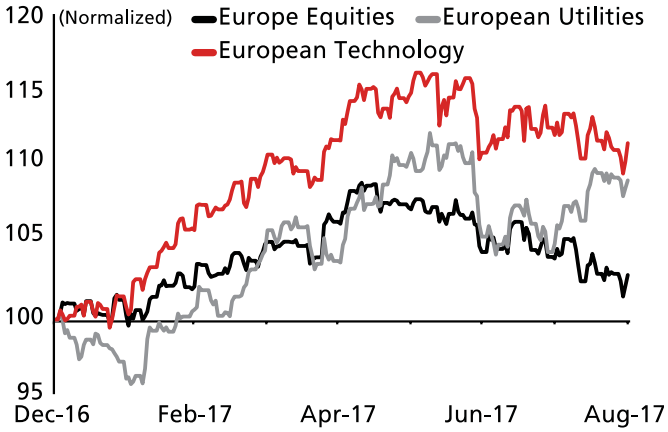
prises averaged at 70%. On a full-year basis, the market consensus is forecasting earnings before interest, tax, depreciation, and amortisation (EBITDA) growth of 14.5% for Europe, while gross domestic product (GDP) growth is expected at 2.0%. At 15.5x forward price-to-earnings (P/E), the valuation for Europe remains expensive in absolute terms, as the market is now trading above the expensive one standard deviation mark.

Figure 1: Historically, there are occasions where the EUR/USD and European equities rallied in tandem



Source: Bloomberg, DBS

Figure 2: European Utilities and Technology have been the standout performers this year



Source: Bloomberg, DBS

Japan Equities

Jason Low, CFA
Strategist

Neutral on Japan

While recent macro data and earnings have been strong, Japanese equities underperformed Asian and global equities from July to August on the back of a stronger JPY and Prime Minister Shinzo Abe's falling popularity over the quarter. We stay Neutral on Japan as valuations are undemanding while profits are rising. Macro backdrop has also been strong lately, helped by a supportive Bank of Japan (BOJ) which is unlikely to tighten monetary policy until 2018. Efforts to improve corporate governance and return capital to shareholders are also gradually making progress. However, inflation remains stubbornly low despite efforts from the BOJ.

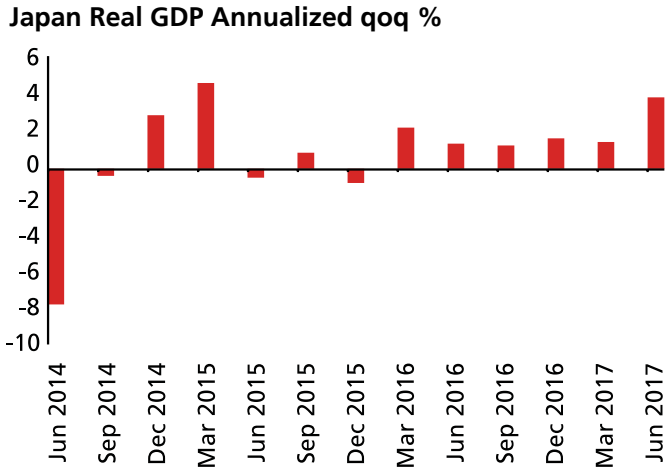
Underperformance of Japanese equities in 3Q17

Japanese equities underperformed global equities by 3.3% (in local currency terms) from July to August. This came as the JPY strengthened by 2.1% in the same period on safe haven flows and dollar weakness.

Strong macro backdrop over the past two months

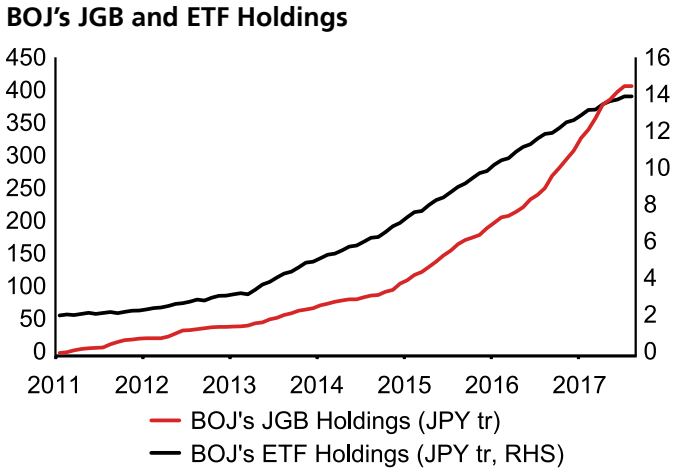
The Japanese economy grew at its fastest pace since 1Q15, achieving a sixth straight quarter of expansion, bolstered by strong domestic demand. Gross domestic product (GDP) grew at an annualised 4% in the three months ending June, topping consensus

Figure 1: Sixth consecutive quarter of expansion



Source: Bloomberg, DBS

Figure 2: BOJ already owns more than 40% of outstanding JGB bonds



Source: Bloomberg, DBS

expectations of 2.5% (Figure 1). This was supported by the 0.9% q/q growth in private consumption – which makes up about two-thirds of the Japanese economy and added 50 bps to real GDP growth. Further, the unemployment rate remained at its lowest levels in 22 years, at 2.8%. Active job offers-to-applicants ratio reached a 43-year high of 1.5x, lifting consumer confidence to a four-year high. However, wages remained weak, while inflation stayed disappointingly subdued and well below its 2% inflation target – which the BOJ has pushed back six times to 2019/20.

BOJ unlikely to tighten monetary policy anytime soon

BOJ Governor Haruhiko Kuroda reiterated at the recent Economic Policy Symposium of global central bankers at Jackson Hole, Wyoming that accommodative monetary policy will continue for "some time". At its June policy meeting, the BOJ pledged to continue its quantitative easing programme, while maintaining short-term interest rates at -0.1% and the 10-year Japanese Government Bond (JGB) yield around 0% under the yield curve control policy. Governor Kuroda also pledged to increase its bond holdings at JPY80t annually, despite significant slowdowns in purchases recently. Recall the BOJ already owns more than 40% of outstanding JGB bonds and will own more than half of the float in less than a year's time (Figure 2). Similarly, the central bank already owns around 5% of the free-float market capitalisation of Japanese equities, according to Morgan Stanley. The sustainability of these asset programmes could be questionable over the medium term.

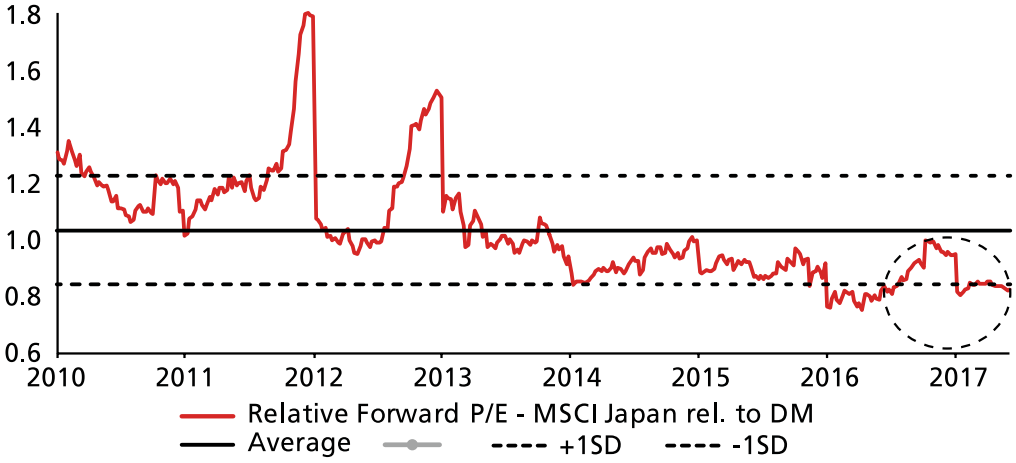
Stable politics are supportive of Japanese equities

A stable political backdrop has helped Japanese equities over the past years, with Abe's second term already longer than those of his five predecessors. But there have been recent fears of falling support rate for Abe's Cabinet, ahead of next September's LDP Presidential election. Fortunately, at current juncture, it seems the opposition remains too weak to pose a threat to Abe in carrying out his economic reforms – Renho Murata, the leader of the main opposition, the Democratic Party, resigned a few months into her role.

Valuations fairly priced at 14.0x forward P/E

MSCI Japan trades at 14.0x forward price-to-earnings (P/E) – a slight discount to its seven-year historical average of 14.6x. On a relative P/E basis, Japanese equities are trading at a 20% discount to Developed Markets equities which is at the lower end of its relative valuation range (Figure 3). While on a price-to-book (P/B) basis, Japanese equities trade at an undemanding 1.3x while generating a 9.2% return on equity.

Figure 3: Japanese equities at an attractive discount to Developed Markets



Source: Bloomberg, DBS

Strong earnings momentum

Japanese corporates reported a strong set of 2Q17 results with 72.0% of Nikkei 225 companies beating profit estimates while 61.5% of companies beat topline estimates. Among the sectors, utilities, energy, and materials outperformed others, having a higher percentage of earnings beats. Nikkei 225's 12-month trailing earnings per share (EPS) has rebounded since 2016 and is now near a historical high at JPY1,107. The consensus expectation is for strong earnings momentum to continue, with 23% earnings growth expected in 2017 – higher than most of its Developed Markets peers including the US.

Corporates progressing in returning capital and corporate governance

Since the launch of the JPX Nikkei 400 Index in January 2014, Japanese companies have been making steady progress in improving its corporate governance and return of capital to investors. Dividends and share buybacks have been on the uptrend every year since, with Nikkei 225's distributions per share (DPS) reaching a record-high this year at JPY346 and dividend payout rising above 30% in 2016.

Asia Pacific ex-Japan equities

Joanne Goh
Strategist

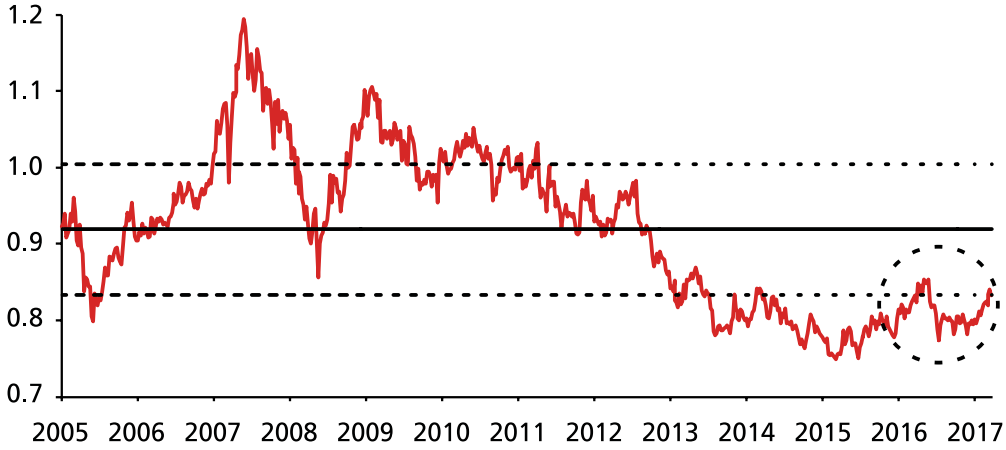
Jason Low, CFA
Strategist

Asian equities trade at attractive valuations relative to its Developed Markets peers

While valuations in Asia are not cheap on an absolute basis, they are still trading at attractive levels relative to Developed Market (DM) (Figure 1). Barring exogenous shocks such as the escalation of tensions in the Korean peninsula and trade wars, Asian equities are likely to outperform its DM peers. Further broad drivers of global recovery – weak US dollar and low bond yields – remain relatively intact to support Emerging Markets (EM).

Figure 1: Asia Pacific ex-Japan trading at attractive valuations relative to DM

Relative P/E Valuations - MSCI APxJ rel. to DM



Source: Bloomberg, DBS

Easy money has been made in China/Hong Kong. Downgrade to Neutral

We like markets that have re-rating potential, low-enough valuations, and earnings growth to support further upside. While Hong Kong and China markets are good candidates, with the assurance of stability from the "Beijing put", we believe the easy money on the "Beijing put" trade has been made and volatility could rise as profit-taking sets in ahead of the National Party Congress (NPC) on 18 October. We downgrade China/Hong Kong markets to Neutral. However, concerns over a slowdown after the NPC meeting would dispel if a smooth continuation in leadership under Party Chairman Xi Jinping can be assured, and policies, reforms, and China's long-term visions on the Belt and Road Initiative (BRI) can be realised. We will be buying on weakness.

Prefer ASEAN given lagging performance and limited downside

In hedging against tail risks, we believe laggard markets like Thailand and Malaysia would be less subjected to profit-taking risks and hence, downside should be quite limited. On the other hand, there is a potential upside for Malaysia if election chatter drums up in the fourth quarter. For Thailand, easing political tensions and the end of the late king's mourning period should lead to better sentiment for local funds and thus slow the selling into the markets. We are raising Thailand and Malaysia to Overweight in 4Q17 (Figure 2).

Figure 2: Summary of our Asian market recommendations

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

ASEAN less vulnerable to US Fed rate hike

We believe the ASEAN markets are less vulnerable to a US Federal Reserve rate hike compared to past events. Importantly, inflation in ASEAN markets are heading lower and thus need not follow US monetary policy in hiking interest rates. On the other hand, there is room for rate cuts, which make bonds look attractive. Evidence is in a stable rupiah this year, which is supported by strong reserves as well as sound monetary and fiscal policies, and has won Indonesia an investment grade rating by S&P. This has greatly reduced the possibility of sustained fund outflows should a US rate hike take place. In Thailand and Malaysia, currencies should be well supported by positive current account balance as long as the exports cycle remains strong. As for the weakening peso, a currency crisis in the Philippines is also quite unlikely as it is still being supported by strong overseas remittances and foreign holdings of bonds are not high. We are keeping the Philippines as Overweight, and Indonesia as Neutral.

Neutral Singapore, Korea; Underweight Taiwan, India

The ending of the recovery in cyclical exports has prompted us to relook export-oriented markets. As exports recovery normalises by the end of the year and year-on-year base effect starts to dissipate, a sharp dip in on-year gross domestic product (GDP) growth can be expected. The expected launch of new iPhone models at the end of year could smooth out the dip, and domestic factors – such as a broader-based recovery including the services sector in Singapore – and the effects of stimulus kicking in – such as in Korea – could offset the weakness. We maintain our Neutral position in Singapore and Korea, but keep Taiwan as Underweight. While Korea and Taiwan are both heavily exposed to the tech cycle, the innovation in 3NAND and OLED should have wider and better application and longer product life spans. India is an Underweight due to its high valuations and weak earnings outlook, while the unintended impact of the goods and services tax (GST) reform coming through as higher inflation should not be ignored.

Emerging Market Bonds

Neel Gopalakrishnan
Strategist

As we head into the last quarter of 2017, the key concern for Emerging Market (EM) bond investors remains the same as that when the year started – that is, the risk of rising interest rates and the impact on bond valuations. A combination of several factors such as: i) US President Donald Trump's inability (so far) to implement his policies, some of which were perceived to be positive for growth and inflation; ii) The absence of a pick-up in inflation in most markets; and iii) Rising geopolitical tension, which led to a fall in US Treasury rates, has supported a better-than-expected return for EM bond investors. The Bloomberg Barclays Asia High Grade Index (BBAHGI) returned around 5.3% from January to end-August while the JPMorgan Corporate Emerging Market Diversified Index returned a more impressive 7.25% in the same period, supported by an improving economic and political situation in Latin America, Africa, and Eastern Europe.

EM bond performance relative to global bonds (January to end-August)	
EM USD Sovereign	7.6%
EM USD Aggregate	6.6%
EM USD Corporate / Quasi sovereigns	5.9%
US High Yield	5.5%
EUR High Yield	5.5%
US Investment Grade	4.9%
EUR Investment Grade	-1.8%

Source: Barclays Research, DBS

It remains a challenge, however, for EM bond investors to find value. Yields have fallen further through the year – the BBAHGI had an average yield of around 3% (average A- rating) – while the comparable Asia high-yield index had a yield of around 5.4% (B+ rating). However there remains plenty of liquidity to be deployed. For example, primary bond issue in Asia has generally strong order books with at least 5x subscription seen in many cases.

We believe there are still selective opportunities in the BBB/BB rating buckets, although investment at this point is more for coupon carry than meaningful price appreciation. Any temporary correction will likely be seen as a buying opportunity, given the technical strength of the market. We would, however, refrain from going down the credit curve (single B or lower) giving rising credit event risk and would prefer subordinated bonds of higher quality issuers instead. Given the interest rate outlook, our preference would be for shorter tenor of less than five years. We see better relative value in EM markets outside Asia, such as in Eastern Europe and Latin America.

Currencies

Benjamin Wong
Strategist

The dollar bull is maturing

Our core view of the US dollar, as represented by the US Dollar Index (DXY), is that it has limited upside potential. On the medium term, it is nearing the end of a bull cycle that began in 2011 as ingredients for a strong US dollar are slowly being edged out.

The dollar started the year with a bang, staged a strong recovery from March 2008's lows around 70.69. The then freshly-elected US President Donald Trump's various electoral reflationary promises, coupled with Federal Reserve's projected policy normalisation path have provided investors with hopes of a strong USD rally.

But alas, that hardly lasted.

Trump, even in his early days, has proved to be unconventional. US Presidents traditionally leave comments on level of the dollar to their Treasury Secretaries. Trump, however, referenced US dollar valuation early in the game, saying "our currency is too strong. And it's killing us".

Clearly, the US dollar is being developed as a silent weapon of protectionism. And as the Trump Administration advances and goes ahead into North American Free Trade Agreement (NAFTA) negotiations (and probably with China at some stage), the spectre of a trade weapon does come into the picture. The US cannot fault China as a currency manipulator given the Renminbi has strengthened by close to 6% year-to-date.

Despite holding the numbers, the Republicans in Congress and Senate have failed to take health care reforms forward. This has severely undermined the US dollar as the capability of the Trump Administration advancing its reflationary and stimulus agenda is being questioned – one would have expected holding three echelons of power in the White House and both houses will empower the Administration to swiftly usher in the period of radical pro-growth policy changes.

Abandoning the border adjustment tax proposal also took away a game-changer plank for the USD. This destination-based cash flow tax would have notionally lifted the US dollar trade-weighted index by an estimated 10-15%. But there is something grinding in the background, as the dollar's decline has been accompanied by a sharp fall in the Bloomberg US economic surprise index.

But the DXY is also heavily laden (at 57.6%) with Euros in its composition. The EUR has been performing astonishingly well since French President Emmanuel Macron's electoral victory in early-May, followed by a resounding 308 seats won by his La Republique En Marche. The currency has been re-priced on the perspective of a European Central Bank's (ECB) nominal rates mishap vs. a Taylor's Rule guidance at around 2.45%, a relief rally on clear rejections of populism demonstrated in both the Dutch and French elections, and the revitalised fact that the Eurozone has walked away from disintegration threat. Just take a look at the Sentix Euro Break-up Index – it has moved to eclipse the lows last seen in June 2014. The EUR is back and, by default, the USD loses its edge.

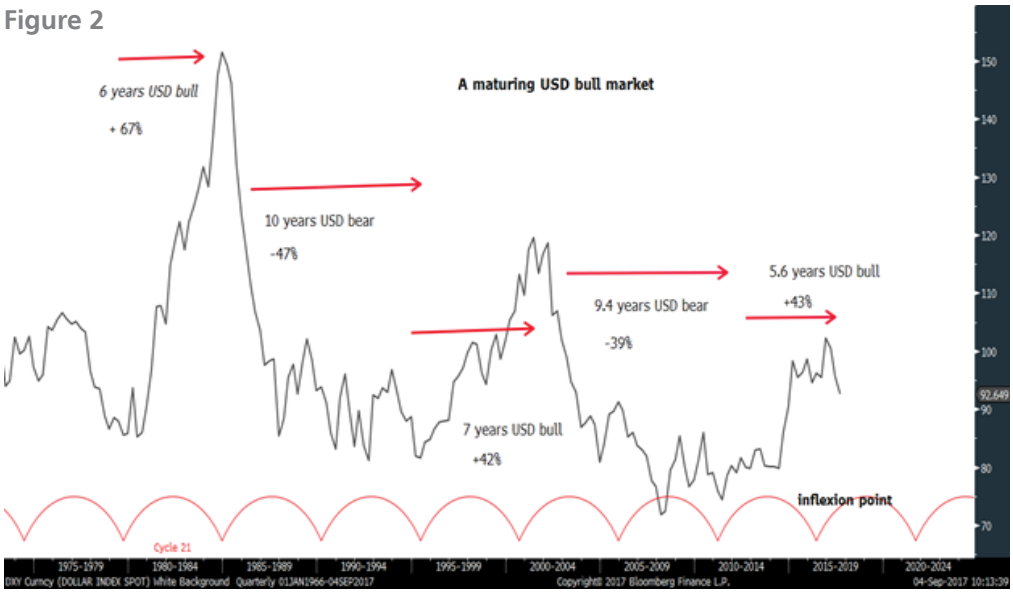
Figure 1

Source: Bloomberg, DBS

In Figure 1, the DXY has retraced an impressive 61.8% Fibonacci-wise of its decline from 121.02 to the Global Financial Crisis's lows around 70.69. The index has also completed a typical five-legged exhaustion move from the 72.72 lows. Both are telltale signs of the dollar's limited upside potential. The DXY has re-tested the May's 91.91 lows, but the USD/JPY cross, being the next large component of the index at a 13.6% weight, remains the last shoe to fall. A truncation of the DXY's key 89.62 support could be ominous.

Figure 2 shows the US dollar bear trading in nine-ten year cycles, while walking in six-seven year cycles. The current cycle for the dollar bull is aged close to 5.6 years and as the cycle finder on the bottom of the chart hints, the US dollar bull market is surely aging and maturing.

Figure 2



Source: Bloomberg

Dollar Weakness a tailwind for commodities

Source: AFP Photo

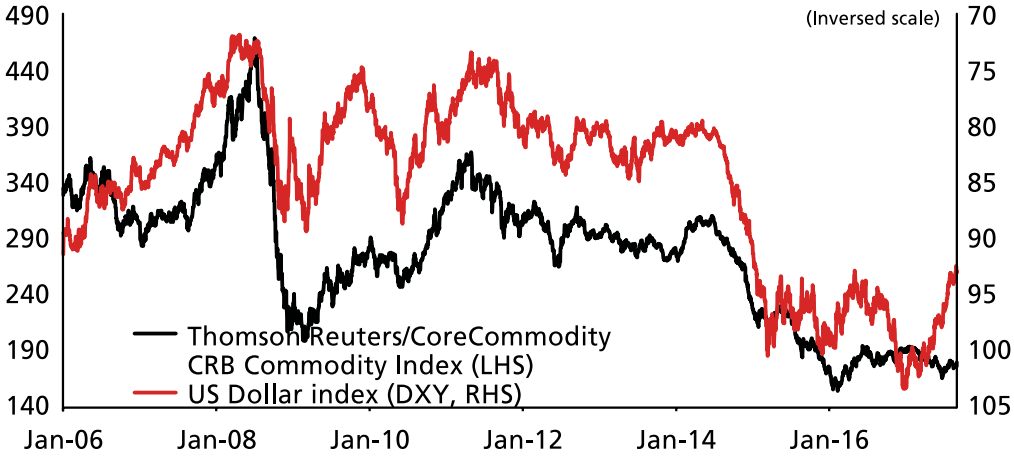
Commodities

DBS Chief Investment Office

Stay Overweight on commodities

The broad commodity complex – as represented by the Thomson Reuters/CoreCommodity CRB Commodity Index – has gained 3.5% QTD and we maintain our Overweight stance on this space during the fourth quarter. We believe that the combination of steady global economic growth and prevailing dollar weakness (Figure 1) will continue to underpin commodity prices. Indeed, China is amongst the largest consumer in the world and the ongoing stabilisation of its domestic economy auger well for outlook of commodity prices. Segmental performance, however, will continue to show disparity.

Figure 1: Close inverse relationship between commodities and the US Dollar Index



Source: Bloomberg, DBS

Investment Theme 1: Dollar Weakness

Dylan Cheang
Strategist

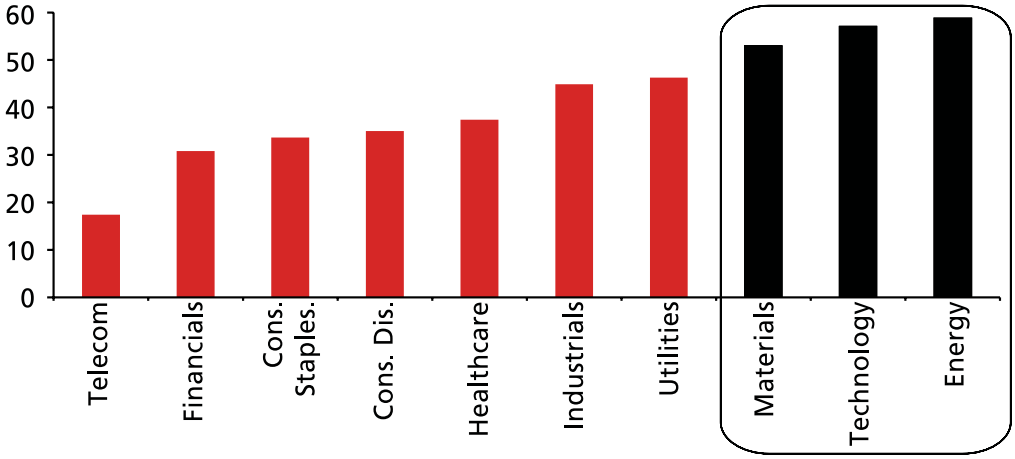
Overweight US sectors with large foreign sales

Dollar weakness tends to benefit the US economy through two channels: (1) Enhancing the competitiveness of US exporters; and (2) Currency translation gains for the overseas revenue of US companies. Companies with large proportion of overseas revenue will be geared beneficiaries of dollar weakness.

Data from S&P Dow Jones Indices show that US sectors with large proportions of foreign sales include technology, materials, and energy. Conversely, sectors with low proportions of foreign sales include telecoms and financials. There appears to be a strong negative correlation between the dollar and US cyclical sectors with global exposure. The average weekly correlation for technology, industrials, materials, and energy, relative to the DXY, is -0.28 during the January 2005 to August 2017 period.

The positive impact arising from dollar weakness appears to tie in with the technology sector's recent earnings revision trend. On a six-month basis, the consensus earnings forecast for technology has been revised up by 6.1%, the highest among the US sectors. Conversely, the six-months upward earnings revision for non-cyclicals was more modest at 1.0%.

Figure 1: Technology, Energy and Materials have the largest proportion of non-US revenue



Source: S&P Dow Jones Indices, S&P Global Market Intelligence (as of 2016)

Investment Theme 2: Asian Dividends

Jason Low, CFA
Strategist

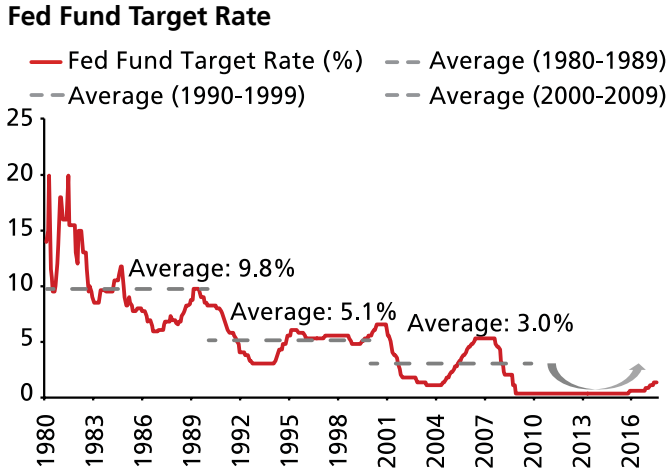
Beneficiary of gradual rates outlook and demographics

Asian dividend-yielding equities would continue to appeal to investors, driven by both macro and fundamental factors. As the hunt for yield continues in today's low interest-rate world, Asian dividend-yielding equities could benefit from an extended period of gradual rates. Demographics globally and in Asia Pacific ex-Japan are also driving the demand for dividends. In addition, dividend-yield spreads in Asia Pacific ex-Japan still compare favourably to other regions, supported by growing free cashflow and relatively stronger balance sheets.

Gradual rate hike outlook

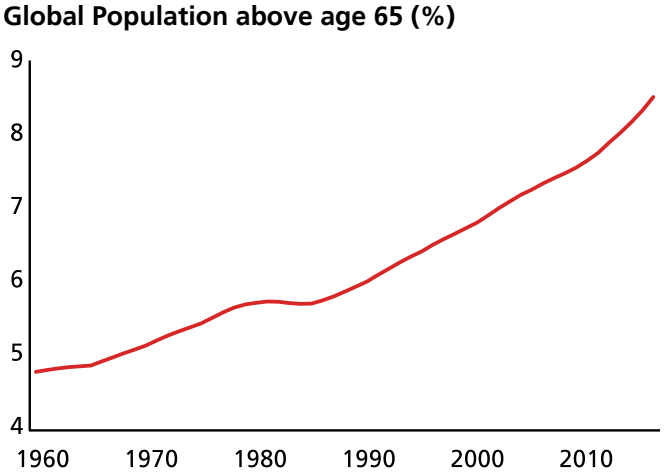
With the US Federal Reserve now in gradual rate-hiking mode coupled with a falling neutral rate – arising from demographics and productivity issues – Fed Fund target rates are unlikely to return to previous highs. In fact, the latest dot-plot signalled the target rate is likely to settle around 3% over the longer term, much lower than the 5.25% peak seen in the 2007 cycle (Figure 1). The market's outlook on rates is also muted. A Bloomberg consensus of economists shows expectation for only one more rate hike for the rest of 2017 and another 2.3 rate hikes in 2018 (compared to three hikes on the dot-plot). Markets, meanwhile, are looking at barely one rate hike by the end of 2018. A gradual, longer-term rate hike outlook places dividend-yielding stocks in a positive light.

Figure 1: Gradual longer term rates ahead



Source: Bloomberg, DBS

Figure 2: Ageing population drives demand for dividends



Source: The World Bank, DBS

Demographics driving demand for dividends

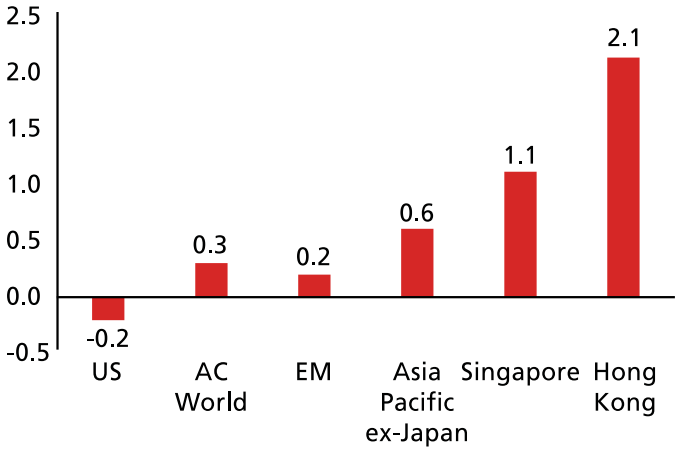
According to the US Census Bureau, the global population above the age of 65 is projected to make up 17% of the world's population by 2050 – double that of today's 8.5% (Figure 2). This ageing trend is similarly seen in Asia. In China, for example, the above-65 population made up 10.0% of its population in 2016, compared to just 3.7% in 1960. As there has been a strong positive relationship between older population and demand for higher dividend-paying assets.

Attractive dividend yield and yield spreads in Asia Pacific ex-Japan

Asia Pacific ex-Japan offers an attractive dividend yield of 2.7%, 20 bps more than the global average. More importantly, Asia Pacific ex-Japan also offers a yield spread (against the 10-year US Treasury yield) of 60 bps – higher than the global average of 30 bps and US's -20 bps. Asian countries that stand out include Singapore and Hong Kong with dividend yield spreads of 110 bps and 210 bps, respectively (Figure 3). The decent yield pick-up, coupled with Asia's strong dividend growth rates since 2002, offer investors an opportunity to buy into Asia's ongoing growth story at a discount. This is helped by a gradual improvement in the dividend-paying culture in Asia. In fact, companies which are able to allocate capital efficiently and sustain their dividend payments tend to have better corporate governance and often deliver better total returns.

Figure 3: Attractive yield spreads in Asia Pacific ex-Japan

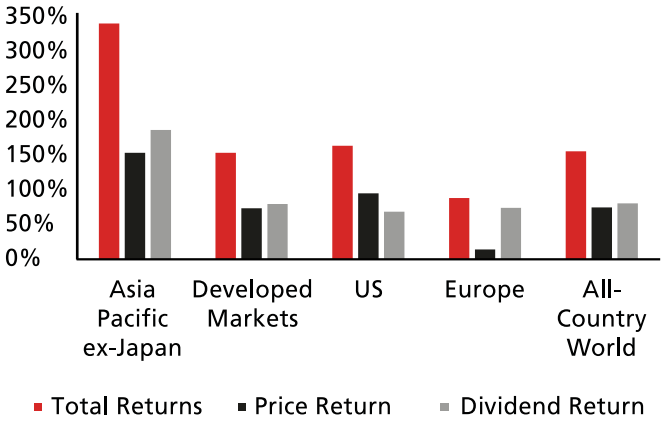
Dividend Yield Spread (%)



Source: Bloomberg, DBS

Figure 4: Dividends made up more than 50% of total returns in Asia from 2002-16

Returns Breakdown (2002 - 2016)



Source: Bloomberg, DBS

Strong fundamentals driving dividend growth in Asia Pacific ex-Japan

Asia Pacific ex-Japan dividends have grown an impressive 231% since 2002 and is forecasted to grow 19% in 2017. These compare favourably to the dividend growth seen and expected in Developed Markets, and is backed by strong free cashflow. Gearing is also lower compared to Developed Markets. In addition, Asia's payout ratio stood at 44%, compared to 53% in Developed Markets, and has been trending below its historical average of 48%.

Total return an appropriate approach in an uncertain environment

The global political climate remains uncertain with North Korea and trade wars dominating headlines. Investors should look at a total return approach – through capital gains and dividends – to generate returns. Historical returns for Asia Pacific ex-Japan show the benefits of employing such an approach.

Singapore REITs would be beneficiaries

Singapore Real Estate Investment Trusts (REITs) reported a 5% growth in distributions in 2Q17, with 7% and 8% on-year growth in revenue and net property income, respectively. Valuations are still undemanding at 1x price-to-net asset value (P/NAV) and 6.1% yield. The yield spread at 4.0% is still above historical average of 3.8%. DBS Group Research is positive on the hospitality and office sectors.

The hospitality sector in Singapore is currently enjoying better average daily rates in 2H17. Looking ahead, there is a strong pipeline of meetings and conventions in 2018 coupled with a fall in supply growth of hotel rooms. In the office sector, supply is expected to fall significantly over 2018-2020 while pre-commitment rates for new supply have so far been positive.

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