MCI (P) 081/12/2015

1 April - 30 June 2016

INVESTMENT OUTLOOK – 2Q-2016

Policy vs. The Cycle

Dear Valued Client,

The struggle by central banks and governments to hold back cyclical downturns in economies and markets will likely lead to more two-way volatility.

Since August last year, risk asset markets have been "mean-reverting" within declining trend channels. The most likely scenario now is that they decline anew within these downtrend channels during the coming months.

It is possible the words and actions of the big three central banks – the European Central Bank (ECB), the Bank of Japan (BOJ), and the US Federal Reserve – may support risk asset markets a bit longer. They may even attempt to build sideways ranges for a while. But a new bull market? No.

Rewind to the start of the year, when we spoke about big two-way volatility in what will eventually end up a bear year. That is, there will be big swings in markets in both directions; monthly ranges will expand; but by the end of the year, the trend will likely be clearly bearish.

The drivers of big volatility in both directions are the conflicting forces of the cycle and government/central bank interventions.

In a more normal world, central banks would have allowed rates to go up as the economic cycle matured, and allowed asset markets to decline. But this time, as the cycle matures, economies have remained anaemic, and central banks have no stomach for the cycle because economic foundations are fragile.

So central banks have been dishing out unconventional policies, including deeper negative deposit rates. The ECB has also offered to lend to commercial banks at negative interest rates. And market chatter has started up about direct government spending financed by quantitative easing (QE).

The market is acutely aware of the long-term risks of the above policies. Yet, it also understands that central banks are trying to change economic behaviour – forcing consumers to buy now rather than later; savers to switch from cash to risk assets; and banks to lend – hence the likelihood of more two-way volatility in global equities.

In the final analysis, however, the direction for equities will likely be decided by earnings. They are in recession in emerging markets and under pressure in developed markets. So, the bear will likely continue to dominate. Negative interest rates – along with speculation of policy stimulus in China – have helped a rebound in commodities. While it is possible that the prices of some commodities may have bottomed on anticipation of supply destruction, we are maintaining a Neutral weight on this asset class. The bottoming process will likely be protracted given sluggish economic conditions.

In the first quarter, the US dollar tended to trade inversely with global equities – weaker when risk appetite improved, but stronger on risk aversion. And almost as a reverse image of equities, the US dollar index (DXY) is now at the bottom of an uptrend channel, with a rebound likely in coming months. With negative interest rates likely to stay and even spread, we have upgraded bonds from Underweight to Neutral. What else can investors do in an equities bear market with zero-to-negative interest rates? Focus on quality and hold to maturity.

Thank you for investing with DBS.

Lim Say Boon
Chief Investment Officer, DBS Bank

Equities

Expect another round of price weakness

Bonds

Negative interest rates likely to stay or even spread – upgrade bonds to neutral weight

Currencies

The US dollar could benefit from risk aversion in 2Q-2016

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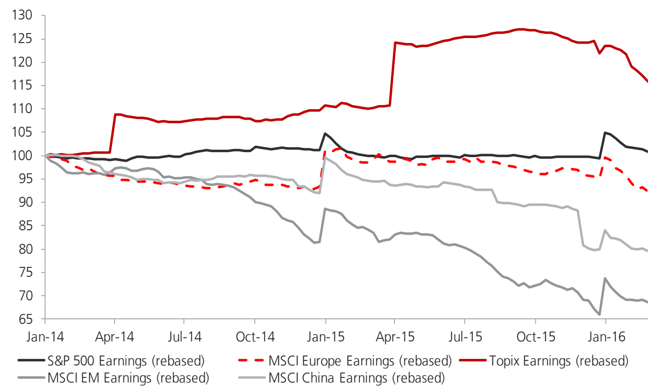
EQUITIES

The value of any stock is theoretically the net present value of its expected future stream of income. So it's about expectations of future earnings and the discount rate. Stock valuations in the developed markets have been driven to cyclical highs by central bank suppression of the risk-free component of that discount rate rather than bullish earnings expectations. Ageing demographics, low productivity growth rates, and dangerously high levels of indebtedness will overhang economic growth around the world for many years. Meanwhile in developed markets, profit margins have peaked and are mean reverting.

So it's all about cheap money rather than earnings, which are in recession in the emerging markets and under downward pressure in the developed markets. But there are limits to how far cheap money – or even negative interest rates – can push valuations. Firstly, investors will likely use a "normalised" (long-term) risk-free rate rather than zero or negative interest rates. Secondly, the risk premium of the discount rate could actually rise as interest rates dip to zero and beyond. That is, zero/negative rates are signalling historically abnormal economic conditions and hence uncertainty about the future.

Arguably, cheap money was already in the price as the risk-free rate approached zero. Beyond that, zero or negative rates may do nothing more for valuations as investors look to long-term rates as a guide and as risk premiums rise. So in the end, corporate earnings are likely to be decisive. And they are recessionary or under downside pressure at the moment.

Fig 1: Earnings Are Declining or Under Pressure

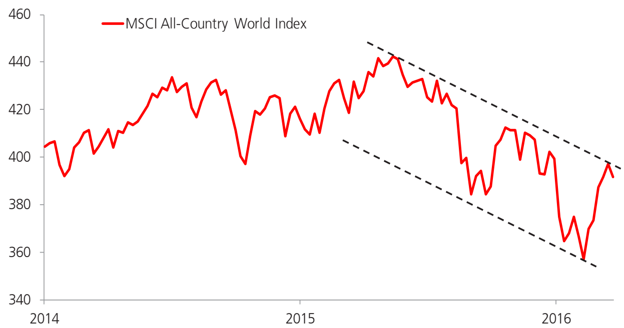


Source: Bloomberg, DBS CIO Office, as of end March 2016

We called this an equities bear market. European, Japanese, Chinese, Emerging Markets, and Asia ex-Japan indices have fallen into bear market territory. They have regained some lost ground, but are probably not out of the bear's grip just yet. US equities are not yet in a bear market. But historically, US stocks tend to do better ahead of a Presidential election than afterwards. The global equities rebounds in February-March were upswings within downtrend channels. (Figure 2) And this pattern was observed in risk assets around the world – including commodities and commodity currencies – not just equities. Markets do not move in straight lines, whether they are in uptrends or downtrends.

Earnings are critical. As long as earnings are declining or under downward pressure, we will remain bearish towards equities on a 12-month view.

Fig 2: Up and Down, the Downtrend Channel



Source: Bloomberg, DBS CIO Office, as of end March 2016

The contest between cheap money and weaker earnings will bring great volatility both ways. For short periods, market sentiment can be driven to extremes by a belief in the power of "unlimited" central bank and government fiscal firepower. We don't buy the idea of "unlimited" just as we don't buy the idea of a "free lunch". There are political obstacles to bigger fiscal deficits in the US and the Euro Area. Unlimited quantitative easing also exposes central bank capital to market fluctuations and could potentially put at risk the financial sector's stability and the central bank's credibility. Negative interest rates are not cost free either – they could erode commercial banks' earnings and complicate the pricing, loss reserving and capital management strategies for insurance companies. Indeed, would central banks buy unlimited amounts of negative yielding bonds?

China's abandoning the path of economic restructuring, reforming state-owned enterprises and working down bad debt has a price too – future growth. China could reignite current economic activity by expanding credit rapidly. That could take risk assets higher for a while. That is, until the market realises it has borrowed from future growth, and setting up a greater debt bubble to deal with in a few years. Expanding credit and economic activity would not necessarily lead to greater profitability, which is critical to stock pricing. Remember the problem in China to begin with was not a shortage of savings and capital. It was the misallocation of capital. Without reform, more credit could simply mean more misallocated capital, not more corporate earnings. We are Underweight equities on a 12-month view. Out of the big two-way swings, we expect prices will end the year lower. But we favour Emerging Market (EM) equities over Developed Markets (DM), on a 12-month time frame. This is not a trade to rush: 1) The base-building/bottoming of commodities such as iron ore, industrial metals, and crude oil is likely to extend over months. Don't expect a V-shaped recovery. 2) The US dollar remains on an upward channel notwithstanding recent weakness. And EM equities indices are still negatively correlated to the US dollar index, DXY. 3) There remains a risk that the Chinese yuan could erode significantly over the course of coming months, causing another round of risk aversion in EM.

But EM equities are a trade to watch for later this year: 1) Zero and negative interest rates could slow the funds outflow from EM. 2) Commodity markets are likely to stabilise on anticipation of supply destruction. 3) Valuations are turning more favourable towards EM relative to DM. 4) The decline in EM earnings is very advanced compared to DM, where earnings could enter recessions at different stages over the next 12 months. 5) Positioning is very light in EM equities. We are Neutral weight on EM equities on a 12-month horizon.

BONDS

The widening and deepening of negative interest rates over recent weeks were pivotal events for asset markets. The Bank of Japan joined NIRP (negative interest rate policy) and the European Central Bank deepened its negative deposit rate and extended it to its lending rate to commercial banks. And given the apparent determination of central banks to hold back economic and market cycles, negative interest rates are likely to stay – indeed, spread and deepen.

We are upgrading bonds to neutral weight. What else can private/individual investors do when faced with an equities bear market amidst ultra-low/negative interest rates? Stick with quality, hold to maturity, and be prepared to accept mark-to-market volatility. We are mindful that spreads could widen if equities head south again. But as new issuance supply slows, spread widening could be limited by investors snapping up existing bonds to enhance their portfolio yield.

For 2Q-16, we expect strong Singapore corporate bond issuance, underpinned mainly by significant maturities and a window of opportunity given the US Federal Reserve's dovishness and a likely slowing in the pace of interest rate normalisation. For Singapore Dollar bonds, we are constructive on risk within the 2-3 year bucket, given: 1) recent spread widening 2) the relative flatness of the sovereign/swaps curves and 3) the pushing back of interest rate expectations in the US. Whilst we are expecting 2Q-16 to be broadly constructive for Singapore Dollar credits, we think performance within high yield bonds will be patchy, focused on specific names – those heavily beaten down or with M&A possibilities.

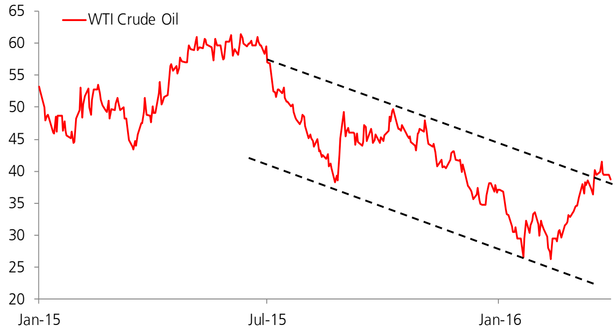
For US Dollar investment grade credits, we see some value in oversold Chinese property names that were perceived to be at risk of downgrades. Based on the FY15 results released, we think most negative rating actions should be behind us for the time being. The Chinese oil complex looks interesting but we would prefer to wait for Moody's to complete its review for downgrades of oil majors before adding on positions. Among high yielders, we are selectively constructive in the Chinese property space, preferring to stick with the better names (i.e. high B/BB rating bucket).

Beyond Asia, we favour some Tier 1 and Tier 2 names in the European banking sector, which pay high single digit yields to call. We would only focus on quality names which would require massive write-downs before their trigger ratios are triggered. But these instruments are highly correlated to the equity markets. We would only recommend them to investors with suitable risk profiles.

COMMODITIES

The broad commodities complex – mirrored by the Thomson Reuters/Core Commodity CRB Index – rebounded strongly in 1Q-16. But at this stage, the up move is still consistent with a technical rebound within a downtrend. And indeed, very similar technical pictures are evident in charts for industrial metals, iron ore, and crude oil. (Figure 3)

Fig 3: Oil Tries to Break Out of Downtrend Channel



Source: Bloomberg, DBS CIO Office, as of end March 2016

It is possible that base building has started for selected commodities. Hence we are Neutral weight allocation on commodities. But the process is likely to be protracted, not V-shaped. Markets will try to price in supply destruction ahead of reality. But for now, many commodities remain oversupplied, amidst weak demand. Crude oil possibly has the most promising outlook. To be clear, it remains oversupplied due to resilient US production, high OPEC output, and the gradual return of Iranian oil. But the early stages of global oil rebalancing have begun, and will likely continue as long as the West Texas Intermediate (WTI) crude price remains below USD45-50 a barrel, forcing US shale oil producers to continue reducing output. Meanwhile, the recent spike in iron ore prices is probably unsustainable, and largely attributable to transient factors: 1) rising physical demand from low inventories at Chinese steel mills in the spring season, exacerbated by; 2) potential risks of renewed government-imposed pollution-related production restrictions; and 3) fast-rising traded volume in synthetic iron ore indices, which increases volatility.

Underlying Chinese demand could weaken further. Steel is in oversupply, and requires capacity closures, putting downside pressure on iron ore. Aluminium is also an oversupplied industry, with Chinese smelters running at below 75% capacity. The global market is projected to be in surplus by around 500,000 tonnes this year. A deficit market is needed to absorb this huge inventory overhang. Copper prices also face major headwinds from downside risks to demand and oversupply. As with aluminium, market sentiment, not fundamentals, has driven copper's recent price surge, which is unlikely to be sustained.

CURRENCIES

The currency market has entered an uncertain – and more volatile phase – of an undeclared currency war. The Bank of Japan (BOJ) has joined European central banks in negative interest rates. The European Central Bank (ECB) took its deposit rate even deeper negative and extended it to the rate at which it lends to commercial banks. At face value, these actions were about encouraging banks to lend and so stimulate economic activity. But it would be naïve to think a complementary agenda might not be to weaken their respective currencies as a form of monetary stimulus. In any case, neither the BOJ nor the ECB have been particularly successful in their devaluations. That's because the US Federal Reserve, in turn, has talked down interest rate expectations, thus weakening the US dollar.

Guy Debelle, Reserve Bank of Australia's Assistant Governor, recently made some telling remarks on this undeclared currency war. "Most central banks want lower currencies, to push up inflation or create a bit more activity. But obviously everyone can't have (a) depreciating currency, that's what happens when you have relative prices," Bloomberg quoted him as saying. By definition, not all currencies can go down at the same time. So central banks bide their time and take turns at weakening theirs. The acceleration of central bank policy communication and intervention to depreciate their currencies have made the currency markets more volatile.

On balance, the US dollar could strengthen moderately in 2Q-16 – although not uniformly – as US economic data should come in stronger than its trading partners. Renewed equities market weakness will also help the US dollar against most currencies as a risk aversion trade.

2Q-16 Tactical Asset Allocation Strategy

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

*DM refers to Developed Markets