Source: AFP Photo

18 June 2018

Steer Through Rough Seas

Expect elevated volatility

Policy tightening, Eurozone politics, and trade war fears to keep markets in check.

Move equities to Neutral; cash to Overweight

Within a multi-asset portfolio, we raise cash out of equities for future investment opportunities. Within equities, continue to prefer US over Europe. Move Asia to Neutral from Overweight.

Engage bonds for superior income

Hold bonds for incremental yield over cash deposits through a portfolio of diversified credits. BBB-/BB-rated bonds are preferred on risk-adjusted returns. Maintain portfolio duration at between 3 to 4 years, on the back of a flat yield curve.

Invest in beneficiaries of structural trends

Participate in the long-term growth trends of Asian Tourism and Ageing Population. Stay invested in Structural Winners of the new digital economy.

Produced by:
DBS Chief Investment Office

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Kelly Tay	Head, Investment Communications
Yu Guo	Editor
Cheryl Han	Editor

Contents


Source: AFP Photo

CIO INSIGHTS

Foreword

Dear valued clients,

Led by our Chief Investment Office and a team of over 100 research analysts, we are pleased to bring you 3Q18 CIO Insights, an all-in-one investment guide to help you navigate and seize opportunities in these uncertain times. In this report, you will see what constitutes our risk-adjusted asset allocation models, as well as our top investment ideas across different asset classes.

Thanks to your continuous support, DBS's wealth management business has delivered consistent growth over the past few years. The successful acquisition of ANZ's Asian retail and wealth management business has also added a large customer franchise in the key markets of Indonesia and Taiwan.

In May, we unveiled a bold new brand promise. After more than a decade of establishing our Asia heritage with "Living, Breathing Asia", DBS is evolving its positioning to "Live more, Bank less". These are more than just words; they reflect our firm belief that in the digital era, we need to deliver banking that is so simple, seamless, and invisible, that customers have more time to spend on the people or things they care about. But while we have embarked on this digital transformation, we firmly believe in the strength of long-term personal relationships built on trust and respect. That is why we sincerely hope to be able to continue on this growth path with you, and to be your trusted wealth management partner in the long term – through up and down cycles, good times and bad.

We look forward to serving you better in this new era of banking. Thank you for being with us on this transformational journey!

Tan Su Shan
Group Head
Consumer Banking & Wealth Management

Executive Summary

Dear valued clients,

In sharp contrast to the smooth ride of 2017, inflation and trade war fears sent financial markets on a roller-coaster ride in the first half of 2018.

In our 1Q18 CIO Insights entitled "The Bull Ain't Done", we were optimistic the bull trend – albeit nine years old – would continue. As the quarter unfolded, this view was indeed challenged. We held on to our bullish view and recommended clients "Mind The Bends" in our 2Q18 CIO Insights.

Looking back, I'm glad to report our calls have been largely on target. On asset class, equities outperformed bonds. On regional allocation, our preference for US over Europe paid off.Asian equities performed in line with the world index. On investment themes, our high-conviction call on US Technology was a stand-out winner. Global Financials, however, lagged.

So where do we now stand, at the midpoint of 2018?

Despite the see-saw in markets, we stay engaged with risk assets within a diversified global portfolio. The world economy continues to be on sound footing, with inflation under control. Credit spreads remain resilient and equity valuations have normalised on the back of strong earnings growth and the pause in the bull trend.

We are, however, cognisant that there are mounting risks. These include continued trade war fears, and uncertainties from the Italian political fiasco which may trigger a broader European Union (EU) crisis. Hence, we have titled this publication "Steer Through Rough Seas". For the coming quarter, we move equities from Overweight to Neutral and raise cash to Overweight.

On equities, we adopt a thematic investing approach – looking for companies that are clear beneficiaries of secular trends. For example, we see the long-term growth trajectory of Asian Tourism, Ageing Population, and Structural Winners (who are champions of the new data world we now live in). We continue our Overweight stance in US stocks, Technology, Financials, and Asian Dividends.

This quarter, we also include two Special Features - "Disparity in Volatility" and "New Realities".

Do enjoy the read.

Hou Wey Fook, CFA
Chief Investment Officer

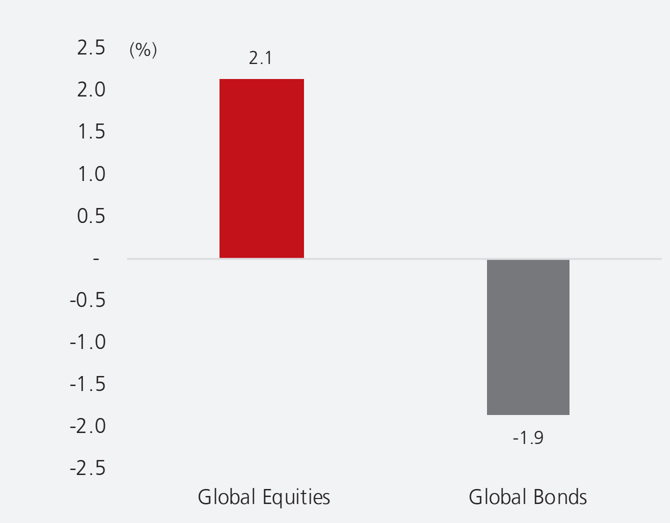
Asset Allocation | 3Q18

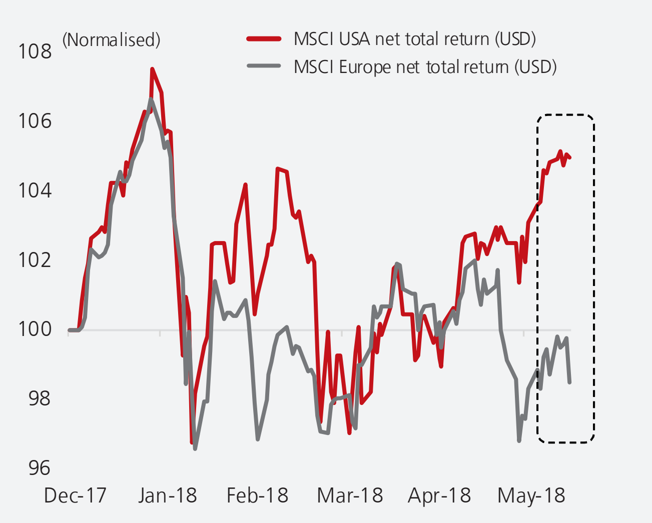
Move equities to Neutral; raise cash

Source: AFP Photo

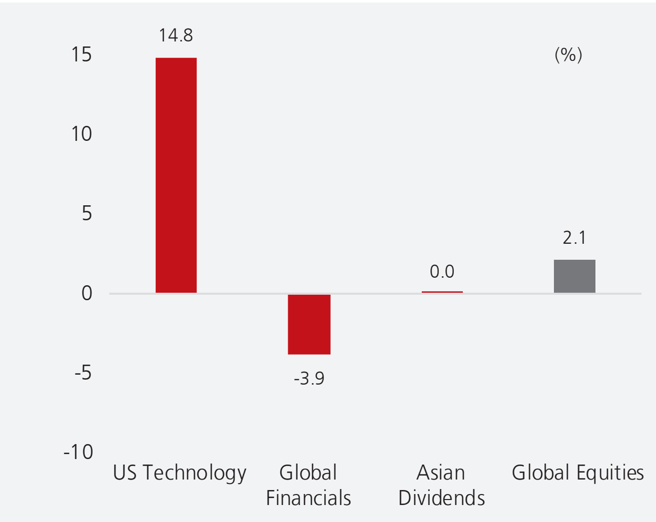
Review of CIO Investment Calls

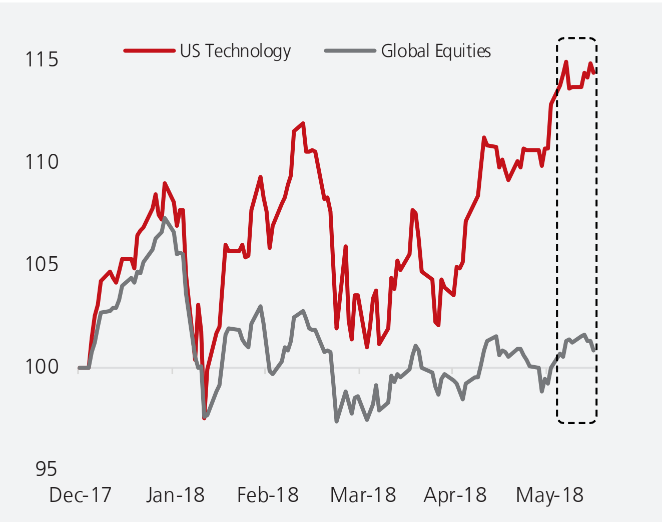
We adopted a pro-risk stance at start of the year by going Overweight Equities and Neutral Bonds. This strategy has panned out well as Global Equities have outperformed Global Bonds by 4.0 percentage points year-to-date (as of 15 June 2018). Within Equities, our bullish US and bearish Europe call also reaped dividends as US outperformed Europe by 6.5 percentage points.





Our 1H thematic recommendations were: (a) US Technology; (b) Global Financials; and (c) Asian Dividends. On average, our thematic baskets outperformed equities by 1.5 percentage points. US Technology is the standout performer as it outperformed by 12.7 percentage points.





Source: Bloomberg, DBS

DBS

Macro Outlook

Monetary Policy
The Fed is on track to raise rates every quarter from now until end-2019. Interest-rate markets are pricing in less than what the Fed intends to deliver.

Economic Growth
Soft US economic momentum in 2Q18 will prove transitory as growth outlook remains upbeat. External pressure for Asia is on the rise.

Geopolitics
US-China trade war risks linger, and the situation remains fluid. Populism rears its head in Italy, with wider implications for the Euro Area.

Inflation
US inflation to stay at c.1.8%. That said, the Fed is unlikely to wait for actual inflation to surprise on the upside before turning hawkish.

Fiscal Policy
US fiscal policy to remain pro-growth as the government embarks on tax reform and infrastructure spending.

Markets Outlook

Equities
Stay constructive on US equities, given strong macro outlook and earnings resilience. Downgrade Asia amid rising yields and US dollar strength.

Currencies
Scope for further US dollar strength given strong US macro outlook. Weak EU data flow to weigh on the euro.

Rates
More room for further ascent in UST 10-year yield. Curve flattening on the cards as the Fed tightens. Enthusiasm for loose monetary policy by ECB and BOJ is waning.

Credit
Downgrade EM bonds given US dollar's strength and rising rates. EM Asia, however, offers value. In DM, favour high yield over high grade.

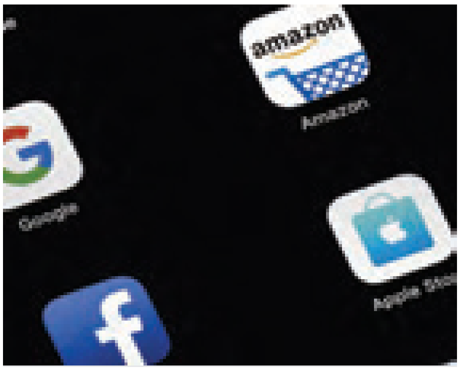
Thematics
Gain exposure to companies riding the Asian tourism boom and the ageing trend. Pick companies with advantages in the digital economy.

CIO Investment Themes

Asian Tourism

Asian tourism on the rise as income levels grow in China, India, and Southeast Asia. Seek exposure to companies that benefit from this uptrend.

New Theme | CIO Insights 3Q18



Structural Winners

Global technological advancements are leading to industry-wide structural shifts and disrupting business models. Gain exposure to companies that may emerge as Structural Winners.

New Theme | CIO Insights 3Q18

Ageing Population

The global population is growing older, and people are living longer. Demographics will be a key factor driving social demand patterns over the next few decades.

New Theme | CIO Insights 3Q18


Source: AFP Photo

Quality Play

Buy quality stocks amid rising volatility. Our selection criteria for "quality"are: (a) Strong balance sheet; (b) Good cash-flow generation; (c) Positive earnings growth prospects; and (d) Reasonable valuation.

Ongoing Theme | CIO Insights 2Q18

Asset Allocation

Hou Wey Fook, CFA
Chief Investment Officer

Dylan Cheang
Strategist

A pause in the equity market, not the start of a bear trend

Humans go through mid-life crises – stages in life where mood swings are common. Financial markets are not dissimilar, reflected in the heightened volatility seen during the first half of the year. After a long nine-year bull run, this is certainly unsurprising.

Wild swings of exuberance and pessimism epitomise the polarised views of investors today. This is not helped by the US President's frequent utterances – markets swing between risk-on and risk-off behaviour on the back of Trump-on and Trump-off tweets!

As we now enter 2H18 and a higher-volatility regime, we need to conduct a full diagnosis of our investment case and ascertain if our base assumptions remain intact. First, the headwinds:

- **Headwind 1:** Impact of rising yields on equities
- **Headwind 2:** Valuations are no longer cheap
- **Headwind 3:** Rising inflationary pressure

Next, the tailwinds:

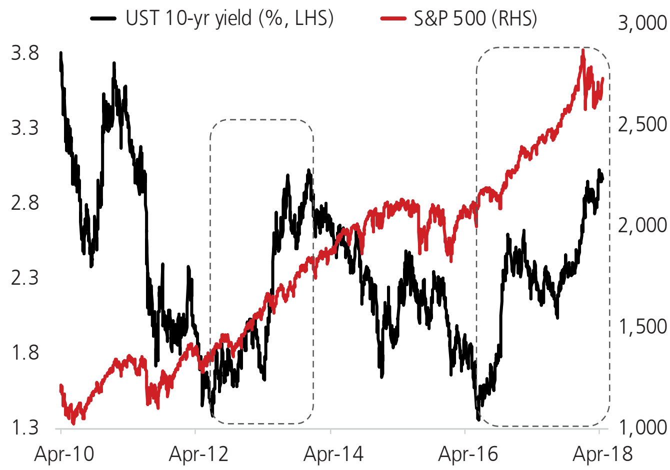
- **Tailwind 1:** Robust earnings momentum
- **Tailwind 2:** Low recession risks
- **Tailwind 3:** Credit spreads remain tight

Headwinds – Factors that may derail the equity rally

Headwind 1: Will rising yields kill the equity bull? In June's Federal Open Market Committee (FOMC) minutes, the US Federal Reserve sounded decidedly upbeat on its outlook of the US economy, saying that "the labor market has continued to strengthen (and) economic activity has been rising at a solid rate." This upbeat view ties in with those of our economists, who are now expecting the Fed to push rates up every quarter until the end of 2019, thus bringing the Fed funds rate to 2.5% by end-2018 and 3.5% by end-2019 (vs. the Fed's forecast of 2.1% and 2.9%, respectively).

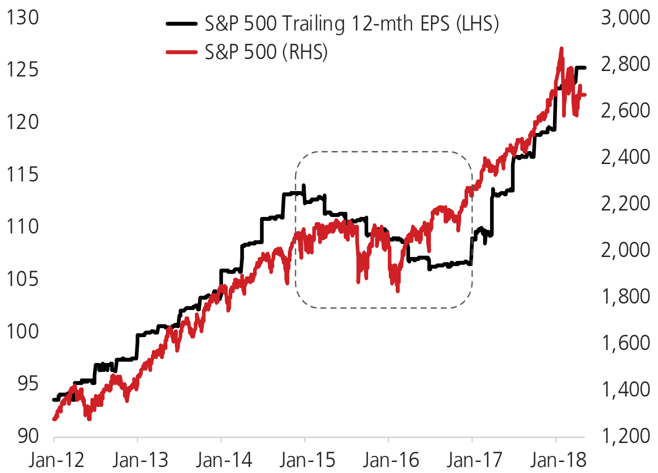
Are higher rates negative for equities? Past trends shown in Figure 1 do not suggest so, particularly when inflation is not in an uncontrollable situation. We believe the situation today is similar and therefore, a 3–3.5% yield on the US Treasury (UST) 10-year remains fair. In fact, Figure 2 shows that corporate earnings have been the main driver of US equities, not interest rates.

Figure 1: Rising yields have non-lasting impact on US equities historically



Source: Bloomberg, DBS

Figure 2: Earnings are the main driver of US equities, not rates



Source: Bloomberg, DBS

US equities trading at "fair value" after recent correction

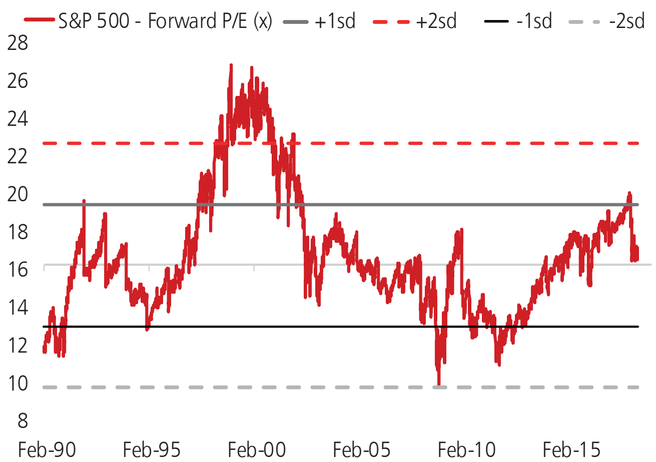
Headwind 2: Are US equities expensive? Today, the S&P 500 Index is trading at c.17x forward price-to-earnings (P/E), broadly in line with the long-term median level of 16x. The recent market pullback, coupled with forward earnings upgrades, have brought US equity valuations down to more attractive levels.

On a relative basis, US equities look attractive compared to other asset classes. The gap between the US earnings yield and that of the UST 10-year yield stands at 1.8 percentage points. While this is nowhere as high as the levels seen during 2009 and 2011, nonetheless, it remains above the long-term median.

US equities looking attractive relative to US treasuries and HY corporate bonds

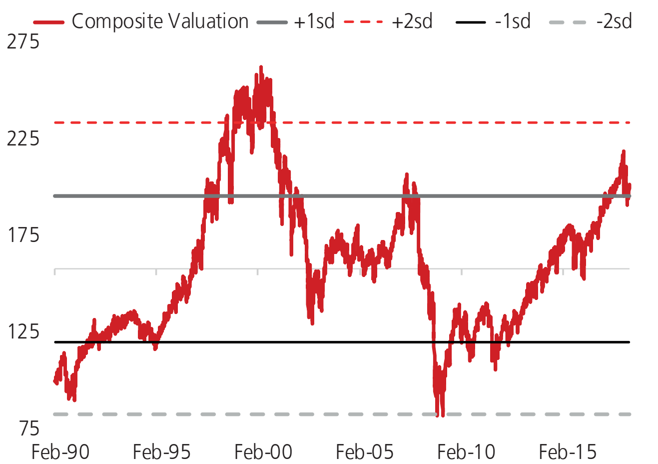
Similarly, the relative attractiveness of US equities compared to US high-yield corporate bonds has also improved. At their peak, equities were yielding 15.4 percentage points lesser than high yields bonds in late-2008 (Figure 6). But the gap has since narrowed to 1.5 percentage points as high-yield bonds continue to re-rate and trade at higher valuations.

Figure 3: After recent pullback, US forward P/E is no longer looking expensive



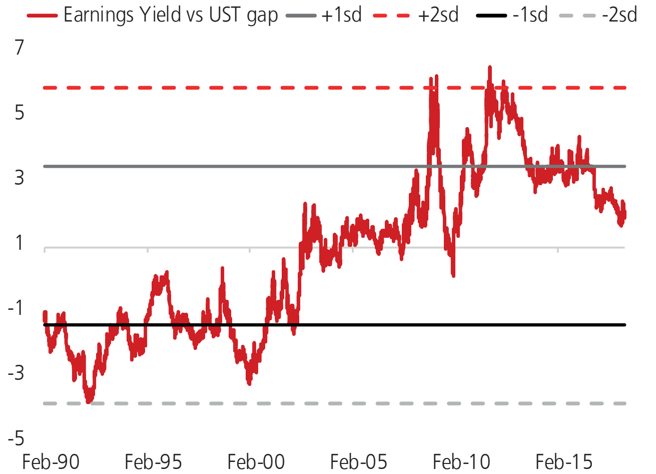
Source: Bloomberg, DBS

Figure 4: On a composite basis, US valuation is at the 1-standard-deviation mark



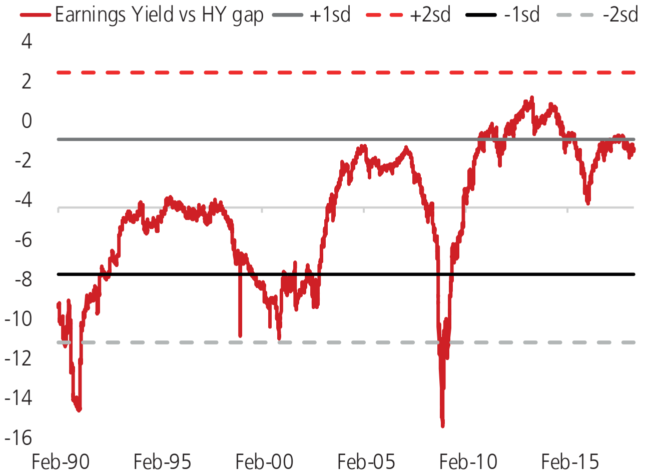
Source: Bloomberg, DBS

Figure 5: On a yield gap basis, the US earnings yield remains above that of the UST 10-year yield



Source: Bloomberg, DBS

Figure 6: US earnings yield is looking attractive relative to high-yield bonds



Source: Bloomberg, DBS

On balance, we believe US stocks are trading at fair value – neither expensive nor cheap.

Falling employment in the US no longer results in the same level of wage growth

Headwind 3: Is US inflation on the verge of breaking out? Much has been said about US inflation being on the rebound as the output gap narrows and employment picks up. But a closer look at the numbers suggests otherwise. Figure 7 shows the long-term relationship between the US unemployment rate and wages. It is evident that falling unemployment in the country is no longer resulting in the same level of wage growth. In Table 1, we identify four periods since 1982 where the US unemployment rate hit a trough, and look at the corresponding level of highest wage growth attained (Table 1).

Table 1: Relationship between US unemployment rate and wage growth

Periods	Trough unemployment rate	Peak wage growth
3Q89 - 2Q90	5.2 - 5.4%	5.5%
2Q00 - 4Q00	3.9 - 4.0%	4.4%
4Q06 - 2Q07	4.4 - 4.5%	3.7%
2Q17 - 1Q18	4.1 - 4.3%	2.7%

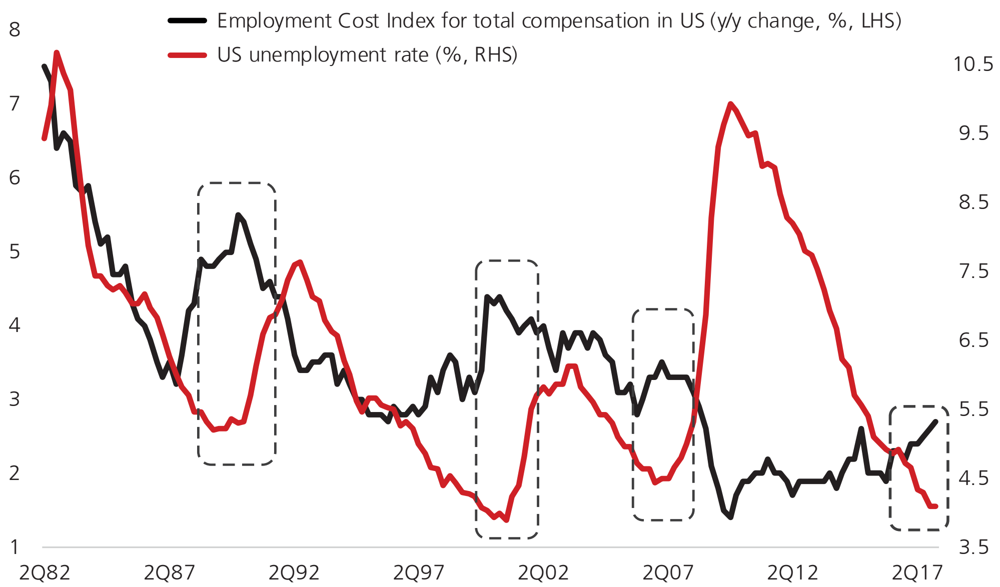
Source: Bloomberg, US Bureau of Labor Statistics

The data shows that over the historical troughs in the US unemployment rate, the robustness of wage growth diminished. At the start of the 1990s, it was 5.5%. By the beginning of this millennium, it fell to 4.4%. In the 2006-2007 era, it shrunk further to 3.7%. In the present trough in unemployment rate, wage growth is only at the c.2.7% level.

In this context, enthusiasm pertaining to the recent "jump" in US core inflation should be curbed. As Figure 7 shows, the longer-term trend for core inflation remains downward slopping and trending closely with US wage growth.

What are the factors behind the weakness in US core inflation?

Figure 7: Falling US unemployment rate no longer results in the same level of wage growth of yesteryears



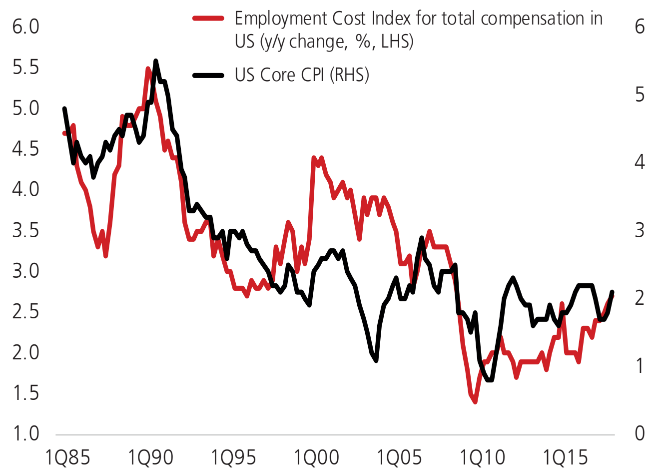
Source: Bloomberg, DBS, US Bureau of Labor Statistics

Potential causes of weak US core inflation:
1) Larger-than-expected spare capacity
2) Falling participation in US employment
3) Technological advancement

One, the current spare capacity in the US might actually be larger than the unemployment rate suggests. This can be illustrated by the US labour participation rate. Since the start of this millennium, the participation rate has been falling; this means that the number of "discouraged workers" in the US is on the rise. Labour slack in the US could therefore be larger than expected, and the potential re-entry of these "discouraged workers" would serve as a dampener for wage growth.

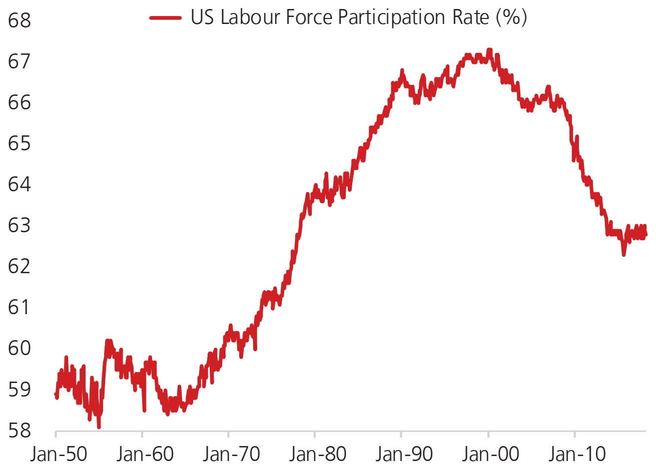
Another plausible reason for subdued wage growth in the US stems from the impact of technological advancements. Technology has paved the way for automation throughout the services/manufacturing sectors, while gradually eradicating the role of the "middle man". Such developments have a deflationary pressure on wages.

Figure 8: The overall downtrend in US wage growth augurs well for a moderate outlook for core inflation



Source: Bloomberg, DBS

Figure 9: Low US labour participation rate suggests that spare capacity in the US could be larger than expected



Source: Bloomberg, DBS

Tailwinds – Factors that support the equity rally

US corporate earnings remained robust in the 1Q reporting season

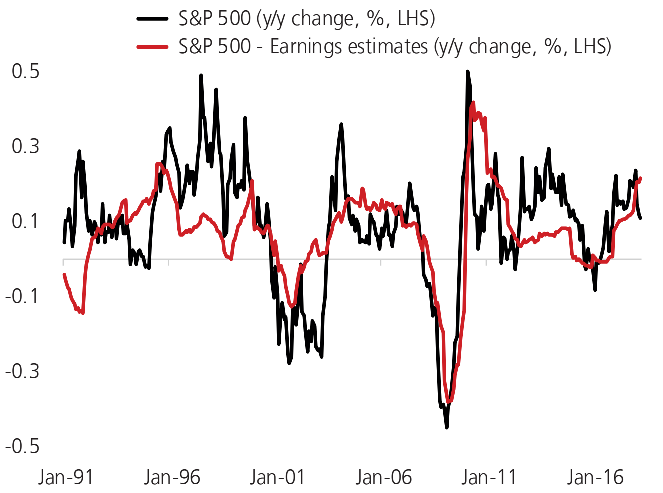
Tailwind 1: Earnings remain robust. In 1Q18's CIO Insights "The Bull Ain't Done", our constructive case on equities was premised on the fact that the corporate earnings outlook is expected to remain robust. This view stays. The first quarter's US earnings season saw c.81% of companies reporting positive earnings surprises while the proportion of companies seeing actual earnings growth was even higher at c.86%. Sectors which posted a standout performance included Industrials and Technology. On balance, the continuation of upbeat earnings momentum should underpin the outlook for US equities.

UST operating margin remains sizeable and this is mainly due to the tech sector

US operating margins, meanwhile, continue to stay elevated between the 12-14% range; this was mainly due to the strength of margins in Technology. Indeed, operating margins for the tech space have almost doubled from 12% in mid-2009 to 23% currently. On an EBITDA (earnings before interest, taxes, depreciation, and amortisation) basis, tech margins have also surged from 18% to 30% over the same period, and market consensus is expecting this to increase to 32% by the year's end.

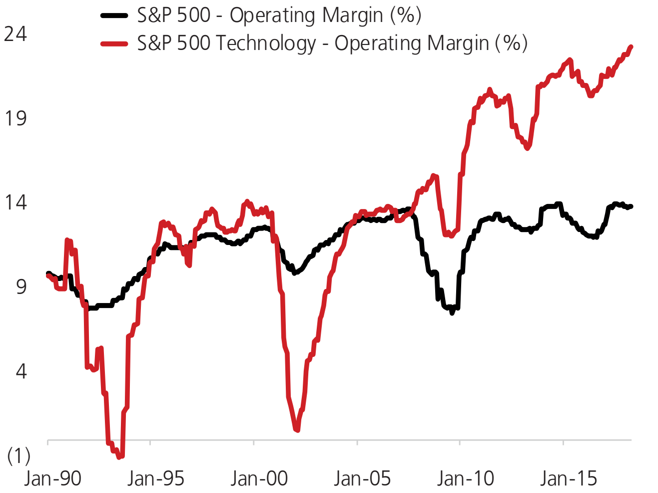
Much has been said about the negative impact of rising wages on corporate profit margins. This view, however, is unsubstantiated through our observation of historical trends. Figure 12 shows the long-term relationship between US personal income growth and operating margins for US companies. It is evident that the two variables trend in tandem, and this contradicts the widely-held view that rising wages means margins contraction. In reality, rising wages typically come when the business cycle is in an expansionary mode, and the growth in top-line revenue far outstrips the increase in labour cost – resulting in a net expansion of operating margins for corporates.

Figure 10: US earnings estimates momentum augurs well for the trajectory of US equities



Source: Bloomberg, DBS

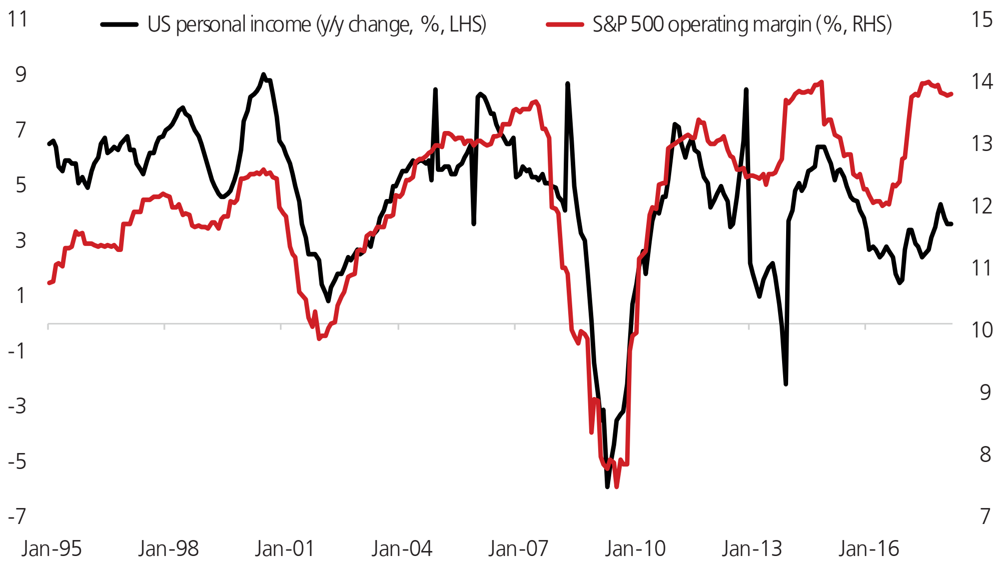
Figure 11: US operating margins remain strong thanks to the tech sector



Source: Bloomberg, DBS

Tailwind 2: Low recession risks. A prerequisite for a bear market is that recession risks must be high or have reached an extreme. But as Figure 13 shows, this is currently not the case. In fact, the US Federal Reserve is expecting only a 7% chance of a recession in the US in 12 months' time. Similarly, despite recent concerns on yield-curve flattening, the

Figure 12: US personal income actually correlates with the operating margins of US companies



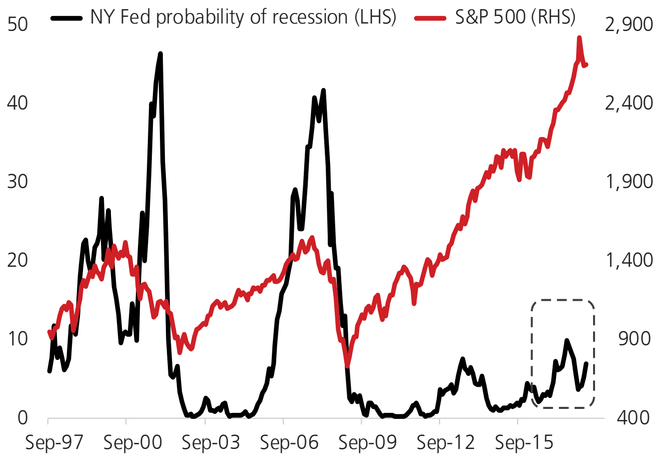
Source: Bloomberg, DBS

yield curve is not expected to invert anytime soon. This suggests that a recession is still some time away.

Financial imbalances in the US has shifted from the private to the public sector

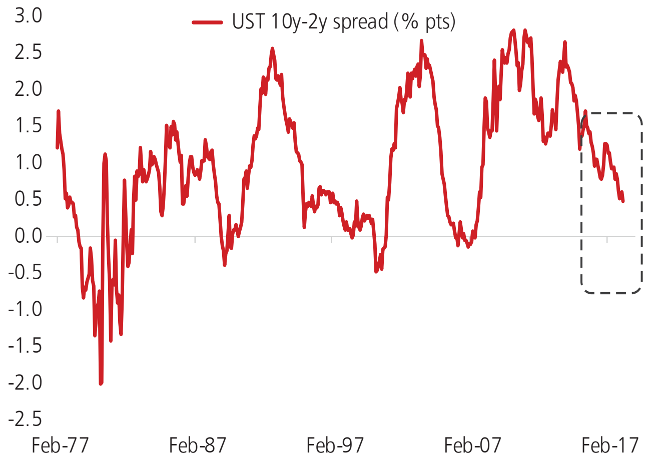
Another factor underpinning our positive macro outlook is the overall absence of structural imbalances in the system. As Figure 15 shows, since the Global Financial Crisis, financial imbalances in the US have shifted from the private sector to the public space. Such a shift is important as it reduces the chance of panic de-risking of portfolios, should macro uncertainties rise.

Figure 13: Probability of recession in the US remains low



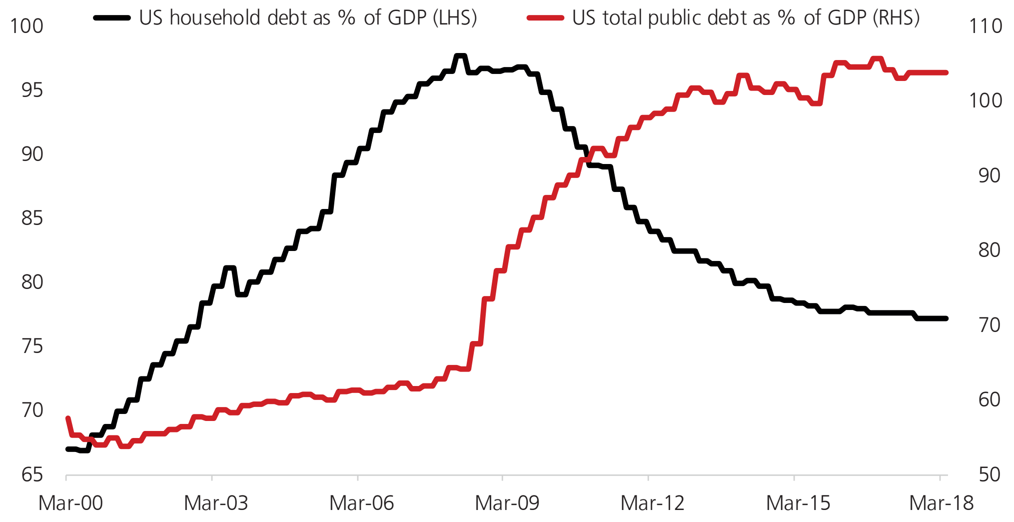
Source: Bloomberg, DBS

Figure 14: The UST yield curve is not likely to invert anytime soon



Source: Bloomberg, DBS

Figure 15: Financial imbalances have transferred from the private to public space

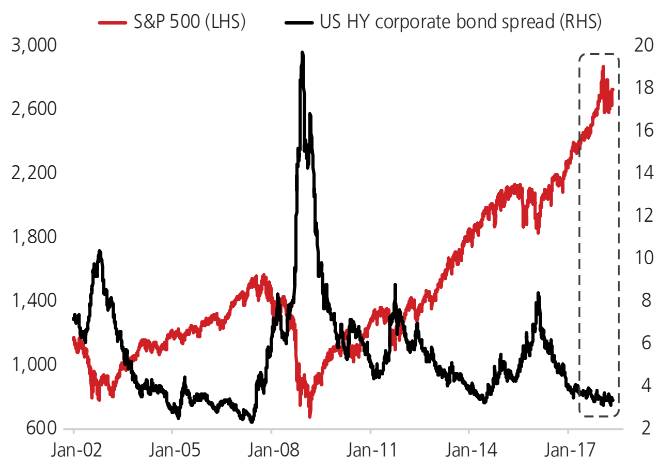


Source: Bloomberg, DBS

High-yield credit spreads have remained tight during recent market volatility

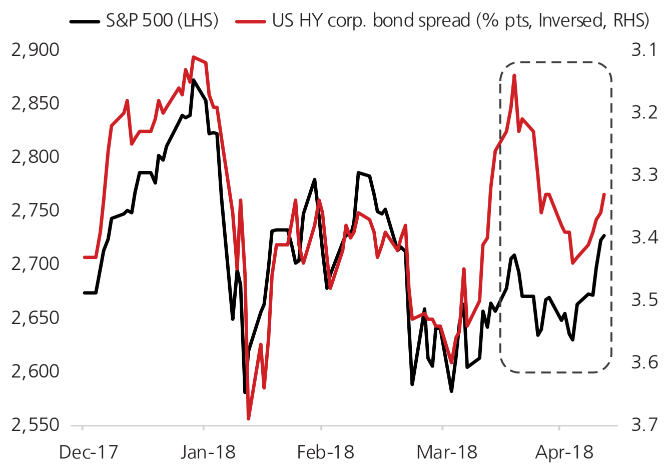
Tailwind 3: Tight credit spreads. Previous episodes of major sell-downs in equity markets were typically accompanied by a sharp widening of credit spreads; this was evident in both the "dot-com" crash and subprime crisis (see Figure 16). However, during the recent bout of equity market weakness, US high-yield credit spreads barely moved. The tightness in spreads is partly attributed to technical factors given the general preference for leveraged loans issuance this year as opposed to high-yield bonds. But the other major factor supporting this space lies in the fact that recession risks – and by extension, default risks – remain low.

Figure 16: US high-yield spreads remain tight despite equity-market volatility



Source: Bloomberg, DBS

Figure 17: Glass half full or half empty? Equity investors are seemingly more bearish than credit investors



Source: Bloomberg, DBS

Market returns will likely be constrained during the second half, as volatility rises

Elevated volatility to continue amid rough seas: taking a pause on our Overweight stance

All in all, the above analysis suggests that the equity upcycle remains intact and we are not at the start of a bear market. However, we expect elevated volatility in the coming months on the confluence of the following headwinds:

a) Lingering global trade war concerns
b) Policy tightening fears
c) Geopolitical uncertainties in Europe

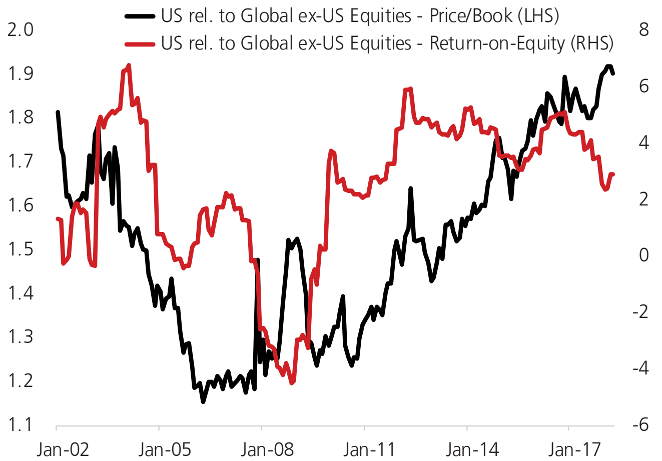
Given the inter-play between positive macro fundamentals and these headwinds, we see broad market returns in 2H as likely being constrained. At the same time, we see a wide dispersion of returns across different sectors. From an asset allocation perspective, we move equity allocation to Neutral - but within equities, we are Overweight growth stocks.

Neutral equities; Overweight US over Europe

For 3Q18, we turn Neutral on equities as our positive US view is offset by a more cautious stance on Europe. Our constructive US stance is premised on the fact that the market remains well supported by robust earnings and pro-growth government policies, while valuations have also become more attractive after the recent pullback.

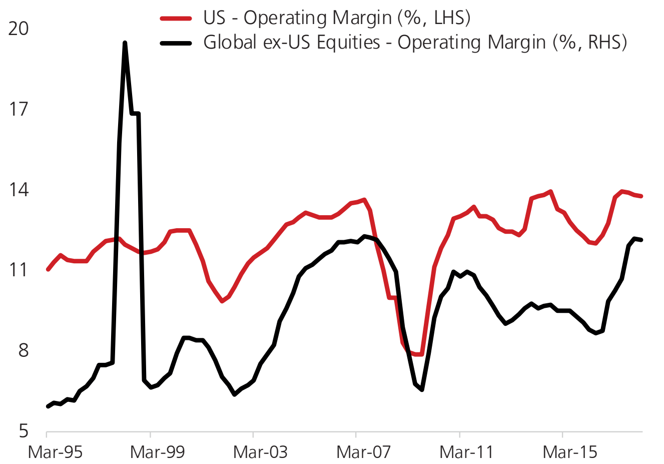
On a relative basis, considering the higher return on equity (ROE) on US equities, their valuation premiums are justified (Figure 18). In addition, US equities' operating margin premium remains sizeable over that of global ex-US equities (Figure 19).

Figure 18: US's valuation premium is justified by higher ROE



Source: Bloomberg, DBS

Figure 19: US equities continue to possess sizeable operating-margin premium compared to the rest of the world



Source: Bloomberg, DBS

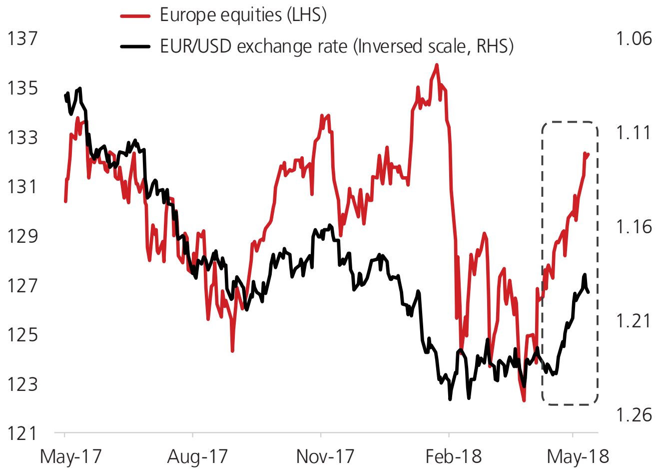
Europe stays at 3M Underweight

Meanwhile, we stay Underweight on Europe given that the recent tailwind arising from euro weakness is expected to take a breather (Figure 20). Indeed, the euro has depreciated against the greenback from March to May this year and based on our currency strategist's forecast, there is limited room for the EUR/USD for depreciate further. On the other hand, the region remains saddled with geopolitical uncertainties – from Brexit to the Catalan declaration of independence, and more recently, the rise of populism in Italy

AxJ equities moved to Neutral amid rising rates and stressors in other parts of Emerging Markets

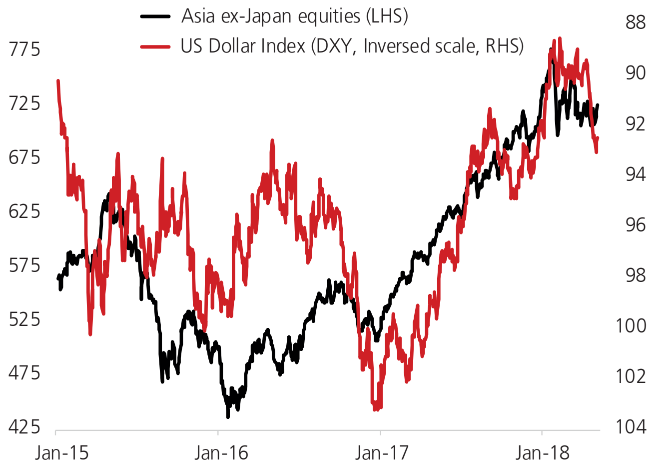
In the case of Asia ex-Japan (AxJ), we move the region to Neutral as rising rates and the stressors in other parts of Emerging Markets are expected to weigh on its medium-term outlook. Besides, the recent earnings momentum for the key markets in the region remains subdued. In the H-share market, only 48% of the companies reported positive earnings surprise. For Taiwan, the proportion is even lower at 33%. The situation is not dissimilar in Southeast Asia as earnings surprise for Indonesia stands at only c.32%. That said, we refrain from going Underweight, given that the region's valuation discount to Developed Markets will continue to underpin sentiment.

Figure 20: Recent tailwind from euro weakness to take a breather



Source: Bloomberg, DBS

Figure 21: The return of USD strength is a major headwind for AxJ equities



Source: Bloomberg, DBS

Maintain Underweight Government Bonds; Downgrade EM Bonds to Neutral amid rising USD strength

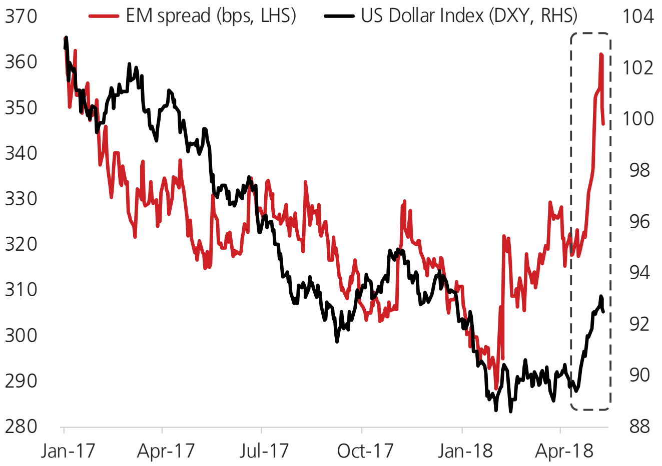
The trajectory for government-bond yields remains upward as global economic growth continues. This underlines our cautious call on this space in general.

Favour HY over IG corporate bonds

Within HY, favour DM over EM

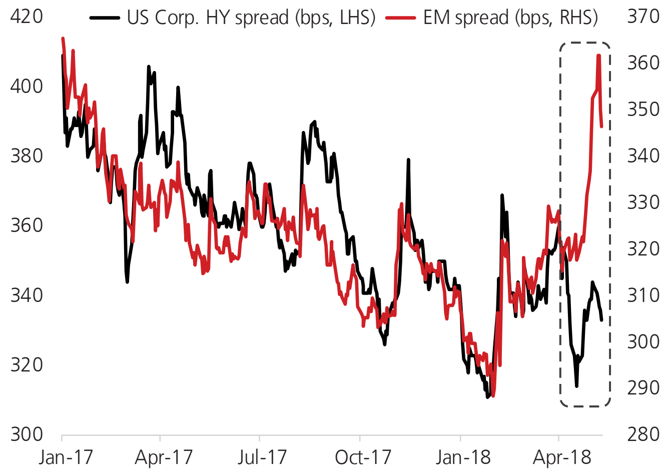
In corporate credits, we continue to favour High Yield (HY) over Investment Grade (IG), given that HY bonds perform better in a positive economic growth environment and are less sensitive to rising rates. But within HY, we prefer Developed Markets (DM) over Emerging Markets (EM). Since 18 April, the US Dollar Index (DXY) has surged and this has coincided with substantial widening for EM spreads (Figure 22). Over this period, EM bond spreads widened by c.29 bps, as compared to c.19 bps for US corporate HY (Figure 23).

Figure 22: Recent USD strength driving EM spreads wider



Source: Bloomberg, DBS

Figure 23: Recent spreads widening has been more substantial for EM bonds than US corporate HY



Source: Bloomberg, DBS

Upgrade cash to Overweight; US dollar strength a headwind for gold

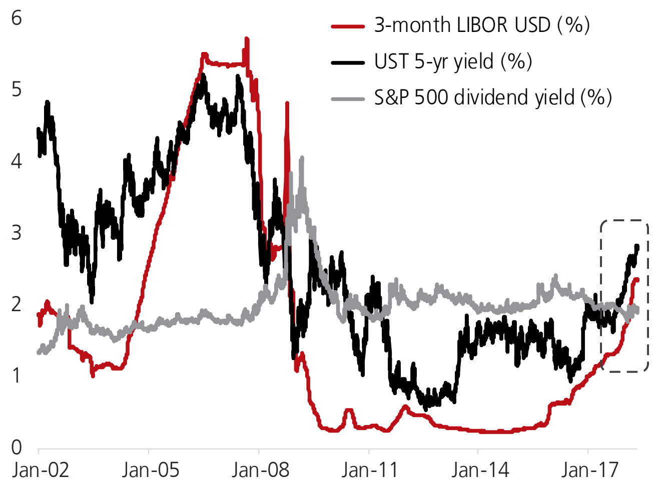
Upgrade cash to Overweight

Three-month LIBOR yields more than S&P 500 dividends

Given the rise in deposit rates and the corresponding impact on bonds, we are upgrading cash to Overweight while downgrading EM bonds. We believe this strategy is also timely as we are in a higher-volatility environment; the additional cash weighting would add more robustness to portfolios as well as provide flexibility to redeploy them into the market, should opportunity arise. On valuation, the recent rise in rates has made cash relatively attractive vs. the other asset classes (Figure 24).

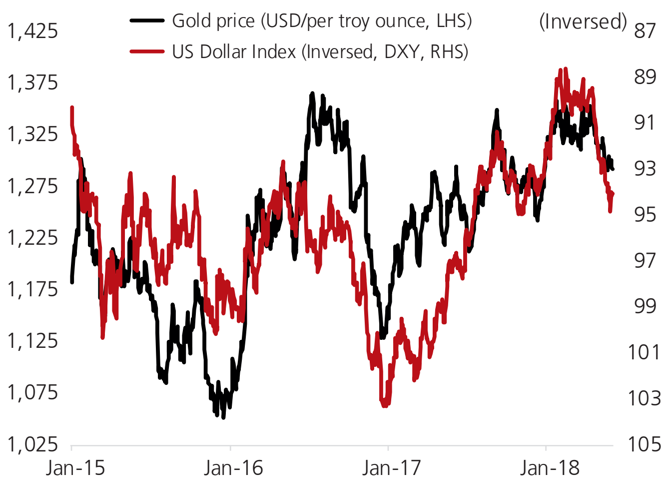
Gold is expected to be caught between the cross-currents of US-dollar strength, rising rates, and robust physical demand. As Figure 25 shows, gold has historically correlated inversely with the greenback. Hence, our expectation of US-dollar strength during the second half does not augur well for its outlook. That said, we do not expect gold to undergo significant pullback given that rising geopolitical uncertainties around the world should drive some demand for the precious metal. Moreover, demand from central banks continues and this is broadly in line with previous trends.

Figure 24: US three-month LIBOR now yields more than S&P 500 dividends



Source: Bloomberg, DBS

Figure 25: USD strength a headwind for gold



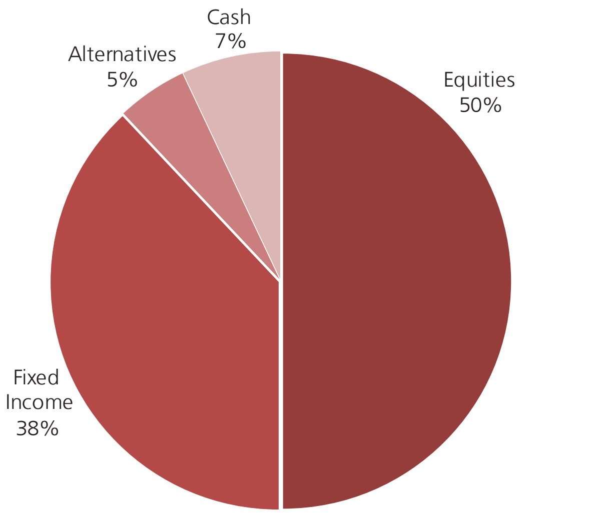
Source: Bloomberg, DBS

Table 1: 3Q18 – Global Tactical Asset Allocation

Asset Class		
	Three-Month Basis 3Q18	**12-Month Basis 3Q18**
Equities	**Neutral**	**Neutral**
US Equities	Overweight	Underweight
Europe Equities	Underweight	Neutral
Japan Equities	Neutral	Neutral
Asia ex-Japan Equities	Neutral	Overweight
Bonds	**Underweight**	**Underweight**
Developed Markets (DM) Government Bonds	Underweight	Underweight
Developed Markets (DM) Corporate Bonds	Underweight	Neutral
Emerging Markets (EM) Bonds	Neutral	Neutral
Alternatives	**Neutral**	**Overweight**
Gold	Neutral	Neutral
Hedge Funds	Neutral	Overweight
Cash	**Overweight**	**Neutral**

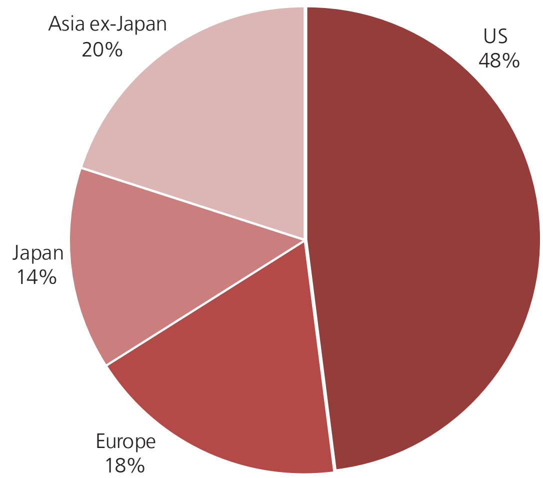
Source: DBS

Figure 26: TAA breakdown by asset class (Balanced Profile, three-month view)



Source: DBS

Figure 27: TAA breakdown by geography within equities (Balanced Profile, three-month view)

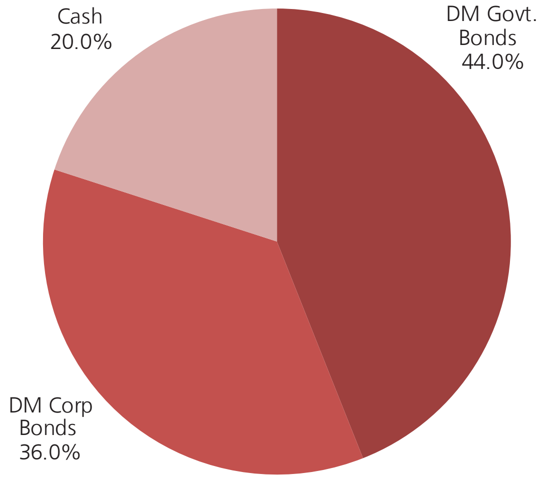


Source: DBS

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

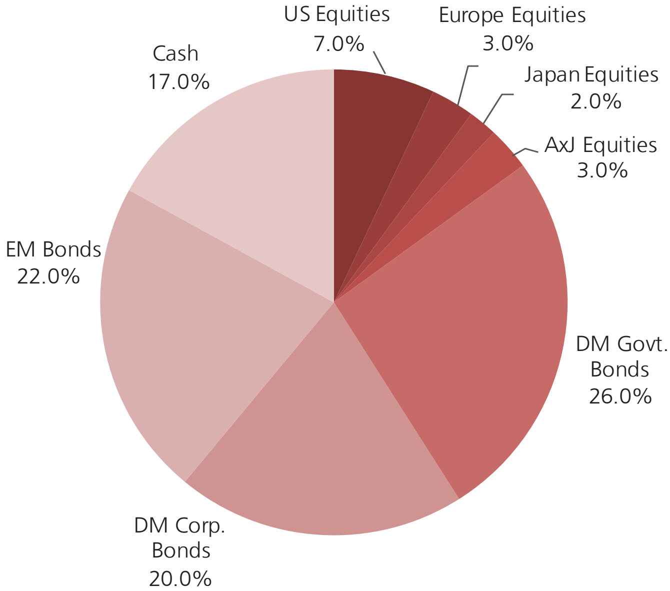


Source: DBS, Morningstar Investment Management Asia Limited

Moderate

	TAA	SAA	Active
Equities	15.0%	15.0%	
US	7.0%	6.0%	1.0%
Europe	3.0%	4.0%	-1.0%
Japan	2.0%	2.0%	
Asia ex-Japan	3.0%	3.0%	
Fixed Income	68.0%	75.0%	-7.0%
Developed Markets (DM)	46.0%	53.0%	-7.0%
DM Government Bonds	26.0%	30.0%	-4.0%
DM Corporate Bonds	20.0%	23.0%	-3.0%
Emerging Markets (EM)	22.0%	22.0%	
Alternatives	0.0%	0.0%	
Gold	0.0%	0.0%	
Hedge Funds*	0.0%	0.0%	
Cash	17.0%	10.0%	7.0%

*Only P4 risk rated UCITs Alternatives

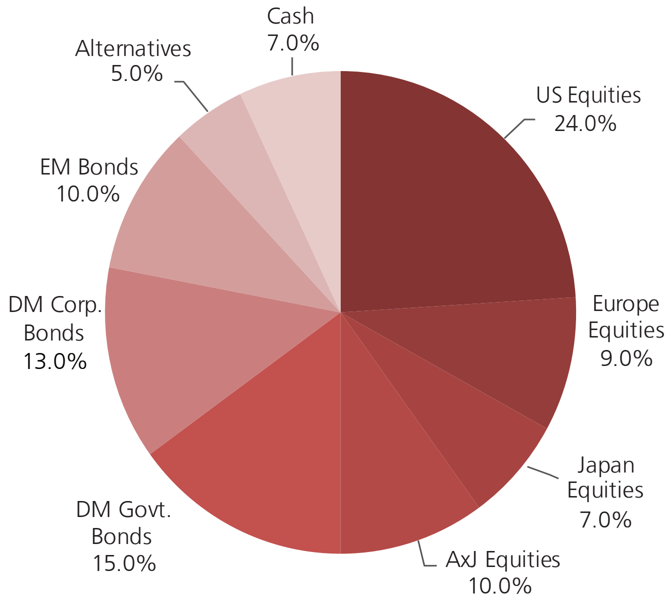


Source: DBS, Morningstar Investment Management Asia Limited

Balanced

	TAA	SAA	Active
Equities	50.0%	50.0%	
US	24.0%	22.0%	2.0%
Europe	9.0%	11.0%	-2.0%
Japan	7.0%	7.0%	
Asia ex-Japan	10.0%	10.0%	
Fixed Income	38.0%	40.0%	-2.0%
Developed Markets (DM)	28.0%	30.0%	-2.0%
DM Government Bonds	15.0%	16.0%	-1.0%
DM Corporate Bonds	13.0%	14.0%	-1.0%
Emerging Markets (EM)	10.0%	10.0%	
Alternatives	5.0%	5.0%	
Gold	2.0%	2.0%	
Hedge Funds*	3.0%	3.0%	
Cash	7.0%	5.0%	2.0%

*Only P4 risk rated UCITs Alternatives

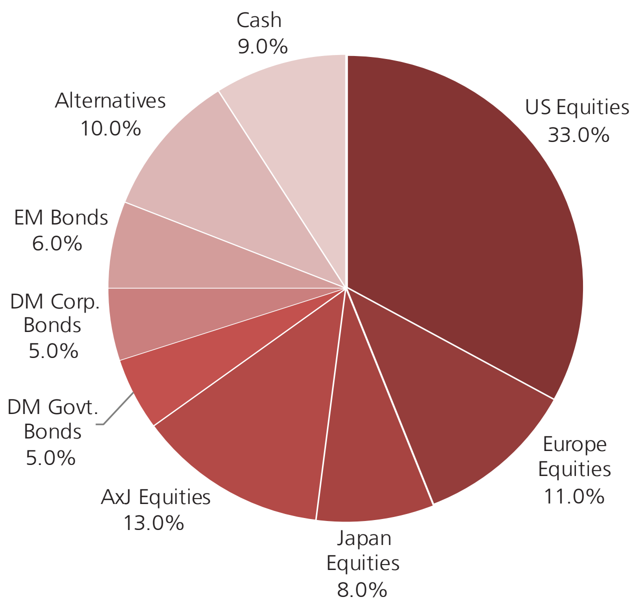


Source: DBS, Morningstar Investment Management Asia Limited

Dynamic

	TAA	SAA	Active
Equities	65.0%	65.0%	
US	33.0%	30.0%	3.0%
Europe	11.0%	14.0%	-3.0%
Japan	8.0%	8.0%	
Asia ex-Japan	13.0%	13.0%	
Fixed Income	16.0%	20.0%	-4.0%
Developed Markets (DM)	10.0%	14.0%	-4.0%
DM Government Bonds	5.0%	7.0%	-2.0%
DM Corporate Bonds	5.0%	7.0%	-2.0%
Emerging Markets (EM)	6.0%	6.0%	
Alternatives	10.0%	10.0%	
Gold	4.0%	4.0%	
Hedge Funds*	6.0%	6.0%	
Cash	9.0%	5.0%	4.0%

*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".

Global Macroeconomics | 3Q18

Hawks everywhere

Source: AFP Photo

Global Macroeconomics

Taimur Baig, Ph.D.
Chief Economist

Radhika Rao
Economist

Ma Tieying
Economist

Suvro Sarkar
Analyst

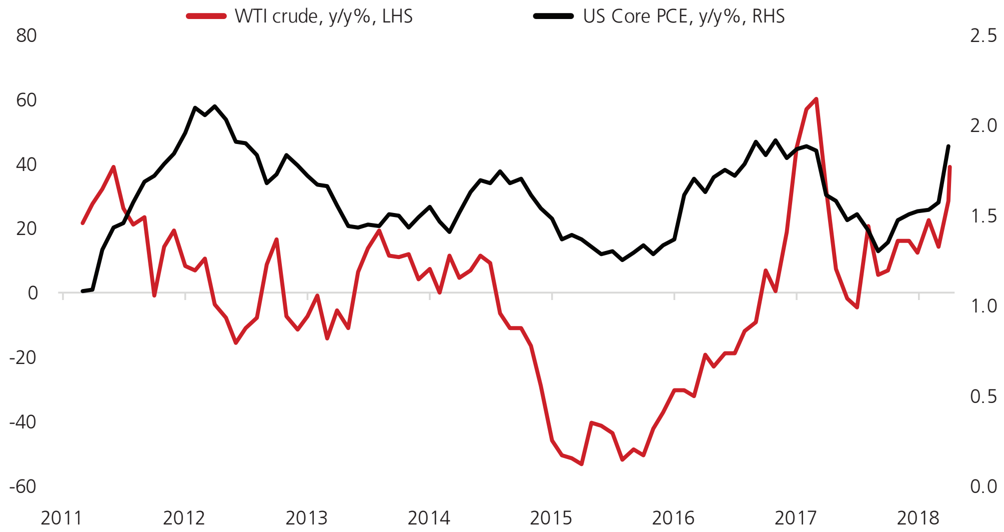
United States: Hawks everywhere

Trade frictions make up only one of many US-induced stress points. Governments are wary of protectionism, but there appears little sympathy for China. Instead, there is worry about which country will be affected next (car tariffs on Germany, for instance, or what happens with the North Atlantic Free Trade Agreement (NAFTA)). We think that a US-European Union (EU)-Japan coalition is likely on the next round of trade measures on China, especially regarding subsidies for state-owned enterprises.

Risk of trade policy errors is high. The general view on the US administration's trade strategy is that recent departure of key officials has left the debate on trade dangerously one-sided. The desire to take punitive measures is considerable, with the idea that tariffs announced so far are just an opening gambit for negotiations is likely to be incorrect. The administration's stance on geopolitical matters, especially on Iran, and various ongoing internal investigations all point to higher political risk in the coming months.

A leg-up in inflation and good growth lie ahead. Inflation risks in the US are rife – from small business surveys on wages and input cost (especially with respect to construction) to the large fiscal impulse from the tax cuts that will start showing up in the data from 2Q onward. Strong oil and industrial metal prices, continued tightening of the labour market, and rising fears of a conflict in the Middle East would keep core and headline inflation risks elevated, in our view.

Figure 1: Oil and core inflation have nudged up together

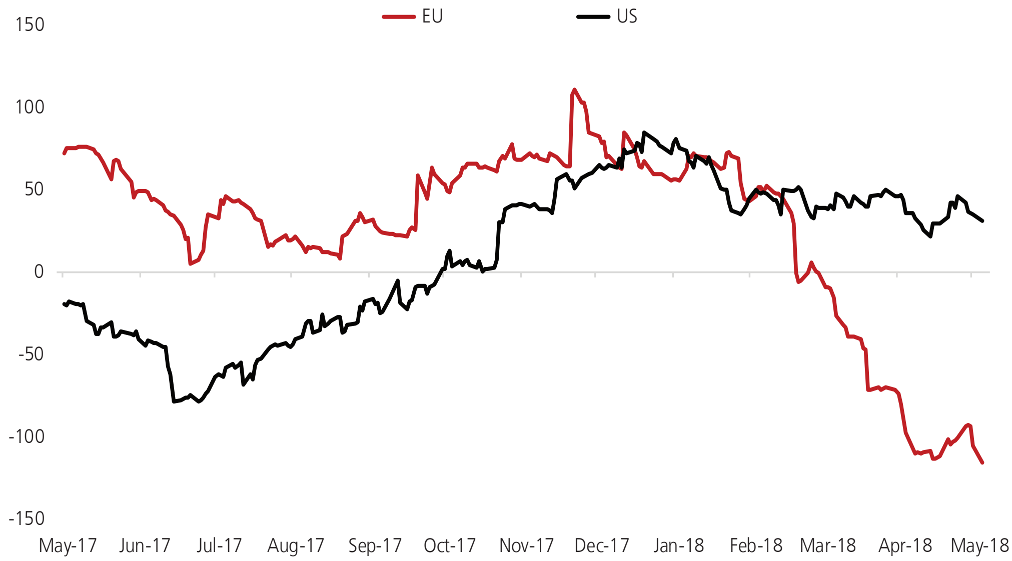


Source: Bloomberg, DBS

Rates markets are pricing in less than what the Fed wants to deliver

Expect a proactive Fed. While most, including the Federal Reserve, do not expect a major spike in inflation, it has become increasingly clear from the central bank's communication that Fed governors will not wait for actual inflation prints to surprise on the upside before taking a more hawkish stance. The conviction on the wage-price link is high among senior Fed officials, and they are worried about imbalances likely to arise from a very large late-cycle stimulus. Against this background, we now think the Fed is on track to push up rates every quarter from now until the end of 2019. This will take the Fed funds rate to 2.5% and 3.5% at end-2018 and end-2019, respectively. They may even do more if growth goes back to well above 2.5% (after a seasonally weak 1Q18).

Figure 2: Sharp divergence in the economic surprise index



Source: Bloomberg, DBS

Higher volatility is inevitable. Asset managers have been overwhelmingly short duration, short USD, and yet constructive on Emerging Markets. The direction of long-term yield is clearly upward, and the recent flattening of curves is likely to pause. Once the seasonally-weak 1Q US gross domestic product (GDP) data is behind, the market will likely focus on inflation and rate hikes, causing steepening in the front of the yield curve. US fixed income managers have found being long European bonds through the swap market attractive, but this reflects an embedded short dollar view, which we think has begun to turn as the US-EU growth differential widens from 2Q onward.

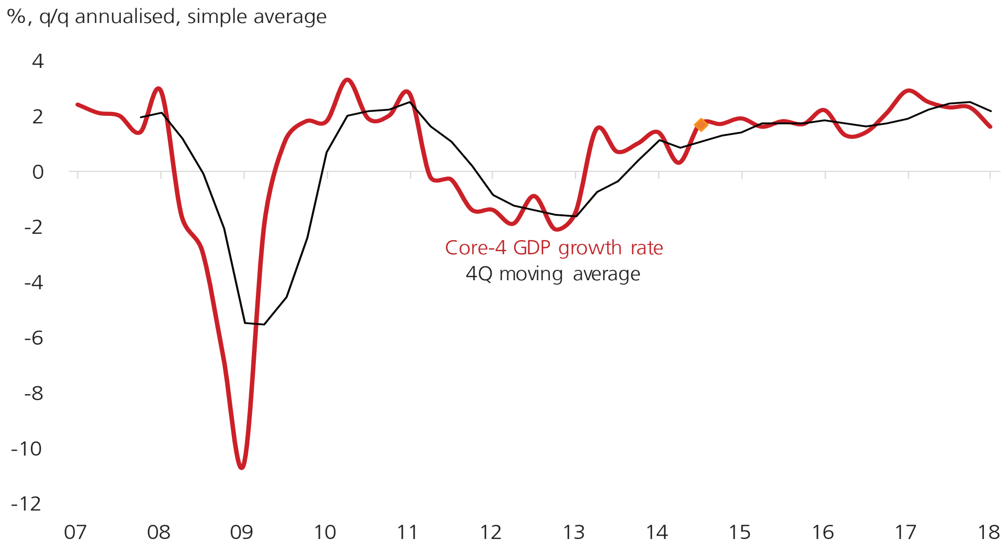
Eurozone

Sentiment toward the Eurozone economy has turned more guarded into 2018

After achieving the best growth in a decade last year, sentiment toward the Eurozone economy has turned more guarded into 2018. Increased sensitivity to global uncertainties – particularly trade protectionist threats and higher oil prices – have emerged as headwinds, with the stronger euro adding to the pain. Caught between a softening demand trajectory and inflation that remains well below the target, the European Central Bank (ECB) treads a fine line on the policy front.

The Eurozone economy was off to a soft start in 1Q18 as growth slowed to 2.5% y/y (0.4% q/q) from a strong 2.8% y/y (0.7% q/q) in 4Q17. In addition to external worries, domestic activity was also impacted by unfavourable weather conditions, strikes in France, and other temporary factors. Retail sales eased to 2.2% y/y (value basis) in 1Q18 vs. 3.2% in 4Q17. Sales in volume terms also eased. Credit growth to businesses lost momentum and pulled back production/manufacturing activities. Industrial production declined for three consecutive months to February 2018 (m/m basis), with a sharper pullback in the purchasing manager's indices (PMI) likely a payback of a strong finish to 2017.

Figure 3: GDP growth in core-4 (Germany, Italy, Spain, France) moderates



Source: Bloomberg, DBS

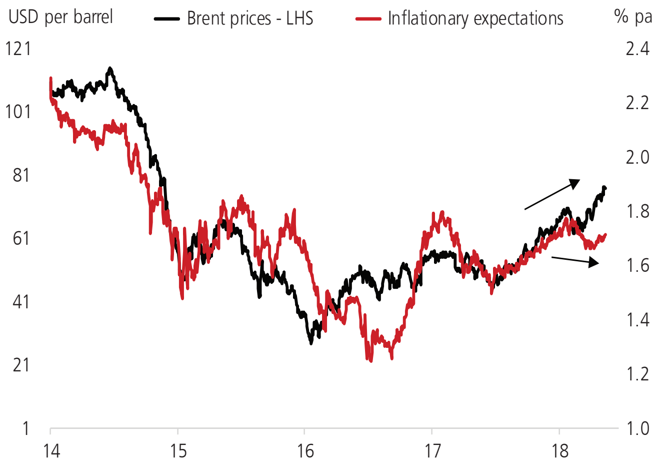
Inflation pressures remain elusive and well below target

Inflationary pressures, meanwhile, remain elusive and well below target, providing policymakers sufficient headroom to maintain an accommodative policy bias. April inflation softened to 1.2% y/y from 1.3% in March, as the impact of high energy prices was mitigated by a strong domestic currency. Core inflation was softer at 0.7%, compared to the recent range of 0.9-1%. Inflationary expectations stay soft despite rising energy prices. Wage pressures are, however, likely to turn less of a drag after Germany's plan to increase wages for 2.3m government workers at a staggered annual pace of 3.2% retroactive to March, 3.1% from April 2019, and another 1.1% from March 2020.

Impact of political developments is now spilling over to the global markets

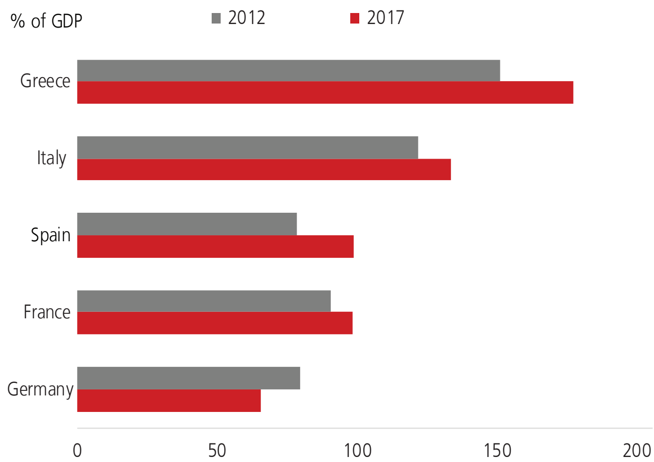
Political risks in the Eurozone are, meanwhile, on the rise. Italy has taken the centre-stage after its March 2018 elections failed to provide a clear mandate. A lack of consensus on cabinet appointments, which along with simmering tensions between the incoming far-right coalition government and Italian President Mattarella, has increased the likelihood of fresh elections, to be held as early as 4Q18 or 1Q19. Investors fear that a re-election might give a bigger mandate to the Eurosceptic parties and push the economy further away from the fiscal austerity/reforms (see Figure 5), or even worse, consider exiting the union. Concurrently, Spain is headed into a no-confidence vote, while Brexit developments continue to be muddied by internal disagreements and the lack of a common view on the way forward. UK Prime Minister Theresa May plans to unveil the post-Brexit blueprint ahead of a crucial European Union (EU) summit in late-June. The UK officially leaves the bloc in March 2019, entering a transition phase until December 2020.

Figure 4: Inflationary expectations stay soft despite rising energy prices



Source: Bloomberg, DBS

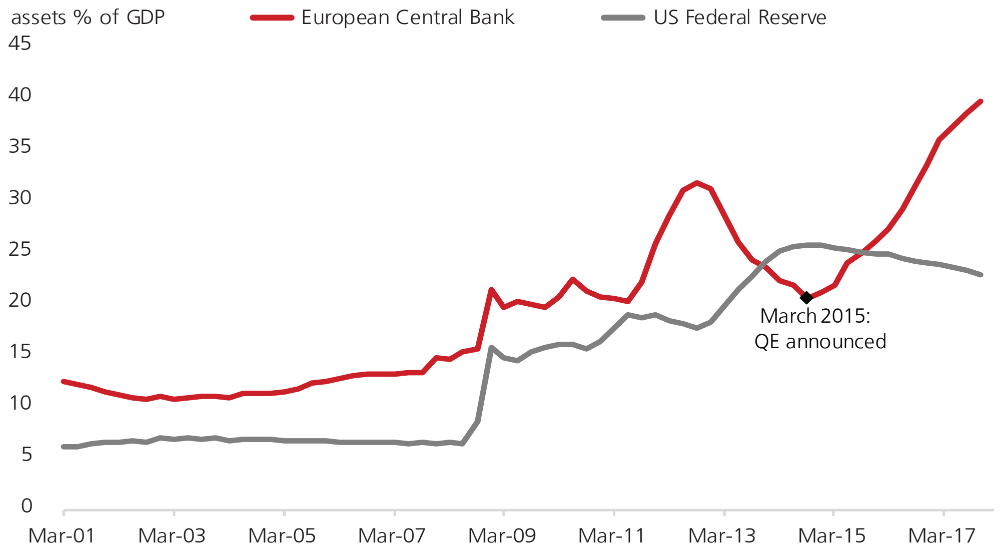
Figure 5: Government debt levels (as % of GDP)



Source: Bloomberg, DBS

Attention will swiftly turn to the official response over the coming weeks. The ECB is likely to include the challenging political backdrop as a fresh risk, increasing the likelihood of a modest downward adjustment in the 2018 gross domestic product (GDP) estimate. Taper talks and policy normalisation will be on ice until more clarity emerges. Signs of broader stress in the other European markets will require the ECB to consider other support tools in their arsenal. Besides an accommodative policy stance and verbal intervention, the central bank might temporarily buy more Italian debt in its quantitative easing (QE)-mix. Also, similar to the liquidity assistance provided to Greek banks, the Italian authorities might be able to provide a helpline to its finance institutions.

Figure 6: US Fed and ECB balance sheets diverge



Source: Bloomberg, DBS

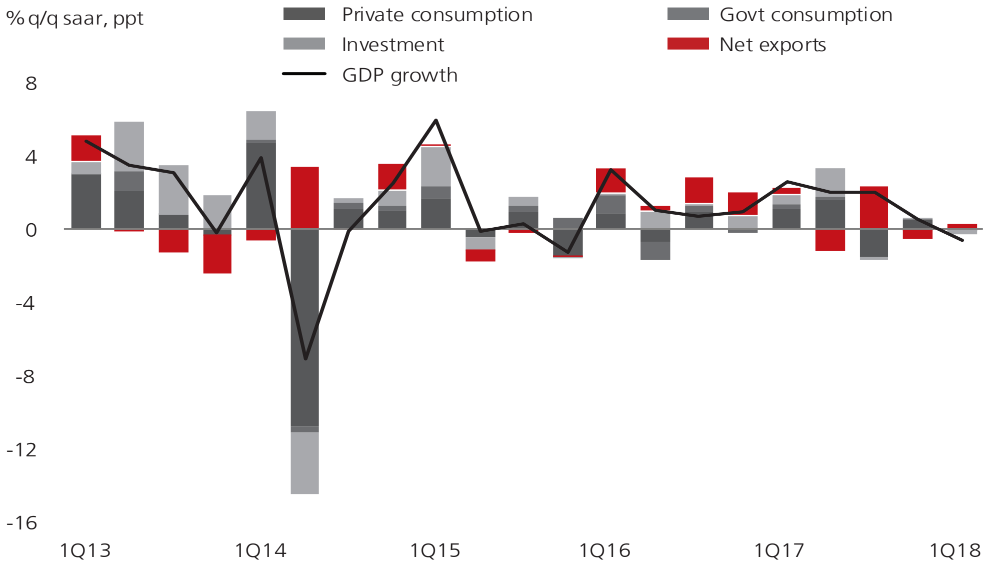
Next, the Outright Monetary Transactions (OMT) programme (an emergency bond-buying scheme announced back in 2012 but remains unused) might help to calm market sentiment. Eligibility for OMT assistance will, however, depend on the extent to which far-right parties (assuming they return with a bigger mandate in the re-elections) adhere to the strict pre-conditions or make concessions to tap these precautionary support lines.

Japan

A modest recovery remains on track

A modest growth recovery remains on track, notwithstanding the weakness in 1Q gross domestic product (GDP) (-0.6% q/q saar, preliminary). The unusually cold weather and heavy snows dampened outdoor consumption activities at the start of this year. The 6% appreciation in the yen vs. the US dollar also depressed export sales. These disruptions should be temporary and will likely fade. The weather-sensitive food prices have eased notably starting from March. Meanwhile, the USD/JPY rate has bounced back since April, as the impact of rising US bond yields/widening US Treasury (UST)-Japanese Government Bond (JGB) yield differentials offset that of geopolitical uncertainties and risk aversion.

Figure 7: GDP growth fell in 1Q on both exports and domestic demand

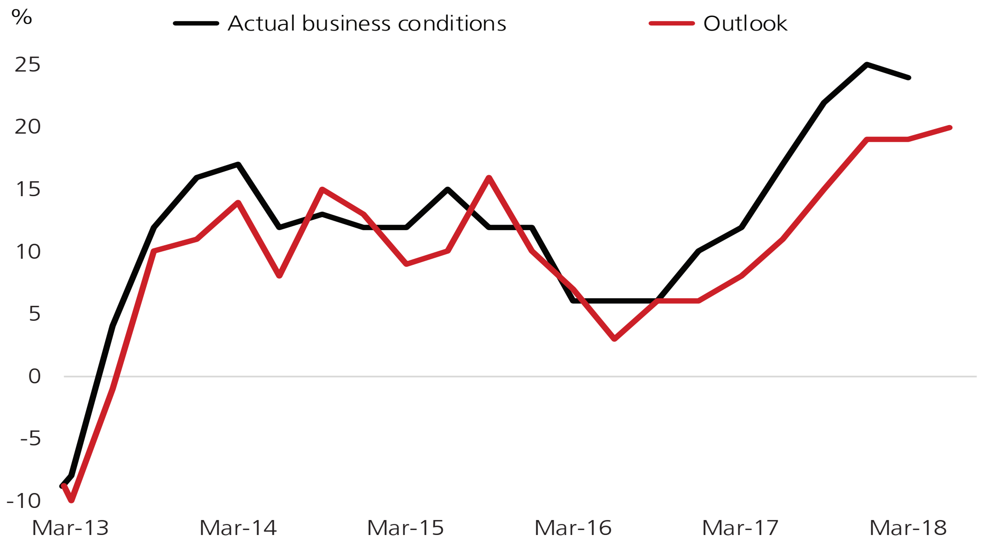


Source: CEIC, DBS

The outlook for reflation remains intact

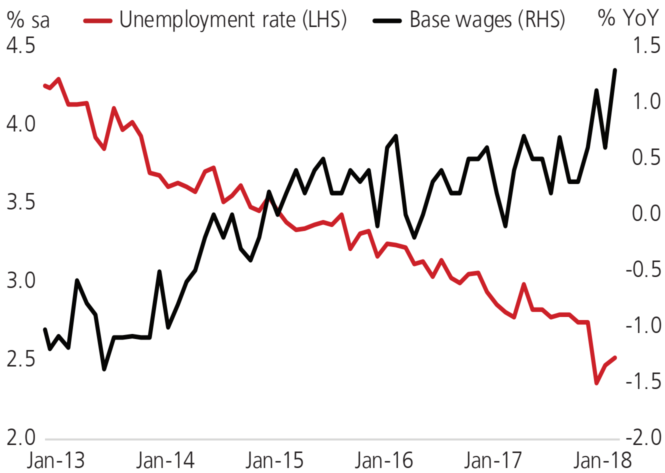
In line with our view that the growth recovery remains on track, we also think that the outlook for reflation is intact. The labour market has continued to tighten, with the unemployment rate falling further to a 25-year low of 2.5% in March, and base wage growth creeping higher to 1.3%. The underlying core-core inflation has risen slightly to 0.4% y/y in 1Q, up from the bottom of about 0% in mid-2017. Underlying inflation is expected to continue picking up, albeit slowly, in the rest of this year.

Figure 8: Tankan outlook index (large manufacturers) points to a better 2Q



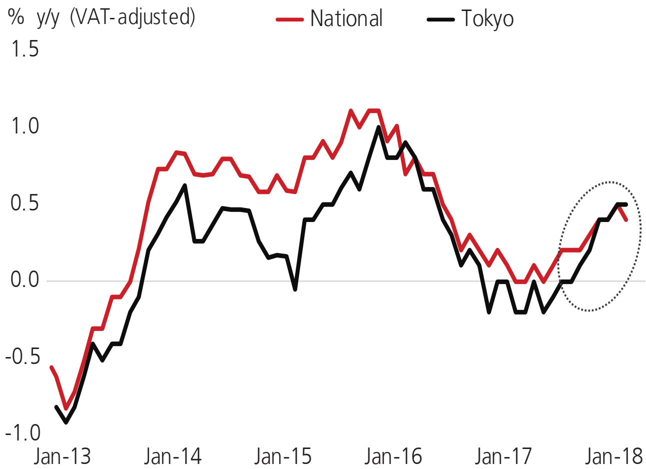
Source: CEIC, DBS

Figure 9: Labour market conditions tightened further



Source: CEIC, DBS

Figure 10: Core-core CPI inflation remained on mild uptrend



Source: CEIC, DBS

Risks abound: trade protectionism, oil prices, domestic politics

A number of risks will need to be closely watched, however, including trade protectionism, oil prices, and domestic politics. Japan did not receive any exemption from the new steel tariffs imposed by US President Donald Trump on the US's major trade partners in March. Given its position as one of the top foreign direct investment (FDI) investors in China, Japan could also be indirectly hurt by Trump's tariff measures on Chinese exports.

BOJ is in no hurry to end asset purchases or raise rates

Higher oil prices will push up Japan's consumer price index (CPI) numbers and help the Bank of Japan (BOJ) achieve the reflation target. But it would also offset precious wage gains, erode consumers' real purchasing power, and eventually, lead to a decline in demand-side inflation.

The land sale scandal surrounding Prime Ministry Shinzo Abe's administration has been spreading, sending his approval rating to record lows. It is no longer a sure bet that Abe can win the Liberal Democratic Party (LDP) leadership election in September and stay as Prime Minister for another few years. An unexpected leadership change could mean a reassessment of the stimulus policies under Abenomics, which would weigh on investor and business confidence.

BOJ appears confident about the short-term economic outlook but cautious on the medium-term. The central bank removed the timeline for achieving the 2% inflation target at April's meeting, and flagged risks to the FY19 growth outlook (citing the second-phase sales tax hike and global uncertainties). Given the need to ensure a sustainable growth recovery and a clear end of deflation, the BOJ should be in no hurry to end asset purchases or to raise interest rates in 2018-2019.

Asia: Dealing with rising oil and rising rates

Decent growth, but external pressures have risen. The macro stability of India and Indonesia are under scrutiny

While growth is largely holding up, Asia's interest rates and exchange rate markets have turned restless. Pulled and pushed by trade frictions, the US dollar rally, Federal Reserve policy, and rising oil prices, Asia's oil-importing economies are seeing a worsening of external balances, corporates are gearing up for higher borrowing and refinancing costs, and central banks' policy room is becoming more constrained. As two large economies with considerable exposure to commodity prices and foreign currency borrowing, India and Indonesia are feeling the most acute macro pressures in the region.

Not all problems are imported. While the bond and FX markets in India and Indonesia are under external pressure, there are domestic drivers of underperformance as well. From a looming election calendar to questions about energy-pricing policy, and lingering governance-related concerns, these two economies have additional risks brewing. They were part of the "fragile five" during the 2013 taper tantrum, and in a scenario of stronger USD and higher oil, their markets and economies could face sustained pressure again, in our view.

Policymakers are taking proactive measures. In the case of India, in a bid to calm sentiment and address financing fears, the authorities have taken measures to boost inflows, with limits for foreign portfolio investments into debt raised recently. Following this, the Reserve Bank of India (RBI) relaxed its rules for investments – including reducing the residual maturity period, withdrawing the auction mechanism from 1 June, and revising the cap on aggregate portfolio investments into a single security.

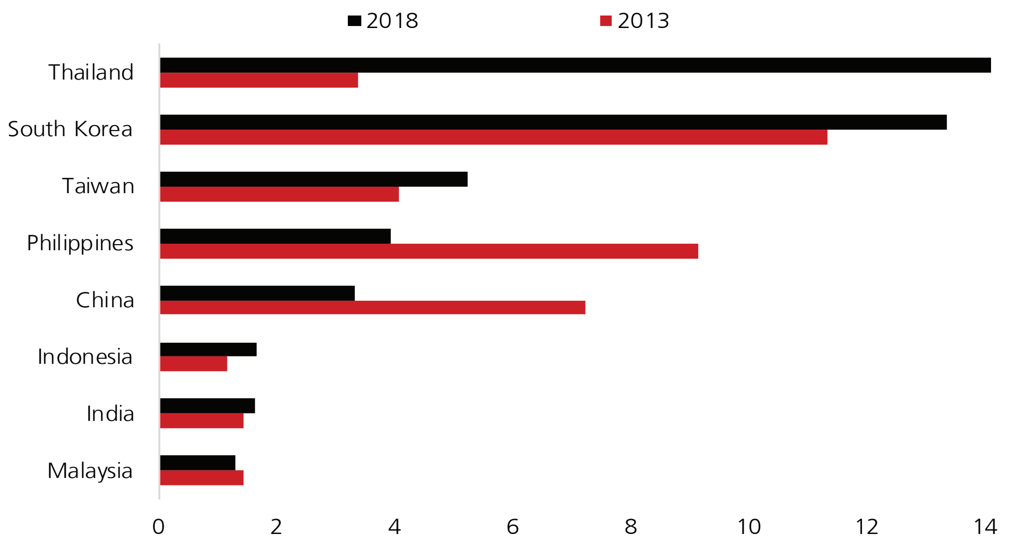
RBI is facing a challenging front. The central bank's minutes from the April meeting saw a majority of the committee members highlighting upside risks to inflation, pinning the bout of weak inflation in 1Q18 on temporary and seasonal forces. Adverse base effects and seasonality are likely to push inflation toward the 5% mark until June/July, from April's 4.6% y/y. Taking a leaf out of the regional policy action, the need to contain volatility and high core inflation (testing the higher end of the 2-6% CPI target) convinced the RBI to hike rates in June. While they maintained a neutral stance, we see the risk of a shift to a hawkish bias in 3Q and a tightening of policy rates again. Sticky core inflation and financial stability will be the key determinants of the depth and length of the tightening cycle, which will also have to be balanced with the need to support the ongoing banking sector deleveraging process. Policymakers are likely to monitor the scale of the increase in minimum support prices, updated monsoon forecasts, and oil-price direction in the coming months.

Indonesia upped the anted by prioritisng financial stability over growth. With rupiah stability as the mandate, the new Bank Indonesia (BI) Governor, Perry Warjiyo, voted to frontload policy tightening by raising the benchmark BI rate by a cumulative 50 bps in May to 4.75%. This also helped to front-run the US Federal Reserve's rate hike in June, while containing volatility in the domestic currency and bond markets. Further tightening is likely if pressure on the rupiah returns amid a firm dollar, higher US rates, and lingering Eurozone political worries. To mitigate subsequent downside risks to growth, the BI signalled that non-monetary policy tools will be tapped, which includes a lower loan-to-value framework for selected sectors and ample liquidity support.

External funding needs of China, Malaysia, and the Philippines are considerable

In addition to India and Indonesia, external finance needs of China, Malaysia, and the Philippines could become onerous this year. While market participants will not be surprised by currency-depreciation risks characterising Malaysia and the Philippines, our short view on the yuan is not at all with consensus. The USD1t loss in FX reserves from two years ago has drastically changed China's reserves cover, as per our analysis. Watch out for many bumps along the path of Asia's FX in the coming months.

Figure 11: Ratio of reserves to gross external financing



Source: BIS, CEIC, DBS

China and India have been characterised by contrasting economic trends this year. China has seen strong support from external demand while domestic demand has been lacklustre, whereas India has faced lacklustre trade but rebounding domestic demand. Still-low interest rates and sustained policy support will likely counter external headwinds, but the going will be challenging for Asia's two largest economies in the second half of the year, with downside risks rising.

Oil prices get a shot in the arm

In the longer term, there may be more challenges to oil prices but in the near term, outlook seems bullish in the face of supply constraints

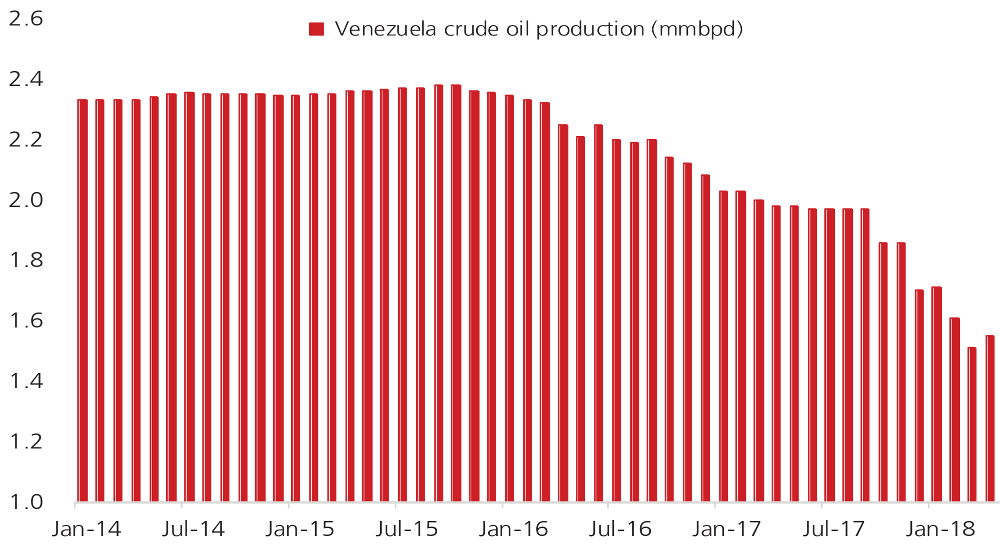
We revise up our oil price forecasts on several factors: i) Premium to account for the increased geopolitical risks in play; ii) Breakdown of the Iran nuclear deal; iii) Better-than-expected compliance to the production cuts from the Organization of the Petroleum Exporting Countries (OPEC) – mainly due to declining production from crisis-hit Venezuela;and iv) Faster-than-expected inventory normalisation trends in the US and Organisation for Economic Co-operation and Development (OECD) countries. We expect a tighter oil market and are revising up our 2018 average Brent crude oil price forecast to USD70.00-75.00 per barrel, from USD60.00-65.00 per barrel earlier. Our 2019 average forecast for Brent is slightly lower at USD65.00-70.00 per barrel, as we expect some moderation due to rapidly-increasing US shale supplies as well as a gradual exit from OPEC production cuts over time (Table 1). We believe there could be further upside risks to our forecasts, especially if oil production from Venezuela falls further off the cliff in the coming months (Figure 12).

Table 1: Quarterly oil price forecast 2018/19

(USD per barrel)	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
Average Brent crude oil price	68.0	75.5	75.0	73.5	72.0	68.0	69.5	70.5
Average WTI crude oil price	64.0	71.5	71.0	69.5	68.0	64.0	65.5	66.5

Source: DBS

Figure 12: Venezuela crude oil production: Dented by domestic economic woes



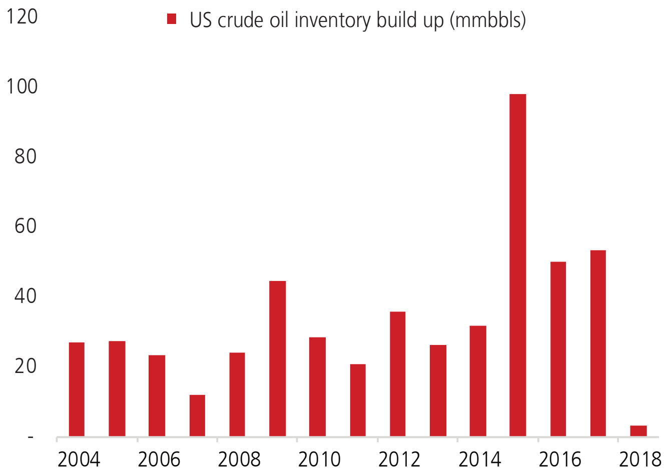
Source: Bloomberg, DBS

Expect volatility as geopolitical issues remain. Geopolitical tensions in the Middle East (i.e. Syria) was one of the early factors that rekindled the oil-price rally, but what has really fanned the fire is the US's pull-out from the Iran nuclear deal. Renewed restrictions on Iranian oil exports over the next few months will boost the global demand-supply balance. While mostly factored into current oil prices, we believe volatility will continue and oil prices could test levels above USD80.00 per barrel in the near term, as uncertainty lingers around the timing and quantum of eventual export cuts, as well as response from Iran's importers including Europe, China, and India.

Normalisation of inventory trends worldwide is the key fundamental factor behind the rally in oil prices

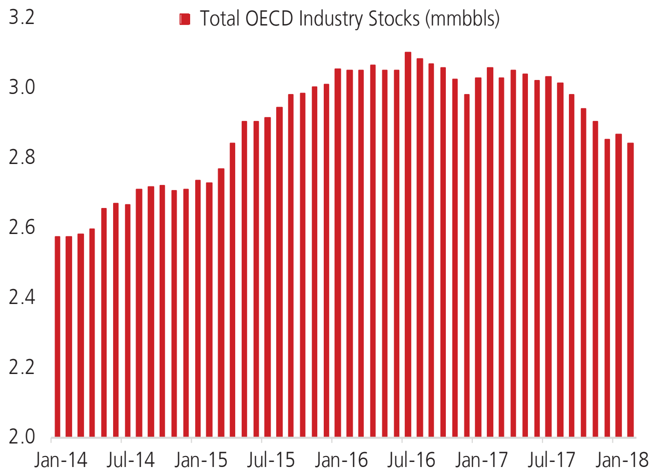
US shale oil growth is a moderating influence, but inventory drawdowns dominate. US oil production is averaging around 10.6m barrels per day (mmbpd) – about 1.1mmbpd higher than the 2017 average. Despite the shale rally, draws in US crude oil inventories have continued in 2018. While the first few months of the year typically see some seasonal inventory build-ups owing to refinery maintenance schedules amid off-peak demand, 2018 numbers have shown a stark deviation from the norm (Figure 13), and the strong inventory moderation trend seen since 2H17 continues in 2018. OECD inventory levels show a similar trajectory and underpin our optimism (Figure 14). These stocks have been falling consistently since July 2017, and are down to about 2.8b barrels as of end-February 2018, which is only about 30m barrels above the five-year average, as estimated by the International Energy Agency (IEA) in its latest Oil Market Report (OMR).

Figure 13: US crude oil inventory builds in first 15 weeks of the year (by year)



Source: Bloomberg, DBS

Figure 14: OECD crude oil stocks show continuous decline since July 2017



Source: DBS, IEA

Table 2: GDP growth and CPI inflation forecasts

	GDP growth, % y/y				CPI inflation, % y/y, ave			
	2016	2017	2018F	2019F	2016	2017	2018F	2019F
China	6.7	6.9	6.6	6.2	2.0	1.6	2.1	2.2
Hong Kong	2.0	3.8	3.3	2.9	2.4	1.7	2.0	2.5
India*	8.0	7.1	6.6	7.2	4.9	4.5	3.6	4.6
Indonesia	5.0	5.1	5.3	5.4	3.5	3.8	4.0	4.5
Malaysia	4.2	5.9	5.0	5.0	2.1	3.9	2.6	3.0
Philippines**	6.9	6.7	6.7	6.7	1.3	2.9	4.2	3.5
Singapore	2.0	3.6	3.0	2.7	-0.5	0.6	1.0	1.8
South Korea	2.9	3.1	2.9	2.9	1.0	1.9	1.8	1.8
Taiwan	1.4	2.9	2.8	2.4	1.4	0.6	1.3	1.0
Thailand	3.2	3.9	4.0	4.0	0.2	0.7	1.5	1.5
Vietnam	6.2	6.8	6.4	6.6	2.7	3.5	3.6	3.8
Eurozone	1.8	2.5	2.2	2.2	0.2	1.5	1.4	1.4
Japan	0.9	1.7	1.1	0.9	-0.1	0.5	0.8	1.0
United States***	1.5	2.3	2.6	2.5	1.3	2.1	1.8	1.8

* refers to year ending March ** new CPI series *** eop for CPI inflation

Source: CEIC, DBS

Table 3: Policy interest rates forecasts, eop

	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.00	6.00	6.25	6.50	6.50	6.50	6.50	6.50
Indonesia	4.25	4.50	4.75	4.75	4.75	5.00	5.00	5.00
Malaysia	3.25	3.25	3.50	3.50	3.50	3.50	3.50	3.50
Philippines	3.00	3.25	3.50	3.50	3.75	4.00	4.00	4.00
Singapore**	1.40	1.65	1.90	2.15	2.15	2.40	2.40	2.65
South Korea	1.50	1.50	1.75	2.00	2.00	2.25	2.25	2.25
Taiwan	1.38	1.38	1.38	1.50	1.50	1.63	1.63	1.75
Thailand	1.50	1.50	1.50	1.50	1.75	2.00	2.25	2.50
Vietnam***	6.25	6.25	6.25	6.25	6.50	6.50	6.75	6.75
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	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.50

*1-year lending rate. **3M SOR. ***Prime rate. Source: DBS

US Equities | 3Q18

Stay positive amid robust Tech outlook

Source: AFP Photo

US Equities

Dylan Cheang
Strategist

Beyond 1H18 volatility – Go back to fundamentals

We remain constructive on US equities despite the recent uncertainty over the pace of Federal Reserve rate hikes, a flattening yield curve, and a potential trade conflict between the US and China. Investors are particularly concerned whether a sharp drawdown on the S&P 500 Index will ensue should the US Treasury (UST) 10-year yield breach the 3% mark on a sustained basis. So far, this has not been the case. In fact, US equities have continued to grind higher even though the 10-year yield has crossed 3.1%.

This suggests one thing: Equity markets are becoming increasingly desensitised to gradual rises in government-bond yields (Figure 1).

Indeed, an improving economy leads to stronger inflation – necessitating higher interest rates. Above all, rates are rising from historical lows and a slight increment in the cost of capital is not going to significantly impact the broader economy. This is something the market understands. So on that basis, we believe US equities should continue to grind higher in 2H18, underpinned by positive corporate fundamentals.

US earnings and margins: The best is yet to come. The first-quarter US reporting season has vastly exceeded market expectations. About 81% of the companies reported positive earnings surprises, with the proportion particularly high among global cyclicals compared to non-cyclicals (84% vs. 75%). Moreover, c.86% of the companies reported earnings growth during the quarter, with the highest proportion coming from Materials

Figure 1: Desensitised to rising rates? US equities trading higher in tandem with UST 10-year yield

Source: Bloomberg, DBS

Figure 2: US macro momentum suggests there is further room for earnings growth

Source: Bloomberg, DBS

(c.96%) and Technology (c.95%). Undoubtedly, there have been widespread concerns that the quarter represented a "high watermark", and earnings have peaked.

We think otherwise.

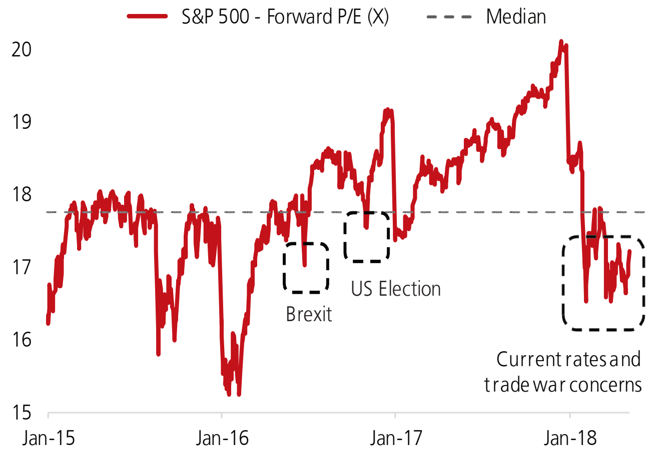
Earnings growth to stay upbeat amid positive boost from US tax cuts

Prevailing momentum in the US economy suggests there is room for further earnings growth as the tax cuts work their way through the economy (Figure 2). Besides, corporate margins have remained firm despite the maturing economic cycle. With wage growth staying subdued, we see little risk of margins narrowing substantially.

S&P 500 currently trading at fair valuation

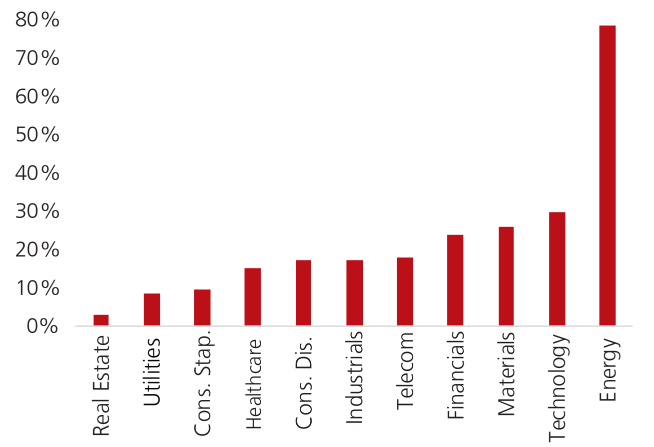
Valuation no longer expensive: US forward P/E has fallen back to Brexit and pre-Trump levels. An oft-cited misconception is that US equities are expensive. This is no longer true. Figure 3 shows that the forward price-to-earnings (P/E) ratio for S&P 500 is now back to levels last seen during Brexit and the US Presidential election. The driving factor for lower P/E is the upward revision in earnings forecasts, on the back of positive business conditions. Sectors with the largest upward earnings revisions include Energy and Technology (Figure 4).

Figure 3: US valuations are currently back to Brexit and pre-Trump presidency levels



Source: Bloomberg, DBS

Figure 4: Strong upward earnings revisions this year (as of May 2018)

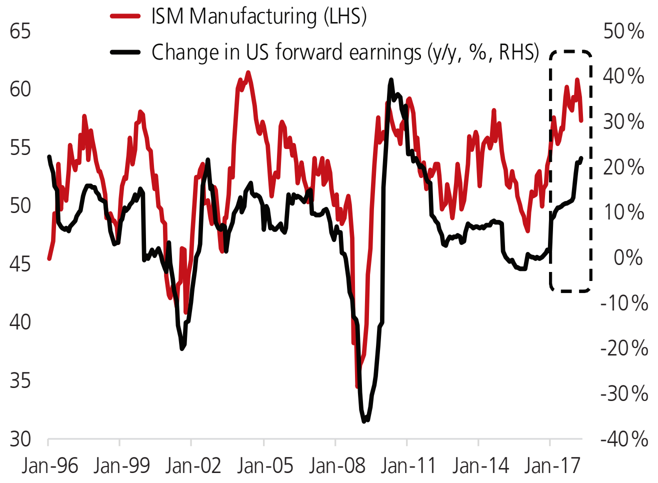


Source: Bloomberg, DBS

Inflation remains subdued despite healthy growth momentum

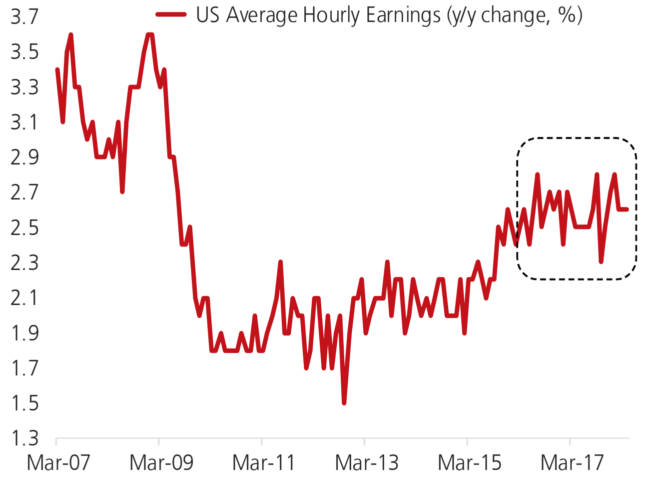
Healthy growth with subdued inflation: The right combination. Despite early signs the economic surprise index may be rolling over, Institute for Supply Management (ISM) manufacturing and non-manufacturing indices continue to point to an economy that is expanding – albeit at a slower pace (Figure 5). Interestingly, both wage growth and inflationary pressures remain subdued, even in this environment of low unemployment. Market jitters over a sharp jump of 2.8% y/y for average hourly earnings in January have eased after subsequent monthly figures recorded a lower 2.6% y/y. Therefore, such an environment of healthy growth and subdued inflation would be supportive of the equity market.

Figure 5: Growth momentum in the US remains healthy



Source: Bloomberg, DBS

Figure 6: But wage growth remains subdued



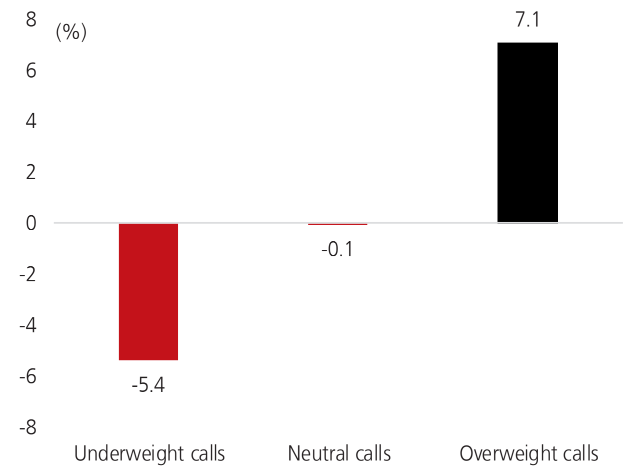
Source: Bloomberg, DBS

US Sector Allocation: Strong outperformance in our pro-cyclical calls

Strong performance by US Technology and Consumer Discretionary

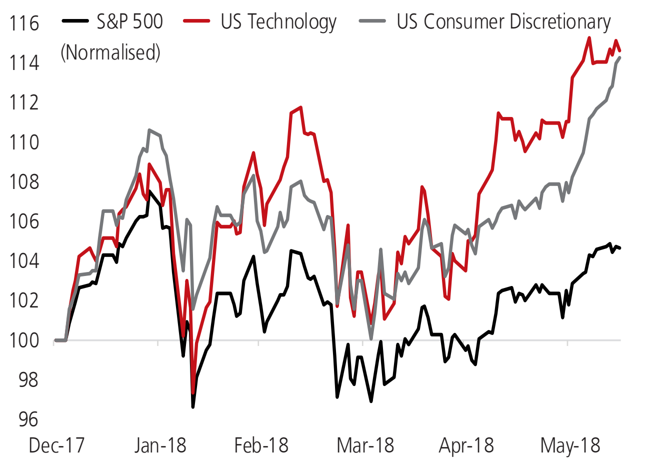
Our strong bias toward pro-cyclical sectors since the start of the year has paid off. In aggregate, our Overweight calls registered average dollar-based total returns of 7.1% year-to-date (YTD) (as of 15 June) have outperformed our Underweight (-5.4%) calls by a substantial 12.5 percentage points. Among our Overweight sectors, Technology and Consumer Discretionary registered strong returns of 14.8% and 14.4%, respectively.

Figure 7: Our Overweight calls have vastly outperformed Underweight ones



Source: Bloomberg, DBS

Figure 8: Notable outperformers are US Technology and Consumer Discretionary



Source: Bloomberg, DBS

Technology companies reported robust 1Q18 earnings

In Technology, initial market concerns proved unfounded as the New York Stock Exchange FANG+ Index rebounded with a YTD return at 35.7% – outperforming the broader market by 30.8 percentage points. The sharp recovery in Technology was attributed to strong first-quarter earnings, which saw c.93% of the companies reporting positive surprises. Earnings growth during the quarter was extremely robust at 34%. More importantly, Technology continues to demonstrate a robust growth trajectory.

Stay pro-growth

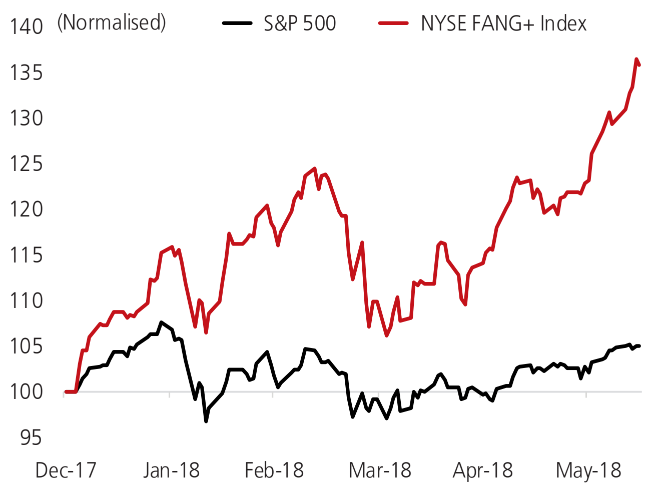
For 3Q18, our US sector calls remain unchanged. We maintain a pro-cyclical stance with Overweight calls on Technology and Consumer Discretionary. Technology will continue to benefit from the disruption of traditional business models, while in the case Consumer Discretionary, consumers' disposable incomes are expected to get a boost from recent tax cuts. Meanwhile, with the Fed remaining in tightening mode, rates-sensitive sectors like Utilities and Real Estate will continue to underperform.

Table 1: 3Q18 US Sector Allocation

	Overweight	Neutral	Underweight
US Sectors	Technology	Energy	Telecom
	Industrials	Cons. Staples	Utilities
	Cons. Discretionary	Materials	Real Estate
	Financials	Heath Care	

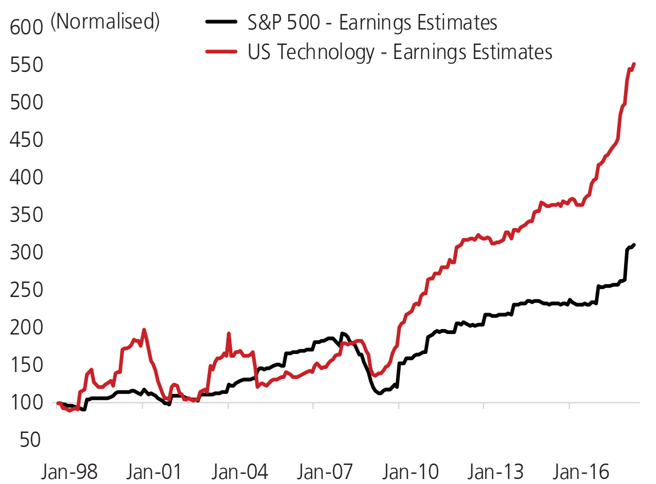
Source: DBS

Figure 9: Sharp rebound seen in "FANG" stocks



Source: Bloomberg, DBS

Figure 10: Strong fundamentals driving tech momentum



Source: Bloomberg, DBS

Table 2: US Sector key financial ratios

	Forward P/E (x)	P/B (x)	EV/EBITDA (x)	ROE (%)	ROA (%)	OPM (%)
S&P 500	17.3	3.3	13.3	14.2	3.0	13.8
S&P 500 Financials	13.2	1.5	-	8.9	1.0	29.2
S&P 500 Energy	19.5	2.0	13.5	7.0	3.4	4.3
S&P 500 Technology	19.4	6.4	15.0	19.8	8.0	23.5
S&P 500 Materials	16.7	2.6	13.6	12.4	5.3	10.9
S&P 500 Industrials	17.4	4.8	13.3	21.1	5.5	11.6
S&P 500 Cons. Staples	17.3	4.9	13.4	24.9	7.7	9.7
S&P 500 Cons. Discretionary	20.6	5.5	13.2	24.2	6.5	10.7
S&P 500 Telecom	10.2	1.9	7.0	29.9	8.2	16.4
S&P 500 Utilities	16.0	1.8	11.5	9.7	2.5	17.0
S&P 500 Real Estate	38.7	3.2	20.7	9.3	3.7	24.2
S&P 500 Health Care	15.7	4.0	14.5	12.8	4.7	9.3

Source: Bloomberg

Europe Equities | 3Q18

Geopolitics: The big unknown

Source: AFP Photo

Europe Equities

Dylan Cheang
Strategist

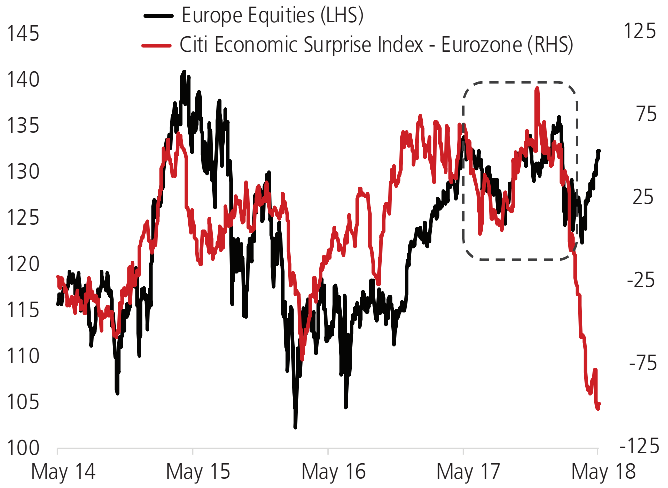
No change in cautious stance amid geopolitical uncertainties

We started the year with an Underweight call on European equities. Our cautious stance was premised on three factors: (a) Euro strength; (b) Subdued earnings; and (c) Geopolitical uncertainties. Moreover, macro momentum was also starting to slow, evident from the sharp drop in the region's manufacturing purchasing managers' index (PMI) from 60.6 in December 2017 to 55.5 in May 2018. Similarly, retail sales moderated from +3.7% y/y in November 2017 to +0.8% y/y in March 2018. Europe equities were trending broadly in line with the region's economic momentum before the relationship broke down toward the end of the first quarter (Figure 1).

Heading into 3Q, we are maintaining our cautious stance on the region given that the tailwind arising from euro is expected to subside in the coming months. To recap, the euro has been on a tear since 2017, rallying 17% until end-1Q18. Until recently, one of the key drivers behind the euro's strength lay in the market's expectation that the European Central Bank (ECB) will soon end monetary accommodation as the economic recovery in the region gathers steam. However, that narrative has changed.

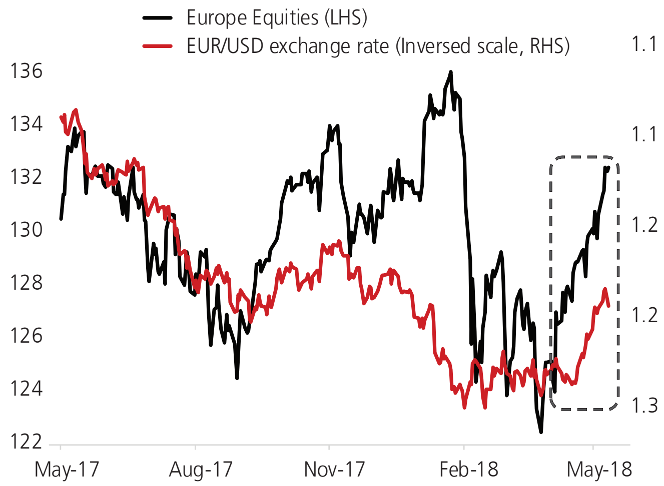
ECB President Mario Draghi acknowledged that the recent moderation of growth momentum warranted some concern. His remarks were generally perceived as dovish and the euro has since depreciated against the greenback, driving Europe equities higher (Figure 2).

Figure 1: Europe equities trended in tandem with macro momentum until late-1Q18



Source: Bloomberg, DBS

Figure 2: Since then, the euro has become the key driver of Europe equities



Source: Bloomberg, DBS

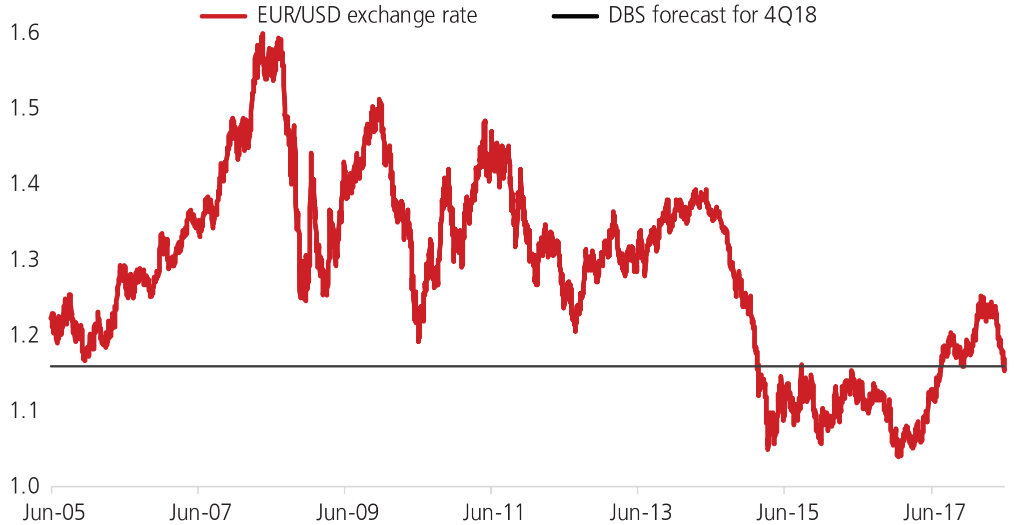
Our forecast shows that further euro weakness is unlikely from the current level

Euro weakness: As good as it gets? Nothing lasts forever. The euro depreciated 5.1% against the greenback between March and May 2018. At the current level of 1.1693 (as of 31 May), there is limited scope for EUR/USD to fall further. In fact, based on our currency strategist's forecast, EUR/USD is expected at 1.17 in 3Q18 and should reach 1.16 in 4Q18. Hence, the prevailing bout of euro weakness at the current level is already ahead of our expectations. More crucially, the euro is expected to strengthen against the US dollar in subsequent quarters, hitting 1.20 by 4Q19 (Figure 3).

European geopolitics is a clear and present danger for the region

European geopolitics – The big unknown. Europe has been engulfed by geopolitical uncertainties in the past few years – from Brexit to the Catalan declaration of independence. More recently, tension in Europe ratcheted up again amid policy uncertainties in Italy. The populist Five Star Movement and League parties have emerged victorious in the 2018 election, paving the way for rising Euroscepticism in the country. Given the pro-stimulus stance of the populist coalition, expect spending hikes and taxation cuts to follow while structural reforms take a back seat.

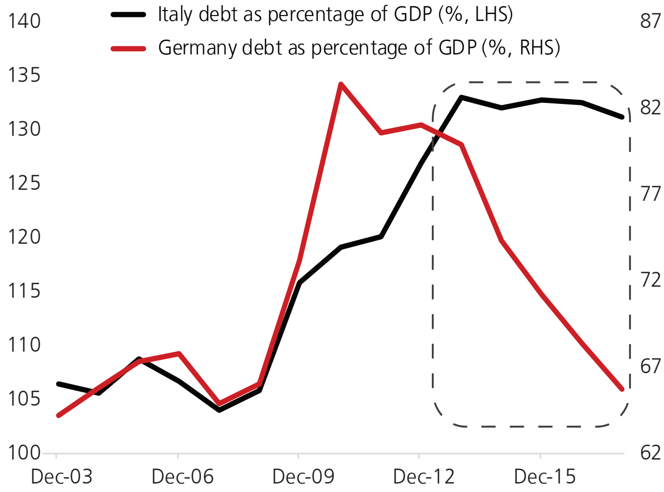
Figure 3: Euro weakness – As good as it gets?



Source: Bloomberg, DBS

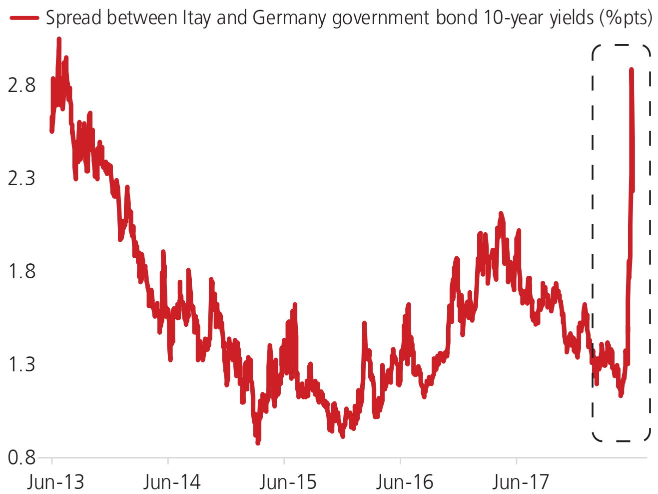
Currently, debt as percentage of gross domestic product (GDP) in Italy stands at 131.2% and this is already substantially higher than the European Union (EU)-mandated level of 60% (as stipulated under the Stability and Growth Pact) (Figure 4). Populist policies which are expected to be implemented in the coming quarters will only worsen the situation. Italy has been widely described as "too big to fail, but also too big to bail". A severe deterioration of its fiscal positioning will therefore unsettle bond markets (Figure 5) and more importantly, challenge the very notion of "unity" in the Euro Area.

Figure 4: Debt as percentage of GDP remains elevated in Italy (a stark contrast to Germany)



Source: Bloomberg, DBS

Figure 5: The spread between Italian and German government bond 10-year yields has already widened substantially

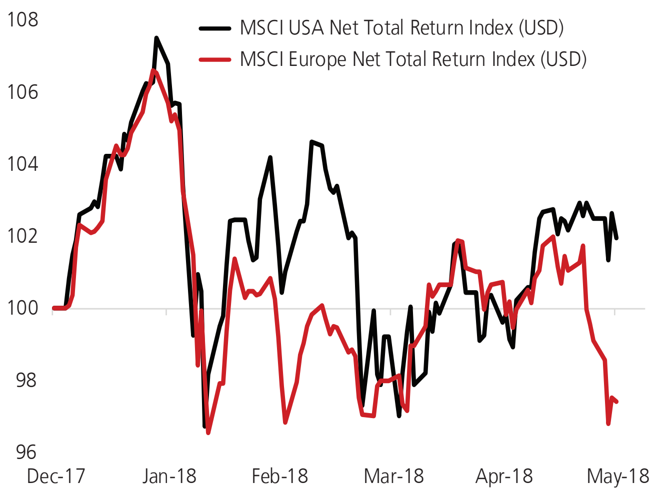


Source: Bloomberg, DBS

US to outperform Europe on the back of strong earnings momentum

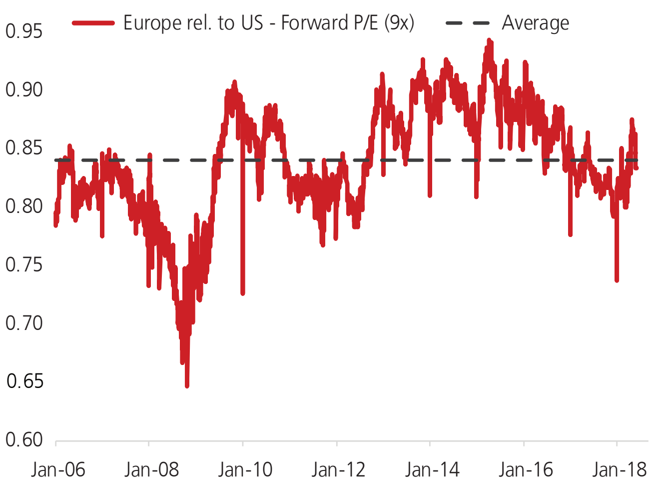
US outperformance over Europe to persist. On a US-dollar-based net total return basis, the US has outperformed Europe substantially this year (Figure 6) and we expect the robust momentum to persist. Unlike Europe, the recent reporting season shows that US corporate earnings remain in the pink of health and this is reflected in the consensus forecast for earnings growth in 2018 (29% for the US vs. 12% for Europe). Moreover, Europe's valuation discount is no longer at an extreme and it is currently only at the long-term average level (Figure 7).

Figure 6: US has outperformed Europe this year



Source: Bloomberg, DBS

Figure 7: Europe's valuation discount to the US is now back to the long-term average



Source: Bloomberg, DBS

Table 1: Europe Sector key financial ratios

	Forward P/E (x)	P/B (x)	EV/ EBITDA (x)	ROE (%)	ROA (%)	OPM (%)
MSCI Europe	14.4	1.8	9.8	12.2	1.5	11.3
MSCI Europe Financials	10.8	1.0	-	7.1	0.4	18.4
MSCI Europe Energy	13.9	1.5	7.5	7.4	3.2	6.6
MSCI Europe Technology	22.9	3.8	18.4	8.4	3.9	9.8
MSCI Europe Materials	14.1	2.1	8.7	14.9	6.2	9.9
MSCI Europe Industrials	17.3	3.1	11.1	18.5	5.3	8.2
MSCI Europe Cons. Dis.	12.9	2.1	7.5	15.4	5.1	9.2
MSCI Europe Cons. Staples	18.5	3.0	14.5	32.2	11.6	10.4
MSCI Europe Telecom	13.7	1.5	5.9	7.5	2.5	12.9
MSCI Europe Utilities	13.5	1.5	7.5	12.5	2.9	8.7
MSCI Europe Health Care	15.8	3.4	14.2	17.7	7.5	16.8
MSCI Europe Real Estate	18.8	1.0	11.7	11.2	5.3	134.3

Source: Bloomberg

Japan Equities | 3Q18

Lacking catalysts

Source: AFP Photo

Japan Equities

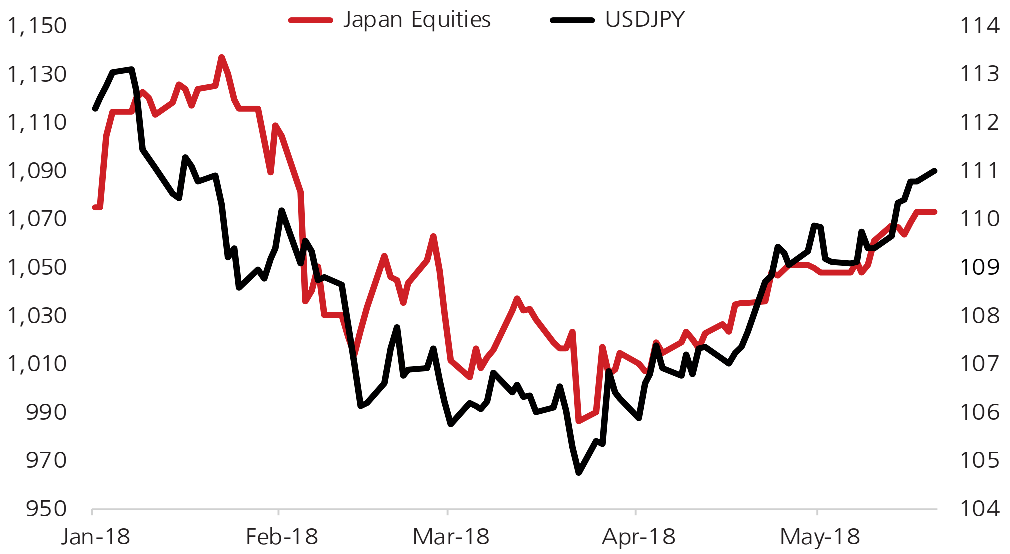
Jason Low, CFA
Strategist

Stay Neutral

Japan equities have generally outperformed global equities (in local-currency terms) in recent months, on the back of a weaker yen. The outperformance has also come despite Japanese Prime Minister Shinzo Abe's falling approval ratings, amid fallout from a string of scandals and a mediocre earnings season so far. The yen weakened by about 4% against the US dollar since the start of 2Q to late May, on higher US long-term interest rates. This supported the upside of Japan equities. At 14x forward price-to-earnings (P/E), valuations are inexpensive. While earnings are on track, it has been a largely lacklustre reporting season thus far. Stay Neutral.

Outperformance of Japan equities in 2Q18. After underperforming global equities in 1Q18, Japan equities made a strong comeback in 2Q18. The outperformance of Japan equities was supported by a much weaker yen (Figure 1), which helps the competitiveness of the country's export sector by making yen-denominated products cheaper for overseas buyers. That is, a weaker yen helps corporate profits, especially those of exporters. This outperformance came through despite generally negative political developments, Abe's falling approval ratings, and a mediocre earnings season. DBS expects USD/JPY to rise to 114 by end-2018. This should be generally positive for Japan equities, all other things constant.

Figure 1: A weaker yen helped Japan equities outperform this quarter

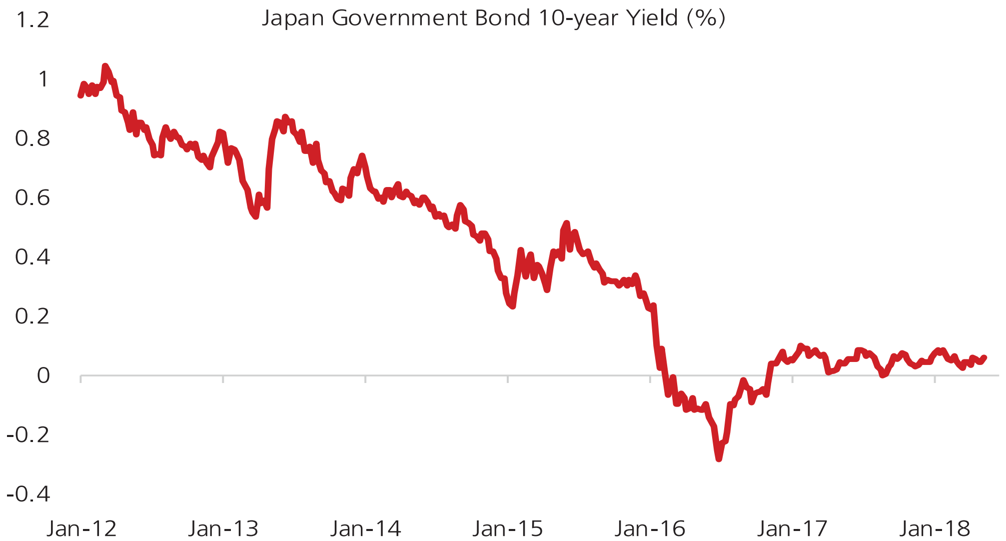


Source: Bloomberg, DBS

A third term for Abe may be best for markets

Abe's approval rating at new low, but a third term for the incumbent could be best for markets. Plagued by a scandal fallout, Abe's approval rating fell to 26.7% in a survey done by Nippon TV released in mid-April – the lowest since he came to power in December 2012. Widely expected to run for a third term as ruling Liberal Democratic Party (LDP) leader in September, Abe's political future is now in question – and with it, the future of Abenomics and its attendant expansionary fiscal policies. That said, a Reuters poll done in late April showed that the Japanese business community still views the prime minister positively. Political stability, a lack of confidence in political alternatives, and the continuation of Abenomics policies (Figure 2) were cited as reasons for their largely positive view. Markets hate uncertainty. Thus, a third term for Abe may be best for markets, ensuring policy continuity and political stability.

Figure 2: Continuation of Abenomics and accommodative monetary policies necessary



Source: Bloomberg, DBS

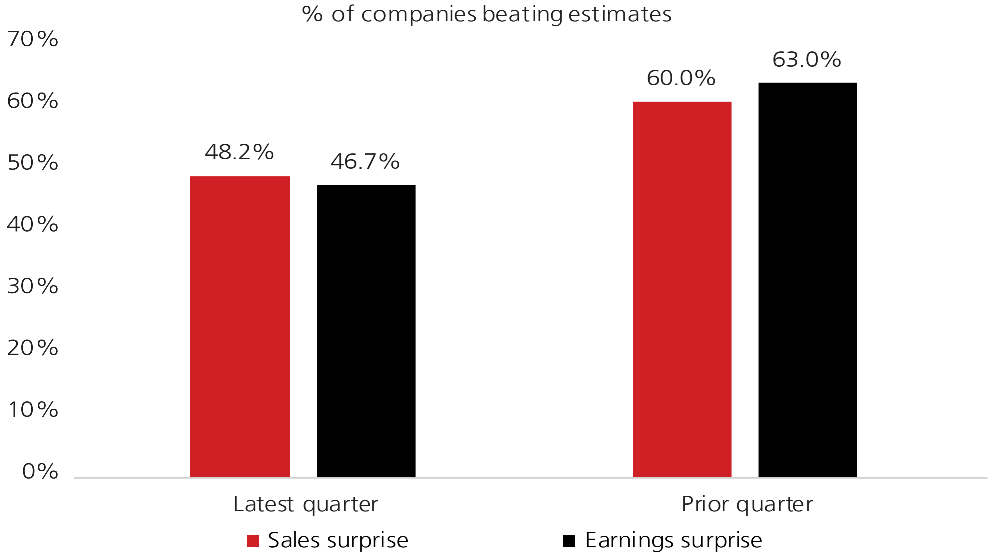
Increasing geopolitical and trade risks generally not positive for equities

Increasing geopolitical and trade risks look to test Japan equities. Despite recent meetings with US President Donald Trump, Abe has not made concrete progress on the trade front in exempting Japan from US tariffs, or in convincing the US to reverse its Trans-Pacific Partnership (TPP) snub. More recently, Abe's hosting of China's Premier Li Keqiang and South Korean President Moon Jae-in at a summit in mid-May also underlined his neighbours' divided views on the issue of North Korea's nuclear and missile programmes.

While earnings have been largely in line, they have been mediocre compared to previous quarters

Earnings lacklustre compared to previous quarters. While earnings are generally on track, it has been a lacklustre season. The strong beats of previous quarters are a thing of the past. In the latest earnings season, slightly less than half of Japanese corporates beat earnings estimates and sales estimates (Figure 3). This is a drag on Japan equities, if not for the weakening yen.

Figure 3: Earnings have been mediocre in this season

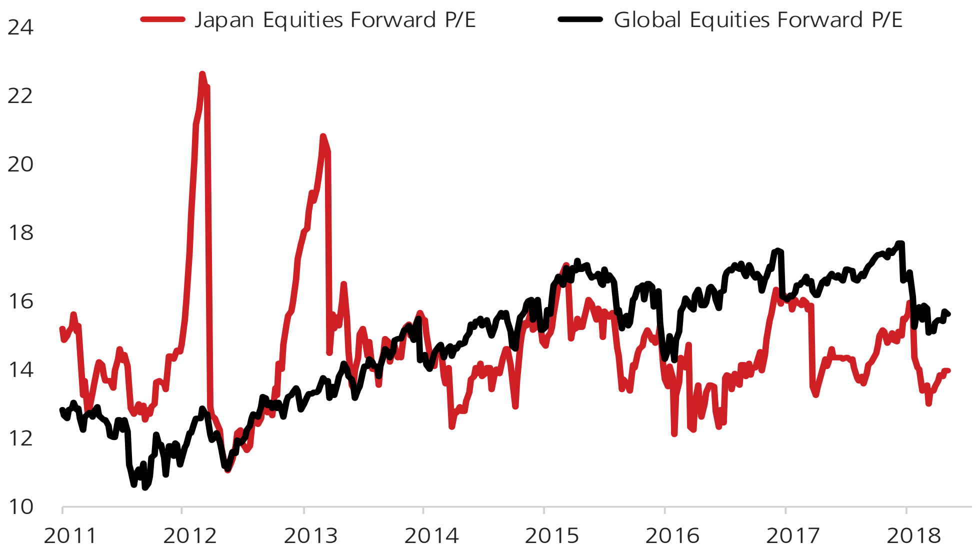


Source: Bloomberg, DBS

Japan equities trade at inexpensive valuations

Valuations remain reasonable on absolute and relative basis. Japan equities trade at about 14x forward P/E which is still below their seven-year historical average. On a relative basis, Japan equities are also inexpensive. They trade at a 10% discount to global equities (Figure 4).

Figure 4: Valuations are undemanding



Source: Bloomberg, DBS

Asia ex-Japan Equities | 3Q18

Headwinds to dampen performance

Source: AFP Photo

Asia ex-Japan Equities

Jason Low, CFA
Strategist

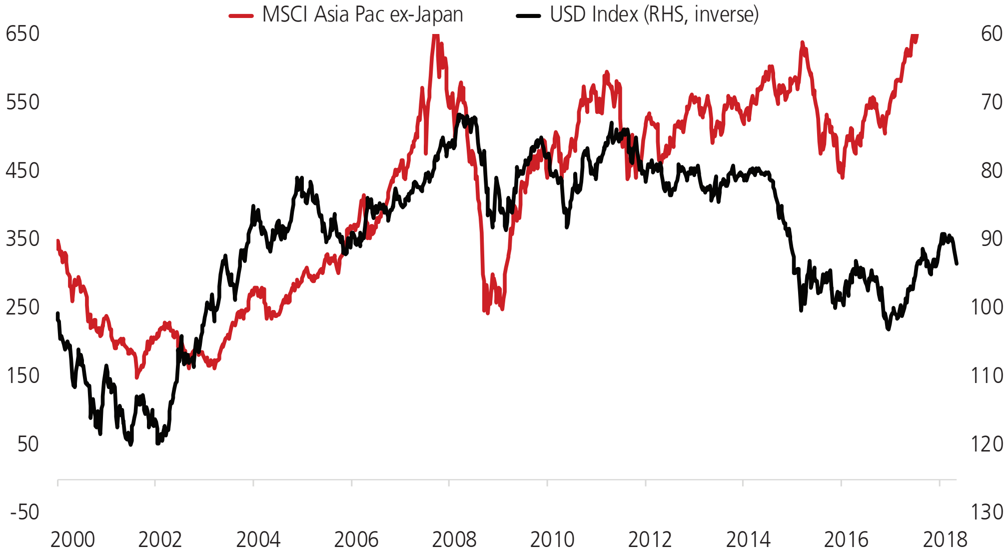
Joanne Goh
Strategist

Headwinds to dampen performance. Move to Neutral.

Asia ex-Japan (AxJ) equities continued their rally in 2Q18 (as of 16 May), but 3Q18 will likely be challenging. While valuations remain undemanding, there are headwinds facing the region's equities over the coming months. They are set to be tested by a mix of higher inflation, rising rates, trade tensions, stronger US dollar, and potential capital outflows. We see a more challenging AxJ equity market in the near term, but stay engaged over the long-term. We move AxJ equity to Neutral on the back of trade uncertainties, as well as potential contagion from Europe and global Emerging Markets. Prefer exposure in fundamentally stronger countries, like Hong Kong/China and Singapore.

AxJ performance may be dampened in the near term. The combination of higher rates, a stronger US dollar, and unresolved trade tensions pose roadblocks to AxJ equities. While valuations remain undemanding and macroeconomic fundamentals stay generally

Figure 1: A strong USD presents a roadblock to Asian equities



Source: Bloomberg, DBS

strong, these temporary headwinds may somewhat dampen the region's performance in the near term.

Remain positive over the long-term. Despite the above concerns, it is pertinent to take a longer-term perspective. Investors should not throw the baby out with the bathwater. Learning from the past, Asia markets become embattled when they are not able to pay USD-denominated debt such as in the 1997/1998 Asia Financial Crisis and in the

2008/2009 Global Financial Crisis. It seems unlikely that the shape of a "crisis" today will resemble anything of the past. In fact, Asia's countries are now largely driven by domestic growth stories and have, over the last two decades, built a larger pool of local capital. This is also supported by the rise of consumption-hungry middle class in the region. By 2030, two-thirds of the world's middle class will be living in Asia.

Within Asia, gain exposure to HK/China, Malaysia, and Singapore

Positive on Hong Kong/China, Malaysia, and Singapore. When separating the winners and losers within Asia, India and Indonesia are particularly vulnerable due to their current and budget account deficits, as well as their dependence on oil. Conversely, China and Singapore benefit from strong external balance sheets and fiscal balances that will help them to remain relatively resilient to these headwinds. Following the surprise election win by Malaysia's Pakatan Harapan (PH, Alliance of Hope), the opposition coalition led by the then-former Prime Minister Mahathir Bin Mohamad, domestic sentiment is certain to improve dramatically, especially with the abolishment of the goods and services tax (GST) and potential re-introduction of fuel subsidies. We believe Malaysia equity markets can be supported by positive domestic sentiment (Figure 2).

Figure 2: Asia ex-Japan Country Allocation

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

Source: DBS

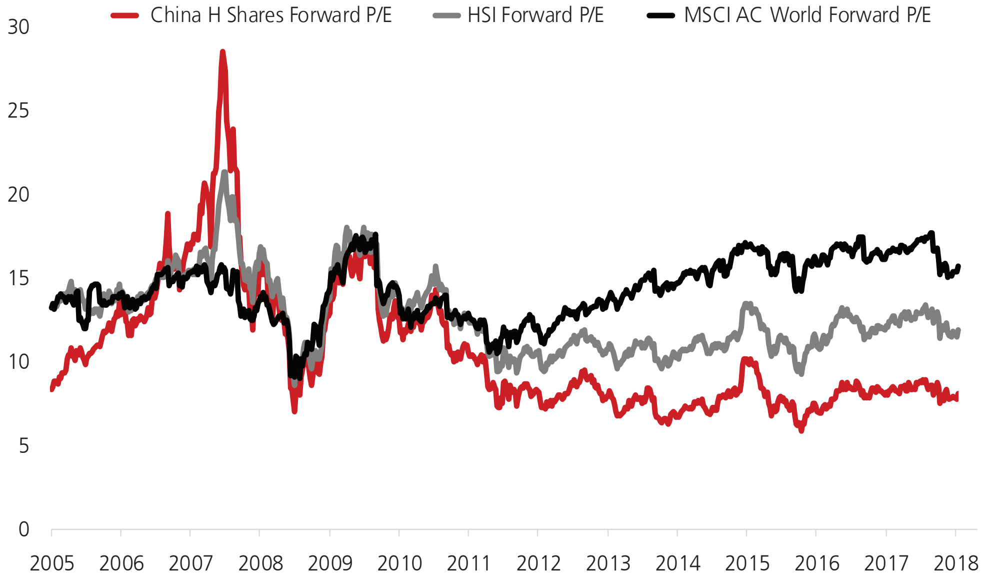
Stay engaged in HK/China domestic sectors

Focus on domestic sectors in Hong Kong/China. Valuations continue to be attractive in Hong Kong/China (Figure 3). But at the epicentre of the trade war disputes, this market may suffer volatility, especially in export-driven sectors. The first round of trade talks between the US and China made scant progress and showed how far apart their respective positions are. On a positive note, the two sides have agreed to continue with the dialogue. We prefer to stay engaged in the Hong Kong/China markets through domestic sectors including China properties, Hong Kong/China banks and insurance, and the Hong Kong consumer sector.

ASEAN offers solid long-term prospects with the rise of the middle class and attractive demographics

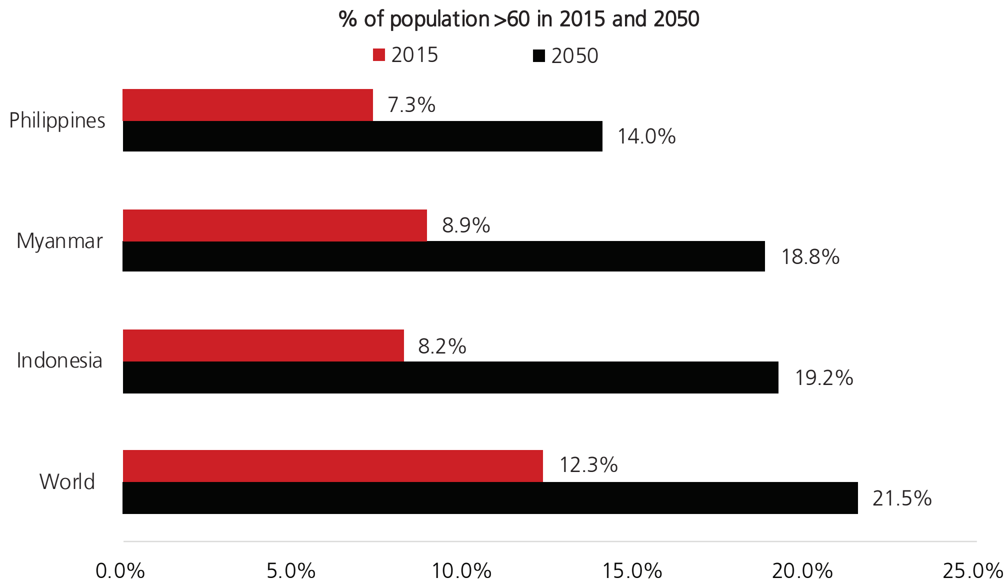
ASEAN offers solid long-term prospects on the rise of middle class and attractive demographics. Uncertainties, especially with regard to the US dollar's trend and interest rates could sap the risk appetite for ASEAN markets in the near term. However, we believe there are opportunities within the region for long-term investors. ASEAN largely remains an attractive demographics story (Figure 4). The region's strengths lie in a relatively young and sizeable population, generally sound macroeconomic fundamentals, and a growing middle class. The Asian Development Bank predicts that the ASEAN middle class population will rise to 65% by 2030, from 29% in 2010. Clearly, the rise of the consumption-hungry ASEAN middle class is a fundamental driver in the region's growth prospects in the coming years. Indeed, consumer and investment spending are key growth drivers. These, together with reforms and generally stable politics, present opportunities.

Figure 3: Hong Kong/China valuations continue to be attractive



Source: Bloomberg, DBS

Figure 4: ASEAN has an attractive demographics story

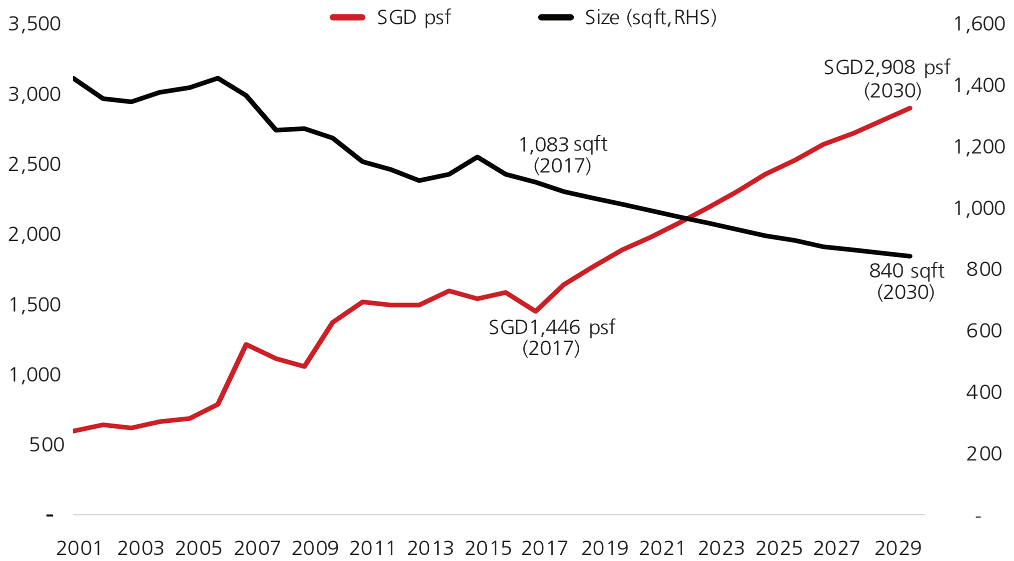


Source: DBS, United Nations

Seek growth in ASEAN banks, consumption, tourism, and Singapore property

Favour ASEAN banks, consumption, tourism, and Singapore property. Along with a broad-based economic expansion, ASEAN banks – which are the most sensitive to economic activities – should benefit from a resilient domestic economy as consumption and investment start to pick up, which would in turn drive the demand for loans. Domestic consumption will benefit from attractive demographics and the rise of the middle class. It will also be the least affected by protectionism threats. ASEAN tourism is poised to accelerate with the estimated increase of the number of international visitors into the region – by 5-6% in 2018 – led by growth in key markets such as Thailand, Malaysia, and Singapore. Meanwhile, Singapore property should continue to ride on the broad-based economic recovery (Figure 5). Developers' desire to land bank have continued to push property prices higher. We continue to favour Singapore property developers. While we are Neutral on Singapore real estate investment trusts (REITs) on rising rates, their high dividend yields and improving demand prospects are positives. Favour selective exposure in the hospitality, commercial, and industrial sub-sectors.

Figure 5: Singapore property to ride on a broad-based economic recovery



Source: DOS, DBS, MND

DM Government Bonds | 3Q18

US policy turning restrictive

Source: AFP Photo

DBS

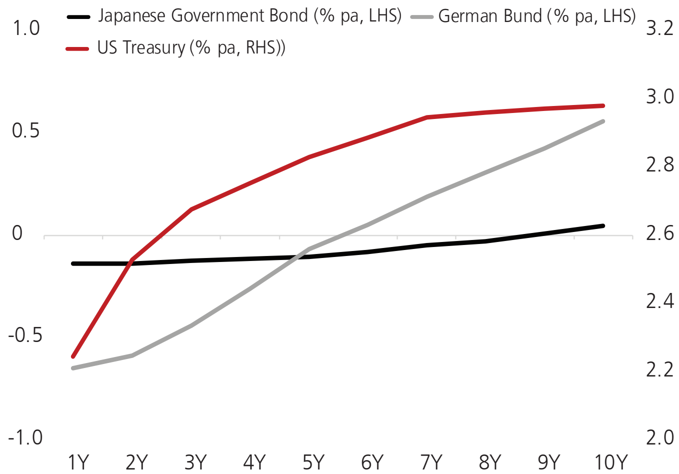
DM Government Bonds

Eugene Leow
Strategist

USD interest rates have been buoyant over the past few months. Generally-firm inflation numbers, plus the fact that the US unemployment rate fell to 3.9% (levels not seen since 2000), convinced the market that the Federal Reserve will be able to continue hiking rates over the coming year. While USD rates may look high compared to two years ago, we think that the ascent is not done. Much more is needed to price in rises for 2019, and intermediate tenor rates are not ready if the Fed hikes to 3.50% by end-2019 as we expect.

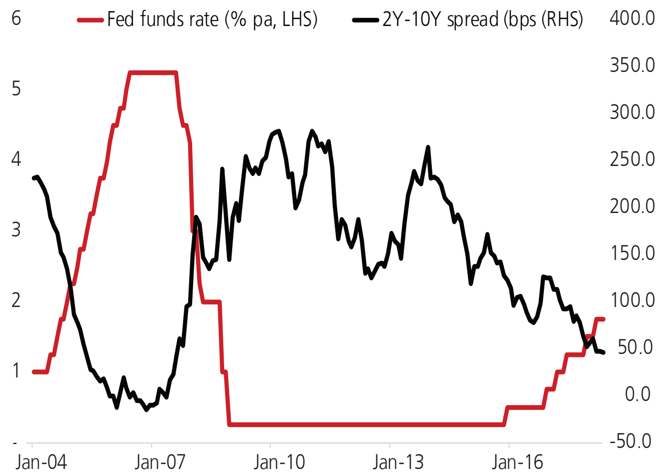
As the Fed policy moves past neutral and into restrictive territory, we think that the curve will flatten. US consumer price index (CPI) stands at 2.4% y/y in March. With the policy rate (upper bound) at 1.75%, the real rate is still negative, implying that monetary policy is still on the loose side. Rising inflation has actually offset a chunk of the tightening that the Fed has embarked on over the past year. Assuming inflation hovers just above 2%, it would require the Fed to hike twice more for real rates to turn zero, and another three times before the monetary policy setting is close to neutral (3%).

Figure 1: G-3 Curves



Source: Bloomberg, DBS

Figure 2: The curve tends to flatten as the Fed hikes rates



Source: Bloomberg, DBS

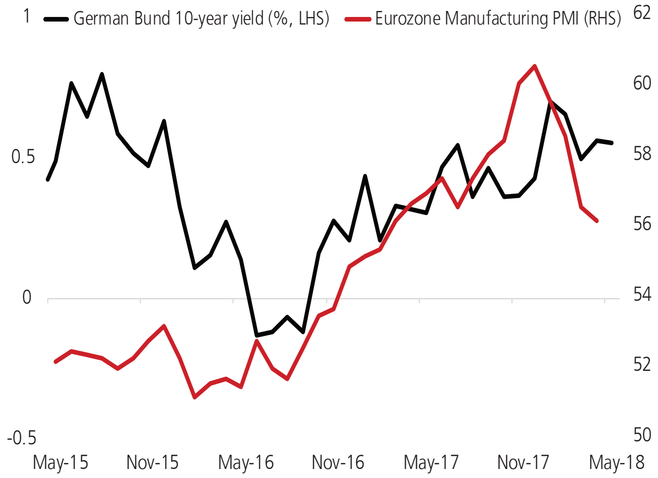
As real rates rise, the market should draw comfort that the Fed is still sticking to its mandate of keeping price pressures in check, especially at a time when the labour market is becoming increasingly tight. Therefore, if inflation is priced in correctly (five-year breakeven just above 2%) and the Fed keeps real rates high, uncertainties over inflation should ease - which should in turn drive term premiums lower, flattening the curve in the process. This largely explains why we have factored in a flat curve toward the end of 2019.

In contrast, enthusiasm over less-loose monetary policy by ECB and BOJ appears to have waned somewhat. In some ways, there has been a divergence in policy outlooks between the Fed and the other two major central banks. Notably, economic data out of the Eurozone have been disappointing with manufacturing purchasing managers' index (PMI) numbers coming off sharply since late 2017. This has reduced the urgency for the European Central Bank (ECB) to bring forward the end of taper, and by extension, consider raising short-term rates.

The BOJ is moving slowly toward tapering

Meanwhile, Japan's economic numbers are holding up better than the Eurozone with wages appearing to be ticking up. However, the Bank of Japan (BOJ) appears to be in no hurry to tighten policy. Instead, the central bank is taking baby steps toward tapering with rhetoric suggesting that active discussion could take place in 2019. Interestingly, the BOJ has also dropped the reference to achieving the 2% CPI target by FY19. Arguably, this provides greater flexibility if the BOJ intends to normalise policy gradually in 2019 and 2020.

Figure 3: 10-year German yields have come off as PMI cools



Source: Bloomberg, DBS

Figure 4: Japanese Government Bond yields are still directionless

Source: Bloomberg, DBS

The market should gravitate toward policy normalisation again

The perceived policy divergence between Fed and ECB/BOJ is unlikely to last long. Unless Eurozone data becomes much weaker, it may not be that easy to derail the current plan to end quantitative easing by 4Q19. FX considerations also play a part. The strength of the euro and the yen in the early part of this year was a clear impediment for normalisation, as currency strength dampens domestic inflation expectations while eroding external competitiveness. Such considerations have also waned somewhat as the US dollar's strength took hold over the past few months. In short, volatility in economic data and FX will lead to the ebb and flow of euro and yen rates. However, the bigger picture remains that quantitative easing is a crisis-era policy. Now that the crisis is way behind us, it would be a matter of time before the market likely gravitates back to normalisation, driving euro and yen rates higher.

Table 1: Rates forceasts

		2018				2019			
		1Qa	2Q	3Q	4Q	1Q	2Q	3Q	4Q
US	3M Libor	2.31	2.30	2.50	**2.75**	3.00	3.25	3.50	**3.75**
	2Y	2.27	2.60	2.75	**2.90**	3.05	3.20	3.35	**3.50**
	10Y	2.74	3.00	3.10	**3.20**	3.30	3.40	3.50	**3.50**
	10Y-2Y	47	40	35	**30**	25	20	15	**0**
Japan	3M Tibor	0.07	0.05	0.05	**0.05**	0.05	0.05	0.05	**0.05**
	2Y	-0.13	-0.12	-0.11	**-0.10**	-0.08	-0.05	-0.03	**0.00**
	10Y	0.05	0.09	0.10	**0.10**	0.10	0.10	0.10	**0.10**
	10Y-2Y	18	21	21	**20**	18	15	13	**10**
Eurozone	3M Euribor	-0.33	-0.30	-0.30	**-0.25**	-0.20	-0.10	0.00	**0.10**
	2Y	-0.60	-0.30	-0.20	**-0.10**	0.00	0.10	0.20	**0.30**
	10Y	0.50	0.80	0.90	**1.00**	1.13	1.25	1.38	**1.50**
	10Y-2Y	110	110	110	**110**	113	115	118	**120**
Indonesia	3M Jibor	5.36	5.90	6.15	**6.15**	6.15	6.40	6.40	**6.40**
	2Y	5.51	6.70	6.85	**7.10**	7.20	7.30	7.40	**7.50**
	10Y	6.68	7.15	7.25	**7.40**	7.55	7.70	7.85	**8.00**
	10Y-2Y	117	45	40	**30**	35	40	45	**50**
Malaysia	3M Kibor	3.69	3.65	3.90	**3.90**	3.90	3.90	3.90	**3.90**
	3Y	3.45	3.70	3.80	**3.85**	3.85	3.85	3.85	**3.85**
	10Y	3.94	4.20	4.25	**4.30**	4.35	4.40	4.45	**4.50**
	10Y-3Y	50	50	45	**45**	50	55	60	**65**
Philippines	3M PHP ref rate	4.08	4.05	4.20	**4.20**	4.25	4.30	4.30	**4.30**
	2Y	4.16	4.60	4.80	**4.90**	5.00	5.10	5.20	**5.20**
	10Y	6.00	6.60	6.70	**6.80**	6.90	7.00	7.00	**7.00**
	10Y-2Y	184	200	190	**190**	190	190	180	**180**
Singapore	3M Sibor	1.45	1.70	1.85	**2.05**	2.25	2.45	2.65	**2.85**
	2Y	1.79	2.00	2.10	**2.20**	2.30	2.40	2.50	**2.60**
	10Y	2.29	2.50	2.60	**2.70**	2.80	2.85	2.90	**2.90**
	10Y-2Y	50	50	50	**50**	50	45	40	**30**
Thailand	3M Bibor	1.57	1.60	1.60	**1.60**	1.85	2.10	2.35	**2.60**
	2Y	1.32	1.45	1.50	**1.60**	1.80	2.00	2.20	**2.40**
	10Y	2.40	0.50	2.60	**2.70**	2.80	2.90	3.00	**3.00**
	10Y-2Y	107	-95	110	**110**	100	90	80	**60**

		2018				2019			
		1Qa	2Q	3Q	4Q	1Q	2Q	3Q	4Q
China	1yr lending rate	4.35	4.35	4.35	**4.35**	4.35	4.35	4.35	**4.35**
	3Y	3.56	3.20	3.20	**3.30**	3.40	3.50	3.60	**3.70**
	10Y	3.75	3.60	3.65	**3.70**	3.75	3.80	3.85	**3.90**
	10Y-3Y	19	40	45	**40**	35	30	25	**20**
Hong Kong	3M Hibor	1.21	1.70	1.90	**2.15**	2.40	2.65	2.90	**3.15**
	2Y	1.42	1.90	2.05	**2.20**	2.35	2.50	2.65	**2.80**
	10Y	1.99	2.30	2.40	**2.50**	2.60	2.70	2.80	**2.80**
	10Y-2Y	57	40	35	**30**	25	20	15	**0**
Taiwan	3M Taibor	0.66	0.66	0.66	**0.74**	0.74	0.81	0.81	**0.89**
	2Y	0.45	0.60	0.60	**0.68**	0.68	0.75	0.75	**0.83**
	10Y	0.99	1.15	1.25	**1.35**	1.45	1.55	1.60	**1.65**
	10Y-2Y	54	55	65	**68**	78	80	85	**83**
Korea	3M CD	1.65	1.65	1.90	**2.15**	2.15	2.40	2.40	**2.40**
	3Y	2.22	2.25	2.30	**2.35**	2.40	2.45	2.45	**2.45**
	10Y	2.62	2.80	2.85	**2.90**	2.95	3.00	3.05	**3.10**
	10Y-3Y	41	55	55	**55**	55	55	60	**65**
India	3M Mibor	7.48	7.00	7.00	**7.15**	7.15	7.30	7.30	**7.30**
	2Y	6.85	7.25	7.30	**7.40**	7.50	7.60	7.70	**7.80**
	10Y	7.40	7.70	7.80	**7.90**	8.00	8.10	8.20	**8.30**
	10Y-2Y	55	45	50	**50**	50	50	50	**50**

%, eop, govt bond yield for 2Y and 10Y, spread bps
As of 14 May 2018

Source: Bloomberg, DBS

DM Corporate & EM Bonds | 3Q18

Shift EM Bonds to Neutral

Source: AFP Photo

DBS

DM Corporate & EM Bonds

Philip Wickham
Fixed Income

Cheng Xin Yi
Fixed Income

Willie Keng, CFA
Fixed Income

Underweight DM Corporate and Neutral EM Bonds

On a three-month basis, we have lowered our weighting on Developed Market (DM) corporate bonds to Underweight (from Neutral), and moved Emerging Market (EM) bonds to Neutral (from Overweight). Our main concerns stem from the negative combination of:

a) Rising energy prices: Although partially a result of heightened geopolitical risks, higher energy prices negatively impacts Emerging Asia given its status as an oil-and-gas importer (excluding Malaysia);

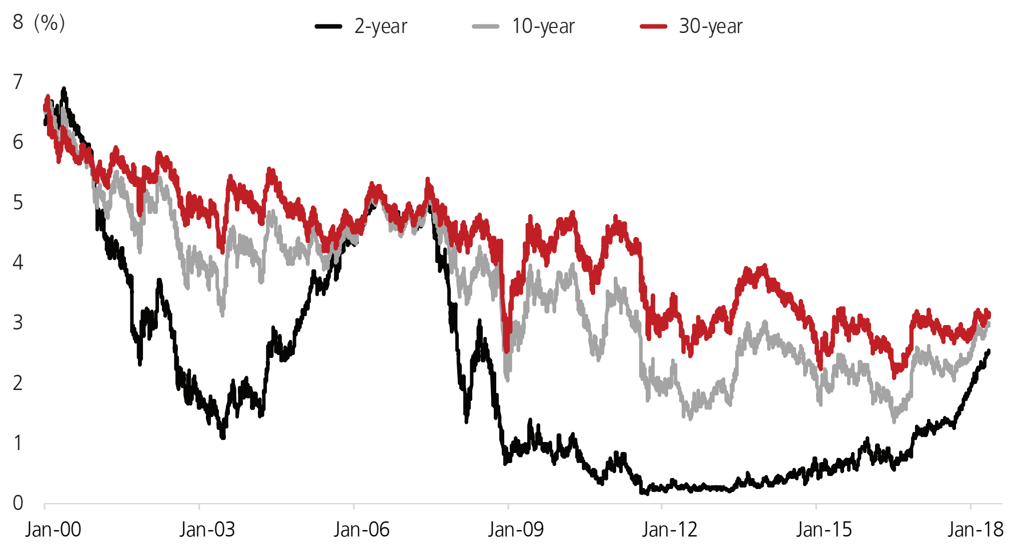
b) Dollar strength: A strengthening US dollar usually results in economic difficulties for EM economies; and

c) Rising rates: Higher rates for the US dollar would feed into the prior point.

All three factors are generally viewed as negative for EM bonds, as history has unfortunately illustrated over the last few decades.

The adverse impacts are partially offset by a benign supply outlook for US-dollar-denominated debt in 2018 as well as a generally-supportive yield curve (which is not expected to move into an inversion position this year). However, these are modest

Figure 1: UST yields since 2000



Source: Bloomberg, DBS

compared to the current negative developments. For example, the US Treasury (UST) 10-year yield broke through the 3.0% handle twice before rallying. Compared to 2011 when the 10-year yield was last at this level (the 2-year yield was around 0.4% and the 30-year yield was around 4.3%), the current yield curve highlights the substantial flattening that has occurred since then (Figure 1, as the 2-year, 10-year, and 30-year yields approach each other this year).

We still see value in Emerging Asia issues, especially Chinese ones

Attractive opportunities in select sections of both spaces. Despite the headwinds, we continue to view sectors within the EM bonds category as providing value – predominantly Emerging Asia issues, specifically Chinese ones. The pullback in valuations for such notes (from an average yield of around 6-8% for speculative-grade issues over the first four months of the year) results in several attractive investing opportunities.

Figure 2: Spread movements for HY bonds

Source: DBS, JPMorgan, Markit Group

In DM corporate, prefer HY to high grade

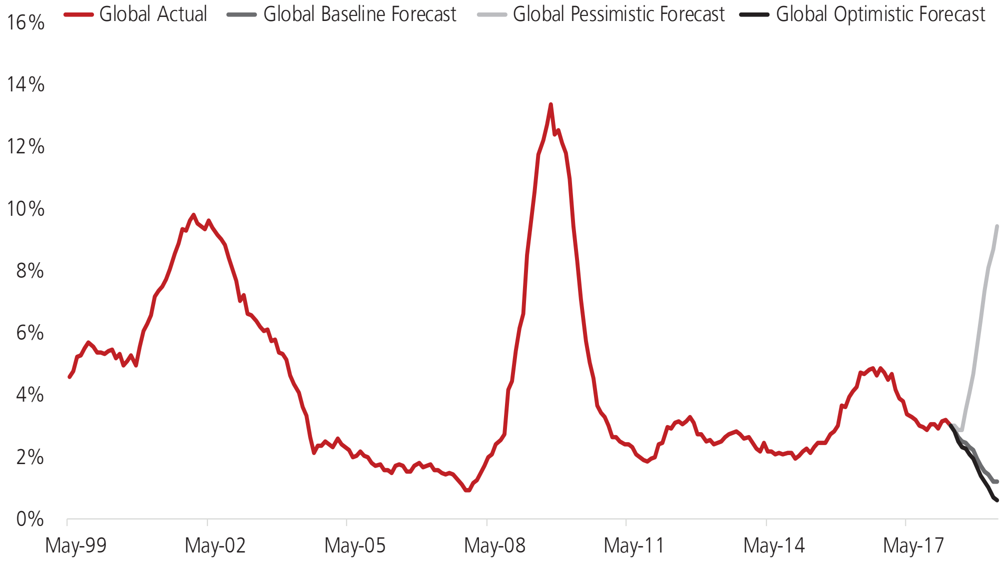
Favour Western European banks, specifically French and Swiss

Moreover, within the DM corporate space, we generally prefer high-yield (HY) to high-grade bonds given where we feel we are in the economic and credit cycle. Even so, we prefer DM corporates with a debt-reduction strategy, which also provides rating uplifts as management executes it. We continue to prefer Western European banks – specifically the French and the Swiss – given their lower operational risk and modest Brexit risk profiles. We also recommend investing in Australian and Turkish banks, outside the core Asia financial sector, given attractive valuations, interesting risk-reward profiles, and yield pickups.

Within EM, Asia is expected to outperform in the coming months given heightened volatility in other regions

Geographic diversity remains a positive over the long term. Diversification across geographies remains a key investment rationale as its benefits are still significant for investors. We argue that investors should have significant exposures outside Asia to enjoy diversification benefits over the long term, through purchasing benchmark credits in Emerging Europe, Latin America, and Africa. Maintaining a heterogeneous bond portfolio also mitigates the idiosyncratic risks of political and regulatory risks largest present in EM (such as the current economic issues in Argentina). However, we acknowledge that over the next few months, Asia is likely to be an outperformer within EM given the expected higher volatility in other regions, namely Latin America.

Figure 3: Global speculative-grade default rates (actual and forecast)



Source: DBS, Moody's

Stick with BBB/BB credits

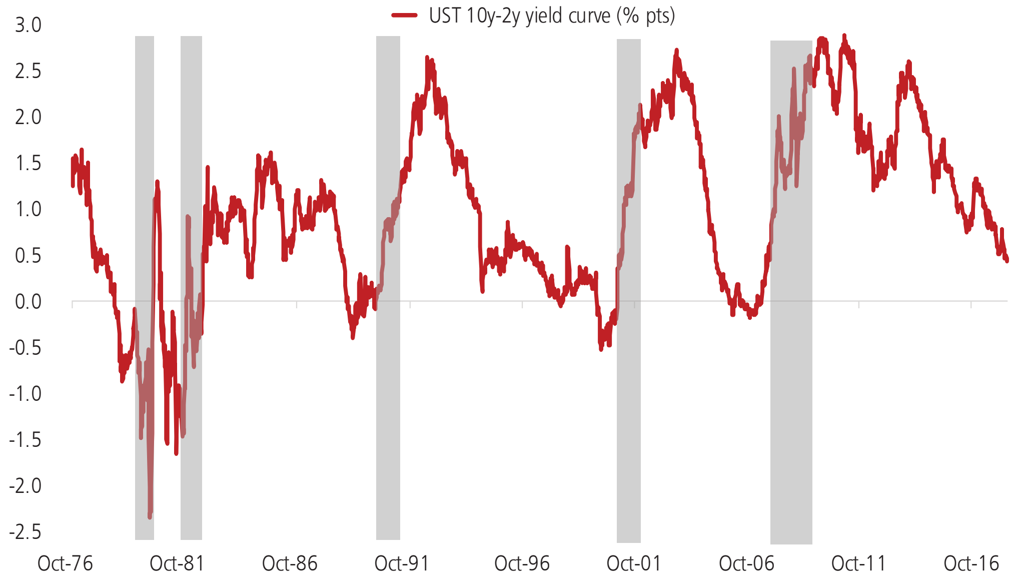
The BBB/BB bucket of bond issues provides best risk-return balance. We continue to remain with the BBB- and BB-rated credit buckets for the large majority of our investment recommendations. We regard the risk-reward profiles for these issuers as attractive compared to the higher-grade A-rated and higher, or the B-rated and lower notes. In our view, the risk-adjusted return profiles of our selections remain alluring for an individual investor. Note that we focus on credits with an improving credit profile and/or stable operations, which should also provide a cushion in case our view of a benign economic outlook through 2018 proves to be misplaced.

Yield-curve inversion a rising concern given recent curve flattening

A flattening yield curve is a common occurrence at the end of a credit cycle. Investors have begun to watch the yield curve as inversion becomes a possibility, flattening to the lows since the end of the last decade during the Global Financial Crisis. The length of the current expansion in the US is twice the historical normal, and approaching its tenth year, albeit with subdued growth rates from the start. As such, we highlight that yield inversions do occur and are generally viewed as an indicator of a looming economic recession. But this is hard to act upon as it occurs up to two years in advance. While an inversion now would signal an economic downturn sometime in the next five years, this is hardly a surprising forecast for experienced investors.

Another indicator is the macro data from the Fed, such as the six-month moving average of payrolls – a strong indicator for a turn in the cycle. Until the six-month moving average of payrolls starts to approach zero (from around 200,000 now), we expect the existing situation to continue with the yield curve remaining flattish. However, if the yield curve inverts and payrolls start to trend lower, we will have to start considering a turn in the global economic cycle.

Figure 4: Curve inversion preceded US recessions historically

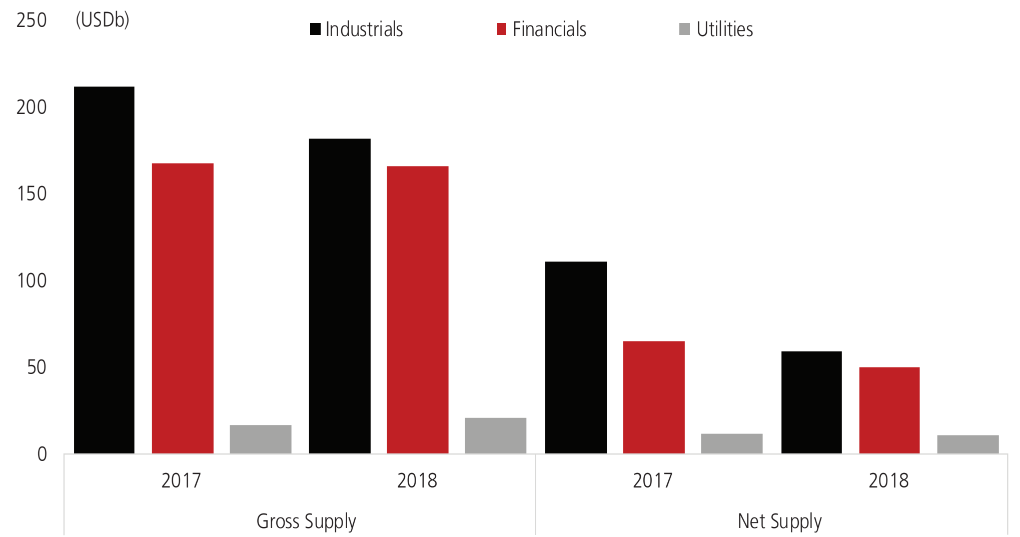


Source: Bloomberg, DBS

Sharp decline in USD corporate issuance from Industrials

Declining issuance of US-dollar-denominated corporates in 2018. According to data from Barclays, the US-dollar-denominated fixed-rate corporate supply is down USD28b (-7%) for the first four months of 2018 compared to the same period last year. Moreover, net supply was down a more substantial USD120b (-36%) over the same four-month period. The reduced corporate issuance is primarily from industrials, with gross and net supply down 14% and 47%, respectively. For Financials issuance, gross supply was relatively steady (-1%) while net supply was down 26% during the first four months of the year.

Figure 5: January-April gross and net corporate supply



Source: Barclays

For rest of the year, supply will come mainly from Industrials while Technology issuance stays subdued

The mix of supply is expected to lean toward Industrials for the rest of 2018 as historically around 40% of the Financials supply occurs in the first four months of the year (since 2010), vs. c.30% of Industrials supply occurring before May each year. However, we anticipate that issuance from Technology corporates will remain low given the continued repatriation of overseas cash after last year's tax reforms. Apple Inc, Microsoft Corporation, and Oracle Corporation have not issued at all this year, compared with the USD27b issued by the same time 2017. The current net supply reduction would be the first since 2013 and would provide a positive technical to the credit markets this year.

In addition, while net supply of corporate issues is likely to decline, long-dated non-Financials issuance is increasing (higher by 38% in the first four months of 2018 vs. same period 2017). This is partially from large issuance from CVS Pharmacy of USD13b in 20- and 30-year bonds to fund its acquisition of Aetna Inc. Nonetheless, there were 20 other issuers having printed USD1b or more of long-dated bonds. We highlight that the flattening of the yield curve allows corporates to extend duration within a significant increase in yield. The last time we saw the yield curve flatten, between 2005 and 2007, we also witnessed a significant rise in long-dated issuance from corporates.

Currencies | 3Q18

Dollar recovery in motion

Source: AFP Photo

DBS

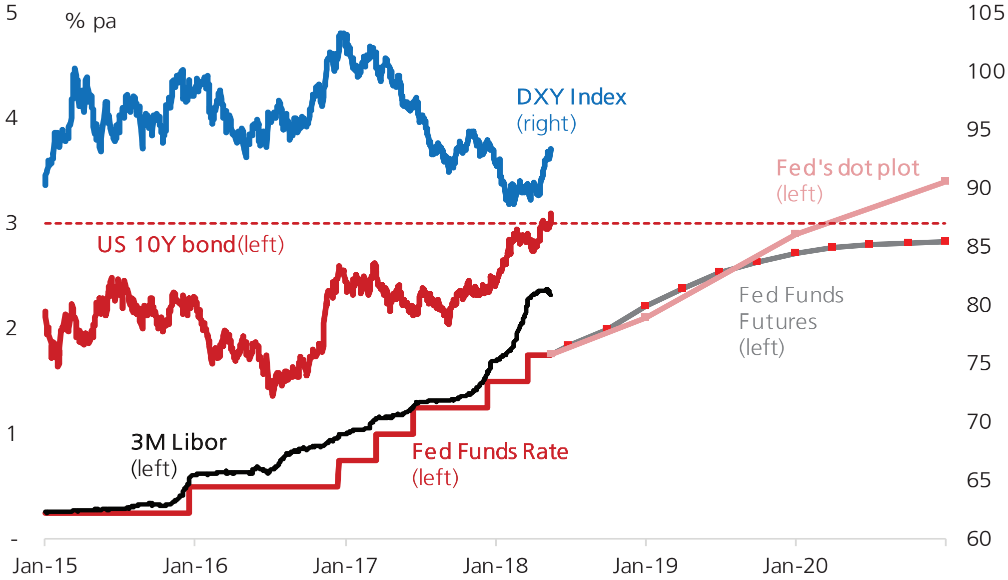
Currencies

Philip Wee
Strategist

USD recovery gains momentum

The US dollar, as measured by the US Dollar Index (DXY), has recovered this year's losses with scope for more appreciation over the rest of 2018. The US has the strongest growth/inflation/interest-rate outlook compared to the Eurozone, United Kingdom, Japan, and Australia. With the Federal Reserve tolerating inflation above its 2% target, we have penciled in a more hawkish US rate hike profile of one rate increase every quarter. Effectively, we now see three hikes instead of two for the rest of 2018, followed by another four increases instead of two in 2019. The US dollar's appreciation has gained traction now that the US Treasury (UST) 10-year yield is setting its sights higher after breaching 3%.

Figure 1: USD recovery is underpinned by a hawkish Fed outlook



Source: Bloomberg, DBS

The outlook for the euro has moderated with the Eurozone economy. The euro fell below its psychological 1.20 level in May – when consensus could no longer ignore the weak European Union (EU) data flow, and had to downgrade its 2018 Eurozone growth outlook. The slowdown was affirmed by a deceleration in Germany's gross domestic product (GDP) growth to 2.3% y/y in 1Q18 from 2.9% in 4Q17. The euro is set trade in a lower 1.15-1.20 range, as speculators reduce their record long euro positions put on during last year's decade-high growth. Pushing the euro below 1.15 will require further growth disappointments, which will roll back monetary policy normalisation expectations at the European Central Bank (ECB).

Emerging Market jitters returned in May

A reality check has forced the British pound into a lower 1.30-1.40 range. The pound's surge to 1.44 from 1.38 in March-April was driven by strong expectations for a Bank of England (BOE) rate hike in May, and possibly another in November. Unfortunately, the UK's growth and inflation faltered, and reduced odds for a hike this year. This, coupled with a sharply weaker euro, pushed the pound below 1.35 in May.

AUD has lost its appeal as a carry trade

Carry trades have lost their appeal on a more hawkish Fed outlook. The Fed hike on 21 March took the US policy rate above its counterparts in Australia, South Korea, and Thailand. The greenback is expected to widen its rate differential against these currencies that belong to central banks with no desire to join the Fed in normalising monetary policy this year. The Australian dollar has moved into in a lower 0.70-0.75 trading range against the US dollar. The Thai baht is set to join the Korean won and other Asian currencies in returning this year's appreciation.

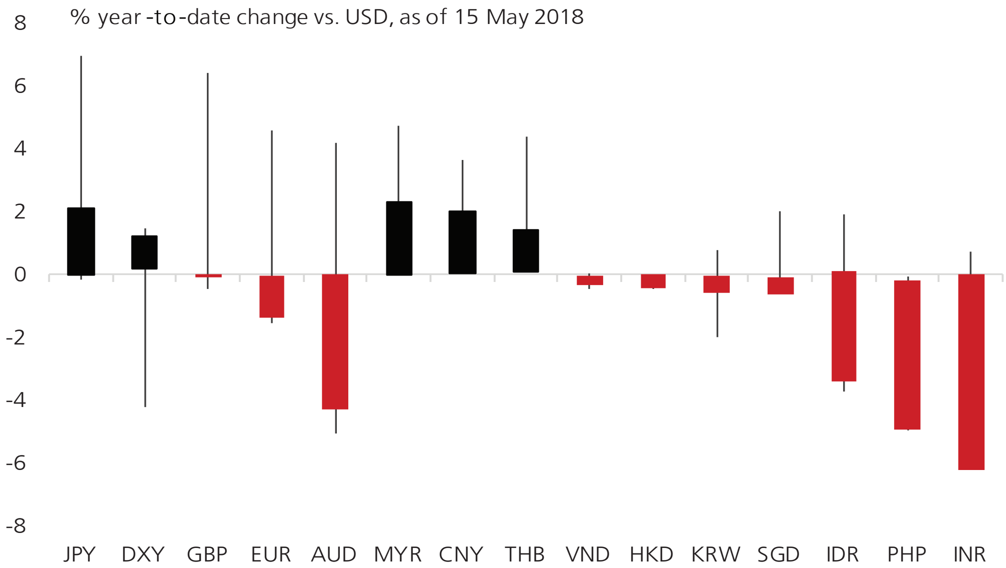
The Japanese yen is no longer considered an attractive funding currency. Speculators have unwound their large short yen positions, due to the currency occasionally reprising its safe-haven role from increased market volatility. Ironically, this has allowed the yen to focus on the widening US-Japan rate differentials and depreciate back into its 110-115 range.

Emerging Asia on guard against complacency

Asian currencies depreciate on rising US rates and higher oil prices

A more hawkish US rate-hike outlook and higher oil prices have led most Asia ex-Japan (AxJ) currencies to depreciate for the year. The US dollar's global resurgence was best reflected by the Singapore dollar giving up this year's appreciation less than a month after it returned (on 13 April) to a mild appreciation stance for its exchange-rate policy. Even the stronger currencies – such as the Chinese yuan, the Malaysian ringgit, and the Thai baht – have returned more than half of this year's gains. Not surprisingly, the three weakest currencies – the Indian rupee, the Philippine peso, and the Indonesian rupiah – have wider twin current account and fiscal deficits.

Figure 2: More currencies have given back their gains in 2018



Source: Bloomberg, DBS

Led by Argentina and Turkey, Emerging-market jitters have returned in May. As of mid-May, the Argentina peso and Turkish lira have depreciated 22.6% year-to-date (YTD) and 14.4%, respectively, to all-time lows. **While Asia is fundamentally stronger, these countries have some lessons for the region's currencies.** Both Argentina and Turkey suffer from double-digit inflation and current account deficits of more than 5% of GDP. Raising interest rates have not helped to stabilise their currencies. Argentina eventually decided on 8 May to seek a standby facility with the International Monetary Fund (IMF). Turkey's banking sector is under negative watch, with its central bank at risk of losing its credibility and independence after the election scheduled for 24 June.

Rupee to weaken further to 70

With higher oil prices widening its current account deficit and lifting inflation amid rising US rates, **India will find it challenging to defend its rupee and prevent Indian bond yields from rising at the same time.** The rupee's vulnerability to higher oil prices was evident in May, when it swiftly fell past 67 and 68 after US President Donald Trump withdrew America from the Iran nuclear deal and led West Texas Intermediate (WTI) crude oil prices above USD70.00 per barrel. In doing so, the rupee overtook the Philippine peso as the worst-performing currency in Asia. **Hence, we have downgraded our forecast for the rupee, which we now see depreciating to 70 in 2019.**

Rupiah depreciated past 14,000

The Indonesian rupiah first depreciated past 14,000 on 7 May, the day Indonesia missed its 1Q18 GDP growth target. Moody's warned that Indonesia's exchange rate and interest rate weaknesses could be credit negative. This notice came less than one month after Moody's upgraded (on 13 April) Indonesia's sovereign debt rating by a notch to Ba2. Indonesia will probably need to consider the experiences of the Philippines, Argentina, and Turkey in deciding whether to raise rates to stabilise its exchange rate.

Peso weaker on higher inflation

In the Philippines, the first hike in four years (on 10 May) did not prevent the peso from falling to a new year's low past 52. Consumer Price Index (CPI) inflation rose to a five-year high of 4.5% y/y in April, above its official 2-4% target. The central bank lifted its 2018 inflation forecast to 4.6% from its previous estimate of 3.9%, which suggested that inflation could average at a higher 4.9% for the remaining months of the year.

Asian currencies to return some of 2017's gains

Overall, the factors that led Asian currencies stronger throughout 2017 have weakened substantially. US monetary policy normalisation has become tighter-than-expected with the UST 10-year yield pushing higher above 3%. Geopolitical risks have heightened in the Middle East, and with these, the risk of an oil-price shock. Last year's strong cyclical rebound is unlikely to be repeated with downside risks from US-China trade tensions. Moreover, even with the historic 12 June US-North Korea summit in Singapore – where both countries' leaders pledged to work toward "a lasting and stable peace" – there remains plenty of uncertainty going forward. There is no guarantee that North Korea will denuclearise completely.

Table 1: DBS currency forecasts

Exchange rates, eop								
	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
China	6.28	6.40	6.50	6.60	6.55	6.50	6.45	6.40
Hong Kong	7.85	7.84	7.83	7.82	7.82	7.81	7.81	7.80
India	65.2	68.5	69.0	69.5	70.0	70.5	71.0	71.5
Indonesia	13,728	14,100	14,150	14,200	14,250	14,300	14,350	14,400
Malaysia	3.86	4.00	4.10	4.20	4.18	4.15	4.13	4.10
Philippines	52.2	53.0	53.5	54.0	54.5	55.0	55.5	56.0
Singapore	1.31	1.34	1.36	1.38	1.37	1.36	1.35	1.34
South Korea	1,064	1,100	1,125	1,150	1,140	1,125	1,115	1,100
Thailand	31.2	32.2	32.9	33.6	33.3	33.0	32.7	32.4
Vietnam	22,775	22,836	22,903	22,970	23,022	23,074	23,246	23,177
Australia	0.77	0.75	0.74	0.73	0.74	0.74	0.75	0.75
Eurozone	1.23	1.18	1.17	1.16	1.17	1.18	1.19	1.20
Japan	106	111	113	115	114	113	112	111
United Kingdom	1.40	1.34	1.33	1.32	1.33	1.34	1.35	1.36

Australia, Eurozone, and United Kingdom are direct quotes.

Source: DBS

Alternatives - Gold | 3Q18

Dollar, rates to cap gold

Source: AFP Photo

Alternatives: Gold

Eun Young Lee
Analyst

USD strength and rising rates to keep gold soft

From a strong 1Q18 to a weak 2Q, influenced by USD's movement. There tends to be a negative correlation between gold and the US dollar. Indeed, gold gained strongly from November 2017 onward following the depreciation of the dollar, and lost steam in 2Q18 as the greenback appreciated.

Mixed environment surrounding gold. Rising real interest rates are also a negative for gold. Despite the recent nominal interest-rate hikes in the US, real interest rates have not yet increased as much, as inflation has been rising as well. At the same time, growing uncertainties in the political landscape and financial-market volatility may stimulate appetite for gold. The sustained inflow to gold-backed exchange-traded funds (ETF) could be partially driven by risk-aversion, in our view. From January to April 2018, net inflow to these ETFs amounted to USD4.2b, up 4.2% y/y.

Expectations for a modest rise in 3Q18. Our bullish house view on the US dollar and interest rates fend off a bullish call for gold. However, gold may gain momentum backed by sustained growth in physical demand for gold, which is expected to increase by 2.3%, and a rebound in bar-and-coin demand after registering negative growth of -2.8% in 2017. Also, central banks will continue to be buyers of gold, in line with past behaviour. Our forecast for gold's price in 3Q18 is at USD1,325 per ounce, which will trend down to USD1,310 per ounce toward the end of the year. This is in line with our economists' forecasts for the US dollar to strengthen at an accelerated pace, and with rising interest rates.

Table 1: DBS gold price forecasts

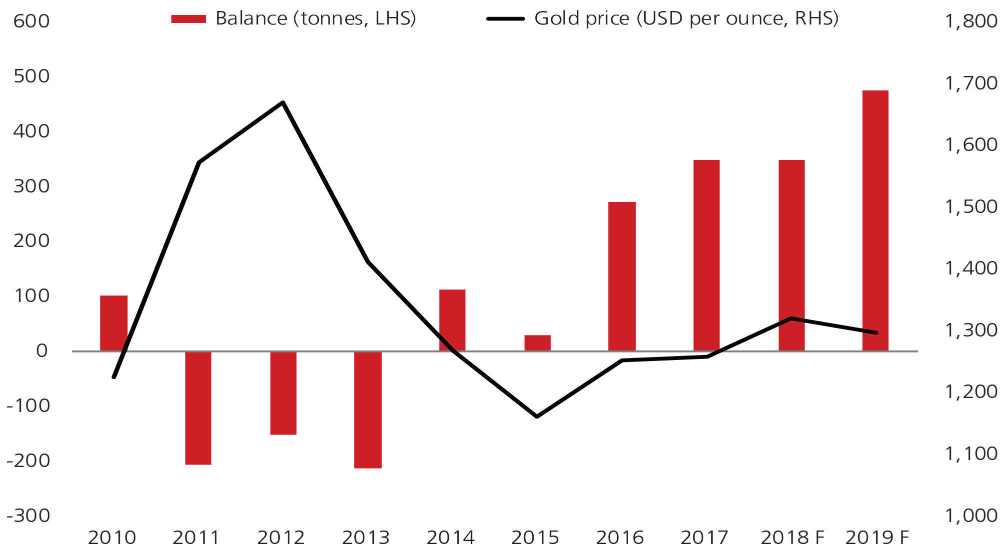
(USD per ounce)	1Q18	2Q18F	3Q 18F	4Q18F	1Q19F	2Q19F	3Q19F	4Q19F
LBMA Gold Price (average)	1,325	1,310	1,325	1,310	1,300	1,290	1,290	1,300
y/y (%)	9.0%	4.3%	3.7%	2.7%	-2.2%	-1.5%	-2.6%	-0.8%
q/q (%)	4.2%	-1.5%	1.1%	-1.1%	-0.8%	-0.8%	0.0%	0.8%

Source: Bloomberg, DBS, World Gold Council

We are neutral to bearish for gold in the longer term

Surplus in gold market to extend into 2019. We are neutral to bearish for gold over the medium to long term, attributable to: i) High interest rates, at levels not seen in the last ten years, eventually lifting the opportunity cost of holding gold; and ii) Swelling surplus in the gold market despite our projection of a supply decline. We expect physical gold demand to rise by 3.9% in 2019 from 2.3% in 2018, as the negative impact from increasing goods and service tax (GST) in India (the second-largest gold market in the world) normalises. Gold supply is projected to grow 2.4% in response to higher gold prices in 2018, but to decline 1.1% in 2019 due to less supply from recycling. We do not expect any drastic deterioration in the supply-demand balance of gold as the secondary supply will opt to react instantly on price volatility, and stricter environmental regulation for smelters in China should limit supply growth. All in all, gold prices in 2019 are projected to be below those in 2018.

Figure 2: Global gold supply-demand and price forecast



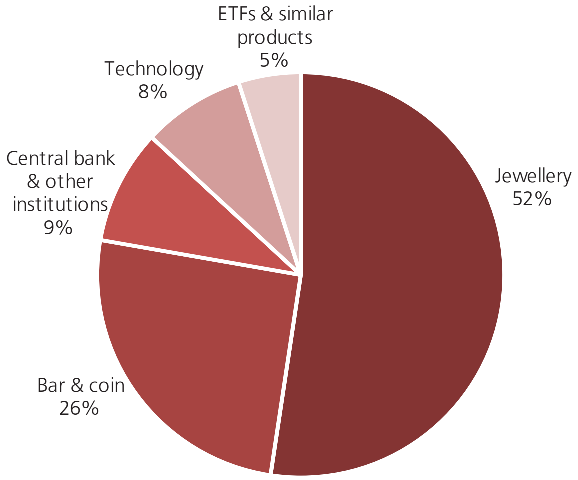
Source: Bloomberg, DBS, World Gold Council

Physical gold consumption to continue expanding, underpinned by global economic growth

Stable growth ahead for jewellery and industrial uses. Physical demand for gold, accounting for 60.5% of total gold demand, constitutes industrial uses and jewellery. Jewellery made up 52% share of global gold demand in 2017. Meanwhile, investment demand comprises bar-and-coin demand as well as ETFs and similar products, which accounted for 26% and 5% of total demand, respectively.

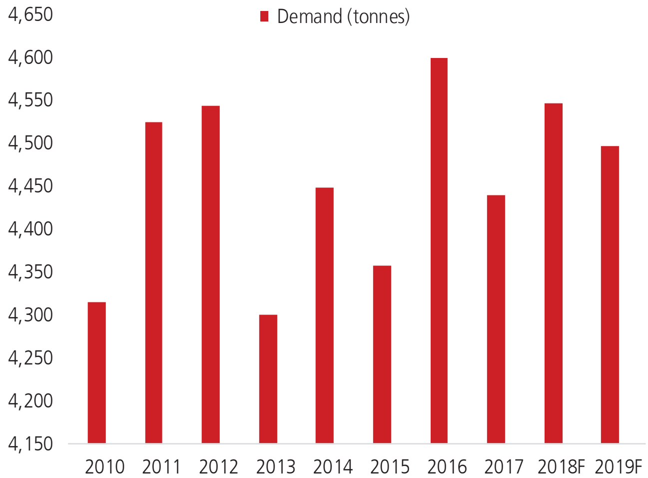
Physical gold demand expanded 6.6% y/y to 2,476 tonnes in 2017 – the first year of growth since 2013 – backed by an improving economic environment. Economic growth supports gold consumption, as demand for jewellery and gold-containing technology (such as smartphones and tablets) rise along with higher income. On the back of resilient economic growth forecasts around the world, we expect the physical demand for gold to remain on a steady uptrend, growing by 2.3% in 2018 and 3.9% in 2019.

Figure 3: Gold demand breakdown (2017)



Source: DBS, World Gold Council

Figure 4: Gold demand trend and forecast

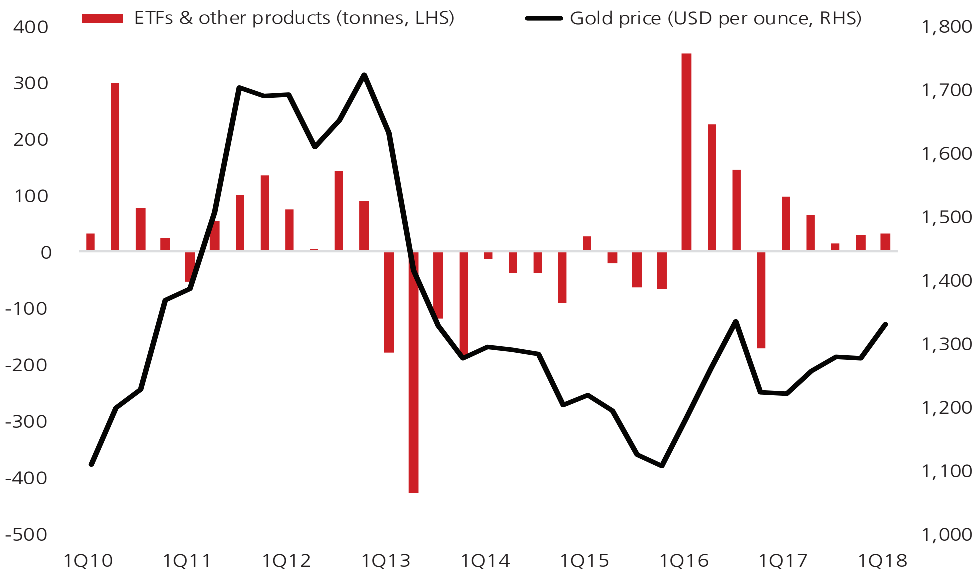


Source: DBS, World Gold Council

We estimate net inflow to gold ETFs in 2018, and net outflow in 2019

ETF flows: A wild card for gold prices. Historically, fund flows to ETFs have also influenced gold prices. We estimate net inflow to ETFs in 2018 and net outflow in 2019 to be in line with gold's fundamental changes.

Figure 5: Gold demand for ETFs and other products vs. gold's price



Source: Bloomberg, DBS, World Gold Council

Investment Theme | 3Q18

Asian Tourism

Source: AFP Photo

Investment Theme I: Asian Tourism

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Strategist

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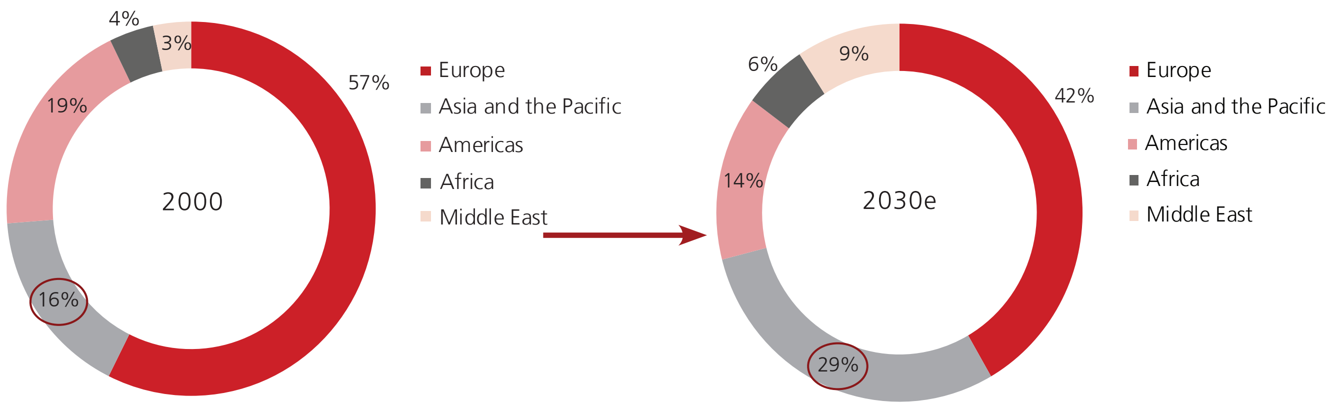
Analyst

Tourism in Asia is on a firm, long-term growth trend, driven by escalating income levels in China, India, and Southeast Asia. The Chinese are already the world's largest outbound travelers in absolute numbers, even though less than one in 10 Chinese citizens hold a passport today. The combined 2b population of India and Southeast Asia, as well as rising consumption spending, are also directly benefitting the Asian tourism sector.

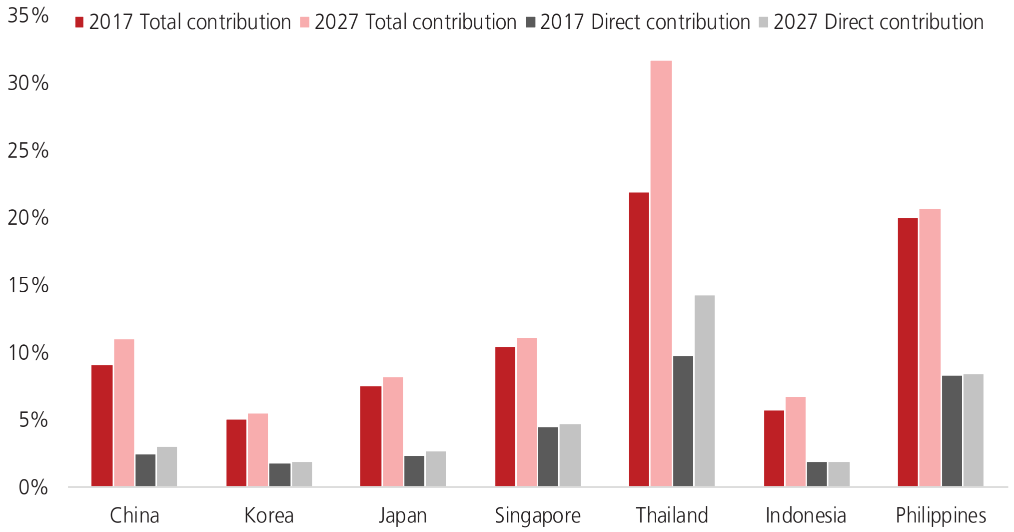
Tourism in Asia to continue robust growth. The number of Asia Pacific visitor arrivals rose to 308.4m in 2016 from 110.3m in 2000, representing a 6.5% compound annual growth rate (CAGR), compared to the 3.9% world average. Indeed, Asia Pacific was the fastest-growing region in the world over this period. Asia Pacific's share of tourist arrivals also rose to 25% in 2016, from 16% in 2000. This growth trend is expected to continue, with the number of visitor arrivals in the region expected to grow to 577.4m by 2030, taking a 29% share globally. (Figure 1). In fact, tourism will play an increasingly pivotal role in many major Asian economies over the next decade. According to the World Travel and Tourism Council (WTTC), tourism is projected to contribute 10.7% total contribution to Asia Pacific's gross domestic product (GDP) by 2027. For China – the second-largest economy in the world – tourism is expected to contribute over 10% of gross domestic product (GDP) by 2027. In Thailand, tourism is projected to make up more than 30% of GDP by then (Figure 2).

Figure 1: International visitor arrivals by region (2000 - 2030e)



Source: UNWTO, DBS

Figure 2: Tourism a key driver of Asian GDP over the coming decade



Source: World Data Atlas, WTTC, DBS

Chinese tourists projected to make up 40% of Asia Pacific travel market

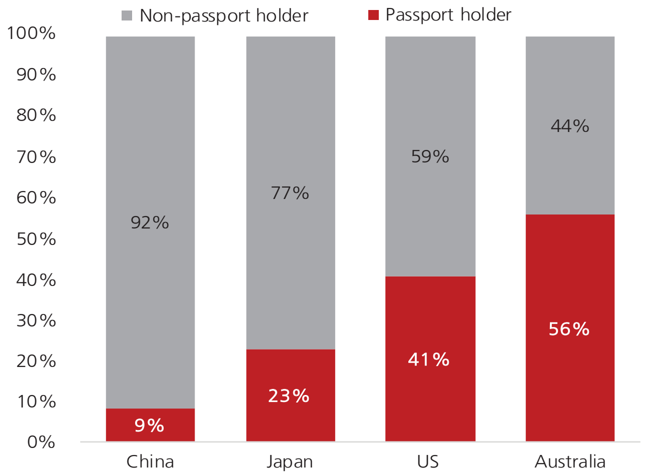
Explosive growth in Chinese outbound travel driving tourism in Asia. In 2017, Chinese tourists accounted for c.36% of total arrivals in Asia Pacific. For the past several years, c.80% of tourist arrivals to Asia Pacific came from intra-Asia – of which nearly half were Chinese tourists. The Pacific Asia Tourism Association (PATA) projects that Chinese tourists will form c.40% of the market in Asia Pacific, and remain the driver of Asia tourism growth over the next few years. Indeed, the number of Chinese tourists travelling outbound has grown to 130.5m in 2017 from 98.2m in 2013 – becoming the world's largest outbound source market. Yet, less than one in 10 Chinese citizens own a passport. Imagine the sheer potential for growth as passport penetration catches up with Japan or even the US (Figure 3). Indeed, PATA predicts that about 60m Chinese tourists will travel to Asia Pacific (ex-Hong Kong, Taiwan, and Macau) in 2020, a 24.3% growth from 2017 levels.

What will continue to drive the growth of Chinese outbound tourists?

By 2030, China's upper middle class to make up 35% of population (from 10% today)

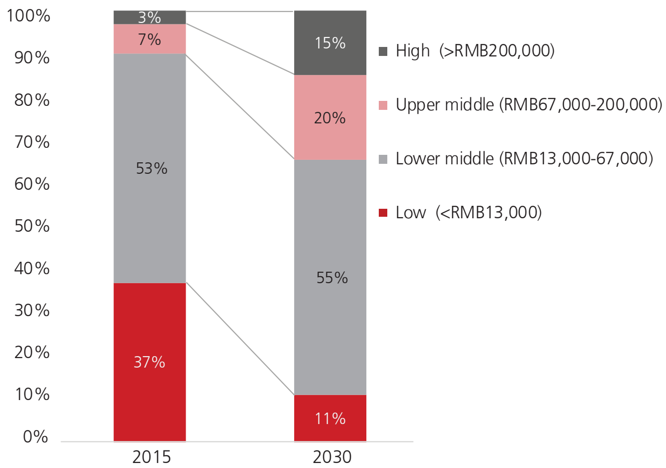
1) Rising Chinese middle class. China has seen tremendous improvements in economic prosperity over the past few decades. Its gross national income (GNI) per capita has risen to USD8,250 in 2016, from just USD940 in 1990 – a ninefold increase or 8.7% CAGR over the period. By the World Bank's definition, China is now an upper-middle income economy. It is expected to overtake the US by 2030, in terms of aggregate GDP. Today, only about 10% of the Chinese population has an annual disposable income in excess of USD10,000. By 2030, this high- to upper-middle-class bracket in China (as forecasted by the Economist Intelligence Unit) is poised to grow to 35% of the population (Figure 4).

Figure 3: Less than one in 10 Chinese citizens own a passport



Source: eyefortravel, US Travel Association, Forbes, Ministry of Foreign Affairs (Japan), Australian government, DBS, as of 2016

Figure 4: China's rising middle class



Source: Economist Intelligence Unit, DBS

Further visa relaxation to come on board

2) Further visa relaxation for Chinese tourists. Complex, lengthy, and costly visa application processes for Chinese tourists have been a major hindrance in promoting overseas travel. In recent years, however, positive steps have been taken by Asian countries to relax visa restrictions and application processes for Chinese tourists. By 2017, a total of 20 Asian countries had implemented visa-on-arrival policies for Chinese travelers, including Indonesia, Laos, Myanmar, Thailand, Brunei, Vietnam, and Cambodia, with two visa-free regions – Bali and Jeju Island. Japan and Nepal also relaxed their visa requirements in 2015 and 2016, respectively. Expect to see more Asian countries – like India and the Philippines – relax visa requirements to entice more Chinese tourists. Establishing more visa offices in lower-tier cities could also help attract more outbound travel. For example, Thailand has opened six visa offices in Tier-2 cities including Xiamen, Xi'An, and Qingdao (Figure 5).

Technology has increased the ease of trans-border consumption, driving Chinese spending overseas

3) Technological advancements have enabled further outbound travel and consumption. As of 2016, China's Internet penetration rate was close to 53%. This moderately high level of penetration has helped Chinese outbound travel; 72% of Chinese tourists planned their trips online through travel websites and social media in 2017, according to China Luxury Advisors/Fung Global Retail & Technology. Besides, the rapid development and adoption of Chinese online payment apps overseas – including Alipay and WeChat Pay – have increased the ease of trans-border consumption, driving Chinese tourists to spend abroad (Figure 6).

China looks to build more airports to cater to Chinese travellers' burgeoning demand

4) Infrastructure improvements to keep pace with increasing outbound tourism. With China's busiest airports already operating near or over their designated capacity, there are plans in place to build more airports, mostly in lower-tier cities, to cope with this surging demand. By 2020, the Chinese government plans to have 260 airports, up from 218 airports in 2016. Further, many of these existing top airports are undergoing expansion via the building of more terminals and runways. We believe massive airport construction plans in lower-tier cities and the expansion plans of top airports will directly support the Chinese outbound tourism uptrend.

Figure 5: Visa policies of Asian countries for Chinese tourists (2017)

Asia	Time released	Country/region
Visa-free	2015	Indonesia
	2008	Jeju Island (Korea)
Visa-on-arrival/ETA	2016	Azerbaijan
	2012	Bahrain
	2009	Timor-Leste
	2005	Indonesia
	2017	Qatar
	2014	Laos
	2010	Lebanon
	2007	Maldives
	2012	Myanmar
	2016	Nepal
	2012	Sri Lanka
	2014	Thailand
	-	Turkmenistan
	2016	Brunei
	2005	Iran
	2017	Armenia
	2012	Jordan
	2014	Vietnam
	2014	Cambodia
	2014	Bangladesh
Relaxation of Visa requirement	2015	Japan
	2016	Nepal

Source: Chinese government, DBS

Luxury goods demand to see uplift from booming Chinese outbound tourism

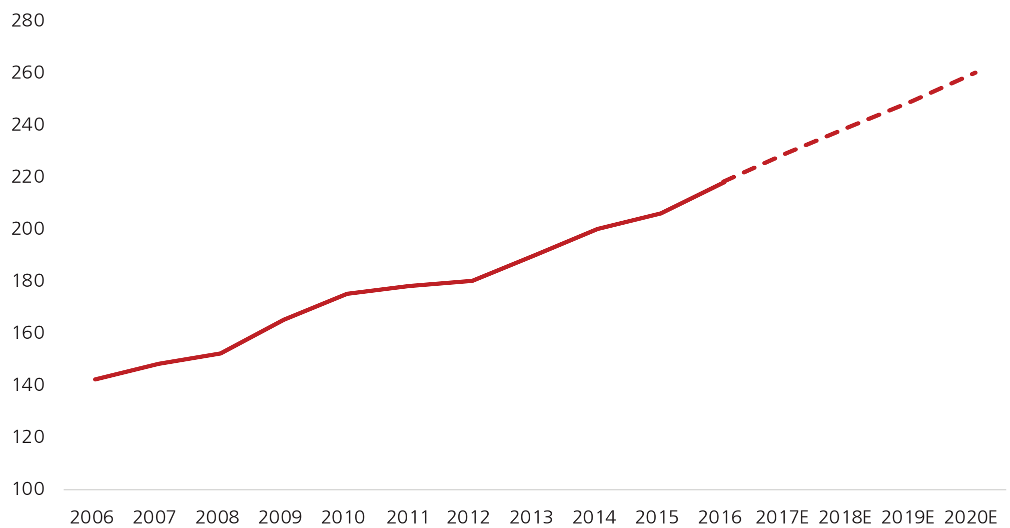
Strong Chinese outbound travel a boon for luxury goods. According to a report by McKinsey in 2017, Chinese spending on luxury goods jumped to RMB537.3b in 2016 from RMB151.6b in 2008. Indeed, spending contribution by the Chinese on luxury products globally tripled to 32% within six years; this is projected to climb to 44% by 2025. This Chinese spending on luxury goods is mostly conducted overseas, due to the relatively cheaper price and perceived better quality compared to its domestic markets. In fact, 76% of luxury goods expenditure was made overseas in 2016. This was likely helped by the rapid growth of outbound travel from lower tier cities in China (where the range and availability of luxury goods are more limited).

Figure 6: Major apps used by Chinese tourists

Planning and booking	Payment	Translation
Ctrip 携程	UnionPay 银联	有道 youdao
途牛 tuniu.com	支付宝 ALIPAY	Bai du 翻译
同程旅游	微信支付	科大讯飞 IFLYTEK

Source: DBS

Figure 7: Number of civil airports in China (2006 – 2020e)

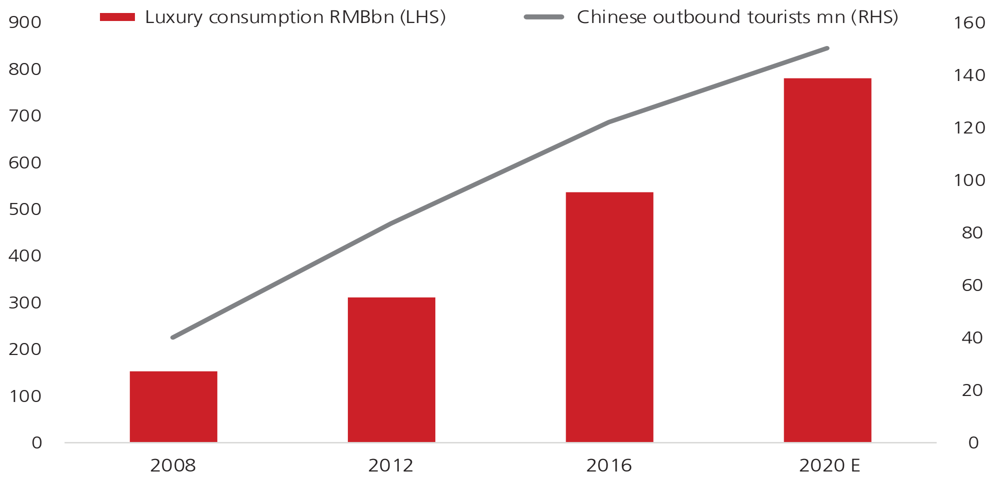


Source: Wind, China's 13th Five-year Plan, DBS

India and SEA offer tremendous potential for the Asian tourism trend

India and Southeast Asia's potential cannot be ignored. As the world's second-most populous country, India has huge potential for outbound tourism. The number of outbound tourists from India has grown at a CAGR of 9.7% from 3.5m in 1996 to 21.9m in 2016. This is estimated to grow at 10% CAGR from 2017-2022, to reach 38.7m. For Indian travelers, the US, Singapore, and Thailand are the most attractive destinations. By the same token, the Association of Southeast Asian Nations (ASEAN), with its aggregate population of 640m, has tremendous potential in driving Asian tourism. With a rapidly-growing middle class and the proliferation of low-cost carriers such as AirAsia, Scoot, and Vietjet, outbound travel is firmly on an uptrend.

Figure 8: Chinese outbound tourism a boon for luxury goods

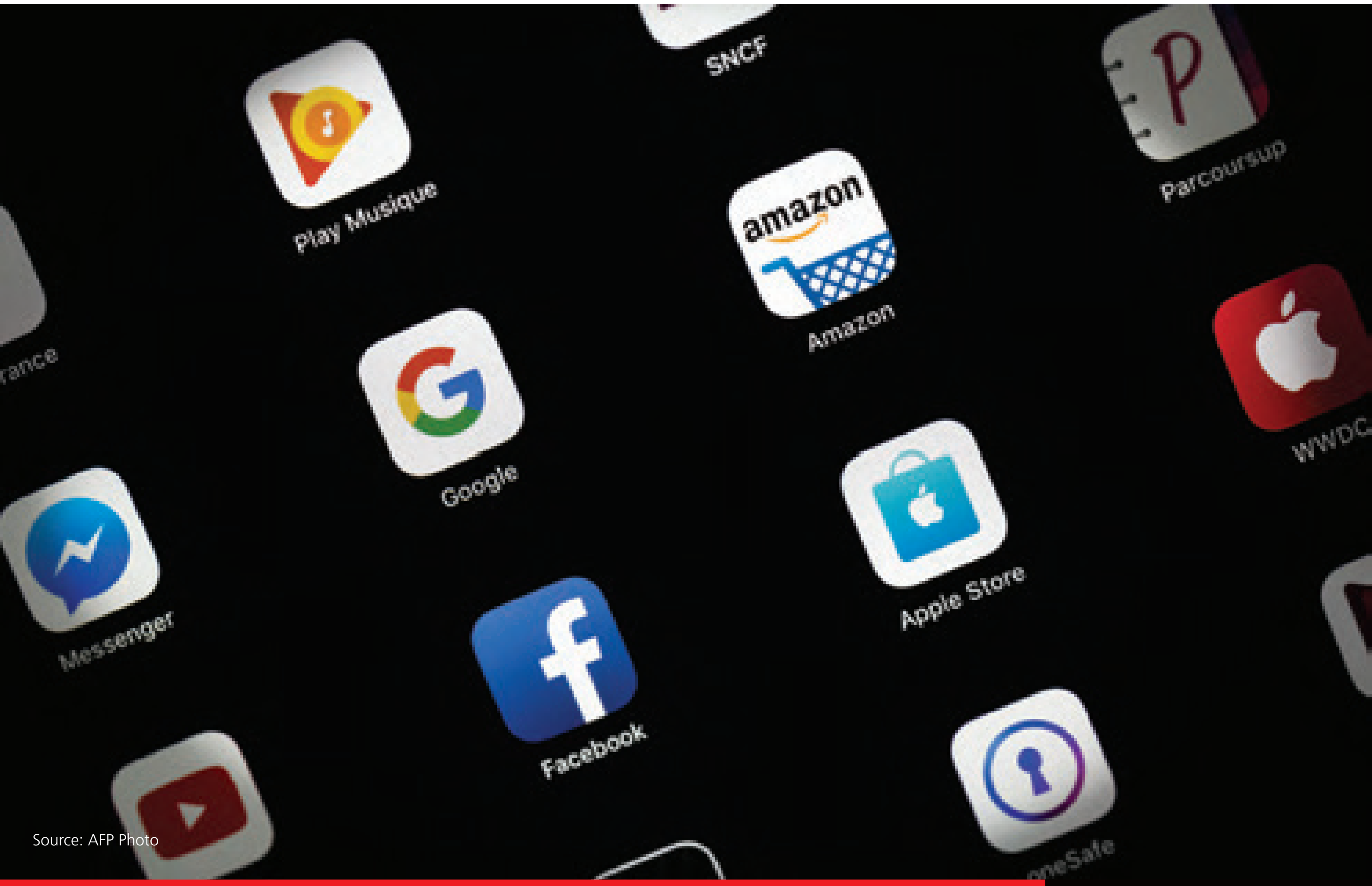


Source: McKinsey, CEIC, PATA

Riding the Asian tourist boom. Rising Asian tourism is a long-term secular trend, especially given the low percentage of passport-holding Chinese today, as well as the rising middle class across China, India, and ASEAN. Beneficiaries of this Asian tourism uptrend include regional airports, hospitality, gaming, and luxury sectors.

Investment Theme | 3Q18

Structural Winners



Source: AFP Photo

Investment Theme II: Structural Winners

Subhra Chatterjee
Equities

Dylan Cheang
Strategist

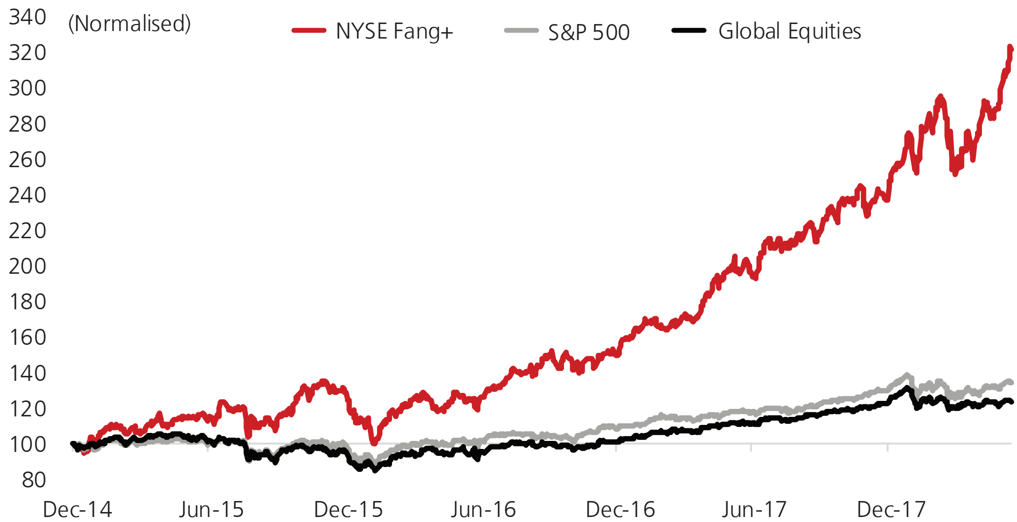
Technological changes leading to structural shifts

Thanks to sweeping advancements in technology, whole industries are facing massive structural shifts and having their business models disrupted. The rapid proliferation of e-Commerce, robotics, and the 'Internet of Things' has created huge challenges for incumbents in traditional brick-and-mortar industries. The emergence of blockchain, for instance, will encroach on the role of the middleman in banking, finance, and retail. Even so, while technological innovation leads to disruption, it also creates new growth opportunities: both for the disruptors, as well as for nimble companies that ride the structural shifts. These companies will emerge as structural winners.

From a financial markets perspective, investors are already rewarding companies that are deemed structural winners in the new economy. One needs to look no further than the robust outperformance of the NYSE FANG+ Index, which comprises high-growth stocks in the Technology sector. Since 2015, the index has outperformed the S&P 500 Index by ~187 percentage points and global equities by ~198 percentage points. The outlook of these companies continues to be upbeat, with earnings growth expectations at 9.8% y/y in 1Q19 and 25% y/y in 1Q20 – driven by both top-line growth and margin expansion.

In this thematic report, we zero in on the key drivers of this disruptive wave and highlight how investors can take advantage of it.

Figure 1: Disruption is here – Strong outperformance of the NYSE FANG+ Index



Source: Bloomberg, DBS

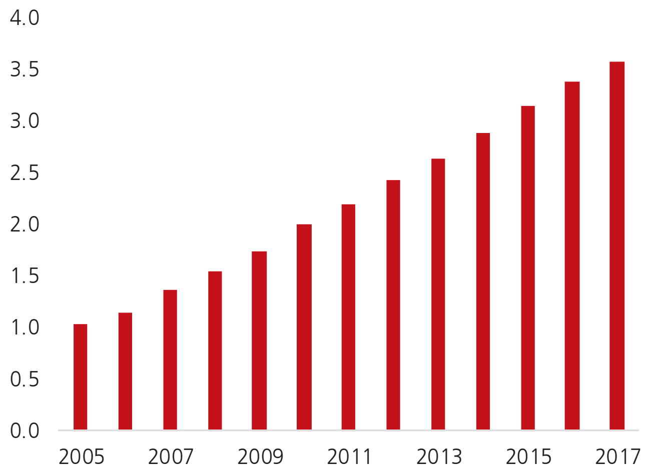
Roughly half of the global population are Internet users

The Internet – A major force of disruption. Growing worldwide Internet adoption (Figures 2 and 3) is changing the way we as a society live, work, shop, travel, access information, and even interact with one another. Globally there are an estimated 3.6b Internet users (or roughly 50% of the world's population). This, in our view, presents great opportunities for Internet companies. The Internet has been one of the biggest disruptive forces in technology and not surprisingly, Internet companies are the key beneficiaries of this trend.

While there are numerous industries undergoing structural shifts as result of the Internet, we focus on the three sectors that are undergoing the greatest disruption:

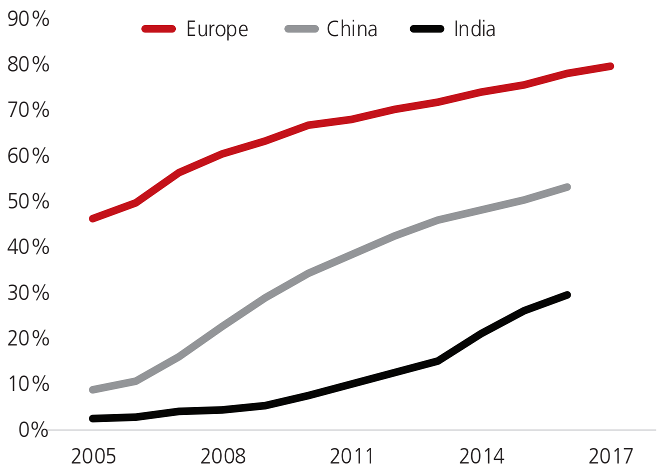
- Retail
- Advertising
- Payments

Figure 2: Number of internet users - globally (b)



Source: Bloomberg, DBS

Figure 3: Percentage of population with internet access



Source: Bloomberg, DBS

Monetisation of the Internet. There are three different verticals of the Internet, namely: Search, Social Media and e-Commerce. There are two primary methods of monetisation used by internet companies: advertising-led and non-advertising/retail-led.

- Advertising-led: Search and social media-based internet companies primarily use the advertising-led monetisation model, where user data is collected and analysed, and user profiles are then matched to potential advertisers at a fee.
- Non-advertising/Retail-led: e-Commerce-based internet companies have multiple ways of monetisation – sales of goods and/or services, payments, logistics, Cloud, and advertising – but they predominately rely on a non-advertising led business model.

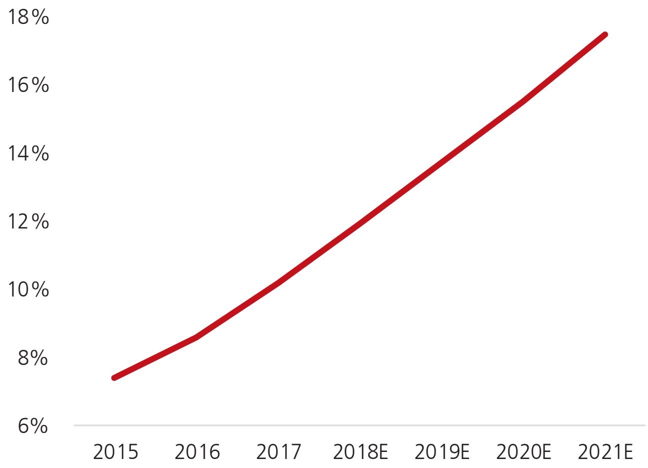
Disrupting retail – From offline to online

The retail sector presents sizeable opportunities for Internet companies

Global gross domestic product (GDP) is estimated at around USD76t, while retail sales are estimated at USD23t. Retail is an obvious focus for internet companies, representing a sizeable market opportunity that accounts for roughly a third of global GDP.

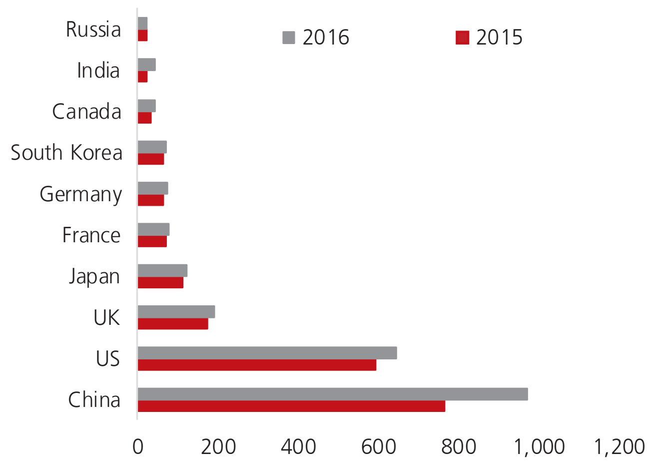
Today, online retail makes up around 10% of global retail sales, and that number is expected to rise to more than 17% in five years' time (Figure 3). China and the US are the largest business-to-consumer (B2C) e-Commerce markets globally (Figure 4). In fact, when combined, the two countries' e-Commerce markets are larger than that of the rest of the world put together. Currently, an estimated 19% of retail sales in China are already online; as internet penetration grows, this number keeps rising.

Figure 4: e-Commerce share of total global retail sales



Source: eMarketer; statista.com

Figure 5: B2C e-Commerce market size (USDb)



Source: ecommerce-europe.eu; statista.com

Robust outlook for e-Commerce companies with sizeable scale in US and China

Structural winners surfacing in e-Commerce. As more retail spending moves online, more challenges will arise for a number of incumbent players in retail – from shopping mall operators and retail stores, to branding agencies. However, large-scale internet companies focusing on e-commerce, particularly in the US and China, will end up as structural winners in retail.

To highlight this point, we took the top three e-Commerce retailers in the US and/or China and seven of the largest brick-and-mortar retailers in the markets. We aggregated their sales, indexed at 100 in 2010, and applied their average growth rates over the last seven years to see how the online retailers have fared vs. their brick-and-mortar competitors. Figure 6 clearly highlights the magnitude of the growth differential, with e-Commerce players growing almost ten times faster over the last seven years vs. the brick-and-mortar retailers.

This trend is likely to continue.

Disrupting advertising – Ads in the digital age

Consumers increasingly spend more time on phones and mobile devices

Over the last decade, the rise of mobile devices and growing Internet penetration has changed the way people consume content. Consumers are increasingly spending more time on their phones and other mobile devices. This shift in consumer behavior is evident in how advertisers allocate their advertising budget.

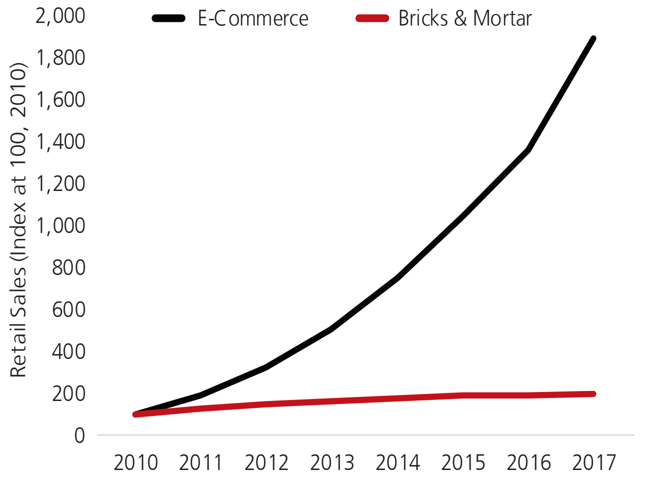
Major disruption underway in the advertising market

The global advertising market is estimated at USD650b and is growing at 5.4% per annum. The large and growing market size, coupled with changing consumer behavior, has made the advertisement market an obvious target for internet companies to disrupt – and in particular, search and social media internet companies which predominantly rely on an advertising-based model.

Television ads have been overtaken by online ads

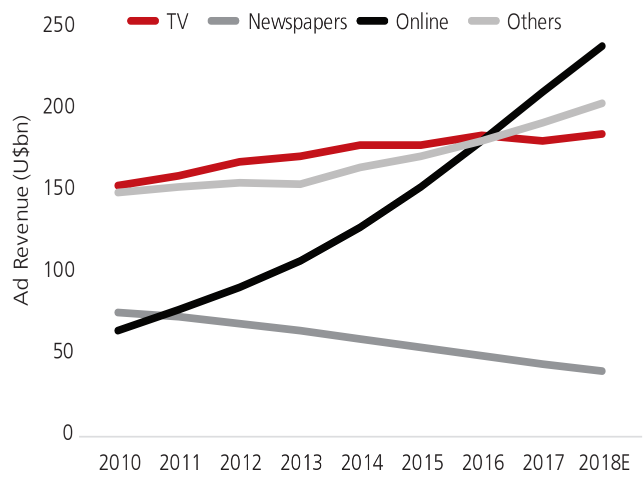
Television advertising, which (for the last two decades) has been the largest segment of the global ad market, has now been overtaken by online advertising, which now accounts for 35% of the world's advertising market (Figure 6). The online advertising has grown at a compound annual growth rate (CAGR) of 18%, which is seven-and-a-half times faster than that of television advertising, and three times faster than growth in the overall advertising market. The spending on newspaper advertising has actually declined over this period.

Figure 6: Retail Structural Winners - online vs. offline



Source: Bloomberg, DBS

Figure 7: Global advertising revenue (USDb)



Source: Bloomberg, MagnaGlobal

Table 1: Growth rate of global ad market, 2010-2018

Total Global Ad Market	5.4%
TV	2.4%
Newspaper	-7.9%
Online	18.1%
Others	4.1%

Source: Bloomberg, DBS

Positive outlook for Internet companies focusing on the ad-driven model in the "Search and Social Media" Internet verticals

Structural winners unfolding in advertising. More advertising spending moving online poses headwinds for organisations like television networks, advertising agencies, and news publishers. Internet companies focused on an advertising-driven model in the "search" and "social media" Internet verticals are likely to be the structural winners. Pricing power in the online advertising market comes from the number of users (or "eyeballs") the internet platform can attract. It is the case of "the big getting even bigger".

This also explains why the online advertising market is fairly consolidated, with the top two search and social media companies accounting for over 60% of the global online advertising market. To illustrate this point, we looked at the advertising sales of the top two global, advertising-based internet companies, and compared their advertising revenue growth trajectory with that of the overall market, as well as with the online advertising market.

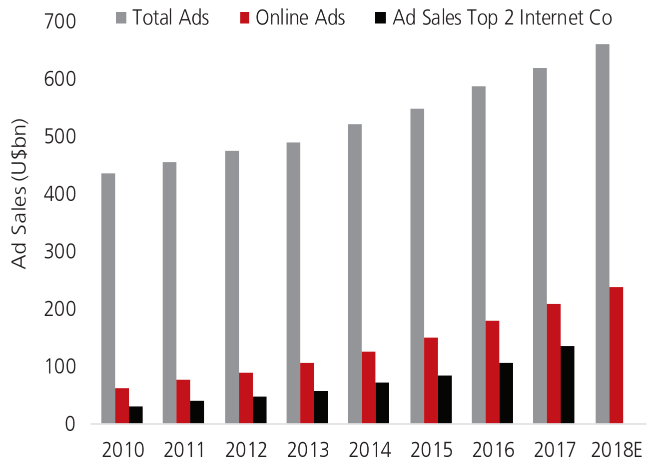
Figure 8 shows how online advertising has been increasing in market share, while the top two internet companies have kept their dominance within the online advertising space.

Disrupting payments – Going cashless

Digital transactions are on the rise

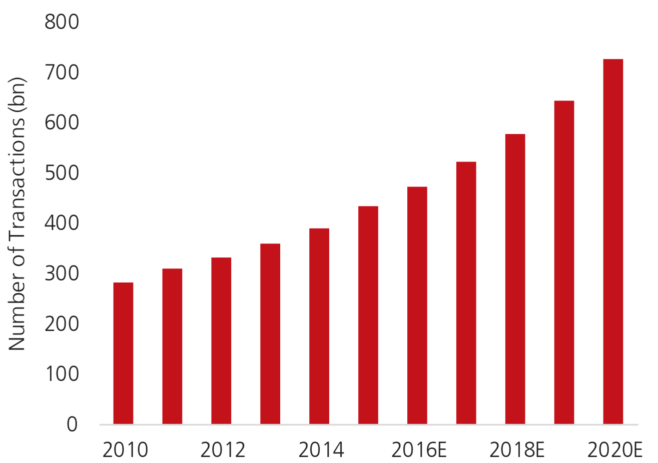
The rise in consumer spending, mobile payments, digital wallets, and e-commerce creates a powerful secular trend in the growth of digital transactions. Increasing financial inclusion is leading to a growth in the number of people with bank accounts in emerging markets like India, China, and Indonesia. This, coupled with a rise in credit or debit card penetration, is creating a powerful growth engine for non-cash transactions. Figure 9 and Figure 10 highlight the growth in non-cash transactions volume, as estimated by Capgemini.

Figure 8: Structural winners - online advertising



Source: Bloomberg, DBS

Figure 9: Volume of non-cash transactions



Source: CapGemini, DBS

Table 2: Growth non-cash transactions (CAGR 2014-2020)

Global	11%
Central Europe, Middle East, and Africa	10%
Emerging Asia	31%
Latin America	7%
Mature Asia-Pacific	8%
Europe	7%
North America	4%

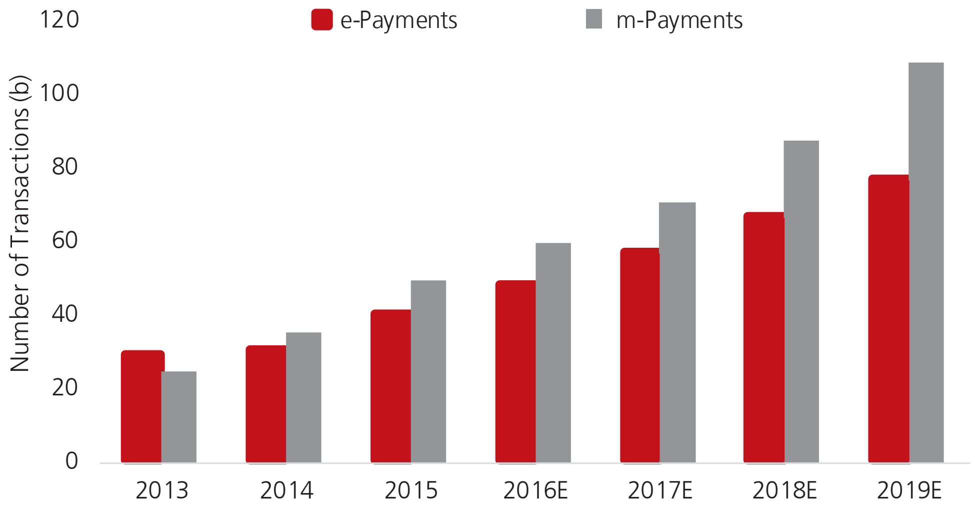
Source: Capgemini, DBS

Cash still accounts for c.30% of transactions in Developed Markets and close to 70-80% in Developing Markets

The payments sector is heating up. The growth of e-Commerce and the shared economy, aided by the rise of smartphone penetration, has created a powerful secular trend for e-payments and m-payments (mobile payments). e-Payments are growing at 17% CAGR, while M-payments are growing at more than 20% (Figure 11). Given that cash still accounts for an estimated 30% of all transactions in Developed Markets and close to 70-80% in developing markets, the headroom for growth in electronic payments is huge.

As a result, there is widespread interest in the payments space, from companies like banks, private equity firms, payment processors, internet companies, transportation companies, mobile phone manufacturers, and even governments. The strong interest can also be seen in the increasing number of recent mergers and acquisitions (M&A) activity in the payments space.

Figure 10: Volume of non-cash transactions



Source: Capgemini, DBS

Structural winners emerging in payments. Given the huge opportunities in payments and the possibility for segmentation within this space (between traditional commerce, e-Commerce, peer-to-peer, and shared economy), there could be numerous winners. We believe there will be three main types of players emerging in payments, namely:

- Traditional payment processors which act as a tollbooth on consumer spending
- Social media/messaging platforms which target the large peer-to-peer market
- e-Commerce players than can successfully link payments to commerce

While it is too early to say who the structural winners will be, one thing is for sure – Cash will inevitably be the structural loser.

Investment Theme | 3Q18

Ageing Population

Source: AFP Photo

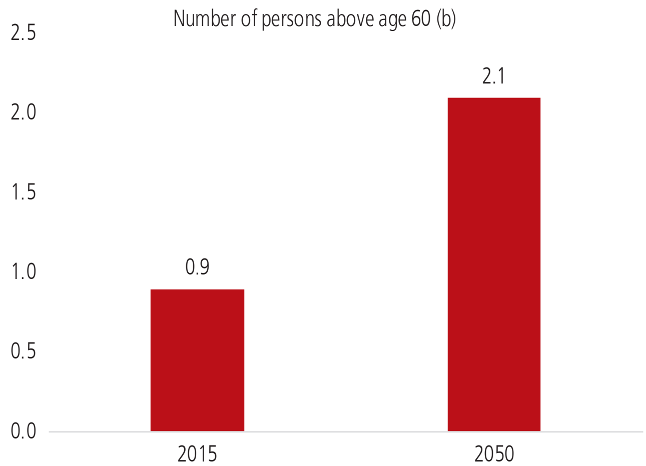
Investment Theme III: Ageing Population

Jason Low, CFA
Strategist

The global population is growing older and people are living longer. Demographics will be a key factor driving social demand patterns over the next few decades. According to the United Nations, by 2050, 21.5% of the global population will be above age 60. In fact, the number of elderly persons above 60 will more than double from 900m in 2015 to 2.1b in 2050 (Figure 1). Asia will account for the largest proportion of the world's ageing population in 2050, at 62.3%, Deloitte estimates. In China, the world's most populous nation today, almost four in 10 persons will be above 60 by 2050. Life expectancy is also expected to continue rising to 77 years by 2050, from about 72 years today. The impact of this megatrend is multi-faceted and pivotal in determining trends across sectors. As the working population shrinks in most regions, dependency ratios will rise – disrupting consumer patterns and investment flows.

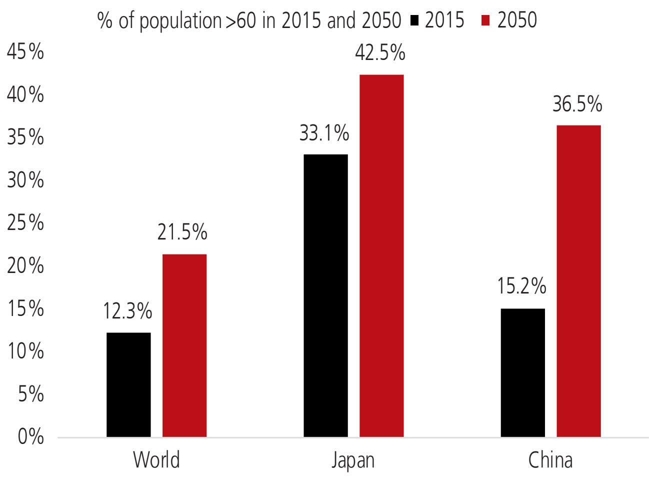
The global population is ageing. While world population growth peaked in the 1960s, people are now living longer. Global life expectancy is poised to increase to almost 77 years in 2050, compared to 71 years in 2015. As such, world population is going to increase by more than 30% to 9.7b in 2050, from 7.3b in 2015. The consequence: a rapidly ageing population. By 2050, the proportion of the global population above 60 will increase to 21.5% from just 12.3% in 2015 (Figure 2). All major regions in the world except Africa will have nearly a quarter or more of their populations aged 60 or over. In China, the world's most populous nation today, every four in 10 persons will be above age 60. In Europe, 34% of population will be above 60 by 2050. The situation is even more

Figure 1: Number of aged to more than double globally in 2050



Source: United Nations, DBS

Figure 2: Ageing global population



Source: United Nations, DBS

dire in Japan, where 42.5% of the nation will be 60 and older. Indeed, global median age is expected to rise to 36.1 years old in 2050 from 29.6 years today. A bright spot, though, is the Association of Southeast Asian Nations (ASEAN), which is projected to have a relatively young population even in 2050.

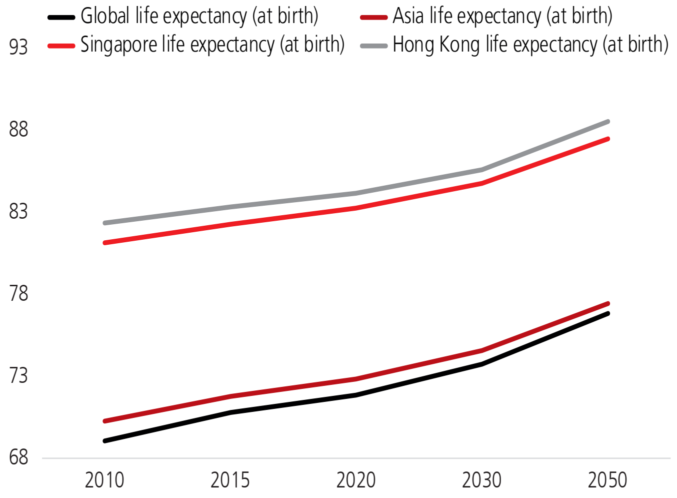
Average global life expectancy to increase to 77.5 years in 2050

People are also living much longer than before. Global life expectancy is expected to rise to nearly 77 years old by 2050, from around 71 years old in 2015. All major geographical regions in the world will see increased lifespans, with the increase most notable in Africa. This is on the back of increased accessibility and effectiveness of health care. In Asia, life expectancy is also expected to increase to 77.5 years in 2050, from just 71.8 years in 2015 (Figure 3). In Hong Kong, a child born in 2050 is expected to live till 89 years old. Closer to home in Singapore, life expectancy is also expected to hit 88 years by 2050.

The most populous countries in ASEAN will remain relatively young in 2050

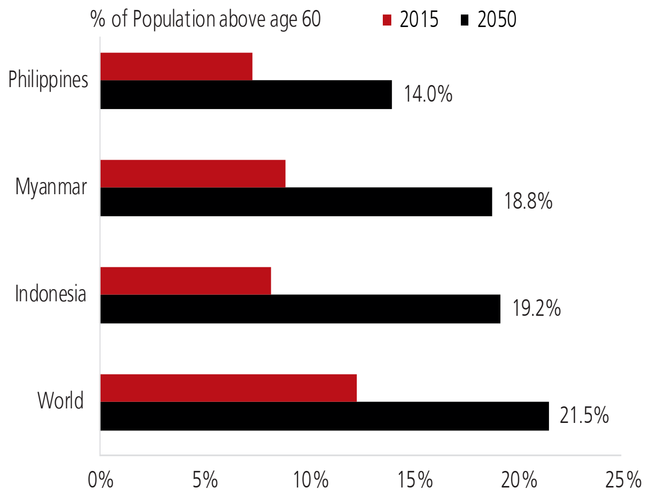
ASEAN – a bright spot. While the rest of the world is ageing, many ASEAN countries will remain relatively young in 2050. Within ASEAN's most populous nations, the working class is expected to stay relatively large in 2050. In fact, the proportion of the elderly in many of these populous ASEAN countries will still be below the world average then (Figure 4). For example, in the Philippines, the second-most populous country in ASEAN, the elderly population above 60 will only make up 14% of the population – way below the 21.5% global average. Indeed, ASEAN remains largely an attractive demographics story. The region's strengths lie in a relatively young and sizeable population, generally sound macroeconomic fundamentals, and a growing middle class. The Asian Development Bank predicts that the ASEAN middle class population will rise to 65% by 2030, from 29% in 2010. Clearly, the rise of the consumption-hungry ASEAN middle class will be a fundamental driver in the region's growth prospects over the next few decades. Indeed, consumer and investment spending are key growth drivers. Together with reforms and generally stable politics, these present opportunities. Companies with exposure to domestic ASEAN demand should reap rewards over the longer term. In the near-term, the consumer sector also stands out as one which is least affected by trade protectionism talks.

Figure 3: Increasing life expectancy across the world



Source: United Nations, DBS

Figure 4: ASEAN still relatively young in 2050

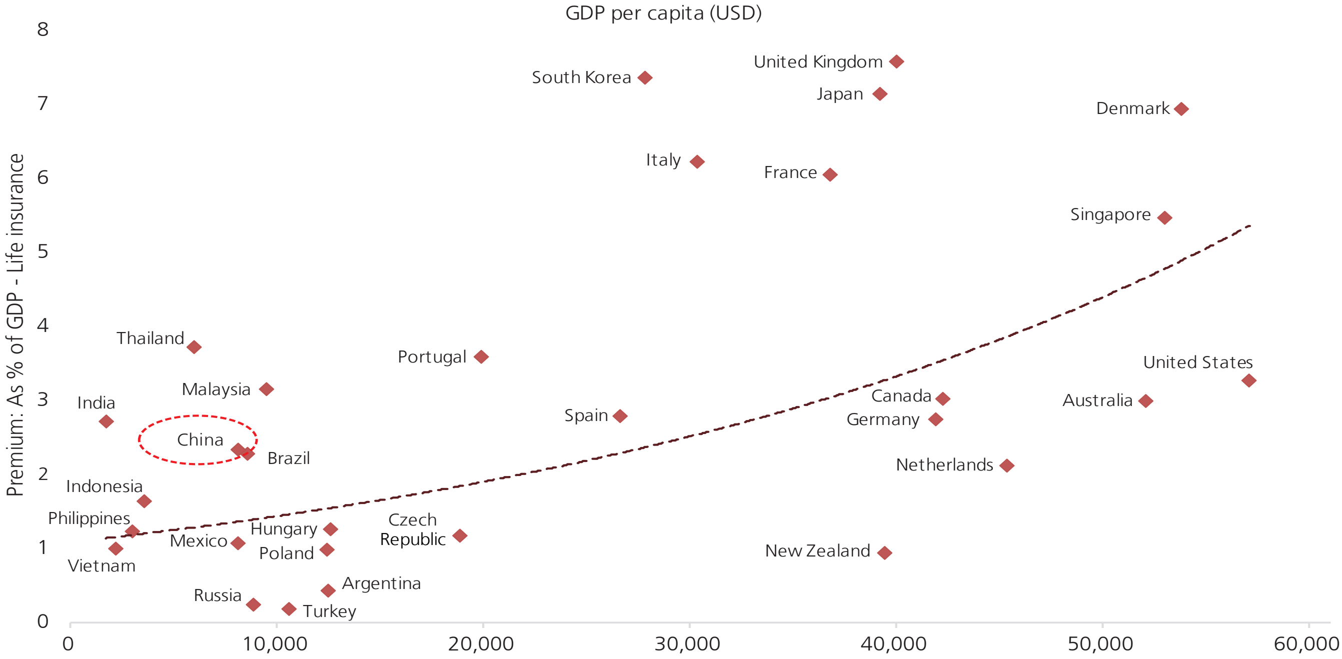


Source: United Nations, DBS

Demand for wealth management and life insurance should rise with increased longevity

With increased global longevity, the needs for wealth management and insurance services will likely rise. As the global population lives longer and wealth accumulates, demand for insurance and wealth management should see a corresponding increase. Indeed, we see opportunities in the Asian Insurance sector, where the overall penetration rate for life insurance remains low. Premiums on life insurance in Emerging Asia make up only 2.3% of gross domestic product (GDP) compared to 4.3% of GDP in G-7 countries. We believe China's low insurance coverage (Figure 5), the launch of the China Risk-Oriented Solvency System, and policy guidance will continue to direct China life insurers to re-focus on traditional life products and value enhancements.

Figure 5: Low life insurance penetration rates in China



Source: Swiss Re, DBS

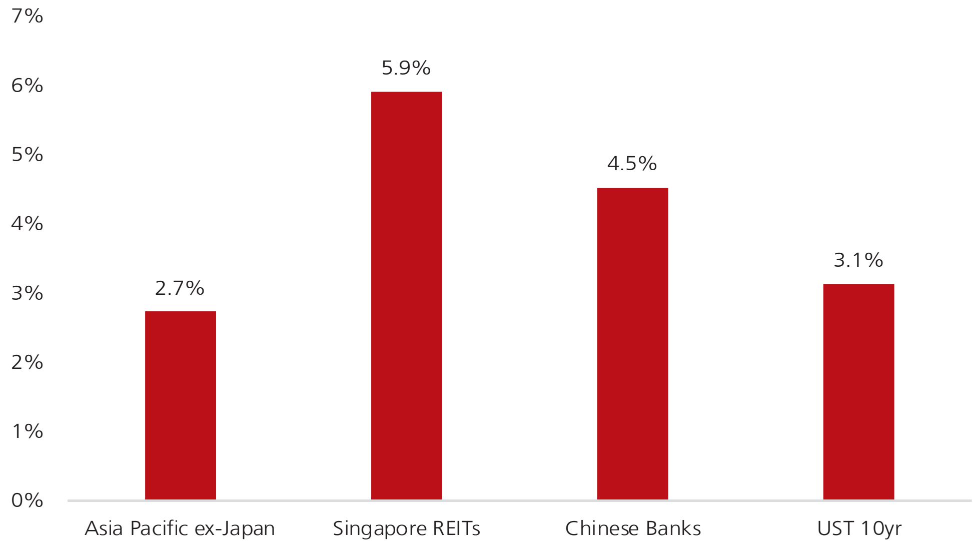
Demand for passive income and dividends to grow as population ages

As the global population ages, demand for passive income and dividends are likely to rise. When lifespans increase and retirement ages are raised, adequate savings and less volatile investments become of paramount importance. With longer life expectancy, holding periods for investments will also increase. As such, the ageing population will increasingly seek income from relatively stable, longer-term investments, in order to maintain (or at least be close to) their current lifestyle. As the world continues to age, we see a corresponding rise in demand for passive income and dividends. Besides, dividend-yielding stocks have shown lower volatility and enhanced returns over the long term, based on several studies.

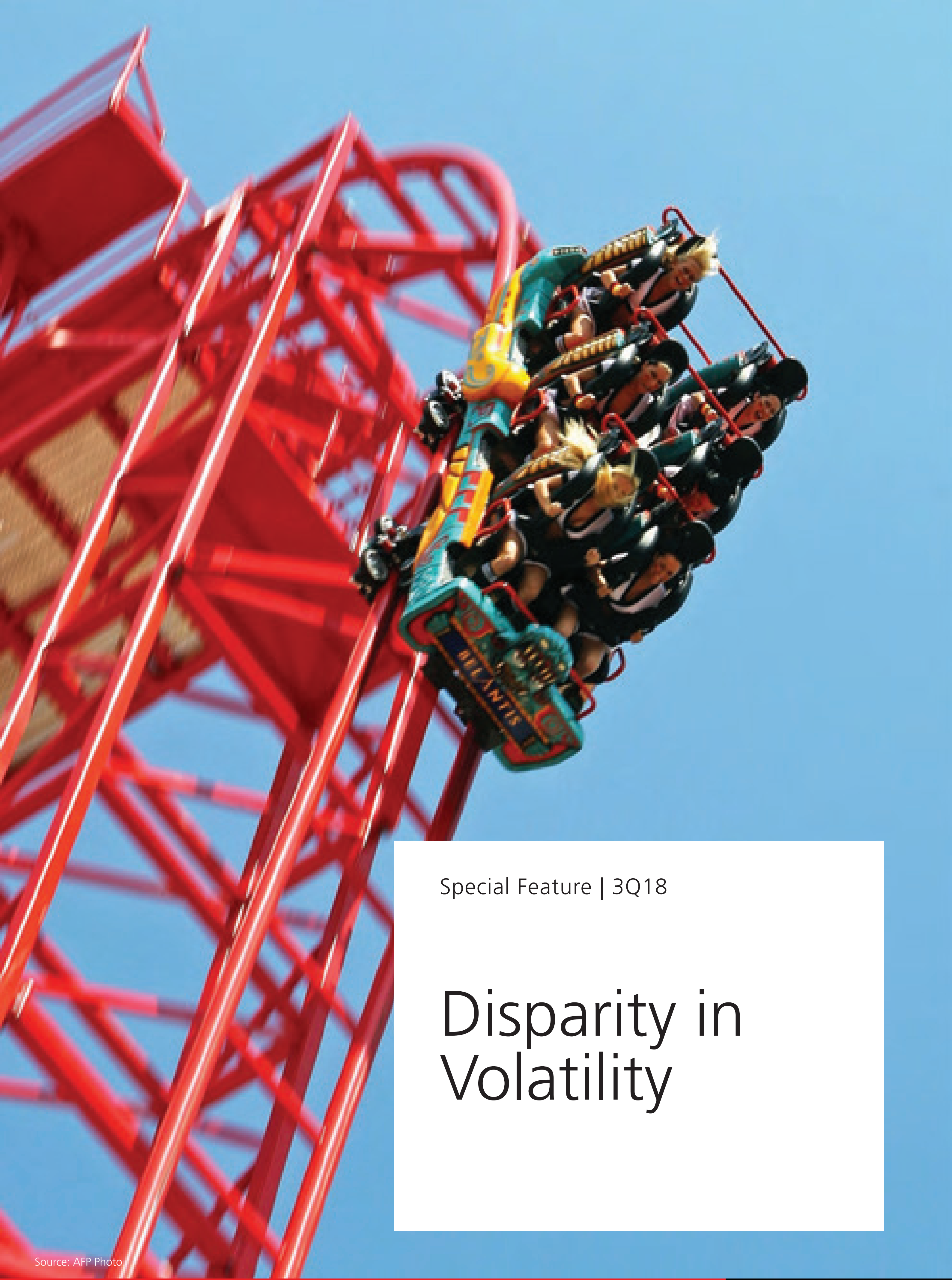
Asia: a fertile hunting ground for dividends

Asia remains a fertile hunting ground for dividends, given attractive absolute dividend yields and yield spreads (Figure 6). While growth investors may ignore dividends, they can be a very powerful source of returns for the ageing population. Historical returns for Asia Pacific ex-Japan show the benefits: more than half of total returns for the region came from dividends, highlighting how they can be a sustainable source of returns over the longer term.

Figure 6: Asia a fertile ground for dividends



Source: Bloomberg, DBS, as of 18 May 2018



Source: AFP Photo

Special Feature | 3Q18

Disparity in Volatility

DBS

Special Feature I: Disparity in Volatility

Dylan Cheang
Strategist

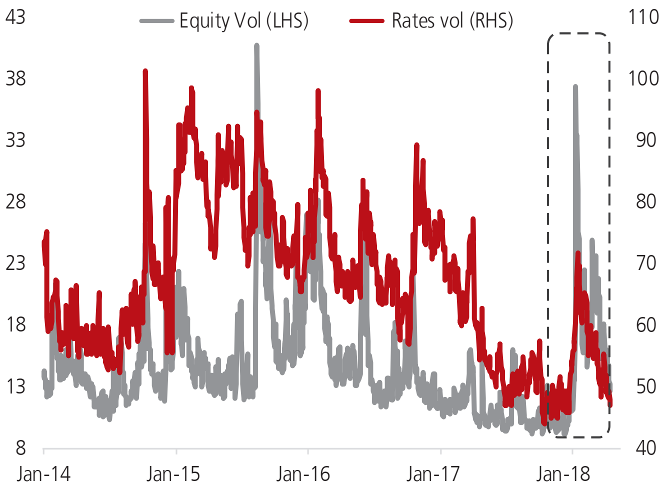
Disparity in cross-asset volatility

As central banks around the world embark on policy normalisation amid challenging risk assets valuations, market volatility (vol) could stay elevated in the second half of the year. But interestingly, the recent spike in volatility is not broad-based; it straddles across different asset classes. In fact, it was only the implied vol for equity that rose sharply while that of rates and currencies remained fairly subdued (Figures 1 and 2). This explains the sharp spikes seen in the ratios for equity/rates and equity/FX implied vols.

The extreme levels exhibited by these ratios show that investors' opinions on the outlook of financial markets are disparate across different asset classes. Broadly speaking, a low-volatility environment is often associated with a "risk-on" mode in which investors turn positive on risk assets. Conversely, a high-volatility environment is associated with a "risk-off" mode in which investors flee to safety and turn defensive in their asset allocation.

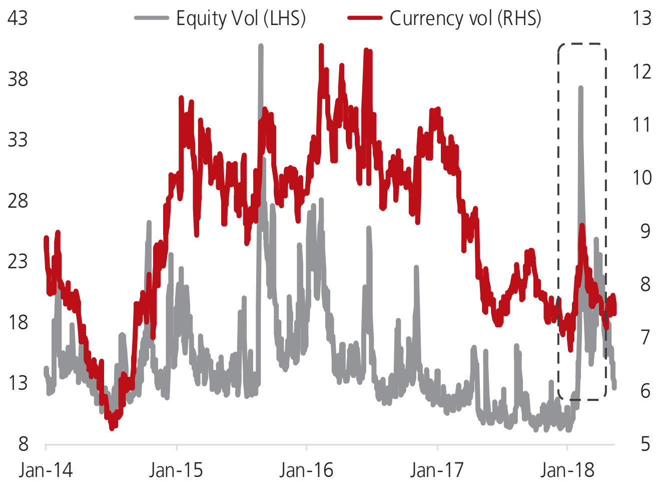
Recent concerns on the Federal Reserve's monetary tightening and global trade tensions have driven equity vol sharply higher. In equities, paranoia and fear have clearly dominated as investors started to: (a) Extrapolate single data points into a broad trend (in terms of US wage growth); and/or (b) Extrapolate the trade skirmish between the US and China into a full-fledged trade war. Sentiment continues to be extremely cautious despite a robust quarterly earnings season in the US.

Figure 1: Sharp spikes in equity vol have not been accompanied by similar moves in rates vol



Source: Bloomberg, DBS

Figure 2: Similarly, currency vol has remained subdued despite sharp gains in equity vol



Source: Bloomberg, DBS

Sharp disparity in cross-asset volatility has historically led to strong upside for equities

Investors' sentiment in the rates and currency space were, however, more sanguine; this explains the subdued movements in volatility despite the sharp moves in equities. The wide disparity in vol behaviour shows that despite recent headwinds, a broad-based sell-down in risk assets is not necessarily imminent. On the flipside, our analysis shows that such disparity in volatility has historically led to a strong upside for the equities space in the ensuing six to 12 months.

Table 1: Historical performance of the S&P 500 after the peaking of the equity/rates vol ratio

	Six-month performance	12-month performance
July 1998	14%	19%
January 2009	8%	36%
May 2010	12%	24%
August 2011	14%	25%
December 2012	15%	31%
August 2015	2%	15%
Average	**11%**	**25%**

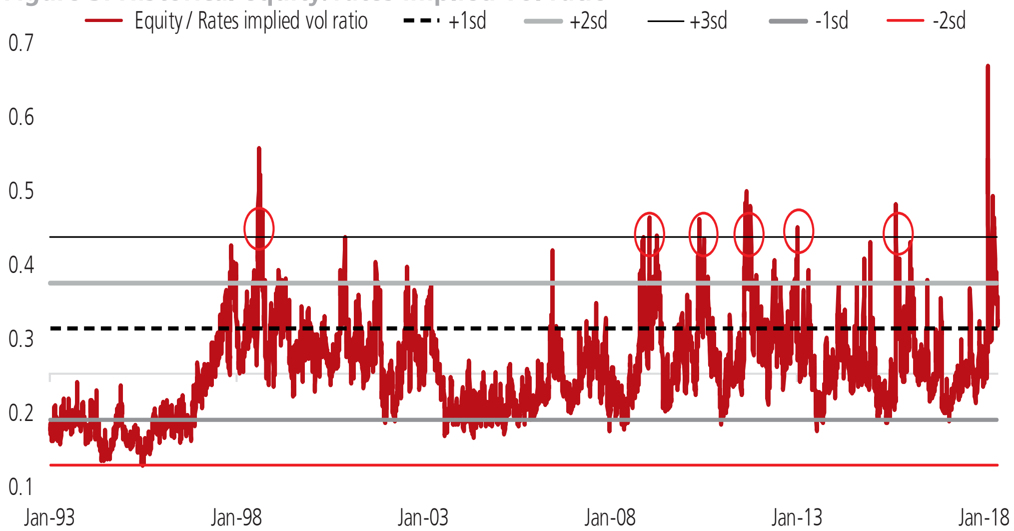
Source: DBS

Whenever the equity/rates implied vol ratio exceeded 3 standard deviations, the S&P 500 gained 11% on average over the next six months

As Table 1 shows, gaining exposure to equities during such periods could be rewarding. In the last two decades, whenever the equity/rates implied vol ratio exceeded the 3-standard-deviation mark, the S&P 500 Index gained by an average of 11% over the next six months, while the average gain for the subsequent 12 months was 25%.

In the latest bout of market volatility, the equity/rates vol ratio hit 3 standard deviations in early February. Volatility for the S&P 500 remained elevated before showing signs of a pullback in recent months amid abating trade fears and a strong reporting season, which reaffirmed that US corporate earnings trajectory remains on track.

Figure 3: Historical equity/rates implied vol ratio



Source: Bloomberg, DBS

Figure 4: Gaining exposure to equities when the vol ratio has hit an extreme has historically been rewarding

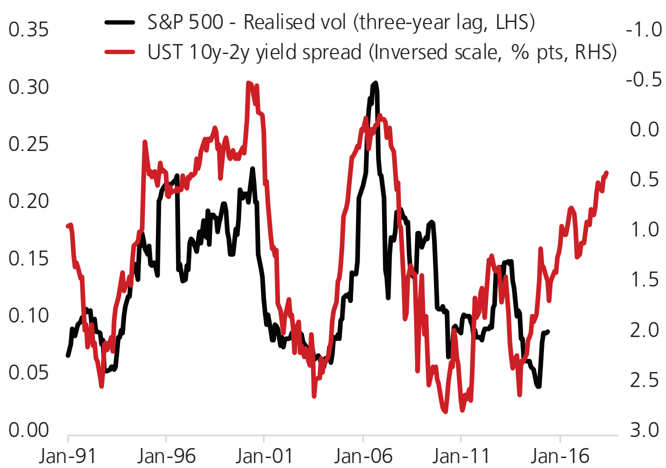
Source: Bloomberg, DBS

The flattening yield curve suggests rising volatility ahead

Meanwhile, volatility to trend higher amid flattening yield curve. The UST 10-year-2-year yield curve has been flattening since 2014 and our rates strategist is expecting the spread to reach zero by 4Q19. Historically, a flattening yield curve is associated with rising recession risks and by extension, higher realised equity vol. This time will be no different. As Figure 5 shows, the yield curve suggests that realised vol for S&P 500 will rise to levels last seen in 2006 in the coming periods.

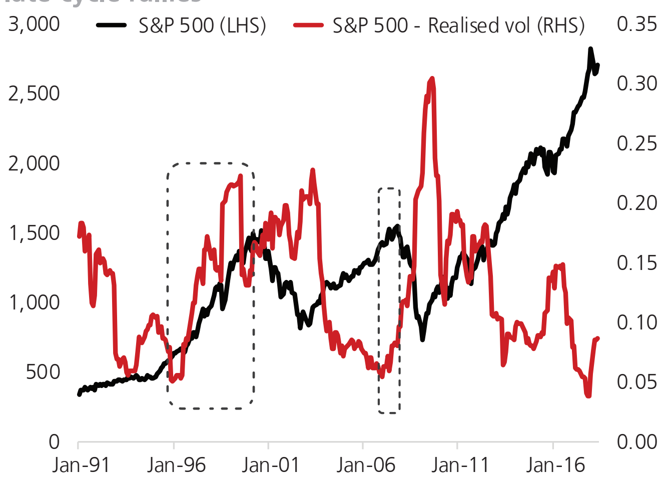
Such a move is, however, broadly in line with previous late-cycle rallies. For instance, in the run up to the "dot-com" bubble peak, realised equity vol rose in tandem all the way from mid-1996 until mid-2000. The same happened during the 2003-2007 market rally, which saw vol rising in line with the market during the final stage (see Figure 6).

Figure 5: Realised vol poised to rise amid flattening yield curve



Source: Bloomberg, DBS

Figure 6: Realised vol has historically rose during late-cycle rallies



Source: Bloomberg, DBS

Special Feature | 3Q18

New Realities

Source: AFP Photo

DBS

Special Feature II: New Realities

Ken Lee
Independent Research Contributor
CEO, Belleview Research

Special Feature: 10 New Realities that will Shake Businesses Up

1. China's ageing opportunities

By 2030, China's elderly population alone will be bigger than the total population of any other country in the world, except India. China's ageing speed is twice that of the developed world. Total pension (public and private) assets as a percentage of gross domestic product (GDP) stands at 35% for Hong Kong and Korea, while it is only at 10% for China. Health care spending per capita for the US and Australia is USD9,000 and USD6,000, respectively, whereas it is only USD450 for China. Thus, there are strong tailwinds in China's insurance, pharmaceutical, and health sectors.

2. MedTech: The USD8t disruption

The global health care industry is worth USD8t, but it is dominated by longstanding incumbents and has yet to modernise. Many tech companies are developing nanoparticles to be infused or injected into human bodies for medical monitoring. They also believe that people can live up to 200 years old. The price of DNA sequencing is piercing the inflection point of USD100 per request, per person. Medical technology (MedTech) is a massive theme – a solution to the ageing populations of China and other developed countries, too.

3. New energy landscape

Renewable energy technologies will have as big an impact as hydraulic fracturing – if not greater. Having free energy is not a question of if, but of when and how. Many milestones achieved by renewables in recent years have gone relatively unnoticed. In the US, the solar sector is generating 11 times more jobs than oil and gas. Saudi Arabia achieved a world record last year in solar pricing of less than USD0.02/kwh. In fact, the world is quietly embarking on a brand-new energy landscape.

4. A new material reality

A new material called graphene has gained a lot of traction in terms of its application and commercialisation. It is harder than diamonds, 200 times stronger than steel yet flexible, and is entirely transparent. It conducts electricity and heat better than any other material and is porous only to water. This material will have a significant impact on different industries such as renewable energy, battery storage, aircraft engineering, and water.

5. Tech war: China vs. the world

If you asked the question "Is China innovative?" five to seven years ago, you would have been laughed at. Today the answer is mixed – there are leading and lagging sectors of China's technologies. Leading ones include e-Commerce, mobile payments, and transportation. Lagging ones – the opportunities – include Artificial Intelligence (AI), MedTech, augmented/virtual reality (AR/VR), and software. China is harnessing AI to boost its soft power. A group of emerging Chinese companies will dominate electric vehicles, shared transportation, digital hardware, semiconductors, genetics, AI, and high-performance computing in the coming years.

6. Millennials: The most influential generation ever
Millennials are defined as people born in the 1980s and 1990s. Today they account for 26% of the world's 7b population. By 2025, they will account for 75% of the world's global workforce; naturally, they will become the biggest consumer segment. In addition, 31% of China's population are millennials, despite its ageing demographic. In India, a staggering 60% of the population (or 700m) are millennials – more than the entire population of the European Union (EU). Millennials have different values and preferences from other generations. To capture them as future customers, companies must hire, engage, and empower them as employees.

7. c-Commerce: You will soon talk to machines more than your spouse
Smartphones brought us from e-Commerce to m-Commerce. Many tech giants believe c-Commerce has just arrived; "c" stands for "conversational" or "chat". There are several reasons for this. A major one is that are too many apps – in fact, we are drowning in them. Tech giants believe that in the future, only messaging apps are needed. Consumption has migrated from physical shops to telephones (1-800-xxx); then from websites (e-Commerce) to apps (m-Commerce). With c-Commerce, you need none of these. This is the millennial generation's user experience.

8. e-Sports
e-Sports – competition using video games – is now a major form of media consumption among youth. It may enter the Paris 2024 Olympic Games as a new "sport". In fact, a recent e-Sports event had a record USD100m prize pool. Its ecosystem includes sponsors, game publishers, tournaments, platforms, players, and audiences/viewers. The influential players in this arena will likely benefit.

9. The eighth mass medium
Across our history, seven forms of mass media (print, recordings, cinema, radio, television, the Internet, and smartphones) have changed the way we live and consume, as well as created winners and losers. We believe the eighth mass medium has already arrived – augmented reality (AR) and virtual reality (VR). Smartphones and tablets will become obsolete sooner than thought. The eighth mass medium's value chain comprises semiconductors, components, headsets, platforms, applications, and content.

10. The rise of more machines
There are currently 4b jobs worldwide for a population of 7b. According to a Google futurist, 2b jobs will be replaced by AI and robotics by 2030. There could only be two types of jobs in the future: managing robots, or being a minion of robots. The question is whether it is a zero-sum game between humans and robots. With AI, the existence of human knowledge is migrating to a new frontier. How will human knowledge continue to exist? What are the unique qualities of the human brain vs. machines? How should we educate our kids and robot-proof them?

In this piece, we have elaborated on the implications of these new realities, and offered some ideas on how you can traverse – and embrace – these new realities. Going forward, it is clear that those who will stay ahead are the ones who will be able to identify new value chains and key influential players, as well as upcoming challengers, winners, and losers.

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