Quarterly Investment Strategy
Second Quarter 2018

Ageing bull or raging bull

UOB Asset Management

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Investment Strategy

2018 started with euphoria from 2017, before sliding into corrections in late January/early February. As we look ahead to build our outlook for the year, we assess if the first quarter will be representative as to how investments will perform. Our view is that we are in the midst of an ageing bull market, however without signs of fading out anytime soon.

Our review of global growth, economic surprises, earnings, fund flows, valuations, overheating and interest rates leads to a conclusion of a healthy macro backdrop with solid growth and low risks of overheating. We see growth to be strong enough to withstand modest monetary policy tightening from leading central banks.

Our opinion is that the performance of the markets in the earlier part of January is going to be more representative of returns throughout the year, alongside sufficient broad-based growth which suggests the bull market is likely to charge ahead for longer.

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Global Asset Allocation

Sector Allocation	View	Notes
Equities	+	**Rationale:** Solid broad-based global economic growth continues. Corporate earnings growing at healthy rates across most regions. **Risks:** Market valuations are above average. The cycle has been in expansion mode for nine years. Inflation could rise and trigger rate hikes that slow growth.
Fixed Income	-	**Rationale:** As the cycle normalises, central banks will start to normalise rates higher, which will be a headwind for fixed income performance. **Risks:** Inflation could surprise on the upside and the rate hike path could steepen and become an even greater headwind.
Commodities	+	**Rationale:** Strong supply and demand trends in gold, oil and copper, with strong demand coming from China. **Risks:** China's growth could slow more than expected.
Alternatives	■	**Rationale:** The equities outlook is strong currently and we turn neutral on alternatives, focusing on market neutral hedge fund strategies that produce steady returns at good risk levels. **Risks:** Extreme market volatility and market movements outside of individual company performance.
Cash	--	**Rationale:** We are underweight on cash in a pro-growth environment that should lead to strong returns in equities and commodities. **Risks:** Any correction, even a temporary one, would benefit from having extra cash to deploy.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Summary

Global growth and corporate earnings are growing at very solid rates in 2018, according to multiple indicators. The cycle is mature and has expanded for nine years which could induce the temptation of reducing risks. Additionally, the economic cycle has "normalised" with slack taken up, inflation levels rising and a hike in interest rates. Historically, there have not been many periods in which equities underperformed in years of good global growth, along with hiking interest rates. While it is not surprising that markets are concerned about the implications of "normalising", there is significant evidence that equities should perform well in this type of environment. Fixed income should face some headwinds from rising rates, however, the path is modest and returns in the asset class should remain positive.

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Global Investment Strategy

Ageing bull or raging bull

At the start of 2018, we argued that the global investment cycle has moved decisively out of a deflationary environment towards a more normalised cycle. Now that the cycle is normalising, we turn to emphasise what to expect in the final years of a bull cycle that usually coincides with rising equities, commodity prices and interest rates. Our assessment of macroeconomic growth is to expect better growth in 2018 and hence, we think the cycle continues. We maintain a recession checklist, and until we get traditional warning signs that the cycle is near the end, we remain bullish.

While our cycle framework was fairly straightforward, a sharp correction in February tested that view. At the start of February global equities declined by 10% as stock markets across the world followed the lead from the US. Fixed income markets also corrected as global long term yields climbed. The 10-year US Treasury (UST) yield climbed from 2.4% to 2.85% over the first two months of the year, putting pressure on bonds worldwide. Many investors are asking if this correction is potentially the end of the cycle and if rising rates might be the trigger for the next downturn.

A 10% equity correction and a spike in volatility appears unsettling, however, it is in line with equity market behaviour over bull markets. For context, there were 7 corrections of 5% or more over the bull market from 2003 to 2007, followed by new highs within 2 months of recovering losses. We also note that rising rates feature as typical backdrops to bull markets. Again through the previous expansion cycle of 2003 to 2007, the US Federal (Fed) Funds rate and the 10-year USTs were trending up over several years and equities continued to perform. The bull market only really ended when the next recession came.

> "There are not many historical periods where equities have underperformed in the face of globally synchronised growth and rising corporate earnings. We don't think 2018 will be one of them."

Still, we continue to monitor our checklist for the next recession. Compared to last quarter, little has changed and our indicators still point to the greater likelihood of the cycle extending for over a year. The yield curve has not inverted, leading indicators have not softened, credit growth is not overheated, high yield spreads over investment grade spreads have not widened, recession probability models have not increased, and market measures of stress and correlations are not showing signs of concern. Thus we think the bull market continues and the correction is still in line with traditional bull market corrections.

The global expansion is mature as it has persisted for 9 years, but it is not giving any signs of it fading just yet. Hence we are overweight on global equities and underweight on fixed income. We are overweight on commodities, and maintain a neutral call on alternatives and hold an underweight position in cash.

The top risks for the coming quarters are inflation surprises, a China slowdown and geopolitical tensions. After years of flirting with deflation in the developed markets, the global environment has shifted decisively toward a more normal cycle. Growth in China as of early 2018 remains stable and geopolitical risk appears to have subsided. We would not describe any of the risks as particularly threatening, however, it is prudent to remain on the lookout for factors that could derail a bull market.

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US Equity

Country Allocation	View	Notes
US	+	**Rationale:** US economic indicators have improved to higher levels and corporate earnings have improved over the past quarter. Meanwhile corporate and consumer surveys showed businesses holding bullish views about the economic outlook. **Risks:** Inflation could surprise on the upside with low unemployment amid expectations the Fed is behind the curve on monetary policy.

Summary

US corporate tax cuts are contributing to earnings growth, giving a boost to bullish corporate sentiment. We think inflation targets will not be met until end-2018, and true inflation concerns will not surface until 2019.

Europe Equity

Country Allocation	View	Notes
Europe	–	**Rationale:** Leading economic indicators are still at high levels which appeared to have peaked and are declining modestly. Gross domestic product (GDP) and corporate growth revisions are modestly lower compared to other developed markets. **Risks:** Geopolitical risks have moderated in the region though uncertainty hangs over the United Kingdom (UK) from its exit from the European Union (EU).

Summary

On a relative basis, we see better leading indicators and corporate earnings improvement in the US and Japan. The strong Euro has become a modest headwind for European businesses. While political risks have abated, the lack of consensus in Italy will restrain much needed reforms.

Japan Equity

Country Allocation	View	Notes
Japan	■	**Rationale:** Domestic economic conditions improvements continue along with tailwinds from a global economic upcycle. BoJ accommodative monetary policies are supported by inflation levels which are below target, which would help to support the market. **Risks:** Structural issues such as demographic trends remain an overhang on the country.

Summary

Economic data continues to witness solid improvement along with tailwinds from the global economic upcycle. While inflation is picking up, it remains below target and likely to reinforce Bank of Japan's (BoJ) accommodative monetary policies, which would help support the market. Developments in corporate governance and corporate performance continue to show positive momentum.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

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Asia Ex-Japan Equity

Country Allocation	View	Notes
China	+	**Rationale:** Stable economic growth and strong corporate profits. The government is pushing through more reforms, deleveraging and rebalancing measures. Macro-risks are subsiding and valuations are still cheap compared to regional and global markets, particularly for 'H' shares. Expect the market's re-rating to continue in 2018. **Risks:** Further liquidity tightening measures and a possible dip in property sales.
Hong Kong	■	**Rationale:** Tight demand and supply fundamentals. Central office rental trends and recent transactions remain strong while retail sales are recovering. Strong recovery in Macau gaming revenues and further growth is supported by better infrastructure connectivity. **Risks:** Lofty prices of HK residential property remains a social problem alongside perceived political interference from China.
India	-	**Rationale:** High market valuations. Downward earnings revisions may still continue after a large scale banking fraud scandal. **Risks:** A recapitalisation of banks may spur a recovery in capital recapitalisation (capex). Strong domestic liquidity in the financial system post-demonetisation could support the equity markets.
Indonesia	■	**Rationale:** Capex recovery and exports driven by high coal prices should support economic growth along subdued inflation and accommodative monetary policy. Domestic consumption could improve with government financial aid and job creation. **Risks:** Domestic consumption remains soft.
Malaysia	-	**Rationale:** Uncertainty from the upcoming general elections and limited further upside to the Ringgit. **Risks:** Upside to economy and earnings growth from strong construction orders. Restructuring of government-linked companies.
Philippines	-	**Rationale:** Tax reforms have accelerated inflation and the current account deficit has put pressure on the Philippine peso. Congress may remove some tax incentives that could affect foreign direct investment and business process outsourcing. **Risks:** GDP expansion and domestic consumption has held up despite inflation pressures.
Singapore	+	**Rationale:** Strong GDP growth momentum has continued into 2018 with more positive earnings revisions to follow. Recovery in the real estate sector. Singapore valuations are attractive relative to ASEAN peers. **Risks:** Rising interest rates could hit the real estate sector and stall recovery.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

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Country Allocation	View	Notes
South Korea	■	**Rationale:** Downward earnings revisions in the technology sector with a pick up expected only after the second quarter. The consumer sector continues to struggle with negative earnings revisions. Financials are expected to benefit from global and domestic recovery and improved cost to income ratios. Valuations are the lowest in Asia and remain cheap. **Risks:** Issues surrounding Sino-Korea relations. Domestic regulation risks remain as President Moon is comparatively less pro-business than his predecessor.
Taiwan	–	**Rationale:** Downward earnings revisions and weaker than expected demand for smartphones in China. **Risks:** Taiwan market valuations are one of the lowest in Asia with strong free cash flows and high dividend yields.
Thailand	■	**Rationale:** The economy should continue a strong growth momentum in 2018, led by tourism, consumption, and exports. Acceleration in government infrastructure investments. Benign inflation and a strong current account surplus has seen the Thai baht strengthen. **Risks:** Election postponement may delay investment recovery. Market valuations are still on the high side.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Summary

Asia is seeing a second year of profitability improvement after five to six years of declines. Earnings revisions have outpaced global markets throughout 2017 and continue to do so in 2018. Yet, market valuations in Asia are still reasonable. Asian markets are trading slightly above their 18-year historical mean level on price-to-book and price-to-earnings ratios, and at a sizeable discount compared to global markets.

Underlying Asia's strong performance last year and carrying into 2018 has been China. The country's industrial profits and corporate earnings rebounded strongly in 2017, helped by capacity rationalisation, improving utilisation and a rebound in producer price inflation index following government-led supply side reforms. This has given more breathing room for the government to step up on economic rebalancing, financial deleveraging and reforms. With macro risks subsiding and more focus on executing reforms in the leadership's second term post the party congress, we can expect China's momentum of rerating to continue.

However, momentum has reversed in the North Asian markets, particularly in Korea and Taiwan. Southeast Asia is seeing better momentum so far in 2018 after underperforming in 2017. We have seen more positive earnings revisions in the region compared to North Asia, particularly for Indonesia, Singapore and Thailand.

We continue to be positive on Asia given the backdrop of improving global economic growth, continued positive earnings revisions and cheaper valuations versus global markets. Strong positive fund inflows and domestic liquidity should also help support the Asian markets. Barring a potential trade war with the US or a sharp spike in inflation and interest rates leading to heightened global risk aversion, Asian markets should continue their trend of outperformance.

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Global Fixed Income Strategy

Sector Allocation	View	Notes
Developed Market (DM)	-	**Rationale:** Structural forces are driving global yields higher - leading inflation indicators are trending up in the US while expectations of policy normalisation are prevalent in Europe and the UK. While Japan government bond (JGB) yields are still contained by yield curve control, risks are skewed toward the upside. Rising global yields are likely to pressure the BoJ into adjusting the yield target higher. **Risks:** The current circumstance could be a repeat of the scenario in the US around early 2017 where the market expected inflation to trend higher but instead dipped sharply.
DM Government	--	**Rationale:** While yields in Europe and the US are likely to head higher in tandem, they remain at different stages of the tightening cycle, with EU still in the infancy of policy normalisation. As such, the yield curve in Europe should steepen more compared to the US. **Risks:** Should volatility continue to rise and risk aversion takes hold, expect demand for safe haven DM bonds to increase.
DM Credit	-	**Rationale:** Creditworthiness continues to improve across sectors, reflecting healthy fundamentals. **Risks:** Rate shocks and geopolitical tensions that may trigger credit spreads to widen.
Emerging Market (EM)	+	**Rationale:** EM is expected to be one of the drivers of global growth. Growth in EM is broad-based and synchronised, creating a positive feedback loop. Valuations are fair to attractive. **Risks:** The risks to watch include the pace of US monetary tightening and protectionist measures, deleveraging in China, inflation surprises, idiosyncratic EM political risks, geopolitical risks.
EM Government	■	**Rationale:** Generally more positive policy tone emanating from EM. Most countries have deployed both monetary tools (currency depreciation, rates) and fiscal tools (subsidy cuts, value-added-taxes) to improve their imbalances. **Risks:** Sensitivity to sharp commodity price declines and/or sharply higher USD funding costs. Idiosyncratic risk such as an exit from the North American Free Trade Agreement (NAFTA) negotiations could impact Mexico negatively.
EM Corporate	-	**Rationale:** EM corporate fundamentals showed improvement with defaults running at historic low rates, and stabilising levels of leverage levels. Overall, EM corporate credit is trading relatively expensive to EM sovereigns and quasi-sovereigns. **Risks:** Protectionist US trade policies, idiosyncratic EM political risks, geopolitical risks. A potential recovery in the capital expenditure or mergers and acquisitions cycle would be cash flow negative.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

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Sector Allocation	View	Notes
EM Local Currency	+	**Rationale:** Returns for the asset class should moderate in 2018 compared with 2017, while return dispersion among countries should increase. **Risks:** Higher than expected inflation, geopolitical risks, rising protectionism, and a slowdown in growth momentum in EM.
Duration	-	**Rationale:** A short duration stance is prudent as yields are likely to head higher in the coming quarter. **Risks:** The safe haven appeal of USTs might overwhelm any inflationary impact in the event of an escalation of trade friction between the US and China.
Yield Curve	+	**Rationale:** Risk appetite should remain steady in the coming quarter, while spreads between 2-year and 10-year USTs are likely to remain supported at technical levels. **Risks:** Spreads between 2-year and 10-year USTs will tighten should the technical support spread of 50 basis points be broken.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Summary

The fixed income markets are more vulnerable to an inflation scare rather than a real return of inflation. With the latest US wage and inflation data pointing to a potential return of inflation, our house view holds that 10-year US Treasury (UST) yields are likely to stay generally between 2.8% and 3.1% for the second quarter.

Though a bear market for DM government bonds began in the middle of 2016, credit spreads have not risen significantly. A more aggressive unwinding of quantitative easing and rising market volatilities could possibly trigger such a rise in spreads.

Meanwhile, the macro environment is supportive of EM fund flows over the medium term as inflows into emerging market local currency and hard currency markets still remain positive year-to-date.

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Regional Allocation	View	Notes
Latin America	+	**Rationale:** High real rates and better current account balances act as a buffer should US rates move higher. On fiscal policy, policymakers are expected to stay on a path of consolidation but with reduced pressure to cut expenditure, as tax revenues rise. Valuations in the region remain attractive, on a relative basis. **Risks:** A renewed political crisis in Brazil might slow down the pace of reform. The region will see elections in Colombia and Mexico in mid-2018 and in Brazil in October 2018. Any failure to NAFTA negotiations will weigh as an idiosyncratic risk for Mexico.
CIS/EE*	■	**Rationale:** Gradual recovery is supported by further improvement in domestic demand growth in Russia and solid growth in Poland and Turkey. Russia is expected to regain its investment grade status reflecting prudent policy response which has allowed the country's economy to adjust to lower commodity prices and international sanctions. In Turkey and Poland, strong domestic demand growth adds to inflationary pressures. Valuations are moderately expensive. **Risks:** Geopolitical risks including Russia's involvement in US politics could result in further sanctions; weaker macro and political stability in Turkey could lead to further downgrades.
Middle East/Africa	■	**Rationale:** South Africa's narrative turned positive after the appointment of Cyril Ramaphosa to the Presidency. Rhamposa signalled a restoration of the rule of law and an end to a deeply ingrained system of patronage. Moderate strengthening of oil and resource prices in the wake of Organisation of the Petroleum Exporting Countries (OPEC) production cuts has moderately eased pressure on oil exporters. Many countries have deployed both monetary tools and fiscal tools to improve their imbalances. **Risks:** A weakening of oil prices would negatively impact fiscal budgets. However, Middle Eastern sovereigns have the lowest debt to GDP ratios and strong access to capital markets. Further escalation in the political dispute between Qatar and the Gulf Cooperation Council (GCC) might lead to price volatility in the region.
Asia	■	**Rationale:** Steady global macroeconomic conditions remain supportive for improving corporate earnings. Stretched valuations coupled with increased issuances may bring some softness for credit spread. Credit bonds will continue outperforming on the back of a hunt for yield with a low interest rates and benign inflationary environment, alongside healthy EM fund flows. **Risks:** Any sharp increases in global interest rates may moderate risk appetite. China's reforms continue to add to growth pressures. Markets still remain wary of challenges domestically in the US and geopolitical risk from the Korean Peninsula.
Singapore	+	**Rationale:** Growth for 2018 is likely to continue where 2017 left off. With an expansionary fiscal budget, growth should come in at the upper end of the official forecast. **Risks:** The openness of Singapore's economy renders vulnerable to the risks of trade retaliation between the US and China.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

* Commonwealth of Independent States and Central and Eastern Europe

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Currencies

FX Allocation	View	Notes
US Dollar **US$**	–	**Rationale:** USD weakness remains a function of the relative proximity to the end of its tightening cycle relative to other developed markets. **Risks:** USD could rally if the Fed terminal rate is revised higher, or if the European Central Bank (ECB) or BoJ turned dovish.
Euro **€**	+	**Rationale:** EUR/USD remains on a fundamental buy due to strong economic momentum and inevitable policy normalisation. **Risks:** Speculative positioning is at extreme levels and risk of a pullback cannot be discounted. Inflation in the Eurozone also remains low by historical standards.
Japanese Yen **¥**	+	**Rationale:** While the BoJ has tried gamely to stick to a dovish rhetoric, it should only be a matter of time before the market sentiment on policy normalisation starts intensifying. **Risks:** After showing some signs of an increase in the recent past, structural forces might still contrive to drive inflation prints lower.
Singapore Dollar **S$**	+	**Rationale:** The nominal effective exchange rate (NEER) remains cheap by recent standards and its strength should only intensify into April with tightening expected at the next central bank policy meeting. **Risks:** NEER strength could abate should the policy tightening be delayed until October, though any fall is unlikely to be too extended.
China Renminbi **CNY**	■	**Rationale:** Strength should persist with onshore sellers selling the USD on any upward movement in the USDCNY, against the backdrop of continued confidence in the domestic economy. However, with CNY already heavily overbought, we do not see value at current levels. **Risks:** China remains at the forefront of any trade sanctions from the US and would bear the brunt of any potential trade war.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Summary

Even as UST yield spreads against other developed market government bonds trend higher and US inflation numbers rise, US dollar strength is likely to be curtailed with market expectations of an eventual end to the Fed tightening cycle. Although a higher Fed terminal rate might be sufficient to reverse US dollar weakness, the current prospects of the rate shifting higher are unlikely in the short-term.

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Commodities

Sector Allocation	View	Notes
Commodities	+	**Rationale:** Global economic growth remains in expansionary territory. Chinese supply side reforms are reducing production and tightening global supply-demand balances, yet commodity producers have yet to respond with increased capex. Growing interest in electric vehicles is a long-term structural positive. **Risks:** Further US interest rate increases could derail global growth and strengthen the USD which is negative for commodities. Increased protectionism or slowing economic activity in China would negatively impact demand in 2018.
Gold	+	**Rationale:** Accelerating inflation would be positive for gold if central banks were slow in raising interest rates. There is positive demand from physical gold exchange traded funds (ETFs) and central banks. **Risks:** Higher real interest rates could be negative for gold, which does not pay interest. The bullion is also vulnerable to upward moves in the USD.
Base Metals	+	**Rationale:** Inventory levels are falling, with supply outlook lacklustre due to continued lack of investment in new capacity. Manufacturing PMI and industrial production data remain strongly positive. **Risks:** Weaker demand as a result of slowing economic growth, particularly from China. Elevated speculation in futures markets. Country-specific risks on taxation and ownership remain a concern
Bulk Commodities	■	**Rationale:** Chinese government continues to close low-quality domestic production of iron ore, coal and steel, benefiting higher grade producers overseas. Seasonal Australian rainfall presents supply risk. **Risks:** A slowdown in China's domestic property market will weaken demand while winter production cuts and seasonal strong demand whittles down.
Energy	■	**Rationale:** OPEC has extended its production cuts to December 2018, with support from Russia. Positive aggregate crude oil demand growth, particularly from China and India. Supply risk from Venezuela, Nigeria and Iraq. **Risks:** Strong increases in US onshore shale production, possible breakdown in OPEC production discipline, or an early end to OPEC supply cuts. High level of speculative positions.
Agriculture	-	**Rationale:** Agricultural prices are trading at historically low levels, presenting upside risk in the event of unusual weather conditions. **Risks:** No sign of bad weather conditions. Recent years have seen favourable weather and bumper harvests.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Summary

Global economic growth remains in expansionary territory, with global industrial production and purchasing managers' index (PMI) data supporting continued demand strength. Chinese demand is expected to hold till the second half of 2018. Over in the US, the increasing protectionist rhetoric poses a risk to future economic growth, but such rhetoric has yet to translate into actual legislation.

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Alternatives

Sector Allocation	View	Notes
Hedge Funds	+	**Rationale:** Volatility has started to rise from historically low levels. Rising interest rates may lead to more dispersion amongst individual stock performance as market participants begin to incorporate value into their investment considerations as opposed to purely growth. This may be beneficial for fundamental biased strategies that are hedged. **Risks:** The upward momentum in asset prices may continue due to healthy corporate fundamentals which may lessen the attractiveness of hedged strategies.
Private Equity	+	**Rationale:** Heightened volatility in the public markets and the superior growth potential of private companies make private equity an attractive asset class for generating alpha. **Risks:** Valuations are not cheap in certain sectors such as healthcare due to industry attractiveness and abundant liquidity.

Maximum Overweight: ++ Slight Overweight: + Neutral: ■ Slight Underweight: - Maximum Underweight: --

Summary

Many of the sectors and companies still continue to exhibit strong growth leading to a divergence of performance amongst companies, sectors and geographies. Strategies which focus on identifying such opportunities that also hedge market risk could be relatively more attractive.

There are also industries that are facing challenging times and disruptive competitors creating opportunities for funds that have the ability to take advantage of these changes be they structural or cyclical.

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Contact Details

Singapore

UOB Asset Management Ltd
Address 80 Raffles Place
UOB Plaza 2 Level 3
Singapore 048624
Tel 1800 222 2228 (Local)
(65) 6222 2228 (International)
Fax (65) 6532 3868
Email uobam@uobgroup.com
Website uobam.com.sg

UOB Alternative Investment Management Pte Ltd
Address 80 Raffles Place
#16-21, UOB Plaza 2
Singapore 048624
Tel (65) 6539 2646
(65) 6222 2228 (International)
Email uobaim@uobgroup.com
Website uobaim.com.sg

Malaysia

UOB Asset Management (Malaysia) Berhad
Address Level 22, Vista Tower, The Intermark
No. 348 Jalan Tun Razak, 50400 Kuala Lumpur
Tel (60) (03) 2732 1181
Fax (60) (03) 2164 8188
Website uobam.com.my

Thailand

UOB Asset Management (Thailand) Co., Ltd
Address 23A, 25 Floor, Asia Centre Building, 173/27-30, 32-33
South Sathon Road, Thungmahamek, Sathon, Bangkok 10120, Thailand
Tel (66) 2786 2000
Fax (66) 2786 2377
Website uobam.co.th

Brunei

UOB Asset Management (B) Sdn Bhd
Address FF03 to FF05, The Centrepoint Hotel, Gadong
Bandar Seri Begawan BE 3519, Brunei Darussalam
Tel (673) 2424806
Fax (673) 2424805

Taiwan

UOB Asset Management (Taiwan) Co., Ltd
Address Union Enterprise Plaza, 16th Floor,
109 Minsheng East Road, Section 3, Taipei 10544
Tel (886)(2) 2719 7005
Fax (886)(2) 2545 6591

Japan

UOB Asset Management (Japan) Ltd
Address 13F Sanno Park Tower, 2-11-1 Nagatacho, Chiyoda-ku,
Tokyo 100-6113 Japan
Tel (813) 3500-5981
Fax (813) 3500-5985

China

Ping An UOB Fund Management Company Ltd
Address 34F, Ping An Financial Center, No 5033, Yitian Road,
Futian District, Shenzhen 518033
Tel (86) 755-2262-3179
Fax (673) 755-2399-7878

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