Quarterly Investment Strategy
First Quarter 2019

Advancing with caution

UOB Asset Management

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Investment Strategy

While the fundamental macro calls throughout 2018 were largely correct, the market reaction was less constructive at the end of the year. Despite global gross domestic product (GDP) growth remaining above trend in 2018 and double-digit earnings growth in most regions, equity and fixed income markets struggled to achieve positive returns. The policies from the US Federal Reserve (Fed) has translated into a tighter monetary environment, and it appears increasingly clear that markets are behaving similarly to what they did in 1994 which led to both negative returns for global equity and fixed income markets.

Quantitative tightening, weak private sector loan growth, rising oil prices, a strong US dollar, and trade uncertainties have all contributed to a more challenging environment than what would be implied by rate hikes. The silver lining is that most of the issues that have contributed to tighter liquidity in 2018, are likely to improve in 2019. For instance, the Fed may pause rate hiking in the first half of 2019, oil prices are expected to moderate and remain rangebound in 2019, amid some progress on trade issues between the US and China.

2019 presents a weaker fundamental outlook compared to 2018. We expect US fiscal stimulus to taper off, global earnings growth to fall to high single digit levels and climbing odds of a recession in two years. Our overall view is that both equity and credit markets are oversold with liquidity relief in 2019. Hence, we maintain our investment weights and continue to overweight equities, underweight fixed income and commodities, overweight alternatives and underweight cash. 2019 would deserve more caution once markets recover from oversold levels and we will be carefully monitoring our recommendations throughout the year.

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Global Asset Allocation

Sector Allocation	View	Notes
Equities	+	**Rationale:** Although the cycle is ageing, GDP and earnings growth outlook looks attractive. Valuations have turned attractive after the correction in 4Q18. The maturing cycle justifies more caution in 2019, however at higher levels. **Risks:** Many risks continue to weigh on global equity markets. Key risks like trade wars and Fed tightening look fully priced into markets.
Fixed Income	-	**Rationale:** Risks of rising rates and widening credit spreads has been a headwind to fixed income performance throughout 2018. The headwinds should ease in 2019 with returns likely to be muted. **Risks:** Bond yield moves have already been priced in. If growth disappoints, bonds could be a surprise winner.
Commodities	-	**Rationale:** Commodities show a mixed performance. Gold has gained while energy has weakened sharply in the last quarter. Slowing demand in China has also moderated the outlook for metal pricing. **Risks:** China's growth could slow more than expected. USD strength could continue.
Alternatives	+	**Rationale:** Equity and fixed income trends have been lacklustre which give alternatives room to achieve returns on lower volatility. **Risks:** Extreme market volatility and market movements outside of individual company performance.
Cash	■	**Rationale:** We expect equity, fixed income and alternatives to all be able to achieve positive returns over the coming quarter at levels higher than cash rates. **Risks:** Cash rates are rising and market weakness could make it more attractive to overweight cash at some point.

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

Summary

While investors should become increasingly cautious as the cycle ages, we think markets were oversold at the end of 2018. Thus, we would overweight risk assets and seek better value before getting more cautious. The Fed should slow its pace of rate hikes and we still expect the world to be able to navigate the various risk issues that have been an overhang on asset performance. Hence we continue to overweight equities, underweight fixed income and commodities. We think the benefits of alternatives help portfolios in these volatile periods. We also raise cash to a neutral position as cash rates are finally starting to offer positive returns net of inflation.

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Global Investment Strategy

Advancing with caution

The start to 2019 comes with a mixed picture. Although the key risks that were previously weighing down on markets outlook are improving, GDP numbers and earnings growth figures are moderating. This leaves expectations for returns to be more modest in 2019. In the present environment, though rate hikes are fairly modest by historical standards, the overall environment with quantitative tightening, low private sector loan growth, a strong US dollar, rising oil prices, and trade conflicts contributed to more aggressive tightening of global financial conditions.

While asset markets have priced in the risks, we would argue that the outlook for most of the risk issues has been improving. Firstly, we think the case for a Fed pause to rate hikes has grown substantially. The key inflation measures have been falling in recent months, and interest rate sensitive sectors such as housing and automotives have been showing signs of weakness. Since monetary policy works on a 6 to 12 month delay, the case for a pause has strengthened as the rate hikes of the past year may have tightened financial conditions more than the Fed had intended.

On the geopolitical front, there are signs of improvement when it comes to US-China trade negotiations. Brexit is likely to remain an overhang throughout the first quarter, and a vote is likely to boil down to the "compromise" plan or a hard Brexit. While few are voting now for the compromise, we would expect most of the UK Parliament to prefer to avoid the hard Brexit scenario, therefore our base case remains that a compromise deal will be accepted.

While the risks may ease in 1Q19, we expect the overall growth fundamentals to moderate and that recession risks to increase as we get closer to the end of 2020. Though most indicators still point to another year of above-trend global growth in 2019, others such as the steepness of the yield curve are giving signals that we are approaching the end of the cycle.

We would not recommend immediately cutting risks at the first sign of a yield curve inversion. Often, markets do not stop performing at the first sign of a yield curve inversion and conversely, equity returns continue to post advances beyond the first year of yield curve inversion. Instead, we would continue to drive our views on the fundamental outlook for issues such as growth and earnings, but start to exercise more caution in the coming year.

> "The story could flip in 2019 as the opposite of 2018 – with moderating GDP and corporate earnings growth, slower pace of rate hikes and settlement to some risk issues."

Our outlook is modestly more cautious but not bearish. Within equities, valuations have turned attractive and are oversold in most markets. Global growth and earnings remain fundamentally supportive, but risk taking is likely to remain subdued until key global risk issues are mitigated. For fixed income markets, the potential for Fed moderation could help return the asset class to positive returns in 2019. The average yield for bond portfolios have risen significantly in 2019 due to Fed rate hikes and spread widening. If the pace slows in 2019, fixed income could perform much better. Although commodities do frequently outperform in late cycle stages, mixed signals in the oil markets and China's moderating demand for base metals turns the commodity outlook into a mixed one. We recommend staying balanced and cautious as we monitor the outlook for 2019.

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US Equity

Country Allocation	View	Notes
US	+	**Rationale:** US growth will moderate in 2019 as fiscal stimulus moderates. Overall growth should remain above trend and corporate earnings should remain at high single digit levels. **Risks:** US policy risks remain over trade conflicts and government shutdowns.

Summary

The US offers the most convincing outlook for growth and earnings within the developed markets. Valuations in terms of forward price-to-earnings ratios have fallen back to average levels with a rise in corporate earnings and a range bound equity market.

Europe Equity

Country Allocation	View	Notes
Europe Equity	–	**Rationale:** Leading indicators softened through 2018, though some of the slowdown was triggered by auto production and emission standards changes. Nevertheless, we have yet to see signs of growth stabilisation. **Risks:** Italian politics may turn messy and increasingly hostile towards the European Union. Additionally, Brexit negotiations are in their final stages which could result in increased uncertainties.

Summary

While growth is still healthy in Europe, we see better leading indicators and corporate earnings improvement in the US and Japan. The first half of 2019 will likely be a particularly heightened time for European risks in Italy and from Brexit. Though a Brexit deal is likely to eventually proceed, the process is going to be volatile through most of the first quarter.

Japan

Country Allocation	View	Notes
Japan Equity	■	**Rationale:** Domestic demand should remain firm given fiscal stimulus measures to alleviate the impact of a consumption tax hike ahead. **Risks:** BOJ tightening, escalation in US-China trade war, deterioration in trade relations with the US, sharp appreciation in the yen.

Summary

Despite supportive valuations, GDP growth is muted compared to other regions. It is also vulnerable to external risks (weaker global demand, trade protectionism). The Bank of Japan (BOJ) is likely to remain accommodative in view of benign inflation.

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Asia Ex-Japan Equity

Country Allocation	View	Notes
China	–	**Rationale:** Valuations, especially "A" shares are at distressed levels with slower economic growth and further earnings cut in the near term. Credit easing and infrastructure investments may not soften the blow from trade wars. **Risks:** A resolution to the US-China trade war. Growth acceleration from government policy tailwinds.
Hong Kong	+	**Rationale:** Attractive valuations and a safe haven with the USD peg. Resilient office rental demand and strong Macau gaming revenues. **Risks:** Looming residential property price correction in view of rising rates and stretched affordability.
India	–	**Rationale:** Valuations still relatively expensive against regional peers amid slowing growth and rising inflation. Forward earnings expectations still overly optimistic against a challenging macro backdrop (higher oil prices, muted private capex recovery and ongoing liquidity crunch). **Risks:** Strong INR with further upside if the USD or oil prices retreat, and with any positive foreign fund flows
Indonesia	+	**Rationale:** Proactive tightening monetary policy and introduction of new hedging tools will reduce IDR volatility. Broad-based consumption recovery in 2018 to continue into 2019 as the government increases subsidies and spending with the 2019 budget. **Risks:** Sharp slowdown in the domestic economy, higher oil prices and/or IDR weakness.
Malaysia	–	**Rationale:** Valuations look fair amid a tough economic growth backdrop. Slowdown in export momentum and moderating Chinese growth. Higher deficit expected. Malaysian government's institutional reform and fiscal consolidation policy initiatives to weigh on economic growth and corporate earnings. **Risks:** A sharp spike in oil prices could strengthen MYR and boost the market.
Philippines	–	**Rationale:** Inflation will normalise from a temporary suspension of a fuel tax hike. However, an aggressive infrastructure roll-out, persistent current account deficit and deterioration of fiscal balances remain. **Risks:** Continued healthy domestic demand. A reversal in USD strength could support the peso and the market.

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Country Allocation	View	Notes
Singapore	+	**Rationale:** Earnings outlook is improving, led by stabilising property market and better banks' profitability (rising net interest margins and falling credit costs). Valuation is attractive with government fiscal flexibility to support growth. **Risks:** Adverse slowdown in GDP due to US-China trade war, quicker Fed rate hikes.
South Korea	■	**Rationale:** Valuations are compelling, however subdued growth and downside risks from ongoing adjustment in the technology semiconductor cycle are likely to contain any potential upside. **Risks:** Prolonged slump in memory chip prices, weak capital expenditure investment spending due to US-China trade issues, subdued private consumption due to delays in fiscal spending.
Taiwan	-	**Rationale:** Further downward earnings revisions due to disappointing new smartphone launches. Vulnerable to potential supply-chain disruption from an escalation in US-China trade tensions. **Risks:** Stronger than expected recovery in smartphone sales.
Thailand	-	**Rationale:** GDP growth momentum slowing, lower oil prices could lead to downwards earnings revisions for the sector. A wildcard could be the general elections in 2019. Inflation remains benign and may hinder the rate hiking cycle. **Risks:** Strong regional exports, elevated oil price, government infrastructure investments materialising as planned.

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

Summary

Asia's growth is expected to trend down with a slowdown in exports and investment momentum. Whilst Asian countries stand to benefit from a potential fading of US dollar strength, Asian market performance and corporate profitability will continue to be impeded by softening China economic activity, slower semiconductor demand and a pullback in capital expenditure (capex) due to trade uncertainties between the US and China. Despite the current trade truce made at the G20 summit, the rift between both sides is unlikely to be fully resolved with tough negotiations ahead and tensions likely to persist.

Asian equity market valuations have turned compelling, and are trading near one standard deviation below their 18-year historical mean (on price-to-earnings and price-to-book ratios), and at an attractive discount to global markets. However, negative investor sentiment is likely to remain in the absence of a de-escalation to the US-China trade war. We are more cautious in this current environment and favour defensive sectors. Hence, we retain our preference for quality blue chips and high-dividend yielders.

South East Asia offers a more compelling story compared to North Asia. The key upside risks to our cautious view include a sharp reversal in US dollar strength, inflows into Asia and a full resolution to trade issues between the US and China.

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Sector Allocation	View	Notes
Developed Market (DM)	–	**Rationale:** Macroeconomic fundamentals should remain supported and bond yields should head higher. Although the outlook for corporate credits remains robust, forward guidance is becoming increasingly testy. **Risks:** Event risks have the potential to disrupt the cogwheels of the global economy.
DM Government	–	**Rationale:** Europe and Japan are long overdue for normalisation of monetary policy. While the Fed has shown signs of hesitation with regards to its hiking path, we expect an eventual ascent towards neutral rates in 2019. **Risks:** Risk aversion could see demand for DM sovereign bonds spike higher should any of the aforementioned risks blow up.
DM Credit	–	**Rationale:** US earnings growth should remain robust which provides support for US credit fundamentals. Global backdrop and technicals are still generally supportive of US investment grade credits. **Risks:** Corporate leverage remains a concern while merger and acquisition activity will continue into 2019, albeit at a slower pace. European Central Bank (ECB) monetary tightening in 2019 could put pressure on credit spreads.
Emerging Market (EM)	■	**Rationale:** EM growth will likely moderate amid tighter US financial conditions and global quantitative easing. Growth indicators, such as consumer confidence and business sentiment show signs of plateauing. **Risks:** Faster pace of US monetary tightening and protectionist measures, rapid FX depreciation, Chinese deleveraging, inflation surprises, and geopolitical risks.
EM Government	■	**Rationale:** Generally a more balanced policy tone from EM. With the exception of Turkey, most countries have deployed both monetary tools (currency depreciation, rates) and fiscal tools (subsidy cuts, value-added-taxes) to improve their imbalances. However, tighter global financial conditions will likely keep upward surprises to GDP growth contained. **Risks:** Sensitivity to sharp commodity price declines and/or sharply higher USD funding costs and rapid FX depreciation. Risks such as an escalating trade war, geopolitical and political events would particularly impact manufacturing exporters negatively.
EM Corporate	■	**Rationale:** Overall, EM corporate credit is trading fair to EM sovereigns and quasi-sovereigns. **Risks:** Protectionist US trade policies, EM political risks, geopolitical risks. A potential recovery in the capital expenditure or mergers and acquisitions cycle would be cash flow negative.

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Sector Allocation	View	Notes
EM Local Currency	–	**Rationale:** While lower oil prices indicate fewer headwinds for the asset class, it is hard to see any tailwinds on the horizon. **Risks:** EM local currency could rally if oil prices or the USD plummets downward.
Duration	■	**Rationale:** While we are still biased towards long duration in the US, the trade does not look too attractive from a risk to reward point of view. Meanwhile, longer end rates should rise in Europe/Japan. **Risks:** ECB and BOJ could delay their long overdue normalisation policy.
Yield Curve	■	**Rationale:** Structural flattening of the yield curve should continue in the US in 2019. On the other hand, European rates have been depressed for too long on the long end, and we expect a reversal in 2019. **Risks:** Should the terminal rate in the US be raised again, we could see an extension to the hiking cycle. On the other hand, more political tumult from Italy could see investors pricing in a lower terminal rate for the ECB.

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

Summary

Although global uncertainty remains elevated (Mueller investigation, trade war, Brexit, Italian budget), headwinds on EM assets should dissipate with lower oil and a weaker dollar cross index (DXY). However, this does not mean that the asset class will encounter tailwinds.

While we expect the yield curve to structurally flatten in 2019, current spreads between 2-year and 10-year US Treasury yields do not look too attractive from a risk to reward perspective. Rather, we would wait for dips to long duration.

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Regional Allocation	View	Notes
Latin America	■	**Rationale:** Expectation of a moderate pace of growth in 2019 led by improvement in investment sentiment towards Brazil. We believe macro fundamentals in the region are still solid but remain mindful of the policy uncertainty, especially from Mexico. Stronger external balance sheet and somewhat better starting point on inflation should help Latin American countries better absorb uncertainties. **Risks:** Policy direction could shift, raising medium-term risks to growth.
CIS/EE*	■	**Rationale:** Aside from potential US sanction risks, Russia's external vulnerability remains low given its conservative central bank, a fiscal rule and twin surpluses. In Turkey, external balances are likely to improve after a sharp depreciation of its currency in August. The current account balance has turned positive, and the external gap looks set to shrink going into 2019. In Poland, growth is projected to increase while the fiscal outlook will remain positive, buoyed by robust economic growth and a tighter tax system. **Risks:** Risk of further sanctions on Russia. Liquidity and solvency risk from Turkish banks.
Middle East/Africa	+	**Rationale:** Economic conditions in the Africa region will likely moderate with weakening commodity prices acting as a detractor to economic growth. Meanwhile, we are constructive on countries in the Gulf Cooperation Council given their pegged currencies and limited exposure to trade wars, in addition to a still-healthy oil price backdrop. **Risks:** Weakening oil prices would adversely impact fiscal budgets. However Middle Eastern sovereigns have the lowest debt to GDP ratios and strong access to capital markets.
Asia	■	**Rationale:** Modest growth remains a support for credit assets. Increased attractiveness of bond valuations alongside an explicit easing stance from Chinese authorities will likely deter any massive sell-off. Steady pacing of new issuances also helped to ensure smooth digestion in the market. **Risks:** Any sharp escalation of global trade tussles may lead to an increase in corporate funding costs and undue pressures on certain industries. Further weaknesses in Asian currencies will add to woes.
Singapore	+	**Rationale:** Growth outlook remains on a steady growth path while a strong SGD should mean that Singapore bonds should remain attractive. **Risks:** With trade conflicts still unresolved, any escalation of risks could derail the economy.

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

* Commonwealth of Independent States and Central and Eastern Europe

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FX Allocation	View	Notes
US Dollar **US$**	-	**Rationale:** It is very likely that the Fed will stop its hiking cycle in 2019 while ECB and BOJ are likely to commence long delayed normalisation plans. **Risks:** Demand will surge with a selloff in EM.
Euro **€**	+	**Rationale:** Despite some softening in data, ECB normalisation of monetary policy is long overdue and the central bank cannot afford to put it off for much longer. **Risks:** Populism policies from Italy could be a problem, especially if it spreads to other European nations.
Japanese Yen **¥**	+	**Rationale:** The BOJ should continue with its stealth tapering and normalisation of monetary policy in 2019, despite claims otherwise. **Risks:** With onshore returns depressed for so long, appetite for risk could see the JPY liquidated for higher yielders.
Singapore Dollar **S$**	++	**Rationale:** The Monetary Authority of Singapore is expected to raise the slope of the nominal effective exchange rate in April 2019. **Risks:** A renewed escalation to the US-China trade rhetoric could trigger another SGD sell-off.
China Renminbi **CNY**	-	**Rationale:** Technical charts do not show a clear bias for CNY strength. **Risks:** Should trade tensions escalate further, CNY could depreciate further than expected.

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

Summary

There are little reasons to support US dollar strength for 2019. The Fed is likely to pause or stop its hiking cycle, while other central banks are expected to normalise policy, albeit later in the year. This should lend support to other major currencies.

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Sector Allocation	View	Notes
Commodities	–	**Rationale:** Moderating global growth, weakening China PMIs, strong USD trends and trade wars are all providing a cautious backdrop to the global commodity outlook. Most commodities were fairly stable in 4Q19, however, oil which had previously been the strongest performing commodity, declined significantly. **Risks:** Some of the overhangs such as the liquidity tightening from the Fed and any rally to the USD could lead to commodity rallies. The demand backdrop in an environment of trade conflicts implies continued price risks for most commodities.
Gold	+	**Rationale:** Strong gold performance relative to most asset classes in 4Q18 could continue if the Fed pauses in early 2019. Rising volatility improves golds use as a flight to safety asset. Rising real rates have been the key headwind for gold. **Risks:** Inflation expectations in markets around the world have been declining as oil prices have dropped which could lead to lower demand from investors using gold as an inflation hedge.
Base Metals	■	**Rationale:** After a weak 2Q18, most base metal prices remained stable in 2H18. But weaker China PMIs and increasing risks around global trade weigh on the outlook. **Risks:** Trade wars could significantly disrupt supply chains and weaken demand for metals that are tied to industrial growth.
Bulk Commodities	■	**Rationale:** Bulk commodities have largely defied the trade concerns and remain positive for the year. China supply-side reforms have supported the trade sensitive sector. **Risks:** China PMI softness and the potential for residential housing to slow could undermine bulk commodity resilience.
Energy	■	**Rationale:** Oil prices have declined on US waivers to China and India on Iran sanctions, US shale production, lack of OPEC cohesion and potentially slower global growth. **Risks:** US waivers on Iran could prove temporary and US shale production could slow with prices closer to the breakeven levels at US$52. Global oversupply is not significant compared to the 2015 oversupply that led to sharp oil weakness.
Agriculture	–	**Rationale:** Agriculture prices have been mixed in 2018 as moderate weather boosted supply and trade wars hit certain sectors. Overall demand remained healthy to keep prices relatively stable. **Risks:** Several key agriculture products have been caught in the growing trade war and prices have largely suffered as a result.

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

Summary

Trade tensions between the US and China are putting export commodities in jeopardy while moderating purchasing managers' index (PMI) data lends weak support to demand strength.

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Alternatives

Sector Allocation	View	Notes
Hedge Funds	++	**Rationale:** Rising interest rates, US-China geopolitics, trade wars and peaking growth are cause for concern. On the other hand, valuations are getting quite attractive and much of the negative news is already well digested by the market. Therefore volatility should continue. This may benefit absolute return strategies which are able to adjust their levels of exposure and fundamental focused strategies that are hedged. **Risks:** Asset markets may rally due to the resolution of these concerns which may lessen the attractiveness of hedged strategies.
Private Equity	+	**Rationale:** Enhanced diversification to a portfolio of traditional assets and superior return opportunities at reduced volatility makes private equity an attractive opportunity in the current volatile environment. **Risks:** Valuations are not cheap after a prolonged period of inflows amid abundant liquidity although this is in the process of correcting.

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

Summary

Alternative investments are seeing a boon, as investors look for protection and returns, triggered by rising interest rates, rising geopolitical risks and concerns about peaking growth.

Hedge funds have proven to be able to provide protection in periods of volatility in Asia while private equity continues to provide access to high growth businesses, superior yields and returns from active operational restructuring and improvements.

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