

“Although FX markets leaned on the euro’s side, we stick to our view that speculation on an early normalisation of ECB monetary policy is premature. Furthermore, with stronger inflation ahead, Fed funds rate hikes are likely to continue.”

- Julius Baer

Review

September was another month in which political risks were centre-stage: US-N.Korea 'war of words'; the German election; UK PM May's apparent compromise offer to the EU; Abe's call for a snap election next month. Whilst N.Korea's missiles and invective resulted in a short-term spike in volatility, markets mostly digested it and moved higher. The German election was taken negatively for EU cohesion as perceived, as limiting the further integration reforms that Macron is championing. The EURO fell sharply; STOXX, though, rose. The surprise in Japan was that the Democratic Party of Japan disbanded, with many of its MPs joining Tokyo Governor Koike's new (and 'extreme rightist', says CLSA) Party of Hope, and providing a far more serious challenge to Abe and LDP than initially assumed with potential consequences for Abe-nomics, JPY & NIKKEI.

September proved in the end to be a risk-on month. That said, market leadership may be passing from EM to DM, and from 'growth' assets to 'value'. Equities mostly rallied, with SPX again reaching multiple record highs on optimism around tax reform. Earlier this had almost been written-off, but lately it has helped catalyse a rotation into reflation trades.

STOXX rose on a weaker EURO to 2M-highs. EM/AXJ equities underperformed DM equities for the first time this year. MSCI EM fell -1.4% following the FOMC meeting, which had been taken as 'hawkish'.

FI boomed on weaker macro data, but then sold-off again. Specifically, the yield on 10-year USTs fell to a YTD low of 2.06% before rising to technical resistance (the 200DMA at 2.35%). The two-year yield was close to 1.5%, its highest level since 2008.

The USD (DXY) bounced off 3Y lows, having fallen below 92, to recover above technically important support at 92.80. CNY fell more than 3% from on the back of appears to be an inflection point in PBOC's FX policy.

Oil jumped to a 26m-high, peaking at just below \$60/bbl, before easing off a little. Gold, moving inversely to UST yields, fell back sharply from YTD highs at \$1,360/Oz to key support at \$1,280/Oz.

Outlook

THE REFLATION TRADE IS BACK ON. There are signs that a ‘reflation’ trade is once again upon us. The dollar has bounced off its lows. UST yields have risen by close to 30bps on 10Y; 2Y Treasury yields are at post-GFC highs. ‘Value’ sectors such as Financials, SMEs, Energy & Mining are out-performing ‘growth’ sectors such as IT in the last few weeks.

We have had a reflation rotation in each of the past 2 years – notably the huge rally after last year’s US election. A key differentiation this time is that the recovery in global economic growth is synchronised for the first time since 2007. Another is that Fed is not the only DM central bank tightening and looking to reduce QE. In other words, a back drop to the cyclical reflation to deflation rotation is a growing likelihood of ‘normalisation’ in monetary policy globally (Japan being the exception).



Historically ‘normalisation’ favours ‘value’ and is often linked to higher-than average-volatility. There is growing evidence that headwinds on growth and inflation from the ravages of GFC (the worst household ‘recession’ since 1929-’33) are morphing into tailwinds. US tax reform is inflationary as it implies a significant increase in US budget account deficits going forward, meaning more debt and possibly some crowding out. It’s also supportive of ‘value’ sectors with far higher effective tax rates (for example, the SPX energy sector’s ETR is 38%, compared with IT at under 23% and a proposed 20% rate). The question is what might we do in terms of sector weightings about this and what the signs to watch for might be.

HOW TO PLAY THE REFLATION TRADE: In today’s algo-driven world of momentum investing and ETF-mania, the rotations from deflation/‘growth’ sectors to reflation/‘value’ sectors are often violent and rapid. In many cases, you either need to be positioned ahead of the ‘rotation’ or act fast to surf it. Our emphasis is on being positioned ahead of such trades or, better still, taking a 1-3Y view of the underlying secular trend, and sticking to our view of it independent of volatility spikes.

The most obvious steps are to reduce USTs, go overweight equities & have a pronounced ‘value’ bias by adding to Energy and Financials, going underweight on EM and overweight on NIKKEI & STOXX. In the US, rotate sector weightings to a hefty value bias, and a greater SME weighting. IT might be more vulnerable now given rising fundamental risks. Adding to Energy exposure makes sense here, given its underperformance YTD. It is a key ‘value’ sector, and there has been fundamental improvement: ‘big oil’ has lowered its integrated breakeven cost from near \$60/bbl to \$35/bbl.

US Equities - Review

SPX saw solid gains after insipid returns in August. The SPX, DOW, NASDAQ and Russell SME 2,000 indices all touched record highs; SPX breached the psychologically important 2,500 hurdle. Optimism on tax reform was a primary driver, as a 15 percentage point cut in corporate taxes (to 20%) would theoretically boost SPX EPS FY18 by around 15% - especially bullish for higher tax paying sectors as Energy & Financials.



As we had seen in Q4CY16, there was a sizeable rotation into 'reflation' trades. Energy, Financials, Industrials and Smaller Caps all outperformed sharply whilst IT was mixed and other 'growth' sectors underperformed along with bond proxies.

Macro data were mixed: weak housing, retail spending and PCE data stood in counterpoint to cycle-high manufacturing (PMI) data and solid consumer surveys. Hurricanes likely distorted the data on the consumption side. Separately, Q2 GDP data was upgraded,

A key focus was the FOMC meeting, which markets interpreted as hawkish. Yellen reaffirmed that the Fed would continue to 'gradually' raise rates. There was only a modest change to its 'dots' plots.

US Equities- Outlook

Amongst the key drivers going forward will be political developments around tax cuts. There remain significant questions to be resolved on how they might be funded and when they might happen. Our view is some form of tax cuts will gather bipartisan support, with a 50% chance of passage in the next three to six months.

Q3 results will also be a factor for investors. We see these as likely constructive: consensus forecast is modest at +4.5% YoY, making yet another 'beat' probable.

Indications are that the GOP leadership and White house staff have reached some deal around a \$1.5trn deficit spend. Views are mixed as to whether this is more a short term 'sugar rush' or a more sustained boost to GDP.

Q3 GDP will likely be hit by the hurricanes, perhaps by 60-70bp. Much will be recovered in Q4. Most activity leading indicators are constructive whilst weaker housing is more a headwind from a lack of supply. We are with the Fed view tepid inflation is 'transitory'.

EU Equities – Review

STOXX recovered last month, helped by a peak in the Euro. Its retreat after German election results led to STOXX hitting two-month highs. FTSE 100 was more mixed; GBP was strong earlier in the month, after ‘hawkish’ BOE comments, but eased back later. Macro data also disappointed, and Conservatives’ position on BREXIT negotiations remains confused.

Robust macro data took a back seat to politics, with the German election result a key focus. The poor showing by SPD and decision to go into opposition means Merkel’s coalition will likely include the FDP. This latter is opposed to immigration, and to further EU integration. Markets interpreted events as slowing prospects of a full fiscal and monetary Union. The strong showing by AfD strengthens the view that populism in the EU has not been defeated. Polls in Italy, showing anti-Euro parties with a collective majority, reinforce this point. Macron has impressed with his EU vision, but his ability to change France’s archaic labour laws matters more now.

Markets have basically ignored the Catalan crisis. That said, the situation is almost an impossible one for Rajoy and Spanish nationalists. There is a risk this will turn into a much longer-running problem. Sadly, it highlights the decision by the Courts to overturn the well-crafted autonomy agreement with Catalonia in 2010. The heavy-handedness of Madrid risks pushing a majority of Catalans to support independence now, where previous polls suggested that separatists were in the minority at around 40% of voters

EU Equities – Outlook

STOXX is seeking to break out above 400. Much will depend on whether the Euro falls further from here. In the short term it is hard to see what the catalysts might be, but the ECB meeting this month could be a lively one, at which it might announce QE tapering. Whether Draghi can achieve a ‘dovish’ tapering, which is likely what ECB wants, is a key question. Several strategists have moved DAX to overweight on the basis of a weaker Euro. As well, stronger global GDP growth will help this export-gear market. But it’s worth noting in passing that Q3 results may have been impacted by the stronger Euro.

Politically, things remain dour. It may take a few months for Merkel to form a coalition government. BREXIT negotiations may remain stalled in substance until next year. Italy has to hold its election by May ’18 (likely Q1CY18). The Catalan crisis may rumble on, with the after-effects of Police violence making an agreement harder

APAC AND EM Equities – Review

Nikkei 225 regained the important 20,000 level, but has not moved much beyond. Abe’s gamble on a snap election, after his popularity was given a boost by North Korean tensions, initially was welcomed by investors. However, disbanding of the DJP gives the extreme-right Party of Hope a national infrastructure and a genuine chance of wounding the LDP, and this has made investors warier. Separately, BOJ remains accommodative.

EM/AXJ equities saw strong inflows last month. However, there was an portentous inflection point following the FOMC meeting, as around \$2bn of foreign outflows led to the first major such sell-off for several months. ASEAN markets saw sizeable outflows. JCI has had net outflows of close to \$1bn YTD. KLCI saw M\$1BN of outflows last week. The exception is Thailand, as SET saw inflows. KOSPI was understandably volatile around North. Korean developments, but ultimately investors proved resilient.

PRC A-shares delivered 18% YoY earnings growth. If banks and oil companies are excluded, growth was +36%. Contrary to forecasts, the latest PMI data beat forecasts. The important PPI number moved up; this is an important leading indicator for profits growth. In markets, an unexpected further crackdown on residential property saw this sub-sector come off hard. An equally unexpected move by PBOC to cut banks' reserve rate requirement boosted PRC banks' shares.

APAC AND EM Equities – Outlook

Nikkei and JPY face considerable uncertainty due to the snap election, probably on 22nd Oct. If the LDP were to lose more than 50 seats, Abe might not survive. If he goes, so, too, might Abenomics and the weak-JPY policy. Perhaps not, though: most of Abe's most likely successors hold similar views on strategy. Obscured in the political noise is that Nikkei is relatively cheap compared with other developed markets, even though it has the best global earnings YTD and arguably better governance. Foreign investors are also still very underweight Nikkei

Historically EM/AXJ markets suffer in a deflation trade. The risk is greater than usual this time, with MSCI AXJ up 30% YTD and out-performing DM for the first time since the 2008 crisis. A stronger USD could further erode returns in the USD-adjusted terms that global investors largely use. GS expects a short-term correction in EM and AXJ asset prices, but also sees longer-term support. A saving grace is that global allocators remain still very underweight AXJ & EM.



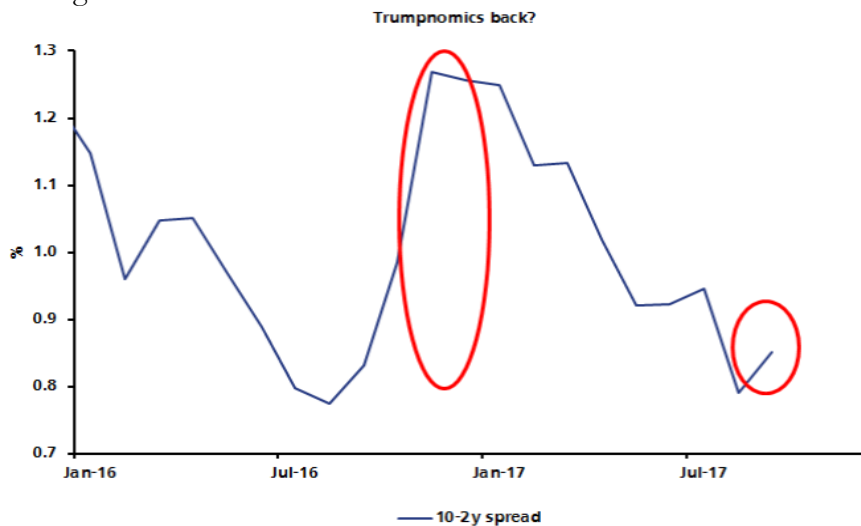
A key event for Greater China markets is the CCP's 19th Party Congress later this month. It is anticipated that Xi Jinping will consolidate power and, potentially, seek to remain at the top after a 2022 expected retirement. The key question is whether this will allow the PRC to embark of difficult structural reforms and to continue to deleverage.

FIXED INCOME – Review

After a strong rally early in the quarter, government bonds sold off in September, as markets started to take central bank tightening communications more seriously. UST yields rose sharply after the FOMC meeting, on the back of Trump’s tax plan and of hawkish remarks from Janet Yellen. Ten-year Treasury yields, rising for most of the month, are approaching the 200DMA at 2.34%. The yield curve is flattening as well, 2Y yields close to 1.5%, a post-GFC high. Fed Futures hike probabilities rose from a low of 23% at the beginning of the month for the September meeting, to over 70% now for the December meeting.

Bund yields continue to rise, albeit at a slower rate, and are just below 50bps technical resistance. However, some market participants see yields moving sideways from here, as the ECB has revised down its inflation projection. Tangentially, and unsurprisingly, Spain’s sovereign yield has risen following the Catalan crisis.

US IG spreads over USTs continue to tighten. This is likely on the back of potential tax reform in the US. The reasoning is that it could benefit companies’ bottom lines, and reduce their cost of debt, reducing the attractiveness of leverage.

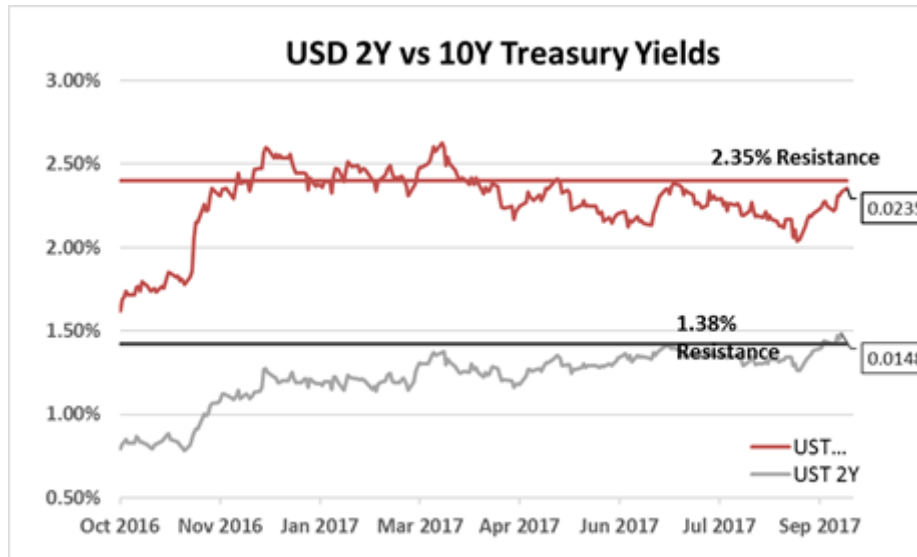


Source: Bloomberg

AXJ/EM FI saw yields rise after a bout of selling by investors last week. PRC real estate developers’ HY FI sold-off after PRC government came out with more property restrictions. This segment faces a substantial refinancing risk next year on longer maturities, and over 70% of their local CNY debt faces call optionality dangers.

FIXED INCOME – Outlook

FI strategists are polarised. Some expect yields to move sideways or down from here. These see the recent rise in yields providing an attractive opportunity to re-enter. Others are forecasting a return in inflation, precipitating higher yields. Much depends on whether the tepid inflation we've had this year is 'transitory' or more structural. Our base case is that the global economy is 'normalising', and that there are upside risks to inflation.



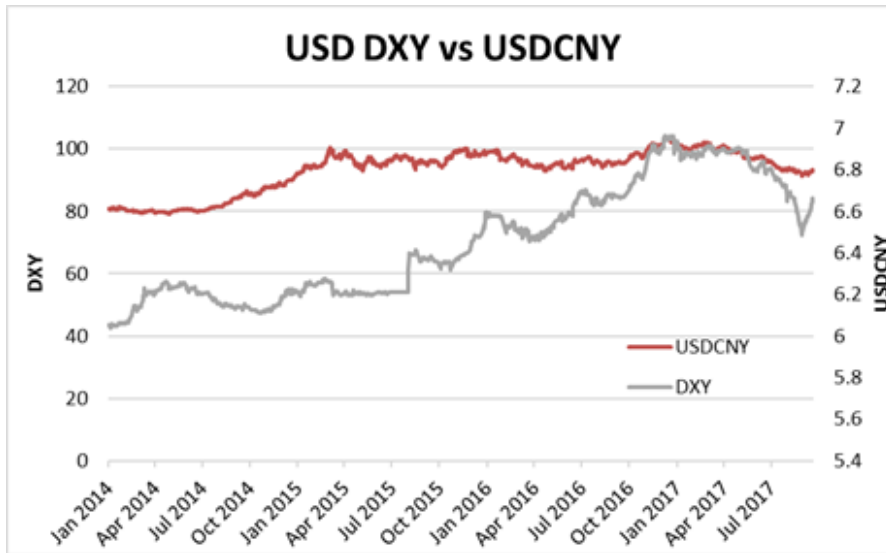
Whilst fundamentals may become more hostile for higher-quality FI, supply-demand dynamics are still supportive of lower yields. given the sheer amount of cash sitting idle, as well as the need to reinvest proceeds of maturing bonds. However, a study by BIS on Bunds notes that as yields fall, large insurers are compelled to buy ever more quality FI to meet liability demands, thus adding to pro-cyclical buying – and this may well reverse as yields rise. Likewise, a BOE study finds that the business pressures attending capital adequacy regulations in a falling-rate environment push large financial buyers to buy more high-quality bonds and reduce HY FI.

EM FI spreads are at levels rarely seen despite the build-up in credit since GFC. Accordingly, EM FI looks to be a dangerous asset class, should reflation impact push up UST yields. The risks are even greater given the huge inflows by FIIs since the crisis and especially this year. EM LCD FI could be especially vulnerable. Historically sell-offs are vicious in Indonesian, Korean and Indian FI, though the latter two have much-improved FI metrics. The impact may be limited by the ongoing 'hunt for yield', as well as by the inclusion of greater EM representation in FI indices (thus effectively requiring greater institutional holdings).

Reflation would likely help underpin sectors in HY such as Energy & Commodities. Countries with large exposures to these sectors should benefit generally as well. Higher commodity prices and weaker FX might help Brazil, Mexico and Russia, and allow their central banks to reduce interest rates.

FX – Review

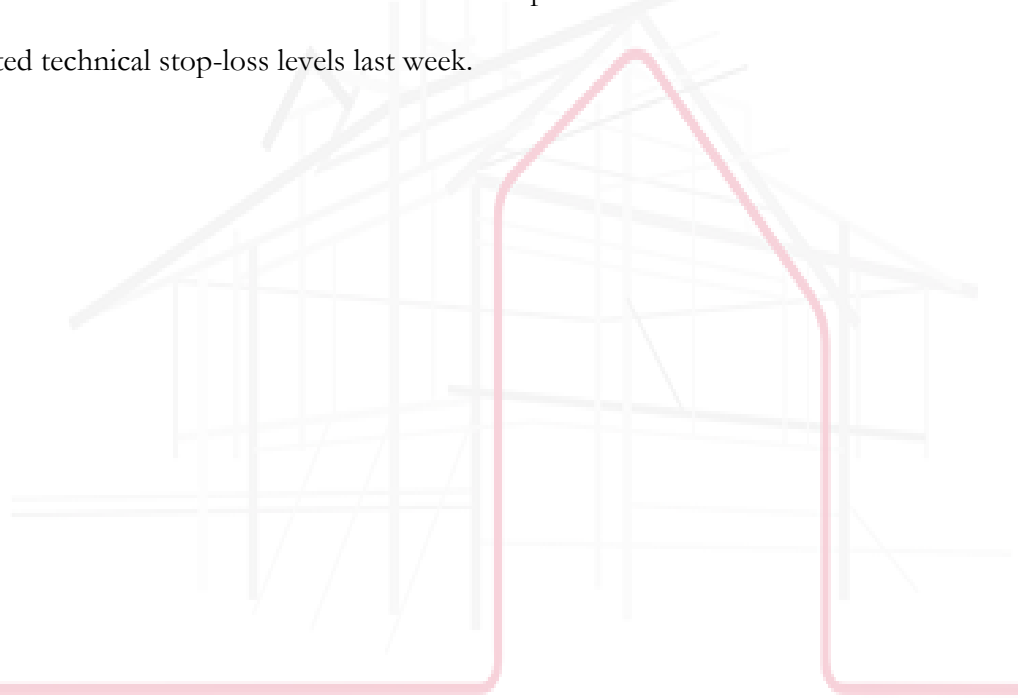
USD DXY tested the lows in its 3y trading range earlier in the month, but then recovered. A more ‘hawkish’ Fed perception, traction in Trump’s tax plan, the German election feeding concerns over reform optimism and Catalan crisis contributed. In addition, trading sentiment and positioning in USD was very bearish. The Euro retreated from 1.23 highs to test key support below 1.17. GBP pulled back from above 1.36 to test support at 1.3260 and JPY weakened from 108 to as low as 113.



The largest decline amongst major currencies was the CNY. The high-water mark came at 6.49 on 7 Sept, at which point the currency had strengthened more than 7% YTD against the dollar. At this point, PBOC was spurred to act, and eased capital controls in force for first time in 2y. It’s now off more than 2.4% from that point.

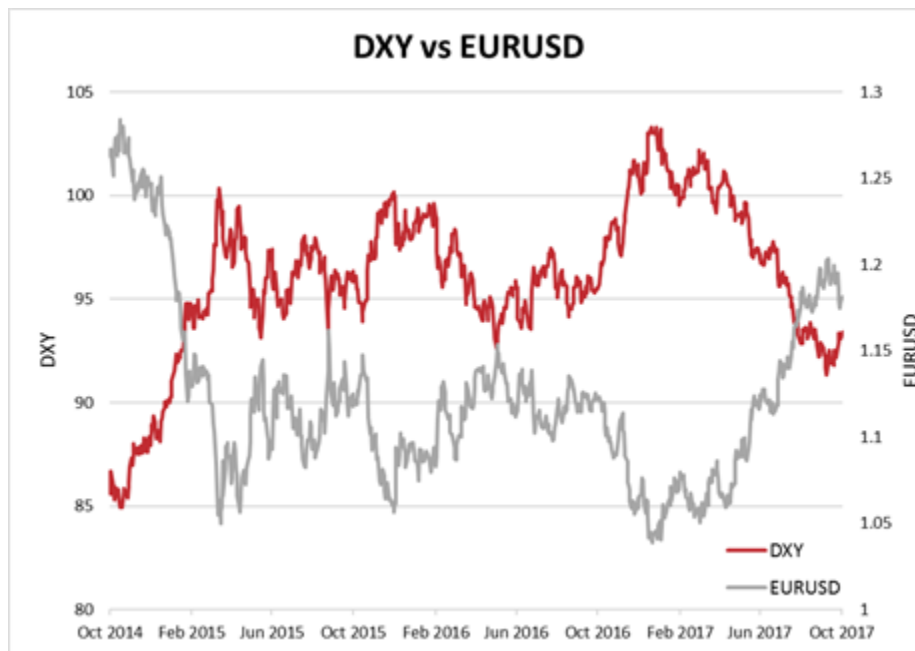
The SGD did not break below key support at 1.3350 earlier in the month and has subsequently weakened back to just below 1.36. However recent macro data has been much stronger than forecast; August’s industrial production came in at +19% YoY as semiconductor output soared.

Both INR and IDR tested technical stop-loss levels last week.



FX – Outlook

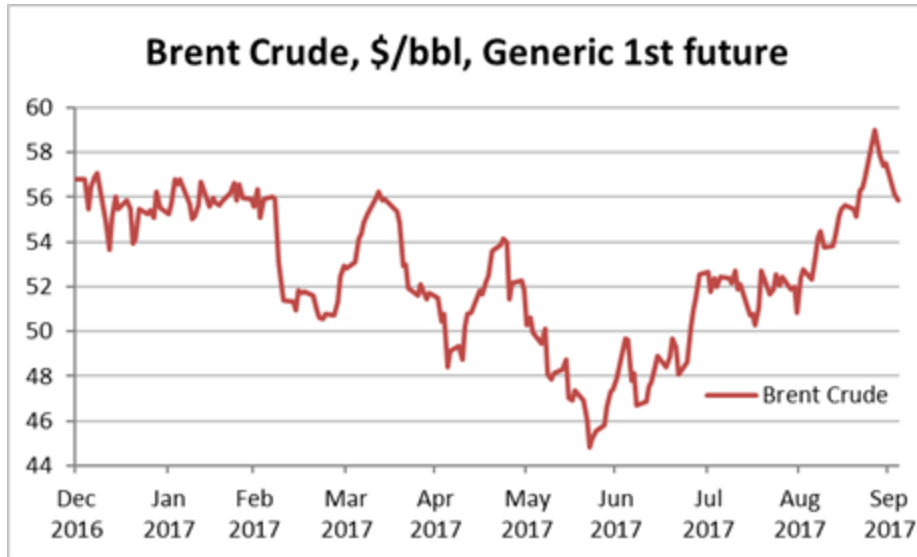
Our base case is for moderate USD strength and for DXY to mean-revert back towards the mid-point in its 3y range of 91-1.05 at 97 over the few months driven by further Fed hikes and continued more accommodative behaviour by ECB, BOE and BOJ. We also see several EM central banks – notably Brazil, Mexico and Russia – cutting interest rates as inflation eases-off. In the short-term currencies may move sideways with JPY potentially volatile around political developments in next 3 weeks to election day.



The main support for GBP is the recently more hawkish BOE but recent macro data have disappointed as latest Mfr. PMI shows, capex by companies is slowing sharply and inflation may have peaked whilst the Boris vs. May conflict over BREXIT illustrates Conservative party remains unable to present a united front for increasingly urgent negotiations. There is a real possibility the next policy signal by BOE might be more 'dovish'.

COMMODITIES – Review

A combination of stronger demand data and signs that OPEC might cap output helped drive oil price through the 18m trading range. Prices ran to nearly \$60/bbl, before settling at \$56 by month-end. Last month a number of strategists lifted their oil price forecasts for first time in over 6m. Reports have circulated that the larger integrated oil giants have slashed costs and capex massively. Breakeven costs have been driven down to \$35-40/bbl, meaning substantial profits and cash flows.



Gold moved inversely to UST yields to move from a YTD-high above \$1,360/Oz to test key support at \$1,280/Oz as political fears around N. Korea eased-off later in the month. Russia has continued to buy gold and accounted for almost 40% of all central banks' buying in Q2CY17.

COMMODITIES – Outlook

Our base case is a synchronised global recovery, which obviously is positive for oil demand. On the supply side, if OPEC can remain disciplined on production quotas, it will provide some additional support for the oil price. However, the 'swing' producer is the US shale oil industry. Oil at \$60 brings more marginal fields back online. It would also allow for many drilled, but not yet producing, wells to be quickly brought into action.

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