Watch Earnings and the Central Banks rather than politics

Macro Review

The month of October provided a number of political events: Abe's successful snap election; Xi Jinping's consolidation of power with no apparent heir, along with the newly formed standing committee in the 19th CCP Congress; and the resolution of the Catalan crisis that saw its President ousted by the Spanish government.

On the equities front, Abe's re-election was largely positive for the NIKKEI 225, which saw 16 consecutive sessions of gains - its longest-running streak. The success of the 19th Party Congress was also taken well by markets with the view that reforms and crackdown on corruption will continue to drive the world's second largest economy. In the US, we continue to see frequent fresh highs as market speculation of Trump's new Federal Reserve chairman, and passing of the budget resolution appears to have paved the way for tax reforms and or cuts. The next question is whether they will be phased-in and at what pace. The STOXX 600 index continues to benefit from a weaker Euro, a result of the ECB's decision to continue its asset purchasing programme through 2017, albeit at a slowing pace from January 2018.

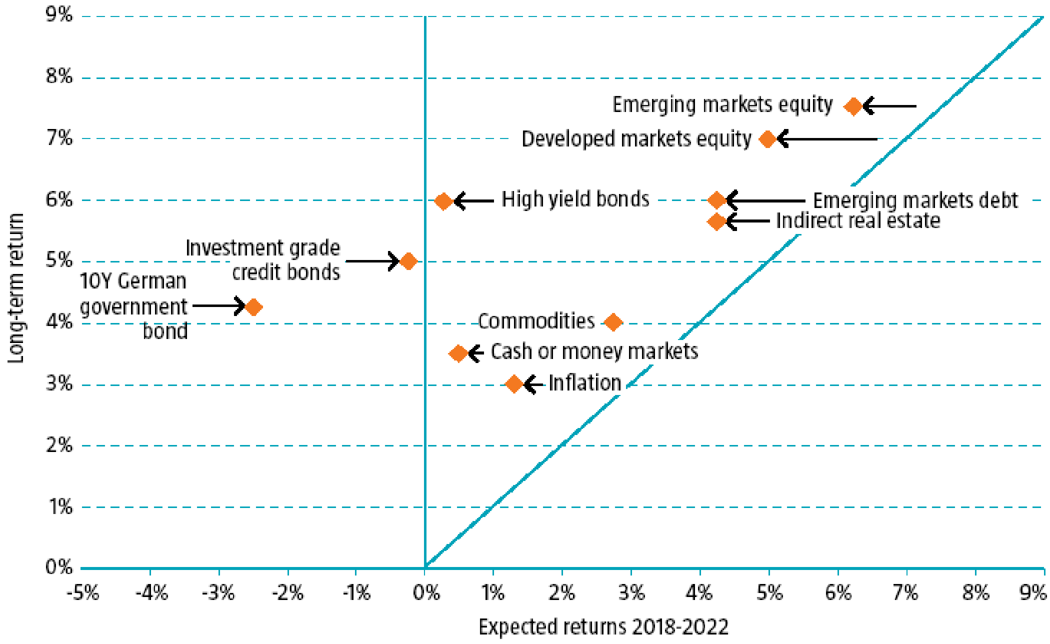
US Fixed Income for October was a mixed bag as unconvincing inflation data saw timely coupling with ongoing speculation of who the Fed chair mandate would be passed on to. Passing of the budget resolution underpinned US 10Y Treasury yields which hit a high of 2.46%, well above the 2.34% 200 day moving average mark. With the advance GDP for Q3 coming in at 3.0% vs estimates of 2.5%, it's not hard to see why markets have almost fully priced in a Dec rate hike. In Europe, the ECB appears to have successfully avoided a "taper tantrum" like the one in 2013, when the Fed announced scaling back asset purchases. The German 10y bond yield traded generally lower, within the 0.4% to 0.42% range. It is interesting to note that Yellen, in her speech, expressed a view that the Fed may potentially revisit its "unconventional" monetary policies in the future i.e. the option of QE during recessions remains on the table

The DXY continues to trend upwards to end the month at 94.55, not just following the series of U.S-related events but a weakened Euro on the back of ECB's announcement and the seemingly lowered tensions in the Catalan crisis. The JPY weakened to 113.73/dollar, driven by Abe's election and the softening of geopolitical risks within the Korean Peninsula. Risk-on markets have seen Gold trading below the 1,300/Oz. mark for most of October, despite earlier exceeding that price amidst geopolitical tensions in North Korea.

Macro Outlook

Many assets are looking expensive and history supports the view that this will limit future returns. Volatilities are also at low levels and there is growing concern that these may spike at some point. These realities suggest a more cautious outlook is required although it remains difficult to see an immediate catalyst which will cause a sharp correction. That said, the expected transition of Developed Market Central Banks from 'QE' to a gradually tighter position means that higher volatility is more probable. Riskier assets may suffer most if there were to be a sharp pick-up in volatility and thus we are gradually moving away from these. Alternative investments should offer the best risk-adjusted returns. Overall, portfolio diversification will be beneficial and reducing high yield holdings in favour of better credit quality will provide some protection.

Expected returns 2018-2022 and changes in five-year expected returns (arrows)

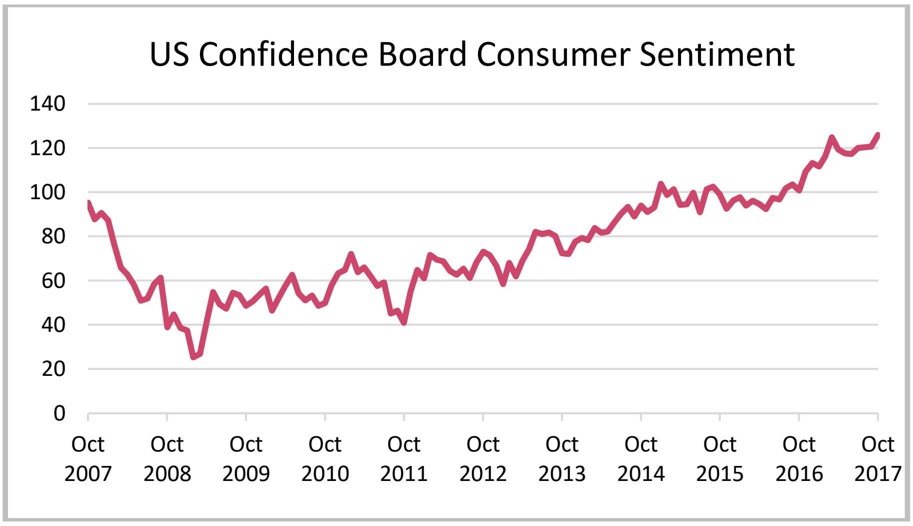


Source: Robeco. Arrows show the change in expectations from last year's estimates.

We note that ROBECO released their 5y USD-adjusted expected returns for the major asset classes last week and this makes for sober reading as they forecast much lower numbers than seen in the past with losses from JGBs and Bunds, 1.4% annualised returns from US Treasuries, 2% returns from US equities, 5-6% returns from equities led by EM equities. ROBECO expects volatility will rise and that we will get a mild recession at some point in the next 5 years that will impact risk assets significantly. Of course, all this remains to be seen but we certainly share the view that caution on riskier assets is more prudent.

US Equities - Review

- October was generally positive for all three benchmark indices, as investors mostly shrugged off concerns over damages in September hurricanes, to hit record highs driven mainly by a good earnings season with the IT sector notably reporting better-than-expected earnings. 63% of SPX reported Q3 results with many significantly beating expectations. The passing of the budget resolution, that potentially paved the way for further progression on tax reforms, boosted markets.
- We continued to see improving economic data. Fed Fund Futures put a December hike at over 80% probability. Consumer sentiment, wage growth, PPI and retail sales all registered month-on-month gains. Q3 GDP forecast came in at 3.0% vs estimates of 2.5%, despite concerns over the disruptive effect of the recent hurricanes.



Source: Bloomberg

US Equities- Outlook

- With a further 25% of SPX reporting this week, the total SPX Q3 results will be almost 90% complete. We will see investor focus switching to October Nonfarm Payrolls on Friday and to any unexpected rhetoric from today's FOMC meeting.
- The anticipated announcement of Jerome Powell as the next Fed Chairperson has occurred. Markets like this as he is seen as a 'continuity' candidate in-line with the dovish Yellen Fed era, but we see this a little differently – Powell is a centrist and he will, as will the Fed, be driven by the data.
- Another key driver will be the waxing and waning around tax cuts with latest news focusing-in on difficulties in reconciling GOP fiscal 'hawks' to a potential extra $1.5trn budget deficit over the next decade. Mnuchin believes tax reform may happen by YE17 but markets only slightly believe this.
- Special Counsel Mueller had three former Trump officials arrested over links to Russia's interference in the US election and the question markets will ask is whether Trump will be implicated directly. The investigation process will have to run its course and, whilst it is too early to predict the final outcome, it is likely that the Trump administration will be distracted and will likely have trouble pursuing its agenda.

EU Equities – Review

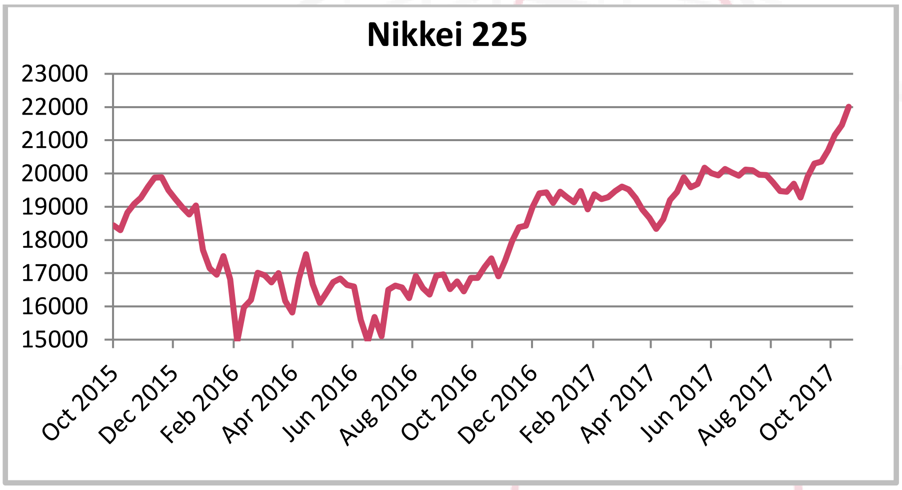
- STOXX 600 saw mixed results, reaching three-month highs but then falling after the release of disappointing Q3 earnings. It later regained ground to 395, attributable to ECB's dovish decision to reduce, but lengthen, their QE program. There was weakness in the EURO.
- FTSE 100 recovered towards the 7,500 level, on the back of a weaker GBP and solid Q3 results.
- EU macro data continued to surprise positively with a better expected Q3 GDP print and lower unemployment whilst the critical bank lending data also saw improvement.
- The Catalonian situation threatened to escalate. PM Rajoy moved quickly to impose Article 155; taking control over Catalonia; removing Puigdemont from office and ordering fresh regional elections scheduled for 21^{t} December. That led to a relief rally in the last week of 3% on IBEX based on the belief that Madrid has effectively limited the possible crisis, at least for now.

EU Equities – Outlook

- STOXX 600 remains correlated to the EURO and the latter's recent fall to test below 1.16 might have mostly priced-in shorter term heightened political risks after the Austrian and Czech elections saw populism gain ground and a 'dovish' ECB. The potential to punch through the key resistance level of 400 will require better Q3 earnings.
- FTSE 100 will track GBP and Q3 earnings. The BOE raised rates by 0.25% and left open some possibility for further increases. This was discounted by the market and might remove a support for GBP with developments on BREXIT taking over the running.
- Whilst GBP weakness has boosted FY17 earnings FY18, barring another GBP collapse, will likely only rise 7% limiting FTSE upside as investors turn towards 2018 outlook.

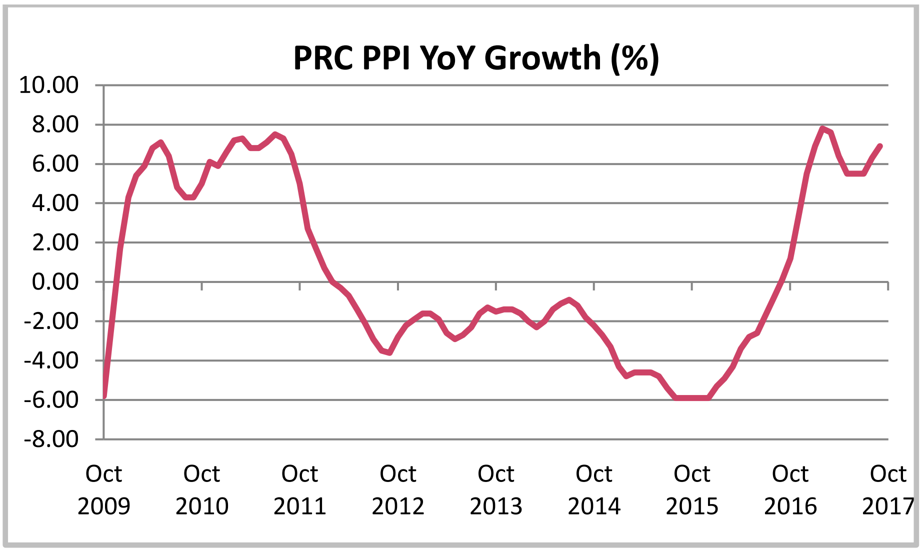
APAC AND EM Equities – Review

- Nikkei traded above the 20,000 level for the entire month, continuing upward momentum that saw the index registering consecutive gains for 16 sessions straight to a multi-year high. Abe's snap election gamble paid off as his LDP regained 2/3 majority and continuation of Abenomics and weak JPY policy.



Source: Bloomberg

- MSCI AXJ index rose another 3%, bringing YTD increase up to 32.9%, continuing its outperformance over DM with KOSPI +5% this month, as investors shrugged off tensions within the Korean Peninsula. ASEAN underperformed with JCI Index and SET Index gains of 1.7% and 1.8% respectively. India gained after the announcement of a $32bn PSU banks' recapitalisation plan as their feeble balance sheets are seen to be a key impediment to economic growth.



Source: Bloomberg

- A-Shares index hit a 22-month high of 3,578.21 after the CCP 19th Congress as Xi Jin Ping was seen to consolidate power. Markets have taken this to be positive as it gives Xi the ability to pass reforms without obstruction and leaves him well positioned to continue ruling China beyond 2022.

APAC AND EM Equities – Outlook

- Whilst foreign investors have poured money into Japanese equities last month after the election, they remain heavily underweight as do local retail investors. We remain positive that the Nikkei could outperform other DM equity markets into YE17 as we expect inflows to continue, JPY to weaken, and Q3 results to 'beat' consensus and so maintain the best earnings growth of any major DM equity market.
- A-Shares may consolidate after the rally into, and after, CCP Congress. 3,600 is an important resistance and chances are the PRC government may now start to deleverage and tighten liquidity, thus slowing GDP growth. However, Q3 results appear to be much stronger than Q2 and that that might offset some consolidation.
- India's equities could outperform after yet another example of Modi's ability to get reforms moving, as he focused on the problems in the PSU banks. This is one thing that is leading us to prefer Indian equities over PRC equities.
- ASEAN remains a laggard. Indonesian equities have seen net redemptions YTD by foreign investors but this has ceased and the macro picture is looking more encouraging.

FIXED INCOME – Review

- The month of October saw a fluctuation of UST yields with mixed reports on inflation and constant speculation of who the next Fed Chairperson will be. The 10Y sold-off, hitting a yield high of 2.47% at one point, but ended the month at 2.40% which was below the significant 200 day moving average as hopes rose that the "dovish" Powell would be appointed.
- Spreads remained 'tight' in credit globally in both IG and HY as investors continued to chase yield.
- Following ECB's decision to continue its asset purchase program, German 10Y Bund yields pushed lower to 36bps as Draghi also hinted that interest rates will remain at "present levels for an extended period of time" and well past the end of QE. The Catalan crisis boosted 'safe' haven demand too.
- In Asia, Q3 debt insurances amounted to US$67.8bn, an increase of 18.2% YoY. Pessimism developed in the CNY bond markets as China steps up its efforts to reduce leverage within the financial sector. BOJ maintained its monetary policy and yield curve control in its meeting yesterday as expected.

FIXED INCOME – Outlook

- Further rises in UST yields will require stronger growth and higher inflation to break above resistance at 2.40% on 10Y. The big question is whether 'dovish' FI markets are right in forecasting tepid inflation that supports the YTD flattening of the US yield curve as are signs inflation is rising – not least in PRC's important PPI data.
- Stronger global GDP growth; easing default fears; excess liquidity; ongoing global QE FI buying; and the lack of yield in sovereigns and IG are pushing HY spreads ever tighter and absolute yields ever lower. This might persist for longer but the HY asset class looks increasingly vulnerable to any unexpected 'shock'.
- We continue to prefer Senior Loans over HY FI and shorter duration over longer duration in FI. We see less risk in UST 2Y paper now if want to become more defensive.
- EM FI's higher yields, in a yield starved world, will continue to attract inflows until another risk-off correction blows through or we get a faster rise in USD or US rates. However underlying credit metrics for EM are improving, as trade picks up and commodity prices gain – not least oil – thus boosting current accounts and reducing FX risks.

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FX – Review

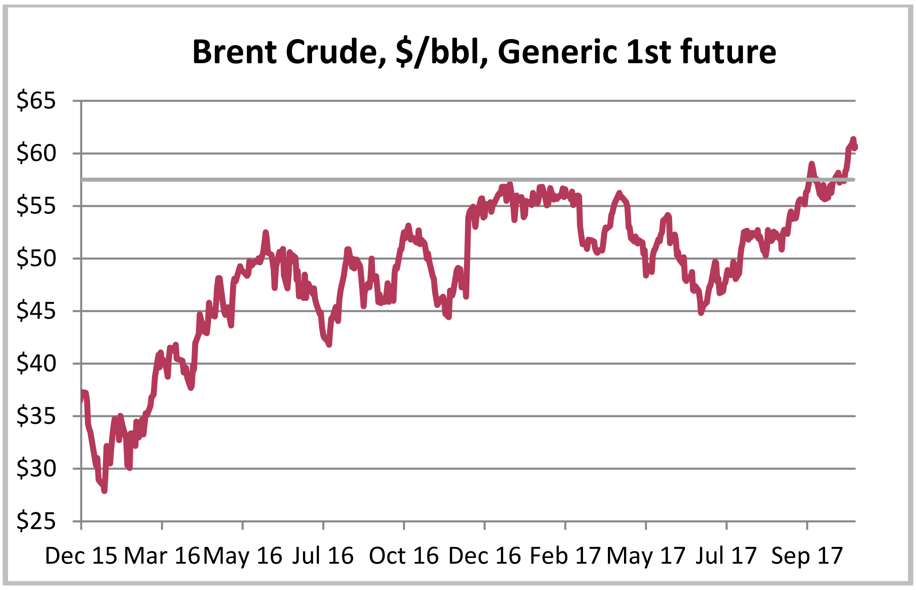
- The DXY rallied towards month-end, breaking resistance levels and reaching a 3-mth high at 95.03, before closing at 94.54 and its best month since February. The drivers included momentum around Trump's tax reform after Congress passed the US budget; Q3 growth of 3%; and a more 'dovish' ECB.
- ECB's decision to lengthen QE also contributed to the EUR breaking support levels and slump to 3mth lows, closing at 1.165. GBP closed lower last month amidst BREXIT uncertainty despite BOE's likely hike.
- JPY weakened through 114 to a three-month high after Abe's victory and from weaker than expected Japanese CPI.
- SGD also broke support levels and reached above 1.3660 despite stronger Q3 GDP as the Monetary Authority of Singapore October review was more 'dovish' than expected. Consensus is in the 1.38-1.40 range YE17.

Source: Bloomberg

FX – Outlook

- After quite sizeable USD gains vs. EURO, JPY and CNY last month, we think DXY might consolidate in the short term, as markets wait for further catalysts. US tax reforms face further hurdles whilst there remains a genuine risk Trump gets embroiled in Mueller's investigation.
- We doubt the appointment of Jerome Powell as new Fed Chair will alter US monetary policy as he is likely to watch and respond to the data. The more interesting development will be the other four appointees Trump can make to FOMC we think would make its composition more 'hawkish'.
- CNY forecasts YTD have been amusing to watch as consensus switched from expecting a much weaker outlook through 7.00 to 7.20 with some even at 7.50 at YE16 to now much more modest declines to 6.70 YE17 with several forecasting a stronger CNY from here vs. USD. We doubted the earlier much weaker CNY depreciation fears and maintain our view PBOC will seek a relatively stable CNY but that 6.50 is too strong.

COMMODITIES – Review



Source: Bloomberg

- Brent Oil broke firmly above the 2yr trading range of $45-55/bbl to reach $61/bbl, amid speculation that OPEC will agree, at its Nov. 30 meeting, to extend cuts to YE18 with support from Russia. Saudi's Crown Prince's backing of this extension built momentum as did forecasts of stronger global demand and falling commercial inventories.
- Gold prices briefly touched the $1,300/Oz mark in early October on rising North Korean tension. Moving inversely to DXY it retreated to $1270/Oz as geopolitical tensions eased and investors adopted a more "risk-on" stance.

COMMODITIES – Outlook

- Forecasting the oil price makes a mockery of consensus most of the time. However we have added Energy exposure through buying equity of the large, integrated oil companies ('IOCs') as we see the oil price supported above $50/bbl whilst the IOCs have substantially reduced their breakeven cost below $50/bbl.
- Gold has remained supported above the key support around $1,270-80/Oz despite a risk-on mood caused by better global GDP growth and robust global Q3 earnings. We continue to see the merits of holding Gold in portfolios for diversification and as a 'tail-risk' safe haven asset but, for shorter term horizons, we think it may weaken towards $1,250/Oz or lower by YE17.

For more information, please contact your Crossinvest advisor or email us at <cross-insight@crossinvest.com.sg>.