



# What's next for the reflation theme?

### Investment Strategy

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# Investment Strategy

The “reflation theme” dominated investment trends at the end of 2016 and for the first quarter of 2017. We had highlighted in our investment strategy last quarter that reflation was the underlying driver of our view to be overweight on equities and be underweight on fixed income. For 2Q 2017, we continue to believe that the theme will dominate the investment landscape.

In 2016, we had highlighted that inflation trends around the world had stalled and that market pricing of long term inflation expectations had collapsed to historical lows. As growth and inflation picked up at the end of the year, we argued that this pickup was particularly important for asset allocation decisions. Without inflation, the investment cycle and the “investment clock” theory are stalled. In the absence of an investment clock, there is no need to tactically shift asset classes – history demonstrates that in a deflationary period or with low inflation, investing in fixed income is preferred.

This reflation will likely lead to a normalisation of interest rate policy by central banks in general including the US Federal Reserve (Fed). As rates are normalised and growth improves, then equities will likely be in favour relative to fixed income investments. Better growth supports corporate earnings prospects and supports equity valuations, while rising rates have hurt fixed income valuations.

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# Global Asset Allocation

Sector Allocation	View	Notes
 Equities	+	<p><b>Rationale:</b> Strong trends in leading indicators implying an improving outlook for global growth and corporate earnings. Policies such as infrastructure spending and tax cuts could further stimulate growth.</p> <p><b>Risks:</b> Significant policy uncertainty in the US as well as political uncertainty in Europe. Protectionism and the prospect of trade wars could dampen growth prospects.</p>
 Fixed Income	-	<p><b>Rationale:</b> Interest rates are rising and growth is picking up which pushes bond yields higher. We prefer corporate credits over government bonds.</p> <p><b>Risks:</b> Rates are expected to rise gradually in 2017. Growth may accelerate and result in faster rate hikes than expected while a soft patch in growth will delay hikes.</p>
 Commodities	+	<p><b>Rationale:</b> Reflation and stronger growth are supportive of commodity prices. In particular stronger growth in China pushes commodity demand higher.</p> <p><b>Risks:</b> A strong USD and potential protectionist trade policies could undermine strength in commodities correction.</p>
 Cash	-	<p><b>Rationale:</b> We are underweight on cash in a pro-growth environment that should lead to strong returns in equities and commodities.</p> <p><b>Risks:</b> Any correction, even a temporary one, would benefit investors who have extra cash for deployment.</p>

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

## Summary

Leading indicators are pointing to better growth, and rising inflation is driving the Fed to target multiple rate hikes in 2017. A stronger growth rate supports better corporate profits which in turn supports better equity prices while rising rates imply a weaker fixed income outlook. We thus maintain an overweight position in equities and continue to be underweight on fixed income as we expect the reflation theme to continue further into 2017.

Risks to our outlook include political risks from Europe - French and German elections could signal weakness of political unity threatening the very core of Europe. Additionally, the US appears to be leading global growth and further fiscal support is expected, however political leadership may disappoint in delivering new policies. US policies in Asia remain uncertain over trade with China and North Korea.

# Global Investment Strategy

## What's next for the reflation theme?

The reflation theme had gained traction following the US election in November. It rested on the premise that economic trends were improving throughout the second half of 2016 alongside additional fiscal policy support from a Republican controlled Congress and Presidency. So far, the economic indicators are better than expected, however, increased uncertainty regarding policy support remains in the background.

There are several bullish macroeconomic trends that provide a solid backdrop to our investment views. The strongest trends are in leading indicators, confidence, and corporate earnings. These started to improve in the middle of 2016 and have risen to robust levels. In early 2016, across the developed markets, manufacturing and industrial production indices were at or slightly below "50", implying that activity was flat or declining. Over recent months however, numbers have rebounded to healthy levels ranging from 53 to 56 implying expansion and are at the strongest levels reported since the last downturn in 2008.

Global investors have built expectations that political gridlock has ended in the US and Republicans are eager to slash taxes and cut regulation in a bid to stimulate growth that has also boosted confidence. Consumer confidence had been steadily improving over the years and has hit levels not achieved in over 15 years. Small business confidence has also skyrocketed to levels higher than during the bull markets of the Reagan or Clinton administrations.

Equities have been rallying on these indicators and optimism. Though investors are nervous about equity valuations, improving corporate profits have provided support to the markets. The consensus expectation in the US is for corporate profits to grow by 10%. Other developed and emerging markets have corporate profit expectations at or above the US levels. Furthermore, earnings revisions have been positive across most markets in recent months. Our view is that it would be consistent with other macro trends if 2017 turned out to be a year where profit expectations steadily increased through the course of the year.

“Leading indicators are as strong in two decades, but they will be tested by political risks in Europe and the US.”

The economic momentum in the US finally appears to be gaining traction in a manner that will increase wages, inflation and interest rates. We call this a normalisation of the cycle or a reflation of the cycle. Normalisation implies that the investment cycle will follow more traditional patterns where better growth drives investments toward equities over fixed income at the later stage of the investment cycle. Within fixed income investments, we would expect corporate bonds to outperform government bonds as there is some room with credit spreads to cushion the effect of rising rates. Credit spreads have tightened over the past year but are still wider than the levels seen in the last years of the last cycle.

Risks to the positive economic momentum include political risks from Europe and the US. In Europe the French and German elections have the risk of running into anti-Euro, nationalistic sentiments similar to elections in the UK and the US in 2016. In the US, the inexperience of President Donald Trump could lead to delays in expected policy support and potential wild cards with policies. Growth in China remains solid as of the end of the first quarter of 2017, however, we continue to monitor the high debt levels as a source of potential risk.

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# US Equity

Country Allocation	View	Notes
US 	+	<p><b>Rationale:</b> Leading economic indicators improve while fundamental conditions remain supportive. Proposed corporate and income tax cuts will be positive for retail spending and corporate profits.</p> <p><b>Risks:</b> Uncertainty over proposed Trump policies such as border adjustment taxes, renegotiation of trade treaties and increased protectionism.</p>

## Summary

We remain overweight on the US as it remains attractive for selective value plays. Earnings growth is expected to pick up again with improving economic conditions. A tightening labour force will result in higher wage inflation, while higher disposable incomes and lower gasoline prices will support the retail sector. We retain the view that the US remains on a strong recovery trajectory.


# Europe Equity

Country Allocation	View	Notes
Europe 	-	<p><b>Rationale:</b> Leading economic indicators continue to improve in Europe even as conditions in the UK decline. The earnings gap between Europe and US remains wide since the global financial crisis and the region remains highly leveraged to an earnings upswing.</p> <p><b>Risks:</b> Geopolitical risks remain high with uncertainty over a heavy political calendar for many countries in the region as well as for the UK after its exit from the European Union.</p>

## Summary

We hold an underweight position in Europe despite the potential for further economic recovery. A weaker euro has helped lift confidence and boost economic activity. The region also has significant operating leverage for an upturn in economic activity with profit margins currently at trough levels. However, we are cautious against the backdrop of increasing geopolitical risks in the region.

# Japan Equity

Country Allocation	View	Notes
Japan 	■	<p><b>Rationale:</b> Economic conditions remain mixed in Japan as monetary policies continue to be supportive. Inflation appears to be picking up which should evict deflationary fears.</p> <p><b>Risks:</b> Structural issues such as demographic trends remain an overhang on the country.</p>

## Summary

We retain our neutral position in Japan. Economic data remains mixed but we believe that the Bank of Japan (BoJ) will remain accommodative, which would help to support the market. Despite disappointments on policy and the anaemic economic backdrop, there are some positive developments in corporate governance and corporate performance.

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Country Allocation	View	Notes
China 	+	<p><b>Rationale:</b> Recent improvements in economic activity and earnings growth, coupled with renewed focus on debt deleveraging give comfort that the slowdown in GDP growth will be manageable and asset quality risks will be contained.</p> <p><b>Risks:</b> Higher consumer price inflation, regulators possibly tightening monetary conditions to control financial leverage and prevent overheating.</p>
Hong Kong 	-	<p><b>Rationale:</b> Central office rental trends remain healthy, while visitor arrivals are stabilising. The peg to the USD makes it a safe haven currency.</p> <p><b>Risks:</b> Headwinds for the property sector from rising interest rates and property tightening.</p>
India 	-	<p><b>Rationale:</b> The government's demonetisation policy in 2016 has resulted in economic growth headwinds and a downward revision of corporate earnings. Market valuations are still expensive.</p> <p><b>Risks:</b> Better-than-expected growth rates or if low inflation encourages monetary easing. A weakening USD would encourage fund flows to India.</p>
Indonesia 	-	<p><b>Rationale:</b> Higher commodity prices lead to stronger net export growth and support current account balances.</p> <p><b>Risks:</b> Political risks going into April with the Jakarta governor election. Inflationary pressure is rising from domestic electricity tariff hikes.</p>
South Korea 	+	<p><b>Rationale:</b> Korea is leveraged to global cyclical recovery and reflation themes. Corporate earnings, exports and imports have exhibited an improving recovery trend.</p> <p><b>Risks:</b> Political leadership in transition, and uncertainty over the candidature and economic initiatives from the next Korean President. Rising US rates will raise the burden on household debt.</p>
Malaysia 	-	<p><b>Rationale:</b> Recovery in oil prices alleviating stress on government finances. Restructuring of government linked companies is a positive move.</p> <p><b>Risks:</b> Current account position has deteriorated, leading to currency weakness. Possibility of tighter capital controls has affected foreign investors' sentiment.</p>
Philippines 	-	<p><b>Rationale:</b> Planned government initiatives to accelerate infrastructure spending. Consumer spending remains robust over civil servant wage hikes and strong remittances from overseas foreign workers.</p> <p><b>Risks:</b> Failure to execute tax reforms could derail ambitious infrastructure plans, while changes could impact corporate earnings. Strong consumption trends could increase imports that may swing the current account into a deficit.</p>

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

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Singapore 	+	<b>Rationale:</b> Singapore is leveraged to global economic recovery and corporate earnings should register a mild recovery in 2017. <b>Risks:</b> Increasing global trade protectionism will impact exports.
Taiwan 	■	<b>Rationale:</b> Anticipation of the iPhone8 launch should benefit the Taiwanese component supply chain in the later part of Q2. <b>Risks:</b> Earnings in the technology sector are cyclical. Economy is vulnerable to potential trade barriers imposed by the US.
Thailand 	■	<b>Rationale:</b> Economy should witness a broad-based recovery in GDP from government spending and consumption. <b>Risks:</b> External or domestic events may disrupt tourism sector, while increasing global trade protectionism will impact exports.

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

## Summary

Asia is a beneficiary of global growth recovery and reflation. The recent economic indicators have shown improvement, including purchasing manager indices (PMI) and exports led by a commodity price rebound, which should lead to improving earnings and profitability. Meanwhile inflation has also picked up, putting an end to the monetary easing cycle for Asian central banks. However, we believe it is too early in the region for central banks to enact monetary tightening measures as inflation is coming up from a low base and still within target ranges.

Despite the strong start to Asian markets, valuations remain reasonable and below the mean level on a price-to-book basis. Earnings revisions have also turned positive led by cyclicals in Korea and Singapore. As the Fed raises interest rates, we expect the US dollar to strengthen against Asian currencies, and this could be a short term headwind for Asian markets. However as global economic recovery broadens out, Asian economies should benefit, and history has shown that there are many periods where Asian markets have performed well despite US dollar strength. We prefer export-oriented North Asian markets over domestic-led ASEAN economies. The impact of US President Trump's trade policies on Asian exports remains a key risk.

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Sector Allocation	View	Notes
Developed Market (DM) 	-	<p><b>Rationale:</b> Bond yields are rising with a pace of rate normalisation that is gradually picking up.</p> <p><b>Risks:</b> Growth numbers slowing or if geopolitical risks weighs on central banks which would delay monetary tightening.</p>
DM Government 	--	<p><b>Rationale:</b> Central banks have been very accommodative with monetary policy with the stance expected to tighten in varying degrees.</p> <p><b>Risks:</b> Economic slowdown or an escalation of political risks would derail central bank tightening.</p>
DM Credit 	-	<p><b>Rationale:</b> US credits are preferred over European names because of their stronger fundamentals and growth outlook. We are neutral on Japan.</p> <p><b>Risks:</b> US credits are not cheap but there is still room for some compression for sectors including banks, financials and energy.</p>
Emerging Market (EM) 	■	<p><b>Rationale:</b> Gradual EM recovery continues to be led by commodity exporters. Macro-stability risks are lower compared to 2013, which have helped EM economies withstand the recent rise in US interest rates. The recovery should support overall EM growth despite higher DM interest rates. Valuations are fair to inexpensive.</p> <p><b>Risks:</b> Potential US protectionist policies, a Chinese hard landing or commodity price declines which would dent growth.</p>
EM Government 	■	<p><b>Rationale:</b> Generally more positive policy tone emanating from EM. Fundamentals have improved in aggregate since 2013. Most countries have deployed both monetary tools and fiscal tools to improve their imbalances.</p> <p><b>Risks:</b> Sensitivity to sharp commodity price declines and/or sharply higher USD funding costs. The search for yield may become more discerning, with investment flows to countries that experienced difficult macro-economic adjustments (e.g. Brazil) attracting the bulk of FDI.</p>
EM Corporate 	■	<p><b>Rationale:</b> EM corporate fundamentals showed some sequential improvement in 2016. We are underweight on corporates due to lack of relative value versus sovereigns and quasi-sovereigns.</p> <p><b>Risks:</b> US trade policies, downsides to EM growth, and potential recovery in the capital expansion cycle.</p>
EM Local Currency 	-	<p><b>Rationale:</b> Risky assets had a strong performance year to date, however we maintain caution on the duration of low yielding bonds while remaining positive on the rates of high yielding bonds.</p> <p><b>Risks:</b> Higher inflation in developed countries could prompt central bank policy to a more hawkish stance. Reduced monetary policy support meanwhile could lower returns in local currency markets.</p>

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



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Sector Allocation	View	Notes
 Duration	-	<b>Rationale:</b> Expectations are for major central banks to gradually scale back on accommodative monetary policies. <b>Risks:</b> Geopolitical risks may extend a dovish outlook or delay tightening measures from major central banks.
 Yield Curve	+	<b>Rationale:</b> The US Treasury yield curve may bearish flatten. The front end of the yield curve would price in hikes from the Fed. Meanwhile increases on the back end of the curve would be hampered by the effect of hikes putting a dampener on growth and inflation. <b>Risks:</b> The German government bond yield curve may steepen as the focus shifts from purchases towards the shorter maturity bonds.

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## Summary

The bonds markets are still assessing policies from US President Trump. The US dollar and interest rates may resume the up-trend after recent consolidation, while waiting for clarity on his policies. While his fiscal policies imply higher growth and higher inflation expectations, we believe risk assets including equities might have moved too fast in discounting the positive impact from the reflationary regime with potential policy risk.

We now expect at least 2 to 3 rate hikes this year from the Fed, with US 10-year rates ranging from 2.5% to 2.75%. The US dollar is expected to remain strong, supported by the tax reforms and relative yield trades. In Europe, the heavy elections calendar (France in April and Germany in September) carries political risks that could skew economic outcomes to the downside which may derail central bank tightening in the developed markets.

Emerging market (EM) fundamentals have improved on the back of countries employing monetary policy tools (e.g. currency depreciation, interest rates) and fiscal measures (e.g. subsidy cuts, taxes) to improve their imbalances. While rate sensitivity and vulnerability toward US interest rate hikes have declined, investors should also be prepared for higher market volatility in the EM from potential trade protectionism.

We prefer commodity exporting countries than those with economies reliant on manufacturing exports. Under these circumstances, we will position our funds opportunistically and defensively to take advantage of any risk pullback, as we expect risk-on markets to fade and risk-off yields to stabilise.

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Regional Allocation	View	Notes
Latin America 	■	<p><b>Rationale:</b> Regional growth is showing signs of stabilisation, led by Brazil and Argentina.</p> <p><b>Risks:</b> Fiscal policy is constrained by weak revenue growth. Mexico's outlook is overshadowed by risks from US policy action.</p>
CIS/EE* 	+	<p><b>Rationale:</b> Gradual recovery path remains supported with Russia coming out of recession. However, valuations are overall not compelling on an overall basis.</p> <p><b>Risks:</b> Macro outlook could shift with events including any US policy change on Russia, European elections and the Turkish referendum.</p>
Middle East/Africa 	■	<p><b>Rationale:</b> Many sovereigns have undergone painful macro adjustments such as subsidy cuts, imposed taxes as well as identifying new sources of growth to reduce reliance on petrodollars.</p> <p><b>Risks:</b> Weaker oil prices would negatively impact fiscal budgets. However, Middle East sovereigns have the lowest debt to GDP ratios and strong access to capital markets. Other factors include a China economic slowdown and commodity price weakness.</p>
Asia 	■	<p><b>Rationale:</b> Better-than-expected macroeconomic data in recent months with upside surprises to come. Anchored interest from long-term investors boosted by need for yield and USD assets are likely to drive demand for Asian USD credits.</p> <p><b>Risks:</b> Overall risk appetite may be dampened if the current pace of global recovery stalls or if political risk escalates. Tight valuations of Asian credits may deter investor demand.</p>
Singapore 	-	<p><b>Rationale:</b> The shift from a reliance on monetary policy to fiscal policy under Trump administration may allow normalisation of US interest rates; Trump's rhetoric of overall lower taxes and infrastructure spending may be funded via increased US Treasury issuances; increase in term premium lead by market uncertainties and recovery in oil prices.</p> <p><b>Risks:</b> Uncertainties in European politics and disappointment with the execution of fiscal initiatives by the Trump administration may lead to lower interest rates.</p>

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 <b>US\$</b>	+	<p><b>Rationale:</b> Room exists for the greenback to rebound from a recent retreat with relative monetary policy tightening. Trump's pro-growth policies are also likely to spur capital flows back to the US.</p> <p><b>Risks:</b> Failure of President Trump to deliver on agenda, or countries retaliate against US protectionist trade policies.</p>
Euro <b>€</b>	-	<p><b>Rationale:</b> A heavy political calendar for 2017 with elections in the major European economies demonstrating rising populism and Euroscepticism. Caution is warranted by precedents of unexpected outcomes in UK and US.</p> <p><b>Risks:</b> The Euro may surprise to the upside if election outcomes steer away from Euroscepticism, with little threat to the stability of the European Union.</p>
Japanese Yen <b>¥</b>	■	<p><b>Rationale:</b> The Yen could weaken if the interest rate differential narrows against the US, and when the rise in oil price weakens Japan's trade balance. As a safe haven currency, the JPY benefits in times of heightened uncertainties.</p> <p><b>Risks:</b> Should geopolitical risks escalate, JPY tends to appreciate from the flight to safety bid.</p>
Singapore Dollar <b>SGD\$</b>	-	<p><b>Rationale:</b> Against the backdrop of rising inflation and better-than-expected GDP numbers, we expect USD/SGD to move towards the mid-point of Singapore Dollar Nominal Effective Exchange Rate (S\$NEER) band. The current strength in the SGD may not be sustained and the SGD rate should trade close to the 1.42 level.</p> <p><b>Risks:</b> As the SGD is widely used as a proxy to Asian currencies, it will be affected from any negative global investment sentiment on Asia.</p>
China Renminbi <b>CNY</b>	-	<p><b>Rationale:</b> China's focus on financial deleveraging will likely lead the central bank to allow a weaker CNY to offset the recent tightening of liquidity conditions. Nevertheless, a strengthening USD is likely to lead the USD/CNY higher.</p> <p><b>Risks:</b> The risk of capital flight out of China could force the central bank to intervene in the FX market and result in a stronger CNY against the USD to curb the outflows.</p>

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







## Summary

The current momentum for the US dollar appears to be on the upswing even as policy uncertainties remain with a Trump administration. Most Asian currencies are likely to weaken against the dollar with expected price pressures from a reflationary environment.

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# Commodities

FX Allocation	View	Notes
Commodities 	+	<p><b>Rationale:</b> Improving global economic conditions remain supportive while US supply growth is limited because capital expenditure has declined since 2011. China has also curtailed domestic production.</p> <p><b>Risks:</b> A strong USD has been negative for commodity prices in recent years. Concerns that aggressive trade negotiations by the Trump administration will disrupt the global trade economy.</p>
Gold 	+	<p><b>Rationale:</b> A strong "safe haven" investment demand as a result of economic policy uncertainty, geopolitical risks (e.g. Eurozone, potential trade wars) and US interest rates lagging behind inflation trends.</p> <p><b>Risks:</b> Bullish US economic data could lead the Fed to hike rates multiple times that will result in positive real interest rates. This is negative for gold, which does not pay interest.</p>
Base Metals 	+	<p><b>Rationale:</b> Strong global industrial production figures are supportive of solid demand, while new supply is likely to be constrained by the lack of new investment into mines in recent years.</p> <p><b>Risks:</b> Weaker-than-expected demand. Producers may face country-specific risks caused by unpredictable changes in government policy.</p>
Bulk Commodities 	■	<p><b>Rationale:</b> Environmental considerations have led the Chinese government to limit domestic iron ore, coal and steel production. Meanwhile global infrastructure spending is expected to increase.</p> <p><b>Risks:</b> US infrastructure spending stimulus may stall, or if China reverses recent policy decisions and allows domestic companies to increase production.</p>
Energy 	■	<p><b>Rationale:</b> OPEC production cuts are maintained, oil service companies increasing prices and oil inventories outside of the US continue to decline.</p> <p><b>Risks:</b> Faster-than-expected rate of US shale oil production, OPEC failing to adhere to production discipline and EM demand growth.</p>
Agriculture 	-	<p><b>Rationale:</b> Little risk of weather-related events that could result in poor harvests and supply shocks. Stock reserves remain relatively high.</p> <p><b>Risks:</b> Annual production remains vulnerable to weather-related events.</p>

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

## Summary

A scenario of buoyant global economic growth and industrial production data is supportive of healthy volume growth for commodities, despite the volatile political headlines and related currency volatility. Demand should be supported by anticipated increases in infrastructure spending from China and the United States. The supply outlook remains constrained given reduced global mining investment and Chinese government measures to reduce domestic supply. Gold remains attractive given the potential for negative real interest rates, as well as possible global geopolitical uncertainties.

# 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

## 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

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