INVESTMENT INSIGHT - July 2017

Investment Services Department

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Central Banks remain the center of stage

Investment market finished the first half of 2017 on a strong note. Most major equity indexes gained, and among which, many Asian indexes outperformed by making double-digit returns. Major currencies against the U.S. Dollar buoyed too, as the second quarter was the worst for the Dollar in the last 7 years, with the Dollar Index dropped by 4.7%. Global bond prices were on the rise in general, as shown by various aggregate bond indexes for U.S., Asia, Pan-Europe, emerging market, and the globe. Most key asset classes delivered positive return with the exception of selected commodities.

Global economies showed continuous signs of moderate recovery to date. For the first quarter of the year, annualized GDP growth rates around the world were encouraging. Just to name a few - U.S. , 2.1%, the highest in 6 quarters; Euro Area, 1.9%, the highest in 5 quarters; China, 6.9% , the highest in 6 quarters; and according to the World Bank's June 2017 *Global Economic Prospects*, growth in emerging market and developing economies as a whole will pick up to 4.1% this year from 3.5% in 2016. With this positive backdrop along with market optimism, major central banks including that of the U.S., U.K., Canada, and Eurozone have announced their intention and plans for tapering, while that of China has already tightened their monetary policies via various open market operations over the past months. Among them, latest minutes of the U.S. Federal Open Market Committee ("FOMC") has already revealed plans of balance sheet run-off, with commencement of the same most probably within this year; while minutes from the European Central Bank showed that the taking out of so called "easing bias" with respect to the asset purchase programmes from their policy message was discussed, which kicked-off a wave of government bonds sell-off around the globe. Normalization of monetary policies is necessary to avoid overheating of the economy and excessive inflation, as well as providing more manoeuvring space for future monetary policies; but after quantitative easing of unprecedented scale around the globe for almost a decade, the interaction between the central banks and the investment market has changed

vastly. The super-low interest rate environment and enormous amount of increase in money supply around the world for such a prolonged period have led investors to pile into risky assets due to the low cost of capital, bringing equity indexes to historical highs for many countries. Obvious examples include the Dow Jones Industrial Average, S&P 500, Nasdaq Composite, Korea KOSPI 200, India S&P BSE SENSEX etc. At the same time, the market is extremely jittery to any signals of policy changes from the central banks as investors well understand that it is the liquidity swamp rather than strong fundamentals that supports the current level of asset prices. The central banks, on the other hand, instead of leading the world economies with visionary movements, choose to become more and more "data dependent", taking extremely cautious baby steps in policy changes, in response to not just the latest economic statistics, but more importantly, market reaction to their policies. Today, any careless hawkish statement may be amplified by the sensitive investment market which could trigger uncontrollable domino effect and eventuate in financial turmoil, and no policymakers would like to take that risk.

2017 is a year of tapering for many countries, but whether global economies are ready for this change remained arguable. Inflation remained subdued in most countries with suppressed energy prices; recovery is stable and moderate worldwide, but far from being strong; debt for the largest economies such as U.S., China, Japan are at record high as a percentage of their GDP. Global economic and political cooperation, which are the pillars for rapid global growth, face challenges with the rise of nationalism and protectionism. Last but not least, the increased tension in the Middle East and Korean Peninsula could end up in an outbreak of conflict. Investors should be alert of the potential impact of these issues on the investment market, as damage of which could be beyond saving from mere economic policies. Judging from the rise in price across asset classes over the last 12 months and the current valuation of assets, investors may consider shifting to a slightly more defensive position. With regard to equities, we continue to favor Asian emerging markets over developed markets based on their healthy fundamentals in general and valuation advantage after their underperformance in the past years. Among developed markets, European equities excluding U.K. may come through relatively stronger as supported by their steady recovery and improving economic outlook. As central banks start to tighten their super-accommodative monetary policies, trends for bond yields are likely to move up gradually, but bonds will remain to be a core part of a balanced portfolio for long term stability and diversification. In this respect, choosing bond funds which invest in a diversified portfolio of bonds in terms of duration, currency denomination, industrial sectors and credit qualities would support your portfolio in weathering changing interest rates and volatile foreign exchange market in an unpredictable investment environment.

TABLE 1: Global Stock Markets Performance

	2017 Q2 Return		2017 YTD Return	
	Local Currency	USD	Local Currency	USD
Dow Jones Industrial Average	3.95%	3.95%	9.35%	9.35%
Euro STOXX 50	0.34%	7.05%	7.32%	16.13%
Euro STOXX 600	1.19%	7.96%	7.56%	16.39%
German Stock Index DAX	0.10%	6.80%	7.35%	16.17%
CAC 40	2.23%	9.07%	7.93%	16.79%
Nikkei 225	6.06%	5.07%	5.78%	9.82%
Hong Kong Hang Seng Index	8.50%	8.01%	19.50%	18.69%
Hang Seng China Enterprises Index	2.86%	2.40%	12.48%	11.72%
Shanghai Stock Exchange Composite Index	-0.23%	1.43%	3.61%	6.29%
Shanghai Shenzhen CSI 300 Index	6.99%	8.77%	11.74%	14.62%
Singapore FSSTI	2.78%	4.27%	13.79%	19.59%
Korea KOSPI	10.73%	8.22%	18.15%	24.66%
Taiwan TWSE	6.92%	6.85%	14.61%	21.79%
India SENSEX	4.91%	5.31%	16.97%	23.05%
Indonesia JCI	5.96%	5.97%	11.84%	13.66%
Thailand SET	1.13%	2.35%	4.12%	10.03%
Russia RTS	-8.70%	-8.70%	-11.10%	-11.10%
Brazil IBOV	-3.21%	-8.40%	4.44%	2.66%
S&P Pan Arab Composite Index	2.95%	2.95%	4.09%	4.09%
MSCI World Index	4.19%	4.19%	10.91%	10.91%

Source: Bloomberg (as at 30/6/2017)

TABLE 2: Major Currencies Performance (In terms of USD)

	Change in 2017 Q2	Change in 2017
	In terms of USD	
Euro Dollar	7.27%	8.64%
British Pound	3.78%	5.55%
Japanese Yen	-0.89%	4.07%
Hong Kong Dollar	-0.46%	-0.66%
Chinese Renminbi (CNY)	1.57%	2.42%
Australian Dollar	0.79%	6.67%
New Zealand Dollar	4.67%	5.75%
Singapore Dollar	1.52%	5.13%
Korean Won	-2.24%	5.58%
Taiwanese Dollar	-0.34%	5.99%
Indian Rupee	0.42%	5.18%
Indonesian Rupiah	-0.02%	1.09%
Thai Baht	1.19%	5.42%
Russian Ruble	-4.54%	3.94%
Brazilian Real	-5.59%	-1.73%

Source: Bloomberg (as at 30/6/2017)

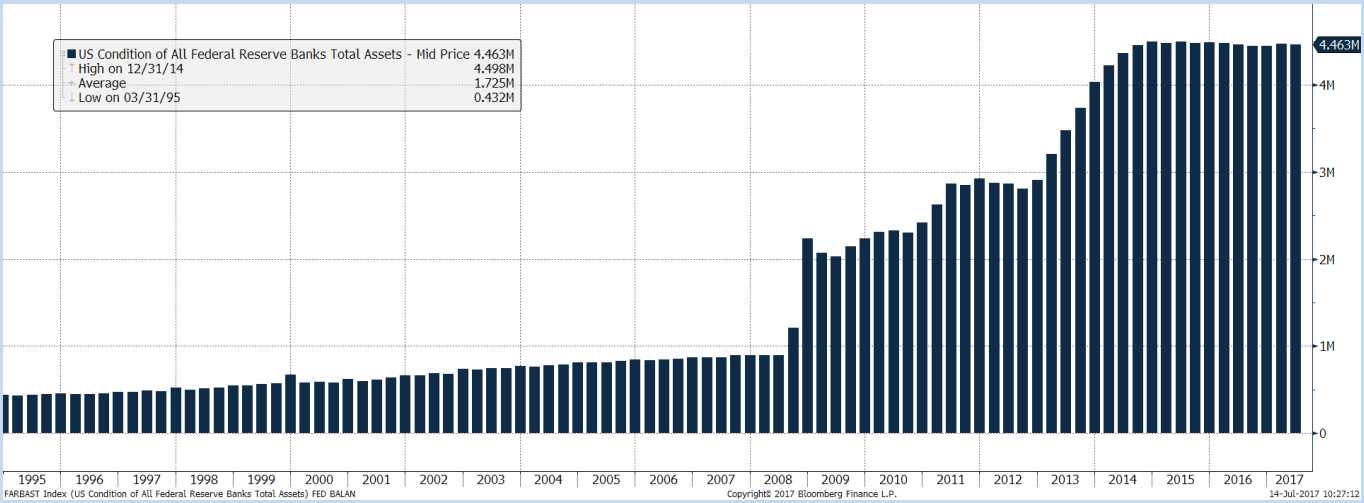
Review Hightlights and outlook around the globe:

United States

- Stock market in U.S. was robust for the first half of the year. The Dow Jones Industrial Average and S&P 500 Index gained 9.35% and 9.34%, while the tech-heavy Nasdaq Index rose 14.76%. It is the best first half of the year for S&P 500 since 2013 and Nasdaq since 2009, and was a sharp contrast with the plight same period last year. The rally was initially fueled by expectations on Trump administration's tax reform and expansionary fiscal policy, and subsequently supported by solid and sustained improvement from labor market, consumer sentiment, and better-than-expected earnings growth. The passing of the stress tests from the Federal Reserve by 34 largest banks in the country further lifted stock prices. The indexes have reached multiple historical highs over the last 6 months, but whether stocks have been overvalued remain questionable, and the same will be revealed shortly following the reporting period of second-quarter earnings which will commence in just a few weeks. Whether the earnings deliver disappointment or pleasant surprises will determine the direction of the stock prices.

- From the minutes of FOMC meeting in March, records showed that the Fed officials supported normalization of the $4.5 trillion balance sheet within the year of 2017. As stated in the minutes, "Most participants anticipated that gradual increases in the federal fund rate will continue and judged that a change to the Committee's reinvestment policy would likely be appropriate later this year." In June's meeting, more details are being discussed in this regard. "For payments of principal that the Federal Reserve receives from maturing Treasury securities, the Committee anticipates that the cap will be $6 billion per month initially and will increase in steps of $6 billion at three-month intervals over 12 months until it reaches $30 billion per month…..the long -run plan is to keep the balance sheet appreciably below that seen in recent years but larger than before the financial crisis" the Fed said. The only question left to be decided is when to start the normalization, and it is believed the rate of inflation and labor market condition will be critical to such decision.

EXHIBIT1: The change in size of Federal Reserve Balance Sheet (1995 – 2017)



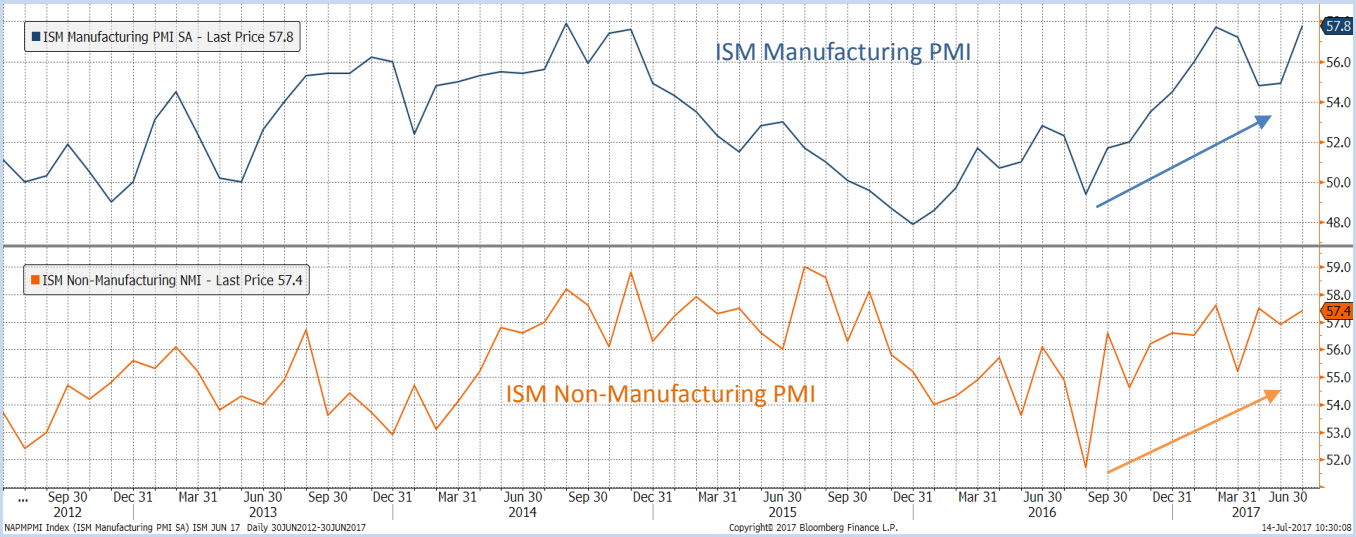
Source: Bloomberg (as at 30/6/2017)

- GDP for the first quarter expanded at an annual rate of 1.4% quarter-on-quarter and 2.1% year-on-year. By historical records, the first quarter of a year tended to underperform relative to the rest of the year due to seasonal factors. The Federal Reserve Bank of Atlanta currently forecasts annual growth rate of 2.9% in the second quarter. In the longer run, President Trump believes that GDP annual growth can hit 4%, or even 5% over the next few years. The corresponding figure for U.S. however, has not exceeded 3% for 11 years already.

- Non-farm payrolls in June increased by 222,000 which is way above the May figure of 152,000 and the market estimate of 179,000. The encouraging figure was a 4-month high which gave instant boost to the U.S. Dollar at the break of the news, and possibly endorsement of a more aggressive approach regarding the normalization of the balance sheet in the next FOMC meeting. Picture for the labor market was not entirely rosy though, as unemployment rate in June rose slightly to 4.4% from May's 4.3%, while average hourly earnings in June grew only a marginal 2.5% year-on-year.

- The ISM Manufacturing PMI rose to 57.8 in June from 54.9 in May and was way above market expectations of 55.2. The figures indicated the strongest expansion of the country's manufacturing sector since August 2014, as output, new orders and employment grew at faster pace. Its non-manufacturing counterpart rose to 57.4 from 56.9 in May, again beating market expectation. Business activities and new orders went up while employment slowed. The majority of the respondents' comments continue to be positive on business conditions and the overall economy.

EXHIBIT 2: The ISM Manufacturing and Non-Manufacturing Index (2012 – 2017)



Source: Bloomberg (as at 30/6/2017)

Europe

- According to the final reading released by Eurostat, the economy of the Eurozone grew at its fastest rate since the fourth quarter of 2015. Compared with the previous quarter, the Eurozone economy expanded 0.6% during the first three months of 2017, better than the second estimate of 0.5%. On a year-on-year basis, it advanced 1.9%. All 19 Eurozone member countries registered positive growth as well.

- Momentum in the Eurozone economy has been building up over the last few quarters and the trend continues. Although the final Markit Eurozone PMI Composite Output Index fell to a four-month low of 56.3 in June, it was still above the earlier flash estimate of 55.7 and only slightly below April and May's six-year record highs of 56.8. The average reading over the second quarter as a whole was also the best outcome since the first quarter of 2011. The expansion was again led by the manufacturing sector, where production rose to the greatest extent since April 2011. Although the rate of growth in service sector activity moderated, it was still among the strongest seen over the past six years.

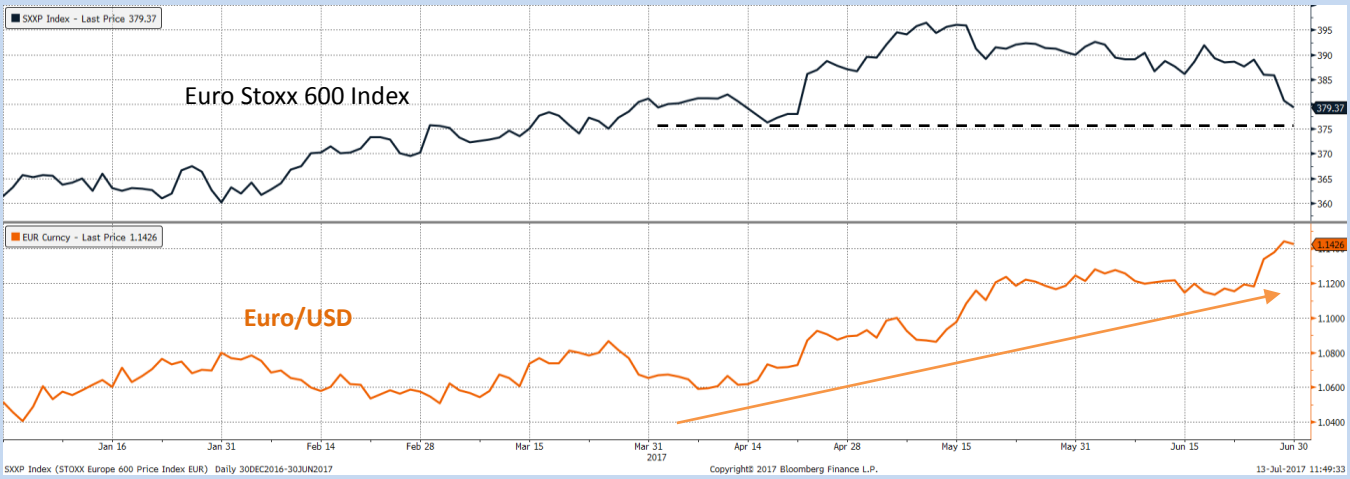
- Besides, the unemployment in the Eurozone has fallen to 9.3% in May, which was the lowest level since March 2009. Among all countries in the Eurozone, Germany recorded the lowest unemployment rate at 3.9% which was a post-reunification lowest record.

- While the Eurozone's economic recovery is becoming increasingly strong and broad, price pressures remain subdued and below the European Central Bank("ECB")'s target. Consumer prices in the Euro Area only increased 1.4% from a year earlier in May 2017, slowing from a 1.9% rise in April and matching preliminary estimates. It was the lowest inflation rate so far this year as cost of fuel and heating oil slowed. Excluding prices of processed food, alcohol and tobacco, the inflation declined to 0.9% from 1.2% in April, and if excluding energy only, it fell to 1.1% from 1.3%.

- As widely expected, the ECB left its monetary policy unchanged during the meeting on 8th June and the asset purchases will be continued at the current pace of €60 billion each month. However, the minutes of the ECB meeting showed that the policymakers were open to a further step towards reducing their monetary stimulus.

- Board-based economic recovery, relatively stable political environment after Emmanuel Macron won the French Presidential election, together with the expectation of the end of ECB's ultra easy monetary policy contributed to the rally of the Euro. While the Euro rose over 7% against the USD in the second quarter, the European benchmark equity index, Euro Stoxx 600, was only flat and underperformed other matured stock markets in the past three months. However, since the economic fundamentals of Europe is improving which should eventually support the growth of corporate earnings in the region, we believe that investors may consider accumulating European equities at this level for medium-to-long term investment.

EXHIBIT 3: European stocks were flat while the Euro rebounded in the 2nd quarter



Source: Bloomberg, (as at 30/6/2017)

Asia

- On 20th June, MSCI announced that they will add mainland Chinese A-shares to its benchmark Index gradually starting from June 2018. China's 222 large-cap stocks will be included in the MSCI Emerging Markets Index which account for around 0.73% of the index. In the short term, the impact of the inclusion may be subtle as 0.73% index weighting only represents an additional inflow of US$10-$11 billion, comparing with the Chinese A-share's around US$50-$60 billion daily trading volume. However, it is a breakthrough for China's equity market and it is believed that the move will also improve the corporate governance of those Chinese listed companies and will attract more money inflow from global investors over time.

- The long-awaited Bond Connect programme kicked off on 3rd July. The scheme, which initially will give international investors access to China's US$9 trillion bond market via Hong Kong Exchanges and Clearing ("HKEX"), marked a milestone in China's further opening up of its capital account. At the same time, it also marked a new chapter for HKEX in expanding its product line from stocks and commodities to bonds, and strengthened the role of the Hong Kong market as a gateway for international investors to access the mainland market.

- From statistics, it seems that the growth momentum of the Chinese economy is still robust following the better-than-expected first quarter GDP growth. The first quarter GDP growth recorded at 6.9% which represented the strongest economic expansion since the third quarter of 2015. Besides, both the recently released official and Caixin manufacturing PMI accelerated and rose to 3-month high at 51.7 and 50.4 respectively in June.

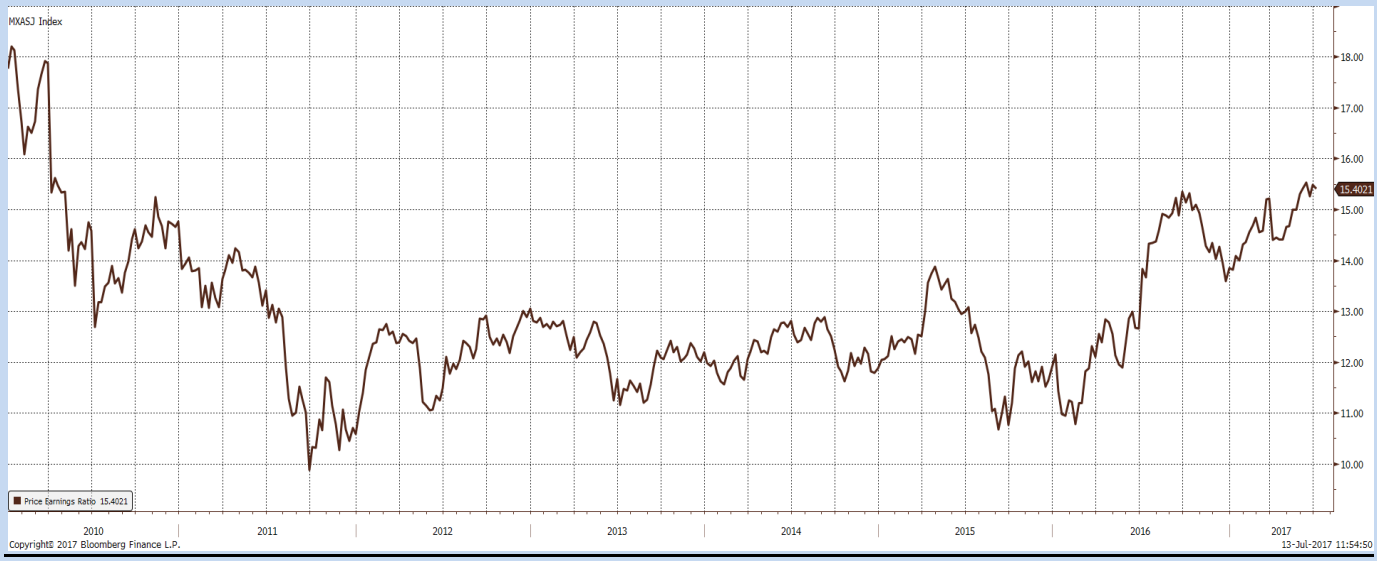
- Apart from this, the service sector is still in the expansionary mode. Although the Caixin Service PMI slowed to 51.6 in June from 4-month high in May, the official non-manufacturing PMI improved to 54.9 from 54.5 in May which was an evidence of a healthy economic structure. In recent years, China has been trying to shift its economy towards a growth model that draws strength from consumption, services and innovation. The service sector accounted for more than half of the Chinese economy last year.

- India launched the biggest tax reform since its independence on 1st July 2017. The new goods and services tax (GST) replaced more than a dozen of levies and unified 29 states and 1.28 billion people into a single market for the first time. Like the demonetization last year, it is expected that the new tax system may bring chaos and uncertainties to the economy in the short term. However, it is believed that the reform will help to curb tax evasion, reduce compliance cost and enhance government revenue in the long term. According to HSBC, the move will help to increase the country's GDP by 40 basis points over 3 to 5 years.

- Confidence among Japan's biggest manufacturers has risen for the third straight quarter to the best level in more than three years. The Bank of Japan's Tankan report, a quarterly survey of more than 10,000 companies, showed a reading of 17 among major manufacturers, the highest level since the first quarter of 2014. On the other hand, the consumer sentiment remained weak and it seems that people are still reluctant to spend. The household spending in May dropped 0.1% from a year before in price-adjusted real terms, and it was the 15th consecutive falling month.

- Asian stocks rallied in the first half of 2017. Among all, Korean and Indian stock market performed the best. They rose 24.66% and 23.05% respectively in terms of U.S. Dollar. In medium-to-long term, we are still positive towards the investment outlook of Asian equity markets since the strong economic recovery in the U.S. and Europe will benefit the export-oriented Asian economies. However, the valuation of the market looked less attractive than before as the Price-to-Earnings ratio of the MSCI Asia (Ex Japan) Index was traded at 15.4x as of 30th June 2017, which was a relatively high level in recent years. It is thought that investors may consider increasing exposure if there is a market correction.

EXHIBIT 4: The P/E ratio of MSCI Asia (Ex Japan) Index is currently at recent-years-high



Source: Bloomberg, (as at 30/6/2017)

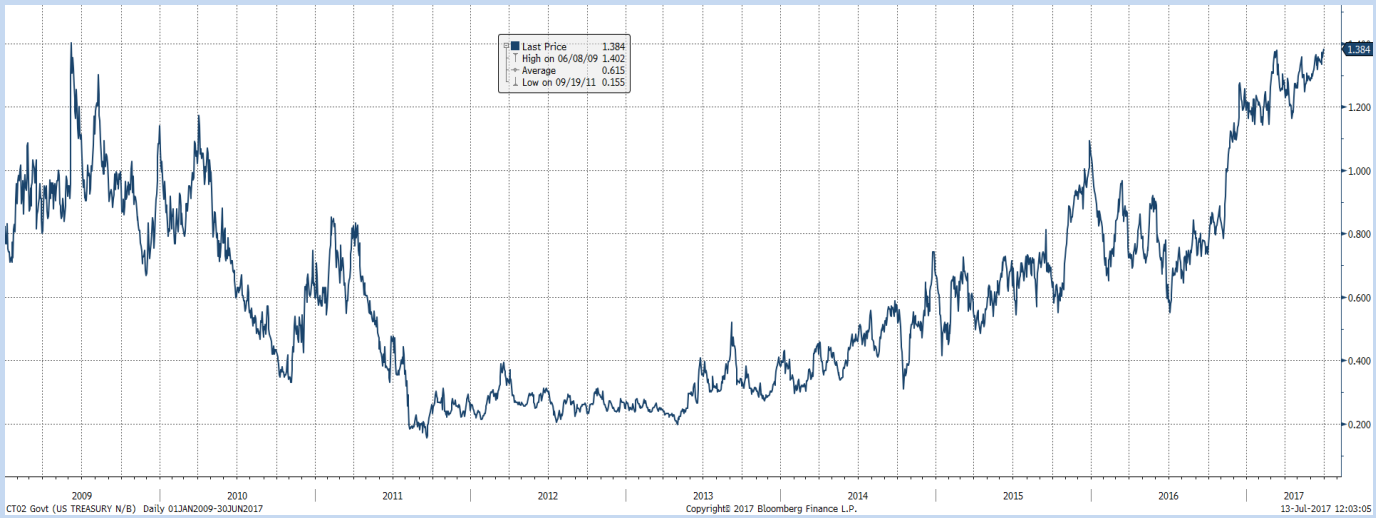
Fixed Income

- As widely expected, the Federal Reserve ("Fed") raised the target range for the federal funds rate by 25bps to 1 % to 1.25 % during its June 2017 meeting. More importantly, the Fed also indicated that they were ready to start reducing its USD 4.5 trillion asset portfolio within a couple of months.

- In Europe, although the ECB left its monetary policy unchanged during its June meeting, the ECB President, Mario Draghi, also commented that "the deflationary forces had been replaced by reflationary one in Eurozone" during the Annual ECB Forum. Investors are expecting that the ECB will also start scaling back its ultra-loose monetary policy program and to begin normalizing interest rates sooner or later.

- Due to the above, a sell-off in global sovereign bonds happened in late June. The 2-year U.S. Treasury yield, which is the most sensitive to interest rate moves, rose to 1.384% which was the highest since June 2009. At the same time, the German 10-year government bond yield also jumped to 0.463% on 30th June from 0.3% a month ago.

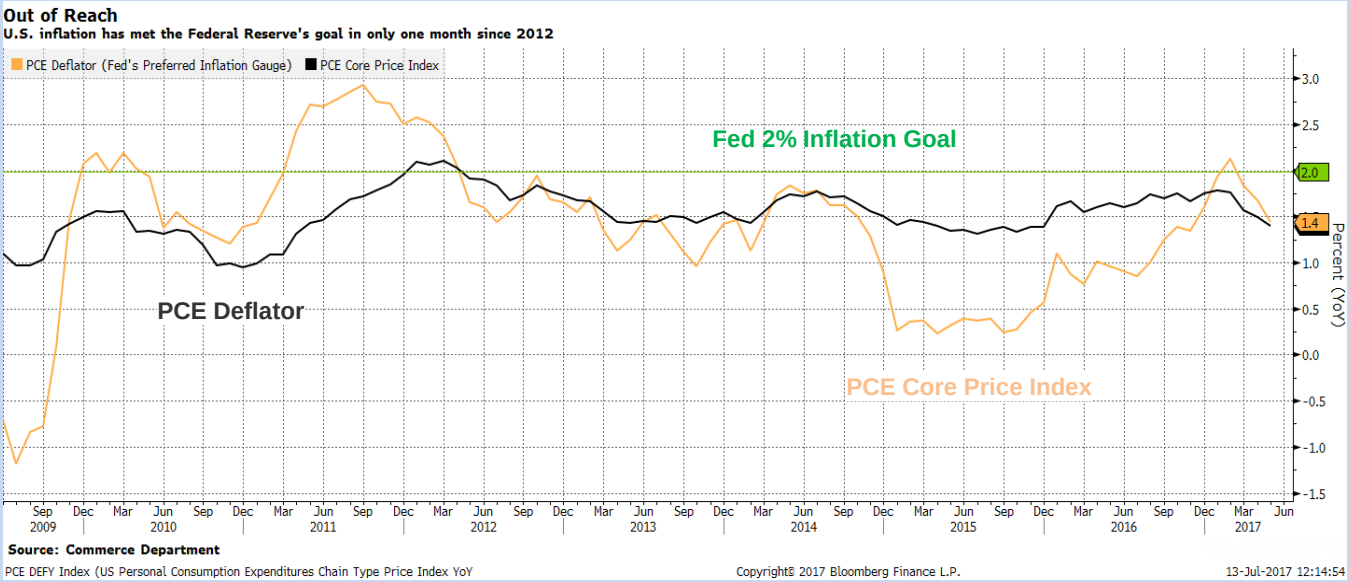
EXHIBIT 5: 2-year U.S. Treasury yield rose to June-2009-High



Source: Bloomberg, (as at 30/6/2017)

- It is expected that monetary policy normalization in U.S. and Europe should be in place soon but the timing and pace of the normalization process will be dependent on the overall economic growth and the consumer price level. From the recently released economic data, the U.S. and Europe economies expanded broadly and the momentum was strong, however, the inflationary pressure was still low and below the central banks' target. It is believed that the monetary policy normalization may only be implemented gradually and cautiously in the coming future.

EXHIBIT 6: Inflationary pressure in the U.S. is still below the Fed's Target



Source: Bloomberg, (as at 30/6/2017)

- High yield bonds continued outperforming other fixed income asset classes. According to the Bloomberg Barclays Global High Yield Index, it rose 3.19% in the second quarter and 6.46% in first half of 2017 respectively. Since growth momentum of global economy goes on and it will improve the overall business environment, the default rate of corporate should remain at a low level and support high yield bond price.

- We believe that fixed income is always an essential part in a balanced investment portfolio in the long term and we would hold a neutral view on the investment outlook of fixed income. Although bonds will likely be impacted by rising rates, the impact will not be uniform across all bond types. For example, high-yield bonds tend to be less sensitive to interest rate than U.S. Treasuries, and the same is true for the floating rate bonds. For this reason, we prefer to maintain a diversified bond portfolio which includes bond issuers from different sectors with different credit qualities and maturities. A diversified fixed income portfolio can help to manage risk, reduce the overall impact of rising rates and provide more stable return.

Commodities

- The first half of 2017 was a tough time for commodities. The Bloomberg Commodity Index, which tracks 22 commodity futures contracts, is down by 5.61% as at 30th June. It was a bad start after a good year in 2016 which finished out more than 11% higher.

EXHIBIT 7: Bloomberg Commodity Index

Source: Bloomberg (as at 30/6/2017)

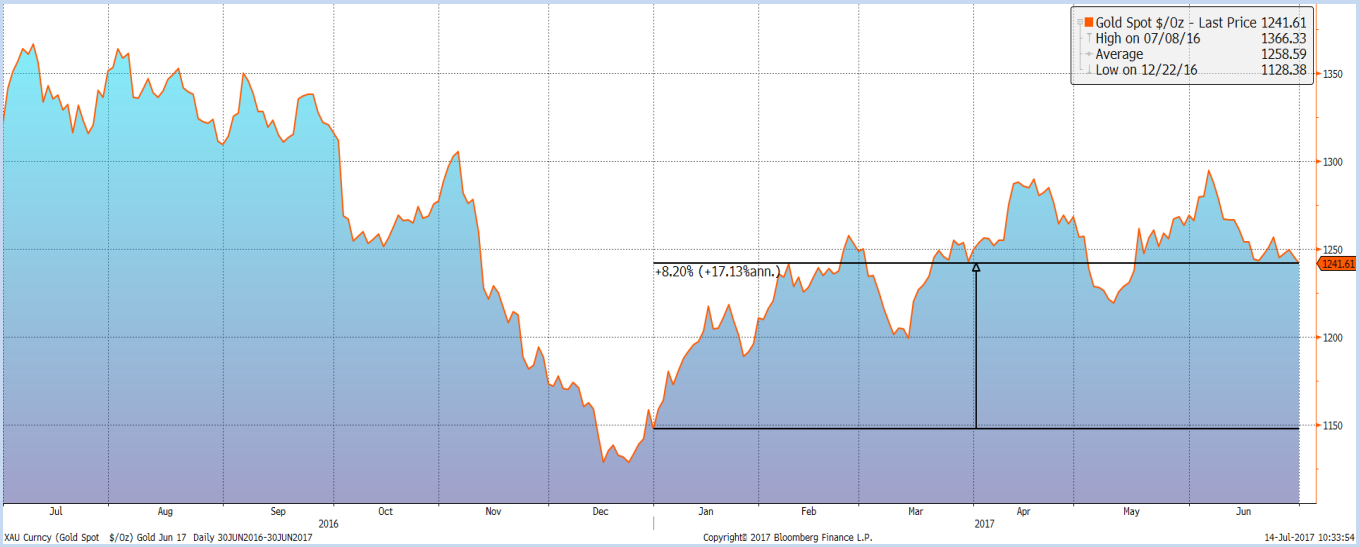
- The energy sector was disappointing. Brent oil and Western Texas Intermediate oil (WTI) tumbled by 9.29% and 9.01% respectively in the second quarter, as there were unexpected increase in stock level as well as a rising output from Libya and Nigeria, which are OPEC members exempted from the production cut. The market is concerned with the failing attempts from OPEC to control the crude glut. The WTI prices technically went into bear market on 20th June (declining for more than 20% since 11th April) but thereafter climbed eight sessions in a row which was the longest streak of gains since December 2009, as seemingly the increase in number of oil rigs in U.S. has come to a halt and supply from shale producers may have hit a bottleneck at current price level.

- After two years of unprecedented declines in upstream oil and gas investment, the International Energy Agency (IEA) predicted in their July report that the situation is going to stabilize in 2017, and in particular, it is forecasted that there will be an upswing of 53% in U.S. shale investment. Other parts of the world are also ramping up spendings on upstream projects, such as Russia and Middle East, but to a much lesser extent, at only single-digit increase. The increase in global investment is beneficial in mitigating the potential risks of depletion of existing fields, as the significant decrease in total energy investments worldwide between 2014 -2016 may end up in a supply squeeze in future if remedies are not taken in time. Of course, the impact of a decrease or increase in investments takes time to reveal due to the nature of the industry.

- Gold price at end of first and second quarter were at similar level, and made a gain of 8.2% in the first half of the year. During the period, gold price peaked on 6th June at close to USD1,300 per ounce but thereafter kept going downhill. Reason for the fall is the consensual comments from key central banks worldwide that appropriate timing for gradual normalization of interest rates is

drawing near. The recent weakness is the U.S. Dollar did not give support to gold price either. In view of the weakening physical demand for the precious metal, along with expectation on rising inflation and interest rates around the globe, near term prospect could be dimmed for gold. Bear in mind however, that geopolitical risk can be on the horizon at any time, thus the traditional wisdom of maintaining a small portion of gold in the portfolio can prove helpful.

EXHIBIT 8: Gold spot price



Source: Bloomberg (as at 30/6/2017)

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