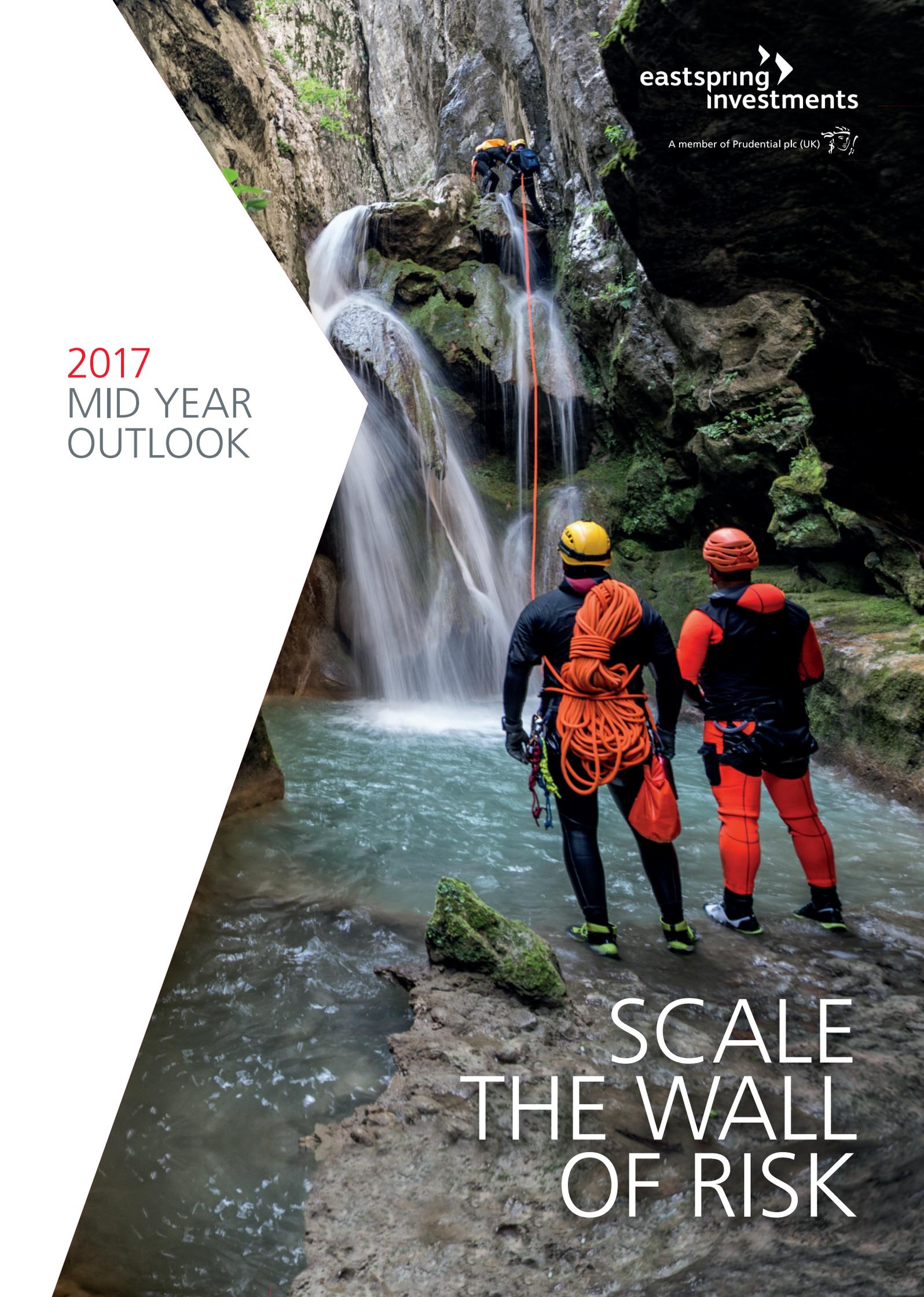


2017
MID YEAR
OUTLOOK

SCALE
THE WALL
OF RISK



THE RUSH INTO RISK ASSETS THAT CHARACTERISED EARLY 2017, LOOKS POISED TO EXTEND INTO THE SECOND HALF OF THE YEAR.

Although markets have rallied, the exuberance normally associated with a peak is noticeably absent¹. Indeed, given the first half's relative outperformance of growth and momentum over value stocks, one could conclude that risk fervor has intensified.

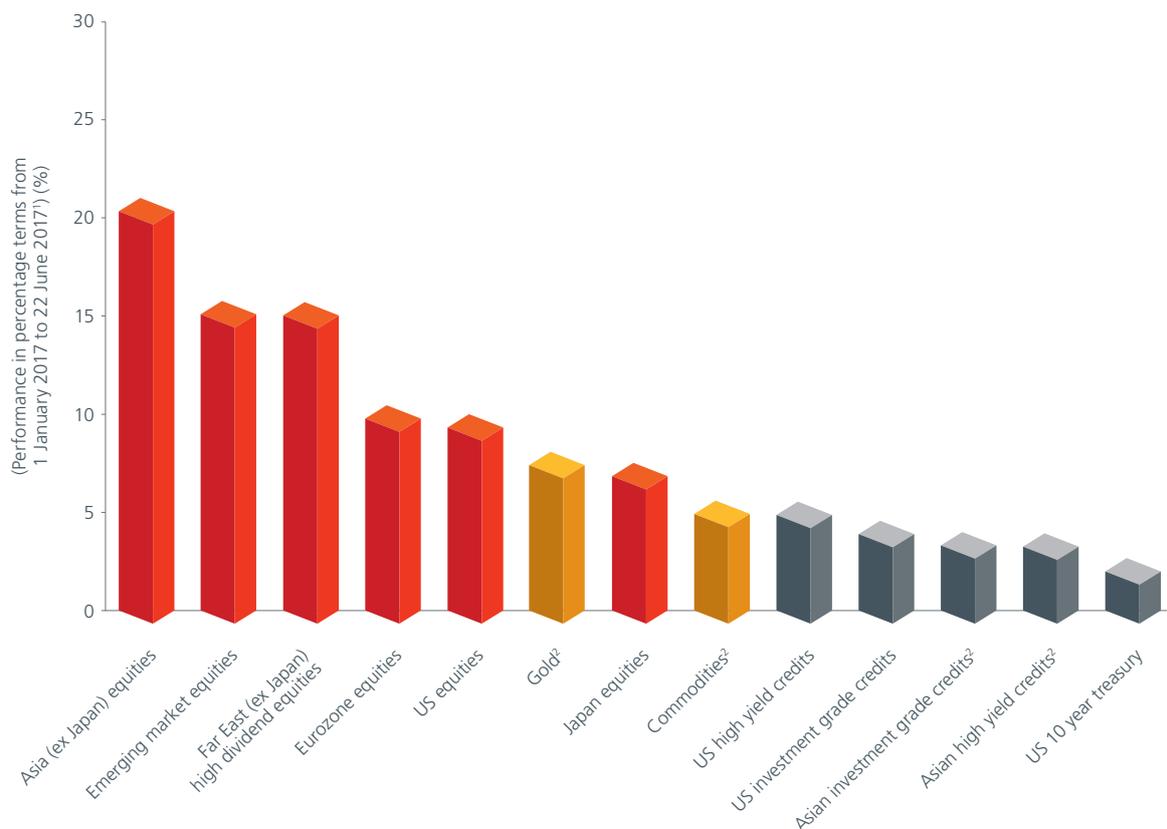
Both equities and higher yielding bonds have been key beneficiaries (Fig.1), each being prodded forward by an unrelenting weight of money.

Emerging and Asian market equities have, additionally, been aided and abetted by earnings upgrades, firmer commodity prices and a US Dollar that has noticeably cooled².

With many equity markets having risen significantly, it is possible that markets will see some consolidation as investors not only "rest" but also succumb to the temptation to lock in a few profits. Abundant liquidity and many "fair" valuations suggest that most markets should be able to absorb any such selling.

Overall, the drivers behind the rallies look to be intact.

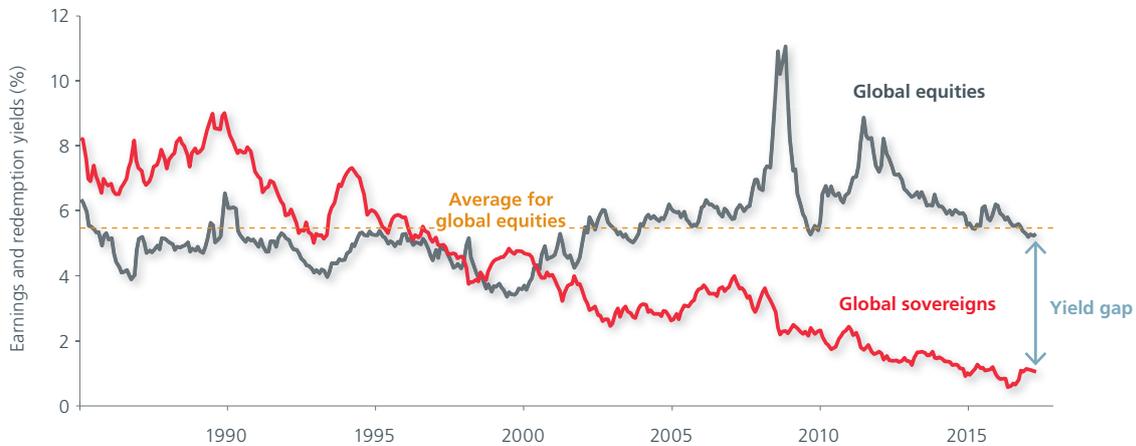
Fig.1. Asia (ex Japan) heads the charge into 2017



Sources: ¹As measured by the Chicago Board Options Exchange Volatility index (VIX) from Datastream, as at 27 June 2017. The index, at 11.06, is hovering around record 20 year lows. The last time it was this low was in early 2016; many commentators point out that it preceded one of history's biggest market sell-offs in 1997. ²The "Trump" rally, which saw the US Dollar trade weighted index rise some 4¾% to its early 2017 peak (and rising some 7½% from its mid-2016 low), has since fallen as investors digest the implications of a possible higher "Trump" budget deficit. Source: The US Federal Reserve Board from Datastream, as at 27 June 2017.

Fig. 1. MSCI, Barclays Capital, JP Morgan, London Bullion Market and the Commodity Research Bureau from Datastream, as at 22 June 2017. All indices are total returns in local currencies (unless indicated otherwise). Note that past performance is not indicator of either present or future performance. ¹In local currencies unless otherwise indicated. ²In US Dollars.

Fig.2. Equity rallies will likely close the yield gap



Yield gap pendulum swings in equity's favour

Taking the strategic view, low redemption yields and the much reduced prospects of bond capital gains have swung the investment pendulum firmly in favour of equities (Fig.2).

This yield gap will close, but will it close due to either an equity rally or a bond sell-off? The former seems more likely given the sustained growth in global liquidity, which should not only drive equities higher but also support expensive bonds. The investment pendulum favours equities both tactically and strategically.

The money wall spurs on investors

The higher markets move, and the higher valuations rise, the greater the significance of the underlying liquidity. Indeed, high liquidity probably accounts for much of the resilience in the volatility index despite rising geopolitical risks.

The liquidity injections seem set to continue. Although the US Federal Reserve Board (Fed) has ended its quantitative easing program, other Central Banks³ have continued injecting liquidity, which has inevitably "leaked" into the wider world. Global liquidity "free" to invest in financial assets is growing

at a steady clip⁴. It is difficult to under-estimate the impact of this historically high level of liquidity. It played a major role in stabilising 2013's "Taper Tantrums" as it cushioned, then reversed, investor fears that retreating liquidity would undermine the markets.

The situation is changing; liquidity fears could re-emerge. The US Fed has already announced plans for shrinking its balance sheet. The European Central Bank and the Bank of England have hinted at following suit, at some point.

Investor reaction to the US Fed move has been limited probably because the Fed's balance sheet as a percentage of GDP will shrink from only 26% as of the fourth quarter of 2017 to a projected 23% by end of 2018⁵.

Being in uncharted territory, Central Banks are moving cautiously. The resulting picture is that global liquidity will remain supportive. The situation should be monitored.

Investors, however, have already discounted in good measure, the 2017 potential rise in US rates⁶. The Fed has less room to manoeuvre than many expect despite its declared intention to hike rates once more this year.

Sources: ³The European Central Bank, the Bank of Japan and the Peoples Bank of China. ⁴Global M1 growth has exceeded global nominal GDP growth, these excess funds are "free" to invest in global assets. ⁵Based on the Fed's projections and the consensus economic forecasts, this ratio is forecast to fall to 19% by end 2019 and 15% by end 2020. ⁶The 30 day Fed Funds Futures have discounted two of the Fed's three anticipated hikes this year (and project rates to be only around 1.75% in early 2020). Source: Bloomberg, as at 27 June 2017.

Fig.2. Bank of America Merrill Lynch Global Government Bond index and the Thomson Reuters' Asia (ex Japan) Equity index from Datastream, as at 22 June 2017. Both series are in US Dollar. Any opinion or forecast is subject to change without prior notice. Note that past performance is no indicator of present or future performance.

Overlooked in the much lauded US jobs data, for example, is the strong bias towards the over 55-year olds⁷; rising jobs and wage bills may not feed retail sales to the extent of the past, (which may explain the recent sharp fall in the Citi US Economic Surprise index⁸).

The underlying picture is that the volume of money, not its price, is in the driver's seat.

Emerging and Asian markets lead earnings upgrades

High global liquidity is not the only factor driving financial markets onwards. As the world economies move into a cyclical upswing, profit forecasts are rising in tandem. The omens are that declared profits could well surprise on the upside, a reversal of the past two years (Fig.3).

Such positive "surprises" have already manifest themselves in Japan where investors, focused on the economy rather than companies, have underestimated the profit rebound⁹.

Skeptics may argue that many equities are fairly valued¹⁰ only because of the strong earnings upgrades seen over the past six months.

That many results outstripped their forecasts blunts this argument. But, there is little leeway for disappointment in the US given stretched valuations there.

Asia beckons

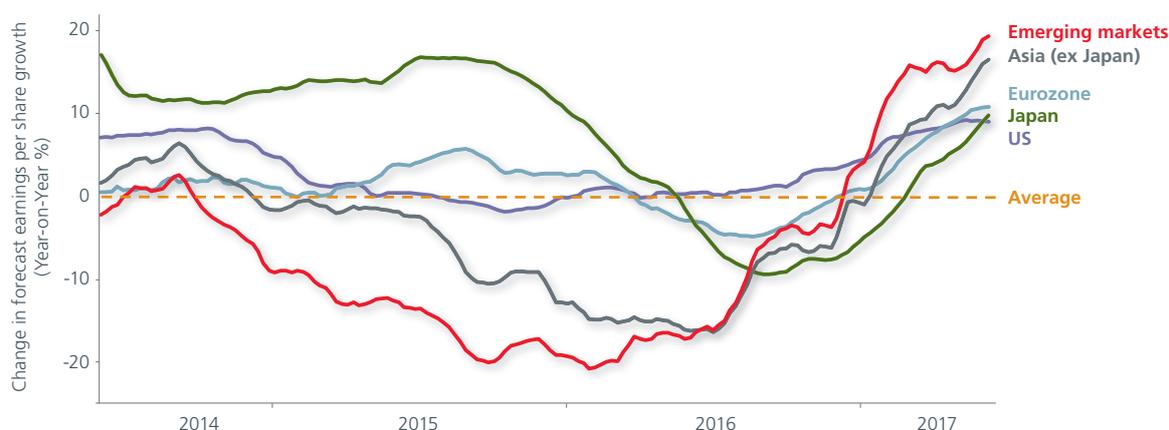
Globally, fairly valued opportunities abound, despite the strong rallies year to date. Indeed, there are many attractive opportunities especially within Asia and some Emerging Markets.

Valuations for Hong Kong's "H" shares, for example are still well below their 10-year average, which is probably an over-discounting of China's banking/property/currency concerns.

Asia's high dividend stocks, too, have been ignored as investors have swung towards growth and momentum.

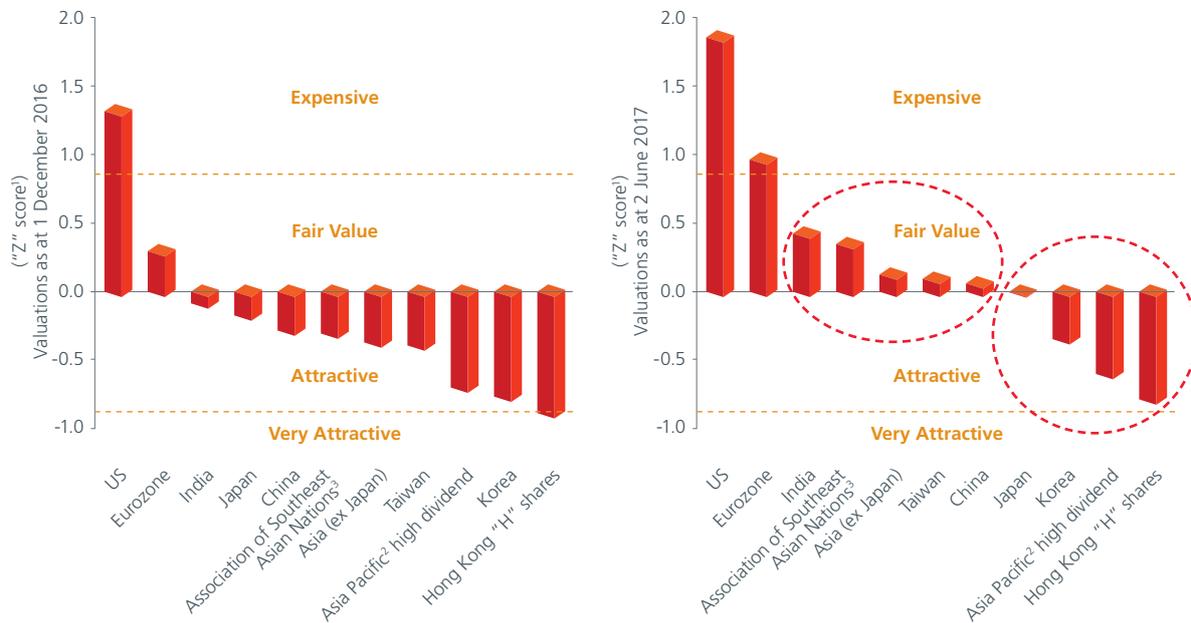
US equity valuations, in contrast, leave little room for disappointment. They will likely remain supported, however, by a prospective earnings yield of around 5½%¹¹, earnings forecast upgrades and on-going liquidity. While the economic cycle is in its upswing, much of the good news appears discounted.

Fig.3. The global earnings cycle swings upwards



Sources: ⁷The media focus on the increase in civilians employed from the 2009 low resulting from the 2008 financial crisis. This number is an apparently impressive 15½ million. The number of additional civilians in jobs since the start of the crisis, however, is only 6¼ million. Of this number, the number of civilians aged 55 and over accounted for 8¼ million. In other words, for those in the 25 ~ 54 age group, there are still 1½ million fewer in jobs than was the case when the crisis hit. ⁸The US Citigroup Economic Surprise index fell from a peak of 58% in mid-March 2017 to a low of -78.6%, as at 16 June 2017. Source: Citigroup, Bloomberg, as at 27 June 2017. ⁹"With the earnings season almost complete, Topix companies beat Q4 F3/17 consensus net income estimates by 10.8%. Operating income & revenues are also topped consensus estimates by 3.2% and 0.2% respectively. Reported F3/17 EPS and DPS have reached new all-time highs". Source: Morgan Stanley MUFG, as at 18 May 2017. ¹⁰As measured by the "Z" score in (Fig.4). ¹¹This figure contrasts with the 30-year average of 6¼% and a negative one standard deviation of 5½%. In contrast, the prospective earnings yield for Eurozone equities is 6¼%, Japan 7% and Asia (ex Japan) 7½%. Based on the IBES Consensus Forecasts from Datastream, as at 27 June 2017. Fig.3. IBES consensus 12-months forward earnings per share forecasts from Datastream, as at 22 June 2017.

Fig.4. Asia looks attractive...even after this year's rallies



Eurozone equity valuations look stretched on similar grounds. Nevertheless, they too, should find support not least because of their discount of more than 40% to US equities, the largest gap since 1989. Eurozone equities should also benefit from rising US rates given their higher exposure to the banks and cyclical sectors. Growth and profits have already materially improved on a forward looking basis.

Relative to the other developed markets, Japan's lower valuation looks very attractive (albeit in line with its 10-year average). Investors may remain cool to this fact, being influenced by the on-going tug-of-war between the success (or otherwise) of "Abenomics" and the fruits of corporate restructuring. The extent to which declared profits exceeded their forecasts in the recent announcements season, has accelerated the upgrade momentum in the profit forecasts, which could yet reflect in higher valuations.

Despite these positives, it is difficult to ignore Asia's and Emerging Markets' attractive valuations. The

omens look good for both not least because they are benefiting from a hitherto unexpected tailwind.

The US Dollar: From headwind to tailwind

One major reason for both Asia (ex Japan) and the Emerging Markets being badly hit prior to 2016 was the impact of the strong US Dollar; investors exaggerated US Dollar debt fears¹².

Since end 2016, the US Dollar has fallen over 5%¹³. Asian and Emerging Markets have rallied strongly.

The issue is whether US Dollar weakness will continue. Bearing in mind the heavy discounting of future US rate rises, the answer to the US Dollar's direction probably lies in the supply. With the Fed's QE program ended, one must look to the relative size of the combined US budget and current account balances for the answer. These "Twin Deficits" exert a powerful influence on the US Dollar, albeit with a variable lag.

Sources: ¹²According to Institute of International Finance, EM Debt Monitor March 2016, the bulk of the rise was in local currencies with foreign debt, particularly US debt being repaid. Bank of America Merrill Lynch (January 2016) estimated that only 28% of Asian debt was in US Dollar. They further estimated that around 23% of Asian sales were in US Dollar. In other words, companies were generating sufficient dollars to service their dollar debt. According to Worldscope (from Datastream as at 31 May 2017) emerging market net debt rose some 400% between 2006 and 2014 (it has since stabilised); the net debt to equity ratio, however, rose from a low 27% to an acceptable 46% and has since fallen to 41%. It is a similar story in Asia (ex Japan). Debt fears are exaggerated. ¹³US Federal Reserve Board from Datastream, as at 27 June 2017. Fig.4. Eastspring Investments, MSCI and IBES from Datastream, as at 22 June 2017. ¹The "Z" valuation is a composite measure giving equal weighting to the variation of the historical price to book ratio from its long-term trend and the variation of the prospective price earnings multiple from its long-term trend over a 10-year period. The two outer dotted lines represent the limits within which around 70% of all world values lie. ²Asia Pacific (ex Japan). ³Based on 9 years data.

Based on the consensus forecasts for 2017 and 2018¹⁴, the “Twin Deficits” are rolling over¹⁵. The message is that the dollar has peaked; any dollar strength on US rate hikes could well be short-lived. Should President Trump push through significantly larger budget deficits as many fear, the US Dollar could fall further.

Whatever the outcome, a major impediment to Asia’s and the Emerging Markets’ rising appears to have been removed: good news for equities and local currency bonds.

Earnings. Liquidity. Valuations. Pulling it together

Asian and emerging market equities, in particular, stand out as being attractive. Despite this year’s rallies, the massive over-discounting of the preceding years has only been clawed back (partially in some instances) with little premia, attached to the higher earnings forecasts.

While investment cases can be made for both the US and Eurozone equities, a fair measure of the good news has been discounted. Earnings yields, while low, have been lower, but there is little room for slippage

in earnings delivery. Of the two, the Eurozone looks relatively better value.

Amongst the developed markets, however, the strategic case for Japan remains the more compelling. Corporate restructuring and profits outstripping forecasts both support higher equity valuations¹⁶. Valuations are in line with the ten year average.

The outlook for bonds remains little changed from the start of the year. Liquidity should support the expensive, “safer” end of the curve, while, at the same time, prodding investors (in search of yield) towards the higher end of the risk spectrum.

Within this dynamic, Asian bonds in general offer a yield premia over their US (and most global) equivalents. Asian investment grade credits, in particular, still offer a premium in line with their 10-year average. This income pickup looks attractive particularly given that interest rates will unlikely rise sufficiently to dilute bond’s coupon appeal. A peaking dollar makes many emerging market local currency bonds look attractive.

With high liquidity underpinning markets, we reiterate our January mantra, “The Biggest Risk is No Risk”.

Sources: ¹⁴Using the consensus forecasts for US budget and current account deficits from Consensus Economics Inc., as at 10 April 2017. ¹⁵As at May 2017, the ratio is projected to ease from -5.8% to -6.3% by end 2018. ¹⁶Tactically, they could retreat if investors persist in tying a strengthening yen (if our peaking dollar analysis is correct) with weaker equities. While this yen/equity link was relevant in the past, it is much weaker today. Whereas, for example, overseas production account for only 2% of total production in the early 1980s, it now accounts for around 22%. Source: Cabinet Office, Japan from Datastream as at 31 May 2017.

OFFICE LOCATIONS

Singapore

Eastspring Investments (Singapore) Limited
10 Marina Boulevard
#32-01 Marina Bay Financial Centre Tower 2
Singapore 018983
Tel: +65 6349 9711

Hong Kong

Eastspring Investments (Hong Kong) Limited
13th Floor, One International Finance Centre
1 Harbour View Street, Central
Hong Kong
Tel: +852 2918 6300

China

CITIC-Prudential Fund Management Co., Ltd
Level 9, HSBC Building, Shanghai IFC
8 Century Avenue, Pudong
Shanghai 200120
Tel: +86 21 6864 9788

India

ICICI Prudential Asset Management Company Ltd
3rd Floor, Hallmark Business Plaza,
Sant Dyaneshwar Marg Bandra (East)
Mumbai-400 051
Tel: +91 22 2648000

Indonesia

PT. Eastspring Investments Indonesia
Prudential Tower
16th Floor Jl. Jend. Sudirman Kav.
79, Jakarta 12910
Tel: +62 21 2924 5555

Japan

Eastspring Investments Limited
Marunouchi Park Building 5F
2-6-1 Marunouchi, Chiyoda-ku
Tokyo 100-6905 Japan
Tel: +813 5224 3400

Korea

Eastspring Asset Management Korea Co. Ltd.
15/F, Shinhan Investment Tower
70 Yeouidaero, Youngdungpo-gu
Seoul, 150-712, Korea
Tel: +822 2126 3500

Luxembourg

Eastspring Investments (Luxembourg) S.A.
26 Boulevard Royal, L-2449 Luxembourg
Grand Duchy of Luxembourg
Tel: +352 27 86 06 50

Malaysia

Eastspring Investments Berhad
Level 12, Menara Prudential
No. 10 Jalan Sultan Ismail
50250 Kuala Lumpur
Tel: +603 2052 3388

Taiwan

Eastspring Securities Investment Trust Co. Ltd
4F, No.1, Songzhi Road,
Taipei 110, Taiwan
Tel: +8862 8758 6688

United Kingdom

Eastspring Investments (Luxembourg) S.A. UK Branch
125 Old Broad Street,
London EC2N 1AR
Tel: +44 20 7569 1953

United States

Eastspring Investments Incorporated
225 West Wacker Drive, Suite 1200,
Chicago Illinois 60606 USA
Tel: +1 312 730 9525

Vietnam

Eastspring Investments Fund Management Company
23 Fl, Saigon Trade Centre 37
Ton Duc Thang Street, District 1
Ho Chi Minh City, Vietnam
Tel: +84 28 39 102 848

Disclaimer

This document is produced by Eastspring Investments (Singapore) Limited and issued in:

Singapore and Australia (for wholesale clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore, is exempt from the requirement to hold an Australian financial services licence and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Australian laws.

Hong Kong by Eastspring Investments (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong.

Indonesia by PT Eastspring Investments Indonesia, an investment manager that is licensed, registered and supervised by the Indonesia Financial Services Authority (OJK).

Malaysia by Eastspring Investments Berhad (531241-U).

United States of America (for institutional clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is registered with the U.S Securities and Exchange Commission as a registered investment adviser.

European Economic Area (for professional clients only) and Switzerland (for qualified investors only) by Eastspring Investments (Luxembourg) S.A., 26, Boulevard Royal, 2449 Luxembourg, Grand-Duchy of Luxembourg, registered with the Registre de Commerce et des Sociétés (Luxembourg), Register No B 173737.

United Kingdom (for professional clients only) by Eastspring Investments (Luxembourg) S.A. - UK Branch, 125 Old Broad Street, London EC2N 1AR.

Chile (for institutional clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Chilean laws.

The afore-mentioned entities are hereinafter collectively referred to as **Eastspring Investments**.

This document is solely for information purposes and does not have any regard to the specific investment objective, financial situation and/or particular needs of any specific persons who may receive this document. This document is not intended as an offer, a solicitation of offer or a recommendation, to deal in shares of securities or any financial instruments. It may not be published, circulated, reproduced or distributed without the prior written consent of Eastspring Investments.

Investment involves risk. Past performance and the predictions, projections, or forecasts on the economy, securities markets or the economic trends of the markets are not necessarily indicative of the future or likely performance of Eastspring Investments or any of the funds managed by Eastspring Investments.

Information herein is believed to be reliable at time of publication. Where lawfully permitted, Eastspring Investments does not warrant its completeness or accuracy and is not responsible for error of facts or opinion nor shall be liable for damages arising out of any person's reliance upon this information. Any opinion or estimate contained in this document may subject to change without notice.

Eastspring Investments (excluding JV companies) companies are ultimately wholly-owned/indirect subsidiaries/associate of Prudential plc of the United Kingdom. Eastspring Investments companies (including JV's) and Prudential plc are not affiliated in any manner with Prudential Financial, Inc., a company whose principal place of business is in the United States of America.

For more information, please email content@eastspring.com



A member of Prudential plc (UK) 

Chicago | Ho Chi Minh City | Hong Kong | Jakarta | Kuala Lumpur | London | Luxembourg | Mumbai | Seoul | Shanghai | Singapore | Taipei | Tokyo