14th February 2018

THE FIRST CUT

All about the BAS(ics)

- **The combination of hawkish rate outlook, higher inflation expectations and technical factors caused yields to spike and equity markets to correct between 2nd to 13th Feb.**
- **Rebound in the equity markets has been relatively mild while yields stayed elevated.**
- **We reiterate that a correction was long overdue and not uncommon during late cycle. Fundamentals remain strong and we maintain our preference for ex-US equities.**

Volatility and volume of trades spiked during the sell-off from 2nd to 5th Feb. The drawdown continued to the end of the week, with US markets clocking in one of their worst weekly performance in two years.

To recap, there were two triggers for the sell-off:

- **On 2nd Feb**, average US hourly earnings growth surprised on the upside, coupled with hawkish tone from the January FOMC meeting earlier on, sparked fears of inflation.
- **On 5th Feb,** technical factors, such as program trades which initiated due to spike in volatility, acerbated the situation.

Inflation concerns were also fed by news that the White House has unveiled a long-awaited infrastructure plan that includes $200 billion in federal infrastructure spending over 10 years. Markets are watching the levels of yields closely and 10-year US Treasury yield has been hovering around 2.85%.

Figure 1: Market performances during the correction
Source: Bloomberg, 13 Feb 2018

		Day 1	Week 1	Week 2 (WTD)
	Index	02-Feb-18	5 to 9-Feb-18	12~13-Feb-18
Equity indices (%)	S&P 500 INDEX	(2.12)	(5.16)	1.66
	STXE 600 € Pr	(1.38)	(5.01)	0.53
	TOPIX INDEX (TOKYO)	(0.33)	(7.09)	(0.88)
	MSCI AC ASIA x JAPAN	(1.02)	(7.57)	1.83
	MSCI EM x ASIA	(2.36)	(5.70)	1.87
US treasury yields (bps)	US Generic Govt 2 Year Yield	(2)	(7)	3
	US Generic Govt 5 Year Yield	2	(5)	(0)
	US Generic Govt 10 Year Yield	5	1	(2)
US dollar index (%)	DOLLAR INDEX SPOT	0.59	1.40	(0.82)

1 PERSPECTIVE ON MARKET CONDITIONS

Markets rebounded slightly after the sell-off and the VIX Index also came down. In the near term, further corrections could occur but fundamentals remain strong.

Prior to this correction, the markets had a very strong run without any meaningful pullback.

From this perspective, the markets are indeed overdue for a correction and a pullback at this juncture is not extraordinary. In fact, some market participants view this drawdown positively as it gives the markets a breather from being overheated.

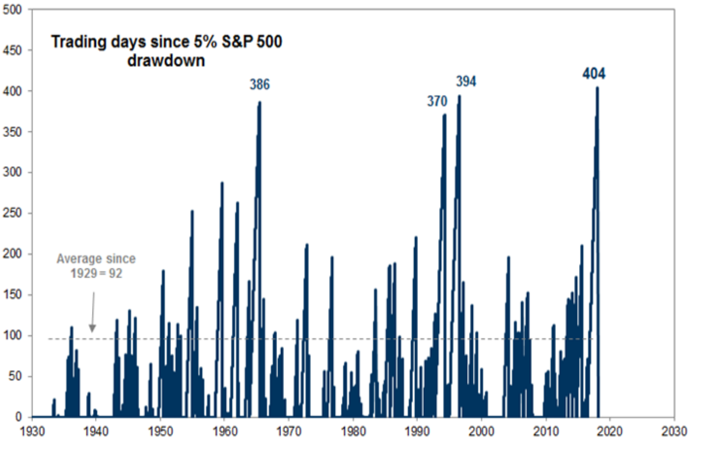

Figure 2: Markets were long overdue for a correction
Source: Goldman Sachs, 5 Feb 2018

We reiterate that fundamentals remain strong.

The global PMI is robust and indicating expansion in the economy, having recovered from lows in 2016. Meanwhile, earnings growth have rebounded and maintained at healthy levels across key regions in US, Europe and Japan.

In the near term, markets could continue to consolidate. However, we do not see this sell-off as start of a bear market.

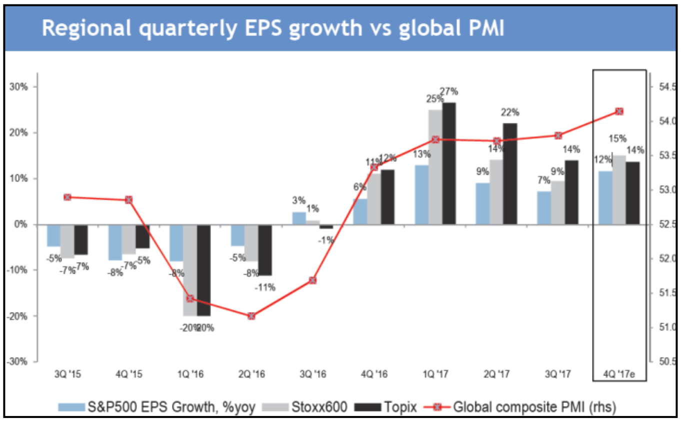

Figure 3: Global PMI and earnings growth are strong
Source: J.P. Morgan, 5 Feb 2018

2 STRATEGY FORWARD

The current equity market pullback is due more to technical reasons and fundamentals remain sound. Clients who are under-allocated to risk assets could make use of the correction to add some risk assets to their portfolio.

EQUITIES

- The current pullback in equities has occurred largely on technical grounds
- We see low probability of rising rates derailing the markets, as long as the earnings growth remains supportive.

Prefer Financials which benefit from rising rates.

Prefer ex-US equities (EM, Europe and Japan) as valuations in these regions are more reasonable and provide a better buffer for higher rates.

FIXED INCOME

- Our House expects **UST 10y yield to reach 2.9% by the end of 2018** and maintains forecast for 3 rate hikes (with the risk of an additional hike).
- With current UST 10y yield at 2.85%, **a large part of repricing is likely to be done.**
- In the short term, the UST 10y yield could grind closer to 3%, but any moves beyond that would require significant upside surprise from inflation and employment data.

Prefer EMD local currency on the basis of yield pick-up and supportive commodity prices. Some local central banks may have room to cut rates due to subdued local inflation.

FOREIGN EXCHANGE

- Dollar index stabilized after the FOMC meeting.

Maintain neutral view on USD. Commodity currencies and EUR are likely to continue to strengthen against USD, while GBP and JPY are expected to weaken against USD from 2nd quarter onwards.