Global Market

Entering into the fourth quarter, investors are likely to stay on the side lines for US equities due to our expectation of a non-event on 3Q earnings results. The mounting pressure on regulatory requirement for media and communication, are headwinds faced by the US tech equities. Health care and life sciences equities are less cyclical in nature and thus, more relatively defensive. In Japan, the re-election of Prime Minister Abe has triggered Yen to depreciate and USD/JPY surpassed the technical support level of 112, along with various economic data reflecting a higher rate of growth, it has become favorable for capitals returning to Japanese equities.

Emerging Market

Global emerging equities experienced much setback in 3Q, due to the headline negative sentiment on Argentina and Turkey, as well as US sanction on Iran and Russia. In view of a much muted trade war concerns in 4Q, investors will refocus on EM countries with strong fundamentals and corporate earnings outlook. We like EM Asia, in particular, the ASEAN stock markets.

HK/China Market

Hong Kong/China equity market was again adversely affected in 3Q due to further escalation of covered goods in import tariff hikes from both parties, but we see the tension will ease a bit later in 4Q as the latest import tariff showed both China and US would like to pace their actions and leave some room to negotiate rather than attacking each other.

Fixed Income Market

On fixed income, emerging market bonds have faced strong headwinds together with the equities in 3Q also due to the plummeting EM FX. After some of the EM country central banks have intervened, the currency market has stabilized and valuations became attractive, in our view. We are selectively positive on some EM country bonds.

Forex Market

On currencies, we expect US dollar index continue to see some support at current level in the near term. EUR and GBP will continue to swing according to Italian government budget situation and Brexit negotiation. On commodity FX, we expect CAD to outperform peers thanks to the confirmation of USMCA.
Executive Summary

Equities

US
Emerging Markets (EM)
Europe
Japan
China / Hong Kong

Global Bond Market

Currencies

EUR
AUD
CAD
EXECUTIVE SUMMARY

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- On currencies, we expect US dollar index continue to see some support at current level in the near term. EUR and GBP will continue to swing according to Italian government budget situation and Brexit negotiation. On commodity FX, we expect CAD to outperform peers thanks to the confirmation of USMCA.
Entering into the fourth quarter, as investors await the outcome of the mid-term elections in the US, and the third quarter earnings season is unlikely to surprise the market to a large extent, US equities will relatively be less robust in terms of performance. The fact that President Trump has shown his determination to investigate the accusations of monopoly status against the large technology companies, along with the mounting pressure on regulatory requirement for media and communication, are headwinds faced by the US tech equities. Health care and life sciences equities are less cyclical in nature and thus, more relatively defensive.

In Europe, corporate earnings remain lackluster and the pace of economic growth in the Eurozone continues to decelerate. In Japan, the re-election of Prime Minister Abe has triggered Yen to depreciate and USD/JPY surpassed the technical support level of 112, along with various economic data reflecting a higher rate of growth, it has become favorable for capitals returning to Japanese equities.

Global emerging equities experienced much setback in 3Q, due to the headline negative sentiment on Argentina and Turkey, as well as US sanction on Iran and Russia. We believe the falling EM FX has already stabilized by now, after many EM governments and EM Central Banks implemented various measures to curb fund outflows and currency weakness. In view of a much muted trade war concerns in 4Q, investors will refocus on EM countries with strong fundamentals and corporate earnings outlook. We like EM Asia, in particular, the ASEAN stock markets.

Hong Kong/China equity market was again adversely affected in 3Q due to further escalation of covered goods in import tariff hikes from both parties, but we see the tension will ease a bit later in 4Q as the latest import tariff showed both China and US would like to pace their actions and leave some room to negotiate rather than attacking each other. We also envisage China equities will benefit from PBOC’s easing bias in monetary policy this quarter, and we believe the policy bias will be toward expansion in infrastructure investment and domestic consumption.

On fixed income markets, in Asia markets, we expect a sharp rise in supply of high yield bonds will continue in 4Q after a quiet primary bond market year to date, and Asia high yield sector could remain in consolidation mode in the near term. Emerging market bonds have faced strong headwind together with the equities in 3Q due to the plummeting EM FX. After some of the EM country central banks have intervened, the currency market has stabilized and valuation became attractive, in our view. We are selectively positive on some EM country bonds. We think the fundamental of Mexico is strong, while Russia should benefit from a higher oil price in 2H18. As for Brazil, we believe the results of presidential election at the end of November are likely to cause some volatility in its currency and bond market. Meanwhile, we are wary of India and Indonesia’s twin-deficit situation.

On currencies, we expect US dollar index continue to see some support at current level in the near term, due to a higher Treasury yield level and strong US economic indicators. The concerns on trade tension and risk averse sentiment have also contributed to the recent strength of the green back. EUR and GBP will continue to swing according to Italian government budget situation and Brexit negotiation. On commodity FX, we expect CAD to outperform peers thanks to the confirmation of USMCA.
A stellar third quarter kept US stocks outperforming year to date. The summer of 2018 has turned out well for U.S. equities markets, as two of the best three months in 2018 for the S&P 500 Index occurred in July and August. After defensive sectors led in July, growth sectors reasserted itself in August.

Trade tensions ease but is not over. After the first 25% tariff on USD50bn worth of China imports were imposed, a further 10% tariff on another USD200 bn worth of imports were also implemented on 24 Sept, increasing to 25% by the end of the year. The White House also threatened tariffs on an additional USD$267 bn worth of imports if China retaliates, which China promptly did on 18 Sept with 10% tariffs on US$60 bn of US imports. So far, China has either imposed or proposed tariffs on US$110bn of US goods, representing most of its U.S. imports. Despite the strained economic relationship, the negative impacts on the US equities have been limited. However, further intensified tension could at the end weigh on US equities with international exposures. US small caps is more correlated with the local economy and could be less affected by the ongoing trade tensions.

Macroeconomic conditions remain sound. Economic fundamentals are sound despite ongoing concerns with trade tensions. The second reading on 2Q18 GDP showed growth of 4.2%, the fastest pace since 2014. GDP growth is forecasted be in the 2.9%-3.2% range for full year of 2018. As the Fed continues pushing rates higher, quarterly growth is expected to slow into 2019. Preliminary GDP growth for 2019 is forecasted to be 2.4% according to FactSet estimates. Strong economic backdrop is one of the strongest factors supporting US equities at current levels.

The Fed maintained the number of projected rate hikes next year. The Fed raised rates by 25 bps in September, for the third time this year, which had been widely expected. There were only minor changes to the Fed’s projections; the long-run neutral estimate of the fed funds rate inched up, while the “accommodative” language was eliminated from the Fed’s statement, which implies it will give the Fed more flexibility in future actions and communications. Updated expectations are now that the Fed will hike once more this year, three times next year.

Robust corporate earnings currently supporting US stock valuations. S&P 500 constituent stocks performed well in 2Q 2018, as earnings per share grew by 25%, and 80.4% of companies performed better than market expectations. Of which, only 7% earnings growth was attributable to tax reforms, while the remaining 18% was due to companies performing better and share buybacks. For the year, corporate earnings momentum should remain potent, with markets predicting earnings growth to reach 23.4% this
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year. Thus currently high valuations are intact. However if the momentum of earnings growth slowed down from currently high estimated levels, over 20% for earnings per share during both the third and fourth quarters of 2018, valuations would be a concern after the markets have repeatedly made historical highs. As a result, further upside potentials could also be limited.

Sector outlooks

Telecommunication Services. Effective 28 Sept, the change in the Global Industry Classification Standard (GICS) framework will change the S&P500, Dow Jones and MSCI index underlying sectors’ classification. The replacing of communication services sector to telecommunication services sector will as a result cut down tech sector of the S&P 500 to about 21% from 26% of the index; consumer discretionary sector to 10% from originally 13%; The new telecommunication sector will represent 10% of the index from originally less than 2% portion. Since movement of companies included the mega-cap stocks formerly perceived more as technology related, the characteristics of telecommunication sector is expected to be changed to become more volatile and lower in dividend pay out because of dilution effects.

Healthcare / Biotechnology Trump has implemented some measures in the hope that pharmaceutical companies would lower drug prices. Although the effectiveness of the plan is yet to be seen. Investors chose to focus on the sector’s upside potentials than the near-term rhetoric. On top of the benefits from tax repatriation, healthcare/biotechnology companies enjoy a lot of positives going forward. Strong balance sheets and cash positions help the companies to increase dividend payout, share buybacks, and M&A activities. Traditionally, the sector outperformed during Fed hiking cycles on average, though government policies and potential actions continue to cause volatilities.

Consumption related The US consumption market remained active and strong. Thanks to tax cut measures, slow and gradual monetary tightening policy, tight labor market and wages trending higher. All these factors contributed to stronger consumer confidence. Online shopping has been gradually replacing brick and mortar stores as the primary shopping channel for Americans. Therefore we are constructive on e-commerce platforms, shops and service providers. The status of the American consumer looks good to us heading into the holiday shopping season.

Information Technology stocks remain the focus of the markets amid robust earnings results. It was reported that 92% of S&P 500 tech companies reporting better-than-expected results in 2Q18, while overall earnings growth looking into 22.8% for full year of 2018. As an integral part our daily lives, such as the development of smartphones, AI, 5G, healthcare and autonomous driving, technological applications and growth are significant in the long run. However, technology equities could be vulnerable if earnings growth moderates or the economic growth slow down. In the short term, the skeptics will focus on the regulators’ monitoring on the industry including issues such as data privacy and other related issues.

Risk considerations: 1) Further escalation of trade tensions; 2) Slowdown of economic growth; 3) surges in oil prices; 4) Geopolitical risks in Europe and the Middle East; 5) Faster-than-expected Fed rate hikes, or the Fed sending unclear signals to markets during normalization; and 6) A strong USD affecting US competitiveness.
12-Month Performance

MSCI Emerging Index

MSCI Emerging Index Data

- Market cap (USD): 13.5 Trillion
- 52-week Hi / Lo: 1279 / 999
- 3-Mth Total Return: -1.0%
- Y-T-D Total Return: -7.5%
- 50 / 250D Mov.Avg.: 1,050 / 1,131
- 2018 Est Yield: 2.7%
- 2018 Estimated P/E: 12.0x
- 2019 Estimated P/E: 10.9x
- 2018 Estimated P/B: 1.56x

Source: Bloomberg L.P.
As of 09/28/2018

Emerging stock markets remain weak. Sino-US trade frictions and several emerging economies being in a state of crisis has led to emerging stock markets declining slightly in the third quarter, recording a QoQ drop of 1%. Asian stocks, deeply affected by trade disputes between China and the US, performed the worst and extended the weak trend displayed at the end of the second quarter, falling 1.5%. Despite the economic turmoil in Turkey and Argentina, emerging European and Latin American stocks benefitted from rebounding material prices, rallying by 2.6% and 4.9%, respectively.

Sino-US trade disputes take center stage. Sino-US trade disputes continued to escalate during the quarter with both countries imposing retaliatory tariffs and expanding the list. This threatens global trade and significantly undermines investment sentiment in emerging stock markets. The uncertainties of the Sino-US trade situation have affected numerous emerging markets that mainly export to China. Asian economies are closely tied to China’s trade as Taiwan, South Korea and numerous ASEAN countries are all part of the supply chain that feeds China’s manufacturing industry. As a result, these stock markets experienced varying levels of impact.

Devaluation the norm among emerging market currencies. Due to the continued strength of the USD, fundamentals of certain emerging economies have weakened. During the quarter, Turkey was threatened by US economic sanctions, triggering substantial capital outflow. Turkish president Erdogan’s intervention in central bank decisions on multiple occasions has also dented investor confidence and the TRY has dropped nearly 40% in the third quarter alone. The resulting domino effect has caused a wave of devaluations among emerging market currencies, with the JPM Emerging Markets Currency Index falling to a record low. The ZAR, IDR, INR, RMB, NTD and KRW displayed different levels of devaluation, with some plunging to historic lows. Central banks were forced to hike rates decisively to prevent further capital outflows.

Emerging markets look set to rebound. After slumping for months, emerging stock markets have already digested a large amount of negative news. The RMB stabilized and the USD weakened, pausing the decline in emerging market currencies. China has also reduced import tariffs for its trade partners, benefitting many emerging countries that mainly export to China. Earnings growth predictions for emerging markets remain optimistic, with expectation of 14.4% growth this year. Analysts slightly lowered predictions for 2019, which stands at 12% now, indicating that international trade disputes have not eroded the solid fundamentals of emerging markets. The PE ratio of emerging markets is 11.9x in 2018, and should fall to 10.6x.
next year, lower than the past five years average and much cheaper than developed markets. In the fourth quarter, we expect emerging markets to rebound in the midst of volatility.

Region Outlook

Emerging Asia Sino-US trade disputes tested the mettle of emerging stock markets in Asia, with the highest weighted China and Hong Kong markets falling the most. While retaliatory tariffs imposed by China and the US may affect corporate earnings, analysts generally maintained a very positive earnings outlook. Markets anticipate Asian (ex-Japan) stock earnings in 2018 shall grow 13.6%, only marginally lower than before the Sino-US trade dispute broke out. Among Asian economies, economic growth in ASEAN countries is mainly driven by consumption, while their reliance on exports is relatively lower. The Sino-US trade dispute may force manufacturers to shift production base from China to ASEAN countries, bringing them economic benefits. The dispute’s effect on Northern Asia is already reflected in recent downward trends, but we expect to see Asian stocks rebound once trade tensions ease.

Latin America Mexico and the US both made concessions before arriving at a new trade agreement. Automobile related terms received the most attention, as the US proposed that automobiles must have 85% of content from the three North American countries of US, Canada or Mexico, significantly higher than the 62.5% stipulated by NAFTA. It was also proposed that automobiles sold in the US must have at least 50% domestically produced parts. After intense bargaining and concessions, it was agreed that for an automobile to be exempt from tariffs, it must have 75% content from the three North American counties, and 40-45% components produced by workers receiving an hourly wage of USD 16. The agreement cleared the uncertainty surrounding Mexico. In rest of Latin America, Brazil will hold general elections in October, but no candidate holds an absolute advantage, presenting substantial uncertainty for Brazilian stock markets. Investors are concerned whether the country’s new government will be capable of implementing sustained reforms, which may lead to turmoil in stock markets.

Emerging Europe Middle East Africa (EEMEA) Turkey hiked official policy rates from 17.75% to 24% in September. The increase of 625 bps was higher than 300 bps anticipated by markets. The Central Bank of Turkey ignored comments from the president and hiked rates considerably, allowing the TRY to regain its strength. Investors were relieved by this development as it provides respite for the emerging markets currency crisis. In Russia, European and US sanctions concerns, coupled with the expectation that the US will roll out more sanctions in November dragged the RUB down. The Central Bank of Russia set rates at 7.5%, the first rate hike in four years, to demonstrate its determination to fight inflation and uphold its currency. The recent surge in oil prices benefitted Russian stocks as the economy is highly correlated with oil prices.

Risk Considerations:
1) Political, liquidity, and currency risks could deteriorate rapidly, 2) Fluctuation on oil / commodity / agricultural prices leading to inflations, 3) Escalations in global trade conflicts could dampen growth, 4) Higher levels of and faster pace of tightening by the US Fed, weighing on EM currencies.
INVESTMENT SUMMARY
- Focus was on European politics and global trade conflict
- Eurozone Citigroup Economic Surprise Index rebounded
- European Central Bank (ECB): economic expansion to continue
- Equity valuations reasonable, skeptical on uncertainty
- Short term volatility might rise

Focus was on European politics and global trade conflict. As of September 25 2018, approximately half of the Stoxx 600 constituents have reported Q2 earnings and 50% of them have beaten analyst expectations, which is comparable to historical averages. However, growth in profits exceeded analysts’ consensus only by 3.1%, lower than the historical average of 4%. While risk appetite improved after fears over European Union (EU)-United States trade tensions eased, European banks’ financial health were concerned amid depreciation of the Turkish lira; Brexit and the Italian budget deficit were also among the worries preventing European stocks from experiencing upward momentum, with the Euro Stoxx 600 index returning only 1.3% during the third quarter. Entering the fourth quarter, the market will remain focused on global trade tensions, Brexit and questions over the Italian government budget deficit. The Euro Stoxx 600 Index might still be narrowly traded round bound.

Eurozone Citigroup Economic Surprise Index rebounded. After the Eurozone reported its highest economic growth rate in almost a decade in 2017, economic numbers have tapered off this year. The Eurozone Citigroup Economic Surprise Index dipped from its 2017 year-end number of positive 92.9 to negative 101 this May. This reflects the European economic data have been lagging market expectations. Nonetheless, Eurozone data have recovered somewhat — unemployment fell to a ten-year low of 8.1% in August, and total employment hit an all-time high in 2Q18. Tightening labor conditions should spur wage growth, providing further impetus for EU economic growth prospects because of higher household spending (which accounts for around half of the Eurozone’s GDP). To a certain degree, those might help the region withstand the negative effects of global protectionism.

European Central Bank (ECB): economic expansion to continue. With the Eurozone’s economy heading towards its fifth consecutive year of growth, the ECB is gradually withdrawing its stimulatory measures. In the September ECB Board Meeting, the central bank announced its asset purchasing program will be slashed from EUR 30 billion to 15 billion starting from October to December; the ECB also said it expects to end the program by the end of 2018, and maintain interest rates at historically low levels until next summer. Although the ECB cut its GDP forecast for 2018 and 2019 to 2% and 1.8% respectively, ECB chief Mario Draghi believes the EU economy’s broad expansion will continue and remains optimistic over the region’s inflation outlook. We believe the ECB is in no hurry to hike rates after ending its asset-buying program; the low interest-rate environment will lower finance costs and boost corporate profits. The easing of EU-US trade frictions will also reduce pressure on European auto makers.

Equity valuations reasonable, skeptical on uncertainty. The outlook for European equity markets remains cloudy due to uncertainty over Brexit
discussions and whether Italy’s budget plans proposed will be accepted by the EU. Combined with rising global protectionist sentiments, the above factors will cause European equity markets to possibly underperform other developed markets in the short term despite European equity valuations remain reasonable. The Euro Stoxx 600 index’s dividend yield is currently 3.7%, higher than the MSCI World Index’s 2.5%. While the Stoxx 600’s current estimated price-earnings (PE) ratio of 13.8x is slightly higher than its 10-year average of 13.7x, it represents a discount to the MSCI World Index’s 15.1x PE ratio.

Short term volatility might rise. With the rates forecast to remain low for an extended time, growth in business investment activity is expected to continue. As EU-US trade talks commence, a trade agreement between the two will become a positive catalyst. In the short-term, be mindful of progress in Brexit negotiations, Italy’s budgets’ proposals or mid-term elections in the US heightening market volatility. During 4Q18, the Euro Stoxx 600 index is expected to consolidate within a trading range.

Germany German Central Bank reported in August indicates that the country’s third-quarter economic growth will slip below the average of the first half even the trade tensions have eased, amid a fall in factory orders and automakers dealing with a new round of emissions testing. Nevertheless, the German economy remains intact compared to others in the Eurozone; should the EU and the USA resolve the problems surrounding motor vehicle tariffs, that should help stabilize Germany’s industrial output and exports. Meanwhile the focus is on the outcome of EU-US trade.

United Kingdom With Great Britain set to formally exit the European Union in less than six months, neither the UK nor the EU have come to an agreement on the terms of Brexit; there has also been in-fighting among the Tories over how Brexit should be handled. Philip Hammond, the British Chancellor of the Exchequer, has said uncertainty over Brexit is damaging the country’s economy: the UK reported business investment fell in the second quarter, and the current account deficit expanded faster than expected. In the near-term, all eyes are on the outcome of Brexit talks, and a mutually agreed deal and an orderly arrangement of the United Kingdom’s withdrawal from EU will be critical.

Italy The Five Star Party-led Italian governing coalitions has announced that the country’s three-years budget will have start with a deficit of 2.4% of the GDP. This figure is significantly higher than the 0.8% deficit set by the previous center-left government and runs afoul of previous Italian promises to the European Union that limit the country’s government deficits to 1.9% of the GDP. European Parliament President Antonio Tajani warned that Italy must slash its debt — Italy’s debt-to-GDP ratio currently stands at 130%, trailing only Greece in the Eurozone. All eyes are now on an EU Commission review of the Italian budget due in November.

Risk Considerations: 1) Growing Italy-EU tensions; 2) EU-US trade talks; 3) ECB hastens rate increases over rising inflationary pressures; and 4) Slowdown in China’s economy
INVESTMENT SUMMARY

- Japanese equities rebounded slightly in Q2 2018
- BoJ maintained the short-term rate target as expected
- Weaker JPY benefits exports
- Japanese stocks continue to attract capital inflows
- The mid-to-long term development of Japan

Japanese equities performed well in Q3 2018. The Nikkei 225 index held well during Q2 2018. Despite persistent concerns about the US-China trade war and global economic growth, Japan commenced Q3 with generally upbeat economic data. Headlines relating to re-emergence of emerging market currency woes and the gradual rate hikes by the Fed caused JPY to start to weaken. At the same time, driven by foreign capital inflows, the Nikkei broke through the 22,000 - 23,000 range and closed at 24,120, a 27 years high, on the last day of the third quarter. The index rose for the fourth consecutive month and was up 5.49% in September. It gained 8.14% in Q3 (outperforming most of the Asian markets) and 5.95% for the first three quarters. Topix Index (representing large caps) and Topix 2nd Index (representing small to mid caps) went up 4.99% and 0.14% respectively during Q3.

BoJ maintained the short-term rate target as expected. The BOJ remained optimistic about the economy and committed to guide the indicative 10-year government bond yield to stay at around the zero level. Adopting the forward-looking guidance, the bank is expected to implement a more flexible and accommodative policy and keep rates low. It is pointed out in the policy statement that the commitment to purchase Japanese bonds in a flexible manner will remain unchanged in response to the moderate economic expansion and the bond holdings will continue to increase at a pace of approximately JPY80 trillion per year. The BoJ's quota of ETF purchase may be higher or lower than JPY6 trillion and the bank will expand purchases of TOPIX-linked ETFs.

Weaker JPY benefits exports. While USD receives support from the Fed's continued policy of gradual rate hikes, the USD/JPY exchange rate dropped raised from 110 at the end of Q2 to close to 114 in Q3, which favors export-oriented businesses. The latest data show exports continue to grow and export stocks have risen. However, progress of trade talks between the US and Japan needs to be watched over the coming months. The US may not impose sanctions on auto exports for the time being, but if negotiations go awry, other export orders may be impacted going forward.

Japanese stocks continue to attract capital inflows. Most economic data released recently are satisfactory. For instance, Japan's Markit Nikkei Manufacturing PMI marked the 25th consecutive month of topping the threshold 50 level on a seasonally adjusted basis in September. This indicates that manufacturing activity continues to expand at a faster pace. The unemployment rate fell to 2.4%, beating expectations. Industrial production and retail sales also recorded growth. Importantly, Abe won three consecutive general elections to be the leader of the ruling party and the Prime Minister with a term of three years up to September 2021. Supported by at least temporary dissipation of political uncertainties, better

Source: Bloomberg L.P.  
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Fundamentals and generally better economic data, Japanese stocks may continue to draw in capital in Q4 (in the first three quarters of 2018, Japanese stocks recorded inflow of capital in 31 of 41 weeks).

**The mid-to-long term development of Japan.** Though the frequent occurrence of earthquakes, typhoons and natural disasters in recent months undoubtedly impacted the growth in number of visitors, it is believed that the tourism industry would continue to thrive in the mid-to-long term. Weakening of JPY may be among the key factors in attracting visitors, not to mention the 2020 Tokyo Olympics. The Japanese government’s economic report for September mentioned that “Japan’s economy continues to recover moderately.” Q4 performance of equities in the past decade (2008-2017) as measured by Nikkei has been negative only in 2008 and 2011 while positive returns were recorded in all other years. Therefore, it is likely that the momentum of Q3 may persist in Q4.

**Risk Considerations:** 1) Worsening trade war may engulf various Japanese export sectors; 2) Risk of yen appreciation; 3) Significant surge in JGB yield; 4) Japan fails to meet BoJ’s inflation expectations; and 5) Slowdown in China’s economy, as China is Japan’s second largest trading partner.
INVESTMENT SUMMARY
- There is sign of slowdown in China's manufacturing amid ongoing trade tension
- USMCA could give the U.S. more bargaining power
- HK stocks performance is limited by the stronger USD
- The Chinese government has proactively launched measures to boost infrastructure and consumption.
- Inclusion of A shares by FTSE Russell and MSCI Emerging Markets will likely help stabilize A share market

There is sign of slowdown in China's manufacturing amid ongoing trade tension Entering 4Q18, HK/China stock markets are still under the impact from uncertainties in US-China trade conflict. Currently, the market has already reflected the increase in tariff rates from both sides. However, China's official and Caixin Manufacturing PMI have clearly declined for the month of September. In particular, the Caixin PMI fell to 50.0 only. Measures such as new orders, productivity and employment have turned weaker, raising market concern whether China growth has slowed down.

USMCA could give the U.S. more bargaining power The U.S., Canada and Mexico have reached a common agreement known as USMCA, which has helped lower the risk of trade conflict among the three nations. The investment sentiment in the Americas will improve as a result, giving Donald Trump more bargaining power in future trade talks with China. More importantly, the agreement contains terms which would discourage member nations from forming trade agreements with China, and they also discourage foreign investors and large-scale tech enterprises from investing in China. Such terms could become obstacles for China to advance its technologies in the future.

HK stocks performance is limited by the stronger USD. Following an interest rate hike in September, the US Fed continued to be optimistic about inflation and employment outlook. The Fed also supports its own stance of raising interest rate steadily, thus providing support to the US dollar. At the same time, Italy's refusal to back down from its budget proposal in front of European Union in early October led to market concern. In particular, Italy's proposal suggests its budget deficit could reach 2.4% within three years, which would exceed the requirement from the European Union. The incident has weakened the Euro and thus strengthened the US Dollar, which broke the 50 and 100 moving average lines. The USD strengthening also limited any potential rebound in the HK stock market.

The Chinese government has proactively launched measures to boost infrastructure and consumption. At the same time, the Chinese government has begun rolling out policies in late July to proactively manage the risks of economic slow down in China. In particular, the issuance of RMB1.35tr local government specialized bonds will speed up, which will help accelerate construction progress of major infrastructure projects. Other than infrastructure investments, State Council has also made announcement to encourage consumer spending, given that China retail sales growth has slowed down in 2018. Such measures will cover the basic areas of spending such as food, transportation and housing. One example is the exemption of
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vehicle purchase tax on new energy vehicles. For the remaining part of this year, corporate taxes and other expense burden may also be relieved. We believe the impact from such measures would be gradually reflected in 4Q18.

Inclusion of A shares by FTSE Russell and MSCI Emerging Markets will likely help stabilize A share market Relative to HK stock market, the A share market enjoys more positive catalysts. In particular, FTSE Russell announced in September to include A shares in three stages. Upon completing the first stage, A shares are estimated to account for 5.5% of FTSE Russell Emerging Markets index. At the same time, MSCI also plans to increase the inclusion factor for A share large caps from 5% to 20%, as well as adding the ChiNext Board to the eligible list of qualified exchanges under the MSCI index methodology. Going forward, the weighting for A share mid caps will also be gradually raised. The proportion of A shares within the MSCI Emerging Markets Index is estimated to grow from 0.7% currently to 3.4% by May 2020. Currently, foreign capital represents less than 10% of the A share market and the level is still significantly below that of Japan and Korea. Over the longer term, inflow from foreign capital will likely help support A share performance.

Risk Considerations: a) potential escalation of US-China trade tension or potential deterioration in US-China relationship; b) faster-than-expected slowdown in the Chinese economy; c) USD strengthens more than expected, or EM currencies weaken further.

Focus Sectors

China insurance After the slow down in 1Q18, new business value (NBV) of life insurers in 2Q18 has rebounded. Other than the phase out of high base effect from last year, increasing agency productivity and the proactive launch of protection products also are likely to keep the growth momentum going into 4Q18. Other than certain individual life insurers, the overall product mix and channel mix also improved, resulting in better profit margins. In terms of P&C, auto insurance premium saw stable growth of mid-to-high single digit in 1H18. Non-auto insurance premium growth was much stronger at over 30-40%. Overall, underwriting profit and cost effectiveness are at healthy levels. However, A share market still remains weak and investment yield could deteriorate if market volatility persists.

Infrastructure Due to the escalation of trade conflicts, consensus found China will increase infrastructure investments to maintain economic growth, which would facilitate Belt and Road Initiative. In fact, The MOF also published the Opinion on the Issuance of Special Project Bonds by Local Governments, which targets local governments issue RMB1.35tn of special projects bonds by the end of October. The Ministry of Finance (MoF) has announced that bonds issued by local governments for special projects amounted to RMB500bn in Sep, and the figure in Aug amounted to RMB420bn, and it is believe that MoF will issue the rest of the quota in Oct. As such, We believe local government special projects bond issuance will increase in Sep and Oct. Despite YTD Infrastructure Fixed Asset Investment grew only 4.2% in August. But we expect that capital from special bond issuance will be available, market expects infrastructure investments will accelerate. Moreover, the railway and infrastructure sector trades at FY18E PE ~9.8x, the valuation remains undemanding.
Cement  The National Development and Reform Commission recently investigated the price rallies of crushed stone, cement and concrete. However, Digital Cement believes this round of investigations is mainly targeting at the surge in crushed stone prices this year, rather than cement. Digital Cement expects that China government is unlikely to impose a price ceiling for cement and production cut during the winter will not be affected. Fundamentally, the Chinese government continues to restrict capacity expansion in the cement sector. The China Cement Association target to reduce clinker capacity by 390 million tons and increase clinker and cement utilization rate to 80% and 70%, respectively, during 2018 and 2020. Relaxed monetary policies and more investments in infrastructure will accelerate the progress of infrastructure projects in the fourth quarter. Supply and demand of cement may further improve, which should support cement prices in fourth quarter, the peak season.

Macau Gaming  Macau Gross Gaming Revenue (GGR) turned to positive since Aug 2016. The growth rate record double-digit growth since Feb 2017. Due to Sino-US trade conflicts, market estimate FY19E GGR will increase 9.8% yoy (VIP +6.3% yoy and mass +9.8% yoy). Despite the growth rate decelerate, we believe the street will revise up FY19E GGR forecast after the ease of trade conflicts. Thanks to the opening of new casinos in these years, the competitive advantages of Macau gaming sector is on the increase. More importantly, the new Cotai ferry terminal already commenced operation, and Hong Kong – Zhuhai – Macao Bridge is also expected to open in 2H18, which could increase the traffic flow and accessibility significantly. For VIP business, the market is more health after consolidation. For mass market business, gaming operators are developing its non-gaming businesses and (MICE) meetings, incentives, conferencing and exhibitions will be the direction. Also, the tourism facilities of Hengqin are under development and China government is planning to develop the Greater Bay Area, which will benefit Macau gaming sector. Also, the gaming license renewal procedure will release soon, which will also reduce uncertainties.

Leasing Landlord and REITs  HK retail sales value upward trend will continue, thanks to the support of Individual Visiting Scheme (IVS), improving accessibility due to the completion of infrastructure. As such, leasing landlord with large scale shopping malls will benefit from their turnover clause. More importantly, mall operators can achieve decent growth via Asset Enhancement Initiatives (AEIs), change of tenant mix, acquisition of existing investment properties or development of their own investment properties. These years, China companies are developing business in HK. The launch of Stock Connects and Bond Connects will attract more financial institutions to expand their HK business. As such, the demand of office space will inevitably increase. Also, experienced landlords are enhancing their value via capital recycling. As such, we are positive on the outlook of the sector. That said, cherry picking is needed, we believe. The sector is famous for low gearing ratio and high dividend yield of ~4-5%.

Education  The total revenue of China private higher education industry increased from RMB69.6bn in 2012 to RMB95.4bn in 2016, with a CAGR 8.2%. Consensus estimated it will reach RMB139bn in 2021, which means 2016 - 2021 CAGR 7.8%. In fact, China national disposable income per capita increased 9% yoy to RMB 25,974 in 2017. The rise of middle class will trigger off the demand of private education services. More importantly, supportive government policies will advocate M&A. The fact is that most of
the listed players conducts M&A these years with decent results. We continue to like the sector thanks to light-asset model, fragmented market, high growth, strong operating cash flow, and value-added services. Despite the Justice Department issued opinion about education services operators should choose "For profit" or "Not for profit" business model create policy risks, we found the impact on higher education operators is limited. The fact is that several higher education operators released M&A after the release of policy, and get the approval from Education Department. That means, the market is over-reacted. As such, we maintain positive on the sector.

China Property Management The average revenue of the top 100 Property Management companies soared from RMB294mn in 2013 to RMB742mn in 2017, representing a CAGR of 26.1%. Meanwhile, the average revenue-bearing GFA managed by the Top 100 Property Management Companies increased from 15.1mn sq m in 2013 to 31.6mn sq m in 2017, representing a CAGR of 20.3%. The increasing disposable income of China resident make them more focus on the service quality. We like the sector due to light-asset model, high organic growth, development of value-added services, parent company support, and M&A opportunities. At present, there are 70,000 players in this fragmented market, and consensus expect the top 100 companies will expand market share to 45% by 2020E, compared with 33.3% in 2017. We prefer players in large-scale, parent company support, quality brands and net cash positions.

China food & beverage In order to cope with uncertainties from US-China trade tension, State Council announced new measures on Sep 20 to encourage consumption, which entails several areas of basic consumption. It also mentioned supporting consumption upgrade for the auto industry, especially the proper implementation of vehicle purchase tax exemption for new energy vehicles. In fact, with China’s retail sales slowing from around 10% in 2017 to 9% by August 2018, demand for luxury goods has weakened. However, there is stronger demand for durable goods, food and beverage, as evidenced by improvement in interim net profit. We expect such basic consumption will continue to benefit from price hike, gross margin expansion and economies of scale in 2H18.

China wind power In the short run, wind power operators’ output and revenue mainly depend on wind speed, which is an unpredictable factor. But in the long run, China continues to encourage the use of new energy. According to the 13th Five Year Plan for development of electricity, China plans to lower the wind curtailment rate to below 5% in 2020, an improvement from 12% in 2017. In 1H18, the national wind curtailment rate was further reduced by five percentage points to 8.7%. A better curtailment rate will increase utilization hour and profitability of wind farms. On the other hand, the renewable energy subsidy from the National Energy Administration will remain the same over 20 years, while the potential “green certificate” might be launched which will ease market concerns over the uncertainty of subsidies. At the end of August this year, the media reported that the MOF has approved RMB 40 billion worth of renewable energy subsidies. Cash flows of wind power operators may improve.
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BONDS

US treasury yield has made an upward breakthrough. Technically, there may be room for further upside. As expected, the Fed announced to raise interest rate by 25 basis points in September meeting. The dot plot indicated that Fed officials expect to raise interest rate once more this year, three times in 2019 and once in 2020, same as the forecast in June. While the pace of interest rate hikes is on track, the inflation has not risen sharply so far. The Fed lowered its inflation forecast for 2019 from 2.1% to 2% and they maintain a wait-and-see stance toward whether Sino-US trade war will have an inflationary impact. Labour market condition is still good in September. Non-farm payrolls rose less than expected, but this was distorted by Hurricane Florence. September unemployment rate fell to near a 49-year low of 3.7% and ADP private sector employment data was much better than expected. Interest rate hikes, inflation and the strong US economy together triggered a technical breakthrough for the US treasury yield. 10-year treasury yield eventually climbed above the year-to-date resistance level of 3.12%. Technically, there may be room for further upside and 3%-3.1% could be the new support level.

EM bond markets may perform differently in the future, depending on the economic, political, and monetary stability of individual country. EM did not perform very well in last quarter. The Fed kept tightening monetary policy, and trade protectionism was hurting export trade in EM. However, EM bond markets showed a significant rebound in mid-September. Several governments increased their efforts to stabilize the currency in order to reduce the capital outflow. Turkey, Argentina, India, Indonesia and Russia have raised their interest rates respectively. For those volatile EM countries like Turkey and Argentina, their Credit Default Swap have dropped significantly from their previous high, helping to stabilize investor sentiment. As the Brazilian presidential election has begun, its political uncertainty could be minimized. Oil exporting countries like Russia can benefit from high crude oil prices. Nevertheless, the room for EM rebound may be restricted by the escalating Sino-US trade conflict and strong US dollar. The market generally expects that EM bond markets would perform differently in the future, depending on the economic, political, and monetary stability of individual countries. Mexico has better a fundamental side. High crude oil prices keeps supporting Russia. For Asian countries such as South Korea, Thailand and Taiwan, they have large current account surpluses and relative low percentage of external debt. These can provide some comfort to their bonds’ investors. On the other side, the market is quite alert on twin-deficit counties. India and Indonesia bonds may be adversely affected on that.

Asian bonds benefit from a series of easing measures by the Chinese government. Chinese property bond expect to be resilient, but associated risks are still there. In order to address the impact of trade conflicts, the Chinese government has implemented a series of stabilization measures since July this year to ease the deceleration in economic growth. The latest measure is to cut the required deposit reserve ratio by 100 basis points, which is greater than the expected 50 basis points. Although the market gradually expects Sino-US trade disputes may become a long-term problem, it also means that the Chinese government will continue to prepare further policy easing. Since July, many Chinese developers have succeeded in issuing CNY bonds onshore. This trend has also spread from large-cap to small-sized developers. The early tight credit environment in China can hope to be relieved. The 3-month SHIBOR, a liquidity gauge of China’s financial market, fell from 4.35% in mid-June to around 2.8%. On the other hand, there have been concerns that most holders of onshore Chinese property bonds would exercise the put feature to sell their bonds back to issuers before the maturity date, pressuring liquidity of those Chinese property developers. However, according to the survey as of September, put ratio of onshore Chinese property bonds (i.e. the percentage of put bonds to total issue size)
has dropped significantly in the third quarter of this year, from 66% in the first year-half to 15% in September. The relative low put ratio alleviates the redemption pressure of Chinese property, which could help minimize the short term refinancing risk of this sector. Moody’s in early October commented that the credit quality of medium to large Chinese property developers could improve in 2019, because they still show strong execution and financial discipline in the face of tough operating conditions, whereas less competitive developers are more affected.

However, the tight government policy in real estate sector has no sign to be relaxed. Although the monetization resettlement policy for shantytown renovation projects will not be cancelled national-wide, it will be phased out in those 3- and 4-tier cities with low inventory of commodity housing and elevated housing price. This would reduce the market demand and some China property developers have already started price cuts, which have a negative impact on their bond prices. In addition, the peak of China onshore bonds redemption continues till next year, potential supply pipeline will weigh on the performance of Asian bonds.

The fundamental of US high yield bond is sound, but the valuation being unattractive. Retreat of US stock could trigger sell-off in US high yield. US high yield bonds has outperformed its European and Asian counterparts so far this year, primarily due to the relative stability of the US economy. The Fed has adjusted upwards the US GDP growth forecasts for this year and the next year at the latest policy meeting, reflecting its optimism about the prospects of the country’s economy. Entering the announcement period of US Q3 earnings, the market is expecting good news on that. Bank of America Merrill Lynch in September has estimated default rates of the US high yield bond issuers to be only around 3.25% for the coming 12 months, which is still low relative to the long term level. However, the US high yield bond’s credit spread has been tightened to an unattractive level. According to Bloomberg Barclay’s bond indexes, Asian High Yield bond yield is currently around 130 basis points higher than US High Yield bond, compared to roughly 0% difference in early 2018. Besides, US stock has been volatile since Oct. Market is predicting after years of bull market, it may be the time to pull-back just like what happened in other stock markets. US high yield bonds have high correlation with US stocks and could negatively impacted. Investors should re-examine their related positions.

Risk Considerations:

i) US rate hike in a faster and greater pace than expected.
ii) Deterioration of US and emerging countries’ economies;
iii) US trade war exploded;
iv) Global inflation being out-of-control;
Sharp decline in asset prices.
4Q 2018 Investment Outlook 16 Oct 2018

EUR / USD
12-Month Performance

Source: Bloomberg L.P.
As of 09/28/2018

INVESTMENT SUMMARY
- Concerns over Italy's finances detrimental to Euro
- US rate hike cycle may extend.
- High oil prices are unfavorable to the euro

Concerns over Italy's finances detrimental to Euro. Italy announced that it will set the 2019 budget deficit target at 2.4% of GDP. This violates the EU's deficit limit of 2% of GDP. The new budget is clearly contrary to the expectations of the former Italian government, to control the 2019 fiscal deficit to GDP ratio of 0.8%. Worried that the friction between the new Italian government and the EU will expand, and even Italy's future path will be further away from the EU, leading to splits. The related concern was pressured on Euro.

US rate hike cycle may extend. As expected, the Fed hiked rates by 0.25% after its September meeting, with the word "accommodative" deleted from its post-meeting statement, suggesting that the Fed remains confident of the economic outlook. Fed Chairman Powell hinted that the interest rate will increase 0.25% in December this year. In 2019, there will be a chance to raise interest rates for three times. In 2020, there will be an opportunity to increase interest rates once more to complete the rate hike cycle. The biggest difference between the September's interest rate meeting and the previous meetings is that in the past, the Fed indicated that the rate hike cycle of the bureau will end at the end of 2019. But Now Powell has extended this rate hike cycle to 2020. The interest rate will peak from the originally expected 3.125% (middle position) and is now raised to 3.375%. This shift adds to the upward momentum of the US dollar.

High oil prices are unfavorable to the euro. Affected by the imposition of sanctions on Iranian oil exports by the United States in early November, supply has reduced doubts and caused high oil prices in the near future. If the situation continues, it may hinder the ECB to tighten its monetary policy. At present, oil in Europe is mainly dependent on imports. When oil prices are high, European consumers' spending on fuel and energy will increase accordingly. This will weaken the buying power of local consumers and indirectly affect the economic recovery in the region, thus reducing the urgency of the ECB to tighten monetary policy. Therefore, the rise in oil prices can also be seen as an upside obstacle to the Euro.
Escalating Sino-US trade frictions negative for AUD. China is Australia's largest trading partner, accounting for nearly one third of the latter's total trade, equivalent to 8% of its GDP. Continued improvement of the Chinese economy will therefore boost Australia's export demand, and vice versa. It is notable that new tariff measures were announced by China and the US last month. The US will charge a 10% tariff on USD 200 billion worth of Chinese imports from 24 September onwards, which will increase to 25% by the end of the year. In retaliation, China imposed 10% or 5% tariffs on 5,207 US products worth approximately USD 60 billion. When including the previous tariffs imposed on USD 50 billion worth of Chinese products, the extensive US tariff list now covers USD 250 billion worth of Chinese goods, nearly half of last year's Chinese exports to the US. The US has also warned that it is ready to charge tariffs on an additional USD 267 billion worth of Chinese goods. Continued escalation of Sino-US trade frictions has become the primary threat to the AUD's future performance. Whether the AUD can regain its strength will be contingent upon China and the US returning to the negotiating table to relieve market concerns.

Emerging market debt crisis weakens demand for goods. The Chinese government tightening policies to contain financial risk, as well as rising Sino-US trade frictions have had a negative impact on the US. Market concerns over the slowing economic growth in China have resulted in faster outflow of foreign capital from Australia, which is closely tied to the Chinese economy. On the other hand, numerous emerging countries have borrowed large sums of USD in the past decade as global central banks implemented accommodative policies. The strength of the USD in recent months and rate hikes in the US have resulted in difficulties for emerging countries such as Argentina, Brazil, Indonesia and Turkey. A vicious cycle is created as these countries' currencies experience substantial devaluation, resulting in more capital flowing towards the USD to hedge risk, and making it more difficult for these debt-burdened countries to repay their USD debts. Australia's economic growth depends greatly on the overall performance of Asia. Besides China, its main trading partners include other Asian countries such as Japan, South Korea and India. China is naturally the primary destination for exports of many emerging economies due to its large demand for goods. If the Chinese economy weakens, demand for imports from emerging markets may decline, dealing a blow to these economies. The economic growth of Australia is being threatened by rising trade frictions and developments in emerging markets.

Robust economic outlook supports AUD. Australia's economy performed well in 2Q18 as GDP achieved 3.4% annualized growth, marking the 27th consecutive year of economic growth, a new record. However, it is worth noting that the country's three-month financing cost is up nearly 9% year-to-date, the three major banks have raised collateralized loan interest rates, which may limit future economic growth. The unexpected 2.5% drop in Australia's seasonally adjusted corporate investments in the second quarter,
disappointing capital expenditure data, coupled with global trade's uncertain outlook have prompted the Reserve Bank of Australia to approach monetary policies cautiously. In its September meeting, the RBA reiterated that if local employment and inflation maintain their current trends, rates will likely be adjusted upwards rather than downwards. Despite this, inflation is expected to remain low for some time, which means there is no compelling reason to adjust rates in the short run. On the other hand, the Fed hiked rates by 0.25% as expected in September. The latest change in the price of interest rate futures suggests the probability of a December rate hike is over 90%. As markets already expect the Fed to implement four rate hikes this year, there will be no unilateral pressure for the USD to rise substantially in the short term.

With US midterm elections about to take place, increased political risk may limit USD performance, creating short term support for the AUD. Nevertheless, rate spreads will gradually undermine the attractiveness of the AUD. Continued trade frictions between China and the US, as well as the worsening of the emerging market crisis may seriously dampen risk appetite, hindering Australia's economic growth and weighing on the mid-to-long term trend of the AUD.
4Q 2018 Investment Outlook  16 Oct 2018

USD/CAD  12-Month Performance

Source: Bloomberg L.P.
As of 09/28/2018

INVESTMENT SUMMARY
- Unclear outlook for rate hikes
- NAFTA? USMCA?
- Oil Impacts the CAD

Unclear outlook for rate hikes. According to Statistics Canada, GDP grew 0.2% MoM in July, higher than 0.1% anticipated by markets, the main attribute of the local manufacturing sector's strong performance. This is a good start for the country's third quarter GDP, and has induced market optimism that local GDP YoY growth will be much higher than the 1.5% predicted by the Bank of Canada (BOC). Annualized local inflation stood at 2.8% in July, which is still near the upper end of the BOC’s target range, and should provide sufficient reason for the BOC to hike rates again at its meeting in the end of October. The current period estimation for the upcoming rate hikes is at 0.25%. However, the BOC anticipates that inflation shall return to target levels of 2% by the beginning of next year, suggesting that it views high inflation in the local economy as a temporary phenomenon, and that the pace of rate hikes will still be impacted by local economic data and global trade.

NAFTA? USMCA? Besides the outlook of rate hikes, markets were also concerned about the future of the North American Free Trade Agreement (NAFTA). Canada's Minister of Foreign Affairs Chrystia Freeland claimed in September that Canada, the US and Mexico have agreed to a new trade agreement, the United States-Mexico-Canada Agreement (USMCA). It will replace NAFTA, which has been effective for 24 years. This announcement also paves the way for leaders of the three nations to sign the agreement at the end of November. Citing two Canadian sources, Reuters reports that the USMCA will relax the US business into the Canadian dairy market and successfully retain the anti-dumping arbitration mechanism of Chapter 19 of the North American Free Trade Agreement, the cultural industry is protected, and Canada is exempted from the 25% tariff on automobile possibly imposed by US President Trump. As over 70% of Canadian exports are shipped to the US, the trade situations are of great importance to the Canadian economy. The final agreement of the three countries can make the market breathe a sigh of relief. However, the supplementary document indicates that it is forbidden for member states to reach a free trade agreement with "non-market economy countries". Once the agreement is signed, a hostile relationship on cross-country trades between Canada and China will be established, which is unfavorable for the economic prospects and international scenes of Canada and Mexico. In addition, the US stance on trade tends to fluctuate quite often and therefore it is too early to tell whether this agreement will benefit Canada and Mexico.

Oil impacts the CAD. Oil prices were recently boosted as the US plans to sanction Iranian crude oil exports in November. As crude oil is Canada's chief export and main source of economic income, this will benefit the CAD. However, Trump has published multiple tweets criticizing the Organization of Petroleum Exporting Countries (OPEC) for pushing up oil prices on the other hand. It is rumored that OPEC and non-OPEC countries will agree to increase daily oil production by 500,000 barrels in the December meeting. In the short
term, OPEC member Saudi Arabia intends to raise daily oil production by 200,000 barrels to satisfy market demand. The considerable increase in short term oil supply should limit the rise of oil prices and affect the performance of CAD indirectly.
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