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J.P.Morgan ASSET MANAGEMENT

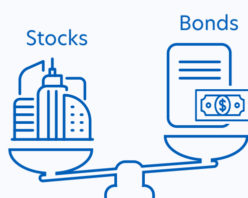
UOB

UOB Investment Insights

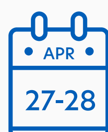
Market PowerBar

APRIL 2023

A LOOK AT THIS MONTH

Key Topics	What Investors Should Know
1 Where are interest rates headed with banking sector troubles?	**The risk of more severe fallout from current shocks in the banking sector should be limited but they have a significant impact on the interest rate outlook.** ▶ While the financial sector may face more scrutiny and volatility, fundamentals remain sound. However, interest rate expectations have been lowered because of the sector's troubles. ▶ While bonds continue to have a place in portfolios, investors should remain diversified and focus on quality companies with strong cash flows.
2 How do different asset classes perform when interest rates change?	**Investors should consider assets that offer protection against interest rate movements and slowing growth.** ▶ A number of bond sectors typically fare well in scenarios where interest rates rise or fall by 1%, while stocks tend to perform well when interest rates are stable. However, they historically underperform in times of high interest rate volatility. ▶ With the US Federal Reserve expected to pause rate hikes in the second half of this year, investors should stay nimble to capitalise on potential capital appreciation in bonds.
3  Investors should maintain diversified portfolios when making investment decisions	**A "60/40" stock-bond portfolio's annual returns are typically positive.** ▶ 2022 was a difficult year for the 60/40 portfolio because both stock and bonds prices fell. However, it is unusual for stocks and bonds to have such a strong positive correlation. This relationship is expected to return to a typical negative correlation eventually. ▶ The diversified portfolio might have temporarily fallen out of favour but it is still useful in scenarios of no recession, a short and shallow recession or a deep recession.

Upcoming Event



Bank of Japan (BOJ) policy meeting

This will be the first policy meeting under incoming Governor Kazuo Ueda. The focus is on whether he will signal a policy shift ahead. Japan's quarterly outlook report will also be released, where inflation projections will be closely watched.

Speak to your UOB Advisor today to find out more.

Topic 1

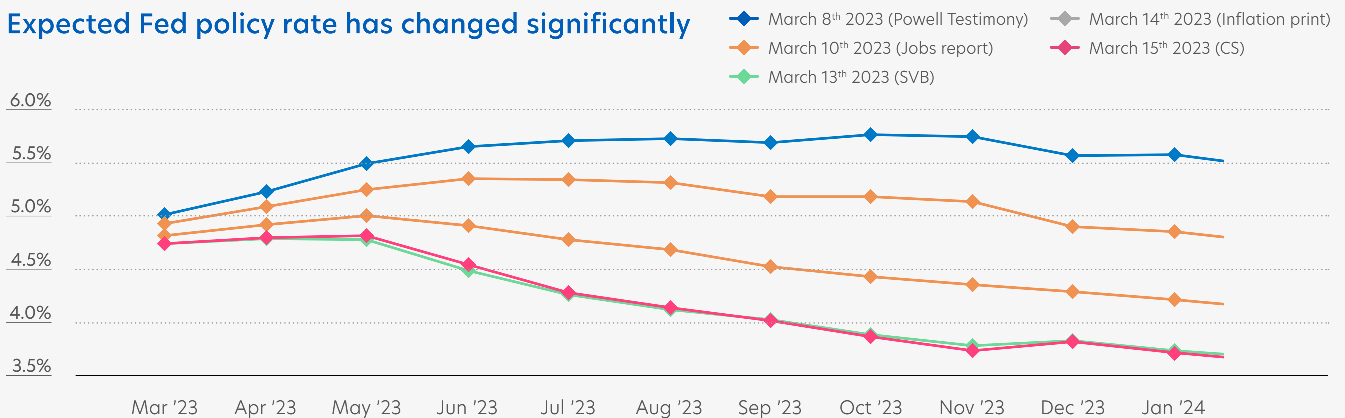
Where are interest rates headed with the banking sector troubles?

The global banking industry is under pressure following the collapse of Silicon Valley Bank (SVB) and UBS takeover of Credit Suisse. While these events have raised concerns about potential reverberations across the financial industry, investors should also consider their impact on the interest rate outlook.

1. Earlier in March, markets were expecting the US Federal Reserve to raise its policy rate to 6% this year, following Fed Chairman Jerome Powell's aggressive comments. However, shocks to the banking sector have led to a significant shift in expectations, with markets now pricing in interest rate cuts of 75 basis points by the end of the year (Figure 1A).
2. As weakness in the banking sector was partly caused by unrealised losses in long-duration bond holdings as interest rates surged over the past year, the Fed faces a fine balancing act between fighting inflation and guarding against financial stability risk.
3. The fallout from current shocks to the banking sector should be limited as banking fundamentals have been improving steadily over the past few years due to more stringent liquidity requirements. Common Equity Tier 1 capital (CET1) ratios* — a measure of a bank's financial strength — in the US and Europe have improved significantly since the financial crisis in 2008 (Figure 1B).
4. That said, the financial sector may face continued scrutiny and volatility as the banking industry could potentially face regulatory and risk management changes. Small to medium-sized banks that are sensitive to a high interest rate environment or those with poor cashflows could remain under the spotlight.
5. While bonds continue to have a place in portfolios, investors should remain diversified and focus on quality companies with strong cash flows.

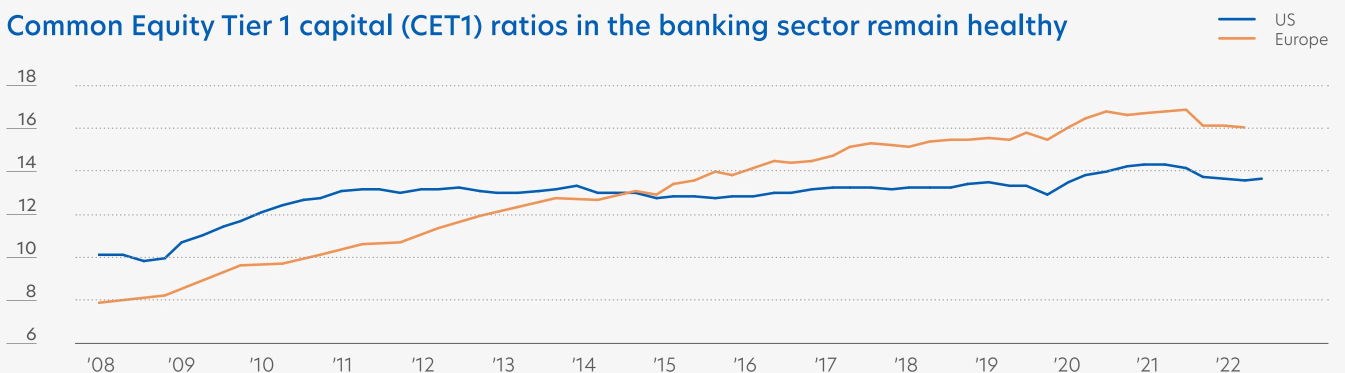
*The Common Equity Tier 1 capital (CET1) ratio is a way to measure how much money a bank has on hand that does not have to be paid back to investors or bondholders (core capital) compared to how much risk it has taken on (risk-weighted assets). A higher ratio means the bank is financially stronger and better able to handle unexpected losses.

Figure 1A



Source: Bloomberg, J.P. Morgan Asset Management.

Figure 1B



Source: FactSet, J.P. Morgan Asset Management.

Topic 2

How do different asset classes perform when interest rates change?

With markets pondering where interest rates will end up, there may be further uncertainty about how bonds will perform over the short term. Investors will also need to consider a potential slowdown in the US economy. As such, investors should position their portfolios with assets that provide protection against interest rate risk and slowing economic growth.

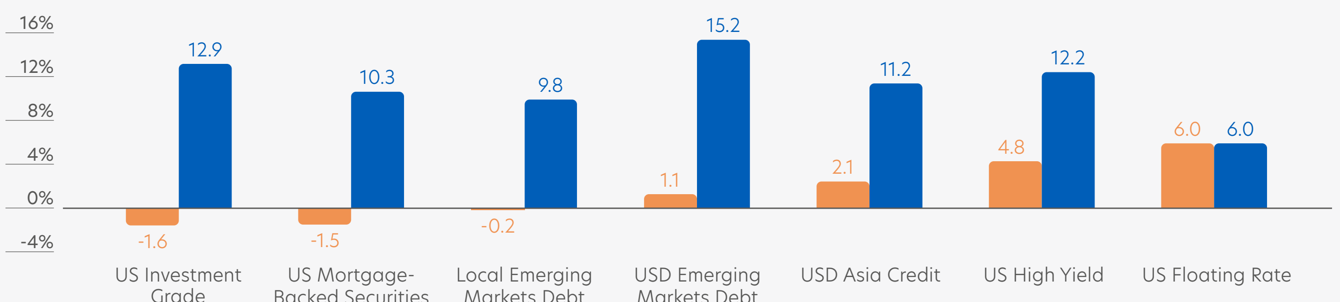
1. Given that bond prices and interest rates tend to move in opposite directions, a fall in yields from this point onwards would offer investors valuable capital appreciation while also locking in a decent coupon rate. Even if interest rates continue to rise, it will likely take a sizeable increase for total returns in the bond sector to turn negative. If interest rates rise by 1%, higher coupons should still be able to compensate somewhat for the drop in bond prices, thereby cushioning the decline in total returns for bonds.

2. Typically, rising interest rates are considered to be beneficial for value stocks and usually negative for growth stocks since their future cash flow gets discounted by a higher risk-free rate. However, our analysis shows that big moves in interest rates in either direction cause volatility in both growth and value stocks. Stocks tend to underperform during periods of high interest rate volatility and generate positive returns when interest rate movements are stable (Figure 2B).

3. Should inflation slow down and should the US enter a sharper economic downturn than expected, the Fed may possibly pause its rate hike cycle before the end of the year. In this scenario, investors should stay diversified and nimble to capitalise on potential capital appreciation in bonds.

Figure 2A

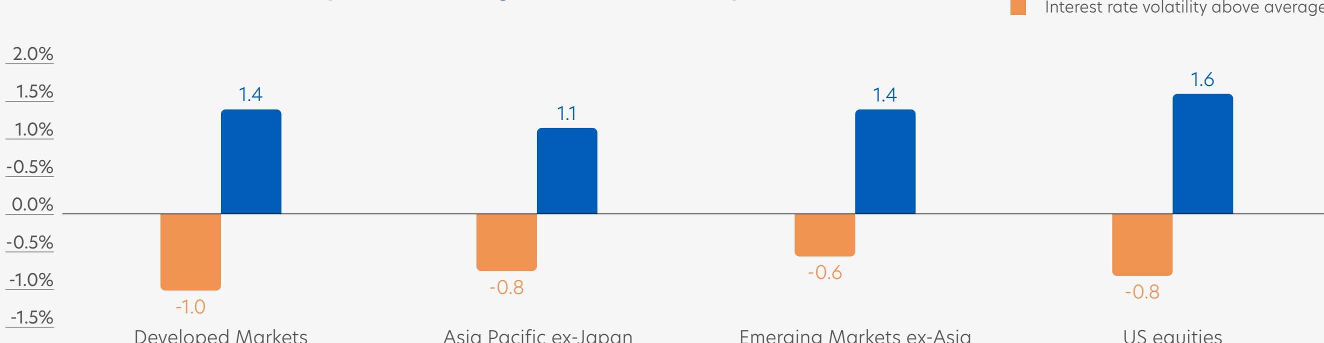
A number of bond sectors typically fare well in scenarios where interest rates rise or fall by 1%



Source: Bloomberg Finance L.P., FactSet, J.P. Morgan Asset Management.

Figure 2B

Stock market returns in periods of high or low volatility



Source: Bloomberg Finance L.P., FactSet, IHS Markit, J.P. Morgan Economic Research, MSCI, Standard & Poor's, J.P Morgan Asset Management.

Topic 3

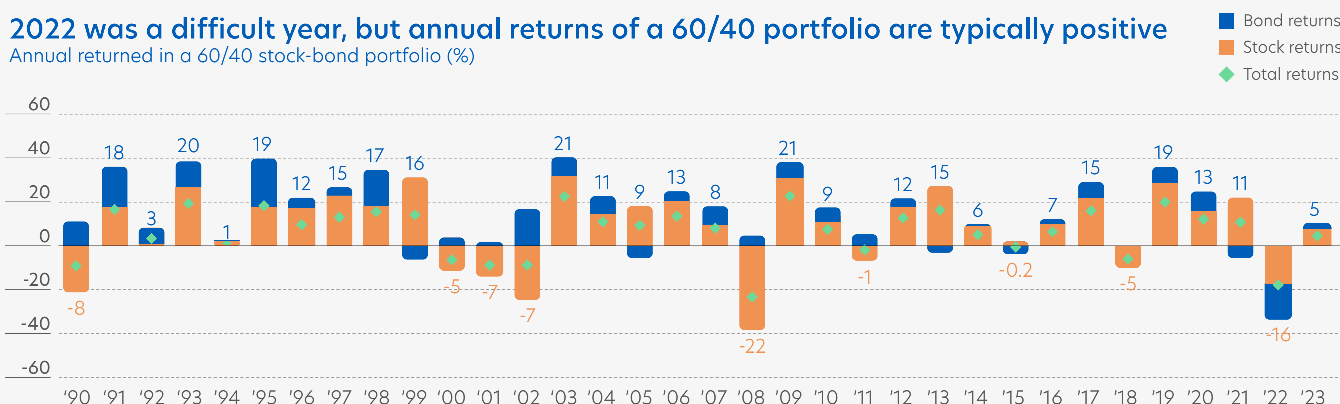
Investors should maintain diversified portfolios when making investment decisions

2022 saw the idea of a "60/40" portfolio (60% of holdings in stocks and 40% in bonds) run into trouble as both bonds and stocks suffered losses. The diversified portfolio might have temporarily fallen out of favour but it is still useful in scenarios of no recession, a short and shallow recession or a deep recession.

1. 2022 was particularly difficult for the 60/40 portfolio and marked one of the few times when both stocks and bonds had negative returns during a calendar year (Figure 3A). In the face of rising rates, bond investments suffered, while stocks also fell due to recession fears.
2. Stock and bond prices do not usually have such a strong positive correlation. In other words, their prices usually move in opposite directions (Figure 3B). This relationship is expected to return to what it was in the past, even with the multiple possible scenarios facing the market.
3. Rate hike expectations have been priced into bond prices, implying limited downside risk for bonds. If the economic situation worsens, the market will shift to safety in bonds and central banks will likely end their policy tightening to prevent a further deterioration in economic growth. If the economy improves, investors will likely shift away from bonds and back into stocks.
4. The 60/40 portfolio might have done badly last year but historical behaviours are expected to return eventually. If bonds and stocks revert to moving in opposite directions, investors would benefit from holding a diversified portfolio.

Figure 3A

2022 was a difficult year, but annual returns of a 60/40 portfolio are typically positive
Annual returned in a 60/40 stock-bond portfolio (%)



Source: Bloomberg L.P., FactSet, MSCI, J.P. Morgan Asset Management. Returns are calender year. Portfolio returns reflect allocations of 60% in the MSCI AC World Index and 40% in the Bloomberg Aggregate Bond Index. Returns are total returns.
Past performance is not a reliable indicator of current and future results.

Figure 3B

Stock and bond prices typically move in opposite directions
Weekly rolling six-month correlation of equities and sovereign bond prices (%)

Source: Bloomberg L.P., FactSet, MSCI, J.P. Morgan Asset Management. Rolling six-month pairwise correlations between weekly returns in equity (MSCI All Country World Index price index) and bond (Bloomberg Global Aggregate, Government Treasuries price indices) markets.

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