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UOB Investment Insights
Quick Note

27 January 2022

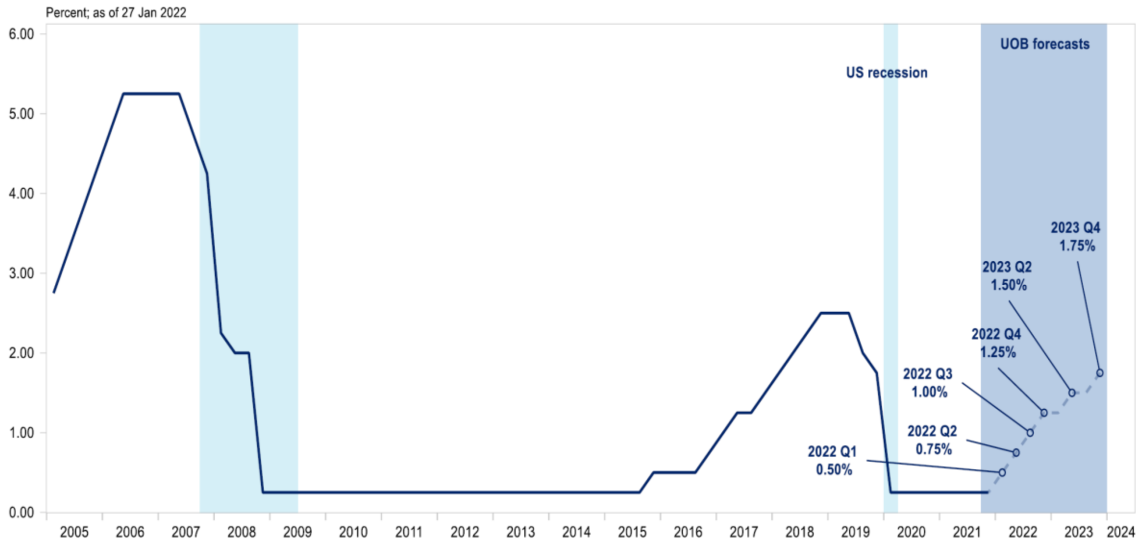
Positioning for Four Rate Hikes

- We expect the US Federal Reserve to hike rates by 25 basis points (bps) or 0.25% four times in 2022. These hikes will challenge both equity and fixed income markets. However, we suggest investors allocate more to equities than fixed income in accordance with their risk appetite to manage this volatility.
- Within equities, we favour value sectors such as Financials and Industrials, catch-up opportunities such as Europe and Japan, as well as Megatrends, which are powered by long-term drivers that give them an advantage to emerge ahead when volatility subsides.
- Income investors can consider Asian investment grade bonds, Sustainability-linked bonds and diversified income sources such as dividend equities and alternatives like infrastructure assets to cope with higher yields.

What happened?

- Following the US Federal Reserve's (Fed) latest Federal Open Market Committee (FOMC) meeting, UOB economists have adjusted our forecasts to expect four 25bps rate hikes in 2022, with the first starting in March 2022 and subsequently in June, September and December 2022 (Figure 1). Do also note that the risk now is for additional or more aggressive hikes rather than less hikes in 2022.

Figure 1: The Fed is expected to raise rates by four times in 2022, starting in March 2022



Source: Macrobond, UOB Global Economics and Markets Research as at 27 January 2022.

- The Fed has highlighted greater urgency to address rising inflation in the US, with the recent consumer price index (CPI) inflation rising by 7% over a year ago, the highest jump since 1982. With US unemployment last reported at 3.9% on 7 January 2022, close to the pre-pandemic rate of 3.5%, the Fed is now able to pursue its other mandate of stabilising inflation.

- Inflation has always been a top concern for policymakers as persistently high inflation increases costs for businesses and reduces consumption, which in turn negatively impact economic growth. This is even more pertinent when the global economy is beginning to emerge from the COVID-19 pandemic. The Fed has been openly communicating its policy intent way before the fact, hence we are unlikely to see a taper tantrum as in 2013.

What should investors do?

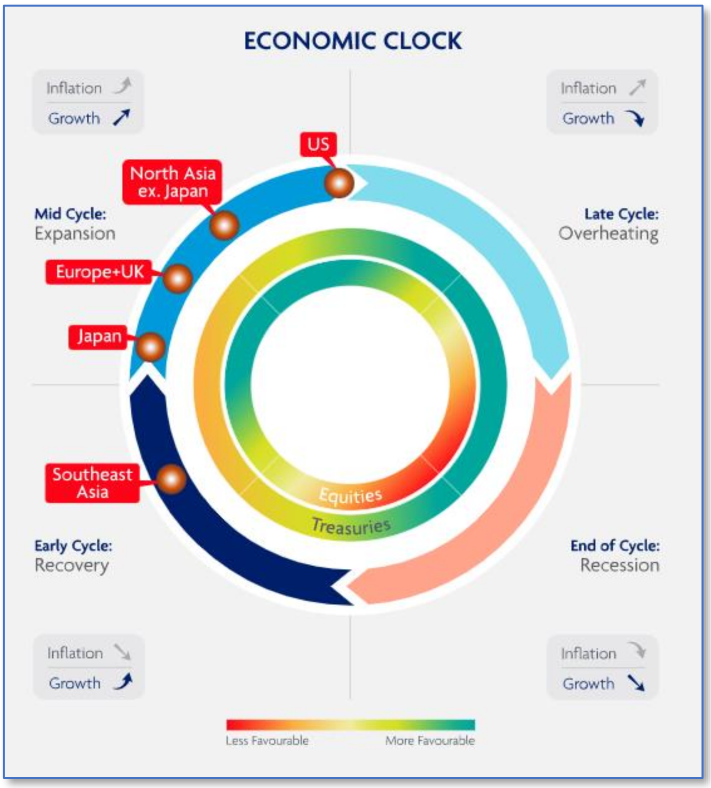
- Higher interest rates are a headwind for both equities and fixed income assets. Hence portfolio decisions should be centred primarily around risk. Our proprietary **Risk-First approach** can help ensure that you take the appropriate amount of risk in accordance with your risk profile. Following which, our suggested course of action to manage this volatility is to increase your portfolio's allocation to equities and reduce allocation to fixed income.

- Within equities, we see opportunities in sector rotation and regional catch-up plays:

    - Rising rates will hurt interest rate-sensitive sectors like Technology and Consumer Discretionary, whose valuations are determined by discounting future earnings against interest rates. **Value sectors** like **Financials** and **Industrials** typically benefit from rate hikes as their discounted valuations make them more attractive against expensive sectors.

    - We also see different regions at different stages of economic recovery (Figure 2). This also presents opportunities in **European and Japanese equities**, which are further behind in recovery and are more attractively valued than US equities.

Figure 2: Different regions are at different stages of economic recovery, providing catch-up opportunities for investors



Source: UOB Global Economics and Markets Research, UOB PFS Investment Strategists (December 2021).

- We expect equity market volatility to remain elevated throughout 2022 as we go through this bumpy road to recovery. Investors can consider riding through this volatility by building up positions in Megatrends such as **Sustainability**, **Global Healthcare** and **Shifting Generational Consumption Patterns** over time, which are driven by long-term structural drivers and are more likely to emerge ahead in the longer run.

- Income investors will face more challenges. Higher US Treasury yields will have a widespread impact on most fixed income assets as they are used as a globally accepted benchmark to price other kinds of debt.
    - Income investors can look for high-quality shorter-duration bonds with higher credit spreads such as certain **Asian Investment Grade (IG) bonds** to be defensive while the higher spreads of Asian bonds can better absorb rising US yields.
    - **Sustainability-linked bonds** are another alternative, with issuance expected to remain strong in 2022 amid the global push towards greater sustainability. Higher issuance will ensure that yields stay at reasonably attractive levels, while the sustainability focus reduces the likelihood that other investors will want to sell out of these bonds.
    - Finally, income investors can also consider diversifying income sources through dividend equities, infrastructure assets and writing covered calls on equity assets, which are options available through our **Income Builder series** of multi-asset solutions.

- Please speak to your UOB Advisor to find out more.

All data are sourced from Bloomberg unless otherwise stated.

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