UOB Investment Insights

Quick Note

15 February 2022

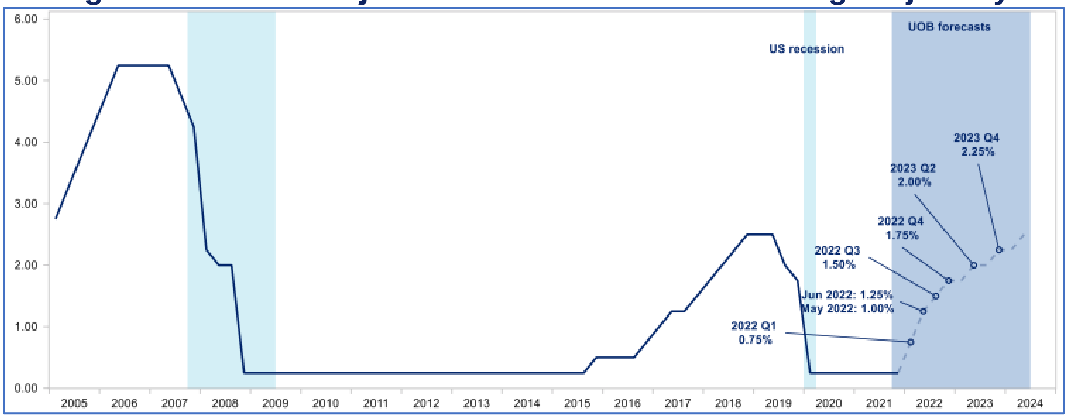
Addressing the Latest Market Concerns

- We explain the Fed's rate hikes and likely impact to markets, our cautiously optimistic view on European equities and why we remain positive on China and Asia ex-Japan in this Quick Note.

The Fed is expected to hike rates to combat inflation

- In response to recent trends of higher inflation in many regions, major developed central banks are projecting tighter monetary policies. In the US, we expect the Federal Reserve (Fed) to hike interest rates by 50bps in its March meeting, before another four 25bps hikes throughout 2022 (Figure 1). The Fed will also be updating its economic and inflation forecasts in March.

Figure 1: UOB's Projected Path of Fed's Rate Hiking Trajectory



Source: UOB Global Economics & Markets Research, 11 February 2022.

- While rate hikes may cause market volatility, it is important to note that central banks tend to only tighten policy when they are confident that economic growth is also robust enough. Both corporations and households currently have higher cash levels than before the pandemic, and historically, the economy has shown that it can absorb rate hikes should the economy continues to grow.

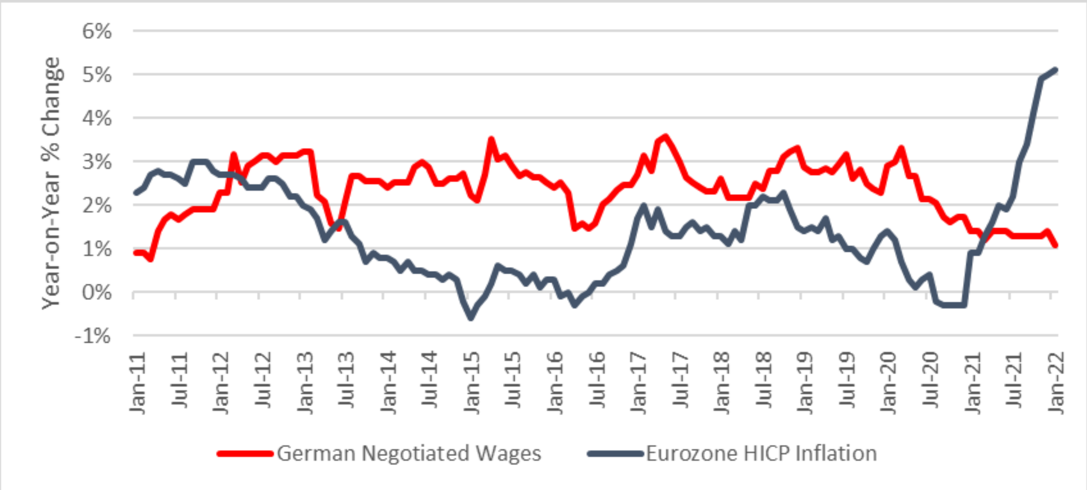
- Stagflation is unlikely at this juncture, as we expect supply chain issues (which has caused inflation since last year) to gradually resolve over time, taking some pressure off inflation sometime in H2 2022.

- In equity markets, growth stocks like technology companies tend to be most affected by rising rates as the present value of their future cash flows are worth less. Their underperformance this year has proven this point. On the other hand, value-cyclical sectors (i.e. Financials, Industrials) tend to benefit in an environment of rising interest rates and positive economic growth. As a whole, equity markets can absorb higher interest rates but the performance of various sectors will be more differentiated instead of broad-based – which means you have to be selective in tactical exposure.

Remaining cautiously optimistic on European equities

- The challenges currently faced by European markets can be summarised to two fronts:
  - Eurozone inflation is currently high, with prices having risen by 5.1% in January 2022 compared to a year ago. High inflation raises pressure on the ECB to shift away from its loose monetary policy and begin raising rates.
  - Geopolitical tensions between Russia and Ukraine have raised the risk premium in European assets. Russian natural gas provides 9% of Europe's total energy consumption, especially for the energy-intensive German industrial complex. Any new sanctions imposed on Russia will likely increase energy prices in Europe, further pushing inflation higher.
- The ECB is expected to begin raising interest rates this year. Markets have priced in the probability of a 10bps hike by June 2022 and a total increase of 40bps by end-2022. Though the ECB is winding down its Pandemic Emergency Purchase Programme (PEPP), it maintains its broader Asset Purchase Programme (APP) which will continue to inject EUR 20 billion every month for as long as needed. Wage pressures are still manageable and do not add to inflation pressures for now (Figure 2). The ECB will meet next on 10 March 2022 and will update their inflation and economic forecasts at that meeting.
- Despite geopolitical tensions, we remain cautiously optimistic on European equities, given their cheaper valuations (EuroStoxx 600 forward P/E is 14.3x versus 19.4x for the US' S&P 500) and COVID-19 reopening momentum. Within European equities, we favour **Financials** as beneficiaries of gradual ECB rate hikes. **Sustainability and renewable energy** will also benefit from Europe's transition towards greener energy sources in order to reduce energy dependence on Russia in the future, reducing the risk of possible Russian sanctions on Europe's economy.

Figure 2: Wage increases remain mild for now and do not contribute to inflation pressures



Source: Gavekal Research/Macrobond as at February 2022.

Stay patient with China and Asia ex-Japan equities

- Due to uncertainties following 2021's regulatory tightening, market sentiment on Chinese equities has been slow to recover. The situation in the real estate sector has improved slightly, as the central government has been directing state-owned property developers to take over projects from troubled developers to ensure that customers' home purchases can be fulfilled.

- While the People's Bank of China (PBOC) has started to ease monetary policy slightly by reducing lending rates, it is possible that investors are waiting for further easing measures or guidance from the regulatory front. A 50bps cut to the Reserve Requirement Ratio (RRR) is expected some time in the future, and risk-assets in China are likely to pick up if the recent improvement in credit growth continues (see Figure 3 below).

Figure 3: China's Credit Growth is Starting to Pick Up

Source: Bloomberg, 15 February 2022.

- On a sector basis, industries that are deemed strategically vital (i.e. semiconductor manufacturing, green-technology, data centers) will continue to benefit over the long term from government support and initiatives. Meanwhile, lifestyle upgrades and the trend of middle-class consumption continue to support our view of China as a long-term structural Megatrend.

- Investors with lower risk appetite can invest in onshore A-shares equities since they are more aligned with China's strategic goals. Opportunistic investors can also diversify with offshore equities aside from the onshore market, which are attractively-valued and sport strong earnings potential this year.

- Investors can also consider investing in the broader Asian region, which is closely tied to China's growth. Across the region, equity valuations remain cheaper than US equities (MSCI Asia ex-Japan forward P/E is currently 13.3x versus 19.4x for the US' S&P 500) and vaccination rates have risen, allowing for economic reopening to take place perhaps except for China and Hong Kong. This will ease the current global supply chain constraints and increase the flow of trade, which are positive drivers for the region's corporate earnings.

What should investors do?

- These issues pose challenges 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 into the respective Core and Tactical allocations of your portfolio.

- **Core Allocation:** Remain well-diversified across various asset classes, sectors and regions.
    - Investors who require income ought to diversify income streams across a variety of short-duration high-quality bonds, floating-rate bonds, dividend equities, infrastructure and real estate assets available under the **Income Builder series** of multi-asset solutions.
    - **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.
    - Investors who do not require income can consider diversified growth opportunities via the **Capital Builder series** of multi-asset solutions.

- **Tactical Allocation:** Invest in tranches to build positions in Megatrends. Near-term opportunities available in sector rotation and regional catch-up plays.
    - Megatrends are transformative forces that drive long-term structural trends. Investors can consider riding through near-term volatility by investing in tranches 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.
    - Investors can also consider investing in regions whose economies are further behind in recovery and are more attractively valued than US equities, such as **European and Japanese equities**. **Asia ex-Japan equities** also offer a more diversified means to tap on China's growth, which is adopting a stance of monetary policy loosening even as the US Federal Reserve tightens.
    - Finally, the most opportunistic investors willing to take higher risks can consider equity sectors that typically benefit from rate hikes, such as **US & European Financials**. **US Financials** have gained from higher rate hike expectations. **European Financials** are expected to benefit the same from impending ECB hikes, although investors should avoid specific financial institutions that have a sizable presence in Russia or derive a significant portion of overall revenue from Russia.
- Please speak to your UOB Advisor to find out more.

All data are sourced from Bloomberg unless otherwise stated.

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