UOB Investment Insights
Quick Note

17 March 2022

Finding Opportunities Amid Fed Rate Hikes and China Concerns

- Income investors can consider floating rate bonds and real assets (such as infrastructure assets) to hedge against the US Federal Reserve's (Fed's) interest rate hikes.
- Chinese equities present an attractive opportunity for investors to enter at cheap valuations. We share two possible approaches for investors to consider.

The Fed Raised Interest Rates By 0.25% As Anticipated

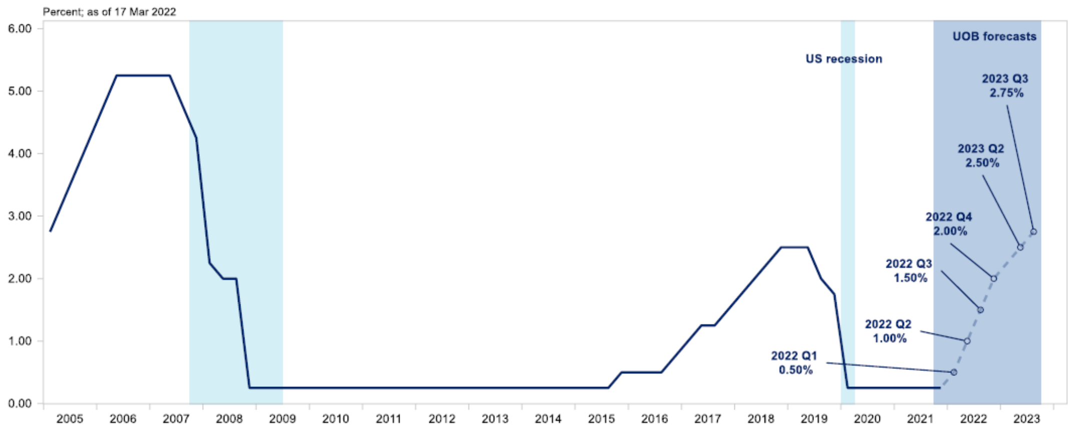
- **2022 Rate Hikes:** Fed policymakers have adopted a more hawkish tone at the latest Federal Open Market Committee (FOMC) meeting – the latest Fed forecasts show that members are anticipating six more hikes of 0.25% each this year (that is, one hike for every remaining meeting in 2022), with some members even anticipating one or more 0.50% hikes.

- **Quantitative Tightening:** The Fed has also announced it will begin reducing its holdings of bond purchases (known as Quantitative Tightening) at a later date. At the press conference, Fed Chair Jerome Powell indicated this could start as early as May 2022.

- **US Inflation Outlook:** Powell acknowledged that US inflation remains high but expects inflation to return to 2% eventually.

- **UOB's Latest Forecasts:**
    - Our economists now expect a 0.25% hike for the remaining six meetings in 2022 (Figure 1), with three more 0.25% hikes in 2023.
    - This will bring the Fed Funds Target Rate to the range of 1.75% - 2.00% by end-2022 (previous forecast: 1.50% - 1.75% by end-2022).
    - The Fed may surprise with a 0.50% hike at the May 2022 meeting if March CPI inflation data (due on 12 April 2022) exceeds 8% year-on-year.

Figure 1. UOB economists expect six more 0.25% rate hikes in 2022



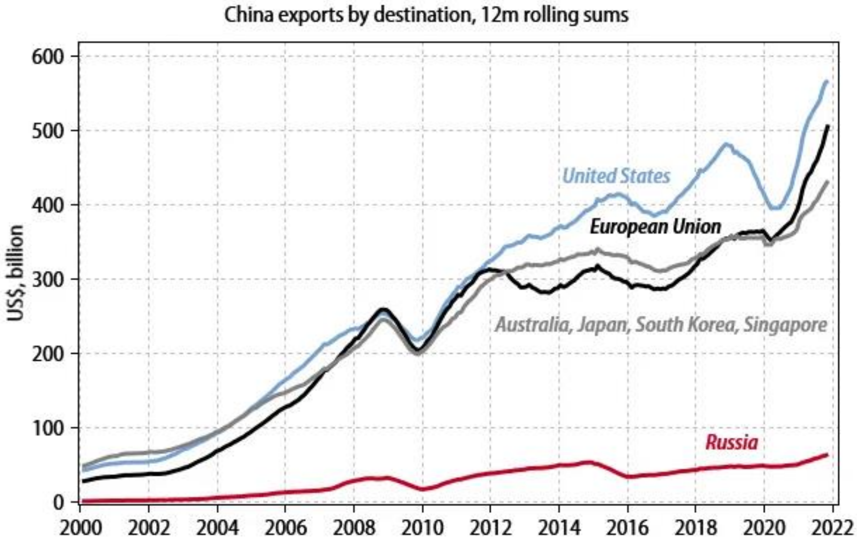
Source: Macrobond, UOB Global Economics and Markets Research, 17 March 2022

- **Market Reactions:** Inflation fears have remained elevated among investors following the sharp increase in oil prices. US equities pulled back after the Fed announced its hawkish stance but resumed their upward climb after Powell announced his confidence in the strength of the US economy and that he expects inflation to return to 2%.

Our Views on Three Concerns About Chinese Equities

1. **China is unlikely to risk Western sanctions just to help Russia.**
   - Chinese companies have thus far complied with Western sanctions on Russia. Foreign Minister Wang Yi has publicly stated that China is "not a party to this crisis".
   - China has more to lose by risking Western sanctions on itself just to aid Russia – China's trade with Russia only amounted to US$69 billion in 2021, versus US$1 trillion in trade with the US and European Union combined (Figure 2).
   - While the decision to impose sanctions rests with the US and Europe, sanctions are still unlikely at this point as both require Chinese exports to bring down high domestic inflation. China also needs to be incentivised to apply diplomatic pressure on Russia to de-escalate the current conflict in Ukraine.

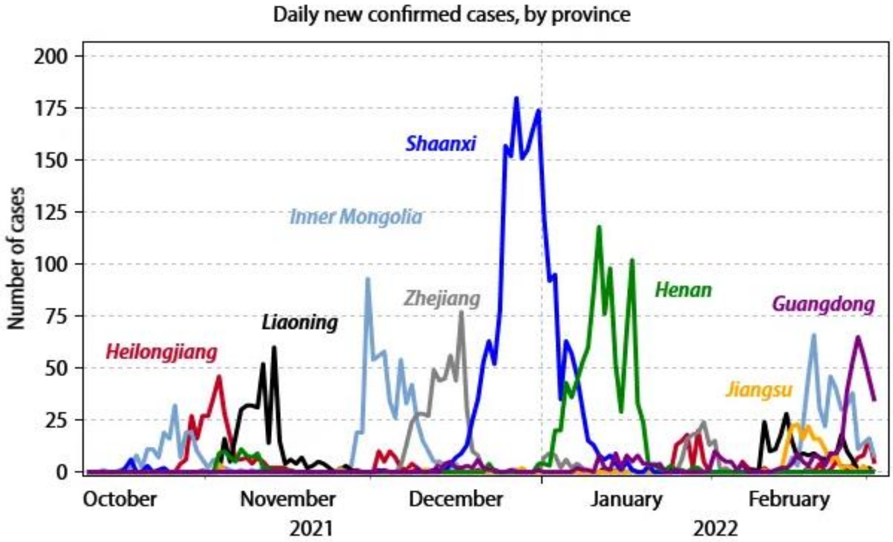
Figure 2. Russian trade is insignificant to China when compared with the US and Europe.



Source: Gavekal Dragonomics, Macrobond

2. **China has contained past COVID-19 outbreaks within short periods of time.**
   - China's zero-COVID policy was in the spotlight again as major cities like Shanghai and Shenzhen have been locked down. China's harsh lockdowns have effectively contained outbreaks in the past (Figure 3), at the cost of supply chain disruptions.
   - With the current Omicron BA.2 variant being more infectious, China has also adapted by introducing more targeted and flexible quarantining strategies, allowing the use of Antigen Rapid Test (ART) kits and approving foreign drugs to treat COVID-19.
   - This round is likely to be no different. Expect supply chain disruptions to persist or even worsen for a short period of time, but the current disruptions will ease eventually when cases fall. Investors need to be prepared for this cycle to keep coming and going so long as China maintains its zero-COVID policy.

Figure 3. China has effectively contained local COVID-19 outbreaks to date



Source: CEIC, Gavekal Dragonomics, Macrobond

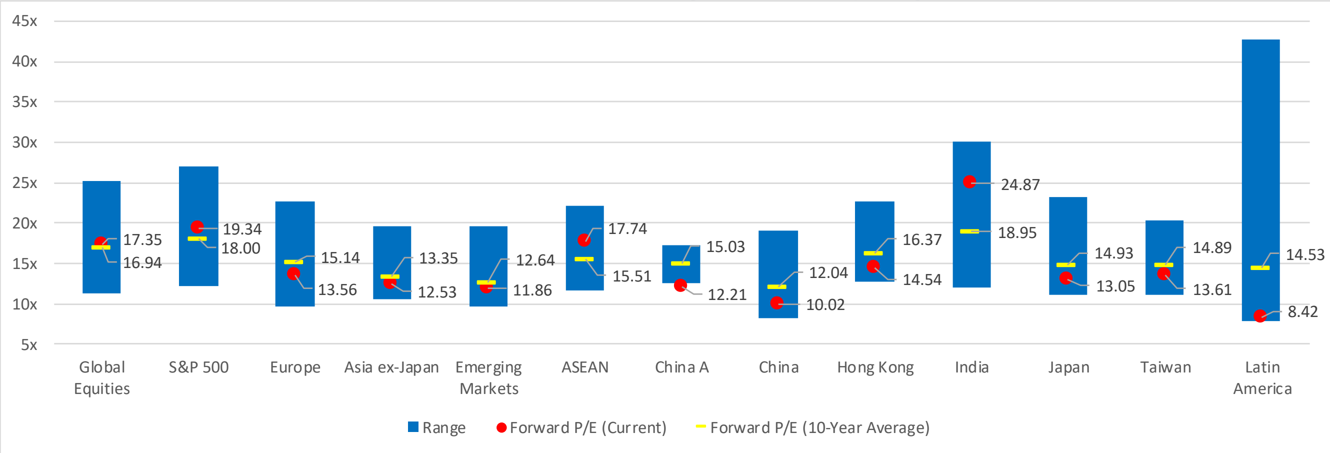
3. **Nothing has changed in the US' targeted delisting of Chinese ADRs; Chinese technology companies still face regulatory uncertainties.**
   - US-listed Chinese American Depository Receipts (ADRs) can still seek re-listing or secondary listing in Hong Kong within the three-year grace period. Most institutional investors will be able to continue investing in these companies, thus demand for these equities will remain healthy. What has changed is the recent realisation that US authorities are indeed serious about pressing on with de-listing.
   - Regulatory uncertainties surrounding technology companies remain, hence investors need to be prepared to accept such ongoing regulatory changes as the norm. It is thus important to invest in high-quality companies that can adapt better to the ever-changing environment.
   - Chinese Vice-Premier Liu He has given reassurance that the government will "take measures to boost the economy in the first quarter (of 2022)" as well as introduce "policies that are favourable to the market". While it is unclear what those precise measures will be, his words were enough to boost market sentiment dramatically.

What should investors do?

- With US interest rates heading higher on Fed hikes, investors should still hold more equities than fixed income within their portfolios in line with our **Risk-First approach** and according to their risk tolerance.

- Amid the uncertainties, equity valuations are cheap (Figure 4) as the recent selling has been indiscriminate. This provides an opportunity to pick up **high-quality assets at cheaper valuations**, which will put investors in a **better position to benefit from the recovery**. However, with volatility remaining high, the prudent approach is to **invest in tranches**, spreading out the entry points over a period of time to average the cost.

Figure 4. Equity valuations across the board are cheaper and are lower than their 10-year historical averages in many regions.



Source: Bloomberg, 17 March 2022

- Investors concerned about volatility should build up positions in Core holdings. Amid the ongoing geopolitical risks and Fed rate hikes expected, it is important to stay diversified across asset classes, regions, sectors and even income streams. Income investors can also consider investing in **floating rate bonds, dividend equities and real assets** (such as infrastructure assets) to hedge against rising interest rates.

- Investors who remain optimistic about markets and have longer time horizons should invest in **Megatrends**, which are more likely to emerge as winners once geopolitical risks subside. Specifically, we remain positive on **Chinese equities** as the fundamental drivers remain unchanged and valuations are very attractive now.

  - Investors concerned with regulatory changes can focus more on **onshore China A-share equities**, which face less scrutiny and are more aligned with Beijing's strategic goals.
  - More opportunistic investors can venture into **offshore Chinese equities** with high quality factors or tap on an active fund manager to seek out such opportunities for you.

- Investors with higher risk appetite can also consider our **High Conviction Call** in **US Financials**, which is our preferred US Value sector and is expected to continue benefiting from Fed rate hikes.

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

All data are sourced from Bloomberg unless otherwise stated.

RIGHT BY YOU