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In collaboration with:

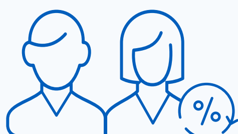
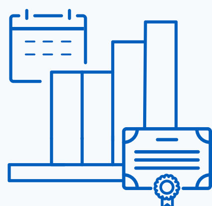
J.P.Morgan ASSET MANAGEMENT

UOB Investment Insights

Market PowerBar

OCTOBER 2023

A LOOK AT THIS MONTH

Key Topics	What Investors Should Know
1 Weakening services sector suggests slower growth ahead	**While the global economy is not yet in a recession, economic data suggests global growth is likely to slow further this quarter.** ▶ The global manufacturing sector has been in contraction for the past 12 months. While the services sector is still expanding, there are signs of weakening. ▶ Given potential downside risks, stay defensive and accumulate Core investments on dips.
2  Consumers are less sensitive to rate changes	**There are concerns about the impact of aggressive rate hikes on the economy, but these effects may not be as significant as they once were.** ▶ Higher interest rates now have a less pronounced impact on the US economy, which is largely driven by the services sector today, as well as on households and consumers. ▶ Any slowdown is likely to be gradual and contained. In this environment, stock markets have the potential to gradually rise, although volatility may increase. Diversify with multi-asset strategies to capture current opportunities and lower volatility.
3  Favour higher bond quality and longer duration	**While US Treasury yields have been climbing recently, bond yields are still expected to fall going forward.** ▶ Given a slowing global economy, focus on quality since investment grade bonds offer attractive yields. ▶ Investors can also start exploring longer-duration bonds which can provide consistent income and potential capital appreciation after interest rates peak.
Upcoming Event	
ECB monetary policy meeting	The ECB is expected to pause interest rate hikes.

Speak to your UOB Advisor today to find out more.

Topic 1

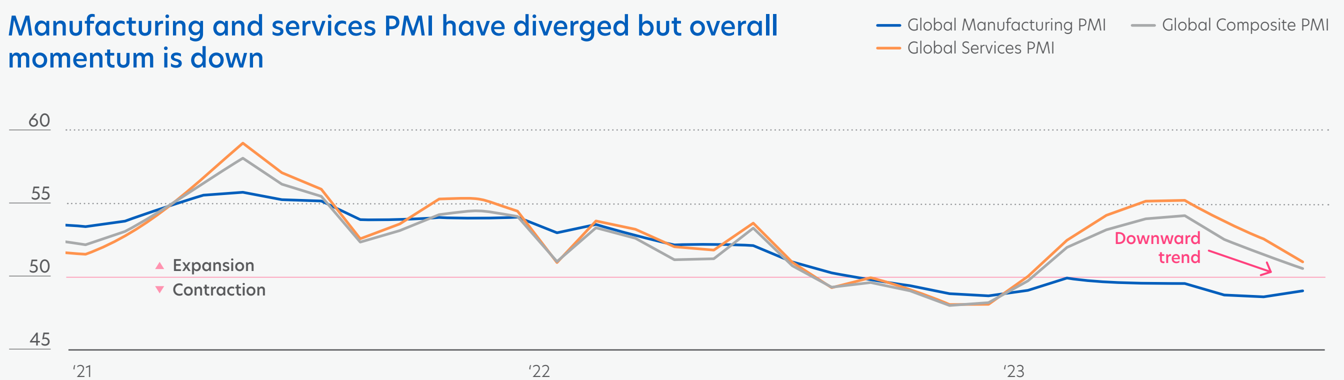
Weakening services sector suggests slower growth ahead

The Purchasing Managers Index (PMI), a key economic activity indicator, is not indicating an imminent recession, but the trend suggests slower growth ahead in this quarter.

1. Recent PMI reports show that the manufacturing and services sectors are still diverging in performance (Figure 1A). Services activity is still expanding but has weakened for the last three months with disappointing numbers from the US, Europe and China. Meanwhile, manufacturing activity has been contracting for the last 12 months, but the pace of contraction slowed in August.
2. As a result, while the economy is still in expansion, the global composite PMI has fallen for three straight months. This means the economy is gradually slowing, even though it is not yet in a recession.
3. With services making up the greater proportion of activity in most major countries, their growth continues to prop up overall economic activity for now. Nonetheless, the possibility of the services industry contracting like the manufacturing industry is a concern. Higher interest rates seem to be dragging activity down, and PMI surveys indicate that the amount of new business being generated has been declining. Furthermore, input costs are rising again due to the recent pickup in energy costs (Figure 1B). This is a worrying sign that inflation may potentially rebound in the short term.
4. Expectations of a recession might have been pushed back in the United States and the rest of the world, but the weakening trend in economic data suggests there could be more downside growth risk ahead this quarter. In such an environment, stay defensive and accumulate Core investments on dips.

Figure 1A

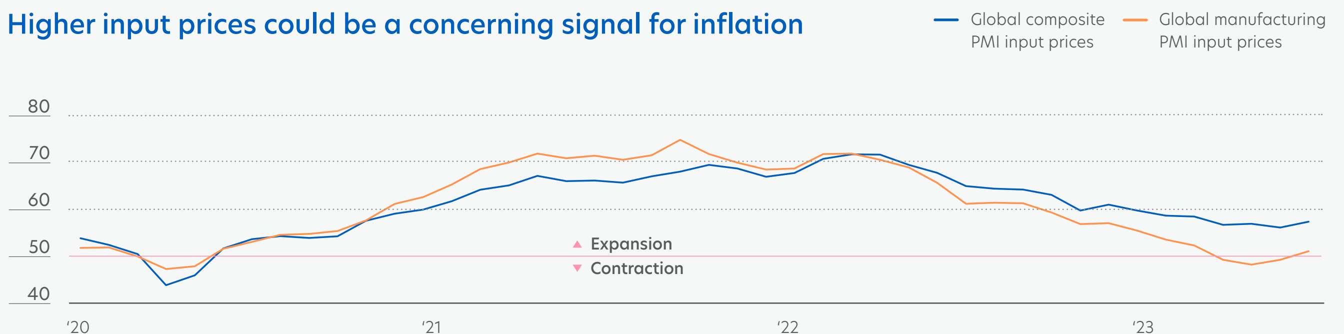
Manufacturing and services PMI have diverged but overall momentum is down



Source: FactSet, S&P Global, J.P. Morgan Asset Management.
PMI above 50 indicates expansion in activity, while PMI below 50 indicates contraction.

Figure 1B

Higher input prices could be a concerning signal for inflation



Source: FactSet, S&P Global, J.P. Morgan Asset Management.

Topic 2

Consumers are less sensitive to rate changes

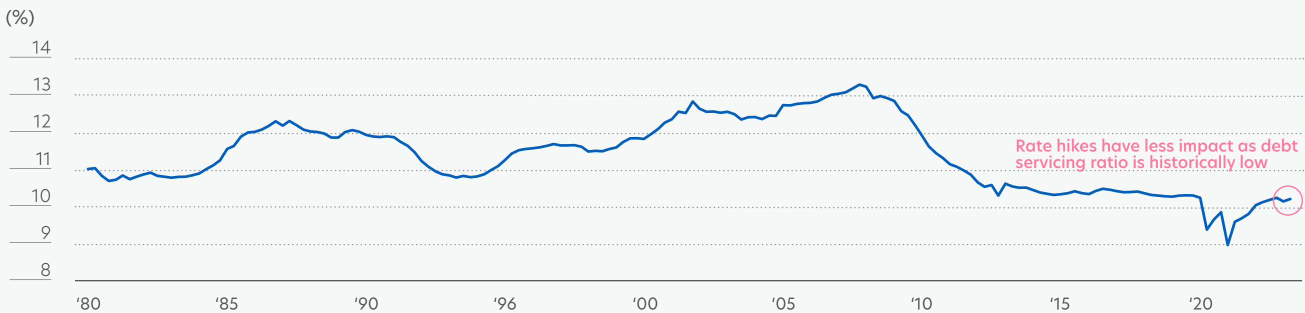
The impact of higher interest rates on consumers may not be as significant as they once were and elevated rates are less likely to weigh heavily on economic activity.

1. The US economy may not be as sensitive to higher rates as it once was, since it is currently driven largely by the services sector. Compared to the past, the US economy is no longer led by the manufacturing and construction businesses which are more capital intensive.
2. Households and consumers are now also less affected by the immediate impact of higher interest rates than before. Mortgage payments are typically where the effect of higher rates is felt most, but the US mortgage market has changed over time. Today, the US mortgage market is mainly composed of fixed rate mortgages, with more than 60% of those mortgages having an interest rate below 4%. As a result, there is less immediate impact to the consumer from the US Federal Reserve's (Fed) 525 basis points (bps) of rate hikes over the past year and a half (Figure 2A).
3. Where higher interest rates will have a bigger impact is on business spending. Fed surveys (Figure 2B) are suggesting that US companies are planning to cut back on capital expenditure in the coming months.
4. However, the labour market remains relatively tight today, which has led to stable levels of personal consumption. In addition, debt servicing payments make up a smaller proportion of consumers' disposable income. These factors may offset the downturn in business investments. As such, the impact of high interest rates will not be as detrimental to the economy, and any recession in the US should be short and shallow.
5. Knowing this, stock markets can still gradually rise but volatility may increase if inflation rebounds in the short term. Diversification is important and multi-asset strategies can help investors capture current opportunities while lowering portfolio volatility.

Figure 2A

US Household debt service ratio

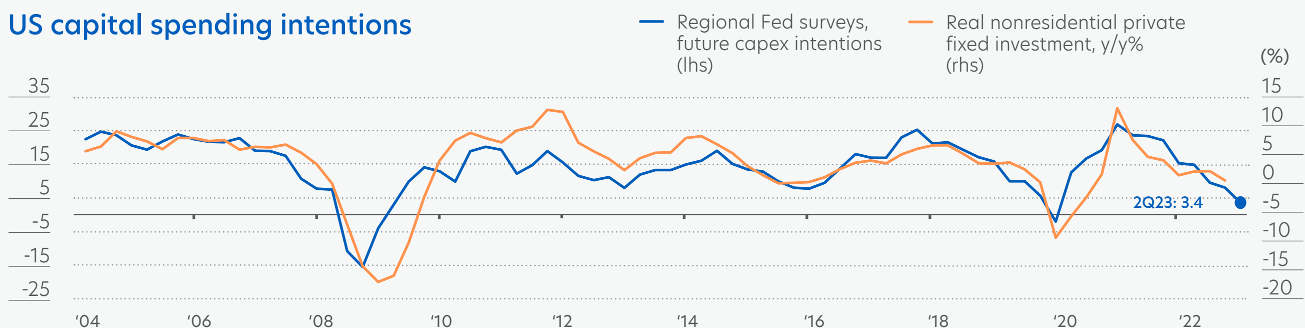
Debt payments as % of disposable seasonal income, seasonally adjusted



Source: FactSet, US Federal Reserve.

Figure 2B

US capital spending intentions



Source: BEA, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Average includes the Chicago Fed, Philly Fed, Richmond Fed, Dallas Fed, Kansas City Fed and NY Fed manufacturing surveys of future capital expenditures. Most recent quarter reflects quarter-to-date average data.

Topic 3

Favour higher bond quality and longer duration

US Treasury yields have been climbing since the US regional banking crisis of confidence abated in April. Nonetheless, bond yields are expected to fall going forward.

1. There are several reasons for the recent rise in US Treasury yields. Stronger-than-expected US economic data and a temporary rebound in inflation means the Fed will have to keep interest rates higher for longer. An increase in US Treasury bond supply and potentially weaker demand from foreign investors have also helped to push yields higher.
2. Bond yields will likely stabilise at current levels before easing going forward. Higher energy prices should be temporary, and price pressures are expected to cool in 2024 while economic growth will continue to soften.
3. High interest rates will not last forever. Typically, US Treasury yields have peaked slightly before the corresponding peak in interest rates (Figure 3A). Since the Fed is near the end of its rate hike cycle, bond yields should be peaking very soon.
4. Given a slowing global economy, it is still prudent to focus on quality bonds. Investment grade bonds are now offering yields typically seen for riskier high-yield debt, presenting opportunities to lock in attractive yields without taking on unnecessary credit risks.
5. Investors can also start exploring longer bond durations since interest rates are near the peak and inflation will likely come down next year. Generally, the longer the duration, the greater the increase in bond prices when interest rates fall, and vice versa. Bonds with longer duration will begin to benefit in periods of flat and falling interest rates that potentially lie ahead (Figure 3B).
6. In this environment, longer-duration bonds provide both a source of consistent income as well as potential capital appreciation.

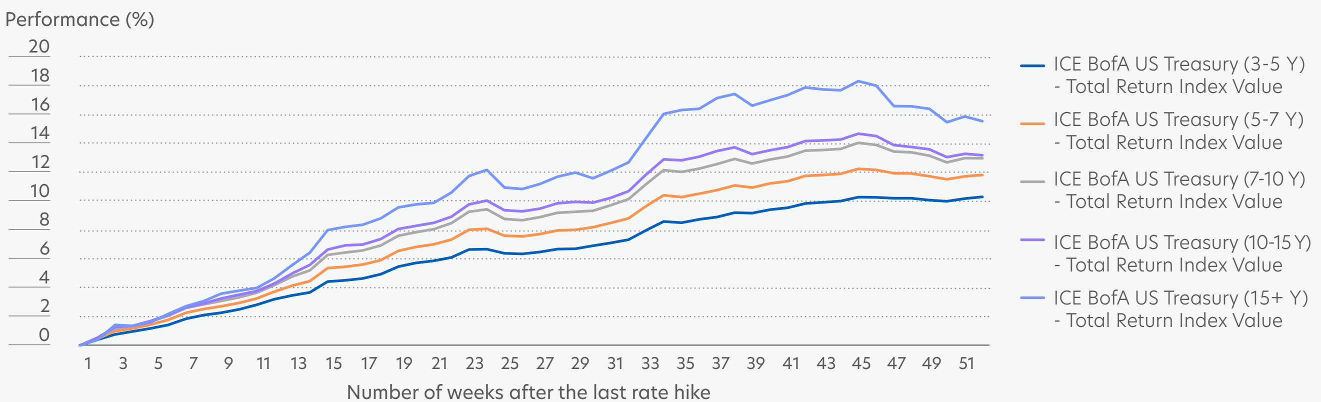
Figure 3A

US Treasury yields have historically peaked before interest rates do

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

Figure 3B

Bond duration performance after the Fed's last rate hike



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

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