UOB House View 1Q 2023

Friday, 02 December 2022

The Team
Global Economics & Markets Research
Private Bank

Global Macro

Global economic outlook is set to be weaker in 2023 with the main driving force being the aggressive pace of monetary policy tightening led by the US Fed Reserve and major central banks to tame multi-decade high inflation. We do not expect a severe recession, due to the absence of financial imbalances. If the Fed does shift to a slower but much longer rate hike trajectory that extends and lifts its policy rate much higher than our projected 5% terminal rate, we will then have to expect a more negative impact on aggregate demand and in turn, a likely deeper/prolonged US recession as a consequence.

Asset Allocation

We maintain a neutral allocation to equities and expect a “Fed pivot” in 2023 or as soon as Dec 2022. Fixed income yields including government and investment grade bonds are now attractive given rich front-end rates. Given the substantial drawdown of a 60/40 Balanced portfolio of close to 20%, we remain constructive that a mixed asset portfolio should revert to a positive return for the full year.

Equities

We deem the recent equity price actions as a “catch-up” to fundamentals after a full year of negative investor sentiments as valuations de-rated sharply from the quick rise in discount rates. For now, we believe that the worst of growth de-rating is likely behind us and there would be less PE de-rating risk going forward. We expect stocks to bottom in 1H 2023.

Fixed Income

The risk-reward is still most attractive at the short to intermediate maturities given the repricing on the front-end rates amid the Fed’s aggressive forward guidance. Longer dated investment-grade credits can also do well as long-end rates continue to price in weakening economic conditions. The credit allocation should continue to favor investment grade over high yield given rising risk of a US recession in 2023.

Commodities

For 2023, we reiterate our confidence in gold as a portfolio diversifier of risk as well as a long-term safe haven asset to own. Once the Fed Funds Target Rate (FFTR) start to peak out after 1Q23, gold will then have a more meaningful recovery. We maintain our point forecasts for gold at USD 1,800 / oz in 1Q23, USD 1,900 / oz in 2Q23 and USD 2,000 / oz across 2H23.

FX & Interest Rates

With the Fed Funds Target Rate (FFTR) estimated to reach its terminal level of 5% by 1Q23, we reiterate the view that the DXY is also likely to peak in 1Q23 alongside US rates. For the front-end rates, upside potential for yields remain in effect into the end of the year and 1Q 23. That said, the magnitude of future increase ought to be lesser than what we have experienced thus far in 2022. From a medium-term holding period perspective; we prefer an opportunistic and positive stance on duration. We expect to see bond yields drift lower across 2023.

Global Macro & Markets Strategy
Que Sera, Sera*

*Whatever Will Be, Will Be. – a song written by Jay Livingston and Ray Evans in 1955.

An Inevitable Downturn For Developed Markets In 2023

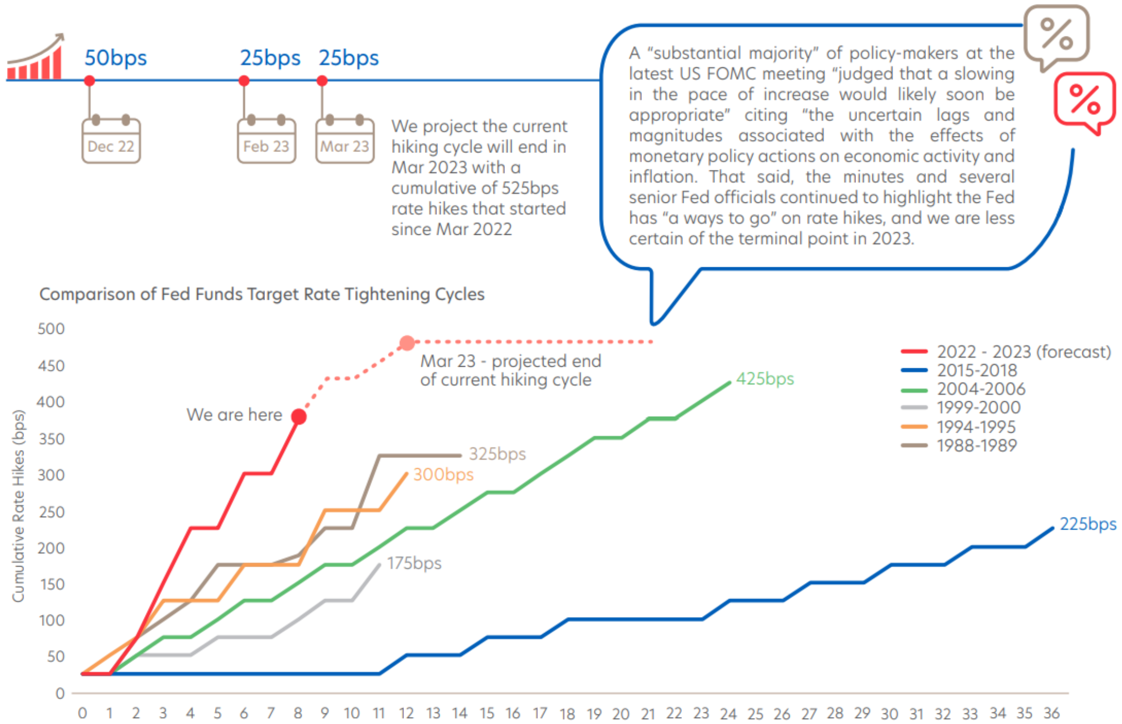
It has been a tumultuously eventful 2022 to say the least; inflation at 40-year highs, a war in Europe, the passing of a Queen, the assassination of a former Prime Minister, a historical third term for a Chinese President, a Chinese economic and real estate slump, the start of an electronics downcycle, and of course, the sharp pace of interest rate tightening by major central banks in the developed markets.

Global economic outlook is set to be weaker in 2023 with the main driving force being the aggressive pace of monetary policy tightening led by the US Federal Reserve and major central banks to tame multi-decade high inflation. The clearest casualty of higher interest rates is the US real estate market where residential fixed investments plunged and exerted a large drag on GDP in 3Q, even exceeding the worst quarter during the pandemic while monthly housing market data continued flashing red, signaling further erosion in housing demand as mortgage rates now exceeded 7% from the record low of 2.65% just in Jan 2021.

That said, we continue to expect the US economy to fall into a shallow recession (-0.5% full year GDP forecast) and higher unemployment (4.5%) in 2023 due to the combination of elevated inflation, global growth slowdown with a European recession (Eurozone GDP at -0.5%, and UK GDP also at -0.5%) and importantly, the impact from the aggressive central bank rate hikes. We are pricing in the US recession to happen in 1H 2023 as we project the Fed to reach its terminal rate (5%) by first quarter next year and stay on a prolonged pause for the rest of year until 1Q 2024.

The implication is of course if the Fed does shift to a slower but much longer rate hike trajectory that extends and lifts its policy rate much higher than our projected terminal 5%, we will then have to expect a more negative impact on aggregate demand and in turn, a likely deeper/prolonged US recession as a consequence. That is not our base case, but admittedly a probable and significant risk scenario. Other risk factors include financial stability risks due to tightening financial conditions and potential global funding markets dysfunction, further escalations in the war in Ukraine and geopolitical tensions. It is noted that many economies no longer consider COVID-19 as a downside growth risk.

US Fed Signaled Potential Slower Pace of Rate Hikes But Higher Terminal Rate



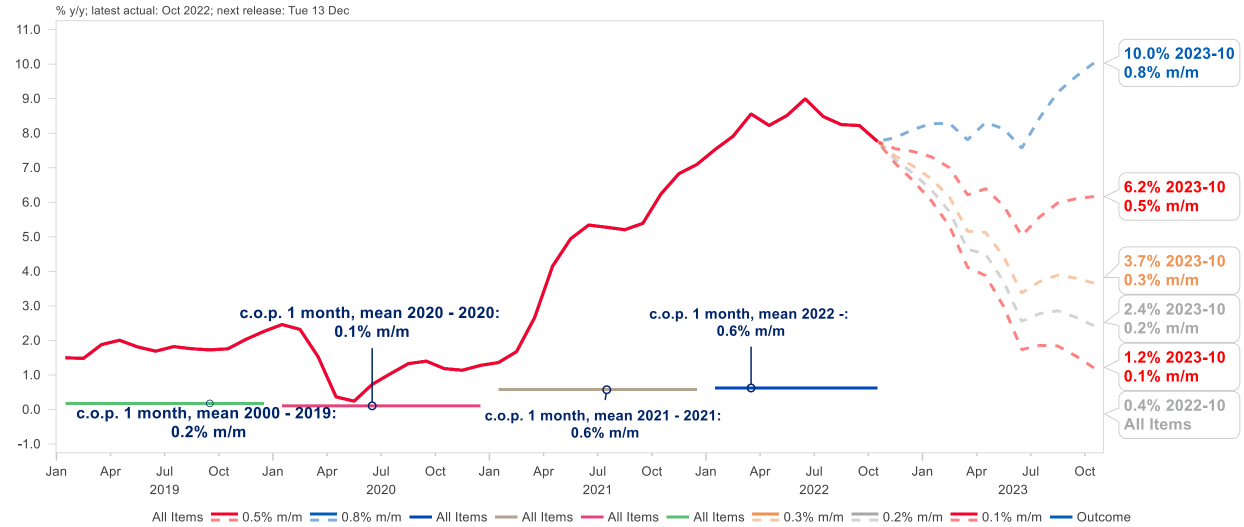
Which brings us to most important question to central banks: Where is inflation heading to in 2023? The latest headline Nov CPI prints out from Eurozone and Oct CPI/PCE prints from US seem to suggest that inflation has peaked (y/y terms) although European inflation may stay elevated especially due to surge in energy prices during the winter months.

Subsequently, we expect both headline and core inflation in DM to ease in 2023, but it will still likely average above the "gold-standard" 2% objective. The US for example, is likely to see inflation average at 3% in 2023, above the Fed's objective but importantly, the balance of risk on inflation remains on the upside and the US cost of living is still materially high, reflected by the persistent rise of food and shelter costs, and that services inflation remains elevated amidst ample demand. We remain wary of risks from several potential inflation shocks including rising labor-employer tensions, a new round of global energy price increases, renewed disruptions in supply chains, on-going impact from the Russian-Ukraine conflict, and the threat of a wage-price spiral.

We illustrate in a simple graph where US inflation may be in 12 months' time. If the m/m pace stayed positive but a more moderate 0.1% for next 12 months (it was 0.4% in Oct versus the 0.6% average in Jan-Sep), then inflation will ease to 1.2% y/y in Oct 2023. But if it is 0.2% (or higher), will imply that inflation will be 2.4% y/y or higher in Oct, above the Fed's 2% objective, and justifies the need for a prolonged pause versus a pre-mature rate cut which will risk of resurgent inflation.

United States, consumer price index scenarios over 12-month horizon

Source: Macrobond, UOB Global Economics & Markets Research



For much of the world, COVID-19 restrictions now seemed like a distant memory from the past, but it remains a painful reality for the second biggest economy in the world. Granted that there are some loosening/easing of measures but China's zero-COVID policy may take a while to unwind (especially during the winter months) and the reopening could be a long road for China, so don't take out the champagne just yet. We expect China's outlook will improve more materially in 2H23 and GDP growth may improve to 4.8% next year (from a projected 3.3% in 2022) as we anticipate further gradual easing of its COVID-19 measures next year (which may quicken as the government plans to accelerate elderly vaccination) as well as flow-through of the stimulus measures to be positive for the economy with a helpful stabilization of the property market even though home sales recovery may take longer in a more uncertain environment.

The role of China, in the face of a looming global downturn in 2023, is really a double-edged sword; a faster than expected durable reopening from COVID-19 restrictions would be a positive factor and help offset some of the downside drivers next year, and could benefit global and especially Asian outlook. Conversely, a prolonged zero-COVID strategy will risk a deeper downturn in global demand and worsen supply chain disruptions.

Beyond growth and inflation worries, 2023 will also present much geopolitical uncertainty. The top geopolitical concern remains to the Russia-Ukraine conflict; when will it end or will it escalate and bring more suffering, will commodity prices skyrocket again, fueling another round of food and energy inflation spike across the world?

Geopolitical tensions between US and China has already been a well-established fixture in the global landscape in recent years, and we are unlikely to see improvement in this area. We only hope that things do not get worse, but chances are it should get more tense next year. Our premise is based on US domestic politics. After the mid-term elections, a divided US Congress has come to pass (where the Republicans regained control of the House of Representatives while the Democrats held on to its slim majority in the Senate for the 118th Congress). This will likely mean a paralysis of domestic policies under the new Congress although President Biden will still be able to get passage for any senior appointments for the remainder of his current term as this falls under the purview of the Senate. The other potential nightmare is the likelihood of the return of the US debt ceiling limit crisis sometime in 2023.

Even as the two main US political parties remained highly polarized and will almost likely disagree on all domestic issues, the one likely issue that both Democrat and Republican lawmakers will agree and work together on will be measures against China. Thus, we expect more Chinese-related measures to be delivered in the next two years ahead of the next major election event, 2024 US Presidential Elections.

FX Strategy: After A Bumper Year, USD Strength Will Normalize In 2023

The relentless and broad-based USD rally this year has lifted USD valuation significantly. Now that the Fed has signaled a slower pace of rate hikes starting "as soon as" Dec, the tailwind behind the USD rally in the last couple of months could start to ease. And given the outsized 16% year-to-date rally in the DXY this year, position recalibration to a slower Fed could easily spark a normalization of the DXY lower. Overall, we reiterate the view that the DXY is likely to peak in 1Q23 alongside US rates. Recession risks are expected to pin EUR/USD and GBP/USD lower towards 1.01 and 1.16 respectively in 1Q23 before recovering gradually towards 1.08 and 1.25 by end-2023. After recording stellar gains in 2022, USD/JPY will normalize lower towards 132 by end-2023.

Next year, while we expect headwinds plaguing Asia FX in 2022 to recede, it is not time to take out the party poppers yet. A slower Fed may lessen the portfolio outflow pressures of Asia FX. However, uncertainty over the China slowdown and the extent of spill over from recessions in the US, UK and EU are big unknowns. Other material risks include the prolonged Russia-Ukraine military conflict and potential global funding markets dysfunction. Overall, we err on the side of caution and expect Asia FX to weaken modestly against the USD across 2023. Specifically, USD/CNY keeps its upward trajectory towards 7.30 by end-2023 on economic and COVID policy uncertainties. USD/SGD is likely to grind higher and revisit the 1.40 level.

Rates Strategy: Taking Stock And Initial Thoughts On SG Rates

For the front end, upside potential for yields remain in effect into the end of the year and 1Q 23. That said, the magnitude of future increase ought to be lesser than what we have experienced thus far in 2022.

From a medium-term holding period perspective; we prefer an opportunistic and positive stance on duration. We expect to see bond yields drift lower across 2023, based on our expectation that Fed Funds Target Rate will peak in 1Q 23 as well as accounting for our view that the balance of risk will increasingly tilt in favour of slowing economic growth and richer safe haven premiums going forward.

Commodities Strategy: Stay Positive On Gold

In 4Q22, the price movements in gold, LME Copper and Brent crude oil were relatively modest and remain well within the confines of much larger volatile trading ranges across the year. For 2023, we reiterate our confidence in gold as a portfolio diversifier of risk as well as a long-term safe haven asset to own. Once the Fed Funds Target Rate start to peak out after 1Q23, gold will then have a more meaningful recovery. We maintain our point forecasts for gold at USD 1,800 / oz in 1Q23, USD 1,900 / oz in 2Q23 and USD 2,000 / oz across 2H23.

For oil, more signs of a global growth slowdown have emerged across 4Q22 and dented the demand outlook for oil. However, the various background supply issues also persisted. On balance, we forecast Brent crude oil at USD 90 / bbl in 1H22 and USD 100 / bbl in 2H22, with rising risks of elevated volatility.

For copper, long term economic growth-related drivers are weakening noticeably and these will likely result in a weaker industrial demand. As such, given the backdrop of global growth slowdown and weak demand from China, it is difficult to expect any meaningful rebound in LME Copper price. Therefore, we maintain our forecast of USD 7,000 / MT and continue to be weary of intermittent price volatility.

Asset Allocation

Global economic data releases continued to signal a material slowdown into 2023. In the US, various yield curves on our watch (10-2Y, 10Y-3M) had inverted. The risk of a recession in the US is relatively high as the Fed is expected to stay restrictive until inflation comes closer to their stated target of 2%. Stocks will be volatile entering a recession as corporate earnings will come under pressure. Having said that, we do not expect a severe or a long-drawn recession, due to a lack of financial imbalances.

We maintain a neutral allocation to equities and expect a "Fed pivot" (smaller rate increases to reach the eventual terminal rate) in 2023 or as soon as Dec 2022. Within equities, investors should be positioned in relatively defensive assets such as the healthcare, utilities, and consumer staples. The strong momentum of higher interest rates this year saw most growth stocks performing poorly. With our expectations of disinflation going into 2023, growth stocks will likely bottom out once the Fed pivots to a less hawkish posture.

Investors should look to lock in attractive yields and focus on the cash flow returns in the coming years. There are also selective markets which are oversold, including China where we expect currently tight COVID-19 restrictions to gradually ease, and the housing sector crisis to stabilize. Markets in ASEAN region will likely weather a potential US recession better and would also benefit from a stabilizing China.

As the current sell-off was catalyzed by the Fed's tightening agenda, any pivot to a less aggressive tone will be beneficial. This will likely happen in Dec 2022 or sometime in 2023. Given the forward nature of markets, investors will be well served by slowing engaging risk assets into any weakness to position for the next cycle.

The incoming economic data should reveal a material slowdown ahead. Against this backdrop, the appropriate strategy continues to be a balanced portfolio of defensives and quality growth stocks; the latter has less cyclical earnings profile and would generally benefit from peaking interest rates.

Fixed income yields including government and investment grade bonds are now attractive given rich front-end rates. In a recession, these assets' value will hold up well and could be an effective hedge against the riskier sleeve in an investor's portfolio. Gold will also feature well as a hedge against a looming recession; we recommend some increase in allocation. Given the substantial drawdown of a 60/40 Balanced portfolio of close to 20%, we remain constructive that a mixed asset portfolio should revert to a positive return for the full year.

Global Asset Allocation For 1Q 2023	Underweight	Neutral	Overweight
Equities		•	
Fixed Income			•
Commodities			•
Alternatives (hedged strategies)		•	
Cash	•		

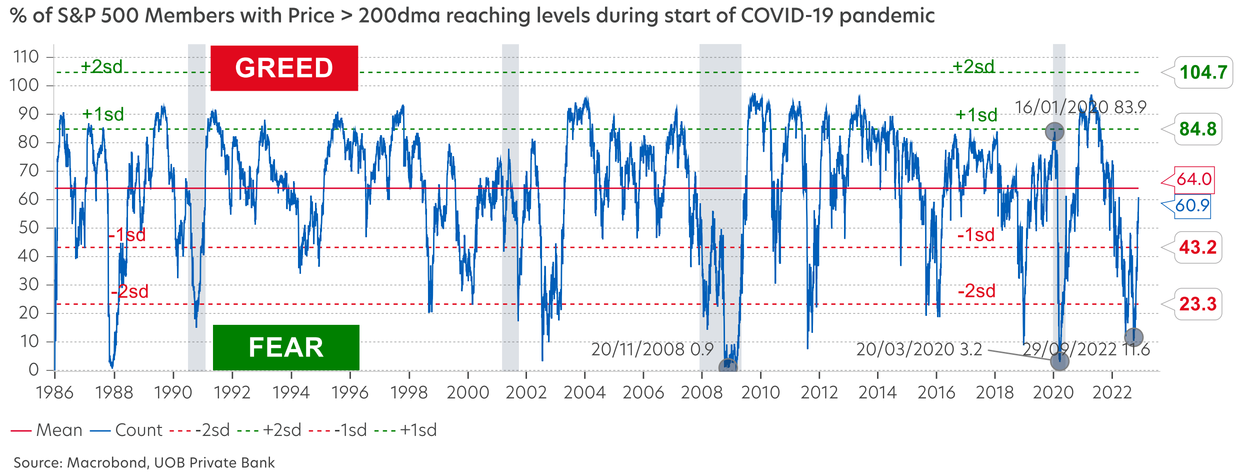
Equities

Since reaching a low towards end September, the market breadth for the US S&P 500 had rebounded significantly, showing investors' positive sentiments and expectations for the "Fed pivot". This was further fueled by the latest lower-than-expected US inflation print (Oct).

In end-Sep, only 11.6% of the S&P 500 constituents were trading with a price above their 200-day moving average. Currently, it has risen to 60.9%, signaling that the positive sentiments are broad-based.

% Share of S&P 500 Members With Price > 200dma Reaching Levels During Start Of COVID-19 Pandemic

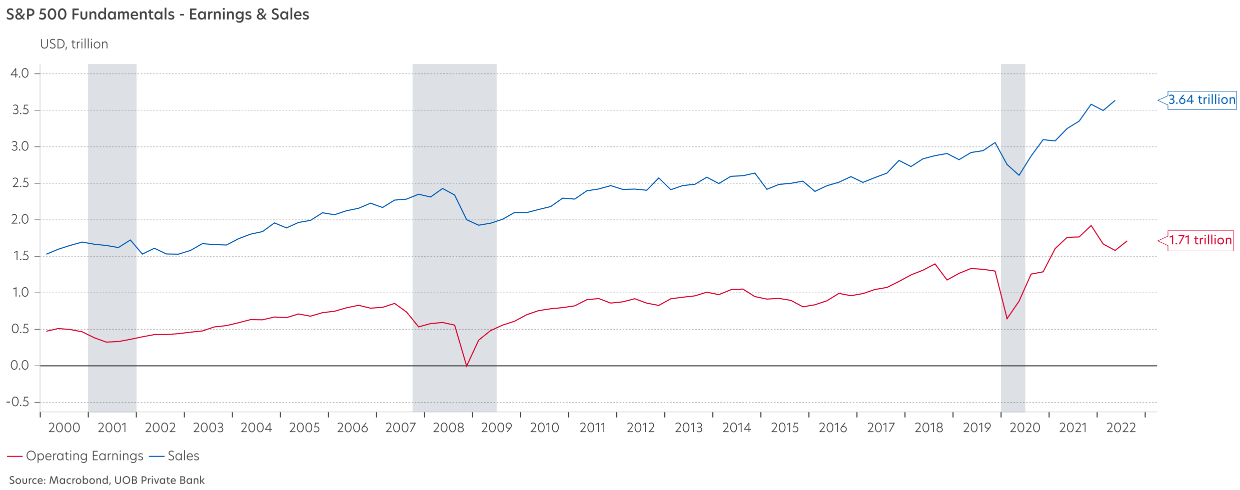
Source: Macrobond, UOB Global Economics & Markets Research



We deem the recent equity price actions as a "catch-up" to fundamentals after a full year of negative investor sentiments when valuations de-rated sharply from the quick rise in discount rates. This is particularly true for long-duration growth stocks that do not pay dividends. As seen from the following chart, fundamentals of S&P 500's constituents remained robust during the sell-off in 2022.

S&P 500 Fundamentals – Earnings And Sales

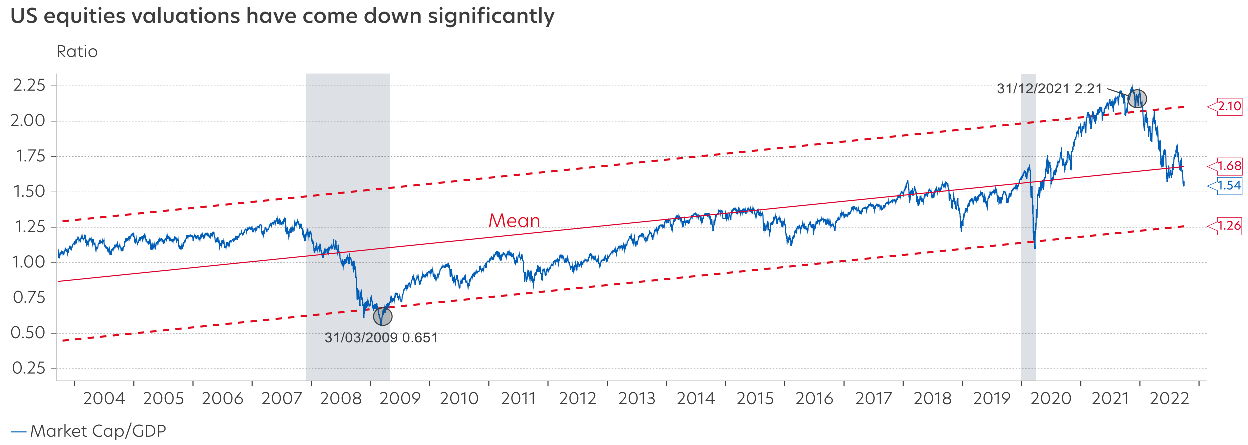
Source: Macrobond, UOB Global Economics & Markets Research



Due to the sell-off for most part of 2022, the US market capitalization to GDP ratio (also Warren Buffet's favorite indicator) had declined from a peak of 221% as of end 2021 to 154% currently. This presents a much better risk-reward profile for investors to inch into equities.

US Equities - Valuations Have Come Down Significantly

Source: Macrobond, UOB Private Bank



For now, we believe that the worst of growth de-rating is likely behind us and there would be less PE de-rating risk going forward. Having said that, due to restrictive financial conditions brought forth by a year of monetary tightening, cyclical stocks will be exposed to earnings risks in 2023.

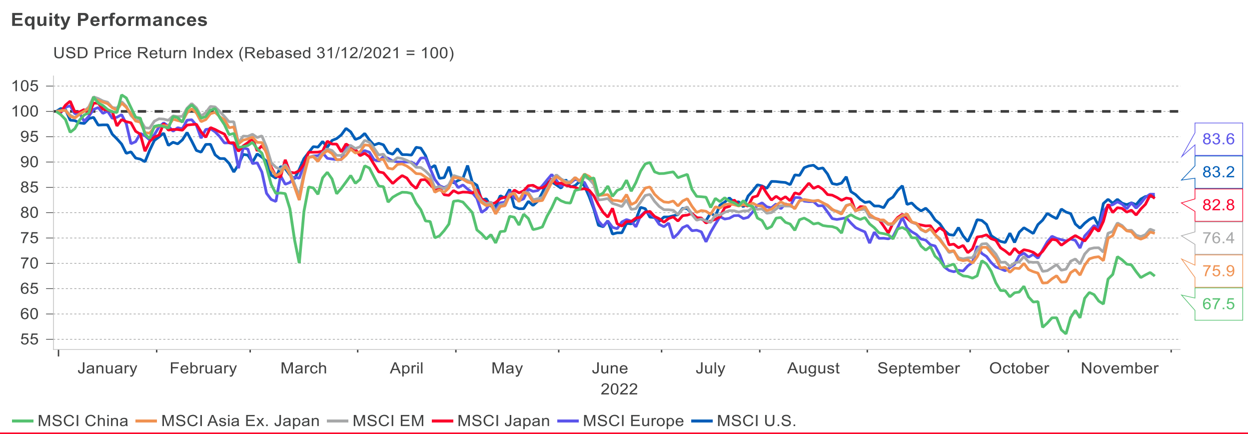
For example, the MSCI USA EPS forecasts for 2023/2024 have been downgraded by 4% to 5% over the past 3 months, with every sector except Energy and Utilities seeing downward revisions. The tech-related Communication Services, Consumer Discretionary, and Info Tech sectors have seen the largest downgrades.

We expect stocks to bottom in 1H 2023. The S&P 500 index's fair value is likely be around 3,400 to 3,500, which we have upgraded recently due to the lower US Oct inflation print. A 60/40 portfolio will potentially deliver positive returns in 2023. In the near term, regional equity positioning should be focused on protecting capital as much as on seeking opportunities.

We recommend focusing on opportunities in defensives, as well as high-quality beaten down growth stocks. Further out, investors can begin to accumulate quality growth and early cyclicals to position for the next cycle. With Fed risk peaking, bad economic news could translate to improved market sentiment as investors look for evidence of a trough in economic data.

Equity Performances

Source: Macrobond, UOB Global Economics & Markets Research



Fixed Income

USD fixed income rallied on expectations that the Federal Reserve will look to "step-down" the pace of rate hikes. The forward curve is also pricing in modest rate cuts beginning late-2023. Meanwhile, broad-based US disinflation could start gaining momentum, with the core CPI data for October 2022 supporting a peak-inflation narrative. While the Fed Chair Powell had ruled out the prospect of a near-term pause, peak US rate expectations are likely to dominate the Fed's continued hawkish rhetoric as the US economy weakens. Tightening financial conditions, a falling US composite PMI, declining housing prices and inverted Treasury yield curves point to a looming US recession.

However, several factors could mitigate the depth of the US economic downturn. They include the absence of significant financial imbalances in the private sector, and well-anchored inflation expectations. In addition, a divided US government is set to impose constraints on the US fiscal expansion. That leaves monetary policy as an important policy lever to cushion the recessionary impact on the US economy later. An unexpected sharp turn in the Fed's policy path would be bullish for the Treasury bonds and should bode well for international currencies versus the US dollar.

For US corporate credits, there is already some cushion in the market-implied default rate within the high-yield sector. High-yield corporates have priced in a net downgrade and default cycle. Further spread widening could take its course once a recession is in full force, with expected defaults likely to rise further in the next 12 months and markets potentially moving into oversold territory. This is consistent with credit rating agencies' expectations for greater downgrade risks within the high-yield sector, especially if debt-servicing costs stay elevated or increase further. The silver lining is that some of these high-yield debt issuers are heading into a downturn with sufficient cash generation to cover annual interest expense at least five times over. Credit fundamentals remained resilient with the default cycle likely to be less severe than in recent recessions.

The risk-reward is still the most attractive at the short to intermediate maturities given the repricing on the front-end rates amid the Fed's aggressive forward guidance. Peak rate expectations should dominate the narrative going forward. Longer dated investment-grade credits can also do well as long-end rates continue to price in weakening economic conditions. The credit allocation should continue to favor investment grade over high yield given rising risk of a US recession in 2023.

For Asia credits, both investment-grade and high-yield corporates were buoyed by hopes of softening inflation and China's stronger efforts to support the ailing property sector. China's regulators have called for banks to provide financial support to stronger developers. Having said that, currently elevated yields on Asian and China junk bonds still reflect high risks of default, especially for the weaker issuers. Credit selection remains key.

Despite more supportive measures to alleviate the liquidity stress and to boost demand, recovery in contract pre-sales is likely to be gradual given weak macro and employment. A gradual easing of COVID-19 restrictions in China remains likely given recent directives and a more decisive move towards vaccination. While upside potential will be limited to stronger developers with access to financing, much of the risks have been priced in. Given our expectation for positive developments, we expect some degree of spread tightening and positive total returns for Asian credits in 2023.

FX, Interest Rate & Commodities Forecasts

FX	01 Dec	1Q23F	2Q23F	3Q23F	4Q23F
USD/JPY	136	142	137	134	132
EUR/USD	1.05	1.01	1.04	1.06	1.08
GBP/USD	1.21	1.16	1.20	1.23	1.25
AUD/USD	0.68	0.65	0.68	0.70	0.70
NZD/USD	0.63	0.61	0.63	0.65	0.65
DXY	105.53	109.0	105.9	103.8	102.0
USD/CNY	7.07	7.18	7.24	7.28	7.30
USD/HKD	7.79	7.80	7.80	7.80	7.80
USD/TWD	30.64	31.3	31.5	31.8	32.0
USD/KRW	1,299	1,350	1,360	1,370	1,380
USD/PHP	56.21	57.5	57.8	58.0	58.0
USD/MYR	4.40	4.55	4.60	4.65	4.65
USD/IDR	15,603	15,900	16,000	16,100	16,200
USD/THB	34.97	35.6	35.8	36.0	36.2
USD/VND	24,610	25,200	25,400	25,600	25,800
USD/INR	81.16	84.5	85.0	85.5	86.0
USD/SGD	1.36	1.38	1.39	1.40	1.40
EUR/SGD	1.42	1.39	1.45	1.48	1.51
GBP/SGD	1.64	1.60	1.67	1.72	1.75
AUD/SGD	0.93	0.90	0.95	0.98	0.98
SGD/MYR	3.25	3.30	3.31	3.32	3.32
SGD/CNY	5.21	5.20	5.21	5.20	5.21
JPY/SGDx100	0.99	0.97	1.01	1.04	1.06

POLICY RATES	01 Dec	1Q23F	2Q23F	3Q23F	4Q23F
US Fed Funds Rate	4.00	5.00	5.00	5.00	5.00
JPY Policy Rate	-0.10	-0.10	-0.10	-0.10	-0.10
EUR Refinancing Rate	2.00	2.75	2.75	2.75	2.75
GBP Repo Rate	3.00	4.00	4.00	4.00	4.00
AUD Official Cash Rate	2.85	3.10	3.10	3.10	3.10
NZD Official Cash Rate	4.25	4.75	5.00	5.00	5.00
CNY 1Y Loan Prime Rate	3.65	3.55	3.55	3.55	3.60
HKD Base Rate	4.25	5.25	5.25	5.25	5.25
TWD Official Discount Rate	1.63	1.88	1.88	1.88	1.88
KRW Base Rate	3.25	3.50	3.50	3.50	3.50
PHP O/N Reverse Repo	5.00	6.00	6.00	6.00	6.00
MYR O/N Policy Rate	2.75	3.25	3.25	3.25	3.25
IDR 7D Reverse Repo	5.25	6.00	6.00	6.00	6.00
THB 1D Repo	1.25	1.75	1.75	1.75	1.75
VND Refinancing Rate	6.00	7.00	7.00	7.00	7.00
INR Repo Rate	5.90	6.50	6.50	6.50	6.50

INTEREST RATES	01 Dec	1Q23F	2Q23F	3Q23F	4Q23F
USD 3M SOFR (compounded)	3.09	4.30	4.80	4.80	4.80
SGD 3M SORA (compounded)	2.92	3.99	4.31	4.31	4.31
USD 3M LIBOR	4.76	5.10	5.10		
SGD 3M SIBOR	4.17	4.45	4.55	4.55	4.55
SGD 3M SOR	4.43	4.70	4.70		
10Y US Treasuries Yield	3.61	4.20	4.00	4.00	3.80
SGD 10Y SGS	2.98	3.55	3.50	3.50	3.30

COMMODITIES	01 Dec	1Q23F	2Q23F	3Q23F	4Q23F
Gold (USD/oz)	1,783	1,800	1,900	2,000	2,000
Brent Crude Oil (USD/bbl)	86	90	90	100	100
Copper (USD/mt)	8,239	7,000	7,000	7,000	7,000

USD 3M LIBOR and SGD 3M SOR will be ceased by end-June 2023
* Forecasts updated as of 02 Dec 2022
Source: UOB Global Economics & Markets Research

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