CIO Insights 2Q22

Anchor in the Storm.

Stagflation, Oil Headwinds

Despite impact from surging oil price on inflation, reopening of economies will support recovery and reduce stagflation risks.

We upgrade China to Overweight.

Anchor on Quality

Elevated market volatility from the conflict in Ukraine warrants holding a portfolio of best-in-class companies in equities. For bonds, prefer the stability of Investment Grade in Developed Markets.

Healthcare as Defensive Growth

The healthcare sector demonstrates growth with defensive characteristics, boosted by an ageing population and continuous innovation that ensures medical advances.

Diversify with Alternatives

Overweight private equity, private debt, and hedge funds for their low correlation with public markets; include infrastructure and gold for strong inflation protection.

AI/PI only

DBS

Content

Executive Summary

Dear valued clients,

Amid the upheaval from the Russia-Ukraine conflict, alongside worries over the impact of surging oil price on inflation and the Fed's rate hikes, many clients are asking if they should just liquidate their portfolios and hold cash.

For sure, market sentiment is never positive in any outbreak of a military conflict.

Although raising cash may mitigate the downside risk for a while, holding a substantial amount of cash is no antidote as rising inflation will only erode its purchasing power over time.

We advocate for portfolios to stay engaged and anchored in the best-in-class companies.

Despite the impact of oil on inflation and the increasing risk of stagflation, economic recovery from the post-pandemic reopening of economies is supportive of staying invested.

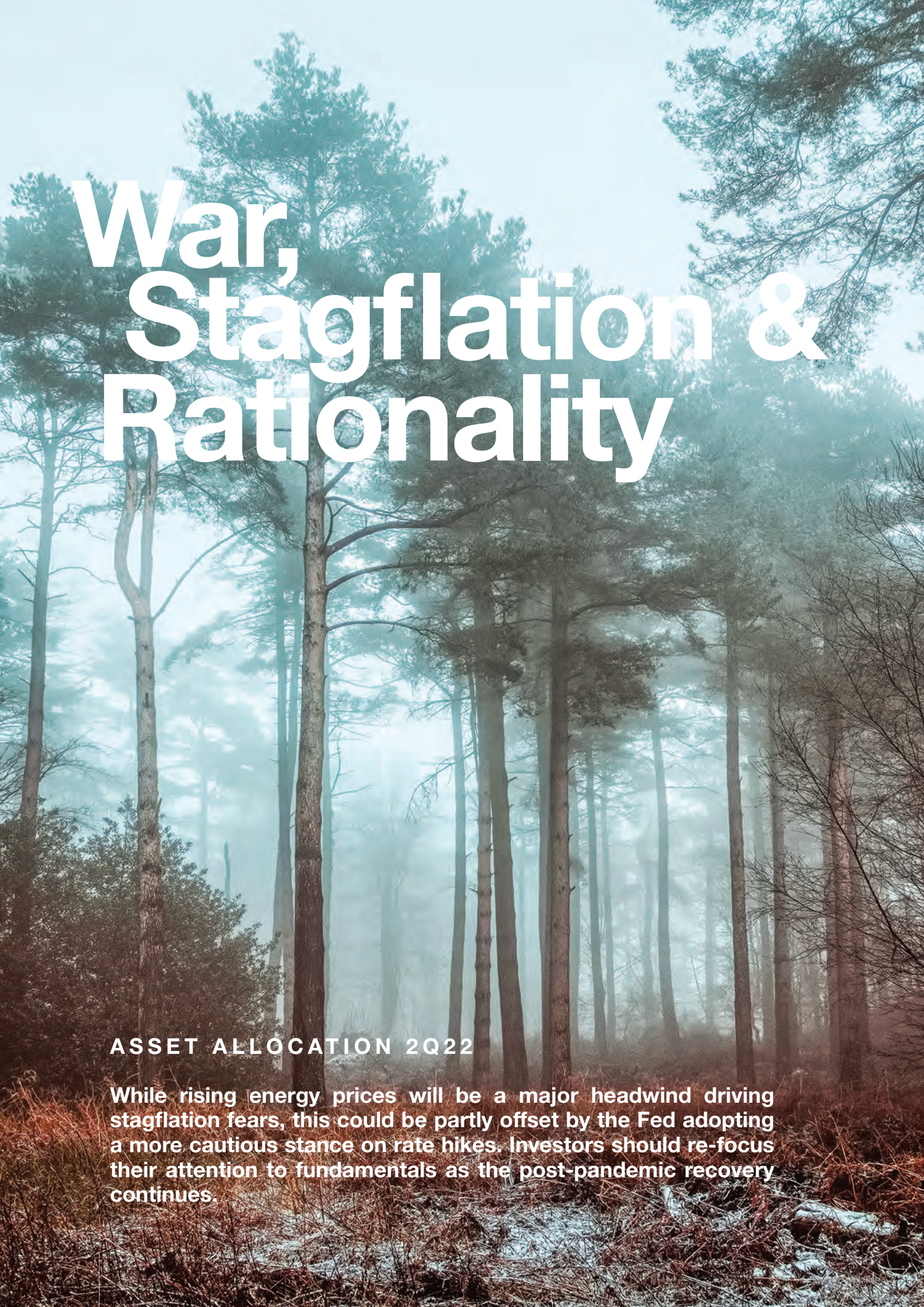
Continue to employ our barbell approach with secular growth equities and income-generating assets, and add gold as a risk diversifier.

We upgrade China to Overweight.

In this edition of CIO Insights, we look at the potential of Growth Capital in the Private Equity space, and highlight Healthcare as a growth sector with defensive characteristics.

We do hope and pray for an end to these very challenging times.

Hou Wey Fook, CFA
Chief Investment Officer



War, Stagflation & Rationality

ASSET ALLOCATION 2Q22

While rising energy prices will be a major headwind driving stagflation fears, this could be partly offset by the Fed adopting a more cautious stance on rate hikes. Investors should re-focus their attention to fundamentals as the post-pandemic recovery continues.

Investment Summary 2Q22

Macro Policy

Key issue for central banks is still uncomfortably high inflation. We see seven US rate hikes in 2022, and the ECB's QE to end.

Economic Outlook

Repeat of 1970s style stagflation is not on the cards as the post-pandemic recovery continues to take hold. US GDP growth to stay around 3%.

Inflation

Inflation to stay elevated but we expect moderation due to base effects and normalisation of supply chain over time.

Equities

We upgrade China to Overweight on valuation and policy support. We turn cautious on Europe amid surging energy prices while maintaining Overweight on US.

Currencies

USD underpinned by a series of Fed rate hikes and policy divergence with the ECB. Flight to safety from geopolitical uncertainties is also supportive.

Rates

10Y UST yield to gravitate towards 2.5% amid elevated inflation. 10Y German yields to drift towards 0.8% and 10Y JGB yields to cap at 0.25%.

Credit

Focus on quality DM IG amid rising volatility and flattening yield curves. 5Y duration is the sweet spot, benefitting from the steep yield curve roll down.

Alternatives

Growth Capital in Private Equity offers exposure to promising companies with expansion potential. Tailwinds for gold remain in place.

Thematics

Rising demand, pricing power of medical products, and development of orphan drugs underpin defensive growth nature of Healthcare sector.

Theme:
Global Healthcare (Part II)

The global Healthcare sector has undergone rapid advancement underpinned by two factors: (1) The development of cures for life-threatening diseases, and (2) Provision of holistic health care solution. Orphan drugs, in particular, are gaining increasing traction and the Total Addressable Market is stipulated to balloon to USD200b by 2024.

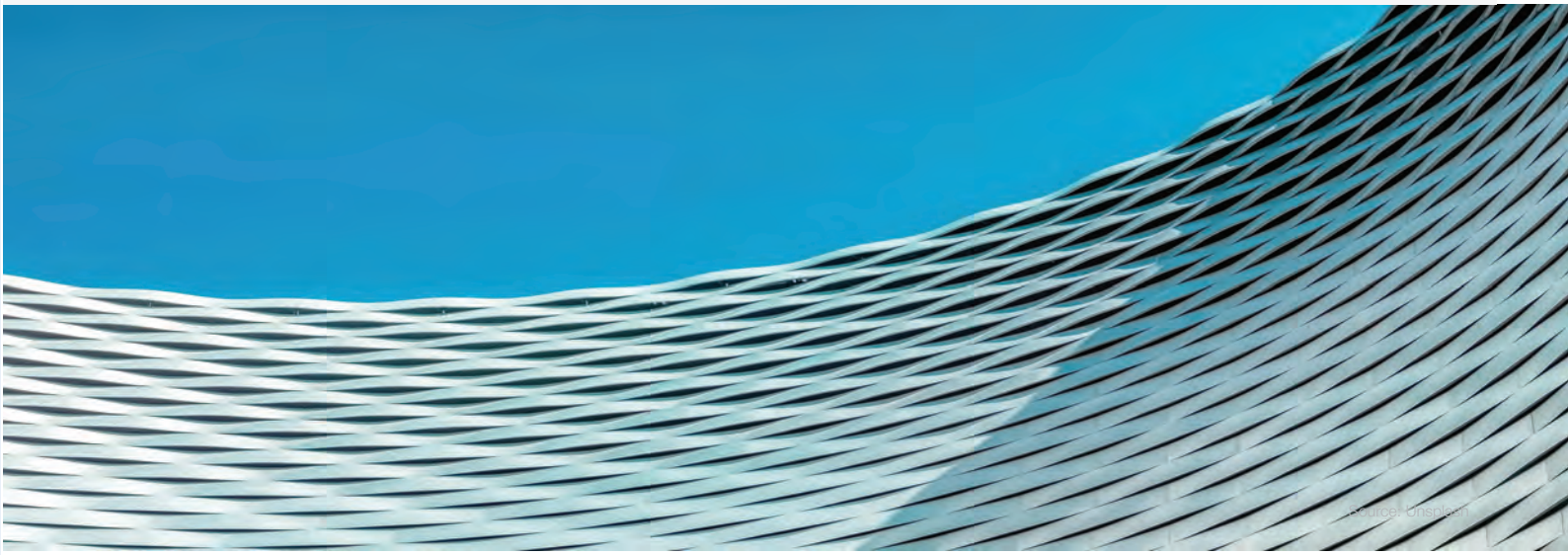
Factors driving the development of Orphan drugs include attractive financial incentives, accelerated regulatory reviews, and policy support.

Special Feature:
ESG - Opportunities in Decarbonisation

With accelerating climate-related developments, decarbonisation is now a powerful and valuable structural growth trend.

The investment opportunity set encompasses three pathways, that of renewable energy, electrification (of transport and industrial processes), and resource efficiency.

We take a close look at the breadth of opportunity available to investors and the areas that are increasingly important in the decarbonisation story.


Source: Unsplash

01. Asset Allocation.

Hou Wey Fook, CFA
Chief Investment Officer

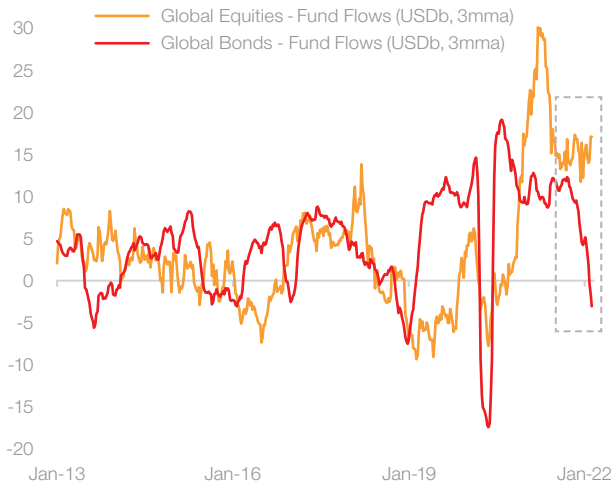
Dylan Cheang
Strategist

Global risk assets started 2022 in turbulent fashion as the combination of rising bond yields and geopolitical tension in Ukraine triggered the classic flight to safety. Global equities and high yield bonds lost 11.9% and 7.4% respectively while gold – a traditional safe haven trade – registered gains of 8.7%. Indeed, initial concerns on Fed monetary tightening were soon superseded by Russia's invasion of Ukraine which potentially marks the start of a new Cold War split along the ideological lines of democracies vs autocracies. As the west stands in unison behind Ukraine and imposed harsh sanctions on Russia, global disruptions in the energy/commodity space will ensure that inflation stays elevated.

The situation in Ukraine remains fluid and the Russian invasion could morph into a long-drawn military campaign given stiff resistance by the Ukrainians. Adding on to the proverbial wall of worries for investors is the recent pivot in market narrative from "reflation" to "stagflation". Stagflation refers to periods where inflation is strong while growth is weak. This is a paradox as weak growth is commonly associated with low inflation. Unsurprisingly, stagflation is the worst growth/inflation combination as it erodes consumer spending and decreases aggregate demand.

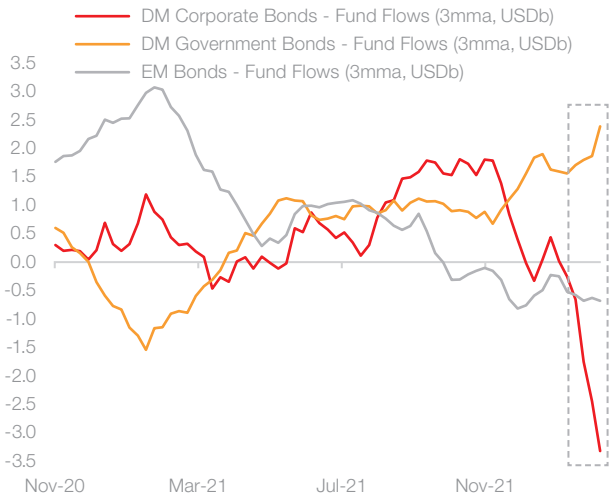
During this period of uncertainties, we advocate calm and rationality in dealing with the major headwinds and our core views are:

Investors rotating from bonds to equities



Source: EPFR Global, DBS

Corporate bonds feeling unloved



Source: EPFR Global, DBS

- Russia-Ukraine crisis: The crisis will not lead to economic contagion given the insignificant size of the Russian economy from a global context. And historically, military conflicts have limited impact on risk assets.

- Stagflation fears: A repeat of 1970s-style stagflation is not on the cards given that the high inflation which we see today is accompanied by steady macro fundamentals.

On the flipside, there are several tailwinds that will underpin the resilience in global risk assets:

- Policy pragmatism: China has taken steps to bolster market confidence by pledging to support the economy as well as introduce market friendly policies. Such policy rethink is not surprising given rising economic headwinds as well as investors' skepticism on the regulatory environment. After all, pragmatism matters.

  By the same token, the Fed has also finally embarked on policy tightening and the central bank is assuming that the rate hikes will contain runaway inflation with no material impact on growth and unemployment. But should their hypothesis be off the mark, we expect the same policy pragmatism to prevail in the US.

- Economic resilience: The post-pandemic recovery continues to take hold in spite of the geopolitical situation in Europe. In the US, ISM Manufacturing remains well above the 50-point mark while manufacturing in the Eurozone remains in the pink of health. Supportive macro conditions are in turn translating to further upside for corporate earnings.

The constructive outlook for equities ties in with investors' positioning. Fund flows data from EPFR Global show USD155b entering the asset class this year, as compared to outflows of USD43b for bonds. This suggests the rotation of funds from bonds to equities has begun given the wall of worries facing the fixed income space. Rising bond yields are pushing HY spreads higher while the withdrawal of central banks' largesse is a bane for IG bonds. DM corporate and EM bonds saw outflows of USD32b and USD5b respectively this year.

Everything has a price: Upgrading our view on China equities

China Vice Premier Liu He, has in a special meeting of the State Council's Financial Stability and Development Committee, stated that the Chinese government will be taking steps to bolster market confidence by supporting the economy as well as introducing market friendly policies. While no specifics have been given so far, we believe that Liu's comments carry heavy significance given that he is widely seen as President Xi Jinping's closest economic advisor.

With Liu drawing the line in the sand and stating China's commitment to support growth and business regulation, we believe the time to turn positive on China equities (and by extension, Asia ex-Japan) has arrived. China equities have undergone substantial derating since early-2021 and currently, it is trading at 37% discount to global equities on forward P/E basis (vs long-term average of 23% discount). Everything has a price. At current levels, we believe the rewards outweigh the risks.

Above all, with the 20th National Congress of the CPC in Beijing scheduled to be held in the second half of this year, we believe the Chinese government will take urgent steps to stabilise the economy ahead of this important meeting.

China equities trading at deep discount to global equities

Source: Bloomberg DBS

In the coming months, we believe investors' concerns will be focused on the following topics which will be addressed squarely in this quarterly:

1. Will the Russia-Ukraine conflict have a long-term impact on risk assets?
2. Will rising bond yields trigger a bear market?
3. Will inflation continue to overshoot?
4. Has Technology stocks "priced-in" the impact of rising bond yields?

Limited long-term impact on risk assets from Russia-Ukraine conflict

As tension in Ukraine lingers on, we look at how this crisis could affect the global economy and financial markets in the coming months.

- Economic Impact – In the broader scheme of things, the risk of economic contagion from the Russia-Ukraine crisis is low given that the Russia accounts for only 1.8% of global GDP (vs 24.7% for US and 17.4% for China). Similarly, in terms of global trade flows, Russia accounts for only 1.7% of global exports (vs 12.1% for China and 9.5% for US) and 1.4% of global imports (vs 12.8% for US and 10.8% for China).

  A bigger threat arising from the crisis will, instead, come from surging energy prices. Indeed, inflation shock coming from supply chain disruption has already pushed bond yields substantially higher and further spikes in energy prices will only exacerbate the situation.

- Financial Impact – A common assumption among investors is that military conflicts are devastating for financial markets. However, drawing from the experience of major military conflicts since 1990, the data suggest otherwise. Global equities have, on average, rallied 38% during military conflicts. The largest rally took place during the Afghanistan and Iraq war. Rising uncertainties, meanwhile, triggered average gains of 138% for gold and 89% gains for crude oil.

Financial impact of past military conflicts

Conflict	Start date	End date	Chang in Global Equities	Change in Gold	Change in Oil
Gulf War	02-Aug-1990	17-Jan-1991	-1%	-1%	-18%
Bosnian War	06-Apr-1992	14-Dec-1995	51%	13%	-4%
War in Afghanistan	07-Oct-2001	31-Dec-2014	86%	311%	175%
Iraq War	20-Mar-2003	15-Dec-2011	57%	367%	293%
Crimea Crisis	20-Feb-2014	26-Mar-2014	0%	-1%	-3%
Average			**38%**	**138%**	**89%**

Source: Bloomberg, DBS

Rising bond yields will not trigger an equity bear market

The US Federal Reserve has in the recent FOMC signalled the imminence of policy rate hikes. More importantly, Fed Chair Powell's stance on staying "nimble" on inflation and his refusal to rule out aggressive rate hikes was widely seen as a sign of hawkishness. The Fed pivot from "gradual" to "nimble" saw sharp upward adjustments of US Treasury yields and correction in equity markets.

Will this herald the start of a bear market? We think not. Fed hiking policy rates on the back of an improving economy will not derail the equity markets and our analysis of historical data validates this view. To analyse how bond yields and growth conditions can impact the trajectory of S&P 500, we look at annual data stretching back to 1963. Using the ISM Manufacturing as proxy for "growth momentum", our analysis drew the following conclusions:

- Prevailing combination of rising bond yields and growth momentum historically generated the highest average annual returns of c.15% for the S&P 500.
- Regardless of rising/falling growth momentum, falling bond yields have, in general, been positive for risk assets with returns averaging at c.8-10% for S&P 500.
- The combination of rising bond yields and weakening growth momentum historically generated the worst returns for S&P 500.

Based on consensus forecast, US GDP and corporate earnings are poised to grow 3.7% and 15.8% respectively in 2022. This suggests that the market is currently in the "rising bond yields and rising growth momentum" category and this is constructive for the outlook of risk assets.

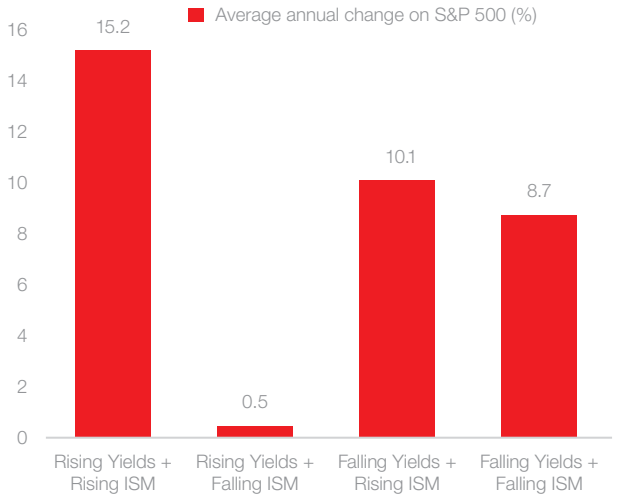
Source: iStock

Rising yields and improving growth momentum is positive for the outlook of equity markets

Period	Average annual change in bond yields (%)	Average annual change in ISM Manufacturing	Average annual change on S&P 500 (%)
Rising Bond Yields & Rising Growth Momentum	+1.0	+9.5	+15.2
Rising Bond Yields & Falling Growth Momentum	+0.6	-7.7	+0.5
Falling Bond Yields & Rising Growth Momentum	-1.1	+5.0	+10.1
Falling Bond Yields & Falling Growth Momentum	-1.0	-7.0	+8.7

Source: Bloomberg, DBS

Historical returns of S&P 500 under different macro conditions



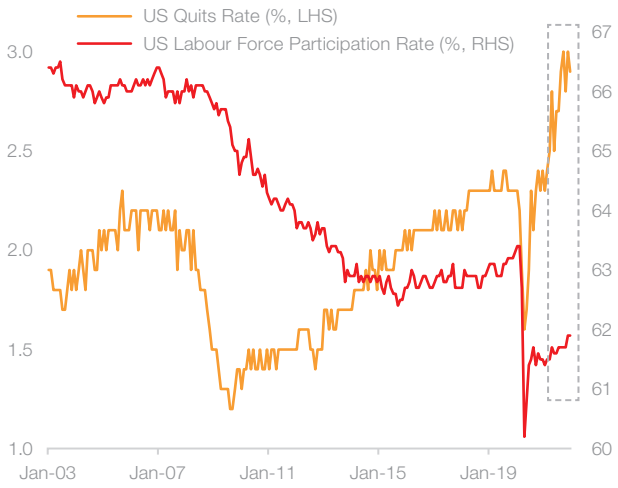
Source: Bloomberg DBS

Peak inflation on the horizon

A key investor concern today surrounds the plausibility of Fed over-tightening in the face of spiralling inflation. However, we believe that the likelihood of inflation overshooting on the upside is low. To recap, the inflation surge that we are seeing currently is predominantly due to: 1) Rising energy prices, 2) Supply chain disruption and 3) Rising wage pressure. With the exception of energy prices (which depends on the geopolitical situation in Ukraine and to what extent the United States will counteract by releasing their own Strategic Reserves), we believe the remaining two factors will see signs of easing in coming months:

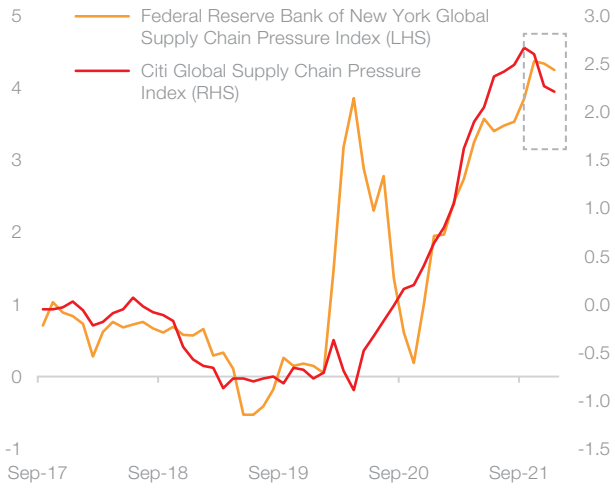
1. Wage pressure: US wage growth has been on a tear and this came on the back of two major factors: 1) Sudden shortage of workers coming at a time when demand is rebounding, 2) Pandemic stress leading to the "Great Resignation" trend which saw large number of Americans quitting their jobs.

Reversal of the "Great Resignation" trend on the cards as working life returns to normalcy



Source: Bloomberg DBS

Supply chain stress to ease as countries abandon "Zero-Covid" strategy



Source: Bloomberg DBS

Indeed, the US "quits rate" has increased from a low of 1.6% in Apr-2020 to 3.0% by Nov-2021. Labour force participation, on the hand, fell from 63.4% in Jan-2020 to 61.9% in Dec-2021. But with corporate working life returning to normalcy while in the case of US, child tax credit expiring, we believe more people will return to the workforce and this will be a major factor alleviating wage/inflation pressure.

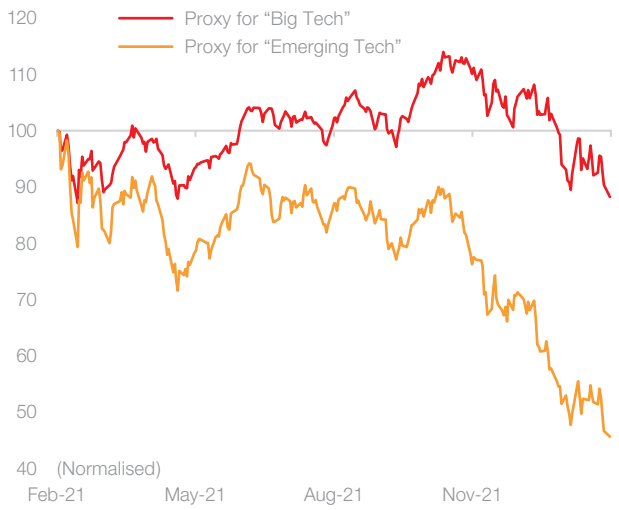
- Supply chain bottlenecks: Disruptions from the COVID-19 pandemic, coupled with an untimely end-demand boom, have triggered massive supply chain disruptions that contributed to the current inflation situation. However, as the world pivots away from a "Zero-Covid" strategy and returns to normalcy, the supply chain bottlenecks are expected to ease in the course of 2022. This is already evident in supply chain pressure indices which are showing early signs of easing.

Rising bond yields reflected in Tech valuation

"Long duration" equities like Technology bore the brunt of the selldown since the hawkish pivot in Fed monetary stance. The selling pressure on Technology is based on the assumption that rising bond yields will translate to lower present value for high growth companies with low profitability on a discounted cash flow perspective. This is also the primary reason why "Big Tech" has vastly outperformed "Emerging Tech" as investors exited Technology plays with low profitability.

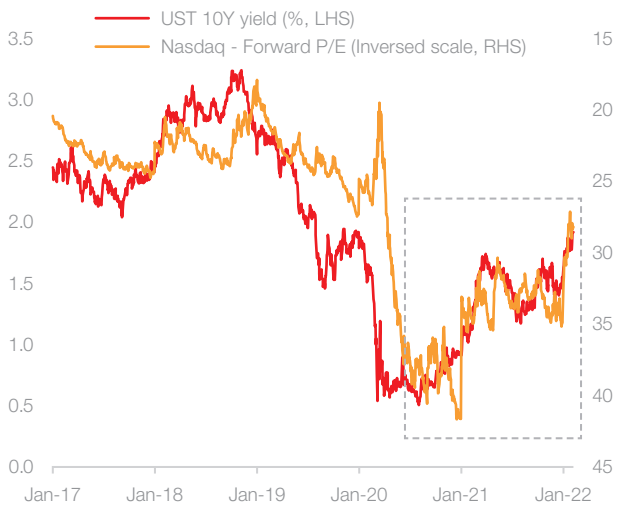
But everything has a price. The high octane selldown in Technology has brought valuations to attractive levels and this suggests that yield concerns on Tech stocks have been largely priced-in.

Stark outperformance of "Big Tech" over "Emerging Tech"



Source: Bloomberg, DBS

Tech valuation pricing in the impact of rising bond yields



Source: Bloomberg, DBS

Historically, the forward valuation for Nasdaq displayed close inverse relationship with bond yields – with rising yields translating to valuation compression and falling yields leading to valuation expansion. Since 2021, the forward P/E for Nasdaq has compressed 32% and this coincided with a 100 bps increase in the UST 10Y yield.

Based on consensus forecast, the latter is expected to hit 2.15% by 4Q22 and the prevailing level of 1.98% suggests that the bulk of the increase in bond yields (and by extension, valuation contraction for Technology) has already taken place.

Going forward, we expect robust Tech earnings to offset the contraction in valuation for the sector. Indeed, earnings momentum for Technology has remained robust despite the pandemic. In the recent US earnings season, Tech reported reporting earnings surprise of 90% and this is the highest on the S&P 500. Earnings forecast for the sector has been revised up 10% this year and we believe more upward revisions are on the cards as the global economic recovery gathers pace.

2Q22 Asset Allocation – Equities remain attractive relative to bonds

Categories	Indicators	Score Range	Equities				Bonds		
			US	Europe	Japan	AxJ	DM Govt	DM Corp	EM Bonds
Fundamentals	PMI	-1 to +1	0	0	0	0	0	0	0
	Economic surprise	-1 to +1	0	0	0	0	0	0	0
	Inflation	-1 to +1	-1	-1	-1	-1	-1	-1	-1
	Monetary policies	-1 to +1	0	0	0	0	-1	-1	-1
	Forecasted EPS growth	-2 to +2	2	1	0	1	-	0	0
	Earnings surprise	-2 to +2	2	1	0	0	-	0	0
Valuation	Forward P/E	-2 to +2	-1	1	0	1	-	-	-
	P/B vs ROE	-2 to +2	0	0	-1	0	-	-	-
	Earnings yield - 10-yr yield	-2 to +2	1	1	1	1	0	0	0
	Free Cashflow yield	-2 to +2	1	2	1	0	-	-	-
	Credit spread	-2 to +2	-	-	-	-	-	0	0
Momentum	Fund flows	-2 to +2	1	-1	0	1	0	0	0
	Volatility	-1 to +1	0	0	0	0	0	-	-
	Catalysts	-2 to +2	0	-1	-1	1	0	1	0
Raw Score			5	3	-1	4	-2	-1	-2
Adjusted Score*			**0.24**	**0.14**	**-0.05**	**0.19**	**-0.18**	**-0.06**	**-0.13**

*Note: The "Adjusted Score" is calculated using the "Raw Score" divided by the maximum attainable score for each category.

Source: DBS

2Q22 Asset Allocation – Equities remain attractive relative to bonds

Cross Assets – Equities maintain relative attractiveness over bonds in a rising yield environment. From a cross-assets perspective, we keep our preference for equities over bonds. In our CAA Framework, equities garnered a higher composite score of 0.13 as compared to -0.12 for bonds.

Fundamentals: The US Federal Reserve has finally pivoted away from ultra-loose monetary policy with a 25 bps hike in the recent FOMC meeting. We expect the Fed to implement another six hikes this year, followed by four in 2023. Apart from elevated inflation, the anticipated hikes are also coming on the back of a strong macro backdrop as economic activities return to normalcy. In the US, GDP is on-track to expand 3.5% while the Eurozone is slated to grow 4.0%.

Equities remain more attractive than bonds

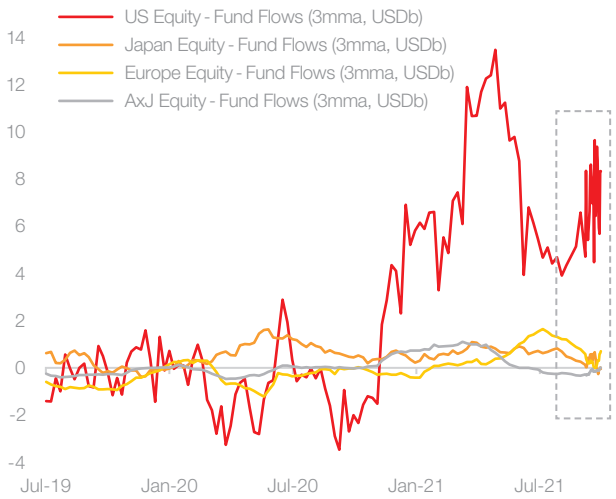
Source: Bloomberg, DBS

Valuation: The gap between US earnings yields and Treasury yields has been largely flat as bond yields rose in tandem with earnings yield. At the current level of 2.2% (as of 17 Mar), equities remain more attractive as an asset class than bonds.

Momentum: On cross-asset flows, global equities registered inflows of USD155b YTD (as of 15-Feb), while bonds saw outflows of USD43b. This suggests ongoing paring back of portfolio exposure to bonds in a rising rates environment.

Equities: Downgrading Europe to Underweight and upgrading Asia ex-Japan to Overweight. With the latest development in Ukraine, we are downgrading our Overweight call on Europe to Underweight given:

US equities registering largest fund inflows this year



Source: EPFR Global, DBS

- Europe has huge dependencies on Russia and Ukraine for its energy needs and the ongoing conflict will result in potential disruption and delays.

- Europe is a net importer of oil and the surge in energy prices will weigh on the profitability of European companies with high energy consumption requirements.

In contrast, we have become more sanguine on the outlook of Asia ex-Japan equities for the coming quarter given:

- On forward P/E basis, the region has derated substantially since early-2021 and it is currently trading at an attractive 18.7% discount to global equities.

- Rising optimism on the outlook for China will be a significant boost for AxJ equities given the significant weight China accounts for in the region.

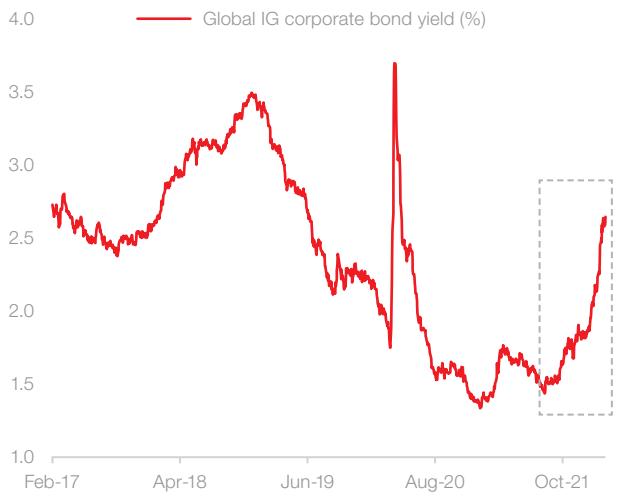
- Select commodity plays in ASEAN will benefit from rising commodity/energy prices.

In DM, we continue to favour US equities for its growth exposure, particularly in the Technology-related space. Global digital disruption is a multi-year theme that will not be derailed by monetary policy tightening and the resilience of Big Tech during the current selldown underpins our view.

Our constructive view on US equities is underpinned by data from EPFR Global which show USD60.2b flowing into the market this year and this far supersedes Europe and Japan. We believe the recent market correction presents a window for investors to gain exposure to secular themes in the US markets.

Fixed Income: Upgrading DM Corporates to Overweight and downgrading EM to Neutral; Favour 5Y duration credit. As the yield curve flattens, we expect higher grade bonds to outperform the riskier ones in the coming quarter and this underpins our decision to upgrade DM Corporates bonds to Overweight and downgrade EM bonds to Neutral. Indeed, global IG bonds are starting to look attractive after recent spreads widening and we advocate investors to go for quality. With a yield of 2.6%, IG credit is a good alternative to cash.

IG credit looking attractive



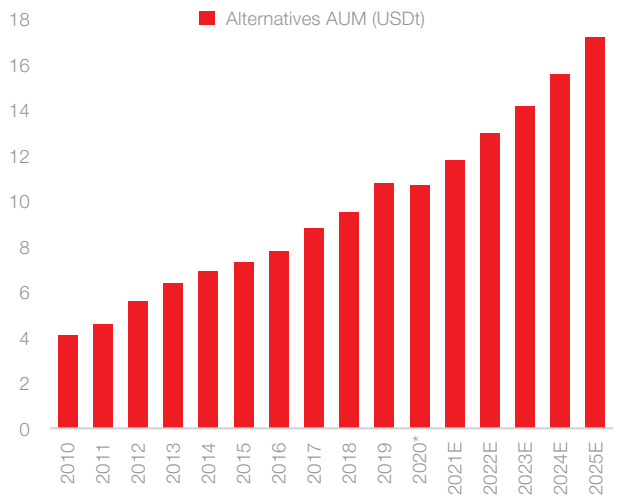
Source: Bloomberg DBS

Duration-wise, we favour the 5Y bucket despite the rising rates environment which would typically compel investors to shorten duration and reduce portfolio sensitivity to bond yields. However, in the current market cycle, the rise in bond yields is accompanied by healthy growth momentum and our analysis shows that the 5-7Y segment historically generates higher returns than the 1-3Y segment.

Alternatives: Seek growth and income enhancement with exposure to Private Equity and Private Debt, while hedging inflation risk with gold. The recent years of strong returns in public markets have compelled investors to search for other growth and income opportunities in private assets (such as Private Equity and Private Debt). Indeed, private assets tend to generate higher returns as business owners are less constrained by regulatory burdens and possess greater control over their business. We expect investor interest in private assets to gain momentum in coming years as the search for new opportunities continues.

In the meantime, investors should also hedge their portfolios against geopolitical and inflation risk with exposure to gold. The demand for gold is expected to stay strong as the flight to safety continues. Gold functions as an effective portfolio diversifier in times of market volatility.

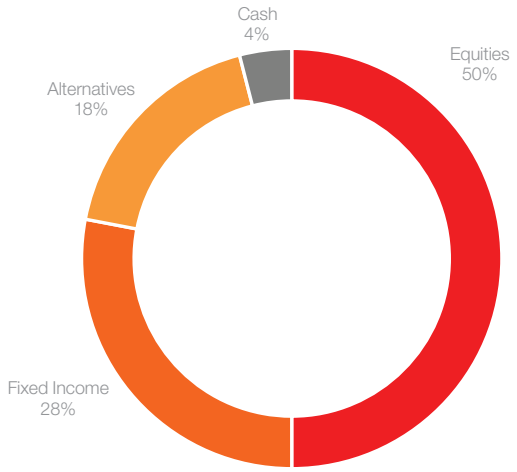
Strong momentum in Alternatives AUM



Source: Preqin

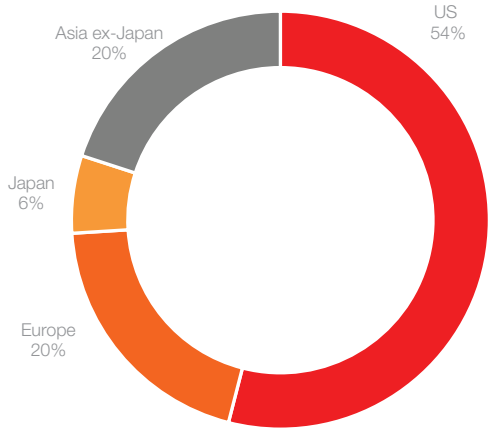
* Based on annualized Jan-Oct data

TAA breakdown by asset class (Balanced Profile)



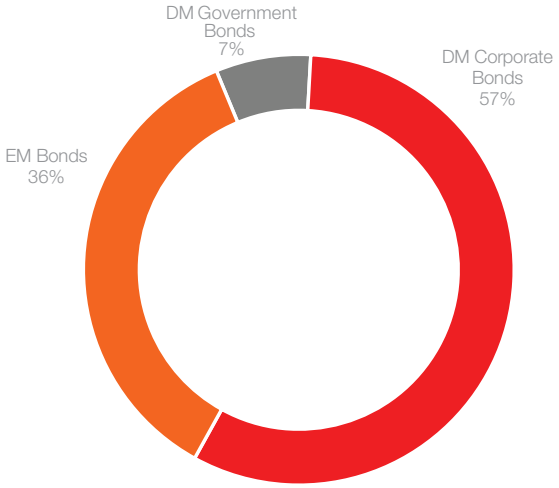
Source: DBS

TAA breakdown by geography within equities (Balanced Profile)



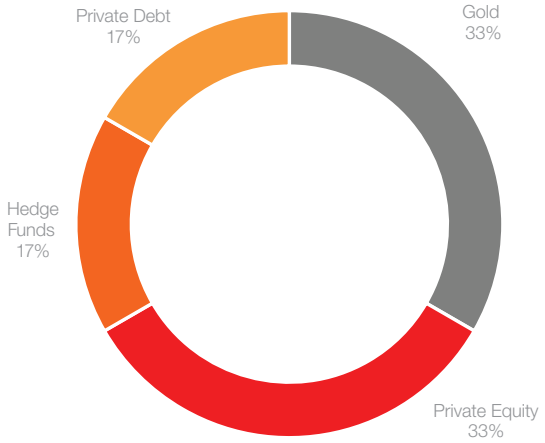
Source: DBS

TAA breakdown by bond types within fixed income (Balanced Profile)



Source: DBS

TAA breakdown by segments within Alternatives (Balanced Profile)

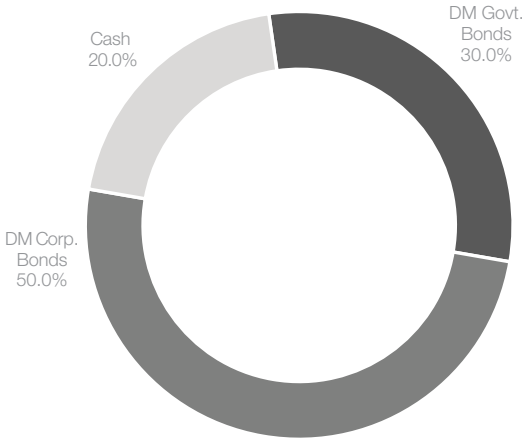


Source: DBS

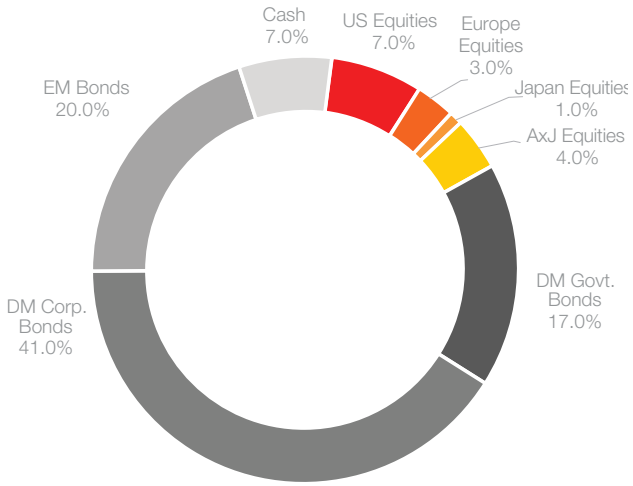
2Q22 Global Tactical Asset Allocation

	3-Month Basis	12-Month Basis
Equities	**NEUTRAL**	**NEUTRAL**
US Equities	Overweight	Overweight
Europe Equities	Underweight	Underweight
Japan Equities	Underweight	Underweight
Asia ex-Japan Equities	Overweight	Overweight
Fixed Income	**Underweight**	**Underweight**
Developed Markets (DM) Government Bonds	Underweight	Underweight
Developed Markets (DM) Corporate Bonds	Overweight	Neutral
Emerging Markets (EM) Bonds	Neutral	Neutral
Alternatives	**Overweight**	**Overweight**
Gold	Overweight	Overweight
Private Assets & Hedge Funds	Overweight	Overweight
Cash	**Underweight**	**Neutral**

Source: DBS



Source: DBS



Source: DBS

CONSERVATIVE

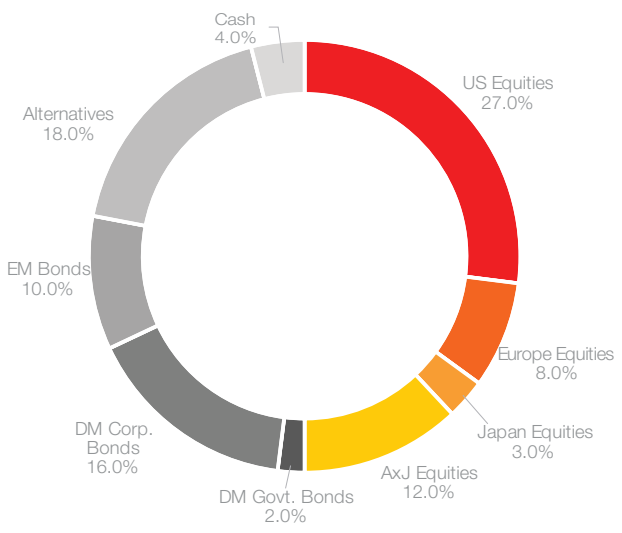
	TAA	SAA	Active
Equities	**0.0%**	**0.0%**	
US	0.0%	0.0%	
Europe	0.0%	0.0%	
Japan	0.0%	0.0%	
Asia ex-Japan	0.0%	0.0%	
Fixed Income	**80.0%**	**80.0%**	
Developed Markets - Government	30.0%	30.0%	
Developed Markets - Corporate	50.0%	50.0%	
Emerging Markets	0.0%	0.0%	
Alternatives	**0.0%**	**0.0%**	
Gold	0.0%	0.0%	
Private Assets & Hedge Funds*	0.0%	0.0%	
Private Equity	0.0%	0.0%	
Hedge Funds	0.0%	0.0%	
Private Debt	0.0%	0.0%	
Cash	**20.0%**	**20.0%**	

*Only P4 risk rated UCITs Alternatives

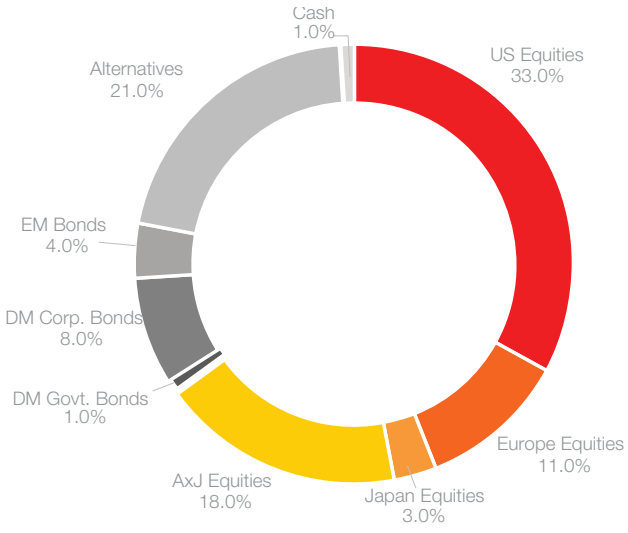
MODERATE

	TAA	SAA	Active
Equities	**15.0%**	**15.0%**	
US	7.0%	6.0%	1.0%
Europe	3.0%	4.0%	-1.0%
Japan	1.0%	2.0%	-1.0%
Asia ex-Japan	4.0%	3.0%	1.0%
Fixed Income	**78.0%**	**80.0%**	**-2.0%**
Developed Markets - Government	17.0%	20.0%	-3.0%
Developed Markets - Corporate	41.0%	40.0%	1.0%
Emerging Markets	20.0%	20.0%	
Alternatives	**0.0%**	**0.0%**	
Gold	0.0%	0.0%	
Private Assets & Hedge Funds*	0.0%	0.0%	
Private Equity	0.0%	0.0%	
Hedge Funds	0.0%	0.0%	
Private Debt	0.0%	0.0%	
Cash	**7.0%**	**5.0%**	**2.0%**

*Only P4 risk rated UCITs Alternatives



Source: DBS



Source: DBS

BALANCED

	TAA	SAA	Active
Equities	**50.0%**	**50.0%**	
US	27.0%	25.0%	2.0%
Europe	8.0%	10.0%	-2.0%
Japan	3.0%	5.0%	-2.0%
Asia ex-Japan	12.0%	10.0%	2.0%
Fixed Income	**28.0%**	**35.0%**	**-7.0%**
Developed Markets - Government	2.0%	10.0%	-8.0%
Developed Markets - Corporate	16.0%	15.0%	1.0%
Emerging Markets	10.0%	10.0%	
Alternatives	**18.0%**	**10.0%**	**8.0%**
Gold	6.0%	5.0%	1.0%
Private Assets & Hedge Funds*	12.0%	5.0%	7.0%
Private Equity	6.0%	2.4%	3.6%
Hedge Funds	3.0%	2.0%	1.0%
Private Debt	3.0%	0.5%	2.5%
Cash	**4.0%**	**5.0%**	**-1.0%**

*Only P4 risk rated UCITs Alternatives

AGGRESSIVE

	TAA	SAA	Active
Equities	**65.0%**	**65.0%**	
US	33.0%	30.0%	3.0%
Europe	11.0%	15.0%	-4.0%
Japan	3.0%	5.0%	-2.0%
Asia ex-Japan	18.0%	15.0%	3.0%
Fixed Income	**13.0%**	**15.0%**	**-2.0%**
Developed Markets - Government	1.0%	4.0%	-3.0%
Developed Markets - Corporate	8.0%	7.0%	1.0%
Emerging Markets	4.0%	4.0%	
Alternatives	**21.0%**	**15.0%**	**6.0%**
Gold	6.0%	5.0%	1.0%
Private Assets & Hedge Funds*	15.0%	10.0%	5.0%
Private Equity	7.0%	4.9%	2.1%
Hedge Funds	5.0%	4.0%	1.0%
Private Debt	3.0%	1.1%	1.9%
Cash	**1.0%**	**5.0%**	**-4.0%**

*Only P4 risk rated UCITs Alternatives

Notes:
1. The above are based on three-month views.
2. Asset allocation does not ensure a profit or protect against market loss.
3. "TAA' refers to "Tactical Asset Allocation". "SAA" refers to "Strategic Asset Allocation".
4. Based on the SAA model, the Aggressive model has the highest risk, followed by Balanced, Moderate, and Conservative, with Conservative being the least risky.
5. The investor type classification for the portfolio has no direct relationship with the Financial Needs Analysis customer risk profile types and the portfolios are not assigned any product risk rating based on the bank's proprietary risk rating methodology.

Inflation on the rise

MACROECONOMICS 2Q22

With looming inflation and an aggressive omicron variant, we see the US contending with multiple rate hikes. The ECB continue to ensure monetary tightening is not premature while in Japan, medium-term recovery prospect remains unchanged.

Source: Unsplash

02. Macroeconomics.

Taimur Baig, Ph.D.
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Analyst

US

Inflation remains front and centre in the minds of investors. Where do we stand? We remain convinced that the supply side drivers of inflation – oil price, chip shortage, and port bottlenecks – will be resolved through the course of this year. We also believe that fiscal policy will act as a major restraining factor to demand this year as many pandemic-era support measures are removed. Consumers' astonishingly strong demand for discretionary goods is also bound to ease this year as services open up.

But there remain numerous areas of concern. What if skills mismatch keeps pushing up wages? What if charges of services spike as consumers flock to restaurants, spas, flights, and hotels? What if companies become convinced of sustained demand for goods and get entrenched in a cycle of raising prices?

Even after considering the pipeline deceleration in inflation due to base effects and expected supply chain normalisation, the US economy will likely have to contend with 3% core PCE inflation 12 months from now, which would almost certainly warrant further hikes in 2023, perhaps by an additional 50-75 bps.

One way to parse through the uncertain outlook is to consider a range of scenarios ahead:

Scenario 1 (40% chance)

This is an ideal situation, with commodity and shipping costs peaking in 1Q22, paving the way for core PCE inflation to fall below 3% by the end of the year. Growth remains strong and unemployment falls below 3.5%, with the labour force participation rate rising to pre-pandemic levels. Against this backdrop, the Federal Reserve steadily raises the upper bound of its funds rate to 1.50% through the course of the year, pausing in quarter four to assess the impact and the outlook, leaving room for further raises in 2023. Company earnings and asset prices remain well supported under this scenario.

Scenario 2 (40% chance)

This is a more challenging backdrop, under which the rate hikes prove to be come in a tad too late, leaving wage and price dynamics unchanged through the year. As a result, core PCE inflation remains well above 3% and the job market stays strong, forcing the Fed to give stronger signals toward sustained rate hikes and expediting quantitative tightening. This becomes a headwind for asset prices, the

investment outlook becomes uncertain, and real GDP growth stumbles in the second half of the year. We find it hard to separate the probability of this scenario from the one articulated earlier.

Scenario 3 (20% chance)

Under this scenario, with no respite to energy and shipping prices, coupled with evidence of wage growth acceleration, the market takes the view that the Fed is substantially behind the curve. This then translates into fear that nothing short of a prolonged string of rate hikes, which pushes the economy into an outright or near recession, would bring inflation under control. The Fed hikes in every policy meeting, including once by 50 bps, pushing down investment, consumer spending, jobs, and wage growth. Inflation however remains high as policy works through lags. The outlook for inflation in 2023 improves, but at the cost of a sharp loss of growth momentum. This scenario would most likely come with a sharp correction in asset prices.

Eurozone

Tailwinds and headwinds. A receding Covid count will be a tailwind for the Eurozone economy, as high vaccination rates across the Eurozone member countries kept hospitalisation rates in check. Geopolitics is, however, emerging as a key headwind as Russia's invasion of Ukraine carries economic as well as medium-term diplomatic/ security implications for the region.

The economic impact is likely to be felt through various channels. Firstly, energy supplies are at risk if the conflict escalates further. Total import dependency for gas/ crude/ NGL is at >90% for the EU at large, of which 41% of gas and 27% of oil/NGL come from Russia (2019). Supplies have not been interrupted as yet but there are lingering concerns over disruptions, pushing few buyers to already seek alternatives. Other key imports from Russia include metals such as coal, copper, aluminium, while corn, soyabean, seed oils, iron ore and the like are EU's key purchases from Ukraine.

Three scenarios for the US economy

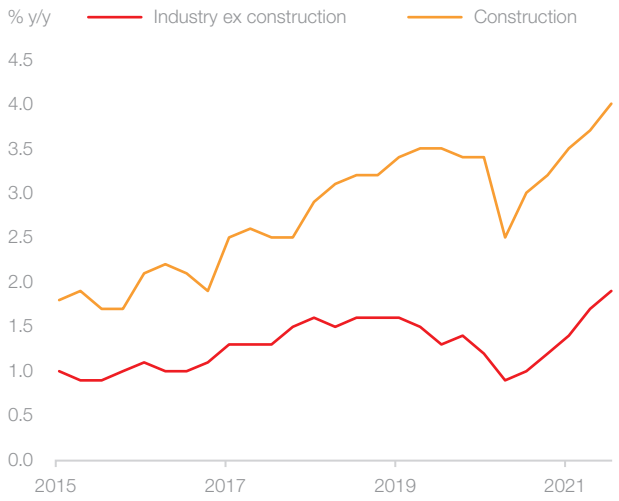
	Scenario 1	Scenario 2	Scenario 3
Probability	40.0%	40.0%	20.0%
Unemployment, end-22	3.5% or lower	3.5% or lower	3.5% or lower
Labour force participation rate, end-2022	63.0	61.5	62.0
Core PCE inflation, end-22	Less than 3%	3-4%	4-5%
Fed rate hikes in 2022, bps	125	150	200
2022 real GDP growth	3.5%	Less than 3%	1.5%
Asset prices	Well supported	Some downside	Major downside

Source: CEIC, Bloomberg, DBS

The broad rally in oil prices prompted the ECB to revise up its baseline oil assumption for 2022 to USD92.6/bbl vs USD77.5/bbl outlined in Dec21. It is expected to stay high at USD82.3/bbl in 2023 and return to sub-USD80 in 2024. Reflecting pipeline risks, we raise our inflation forecast by 80 bps to 4.8% for 2022, while lowering our GDP forecast to 3.5% y/y for this year, from 4% earlier. Lastly, European bank exposure to Russia is highest among the subsidiaries of institutions from Austria, Italy, and France, according to BIS data.

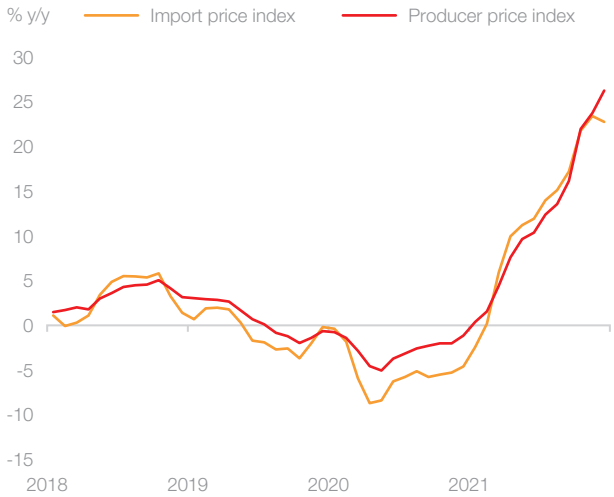
On the pandemic, as global trends suggest, the current wave of infections and its impact on economic activity is likely short-lived. Lead supply indicators also point to easing bottlenecks and logistical disruptions, which should bode well for the zone's production and export trends. The fall in the unemployment rate, if accompanied by a pickup in the labour participation rate, will be a catalyst for a more durable consumption revival. For now, the recovery in consumer confidence trails the lift-off in business sentiments. This likely reflects pandemic-led caution and the lack of strong wage growth despite rising job vacancies and anecdotal labour shortages. Financing conditions are favourable. The Next Generation EU (NGEU) fund outlays will add momentum to investment growth.

Job vacancies rise



Source: CEIC, Bloomberg, DBS

Domestic and imported price pressures reign



Source: Bloomberg, DBS

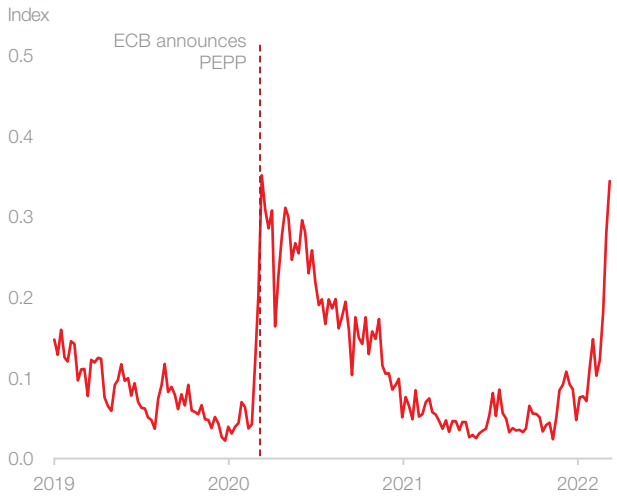
While inflation is at record highs, the risk of generalisation in price pressures is not yet evident in wage as well as negotiated wage growth. Job vacancy rates are up, implying tightness in labour markets, leaving the door open for second-round effects if wage growth matches the commensurate improvement in demand.

In its March policy review, the ECB acknowledged heightened uncertainty over the economic and policy outlook on geopolitical risks. Stagflation is not a base case, but hues were evident in the staff forecast revisions. While asset purchases will continue under the aegis of the Asset Purchase

Program (APP), monthly purchases will be reduced by June. The door has been left open to stop these purchases by 3Q subject to risks. A mention that policy rates might increase "shortly after" taper was replaced with "sometime after".

The QE taper decision was along our assumption. Given the highly uncertain outlook, the ECB has prudently introduced flexibility on the path thereafter, premised on which we delay our call for the deposit facility rate to be raised to zero to 1H23 vs 2H22 before. The main refi rate might be adjusted in 2H23, raised by 15-25 bps, cumulatively. Governments, meanwhile, might play their part, taking cues from the EU's plans of joint bond sales to finance energy and defence spending, although understandably much negotiation will be required to carry through with these plans. The Eurozone's financial system systemic stress indicator had settled at lows mid of last year but has since risen sharply due to geopolitical risks.

Financial system systemic stress indicator



Source: Bloomberg, DBS

Japan

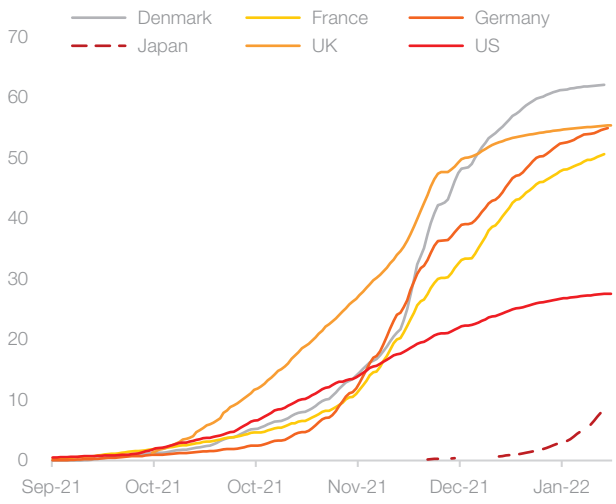
GDP growth forecast for this year has been trimmed to 2.2% from 2.5%, and revised up to 1.8% from 1.2% for 2023. The near-term growth outlook is dampened by the resurgence of Covid. Due to the rapid spread of the omicron variant, daily infection numbers in Japan hit 100k in February, exceeding four times the previous peak recorded in the summer of 2021. Prime Minister Fumio Kishida's government re-imposed the quasi-state-of-emergency measures. Google mobility data for retail and recreation activities fell back into the negative territory.

The medium-term recovery prospect remains unchanged. Global experience suggests that omicron infections decline rapidly after a massive month-long surge. An easing of restriction measures and a rebound in consumption could be expected in 2Q. Nonetheless, the rollout of Covid vaccine boosters is slow in Japan. Only 20% of the population have received the booster doses as of mid-February, compared to 50-60% in many European countries. A complete removal of restrictions and a full recovery in consumption will still take time.

Source: Unsplash

Source: Unsplash

Covid boosters per 100 people

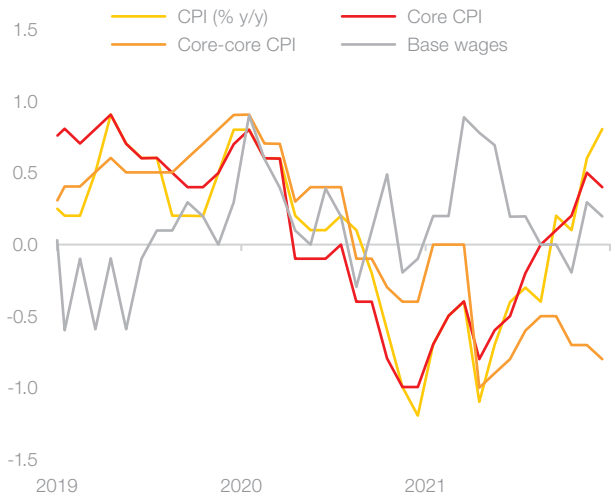


Sources: CEIC, DBS

The outlook for external demand recovery remains intact. Automobile exports have started to pick up since 4Q21, thanks to the dissipation of supply chain disruptions in ASEAN and the easing of auto part shortage for Japanese carmakers. A further recovery is expected towards the later part of this year, as the global auto chip shortage continues to ease along with the massive expansion in semiconductor investment. A cheap yen should also help to bolster Japanese exporters' earnings and strengthen their competitiveness. The yen has depreciated 10% vs the dollar over the past 12 months, or 7% on the nominal effective exchange rate basis.

Inflation forecasts are lifted to 0.9% for 2022 and 2023, up from 0.5% previously. Headline and core CPI have turned marginally positive since 4Q21, largely driven by food and utility items. The core-core CPI excluding fresh food and energy has remained in the negative territory. In absence of a full recovery in the labour market and a substantial rise in wage growth, underlying inflation will likely remain subdued through this year and early 2023. Our forecast revision mainly reflects the imported inflation caused by energy price increase and yen depreciation.

Inflation and wage growth remain weak



Sources: CEIC, DBS

The BOJ is in no hurry to follow other DM central banks to normalise monetary policy. Under the existing policy framework of Quantitative and Qualitative Easing with Yield Curve Control, the BOJ promises to continue expanding its monetary base until core CPI exceeds 2% and stably stays above this level. Despite higher energy prices and yen weakness, it still appears difficult to achieve the 2% inflation target during our forecast period. In our view, minor policy tweaks – widening the range of 10Y JGB yield target by 5-10 bps – are possible over the next 12 months, should market yield persistently test the upper ceiling of the BOJ's ±0.25% target amid a synchronous rise in global yields. Significant policy adjustments – ending the negative short-term policy rate, raising the 10Y yield target, or shifting to anchor the 5Y JGB yield – may only come in 2H23 at the soonest, after Governor Haruhiko Kuroda completes his 10-year term in April.

Asia

As the Fed gears up for interest rate normalisation, yield curves have shifted in anticipation. The short end of the curve has steepened, USD has been strengthening, and equity market volatility has risen considerably. For EM economies, the environment for fund raising, at the private or sovereign levels, has become challenging. Additionally, high commodity prices will compound the outlook for energy import-dependent economies.

Hence the year that was supposed to be about reopening after prolonged pandemic-induced stringent measures, is likely going to be a challenging one for a number of emerging economies with inadequate external buffers against substantial funding needs. But which are these economies within a large cohort?

Recently we completed a comprehensive macro risk assessment exercise, looking at over two dozen key EM economies. Economies scoring poorly in this exercise run risks of disorderly currency depreciation, capital flow volatility, debt service difficulties, and broader financial and economic distress.

Key indicators of analysis are foreign exchange reserves, fiscal balance, private and public sector debt, external (hard currency) debt, savings-investment balance, gross external funding requirement, and real exchange rate (REER). With the exception of REER, the vulnerabilities are assessed in simple ordering. If country A's debt if higher than country B's debt, A scores poorer than B.

As for REER, the comparison is a little more complex. If a country's real exchange rate is 30% above trend, is it more vulnerable than a country which is facing a 30% undervaluation relative to trend? Both are large misalignments, and both come with associated risks. In the former case, the risk could be economic overheating, excess and unhedged

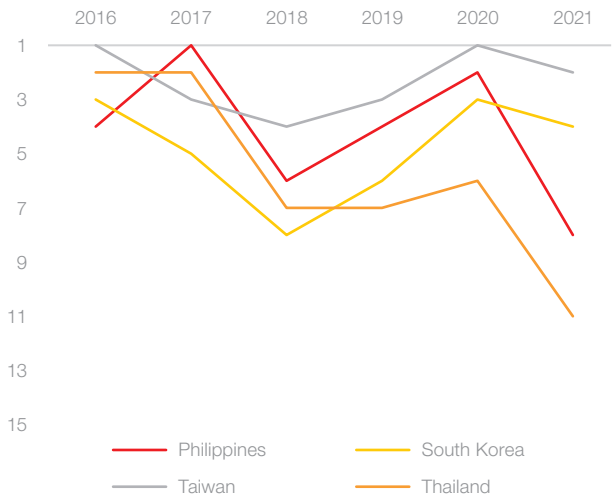
borrowing, and excess capital inflows. In the latter case, the risk would include high imported inflation, loss of purchasing power, and external debt service difficulties. We deal with this issue by taking the absolute deviation of REER from long-term trend; this allows us to catch risks at both ends of the spectrum.

We examine the evolution of these indicators across time series and cross section data, which allows us to glean shifts in relative vulnerability.

Key findings:

- In general, vulnerability indicators have worsened in EM in recent years, as both the cover for foreign obligations and fiscal position have slipped in many countries.
- Compared to some large EM economies, Asian countries look fairly healthy.
- Taiwan and South Korea have some of the best scores in the EM space.
- Thailand and the Philippines have downshifted somewhat from strong external positions.
- China, India, Malaysia, and Indonesia fall in the middle of the EM vulnerability cohort; while there are other economies with worse fundamentals, a year of higher rates and likely volatility in capital markets will keep the policymakers of these four economies on their toes.

Vulnerability ranking over time

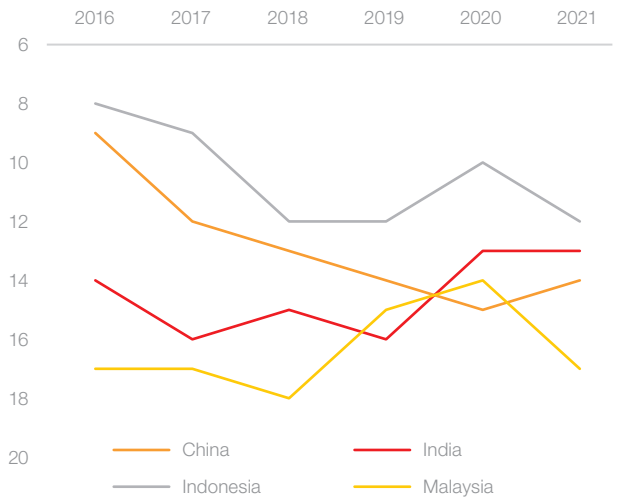


Source: CEIC, DBS

We also run the exercise with the data available for each year, going back to 2016. We find:

- South Korea and Taiwan have consistently led EM rankings.
- India, Indonesia, and Malaysia have not moved much.
- Driven largely by massive debt build-up, both private and public, China has slipped from #9 in 2016 to #14 in 2021.
- The pandemic has been harsh on the Philippines and Thailand, as the former slipped from #3 in 2016 to #8 in 2021, while the latter slipped from #2 to #11 during the same period.

Vulnerability ranking over time



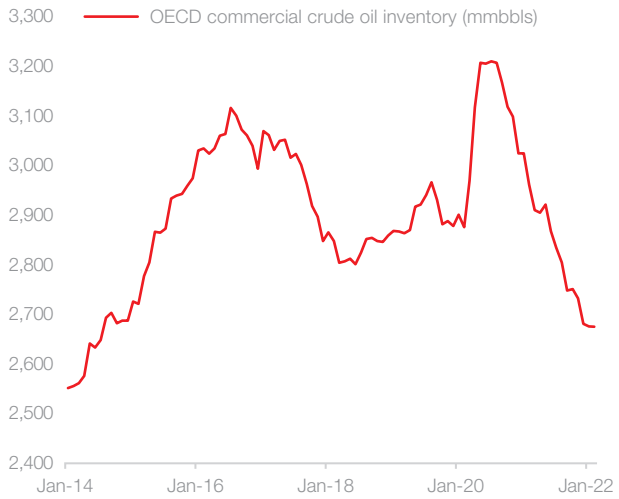
Source: CEIC, DBS

Geopolitical risk premium makes a comeback in oil markets

Back to USD100/bbl era and more as Russia-Ukraine conflict escalates. Brent crude oil prices crossed USD100/bbl as Russia started military operations in Ukraine, and as the conflict has dragged on, Brent crossed the USD130/bbl barrier in a sharp upwards move. As the conflict rages, Western countries, including the US and NATO allies, have imposed a series of sanctions on Russia and connected individuals. But given that Russia is a major exporter of energy including both oil and gas, and Europe is already reeling from a gas crisis, energy commodities have so far been kept out of the purview of sanctions for fear of boomeranging.

The recent spurt in oil prices above towards USD130/bbl comes as news that the US and EU allies are considering a direct ban on Russian crude oil imports. While US has gone ahead and banned Russian oil imports, the EU, which is the major importer of Russian oil, has shied away from direct sanctions so far. However, while oil is officially out of the sanction's purview for now, many refiners have adopted self-imposed embargoes of Russian crude cargoes. Thus, at least between 1.5- 2.0 mmbpd of Russian oil could be out of the market for a few months. In a bear case scenario, a direct ban on Russian oil imports by the US, EU, and other OECD countries could impact 3-4 mmbpd of global oil supplies, and it would be very difficult to offset this by any means over any feasible period, regardless of OPEC surplus capacity, US shale production uplift or Iran nuclear deal.

Tight inventories make oil market susceptible to supply shocks and volatility



Source: Bloomberg, DBS

Extreme oil prices possible in 2022. In our base case scenario, we revise up our average Brent crude oil forecast for 2022 to USD95-100/bbl (from USD77-82/bbl), though spikes even up to USD150/bbl cannot be ruled out. In a bear case scenario of direct sanctions on Russian crude and a lengthy conflict dragging on, our average Brent crude oil forecast for 2022 would be around USD110-115/bbl, with peaks of around USD180-200/bbl.

Once the conflict deescalates or is resolved through talks, we believe oil prices will moderate, but far from pre-conflict levels, as some sanctions and disruptions will linger and there could be structural changes in the way some countries lower their dependence Russian oil imports. Thus, not only are our oil price forecasts for 1H22 revised up materially, but we also expect higher than previously forecast oil prices to persist in 2H22 as well. There is no change yet to our 2023 forecasts of average Brent crude oil to moderate to USD85-90/bbl.

Overall, supplies will stay tight as OPEC+ struggling to meet production targets and structural underinvestment trends persist. OPEC+ members have continued to stick to the 0.4 mmbpd monthly output increase despite the volatility in the market and Ukraine conflict. To recap, OPEC+ countries plan to increase production every month by 0.4 mmbpd and exit the production cuts in an orderly fashion by the end of September 2022. While USD100 oil is necessarily not something that OPEC countries want, we believe OPEC is unlikely to emerge as a hero to cool down oil prices, given

Quarterly average oil price forecast 2022/23 – DBS base case view

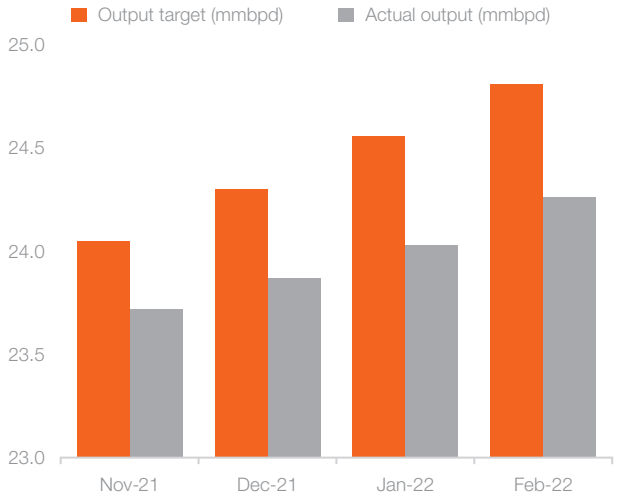
(USD per barrel)	1Q22F	2Q22F	3Q22F	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F
Average Brent crude oil price	100.0	107.5	94.0	87.5	87.0	86.0	88.5	90.5
Average WTI crude oil price	97.0	104.5	91.0	84.5	84.0	83.0	85.5	87.5

Source: DBS

current constraints. In reality, a lot of OPEC members are struggling to even meet their current production quotas owing to underinvestment, especially some of the African states. Structural underinvestment trends amid the global energy transition scenario also lends support to oil prices further in the medium term, as global upstream oil and gas capex spending trends remain muted despite record high cashflows for oil companies in recent quarters.

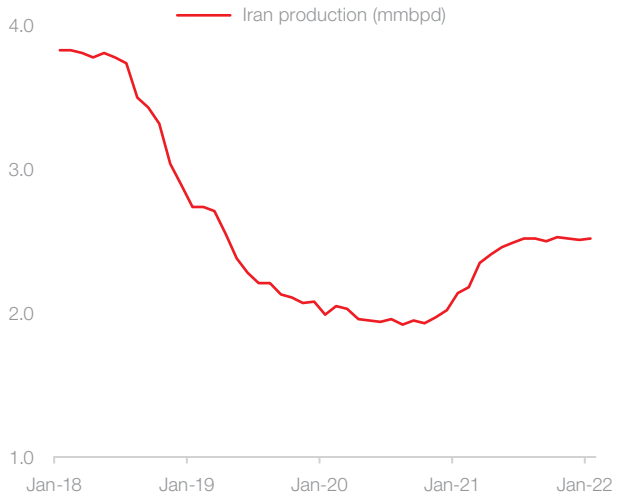
Potential US-Iran nuclear deal among few moderating factors for rest of the year. Discussions on reviving the Iran nuclear deal has been ongoing in Vienna since late last year, and in recent days, indications have been that a deal may be imminent, possibly before the end of March 2022. However, experience has shown that delays are likely. Whenever the final agreement is signed, though, it will definitely have a one-off negative impact on oil prices, and potentially wipe off some of the current geopolitical risk premium, but we reckon it would not cause the market to crash. Other moderating factors for oil include: i) the potential rise in US shale production in response to high oil prices and ii) larger than expected Federal Reserve rate hikes.

OPEC production falling below output target levels last few months



Source: Bloomberg, DBS

Iran production is currently around 1.5 mmbpd below previous peak



Source: Bloomberg, DBS

GDP growth and CPI inflation forecasts

	GDP growth, % y/y				CPI inflation, % y/y, ave			
	2020	2021	2022F	2023F	2020	2021	2022F	2023F
Mainland China	2.3	8.1	5.3	5.0	2.5	1.0	2.5	2.2
Hong Kong	-6.1	6.4	2.4	2.7	0.3	1.6	2.2	2.0
India	-6.7	9.0	6.5	6.2	6.6	5.1	5.2	4.8
India (FY asis)*	-6.6	8.5	7.5	6.0	6.2	5.4	5.0	4.6
Indonesia	-2.1	3.7	4.8	4.3	2.0	1.6	3.0	2.5
Malaysia	-5.6	3.1	5.5	4.7	-1.1	2.5	2.5	2.0
Philippines**	-9.6	5.6	6.5	6.3	2.4	3.9	3.7	3.3
Singapore	-5.4	7.6	3.5	3.0	-0.2	2.3	3.8	3.2
South Korea	-0.9	4.0	2.8	2.8	0.5	2.5	2.7	1.9
Taiwan	3.4	6.4	2.8	3.0	-0.2	2.0	2.3	1.2
Thailand	-6.2	1.6	3.5	4.2	-0.8	1.2	3.5	1.6
Vietnam	2.9	2.6	8.0	6.8	3.2	1.8	3.6	3.4
Eurozone	-6.5	5.5	3.5	2.5	0.3	2.6	4.8	2.0
Japan	-4.5	1.6	2.2	1.8	0.0	-0.2	1.6	0.9
United States***	-3.5	5.7	3.5	2.5	1.3	4.7	5.0	2.6

* refers to fiscal years, i.e. 2020 represents FY21 - year ending March 2021.

** new CPI series. *** eop for CPI inflation.

Source: CEIC, DBS

Policy interest rates forecasts, eop

	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23
Mainland China*	3.65	3.60	3.50	3.50	3.50	3.50	3.65	3.65
India	4.00	4.00	4.25	4.50	4.75	5.00	5.00	5.00
Indonesia	3.50	3.50	4.00	4.25	4.50	4.50	4.50	4.50
Malaysia	1.75	1.75	2.00	2.25	2.50	2.50	2.50	2.50
Philippines	2.00	2.00	2.00	2.25	2.50	2.75	2.75	2.75
Singapore**	0.52	0.92	1.32	1.40	1.52	1.70	1.70	1.70
South Korea	1.25	1.25	1.50	1.50	1.75	1.75	2.00	2.00
Taiwan	1.38	1.50	1.63	1.75	1.88	2.00	2.12	2.25
Thailand	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
Vietnam***	4.00	4.00	4.00	4.50	5.00	5.00	5.00	5.50
Eurozone	0.00	0.00	0.00	0.00	0.05	0.05	0.15	0.15
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
United States	0.50	1.00	1.50	2.00	2.25	2.50	2.75	3.00

* 1-yr Loan Prime Rate; ** 3M SOR ; *** prime rate.

Source: CEIC, DBS

Beyond policies and geopolitics

US EQUITIES 2Q22

The acute market correction this year signals a clear disconnect between equity prices and corporate earnings estimates. This suggests investors are either overly pessimistic, or that analysts and corporates are overly sanguine. We believe the answer lies somewhere in between.

Source: Unsplash

03. US Equities.

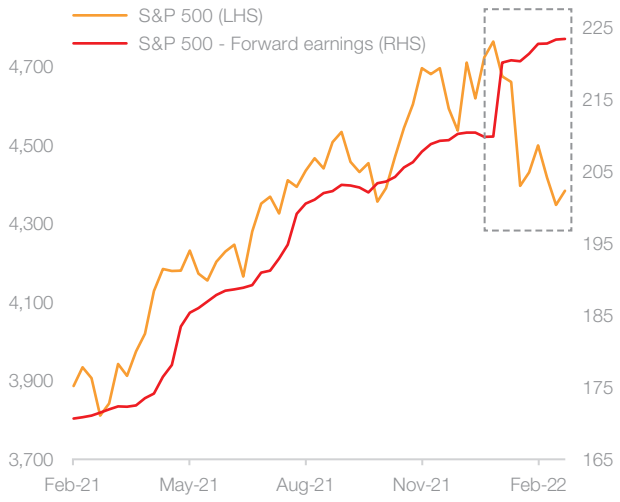
Dylan Cheang
Strategist

Major disconnect emerging between equity prices and earnings forecasts. US equities started 2022 on a weak footing as concerns over Federal Reserve policy tightening drove "long duration" equities (like select Technology plays) and rates sensitive equities (like Real Estate) lower. On the flipside, the Russia-Ukraine conflict and surging energy prices propelled US Energy sharply higher as the sector is perceived as both "value" and "dividend" play.

With the acute market correction this year, a significant disconnect between equity prices and corporate earnings estimates is emerging. While the S&P 500 is down 8.0%, forward earnings estimates have been revised up by 6.5%. This suggests two things: (1) Global investors are overly pessimistic, or (2) Analysts and corporate CEOs are overly sanguine. We believe that the answer lies somewhere in between.

As we head into 2Q22, we believe that the headwinds weighing on market sentiment during the first quarter will falter and instead, the following narratives will increasingly transpire: (a) Fed rate hiking concerns are mostly priced in and (b) the Russia-Ukraine conflict has little impact on the global economy. If our view is right, then the focus will switch to corporate fundamentals again (as opposed to policies and geopolitics).

Disconnect between share prices and earnings



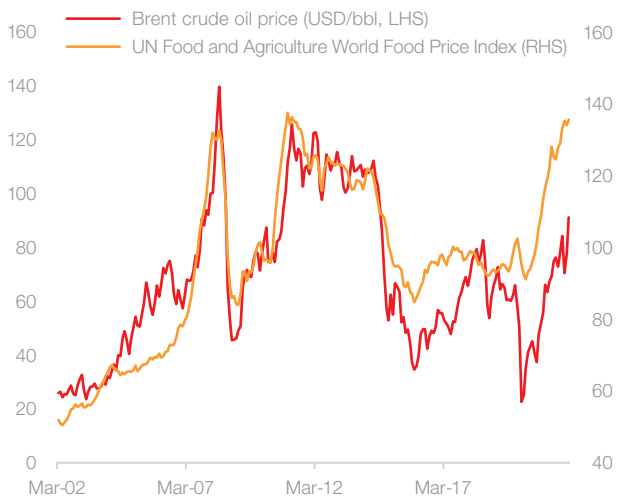
Source: Bloomberg, DBS

Navigating elevated energy and food prices. The Russia-Ukraine crisis could be a long-drawn affair with no clear resolution in sight. Geopolitical uncertainties, coupled with the imposition of sanctions on Russia, suggest that energy and food prices will stay elevated in the foreseeable months.

A clear winner in such an environment is the US Energy sector given that rising energy prices will boost the profitability of US oil majors and enable these companies to pay higher dividends or conduct shares buyback. Shell, for instance, has announced shares buyback of USD8.5b in the first half of this year after reporting robust earnings.

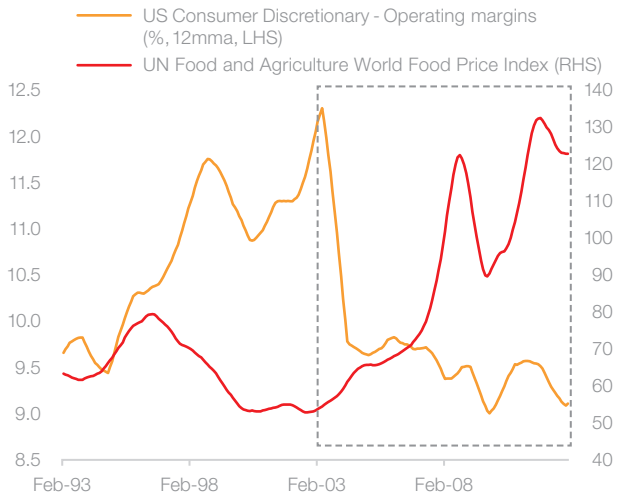
On the flipside, surging food prices will be negative for US Consumer Staples companies that fail to pass on the rising input cost. Since June 2020, the UN Food and Agriculture World Food Price Index has surged 48.8% and historical data show that food prices possess a broad inverse relationship with the operating margins of consumer staples companies. Case in point: Between May 2003 and November 2012, food prices increased 126% and it resulted in a 3.2 %pts operating margin contraction for the Consumer Staples sector.

Energy and food prices on the rise



Source: Bloomberg DBS

Rising food prices weigh on the margins of consumer staples companies



Source: Bloomberg DBS

Source: Unsplash

2Q22 US Sector Strategy – Stay the course

Our long-term conviction call on Technology-related plays did not pan out as anticipated in 1Q22 as the rise in bond yields triggered the switch away from sectors perceived as "long duration". But as investors increasingly "price in" the trajectory of Fed rate hiking, we believe that the selldown in Technology will bottom during 2Q. Our optimism is two-fold:

1. The Technology space operates in a digital borderless world and unlike "traditional" sectors, it is less impacted by rising energy and commodity prices.

2. Earnings forecast for the sector remains upbeat with consensus expecting 19% earnings growth this year and this underlines the sector's resilience.

The huge run-up in energy prices, meanwhile, could take a breather by 2Q and henceforth, the Energy sector is maintained at Neutral as most of the upside has likely been priced in.

2Q22 US Sector Allocation

	Overweight	Neutral	Underweight
US Sectors	Technology	Materials	Utilities
	Comm. Services	Real Estate	Cons. Staples
	Cons. Dis.	Energy	Industrials
	Health Care		
	Financials		

Source: DBS

US sector key financial ratios

	Forward P/E (X)	P/B (X)	EV/EBITDA (X)	ROE (%)	ROA (%)	OPM (%)
S&P 500 Index	19.6	4.4	14.7	20.7	4.1	16.1
S&P 500 Financials	14.6	1.6	7.2	15.5	1.6	31.0
S&P 500 Energy	12.4	2.3	9.4	13.9	6.0	9.2
S&P 500 Technology	24.9	10.3	20.1	36.1	13.6	26.2
S&P 500 Materials	15.3	3.1	10.8	18.5	7.7	16.0
S&P 500 Industrials	20.2	5.2	14.9	19.8	5.1	12.3
S&P 500 Con. Staples	21.6	6.8	16.3	27.0	7.8	9.5
S&P 500 Con. Discretionary	26.2	10.1	17.8	36.9	8.1	9.7
S&P 500 Comm. Services	17.7	3.8	12.1	20.0	7.7	21.9
S&P 500 Utilities	19.7	2.2	14.5	8.6	2.2	15.0
S&P 500 Real Estate	42.5	3.9	24.7	10.8	4.1	22.7
S&P 500 Health Care	15.7	4.9	14.8	22.8	8.0	10.5

Source: Bloomberg
*Data as at 2 March 2022

Shadow of the storm

EUROPE EQUITIES 2Q22

Europe, being closer in proximity and dependent on Russia for energy supplies, will likely suffer from a confidence crisis amid higher energy prices and lingering uncertainties pressuring growth. We downgrade the region to Underweight.

Source: Unsplash

04. Europe Equities.

Joanne Goh
Strategist

The global risk-off sentiments have hit Europe hard. Europe equities have corrected 16% from the historical peak in January to the recent bottom with Financial stocks losing 23%.

Markets are recovering but the Russia-Ukraine crisis has posed downside economic risks to the region as the military conflict is likely to drag on.

Even with an eventual settlement, risks to corporate earnings are high as rising energy prices and business disruptions will linger for some time.

Under pressure

Source: Bloomberg, DBS

Investors have sold European stocks as risk-off sentiments prevail. Indeed, Europe is in the eye of the storm. Being close in proximity and dependent on Russia for energy supplies, Europe will likely suffer from a confidence crisis amid higher energy prices and lingering uncertainties pressuring growth. ECB policymakers estimate the Russia-Ukraine conflict may shave 0.3-0.4% off GDP for the region and 1% under a severe scenario.

The reaction this time round can also be alluded to heavy profit-taking due to the region's significant outperformance and inflows last year. Europe equities had the best annual performance last year for decades as the region recovered strongly from Covid-19.

Needless to say, the economic impact from the crisis is multifaceted and complex, and it is difficult to assess how long the conflict will last. Spiking commodity prices and inflation, supply chain disruption, tightening liquidity, and sharp drop in exports form the initial impact. However, we believe a deep impact will be felt far and beyond even after the crisis ends. Even with an eventual settlement, markets will refocus on sustained earning and margin risks, and we believe there will be a series of earnings downgrades to follow.

We are downgrading the region to Underweight in view of these uncertainties.

Impact from the Russia-Ukraine crisis

Our current thoughts for Europe equities are:

1. The crisis does not change the pro-growth stature of the ECB and the EU which will continue to support restructuring of Europe industries.

   The ECB and national governments have put in effort to ensure a sustainable recovery from Covid-19 for the short term and in the longer term, with rescue and recovery funds, by which households and businesses are given cash and loan assistance. Governments also made use of the recovery funds, termed as NextGeneration EU (NGEU) funds to invest in green projects and new industrialisation projects, such as semiconductors and robotics.

   In response to the current Russia-Ukraine crisis, European governments are trying to sustain the recovery with more fiscal spending as energy prices rise further. The geopolitical situation has also triggered higher spending in defense.

2. As the Ukraine crisis unfolds with Russia facing broadening sanctions and military responses, the post-pandemic recovery for Europe is likely to be delayed due to weak consumer and business confidence. Early signs of suspended trade flows, supply chain disruption, tightened liquidity, and rising commodity input prices have already been reported to hit businesses. ECB policymakers estimate that the Russia-Ukraine crisis may shave 0.3-0.4% off GDP for the region, and 1% under a severe scenario.

3. EU countries and corporates may need a longer time to adjust to Russia's expulsion from SWIFT. Uncertainties such as Russia's default as well as supply chain and trade disruption due to suspension of non-payments are issues that businesses have to grapple with.

4. Higher energy prices driving inflation could undermine consumer confidence and delay the anticipated post-pandemic recovery.

   Europe is a net energy importer and relies on 80% of imports to meet its natural gas needs, of which Russia accounts for 20%. Supply challenges, especially with the abortion of the Nord Stream 2, are likely to lead to higher prices down the road.

5. High energy prices and supply chain disruption will affect European countries, such as Germany, more than the others due to their proximity to the region.

Higher risk buffer now

Source: Bloomberg, DBS

Industrialised countries, such as Germany, will be affected the most as it depends on Russia for 30% of its gas needs. 34% of crude and 53% of hard coal come from Russia.

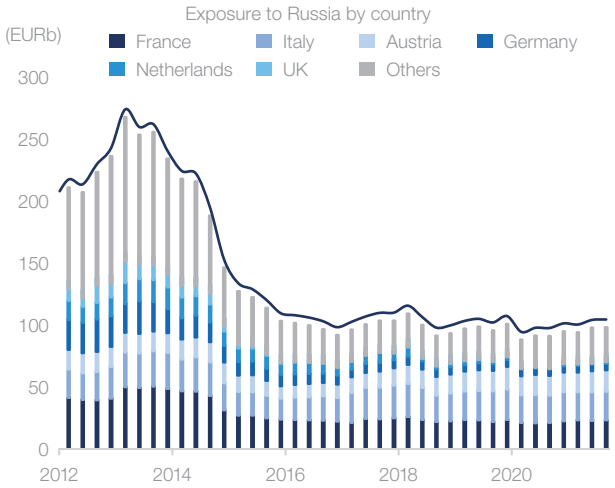
Germany's economic research institute has downgraded this year's GDP to 2.1% from its previous 4% forecast, citing that without the strong post-pandemic boost, output would be negative this year due to the Russia-Ukraine crisis.

6. There is, however, more tolerance for risk compared to 2014. The Eurozone's current equity risk premium is a lot higher than in 2014, indicating that the market has more buffer for risk tolerance now compared to before. We believe lower interest rates, supportive EU policies, and more diversified sector exposure should make the region more resilient to the risks surrounding the Russia-Ukraine crisis than before.

7. We do not see systemic risk in Europe's financial system as the overall banking sector exposure to Russia has come off since 2013 and is manageable. We expect the ECB to exercise policy flexibility in providing liquidity and delaying rate hikes despite higher inflation. Investors will need to scan for European banks with substantial exposure through lending to Russian corporates, as they would not be able to receive interest payments through SWIFT, and corporates may face bankruptcy risks as the crisis escalates.

In view of the near-term uncertainties, we reduce Europe to Underweight on a relative basis. We believe the US and Asia are more sheltered from the crisis.

European banks' exposure to Russia has more than halved since 2013



Source: Bloomberg, DBS

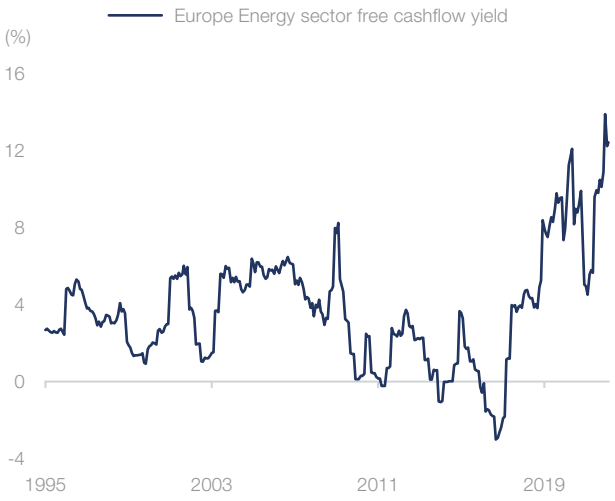
Stay with oil majors, Luxury, Health Care, and Tech sectors

We thus recommend clients to stay selectively in resilient sectors during the heightened volatility. These would include oil majors, Luxury, Health Care, and Tech sectors.

Select Europe oil majors are reported to have held about 15-20% of Russian oil companies. We believe this should be manageable in view of their diversified sources of income and the earnings' offset from higher oil prices.

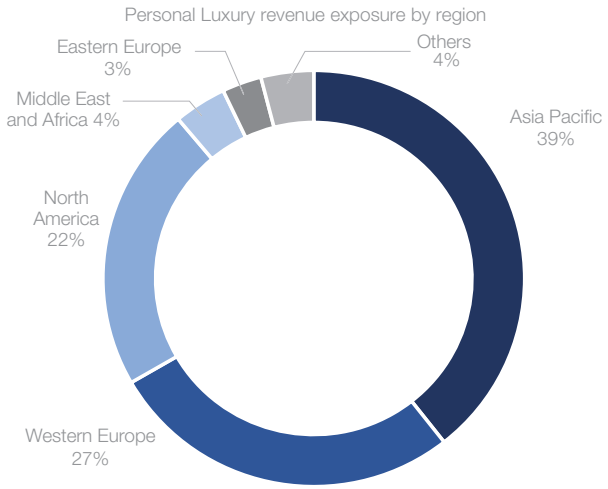
Meanwhile, OPEC is sticking to its planned production despite supply disruption risk from the Russian crisis, while the additional supply from Iran remains unclear at time of writing. We think there is a geopolitical premium being priced into oil prices right

Energy sector's free cashflow is the highest on record



Source: Bloomberg, DBS

Luxury sector: The world is its market



Source: Bloomberg, DBS

now. We have raised our forecasts for 2022 to take into account higher 1Q average, but retained our forecasts for 2023 at USD85-90/bbl. Tight supplies due to persistent structural underinvestment trends will continue to support oil prices.

Earnings and cashflow were at record highs for the oil majors in 2021. We expect earnings and dividends upgrades as buybacks remain favoured for shareholder returns.

Earnings for the Luxury sector should be shielded from the turmoil as earnings share and growth are diversified globally, with Asia Pacific countries as the main contributor. Moreover, with a weaker euro and strong pricing power, demand should stay resilient.

For the Technology sector, we maintain convictions on semiconductor upstream and equipment, software services, cyber security, cloud computing, and EV supply chain. We expect a surge in end demand for chipsets as global supply chains expedite production, stock up inventory, and drive up average selling prices.

For the Healthcare sector, we like large pharmaceuticals and drug developers which lead the development of patented drugs, and healthcare devices. There should also be a surge in end demand for medical supplies and healthcare solutions as a result of the crisis.

Uneven road ahead

JAPAN EQUITIES 2Q22

Japan's economy is likely to return to negative territory as omicron spreads, hindering the resumption of economic activities. The development of the Russia-Ukraine crisis would also hurt the nascent recovery.

Source: Unsplash

05. Japan Equities.

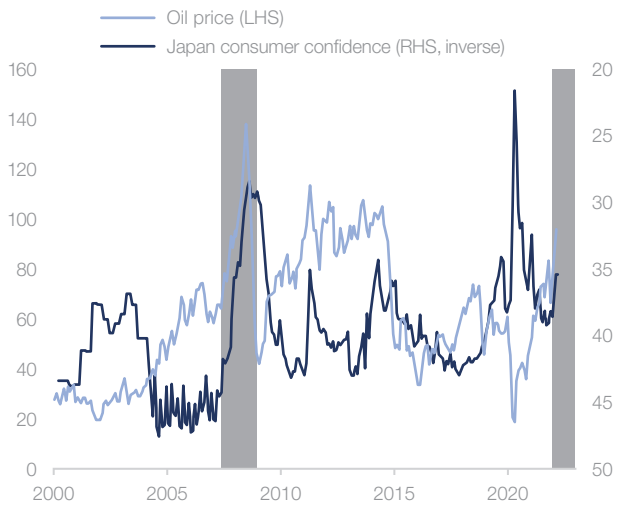
Joanne Goh
Strategist

Japan equities remained sensitive to external risk events as it corrected 14% at one point, before returning flat for the quarter. Heightened geopolitical tensions, Federal Reserve tightening, rising omicron cases in Asia, and higher inflation globally took a toll on the markets in a dearth of positive news domestically.

Japan's economy is likely to return to a negative territory in 1Q this year as omicron spreads, hindering the resumption of economic activities. This should, however, mark the nearing of the end of the pandemic when inferred from global trends. We have trimmed our GDP growth this year but pushed next year's higher, in view of the delay in consumption recovery. However, the development of the Russia-Ukraine crisis could hurt the nascent recovery.

Japan was sold off in line with the rest of the world as the Russia-Ukraine conflict deepened. Japan is not directly impacted by the crisis, but a spiralling oil price will have a heavy impact on its economy. As a heavy industrial user of oil and a net oil importer, a higher oil bill will worsen its trade balance. We estimate that a USD10 increase in oil price will reduce trade balance by 0.2% of GDP and raise inflation by 0.35 %pt. For an economy which is still struggling with Covid recovery, higher inflation would affect domestic sentiments further. Moreover, the Japanese yen will likely weaken as it loses its safe haven status under the threat of widening yield gap as a result of Fed tightening, thereby worsening the import bill.

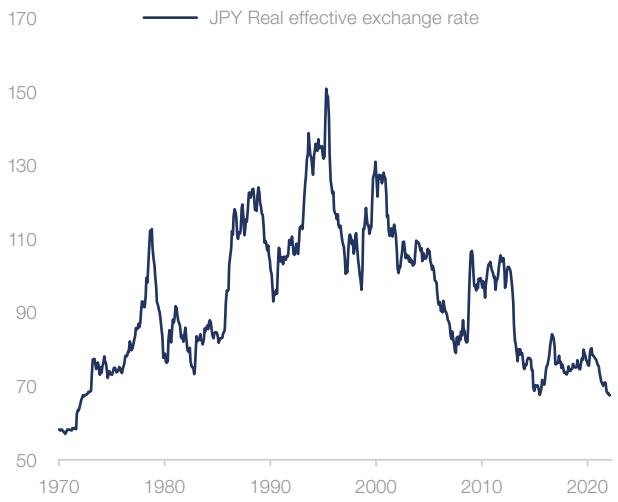
High oil price, weak consumer confidence



Source: Bloomberg, DBS

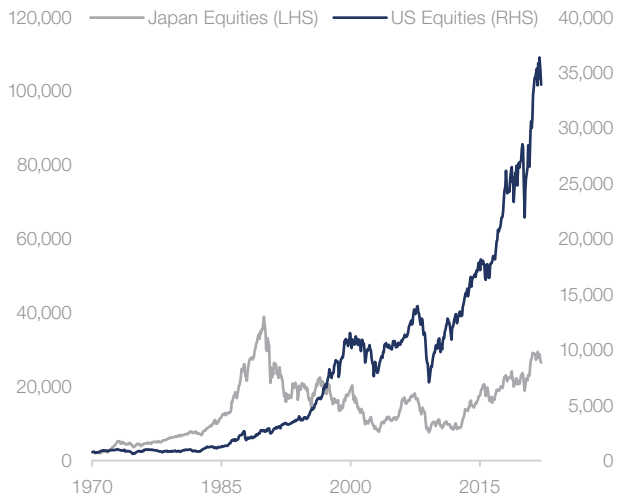
Exports driver intact. Electronics exports have been Japan's key engine of economic growth. The outlook remains intact with the prospects of easing China policies. The crisis between Russia and Ukraine could extend the tightness in supply and drive pricing power for Japan's exports products such as vehicles, vehicle parts, and semiconductors. Meanwhile the yen's effective exchange rate has slumped to a historic low, driving Japan's competitiveness in the exports market.

Cheapening yen



Source: Bloomberg, DBS

Structural differences between the US and Japan led to bifurcated performance



Source: Bloomberg, DBS

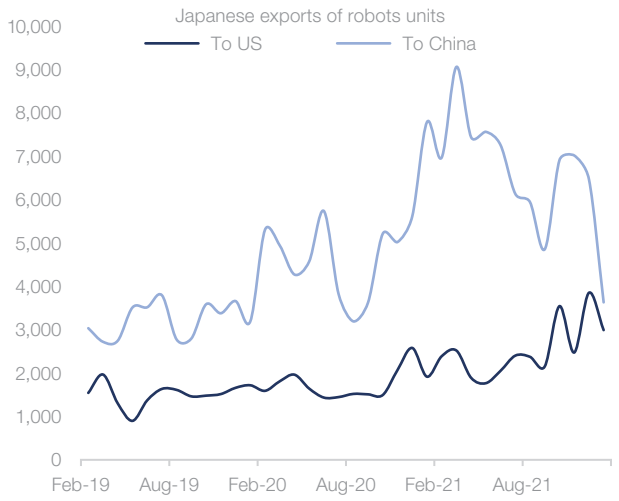
Valuations are cheap but unexciting growth. The Topix Index trades at 13.3x, which is below its long-term average of 15x. While cheap, the lack of long-term growth drivers makes it an unexciting market. An ageing and declining population, inflexible labour market, and low productivity are some of the common reasons cited for the lack of growth.

Sector impact from rising oil and commodity prices. However, a weak yen supports global competitiveness but increases input costs, especially when global inflation is rising. We recommend staying in sectors where Japan has a global competitive edge, such as autos, automation, semiconductor sectors; and stick with quality big stocks that can manage costs better.

Autos. Moves to make up for lost car production because of supply disruption in the past two quarters will boost profits for automakers. Rising costs, however, will remain a concern as prices for raw materials such as steel, copper, and lithium are rising. A cheaper yen and having multiple models including EV or hybrid cars should boost Japanese automakers' brand competitiveness. We expect robust US and China sales in an economic recovery scenario.

Automation. Another sector which has been affected by a shortage of semiconductor chips is the robotics sector. We expect production to ramp up as supply chain disruption eases. Reflecting the post-pandemic recovery, the World's largest Robot Trade

The US and China are top two exports destination for Japan's robots



Source: Bloomberg, DBS

Limited margin expansion story for Japanese banks

Source: Bloomberg, DBS

Show, iREX International Robot Exhibition, was just held in Tokyo in March this year after a three-year break. We expect demand for automation robots to extend to sectors beyond traditional industries such as in services to minimise human contact in the aftermath of the pandemic crisis.

Upstream semiconductor. Notably the sector has overtaken Japanese vehicles as a key exports sector and global interest in the sector is high due to global supply shortage. However, Japan has yet to establish itself as a producer of high spec, globally competitive chips. A renewed R&D and capex drive will need to be undertaken in order for Japan to win in the semiconductor race. We are positive on the upstream semiconductor machinery sector.

Construction and mining equipment manufacturers. The demand for mining equipment could be lifted by high commodity prices driving bustling exploration activities. We think the property construction slowdown in China should be sufficiently priced in and stabilised as China is expected to stimulate the economy by increasing infrastructure investment, stabilising the housing market.

Trading companies should enjoy the windfall of high commodity prices amid strong demand. With supply shortages due to logistics disruption, Russia-Ukraine conflict, and natural disasters, we believe increasing trade margins for intermediaries can still be maintained.

Banks. Banks have outperformed the broad Topix index in line with rising yields since the beginning of the year. Focus is now on Fed rate hikes and quantitative tightening, and how these measures would change US and global long-term interest rate trends, especially when risk of stagflation is rising. The BOJ's view on how it sees "bad" inflation arising from oil to reach its 2% target also has bearing on Japanese yields going forward.

Given the limited scope of how Japanese bond yields can rise, we would be selective on banks and focus on those that can show improvement in capital efficiency and improve shareholder returns.

Earnings to see green shoots

ASIA EX-JAPAN EQUITIES 2Q22

AxJ equities remain volatile on US Fed policy and the Russia-Ukraine crisis. However, we believe impact from the latter will be manageable.

Source: Unsplash

06. Asia ex-Japan Equities.

Yeang Cheng Ling
Strategist

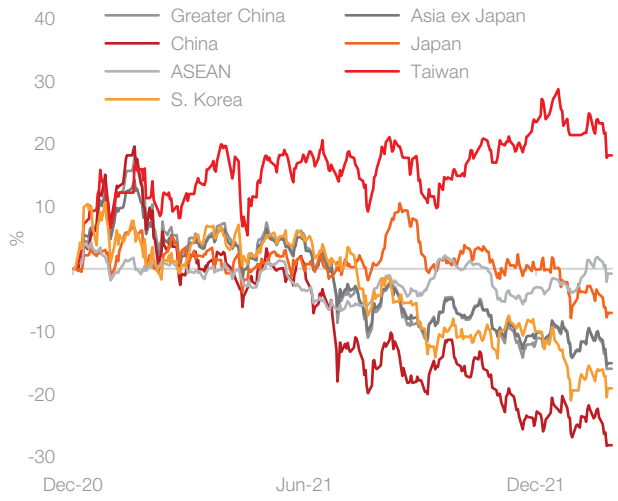
Joanne Goh
Strategist

In 2021, AxJ equities lost 8%, led by China equities which ended last year down 21%. Taiwan, however, bucked the trend by staging a gain of 20%, driven by its prominence in technology stocks.

Since the start of 2022, Asia stocks have continued to stay volatile alongside the bigger markets of the US and Europe, on the back of uncertainties from Fed policy and the conflict in Ukraine.

On the latter, we believe the impact will be somewhat manageable, as there are limited economic interactions between AxJ and Ukraine/Russia. For example, in 2021, China and South Korea exports to Russia were only USD8.3b and USD10b respectively.

China equities led the decline in 2021



Source: Bloomberg, DBS

Upward earnings revision showing green shoots

Unlike 2021 where the greater part of the year saw consecutive downgrades in earnings forecasts, 2022 started with encouraging signs of upward revisions. Indications are setting the tone for the bottoming and potential future revival in earnings.

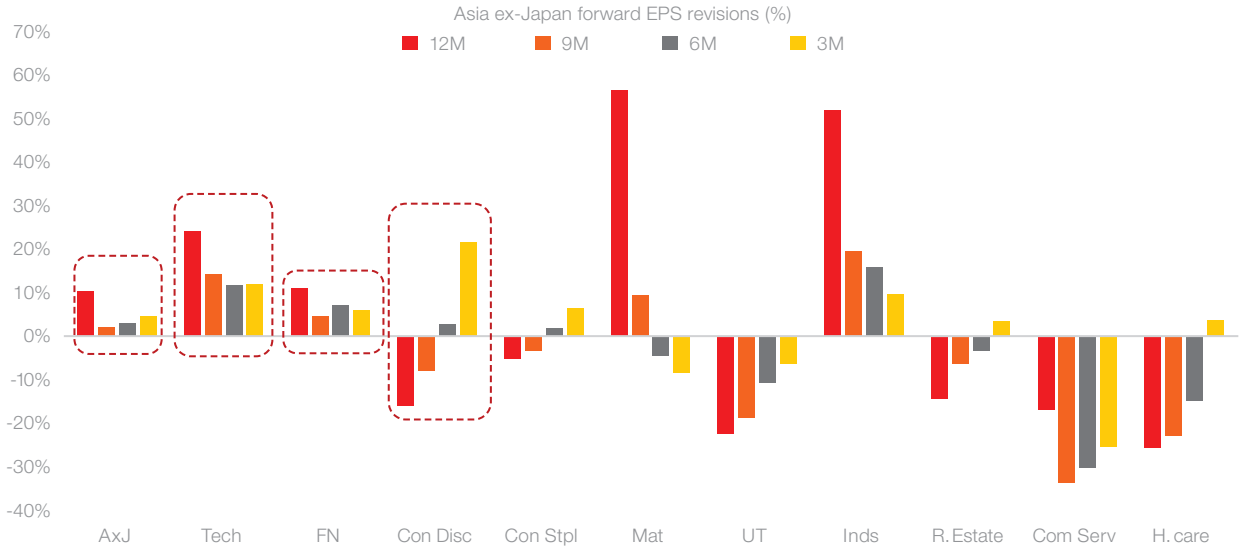
Earnings forecast is now 3-5% higher than where it was six months ago, led by better earnings expectation in Technology, Financials, and Consumer sectors.

Raise Asia ex Japan to Overweight

After hitting a recent trough, AxJ equities are showing signs of recovery. In addition to revival in earnings forecast, Chinese policymakers' renewed commitment to bolster domestic growth in 1Q, plans to implement market-friendly policies, and actions in addressing the pending Holding Foreign Companies Accountable Act/US ADR issues through bilateral discussions are all pointing towards the bottoming of expectations and sentiment. This substantiates our decision to raise our 3-month recommendation in AxJ to Overweight.

The improving earnings outlook in Technology, Financials, Consumer Discretionary, and Consumer Staples, which collectively account for a significant 70% weight in the AxJ index, will have strong bearing on the market direction. With the Greater China region making up more than two-thirds of the Asian index weight, improvement in forward earnings in contrast to current market valuation is a compelling reason for investors to relook this region.

Earnings valuations to see green shoots



Source: Bloomberg, DBS

Divergence in equities and earnings presents opportunities

Source: Bloomberg, DBS

Policy divergence

Policy divergence between the world's two largest economies will continue as China and the US are at different parts of the economic cycle – China is slowing down hence its monetary policy will be loosened in contrast to the US. For example, we see China having the room to reduce its RRR rate to boost liquidity conditions in the banking sector.

While the world is battling inflationary pressure, China's consumer price index has stayed within a comfortable range of between 1-3%. In addition, easier monetary policies will facilitate China in reducing reliance on export-led growth in favour of larger contributions from domestic consumption.

We expect Chinese authorities will continue to support local firms, particularly SMEs, by ensuring credit availability to the broader corporate and real estate sectors. We are cognisant that the current debt situation of Chinese real estate developers is not likely to be settled within the immediate time horizon, but gradual steps towards a resolution will lead to improved sentiment and outlook.

Meanwhile, the market is looking forward to the end of further regulatory measures on the "new economy" sector. Compelling valuations should attract investment funds to revisit this essential sector as the inherent fundamentals remain intact. With the confidence issue and contagion impact from real estate developers progressively priced in, technology-related stocks are likely to find a bottom.

Room for further China RRR cuts as CPI heads lower

Source: Bloomberg, DBS

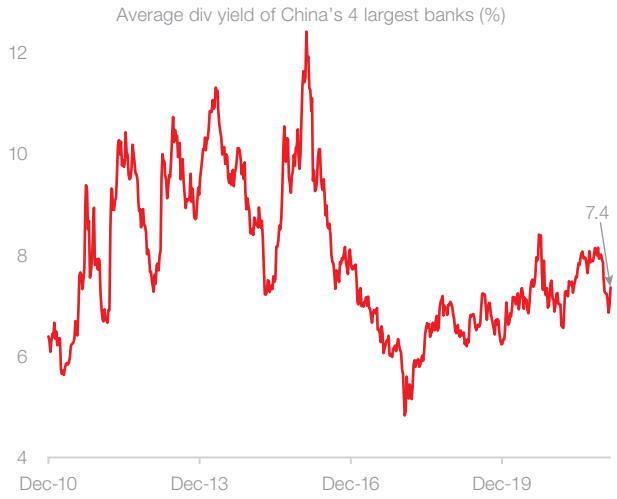
Constructive on Asia Financials

Asian financial stocks are among our high conviction ideas for the income side of our barbell strategy, due to their attractive dividend yields and sustainability of dividend payouts. Over the past two years, China banks have weathered the economic challenges brought about by the pandemic and will remain an important pillar in the world's second largest economy.

Banks in China have been distributing a sustainable 30% of their net profits as dividends over many market cycles. The following chart shows the four largest state banks offer a very attractive average dividend yield of 7% based on current share prices.

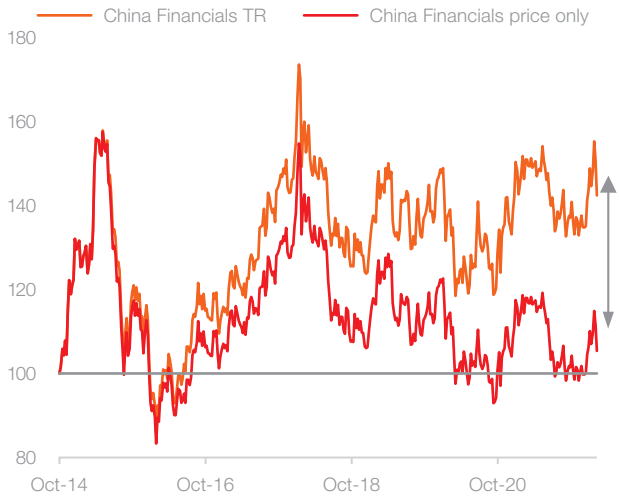
To put it into perspective, most of the total returns from investing in China banks come from dividends. We continue to believe the current high level of dividends will act as the main source of total returns going forward.

Attractive and sustainable dividends from China Banks



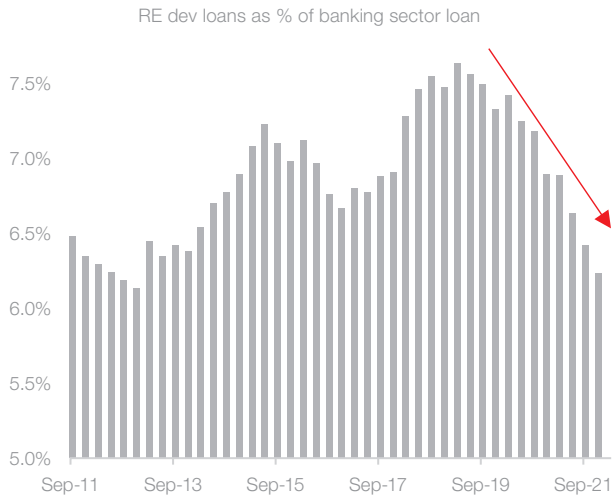
Source: Bloomberg, DBS

Strong return from Chinese financials' dividends



Source: Bloomberg, DBS

China banks' real estate exposure has come off from high



Source: Bloomberg, DBS

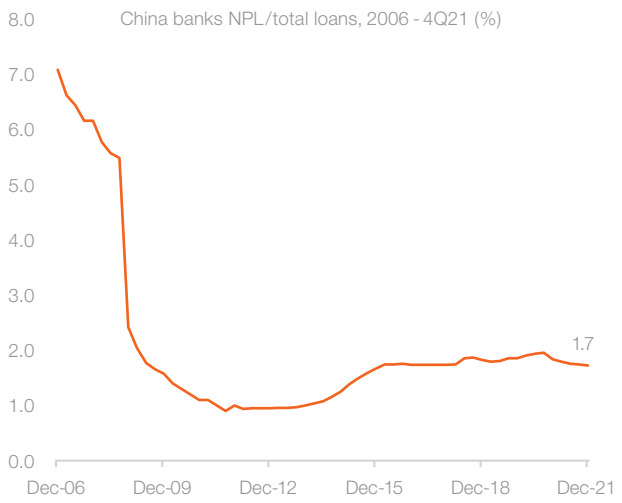
China's property development sector and loans exposure will remain closely watched. We are optimistic the banking sector's direct loan exposure to real estate developers is manageable and this figure has been on a declining trend. Meanwhile, the regulators have repeatedly affirmed that the situation can be ringfenced and would not become a systemic problem.

As of end-2021, exposure to real estate developers has been reduced further to 6.2% of the total banking sector's loan outstanding, the lowest level since 2012 and a stark improvement from the peak of 7.6% in 1Q19. As such, loan exposure to real estate developers should not threaten the banking sector's asset quality and ability to continue distributing attractive dividends.

Amid slowing economic growth and property demand, as well as heightened risks of bond defaults, the PBOC announced a series of supportive measures, including a reduction in banks' RRR of 50 bps in December 2021 to supply liquidity to capital markets. The central bank could further reduce RRR and implement dedicated policy easing to support the local economy and prevent a broad-based and abrupt slowdown. There is adequate scope for the PBOC to prolong policy easing and provide liquidity by reducing the banks' RRR which is presently at 11.5%.

As a result, asset quality among large state-owned banks is anticipated to be sturdy amid their higher exposure to better quality large corporate loans and more diversified loan mix comprising manufacturing,

Sturdy asset quality



Source: Bloomberg, DBS

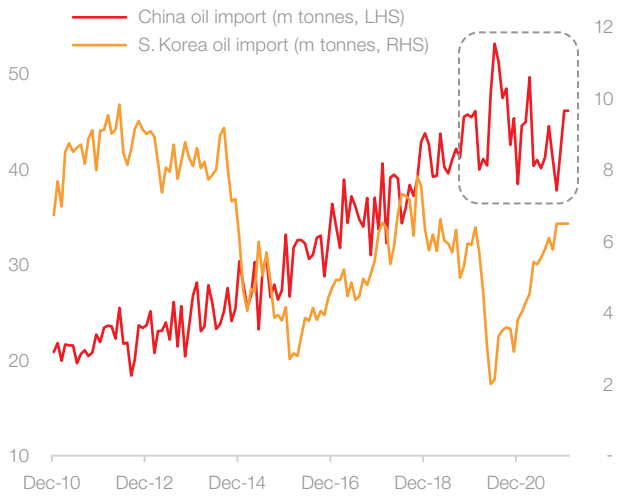
consumer, credit card, mortgages, retail, wholesale, and export sectors. Based on official data, the sector's overall non-performing loan ratio has remained stable at 1.8% since 2015 and also worth noting is that the loan loss provisions among large state banks were at more than 200% as at end-2021.

Oil price tail risk – manageable

Geopolitical risks could disrupt the supply of oil and result in further spikes in energy prices. Being predominantly a net oil importing region, the prolonged high oil prices will cause an unwelcome impact to some Asian governments' budget balances, which are already stretched, owing to heightened covid related expenses and social supports. For example, South Korea, a prominent technology exporting country, imports 6m tonnes a month.

China is relatively insulated to oil price swings – China imported some 3.8b barrels of crude oil in 2021, making it the world's largest oil importer. Using USD80/bbl as a gauge, this was equivalent to USD300b in value, but a mere 1.8% of China's GDP value of USD17t. Therefore, the impact of rising oil price to the Chinese government's balances should remain manageable. Hypothetically, even by assuming China would pay an average of USD100 for a barrel of oil in 2022, the impact to GDP will still be controllable at around 2% and should not trigger any apparent upward pressure to CPI.

Not affected by higher oil price



Source: Bloomberg, DBS


마사지
755-7008
사주占
신비안 神飛眼
Cafe
신한 부동산
771-8959
본죽
755-3562
元 ¥
$ €
MONEY EXCHANGE
오케이 1F
MYOUNG DONG
LOVE
NATURE REPUBLIC
HOTEL SKYPARK

Source: Unsplash

Catalysts at the gate

Despite prevailing headwinds surrounding the region, the investing fraternity is monitoring the situations below for catalysts:

1. Resolution for the real estate sector – steps taken to effectively prevent contagion risks, ongoing improvement in the sector's leverage ratio, settlement of bonds that come due, and the halting of new defaults on existing issues.
2. Policy normalisation in the technology/new economy sectors – standard, transparent, and predictable regulation to govern the sector, stabilisation in the operating environment and return of positive profit outlook in the coming quarters.
3. Introduction of supportive monetary policies and the implementation of tangible plans to bolster the economic growth momentum.
4. Gradual easing in Covid associated mobility restrictions and effects to consumption.
5. Alleviation of output bottleneck along the supply chain.

These initiatives and action plans will bring about better corporate earnings and investment outlook. As such, forward-looking portfolio investors will definitely welcome such resolutions, setting the scene for a more decisive re-rating across the region, mainly led by China.

A sound validation for re-rating is the compelling valuations after the region's relative underperformance to global peers, rising vaccination rates, and restarting of economic activities.

Currently, expectations have been set low and we believe the market has yet to price in the benefits of the reinstatement of activities pertaining to reopening and thus the ensuing earnings recovery over the longer horizon.

The P/B valuations among AxJ equities approached its historical mean again after the market corrections, and a similar pattern has been observed in the forward price-earnings ratio. As such, earnings multiples have become undemanding.

In the broader AxJ context, we maintain our preferences for the following sectors:

1. Upstream technology enterprises, especially in semiconductor development and wafer contract manufacturing sectors where Asian firms are holding pole position at the top of the supply chains.
2. Sectors that are closely aligned with domestic demand, being beneficiaries of the resilient and fast expansion in consumer spending, and also the gradual reopening of borders. This will include tourism-related and hospitality industries.
3. e-Commerce eco-systems which continue to deliver robust revenue and earnings growth, as these sectors are well-positioned at the forefront to benefit from government-led stimulus and concrete fine-tuning in policy stance.
4. Dividend-yielding stocks where Asia is undoubtedly the fertile ground providing generous dividend returns. This includes China large state banks and Singapore REITs which have adhered to their respective constant payout ratios, and Singapore banks.

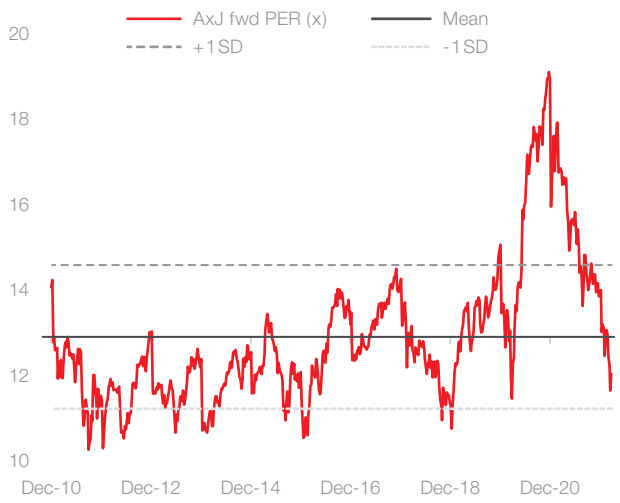
Stay focused on themes and firms with established fundamentals, valuation support, earnings growth, and credible earnings quality as we anticipate increasing deviation between sectors with secular thematic trends and those without.

ASEAN — Shelter in the storm

ASEAN markets have stayed resilient in the midst of global volatility. The region returned c.2% in 1Q-to-date despite global risk-off sentiments amid Fed tightening worries and the Russia-Ukraine crisis. The main themes of higher interest rates benefitting the banks, higher commodity prices supporting exporters, and recovery from Covid will continue to support the region's economies and equities.

The region's valuations have improved after 4Q21's results which surprised on the upside. We believe a continuous upgrade in earnings can support the valuations. Domestic tailwinds of re-opening and a positive global capex outlook are key drivers, while the situation in Eastern Europe and risk of stagflation bear monitoring for global risk-off.

Forward PER back at below mean



Source: Bloomberg, DBS

P/B at attractive level

Source: Bloomberg, DBS

Valuations more palatable after earnings surprise

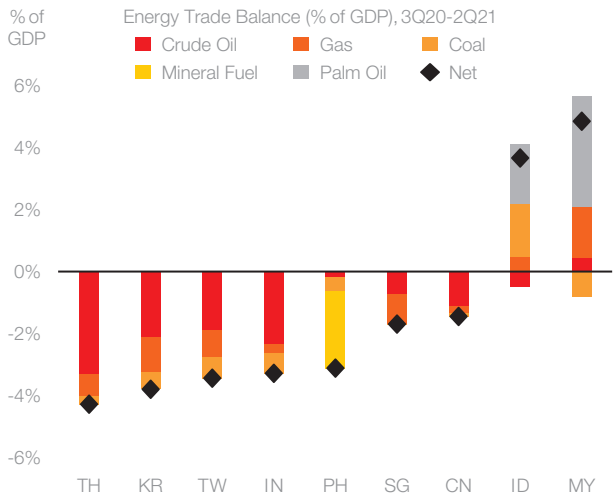
Source: Bloomberg, DBS

Higher commodity prices a double-edged sword for ASEAN

The region has limited exposure to Ukraine/Russia as trade dependency between the two regions are minimal at less than 1% of total trade. However, if the crisis is prolonged, the region's 8% trade with the EU region could be at risk of supply disruption and weak consumer sentiments over there.

The net impact is mainly through higher commodity prices; commodity exporting countries such as Malaysia and Indonesia should benefit with their rich palm oil, natural gas, coal, metals, and minerals exposure. Thailand and Vietnam are net oil importers and should be affected by higher energy prices through deteriorating balance of payments and inflation if they are left unchecked. Upstream oil companies in Thailand, commodity producers in Malaysia and Indonesia, and shipyards in Singapore stand to benefit from higher oil prices.

Commodity exposure a mixed bag among ASEAN countries



Source: CEIC, DBS

Higher interest rates

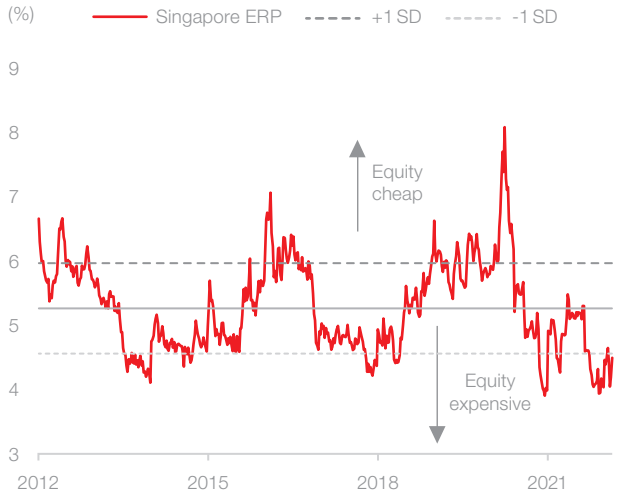
Despite geopolitical risks, our view is for the US Fed to stay on course to deliver seven rate hikes this year on inflation worries. Although we could see correspondingly higher rates in ASEAN countries, aggressive hike paths are unlikely as Asia has relatively contained inflation and lower external financing risks, presenting the flexibility to stay accommodative for longer. Singapore tends to follow closely on US rate hikes and the banks are the biggest beneficiaries of rate hikes on NIM expansion.

Recovery from Covid-19

The region is poised for reopening in the second half of the year as the pandemic eases further. Substantial economic improvement was already seen in 4Q21's GDP growth and the strong momentum is likely to spill into this year.

Besides banks and the commodities sector, the property sector stands to benefit from the positive sentiments that trickle down from the recovering economy. Interest rates still remain low by historical standards despite talks of rate hikes, and liquidity is still abundant. Property is a good hedge against inflation as property values are seen as gradually rising over time and the gearing made on property

Low tolerance for risk in Singapore



Source: Bloomberg, DBS

purchases is a better use of cash which loses value over inflation. REITs are property proxies where rental and cap rates will be rising in line with inflation as global economies re-open. Hospitality and retail REITs stand to benefit the most from these trends.

We believe investors should monitor for signs that suggest China is deviating from its zero-Covid policy as China is ASEAN's largest source of tourists. This could come about sooner than expected as China introduces tangible plans to bolster the economic growth momentum, and seek to minimise the economic and social disruption to the economy from its Covid zero policy. Airports, airlines, retail, and hospitality sectors will be the key beneficiaries. Fewer than expected flights and tourists, as well as rising oil prices as a result of the Russia-Ukraine crisis, are key risks for the sector.

Singapore, after being the best performer globally due to a strong set of banking results and better than expected economic growth, succumbed to global risk aversion. Singapore's ERP has very low buffer for risks as the ERP trades towards the low end. We expect high volatility as the Russia-Ukraine crisis unfolds. However, Singapore could be supported with its high-yielding stocks such as Banks and REITs which pay around 4-7%, as flight to safety drives investors to these stocks.

We continue to favour the banks as they should benefit from the economic re-opening and interest rates rising. Singapore Banks have minimal direct exposure to Russia and are managing risks around Russian sanctions carefully. REITs may find some relief as bond yields fall and we continue to like them as re-opening trades. Singapore, as a REITs hub, may have REITs which are exposed to European assets — these REITs are likely to underperform amid economic uncertainties in Europe, and as EUR weakens against SGD.

Indonesia has a better profile among ASEAN markets to stay resilient in this crisis. Drivers include high commodity exposure, strong foreign flows into its commodity sectors, demand normalisation from the easing Covid-19 situation, its Current Account turning positive, and a credible central bank which has so far managed its historically-vulnerable finances well.

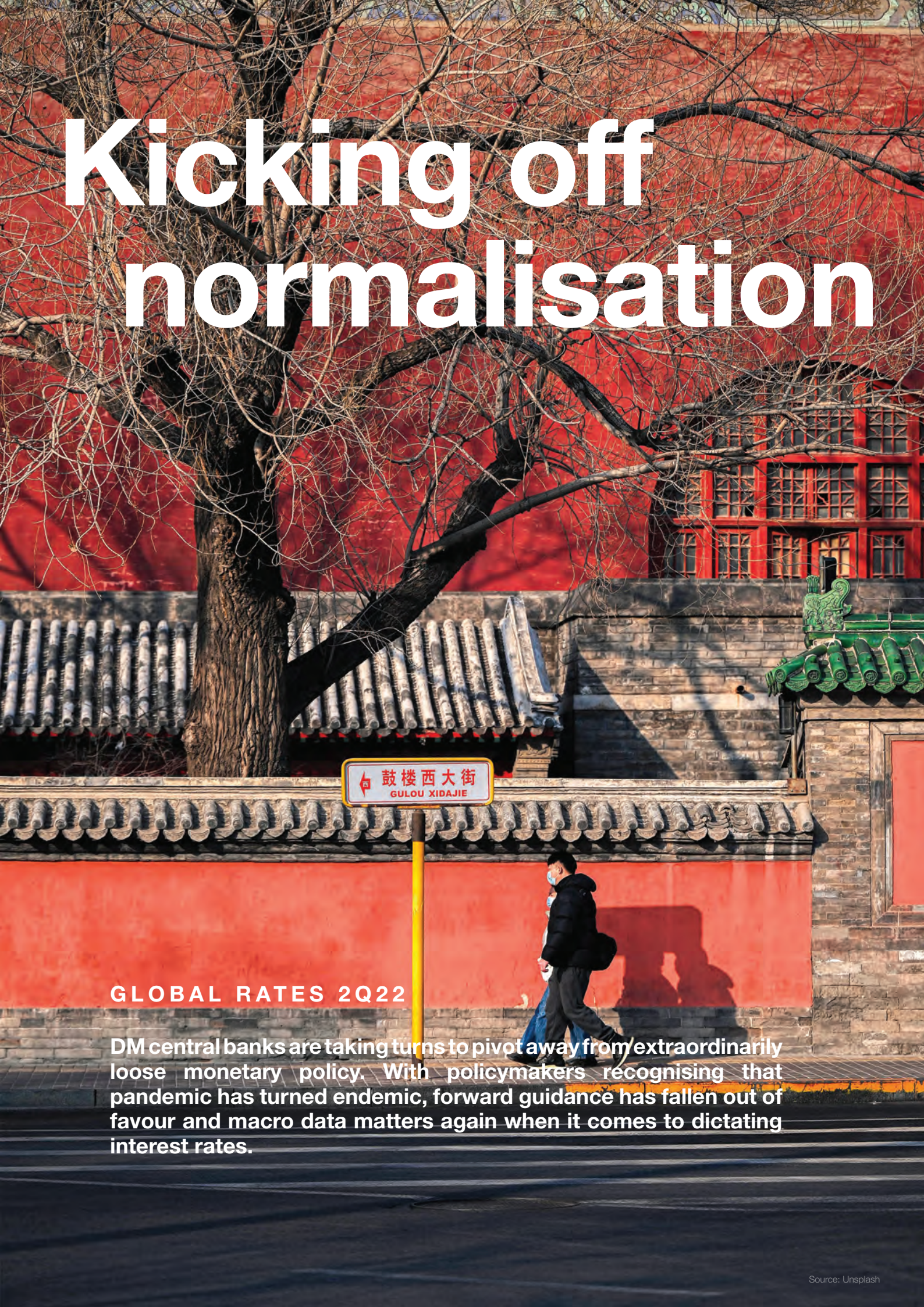
Foreign flows into Indonesia surprisingly were still strong ahead of the expected Fed rate hike in March. In the past, EM like Indonesia would suffer from outflow ahead of Fed tightening or any risk-off event. The rupiah is more resilient this time compared to 2013 and 2015 taper tantrums and rate hikes due to positive trade balance and lower foreign ownerships in government bonds.

We expect more upward earnings revisions, especially from banks after they reported a strong set of results, and commodity stocks due to higher commodity prices in 1H22.

Potential earnings upside to support valuations further

Source: Bloomberg, DBS

Kicking off normalisation



GLOBAL RATES 2Q22

DM central banks are taking turns to pivot away from extraordinarily loose monetary policy. With policymakers recognising that pandemic has turned endemic, forward guidance has fallen out of favour and macro data matters again when it comes to dictating interest rates.

Source: Unsplash

07. Global Rates.

Eugene Leow
Strategist

Duncan Tan
Strategist

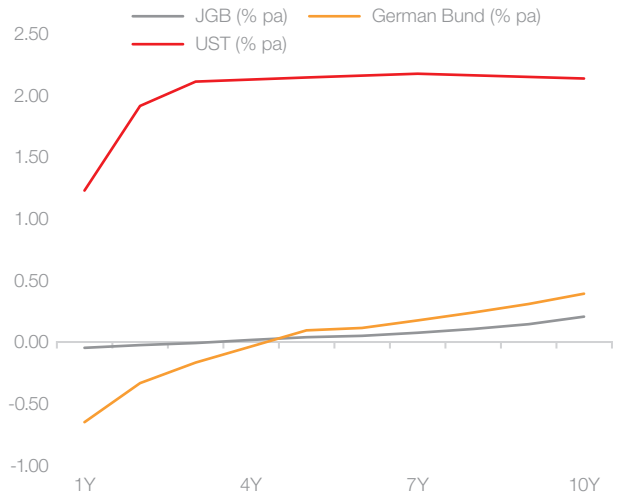
DM central banks have fallen in line, taking turns to pivot away from extraordinarily loose monetary policy. With policymakers recognising that pandemic has turned endemic, there is little reason to run QE and/or keep rates floored at zero. Over the past few months, the RBA and even the usually dovish ECB had a hawkish pivot, joining the Federal Reserve and the BOE. There appears to be little interest in suppressing interest rates when the economy/markets are not in a crisis mode. This means that forward guidance has fallen out of favour and macro data matters again when it comes to dictating interest rates. The Russia-Ukraine conflict does complicate matters in so far as it pushes inflation higher while dragging on economic growth. However, this should be nuanced.

The key issue dogging central banks is still uncomfortably high inflation prints. In the US, headline CPI hit 7.9% in February. While a combination of factors including base effects, energy prices, and supply disruptions contributed to this print, more stable measures point to inflation of around 4-5%, way above the 2% target. With the labour market running strong even through the omicron wave, there is little doubt that the Fed would need to hike rates. **We see seven hikes (one has been delivered) in total 2022 and another four in 2023. This will take the Fed funds rate to 3%, clearly above neutral settings.** The inflation backdrop has likely worsened with commodity prices surging. However, we are not convinced that growth in the US would be materially affected. rate hikes could be more aggressive with back-to-back hikes looking plausible in the initial phase of tightening.

For the Eurozone, 5% y/y CPI in December was the tipping point. The ECB announced taper and QE could end in 3Q. That said, we think that the ECB could be more cautious on rate hikes as there could be spillover from the Russia-Ukraine crisis on the economy. We have pencilled in modest hikes in 1H23. Note that the ECB would still be tightening at a markedly slower pace than the Fed. Lastly, **we still think that tightening by the BOJ appears unlikely.** Economic momentum is still weak and the price pressures are nascent even with the rise in commodity prices. While PPI figures are climbing, there has not been much passthrough to CPI (0.5% y/y in January). There is an outside chance that the BOJ would widen the 10Y yield target range beyond 25bps either way or reduce the tenor controlled to the 5Y sector. However, that is not our core view.

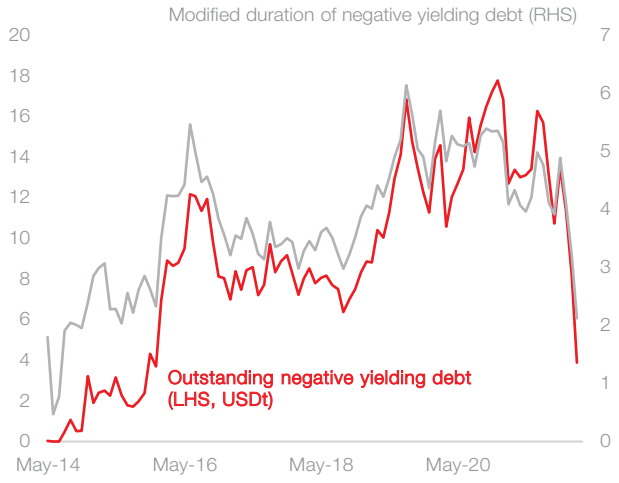
Against this backdrop, we maintain our flattening view on the UST curve over the medium term. 10Y US yields should head towards 2.5%. We think that the EUR curve would initially steepen and then flatten to reflect some caution on growth and possibly delayed rate hikes. Directionally, we think EUR rates should head modestly higher. While there are significant uncertainties, we think **10Y German yields could be capped at around 0.8%** in the current cycle. Lastly, **10Y JGB yields could hug close to 0.25% (upper limit set by the BOJ) in the coming quarters** as global yields exert upward pressures. Stagflation risks have risen amid spillover growth concerns and elevated prices pressures.

G-3 curves anticipating normalisation



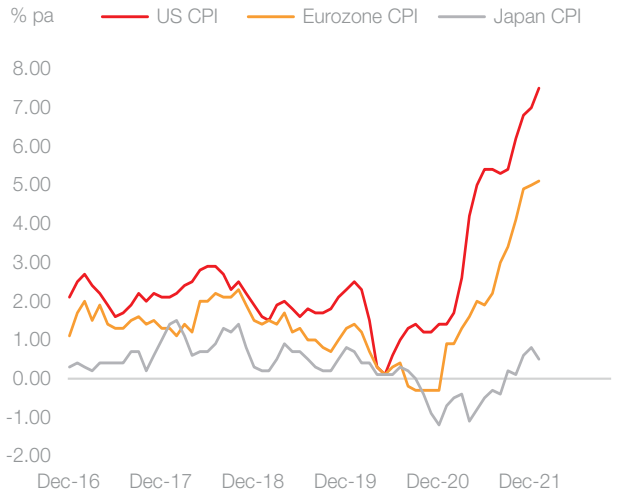
Source: Bloomberg, DBS

Stock of negative yielding debt declines



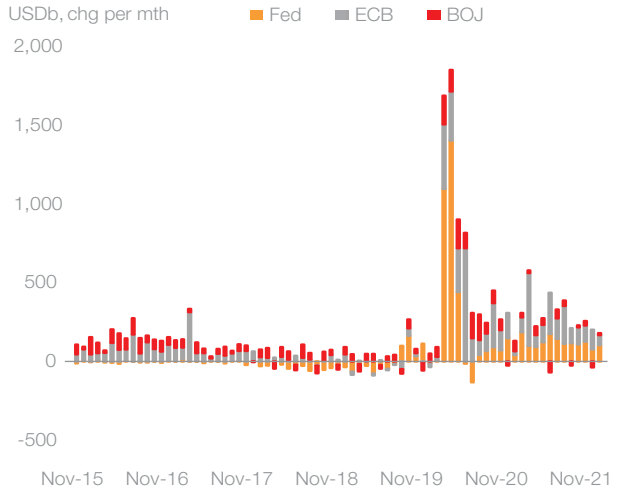
Source: Bloomberg, DBS

Inflation at multi-year high



Source: Bloomberg ,DBS

QE will slow/stop in 2022



Source: Bloomberg ,DBS

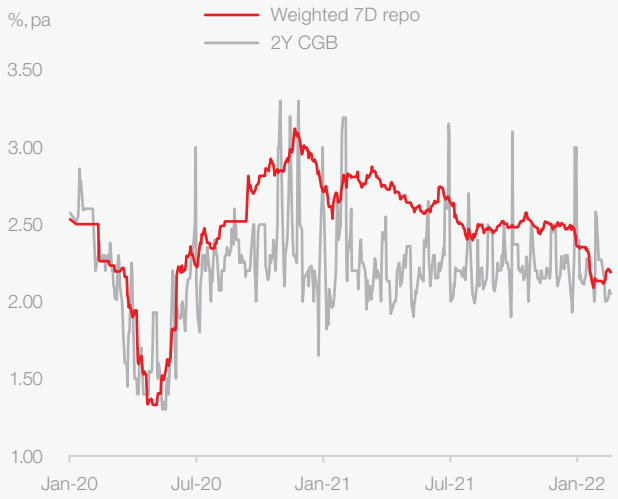
Source: Unsplash

Asia Rates

CNY rates: Growth concerns

There are still no clear signs of stabilisation in China's economy despite piecemeal policy support over the past few months. Notably, the official manufacturing PMI is still barely treading water while the services PMI is taking a hit from Covid curbs. We think that the outlook will be challenging for the immediate couple of quarters. Onshore rates/yields are pricing further monetary easing and growth concerns via bull steepening in the CGB curve. With 2Y yields already close to 2.1%, near to where the 7D repo has been hovering at, we think that downside may be limited. In any case, we think a chunk of the monetary policy divergence has already played out, especially in the intermediate tenors (2Y-5Y). If China's economy bottoms out in the coming quarters, onshore rates could see a mild upward drift. We think 10Y CGB might offer more value.

2Y yields already reflect PBOC easing

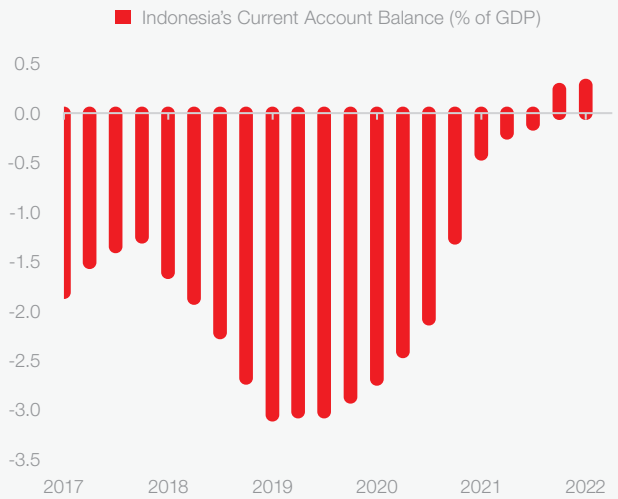


Source: Bloomberg, DBS

IDR rates: Better defences compared to past Fed hike cycles

Indonesia government bonds (IndoGB), fundamentally, can be quite sensitive to sharp increases in short-term US rates and tightening in US financial conditions (including wider US credit spreads). Recognising the risks around a more hawkish Fed, BI has signalled that the focus of monetary policy will tilt towards being more "pro-stability", which includes ensuring currency stability. Compared to past Fed hike cycles, Indonesia is coming into this Fed hike cycle with better defences – Current Account deficit is expected to be narrower and inflation risks are benign. Therefore, we do not expect BI to normalise liquidity and hike rates in an aggressive manner that would drive significant volatility in IndoGB. On a relative basis, against other Asian bonds, we expect IndoGB to outperform due to superior buffer from lower inflation risks, higher nominal yields (to offset price losses from higher global yields), and support from Indonesia's much improved external balances.

Indonesia's Current Account balances are much improved

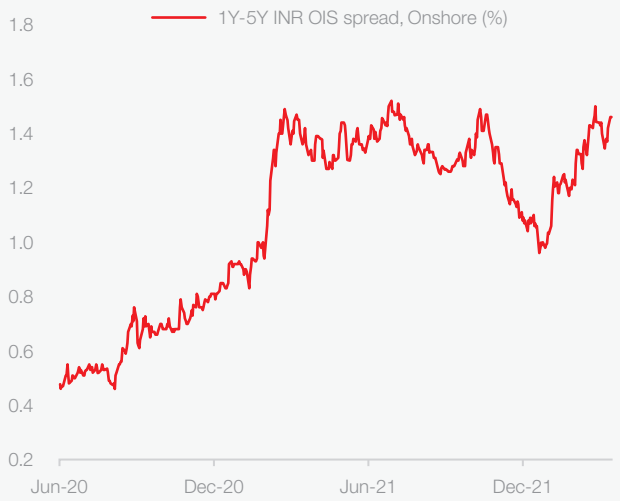


Source: Bloomberg, DBS

INR rates: Tighter liquidity and record FY22/23 bond supply

With larger sizes of variable rate reverse repo auctions to absorb more surplus liquidity at higher rates, coupled with lower liquidity injections via RBI's GSec purchases and FX operations, it is clear that the 2022 trend is for tighter liquidity and higher cost of funding. Therefore, overnight call and repo rates should be expected to rise within the rate corridor and towards the policy repo rate. That said, it is challenging to put on pay OIS positions if RBI remains dovish. If RBI continues to push back or under deliver against markets' aggressive hike expectations, OIS curve should be expected to steepen further. FY22/23 bond supply will be non-trivial for markets to absorb unless RBI restarts GSAP (which we think is unlikely). Local players such as insurance firms and mutual funds will need to step up their buying. In the near term, elevated oil prices could support inflation concerns and put upward pressures on INR rates.

Expect INR OIS curve to steepen further

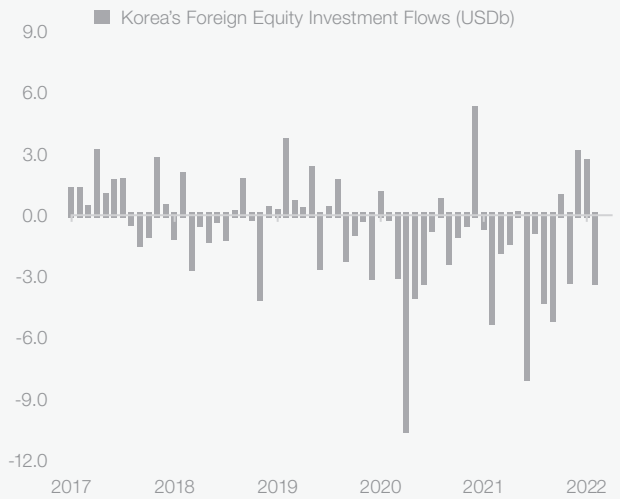


Source: Bloomberg, DBS

KRW rates: Equity outflows weigh on bond total returns

From a total returns perspective, Korean Treasury Bonds (KTB) was one of the worst underperformers in 2021, recording total returns of around -11%. The linkage between KTB performance and macro factors (e.g. earlier normalisation of monetary policy, stronger growth recovery) has been weak. Instead, to a greater extent, KTB performance has been decided by flows. Equity portfolio investment outflows by both locals and foreigners has been especially large (comparable to the size of South Korea's Current Account surplus) and has weighed heavily on total returns. In 2022, we attach a low likelihood to positive absolute returns but think that KTB could outperform within Asia by virtue of its larger valuation discount. On the key factor of equity outflows, we recognise that outflows by the National Pension Fund are structural in nature but think that outflows by other locals should ease and foreign inflows could return.

Large foreign equity outflows in South Korea since 2020

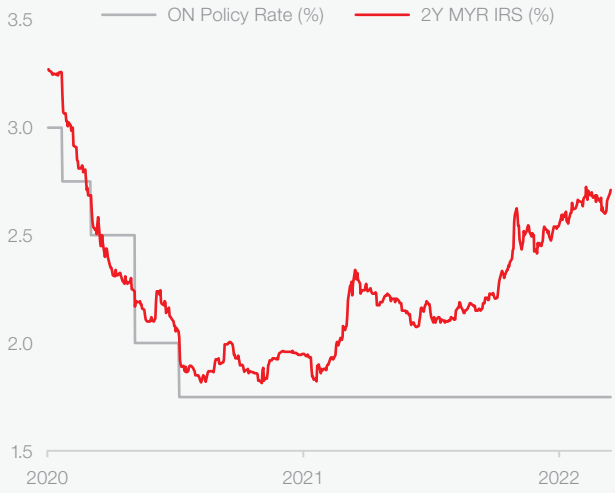


Source: Bloomberg, DBS

MYR rates: Turnaround in EPF demand for long bonds

Compared to Asian peers, Malaysia's growth prospects are stronger, and its fiscal consolidation process is expected to be slower. This, in our view, is a recipe for relative underperformance of MYR rates, especially in the shorter tenors where hike pricing could have more room to rise. In 2022, we expect that there will be no new pension withdrawal schemes introduced. Normalisation of the pension contribution rate to 11% around mid-year, and stronger economic growth this year should result in a fast rebuild of Employee Provident Fund (EPF)'s assets and consequently, a pronounced rebound in EPF's buying of long duration Malaysia Government Securities (MGS). As a result, we think that a turnaround in EPF's demand will be the dominant factor anchoring long duration MGS and those bonds should outperform on the curve. In the near term, Malaysia's positive oil trade balances, at a time of elevated oil prices, could support some resiliency of MYR rates against Fed hikes.

Room for rate hike pricing in Malaysia to rise further

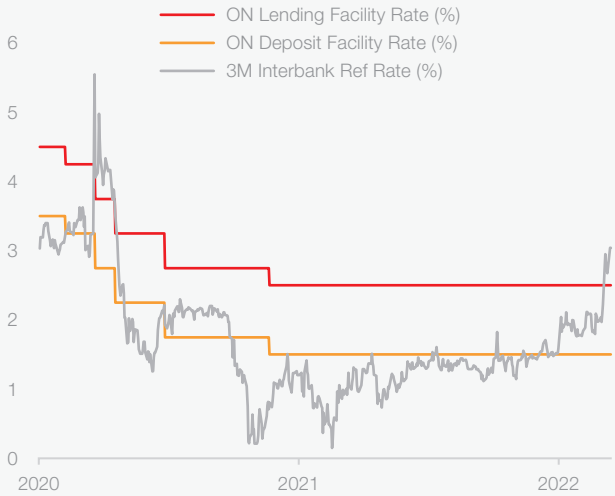


Source: Bloomberg, DBS

PHP rates: Shorter-term bonds preferred

In 2Q, we expect BSP to stay focused on supporting growth, with some prospects of liquidity support via further lowering of banks' required reserve ratio. Inflation prints have eased in recent months, taking off some upward pressures on bond yields. That said, elevated energy prices and greater domestic demand from ongoing reopening mean that average inflation for 2022 is expected to come in at close to the top end of BSP's 2-4% target band. The trade deficit could also persist on its widening trend from the associated rise in imports. Considering the various risk factors, we are cautious of duration as we think bond yields have substantial room to adjust much higher over the near to medium term. Shorter-term bonds are preferred as they would be better anchored by still-flushed onshore liquidity. In 2Q, BSP could also provide some guidance on its plan for the eventual normalisation of its extraordinary liquidity measures.

Prospects of further lowering of banks' RRR support liquidity in Philippines

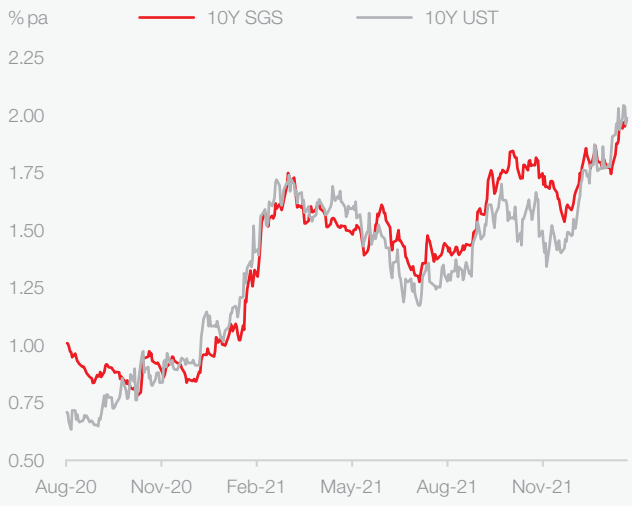


Source: Bloomberg, DBS

SGD Rates: Outperformance to extend to the longer tenors

MAS steepened the SGDNEER band again in January, in an off-cycle move. Worries about inflation probably prompted urgency from the MAS and we see a reasonable chance that another round of tightening would take place at the scheduled meeting in April. Twin tightening from the Fed and the MAS would lead to SGD rates outperformance from a receive perspective. This view has played out across and is most apparent in the shorter tenors (around the 2Y sector), but we think that this could extend out into the 5Y-10Y segment. There is a reasonable chance that market participants will rethink the terminal rate for the US. This would offset some duration concerns stemming from the SGS (infra) issuance set for mid-2022. In any case, this issuance would be the ultra-long tenors (30Y and beyond) and might not have much that much impact on the belly tenors. We are sticking to our view of SGD rates outperformance.

10Y SGS can outperform 10Y UST

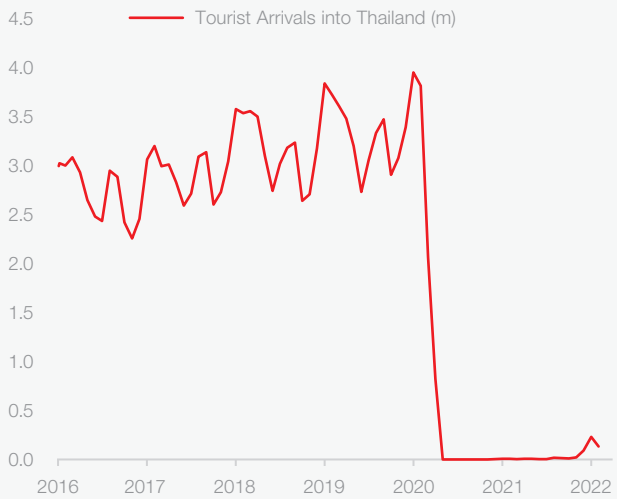


Source: Bloomberg, DBS

THB rates: Attractive roll-down

Besides new variants weighing on global travel appetite, outbound travel restrictions in many countries (especially China which accounted for close to 30% of tourist arrivals pre-pandemic) suggest that full or close-to-full recovery of tourist arrival numbers will be slow and may not be possible within 1H. Despite a weaker recovery and BOT likely to be a laggard in hiking rates (our economist expects lift-off only in 2Q23), THB rates have exhibited a high beta in following US rates higher. We think to a large extent, the recent market repricing of global rate hikes has been broad-based without adequate consideration for individual economies' circumstances. And therefore, we think THB OIS/IRS rates could have the most scope to retract lower once US rates stabilise. Even if THB rates stay elevated, a receiver could pick up attractive roll-down with the passage of time, assuming BOT remains a laggard.

Tourism recovery will be slow for Thailand



Source: Bloomberg, DBS

Rates forecasts

		2022				2023			
		1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
US	3M SOFR OIS	0.50	1.00	1.50	1.90	2.10	2.30	2.50	2.75
	2Y	1.90	2.10	2.30	2.45	2.55	2.65	2.70	2.70
	10Y	2.10	2.25	2.40	2.50	2.60	2.70	2.70	2.70
	10Y-2Y	20	15	10	5	5	5	0	0
Japan	3M TIBOR	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07
	2Y	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05
	10Y	0.20	0.20	0.25	0.25	0.25	0.25	0.25	0.25
	10Y-2Y	25	25	30	30	30	30	30	30
Eurozone	3M EURIBOR	-0.50	-0.50	-0.50	-0.50	0.10	0.10	0.10	0.10
	2Y	-0.40	-0.30	-0.10	0.10	0.30	0.40	0.40	0.40
	10Y	0.20	0.30	0.40	0.50	0.60	0.70	0.80	0.80
	10Y-2Y	60	60	50	40	30	30	40	40
Indonesia	3M JIBOR	3.65	3.70	4.25	4.55	4.80	4.80	4.80	4.80
	2Y	4.25	4.40	4.60	4.85	5.10	5.35	5.60	5.70
	10Y	6.60	6.85	7.10	7.15	7.20	7.25	7.20	7.15
	10Y-2Y	235	245	250	230	210	190	160	145
Malaysia	3M KLIBOR	1.97	1.99	2.26	2.53	2.80	2.82	2.84	2.86
	3Y	2.75	2.80	3.00	3.15	3.30	3.30	3.25	3.20
	10Y	3.65	3.80	3.95	4.05	4.10	4.15	4.20	4.20
	10Y-3Y	90	100	95	90	80	85	95	100
Philippines	3M PHP ref rate	3.00	3.00	3.10	3.40	3.65	3.90	3.90	3.90
	2Y	3.60	3.70	3.85	3.95	3.95	4.00	4.00	4.05
	10Y	5.80	6.05	6.30	6.30	6.30	6.30	6.25	6.25
	10Y-2Y	220	235	245	235	235	230	225	220
Singapore	3M SORA OIS	0.50	0.80	1.25	1.60	1.75	1.90	2.05	2.25
	2Y	1.55	1.70	1.85	1.95	2.00	2.05	2.10	2.10
	10Y	2.10	2.15	2.25	2.30	2.35	2.35	2.35	2.35
	10Y-2Y	55	45	40	35	35	30	25	25

%, eop, govt bond yield for 2-year and 10-year, spread bps.

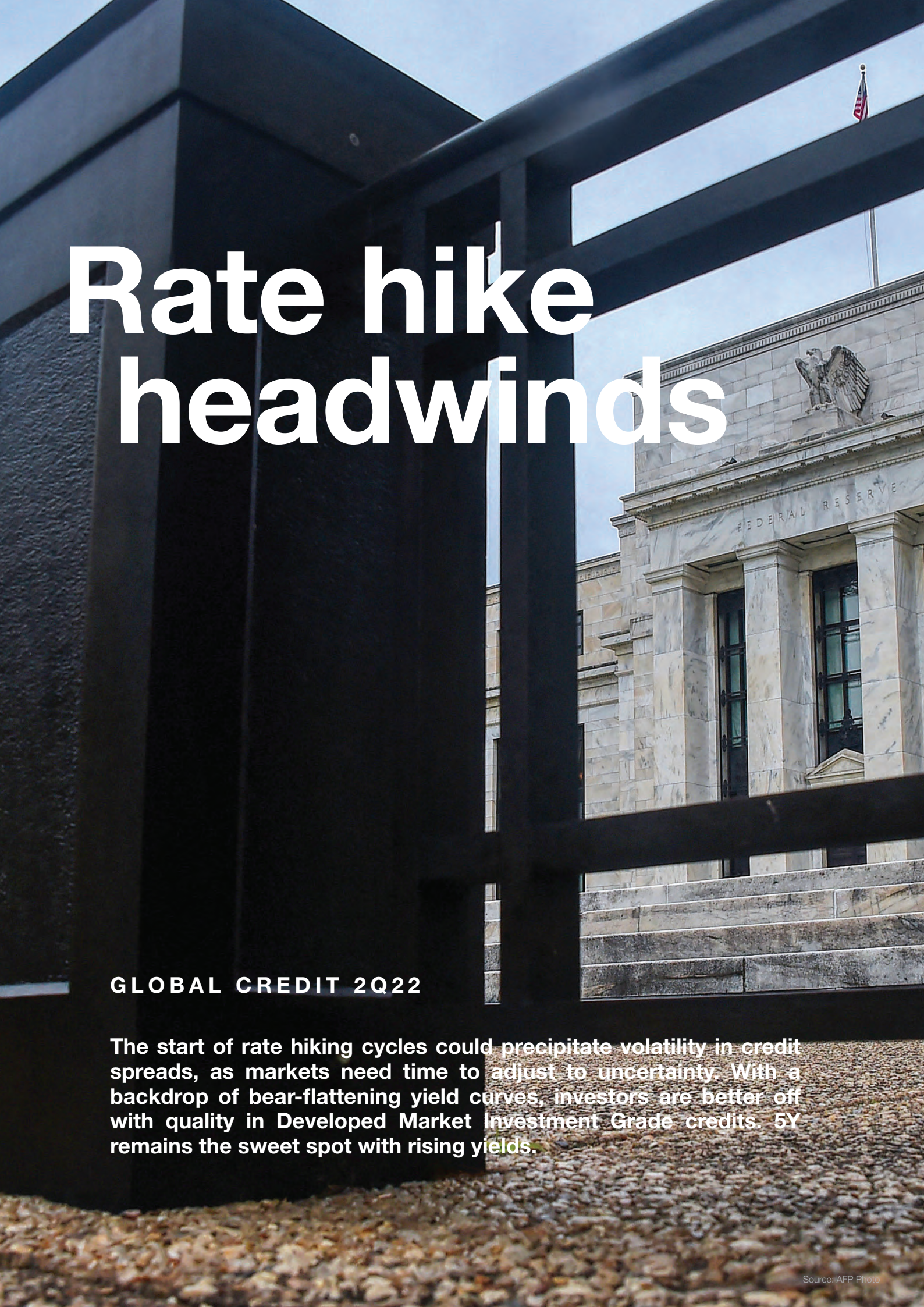
Source: CEIC, Bloomberg, DBS

		2022				2023			
		1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Thailand	3M BIBOR	0.62	0.62	0.62	0.62	0.62	0.87	0.87	1.12
	2Y	0.65	0.70	0.80	0.85	0.95	1.05	1.05	1.10
	10Y	2.30	2.40	2.50	2.55	2.70	2.85	2.85	2.90
	10Y-2Y	165	170	170	170	175	180	180	180
Mainland China	1Y LPR	3.75	3.70	3.65	3.65	3.65	3.65	3.70	3.75
	2Y	2.15	2.20	2.30	2.40	2.50	2.60	2.60	2.60
	10Y	2.70	2.70	2.75	2.80	2.85	2.90	2.95	3.00
	10Y-2Y	55	50	45	40	35	30	35	40
Hong Kong	3M HIBOR	0.60	1.00	1.40	1.75	1.90	2.05	2.25	2.50
	2Y	1.40	1.60	1.80	1.95	2.05	2.15	2.20	2.20
	10Y	1.95	2.05	2.15	2.20	2.25	2.30	2.30	2.30
	10Y-2Y	55	45	35	25	20	15	10	10
South Korea	3M CD	1.45	1.45	1.70	1.70	1.95	1.95	2.20	2.20
	3Y	2.30	2.50	2.65	2.80	2.85	2.95	2.95	2.95
	10Y	2.75	2.90	3.00	3.10	3.15	3.25	3.20	3.20
	10Y-3Y	45	40	35	30	30	30	25	25
India	3M MIBOR	4.20	4.30	4.50	4.70	4.95	5.20	5.30	5.40
	2Y	4.90	5.00	5.30	5.50	5.65	5.90	5.90	6.00
	10Y	6.80	6.85	6.95	7.05	7.10	7.20	7.20	7.20
	10Y-2Y	190	185	165	155	145	130	130	120

%, eop, govt bond yield for 2-year and 10-year, spread bps.

Source: CEIC, Bloomberg, DBS

Rate hike headwinds



GLOBAL CREDIT 2Q22

The start of rate hiking cycles could precipitate volatility in credit spreads, as markets need time to adjust to uncertainty. With a backdrop of bear-flattening yield curves, investors are better off with quality in Developed Market Investment Grade credits. 5Y remains the sweet spot with rising yields.

Source: AFP Photo

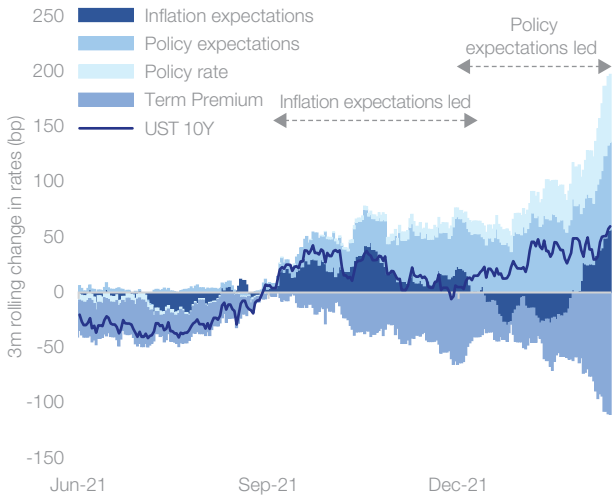
08. Global Credit.

Daryl Ho, CFA
Strategist

Prepare for lift-off. And so, it begins. Nearly two years from the day that the US Federal Reserve cut rates to zero and restarted unconventional monetary policy to combat a once-in-a-generation pandemic threat, the world had staged a comeback so remarkable that such extraordinary policies are now beginning to look superfluous – some would even say unwarranted. Central banks around the world are now racing to pull back excessive support, in light of a threat deemed more nefarious than the coronavirus itself – inflation.

The all-knowing bond markets. What was initially "transitory" inflation was eventually revealed to possess an unwelcome persistence, to the point that policymakers had to swallow some humble pie, speed up the tapering process, and bring forward the rate hiking cycle. This was not missed by the bond markets. A keen observer would have noticed that the UST yields had factored in the distinct shift in the policy tone from the Fed that came towards the end of 2021. Breaking down the US 10Y yield movements into its components, we note that while inflation expectations drove much of the yield movements higher in 4Q21, the turn of the year in 2022 saw policy expectations taking over the driver's seat in bringing yields another leg higher.

Policy hawks have driven yields higher



Source: Bloomberg, DBS

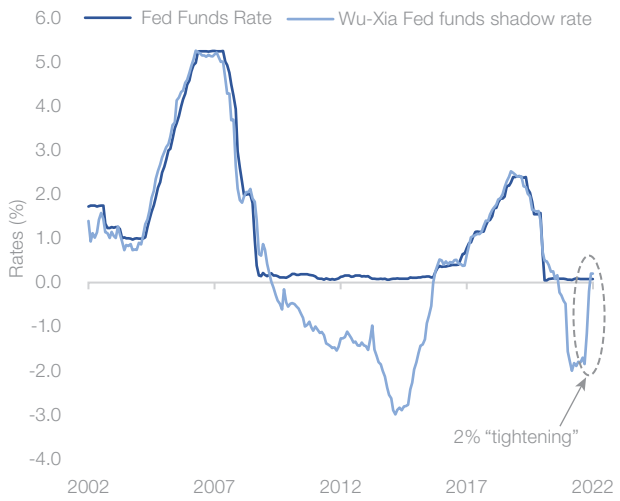
"Tightening" had already begun prior to the hiking cycle. For financial markets that have grown accustomed to the support of central banks in asset valuations, the news had inevitably resulted in some indigestion at the turn of 2022, with most markets trading in the red for the year. Considering the extent of volatility that the markets have already faced thus far, one cannot help but feel an impending gloom wondering what would happen to risk assets when the Fed eventually does begin to hike rates.

To that point, one should also be mindful that in an age of extraordinary monetary policy, interest rates are but one of many monetary policy tools that the authorities utilise; others include QE, forward

guidance, and direct purchases of risk assets, etc. To consider the unobservable influences of such extraordinary policy tools, researchers Jing Cynthia Wu and Fan Dora Xia devised an alternative "shadow" Fed funds rate; to express the combined effect of all monetary easing measures into a single hypothetical policy rate that was allowed to go below the zero bound. For example, this Wu-Xia shadow rate hit a low of -2% right as the Covid-19 delta wave was cresting in mid-2021.

More recently, the compounded effects of tapering and Fed communication saw a tightening of the shadow rate to a degree of +2% in recent months – the equivalent of eight 25 bps hikes – since end-November 2021. Given that the Wu-Xia shadow rate is a preferred measure by the Atlanta Fed, we believe that policymakers would have taken into account the speed by which unconventional policy actions have already tightened financial conditions, and not move to hike more aggressively than what is already priced by the markets.

Shadow tightening had already begun



Source: Atlanta Fed, Bloomberg, DBS

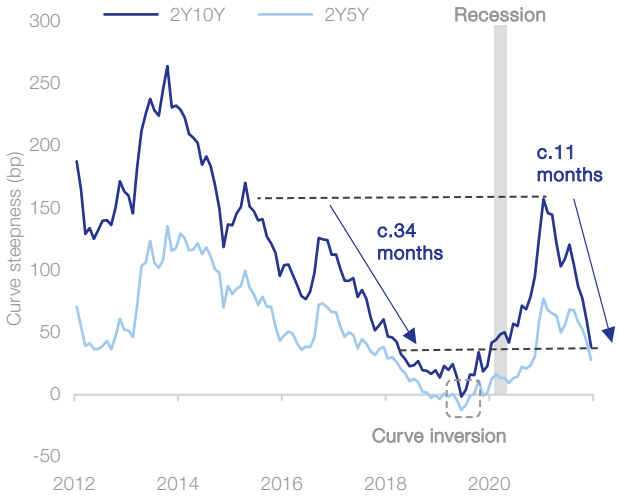
Gazing into the yield curve crystal ball. Aside from shadow rates, one other measure that policymakers would be keenly focusing on is the shape of the yield curve. The inversion of the yield curve has been one of the most reliable recession indicators in financial history, preceding every recession since 1957. In theory, such a phenomenon arises when the long-term outlook dims to a degree that investors flock to longer-dated risk-free treasuries, flattening the curve.

Rate hikes, meet curve inversion. Most noticeably, this steepness had already moderated since 2Q21. What is concerning however, is the speed by which the flattening had occurred. During the previous hiking cycle (2015–2018), the 2Y/10Y slope declined from c.150 bps to c.30 bps with the Fed already midway through hiking, and it flattened over a course of 34 months. Recession then hit a mere c.1.5 years after.

In this episode, the same flattening has occurred in a short span of just 11 months, all without a single hike to its name. The markets may be considering that the current instance of inflation – driven by supply chain disruptions – may not be indicative of healthy economic functioning, and rate hikes may choke growth off prematurely. Nonetheless, this remains

another indicator that suggests that policymakers should embark on this hiking cycle with a bit more caution than the last.

Recession risks rise with curve flattening

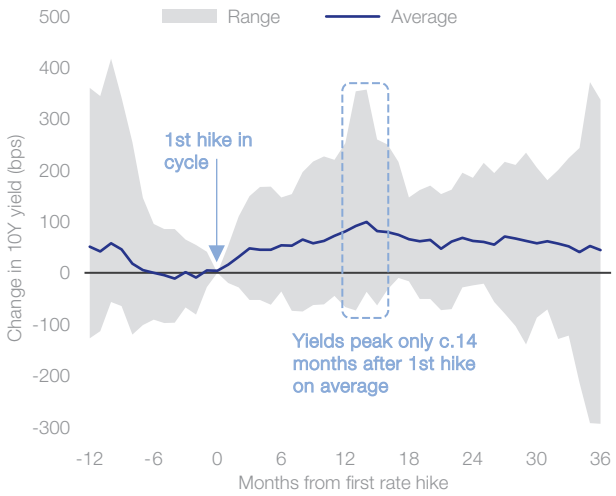


Source: Bloomberg, DBS

Wheels have been set in motion. Given that (a) there has been significant policy tightening through unconventional means, and that (b) the yield curve now has a lower buffer to inversion, we believe that we may have passed the point of peak hawkishness in this cycle. However, what now comes is the follow through – where central bankers attempt to hike in line with what has been priced into the markets. Historical data have shown that at this point in the cycle, yields can still have the propensity to drift higher.

Analysing the behaviour of the 10Y UST yield over the past seven hiking cycles since 1972, we notice that yields only peak c.14 months on average after the first hike, indicating that there remains an upward bias to interest rates that could detract from total returns in credit investment. This is because hikes in general proceed only when supported by stronger economic data, which would naturally see the 10Y yield drift up towards the long-term neutral rate of 2.5%.

Yields peak about a year after the first hike



Source: Bloomberg, DBS

Credit spreads and hiking cycles. Next, we look at how spreads behaved over the previous hiking cycles. Across various credit markets, we note largely similar observations. Credit spreads tend to exhibit volatility in the period six months pre- and post- the first rate hike, as the markets need time to adjust to the uncertainty of the risk event. Past that period however, credit spreads would generally gravitate lower up to 24 months after the first hike, as economic data validate a healthy growth environment – with the risker EM and HY markets seeing the largest spread compression, supported by risk-seeking behaviour.

Credit spreads behave well in hiking cycles

Source: Bloomberg, DBS

The risks in the near term. Nevertheless, given that we are within the proximity of volatility preceding the first hike, this warrants some caution for credit. This is especially pertinent under the current environment of bear flattening yield curves in the eve of a rate hiking cycle. We ran an analysis across DM, EM, and HY credit segments, looking at the average weekly change in credit spreads under various degrees of curve bear flattening, and came up with the following observations:

1. Under the most aggressive episodes of bear flattening, credit spreads tend to widen the most significantly. This is intuitive given that bear flattening signals dual headwinds of tighter monetary policy, and a modest long-term outlook.

2. DM IG markets exhibit the lowest volatility under bear-flattening yield curves, while HY markets exhibit the highest.

3. If curve bear flattening is relatively benign (long-term rates rising with short-end hikes), credit spreads tend to tighten, with the riskiest markets having the best performance.

Preference for quality. In light of the (a) anticipated near-term volatility and (b) flattening yield curves, we prefer to remain up in quality for the quarter with a focus on DM IG, before seeking an opportune moment to add risk further down the road when rate hike headwinds ameliorate.

Source: Unsplash

Weekly change in credit spreads under curve bear flattening

Percentile	Developed Markets				Emerging Markets					High Yield				
	Global IG	US IG	Eur IG	US MBS	EM USD	GCC USD	LatAm USD	EMEA USD	Asia USD	Asia IG	Global HY	US HY	Eur HY	Asia HY
0-10th	3.1	2.8	2.9	1.7	11.2	7.3	14.0	13.9	7.5	-0.7	16.0	16.5	11.9	20.5
10-20th	0.0	-0.1	-0.3	1.2	1.7	1.3	2.7	2.1	0.5	-0.1	1.6	2.2	-2.0	-4.3
20-30th	0.8	0.1	1.1	2.0	6.4	4.9	10.7	6.6	2.4	0.5	7.4	10.5	4.1	10.1
30-40th	0.0	-0.3	0.4	0.3	5.6	3.4	12.6	4.8	1.8	0.3	6.6	5.8	0.0	6.1
40-50th	-0.3	-0.3	-1.3	1.0	-0.4	-0.2	0.8	-2.3	0.5	-0.1	-3.5	-4.0	-5.9	3.9
50-60th	0.3	0.2	0.1	1.0	2.7	2.7	-2.4	5.3	4.3	1.1	1.3	-0.3	-1.0	15.8
60-70th	1.0	0.9	1.9	1.8	4.1	3.6	12.5	1.9	0.6	-1.6	2.2	3.5	5.5	-6.1
70-80th	0.7	0.7	0.8	-1.1	2.0	0.4	4.0	1.9	-0.1	17.2	2.7	1.3	2.7	4.0
80-90th	-0.4	-1.0	0.6	-1.7	-2.1	-1.8	-2.3	-3.2	-0.3	-1.8	-4.9	-7.2	-0.4	-7.0
90-100th	-0.5	-0.6	-0.7	0.6	-2.7	-0.4	-1.5	-4.2	-1.3	-0.4	-4.2	-3.9	-2.0	-4.2

Most Aggressive

Curve bear flattening

Least Aggressive

Source: Bloomberg, DBS

Finding the duration sweet spot. With yields drifting higher, credit investors may also be eager to shorten duration risk to reduce portfolio sensitivity to interest rates. Based on our analysis of historical data however, a reallocation towards the shortest duration bonds – rather unintuitively – does not lead to the optimal performance. We collated monthly data going back to 2001 on the 10Y UST yield (to assess yield movements), as well as the ISM Economy-Weighted Manufacturing & Non-Manufacturing Composite PMI (as a proxy for growth momentum) – and measured how changes in each factor influenced the returns of the Bloomberg Barclays Global Corporate Aggregate Index by duration bucket.

5Y is the place to be. Under periods of rising bond yields, it was the 5Y bucket that generated the highest average annual returns. Investors in this bucket benefitted from (a) the steeper curve roll-down effects (meaning that they were compensated

5Y is the sweet spot with rising yields

	Average annual return by duration bucket				
	1-3Y	3-5Y	5-7Y	7-10Y	>10Y
Rising Bond Yields & Rising Growth Momentum	5.8%	7.5%	9.8%	8.3%	8.2%
Rising Bond Yields & Falling Growth Momentum	2.4%	3.1%	4.2%	3.7%	2.8%
Falling Bond Yields & Rising Growth Momentum	4.1%	6.3%	8.4%	9.4%	12.0%
Falling Bond Yields & Falling Growth Momentum	3.3%	3.9%	3.8%	4.2%	6.4%

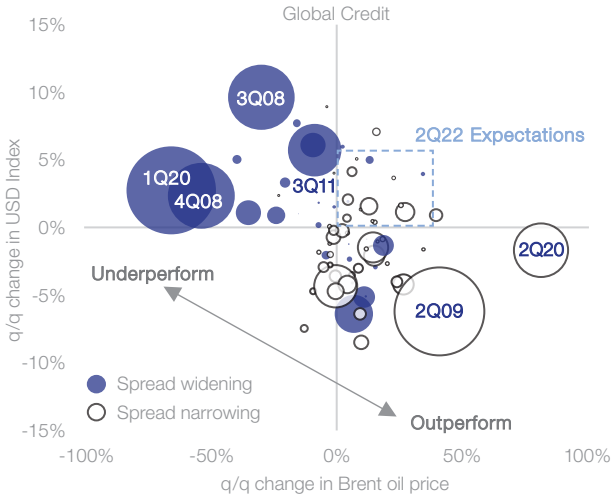
Source: Bloomberg, DBS

for duration risk up to this point), while they were at the same time (b) comparatively insulated from interest rate sensitivity in the long end.

The influence of oil and the dollar. Finally, we look at the historical influence of the USD and oil prices on credit spreads. Intuitively, credit spreads see the highest degree of tightening under a weaker USD (indicative of policy easing) and higher oil prices (indicative of strong growth momentum). For the coming quarter, oil prices remain buoyed by positive momentum as well as geopolitical tensions from the Russia-Ukraine conflict, but the USD is likely to be bolstered by the embarkation of the Fed hiking cycle. This generally points to only flat or modest spread tightening, which indicates that returns would likely be derived more from coupon yields than price appreciation.

Modest returns from lower starting yields. Such lower return expectations also find support in historical trends. With global credit yields starting at their current levels (3.5%), trendlines suggest that the one year forward returns for credit falls around c.4.5%, with a downside bias for return expectations under hiking cycles.

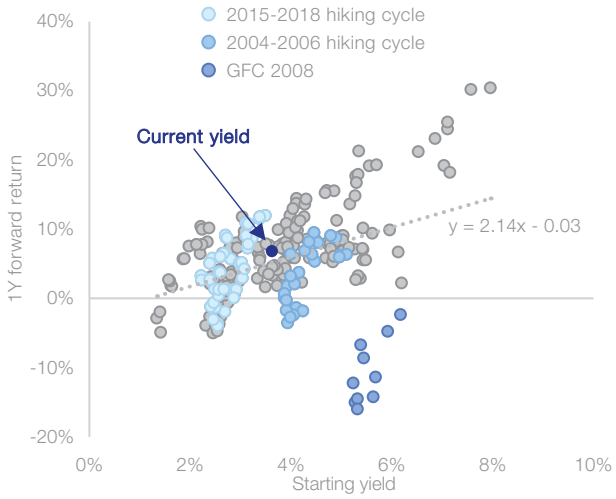
Stronger USD and higher oil prices = modest spread tightening



Source: Bloomberg, DBS

Bubble size is commensurate with the relative degree of spread movements

Low starting yields, low expected returns



Source: Bloomberg, DBS

In summary, we believe that the current environment favours an up-in-quality bias for credit exposure. With rate hikes well under way, the bias towards higher yields and bear-flattening curves suggests that credit spreads may still have the propensity to widen modestly. Higher oil prices could be a tailwind, although USD strengthening would counteract this factor to a certain degree. From a portfolio perspective, given that yields have already drifted meaningfully higher, investors are now more adequately compensated for unforeseen risk-off events; as such we believe that an investor's portfolio should always carry a natural allocation to lower-risk credit instruments in the core portion of the portfolio as a form of (a) insurance against low probability but high impact adverse outcomes, and (b) as a stable source of income generation over the long run. We believe a focus on DM IG credit would suit investors well for the quarter, with the 5Y duration being the portfolio sweet spot.

The great stimulus exit amid geopolitical risks

GLOBAL CURRENCIES 2Q22

We have revised up our target for the USD. The Fed keeps surprising on its hawkishness to normalise monetary policy even as the Russia-Ukraine conflict heightens geopolitical, economic, and financial market risks.

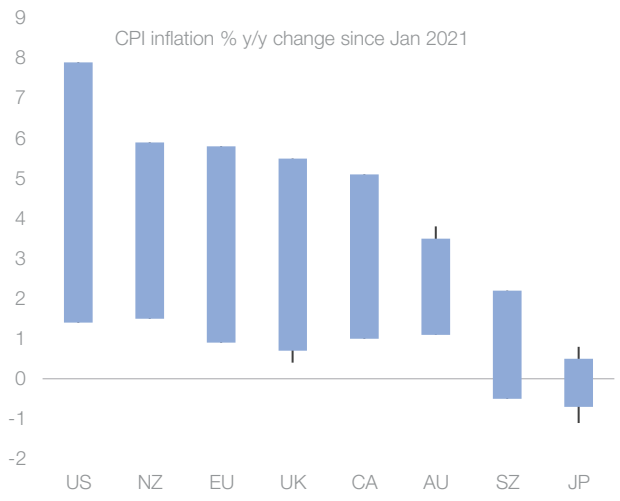
Source: iStock

09. Global Currencies.

Philip Wee
Strategist

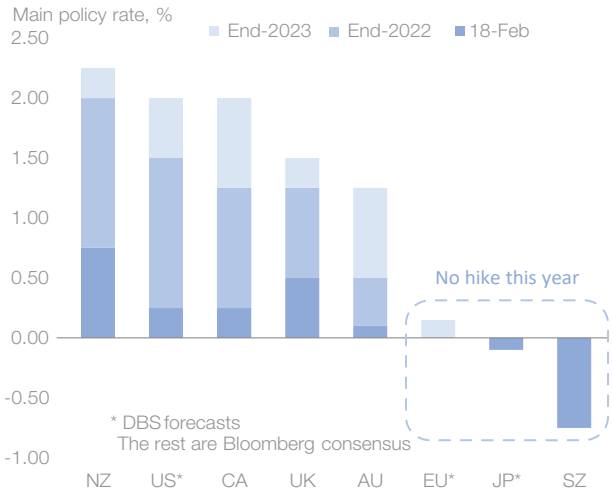
For the first time in several decades, inflation has become a significant issue. Uncomfortable with elevated and persistent inflation, Western central banks have shifted to a hawkish pivot in monetary policy. However, central bankers want rate hikes to be a foundation of confidence and not as another source of uncertainty. Earlier hopes for inflation to peak around mid-2022 and fall in the second half of the year on base effects and easing supply constraints have been undermined by surging energy and food prices from Russia's invasion of Ukraine. The Federal Reserve has the most credible roadmap to return US rates to 3% by 2023. Conversely, the BOE has been less proficient in communicating its strategy amidst recession worries. ECB and RBA have set conditions to lift rates later this year, keeping them behind the race to normalise monetary policy. Japan and Switzerland will stand out with no hikes in 2022 and 2023. On a relative basis, there is room for the USD to remain supported until late 2022.

Inflation has risen to elevated levels for most DM economies since 2021



Source: Bloomberg DBS

US will lead rate hikes in 2022 except against NZ



Source: Bloomberg DBS

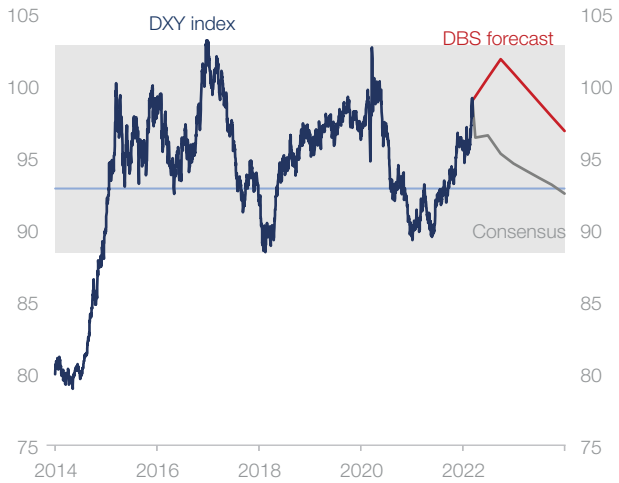
To add fuel to the fire, Russia invaded Ukraine on 24 February. Many businesses and investors were caught in the crossfire of economic and financial sanctions from the US and NATO allies against Russia. More governments face a cost-of-living crisis from the sudden surge in commodity and food prices, which will draw voters' ire if left unaddressed. Despite more countries reopening borders to international travellers, investors have started scrutinising emerging Asian economies, especially the net oil importers. Lower growth forecasts from China and Europe have dampened the global outlook. More importantly, geopolitics and polarisation threaten to weaken the multilateral framework for trade and investments that benefit the world. Unfortunately, it was easier for America to accurately predict the start of the invasion than for anyone today to visualise the endgame. Ukraine could become the "New Afghanistan" keeping the EU and NATO in a long standoff with Russia.

Miscalculations and military incidents could draw NATO directly into the military conflict. Hence, the situation can get worse before it gets better.

We have raised the DXY target to 100-102 by 3Q22. Our chief economist forecasts seven increases in the Fed Funds Rate to 2% this year, followed by another four hikes to 3% in 2023. America has the highest headline and core inflation amongst its DM peers. President Joe Biden's top priority is getting prices under control and supporting the Fed's plan to normalise monetary policy. Russia's invasion of Ukraine also generated USD demand from escalating energy prices and a flight to safety from businesses and investors caught in an unwieldy crossfire of Russian sanctions led by the US and NATO allies. Without a predictable endgame, the Russia-Ukraine crisis is at risk of evolving into a broader and complicated "Cold War" beyond the West and Russia. Our base scenario for the USD to peak in 3Q22 will weaken if US inflation fails to slow in 2H22 and keeps the Fed hawkish amidst a more pessimistic global outlook. The last time the DXY pushed above 105 was in 2000, from the EUR's fragile launch into the bursting tech bubble.

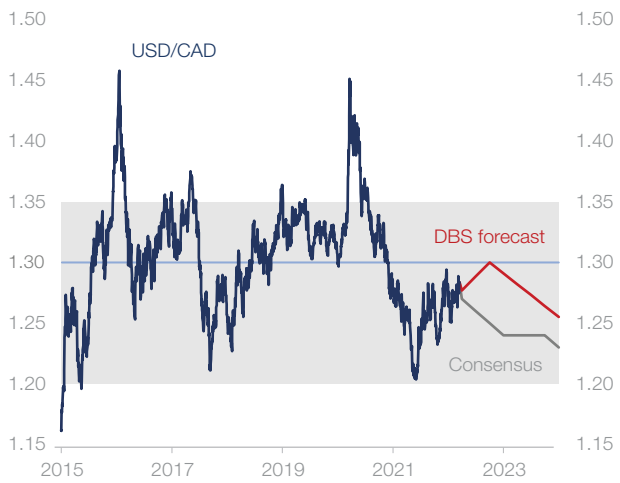
CAD has been consolidating between 1.23 and 1.30 per USD since mid-2021; it should continue to do so in 2022 and 2023. The Canadian economy has fully recovered from the pandemic. Employment is back above pre-pandemic levels and wages are rising from acute labor shortages. BOC abruptly ended its asset purchases program last October and started its rate hike cycle on 2 March. BOC reckons rates might need to move above its neutral rate to return CPI inflation from a 30-year high of 5.7% y/y in February to its 2% target. According to a Reuters poll, CPI inflation is likely to peak above 6% in the coming months. BOC believes that the pandemic has lowered the neutral rate to 1.75% and 2.75%, with a mid-point of 2.25%. According to Bloomberg consensus, the BOC will increase the overnight lending rate by 25 bps every quarter to 1.25% by end-2022 and 2.00% by end-2023. Although the

USD Index is positioned to push above 100



Source: Bloomberg DBS

Canadian dollar is hawish, so is the USD



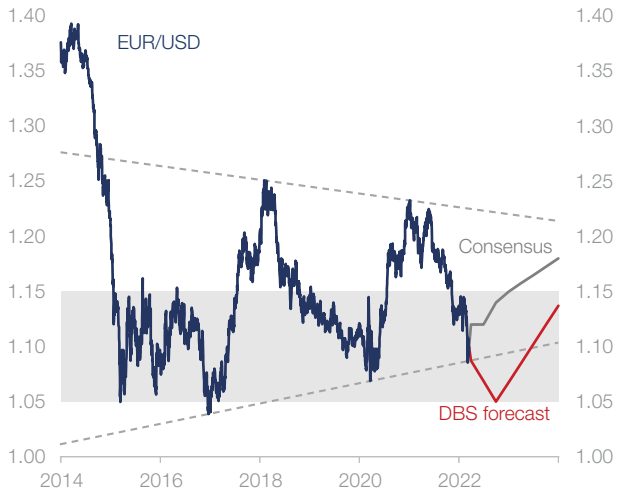
Source: Bloomberg DBS

BOC's hike cycle is nearest to the Fed, it still falls short of DBS's forecast for the Fed Funds Rate to rise to 2% this year and 3% next year.

EUR to trade a lower 1.05 to 1.10 range. Stagflation worries emerged after Russia invaded Ukraine. At its governing council on 10 March, the ECB downgraded its 2022 growth forecasts to 3.7% from 4.2% and lifted this year's CPI inflation forecasts to 5.1% from 3.2%. More importantly, the ECB reaffirmed that it would be more patient than the Fed in normalising monetary policy. First, monthly net purchases under the Asset Purchase Programme will double to EUR40b in April (instead of 2Q) before falling to EUR30b in May (instead of 3Q), and back to the current pace of EUR20b in June (instead of from October). Second, the ECB forecasts inflation excluding food and energy (which strips out the price spikes triggered by the Russian-Ukraine crisis) to average 2.6% in 2022 before slowing below 2% to 1.8% in 2023 and 1.9% in 2024. The verdict is still out on whether the ECB will end net purchases in 3Q22, the precondition for an ECB hike in late 2022.

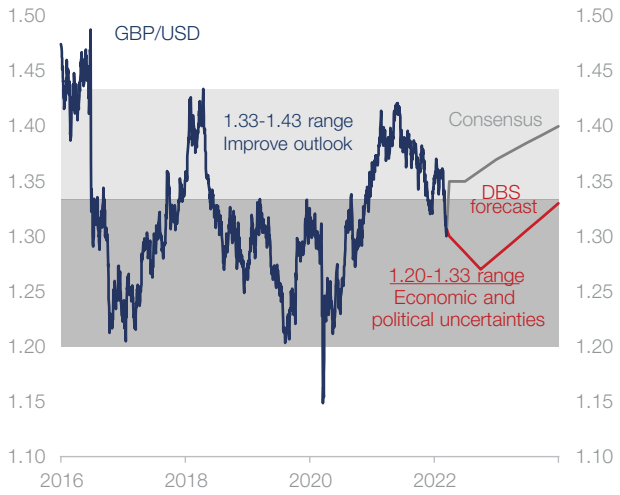
Stagflation worries to pull GBP down to 1.25-1.30. Following Russia's invasion of Ukraine, the BCC downgraded UK's growth for 2022 to 3.6% from 4.2% previously. The BCC has a higher inflation peak at 8% in 2Q22 than the BOE's projected 7.25% peak in April. The British people view high inflation as a cost-of-living crisis, not helped by higher rates adding to mortgage costs. With the Gilt yield curve (10Y vs 2Y spread) flat at 10-20 bps, the market no longer expects aggressive rate hike bets that could tip the UK economy into recession. After three back-to-back hikes from December to March, consensus expects two more BOE hikes to 1.25% by end-2022 and one in 2023 to 1.50%. DBS forecasts the Fed to hike rates seven times to 2% this year and four times to 3% next year. British Chancellor of the Exchequer Rishi Sunak will be under pressure to provide more tax and cost of living cuts exacerbated by the Ukraine crisis.

Euro is held down by stagflation risks



Source: Bloomberg, DBS

British pound is also held down by stagflation risks

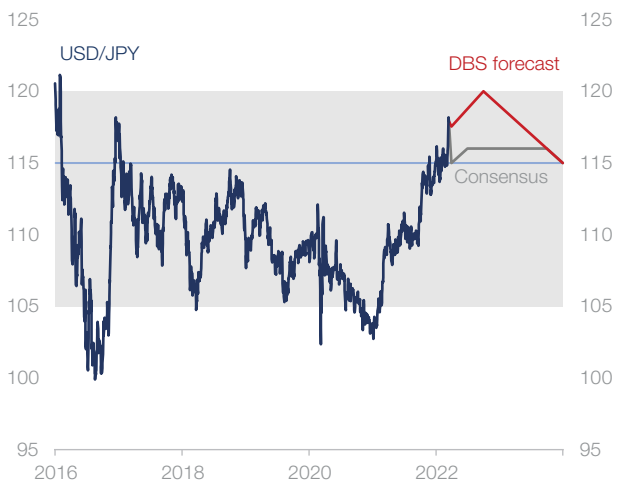


Source: Bloomberg, DBS

Dovish BOJ to keep JPY depreciating towards 120 per USD. The BOJ has ruled out policy tightening to address cost-push inflation. At 0.5% y/y in January, Japan's CPI inflation was significantly below the high inflation in other DM economies. After stripping food and energy prices (the components impacted by the Russia-Ukraine crisis), inflation was minus 1.1%, the weakest level since March 2011. The BOJ has reaffirmed its commitment to the Yield Curve Control framework by capping the 10Y JGB yield at 0.25% via unlimited bond purchases. BOJ warned that exiting its ultra-loose monetary policy would result in losses on its massive bond holdings. The finance ministry has rejected converting the JGBs held by the BOJ into perpetual bonds which it fears could lift bond yields. Even so, higher oil imports have led to the widest current account deficit since 2014. Policymakers also worry about the cost of living hit to households. The BOJ has scheduled its quarterly review of growth and inflation projections at its 27-28 April meeting.

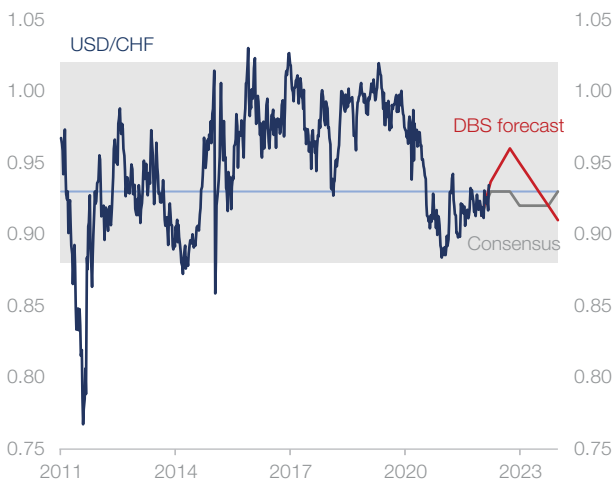
CHF to break out of its multi-month range between 0.91 and 0.9350 and depreciate to 0.96 per USD. On 7 March, the SNB threatened interventions to arrest the fall of EUR/CHF at parity. The SNB discouraged the CHF as a safe-haven currency in times of heightened uncertainties and acute market volatility. A week later, the Russia-Ukraine conflict led the Swiss State Secretariat for Economic Affairs to downgrade this year's growth forecast for the export-dependent economy to 2.8% from 2.0% previously and lift its 2022 inflation forecast to 1.9% from 1.1%. On 28 February, Switzerland joined the EU in imposing sweeping sanctions on Russia. The decision should have a limited impact on foreign trade because Russia is Switzerland's 23rd largest trading partner. However, Switzerland is a significant commodity hub for Russian oil and oil products, and Russian and Ukrainian grain. The Trade Union Federation has called for wage increases to offset the purchasing power losses from higher energy and food prices.

Japanese yen is bearish on "dovish BOJ and hawkish Fed"



Source: Bloomberg, DBS

Swiss franc is weak on interventions by a dovish SNB

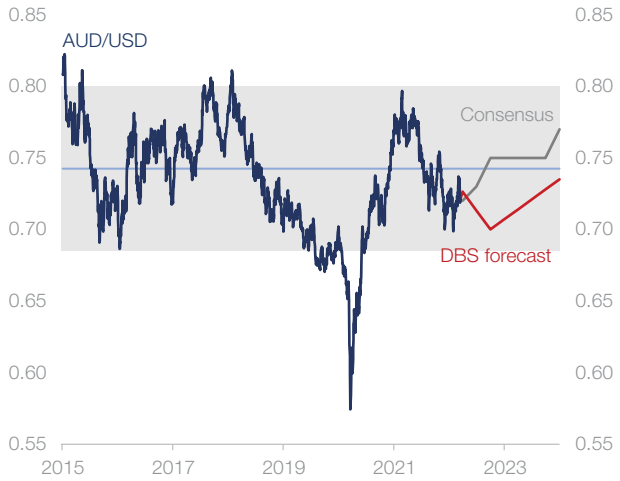


Source: Bloomberg, DBS

AUD found support at 0.70 but pushing above 0.75 might be challenging. The odds for the AUD to break below 0.70 towards 0.68 have diminished. The Russia-Ukraine crisis increased the AUD's positive correlation to rising commodity prices risks. For the first time in nearly two years, Australia reopened its international border without quarantine from 21 February to foreigners who received two Covid-19 vaccine doses. However, the verdict is still out if surging commodity prices can push the RBA to bring its rate hike into 2022 from 2023. Although the RBA acknowledged that inflation risks have increased, it wants the unemployment rate to drop to the "high threes" and wage growth to reach 3% to 4%. The latter is important because higher pump prices raise the cost of living and hold back consumer spending. Local producers reportedly lacked the infrastructure and workers to capitalise on the commodity bonanza. Hence, the AUD is still not immune to the Fed hike cycle; we see five rate increases through 3Q22.

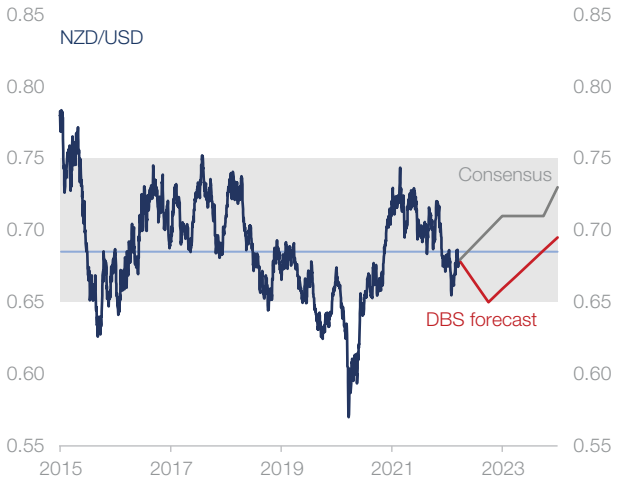
NZD found support at 0.65 but looks capped at 0.70. NZD benefitted from the higher commodity prices triggered by the Russia-Ukraine crisis. However, rising energy and food prices have, together with high rentals, led to a cost-of-living crisis in New Zealand, adding to public discontent over the latest Covid outbreak and the protests over the anti-vaccine mandate. For the first time since Prime Minister Jacinda Ardern took office in 2017, her Labour Party polled second place in March. Against this backdrop, the RBNZ's more aggressive hike trajectory might not be positive for the NZD. After three hikes from October to February totalling 75 bps to 1.00%, the RBNZ is targeting to lift the official cash rate to 2.50% by early 2023 and 3.25% by 4Q24, and has not ruled out a larger 50 bps hikes if needed. Believing long-term inflation expectations have increased and become anchored, RBNZ expects inflation to accelerate to 6.6% in 1Q22 from 5.9% in 4Q21 before gradually returning to its 1-3% band in 2Q23.

Australian dollar is caught between rising commodities and a lagging RBA



Source: Bloomberg, DBS

New Zealand dollar is not drawing support from a hawkish RBNZ



Source: Bloomberg DBS

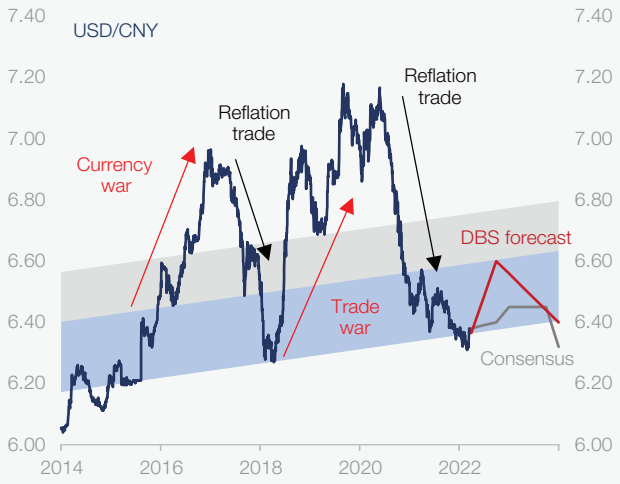

Source: Unsplash

Asia Currencies

CNY

CNY might have peaked at 6.31 per USD at end-February; our forecast is 6.60 by 3Q22. China has set an economic growth target of around 5.5% for 2022, its lowest in decades. China will struggle to repeat last year's feat of topping the 6% target with 8.1% growth. This year, export growth will slow from 20% last year because of heightened global uncertainties triggered by the Russia-Ukraine crisis. Hence, China will expand fiscal and monetary policies to lift domestic demand weighed by its Covid Zero policy amidst continuing clampdowns in the private sectors. Nonetheless, the PBOC estimated the economy could grow 5% to 5.7% in 2021-2025 without stoking inflation. Our economists expect the PBOC to further lower interest rates and required reserve ratios this year, setting policy in the opposite direction of the US. Against this background, the CNY looks overvalued as reflected by a CFETS RMB Index stronger than its 2015 highs.

Chinese yuan might have peaked in February

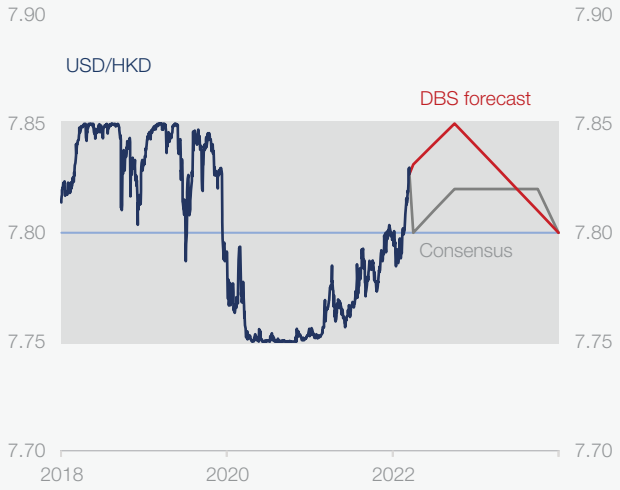


Source: Bloomberg, DBS

HKD

USD/HKD has ascended into 7.80-7.85, the upper half of its convertibility band. Like 2017-2018, USD/HKD should hold above 7.80 during this Fed hike cycle in 2022-2023. The HKD Peg to the USD should keep the 3M Hibor rising with US short rates towards 1.50% this year and near 1.90% next year. After a rebound to 6.4% growth last year, our economist forecasts the Hong Kong economy to slow to 2.4% in 2022. At the time of writing, HK SAR suffered its fifth and worst Covid-19 outbreak, which Chief Executive Carrie Lam warned has yet to pass its peak. This, coupled with a Covid Zero policy, will see the territory falling behind other Asian countries that have moved to endemic policies in reopening economies and borders. To cushion the economy, Fitch expects the budget deficit to widen to 3% of GDP in the fiscal year ending March 2023. Meanwhile, global financial markets, including the HK SAR, have been reeling from the geopolitical volatility triggered by the Russia-Ukraine crisis. As of 11 March, the Hang Seng Index fell 12.2% YTD this year, closer to the 14.1% loss for the whole of 2021.

Hong Kong dollar is weighed by Covid and a hawkish Fed

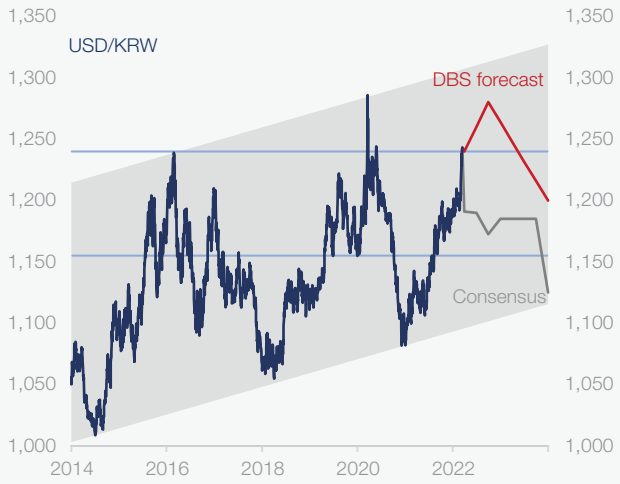


Source: Bloomberg, DBS

KRW

KRW to depreciate within a higher range of 1200-1300 per USD. KRW slid 8.6% to 1,190 per USD to become Asia's third weakest currency in 2021. The decline was also the worst since the global financial crisis in 2008. Although the BOK hiked rates three times in August-January to its pre-pandemic level of 1.25%, the KRW has been retreating with the JPY on an indexed basis since 2021. As per our economists' projections, the US policy will start rising in March and converge with the BOK rates in 3Q22. Not good, considering that the KOSPI has been on a downtrend after the Fed's hawkish pivot in mid-2021. The other challenges facing KRW include a decade-high CPI inflation, record-wide trade deficit, and record-high household debt of more than 100% of GDP. It remains to be seen if incoming President Yoon Suk-yeol can unite the people, put North Korea on a path to denuclearisation, and balance relations between the US and China. The IMF would also prefer the next administration to shift policy from supporting the economy towards structural reforms that add social safety nets and develop new growth drivers.

South Korean won has been the worst Asian currency this year so far



Source: Bloomberg, DBS

SGD

After Russia invaded Ukraine on 24 February, we have reinstated our start-of-the-year call for USD/SGD to trade in a 1.34-1.39 range this year. We had earlier narrowed the band to 1.34-1.37 after the MAS steepened the slope of SGD NEER policy band at an unscheduled meeting on 25 January. According to our model, the band is presently appreciating 2% a year, twice the 1% pace set last October. The increase in the slope is consistent with the upward revision in the official forecast for 2022 core inflation from 1-2% to 2-3%. We maintain our call for the MAS to steepen the slope again to 3% at the scheduled April policy review, in line with our economist's call for core inflation to average 3% this year. Re-centring the band higher is less likely because of generalised USD strength. A tighter policy should help to increase the SGD's resilience to currency volatility, especially in emerging markets, arising from monetary tightening in Western economies, unstable geopolitics, rising commodity prices and supply disruptions.

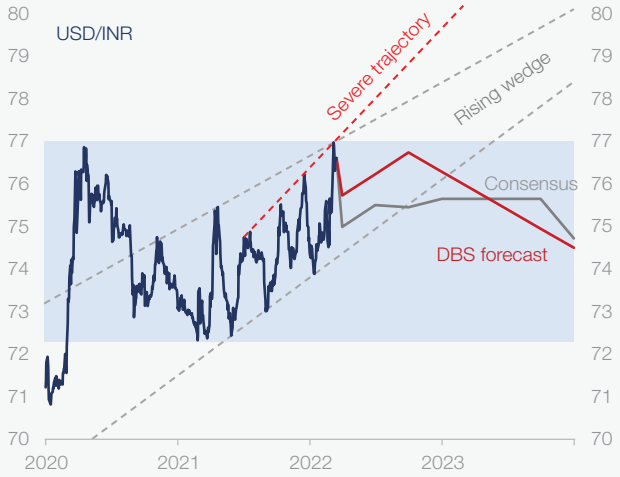
Singapore dollar is resilient from MAS tightening

Source: Bloomberg, DBS

INR

Following the Russia-Ukraine crisis, USD/INR should struggle to keep inside its post-Covid range between 72 and 77. Our forecasts represent the mid-point of a rising wedge that USD/INR has been fluctuating within since 2021. If intact, the wedge projects USD/INR ending the year between 76.1 and 78.4. A severe scenario could push USD/INR closer to 80 by end-2022. INR faces several challenges this year. First, our economist expects the RBI to hike rates twice in 2H22, less than the five US rate increases in the first three quarters. Second, higher oil prices will keep India's inflation above its 2-6% target and pressure the record trade deficits. India is a net oil importer. Our economist expects the current account deficit to widen from 1.8% of GDP in FY22 to 2% in FY23. Third, due to market volatility from concerted rates hikes in DMs and disruptive geopolitics, capital inflows will be less forthcoming. Even so, be mindful of India's massive war chest to smooth exchange rate volatility via interventions. Since the Fed taper tantrums in 2013, foreign reserves have more-than-doubled to USD630b today.

Indian rupee fluctuates within a wedge with downside risks



Source: Bloomberg, DBS

IDR

Expect IDR to be stable within the 14,000-15,000 per USD range set since May 2020. The BI is confident Indonesia can weather global monetary tightening because of a better policy framework, higher foreign reserves, and deeper financial markets. Our economist expects BI to hike rates every quarter from 2Q22 to 1Q23 to cushion against multiple Fed hikes. Unlike many countries, inflation is stable near the floor of its 2% to 4% target. Indonesia is on track to reinstate its fiscal ceiling of 3% of GDP in 2023. Higher tax revenues from the recovery and high commodity prices will help the country return to a sustainable fiscal position. The finance ministry projects a narrower budget deficit of 4% of GDP from 4.65% in 2021. Last year's shortfall was smaller than the 5.7% projected, thanks to record exports and high commodity prices boosting revenues. Indonesia plans to increase the value-added tax from 10% to 11% from April 2022 and 12% by 2025.

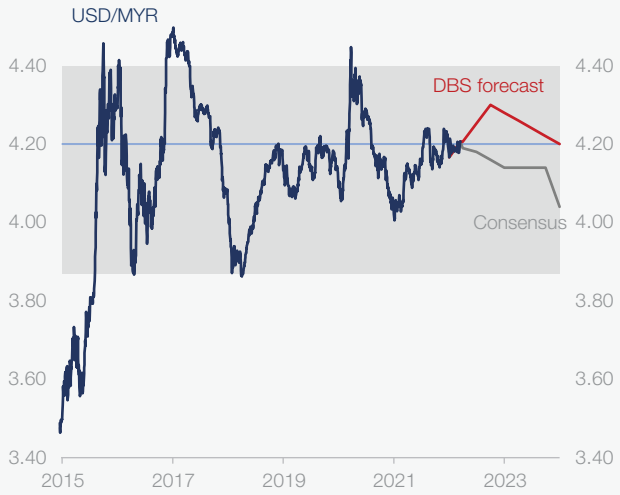
Indonesian rupiah has a sound range of 14,000-15,000

Source: Bloomberg, DBS

MYR

We expect USD/MYR to depreciate to 4.30 per USD, in line with its Asian peers. USD/MYR has been stable in a 4.14-4.24 range since mid-2021. The BNM attributed the exchange rate's resilience to easing Covid restrictions and the vaccination boost in Malaysia. The country's net oil exporter status insulated it from the global energy price surge triggered by the Russia-Ukraine crisis. In 2021, the trade surplus ballooned to a record MYR257b but a wider services deficit narrowed the current account to MYR53.5b. From 1 April, Malaysia will reopen its international borders and transition to a Covid-19 endemic phase. Most observers expect the government to meet its 5.5% to 6.5% growth target for 2022. According to our forecasts, the BNM will keep the policy rate differential positive with the US this year. DBS sees the Fed Funds Rate rising from 0.25% to 1.50% between March and 3Q22, and the BNM raising rates in 2H22 from 1.75% to 2.25%. All said, the MYR is still a managed floating exchange rate that correlates with other Asian currencies.

Malaysian ringgit can depreciate out of its 4.14-4.24 range

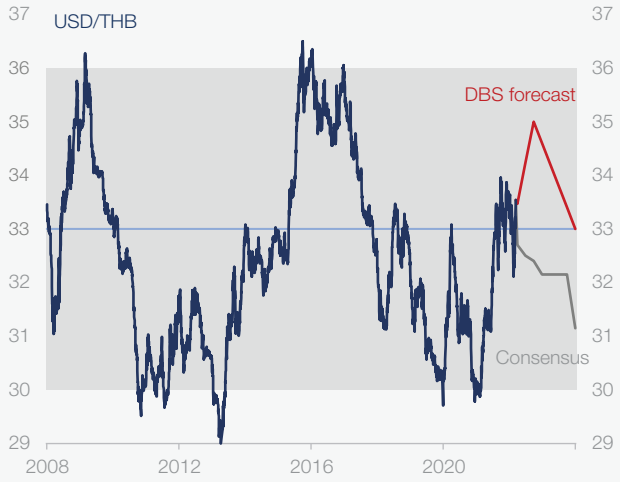


Source: Bloomberg, DBS

THB

We expect USD/THB to rise above the 32-34 range set since mid-2021. The THB is caught between Thailand reopening its tourism-dependent economy and headwinds from unpredictable geopolitics and volatile markets. Before Russia invaded Ukraine in late February, the THB was the best Asian performing currency from Thailand reopening borders to fully and partially vaccinated foreigners, and looking for Covid-19 to be endemic by July. Since the invasion, the THB reversed into the second-worst Southeast Asian currency (as of 11 March) from surging oil prices, which will also delay the return of the current account deficit into a surplus. Thailand also faces stagflation risks. The Finance Ministry is not optimistic about achieving this year's growth target of 3.5% to 4.5%. The central bank's desire to hold rates at 0.50% to support growth will be challenged if core inflation, which surged to 1.8% y/y in February from 0.5% in January, breaches the official 1% to 3% target. Against this background, THB is likely to be less resilient to the Fed hike cycle starting on 16 March.

Thai baht can also depreciate out of its 32-34 range

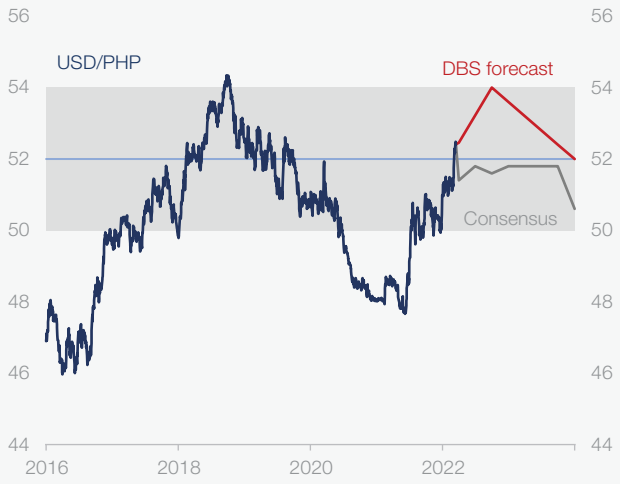


Source: Bloomberg, DBS

PHP

PHP to depreciate to 53-54 per USD. The PHP started 2022 in a stable 51.0 to 51.5 range until the Russian invasion of Ukraine weakened it past 52 for the first time in 2.5 years. The BSP estimated that high oil prices of USD120-140 per barrel could lift inflation to an average of 4.4% to 4.7% this year, above the 2-4% target. For now, the BSP has raised this year's inflation forecast only to 3.7% from 3.4%, which will allow it to keep monetary policy accommodative to achieve this year's official growth target of 7% to 9%. Our economist expects only one BSP hike in 4Q22. Hence, USD/PHP is likely to remain firm from the five Fed hikes we expect this year. Rating agencies and investors are watching to see if the next president elected on 9 May will continue the sound policy framework of his predecessors and steer towards fiscal consolidation. On a positive note, the Philippines has, in mid-February, reopened its borders to fully vaccinated foreign travellers from visa-free countries. The Department of Tourism is hoping for a full reopening by April.

Philippine peso is in a weaker 52-24 range



Source: Bloomberg, DBS

VND

The appreciation path of the VND against the USD might be closer to the mid-point instead of the stronger limit of a potential price channel. Our economists expect the SBV to hike interest rates in 4Q22 after five US rate increases from May into 3Q. Assuming real GDP growth rebounded to 8.0% in 2022 from 2.6% in 2021, Vietnam is likely to become attractive again as a manufacturing hub for multinational companies on measures to reduce supply disruptions and address labour shortages from Covid. Last October, Vietnam abandoned the "Covid-Zero" policy in favour of a "Living with Covid" policy. In January, the country eased re-entry procedures for expatriates and overseas Vietnamese. In December, the US Treasury Department (USTD) refrained from naming Vietnam a currency manipulator despite having met the three criteria as one. Last July, the USTD and SBV issued a joint statement for Vietnam to avoid manipulating exchange rates to prevent effective balance of payments adjustments or gain an unfair competitive advantage.

Vietnamese dong is still on a modest appreciation path

Source: Bloomberg, DBS

DBS currency forecasts

Exchange rates, eop	11-Mar	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23
China	6.3393	6.36	6.48	6.60	6.56	6.52	6.48	6.44	6.40
Hong Kong	7.8293	7.83	7.84	7.85	7.84	7.83	7.82	7.81	7.80
India	76.593	75.7	76.2	76.7	76.3	75.8	75.4	75.0	74.5
Indonesia	14,301	14,360	14,630	14,900	14,760	14,620	14,480	14,340	14,200
Malaysia	4.1958	4.21	4.25	4.30	4.28	4.26	4.24	4.22	4.20
Philippines	52.288	52.5	53.2	54.0	53.6	53.2	52.8	52.4	52.0
Singapore	1.3629	1.37	1.38	1.39	1.38	1.36	1.35	1.33	1.32
South Korea	1232	1240	1260	1280	1264	1248	1232	1216	1200
Thailand	33.299	33.5	34.2	35.0	34.6	34.2	33.8	33.4	33.0
Vietnam	22,859	22,740	22,690	22,640	22,590	22,530	22,480	22,430	22,380
Australia	0.7293	0.73	0.71	0.70	0.71	0.71	0.72	0.73	0.74
Canada	1.2744	1.28	1.29	1.30	1.29	1.28	1.27	1.26	1.26
Eurozone	1.0912	1.09	1.07	1.05	1.07	1.08	1.10	1.12	1.14
Japan	117.29	118	119	120	119	118	117	116	115
New Zealand	0.6809	0.68	0.66	0.65	0.66	0.67	0.68	0.69	0.70
Switzerland	0.9342	0.94	0.95	0.96	0.95	0.94	0.93	0.92	0.91
United Kingdom	1.3037	1.30	1.29	1.27	1.28	1.29	1.31	1.32	1.33
United States	99.124	99.4	100.7	102.0	101.0	100.0	99.0	98.0	97.0

Australia, Eurozone, and United Kingdom are direct quotes.

Source: Bloomberg DBS

Persistent Tailwinds

ALTERNATIVES: GOLD 2Q22

Gold's demand remains robust as it continues to be a strong hedge against recession, hyperinflation, and higher volatility. It will also continue to be a risk diversifier in our barbell portfolio.

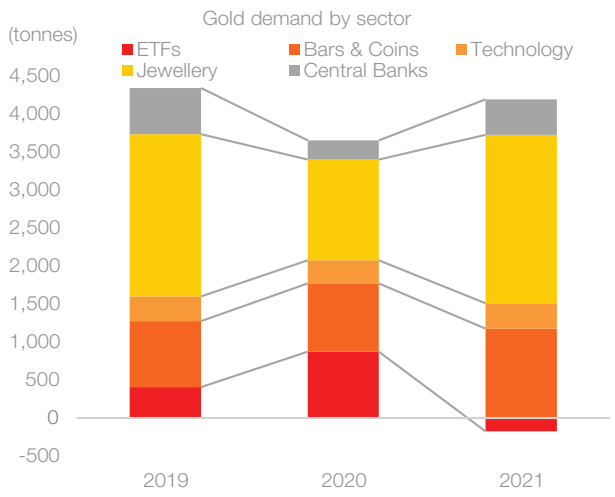
Source: Unsplash

10. Alternatives: Gold.

Joanne Goh
Strategist

Gold demand remained robust in 2021 despite a year of rising interest rates and a strong dollar. Indeed, diversified sources of demand helped support gold prices which stayed rangebound in the year. During the year, overall demand grew 10% and recovered to near 2019 levels. Demand from central banks were higher by 82% compared to 2020 levels, followed by jewellery fabrication 67%, bar and coin investment 31%, and technology 9%. However, ETF gold investors were less positive on gold in 2021, withdrawing 173 tonnes of gold, compared to a record purchase of 874 tonnes in 2020. We believe this is due to the strong performance in other risk assets such as bitcoin and equities, but this should turn around given the volatility seen in the latter two asset classes, as well as in bonds, thus driving safe haven demand to gold.

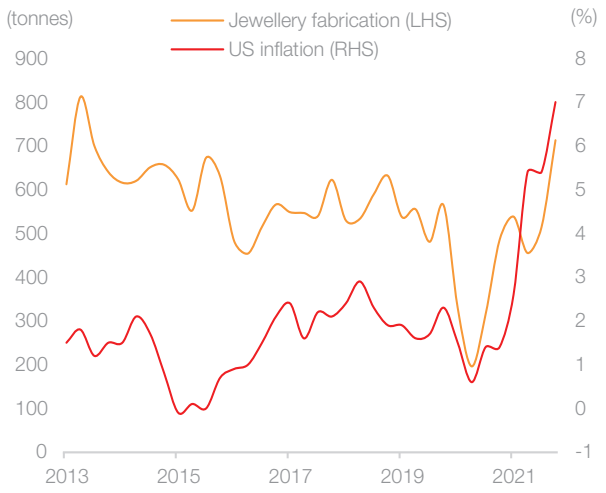
Gold that glitters — Fundamental demand returned in 2021



Source: Metal Focus, World Gold Council, Bloomberg

In particular, gold demand rose substantially in 4Q21, when inflation started to overshoot expectations. We expect inflation to stay elevated in the near term, as a result of higher oil prices and global supply chain disruption, amid demand-pushed inflation arising from a strong post-pandemic recovery. This should sustain the demand for gold, as an inflationary hedge while discretionary spending on gold jewellery should remain strong.

Jewellery sales is a post-pandemic and inflation play



Source: Metal Focus, World Gold Council, Bloomberg

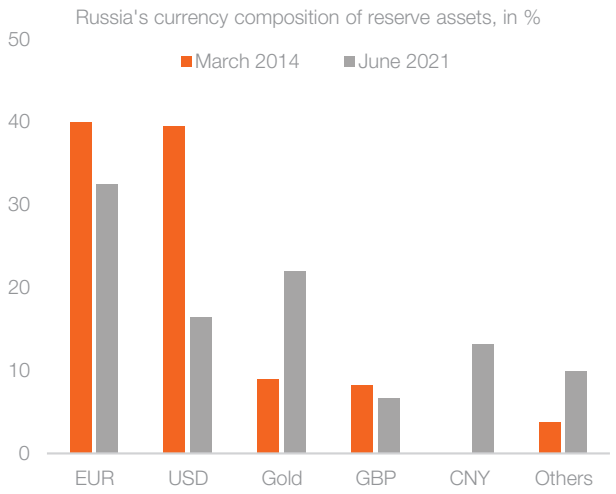
EM central banks hoarding gold

Russia-Ukraine tensions continue to keep a bid on gold's safe haven demand. Back in early 2014 when tensions first escalated, gold prices rose by USD100 or 7% in a month.

We believe that gold acting as an effective geopolitical hedge stems from the view that gold would prove to be useful for countries when they are faced with the threat of US sanctions. Notably, since 2014, Russia's gold reserves have surpassed US Treasury holdings, reflecting the appetite for gold as a currency diversification tool among EM countries amid heightened political tensions.

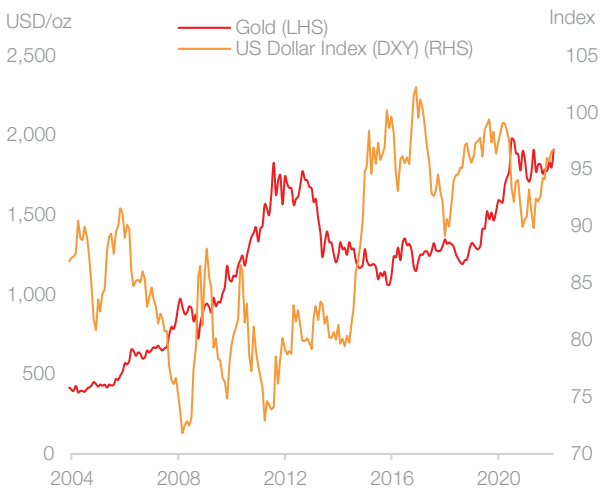
While remaining supported by demand for hedges in this volatile time, gold has strong upside potential should the dollar weaken. There are a few scenarios where we believe the dollar is unlikely to rise as much as last year. First, the market may have overly priced in aggressive six to seven Fed rate hikes; second, bond yields have exceeded the pre-pandemic level of 2%; third, although the ECB would be more patient than the Fed in normalising monetary policy, it is accelerating its QE tapering programme as inflation hit 5.8% in February; and fourth, rising inflationary risks would suggest growth slowdown later on, warranting the Fed to be mindful of policy missteps. Our long-term currency DEER model implies that the dollar is over-valued by 11.7%.

Central banks buy gold for reserve diversification



Source: Central Bank of Russia, IIF

Inverse relationship of gold vs DXY



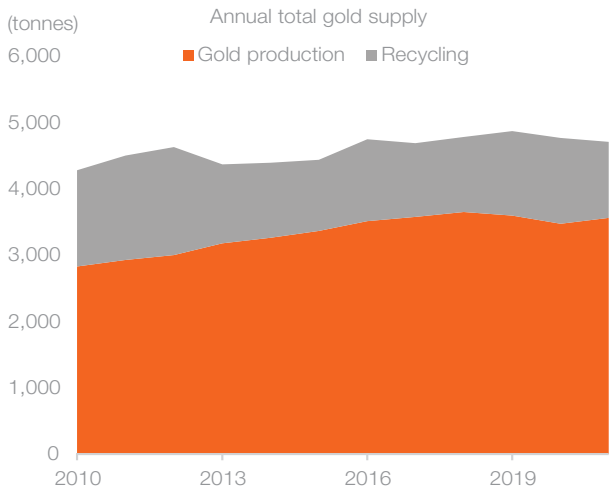
Source: Bloomberg, DBS


Source: Unsplash

Rising inflation, geopolitical risks, and a sharp selloff in equities drew net global gold ETF inflows in 2022 YTD. It is these diversified attributes of gold as effective hedges which support its demand.

Meanwhile, the supply of gold is still limited by gold's scarcity, as gold producers' project pipeline is increasingly short of large, high-quality assets needed to replace ageing major gold mines. Moreover, the pandemic has impacted exploration plans for mining companies in the past two years.

Gold supply flatlined



Source: Metal Focus, World Gold Council, Bloomberg, DBS

Gold's relative value appears cheap with tolerance for rate hikes

We test gold's relative value against its hedging qualities, measuring it against other comparable assets where gold is used as a store of value for inflation hedge (commodities), gold's relative asset pricing (SPX P/E), and gold's opportunity costs to other yields (combination of dividend yields, bond yields, and Fed funds rate).

Summary table of gold's relative value

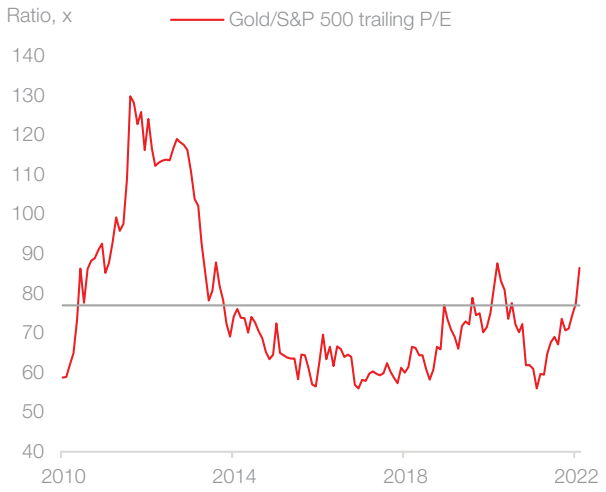
	Asset	Gold (overvalued/ undervalued)
Gold as inflation hedge	Commodities	-4%
	Real rates	-29%
	CPI	-2%
Gold as alternative asset	Equities	6%
Opportunity cost of Gold	Average yields	2%
Average		-5%

Source: DBS

The conclusions as highlighted in the summary table are:

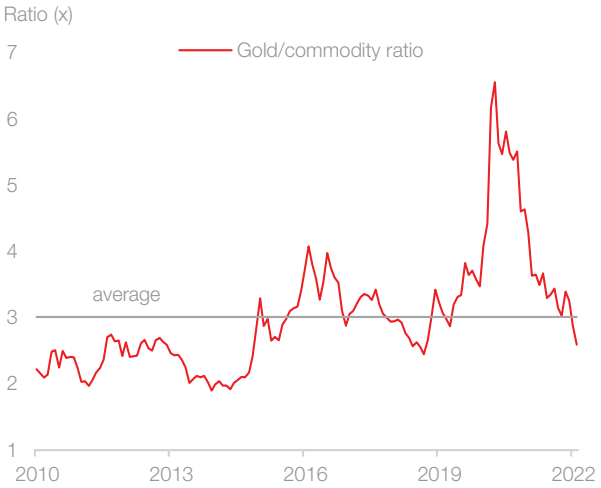
i. Gold is deemed as still undervalued vs other inflationary assets, especially with regard to real rates
ii. Gold does not look attractive as an alternative asset when compared to equities using S&P P/E
iii. Despite zero interest bearing, gold is only marginally overvalued when compared to other yielding instruments such as dividends, short-term Fed funds rate, and long-term bond yields
iv. Current gold is still undervalued by 5% when taking into consideration all these multifaceted attributes, which brings the fair value of gold price to around USD2,200/oz

Gold as an alternative asset is more expensive than equities



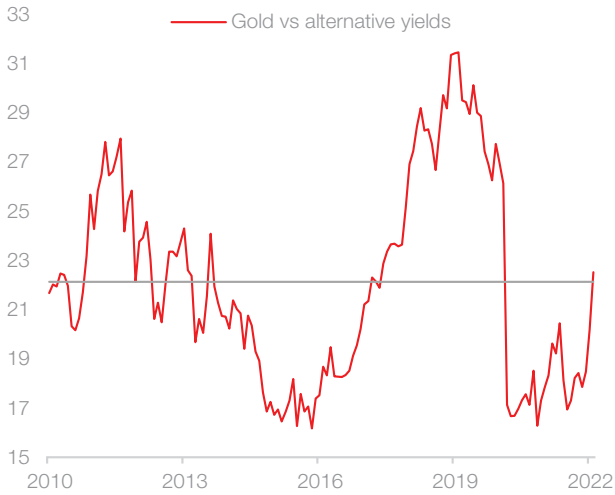
Source: Bloomberg, DBS

Gold as a store of value is cheaper than other commodities



Source: Bloomberg, DBS

Opportunity costs of gold expanded as yields rise

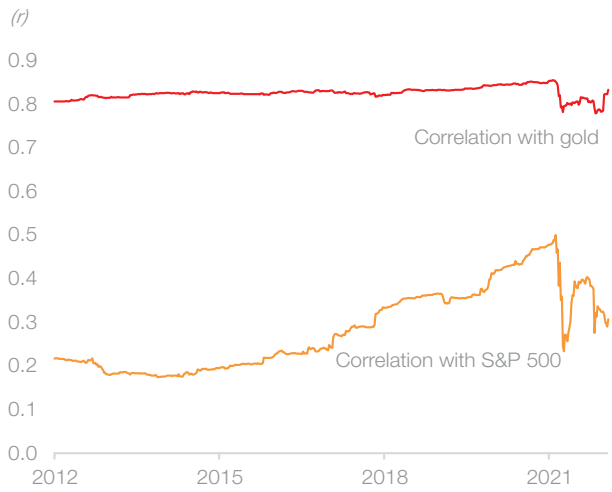


Source: Bloomberg, DBS

Gold mining stocks more correlated to gold price than S&P

Gold mining stocks as a leverage play on gold prices should be favoured in this rout of volatility as the sector is more correlated to gold price than the S&P. Miners' earnings are sufficiently well protected at the gold price of USD1,800 per oz with an all-in sustaining cash cost (AISC) of average USD1,200, given rising costs.

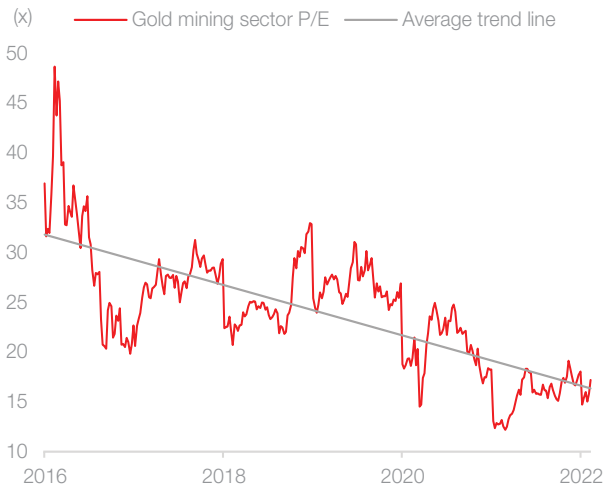
Gold mining sector's an attractive diversifier during market distress



Source: Bloomberg, DBS
* correlation calculated from 52-week rolling correlation of weekly returns

The sector has de-rated an average of 25x to 15x, as general investors ignored this obscured sector. We believe that with higher gold price and strong cash flow, the hunt for growth options through M&A will be back in focus in 2022.

Gold miners are ignored by investors



Source: Bloomberg, DBS

Investment summary

We recommend investors to hold gold and gold equities as risk diversifiers in a barbell portfolio. We upgrade our gold price forecast to reach USD2,200 by end of this year.

Growth Capital in Private Equity

ALTERNATIVES: PRIVATE ASSETS 2Q22

In addition to diversification merits, investors stand to benefit from access to a wider investment universe, exposure to growth sectors, and attractive returns with a modest loss ratio.

Source: Unsplash

11. Alternatives: Private Assets.

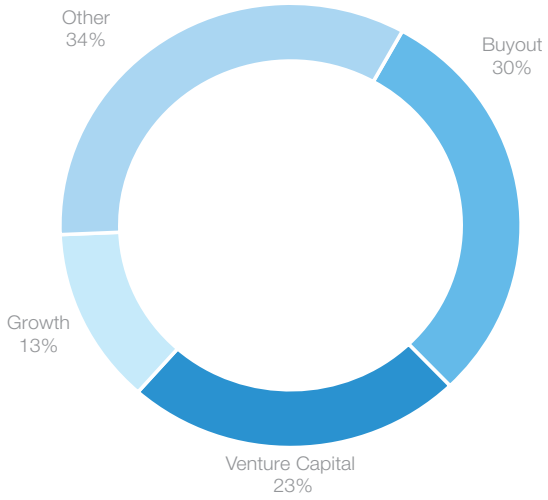
Beatrice Tan
Analyst

An oasis of calm in a volatile world. Global risk assets underwent unprecedented disruption in 2020 as a result of the pandemic. The PE space, however, remained an oasis of calm given its low correlation with traditional asset classes. With the prevalence of ample liquidity and structurally low interest rates, global investors are increasing their exposure to PE in a bid to enhance portfolio returns. This is particularly evident amongst pension funds, sovereign wealth funds, and family offices.

While buyouts have been the traditional focus of PE, the hunt for value-creation opportunities, combined with a business climate of positive disruption and transformation, has brought Growth Capital strategies into focus. Given the minimal use of leverage in the capital structure of the target companies, and the focus on significant expansion, Growth Capital is also commonly known as 'growth equity' or 'expansion capital'.

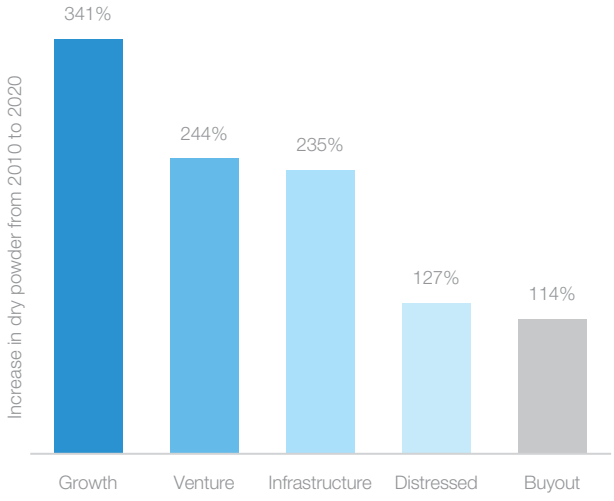
Over the past decade, funds have been seeking innovative new ways to create value and generate returns. Disruption to traditional business models, facilitated by technological advancements and catalysed by the pandemic, has further added vibrance to the growth investing space.

PE strategies by AUM



Source: Preqin Pro, DBS
(Based on data as at 30 Jun 2021)

Growth Capital is the PE strategy that has attracted the largest increase in dry powder



Source: Preqin, Thomson Reuters, SPACInsider, Bain Capital

Growth Capital – the vibrant intersection between venture capital and buyouts. As a fast-growing space straddling the middle ground between venture capital (investing in start-ups that are still developing a feasible product and pursuing early adopters) and buyouts (taking over mature companies with years of proven cash flow and profitability), Growth Capital exhibits some characteristics of both strategies.

Companies deserving of Growth Capital investments should already be successful businesses – this suggests a proven value proposition, commercially viable products and/or services, and customer acquisition strategies. However, this is not all. Importantly, Growth Capital targets must also have significant upside growth potential that can be realised with the aid of the capital injected by Growth Capital investors.

The realisation of such growth potential often comes from meeting untapped opportunities by expanding into new markets or scaling up within existing markets. When the target successfully expands, Growth Capital firms draw a profit by selling their stake at a handsome profit, either to other private investors or when the company goes public.

Structure of Growth Capital investments. A distinct feature of Growth Capital investments is the active role played by the existing management team of the target company. Growth Capital investment usually comes in the form of a large minority stake (usually up to 20%). Such a stake means that Growth Capital firms do not control the company – strategic and operational decisions remain with the company's existing management. Hence, a successful Growth Capital investment requires a competent, cooperative, and reliable management team. Growth Capital investors need to be able to trust management to successfully navigate the company through its next stage of growth using the additional capital injected.

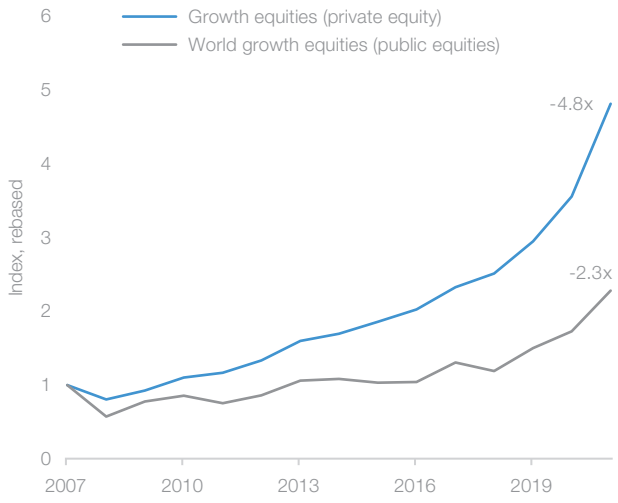
However, this does not mean that Growth Capital firms are necessarily passive investors. They may influence the company's decisions and work closely with the management. To this end, Growth Capital investments are typically accompanied by certain conditions required by the investor. Some essential conditions include a seat on the company's board of directors and/or rights to approve material decisions (e.g., key changes in expansion plans, acquisitions or divestitures, capital issuance, and changes in key employees).

The attraction of Growth Capital. In addition to diversification merits and returns exceeding that of listed equity investments, investors in Growth Capital also stand to benefit from the following:

- **Access to a wider investment universe** – Growth Capital gives investors access to a universe of growing companies, many of which are privately owned. In general, companies are opting to stay private for longer. This could be to retain flexibility, avoid regulatory and administrative costs associated with going public, or simply because the increasing amount of private capital available makes going public less necessary than before. According to Statista, the median equity raised by companies in the US before going public increased significantly over the past decade to USD167m in 2020, up from just USD67m a decade earlier. This suggests that the Growth Capital space is growing significantly, which in turn presents a wider universe of investment opportunities.

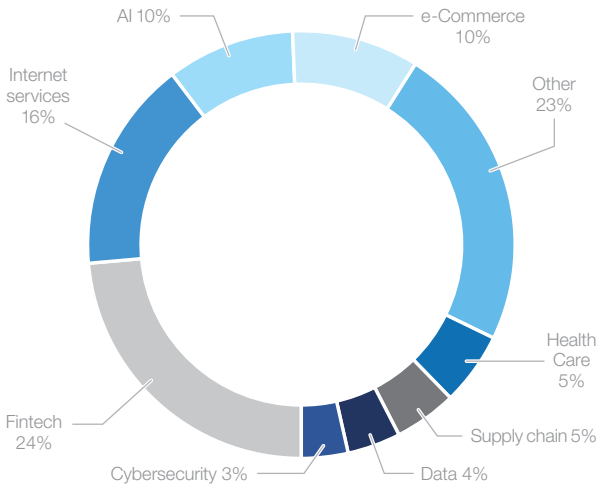
- **Exposure to growth sectors** – Growth Capital deals tend to be in fast-growing sectors that expand more rapidly than the broader economy. Such sectors include technology, healthcare, fintech and business services – all of which have historically produced significant number of "Unicorns" (i.e., private companies which have achieved billion-dollar-plus valuations). Such investment opportunities are not typically directly available to investors in the public markets. An investor seeking this profile of returns ought therefore to consider investing in Growth Capital funds.

Growth Capital gains momentum – Growth Capital index's NAV-based return PE vs market capitalisation of growth equities (public equity)



Source: Bloomberg, DBS

Successful Growth Capital deals: Valuation of Unicorns by sector



Source: CB Insights, DBS
(Based on data as at 31 Dec 2021)

- **Potentially attractive returns with a modest loss ratio** – Growth Capital offers a distinct risk-reward profile at the intersection of venture capital and buyout investments. On one hand, compared to venture capital investments, Growth Capital firms tend to exhibit lower capital losses because the target companies have already established traction and mitigated early-stage risks such as proof-of-concept or attracting early adopters. On the other hand, like buyout targets, Growth Capital target companies have established businesses. However, unlike buyouts which are typically highly leveraged, Growth Capital strategies involve minimal leverage. Rather than siphoning off cash flows to meet hefty interest and debt servicing obligations, almost all the capital can be dedicated to the expansion plan. This allows Growth Capital to enjoy greater upside potential than buyouts.

Risks of Growth Capital investing. Despite the attraction of Growth Capital investing, investors should also keep in mind the following risks that may impede the performance of Growth Capital:

- **Execution of expansion plan** – The increase in investment value depends on successful execution of the company's expansion plan. This comes with inherent risks. To mitigate this uncertainty, investment firms must assess each possible Growth Capital target shrewdly prior to investing. Resources must be dedicated to evaluating the feasibility of management's expansion plan and independently measure the growth potential of the company.
- **Cooperation with existing management and investors** – In addition to the company's founders and management, Growth Capital firms may also need to cooperate with investors from earlier funding rounds. To mitigate the risks of stakeholder conflicts derailing a successful investment, astute fund managers should ensure that stakeholders are aligned on the company's mission and roadmap prior to selecting a target. They should also select targets with which their investment firm has synergies, to meaningfully contribute to the expansion plan.

Value-add of Growth Capital investors. Most ideal targets are already established and cash generating businesses. Such companies usually do not actually need the additional equity to continue operating successfully. These companies are at an inflection point, faced with the decision whether to (1) continue using the existing capital, reinvesting retained profits to grow the business steadily, or (2) receive growth investment and accelerate its growth path. This creates a symbiotic relationship between investor and target, and it is contingent on Growth Capital investors to prove their value before a company accepts their investment.

Non-capital value-add is what differentiates one Growth Capital firm from another. The more value-added competencies a firm brings, the more attractive it will be as an investor. These competencies include an ecosystem network, and resources and expertise to navigate obstacles. The more value-add the investor brings, the more influence it will have in the company's decisions.

Picking a suitable Growth Capital fund. There is a growing presence of investment firms offering Growth Capital exposure. Other than PE firms, late-stage venture capital firms, hedge funds, and mutual funds also provide investors with options to invest in this space. When selecting a Growth Capital fund to invest in, investors would do well to consider the following:

- **Resourceful and well-connected fund managers** – Deal sourcing and evaluating the suitability of targets may take years of building relationships with the management teams of potential targets and understanding their business philosophy. For existing investments, fund managers must also have the resources to be actively involved and meaningfully influence growth of the companies.

- **Core competencies and track record** – The firm should possess competencies in one or more key areas to complement the expansion needs of businesses. Examples of such areas include M&A, IPO, process improvement, market entry etc. The firm should exhibit a track record of successful deals within its area of focus.

- **Scale of the overall investment firm** – Scale is often linked to the success of a Growth Capital fund. Having sufficient scale ensures the requisite resources to canvass the market for deals to originate, a wider business network, and a wider range of competencies.

In conclusion, Growth Capital serves as a vibrant addition to an investor's existing PE exposure that exhibits a distinct risk and return profile. Astute fund managers' careful selection of suitable Growth Capital targets allows investors to benefit from the expansion plans of already successful businesses, providing growth potential even during cyclical headwinds.

Global Healthcare - Defensive Growth

THEME – GLOBAL HEALTHCARE (PART II)

The Healthcare sector represents 15% of global equities and demonstrates stable and secular growth characteristics. This quarter, we focus on orphan drugs and how pharmaceutical firms benefit from this important development.

Source: Unsplash

12. Global Healthcare (Part II).

Yeang Cheng Ling
Strategist

In 1Q22, we discussed the positive long-term outlook of the healthcare sector. This quarter, we deep dive into the orphan drug subsector and how pharmaceutical firms benefit from this important development.

As the saying goes, health is wealth. The Healthcare sector accounts for c.15% of the global equities benchmark, and demonstrates stable and secular growth characteristics. Thus, we continue to firmly advocate investing in the sector due to its characteristic of "defensive growth". This defensive nature arises from relatively low price elasticity for medical products and services. Growth is driven by rising end demand and constant increase in medical remedies and solutions.

"Healthy citizens are the greatest asset any country can have"
Winston Churchill

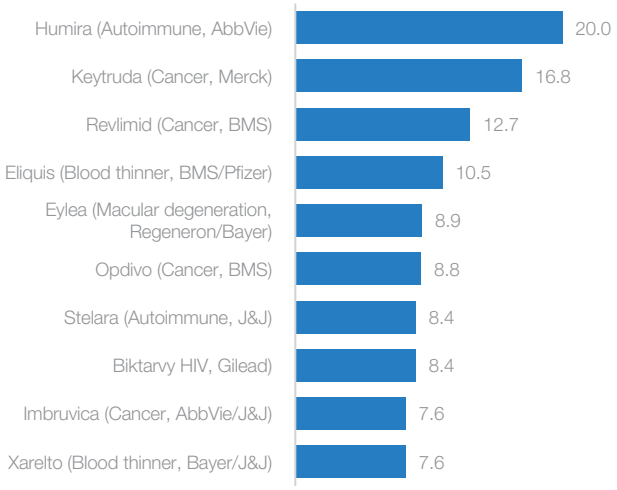
The future of global healthcare. Healthcare firms have achieved significant progress in creating better cures for life-threatening diseases; and providing all-inclusive healthcare solutions. The sector's future remains bright driven by wide range of secular factors.

The role of healthcare organizations is evolving to providing solutions rather than merely selling products. The sector's dynamic progression along the healthcare value chain will include emphasis on life sciences and orphan drugs, evolution of equipment and devices, strategic M&A opportunities, expansion of balance sheet strength, product diversity, digital transformation, and sustainable profitability.

Healthcare firms have more than patented drugs. Industry leaders will continue to enjoy revenue generated from their core branded products, especially in blockbuster drugs where these firms have pricing power, global presence, and patent privileges.

For example, the 10 bestselling drugs were projected to generate sales value of USD110b in 2021. Although this annual figure appears huge at first glance, it accounts for a mere 16% of the combined revenue of the top 15 (ranked by index weight) pharmaceutical and biotech firms, demonstrating the sector's well-diversified revenue composition and low dependency on a single product. Besides portfolios of core drugs, the firms typically have a wide range of remedies that play equally important roles in recurrent income generation.

Bestselling drugs in 2021 (USDb)



Source: EvaluatePharma, DBS
* BMS – Bristol Myers Squibb

Orphan drugs: A new frontier. Orphan drugs are drugs that can treat rare diseases; their development is supported by government funding and regulations like the Orphan Drug Act of 1983 in the US. Similar legislation was subsequently adopted by Japan in 1993 and the EU in 2000. Such regulatory support had seismic implications for the development of orphan drugs in the decades that followed.

It is not uncommon for government agencies to initiate medical innovation and drug development during critical times, usually by data sharing, licensing privileges, and financial support.

With some 7,000 rare diseases impacting 400m people globally and counting, orphan drugs are playing increasingly important roles in saving lives. It is therefore crucial that effective treatments be developed and made available.

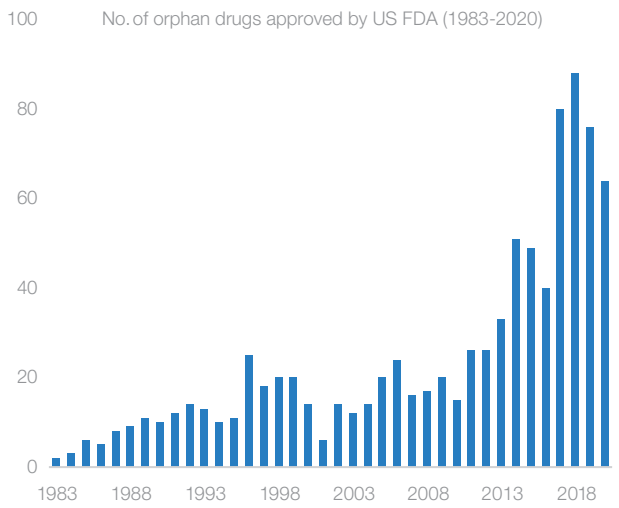
The winners are once again sector leaders which develop and commercialise these orphan drugs, as they have the financial means, technical knowhow, biomedical database, R&D capability, and thus patent ownership.

Since the early 80's, the number of orphan drugs designations granted by the US FDA has been on the rise, with some becoming mainstream cures for rare diseases. At the going rate, orphan drugs are on track to play a larger role in saving lives in the future.

Other driving factors include the emergence of rare diseases and the dire need to treat them where existing remedies fall short, as well as technological advancement in the development of such cures. For example, the use of gene sequencing, antisense therapy (to treat neurodegenerative and neuromuscular disorders), and data analytics have played an important role in the discovery of new types of orphan drugs.

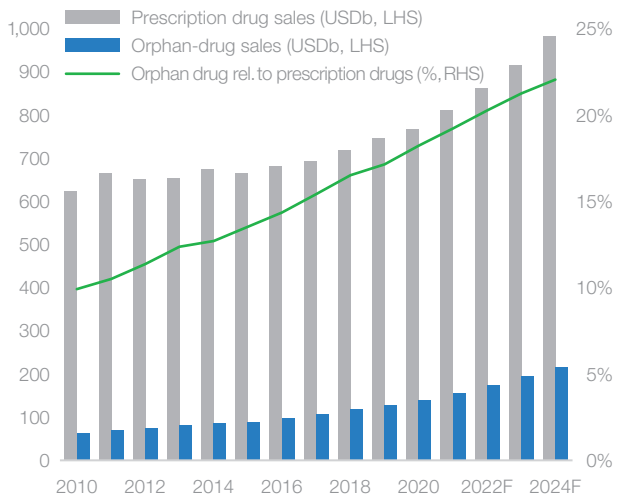
Backed by more advanced R&D capabilities, credible track record, large pool of proven data, capacity for large-scale clinical trials, and superior financial resources, large healthcare firms will remain at the forefront of identifying new solutions, dominating the pole positions in orphan drug development.

Rising orphan drugs approval by the US FDA



Source: US FDA, Pharmaboardroom, DBS

Orphan drugs are an important remedy



Source: EvaluatePharma, DBS

The development of orphan drugs is highly rewarding. At times, orphan drugs could end up being the stepping stones for larger-scale patented drugs development that eventually give rise to new commercialisation opportunities.

A huge and rising addressable market. Half a century ago, there were limited cures for patients who suffered from rare diseases until orphan drugs were officially recognised by the authorities. The Orphan Drug Act has supported the development of new remedies to tackle rare diseases which were then deemed commercially and financially unattractive among healthcare firms. This policy kickstarted incentives for the pharmaceutical firms to research and develop cures for rare illnesses.

Global sales of orphan drugs reached USD62b in 2010, equivalent to 10% of the sales of patented drugs. The growth of orphan drugs sales is forecast to outstrip that of the latter and presents a mammoth TAM of more than USD200b by 2024, an amount equivalent to 22% of patented drugs.

In parallel, the total annual orphan drug sales among the top 10 drug makers are forecasted to reach USD120b by 2024. The manufacturers and leading developers of orphan drugs are principally the major pharmaceutical firms, which also dominate the scene of patented drugs. At projected annual market value of USD217b by 2024, orphan drugs will become a large enough business to attract healthcare industry leaders to further plough in enormous R&D expenditure into this segment in bids to expand their remedy offerings.

Based on a study by the University of Michigan, treatment of rare diseases accounted for 30% of orphan drugs revenue while the remaining 70% was generated from the use of orphan drugs in treating common illnesses. This shows that orphan drugs have a much larger, but currently unrecognised, effective TAM in treating regular illnesses. In parallel, orphan drugs currently only cover less than 10% of rare diseases, and this clearly indicates the potential of this market segment in the healthcare industry for years to come as their use continues to expand.

There are several reasons for industry leaders to develop orphan drugs:

1. Higher probability of success as they use targeted genetic approaches in their R&D processes
2. Little or zero competition
3. Marketing exclusivity
4. Attractive financial incentives
5. Accelerated regulatory review
6. Support from authorities
7. Higher price tag
8. Shorter development cycles

Essentially, orphan drugs are a profitable business. Based on a study done by the University of Liverpool, firms with marketing exclusivity for orphan drugs are more profitable than those without. Of late, the list of countries that offer regulatory incentives for the development of orphan drugs has expanded further; it includes countries and regions such as the US, Europe, Japan, Australia, South Korea, Brazil, and India.

In the US, orphan drugs are granted commercial exclusivity of seven years and may receive additional extension after the expiration of exclusivity. In the UK, commercial exclusivity is longer at 10 years. Such factors are tailwinds in favour of the ongoing development of orphan drugs.

The 10 bestselling orphan drugs are expected to generate more than USD50b of annual revenue in 2024. With rising awareness of rare diseases and availability of orphan drugs, more patients will be treated, increasing the revenue outlook of this segment.

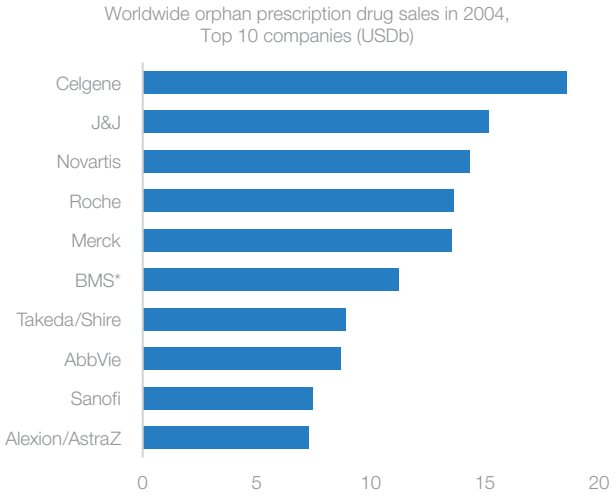
For example, to seize the opportunity of orphan drugs for a variety of immune-mediated rare diseases, AstraZeneca acquired Alexion in a deal worth USD39b, making it the largest healthcare deal in 2020. Similarly, Shire was acquired at a hefty price tag of USD81b by Takeda for access to rare disease development among other strategic reasons.

Evidently, orphan drugs and the treatment of rare diseases are increasingly becoming mainstream businesses for large healthcare firms. In the long-term, this development will be highly sought after.

Secular drivers for healthcare breakthrough. Besides developing new drugs and advanced remedies, we anticipate the future growth drivers of the healthcare industry to be multi-pronged and abiding. The key potential areas include:

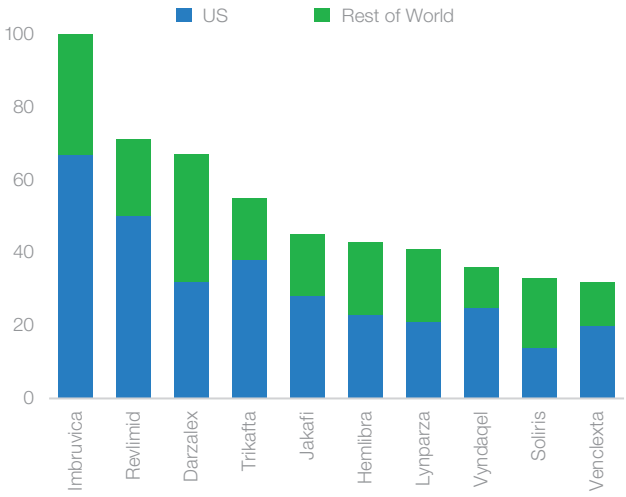
1. Preventive therapies and early detection
2. Immunology
3. Remedy for new infectious diseases
4. Artificial intelligence applications to track and predict occurrence

Projected prescription sales of orphan drugs in 2024, top 10 companies (USDb)



Source: EvaluatePharma, Pharmaboardroom, DBS
*BMS: Bristol-Myers-Squibb

Projected annual sales of the top 10 orphan drugs in 2024, by type (USDb)



Source: EvaluatePharma, DBS

5. Data-driven approaches in facilitating clinical trials for better efficacy
6. Post-treatment patients monitoring and bespoke personal care
7. Customisation of curative treatments
8. Precision equipment in robotic surgery, nanotechnology, and tissue engineering
9. Predictive intelligence in R&D outcomes
10. Digital and virtual platforms in doctor-patient interactions

Source: Tribecaknowledge.com, DBS

With a strong demand-supply backdrop, conducive policy support, pandemic situation, surging demand for holistic healthcare services, and innovation, healthcare firms will continue to invest heavily to capture the secular long-term uptrend.

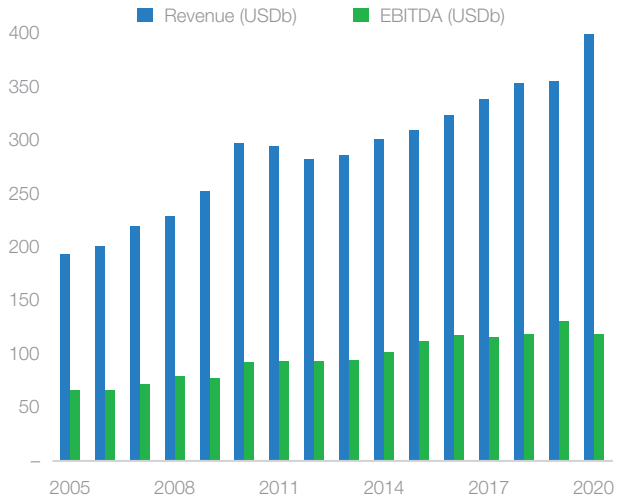
Robust revenue and profitability. Another distinct feature of the Healthcare sector is its admirable earnings quality and stability. For more than two decades, the sector has consistently produced earnings outcome that were ahead of expectations, further supporting our constructive perspective to stay invested in this sector.

Over economic and financial cycles in past decades, healthcare earnings have stayed unscathed. Based on data since 2000, an average 70% of firms delivered positive earnings surprises as opposed to 20% that reported negative surprises. This solid trend has been remarkably consistent throughout, further justifying healthcare as one of the preferred sectors over the long term.

We analysed the financials of leading healthcare firms in the US and Europe. Over the past 16 years between 2005 and 2020, they have exhibited steady revenue and EBITDA trends with low volatility in earnings, even during financial and economic crises. US firms showed steady uptrends in revenue and EBITDA; similarly, Europe firms demonstrated resilience over the same period.

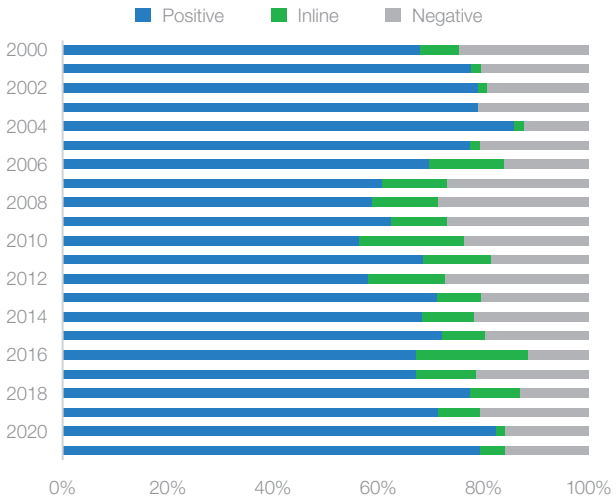
From the charts, EBITDA margins remained stable at around 30%. This is thanks to rising demand, development of new remedies and solutions, unwavering pricing power, as well as patent protections. Sustainable profitability enables the sector and its players to maintain their commitments in endless and massive R&D spending to continue rolling out patented and orphan drugs.

Combined revenue and EBITDA of leading US healthcare firms (2005-2020)



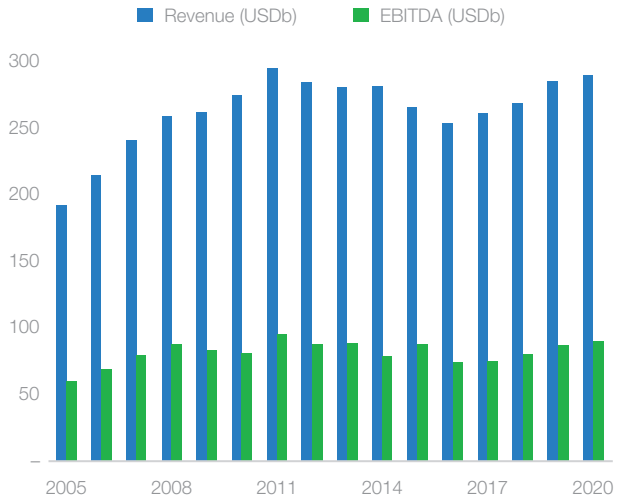
Source: Bloomberg, DBS

Credible ability to deliver positive earnings



Source: EvaluatePharma, DBS

Combined revenue and EBITDA of leading EU healthcare firms (2005-2020)



Source: Bloomberg, DBS


Source: Unsplash

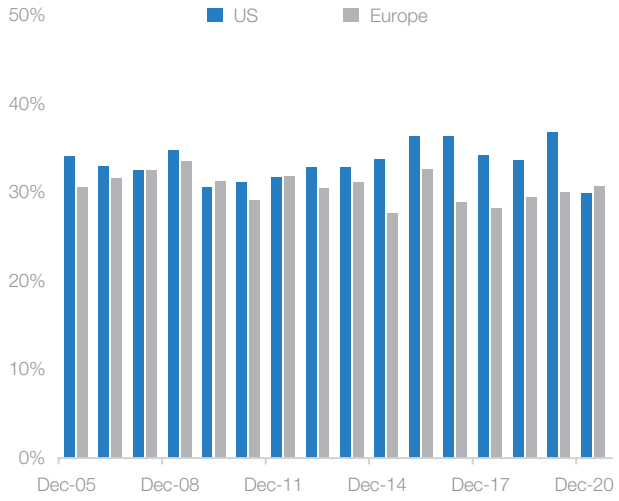
Investment in Healthcare brings – "defensive growth". Healthcare is a distinctive industry that will continue to enjoy revenue and earnings uptrend over economic cycles. The revenue and forward earnings were further upgraded at the start of 2022, which will be a tailwind in supporting the sector's future share price performance. Using 2005 as the base year, the earnings of healthcare firms have largely outgrown global equities without undergoing any obvious mid-cycle obstruction, owing to its "defensive growth" nature.

Industry leaders are in favourable positions to dive deeper into developing new methods to diagnose, prevent, treat, and cure unknown diseases. Hence, farsighted investors who capture this theme will be rewarded.

Evidently, the sector offers superior shareholder returns on both absolute and relative basis. Its forward ROE consistently expanded to 30% from 20% over the past 10 years, demonstrating healthcare firms' ability to generate greater profitability, give superior shareholder returns, and utilise capital efficiently.

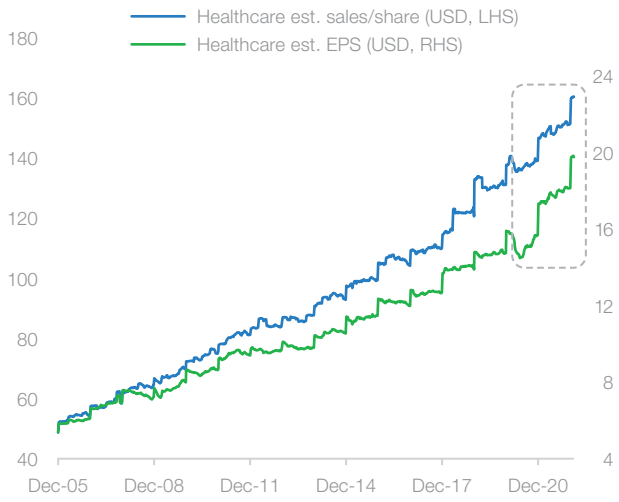
Given the distinct characteristic of "defensive growth" – robust and solid earnings potential while remaining defensive in nature – the sector's valuation discount to global equities is not justified. We expect the valuation discount to normalise in reflection of the sector's unique and superb fundamentals, which include resilience and growth in earnings, global reach, and their fundamental importance to existing and future generations.

Healthcare firms command stable EBITDA margins (2005-2020)



Source: Bloomberg, DBS

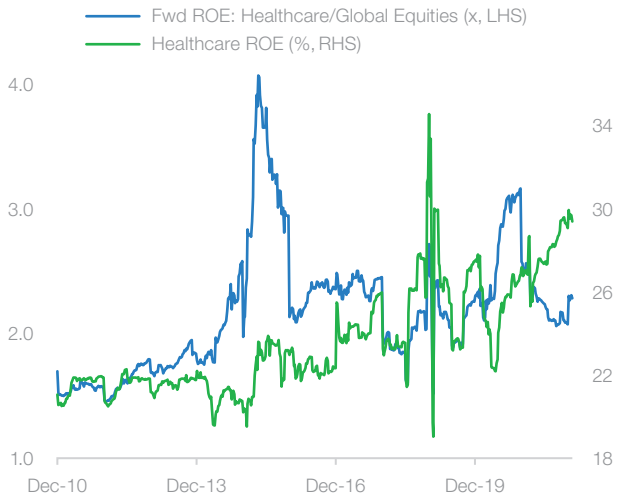
Solid earnings in Healthcare sector



Source: Bloomberg, DBS

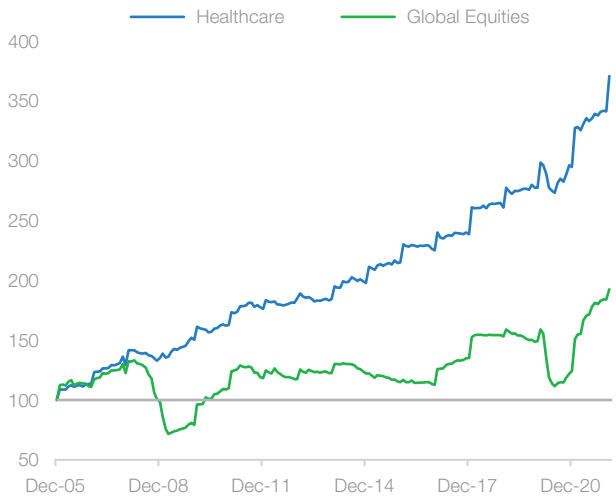
Additionally, the discovery of antivirals and new remedies will reshape the global healthcare industry. The world undoubtedly needs better drugs, vaccines, cures, equipment and tools, and credible healthcare solutions. This further supports our long-term investment thesis on the Healthcare sector as a long-term key holding in the Growth side of the Barbell Strategy.

Attractive shareholders returns



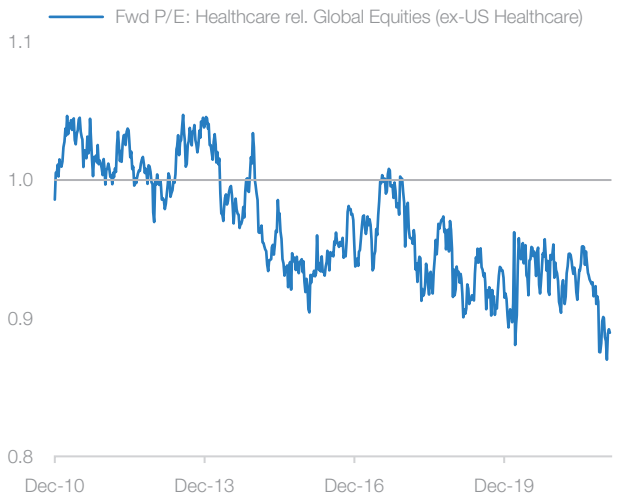
Source: Bloomberg, DBS

Earnings growth outpaced global equities (2005 = 100)



Source: Bloomberg, DBS

Valuation discount is unjustified



Source: Bloomberg, DBS

ESG: Opportunities in Decarbonisation

SPECIAL FEATURE – ESG: OPPORTUNITIES IN DECARBONISATION

Transitioning to a low carbon economy requires a radical overhaul of the energy system, transport system, and many other aspects of the global economy. The massive scope of change affords numerous opportunities for investors to consider.

Source: Unsplash

13. ESG: Opportunities in Decarbonisation.

Ninety One

Why does decarbonisation matter?

Decarbonisation is the process of reducing carbon emissions to limit the impact of climate change. It is crucial because the world is currently on track for average temperature rises that will have severe environmental, social, and economic consequences. For investors, decarbonisation matters because transitioning to a low-carbon economy requires a radical overhaul of the energy system, transport system, and many other aspects of the global economy. To illustrate the changes required, a recent International Energy Agency (IEA) Report highlighted that we need to invest over USD4t annually in clean energy by 2030 to get to net-zero by mid-century – a huge increase from the approximately USD1t spent over the last few years[1].

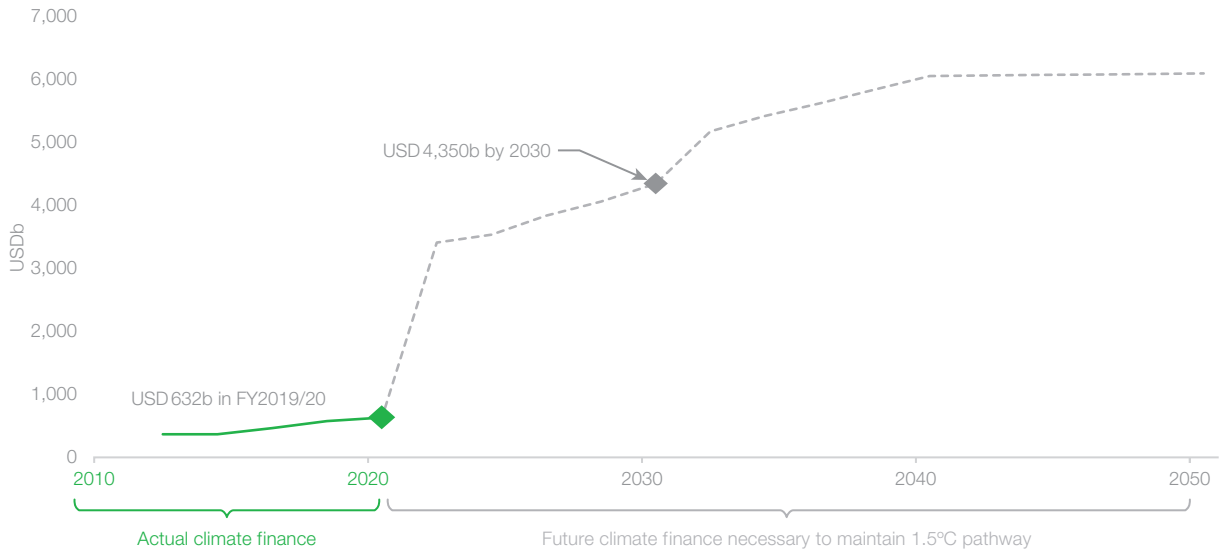
Decarbonisation is now a mainstream investment priority

Decarbonisation is a powerful and potentially valuable structural growth trend. The speed at which climate-related developments are occurring — across policy, technology, and consumer trends — is accelerating. There are not many growth stories that include "human survival" among their drivers.

1. Policies support the move to a low-carbon world

   Many people thought climate targets would be shelved when the pandemic struck. In fact, the opposite happened as governments ramped up their environmental plans, partly to stimulate their economies. China, Japan, and South Korea

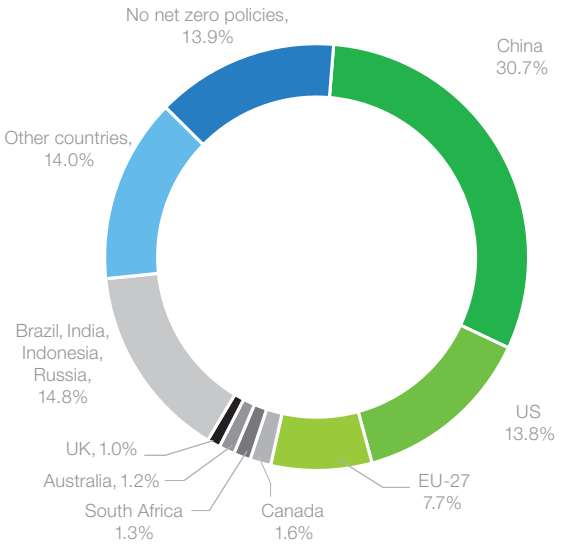
Globally tracked climate finance flows and the average estimated annual climate investment need through 2050



Source: Climate Policy Initiative Global Landscape of Climate Finance 2021 – December 2021

[1] Source: International Energy Agency, Net Zero by 2050 - A Roadmap for the Global Energy Sector.

Drivers of decarbonisation



c.86%

Total share of global emissions accounted for by net-zero pledges (including policies, declarations, pledges, and proposals)

Source: Emissions Data from BP, countries determined as "net zero" from Energy & Climate Intelligence Unit (ECIU), as of 31 December 2021

committed to "net-zero" in 2020, while the EU focused its Covid-recovery strategy on green sectors. In addition, the Biden administration has set an ambitious agenda to mitigate climate change, including new commitments on infrastructure, wind energy, and energy-efficient homes.

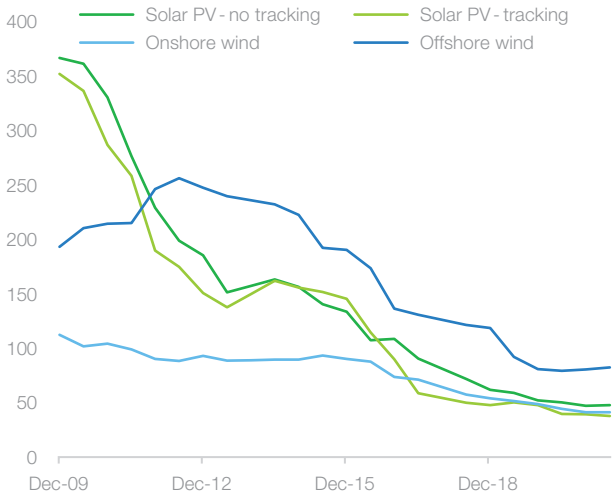
2. Clean-tech innovation and cost deflation are continuing

New and more cost-effective technology has brought us to a point where solar and wind energy are often cheaper than the old primary energy sources, notably coal. Increasingly, the near-term economics of "green" technologies support the ecological and moral imperative to push decarbonisation further, faster. We believe clean-tech prices have further to fall, reinforcing the competitiveness of renewable power sources.

3. Consumer behaviour is changing

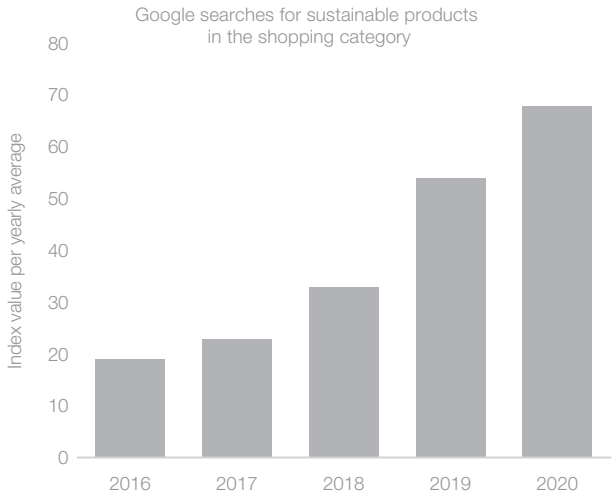
Consumers are increasingly concerned about climate change and are altering their behaviour. An Economist Intelligence Unit (EIU) report indicates that the number of Google searches for sustainable goods increased by 71% between 2016 and 2020. Another report conducted by Harvard Business Review in 2019 showed that 41% of Chinese consumers want eco-friendly products, while the sale of organic products in India has grown by 13% since 2018.

Levelised cost of energy – wind and solar



Source: Bloomberg BNEF, IEA, as of June 2021

Google searches globally for sustainable products in the "shopping" category – WWF and EIU



Source: WWF and EIU report 2021: "An Eco-wakening"

The three paths to decarbonisation

When discussing allocating to decarbonisation, many investors often think of wind and solar farms, or electric-car manufacturers. But the range of companies required to reduce global emissions is much broader than that, encompassing businesses in sectors as diverse as chemicals, software, semiconductors, logistics, and waste management. Indeed, it is important to consider not just the direct beneficiaries of the energy transition, but the entire supply chains that need to be built around them. For example, to deliver the many millions of lithium-ion batteries required to electrify transportation and balance out intermittent renewables, we need to invest not only in battery manufacturing, but also in battery metals (lithium, nickel, cobalt and copper, among others), the power semiconductors, and power electronics required to manage those batteries.

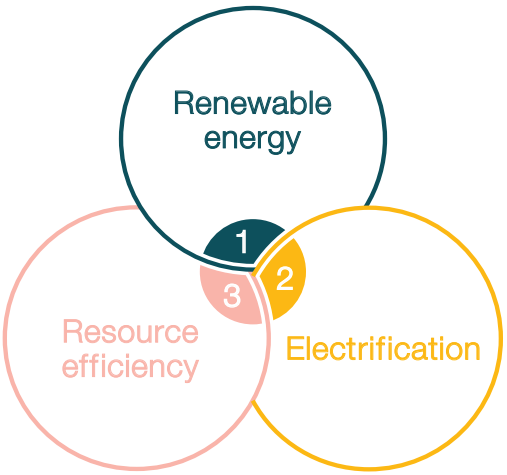
From a regional perspective, some portfolios that focus on climate change tend to direct most of their investments towards the developing world. In our view, EM offer huge potential for investors in decarbonisation. Certain companies in China in particular, are global leaders in technologies that are crucial to efforts to tackle climate change. We must also remember that we will not achieve our climate goals unless the developing world also decarbonises: the majority of carbon emissions today and 90% of emissions growth come from EM. Investment is crucial to help EM successfully transition to a low-carbon economic model, yet the decarbonisation funding gap is most acute in developing countries.

At the broadest level, the decarbonisation investment opportunity set can be described as encompassing three pathways to a low-carbon future: 1) renewable energy, 2) electrification (of transport and industrial processes etc), and 3) resource efficiency. A diverse group of companies is needed to drive the global economy down these pathways, spanning multiple sectors and regions. A spread of market capitalisations is also needed, but generally with higher-than-average growth rates. The table below provides an overview of the breadth of opportunity available to investors. It highlights areas such as agriculture, factory, and building efficiency, which are increasingly important in the decarbonisation story.

Case study: Vestas Wind Systems[2]

Vestas is the world leader in wind-turbine manufacturing. Sustainable decarbonisation will require a complete change in how we generate electricity, with a move away from fossil fuels and towards renewable energy, mainly wind and solar. The IEA's net-zero pathway calls for scaling up wind rapidly this decade. Wind capacity will need to increase 4x by 2030 and 11x by 2050, reaching annual additions of 390GW by 2030 (from 114GW in 2020). In addition, repowering, which is still at a nascent stage, centred around Europe and the US, will support a continuous high level of activity in more mature markets.

Opportunities in decarbonisation



1 Renewable energy	2 Electrification	3 Resource efficiency
Solar	Electric vehicles	Waste management
Wind	Autonomous vehicles	Homes and buildings
Clean Power Utilities	Industrial electrification	Agriculture
Smart grids	Hydrogen economy	Consumer products
Networks	Heating and cooling	Factories

Source: Ninety One

Case study: Zhejiang Sanhua Intelligence Controls[2]

Zhejiang Sanhua Intelligence Controls is a leading global supplier of heating, ventilation, and air conditioning (HVAC) components, as well as automotive heat-management systems. Sustainable decarbonisation will require a rapid transition in both the auto and HVAC sectors, away from internal combustion engines and traditional HVAC equipment to EVs powered by renewable energy and more efficient HVAC units.

Case study: Novozymes[2]

Novozymes is a biotech and specialty chemicals company that produces enzymes and microbes which serve as catalysts to start biological processes. End-consumer preference for environmentally friendly products is increasing and should further drive switching away from petrochemical-based, carbon-intensive products. Longer term, we could see premium pricing for biological alternatives over petrochemicals. Within food, beverage & human health, and agriculture, animal health & nutrition, customers are also increasingly being offered more environmentally friendly options, with biological solutions replacing fossil-fuel based products.

Investing in decarbonisation in a pandemic/post-pandemic world

We believe the long-term structural case for businesses that are positively exposed to decarbonisation remains very much intact. The market continues to underestimate the growth potential of decarbonisation companies in general, in our view. Consequently, we believe the valuations of select decarbonisation-linked businesses are still attractive, even after another strong year for global equities overall.

Within the universe of businesses that are contributing to sustainable decarbonisation, several sectors were impacted in 2021 by supply-chain disruptions, rising freight and energy costs, and shortages of semiconductors and other components. At the start of 2022, with energy prices remaining high and continuing uncertainty over the omicron variant, these issues remain near-term challenges for a number of climate-solutions companies. We expect these headwinds to fade in the coming months, though the timing of this is difficult to predict.

From a longer-term perspective, the journey towards net-zero is still only in its early stages, and decarbonisation will need to accelerate significantly to get anywhere close to the carbon targets set in the Paris Agreement. Given this, we continue to see a substantial opportunity for long-term investors in decarbonisation. But we would emphasise that market moves in 2021 highlight the importance of an active, diversified, valuation-focused, research-intensive approach to this area.

2 For illustrative purposes only. This is not a buy, sell, or hold recommendation for any particular security.

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Glossary.

Acronym	Definition
ADR	American depositary receipt
ASEAN	Association of Southeast Asian Nations
AUM	Assets under management
AxJ	Asia ex-Japan
bbl	barrel
BI	Bank Indonesia
BNM	Bank Negara Malaysia
BOC	Bank of Canada
BOE	Bank of England
BOJ	Bank of Japan
BOK	Bank of Korea
BOT	Bank of Thailand
BSP	Bangko Sentral ng Pilipinas
bpd	barrels per day
CGB	China Government Bonds
CPI	consumer price index
DM	Developed Markets
DXY	US Dollar Index
EBITDA	earnings before interest, tax, depreciation, and amortisation
EC	European Commission
ECB	European Central Bank
EM	Emerging Markets
eop	end of period

Acronym	Definition
EPFR	Emerging Portfolio Fund Research
EPS	earnings per share
ERP	equity risk premium
ESG	Environmental, Social, and Governance
e-Sports	electronic sports
ETF	exchange-traded fund
EU	European Union
EV	electric vehicle
FOMC	Federal Open Market Committee
FX	foreign exchange
GDP	gross domestic product
GFC	Global Financial Crisis
HIBOR	Hong Kong Interbank Offered Rate
HKMA	Hong Kong Monetary Authority
HY	high yield
IC	integrated circuit
IG	investment grade
IMF	International Monetary Fund
IPO	initial public offering
IRS	interest rate swap
ISM	Institute for Supply Management
IT	Information Technology
JGB	Japanese Government Bond

Acronym	Definition
KTB	Korea Treasury Bonds
LATAM	Latin America
M&A	Mergers and acquisitions
MAS	Monetary Authority of Singapore
mmbpd	million barrels per day
NATO	North Atlantic Treaty Organisation
NAV	net asset value
NGL	Natural gas liquids
NIM	net interest margin
OECD	Organisation for Economic Co-operation and Development
OIS	overnight indexed swap
OPEC	Organization of the Petroleum Exporting Countries
OPM	operating profit margin
PCE	personal consumption expenditure
P/B	price-to-book
P/E	price-to-earnings
PBOC	People's Bank of China
PE	Private Equity
PMI	purchasing managers' index
PPI	producer price index
PRR	price-to-research ratio
QE	quantitative easing
R&D	research and development
RBA	Reserve Bank of Australia
RBI	Reserve Bank of India

Acronym	Definition
RBNZ	Reserve Bank of New Zealand
REIT	real estate investment trust
RM	relationship manager
ROA	return on asset
ROE	return on equity
RRR	reserve requirement ratio
SAA	Strategic Asset Allocation
SBV	State Bank of Vietnam
SD	standard deviation
SNB	Swiss National Bank
SOE	state-owned enterprises
SOFR	Secured Overnight Financing Rate
SORA	Singapore Overnight Rate Average
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TAA	Tactical Asset Allocation
TAM	total addressable market
UCITS	Undertakings for Collective Investment in Transferable Securities
UN	United Nations
US FDA	United States Food and Drug Administration
UST	US Treasury
WTI	West Texas Intermediate
WWF	World Wildlife Fund
YTD	year-to-date
YTW	yield to worst

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