CIO Perspectives

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Hou Wey Fook, CFA
Chief Investment Officer

DBS Chief Investment Office

Key Points

- Markets entered "capitulation mode" with broad-based selloff in risk assets despite Fed Chair Powell downplaying the plausibility of a 75 bps hike this year
- In spite of headwinds arising from Fed hawkishness, we see light at the end of the tunnel given:
  - Aggressive rate hikes priced-in
  - Decelerating core inflation
  - Potential U-turn in Fed rhetoric
- Our defensive asset allocation stance pays off as Alternatives outperforms Equities and Bonds
- Stay invested with the Barbell portfolio approach with particular focus on:
  - Inflation Winners: Key beneficiaries of a rising inflation environment are Commodities, Energy Majors, and Singapore Real Estate Investment Trusts
  - Quality Growth Equities: Maintain preference for quality companies with strong market positioning and resilient earnings profile (eg. profitable Tech and Healthcare)
  - High Grade Credit: Focus on quality credit to reduce portfolio spread volatility, with DM IG markets demonstrating the lowest volatility historically under bear-flattening yield curves.

ASSET ALLOCATION

Focus on Inflation Winners and Quality Plays

Glass half full or half empty? Seeing light at the end of the tunnel. The respite in global risk assets post-FOMC meeting on Wednesday (4 May) – which saw Fed Chair Powell downplaying the plausibility of a 75 bps hike this year – proved short-lived. Markets have since entered "capitulation mode" with broad-based selloff in equities and corporate bonds. The S&P 500 lost 7.2% while the Technology-heavy Nasdaq index suffered heavier selldown of 10.3% as yield concerns weighed on growth equities. Bonds were not spared from the volatility either with US HY spreads widening 47 bps.

Clearly, investors' fears have reverberated across risk assets this year on concerns of Fed hawkishness in tackling multi-decade high inflation. Despite the prevailing headwinds, we see light at the end of the tunnel and our optimism is based on:

1) Aggressive rate hikes priced-in: Fed funds futures pricing shows that this hiking cycle is one of the most rapid in the last 30 years and this suggests that most of the aggressive hikes have already been priced-in.

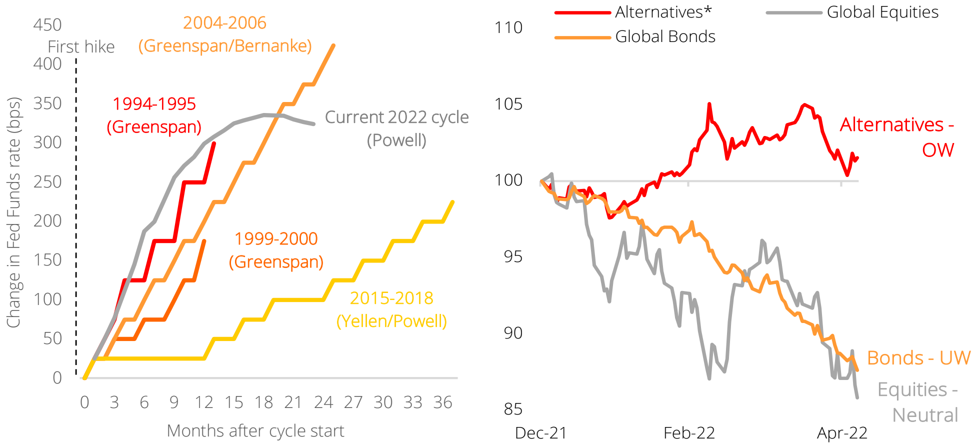
2) Decelerating core inflation: Stripping out the effects of higher food and energy prices, core inflation prints have already begun to show signs of deceleration, given the slowing global growth trajectory as well as moderating base effects.

3) Potential U-turn in Fed rhetoric: The present inflation is driven by supply chain disruption, labour force attrition, and exogenous oil shocks – all largely supply-related factors. Monetary tightening is more effective against demand-driven inflation and may not cure this inflationary episode with necessary precision. There is, therefore, a likelihood that the hawkish Fed rhetoric will reverse once fundamental realities begin to materialise in economic data.

Alternatives outperforming Equities and Bonds; Defensive CIO asset allocation reaping dividends. From an asset allocation perspective, our strategy of Overweighting Alternatives over Equities and Bonds has paid off in the current environment. Year-to-date, Alternatives* has gained 1.5% while global equites and global bonds lost 14.2% and 12.4%, respectively.

Gold, in particular, proved its resilience by registering a 3.0% increase. Within equities, our long-term conviction on the US has panned out marginally well as the market outperformed Europe and Japan by 1.8% pts and 0.3% pts, respectively.

Figure 1: Aggressive hikes priced-in; Alternatives outperforming equities and bonds



Source: Bloomberg, DBS
*Consisting of 50% Morningstar Diversified Alternatives Index and 50% Gold

Stay invested with Barbell Strategy – Focus on inflation winners and quality plays. We advocate portfolio allocators to stay invested with the Barbell portfolio approach (comprising growth equities, dividend equities, high grade credit, and gold as risk diversifier) to steer their investments during this period of extreme market volatility. From a top-down perspective, the key areas of focus will be on:

1) Inflation Winners: As we have highlighted in our report *CIO Vantage Point – Inflation Chronicles* (April 2022), the key beneficiaries of a rising inflation environment are (a) Commodities, (b) Energy Majors, and (c) Singapore Real Estate Investment Trusts (S-REITs).

   - In commodities, we believe oil, base metals, and gold will outperform given the supply shortage and energy transition narratives behind them. These factors will underpin prices in the commodity complex.
   - Energy Majors are geared beneficiaries of rising energy prices (a key contributing factor to the inflation surge that we see today). Another tailwind adding to the sector's resilience lies on its ability in maintaining stable earnings through the cycles, underpinned by structural factors such as the underinvestment in fossil fuels capacity.
   - Lastly, S-REITs also serve as a good inflation hedge given that rental and property values tend to rise in tandem with rising inflation. Importantly, the ability of S-REITs in paying dividends is less impacted by rising interest rates due to their reasonable levels of gearing.

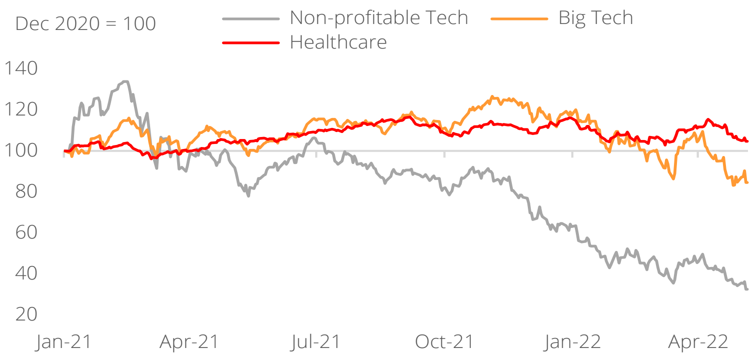
2) Quality Growth Equities: Growth equities have underperformed the broader market as a result of concerns on rising bond yields. However, we advocate investors maintain exposure to this space (such as Technology and Healthcare) to capture growth opportunities when macro conditions turn.

   We have a particular preference for quality companies with strong market positioning and resilient earnings profile as they are more likely to navigate a rising bond yields environment successfully. Since the start of the year, non-profitable Technology stocks have corrected c.60% while Big Tech and Healthcare remained resilient.

3) High Grade Credit: The dual headwinds of tighter monetary policy and modest growth outlook support expectations of aggressive bear flattening which is typically accompanied by a widening of credit spreads across bond markets. Considering this, we prefer to focus on quality credit to reduce portfolio spread volatility, with Developed Markets Investment Grade (DM IG) markets demonstrating the lowest volatility historically under bear-flattening yield curves.

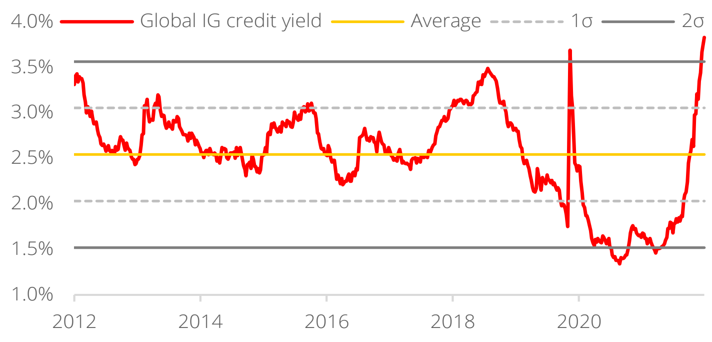
   And while it is difficult to anticipate when a turnaround would come, investors are currently well compensated for waiting; global high grade credit aggregate yields have exceeded 3.8%, a level that exceeds even the 2020 pandemic crisis – and more than 2 standard deviations wide of its 10-year history. Should the economy take an unforeseen downturn, the unwinding of hawkish expectations would become a strong tailwind for this asset class.

Figure 2: Outperformance in quality plays



Source: Bloomberg, DBS

Figure 3: Investors are well compensated with high quality credit



Source: Bloomberg, DBS

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