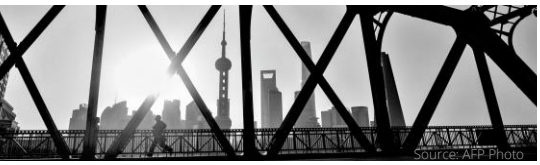

CIO Perspectives

3 June 2022

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ASSET ALLOCATION

Risk assets look rewarding on a 12-month time frame

Key points

- Bearish sentiments surrounding hawkish Fed and stagflation fears triggered acute selldown in risk assets this year; "Long duration" sectors bore the brunt of the correction
- Our analysis of data going back to 1927 suggests attractive risk-reward in deploying fresh funds in risk assets now
- Historically, after an acute selldown at the start of the year, the S&P rallied 20% on average in subsequent 12 months
- The year's selldown is driven predominantly by valuation contraction as investors recalibrate forward growth expectations
- Corporate fundamentals (earnings), however, have remained resilient
- Market volatility is expected to stay elevated as the Russia-Ukraine crisis and high inflation persists
- Quality stocks are expected to outperform during times of heightened volatility

Food for thought – history suggests positive 12-month returns for risk assets after acute correction. Global equities teetered on the edge of a bear market this year on overwhelming bearish sentiment relating to the hawkish Fed and stagflation fears. "Long duration" sectors, particularly those relating to Technology, bore the brunt of the selldown as concerns mounted on how rising bond yields will impact the valuations of growth equities. But, given the magnitude of the correction, it is now worth taking a step back to re-assess the risk-reward of putting fresh funds to work.

Using the US equity market as a proxy in our analysis, we look at how risk assets tend to perform in the subsequent 12 months after an acute correction. On a year-to-date basis, the S&P 500 has corrected 13.3% in January to May 2022. Looking through historical data dating back to 1927, there were only five other occasions where the S&P 500 registered higher magnitude of losses during the first five months of the year and this took place in 1931, 1932, 1940, 1962, and 1970. The key observations are:

The S&P 500 fell 23.8% on average during those occasions, with the minimum corr at -15.1% and the maximum at -45.0%. In contrast, the selloff this year is comparably intense at -13.3%

In the subsequent 12 months, the S&P 500 has rallied 20.0% on average after th correction (with positive returns on four out of the five occasions).

Table 1: Historical returns for S&P 500 after acute selldown at start of the year

	S&P 500 (closing price)	% chg. in first 5 months of the year	Subsequent 12 months performance
End-May 1931	13.02	-15.1%	-65.7%
End-May 1932	4.47	-45.0%	+115.7%
End-May 1940	9.27	-25.6%	+1.2%
End-May 1962	59.63	-16.7%	+18.7%
End-May 1970	76.55	-16.8%	+30.2%
Average	-	**-23.8%**	**+20.0%**
End-May 2022	4132.15	-13.3%	

Source: Bloomberg, DBS

Taking our analysis one step further, we dissect the market corrections into the following components: (a) Price-to-Earnings (P/E) ratio and (2) Earnings. The purpose of this step is to ascertain if the selldown is predominantly driven by investors' sentiments and expectations (proxied by valuation) or actual fundamentals (proxied by earnings).

As only data going back to 1954 are available for this purpose, our findings below are based on observations made for 1962 and 1970. Our key findings are:

- P/E valuations for S&P 500 contracted by 13.7% on average during those occasions, a level that is slightly lower than the current P/E contraction of 16.0%.
- Corporate earnings fell 3.3% on average for those occasions. In contrast, earnings gained 3.2% in the course of the current selldown.

Table 2: De-composition of past corrections on S&P 500

	Change in P/E valuation	Change in earnings
End-May 1962	-17.5%	0.9%
End-May 1970	-9.9%	-7.5%
Average	**-13.7%**	**-3.3%**
End-May 2022	-16.0%	3.2%

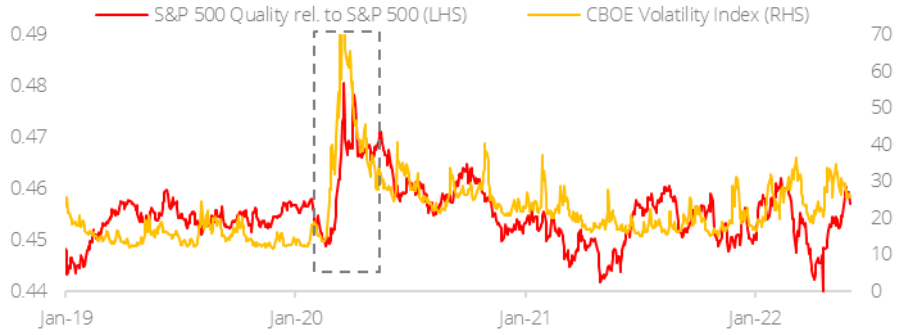
Source: Bloomberg, DBS

Risk-reward looking attractive; Time to deploy a portion of your excess cash holdings in risk assets. Using history as a guide, it is evident that partial deployment of excess cash in risk assets looks compelling at this juncture. As opposed to trying to "time" for a market trough, a more relevant question investors should ask oneself is: "Where would my investments be in 12 months' time?". Our analysis has established the following views:

1. After a sharp selldown at the start of the year, markets have historically rallied 20% on average over the next 12 months.
2. This year's selldown is driven predominantly by the recalibration in investors' sentiments/expectations which results in valuation multiples contraction. Corporate fundamentals (notably, earnings), however, have remained resilient and this augurs well for the outlook.

Go for Quality Plays in times of heightened volatility. Market volatility is expected to stay elevated as the Russia-Ukraine crisis and high inflation persists. Using the S&P 500 Quality as a proxy, quality stocks have performed the broader markets in times of heightened volatility, and this time shall be no different.

Figure 1: Quality stocks outperforming broader market when volatility spikes



Source: Bloomberg, DBS
Note: Chart is truncated

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3 June 2022

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