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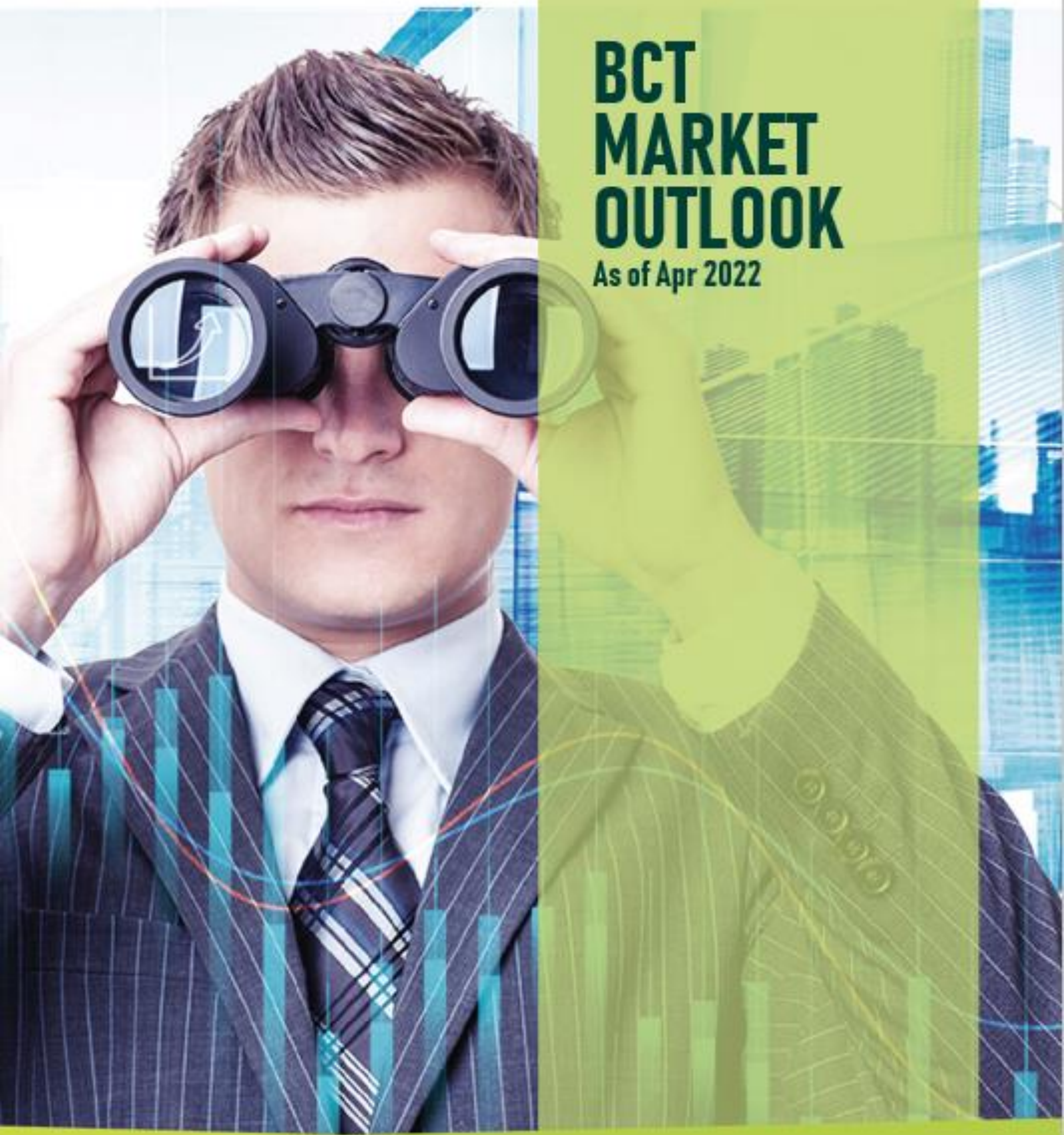
# BCT MARKET OUTLOOK

As of Apr 2022



# CHINA'S PANDEMIC WORSENS
# FED TO RAISE RATES AGGRESSIVELY

| Investment Markets | BCT's Investment Views | Summary |
|---|---|---|
| **Equities** | ▬ | |
|  U.S. | ▬ | We are neutral on U.S. equities. While we see pressures from higher inflation and removal of Fed support, we also believe labour markets are strong and consumer earnings and savings high. |
|  Europe | ▼ | We believe rising PPI inflation may affect earnings, particularly for companies that are unable to pass rising input costs to consumers. Importantly, although markets have bounced back, current valuations do not reflect the deteriorating earnings outlook in the region. Hence, we are slightly underweight on European equities. |
|  Japan | ▬ | We are neutral on Japan's equities. While prices for oil and other inputs in general could affect company margins, we are seeing accommodative policies. The evolving COVID-19 situation is another key factor that causes us to stay vigilant on earnings. |
|  Asia Ex-Japan | ▬ | We are neutral on Asian equities regarding COVID-19 resurgence and inflation concerns, supported by the Russia-Ukraine conflict. The resulting price increases across energy, commodities, and agricultural products are adding to inflationary concerns across the world and particularly in Asia. |
|  China & Hong Kong | ▲ | We are slightly overweight on Chinese and Hong Kong equities. Latest COVID-19 related lockdowns could impact supply chains and growth. While government support remains strong and targeted. On a long-term view, we think the country presents bottom-up opportunities. |
| **Global Bonds** | ▬ | |
| Government Bonds | ▼ | We are slightly negative on government bonds. Government bonds should be considered for their protective nature in times of market stress, but keep in mind that the rate direction is up. |
| Credit | ▬ | We are converging to a neutral view on credit as markets may be affected by increasing volatility, upwards pressures on core rates, and higher inflation. In addition, there are concerns about corporate earnings due to potentially weakening Gross Domestic Product (GDP) growth in Europe. |

| Scales of Weighting | ▼ Underweight | ▬ Neutral | ▲ Overweight |
|---|---|---|---|

## U.S. EQUITIES

U.S. stocks ended the quarter with their first quarterly decline since Q1 2020, S&P 500 was down for -4.6%. However, in March, the S&P 500 posted a positive return with a monthly growth of +3.7%. Over the quarter, value stocks outperformed growth stocks. The U.S. Manufacturing Index in March was 58.8 points, up from 57.3 in February. U.S. manufacturing growth accelerated in March as strong demand and improving prospects countered the headwinds of soaring cost pressures and the Russia-Ukraine conflict. In terms of monetary policy, as expected, the Federal Reserve (the Fed) raised its short-term lending rate by +0.25% at its March meeting. It was the first rate hike by the Fed since 2018 and marked a key step away from the ultra-accommodative monetary policy the central bank instituted in the early days of the pandemic. Policymakers also released an updated economic forecast, which showed they had been expecting to keep raising rates in 2022. In addition, they downgraded their forecast for economic growth, while revising inflation projections upward.

The increase in energy and commodity prices, which is pushing inflation higher, is negatively impacting the U.S. consumer confidence and spending. At the same time, companies' capital expenditures (CapEx) intentions remain high, suggesting that while U.S. consumption may be decelerating, CapEx should remain resilient to the Ukraine war confidence hit. We expect Gross Domestic Product (GDP) to keep decelerating towards potential, while headline inflation will grind higher for the next few months before resuming a downward path. The March Federal Open Market Committee (FOMC) meeting was hawkish on many fronts. The Fed wants to move to more restrictive levels in order to restore price stability. Chair Powell was clear on the determination to do whatever it takes to bring inflation down. The Summary of Economic Projections is now showing a median terminal rate at 2.75% as early as late 2022 or early 2023. We are neutral on U.S. equities. While we see pressures from higher inflation and removal of Fed support, we also believe labour markets are strong and consumer earnings and savings high. This, coupled with robust corporate balance sheets and domestic energy supplies, should mitigate the risks from rising energy prices. We are slightly overweight on U.S. value equities. We believe quality value names that show strong pricing power, a tendency to maintain earnings growth and operational efficiencies present selective opportunities because valuations in this segment are still attractive. We are slightly underweight on U.S. growth equities. Valuations are still high in this group, but we realise that certain names are incrementally becoming attractive after the recent correction. However, rising rates will pressurise prices in the still-overvalued segments. We stay cautious overall.

## EUROPEAN EQUITIES

In Europe, over Q1, the large majority of equity indices posted negative return. Europe is the area exposed to the conflict in Ukraine the most, in particular, through the effects of soaring energy prices, supply chain disruptions, and geographic proximity. In Europe, consumer confidence plunged sharply in March, hurt by the surge in prices. However, labour markets are still improving and wages are rising. Eurozone annual inflation rate rose to a fresh record high of 5.9% in February from 5.1% in January, and it was above preliminary estimates of 5.8%. Energy continued to record the biggest price increase followed by food. The Eurozone manufacturing sector registered a further slowdown in growth at the end of Q1 with the Purchasing Managers' Index (PMI) falling to 56.5 in March, from 58.2 in February. The PMI data signalled the slowest improvement in operating conditions faced by goods producers since the beginning of 2021. Geopolitical tensions weighed on demand and had a noticeable impact on business confidence. From a monetary perspective, the European Central Bank (ECB) left the monetary policy unchanged and confirmed that the tapering of the pandemic emergency purchase programme will conclude in June and the asset purchase programme will gradually end over Q3 2022 but with the usual conditionality and data-dependency.

As the increase in energy and commodity prices continues to impact European households and businesses as the Russian-Ukraine conflict continues, we expect European countries' domestic demand to suffer a significant hit. The Russia-Ukraine war has now put Europe's economy recovery on hold; on the inflation front, we expect inflation to rise higher for a few months and then to decelerate, assuming weaker energy and commodity price dynamics in the second half of the year. The ECB announced it could end its net asset purchases in Q3, also with a more pronounced tapering in Q2, surprised the consensus. At the same time, guidance on interest rates, which ECB now plans to increase "some time" after the end of net asset purchases rather than "shortly after", suggests that it wants to keep more flexibility on the timing of rate hikes. The ECB is determined to deliver on its price stability mandate, but it acknowledged the high level of uncertainty and the path of monetary policy will therefore be even more data-dependent. We believe rising Producer Price Index (PPI) inflation may affect earnings, particularly for companies that are unable to pass rising input costs to consumers. Importantly, although markets have bounced back, current valuations do not reflect the deteriorating earnings outlook in the region. Hence, we are slightly underweight on European equities.

## JAPANESE EQUITIES

Japan lagged over the quarter with the Nikkei 225 performing -2.7% in total return terms and the TOPIX (Net Return) posting -1.3%. However, over March, the indices grew +5.6% and +4.1% respectively. As number of new COVID-19 cases dropped, the government lifted social distancing restrictions in mid-March and started to open its borders to a limited number of visitors. Private consumption has recovered at a faster pace, leading the overall economy in 2022. Since the beginning of 2022, the global hawkish shift set the tone for the equities market and aided in the acceleration of a shift in market dynamics. This was particularly noticeable in Japan, where value-style companies outperformed growth stocks. National and Tokyo inflation have picked up further on stronger food and energy prices. However, core inflation (ex. energy and food) prints were still in the negative territory. The Bank of Japan (BoJ) has left its policies unchanged again in March. Governor Kuroda stated clearly that the expected cost-pushed jump in headline inflation to 2% in April would not be enough for BoJ to tighten its monetary policy, especially amid heightened uncertainty over Russian-Ukraine conflict. BoJ is also offering unlimited bond buying to defend its yield target, amid rising U.S. treasury yields. At the same time, until end 2021, Japan's GDP was still below pre-pandemic levels.

While the weaker yen and rising commodity prices dim business sentiment especially raw material manufacturers, the demand for machinery continues to hold up. Expectations among domestic services providers have been mixed, but concerns over food and energy costs appeared to outweigh the positivity of reopening in the March Tankan survey. With these catalysts in mind, we maintain our view that economy will recover at a gradual pace in 2022, chiefly driven by private consumption as external balance deteriorates. We expect core inflation to turn positive when the negative drags from mobile phone fee reduction dissipate in Q2, but underlying inflation remain subdued as output gap is not expected to close till late 2024. The steep slide in yen against dollar has caught policymakers' attention. At BoJ's semiannual report to lawmakers, Governor Kuroda reiterated a weaker yen is beneficial for the economy. Besides, BoJ sees the expected increase in Consumer Price Index as a short-term phenomenon on the back of higher energy prices, warranting persistent powerful easing. We are neutral on Japan's equities. While prices for oil and other inputs in general could affect company margins, we are seeing accommodative policies. The evolving COVID-19 situation is another key factor that causes us to stay vigilant on earnings.

## ASIA EX-JAPAN EQUITIES

In March, Asia had mixed return with negative performance over the region (-3.3%) in USD terms. The best performer was the Indian Sensex (+4.1%). Digital transformation, "Made in India", financialisation of savings and increasing weight in indices with more Initial Public Offering (IPO) to come in new-economy sectors; although short term, this is offset by high valuations in cyclical and new-economy sectors, as well as higher oil prices. The Korea Composite Stock Price Index (KOSPI) was also positive (+2.2%) thanks to healthy but peaking exports, attractive valuations, mostly in the still dominant technology and financial corporations. Among the developed Asian markets, Singapore led the table with the Straits performing +9.1% in Q1 and +5.1% in March following blue chips gain of interest with recent volatility in global equity market. Southeast Asian economies continued to recover and ease quarantine rules despite rising Omicron cases. Manufacturing PMI indices for the region remained broadly expansionary as factory activities pick up. Global inflationary pressures have been boosted by the Russia-Ukraine conflict and are proving to be persistent across most emerging markets (EM), as the latter tend to have a large share of food prices in their inflation baskets. Despite the Fed normalization process, Asia Central Banks did not change their rates, the only exception being Taiwan across the main countries, which raised rates by 0.25% in line with the Fed.

Omicron cases remain elevated across EM Asia, yet authorities are determined to reopen. Growth forecasts weakened as a result of numerous countries exposed to the effect of the Russia-Ukraine conflict as well as China disrupting the fragile labour market and consumption recovery due to the zero COVID-19 policies. The inflation outlook has revised indiscriminately up on raising energy and food prices and more persistent supply chain disruption. Inflation should be closely monitored as growth expectations regain momentum and the broad weakness in the economy has caught authorities' attention. Asia should experience a more benign inflation picture across the EM universe. Higher commodity prices are likely to have a varied impact on Asia's growth, current account, inflation and fiscal outlook. This applies to oil in particular, but also agricultural products and metals. Some countries could benefit from higher oil prices but others would be more sensitive to price developments. In India, external vulnerabilities are limited compared to previous episodes of Fed tightening. Despite the prospect of rising inflation, the Reserve Bank of India is committed to remaining accommodative and sustaining growth as long as necessary. We are neutral on Asian equities due to COVID-19 resurgence and inflation concerns, supported by the Russia-Ukraine conflict. The resulting price increases across energy, commodities, and agricultural products are adding to inflationary concerns across the world and particularly in Asia that is predominantly a net energy importer, with the exception of Australia and Malaysia.

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## CHINA & HONG KONG EQUITIES

The Chinese Shanghai Composite Index was in a negative territory with a fall of -10.6% in Q1 and -6.1% in March. Similarly, the Hong Kong Hang Seng Index experienced a negative quarter and month with a return respectively of -6% and -3.2%. China was affected by the worst outbreak since Q1 2022. Local governments - including major cities such as Shanghai and Shenzhen - reverted back to zero COVID-19 policies and city-wide lockdowns. Shanghai is currently split in two regions, with the Huangpu river as the dividing line. Half of its 26 million people are being locked down until 1st April, and the other half of the city is expected to follow suit. After disappointing February credit data and the sell-off in the stock market, the National People's Congress (NPC) and other comments by officials confirmed a continuation in policy support to the economy as well as lately to the equity markets. The development of the Russia-Ukraine conflict in March increased the probability of a "short" war with a cease-fire and full-fledged negotiations in the coming months. China's bargaining power has in fact increased considerably and China will play a key role in ending the crisis.

The new wave of COVID-19 has hit a number of major cities as well as export hubs, prompting local governments to adopt targeted lockdowns and mass testing. Expecting a continuous zero COVID-19 policy at least through the first half of the 2022, this round of tightening measures adds downside risks to our growth forecasts. As consumption is under greater pressure, underlying inflation remains subdued. The fading of negative base effects may push core inflation higher later this year, but this will not prevent the People's Bank of China (PBoC) from maintaining an accommodative approach amid a fragile growth recovery. Although the PBoC left the one-year Medium-Term Lending Facility Rate (MLF) and the one-year Loan Prime Rate (LPR) unchanged in March, we believe the easing cycle is not over yet, with a challenging recovery outlook and soft consumer inflation. An additional 0.10% policy rate cut (MLF & LPR) plus a 0.50% Required Rate of Return (RRR) cut are still likely. We also expect a resumption of credit growth, driven by higher public lending. We are slightly overweight on Chinese and Hong Kong equities. Latest COVID-19 related lockdowns could impact supply chains and growth. While government support remains strong and targeted, we are monitoring how the Russia-Ukraine conflict affects the commodity importer. On a long-term view, we think the country presents bottom-up opportunities.

## GLOBAL BONDS

Overall, the European Economic and Monetary Union (EMU) Government short-dated bond indices had negative returns during the quarter as yields rose in most European markets. The 3-5 year index fell 3% in Q1 and -1.7% in March whilst the 5-7 year index posted a negative return of -4.5% over the quarter and -2.2% in the last month. In European credit markets, the European iTraxx Main credit index widened by approximately +0.25% during the quarter from +0.48% at the end of December to +0.73% by end March. While our long-term stance remains defensive in core Europe, the U.S. and the United Kingdom (UK), we are slightly less cautious amid markets' flight to quality and repricing of Euro rates. Speaking of sovereign bonds, the prospect of more aggressive monetary tightening meant it was a bad quarter for sovereign bonds. Chinese government bonds have outperformed other sovereign bonds recently. Its subdued inflation and economic slowdown put China on a different monetary policy framework compared to the U.S. and Europe. The effect of the rising rates weighed on corporate space with the Bloomberg Barclays Euro Aggregate index falling -1.2% in March. The U.S. equivalent index underperformed its European counterpart, posting a negative return of -2.5% in March.

Long-term rates remain too low in a persistently high inflationary environment. Recent hawkish turns by Central Banks (CBs) confirm that the rate direction is up. We continue to remain tactical as this can assist with hedging during periods of turbulence. U.S. core yields will continue to fluctuate on the back of inflation, expected policy action, and investors' search for safety. We acknowledge that domestic economic activity should be driven by strong labour markets, consumer earnings, and relatively easy financial conditions. We are slightly underweight on U.S. bonds.

ECB aims to minimise the economic shock and at the same time tame stubborn inflation and is thus displaying relatively hawkish overtures. Receding policy support from the ECB in an environment of high inflation and economic growth concerns allows us to stay slightly underweight on European Union (EU) bonds. Chinese debt offers diversification for global portfolios and could benefit from concerns over the country's economic growth and the accommodative stance of the PBoC. Thus, we remain slightly overweight on Chinese bonds. Combine these hawkish tones with potential pressures on earnings and you get a situation where investors should tread cautiously regarding risk assets, despite strong corporate fundamentals. Government bonds should be considered for their protective nature in times of market stress, but keep in mind that the rate direction is up. We are converging to a neutral view on credit as markets may be affected by increasing volatility, upwards pressures on core rates, and higher inflation. In addition, there are concerns about corporate earnings due to potentially weakening Gross Domestic Product (GDP) growth in Europe.



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