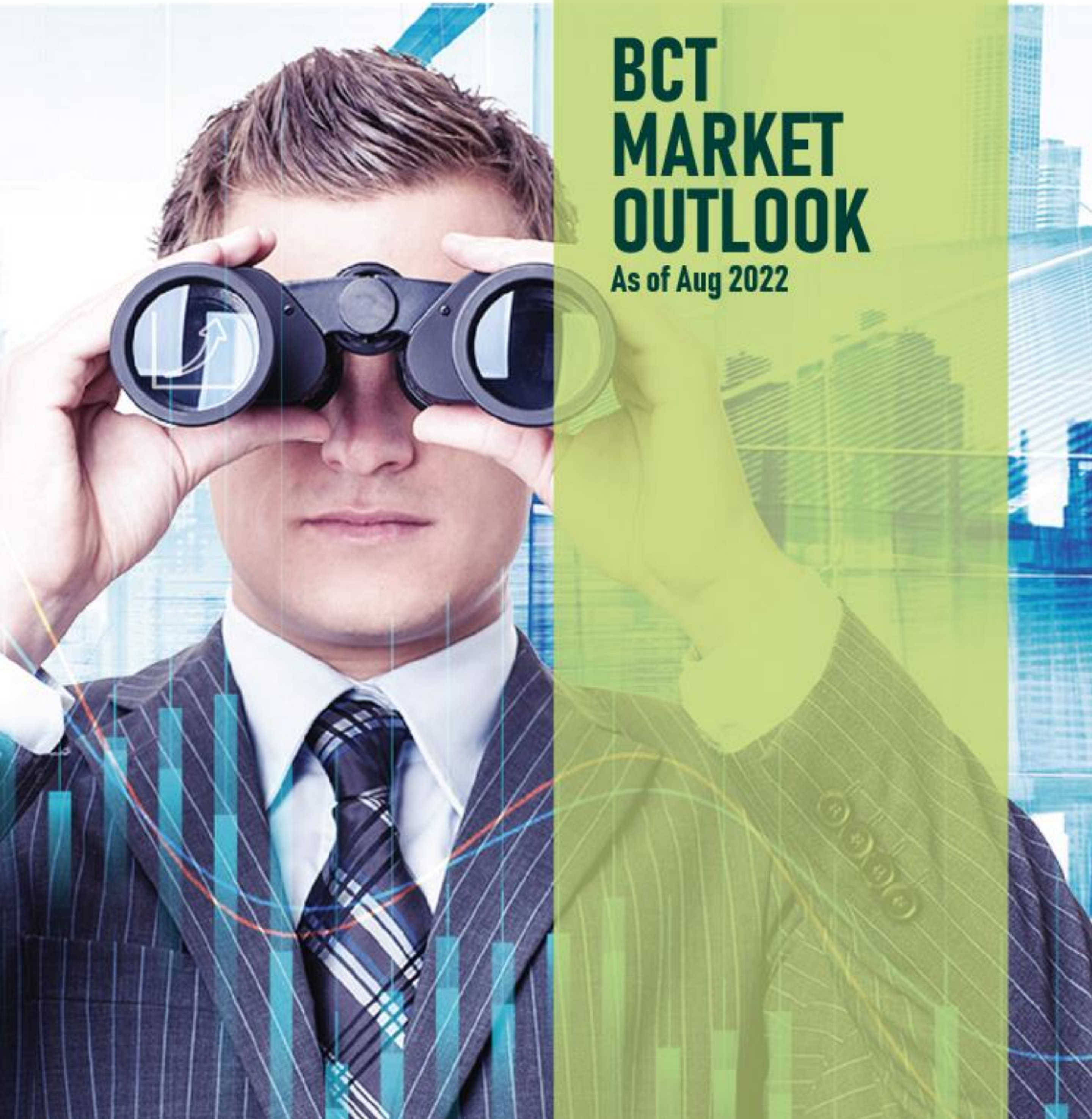
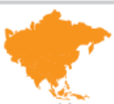
# BCT MARKET OUTLOOK

**As of Aug 2022**



# U.S. INFLATION FELL FROM A 40-YEAR PEAK, AND THE EUROPEAN CENTRAL BANK RESTARTED RAISING RATES AFTER 11 YEARS

| Investment Markets | BCT's Investment Views | Summary |
| --- | --- | --- |
| **Equities** | ▬ | |
|  U.S. | ▲ | We believe growth deceleration is on the cards but a recession is not, as consumer and corporate balance sheets remain strong even though there are signs of some weakness. |
|  Europe | ▼ | The macroeconomic backdrop is weak, coupled with weak business confidence, leading us to stay cautious. Markets are not pricing in a strong recession, but we believe we may see a recession in corporate earnings. |
|  Japan | ▬ | We stay neutral amid the headwinds on global growth, given the export-oriented nature of Japanese markets. However, a weak yen should be supportive. |
|  Asia Ex-Japan | ▬ | Most central banks moved to normalise policy throughout the month. However, Southeast Asian nations carried on with their reopening efforts. |
|  China & Hong Kong | ▲ | Economic recovery driven by reopening, accommodative monetary and fiscal policies, and continuing vaccinations lead us to be tactically positive. We closely monitor zero-COVID policies and potential subsequent lockdowns. |
| **Global Bonds** | ▬ | |
| Government Bonds | ▬ | We are neutral towards government bonds. Inflation and Fed policy remain the key variables, which recently has been affected by economic growth concerns. |
| Credit | ▲ | We are slightly overweight on credit. In the U.S., resilient labour markets and relatively strong consumption should be supportive for credit. In Europe, fundamentals and margins are strong, but high inflation and potential effects of the pass-through of higher prices to consumers. |

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

## U.S. EQUITIES

The U.S. equity markets had a positive month in July, with the S&P 500 rising by 9.2%. U.S. equities rallied in response to expectations that slowing economic conditions would mean tempered interest rate hikes, and investors seemingly penciled in a lower terminal federal funds rate after the Q2 economic slow-down. Over the month, growth stocks outperformed value stocks, with the former up for 12.8% against a gain of 5.8% for value. The Q2 U. S. Gross Domestic Product ( GDP ) came in at -0.9%, which has been the second consecutive print in contractionary territory. U.S. Manufacturing index was 52.2 in July, down from 52.7 in June. The headline Purchasing Managers' Index (PMI) dropped to its lowest level since July 2020. Demand growth is cooling as households are facing increased cost-of-living. Corporate capital spending is also showing signs of moderating due to tightening. Contributing to the drop in the headline index was a renewed fall in new orders in June.

In the U.S., signs of decelerating growth are increasing as high inflation bites into consumers' disposable income and companies' margins. While we do not see activities contracting in Q2, risks to our projections remain on the downside. In July, on an annualised basis, headline inflation was 8.5%, down from 9.1% in June and below forecasts. We are slightly overweight in U.S. equities. We believe growth deceleration is on the cards but do not think recession is arriving, as consumer and corporate balance sheets remain strong even though there are signs of weakness. Key parameters are how companies can sustain earnings. We are overweight in U.S. value equities. Value equities' outperformance has continued year-to-date, but there are pressures in the form of deceleration that could affect the segment. We are focusing on the more quality-oriented and less cyclical areas. We are underweight in U.S. growth equities. We are cautious on the expensive growth sector in general, particularly the unprofitable areas, given that valuations could be further affected by movement in core yields.

## EUROPEAN EQUITIES

The European equity index posted positive returns: during the month, the MSCI Europe appreciated by 6.1% in total return. In terms of economic data, an early estimate of inflation came in above expectations, at 8.9% in July, up from the 8.6% registered in June. The rise in headline inflation was driven by food and energy prices. European natural gas prices rose after Russia reduced gas supplies from the Nord Stream pipeline to 20% of capacity, citing the need for maintenance on another turbine. Q2 GDP from major economies in Europe surprised on the upside, due to the reopening effect operating via increased consumption and contribution from services exports and tourism. From a monetary perspective, the European Central Bank (ECB) raised interest rates by 0.5% as part of its efforts to curb rising inflation.

The ECB remained hawkish and decided to raise the three key ECB interest rates by 0.5% and approved the Transmission Protection Instrument (TPI). TPI is ECB's new "anti-fragmentation tool", designed to prevent bond yields in the periphery (Italy in particular) widening inordinately comparing with German yields. Eurozone Purchasing Managers' Index (PMI) fell to 49.8 in July, from 52.1 in June, signaling the first deterioration in overall manufacturing sector conditions in the last two years. The decrease in the headline figure was due to a reduction in new orders which, aside from those seen during the pandemic restrictions, was the sharpest since the Eurozone sovereign debt crisis in 2012 as steep inflation squeezed demand. We are underweight in European equities. The macroeconomic backdrop is weak, coupled with weak business confidence, leading us to stay cautious. Markets currently are not pricing in a recession scenario, but we might see a recession in corporate earnings.

## JAPANESE EQUITIES

In Japan, the ruling Liberal Democratic Party (LDP) - Komeito coalition retained its comfortable majority in the parliamentary upper house election, providing them with more capital and popular support to implement reforms to stimulate the economy. The assassination of Japan's former Prime Minister Shinzo Abe overshadowed market developments in July. Despite leaving office, Mr. Abe continued to hold a significant amount of power inside the governing Liberal Democratic Party. However, in the immediate aftermath, the LDP's good showing in the elections for the Upper House as a result has strengthened the position of the incumbent Prime Minister Kishida. The Bank of Japan (BoJ) maintained its ultra-loose monetary policy to support the country's economy continuing to diverge from other central banks' tightening policies. In this context, in July, the Japanese TOPIX advanced 3.7% and the Nikkei 225 rose 5.3% in total return basis.

The BoJ stood firmly as a dovish outlier in July, resisting pressures from bond and Foreign Exchange (FX) markets to make a policy change. Governor Kuroda delivered two clear messages. Firstly, BoJ will stick to the yield curve control (YCC) policy in order to support the economic recovery, and an expansion of YCC band is equivalent to a tightening. Secondly, a sharp yen depreciation will hurt the economy, especially business investments. His statement gained support from Prime Minister Kishida, who believes FX is only one of several factors to consider for monetary policy. We expect no change to the YCC during Kuroda's term. We are neutral in Japan's equities. We stay neutral amid the headwinds on global growth, given the export-oriented nature of Japanese markets. In addition, the domestic economy is expected to recover through consumption in recent months, but the latest wave of COVID-19 infections has added uncertainty over the timing.

## ASIA EX-JAPAN EQUITIES

Equities in Asia had a loss in July as gains in India, South Korea, and Singapore were offset by muted performance in Taiwan, Indonesia and Malaysia due to sluggish economic development, continuous COVID-19 lockdown measures and regulatory difficulties. India market posted the strongest performance owing to increased investor optimism. Following the announcement that the economy had expanded by 0.7% in Q2 compared to Q1, South Korea also made significant gains in July. As a consequence of investor optimism in corporate earnings and support from energy and technology companies, Singapore had a solid month in July.

In terms of policy, the Reserve Bank of India (RBI) surprised markets by hiking its benchmark rate by 0.4%. The RBI communicated a clear focus on bringing down inflation and further rate rises in the next few central bank meetings. In Malaysia, Bank Negara Malaysia (BNM) also hiked rates during the month. Besides citing rising inflation, BNM also highlighted factors such as an improving growth outlook, a tight labour market and global central bank tightening. In Thailand, right after arrival test was removed, authorities further relaxed restrictions by announcing the reopening of nightlife venues from 1 June in order to help to speed up the tourism recovery. Bank Indonesia (BI) kept its policy rate unchanged at 3.5%, but accelerated the tightening in domestic liquidity conditions by announcing a series of reserve requirement hikes from 5% currently to 6% in June, 7.5% in July and 9% in September. We are neutral in Asian equities, with Indonesia's central bank being the notable exception, most central banks moved to normalise policy throughout the month. However, Southeast Asian nations carried on with their reopening efforts.

## CHINA & HONG KONG EQUITIES

In China, sentiment recovered as the State Council stepped up policy support and the People's Bank of China (PBoC) announced a 0.15% 5-year Loan Prime Rate (LPR) cut, only five days after the mortgage floor was lowered by 0.2%. Housing policy has turned looser, with local governments in full-fledged easing mode. China held its Politburo meeting on 28 July, the meeting confirmed the overall easing stance of macro policy, which should focus on demand expansion. In terms of monetary policy, credit expansion policy was confirmed, credit support for the corporate sector will be increased. In Hong Kong, unemployment rate has improved from 5.1% in May to 4.7% in June, due to moderating local epidemic situation in general and the gradual relaxation of social distancing measures. In addition, Consumption Voucher Scheme and the 2022 Employment Support Scheme have also helped the employment market.

Mortgage rates plunged again in June to their lowest level since 2014, and interbank market rates stayed ultra-low. This argues against another policy rate cut from the PBoC, as liquidity and financing conditions have loosened so much in reality. We keep rolling with a 0.1% Loan Prime Rate (LPR) cut. Such a cut would be deployed as a sentiment booster if China has another wide-scale outbreak. Even without further rate cuts, we expect the PBoC to maintain an accommodative stance in the rest of 2022, to assist the recovery and fiscal stimulus. In Hong Kong, number of Omicron cases has increased to above 4,000 cases per day. Government has extended the current social distancing measures in phase 2 situation till 11 August. Government will review the hotel quarantine policy which may help inbound and outbound travel. We are overweight in Chinese and Hong Kong equities. Though we stay watchful of the evolving zero-COVID policies and potential subsequent lockdowns, we have further improved our outlook for China equity given the policy support, economic reopening, and signals of possible relaxation of the zero tolerance of COVID-19 approach.



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## GLOBAL BONDS

In July, bond yields decreased, easing some of the strong pressure experienced so far this year. Bonds were underpinned by softening U.S. data as investors evaluated the possibility of an economic slump and more gradual interest rate increases. The Federal Reserve (the Fed) hiked rates by 0.75% for the second straight month after headline inflation again beat expectations at 9.1% in July. Inflationary pressure continued to build on the more sticky elements of accommodation and services. During July, we saw the U.S. yields lowering and the curve flattening with the largest moves in the mid-term maturity names. In Europe, in order to combat growing inflation, the ECB increased interest rates by 0.5%. This larger than expected adjustment was combined with the announcement of a new bond buying tool called "Transmission Protection Instrument", which was introduced as a measure against the surge in borrowing costs and it also supposed to be used against any unprecedented market activity that could pose a threat to the transmission of monetary policy across Europe.

We are neutral in government bonds. Inflation and Fed policy remain the key variables, which recently has been affected by economic growth concerns. As a result, we stay neutral but active in adjusting our stance. While we are close to neutrality in core Europe, we acknowledge the ECB's difficult task in tightening policy to tame inflation, prevent fragmentation and support growth. Thus, our stance remains flexible to benefit from tactical yield movements across geographies. We are slightly overweight in credit. In the lookout for strong corporate fundamentals, we remain biased towards high-quality credit, where fundamentals more accurately reflect valuations. Resilient labour markets and relatively strong consumption should be supportive for credit. In light of ongoing pressures on supply chains, geopolitical tensions, and a hawkish ECB, we continue to monitor the earnings impacts of these factors. For now, fundamentals and margins are strong, but high inflation and potential effects of the pass-through of higher prices to consumers lead us to be neutral.