BCT MARKET OUTLOOK

As of May 2022

COVID-19 CONTROL STRATEGY MAY DETERMINE THE DIRECTION OF THE CHINESE ECONOMY AMID THE CURRENT DOWNWARD PRESSURE

Investment Markets	BCT's Investment Views	Summary
Equities	▬	
U.S.	▲	Despite pressures from higher inflation and removal of Fed support, labour markets are strong with high consumer earnings and savings. This, coupled with robust corporate balance sheets and domestic energy supplies, should mitigate the risks from rising energy prices.
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.
Japan	▬	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	▬	Recovery theme is still on track with more restrictions elevated. 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.
China & Hong Kong	▬	The zero COVID-19 policy is likely to weigh on economic growth (and supply chains) and the 5.5% target will be difficult to achieve, leading us to be a bit more cautious in the near term. However, selective, long-term opportunities remain amid policy support as the country transits to a more balanced economic growth model.
Global Bonds	▬	
Government Bonds	▼	In U.S., the Fed is continuing its hawkish pivot and inflation remains stubborn, hence we are cautious on U.S. government bonds. The geopolitical tensions and market stress together with the rising interest rates after the end of QE, we are slightly cautious in European government bonds.
Credit	▬	In credit, for U.S. Investment Grade, corporate fundamentals are still strong. In Europe IG, spreads have retraced and corporate fundamentals remain solid. However, sentiment is fragile owing to high inflation, the recession risk in Europe and the less accommodative ECB.

Scales of Weighting	▼ Underweight	▬ Neutral	▲ Overweight

U.S. EQUITIES

In the U.S., the S&P 500 closed April with a -8.7% return. Value stocks outperformed growth stocks, with the former down -5% against a loss of -12.5% for the growth. The U.S. equity market had a poor month explained by the sharp rise in long-term rates, coupled with an inversion of the U.S. yield curve signaling a possible recession led to a fall in equities at the beginning of the month. Subsequent risk-off tone from geopolitics and the hawkish tones in comments from the Federal Reserve (Fed) policymakers affected investors' sentiment. The inflation is compressing real incomes and could negatively impact consumer confidence, spending and saving behavior. In terms of monetary policy, Fed Chair Jerome Powell said a 0.50% rate increase could be on the table in the May policy meeting, indicating appropriateness to move slightly more quickly. The Fed's rate-hiking cycle would risk pushing the economy into recession, despite the historically strong labour market.

For the U.S. equities market, the recovery should be driven by a strong labour market and solid consumer balance sheets, but inflation may affect disposable incomes. Earnings are likely to increase due to inflation, when rates rise, these earnings would be discounted by a higher cost of capital. Hence, some pressure on valuation multiples is expected. Strong consumer spending and labour markets will support overall demand, allowing us to believe that a recession is unlikely, though we may see some pressures on economic growth. Given that real yields are close to positive and nominal yields are rising, we are watching how these affect equities. We are slightly overweight on U.S. equities given resilient consumer demand and solid labour markets. We are overweight in U.S. value equities. The uncertainty around rising costs requires a focus on high-quality value companies that are less cyclical and can deliver sustainable earnings growth. While the rotation favouring value stocks may suffer near-term setbacks, moving towards these names is likely to continue in the long term. We are underweight on U.S. growth equities. Despite the recent underperformance of growth versus value, the long-term valuation of growth as a sector remains high. We also acknowledge some segments becoming attractive but rising rates could pressurise valuations.

EUROPEAN EQUITIES

In Europe, the large majority of equity indices posted negative returns. In April, the MSCI Europe depreciated -0.7%. The markets pulled back on concerns about slowing economic growth, high inflation and tightening monetary policy. However, the loss was modest compared to the U.S. market, thanks to encouraging quarterly earnings reports and relatively less hawkish European Central Bank (ECB) with President Lagarde carefully drawing a distinction between the U.S. and European situation. The increase in energy and commodity prices continues to weigh on households and businesses as the Ukraine war drags on, putting the recovery of domestic demand on hold and increasing the risks of technical recession in some countries. Simultaneously, supply-chain disruptions are returning, while risks of gas and energy rationing are exacerbating concerns among producers. In April, the ECB failed to deliver additional hawkish surprises, following the ones delivered in previous meetings. The timing for the end of quantitative easing (QE) in Q3 was confirmed, while ECB's rates guidance and the sequence between the end of QE and rate normalisation were confirmed too.

In European equities, current valuation dispersion is high, encouraging us to be selective yet balanced given the risk outlook. Certain areas such as value remain attractive, though we are now focusing more on less-cyclical, defensive aspects because of the clear economic deceleration. Supply and energy-driven inflation will rise further for a few months before starting a progressive deceleration under the assumption of lower energy and commodity prices in the second half of the year. Also, we fear that some fundamental risks such as regulatory headwinds and very high profit margins are not sufficiently appreciated by the market. We stay very selective and rely on bottom-up approach to identify names that can generate sustainable, long-term returns. Our baseline scenario points to QE likely ending in July, followed by two rate hikes before year end, and by a third in Q1 2023. We are slightly underweight on European equities. Slowing economic growth and persistent cost pressures are likely to affect consumer spending and corporate earnings. We are looking for signs of companies being able to pass on rising costs to consumers and how that may affect overall inflation.

JAPANESE EQUITIES

In Japan, the Nikkei 225 fell -3.5% in total return terms. The Bank of Japan (BoJ) remained dovish at its April monetary policy meeting, leaving interest rates unchanged at their near-zero levels and maintaining the scale of its asset purchases. The BoJ's decision signaled a continued divergence from the monetary policy tightening pursued by other major central banks and sent the yen sharply lower. For the first time in two decades, the Yen reached the 130 level versus the dollar, showing both weakness of the currency and strength of the dollar. In strong contrast to its peers, the BoJ is staying unwaveringly dovish and disregarding the sharp movement. Speculations had built up before the April meeting that the BoJ could start to fine-tune its communication by adjusting its forward guidance. Instead, it maintained its forward guidance and introduced daily fixed-rate purchases to defend its yield curve control (YCC) policy.

Japan remains the exception that continues to register mild consumer inflation amid rising global food and energy prices. Both temporary technical factors and lackluster demand are responsible for its missing high-inflation. Technical factors – such as the reduction of mobile phone charges in April 2020 and rebasing in August – will start to recede and add about 1% back to CPI. The inclusion of a new core inflation forecast in the outlook report suggests that the BoJ expects underlying inflation to stay subdued throughout the year of 2022 and 2023 and is not in a rush to change its YCC target. Meanwhile, the economy has struggled to recover from the double hit from the consumption tax hike (in late 2019) and then COVID-19 in the past two years. Gross domestic product (GDP) has yet to come back to its pre-COVID-19 level, and the case for a strong recovery ahead is still weak from our perspective. We are neutral on Japan's equities. A mild deterioration in economic momentum leads us to remain vigilant on earnings. Strong corporate governance, stimulus support and productivity gains should be supportive for the markets.

ASIA EX-JAPAN EQUITIES

Asia ex-Japan equities fell as China attempted to manage its biggest COVID-19 outbreak. Fears arose that the ensuing economic disruptions would have a larger impact on global economy, exacerbating global supply chain shortages. Simultaneously, Asia inflation displayed signs of picking up. Investor sentiment was further dampened by expectations of increasing interest rates, the ongoing Russian invasion of Ukraine and its impact on global food and energy prices. Monetary Authority of Singapore similarly exhibited concerns on the ramifications of global inflation and tightened policy by raising the Singapore Dollar Nominal Effective Exchange Rate slope slightly and re-entering the center of its policy band to prevailing levels. The Reserve Bank of India also signaled that inflation concerns had overtaken worries concerning sluggish growth. In the Philippines, presidential candidate Ferdinand retained his lead of 56% in the voters' preference survey.

Reopening optimism remained a prominent theme within Southeast Asia. Singapore announced the end to most virus restrictions towards the beginning of May, including scrapping pre-departure PCR test for incoming fully vaccinated travelers. Indonesian authorities relaxed international borders for fully vaccinated travelers and only require visitors to present a negative result from PCR test taken within 48 hours before departure. In Thailand, foreign travelers will not need to perform pre-departure PCR tests in the future. In Malaysia, effective 1 May, the government will ease movement restrictions, which includes scrapping mandatory mask in outdoors, and tests upon arrival for fully vaccinated travelers. However, some Asian central banks are normalising policies under rising inflation. Monetary Authority of Singapore tightened monetary policy stance; Bank of Korea hiked its policy rate, marking its fourth hike since pandemic started; Reserve Bank of India maintained its accommodative stance yet introduced a new floor to its monetary policy corridor via the Standing Deposit Facility. We are neutral on Asian equities. As countries are reopening their borders, and the recovery theme is on track, it will incentivize economic development through business and leisure travel. However, Asia CPI inflation displayed signs of picking up, interest rates are expected to rise under policies normalizing.

CHINA & HONG KONG EQUITIES

China experienced renewed virus outbreaks and imposed lockdown on key industrial cities, including Shanghai. During the month, China demonstrated little inclination to deviate from its zero-COVID policy. Lockdowns in Shanghai incurred significant consequences on economic activity. Amid subsequent growth concerns, various economists slashed China growth forecasts for the year. In a bid to calm markets, the People's Bank of China pledged to step up policy support for the economy. The Reserve Requirement Ratio for banks was cut by 0.25% during the month. However, the magnitude and lack of any cut to Loan Prime Rates disappointed investors. Towards the end of April, President Xi called for an “All Out” infrastructure boost to push the economy. The Politburo’s quarterly meeting urged an enhanced effort to meet economic growth targets and support the healthy growth of the platform economy. In Hong Kong, the unemployment rate worsened to 5.0% in the beginning of April. By end of April, the number of Omicron cases declined to below 1,000 cases, hence the government has relaxed social distancing measures, which helped the overall economy recover.

In China, the broad slowdown in economic activities since March, extended lockdown in Shanghai, and expanded restrictions into other regions are expected to send China into a transitory recession in Q2. The downward drag of zero-COVID policy on economic growth has become more evident, a broad easing is now warranted. The Politburo’s supportive signals will help stabilize the equity markets. New lockdowns in China add further pressure on persistent supply-chain disruptions and on China’s growth as COVID-19 policy has forced some factories to halt operations for weeks, weighing on exports. This could put further pressure on global supply chains in the near term. In Hong Kong, retail sales should improve after relaxing social distancing measures in late April. We are neutral on Chinese and Hong Kong equities. New lockdowns will weigh on the full-year outlook, we have cut our real GDP forecasts for this year to +3.5%. However, two supportive points remain for the Mainland’s economy: the People Bank of China should support the Mainland’s economy with its easing stance and the country appears to be insulated from the Russia-Ukraine war in terms of economic spillovers.

GLOBAL BONDS

Risk assets were affected across the board with credit losing ground and sovereign bonds had a poor month due to higher inflation and the prospect of more aggressive rate hikes. The J.P. Morgan Economic and Monetary Union Government short-dated bond indices had negative returns during the month as yields rose in most European markets. Speaking of sovereign bonds, the prospect of tighter monetary policy saw another month of declines, with the U.S. Treasuries losing ground for a 5th consecutive month and EU government bonds seeing one of their worst monthly performances. Risk sentiment was less supportive, in line with generally weaker equities, and news flow from central banks continued to be the main driver of fixed income markets with U.S. corporate bonds being more under pressure during the month. European credit markets were broadly less impacted than the U.S. and during the month the Bloomberg Barclays Euro Aggregate index fell -2.7%, outperforming the Bloomberg Barclays U.S. Corporate index.

Upward revisions to inflation are causing central banks to accelerate their tightening programmes. While the ECB is cautious due to the high level of uncertainty around growth, the Fed seems keen to reach to its neutral policy rate as soon as possible. Geopolitics and stagflation are adding another layer of uncertainty to markets. We are cautious towards government bonds because the Fed is continuing its hawkish pivot and inflation remains stubborn, hence we are cautious on U.S. government bonds. Following the geopolitical tensions and market stress together with the rising interest rates after the end of QE, we are slightly cautious on European government bonds. We are neutral on credit overall. In credit, for U.S. Investment Grade (IG), we believe corporate fundamentals are still strong. However, with Fed’s quantitative tightening and rising core yields, we remain neutral towards U.S. corporate credit. For European IG, we believe spreads have retraced from the levels seen in early March and corporate fundamentals remain solid. However, sentiment is fragile owing to high inflation, the recession risk in Europe and the less accommodative ECB. Hence we are neutral on Europe credit.

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