CIO Insights 4Q23

The Next Yield Play.

Soft Landing Ahead

Lower growth and lower inflation point to a peak in US policy rates. Rate cuts are however not imminent. This environment is not unsupportive of risk assets such as credit and equities.

IG as the Next Yield Play

Swift normalisation of Fed policy, from zero-bound rates to pre-Global Financial Crisis levels of 5%, favours Investment Grade bonds over dividend-yielding equities and cash deposits as the next yield play.

Stay with Quality Plays

Stay with quality plays that possess moat characteristics and sustainable earnings growth. Despite compelling valuations in China, strong policy stimulus is needed to catalyse a sustained recovery.

Alternative Assets for Resilience

Private credit and private equity are long-term "alpha" return drivers in a portfolio. Stay with Gold as a hedge against market shocks and dislocations.

Source: iStock

Content

Executive Summary

Dear valued clients,

Our high conviction call to engage with risk assets at the start of the year has paid off. The 60/40 portfolio delivered higher returns than cash deposits in spite of worries surrounding recession as well as fear of rate hikes from heightened inflation.

For the last quarter of 2023, we advocate investors put their excess cash to work in portfolios, employing our Barbell strategy with an emphasis on high quality companies across credit and stock markets.

With rates back to 2007 pre-Global Financial Crisis levels, the near 6% annual coupon income from holding Investment Grade (IG) bonds is preferred over dividend-yielding equities and cash deposits as the next yield play.

In addition, if there are exogenous events that lead to market dislocations, IG bonds would cushion the overall portfolio against any sharp drawdown in equities. This echoes our Liquid+ strategy which prioritises a mix of higher-quality corporate bonds and low-risk government bonds to secure steady yields amid volatile times.

On the growth end of the Barbell strategy, stay with quality plays that possess moat characteristics and sustainable earnings growth. Accordingly, we remain overweight US equities where I.D.E.A. (Innovators, Disruptors, Enablers and Adapters) companies are well represented.

We also believe that investors should build exposure to private assets, where a large contributor of their long-term returns come from value-added "alpha", and not "beta" returns subject to market direction.

In this publication, we've included a thematic analysis on commodities, its outlook, and the role it plays within a portfolio construct.

Do enjoy the read.

Hou Wey Fook, CFA

Chief Investment Officer

Deliberation & Recalibration

ASSET ALLOCATION 4Q23

Shifting macro and geopolitical conditions warrant a recalibration of our base case assumptions. We look towards the re-emergence of "higher for longer", income equities giving way to bonds, and await policy catalyst for China-related exposures.

Source: iStock

Investment Summary 4Q23

Macro Policy

Fed to pause, but balance sheet reduction and rising real interest rates continue to tighten monetary conditions until inflation falls towards target.

Economic Outlook

Growth headwinds posed by higher-for-longer rates and tightening funding conditions. Slower US and Japan growth in 2023; China and Europe slowdown to stabilise.

Equities

Stay with quality plays against macro growth uncertainties. Be selective of dividend yielding equities amid elevated bond yields.

Credit

Reiterate bias for Investment Grade credit in 3-5Y duration segment. It is best equipped to weather higher-for-longer rates. Remain cautious on High Yield credit amid widening spreads and rising defaults.

Rates

Favour safety of shorter duration government bonds as rates peak. Sizeable Treasury issuance and muted BOJ intervention pose upward pressure on long-end yields.

Currencies

DXY to end the year stronger. JPY remains volatile amid BOJ's slow pace in tightening policy. EUR to face headwinds from lower growth and negative interest rate differentials with the dollar.

Alternatives

Private equity secondaries are attractive amid challenges facing private markets. Gold remains a core holding as risk diversifier in a portfolio.

Commodities

Still early days for a sustainable new rally cycle for the commodity complex. Outlook tempered by lacklustre policy stimulus in China. Oil price to peak out on growth concerns.

Thematics

Element of timing needed to maximise returns from commodity investing; align portfolio exposure with next super cycle. Stay with select individual commodities as inflation hedge.

Theme: Commodities

Commodities rebounded in July on easing macro conditions. But it is still early days for a sustainable new rally cycle for commodities. Furthermore, China, the largest consumer of commodities globally is facing a series of headwinds in the form of lacklustre policy stimulus and weak economic growth.

In this piece, we explore the element of timing in commodity investing, including the efficacy of commodities as an inflation hedge and portfolio risk diversifier.

Source: Unsplash

01.
Asset Allocation.

Hou Wey Fook, CFA
Chief Investment Officer

Dylan Cheang
Strategist

The recession that never was. The late economist John Maynard Keynes famously said, "When the facts change, I change my mind". These words resonate with investors navigating the ebbs and flows of global financial markets today.

Since mid-2022, the street has been calling for the imminence of a US recession "within 12 months". The train of thought was simple: High inflation, coupled with rising interest rates, will hit domestic consumption and throw the economy into a tailspin. This assumption was reinforced by the fact that the US Treasury yield curve – historically a harbinger of impending recession – had undergone inversion.

But a year has passed. And the much talked-about recession is still nowhere in sight. We attribute this phenomenon to a confluence of factors happening on the American corporate and households front. On the corporate side of the equation, US earnings have remained strangely resilient despite rising bond yields and this could be attributed to:

1. Sharp reduction in interest expense: Based on conventional thinking, companies' interest expense will increase as policy rates rise and historically, this has been the case:

    » In Mar-1989, the Fed Funds rate peaked at 9.75% and interest payments (plus miscellaneous) as percentage of net operating surplus for US non-financial companies peaked at 37.9% in subsequent six quarters.

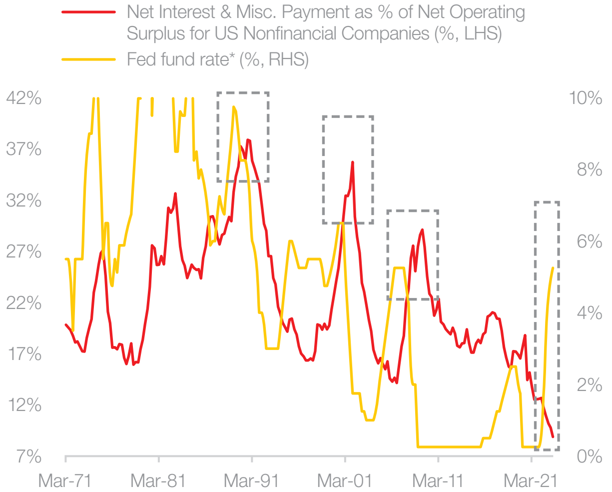
    » In Jun-2000, the Fed Funds rate peaked at 6.5% and the interest expense ratio hit a high of 35.7% in subsequent six quarters.

    » More recently in Jun-2006, we saw the Fed Funds rate peaking at 5.25% and the interest expense ratio plateaued at 29.1% in subsequent 12 quarters.

But post-Subprime crisis, the reverse happened. As central banks around the world slashed policy rates to the zero bound, US companies seized the opportunity to refinance their liabilities to long-term fixed debt at low interest rates.

This explains why, despite the Fed fund rate hitting 5.25% in this monetary tightening cycle, the interest expense ratio has fallen to a low of 8.9% (vs. long-term average of 22.1%). Low interest expense allows US companies to maintain their corporate profitability despite macro headwinds.

Interest expense ratio on the decline despite rising bond yields



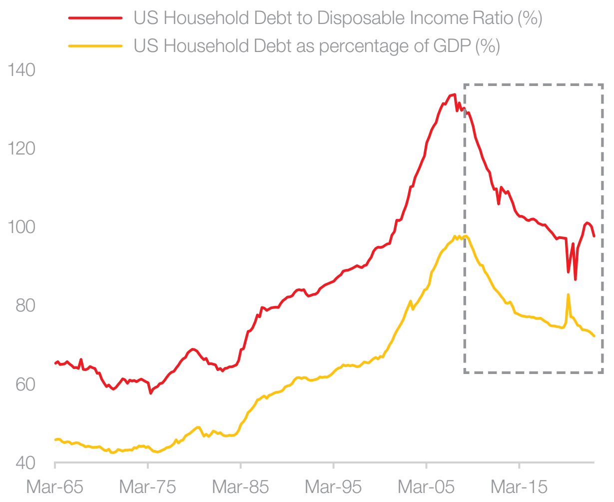
Source: Bloomberg, DBS
*Chart is truncated

2. Prevalence of "Greedflation": The phenomenon of "Greedflation", a point which we highlighted last quarter, refers to companies taking advantage of rising inflation to mark up their average selling prices far higher than the increase in input cost. This underpins why US profit margins have managed to stay elevated despite tightening monetary condition. Lael Brainard (the previous Vice Chair of US Federal Reserve) previously highlighted the prevalence of this trend during the start of the year.

On the households front, US domestic consumption has similarly remained resilient and this is due to:

3. Sharp reduction in interest expense: US household savings grew at an unprecedented rate during the pandemic amid strong fiscal response from the federal government and weakness in consumer spending (given economic closures and social distancing). While these savings have undergone rapid drawdowns since, the Fed estimates that c.USD500b worth of excess savings still exist in the economy and underpin domestic consumption.

American household balance sheet in healthy shape



Source: Bloomberg, DBS

4. Low household debt: US household debt to disposable income has remained near historical lows as it retraced from the high of 133.72% in 1Q08 to 97.68% in 1Q23. This suggests American household balance sheets remain healthy and are less impacted by rising rates given the absence of excessive gearing during the boom years.

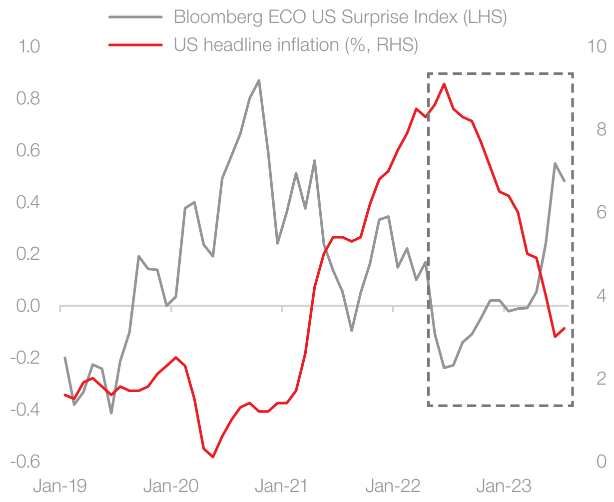
5. Resilient labour market: A commonly held assumption is for the US labour market to deteriorate as rising rates weigh on economic activities. The reverse, however, is happening. Despite aggressive Fed tightening, US unemployment remains near historical lows while salary gains are at historical highs, averaging at 4.8% since 2020.

   Factors underpinning US labour market strength include (a) strong fiscal response to the Covid-19 pandemic and (b) phenomenon of dislocated workers securing salary increments upon their return to the workforce given widespread labour shortages.

Time for a recalibration of base-case assumptions. Clearly, the street has vastly misinterpreted the strength and underlying resilience of the US economy. Given the prevalence of "Goldilocks" conditions (characterised by moderating inflation and firm economic momentum), the likelihood of a "soft landing" for the US economy is on the rise.

But the fight against inflation is far from over. While inflationary pressure has softened globally, central bankers are now facing the dilemma of navigating between further tightening or putting rates on hold as they await the effects from previous rate hikes.

"Goldilocks" conditions in play



Source: Bloomberg, DBS

Rate hikes, meanwhile, are admittedly a blunt and inappropriate instrument to solve today's inflation challenges. The stubbornly high inflation stemmed not from overheating demand but from global supply chain shocks arising from the Covid-19 pandemic and ongoing Russia-Ukraine crisis. Solving supply shocks is never going to be easy.

In the coming quarter, the shifting macro and geopolitical landscape warrants a recalibration of our base case assumptions and we believe that the following themes will dominate in 4Q23:

- Re-emergence of "Higher for Longer"
- End of an era: Preference for bonds over income equities
- China: In dire need of policy clarity

Re-emergence of "Higher for Longer"

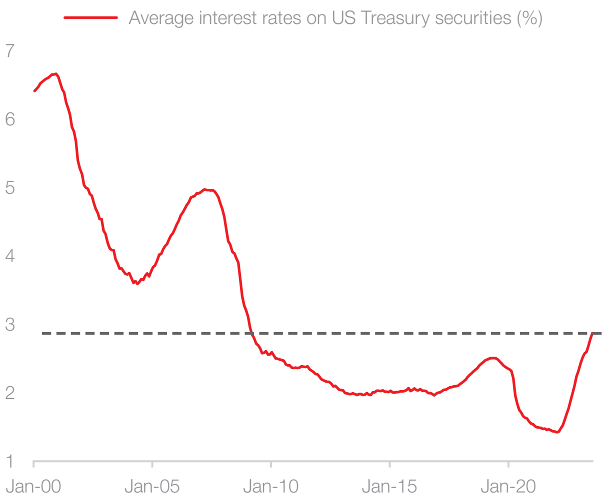
Resurgent bond yields and implications for risk assets. Inflation-adjusted bond yields are rising. From the lows of 1.06% on 6 April, the Treasury Inflation-Protected Securities (TIPS) 10Y yield has surged to 1.922% (as of 13 Sep) due to:

1. US economic resilience: US economic data has been surprising on the upside and this is evident from the broad up-move in the Citi Economic Surprise index this year. Retail sales, ISM Services, and strong employment numbers all suggest that US consumers can withstand the pressure from rising inflation and interest rates. In fact, the Atlanta Fed is currently projecting GDP growth of 5.571% (vs. 1.942% back in 3 Jul) as the recovery gathers.

2. Rising Treasury issuance: Treasury issuance is on the rise. Based on projections from the US Department of Treasury, the auction size for the 2Y note is expected to be at USD51b in October (vs. USD42b in March) while issuance of the 5Y note is slated to be at USD52b (vs. USD43b in May).

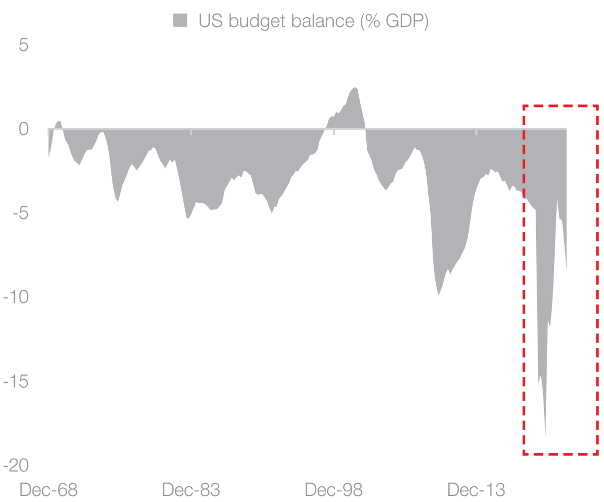
   The increase in auction sizes is driven by two factors: (a) rising Treasury debt servicing cost in the US as the average interest rate for Treasury securities hit 2.873% in July (highest level since Feb-2009) and (b) the need to bridge the gap between tax revenue and government spending.

US debt servicing cost on the rise



Source: Bloomberg, DBS

US budget deficit: Sustainable?



Source: Bloomberg, DBS

3. BOJ loosening of YCC: The BOJ has taken steps to loosen its YCC policy by allowing the 10Y JGB yield to fluctuate within a 1% band (as opposed to 0.5%). A resilient Japanese economy, coupled with rising price pressure and lingering yen weakness, are likely to prompt the BOJ to further tighten monetary policy.

   For years, Japanese investors have been one of the biggest buyers of foreign bonds in the global search for yield. But as bond yields in Japan head higher, these investors will increasingly switch out of foreign markets to seek opportunities at home, and this will inevitably put upward pressure on global bond yields.

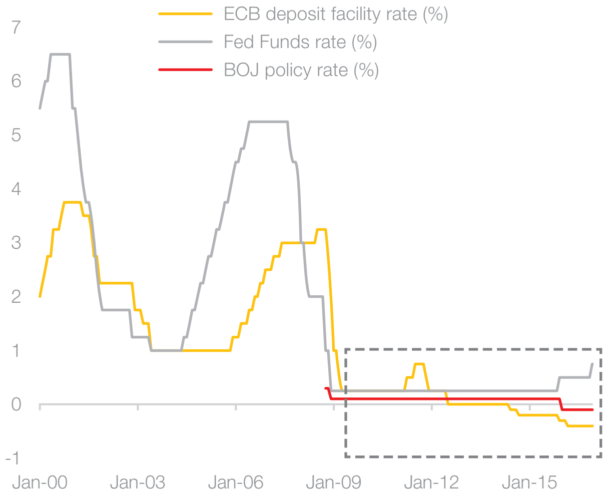
We believe the bar for rate cuts is set sufficiently high and the Fed will likely keep rates on hold (at elevated levels) in the forthcoming months until recessionary signals emerge. Until then, elevated bond yields are expected to weigh on growth equities from a valuation perspective. Companies with weak profitability and low cash flow will be particularly impacted.

End of an era: Preference for bonds over income equities

The global "search for yield" – A recap. Since the Global Financial Crisis in 2008, the Fed adopted a "zero interest rate" policy by cutting rates close to the zero bound – a similar move previously adopted by the BOJ. This, followed by years of quantitative easing, kept long-term Treasury yields anchored to the lows.

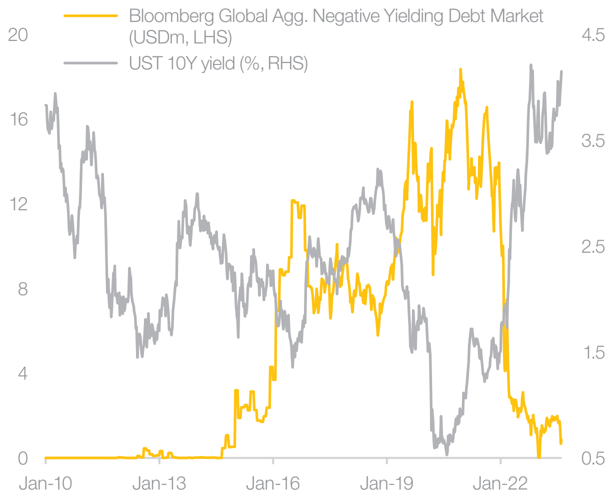
In the decade that followed, a common portfolio strategy adopted by investors was the global "search for yield". To support economic activities and attain overall price stability, the ECB and BOJ introduced a "negative interest rate" policy (in 2014 and 2016 respectively), setting the stage for a global deluge of negative yielding government bonds in subsequent years.

Policy rates headed south after Subprime crisis



Source: Bloomberg, DBS

Broadly inverse relationship between negative yielding bonds and bond yields



Source: Bloomberg, DBS

Yield scarcity drove portfolio allocators to income equities. Global bond yields languished in the doldrums after the Global Financial Crisis. And despite a brief reprieve during 2017-2018, yields resumed their downward spiral when Covid-19 pandemic struck. To rescue fledging economies hard hit by the crisis, central banks took out their usual playbook and slashed policy rates again.

The scarcity in yield compelled portfolio allocators to divert their exposure from government bonds to corporate credit and beyond:

» From 2001-2010, the average yield for US 10Y Treasuries was 4.1%. However, aggressive monetary easing and overall economic instability drove the average yield to 2.1% from 2011-2021 (a decline of 200 bps).

Strategies to navigate yield scarcity

	Average yield (%)
UST 10Y yield (2001 till 2010)	4.1
UST 10Y yield (2011 till 2021)	2.1
Bonds – Blended Yield (2011 till 2021)	2.6
Bonds & Income Equities – Blended Yield (2011 till 2021)	3.1

Source: DBS

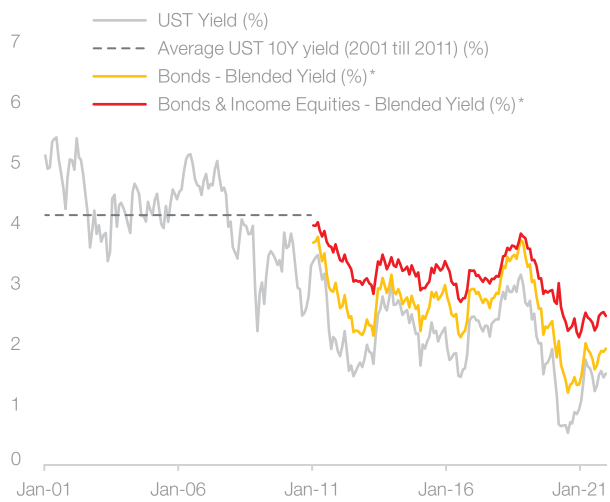
» To enhance portfolio yield, investors diverted their exposure from government bonds to corporate credit. An equal-weighted portfolio consisting of government and corporate bonds garnered an average yield of 2.6% from 2011-2021.

» To further enhance portfolio yield, investors switched their allocation to income equities. An equal-weighted portfolio consisting of government bonds, corporate bonds, and income equities garnered an average yield of 3.1% from 2011-2021.

The third strategy of combining bonds and income equities was widely adopted during years where yield was in extreme scarcity.

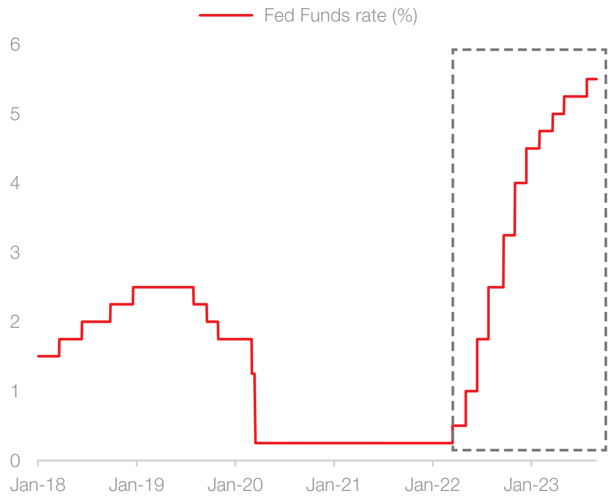
Changing Lanes – Rising preference for bonds over income equities. The post-pandemic inflation surge as a result of the Russia-Ukraine crisis and supply chain disruption took central bankers by surprise. US headline inflation rose and hit a peak of 9.1% in Jun 2021 (the highest since the early-80s), compelling the Fed to pivot from its “transitory inflation” narrative to hawkish monetary tightening.

Investors gained exposure to income equities to enhance portfolio yield



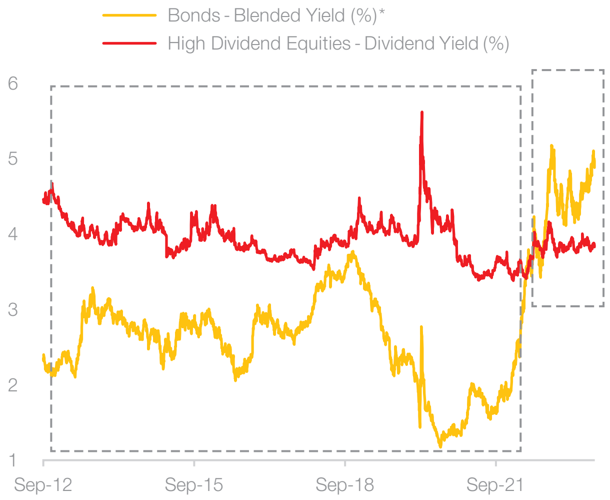
*Consisting of US government & corporate bonds
Source: Bloomberg, DBS

Acute Fed pivot from "transitory inflation" narrative



Source: Bloomberg, DBS

Blended bond yield exceeding dividend yield



*Consisting of US government & corporate bonds
Source: Bloomberg, DBS

Now, with bond yields expected to stay "higher for longer", a recalibration of the "search for yield" portfolio strategy is necessary.

Since Aug 2022, the blended yield for bonds (consisting of Treasuries and corporate bonds) has superseded the dividend yield for income equities. This suggests that the addition of income equities no longer boosts the overall yield of a portfolio. And therefore from a yield perspective, we prefer bonds over income equities at this part of the market cycle.

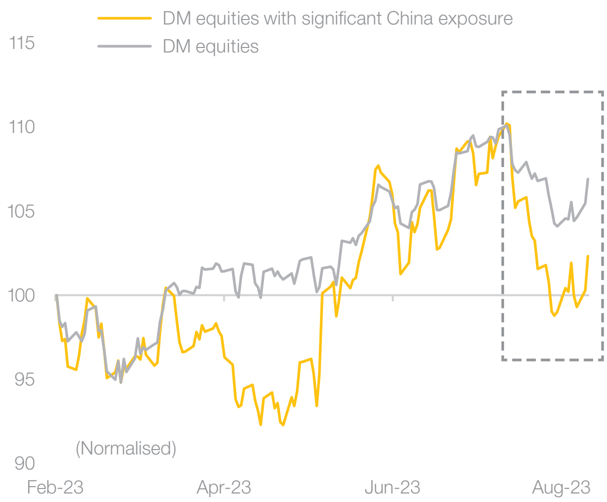
China: In dire need of stimulus and policy clarity

"Japanification": The Chinese great wall of worries. Back in January, confidence on China's outlook was sky high. But the mood has soured quickly as the market was subsequently dealt a one-two punch. The first was the weaker-than-expected post-pandemic economic reopening. Indeed, initial hopes of strong pent-up demand spurring domestic consumption failed to transpire as Chinese consumers stayed on the sidelines even after the end of the Covid-zero policy.

The fiasco surrounding Country Garden rekindled systemic concerns on the real estate sector (which accounts for roughly one quarter of China's economy) and the shadow banking space. More crucially, it also put the spotlight on China's "Japanification" moment as conversations surrounding structural imbalances in the Middle Kingdom took hold. Hopes of massive policy stimulus coming to the rescue, meanwhile, remained elusive. While the PBOC has cut lending rates, these policy measures are not substantial enough to give the economy a massive boost.

Investors are not standing still in the face of these headwinds. De-risking in China-related exposure is gathering steam; since August, a DM index consisting of companies with substantial China exposure has underperformed the broader market by 4.3 %pts (as of 29 Aug). We believe such weakness will persist until substantial monetary/fiscal stimulus and further clarity on government policies are evident.

Underperformance of DM markets with substantial China exposure



Source: Bloomberg, DBS


Source: Unsplash

4Q23 Asset Allocation – Preference for bonds over equities

Categories	Indicators	Score Range	Equities				Bonds		
			US	Europe	Japan	AxJ	DM Govt	DM Corp	EM Bonds
Fundamentals	PMI	-1 to +1	0	0	0	0	0	0	0
	Economic surprise	-1 to +1	0	-1	0	1	-1	1	1
	Inflation	-1 to +1	0	0	0	1	0	0	1
	Monetary policies	-1 to +1	0	0	-1	1	0	0	1
	Forecasted EPS growth	-2 to +2	0	-1	-1	0	-	0	0
	Earnings surprise	-2 to +2	1	-1	-1	0	-	0	0
Valuation	Forward P/E	-2 to +2	0	0	0	1	-	-	-
	P/B vs ROE	-2 to +2	0	-1	-1	0	-	-	-
	Earnings yield - 10Y yield	-2 to +2	-1	-1	0	1	2	2	1
	Free Cashflow yield	-2 to +2	0	0	1	0	-	-	-
	Credit spread	-2 to +2	-	-	-	-	-	0	0
Momentum	Fund flows	-2 to +2	1	-1	1	0	2	1	-1
	Volatility	-1 to +1	0	0	0	0	0	-	-
	Catalysts	-2 to +2	0	0	0	0	0	0	0
Raw Score			1	-6	-2	5	3	4	3
Adjusted Score*			**0.05**	**-0.29**	**-0.10**	**0.24**	**0.27**	**0.25**	**0.19**

*Note: The "Adjusted Score" is calculated using the "Raw Score" divided by the maximum attainable score for each category.

Source: DBS

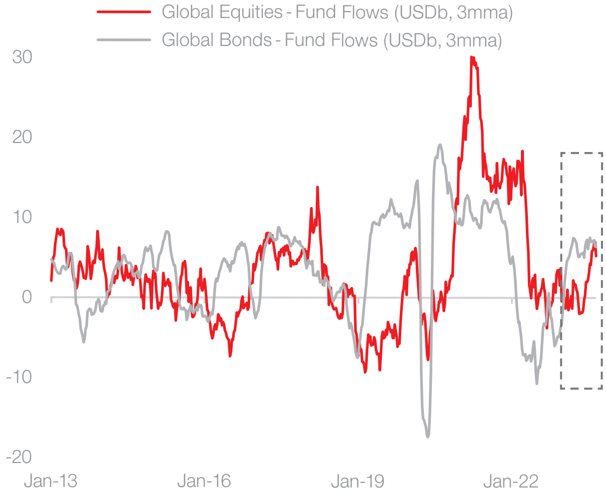
Cross Assets – Marginal preference for bonds over equities. The latest scoring on our CAA framework suggests that our view on both equities and bonds is broadly Neutral in 4Q, with a slight preference for bonds over equities (in particular dividend stocks).

Fundamentals: The US economy has remained broadly resilient despite tightening financial conditions and this is evident from economic indicators like retail sales and investments. Corporate and household balance sheets are evidently robust enough to absorb the increase in the cost of capital. Inflation, meanwhile, is on an easing path and the likelihood of a sharp spike in inflationary pressure further down the road is low.

On corporate earnings, the proportion of companies reporting positive earnings surprise in the US has improved marginally from 78.5% to c.79.9% in the recent reporting season. That said, the percentage of companies reporting actual earnings growth remains underwhelming at 57.4% as corporate margins pressure persists. Sectors that registered low percentage of earnings growth include Energy (c.21.7%) and Materials (c.27.6%).

Valuation: The gap between US earnings yield and US 10Y Treasury yield has contracted further to 0.324% in 3Q23 (as of 13 Sep) as bond yields continued their upward march during the quarter. Bonds are looking marginally more attractive than equities at this juncture.

Bonds continue to see stronger inflows than equities



Source: EPFR Global, DBS

Momentum: Inflows into global bonds remained healthy at USD50.9b during the quarter (as of 23 Aug), bringing total flows to USD230.3b YTD. Equities registered inflows of USD36.2b as well and this accounted for close to half of total net inflows for the year.

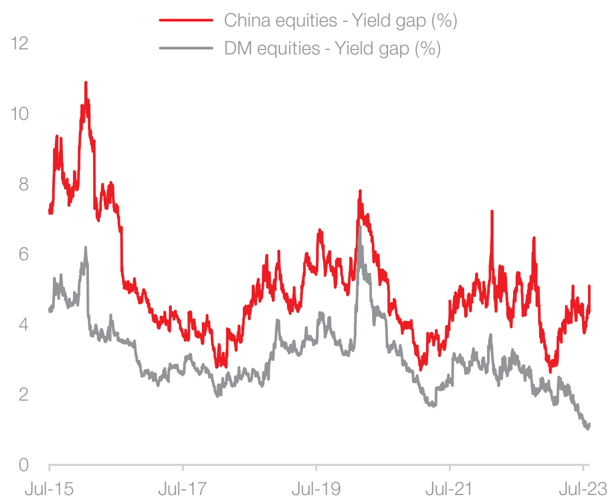
Equities: Equities on the retreat amid rising bond yields; little differentiation in regional performance expected. Global equities underwent a broad-based retreat in 3Q23 as resurgent bond yields triggered broad-based profit taking. Global equities was down 1.5% (as of 25 Aug) and no region was spared from this selldown. In DM, Japan and Europe underperformed with respective losses of 3.1% and 3.0%. The US managed to outperform marginally with a 0.8% decline, buoyed by strong performance in the energy space.

With bond yields staying "higher for longer", we expect equity markets to stay subdued in 4Q23 with little differentiation in performance among the key regions. The huge run-up in 2Q23 was predominantly driven by expectations of peak Fed. But the rhetoric at Jackson Hole suggests that this is not the case and hence, the initial enthusiasm for interest-rate sensitive plays will see some tapering in the months ahead.

Within DM, we maintain a preference for US and Japan given stronger macro momentum in these markets. Europe, on the other hand, continues to face recession headwinds as high inflation is forcing households to cut back on consumption.

Our call on Asia ex-Japan continues to underwhelm given overall weakness in China equities. But given the sharp run-up in DM equities, China is looking attractive from a valuation perspective. The yield gap stands at 5.1% and this is 393 bps higher than DM. A strong dose of policy stimulus will rekindle the animal spirits for the market.

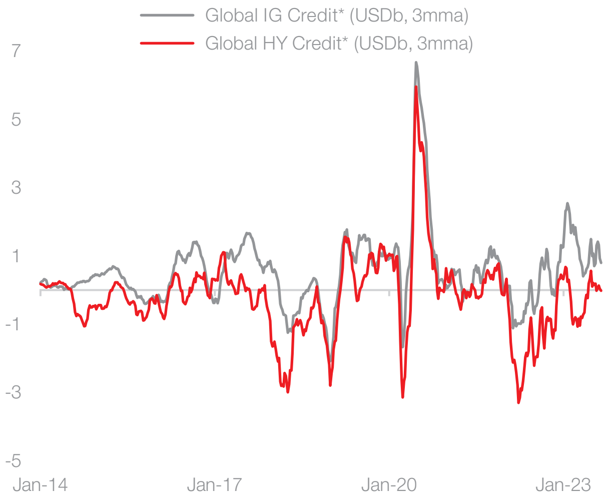
Attractive yield gap for China equities



Source: Bloomberg, DBS

Quality plays to outperform as the going gets tough. Despite overall headwinds, there is one silver lining: The outperformance of quality plays. Using US equities as proxy, since August, US quality stocks have outperformed the broader market. This reinforces the view that as the cost of capital rises, companies with strong fundamentals to withstand the challenging environment are preferred among portfolio allocators.

HY credit funds registered outflows this year



Source: EPFR Global, DBS
* Chart is truncated

<u>Bonds</u>: **Favour quality plays; sweet spot remains with A/BBB credit in 3-5Y duration bucket.** The abundance of government bonds offering attractive real yields is crowding out private sector issuance. This inevitably compels corporate issuers to delay their issuance in the hope that the financing could be done at a more favourable interest rate in the future. In this deleveraging phase, investors should stick to IG credit with strong balance sheets that can tide them through periods of volatility and high interest rates. Sweet spot remains with A/BBB credit in the 3-5Y duration bucket.

Meanwhile, we maintain our cautious view on HY credit. The latter possesses substantially lower duration compared to IG and this translates to higher refinancing risks in the years ahead. We expect HY spreads to widen next year as default risks mount in a high interest rates environment. Fund flows data from EPFR Global reinforces our view. On a YTD basis, fund inflows into IG credit totalled USD41.2b (as of 23 Aug) while HY credit registered outflows of USD9.1b.

<u>Alternatives</u>: **Seek opportunities in PE secondaries and private credit; gain exposure to gold as portfolio risk diversifier.** Despite moderating company valuations and bleak exit prospects, we see opportunities in the private equity secondaries market space. The same can be said for private credit. While the latter faces competition from attractive bond yields in public markets, portfolios with exposure to opportunistic strategies will still provide diversification benefits as they allow investors to hedge against economic headwinds through dislocations and defaults.

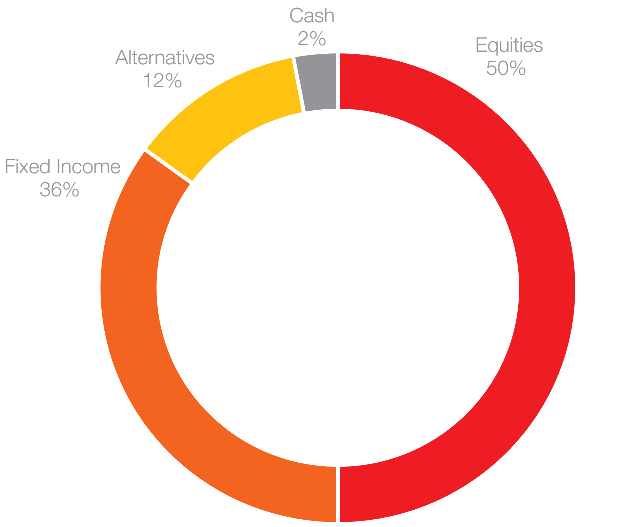
On gold, we maintain our constructive view with a 12M target price of USD2,050/oz. The peaking of Fed monetary tightening cycle and potential rate cuts starting in 2H24 are tailwinds for the precious metal. Apart from ETFs, we also see rising demand from central banks as simmering geopolitical uncertainties fuel the de-dollarisation narrative. Gain exposure to gold as a portfolio risk diversifier given its low correlation with major asset classes, in particular, global equities.

4Q23 Global Tactical Asset Allocation

	3-Month Basis	12-Month Basis
Equities	**Neutral**	**Neutral**
US Equities	Neutral	Overweight
Europe Equities	Underweight	Underweight
Japan Equities	Neutral	Underweight
Asia ex-Japan Equities	Overweight	Overweight
Fixed Income	**Overweight**	**Underweight**
Developed Markets (DM) Government Bonds	Overweight	Underweight
Developed Markets (DM) Corporate Bonds	Overweight	Neutral
Emerging Markets (EM) Bonds	Underweight	Neutral
Alternatives	**Overweight**	**Overweight**
Gold	Neutral	Overweight
Private Assets & Hedge Funds	Overweight	Overweight
Cash	**Underweight**	**Neutral**

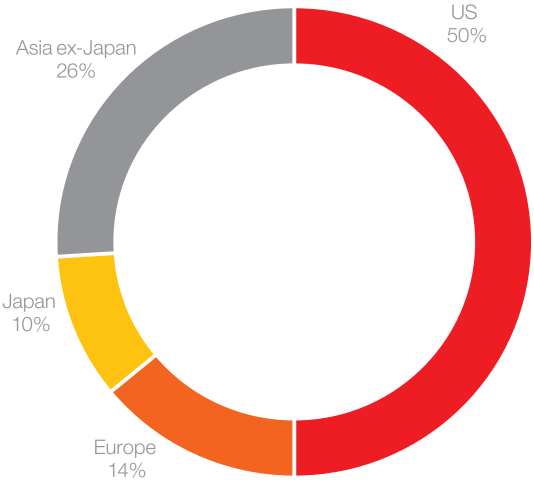
Source: DBS

TAA breakdown by asset class (Balanced Profile)



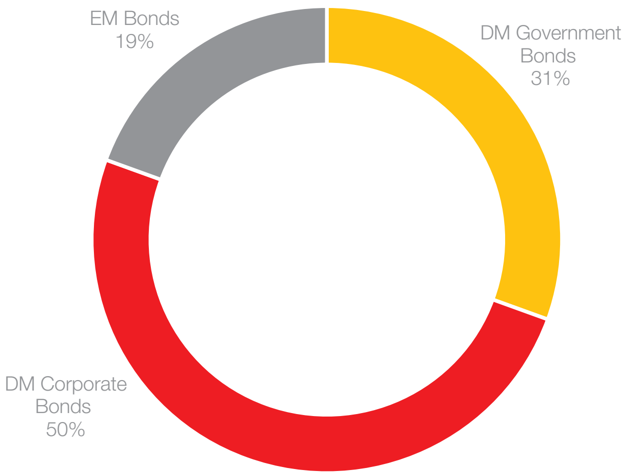
Source: DBS

TAA breakdown by geography within equities (Balanced Profile)



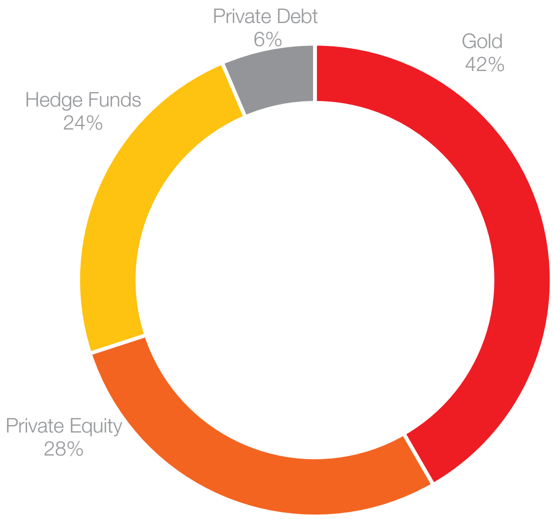
Source: DBS

TAA breakdown by bond types within fixed income (Balanced Profile)

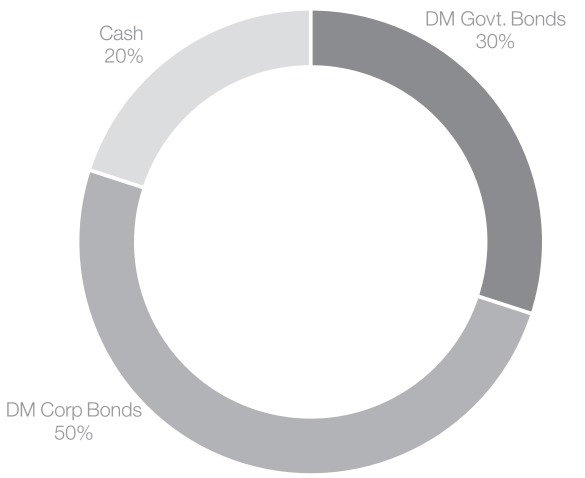


Source: DBS

TAA breakdown by segments within Alternatives (Balanced Profile)



Source: DBS



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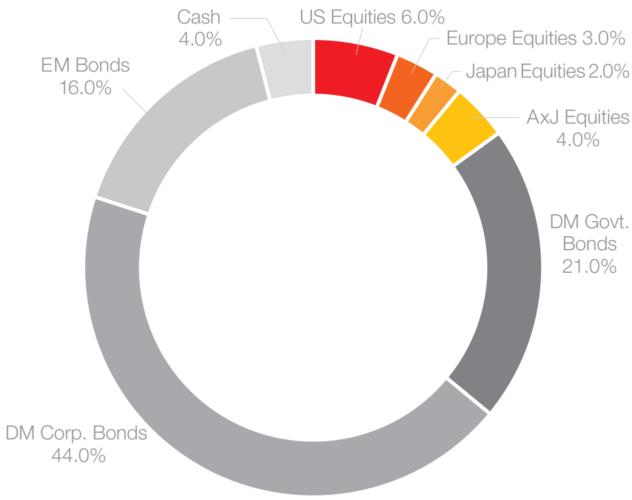


Source: DBS

CONSERVATIVE

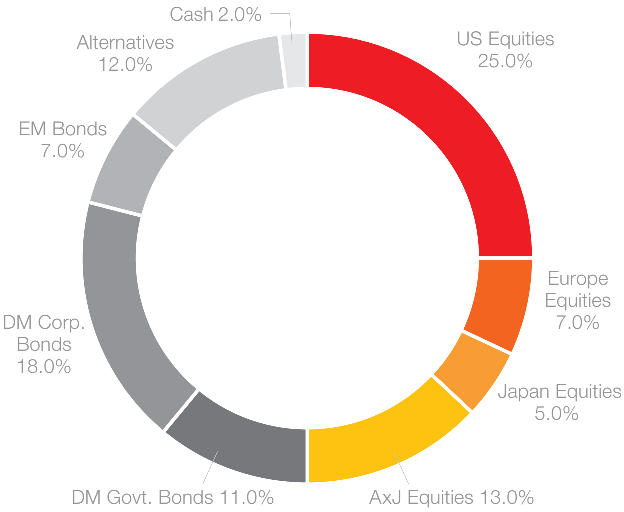
	TAA	SAA	Active
Equities	**0.0%**	**0.0%**	
US	0.0%	0.0%	
Europe	0.0%	0.0%	
Japan	0.0%	0.0%	
Asia ex-Japan	0.0%	0.0%	
Fixed Income	**80.0%**	**80.0%**	
Developed Markets - Government	30.0%	30.0%	
Developed Markets - Corporate	50.0%	50.0%	
Emerging Markets	0.0%	0.0%	
Alternatives	**0.0%**	**0.0%**	
Gold	0.0%	0.0%	
Private Assets & Hedge Funds*	0.0%	0.0%	
Private Equity	0.0%	0.0%	
Hedge Funds	0.0%	0.0%	
Private Debt	0.0%	0.0%	
Cash	**20.0%**	**20.0%**	

*Only P4 risk rated UCITs Alternatives

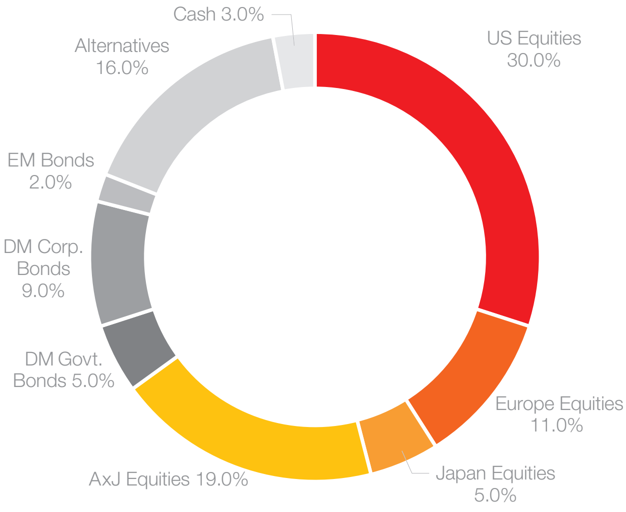
MODERATE

	TAA	SAA	Active
Equities	**15.0%**	**15.0%**	
US	6.0%	6.0%	
Europe	3.0%	4.0%	-1.0%
Japan	2.0%	2.0%	
Asia ex-Japan	4.0%	3.0%	1.0%
Fixed Income	**81.0%**	**80.0%**	**1.0%**
Developed Markets - Government	21.0%	20.0%	1.0%
Developed Markets - Corporate	44.0%	40.0%	4.0%
Emerging Markets	16.0%	20.0%	-4.0%
Alternatives	**0.0%**	**0.0%**	
Gold	0.0%	0.0%	
Private Assets & Hedge Funds*	0.0%	0.0%	
Private Equity	0.0%	0.0%	
Hedge Funds	0.0%	0.0%	
Private Debt	0.0%	0.0%	
Cash	**4.0%**	**5.0%**	**-1.0%**

*Only P4 risk rated UCITs Alternatives



Source: DBS



Source: DBS

BALANCED

	TAA	SAA	Active
Equities	**50.0%**	**50.0%**	
US	25.0%	25.0%	
Europe	7.0%	10.0%	-3.0%
Japan	5.0%	5.0%	
Asia ex-Japan	13.0%	10.0%	3.0%
Fixed Income	**36.0%**	**35.0%**	**1.0%**
Developed Markets - Government	11.0%	10.0%	1.0%
Developed Markets - Corporate	18.0%	15.0%	3.0%
Emerging Markets	7.0%	10.0%	-3.0%
Alternatives	**12.0%**	**10.0%**	**2.0%**
Gold	5.0%	5.0%	
Private Assets & Hedge Funds*	7.0%	5.0%	2.0%
Private Equity	3.4%	2.4%	1.0%
Hedge Funds	2.8%	2.0%	0.8%
Private Debt	0.8%	0.5%	0.2%
Cash	**2.0%**	**5.0%**	**-3.0%**

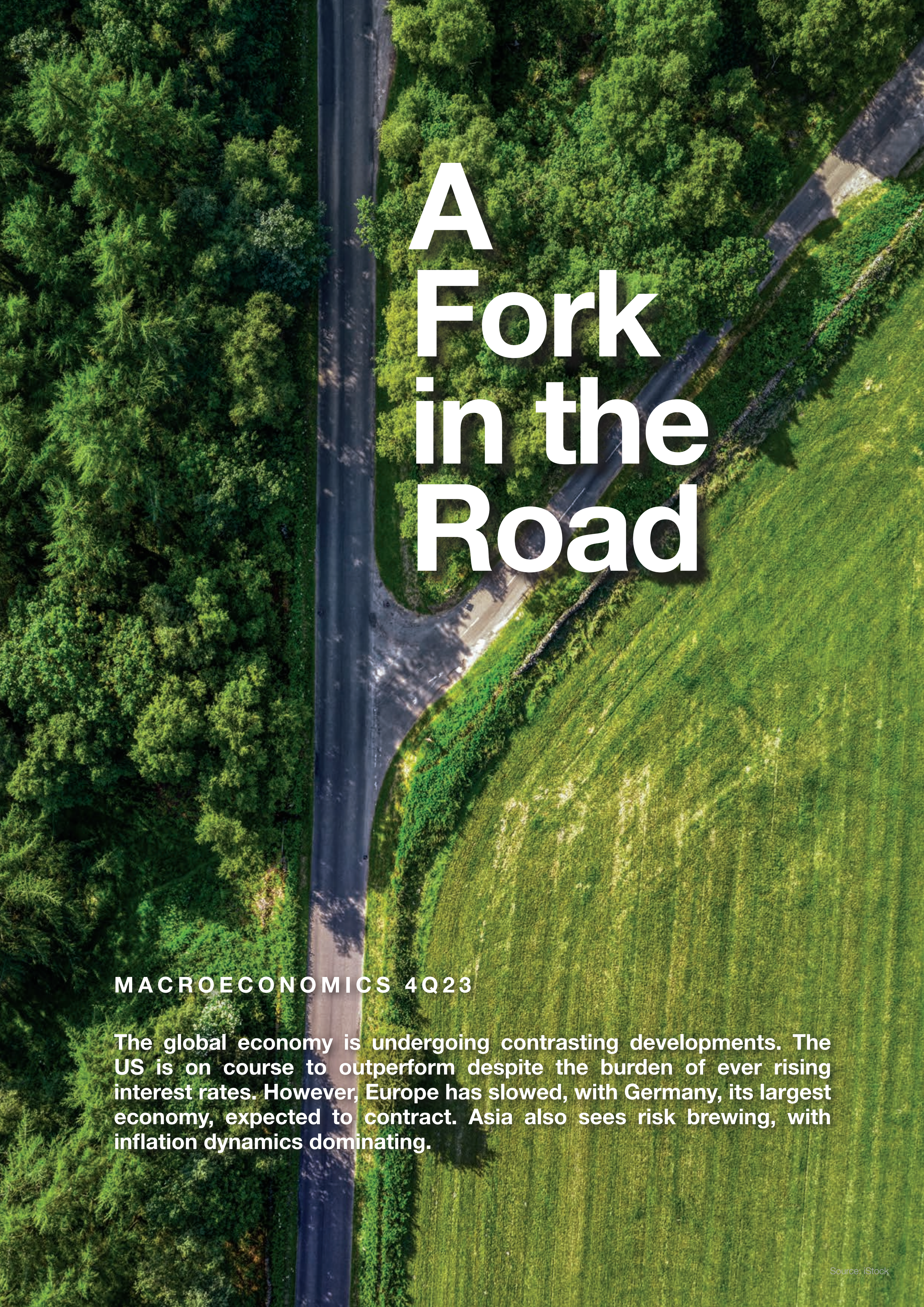
*Only P4 risk rated UCITs Alternatives

AGGRESSIVE

	TAA	SAA	Active
Equities	**65.0%**	**65.0%**	
US	30.0%	30.0%	
Europe	11.0%	15.0%	-4.0%
Japan	5.0%	5.0%	
Asia ex-Japan	19.0%	15.0%	4.0%
Fixed Income	**16.0%**	**15.0%**	**1.0%**
Developed Markets - Government	5.0%	4.0%	1.0%
Developed Markets - Corporate	9.0%	7.0%	2.0%
Emerging Markets	2.0%	4.0%	-2.0%
Alternatives	**16.0%**	**15.0%**	**1.0%**
Gold	5.0%	5.0%	
Private Assets & Hedge Funds*	11.0%	10.0%	1.0%
Private Equity	5.3%	4.9%	0.5%
Hedge Funds	4.5%	4.0%	0.4%
Private Debt	1.2%	1.1%	0.1%
Cash	**3.0%**	**5.0%**	**-2.0%**

*Only P4 risk rated UCITs Alternatives

Notes:
1. The above are based on three-month views.
2. Asset allocation does not ensure a profit or protect against market loss.
3. "TAA' refers to "Tactical Asset Allocation". "SAA" refers to "Strategic Asset Allocation".
4. Based on the SAA model, the Aggressive model has the highest risk, followed by Balanced, Moderate, and Conservative, with Conservative being the least risky.
5. The investor type classification for the portfolio has no direct relationship with the Financial Needs Analysis customer risk profile types and the portfolios are not assigned any product risk rating based on the bank's proprietary risk rating methodology.



A Fork in the Road

MACROECONOMICS 4Q23

The global economy is undergoing contrasting developments. The US is on course to outperform despite the burden of ever rising interest rates. However, Europe has slowed, with Germany, its largest economy, expected to contract. Asia also sees risk brewing, with inflation dynamics dominating.

Source: iStock

02. Macroeconomics.

Taimur Baig, Ph.D.
Chief Economist

Radhika Rao
Economist

Ma Tieying
Economist

Suvro Sarkar
Analyst

US

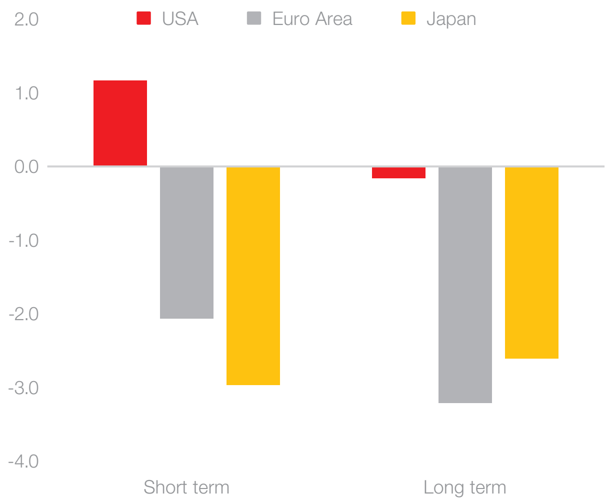
A spring in the US economic cycle. Instead of slowing under the burden of 5%+ interest rates, real economic indicators such as retail sales, housing, travel, and investments have surprised on the upside. It turns out that the balance sheets of US firms and households are sufficiently robust to absorb the rate costs thus far. Delinquencies may rise in the months ahead due to refinancing, and earnings might get hit, but so far, the going has been good. At this moment, there is gathering upside to our 2023 growth forecast of 1.4%.

Inflation has been on an easing path. Despite some adverse developments in the food and energy areas, inflation has retreated from the peak of c.9% last year to c.3% presently. There may not be much room left for additional disinflation in our forecasting horizon, but we do not see risks of a meaningful rebound in inflation pressures this year. The Fed should have room to pause for an extended period.

The Fed may be all but done with hiking policy rates, but monetary conditions are not done tightening at all. Reduction in the central bank's balance sheet would continue apace through this year and beyond. After all, despite the quantitative tightening done so far, the balance sheet is at USD8.2t, still double that of the pre-pandemic level.

Additional tightening would come even if the Fed holds the policy rate constant. For the rest of the year, we forecast disinflation of another 40 bps at the headline level and another 80 bps at the core PCE level. It follows therefore that 40-80 bps of real interest rate increase is in the pipeline. This would help the Fed demonstrate its vigilance over inflation.

Room for real rates to rise



Source: CEIC, DBS
Real rates calculated by taking the difference between short or long-term rates and average inflation.
2023 annual inflation forecast is used. Rates refer to June 2023

The complication would come next year, if both headline and core inflation rates get stuck at around 3%. Real rates will stop rising, putting the Fed in a bind as its 2% inflation target would remain elusive. Resuming rate hikes would be very challenging, as economic growth would be 1% by then, if not lower, as per our forecast.

A very different ballgame in Europe or Japan. Monetary conditions in Europe and Japan are not even close to being restrictive given the relatively high rates of prevailing inflation. The ECB tightened policy further on 27 July, with the benchmark deposit rate reaching 3.75%, matching the high last seen in 2001. While there is some indication of inflation easing in the Eurozone, the situation is far more uncomfortable for the ECB than it is for the Fed.

We are sure the ECB would not want to undermine sentiments at a time when the economy is slowing, but we also recognise that it is in no position to give dovish signals. Either through further rate hikes or through disinflation, real rates have only one way to go in the Euro Area, and that is up. When the BOJ stated during its July meeting that it would consider the 0.5% cap on 1Y government bond yield as a suggestion, not a rigid limit, the announcement caused major moves in Japan's currency and bond space. By also stating that the central bank would buy bonds at 1% yield, the BOJ effectively adjusted yield curve control policy upward. While the instrument and modality are very different from the ECB, the result would be largely the same – a rise in real interest rates.

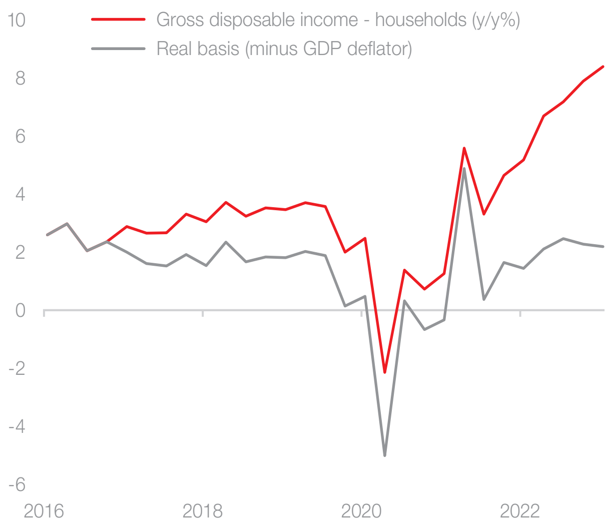
Hence, a mix of higher-for-longer rates and some disinflation would push up real rates in major economies. These developments would not dominate headlines the way typical nominal policy rate hikes do, but they would be profoundly consequential for growth (negative), currencies (EUR and JPY to rise over USD), and credit (tighter funding conditions).

Eurozone

Technical recession averted. The Eurozone economy expanded by 0.8% y/y in 1H23, slowing from average 3.4% growth in 2022. The revised sequential pace saw the bloc narrowly avert a technical recession at the start of the year, even though momentum was subdued. France and Spain boosted the overall growth numbers, besides Ireland which posted the largest increase among the member countries in 2Q (+3.3% q/q sa and 2.8% y/y), magnifying the overall lift.

Downtrend has eased. After a large correction in sentiment indicators in the first half of the year, there are early signs that the downtrend has eased and stabilised at weak levels into 3Q, as signaled by August Sentix and ZEW sentiment indices.

Gross disposable incomes



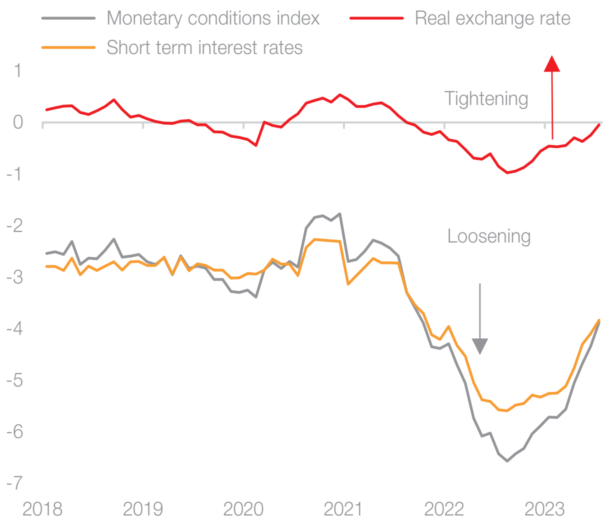
Source: CEIC, DBS

Households have benefited from a tight labour market, improving real wage growth, and pick-up in gross disposable incomes (real and nominal). We are, however, skeptical of a sharper rebound in consumption spending in the face of a bounce in global energy prices, simmering geopolitical issues, still above target inflation prints, and the rising cost of financing.

Barring a sharp upturn in commodity prices this year, a good part of the boost is likely to filter through the terms of trade benefit, also easing pressure on business costs. The bloc weathered the energy crisis well last year due to strong supply diversification, with storage levels likely to be well-supported this year. Manageable energy prices will also allow governments to gradually withdraw support measures in the coming months. We maintain our full year growth forecast at 0.6% y/y, more conservative than the ECB's projection of 0.9% (as of the July assessment).

Even as wide public deficits are growth-supportive, the aggressive rate tightening moves and the subsequent transmission to the real economy have taken a toll on credit demand from the industry and households. The July bank lending survey noted a drop in firms' net demand for loans in 2Q23 to an all-time low since the start of the survey in 2003. Demand for house purchases was also hurt by high interest rates, weakening housing market prospects, and low consumer confidence.

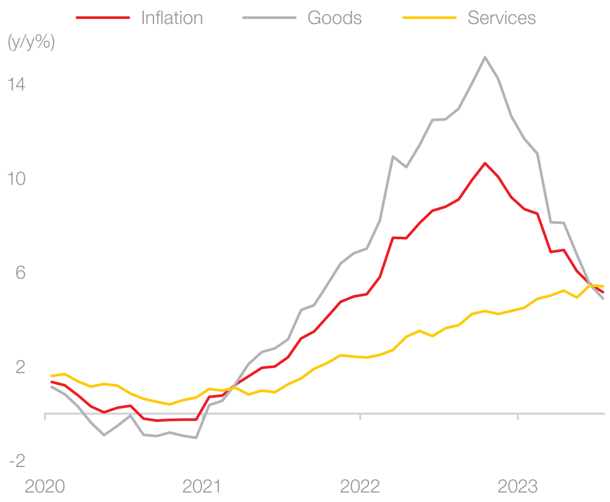
ECB's Monetary condition index tightens



Source: ECB, CEIC, DBS

Headline inflation has decelerated at a faster pace than core readings, helped by a correction in industrial goods, while service price pressures prove to be sticky. Among the member countries, inflation prints have been distorted, for example by withdrawal of support for the electricity bills the same time a year ago. The recent bounce in the global oil prices poses a near-term risk to the pace of fall in inflation, which is likely to keep the risk of further tightening alive. Our full year average stands at 5.6%.

Goods vs Service inflation drivers



Source: CEIC, DBS

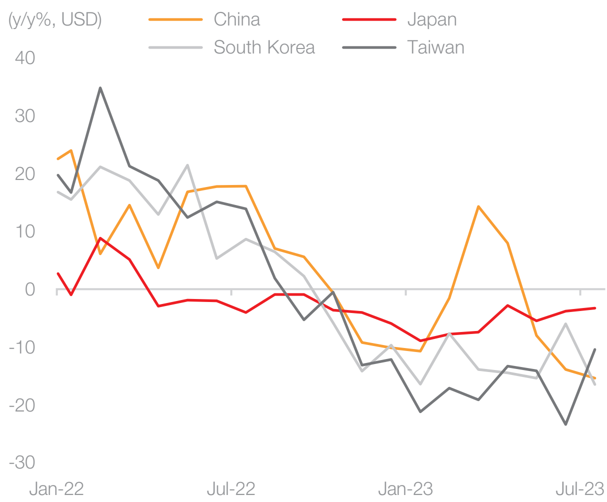
Factoring in the September 2023 hike, the cumulative increase in this cycle was a record 450 bps. Headline and core inflation readings are on the decline, but still above target. Factoring in concurrent weakness in activity indicators, the scope for further aggressive rate hikes is limited. At the latest review, President Lagarde remarked that "interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target". This can be construed to mean that rates might have peaked, but policy will be kept restrictive for an extended period of time to tame price pressures, putting to rest any hopes for a reversal in the policy direction towards easing. On the fiscal end, slowing inflation and GDP deflators are likely to see a slowdown in the decline (or even translate into a pick-up) in public debt to GDP levels through this year and the next.

Japan

Bucking the trend of a widespread slowdown. Japan maintained a steady expansion of 2.0% y/y in 2Q, mirroring the growth seen in 1Q. The robust 1H23 GDP performance justifies an upward revision of the full-year 2023 growth forecast, from 1.2% to 2.0%. This signifies a notable acceleration of about 1 %pt compared to the previous year, bucking the regional trend of a widespread slowdown.

Japan's exports exhibit a slightly better performance compared to regional peers amid the ongoing global trade downturn. Its diversified exports portfolio, characterised by a relatively small reliance on the electronics sector, underlines this resilience. Electronics constitute 19% of Japan's total exports,

Japan's exports fell at a relatively moderate pace



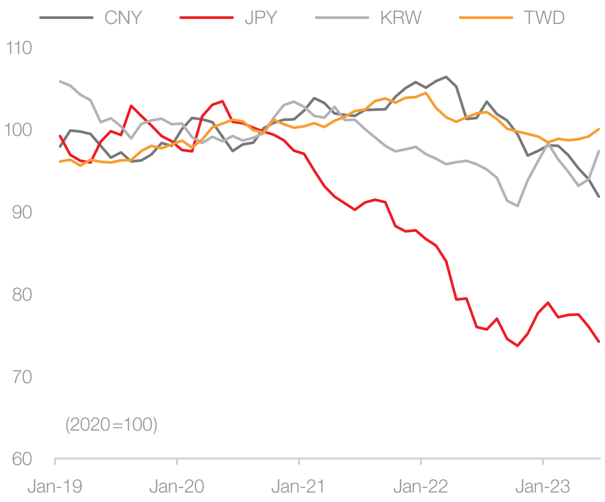
Source: CEIC, DBS

in contrast to China, South Korea, and Taiwan, where the proportion ranges from 30% to 50%. The electronics sector, impacted by waning demand and inventory destocking, has encountered challenges post-Covid. Conversely, the automotive sector, accounting for 17% of Japan's exports, is on a path to recovery, benefiting from supply chain stabilisation and the easing of chip shortages.

Furthermore, the yen's substantial depreciation also adds to Japan's export resilience. The JPY REER has witnessed a cumulative 25% decline since the outset of the pandemic in early 2020. The undervalued yen bolsters the competitiveness of Japan's exports. It also fosters the process of production reshoring, as a rising number of Japanese MNCs rebuild supply chains in the post-pandemic landscape.

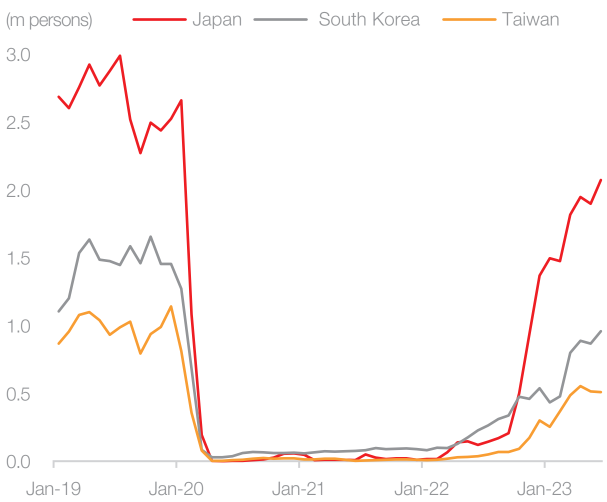
Tourism boosting Japan's recovery. Notably, Japan's tourism exports have performed better compared to regional counterparts since the post-Covid reopening. While China was a dominant source of tourism before Covid, Japan has effectively diversified its tourist sources in the post-pandemic era. Chinese tourists constituted 30% of Japan's total visitor arrivals in 2019, a proportion that dwindled to merely 5% in 1H23. The rest of Asia now contributes a substantial 70% to Japan's visitor arrivals. A weaker yen and Japan's enticing tourism resources have bolstered this impressive recovery.

JPY REER has fallen 25% since 2020



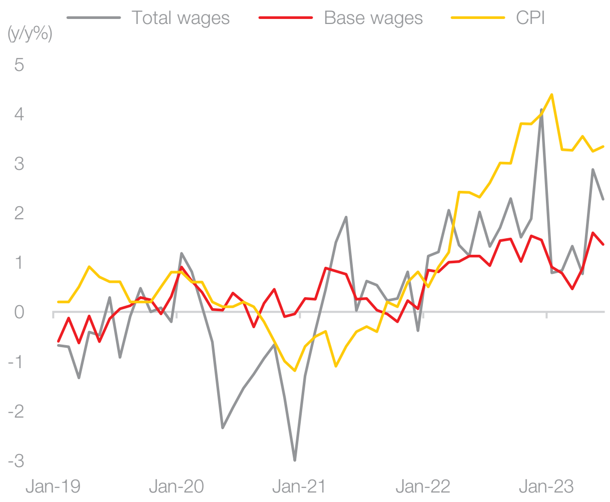
Source: CEIC, DBS

Japan's visitor arrivals have recovered 80%



Source: CEIC, DBS

Wage growth lagging behind inflation



Source: CEIC, DBS

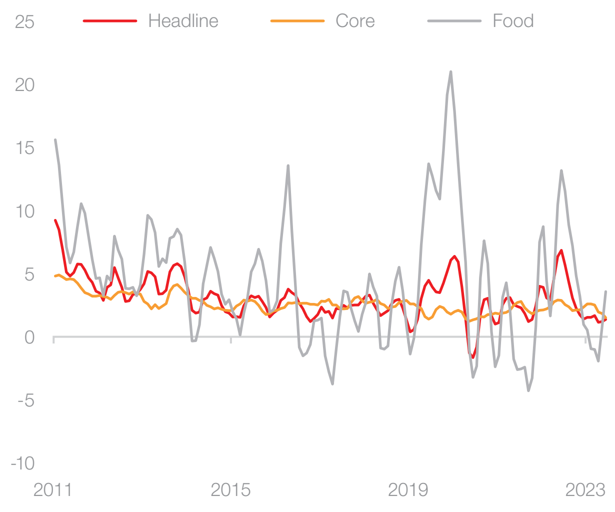
On the domestic front, Japan's recovery in consumer spending has followed a relatively slow and gradual path. Private consumption expenditure has largely returned to the pre-pandemic levels recorded in 4Q19, but they remain slightly below the 3Q19 levels preceding the 2019 sales tax hike. The ultra-low interest rate environment, appreciating asset prices, improving labour market conditions, and recovering consumer confidence collectively bolster consumption prospects. However, the primary impediment lies in surging inflation, driven by the yen's depreciation and elevated import costs. Although wage growth has picked up post Shunto negotiations, it still failed to adequately offset the inflationary impact. As a result, diminishing real wages have curtailed consumers' purchasing power and dampened consumption.

The impressive headline growth, despite varying performances between exports and domestic demand, bolsters the BOJ's assertion that the net impact of a weak yen remains beneficial for the overall economy. Following the YCC adjustment in July, the BOJ has embraced a more flexible approach, allowing the 10Y JGB yield to fluctuate between -0.5% and 1.0%. We expect the BOJ to maintain the YCC policy framework for the rest of the year.

Asia

Inflation worries less pronounced today than they were a year ago; in the US, headline and core inflation momentum, measured as 3M/3M, seasonally adjusted, annualised rate, is presently running at sub-3% and sub-5%, respectively. This is good news, given the inordinate impact of US monetary policy on global liquidity and rates. As the Fed pauses rate hikes given the improving backdrop of price increases, many central banks worldwide would also find room to pause.

Inflation momentum in Asia



Source: CEIC, DBS
Inflation momentum calculated as three month over three month (3M/3M), seasonally adjusted, annualised rate.

But that does not mean that price developments are uniform worldwide. Even though inflation is coming down in Europe and the UK, it is nonetheless much higher than in the US. For the likes of the BOE and ECB, the outlook remains challenging.

Stable core inflation in Asia. Asia's dynamic has had its own set of idiosyncrasies. Despite being hit by supply side disruptions, energy and food price spikes, and pandemic-era policy-induced macroeconomic volatility, core inflation has remained largely stable in the region. Our GDP-weighted measure of headline inflation momentum for Asia has remained below 4% through this entire cycle, a far more favourable development compared to the US or EU, or elsewhere in the EMs. We believe this is primarily attributed to the fact that output gaps have yet to close in Asia in this post-pandemic recovery phase. After all, the pandemic-era stimulus measures in this part of the world, with the notable exception of Singapore, were much more modest than what has been observed in the West. A key difference between US/EU/UK and Asia is the link between headline and core. Unlike the case in most industrial economies, headline inflation tends to pull up core in Asia, and not the other way around. This is because food and fuel make up a much larger chunk of EM Asian CPIs than their industrial counterparts.

Risk brewing in Asia. We have noted a resumption of rising food prices in many parts of the world. From cereals to protein, and cooking oil to vegetables, supply side worries have resurfaced due to factors ranging from El Niño to Ukraine's grain supply situation. This could spoil Asia's disinflation dynamic for the rest of the year.

Case in point: India. The authorities, while comfortable about the growth outlook, have acknowledged risks of a sharp upside to inflation in the near-term, driven predominantly by food segments due to inclement weather and seasonal forces. Together with higher foodgrains, pulses, and few other protein sources, the upswing is being compounded by a skewed monsoon, ongoing El Niño, and build-up in global food prices due to geopolitical tensions. Recent cautious commentary by the RBI was accompanied by an upward revision in the FY24 inflation forecast to 5.4% from 5.1% earlier.

China stands in sharp contrast to India. Waning growth and inflation dynamics form the narrative there. This is reflected in the price of shipping bulk goods to China, along with global metals and energy prices. Given China's outsized role in the global commodity markets, its weakening import demand is sending disinflationary impulse to the global economy. We, however, do not see this is as an unmitigated negative. Commodity deflation only hurts a few relatively wealthy exporters, while it spreads welcome relief for many economies struggling with inflation.

Oil: 2H23 could be near-term peak for oil

2H tracking better than 1H, as we had expected. Despite OPEC+ cuts, Brent crude oil price remained range-bound between USD70-80/bbl for a while in 2Q23 – a slower-than-expected showing. However, oil has rebounded over the last few months and breached the USD95/bbl mark. In our previous report, we had flagged our conviction that there would be a better oil price trajectory in 2H23. This is on the back of faster demand-supply balancing and the possibility of a deficit market emerging given the solo cuts from Saudi Arabia and seasonally higher demand. That trajectory seems to be playing out in line with our expectations, though the pace is faster than anticipated on the back of extended supply cuts from Saudi.

Can the rally be sustained? While the oil market deficit could continue to widen and prop up prices in the short term, we anticipate that the current one-way street could face some roadblocks. This includes renewed concerns around the global economic outlook if future data points worsen, a sticky inflation print leading central banks towards further tightening measures, possibility of demand destruction at USD100/bbl oil, and a stronger US dollar environment, among others. As such, despite the faster-than-expected oil price rally, we keep our average Brent crude oil price forecasts unchanged for now (2H23: USD85-90/bbl; 2024: USD80-85/bbl), with an upside bias.

Brent crude oil price on the rebound in 2H23

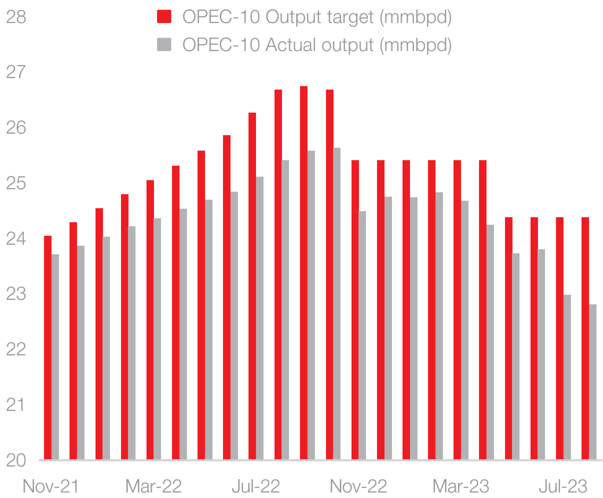
Source: Bloomberg, DBS

Sustained production cuts from Saudi have helped push market into deficit. The latest leg of the oil price rally has been driven by an extension of oil supply cuts by Saudi and to a lesser extent, Russia. On 5 September 2023, Saudi announced an extension of its 1.0mmbpd voluntary production cut till the end of December 2023. This would bring Saudi production to around 9mmbpd in the current months, a steep drop compared to the 11mmbpd production back in Sep 2022. Russia extended its 0.3mmbpd export cuts till the end of the year as well. We initially expected Saudi to gradually phase out some of the cuts by the end of the year given the tight market conditions, but it seems "doing whatever it takes" to keep oil prices elevated is a serious statement of intent.

Chances of a global hard landing have eased; we revise upwards our oil demand estimates for 2023. We had earlier revised downwards our 2023 global oil demand growth estimates to 1.0mmbpd, but the material slowdown and possibility of negative oil demand growth in mature economies like the US, the EU, and Japan have not materialised despite multiple rounds of rate hikes by the Fed and ECB. Given the demand trajectory we have seen so far in 2023, we are revising upwards our global oil demand growth estimates for the year to 1.5mmbpd. This is still on the conservative side compared to projections from global agencies (EIA, IEA) and OPEC. Despite the growth we are projecting, we are still looking at pre-Covid demand highs (101.9mmbpd recorded in 3Q19) only being re-visited in 2024.

Chinese oil demand has room to disappoint, capping our optimism on oil price trajectory. China's move away from the Covid-zero policy in late 2022 boosted hopes for strong oil demand growth after a disappointing 2022, when oil consumption and oil imports both fell in China. However, economic data in recent months has been disappointing and points to lingering slowdown trends, with retail sales growth slipping and investment and credit growth dragged by property sector woes. Under this scenario, our forecast of a 5% GDP growth in China in 2023 may come under downside risks. While authorities have instituted rate cuts and may also consider mild stimulus measures to revive growth, risks to the Chinese economy and the pace of oil demand growth will continue to cap optimism around oil prices.

OPEC's pre-emptive production cuts aimed at keeping oil prices at elevated levels



Source: Bloomberg, DBS

Quarterly average oil price forecast 2023/24 – DBS base case view

(USD per barrel)	1Q23A	2Q23A	3Q23E	4Q23F	1Q24F	2Q24F	3Q24F	4Q24F
Average Brent crude oil price	82.0	77.5	85.5	90.0	82.5	82.0	82.0	79.0
Average WTI crude oil price	76.0	73.5	81.5	86.0	79.5	79.0	79.0	76.0

Source: DBS

GDP growth and CPI inflation forecasts

	GDP growth, % y/y				CPI inflation, % y/y, ave			
	2021	2022	2023F	2024F	2021	2022	2023F	2024F
China	8.1	3.0	5.0	4.5	0.9	2.2	1.0	1.8
Hong Kong SAR	6.3	-3.5	4.8	2.0	1.6	1.9	2.0	2.0
India	8.9	6.7	5.8	6.0	5.1	6.7	5.8	4.0
India (FY basis)*	9.1	7.2	6.0	5.8	5.5	6.7	5.5	4.2
Indonesia	3.7	5.3	5.0	5.0	1.6	4.2	3.7	3.2
Malaysia	3.1	8.7	4.0	4.8	2.5	3.4	2.7	2.5
Philippines	5.7	7.6	5.8	6.5	3.9	5.8	5.4	3.2
Singapore	7.6	3.6	1.2	2.8	2.3	6.1	4.7	3.5
South Korea	4.1	2.6	1.5	2.4	2.5	5.1	3.4	2.0
Taiwan	6.5	2.4	0.5	3.5	2.0	2.9	2.3	1.4
Thailand	1.5	2.6	2.8	3.8	1.2	6.1	1.7	2.0
Vietnam	2.6	8.0	4.6	6.5	1.8	3.2	3.0	3.5
Eurozone	5.3	3.5	0.6	1.0	2.6	8.4	5.6	2.5
Japan	2.2	1.0	2.0	1.0	-0.2	2.5	3.0	1.0
United States	5.9	2.1	2.0	1.2	4.7	8.0	3.9	3.0

* refers to fiscal years, i.e. 2020 represents FY21 - year ending March 2021.

** new CPI series. *** eop for CPI inflation.

Source: CEIC, DBS

Policy interest rates forecasts, eop

	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24
Mainland China*	3.65	3.55	3.45	3.45	3.45	3.45	3.45	3.45
India	6.50	6.50	6.50	6.50	6.50	6.00	5.75	5.50
Indonesia	5.75	5.75	5.75	5.75	5.25	4.75	4.75	4.75
Malaysia	2.75	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Philippines	6.25	6.25	6.25	6.25	5.75	5.25	5.25	5.25
Singapore**	3.53	3.62	3.75	3.75	3.75	3.62	3.35	3.08
South Korea	3.50	3.50	3.50	3.50	3.25	3.00	2.75	2.75
Taiwan	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88
Thailand	1.75	2.00	2.25	2.25	2.25	2.25	2.25	2.25
Vietnam***	6.00	4.50	4.00	4.00	4.00	4.00	4.00	4.00
Eurozone	3.50	4.00	4.50	4.50	4.50	4.50	4.00	3.50
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
United States	5.00	5.25	5.50	5.50	5.50	5.50	5.00	4.50

* 1-yr Loan Prime Rate; ** 3M SOR ; *** prime rate.

Source: CEIC, DBS

Not Too Hot, Not Too Cold

US EQUITIES 4Q23

A soft landing for the US economy is on the cards. For 4Q23, we seek exposure to the following themes – Selective Tech Exposure, Higher for Longer, and an Ageing Population. Stay overweight on Technology, Communication Services, Financials, and Healthcare.

Source: iStock

03.
US Equities.

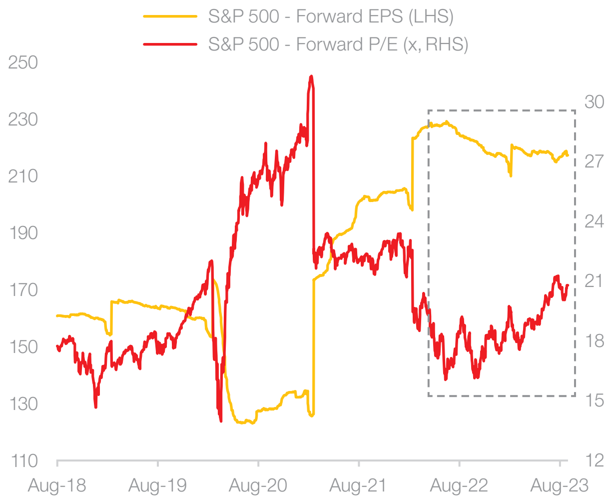
Dylan Cheang
Strategist

Moderation in S&P 500 performance amid changing macro dynamics. After a high octane 2Q23 which saw the S&P 500 registering gains of 8.7% (on a total returns basis), performance reverted to a more subdued level in 3Q23 with total returns of 0.6% (as of 6 Sep). While defensive sectors such as Utilities (-5.6%) and Consumer Staples (-3.3%) were major drags on performance, the Energy sector proved to be a standout performer. Riding on the momentum in crude oil price amid concerns over a global supply crunch, the Energy sector rallied 12.4% (far exceeding the 5.4% gain seen in Communications Services).

A breakdown of the S&P 500 performance unveiled two things:

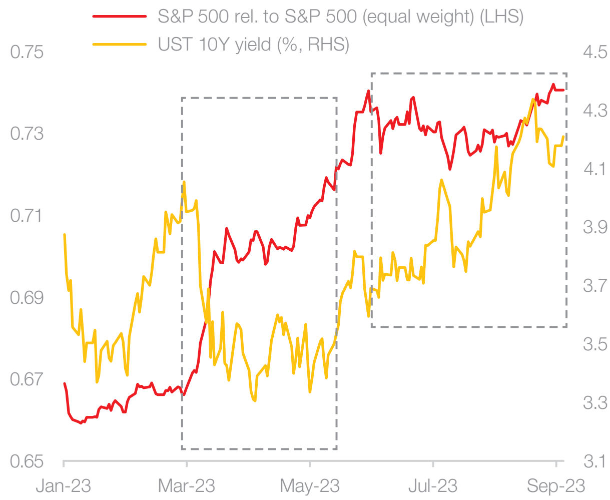
1. Valuation expansion amid rising "soft landing" expectations: All gains seen during the quarter were driven by the expansion of valuation multiple as opposed to earnings growth. Valuation expansion, in turn, reflects rising optimism that a "soft landing" for the US economy is on the cards given the resilience in recent economic data. In fact, the Atlanta Fed is projecting GDP growth of 5.576% (vs 1.942% back in 3 Jul) as the US economy gathers momentum.

S&P 500 up-move in 3Q driven entirely by valuation multiple expansion



Source: Bloomberg, DBS

Outperformance of growth equities to ebb as bond yields rise



Source: Bloomberg, DBS

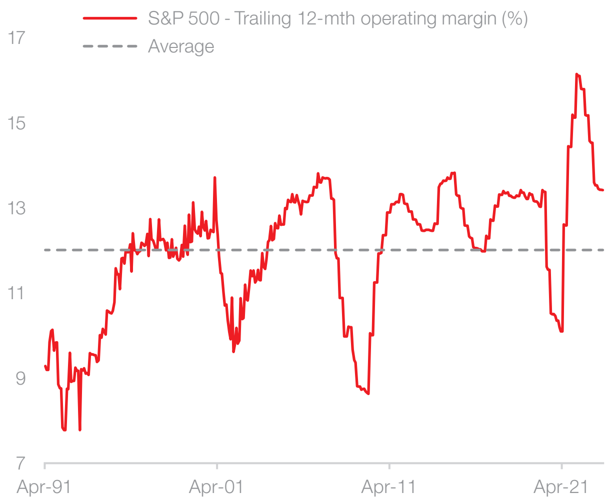
2. Outperformance of growth equities to ebb as bond yields rise: Back in 2Q23, the S&P 500 registered sharp outperformance over the S&P 500 (equal weighted) as growth equities rallied on the back of falling bond yields. Falling cost of capital is positive for growth companies from a valuation perspective. However, given the recent rebound in bond yields and rising expectations of "higher for longer", the outperformance of growth equities has moderated sharply and shall remain so as rates stay elevated.

US corporate earnings: Not as dire as initially thought. Back at the start of the year, the street was expecting US corporate earnings to fall on the back of margins compression. Such an assumption makes sense given that rising interest rates are expected to weigh on the top-line revenue for companies. Labour market resilience and robust salary growth, meanwhile, were expected to push operating expenses higher, translating to a margin squeeze for companies. But in the end, things were not as dire as initially expected.

On a YTD basis, the trailing 12-month operating margin (OPM) for the S&P 500 dipped 1.1 %pts. But despite the contraction, the prevailing OPM of 13.4% is nonetheless 1.4 %pts higher than the long-term average of 12.0%. This margin resilience, in turn, is translating to strong earnings beat. In the recent reporting season, earnings surprise remained high at 79.6%, propelled by strength in Technology, Communication Services, and Healthcare.

Investors' sectoral allocation: High conviction on Telecom Services and Healthcare. Sector allocation data from EPFR Global suggests that investors are currently Underweight on most sectors in the US to fund their Overweight calls on

US operating margins remain above long-term average despite macro headwinds



Source: Bloomberg, DBS

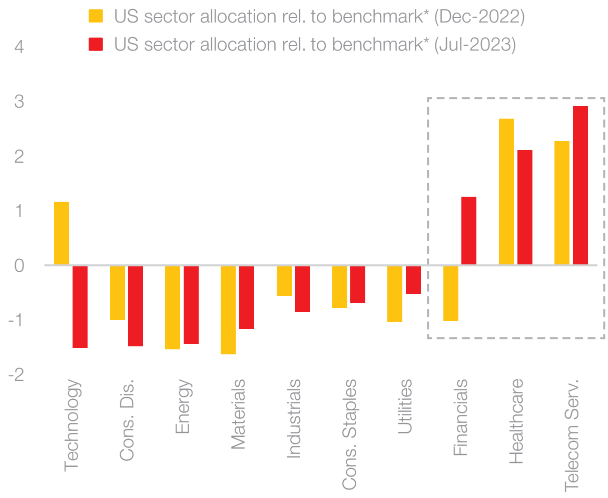
Telecom Services, Healthcare, and Financials. The key sectoral switch made YTD involved investors switching out of their Overweight positioning in Technology (at +1.2 %pts in Dec 2023) to fund an Overweight in Financials (at +1.3 %pts in Jul 2023). The latest sectoral allocation numbers suggest that the following themes are in play:

- Selectivity in Tech-related exposure: The rise in bond yields has, unsurprisingly, compelled investors to pare back their bullish stance on Tech-related plays. Indeed, investors have turned Underweight on Tech to fund an Overweight on Financials. But not all Tech-related plays experienced a reduction in weights. Sector allocation for Telecom Services actually rose from 2.3% to 2.9% and this is presumably propelled by the strong momentum in bellwether companies such as Alphabet and Meta Platforms.

- Re-emergence of "higher for longer": As highlighted in our asset allocation chapter, bond yields are expected to stay higher for longer in the medium term given (a) US economic resilience, (b) rising Treasury issuance, and (3) BOJ loosening of YCC. Elevated bond yields is positive for the outlook of banks' NIM and this explains why investors have turned Overweight on US Financials over the course of the year.

- Secular exposure to Healthcare: While investors' exposure to Healthcare moderated slightly this year, it nonetheless remained at a significant Overweight of +2.1 %pts. Buoyed by an ageing population, Healthcare remains a long-term secular theme and the sector is poised to register earnings growth of 11.6% in 2024.

Investors are Overweight on Telecom Services, Healthcare, and Financials



Source: Bloomberg, DBS
* Proxied by ETF weights

4Q23 US Sector Strategy – Maintain thematic approach

Energy the standout performer. Our Overweight calls outperformed our Underweight calls by 4.4 %pts in 3Q23 (as of 6 Sep). Within the Overweight basket, Communications Services registered the largest gains of 5.4%, followed by Financials at +1.7%. In the Underweight basket, the weakest performers include Utilities (-5.6%) and Consumer Staples (-3.3%). Our Neutral rated basket, meanwhile, registered gains of 3.0% on average and this is predominantly due to the sharp rally in Energy (+12.4%) as crude oil price trended higher during the quarter.

There is no change in our sector allocation for the forthcoming quarter. Our Overweight calls remain broadly in line with the street as we seek to gain exposure to the following themes:

- Selective Tech Exposure: Overweight Technology and Communication Services
- "Higher for Longer": Overweight Financials
- Ageing Population: Overweight Healthcare

US Sector Allocation – 4Q23

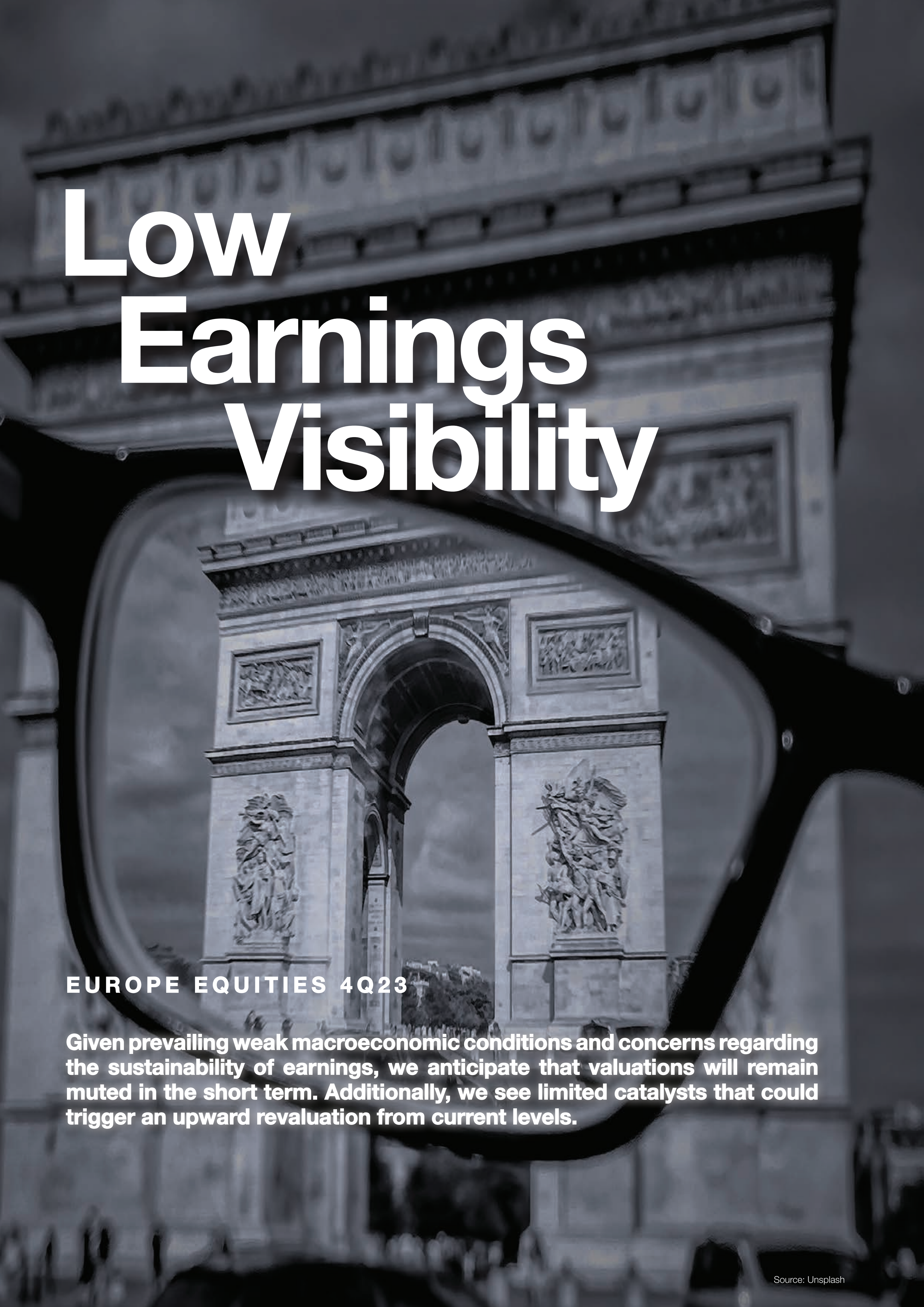
	Overweight	Neutral	Underweight
US Sectors	Technology	Real Estate	Utilities
	Comm. Services	Energy	Cons. Staples
	Health Care	Cons. Dis.	Industrials
	Financials		Materials

Source: DBS

US sector key financial ratios

	YTD Total Returns (%)	Forward P/E (x)	P/Book (x)	EV/EBITDA (x)	ROE (%)	ROA (%)	OPM (%)
S&P 500 Index	0.6	20.6	4.2	14.1	17.6	3.6	13.4
S&P 500 Financials	1.7	14.4	1.8	-	12.1	1.3	18.9
S&P 500 Energy	12.4	12.1	2.4	5.5	26.0	12.7	17.3
S&P 500 Technology	0.5	30.2	10.5	23.2	29.1	12.1	23.6
S&P 500 Materials	-1.0	18.5	2.8	12.2	13.8	5.9	12.5
S&P 500 Industrials	-0.8	19.7	5.2	14.6	25.4	6.7	11.8
S&P 500 Con. Staples	-3.3	20.1	6.1	17.3	23.1	6.6	7.2
S&P 500 Con. Discretionary	-0.3	25.4	9.1	16.1	27.3	6.0	9.0
S&P 500 Comm. Services	5.4	18.7	3.6	13.5	11.3	4.4	14.8
S&P 500 Utilities	-5.6	16.5	1.9	13.2	8.9	2.3	16.4
S&P 500 Real Estate	-3.0	35.0	2.8	19.7	8.6	3.5	23.2
S&P 500 Healthcare	-1.0	18.7	4.6	16.1	16.7	5.8	8.3

Source: Bloomberg
* Data as at 6 Sep 2023



Low Earnings Visibility

EUROPE EQUITIES 4Q23

Given prevailing weak macroeconomic conditions and concerns regarding the sustainability of earnings, we anticipate that valuations will remain muted in the short term. Additionally, we see limited catalysts that could trigger an upward revaluation from current levels.

Source: Unsplash

04.
Europe Equities.

Joanne Goh
Strategist

Rising interest rates dampener on Europe equities. The Europe stock index has registered a 9% increase in the current year, with majority of these gains concentrated in the first half of 2023. During that period, investors displayed optimism regarding China's reopening after the pandemic, and were relieved to see Europe avoiding a potential recession. However, the third quarter saw losses primarily due to rising interest rates and unfavourable economic developments.

Absence of upward earnings revision to fuel equity rally. Second quarter results were rather pessimistic, where approximately 20% of companies reported positive earnings surprises. This is a significant decrease compared to the previous quarter where 61% of companies surpassed earnings expectations. Consequently, the absence of upward earnings revisions necessary to fuel an equity rally became evident.

Net upward revisions needed for index upside

Source: Refinitiv, DBS

Technical recession averted in Eurozone but macro still weak

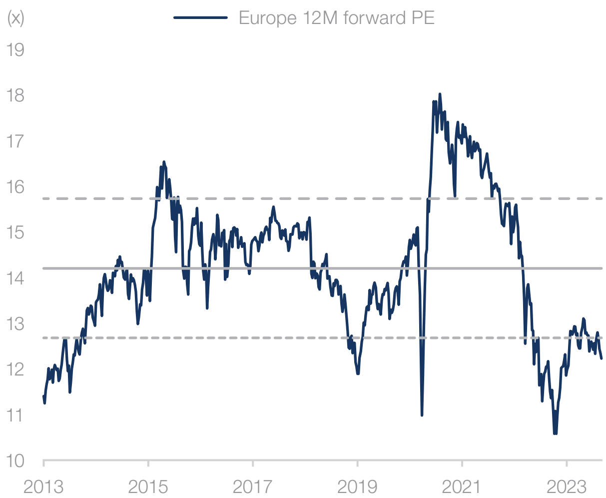
The Eurozone economy saw a y/y expansion of 0.8% in 1H23, marking a slowdown from the robust average growth of 3.4% observed in 2022. Nevertheless, there are initial indications that this deceleration has stabilised at a low level as we enter 4Q.

Households have enjoyed some benefits stemming from a tight labour market, improvements in real wage growth, and an increase in gross disposable incomes, both in real and nominal terms. Notably, France and Spain contributed to the overall growth figures with their domestic and global travel sectors experiencing a recovery.

However, we remain cautious about the prospect of a significant resurgence in consumer spending, given the recent rebound in global energy prices, ongoing geopolitical tensions, persistently high inflation levels, and the rising cost of borrowing. Considering September 2023's interest rate hike, the cumulative increase in this cycle reached a record-breaking 450 bps. Any prolonged pause at this peak rate will continue to underscore a tightening of monetary conditions.

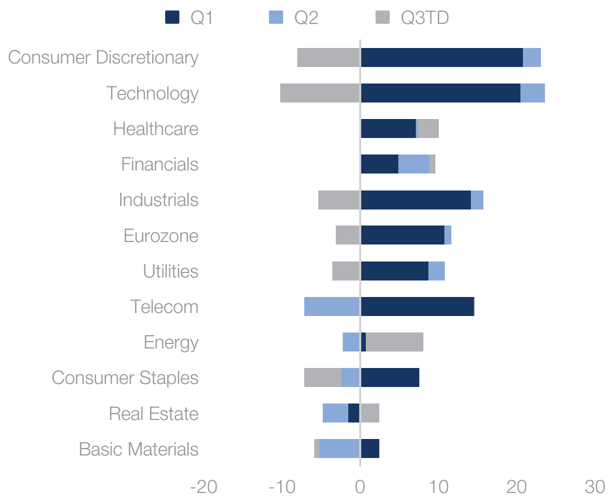
Furthermore, the most recent PMI data indicated a further decline in August, primarily driven by weakness in the service sector, which is typically considered more resilient.

Cheap but no rerating catalysts



Source: Refinitiv, DBS
Note: Bands are average and +/- 1SD

Europe YTD performance by sector



Source: Refinitiv, DBS

Valuations to remain muted in the short term. The STOXX Europe 600 currently trades at a forward P/E ratio of 12.5x, which is lower than its 10Y average of 14.2x. Given the prevailing weak macroeconomic conditions and concerns regarding the sustainability of earnings, we anticipate that valuations will remain relatively muted in the short term, with limited catalysts that could trigger an upward revaluation from the current levels. The sectors leading the index gains are technology, consumer discretionary, and healthcare. We reiterate our positive stance and continue to favour these sectors as their earnings are supported by enduring secular trends.

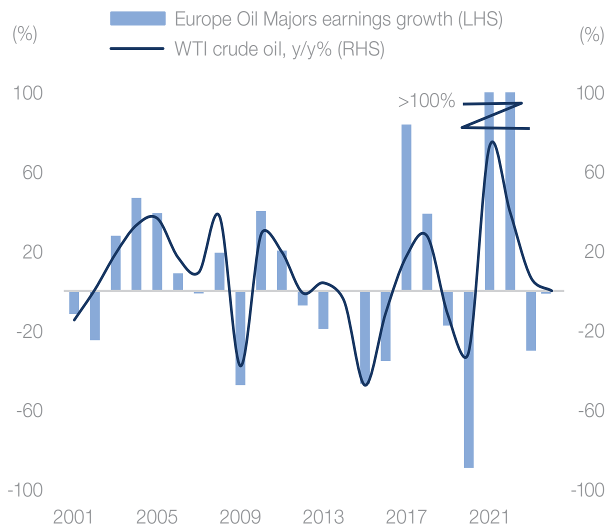
In contrast, we are downgrading Europe's oil majors to a Neutral rating. This adjustment is influenced by the higher rate environment, which is diminishing investors' appetite for dividend-yielding stocks as yield spreads narrow.

Energy - Near-term peak for oil price and earnings growth

Slightly lower trajectory for oil prices in 2024. The Brent crude oil price had remained within the range of USD70-80/bbl for some time before creeping up towards USD100 in 3Q. This increase was driven by a faster balancing of supply and demand, along with the potential emergence of a supply deficit market due to Saudi Arabia's unilateral cuts and seasonally higher demand. However, we believe that sustaining oil prices at these levels will necessitate significant supply discipline from OPEC+, especially via export restrictions from Saudi Arabia and possibly some export limits from Russia. The supply-demand balance, which is expected to be in deficit in the second half of 2023, is to a large extent artificial, and oil prices could retreat once some of the supply cuts are gradually reversed, possibly in 2024. Consequently, we foresee a slightly lower trajectory for oil prices in 2024. Our average Brent crude oil price forecasts are now USD85-90/bbl (2H23) and USD80-85/bbl (2024), with an upside bias.

Neutral on Energy sector. Following the peak in earnings growth that aligned with the surge in oil prices in 2021 and 2022, we anticipate that Europe's integrated oil majors will experience flat earnings growth in the subsequent years, with dividend growth also expected to remain flat. Our primary interest in Europe's integrated oil majors lie in their capacity to generate free cash flow and offer high dividend yields. However, as Eurozone bond yields rise to 2.5% from the lows of -0.6% two years ago, dividend yields of 5.2% are now viewed as less appealing than before. Additionally, companies in this sector have chosen share buybacks over dividend yields as a means to reward shareholders. Although such decisions should benefit shareholders in the long run, the sector's P/E ratio has continued to decline in the context of weak global sentiment. As a result, we are adjusting our stance on the sector to Neutral.

Europe oil majors earnings growth vs oil price



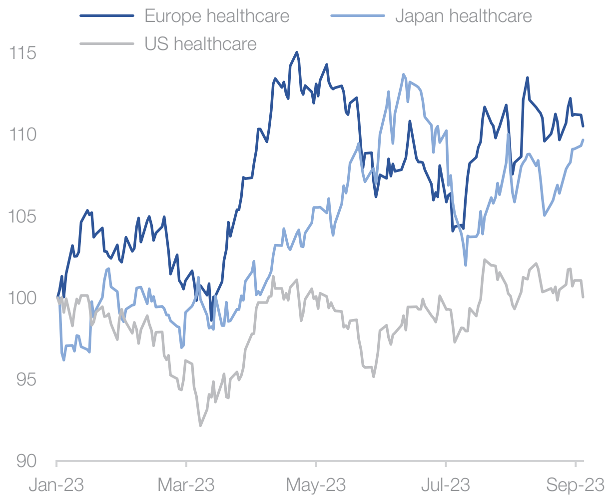
Source: Refinitiv, DBS

Healthcare

Preference for pharmaceutical and MedTech subsectors. The global healthcare sector has consistently demonstrated resilience during periods of market downturns, primarily due to the inelastic nature of healthcare service demand. Several factors shape the sector's prospects, including an ageing population, technological advancements, changes in healthcare policies, escalating costs, and increasing affluence. The ageing population contributes to a higher demand for healthcare services, while innovations like telemedicine present opportunities for enhanced care and efficiency. As the global pandemic gradually subsides, a robust recovery in medical procedures, alleviation of staffing shortages, and the introduction of new products could potentially initiate a burgeoning cycle that propels growth forward.

Our preference lies with companies operating in the Pharmaceutical and MedTech equipment subsectors, with a specific focus on globally recognised healthcare firms possessing diversified product portfolios. These companies face fewer regulatory and pricing pressures and are less exposed to the risks associated with drug discoveries and the expiration of exclusivity periods.

Cheaper valuation and less regulatory risk in Europe drive performance divergence



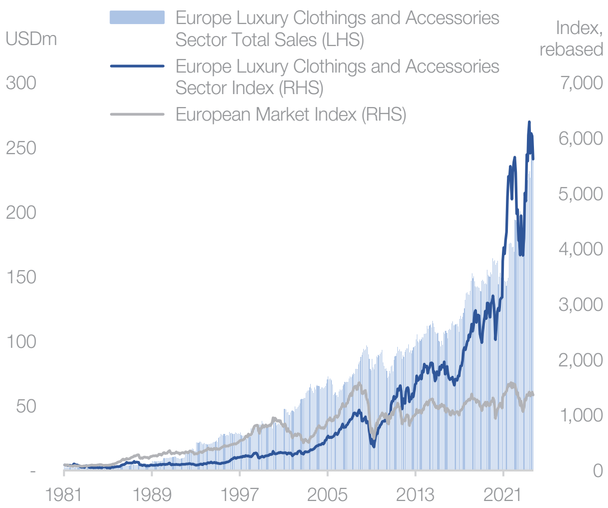
Source: Refinitiv, DBS

Luxury sector – Still in vogue

Go for high quality stocks in the luxury sector. In the latest earnings season for 2Q23 results, the consumer discretionary sector produced the highest sales growth at 12.1% from a year ago. Within this space, luxury names such as LVMH (MC FP) and Hermes (RMS FP) reported 13% and 22% y/y revenue growth respectively on the back of robust sales in Europe and China. This stellar earnings momentum broadly ties in with the c.12.8% rally of the European consumer discretionary sector this year (vs c.5.5% for STOXX Europe 600 Index).

Luxury companies are investing in marketing initiatives, rebranding efforts, and acquisitions to capture a larger portion of the market, which largely comprises millennials' spending habits and an expanding middle class. A noteworthy example is Tiffany & Co., whose strong performance can be attributed to a new approach implemented after its acquisition by LVMH. This strategy shift involves a greater focus on social media and celebrity endorsements in its advertising, successfully connecting with younger consumers. As a result, Tiffany & Co. now holds the distinction of being the group's second-largest brand.

Rising secular trend



Source: Refinitiv, DBS

Our positive stance on this sector persists and we recommend that investors accumulate high quality stocks within the sector. The removal of restrictions on Chinese overseas group travel could potentially lead to an upswing in Chinese tourists on a global scale, providing a favourable backdrop for further growth.

Banks – government intervention fears persist

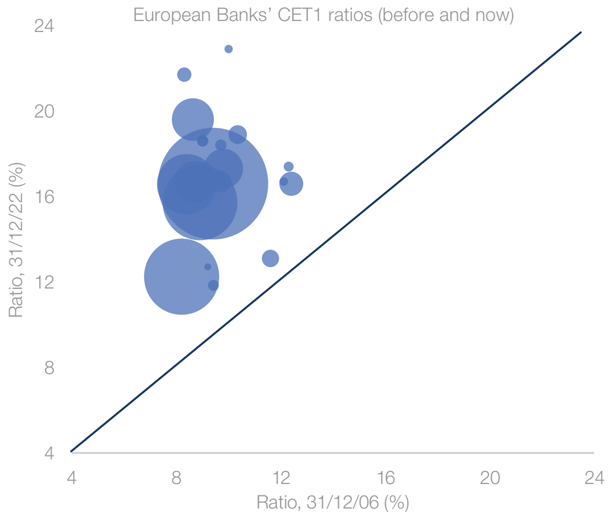
Confidence in the banking sector remains low. The banking sector currently trades at a substantial discount compared to the broader market. Investors are seeking a higher risk premium to compensate for the potential of further unexpected government interventions. Recent developments, such as the Italian government's announcement of new tax targets for excess profits generated by Italian banks, have raised concerns about the possibility of similar tax measures being extended to other European countries. These concerns have been amplified by the sector's suspension of dividends in 2020 at the government's recommendation and the abrupt liquidation and recent takeover of Credit Suisse.

Despite these uncertainties, European banks maintain robust balance sheets. In contrast to the post-GFC period when banks faced significant capital challenges due to deleveraging and rising capital requirements, their balance sheets are currently well capitalised, boasting an average CET1 ratio of 15.5%. Unlike the period before the GFC, household savings rates remain elevated, and corporate balance sheets are relatively healthy.

However, earnings outlook remains subdued. Aggressive interest rate tightening measures and their subsequent impact on the real economy have dampened credit demand from both the industry and households. The July bank lending survey reported a significant drop in firms' net demand for loans in the second quarter of 2023, reaching its lowest point since the survey's inception in 2003. Demand for house purchases has also been affected by high interest rates, weakening prospects in the housing market, and low consumer confidence.

Given ongoing concerns regarding the macroeconomic environment, credit tightening, and the sustainability of earnings, we anticipate that valuations will remain restrained in the near term, with limited catalysts to drive a revaluation of the sector.

Well capitalised balance sheet



Note: Bubbles above the 45-degree line suggests that adequacy ratios are better now compared to pre-GFC

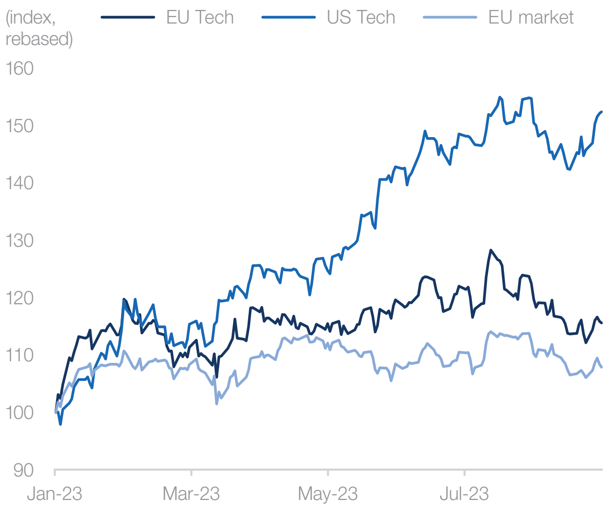
Source: Refinitiv, DBS

Europe Tech

Fundamentals remain intact for Europe Tech. While European Tech may have lagged its US counterpart, it stands out as the best performing sector in Europe YTD. The sector did experience some effects from the consolidation within the Global Tech industry during the third quarter due to increasing US bond yields. However, its underlying strengths and fundamentals remain intact.

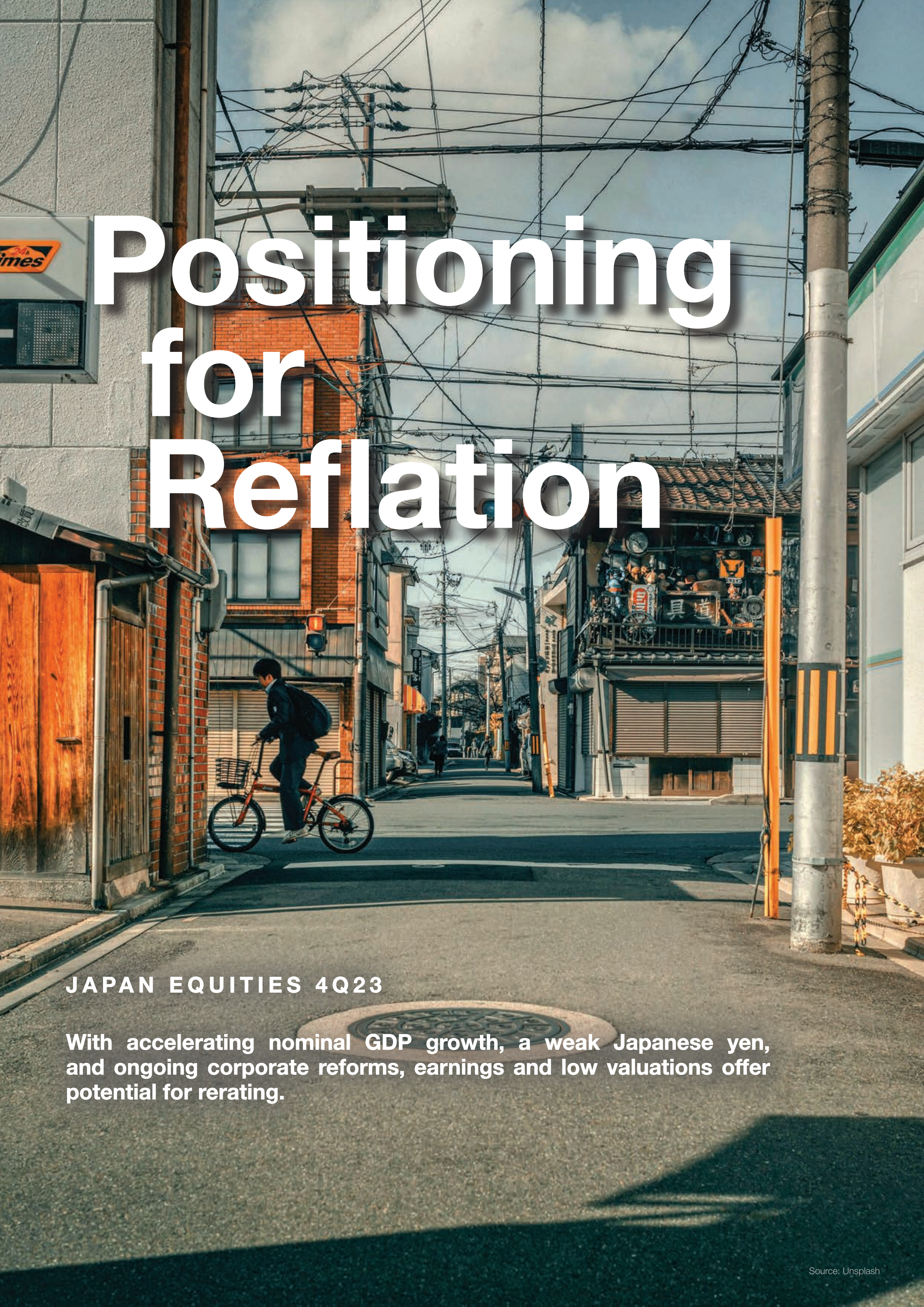
In particular, the semiconductor sector is capitalising on the ongoing digitalisation trend and the shift towards deglobalisation. European semiconductor companies primarily focus on upstream activities such as manufacturing equipment and chip design, where capital expenditures remain stable. These companies possess a competitive edge in technological leadership within their respective niches. For instance, ASML produces the most advanced computer chips globally and holds a unique position in this regard. It is worth noting that ASML's cutting-edge chip manufacturing technology, including deposition and immersion lithography systems, has led to export restrictions against China, spearheaded by the Biden administration.

Europe Tech is a leading sector in Europe



Source: Refinitiv, DBS

In the United States, the recently enacted Chips and Science Act allocates over USD52b for semiconductor research, development, and manufacturing, while also providing a 25% investment tax credit for capital expenditures. This legislation is expected to prompt many companies to accelerate their investments in manufacturing, consequently bolstering the outlook for capital expenditure within the semiconductor sector. Similarly, in Europe and Japan, similar chip acts or programs have been put into effect to establish local manufacturing capabilities and enhance chip security.



Positioning for Reflation

JAPAN EQUITIES 4Q23

With accelerating nominal GDP growth, a weak Japanese yen, and ongoing corporate reforms, earnings and low valuations offer potential for rerating.

Source: Unsplash

05. Japan Equities.

Joanne Goh
Strategist

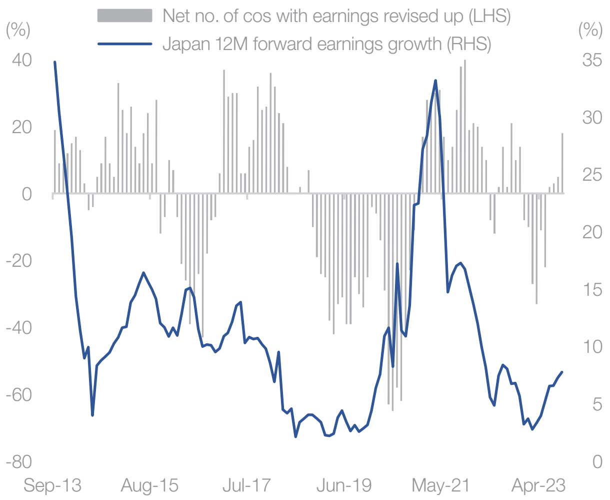
Slowing momentum. Following a robust 20% surge in the TOPIX price during the first half of the year, momentum slowed down in the third quarter, returning a modest 5%. This deceleration was evidently influenced by rising US bond yields, triggered by better-than-expected US economic growth that reduced expectations of Fed rate cuts, and concerns over a US credit rating downgrade, which raised fiscal worries. In a global trend, the BOJ joined other central banks by raising interest rates, eliminating the cap on 10Y JGBs from 0.5% to 1%.

Room for rerating. The TOPIX index also took a pause to assess the health of Japan's corporate sector during the earnings season. The results for the first quarter of fiscal year 2023 exceeded expectations, leading to an upgrade in earnings forecasts for 20% of Japanese corporations. The average 12-month earnings growth rate rose from 3.7% at the beginning of the year to the current 7.8%. With accelerating nominal GDP growth, supportive policies, a weak Japanese yen, and corporate reforms in play, earnings are expected to provide fundamental support to equities. These factors are anticipated to sustain the market rally, albeit at a moderate pace. Additionally, PE valuations, currently trading at the 10Y average of 14x, leave room for further rerating, supporting a positive outlook for Japanese equities.

Positioning for reflation

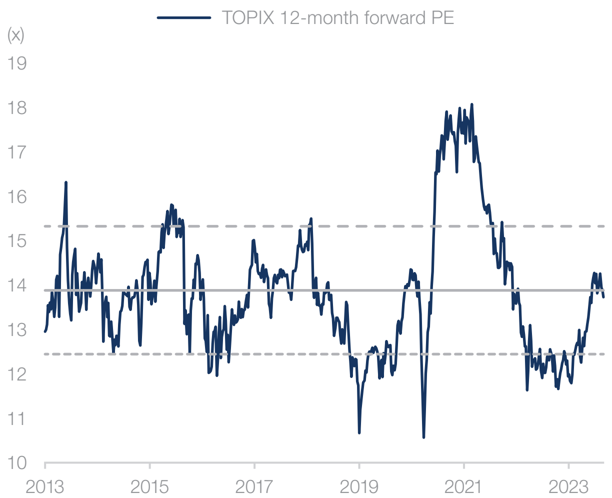
The Japanese GDP experienced growth acceleration in the first half of 2023, with nominal GDP expanding by 5.4% y/y in the second quarter. However, this growth was driven primarily by a surge in inflation to 3.3% and real GDP growth of 2%. While these figures surpass historical averages, their sustainability and implications for long-term growth remain uncertain.

Positive earnings vibe



Source: Refinitiv, DBS

Average PE leaves room for rerating



Source: Refinitiv, DBS

Kishida's new cabinet government will introduce an economic stimulus package that includes measures to counter issues such as inflation and depopulation, so that Japan's economy can "enter a new phase".

BOJ Governor Kazuo Ueda has dismissed the possibility of an imminent exit from ultra-loose monetary policy, arguing that inflation driven by robust domestic demand and higher wage growth is necessary for sustainable reflation. We believe reflation trades need to be supported by earnings for them to be sustainable. These would include exports stocks with leading global market share, consumer discretionary in retail and F&B, semiconductors, and banks.

Government support for "economically important sectors" to sustain growth

Amid the ongoing global trade downturn, Japan's export performance surpasses that of its neighbouring countries. This resilience can be attributed to its diverse export portfolio encompassing electronics, automotive, machinery, high-precision equipment, and the emerging tourism sector (classified as service exports). These sectors complement each other, mitigating weaknesses and strengths through cycles. For instance, the electronics sector faced challenges due to reduced demand and inventory destocking post-Covid. In contrast, the automotive sector, comprising 17% of Japan's exports, is recovering thanks to supply chain stabilisation and the easing of chip shortages. These economic heavyweights have fostered the global market leaders that have proven their mettle over time.

Weak yen, strong boost. Government support measures are expected to highlight the economic significance of these sectors. One example is the substantial depreciation of the yen, with the JPY witnessing a cumulative 25% decline since the beginning of the pandemic in early 2020. The undervalued yen enhances the competitiveness of Japan's exports and encourages the reshoring of production as more Japanese MNCs rebuild their supply chains in the post-pandemic landscape. The weakened yen has also contributed to the revival of the tourism sector.

JPY has fallen 25% since 2020

Source: CEIC, DBS

Net-zero targets a key driver. Another illustration of the government's engagement with sector leaders to achieve national strategic goals is its plan to invest in the semiconductor sector to produce cutting-edge technology chips. The government is already collaborating with the automotive sector and industrial conglomerates to develop energy solutions to reach its net-zero target.

Booming tourism. Notably, Japan's tourism exports have outperformed those of its regional counterparts since the post-Covid reopening. While China was the dominant source of tourism before Covid, Japan has successfully diversified its tourist sources in the post-pandemic era. The number of foreigners entering Japan reached 80% of pre-pandemic levels, before China's full reopening. Chinese tourists constituted 30% of Japan's total visitor arrivals in 2019, a figure that has dwindled to just 5% in the first half of 2023. The rest of Asia now accounts for a significant 70% of Japan's visitor arrivals. The combination of a weaker yen and Japan's attractive tourism resources has bolstered this remarkable recovery.

To capitalise on these trends, we recommend investing in globally leading companies in these strategically important sectors.

Consumption hindered by reduced purchasing power

Wage growth a hindrance. On the home front, the significant rise in inflation, primarily attributed to the depreciation of the yen and increased import expenses, may hinder the eagerly awaited rebound in domestic consumer spending. While there has been some improvement in wage growth following the Shunto negotiations, it has still not been sufficient to counteract the inflationary pressures.

Consequently, the reduction in real wages has constrained consumers' purchasing power and subdued overall consumption. We believe that the government needs to take additional steps to enhance household wealth. Interestingly, the government has been promoting investment in the stock market as a means for individuals to accumulate wealth. An extremely low interest rate environment, rising asset prices, improved labour market conditions, and recovering consumer confidence level collectively strengthened the outlook for discretionary spending, especially in areas such as specialty retail and F&B establishments.

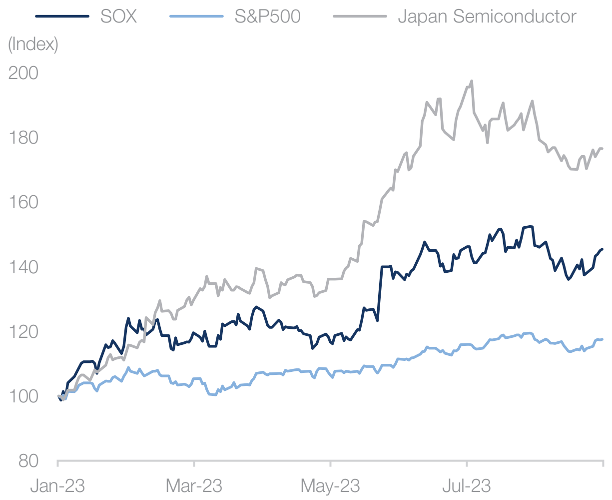
Wage growth lagging behind inflation

Source: Refinitiv, DBS

Japan semiconductor sector

The Philadelphia Stock Exchange Semiconductor Index has shown remarkable performance this year, surpassing the S&P 500 Index and other major benchmarks by a significant margin. Japan's semiconductor index has also shown impressive outperformance.

Global semiconductor uptrend



Source: Refinitiv, DBS

With strong government backing, we anticipate that Japan's semiconductor industry will continue to reap the benefits of global trends in digitalisation and deglobalisation. Prime Minister Fumio Kishida's administration has committed billions of dollars in subsidies to boost domestic chip production, positioning the country to take advantage of the escalating tech rivalry between the US and China while regaining its leadership in semiconductor manufacturing. The pivotal role of Japan in chip-making equipment and materials is key to Japan becoming a global leader. It has set its sights on establishing a cutting-edge chip foundry by 2027 and challenging the leading TSMC in mass-producing two-nanometer chips within four years.

The public listing of Arm in the US, a privately held firm under the ownership of SoftBank, is poised to generate heightened excitement within Japan's semiconductor landscape. Arm is renowned for its expertise in chip design and technology licensing, evident in the instrumental role it plays in the production of over 1b smartphones each year.

Japan banks

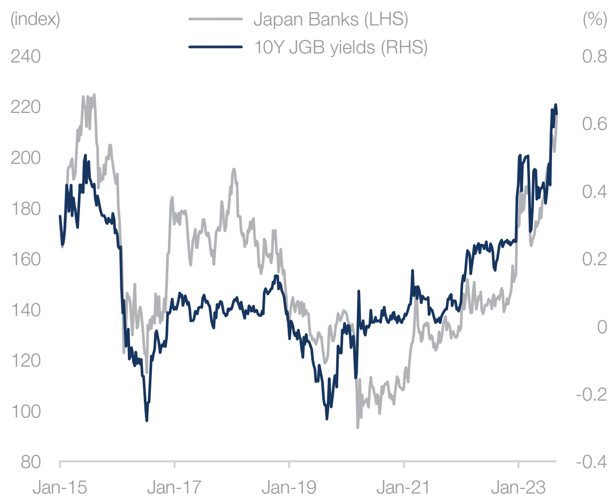
Japanese banks' stock prices are responding favourably to the gradual relaxation of the central bank's cap on bond yields. This adjustment has occurred twice, first in December 2022 and recently in July 2023, allowing yields to rise to a maximum of 1%.

The banking sector's earnings have also shown resilience as the economy experiences a reflationary period, with banks being the primary beneficiaries in such an economic environment. In addition to the profitability improvements stemming from shifts in their business portfolios or loan mix, growth in fee-based services, and reductions in operating expenses, banks can anticipate higher loan growth and wider interest margins. Transitioning away from NIRP is expected to boost bank valuations, as it marks a departure from multi-year deeply discounted valuations experienced under NIRP, coinciding with an improved profit outlook.

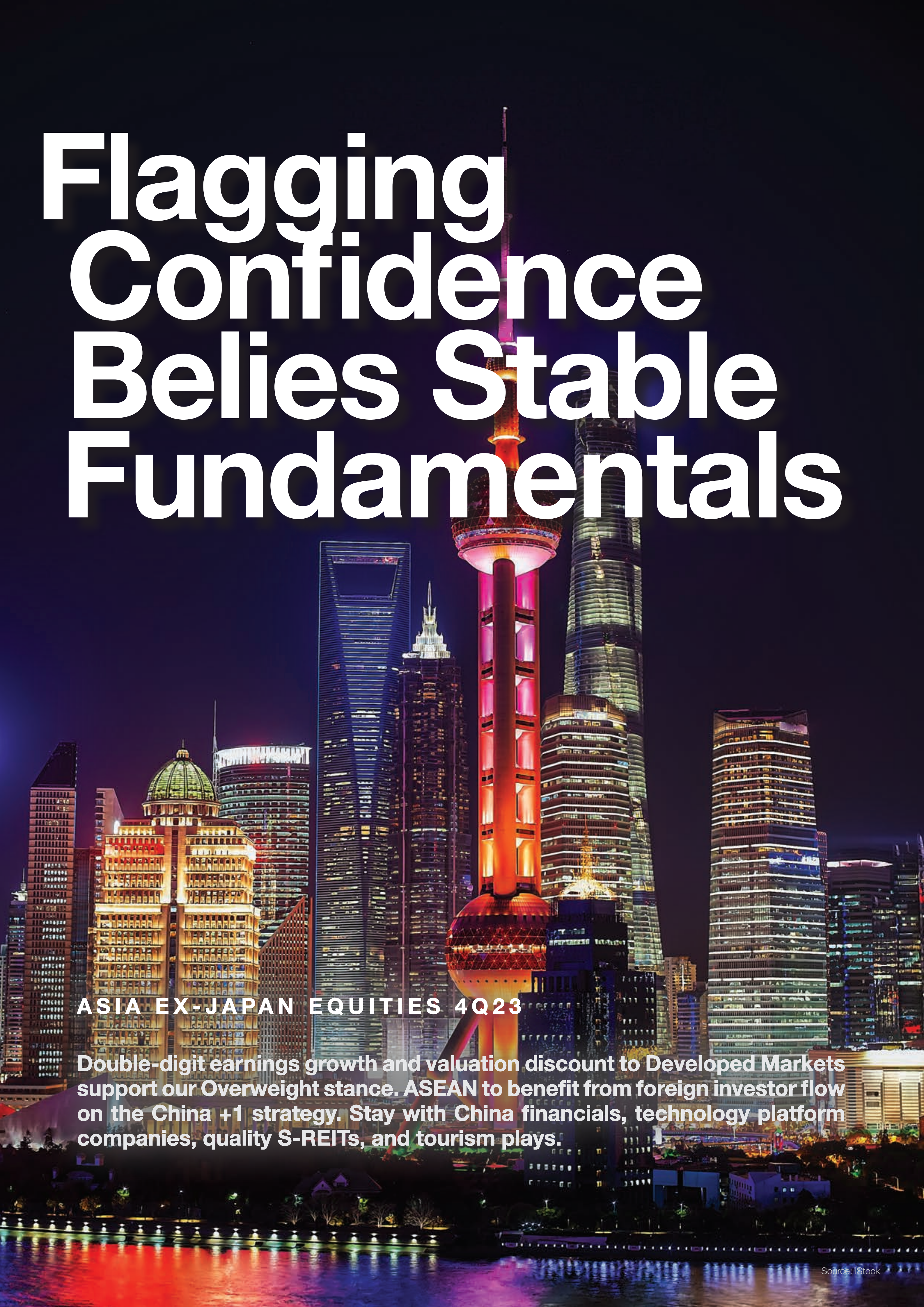
However, there are lingering concerns regarding the valuation of banks' investment securities in JGBs if the central bank decides to completely abandon its control over the yield curve. It is crucial to underscore that banks hold JGBs on their balance sheets, and any decreases in their accounting values will primarily impact a bank's capital ratios rather than leading to immediate earnings losses.

In general, Japanese banks maintain strong capital adequacy ratios, which can absorb such losses, especially if the increase in yields occurs gradually. Furthermore, the bank's capital is bolstered by a diversified and substantial base of retail deposits. Simultaneously, an improvement in their baseline earnings, driven by higher interest margins, can offset the decline in their capital bases over the long term. Therefore, higher interest rates should still exert an overall positive impact on the banks.

Rising bond yields and bank performance



Source: Refinitiv, DBS



Flagging Confidence Belies Stable Fundamentals

ASIA EX-JAPAN EQUITIES 4Q23

Double-digit earnings growth and valuation discount to Developed Markets support our Overweight stance. ASEAN to benefit from foreign investor flow on the China +1 strategy. Stay with China financials, technology platform companies, quality S-REITs, and tourism plays.

Source: iStock

06.
Asia ex-Japan Equities.

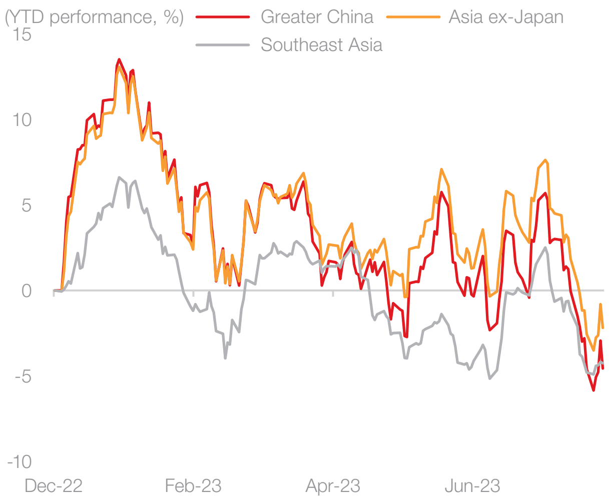
Yeang Cheng Ling
Strategist

Joanne Goh
Strategist

Asia ex-Japan equities trailed global markets this year, having surrendered the gains achieved at the start of the year owing to a slew of challenges which weighed on sentiment and investors' expectations.

Headwinds outweighed gains. The performance of equities deteriorated as the region was confronted by a series of headwinds such as a hawkish US Federal Reserve that weighed on broader markets. This was further exacerbated by a series of adverse developments in China, the largest economy in the region and a significant trade partner, as well as the ongoing tensions surrounding North Asia.

AxJ equities surrendered gains



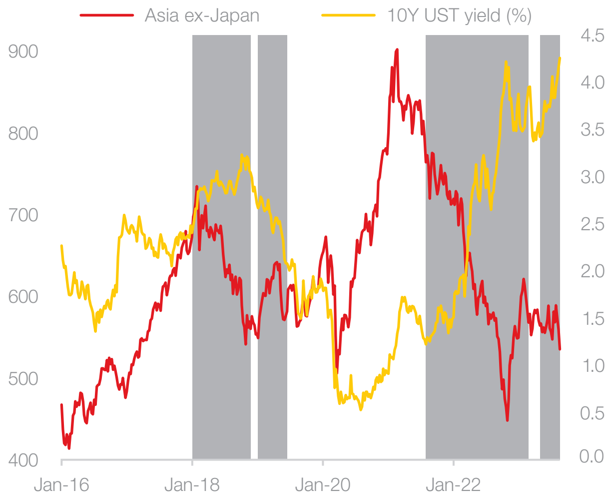
Source: Bloomberg, DBS

Strong trade ties in AxJ

Source: Bloomberg, DBS

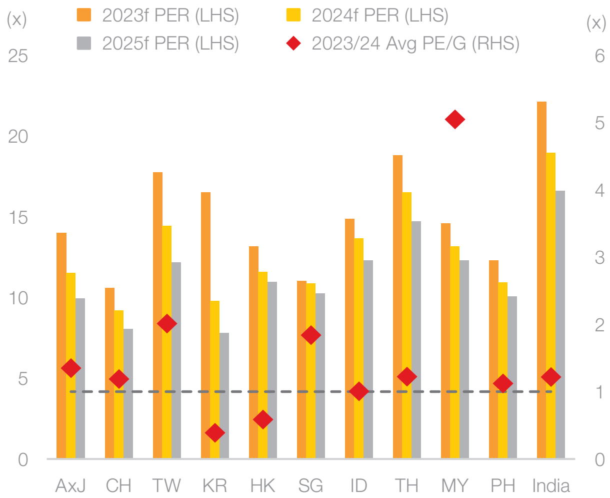
Boost from strong Asian ties. Despite geopolitical headwinds and slower global growth, the rising bilateral regional trades indicate stronger ties among member countries. Notably, the combined trade value between China and Southeast Asian nations continues to edge higher, anchoring the importance of intra-regional dependence.

Inverse relationship with US bond yields



Source: Bloomberg, DBS

AxJ: Bifurcated valuations across markets



Source: Bloomberg, DBS

There is a close inverse correlation between AxJ equities returns and US interest rates. While the US Fed Funds rate may stay elevated for now, we believe the rate hike cycle is nearing the end. In light of this, the region's equities are expected to form a base at current levels while the market awaits monetary easing from DM.

Cautiousness priced in. AxJ corporate sectors are expected to deliver earnings growth of 22% and 16% in 2024 and 2025 respectively, after a muted 2023 as the region gradually emerges from the pandemic.

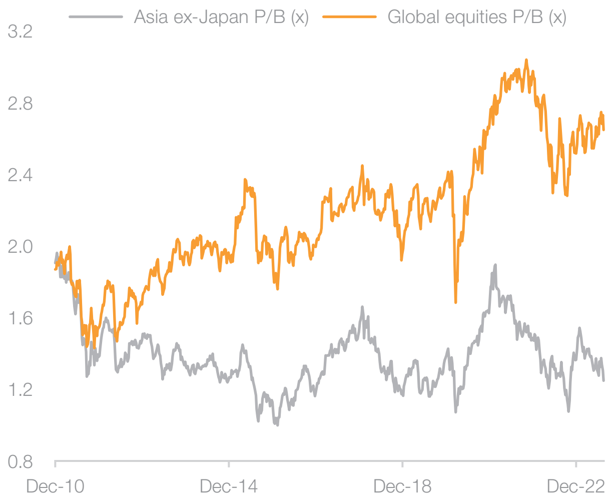
The forward PER of 9x-11x shows that investors have already priced in a lot of cautiousness.

Within the region, North Asia earnings are forecasted to be 15 - 16% higher over next two years due to:

1. China equities earnings recovery after a soft patch in 2023 as government measures take effect from 2024
2. Earnings among Taiwan corporates riding on stronger demand for semiconductors driven by greater adoption of AI
3. Southeast Asia earnings estimated to grow 7 - 8% over the next two years

The region's steep P/B discount compared with global peers is sentiment and confidence driven, as opposed to an earnings quality issue. Given time and revival in outlook, we expect the steep discount to narrow.

Widening valuations



Source: Bloomberg, DBS

Valuation below historical mean

*Chart truncated
Source: Bloomberg, DBS

China – awaiting policy implementation

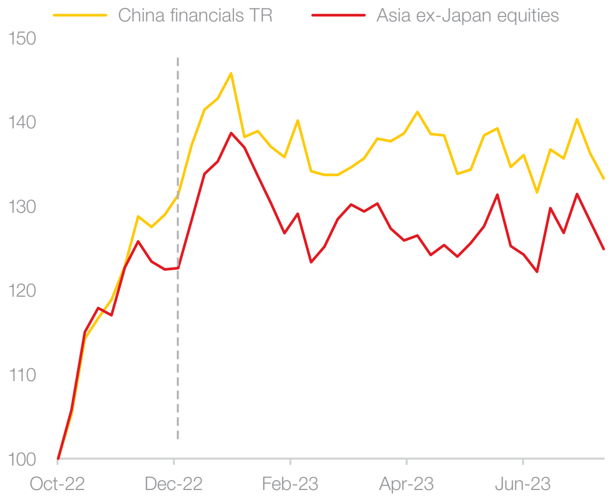
China banks surrendered YTD gains. China equities and financial stocks have come under selling pressure and retraced some 20% from their respective peaks this year. Our call on China equities and financials panned out well in the earlier part of the cycle when they delivered close to 60% and 50% of total returns since the conclusion of the party congress, only to surrender half of the gains owing to a recent series of adverse developments surrounding the real estate sector, weighing on sentiment and outlook.

The financial woes of real estate developers sent shockwaves across China equities for fear of catastrophic ramifications on the banking sector and contagion impact to the broader economy, which is already flickering with slowing growth.

Meanwhile, the following news has pressured China financials of late:

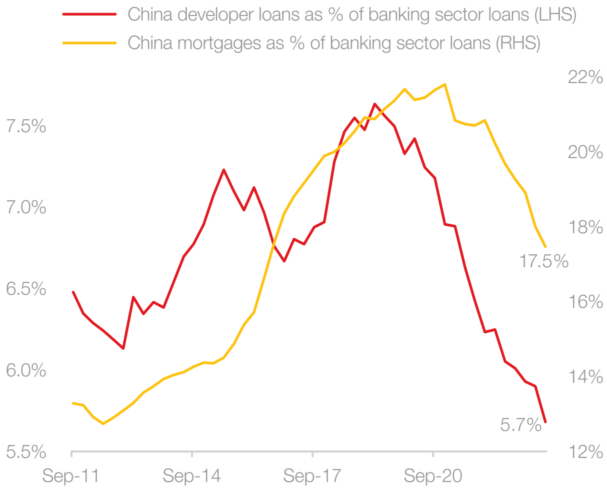
1. Bankruptcy risk of Evergrande after it failed to service part of its debt and interest payments
2. Fears about Country Garden defaulting on its bond after missing interest payments
3. PBOC announced its second cut in three months of MLF rates to 2.5%, raising market concerns on banks' profit margins and ability to pay dividends
4. Zhongzhi Group, an asset management firm which manages some CNY1t worth of assets, missed payments for some of its investment trust products

China financials have been resilient (indexed on end October 2022)



Source: Bloomberg, DBS

Declining loan exposure to real estate



Source: Bloomberg, DBS

Banks on the defense. While developers are plagued by the issues of repaying bonds and servicing coupon payments, the banking sector has been reducing exposure to real estate related loans over the past four years. As at end June, loans to real estate developers and mortgages stand at 23.2% of total banking sector loans, a sizeable reduction from 30% in 4Q19.

Notably, banking sector loans to developers have also contracted to a multi-year low of 5.7% from the peak of 7.6%. We anticipate the downtrend to persist over the coming quarters, alleviating the asset quality concerns among banks.

More government support expected. China's macro data has generally come in weaker than expected. Shrinking exports, waning producer price index, and low consumer confidence levels are prompting the government to focus on boosting the domestic economy and enhancing its resilience. On this score, we expect more supportive measures to be introduced by policymakers, and more importantly, impactful implementations.

Weak PPI suppressing industrial profits

Source: Bloomberg, DBS

Feeble domestic confidence

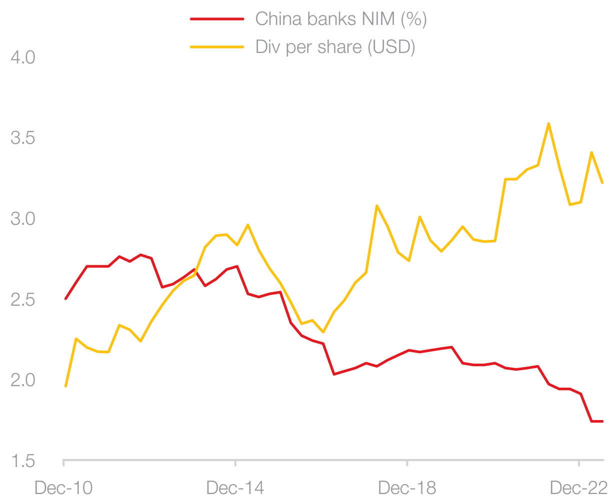
Source: Bloomberg, DBS

China financials as an income generator

While profit growth of China banks will likely lag GDP growth in the near term, their longer-term narrative as income generators remains intact.

Evidence of this can be seen in the bifurcation between NIM and dividend distribution. NIM has been declining since the start of last decade, but that did not affect banks' dividend distribution capacity. Over the same period, dividend per share increased 60% as opposed to the NIM trend.

Dividend distribution unscathed by NIM



Source: Bloomberg, DBS

Knowing the financial sector's importance to the broader economy and confidence, we expect policymakers to pull out every possible stop to prevent a crisis in this industry.

While the sector's valuations have continued to derate owing to macro headwinds and rising bond yields that divert investment fund flows from conventional dividend paying stocks, our premise on China financials' sustainable dividend payout still holds. With rate hiking cycles among DM nearing the end, the narrative to stay invested in high dividend yield stocks will rematerialise.

We retain the view that dividend yields based on current prices should remain intact at 8% and above. However, we will not add weight to banks and China equities until signs of stabilisation and further policy support and implementations from the authorities are seen.

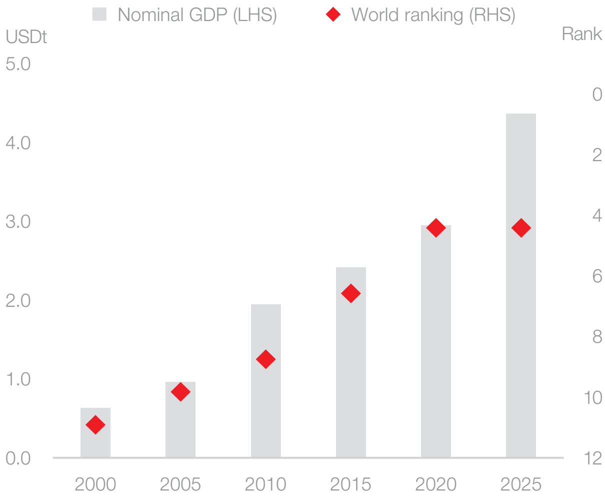
ASEAN's resilience

We expect that ASEAN-6 economies will flourish with favourable demographic trends, increased regional integration, and diversification of supply chains. These factors are expected to shield ASEAN economies from the challenges presented by the global economic landscape. The bloc has demonstrated robust performance, surpassing the global growth rate of 3.6%. This success can be attributed to greater economic integration within the region, China's growth trajectory, and improved fundamental economic indicators. Over the past two decades, ASEAN-6 has experienced significant economic expansion, resulting in heightened prominence. It is projected that the combined nominal GDP of ASEAN-6 will exceed USD4t by 2025. This would position the bloc as the fifth largest globally, trailing only the US, China, Japan, and India, and securing the fourth spot within Asia.

Valuations at battered down levels

Source: Bloomberg, DBS

ASEAN-6 nominal GDP and world ranking



Source: IMF, DBS


Source: Unsplash

Immediate challenges for ASEAN

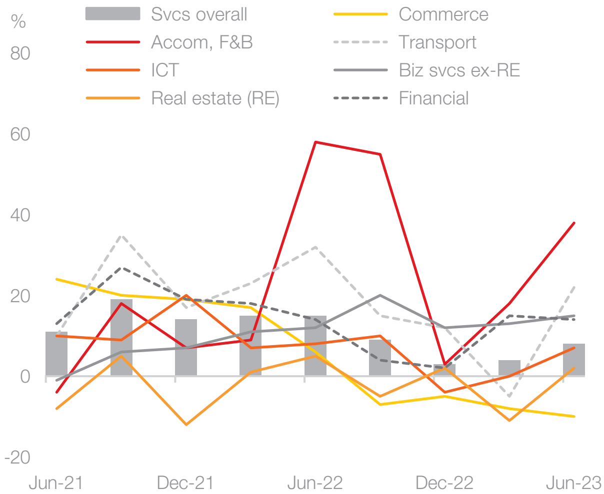
Bright spots in Singapore, Thailand, and Indonesia. Short-term challenges facing ASEAN economies include a deceleration in global growth that is adversely affecting export-oriented nations such as Singapore, Thailand, and Vietnam. Moreover, a resurgence in inflation driven by rising oil and food prices could necessitate central banks to implement further tightening measures, thereby imposing a brake on domestic growth. In the realm of capital market flows, a strong US dollar is likely to divert investments away from EM, including ASEAN. On the upside, opportunities stemming from the return of Chinese tourists are poised to drive the next phase of international travel and tourism within ASEAN. Singapore, Thailand, and Indonesia are our preferred ASEAN picks.

Singapore - Positive prospects in travel services

Thriving travel sector despite volatility. Amid the external global challenges in 2023, Singapore's economy is experiencing a soft phase. Nevertheless, the services sector remains resilient and continues to expand, predominantly due to travel-related services. Passenger traffic at Changi Airport has recovered to 45% of 2019 levels as of July. A more substantial influx of tourists is anticipated in the second half of the year as flight connectivity gradually improves, especially from China.

Given the significant upswing in global air passenger activity post pandemic, channel checks indicate that the aircraft maintenance, repair, and operations

Services 6M forward business expectations have eased but still remain positive



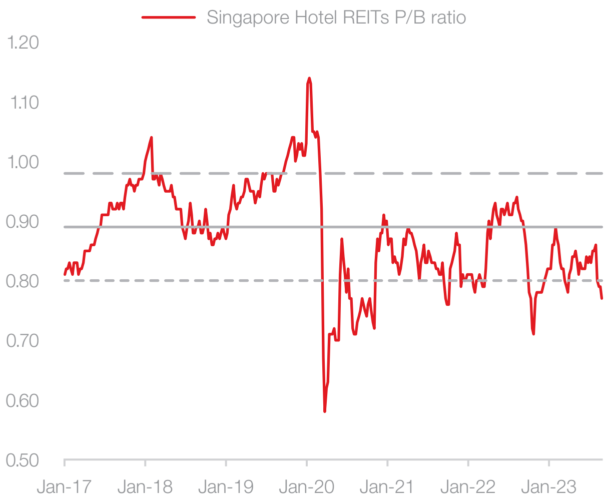
Source: CEIC, DBS

(MRO) market is becoming increasingly tight. While airlines still have a backlog of deferred maintenance to clear, we anticipate that MRO operators will experience increased demand over the next few years due to widespread technical issues with new generation engines, as well as prolonged OEM delivery delays that have prompted airlines to postpone the retirement of older aircraft.

Drivers for hotel demand are intact to support a stellar 2H23 from (i) much stronger inbound numbers from China, (ii) a stronger MICE calendar alongside Formula One, and (iii) budget conscious travellers reorganising travel plans as flight capacity expands. The recent sell down due to rising bond yields within the S-REITs sector repositions hotel S-REITs at an attractive entry price relative to the same time last year. The current trading price implies a sector price-to-book of c.0.79x, as opposed to c.0.94x in August 2022. Operationally, we foresee stronger y/y results – propelled by the overseas market in 2H23 – for a full year 15% y/y DPU growth, and a forward yield of 5.9% and 6.5% in FY23/FY24.

Global oil demand growth in 2023 is also trending higher than our earlier forecast, despite weak China macro data. Oil service providers such as drilling and FPSO companies are seeing booming demand after years of underinvestment.

Hotel sector historical P/B chart (2017 - July 2023)



Bands represent -1 s.d., average, and +1 s.d. Source: Refinitiv, DBS

Thailand - Impact of political clarity

Thailand finally has a new PM after a three-month post-election stalemate. The successful PM confirmation reduces the biggest domestic risk and uncertainty to Thailand's growth outlook. With the acceptance and formation of a government, we expect the business environment to improve. The new government's key priority will be to sustain Thailand's post-pandemic economic recovery, which has lagged regional peers. Light foreign investor position amid low valuations and a recovering domestic economy substantiates our constructive view on the market.

Tourism a key driver for Thailand. Thailand's Consumer Confidence Index has increased for the 13th consecutive month to hit a 40-month high in June 23. Private consumption continues to expand and has already exceeded the pre-pandemic level, except from the non-residence sector. With the accelerating growth of international tourist arrivals, we expect the Index to improve. Total international tourist arrivals amounted to 12.9m people in 1H23, on track to meet BOT's target at 29m in 2023. Tourist numbers from China can be expected to accelerate in 2H23 following the easing of restrictions on group travel.

Our preferred sector plays are beneficiaries of recovering domestic consumption, tourism, and medical tourism plays. The focus is on leaders possessing strong cashflow generating capacities and positive earnings outlooks with solid balance sheets and reasonable valuation in their respective industries.

Key risk factors to watch out for in Thailand are export weakness amid a challenging global economic landscape and agricultural output risks from the El Niño effect.

Indonesia - Focus on 2024 presidential election

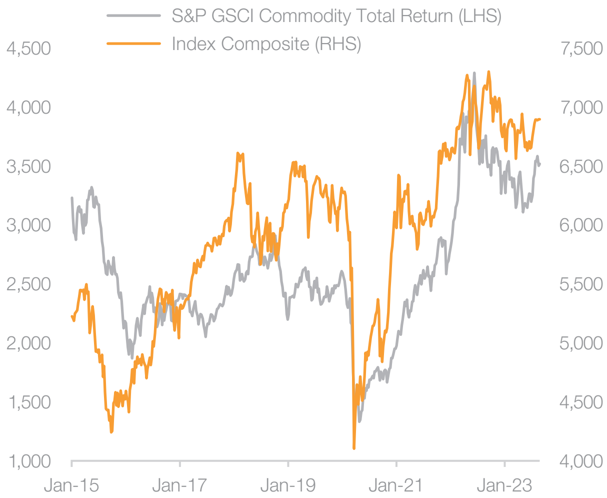
Favour bank and consumer sectors. Indonesia will host its next presidential election in February 2024, as Jokowi's two-term limit will end, and a new president will take office by October 2024. We are optimistic that political stability will be maintained, especially with Jokowi's super-coalition support in Parliament. One of the most significant developments during Jokowi's second term (2019-24) is the strong FDI momentum and controlled inflation. Recent trends of positive Current Account, low inflation, stable rupiah, and GDP returning to 5% should substantiate foreign investors' confidence in the country. We maintain our preference for bank and consumer sectors as beneficiaries of long-term demographics and urbanisation secular trends.

Near-term China slowdown risks dampening commodity prices, USD strength distracting foreign flows away from EM, and the impact of El Niño on food prices and inflation are key risks to watch.

Consumer confidence rising steadily

Source: CEIC, DBS

Indonesia market performance correlated to commodities



Source: Refinitiv, DBS

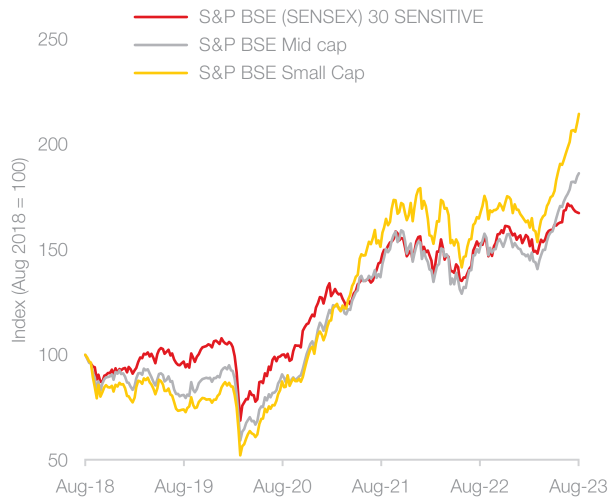
India - Earnings and GDP growth standout

India's increasing appeal. India's Sensex Index has surged to new heights, driven by positive earnings momentum and foreign flows. Favourable macro trends, including disinflation, a halt in RBI rate hikes, and increased FDI interest which sees India as an alternative to China, where growth and stimulus policies have disappointed markets - are bolstering India's appeal.

In India, rising domestic demand underpinned by a young, growing demographic, points to the robustness of its consumer staples sector, while a vast unbanked population and government push for digital banking underpins the banking sector's potential. In addition to its large and fast-growing population, supportive policy tailwinds and a focus on investments to supercharge manufacturing growth are set to boost India's pharmaceuticals. A policy push for investments is also likely to benefit India's vibrant IT services sector, where its domestic powerhouses are well-positioned to ride on secular growth trends in the global digital economy.

We recommend exposure to India via mid/small cap mutual funds which can capture the opportunities brought about by the world's fifth largest economy in the world by nominal GDP, and yet with significant room to grow as it lags in per capita income.

Opportunities in India's small/mid caps



Source: Refinitiv, DBS

AxJ - Selective and thematic

Credible fundamentals support our ongoing constructive stance on AxJ, including valuation discounts, stable earnings trends, and the presence of middle-income spending. In addition, ASEAN will also benefit from its strengthening ties with China.

We recommend staying selective and thematic-driven on AxJ, as the recovery and rerating will not be identical across countries and sectors.

Finding the Neutral

GLOBAL RATES 4Q23

While the door to further rate tightening has not closed, policymakers have shifted towards a more balanced stance. Short-term rates have hit a steady state in the US and Eurozone while long-term rates have yet to settle. Risk-reward favours 2Y-5Y duration.

Source: iStock

07. Global Rates.

Eugene Leow
Strategist

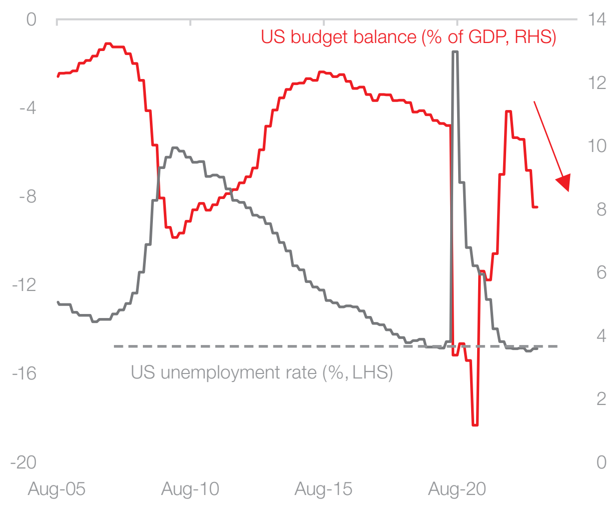
Duncan Tan
Strategist

DM interest rates finding a new neutral suited for a volatile environment in the coming years. Cyclically, the Fed and the ECB are probably near to, if not already, at the end of their respective tightening cycles. The Fed and the ECB have already delivered 525 bps and 425 bps of hikes in the current cycle. While the door for further tightening has not been closed, it does seem that policymakers have shifted towards a more balanced outlook. If our view is right, upside to 2Y tenors for UST and EGB should be capped. Within the G3, only the BOJ is seen to still be lagging the rest of the world in dealing with inflation. However, as slow as the BOJ is, it still tightened twice in the cycle, with the 10Y JGB yield cap now set at 1%.

Longer-term rates figuring where to settle as short rates hit a steady state in the US and Eurozone. Fears of a recession were mostly acute for the past few quarters, and this has been reflected in the inversions seen in the US Treasury and German Bund curves. Between jumbo-sized hikes across multiple central banks, stresses in the banking sector, and US debt ceiling woes, investors were concerned about downside risks to the economy and Fed cuts. However, the focus has since shifted to economic resilience, higher-for-longer rates, sizeable US Treasury issuances, and less distortions from the BOJ (allowing the market to play a greater role in determining 10Y JGB yield). We should also be cognisant that QT is still ongoing for the Fed and ECB. All else equal, the private sector will have to finance an increasing amount of government debt. QT will likely persist for about a year more. A minor economic shock (that necessitates a few rate cuts) will probably be insufficient for the Fed or ECB to pause QT. All these suggest that greater term premium should be accorded to the longer-tenors.

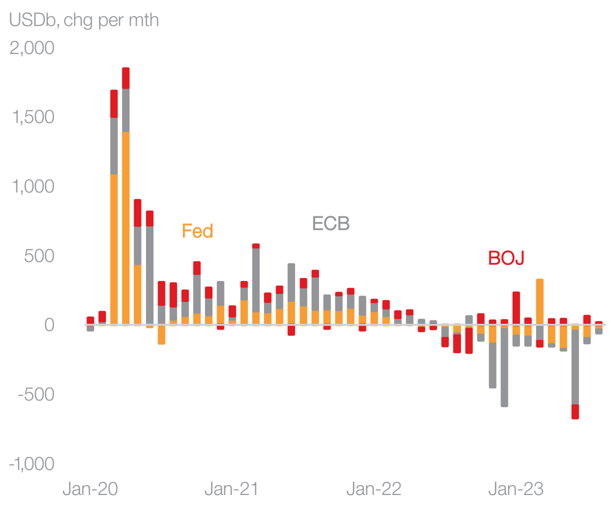
We prefer the safety of shorter duration govvies (2Y out to 5Y), noting that that the bulk of tightening is done for the Fed and ECB. With yields in those tenors already elevated (not pricing in too many cuts), these tenors can be a safety play should things go awry for the global economy. Conversely, there are a lot more factors to consider for the longer end. Curve wise, we still see steepening as the most likely scenario. A burst of bear steepening took place in recent months, but that could shift into bull steepening when a downturn becomes clearer.

US fiscal worries add to term premium



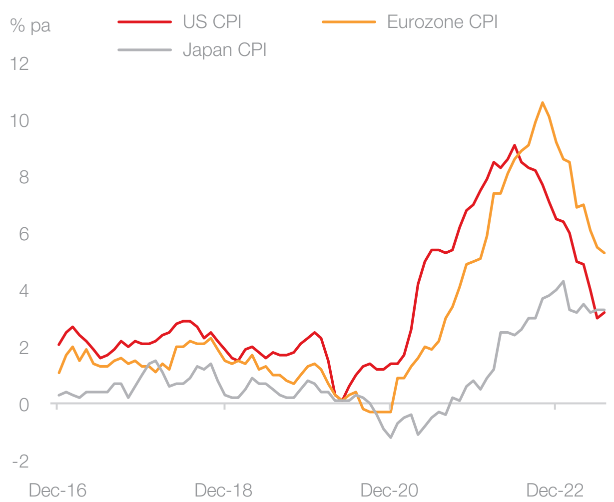
Source: Bloomberg, DBS

QT will probably last for another year



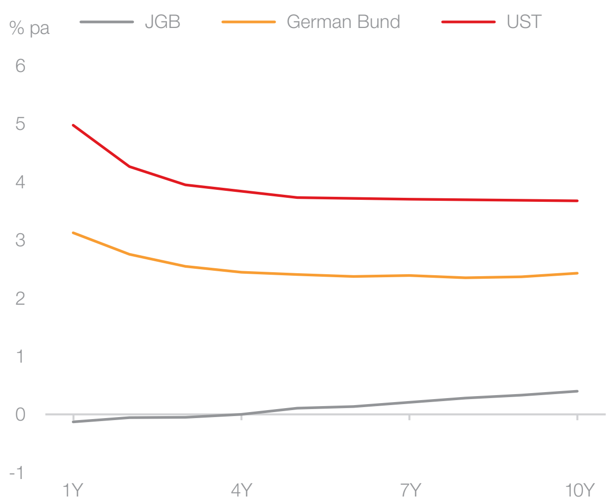
Source: Bloomberg, DBS

The easy part of disinflation is done



Source: Bloomberg ,DBS

Steepening from deeply inverted levels



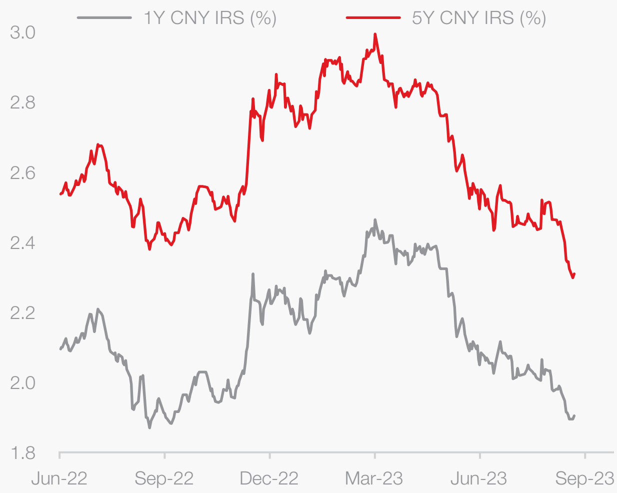
Source: Bloomberg ,DBS

Asia Rates

CNY rates: Bearish sentiments on growth

Sentiment towards China outlook remains quite bearish, as economic data continues to disappoint and negative news flow (around property developers and trust companies) creates worries of financial contagion. Policymakers continue to make pledges of economic support. If support remains skewed towards further rate cuts (OMO/MLF/LPR/deposit/mortgage rates), then IRS rates could fall further. If support pivots towards fiscal (e.g., increasing special LGB issuances) or significantly props up the property sector, it would be easier for IRS rates to find a bottom. Our base case is for CNY Rates to stay stable at current low levels with modest upside room. Liquidity appears to be sufficient but not necessarily flush – 7D Repo fixings are not as low relative to OMO rate, compared to the 2Q-4Q22 period. If we get more liquidity injections to ward off contagion risks, fixings could push lower.

China swap rates have yet to find a bottom

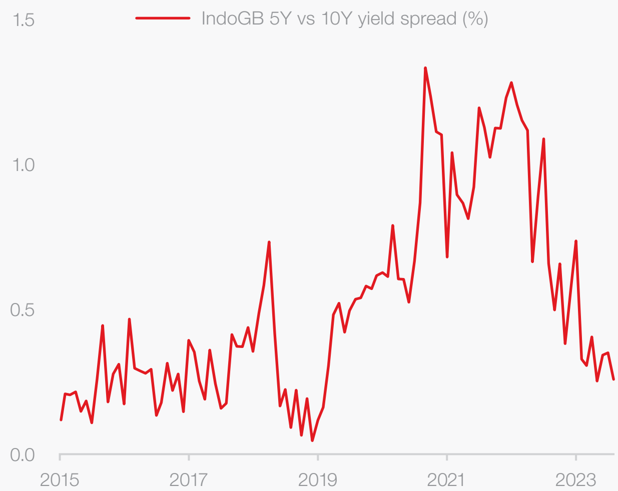


Source: Bloomberg, DBS

IDR rates: Limited scope for duration to rally

BI unlikely to signal rate cuts as uncertainty on peak Fed rates remains. 10Y IndoGBs are no longer as attractive – the following factors are likely to maintain a relatively high level of 60-80% passthrough from 10Y US Treasury yields. One, a supported US dollar/depreciating IDR would drive a wider FX risk premium and international investors would require higher IndoGB yields to compensate. Two, from a valuation perspective, 10Y IndoGB-UST yield differential should be considered as rich and stretched, and therefore, biased to re-widen. Three, specifically for domestic investors, the case to buy long-tenor IndoGBs is quite weak due to the flatness of the curve and low prospects for near-term BI rate cuts. We think 10Y IndoGB yields would need to further steepen relative to front-end yields (0-3Y) by at least 30 bps, for local investors to generally turn more in favour of extending duration.

Flatness of IndoGB curve means low incentives to extend duration

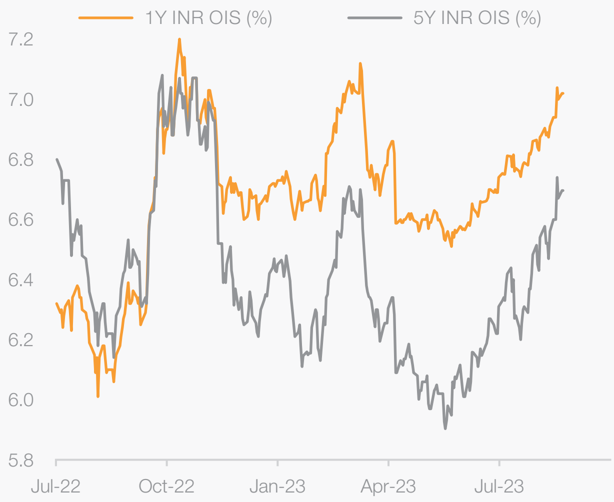


Source: Bloomberg, DBS

INR rates: Heavy bond supply and volatility in food prices

RBI has acknowledged that the recent firming in food prices would significantly push up near-term inflation prints, but for now, expects inflation to peak in the July-September quarter and moderate in subsequent quarters. However, if price shocks turn out to be more recurrent or persistent, the RBI affirms that it stands ready to hike rates further to anchor inflation expectation. With July and August CPI printing above the top of the RBI's target range for inflation, we expect OIS curve to be pricing for high chance of hike (more than 50%) at the next Monetary Policy Committee meeting in October. Indian Government Bond supply continues to be heavy and with near-term worries of volatility in food prices, OIS rates could face further upward pressures. Externally, higher US rates also exert a larger passthrough to OIS rates, compared to other regional swap markets. Tactically, any dips in OIS rates could present good risk-reward to enter payers.

Upward pressures on India swap rates could persist

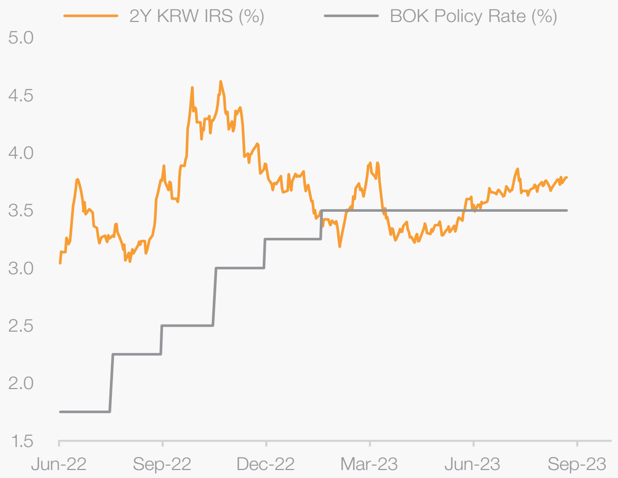


Source: Bloomberg, DBS

KRW rates: Largely a beta proxy to US rates

Economic outlook seems to be bottoming, recovery in semiconductor sector could be near. We expect the BOK to have hit peak rates, but they remain likely to push back against rate cut expectations amid still-elevated core inflation. Compared to regional central banks, the BOK's reaction function is relatively more sensitive to Fed policy, due to their focus on Korea-US rate differentials and the potential impact on the KRW FX. With US data still holding up and markets keen to price for more US term premia, pay KRW swaps could be a good beta proxy for rising US rates. That said, passthrough from higher US rates to KRW swaps could be reduced by bullish sentiments towards Korean equities and the associated equity inflows supporting KRW FX. On technicals, much lower net supply of Korea Treasury Bonds in 2023 is a positive.

Rate cut pricing in Korea swaps have been unwound

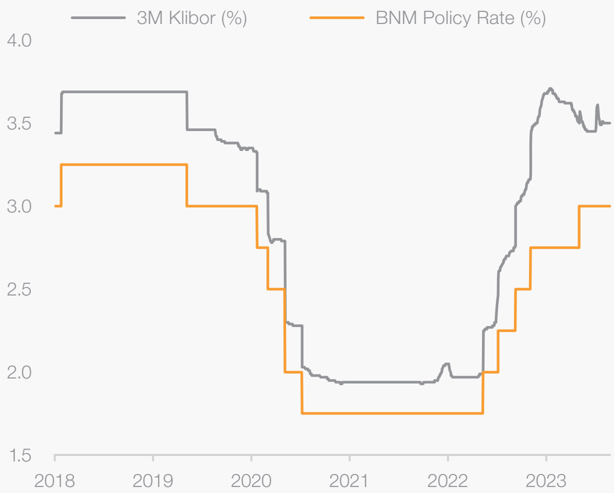


Source: Bloomberg, DBS

MYR rates: Change in stance

Change in BNM's stance. Inflation risks are no longer seen as tilted to the upside and the risks of financial imbalances are now perceived to be limited. This change in stance affirms our view that the policy rate would be kept unchanged for the rest of 2023. In addition, the timing of changes to more targeted subsidies and removal of some price controls have been pushed out to 2024, which removes some near-term risks to inflation. KLIBOR-policy rate spread has been widening recently, due to BNM tightening liquidity via increasing sizes of OMOs and Bill issuances. Front-end bond yields and MYR IRS rates look fairly priced for an on-hold BNM at 3.0%. The recent announcement to allow Employee Provident Fund (EPF) members to take out bank loans against their retirement savings could drive expectations of lower EPF demand for long-duration government bonds and result in a steeper curve.

Klibor-policy rate spread is wide in Malaysia

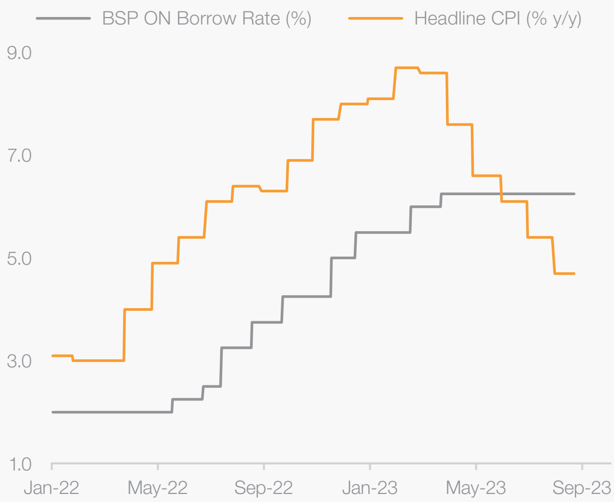


Source: Bloomberg, DBS

PHP rates: Lower correlations to US rates

BSP expected to stay on hawkish pause, keeping policy rates unchanged, at 6.25% for the rest of 2023. Headline inflation is expected to return to the target by 4Q, but BSP remains concerned about pipeline risks, including the recent climb in global energy and food, as well as domestic catalysts like transport costs, minimum wage increases, utilities, besides a weaker PHP. Despite the low prospects for policy rate cuts, government bonds could outperform regional bonds, due to traditionally low correlations to higher US rates. YTD, fiscal performance has also been strong, and the pace of net issuances is likely to slow in 4Q. Banking liquidity remains elevated and would be supportive of bond demand from banks.

Policy rates to be kept unchanged at 6.25% in Philippines

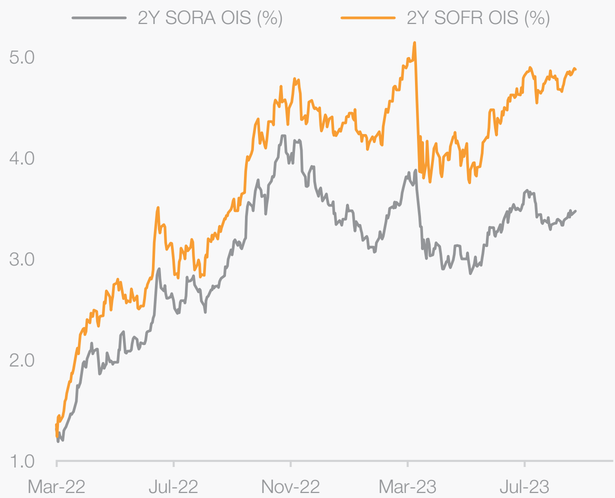


Source: Bloomberg, DBS

SGD Rates: Front-end outperformance to continue

Tightening cycle likely over, MAS expected to keep policy settings unchanged in October. Considering a still hawkish Fed coupled with expectations of stable O/N SORA and the steep slope of SGDNEER policy, we believe that all-round factors are still conducive for front-end (up to 2Y) SORA OIS and Singapore Government Securities (SGS) bonds to outperform US equivalents. Further out the curve, divergence in bond supply trends would help to anchor SGS yields against rising US Treasury yields. While there are market worries over increasing US Treasury coupon supply, there are no such worries for SGS. At some point in 1H24, when we get closer to both the Fed and MAS's easing cycles, SGD rates should start to underperform USD rates.

Still conducive for front-end SORA OIS to outperform SOFR OIS

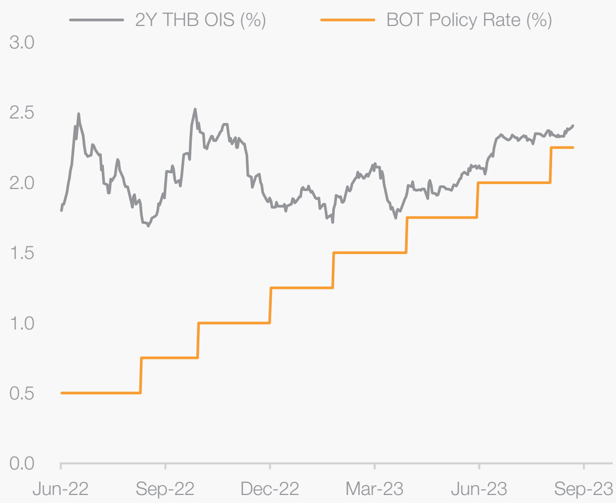


Source: Bloomberg, DBS

THB rates: BOT in wait-and-see mode

Easing inflation prints helped by favourable base effects and broad decline in commodity-related prices. At the August meeting, the BOT hiked 25 bps to 2.25%, in what we expect to be the last hike of this cycle. Policy statement suggests that the BOT has turned less hawkish on upside inflation risks and could adopt a wait-and-see approach, amid domestic political uncertainty and the associated downside risks to growth. Inflation risks could grow in 4Q when the tourism sector would recover more fully and some of the populist election promises (e.g., cash handouts, wage increases) could be implemented, leading to higher incomes and consumption. Market pricing is for the policy rate to peak at 2.25 or 2.50%, which we think could be slightly under-pricing the inflation risks ahead.

Thai swaps may be under-pricing inflation risks



Source: Bloomberg, DBS

Rates forecasts

		2023				2024			
		1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
US	3M SOFR OIS	4.91	5.26	5.38	5.38	5.38	5.25	4.75	4.38
	2Y	4.03	4.90	5.00	5.00	4.85	4.70	4.50	4.30
	10Y	3.47	3.84	4.35	4.35	4.30	4.30	4.25	4.25
	10Y-2Y	-56	-106	-65	-65	-55	-40	-25	-5
Japan	3M TIBOR	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07
	2Y	-0.06	-0.07	0.00	0.00	0.00	0.00	0.00	0.00
	10Y	0.35	0.40	0.90	0.90	0.85	0.80	0.80	0.80
	10Y-2Y	41	47	90	90	85	80	80	80
Eurozone	3M EURIBOR	3.05	3.58	4.00	4.00	4.00	3.85	3.35	2.90
	2Y	2.68	3.20	3.40	3.40	3.40	3.15	2.95	2.70
	10Y	2.29	2.39	2.80	2.80	2.80	2.65	2.55	2.50
	10Y-2Y	-39	-80	-60	-60	-60	-50	-40	-20
Indonesia	3M JIBOR	6.76	6.74	6.75	6.75	6.15	5.55	5.55	5.55
	2Y	6.29	5.87	6.15	6.15	5.75	5.35	5.35	5.35
	10Y	6.79	6.26	6.50	6.65	6.70	6.70	6.55	6.45
	10Y-2Y	50	39	35	50	95	135	120	110
Malaysia	3M KLIBOR	3.62	3.45	3.45	3.40	3.40	3.40	3.40	3.40
	3Y	3.35	3.48	3.50	3.45	3.45	3.40	3.35	3.30
	10Y	3.91	3.84	3.90	3.90	3.85	3.85	3.80	3.80
	10Y-3Y	53	36	40	45	40	45	45	50
Philippines	3M PHP ref rate	6.09	6.41	6.25	6.10	5.60	5.10	5.10	5.10
	2Y	5.86	6.31	6.25	6.10	5.60	5.25	5.25	5.25
	10Y	6.23	6.29	6.80	6.75	6.25	6.00	6.00	6.10
	10Y-2Y	45	-2	55	65	65	75	75	85
Singapore	3M SORA OIS	3.53	3.79	3.75	3.75	3.75	3.62	3.35	3.08
	2Y	3.11	3.59	3.55	3.55	3.40	3.35	3.25	3.15
	10Y	2.94	3.07	3.20	3.20	3.10	3.10	3.05	3.05
	10Y-2Y	-17	-52	-35	-35	-30	-25	-20	-10

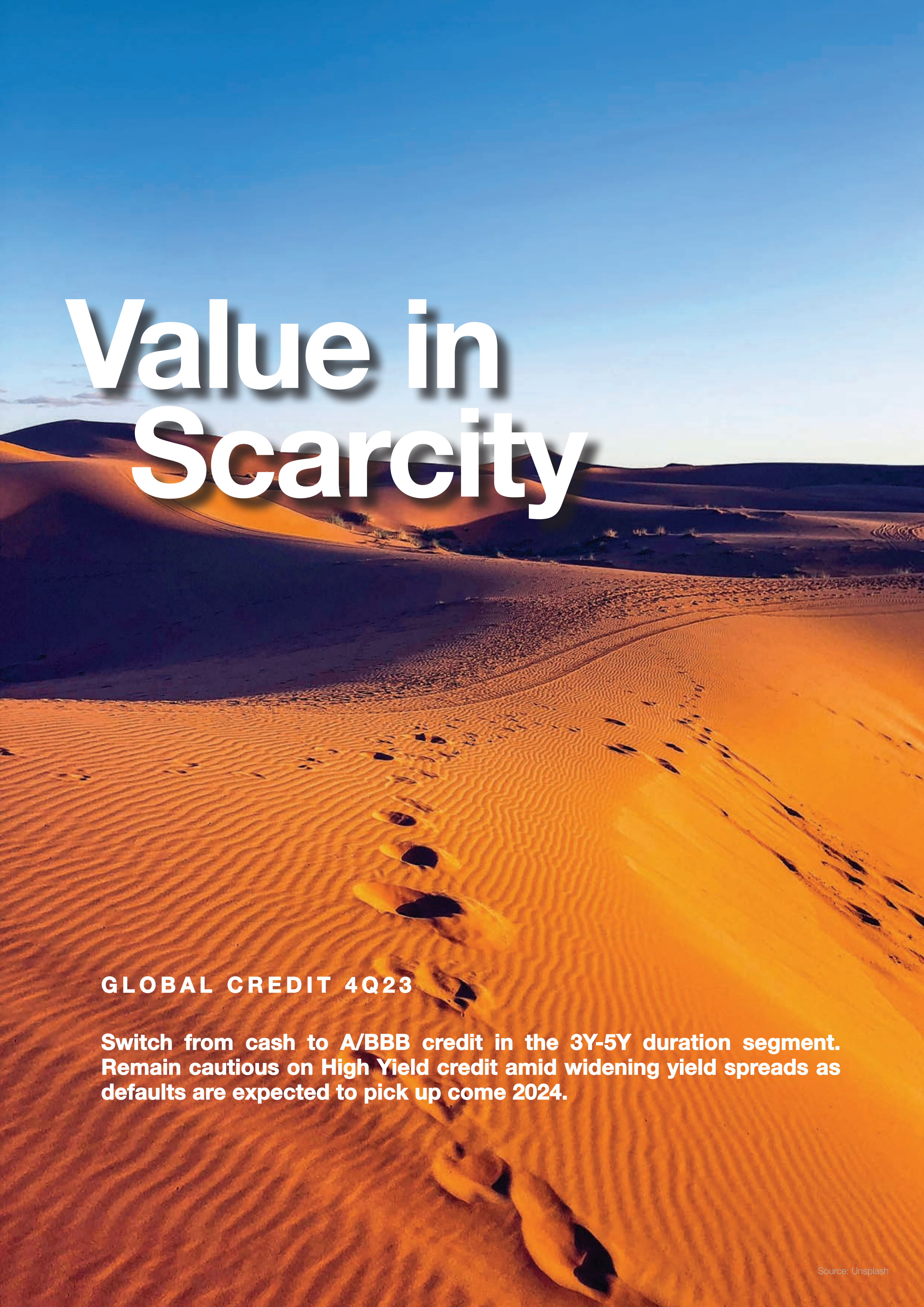
%, eop, govt bond yield for 2-year and 10-year, spread bps.

Source: CEIC, Bloomberg, DBS

		2023				2024			
		1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Thailand	3M BIBOR	1.89	2.21	2.40	2.40	2.40	2.40	2.40	2.40
	2Y	1.79	2.14	2.30	2.35	2.30	2.25	2.25	2.25
	10Y	2.43	2.56	2.70	2.75	2.70	2.65	2.65	2.65
	10Y-2Y	64	42	40	40	40	40	40	40
Mainland China	1Y LPR	3.65	3.55	3.45	3.45	3.45	3.45	3.55	3.65
	2Y	2.38	2.12	2.10	2.10	2.00	2.00	1.95	1.95
	10Y	2.86	2.64	2.60	2.60	2.50	2.50	2.55	2.60
	10Y-2Y	48	52	50	50	50	50	60	65
Hong Kong, SAR	3M HIBOR	3.71	4.97	5.28	5.28	5.28	5.20	4.75	4.38
	2Y*	3.78	4.56	4.80	4.80	4.65	4.50	4.30	4.20
	10Y*	3.53	3.86	4.25	4.25	4.20	4.20	4.15	4.15
	10Y-2Y	-25	-70	-55	-55	-45	-30	-15	-5
Korea	3M CD	3.59	3.75	3.65	3.65	3.40	3.15	2.90	2.90
	3Y	3.29	3.66	3.80	3.65	3.35	3.05	3.05	3.05
	10Y	3.36	3.66	3.90	3.90	3.75	3.50	3.50	3.50
	10Y-3Y	7	0	10	25	40	45	45	45
India	3M MIBOR	7.44	7.19	7.20	7.20	7.15	6.60	6.35	6.10
	2Y	7.05	7.02	7.05	6.90	6.85	6.20	5.90	5.65
	10Y	7.31	7.12	7.30	7.30	7.15	7.05	7.00	6.95
	10Y-2Y	27	10	25	40	30	85	110	130

%, eop, govt bond yield for 2Y and 10Y, spread bps. *swap rates.

Source: CEIC, Bloomberg, DBS



Value in Scarcity

GLOBAL CREDIT 4Q23

Switch from cash to A/BBB credit in the 3Y-5Y duration segment. Remain cautious on High Yield credit amid widening yield spreads as defaults are expected to pick up come 2024.

Source: Unsplash

08. Global Credit.

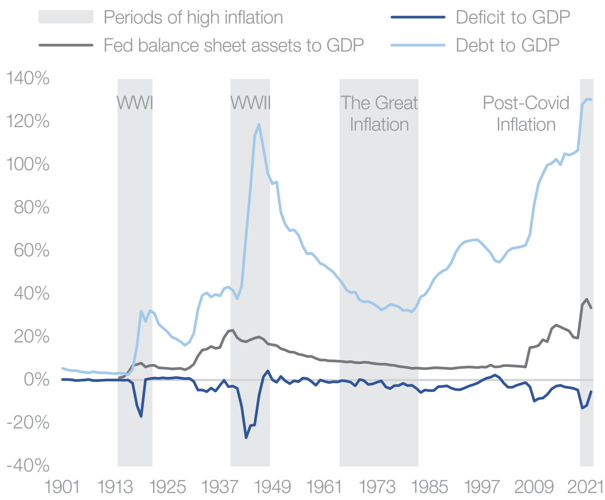
Daryl Ho, CFA
Strategist

Do high interest rates always fix inflation? Conventional wisdom assumes so, citing a plethora of channels by which tight policy deters economic activity, including (a) slowing growth by making credit more expensive for consumers to spend and companies to invest, (b) incentivising savers, (c) decreasing the fair value of assets (higher discount rates for future cash flows), and by lowering asset prices, (d) causing a negative "wealth effect" that reduces consumption. It is for these reasons that policymakers had embarked on one of the most aggressive rate hiking cycles in 2022, to deal with an inflation problem that the world had not seen in more than 40 years.

Yet these are not conventional times. The mechanisms above are largely effective in stymying private sector credit creation, but this leaves an obvious question – what if private sector money creation was not primarily responsible for the inflation observed today? What if – on the supply side – geopolitical tension is more fundamentally impeding the free flow of goods, labour, and capital than rates-disincentivised capital investments are? What if demand was more fuelled by rates-insensitive deficit spending than private sector/household borrowing?

The questions become rhetorical as the data becomes evident.

2020s inflation echoes its wartime past

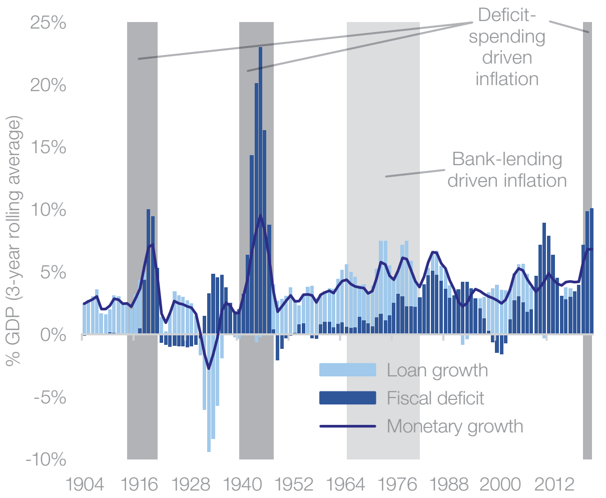


Source: Bloomberg, Federal Reserve Board, Centre for Financial Stability, St Louis Fed, Jordà Schularick-Taylor Macrohistory Database, DBS

History doesn't repeat itself, but it often rhymes. Indeed, the present post-pandemic inflation – closely scrutinised – reveals the large role played by fiscal policy in its wake, echoing the high deficits, debt, and central bank balance sheet elements of a wartime past. Where large deficit spending was incurred at the time of the world wars to purchase munitions and tanks, the same was done pre- and post-pandemic through unemployment benefits and ever-higher government outlays. Central banks kept interest rates low and expanded their balance sheets to keep debt burdens manageable. Supply chains, once disrupted by a world in kinetic conflict, are now disrupted by geopolitical realignments and reshoring.

Deficit spending grew the supply of money. More clarity is observed as we parse over historical data on money supply. There were four significant periods of high inflation in the century prior, all of which were – as Milton Friedman would have it – driven by a more rapid increase in the quantity of money than in output. However, of such episodes of monetary growth, three of which were driven by war or "war-like" deficit spending, while only one – the great 1970s inflation – was more bank-lending led (the post-war boom in industry and favourable demographics of the baby boomer workforce fuelled an era of rising wages and consumption). Even though high inflation was the unifying experience in these occasions, the method of dealing with inflation varied significantly; depending on the drivers of said inflation.

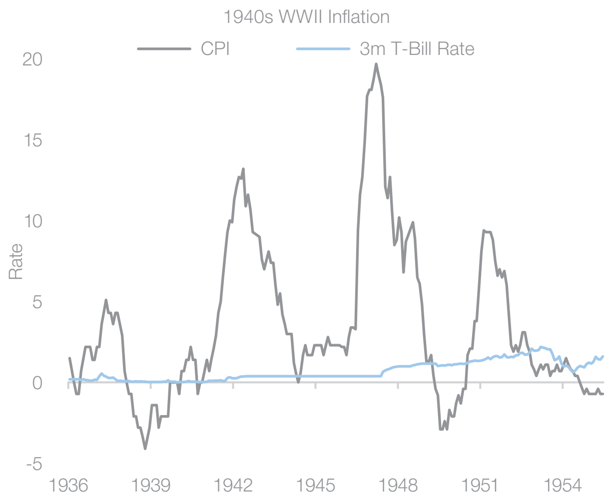
This is not the 1970s - deficit spending is primarily responsible for post-pandemic monetary growth



Source: Bloomberg, Jordà-Schularick-Taylor Macrohistory Database, Federal Reserve Bank of the US, Lyn Alden Investment Strategy, DBS

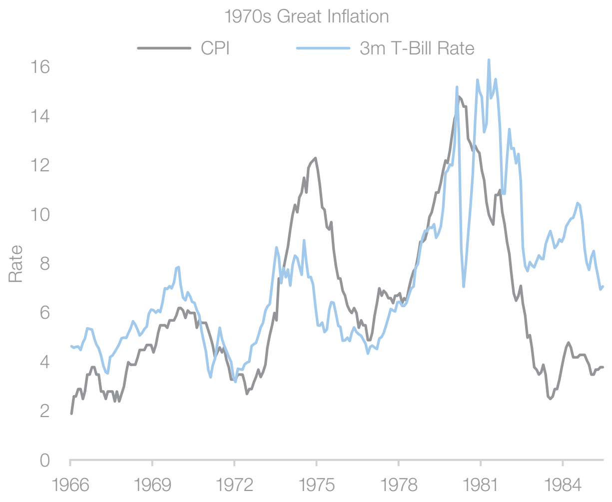
One size does not fit all. Contrary to popular belief, raising interest rates was not always the necessary solution to the inflation problem. In the WWII decade of the 1940s, inflation eventually reverted to lower levels after the war, all while the Fed kept interest rates well below the rate of inflation. Then Fed chair Marriner S. Eccles believed in deficit spending as a tool of countercyclical policy, and after the war, opined that that the government should control inflation through running budget surpluses (not rate hikes). Eventually the war ended, deficit spending stopped, and supply chains normalised as the world retooled for peacetime. Higher interest rates hardly featured as inflation normalised.

Rate hikes were not the solution to the 1940s inflation…



Source: Federal Reserve Bank of St. Louis, Bloomberg, DBS

…but it conquered the 1970s Great Inflation

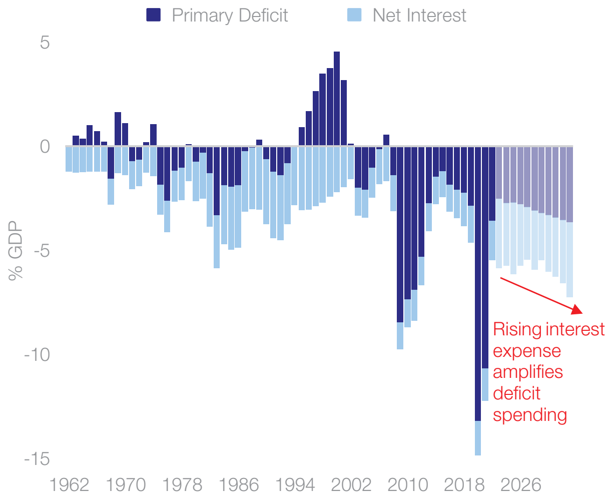


Source: Federal Reserve Bank of St. Louis, Bloomberg, DBS

Paul Volcker – the right man for the job. The 1970s, on the other hand, was the decade where rate hikes were the necessary evil. Rising wages and consumption demand led by bank lending risked cycling inflation expectations in a feedback loop that could cause runaway prices. Stiflingly high rates acted as the "circuit breaker" for demand, which is particularly effective when bank lending is the primary cause of money supply growth, while public debt is low in contrast.

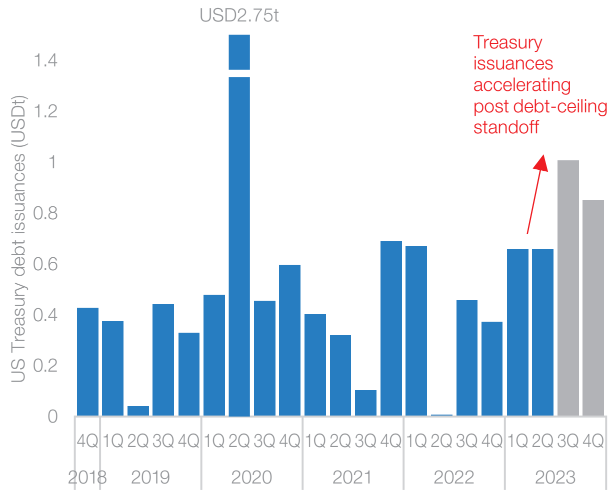
A 1970s solution for a 1940s problem. Knowing that the post-pandemic inflation more closely resembles inflation in the 1940s than the 1970s, it is perhaps curious that Fed chair Jerome Powell has invoked the name of Paul Volcker in his commitment to deal with inflation today, when Marriner Eccles could be a more appropriate choice. A mix of austerity and diplomacy seems a more precise solution for today's inflation, yet interest rates continue to be the blunt instrument of choice – perhaps because the Fed does not have the tools for deficit-driven inflation. Fed tightening works insofar as high rates slow the pace of private money creation, but so long as deficit spending persists, the brakes and accelerator are both on at the same time, which is a recipe for inflation volatility down the road.

Deficits on a runaway train



Source: US Congressional Budget Office, DBS

US Treasury issuance accelerating post debt-ceiling standoff…

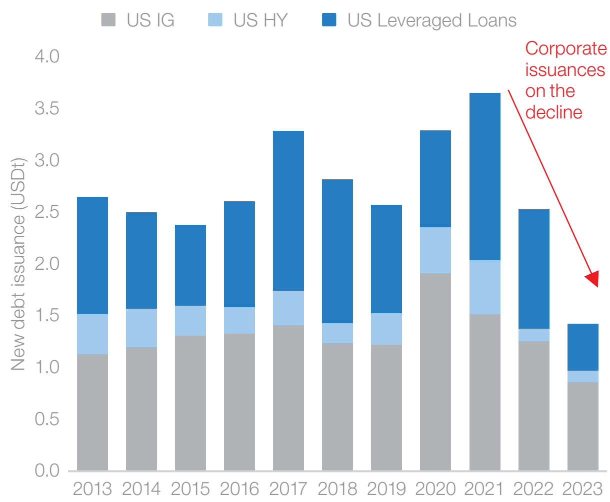


Source: US Department of the Treasury, DBS

The surprising twist – high rates can aggravate inflation. The key difference between the high rates today and the 1970s is the level of public debt (>110% today versus c.40% in the 1970s in the US). High rates on such a large debt denominator leads to ever rising interest expenses – resulting in even higher deficits in a vicious cycle which is stimulative on balance. The US Congressional Budget Office is acutely aware of this risk, having forecasted deficits over the next 10 years to keep escalating on the back of rising interest servicing costs.

Your loss is my gain. The irony is that deficits for the government is a surplus for the private sector. This could be why the economy has continued to surprise in terms of resilience in the face of high rates – the comparatively more prudently-levered private sector is indirectly benefitting from such transfers. For reference, Apple's c.USD62b could earn a passive c.USD3b in annual interest just by being invested in short-term government bills.

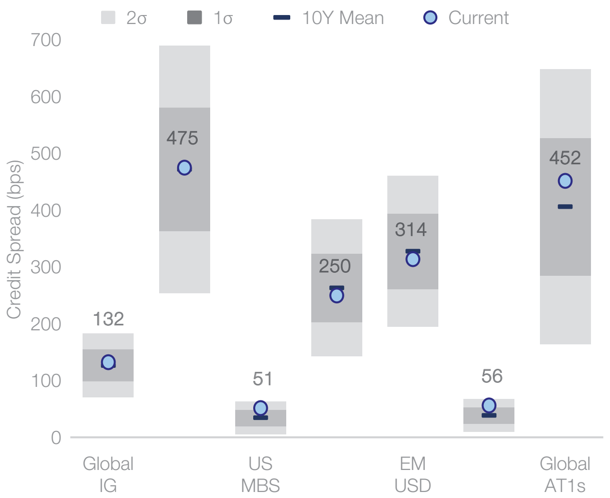
…while private sector issuances are collapsing under high rates



Source: Bloomberg, DBS

What does this mean for credit? The corollary to the argument above is that there would be a gradual but certain crowding out of the private sector by public sector financing needs. Companies would find it challenging to find lenders at a fair price, noting the increasing abundance of default risk-free government debt paying positive real rates. The first effects of this dynamic are already evidently seen in the issuance trends over the next few months – while treasury issuances are projected to come in at c.USD1.8t in just the second half of 2023, corporate primary issuances have slowed to a trickle in the same period.

Credit spreads reflect benign risk among corporate issuers

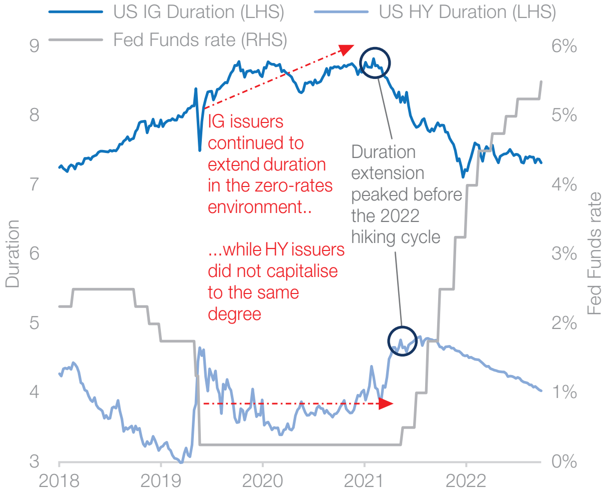


Source: Bloomberg, DBS

Kicking the can down the road. We believe that corporate issuers have no choice but to kick the can down the road, postponing issuances as far out as possible in the hope that an eventual decline in the interest rate environment would allow for financing at more normalised rates. In a way, this “crowding out” results in involuntary deleveraging in the private sector, which at the margin favours taking corporate credit risk as their balance sheets improve. The combination of (a) fundamentally improving credit risk, and the (b) supportive technicals of diminishing supply of credit, could be why spreads are trading with such a sanguine outlook.

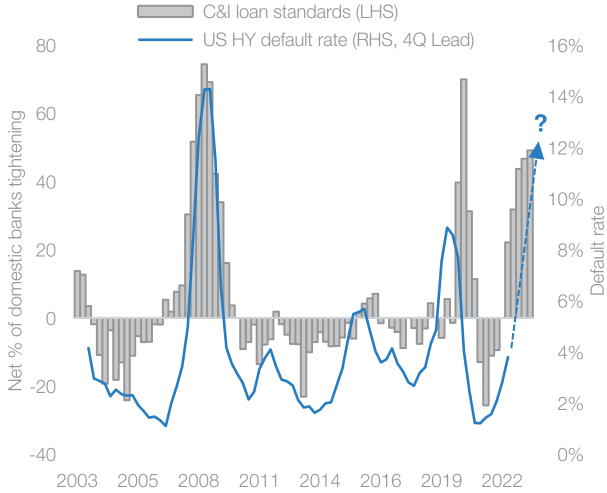
No time for complacency. We caution, however, that this warrants much more selectivity in credit risk. If corporates are indeed deleveraging in the hope that rates would normalise at lower levels down the road, investors need to be positioned with credit issuers that have the financial health to tide over this period of high rates without running into liquidity risks. This favours high quality IG issuers at the margin due to two factors.

IG issuers are better insulated from rising interest rates, having extended duration



Source: Bloomberg, DBS

Tightening lending standards suggest rising HY defaults



Source: Bloomberg, DBS

Firstly, IG issuers have extended duration to a much larger degree, minimising exposure to rising rates. Corporate issuers had taken advantage of the zero-rates environment in 2020-2021 to lock in low funding costs for the long term. The average duration of IG issuers in the US peaked as high as 8.8 years in 2021, meaning that on aggregate, these companies would not face refinancing strain in their bonds for much of the remainder of this decade. The same however, could not be assumed for HY markets. We note that HY issues have on average half the duration of IG issues, as investors prefer not to have long duration exposure to junk risk. Moreover, these issuers did not meaningfully extend duration during the low-rate years of 2020-2021, implying that refinancing at much higher rates is a risk likely approaching in the years of 2024-2025.

Secondly, rating agencies are already anticipating rising default rates in 2024. As the aim of Fed tightening is to suppress the private sector to offset the stimulative deficits in the public sector, bank lending standards have consequently tightened, hindering access to liquidity. The C&I loan standard survey is typically an accurate leading indicator of the default cycle, and it is already pointing to a much higher default rate in 12 months – in line with forecasts by credit ratings agencies. This again supports investor positioning in much higher quality credit to avoid a turn in the credit environment.

Duration risk is not to be trifled with. We also remain committed to avoiding duration risk, preferring the 3–5-year duration segment on the back of several known risks on the horizon:

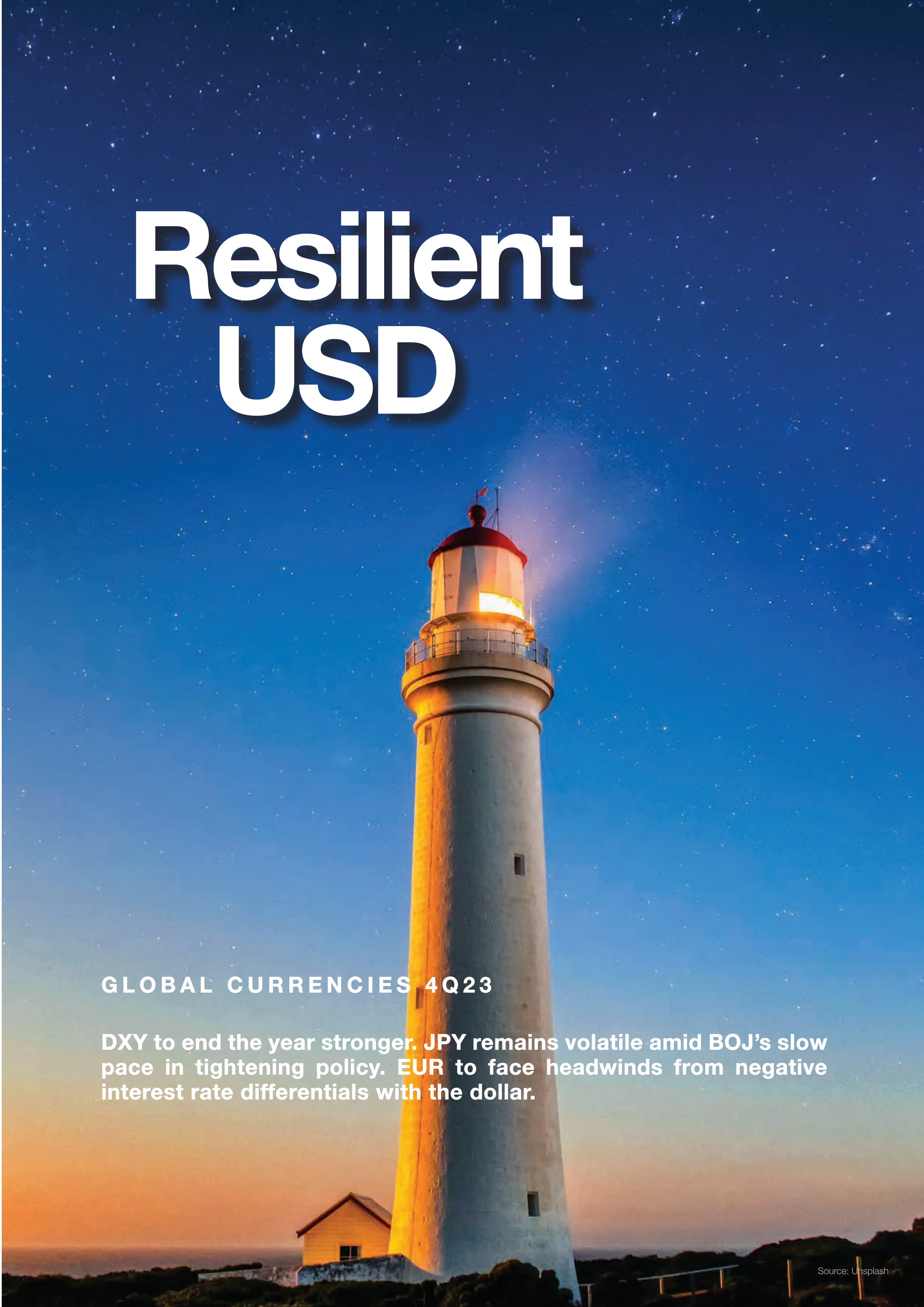
a. **Inflation uncertainty.** Given the notion that there are stimulative effects of higher projected deficit spending, 10-year breakeven inflation expectations of c.2.3% seem low, especially in the context of a deeply inverted yield curve.

b. **Policy normalisation in Japan.** The BOJ seems to be on track to normalise policy to deal with rising domestic inflation. This diminishes the attractiveness of longer dated USTs for Japanese investors in favour of JGBs.

c. **Higher Treasury issuance.** The US Treasury is set to issue more Treasury debt for the remainder of 2023, and may selectively issue in the longer end to take advantage of the inverted yield curve. The US debt downgrade by Fitch, while not dire, is not encouraging in terms of the trajectory of US indebtedness.

d. **Commodity prices.** Commodity prices are re-accelerating under the narrative of a soft-landing, which does not bode well for inflation prints down the road.

In summary, we continue to reiterate a high-quality bias for credit investors. We believe that the rate hiking cycle is nearing its end, which gives us confidence that headwinds for credit in the short end have all but abated. Investors should therefore take the opportunity to switch from cash to short-term credit, with the view that deposit rates have probably peaked. IG credit retains dual advantages of (a) stronger balance sheets to tide through an elevated-for-longer rates environment, and (b) a technical tailwind of diminishing issuance and supply. We are cautious on HY, which could see spreads widen as defaults are expected to pick up come 2024. The sweet spot remains with A/BBB credit in the 3-5Y duration segment.



Resilient USD

GLOBAL CURRENCIES 4Q23

DXY to end the year stronger. JPY remains volatile amid BOJ's slow pace in tightening policy. EUR to face headwinds from negative interest rate differentials with the dollar.

Source: Unsplash

09. Global Currencies.

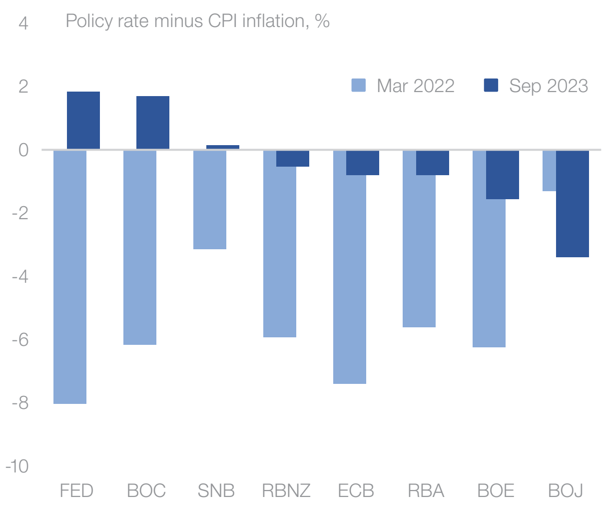
Philip Wee
Strategist

Chang Wei Liang
Strategist

The USD's selloff in early 3Q23 fizzled as quickly as it erupted. For the third time this year, the USD Index (DXY) recovered on the Fed's push for "higher for longer" rates. Unlike the previous two failed attempts, a robust US economic outlook backs the greenback. The USD was also a haven from heightened global uncertainties, i.e., China's economic confidence crisis, increased geopolitical and economic fragmentation risks, and the Eurozone's stagflation risks. When central banks finally end their tightening cycles and move towards keeping rates high into 2024, the US will own the highest real policy rates in DM, with interest rate differentials favouring the USD. Within the DXY basket, JPY, CAD, and SEK have depreciated near last November's lows. Conversely, EUR, GBP, and CHF look expensive, with 10-13% gains from the same lows. The European Commission predicted a German recession hurting the EU's growth in 2023 and 2024. The odds have also increased for a UK recession in 2H23. As 2023 ends, JPY could rebound if the BOJ paves the way for monetary policy normalisation.

Emerging Asian currencies started faltering in May. As of mid-September, Asian currencies excluding IDR were weaker against the greenback in YTD terms. Attention shifted from financial stress and the debt ceiling crisis in the US towards China's confidence crisis over its disappointing economic recovery and property crisis. As the US-China rivalry escalated amid a better US economic outlook, China de-risking worries eclipsed de-dollarisation fears. In early September, CNY was the only currency that depreciated past last year's worst level. Interest rate differentials started to favour the US from the Fed's push for "higher for longer" rates. Conversely, Asian central banks paused on inflation cooling back to or towards their targets amid the region-wide export recession. US-China rivalry has become a double-edged sword for Southeast Asia. Apart from investment opportunities via the "China plus one" strategy, the region is alert to efforts by the US and China to exert influence and recognise Taiwan as the most dangerous flashpoint. Hence, investors should not be complacent heading into January 2024's Taiwan presidential elections.

US real policy rate is positive and the highest in Developed Markets



Source: Bloomberg DBS

EUR, GBP, CHF look expensive vs. other DXY currencies

Source: Bloomberg DBS

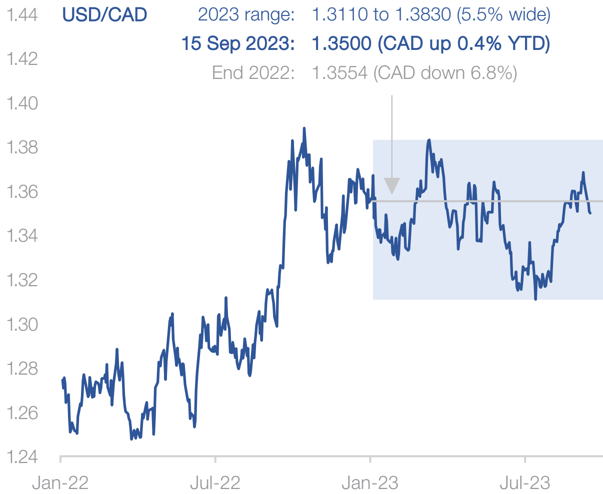
USD Index rebounds from the year's low to the year's high

	Year	1Q	2Q	3Q	4Q
DBS	2023	102.5	102.9	105.6	107.0
forecast	2024	105.5	103.9	102.4	100.9

Source: Bloomberg DBS

We cannot rule out the DXY ending 2023 at a new high. Apart from the brief dip below 100 in July, DXY has been consolidating in a 101-106 range this year. Despite Fitch axing America's triple-A debt rating on 2 August, DXY staged the year's strongest rally from 99.6 to 105 in 3Q23 on the Fed's third push for "higher for longer" rates. The first attempt in February was hijacked by financial stress triggered by Silicon Valley Bank's collapse. The second push in May was undermined by the US federal debt crisis and the Fed's first pause on 14 June. For this third push, the US economic outlook has improved and looks strong vs. China and Europe. At the FOMC meeting on 26 July, the Fed hiked again, and Fed staff stopped forecasting a US recession. Since then, the Atlanta Fed GDPNow model lifted its forecast for 3Q23 GDP growth to 5.57% q/q saar from 2.4%. CPI inflation bottomed at 3.2% y/y in June and climbed again to 3.6% in August, with core inflation well above the 2% target at 4.3%. The US real policy rate is not only positive but also the highest in G7.

The Canadian dollar entered a weaker 1.33-1.39 range in September



	Year	1Q	2Q	3Q	4Q
DBS	2023	1.35	1.32	1.36	1.39
forecast	2024	1.38	1.36	1.35	1.34

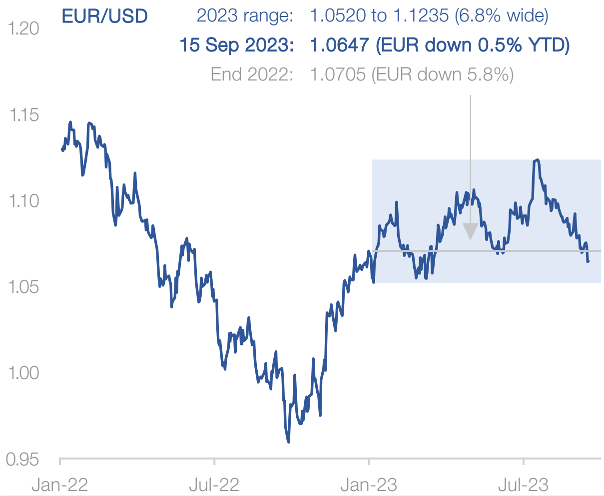
Source: Bloomberg DBS

We expect USD/CAD to keep an upside bias within a 1.35-1.40 range, the upper half of the 1.30-1.40 band set in mid-September 2022. USD/CAD rebounded to 1.37 in September after hitting a 10-month low of 1.31 on the USD sell-off into mid-July. Despite CPI inflation rising to 3.2% y/y in August from 2.8% the prior month, the BOC kept the overnight lending rate unchanged at 5% in September. The Canadian economy surprised with a 0.2% q/q saar contraction in 2Q23 from household consumption growth crumbling to 0.2% from 4.7%. Monetary policy turned restrictive, i.e., the real policy rate, at 1.73%, was above BOC's estimated neutral range of 0-1%. After 475 bps worth of rate hikes over 17 months, high borrowing costs and tighter bank lending standards have stressed the mortgage sector. The unemployment rate increased to 5.5% in August, or its worst level since January 2022. Core inflation fell the eighth month to 3.6% y/y in August. Unlike the Fed's 2% inflation target, the BOC has a target range of 1-3%, one reason why the BOC paused three times this year vs. the Fed's single pause, resulting in higher real policy rates for the US (2.32%) vs. Canada (1.73%).

EUR to end 2023 weaker after returning this year's gains. EUR's depreciation became more entrenched after the US and Eurozone's growth outlooks switched at their central bank meetings in July. The ECB warned that the Eurozone's outlook has deteriorated while Fed staff stopped forecasting a US recession. After delivering a "dovish hike" in September, the ECB emphasised on keeping rates high longer to achieve its 2% inflation target mandate. Stagflation is challenging EU unity. Budgetary battles have started between Brussels and EU nations prioritising economic growth. Italy wants to further suspend the Stability and Growth Pact, which has been on hold since 2020 because of the Covid pandemic and Russia's invasion of Ukraine. Germany and France have called on the European Commission (EC) to reduce bureaucratic burdens on companies to stimulate private-sector investment. Protectionism tendencies have increased after the EC downgraded the 2023-2024 growth forecasts in September. The EC launched an investigation into China's state subsidies for its electrical vehicle manufacturers, which China has criticised as "blatantly protectionist." France ordered Apple to stop selling its iPhone 12 models for exceeding the radiation exposure limits or risk a recall. Belgium and Germany have followed up with similar probes.

Look for GBP to give back more of this year's rally. GBP/USD retreated to 1.26 in August after hitting the year's high of 1.3140 in mid-July. The factors responsible for the GBP's stellar 27% rally after the UK mini-budget crisis have waned. The BOE is near the end of its tightening cycle after delivering a 12th hike to 5.25% in early August. CPI inflation fell steadily to 6.8% y/y in July from 7.9% in June, lifting expectations for Prime Minister Rishi Sunak to fulfill his pledge to halve inflation this year. Consensus agreed and saw CPI inflation averaging 4.5% y/y in 4Q23, down from its 11.1% peak last October. Unlike the start of 2022, the UK economy is less likely to dodge a recession over the next year. The additional hikes this year have brought monetary supply growth. In August, the S&P CIPS services and manufacturing fell below the breakeven 50 level for the first time since January. Nationwide house prices declined a seventh month by 5.3% in August, its worst since 2009. Interest rate futures now see BOE rates peaking at 5.50% this year instead of 6.50% in 1Q24.

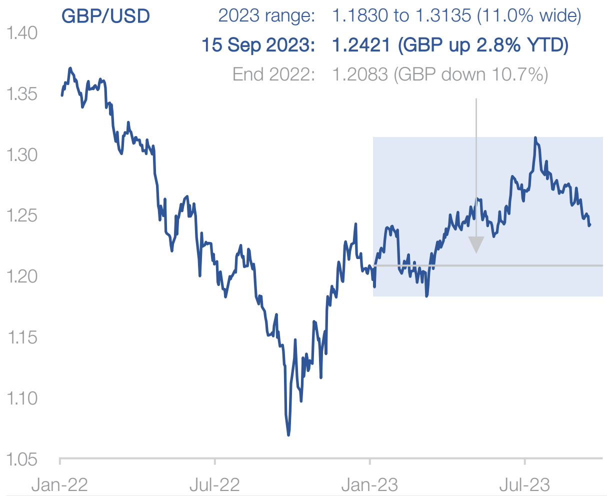
The Euro is still high despite having returned this year's appreciation



	Year	1Q	2Q	3Q	4Q
DBS	2023	1.08	1.09	1.06	1.05
forecast	2024	1.07	1.09	1.11	1.12

Source: Bloomberg, DBS

The British pound can give back more of this year's rally



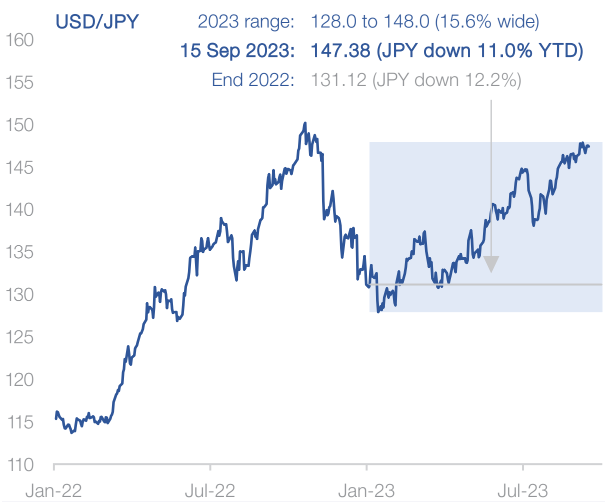
	Year	1Q	2Q	3Q	4Q
DBS	2023	1.23	1.27	1.24	1.21
forecast	2024	1.23	1.25	1.27	1.29

Source: Bloomberg, DBS

JPY volatility stays high as the spotlight falls on when the BOJ could pare back stimulus. Large rate differentials between the BOJ and the Fed could narrow in 2024, with Governor Ueda stating that negative rates could end once 2% inflation is in sight. In July, the BOJ also increased flexibility for its YCC framework by allowing the 10Y yield to drift above its reference range of +/-50bps around 0%, up to a limit of 1%. This tweak gives markets a greater role in determining bond yields, which should improve market functioning and limit shocks when the BOJ eventually withdraws from YCC. JPY volatility was also stated as a factor for the BOJ, reflecting discomfort over the weak JPY. The BOJ's Tamura mentioned that labour shortages and slower labour force growth could change Japanese firms' wage- and price-setting behaviour. In addition, wage growth could pick up further from a third year of rising corporate profits, increasing the likelihood of sustained inflation. Thus, while JPY weakness may linger in the short-term, USD/JPY could ease below 140 in 2024 on possible BOJ policy normalisation.

USD/CHF to return above 0.90 by the end of 2023. The factors that propelled the CHF as the strongest DM currency in the first seven months have waned. USD/CHF was not spared from the greenback's rebound on a resilient US economy in August-September. Conversely, the Swiss economy is looking at weaker growth in 2H23 after real GDP growth flattened to 0% q/q sa in 2Q23 from 0.3% the prior quarter. Economic headwinds in the Eurozone and China have led to negative export growth and brought manufacturing PMIs below 40 for the first time since 2009. Contrary to expectations, SNB did not hike on 21 September to its 2% neutral rate. With CPI inflation returning inside its 0-2% target range, the real policy rate turned positive on the June hike. The seasonally adjusted unemployment rate hit a nine-month high of 2.1% in July, and wages did not keep pace with inflation. The SNB will probably lean towards keeping rates high for longer. The Swiss elections on 22 October could produce a more right-wing government and hamper the recent efforts to restart negotiations on the cooperation agreement with the EU called off by Bern in 2021.

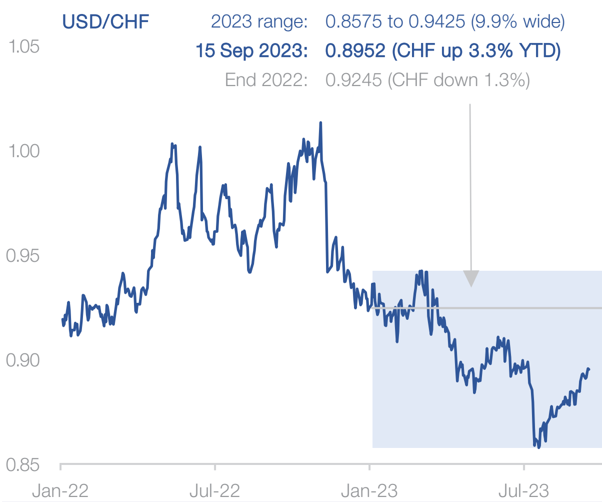
The Japanese yen's recovery at the end of 2023 hinges on the BOJ



	Year	1Q	2Q	3Q	4Q
DBS	2023	133	144	148	152
forecast	2024	148	144	140	136

Source: Bloomberg, DBS

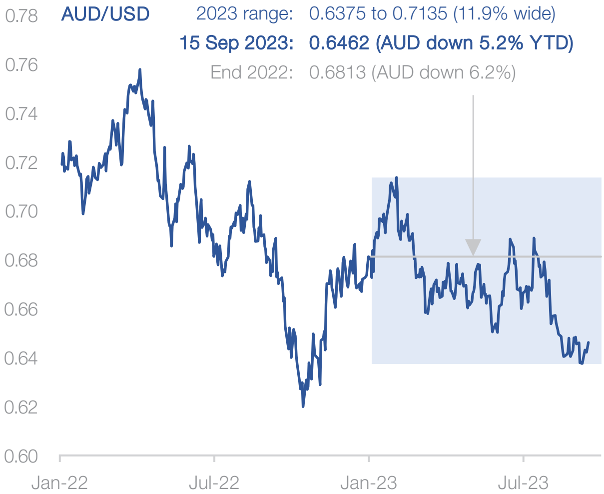
The Swiss franc will be the most expensive currency when SNB hikes end



	Year	1Q	2Q	3Q	4Q
DBS	2023	0.92	0.90	0.90	0.93
forecast	2024	0.92	0.92	0.91	0.91

Source: Bloomberg DBS

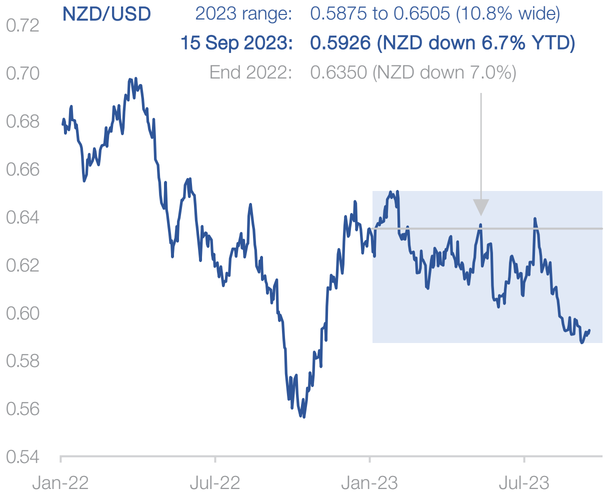
The Australian dollar cannot shake off global growth worries



	Year	1Q	2Q	3Q	4Q
DBS	2023	0.67	0.67	0.64	0.62
forecast	2024	0.64	0.65	0.67	0.69

Source: Bloomberg, DBS

The New Zealand dollar eventually broke below 0.60



	Year	1Q	2Q	3Q	4Q
DBS	2023	0.63	0.61	0.59	0.57
forecast	2024	0.58	0.60	0.61	0.63

Source: Bloomberg, DBS

AUD faces downside risks from a slowing China and higher interest rates. Between February and August, AUD went from the top to the third worst-performing DM currency. AUD tumbled from 0.69 in mid-July to 0.64 in mid-August. First, the USD Index (DXY) rebounded the year's low after the Fed pushed for "higher for longer" rates on a relatively robust US economic outlook. Second, it did not help that the RBA paused in July and August. Economists polled by Bloomberg and interest rate futures see a slim chance of a final RBA hike in 4Q23 after CPI inflation fell a fourth month to 4.9% y/y in July, its lowest level since February 2022. Third, AUD was burdened by China's economic confidence crisis and the depreciation across Asian currencies. Australia exports three-quarters of its goods to Asia. Treasurer Jim Chalmers viewed RBA's sharp rate increases and China's slowdown as the two most significant risks to the Australian economy. New RBA Governor Michele Bullock plans to consider climate change when setting interest rates after assuming office on 18 September.

NZD to languish below the 0.60 level it broke in August for the first time since November. The RBNZ ended its hiking cycle on 24 May after lifting the official cash rate 12 times by 525 bps to 5.50%. In mid-June, Statistics New Zealand reported the economy entered a technical recession in 1Q23. CPI inflation peaked at 7.3% y/y in 2Q22 and slowed to 6% in 2Q22, its lowest level since 4Q21. Fitch downgraded (in June) the outlook of NZ banks from neutral to deteriorating on economic headwinds hitting earnings and asset quality. Although Fitch affirmed (in August) the stable outlook for the AA+ sovereign rating, Fitch warned of risks from high household debt and the record-wide current account deficit (8.1% of GDP in 2022). The next government formed after the general elections on 14 October must uphold strong governance and commit to lowering gross government debt as a proportion of GDP over the medium term. Polls see the centre-right opposition (comprising the National and ACT parties) winning majority support to form a coalition government.

Asia Currencies

CNY

The PBOC is increasing efforts to stabilise the CNY. Capital outflows from China have risen amid a growth slowdown, a decline in enterprise profitability, property debt concerns, and policy rate cuts. Negative rate differentials relative to the USD have widened for the third time this year, with state banks cutting deposit rates by 10-25 bps in late August as they prepare to lower mortgage rates. To stabilise CNY sentiment, China warned in September that it could take action to resist one-sided FX speculation. PBOC has already enacted a series of measures to strengthen the CNY, including setting strong CNY fixings for close to two months, tightening liquidity in the offshore CNY market, and cutting the onshore FX reserve requirement ratio by 200 bps to 4%. We believe further CNY trade-weighted depreciation does not align with policymakers' intentions. However, USD/CNY may still adjust upwards if the USD is to strengthen broadly. The policy guidance for a stable CNY is solidly backed by USD3t of FX reserves and a large current account surplus. We think CNY stability is achievable and expect USD/CNY to consolidate around 7.30-7.40 before easing back below 7.00 in late 2024.

The Chinese yuan was undermined by a confidence crisis

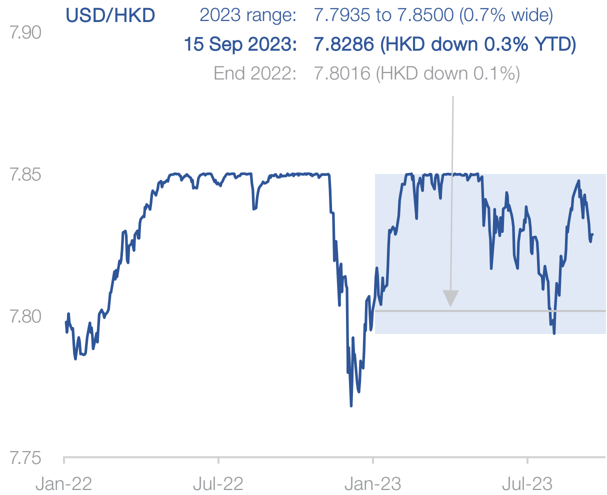
	Year	1Q	2Q	3Q	4Q
DBS	2023	6.87	7.25	7.29	7.38
forecast	2024	7.26	7.14	7.02	6.90

Source: Bloomberg, DBS

HKD

USD/HKD consolidates above 7.80. USD/HKD had become more volatile amid tight HKD liquidity, though it remains around the upper half of its trading band from 7.75-7.85. Hong Kong's aggregate balance remains at multi-year lows of around HKD 45b from May to August, supporting HIBOR rates and narrowing the negative rate differential with USD rates across the curve to under 50 bps. Consequently, long USD/HKD carry trades are no longer attractive, though sporadic HKD liquidity shifts could still drive short-lived rebounds in USD/HKD. Meanwhile, Hong Kong's prime rate has hiked by a cumulative 25 bps in May and July this year, indicating a pick-up in the pass-through from rising market rates to lending rates, which could weigh on housing market activity. Nevertheless, the HKMA should be resolute in maintaining the USD/HKD peg, which continues to serve Hong Kong well and support its role as a financial hub in North Asia. Going into 2024, USD/HKD may eventually ease below its 7.80 mid-point on a recovery in activity as Chinese tourist inflows recover to pre-pandemic levels, on top of likely Fed rate cuts.

The Hong Kong dollar fluctuates within 7.80-7.85 of its convertibility band



	Year	1Q	2Q	3Q	4Q
DBS	2023	7.85	7.84	7.83	7.84
forecast	2024	7.83	7.81	7.80	7.79

Source: Bloomberg, DBS

KRW

KRW faces risks from sluggish exports and household debt. South Korea's export growth bottomed after a long decline since 2022, but the recovery has been weak and tentative. A concurrent slowdown in China and renewed weakness in the JPY are frustrating hopes of a vigorous rebound until 2024. Furthermore, rising household debt burdens amid higher rates could result in credit strains and weigh on consumption. Korea's household debt delinquency, while low on an absolute basis, is rising back to 2015 levels. Signs of a bottoming out in the Korean housing market and price declines narrowing to -0.1% m/m in August should contain worries around real estate debt. While the BOK still sounds hawkish on inflation, rates will likely be kept on hold given growth risks, limiting any support for the KRW. The larger-than-usual foreign bond and equity inflows in 2Q23 have also abated amid weaker-than-expected performance by the Korean semiconductor industry. Given both internal and external demand risks, we see scope for USD/KRW to test higher towards 1,360 in 4Q23 and stay above 1,300 for 1H24.

The South Korean won has held up better but there is little room for complacency

	Year	1Q	2Q	3Q	4Q
DBS	2023	1302	1318	1330	1360
forecast	2024	1340	1310	1290	1260

Source: Bloomberg, DBS

SGD

USD/SGD could shift into a higher 1.36-1.39 range in 4Q23. In September, USD/SGD traded above its seven-month range between 1.32 and 1.36. We expect the MAS to keep SGD NEER policy unchanged again at its semi-annual policy meeting in October. The progressive appreciation of the SGD NEER policy band from October 2021 to October 2022 is working to lower inflation. Averaging 0.3% m/m in the first seven months, CPI All-Items and core inflation should achieve MAS's 2023 forecasts of 4.5-5.5% and 3.5-4.5%, respectively. Having declined to 3.8% yy in July, core inflation should end 2023 within the MAS's 2.5-3% target. Meanwhile, Singapore's economic outlook has darkened with the global economy. In August, the Ministry of Trade of Industry narrowed the 2023 GDP growth forecast to 0.5-1.5% from 0.5-2.5%. A month later, the Ministry of Manpower warned that labour demand could cool more this year. The government is monitoring for unpredictable and dangerous outcomes from the intense US-China rivalry and competition. If a global recession becomes imminent, the SGD NEER should plunge into the lower half of the policy band, as it did during the Covid outbreak in February 2000. Under this situation, expect USD/SGD to push above 1.40.

The Singapore dollar weakened above the 1.32-1.36 range

	Year	1Q	2Q	3Q	4Q
DBS	2023	1.33	1.35	1.37	1.38
forecast	2024	1.37	1.36	1.35	1.34

Source: Bloomberg, DBS

INR

We cannot rule out USD/INR trading above the 81-83 range of the past year. INR was resilient to the USD's rebound in 3Q23 because USD/INR did not fall during the global USD selloff in November-January. However, USD/INR traded with USD/CNY above last year's high in September, possibly due to India's desire to attract foreign investments from companies pursuing a "China plus one" strategy. Hence, investors will be nervous if Prime Minister Narendra Modi's Bharatiya Janata Party (BJP) narrows its lead into the general elections in April-May 2024. Although GDP growth rebounded to 7.8% y/y in 2Q23 from 4.5% in 4Q22, voters were unhappy with high inflation and unemployment. The opposition parties have joined forces to deprive the BJP of a third victory. INR also faces risk from a further narrowing in the Fed-RBI policy rate differential, which has decreased to 100 bps from 350 bps during the Fed tightening cycle. The Fed is more likely to hike in 4Q23 than the RBI, which does not expect CPI inflation to stay above the 2-6% target beyond July-October. India's export recession since 4Q22 should weigh on the current account deficit, but we expect the fiscal deficit to meet the 5.9% of GDP target in FY23-24.

The Indian rupee may weaken out of its year-long range

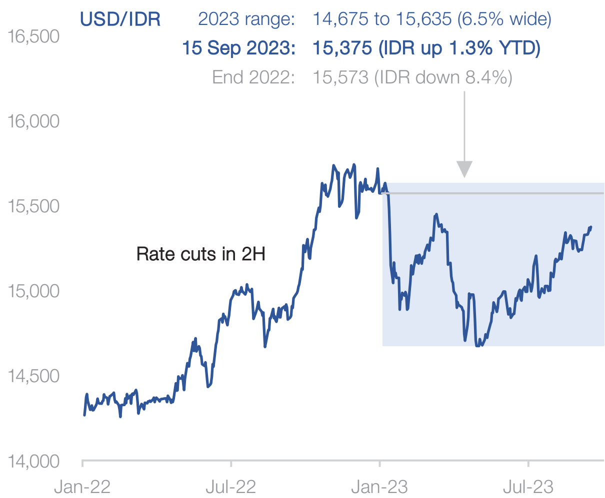
	Year	1Q	2Q	3Q	4Q
DBS	2023	82.2	82.0	83.2	84.0
forecast	2024	83.8	83.6	83.4	83.2

Source: Bloomberg, DBS

IDR

USD/IDR could average 15,440 in the final quarter, achieving the official forecast of 14,800-15,200 for 2023. Although the IDR was Asia's best-performing currency, USD/IDR traded into a higher 15,000-15,400 range in 3Q23 from 14,600-15,000 in 2Q23, in line with the depreciation across Asia. Neither was the IDR spared from the region-wide export recession and a sharply narrower interest rate differential against the US. Since February, BI has kept rates unchanged at 5.75% while the Fed hiked another 100 bps to 5.25-5.50% in July. With CPI inflation back inside its 2-4% target, BI wants to insulate the exchange rate and domestic bond yields from more surprise Fed tightening, keeping US yields and the USD high. To achieve this, BI announced on 24 August that it would end Operation Twist and start issuing (from 15 September) BI Rupiah Securities or SRBIs, offering "very attractive" yields for foreign funds. Indonesia faces uncertainties ahead of the Presidential election scheduled for February 2024, with the election cycle going into full swing in 4Q23. Rating agencies and foreign investors need assurances that the next president will press on with President Jokowi's economic policies that rely heavily on private investments.

The Indonesian rupiah did not buck the Asian currency depreciation



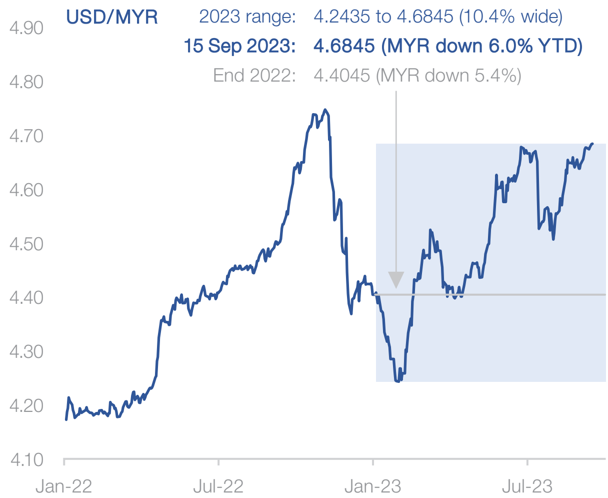
	Year	1Q	2Q	3Q	4Q
DBS	2023	14,996	15,066	15,380	15,500
forecast	2024	15,350	15,200	15,050	14,900

Source: Bloomberg, DBS

MYR

USD/MYR could push more toward last year's high. MYR is Southeast Asia's weakest currency this year. As of 7 September, MYR depreciated 5.8% YTD to 4.6755 per USD, close to its weakest level, 4.7485, last November. MYR returned 90% of its gains from the USD selloff in November-January. The 3Y US-Malaysian bond yield differential turned positive on 20 July and increased to 42 bps on 7 September. BNM hiked only once in 2023, by 25 bps to 3% in May, after four hikes in 2022. CPI inflation fell to 2% y/y in July from 2.4% in June, below the 2.8-3.8% average forecast by BNM for 2023. BNM expects full-year growth to come at the low end of its 4-5% forecast after GDP growth dropped to a two-year low of 2.9% y/y in 2Q23. Like other Asian currencies, the global slowdown hit Malaysia's exports and did not spare the MYR. In the long term, Prime Minister Anwar Ibrahim is positioning Malaysia as a neutral investment destination from heightened US-China rivalry. Investor confidence in the Madani Economy framework improved after he attracted Tesla and Google to set up shop in Malaysia.

The Malaysian ringgit is the weakest Asia ex-Japan currency



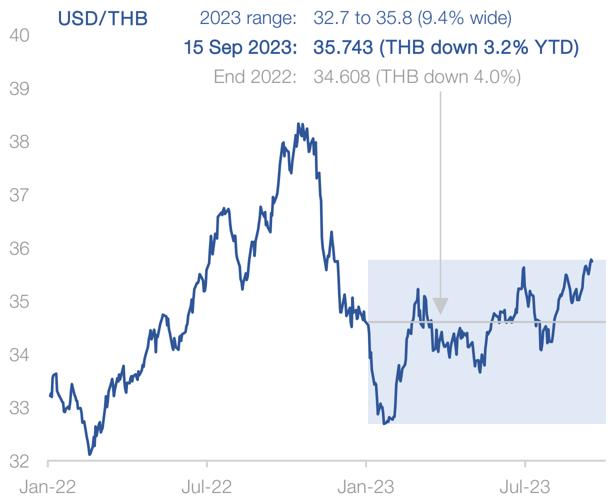
	Year	1Q	2Q	3Q	4Q
DBS	2023	4.42	4.67	4.70	4.75
forecast	2024	4.70	4.65	4.60	4.55

Source: Bloomberg, DBS

THB

USD/THB could rise into a higher 35.5-37.5 range. USD/THB swung in a 33.7-35.7 range despite the political uncertainties following the Thai general elections held on 14 May. We attribute the relative stability of the THB vs. other Asian currencies to the BOT matching the Fed's four hikes this year. According to the BOT, the 2.25% policy rate was close to neutral or a level that achieves sustainable inflation while keeping the economy growing at 3-4% without fiscal imbalances. However, the BOT is looking to downgrade its 2023 growth forecast from 3.6% after the economy slowed to 1.8% y/y in 2Q23 from 2.6% in 1Q23. With CPI inflation averaging 2% in the first eight months, the BOT plans to lower this year's inflation forecast from 2.5%. Although the BOT prefers less exchange rate volatility, it will not go against market forces. On 5 September, the Thai King swore in Prime Minister Srettha Thavisin and his 11-party coalition government. Fitch believed the campaign pledges to raise social spending which will support growth in the short term, but would constrain fiscal consolidation and add upward pressure on the government debt-to-GDP ratio.

The Thai baht is not going against the USD's rebound



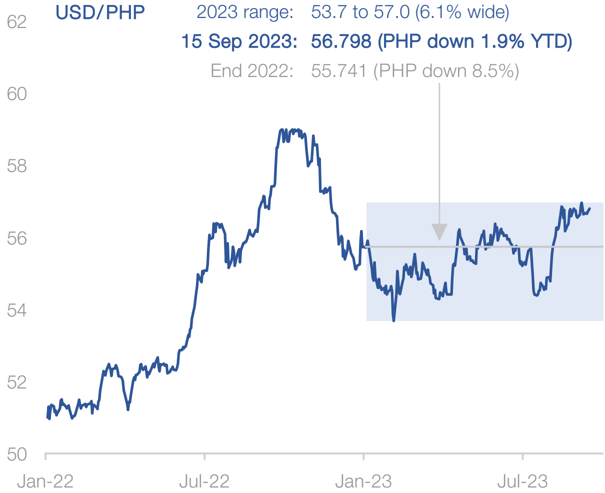
	Year	1Q	2Q	3Q	4Q
DBS	2023	34.1	35.3	35.9	36.5
forecast	2024	35.9	35.3	34.6	34.0

Source: Bloomberg, DBS

PHP

USD/PHP to trade a higher 56-58 range for the rest of 2023. USD/PHP surged from 54 to 57 on the USD's global rebound in July-September. The positive Philippine-US policy rate spread narrowed to less than 100 bps during this period. In August, the real policy rate was wider in the US (232 bps) vs. the Philippines (95 bps). There are doubts that the government can achieve its 6-7% growth target this year. After a robust 7.6% expansion boosted by tourism spending and the election in 2022, economic growth cooled to 5.3% in 1H23 from an export recession, government underspending, and high borrowing costs weighing on domestic demand. BSP paused after its ninth hike to 6.25% in March on its projection for CPI inflation (which fell from 8.7% y/y to 5.3% in January-August) to return to its 2-4% target in 4Q23. On 30 June, the BSP lowered the banks' reserve requirement ratios by 250 bps to 9.5% to "ensure stable domestic liquidity and credit conditions" after 425 bps of rate increases. In June, the Development Budget Coordination Committee (DBCC) narrowed this year's USD/PHP forecast to 55-57. The forecast was lowered to 53-57 in April from the 55-59 projected last December.

The Philippine peso to test the official forecast range of 55-57



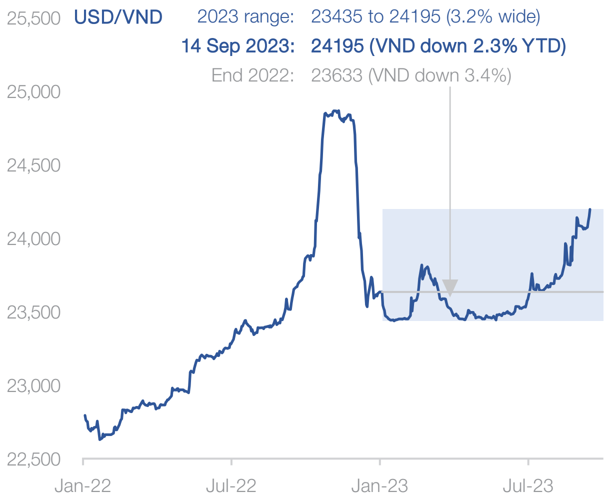
	Year	1Q	2Q	3Q	4Q
DBS	2023	54.4	55.2	56.9	58.0
forecast	2024	57.4	56.9	56.3	55.8

Source: Bloomberg, DBS

VND

USD/VND rebounded with the greenback in 3Q23. By mid- September, USD/VND hit a nine-month high at 24,195 and recovered half the losses from the November-January selloff. The odds for the trade-reliant Vietnamese economy to meet its official growth target of 6.5% for 2023 have lessened. GDP growth slowed from a robust 8% (Asia's strongest) in 2022 to 3.7% in 1H23 from weakened global demand, the broad anti-corruption campaign, and the property downturn. In July, Fitch saw a lesser risk of the property sector's saddling the government, but S&P reckoned the troubles could spill over into the banking sector. In August, the World Bank moderated Vietnam's growth forecast to 4.7% in 2023, 5.5% in 2024, and 6% in 2025. When US Treasury Secretary Janet Yellen visited Hanoi in July, the SBV pledged not to "use exchange rate policy to create unfair trade competitive advantages". As of 8 September, VND depreciated 1.8% YTD vs. USD, less than the average 2.5% in Asia ex-Japan currencies. During US President Joe Biden's visit in September, Vietnam upgraded its relationship with America to its highest level, on par with China, Russia, India, and South Korea.

The Vietnamese dong gave back half its November-January gains



	Year	1Q	2Q	3Q	4Q
DBS	2023	23,471	23,583	24,210	24,310
forecast	2024	24,140	23,980	23,810	23,640

Source: Bloomberg, DBS

DBS currency forecasts

Exchange rates, eop	14-Sep	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24
China	7.2789	7.29	7.38	7.26	7.14	7.02	6.90
Hong Kong	7.8285	7.83	7.84	7.83	7.81	7.80	7.79
India	83.040	83.2	84.0	83.8	83.6	83.4	83.2
Indonesia	15,355	15,380	15,500	15,350	15,200	15,050	14,900
Malaysia	4.6838	4.70	4.75	4.70	4.65	4.60	4.55
Philippines	56.755	56.9	58.0	57.4	56.9	56.3	55.8
Singapore	1.3635	1.37	1.38	1.37	1.36	1.35	1.34
South Korea	1,326	1,330	1,360	1,340	1,310	1,290	1,260
Thailand	35.778	35.9	36.5	35.9	35.3	34.6	34.0
Vietnam	24,195	24,210	24,310	24,140	23,980	23,810	23,640
Australia	0.6440	0.64	0.62	0.64	0.65	0.67	0.69
Canada	1.3508	1.36	1.39	1.38	1.36	1.35	1.34
Eurozone	1.0643	1.06	1.05	1.07	1.09	1.11	1.12
Japan	147.47	148	152	148	144	140	136
New Zealand	0.5912	0.59	0.57	0.58	0.60	0.61	0.63
Switzerland	0.8956	0.90	0.93	0.92	0.92	0.91	0.91
United Kingdom	1.2409	1.24	1.21	1.23	1.25	1.27	1.29
United States (DXY)	105.405	105.6	107.0	105.5	103.9	102.4	100.9

Australia, Eurozone, New Zealand and United Kingdom are direct quotes.

Source: Bloomberg, DBS

Retaining its Shine

ALTERNATIVES: GOLD 4Q23

Eventual peak in rates and the dollar should prove supportive for gold. Given its low correlation with equities and credit, gold remains a core holding as a portfolio risk diversifier.

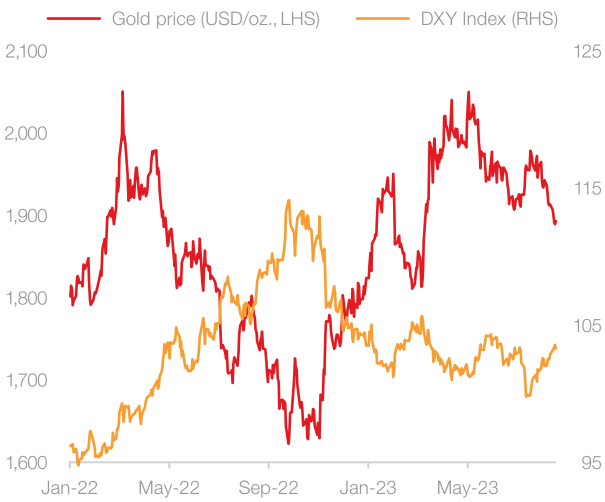
Source: Unsplash

10.
Alternatives: Gold.

Goh Jun Yong
Analyst

Same old (dollar) story. At this point, it should not be surprising that gold price movements are inversely related to the dollar. Since the start of the Fed's rate hiking cycle in March last year, gold has essentially behaved as a counterweight to the dollar, falling when the dollar strengthens and vice versa. 3Q23 was a mixed quarter for gold - July saw some gains (+3.1%) for the precious metal on the back of a weakening dollar as markets anticipated a sooner-than-expected end to the US rate hiking cycle due to the materialisation of "goldilocks" conditions. However, August saw a reversal of these gains as US inflation metrics regained some momentum. Headline inflation for July edged up to 3.2% from 3.0% in June (the first increase in headline inflation since June 2022), and PPI surprised on the upside. This reopened the door to the possibility of further rate hikes and saw the dollar firm up marginally.

Gold continues to show strong negative correlation with the dollar



Source: Bloomberg, DBS

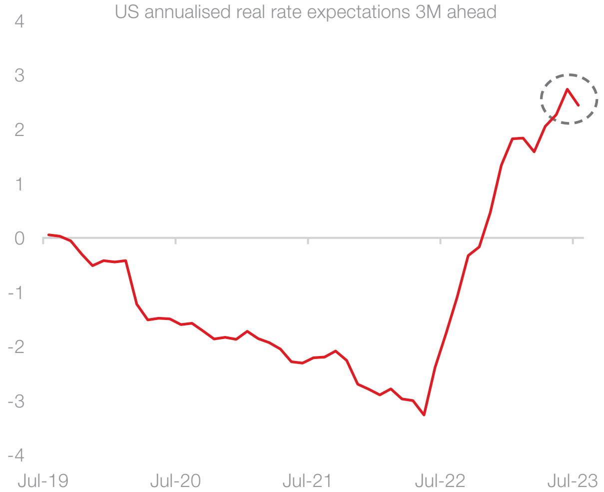
Eventual dollar weakening should prove beneficial for gold. While it is possible that hotter than expected macro data may prompt additional hikes moving forward, we believe that there will be a limit to further monetary tightening due to debt sustainability concerns. The US is currently running at elevated levels of debt-to-GDP, and continuing to hike rates will dramatically increase the amount of interest payable by the US government on its sovereign debt. Therefore, in the absence of extreme surprises in inflation figures, it is safe to assume that US rates will eventually pause in the near future. This would likely weaken the dollar. The interest rate differential between US and the rest of the developing world will reduce, and that should accordingly provide support for gold prices moving forward.

Real and nominal rates could be diverging. Other than the dollar, gold also has a strong negative correlation with treasury yields. This makes sense as the opportunity cost of holding gold rises when rates increase. With rates expected to stay elevated for longer, there is concern that this opportunity cost will weigh on gold prices. This could be further exacerbated if rates hike further than the widely projected 5.5% terminal rate. And while such concerns are valid, we feel they may be slightly overblown in magnitude as the opportunity cost of holding gold corresponds more with real rates than with nominal rates. With inflation falling at a decreasing rate, and even showing some rekindling in the month of July, we are starting to see real rates stagnate and even fall in 2Q23. Notably the US annualised real interest rate expectations 3 months ahead dipped from 2.7% in June to 2.4% in July. Regardless of whether inflation remains sticky or regains momentum, we could see a divergence in the directionality of nominal and real rates for the first time since the beginning of the Fed's rate hiking cycle, and a waning of the strong negative correlation between treasury yields and gold price could take place.

Stagflation lite should be positive for gold. Simultaneous growth in nominal rates and a stagnation/reduction in real rates suggests that the economy might be entering a state reminiscent of stagflation. This is especially pertinent considering the fact that the US labour market has shown signs of weakening in the recent months – non-farm payrolls came in at 187,000 for July, lower than economists' forecast of 200,000. A low yet positive GDP growth coupled with persistent elevated inflation suggests a lack of genuine economic growth and challenges the conventional relationship between inflation and unemployment. Historically, gold benefits from the uncertainty brought about by such situations as investors flock to safe haven assets to protect themselves from downside risks.

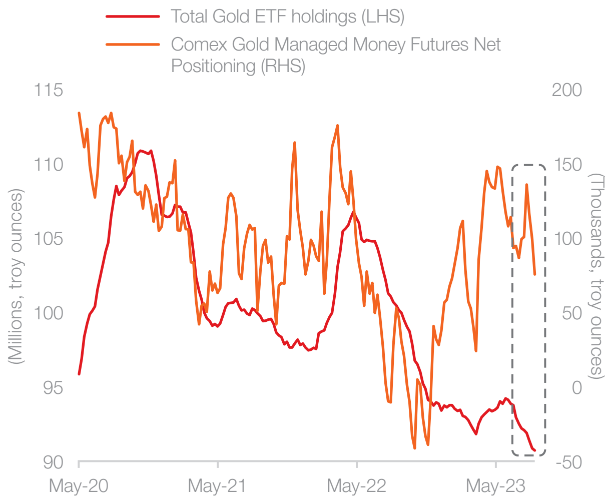
ETFs remain oversold and gold futures see further outflows. ETF flows remained negative for July and August but outflow volumes have narrowed, leaving capacity for investment flows to pick up should the right catalyst materialise. Among regions, Asia was the only source of inflows during the month of July, recording net positive flows of USD131.5m. Europe and US both recorded sizeable outflows of USD1,312.2m and USD985.6m respectively during the same month. That left total holdings of global gold ETFs at 90.7m troy ounces as at mid-August, the lowest since April 2020 and 18% below the previous high of 110.8m troy ounces in November 2020. There were also sizable outflows from COMEX Gold Managed Money Futures during the past quarter; as their net positioning dropped from 136m troy ounces in late July to 76m troy ounces in mid-August. All this underscores the demand potential from ETFs and gold derivatives as they are currently both oversold.

Expectations for short term real rates have started to fall despite consistently rising nominal rates



Source: Bloomberg, DBS

Reduction in Gold ETF holdings and COMEX net longs in August

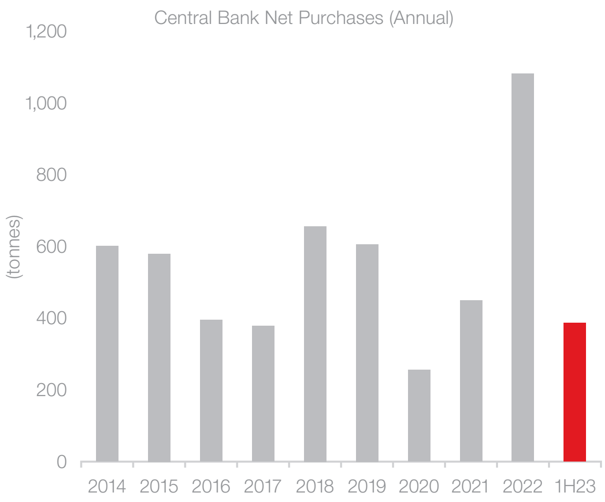


Source: Bloomberg, DBS

Central bank buying slowed but remained firmly positive. While nowhere near the momentous levels in 2H22, central bank gold buying remains buoyant in 2023. 2Q23 saw total disclosed central bank buying of 55 tonnes in June, the first month of significant buying since February. This took the total quarter's net purchases to 103 tonnes, and the 1H23 cumulative total to 387 tonnes, which is a first-half record for central bank buying. At individual country level, Turkey, which has historically been one of the largest buyers of gold, returned to being a net buyer in June after three consecutive months of net sales. Other major buyers during the month include China and Poland. While demand may have eased this quarter, we believe that the long-term trend is still a positive and constructive one. De-dollarisation is slowly but surely gaining momentum; countries are moving away from using the dollar for select trade transactions, and actively diversifying their foreign exchange reserves to reduce reliance or concentration on the dollar and dollar assets. Gold will benefit from this trend as it is a ready substitute, being a neutral hard asset that is not tied to any country of economy.

Jewellery demand, bar and coin investments stay resilient. Global jewellery consumption eked out a marginal increase despite record average gold prices during the past quarter; demand was up 3% on a y/y basis at 476 tonnes for 2Q23. This was mainly driven by China, which saw firmer demand due to its post-Covid recovery; demand during the quarter totalled 132 tonnes, a 28% increase y/y. This helped to offset weak demand in India as consumers were deterred by record gold prices. Jewellery demand on the whole has yet to recover to 10Y average levels, but in the context of the very high gold price environment, demand is still considered relatively robust. Bar and coin demand also contributed to the resilient demand for gold in 2Q23; total demand for 2Q23 was 278 tonnes, 6% higher than 2Q22. This was driven primarily by China, Turkey, and Middle East, which saw a surge in market specific demand.

Central bank gold purchases set a first-half record of 387 tonnes in 1H23



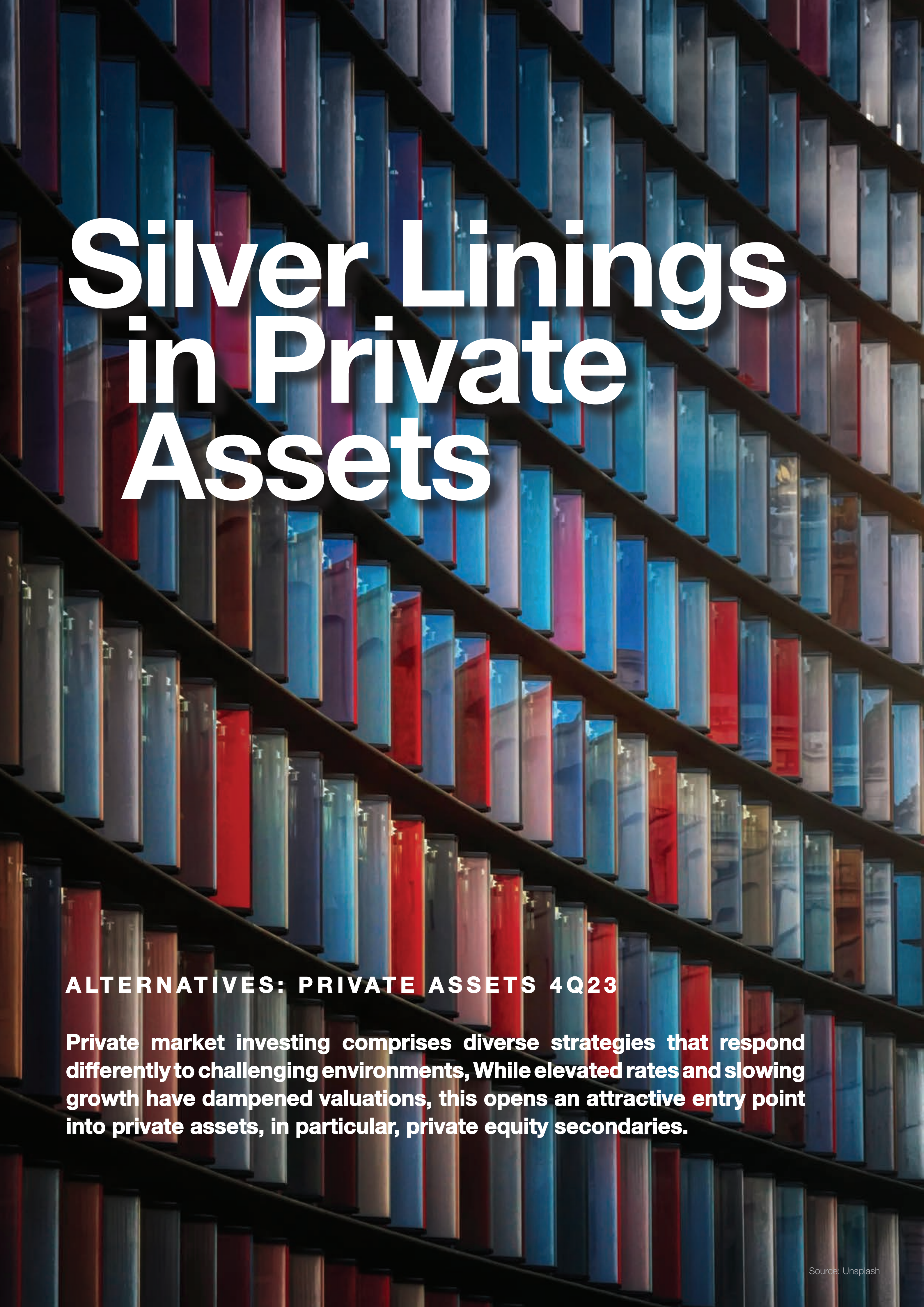
Source: Bloomberg, World Gold Council, DBS

Gold remains a mainstay in the alternatives bucket. We remain constructive on gold with a 12M target price of USD2,050/oz. With rates set to peak in 2023 and potential rate cuts in 2H24, the outlook for the dollar and rates are set to weaken; this will be the most pertinent driver of gold price in the short to medium term. Investment demand in the form of ETFs and (to a lesser extent) OTC derivatives, should provide ample liquidity for a gold rally when dollar and rate catalysts materialise. Moreover, central bank buying looks to have entered a new era of elevated buying as geopolitical tensions continue to shape the de-dollarisation narrative, albeit slowly. We continue to advocate for gold as a portfolio risk diversifier given its low correlation with other major asset classes, and especially global equities, which shares a correlation coefficient of 0.10 with Gold over the past 50 years. Investors can gain exposure to gold via the following expressions: i) physical gold; ii) gold futures; iii) ETFs and managed funds on physical gold and gold mining equities; or iv) direct holdings in gold mining equities, which are essentially a leveraged expression of gold.

Gold has low correlation with major asset classes

Asset Class	Global Equities	Global Inv Grade Bonds	US High Yield Bonds	Emerging Markets Bonds	Sovereign Inv Grade Bonds	Broad Commodities	Crude Oil	Industrial Metals	Soft Commodities	Food Commodities	Gold
Global Equities	1.00	0.35	0.65	0.59	0.51	0.45	0.23	0.59	0.39	0.19	0.10
Global Inv Grade Bonds	0.35	1.00	0.32	0.41	0.89	0.22	0.09	0.31	0.32	0.10	0.42
US High Yield Bonds	0.65	0.32	1.00	0.61	0.56	0.41	0.23	0.46	0.41	0.21	0.07
Emerging Markets Bonds	0.59	0.41	0.61	1.00	0.83	0.29	0.22	0.40	0.40	0.12	0.29
Sovereign Inv Grade Bonds	0.51	0.89	0.56	0.83	1.00	0.31	0.21	0.34	0.40	0.19	0.45
Broad Commodities	0.45	0.22	0.41	0.29	0.31	1.00	0.84	0.62	0.70	0.42	0.29
Crude Oil	0.23	0.09	0.23	0.22	0.21	0.84	1.00	0.43	0.45	0.23	0.18
Industrial Metals	0.59	0.31	0.46	0.40	0.34	0.62	0.43	1.00	0.57	0.40	0.33
Soft Commodities	0.39	0.32	0.41	0.40	0.40	0.70	0.45	0.57	1.00	0.53	0.35
Food Commodities	0.19	0.10	0.21	0.12	0.19	0.42	0.23	0.40	0.53	1.00	0.18
Gold	0.10	0.42	0.07	0.29	0.45	0.29	0.18	0.33	0.35	0.18	1.00

Source: Bloomberg, JPM, Refinitiv, LME, Euronext Amsterdam, Food and Agricultural Organisation of the United Nations



Silver Linings in Private Assets

ALTERNATIVES: PRIVATE ASSETS 4Q23

Private market investing comprises diverse strategies that respond differently to challenging environments, While elevated rates and slowing growth have dampened valuations, this opens an attractive entry point into private assets, in particular, private equity secondaries.

Source: Unsplash

11. Alternatives: Private Assets.

Beatrice Tan

Analyst

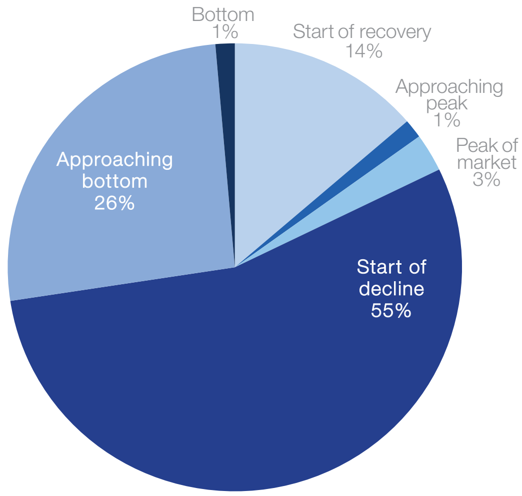
One would be surprised to learn that the structural shifts in focus from public to private capital markets remains underway, despite a combination of aggressive policy tightening, high interest rates, and stubborn inflation threatening to derail both economic and financial asset performance in the near term. Even so, private market investments are not completely immune against headwinds riling the wider investing landscape. These headwinds have tightened the lid on economic growth, slowing private market deal flows to a trickle. Asset valuations face downward pressure, and opportunities for funds to cash out are becoming few and far between.

It is worth noting that private market investing is merely an umbrella term for investing outside of the public markets. It comprises diverse strategies, each of which respond differently to a volatile environment. In this quarterly update, we examine the outlook for various private market investing strategies in the current landscape.

Funding challenges, slowing growth dampening the outlook for venture capital and growth equity investing. Recent quarters have been challenging for growing companies in need of capital. Companies are finding it harder to raise capital, with the pendulum of power swinging in favour of funds with dry powder to deploy. With higher costs of capital, investors are becoming more discerning, and companies' path to profitability is an increasingly important consideration in investment selection.

Investors anticipating a declining macro environment

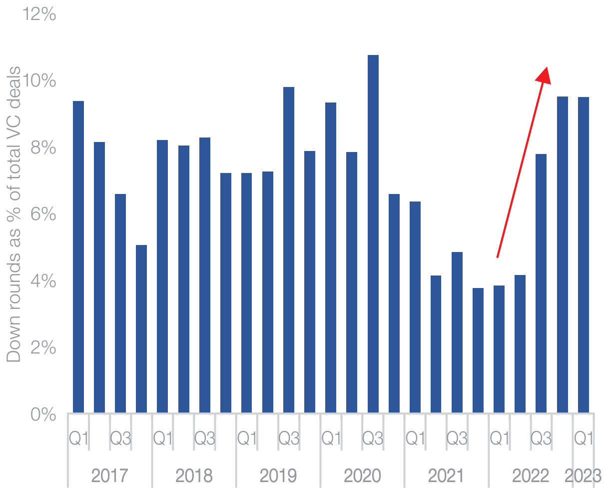
Investor views on the current point in the macroeconomic cycle



Source: Preqin Investor Survey June 2023, DBS

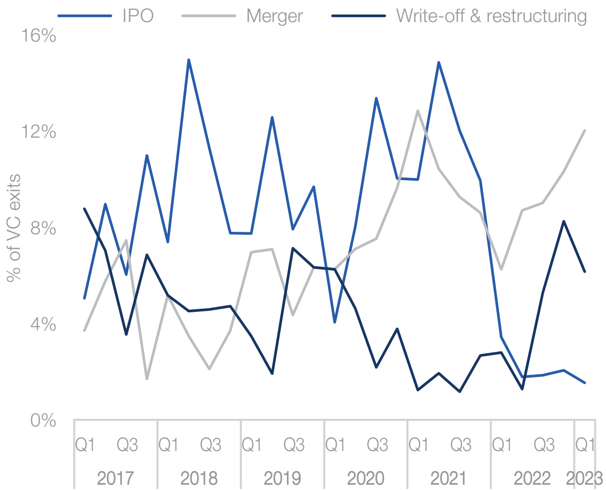
While the ecosystem was previously fuelled by readily available capital and focused on revenue drivers such as growth prospects and total addressable market, rising opportunity costs and slowing economic growth, aggravated by strained funding conditions to small companies, have resulted in a moderation of valuations since the prior exuberance of 2020/21. This challenging environment is evidenced by a rising prevalence of down rounds, write-offs, and restructuring amongst venture-backed companies.

Calibration in valuations: Down rounds* increasingly prevalent in venture capital



Source: Preqin, DBS
*Down round: Financing round in which a company issues shares at a lower price per share than it did in an earlier financing round

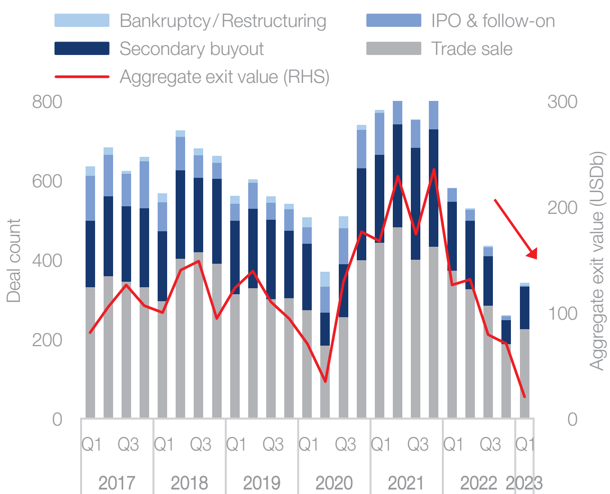
More venture capital write-offs, mergers, as IPO markets slump



Source: Preqin, DBS

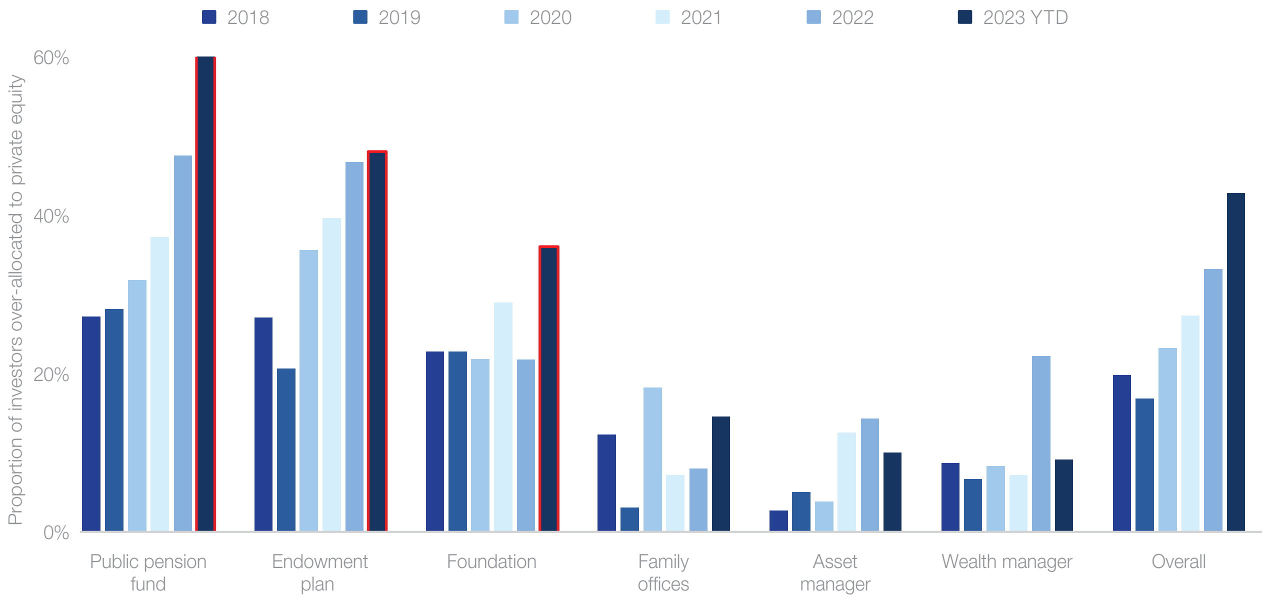
Outlook for buyout strategies challenged by high borrowing costs and tepid exit environment. Buyout strategies typically involve acquiring a company using significant amounts of debt. Floating rate borrowing is prevalent in buyout transactions, and elevated borrowing costs would conceivably impact the viability of such investments. Additionally, exit prospects for buyouts are trying, with exit activity reaching its lowest quarterly levels since the early days of the pandemic. While exits could pick up as buyers and sellers eventually settle on asset valuations, the current dearth in suitable exit opportunities implies extensions in funds' investment holding periods and a potential for delayed distributions to LPs. This would render LPs unable to recycle distributions from existing funds into new investments, intensifying an already tight fundraising outlook in private assets.

PE exit activity slows



Source: Preqin, DBS

More than half of pensions and endowments are now overallocated to private equity



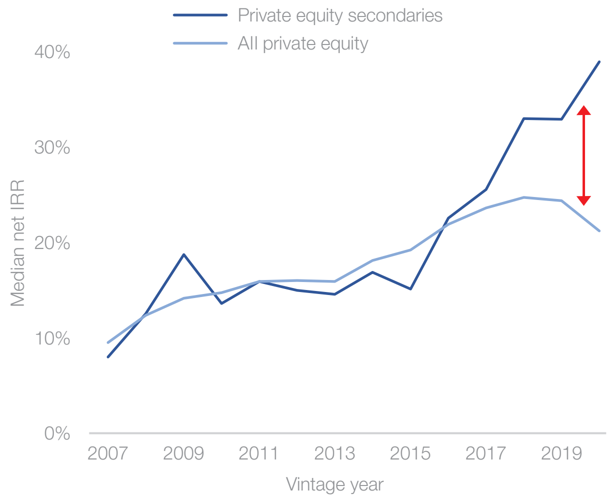
Source: Preqin, DBS
2023 YTD data as of May 2023

Private equity secondaries benefitting from broader market headwinds. In a challenging private market investing environment, the silver lining is increasingly attractive opportunities for secondary investing, where private equity secondary funds buy over existing private equity positions from the primary investors. In addition to structural factors (such as growth and maturation of the private equity industry demanding a source of secondary liquidity), current market dynamics have been creating supply in private equity secondary markets. These include:

- Private equity funds close to the end of their term but facing a lack of suitable exit opportunities could be compelled to sell their holdings on the secondaries market if they are unable to extend their investment holding periods (for example, due to LPs demanding liquidity).
- Volatility in public markets has resulted in many of the largest LPs (pensions and endowments) now being overallocated to the asset class. The need for these investors to rebalance their portfolios further adds to the ample supply of opportunities in private equity secondaries.

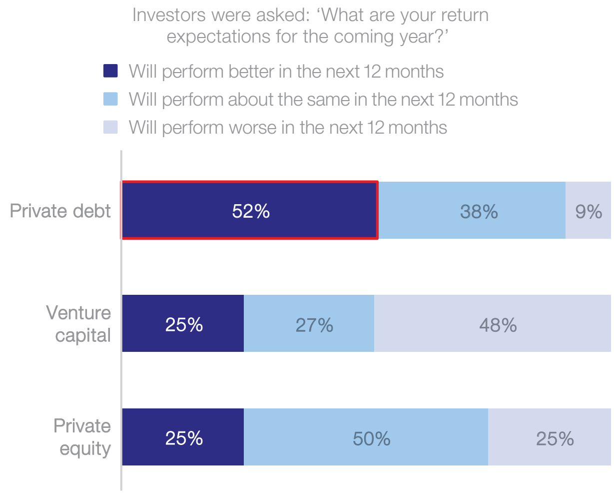
This glut of investment opportunities in secondaries has made it a buyer's market, allowing secondary funds to purchase stakes at historically attractive discounts, which then translate to better expected

Secondary fund vintages performing well compared against overall private equity



Source: Preqin, DBS

Investors remain optimistic on private credit performance relative to other private assets in the near term



Source: Preqin Investor Survey June 2023, DBS

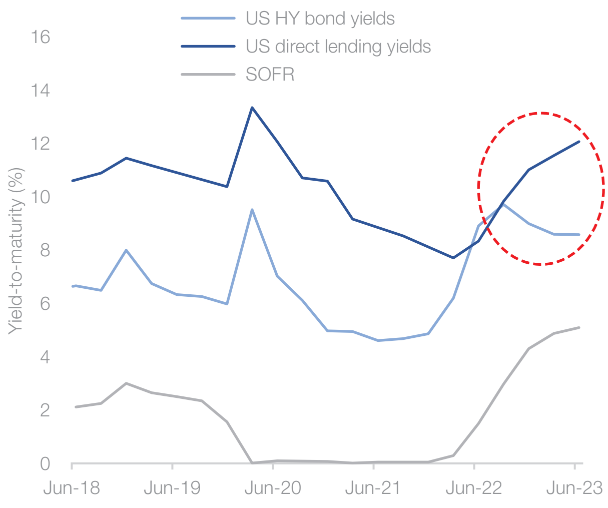
Private credit complements other sources of capital to support businesses in tight credit conditions. Meanwhile, investors appear to be favouring private credit (also known as private debt), according to surveys conducted by Preqin and S&P. Direct lending strategies form the bulk of private credit, and factors supportive of direct lending in the current environment include:

- *More borrowers seeking financing by private credit* – Debt financing has become scarce for middle market borrowers which are traditionally targets of most direct lending funds. Tightened bank lending standards, and slowing high yield bond issuance imply the opportunity for private credit funds to finance higher quality assets that may have been previously capitalised by other lenders.

- *Private credit funds have more negotiating power* – Direct lending transactions are known to have provisions to safeguard the lender's capital against borrowers' non-performance. Currently stretched funding conditions strengthen lenders' negotiating power to obtain higher pricing and more favourable covenants with borrowers.

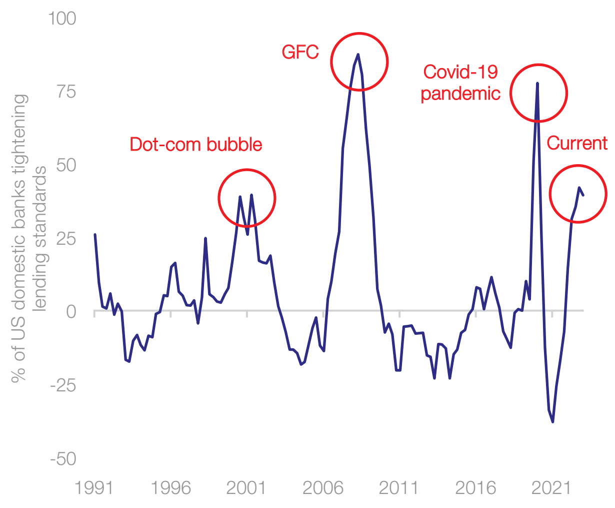
- *Floating rate loans have benefitted from rising rates* – As interest rates have surged to record-high levels, direct lending yields have correspondingly adjusted higher, giving direct lending yields an attractive yield spread over bonds.

Direct lending yields have adjusted with rising rates



Source: Bloomberg, Cliffwater Direct Lending Index, DBS

Banks are tightening their lending standards



Source: Board of Governors of the Federal Reserve System, DBS

Notwithstanding these benefits, we are mindful of risks on the horizon as an environment of moderating growth weighs on the credit quality and liquidity of businesses. Rising costs and shrinking consumer budgets are particularly concerning for heavily indebted companies, as further deterioration in profitability and demand would leave such businesses at risk of falling into distressed positions. Although advantageous relationships between direct lending funds and their borrowers would facilitate negotiation of potential workouts, rising defaults nonetheless remain a pertinent risk.

Growing pockets of distress given refinancing woes. Given the above dynamics, S&P projects loan defaults in speculative-grade credits to become even more prevalent in the months to come, as companies find it increasingly difficult to refinance their liabilities or raise fresh funds. According to LCD data, more loans are maturing in the next couple of years than any other comparable period in the history of the Morningstar LSTA US Leveraged Loan Index.

Speculative grade credit defaults on the rise

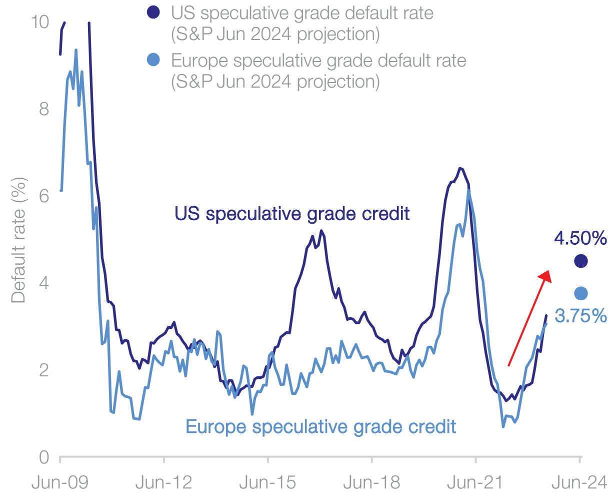
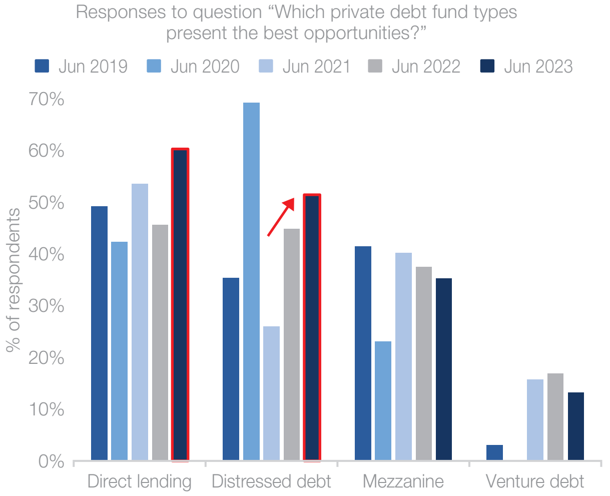


*Chart truncated
Source: S&P Ratings Direct, DBS

Distressed debt sees a revival in investor interest



Source: Preqin Investor Surveys, DBS

C.USD90b is due to mature through to the end of 1Q25, marking the largest quarterly volume maturing in the next two years.

Rising defaults create distress investing opportunities. Although these prospects paint a bleak picture for the wider investing environment, distressed debt funds typically flourish under such circumstances. A rise in defaults and market dislocations create more opportunities for distressed funds. It is no wonder that private asset investors' interest in distressed debt strategies have seen a revival since 2021.

Diversification for an all-weather portfolio. Considering how the various private market strategies fare differently in a volatile macroeconomic environment, exposure to different private asset classes serves as an additional source of portfolio diversification. Private equity, despite facing headwinds of moderating company valuations and bleak exit prospects, finds silver linings in the secondaries market, which is attractive both from a structural and tactical perspective. Private credit faces competition from attractive bond yields available in public credit markets. Nonetheless, a diversified portfolio with exposure to opportunistic strategies could allow investors a hedge against economic crisis by capitalising on further market dislocations and defaults.

Given the wide dispersion of returns for private assets compared to the public markets, manager selection plays a central role in private market investing. This is especially crucial in down cycles, where alpha creation is highly contingent on the skill and connections of the managers to identify and secure access attractive opportunities, and work through distressed situations to engineer the best exit outcomes for LPs.

A Deep-dive into Commodities Investing

THEMATIC STRATEGY - COMMODITIES 4Q23

The benefits of holding commodities for the long run are most pronounced during commodity super cycles and should therefore be timed as such. Stay with select individual commodities instead of broad commodities as an inflation hedge.

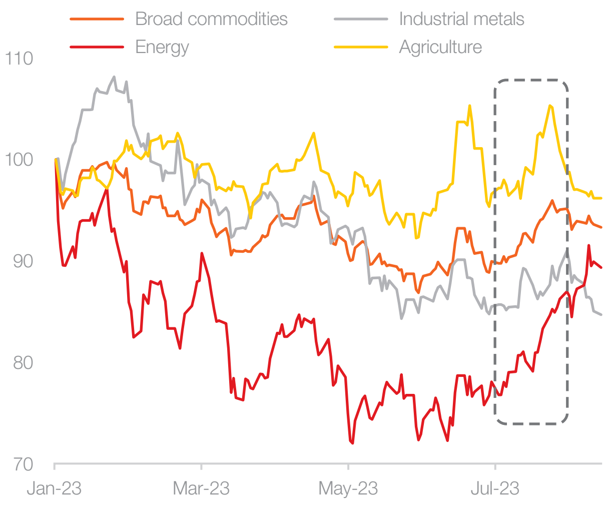
Source: iStock

12. Commodities.

Goh Jun Yong
Analyst

Commodities rebounded in July on easing macro conditions. July saw a mini revival in commodities albeit in select pockets within the overall complex. OPEC+ and Saudi-driven production cuts finally started to have a material upward impact on crude prices, industrial metals like copper and aluminium found some price stability thanks to successful auto de-stocking in China, and agricultural commodities spiked again on port disruptions related to the Russia-Ukraine conflict as well as adverse weather conditions globally. But perhaps more importantly, the overall macro environment for the US (and western Europe to some extent) appears to be trending towards a "Goldilocks" scenario; the Fed is approaching the end of its rate hiking cycle, inflation is moderating, and GDP growth and unemployment have remained resilient. In essence, demand conditions for commodities are starting to look materially better.

July's commodity rally was largely led by energy



Source: Bloomberg, DBS

Doubts over China demand caps optimism. The confluence of these positive factors drove strong performance for commodities for the month of July; the Bloomberg Commodities Index rose 5.8%, led by the energy sub-index which returned 11.4%. The agricultural commodities and industrial metals sub-indices also made gains of 2.1% and 6.4% during the month respectively. However, does this mean it is a good time to enter the market for commodities? We think it is still early days for a sustainable new rally cycle and macro conditions could quickly change. While the West is experiencing "Goldilocks" conditions, China's situation is far from perfect. Investor sentiment surrounding China has been flagging due to unmet expectations regarding the announced policy stimulus measures. The country's recent macro-data points have also been left wanting; manufacturing PMI for July remained under 50, in contractionary territory while youth unemployment rose to a record-high of 21.3% in June. And last but certainly not least, blow-ups in the country's property and shadow banking sectors have contributed to a further broad-based de-risking in China-related exposure. These negative factors have undoubtedly dampened the demand outlook for commodities as China is far and away the largest consumer of commodities globally.

China is the main producer and consumer of industrial metals

	Top 3 consuming countries/regions	Top 3 producing countries/regions
Aluminium	China – 60% EU – 10% US – 8%	China – 60% Russia – 5% Canada – 5%
Copper	China – 55% EU – 12% US – 7%	China – 43% EU – 10% Chile – 9%
Nickel	China – 54% EU – 9% US – 3%	China – 20% Japan – 6% Canada – 4%
Zinc	China – 50% EU – 14% US – 7%	China – 46% EU – 14% South Korea – 6%
Crude steel	China – 52% Other Asia – 19% EU – 8%	China – 51% Other Asia – 20% EU – 8%

Source: EIU, DBS

Copper prices and China GDP growth are intertwined

Source: Bloomberg, DBS

Taking a closer look at commodity investing. With China casting a shadow over the commodities space, we do not believe that the entry point for the next super cycle has arrived yet. In addition to addressing when investors should pull the trigger, we also seek to answer some of the following questions about commodity investing:

1. How does commodity investing augment portfolio returns?
2. Are commodities a good inflation hedge?
3. Are commodities a good portfolio risk diversifier?
4. How should commodities be expressed in a balanced, well-rounded portfolio?

Timing the market could boost commodity investing returns. Unlike stocks and bonds, a case can be made that timing the market could be superior to "time in the market" for commodities. We conducted an analysis comparing the returns of two portfolios – one with a 60/40 allocation to equities and bonds respectively, and one with a 55/35 allocation to equities and bonds with the remaining 10% weight assigned to commodities. Over the period spanning from 30 December 1999 to 10 August 2023, the 60/40 portfolio returned an annualised 6.4%, outperforming the portfolio that included commodities, which returned 6.2%. When we shorten the look-back period to 10 years (10 August 2013 – 10 August 2023), the underperformance caused by commodities remains – the 60/40 portfolio returned an annualised 3.4% while the commodity-spiked portfolio returned 3.1%. Historical figures tell a straightforward picture: the inclusion of commodities created drag on overall portfolio returns, at least for the given time frame. Ostensibly, a longer look-back period would present a more favourable picture for commodities as the period between 1960s and 1970s was a commodity super-cycle that saw broad commodity prices more than triple on the back of US dollar depreciation after the abolishment of the Bretton Woods System and the oil shocks of the 1970s. From a theoretical standpoint, it would make good sense to have portfolio exposure to commodities during super cycles. The obvious question is then: are we in one now? Unfortunately, the answer is no; supply is constrained from underinvestment, demand while growing is less broad-based and more sub-asset class specific, and prices have retraced a large portion of its gains brought about by the Covid supply shock in 2020 and Russia-Ukraine war in 2022.

Select commodities more effective than broad commodities as inflation hedge. We similarly compared the performance of broad commodities against US CPI over a 30Y, 20Y, and 10Y period and found weak positive correlation between the two. For the 30Y and 20Y look-back periods, the

Recent history suggests commodities do not boost returns for a 60/40 portfolio

(Annualised returns, %)	Time Frame	
Portfolio	12/30/1999 - 8/10/2023	8/10/2013 - 8/10/2023
60/40 - Stocks and Bonds	6.40%	3.40%
55/35/10 - Stocks, Bonds and Commodities	6.20%	3.10%

Source: Bloomberg, DBS

Copper and wheat show strong positive correlation with past 10Y inflation

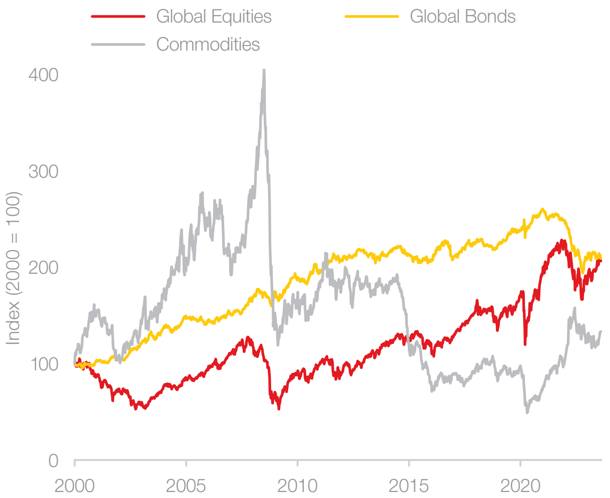
(Correlation coefficient)	Time Frame		
Commodity	30Y	20Y	10Y
WTI	0.26	0.40	0.56
LME Copper	0.25	0.38	0.74
Wheat	0.32	0.41	0.76

Source: Bloomberg, DBS

correlation was 0.22 and 0.24 respectively. Over the 10Y look-back period, the correlation weakened to 0.16. This suggests that broad commodities offered limited effectiveness as an inflation hedge in recent history. Instead, select individual commodities may offer more on this front. We looked at three commonly traded individual commodities – crude oil, copper, and wheat – and found that all three displayed an increasing correlation with inflation over time. Notably, both copper and wheat have a strong positive correlation (>0.7) with inflation over the past 10 years. Nonetheless, it must be acknowledged that inflation ran at a relatively low levels during the past decade, and these 10Y figures should be taken with a pinch of salt. Overall, the jury is still out on whether commodities can effectively protect investors from the capital eroding properties of inflation.

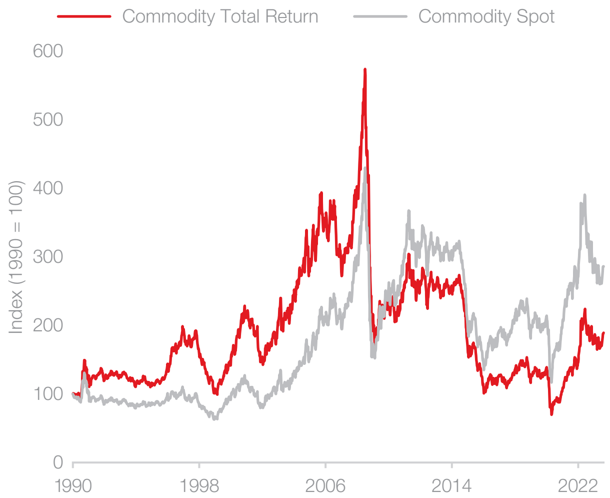
Undeniable function as portfolio risk diversifier. We have not been shy about advocating for exposure to commodities given its low correlation with other major asset classes such as stocks and bonds, and this has not changed. As a portfolio risk diversifier, this low correlation is universal across multiple different timeframes across history as well. Over the past 30 years, broad commodities show a very weak negative correlation with global equities (-0.09) and a weak positive correlation with global bonds (0.17). In that regard, it is clear that holding commodities in one's portfolio will help to lower volatility-related risks. What is unclear however, is whether holding commodities in one's portfolio brings about a higher level of risk-adjusted returns; in other words, whether commodities reduce portfolio risk to a greater extent than returns are sacrificed. The answer to that question is up for debate, and the data will no doubt paint different pictures based on the time frame that is selected. As alluded to earlier, the benefits of holding commodities for the long run are most acutely felt during commodity super cycles and should therefore be timed as such.

Divergent performance of equities, bonds, and commodities over time



Source: Bloomberg, DBS

Negative roll yields have dampened commodity investing returns in the past decade



Source: Bloomberg, DBS

Contango troubles. In our CIO Vantage Point: Commodity Investing, we highlighted negative roll yields as a potential risk in commodity investing. Negative roll yields occur when commodity markets are in contango (a situation where the price of further-dated futures are higher than nearer-dated ones and spot price) and investors have to roll over their commodity position by exiting nearer dated futures and simultaneously longing contracts that have a more distant maturity. Negative roll yields are partially responsible for the divergence in performance between the commodities spot and total return indices. The latter tracks the returns from investing in fully collateralised commodity futures and is more realistic for most investors as taking physical delivery of commodities is often not feasible.

Dealing with negative roll yields. To minimise the problem of negative roll yields, some funds and exchange-traded funds (ETF) spread their exposure across range of maturities (rather than just front-month) and maintain this constant maturity profile through daily rolling of contracts. To avoid roll yield altogether, investors can also invest directly in physical commodities where appropriate or feasible (e.g. precious metals).

Devil is in the (implementation) details. To summarise, a long-term buy and hold strategy for commodities rarely, if ever, boosts the returns of a traditional 60/40 portfolio. Furthermore, broad commodities are ineffective as an inflation hedge although it does consistently serve as a portfolio risk diversifier given its low correlation with other major asset classes. While this may seem like a damning assessment of commodities, it cannot be farther from the truth. Commodities still fulfills an important function as a portfolio risk diversifier and varying the allocation in line with commodity super cycles will further increase the effectiveness of that function, and help to maximise a portfolio's risk-adjusted returns.

A dynamic portfolio positioning is preferable. During periods where commodity markets do not fulfill the conditions for a super cycle, it may be more prudent to keep a lower allocation to commodities, and instead express the asset class through more tactical avenues such as structured products. Alternatively, investors can choose to adopt a more thematic approach towards commodity investing. For example, investors who are bullish on green metals due to the secular electrification trend can invest in companies along the battery metals value chain. When it's all said and done, the ultimate caveat in investments apply to commodities; past performance (or lack thereof) does not guarantee future performance and vice versa. However, looking at history will hopefully give us a better idea of how best to position commodities in one's portfolio, whether it is timing, allocation, or product expression.

Correlation matrix using weekly data from 1973 – 2023

Asset Class	Global Equities	Global Inv Grade Bonds	US High Yield Bonds	Emerging Markets Bonds	Sovereign Inv Grade Bonds	Broad Commodities	Crude Oil	Industrial Metals	Soft Commodities	Food Commodities	Gold
Global Equities	1.00	0.35	0.65	0.59	0.51	0.45	0.23	0.59	0.39	0.19	0.10
Global Inv Grade Bonds	0.35	1.00	0.32	0.41	0.89	0.22	0.09	0.31	0.32	0.10	0.42
US High Yield Bonds	0.65	0.32	1.00	0.61	0.56	0.41	0.23	0.46	0.41	0.21	0.07
Emerging Markets Bonds	0.59	0.41	0.61	1.00	0.83	0.29	0.22	0.40	0.40	0.12	0.29
Sovereign Inv Grade Bonds	0.51	0.89	0.56	0.83	1.00	0.31	0.21	0.34	0.40	0.19	0.45
Broad Commodities	0.45	0.22	0.41	0.29	0.31	1.00	0.84	0.62	0.70	0.42	0.29
Crude Oil	0.23	0.09	0.23	0.22	0.21	0.84	1.00	0.43	0.45	0.23	0.18
Industrial Metals	0.59	0.31	0.46	0.40	0.34	0.62	0.43	1.00	0.57	0.40	0.33
Soft Commodities	0.39	0.32	0.41	0.40	0.40	0.70	0.45	0.57	1.00	0.53	0.35
Food Commodities	0.19	0.10	0.21	0.12	0.19	0.42	0.23	0.40	0.53	1.00	0.18
Gold	0.10	0.42	0.07	0.29	0.45	0.29	0.18	0.33	0.35	0.18	1.00

Source: Bloomberg, JPM, Refinitiv, LME, Euronext Amsterdam, Food and Agricultural Organisation of the United Nations

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Glossary.

Acronym	Definition
AI	artificial intelligence
ASEAN	Association of Southeast Asian Nations
ASP	average selling price
AUM	Assets under management
AxJ	Asia ex-Japan
bbl	barrel
BI	Bank Indonesia
BNM	Bank Negara Malaysia
BOC	Bank of Canada
BOE	Bank of England
BOJ	Bank of Japan
BOK	Bank of Korea
BOT	Bank of Thailand
BSP	Bangko Sentral ng Pilipinas
bpd	barrels per day
bps	basis points
CAGR	compound annual growth rate
CET1	Common Equity Tier 1
CIPS	Chartered Institute of Procurement & Supply
CPI	consumer price index
DBCC	Development Budget Coordination Committee (Philippines)
DM	Developed Markets
dma	day moving average
DPU	distribution per unit
DXY	US Dollar Index
EBIT	earnings before interest and taxes
EBITDA	earnings before interest, tax, depreciation, and amortisation
EC	European Commission
ECA	European Chips Act
ECB	European Central Bank
EGB	European Government Bonds
EIA	Energy Information Administration
EM	Emerging Markets
eop	end of period
EPF	Employee Provident Fund
EPFR	Emerging Portfolio Fund Research
EPS	earnings per share
ESG	Environmental, Social, and Governance
ETF	exchange-traded fund
EU	European Union
EV	electric vehicle
FOMC	Federal Open Market Committee
FDI	foreign direct investment
FX	foreign exchange
G3	Group of Three
G7	Group of Seven
GDP	gross domestic product
GFC	Global Financial Crisis
HIBOR	Hong Kong Interbank Offered Rate
HKMA	Hong Kong Monetary Authority
HY	high yield
IEA	International Energy Agency
IndoGB	Indonesian Government Bonds
IG	investment grade
IMF	International Monetary Fund
IPO	initial public offering
IRS	interest rate swap
ISM	Institute for Supply Management
IT	Information Technology
JGB	Japanese Government Bond
KLIBOR	Kuala Lumpur Interbank Offered Rate
LGB	local government bonds (China)
LGFV	local government financing vehicle
LME	London Metal Exchange
LP	limited partner
LPR	loan prime rate

Acronym	Definition
LSTA	Loan Syndications and Trading Association
LVMH	Moët Hennessy Louis Vuitton
MAS	Monetary Authority of Singapore
MBS	Mortgage-backed securities
MLF	medium-term lending facility
mmbpd	million barrels per day
MNC	multinational corporation
NEER	nominal effective exchange rate
NIM	net interest margin
NIRP	negative interest rate policy
NPL	nonperforming loan
OIS	overnight indexed swap
OMO	Open Market Operations
OPEC+	Organisation of the Petroleum Exporting Countries
OPM	operating profit margin
OTC	over the counter
P/B	price-to-book
P/E	price-to-earnings
PBOC	People's Bank of China
PCE	personal consumption expenditure
PE	Private Equity
PER	price-to-earnings ratio
PM	Prime Minister
PMI	purchasing managers' index
PPI	producer price index
QT	quantitative tightening
RBA	Reserve Bank of Australia

Acronym	Definition
RBI	Reserve Bank of India
RBNZ	Reserve Bank of New Zealand
REER	Real Effective Exchange Rate
REIT	real estate investment trust
ROA	return on asset
ROE	return on equity
S-REITs	Singapore real estate investment trust
SAA	Strategic Asset Allocation
SBV	State Bank of Vietnam
SD	standard deviation
SGS	Singapore Government Securities
SNB	Swiss National Bank
SOFR	Secured Overnight Financing Rate
SORA	Singapore Overnight Rate Average
SRBIs	Bank Indonesia Rupiah Securities
TAA	Tactical Asset Allocation
ThaiGBs	Thailand Government Bonds
TOPIX	Tokyo Stock Price Index
TP	target price
TPI	tax and price index
TSE	Tokyo Stock Exchange
UCITS	Undertakings for Collective Investment in Transferable Securities
UST	US Treasury
WTI	West Texas Intermediate
YCC	Yield control curve
YTD	year-to-date

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