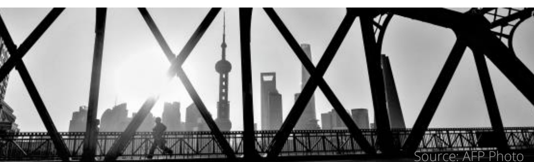



# CIO Weekly

6 July 2021

## Key Points

- **Equities:** Risk-reward favourable for gold prices leading up to August
- **Credit:** Financial capital instruments for yield
- **FX:** DXY and UST 10Y yield barely changed; AUD's recovery from its lowest level to stall at 0.76
- **Rates:** US Fed delivering an outcome similar to Operation Twist; beyond short-term gyrations, downward pressures on yields to weaken when Fed decides to taper
- **Thematics:** Chinese automakers speeding ahead in ESG race
- **The Week Ahead:** Keep a lookout for US change in initial jobless claims; China inflation

## Equities: Look beyond gold's near-term volatility and include gold as a risk diversifier in portfolio

Gold prices went on a roller coaster ride in the first half of the year as uncertainties over the Federal Reserve reigned. At the current prices, we believe the risk-reward is favourable as gold prices trade toward our year-end target price of USD2,000 per ounce. Based on our quantitative model, gold price fair value should be around USD1,910-2,048 when US 10Y bond yields are around 1.4-1.8% and the US Dollar Index (DXY) around 90-95.

However, we believe the ride is going to be bumpy leading up to August before the Jackson Hole symposium, when Fed chairman Jerome Powell will testify on the state of the US economy and outlook on monetary policies; there will be more clarity then.

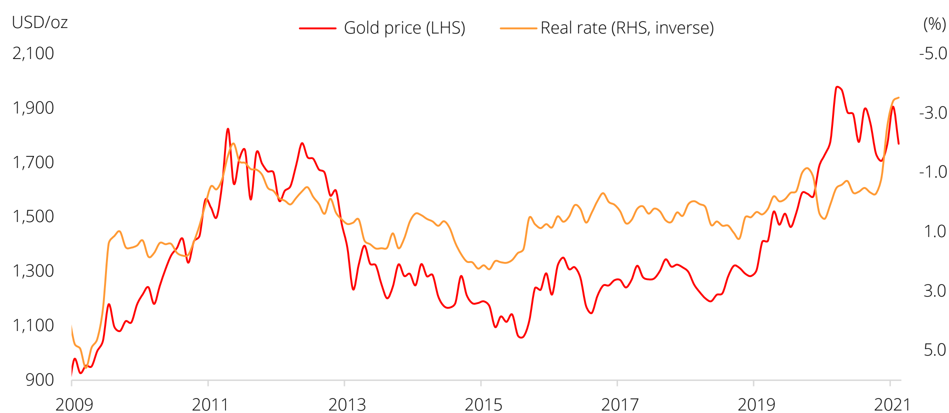
Our base case looks for bond yields to top 1.75% by the end of this year and DXY to peak at 94 in 3Q21. Inflation has probably passed its peak but could still hover at above the Fed's target of 2% for the rest of the year, and hence chatter about tapering and rate hikes will gather pace. To us, the more important indicators to watch are unemployment rates and wage growth. However, with the economy re-opening and the end of the job support plan in the US nearing, these indictors could continue to be murky.

Investors should look beyond this near-term volatility and continue to include gold as a risk diversifier in their portfolio. Its inverse correlation with bond yields, USD, and real rates, and positive correlation with stock market volatility render it an effective insurance against the vulnerability of fiat currencies with unlimited quantitative easing printing and macro uncertainties. Central banks around the world are demanding gold as an alternative to USD, and with interest rates at such low levels, the opportunity costs of holding gold are almost non-existent.

We continue to stay constructive on gold and recommend silver and gold/silver miners as higher beta and leverage plays on gold.

Joanne Goh | Strategist

Figure 1: Gold tends to perform well when realised inflation is elevated and rising, and when bond yields stay low




Source: Bloomberg, DBS

### GLOBAL CROSS ASSETS

Returns of cross assets around the world

| Index | Close | Overnight | YTD |
|---|---|---|---|
| DJIA | 34,786.35 | 0.0% | 13.7% |
| S&P 500 | 4,352.34 | 0.0% | 15.9% |
| NASDAQ | 14,639.33 | 0.0% | 13.6% |
| Stoxx Europe 600 | 458.36 | 0.3% | 14.9% |
| DAX | 15,661.97 | 0.1% | 14.2% |
| CAC 40 | 6,567.54 | 0.2% | 18.3% |
| FTSE 100 | 7,164.91 | 0.6% | 10.9% |
| MSCI AxJ | 875.31 | 0.1% | 3.8% |
| Nikkei 225 | 28,598.19 | -0.6% | 4.2% |
| SHCOMP | 3,534.32 | 0.4% | 1.8% |
| Hang Seng | 28,143.50 | -0.6% | 3.4% |
| MSCI EM | 1,354.47 | -0.1% | 4.9% |
| UST 10-yr yield* | 1.42 | 0.0% | 51.1 |
| JGB 10-yr yield* | 0.03 | -12.8% | 1.7 |
| Bund 10-yr yield* | -0.21 | -10.2% | 36.0 |
| US HY spread* | 2.67 | 0.0% | -93.0 |
| EM spread* | 316.04 | 0.0% | -6.9 |
| WTI (USD) | 75.16 | 0.0% | 54.9% |
| LMEX | 4,194.60 | 0.8% | 22.8% |
| Gold (USD) | 1,791.77 | 0.3% | -5.6% |

Source: Bloomberg
* Changes in basis points

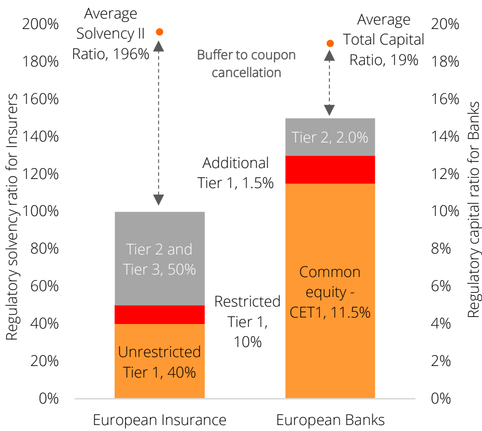



Figure 2: European RT1s have large capital buffers

Source: Bloomberg, DBS

## Credit: Financial capital instruments for yield

The Financials sector has been one of the best performers this year on steepening yield curves. For banks, this bodes well for net interest margins (NIM) as they tend to borrow in the short end and lend in the longer end, while insurers tend to see upside as a higher yield environment tends to enhance both earnings and solvency metrics. While credit as an asset class tends to experience headwinds in a rising rate environment, the Financials space seems to be able to provide that counterbalance of improving fundamentals; as such, spreads should remain well behaved despite the macro backdrop of higher yields.

In this regard, bank AT1s are a well-established space where investors can capture attractive value; this despite the expected erosion of capital buffers as banks are expected to resume dividend payments and share buybacks. We would also like to highlight the comparatively less prominent insurance RT1 (Restricted Tier 1) space. The European insurance sector enjoys higher profitability, global scale, and leading strategic positions compared to the continent's banking sector, while capital buffers of insurance companies are also superior to banks with average Solvency II Ratios at c.196% (against the requirement of 100%). We believe that investors should continue to find opportunities in financial capital instruments for income generation in a yield scarce world.

Daryl Ho | Strategist

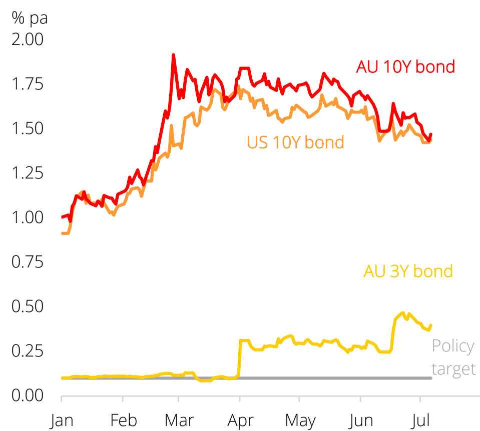



Figure 3: AU 10Y bond yield fell towards its US peer

Source: Bloomberg, DBS

## FX: RBA meeting today, FOMC minutes tomorrow

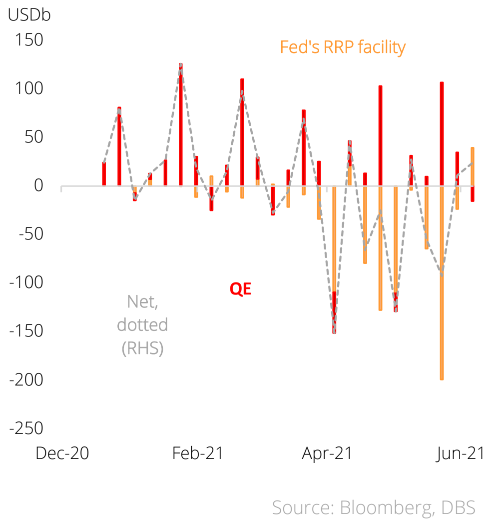
**AUD's recovery from its lowest level will stall at 0.76,** a level that has turned from the year's support into its resistance. Australia's 10Y bond yield, which fell to 1.47% from 1.80% since mid-May, no longer has a sizeable premium over its US counterpart. The Reserve Bank of Australia (RBA) will, at its monetary policy meeting today (6 July), sound more optimistic about the recovery and play down the incoming higher inflation as temporary. The RBA will look past the latest fall in the unemployment rate and focus on lifting wage growth to achieve its inflation target. The new wave of infections and low vaccination rates have also relegated Australia's reputation at combating Covid-19. The RBA is expected to position itself behind the Federal Reserve in rolling back its pandemic-related measures. More so if it announces another round of quantitative easing worth AUD100b and maybe extend its 3Y bond target issue by another six months to November 2024. The 3Y bond yield has, since April, risen from the 0.10% target to 0.40%.

**DXY and the US 10Y Treasury yield were barely changed around 92.2 and 1.40%, respectively.** US stock markets were closed on Monday in observance of Independence Day on Sunday; futures indicate a flat opening today. The Federal Open Market Committee (FOMC) minutes tomorrow will provide more insights into why the majority of Fed officials brought forward rate hike expectations into 2023 at the June meeting, and how close the Fed is to a decision on tapering asset purchases at the Jackson Hole Symposium in August or the September FOMC meeting. The minutes will not capture the July nonfarm payrolls which added the most jobs this year. The relentless climb in oil prices to their highest levels since October 2018 should also support the Fed's view that inflation is likely to stay high longer than they initially thought. The S&P 500 Index and the Nasdaq Composite Index have resumed posting new record highs in anticipation of better growth in the second half of the year from the reopening of the US economy. An upside surprise in the US ISM services index today would support the view. As for the US Dollar Index (DXY), it appreciates best when both US stocks and bond yields rise together.

Philip Wee | FX Strategist

## Rates: The Fed's current policies are similar to Op Twist

Figure 4: Net liquidity (chg per week)




Source: Bloomberg, DBS

**The US Federal Reserve is delivering an outcome that is similar to its earlier Operation Twist.** Operation Twist occurs when the Fed uses proceeds of its sales from short-term bills to purchase longer-term US Treasuries (UST). This programme was last used in late 2011/2012. In practise, this applies flattening pressures on the UST curve. Today, the Fed is withdrawing liquidity (USD730b as of 2 July) via the Reserve Repo facility while buying UST and MBS amounting to USD120b every month. Note that the surge in RRP facility usage only took place in recent months when the flood of USD liquidity became overwhelming. When the Fed tweaked the RRP rate higher by 5 bps, it also made this rate more attractive compared to alternatives such as T bills.

The net impact of these actions is that LIBOR and other short-term USD rates have adjusted higher as liquidity gets sucked into the RRP facility. Viewed from this perspective, the RRP facility has undone five months of QE, **rendering Fed's policy liquidity neutral for the past five months (similar to Operation Twist).** In the coming few weeks, there would be considerable noise as the July debt ceiling looms. If the ceiling is not suspended, there would be a further drawdown in the Treasury cash balance to USD450b (down about USD400b from current levels) and a further shortage of T-bills. It would be reasonable to assume that the RRP facility would climb past the USD1t mark amid the shortage of money market assets. **Beyond these short-term gyrations, we would expect downward pressures on yields to weaken when the Fed decides to taper.**

Eugene Leow | Rates Strategist

# Thematics: Chinese automakers speeding ahead in ESG race

- Global automakers ahead of the pack to integrate climate-related issues into business strategies
- EV automakers usually have higher valuation multiples and easier access to green bond market
- Chinese automakers improving sustainable mobility initiatives, climate-related financial disclosures
- Mainland China likely to account for about half of global EV industry's new investments over 2021-2025
- China expected to achieve around 20m EV sales, representing approximately 40% of global sales, by 2040

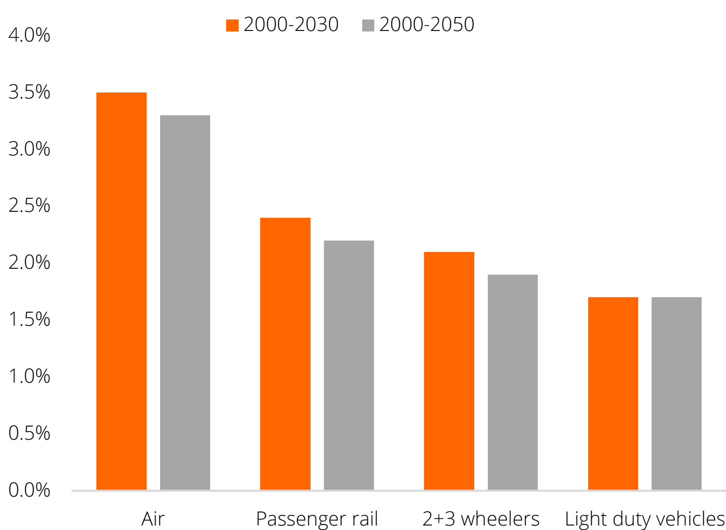
**Rewards of going green.** As global decarbonisation races ahead, automakers are accelerating their vehicle electrification pace in the next five years, and we estimate industry players need to invest some USD200-300b from 2021-2025 to develop the electric vehicle (EV) ecosystem to journey to a low carbon environment. EV automakers usually have higher valuation multiples and easier access to the green bond market.

**Mainland China's green clout.** Chinese automakers are improving on their sustainable mobility initiatives, as well as climate-related financial disclosures. The market is likely to account for about half of the global EV industry's new investments over 2021-2025. China expects to achieve around 20m EV sales, representing approximately 40% of global sales, by 2040.

**Will Chinese automakers face transition risk?** Our conclusion is since Chinese players and the government have invested huge amounts into new technologies and products in recent years to meet the stringent policy on $CO_2$ emissions, they should be able to address policy and legal risks relatively well. Among Chinese automakers, BYD (1211 HK) has the lowest transition risk given its high exposure to the EV market. Guangzhou Auto Group Co (2238 HK) also stands out as it has made remarkable improvements on its environmental disclosure, while Great Wall Motor's (2333 HK) heavy investment into manufacturing cleaner vehicles for green travel also sets it apart.

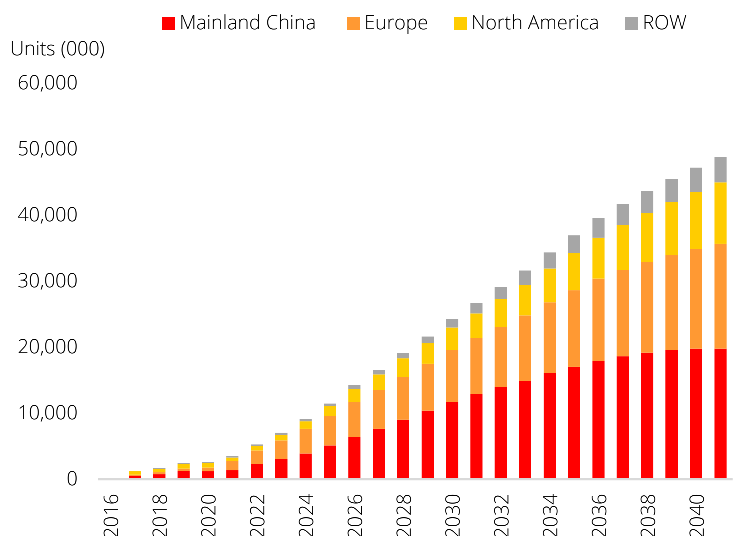
Rachel MIU | Analyst

Figure 5: Transportation (by mode) – long-term growth projections




Source: World Business Council for Sustainable Development, Mobility 2030: Meeting the Challenges to Sustainability, 2004

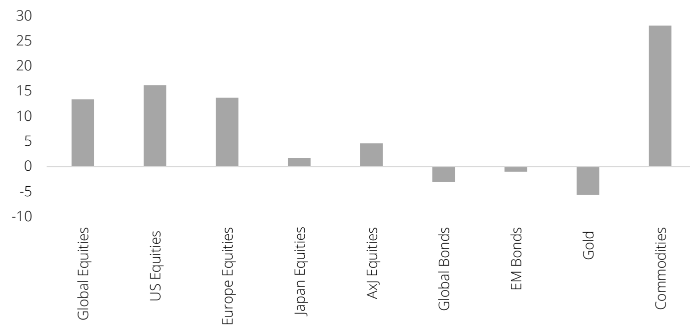
Figure 6: Global EV market annual sales projections



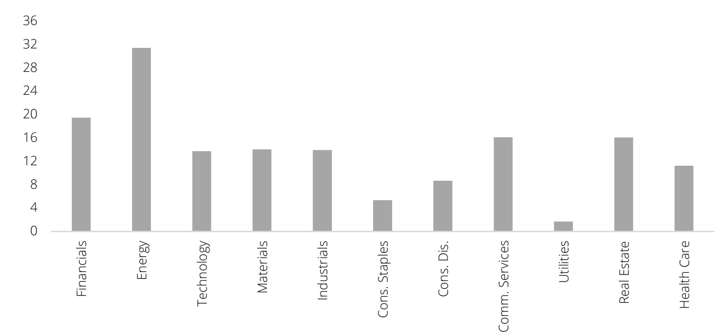

Source: ACEA, CAAM, DBS

# CIO Markets Watch

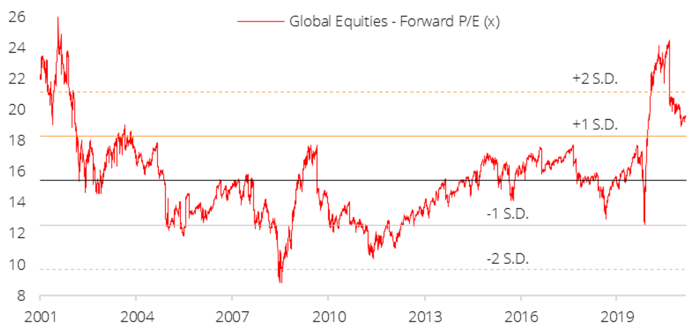
Global Cross Assets YTD Returns



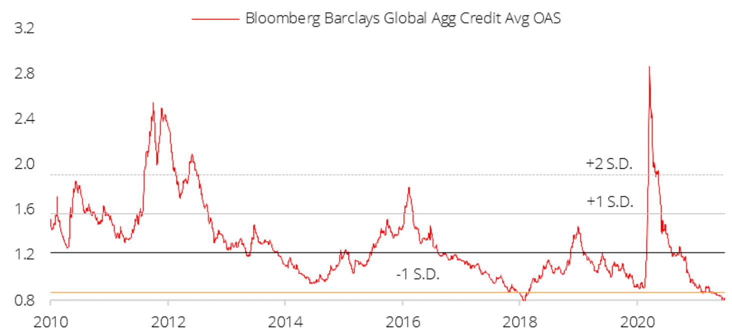

Global Sector YTD Returns




Global Equity Valuation




US Corporate Spreads




INDEX RETURNS

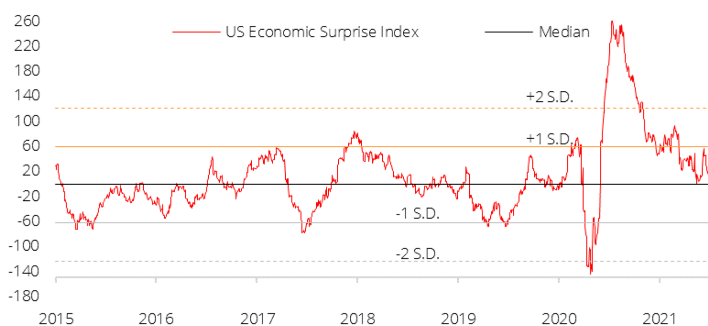
| | 1 week | MTD | QTD | YTD |
|---|---|---|---|---|
| Equities | | | | |
| S&P 500 | 1.4% | 1.3% | 1.3% | 15.9% |
| NASDAQ | 1.0% | 0.9% | 0.9% | 13.6% |
| Russell 2000 | -0.7% | -0.2% | -0.2% | 16.8% |
| Stoxx Europe 600 | 0.8% | 1.2% | 1.2% | 14.9% |
| Nikkei-225 | -1.5% | -0.7% | -0.7% | 4.2% |
| MSCI WORLD | 0.8% | 1.1% | 1.1% | 13.4% |
| MSCI ACWI | 0.5% | 0.8% | 0.8% | 12.2% |
| MSCI Asia ex-Japan | -2.0% | -1.6% | -1.6% | 3.8% |
| MSCI EM | -1.9% | -1.5% | -1.5% | 4.9% |
| HSCEI | -5.4% | -3.6% | -3.6% | -4.3% |
| SHCOMP | -2.0% | -1.6% | -1.6% | 1.8% |
| Hang Seng | -3.8% | -2.4% | -2.4% | 3.4% |
| STI Index | 0.5% | 0.3% | 0.3% | 10.5% |
| Fixed Income | | | | |
| Barclays Global Aggregate | 0.0% | 0.2% | 0.2% | -3.1% |
| Barclays US Aggregate | 0.3% | 0.1% | 0.1% | -1.5% |
| Barclays US High Yield | 0.4% | 0.2% | 0.2% | 3.8% |
| Barclays Euro Aggregate | 0.3% | 0.1% | 0.1% | -2.2% |
| Barclays Euro High Yield | 0.0% | 0.0% | 0.0% | 3.6% |
| JPM EMBI Global | 0.0% | 0.0% | 0.0% | -1.0% |
| JPM EMBI Global Diversified | 0.0% | -0.1% | -0.1% | -1.2% |

PRICES & SPREADS

| | Spot | 1Q21 | 4Q20 | 3Q20 |
|---|---|---|---|---|
| Rates | | | | |
| Fed Funds Target | 0.25 | 0.25 | 0.25 | 0.25 |
| ECB Main Refinancing Rate | 0.00 | 0.00 | 0.00 | 0.00 |
| BOJ Policy Balance Rate | -0.10 | -0.10 | -0.10 | -0.10 |
| US Treasury 10-yr | 1.43 | 1.47 | 1.74 | 0.92 |
| Japanese Govt Bond 10-yr | 0.03 | 0.05 | 0.09 | 0.02 |
| German Bunds 10-yr | -0.21 | -0.21 | -0.29 | -0.57 |
| Spreads | | | | |
| US Agg Corporate Spread | 0.82 | 0.80 | 0.91 | 0.96 |
| US Corporate HY Spread | 2.67 | 2.68 | 3.10 | 3.60 |
| Euro Agg Corporate Spread | 0.86 | 0.86 | 0.94 | 0.95 |
| EM USD Agg Spread | 2.59 | 2.57 | 2.67 | 2.68 |
| Currencies | | | | |
| US Dollar Index (DXY) | 92.2 | 92.4 | 93.2 | 89.9 |
| EUR/USD | 1.19 | 1.19 | 1.17 | 1.22 |
| USD/JPY | 111.0 | 111.1 | 110.7 | 103.3 |
| USD/CNY | 6.5 | 6.5 | 6.6 | 6.5 |
| Commodities | | | | |
| WTI Oil | 75 | 73 | 59 | 49 |
| London Metal Exchange (LMEX) | 4195 | 4152 | 3787 | 3415 |
| TR/CC CRB Commodity | 215 | 213 | 185 | 168 |
| Gold | 1792 | 1770 | 1708 | 1898 |

# CIO Economics Watch

US Economic Surprise Index




Asia Pacific Economic Surprise Index

MACRO CALENDAR

| | Date | Period | Survey | Prior |
|---|---|---|---|---|
| United States & Eurozone | | | | |
| Initial Jobless Claims (US) | 08-Jul | 03-Jul | 350k | 364k |
| MBA Mortgage Applications (US) | 07-Jul | 02-Jul | -- | -6.90% |
| Wholesale Inventories m/m (US) | 09-Jul | May | 1.10% | 1.10% |
| ISM Services Index (US) | 06-Jul | Jun | 63.5 | 64 |
| Markit US Composite PMI (US) | 06-Jul | Jun | -- | 63.9 |
| Continuing Claims (US) | 08-Jul | 26-Jun | 3325k | 3469k |
| Langer Consumer Comfort (US) | 08-Jul | 04-Jul | -- | 55.1 |
| ZEW Survey Expectations (EU) | 06-Jul | Jul | -- | 81.3 |

MACRO CALENDAR

| | Date | Period | Survey | Prior |
|---|---|---|---|---|
| Asia | | | | |
| CPI y/y (CN) | 08-Jul | Jun | 1.30% | 1.30% |
| BoP Current Account Balance (JP) | 07-Jul | May | ¥1807.2b | ¥1321.8b |
| Core Machine Orders m/m (JP) | 11-Jul | May | -- | 0.60% |
| PPI y/y (JP) | 11-Jul | Jun | -- | 4.90% |
| GDP y/y (SG) | 06-Jul | 2Q | 14.20% | 1.30% |
| PPI y/y (CN) | 08-Jul | Jun | 8.80% | 9.00% |
| Money Supply M2 y/y (JP) | 08-Jul | Jun | 8.20% | 8.30% |
| Money Stock M2 y/y (CN) | 08-Jul | Jun | 6.00% | 7.90% |

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