CIO Weekly

19 April 2022

Equities: Go for quality plays in S&P 500

Key Points

- Equities: Fed quantitative easing contributing to yield curve distortion; Go for quality plays on S&P 500 as uncertainties mount
- Credit: Focus on quality amid near-term volatility
- FX: DXY appreciation mirrors the 2.5 bps increase in UST 10Y yield; But index near overbought levels with 14-day RSI reading near 70
- Rates: Longer-term USD rates (10Y yields are above 2.8%) pricing in neutral rate after sharp selloff since start of the year
- Thematics: Upstream beneficiaries of rising agri-commodity prices
- The Week Ahead: Keep a lookout for US change in initial jobless claims; Japan industrial production numbers

GLOBAL CROSS ASSETS
Returns of cross assets around the world

Index	Close	Overnight	YTD
DJIA	34,411.69	-0.1%	-5.3%
S&P 500	4,391.69	0.0%	-7.9%
NASDAQ	13,332.36	-0.1%	-14.8%
Stoxx Europe 600	459.82	0.0%	-5.7%
DAX	14,163.85	0.0%	-10.8%
CAC 40	6,589.35	0.0%	-7.9%
FTSE 100	7,616.38	0.0%	3.1%
MSCI AxJ	698.96	-0.7%	-11.4%
Nikkei 225	26,799.71	-1.1%	-6.9%
SHCOMP	3,195.52	-0.5%	-12.2%
Hang Seng	21,518.08	0.0%	-8.0%
MSCI EM	1,106.68	-0.6%	-10.2%
UST 10-yr yield*	2.85	0.9%	134.3
JGB 10-yr yield*	0.24	1.3%	17.6
Bund 10-yr yield*	0.84	0.0%	102.1
US HY spread*	3.52	0.9%	69.0
EM spread*	348.48	0.1%	18.2
WTI (USD)	108.21	1.2%	43.9%
LMEX	5,130.40	0.0%	14.0%
Gold (USD)	1,978.91	0.0%	8.2%

Source: Bloomberg
* Changes in basis points

Fed quantitative easing and yield curve distortion. Recent inversion of the US Treasury 10Y-2Y yield curve (a situation where short-term yields are higher than long-term yields) has sounded the alarm bells on whether this heralds an imminent recession. Since the 1970s, yield curve inversions are historically followed by economic recessions and investors are assuming that this time will be no different.

But as we have argued in our report CIO Perspectives – Don't fear the curve inversion (dated 1 April 2022), prolonged periods of Federal Reserve quantitative easing may have inadvertently led to distortions in the yield curve, diminishing its usefulness as a predictor of recessions along the way.

Indeed, quantitative easing has the effect of suppressing the term premium (which is the additional yield needed to compensate an investor for taking on additional duration risks). From January 1995 to November 2008, the term premium averaged 1.0%. However, since December 2008, the average term premium has fallen to 0.1%.

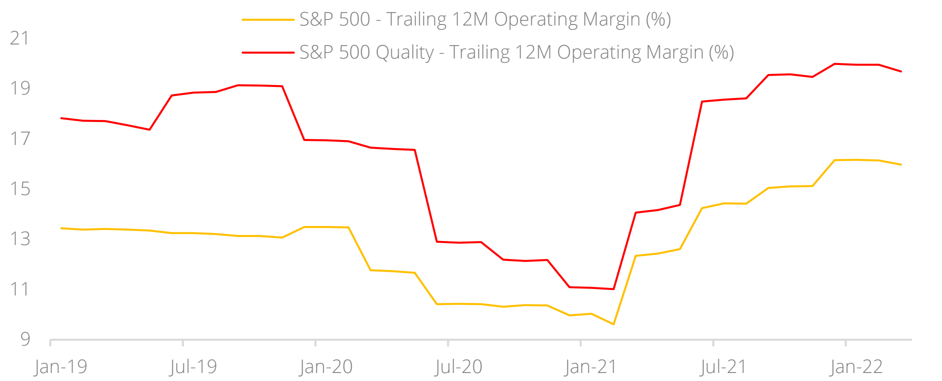
Lower term premium weighs on long-term bond yields and our analysis suggests that if a normalised term premium is used instead, the yield curve will currently be at a level that is far from inversion.

Go for quality plays on S&P 500 as uncertainties mount. Global risk assets will continue to face the proverbial wall of worries in the coming months as inflation and geopolitical concerns mount. In such a challenging environment, we advocate investors to go for quality plays in their securities selection. Quality companies with strong branding and market positioning are able to pass on rising costs in an inflationary environment to end consumers and protect their profit margins.

As Figure 1 shows, the 12-month trailing operating margin for US quality companies has exceeded those of the broader market by an average of 3.7 %pts since 2019. The strong buffer in profitability provides the necessary downside protection as input costs grind higher, in particularly across the commodity space. In terms of return on equity (ROE), US quality companies similarly possess higher ROE than the broader market by 8.5 %pts on average.

Dylan Cheang | Strategist

Figure 1: US quality companies possess strong profit margins



Source: Bloomberg, DBS

Credit: Focus on quality amid near-term volatility

With the Federal Reserve finally embarking on the first of its rate hikes, we anticipate some near-term volatility in the coming months as markets adjust to the hiking cycle. While a recession is not in our base case expectation, we believe the current environment warrants some caution for credit, since the dual headwinds of tighter monetary policy and modest long-term outlook support expectations of aggressive bear flattening, which is typically accompanied by significant widening of credit spreads across bond markets.

Based on our analysis of the average weekly change in credit spreads across Developed Markets (DM), Emerging Markets (EM), and High Yield (HY) credit segments under past periods of aggressive curve bear flattening, we have observed that HY spreads demonstrate the most significant widening whereas DM IG spreads widen the least. The relatively low volatility of DM IG markets under bear flattening yield curves validates our preference to focus on quality, as outlined in the 2Q22 Global Credit outlook.

Daryl Ho, CFA | Strategist

Figure 2: Weekly change in credit spreads under curve bear flattening

Percentile	Developed Markets				Emerging Markets						High Yield			
	Global IG	US IG	Eur IG	US MBS	EM USD	GCC USD	LatAm USD	EMEA USD	Asia USD	Asia IG	Global HY	US HY	Eur HY	Asia HY
0-10th	1.7	1.7	2.2	0.8	6.9	3.2	9.3	5.7	5.6	-0.1	10.7	11.4	8.5	12.1
10-20th	-0.3	0.0	-0.1	0.0	-3.6	-1.1	-4.2	-7.9	1.0	1.8	-4.1	-3.2	-3.6	-2.7
20-30th	0.6	1.0	-0.3	0.4	5.1	-0.1	18.3	0.9	-0.5	0.1	10.0	10.9	0.4	-0.1
30-40th	-0.4	-0.7	-1.1	1.1	-0.8	-0.9	-2.2	-1.9	1.5	-1.6	-7.0	-8.2	-7.6	2.9
40-50th	-1.5	-1.5	-2.4	-0.5	-3.1	-1.4	-3.2	-2.6	-3.2	-1.5	-8.6	-10.7	-9.6	-7.4
50-60th	0.1	-0.2	0.1	-0.6	0.4	0.5	-0.6	2.3	-0.8	-1.3	-3.4	-5.1	-2.4	-6.2
60-70th	-0.4	0.0	-1.0	-0.7	-1.1	-3.2	-1.5	-2.0	-0.2	-1.2	-2.2	-2.2	-3.0	0.6
70-80th	-2.0	-2.8	-1.9	0.0	-4.4	-4.3	-5.7	-4.9	-2.8	-3.7	-11.1	-13.4	-9.2	0.0
80-90th	-0.4	-0.8	0.9	-0.9	-4.4	-3.4	-7.8	-4.8	-1.0	-0.7	-6.8	-8.1	-0.7	-6.8
90-100th	-1.6	-2.0	-1.2	-0.5	-5.0	-3.4	-3.1	-6.3	-5.0	-2.5	-9.5	-10.6	-4.1	-15.5

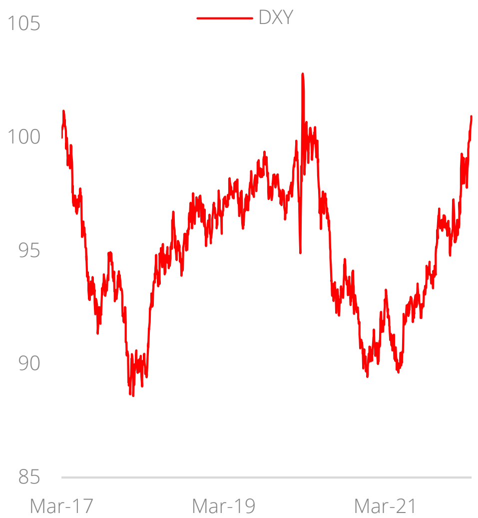
Most aggressive

Curve bear flattening

Least aggressive

FX: USD higher but becoming overbought

Figure 3: Near overbought territory



Source: Bloomberg, DBS

DXY appreciated 0.3% to 100.8, mirroring the 2.5 bps increase in the US Treasury 10Y yield to 2.853%. The rise in the long bond yield after the long Easter weekend was considered mild. St Louis Fed President James Bullard maintained his support for a 50 bps hike at the Federal Open Market Committee meeting on 4 May. However, Bullard was open to a 75 bps hike in the future, if needed, to bring rates to 3.50% this year. Speaking today (19 April), Chicago Fed President Charles Evans is unlikely to favour raising rates too quickly and wants rates to end 2022 at a neutral setting of 2.25% to 2.50%. On Thursday, Fed Chair Jerome Powell is expected to affirm his soft landing view at an International Monetary Fund (IMF) panel discussion on the global economy. **We remain wary that the DXY is near overbought levels with a 14-day RSI reading near 70.**

Today, the IMF is set to downgrade 2022 global growth forecast which was lowered to 4.4% from 4.9% in January. As a preview, the World Bank downgraded its global growth projection to 3.2% from 4.1% yesterday, citing elevated inflation, the war in Ukraine, and the ongoing pandemic. China also reported GDP growth slowing to 1.3% q/q in 1Q22 from 1.6% in 4Q21 from its "Covid Zero" policy. Our economists lowered China's 2022 real GDP growth to 4.8% from 5.3%, well below that government's 5.5% target. Apart from noting the weaker high-frequency data (retail sales, unemployment rate, industrial production, and fixed asset investment) in March, sluggish corporate long-term lending indicated downbeat business sentiment and regulatory uncertainty. **CNY has been in a 6.36-6.38 per USD range this month with a downside bias.**

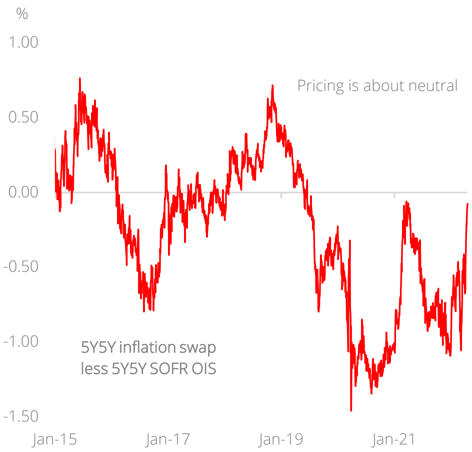
EUR depreciated 0.3% to 1.0782, below 1.08 for the first time since May 2020. The European Union (EU) is under pressure to respond with an embargo on Russian oil which Organisation of the Petroleum Exporting Countries said would be "nearly impossible to replace. Brent crude oil prices increased 1.3% to USD113.16 per barrel, its highest level since 30 March. Ukrainian President Volodymyr Zelenskyy warned that Russian troops had started a major new offensive in Donbas to take control of eastern Ukraine. Zelensky fears that the worst might be ahead with Russia possibly deploying either nuclear or chemical weapons. Zelensky has submitted a completed questionnaire on EU membership handed to him by European Commissioner Ursula von der Leyen during her visit to Kyiv on 8 April. War fears aside, events on Wednesday might support the EUR. Bundesbank President Joachim Nagel and German Finance Minister Christian Lindner might push for European Central Bank hikes at the IMF/World Bank Spring Meeting. The TV debate between President Emmanuel Macron and far-right Eurosceptic opposition candidate Marie Le Pen has the potential to shape the French presidential runoff on 24 April. Polls currently favour Macron's re-election.

Philip Wee | FX Strategist

Rates: Longer-term rates are pricing in neutral

After a sharp selloff since the start of the year, longer-term USD rates (10Y yields are above 2.8%) are finally pricing in neutral. We would again emphasise that neutral is relative to where inflation expectations are. We think 5Y5Y real rates might be the best way to sidestep supply side pressures arising from economic reopening and the Russia-Ukraine conflict. By capturing the medium-term perspective, it is clear that the Fed on path to normalisation should bring real rates close to zero, something that we had flagged back in January. **5Y5Y real rates are now at 0.07%, up close to a 100bps since the start of the year.**

Figure 4: 5Y5Y Implied Real Rates



Source: Bloomberg, DBS

Accordingly, we are also neutral on long-term rates, noting that our 2Q forecast of 2.80% has already been hit. There can be considerable swings on either side of 2.80% as market participants grapple with uncertainties over the terminal rate for the cycle and fears about quantitative tightening. This fear is reflected in elevated implied and realised rates volatility. Note that implied rates volatility is the single largest stress point amongst indicators that we track. 2Q would likely mark peak duration fears, in our opinion. As the market prices in a Fed that brings policy settings into restrictive territory, the market may well take longer-term rates higher than neutral as well. However, at these levels, we are reluctant to chase USD rates higher, noting that a large chunk of the move may already be done. **We are also not convinced that steepening is a trend that can persist in a Fed tightening cycle and prefer to fade the 2Y/10Y close to 40 bps.**

Eugene Leow | Rates Strategist

Thematics: China F&B – Russia-Ukraine conflict to hurt earnings

- Russia-Ukraine conflict has elevated global commodity prices, with some surging >50% y/y in March
- Selected agri-commodity prices rise more moderately in China but palm oil price soars >70% in March

Sensitivity analyses suggest substantial earnings impact on instant noodle players

Major shock to agricultural commodities. Russia and Ukraine are key players in the agricultural sector globally. Already high global commodity prices, no thanks to the Covid-19 resurgence and logistics disturbance, surged further following sanctions imposed on Russia, registering strong double-digit growth. In China, commodities such as corn, raw milk, sugar, wheat, and soybean meal saw much milder increases during March. But palm oil and aluminium (used in packaging raw materials) soared 72% and 30%, respectively.

Negatively impacted sectors. Food processors like instant noodle makers have warned that higher palm oil prices may have already offset the companies' price hikes over the past 12 months. Palm oil, up >55% y/y in 1Q22, normally takes up <10% of cost of goods sold. This could hurt the gross margins of food processors. Based on DBS Group Research's sensitivity analyses, we estimate FY22 earnings of food processors could be impacted by 1-3% for every 5% increase in palm oil price. As such, we lowered the FY22F gross margin of food processors under our coverage.

Stay selective. On the back of rising agri-commodity prices, upstream players may benefit better from the uptrend. We believe mid-downstream processors could face higher cost pressure in 1H22 and affect near-term sentiment. However, we expect leading dairy companies to find ways to largely offset the cost impacts through passing on the costs to consumers as well as further product-mix enhancement.

Alison FOK | Analyst

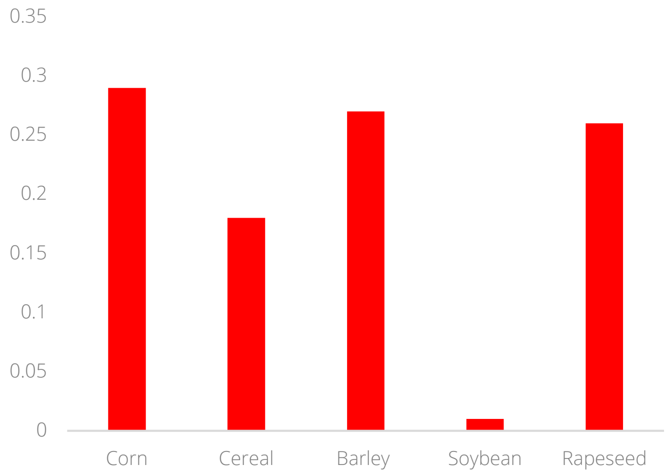
Alice HUI | Analyst

Mavis HUI | Analyst

Clement XU | Analyst

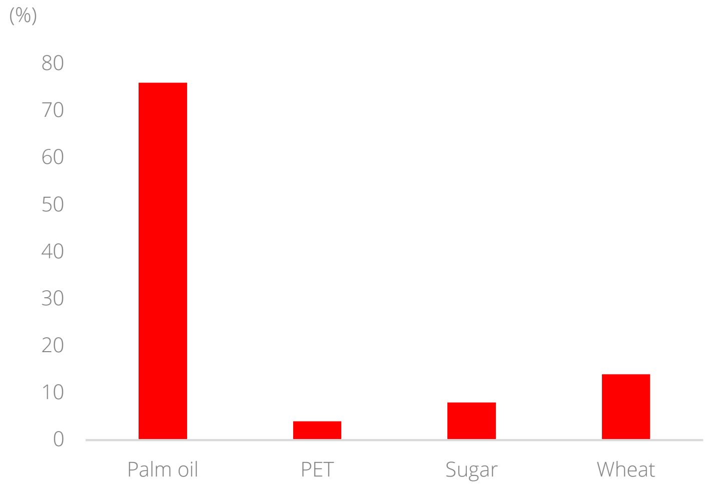
Tina HU | Analyst

Figure 5: Ukraine's & Russia's % share of China's total import figures



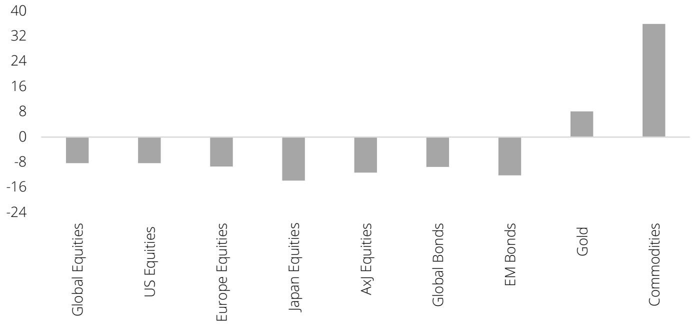
Source: China Custom, WIND, DBS (for 2021)

Figure 6: Raw material price changes (% y/y) – March 2022

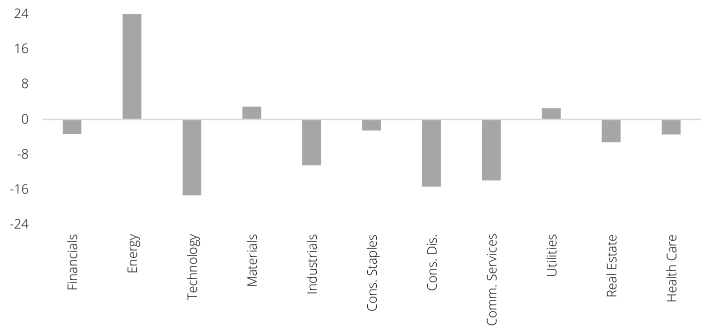


Source: DCE, Shanghai Futures Exchange, MARA, CEIC, DBS

Global Cross Assets YTD Returns

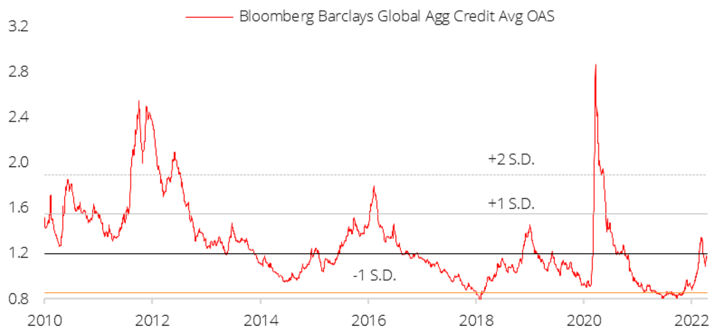


Global Sector YTD Returns



Global Equity Valuation

US Corporate Spreads



INDEX RETURNS

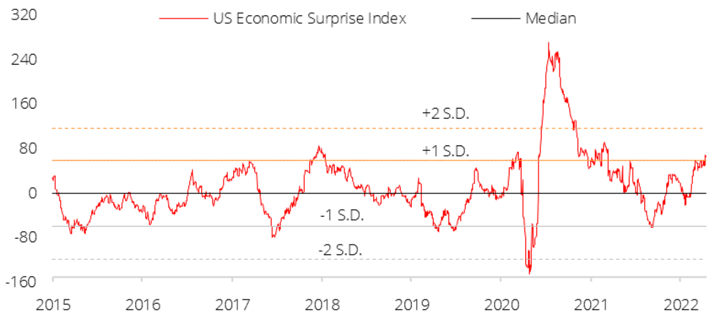
	1 week	MTD	QTD	YTD
Equities				
S&P 500	-0.5%	-3.1%	-3.1%	-7.9%
NASDAQ	-0.6%	-6.2%	-6.2%	-14.8%
Russell 2000	0.5%	-3.9%	-3.9%	-11.4%
Stoxx Europe 600	0.3%	0.9%	0.9%	-5.7%
Nikkei-225	-0.1%	-3.7%	-3.7%	-6.9%
MSCI WORLD	-0.6%	-3.2%	-3.2%	-8.6%
MSCI ACWI	-0.6%	-3.2%	-3.2%	-8.8%
MSCI Asia ex-Japan	-0.3%	-3.5%	-3.5%	-11.4%
MSCI EM	-0.5%	-3.1%	-3.1%	-10.2%
HSCEI	2.5%	-1.9%	-1.9%	-10.3%
SHCOMP	0.9%	-1.7%	-1.7%	-12.2%
Hang Seng	1.5%	-2.2%	-2.2%	-8.0%
STI Index	-1.8%	-3.1%	-3.1%	5.7%
Fixed Income				
Barclays Global Aggregate	-0.7%	-3.5%	-3.5%	-9.4%
Barclays US Aggregate	-0.6%	-3.1%	-3.1%	-8.8%
Barclays US High Yield	0.1%	-2.0%	-2.0%	-6.8%
Barclays Euro Aggregate	-0.2%	-2.2%	-2.2%	-7.5%
Barclays Euro High Yield	-0.4%	-0.9%	-0.9%	-5.0%
JPM EMBI Global	-0.3%	-3.1%	-3.1%	-12.1%
JPM EMBI Global Diversified	-1.1%	-3.1%	-3.1%	-13.7%

PRICES & SPREADS

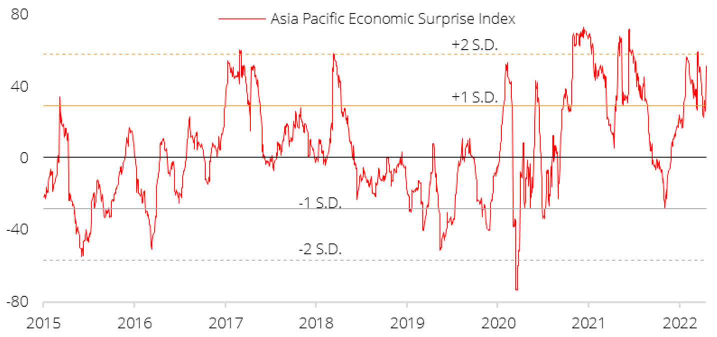
	Spot	1Q22	4Q21	3Q21
Rates				
Fed Funds Target	0.50	0.50	0.25	0.25
ECB Main Refinancing Rate	0.00	0.00	0.00	0.00
BOJ Policy Balance Rate	-0.10	-0.10	-0.10	-0.10
US Treasury 10-yr	2.86	2.34	1.51	1.49
Japanese Govt Bond 10-yr	0.24	0.21	0.07	0.07
German Bunds 10-yr	0.84	0.55	-0.18	-0.20
Spreads				
US Agg Corporate Spread	1.23	1.16	0.92	0.84
US Corporate HY Spread	3.52	3.25	2.83	2.89
Euro Agg Corporate Spread	1.35	1.31	0.97	0.87
EM USD Agg Spread	3.11	3.13	2.85	2.87
Currencies				
US Dollar Index (DXY)	100.8	98.3	95.7	94.2
EUR/USD	1.08	1.11	1.14	1.16
USD/JPY	127.0	121.7	115.1	111.3
USD/CNY	6.4	6.3	6.4	6.4
Commodities				
WTI Oil	108	100	75	75
London Metal Exchange (LMEX)	5130	5174	4502	4161
TR/CC CRB Commodity	316	295	232	229
Gold	1979	1937	1829	1757

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)	21-Apr	16-Apr	180k	185k
CPI y/y (EU)	21-Apr	Mar	7.50%	7.50%
MBA Mortgage Applications (US)	20-Apr	15-Apr	--	-1.30%
S&P Global US Mfg PMI (US)	22-Apr	Apr	58	58.8
S&P Global Eurozone Mfg PMI (EU)	22-Apr	Apr	54.7	56.5
Housing Starts (US)	19-Apr	Mar	1740k	1769k
Existing Home Sales (US)	20-Apr	Mar	5.78m	6.02m
Leading Index (US)	21-Apr	Mar	0.30%	0.30%

MACRO CALENDAR

	Date	Period	Survey	Prior
Asia				
Industrial Production m/m (JP)	19-Apr	Feb	--	0.10%
Jobless Rate (JP)	25-Apr	Mar	--	2.70%
CPI y/y (CN)	25-Apr	Mar	--	4.30%
Jibun Bank Japan PMI Mfg (JP)	21-Apr	Apr	--	54.1
Job-To-Applicant Ratio (JP)	25-Apr	Mar	--	1.21
Natl CPI y/y (JP)	21-Apr	Mar	1.20%	0.90%
Industrial Production y/y (JP)	19-Apr	Feb	--	0.20%
Natl CPI Ex Fresh Food y/y (JP)	21-Apr	Mar	0.80%	0.60%

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