Taming inflation at all costs

Quarterly Investment Strategy
Third Quarter 2022

Summary of Investment Conclusions

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1. **Need to stay cautious in a very uncertain environment.** We stay underweight both equities and fixed income, overweight cash and alternatives.
2. **UOBAM leans toward a “soft landing” view.** But we acknowledge that the risk of a “hard landing” needs to be risk managed.
3. **Rising interest rates will continue to slow expansion.** But at some point soon bond yields may peak, creating an opportunity in fixed income.
4. **Investment opportunities are forming.** Long-term expected returns are improving rapidly.

Summary of Investment Conclusions

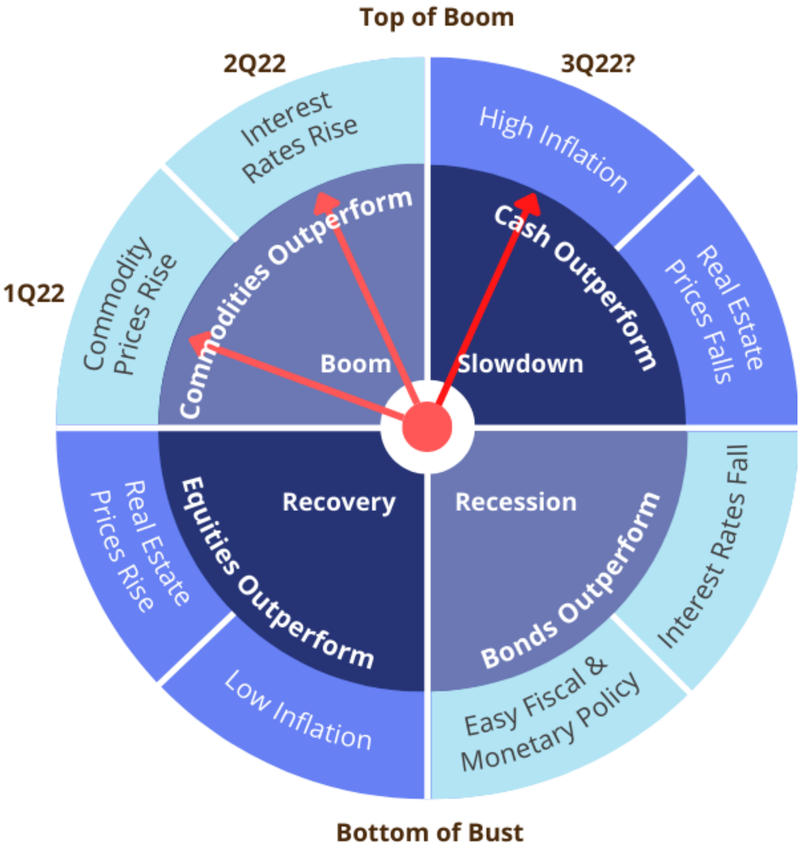
5. **Inflation improvements are expected.** But it is uncertain how quickly this will happen and how the markets will react to partial improvements.

6. **We expect bond yields to range between 2.5% and 3.25%** in the second half of 2022.

7. **We expect the USD to be well supported.** The currency expected to benefit from stronger economic growth, rising yields, and relative tighter monetary.

8. **We continue to like alternatives.** Real assets, including property, commodities, and gold can outperform in an inflation environment but could peak under a “hard landing”.

UOBAM Investment clock



- The post recovery period (when interest rates start to normalise) usually lasts 3 to 5 years.
- At the start of the year, the world appeared to be in the good part of the economic cycle.
- But the mid-cycle expansion looks like it may last less than one year, and has rapidly shifted to a dangerous part of the cycle.

Global Asset Allocation

	- -	-	N	+	+ +
Equities	○	●	○	○	○
- US Equities	○	➤	●	○	○
- European Equities	○	●	○	○	○
- Japan Equities	○	○	●	○	○
- Asian ex Japan Equities	○	○	○	●	○
Government Bonds	○	●	○	○	○
Investment Grade Credits	○	○	○	●	○
High Yield Credits	○	○	●	○	○
Real Estate Investment Trusts	○	○	○	●	○
Commodities	○	○	○	●	○
Alternatives (Hedged Strategies)	○	○	○	●	○
Alternatives (Private Equity)	○	○	○	●	○
Cash	○	○	○	●	○

Source: UOBAM, 8 June 2022

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UOBAM House View remains cautious

Note:

*3-6 months horizon

Central Bank options in response to rising inflation

Door 1 – Prioritise employment

Door 2 – Talk tough until signs of unemployment

Door 3 – Taming inflation at all costs

Repeating the 1970s FED – many years of lingering inflation

Inflation disappears as supply chains improve

Hard landing – significant recession with high unemployment

Soft landing – significant recession with high unemployment

Global GDP is strong and corporate earnings growth is positive

Global growth expectations have moderated, but still appear relatively healthy

Real GDP Growth Consensus Estimates (%)

	2018	2019	2020	2021F	2022F	2023F
Global	3.6	2.9	-3.1	6.1	**3.3**	3.3
United States	2.9	2.3	-3.4	5.7	**2.7**	2.1
Eurozone	1.8	1.6	-6.4	5.4	**2.8**	2.3
Japan	0.6	-0.2	-4.5	1.8	**2.1**	1.8
Asia ex. Japan	6.0	5.4	1.3	5.6	**5.1**	5.1
China	6.7	6.0	2.2	8.1	**4.8**	5.1

Earnings growth expectations are also healthy around the world

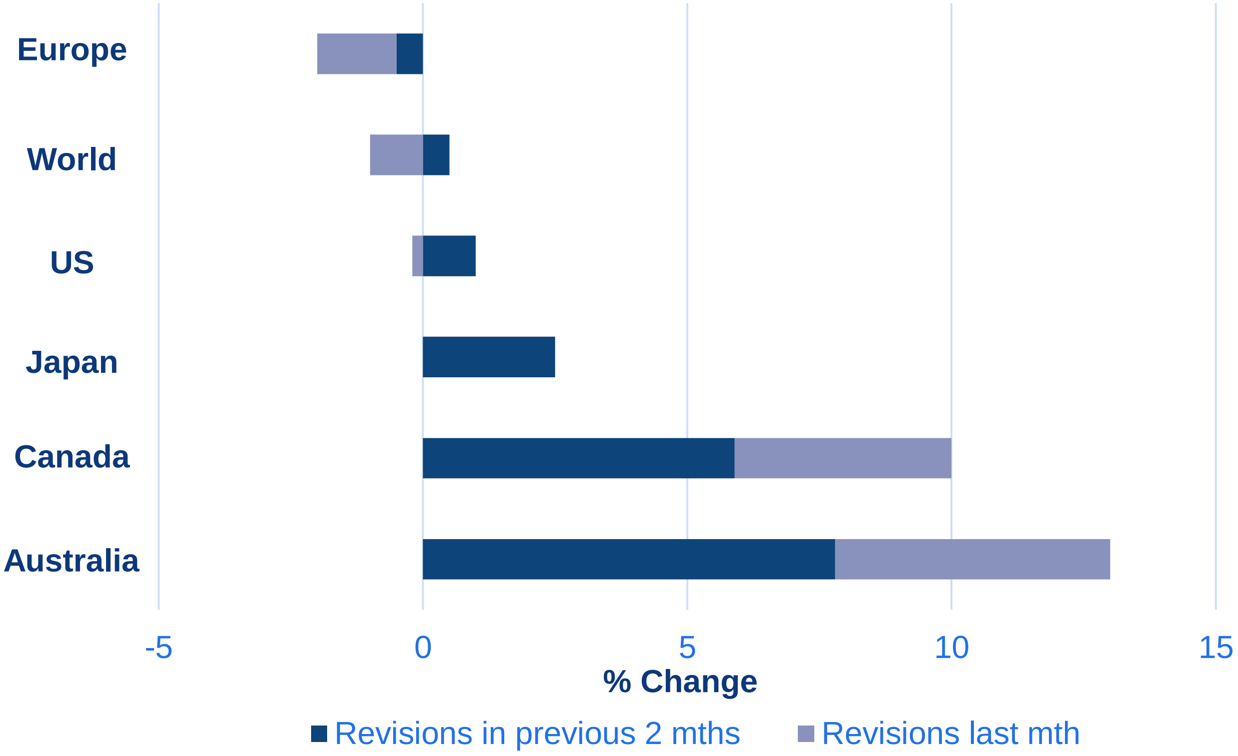
Based on Calendar Year

	EPS Growth (YoY%)		PER		DVD YLD	PBR		ROE	
Regions	2022E	2023E	2022E	2023 E	2022E	2022 E	2023 E	2022 E	2023 E
US	7.8	10.2	18.0	16.3	1.6	3.7	3.4	20.6	20.6
Europe	2.2	4.6	12.5	12.0	3.5	1.7	1.6	13.8	13.6
Japan	15.7	5.4	12.8	12.2	2.6	1.2	1.1	9.6	9.5
Asia ex Japan	1.6	11.7	12.2	11.0	2.9	1.4	1.3	11.7	12.0
China	7.3	16.0	10.9	9.4	2.6	1.2	1.1	11.2	11.8

Source: Factset UOBAM , 17 May 2022

Developed Markets (CY1)

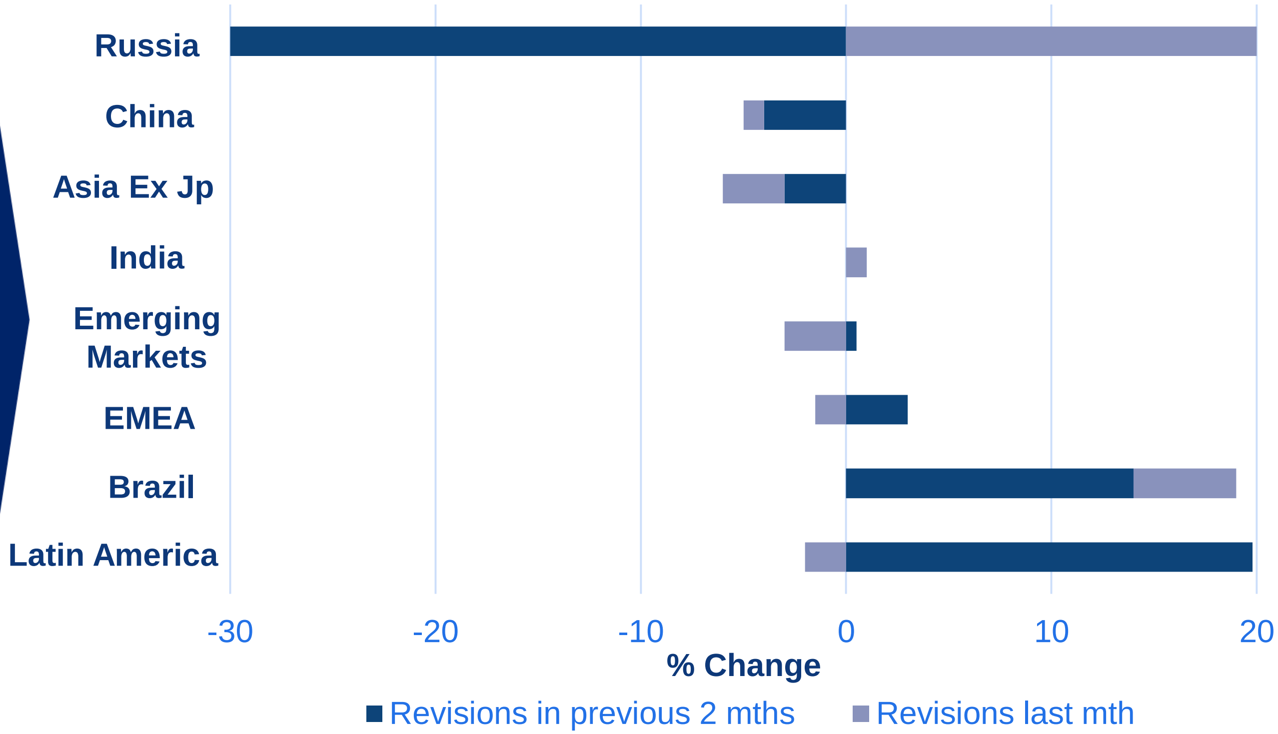
Earnings Revisions are still positive in most regions



Source: Factset, UOBAM , 17 May 2022

Emerging Markets (CY1)

Earnings Revisions are still positive in most regions



Source: Factset, UOBAM , 17 May 2022

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But inflation is becoming a persistent problem

Many contributors to the inflation storm

Previous few decades
- End of structural disinflation

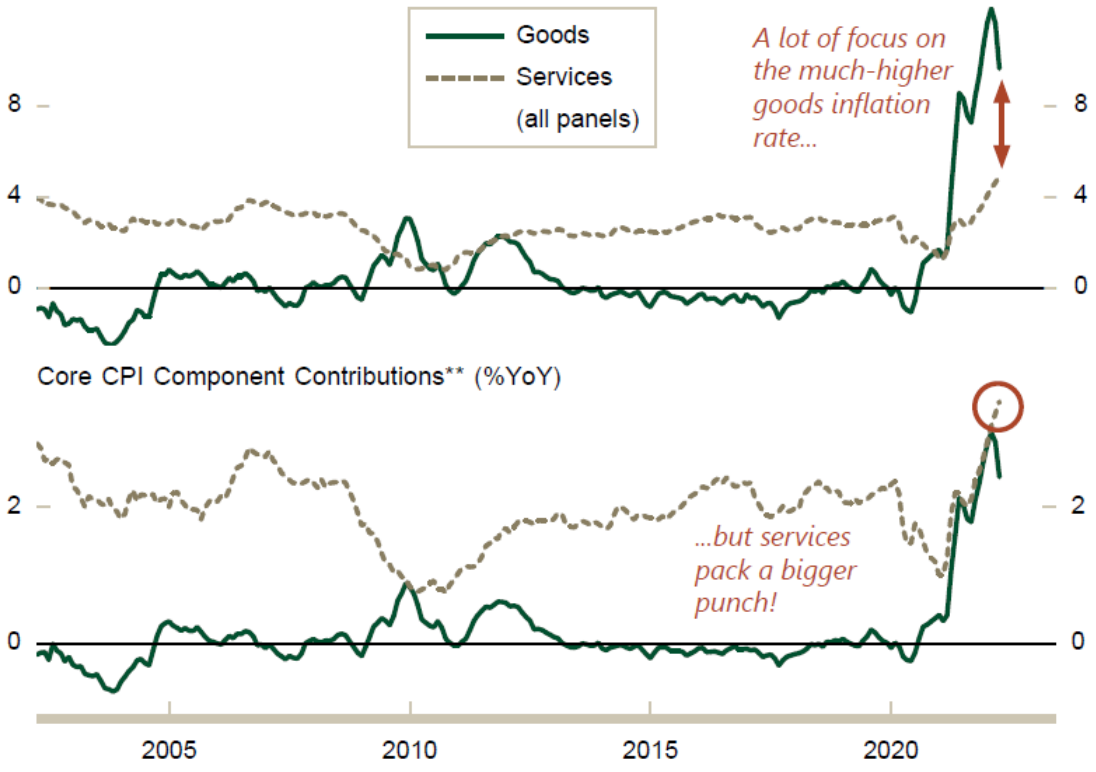
Previous few years
- End of accommodative monetary policies

Since 2021
- Covid-related supply disruptions

2022
- Energy and food shock from war and sanctions

Services inflation is on the rise

US Core CPI Component Inflation (%YoY)



Source: U.S. Bureau of Labor Statistics , May 2022

It all started with goods inflation that is probably transient.

But services inflation tend to be more persistent and is starting to become a problem.

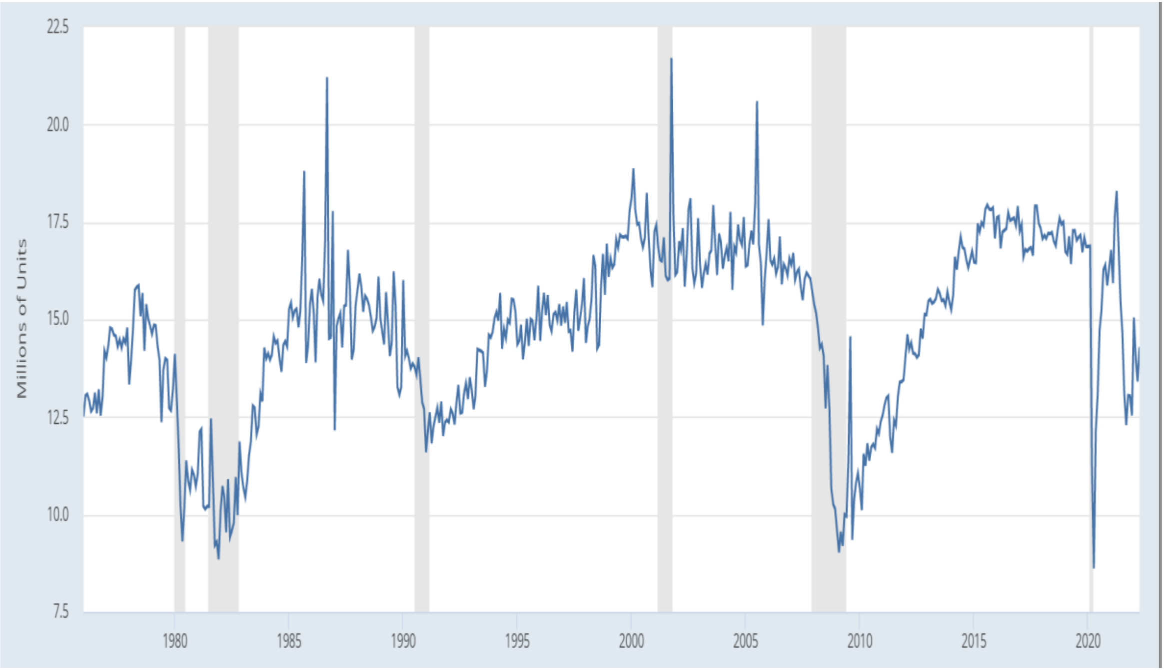
Note:

* Core excludes food & energy

** MRB calculation

Key supply problems example - autos

US sales of autos and lightweight trucks (millions of units)

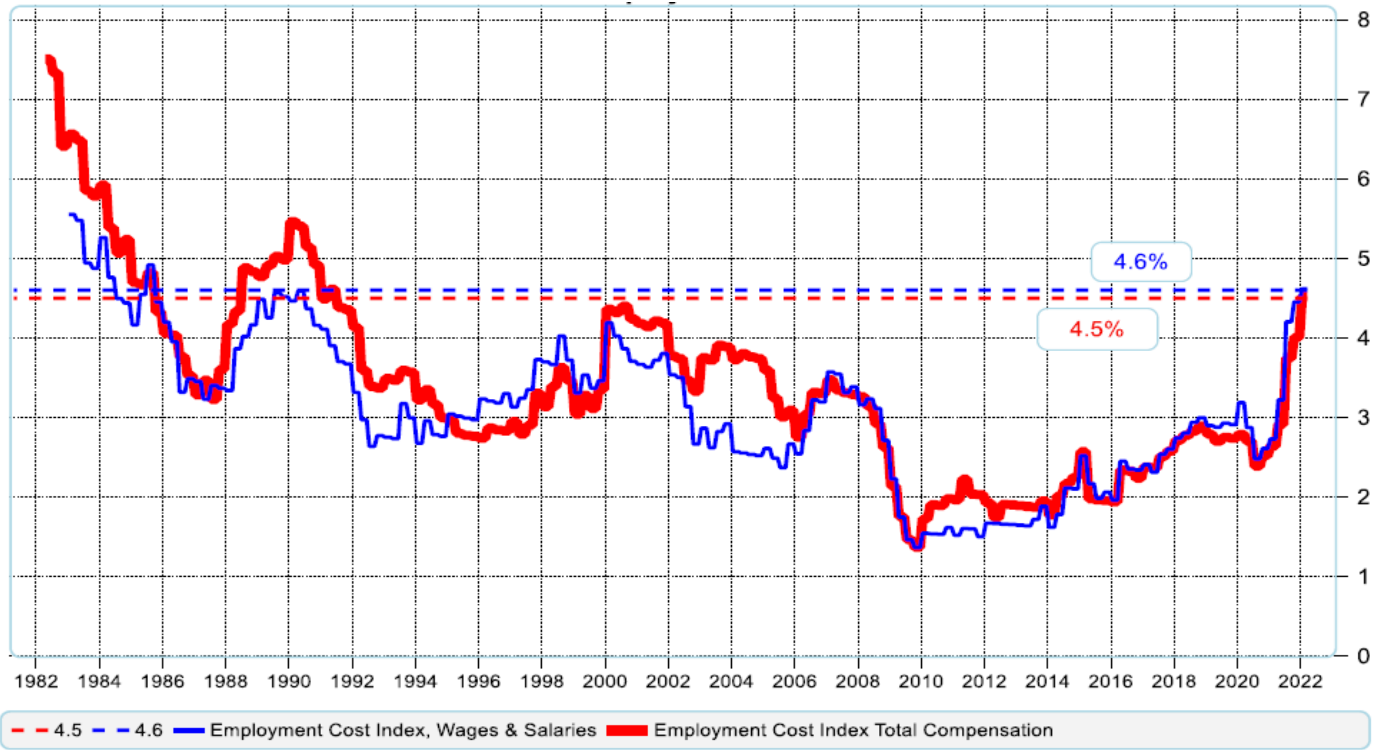


Source: U.S. Bureau of Labor Statistics , May 2022

- When the economy is strong, US auto sales reaches about 18m pa.
- Currently sales are about 14m due to supply shortages
- This is impacting the used car and rentals markets, and driving up core inflation .
- To control auto inflation, either supply must rise to 18m, or the Fed must reduce demand to 14m (i.e. recessionary levels)

Wages are up but not out of line with historical levels

US Employment Cost Index



Source: Macrobond

Productivity issues need to be resolved

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- The social contract for service work has been broken.
- “Work from home” is now a negative (i.e. it worked better when people had nowhere else to go).
- Travel restrictions are still inhibiting international business.
- Burnout in some sectors (e.g. healthcare) after a long pandemic.
- Human Resources unable to do good matching since they are overwhelmed by new criteria (e.g. health mandates).

Productivity issues need to be resolved (Con’t)

- Child-care remains haphazard, so labor is being supplied erratically & without specialisation.
- Schooling has been inconsistent, also affecting family labor supply.
- Elevated U.S. quits rates meaning learning new (but not better) processes.
- There’s still a consumer cash cushion, so the search for work has been slow the past several years.
- Excess retirements have removed accumulated skills & experience from the workforce.

Structural issues threaten to exacerbate inflationary pressures

1. Macro Policy

Central banks are ending expansionary policies

2. De-globalisation

US-China trade and bilateral relations at crisis levels

3. Technology

Disruptors are becoming monopolists

4. Energy Transition

The world is transitioning from cheap oil to capital-intensive green solutions

5. Politics

End of Davos, rise of populists

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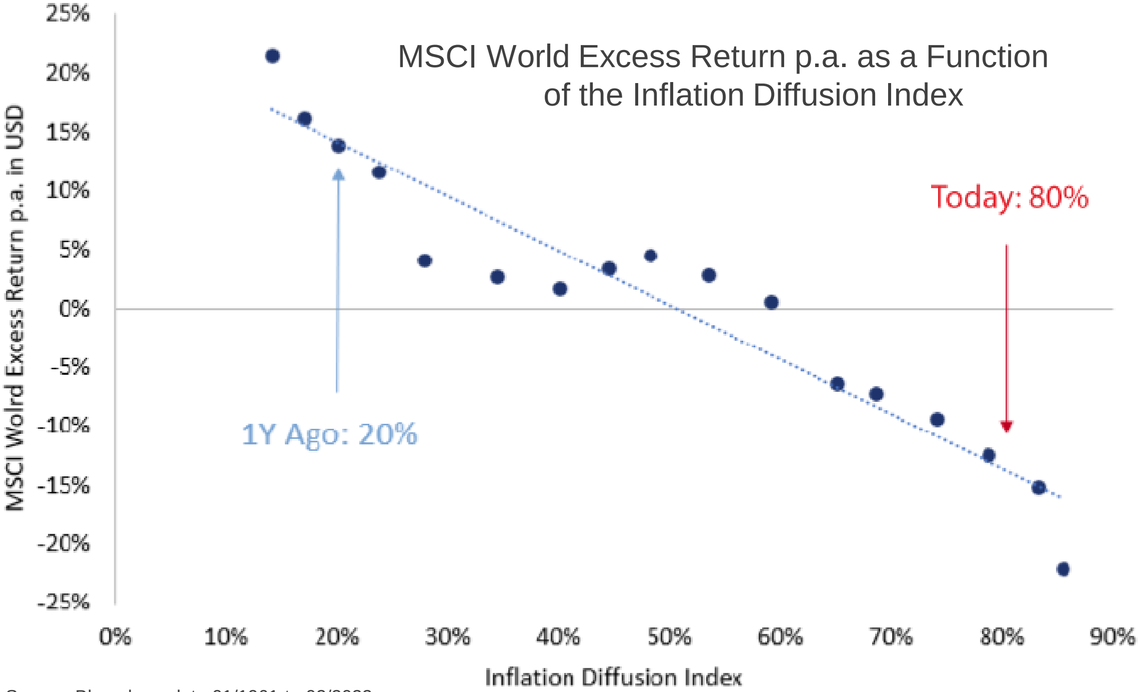
Inflation fears have dampened market performance

Inflation is correlating poorly with market performance



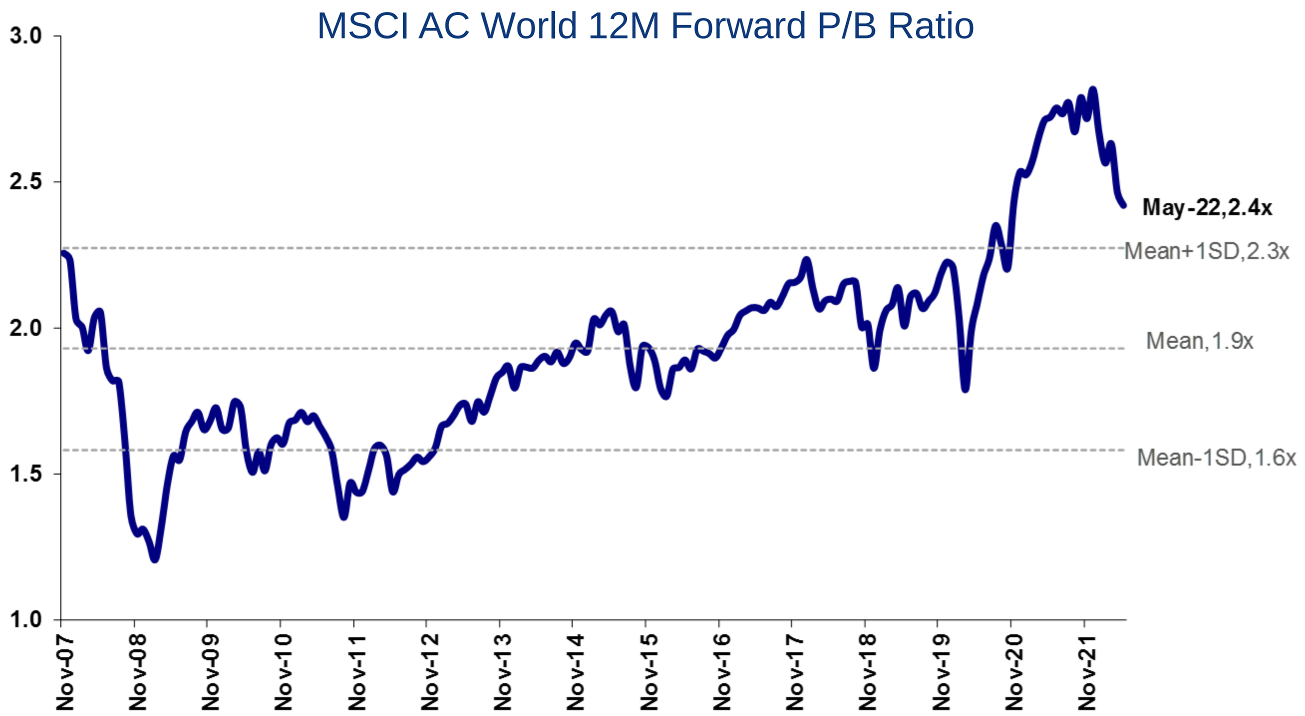
Source: Bloomberg data 01/1961 to 02/2022

Inflation Diffusion Index: Percentage of the 40 countries tracked by Gavekal-IS in an inflationary mode

Inflation Diffusion Index: Percentage of countries in an inflationary mode

Sample: 40 countries

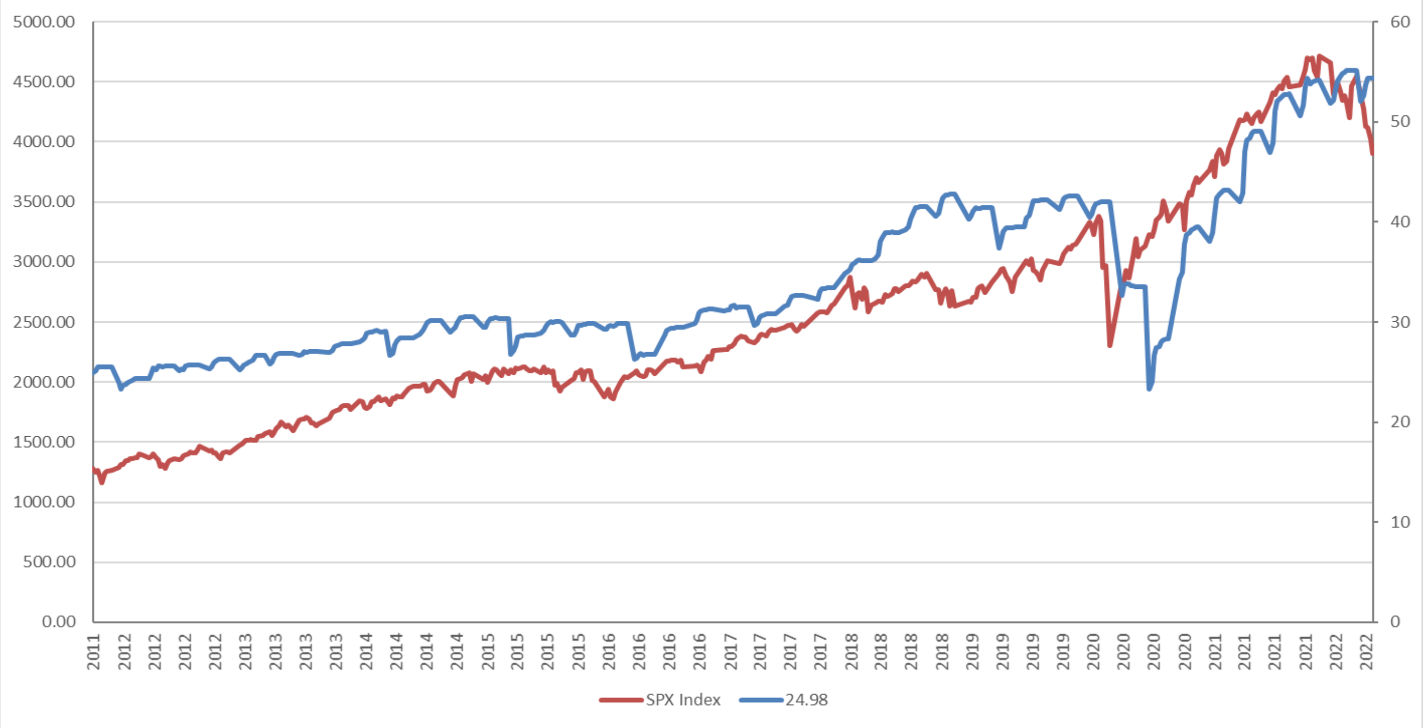
Inflation has the potential to challenge margins, leading to a drop in valuations



Source: Factset Market Aggregate, Factset, 31 May 2022

More nominal earnings forecasts have caused markets to correct

SPX fwd EPS vs SPX performance



The Case For A Soft Landing

(UOBAM House View)

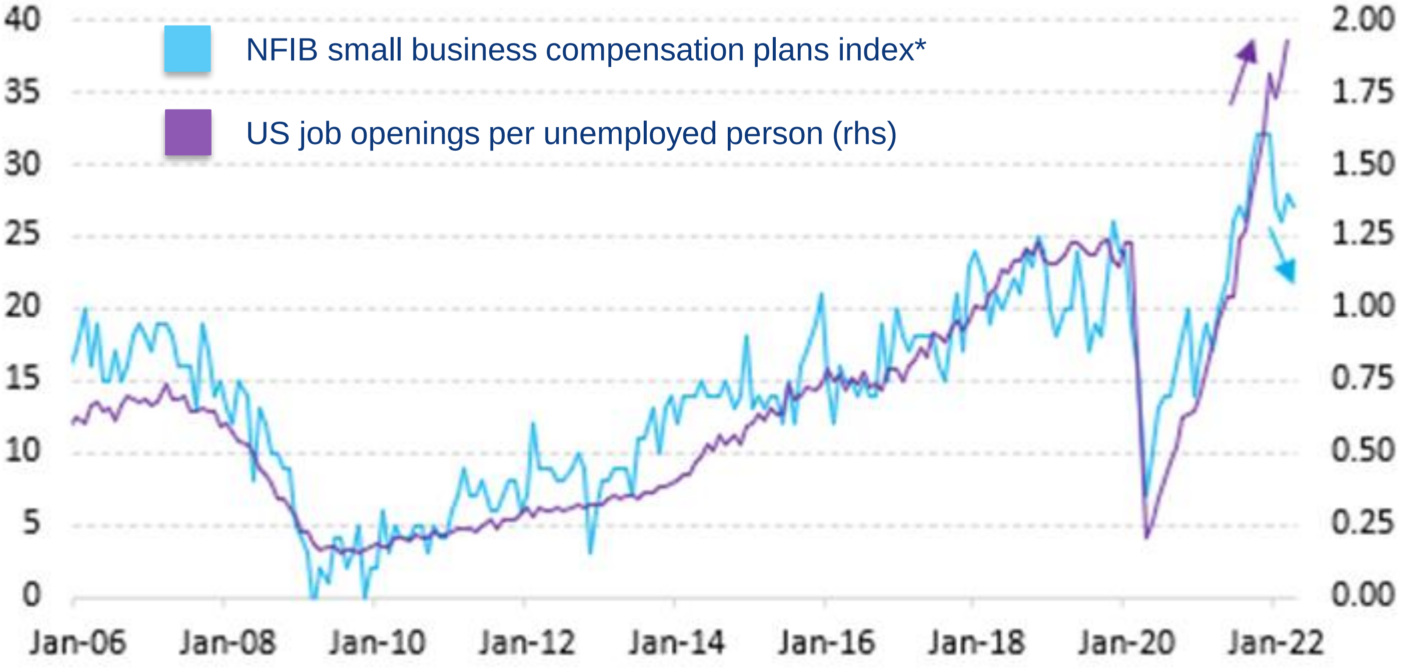
The case for a soft landing

- The Fed’s explicit goal is to reduce excessive job openings without creating high unemployment.
- Base effects and more time to reopen may go a long way to improving inflation.
- Household and corporate balance sheets are healthy.

The case for a soft landing (cont.)

- Structurally, the US economy ie demand, employment, housing, and banking all look strong.
- Earnings growth has increased 5 -10% and could hold up better than expected.
- High valuations have adjusted rapidly in the US. Outside the US, valuations were reasonable.

The Fed's goal is to reduce job openings rather than create unemployment

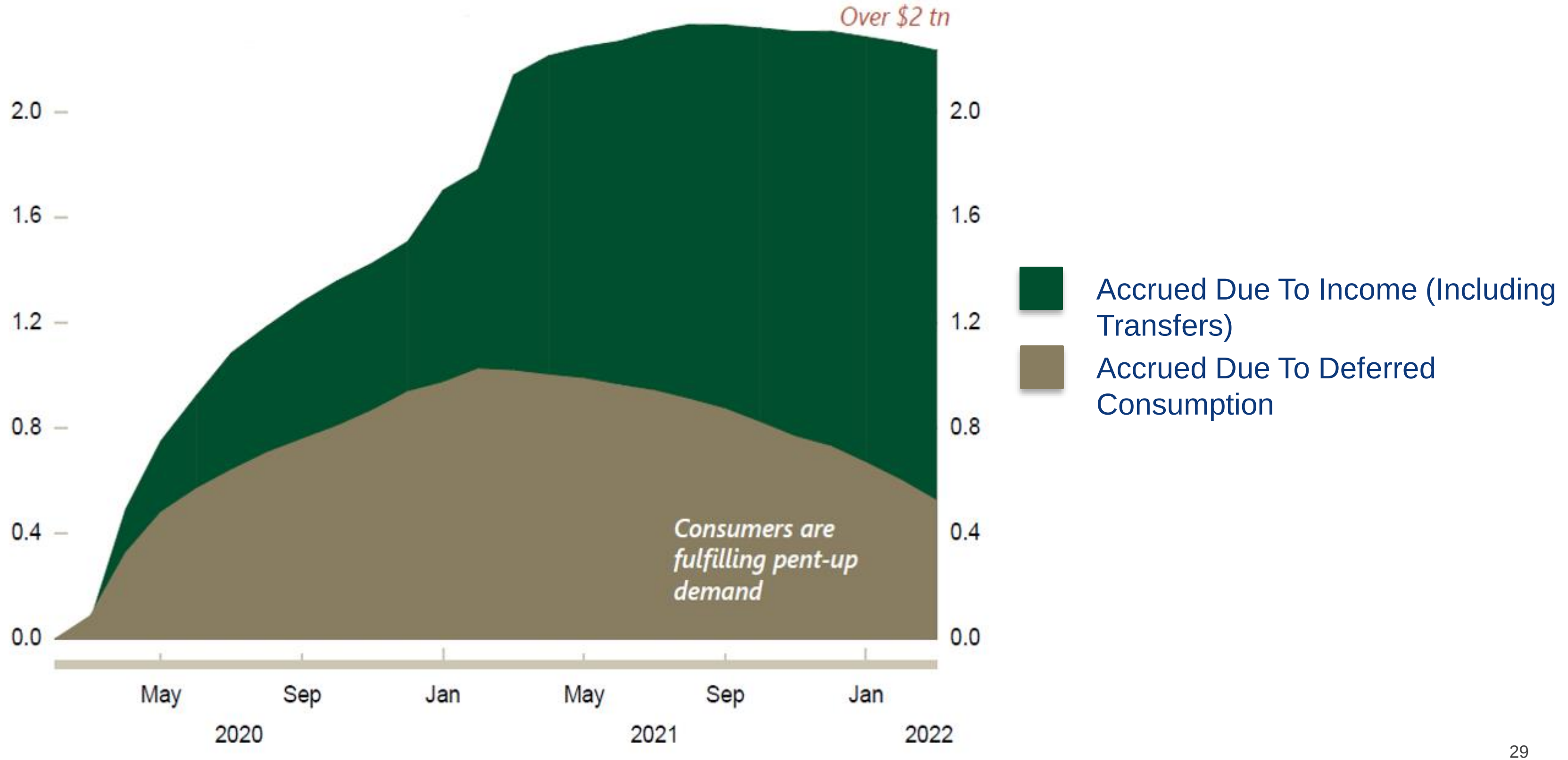


Source: NFIB, BLS, Vanda

* Net % of respondents planning on increasing employee compensation in the next three months.

Household balance sheets are strong

U.S.: Accumulated Excess Savings* (US$ tn)



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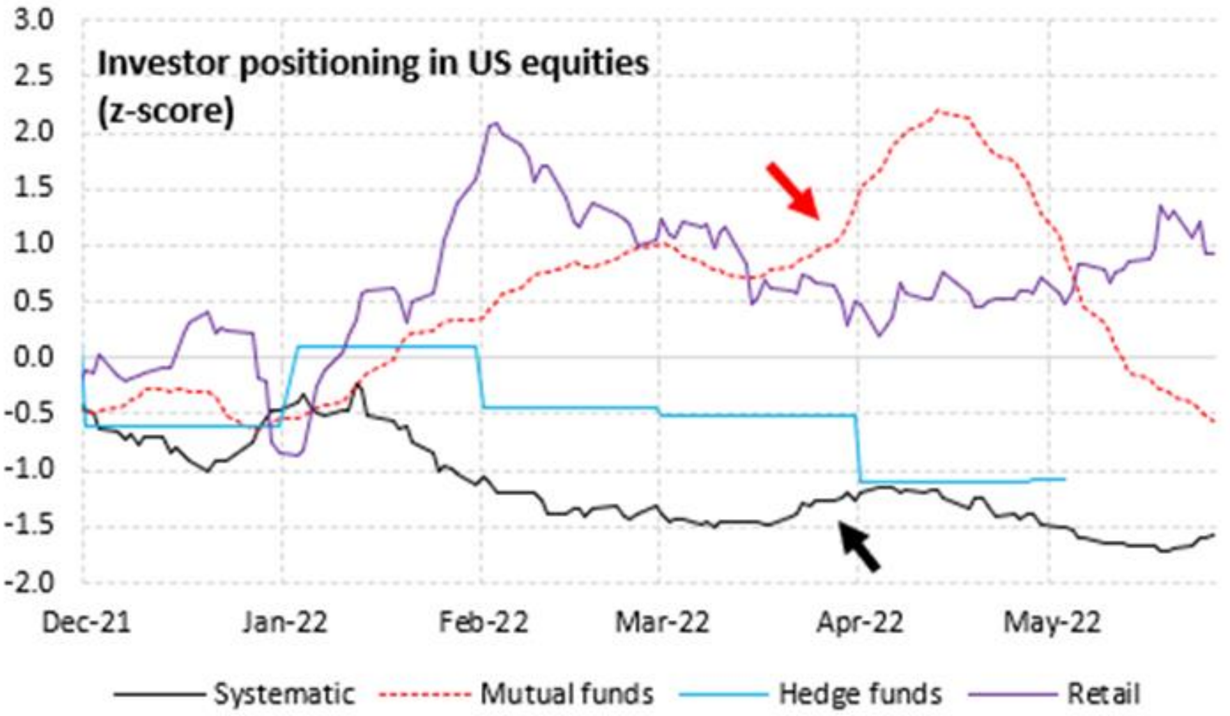
Institutional investors are already underweight equities, only retail are lagging



Source: Bloomberg, Vanda

Even in a complicated macro world, there remain investment opportunities

Things that could be supportive of equities

- Rising prices can inflate company earnings. So as long as there is no recession, equities stand to benefit
- Asia is enjoying the green shoots of re-openings. As COVID fades, supply and inflation should normalise.

Things that could be supportive of equities (cont.)

- Household and corporate balance sheets are strong.
- Inflation could fade over the next three months due to base effects.
- Markets may be overpricing a recession or stagflation.

Things that could be supportive of bonds

- Bond yields are becoming attractive
- Bigger yield spikes are now needed to generate negative returns
- The next three months should see inflation improve due to base affects
- Lower inflation can lead to lower bond yields and higher bond prices
- The yield spread (differential) between government and high grade bonds could start to normalise

Potential for positive total returns when spreads normalise

One-year total return of a 7-year duration bond fund

Scenario 1: yields rise to 4%

	Current	1 Year
Yield	3.14	4
IG spreads now	1.45	1.45
Total yield	4.59	5.45
Implied price of par $1000	730.4	689.7
Capital gain		-5.6
Yield		4.59
Total Return		***-1.0***

Scenario 2: yields rise to 3.5%

	Current	1 Year
Yield	3.14	3.5
IG spreads now	1.45	1.45
Total yield	4.59	4.95
Implied price of par $1000	730.4	713.1
Capital gain		-2.4
Yield		4.59
Total Return		***2.2***

Scenario 3: yields rise to 3.0% and credit spread normalise

	Current	1 Year
Yield	3.14	3
IG spreads now	1.45	1.15
Total yield	4.59	4.15
Implied price of par $1000	730.4	752.3
Capital gain		3.0
Yield		4.59
Total Return		***7.6***

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