2022 Mid-year Outlook: Pains Before Gains

Summary

- Market concerns have shifted from inflation shock to recession risk. The financial and economic indicators suggest a 35% probability of a US recession in the next 12 months.
- Potential "pains" include (1) corporate earnings downgrades; (2) still plenty of room for investor to reduce equity positioning given still heavy exposure; and (3) highly leveraged high yield companies could be under pressure with fast surging borrowing costs.
- Potential "gains" after "pains" are the Fed pivot and more clarity on political and policy directions after China's 20th Party Congress held in autumn this year.

How large is the recession risk?

Market concerns have recently shifted from inflation shock to recession risk as central banks remain hawkish and tighten aggressively when economic growth is already slowing significantly. US 1Q GDP growth is -1.2% (qoq saar). The Atlanta Fed GDPNow forecast (a nowcasting model) is currently at -1.9%. This indicates that a technical recession (defined as two consecutive quarters of negative growth) may already be underway.

The traditional definition of a recession by NBER (National Bureau of Economic Research) is that a significant decline in economy activity is spread across the economy and that lasts more than a few months. For now, there are still no broad-based weaknesses, especially the US job market remains very strong (a lagging indicator though).

There is no doubt that the risk of a true recession is rising. Different indicators are showing different probability of a US recession. On average, the financial and economic indicators currently suggest a 35% probability of a US recession in the next 12 months.

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THE PROBABILITY OF A US RECESSION WITHIN 1-YEAR IS CURRENTLY AT 35%

Financial Indicators	Current Level	Implied 1-Year Recession Probability	Level At 36% Recession Probability
S&P 500 drawdown from peak (%)	-21	65%	-8.3
A/BBB bond spread (bps)	175	33%	185.8
Yield Curve (10yr - 3m, bps)	159	13%	62.3
Average Financial Indicators		**37%**	

Economic Indicators	Current Level	Implied 1-Year Recession Probability	Level At 50% Recession Probability
Consumer sentiment	45.5	88%	53.3
Non-manufacturing sentiment	58.1	32%	54.3
Manufacturing sentiment	57.3	44%	55.7
Payrolls	408	37%	384
Unemployment rate	3.6	0%	5.9
Initial jobless claims	226.4	0%	543.4
Average Economic Indicators		**34%**	
Average Of Financial & Economic Indicators		**35%**	

Source: Bloomberg, BNP Paribas (WM), as of 29 June 2022.
Past performance is not indicative of current or future performance.

How much recession risk has the market priced in?

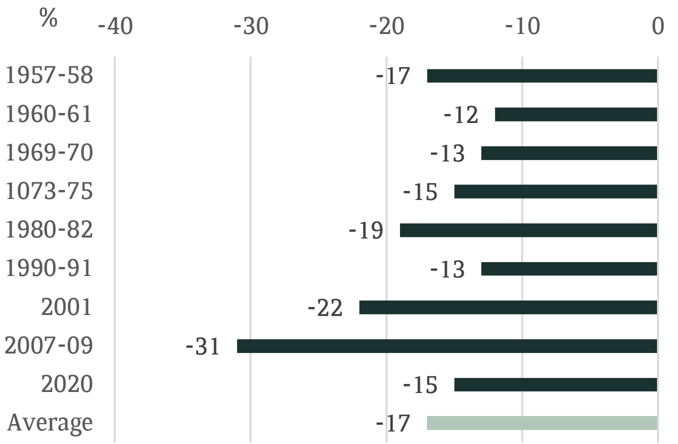
Despite a 21% drawdown YTD in the S&P 500, it seems that the market has yet to fully priced in a US recession scenario as average drawdown over the past 9 recessions since 1950s was 34%. The drawdown so far represents a 65% probability of a US recession. Moreover, investment grade bond spreads and yield curve are still pricing a much lower probability of a recession.

Why more "pains" are likely in the summer months?

Firstly, consensus earnings estimates look too optimistic with 2022 earnings growth forecast for US still at +9.5% amid rising risk of a hard landing. The average earnings drawdown of S&P 500 in the past 9 recessions is -17%. We could see significant downgrades in earnings forecasts during/after the upcoming earnings reporting season if results (a lagging indicator) do not beat consensus. A downward trend in earnings revisions usually does not bode well for equity market.

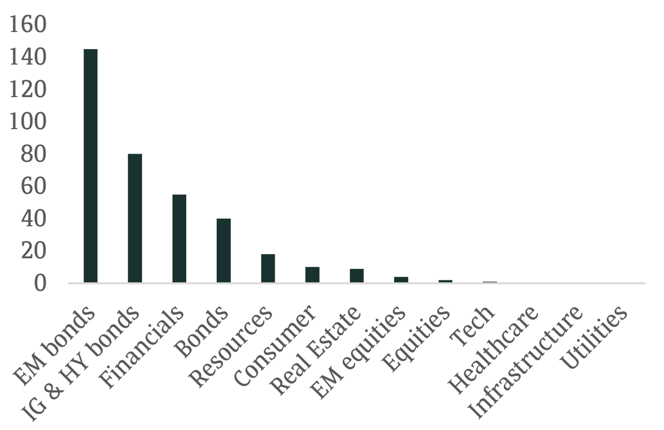
Secondly, despite the very bearish/fear investor sentiment according to different sentiment/survey indicators, investors' positioning remains heavy on equities. While there has been notable outflows in credit with cumulative flows of investment grade, high yield and EM bonds down over 40% from the 2021 peak, equities barely see any net outflows amid sharp corrections in returns YTD.

S&P 500'S EARNINGS DRAWDOWN AROUND PAST US RECESSIONS



Source: Factset, Jefferies, BNP Paribas (WM), as of 5 Jul 2022.
Past performance is not indicative of current or future performance

SIGNIFICANT OUTFLOWS (CAPITULATION) HAVE SEEN IN CREDIT BUT NOT YET IN EQUITIES



Source: BofA, EPFR, BNP Paribas (WM), as of 7 July 2022.
Past performance is not indicative of current or future performance.

HIGH YIELD SPREAD IS WIDENING BUT YET TO BE AT RECESSION LEVELS

Source: Bloomberg, BNP Paribas (WM), as of 7 July 2022.
Past performance is not indicative of current or future performance.

Thirdly, if earnings growth is set to fall, companies in particular high yield corporates with high leverage could be under pressure amid surging borrowing costs and tightening financial conditions. High yield spreads have been widening but they are still not consistent with the levels seen in past recessions.

What are the potential "gains" after "pains"?

The Fed pivot - Don't fight the Fed! So the market believes that when the Fed makes a dovish pivot, we could see a relief rally in risk assets. However, the bar for a Fed pivot is high as they had been behind the curve and their major concern is that the elevated inflation could become entrenched. In the near term, the Fed would still want to sacrifice growth to restore price stability as they can only affect the demand side of the inflation equation but cannot do much on the supply side.

What could trigger a Fed pivot?

1) **A sustain decline in headline inflation** – We believe US inflation may have peaked/will peak soon. While prices in the services sector continue to pick up, food and commodities prices are falling. There are more signs of easing in supply chains disruptions. Long-term inflation expectations are also falling.

2) **A "credit event" with systemic threat** – This is hard to predict, but a fast tightening cycle may trigger a major financial accident, giving the Fed no option but to ease.

3) **Significant rise in unemployment rate** – This is less likely in the near term as the US job market remains very tight, while the problem of lack of labour supply should ease gradually with fading impacts from the pandemic.

We expect the Fed to hike another 75bp in July and 50bp in September. As the Fed funds rate would exceed the neutral rate by then and inflation is expected to decline, we expect a slower pace of tightening with 25bp hikes in November and December, respectively. Hence, the policy rate will reach 3.5% by end-2022. This is our terminal rate forecast for this cycle as the Fed may need to cut rates in 2H 2023 as the focus would be shifting to avoid a recession.

More clarity after China's Party Congress - The 20th Party Congress (holds every 5 years) that will be held in autumn this year will announce major leadership changes. More certainty on political and policy directions should benefit Chinese assets.

Some relaxation in Covid restrictions, re-opening of economy, easing measures and potential completion of regulatory crackdown have lifted investor sentiment. For now, we prefer to play China via A-shares which are more domestically-driven as offshore Chinese equities are more vulnerable to a volatile global equity markets. We expect some consolidation in A-shares in the near term after a strong rebound in June, while corrections are buying opportunities.

STRATEGY: Quality & Protection

- As we expect market volatility to stay high in the near term, investors should consider brining Quality and Protection to their portfolios. Instead of holding too much cash which offers negative real returns, investors can focus on income and alternative strategies.

- We stay defensive in the short term and remain neutral in equities (downgraded from positive since February 2022 against consensus views) and upgraded US governments bonds to neutral from negative recently. We favour short-to-medium duration investment grade bonds which offer the highest yields since 2018 (4-5%) and quality stocks with pricing power and sustainable dividend yields.

- It is important to build satellite allocations from private equity, private real estate and hedge funds in order to diversify and lower overall portfolio volatility as they tend to have lower correlation with traditional asset classes. (For further details, please refer to our Investment Navigator – Asia Edition in May 2022 "*Diversification is the Only Free Lunch: Alternatives in a Volatile Market*")

Overview of our CIO Asset Allocation for July 2022

	Views Current	Views Prior	Constituents	We like	We avoid	Comments
EQUITIES	=	=	Markets	UK, Latin America, Canada, Australia, Singapore, Indonesia		■ We remain neutral overall on equities as an asset class as we await further potential reduction in uncertainties.
			Sectors	Oil & Gas, Financials, Healthcare, EU Real Estate, Semiconductors, Construction Materials, Precious/"battery" Metals		■ We favour defensive sectors but stay hedged against inflation.
			Styles/ Themes	Megatrend themes		■ **Security, inflation hedging & circular economy themes.**
BONDS	=	=	Govies	US short-end Treasuries		■ **We raised our 10-year US bond yield target to 3.25%.** ■ We are **neutral on US government bonds**.
			Segments	Emerging Markets Bonds (USD + local currency)		■ We are **neutral on US investment grade (IG) & high yield (HY)**. ■ We prefer **short-to-intermediate duration US IG bond.**
CASH	-	-				
COMMO-DITIES	+	+		Gold & Base Metals		■ **Gold - positive**: gold to trade in the $1900-2100 range. ■ **Oil - neutral**: Brent to stabilise in the $105-115 range at the end of 2022. ■ **Base metals –positive: Medium-term remains bullish due to lack of investments in new mines and the needs of energy transition**
FOREX			EURUSD			Our 12-month target remains at 1.12.
ALTERNATIVE	+	+		Real Estate; Macro & Event-driven Hedge Funds		We are neutral on Relative Value & Long/Short Equity.

Note: + Positve / = Neutral / - Negative

GDP & CPI Forecasts

		GDP (YoY%)			CPI (YoY%)		
		2021f	2022f	2023f	2021f	2022f	2023f
	Global	5.6	4.8	3.8	-	-	-
Developed	US	5.7	2.6	1.9	4.7	7.5	3.9
Developed	Japan	1.7	1.4	1.1	-0.2	1.9	1.0
Developed	Eurozone	5.3	2.5	2.3	2.6	7.9	4.1
Developed	UK	7.4	3.6	1.5	2.6	8.0	4.4
	Developing Asia	6.7	6.6	5.3	3.9	6.3	4.6
North Asia	China	8.1	3.7	5.7	0.9	2.3	3.4
North Asia	Hong Kong*	6.4	0.5	4.9	1.6	1.9	2.1
North Asia	South Korea	4.0	2.7	2.1	2.5	4.6	2.6
North Asia	Taiwan*	6.3	3.2	2.9	1.8	2.3	2.2
South Asia	India	9.3	8.3	6.2	5.4	7.9	5.9
South Asia	Indonesia	3.7	4.9	5.0	1.6	3.5	3.5
South Asia	Malaysia	3.3	6.3	4.4	2.5	2.7	2.8
South Asia	Philippines*	5.6	6.5	6.3	3.9	4.3	3.7
South Asia	Singapore*	7.6	4.0	2.9	2.3	3.5	2.0
South Asia	Thailand	1.6	3.9	4.9	1.2	6.4	2.4

Source: BNP Paribas Group Economic Research, BNP Paribas Global Markets forecasts as of 30 June 2022
* IMF data and forecasts as of 30 June 2022

GROWTH

- Given the current disruptions, we downgraded our growth forecasts to below-trend level. **Nevertheless, risk of a recession is rising.**
- In the US, we expect a growth deceleration but no imminent recession. The economy remains dynamic thanks to household consumption, business investment and a strong labor market. **We downgrade our GDP growth forecasts to 2.6% in 2022 and 1.9% in 2023.**
- Eurozone has the possibility of a quasi-stagnation in the next quarter. **We revised down our GDP growth forecast to 2.5% for 2022 and 2.3% for 2023.**

INFLATION

- Given the higher energy and food prices and the uncertainties about the degree of pass-through, Inflation will likely settle above its pre-pandemic average in most countries.
- In the US, inflation hit 9.1% y/y in June amid soaring gasoline prices. **We revised up our inflation forecast to 7.5% y/y in 2022 and 3.9% y/y in 2023.**
- In Eurozone, inflation reached 8.1% y/y in May. In addition, UK inflation hit 9.1% y/y in May. **We expect higher inflation for longer due to high energy and food prices and second-round effects.**

Equities

POSITIVE | NEUTRAL | NEGATIVE

OVERALL GLOBAL: NEUTRAL

Positive	Neutral	Negative
COUNTRY		
UK Japan Emerging Mkt	Eurozone US	-
SECTOR		
Energy Healthcare Financials	Comms. Materials Industrials Consu. Sta. Utilities Real Estate Technology Consu. Discre.	

OVERALL ASIA: POSITIVE

Positive	Neutral	Negative
COUNTRY		
China Singapore South Korea Indonesia	Taiwan India, Thailand Malaysia Philippines	-
SECTOR		
Comms. Consu. Discre. Consu. Sta. Healthcare Technology Industrials	Energy Materials Real Estate ▲ Financials	▼ Utilities

- **We remain neutral on global equities, which we downgraded earlier than consensus since February 2022,** while awaiting further potential reduction in uncertainties (inflation, rising bond yields, monetary policies, war in Ukraine, energy crisis).
- **We continue to be defensive and recommend high dividend/buyback stocks**, while remaining **bullish on oil & gas**, which has been the best-performing equity sector in 2022 despite the recent correction.
- **We continue to recommend China exposure via A-shares given the gradually easing of covid restrictions and upcoming stimulus.**
- We upgraded Asian financials to neutral from negative as net interest margins will improve for banks amid monetary tightening.
- We downgraded Asian utilizes to negative from neutral as IPPs (independent power producers) are seeing upward costs pressure.

		1-month (%)	YTD (%)	2021 (%)	Forward PE (x)	Trailing PB (x)	Dividend Yield (%) 2022f	EPS Growth (%) 2022f	EPS Growth (%) 2023f	ROE (%) 2022f
Developed	US	-8.4	-21.7	25.2	16.4	3.8	2.2	9.5	9.7	22.0
	Japan	-2.9	-7.0	11.4	12.5	1.3	2.4	42.4	9.9	8.9
	Eurozone	-9.3	-20.3	20.1	11.5	1.5	3.4	13.3	5.4	11.5
	UK	-5.4	-0.5	15.0	10.1	1.7	3.9	16.4	-0.3	11.8
	Asia Ex-Japan	-5.1	-17.3	-6.4	12.4	1.6	3.1	9.6	11.2	11.6
North Asia	China	5.8	-11.0	-22.7	12.1	1.6	3.0	11.2	15.6	11.2
	China A-shares	9.6	-9.2	-5.2	16.4	2.9	1.6	17.0	15.6	11.3
	Hong Kong	0.9	-4.1	-5.9	14.5	1.2	3.2	9.7	16.4	8.4
	South Korea	-13.2	-22.5	-1.6	8.4	1.0	2.5	-0.1	7.7	13.4
	Taiwan	-13.2	-20.7	21.6	11.5	2.3	4.1	8.3	0.4	20.8
South Asia	India	-5.2	-10.4	27.3	19.4	3.4	1.8	17.6	14.1	14.6
	Indonesia	-7.7	2.0	1.5	13.9	2.6	3.1	28.0	5.6	16.9
	Malaysia	-7.8	-7.8	-7.3	13.5	1.5	4.1	-6.6	12.8	10.3
	Philippines	-9.4	-12.1	0.9	15.1	1.8	1.7	16.1	20.0	8.3
	Singapore	-1.7	0.4	9.8	15.7	1.3	4.2	52.2	24.5	8.8
	Thailand	-5.4	-2.8	7.1	17.1	2.2	2.6	19.9	12.4	9.4

Source: MSCI indices in local currency terms, Bloomberg, Datastream, BNP Paribas (WM), as of 30 June 2022

Fixed Income

POSITIVE NEUTRAL NEGATIVE

OVERALL GLOBAL: NEUTRAL		
Positive	Neutral	Negative
EMD (LC) EMD (HC) Short-term UST	US IG High Yield Long-term UST	-

OVERALL ASIA (USD): NEUTRAL		
Positive	Neutral	Negative
	India, China Philippines South Korea ▼ Hong Kong ▼ Indonesia	-

		Total Return (%)			Yield-to-Worst (%)
		1-Month	YTD	2021	
Asia	Asia USD Bond	-2.0	-10.8	-1.7	5.4
	Asia Local Currency Bond	-3.8	-11.7	-7.0	4.6
	China	-1.8	-10.2	-4.6	6.0
	Hong Kong	-1.6	-9.5	0.8	4.8
	India	-3.2	-10.6	3.2	6.9
	Indonesia	-3.6	-14.7	0.8	5.3
	Singapore	-0.9	-8.7	0.5	4.3
	South Korea	-0.8	-6.4	-0.3	3.9
	Philippines	-3.1	-13.2	-0.1	4.9
Other Regions	US 10-year Treasuries	-0.7	-8.5	-3.0	3.0
	US Investment Grades (IG)	-1.6	-10.3	-1.5	3.7
	US High Yield (HY)	-6.7	-14.2	5.3	8.9
	Emerging Market USD Bond	-2.3	-11.6	-2.8	6.5

Source: Barclays indices, Bloomberg, BNP Paribas (WM) as of 30 June 2022

US Treasury 12-month Yield Targets (%)	2Y	5Y	10Y	30Y
	▲ 3.25	▲ 3.25	▲ 3.25	▲ 3.25

- Following May's inflation print of 8.6%, the Fed aggressively hiked rates by 75bps hike by in the June FOMC. We now expect the central bank to further front-load the rate hikes this year with another **75bp hike in July, 50bp hike in September, followed by 25bps each for the November and December meetings.** We expect the Fed Funds rate at 3.5% by end-2022, which is also our expected terminal rate.
- For **ECB**, the guidance is clear for net purchases to end on 1st July, and for rates to lift off in the July meeting. We expect a 25bps rate hike in July, 50bps at the September and October meeting as high inflation persists, then back to 25bps rate hikes.
- Our 12-month targets for 2Y, 5Y, 10Y and 30Y US Treasury yield are revised up to 3.25% from 2.75%.
- We **prefer good quality short-duration DM investment grade bonds** as yields rise to attractive levels (4-5%) that we haven't seen since 2018 and default risks are low.
- We downgraded HK and Indonesia credit from positive to neutral. We concern that commercial and retail properties (typically account for good portion of HK companies' asset and recurring income), will be under pressured due to the border closures. Indonesian credits had weakened given the general risk-off environment but we expect the space to remain supported by flows away from China.

Forex & Commodities

POSITIVE NEUTRAL NEGATIVE

12-MONTH FOREX VIEW

Positive	Neutral	Negative
JPY EUR GBP AUD NZD CAD CNY SGD THB	HKD KRW TWD INR IDR MYR PHP	USD

COMMODITIES

Positive	Neutral	Negative
Gold Base metal	Oil	-

JPY continues its downward trend as the BoJ remains determined to control the yield curve at 0.25% for the 10-year bond despite the collapse of the yen by more than 18% since the beginning of the year. If BoJ allows rates to rise and if the Fed delivers less than expected, the interest rate differential with the United States could be lower over the near year, a bullish factor for the yen, albeit with moderate upside. **We change our 3-month target from 124 to 140 and 12-month target from 120 to 130.**

The downward revision of the economic growth outlook led us to revise our targets for commodity-related currencies. **Kiwi and Aussie** are moving away from our targets due to rising risks of a major global economic slowdown and lower demand in China. **We remain bullish on these currencies but revised our targets downwards.**

GOLD: Worries about war, inflation and growth should continue to support the demand for gold as a safe heaven, while rising real bond yields and the USD strength should be less obtrusive going forward. **A Fed pivot next year could boost the yellow metal. We expect gold to go back in the $1900-2100 range .**

OIL prices could spike higher as a progressive ban on Russian oil is discussed and as Chinese demand start to normalise post Covid lockdowns. However, a mix of demand destruction, higher non-OPEC production and Russia redirecting its exports **could help Brent prices ease in the $105-115 range at the end of 2022.**

BASE METALS: The short-term outlook is clouded by the recession fears but the balance of risks on the medium-term remains bullish due to the lack of investments in new mines, the risks of supply disruptions and the huge quantity of base metals needed for the energy transition

Forex Forecasts

		Spot	3-month		12-month	
		As of 14 July 2022	View	Target	View	Target
Developed	USD Index*	104.69	=	105.9	-	98.4
	Japan	135.9	=	140	+	130
	Eurozone	1.045	+	1.03	+	1.12
	UK	1.214	+	1.23	+	1.33
	Australia	0.688	+	0.74	+	0.74
	New Zealand	0.621	+	0.68	+	0.68
	Canada	1.290	+	1.25	+	1.25
Asia Ex-Japan	China	6.694	=	6.60	+	6.50
	Hong Kong*	7.847	=	7.85	=	7.85
	South Korea*	1,298	=	1,260	=	1,255
	Taiwan*	29.73	=	29.7	=	29.5
	India	78.97	=	78.0	=	80.0
	Indonesia*	14,898	=	14,500	=	14,800
	Malaysia*	4.408	=	4.39	=	4.30
	Philippines*	54.99	=	53.5	=	54.5
	Singapore*	1.392	=	1.38	+	1.32
	Thailand*	35.36	=	34.70	+	32.80

Source: BNP Paribas (WM) as of 14 July 2022
*BNP Paribas Global Markets forecast as of 14 July 2022

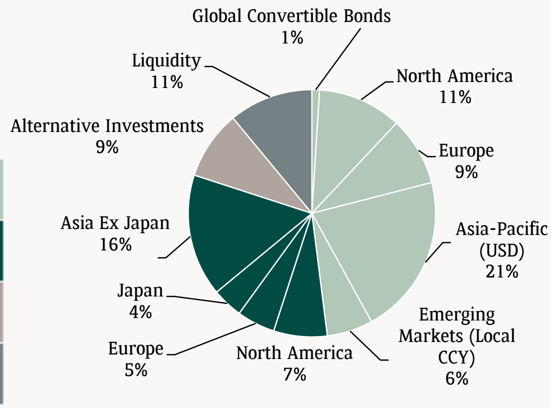
Note: + Positve / = Neutral / - Negative

Strategic & Tactical Asset Allocation

OUR TACTICAL ASSET ALLOCATION IS BASED ON OUR CIO'S ASSET ALLOCATION VIEWS. THERE IS NO CHANGE TO LAST MONTH'S ALLOCATION.

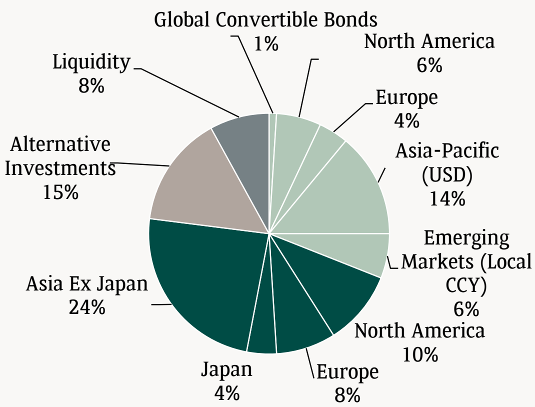
INVESTMENT PROFILE: BALANCED

	STRATEGIC ASSET ALLOCATION	TACTICAL POSITIONING	THIS MONTH'S TACTICAL ASSET ALLOCATION
FIXED INCOME	50%	-2%	48%
EQUITIES	30%	2%	32%
ALTERNATIVES	10%	-1%	9%
LIQUIDITY	10%	1%	11%



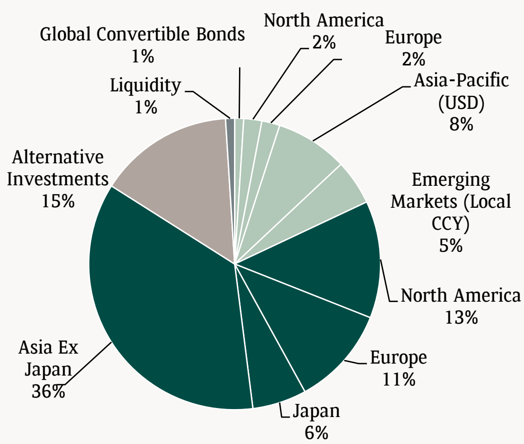
INVESTMENT PROFILE: DYNAMIC

	STRATEGIC ASSET ALLOCATION	TACTICAL POSITIONING	THIS MONTH'S TACTICAL ASSET ALLOCATION
FIXED INCOME	35%	-4%	31%
EQUITIES	45%	1%	46%
ALTERNATIVES	15%	-	15%
LIQUIDITY	5%	3%	8%



INVESTMENT PROFILE: VERY DYNAMIC

	STRATEGIC ASSET ALLOCATION	TACTICAL POSITIONING	THIS MONTH'S TACTICAL ASSET ALLOCATION
FIXED INCOME	20%	-2%	18%
EQUITIES	65%	1%	66%
ALTERNATIVES	15%	-	15%
LIQUIDITY	0%	1%	1%



Source: MyAdvisory, as of 8 July 2022
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