FPA Financial

Investment Committee Policy Summary

September 2022

F·P·A

Economy / Stock Market / Bond Market/ Currency Outlook

Q2 GDP fell by 0.6% qoq saar

- US GDP fell by 0.6% qoq seasonally adjusted annualised rate (saar) in Q2 2022, an upward revision from the initiate estimate of a 1.5% contraction. Consumer spending increased at a revised rate of 1.5% from an initial estimate of 1.0% in the second quarter, which reduced some of the drag from a sharp slowdown in inventory accumulation, dispelling fears that a recession was underway. In the first quarter of 2022, real GDP contracted at a 1.6% rate.

- However, the revised GDP figures offered evidence that the housing market is struggling under the weight of rising borrowing costs. Residential investment contracted at a 16.2% pace in the second quarter, worse than the initially estimated 14% decline, according to the Commerce Department

- Most financial institutions have revised their 2022 GDP projections downwards highlighting that persistent geopolitical tension could push commodity prices still higher & delay supply chains, taking inflation up and growth down.

- For 2022, the US economy is expected to expand by between 1.10% and 2.30% while growth in 2023 is expected to be between -0.40% and 1.30%, as shown in **Exhibit 1** on the next slide.

GDP Forecast By Various Institutions

Exhibit 1: US GDP Forecast for 2022 and 2023

	2022F	2023F
IMF (July)	2.30%	1.00%
EIU/ Economist (Jul-22)	2.30%	1.30%
SMBC (Aug-22)	1.10%	0.00%
Bank of America (Aug-22)	1.30%	-
Conference Board (Aug-22)	1.30%	0.20%
Bank of Singapore (Aug-22)	1.60%	0.80%
Citi (Aug-22)	1.60%	0.70%
Wells Fargo (Aug-22)	1.70%	-0.40%
DWS (Aug-22)	1.90%	0.70%
DBS (Aug-22)	2.00%	1.30%

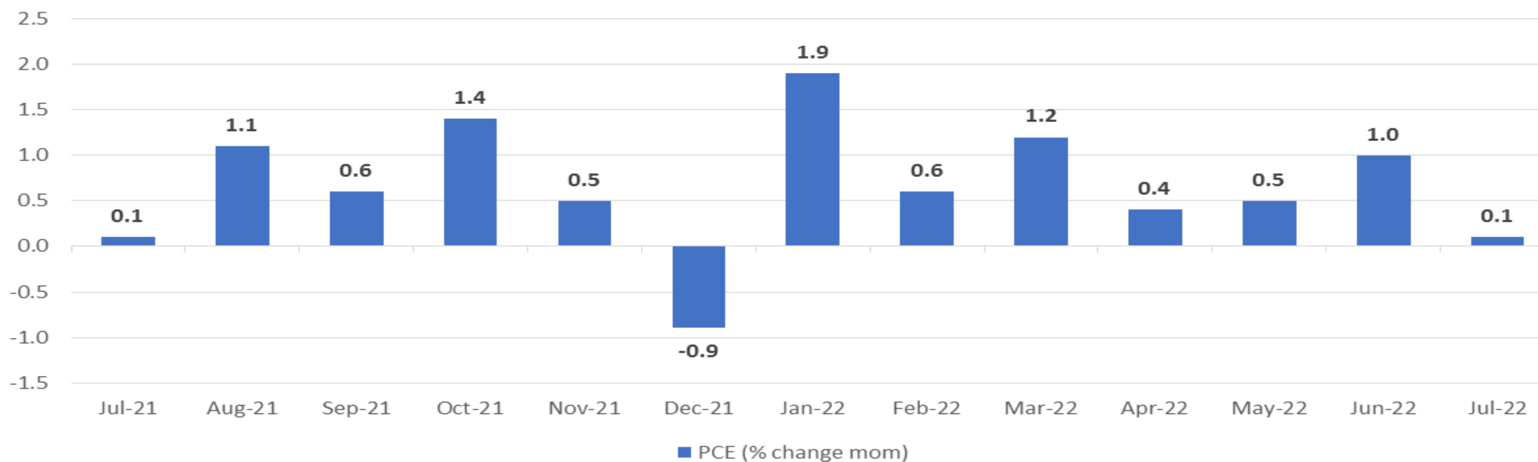
Source: Respective financial institutions

Consumer Spending Inched Forward by 0.1% mom in July

- Consumer spending growth, a key engine of the economy, increased modestly in July as Americans withstood historically high inflation and rising interest rates. U.S. households boosted their spending at a seasonally adjusted 0.1% pace in July from the month before, compared to a revised 1.0% rate in June, as shown in **Exhibit 2**.

- Americans spent less on gasoline last month, a reflection of lower prices at the pump. They slowed their outlays for services, and continued to spend money on long-lasting goods such as cars. Consumers have become more cautious in recent months as they have faced economic disturbances, including supply-chain disruptions and rising interest rates that make mortgages and car loans more expensive. Inflation has cooled slightly but held near historic highs, triggering many Americans to adjust their spending habits. Still, consumers continue to spend more each month, a sign that wage growth and pandemic savings are helping them to endure higher prices

Exhibit 2: US Monthly Personal Consumption Expenditures (% change mom)



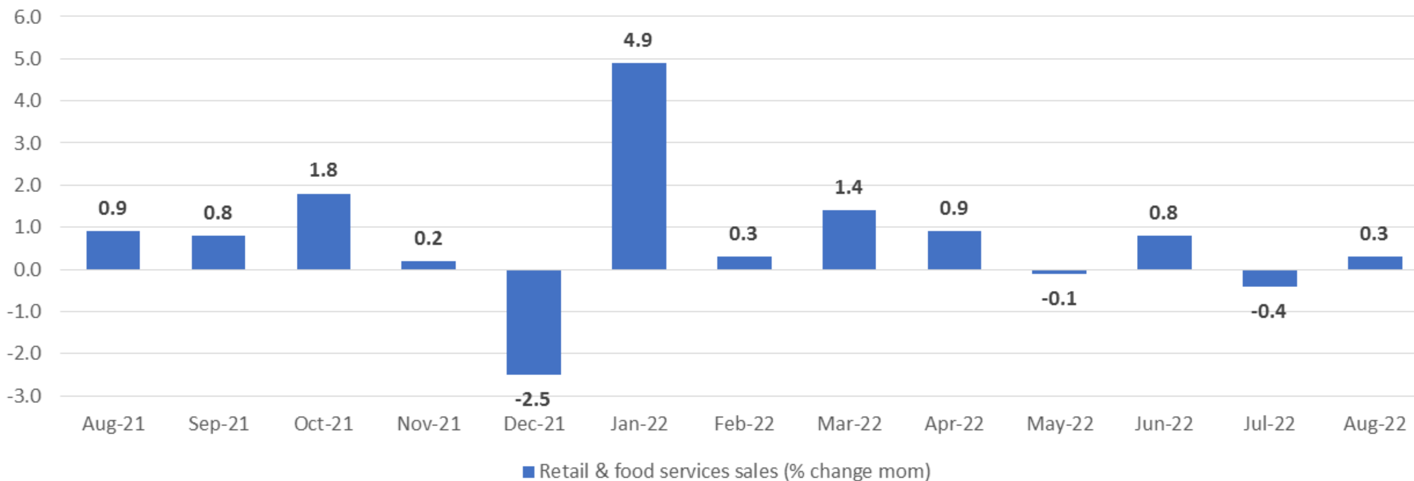
Source: Data compiled from BEA

Retail Sales Rose Slightly in August

- Retail sales—a measure of spending at stores, online and in restaurants — rose by 0.3% in August compared with the previous month. The gain outpaced inflation and marked a reversal from July's 0.4% decline as shown in **Exhibit 3**. Broadly, consumers are able to increase their spending a bit, when factoring in rising prices. Shoppers had some additional wiggle room in August because of falling gasoline prices.

- August's retail spending growth was led by a 3% gain in auto dealership sales. Spending at bars and restaurants, the only services category in the retail sales report, increased by 1.1% in August—showing consumers are eager to dine out despite increased menu costs. In addition, Sales at department stores, clothing stores and sporting goods stores all picked up in August, a key month for back-to-school spending.

Exhibit 3: US Monthly Retail And Food Services Sales (% change mom)



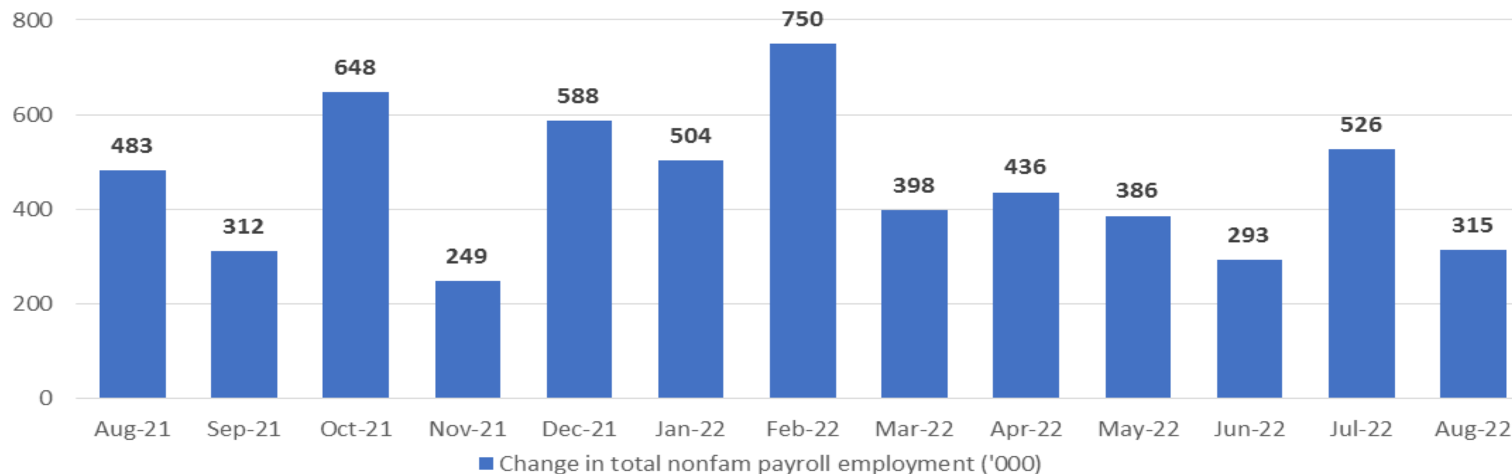
Source: Data compiled from Department of Commerce

US Labor Market Cooled Slightly in August

- According to the Labor Department, employers added 315,000 new jobs in August, a robust increase but down from a gain of 526,000 in July, as shown in **Exhibit 4**. August's deceleration marked a pullback from robust gains that characterized much of the past two years. Still, job growth remained well above the prepandemic trend.

- Professional and business services led payroll gains with 68,000, followed by health care with 48,000 and retail with 44,000. Leisure and hospitality, which had been a leading sector in the pandemic-era jobs recovery, rose by just 31,000 for the month after averaging 90,000 in the previous seven months of 2022. Manufacturing rose 22,000, financial activities gained 17,000 and wholesale trade increased by 15,000.

Exhibit 4: US monthly change in nonfarm payroll employment (in thousands)



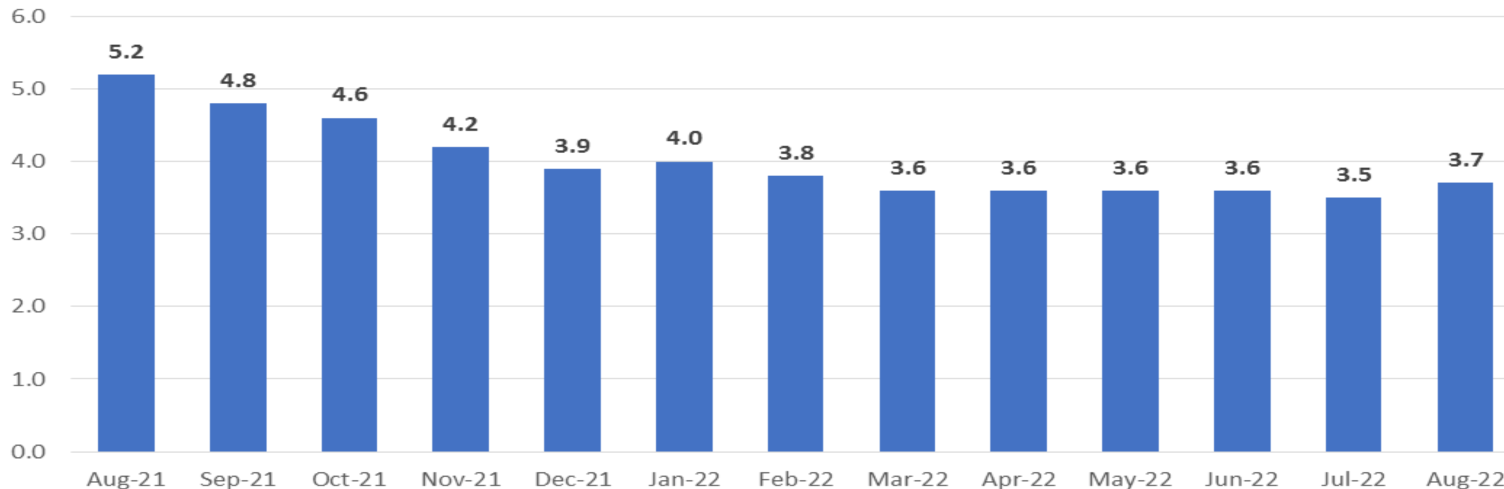
Source: Data compiled from Department of Labour

US Unemployment Rate Rose to 3.7% in August

- The unemployment rate rose to 3.7% in August from 3.5% the prior month, as shown in **Exhibit 5**. The increase in the unemployment rate reflected more workers entering the labor force. The share of adults working or seeking a job rose to 62.4% in August from 62.1% in July, as participation among women ages 25 to 54 jumped to the highest level since 2000.

- The rise in labor-force participation—along with other signs such as lower average weekly hours worked—suggested employers are finding it easier to hire. That could help ease wage pressures in the coming months. Average hourly earnings rose by 5.2% in August from a year earlier, in line with the previous month and down from a recent peak of 5.6% in March. Wages rose by 0.3% in August from a month earlier, down from July's increase.

Exhibit 5: US Monthly Unemployment Rate (%)



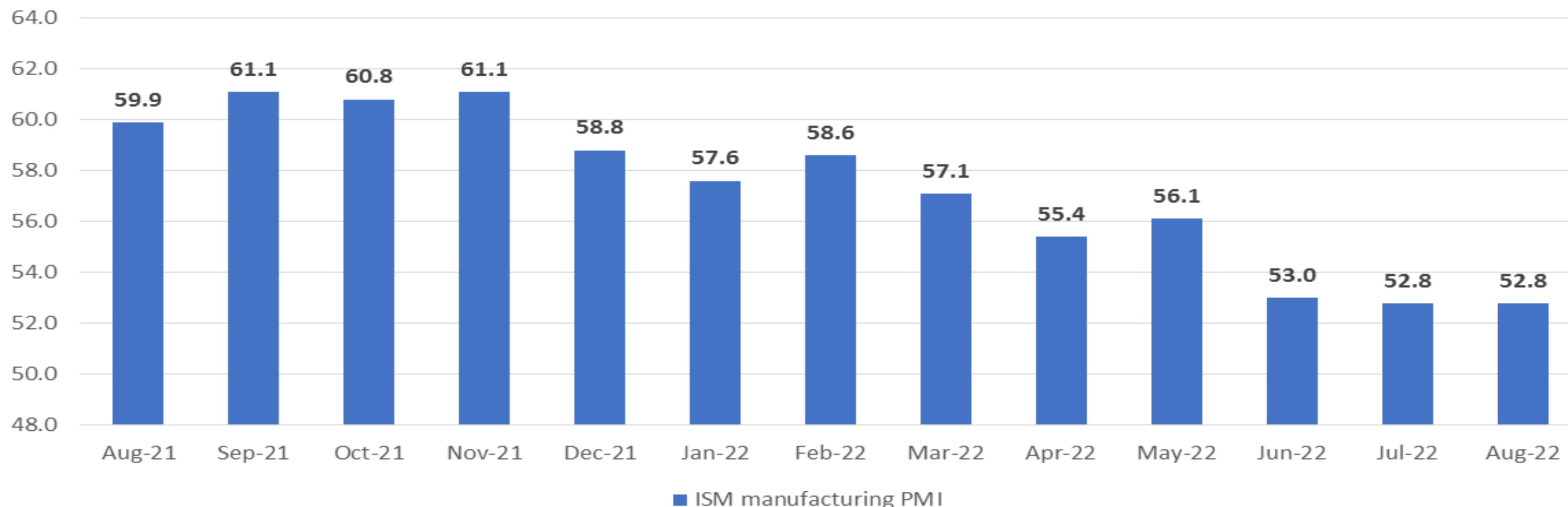
Source: Data compiled from Department of Labour

Manufacturing Activity Expanded for the 27th Month in August

- According to the Institute for Supply Management, the index of manufacturing activity remained flat at 52.8, a level it has now stuck at for three months, as shown in **Exhibit 6**. That suggests that the loss of economic momentum seen earlier in the year is flattening out and is still solidly above 50—the dividing line between growth and contraction

- According to Timothy Fiore, chair of ISM's Manufacturing Business Survey Committee, prices expansion eased dramatically in August, which — when coupled with lead times easing — should bring buyers back into the market, improving new order levels. He added that companies continued to hire at strong rates in August, with few indications of layoffs, hiring freezes or head-count reductions through attrition

Exhibit 6: ISM Monthly Manufacturing PMI



Source: Data compiled from ISM

Housing Market Cooled In July

- U.S. existing home sales fell in July for the sixth straight month, the longest streak of declines in more than eight years, as higher mortgage rates and a shortage of homes for sale are cooling the property market.
  - According to the National Association of Realtors (NAR), existing-home sales fell by 5.9 % in July from the prior month to a seasonally adjusted annual rate of 4.81 million, the weakest pace of sales since November 2015, excluding the three-month pandemic-related drop in the spring of 2020. July sales tumbled 20.2% from a year ago. The median sales price of an existing home fell to $403,800 from a record $413,800 in June, the first decline since January, according to NAR.
  - The average 30-year mortgage rate stood at 5.13%, well above the 2.86% rate of a year ago according to Freddie Mac. Before this year, mortgage rates hadn't topped 5% since 2011.
  - Housing starts, a measure of U.S. home-building, fell by 9.6% in July from June and residential permits, which can be a bellwether for future home construction, dropped by 1.3%
- Sales of new U.S. single-family homes plunged to a 6-1/2-year low in July as persistently high mortgage rates and house prices further eroded affordability.
  - The Commerce Department reported that new home sales tumbled in July by a seasonally adjusted 12.6% from June, and 29.6% below the same period a year ago. The median sales price of new houses sold in July 2022 was $439,400. There were 464,000 new homes on the market at the end of last month, the most since March 2008 and up from 450,000 units in June. This represents a supply of 10.9 months at the current sales rate.

Budget Deficit Narrowed by 65% yoy in August

- The federal government ran a deficit of $220 billion in August, a shortfall that widened compared with the year before as spending grew faster than revenue collection last month.

- The government spent $523 billion last month, a $84 billion increase that largely reflected calendar differences in how payments were distributed in August 2021. Government revenues were $304 billion, a $35 billion increase. Adjusted for calendar differences, the deficit in August of this year and August of last year were roughly the same, the Treasury Department said in its monthly budget statement.

- The wider monthly deficit comes as the gap between government revenue and spending has narrowed dramatically this year. Through the first 11 months of the federal fiscal year, the deficit has shrunk by almost $1.8 trillion, a 65% decline.

- Though the fiscal year is almost over, the size of the annual deficit is uncertain. The nonpartisan Congressional Budget Office said in its own estimates this month that President Biden’s move to cancel at least $10,000 of student debt from some borrowers could increase spending in September beyond their projections.

- Absent new spending on student loan relief, CBO said the deficit was on track to be $1 trillion for the fiscal year, a drop from the $2.8 trillion gap last year. The shrinking deficit is due to two factors: much lower government spending after the end of major pandemic relief spending and higher tax revenues.

Strong fiscal stimulus to support growth

Inflation Reduction Act

- WSJ reported that President Biden signed the Inflation Reduction Act (IRA) into law to lower prescription drug prices, boost the renewable energy sector and impose new taxes on large corporations.

- The key provision in the IRA includes

  - **Creation of a 15% corporate minimum tax rate**: Corporations with at least $1 billion in income will have a new tax rate of 15%. Taxes on individuals and households won't be increased. Stock buybacks by corporations will face a 1% excise tax.

  - **Prescription drug price reform**: The Inflation Reduction Act will allow Medicare to negotiate the price of certain prescription drugs, bringing down the price beneficiaries will pay for their medications. Medicare recipients will have a $2,000 cap on annual out-of-pocket prescription drug costs, starting in 2025.

  - **Affordable Care Act (ACA) subsidy extension**: Currently, medical insurance premiums under the ACA are subsidized by the federal government to lower premiums. These subsidies, which were scheduled to expire at the end of this year, will be extended through 2025. Approximately 3 million Americans could lose their health insurance if these subsidies weren't extended, according to the U.S. Department of Health and Human Services.

  - **Energy security and climate change investments:** The bill includes numerous investments in climate protection, including tax credits for households to offset energy costs, investments in clean energy production and tax credits aimed at reducing carbon emissions.

Strong fiscal stimulus to support growth

Inflation Reduction Act

Exhibit 7: Breakdown of Inflation Reduction Act

Policy	Cost (-)/ Savings (2022-2031)
Energy and Climate	**-$391 billion**
Clean Electricity Tax Credit	-$161 billion
Air Pollution, Hazardous Materials, Transportation and Infrastructure	-$40 billion
Individual Clean Energy Incentives	-$37 billion
Clean Manufacturing Tax Credits	-$37 billion
Clean Fuel and Vehicle Tax Credits	-$36 billion
Conservation, Rural Development, Forestry	-$35 billion
Building Efficiency, Elecrification, Transmission, Industrial, DOE Grants and Loans	-$27 billion
Other Energy and Climite Spending	-$18 billion
Health Care	**-$108 billion**
Extension of Expanded ACA Subsidies (three years)	-$64 billion
Part D Re-Design, LIS Subsidies, Vaccine Coverage, Insulin	-$44 billion
Total, Spending and Tax Breaks	**-$499 billion**
Health Savings	**$281 billion**
Repeal Trump-Era Drug Rebate Rule	$122 billion
Negotiation of Certain Drug Prices	$96 billion
Drug Price Inflation Cap	$63 billion
Revenue	**$457 billion**
15 Percent Corporate Minimum Tax	$222 billion
IRS Tax Enforcement Funding	$101 billion
1 Percent Excise Tax on Stock Buybacks	$74 billion
2-Year Extension of the Limitation on Excess Business Losses	$53 billion
Methane Fee, Superfund Fee, Other Revenue	$07 billion
Total, Savings and Revenue	**$738 billion**
Net Deficit Reduction	**$238 billion**

Figures may not sum due to rounding.

Source: The Congressional Budget Office

- By the Congressional Budget Office's (CBO) estimates, the legislation includes $738 billion of offsets to fund roughly $499 billion of new spending and tax breaks as shown in **Exhibit 7**.
- The legislation is estimated to reduce deficits by $238 billion over a decade, including by more than $61 billion in 2031 before interest.

Strong fiscal stimulus to support growth

CHIPS and Science Act

- President Biden signed the bipartisan Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act of 2022 to tackle some of the biggest manufacturing and innovation challenges. The Act will invest $50 billion through the Department of Commerce's CHIPS for America Fund to revitalize the domestic semiconductor industry, protect American national and economic security, preserve U.S. leadership in the industries of the future, create good-paying jobs, and build strong communities in the United States.

- The Department of Commerce has identified four strategic goals for the CHIPS for America Fund:

  - Invest in U.S. production of strategically important semiconductor chips, particularly those using leading-edge technologies.

  - Assure a sufficient, sustainable, and secure supply of older and current generation chips for national security purposes and for critical manufacturing industries.

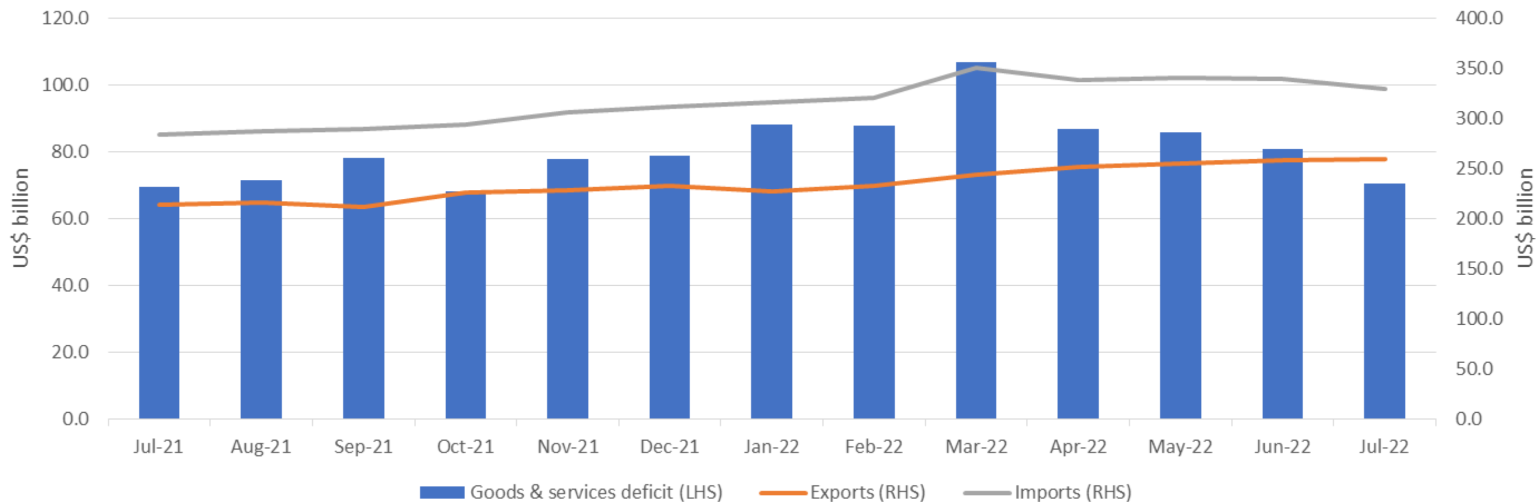
  - Strengthen U.S. semiconductor research and development (R&D) leadership to catalyze and capture the next set of critical technologies, applications, and industries.

  - Grow a diverse semiconductor workforce and build strong communities that participate in the prosperity of the semiconductor industry.

Trade Deficit Narrowed in July

- The trade gap in goods and services fell by 12.6% in July from the prior month to a seasonally adjusted $70.65 billion, the Commerce Department said, retreating from a record $80.88 billion deficit the prior month as shown in **Exhibit 8**.
- Imports fell 2.9% to $329.94 billion in July, reflecting declines in American purchases of consumer goods and industrial supplies. Exports grew 0.2% to $259.29 billion in July from the prior month, helped largely by higher shipments of capital goods like computers and industrial machinery.
- Although the U.S. trade deficit has narrowed in recent months, it remains wide by historical comparison, reflecting the strength of the U.S. economy compared with other major economies.

Exhibit 8: US Monthly Goods And Services Deficit, Exports And Imports (in US$ billion)



US Economy: Summary of our views

- We believe recent economic indicators suggest that the economic recovery has slowed. The US economy contracted by 0.6% qoq saar in the second quarter as strong consumer spending failed to offset the struggling housing market, under the weight of rising mortgage cost. Most financial institutions have revised their full year forecast downwards and projected annual growth of between 1.10% and 2.30% for 2022 and -0.4% and 1.30% for 2023.

- Consumer spending, a key engine to economic growth rose modestly by 0.1% mom for a seventh straight in July as consumers have become more cautious in recent months as they have faced economic disturbances, including supply-chain disruptions and rising interest rates that make mortgages and car loans more expensive. Retail sales rose by 0.3% mom in August as consumers spent at stores and restaurants at a steady pace last month, showing persistent demand despite high inflation.

- The US job growth cooled slightly in August as the economy added 315,000 jobs, a robust increase but down from a gain of 526,000 in July. Meanwhile, the unemployment rate increased to 3.7% in August from 3.5% the prior month and the labor-force participation rate rose to 62.4% in August from 62.1% in July.

- The manufacturing Purchasing Manager's Index (PMI) expanded for the 27th month in a row in August and remained flat at 52.8, a level it has now stuck at for three months, suggesting that the loss of economic momentum seen earlier in the year is flattening out.

- Sales of previously owned homes and new homes declined 5.9% and 12.6% mom respectively as higher interest rates and the shortage of homes for sale reduced buyer demand. Further, with more rate hikes expected in 2022, mortgage rates could continue to rise, which could deter buyers.

US Economy: Summary of our views

- Meanwhile, even though US trade deficit narrowed in July, shrinking 12.6% for the month, the trade deficit remains large compared with prepandemic levels.

- The federal government ran a deficit of $220 billion in August bringing the deficit this fiscal year to US$945.7 billion, 65.1% lower than the US$2.7 trillion deficit the government ran during the same period last year. The government spent $523.3 billion last month, a $84 billion increase and revenues were $303.7 billion, a $35 billion increase.

- Mr Biden signed an approximately US$738 billion Inflation Reduction Act aiming to lower deficit, make historic investments into clean energy and hold the top 1% accountable and a CHIPS & Science Act which will invest $50 billion to revitalize the domestic semiconductor industry. This could provide a boost to jobs and economic growth in the US

- Considering the above, barring a significant deterioration in the geopolitical tension between Russia & Ukraine and China & Taiwan, we are neutral on US economic outlook.

US Equities

- Over the period from 01.07.22 to 16.09.22, the DJIA fell by 0.88% to 30,822.42, the S&P 500 rose by 1.25% to 3,873.33 and the NASDAQ rose by 2.88% to 11,448.40. During the period, the Fed raised interest rates in July by 75bps and is expecting more interest rate hikes for the rest of 2022. The US economy contracting for the second consecutive quarters also weighed on sentiments.

- Latest data provided by MSCI as at 31.08.22 show that MSCI US index was trading on a forward PE of 17.26x, higher than Factset's calculation of S&P 500 10 year-annual PE multiple of 17.00x as at 09.09.22. At the same time, MSCI US index's current PB multiple of 4.00x is also higher than JP-Morgan's calculation of S&P 500 long term average trailing PB multiple of 3.00x as at 30.06.22.

- According to Factset, analysts have been more pessimistic in their revisions to earnings estimates for S&P 500 companies for the third quarter compared to recent quarters, while companies have been slightly less pessimistic in their earnings outlooks for the third quarter compared to recent quarters. However, both analysts and companies have been more pessimistic in terms of earnings expectations for Q3 compared to recent averages

- More S&P 500 companies have issued negative EPS guidance for Q2 2022 compared to recent quarter. As at 09.09.22, 103 companies in the index have issued EPS guidance for Q3 2022, Of these 103 companies, 63 have issued negative EPS guidance and 40 have issued positive EPS guidance. The number of S&P 500 companies issuing negative EPS guidance for Q3 2022 (63) is lower than the numbers for Q1 2022 (68) and Q2 2022 (72), but higher than the 5-year average (58).

US Equities

- According to a recent Factset report, in terms of estimate revisions for companies in the S&P 500, analysts have lowered earnings estimates for Q3 2022 by a larger margin compared to recent quarters and the 5-year average. On a per-share basis, estimated earnings for the third quarter have decreased by 5.5% since June 30. This is the largest decline in the quarterly EPS estimate for a quarter since Q2 2020. This decrease is also larger than the 5-year average of -2.3%.

- The estimated year-over-year earnings growth rate for Q3 2022 is 3.7% as shown in **Exhibit 9**, which is below the 5-year average earnings growth rate of 14.8% and below the 10-year average earnings growth rate of 8.9%. If 3.7% is the actual growth rate for the quarter, it will mark the lowest (year-over-year) earnings growth rate reported by the index since Q3 2020 (-5.7%).

Exhibit 9: Factset's Earnings and Revenue Growth for S&P500

Period	Earnings growth (%)	Revenue growth (%)	Period	Earnings growth (%)	Revenue growth (%)
Q4 2021 (actual)	31.2%	16.1%	Q4 2022 (expected)	4.8%	6.5%
CY 2021 (actual)	47.7%	16.5%	CY 2022 (expected)	7.9%	10.8%
Q1 2022 (actual)	9.2%	13.6%	Q1 2023 (expected)	7.4%	6.3%
Q2 2022 (Actual)	6.2%	14.0%	Q2 2023 (expected)	6.3%	3.6%
Q3 2022 (expected)	3.7%	8.8%	CY 2023 (expected)	8.2%	4.5%

Source: Complied using data from Factset

US Equities

- Financial institutions have mixed forecasts on the direction of the stock markets. The S&P 500 targets for FY2022 range from 3,400 to 4,800. The S&P 500 was trading at 3,873.33 points as at 16 September 2022. Given those targets, the implied returns for FY2022 would be between -12.2% and 23.9%.

DWS, BOS, Goldman Sachs and UBS are neutral on US equities

- **DWS**
  - DWS lowered its oil targets, but raised Energy profits on profit beats in 2Q relative to oil prices. DWS September end 2023 S&P 500 target is 4200 with little return potential from current levels.
  - DWS is still worried about unrealistically high S&P EPS expectations for 2023. Corporate margins are likely to suffer, at least a little, not only because they are at record highs now with immediate cyclical risks, but also because of wage, tax, regulation pressures ahead and lingering input cost pressures.
  - The extraordinary USD-strength will add additional earnings pressure to US multinationals, with the negative currency impact doubling from Q1 to Q2. DWS keeps its 2023E S&P EPS at $235, but added $5 worth of S&P EPS to 2023E Energy earnings.
  - DWS prefers Health Care with its profits supported by innovation in medicine and medical devices. Utilities are an attractive bond substitute with non-cyclical and inflation protected dividend yields. DWS likes Banks as we don't expect a surge in credit costs. DWS also likes Communications given its role in digitalization and virtualization and that valuations acknowledge pricing and investment pressures from competition and disruption risks

US Equities

- **BOS**
  - BOS noted that the US earnings season is well underway; corporate results are somewhat mixed though beating earnings per share (EPS) estimates on average. Under the hood, firms are undoubtedly facing macro headwinds, which is translating into concerns such as potential CAPEX cuts and elongated sales cycles.
  - Companies across sectors are also feeling the impact from the strong US dollar. The US economy has also entered a technical recession in the first half of the year, though the economy is not (yet) experiencing a broad-based, sustained contraction in activity. Still, BOS believes investor expectations have also been suitably calibrated, given that a number of these headwinds are well-understood by the market.
  - While it believes that the S&P 500 Index has already worked through a significant part of the peak-to-trough downside in light of the front-loading of rate hikes, inflationary pressure remains one of the key factors in determining the ability for the market to stage a sustained recovery from here

- **Goldman Sachs**
  - Goldman Sachs believes that the economy will be able to avoid a recession this year. But if a downturn does happen, he warns there's a lot more pain ahead for the stock market
    - Assuming there's no recession: The S&P 500 will end the year at 4300.
    - Assuming there’s a recession this year: The S&P 500 will end the year at 3150, that'd be more than the average S&P 500 drop of 30% in recessions going back to 1947

US Equities

- **UBS**
  - UBS noted that with rates likely to stay higher for longer, its base case is for further volatility, earnings downgrades, and higher-than-expected default rates over the course of the next year. UBS's price target for the S&P 500 in June 2023 is 4,200
  - Meanwhile, uncertainty remains high over the course of inflation, energy prices, the war in Ukraine, and economic policy in China, so investors should remain alert to the risk of more adverse scenarios. It sees this as a time to be selective in equities.
  - UBS recommend investors to be selective in long-term growth. Growth stocks remain sensitive to changing expectations around inflation and interest rates, and so UBS advocate selectivity within growth at this stage.
  - UBS recently opened a new theme focused on the "circular economy" discussing the investment opportunity in waste management and collection (recycle), plastics (reduce), and resale as a service (reuse). It thinks companies embracing 'circularity' stand to benefit from changing regulation, shifting consumer preferences, resource scarcity and cost pressures, and technological innovation

US Equities

HSBC and JPMorgan are positive on US equities

- **HSBC**
  - The Bank maintained its positive outlook on US equities, noting that US equities are vulnerable to earnings downgrades but the market has cheapened and that means that prospective Sharpe ratio are now higher. Exposure to quality names, mega-cap tech and digital economy is part of a defensive asset allocation

- **JPMorgan**
  - JPMorgan noted that 2022 has been a challenging year for equity markets, as the macroeconomic picture continues to be characterized by slower growth, persistent inflation, as well as tighter monetary and fiscal policy. Earnings will remain the primary driver of returns.
  - However, the bottom line is that recession risks are rising and markets are in the process of pricing this in. At the same time, however, forward earnings estimates are still too high, leading some to believe that markets could see a significant decline as profit forecasts are revised lower.
  - JPMorgan prefer sectors with operating leverage – materials, energy, and consumer staples – but also structural growth stories like technology and healthcare, which are looking more attractively valued following the sell-off seen during the first half.
  - It was also recently reported that JPMorgan reiterated its year-end price target of 4,800 for the S&P 500.

US Equities

However, Bank of America and Morgan Stanley are negative on US equities

- **Bank of America (BofA)**
  - According to BofA, there's no ground for celebration: even as sentiment showed an improvement for the full month, optimism has diminished following Aug. 26's hawkish commentary from Federal Reserve Chair Jerome Powell. "Improved sentiment, especially following a 17% rally off the June lows, suggests the bulls haven't fully capitulated yet," BofA said
  - Bank of America's head of US equity and quantitative strategy, wrote in a note to clients. "We still see no real signs of a bull market and maintain our 3,600 year-end target on the S&P 500."

- **Morgan Stanley**
  - Morgan Stanley noted that investors should brace for more pain as US stock indexes haven't yet hit bottom for the year.
  - Morgan Stanley views S&P500 reaching 3,400 for the growth recession or soft landing scenario, and in a worst case scenario, a "proper recession" would bring the index somewhere close to 3,000.
  - Morgan Stanley believes that P/E multiple is wrong not because the Fed is going to be hawkish, but because the equity market is being too optimistic about the earnings outlook. Morgan Stanley believes the multiples will start to come down as earnings get cut and then somewhere in the middle of that earnings cut process the market will bottom probably between September and December

US Equities

- We have summarized the S&P 500 targets from various financial institutions as shown in **Exhibit 10**.

Exhibit 10: 2022 S&P 500 Index Target

Financial Institutions	S&P 500 target	
	2022	Expected returns****
Current S&P 500 as at 16.09.22	3925	-
Morgan Stanley	3400	-12.2%
Bank of America	3600	-7.1%
DWS*	4200	8.4%
UBS**	4200	8.4%
Goldman Sachs***	4300	11.0%
JPMorgan	4800	23.9%

**Next twelve months target (Sep 2023)*

*** Jun 2023 forecast*

**** Assuming no recession*

*****Based on closing price as at 16.09.22*

Source: respective financial institutions, Bloomberg, Yahoo Finance

US Equities

There are also downside risks that could have a negative impact on the stock market

- The Inflation Reduction Act could hurt corporate earnings
  - As discussed on slide 12, the Inflation Reduction Act has two major tax provisions, both of which apply to corporations: A 15% minimum tax for companies with more than $1 billion of book income per year, and a 1% excise tax on stock buybacks.
  - The Joint Committee on Taxation estimated that up to about 150 companies could be affected. A little less than half of the assumed-to-be-effected companies are in growth sectors like Tech, Consumer Discretionary, and Communication Services; Healthcare accounts for about a third. Those sectors may feel earnings per share headwinds to the tune of 1-2%.
  - JPMorgan estimates that with the implementation of the Inflation Reduction Act, 1% excise tax on share buybacks along with the revised 15% corporate minimum tax would subtract 3% from S&P 500 earnings growth in 2023, with the corporate minimum tax accounting for 2.6 percentage points of the total 3% reduction.
  - On the corporate minimum tax, Goldman Sachs believes that the bill would lower S&P 500 per-share earnings by 1% in 2023, with health-care and technology companies—which have low effective tax rates—being most affected. On the tax on share buybacks, Goldman Sachs see this provision, which would make companies pay a 1% tax when they repurchase their own shares, shaving off 0.5% from S&P 500 earnings given the pace of buybacks stays consistent.

US Equities

- Geopolitical risks
  - Russia-Ukraine conflict
    - WSJ reported that Russia's invasion of Ukraine this year has roiled global energy markets and caused food shortages in some parts of the world. The disruptions could intensify during the winter, with soaring energy costs causing a recession in Europe and weakening the economies of the United States and many other nations. A broader and more devastating conflict remains possible.
  - China-Taiwan tension
    - House Speaker Nancy Pelosi's recent visit to Taiwan enraged China's communist government, which has launched missiles over the island and conducted threatening military exercises meant to remind the world that China plans to annex Taiwan someday, whether peaceably or by force. If that involved armed conflict, it would probably cause more damage to the world economy and global markets than any military confrontation since World War II.
    - It was reported that the US Senate recently advanced a bill that will be directly providing billions of dollars in military aid to Taiwan and making ties more official, ramping up support following soaring tensions with Beijing. The new legislation will involves US security assistance of US$4.5 billion over four years, a step sure to infuriate Beijing. It also lays out sanctions on China if it uses force to try to seize the island.
    - WSJ reported that the Rand research organization estimates that a war involving China and the United States would slice 5% off the $23 trillion U.S. economy, that would be the biggest blow to American prosperity since the Great Depression in the 1930s. In 2009, amid the Great Recession, U.S. gross domestic product dropped by just 2.6%. The S&P 500 stock index bottomed out in 2009 55% below its prior peak, which might be a mere taste of the losses investors could expect from a U.S.-China war
    - Overall, the high uncertainty to the geopolitical tensions would weigh on investors' sentiments

US Equities

- Rising inflation concerns
  - As seen over the last few months, rising inflation concerns have weighed on sentiments in the stock markets. Technology stocks in particular had corrected as investors pivoted to cyclical and value names that are likely to benefit from the rising oil prices.
  - Recent indicators suggest that prices have remained high, largely owing to supply shortages, China lockdowns and the Russia-Ukraine war. Federal Reserve (Fed) officials also recently signalled that it would continue lifting rates this year at the most rapid pace in decades to fight inflation that is running at a 40-year high.

- Slower economic growth
  - As mentioned on slide 3, the US economy fell at an annualized rate of 0.6% in Q2 2022. Many financial institutions have also revised their GDP growth forecast downwards due to persistent inflation and rising hawkishness by the Federal Reserve. There is a possibility that consumers and businesses may cut their spending. This may negatively impact companies' profitability and weigh on investors' sentiments

- Mid-term elections
  - Mid-term elections in November may also add uncertainties to the US equities market. The Democrats face the possibility of losing their (slight) majority in one or both chambers, which could result in policy gridlock. Therefore, there is a possibly that there would be lesser fiscal spending after the US midterm elections, which could slow the US economy.
  - Further, the Supreme Court's recent decision to overturn the 1973 landmark decision (Roe v. Wade) that had recognized a woman's right to an abortion, has increased tensions among Americans and may prove to reflect badly on the Democrats.
  - Bloomberg also reported that since 1950, the S&P 500 has averaged an intra-year pullback of 17.1% in mid-term election years

US Equities: Summary of our views

- We are currently neutral on US equities. The three indices were mixed since our last Asset Allocation meeting as DJIA fell by 0.88% while S&P and NASDAQ rose by 1.25%% and 2.88% respectively. During the period, local and foreign developments weighed on investors' sentiments. Local developments include, the contraction in the Q2 GDP of 0.6% qoq saar, rising inflation concerns and a hawkish Fed, while foreign developments include prolonged Russia-Ukraine war, China-Taiwan tensions and the lockdown measures in China.

- According to latest data provided by MSCI, the MSCI US Index is currently trading on a forward PE multiple of 17.26x, higher than Factset's calculation of S&P 500 10-year PE multiple of 17.00x. Similarly, the current PB multiple of 4.00x is also higher than JP-Morgan's calculation of S&P 500 long term average trailing PB multiple of 3.090x.

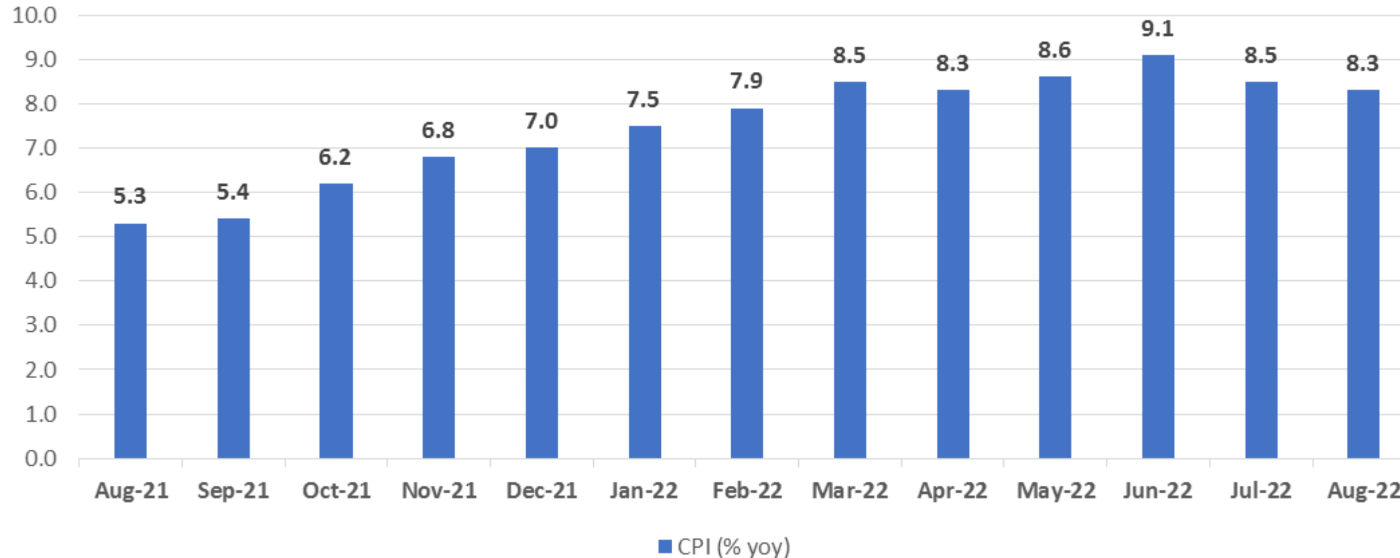
- Financial institutions have mixed forecasts on the direction of the stock markets with S&P targets ranging from 3,400 to 4,800.

- We are also mindful that there are risks to the stock markets. The recently signed Inflation Reduction Act and a slower economic growth could weaken earnings growth and lower the attractiveness of equities. The uncertainties relating to the duration & the extent of Russia-Ukraine war could exacerbate Covid-19 supply chain backlogs and the China-Taiwan tension could weigh on investors' sentiments. Inflation remains high and the Fed may continue its hawkish stance for the rest of the year. With more interest rate hikes, US equities, especially the technology stocks may undergo another correction. Lastly, the results of the upcoming midterm elections in November 2022 could also inject volatility into the stock market

US CPI Remained high in August

- U.S. consumer prices overall rose more slowly in August from a year earlier, but increased sharply from the prior month after excluding volatile food and energy prices, showing that inflation pressures remained strong and stubborn.
- The Labor Department reported its consumer-price index rose 8.3% in August from the same month a year ago, down from 8.5% in July and from 9.1% in June, which was the highest inflation rate in four decades as shown in **Exhibit 11**.

Exhibit 11: US Consumer Price Index (% change yoy)



Source: Data compiled from BLS

US Core PCE Increased By 4.6% yoy in July

- Core personal consumption expenditures price index (Core PCE), the indicator in which the Federal Reserve 2.0% inflation goal is based on, rose 4.6% in July from a year before, the smallest annual advance in nine months followed a 4.8% rise in June. On a monthly basis, core prices rose a seasonally adjusted 0.1% in July, the weakest reading since February 2021, after increasing by 0.6% in June.
- According to Federal Open Market Committee (FOMC), Core PCE is most consistent with the Federal Reserve's mandate for maximum employment and price stability
- Wells Fargo believes that the rapid rate at which employers continue to hire, and the still-elevated number of small businesses that report plans to raise compensation, suggests there may be further pressure in the pipeline for labor costs. Wells Fargo believes the FOMC will err on the side of caution when it comes to inflation and not take its foot off the pedal until there is compelling evidence that it is slowing on a sustained basis. It forecasts that core PCE inflation will still be more than double the Fed's target at 4.3% by the end of the year, while the tight stance of policy is likely to tip the economy into a recession, Wells Fargo expects it will help reduce core PCE inflation back to roughly 3% around the middle of next year. As Fed policymakers see inflation easing and the economy buckling, Wells Fargo expects the policymakers will opt to ease financial conditions.

US Bonds

- Financial institutions have revised their 2022 inflation projections upwards as US inflation noticeably outpaced consensus expectations. The uncertainties surrounding the economic outlook, lockdown measures in China causing the disruptions to supply chains, tight labour market, surge in oil prices and agricultural commodities also contributed to the upward revision of inflation projections.
- For 2022, financial institutions are expecting CPI to reach between 4.80% and 8.00%. Meanwhile, Core PCE is expected to reach between 4.20% and 4.80% and 10-year bond yield is expected to reach between 2.80% and 3.25% in 2022 as shown in **Exhibit 12**.

Exhibit 12: CPI, Core PCE and 10-year Bond Yield Forecast for 2022

Name of institution	FY2022		
	CPI	Core PCE	10-year bond yield
DWS (Aug)	4.80%		3.25%
Wells Fargo (Aug)	8.00%	4.80%	2.88%
BofA (Aug)	7.90%		
Conference Board (Aug)		4.80%	
Goldman Sachs (Aug)		4.50%	
Credit Suisse (Sep)		4.20%	
BOS (Aug)			2.80%

Source: Respective financial institutions

US Bonds

- As at 16.09.22, the US bond yields reached 3.144% for the 3-month rate, 3.808% for the 6-month rate, 3.867% for the 2-year rate, 3.453% for the 10-year rate and 3.518% for the 30-year rate.

- Treasury yields have been on the rise recently with concerns of inflation remaining elevated and the Federal Reserve's plans to continue aggressively tightening monetary policy.

- The Federal Reserve raised the fed funds rate by 75 basis points (bps) to a range between 2.25% and 2.50% at its July meeting and signalled it would continue lifting rates this year, albeit with greater caution to avoid overdoing rate rises. However, the Fed continued to restate its commitment to higher interest rates until it is confident that inflation is under control, even if unemployment rises as a result. The Fed said that the recent improvement in inflation figures was insufficient for the fed to start considering cutting rates, and the Fed is likely to weigh whether to raise rates by 50bps or 75bps at its next meeting in September.

- However, there are also expectations of a 100 basis point hike in September. WSJ recently reported that CME Group Fedwatch tool showed markets giving a 34% chance for a full percentage point increase. That would be the biggest rate hike in 40 years.

- Former US Treasury Secretary Lawrence Summers commended the Federal Reserve for its resolve to restrain inflation as a priority. He praised the Fed for its acknowledgement that there would be a price to pay for cooling inflation, noting that short-term hits to employment and wages were acceptable for ensuring long-term prosperity. The Fed has "prioritised inflation, making clear that it recognised that the prioritisation would have short-term adverse consequences that wouldn't be easy," Summers said, adding that the central bank was now as well-position as it could be given, in his view, the errors committed in the recent past.

US Bonds

- Financial institutions have pencilled in a further rate hikes for 2022 as the Federal Reserve signalled elevated interest rates and rate hikes until it was confident inflation is under control. The interest rates forecast from various financial institutions are as follows:
  - DWS– Believes that inflation remains sticky as rents and higher wages phase in. DWS's economists only see a 40% chance of a soft landing for the US economy in the next few quarters. However, DWS expects the Fed to remain in inflation fighting mode and to not stop hiking rates until it reaches at least 3.50% - 3.75% by end of 2022, with the possibility of further hikes in early 2023. DWS then expects no further changes to interest rates till September 2023.
  - Wells Fargo – Wells Fargo noted there were reprieves in price pressure recently. While it would be premature to declare the peak for inflation, the slowdown in July's inflation takes pressure off the Federal Reserve and opens the door to potentially less aggressive tightening. Wells Fargo expects a 75bps rate hike in September, but acknowledges that there is still quite a bit of data to be released prior to the Fed's meeting. Specifically, another soft inflation reading in August might prompt the Fed to increase rates by a less aggressive 50bps.
  - Morgan Stanley – Morgan Stanley notes that inflation appears to be finally be cooling, according to recent inflation data. This should take some pressure of the Federal Reserve to deliver another 75bps rate hike in September, though the Fed still has work to do as inflation is still elevated. Morgan Stanley is forecasting a 50bps rate hike in September and November, and a 25bps rate hike in December, for a peak rate of 3.625%.

US Bonds

- UOB – UOB noted that the Federal Reserve is still on an interest rate tightening path and expects that interest rates would increase by 50bps in September. UOB also expects another 50bps hike in November, and a 25bps increase in December, for an expected interest rate of 3.50 – 3.75% by the end of 2022, well above the neutral stance. UOB also maintains its forecast of another 25bps increase in 1Q2023, bringing their expected terminal interest rate at 3.75 – 4.00% by the end of 1Q 2023, and a pause to the current rate hike cycle.

- Credit Suisse – Credit Suisse expects another 125bps of rate hikes by the end of 2022, with an additional 25bps hike in 1Q2023. Credit Suisse points to the possibility of a shift to a structurally higher and more volatile inflation regime as providing upside to policy rates in 2023. Credit Suisse believes that should inflation settle around 3 – 4%, there would be more hikes in 2023 towards a higher terminal rate. However, policymakers would have to decide the extent to which they will fight 3 – 4% inflation at the cost of ever-weakening growth. Credit Suisse noted that the Federal Reserve hiked rates in the middle of all three recessions between 1972 and 1982 before ultimately easing.

- We have summarized the interest rates forecast from various financial institutions as shown in **Exhibit 13**.

Exhibit 13: Financial Institutions' Projected Number of Hikes and Expected Interest Rate

Financial institutions	FY2022 expected interest rate
SMBC	3.38%
UOB	3.50%-3.75%
Credit Suisse	3.50%-3.75%
Morgan Stanley	3.63%
BofA	3.63%
Wells Fargo	3.75%-4.00%

Source: Respective financial institutions, Yahoo Finance

US Bonds: Summary of our views

- On the bond market, since our last Asset Allocation meeting, bond yields rose as traders worried about how high the Fed might raise interest rate and long it might hold them there. The August CPI report also showed that inflation persisted more than expected.

- The Consumer Price Index (CPI) rose by 8.3% yoy in August, marking the eleventh straight month of inflation above 6.0%. Core PCE inflation, the Fed's preferred measure of inflation rose by 4.6% yoy in July compared to June's 4.9% yoy rise, above the Fed's inflation target of 2.0%

- The latest Fed projections signalled a much more aggressive path of rate rises to fight inflation that is running at a 40-year high. Fed Chairman Powell recently announced that Fed officials are likely to weigh whether to raise rates by a half point or 0.75 point at their next meeting, after reaching consensus that rates would need to reach high-enough levels to slow the economy's growth by reducing investment, spending and hiring, even at the expense of rising unemployment. However, there are also expectations of a 100 basis point hike with CME Group Fedwatch tool indicating a 34% chance of a full percentage point increase in September In addition, various financial institutions have also projected interest rates of between 3.38% and 4.00% in 2022

- Against this backdrop, we are currently negative on US government bond market outlook. However, with a hawkish Fed, the downside risks to growth, and eventually inflation, will increase. This could weaken the case for more 75 percentage points interest rate hikes in 2022. In addition, if the Covid-19 situation were to worsen or if consumer spending were to weaken in the coming months, it could slow the economic growth. This could be a consideration for Fed to hold back on raising raise interest rate too aggressively.

US Currency

- Over the period from 01.07.22 to 16.09.22, the US Dollar Index (DXY) rose by 4.39% to 109.76 from a level of 105.14. The USD has gained recently due to rising expectations that the Fed will have to lift interest rates aggressively to tame inflation. Latest FOMC projections suggest the median Fed fund rate to be 3.40%. Meanwhile, as highlighted earlier on slide 35, various financial institutions are expecting interest rates to reach at least 3.38%.

UBS, Credit Suisse, UOB, and USBC are positive on USD

- **UBS**
  - UBS noted that the EUR/USD was trading below parity for the first time since 2002, as European growth risks continue to intensify and contribute to USD strength. Elevated energy prices are also a drag on the EUR, while a slowing economy and political paralysis are likely to weigh on the British Pound and China's economic recovery has been slower than expected, supporting the USD.
  - UBS has revised its currency forecasts to reflect a stronger USD, expecting EUR/USD to reach 0.96 and GBP/USD to reach 1.12 by the end of 2022, and USD/CNY to reach 7.0 in the months to come.
  - In the medium term, UBS believes the USD would top out over the next six months, as the market anticipates changes to the Federal Reserve's hawkish stance, Europe's energy woes, and China's growth woes. USB expects changes in the Fed's policy stance like to be the first to kick in in 2023 if inflation moderates enough. Better economic data from China in early 1H2023 would likely follow, with a levelling of energy prices in 2H2023 as redirecting trade flows and substitution forces on the demand side solidify. Slowing US growth would also hinder USD gains in the long run.

US Currency

- **Credit Suisse**
  - Credit Suisse noted that a perceived peak in US rates resulted in broad USD softness and improved risk sentiment. However, underlying inflationary pressures persist and Credit Suisse believes it would be premature to rule out further interest rate hikes in the US.
  - Credit Suisse expects the USD to continue to benefit from relatively better growth and higher carry due to near-term policy tightening in the US. Credit Suisse expects both the Eurozone and UK to dip into recession, keeping the EUR and GBP relatively weaker despite monetary policy tightening by the respective central banks.
  - Increased US growth fears could halt the USD's upside via lower-than-expected interest rates. However, Credit Suisse believes any such pause would be temporary as global growth concerns would eventually mount further and create a flight to safety that would benefit the USD.

- **UOB**
  - UOB noted that the USD has been boosted by the Federal Reserve's renewed commitment to continue its aggressive rate hikes. UOB also believes that the drivers underpinning the USD rally remain intact, namely the unique macro backdrop that caused high inflation and in turn Fed interest rate hikes, elevated exchange rate volatility providing tailwinds to USD strength, and heightened growth concerns spurring safe haven USD flows. UOB believes that USD would continue to strengthen while these drivers remain intact.
  - UOB maintains the view that the USD will stay strong against G-3 peers, the EUR and JPY. Furthermore, the expected recovery in GBP, AUD, and NZD are expected to be delayed as global risk sentiment is curtailed by further monetary tightening. The energy crisis in Europe has worsened, adding pressure on the EUR/USD rate and complicating discussions within the European Central Bank to normalise monetary policy to fight inflation. UOB believes Europe's macroeconomic risks are still biased towards the downside, and as such expects the USD to continue strengthening against the EUR

US Currency

- **HSBC**
  - HSBC noted that the Federal Reserve has made clear it needs proof that inflation is slowing sufficiently for it to signal a return to target is in the offing. A sequence of weak employment data might give the Fed greater confidence that inflation might fall, but strong employment data in July delays the start of any such sequence. Currently, wage growth remains well ahead of a level consistent with the Fed's 2% inflation target, and unemployment is at five-decade lows. UOB believes that until there are clear and consistent signs that inflation is set to return to the Fed's target, monetary tightening and associated USD strength are likely to persist.
  - HSBC also notes the possibility of dovish policy pivots outside the US, as other economies such as the UK and Eurozone, face tougher growth-inflation challenges. HSBC also believes that markets continue to underplay the importance of the current global economic slowdown, and opines that the risk adverse implications of the slowdown would continue to support the USD given its status as a safe-haven currency.

US Currency

- The latest currency forecasts for EUR/USD, AUD/USD, USD/SGD and USD/JPY by UOB, DBS and OCBC for 2022 and 2023 are shown in **Exhibit 14**.

Exhibit 14: Financial Institutions' EUR/USD, AUD/USD, USD/SGD and USD/JPY Forecast

	2022		2023	
	Q3	Q4	Q1	Q2
EUR/USD				
UOB (Sep)	0.98	0.97	0.99	1.00
DBS (Sep)	0.99	0.96	0.98	1.00
OCBC (Sep)	1.01	1.02	1.03	1.05
AUD/USD				
UOB (Sep)	0.67	0.66	0.68	0.69
DBS (Sep)	0.67	0.65	0.67	0.68
OCBC (Sep)	0.69	0.70	0.71	0.72
USD/SGD				
UOB (Sep)	1.41	1.42	1.42	1.42
DBS (Sep)	1.41	1.42	1.41	1.40
OCBC (Sep)	1.38	1.37	1.36	1.35
USD/JPY				
UOB (Sep)	139	139	139	139
DBS (Sep)	141	145	142	138
OCBC (Sep)	139	136	132	130

Source: Respective financial institutions

US Currency: Summary of our views

- On the currency market, the USD, as reflected by the DXY, has appreciated by 4.39% since our last Asset Allocation meeting.

- Recent rising bond yields have increased USD attractiveness. Further it was also reported that the Federal Reserve remains committed to bring down inflation, with Fed Chair Jerome Powell delivering a hawkish speech at the Jackson Hole Symposium stating that the Fed will continue raising interest rates and hold them at a higher level until it is confident inflation is under control even if unemployment rises, which is a positive for USD.

- EURUSD was trading below parity for the first time since 2002, as the energy crisis in Europe worsened and peripheral spreads widened, adding pressure to the EUR/USD. In addition, a slowing economy and political paralysis are likely to weigh on the British pound, while China's economic recovery has been slower than expected. Hence, USD is expected to continue to benefit from relatively better growth and higher carry.

- In addition, as global growth concerns mount further, there would be an increased demand for safety, the safe haven status of the USD would thus underpin the currency.

US Currency: Summary of our views

- There are also factors which may result in a weakening of the USD

  I. The persistent US current-account deficit. Though it narrowed in July, shrinking by 12.6% for the month to US$70.65 billion, it remains large compared with prepandemic levels. Exports grew by 0.2% to $259.29 billion, helped largely by higher shipments of capital goods like computers and industrial machinery. Imports fell by 2.9% to $329.94 billion, reflecting declines in American purchases of consumer goods and industrial supplies. The high current-account deficit may suggest an increase in supply of USD on the foreign exchange market, which could in turn result in downwards pressure on the currency.

  II. Slower growth given that the US economy contracted for the second-consecutive quarterly in 2022. Increased growth fears may impede the Fed's tightening plans and could also halt USD's upside

- Considering the above, we are currently positive on USD

Our Contact Details

Please contact our wealth managers for further information at:

FPA Financial Corporation Pte Ltd
60 Paya Lebar Road,
#11-02 Paya Lebar Square
Singapore 409051
Tel: (65) 6323 1788   Fax: (65) 6323 1768
www.FPAFinancial.com

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