The Way We See It

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The Two Big Risks

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At the time of writing (morning of 22nd February), US and global investors are concerned about two big risks which are likely to focus their mind in the near term. In other words, they are likely to ignore all the better-than-expected US economic growth and corporate earnings news announced over the past few weeks.

What are the two big risks ? First and foremost, it is the geopolitical tensions relating to the feared invasion of Ukraine by Russia. Secondly, the Fed's magnitude of monetary policy tightening.

Risk #1 - Russia vs Ukraine and NATO

This geopolitical uncertainty is a "top of mind" risk for investors. It is likely to dominate media headlines in coming days or weeks. Some feared that it could be the beginning of a "small-scale WW3", should the US and NATO armies decide to get involved to fight with the Ukrainians against Russia.

While it is not our intention nor our expertise to write a long and detailed discourse on the possible outcomes of this conflict, our view is that investors'

sentiment will, in the short-term, remain fragile, possibly panicky. At the time of writing, Asia Pacific markets already got marked down, in line with a very weak US equity futures market.

Thus, consistent with the cautious outlook for risk assets which we presented in our 2022 Outlook document in November last year, this geopolitical risk is expected to continue to put pressure on key risk assets, including growth equities (NASDAQ, FAANG, Technology and other hot sectors, including ESG, Biotech, etc), high yield bonds, and crypto assets. Cash is likely to be king in the short-term. This risk would only fade if and only when Russia, Ukraine and NATO were to agree to and abide by a certain peaceful plan.

Pressure remains on risk assets and cash is king in the short-term

Risk #2 - Fed's Monetary Tightening

The Fed has made it clear that they are becoming increasingly concerned about the escalating trend of higher consumer and producer prices in the US economy. They also communicated that they are relatively late in implementing tightening measures. Had the above geopolitical conflict not taken place, many economists predict that the Fed would raise rates, for the first time since 2019, by 50 bps in the FOMC meeting next month, instead of the standard 25bps.

While the threatening external backdrop would have normally pointed to a no-action or even a small easing gesture, the Fed is not expected to be accommodative this time around. This is simply because the US domestic economy is experiencing a very high and persistent inflationary trend, caused by strong domestic demand and continuing supply bottlenecks.

Hence, in our opinion, given the above conflicting external versus internal settings, the Fed is likely to raise the Fed Fund rate by 25bps in the March FOMC meeting. It is likely to be the first of four to six rate hikes in 2022, based on the published forecasts made by economists of major financial institutions. In addition, QE is likely to end by March or April, and be

replaced by the beginning of QT (quantitative tightening), starting in the second half of the year.

The impact of the above is obviously negative; not so much for the US economy, but for leveraged investors in equities, high yield bonds, crypto, and, to a lesser extent, weak emerging market debt borrowers and US real estate.

Turn from QE to QT; monetary tightening to last for at least a year.

In brief, the monetary tightening risk is likely to last for a year or longer for risk asset investors. The magnitude and duration of the tightening phase are likely to depend on the trend of US inflation, and the timing of a more stable and normalization of domestic demand and supply factors. In other words, the Fed will pause when they perceive that the US economy has reached a sustainable growth environment, i.e, a better economic equilibrium level.

Economic and Asset Allocation Implications

Economic Implications: We believe that the Russian-Ukraine conflict is not likely to impact significantly on the consumption and production activities in the US, Asia Pacific and other parts of the Emerging world. Sentiment in Europe, however, is likely to be affected in a more pronounced manner. Having said that, in overall terms, the economic impact, at a global level, is unlikely to be too severe, unless there are disruptions to the supply of energy from Russia to the rest of the world, which would propel oil and gas prices to even higher levels in the short-term. As far as the impact of the Fed's tightening is concerned, it is our view that the gradual pace to be implemented is unlikely to impact significantly on US and global consumers and corporates (with the exception of weak and indebted entities).

Asset Allocation Implications: In line with our overall cautious investment stance which we outlined in our November Outlook and our January update documents, it remains our view that investors should remain defensively positioned for the majority of the time while the Fed is tightening ("Don't Fight The Fed" saying on Wall Street). Of course, depending on the extreme sentiment and positioning of investors, there will be great trading opportunities for nimble investors and fund managers (such as the current environment when fear is dominating investors' mind, and quant-driven funds have already substantially reduced their exposure to risk assets).

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