Economic and Market Outlook Q1'2022

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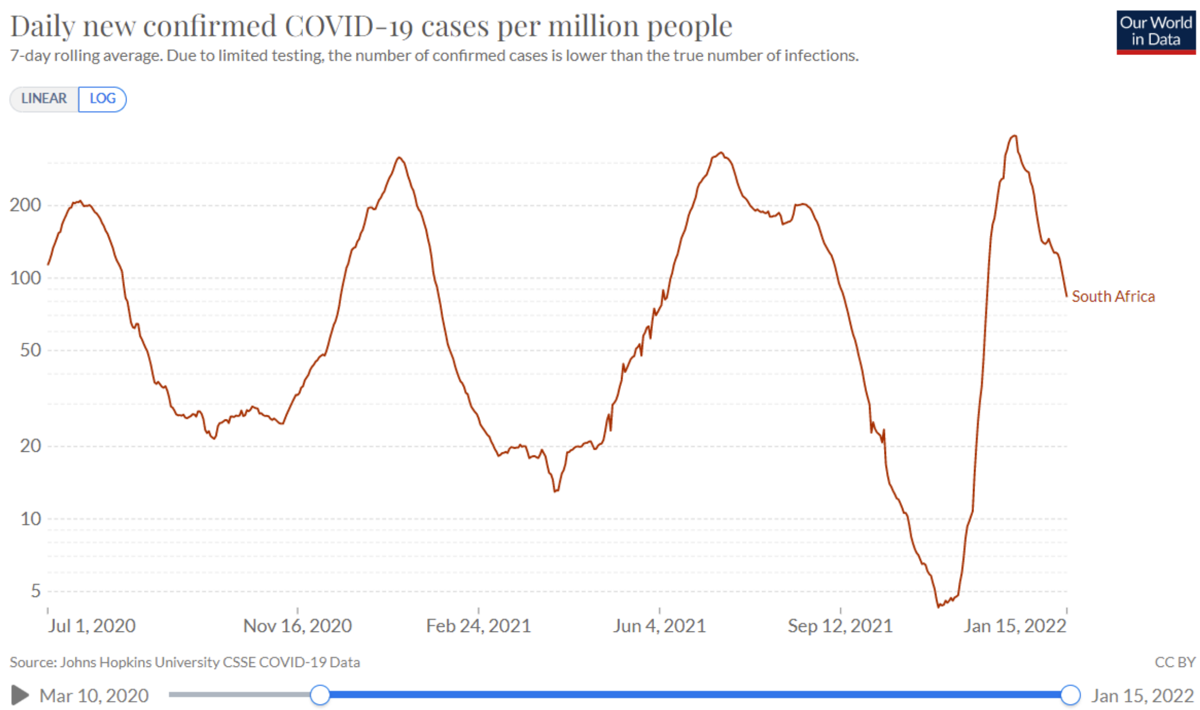
2022 Outlook: Rising rates & volatility, focus on large cap with quality cash flows

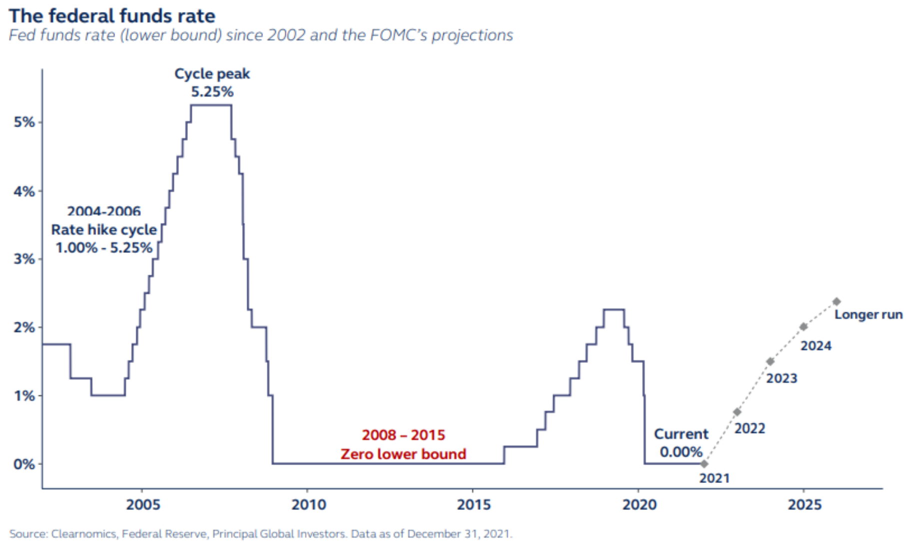
Year 2022 have started with a lot of developments that impact how we look at the global economy and various capital markets. The rise of Omicron that started in South Africa around the end of November last year had greatly impacted risk assets around the world, as investors came to realization that Covid wouldn't so easily go away, while countries around the world quickly shut down their borders to travelers from South Africa. Capital markets declined as investors were reminded of how a discovery of a new Covid strain could lead to disruptions of economic activities, and to company's revenue-generating ability. However scary a thought that is, it does seem that this time around, the severity of the new strain has been less than the previous ones; while new cases have already been dropping in South Africa after only about a month of discovery, perhaps suggesting a milder effects on the global economy in 2022.



Source: Johns Hopkins University CSSE COVID-19 Data. Data as of January 16, 2022

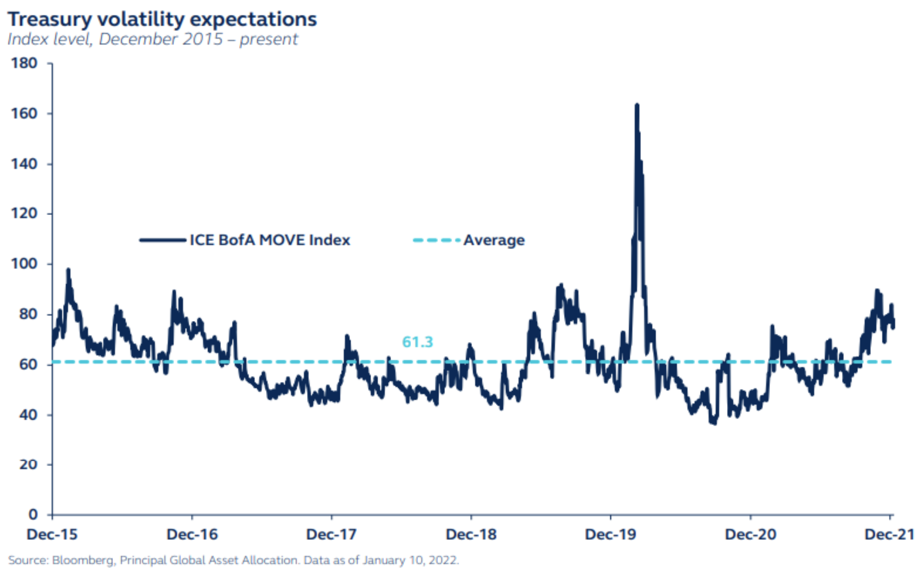
Unfazed by the negative effect that the Omicron may portend, the Fed has been raising their concerns on the inflation outlook, and the changing dynamics of the monetary policy. The minutes of the most recent FOMC meeting revealed the discussion that the members had on the appropriateness of the reduction of QE, or what they officially termed as the "Balance Sheet Runoff". As this hasn't been in anybody's mind at the very start of the year, the discovery that the Fed had already been talking about this back in December had startled the market. Economists around the world are now beginning to move up their expectations of the first hike in the Fed funds rate, dubbed "Liftoff" by the Fed; along with increasing number of hikes expectation; and also the timing of when the Balance Sheet Runoff would happen in 2022. Currently, our view is for the first hike to begin in June 2022, and for a total of 3 hikes in the year, and for the Balance Sheet Runoff to begin sometime in the second half of 2022, perhaps in Q4.

บริษัทหลักทรัพย์จัดการกองทุน พรินซิเพิล จำกัด 44 อาคาร ซีไอเอ็มบี ไทย ชั้น 16 ถนนหลังสวน แขวงลุมพินี เขตปทุมวัน กรุงเทพ 10330
โทรศัพท์ 0 2686 9500 โทรสาร 0 2657 3167 www.principal.th



Source: Clearnomics, Federal Reserve, Principal Global Investors. Data as of December 31, 2021

These key developments have now given us a chance to reflect on what could be happening next in the markets. The economic cycle in the US is much more advanced than in other countries, and the Fed probably feels justified to be more vocal in the fight against high inflation. This will be putting downward pressure on financial conditions in the US, first and foremost, while there will also be reverberations across the world as capital flows back to the US. The rise in US Treasury yields is already happening as a result of the Fed becoming more hawkish. We should see further increase in the expected volatility in the bond market in 2022, which is the year that the Fed “pivots” to actively fighting inflation. Historically high correlation between equity and bond volatility also leads us to expect more frequent periods of equity market corrections this year. We should note that historically stock market pullback of around 5% usually happens around 5 times per year on average. Another important point to note is that US real yields is still in a deeply negative territory, while the growth rate of the US will be significantly above trend in 2022.



Source: Bloomberg, Principal Global Asset Allocation. Data as of January 10, 2022

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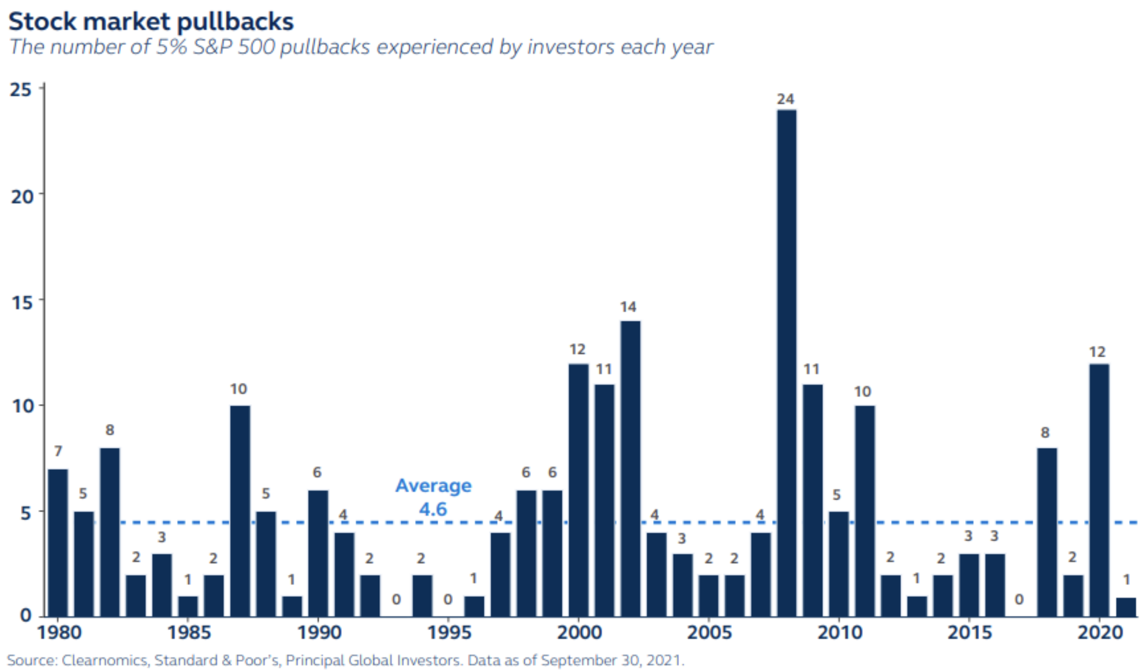
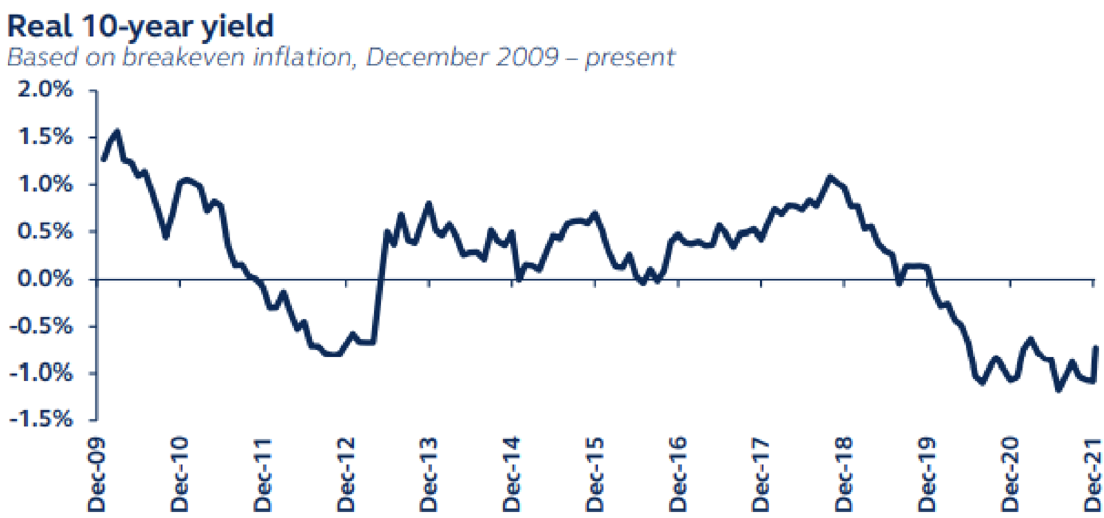


Source: Clearnomics, Standard & Poor's, Principal Global Investors. Data as of September 30, 2021



Source: Bloomberg, Principal Global Asset Allocation. Data as of January 10, 2022

All this points toward a continued period US equity market outperformance, versus emerging markets, where we see another year of struggling returns resulting from lower China growth rate, declining liquidity from the Fed, a stronger US dollar, slow to recover international tourism, and high oil prices impacting growth of net oil importers. Another equity market we like is European equities, where think that growth is still favorable, and conducive to positive returns for the equities; while we shouldn't see policy rate hike there until 2022 have passed.

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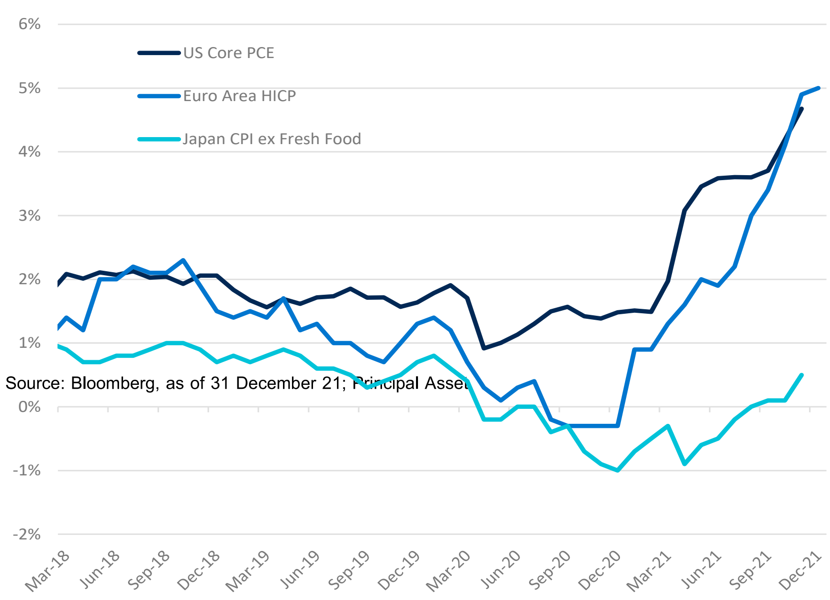
As the global cycle moves into a slower growth rate period, we are tempering our expectation for equity market returns. However, it should be higher than what you get for investing in bonds during rising rates and declining balance sheet. With volatility awaiting us in 2022, we are more cautious in our equity style preference, and advocate a quality tilt toward big cap exposure, as large companies with positive cash flows will show clear advantage over smaller cap with negative cash flows.

For thematic investments, we still like a few global themes for its potential long-term growth. Once market has priced in enough of the risk of rate hikes and balance sheet runoff, downside might start to be limited, while the structural stories for these themes are quite compelling. We like Electric Vehicle theme due to the high EV adoption rate expected in 2030, translated to near 30% growth of EV sales per year. Another theme that we like is the Metaverse theme. It is still in early days. But that means that the Metaverse-related markets can have a long way to expand.

Finally, a relook at Thai equities is warranted. This is because equity market returns usually correspond best to improvement in growth, and Thai economy stands out well this year. For illustration, looking at the growth expectation for 2022 vs 2021 published by the Bank of Thailand, Thailand is expected to grow at 3.4% this year compared to 0.9% in 2021. This translates into a growth rate difference of +2.5%, much higher than what the IMF is expecting for the global GDP of 4.9% in 2022 against 5.9% in 2021, meaning a growth rate difference of -1%. In simple terms, Thailand is in a growth recovery phase, whereas the global economy is moving into a mid-cycle phase. Market returns are usually higher for recovery phase economies. Along the same line of thinking, IMF expects Vietnam to grow by 6.6% in 2022 (market economists are forecasting higher than 7% in 2022) against 3.8% in 2021, which has a growth rate difference of +2.8%. Thailand and Vietnam are probably worth having as exposure within the portfolio for 2022 growth recovery.

Global outlook in Q1'2022

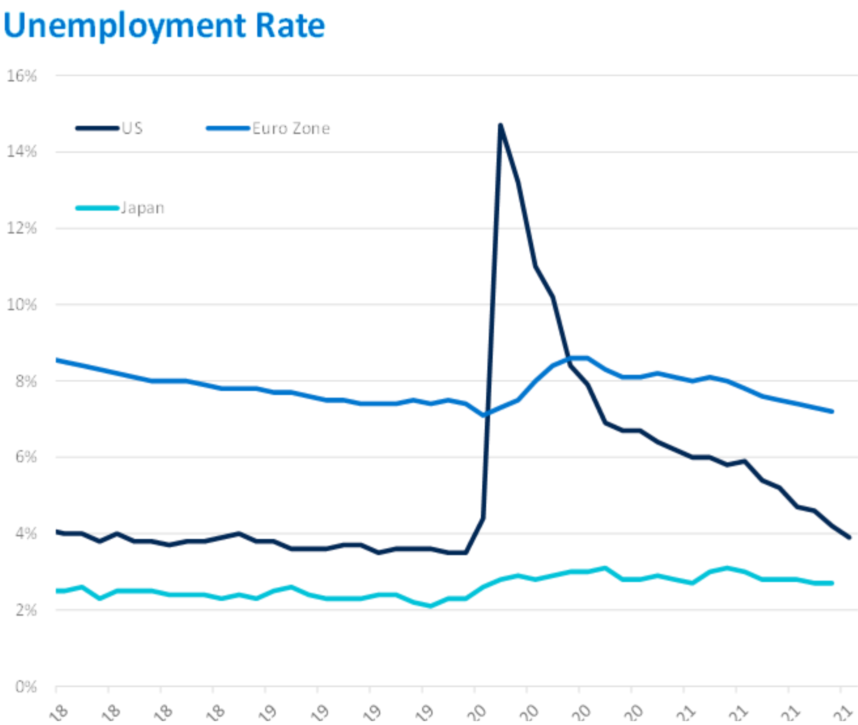
Inflation



Source: Bloomberg, as of 31 December 21; Principal Asset Management

Inflation rate is accelerating in the US. This was caused by three main factors: 1) labor shortage in the US; 2) elevated oil price; and 3) supply chain disruption. We expect these three factors will diminish in Q3 or Q4 2022. However, we expect risk assets to still perform during rising interest rate cycle, barring few corrections along the way.

The US government provided stimulus packages during the height of the Covid-19 outbreak to help people who cannot find jobs and struggling to commute to work. With the remaining benefit handouts after the Covid situation had improved, people had become less eager to go back to work , leading to labor shortages. Another reason is from people who are willing to work but are unable to travel to their workplace, as they are either in another country or because they are unable to travel due to the restrictions in place. This has created substantial spike in wage growth and pushed up goods prices from greater consumer purchasing power. We expect this factor to ameliorate when the vaccines are more broadly distributed, and international travel fully resumes.



Source: Bloomberg, as of 31 December 21; Principal Asset Management

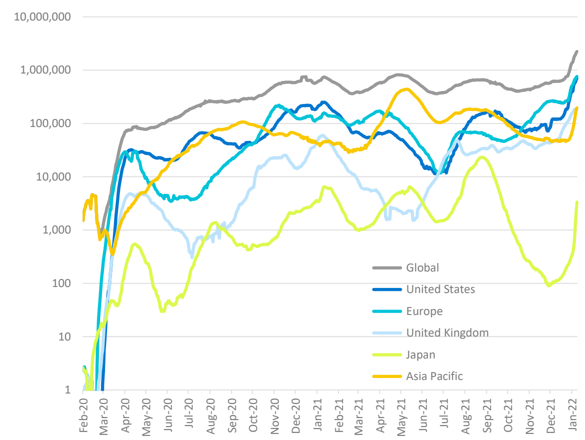
The conflict between Russia and Ukraine is turning more intense, leading to tighter supply of energy exports from Russia. While wider concerns on ESG issues have helped to discourage oil companies in the US from producing shale oil. The limited oil production has contributed to the rise in oil prices . While hard to estimate, we believe oil prices will stabilize once supply and demand gap becomes more balanced later this year.

The last reason of high inflation is supply chain disruption that started during the spread of Covid-19 last year during global shutdowns. This had caused permanent shutdown in many small businesses around the world. Once demand returns, idle production cannot resume right away. It could take sometime to create production capacity, and we expect the situation will be better in Q3 or Q4 2022.

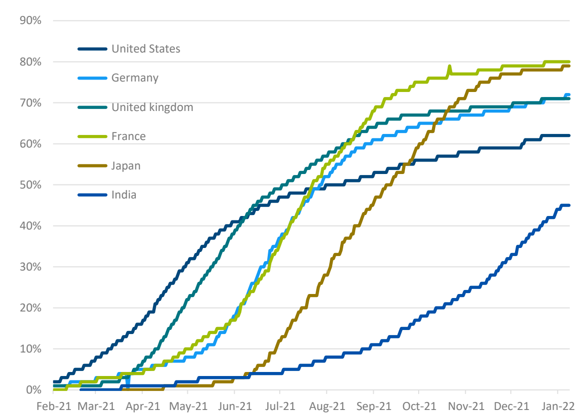
Therefore, the inflation could probably remain high in the beginning of 2022, and normalize in the second half of the year. Meanwhile, if the Fed keeps interest rate at extremely low level, there is a risk of financial instability. It might encourage business owners to overleverage, and the economy to become overheated, which will then lead to another asset price bubble in many industries, and eventually lead to another recession down the road.. Therefore, the Fed needs to be very cautious and avoid policy mistakes, which could lead to either hyperinflation if they decided to raise policy rates too slowly or obstruct economic growth if they raised interest rate too fast.

Another key factor we need to keep an eye on is the development of Covid-19 pandemic. The Omicron strain has kept infection rates high again after the Delta strain had been contained, even though, vaccination had progressed aggressively during the end of last year. However, the death rate from the Omicron strain has been very low among vaccinated patients. Therefore, we expect a very low chance of strict shutdown in most places like in the past year, and the economic growth of countries like the US and Europe to retain most of its growth momentum; while we expect rapid recoveries in Japan and Asia in 2022.

COVID-19 Confirmed Case



Vaccination



Source: Bloomberg, as of 8 January 22; Principal Asset Management

On the issue of QE tapering by the Fed, we expect this to end in March 2022. This will then be followed by Quantitative Tightening, which could happen in the second half of this year after the Fed monitors the effect from 1-2 rate hikes. On this, we expect 3 hikes during 2022, with rising probability that they could hike 4 times, which could mean the first hike in March.

Periods	Expectation	Beginning QE	Taper Rate	Ending QE	Ending B/S	B/S to GDP	QE to B/S	QE to GDP	QE to Mcap
Aug'21	(Jackson Hole Symposium)	$120bn	-	$120bn	$8,333bn	36.6%	1.4%	0.5%	0.2%
Sep'21 (meeting)	-	$120bn	-	$120bn	$8,453bn	37.2%	1.4%	0.5%	0.2%
Oct'21	-	$120bn	-	$120bn	$8,573bn	37.7%	1.4%	0.5%	0.2%
Nov'21 (meeting)	(1) Begin reducing $15bn	$120bn	$15bn	$105bn	$8,678bn	38.2%	1.4%	0.5%	0.2%
Dec'21 (meeting)	(2) Reduce $15bn; announce increase	$105bn	$15bn	$90bn	$8,768bn	38.6%	1.2%	0.5%	0.2%
Jan'22 (meeting)	(3) Begin reducing $30bn	$90bn	$30bn	$60bn	$8,828bn	38.8%	1.0%	0.4%	0.2%
Feb'22	(4) Reduce $30bn	$60bn	$30bn	$30bn	$8,858bn	39.0%	0.7%	0.3%	0.1%
Mar'22 (meeting)	(5) Reduce final $30bn	$30bn	$30bn	$0bn	$8,858bn	39.0%	0.3%	0.1%	0.1%
Apr'22 (meeting)	-	$0	-	$0	$8,858bn	39.0%	0.0%	0.0%	0.0%
May'22	-	$0	-	$0	$8,858bn	39.0%	0.0%	0.0%	0.0%
Jun'22 (meeting)	1st rate hike 25bp	$0	-	$0	$8,858bn	39.0%	0.0%	0.0%	0.0%
Jul'22 (meeting)	-	$0	-	$0	$8,858bn	39.0%	0.0%	0.0%	0.0%
Aug'22	-	$0	-	$0	$8,858bn	39.0%	0.0%	0.0%	0.0%
Sep'22 (meeting)	2nd rate hike 25bp	$0	-	$0	$8,858bn	39.0%	0.0%	0.0%	0.0%
Oct'22	-	$0	-	$0	$8,858bn	39.0%	0.0%	0.0%	0.0%
Nov'22 (meeting)	-	$0	-	$0	$8,858bn	39.0%	0.0%	0.0%	0.0%
Dec'22 (meeting)	3rd rate hike 25bp	$0	-	$0	$8,858bn	39.0%	0.0%	0.0%	0.0%
Total		$765bn	$120bn	n.a.	n.a.		8.9%	3.4%	1.5%

Source: FOMC, as of 15 December 2021

Thailand outlook Q1'2022

Thailand economy recovered very slowly in 2021 compared to other countries in the region. One of the reasons was the vaccine shortages, while the majority of the available vaccines was the Chinese-made Sinovac that had a very low ability to prevent infection. In Q4 2021, the vaccination rates began to rise meaningfully, and eventually caught up to the region by the end of the year. Therefore, we expect better recovery in 2022, and a very low chance of shutdown, since Thai economy is driven by exports and tourism. We expect the Thai baht to appreciate, and the Bank of Thailand to potentially hike the policy rate one time this year, since the economic growth is still very fragile and the government still needs enormous funding for stimulus packages. There is a rising chance that Thailand might have an election sometime later this year, which can also increase consumer spending during the campaign.

Thai Fixed income: very low interest rate

As the interest rate environment is in a rising trend, fixed income performance would be negatively affected if the bond or portfolio duration is high. Currently in the very low yield environment, the carry return which can mitigate capital loss from rising interest rate is also low. To avoid high fluctuations in the market, we will focus in 2-to-3-year maturity government bonds and corporate bonds in order to keep our portfolio duration close to the benchmark. Moreover, we will find opportunities to invest in corporate bonds with decent spread which can provide higher return in the long run. To cope with high inflation in the near term, inflation-linked bond is preferable when we find attractive offers in the market.

Thai equity market: benefits from reopening

We believe that the Thai stock market can recover from weak sentiment in recent years from the spread of Covid-19. The reopening of the country will benefit tourism and consumption. Oil price remaining high will also benefit Thai stock market since energy sector has a very high weight in the market. We expect listed company earnings can grow by 12% on average this year. The sectors that we like are the banking sector, which should benefit from rising interest rate environment; and the information & communication technology sector, which should benefit from lessened market competition due to consolidation of market players.

Foreign equity markets: rising rates and volatility

Global economic growth is forecast to be lower than in the previous year due to slower growth rate in the US and Europe. However, we expect better growth rates in countries such as Japan, ASEAN, and Thailand.. The major risks to the global markets are from the mutation of the virus and Fed tightening monetary policy too much. While inflation rates could be high during the first half the year, we expect the situation to improve later in the year. Meanwhile, long-term fiscal stimulus package containing infrastructure development plan in the US could potentially drive investments and employment in long-run, and we expect "Clean energy" related businesses can perform well.

Alternative investments: bottoming-out

The reopening in Thailand and Asia is the major driver of property and REITs returns. With low leverage in most of the REITs in Singapore and Thailand, they also get very secured incomes. So, current dividend yield ranges between 4-6%. Valuation is attractive, and volatility is lower compared to equities; therefore, we expect both price appreciation and dividend to contribute to positive return this year. The selection could be REITs that benefit from reopening and consumption with stable cash flows, and some of those REIT operators who have the ability to transfer the impact of high inflation to their tenants. We are underweight office names that have become less attractive from decrease in office rental areas.

Warning: Past performance of the fund is not a guarantee for future performance. Investors should understand product characteristics, conditions of return and risk before making an investment decision.

For more information, please contact Principal Asset Management Company Limited. Tel. 02 686 9500 press 2

บริษัทหลักทรัพย์จัดการกองทุน พรินซิเพิล จำกัด 44 อาคาร ซีไอเอ็มบี ไทย ชั้น 16 ถนนหลังสวน แขวงลุมพินี เขตปทุมวัน กรุงเทพ 10330
โทรศัพท์ 0 2686 9500 โทรสาร 0 2657 3167 www.principal.th