Rethinking Asset Allocation in a Balanced Portfolio

Key Takeaways

- Commodity related assets and USD outperformed other asset classes throughout 2022
- Monetary tightening (tapering, interest rate hikes and balance sheet shrinking) has boosted USD value, yet high inflation triggers investor to seek a hedge that can be found in commodity related assets
- Polls suggest to overweight equity over bond that we think may reflect a tactical move after stock market sell off bringing valuation at a more discounted fashion, yet polls also suggest to raise cash and diversify to alternative assets, while reducing bond holdings
- Taking a view at steady gold price and rising oil prices have indicated that market tone has skewed towards the downside on the back of higher than targeted inflation may persist longer and skepticism over whether the Fed aggressiveness in tightening bringing a soft landing mode for economy and market at the end
- Strategy implication for domestic financial assets : maintain overweight equity over bonds but add corporate bond to optimize risk adjusted return in a balanced portfolio

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Commodity related assets turned to be the best performing assets

We tried to track global assets performance during 2022 and found out commodity related assets and USD outperformed others. Nominal oil prices soared by +50% ytd and stayed above USD100/barrel. Meanwhile gold rose only +2% ytd at the same time. USD index increased by +6% ytd while global equities and government bonds fell -14% and -9% ytd respectively. The relatively new digital asset cryptocurrency dropped -46% ytd and becoming the worst performing asset during this year (Exhibit 1).

The end of ZLB rates and no more easy money era

2022 has been challenging for financial markets. Stubbornly high inflation caused global CB to take a hawkish stance aggressively. The Fed is expected to bring FFR target rate at 2.75-3.00% and reducing its swollen B/S by USD538bn from the peak by the end of FY22F (Exhibit 2). US CB to shrink its B/S by USD47.5bn by Jun-22 and begin to tighten further by USD90bn in Sep-22. It has boosted the USD value and triggering capital outflows from EM economies and hence depreciating their currencies. Global financial markets are now in a tightened mode ending cheap and easy money era.

Taking a view at recent asset allocation polls in a balanced portfolio

High inflation (Exhibit 3) caused by supply disruption may cost global output to decelerate (Exhibit 4). Recent balanced fund asset allocation polled by Reuters indicated that markets have shifted towards non-bond assets. As at the end of May-22, polls suggested to raise cash to 5.21% (vs 3.59% in Dec-21) and overweight alternative assets to 5.99% (vs 5.70% in Dec-21) in order to hedge against turmoil. However, polls also suggested to increase equity holdings to 52.16% (vs 50.34% in Dec-21 and averagely 48.82% from Feb to Apr-22). We think that this is caused by equity sell off during Fed's tightening and indicated a tactical movement to capitalize on stocks discounted valuation (Exhibit 5).

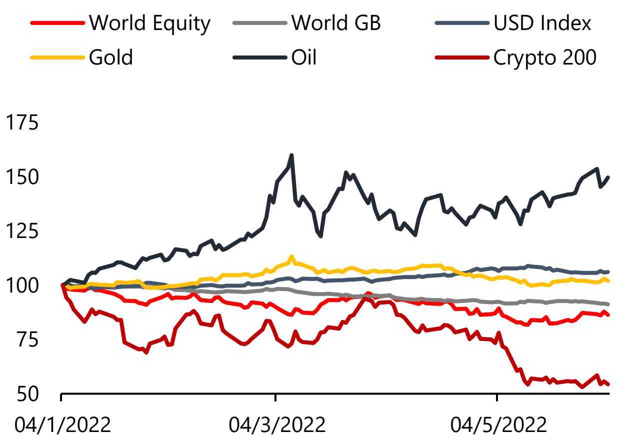
Gold and oil price has something to tell us about market tones

Unlike in the previous tightening cycles when gold price dropped >50% in USD value, the safe haven asset seemed to be steady around USD1,800-1,950 per ounce this year (Exhibit 6). We think that this may showed markets expect higher pace of inflation above Fed's long term target at 2% may prevail in the near term. In addition, we also think that this also reflect skepticism on Fed's aggressive tightening could end in a safe landing mode. Note that spread between short and long term rates narrowed and remained below its long term -1std. From historical perspective, spread between 2-10 year UST note has been a highly accurate leading indicator to gauge economic turbulence. Based on our calculation, if the spread narrowed to below its long term -1std recession is likely to occur in the upcoming months (Exhibit 7). However gold to oil ratio has declined to its long term average 17x (Exhibit 8). Indeed economic output improved along with lower pandemic risk and rising mobility. However the downtrend of gold to oil ratio is more affected by tight energy market that only promote higher oil prices and triggering higher inflation pace as well as inflation expectation. Albeit OPEC+ agreed to ramp up production to 648,000 bpd in July and August (vs 432,000 bpd recently), the gradual reopening of Chinese economy would still bring a net-net deficit oil balance, in our view. All in all we think that risk for global economy and market is still skewed towards the downside.

Strategy implication : opportunity in domestic equity and corporate bonds

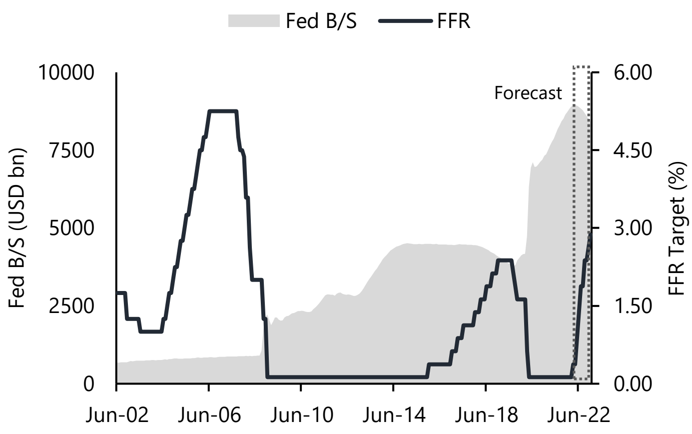
We maintain overweight on equity on the back of its long term positive correlation with commodity prices and its recent resilience during market turmoil. Note that ytd risk free rate has jumped >50 bps along with massive foreign outflows. Unlike in government bond market, inflows keep coming to equity. Despite the recent rally, valuation wise, JCI is now traded with the earning yield above of its 3-year average, which we think to remain attractive (Exhibit 9). Interestingly during the yield spike triggered by Fed's tightening, credit spread between AAA-A corporate bonds for 3 and 5 years maturity continuously to narrow indicating a lower risk for investing in corporate bond (Exhibit 10). Worth noting that corporate bonds total return also outperformed government bond total return since Dec-21 (Exhibit 11), meaning that it is not only affected by higher coupon rate but also more resilient price. Therefore we also suggest to add corporate bond in a balance portfolio.

Exhibit 1. Commodity related asset outperformed



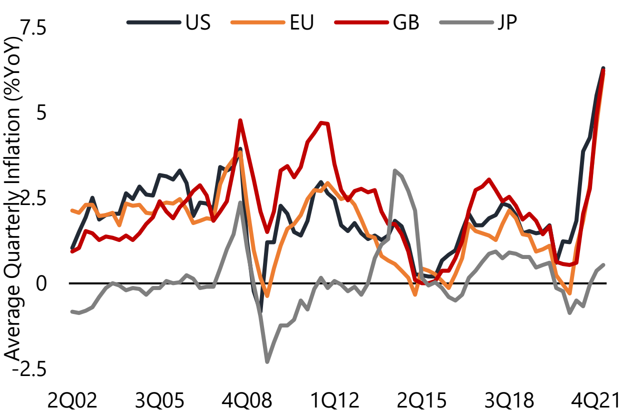
Sources : Bloomberg, MNCS Research

Exhibit 2. FFR target at 2.75-3.00% and Fed B/S at USD8.4tn FY22F



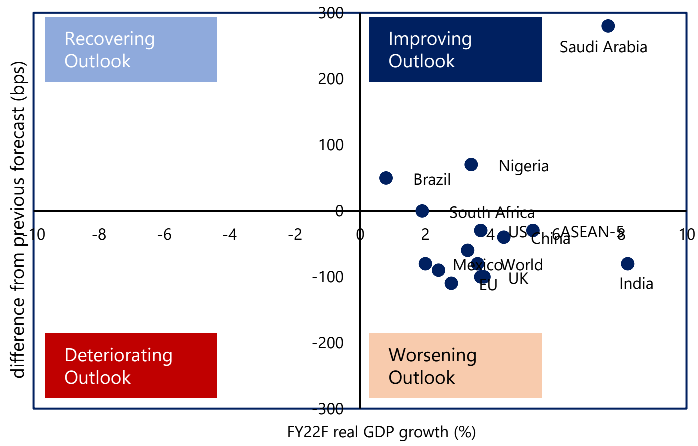
Sources : Bloomberg, CME Fed Watch, MNCS Research

Exhibit 3. DM markets inflation jumped to multi-decade highs



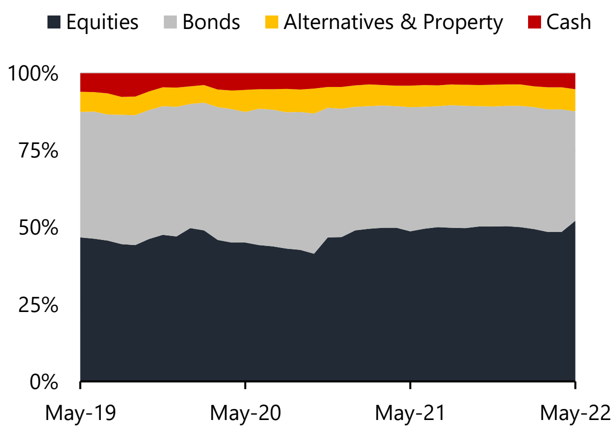
Sources : Bloomberg, MNCS Research

Exhibit 4. LT positive correlation between JCI and coal & CPO prices



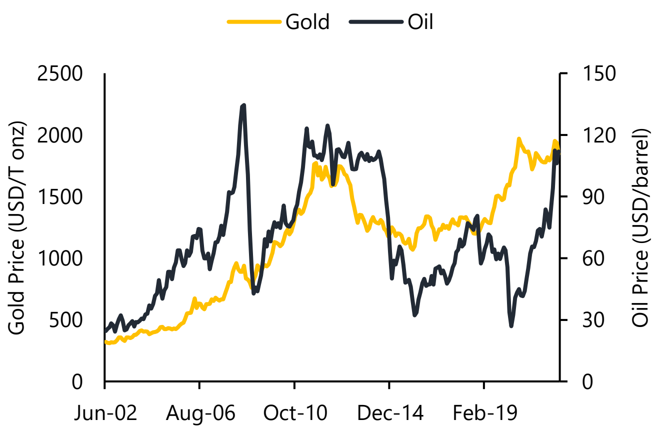
Sources : International Monetary Fund, MNCS Research

Exhibit 5. Balance fund : OW stocks & alternatives, raise cash!



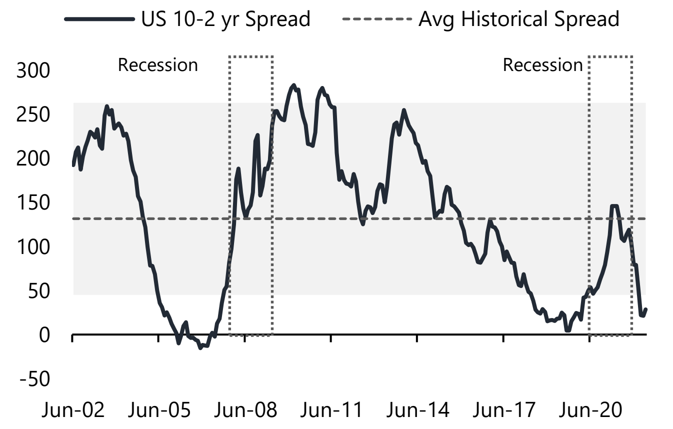
Sources : Reuters Polls, MNCS Research

Exhibit 6. Steady gold price and rising oil prices



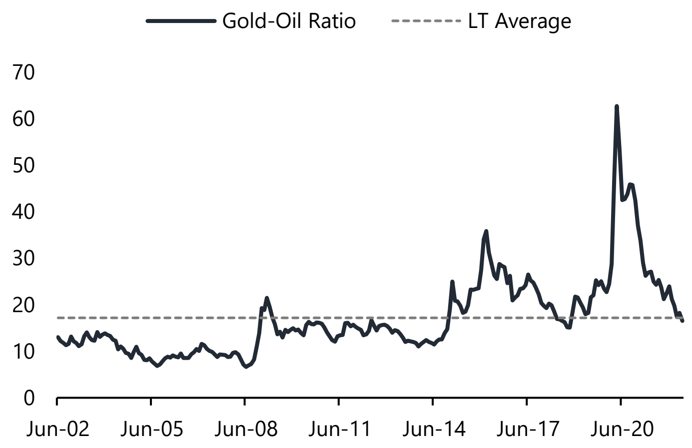
Sources : Bloomberg, MNCS Research

Exhibit 7. Recession proxy : narrowed spread 2-10 yr UST note



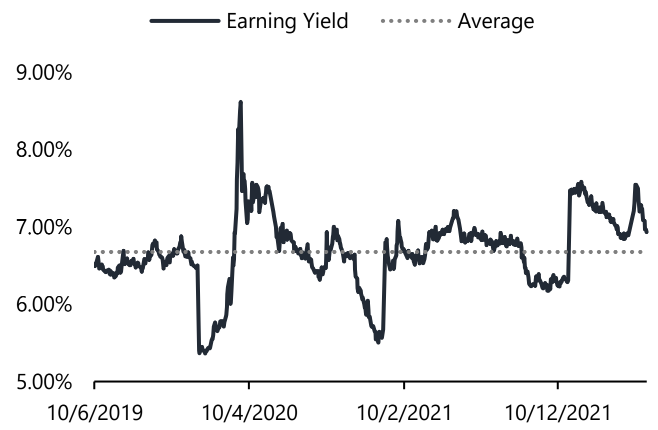
Note: grey area indicate stdev. Sources : Bloomberg, MNCS Research

Exhibit 8. Gold/oil back to average 17x reflects tightened oil market



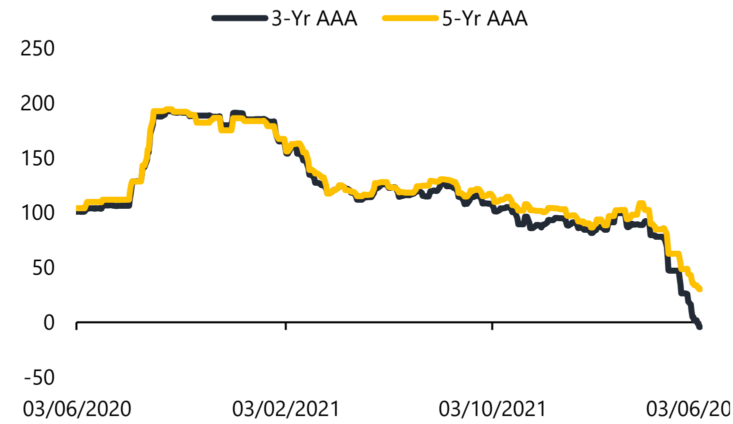
Sources : Bloomberg, MNCS Research

Exhibit 9. JCI earning yield above its 3-year average



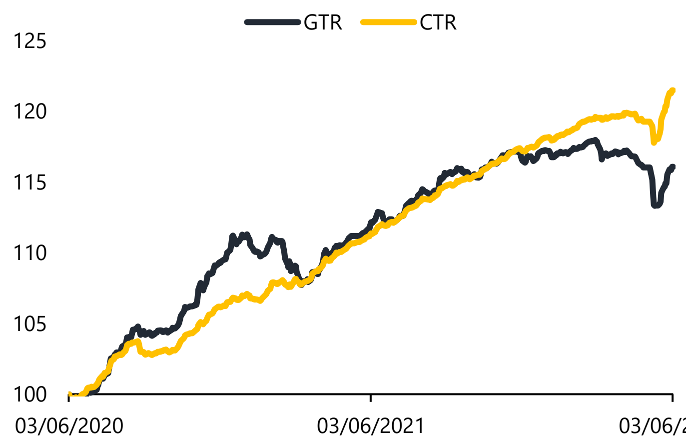
Sources : Bloomberg, MNCS Research

Exhibit 10. Spread of corp. bonds narrowed implying a lower risk



Sources : Bloomberg, IBPA, MNCS Research

Exhibit 11. CTR outperformed GTR



Sources : Reuters Polls, MNCS Research

MNC Research Industry Ratings Guidance

OVERWEIGHT: Stock's total return is estimated to be above the average total return of our industry coverage universe over next 6-12 months

NEUTRAL: Stock's total return is estimated to be in line with the average total return of our industry coverage universe over next 6-12 months

UNDERWEIGHT: Stock's total return is estimated to be below the average total return of our industry coverage universe over next 6-12 months

MNC Research Investment Ratings Guidance

BUY : Share price may exceed 10% over the next 12 months

HOLD : Share price may fall within the range of +/- 10% of the next 12 months

SELL : Share price may fall by more than 10% over the next 12 months

Not Rated : Stock is not within regular research coverage

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