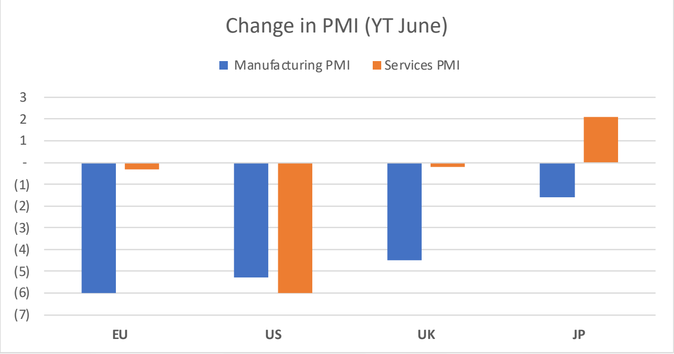
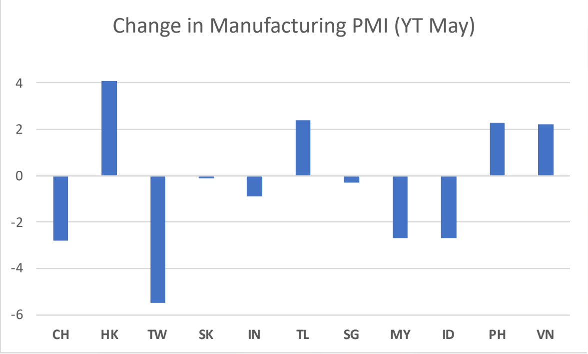
Singapore 3Q 2022 Strategy

The de-rating in global markets in 2Q was sharp and brutal, reflecting macro concerns, rising rates and inflation. Singapore's STI gave back all its gains in 1H. YTD, it was down 1.0%. The outlook for 3Q and 2H is dimmed by: 1) a slowdown in manufacturing PMIs, in particular in developed economies; 2) higher commodity and manpower costs, putting margins at risk; and 3) food inflation eating into household income. We expect more earnings downgrades after the 2Q reporting season as the cost pressure becomes more apparent when earlier inventories run down.

PMIs retreating in developing markets, with some bright spots in Asia

Manufacturing PMIs, though still expansionary (at above 50 points), retreated between April and June in developed markets. The decline in service PMIs is a bigger concern, as consumption contributes to more than 60% of GDP in the US and UK, and 50% in the EU.





Source: Trading economics

Taiwan's PMI slipped 5.5 points to 50. This suggests a potential slowdown in semiconductor and electronics output in 3Q. Tech manufacturers are flagging inventory control as their key focus, pointing to lower output and more inventory drawdowns. Singapore's semiconductor exports accounted for 12.1% of NODX in 2021, and 12.7% in the first five months of 2022. Growth was +21.8% yoy in the first five months, but this is expected to slow.

On the other hand, emerging markets reopened and relaxed COVID restrictions only in late 2021. Hence, their economic activities are still recovering. A pick-up in manufacturing and resumption of tourism might just hold up PMIs and growth in 3Q for Thailand, the Philippines and Vietnam.

Hong Kong and China, which are scaling back COVID restrictions, should fare better in 2H in terms of GDP growth, versus other parts of Asia.

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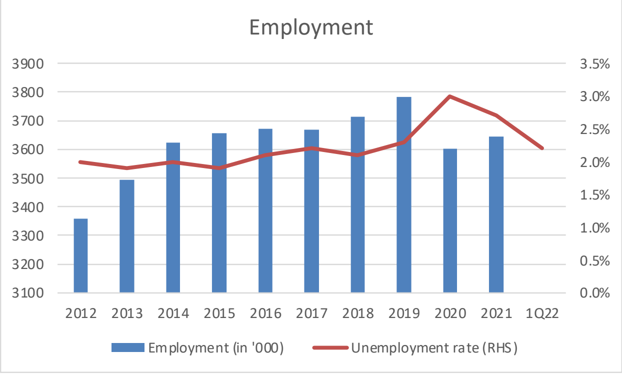
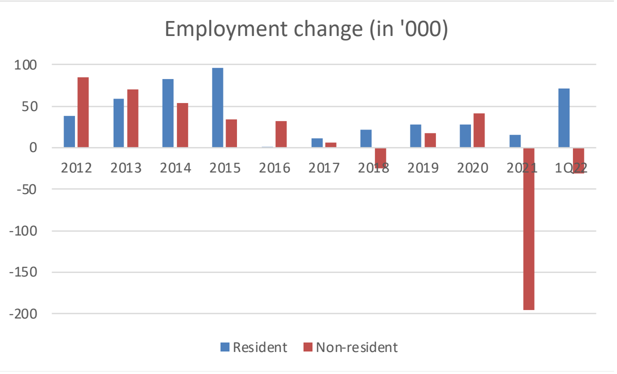
Cost inflation has not been priced in

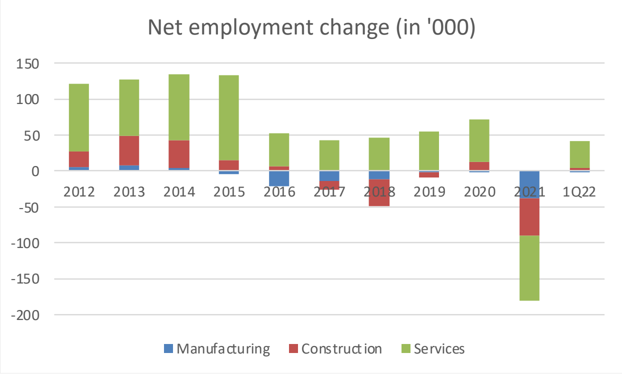
Besides costlier energy, Singapore corporates face a wage-cost spiral, stoked by a low unemployment rate of 2.2%. Total employment has fallen since COVID, mainly due to the departure of foreign workers and those in the service sector. There was still a net outflow of foreign workers in 1Q22, despite a relaxation of border controls.

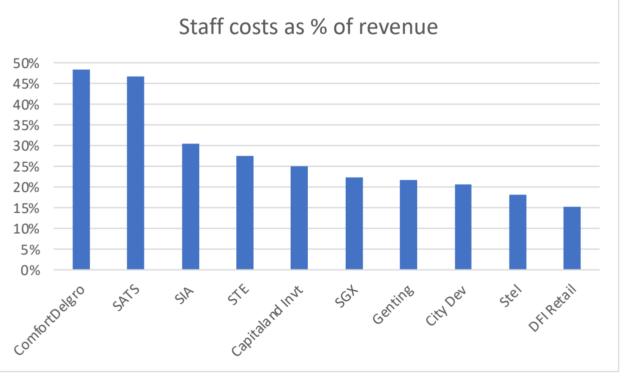
Given an aging population and the slow return of foreign workers (with a stringent quota system), unemployment is expected to stay low. Higher wage bills are likely to persist, pinching corporate margins. Longer term, this might incentivize investments in automation; shorter term, earnings will be hurt.

Among the index stocks, SIA was the worst hit, given that staff and energy costs account for 30.4% and 26.6% of its revenue in FY22 (Mar) respectively.









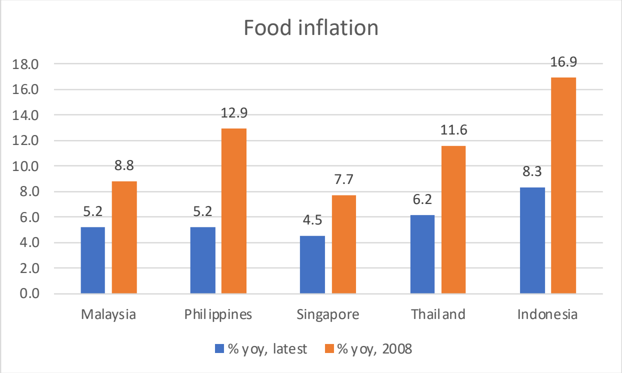
Source: singstat.gov.sg

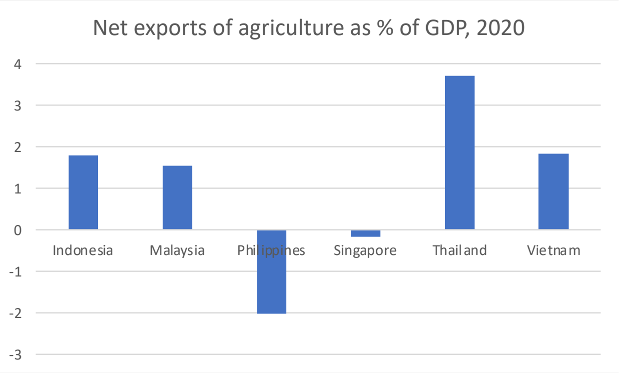
Source: Annual reports

Food inflation is a cause for concern

Disruptions in crop output and distribution, higher costs of fertilizers, and a stronger US$ viz-a-viz regional currencies have pushed up food inflation. Food accounts for a bigger share of the CPI basket in emerging markets and weighs on household income. Though the increase so far is still below the spike in 2008, we expect inflation to edge higher in 2H, as regional currencies further weaken. This assumes policy interest rates in the region cannot keep pace with the US rate hikes. Countries such as Indonesia and Malaysia might cut their subsidies on food to relieve the pressure on fiscal positions, further fuelling food inflation.

Input cost increases can be passed through to consumers in the early phase, when there is pent-up demand during economic reopening. Subsequent increases, though, will affect demand, on top of the lagged effects of cost inflation on manufacturers' margins.





Stick to price leaders

Construction is likely to be the sector to do the heavy-lifting in 2H2022. Housing and infrastructure projects will take priority to address tight supply and the surging prices of HDB resale flats. We continue to recommend building-material suppliers BRC Asia, HG Metal and Pan United, which are expected to pass on cost increases. They are also able to improve margins through value-added pre-fabrication work which is now done at warehouses instead of construction sites due to space and manpower constraints. We also like stocks exposed to Hong Kong's economic rebound, such as Hongkong Land and DFI Retail Group.

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