SECTOR UPDATE

Banking – Singapore

Upside From Higher Interest Rates vs Perceived Threat From Looming Recession

The Fed accelerated the tempo of rate hikes to quell inflationary pressure. We expect another 75bp hike on 27 July but the intensity of hikes could ease after the FOMC meeting on 21 Sep 22. The resilient labour market and strong households' and companies' balance sheets in the US ensure that potential economic downturn, if it materialises, would be mild. BUY DBS (Target: S$38.78) and OCBC (Target: S$14.95) for their 2022 dividend yields of 4.8% and 4.9% respectively. Maintain OVERWEIGHT.

WHAT'S NEW

- **Fed's renewed fervour to clamp down on inflation.** The Fed has accelerated the tempo of interest rate hikes to quell inflationary pressures. It hiked the Fed Funds Rate by a massive 75bp to 1.50% after the FOMC meeting on 15 Jun 22. Based on the Fed's dot plot, the median projected path for Fed Funds Rate would hit 3.4% by end-22 and 3.8% by end-23. The forecast translates to four hikes totalling 200bp in 2H22, and we expect another 75bp hike on 27 July. The rate hikes are front-loaded in 2022 and the intensity of rate hikes could ease after the FOMC meeting on 21 Sep 22.

- **Interest rates in Singapore have moved up in tandem.** Higher inflation and the Fed's intervention have caused short-term interest rates to surge. The US yield curve has flattened, indicating a slowdown in economic growth. Fortunately, the 10-year – 2-year term spread has stayed marginally positive at 0.1%. The current short-end of the yield curve implies forward short-term interest rates at 2.7% for 1Y, 3.4% for 2Y and 3.4% for 3Y. 3-month SIBOR and 3-month Compounded SORA have risen 112bp and 53bp respectively to 1.56% and 0.72% in 1H22. UOB Global Economics & Markets Research forecasts 3-month SIBOR and 3-month Compounded SORA to reach 2.75% (+2.31ppt yoy) and 2.29% (+2.10ppt yoy) respectively by end-22.

- **Core PCE inflation is receding but at an anaemic pace.** US core PCE inflation peaked at 5.3% in Feb 22, the fastest pace in 30 years, overshooting the Fed's target of 2.0%. Since then, core PCE inflation eased 0.3ppt mom to 4.9% in Apr 22. The easing of inflationary pressure coincided with the pick-up in economic activities after daily new cases of the Omicron variant subsided. Implied inflation based on 5-year Treasury Inflation-Protected Securities (TIPS) moderated from a peak of 3.6% in mid-April to the current 2.8%.

- Chairman Jerome Powell said that the Fed needs to see compelling evidence with inflation consistently abating over a couple of months before it pulls back from aggressive rate hikes. The Fed needs to prevent expectations of higher inflation becoming unmoored. President of Cleveland Fed Loretta Mester cautioned that it will take a few years to bring inflation back to 2%.

- **US economy slipping into recession is not a certainty.** The US economy is resilient with a strong labour market and unemployment rate near a 50-year low of 3.6% in May 22. Companies added 390,000 jobs while average hourly earnings grew 5.2% yoy in May 22. There are 2.1 job openings for every unemployed worker. The resilient labour market supports continued growth in domestic consumption to weather the series of interest rate hikes. Households' and companies' balance sheets are strong, ensuring that the potential economic downturn, if it materialises, would be mild. The probability of a US recession in 2023 is only 4.1% based on an indicator developed by the New York Fed.

OVERWEIGHT

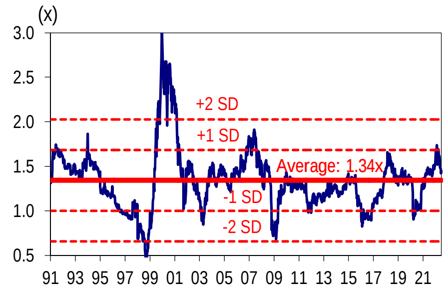
(Maintained)

TOP BUYS

Company	Rec	Share Price (S$)	Target Price (S$)
DBS	BUY	30.21	38.78
OCBC	BUY	11.39	14.95

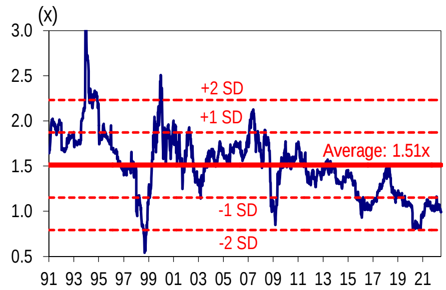
Source: UOB Kay Hian

P/B – DBS



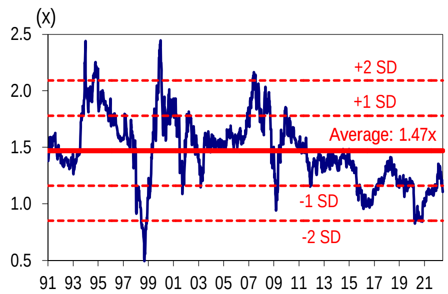
Source: UOB Kay Hian

P/B – OCBC



Source: UOB Kay Hian

P/B – UOB



Source: UOB Kay Hian

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PEER COMPARISON

Company	Ticker	Rec	Price @ 27 Jun 22 (S$)	Target Price (S$)	Market Cap (US$m)	FY	PE 2022F (x)	PE 2023F (x)	P/B 2022F (x)	P/B 2023F (x)	P/PPOP 2022F (x)	P/PPOP 2023F (x)	Yield 2022F (%)	Yield 2023F (%)	ROE 2022F (%)	ROE 2023F (%)
DBS	DBS SP	BUY	30.21	38.78	56,141	12/2021	11.8	10.2	1.41	1.32	9.5	7.7	4.8	4.9	11.6	13.0
OCBC	OCBC SP	BUY	11.39	14.95	36,961	12/2021	10.2	9.2	0.97	0.92	9.1	8.1	4.9	5.3	9.4	10.0
UOB*	UOB SP	NR	26.55	n.a.	32,105	12/2021	10.2	8.4	1.03	0.96	8.4	7.0	4.9	5.8	10.4	12.0
Average							10.7	9.3	1.13	1.07	9.0	7.6	4.9	5.3	10.5	11.7

** Based on consensus estimate*
Source: Bloomberg, UOB Kay Hian

ACTION

- **QT has already begun.** Quantitative tightening (QT) commenced on 1 Jun 22. Monthly cap for treasury securities was initially set at US$30b and increases to US$60b after three months. Monthly cap for mortgage-backed securities started at US$17.5b and increases to US$35b after three months. The pace of QT is much faster compared to the monthly cap of US$50b for the last QT conducted in 2018 and 1H19 when the Fed's balance sheet contracted 16%.

- **Manageable impact from QT during 2018 and 1H19.** We analyse the impact of QT on the share price performance of Singapore banks during 2018 and 1H19, the only historical precedent of QT. We observed that banks' share prices gained 24.1% and outperformed the STI by 15.9% over three quarters during 2H17 (the six months prior to QT) and 1Q18 (commencement of QT).

IMPACT OF QT ON SHARE PRICE PERFORMANCE

	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
Fed's Total Assets (US$b)	4,456	4,449	4,392	4,305	4,193	4,076	3,956	3,827	3,858	4,166
- qoq % Chg	*-0.2*	*-0.2*	*-1.3*	*-2.0*	*-2.6*	*-2.8*	*-2.9*	*-3.3*	*0.8*	*8.0*
STI - Total Return	1.1	6.0	1.1	-3.3	1.3	-5.5	5.1	5.1	-4.7	3.9
Singapore Banks (%)										
MSCI Banks - Total Return	3.3	14.5	6.3	-2.5	1.0	-6.9	2.6	6.0	-1.7	3.1
Relative Return to STI	*2.2*	*8.5*	*5.2*	*0.8*	*-0.2*	*-1.4*	*-2.5*	*0.8*	*3.0*	*-0.8*

Source: UOB Kay Hian

- **Maintain OVERWEIGHT.** Banks gain bargaining power as liquidity is tightened due to higher interest rates and QT. They benefit from NIM expansion with DBS being the most sensitive to higher interest rates. The Russia-Ukraine war exacerbates higher inflation, which could keep bond yields higher for longer. OCBC and UOB benefit from reorientation of supply chains towards ASEAN countries. BUY DBS (Target: S$38.78) and OCBC (Target: S$14.95) for their 2022 dividend yields of 4.8% and 4.9% respectively.

DBS (DBS SP/BUY/S$30.21/Target: S$38.78)

- We expect DBS' NIM to expand by 9bp to 1.54% in 2022 and 43bp to 1.97% in 2023. We forecast earnings growth of 15.9% in 2023 and 9.7% in 2024.

- We expect DPS of S$1.44 in 2022 and S$1.48 in 2023, which represents dividend payout ratios of 56.4% and 50.0% respectively. DBS provides dividend yields of 4.8% for 2022 and 4.9% for 2023.

- Our target price of S$38.78 is based on 1.69x 2023F P/B, derived from the Gordon Growth model (ROE: 13.3%, COE: 8.5% (previous: 8.25%), growth: 1.5%).

KEY ASSUMPTIONS – DBS

	2020	2021	2022F	2023F	2024F
Loan Growth (%)	4.2	9.9	4.5	5.9	4.9
NIM (%)	1.63	1.45	1.54	1.97	2.01
Fees, % Chg	0.2	15.2	0.2	9.8	7.6
NPL Ratio (%)	1.60	1.27	1.38	1.45	1.48
Credit Costs (bp)	79.7	1.3	14.1	27.4	27.2
Net Profit (S$m)	4,721	6,805	6,659	7,721	8,473
% Chg	(26.1)	44.1	(2.1)	15.9	9.7

Source: UOB Kay Hian

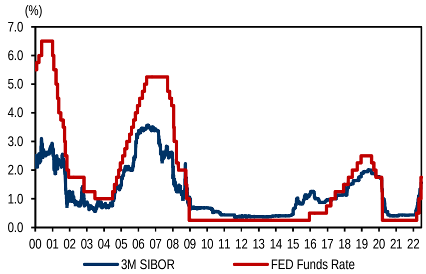
OCBC (OCBC SP/BUY/S$11.39/Target: S$14.95)

- We expect OCBC's NIM to expand by 6bp to 1.61% in 2022 and expand 27bp to 1.88% in 2023. We forecast earnings growth of 11.0% in 2023 and 6.1% in 2024.

- We expect DPS of S$0.56 in 2022 and S$0.60 in 2023, which represents dividend payout ratio of 50.2% and 48.4% respectively. OCBC provides dividend yield of 4.9% for 2022 and 5.3% for 2023.

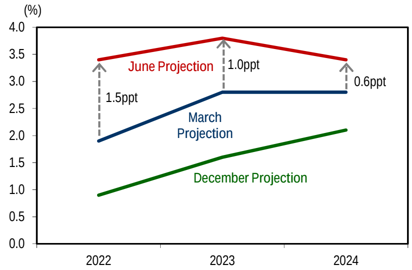
- Our target price of S$14.95 is based on 1.20x 2023F P/B, derived from the Gordon Growth model (ROE: 10.1%, COE: 8.5% (previous: 8.25%), growth: 0.5%).

FED FUNDS RATE VS 3-MONTH SIBOR



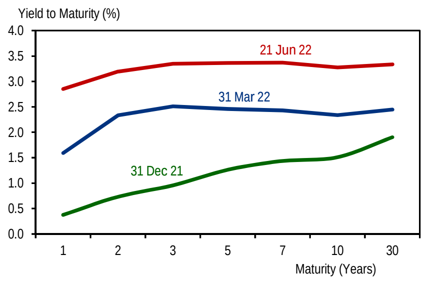
Source: Bloomberg

FED'S DOT PLOT (JUN 22 VERSUS MAR 22)



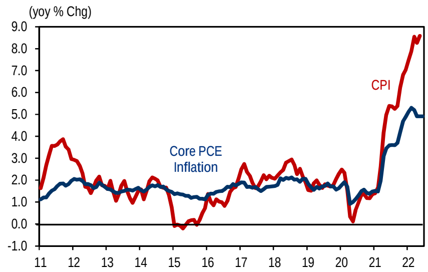
Source: Federal Reserve

US YIELD CURVE



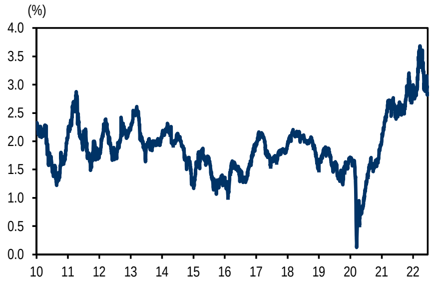
Source: Bloomberg, UOB Kay Hian

US CORE PCE INFLATION VERSUS CPI



Source: CEIC

IMPLIED INFLATION BASED ON YIELD FOR 5Y TIPS



Source: CEIC

KEY ASSUMPTIONS – OCBC

	2020	2021	2022F	2023F	2024F
Loan Growth (%)	0.6	8.6	3.9	3.6	5.2
NIM (%)	1.62	1.55	1.61	1.88	1.91
Fees, % Chg	(5.6)	12.0	0.8	4.0	6.4
NPL Ratio (%)	1.47	1.45	1.53	1.63	1.61
Credit Costs (bp)	76.7	31.3	19.7	27.1	27.7
Net Profit (S$m)	3,588	4,858	5,020	5,572	5,911
% Chg	(26.3)	35.4	3.3	11.0	6.1

Source: UOB Kay Hian

SECTOR CATALYSTS

- NIM expansion in 2022 and 2023, driven by upcycle in interest rates.
- Strengthening of economic growth driven by easing of safe distancing measures and reopening of international borders after Singapore has weathered the Omicron variant.

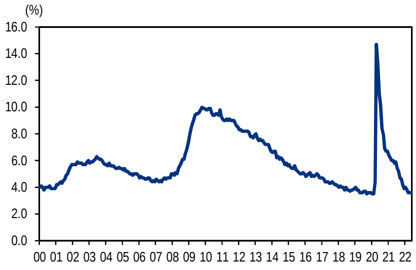
ASSUMPTION CHANGES

- We raised our 2023 earnings forecast for DBS by 7% and OCBC by 3%. Our earnings revisions are tempered by expectations of higher credit costs of 27bp for DBS (previous: 22bp) and OCBC (previous: 24bp) due to slowdown in economic growth in 2023. We have factored in US Fed Funds Rate reaching 3.25% by end-22 and stabilising thereafter in 2023.

RISKS

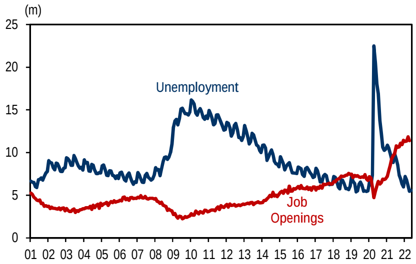
- Escalation of the Russia-Ukraine war beyond Ukraine.
- Geopolitical tension and trade conflict between the US, China and Russia.

US UNEMPLOYMENT RATE



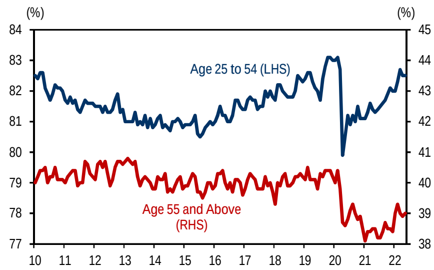
Source: CEIC

US UNEMPLOYMENT VERSUS NON-FARM JOB OPENINGS



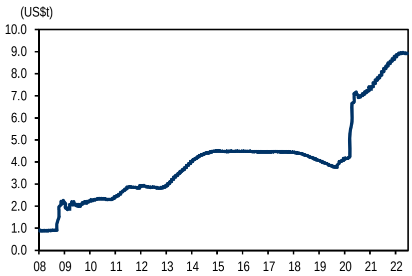
Source: CEIC

US LABOUR FORCE PARTICIPATION RATE



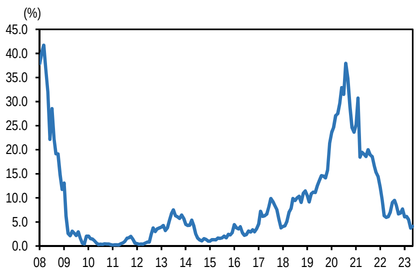
Source: CEIC

SIZE OF THE FED'S BALANCE SHEET



Source: Federal Reserve

PROBABILITY OF US RECESSION – NEW YORK FED



Source: CEIC

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