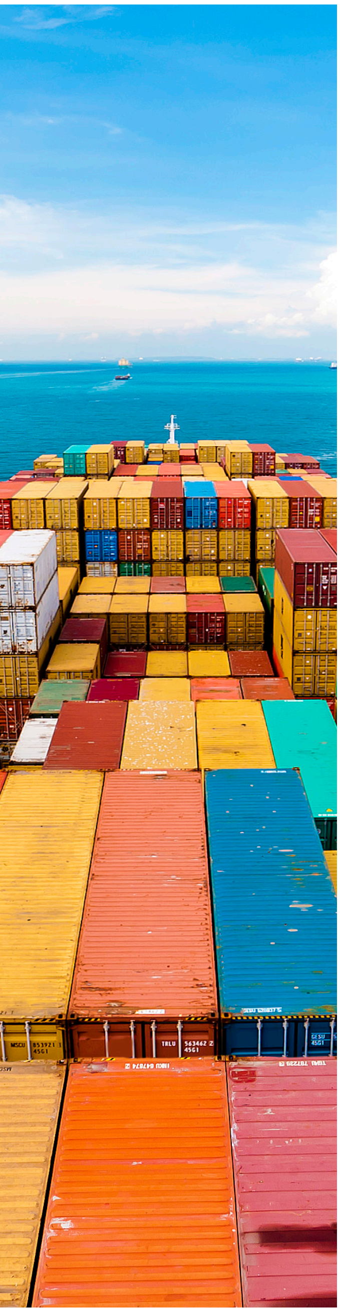
Navigating a surging recovery and significant risk rotations

Fullerton Investment Views - Quarterly report

April 2021

FULLERTON FUND MANAGEMENT



Executive summary

- **The very strong recovery, and progress on COVID-19 containment and vaccination, remains critical in supporting our positive view on risk asset performance.** At the same time, geopolitical risks – a key downside to Asian equities – have increased as President Biden has become more hawkish on issues of contention with China.
- **Rotation, rotation, rotation!** In the first quarter, very strong global equity returns slowed a bit, before pushing to new highs in April. However, the biggest surprise to investors has been the surge in bond yields, especially across Developed Markets (DM). As the reflation trade has matured, significant risk rotations have unfolded from global bonds (and gold) to equities, from growth stocks to value stocks, and from Asian equities toward DM.
- **This 'Goldilocks' environment still needs caution. We have dialled back our outlook for equities from bullish to positive, and continue to favour US and Asian equities.** Investors need to actively manage their portfolios with caution as equity valuations are still high and the extreme lows for yields have likely passed.
- **We are positive on corporate credit,** especially High Yield (HY), with expectations of contained defaults and prospects for spread compression. We remain negative on US bonds duration, with more upside likely for nominal yields over time (driven by slowly normalising real yields). With solid investment flows to Asia likely to continue, we expect the USD to remain weak.
- **What has been very encouraging for investors is that the surge in bond yields across DM has not been driven by overshoots in inflation expectations.** Rather it has been more a reflection of stronger risk appetite, rebounding investment, and above trend growth – collectively reducing the need for 'rock-bottom' nominal yields. The next stages of this normalisation process will be the recovery in real yields.
- **These adjustments should not prove too stressful for risk asset markets, especially equities, because economies do not appear to have been structurally damaged by the COVID-19 driven recession.** Policy stimulus has been extremely effective in fostering recoveries, while productivity and investment growth have rebounded very well.

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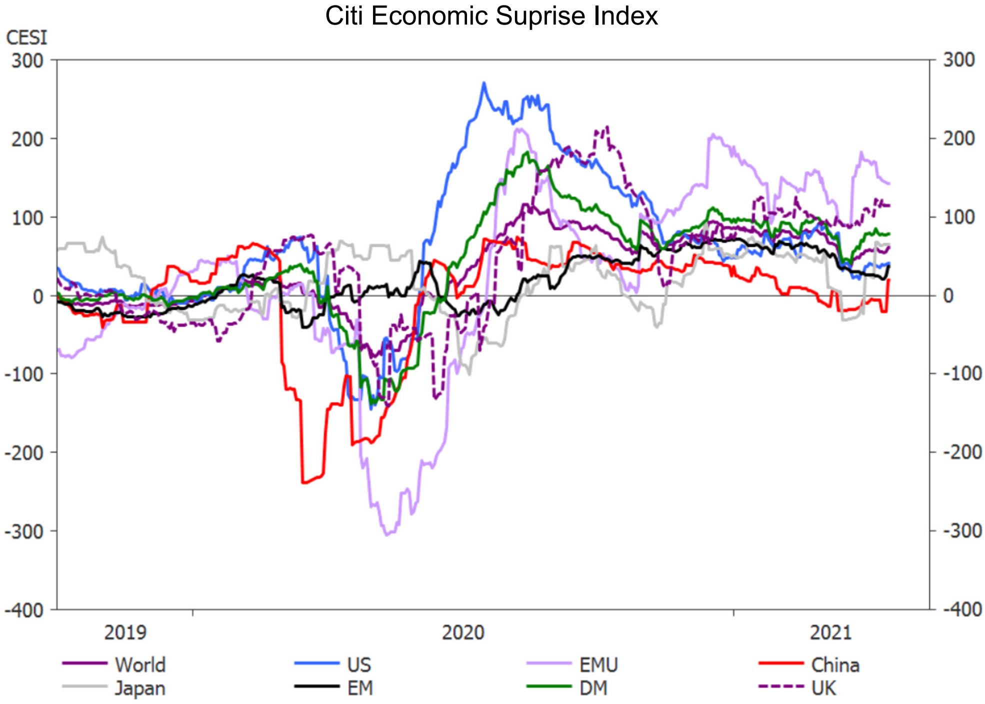
1. Macro backdrop remains very strong

The GDP growth recovery is at record strength

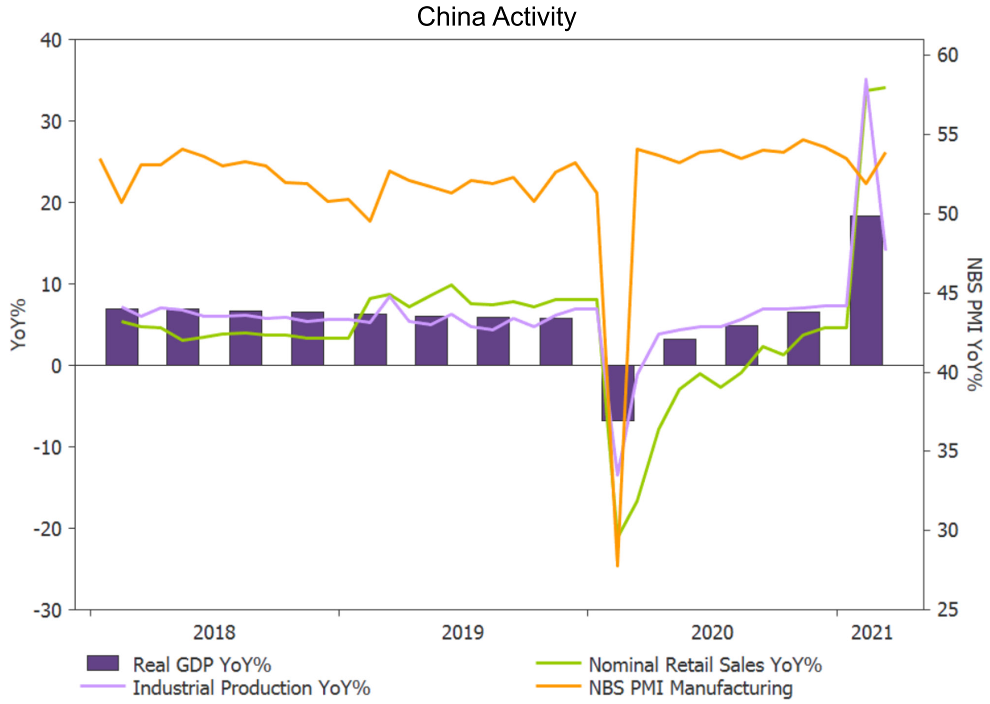
Global growth data has remained robust over Q1, and into Q2 it is still surprising the Consensus forecasts on the upside, especially across DM (see Figure 1). China is still leading the global recovery and its latest activity indicators for Q1 have been very strong, notwithstanding that performance is distorted to some extent by the effects of the Lunar New Year holiday (see Figure 2).

Figure 1: Positive economic data surprises to the Consensus view



Source: Refinitiv Datastream, 18 Apr 2021

Figure 2: China's economic activity indicators are showing strength



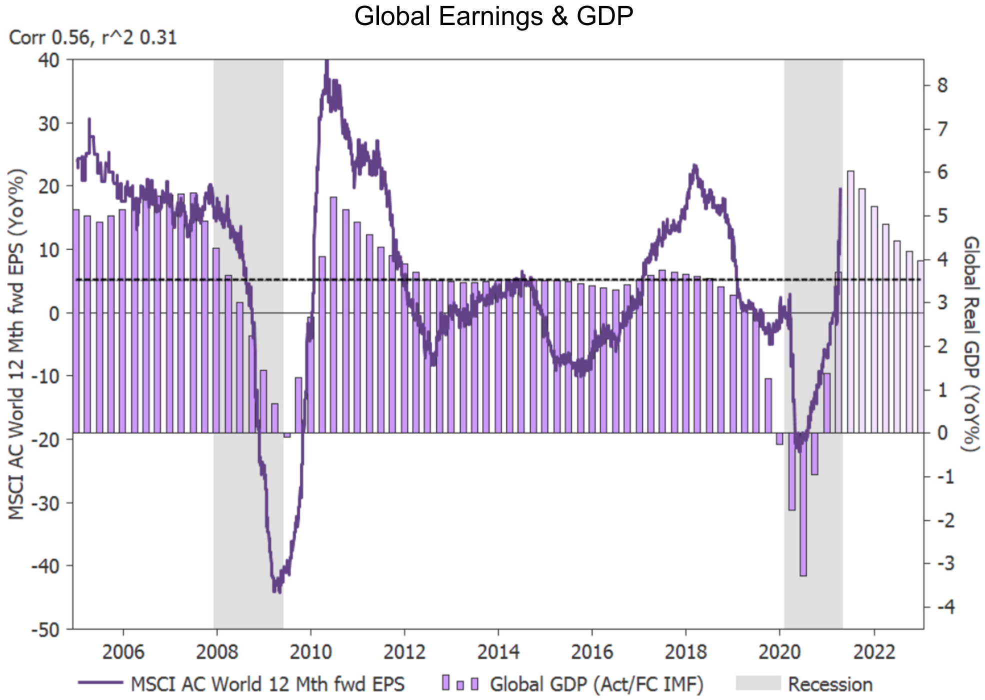
Source: Refinitiv Datastream, 17 Apr 2021

Very strong global growth is driving up earnings and equities

Expected global growth for 2021 was revised up by the IMF to 6% YoY (from 5.2% YoY in our previous report) and is forecast to remain above trend until next year. Strong global GDP growth expectations are feeding into earnings growth expectations (see Figure 3) and this is proving a key driver of the robust rally in global equities.

The Bloomberg Consensus forecasts (as at 18 April 2021) for 2021 are expecting China's growth to be the strongest in a decade at 8.5% YoY; US growth is forecast at 6.2% YoY, which is the strongest in more than 35 years; and European Economic and Monetary Union (EMU) growth is projected at 4.2% YoY (making it the strongest Eurozone performance in 20 years).

Figure 3: Expected global GDP growth and earnings



Source: Refinitiv Datastream, 18 Apr 2021

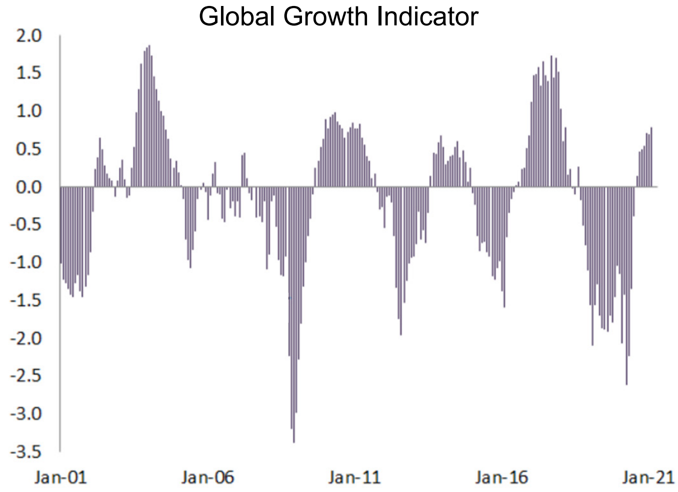
This 'Goldilocks' environment can continue for investors

Fullerton's aggregate global growth indicator continues to gain strength, suggesting this Goldilocks environment for investors can continue (see Figure 4). We are seeing some rotation in the key drivers of the recovery, as consumer demand growth has become significantly stronger in China, while across major developed markets strong consumption demand is getting reinforced by the pick-up in industrial production performance.

Liquidity growth is slowing, especially across China, but should remain supportive

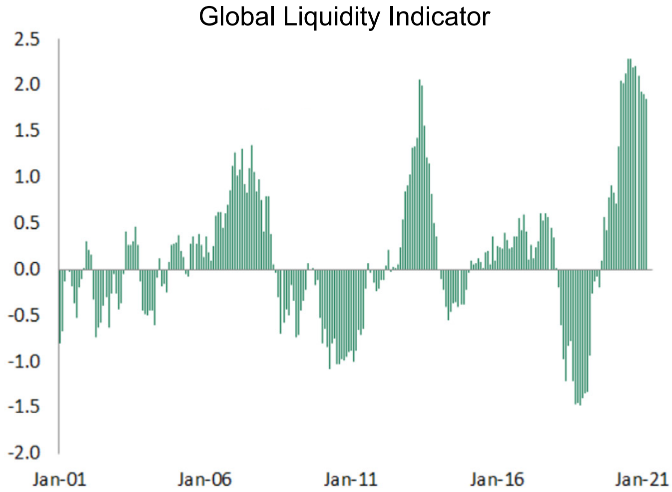
Global liquidity growth remains above trend and while it is slowing, especially in China, it may still prove significantly stronger than economic activity and therefore supportive to risk asset markets (see Figures 5 and 6).

Figure 4: Fullerton's global growth indicator



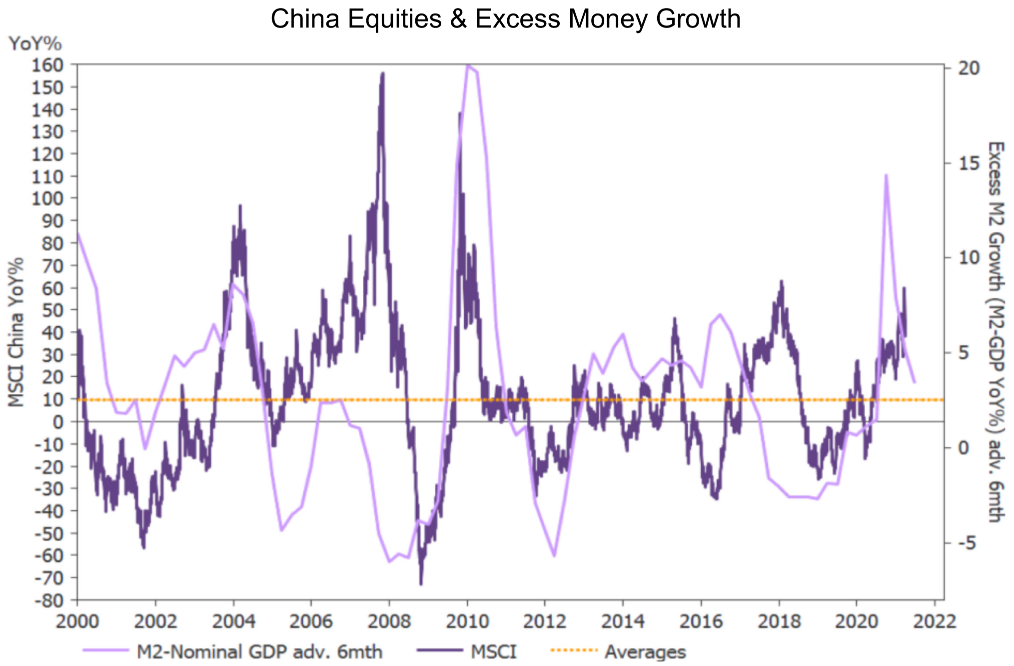
Source: Fullerton, April 2021

Figure 5: Fullerton's global liquidity indicator



Source: Fullerton, April 2021

Figure 6: Excess liquidity growth in China with its equity returns (YoY%)

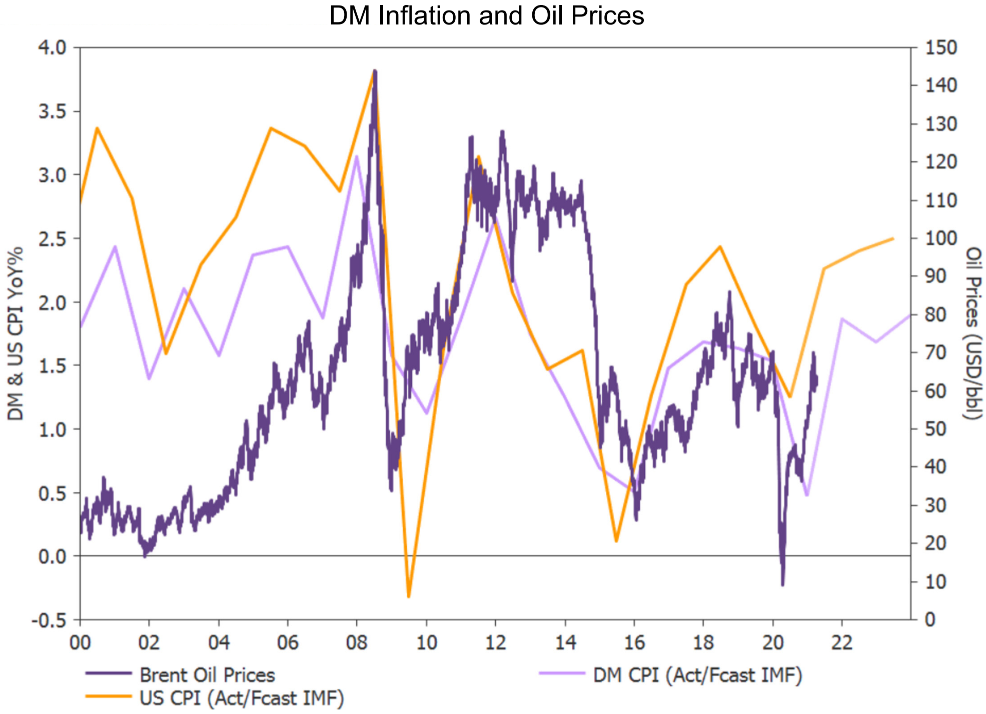


Source: Refinitiv Datastream, 31 Mar 2021

The rebound in CPI inflation should not shock markets

Inflation across DM, led by the US in particular, is rebounding strongly. The expected jump in US inflation this year is significant, at 2.8% YoY by the IMF and at 2.5% YoY by the Bloomberg Consensus (as at 18 April 2021). But this cyclical inflation recovery should not likely result in a long-lasting overshoot that would stress investors and policymakers, as it is largely driven by base-effects and normalising commodity prices (see Figure 7).

Figure 7: DM and US inflation (YoY%), with oil prices

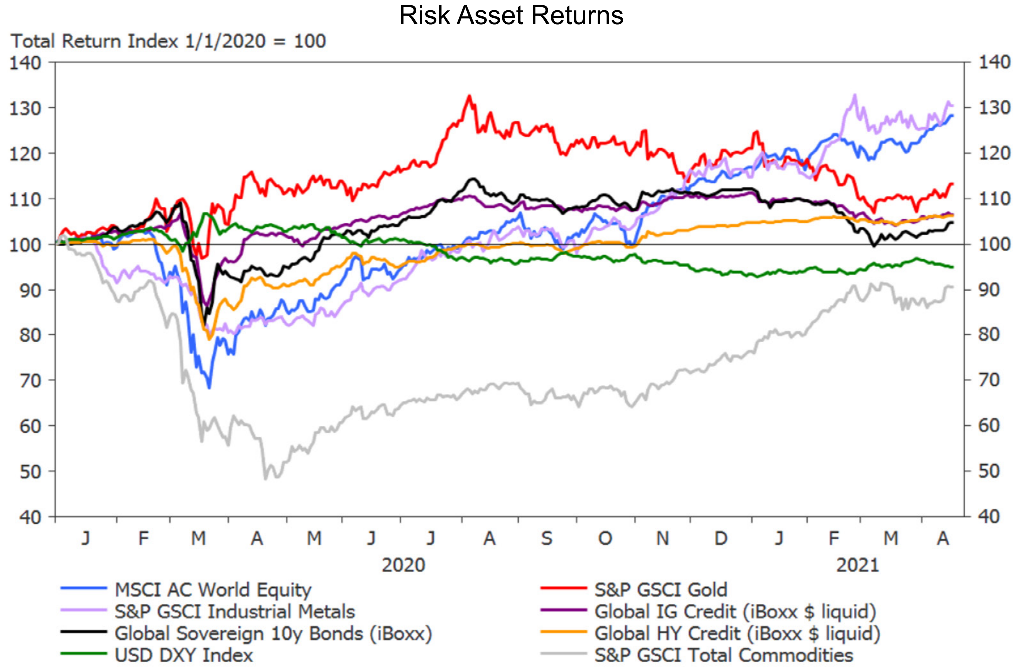


Source: Refinitiv Datastream, 19 Apr 2021

Risk asset returns continue to track macro developments

After the very strong returns in 2020, returns from equities and industrial metals slowed slightly over Q1 2021, but have pushed on further to reach new highs in Q2 2021 (see Figure 8). Corporate credit, especially high yield credit, have seen stronger performance with further spread compression, and are catching up to Investment Grade (IG) credit returns. Returns for global sovereign bonds have suffered from the sharp rise in long-term yields, especially across DM. With more confidence in the economic recovery, and higher real yields, returns from gold have also slipped lower.

Figure 8: Risk asset returns since January 2020

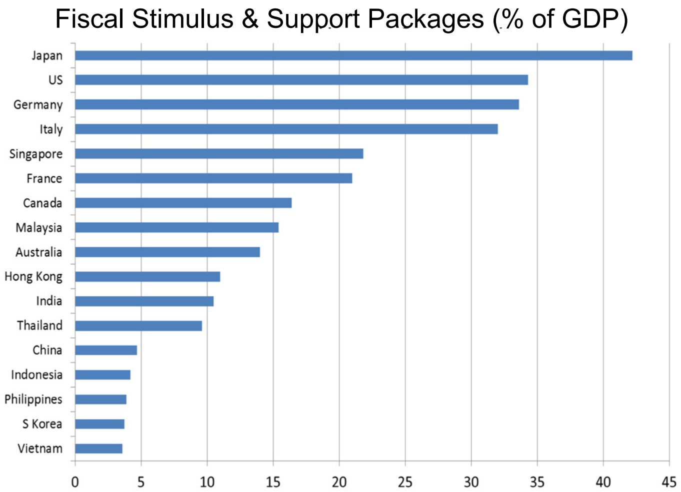


Source: Refinitiv Datastream, 17 Apr 2021

Policy stimulus remains a key driver of our positive outlook for risk assets

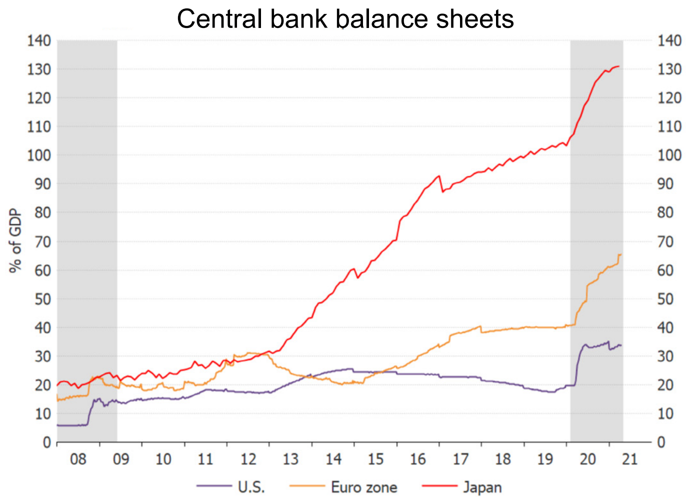
The March 2021 fiscal package from the US, at almost 10% points of GDP (taking US total fiscal stimulus to almost 35% of GDP, as seen in Figure 9), may give a significant boost to growth this year. Stimulus from central banks also remains significant as balance sheet shares of GDP remain high (Figure 10).

Figure 9: Global fiscal stimulus (% of GDP)



Source: IMF, Fullerton, March 2021

Figure 10: G3 central bank balance sheets (% of GDP)



Source: Refinitiv Datastream, 18 Apr 2021

US President Biden has also released plans for longer-term stimulus, amounting to US$2.2 trillion spend on infrastructure, spread over 8 years (which is about 1.3% points of GDP each year) to be funded by a rise in US corporate tax rates (from 21% to 28%). Such stimulus would likely have a positive effect on US GDP growth over time, as estimates of fiscal multipliers are around 1.5 times (i.e. $1.50 increase in GDP results from every $1 of stimulus).

However, US firms could face some margin compression, with funding for the fiscal stimulus coming from higher corporate taxes. That said, US firms may still be able to maintain reasonable margins with on-going cost efficiencies, as we saw around five years ago, when US corporate taxes rates were very high at 35%.

While the final form of this infrastructure stimulus package is still subject to political debate, the announcement seems to have further boosted investor confidence.

Geopolitical risks have increased, while COVID-19 risks remain broadly stable

For Asian equities, in particular, geopolitical risks remain a key downside. Firstly, US-China relations could deteriorate further as President Biden has become more hawkish on China. Issues of contention remain economic competition, intellectual property rights, IT security, territorial claims in the East and South China Seas, the treatment of Taiwan, and human rights management.

Secondly, uncertainties for investors have increased as China continues to adjust its market practice regulations for its IT conglomerates to reduce any significant monopolistic tendencies. Longer-term, these changes could ultimately prove beneficial for the industry, by forcing key players to become more resilient and to seek greater global market share.

The risk of returning to significant COVID-19 lockdowns seems to have faded. However, the global economy is still navigating the vaccination process, and concerns that new cases (especially mutated strains) could surge again. COVID-19 management and vaccination campaigns are unfolding well in the US and the UK, but other countries, like France, Brazil, India, and the Philippines, are finding progress much more challenging.

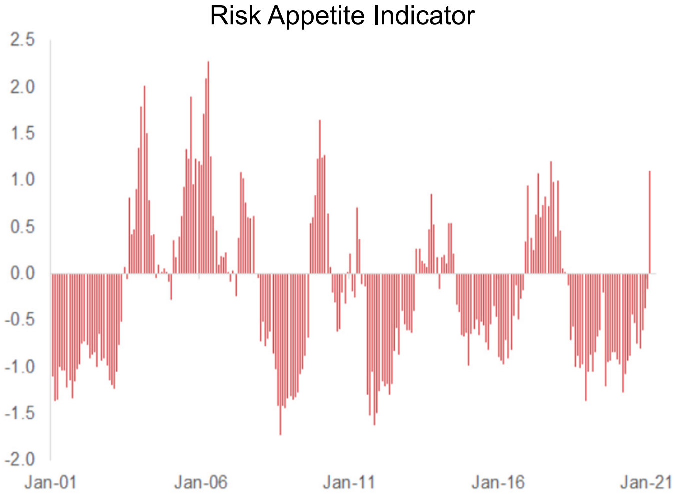
2. Investment strategy – we remain positive on risk assets in 2021

We have revised our outlook for global equities from bullish to positive in Q2 2021, largely because the extreme lows for yields have likely passed and valuations are high. Overall, we still have a positive outlook on risk assets.

Risk rotation is becoming a key theme for investors to navigate

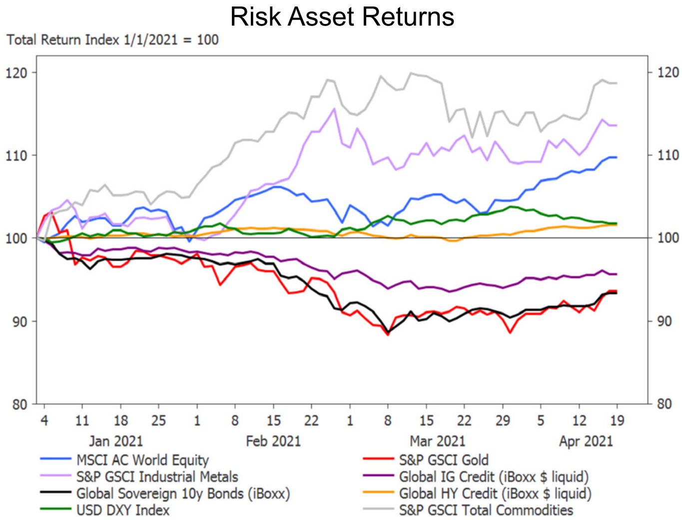
We had noted for a while that investors had been underinvested, but there has been a significant rebound in Fullerton's risk appetite indicator (see Figure 11), with the sharp rise in bond yields, further rotation to equities and away from gold, IG credit, and sovereign bonds (See Figure 12. YTD global equity returns – as measured by the MSCI AC World Index – are 10% higher, while bond returns – as measured by the iBoxx$ Sovereign 10 Years Index – have fallen 8% given the rise in global yields, driven by DM).

Figure 11: Fullerton's global risk appetite indicator



Source: IMF, Fullerton, Apr 2021

Figure 12: Risk asset returns YTD 2021



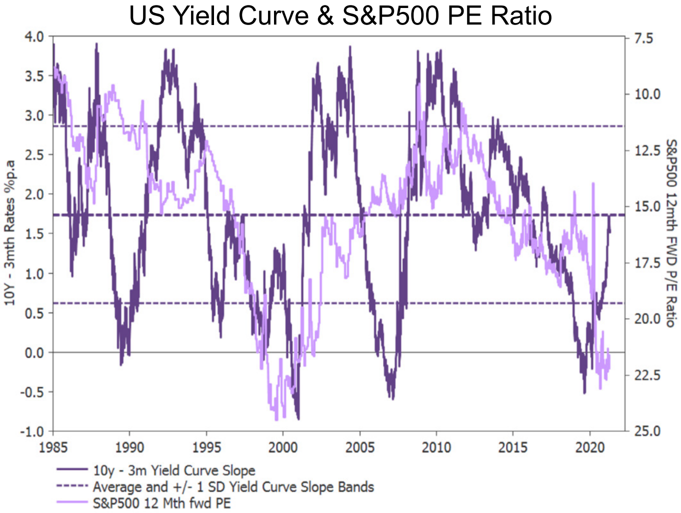
Source: Refinitiv Datastream, 18 Apr 2021

As the rally matures, and as yields continue to normalise, equity returns are likely to slow over time toward more sustainable long-run averages. So far this process of yield normalisation, which has seen the US yield curve return toward its typical slope, suggests that US equity valuations could be around cyclical peaks (See Figure 13).

However, while US 10-year nominal yields are around the pre COVID-19 levels, real 10-year yields are still very low and thus positive for risk assets (See Figure 14). As a result, rotations in risk asset performance are likely to continue until real monetary conditions have normalised.

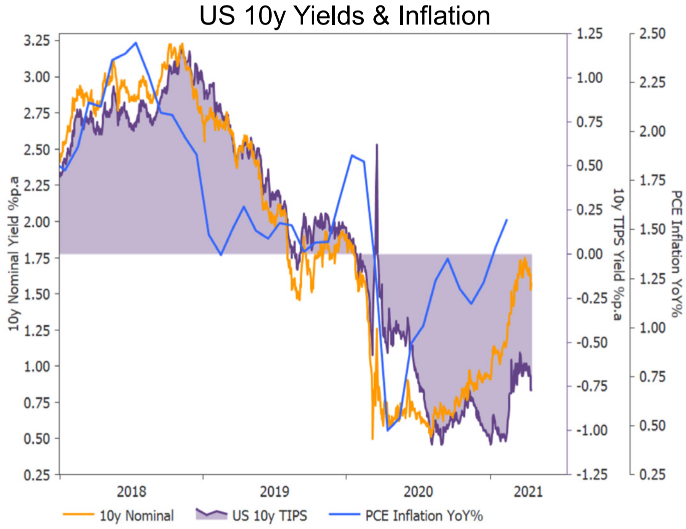
The adjustment back towards higher and more normal yields is still likely to exhibit some volatility and pull-backs along the way, as seen with the latest slip which was driven mostly by stronger long-term bond demand by pension funds. As yields continue to rise there are likely to be periods where fixed-income dependent investors step-back into the market to take advantage of higher yields.

Figure 13: US yield curve slope and equity PE ratio



Source: Refinitiv Datastream, 18 Apr 2021

Figure 14: US 10y yields and inflation

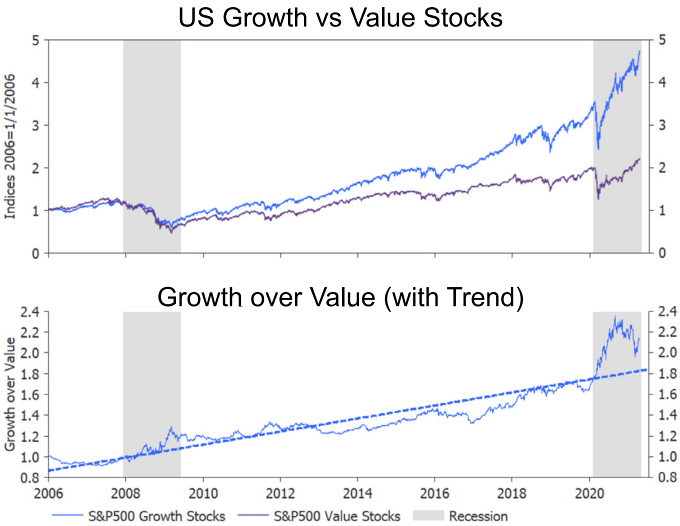


Source: Refinitiv Datastream, 18 Apr 2021

Rotations in equity performance are understandable as the global rally matures

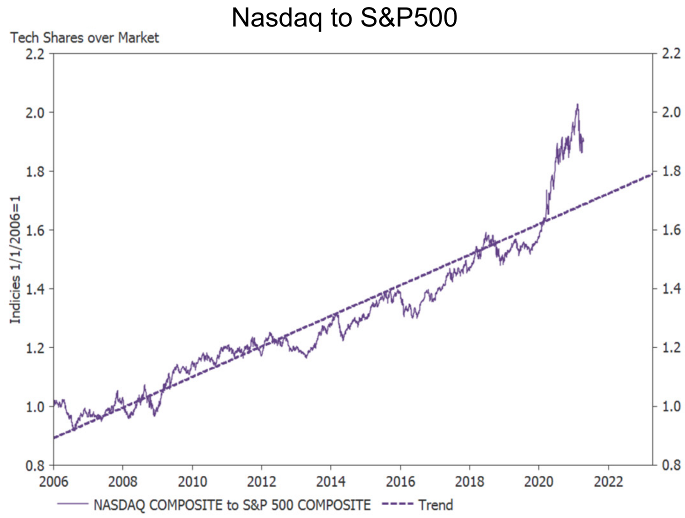
While rotations have an economic rationale, what has been surprising to investors is how fast and forceful some rotations have been. In many respects, this is another feature of just how rapid and compressed the recovery from recession, and rebound in risk asset prices, has been. The broadening of the rally has triggered a significant rotation toward value stocks, as lagging sectors have gained from demand recoveries and stronger earnings growth expectations (see Figure 15). Looking forward, it is likely that the rotation to value stocks will eventually drive growth stocks relative to value stocks back to its rising trend (Figure 15). At the same time, the outperformance of the technology sector relative to the market has also corrected back somewhat, especially in the US (see Figure 16).

Figure 15: Rotations to value stocks



Source: Refinitiv Datastream, 18 Apr 2021

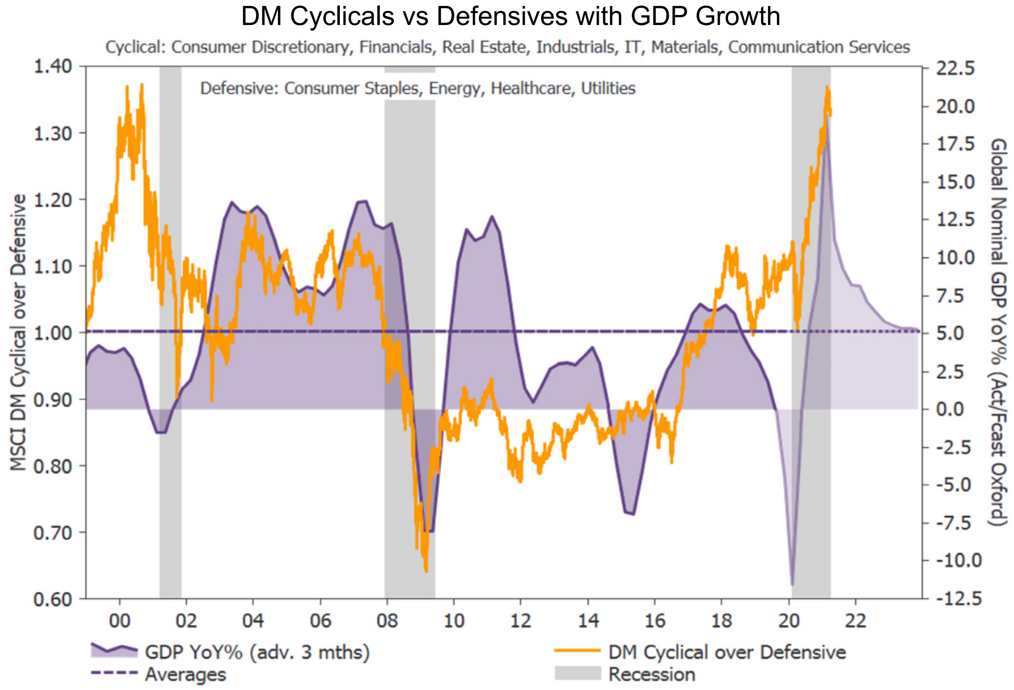
Figure 16: Rotations out of tech



Source: Refinitiv Datastream, 18 Apr 2021

There has also been very strong performance from cyclical sectors, especially across DM, as GDP growth has rebounded significantly above trend. Over time, more defensive sectors may experience better performance as GDP growth expectations peak. Strong rebounds in consumer spending will drive staples demand, while energy sector equities can gain from the rebound in oil prices (see Figure 17).

Figure 17: Cyclical sectors across DM have surged on strong growth

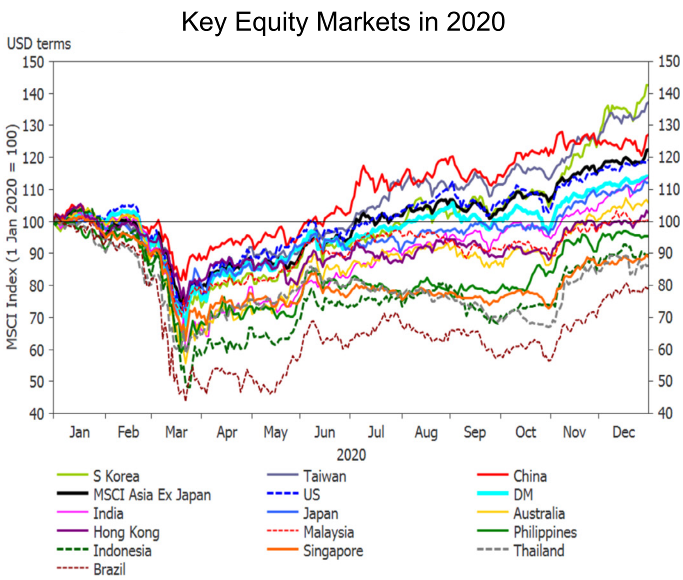


Source: Refinitiv Datastream, 31 Mar 2021

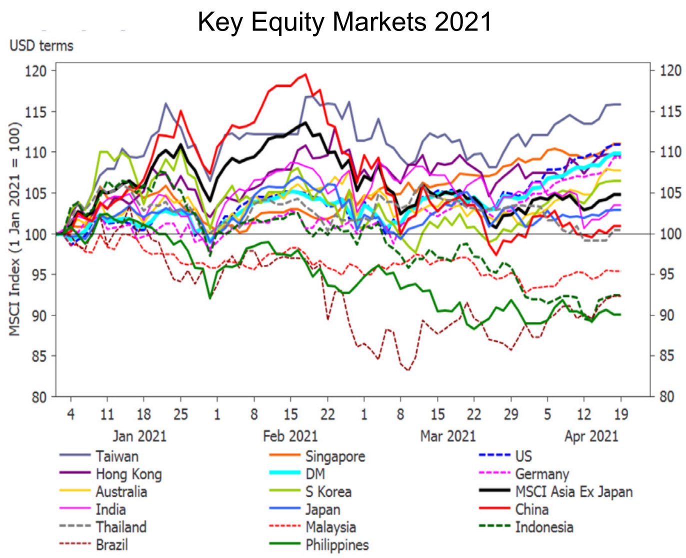
Country rotations are also proving significant

As Consensus forecasts have become much more bullish on the outlook for DM, driven by the US view, Asia's expected growth advantage is at its narrowest in many years. Other factors such as the spike in China's valuations, tighter Chinese liquidity conditions, greater uncertainties surrounding changes in China's industrial policies (for its IT conglomerates), and risks to US-China relations, have all likely contributed to some rotation in equity market performance away from Asia and toward DM (see Figure 18).

Figure 18: Rotations in cross-country equity performance from 2020 into 2021



Source: Refinitiv Datastream, 18 Apr 2021



Source: Refinitiv Datastream, 18 Apr 2021

Asia's laggards have seen some catch-up rally

That said, across Asia, Taiwan is benefiting from strong industrial fundamentals and intra-Asian trade, with less uncertainties on regulations and tighter liquidity (vis-à-vis the Mainland). At the same time, other equity markets that were lagging across Asia have experienced stronger investor demand. For example, India's solid performance has been helped by its strong growth recovery, although it is struggling again to contain new COVID cases. Singapore and Hong Kong have benefited from steeper yield curves (for financials) and stronger hopes for rebounds in services once international tourism re-starts.

Equities – we are positive, especially on the US and Asia

US and European equities, in particular, should be supported by on-going improvements in earnings growth expectations that are tracking stronger realised and forecast GDP growth. As growth remains well above trend, the rally should likely continue to broaden further to other sectors that have been lagging, such as financials, apparel retail, and consumer staples.

While the performance of Asian equities has slipped back this year, largely driven by weak China equities, we remain positive on the region. China's fundamentals are strong, especially the strength in its GDP growth, and rising R&D spending by firms. The key challenge for China's policymakers will be to ensure liquidity (dominated by total social financing) does not tighten by too much too fast, which could stress markets (see Figure 19).

Figure 19: China's equities (YoY%) and growth in Total Social Financing (TSF)

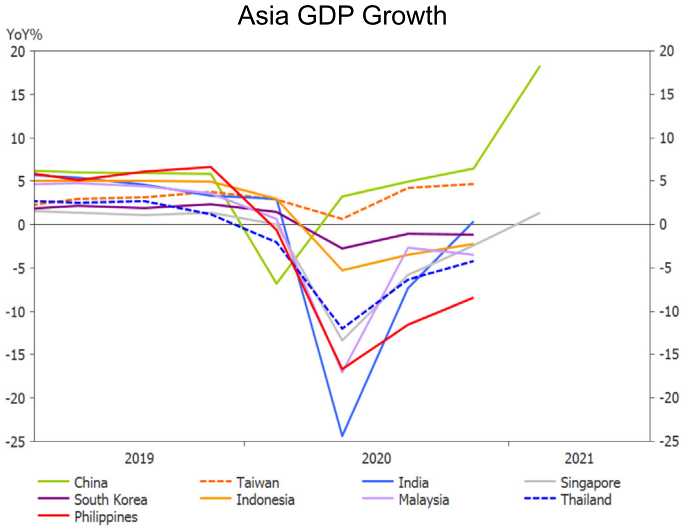
Source: Refinitiv Datastream, 18 Apr 2021

The rest of Asia will likely benefit from a stronger China, as intra-Asian trade growth has rebounded significantly (see Figure 20). Most Asian countries should likely see significant rebounds in YoY GDP growth by 1H 2021 (see Figure 21).

Figure 20: Intra-Asian trade

Source: Refinitiv Datastream, 18 Apr 2021

Figure 21: Asian GDP growth



Source: Refinitiv Datastream, 18 Apr 2021

We continue to favour sectors like consumer products, IT, communications, healthcare, and renewables, as they seem the best positioned to navigate the key trends unfolding even before COVID-19 hit, such as lifestyle changes, rising consumerism, new technologies, and the 'green engine'.

Investors still need to be cautious

As we have dialled back our outlook to positive it remains important for equity investors to continue a disciplined 'bottom-up' stock selection driven by fundamentals, and seek out companies with compelling or perhaps disruptive business models that are best able to deliver consistent upside earnings surprises.

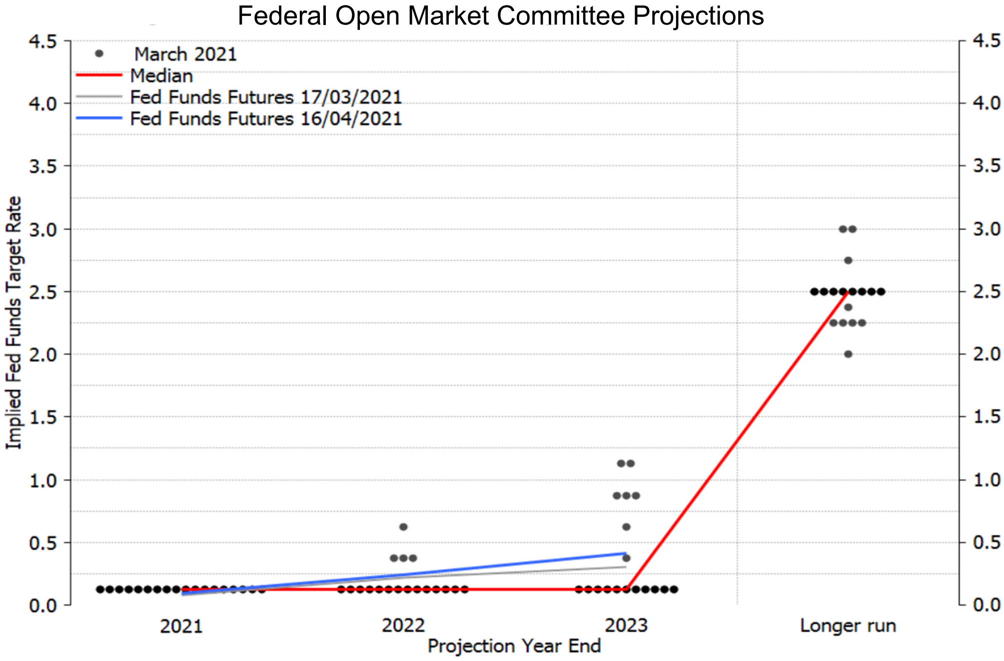
Bonds – we are negative on DM, but Asia offers opportunities

Ultra-low and negative (real) government bond yields across many developed markets reduce the attractiveness of fixed income investments. We remain negative on US bonds but note that a significant sell-off has already unfolded from 'rock-bottom' yields. With the US yield curve around its historic average, there may not be a lot more upside in nominal yields to unfold at least until the Fed starts to increase its policy rate (or if a significant inflation shock causes yields to overshoot). That said, we are unlikely to change our negative investment call on US bonds until real yields have normalised.

US market pricing of the first Fed rate hike moves forward

The US labour market is likely to have normalised by 2023 and the Fed voting majority suggests a first policy rate hike in 2024 as it gives sufficient time for inflation to sustain higher rates that the Fed can be comfortable with. US forward-market pricing has been creeping forward, and is now suggesting that the first Fed rate hike could come in 2023 (see Figure 22). For this to occur it would likely need much stronger inflation than is currently expected for next year and in 2023.

Figure 22: US forward market now prices-in first Fed rate hike in 2023



Source: Refinitiv Datastream, 18 Apr 2021

There is unlikely to be any further significant easing in monetary conditions across Asia, and coupled with strong Asian fundamentals (i.e. forecasts of a sustained growth differential over DM and attractive real yields), pressure is likely to remain significant for currency strength (vis-à-vis USD weakness).

Corporate credit – we are positive, especially on high yield, and again Asia leads the way

We remain positive on Asian high-yield corporate credit as there is more scope for spread compression to come through. At the same time, above trend GDP growth is strengthening corporate balance sheets and minimising default risk.

Investors still need to continue to focus on balance sheet fundamentals to 'cherry-pick' the strongest companies. Asian investment grade credits, where spreads are already around historical averages, are likely to offer less scope for further spread compression. Nevertheless, there are still attractive carry opportunities, especially in a weak USD environment.

We also remain positive on China's corporate credit. Real estate continues to benefit from the strong domestic recovery and above trend growth. The slowdown in liquidity growth is a headwind to some degree but what is important is that the policymakers avoid any excessive tightening. We continue to believe that China's onshore default risk will not become a systemic concern, given that China's policymakers have more than enough resources to ensure financial market stability.

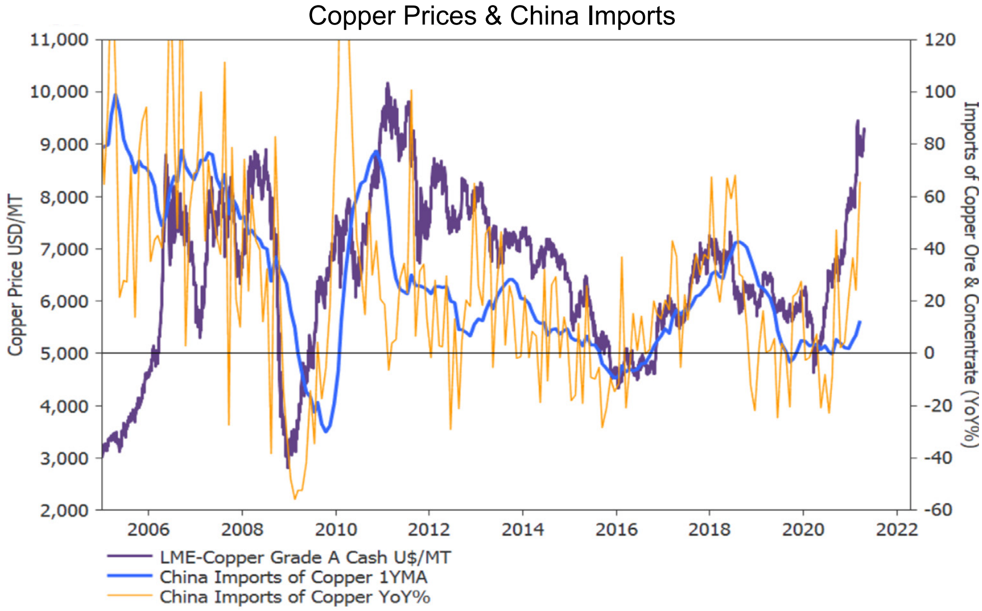
The credibility of China's government in ensuring financial stability is critical in managing shocks to investors, like the latest moves by rating agencies to place Huarong on negative watch. Huarong is one of the 4 key asset management companies in China and plays a significant role in onshore debt management. To avoid any restructuring of its USD debt, Huarong likely needs capital support and an operational restructure. However, the risk of this snowballing and becoming a significant financial crisis for China is backstopped by its policymakers.

Commodity prices track higher on strong demand, especially from China

Returns from the GSCI industrial metals index have rebounded significantly with strong growth across global manufacturing and commodity demand. Copper prices, in particular, have surged in-line with stronger import demand from China (see Figure 23).

Oil prices have risen further to around pre COVID-19 levels of $60-70 USD/bbl range. A key driver of the stronger outlook remains improved expectations of the demand rebound to come, when global tourism and jet fuel demand fully recovers.

Figure 23: Copper prices and China's imports



Source: Refinitiv Datastream, 19 Apr 2021

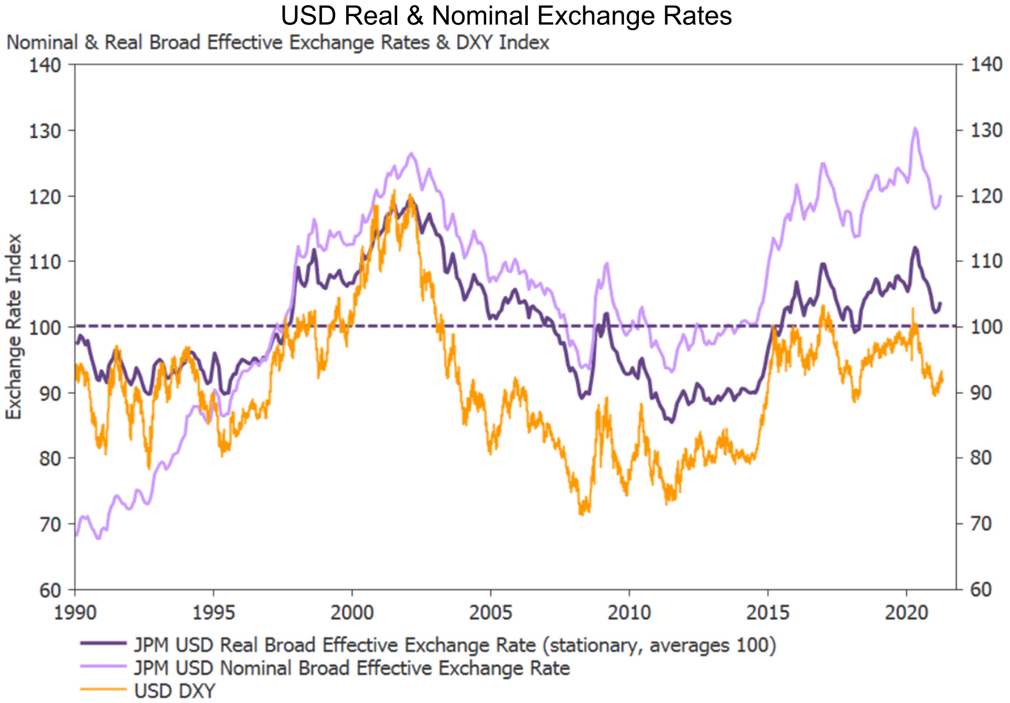
Further USD weakness is possible, while gold prices face headwinds from higher real yields

We have noted for a while that the significant deterioration in the US current account deficit, coupled with the Fed printing money, and less investor risk-aversion over time (motivating more capital outflows, especially into Asia), is collectively driving the USD lower.

The USD may not reach a turning-point until the current account deficit turns around (which may not happen until the fiscal deficit improves) or if US yields jump further on inflation concerns. From a real valuation perspective, broad measures of the US TWI index are not cheap (see Figure 24) so there are unlikely to be any strong forces, at this juncture, to drive a sustainably higher US dollar.

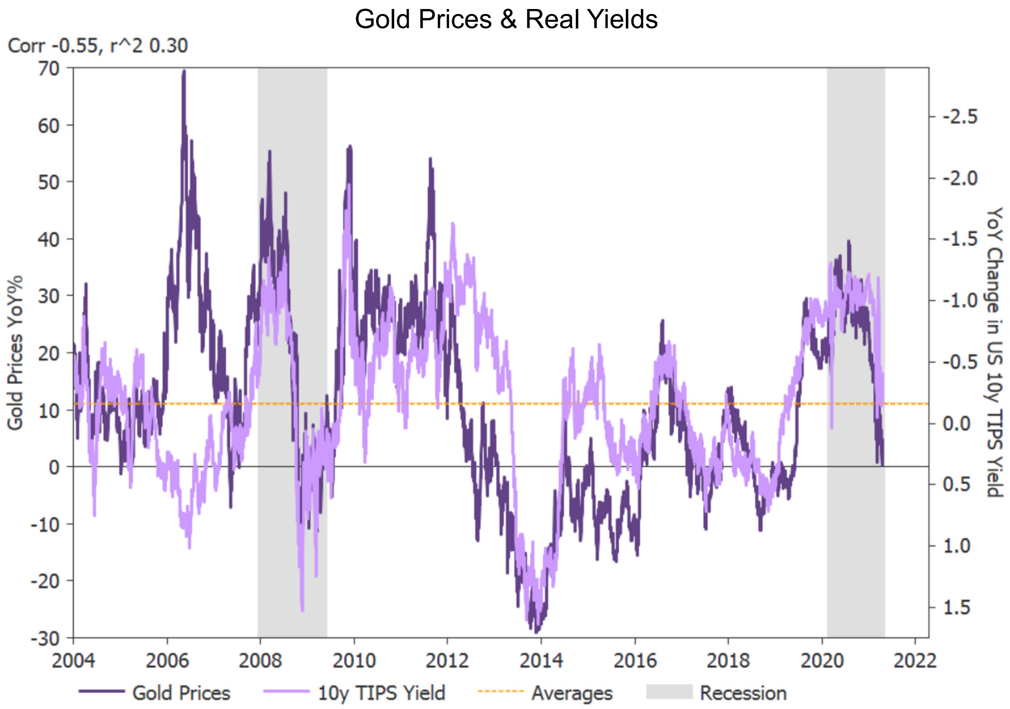
Returns from gold have slipped as real yields have increased (see Figure 25) and as concerns about the sustainability of stronger GDP growth have faded. Gold is still useful in an investment portfolio, especially to give protection against recessionary shocks and adverse geopolitical events.

Figure 24: Deviations in the USD real TWI index as a valuation indicator (neutral = 100)



Source: Refinitiv Datastream, 19 Apr 2021

Figure 25: Gold prices and US real yields



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