What lies ahead for the second half of 2021?

Fullerton Investment Views - Quarterly report

Q3 2021

Executive summary

- **The GDP growth recovery is at record strength, and may be around its peak**. Markets have 'priced-in' a lot of good news. Inflation has also surged significantly above trend.
- **We believe 2H21 is likely to see robust risk asset returns that are above average, but are slowing down as growth continues to ease and as liquidity tightens**. At the same time, over this transition period where inflation has jumped rapidly and monetary conditions will eventually tighten, there could be bouts of significant volatility.
- **We remain positive on global equities** and continue to favour sectors like consumer products, IT, communications, healthcare, and renewables.
- **We are negative on US bonds**, but note that a significant sell-off has already unfolded. There may not be a lot more upside in nominal yields to unfold until the Fed starts to increase its policy rate.
- **We are now cautious on Asian corporate credit** as there is likely to be less spread compression ahead, tighter liquidity, and more credit risks.
- **We have revised our USD outlook to modestly positive**, as the US current account deficit is expected to improve significantly, and as the US terms of trade is rebounding.

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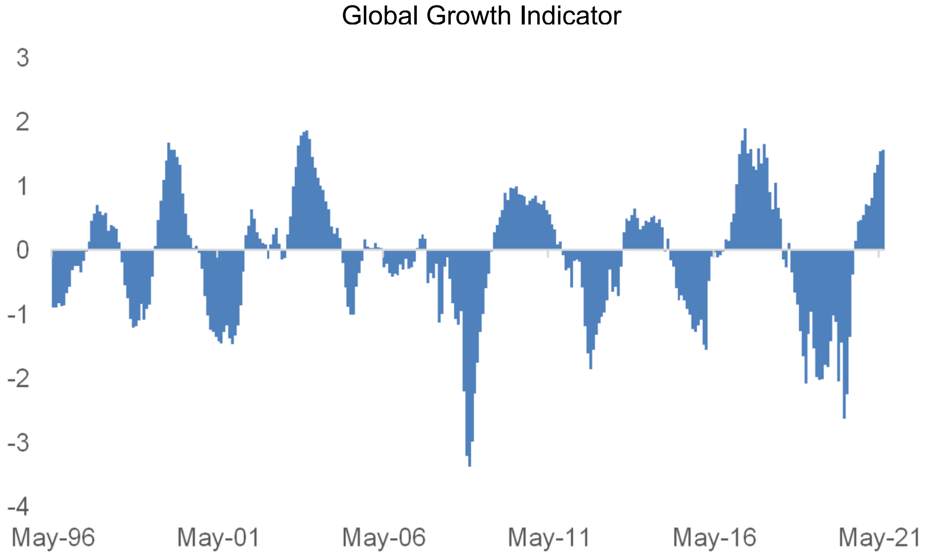
1. The macro backdrop remains very strong

The GDP growth recovery is at record strength, and may be around its peak

Across most countries GDP growth has rebounded very strongly above trend (see Figure 1), and key leading indicators of economic activity may now be around their cyclical peaks.

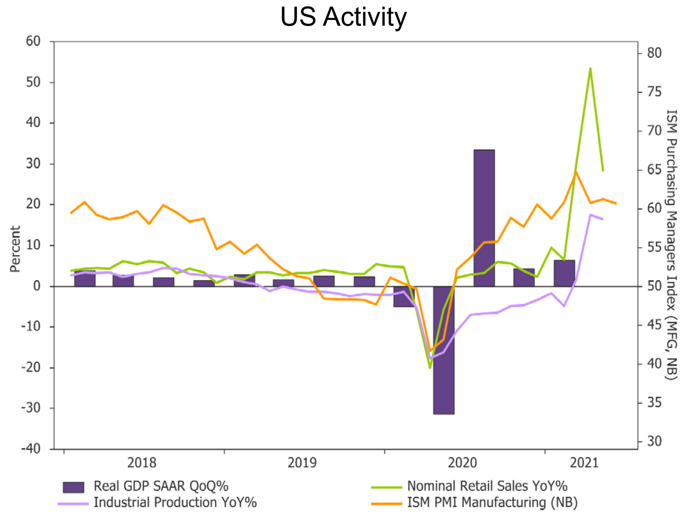
Consumer spending and industrial production indicators have been very robust in China and the US, and may now be set to ease over 2H 2021 (see Figures 2 and 3). Activity indicators across Europe and Japan may be lagging, but have also proved very strong, and could potentially slow later this year (see Figures 4 and 5).

Figure 1: Fullerton's global growth indicator



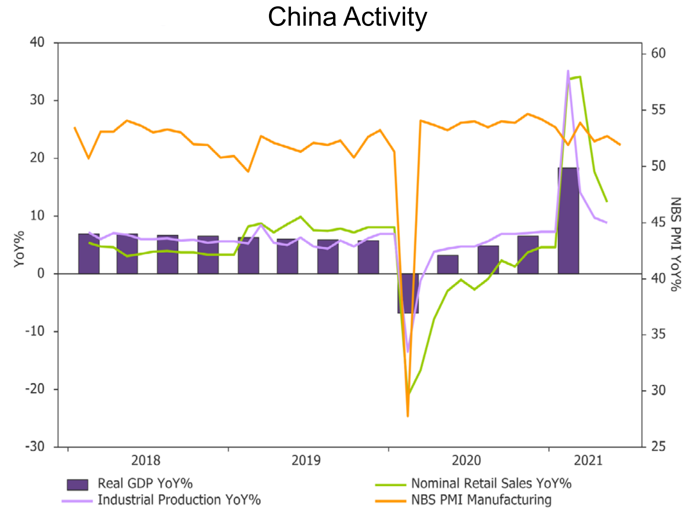
Source: Fullerton, July 2021. The information presented in the chart above are calculated based on Fullerton's internal methodology and subject to changes

Figure 2: US economic activity indicators



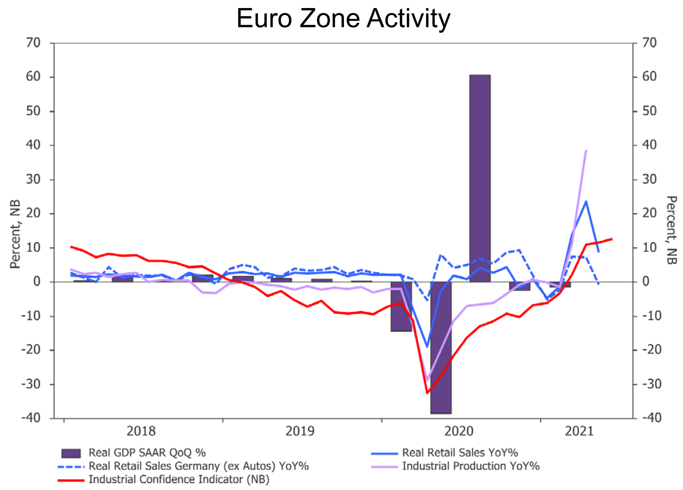
Source: Refinitiv Datastream, 12 Jul 2021

Figure 3: China economic activity indicators



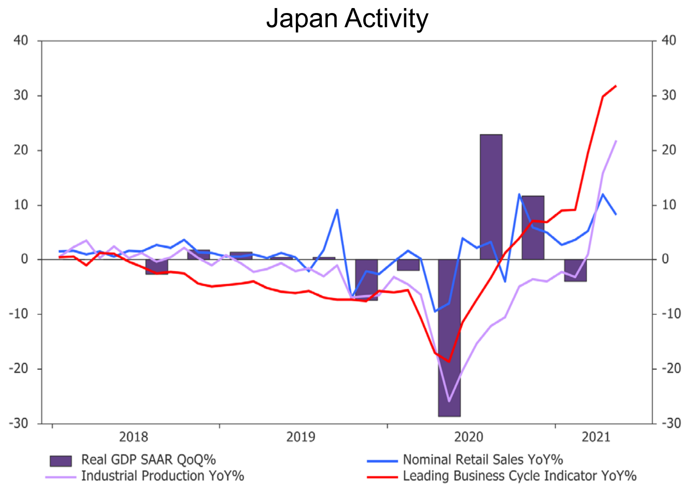
Source: Refinitiv Datastream, 12 Jul 2021

Figure 4: Europe economic activity indicators



Source: Refinitiv Datastream, 12 Jul 2021

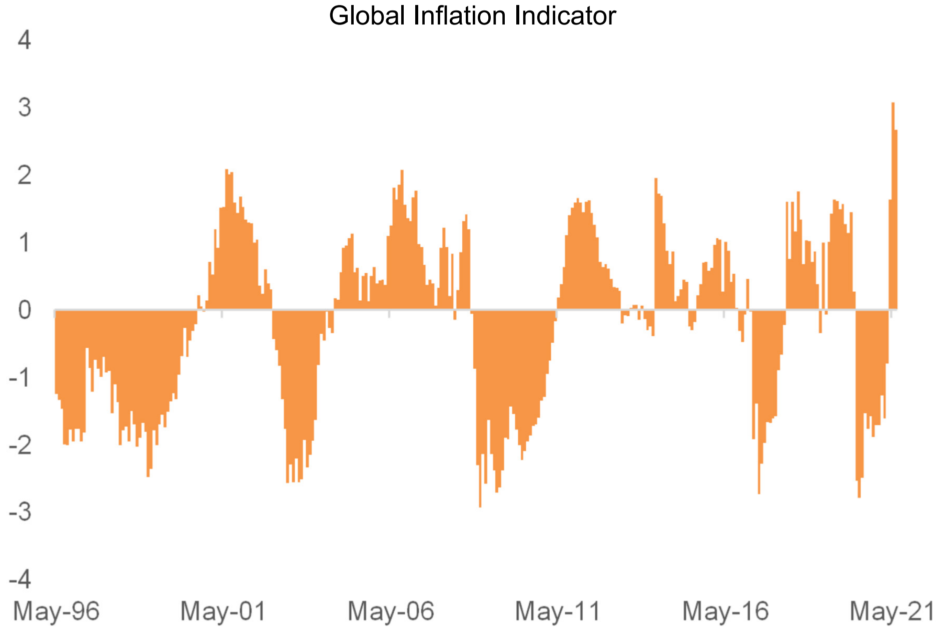
Figure 5: Japan economic activity indicators



Source: Refinitiv Datastream, 12 Jul 2021

At the same time, inflation has also surged significantly above trend, reflecting strong consumer spending, supply-chain bottlenecks, and commodity demand pressures (see Figure 6).

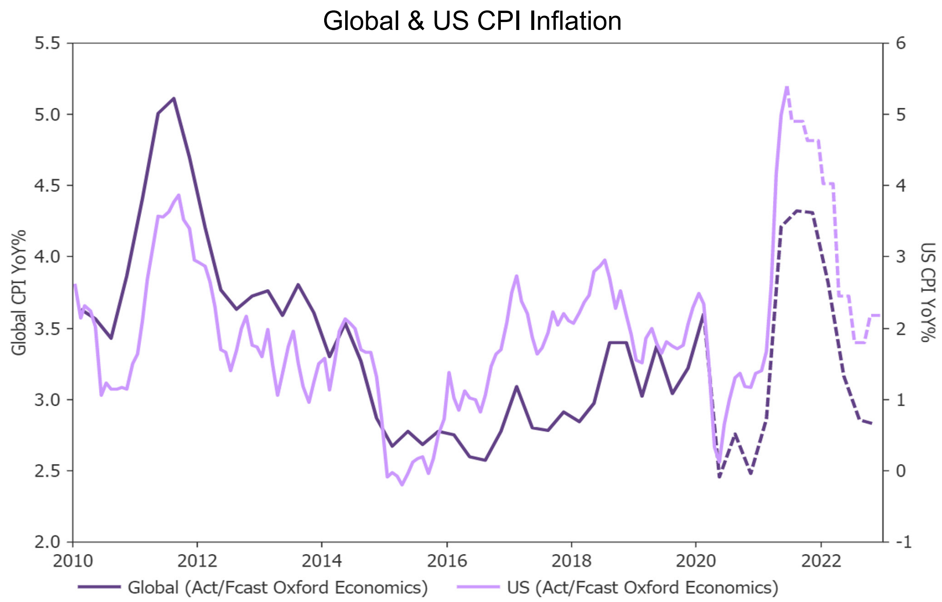
Figure 6: Fullerton's global inflation indicator



Source: Fullerton, July 2021. The information presented in the chart above are calculated based on Fullerton's internal methodology and subject to changes

Like other elements of this business cycle, inflation has rebounded very quickly and may likely only ease back to more normal rates next year (as macro forecasters expect), as global central banks continue to tighten liquidity and as markets price-in higher interest rates (see Figure 7).

Figure 7: US and global inflation (actual and forecasts)



Source: Refinitiv Datastream, 14 Jul 2021

The surge in inflation presents a couple of risks for investors. Firstly, there is the worry that high inflation will cause a slump in GDP growth especially if the spike in raw material costs causes firms to cut their output and households to postpone their spending.

- However, sharp rises in commodity prices and raw materials may not drive declines in output because there can be other off-sets for costs across industries, especially from new technologies and innovations.
- During COVID-19 lockdowns, many firms undertook significant cost rationalisations to help protect their earnings. Margins were then given a further boost with strong demand rebounds as the recession ended. Therefore, many firms should be well-positioned to navigate higher costs.

A second, and more significant, risk is that the large overshoots in inflation will eventually push interest rates higher which could cause equities to correct sharply. The big test for many developed market (DM) economies, which is likely to play-out over the next few years, is: can economic activity still grow solidly with the eventual return to positive real 10-year yields?

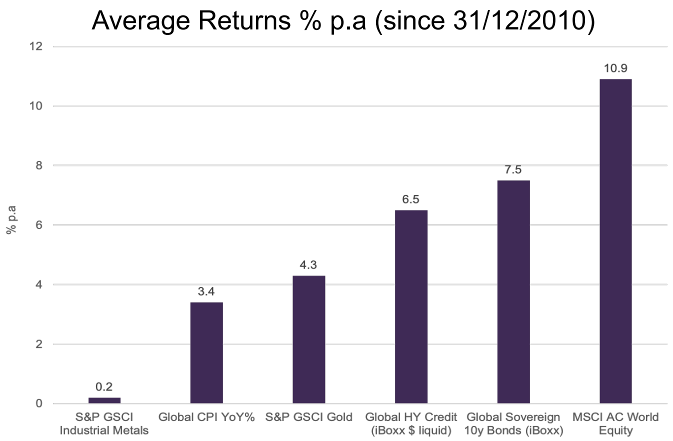
- Economies should be able to navigate higher interest rates and inflation, provided policymakers communicate their intensions clearly to markets, and ensure that they are not forced to tighten interest rates by too much, too fast.
- Economic activity should not be stressed too much, provided productivity and investment growth remains strong. US nominal yields eventually normalising back toward 2.5-3% should not add any significant stress to US corporate borrowing costs as the lending margin over treasuries has been above average.
- Key sign posts for investors to watch will be how markets 'price-in' higher interest rates. Because of credible commitments by global policymakers (to give more supports if growth slumps), we believe that investors should remain confident that risk asset returns can continue to be favourable even as economies adjust and transition back toward a higher real interest rate environment.

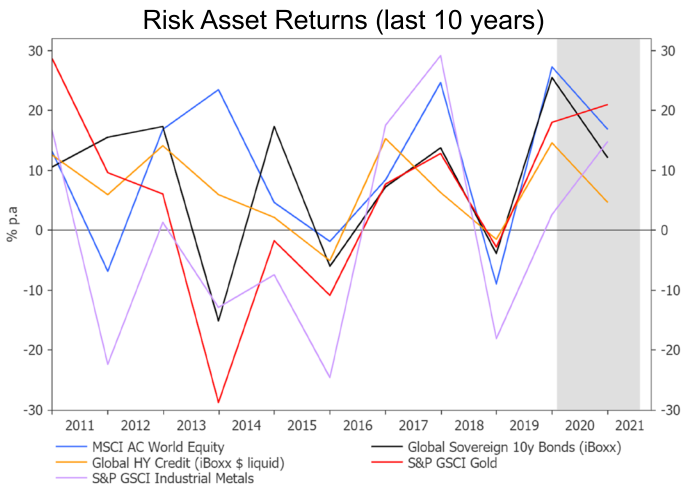
Goldilocks environment can continue, but high inflation may result in greater volatility

We believe that this goldilocks environment can persist for a while longer for investors, but over this transition period, where inflation has jumped rapidly and monetary conditions will eventually tighten, there could be bouts of significant volatility.

If inflation takes longer to return to normal then it could threaten investors' desired real returns from their portfolio. That said, investors should not worry too much because most risk assets (i.e equities, corporate credit, nominal government bonds[1], real estate, and gold), can give significant inflation protection (see Figure 8).

Figure 8: Risk asset returns and global inflation since 2011





Source: Refinitiv Datastream, for the period 31/12/2010 – 14/7/2021

Geopolitical and COVID-19 risks are still significant

Geopolitical risks, especially further deterioration in US-China relations, remain significant. For example, President Biden remains hawkish on issues of contention with China, and the US added 23 Chinese entities to its economic blacklist in July. Such entities are generally required to apply for trade licenses from the US and face tough scrutiny when they seek permission to import items from US suppliers. China responded to the latest US actions by condemning them as a breach of international economic and trade rules.

In China, the IT industry still faces uncertainties surrounding changes in market practice regulations designed to improve market competition. While these changes could ultimately prove beneficial to the industry over the longer term, by forcing key players to become more resilient and to seek greater global market share, in the short term changes may continue to drag on investor confidence.

The G20 has raised concerns at the July meetings about the spread of new variants of the COVID-19 virus, and different paces of vaccination across countries, as key risks to the on-going global economic recovery. Such risks may drag growth back to trend sooner than expected rather than result in a painful 'double-dip' recession for the global economy because policymakers are committed to fighting COVID-19 without returning to draconian lockdowns.

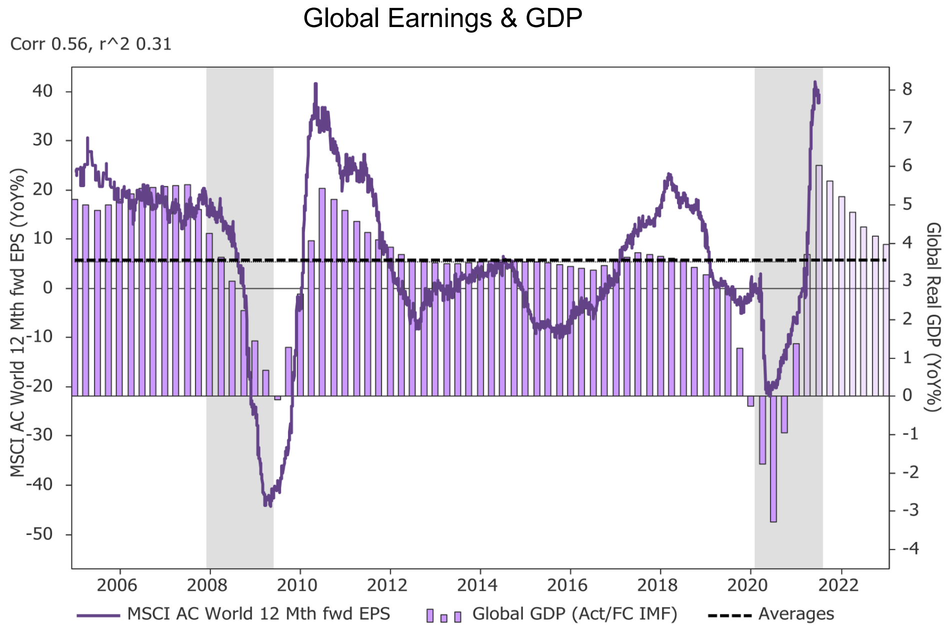
What is also encouraging is that economic activity is more resilient today, having emerged from the COVID-19 driven recession, without the pain of a sharp deleveraging that happened in the years after the Global Financial Crisis (GFC 2008-09). Across most countries, consumption growth is robust and households are saving more, which implies their balance sheets are much stronger than before. In addition, investment growth continues to rebound, which is in contrast to the GFC experience, and should serve to give an added boost to corporate earnings ahead.

[1] Nominal bonds warrant special mention in that often, when inflation rises, yields also rise and so bond holders endure periods of capital losses. However, history has shown that over long periods bond markets can be effective at generating a sufficiently high yield beyond inflation. There has also been the historical boost to returns from the trend decline in bond yields which, with lower starting-points today, is perhaps less likely to continue.

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

There have been significant upward revisions to growth expectations and markets have 'priced-in' a lot of good news. As a result macro data surprises have become less frequent, while global GDP growth and earnings expectations could be within the neighbourhood of peaking for this cycle (see Figure 9).

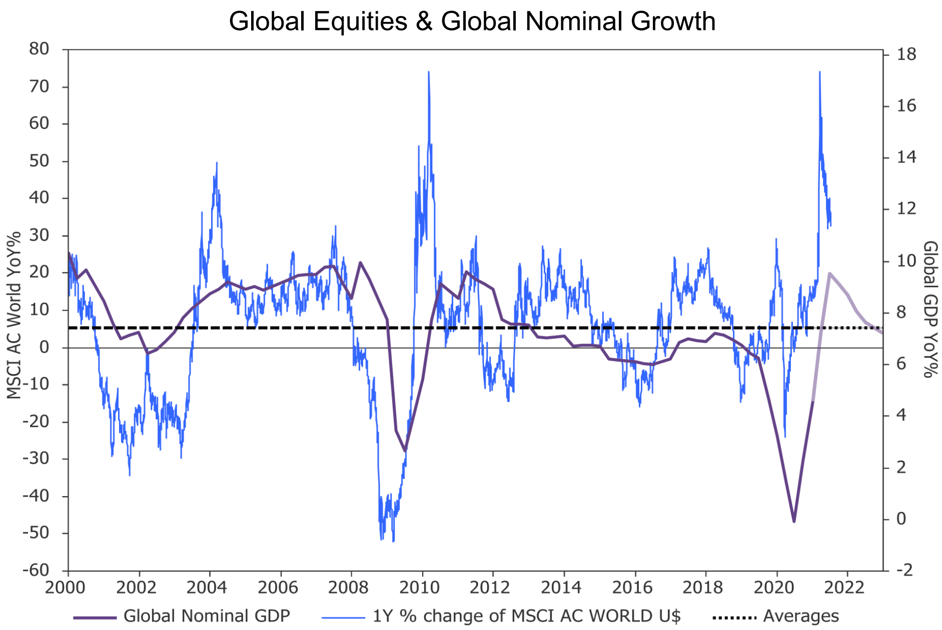
Figure 9: 12 month forward expected global earnings and GDP growth



Source: Refinitiv Datastream, 12 Jul 2021

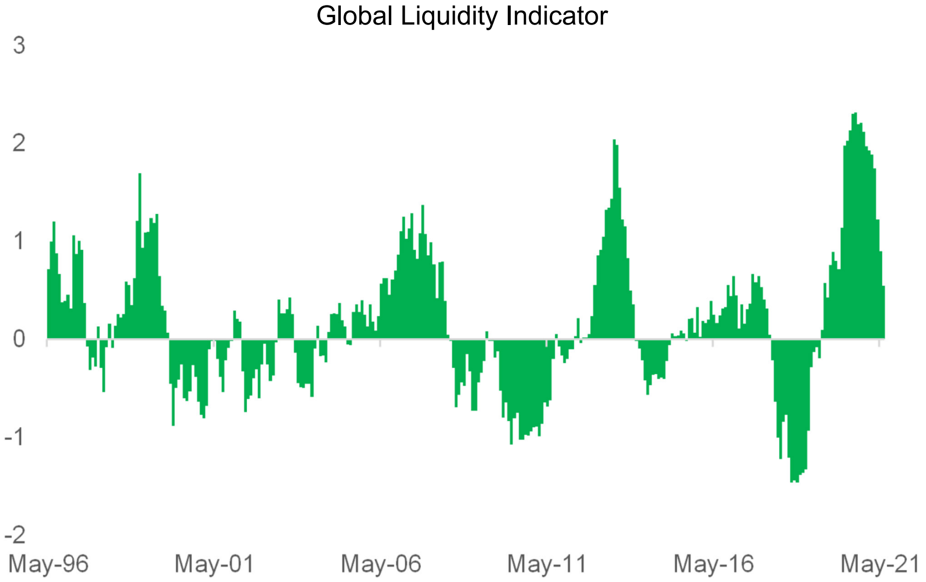
We continue to hold the view that the trend into the second half of the year is likely to be robust risk asset returns that are above average but slowing, as growth continues to ease, and as liquidity tightens (see Figures 10 and 11).

Figure 10: Global equity returns and global GDP growth



Source: Refinitiv Datastream, 12 Jul 2021

Figure 11: Fullerton's global liquidity indicator

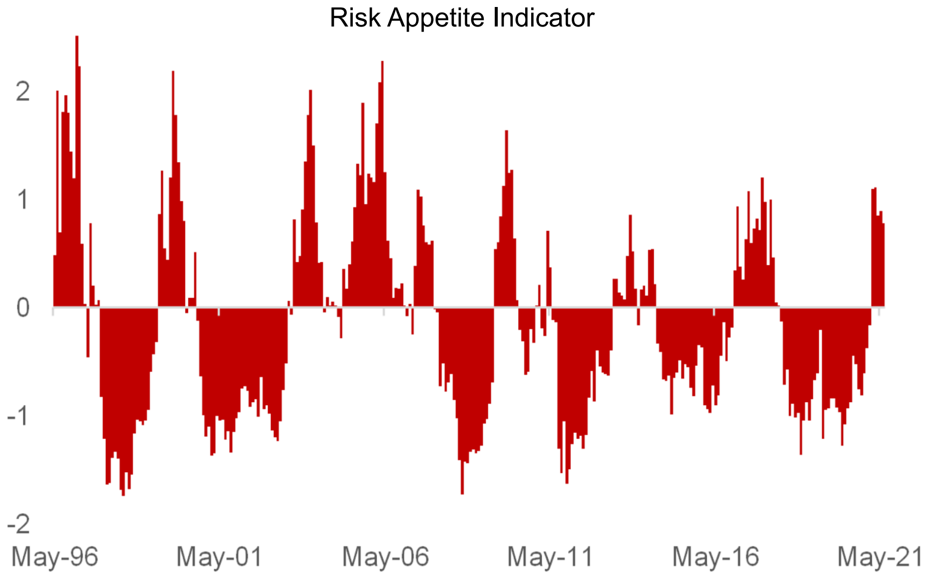


Source: Fullerton, July 2021. The information presented in the chart above are calculated based on Fullerton's internal methodology and subject to changes

Equities – we remain positive as above average returns are likely to continue

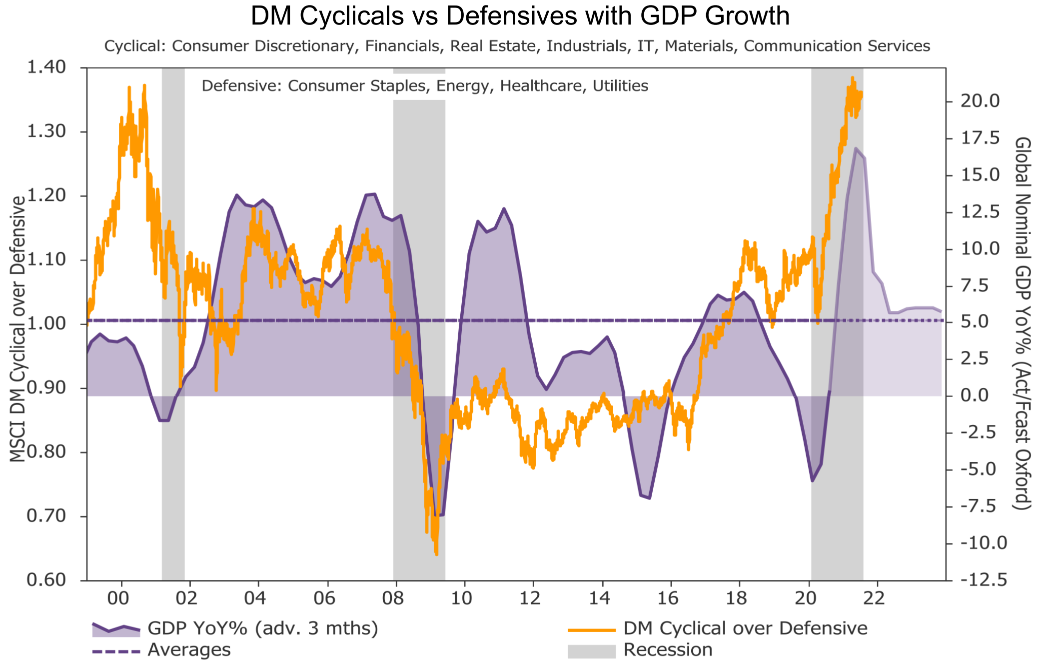
Fullerton's risk appetite indicator remains positive as rotations into equities continue (see Figure 12). The broadening of the rally has triggered a significant rotation toward value stocks, as lagging sectors have gained from demand recoveries and stronger earnings growth expectations. Over time, more defensive type sectors may experience better performance as GDP growth expectations peak (see Figure 13).

Figure 12: Fullerton's risk appetite indicator



Source: Fullerton, July 2021. The information presented in the chart above are calculated based on Fullerton's internal methodology and subject to changes

Figure 13: DM equities - cyclical versus defensives with GDP growth

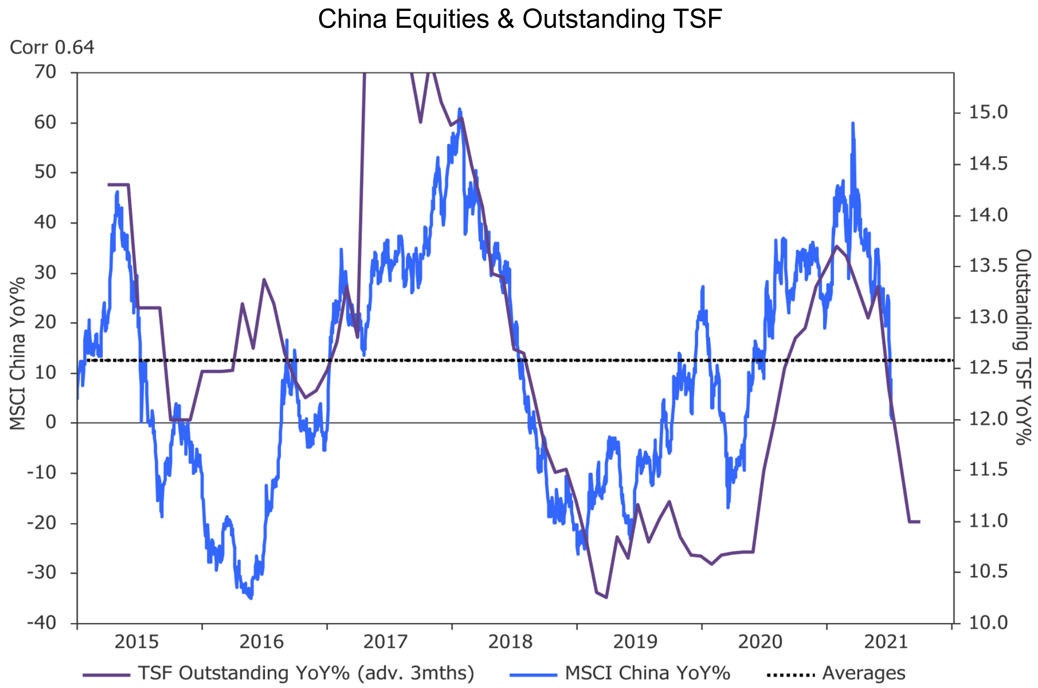


Source: Refinitiv Datastream, 12 Jul 2021

We remain positive on global equities, especially the US, Asia, and Europe, followed by Japan. While the performance of Asian equities has slipped this year, largely driven by weak Chinese equities, we remain positive on the region.

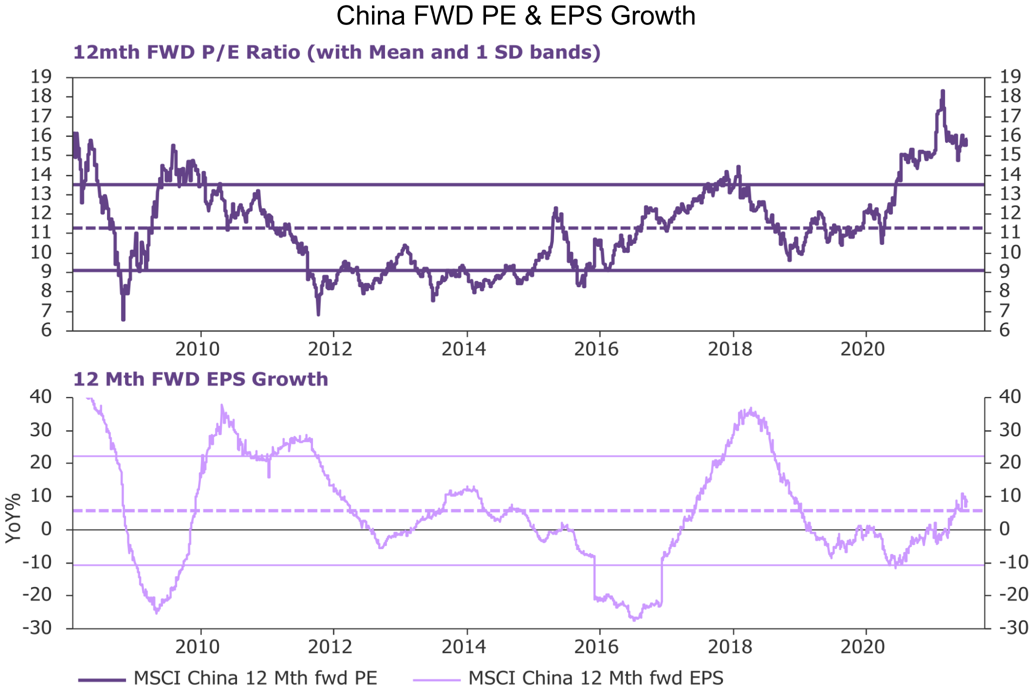
China's liquidity conditions have tightened considerably and we expect that much of this headwind will fade going forward (see Figure 14). At the same time, China's policymakers are also trying to balance tighter liquidity conditions with cuts to reserve ratios for bank lending. On the latter, the People's Bank of China announced a universal reserve-ratio (RRR) cut of 50bps in July, bringing it down to lows not seen since 2007 and releasing liquidity equivalent to about 1% points of GDP. In addition, China's earnings growth expectations continue to improve and its valuations have eased (see Figure 15). The rest of Asia is also benefiting from stronger global industrial production and trade growth.

Figure 14: China's Total Social Financing liquidity (TSF) and equity returns



Source: Refinitiv Datastream, 12 Jul 2021

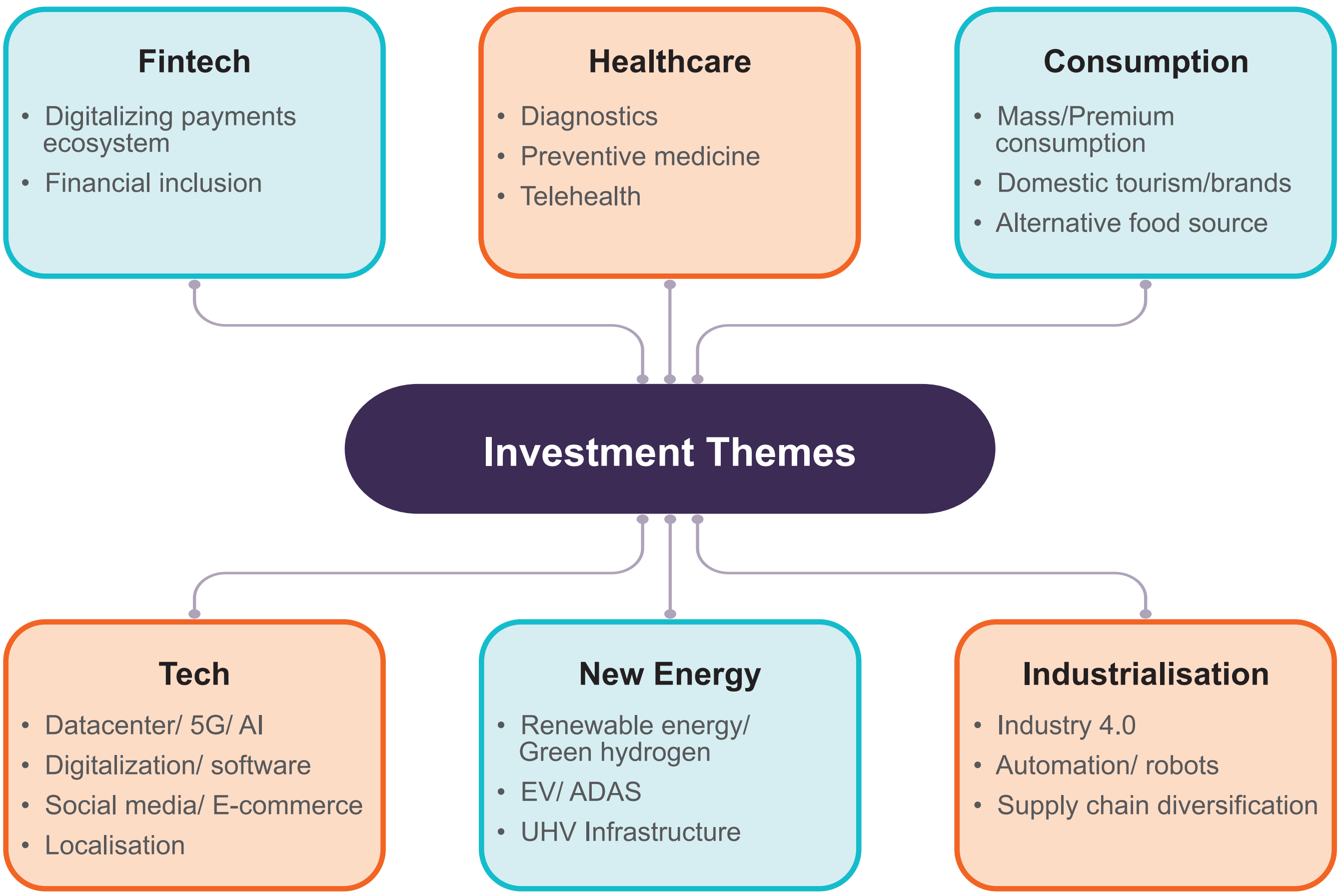
Figure 15: China's 12-month forward earnings growth expectations and P/E ratio



Source: Refinitiv Datastream, 12 Jul 2021

We continue to favour sectors like consumer products, IT, communications, healthcare, and renewables, as they seem well-positioned to navigate the key trends unfolding even before COVID-19 hit, such as lifestyle changes, rising consumerism, new technologies, and the 'green engine' (see Figure 16).

Figure 16: Key investment themes



Source: Fullerton, July 2021

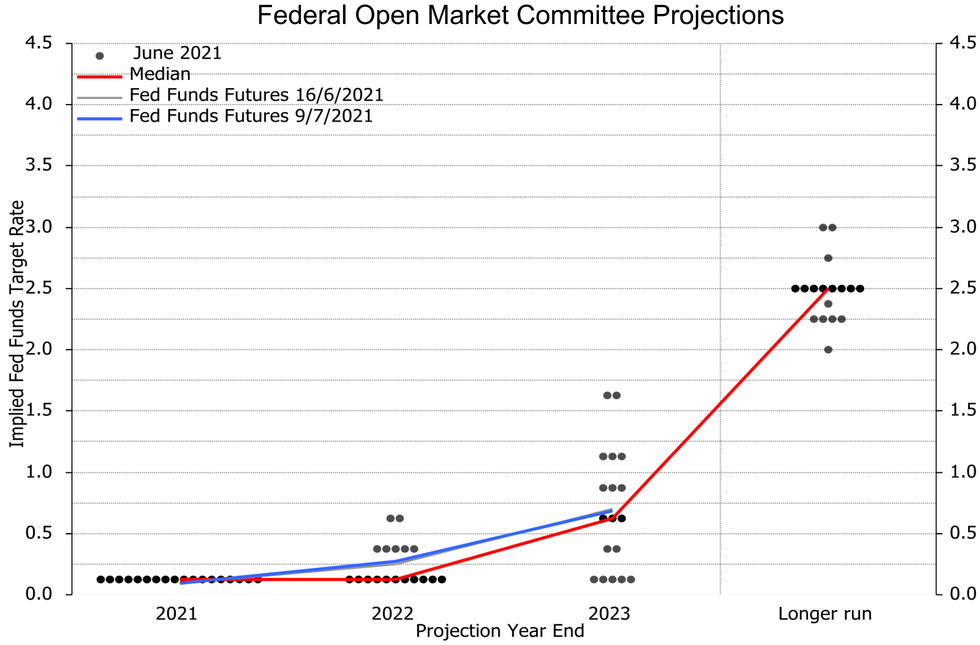
Bonds – we remain negative on duration

We remain negative on US bonds but note that a significant sell-off has already unfolded from ‘rock-bottom’ yields. With the slope of the US yield curve around its historic average, there may not be a lot more upside in nominal yields until the Fed starts to increase its policy rate.

So far, the bond market believes that high inflation will ease over time and there has been no overshoot in its sell-off. In addition, strong bond demand driven by the Fed has also constrained increases in yields. The bond market may put the yield normalisation process on hold until it is more confident that economic growth can withstand higher interest rates.

At the same time, with the jump in inflation, US forward-market pricing of higher short-term rates has been shifted earlier. Markets now suggest that the Fed is likely to taper its balance sheet next year and hike interest rates at least a couple of times in 2023 (see Figure 17).

Figure 17: US Fed projections and forward-market pricing



Source: Refinitiv Datastream, 12 Jul 2021

Corporate credit – we are now cautious, with a negative bias

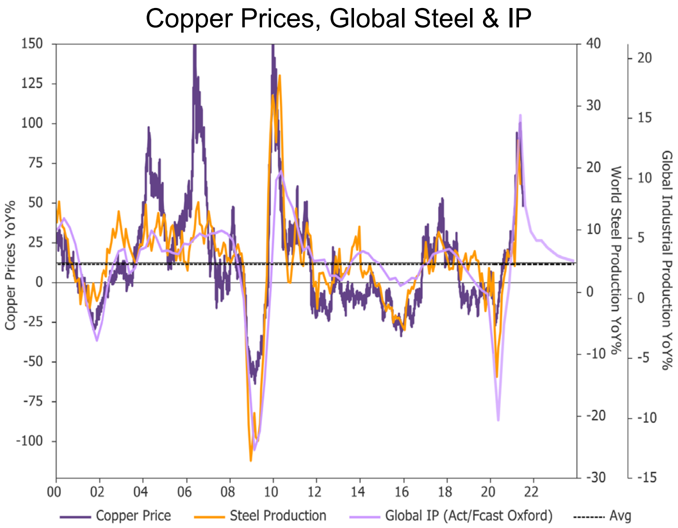
We are now cautious on Asian corporate credit and have shifted our outlook from positive to neutral with a negative bias. Asian investment grade (IG) credit spreads have already narrowed back to around longer-term averages, and are likely to offer less prospect for significant spread gains going forward.

In contrast, Asian high-yield (HY) spreads may have further gains to come. However, at the same time, idiosyncratic credit risks in China have increased (dominated by concerns surrounding the financial health of Huarong and Evergrande) and liquidity is tightening. The consensus view remains that China’s policymakers will backstop any significant risks to financial stability and a “muddling through” is the most likely scenario. It remains very important for investors to continue to focus on balance sheet fundamentals to ‘cherry-pick’ the strongest companies.

Commodity prices may be around the neighbourhood of peaking

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. Commodity prices may now be around their peaks, and may slow alongside global growth expectations (see Figure 18).

Figure 18: Copper prices, steel output growth, and industrial production forecasts



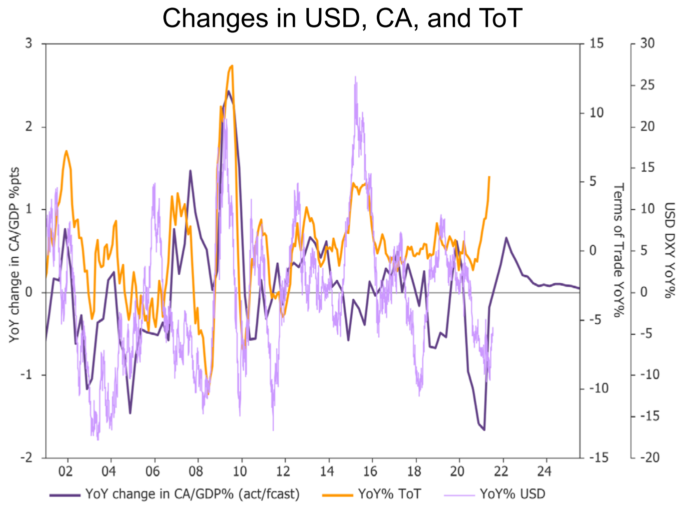
Source: Refinitiv Datastream, 12 Jul 2021

Oil prices are likely to remain well-supported in $75-85 USD/bbl range, as consumption demand is still recovering and the supply-side is well controlled. Returns from gold have slipped as real yields have increased, and as concerns about the sustainability of stronger GDP growth have faded.

We now have a modestly positive outlook on the USD

We have revised our outlook on the USD to positive, as the US current account deficit is expected to improve significantly, and as the US terms of trade has rebounded sharply (see Figure 19). Unless there is a significant adverse shock to investor confidence, we do not expect a strong USD appreciation. On-going risk-seeking capital outflows from the US into Asia may continue with a modestly stronger USD, and Asian corporates should still be able to perform well with above trend growth and stronger earnings.

Figure 19: Changes in the USD, the US current account deficit, and the terms of trade



Source: Refinitiv Datastream, 12 Jul 2021