Recession To Recovery: Emerging Trends and Their Implications

Fullerton Investment Views

August 2020

Executive summary

- As we outlined in our Q2 Investment View, our baseline scenario of a painful but short global recession seems to be unfolding – given stronger macro data, the rebound in markets, and global earnings showing signs of bottoming. Most countries – i.e. the US, Europe, and Asia ex-Japan – should see a return to positive GDP growth by Q3.
- The impact of the recession ending, and GDP increasing, has a very powerful effect – forward-looking markets are rallying on this and expect stronger earnings growth to come through. However, recoveries in economic activity, and unemployment, back to pre-COVID-19 levels will be much slower and likely take several years.
- Lagging weak labour markets should not prove a significant headwind to global markets (just as we saw after the GFC 2008-09). What it will mean is that global central banks will be forced to keep interest rates very low for a prolonged period.
- Key risks that we are concerned about over the next 1-3 years include:
  - a resurgence in COVID-19 lockdowns;
  - greater geopolitical risks;
  - the prospect of an equity market bubble unfolding;
  - and, at the other extreme – high unemployment could depress household spending for much longer than expected, and result in a weak earnings rebound that would disappoint markets (especially in the US).
- A very painful, but relatively short global recession, has created buying opportunities. We remain sanguine about longer-term fundamentals and have become more positive on risk assets (especially global and Asian equities, led by China). Active management is still critical because there are key signposts investors need to watch closely as risk outcomes could be quite bipolar.

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1. Macro backdrop has improved significantly

Our baseline scenario that we outlined in our Q2 Investment View, of a painful but short global recession seems to be unfolding. Stringent lockdown measures to combat the spread of the COVID-19 pandemic have eased and countries are slowly trying to re-open. China is leading the global recovery with its GDP rising again over Q2 at 3.2% yoy.

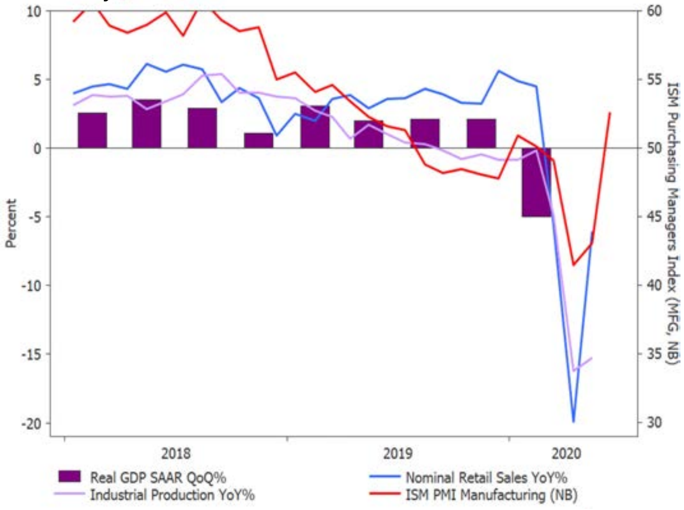
However, the rest of ASEAN is lagging China's recovery as global trade growth is still very weak. Given the sharp fall in Singapore's GDP over Q2 it may not rebound to positive GDP growth until Q4. But, overall, we expect the global recession will end in Q3, when positive GDP growth should return for the US, Europe, and the rest of Asia. If growth returns to positive rates by Q3 for most countries then it will imply a recession of 2 quarters – shorter than the GFC (2008-09) recession which was 4-5 quarters for most countries.

Our call for the global recession to end around Q3 is reinforced by the rebounds we have observed in high frequency data like retail sales, manufacturing surveys, and industrial production (Figures 1-3). At the same time, forward expectations of global earnings growth seem to have bottomed, and markets have rallied significantly since March, driven by the stronger macro data and by the massive policy stimulus (Figure 4).

"With growth rebounding and the recession set to come to an end, it is a good time to become more positive on risk assets. Nevertheless, active management is still critical to navigate this evolving investment climate."

Figure 1: US activity indicators

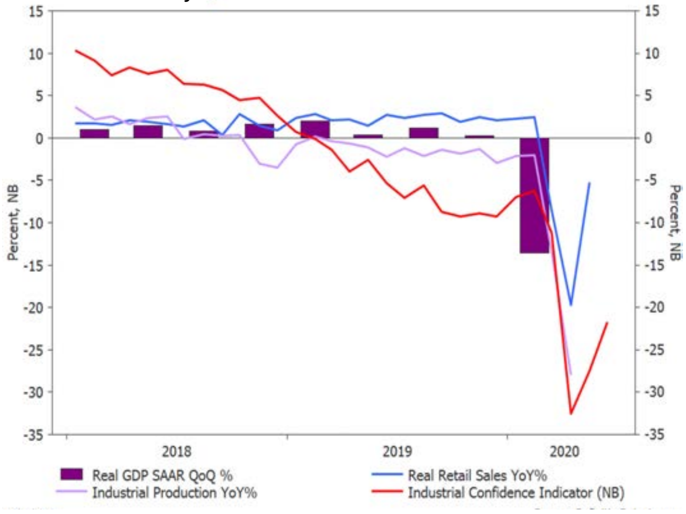
US Activity



Source: Refinitiv Datastream, 8 Jul 2020

Figure 2: Euro zone activity indicators

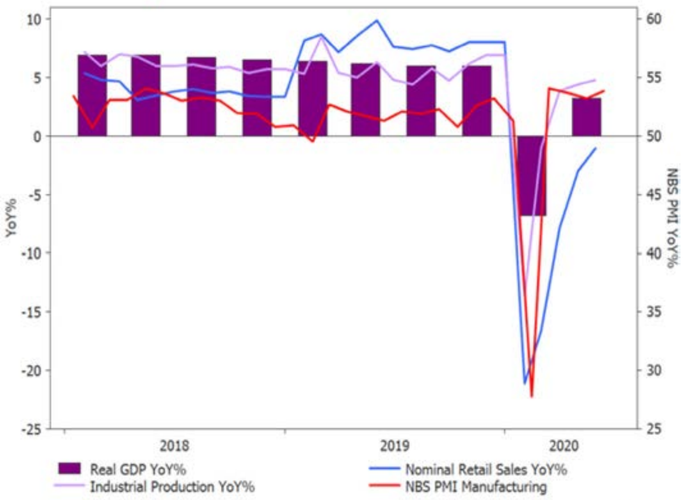
Euro Zone Activity



Source: Refinitiv Datastream, 8 Jul 2020

Figure 3: China activity indicators

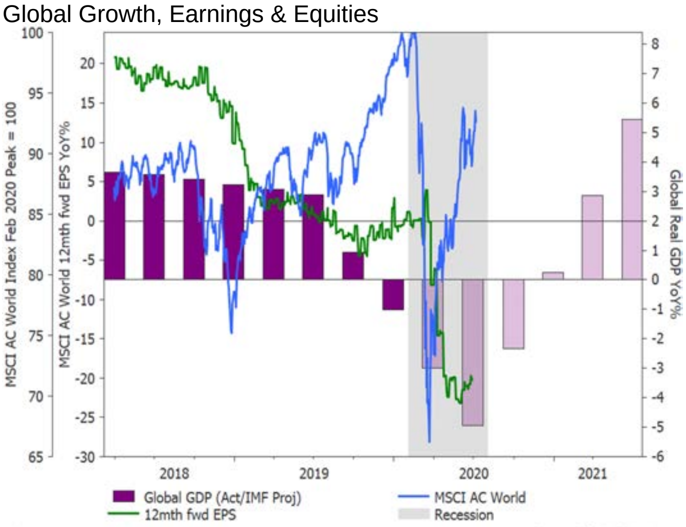
China Activity



Source: Refinitiv Datastream, 16 Jul 2020

Figure 4: Global equities, forward earnings, and GDP growth forecasts

Global Growth, Earnings & Equities

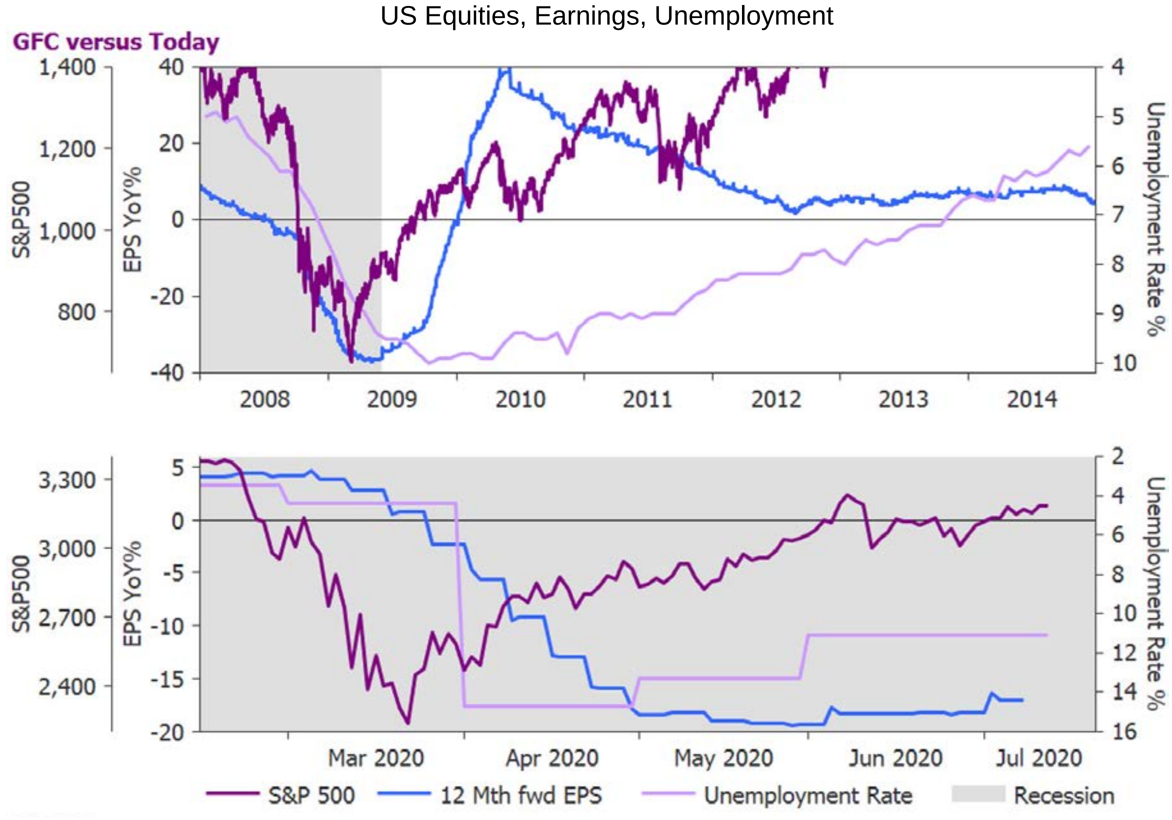


Source: Refinitiv Datastream, 8 Jul 2020

The impact of the recession ending, and GDP increasing, has a very powerful effect – forward-looking markets are rallying on this and expect stronger earnings growth to come through. However, recoveries in economic activity, and unemployment, back to pre-COVID-19 levels will be much slower and likely take several years.

These recovery dynamics are not surprising – at the last recession (the GFC 2008-09) equity markets rebounded the fastest, with the aid of policy stimulus, and with the boost from positive GDP growth rates (when the recession ended). Earnings growth took a bit longer to rebound, while the labour market was very slow to heal (Figure 5). But the lagging weak labour market didn't really prove to be a significant headwind to stronger earnings growth and equity prices – because the return to positive GDP growth translated into a lot more spending.

Figure 5: US equities, earnings, unemployment (post-GFC experience versus today)

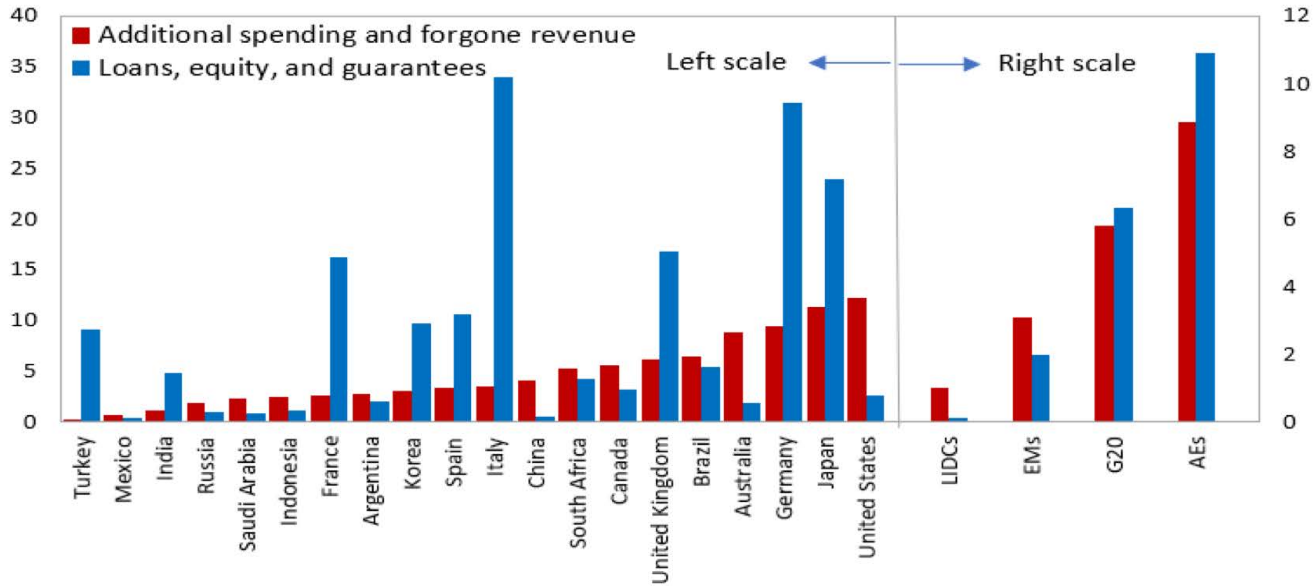


Source: Refinitiv Datastream, 13 Jul 2020

Fiscal and monetary stimulus is still feeding through

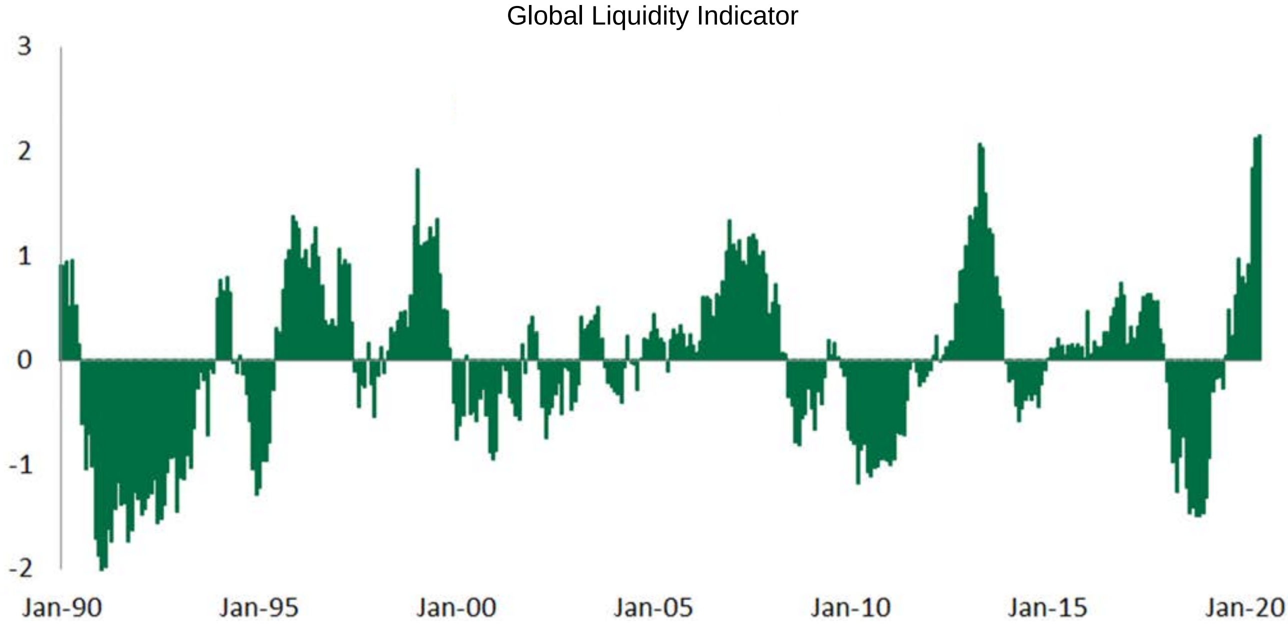
Fiscal policy stimulus alone, which has the most direct effect on growth, is running at 12% of GDP on average across the G20 countries – which is around six times larger than the average fiscal stimulus seen during the GFC (Figure 6). Our liquidity indicator, driven mostly by central bank injections, is also very strong (Figure 7).

Figure 6: Fiscal measures in response to the COVID-19 pandemic (% of GDP)



Source: National authorities; and IMF staff estimates.
Note: Data are as of June 12, 2020. Country groups are weighted by GDP in purchasing power parity-adjusted current US dollars. Revenue and spending measures exclude deferred taxes and advance payments. For details, see the Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic. AEs = advanced economies; EMs = emerging markets; G20 = group of twenty; LIDCs = low-income developing countries.

Figure 7: Fullerton's liquidity indicator



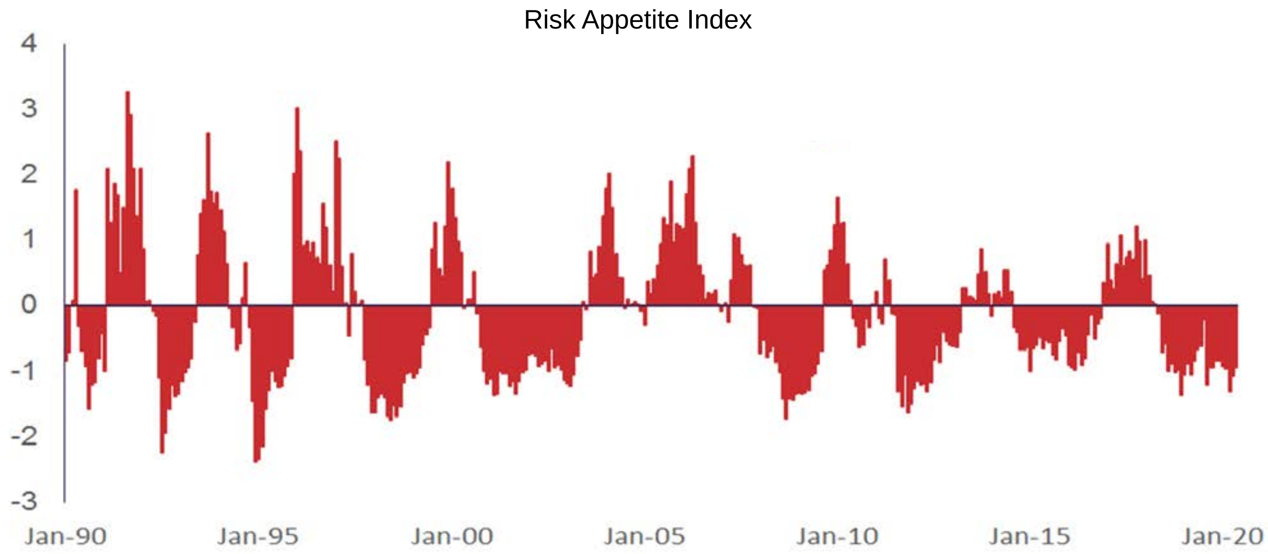
Source: Fullerton, June 2020
For illustrative purpose only. The information presented in the above graph is calculated based on Fullerton's internal methodology and is subject to changes. Past performance is not indicative of future returns.

We believe the market rally is sustainable; markets may be more sensitive to shocks, until sentiment rebounds

We believe the strength in global markets is sustainable, driven mainly by the strong rebounds in growth that are unfolding, ample liquidity, and significant policy stimulus. Because our risk sentiment indicator is still quite bearish it signals that many investors remain underinvested and have missed much of the rally so far (Figure 8). The lack of participation tends to make markets much more sensitive than otherwise to shocks e.g. as we saw in June when COVID-19 infections jumped significantly in the US and global equities fell back by around 5% from their June peak.

Until risk sentiment improves markets may remain more vulnerable than otherwise to shocks. However, with fundamentals continuing to get stronger there should be a sufficient cushion against significant market drawdowns.

Figure 8: Fullerton's risk appetite indicator



Source: Fullerton, June 2020
For illustrative purpose only. The information presented in the above graph is calculated based on Fullerton's internal methodology and is subject to changes. Past performance is not indicative of future returns.

2. Key short-to-medium term risks

Resurgence in COVID-19 infections and a return to lockdowns

A return to the lockdowns, especially in the US and Europe, would likely cause a collapse in confidence, a significant correction in markets, and likely push countries into a ‘double-dip’ recession. What would add to the pain is if the prospect of a COVID-19 vaccine seemed even further away. However, if the COVID-19 re-infection waves proved bad enough then policymakers would be pressured for even more stimulus, and more importantly, to provide COVID-19 management solutions that are less draconian on the economy.

Adverse geopolitical shocks bear close monitoring

US-China relations have deteriorated significantly, and the situation has been exacerbated with the US announcing that it will suspend Hong Kong’s preferential treatment and revoke favourable US-export licenses. Investor confidence could deteriorate further, and markets could fall significantly, if retaliatory actions by either side ratchet-up, especially with actions beyond trade – such as: financial-related sanctions, or tougher restrictions on multinational corporate activities.

There are also uncertainties relating to how US policies may change after the November Presidential election. Biden has proposed to raise corporate tax rates, but at the same time, there is the possibility that tariffs are removed under a Democrat administration (especially the tariffs against China). Regardless of the election outcome, because the US fiscal deficit is expected to surge to modern-day highs this year (c. 24% of GDP) there is a greater likelihood that taxes will have to ultimately rise. The prospect of greater US fiscal austerity over the years ahead could become a significant headwind for financial markets.

A weak earnings rebound

Given the prospect that unemployment rates will be above historic norms for many years, there is the risk, in the US especially, that household spending remains depressed for much longer than expected and derails the recovery in earnings. With expected earnings growth trying to bottom, markets would likely suffer a significant pull-back if stronger earnings growth does not materialise, or worse, has another leg-down.

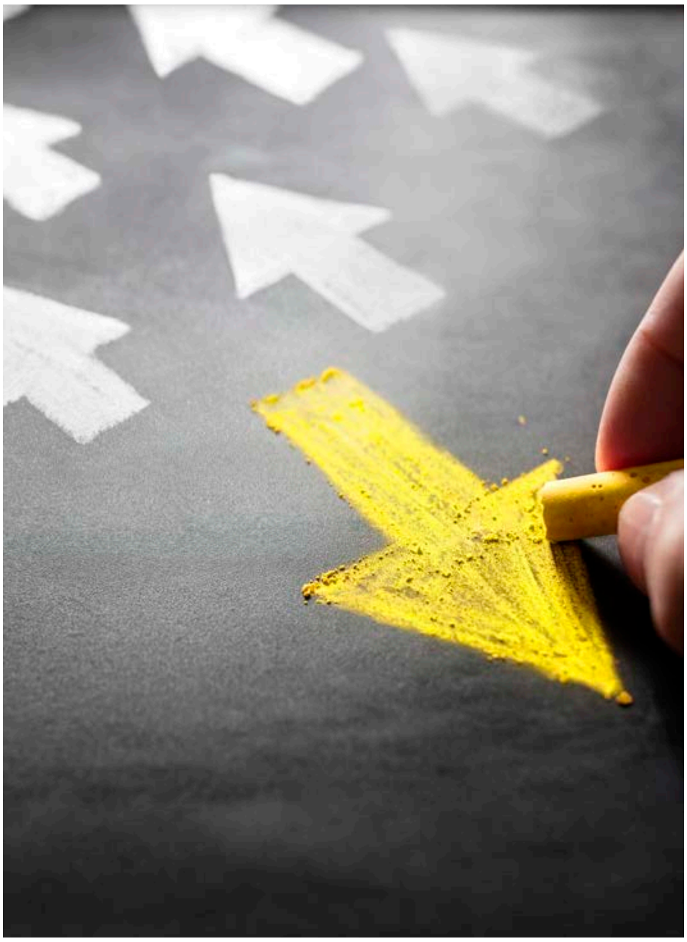
At the same time, if earnings growth doesn’t rebound then it could eventually trigger an adverse spiral of rising defaults, a credit-crunch for corporates, and a painful deleveraging. While debt servicing costs are low, US corporate leverage is at record highs, and the US’ biggest banks have already set aside record-high loan loss provisions.

An equity price bubble could occur

As economic data continues to rebound from very weak levels, the huge policy stimulus and the low interest rate environment runs the risk of eventually creating an equity market bubble. After the GFC (2008-09) there were similar fears, but it wasn’t until after almost a decade later, when the US S&P500 first broke 3,000 points in mid-2019, that investors became concerned about valuations and potential bubbles.

Therefore, trying to consider the time horizon that an equity market bubble could develop over is highly uncertain. However, we think it is a potential risk over the next 1-3 years given how fast markets can move. This time around, equities have already rebounded to a strong starting-point, with the global MSCI equity index around 10% below the all-time highs of February, and policy stimulus is far larger than the GFC experience.

The key signposts to monitor for this risk, over the years ahead, will be how much valuations rise by and how global policymakers will unwind the huge policy stimulus. If valuations do become significantly stretched, and markets are judged to be in bubbly territory, then investors will need to become watchful for exogenous events (such as tighter monetary conditions) that could trigger significant corrections.



3. Longer-term risks

Lower trend growth

The macro consensus expects global growth to rebound above trend next year before settling back around its historic average growth rate of 3.3% p.a. (since 1980). It is still premature to conclude that trend growth rates will be significantly lower post-COVID-19 because the game-changer will be when a vaccine is developed (or when better drugs to fight the disease and weaken its transmission are available).

If trend growth rates are eroded over time then it is likely to be more a reflection of changes in-play before COVID-19 hit, such as less globalisation and more trade barriers. For example, since 2018, the deterioration in US-China relations has seen an increase in trade restrictions, while this year the trade relationship between the US and Europe has also deteriorated. A greater incidence of geopolitical shocks, and less globalisation, could eventually result in structurally lower global trade and growth.

The other significant risk factor, that could push trend growth rates lower, will arise when countries unwind the surge in public debt from all the stimulus programs. The risk of much higher taxes in the future is significant and it could further depress consumption and trend growth. Some countries, especially those still developing, may be more at risk than others. For example, across Asia, India and Indonesia are likely to experience significant deteriorations in their fiscal deficits. Therefore, it will be important for their policymakers to follow some austerity measures over the years ahead to keep their economies attractive to foreign investors.

The key signposts to watch for the risk of lower trend growth will be revisions to long-term GDP growth forecasts by the 'macro consensus', as well as from key global agencies like the IMF.

Stagflation

With such a huge global policy stimulus, and the surge in money growth that is already flowing into stronger credit growth, there is the risk that eventually excessive printing of money drives significantly higher inflation. A stagflation environment would be especially challenging for investors because inflation, that is too high for too long, can crowd-out equity prices while low growth erodes earnings performance.

This risk would likely take several years to materialise because, at present, the recession is driving a significant disinflation across most countries. Furthermore, since central banks have adopted inflation targeting regimes inflation and growth are highly correlated (Figure 9). This relationship would have to break-down for stagflation to unfold, especially across key markets like the US. Another key signpost to monitor is longer-term inflation expectations priced-in by US markets (Figure 10). They would have to rise significantly over time, and overshoot the historic average of 2.3% p.a for inflation, to become concerning to investors.

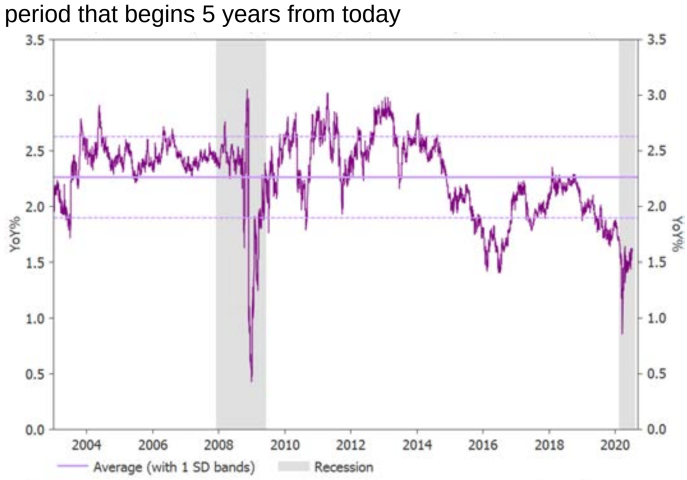
Figure 9: US inflation and growth

Statistically Significant Correlation (0.80, R^2 0.64)

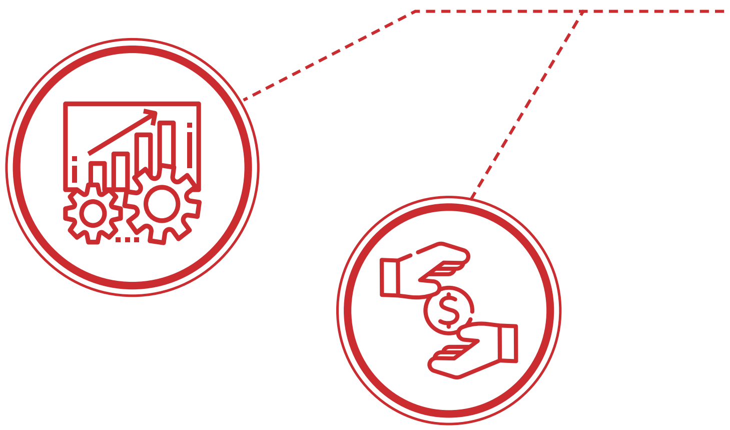
Source: Refinitiv Datastream, 8 Jul 2020

Figure 10: US 5-year 5-year forward inflation expectations

Measure of expected inflation (on average) over the 5 year period that begins 5 years from today



Source: Refinitiv Datastream, 8 Jul 2020

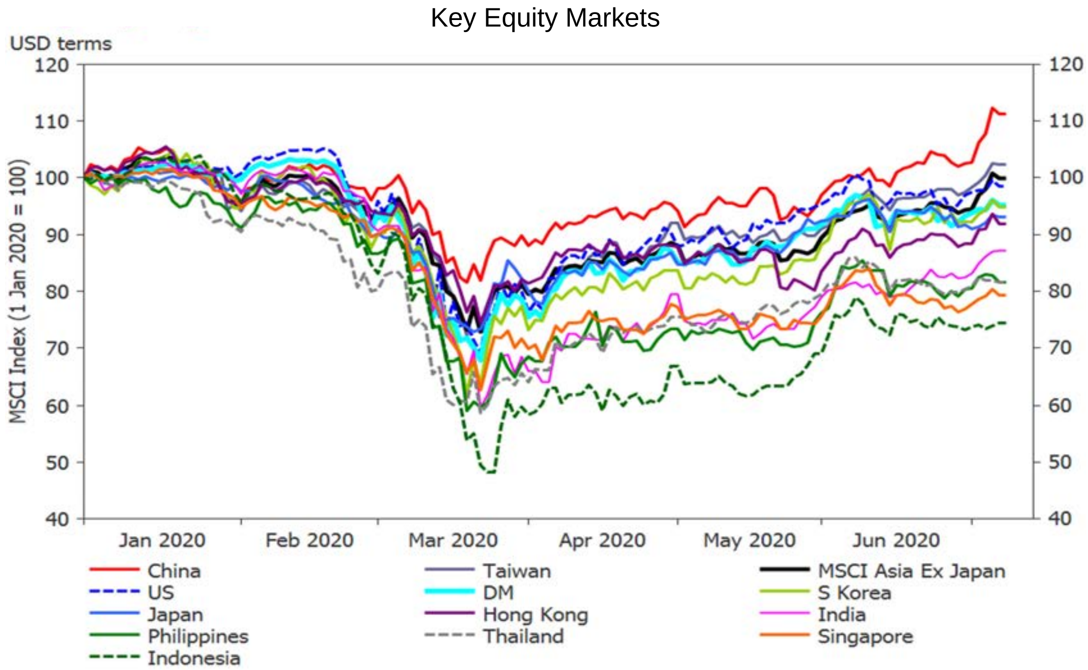


4. Investment strategy – more positive on risk assets

Equities and commodities (especially metals) have rallied significantly with stronger leading indicators of growth, huge policy stimulus, and greater clarity on when the global recession will end (Figure 11 and Figure 12). The recovery has created the buying opportunities we expected (and outlined in our Q2 Investment View), but investors still have to be cautious and selective given the risk that the post COVID-19 environment is fundamentally different.

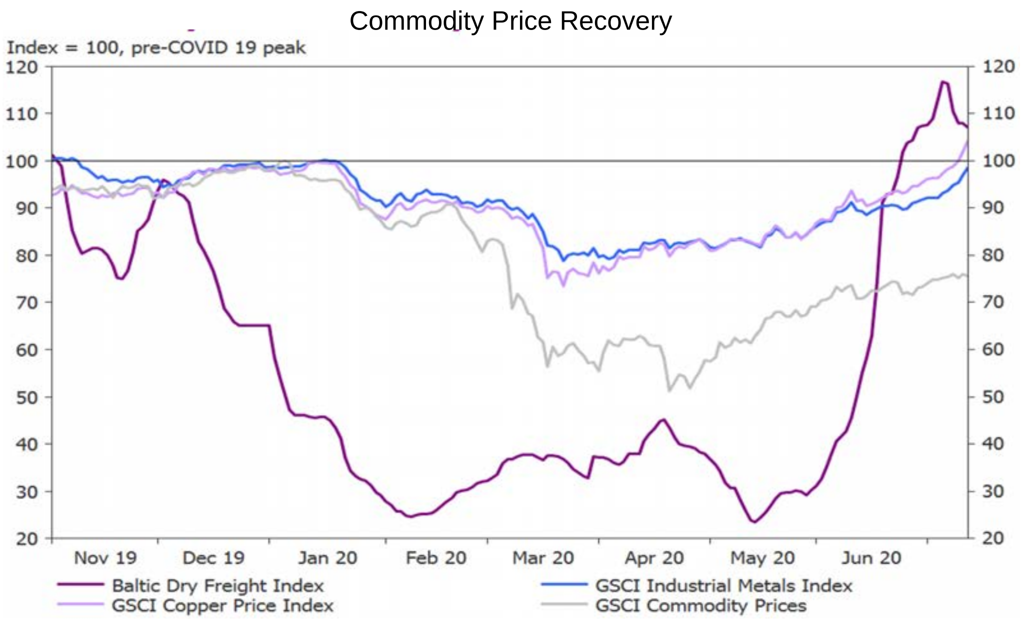
We continue to favour the sectors that are best positioned to navigate the post COVID-19 world e.g. technology, consumer staples, utilities, and healthcare. As the recovery gathers momentum, some sectors that have been lagging, such as industrials and financials, may provide some 'catch-up' buying opportunities. With the strong rebound in industrial metal prices and raw materials it signals that China's industrials and its 'older economy' type stocks are set to improve, which will serve to broaden the rally.

Figure 11: Key equity market performance YTD



Source: Refinitiv Datastream, 8 Jul 2020

Figure 12: Commodity prices have staged a recovery



Source: Refinitiv Datastream, 15 Jul 2020

Equities – positive view on global, Asia and China equities

We are positive on global equities, Asia, and especially China. US equities should continue to get significant support from the growth rebound underway and the huge policy stimulus. The Fed's forward guidance suggests that interest rates will be very low at least until 2023, and with the US rebound looking more robust than Europe, we continue to believe European equities will lag.

For Asian equities, geopolitical risks are a key downside, as the deteriorating US-China relationship could create headwinds for China's companies to gain further global market share – especially if the US shifts its protectionist policies from trade, and further into industry, technology, and financials.

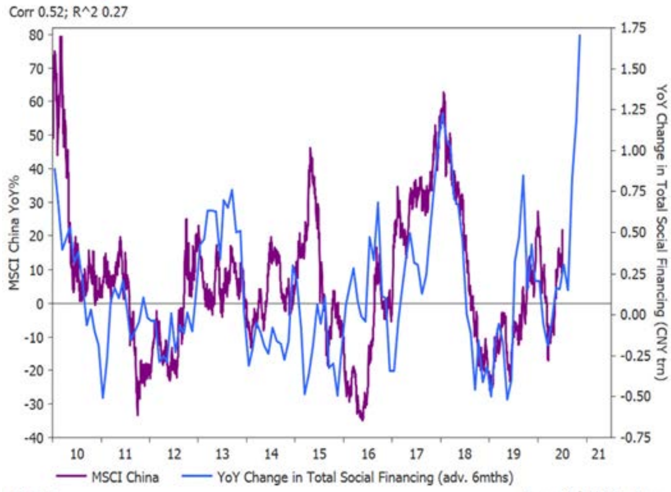
China is the growth engine of the region and its rising middle-class spending is driving solid investment returns from sectors like tech (China's 5G roll-out will immediately create the world's largest 5G network, ahead of the US), healthcare, finance, e-commerce, and consumer brands. These trends will likely continue for many years to come, and the rest of Asia also benefits as intra-Asian trade growth has been significantly stronger than global trade growth for more than a decade now.

Nevertheless, countries dependent on external demand growth outside of Asia (especially from Europe), are likely to lag the China-led recovery, e.g. Singapore, Malaysia, Indonesia, Thailand, and Taiwan. India and Indonesia may also face some additional headwinds as they continue to try and contain their COVID-19 cases, and as their fiscal deficits deteriorate to record highs this year.

Earnings revisions may still have further downside across Asia, although we note that the global earnings cycle is showing signs of bottoming. Investors need to be cautious and selective as valuations have increased, especially in China. But they don't look too concerning yet given low interest rates, huge policy stimulus, and strong liquidity growth (Figure 13). Typically, in the early stages of the recovery, valuations jump and then stabilise, and slip, as stronger earnings growth catches-up.

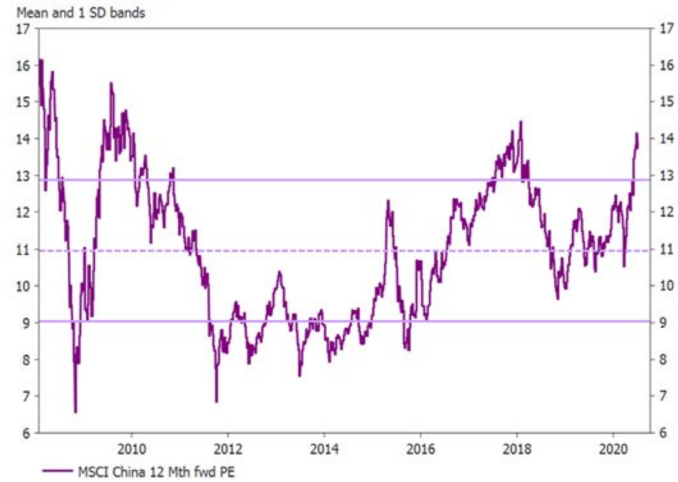
Figure 13: China's equities with total social financing stimulus and valuation (Forward PE)

China Equities with TSF

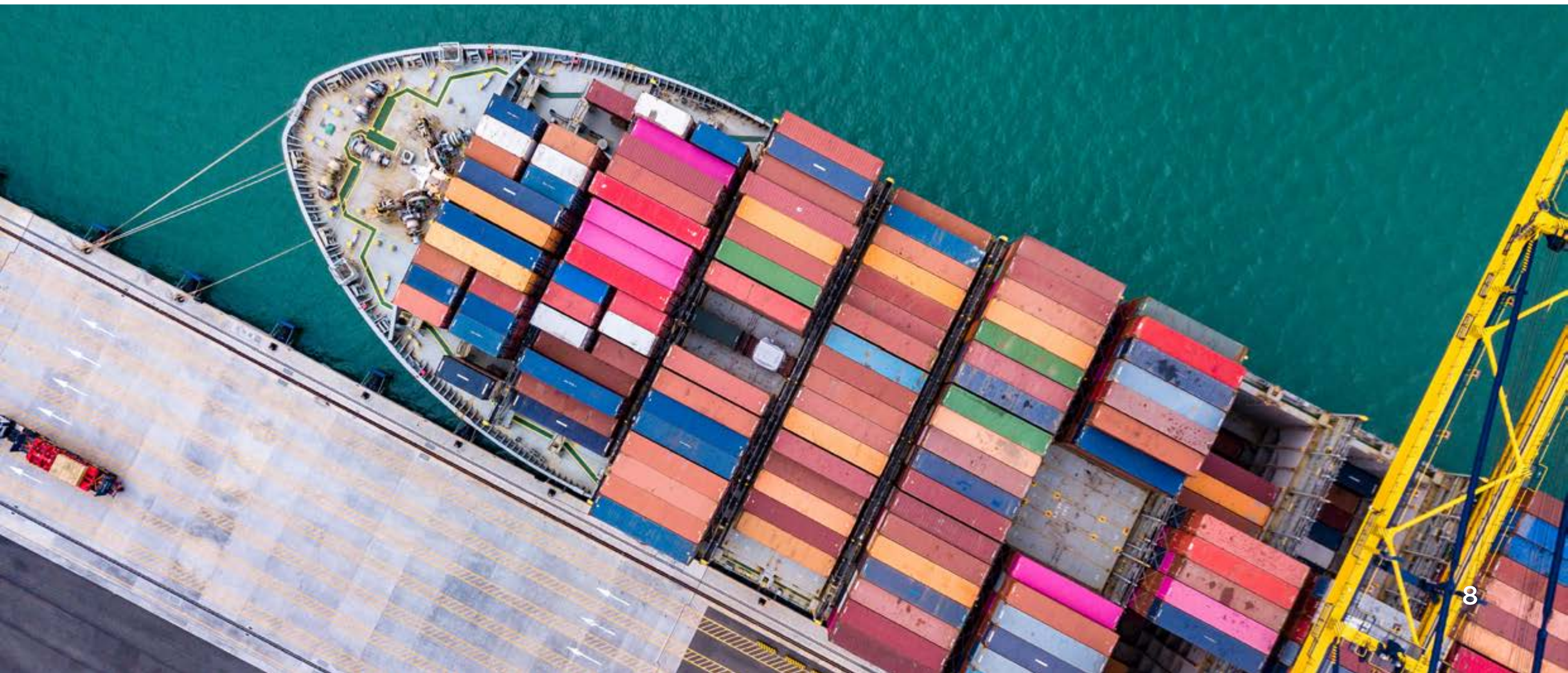


Source: Refinitiv Datastream, 8 Jul 2020

China forward PE



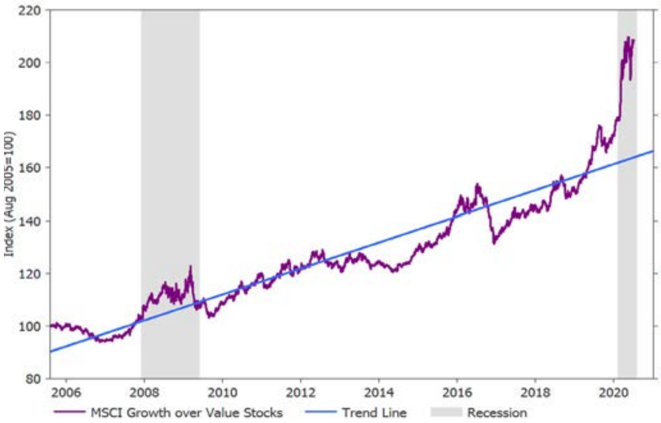
Source: Refinitiv Datastream, 8 Jul 2020



Just as we saw after the GFC (2008-09) – low interest rates need not impose poor equity returns and growth stocks can outperform value stocks. While the very strong performance in growth stocks (relative to value) may have overshot, and could fall back cyclically, its trend outperformance can continue (Figure 14). That is because the companies that best navigate the recovery from the recession will be able to secure more robust cash flows and expand their market share.

Figure 14: Global growth stocks vs value stocks

Growth vs Value Stocks



Source: Refinitiv Datastream, 8 Jul 2020

Fixed income – Asia and China offer investors solid risk rewards

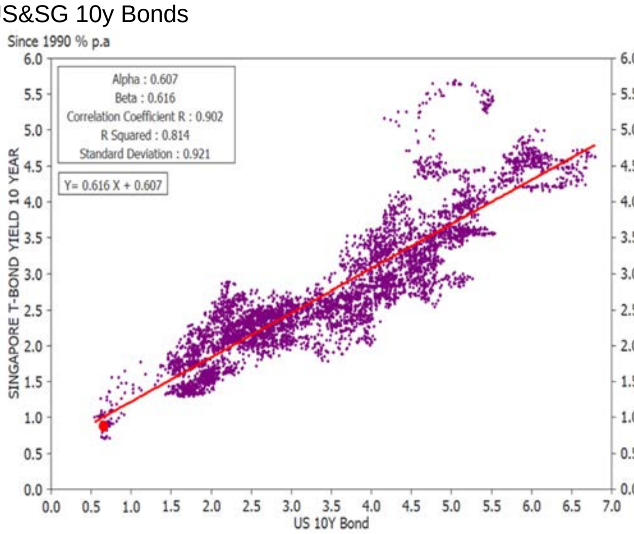
Ultra-low and negative government bond yields, across much of the Developed Market (DM) space, reduces the attractiveness of fixed income investments. However, in the US, bond demand will be supported by the Fed's significant policy stimulus, and so we remain neutral-to-positive on duration.

Because of higher yields versus DM, Asia, and China's fixed income in particular, should be attractive to investors seeking solid risk-rewards with a desire to diversify away from DM. China's fixed income is also superior to most Emerging Debt markets because of China's strong sovereign fundamentals, its low correlations with global markets in general, and the likelihood of a favourable risk-reward balance.

Despite the Fed's huge monetary policy stimulus, and low US interest rates, Singapore's interest rates seem to be tracking consistently. Since 2010, Singapore's discount to the US has faded, perhaps because of the Fed's balance sheet expansion. With US 10-year yields at 0.65% p.a., Singapore yields should be (as they are) at around 0.9-1% p.a. - and as the growth recovery builds momentum then yield curves should, very gradually, steepen (Figure 15).

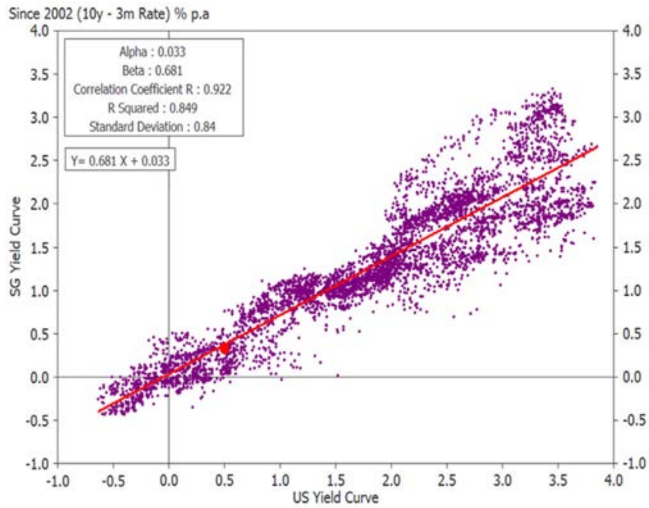
Figure 15: Singapore and US bond yields, and yield curve slopes

US&SG 10y Bonds



Source: Refinitiv Datastream, 8 Jul 2020

SG&US Yield Curve



Source: Refinitiv Datastream, 8 Jul 2020

More positive on corporate credit, particularly IG names with strong fundamentals

Corporate default rates will rise, and lag significantly the rebound in growth, and therefore we remain more cautious about HY-credit exposures than IG (which have stronger balance sheets and fundamentals). That said, we are more positive on corporate credit now, than in our Q2 Investment View, especially as risk appetite has improved and IG spreads have tightened rapidly.

Further spread compression will likely be modest, so investors should expect coupon-carry to dominate returns. We believe that transition downgrade risk (i.e. 'fallen angels' from the IG space) remains low, with around 3% of Asian IG credit at risk. Overall, we expect default events to continue to be largely idiosyncratic, with the average Asian corporate credit default rate likely to peak at around 4-5% (up from the 2.5% estimated at start of year). Investors need to continue to focus on balance sheet fundamentals to cherry-pick the strongest companies.

Commodity prices have rebounded on strong demand

Metal prices, especially copper, have rebounded as we expected, as China's demand recovery has been strong (and as markets are much more confident that the US will avoid a prolonged recession). If the USD can resume a depreciating trend then this can help support oil prices, but the recovery in oil prices is likely to continue to lag other commodities because of high global inventories.

Weaker USD is likely, gold prices have further upside

The significant deterioration in the US current account deficit to come, coupled with the Fed printing money, and less investor risk-aversion over time (motivating more capital outflows), should collectively allow the USD to depreciate further against DM currencies (especially if Europe can sustain its current account surplus). For the broader USD TWI to depreciate significantly requires EM currencies, especially across Latin America, to make significant gains which will likely take time to unfold.

If the Fed decides to pursue yield-curve control (YCC), on the hope it can contain yields with lesser balance sheet expansion, then it could increase the downside risk to the USD (and the upside for gold prices). With the USD real effective exchange rate (REER) overvalued on most metrics, the market may become uncomfortable with an additional Fed policy tool, like YCC, potentially distorting signals from the bond market.

Gold prices can rally given very low interest rates and the likelihood of a weaker USD. Further, with geological risks likely to persist for a while, we believe there is more upside to gold prices, than downside.