Finding opportunities across a challenging investment landscape

Fullerton Investment Views - Quarterly report

Q4 2021

Executive summary

- **The investment environment has become very challenging**, as earnings growth is slowing while inflation has surged. Price pressures may also remain higher for longer. The prospect of inflation being too high for too long increases the risk that it will eventually cause a slump in GDP growth, especially if households postpone their spending and firms cut their output to contain costs.
- **We remain positive on global equities.** Even though growth is slowing, earnings expectations are still significantly above trend, especially across Developed Markets (DM). Our global risk appetite indicator also remains positive, which should potentially continue to underpin equity returns even as they ease over time.
  - **However, we have shifted to a negative outlook on Asian and Chinese equities. The most concerning downside risks to growth have emerged in China**, as its industrial production and retail sales growth have slowed sharply. China's regulatory crackdown and greater geopolitical tensions with the US, could drag on Asia.
  - From a 'bottom-up' perspective, we still favour sectors like consumer products, communications, healthcare, and renewables, as they seem well positioned to withstand a challenging macro backdrop.
- **We remain negative on Asian corporate credit** as there is likely to be less spread compression ahead, tighter liquidity, and more credit risks.
- **We maintain our positive USD outlook**, as positioning has become more supportive, and the US terms of trade has increased significantly.

Author

Robert St Clair
Strategist
Fullerton Fund Management

1. The macro backdrop has become much more challenging

GDP growth is slowing, but is still above trend

As we anticipated in our Q3 Fullerton Investment View[1], GDP growth across most countries is slowing (see Figure 1) but remains significantly above trend, especially across Developed Markets (DM).

Consumer spending and industrial production indicators are especially robust in the US, while its productivity growth also remains well above trend (see Figure 2). Activity indicators across Europe and Japan have slowed more sharply than in the US, but their industrial production growth remains stronger than pre-COVID rates (see Figure 3).

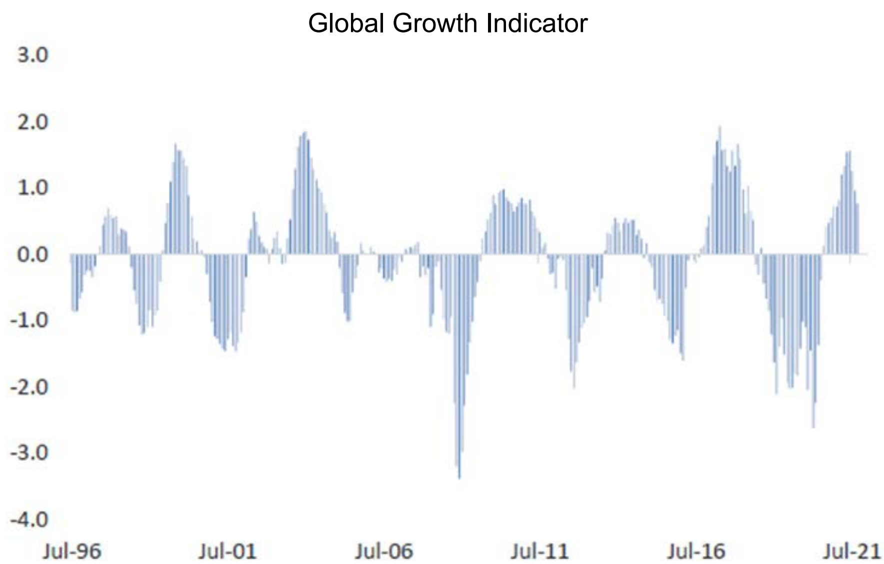
[1] See https://www.fullertonfund.com/what-lies-ahead-for-the-second-half-of-2021/

The most concerning downside risks to growth stem from China

The most concerning downside risks to growth have emerged in China, as its industrial production and retail sales growth have slowed sharply (see Figure 4). At the same time, supply-side weakness is being exacerbated by bottlenecks and energy shortages.

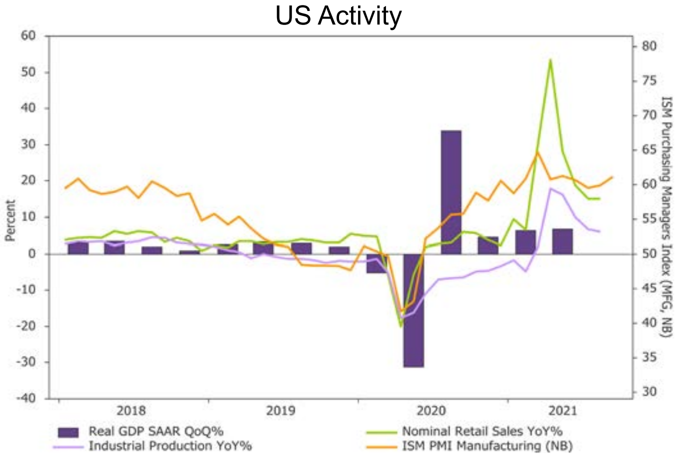
Despite its earlier pledge to reduce carbon emissions by 2030, China's government has already ordered coal miners in Inner Mongolia to increase output to try and meet stronger demand, and to relieve some price pressures. We believe that China's policymakers will provide more stimulus if GDP growth falls sharply below average. Already, there are signs that new total social financing is recovering (see Figure 4), which could potentially help reduce some of the potential downside risk to China's equities.

Figure 1: Fullerton's global growth indicator

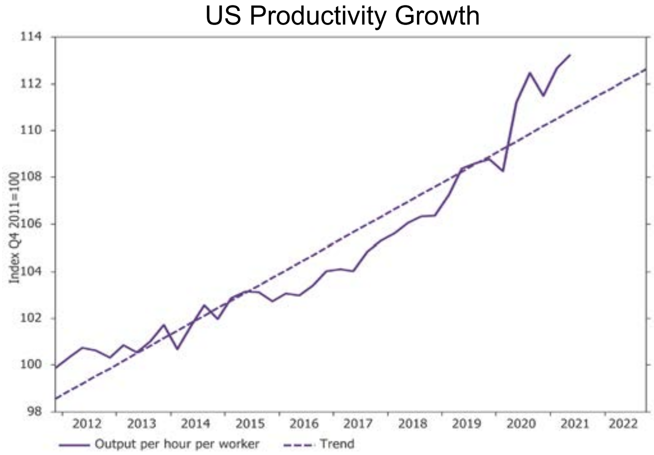


Source: Fullerton, October 2021. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

Figure 2: US economic activity indicators and productivity growth

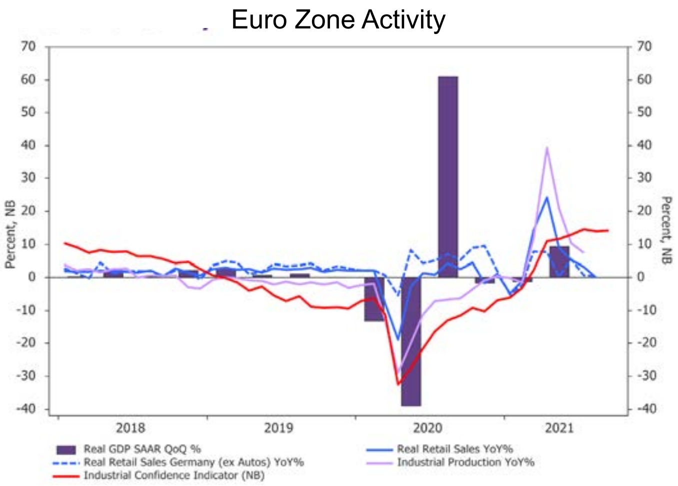


Source: Refinitiv Datastream, 10 Oct 2021

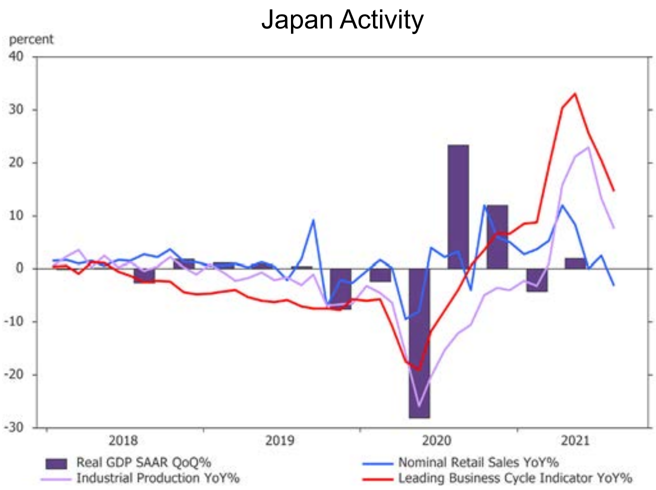


Source: Refinitiv Datastream, 10 Oct 2021

Figure 3: Europe and Japan economic activity indicators

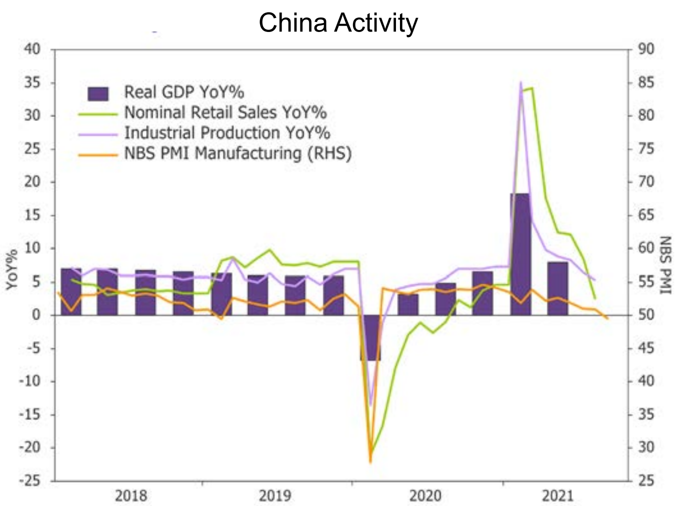


Source: Refinitiv Datastream, 10 Oct 2021

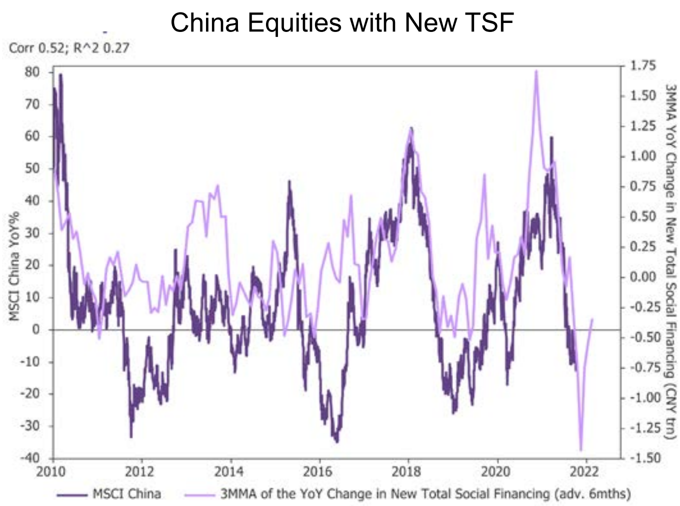


Source: Refinitiv Datastream, 10 Oct 2021

Figure 4: China economic activity indicators and new total social financing stimulus



Source: Refinitiv Datastream, 11 Oct 2021

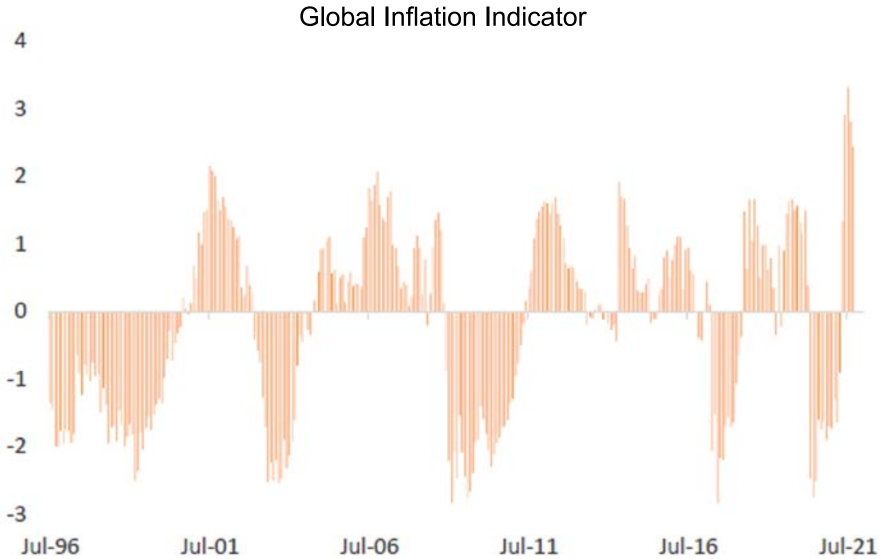


Source: Refinitiv Datastream, 10 Oct 2021

Strong demand, supply-side bottlenecks, and a global energy shortage, have all caused inflation to surge

Inflation has surged significantly above trend, reflecting strong consumer spending, supply-chain bottlenecks, commodity demand pressures, and a global energy shortage (see Figure 5). There is an increased risk that inflation remains higher than expected for longer, especially if wage pressures continue to rise as unemployment falls.

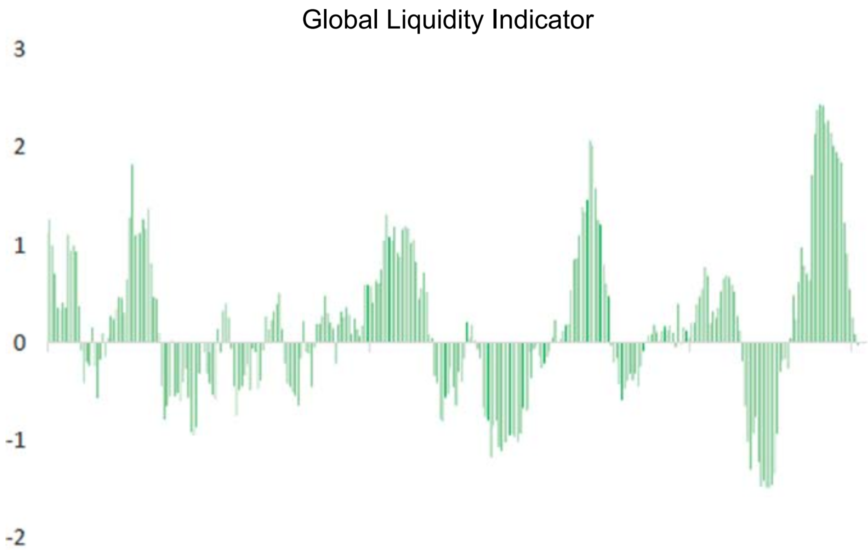
Figure 5: Fullerton's global inflation indicator



Source: Fullerton, October 2021. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

That said, liquidity growth has also slowed significantly, which will likely become somewhat of a headwind to excess demand pressures and inflation going forward (see Figure 6).

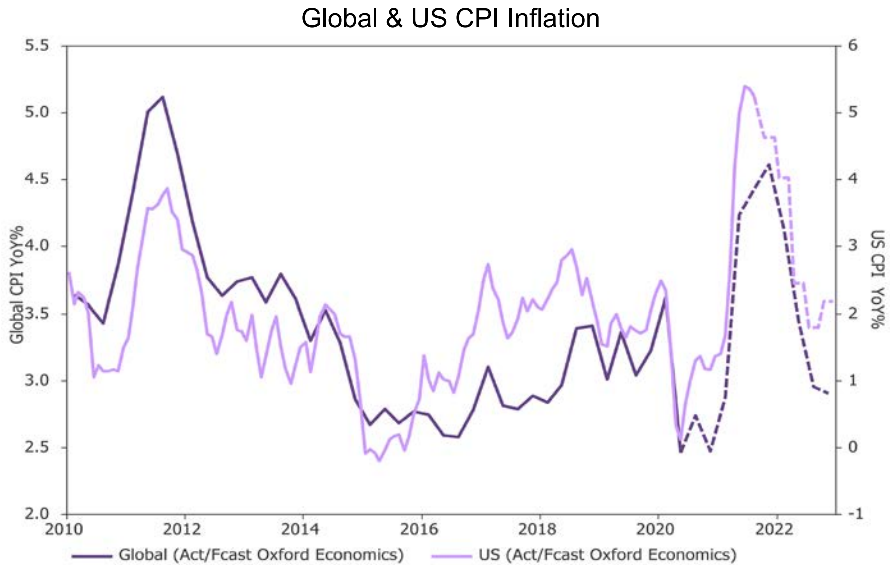
Figure 6: Fullerton's global liquidity indicator



Source: Fullerton, October 2021. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

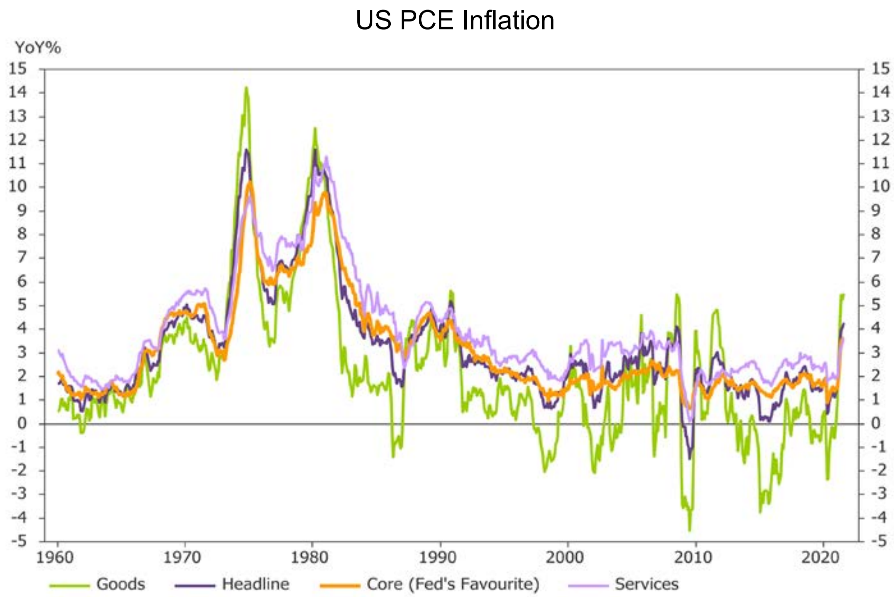
For inflation to fall back and normalise by Q3 2022, as most forecasters expect (see Figure 7), it requires a decline in excess demand pressures, especially for commodities, and a normalisation in goods price inflation. Since 2000, stronger globalisation and trade, combined with new technologies in consumer goods, have made bouts of goods price deflation more probable (see Figure 8). Above trend demand growth, and the prospect of goods prices eventually falling once the adverse supply-side bottlenecks correct, makes this environment unlike the stagflation of the 1970s.

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



Source: Refinitiv Datastream, 10 Oct 2021

Figure 8: US inflation across goods, services, headline, and core



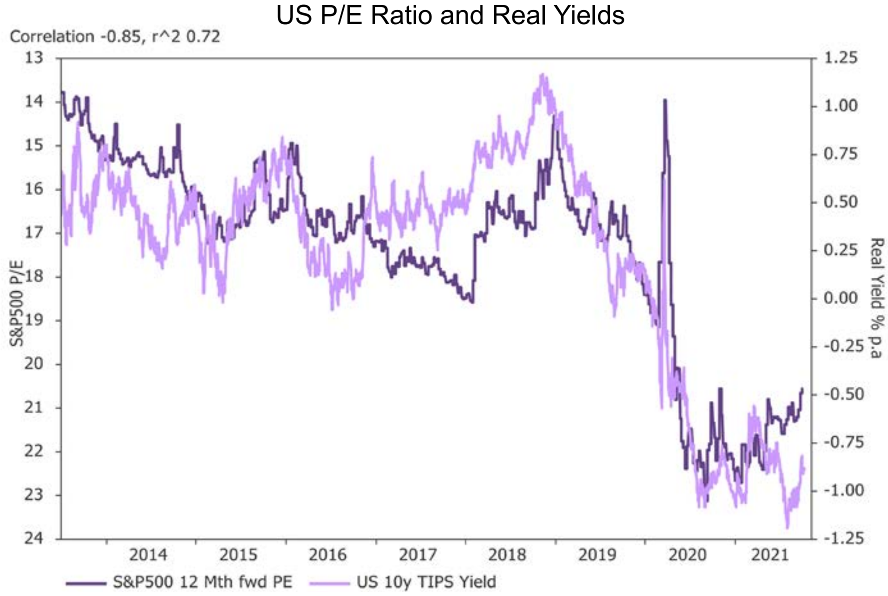
Source: Refinitiv Datastream, 10 Oct 2021

Why high inflation is a potential risk for investors

As we outlined in our Q3 Fullerton Investment View, the prospect of inflation being too high for too long increases the risk that it will eventually cause a slump in GDP growth, especially if households postpone their spending, and firms cut their output to contain costs. There is also the risk that the large overshoot in inflation will eventually push interest rates higher, which could cause equities to correct sharply.

However, with real yields being significantly negative, the environment can remain supportive to equities for some time, fostering high P/E ratios (see Figure 9), especially across DM.

Figure 9: US equity market P/E ratio and real yields



Source: Refinitiv Datastream, 10 Oct 2021

Therefore, we continue to believe that economies should be able to navigate higher interest rates, provided policymakers provide clear communications to markets, and ensure that they are not forced to tighten by too much, too fast. If real yields can slowly rise, then equity market returns can slow gradually over time, without significant overshooting to the downside.

Geopolitical and COVID-19 risks are still significant

Geopolitical risks, especially further deterioration in US-China relations, remain significant. In addition, concerns surrounding China-Taiwan relations have also resurfaced as China has reiterated that there will be a reunification, eventually. While the prospect of further US-China high-level talks are on the agenda, which may address some of the trade issues, the trend of a deteriorating US-China relationship is unlikely to change.

China's regulatory crackdown, predominantly targeting technology and education companies, has triggered sharp falls in its equity markets. These policy actions appear to be driven by the government's larger social and economic agenda, and the desire to achieve more equitable growth outcomes.

There could be far reaching consequences on the competitive landscape in China, and we believe the following industries are more likely to remain resilient for investors: 'new-economy' high-value added manufacturing; industries embracing decarbonisation; and firms serving households. In contrast, firms that may struggle are those making 'monopoly-like' profits across the technology and e-commerce sectors, or with business models driven by excessive leverage.

On US fiscal risks and the government debt ceiling, US politicians have come together to 'kick the can further down the road'. While the stresses have been resolved for now, it does seem that it will be more difficult than previously expected for President Biden to pass all his spending plans.

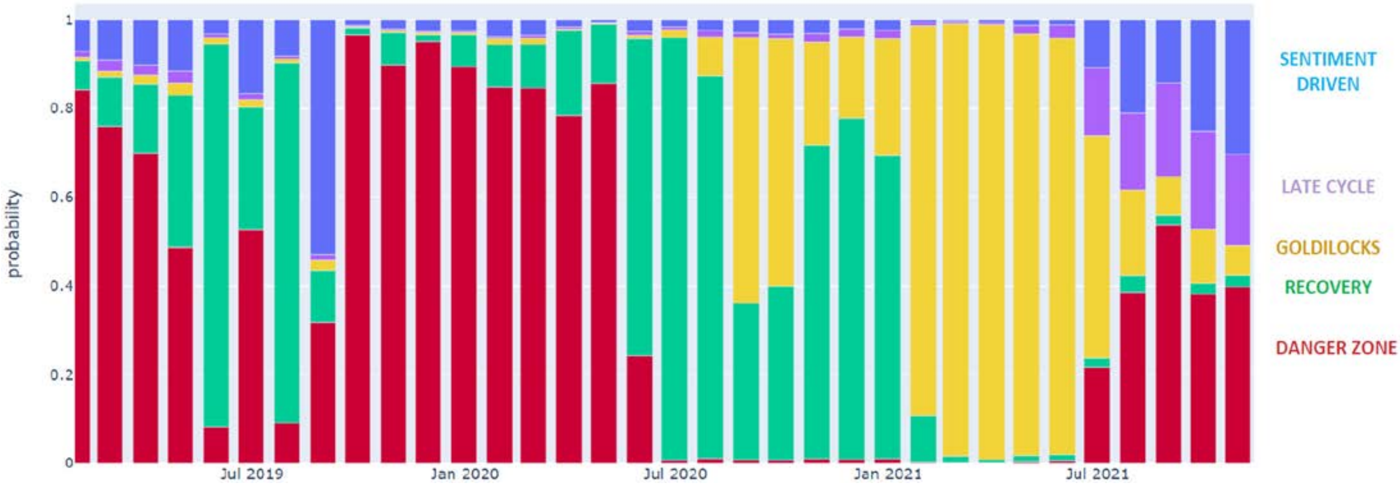
As countries continue to fight the spread of COVID-19, the risks of disruptions to economic activity increase the prospect that growth falls back to trend sooner than expected. However, overshoots to the downside, which would result in painful 'double-dip' recessions, should be avoided because vaccination rates continue to rise, and policymakers remain committed to avoiding draconian lockdowns.

This challenging macro backdrop has seen our regime indictor deteriorate suggesting, investors need to be extra cautious

Our regime indicator has deteriorated amidst this challenging macro environment. Investors are now facing a balance between the adverse 'Danger Zone' environment because of high inflation and downside risks to growth, versus a more positive 'Sentiment Driven' regime, where above trend growth and rising risk appetite can be supportive of risk assets (see Figure 10). There are also some 'Late Cycle' signals emerging, as above trend growth is slowing, and as global central banks are tightening liquidity.

Therefore, investors need to remain especially selective and cautious over this transition period, where above trend growth is slowing, inflation has risen rapidly, and monetary conditions will eventually tighten.

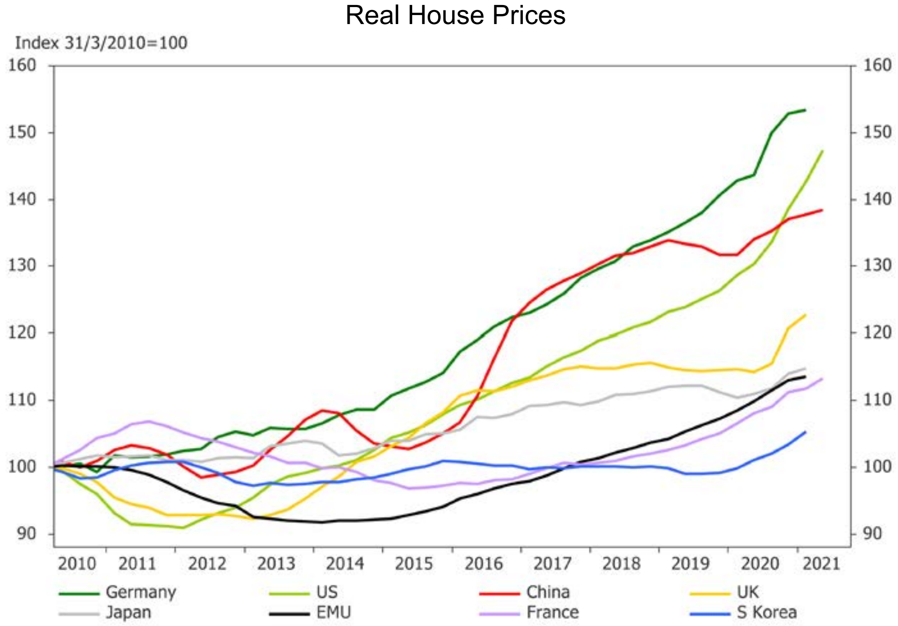
Figure 10: Fullerton's investment environment regime indicator



Source: Fullerton, October 2021. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

There is likely to be increased bouts of volatility, but growth assets like equities and real estate should still be able to generate returns in excess of inflation (as we emphasised in our Q3 Fullerton Investment View). Real house prices, for example, have already increased significantly across most markets (see Figure 11) as investors have diversified further across growth assets.

Figure 11: Real house prices across key markets



Source: Refinitiv Datastream, 10 Oct 2021

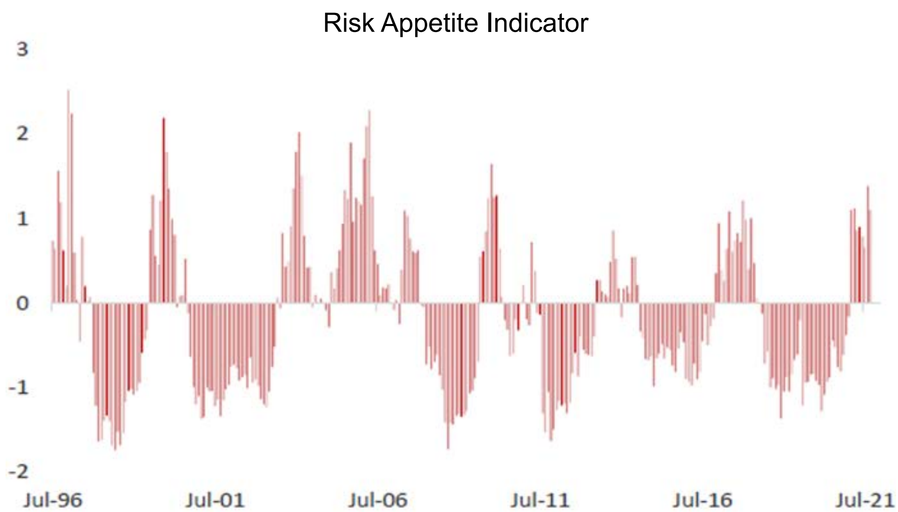
Investment strategy – we remain positive on risk assets

Despite the challenging macro environment, we remain positive on global equities. Although growth is slowing, earnings expectations are still significantly above trend (see Figure 12). Our global risk appetite indicator remains positive (see Figure 13), which should potentially continue to underpin equity returns even as they ease over time. In addition, as outlined earlier, growth in the US is especially strong and low real interest rates should remain supportive.

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

Source: Refinitiv Datastream, 10 Oct 2021

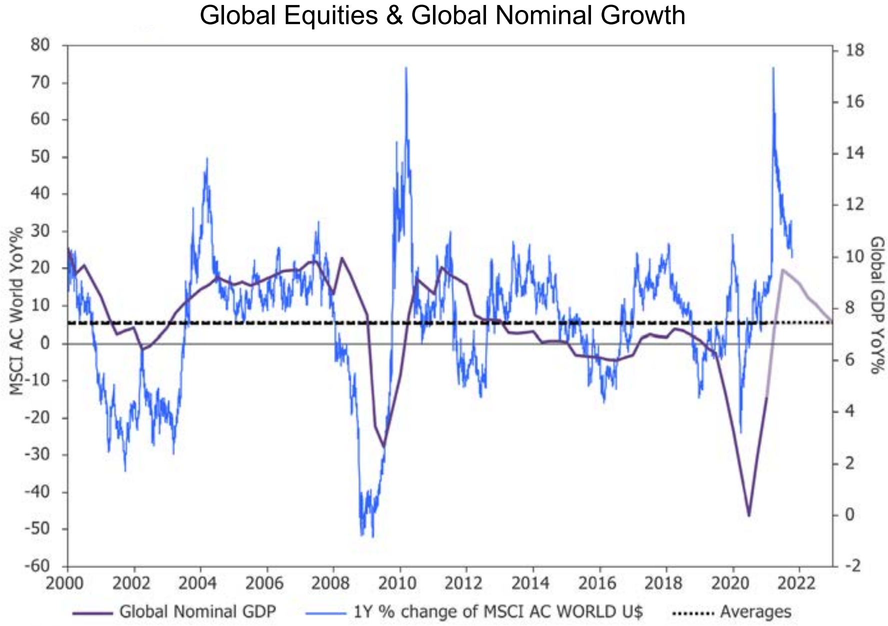
Figure 13: Fullerton's global risk appetite indicator



Source: Fullerton, October 2021. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

We maintain our positive outlook that global equity returns are slowing but likely to hold above historic averages for a period of time (see Figure 14).

Figure 14: Global equity returns and global GDP growth



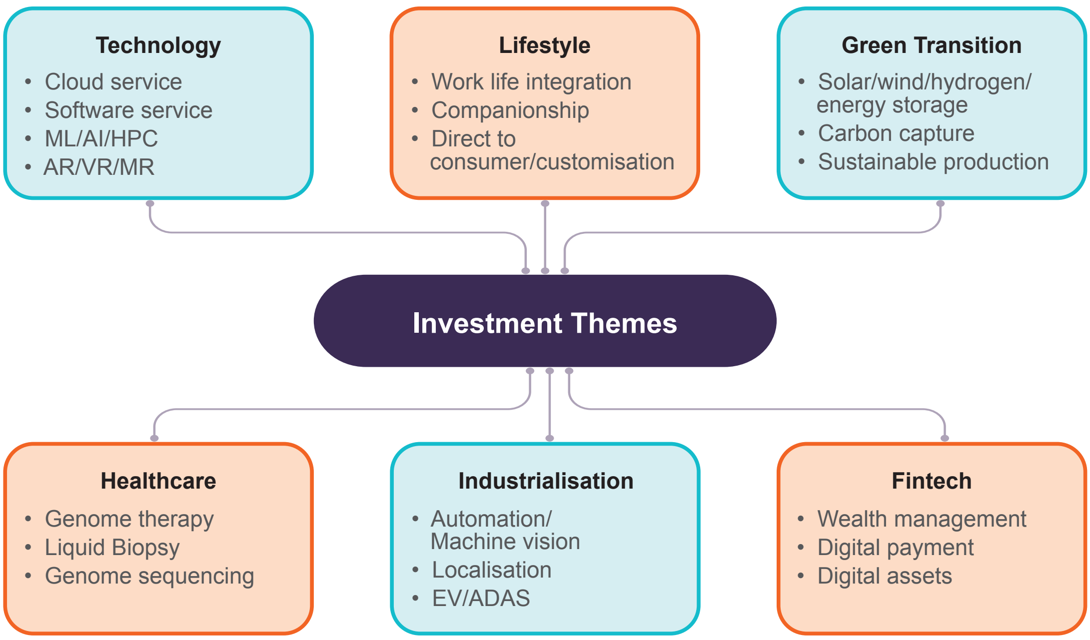
Source: Refinitiv Datastream, 10 Oct 2021

Equities – positive on DM and global equities, but negative on China and Asia

We remain positive on global equities, especially the US and Europe. However, we have shifted to a negative outlook on China equities because of the significant downside risks to growth, and the uncertainties created by its regulatory crackdown. With China's growth indicators slowing, it is likely that intra-Asian trade growth will suffer, and Asian equities will struggle.

From our 'bottom-up' perspective, we still favour sectors such as consumer products, communications, healthcare, and renewables, as they seem well positioned to withstand a challenging macro environment (see Figure 15).

Figure 15: Key investment themes

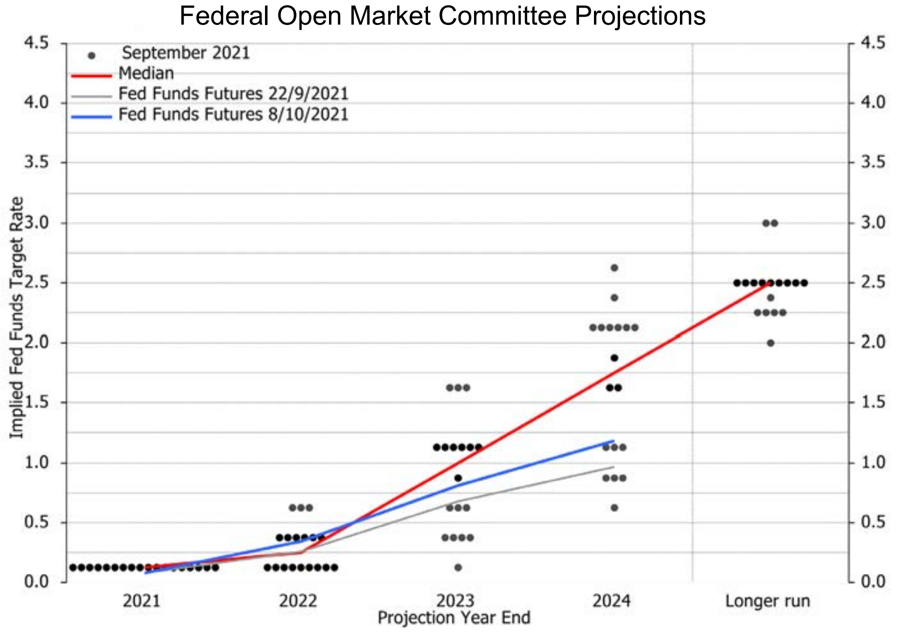


Source: Fullerton, October 2021.

Bonds – we are negative on duration

We remain negative on US bonds, as the Fed has proved a bit more hawkish than the market in signalling its balance sheet tapering (which could conclude by mid-2022) and the rate hikes to come (see Figure 16).

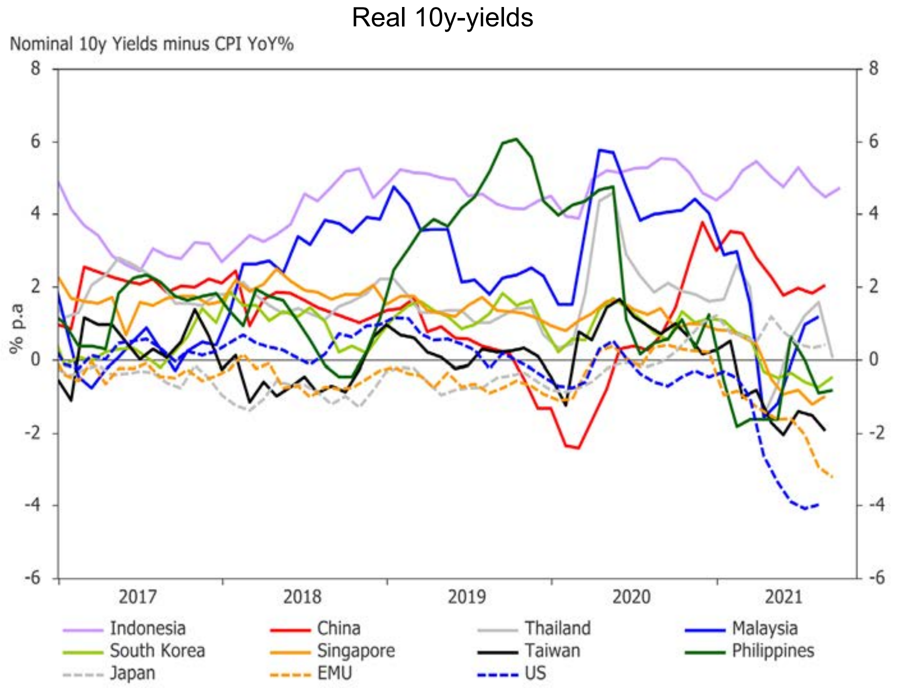
Figure 16: US Fed projections and forward-market pricing



Source: Refinitiv Datastream, 10 Oct 2021

US yields are likely to continue to drift higher, although much of the upward normalisation may not unfold until the Fed makes significant progress with its balance sheet tapering. Across Asian bond markets, real yields may remain attractive for investors seeking carry, especially compared to other key markets (see Figure 17).

Figure 17: Real 10-year yields across key markets



Source: Refinitiv Datastream, 10 Oct 2021

Corporate credit – we maintain our negative bias

As we outlined in our Q3 Fullerton Investment View, we are cautious on Asian corporate credit and have a negative outlook. Asian investment grade (IG) credit spreads have already narrowed to around longer-term averages and are likely to offer less prospect for significant spread gains, going forward.

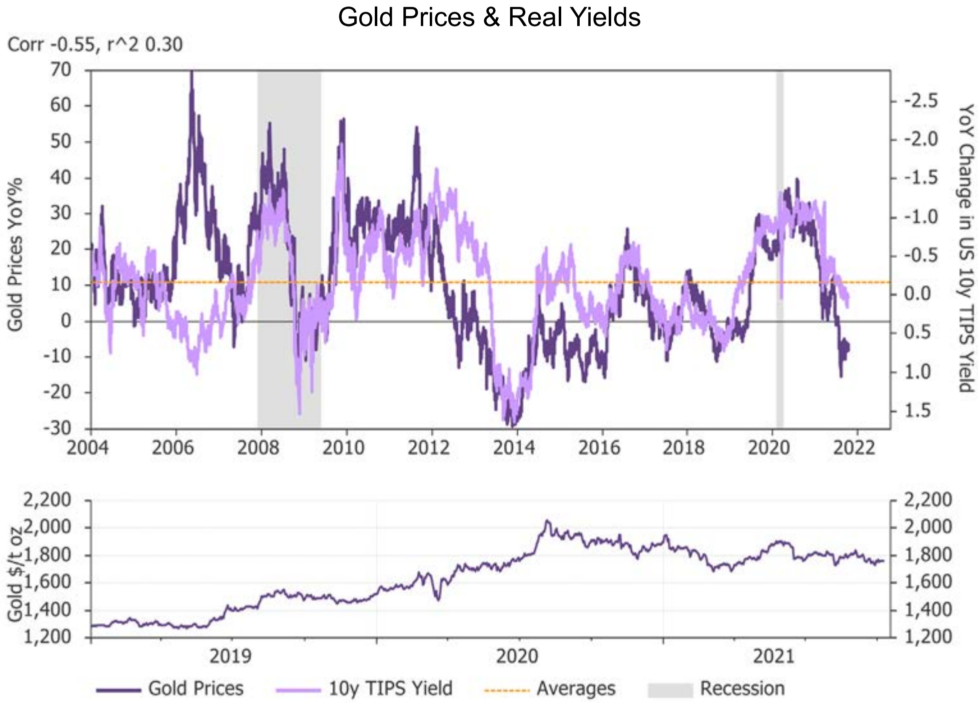
In contrast, Asian high-yield (HY) spreads may have further tightening to come, which may support returns, but default risks, especially in China, have increased. It is likely that China Evergrande will need a financial restructuring and encouragingly, it seems much of its market risk has been priced in. That said, HY default risks and spreads could still suffer further from potential adverse spill-over effects, given concerns surrounding other highly leveraged corporates across China's property market. Investors should assess balance sheet fundamentals and access to funding for this sector.

Commodity prices may hold-up for longer, with the global energy shortage and supply-side bottlenecks

Returns from the GSCI industrial metals index have been slowing but may now hold-up for longer than expected given excess demand and supply-side tightness. Copper prices, in particular, have been supported by robust import demand from China. We also maintain our positive view on oil prices, as consumption demand is still recovering and the supply-side is well controlled.

Returns from gold have slipped as investors may be 'front-running' expected increases in real yields. Subdued gold prices also suggest that markets may not be stressed yet by potential downside risks to growth (see Figure 18).

Figure 18: Gold prices and real US 10y-yields

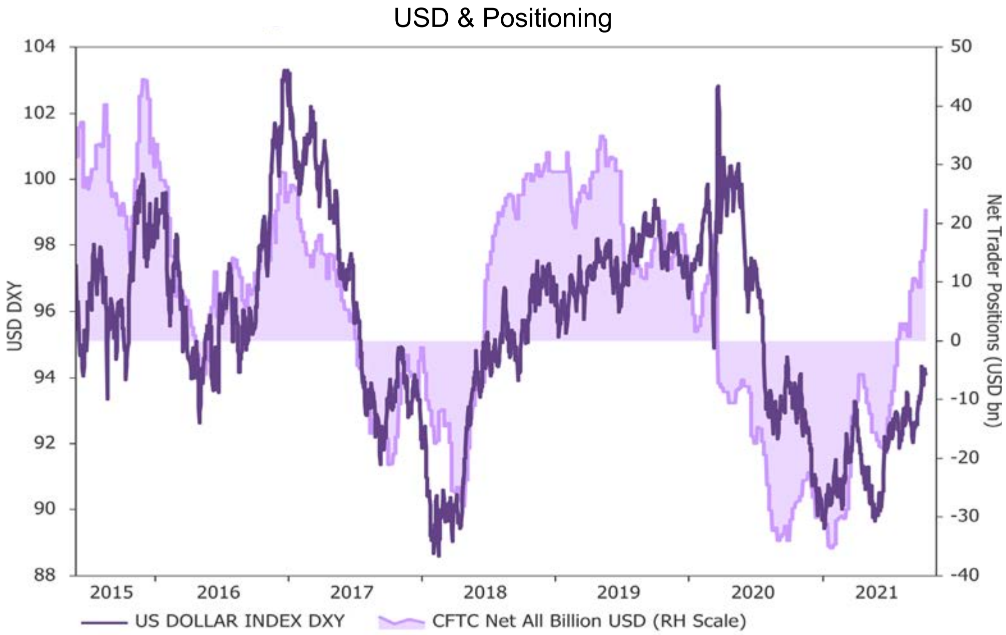


Source: Refinitiv Datastream, 10 Oct 2021

We maintain our positive outlook on the USD

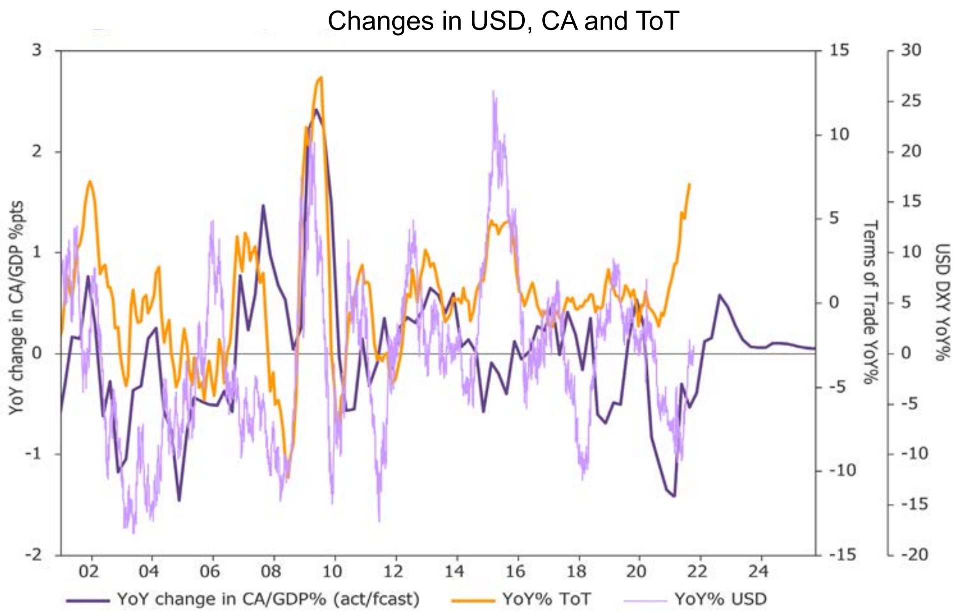
The USD can benefit from three factors – i) more positive positioning (see Figure 19); ii) the expected improvement in the US current account deficit; and iii) much stronger US terms of trade (see Figure 20). That said, unless there is a significant adverse shock to investor confidence, we do not expect a strong USD appreciation.

Figure 19: USD and market positioning



Source: Refinitiv Datastream, 10 Oct 2021

Figure 20: Changes in the USD, the US current account deficit, and the terms of trade



Source: Refinitiv Datastream, 10 Oct 2021