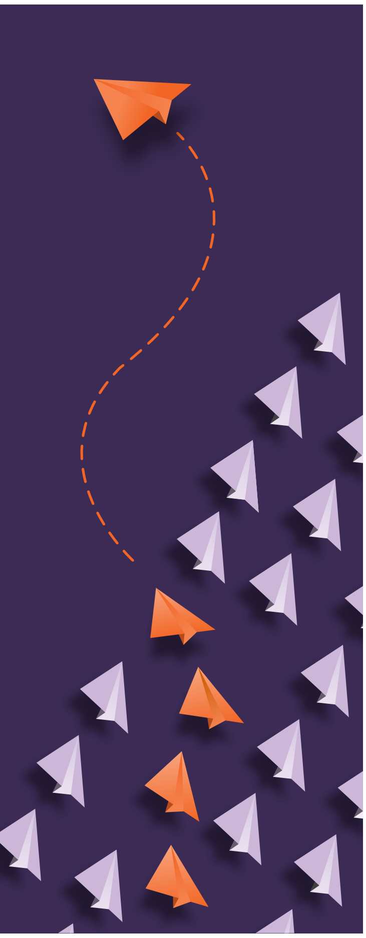
# Future of Investing: Paradigm shifts and trends to watch in Asia

Fullerton Investment Views - Quarterly report

Q1 2022

FULLERTON FUND MANAGEMENT



## Executive summary


In our Fullerton Outlook 2022 webinar "*Future of Investing: Paradigm shifts and trends to watch in Asia*"[1], our panel of in-house and external experts explored three major C's – COVID-19, China and Climate change, and its implications for investors. In this report, we explain further the strategies that can help investors navigate these three themes and the shifting trends across Asia.

- **The macro environment has become more challenging** since the second half of 2021, as investors face greater risks from high inflation and weaker growth.
- That said, **we retain a positive view on global risk assets**, driven by positivity on Developed Market (DM) equities, as earnings growth expectations are still above average and real yields are negative.
- **Due to the paradigm shift in China, coupled with Asia's narrower growth advantage over DM, we are negative on Chinese and Asian equities**. More policy stimulus from China would be positive, but investors still need to be selective as policy shifts have changed the competitive landscape.
- **We believe there are valuable alpha opportunities across sectors that have robust structural trends**, which could be reinforced by spending changes due to COVID-19, Climate change, and reforms in China.


### Author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Strategist
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## 1. COVID-19, China, and Climate change dominate the macro backdrop

### COVID-19 risks could potentially surprise on the downside and boost markets in 2022

COVID-19 has proved to be the most significant shock to global growth and financial markets in modern times. While it is premature to judge, with such rapid and significant medical advances, the management of the pandemic could potentially surprise on the upside in 2022. Such a positive outcome does not seem to be fully 'priced-in' by markets and would likely give a significant boost to growth and risk asset returns.

Countries are adapting to living with the pandemic, with strong drives for testing, vaccinations (see Figure 1), boosters, and increased resources for healthcare. Progress on developing oral anti-viral medications, led by Pfizer and Merck, also remains very positive. Such medications may prove a key tool to help reduce resource strains on hospitals, prevent prolonged lockdowns, and help spending on leisure recover.

[1] Held on 12 January 2022

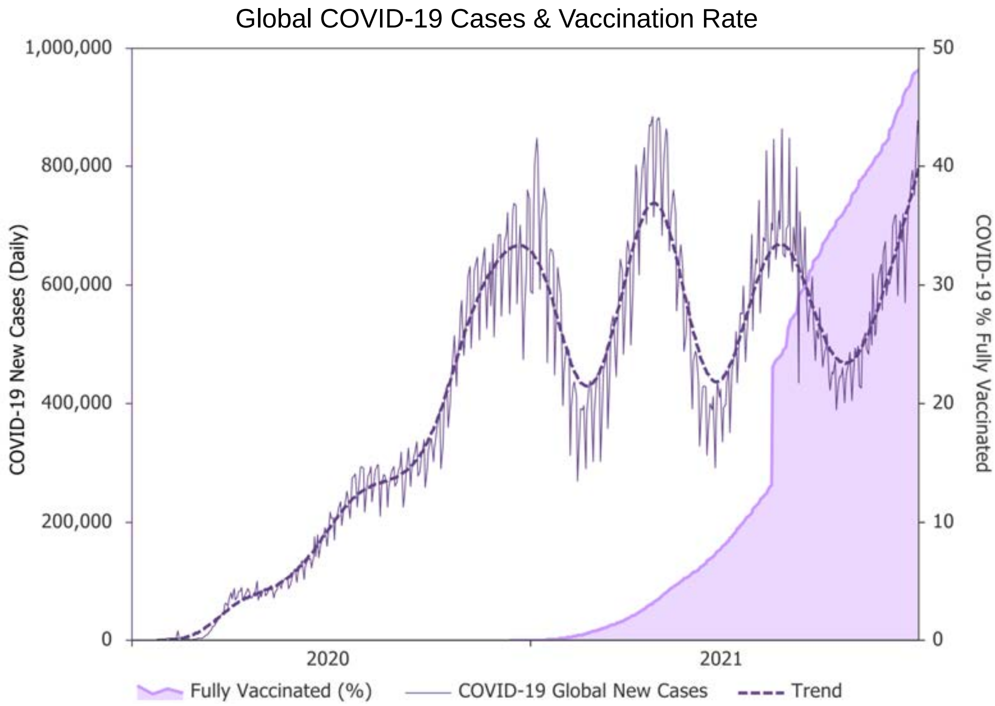
A key risk group remains children, but drug companies like Pfizer have stated that vaccine development will continue to improve and will eventually be spearheaded by a three-dose vaccine regimen for children aged 2 to 16[2].

## Significant uncertainties remain with Omicron

Notwithstanding these positive developments, there are still significant uncertainties surrounding COVID-19, especially the potential adverse impact and lockdown risks from the new Omicron variant. Some countries have reacted by tightening social restrictions sharply, especially on travel, in the hope that more draconian lockdowns can be avoided in the future.

Pfizer has a more negative outlook where they now expect that the pandemic will not reach a global endemic stage until 2024 (prior to the Omicron variant, the consensus across medical science was that the pandemic would end in 2022[3]). Pfizer noted that the Omicron variant was five times more infectious than the Delta variant, but its symptoms could be milder. However, a study by the Imperial College of London concluded that a thorough assessment of the impact of Omicron will still take more time[4].

**Figure 1: Global new COVID-19 cases and vaccination rate**




Source: Refinitiv Datastream, 27 December 2021

## Structural trends may indicate investment opportunities

Regardless of the uncertainty, the world continues to adapt and there are shifts in consumer spending that can create investment opportunities. Households are more constrained by social distancing restrictions, but they have also become more reluctant to eat out as frequently, or to travel as much for work as they did in the past.

Even when COVID-19 becomes advanced in its endemic stage some of these spending trends may not completely reverse. For example, households may continue to place greater importance on work-life balance, so work-from-home (WFH) remains important, and demand for services from the 'metaverse' may continue to rise (i.e the virtual world where people can socialise, work, and play).

There could be investment opportunities across sectors that may get a boost from spending due to COVID-19. These sectors would also have favourable trends in play prior to the pandemic e.g. rising per capita incomes driving stronger demand for consumer products, communications, healthcare and renewables.

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[2,3,4] Source: Reuters 17 December 2021

## China is transitioning to a new policy paradigm

China's regulatory crackdown, predominantly targeting technology and education companies, triggered sharp falls in its equity markets during 2021. 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.

As we explained in our October 2021 research report[5], there could be far reaching consequences on the competitive landscape in China. 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.

China's paradigm shift in its domestic policy could still motivate further regulatory changes over time. Analysts have speculated that China's regulatory crackdown may shift to target online investment brokerages that offer offshore trading services to mainland clients[6]. On 27 December 2021 the Chinese government stated that all domestic firms in sectors that are off limits to foreign direct investment, such as internet news and publishing, must get clearances from regulators before they can list their shares outside the mainland.

A key motivation for tighter regulations across these areas stems from data security and capital flow concerns by policymakers. A risk from these latest regulatory changes is that it further erodes investor confidence, especially across China's pool of domestic retail investors.

## Geopolitical risks have increased

Geopolitical risks, especially further deterioration in US-China relations, remain significant and more worrying than last year. Concerns surrounding China-Taiwan relations have also come back on the radar as China has reiterated that eventually there will be a reunification. While further US-China diplomatic talks may unfold, the trend deterioration in the US-China relationship is unlikely to change any time soon.

Beyond trade, other economic linkages have also deteriorated, as the ongoing US-China debate on auditing standards will likely further limit the ability of Chinese companies to list in the US. Given China's supply chain linkages, to serve the demands from the West, the rest of Asia may also suffer over time. US-Russia geopolitical tensions, over the Ukraine, have also increased to their worst since the collapse of the Soviet Union some 30 years ago.

## Climate change also creates investment opportunities and China is a focal point

Climate change can create new investment opportunities across green energy, as well as across the broader economy as related infrastructure spending increases. China remains a key focal point for such spending, especially as 2021 was dominated by power shortages and production restrictions that proved very disruptive to growth and trade.

The Climate change (UN COP26 Q421) Conference encouragingly resulted in China and the US agreeing to lower methane emissions and phase out the use of coal. However, in achieving carbon neutrality it is no longer just aiming for carbon offsetting but working towards a 'net zero' status driven by eliminating emissions. China intends to reach peak carbon usage by 2030 and carbon neutrality by 2060.

Achieving peak carbon usage by 2030 is a significant undertaking alone, estimated to require an extra US$6.5 trillion in infrastructure investment (or 40% of 1 year's GDP[7]). Therefore, over the next five years or so, China is likely to experience a significant boom in green investments especially across solar, wind, and power grid upgrades. China's significant reliance on coal power will require ongoing diversification, but already China is a global leader in solar power capacity (See Figures 2 and 3).

Beyond China, and across the rest of Asia, rapidly developing ESG practices among financial firms are helping to extend the agenda beyond climate. Read more in the section titled "Why ESG investing?".

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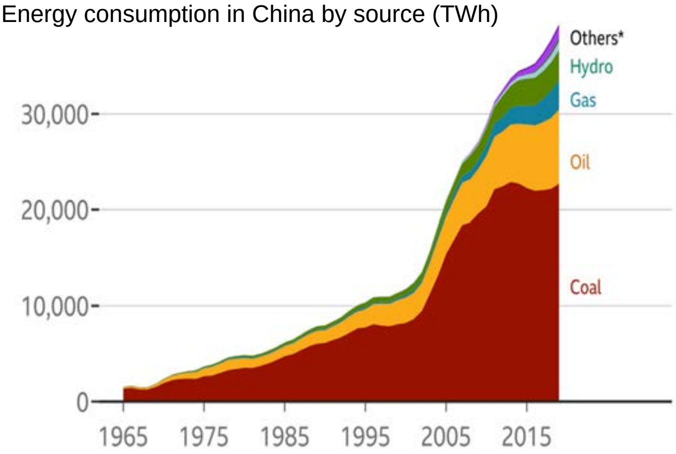
[5] See https://www.fullertonfund.com/chinas-regulatory-shifts-where-do-we-go-from-here/
[6] Reuters News, 18 December 2021
[7] Source: The Financial Times 16 November 2021

**Figure 2: China's energy consumption**

China continues to rely heavily on coal

Energy consumption in China by source (TWh)



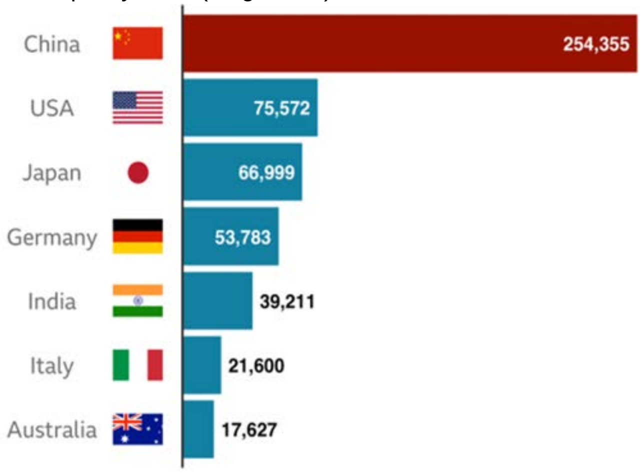

*Solar, wind, nuclear and biofuels

Source: BP Statistical Review of World Energy, Our World in Data, as at 29 October 2021.

**Figure 3: Global solar capacity**

China leads the world in solar power

Total capacity 2020 (Megawatts)

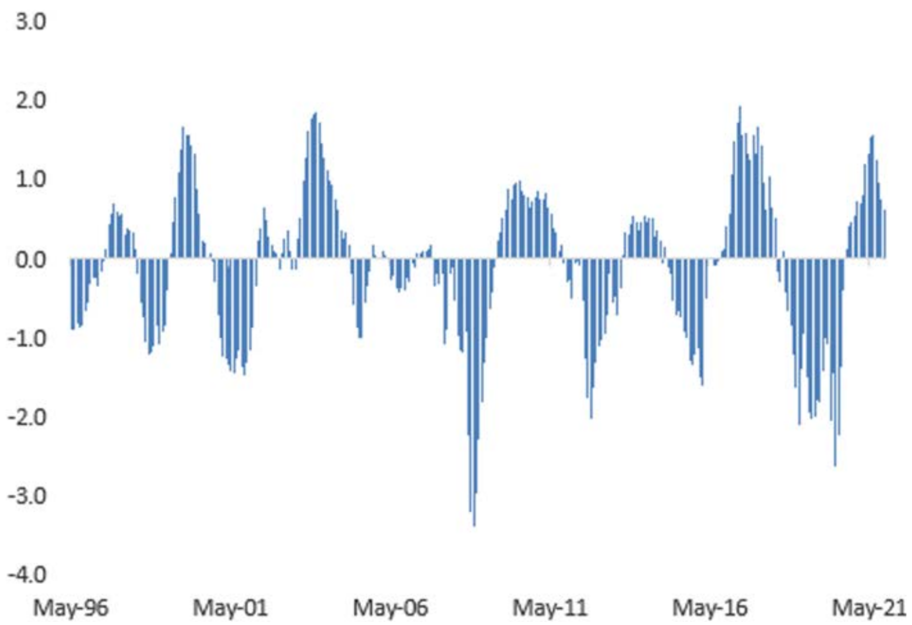



Source: International Renewable Energy Agency, 2021, as at 29 October 2021.

## Across the macro backdrop global GDP growth is slowing, but is still above trend

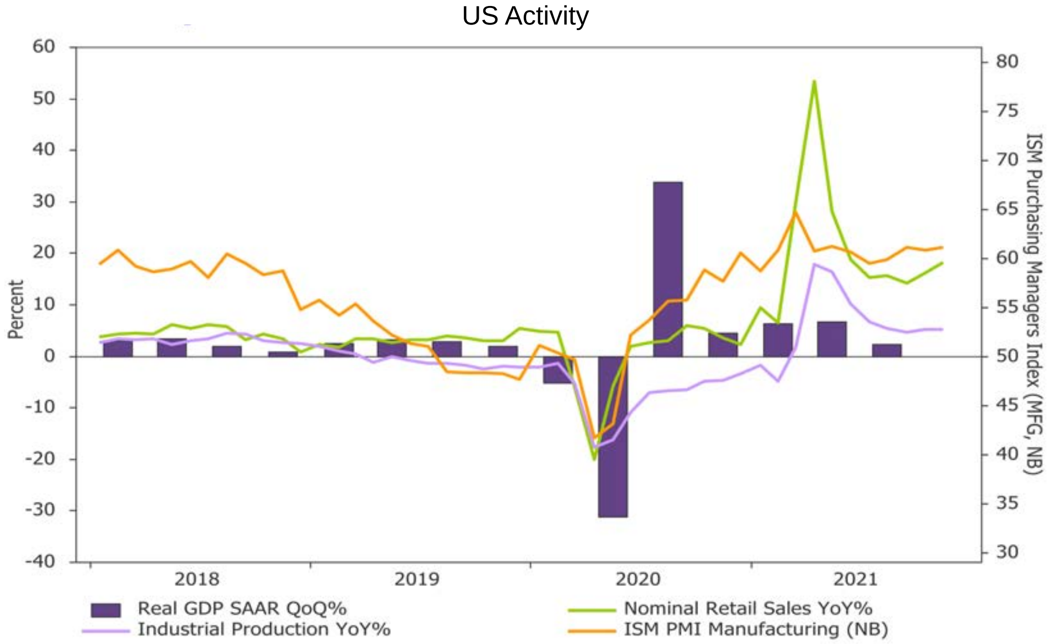
GDP growth across most countries continues to slow (see Figure 4) but remains significantly above trend, especially given the strength across DM. Consumer spending and industrial production indicators remain robust in the US (see Figure 5), while across Europe industrial confidence and production growth is still stronger than pre-COVID rates.

**Figure 4: Fullerton's global growth indicator (deviation from trend)**




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

**Figure 5: US economic activity indicators**

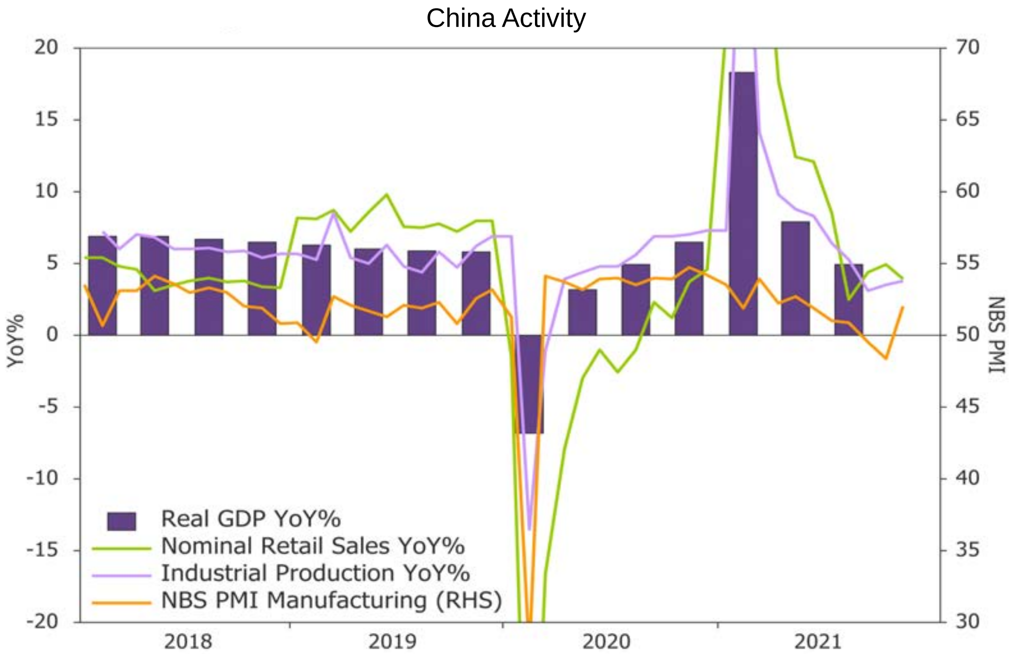



Source: Refinitiv Datastream, 27 December 2021

## Economic indicators could mark bottom of growth slump for China

As we noted in our previous quarterly report[8], the most concerning downside risks to growth have emerged in China, as its industrial production and retail sales growth have slowed sharply (See Figure 6). At the same time, supply side weakness has been exacerbated by bottlenecks and energy shortages.

**Figure 6: China economic activity indicators**



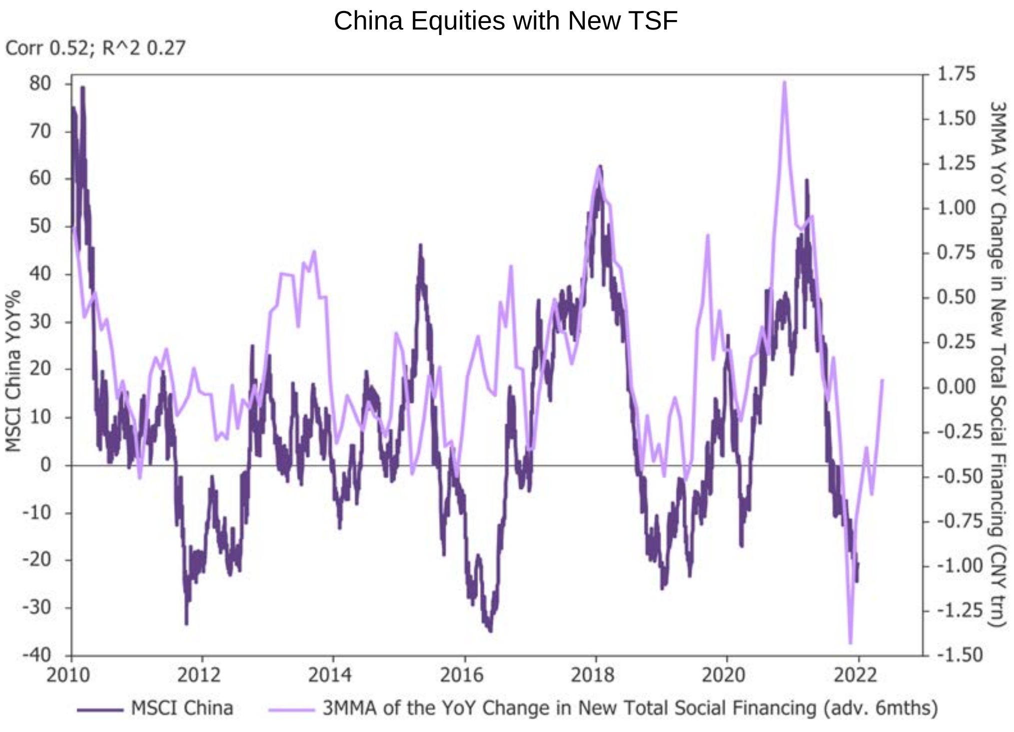

Source: Refinitiv Datastream, 27 December 2021

[8] See https://www.fullertonfund.com/finding-opportunities-across-challenging-investment-landscape/

However, indicators suggest that Q4 2021 could mark the bottom of this growth slump for China. We believe that China's policymakers will provide more stimulus if it appears that GDP growth will fail to rebound by about 1% pts to be back around the 5.6% YoY that the Bloomberg Consensus expects for 2022[9].

China has several policy stimulus tools at its disposal: banking sector reserve asset ratios can be cut further; benchmark lending interest rates for private sector loans could also be reduced. China's policymakers have already shown that they are motivated to provide more stimulus as they cut the banks' reserve requirement ratio (by 50bps on 6 December 2021) and new total social financing (TSF) is increasing again (see Figure 7). More stimulus via TSF has the advantage of a significant leading correlation with Chinese equities, and so the prospect of further policy stimulus by China this year could be a source of upside surprise for investors.

**Figure 7: China equities and new total social financing (TSF) stimulus**



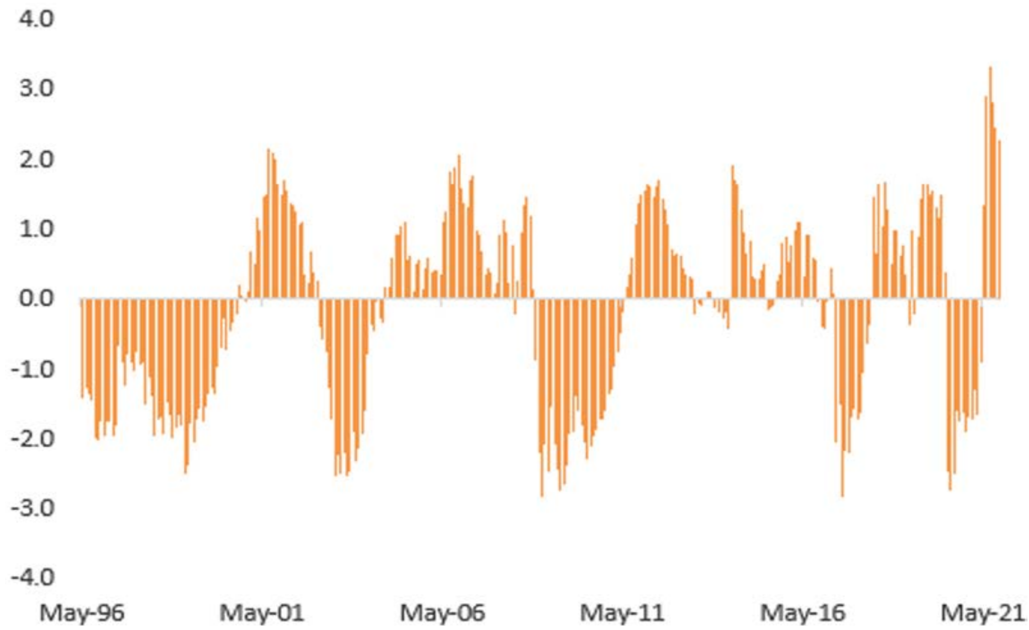

Source: Refinitiv Datastream, 27 December 2021

[9] As at 27 December 2021

## Inflation will be higher for longer, but supply side constraints may be starting to clear

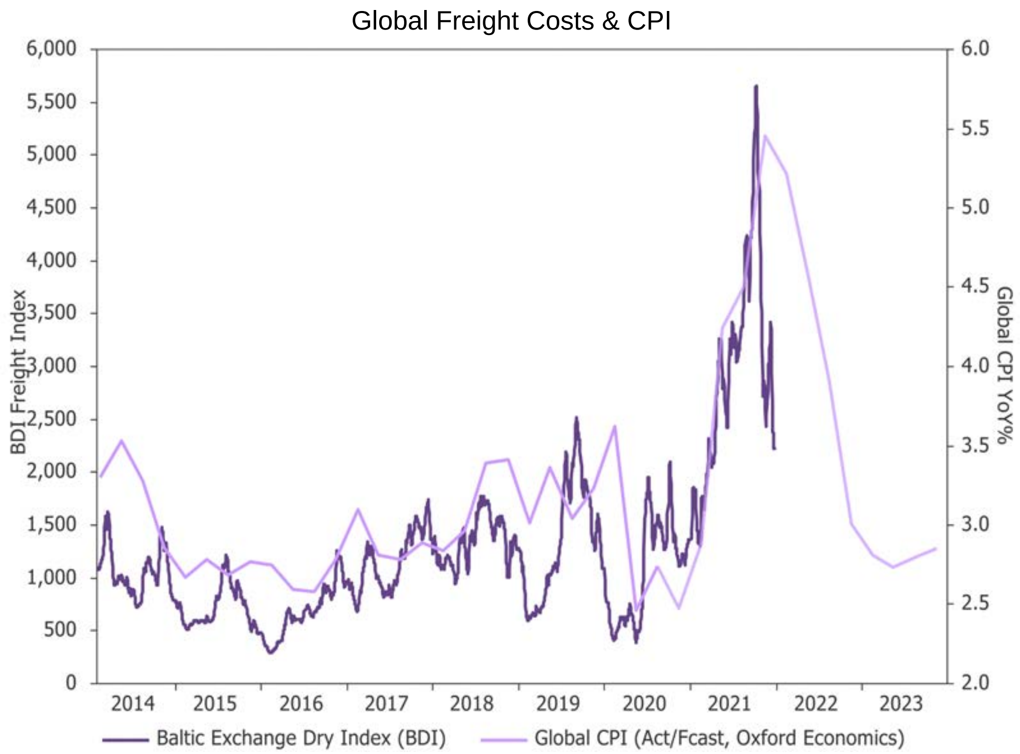
Inflation has surged above trend, reflecting strong consumer spending, supply chain bottlenecks, and commodity demand pressures (see Figure 8). What is now encouraging is that supply side constraints may be easing as global freight costs have corrected (see Figure 9).

**Figure 8: Fullerton's global inflation indicator (deviation from trend)**




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

**Figure 9: Global freight costs and CPI (actual/forecasts)**




Source: Refinitiv Datastream, 27 December 2021

US inflation is now expected by the Bloomberg Consensus to remain higher for longer, at least until 2H 2023, as unemployment falls and wage pressures rise. With the Fed now signalling a more hawkish tightening cycle coupled with US growth being above trend, the probability of a 'soft-landing' in US inflation pressures, without stressing growth too much, has increased.

Therefore, we continue to believe that economies should be able to navigate higher interest rates, provided policymakers communicate clearly to markets, and ensure that they are not forced to tighten by too much too fast. If real yields can slowly rise, then the very strong equity market returns over 2021 can slow gradually over time without significant overshooting to the downside.


## 2. Investment Strategy

### Asset returns consistent with underlying shifts in macro fundamentals

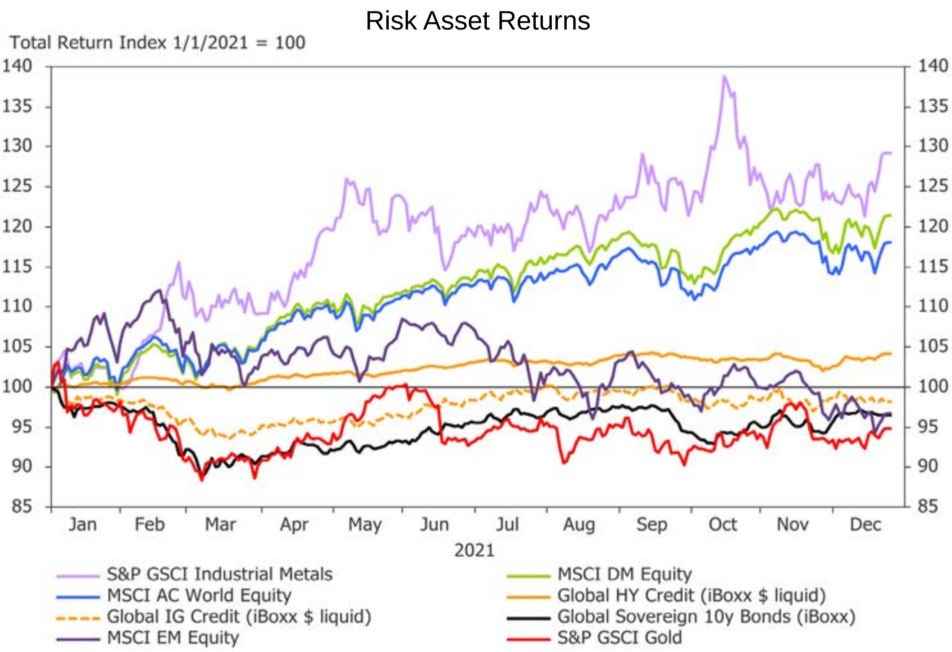
Looking back and understanding the key drivers of risk asset returns over 2021 can help us think about the trends that may continue in 2022. Risk asset returns in 2021 (see Figure 10) unfolded largely consistent with the underlying shifts in macro fundamentals.

For example, returns from industrial metals were the strongest, reflecting above trend global growth, robust industrial production, and supply chain bottlenecks that amplified pricing pressures.

DM equities outperformed global equities largely because of the significant boost from negative real yields and very strong growth, especially in the US, followed by Europe. In contrast, Emerging Market (EM) equities struggled as Asia's growth advantage over DM narrowed significantly, and as China's equities slumped with the sharp slowdown across its real estate sector and its regulatory crackdown.

High-yield (HY) corporate credit outperformed Investment Grade (IG) in harmony with our expectations that HY would ultimately offer greater spread compression, while its default risks would rise but remain idiosyncratic. Government bonds gave poor returns as risk appetite improved, as liquidity tightened, and as interest rates increased. Returns from gold also struggled with higher interest rates and a stronger US dollar.

**Figure 10: Risk asset returns in 2021**

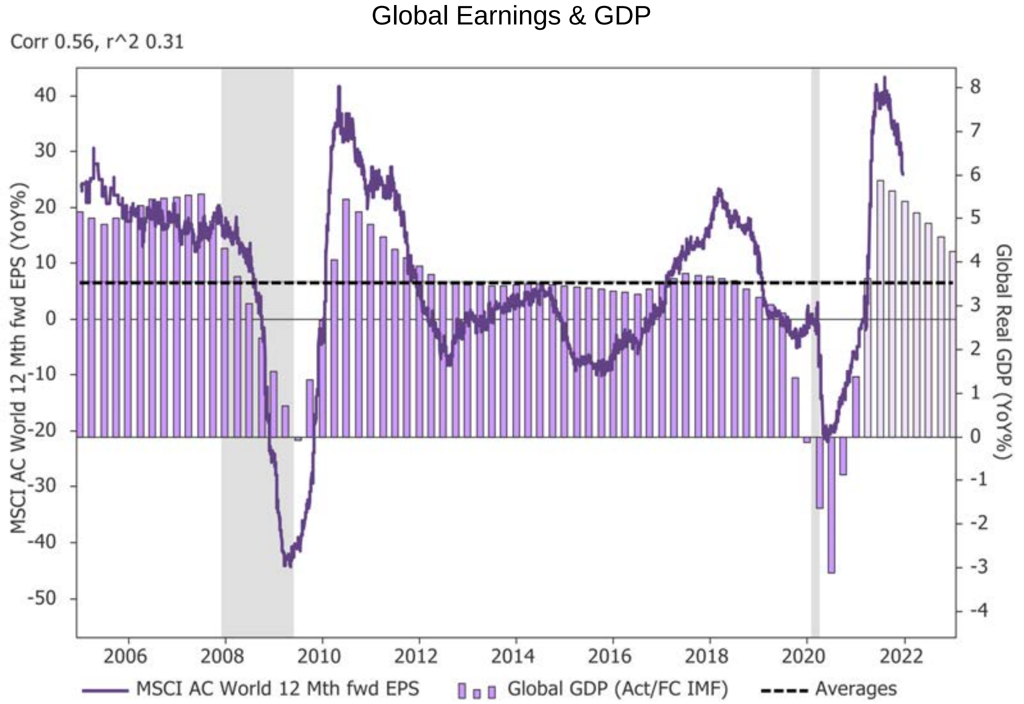



Source: Refinitiv Datastream, 27 December 2021

## Positive on DM and global equities….

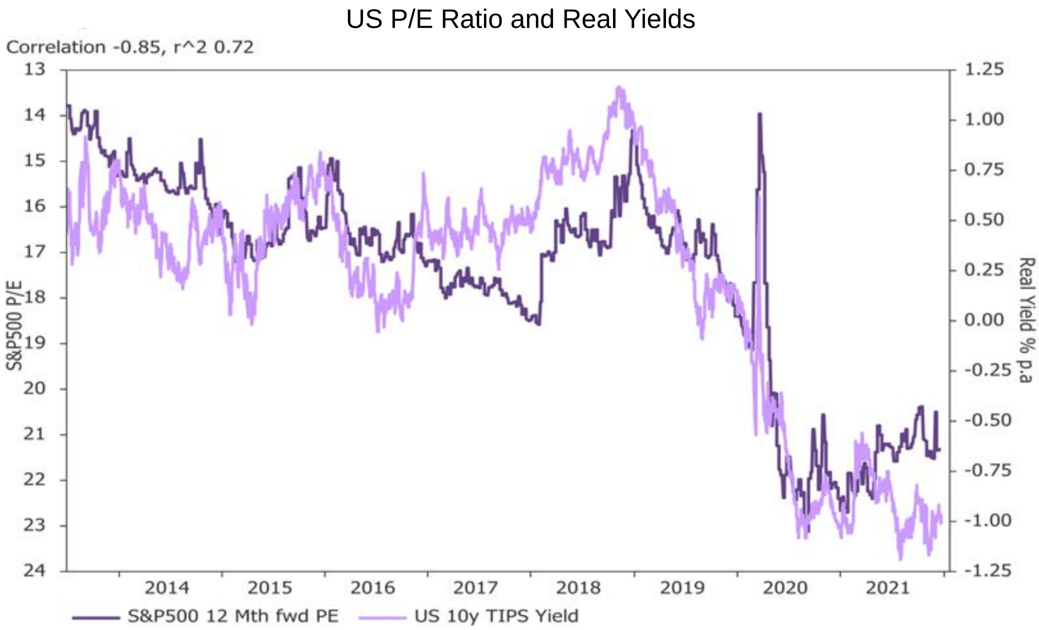
Some of the key trends from 2021 may continue this year. Fullerton remains positive on global equities as though earnings growth expectations are slowing, they are still above historic averages (see Figure 11). Furthermore, while liquidity is tightening and will be a headwind to performance, real yields are still significantly negative and should remain supportive to equities especially across DM (Figure 12).

**Figure 11: Top-down 12-month forward expected global earnings and GDP growth**




Source: Refinitiv Datastream, 27 December 2021

**Figure 12: US equities P/E ratio and real yields**

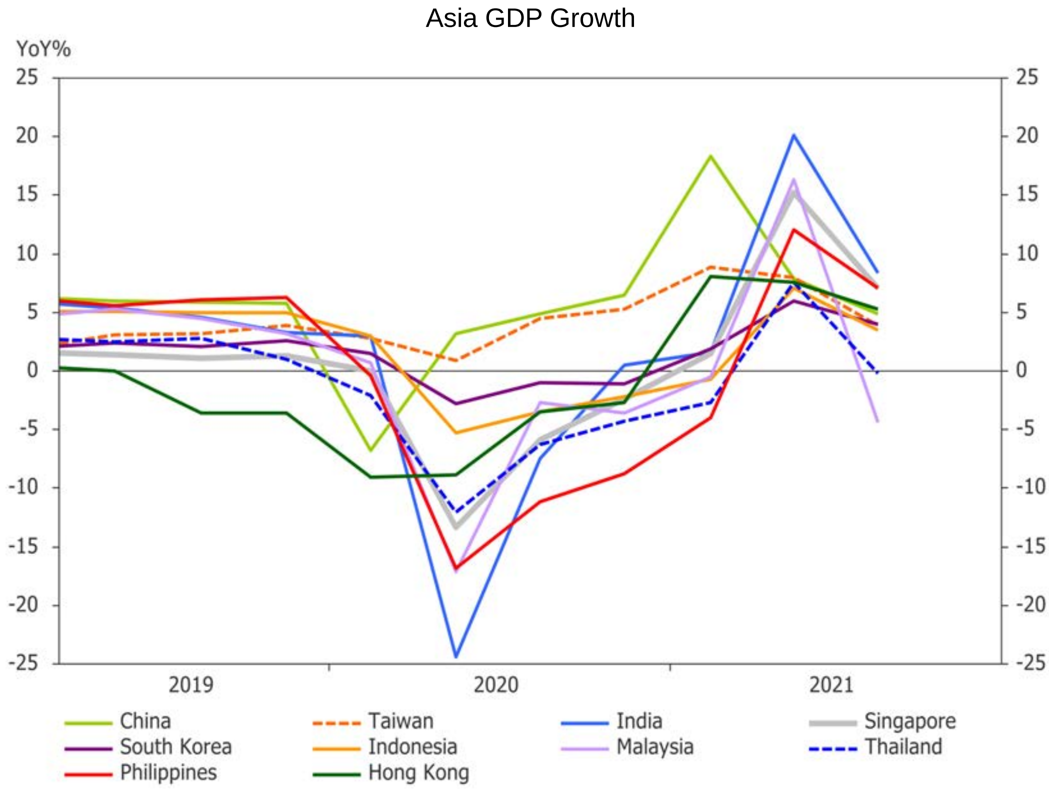



Source: Refinitiv Datastream, 27 December 2021

## …. but we remain negative on China and Asia

Our negative view on China and Asia reflects the significantly narrower growth advantage over DM (as Asian growth has slowed a lot since 2H21. See Figure 13), weakness across China's real estate sector, and the uncertainties created by China's regulatory crackdown (especially across its IT sector).

**Figure 13: GDP growth across Asia**

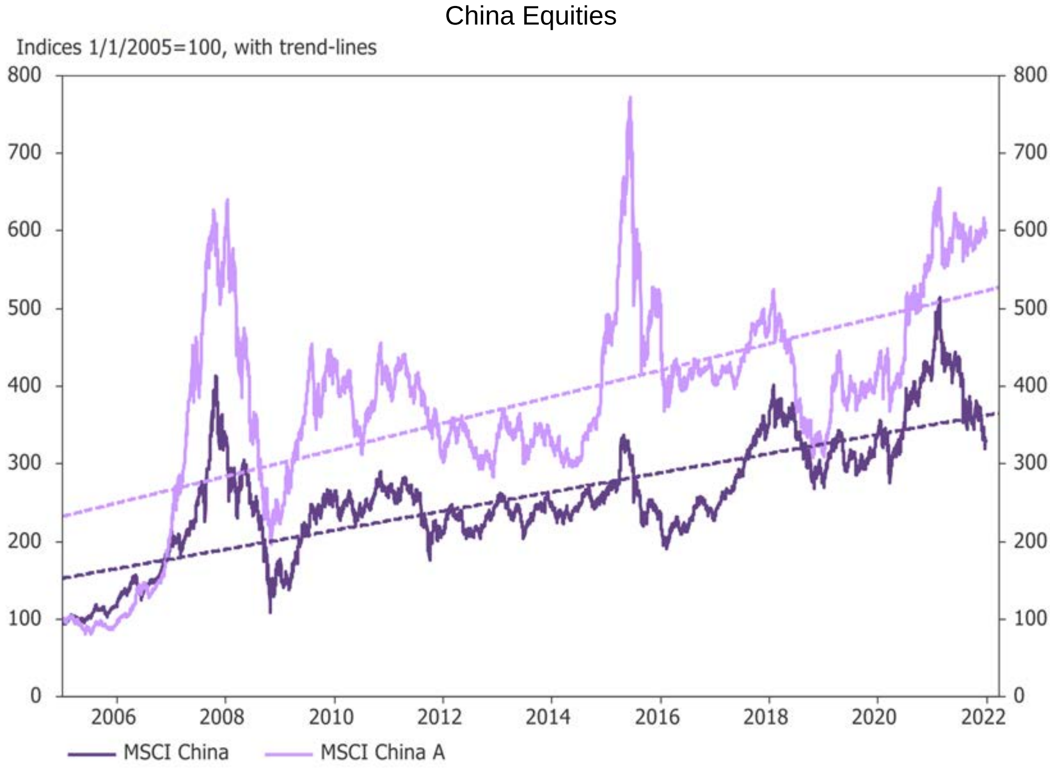



Source: Refinitiv Datastream, 27 December 2021

More policy stimulus from China would be a key signpost for us to reconsider our negative outlook as it would boost China's recovery back to trend growth in 2022. Furthermore, with regional trade likely to benefit from a stronger China, Asia's equity market performance would likely recover.

But even with more policy stimulus to boost growth, investors in China still need to be cautious and selective because policy shifts have created a significant divergence in performance between China A-shares (i.e its domestic market, with its prices running above trend) and China All-shares (i.e domestic and offshore markets, with its prices running below trend, as it has suffered a lot from the de-rating of IT firms given the regulatory crackdown; see Figure 14).

**Figure 14: Trends in China's domestic (A shares) versus all equities**

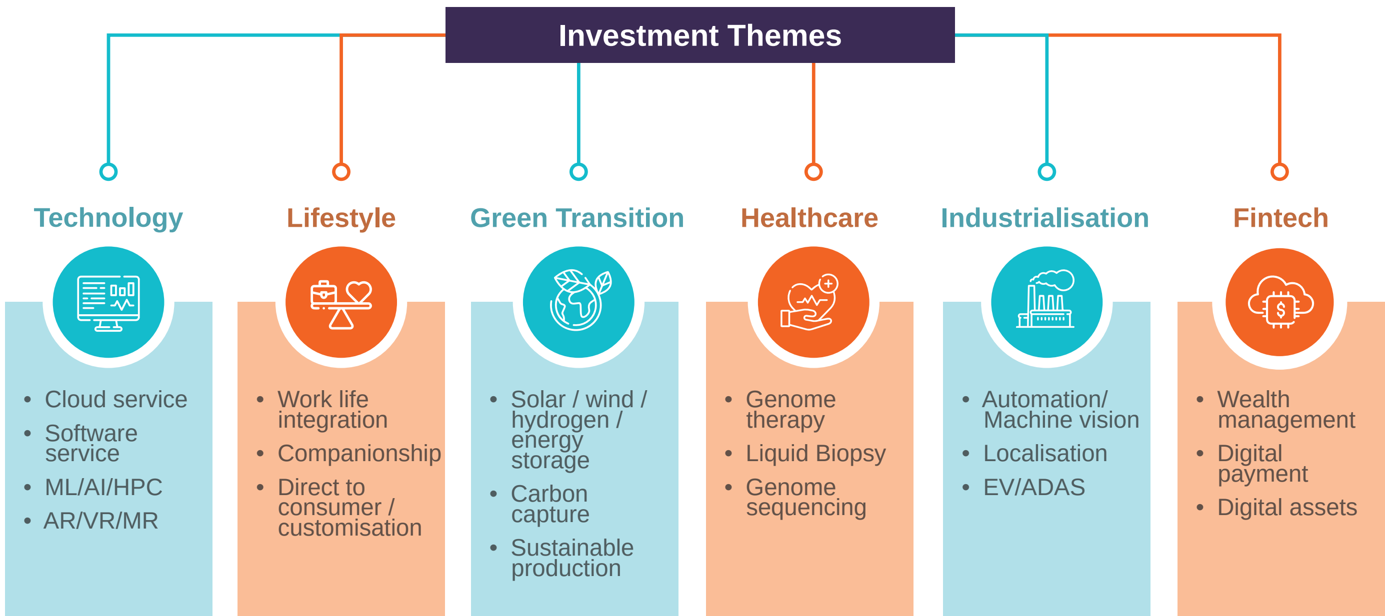



Source: Refinitiv Datastream, 27 December 2021

We believe that investors in Asia and China can still find valuable alpha opportunities across sectors that have robust structural trends, as they should be less impacted by policy changes and cyclical growth weakness e.g consumer products, communications, healthcare, and renewables (see Figure 15).

In addition, some of these sectors may get an added boost from Climate change related investment, and from spending changes due to COVID (e.g. as public health spending rises and as households demand more services from the 'metaverse').

**Figure 15: Key investment themes**

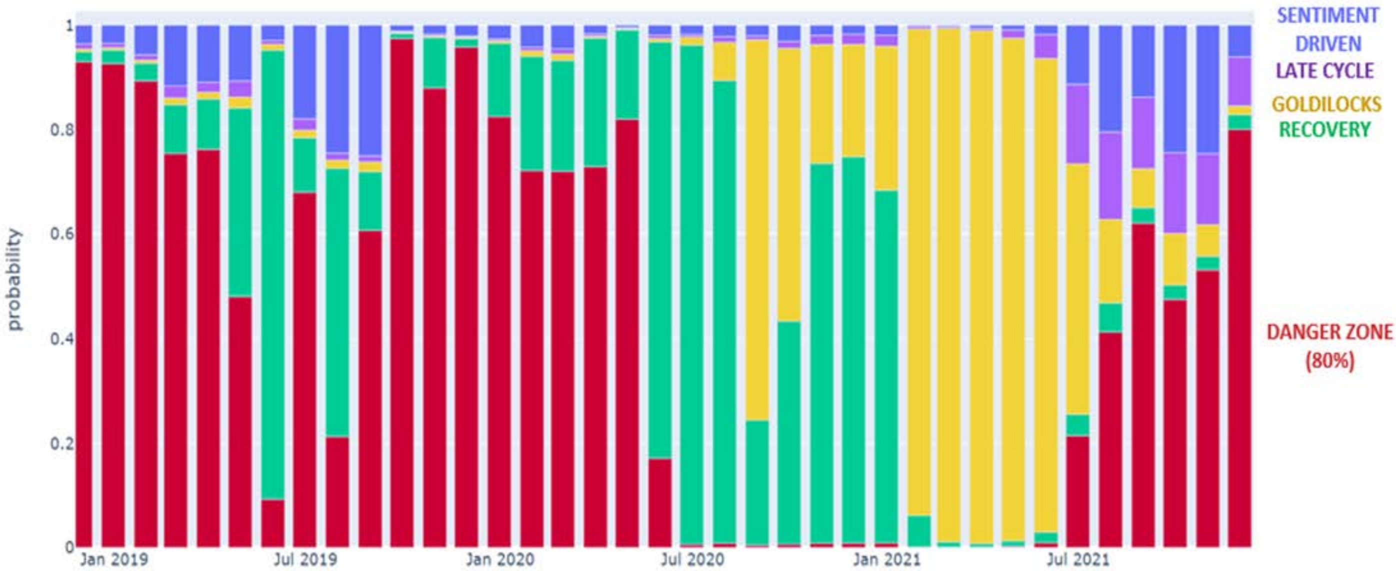



Source: Fullerton, December 2021

## A key risk in 2022 is earnings undershooting

Notwithstanding our positive view on global risk assets, the macro environment has become much more challenging for investors since 2H21. Fullerton's Regime Indicator moved to signal 'Danger Zone' (see Figure 16) suggesting that investors could face greater risks from high inflation and weaker growth.

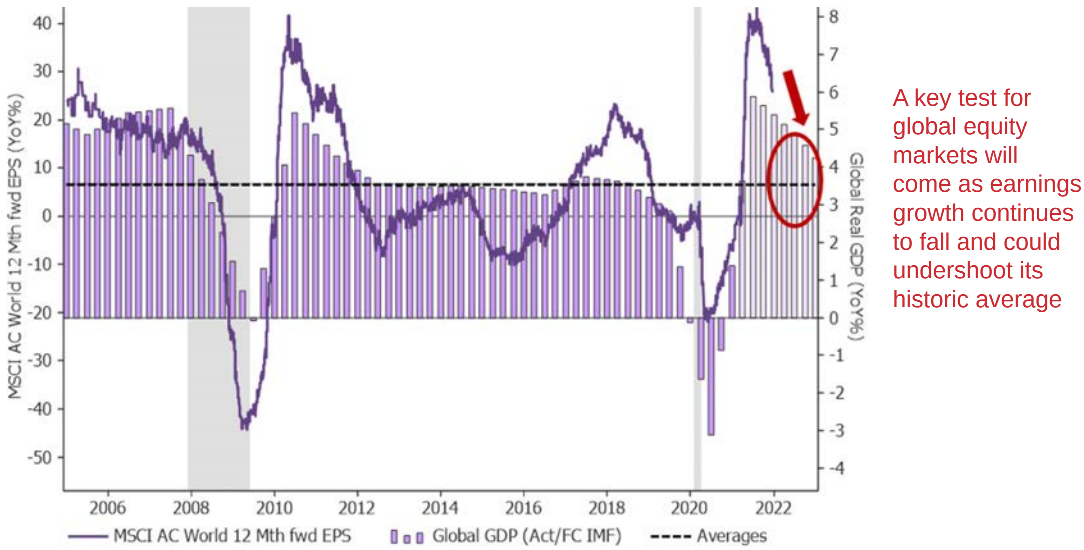
**Figure 16: Fullerton's macro regime indicator (a short-term indicator of the environment investors may experience)**




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

A critical test of the resilience of global equities will come in 2022 when growth is no longer above trend and when real yields are higher. The risk we worry about the most is that as earnings growth falls back to trend it could undershoot and drive a significant fall in global equities (see Figure 17).

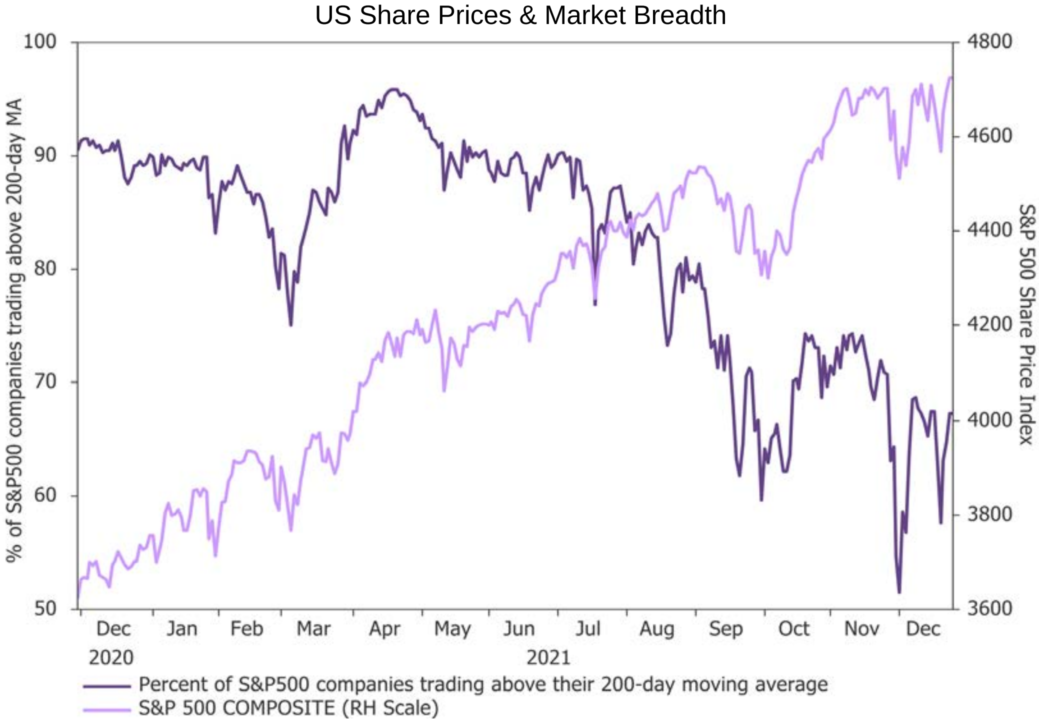
**Figure 17: Top-down 12-month forward expected global earnings and GDP growth**




Source: Refinitiv Datastream, 23 December 2021

To a certain degree these concerns are reinforced by signals from other indicators, such as US equity market breadth (i.e the percent of companies in the market trading above average), which has deteriorated even as the market has trended higher (see Figure 18).

**Figure 18: US equities and a metric of market breadth**



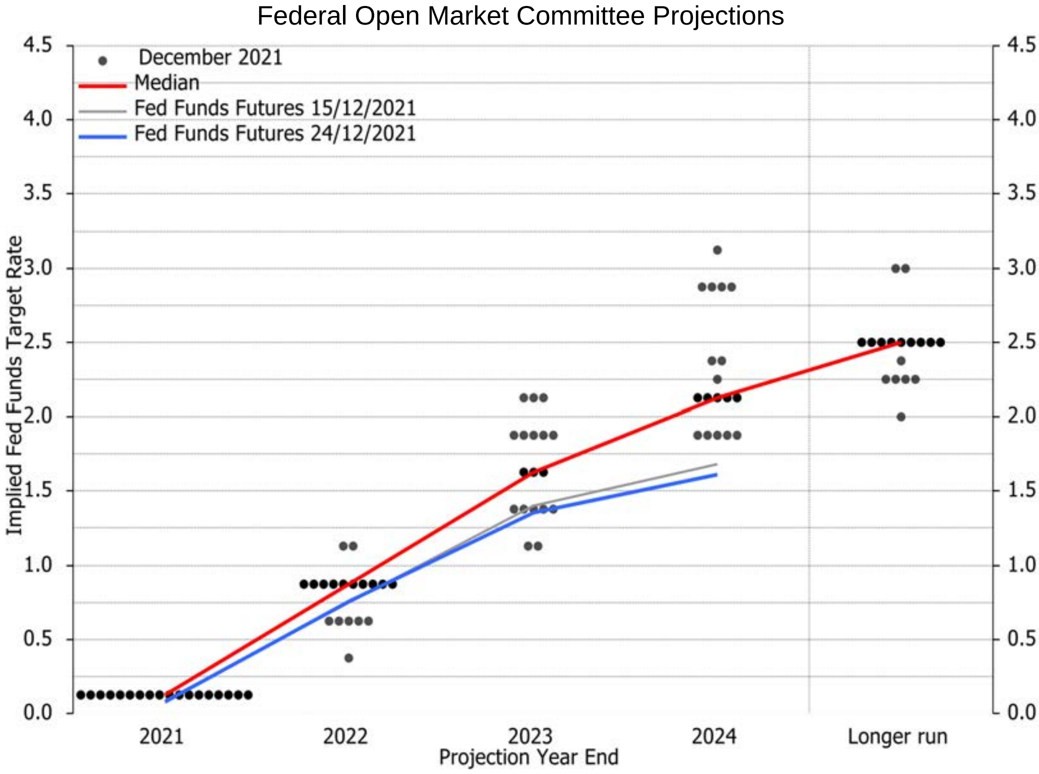

Source: Refinitiv Datastream, 27 December 2021

## Negative on duration for bonds

We remain negative on US government bonds, as the Fed has become more hawkish to try and get back 'on the curve' in terms of signalling enough tightening to ultimately bring inflation down. The Fed has announced a faster balance sheet tapering with its bond purchasing program, of treasuries and agency MBS, set to end by March 2022. What is more important is the profile for higher interest rates and the Fed has signalled around 3 rate hikes in 2022 and 2023 (see Figure 19).

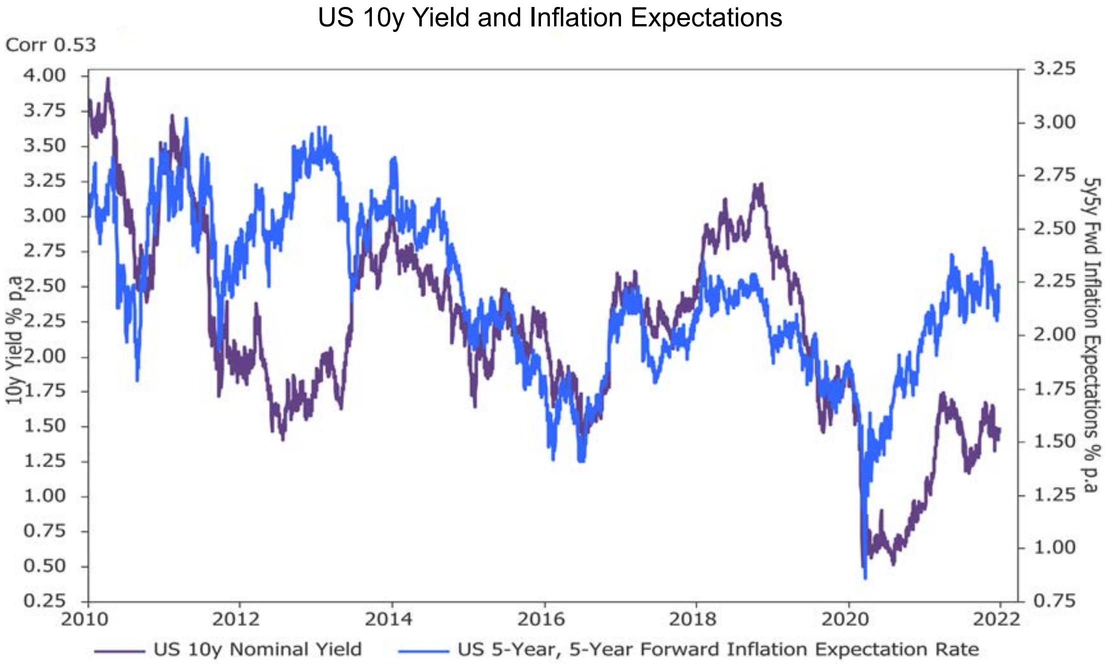
US nominal 10-year yields are likely to continue to drift higher, but the upside may prove to be contained as longer term inflation expectations remain well-anchored (see Figure 20). Across Asian bond markets, real yields may remain relatively attractive for investors seeking carry, especially compared to DM.

**Figure 19: US Fed rate projections and forward market pricing**




FOMC Meeting: 15 December 2021 | Source: Refinitiv Datastream

**Figure 20: US 10-year yields and inflation expectations**




Source: Refinitiv Datastream, 27 December 2021

## Negative bias on corporate credit

We are still cautious on Asian corporate credit with a negative outlook. In tandem with equities, the performance of corporate credit is also likely to suffer with the slowdown in GDP growth. The slump in China's real estate sector, in particular, is likely to be a key driver of higher defaults.

As the default and restructurings of Evergrande and Kaisa unfold, and China's policymakers potentially give more stimulus to help growth rebound this year, then the debt deleveraging should shift further toward more idiosyncratic risks. Nevertheless, investors still need to carefully examine balance sheet fundamentals and access to funding for real estate firms.

Consistent with its performance over 2021, we believe that Asian HY can outperform IG as it still offers greater prospects for spread compression. That said, we also like IG BBB-rated corporates as they may give more cushion against greater interest rate volatility, which could become more evident with the jump in CPI inflation.

## Positive on Alternative investments

We believe that private equity will continue to sustain robust demand, driven by the low yield environment and with new platforms to foster easier access for investors (e.g ADDX in Singapore). Venture capital, in particular, has also benefited from the disruption of COVID-19, with significant growth in investment opportunities across IT/ technology, artificial intelligence (AI), and healthcare.

Asia is likely to remain an attractive destination for more infrastructure investment, and public-private partnerships, especially across renewable energy, healthcare, and education. Real estate could benefit from the significant money printing by global central banks, and as investors seek inflation protection.

Real house prices, for example, have already increased significantly across most markets (see Figure 21) as investors have diversified further across growth assets. However, investors still need to be cautious in the 'new normal' COVID environment as office and retail rental returns may face new headwinds with greater WFH and online shopping.

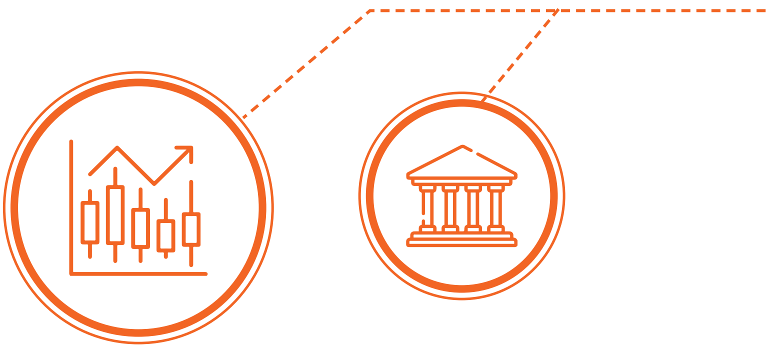
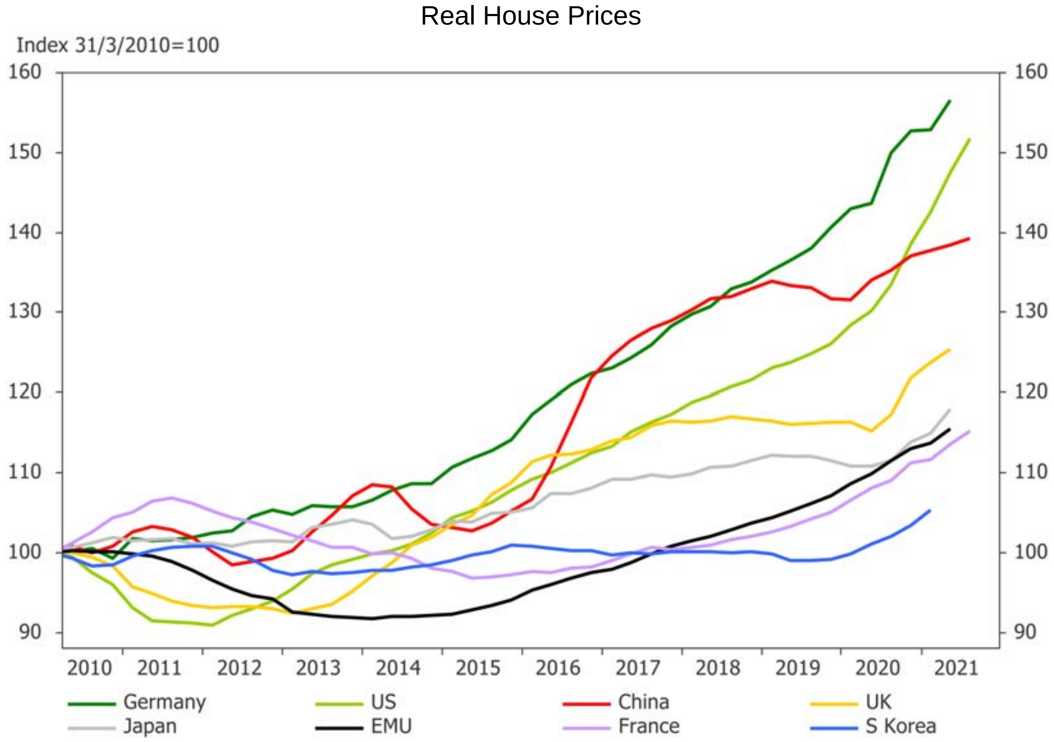


**Figure 21: Real house prices across key markets**



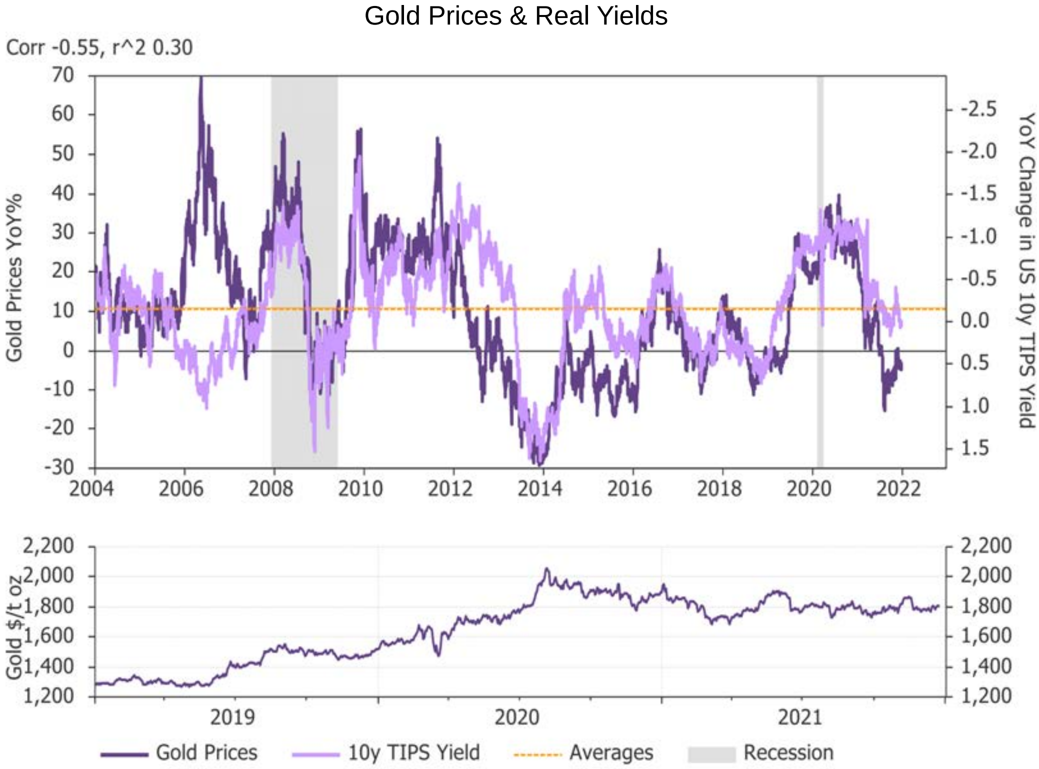

Source: Refinitiv Datastream, 27 December 2021

## Commodity price outlook remains positive

The very strong returns from industrial metals in 2021 are likely to ease in 2022 as excess demand pressures slow and as supply side bottlenecks clear. 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 are likely to remain subdued, as investors continue to expect increases in real yields and as the US dollar holds up. Subdued gold prices also suggest that markets are not significantly worried about potential downside risks to growth (see Figure 22).

**Figure 22: Gold prices and real US 10y-yields**




Source: Refinitiv Datastream, 27 December 2021

## We maintain our positive outlook on the USD

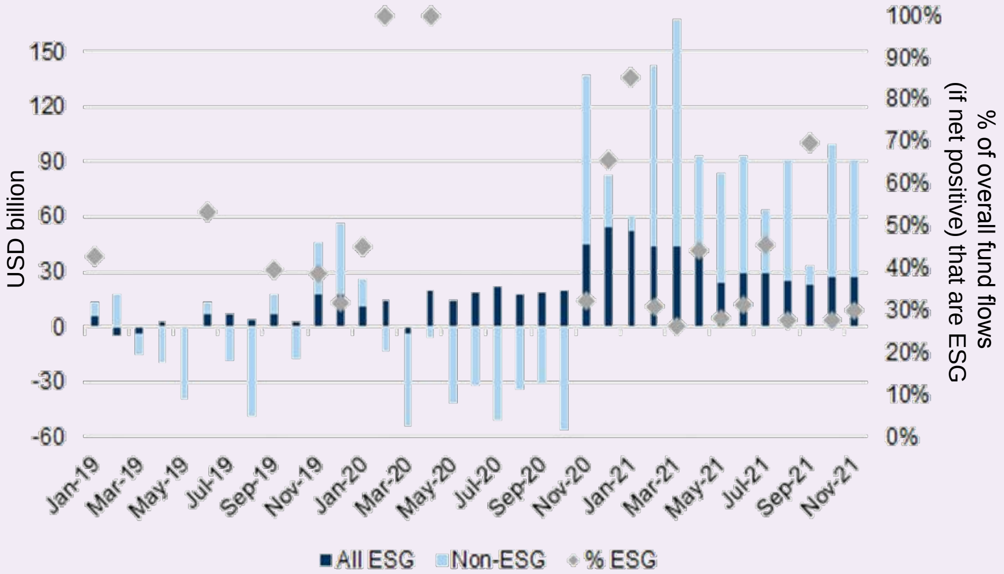
We believe that the US dollar can continue to benefit from the improved US current account deficit, the more hawkish Fed, and from the much stronger US terms of trade. That said, unless there is a significant adverse shock to investor confidence, we do not expect a strong USD appreciation.

# Why ESG investing?

## 2021 was a great year for ESG investing

2021 was a very strong year for ESG fund inflows. A record US$649 billion flowed into ESG focused funds worldwide (as at end November) which was up by 20% from 2020[10]. ESG funds now account for 10% of worldwide fund assets, and of the US$6.1 trillion in ESG funds 59% are across EMA (Europe, Middle East and Africa) and about 41% in US and Asia[11]. ESG funds continue to take share of equity fund flows, though at a more moderate pace than earlier in 2021. (see Figure 23).

**Figure 23: Monthly equity fund flows for ESG & non-ESG funds**



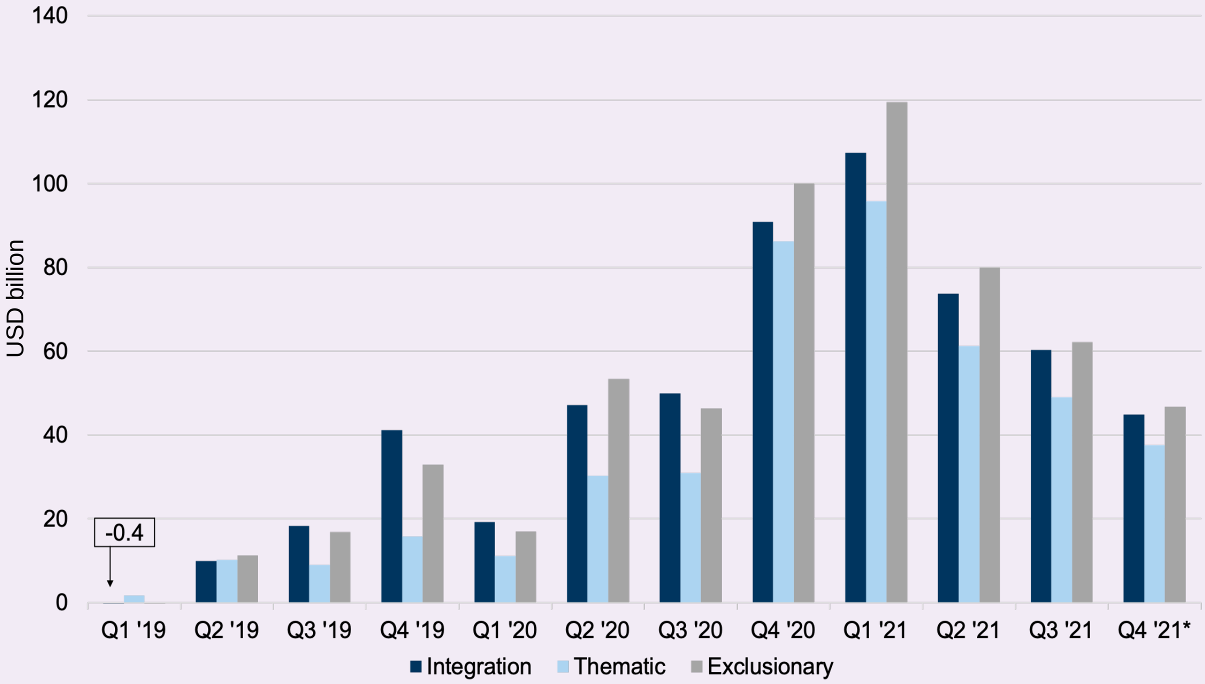

Source: Goldman Sachs Global Investment Research, Morningstar, as of November 2021.

[10,11] Source: Refinitiv Lipper data

## Wide variety of strategies available

There are many strategies that can be used to incorporate ESG into funds. Exclusionary strategies exclude certain sectors or stocks based on norms or value-based screening e.g. tobacco. Integration incorporates ESG factors into the core investment research process, and this can range from using ESG ratings to corporate engagement. Thematic focuses on investing in specific ESG topics, such as renewable energy or gender diversity. Data shows that inflows into all strategies was solid last year (notwithstanding some slowdown into 2H21), with Integration and Exclusionary linked flows the largest, followed by Thematic strategies (Figure 24).

**Figure 24: ESG quarterly flows by strategy**




Q3 ‘21* only through July 2021
Source: Morningstar, Goldman Sachs Global Investment Research, as of November 2021.

We believe that ESG is a framework to use non-accounting data to understand intangible risks and opportunities in our investment companies, and have fully integrated this into our investment research and portfolio management processes. Our suite of ESG funds further delves into thematic ESG alpha opportunities, rooted in the UN Sustainable Development Goals, that we believe are long term structural investment trends.