Switching gears: traversing a slowing growth environment

Fullerton Investment Views - Quarterly report

Q2 2022

FULLERTON FUND MANAGEMENT

Executive summary

- **The investment environment has become particularly challenging, as markets have corrected sharply, earnings growth is slowing, and interest rates are rising.** Extremely high inflation has increased the risk that tighter policy may eventually cause a slump in growth, especially if the highly leveraged economy proves more sensitive than expected to rising interest rates.
- **With significant headwinds from weaker growth, tighter liquidity, and rising interest rates, we have become negative on global equities.** That said, global markets are differentiated, where the US may remain the strongest given its growth is still above trend. In contrast, Europe faces greater headwinds from adverse stagflation forces, while Asia faces greater risks of a 'hard landing' in China. **As a result, we maintain our negative outlook on Asian and Chinese equities.**
- **Managing portfolio drawdowns from potentially painful corrections is prudent, with the aim of being well positioned to take advantage of opportunities once headwinds fade.** We continue to favour sectors like consumer products, communications, healthcare, and renewables, as they seem well positioned to withstand the challenging macro backdrop. Investors should be extra cautious, but remain active as growth assets, like equities and real estate, have favourable longer-term trends that can potentially outperform inflation.
- **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 markets have become more hawkish on Fed rate hikes, positioning is positive, and the US terms of trade remains supportive.

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1. Macro fundamentals have become a stronger headwind

Global GDP growth is slowing, but is differentiated across the regions

As we have been advocating for some time, global growth is slowing and our proprietary global activity indicator has just slipped marginally into negative territory (see Figure 1). That said, growth is slowing at different speeds across the regions. For example, US growth is still robust as its productivity remains above trend (see Figure 2), while Europe and Asia, and especially China, are weaker.

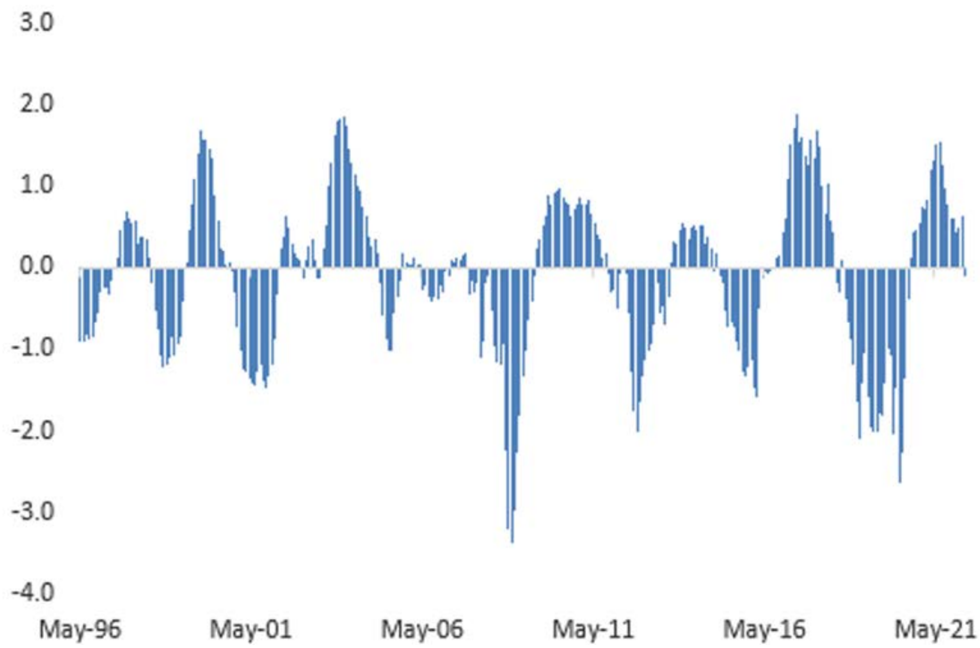
The most concerning downside risks to growth stem from China

The most concerning downside risks to growth remain in China, as its real estate sector has had another leg down. Loans to developers are now falling by the greatest degree in more than a decade, while house sales fell sharply in February, and the construction pipe-line continues to slide (see Figure 3).

In addition, economic activity is struggling with China's zero COVID cases lockdown policy.

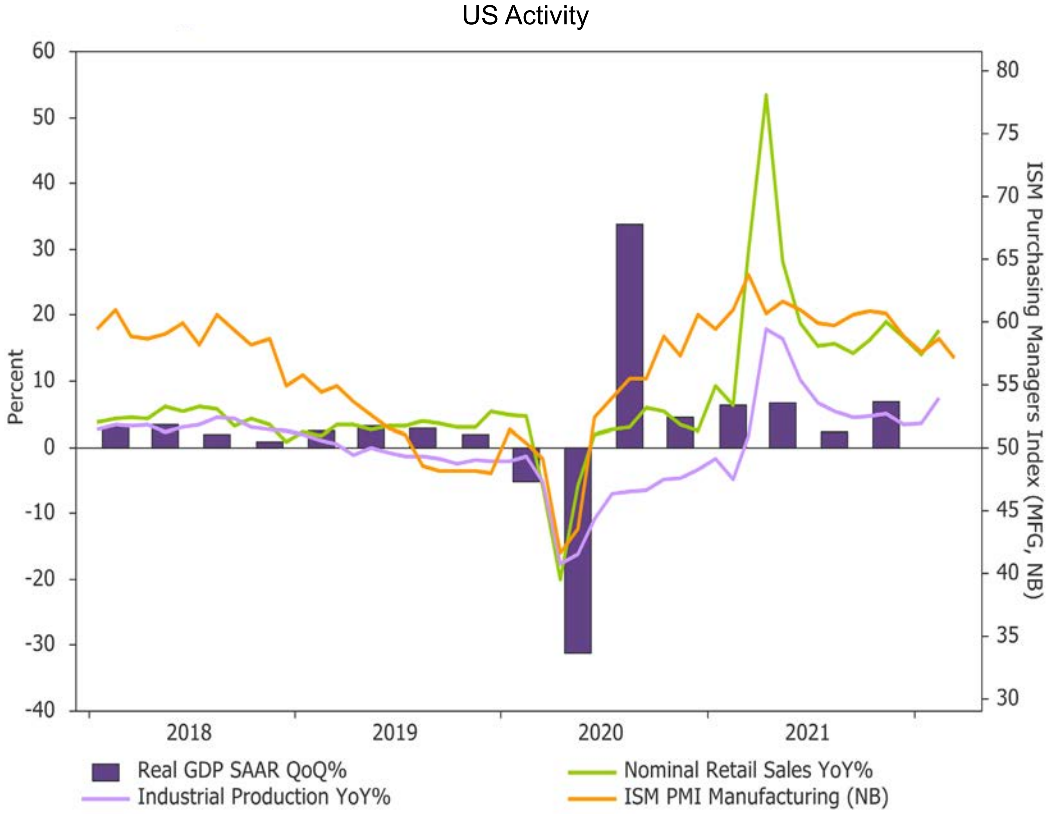
China's most recent policy announcements may have provided a floor to markets, but we believe bolder actions will be needed if growth is to recover toward their target of 5-5.5% YoY this year. Growth across the rest of Asia has pockets of strength, but corporate margins are being significantly squeezed by high inflation pressures.

Figure 1: Fullerton's proprietary global growth indicator



Source: Fullerton, March 2022. 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, April 2022

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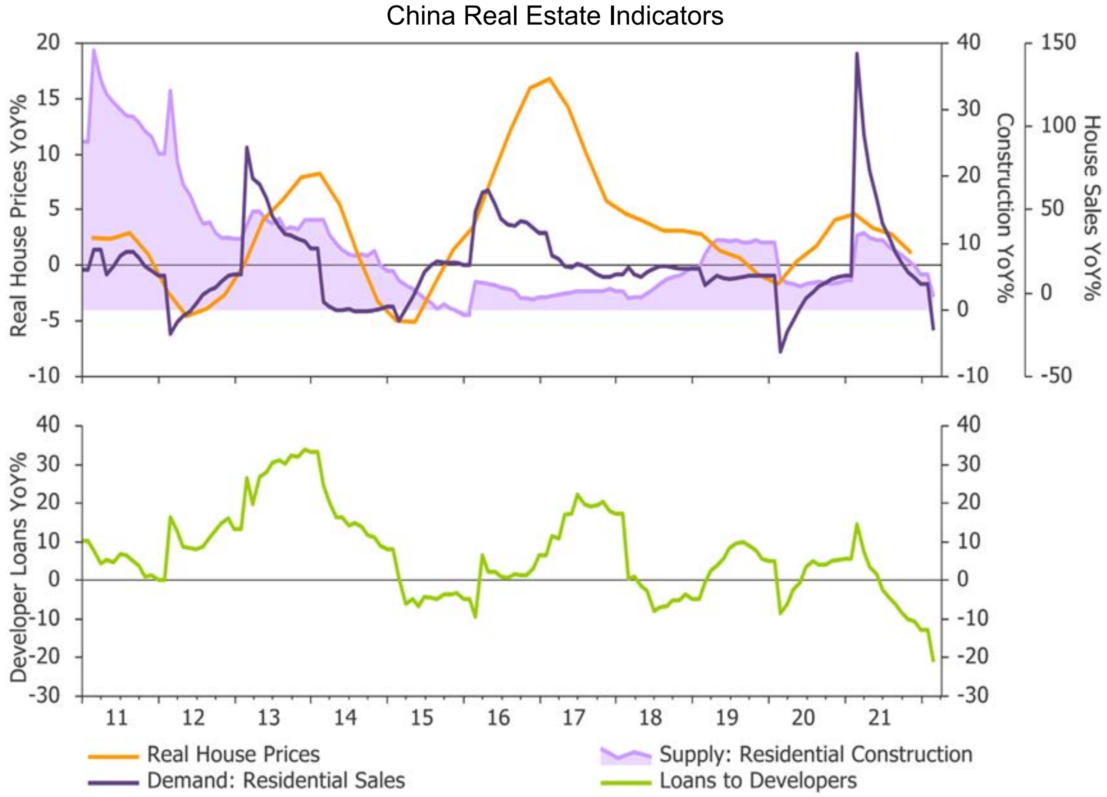
Figure 3: China real estate indicators



Source: Refinitiv Datastream, April 2022

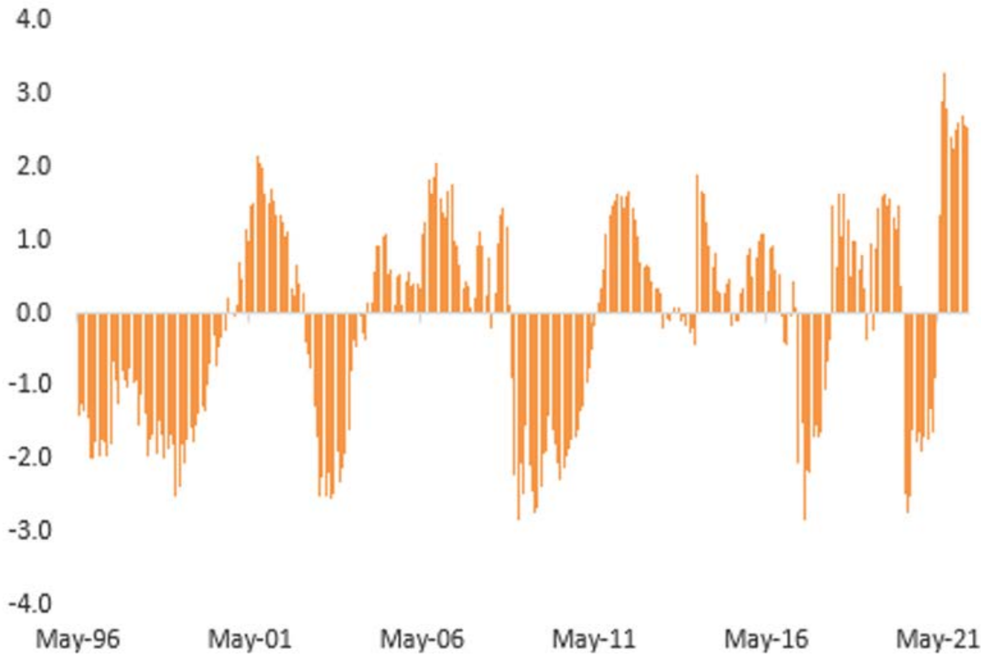
Stagflation pressures have increased significantly, with higher commodity prices and wages

The geopolitical risks created by the Russia-Ukraine war have had their greatest adverse impacts on investor sentiment, and across sectors where Russia has been an important global exporter. This has resulted in global oil prices, European natural gas prices, and food prices, rising significantly.

That said, the fact that oil prices have been able to correct back from extreme highs ($130 USD/bbl) to around $100 USD/bbl suggests that the disruptions to markets have not been as painful as feared. Furthermore, we have not seen big cuts to market expectations for global growth. It does seem that sanctions may be the best weapon against Russia, while at the same time minimising any adverse spillover impacts to the global economy and financial markets.

Nevertheless, global inflation has had another leg up driven by higher commodity prices and rising wage pressures (see Figure 4). The risk has increased that inflation remains higher than expected for longer, especially if wage pressures remain persistent.

Figure 4: Fullerton's proprietary global inflation indicator

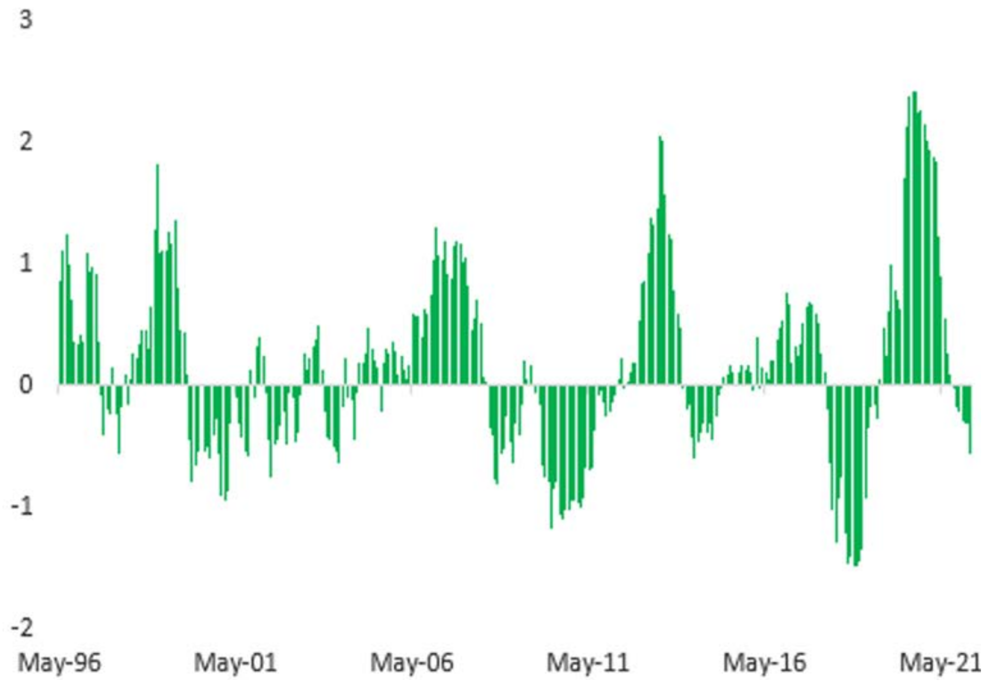


Source: Fullerton, March 2022. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

The war against inflation could eventually cause a slump in growth

The prospect of inflation being too high for too long may accelerate the slowdown in growth underway as households postpone spending and firms cut output to contain costs. More importantly, extremely high inflation has increased the risk that tighter policy could eventually cause a slump in growth. That becomes more likely if the highly leveraged economy proves more sensitive than expected to rising interest rates. At the same time, liquidity continues to tighten which will become an increasing headwind for risk asset performance (see Figure 5).

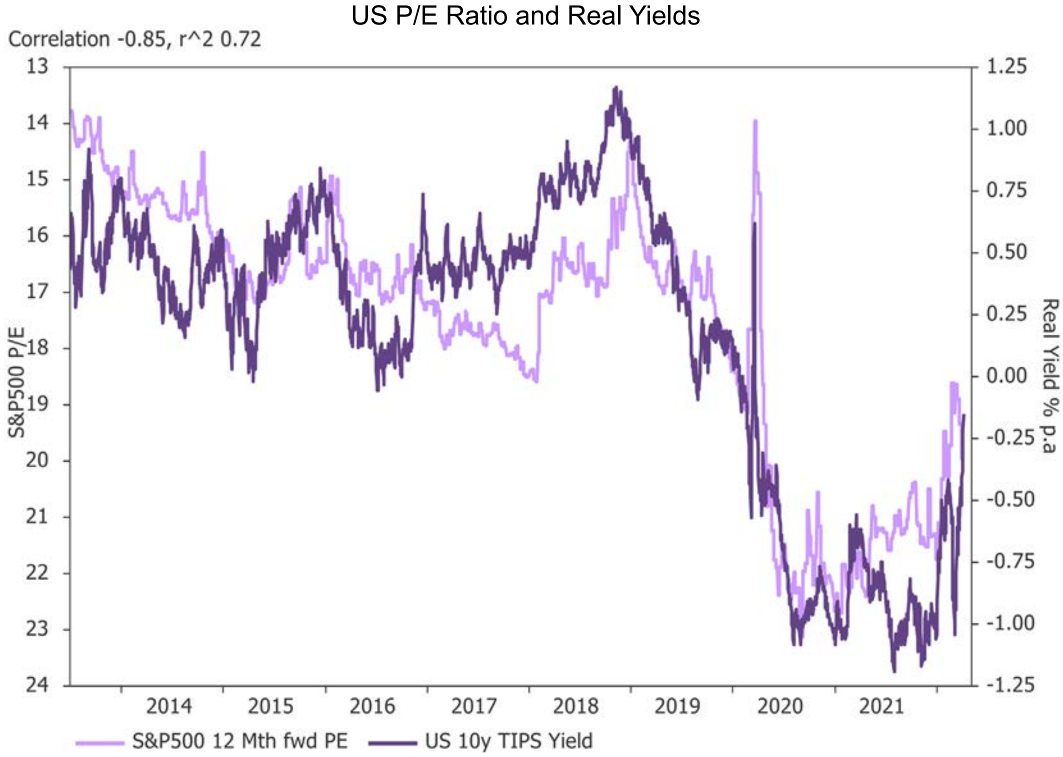
Figure 5: Fullerton's proprietary global liquidity indicator



Source: Fullerton, March 2022. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

Even if the likelihood of recession remains low, rising real interest rates over time are still likely to drive further derating of global equity markets, as we are observing already in the US (see Figure 6).

Figure 6: US equity market P/E ratio and real yields

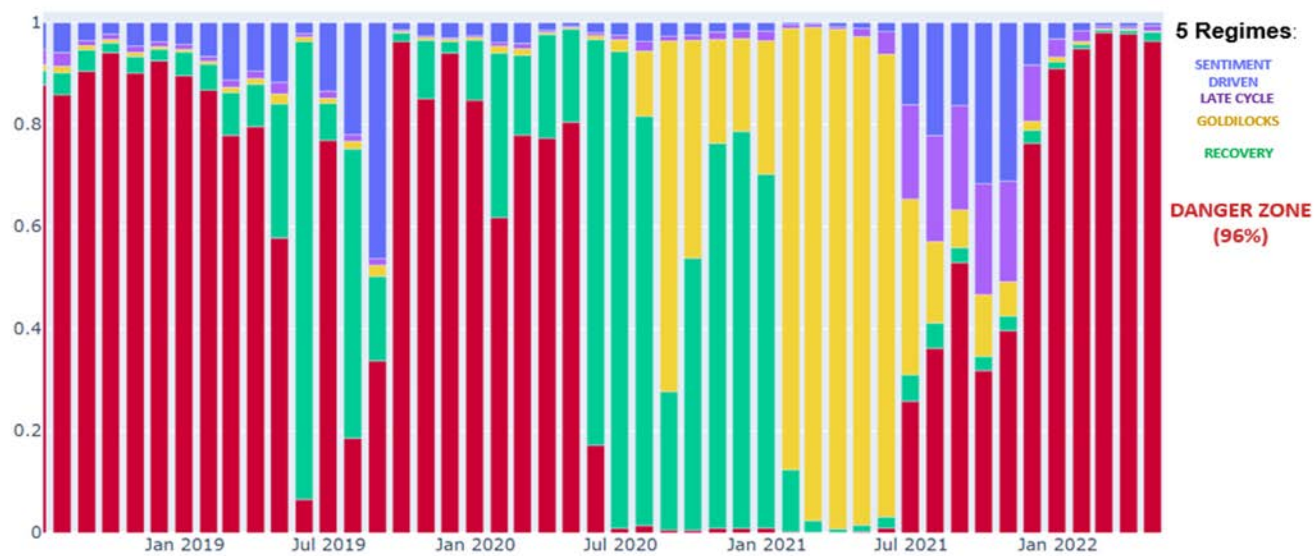


Source: Refinitiv Datastream, April 2022

This adverse investment environment has resulted in our regime indictor remaining in the 'Danger Zone' suggesting investors need to be extra cautious

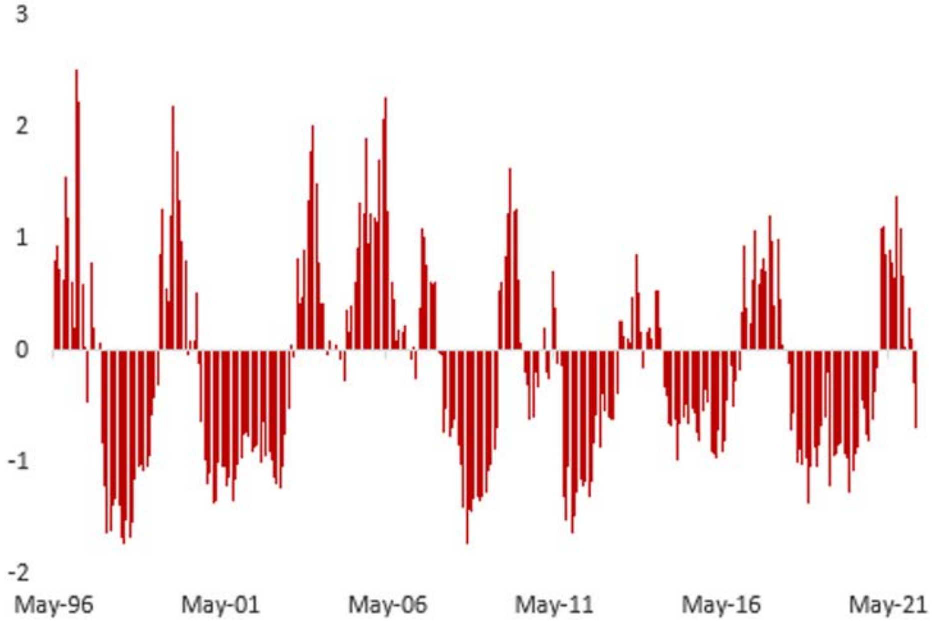
As signalled by our regime indicator, investors continue to face an adverse 'Danger Zone' environment (see Figure 7) because of high inflation and downside risks to growth. These headwinds are reinforced with late cycle dynamics of weaker risk appetite (see Figure 8), as global central banks raise rates and tighten liquidity.

Figure 7: Fullerton's investment environment regime indicator



Source: Fullerton, March 2022. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

Figure 8: Global risk appetite



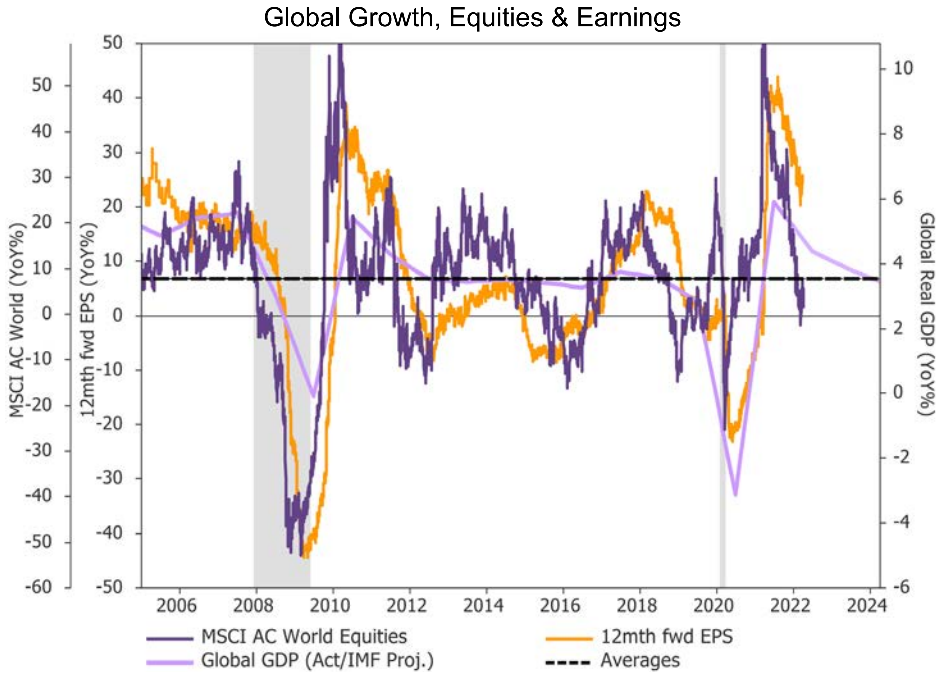
Source: Fullerton, March 2022. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

2. Investment strategy – we have shifted to negative on risk assets

From the start of the year global equity markets had corrected sharply, front-running weaker growth fundamentals to come. At the end of Q1 there was a relief rally as markets priced away some of the extreme downside risks to growth.

However, with global equity returns having settled around long-term averages, and with headwinds remaining from weaker growth and rising rates, there may not be much sustainable upside for investors this year (see Figure 9).

Figure 9: Global equities, expected earnings growth, and GDP



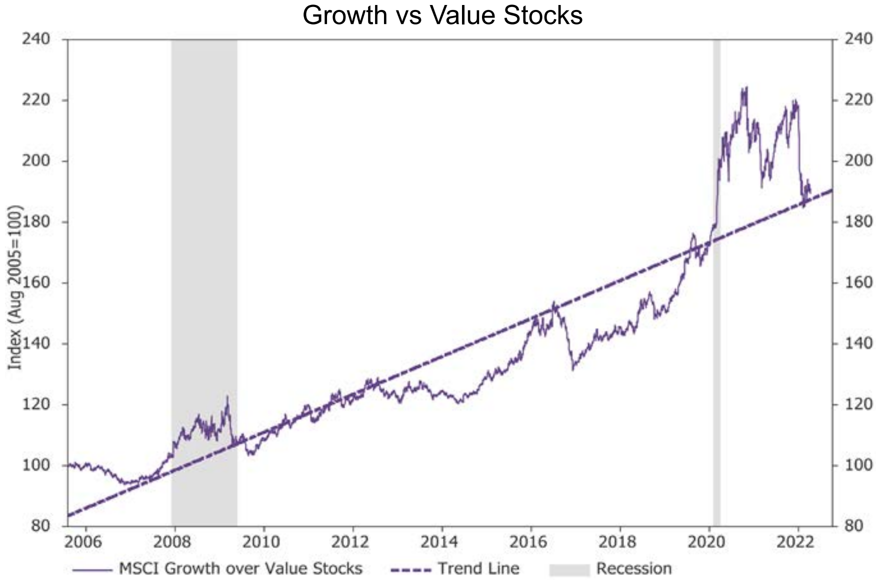
Source: Refinitiv Datastream, April 2022

Investors should be extra cautious, but remain active as growth assets have favourable longer-term trends that can potentially outperform inflation.

In navigating particularly challenging markets investors need to first manage their portfolios from downside risks. That dictates making sure investors have enough safe-haven assets like cash, gold, and currencies that can hold-up with high inflation and significant geopolitical risks. Investors can then be well positioned to take advantage of any opportunities that may unfold across different sectors and countries as headwinds fade over time.

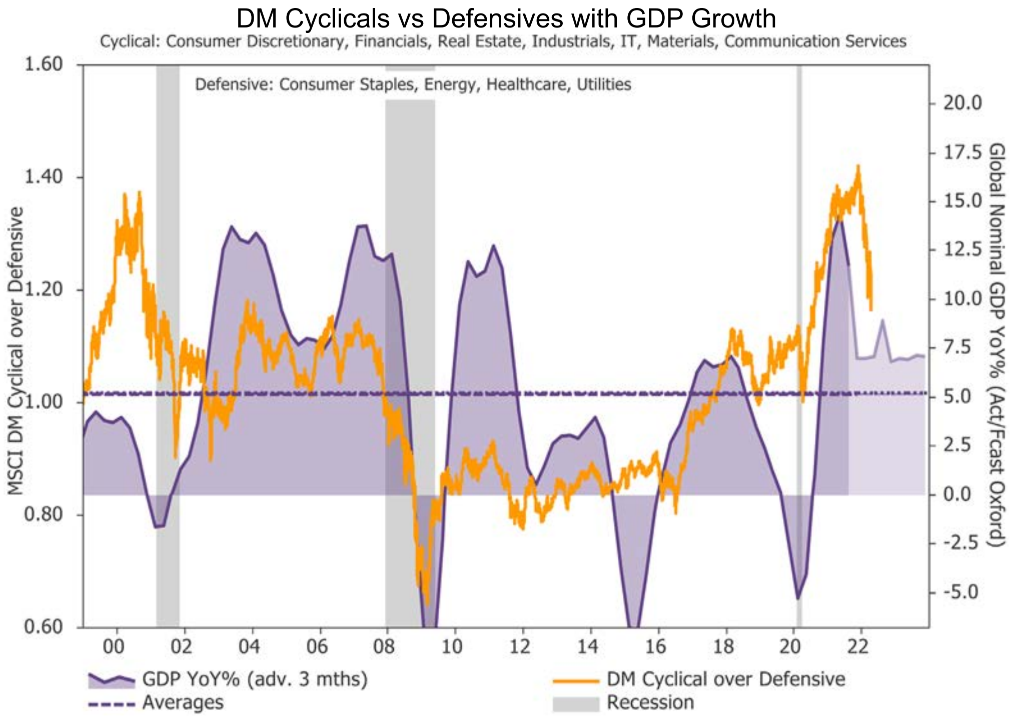
As painful as corrections have been this year, it is premature to be too bearish on global risk assets. Notwithstanding the uncertainties, investors should remain active as growth assets have favourable longer-term trends (see Figure 10) that can potentially outperform inflation, and even as GDP slows, more defensive stocks can potentially perform well (see Figure 11).

Figure 10: Global growth versus value stocks with long-term trend



Source: Refinitiv Datastream, April 2022

Figure 11: Relative performance of DM cyclical and defensive equities with growth expectations



Source: Refinitiv Datastream, April 2022

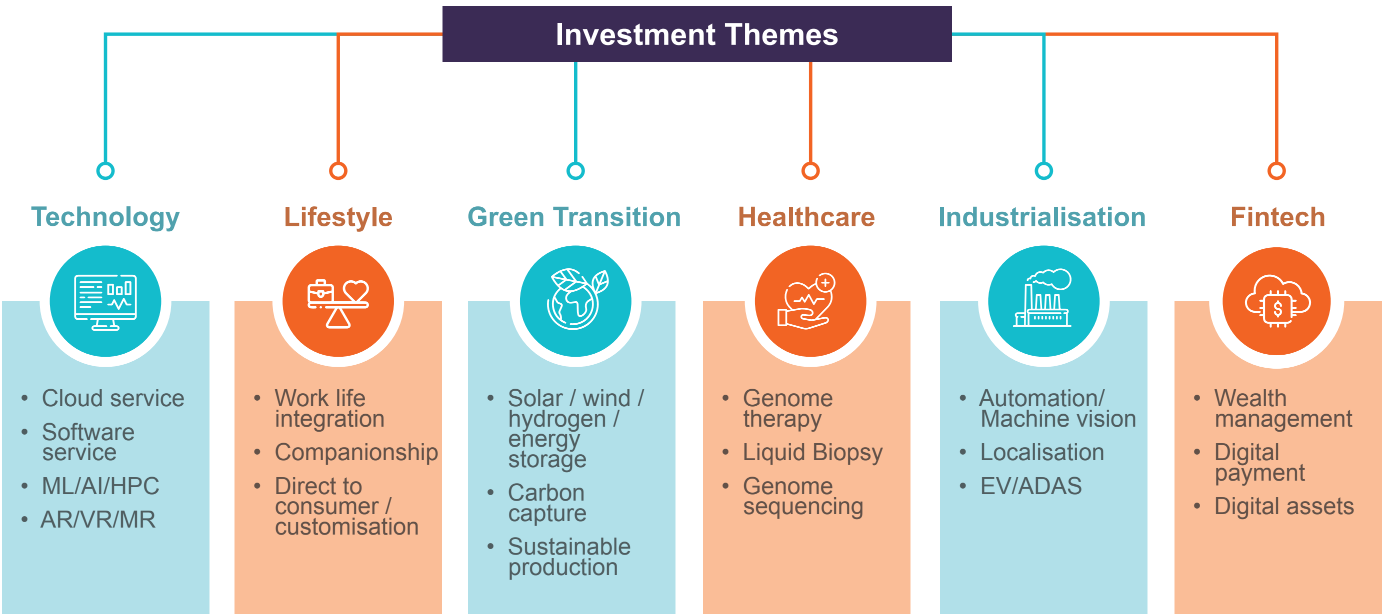
Equities – we are negative, but regions are differentiated

With significant headwinds from weaker growth, tighter liquidity, and rising interest rates, we have become negative on global equities. Investors should be cautious because it is still not clear how the highly-leveraged global economy will cope with the adjustment toward much higher interest rates.

That said, global markets are differentiated, which should continue to provide attractive alpha opportunities selectively across different sectors and countries. For example, the US may remain the strongest market given its growth, and productivity, is still above trend. In contrast, Europe faces greater headwinds from adverse stagflation forces, while Asia faces greater risks of a 'hard landing' in China. As a result, we maintain our negative outlook on Asian and Chinese equities.

We continue to favour sectors like consumer products, communications, healthcare, and renewables, as they seem well positioned to withstand the challenging macro backdrop (see Figure 12).

Figure 12: Key investment themes

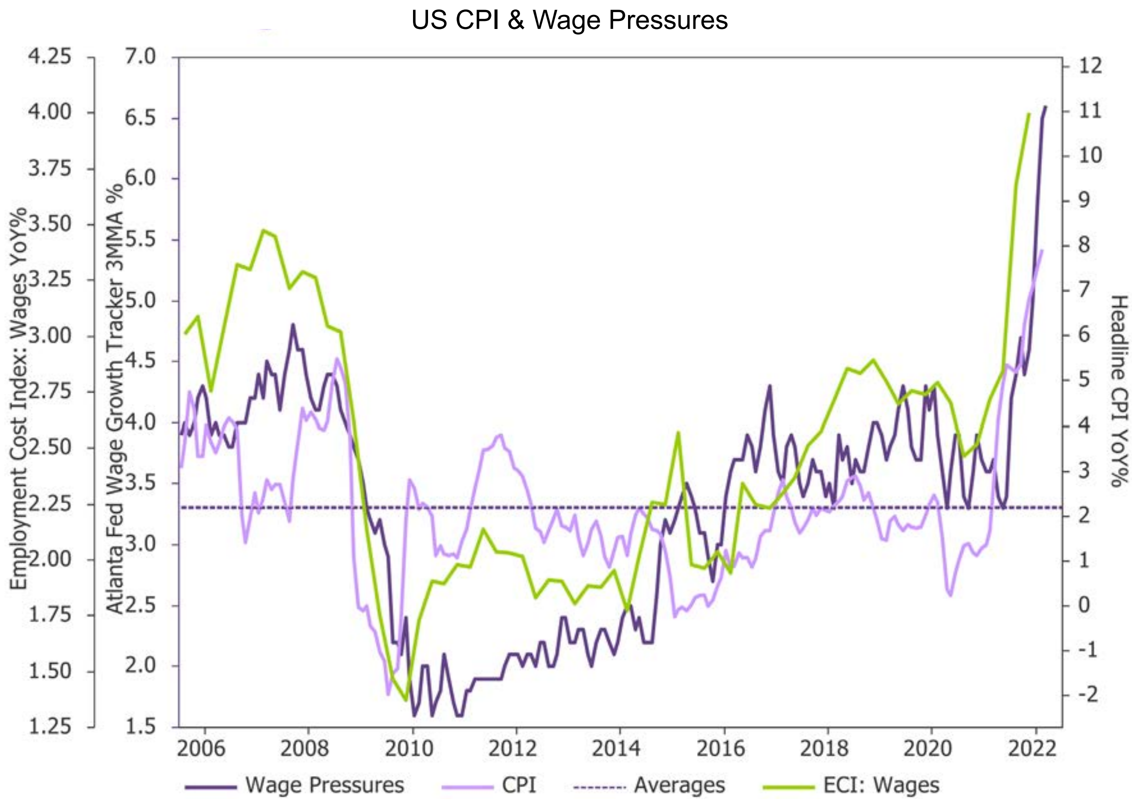


Source: Fullerton, for illustrative purposes only.

Bonds – we are negative on duration

We remain negative on US bonds, as the forward market has become even more hawkish since the Fed's mid-March meeting in part because US wage inflation indicators have had another leg up in Q1 (see Figure 13).

Figure 13: US CPI and wage inflation indicators

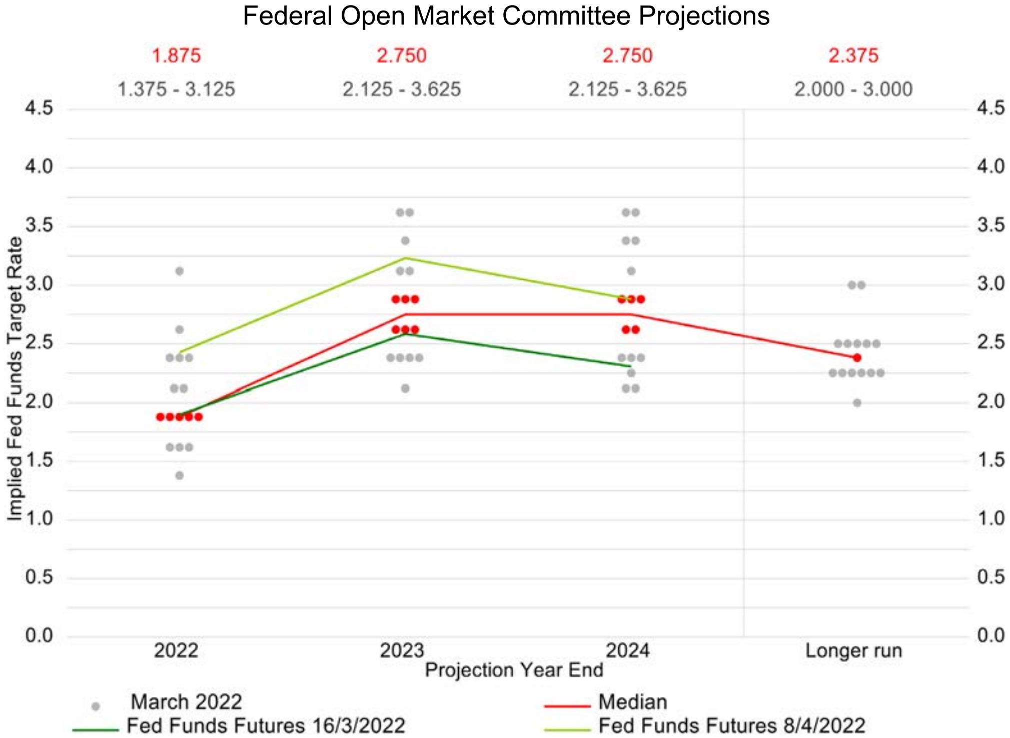


Source: Refinitiv Datastream, April 2022

The US forward market is again signalling that the Fed will need to front-load more tightening, and push rates to 3.25% next year which is above assumptions of longer-term normality (i.e at around 2.25%-2.5%. See Figure 14). A key concern for investors may unfold if the market starts to call for even stronger tightening because of high US wage inflation.

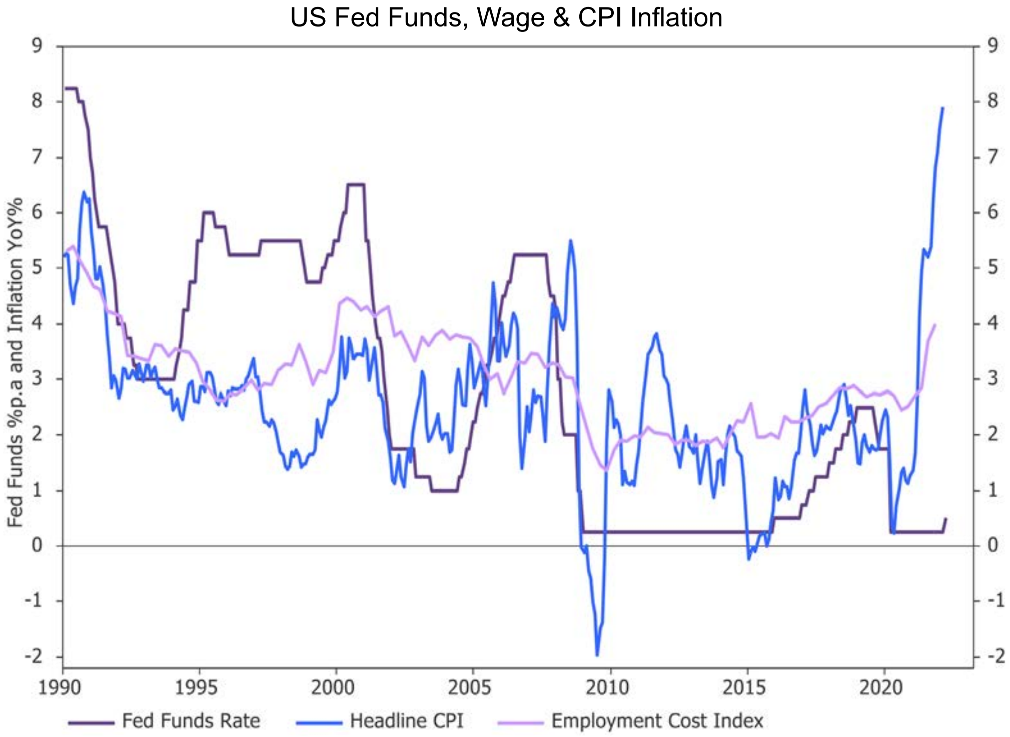
We are already in uncharted territory as the Fed has not had the modern-day experience of bringing inflation down from such highs, and it is still not clear how high the Fed Funds rate may need to go this cycle to win the war against inflation. The last time US wage inflation was this strong the Fed Funds rate peaked at 5.25% (see Figure 15), and the risk of significantly higher interest rates is not on the radar yet, but we believe it should be.

Figure 14: US Fed rate expectations and forward-market pricing



Source: Refinitiv Datastream, April 2022

Figure 15: US Fed Funds interest rate with CPI and wage inflation



Source: Refinitiv Datastream, April 2022

Corporate credit – we maintain our negative bias

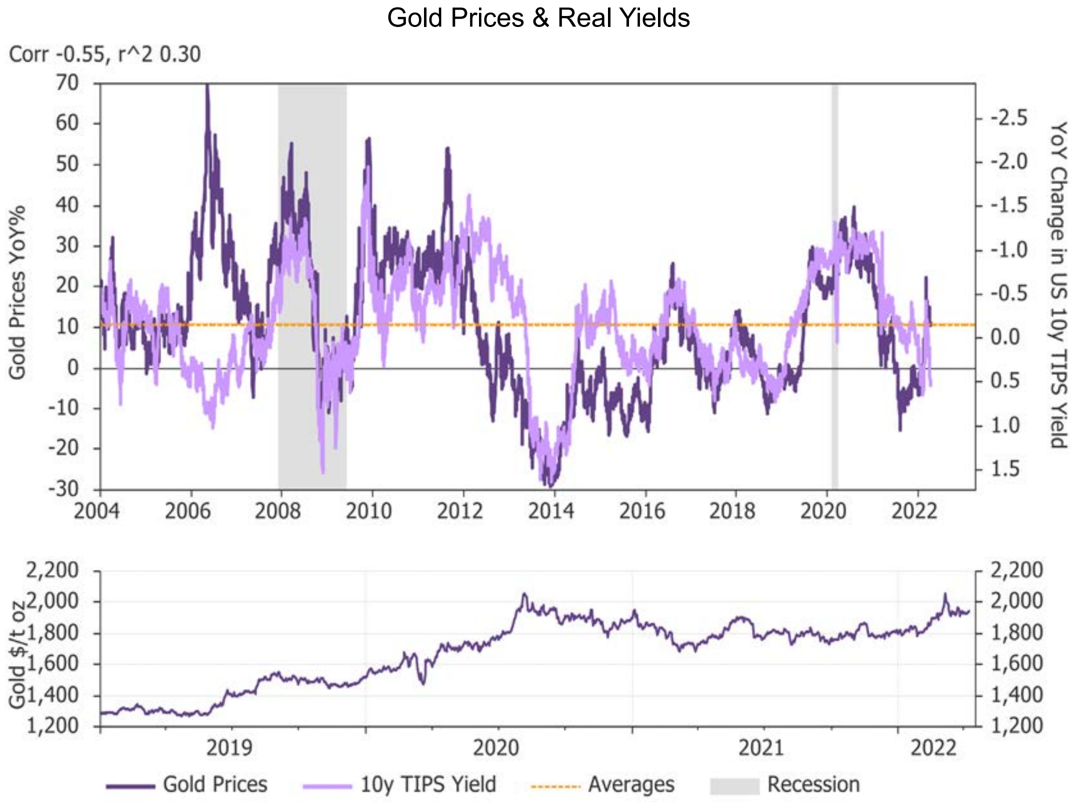
We remain cautious on Asian corporate credit with a negative outlook. Asian investment grade (IG) credit is likely to struggle the most with weaker growth and rising global interest rates. In contrast, Asian high-yield (HY) can offer more cushion against rising rates, provided default risks remain contained, especially within China. Investors need to continue to assess balance sheet fundamentals, and access to funding, across all corporate credit investment opportunities.

Commodity prices may hold-up for longer, with the higher geopolitical risk premium and supply shortages

Returns from the GSCI industrial metals index have increased sharply this year and may 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 global supply is still constrained and US output is still recovering.

Returns from gold have slipped back as acute geopolitical fears have eased. Gold also faces more competition from other risk assets that can also offer downside risk management, such as safe-haven currencies and inflation-linked bonds. That said, any further spikes in geopolitical fears are likely to be supportive to gold prices, while higher real yields are likely to remain a key headwind (see Figure 16).

Figure 16: Gold prices and real US 10y-yields

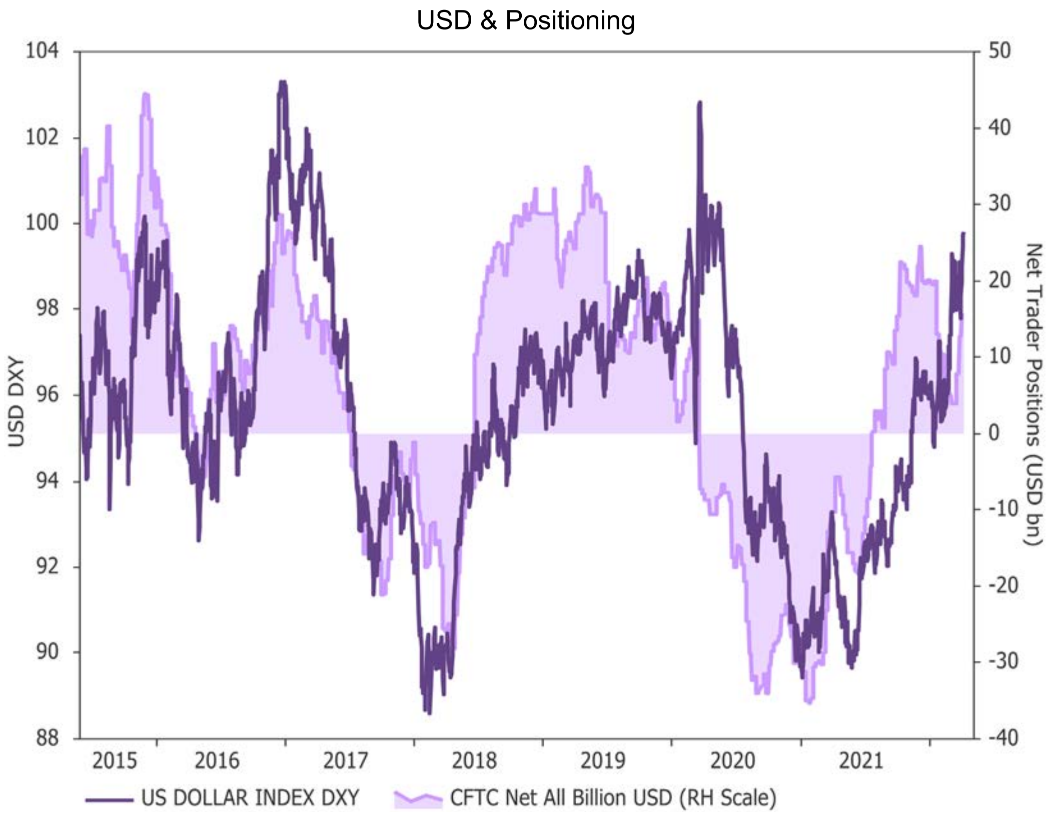


Source: Refinitiv Datastream, April 2022

We maintain our positive outlook on the USD

The USD can benefit from more positive positioning (see Figure 17) and the strong US terms of trade. The USD has also appreciated from safe-haven demand, rising geopolitical risks, and higher inflation. We believe that these fundamentals can remain supportive for a while and the USD may only start to depreciate once the US current account deficit becomes a headwind again.

Figure 17: USD and market positioning



Source: Refinitiv Datastream, April 2022