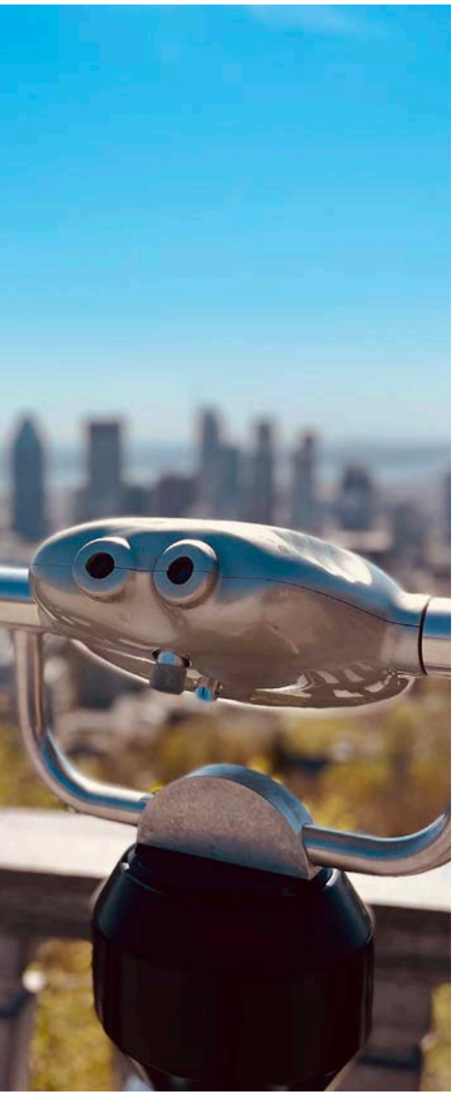
Uncovering opportunities in challenging markets

Fullerton Investment Views - Quarterly report

Q3 2022



Executive summary

- Investors should have defensive strategies in place to manage downside risks, while remaining attentive for opportunities – there are still relative winners in tough markets.
- Equities across regions are sufficiently differentiated, which is likely to provide attractive opportunities and relative trade ideas. We are positive on sectors with well-established drivers, like technology, e-commerce, consumer products, healthcare, financials, and renewables. There is further scope for defensives to outperform cyclicals, especially in Developed Markets (DM).
- Local Asian bond investors who intend to hold to maturity may start to find the relatively higher real yields across some Asian markets attractive. Government bonds may benefit from falling yields due to weaker growth.
- We prefer Investment Grade (IG) over High Yield (HY), given the relatively stronger balance sheets of IG firms in a weaker growth climate.
- The global economy can transition from its stagflationary environment into a soft landing, but we are preparing for the prospect of a global recession, led by DM, where high inflation continues to cause spending to fall and unemployment to rise eventually.
- Policy stimulus may be too late to avoid a recession, but it should help drive recoveries, which typically creates significant alpha opportunities for investors.

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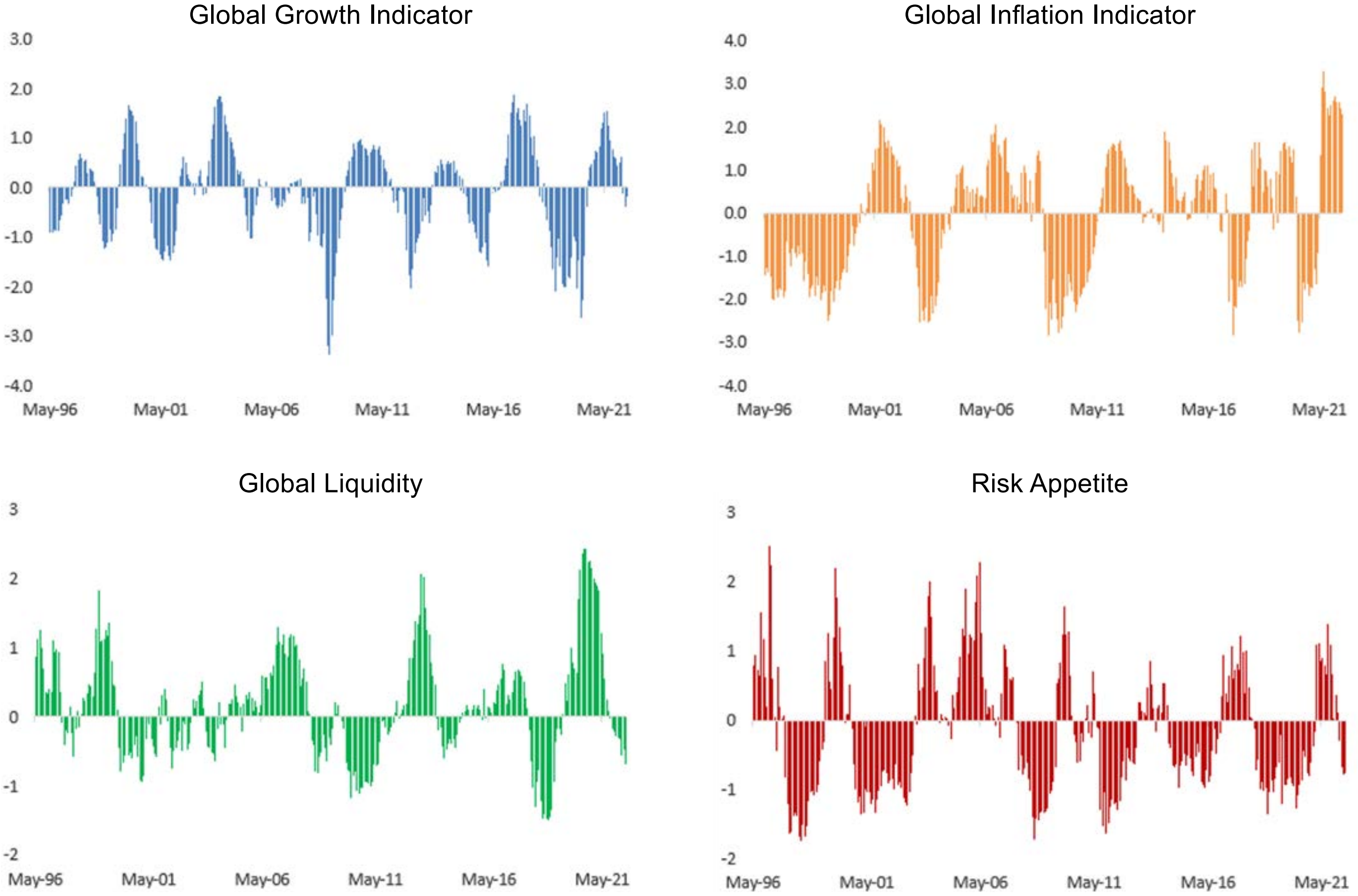
1. Stagflation has led to a challenging investment environment to date

High inflation, weaker growth, and rising interest rates are creating significant headwinds for investors

Our indicators of the four key factors that drive investment returns - growth, inflation, liquidity, and risk appetite - have all deteriorated since our Q2 update (see Figure 1). First, global growth is now below trend, and likely to fall further, as high inflation is contributing to weaker spending and industrial production, especially across key Developed Markets (DM). Second, global inflation remains above trend, and is proving stickier than anticipated as supply-chain constraints and high oil prices continue to drive CPI and wage pressures.

Third, global liquidity is falling further below trend as global central banks continue to tighten monetary conditions in the fight against inflation. Fourthly, the adverse stagflation environment of high inflation, weaker growth, and rising interest rates, is driving a significant slump in risk appetite for investors.

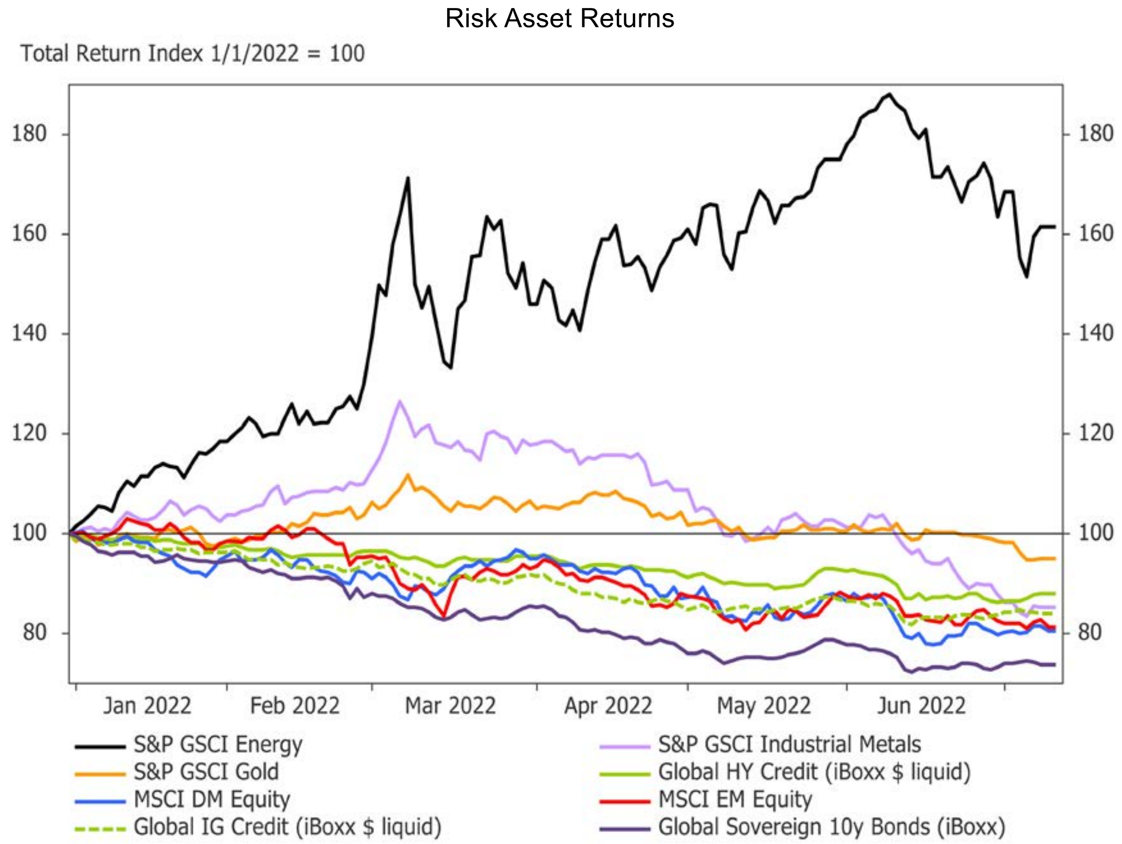
Figure 1: Fullerton's four key factors that drive investment returns



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

Given this backdrop of soft fundamental investment factors, it is unsurprising that the headwinds for investors have increased. A key reason the current investment environment is this challenging is because growth is struggling and inflation is extremely high, and in this modern-day stagflation, just like the experiences of the 1970s, most asset classes are suffering negative returns (see Figure 2).

Figure 2: Risk asset returns 2022 YTD



Source: Refinitiv Datastream, July 2022

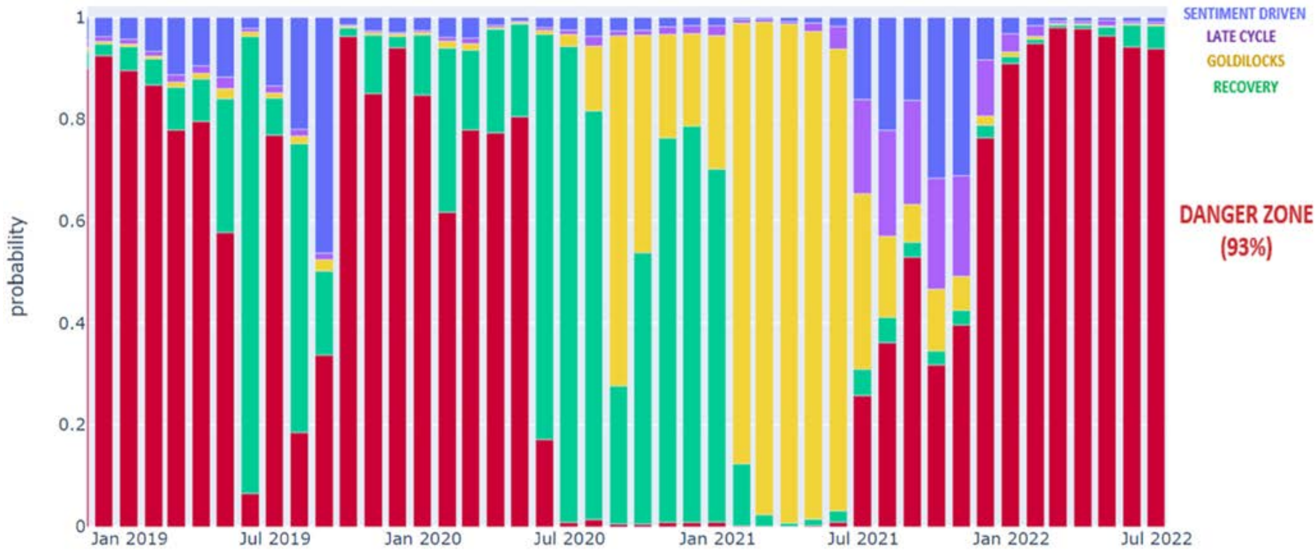
Risk asset returns that are most linked to growth, such as equities, corporate credit, and industrial metals, have fallen significantly as high inflation has driven spending cuts and weaker demand. Nominal government bonds have failed to provide downside protection to investors, as bond returns have also fallen on high inflation and rising interest rates.

In contrast, gold has managed to defend much of its value this year as geopolitical concerns and growth fears have dominated drags from higher interest rates and a stronger US dollar. Ironically, investment returns from energy prices, the key contributor to this stagflation environment, have surged because of tight supply and a higher risk premium stemming from the Russia-Ukraine conflict.

Not surprisingly, our regime indictor remains in the 'Danger Zone' suggesting investors need to remain defensive

Fullerton's regime indicator continues to signal that investors face the adverse 'Danger Zone' environment because of high inflation and weak growth (see Figure 3).

Figure 3: Fullerton's investment environment regime indicator



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

We hope the global economy can transition into a soft landing, but are preparing for a global recession, led by the US and DM

In our Q2 update we emphasised that high inflation was the key risk to global growth and the investment environment, and these concerns have indeed unfolded. Recession fears have surged, as high inflation erodes spending. The adverse wealth effects from the fall in equities, and worries about how sensitive growth may prove to be to higher interest rates, have also come to the fore.

Spending across the US economy is especially sensitive to adverse wealth effects, because more than half of all households have some investment exposure to the stock market. The fall in US equities is already greater than other periods where a recession ultimately occurred. To put it another way, there are only two periods in the last 72 years where there was a bigger fall in US equities and no recession (Source: Goldman Sachs, 22 June 2022).

Therefore, we could conclude that markets are already telegraphing that the adverse wealth effects from falling equities, combined with the stress on households' budgets from high inflation, will ultimately have an unfavourable effect on consumption spending and a recession will occur.

On the other hand, US policymakers and the consensus believe the US economy can still achieve a soft landing in part because corporate profitability is robust, balance sheets are strong, and household wealth is still at record highs. It is possible that these very large financial cushions across households and firms could help to insulate spending against the stresses ahead, and that a recession can be avoided.

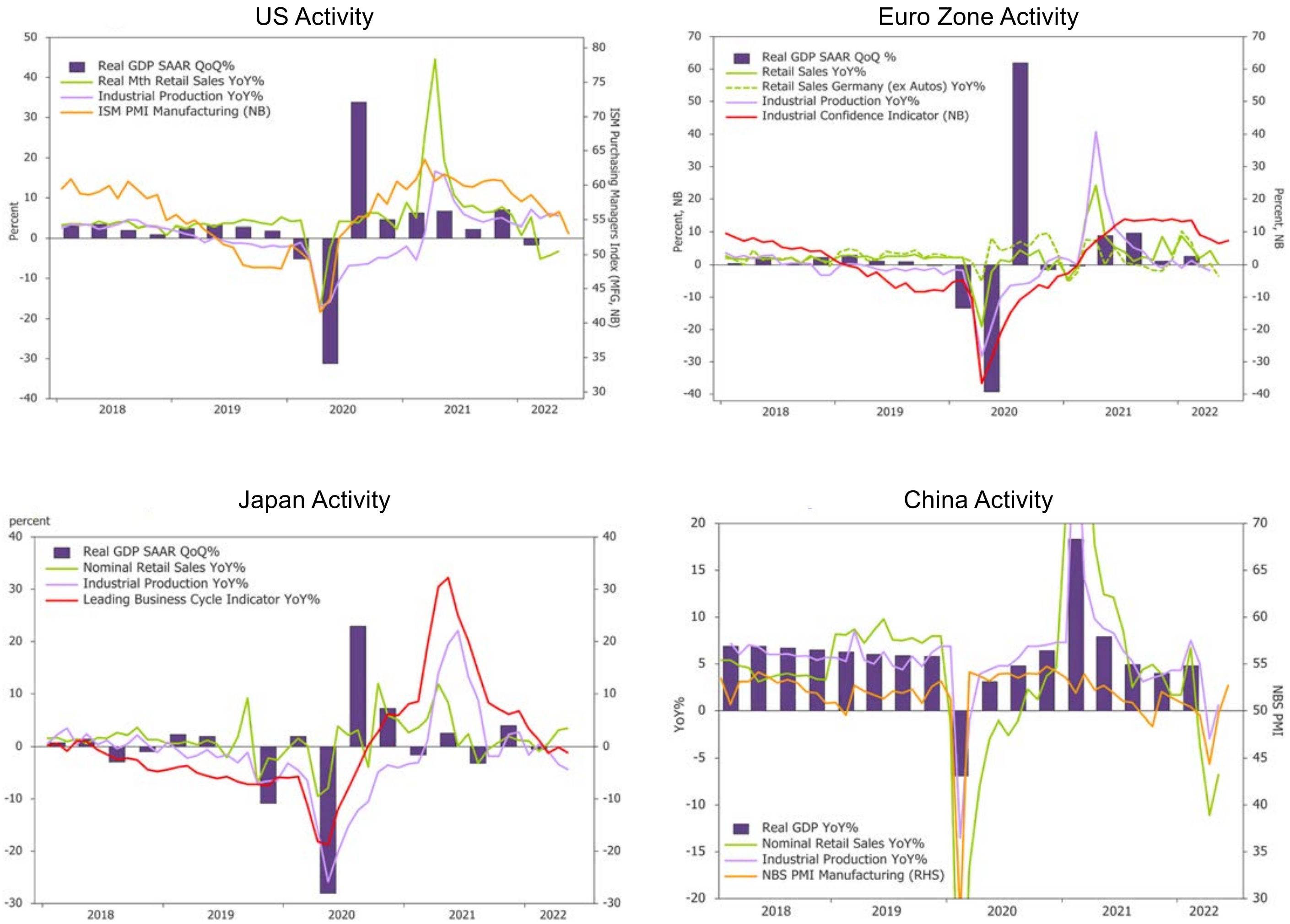
However, the US Fed has also reiterated that inflation has to be under control, and this is unconditional. The alternative strategy, to under-tighten interest rates and leave inflation too high for too long, would ultimately cost more jobs and growth than achieving disinflation back to the Fed's target inflation rate.

There is already clear evidence of such risks as high inflation in the US has contributed to the fall in Q1 GDP and indicators suggest retail spending has fallen going into Q2. This increases the likelihood that US GDP has been falling for six months already, and that the US economy could slide into a recession this year (see Figure 4). US initial jobless claims are rising, but it may not be until next year that stresses intensify, because labour markets will likely take some time to deteriorate.

Retail sales spending and industrial production is also weak across Europe, while Japan's leading business cycle indicator has fallen along with industrial output (see Figure 4).

In line with the Bloomberg Consensus Survey, while we hope that the global economy can transition from its stagflation environment into a soft landing, we are preparing for a global recession, led by weakness in the US and DM, as high inflation continues to cause spending to fall and unemployment to rise eventually.

Figure 4: G4 growth indicators

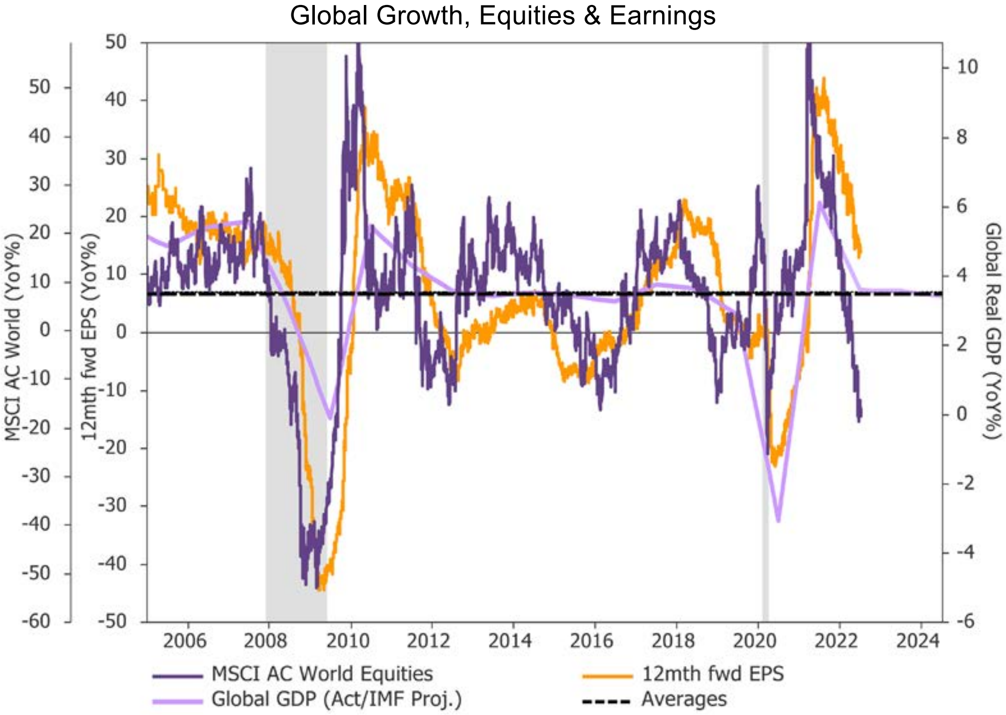


Source: Refinitiv Datastream, July 2022

Our global recession expectations appear consistent with what global equity markets are signalling

Our global recession expectations appear consistent with what global equity markets are signalling. We could see growth contraction that is larger than average, with global growth collapsing to around zero, and a fall in earnings of around 10-15% YoY (which would be more severe than the 2016 earnings recession. See Figure 5).

Figure 5: Global equities, expected earnings growth, and GDP



Source: Refinitiv Datastream, July 2022

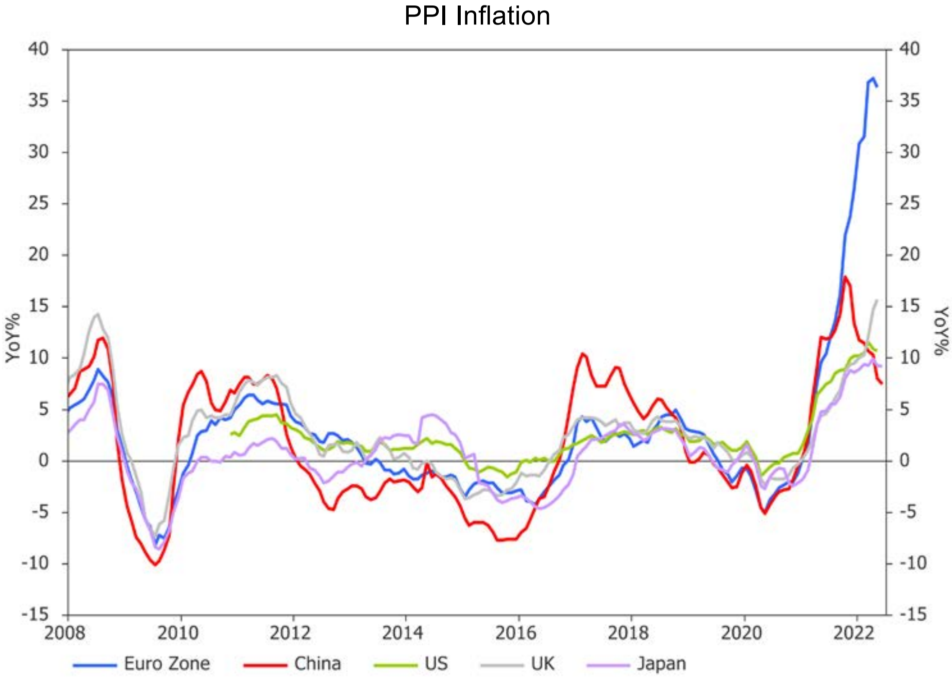
However, even in a global recession, different countries are likely to have differing growth outlooks

Even in a global recession, there are selective alpha opportunities to behold. For example, China is already out of phase with DM, as China is rebounding strongly from its COVID control lockdowns with significant policy stimulus (see Figure 4). Chinese equities have also been a relative outperformer to date in 2022 given the significant differences in cyclical growth, stagflationary pressures, and policy stimulus with its DM peers. YTD to 8 July (in common USD terms) MSCI China has outperformed the S&P 500 by 5.4%, MSCI DM equities by 6.8%, and the Euro Stoxx index by 15.1% (Source: Refinitiv Datastream, 8 July 2022).

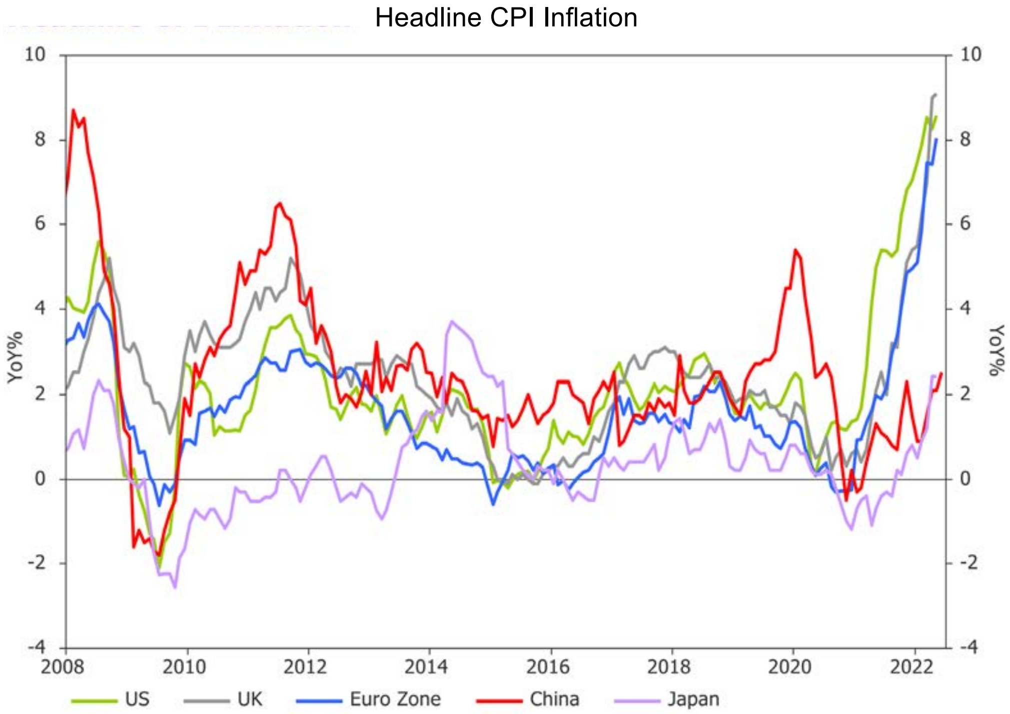
If a global recession unfolds, Asia could prove to be better placed than other countries to provide more timely and targeted policy stimulus to support growth, in part because inflationary pressures are less acute than across DM (see Figure 6).

Europe is facing surging producer price inflation, that is feeding to higher wages and higher CPI, driven in part by record high energy prices as a result of supply stresses from the Russia-Ukraine conflict. Separately, the US and the UK face significant inflation pressures which are being exacerbated by high oil prices, supply-chain rigidities, and greater wage demands.

Figure 6: G5 inflation indicators



Source: Refinitiv Datastream, July 2022



Source: Refinitiv Datastream, July 2022

A global recession this time could be shallower than usual, and while policy stimulus may not stop the slump, recoveries are likely to create investment opportunities

A recession over this cycle may prove more shallow than typical slumps because equity markets have already fallen significantly, and private sector balance sheets, especially in the US, are strong. On the other hand, it could become a deep recession if inflation takes time to fall, or if unemployment rises significantly, as risk assets would likely have another leg down in such a situation.

Any policy stimulus is likely to be too late to avoid a recession, but it should help drive recoveries, which typically create significant alpha opportunities for investors. Fiscal and monetary policy stimulus are likely to be deployed in tandem, especially as policymakers will need to coordinate employment recovery and inflation control.

2. Uncovering opportunities in challenging markets

Investors should be cautious, but also remain attentive for opportunities, because even in bear markets there can still be relative winners

As we emphasised in our Q2 update, to navigate very challenging financial markets investors need to first make sure they are comfortable with their degree of leverage and risk exposure, with sufficient defensive strategies in place to manage downside risks.

This means making sure there is enough holdings of assets like gold, and to a lesser extent cash (denominated in appreciating safe-haven currencies), that can give some insulation against high inflation and further downside to growth. Investors can then consider having some spare resources ready to deploy to take advantage of any opportunities that may unfold, because even in bear markets there can still be relative winners across different sectors and countries.

Equities – we remain less sanguine, but regions are sufficiently differentiated, which can create investment opportunities

Regardless of whether a recession occurs or not, we are experiencing a significant global inflation surge. Therefore, it is paramount for investors to remain alert for relative trade opportunities across both sectors and countries, as some areas will potentially achieve better real growth outcomes than others.

Regions are differentiated, which is likely to continue to provide attractive alpha opportunities. For example, Europe faces significantly greater headwinds than the US from adverse stagflation forces. In contrast, China is benefiting from attractive valuations and its rebound, is driven by policy stimulus. As a result, China's equity market outperformance (YTD in 2022) over the US, and especially Europe, could be sustained into next year.

We remain positive on sectors with favourable well-established drivers…

We continue to favour sectors, especially across China, where positive drivers, like rising per capita incomes and productivity, can provide insulation from downturns and can aid faster recoveries from any cyclical sell-offs. The sectors we are most positive on comprise: technology, e-commerce, consumer products (reflecting the 'experimental lifestyle'), healthcare, financials, and renewables (see Figure 7).

…and we believe there is still further scope for defensive stocks to outperform

As a long-term investor focused on fundamentals we are always positive on growth stocks where a company has strong financials, good branding, and a positive record of growing its market share over time. Through much of this stagflation environment, where equities have been in a bear market decline, there has still been attractive opportunities for investing in defensive stocks against cyclical stocks, especially across DM (and 'cash generators' like staples and utilities, are key ingredients of this strategy).

Figure 7: Key investment themes

Investment Themes

Technology
- Cloud migration / Digital transformation
- Tech enablers (ML/AI/HPC)
- Metaverse (Devices, VR/AR/3D engine)
- Cyber security

Healthcare
- Value-based care delivery
- Global outsourcing
- Living with COVID
- Medical robotics

Cash Generators
- REITs
- Telecommunications and utilities
- Consumer staples

Experiential Lifestyle
- Reopening
- Companionship
- Direct to consumer / customisation

Geopolitics
- Energy security
- Defense
- Localisation / self-sufficiency

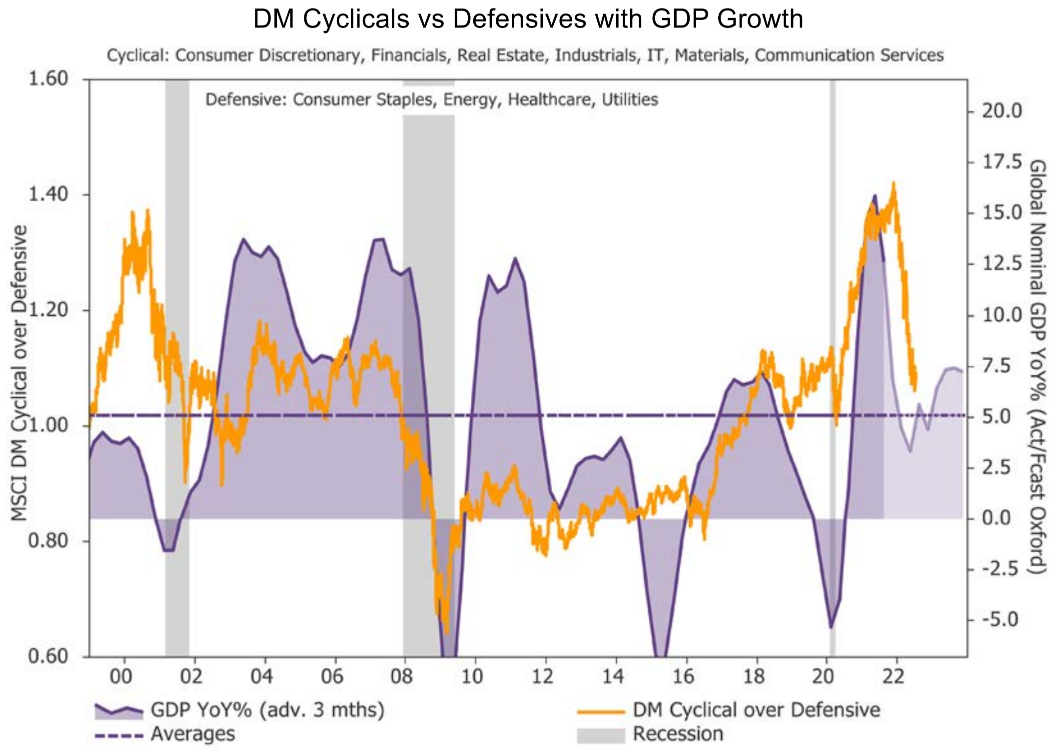
Green Transition
- Renewables / ESS
- Sustainability
- Mobility

Inflation Beneficiaries
- Financials
- Resources
- Pricing power

Source: Fullerton, for illustrative purposes only.

We believe there is still further scope for defensive stocks to outperform, especially if there is a recession, as GDP growth expectations would fall significantly and defensives could beat its long-term average relative performance to cyclicals (See Figure 8).

Figure 8: Performance of DM defensive vs cyclical equities with growth expectations



Source: Refinitiv Datastream, July 2022

Furthermore, when recoveries from recession eventually unfold, we believe that growth stocks are likely to provide attractive alpha opportunities as they rebound and then sustain their long-term positive performance trend (see Figure 9).

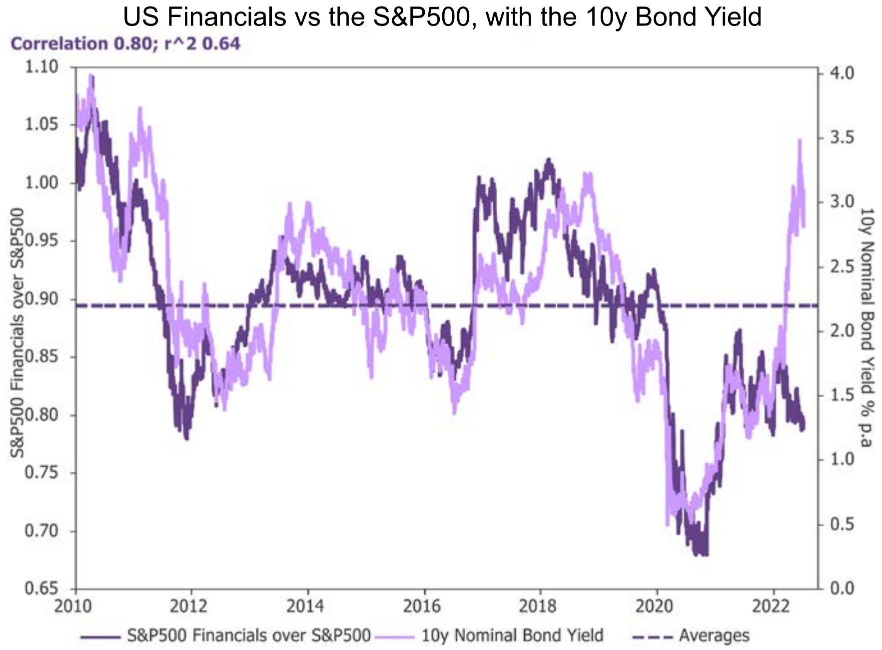
Figure 9: Performance of global growth stocks relative to value stocks

Source: Refinitiv Datastream, July 2022

US financials may also have more catch-up performance to come

Another common characteristic of bear markets is that market dislocations can often appear, as fears cloud fundamental relationships, for investors to take advantage of. For example, we are positive on the financial sector (see Figure 7) and as we have highlighted before, US financial equities, relative to non-financials, appear to have decoupled from rising interest rates (see Figure 10). This may signal more upside potential for returns from US financial equities, which could still be realised, even in the worst-case scenario of a recession, because during recoveries financials often perform strongly.

Figure 10: Performance of US financials relative to the S&P500 with 10y bond yields



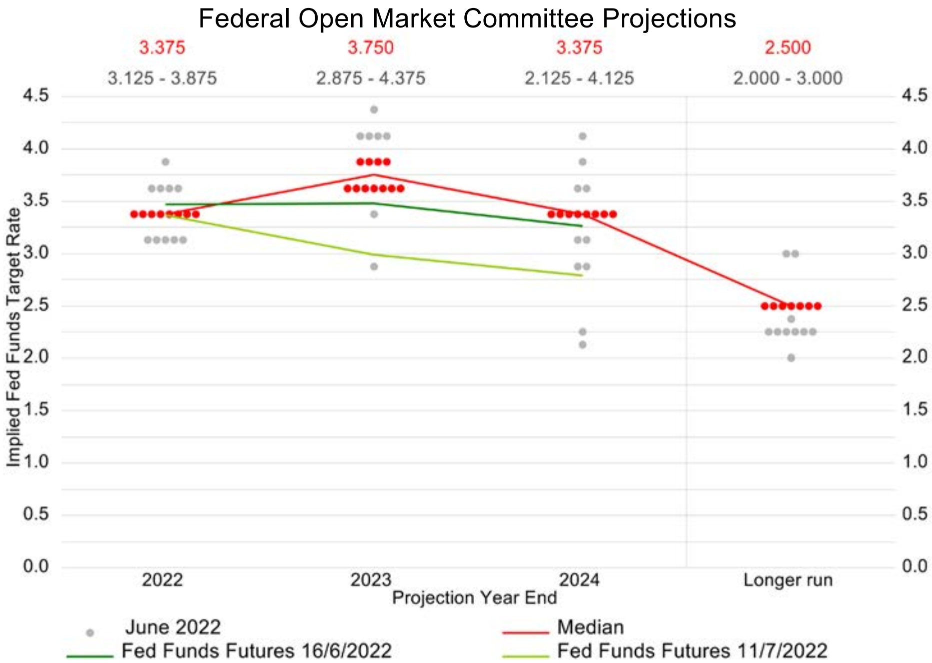
Source: Refinitiv Datastream, July 2022

Fixed income – can benefit from the transition away from stagflation

Nominal government bonds are an obvious asset class most likely to benefit from the transition away from stagflation, as yields are likely to slide with weak growth. However, we remain negative on duration of US government bonds, as it is still not clear how high the Fed Funds rate may need to go this cycle to win the war against inflation.

For example, since the hawkish Fed signalled its desire in June for the Fed Funds rate to peak at 3.75%, the US forward market has become much less convinced, and has pulled back its rate expectations on renewed growth fears (see Figure 11). The prospect of a US recession means inflation could fall faster, and as yields react to growth fears, signs will emerge for investors as to when is the best time to turn positive on duration.

Figure 11: Federal Open Market Committee Projections from the June 2022 meeting



Source: Refinitiv Datastream, July 2022

Asian government bond returns have faced significant headwinds from the strong USD

Local currency Asian nominal government bonds have performed well against DM government bonds as China's nominal yields have slipped a bit this year. However, the Asian USD government bond market has struggled because of the significant appreciation of the US dollar, and unfortunately dollar strength is likely to remain a key headwind for a while. That said, for more conservative local investors that buy-and-hold to maturity, the relatively higher real yields across some Asian markets may start to look attractive.

Stagflation risks are motivating some investors to seek diversification with ILBs

Inflation linked bonds (ILBs) can be a useful hedge against inflation over the longer-term, but as real interest rates may still have some upside to come, there could be some cyclical headwinds for this investment. However, if global stagflation worsens with falling real yields, then total returns could be quite robust for ILBs.

Corporate credit – we maintain our negative bias, but prefer Asian IG over HY

We are constructive on Asian investment grade (IG) bonds relative to high yield (HY) bonds, as we believe IG corporate credit can hold its outperformance. In a weaker growth and rising interest rate environment, IG companies tend to have more resilient balance sheets.

If a global recession unfolds, we expect Asia's IG companies to still have enough market share and financial strength to navigate the slump and potentially outperform HY. Likewise, with concerns over the economy starting to mount, we think investor preferences will shift away from high yield to investment grade. The deteriorating mix of growth and inflation warrant further repricing of risk premia for the high yield sector. In turn, that can offer attractive entry points to extend our exposure in the higher-yielding markets such as Indonesia and India. We are cautious on the Macau gaming sector near-term, as there could be potential delays in the sector's recovery prospects, because of lingering uncertainties around the territory's COVID-related policies. That said, we are also looking for opportunities to gradually build positions in the issuers which could hold out longer-term, and position for an eventual recovery further down the road.

Elsewhere, China's latest stronger-than-expected credit data are encouraging and shows that policy support has stepped up. As the Omicron shock is fading in the country and restrictions ease further, we continue to look for a Q3 rebound in China. China's State-owned Enterprises (SOE) and government-linked issuers could be key beneficiaries as policymakers continue to front-load policy support. With bond maturities for property developers staying elevated in the coming months, further downside risk cannot be ruled out. July is also traditionally a lull period for housing sales in the country. We remain cautious on the China property sector, with a bias towards the better-quality developers. Managing tail risk remains the key strategy for the sector.

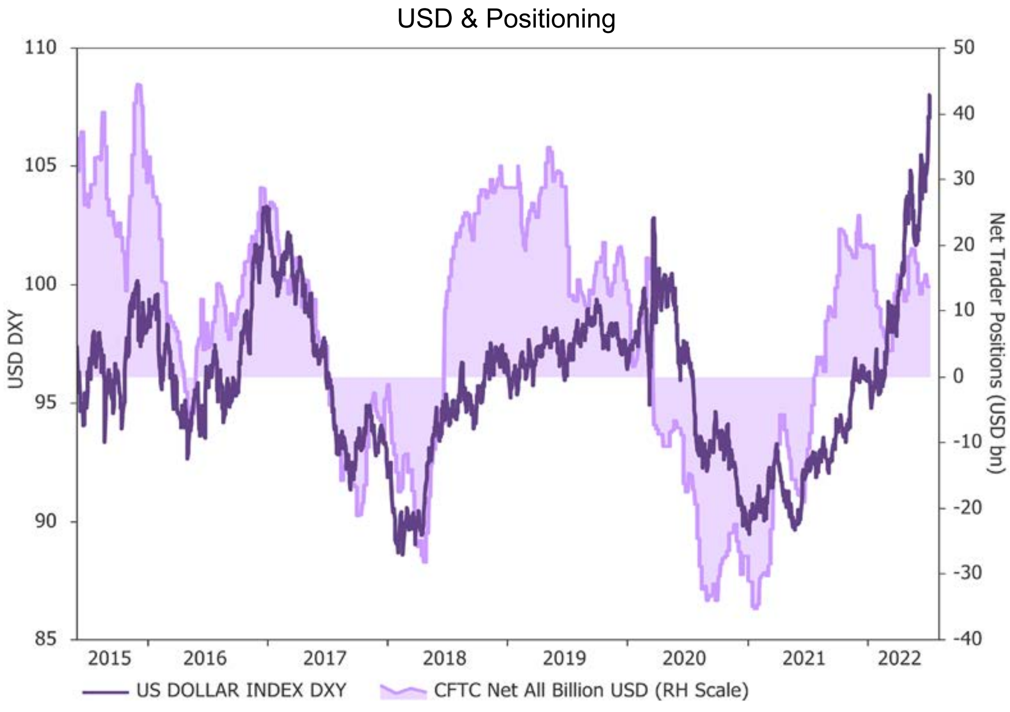
Commodity prices may remain high for a while, with prominent geopolitical risks and supply shortages. But a global recession would likely also result in significant demand destruction and falling prices

Oil prices have been supported by tight supply and strong demand growth, especially from China and India. However, the longer that oil prices remain significantly above $100/bbl the greater the likelihood of demand destruction over time and some correction in prices. If a global recession unfolds then oil prices could fall significantly.

We maintain our positive outlook on the USD

The USD can continue to benefit from the strong US terms of trade, tighter monetary policy by the Fed, safe-haven flows concerned about global recession, and supportive market positioning (see Figure 12). The USD may only experience pressure to depreciate if its value becomes too stretched, or if safe-haven demands moderate in the event a soft landing can be achieved for the US economy.

Figure 12: USD and market positioning



Source: Refinitiv Datastream, July 2022