Investing in a 3G environment

Fullerton Investment Views - Quarterly report

Q4 2022

Executive summary

- **We maintain our view from Q3 2022 that the outlook for risk assets is negative, as the inflation fight by global central banks has intensified.**
- We believe we are **entering a world increasingly shaped by a '3G environment'** – marked by the (3G) forces of a Great Decoupling, Great Volatility, and a Great Reset.
- **The 'Great Decoupling'** is driven by differing inflation pressures and policy responses across countries, combined with significant geopolitical risks motivating less globalisation and more onshoring. This may lead to more investment risks, but may also create alpha opportunities as differentiation across countries widens.
- **The 'Great Volatility'** reflects the rise in return volatility across asset classes, in response to geopolitical risks, high inflation, and tighter monetary conditions.
- **The 'Great Reset'** refers to the rise in real bond yields, especially in the US, which may reflect a return to a more appropriate cost of capital.
- **Key signposts to watch for a more favourable environment** include confirmation that inflation has peaked (implying planned monetary conditions may be tight enough) and stabilisation in China's real-estate market.

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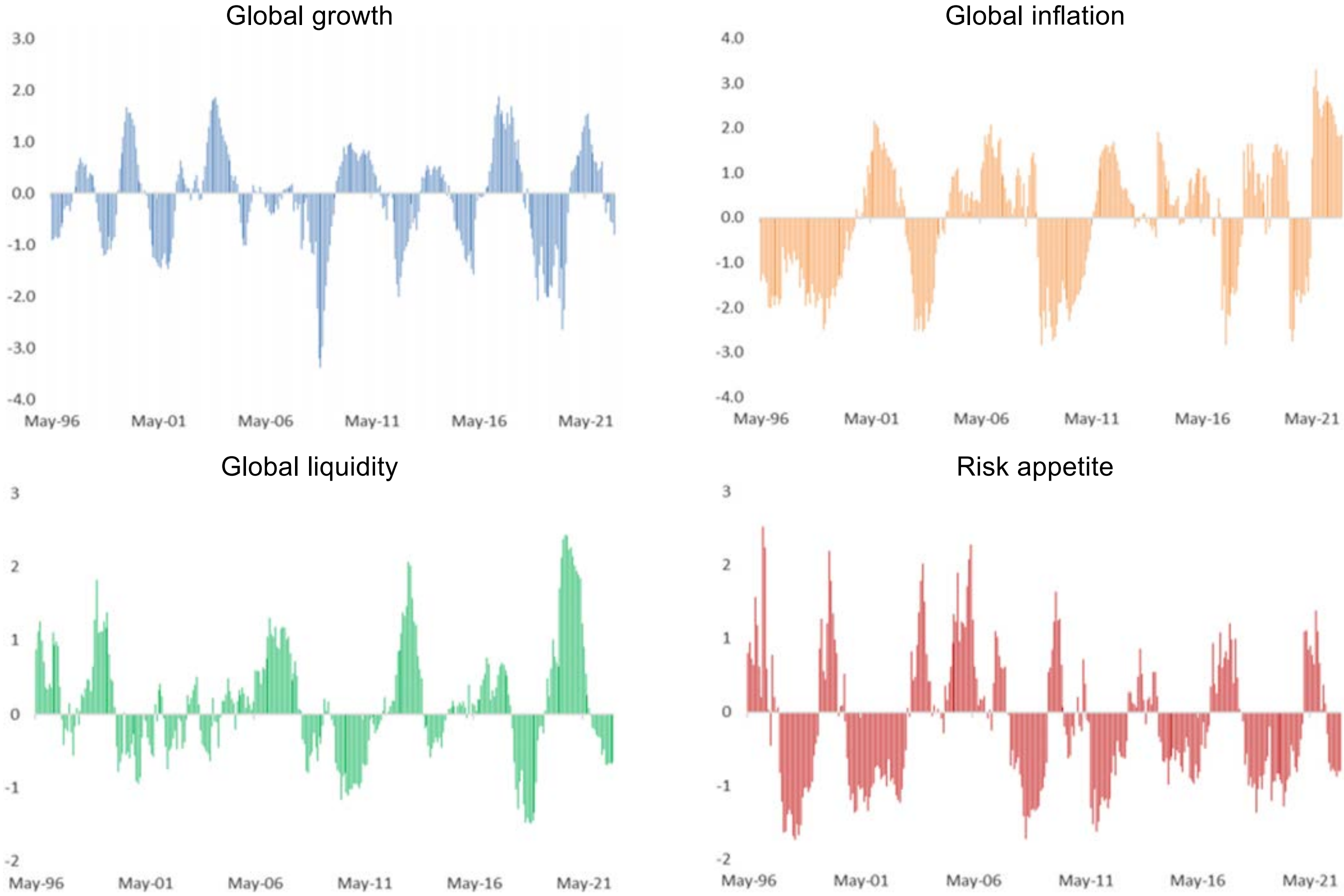
1. High inflation and recession fears keep the investment environment challenging

Global central banks' fight against inflation has become more intense, while the 'growth recession' continues, collectively sustaining 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 Q3 update (see Figure 1). Firstly, global growth is still sliding below trend, and likely to fall further, as high inflation is proving sticky and depressing spending. Secondly, global inflation remains above trend, and the disinflation is proving slow to come through. Thirdly, global liquidity remains tight below trend as the fight against inflation, by global central banks, has intensified. Fourthly, as the investment environment remains challenging, risk appetite for investors is depressed.

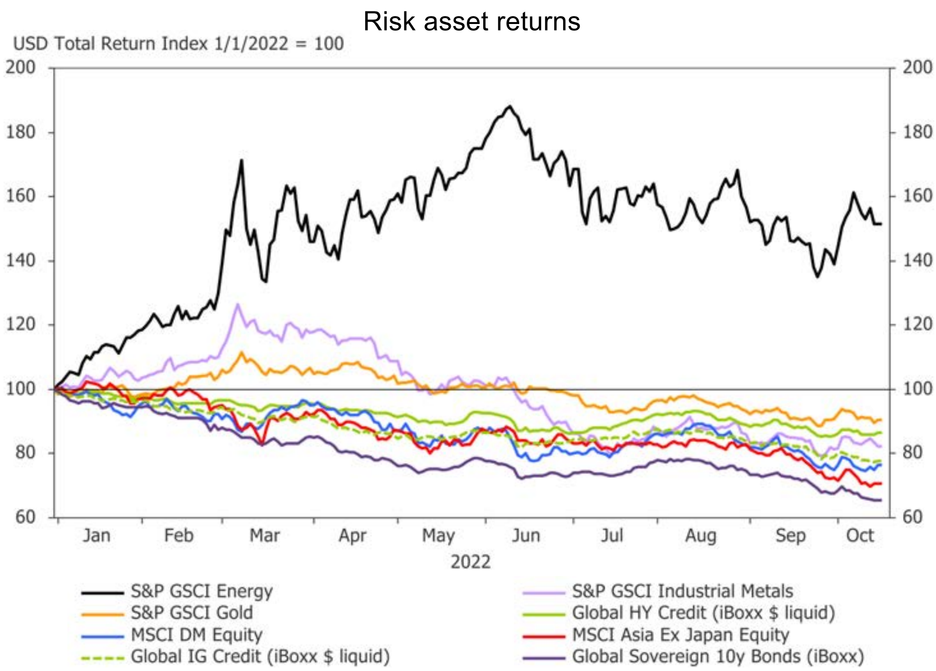
Figure 1: Fullerton's four key factors that drive investment returns



Source: Fullerton, September 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 weak fundamental investment factors, it is not surprising that the headwinds for investors have persisted. Most asset classes are suffering negative returns, while global sovereign bonds have been especially hurt by stagflationary forces and have underperformed global equities (see Figure 2).

Figure 2: Risk asset returns 2022 YTD



Source: Refinitiv Datastream, October 2022

Government bonds have failed to give downside protection to investors, as returns have struggled with sustained high inflation and rising interest rates. Risk asset returns that are most linked to growth, such as equities, corporate credit, and industrial metals, have all fallen with tighter monetary conditions and liquidity, and as high inflation has driven weaker demand.

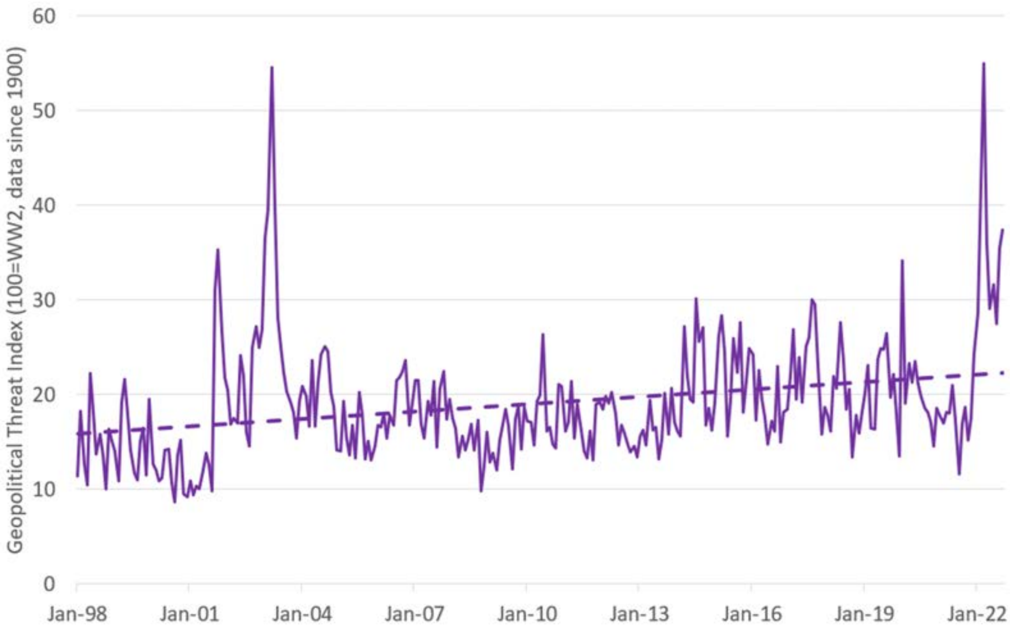
While investment returns from gold have slipped, reflecting the sharp rise in interest rates and the strong USD, it has nevertheless continued to outperform other asset classes (see Figure 2). In part this is likely to reflect sustained geopolitical risks, dominated by the Russia-Ukraine invasion, as well as the deteriorating relationship between China and the US.

Gold may continue to be a useful hedge against geopolitical risks with the 'Great Decoupling'

All these geopolitical risks remain 'known unknowns', and are challenging for investors to price-in. Nevertheless, gold has offered some cushion for investors and we believe this trend may continue as geopolitical risks are likely to persist (see Figure 3).

We believe reactions to geopolitical risks are a key contributor to a 'Great Decoupling' unfolding across countries, as policies shift to become more domestically focused (especially in China), with some push-back against globalisation driving more manufacturing and supply-chain onshoring.

Figure 3: Geopolitical risks remain significant



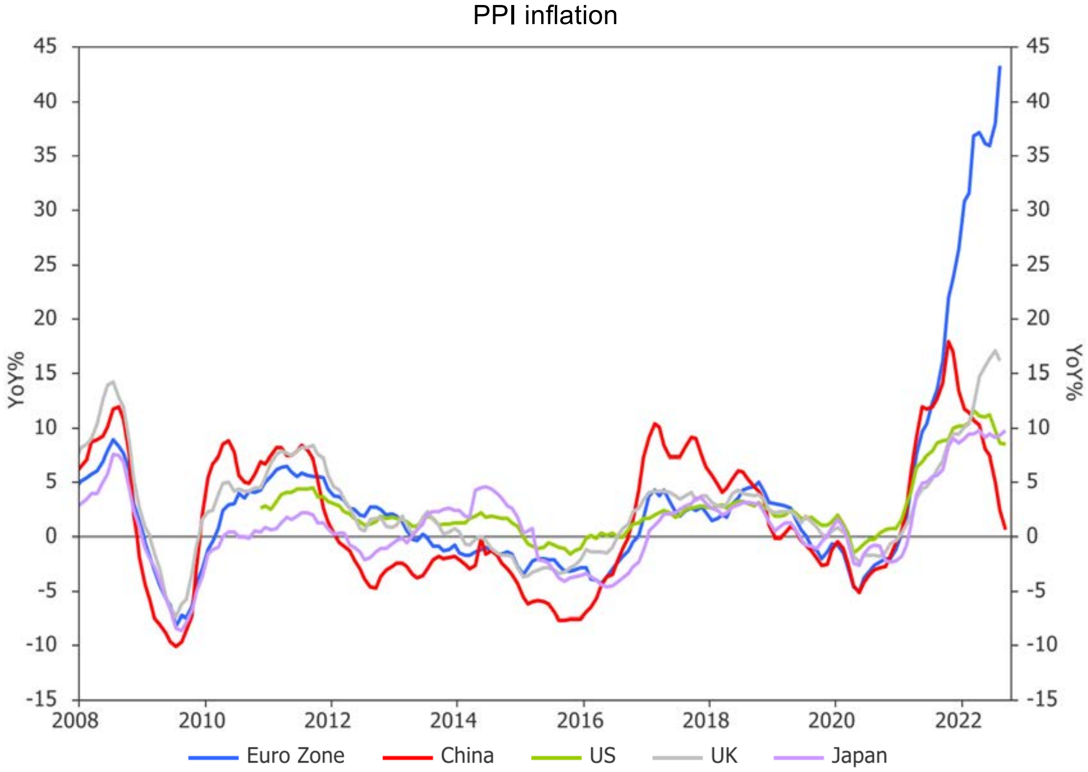
Source: A news-based measure of adverse geopolitical events and associated risks since 1900. The geopolitical risk index spikes now, and around the two world wars (WW2=100, and is the worst period), at the Korean War, during the Cuban Missile Crisis, and with the Iraq War (2003). From Caldara, Dario and Lacoviello, September 2022

Asia and the US could benefit from the Great Decoupling

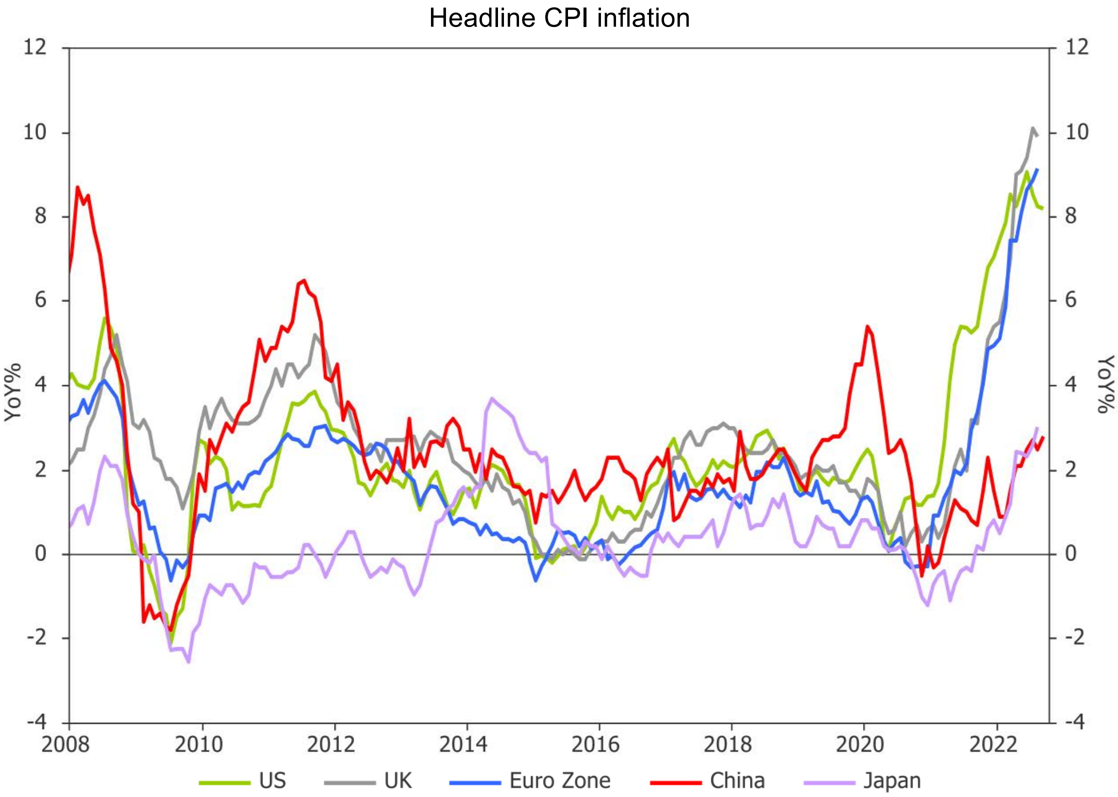
Another key contributor to the great decoupling is the divergent cross-country production-cost pressures (PPI inflation) feeding the inflation pipeline (CPI) at different rates (see Figure 4). For example, dominated by China, Asia, with its relatively better inflation containment, has potentially more policy options to support growth into next year than the West, and can gain greater export competitiveness.

In contrast, the UK and Europe are suffering much greater inflation stress, contributing to significant falls in their currencies and surges in yields. Differentiation across countries, especially Asia versus the West, and the US versus Europe, is likely to create investment opportunities. Countries that are best able to contain inflation and bring it down over time are less likely to suffer sharp rises in yields and much weaker growth.

Figure 4: PPI and CPI inflation pressures across the G5



Source: Refinitiv Datastream, October 2022



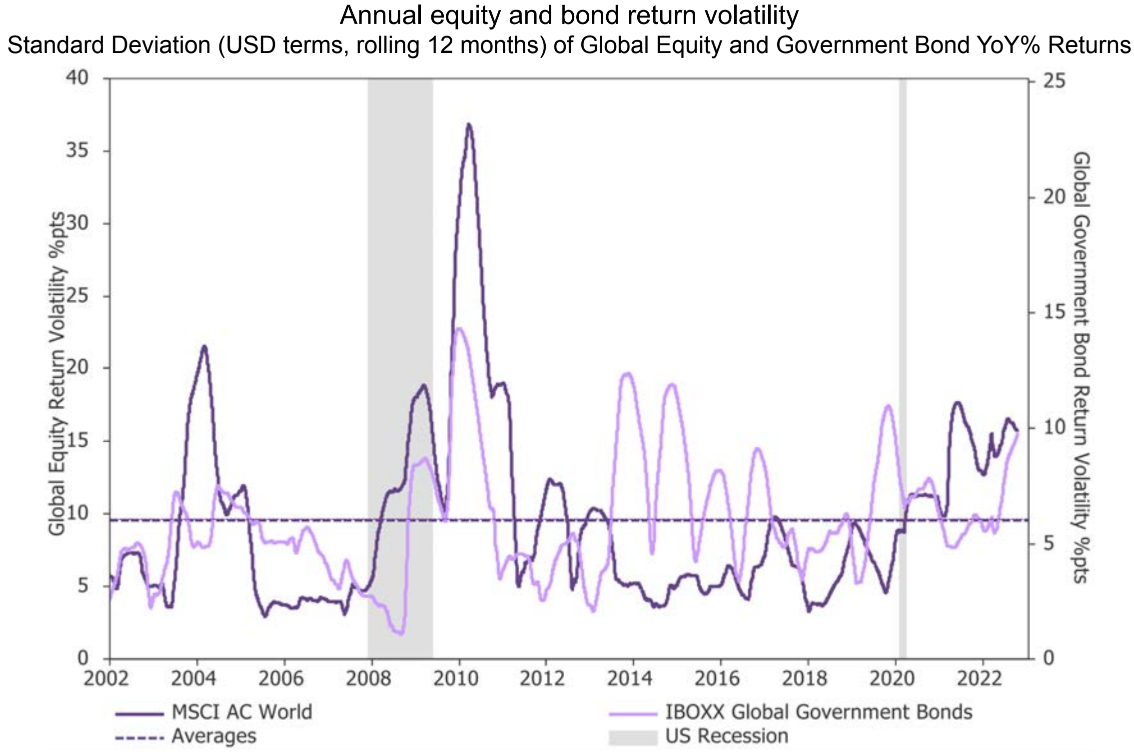
Source: Refinitiv Datastream, October 2022

Investors must also navigate the 'Great Volatility'…

Since 2021 the volatility in global equity returns has surged to its highest levels since the painful debt deleveraging period that unfolded over the years after the recession and Global Financial Crisis (GFC) of 2008-09 (see Figure 5).

More recently, the volatility in global government bond returns has increased back to the levels seen just before the COVID-driven global recession hit, and in the neighbourhood of the volatility experienced during the 2013 'taper tantrum' (where financial markets reacted badly to the tightening in monetary conditions by the US Fed).

Figure 5: Annual volatility in the returns from global equities and bonds



Source: Refinitiv Datastream, October 2022

The increase in global volatility that investors are being forced to navigate likely reflects the challenging economic environment, greater geopolitical risks, and most recently the surge in global real yields. Over September 2022, US real yields spiked by four standard deviations – a jump reminiscent of the 2013 taper tantrum (and the spike in the middle of the GFC).

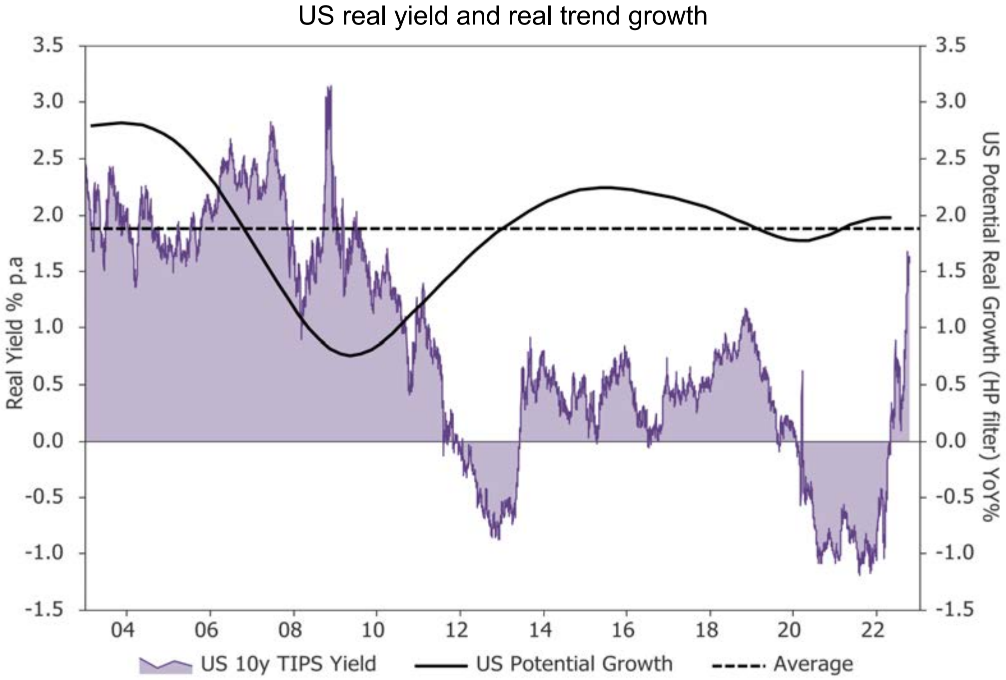
… and the Great Reset

This 'great reset' in global bond yields, driven by Developed Markets (DM) and especially the US, could reflect a shift back to a higher and more appropriate cost of capital, as prevailed during the 'Great Moderation' period prior to the GFC.

We believe the rise in real bond yields is being driven by greater inflation uncertainties (resulting in a higher term premium across bond markets), the potential excess supply of bonds in the pipe-line (especially as key policymakers, like the US Fed, shrink balance sheets), and the fact that US potential growth is holding-up better than expected (at around 2% p.a. See Figure 6).

This rise in real yields creates significant downside risk to earnings growth, valuations, and equity returns. In addition, returns from bonds will likely struggle until yields settle.

Figure 6: US 10y real yield and trend growth

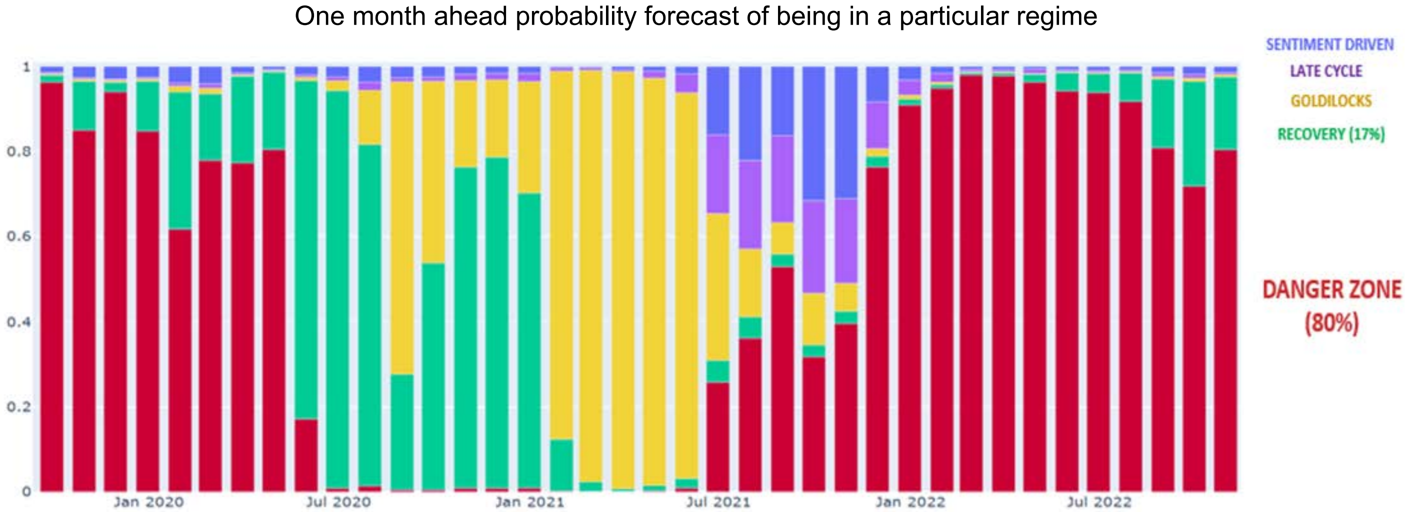


Source: Refinitiv Datastream, October 2022

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 7).

Figure 7: Fullerton's investment environment regime indicator

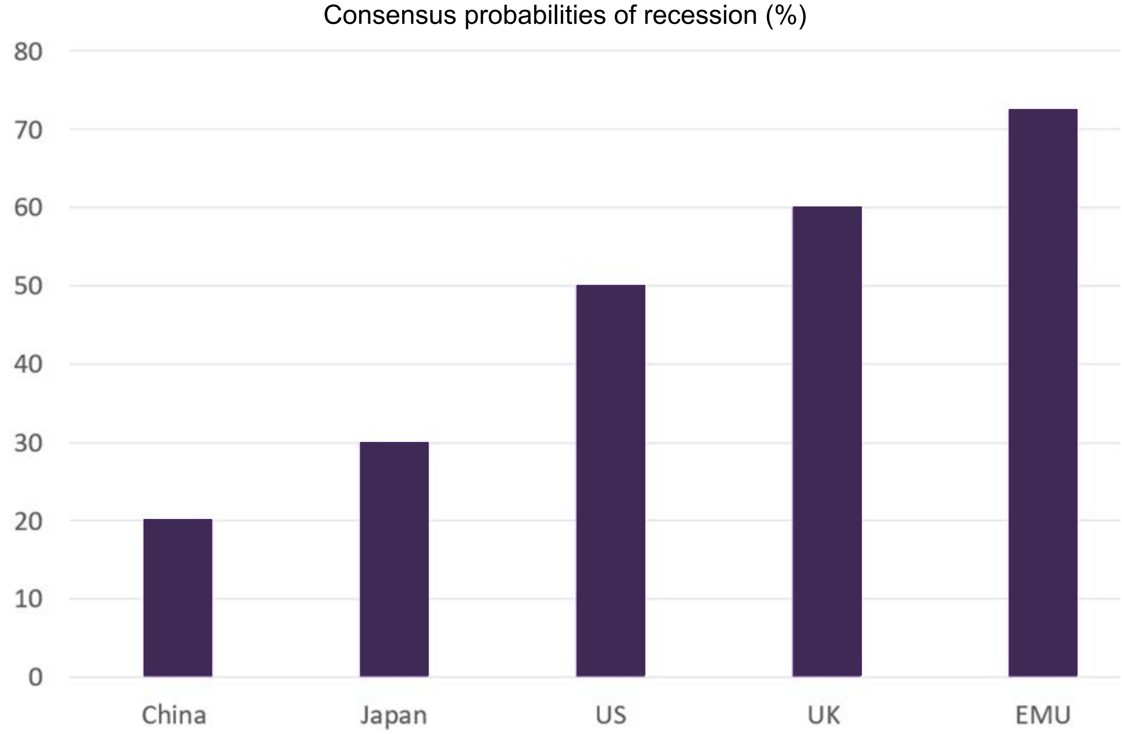


Source: Fullerton, September 2022. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

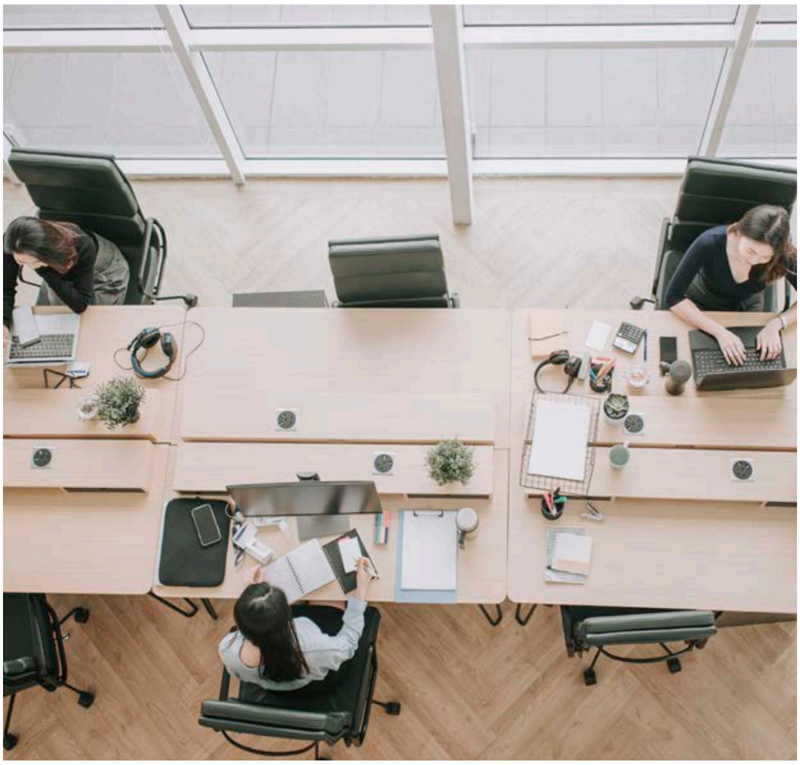
Within this challenging '3G' investment environment, the Consensus has increased the probability of a global recession led by DM, but the US may avoid a painful slump

The Bloomberg Consensus Survey probability of a US recession has increased to 50% from around 30% three months ago (see Figure 8). The Consensus believes there is a greater chance that the European economies fall into recession, as stagflationary stress is much greater there than in the US. Resultantly, bonds and currencies across the EMU and the UK are suffering.

Figure 8: Consensus Survey probabilities of recession



Source: Bloomberg Consensus Survey, September 2022



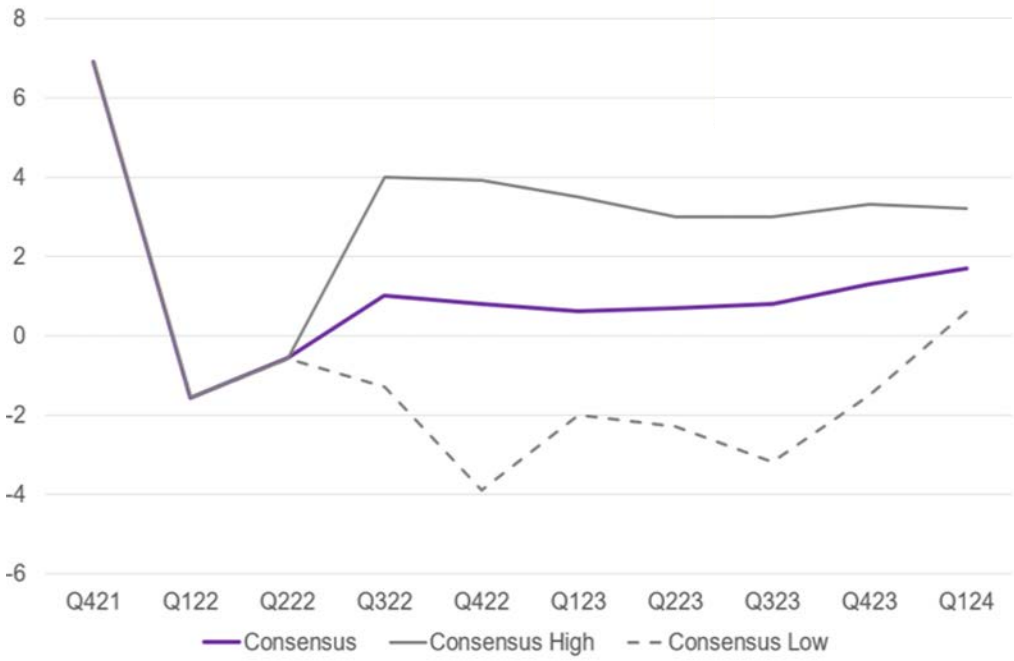
The Bloomberg Consensus majority outlook expects the US 'growth recession' to continue (i.e. where growth is significantly below its 2% p.a. potential) and for a painful recession to be avoided (see Figure 9). In part, this is because the US labour market remains quite robust, combined with corporate profitability holding-up, along with strong bank credit growth, and high levels of household wealth, which are all providing some cushion to spending.

The most bearish Consensus view on the US outlook expects US GDP to fall further this year, and a recession to unfold that is around 'half' a GFC in its intensity (see Figure 9). As we have emphasised for a while, US equity markets have priced-in a lot of bad news already, and current pricing is around the neighbourhood of 'half' a GFC shock (see Figure 9, bottom panel). In addition, current US market pricing signals an equity risk premium, which reflects the jump in yields, of around 4.5% which is also consistent with around 'half' a GFC slump (see Figure 10).

Figure 9: Consensus Survey of US growth scenarios and current US equity market pricing compared to historical bear markets (since 1929)

US real GDP QoQ% SAAR

The GFC had 4 consecutive quarters of falling US GDP with the peak fall being 8.5% (QoQ% SAAR)

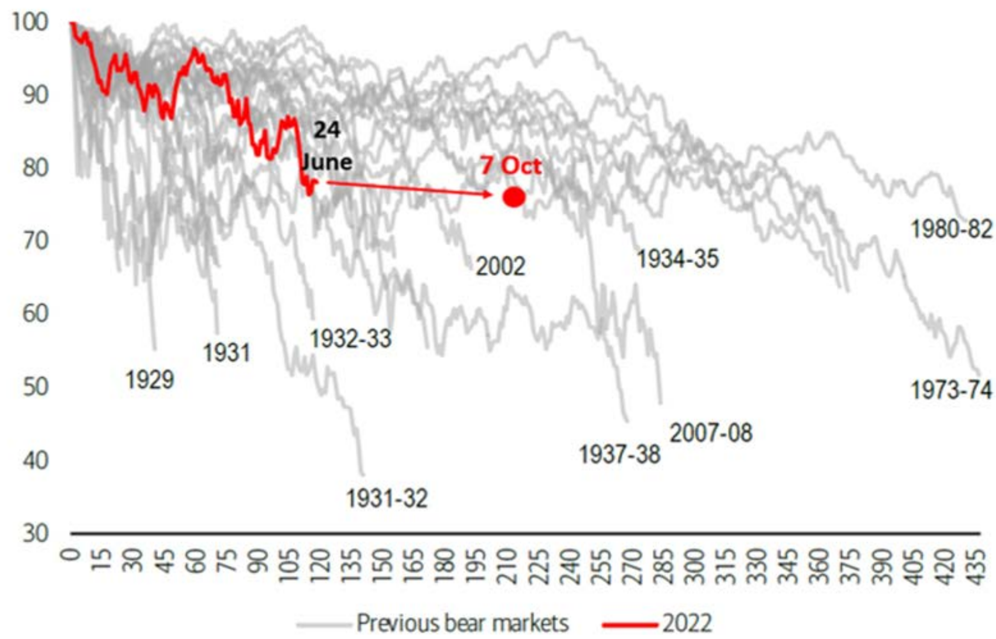


Source: Bloomberg Consensus, September 2022

US S&P500 bear markets since 1929

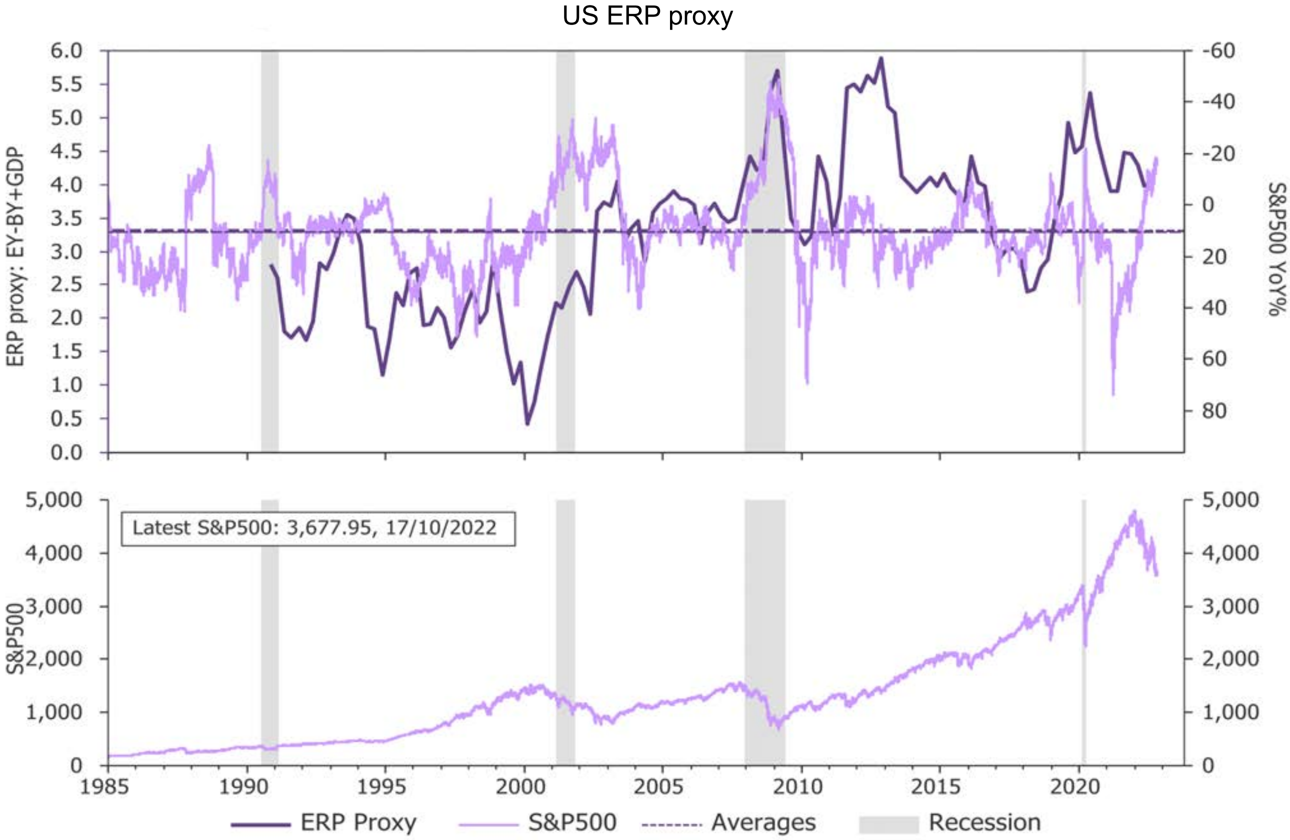
US equities are already down YTD by 'half a GFC' shock

Peak-to-trough declines in historical bear markets (declines of 20%+ without a 20% rally) since 1929



Source: Bloomberg BofA US Equity & Quant Strategy, October 2022

Figure 10: US equities and the equity risk premium (ERP)



Source: Refinitiv Datastream, October 2022

These are encouraging indicators for investors, but the likely bottoming process for US equities may remain volatile, and higher interest rates are a key risk

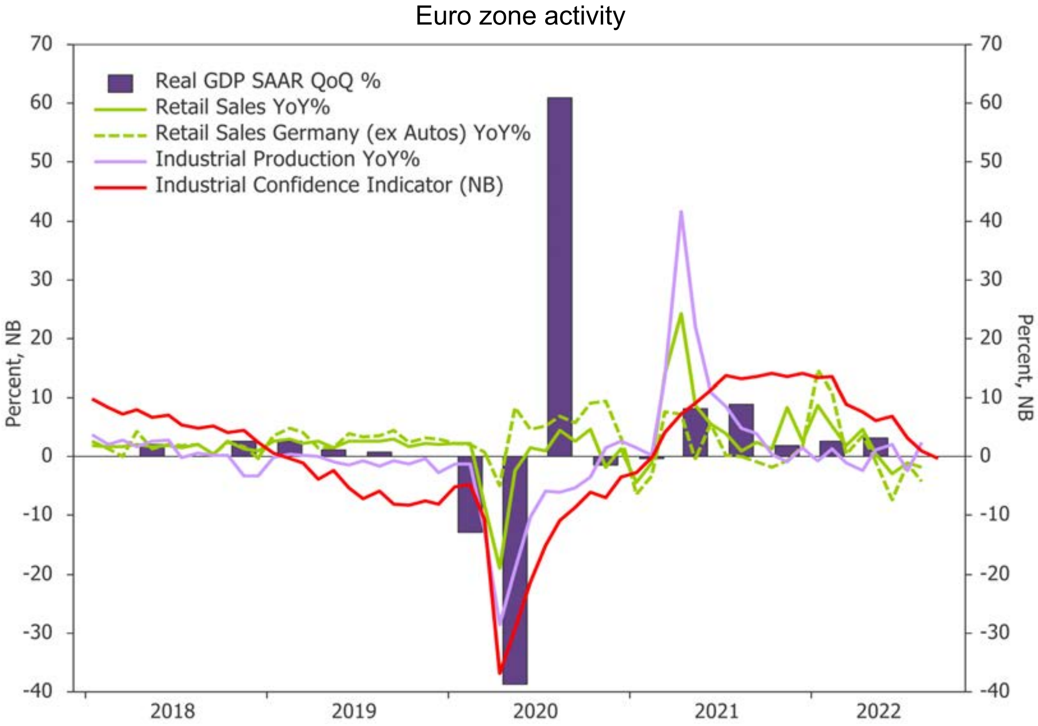
All these indicators are encouraging signs for investors as it may limit the amount of potential downside in US equities. We believe, with mounting evidence that US inflation has peaked, and with that, US equities can continue through a bottoming process into Q1 of next year.

However, this bottoming process is likely to be volatile, and further downside before stabilisation can't be dismissed, given the sharp rise in bond yields and the impact of tighter Fed policy still to be felt by the US economy.

We are more negative on Europe than the US

Consistent with the Consensus view, we are also more negative on Europe (than the US) and the latest activity data does suggest very high inflation, especially for producers, which may push the EMU into recession this year (i.e. German retail sales are falling and the leading indicator of industrial sector confidence has fallen to zero. See Figure 11).

Figure 11: EMU key activity indicators

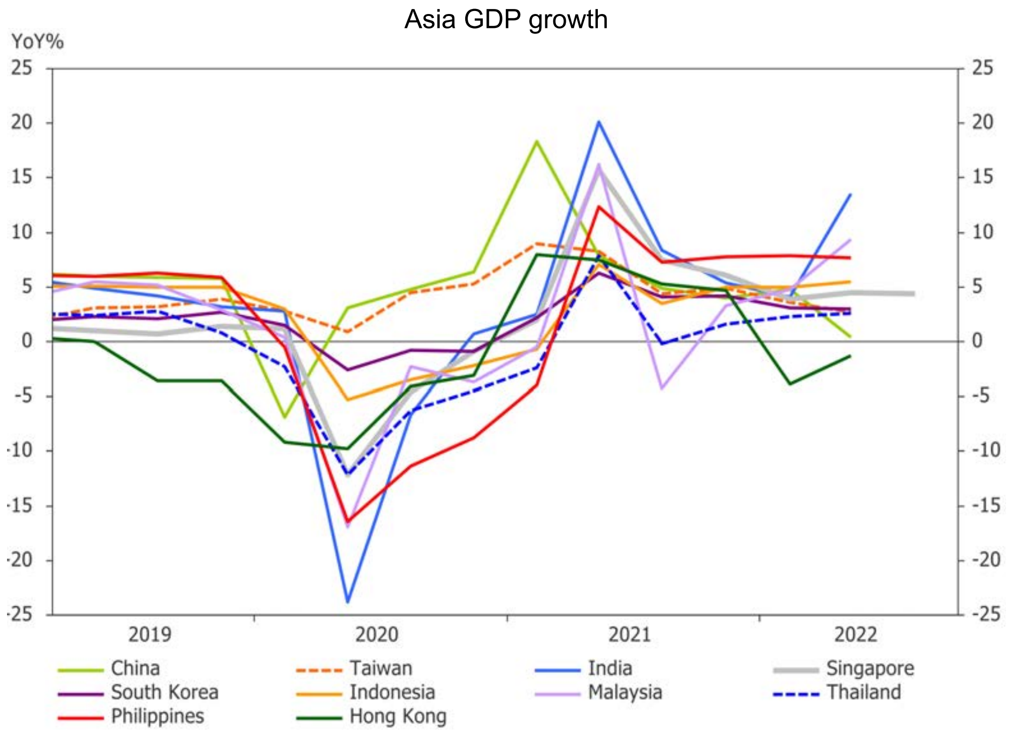


Source: Refinitiv Datastream, October 2022

Economic indicators across Asia are more positive

Excluding China, growth across Asia is holding-up better than anticipated, especially across India, Indonesia, Malaysia, and Singapore (see Figure 12). In part, this reflects the region being able to contain inflation, which has helped support export competitiveness, with the added boost of the strong USD (vis-à-vis weaker Asian currencies). Asia's share of global trade remains on a stronger footing than non-Asian emerging markets and this should help support Asia's growth into next year.

Figure 12: Growth across Asia



Source: Refinitiv Datastream, October 2022

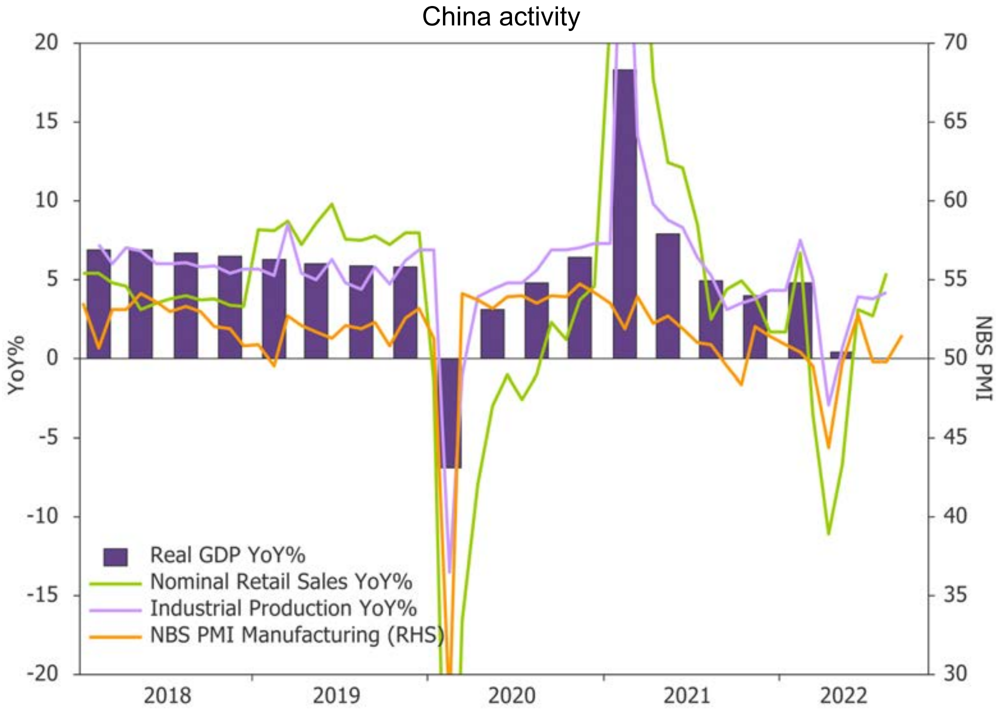
China still has significant headwinds to navigate, but further downside risks to its growth this year may be limited as the latest activity indicators were stronger than expected

President Xi's opening remarks at China's 20th National Congress of the Communist Party (NCCPC) have reinforced the need to sustain national security, especially in defending supply-chains, and the importance of ensuring social stability with high-quality growth (under the 'common prosperity' theme).

China's policy directions are certainly consistent with the 'great decoupling' we have outlined, especially its domestic focus and more onshoring to defend supply-chains and foster higher quality growth. As such, we believe the Party congress this year is unlikely to be an inflection point for any major policy changes.

China's recovery into next year will take time, especially for the stimulus already in the pipe-line to get greater traction, to move back toward its potential growth (of around 5% p.a.). Encouragingly, the latest activity data has been stronger than anticipated, especially retail sales, PMI, and industrial production (see Figure 13). These rebounds should help reduce any further significant downside risks to growth this year.

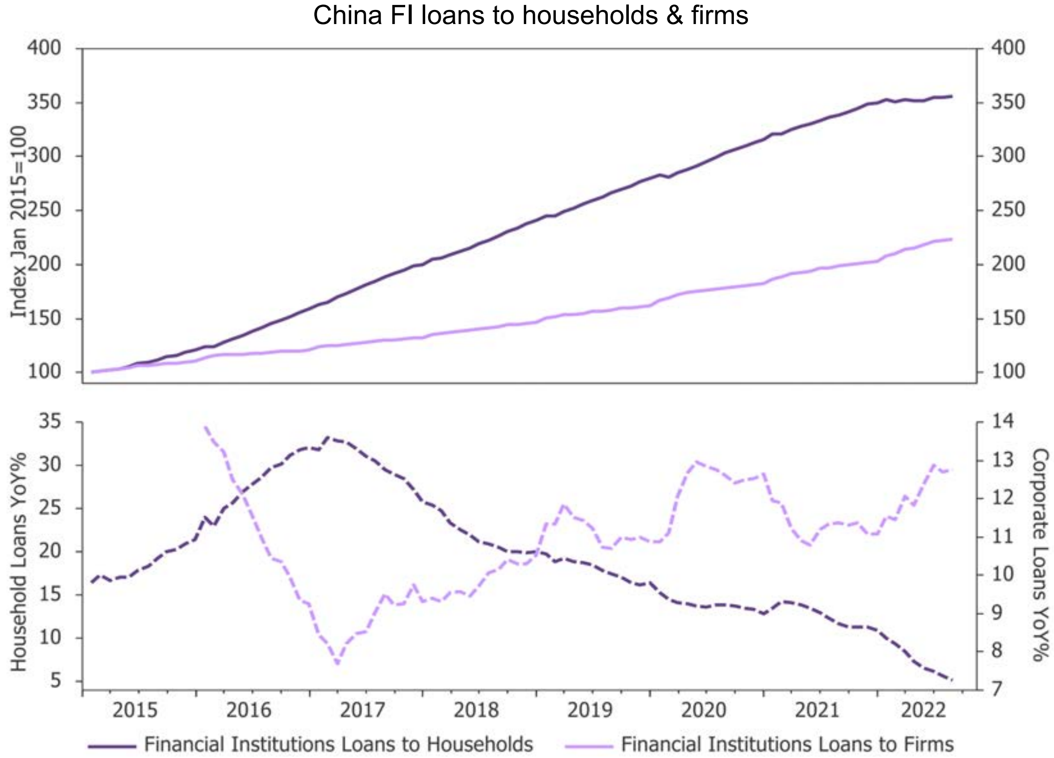
Figure 13: China's key activity indicators



Source: Refinitiv Datastream, October 2022

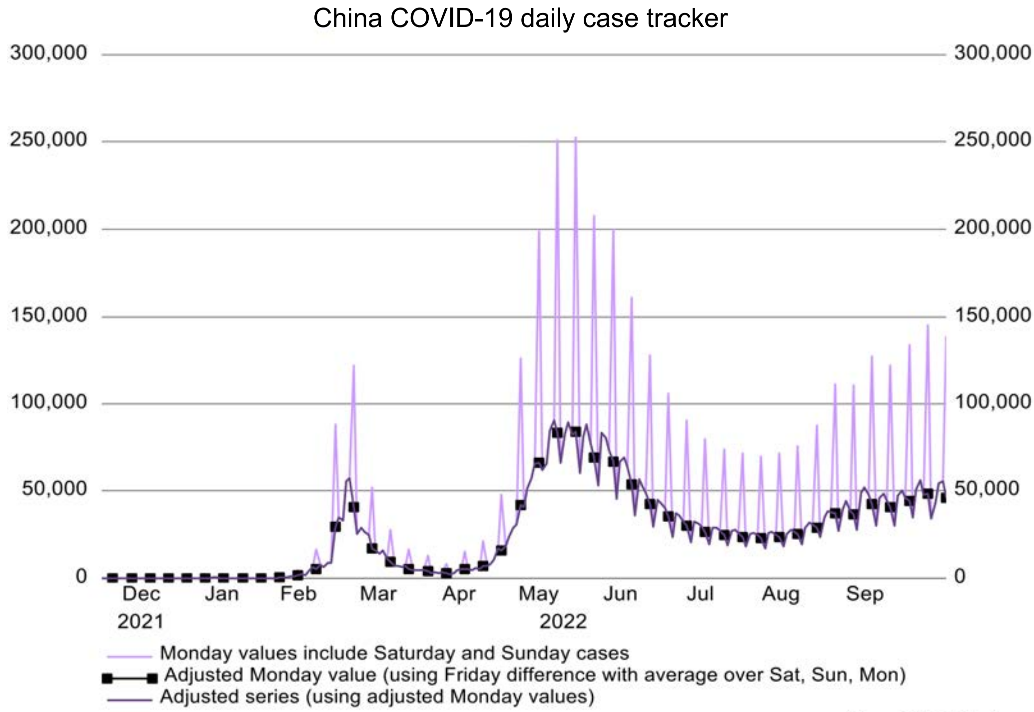
However, China's policymakers still face the significant challenge of converting ample liquidity into stronger credit growth, especially for households (see Figure 14), and balancing economic activity with its COVID control policies, given China's COVID cases are rising again (see Figure 15).

Figure 14: China's credit growth to households and firms



Source: Refinitiv Datastream, October 2022

Figure 15: China's COVID cases



Source: Refinitiv Datastream, October 2022

2. Investment strategies for a 3G environment

We maintain our view from Q3 2022 that the outlook for risk assets is negative, especially as global central banks' fight against high inflation has become more intense.

Figure 16: Summary of Fullerton's views

	Bearish	Negative	Positive	Bullish
Risk Asset Returns		✓		
Asia Equity		✓		
China-A Equity		✓		
Global Equity		✓		
Asia IG Credit		✓		
Asia HY Credit		✓		
US Bonds		✓		
US Dollar			✓	
Oil Prices		✓		

Source: Fullerton Fund Management, October 2022. Views may be subject to change without prior notice.

To navigate challenging financial markets, investors need to make sure they are comfortable with their degree of leverage and risk exposure, with sufficient defensive strategies in place to manage downside risk.

That implies making sure there are enough holdings of assets like gold, and to a lesser extent cash (denominated in USD), that can provide some insulation against high inflation and further downside to growth. Gold, in particular, has performed strongly against other traditional safe-haven assets this year, which is a trend we believe can continue given sustained geopolitical risks. Investors can also consider having some spare liquidity on hand to deploy, to take advantage of any opportunities that may unfold.

Equities – we remain negative, but regions are differentiated, exacerbated by the 'Great Decoupling', which can create investment opportunities

In navigating this '3G investment environment' opportunities can be created by the Great Decoupling – i.e. countries that are best able to contain and tackle inflation over time can benefit from stronger earnings growth and equity performance.

Regardless of whether a recession occurs or not, it is paramount for investors to remain vigilant for relative trade opportunities across both sectors and countries, because some will achieve better real returns than others. In our view, countries are differentiated, which is likely to continue to provide attractive alpha opportunities.

US is stronger than Europe

The US is the region we remain the most constructive on, as compared to the rest of DM, given its labour market is holding-up well. Within DM, the US appears to have the greatest likelihood of a growth recession continuing (i.e. weak growth that is below potential, but still positive). The constructive view is also conditional on the Fed having finally signalled enough tightening to tackle inflation. Furthermore, the US faces significantly less headwinds than Europe from adverse stagflationary forces, especially across the production sectors. As a result, US equities may enjoy relative upside, especially if a recession in Europe unfolds soon.

China is showing signs of improving, but still has headwinds to navigate, and our outlook remains negative

China is also showing some early signs of improvement, but any recovery is likely to take time, and could be weaker than expected. That said, potential opportunities can arise for investors during this 'rebuilding' phase for China, as it tries to recover back toward its potential growth. For example, China's value stocks are likely to continue to outperform growth stocks, at least until there is greater clarity on the strength of growth next year (see Figure 17).

Figure 17: China's key equity sectors

Source: Refinitiv Datastream, October 2022

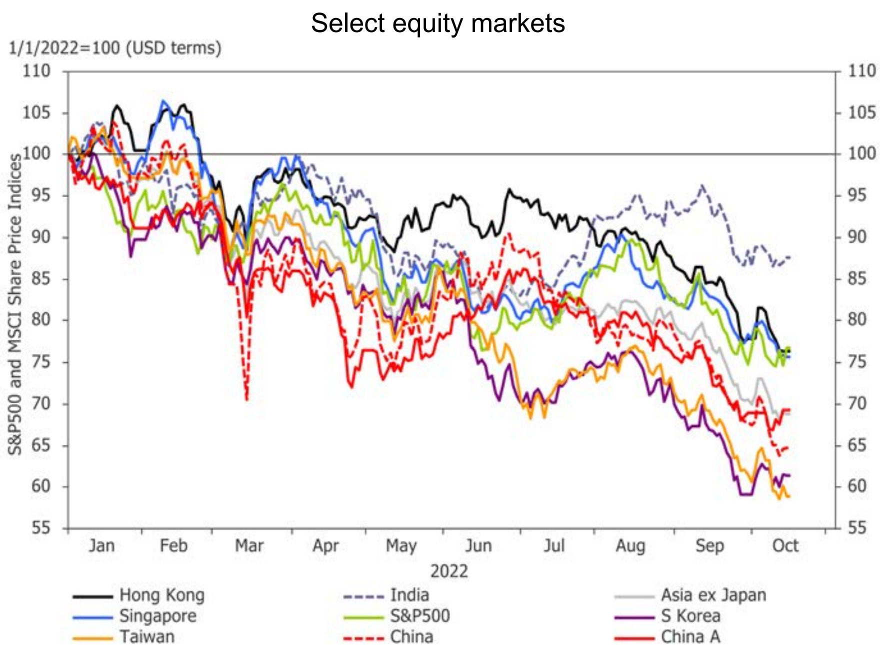
Notwithstanding our negative view on China, there are tentative signs that the real-estate debt deleveraging process may be commencing a bottoming out process (see Figure 35, and Box Item: An early look ahead to 2023).

India also appears to be an early benefactor of the 'Great Decoupling'

Another good example of country differentiation making a difference, especially across this challenging global macro environment, has been the performance of India's equity market. Relative to the rest of Asia, India has outperformed YTD (see Figure 18), which may reflect its strong GDP growth over 1H22, and declines in oil prices.

In addition, while India's inflation is around the highest in Asia, its policymakers have been sufficiently pre-emptive to tighten when required. Further evidence of India's strong fundamentals is that India's yields have remained broadly stable, despite the intensity of the DM bond sell-off and USD strength. Finally, another factor that may have contributed to India's attraction for global investors is the ability to diversify away from geopolitical concerns surrounding China and the US.

Figure 18: Asia and US equity market performance



Source: Refinitiv Datastream, October 2022

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

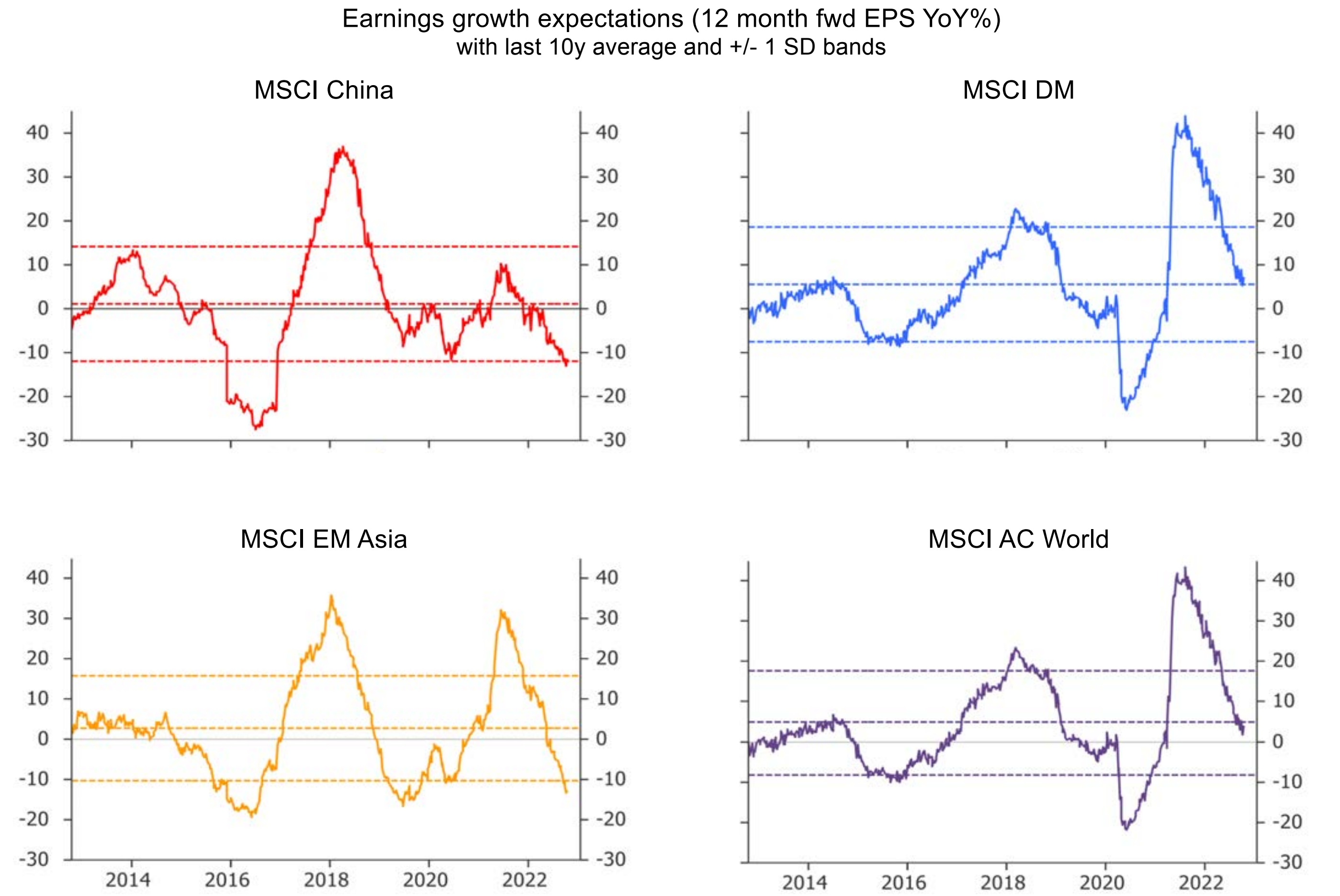
We continue to favour global sectors capable of generating alpha where key drivers have followed a positive trend for many years such as: rising per capita incomes driving stronger demands for technology, e-commerce, consumerism, healthcare, and financials. Renewables are also likely to remain an important source of alpha, as infrastructure spending continues to rise with the 'green transition' and as demands for alternative energy gather further momentum.

Given that downside risks have increased with the rise in real yields – i.e. the 'Great Reset' - we believe there is still further scope for defensive stocks to outperform

The significant rise in real yields across DM, and especially the US, increases the downside risk to earnings growth expectations which could undershoot their average (see Figure 19).

Excluding China, growth across Asia is holding-up better than anticipated, especially across India, Indonesia, Malaysia, and Singapore. The market has priced-in significant downside to Asian earnings expectations, and may now be seeking greater clarity on the bottoming process, and how robust China's rebound into next year can be.

Figure 19: Earnings growth expectations across the key regions

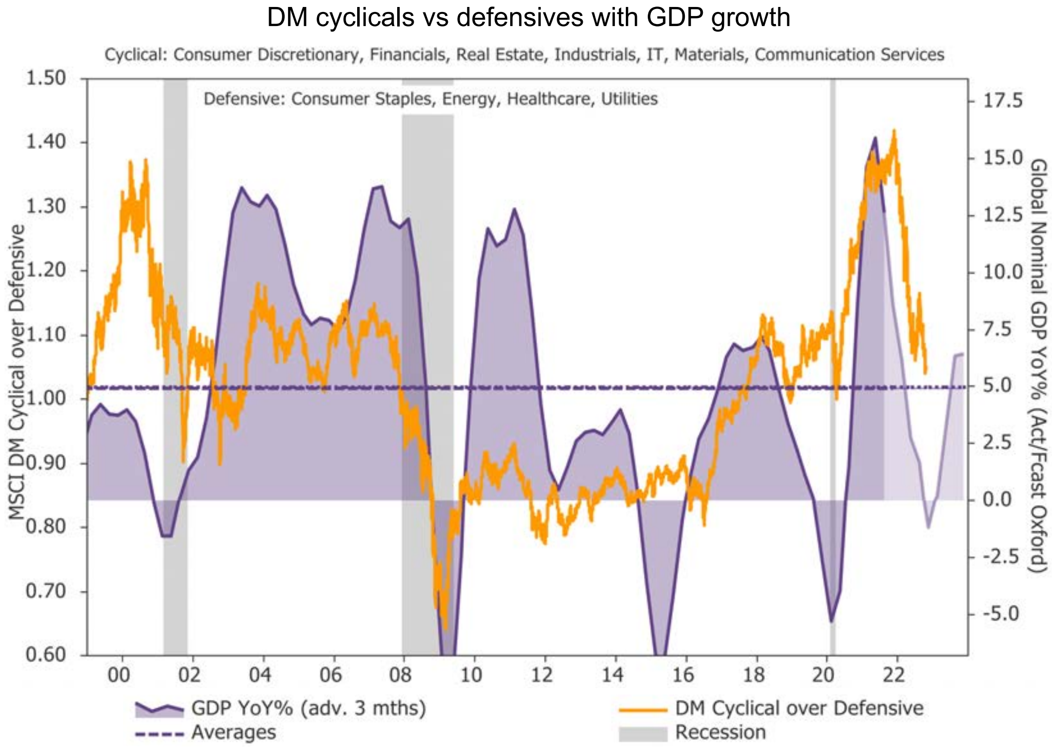


Source: Refinitiv Datastream, October 2022

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. In our view there is still further scope for defensive stocks to outperform, given higher real yields and recession risks (defensives could beat its long-term average relative performance to cyclicals. See Figure 20).

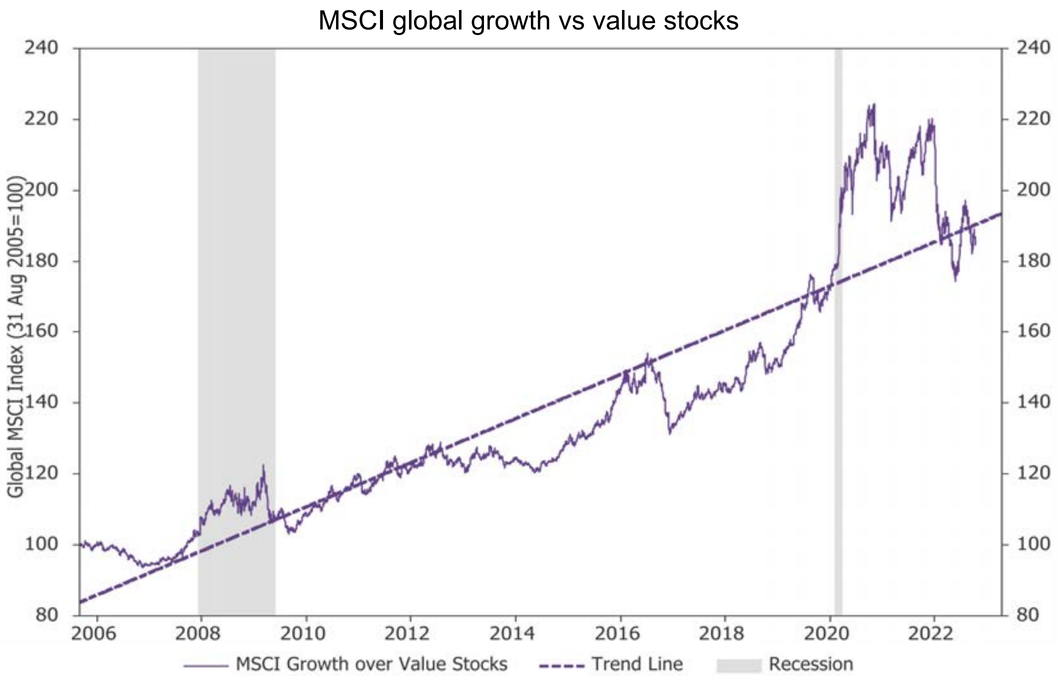
We still believe that growth stocks are progressing through a bottoming process, fluctuating around trend (see Figure 21). As headwinds fade and yields settle, growth stocks are still likely to provide the most attractive alpha opportunities long-term, as they rebound and then sustain their positive performance trend.

Figure 20: Performance of DM defensive vs cyclical equities with growth expectations



Source: Refinitiv Datastream, October 2022

Figure 21: Performance of global growth stocks relative to value stocks



Source: Refinitiv Datastream, October 2022

Fixed-income – we remain negative on duration as yields could overshoot

We remain negative on duration of DM and US government bonds, as there could still be some overshooting to come through for real yields. If a global recession unfolds then government bonds are an obvious asset class to potentially benefit as yields may fall back with weak growth.

In general, returns from Asian USD government bonds have struggled because of the significant appreciation of the US dollar, and unfortunately dollar strength is likely to remain a key headwind for a while. However, that said, with the rise in yields possibly being more conservative going forward, investors that buy-and-hold to maturity may start to lock-in potentially more attractive income streams (not just across Asian bonds, but also across DM).

In addition, Asian Investment Grade (IG) Quasi Sovereign bond returns have outperformed Asian IG corporate and High Yield (HY) credit this year, and this trend may continue as sovereign bonds can give some protection against possible corporate sector headwinds, such as weaker growth and default risks.

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

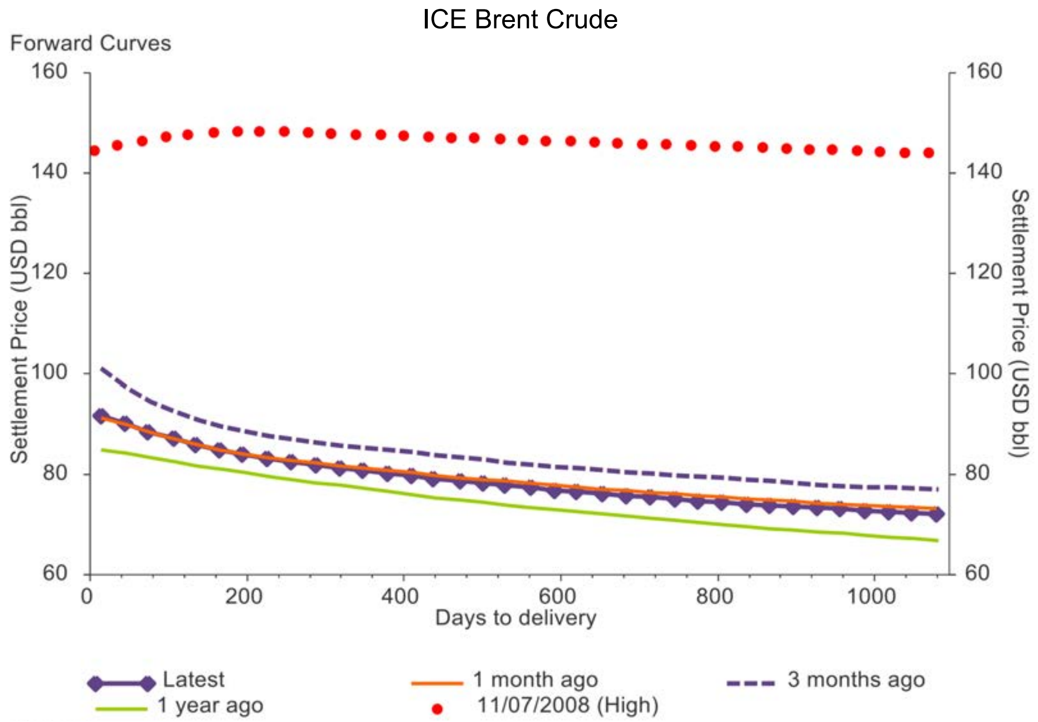
The strong outperformance of Asian IG corporate credit over HY has continued this year, as HY has suffered relatively more from weaker growth and a drag from China's real-estate sector. We believe Asian IG corporate credit can hold its outperformance advantages, especially if growth weakens further with tighter monetary conditions, as IG companies tend to have strong balance sheets.

For corporate bond investors across Asia, the sectors we like the most remain those that have outperformed the broader corporate credit market this year i.e. infrastructure, new industrials, and financials. We believe that these sectors have positive long-term drivers, and can rebound faster in challenging environments. Furthermore, some of these sectors may receive additional boosts from greater geopolitical risks. For example, as countries step-up infrastructure investment to defend supply-chains, and move faster to renewable energy, there could be ensuing investment opportunities that follow.

Commodity prices are likely to remain weak with global demand destruction and recession concerns, but prominent geopolitical risks and supply tightness may reduce some of the downside risk to oil prices

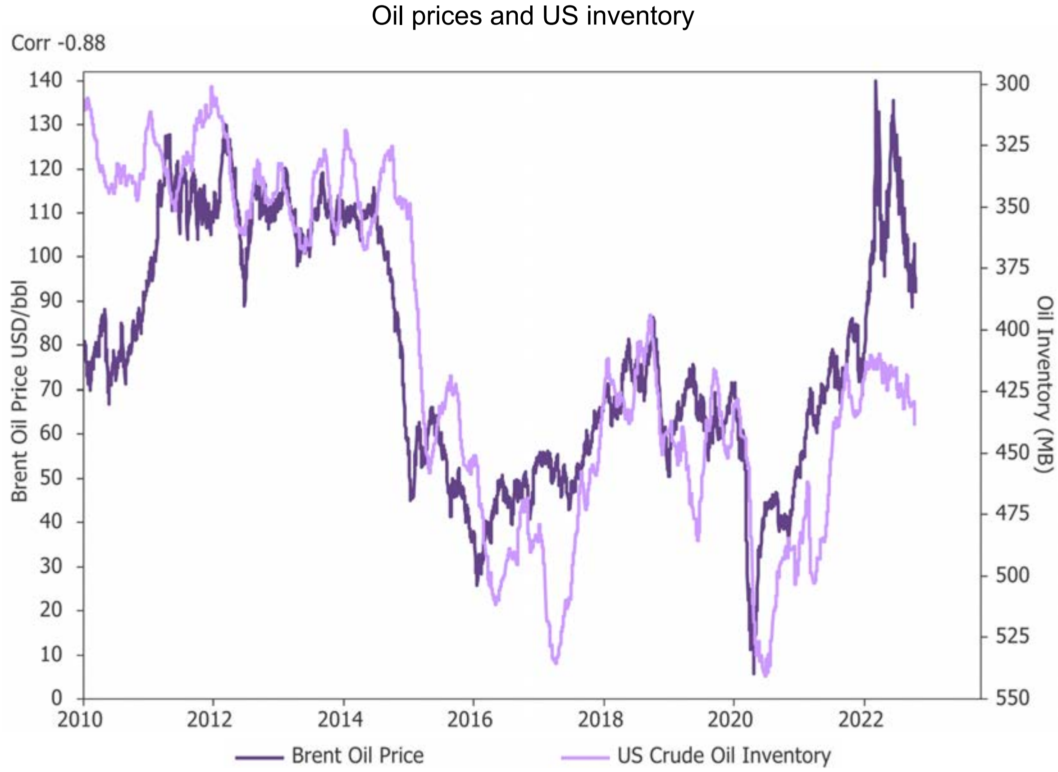
Oil prices have fallen significantly on global demand destruction and rising inventories, but cuts in supply may help provide some floor to prices. Longer-term fundamentals, like forward market expectations (which have been stable for a year now) and inventory levels, continue to signal around $70 USD/bbl as a fair oil price, with geopolitical risks likely to add a premium (see Figures 22 and 23).

Figure 22: Oil market forward price expectations (up to 3 years ahead)



Source: Refinitiv Datastream, October 2022

Figure 23: Oil prices and US inventory

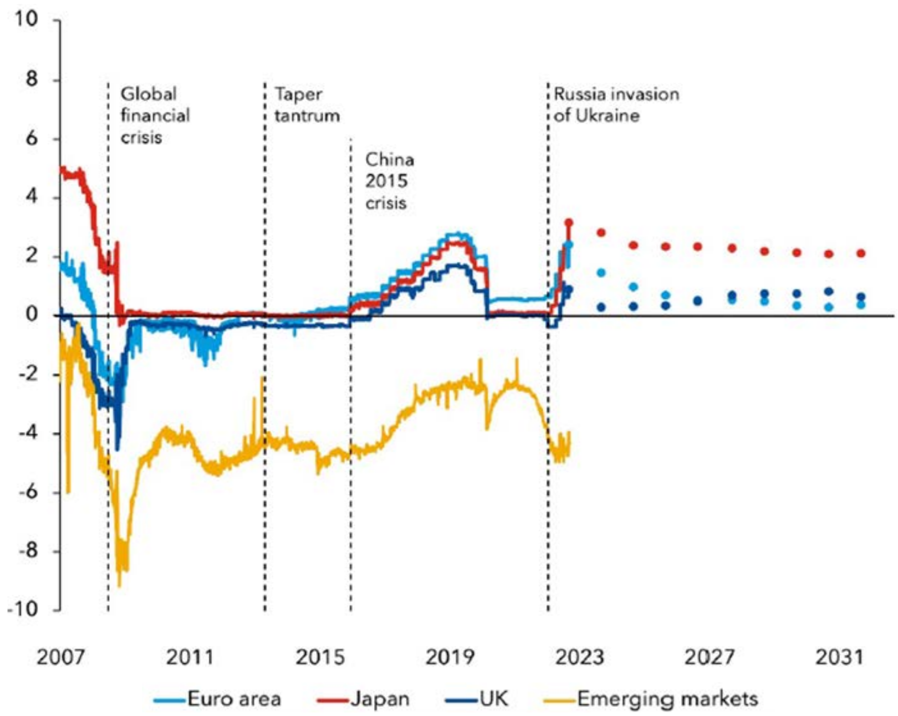


Source: Refinitiv Datastream, October 2022

We maintain our positive outlook on the US dollar

The USD can continue to benefit from the strong US terms of trade, tighter monetary policy by the Fed (which provides an attractive rate differential - see Figure 24), and safe-haven flows concerned about volatility, geopolitical risks, and a global recession.

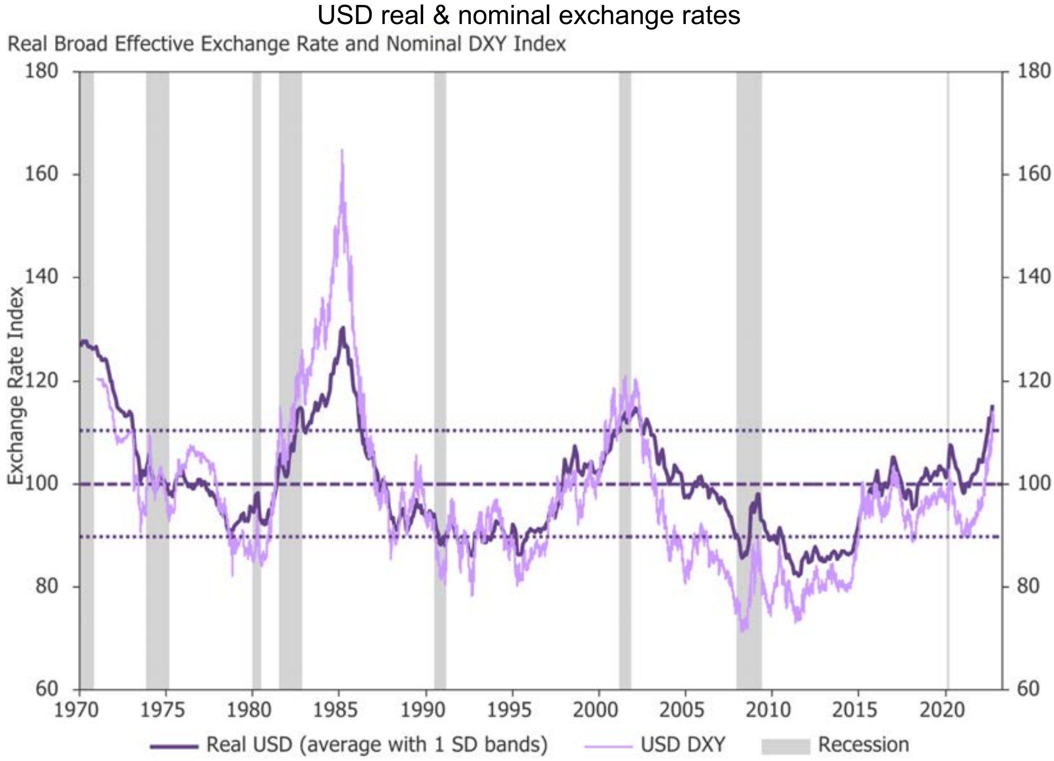
Figure 24: Interest rate differentials are an important driver of USD strength



Source: IMF, October 2022. Actual/IMF forecasts, versus US interest rates in percent. The more positive the differential, the stronger the USD against the depicted currency

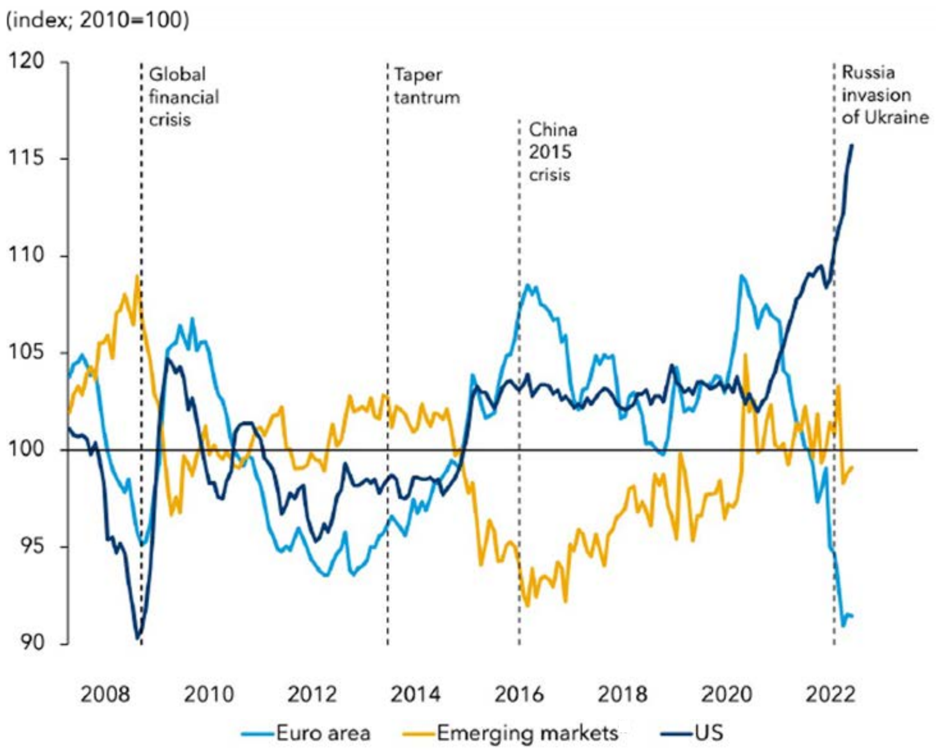
With such supportive fundamentals it appears that the USD may only experience pressure to depreciate if its value becomes too stretched (see Figure 25). The USD is now more than 1 Standard Deviation (SD) expensive, however valuations can overshoot significantly, especially given the size of the positive terms of trade shock the US is enjoying (See Figure 26).

Figure 25: USD valuation (100 is the long-term average with +/- 1 SD)



Source: Refinitiv Datastream, October 2022

Figure 26: The huge outperformance of the US terms of trade is a key driver of USD appreciation



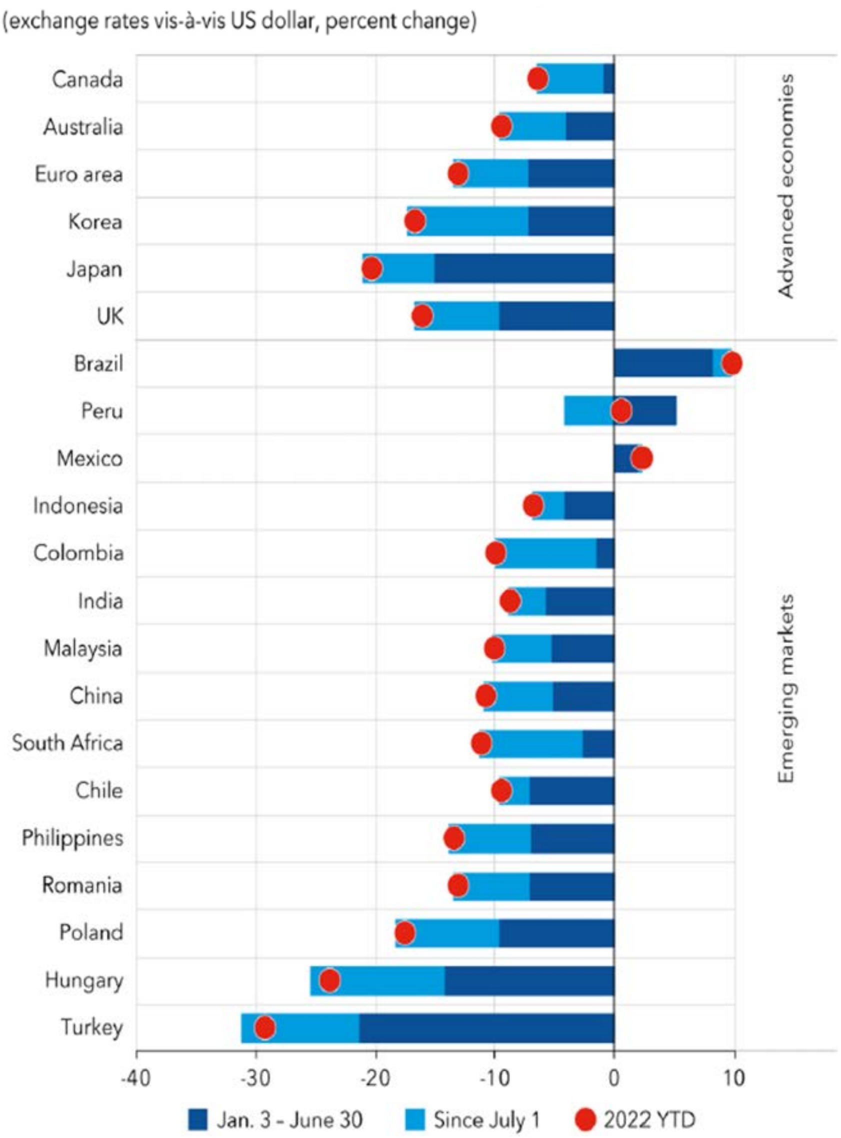
Source: Terms of trade indices, IMF, October 2022

The strong USD does not seem to be stressing Asia too much

The very strong USD does not seem to be significantly stressing financial stability across Asia, but it is having a much bigger adverse impact on other DM. The disequilibria unfolding across global currency markets is symptomatic of 'the Great Decoupling' we have highlighted: inflation and policy response differentiation is creating opportunities for fundamentally-focused investors.

The countries that are best able to contain inflation by tightening monetary policy pre-emptively enough, with orthodox policies (especially fiscal prudence), are being rewarded by investors with stronger relative performance. (see Figure 27).

Figure 27: Currency shifts against the USD



Source: IMF, October 2022

For example, countries judged not to have tightened monetary conditions sufficiently to drive the disinflation process have suffered significant falls in their currencies and/or increases in their 10y yields e.g the UK, Japan, and the EMU (Greece and Italy, in particular, have seen significant rise in their bond yields).

In contrast, there has been no material adverse impact across Asia (ex-Japan) in part because the region is following generally orthodox policies and as such, successfully containing inflation (an exception being South Korea, but its policymakers have now turned increasingly hawkish).

Often in the past, with such a strong USD, we would see significant financial outflows and large depreciation across Asian countries (and large increases in bond yields). However, Asia has evolved significantly over the last decade or so, with inflation targeting, more robust balance of payments positions, and stronger fundamentals, mitigating extreme currency weakness against a backdrop of a very strong USD.

Box Item: An early look ahead to 2023 – some key signposts for a more positive investment environment

Here, we highlight three key developments across the macro economy, in the US and Asia, which if realised, may drive a more favourable investment environment in 2023. These developments are:

- (1) **Confirmation that US inflation has peaked.** US forward-market longer-term inflation expectations are around normal, and if no more significant upside comes through in inflation and wages, then this would be a positive development. If peak inflation is realised, 62 years of historical experience suggests that as US equities progress through its bottoming process, a positive equity trend may re-emerge with time, even if volatility continues and lows are re-tested (Source: UBS. See Figure 32).
- (2) **Planned policy proves tight enough to bring inflation down.** If inflation has peaked, then planned US monetary conditions, as signalled by the Fed in September, may finally be tight enough to bring inflation down next year as projected, which should boost investor confidence.
- (3) **Early positive signs that the debt deleveraging process in China's real-estate sector may be bottoming, along with home sales**.

In contrast, some of the more significant downside risks next year are:

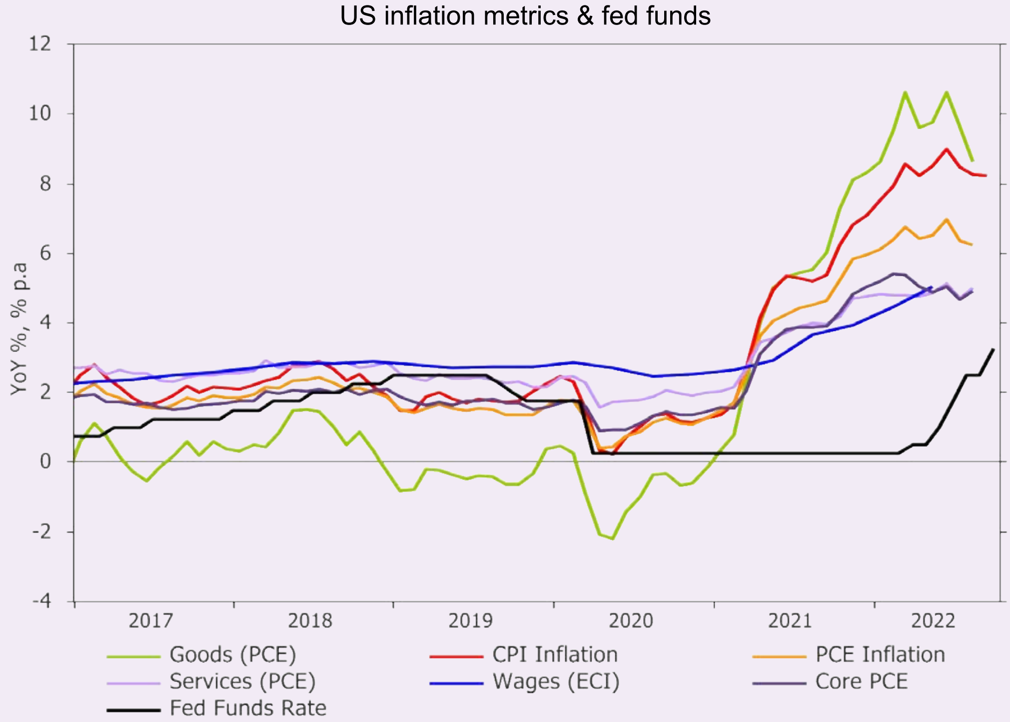
- (1) **A global recession** that is more painful than currently expected by the Bloomberg Consensus Survey and priced-in by US equity markets. This could be sparked by disinflation continuing to disappoint, and key central banks responding by raising rates by more than expected.
- (2) **The factors surrounding the '3G investment environment' described earlier** leading to a significant and sustained overshooting in real yields.

(1) Confirmation that US inflation has peaked.

There is emerging evidence that US inflation has peaked, as goods price inflation is falling (see Figure 28). As this gathers traction it will further drag down aggregate PCE inflation[1]. As supply constraints continue to ease, coupled with lower oil prices, and a strong US dollar, then disinflation should gather pace (see Figure 29).

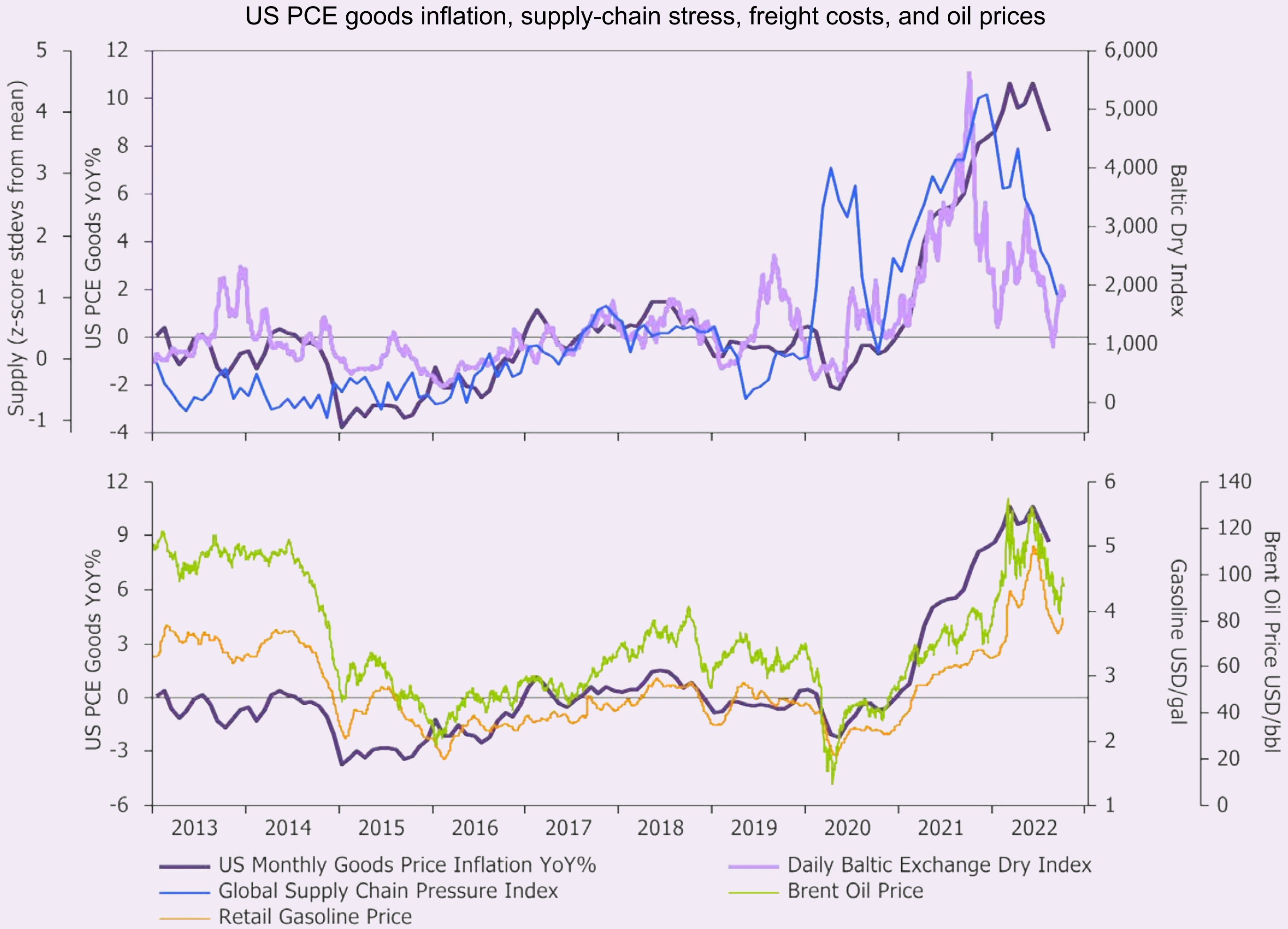
[1] The 'decoupling' between CPI and PCE inflation is not concerning, and is basically technical in that the CPI does not adjust fast enough to shifts in household spending patterns when inflation is high (e.g as excess demand for relatively expensive goods eases, goods price inflation falls, which PCE reflects better than the CPI). That is one reason the Fed favours the PCE measure, and also PCE inflation tends to have a stronger statistical relationship with investment returns (than the CPI). Eventually PCE and the CPI will recouple again, as is the historic norm pre-2020.

Figure 28: US inflation measures and the Fed Funds Rate



Source: Refinitiv Datastream, October 2022

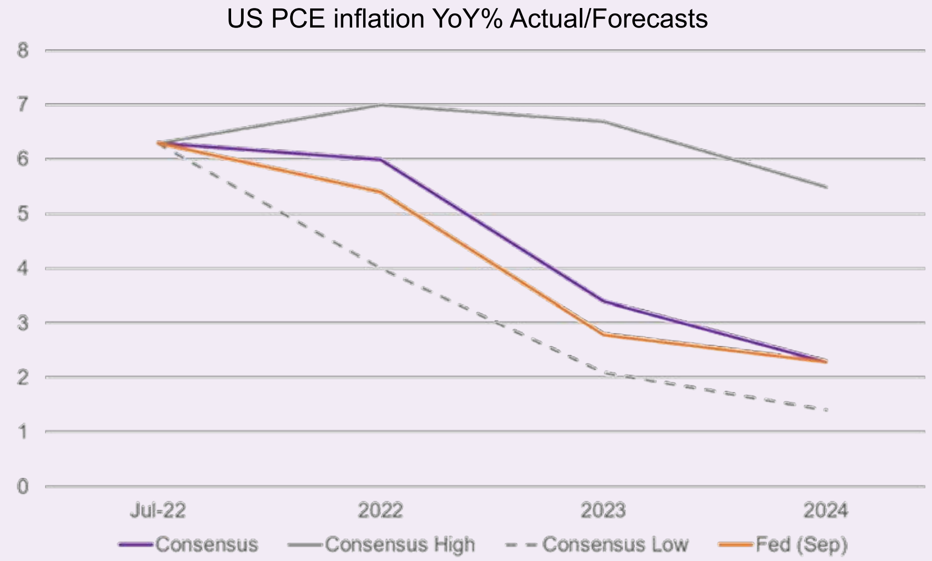
Figure 29: US goods inflation, supply-chain stress, freight costs, and oil prices



Source: Refinitiv Datastream, October 2022

The US output gap has turned more negative over Q2 (with growth significantly below potential). With the Fed's 2H22 rate hikes coming into play, this may help bring greater disinflationary forces to the fore (especially to the prices of services). The Consensus and the Fed (from its September forecasts) expect the same degree of disinflation next year (i.e. a decline of 2.6% pts to 3-3.5% YoY), which if realised, will certainly boost investor confidence (see Figure 30).

Figure 30: US Consensus and Fed inflation forecasts

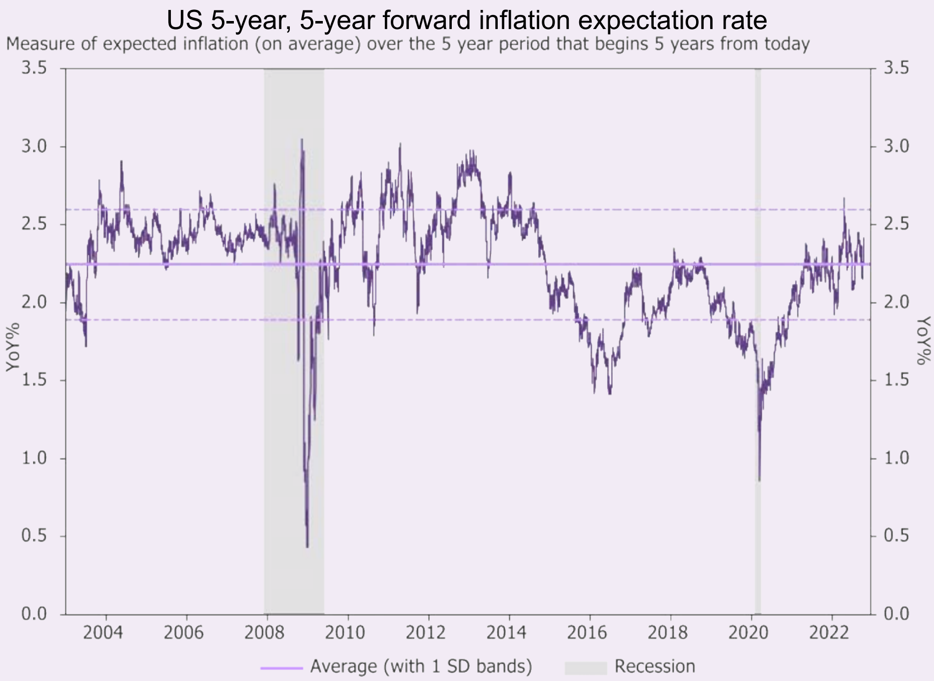


Source: Bloomberg Consensus, FOMC Projections, September 2022

Despite inflation being higher for longer than anticipated, market-based inflation expectations remain well-anchored and this will also help the disinflation process (see Figure 31).

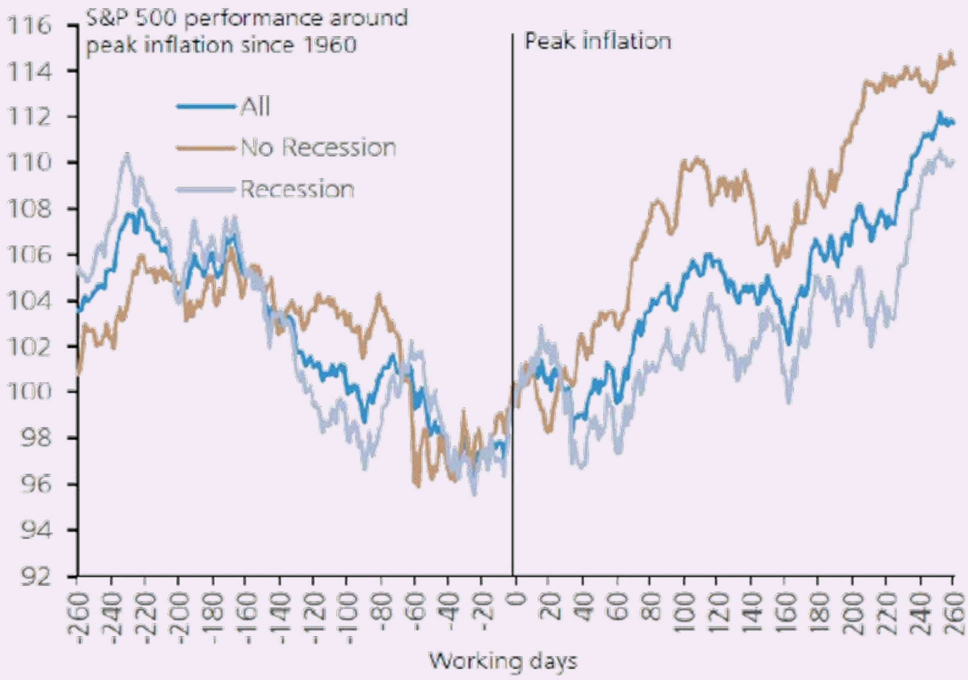
Signs of inflation peaking is a key signpost for investors as this often marks an eventual turning-point for equity market performance (see Figure 32). Even in a recession scenario, equity lows can be re-tested and we do believe that is possible through this bottoming process, especially given the significant rise in interest rates that has occurred. However, a positive trend can eventually return to equities, provided inflation has peaked (and monetary conditions have tightened sufficiently to bring it down).

Figure 31: US inflation expectations are still well-contained



Source: Refinitiv Datastream, October 2022

Figure 32: US equity market performance around inflation peaks in recession and non-recession outcomes (since 1960)



Source: UBS, September 2022

(2) Planned policy proves tight enough to bring inflation down

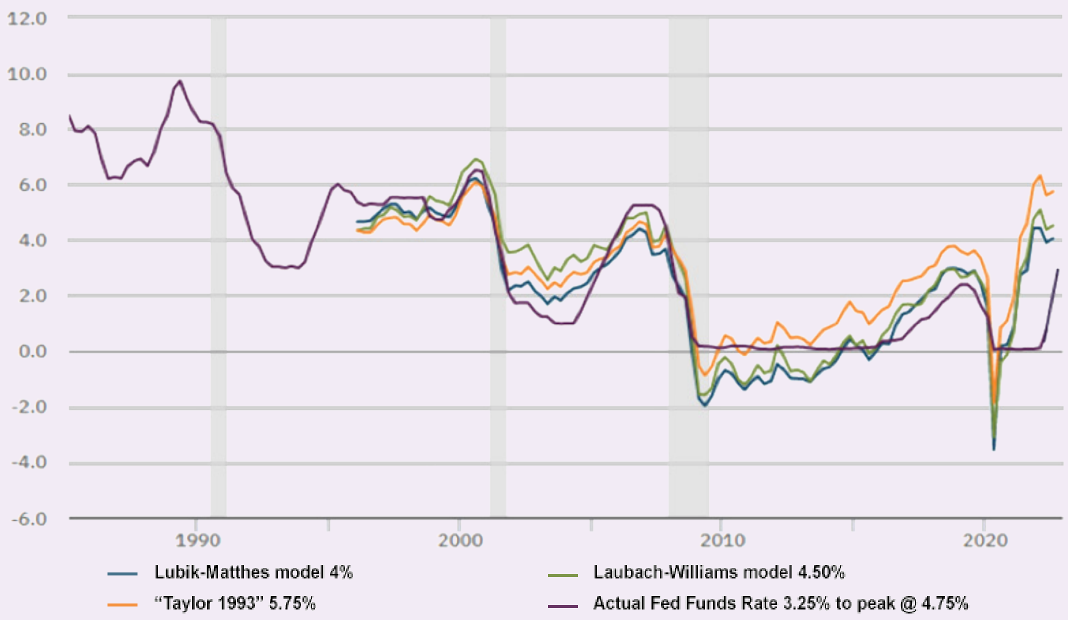
Consistent with US inflation peaking there is also supporting evidence that finally the Fed may have an expected path for monetary conditions that can bring inflation down. If we apply the latest US inflation and output gap data to some of the models used by the Fed in its policy setting considerations, we find that the simple average of the five models employed (three of which are plotted on Figure 33), suggests that the Fed Funds rate could peak at 4.75%[2].

This suggests that the expected disinflation (from Figure 30) should be able to be achieved from the interest rate tightening now signalled by the Fed and priced-in by the forward market (see Figure 34). Estimates of the US output gap have only just become significantly negative (-1% in Q2 22. Source: St Louis Fed) and this will likely deteriorate further and remain a drag on inflation for a while as the US "growth recession" continues.

By the end of the year the Fed Funds rate is likely to be at 4.25% (which will equal core PCE inflation YoY% on current US Consensus forecasts). The Fed Funds rate may then move to peak at 4.75%, to drive the last leg of disinflation, before rate cuts come into consideration in 2024.

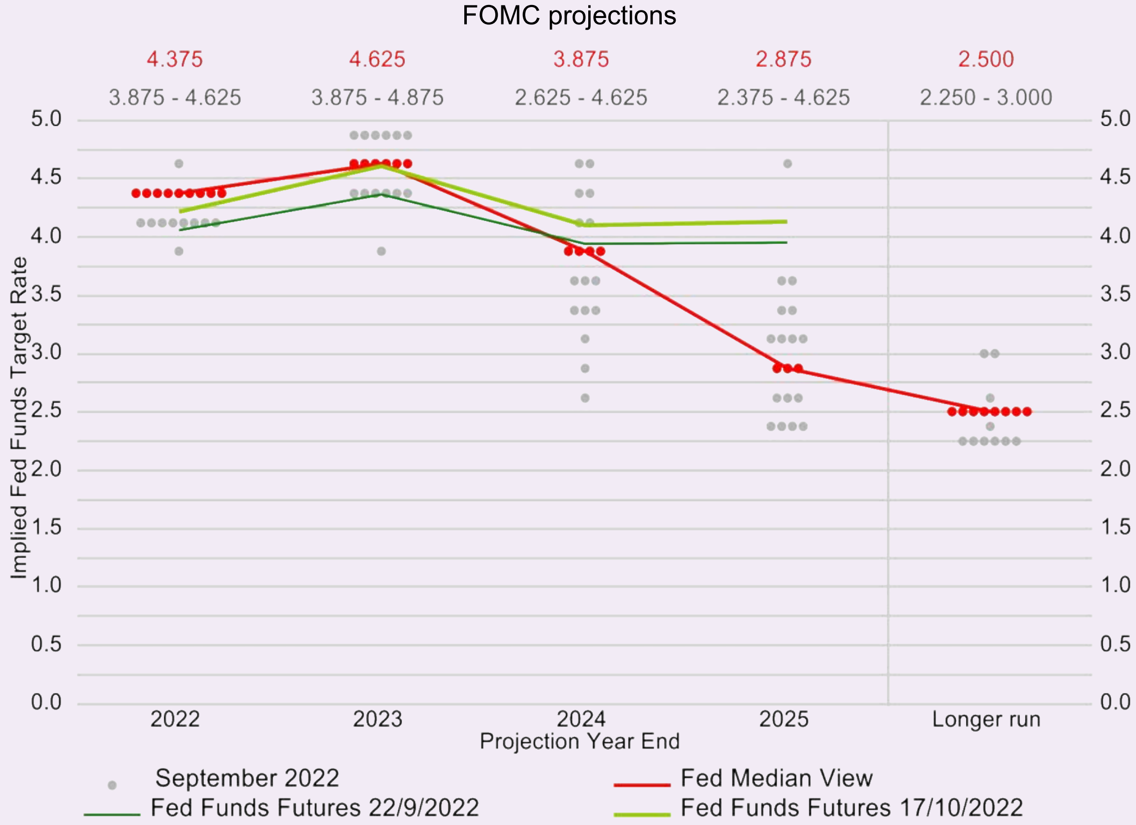
[2] Coincidentally, the Fed also signalled a peak Fed Funds rate of 4.75% in its September forecast update (see Figure 34). From Figure 33, the traditional Taylor Rule (1993) suggests that the Fed Funds rate could be forced significantly above 5%, which is a concerning risk scenario, but this model has tended to overestimate the realised Fed Funds rate since the GFC. Other more modern models we examined were HLW (2017) suggesting 4.25% and Yellen (2015) suggesting 4.75%.

Figure 33: Estimates of the potential peak in the Fed Funds Rate



Source: Fullerton, FRB of Atlanta

Figure 34: The Fed's planned interest rate path (from September) with the latest US forward-market pricing



Source: Refinitiv Datastream, October 2022

(3) Early positive signs that the debt deleveraging process in China's real-estate sector may be bottoming

There are early signs that China's painful debt deleveraging process across its real-estate sector may finally be bottoming along with home sales (see Figure 35). Any recovery is likely to be nascent, and may take time, but these positive signs could significantly improve investor sentiment (as real-estate constitutes around 25-30% of the economy. Source: PIIE Jan 2022). This scenario is already being observed in the performance of equities in China's real-estate sector, which may be in a bottoming process.

Separately, Asia's growth has been holding up well despite significant inflationary pressures, and its trade performance remains on an uptrend. Asia's ability to contain inflation has also been better than DM. This may in turn boost its export competitiveness and create more attractive investment opportunities going into 2023.

Figure 35: Positive signs from China as falling loans to developers may be troughing, along with residential real-estate sales

Source: Refinitiv Datastream, October 2022

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