Winning in the New World Order: Investment trends that will shape 2023 and beyond

Fullerton Investment Views - Quarterly report

Q1 2023

Executive summary

- We have revised our outlook for global risk assets to positive, dominated by our favourable assessment for returns from equities across Developed Markets, China, and Asia, along with Asian corporate credit, and energy commodities.
- The bottoming process for global equities seems to have gained greater traction, and our key signposts for a positive investment view, from our Q422 Investment Outlook, have materialised i.e:
  - there is stronger evidence that US disinflation is unfolding.
  - monetary conditions, as signalled by the US Fed in December 2022, may finally be tight enough to continue to bring inflation down.
  - China is relaxing its tight COVID control policies and its real-estate debt deleveraging process seems to be bottoming.
- In navigating this 'New World Order' and the '3G' forces unfolding, opportunities can unfold – countries that are best able to drive inflation lower may avoid sharp rises in yields, face less employment destruction, and potentially enjoy favourable earnings growth and equity returns. China, the key driver of Asia, is one of the only countries where inflation is low and growth is expected to be significantly stronger in 2023.
- Beyond Asia, investor concerns have shifted away from inflation and back toward downside risks to growth. However, the Consensus view and that of the Fed remains that the US can achieve a shallow or 'growth rate' recession. With US equities falling significantly over 2022 some degree of recession risk may be priced-in, while if a growth rate recession can be realised then there could be some upside for US equities.

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1. The investment environment is likely to be more differentiated in 2023 which can create positive opportunities

Our flagship theme for this year is the prospect of a New World Order. This reflects some push-back against globalisation, given the rise in geopolitical risks from the deteriorating relationship between the US and China, coupled with Russia's invasion of Ukraine. At the same time, the global economy faces challenges from the more established trends of high leverage and transitioning to greener energy.

All these forces may lead to more investment risks, but may also create alpha opportunities, especially as differentiation across countries widens

While some of the potential changes stemming from a New World Order may only impact at longer-term horizons, and seemingly beyond concern for most investors, there are signs that economies and markets are already adjusting. We believe that these adjustments reflect a '3G process' – i.e a Great Decoupling, a Great Reset, and a Great Volatility. Investors need to be cautious as these 3G forces may eventually lead to more investment risks. However, at the same time, these forces may also create alpha opportunities, especially as differentiation widens, between Asia and the West, and between the US and Europe.

The Great Decoupling reflects countries becoming out of sync, with emerging forces driving more nationalistic policies and a regionalised environment. For example:

- With rising global geopolitical risks, after its October 2022 NPC, China has emphasised a greater need to focus on its domestic resources to enhance national security and to protect supply-chains.
- Initiatives like the Regional Comprehensive Economic Partnership[1] has created the largest trade block in history, and is perceived as a boon for greater Asian integration, yet it excludes the US (as does China's Belt & Road programme, which involves more than 60 countries with estimates of $1.25tn USD worth of infrastructure spending to come over the next five years[2]).
- Technology transfer, which has always been a key driver of digitisation and global connectivity, also faces increased hurdles with greater intellectual protectionism, notably between the US and China (e.g especially across the high value-added semiconductor industry, where the US has blacklisted certain Chinese IT companies that it regards as threats to national security and competitiveness).

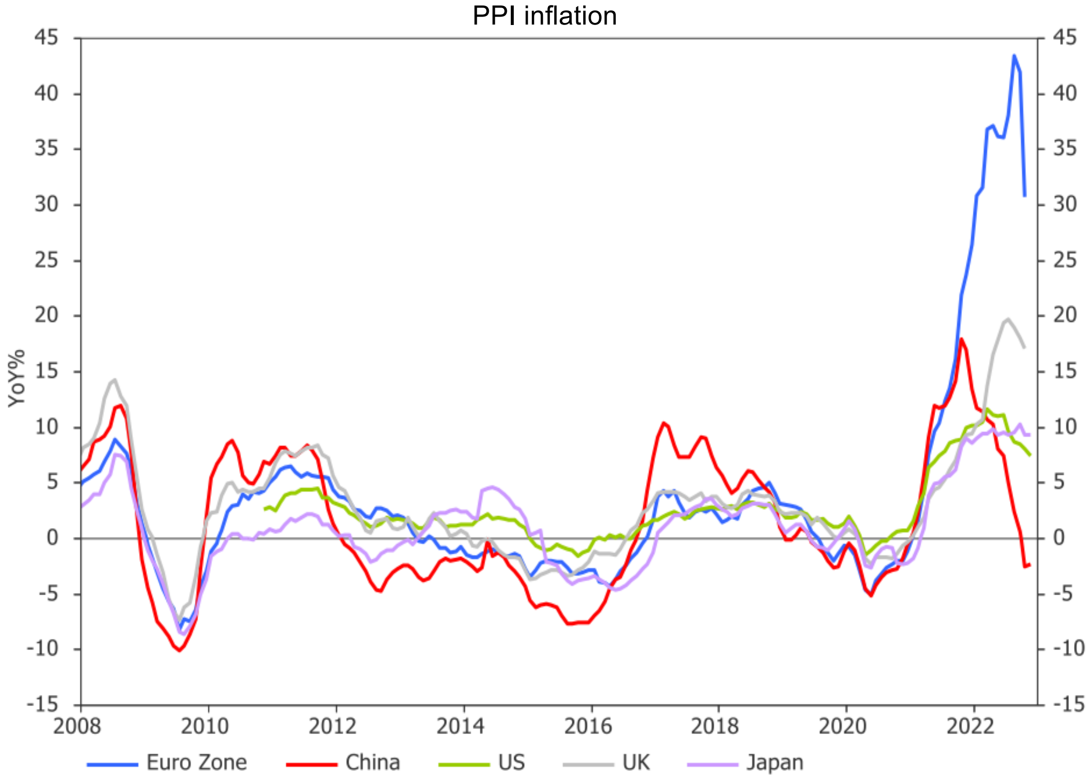
Divergent inflation and cost pressures are also contributing to more differentiated markets

Another key contributor to the Great Decoupling is the divergent cross-country production-cost pressures (PPI inflation, See Figure 1) feeding the inflation pipeline (CPI) at different rates. Asia, dominated by China, with its relatively better inflation containment, may gain greater export competitiveness which can boost earnings expectations over time.

Even as China reopens from its strict COVID control policies it will take time for aggregate demand and cost pressures to rebuild. In contrast, Europe and the UK are suffering much greater inflation stress, which has already contributed to higher yields and significant falls in their currencies. In navigating this '3G investment environment' opportunities can be created by the Great Decoupling, as the countries that are best able to drive inflation lower may avoid sharp rises in yields, face less employment destruction, and potentially enjoy favourable earnings growth and equity returns.

1. The RCEP, effective from Jan 2022, is a cooperative free-trade agreement between 15 Asia-pacific nations, and encompasses about 30% of the world's GDP and population.
2. Source: CFR Jan 2020.

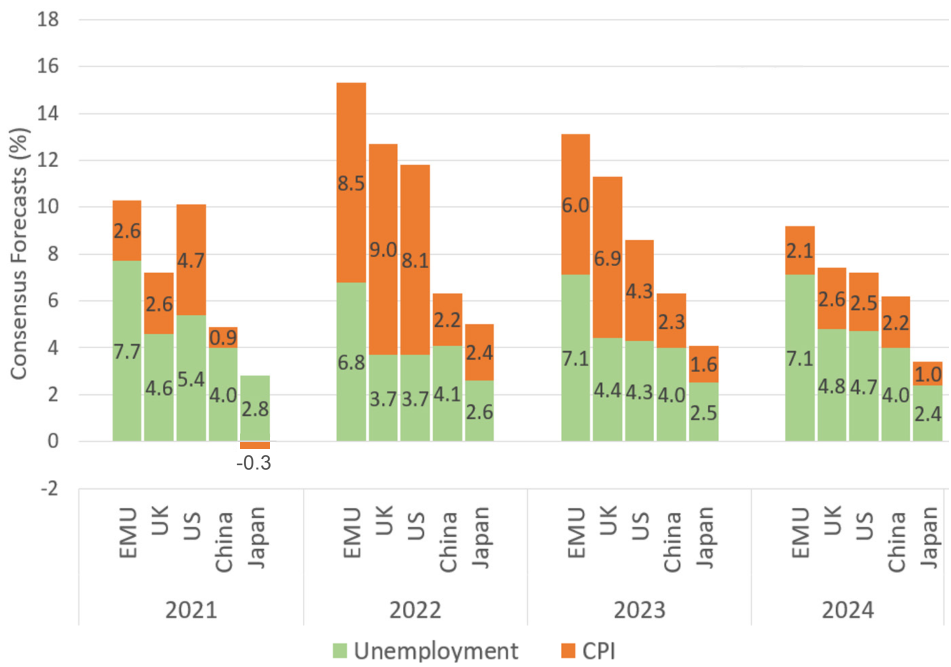
Figure 1: Production cost pressures across key markets (PPI inflation rates)



Source: Refinitiv Datastream, December 2022

Encouragingly, inflation is expected to be lower across most countries in 2023, but it will likely be a more painful adjustment for Developed Markets (DM) than for Asia given Consensus forecasts of higher unemployment across DM (see Figure 2). Asia, dominated by China and Japan, is expected to sustain low inflation for the next two years with limited employment destruction. The Consensus ranks Asia low on the 'misery index' (i.e the combination of inflation and unemployment, see Figure 2) which can result in a macro environment that is supportive for investment returns.

Figure 2: Consensus expectations for inflation and unemployment across key countries

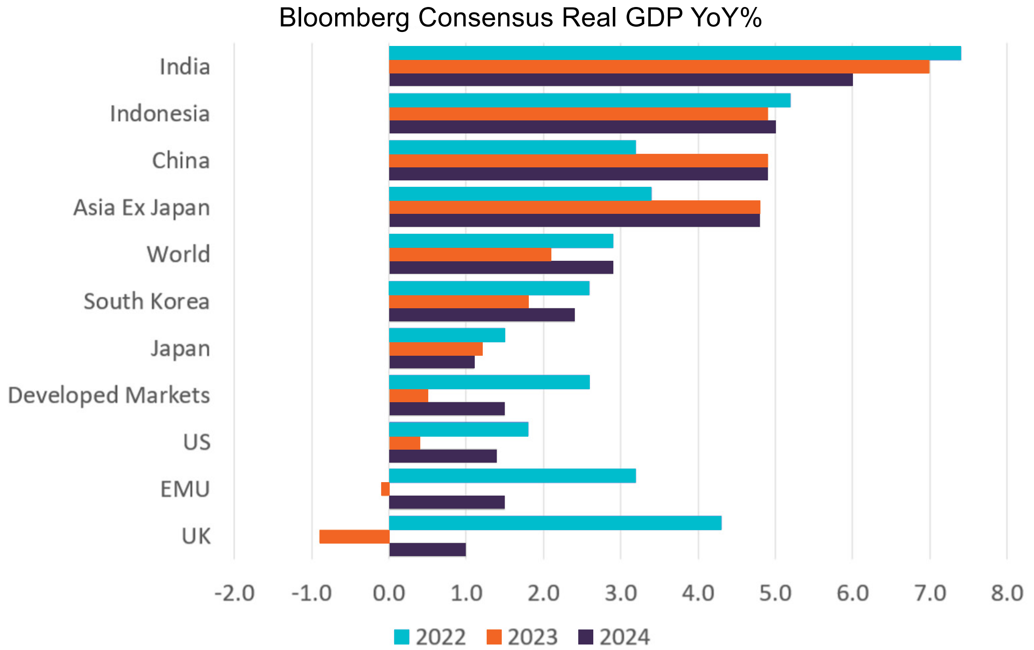


Source: The height of the bars depicts the 'misery index': the higher the bar the more economic pain from inflation and unemployment. Bloomberg Consensus Forecasts, December 2022

Asia has a more positive outlook than Developed Markets

Growth is expected to slow across most Asian economies in 2023, but by relatively more across DM (see Figure 3). These are further signs of a Great Decoupling, where China is one of the only countries where growth is expected to be significantly stronger in 2023. This is likely to further increase the differentiation between the West and Asia, especially if relatively stronger growth across Asia feeds into more positive earnings performance.

Figure 3: Consensus projections for growth over key countries

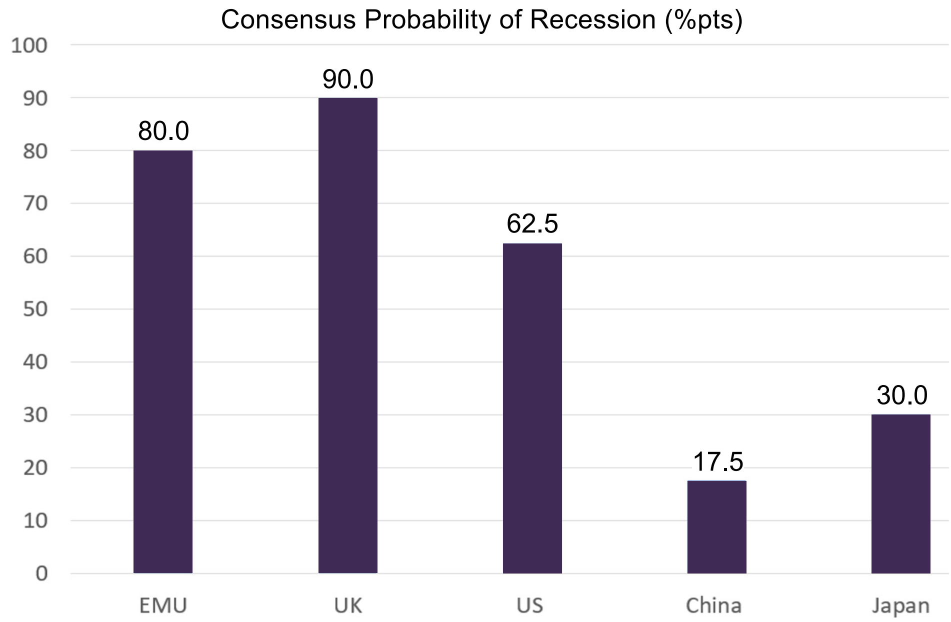


Source: Bloomberg Consensus Forecasts, December 2022

Concerns seem to have shifted from inflation to growth risks

With more evidence that US disinflation is unfolding, investor concerns have shifted back toward downside risks to growth, with some slippage in real yields and the US dollar. Reflecting this, the Bloomberg Consensus surveyed probability of recession in 2023 has increased for the US, and especially for Europe (see Figure 4).

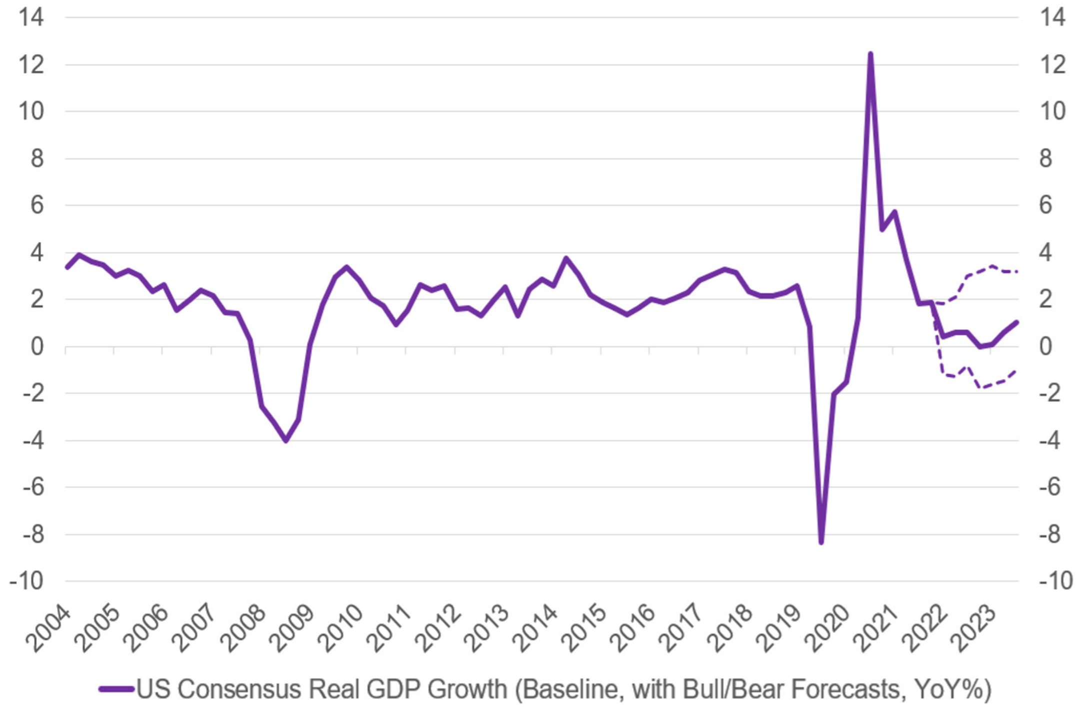
Figure 4: Consensus expectations for recession probabilities in 2023



Source: Bloomberg Consensus Forecasts, December 2022

While the surveyed probability of a US recession is now beyond the 50% threshold, the prospect of a shallow recession, or a 'growth rate' recession (i.e where growth remains positive, but is significantly below trend: which is the Consensus average expectation, see Figure 5), remain in-play, given strong household balance sheets and positive expectations that the labour market may avoid significant stress.

Figure 5: Consensus forecast scenarios for US growth

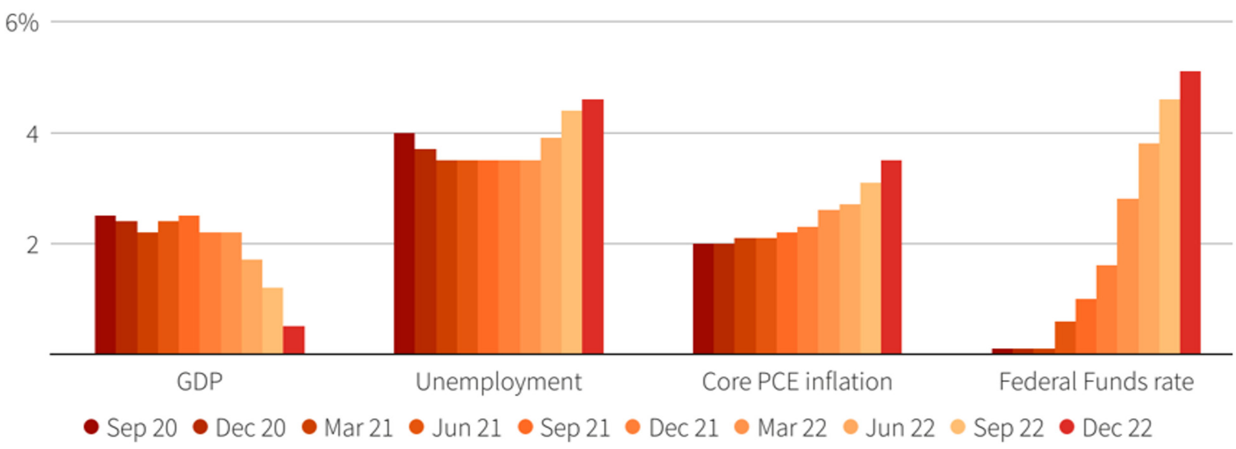


Source: Bloomberg Consensus Forecasts, December 2022

The US Fed, in its December 2022 projections, shared the Consensus view that the US can achieve a growth rate recession in 2023 (i.e with GDP growth forecast at 0.5% YoY), even though the Fed has increased interest rates significantly (see Figure 6). The Fed revised its peak Fed Funds rate expectation to 5.25% in December (from 4.75% in September) and hiked by 50bps to bring the policy rate to 4.5% for 2022.

One potential reason for the relatively hawkish signal could be the Fed's desire to push the US forward-market to move away from pricing-in any rate cuts for 2023. While disinflation is unfolding, and US wage inflation may have peaked, policy still needs to be tight for longer to continue to bring inflation down.

Figure 6: US Fed macro projections for 2023 (made each quarter since Q320)

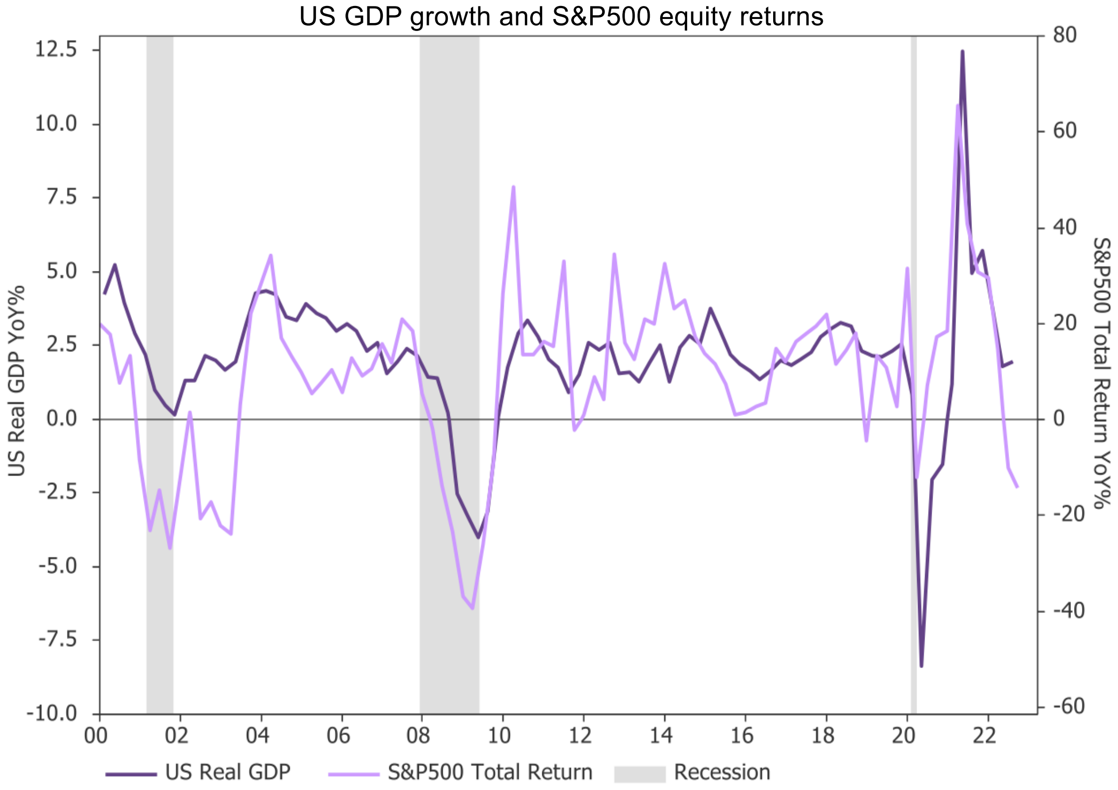


Source: US FOMC, Refinitiv, December 2022

A slump in growth remains a key risk for 2023, but markets may have priced-in enough bad news

The most pessimistic scenario for US growth in 2023 remains a recession that would be about 'half-a-GFC' style slump (see Figure 5). However, because US equities fell by about 20% from their peak in 2022, much of this degree of recession risk may have already been priced-in (see Figure 7). Figure 7 suggests that the US equity market is prepared for a US recession as bad as a peak fall in GDP of around 2.5% YoY, but if a growth recession can be realised then there could be more upside for US equities.

Figure 7: US GDP growth and equity returns



Source: Refinitiv Datastream, December 2022

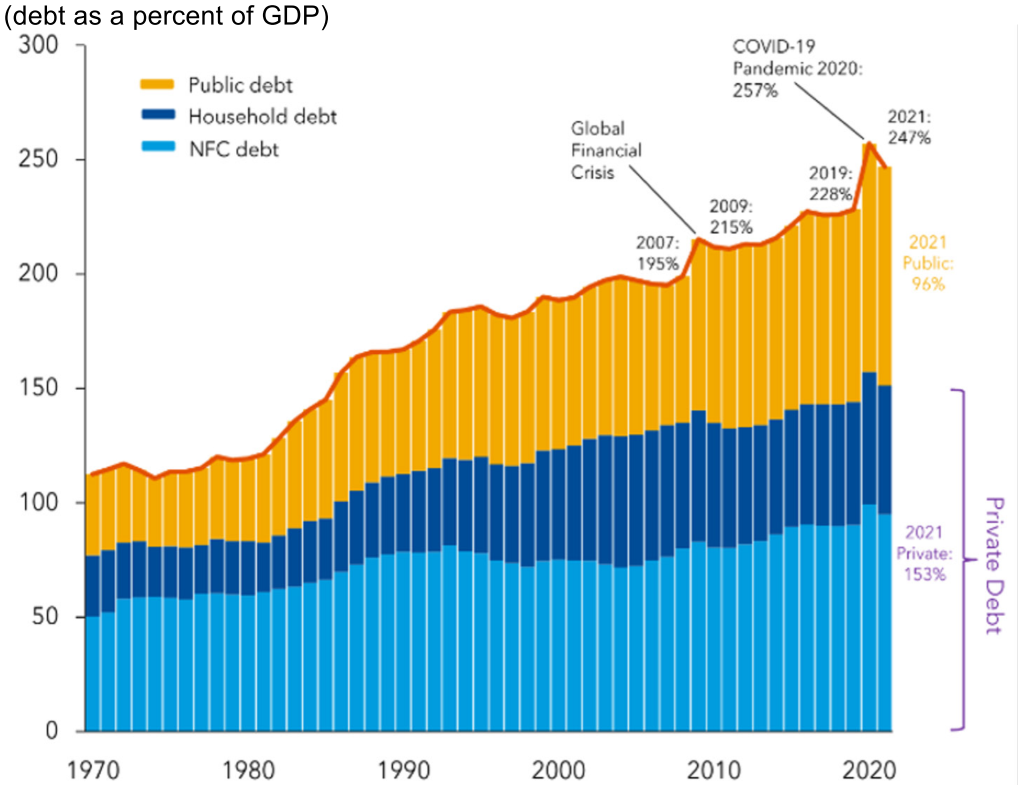
Strong demand for leverage could drive a Great Reset to a higher cost of capital

A potential longer-term hurdle for the global economy is the high degree of leverage (see Figure 8), which we believe could drive a 'Great Reset' where strong demand for debt over time may push up the cost of capital and drive a rebound in real yields to levels higher than those experienced during the 'Great Moderation'.

DM and China have especially high levels of private sector debt that is concentrated across non-financial corporates (see Figure 9). Such significant debt burdens could crowd-out future earnings growth, or in an adverse scenario, result in a surge in NPLs that could spark a financial crisis. However, China, in contrast to Western countries, has the advantage of relatively low government debt and therefore has greater flexibility to provide policy stimulus in the event of any significant financial instability.

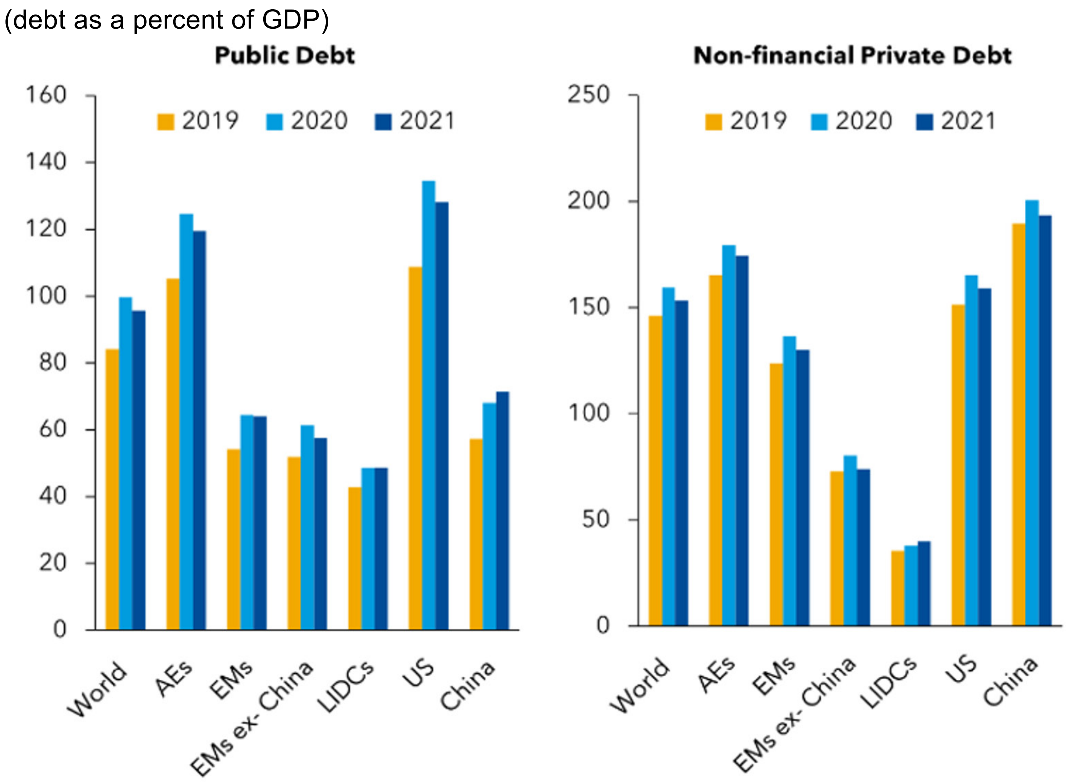
Aside from potential financial stability risks that greater leverage may eventually bring to the global economy, the Great Reset may prove a headwind for financial asset valuations and returns at least until expectations adjust to price-in greater compensation for investors. Equities may struggle for a while with higher yields, while fixed-income investors may start to judge income returns from higher interest rates as attractive. Collectively, these adjustments may help to bring back some balance to the relative return of equities versus bonds (see Figure 10).

Figure 8: Global Public (Government) and Private Sector Debt



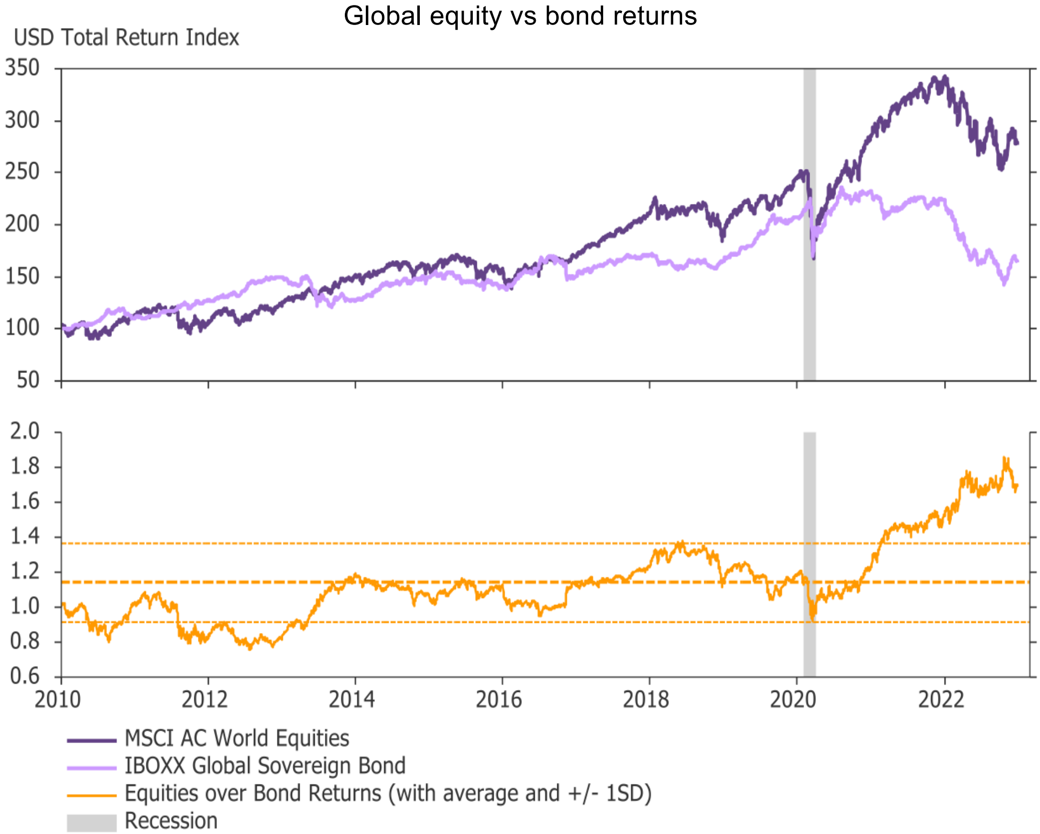
Source: IMF, December 2022. Note: The estimated ratios of global debt to GDP are weighted by each country's GDP in US dollars. NFC = Non-financial corporations

Figure 9: Global Public (Government) and Private Sector Debt Cross-countries



Source: IMF, December 2022. Note: The estimated ratios of global debt to GDP are weighted by each country's GDP in US dollars. AEs = Advanced economies; EMs= Emerging markets; LIDCs = Low-income developing countries.

Figure 10: Global equity versus bond returns



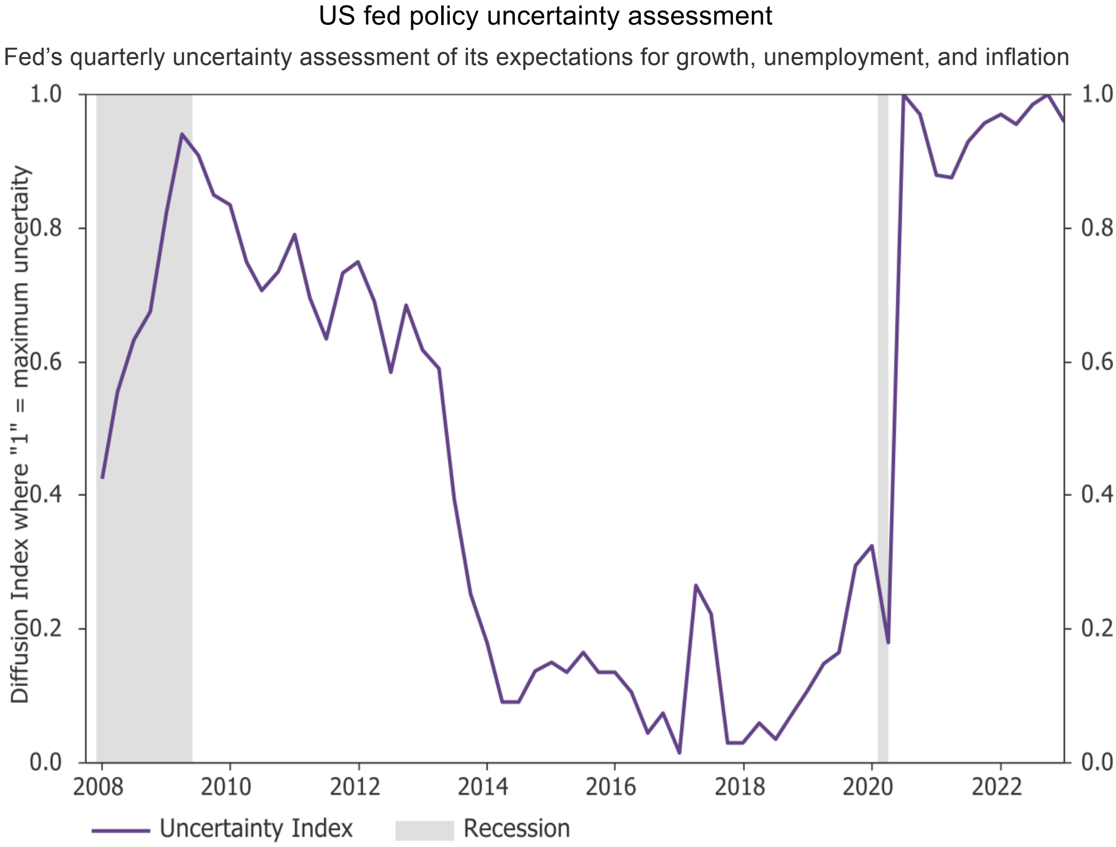
Source: Refinitiv Datastream, December 2022

The 'Great volatility' is underpinned by high uncertainty

The last of the 3G forces that we believe is unfolding is the 'Great Volatility', which reflects not just the rise in volatility of investment returns but also the high levels of uncertainty, especially surrounding the growth outlook and recession risks. Return volatility may continue to ease over time, but investment uncertainties may persist for longer.

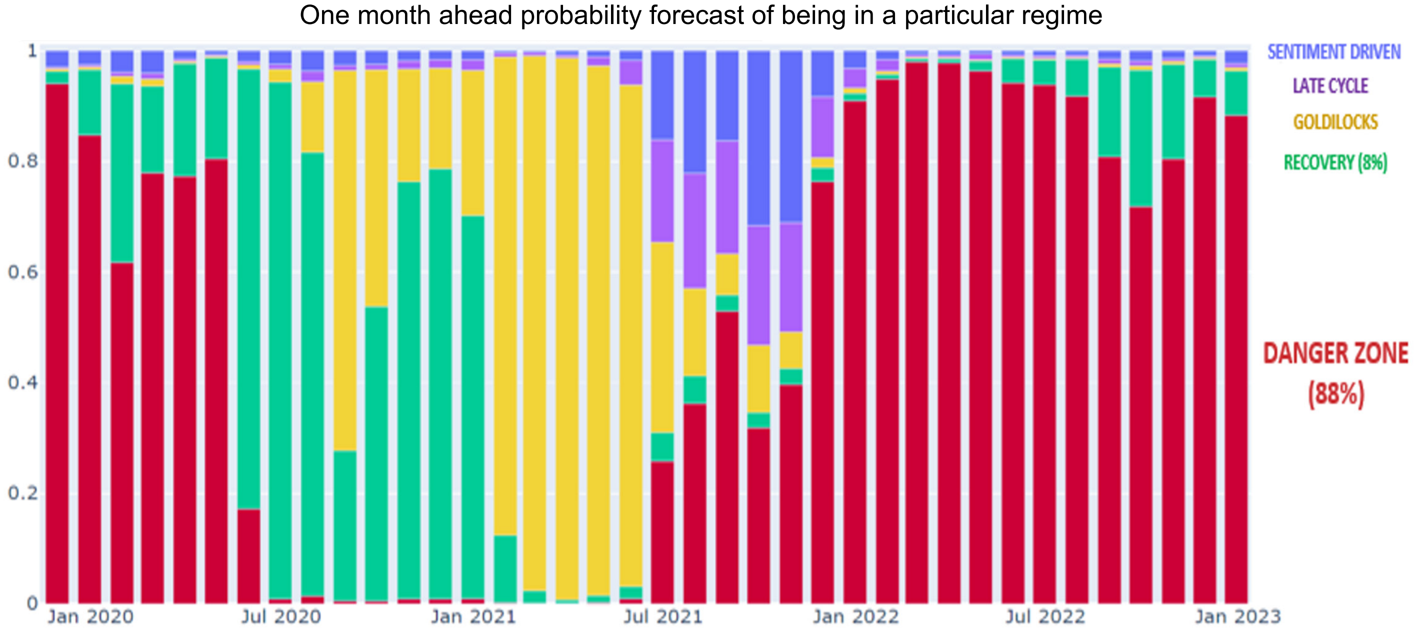
For example, the US Fed has noted that the uncertainty surrounding its macro projections remains very high and is even greater than the GFC period (2008-09. See Figure 11). In addition, Fullerton's Investment Regime Indicator has signalled 'Danger Zone' for a prolonged time, which reflects the stresses from high inflation and weaker growth (See Figure 12). US investors have responded to such uncertainties with record demand for downside protection to their equity investments as the put/call ratio has surged higher (see Figure 13).

Figure 11: The Fed's assessment of uncertainty surrounding its forecasts



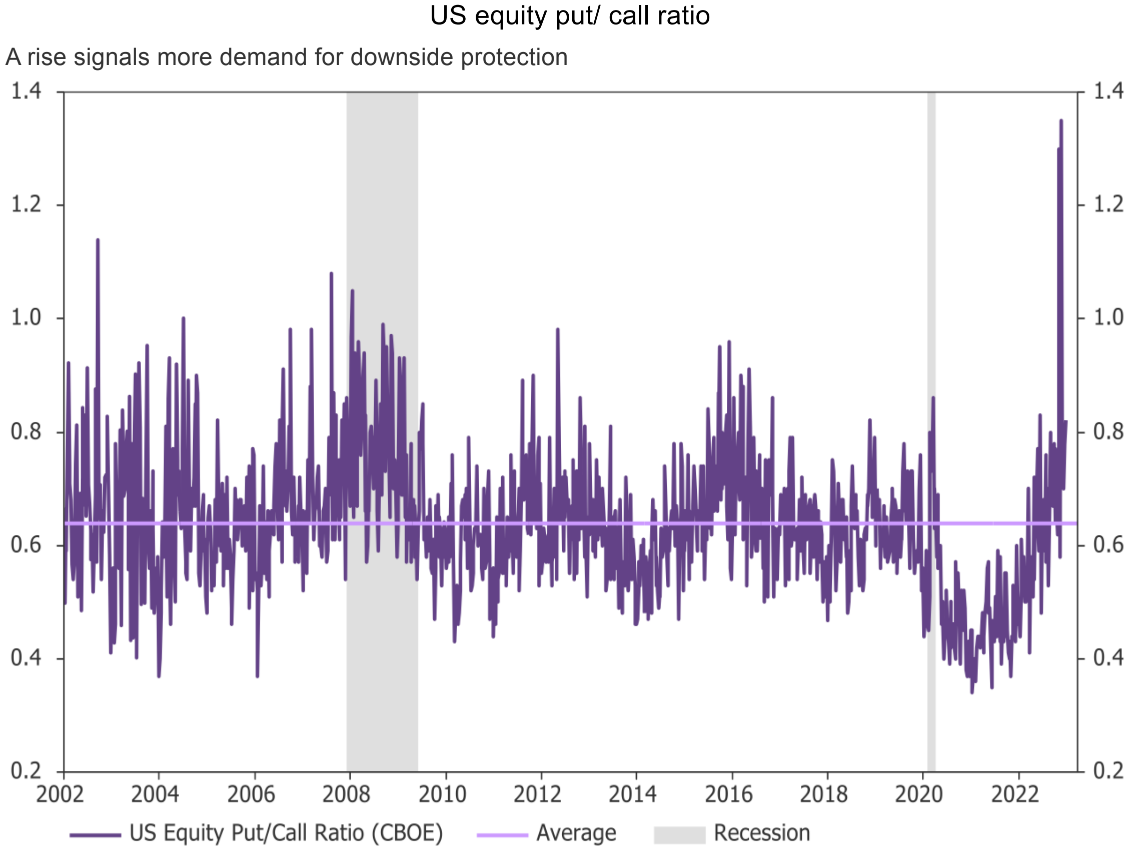
Source: Refinitiv Datastream, December 2022

Figure 12: Fullerton's investment environment regime indicator



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

Figure 13: Demand for downside protection as signalled by put/call ratio



Source: Refinitiv Datastream, December 2022

Even with positive indicators suggesting a more favourable investment environment lies ahead - higher than usual uncertainty, and volatility, may prove problematic for longer than anticipated.

This suggests investors should be cautious, lengthen their investment horizon, and consider some of the structural themes that may help drive returns over the years ahead. These are investment themes we have highlighted before and encompass technological advancement/new higher-value added industrials, healthcare, consumerism, financials, and the green engine[3].

3. For a detailed discussion of such themes and opportunities across Asia see: https://www.fullertonfund.com/fullerton-insights/asia-rise-on-global-stage-emerging-opportunities-and-trends/

2. Investment strategies for a 3G environment

3G forces over 2022 contributed to a challenging investment environment

2022 was a challenging environment for investors, as government bonds failed to give downside protection as returns struggled with high inflation and rising interest rates (see Figure 14). In a similar fashion, risk asset returns most linked to growth, such as equities, corporate credit, and industrial metals, also declined with tighter monetary conditions, falling liquidity, and weaker growth (see Figure 14).

In contrast, gold performed strongly against other traditional safe-haven assets in 2022, offering some cushion to investors as it held its value despite the headwinds from higher interest rates (see Figure 14). We believe favourable returns from gold may continue as geopolitical risks are likely to persist.

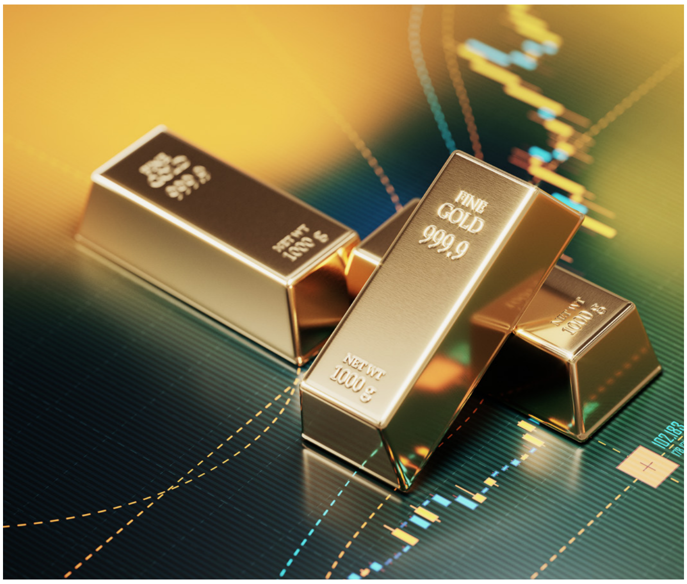
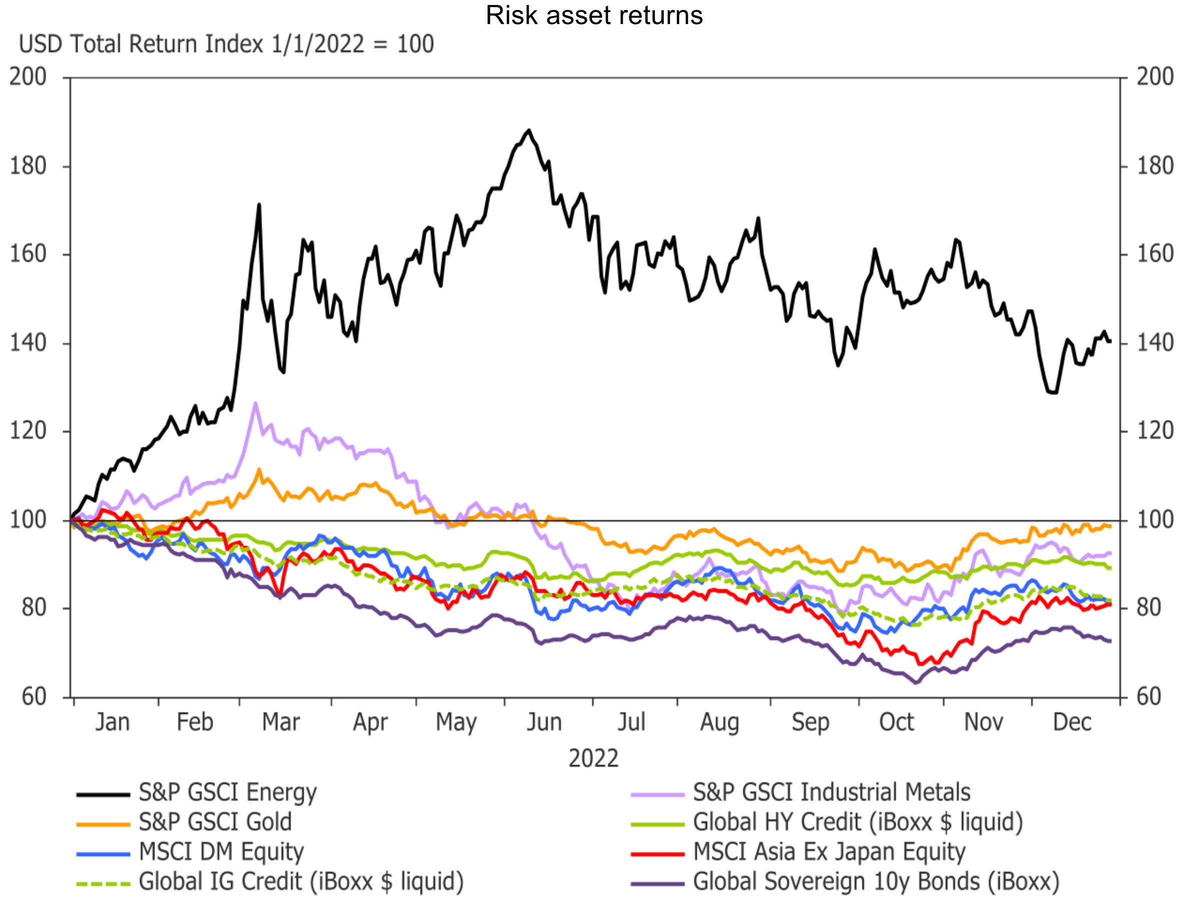


Figure 14: Risk asset returns in 2022



Source: Refinitiv Datastream, December 2022

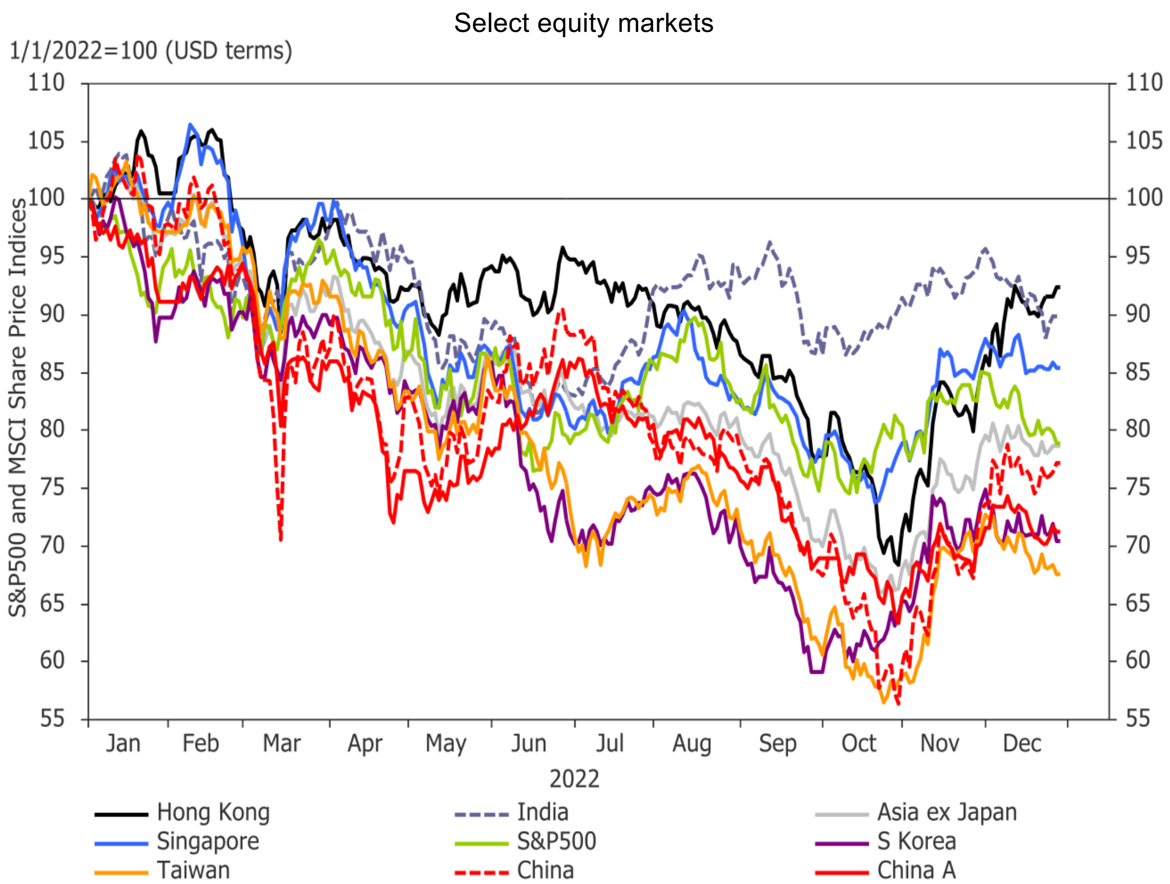
Although oil prices fell back from extreme highs in mid-2022, with weaker growth and some demand destruction, it is likely that returns from energy commodities will remain robust for a while. In part this is because pressures to defend energy resources have increased, with prolonged under investment on the supply-side and geopolitical disruptions (especially in Europe). At the same time, global energy demand is likely to strengthen during 2023, with strong growth from India, and as China's recovery gathers momentum.

The triggering of our key signposts suggests a favourable investment outlook ahead

Encouragingly, the bottoming process for global equities that we discussed last year gained greater traction over Q422 (see Figure 15). We have moved to a positive outlook on DM, China, and Asian equities (see Figure 16) as the key signposts we highlighted in our Q422 Investment Outlook have become more favourable, namely:

- there is stronger evidence that US inflation has peaked and disinflation is unfolding.
- monetary conditions, as signalled by the US Fed in December 2022, with a peak Fed Funds rate of around 5.25%, may finally be tight enough to continue to bring inflation down.
- China is relaxing its tight COVID control policies and its real-estate debt deleveraging process seems to be bottoming, along with house sales. A trough in China's real-estate sector performance is important to its expected growth rebound in 2023 as real estate accounts for about 30% of GDP (source: Business Standard, 17 Aug 2022).

Figure 15: Asia and US equity market performance



Source: Refinitiv Datastream, December 2022

Figure 16: Summary of Fullerton's views

	Bearish	Negative	Positive	Bullish
Risk Asset Returns			✓	
Asia Equity			✓	
China-A Equity			✓	
DM Equity (MSCI World)			✓	
Asia IG Credit			✓	
Asia HY Credit			✓	
US Bonds		✓		
US Dollar		✓		
Oil Prices			✓	

Source: Fullerton Fund Management, January 2023. Views may be subject to change without prior notice.

We have a positive view on DM equities, dominated by the US

Across 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), and as a result US equities may enjoy some relative upside. In contrast, Europe remains our least favoured region, as its adverse stagflation forces remain acute, and the likelihood of a painful recession is greater than that for the US.

We believe China is investable, and have moved to a positive view on Asian equities

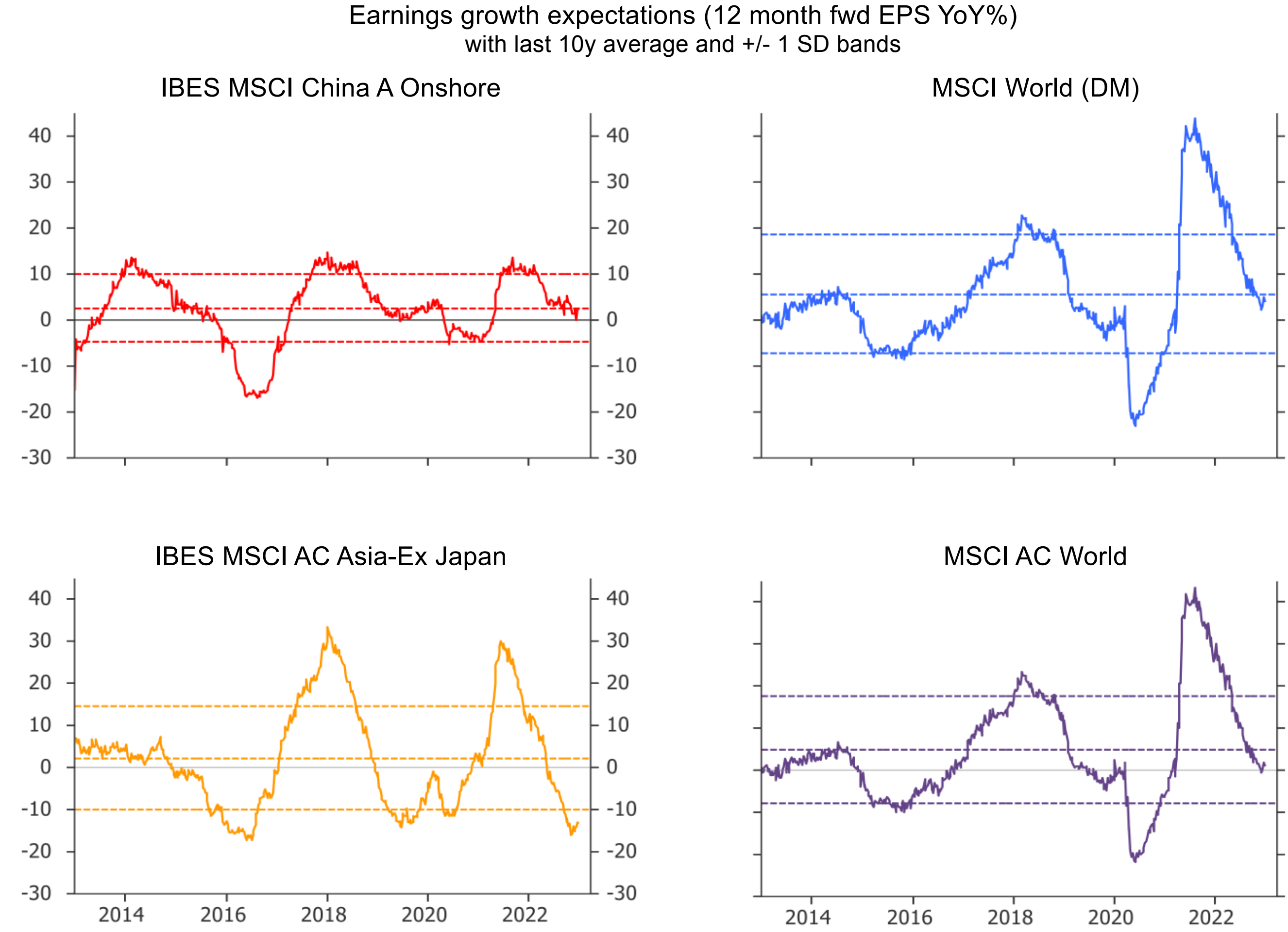
Beyond China relaxing its tight COVID control policies, and its real-estate sector showing signs of stabilisation, other key developments that underpin our positive view on China equities include favourable signals from policymakers. For example, from China's Central Economic Work Conference (CEWC) in December 2022, policymakers reiterated the importance of fostering a growth friendly environment for local companies as well as for foreign investors.

Some investors became more bearish on China's longer-term outlook after the 20th Party Congress (October 2022), with the belief that the on-going pursuit of 'common prosperity' by policymakers implies that growth is no longer a priority. However, we believe that policy announcements since then push-back on this view. We remain positive on China as a long-term investment destination in part because policymakers have reemphasised the importance of driving higher per capita incomes over time to improve wealth and welfare.

The CEWC also emphasised that consumerism and employment need to have a more prominent position in driving China's economy going forward. Real estate was highlighted as a key pillar of the economy, and that it might benefit further from the raft of policy supports announced in November 2022 (focused on financing for developers and stimulating stronger credit growth for households). All these positive developments in China increase the likelihood that a key feature of the Great Decoupling can continue where China is one of the only countries where growth can be significantly stronger in 2023.

Across the rest of Asia growth has also held-up better than anticipated, especially across India, Indonesia, Malaysia, and Singapore. The market has priced-in significant downside to Asian earnings expectations (see Figure 17), and may now be more confident to recover as inflation containment can boost export competitiveness. In addition, China's expected strong growth rebound in 2023 might boost Asian intra-regional demand and trade growth.

Figure 17: Earnings growth expectations across the key regions



Source: Refinitiv Datastream, December 2022

Fixed-income – we remain negative on duration as upside forces on yields remain significant

We remain negative on duration of DM and US government bonds, as upside risk remains for yields as monetary policy needs to remain tight to bring inflation down. This is especially relevant across Europe where the real policy interest rate has not increased enough to drive sufficient disinflation over time. The Bank of Japan also appears to be gradually moving away from its yield-curve control policy, and has allowed market forces to push its 10y nominal yield up to 0.5% p.a.

Furthermore, the strong demand for leverage, especially from the DM corporate sector, is likely to limit any sustainable downside to yields over time. All that said, if a deeper than expected global recession unfolds, then government bonds are an obvious asset class to potentially benefit as yields may fall back sharply with weak growth.

Higher than otherwise yields over time may also start to motivate some investors, especially those with buy-and-hold (to maturity) mandates, to allocate more cash toward bond investments to lock-in potentially more attractive income streams. Furthermore, Asian local currency government bonds that performed well over 2022 were those with high and relatively stable yields e.g India and Indonesia.

However, US dollar strength eroded returns across the board for USD-based investors in local currency bonds. Encouragingly, headwinds from the very strong US dollar may ease further in 2023 as we believe Asian currencies may register gains due to stronger competitiveness and weaker US dollar fundamentals.

Corporate credit – we have upgraded Asia IG and HY to a positive view

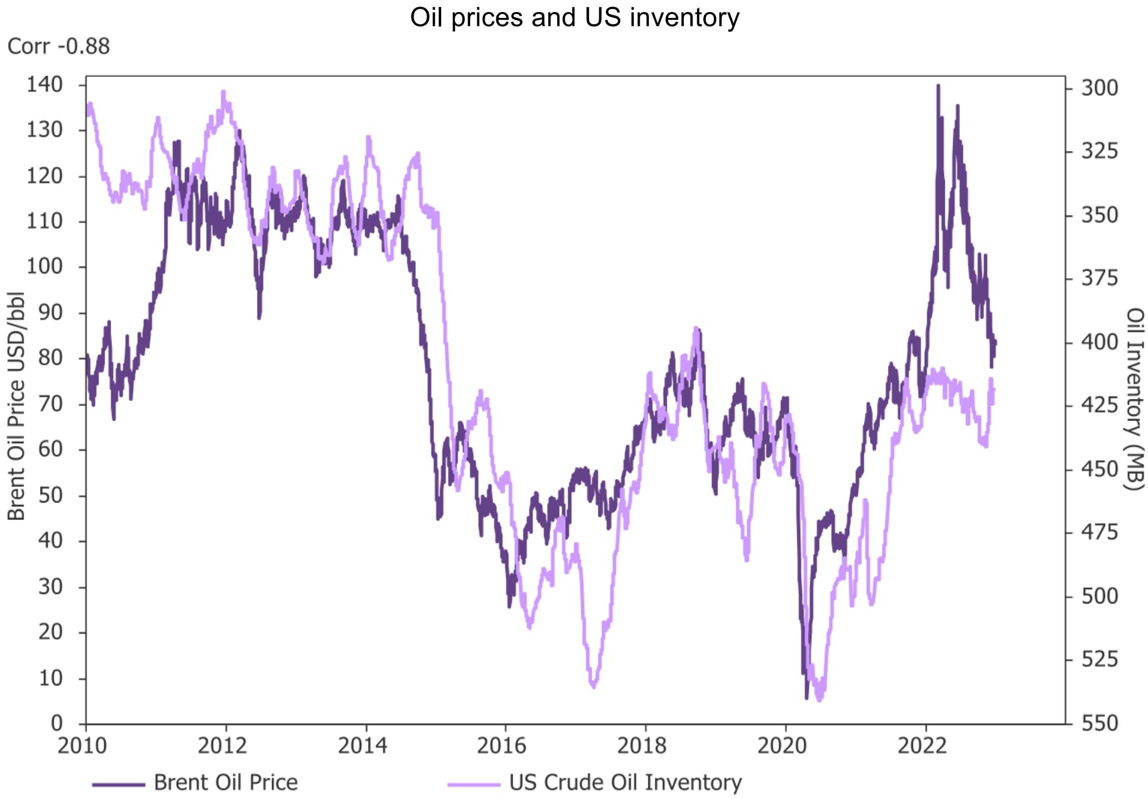
Sentiment surrounding the performance of High Yield (HY) corporate credit has improved significantly, largely on the prospect that China's real-estate sector might strengthen in 2023 with more policy supports. We also believe Investment Grade (IG) corporate credit can perform well, even if growth surprises to the downside, as IG companies tend to have strong balance sheets.

We judge that the risk-reward balance has become more favourable for Asian corporate credit, and the strongest performing sectors are likely to remain those linked to consumerism, financials (especially fintech related), raw materials and infrastructure. 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.

We have a positive view on oil, as global demand growth, driven by China, is likely to pick-up

Oil prices have corrected back to be more consistent with weaker global demand and signals from key barometers like US inventories (see Figure 18). Underinvestment on the supply-side, combined with greater geopolitical concerns, and stronger urgency to defend energy resources, are likely to provide a solid floor to oil prices. With stronger demand growth from India, and as China's recovery gathers traction, oil prices are likely to rise going forward.

Figure 18: Oil prices and US inventory



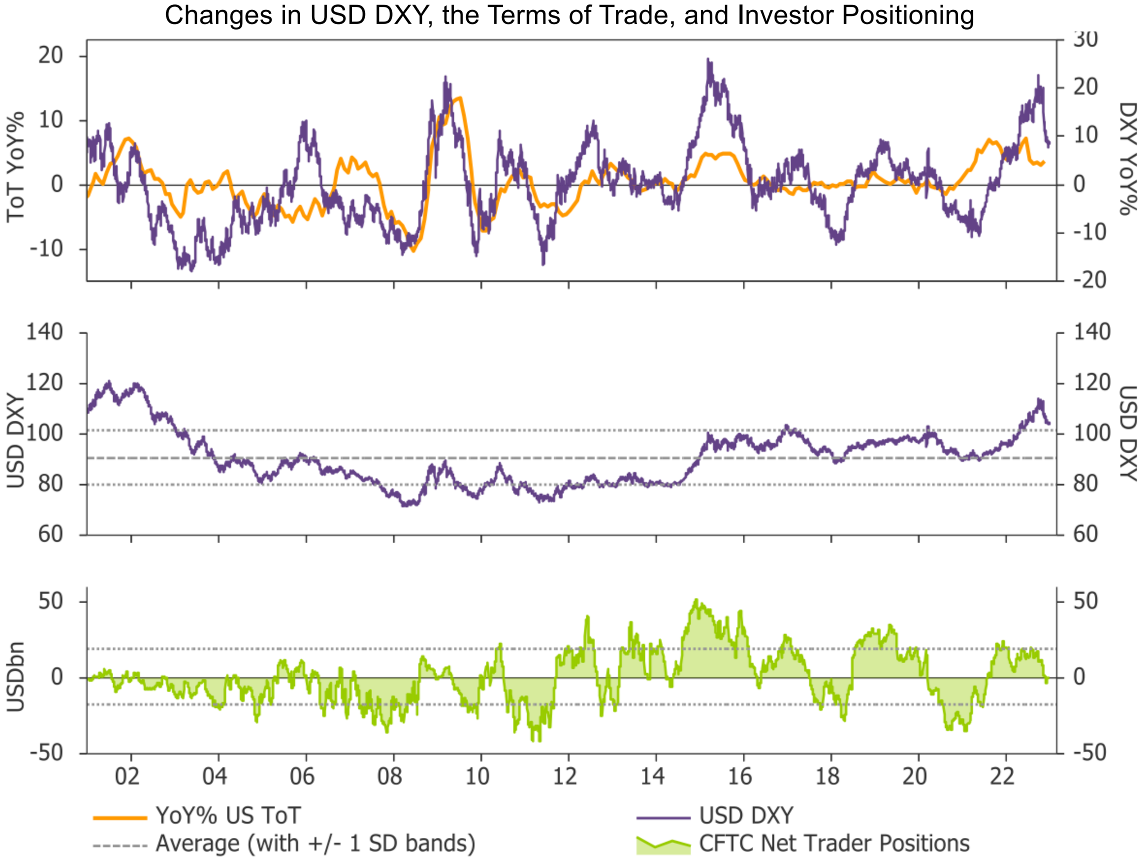
Source: Refinitiv Datastream, December 2022

We have revised the US dollar's outlook to negative

With the correction in the US terms of trade unfolding (see Figure 19), and as the Fed's policy tightening cycle matures (which will reduce the attractiveness of US rate differentials), the USD is likely to get less support. From a fundamental perspective, the US dollar was too overvalued, especially as the US' relative export prices became less favourable (see Figure 19).

In addition, investor sentiment for a strong US dollar has retraced, and net-short US dollar positioning is now emerging (see Figure 19). The US dollar may not stabilise until its valuation slides back to within one standard deviation of its historical average. The weakness in the US dollar is also encouraging from a broader market perspective in that it suggests investors attach a low probability to the prospect of a deep recession.

Figure 19: USD, the terms of trade, and investor positioning



Source: Refinitiv Datastream, December 2022