Scaling the 3Ps: Peak Rates, Peak USD, and Peak Fear

Fullerton Investment Views - Quarterly report

Q2 2023

Executive summary

Against the backdrop of a 'New World Order' shaped by the 3G forces of a great decoupling, a great reset, and a great volatility, we see a 3Ps cyclical play taking hold this year. The 3Ps are: peak interest rates, peak US dollar, and a peak in risk aversion behaviour. The 3Ps could usher in a potentially more favourable environment for risk assets, as the Fed approaches the end of its tightening cycle, and as risk appetite improves further.

A summary of our key takeaways are as follows:

- With broad US monetary conditions already tight, and inflation forecast to continue falling slowly, while growth forecasts are positive, it seems consistent with US Fed funds peaking at 5.25% (a call the Fed has stuck with since December 2022).
- China's recovery has been firm - driven by the reopening, stronger consumption, trade, and real estate sector stabilisation. This has positive spillover effects for Asia.
- Areas we favour the most in this environment are Asian (particularly Chinese) equities. We also have a positive view on DM equities (dominated by the US).
- In fixed income, the higher yield environment may be attractive for 'buy and hold' to maturity investors. Bonds can also give valuable downside cushion against recession risk.
- We maintain our positive view on Asian IG and HY. Fundamentals and interest coverage ratios are firm, and while further spread tightening may be limited, yields are favourable.
- We are negative on the dollar given the US' weak terms of trade and peaking Fed rates.
- We are positive on oil (amid tighter inventories and recovering demand), as well as gold (given geopolitical risks).

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Foreword

'3G' trends with the cyclical '3Ps' can foster a favourable investment environment, especially across Asia

Building on our flagship theme for this year of a 'New World Order' we had outlined that we believe the investment environment is being shaped by the long-lasting forces of a great decoupling, a great reset, and great volatility – a '3G' paradigm where differing economic and geopolitical considerations across regions is leading to less globalisation, differing growth performance, and a multipolar world (the great decoupling). Separately, the cost of capital may rise over time resulting in higher real interest rates than the past (the great reset), while the great volatility reflects higher macro uncertainties and above average geopolitical risks.

While there is a need to manage the risks emanating from the 3G backdrop, there are also potential alpha opportunities to pursue amid the differentiation sparked by the underlying 3G forces.

Against the larger structural background of a 3G world, we see 3 peaks – i.e 3Ps unfolding this year, namely peak monetary conditions, peak dollar, and peak risk aversion.

Understanding the 3Ps

As we move into Q2 2023, we believe that the cyclical shifts surrounding the potential '3Ps' of peak monetary conditions, peak US dollar, and peak risk-aversion, will collectively become increasingly relevant in helping improve investor confidence and expected returns.

Peak monetary conditions – almost there

Very tight US broad monetary conditions, against a backdrop where banks are significantly constraining lending and facing greater financial stresses, suggest that the US Fed may now have greater conviction on its peak Fed Funds rate call. At 5.25%, as revealed in December and reiterated in March, it implies one more 25bps hike to come. From the Fed's March projections it suggests that overall monetary conditions are basically tight enough to continue to slowly bring inflation down (inflation is still not expected to be back at the Fed's target until 2025).

Notwithstanding greater recession risk, sticky inflation continues to dictate that the Fed will maintain its view of no rate cuts until 2024. In a similar vein, if disinflation does not continue to unfold to the degree that the Consensus (and the Fed) forecasts, then the Fed may be forced to hike by more than it has announced. Under such a scenario, recession risk may not rise dramatically because the real policy rate is very low and supportive, private sector balance sheets are strong, and the US labour market remains resilient (e.g the current Consensus and Fed view is that the US unemployment rate is likely to rise by 1.5%pts, peaking at close to 5%, while GDP growth can remain positive).

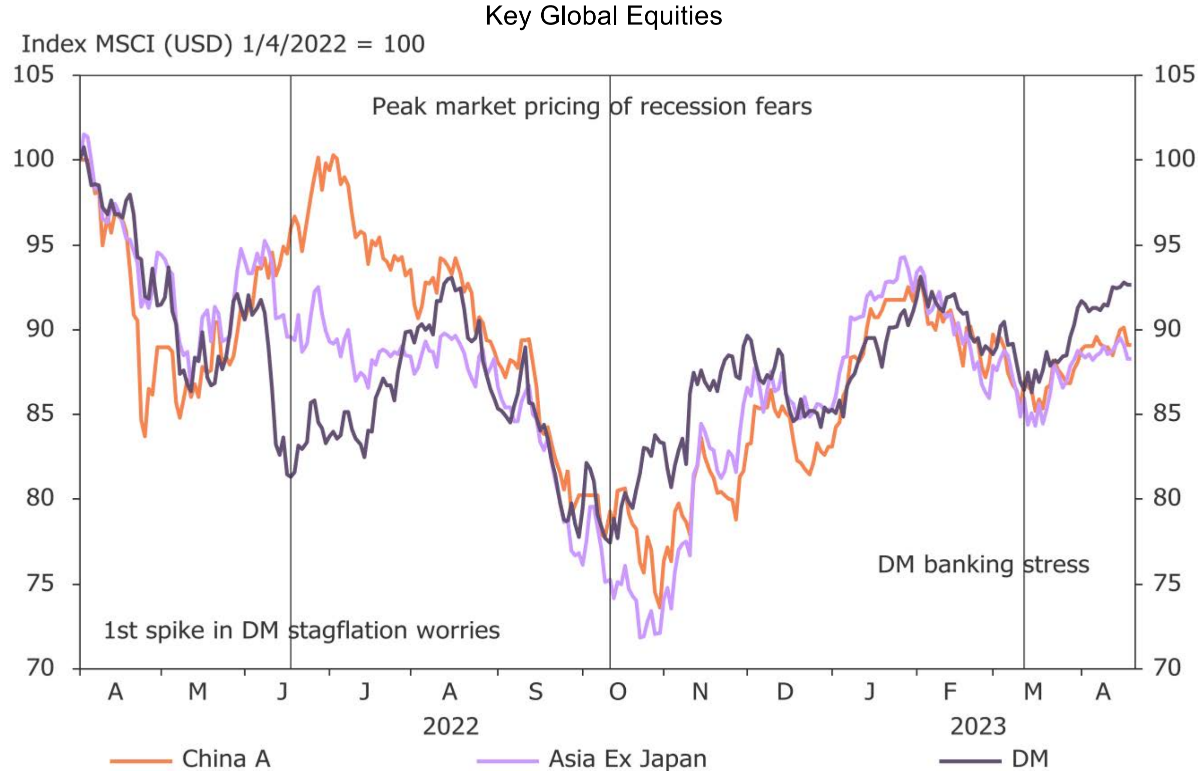
Peak dollar may have past

We believe that the US dollar will continue to slide with the weaker US terms of trade and as the US yield differential becomes less attractive. This can help reinforce improved investor confidence, especially across Asia, as a weaker US dollar often correlates with stronger investment capital inflows to the region. As a safe-haven, 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.

Peak risk-aversion may have been achieved - 2023 is not remotely like 2008, and Silicon Valley Bank was not a Bear Stearns rerun

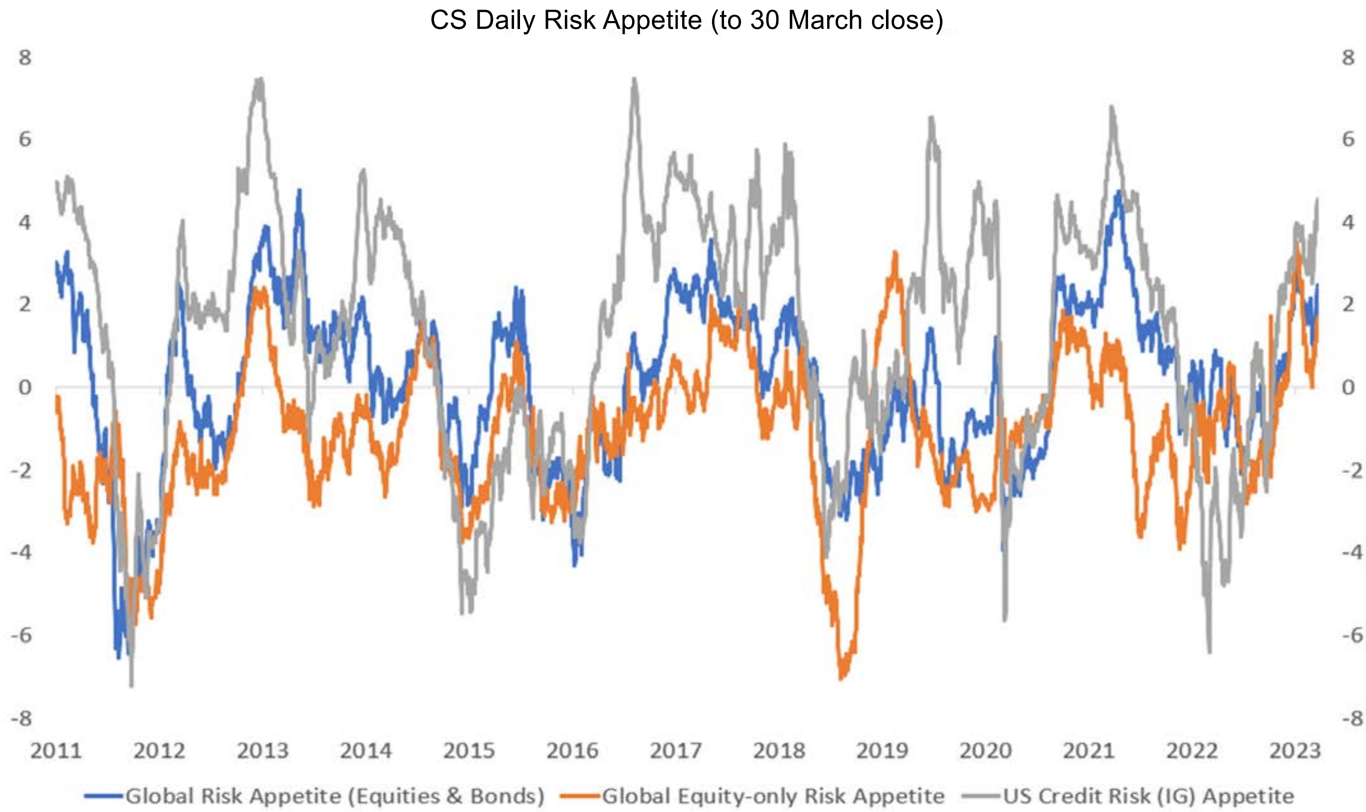
We have already seen global equity markets (Figure 1) and risk appetite (Figure 2) recover strongly from the banking sector stress across the US and Europe in mid-March. Global equities remain well above the Q422 trough and appear to have taken these new shocks in its stride. What has helped to restore investor confidence is that system-wide financial strength indicators are robust and policy backstops to support financials are significant. This increases the likelihood that any further shocks to come, which can't be ruled-out, may prove less disruptive than otherwise by remaining idiosyncratic events.

Figure 1: Developed Market, Asia ex-Japan, and China A performance (April 2022 to April 2023)



Source: Refinitiv Datastream, April 2023

Figure 2: Daily Risk Appetite

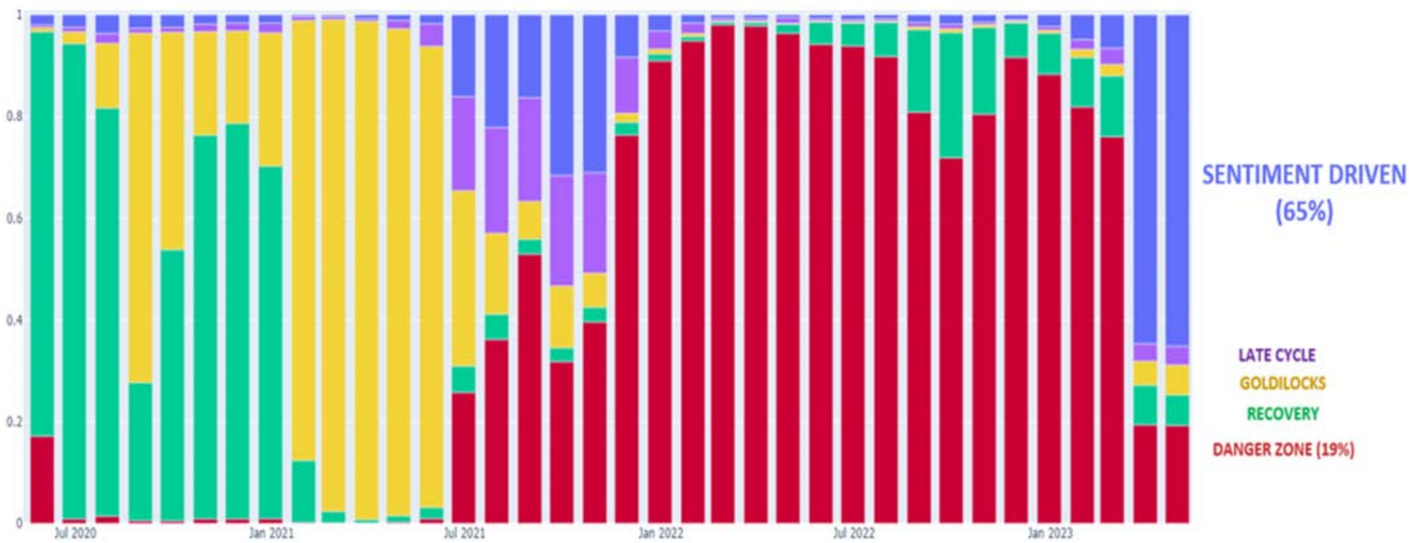


Source: Credit Suisse April 2023

Policymakers will also learn from the shocks over March and will likely strengthen banking sector oversight and regulations going forward. This will further help investor confidence to recover and may contribute to our great reset hypothesis where the cost of capital will drift upwards.

In addition, Fullerton's Investment Regime Indicator (see Figure 3) signals a significant chance that the investment environment is now transitioning to positive sentiment, with greater risk taking, even though growth remains weak and inflation high.

Figure 3: Fullerton's investment environment regime indicator



Source: Fullerton, March 2023. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

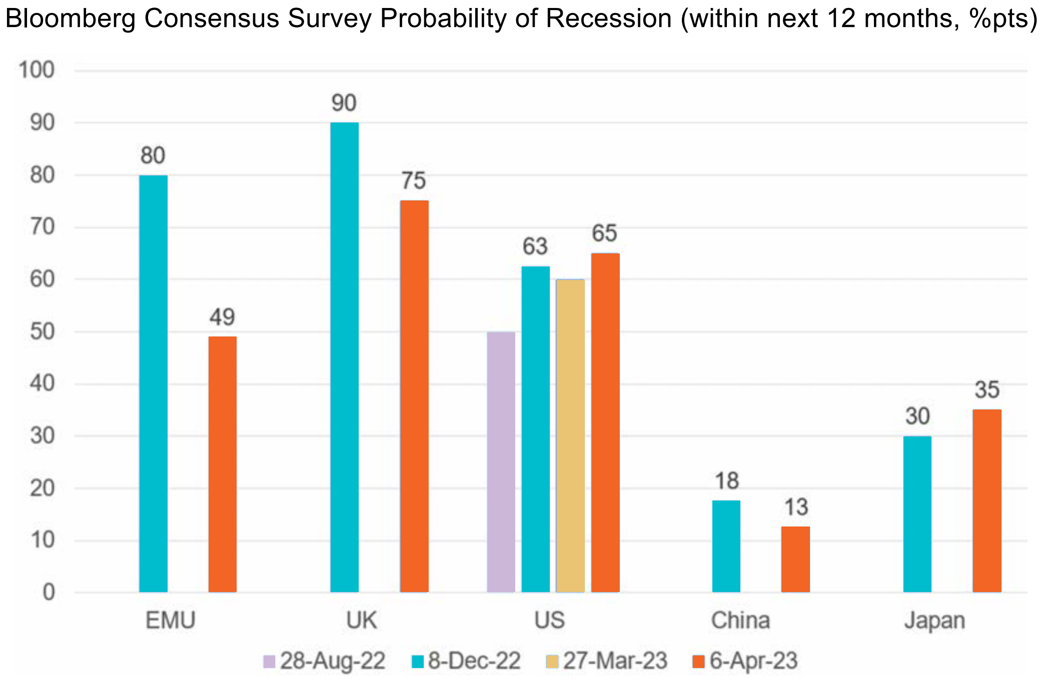
Because equity markets have priced-in significant recession risk we believe that if investors have reached 'peak fear' then upside to risk asset returns can emerge as growth and earnings outcomes can beat bearish expectations.

Macroeconomic overview

The most anticipated recession remains unanticipated

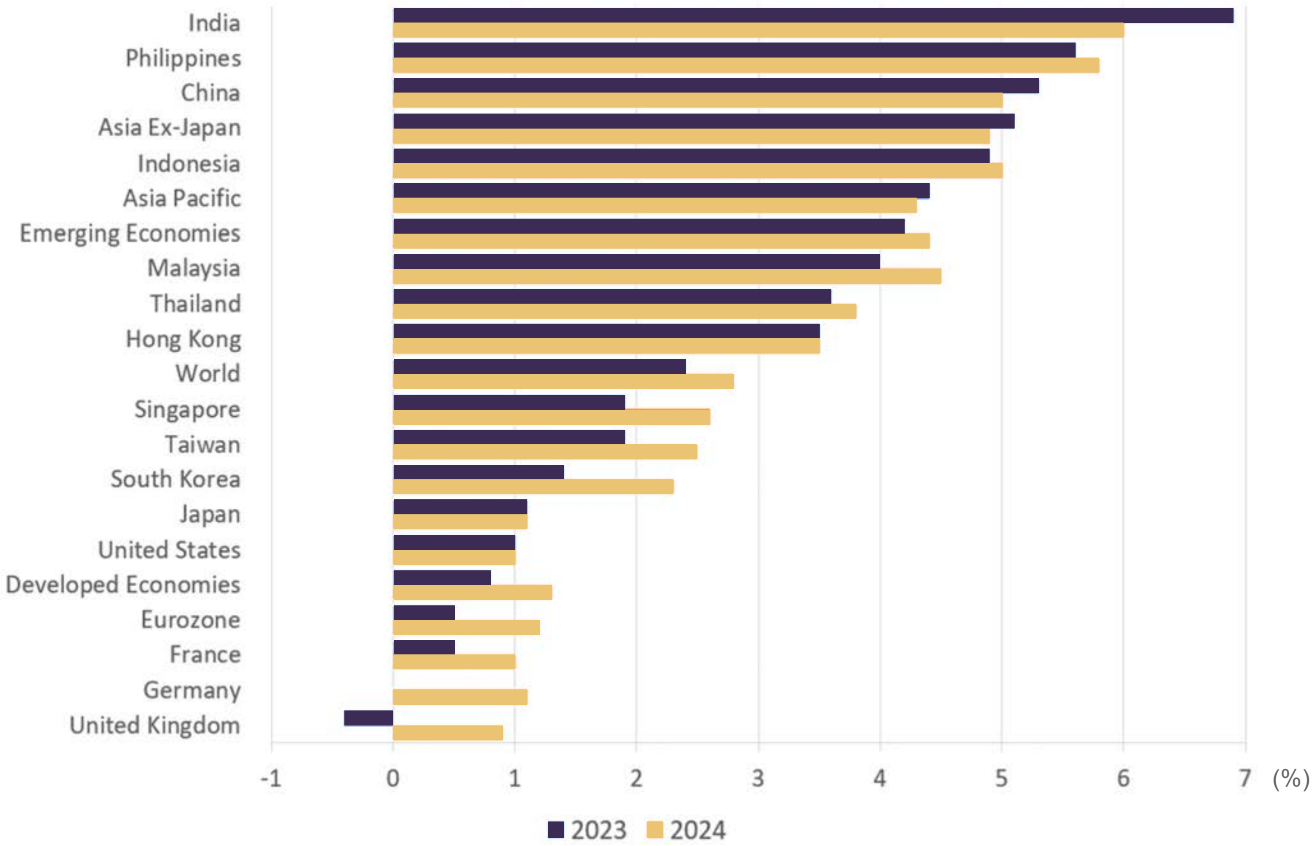
Since January, the US Consensus growth forecasts for 2023 have revised up from 0.5% to 1%, largely reflecting positive macro data surprises, especially across retail sales and household disposable income growth. However, at the same time, recession fears have also increased, with the Consensus surveyed probability of recession (this year) rising from 60% to 65%. In contrast, the Consensus probability of recession for Europe has fallen sharply, even though US and European data surprises are now running equally positive year-to-date (and the US growth forecast for this year is double that of Europe).

Figure 4a: Consensus probabilities of recession



Source: Bloomberg Consensus Forecasts, 6 April 2023.

Figure 4b: GDP growth forecasts – selected countries (2023-2024)

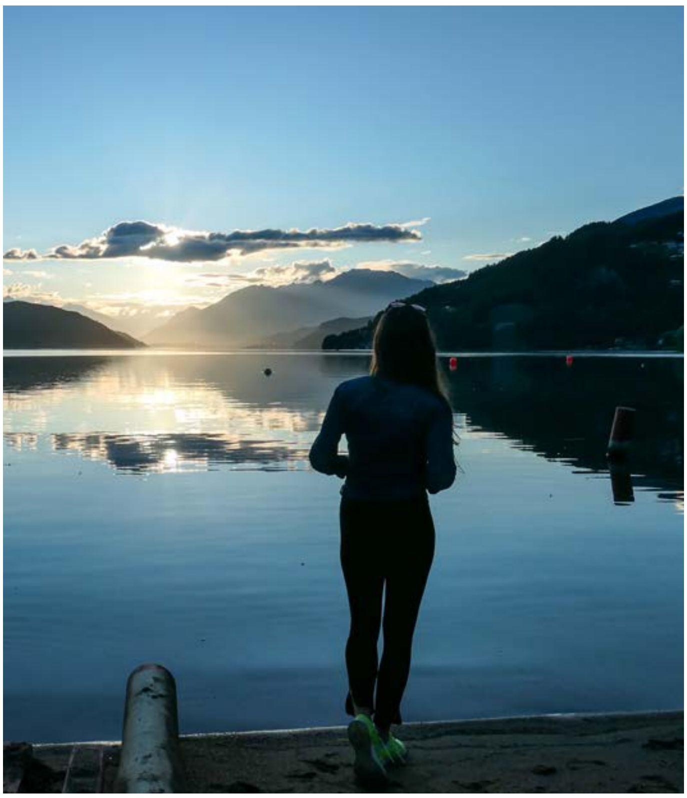


Source: Bloomberg Consensus Forecasts, 30 March 2023

This long-anticipated US recession remains unanticipated and hotly debated. For example, Fed St. Louis President James Bullard has said that US recession fears are 'off-base' and that the strong labour market can keep the expansion going[1]. There is some support for that view in that the US Consensus forecasts expect the US unemployment rate to rise toward 5% (from 3.5% in March) and yet economic activity remains positive with growth forecast at 1% this year and next.

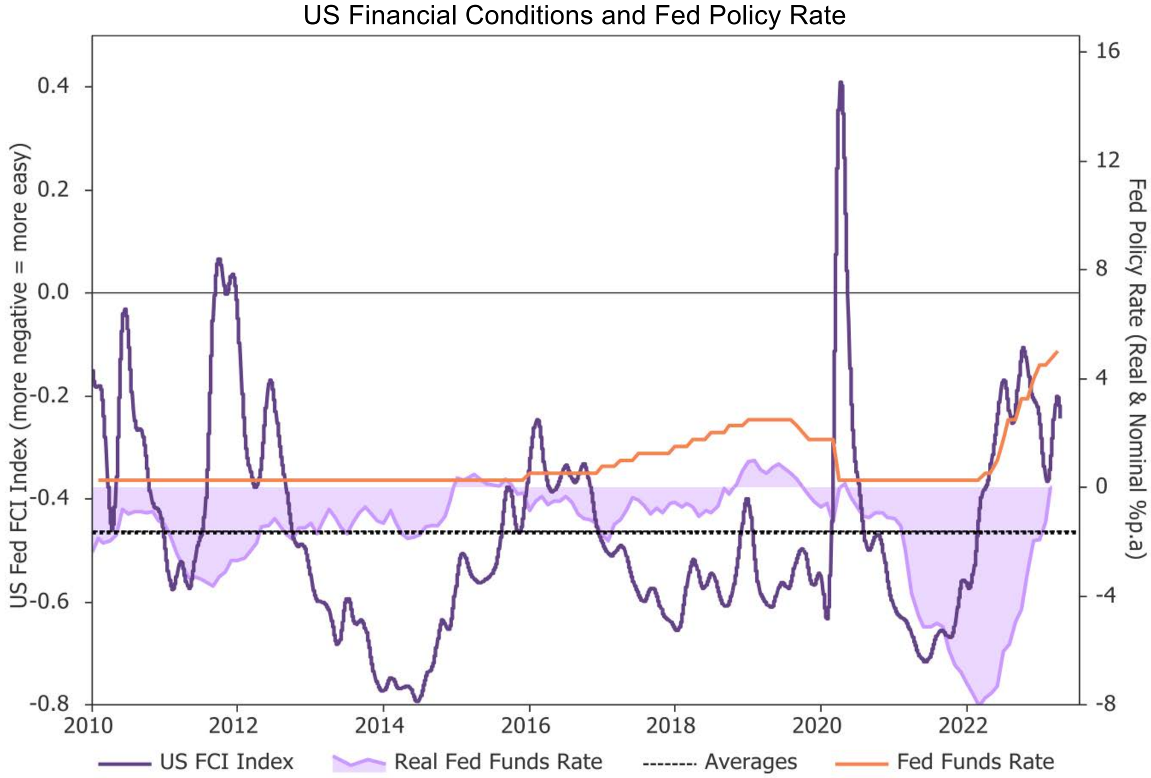
It is possible that a lack of significant stress across the US labour market will give some cushion against recession. In addition, private sector balance sheets are strong, with US corporate profit margins slowing, but still around average, and with household real disposable income growth having recovered back to its long-term average (in part aided by the disinflation to date).

On the other hand, some argue that the inverted yield curve and very tight monetary conditions[2] makes a US recession inevitable. But at the same time, what is often overlooked is that there is significant offsetting cushion coming from real monetary conditions that are much less of a headwind to economic activity (with the US real policy rate at zero).



1. Source: Bloomberg News, 18 April 2023.
2. With reference to Figure 5, US 'easy' monetary conditions (i.e negative FCI) have been sustained on average since the 2008 GFC. Over this cycle, US monetary conditions are still easy but are much tighter than average because of the rapid Fed nominal rate hikes.

Figure 5: US broad financial conditions (FCI), Fed nominal and real policy rates



Source: Refinitiv Datastream, April 2023

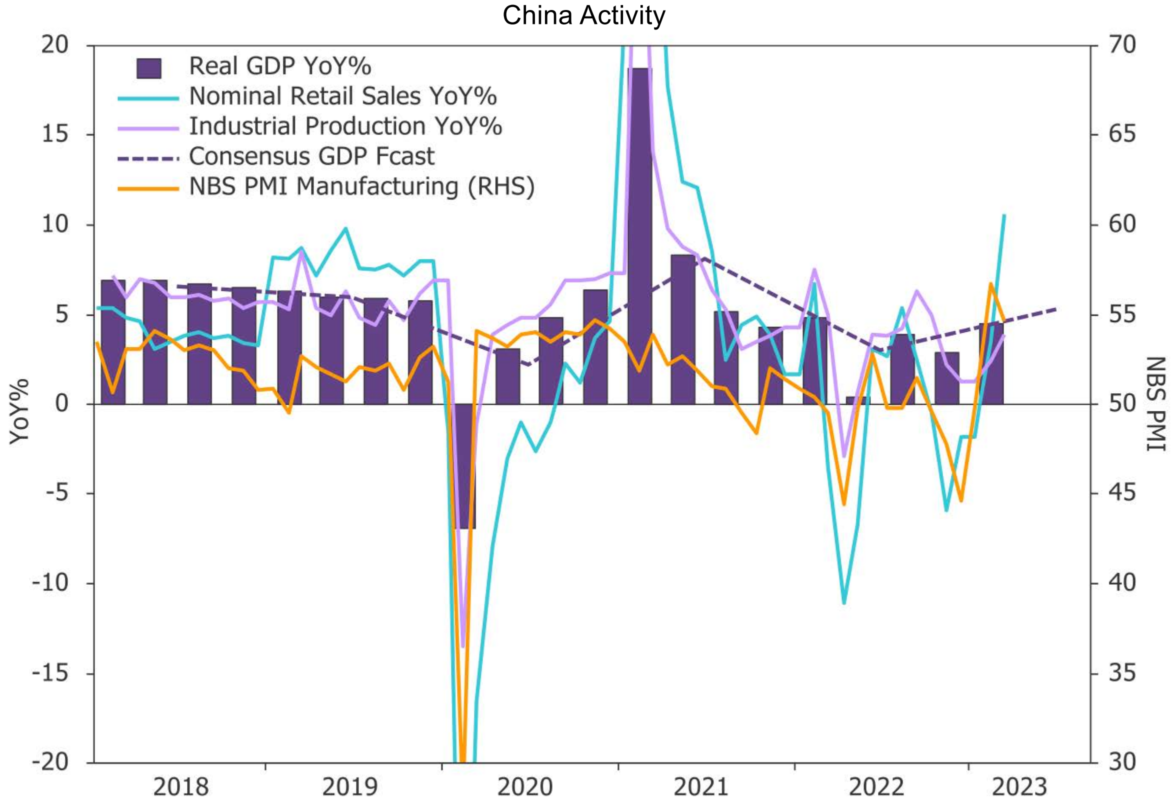
On balance a US recession is still a difficult call

While the prospect of US recession is a difficult call with mixed indicators, what is clearer is that US equity market pricing is very pessimistic suggesting a painful shock of around ‘half a GFC‘-type experience - which lies within the extreme tail of the distribution of Consensus growth forecasts (i.e less than a 5% chance).

Activity data across China has been stronger than expected by Consensus

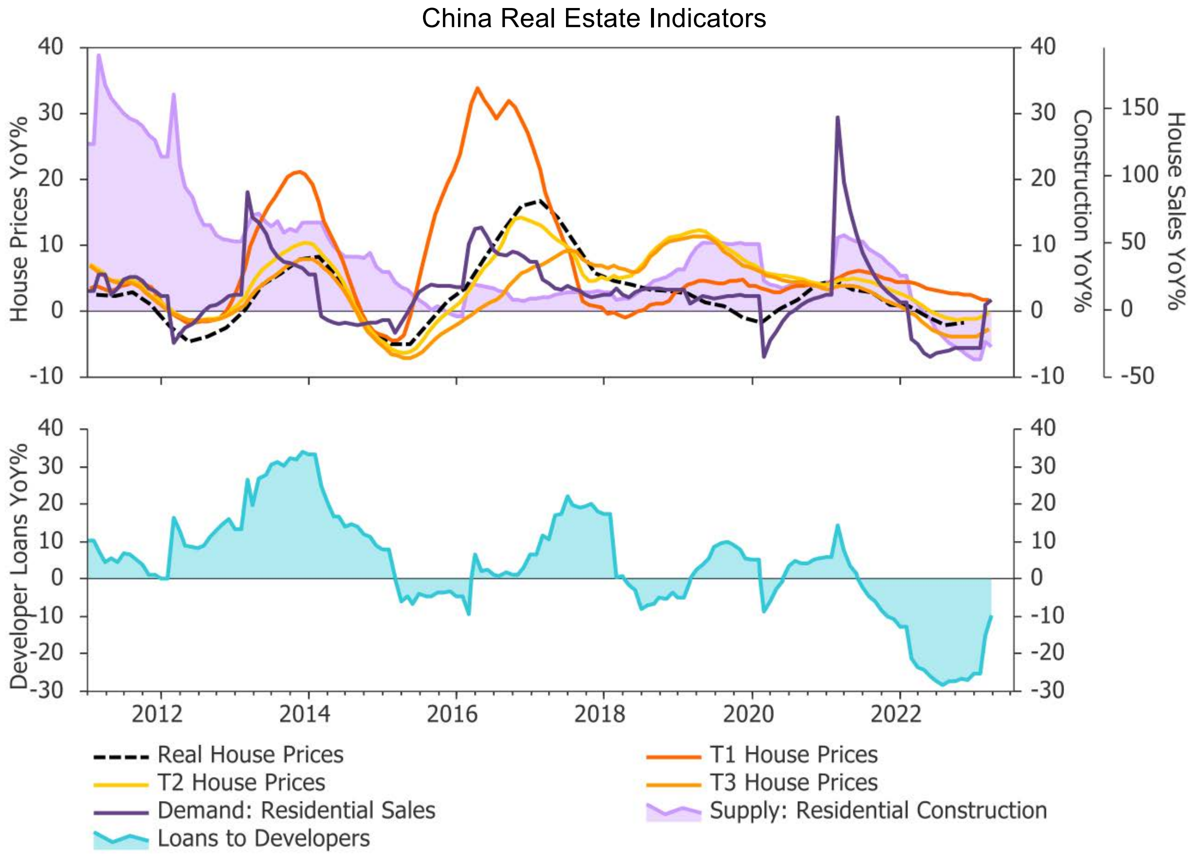
China’s recovery is being driven by much stronger consumption growth, better exports, and some improvement in the real-estate sector with a sharp rebound in house sales (see Figures 6 and 7). Even with the rising hurdle of higher growth expectations from the Consensus, China’s data outcomes have continued to surprise significantly on the upside, especially across industrial production, retail sales, consumption, real-estate, and trade.

Figure 6: China's economic activity on the rebound



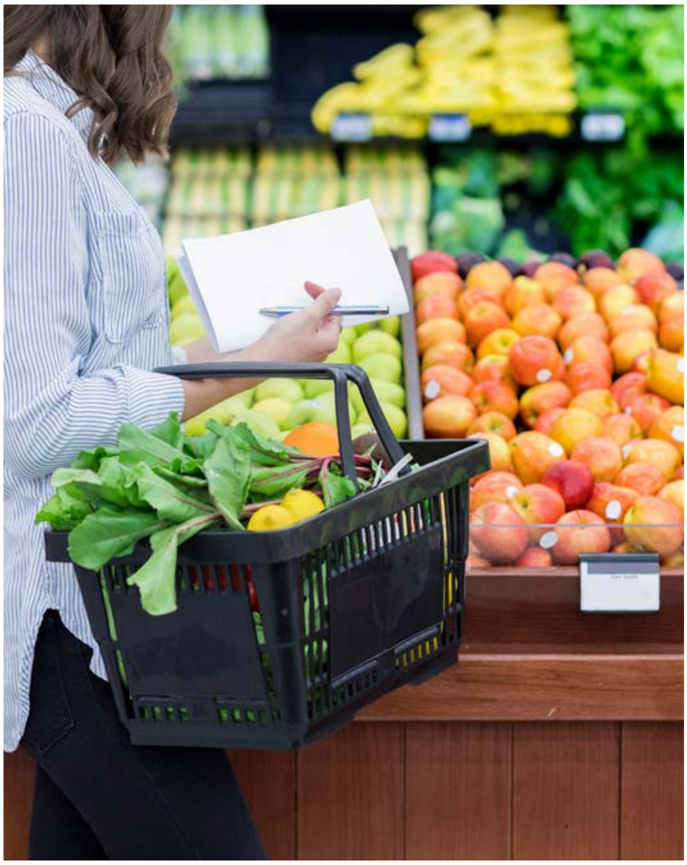
Source: Refinitiv Datastream, April 2023

Figure 7: Stabilising Chinese real estate sector



Source: Refinitiv Datastream, April 2023

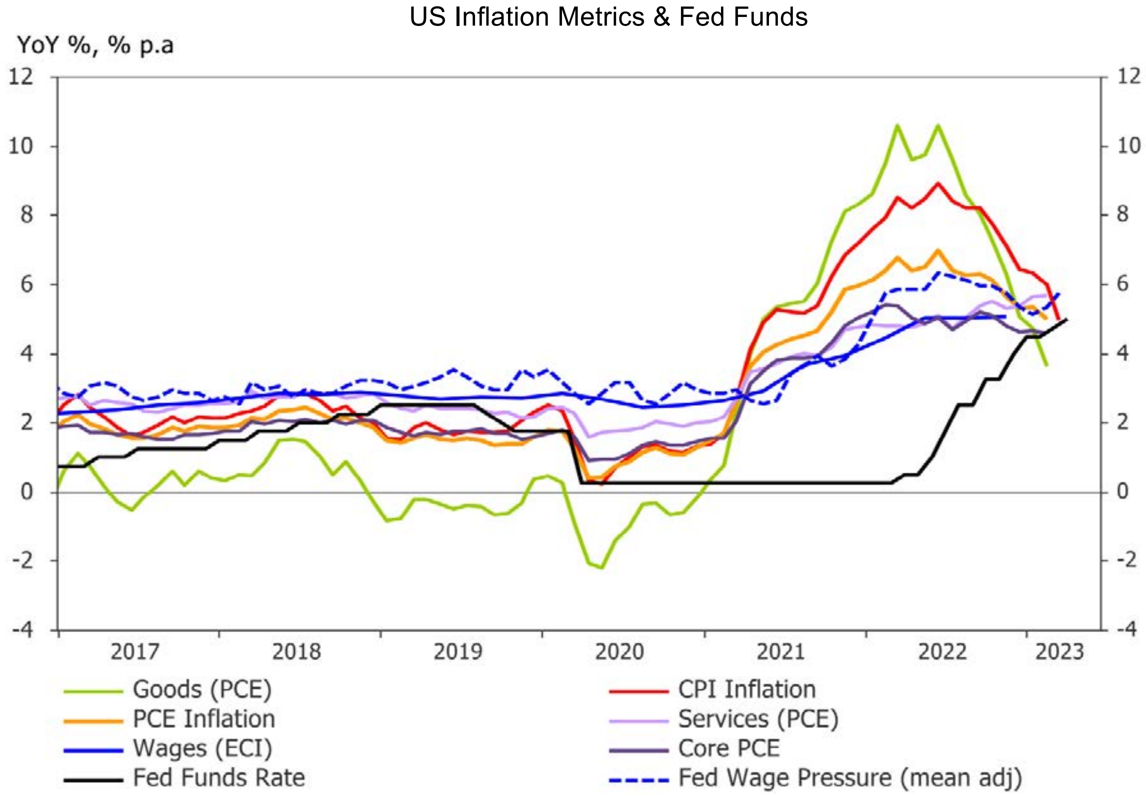
US inflation remains sticky



US services inflation (PCE) is stuck at almost 6% YoY, wage inflation is yet to fall, and the Fed's advance wage pressure indicator has increased over the last couple of months (see Figure 8). Collectively this reinforces the belief that demand is still quite strong, recession risk is modest, and the hurdle for Fed rate cuts is high. That said, sticky inflation does not necessarily mean that the Fed needs much higher policy rates. That is because broad monetary conditions are tight, and a key transmission of monetary policy is the expectations channel which dictates that inflation can fall with limited real economic costs (as expectations drive the adjustment).

There is evidence of this in action as US wage inflation (the blue solid line in Figure 8) has remained flat for more than six months, and has been less than the Fed's leading wage pressure indicator (blue dashed line in Figure 8), even though unemployment is low. If US households' demand less wage gains as disinflation continues, then the US labour market may remain firm. What also helps is that US real unit labour costs faced by firms are very competitive. 'Old-school' thinking that a significant rise in unemployment is needed for inflation to keep falling, may not be true this time given the favourable inflation expectations transmission mechanism.

Figure 8: US inflation metrics and Fed Funds Rate



Source: Refinitiv Datastream, April 2023

Investment strategy and risk-asset outlook

Summary of Fullerton's views (6-12 months ahead)

	Bearish	Negative	Positive	Bullish
Risk Assets			✓	
Asia Equity				✓
China-A Equity				✓
DM Equity			✓	
Asia IG Credit			✓	
Asia HY Credit			✓	
Oil			✓	
Global Sovereign Bonds			✓	
US dollar		✓		

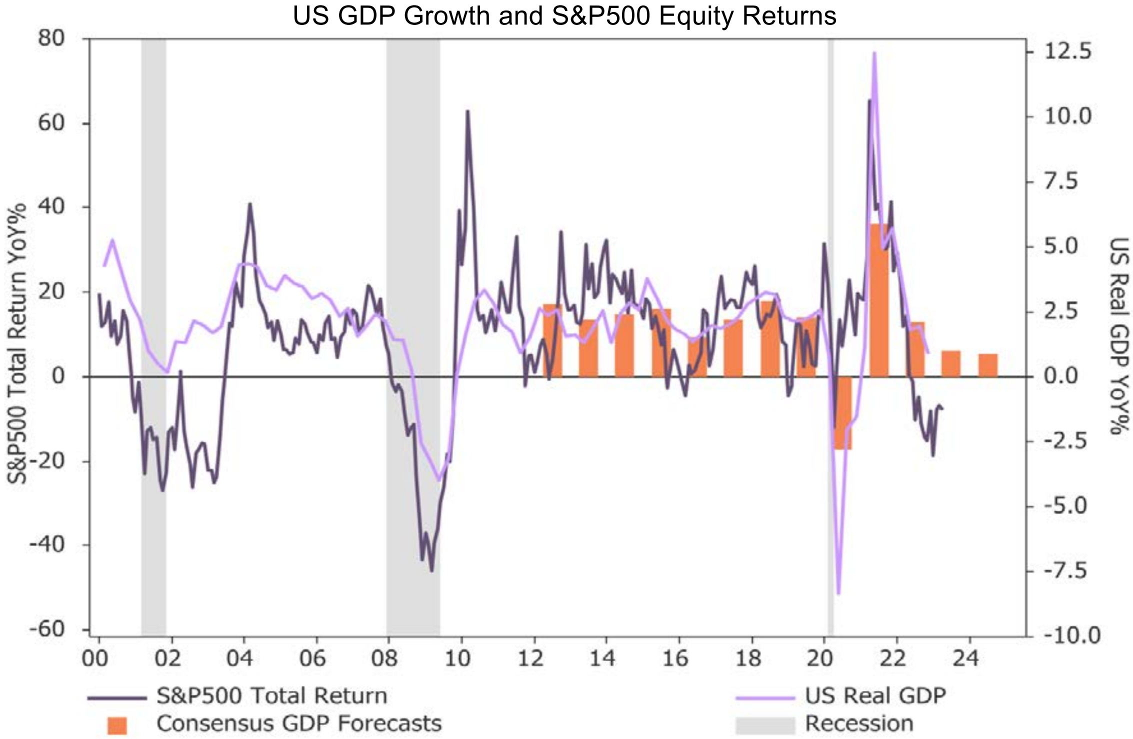
Source: Fullerton Fund Management, April 2023. Views may be subject to change without prior notice.

Equities

We maintain a positive view on DM equities, dominated by the US, and with a favourable outlook for Europe

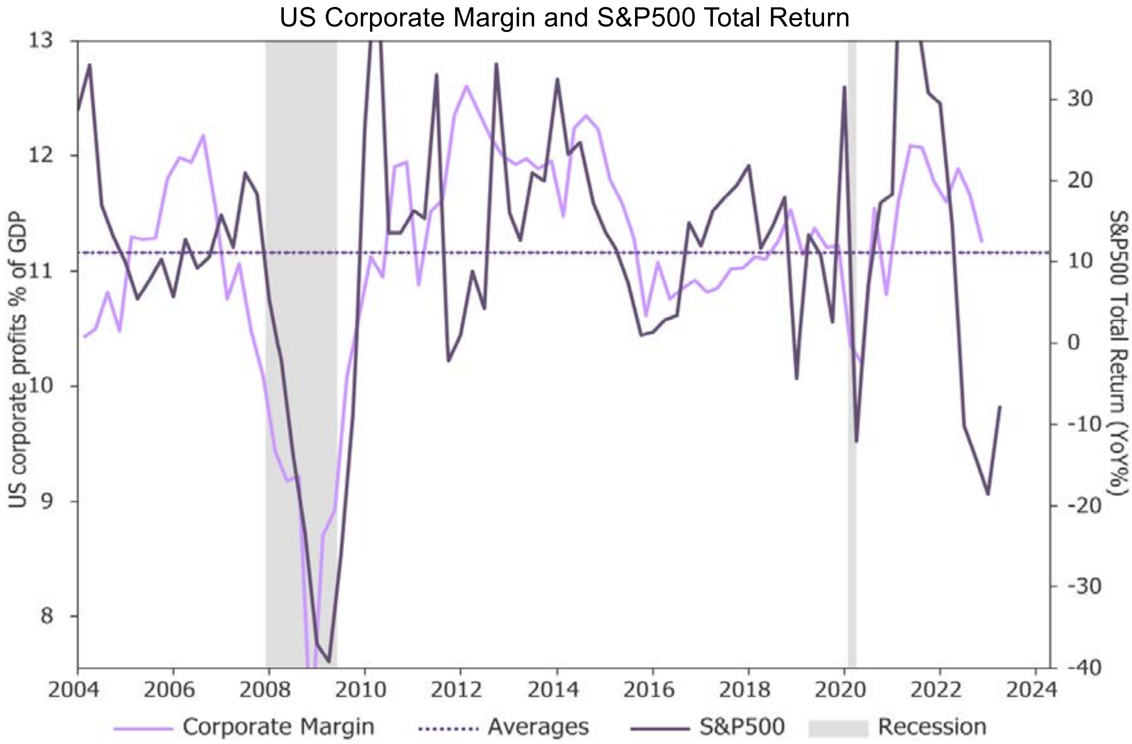
We maintain our positive view on Developed Market (DM) equities, dominated by the US, because it is possible US growth holds-up in positive territory as Consensus forecasts suggest (i.e the bars in Figure 9), and at the same time markets seem too bearish on how painful a potential recession could be (see Figure 9). This is even more evident when we map US equity market pricing with total economy-wide corporate profitability (see Figure 10), where equities have priced-in a significant fall in US corporate margins that is greater than the COVID-driven recession experience and on par with 'half a GFC (2008) shock'. Given expectations of weak and significantly below trend US GDP growth, this year and next, US corporate earnings will likely fall below average but perhaps not to the extent where S&P500 YoY returns are negative.

Figure 9: US growth is expected to hold up, but equities are more pessimistic



Source: Refinitiv Datastream, April 2023

Figure 10: US equities are overly pessimistic on corporate profits



Source: Refinitiv Datastream, April 2023

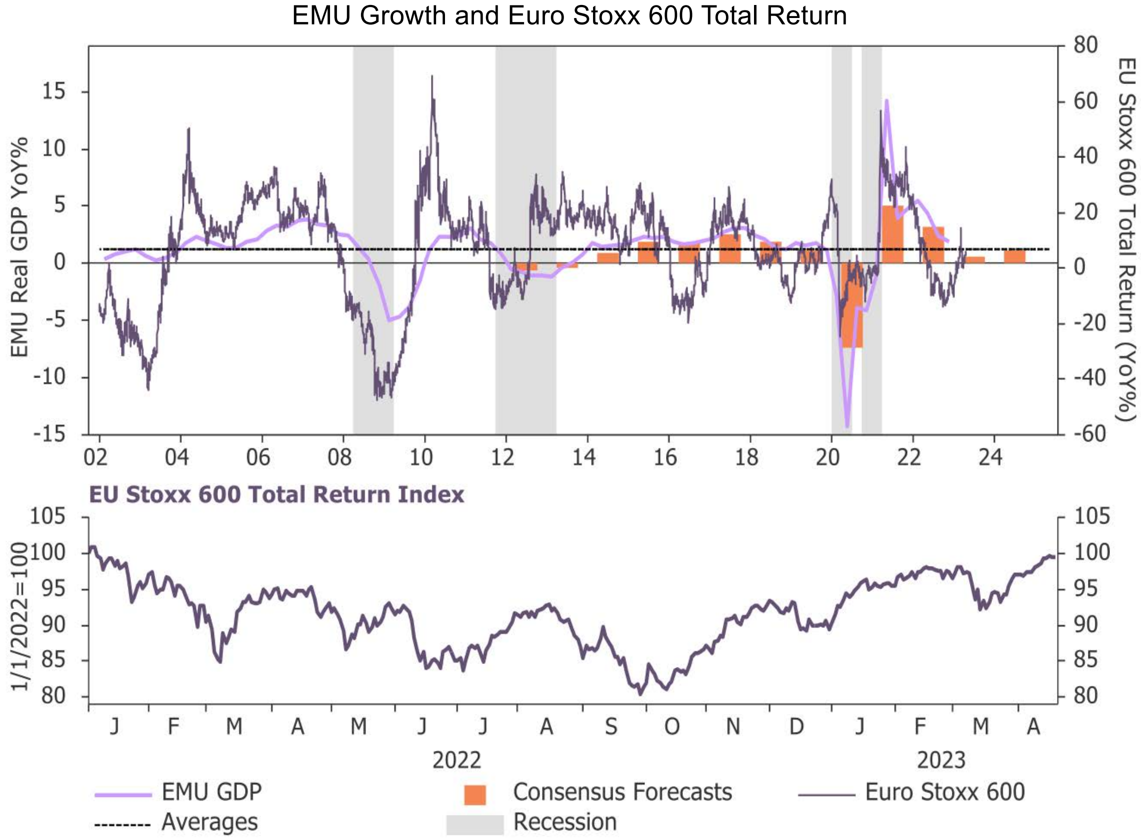
US equity upside can come from improved sentiment and earnings

Reflecting these observations, potential upside in US equities could be driven by improved sentiment as overly pessimistic views are priced-away by the market, and as earnings growth gains support from the low real Fed policy rate, GDP growth remaining positive (which can support top-line revenue growth), and disinflation continuing (which can reduce cost pressures and support margins). One important positive signpost that has already been triggered is that investor sentiment has rebound significantly after the banking sector shocks.

Given Consensus forecasts the outlook is also positive for European equities

European equities have also rebounded strongly as the Consensus has revised down the probability of recession significantly and as market pricing has become much less pessimistic and moved back up toward growth expectations (see Figure 11).

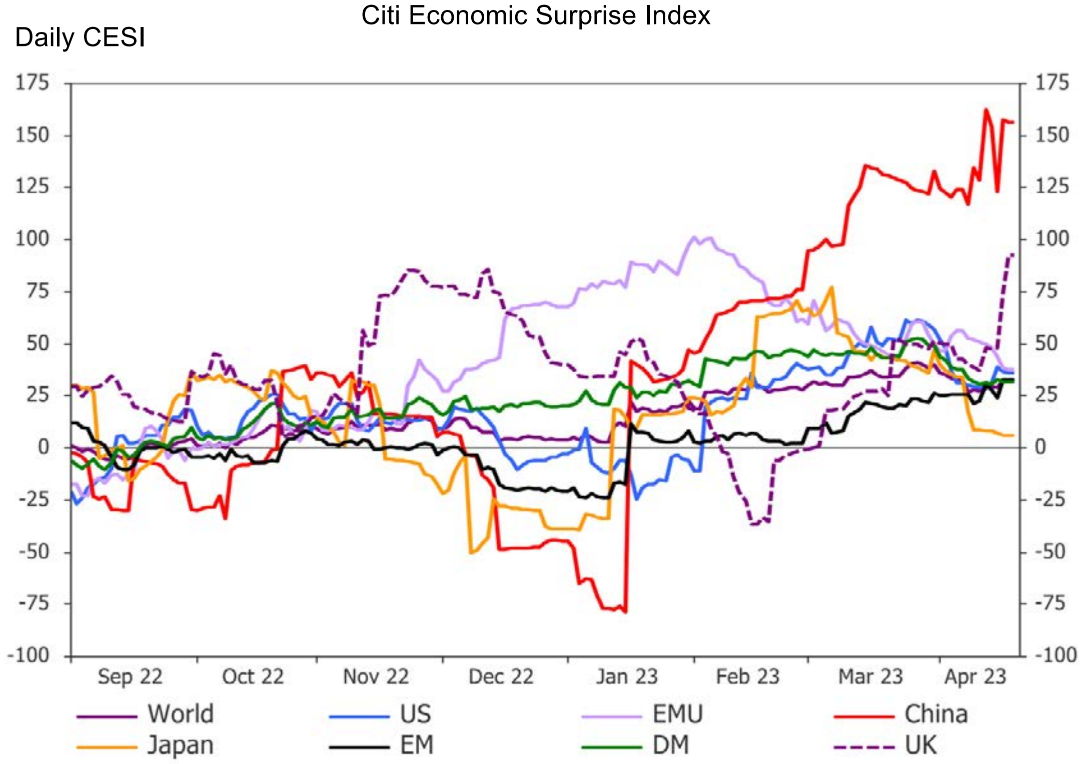
Figure 11: EU equities are more optimistic on growth



Source: Refinitiv Datastream, April 2023

Our belief is that a similar phenomenon may well unfold for the US, especially as the US economic data has tended to surprise on the upside, and is now running equally positive with Europe year-to-date (see Figure 12).

Figure 12: US and EU data is surprising on the upside to the same degree, while China leads

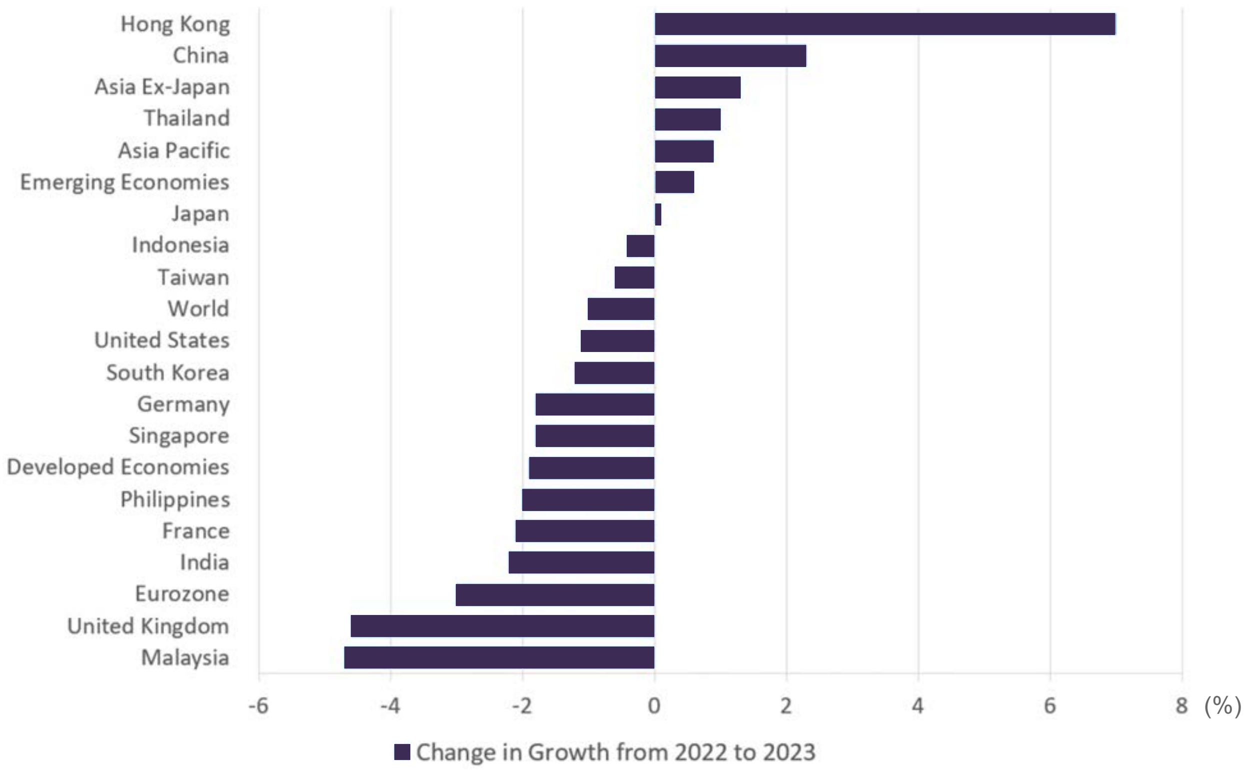


Source: Refinitiv Datastream, April 2023

We are the most positive on China and Asia equities

Fullerton is especially positive on Asian equities, and China (the key driver) is one of the only countries where inflation is low, and growth is expected to be significantly stronger this year (see Figure 13).

Figure 13: Consensus forecasts expected change in GDP growth from 2022 to 2023



Source: Bloomberg Consensus Forecasts 30 March 2023

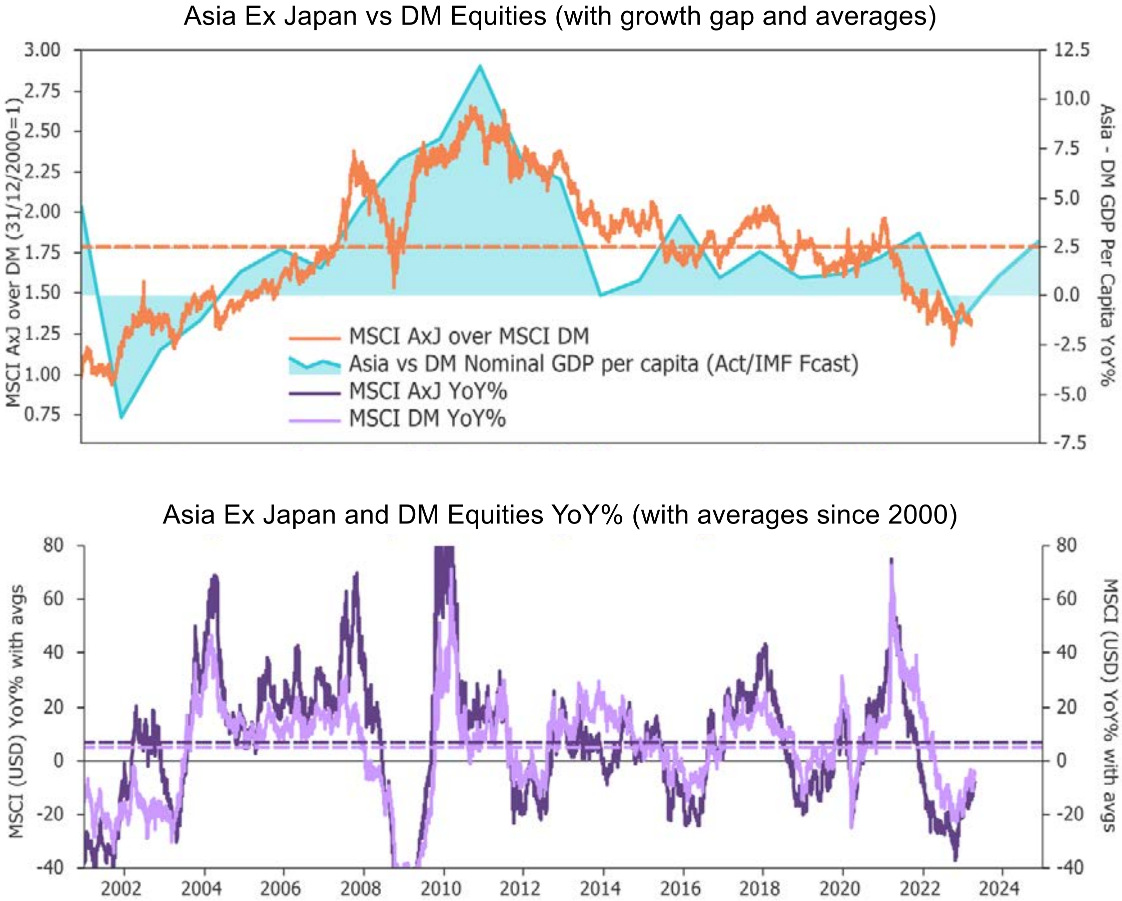
There is still a large amount of liquidity across China that can continue to be deployed into stronger spending and investment, and even after deflating it by current GDP it continues to signal that equity returns could overshoot their long-term average (see Figure 14).

Figure 14: Chinese liquidity indicators improving, potentially supporting upside for Chinese equities

Source: Refinitiv Datastream, April 2023

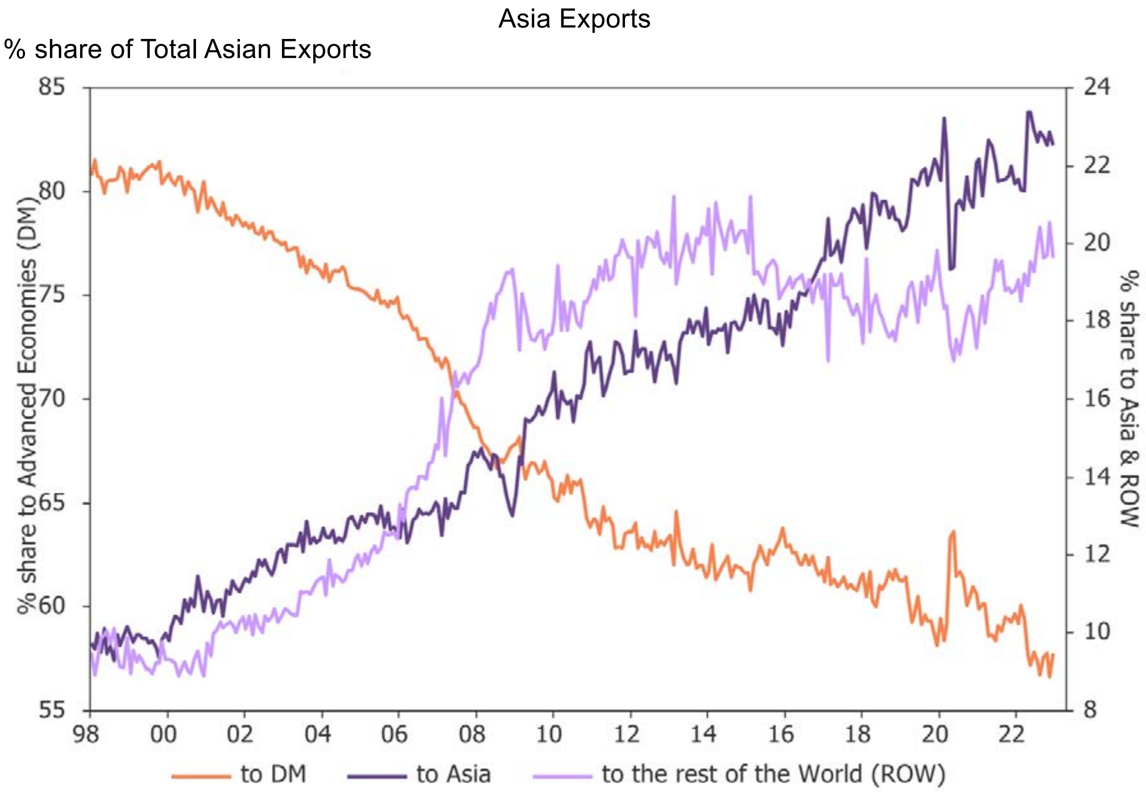
The relative attractiveness of Asia as an investment destination is a key part of our 'great decoupling' hypothesis as the region should gain from its expected growth advantage over DM (i.e Asia's equity market performance can improve relative to DM equities – the orange line can rise to track Asia's expected growth differential over DM in turquoise - see Figure 15). Asia's well-contained inflation outlook, favourable competitiveness, as well as the rising trend in intra-Asian trade (and exports to non-DM markets - see Figure 16), are supportive factors.

Figure 15: Asian equity outperformance over DM could improve given Asia's growth advantages over DM



Source: Refinitiv Datastream, April 2023

Figure 16: Rising intra-Asian trade trend is supportive for the region



Source: Refinitiv Datastream, April 2023

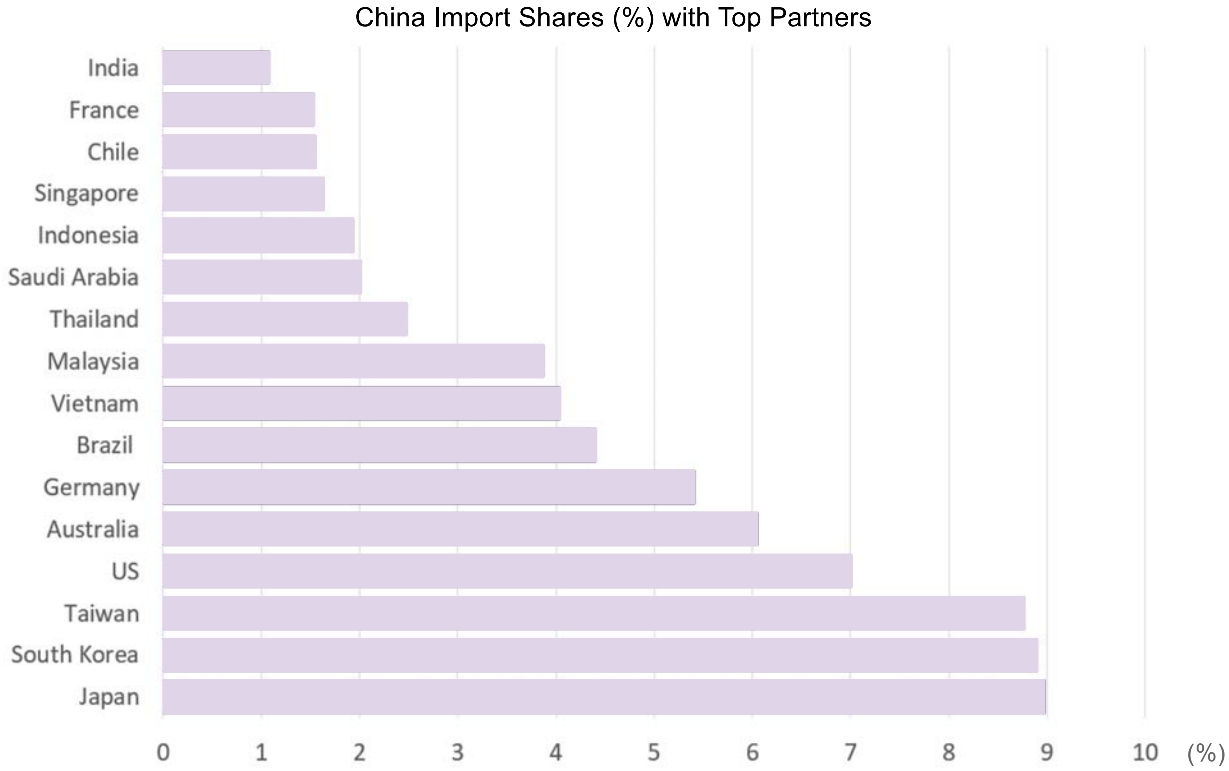
We favour consumerism, new industrials, IT, healthcare, and ESG-linked stocks

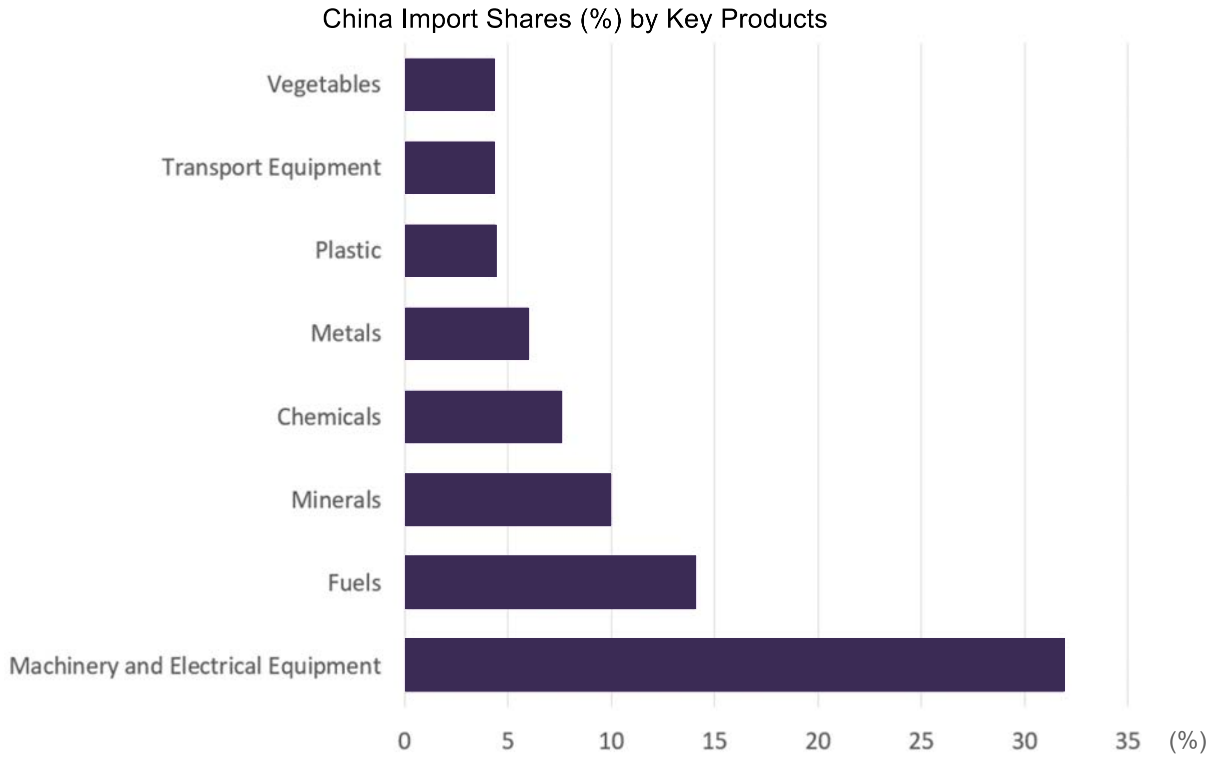
The equity sectors we like have not changed materially from what we have highlighted before. We generally prefer growth over value, and sectors linked to consumerism, IT, new industrials, healthcare, and ESG-leaders. These sectors are favoured as they have a robust trend of historical outperformance. Separately, across DM ongoing disinflation can boost real incomes and earnings, while Asia benefits from its competitiveness and growth advantages.

A key contributor to China's growth rebound this year is likely to be greater consumerism coupled with higher-value added industrials expanding their outputs (especially to meet infrastructure objectives). In turn, stronger demands from China, and improved competitiveness (driven by softer real exchange rates), can benefit the entire region with positive spillovers for:

- **South Korea, Japan, and Taiwan**: especially for firms producing manufactured equipment, machinery, transport equipment, and consumer products.
- **Vietnam and Thailand**: for more labour-intensive manufactures and tourism.
- **Malaysia and Indonesia**: for corporates involved in exporting and supply-chains for raw materials, minerals, and food.
- **Singapore**: for manufactured equipment and tourism.

Figure 17: Potential beneficiaries of stronger demand from China





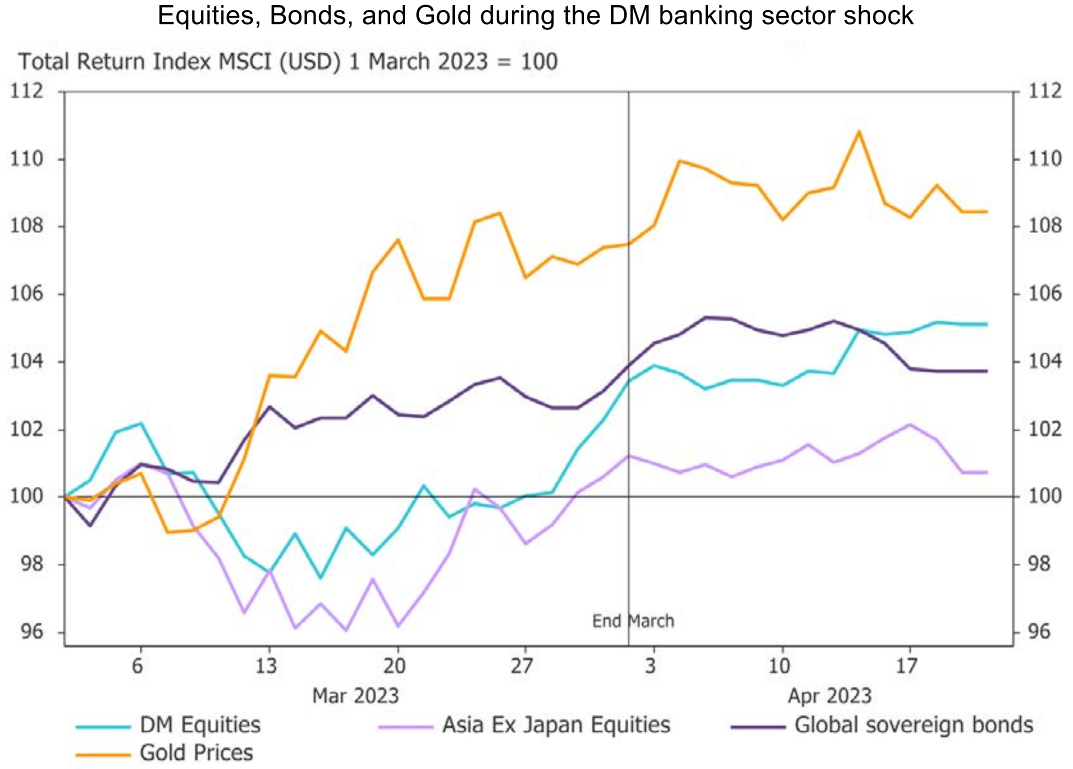
Source: China's key supplier countries and products (% of China's total imports, around $3.2tn USD p.a). World Bank 2022.

Fixed Income

We have turned positive on duration as potential income streams are attractive and bonds give valuable downside cushion from recession risk

We have turned positive on US bond duration as any significant upside to US yields may be constrained by recession fears. Separately, if growth surprises to the downside, then bonds can potentially provide that valuable cushion. As it is, global bond (and gold) investors have already seen some price upside in these assets from the spike in recession fears over mid-March when US and European banks came under significant stress (see Figure 18).

Figure 18: Bonds (and gold) saw some price upside from the March spike in recession fears and equity sell-off



Source: Refinitiv Datastream, April 2023

We have emphasised for a while that higher than usual yields are motivating 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 have tended to perform well are those with high and relatively stable yields e.g India and Indonesia. In addition, other headwinds may ease further as we have a negative outlook on the US dollar, while Asian currencies may register gains reflecting improved investor confidence and potentially greater capital inflows.

Corporate credit – we remain positive on Asia IG and HY

We are especially positive on Asian Investment Grade (IG) corporate credit as carry returns can be attractive, and these firms have strong fundamentals with interest coverage ratios that are higher than during the most stressful time of the GFC (in 2008). While further spread tightening may be limited for Asia IG corporate credit, yields at around 5%[3] are now potentially very attractive for investors. Across Asia, China and Korea IG firms stand-out with strong fundamentals, and robust debt servicing capacity. There is also the added lift from potentially greater revenues likely to stem from China's domestic rebound.

Asia High Yield (HY) corporate credit has greater leverage and is more sensitive to global recession fears, but at the same time returns should improve as China's real estate sector continues to stabilise. We are positive on HY corporate credit but investors need to remain selective.

The corporate credit sectors we like the most align with our positive equity view

We prefer non-financial corporates, and sectors linked to consumerism, new industrials, raw materials and infrastructure (especially as countries increasingly defend supply-chains and continue to invest in renewable energy). We believe these sectors have positive long-term drivers, and as a result, can give some cushion to investors in challenging environments.

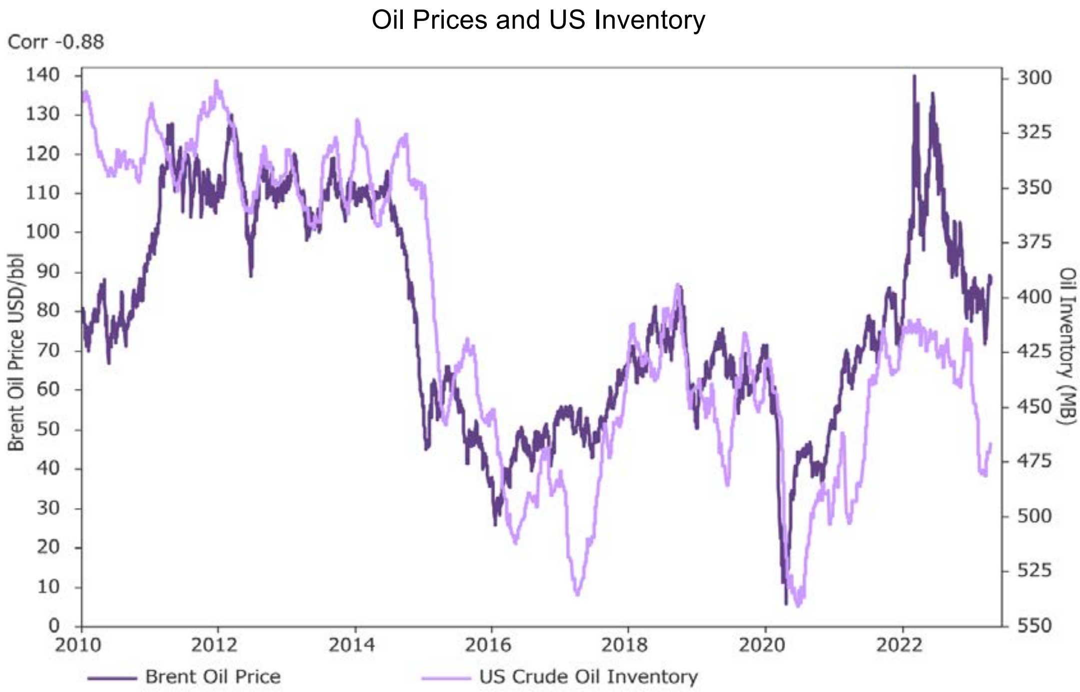
3. Source: Bloomberg, April 2023.

Oil, Gold, and the US Dollar

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

Oil prices have gained some support from the bottoming in US inventories (see Figure 19) and from expectations that the supply-side remains tight and controlled. Underinvestment in capacity, combined with greater geopolitical concerns, and stronger urgency to defend energy resources, should continue to provide a solid floor to oil prices. With stronger demand growth expected, especially from India and China, oil prices are likely to rise moderately going forward.

Figure 19: Oil prices and US inventory



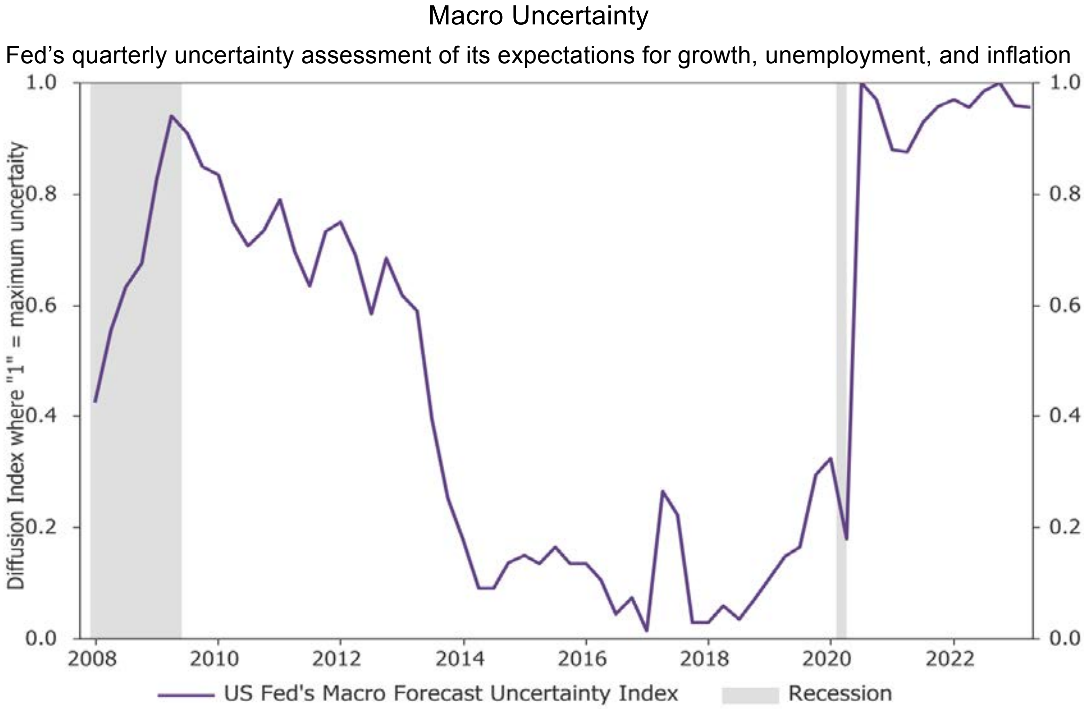
Source: Refinitiv Datastream, April 2023

We are positive on gold

As part of the New World order, gold prices have experienced some unique supportive factors since the COVID-driven recession, such as above trend geopolitical risks and a decoupling from yield strength (especially in 2022, where gold performed well versus other asset classes). Gold again provided valuable cushion to investors in mid-March when recession fears spiked with the banking stresses across the US and Europe.

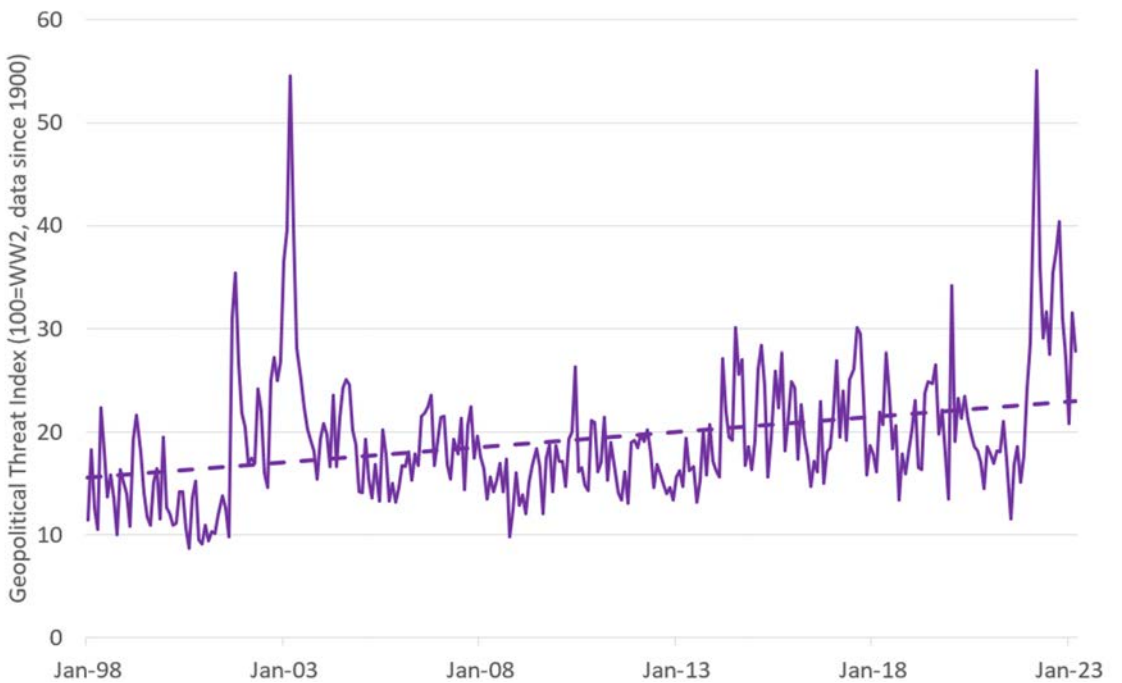
We believe that returns from gold can remain favourable given significant macro uncertainties (especially surrounding growth and inflation. See Figure 20), significant geopolitical risks (see Figure 21), and a weaker USD. There may also be an extra boost to returns from gold when the Fed starts to think about rate cuts next year.

Figure 20: Macro uncertainty remains elevated



Source: Refinitiv Datastream, April 2023

Figure 21: Geopolitical risks since 1998



Source: A news-based measure of adverse geopolitical events and associated risks since 1900. The geopolitical risk index spiked last year, and around the two world wars (WW2=100, which is the worst period), at the Korean War, during the Cuban Missile Crisis, and with the Iraq War (2003). From Caldara, Dario and Lacoviello, April 2023.

We maintain our negative outlook for the US dollar

With the correction in the US terms of trade unfolding, and as the Fed's policy tightening cycle matures (driving less attractive US yield differentials in the process), the USD is likely to continue sliding (see Figure 22). From a fundamental perspective, the US dollar remains overvalued, especially as the US' relative export prices are less favourable.

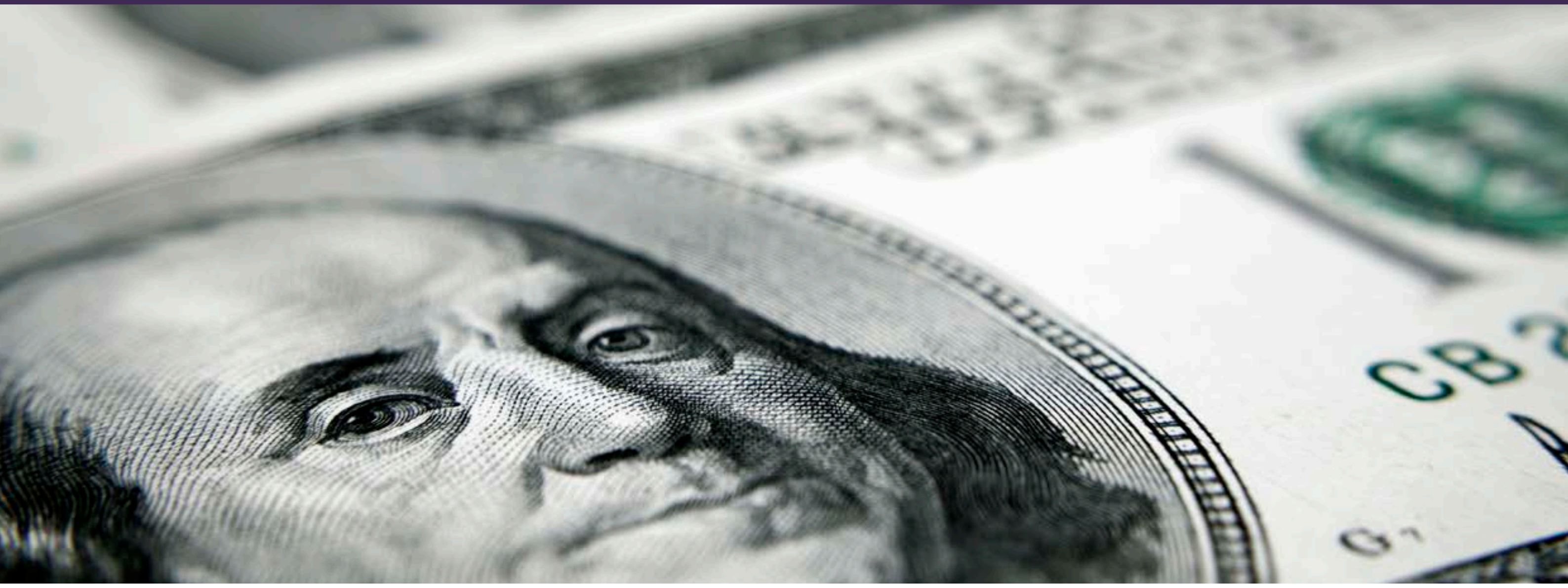
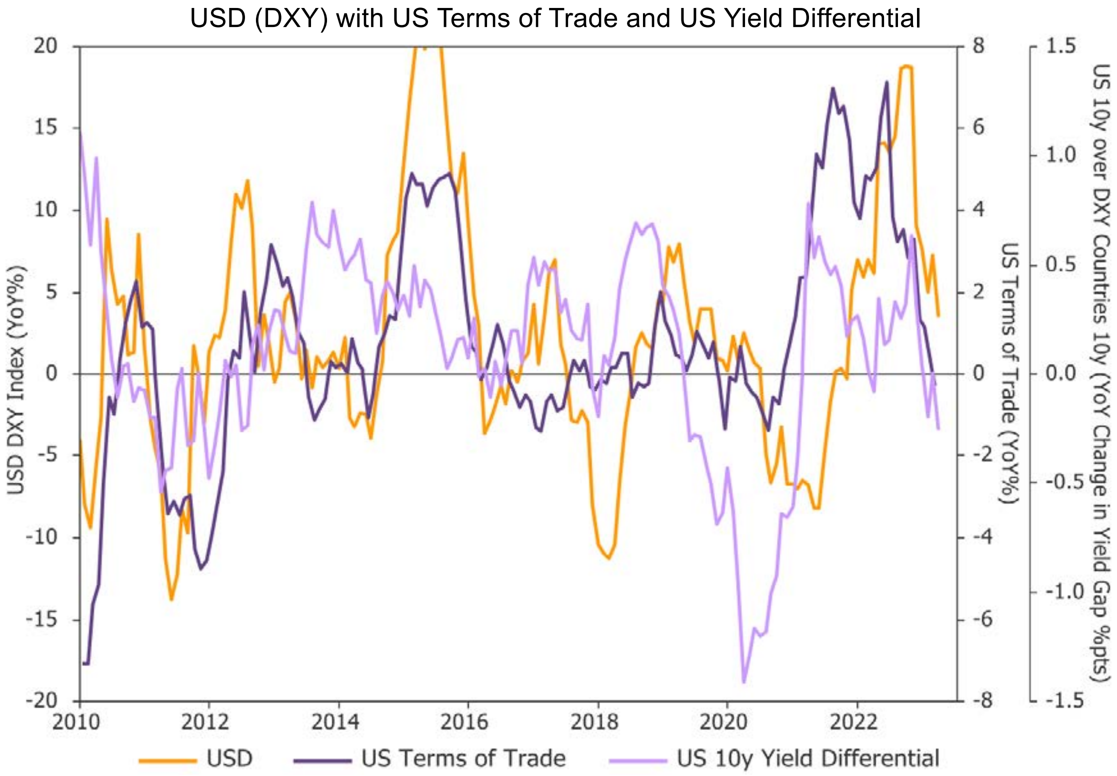


Figure 22: Key drivers of USD weakness: weaker terms of trade and less attractive yields



Source: Refinitiv Datastream, April 2023

From the safe-haven angle, the weakness in the US dollar is also encouraging in that it suggests investors attach a low probability to the prospect of a deep recession.