Our '3G' forces are creating a goldilocks environment

Fullerton Investment Views - Quarterly report

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Contents

Executive summary

- **Fullerton's Macro Regime Indicator has shifted to 'Sentiment Driven' which is positive for returns from global risk assets.**
    - At the same time, the demand for downside protection (i.e the put/call ratio) by US equity investors has fallen back below average suggesting recession fears have faded. We continue to believe that the US can achieve a soft-landing outcome.
- **We maintain our positive view on Developed Market equities (especially the US), global and Asia bonds, and corporate credit.**
    - **But we have revised China and Asia ex-Japan equities to a negative view,** reflecting ongoing weakness in earnings and some of the longer-term challenges that China still has to resolve.
- **DM equities are performing strongly, driven by the US, as growth expectations have been revised-up and as earnings grind higher.**
    - US households and firms have robust financial resources. As such, we believe US growth can be around trend in 2024.
    - While disinflation continues, it is a 'sticky' adjustment process (especially across services), with inflation likely to be above the Fed's target until 2025.
- **In harmony with our '3G' forces of a great decoupling and reset, the US Fed has signalled higher interest rates for longer.**
    - Once the Fed Funds rate peaks, it will likely reinforce positive market sentiment. Markets and macro fundamentals should remain strong enough to continue to successfully navigate tight monetary conditions.
- **Key indicators remain consistent with our view of the USD fluctuating around a downward trend.**

01 Risk-Asset Outlook

Summary of Fullerton's views (12 months ahead)

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

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

We believe that the positive YTD performance of key asset classes can continue (see Figure 1). Against a constructive macro backdrop, we maintain our positive view on Developed Market (DM) equities, global and Asia bonds, and corporate credit.

- **We are positive on equities, especially the US, followed by Japan and Europe:** DM equities can continue to grind higher as earnings expectations improve.
    - **However, we have a negative view on China and Asia equities,** reflecting the likelihood that weak earnings growth continues, and some longer-term headwinds for China will likely drag on the region.
    - That said, there are still attractive opportunities for active-management focused investors across countries that are benefiting from stronger global demands for higher-value added products, IT, ESG related investments, and competitive labour-intensive manufacturing e.g India, South Korea, Singapore, Taiwan, and Indonesia.

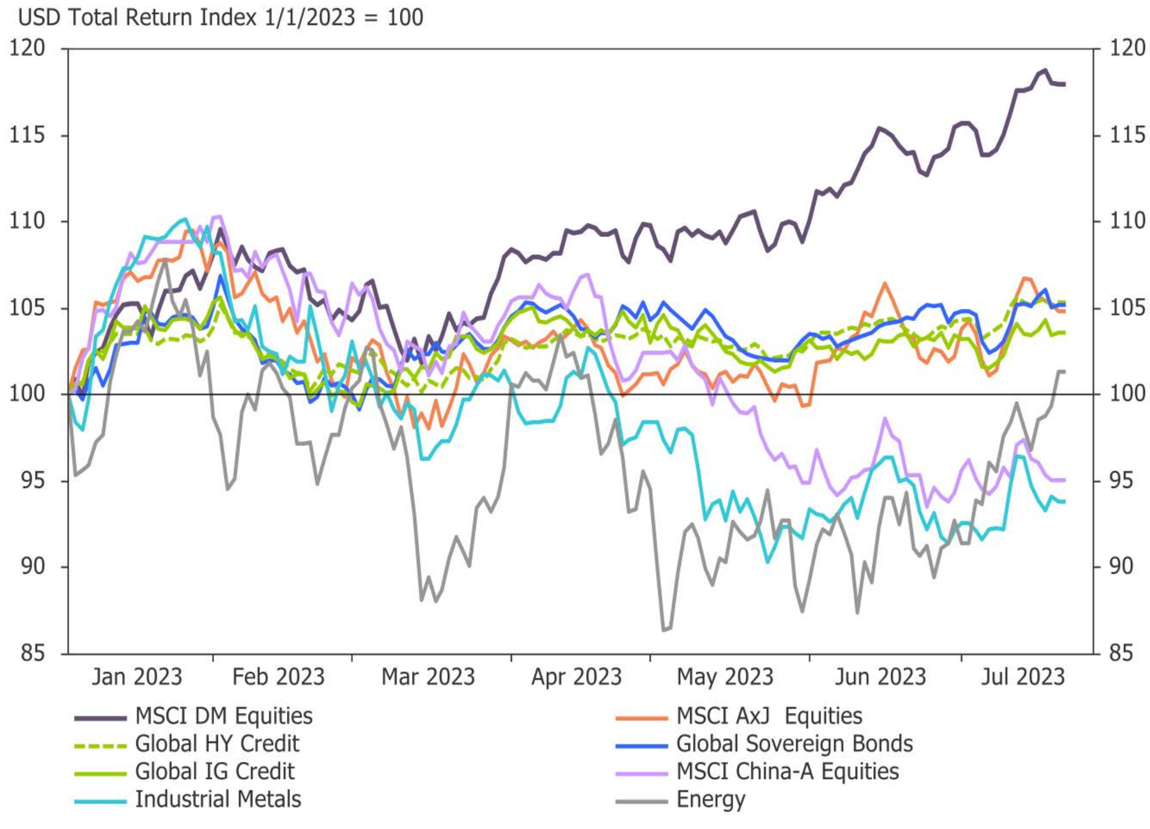
- **We remain positive on fixed-income:** With the likelihood of high interest rates for longer, bonds may generate a favourable income-stream for investors while providing cushion from potential growth shocks. While the performance of equities is likely to continue outperforming fixed-income, the investment environment is very different from 2022 where the current 'goldilocks-like' conditions can result in both equities and bonds performing well.

- **Industrial commodities are struggling,** with less than expected demand from China. **Oil prices may still face some downside risk** if demand across Asia and Emerging Markets (EM) does not rebound.

- **We maintain our negative outlook for the US dollar.** The US terms of trade is deteriorating sharply, the US interest rate differential is slowly becoming less attractive, and the real exchange rate remains overvalued.

Figure 1: Risk asset returns YTD: led by DM equities, we believe the favourable performance across key asset classes can continue

Risk Asset Returns



Source: Refinitiv Datastream, July 2023

02

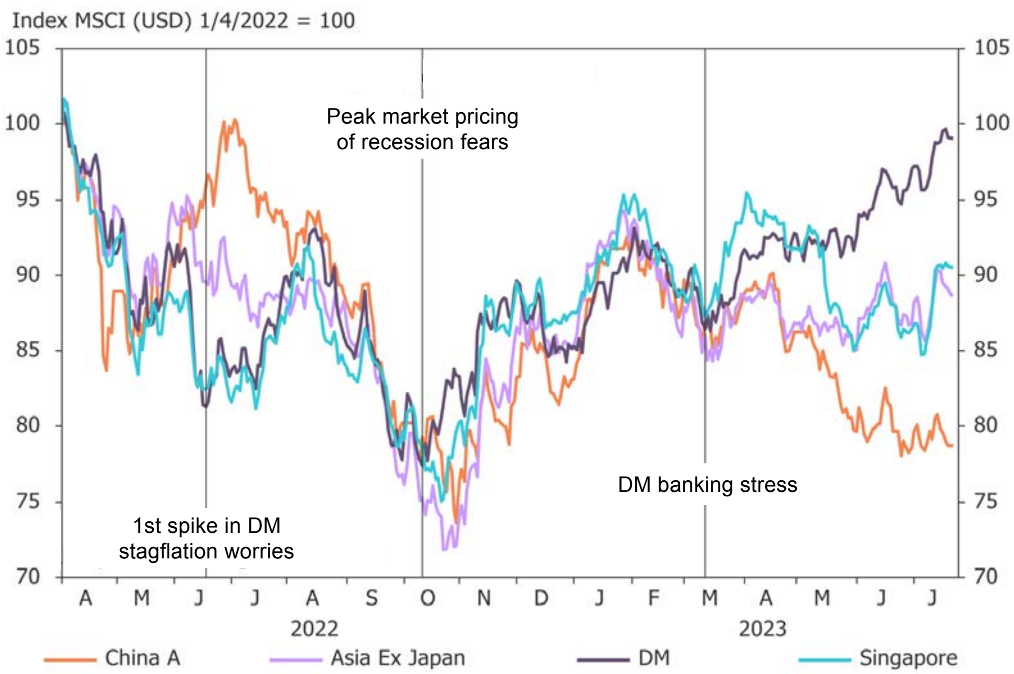
Investment Environment

Our '3G' forces are fostering a goldilocks environment, especially across Developed Markets (DM)

The investment environment continues to unfold consistently with the '3G' forces that we first outlined in November 2022. Firstly, the 'great decoupling' has seen further differentiation in risk asset performance across Asia and Developed Markets (see Figure 2). This decoupling is consistent with the stronger growth and earnings fundamentals unfolding across DM, and especially for the US, in contrast to China and the rest of Asia.

Figure 2: The 'great decoupling' continues between DM, Asia, and China

Key Global Equities



Source: Refinitiv Datastream, July 2023

Secondly, the ‘great reset’, where the robust growth outlook for DM, along with the slow disinflation process (especially across services), signals interest rates may prove higher for longer. Lastly, the ‘great volatility’ reflects the side effects of significant cross-country decoupling where risk asset return volatility has been more varied across Asia than the West.

As we have previously emphasised, there is a need to manage the risks emanating from the differentiation sparked by these underlying 3G forces, but there are also significant alpha opportunities being created, especially across DM.

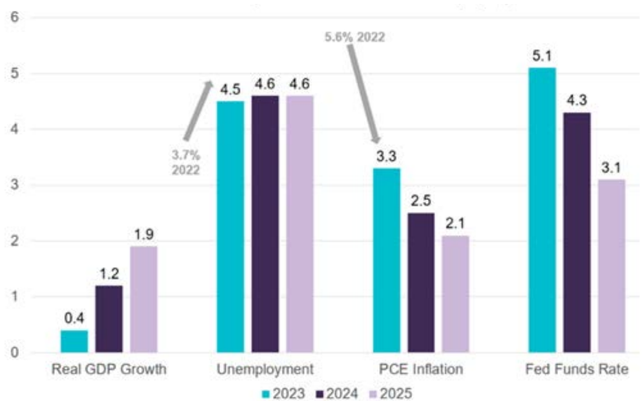
Developed Markets (DM)

We are most positive on DM risk assets, led by strong US fundamentals

The Bloomberg Consensus Forecasts (and the Fed) have revised-up significantly their growth expectations for the US for this year from 0.5% in January to 1.3% currently, while the surveyed probability of recession has remained stable at a 65% chance since December 2022. We maintain our view that the US can avoid recession and achieve a soft-landing outcome. With its updated view in June, the Fed continues to expect the same degree of disinflation – i.e a slow adjustment back to target by 2025 – but has signalled higher rates for longer, reflecting its stronger growth expectations (see Figure 3).

Figure 3: US Fed forecasts (from March and June)

US Fed Projection from Mar 2023 (%pts)



US Fed Projection from Jun 2023 (%pts)

Source: US Fed 2023

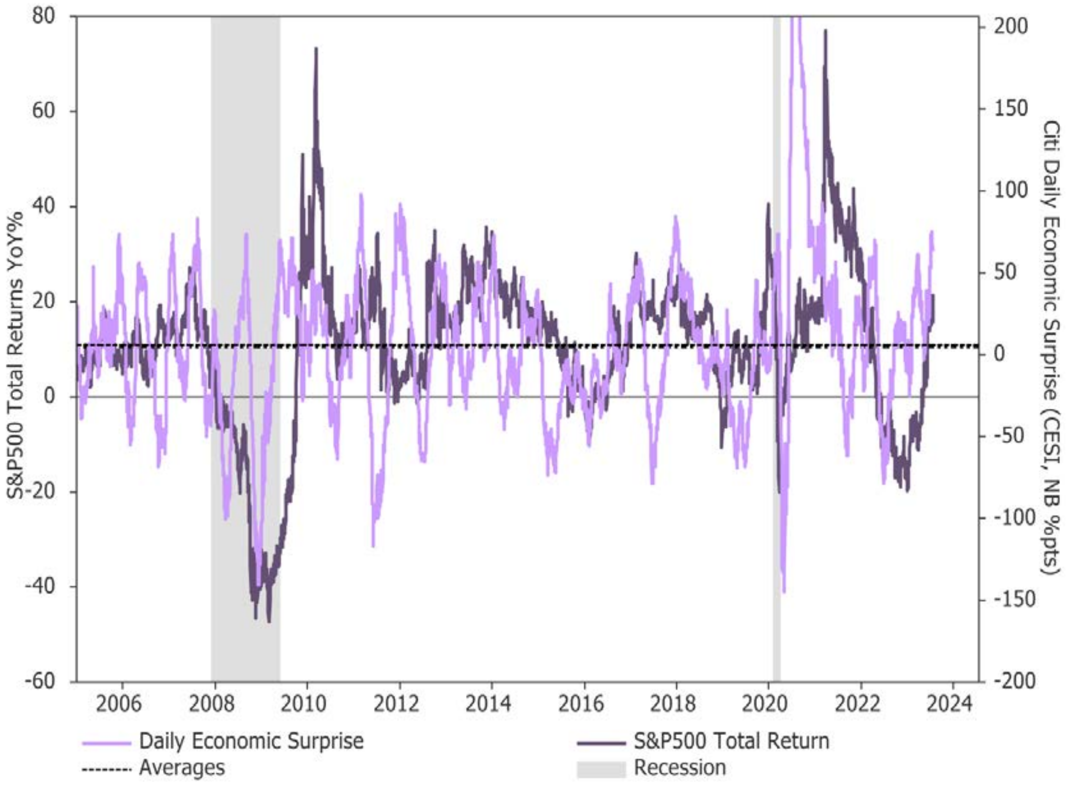
We believe the US economy can continue to successfully navigate high rates for longer

Despite high interest rates we believe US growth can hold around trend in 2024 reflecting upward revisions to expectations, the momentum in positive data surprises, and strong fundamentals across households and firms.

Even as US macro expectations have been revised-up significantly, strong data outturns have continued to surprise on the upside suggesting that financial markets have still not fully adjusted to the positive outlook (see Figure 4).

Figure 4: Even with upward revisions to forecasts US data is still surprising positively and signals more upside for US equities

US Equities and Economic Surprises



Source: Refinitiv Datastream, July 2023

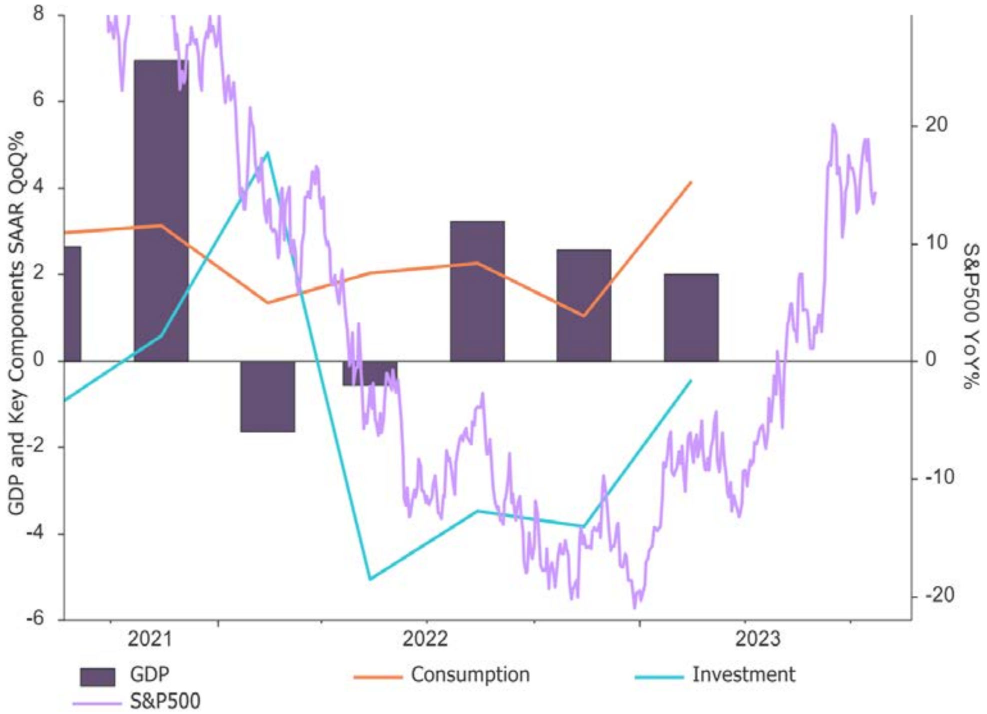
The US business cycle may still have a lot further to run

As US GDP fell over the first six months of last year – i.e a technical recession – the current stage of the business cycle could be relatively early as consumption growth has held-up, investment growth is healing, and equities have recovered strongly (see Figure 5). If US consumption growth is sustained, underpinned by robust spending across the services sector[1], and if investment growth recovers, then the prospect of the US holding at around trend growth in 2024 becomes much more likely.

1. Which is around 75% of the US economy and its high PMI at 53.9 for June signals a very healthy 4% YoY real GDP growth rate.

Figure 5: Solid US consumption growth and improving investment are key indicators suggesting the business cycle still has further upside to come

US GDP Commponents and Equities



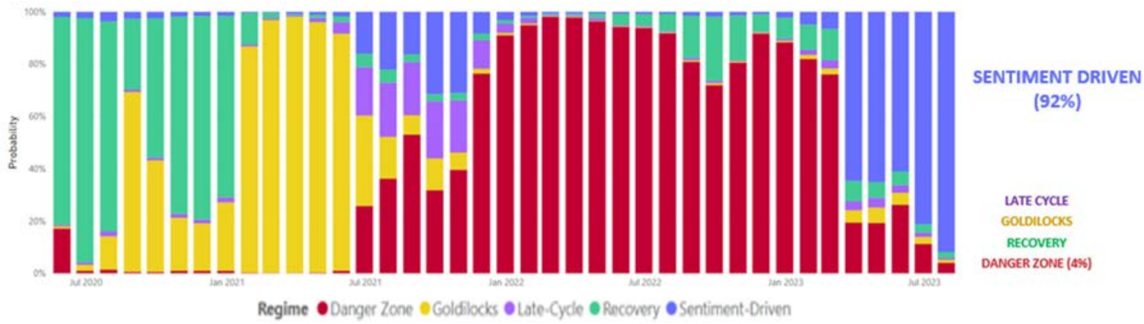
Source: Refinitiv Datastream, July 2023

Fullerton's Macro Regime Indicator has also signalled a favourable shift in the investment environment

The positive state of the business cycle, especially in the US, is also supported by the signal from Fullerton's Macro Regime Indicator which suggests the global investment environment has transitioned into a 'Sentiment Driven' backdrop. This can be very positive for risk asset performance, across both equities and bonds, as investors' risk appetite gathers momentum and as fixed-income interest rates offer attractive income streams (see Figure 6).

Figure 6: Fullerton's Investment Environment Regime Indicator

Forecasted Macro Regime Probability



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

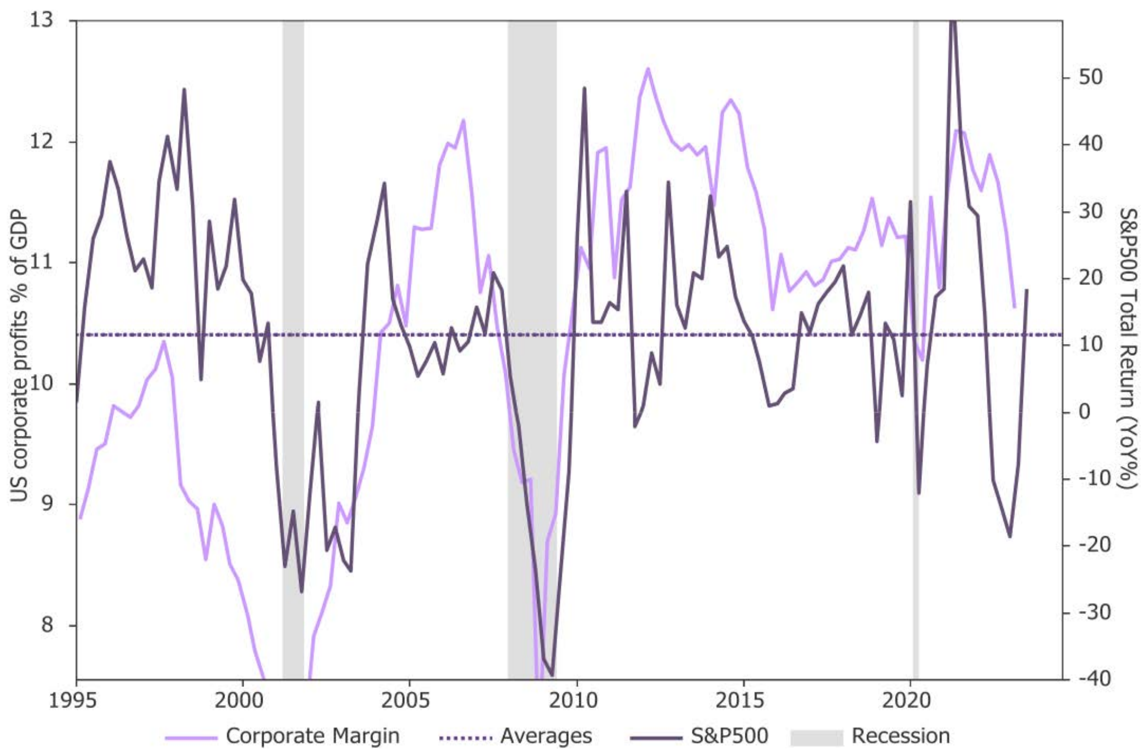
US households and firms have robust financial resources that can help growth hold-up around trend in 2024

US corporate profitability is slowing, but appears unlikely to fall too far below average, which has proved a key driver of US equities pricing-in a more positive outlook (see Figure 7). If corporate margins hold-up, then to meet sustained consumption demand, US firms will be well-placed to spend more on investment. At the same time, US firms are enjoying competitive real unit labour costs which has also helped contain unemployment.

Of course the US unemployment rate is likely to drift upward over the next 12 months or so, but the adjustment may continue to remain slow, which can give households time to adjust to any budget stresses. The Bloomberg Consensus forecasts and the US Fed continue to expect the unemployment rate to slowly rise and settle at around 5%. It should not be forgotten that this is simply unemployment 'normalising' back to its historic average of 5.1% (over the last 10 years) which has coexisted with US real GDP growth averaging around trend of 2.2% p.a. To become a significant source of downside risk to growth and financial markets, the US unemployment rate would need to significantly overshoot 5% (which is a scenario that remains 'off the radar' for US policymakers and the Consensus).

Figure 7: US corporate margin and equity market performance

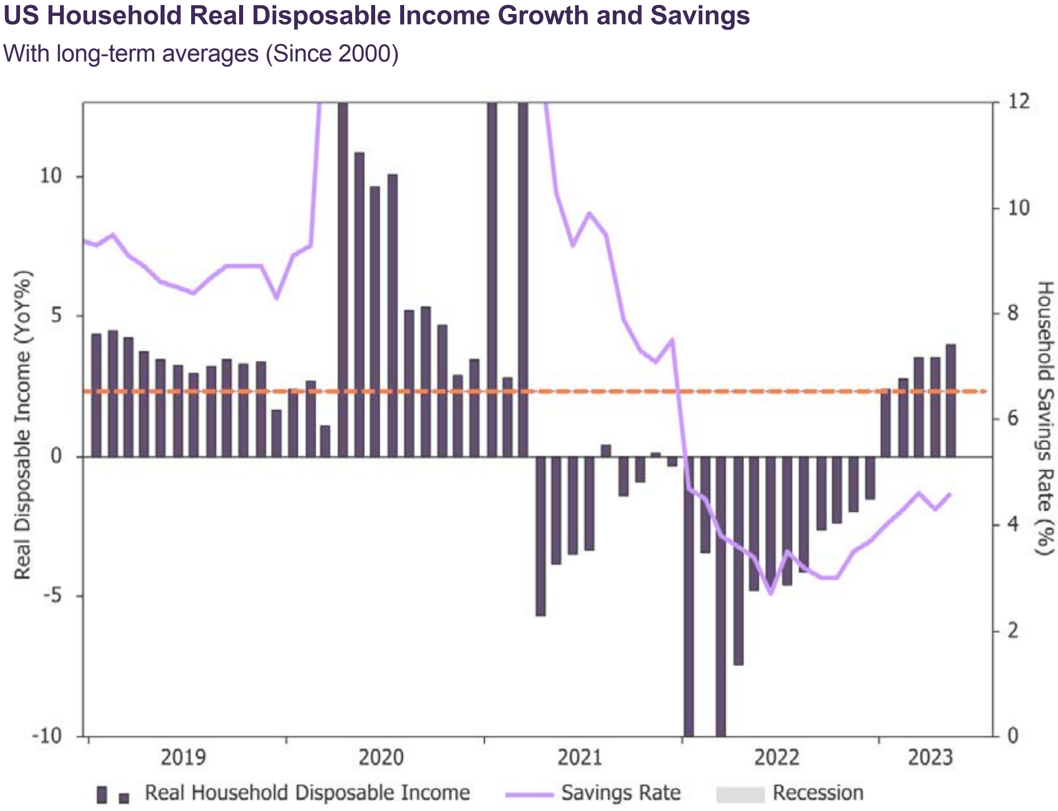
US Corporate Margin and S&P500 Total Return



Source: Refinitiv Datastream, July 2023

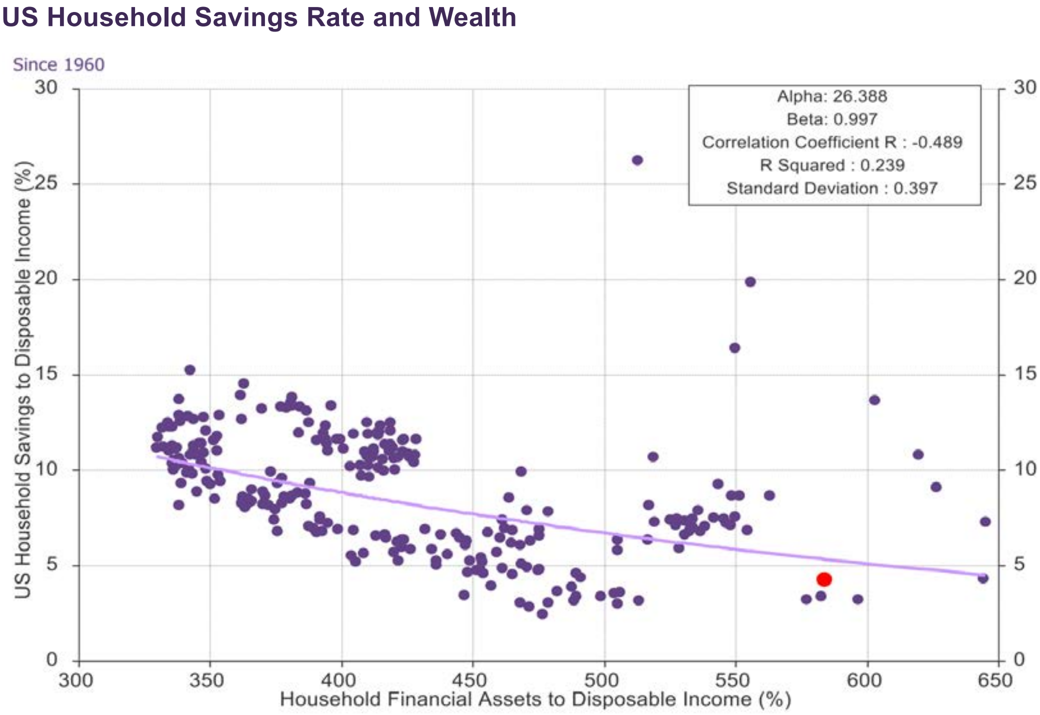
US household real disposable income has already rebounded to above trend growth (see Figure 8), reflecting the solid labour market and disinflation boosting real wage performance. With the household savings rate improving (see Figure 8), coupled with very strong household balance sheets (see Figure 9), positive wealth effects to come (from solid investment returns YTD) could add further support to US consumption and GDP growth.

Figure 8: US real disposable income growth and the savings rate



Source: Refinitiv Datastream, July 2023

Figure 9: US household balance sheets are very strong with high wealth and solid savings

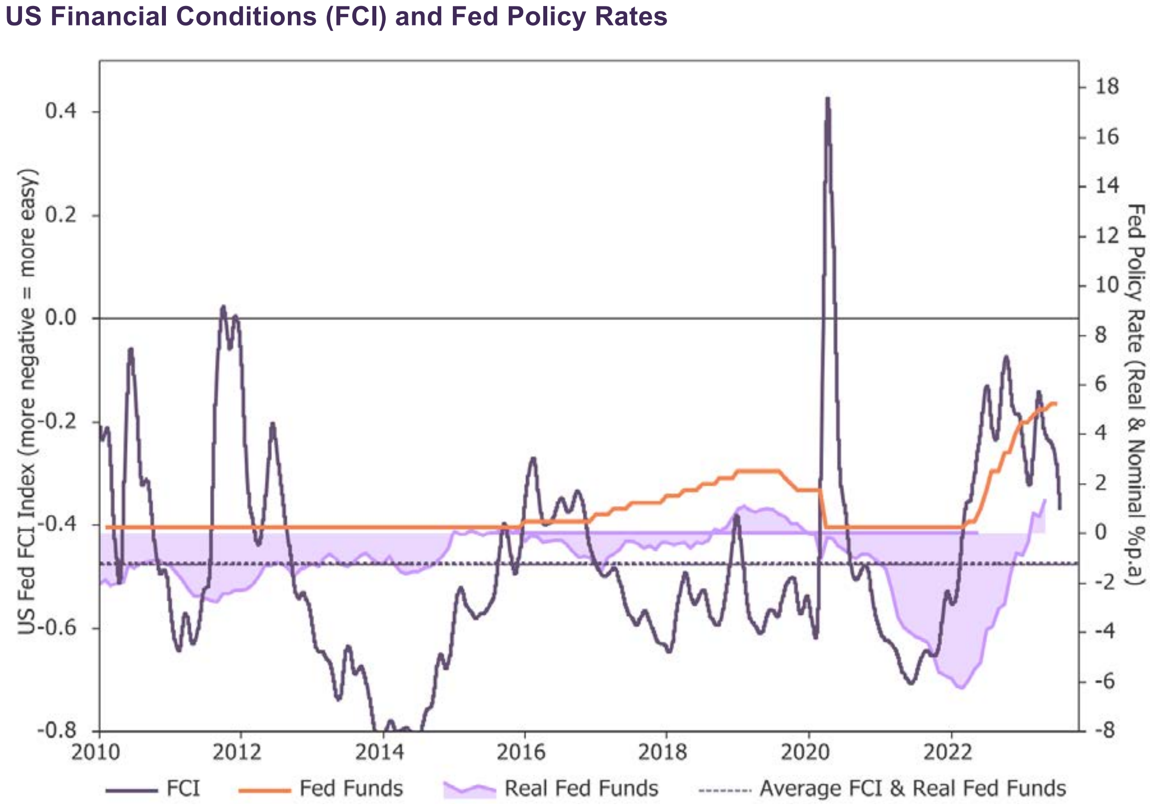


Source: Refinitiv Datastream, July 2023

Why have tight US monetary conditions not proved too stressful for growth?

A common concern is that the inverted yield curve and the high (nominal) Fed Funds rate makes a US recession inevitable. But at the same time, what is often overlooked is that there is significant offsetting cushion coming from broader measures of monetary conditions that have eased this year[2], while the real policy rate is still modest (see Figure 10).

Figure 10: US broad financial conditions (FCI), Fed nominal and real policy rate

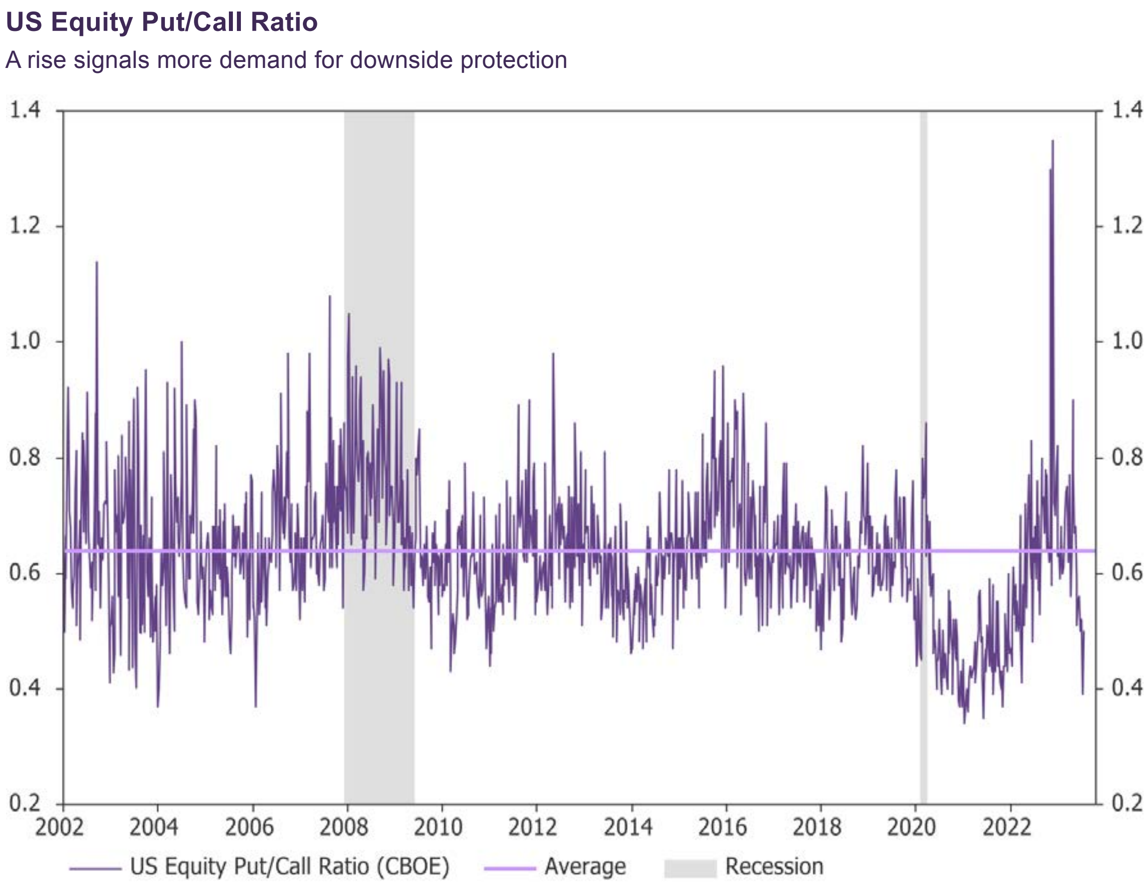


Source: Refinitiv Datastream, July 2023

2. The US Fed's FCI metric is the broadest measure of US monetary conditions available, as it encompasses conditions across money, debt, and equity markets. Beyond market conditions, it also captures the impacts of credit growth, bank lending conditions, and US dollar movements. In part what has helped tight (i.e as Figure 10 shows: the US FCI is above average) broad monetary conditions ease this year (i.e the falling FCI line in Figure 10) is a slowdown in the pace of tighter US bank lending conditions, a weaker US dollar, and relatively buoyant conditions across US debt and equity markets.

Therefore, taking a wider perspective of monetary “tightness”, and looking beyond high nominal interest rates and an inverted yield curve, it becomes more understandable as to why US macro fundamentals, across households, firms, and markets, have remained strong. It is also consistent with US investor positioning, in that even with high interest rates recession fears have faded as the demand for downside equity market protection has fallen back below average (see Figure 11).

Figure 11: Even though interest rates are high the demand for downside protection is low



Source: Refinitiv Datastream, July 2023

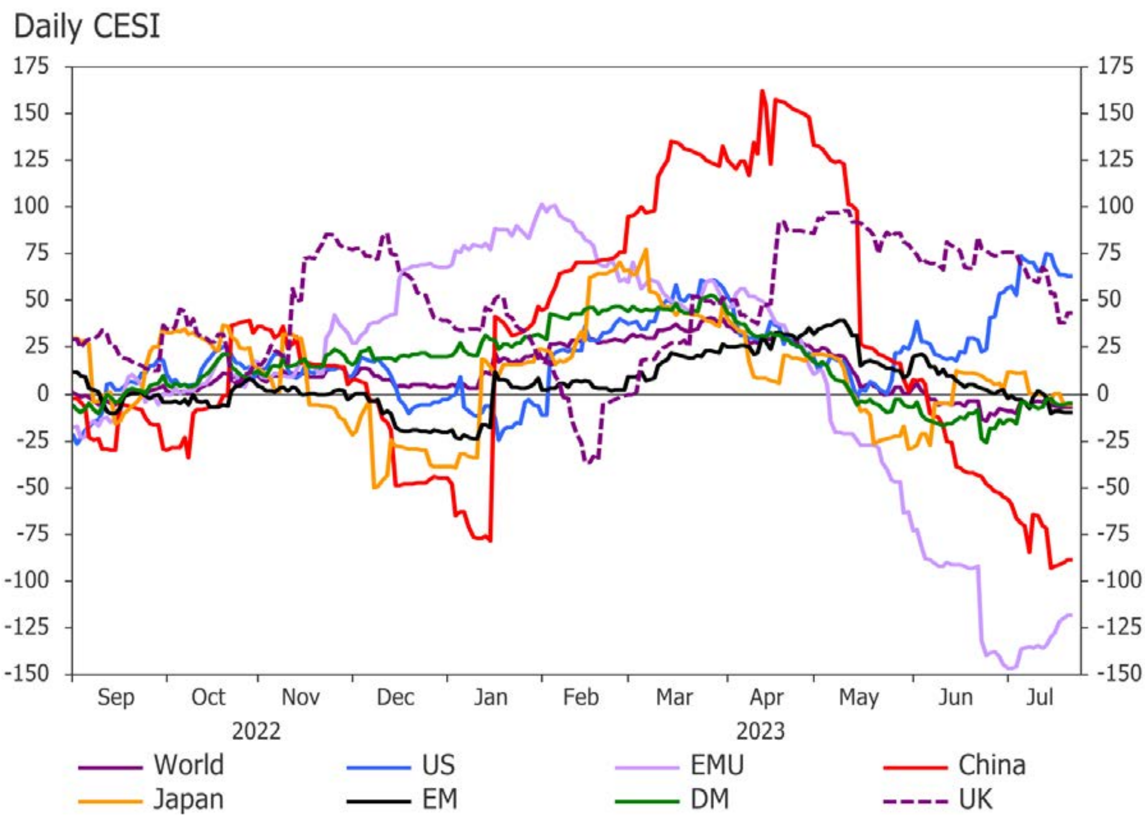
The US has been the growth leader across DM, followed by Japan, and then Europe

Across DM growth performance has been variable, with the EMU proving the weakest region with its GDP growth for this year expected to be just 0.5% by the Consensus. In part this has reflected a run of adverse economic surprises (see Figure 12), and the likelihood of more tightness in monetary conditions to come (as the ECB seems to be lagging the Fed in the inflation fight).

Japan's activity backdrop has been stronger than Europe, and the Bloomberg Consensus forecasts Japan's growth this year to be around 1.3% YoY (on par with the US). The robust outlook reflects consumption growth holding-up, and industrial production improving (see Figure 13). Reflecting these positive fundamentals - Japan's equities have rallied strongly.

Figure 12: Daily economic surprises - the US has proved the most positive, Japan neutral, while Europe and China are the least positive

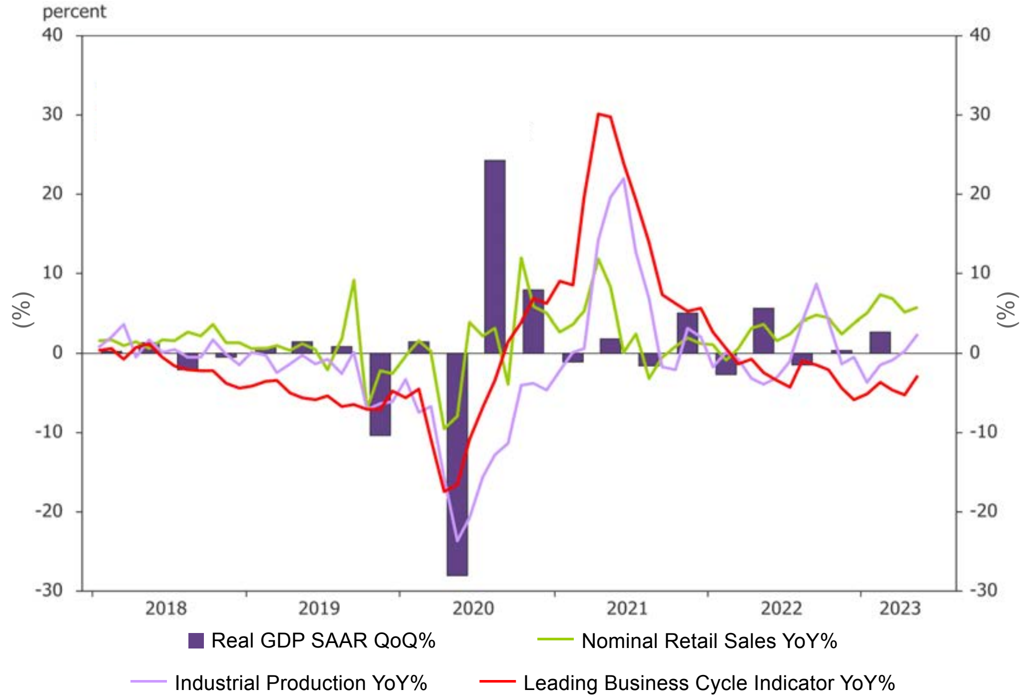
Citi Economic Surprise Index



Source: Refinitiv Datastream, July 2023

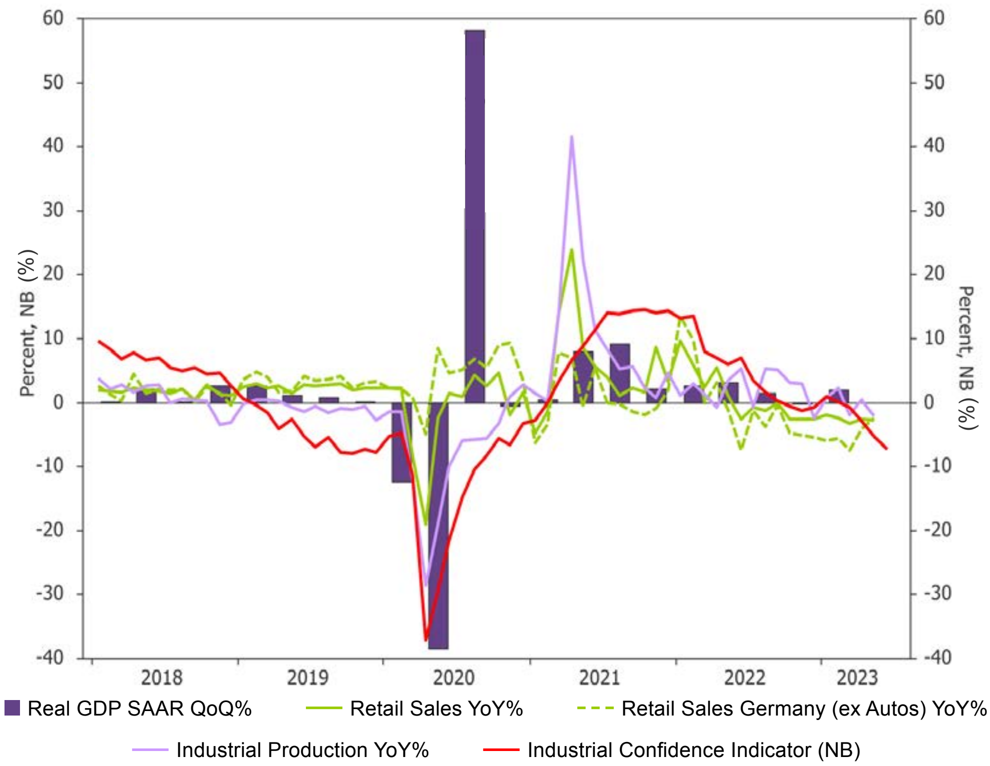
Figure 13: Key activity indicators across Japan and Europe

Japan Activity



Source: Refinitiv Datastream, July 2023

Euro Zone Activity



Source: Refinitiv Datastream, July 2023

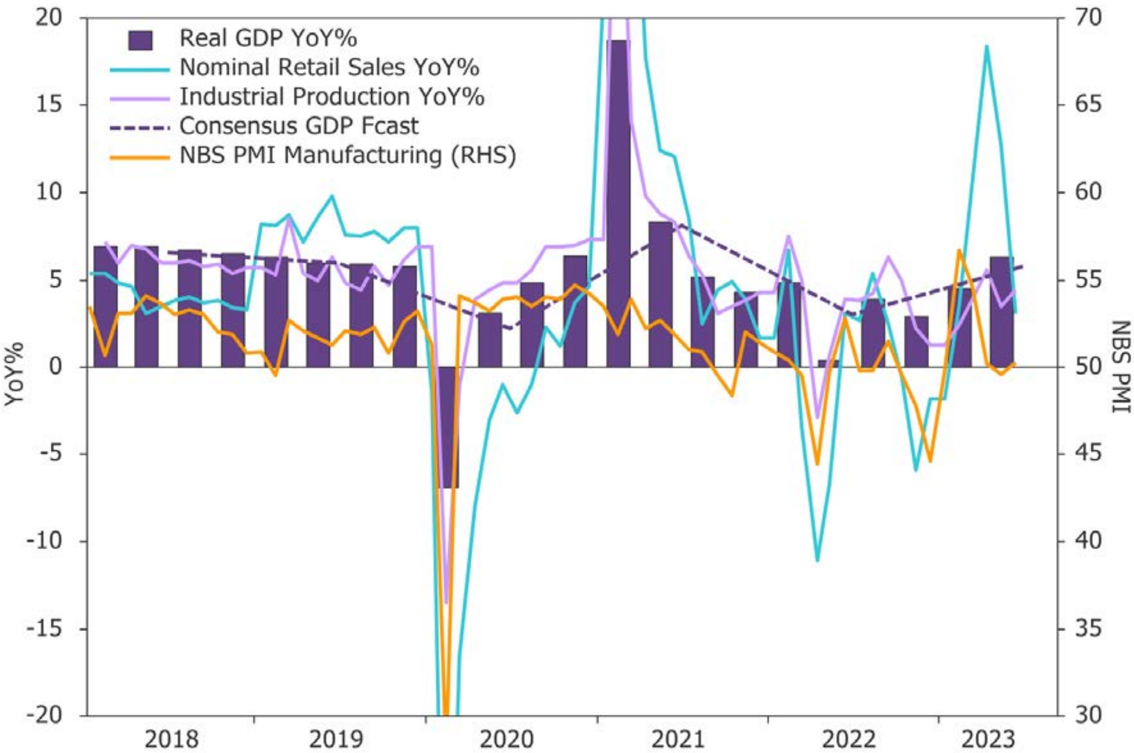
Asia

Cyclical weakness and longer-term headwinds for China will likely drag on the region

The rebound in China's GDP growth into this year was driven mostly by very strong retail sales and consumption, followed by supply-side catchup contributions from industrial production (see Figure 14). But then, after peaking in Q1, consumption growth and manufacturing PMI fell back sharply as firms struggled to improve profitability with softer demand and weak producer output prices.

Figure 14: China's key activity indicators: the rebound proved strong but short-lived

China Activity



Source: Refinitiv Datastream, July 2023

More policy stimulus is likely from China but we don't think it will drive a sustainable rebound in financial markets

China is expected to launch further stimulus into 2H23 to make sure that growth gets back on track to achieve the 5% policy target. These actions are likely to encompass:

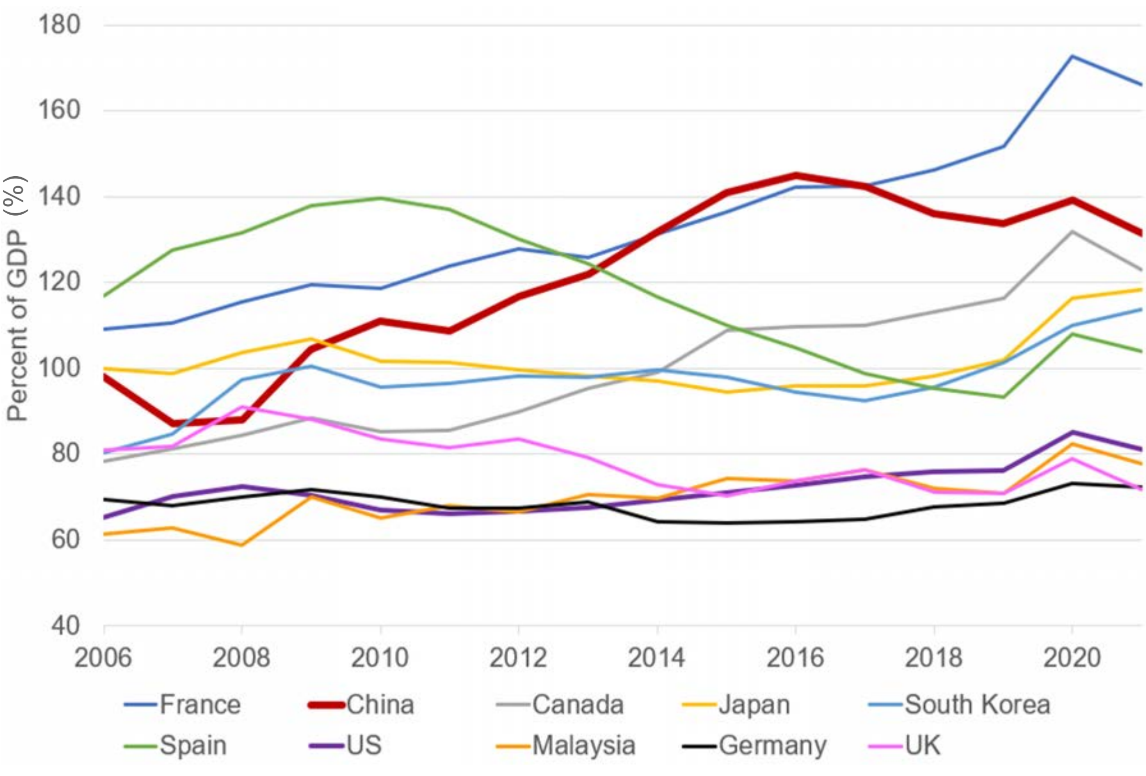
- Easier monetary policy;
- Targeted fiscal spending to boost infrastructure and support household spending.On the latter, China has already announced some measures to increase spending on vehicles, electronics, and home appliances;
- Supports for the real-estate sector, such as mortgage interest rate cuts and extra funding for developers;
- Some SOE hiring initiatives to try and start to reduce high youth unemployment.

We believe such stimulus can certainly help reignite growth but it is unlikely to be significant enough to drive a sustainable rebound in financial market performance. The policy stimulus that seems to be on the agenda for this year is predominantly demand-side focused and we have already seen that significant consumption growth is not sufficient to solve China's supply-side weakness and deflation forces. Beyond this patch of cyclical weakness China also faces significant longer-term headwinds that also underpin our negative outlook.

China's longer-term macro headwinds reflect too much debt, investment, and deflation

We believe that China's longer-term headwinds reflect two key issues. Firstly, there is the pressure from a potential 'balance sheet recession' as high corporate debt, in particular, places funding stress on firms and continues to motivate de-leveraging, which may further weaken demand and prices over time[3] (see Figure 15).

Figure 15: Corporate debt across selected countries – ratios above 100% are generally regarded as high[4]

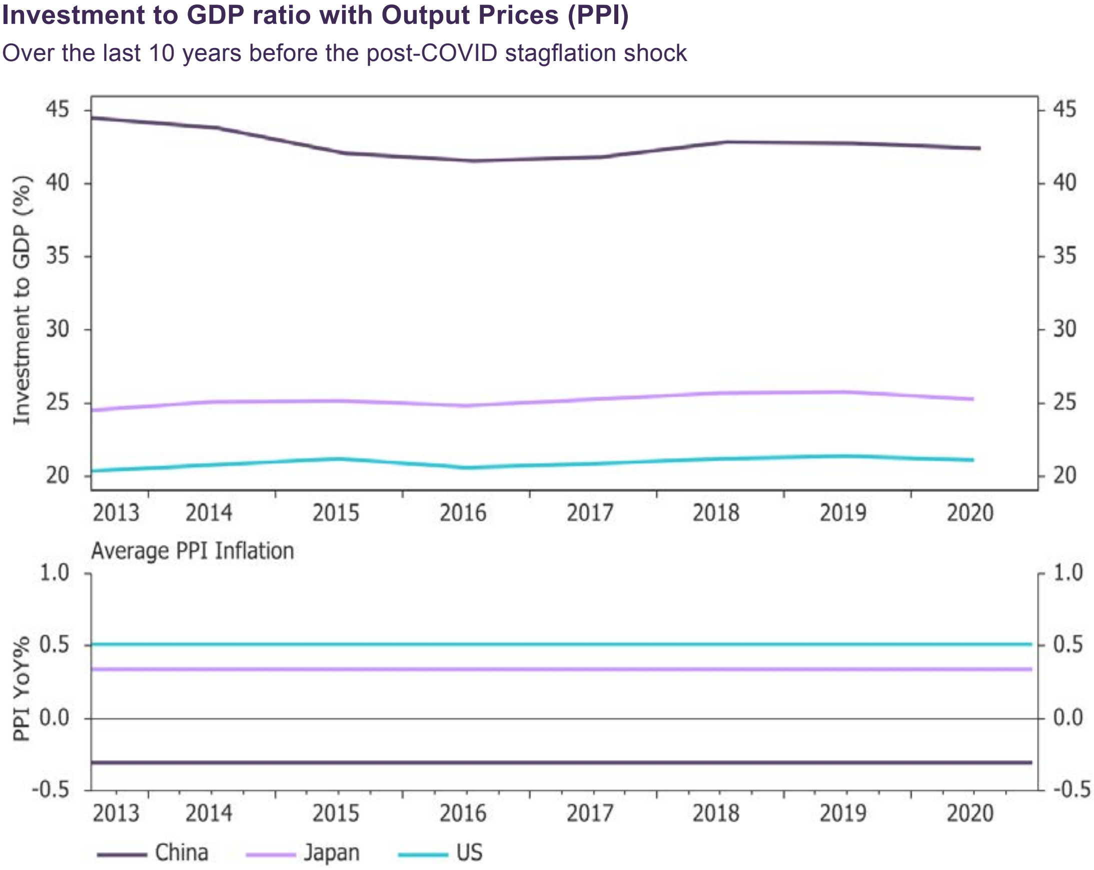


Source: IMF Global Debt Database 2023

3. The IMF highlighted in "Asia Must Monitor Rising Corporate Debt Amid Higher Interest Rates" (May 2023) that highly leveraged companies face much greater stress on earnings.
4. The IMF first noted in 2016 that China's corporate debt, at well over 100% of GDP, was "very high by any assessment" see "Rebalancing China: International Lessons in Corporate Debt" IMF (June 2016).

Secondly, China has the highest investment to GDP ratio in the world yet the supply-side of the economy has struggled with output prices (PPI) that have been falling on average for a prolonged period (see Figure 16).

Figure 16: China, US, and Japan investment (to GDP) and output price performance



Source: Refinitiv Datastream, July 2023

In contrast to the US and Japan, China's investment has not proved productive enough to halt producer price deflationary forces, which has created a significant profitability squeeze across the manufacturing sector. This has certainly hurt confidence and returns for investors as industrial production is such an integral part of the Chinese economy. It may also be a key reason why corporate earnings growth has been in steady decline this year even though GDP growth bounced-back as COVID control measures were removed.

China's policy solutions for its longer-term problems are likely to be multi-pronged, but it will still take time to resolve imbalances

We believe addressing some of China's longer-term problems requires 'multi-pronged' policy actions, and some of these strategies have already been on China's policy agenda for a while i.e:

- Improving the productive returns from investment;
- Rebalancing the economy more towards consumption; and
- Reducing economic exposure to real-estate by motivating less speculation, leverage, and more equitable pricing for all households.

It is easy to draw similarities between the longer-term headwinds that China faces and the experiences of Japan back in the 1990s as it navigated its balance sheet recession and deflationary pressures. Part of Japan's policy solution was to increase government spending significantly to try and support demand and boost inflation[5]. If China were to follow a similar blue-print for such stimulus, around the neighbourhood of $1tn USD per annum (or 5% of GDP) in government spending, then this would likely be welcomed by markets.

However, such plans don't seem to be on the radar for now largely because China's policymakers are understandably focused on solving significant cyclical weakness and the risk that 5% GDP growth won't be achieved. Any policy prescriptions to solve China's longer-term problems will still take time to deploy and drive adjustments, especially to reduce high corporate debt, increase productive returns for investment, and to rebalance the economy more toward consumption.

5. As a result Japan's public debt to GDP ratio increased by about 7% pts each year (on average) that the government was deploying stimulus to try and end the economic stagnation.

03

Equities

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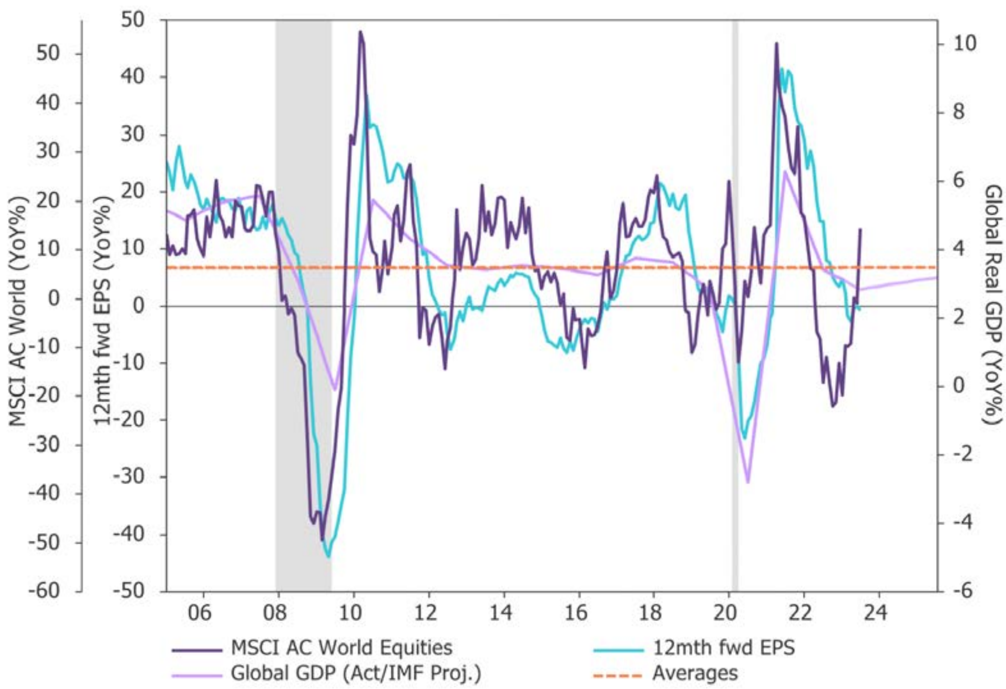
We maintain a positive view on DM equities, dominated by the US, with a favourable outlook for Japan, followed by Europe

We maintain our positive view on DM equities because earnings growth should continue to improve with the prospect of GDP growth being around trend. Dominated by the US, global equities have already re-priced to a more positive outlook and suggest that market earnings growth expectations may be too conservative (see Figure 17).

Figure 17: Global growth, equities, and expected earnings growth



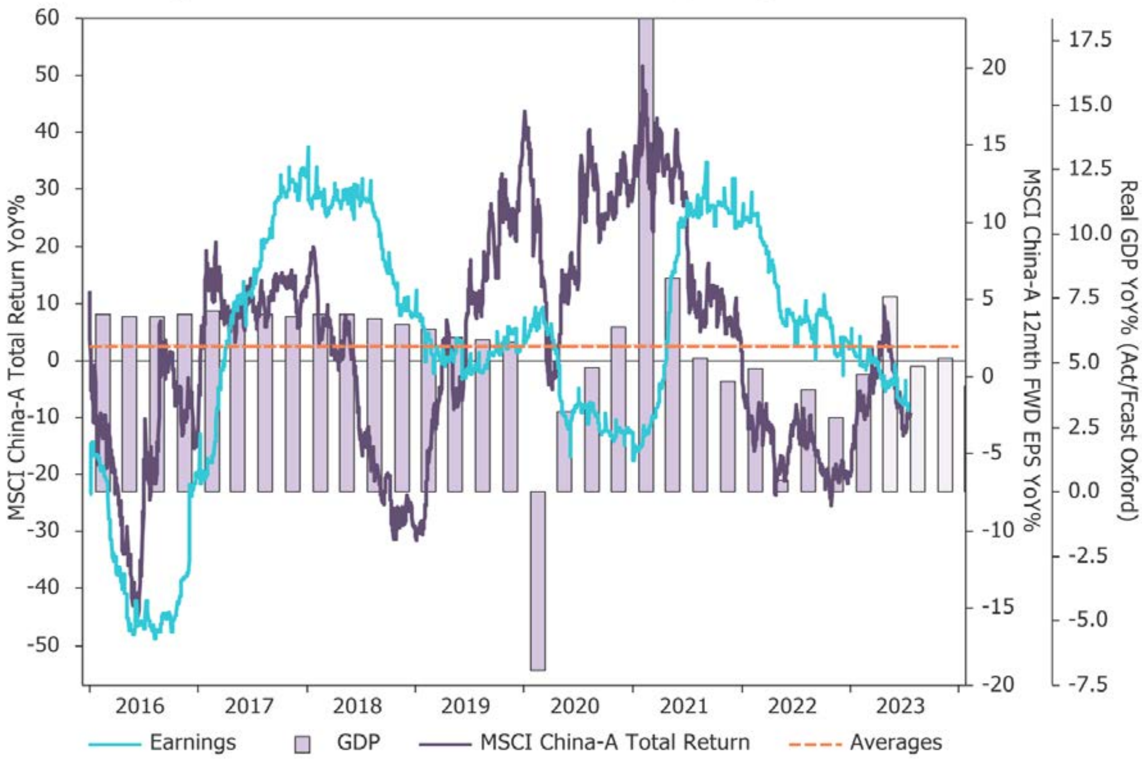
Source: Refinitiv Datastream, July 2023

Reflecting a poor earnings outlook, we have revised China and Asia equities to a negative view

We had held a positive outlook for China equities since the start of the year, as the China market rebounded significantly from Q422 into Q123 on stronger growth expectations with the relaxation of COVID control policies. But then, after peaking in Q1, what proved the most problematic for investors was that stronger economic activity, driven by the surge in consumption, did not feed into better corporate earnings growth expectations. As the latter continued to slide, the rally ended with China's equities falling back significantly to realign with weak earnings growth expectations (see Figure 18).

Figure 18: China's equities, earnings growth expectations, and GDP (actual and forecasts)

China-A Equities with Growth and Earnings Expectations



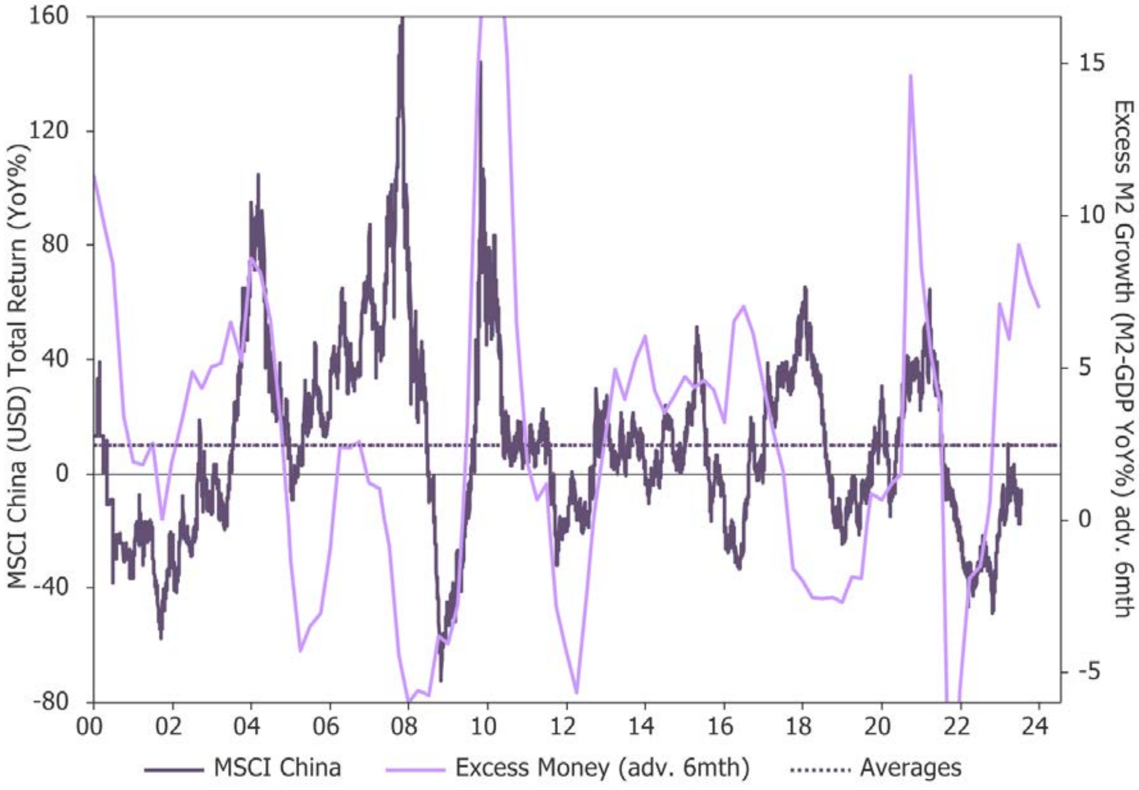
Source: Refinitiv Datastream, July 2023

A common argument against adopting a negative outlook on China equities is that a lot of bad news has now been priced-in and further policy stimulus will drive a recovery. We believe such stimulus can certainly help get growth back on track toward the 5% target, but as outlined in Section 02 Investment Environment, it is unlikely to be significant enough to drive a sustainable rebound in earnings and equity market performance.

Any further policy stimulus may simply drive a rebound in household spending, similar to what we saw after COVID control policies were relaxed, but corporate earnings may remain decoupled and depressed with deflation and high unemployment (especially across the younger cohorts) still featuring as part of the narrative. Furthermore, China's economy already has very easy monetary policy and significant liquidity (in excess of GDP growth) and yet equity markets have decoupled and failed to rally in response to such supports (see Figure 19).

Figure 19: China equity market performance with excess money growth (over GDP)

China Equities and Leading Indicator Excess Money Growth



Source: Refinitiv Datastream, July 2023

We have a negative view on Asia equities as regional earnings are likely to struggle to rise significantly, with the drag from China hitting demand and investor sentiment

Asia has seen its global trade share rise, and has decoupled to some degree from China's weakness (see Figure 2), but earnings growth expectations remain weak (see Figure 20). With a lot of bad news priced-in, earnings expectations across Asia may be progressing through a bottoming process. However, given the potential drag from weaker demand from China, especially for regional firms serving its manufacturing supply-chain, the upside potential to Asian equities may prove limited.

Figure 20: Asia expected earnings growth

Source: Refinitiv Datastream, July 2023

Despite the strong rally across DM equities, and especially the US, valuations are not expensive

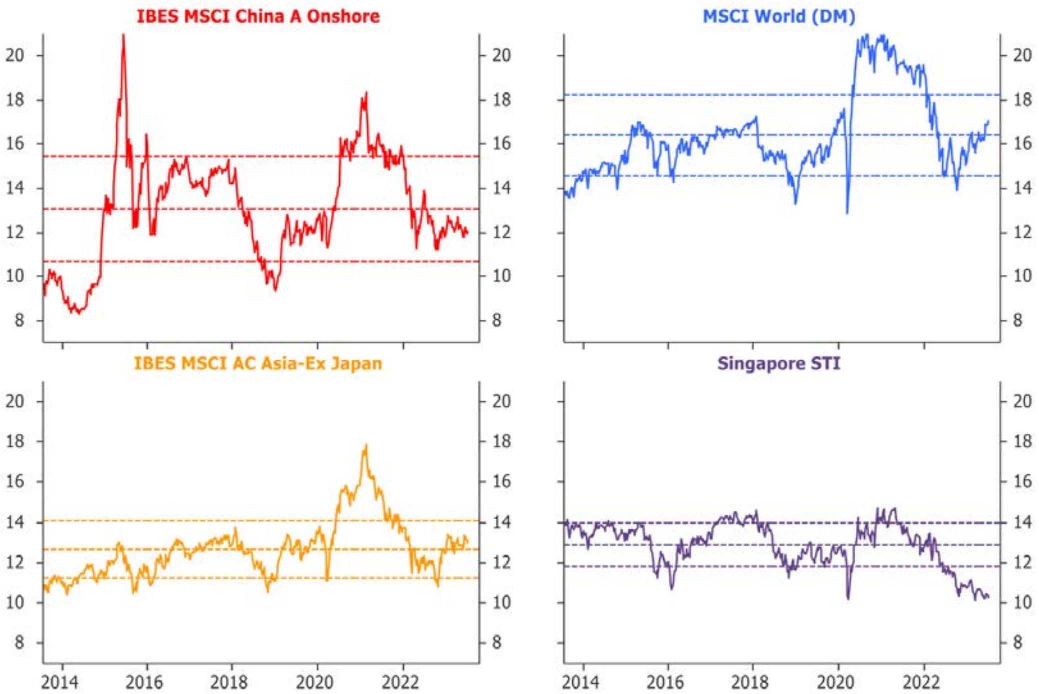
Despite the strength of the US equity rebound, DM and US equity valuations do not look stretched, fluctuating around historic averages (see Figure 21). Asia equities are also around fair-value on average, while China and Singapore equities are cheap (although Singapore's cheap valuation is driven by a few outliers across financials and services/transportation).

From a cross-asset perspective, US equities have marginally shifted to become the most expensive asset class (i.e with the lowest yield, and below the 10y bond yield. See Figure 22) but there are no signs of the degree of overvaluation seen during the last big IT rally (i.e in the lead-up to the Dot Com bust in 2000) when the earnings yield was more than 300bps below bond yields.

Figure 21: Equity market valuations across key markets

Price/Earnings (P/E) based on 12 Mth fwd earnings expectations

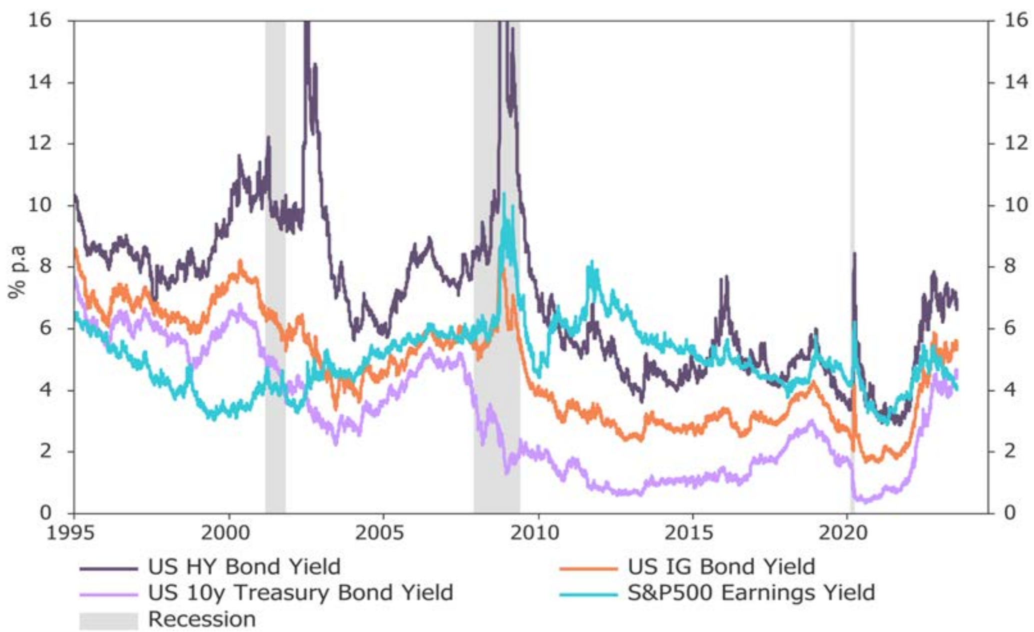
with last 10y average and +/- 1 SD bands



Source: Refinitiv Datastream, July 2023

Figure 22: Valuation indicators across US asset classes (fixed income yields and S&P500 earnings yield)

US Yields across Asset Classes



Source: Refinitiv Datastream, July 2023

Rather than reflecting a speculative bubble, much of the US IT rebound so far has been driven by a return to its historical trend performance relative to the broader equity market (see Figure 23). We maintain a positive outlook on US NASDAQ-related stocks as AI-related investment opportunities suggest a robust spending trend going forward[6].

Figure 23: The US IT rally has been very strong, but there are no signs of overshooting yet – IT stocks have only rebounded back to historical trend performance

Nasdaq to S&P500

Tech Shares over Market (with trend)

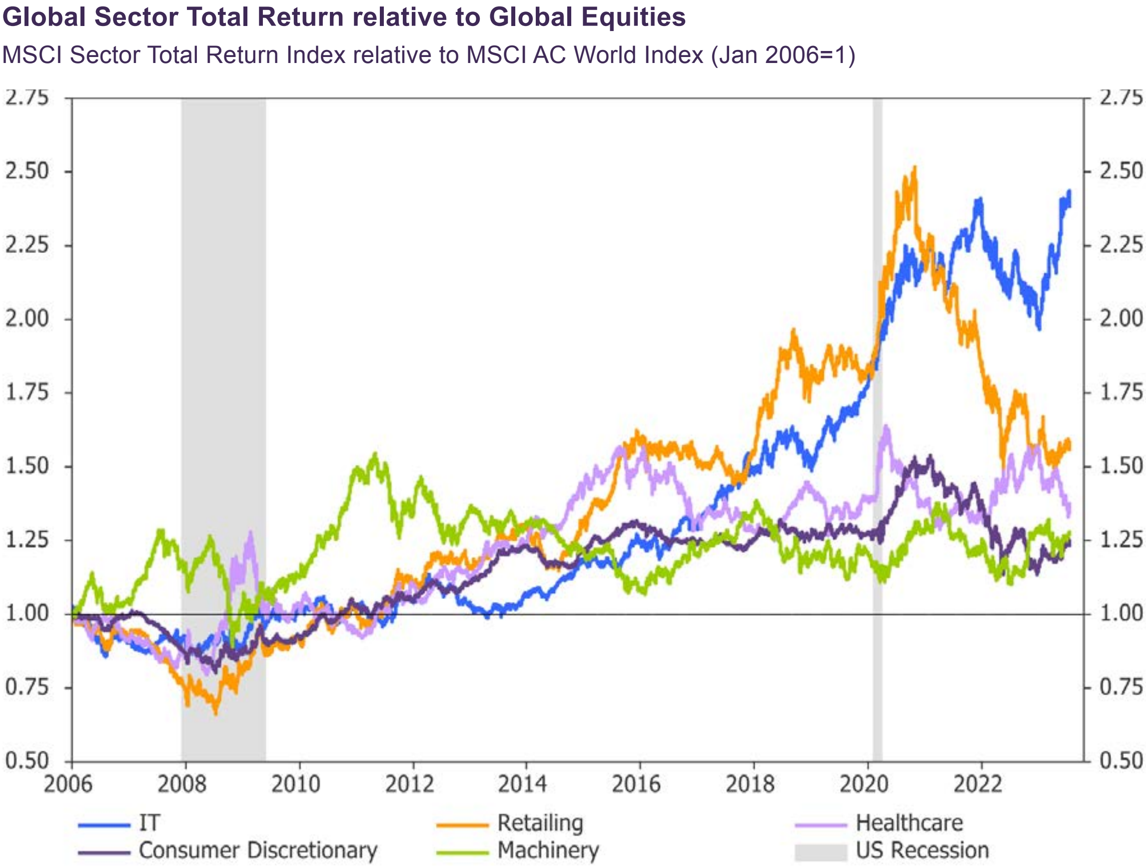
Source: Refinitiv Datastream, July 2023

6. For example, "Sizing the prize: What's the real value of AI for your business and how can you capitalise?" by PwC (2017) predicted that AI-related tech investment and its spillovers to broader spending and productivity could boost global GDP by an extra $1.2tn USD p.a (or 1.2% pts of current world GDP) out to 2030.

We continue to 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 and machinery, healthcare, and ESG-leaders. These sectors are favoured as they are underlined by strong fundamental drivers (such as rising market share from higher spending patterns, coupled with productivity gains containing costs), and a robust trend of historical outperformance (see Figure 24).

Figure 24: Trends in global equity sector alpha



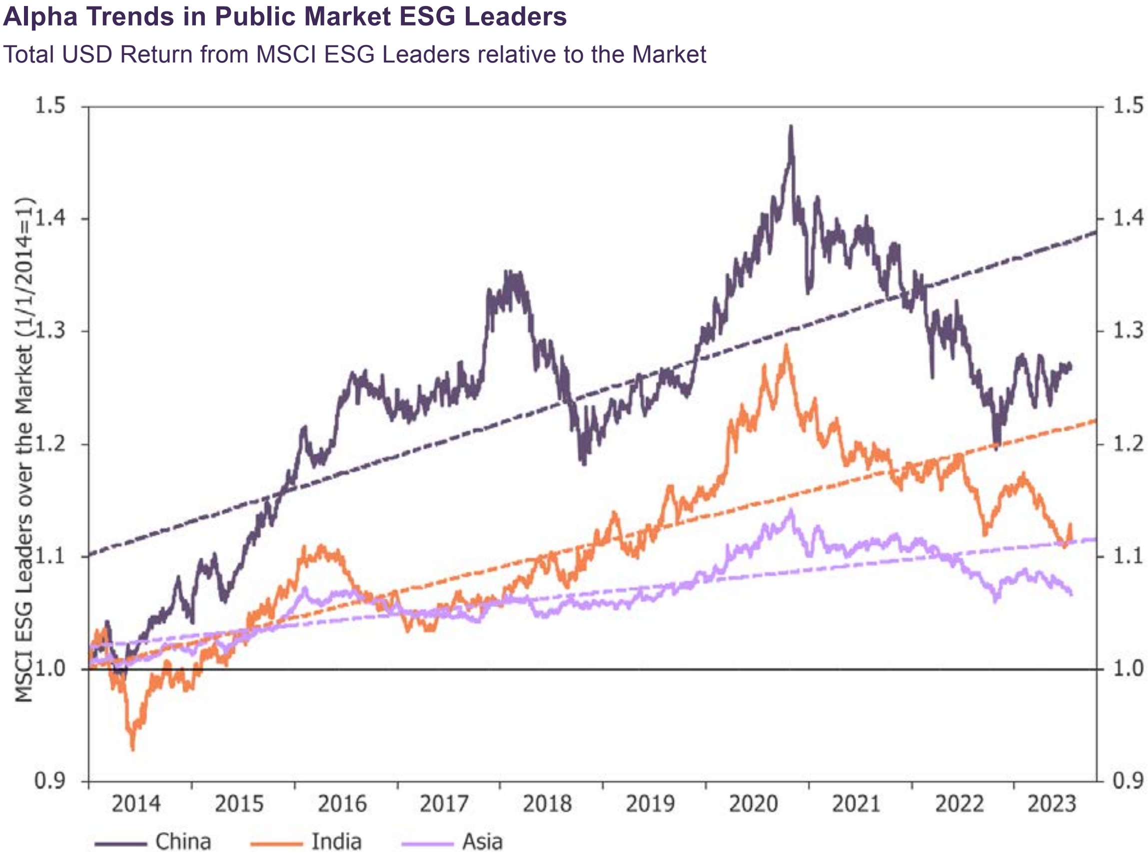
Source: Refinitiv Datastream, July 2023

In Fullerton's recent investment research paper "Creating Value As Asia Decarbonises" (April 2023)[7] we provided more details on why we have a positive outlook for ESG-related investments, especially across Asia. Although the green energy transition across the region is paved with challenges, there is likely to be attractive opportunities as decarbonisation investments scale-up over time.

7. See https://www.fullertonfund.com/fullerton-insights/creating-value-as-asia-decarbonises/

If we look at the historical performance of ESG-leader stock indices across Asia, they have been a trend source of alpha for investors for a while (see Figure 25). That said, ESG-leader returns have suffered with broader market weakness across Asia, however such cyclical weakness may provide relatively cheaper entry-points for investors.

Figure 25: Alpha gains for investors from Asia ESG-leader stocks



Source: Refinitiv Datastream, July 2023

04 Fixed Income and currencies

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Fullerton Fund Management

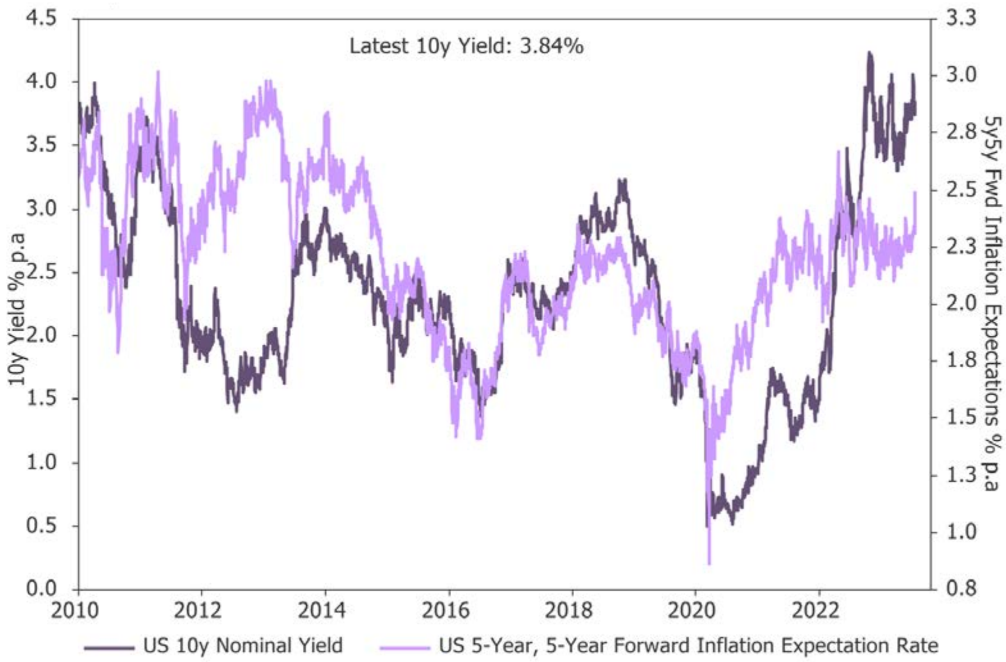
We maintain a positive outlook for returns from global sovereign bonds and Asia corporate credit. With high interest rates for longer, bonds may generate a favourable income-stream for investors while providing cushion from growth shocks

We remain positive on US bond duration and look to extend exposure as yields reach the neighbourhood of peaking. Any further significant upside to US yields may be limited by contained inflation expectations and as the Fed's tightening cycle comes to an end. There is already a record gap of bond yields over inflation expectations and this may help to contain any potential yield 'break-out', especially as disinflation continues (see Figure 26).

Figure 26: US 10y yield and inflation expectations

US 10y Yield and Inflation Expectations

Relationship Correlation: 0.53



Source: Refinitiv Datastream, July 2023

If US yields jump past 4% p.a then that will increase our conviction further to be long duration because the capital gains from the easing to eventually come will be greater than otherwise. Separately, if growth surprises to the downside, then bonds can potentially provide a valuable cushion to the portfolio.

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.

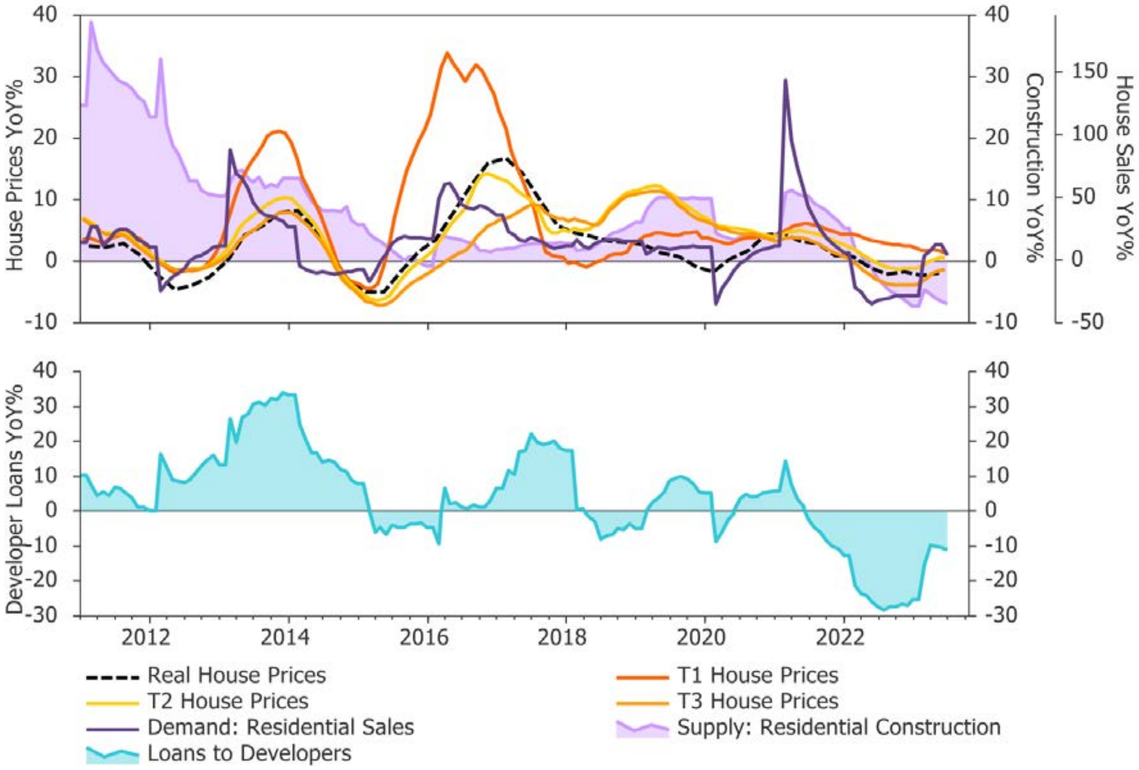
Furthermore, Asian local currency government bonds that have tended to perform well are those with high and relatively stable yields e.g India and Indonesia. In addition, other headwinds may ease further as we maintain our negative outlook for the US dollar, and therefore some Asian currencies may register gains.

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 robust interest coverage ratios. Asia High Yield (HY) corporate credit has greater leverage and is more sensitive to potential growth shocks, but at the same time returns should improve as China's real estate sector continues to stabilise (i.e real-estate sales have rebounded, falls in house prices are moderating, and the worst of the debt de-leveraging process seems to be over. See Figure 27). We are positive on HY corporate credit but investors need to focus on active management and remain selective.

Figure 27: China's very weak real-estate sector seems to be stabilising

China Real Estate Indicators



Source: Refinitiv Datastream, July 2023

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

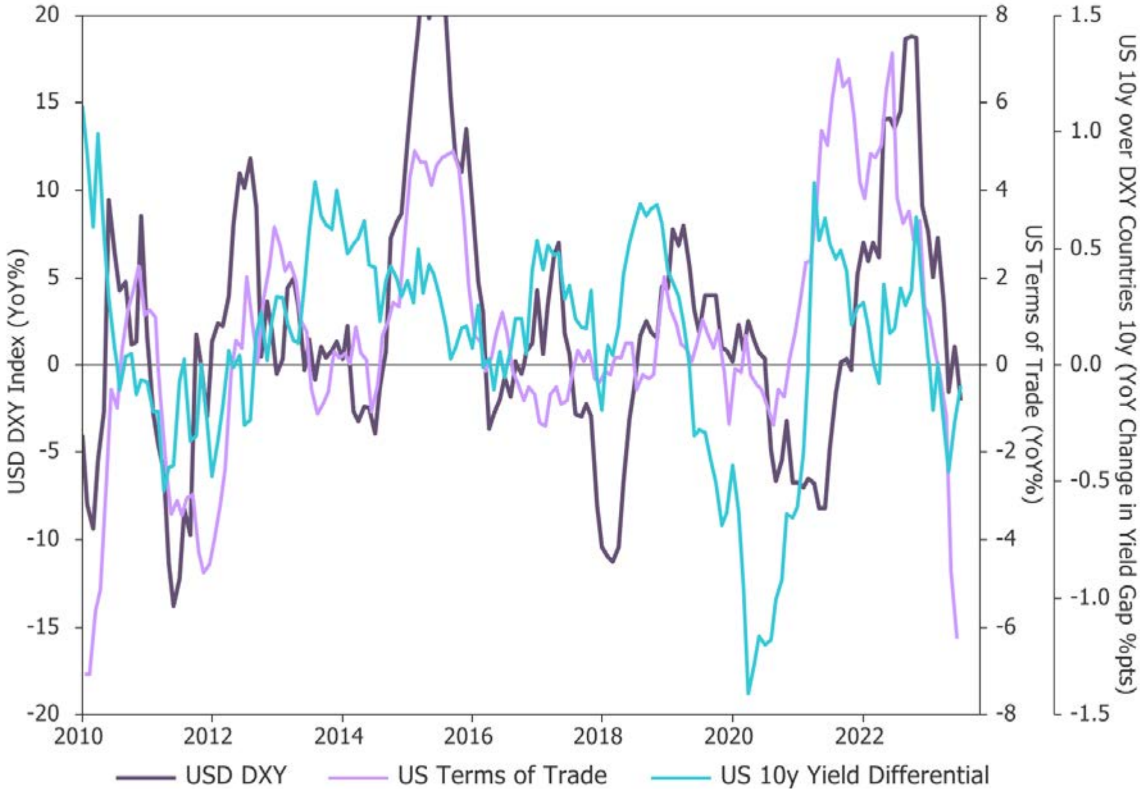
We prefer non-financial corporates, and sectors linked to consumerism, new industrials, raw materials and infrastructure (especially as countries increasingly defend supply-chains and continue to invest in renewable energy). We believe these sectors have positive long-term drivers, and as a result, can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

We maintain our negative outlook for the US dollar

With the sharp correction in the US terms of trade unfolding, the USD is likely to continue sliding (see Figure 28). As the Fed's policy tightening cycle matures the US yield differential is likely to become less favourable, while its recent modest rebound seems to have been priced-in by currency markets. From a fundamental perspective, the US dollar remains overvalued, especially as the US' relative export prices are less favourable.

Figure 28: Key drivers of USD weakness: weaker terms of trade and less supportive yields

USD (DXY) with US Terms of Trade and US Yield Differential



Source: Refinitiv Datastream, July 2023

05

Commodities: oil and gold

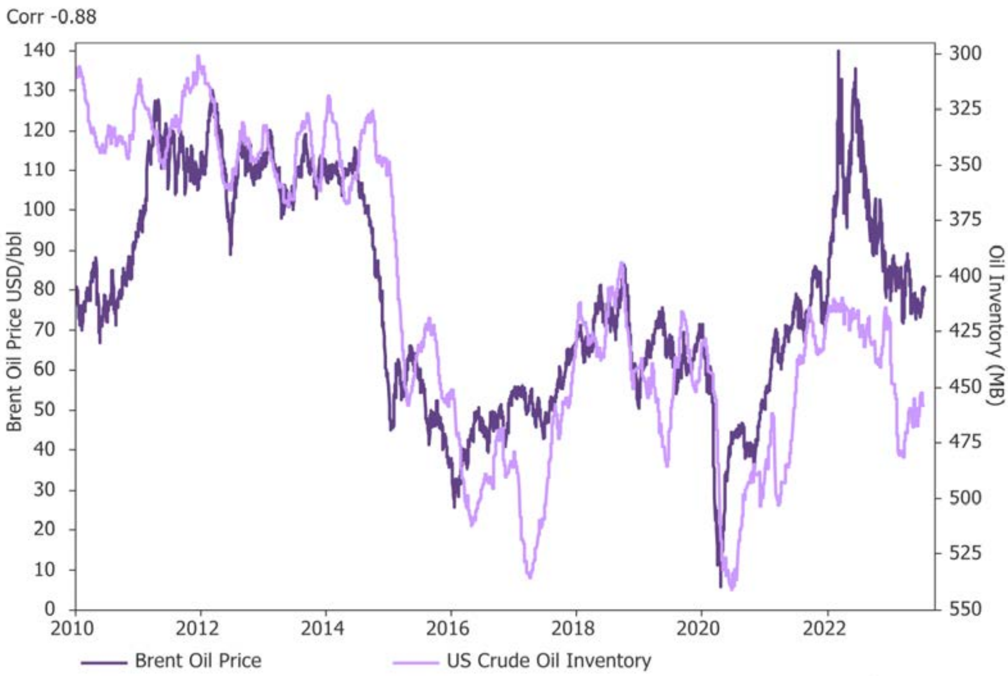
We have shifted to a negative view on oil prices, as demand weakness across China and Asia may prove more significant than supply constraints

Oil prices have been persistently weak this year as inventories across important markets, like the US, have surprised on the upside. As inventories stabilise and global supply remains controlled, any further downside to oil prices may prove limited. Furthermore, there still appears to be some geopolitical risk / supply-tightness premium within oil prices as they have not fallen excessively (i.e to the c. $50 USD/bbl levels) as the high US inventory levels suggest (see Figure 29).

However, we do not foresee strong increases in oil prices either as forward-looking supply indicators may not prove tight enough (see Figure 30) and demand, especially from China and emerging markets, is likely to be weak.

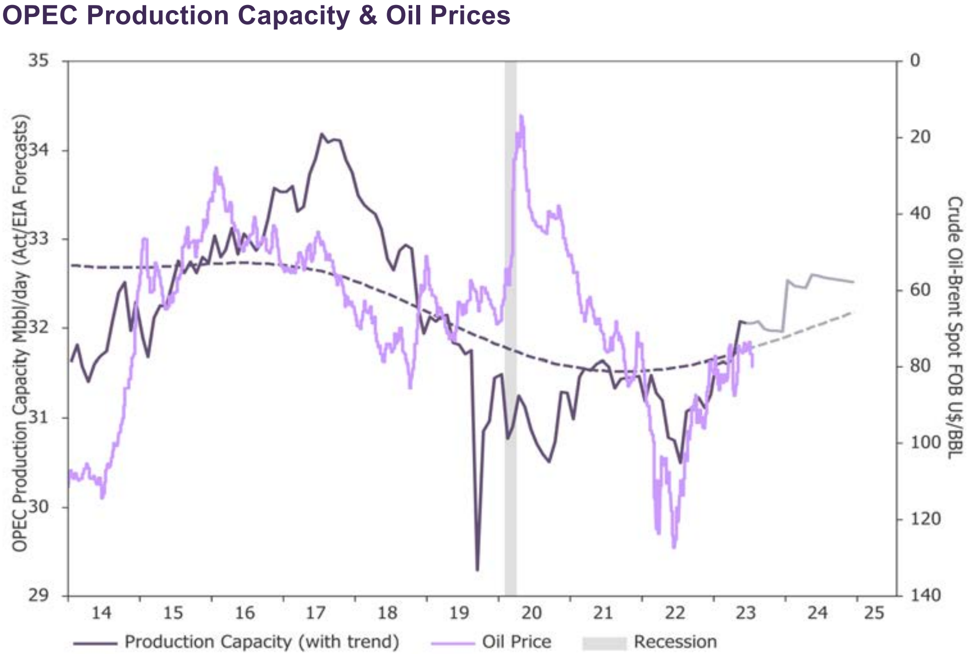
Figure 29: Oil prices and US inventory

Oil Prices and US Inventory



Source: Refinitiv Datastream, July 2023

Figure 30: Oil prices and OPEC forward-looking supply indicators

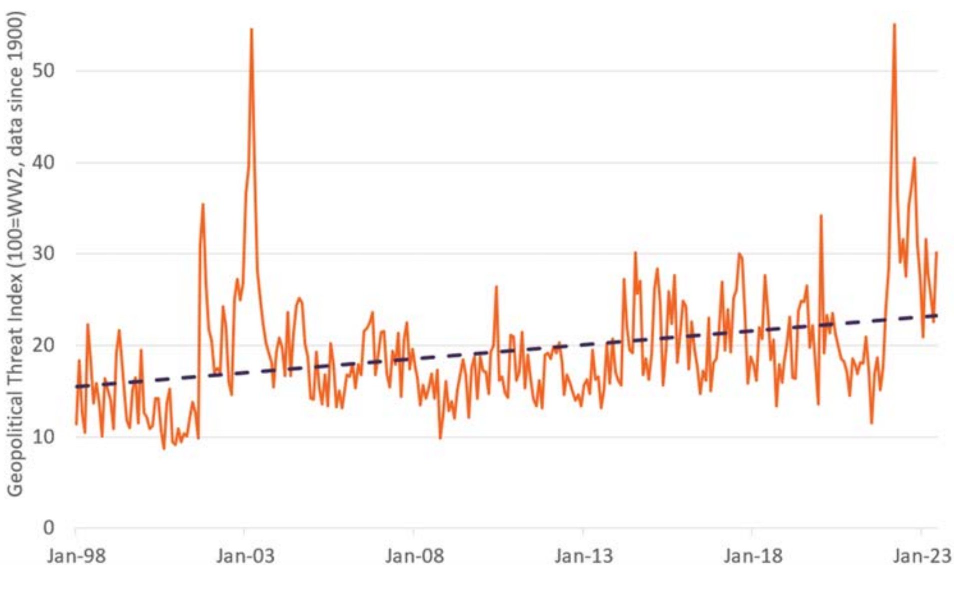


Source: Refinitiv Datastream, July 2023

We remain positive on gold

We believe gold can continue to be an important element in portfolios given the trend rise in geopolitical risks we have highlighted before (see Figure 31). Gold prices have continued to navigate yield strength, and provided valuable cushion to investors in mid-March when recession fears spiked with the banking stresses across the US and Europe. In addition, gold prices may receive further support from USD weakness, which we believe is likely to continue as investors' risk appetite continues to improve.

Figure 31: Geopolitical risk index with trend



Source: A news-based measure of adverse geopolitical events and associated risks since 1900. The geopolitical risk index spiked in 2022, 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, June 2023.