Speedbumps in a Goldilocks environment

Fullerton Investment Views - Quarterly report

Q4 2023

FULLERTON FUND MANAGEMENT

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Executive summary

- **We have a short-term negative view on US equities, given high yields.**
  - With the 'Great Decoupling', alpha opportunities can stem from pockets of growth. If yields overshoot macro fundamentals due to significantly higher risk premium, equities could de-rate.
  - Possible equities 'risk off' means there is reason to stay positive on bonds - because if yields are too high for too long then growth and equities could correct sharply.
- **Greater geopolitical risks ahead, driven by escalation of the Israel-Hamas conflict.**
  - US bond yields holding-up suggests investors believe any adverse spillovers to global risk assets, from the Israel-Hamas conflict, can be contained.
  - If growth deteriorates significantly, the key signposts to watch will be surges in oil prices, and significant falls in bond yields and equities.
- **History suggests that once adverse reactions to geopolitical shocks 'wash-out' risk assets can return to previous trends.**
- **Led by DM equities, we are positive 12 months ahead on global risk assets, bonds and corporate credit.**
  - The US leads DM, due to stronger productivity and resilient demand. This should help risk assets navigate high interest rates with a US and global 'soft-landing' scenario still plausible.
  - Bonds can generate favourable income streams while providing cushion from potential growth shocks.
- **We remain negative on China and Asia equities.**
  - With policy stimulus tailwinds, China's 2023 growth can come in at around the 5% target, but this is unlikely to be sustained.
  - Asia ex-Japan equities have somewhat decoupled from China's weakness, in turn creating opportunities for active investors. But headwinds from weaker Europe demand and a strong USD may limit significant upside.
- **We have turned positive on oil prices and the USD.**

01 Risk-Asset Outlook

We have adopted a short-term negative outlook on US equities, given high yields and greater geopolitical risks driven by the Israel-Hamas conflict

Since US equities started to slide from July, on receding risk appetite and rising bond yields, we have been tactically negative. With the overlay of risks from the Israel-Hamas conflict, investors in Developed Market (DM) equities, and especially the US, should be more cautious and defensive over the near-term.

Summary of Fullerton's Views (1-3 months ahead)

	Bearish	Negative	Positive	Bullish
Asia Equity		✓		
China-A Equity		✓		
US Equity		✓		
US 10y Yield			✓	
Oil Prices			✓	
US Dollar			✓	

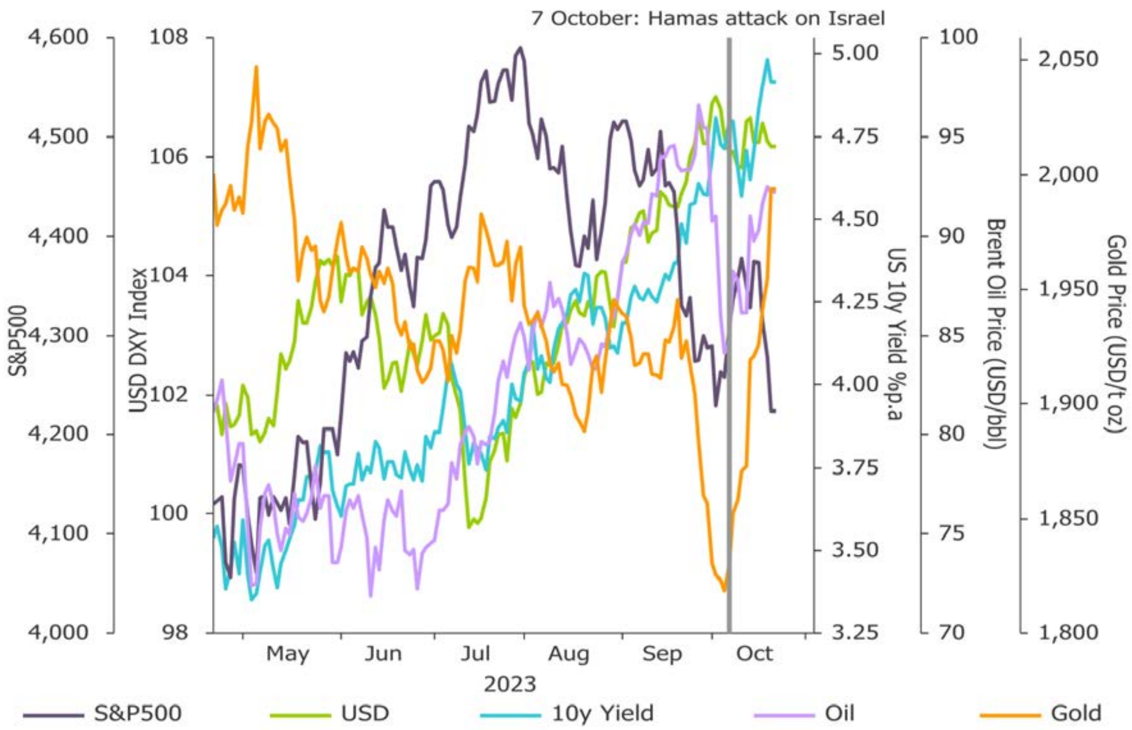
Source: Fullerton Fund Management, October 2023. Views may be subject to change without prior notice

With the escalation of the Israel-Hamas conflict, where ultimately Israel may seek to defeat Hamas in Gaza, market reactions have been 'risk-off'. Oil prices rose, gold prices increased significantly (driven by relatively more safe-haven flows than for the US dollar), and equities fell (see Figure 1).

US bond yields holding-up is consistent with investors believing that any significant adverse spillovers to global risk assets, from the Israel-Hamas conflict, can be contained

US 10y bond yields have held-up (see Figure 1), which suggests that the market is less concerned about the risk of significantly weaker growth. This is consistent with investors believing that Israel's military strength, and US support, can contain any significant adverse global spillovers from the Israel-Hamas conflict. At the same time, the US bond market seems more concerned about US political uncertainties and brinkmanship pushing the yield risk premium higher.

Figure 1: Recent market actions have been risk-off



Source: LSEG Datastream, October 2023

If growth concerns become more significant, then a key signpost will be significant falls in bond yields and equities

A key signpost that would motivate Fullerton to consider a negative longer-term outlook would be an adverse shift in sentiment, with further significant increases in oil and gold prices, and for equities and bond yields to fall in tandem. In a worst case scenario, where growth expectations deteriorate significantly, then this would increase the risk that our Regime Indicator slips from its positive Sentiment Driven signal to that of Danger Zone. If global risk assets start to fall sharply because of adverse growth and oil price shocks, then investors may find some insulation by holding more USD-denominated cash, bonds, gold, and oil-linked risk assets.

Historical experience suggests that once adverse reactions to geopolitical shocks 'wash-out' risk assets can return to previous trends

Investors are fully aware that given the 30 major geopolitical shocks since WWII they must always be prepared for volatility. At the same time, a key takeaway from previous shocks is that equity market declines associated with geopolitical fears have tended to be 'temporary disruptions' and markets often return to underlying trends after a few months[1]. Therefore, we maintain our positive 12-month ahead view for global risk assets and DM equities, led by the US.

Summary of Fullerton's Views (12 months ahead)

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

Source: Fullerton Fund Management, Oct 2023. Views may be subject to change without prior notice.
Note: We are avoiding exposure to China High Yield (HY) Corporate Credit and focusing on selective exposure to HY credits ex-China.

Led by DM equities, we are positive on global risk assets, bonds and corporate credit

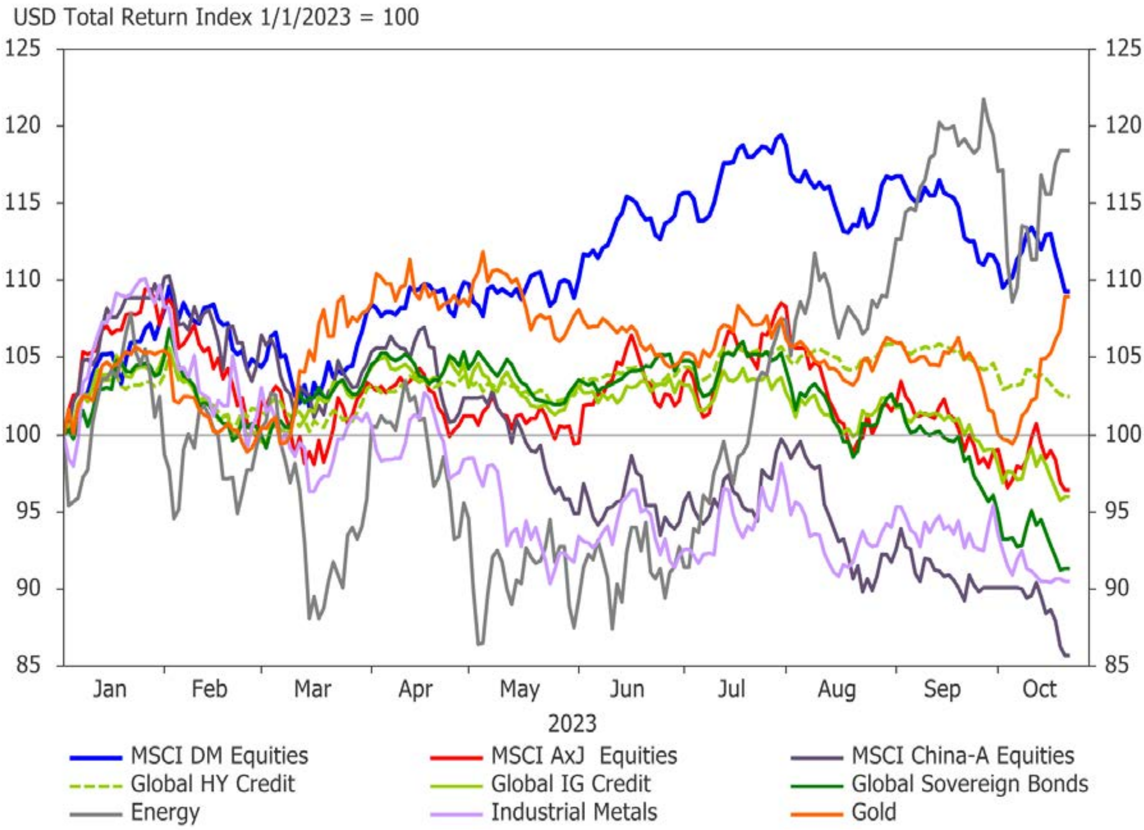
We maintain the view that the positive trend performance of key asset classes we have seen this year may potentially continue into 2024 (see Figure 2), led by DM equities and the US, followed by Japan (with Europe lagging). Fundamentals, especially for the US, remain favourable as growth forecasts have tended to be revised up, while earnings growth expectations remain solid. Robust fundamentals should help risk assets continue to traverse high interest rates and tight monetary conditions, with the prospect of a 'soft-landing' for the US and global growth remaining in play.

1. Source: 'What History Says About Geopolitics And The Market', Reuters, 19 February 2022.

Global sovereign bond returns have fallen with the rise in DM yields (see Figure 2), but we believe that the year-ahead return can be positive because of the high coupon - providing yields do not rebound too high beyond the fundamentals of trend growth and an appropriately positive risk premium. From a historical valuation perspective, US bond yields are rich compared to the S&P500 equity earnings yield, which reinforces the positive view we maintain on US fixed income.

Figure 2: the positive trend performance of key asset classes this year may continue into 2024

Risk Asset Returns



Source: LSEG Datastream, October 2023

In this high yield environment, bonds can generate a favourable income-stream for investors while providing some cushion from potential growth shocks - which is especially relevant given the uncertainties created by the Israel-Hamas conflict. The investment environment is very different from last year, where much lower inflation and reasonable growth can result in both equities and bonds performing well.

We also expect that the total return from Asia Investment Grade Corporate Credit (IG) for the next 12 months can be positive, but we are more cautious as the downside risk to the spread element of total returns has increased, reflecting China's weakness. Investors can increase their diversification across global corporate credit, and especially to the US where yields are attractive and consistent with expectations of robust US growth and corporate earnings.

We remain negative on China and Asia equities

We maintain our negative view on China and Asia equities. China's cyclical growth performance may be recovering with policy stimulus, and growth can be around the 5% target[2] this year, but we still do not believe it will be sufficient to boost markets sustainably. China's longer-term challenges will take time to resolve, and remain centred around balance sheet weakness (especially across corporates, real-estate, and local government) as well as deflation pressures.

Asia ex-Japan equities have decoupled to some degree from China's weakness, which is creating opportunities for active investors across countries that are benefiting from ESG-related spending, robust US demand, and consumerism in Japan. However, headwinds from weaker demand from Europe and a strong US dollar environment may limit broader-based equity upside.

We have turned positive on oil prices and the US dollar

Aside from the upside risk to oil prices from a higher geopolitical risk premium (given the Israel-Hamas conflict), demand and supply fundamentals have also turned more supportive for oil prices. China's demand growth has proved stronger than anticipated, and on the supply-side, OPEC is likely to try and sustain higher prices in this environment. US rig counts are still sliding, and any lack of a tangible US supply response may add to the upward pressure on oil prices over time.

We now have a positive view on the US dollar as the yield differential is more favourable and the US terms of trade is rising (with higher oil prices). To the extent that risk aversion remains elevated, some safe-haven demand for the US dollar may add to its appreciation. That said, the USD remains overvalued (as its real exchange rate is significantly above average) and that may limit its gains to some degree.

2. China's National People's Congress 5% GDP growth target for 2023.

02 Investment Environment

The ‘Great Decoupling’ can continue to offer alpha opportunities, against a backdrop of high interest rates for longer

Decoupling forces continue to unfold and cross-country differentiation has become starker as we head into 2024. The US leads DM, with significant benefits from stronger productivity growth and resilient domestic demand. Japan is enjoying historically high growth driven by stronger consumer spending and a very competitive real exchange rate. Europe is lagging significantly, as its disinflation process weighs heavily on growth. China faces significant longer-term headwinds from its ageing population, overinvestment, high debt, and deflation across output prices. Against this backdrop, China is seeking to become more domestically focused with enhanced local technologies and more resilient supply-chains.

The trend rise in geopolitical risks, exacerbated further by the Israel-Hamas conflict, has underpinned some push-back against globalisation which reinforces cross-country decoupling. The ‘Great Volatility’ that investors are being forced to navigate can persist, as the glaring divergence in cross-country growth and asset performance is adding to return volatility.

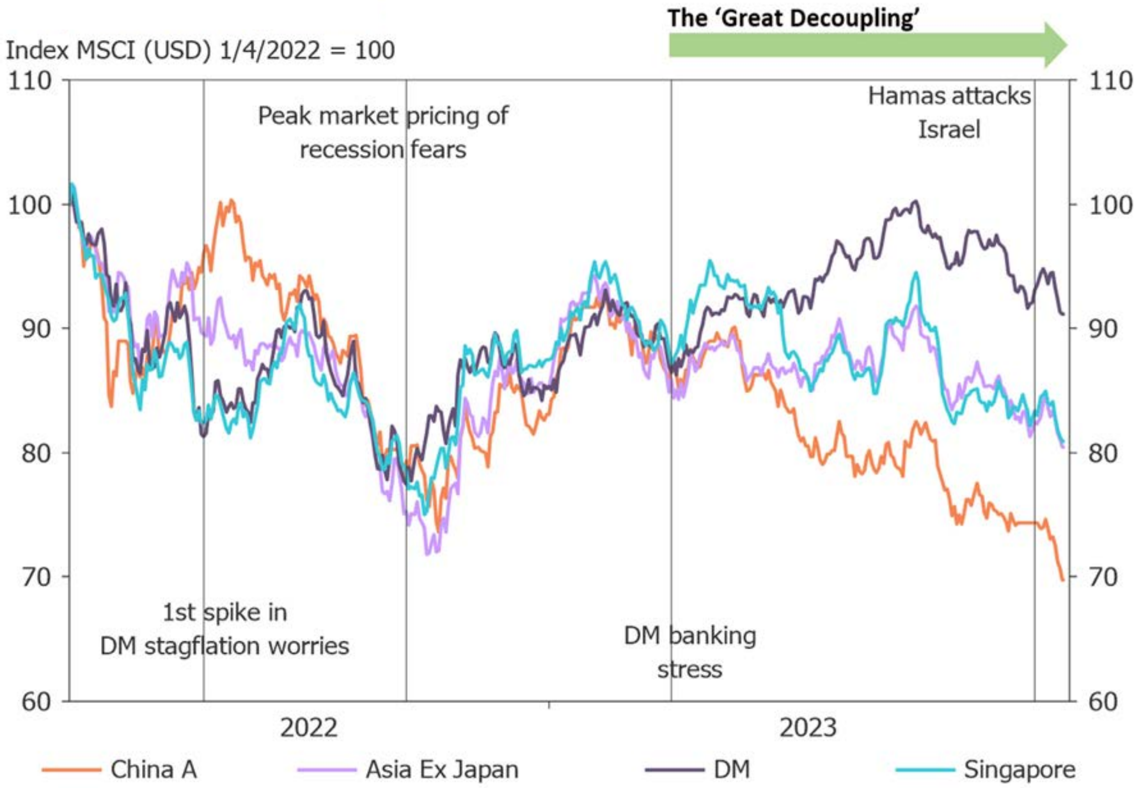
That said, variation in growth can create alpha opportunities for investors. For example, risk asset performance and earnings growth have tended to track changes in macro expectations with the US leading, followed by Japan, Europe, and thereafter Asia and China. The robust performance of US risk assets may continue as expectations for US growth in 2024 have been revised up, most notably by the Fed and the IMF, and trend growth around 2% has become feasible.

In contrast, the growth outlook for Europe and China is materially weaker. Europe faces the greatest likelihood of recession and its growth next year is likely to be the weakest across DM. China’s policy stimulus may be enough to hold growth around the 5% target this year, but next year’s growth may weaken further toward 4%[3]. Regardless of how China’s growth unfolds, we maintain the view that China’s macro environment is unlikely to be favourable enough to support a sustainable recovery in earnings and equities.

3. Fullerton Fund Management estimates.

Figure 3: The 'Great Decoupling' continues between DM, Asia, and China

Key Global Equities



Source: LSEG Datastream, October 2023

Variation in the drivers pushing DM yields higher may create headwinds for some countries

In the US, the yield curve slope has become more 'normal' as yields have risen significantly to realign with trend growth and a higher risk premium. Anchored to such fundamentals, and especially with strong corporate balance sheets, this 'new normal' need not threaten alpha generation. That said, a key risk to the performance of US financial assets into 2024 is if yields overshoot fundamentals, perhaps because political uncertainties and brinkmanship push the yield risk premium too high.

In contrast to the US, yields in Europe have risen not because of robust trend growth but rather because of greater inflation risk premiums. Likewise in Japan, rising yields reflect sticky inflation and expectations of BoJ policy shifts. At the opposite end of the spectrum, to ensure as much liquidity stimulus as possible, China's yields have remained decoupled and historically low relative to the US, and the currency has weakened a lot.

Is the favourable investment environment into next year at risk from high yields, geopolitical risks, and growth weakness across China and Europe?

Investors are most concerned about three key risks across the investment environment as we move into 2024: (i) high yields, that could prove especially stressful for US equities; (ii) geopolitical shocks, dominated by the Israel-Hamas conflict, which could cause oil prices and risk-aversion to surge; and (iii) significant weakness in China and Europe that may threaten global growth and risk asset performance.

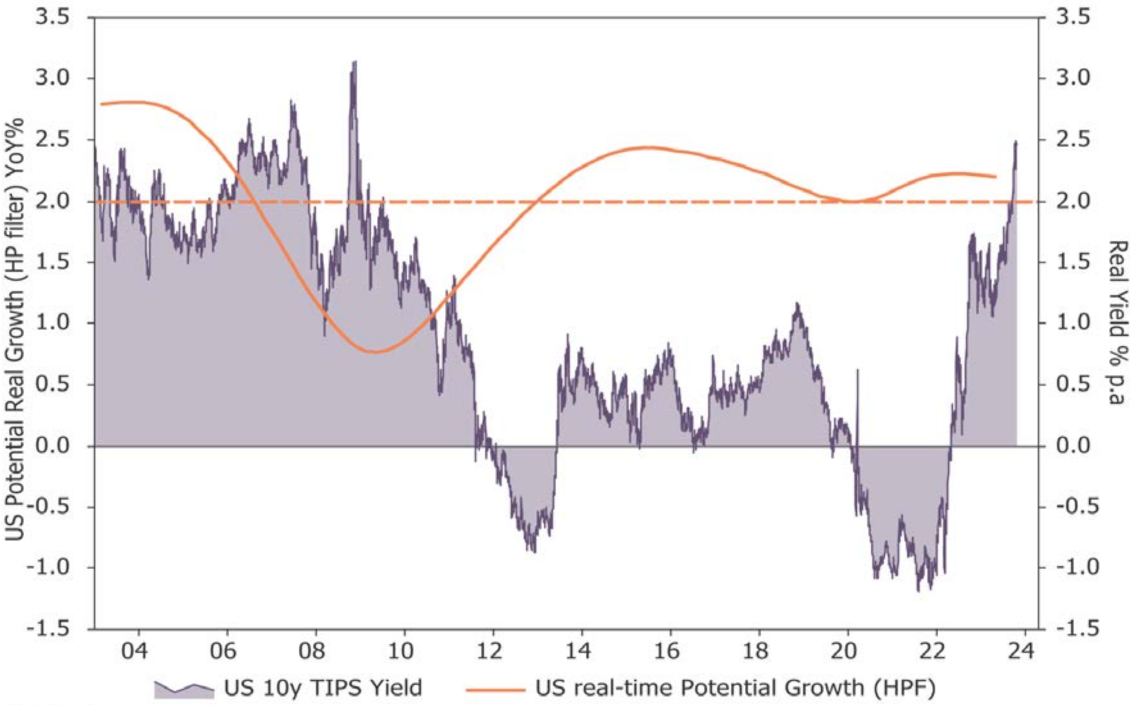
(i) The risk from high yields

Could US 10y nominal yields rise further and sustain rates above 5.25% p.a.? If realised then this would be above Fullerton's assumed trading range for US yields and it would likely prove a significant headwind for equity market performance. There is compelling evidence that such a rise in US bond yields would be beyond the fundamental signals of US trend growth (in both nominal and real terms), inflation expectations, and the 'pricing-in' of a fair risk premium.

For example, when US potential real GDP growth was fluctuating around 2% p.a. in the years before the 2008 Global Financial Crisis (GFC), US real yields also fluctuated around 2% (see Figure 4). With US potential GDP growth rebounding back toward 2% p.a. after the GFC, along with the favourable trend in productivity growth (see Figure 5), it did seem that for much of post-GFC experience, US real yields were too low. We get a similar signal when we look at how yields seem to be converging upwards toward US trend nominal growth, which is rolling-over and likely to slow further as disinflation continues and eventually settle at around 4.5-5.0% (see Figure 6).

Figure 4: Robust US real trend growth signals a real yield around 2% p.a. on average

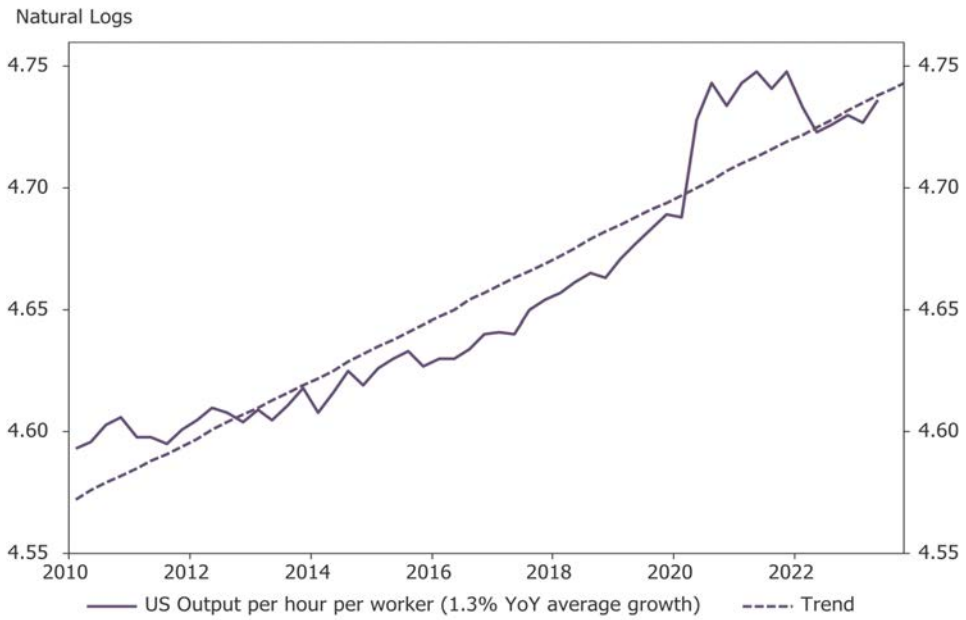
US Real Yield and Potential GDP Growth



Source: LSEG Datastream, October 2023

Figure 5: US productivity has followed a favourable trend, with its growth averaging 1.3% p.a. (consistent with 2% p.a. potential growth when the growth in capital and labour inputs is added)

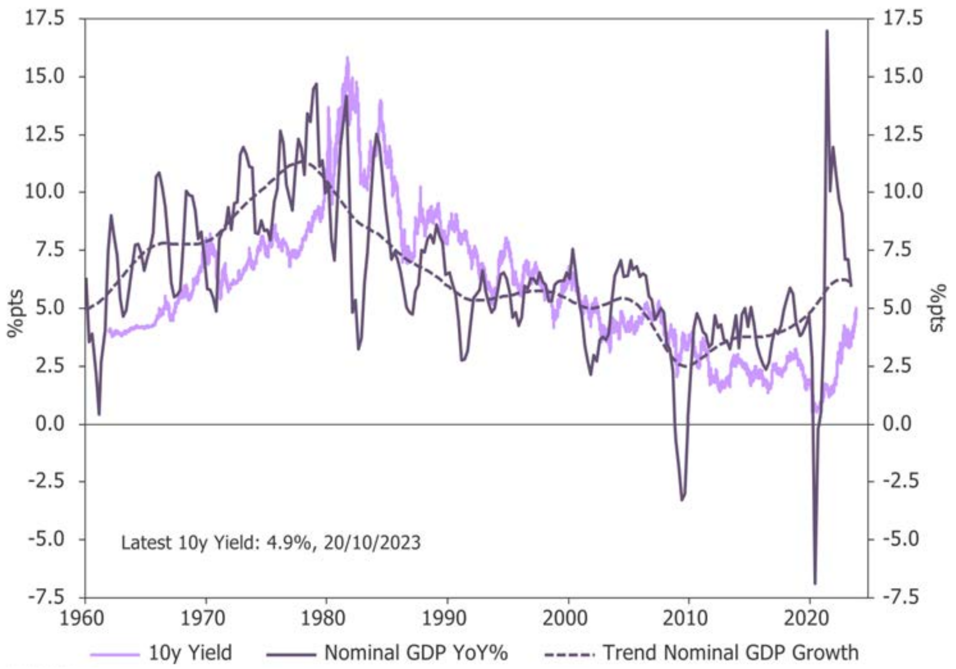
US Productivity with Trend



Source: LSEG Datastream, October 2023

Figure 6: US trend nominal growth signals a long-term sustainable 10y nominal yield around 4.5-5.0%

US 10y Nominal Yield and Nominal GDP Growth

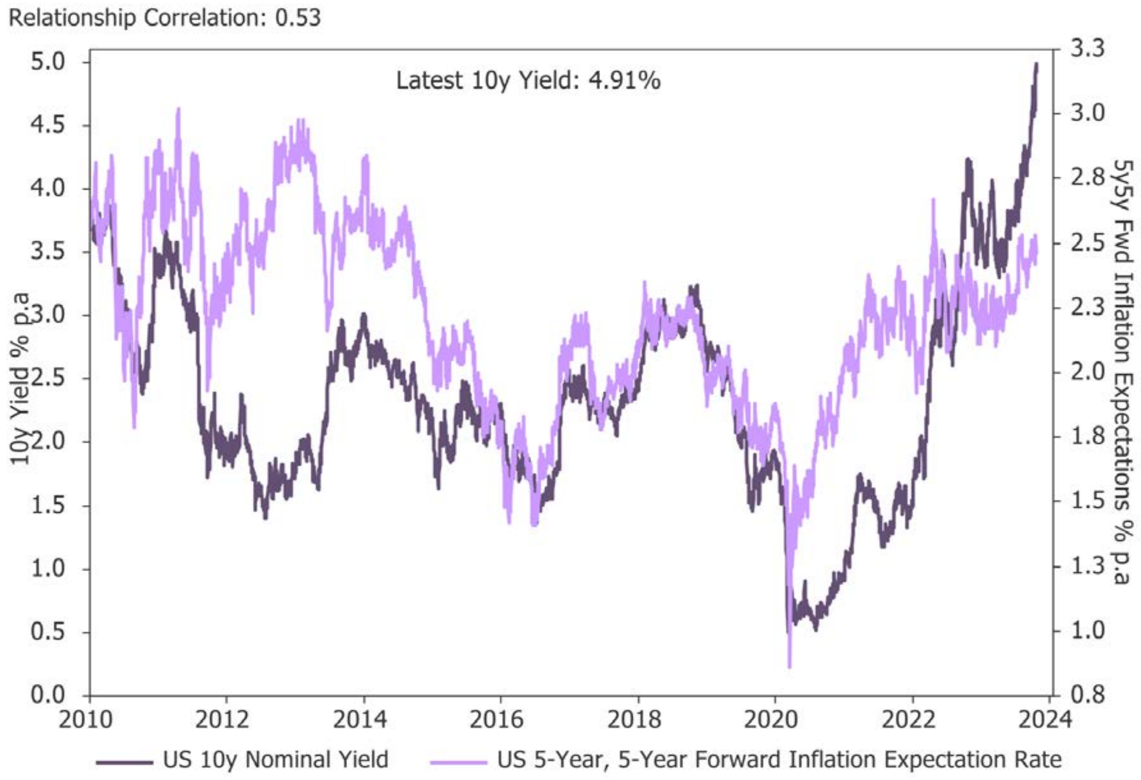


Source: LSEG Datastream, October 2023

The decoupling of US 10y yields to something much higher than what inflation expectations can explain, is unprecedented and bond markets, even after pricing-in a higher risk premium, should struggle to sustain yields significantly higher than 5.25% (see Figure 7).

Figure 7: Anchored US inflation expectations around 2.5% p.a. should stop US 10y nominal yields sustaining rates significantly above 5.25%

US 10y Yield and Inflation Expectations



Source: LSEG Datastream, October 2023

The risk premium presents the greatest risk to drive US yields beyond 5.25%

If we look beyond the fundamentals of growth and inflation it becomes clear that the 'appropriate' risk premium is where the greatest uncertainty lies for investors. If US yields were to rebound and sustain rates above 5.25% it would likely reflect the risk premium overshooting, perhaps because of concerns about US fiscal policy and political brinkmanship.

Concerns about US fiscal policy and political brinkmanship are key risks driving yields higher

At the moment the US (Republican controlled) Congress is in a state of flux as political infighting drags out the election of a new Speaker, while the fiscal deficit is deteriorating, and there is another Federal government shut-down deadline looming (on 17 November - if US lawmakers do not pass spending approvals).

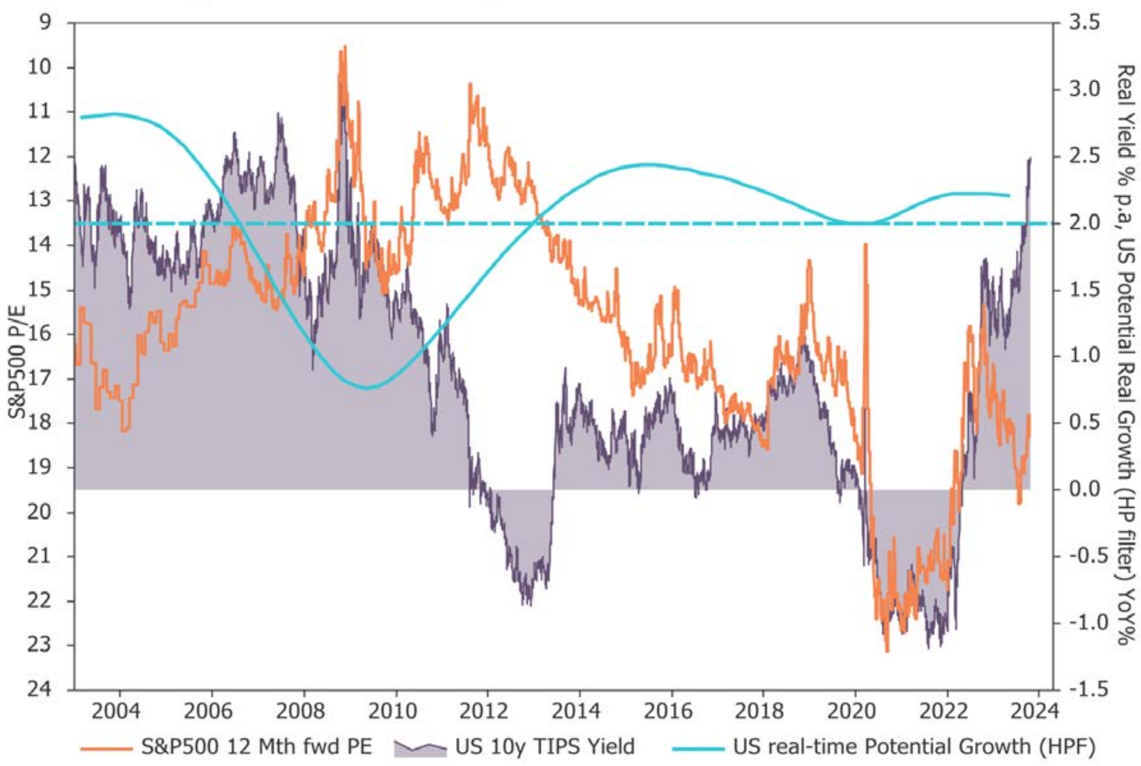
It is concerning that the lack of resolution drags on within the legislative branch at a time when the US needs strong fiscal management. It is exactly this type of 'political brinkmanship' that prompted Fitch Ratings to cut its US credit rating (on 1 Aug 2023) to AA+, a notch below the highest AAA level. Fitch highlighted that it was concerned about repeated debt-limit political standoffs and last-minute resolutions that have led to an 'erosion of governance'. These concerns could indeed contribute to a higher than normal risk premium and force US yields to ultimately sustain rates above 5.25%.

If the risk premium drives US yields to 5.25% or worse how painful could it be for US equities?

With the 'Great Decoupling' continuing, alpha opportunities for investors can continue to stem from pockets of growth, assuming rates do not overshoot. If US yields overshoot the fundamentals of trend real growth and inflation expectations because of a much higher risk premium, then US equities could de-rate. With the sharp rise in US real yields to 2.5% p.a. we have already seen a fall in the US P/E ratio to 17.8x (see Figure 8) - 15x may be possible, or around a 10-15% fall in equity prices, if yields settle too far above US trend growth. This is a risk scenario we continue to monitor but it is also a motivation to maintain a positive outlook on bonds in this environment because if yields prove too high for too long then growth and equities could correct sharply.

Figure 8: If US yields rise too far beyond trend growth then the risk increases that equities de-rate

US Real Yield, Real Trend Growth, and S&P500 P/E



Source: LSEG Datastream, October 2023

(ii) Risks to global financial assets from the worsening Israel-Hamas conflict

A key motivation behind the surprise attack by Hamas against Israel on 7 Oct seems to be to try and drag the Middle East into a wider conflict with Israel. Further escalation would then involve Lebanon and Syria, key allies of Iran. How events ultimately unfold will also depend on the actions and diplomatic negotiations between Israel, other Middle Eastern countries, and key global powers.

The Israel-Hamas conflict is likely to deepen….

Already there are tangible signs of the conflict intensifying. Israel has fired missiles at selected targets in Syria, across the cities of Damascus and Aleppo. In support of Hamas, along Israel's northern border with Lebanon, the Iran-backed Hezbollah group has clashed with Israeli forces in the deadliest escalation of frontier violence since the Israel-Hezbollah war in 2006. The US has promised it will send more military resources to the Middle East in support of Israel and strengthen its defence posture in the region.

…. but given Israel's military strength, and US support, any significant adverse global spillovers can be contained.

Global market reactions have been 'risk-off' with oil prices rising, gold prices increasing significantly, and equities falling. However, US 10y bond yields have held-up which is consistent with investors believing global growth is not at risk, as Israel's military strength, and US support, can contain any significant adverse global spillovers.

Such optimistic views on the conflict are defendable because Israel has the largest stock-pile of US-made weapons deployed in the world (outside of the US). Furthermore, Israel has a long history of significant spending on defence, which tracks around 4.6% of its GDP, making it the fourth highest global spender on military hardware (compared to the US, which ranks the sixth largest spender in the world[4]).

Calls for US financial support may appear constrained given the current state of flux across the US Congress. However, US fiscal resources are certainly available - despite the very large fiscal stimulus unfolding. As it is, US government spending to GDP is at a historical low of 17.5% (as is US military spending at 3.6% of GDP)[5]. There is room for increase on this front. Because the Middle East is so critical financially, geographically, and for US homeland security, it does not seem feasible for US support for Israel to disappoint.

If growth concerns become more significant from a deeper Israel-Hamas conflict, then the key signposts to watch will be surges in oil prices and significant falls in bond yields

Investors may question the belief that adverse global spillovers can be contained if oil prices were to surge to $120 USD/bbl (or worse), and if yields and equities fell significantly in tandem. Therefore, as the Israel-Hamas conflict is such a fluid geopolitical shock, some key signposts to continue watching, to track how investor sentiment may shift are DM bond yields and oil prices (see Figure 9).

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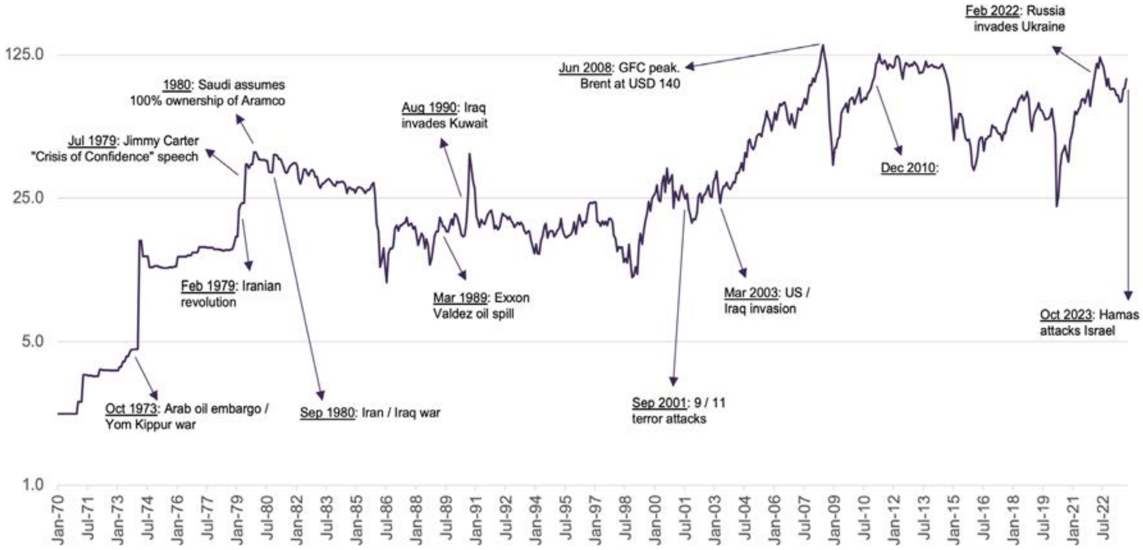
4. Source: Stockholm International Peace Research Institute (SIPRI).
5. Source: LSEG Datastream, October 2023.

Figure 9: Oil prices are a key risk barometer in the Israel-Hamas conflict

Brent Crude Oil Prices (USD/bbl)



Source: LSEG Datastream and Fullerton, Oct 2023. Data is log scale.

(iii) Is the 'goldilocks' investment environment into 2024 at risk from growth weakness across China and Europe?

In its October projections for 2024, the IMF expects US growth of 1.5%, Europe (EMU) at 1.2%, China at 4.2%, and global growth at 2.9%. The IMF view on US growth was revised up significantly by 0.5%pts (from July), and is aligned with the Fed's forecasts (from September), but is more optimistic than the Bloomberg Consensus (which expects just 1% US growth in 2024). Fullerton is more optimistic on US growth than the IMF, but more pessimistic on EMU growth. These different views can 'balance out' which suggests that even with a weak China (where its growth is likely to be well below 5%) potential outcomes for global growth in 2024 can cluster around 3% which can be favourable for risk asset performance (just as we have experienced this year[6]).

A favourable investment environment in 2024 is not threatened by China's weakness - it is more dependent on Europe avoiding a painful recession and the US being around trend growth

If US consumption growth is sustained, especially across the services sector[7], with robust disposable income growth and unemployment (currently 3.8%) remaining below 5%, then the prospect of the US holding at around trend growth in 2024 becomes much more likely. The US corporate sector is also making significant contributions toward achieving trend growth, with its investment growth rebounding, strengthening productivity, and corporate profits (as a share of GDP) tracking well above average.

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6. i.e forecasts for global growth in 2024 at 3% are on par with the latest global growth estimate for this year, tracking at 3%, and where China is expected to achieve its 5% growth target.
7. Which is around 75% of the US economy and its high PMI at 53.6 for September signals a very healthy 4% YoY real GDP growth rate for the sector. In addition, US manufacturing PMI has rebounded from its low this year of 46 (June) to 49 for September.

Robust US growth underpins the prospect of high rates for longer, but solid US fundamentals can still achieve a 'soft-landing'

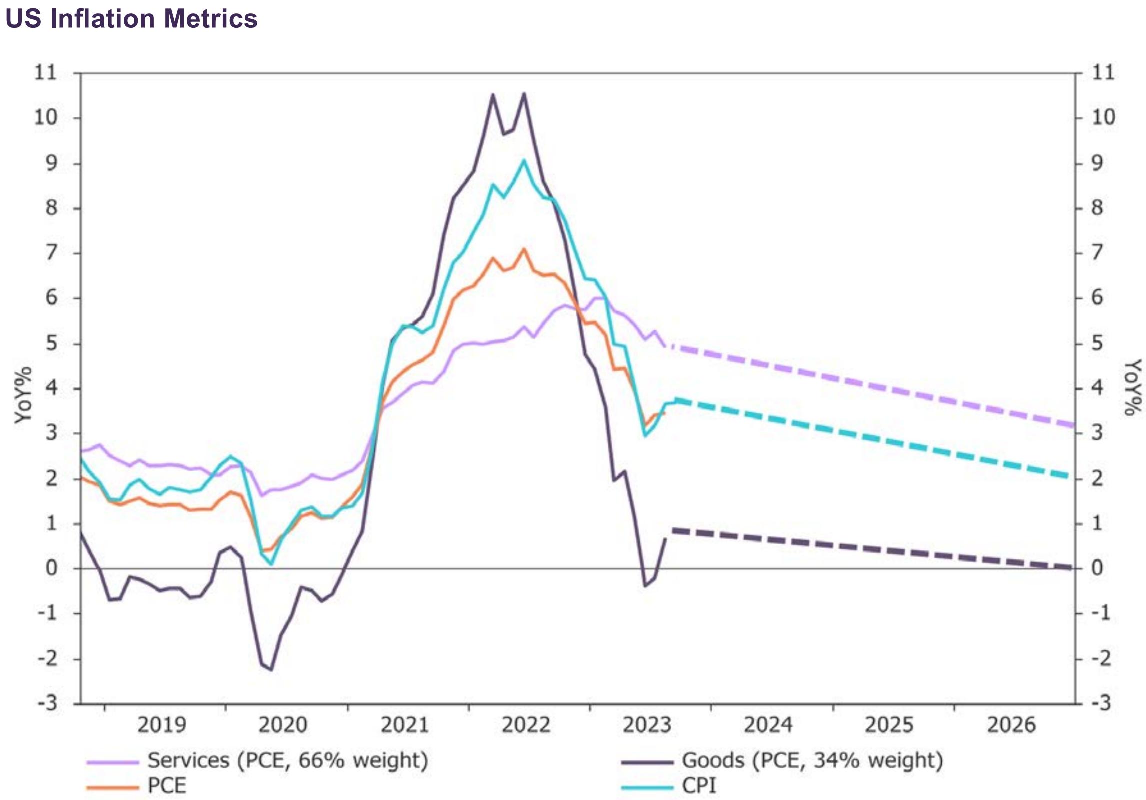
It is the prospect of robust US growth that has resulted in the Fed signalling that rates are likely to remain high for longer. The Fed has assumed that only minimal interest rate cuts may be possible in 2024, of around 50bps, if disinflation continues favourably (see Figure 10). Disinflation across the services sector remains sticky and slow while goods price inflation has normalised (see Figure 11). We continue to believe that robust fundamentals across US households and firms should allow the economy to continue to navigate high interest rates and tight monetary conditions, with the prospect of a 'soft-landing' for the US and global growth remaining in play.

Figure 10: US Fed forecasts

US Fed Projections from September 2023 (%pts)

Source: US Fed, Sep 2023

Figure 11: Inflation forecast paths consistent with the Fed's forecasts (from Sep)



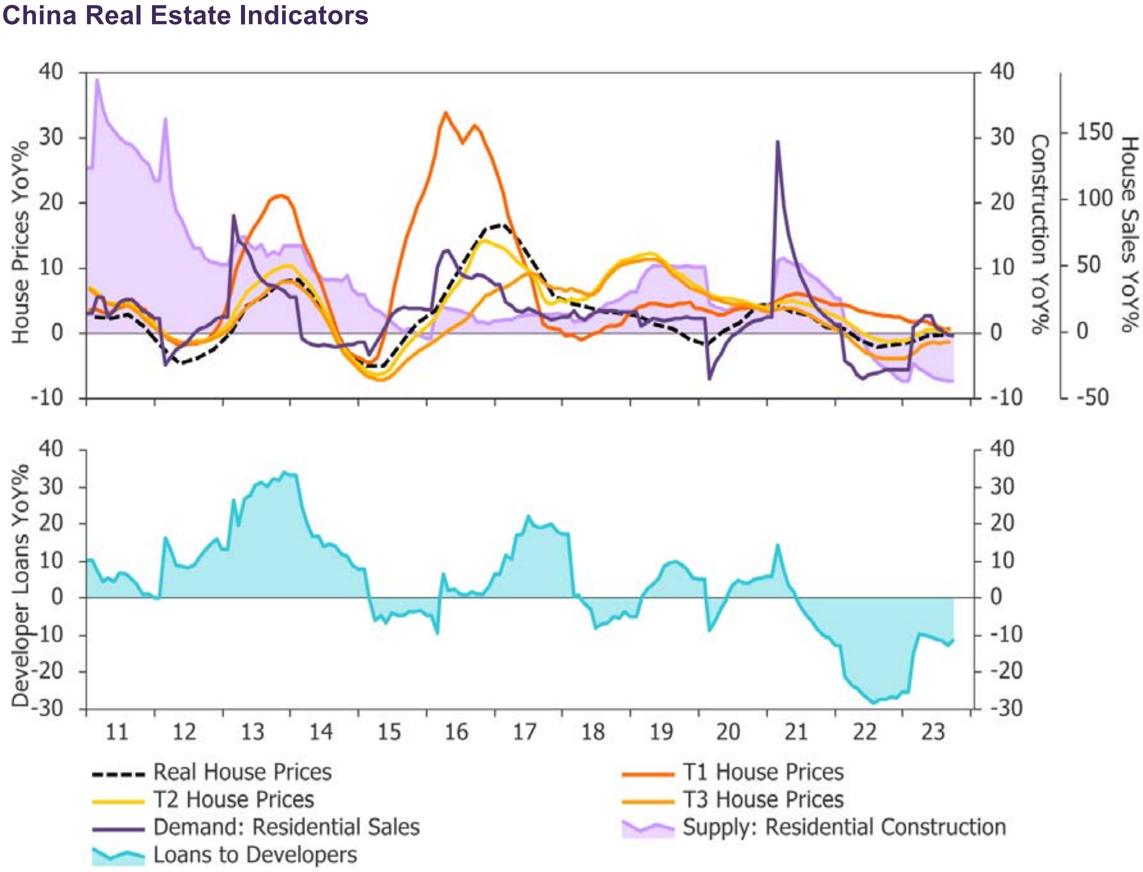
Source: LSEG Datastream, October 2023

China may achieve its 5% growth target this year, but 2024 will be challenging

China's real-estate sector stress is likely to worsen and it may prove difficult for policymakers to remedy in a timely fashion. Restoring confidence requires restructuring struggling property developers, while preserving financial stability and addressing the strains on local government balance sheets (especially given the significant increase in debt).

If real-estate sales fall further as indicators suggest (see Figure 12) then another leg-down in house prices could drive renewed falls in confidence and household spending. If the construction pipeline continues to weaken then this may further 'crowd-out' productive investment and add to local government budget stresses through reduced land sales.

Figure 12: China's real-estate sector remains very weak



Source: LSEG Datastream, October 2023

The healing process for China's risk assets will take more time and require greater clarity on how China's policymakers will act to remedy some of the longer-term headwinds

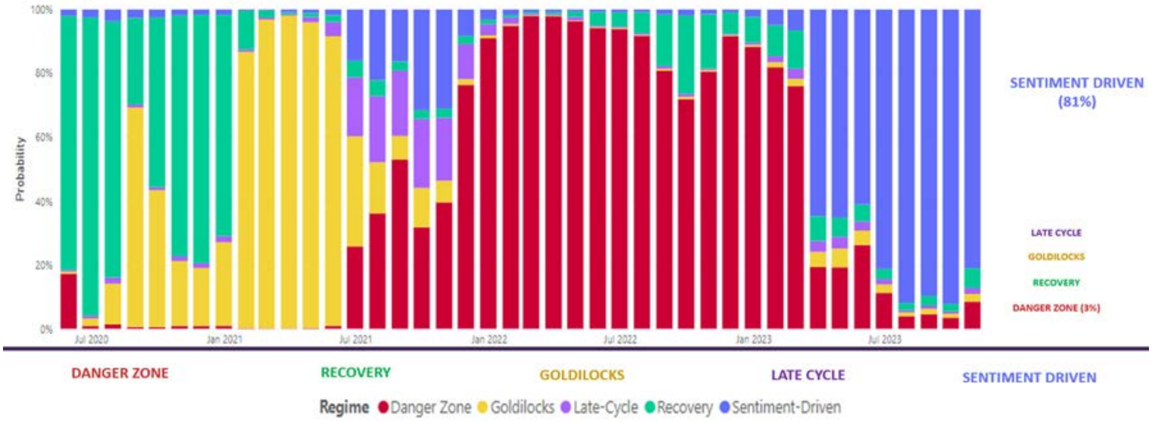
As we emphasised in our Q3 Fullerton Investment View, we believe China's longer-term headwinds reflect two key issues. Firstly, there is the pressure from a potential 'balance sheet recession' as high corporate debt, in particular, places funding stress on firms which may further weaken demand and prices over time. 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. We maintain the view that the healing process for China's risk assets will take more time and greater clarity on how China's policymakers will move to remedy some of its longer-term structural headwinds.

As global growth can achieve a 'soft-landing', Fullerton's Macro Regime Indicator continues to signal a positive Sentiment Driven backdrop

The positive state of the business cycle, especially in the US, remains supported by the signal from Fullerton's Macro Regime Indicator being in the 'Sentiment Driven' zone. This can be 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 13).

Figure 13: Fullerton's Investment Environment Regime Indicator

Forecasted Macro Regime Probability



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

However, the strength of the positive 'Sentiment Driven' signal has slipped, reflecting some pull-back in risk appetite and the rise in DM bond yields. As outlined, under a worst case scenario, where global growth expectations deteriorate significantly, this would increase the risk that our Regime Indicator slips from its positive 'Sentiment Driven' signal to that of 'Danger Zone'.

03 Equities

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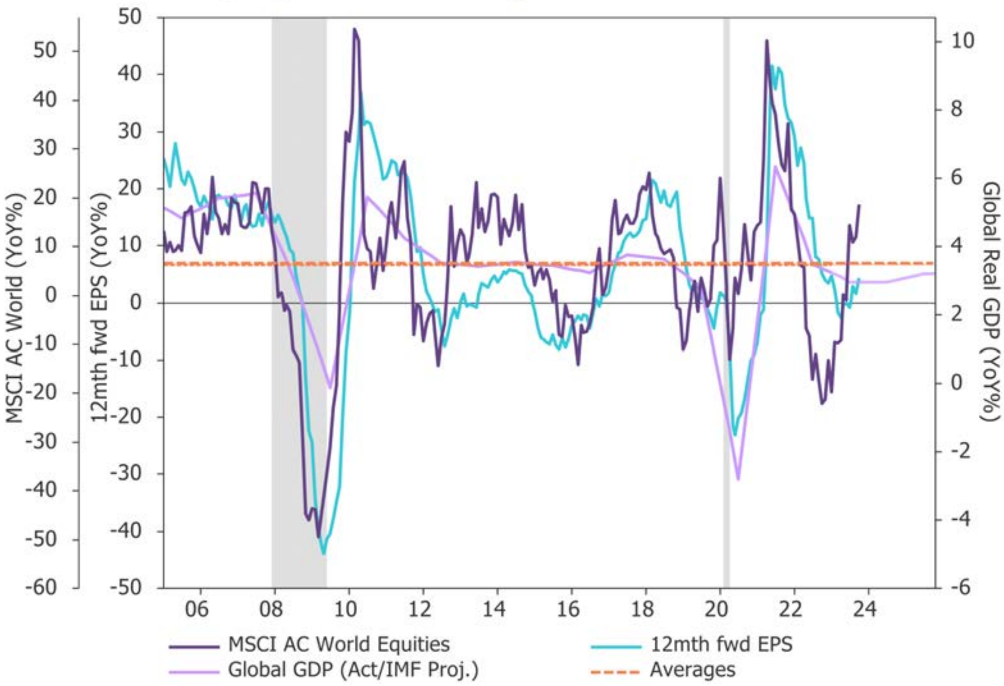
Head of Equities
Fullerton Fund Management

We maintain our positive 12-month forward view on DM equities, dominated by the US, with a favourable outlook for Japan

We maintain our positive view on Developed Market (DM) equities because earnings growth should continue to improve. That said, cyclical risks have increased, and equities may fall further as risk appetite has slipped with the rise in DM bond yields. With the overlay of risks from the Israel-Hamas conflict, investors in DM equities, and especially the US, should be more cautious and defensive over the near-term. Figure 14 suggests that global equity market pricing is still too strong relative to potential earnings growth and to global GDP growth (forecast at around 3% in 2024).

Figure 14: Global growth, equities, and expected earnings growth

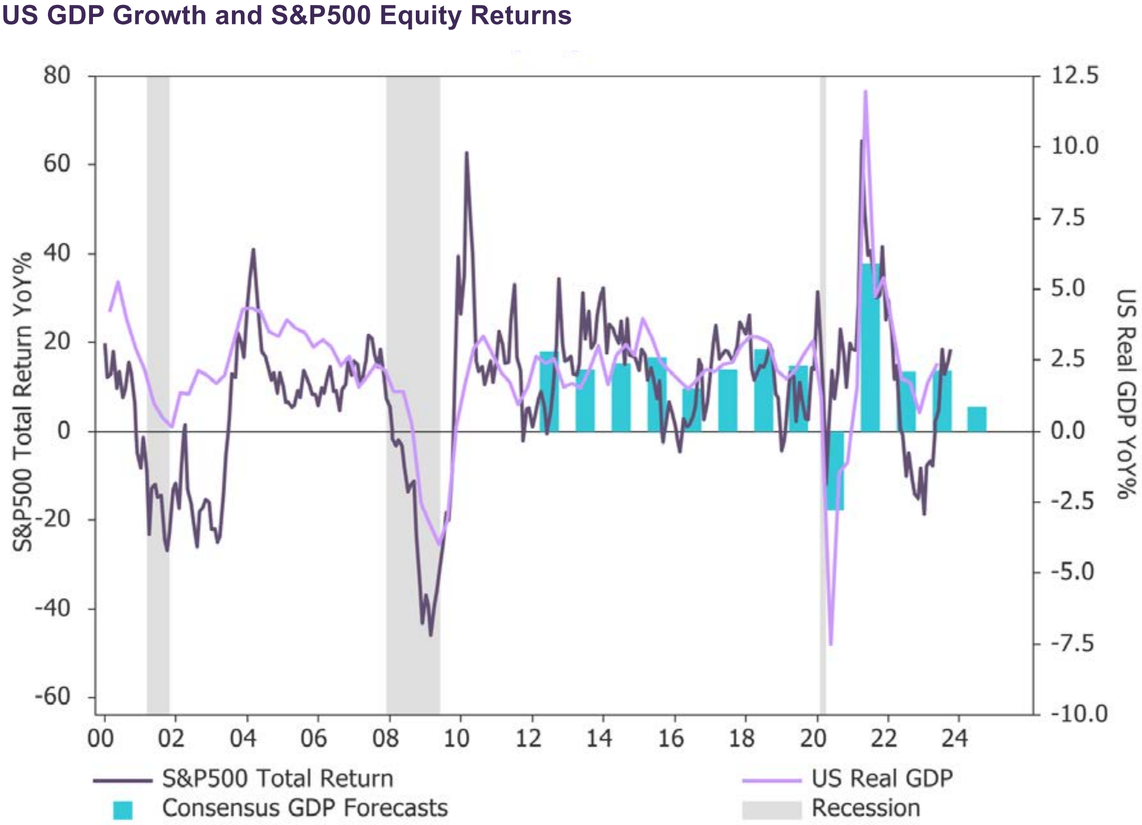
Global Growth, Equities & Earnings



Source: LSEG Datastream, October 2023

In contrast to global markets, US equity market pricing seems consistent with US growth being around trend (see Figure 15). That suggests that a key contributor to potentially over-optimistic global equity returns is that the growth weakness unfolding across Europe has not been fully appreciated by investors and priced-in.

Figure 15: US growth and equity market pricing

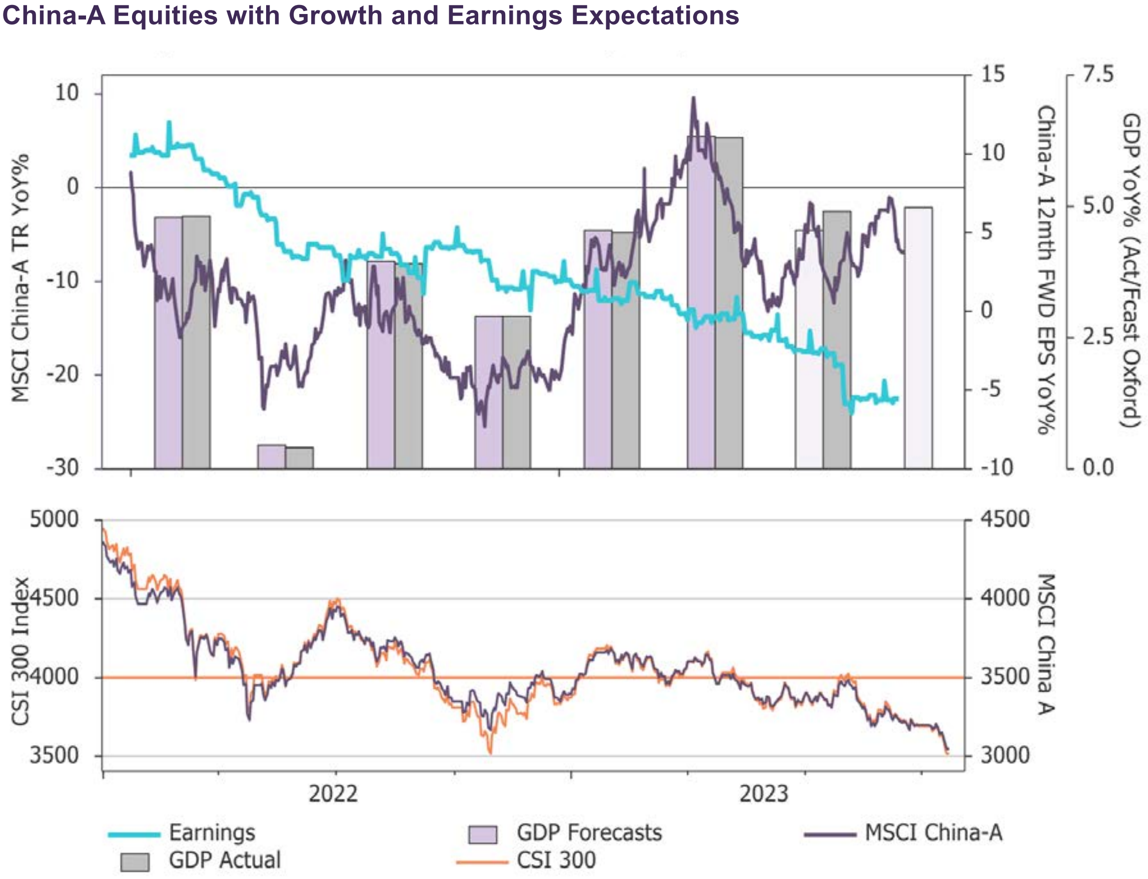


Source: Refinitiv Datastream, October 2023

Reflecting a poor earnings outlook, we maintain a negative view for China and Asia equities

Even though China's policy stimulus has gained traction, and its growth target of around 5% is likely to be achieved this year, earnings growth expectations continue to slide (see Figure 16). Corporate earnings may remain decoupled and depressed with deflation and high unemployment (especially across the younger cohorts) still featuring as part of the narrative.

Figure 16: China's equities, earnings growth expectations, and GDP (actual and forecasts)



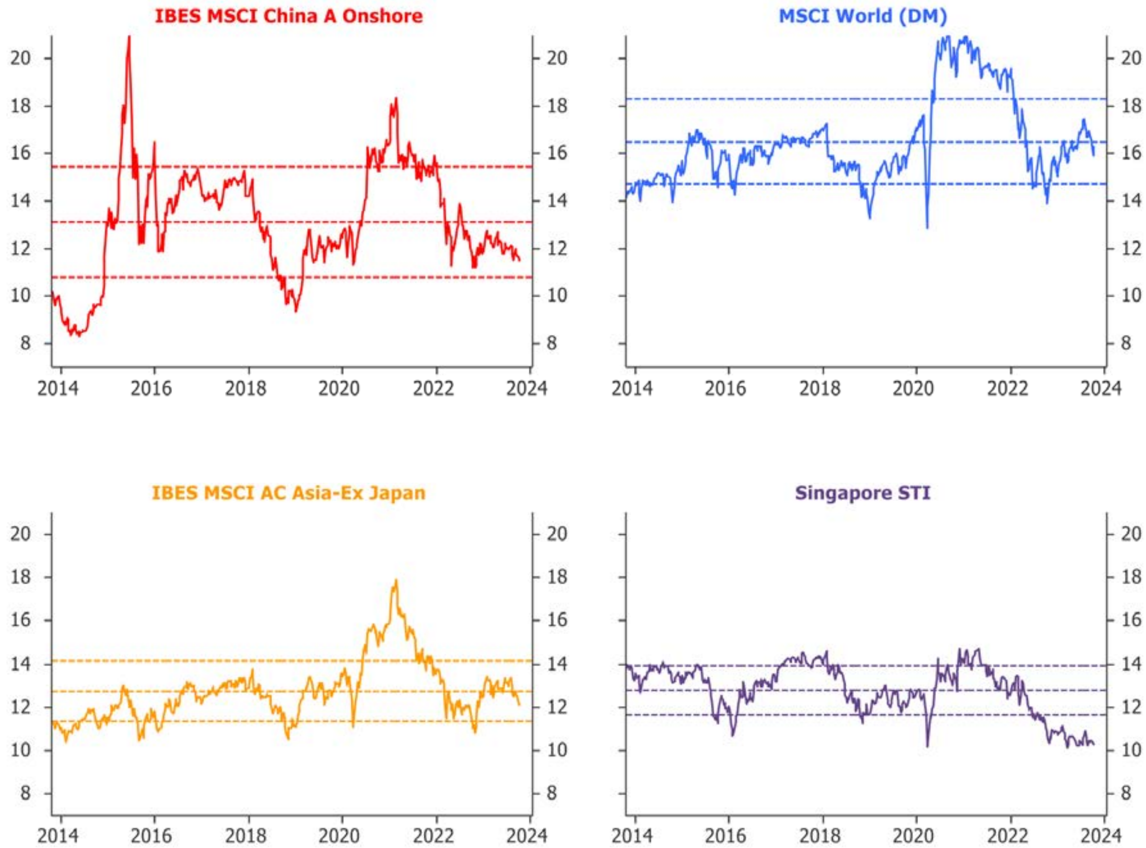
Source: LSEG Datastream, October 2023

Asia ex-Japan equities have decoupled to some degree from China's weakness, which is creating opportunities for active investors across countries that are benefiting from ESG-related spending, robust US demand, and consumerism in Japan. However, headwinds from weaker demand from Europe and a strong US dollar may limit broader-based equity upside.

The cyclical weakness across global equities since July has seen valuations become more attractive

Figure 17: Equity market valuations across key markets

Price/Earnings (P/E) Based on 12 Months Forward Expectations
with last 10y average and +/- 1 SD bands



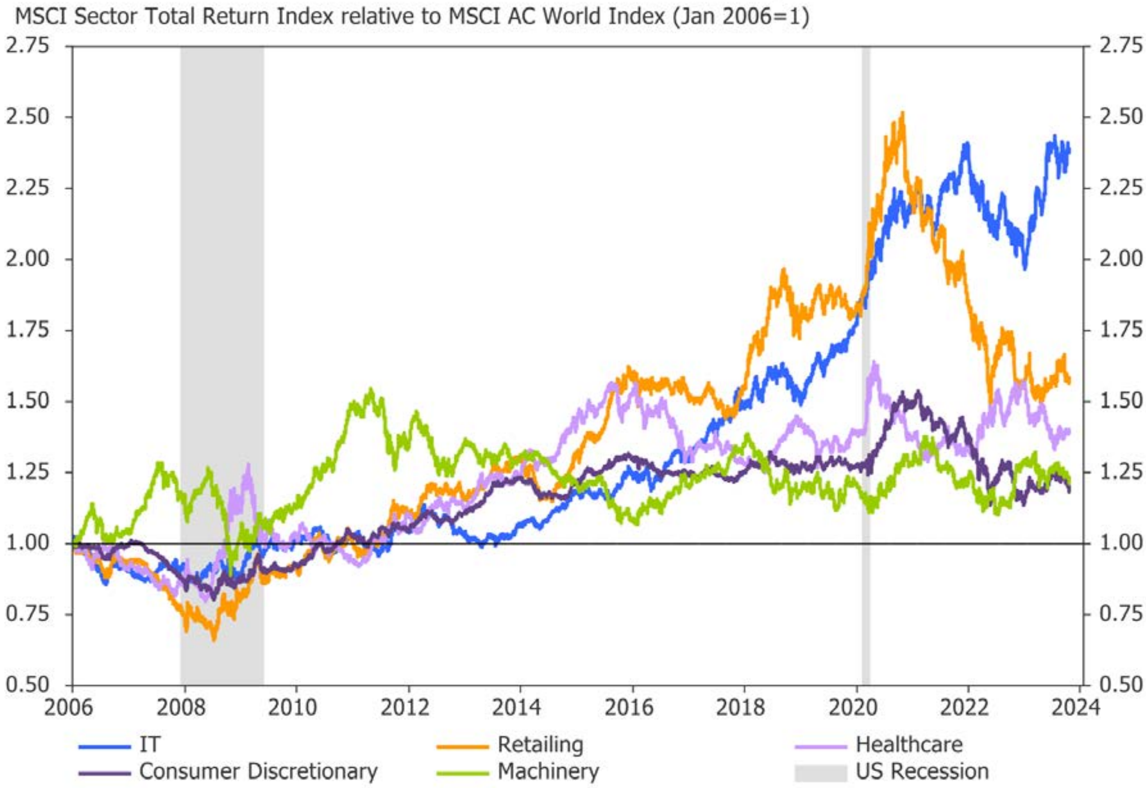
Source: LSEG Datastream, October 2023

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 18).

Figure 18: Trends in global equity sector alpha

Global Sector Total Return Relative to Global Equities



Source: LSEG Datastream, October 2023

In particular, we are positive on the US IT sector, and as we argued in our Q3 Fullerton Investment View, we do not judge the sector to be in a 'speculative bubble'. Much of the US IT sector's rebound has been driven by a return to its historical trend performance relative to the broader equity market[8].

8. See https://www.fullertonfund.com/fullerton-insights/investment-opportunities-in-the-age-of-artificial-intelligence/ for more details on our investment case for IT and how Artificial Intelligence (AI) may prove to be a 'game changer' for economy-wide productivity and IT-related alpha opportunities.

04 Fixed Income and currencies

Angus Hui
Deputy CIO &
Head of Fixed Income
Fullerton Fund Management

With high interest rates for longer, bonds can generate a favourable income-stream for investors while providing some cushion from growth shocks – which is now much more relevant given the Israel-Hamas conflict

We believe the Fed may already be at its peak policy rate for this cycle (i.e 5.5%) which should be tight enough to continue bringing inflation down slowly and back to target by 2026 (as the Fed had projected, see Figures 10 and 11). While an extra rate hike (or two) cannot be dismissed, we believe it may be less likely because the time path to get inflation back to target is sufficiently long. We also agree with the Fed's signal that policy rates are likely to remain high for longer because of robust US growth.

Therefore, we remain positive on US bond duration and look to further extend exposure. What is a key difference from last year, where many investors sought to cut duration (with rising yields and very high inflation), is that inflation continues to come down – and such favourable conditions can result in bonds (and equities) performing well.

As we have outlined, from the fundamental perspective of US trend growth and inflation expectations, US yields should not sustain levels significantly above 5.25%. There is already a record gap of bond yields over inflation expectations and this may help to contain any sustained 'break-out' in yields, especially as disinflation continues.

That said, the key risk to US yields overshooting is driven by a rising risk premium, in part reflecting US political uncertainties, brinkmanship, and the deteriorating budget deficit. If yields ultimately settle too far above US fundamentals, then the likelihood increases of growth eventually becoming stressed. In that scenario, as the correction unfolded, investors holding bonds would likely enjoy significant capital gains.

Diversification into quality global corporate credit can be a valuable supplement to exposure to Asia IG

We expect that the total return from Asia Investment Grade Corporate Credit (IG) for the next 12 months can be positive, but we are more cautious as the downside risk to the spread element of total returns has increased reflecting China's weakness. Investors can increase their diversification across global corporate credit, and especially to the US where yields are attractive and consistent with expectations of robust US growth and corporate earnings.

Asia local currency government bonds that have tended to perform well are those with high and relatively stable yields e.g India and Indonesia. However, for other countries across the region, headwinds to returns may increase as we expect the US dollar to remain strong.

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

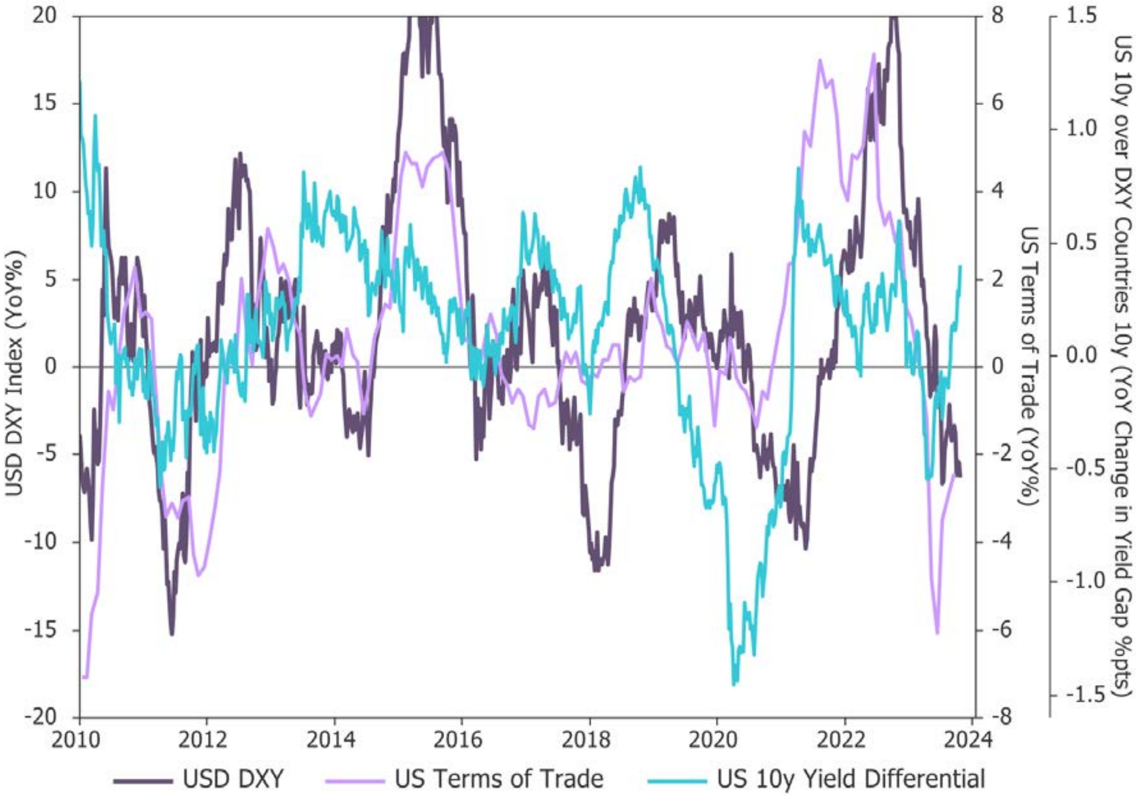
We prefer non-financial corporates, sectors linked to consumerism, new industrials, raw materials and infrastructure. The latter can continue to benefit, especially across Asia, where many countries are enhancing supply-chains and spending significant amounts on renewable energy. We believe all these sectors have positive long-term drivers, and as a result, can provide some cushion to investors in challenging environments.

We have shifted to a positive outlook for the US dollar

With the sharp rebound in the US terms of trade, driven by higher oil prices, the US dollar is likely to appreciate. In addition, the US yield differential should remain favourable for a while (see Figure 19), and the US growth differential is likely to remain the strongest across DM. The Israel-Hamas conflict increases the prospect of greater safe-haven demand for the US dollar, which may prove stronger than previous shocks because the US is now a net oil exporter.

Figure 19: Key drivers signalling a stronger USD: the rebound in the terms of trade and the rising yield differential

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



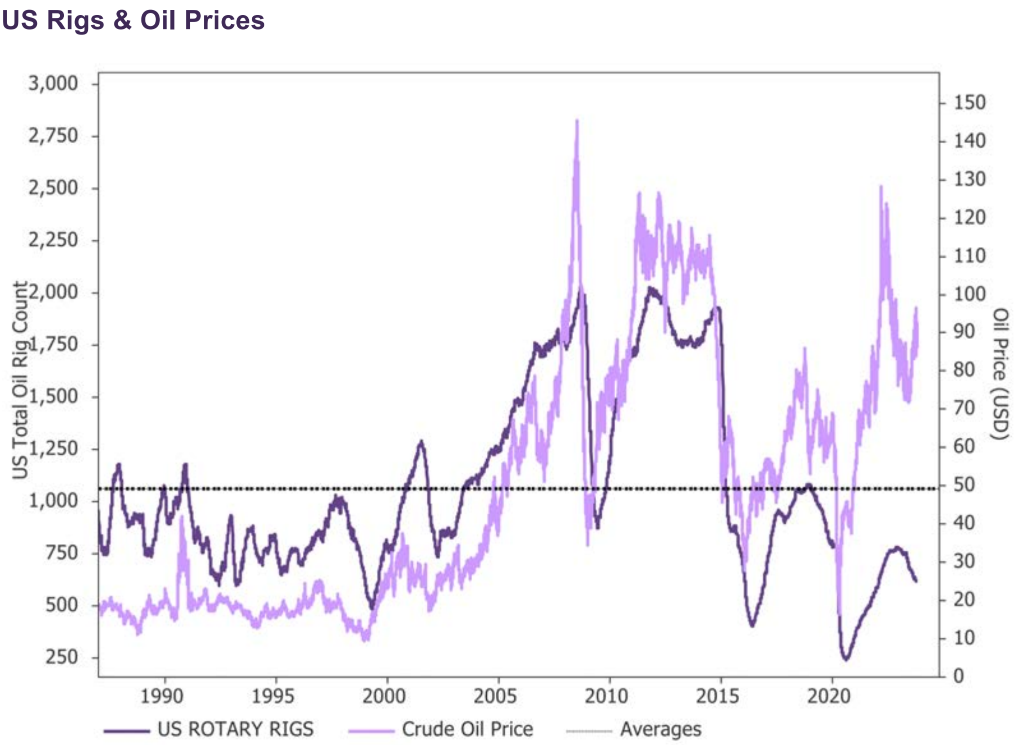
Source: LSEG Datastream, October 2023

05 Commodities: oil and gold

We have shifted to a positive view on oil prices, as demand is likely to prove stronger than expected amid tight supply

Aside from the upside risk to oil prices from a higher geopolitical risk premium, given the Israel-Hamas conflict, demand and supply fundamentals have turned more supportive for oil prices as well. US inventories have fallen significantly and China's demand growth has proved stronger than anticipated. On the supply-side, OPEC is likely to try and sustain higher prices in this environment. Furthermore, US rig counts are still sliding, and any lack of a tangible US supply response may add to upward pressures for oil prices over time (see Figure 20).

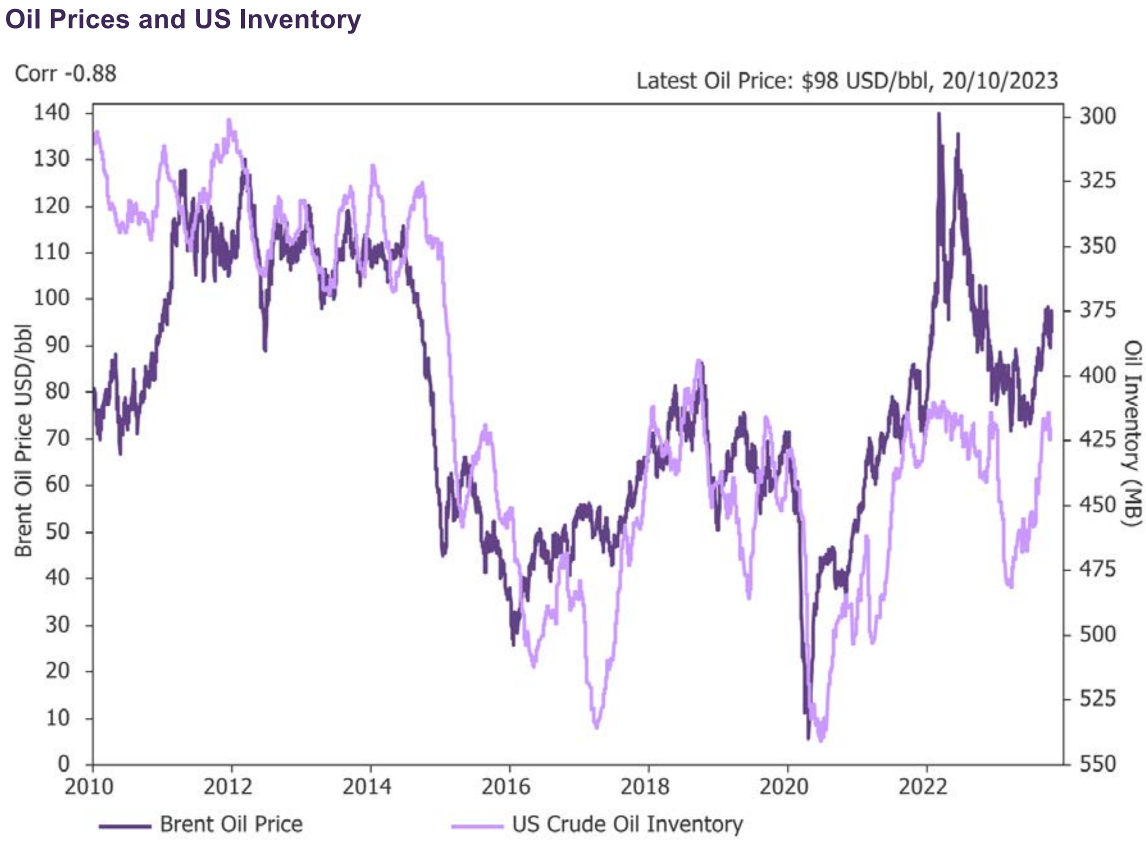
Figure 20: US oil rig count and oil prices



Source: LSEG Datastream, October 2023

The US inventory fall, as a proxy for global demand and supply dynamics, signals an oil price of around $80 USD/bbl, and we have seen a premium as high as $20 USD/bbl, reflecting geopolitical risks (see Figure 21). A key risk from the Israel-Hamas conflict is that this risk premium rises further.

Figure 21: Oil prices and US inventory



Source: LSEG Datastream, October 2023

We remain positive on gold – it is a very useful hedge against geopolitical shocks and macro uncertainties

We believe gold can continue to be an important element in portfolios given the trend rise in geopolitical risks we have highlighted before. Gold prices have continued to navigate yield strength, and provided valuable cushion to investors this month with the Israel-Hamas conflict, and also in mid-March when recession fears spiked with the banking stresses across the US and Europe.