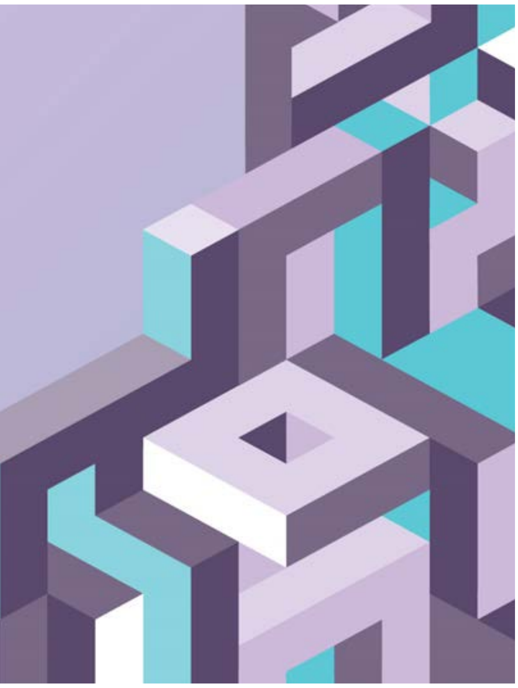
@Crossroads of Opportunities: Goldilocks continues

Fullerton Investment Views - Quarterly report

Q1 2024



Author

Robert St Clair
Head of Investment Strategy
Fullerton Fund Management

Contents

Executive summary

- **We are bullish on global risk assets and Developed Market (DM) equities (especially the US), and positive on Asia ex Japan equities and fixed income**
    - Amidst the 'Great Decoupling', investors should maintain active management to capture alpha opportunities across countries and sectors. Most of the 'speedbumps' highlighted in Q423 in this goldilocks environment have faded.
    - We believe favourable asset return trends from 2023 can continue this year, and expect positive returns from equities and fixed income, with the strongest returns from DM equities. Asia ex Japan equities may potentially outperform returns from 2023.
    - The big positive surprise in December 2023 was the US Fed signalling that rate cuts are now feasible in 2024. Falling yields, especially in the US, realigns with the fundamentals of lower inflation and robust growth. This should prove supportive of risk assets.
    - We expect the US to lead DM, underpinned by stronger productivity, resilient demand, robust liquidity, and easier financial conditions.
    - Our Asia ex-Japan equities positive outlook reflects stronger earnings growth expectations and some decoupling from China's weakness, especially across South Korea, India, and Taiwan.
    - We remain positive on fixed income as yields are attractive enough that bonds can generate favourable income-streams, while providing cushion if growth weakens. A soft-landing for the global economy should ensure robust returns for corporate credit investors.
- **Geopolitical risks persist, dominated by the Israel-Hamas conflict**
    - The Israel-Hamas conflict could broaden. However, historical experience suggests that as adverse reactions to geopolitical shocks 'wash-out' risk assets can return to previous trends. It remains prudent for investors to protect their portfolios from potential adverse geopolitical shocks with some exposure to gold and bonds.
- **We remain negative on China equities**
    - With the boost from policy stimulus, China's growth has recovered to the 5% policy target[1], but we believe more time is needed before markets can achieve a sustainable recovery. Its weak property sector and deflationary pressures are key headwinds.

China's GDP for 2023 increased by 5.2%, hitting the National People's Congress 5% GDP growth target.

01

Risk-Asset Outlook

2023 was a bullish year for global equites, led by Developed Markets (DM), with pockets of strength across Asia

US equities achieved very strong returns, with 26% gains in 2023[2], as US GDP growth remained above trend and as earnings beat Consensus expectations. The US enjoyed significant benefits from stronger productivity growth, resilient domestic demand, and ample liquidity, despite the high Fed policy rate. Across Europe its equity returns were also robust (20% in USD-terms)[3] as CPI inflation, and producer cost pressures, surprised on the downside which helped support spending and margins. Japan equities gained 20% (USD-terms)[4] as its growth, and especially retail sales activity, proved stronger than historic norms.

Asia ex Japan equities managed to end 2023 with a 6% gain (USD-terms) driven by very strong performance from Taiwan equities (32% gains in USD terms), South Korea (up 23% in USD terms) and India (21% gains in USD terms)[5]. Asia ex Japan markets managed to decouple from weakness in China as regional countries benefited from robust demand from the US and Japan. This was especially across spending linked to technology, consumerism, and new industrial outputs, as well as contributions to supply-chains. The key drag to performance across Asia was from China-A equities which fell 13% (in USD terms)[6] as earnings struggled with China's producer price deflation, and weak activity across key sectors like industrial production and real-estate.

2023 was also positive for fixed income investors

Corporate credit instruments across the various global markets recorded returns within a 5-15%[7] (USD-terms) range, while sovereign bond returns (excluding Japan) achieved returns within a 4-10% (USD-terms)[8] window. Real yields supported robust income-streams for 'hold-to-maturity' investors, while active investors enjoyed the sharp correction in DM yields over Q423 as markets accepted that disinflation was proving faster than anticipated. China's policy stimulus helped return its growth to the 5% policy target, while abundant liquidity and reasonable growth over the rest of Asia ensured that investment grade (IG) corporate credit investors were adequately compensated.

2. S&P 500 total returns (source: Bloomberg, January 2024)
3. MSCI Europe total returns in USD terms (source: Bloomberg, January 2024)
4. MSCI Japan total returns in USD terms (source: Bloomberg, January 2024)
5. Performance data quoted refers to the MSCI Asia ex-Japan, MSCI Taiwan, MSCI Korea, and MSCI India indices respectively (source: Bloomberg, January 2024)
6. MSCI China A Onshore returns in USD terms (source: LSEG Datastream, January 2024)
7. Refers to various Bloomberg Bond Indices: from US Corporate IG to US Corporate HY, and other EM Corporate Bond Indices (source: Bloomberg, December 2023)
8. Refers to US 3-Month Treasury Bills and various Bloomberg Sovereign Bond Indices: from German Government Bonds to UK Government Bonds indices (source: Bloomberg, December 2023)

Fullerton believes that the favourable asset return trends from 2023 can continue this year. We expect positive returns from both equities and fixed income, with potentially stronger returns from DM equites, while Asia ex Japan equities may potentially outperform returns from last year.

We have revised up from a positive to a bullish outlook for global risk assets, dominated by DM equities

As US GDP growth is likely to have ended 2023 at 2.6% (Source: US Fed estimate, 13 Dec 2023) we maintain our view that it can slow and settle around its 2% trend this year. With the prospect of US trend growth being sustained, along with strong productivity growth, robust earnings, ample liquidity, and easier financial conditions, we have a bullish outlook for US equity returns.

Contributions to DM equity performance from Europe equities may be enhanced by the ECB potentially easing its policy rate by more than the US Fed in 2024. DM equity returns are also likely to be supported by Japan's growth holding above its historic average this year, along with its competitive real exchange rate.

We are positive on Asia ex Japan equities, and negative on the US dollar

Key regional economies seem to have decoupled from weaker demand from Europe and China. As a result, Fullerton expects that the favourable performance across equity markets in South Korea, Taiwan, and India can continue. Taiwan and South Korea are high-value added manufacturing countries, and should benefit from stronger global IT demands (driven by AI and metaverse related technologies) and as consumer spending holds-up across the US and Japan.

Fullerton has maintained a positive outlook on India equities for more than a year, as earnings growth continues to benefit from competitive production, rising spending power, favourable trade flows, and well-contained inflation.

US dollar weakness can also be broadly supportive for regional equity markets, and our negative view reflects strong US liquidity growth, its weaker terms of trade, and real exchange rate overvaluation.

Fullerton remains positive on corporate credit and global sovereign bonds

With global growth likely to be supportive, potential default rates across corporate credit should be contained and investors well rewarded for risk-taking. Returns from Asia (IG) corporate credit should be positive notwithstanding some potential drag to spread gains given China's macro weakness. Investors can continue to increase their diversification with global corporate credit, and especially to the US, where company performance may remain relatively stronger.

As global inflation continues to come down, especially across DM, it suggests that yields are unlikely to surprise again significantly on the upside which means active bond investors could potentially avoid capital losses. 'Hold-to-maturity' fixed income investors should enjoy attractive interest income streams from above average real yields, with some downside protection if growth unexpectedly slumps. The latter is especially relevant given on-going geopolitical risks and the uncertainties surrounding the Israel-Hamas conflict. Our negative outlook for the US dollar can also be supportive to Asia's local currency bond markets.

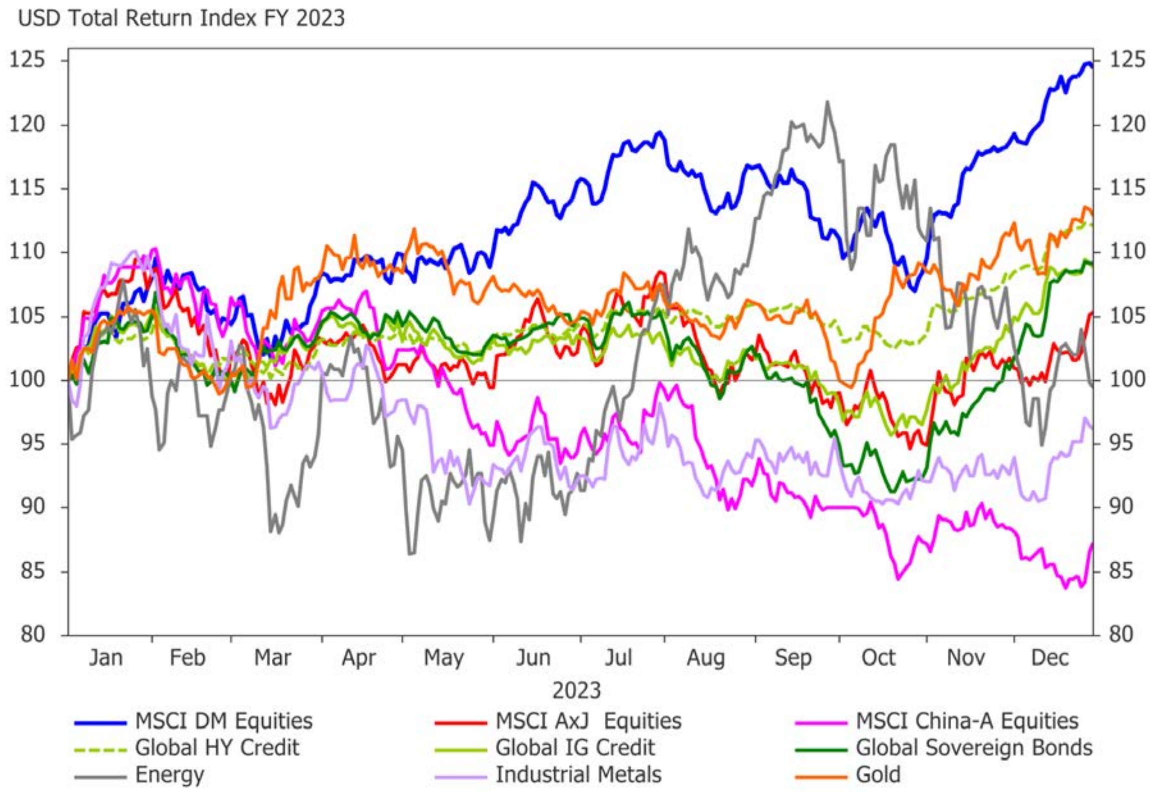
We maintain our negative outlook on China equities, and continue to monitor the prospect of further policy stimulus closely

A lot of bad news has been 'priced-in' to China's equities and with cheap valuations, including some stability coming back to its GDP growth, there may be a floor to the performance of China equities. However, we believe that more healing time will be required for earnings, and the real-estate sector, before there is a sustainable and significant equity market rebound.

China's policymakers may also need to consider further stimulus given the likelihood that growth this year proves weaker than in 2023. Potential policy actions by China this year, especially if it can effectively tackle deflation pressures, is something we continue to monitor closely - as it could become a game-changer for risk asset performance.

Figure 1: Fullerton believes that the positive trend performance of key asset classes in 2023 can continue into 2024

Risk Asset Returns



Source: LSEG Datastream, January 2024

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			✓	
US dollar		✓		

Source: Fullerton Fund Management, January 2024. Views may be subject to change without prior notice.

02 Investment Environment

@Crossroads of opportunities – is underpinned by our '3G forces' of a great decoupling, great volatility, and a great reset

The theme for Fullerton's January Investment Outlook is at the 'crossroads of opportunities' which reflects the on-going interactions of some of the '3G'-trend changes across the investment environment that we first highlighted back in November 2022.

The great decoupling is proving to be an alpha generator

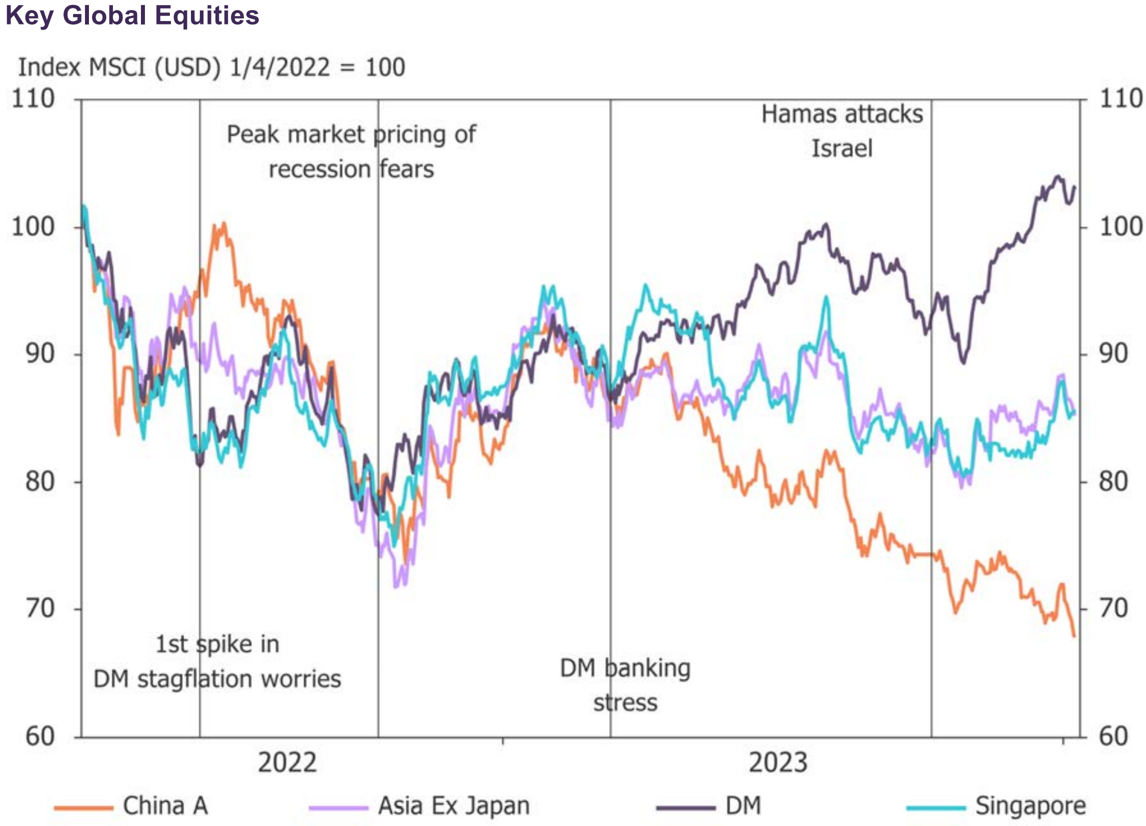
Firstly, decoupling forces continue to unfold and cross-country differentiation has become starker. The US has enjoyed strong productivity growth, low unit labour costs, and resilient domestic demand. Europe's disinflation has weighed more heavily on its growth, but the rapid decline in production cost inflation (compared to selling prices) has given some support to corporate profitability. Japan has experienced stronger growth than its historic average, driven by greater consumerism and a competitive real exchange rate. At the other end of the spectrum, China faces longer-term headwinds from its ageing population, overinvestment, and deflation across output prices which is depressing earnings growth.

Such decoupling, reflecting significant variation in economic performance, has proved to be a positive trend in fostering favourable alpha opportunities for active investors (see Figure 2). Earnings growth and equity market returns have tended to track changes in macro expectations with the US leading DM, followed by Europe, Japan, and thereafter Asia.

DM equities decoupling from Asia is not a new phenomenon considering that US equities have been in the top-3 of global market performers 80% of the time over the last 10 years (source: LSEG Datastream, January 2024). What is more surprising is that Asia has managed to decouple to some degree from China's weakness, with significant strength in equity markets across Taiwan, South Korea, and India.

These countries have benefited from stronger demand from the US and Japan, especially for consumer products, IT-related goods and services, and cost-competitive manufactures. In addition, their domestic demand has proved more resilient than the past, perhaps because they have contained inflation well over this cycle which has given support to real incomes and competitiveness.

Figure 2: The ‘Great Decoupling’ continues between DM, Asia, and China



Source: LSEG Datastream, January 2024

The crossroads of geopolitics: it is enhancing the decoupling across countries and rewiring global trade

The trend rise in global geopolitical tension has enhanced the decoupling across countries, as it has motivated the world’s largest economies to focus greater attention on improving domestic demand, increasing production onshoring, and defending supply chains. For example, the US has become more protectionist on trade flows over time, especially with China, and on the exchange of intellectual property and technology. At the same time, China has been striving to rebalance its economy more toward consumption, defend supply chains, heal its real-estate sector, and boost local research and development (R&D).

In many respects the rivalry between the US and China is rewiring global trade and investment flows. For example, around the middle of last year, US imports from Mexico became larger than its imports from China, and the US trade deficit with China reached 20-year lows (source: LSEG Datastream, January 2024). At the same time, China’s exports to Mexico and other countries across Asia increased significantly, in harmony with stronger US imports from countries like Japan, Vietnam, South Korea, Taiwan, and India.

So far, these shifting trade dynamics seem to be impacting the investment environment by creating stronger risk asset performance across countries that produce high value-added outputs, and have favourable ties to the US, or to China’s supply-chain. As noted earlier, South Korea and Taiwan have benefited from stronger demands for IT, consumer products, and new industrial-related outputs. While countries like Indonesia, Vietnam, India, Thailand, and Malaysia, have benefited from demands for cost-competitive manufactured goods and raw materials.

This year there are elections in the US, Europe, India, Russia, Indonesia, South Korea, and Taiwan[9]. Investors will need to remain watchful if outcomes, especially in the US or Europe, increase the likelihood of tighter protectionist policies. While such developments may simply enhance the trade shifts unfolding already, there is the risk that potential outcomes could create new hurdles for investors to navigate.

Navigating the great volatility

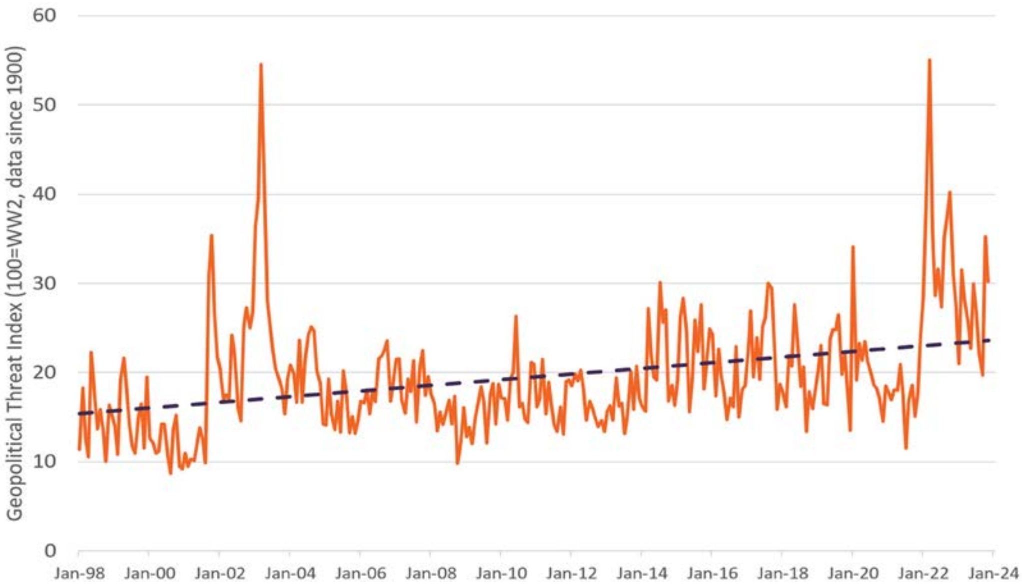
Aside from geopolitics contributing to greater decoupling across countries, which has in turn created favourable alpha opportunities, the downside is that adverse geopolitical shocks have been a key source of volatility. Geopolitical risks have been on a trend rise for more than a decade (see Figure 3), and since the Russia-Ukraine war (Feb 2022) and the Israel-Hamas conflict (Oct 2023), volatility for investors has become more intense.

However, what remains encouraging from historical experience is that equity market declines associated with geopolitical fears have tended to be 'temporary disruptions' with markets often returning to underlying trends[10]. We saw a graphic example of this as equities sold-off in October 2023 with the Israel-Hamas conflict before they rebounded (as oil prices fell) into year-end.

That said, global concerns remain significant that the Israel-Hamas conflict may intensify and broaden. As we emphasised throughout last year, it remains prudent for investors to seek downside protection from geopolitical risks, which are always the ultimate 'known unknowns', with risk-assets like gold and bonds. The advantage of the latter remains the prospect of a favourable investment-income stream and some insulation from potential growth slumps.

Figure 3: The trend rise in geopolitical risks is creating volatility for investors

Geopolitical Threats 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, 1 Dec 2023.

---

9. On 13 January Taiwan elected Lai Ching-te as President, giving his Democratic Progressive Party (DPP) its third term.

10. Source: 'What History Says About Geopolitics And The Market', Reuters, 19 February 2022. The article notes that of the 30 major geopolitical shocks since WWII the associated equity market declines have tended to be temporary with markets returning to underlying trends after a few months.

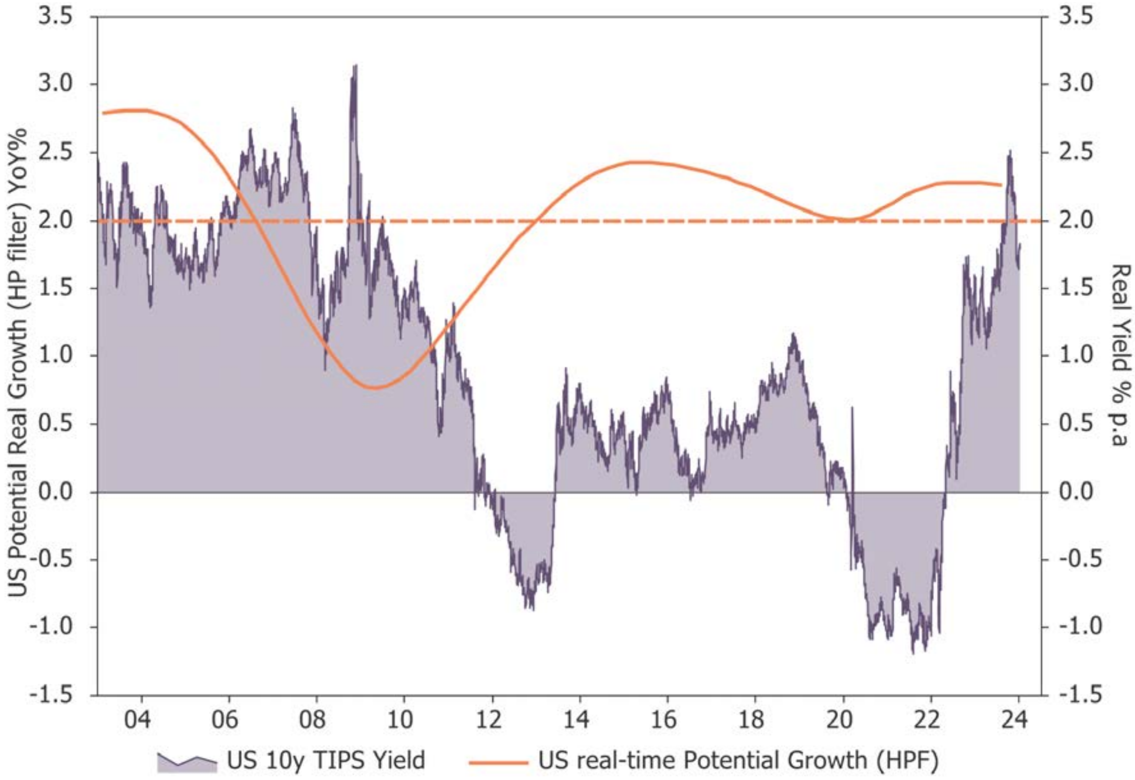
Implications of the great reset: it can be favourable for investors if real yields settle around trend growth

Our bullish outlook for global risk assets and DM equities reflects the opportunities created by economic decoupling, the strong US economy, and the correction in real yields back toward trend growth (see Figure 4).

With US real yields aligned with trend growth, it implies that the cost of leverage and capital is fundamentally more appropriate. This can encourage investment flows to seek more productive projects, with better payoffs than otherwise, as the opportunity cost to ‘leverage-up’ for speculative investments is higher. This phenomenon can help foster a ‘virtuous cycle’ where productivity growth remains strong, depressing real unit labour costs (see Figure 5), which boosts corporate earnings, and encourages further productivity-enhancing investment. As a result equity investors can enjoy higher than otherwise returns.

Figure 4: The great reset trend-shift suggests that real yields may be higher than the past but better aligned with the core fundamentals of trend growth and the cost of capital

US Real Yield and Potential GDP Growth

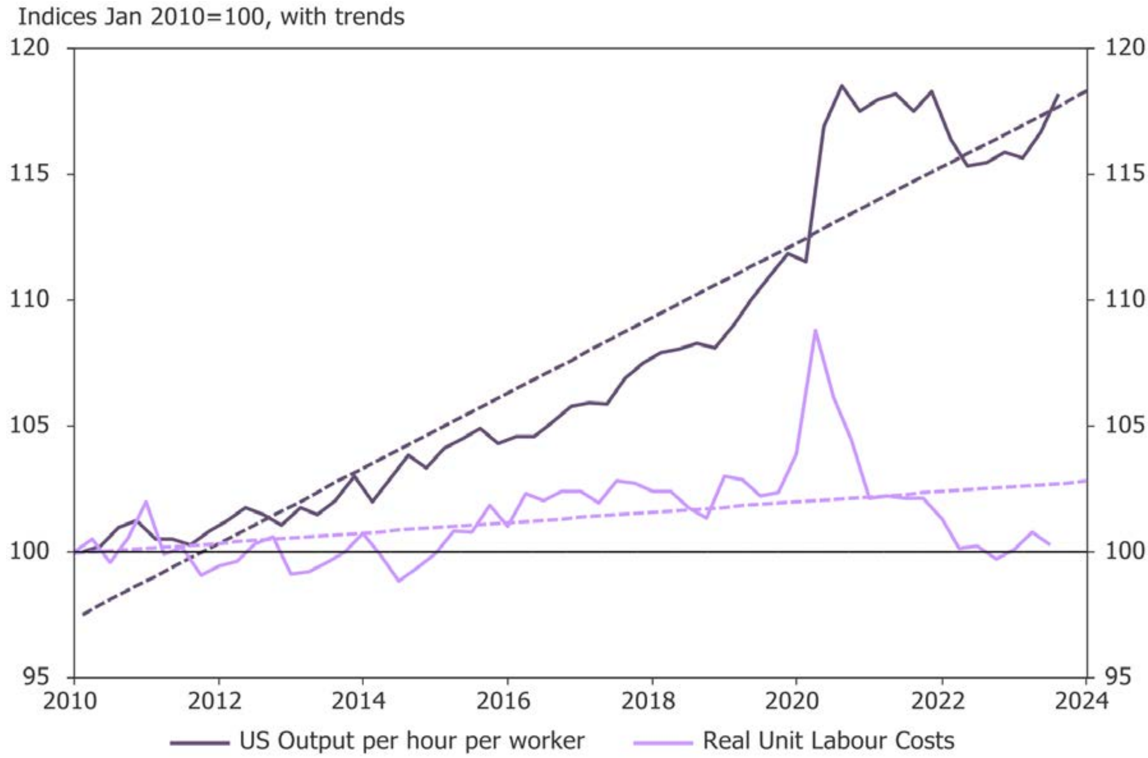


Source: LSEG Datastream, January 2024

Although the great reset hypothesis suggests that the real yield (and its risk premium) may be higher than that experienced over much of the period after the GFC (in 2008), it may not drive any significant de-rating of equity markets if yields settle around trend growth and productivity.

Figure 5: US productivity has followed a favourable trend which has helped depress real unit labour costs

US Productivity and Real Unit Labour Costs

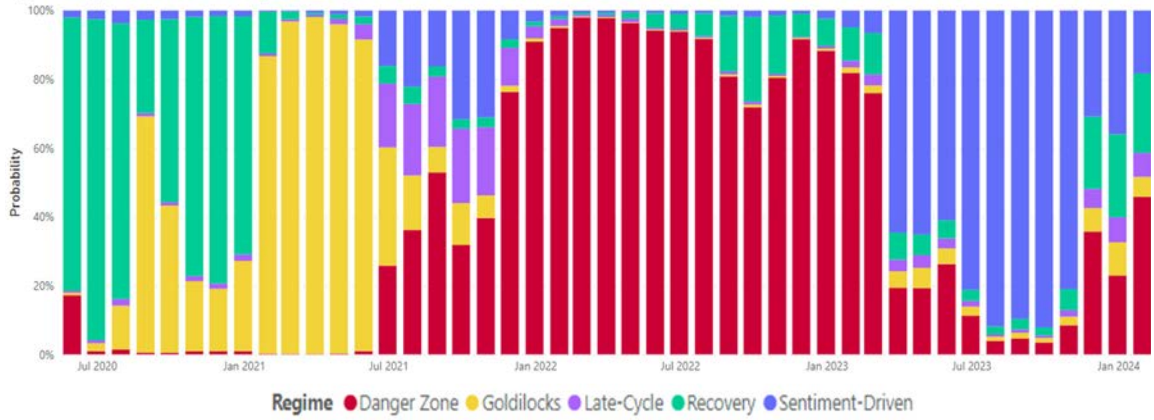


Source: LSEG Datastream, January 2024

As the great reset plays-out Fullerton's Investment Environment Regime Indicator has struggled with mixed signals

In part the significant gyration that DM nominal bond yields went through over Q423, from extreme highs and then back to favourable lows, has resulted in investor sentiment being unsettled and Fullerton's Investment Environment Regime Indicator has a mixed signal (see Figure 6).

Figure 6: Fullerton's Investment Environment Regime Indicator



Source: Fullerton, January 2024. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change.

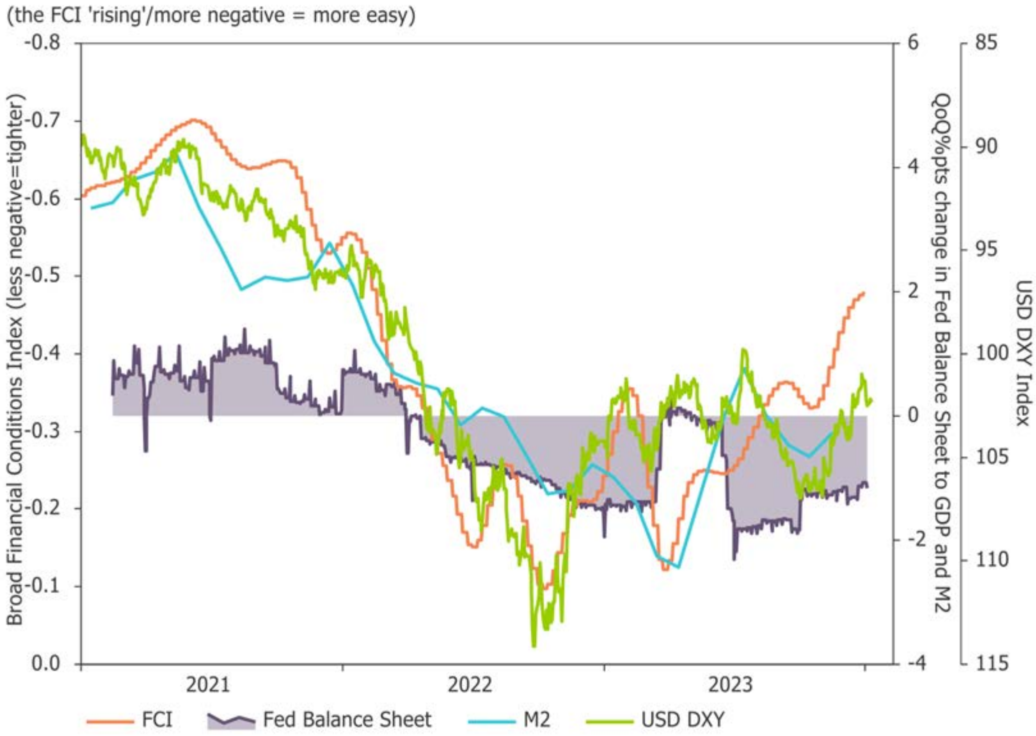
However, the positive fundamental factors of growth, lower inflation, and liquidity, should help a Recovery Regime unfold

We believe that the Recovery Regime is the most likely environment to eventually prevail, once real yields settle around trend growth and risk appetite improves, which can be positive for equity and fixed income returns. Led by the US, broad financial conditions have become significantly more positive for potential risk asset returns, with the fall in yields, a weaker US dollar, and less negative money growth serving as the key drivers (even as the Fed's balance sheet has continued to fall. See Figure 7). In addition, growth in the broadest liquidity indicator for the US, private domestic credit, is especially strong.

That said, the growth in US broad liquidity alone does not always explain significant equity market rallies, but this time it does seem to be helping reflate the market (in addition to the favourable real fundamentals across US firms and households). It also explains why the slowdown in US bank lending growth may not be as painful as usual because broad liquidity growth is providing significant offset.

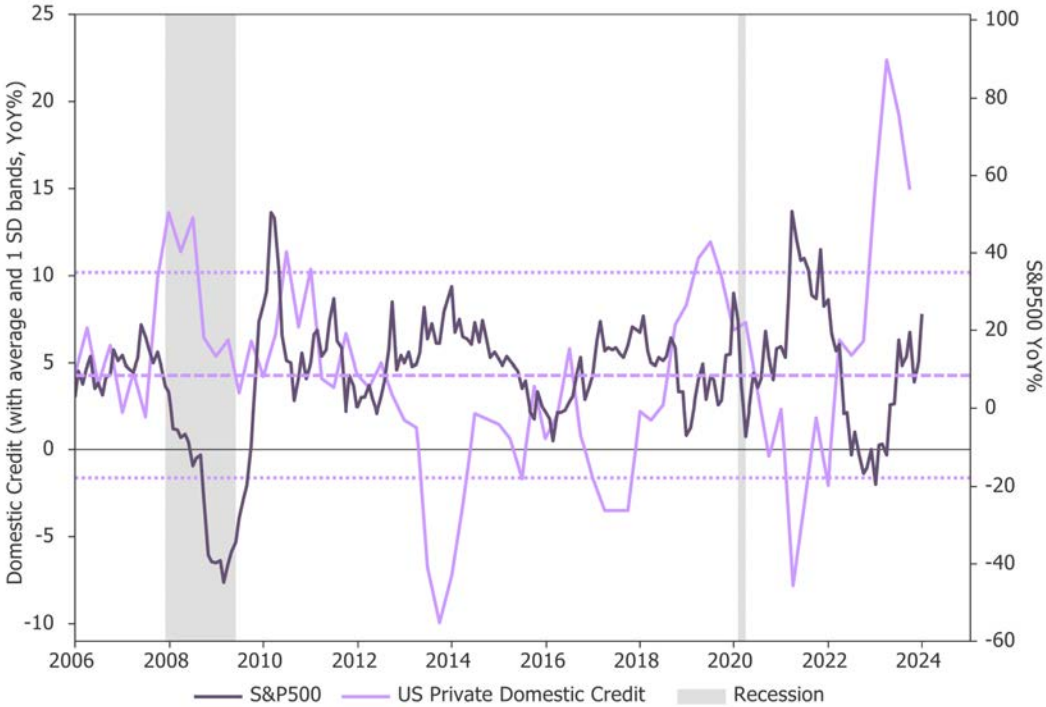
Figure 7: Indicators of US broad monetary conditions (FCI) and domestic credit should prove supportive to risk asset returns.

Monetary Conditions: FCI, Fed Balance Sheet, USD, and M2



Source: LSEG Datastream, January 2024

US S&P500 with Domestic Credit



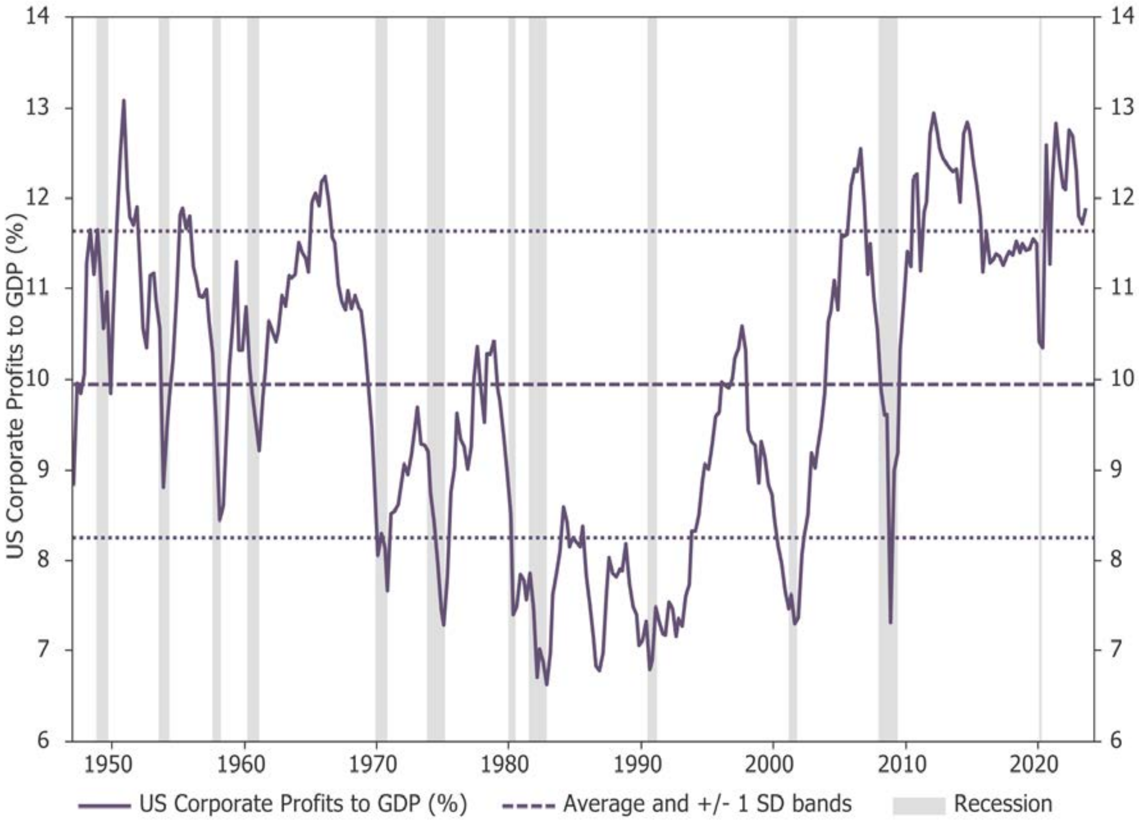
Source: LSEG Datastream, January 2024

The prospect of a bullish risk asset environment is also supported by US corporate profitability still being significantly above average (as a share of GDP), along with solid household disposable incomes (see Figure 8). US household disposable income growth accelerated in November last year, and the savings rate remains supported. Because US household wealth is so high, they can comfortably save less than otherwise and it does not imply that resources for consumption are constrained.

Lastly, on-going disinflation is another key factor supporting the prospect of a Recovery Regime being realised. The stage is set this year for an added boost to risk asset returns and sentiment - as key central banks, like the Fed and the ECB, are likely to cut policy rates as inflation continues to slide toward policy targets.

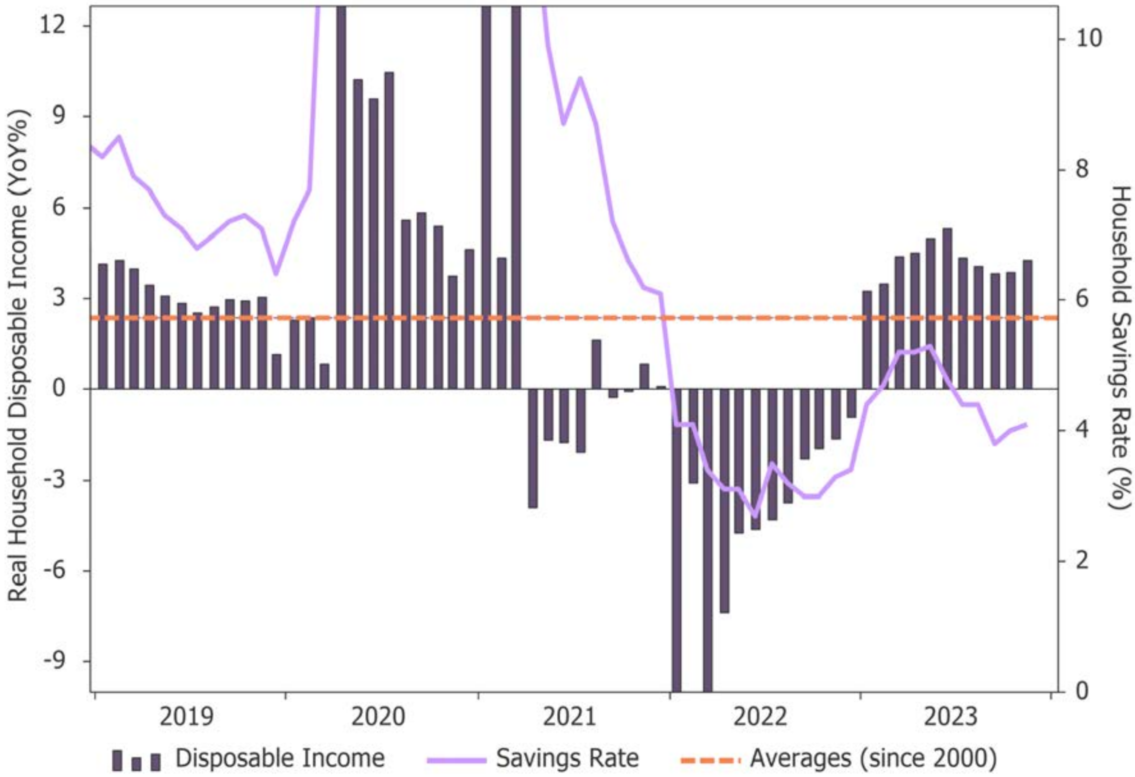
Figure 8: Indicators of US corporate and household strength suggest trend growth can be sustained this year

US Corporate Profits



Source: LSEG Datastream, January 2024

US Household Disposable Income and Savings



Source: LSEG Datastream, January 2024

03 Equities

Choo Jee Meng
Head of Equities
Fullerton Fund Management

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

We have a bullish outlook on DM equities, led by the US

Our belief that the US can settle around 2% trend[11] growth this year reflects its robust labour market helping to sustain consumption, especially across the services sector, and the strong corporate sector. US firms are making significant contributions toward achieving trend growth, with investment rebounding to help strengthen productivity and enhance earnings.

The broadest measure of US liquidity growth has proved very strong since 2H23, and because inflation is coming down, equity returns may get an extra boost as the Fed cuts rates this year as anticipated. All these factors strengthen our conviction that US earnings growth can comfortably reach around 10% this year which increases the likelihood of double-digit equity returns (see Figure 9).

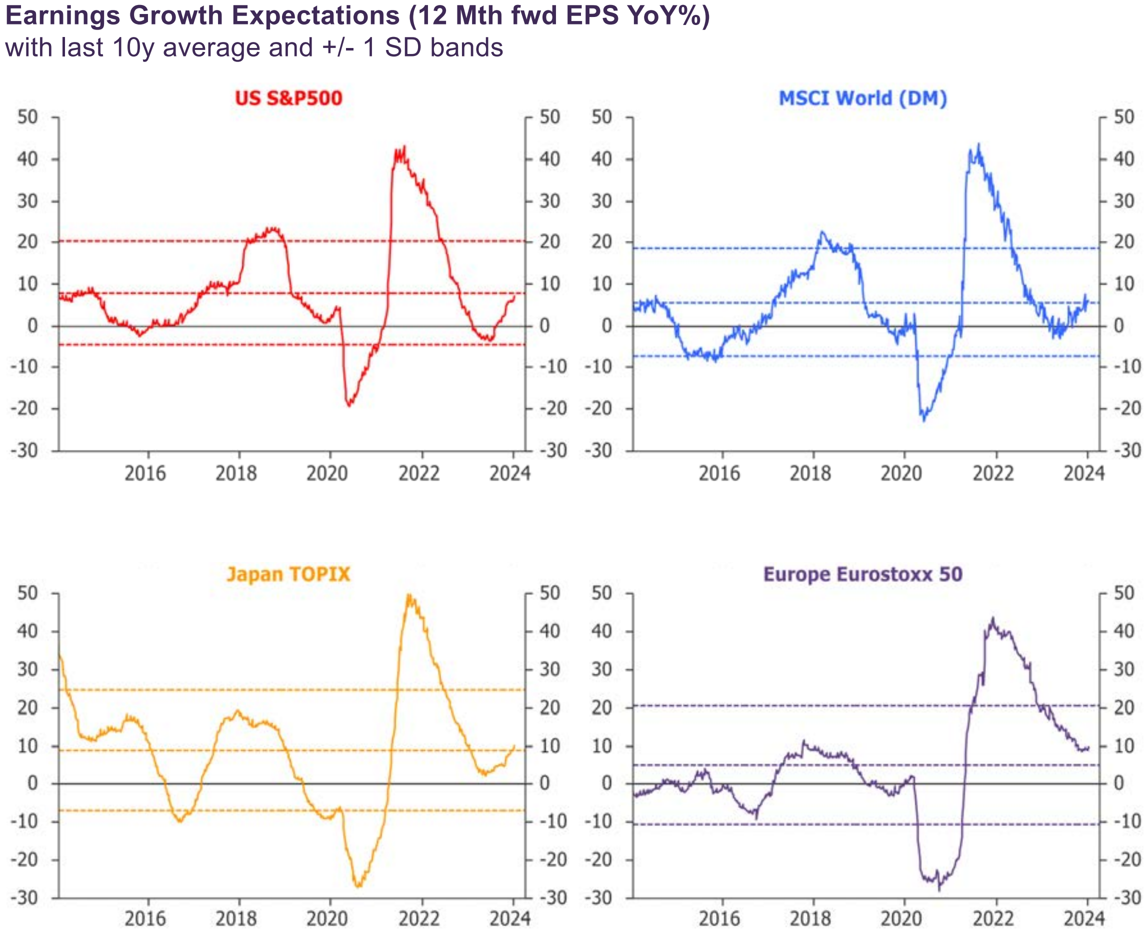
Returns from Europe and Japan equities may also be positive

Europe faces headwinds to its earnings performance from weak growth, as the Consensus expects just 0.5% GDP growth this year and a shallow recession cannot be ruled-out. However, equity returns may get significant support from ECB rate cuts, which could be on a larger scale than what the Fed has signalled for the US.

In addition, Europe's sharp fall in producer price inflation (costs) while CPI inflation (selling prices) has held-up is giving a significant boost to corporate margins and profitability. Japan equities should also benefit from a similar phenomenon, as Japan's PPI inflation has corrected by more than its CPI inflation. Japan's GDP growth is expected by the Consensus to be stronger than Europe, and Japan has a very competitive real exchange rate.

11. Fullerton Fund Management estimates, January 2024

Figure 9: Earnings growth expectations across DM markets



Source: LSEG Datastream, January 2024

We are positive on Asia ex Japan equities

Key regional economies seem to have decoupled from weaker demand from Europe and China, and earnings growth expectations have improved significantly (see Figure 10). In particular, Taiwan and South Korea are high-value added manufacturing countries, and should benefit from consumerism and stronger global IT demands, especially from the US and Japan. The likelihood of on-going US dollar weakness can also be broadly supportive for regional equity markets. Fullerton has maintained a positive outlook on India equities, as earnings growth continues to benefit from competitive production, rising spending power, favourable trade flows, and well-contained inflation.

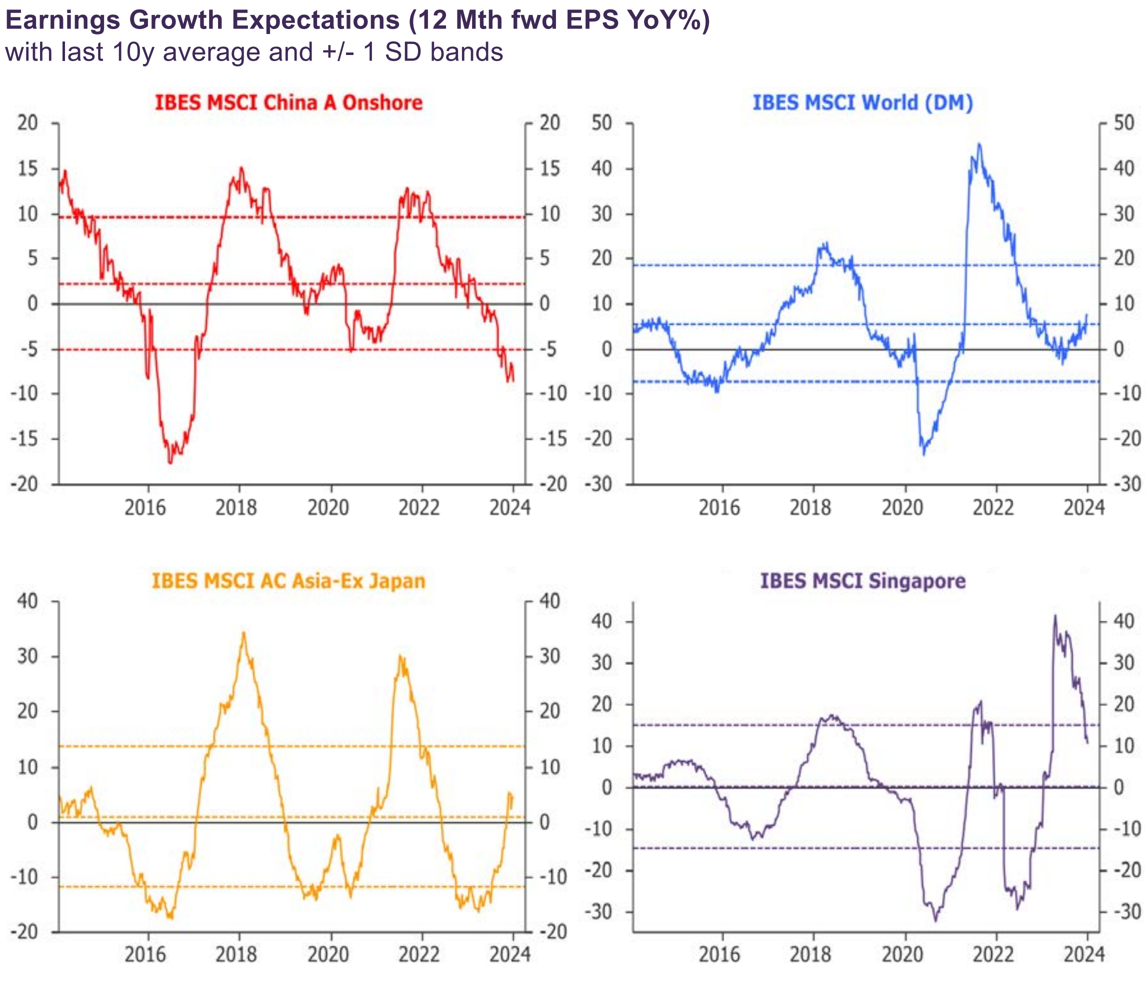
We remain cautious on Singapore equities, as earnings growth expectations continue to slow (see Figure 10). That said, there may be some opportunities for active investors especially across sectors like high-end capital good manufacturing and industrials. Indonesia, Thailand, and Vietnam, are likely to offer alpha opportunities for active investors, as these markets can continue to benefit from stronger consumer demand from the US and Japan. That is especially across more labour-intensive (and cost competitive) manufactured outputs, as well as inputs to supply-chains.

We maintain our negative outlook on China equities, and continue to monitor the prospect of further policy stimulus closely

Even though China's policy stimulus has gained traction, and its growth target of around 5% was achieved last year, earnings growth expectations continue to slide (see Figures 10 and 11). China's corporate earnings may remain decoupled and depressed with deflation (across both CPI and PPI metrics) and elevated unemployment (especially across the younger cohorts).

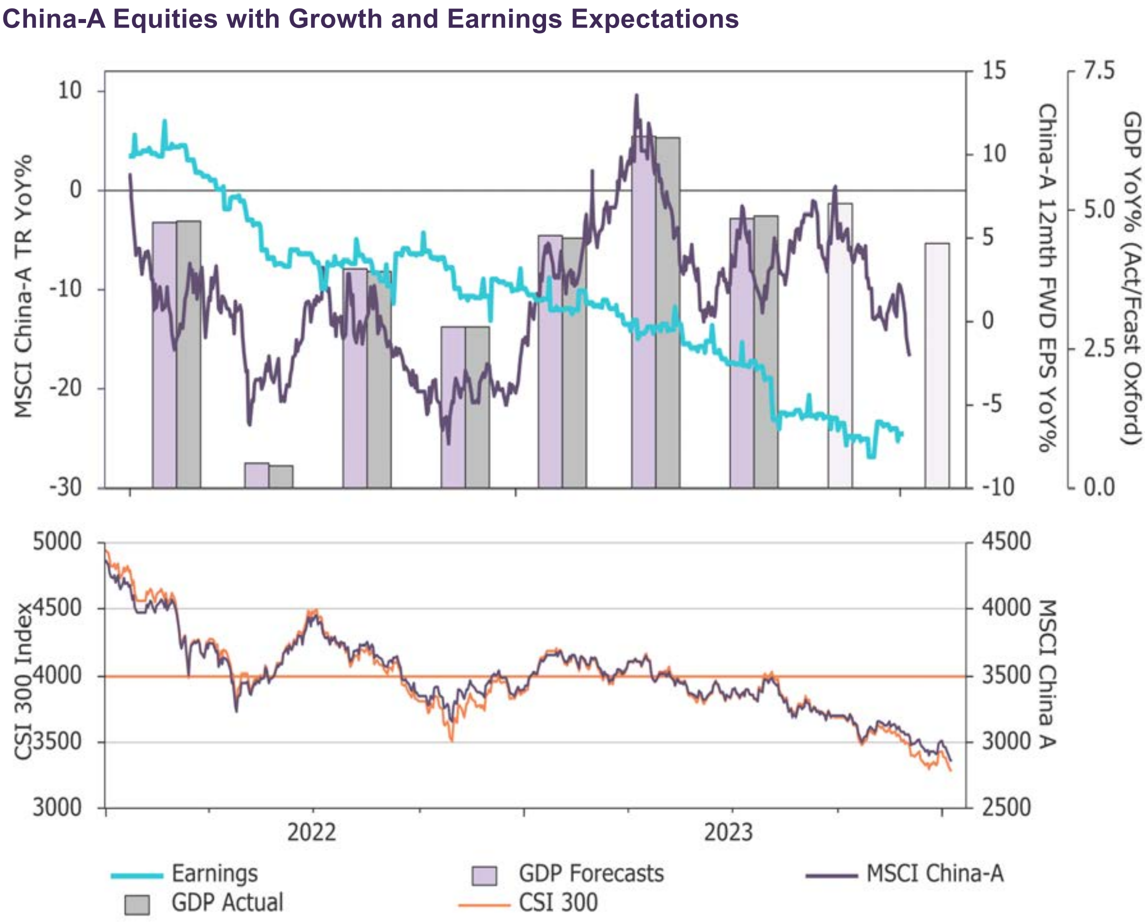
China's policymakers may need to consider further stimulus given the likelihood that growth this year proves weaker than in 2023. Potential policy actions by China this year, especially if it can end deflation pressures, is something we continue to monitor. For now, we maintain our view since the middle of last year that more time will be required for earnings, and the real-estate sector, to improve before there can be any sustainable equity market rebound.

Figure 10: Earnings growth expectations across DM and Asia



Source: LSEG Datastream, January 2024

Figure 11: China equities, earnings growth expectations, and GDP (actual and forecasts)



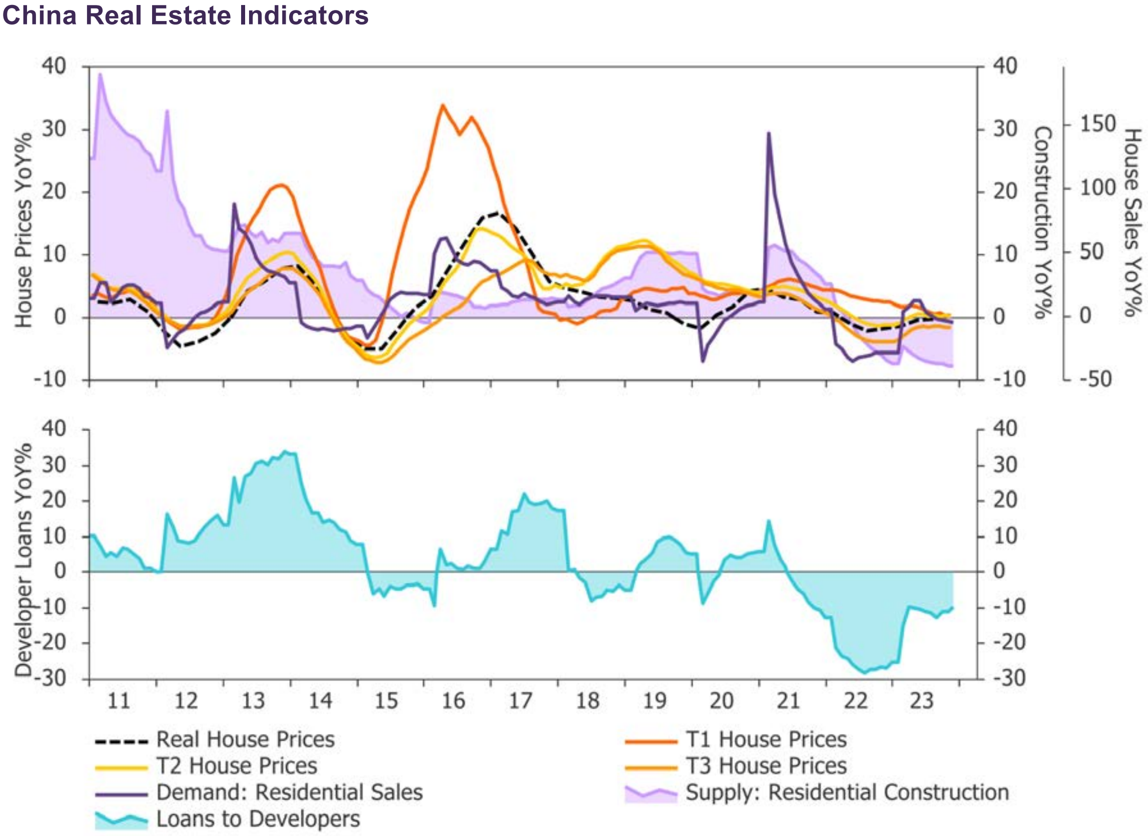
Source: LSEG Datastream, January 2024

China may achieve reasonable GDP growth, but 2024 will still be challenging – the weak real-estate sector is a key headwind

China's real-estate sector stress may worsen and 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).

While the real-estate sector debt deleveraging has stabilised at a steady pace, the construction pipe-line is especially weak (see Figure 12). While that is helping to support house prices, it is dragging significantly on confidence, house sales, and may further 'crowd-out' productive investment (adding further to local government budget stresses through reduced land sales).

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



Source: LSEG Datastream, January 2024

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

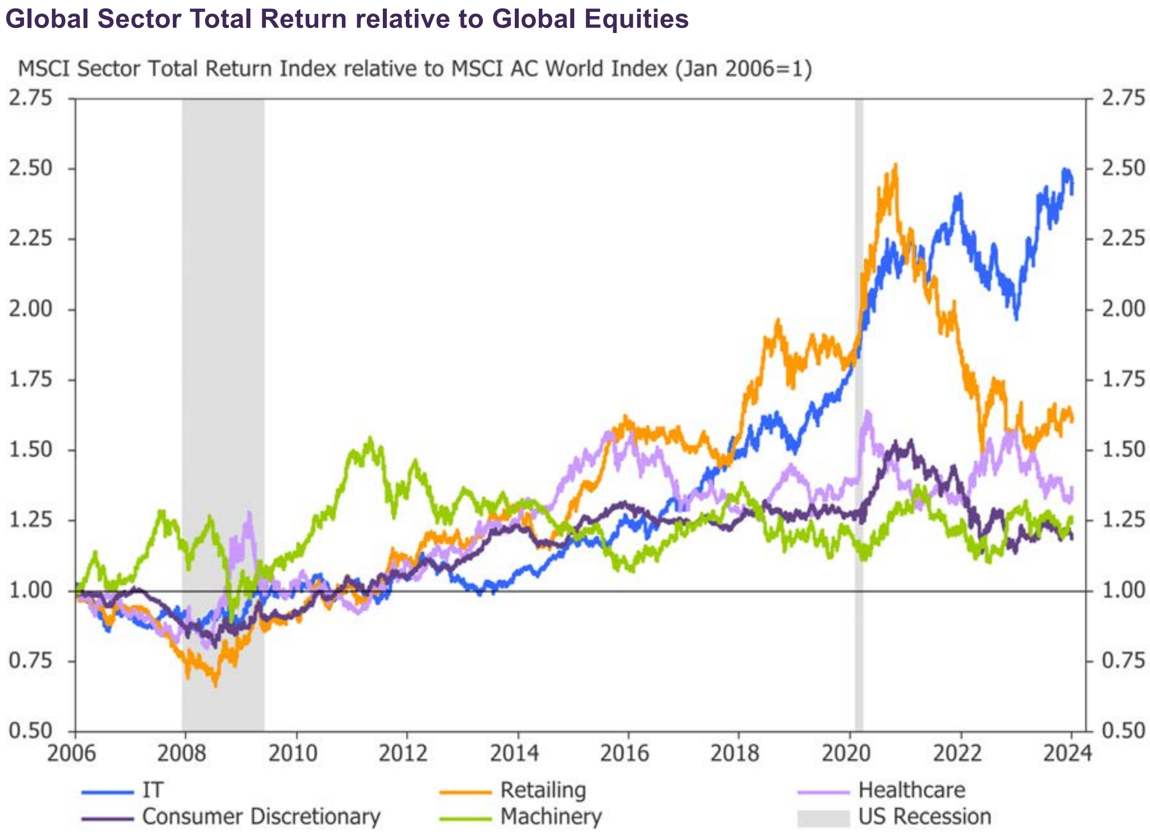
The equity sectors we like have not changed materially from last year. We generally prefer growth over value, and sectors linked to consumerism, IT, new industrials and machinery, healthcare, and ESG-leaders. These sectors are favoured as they are underpinned by strong fundamental drivers (such as rising market share from higher spending patterns, coupled with productivity gains containing costs), and a robust trend of historical outperformance (see Figure 13). Across ESG space, we have highlighted before that Asia's decarbonisation journey is a key element of its favourable longer-term investment outlook, and both public and private markets are likely to present alpha opportunities over time.

Fullerton subscribes to the view that AI may prove to be the core of the 'fifth industrial revolution'

As discussed during Fullerton's January Investment Outlook event – under 'the 3i's of AI' - because of strong fundamentals, we have maintained a positive view on the performance of the tech/IT sector for many years. The tech sector has benefited from several key transformations since 2000, with the internet, ecommerce, social media, and the 'metaverse'[12].

12. An iteration of the internet, the 'metaverse' is a network of virtual worlds. It will likely revolutionise digital experiences, fostering greater consumerism with enhanced social interactions, new products, and services. Further details on Fullerton's positive outlook for the tech sector can be found here: https://www.fullertonfund.com/wp-content/uploads/2023/01/Insights_Enduring-structural-themes_d6_LR.pdf

Figure 13: Trends in global equity sector alpha



Source: LSEG Datastream, January 2024

Now with the advent of Artificial Intelligence (AI)-related technologies, Fullerton believes this may drive further gains in productivity growth and result in lower than otherwise inflation. Aside from such economy-wide macro benefits, we also expect significant alpha opportunities for investors directly across the technology sector as well as across sectors that may enjoy positive spillovers (like consumerism, industrialisation, healthcare, and finance)[13]. Fullerton has also explained how AI analytical tools have played a pivotal role in refining our scenario analysis and in empowering our investment decision process with data-driven insights[14].

---

13. 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.
14. See https://www.fullertonfund.com/fullerton-insights/using-augmented-intelligence-to-enhance-our-investment-process/

04 Fixed Income

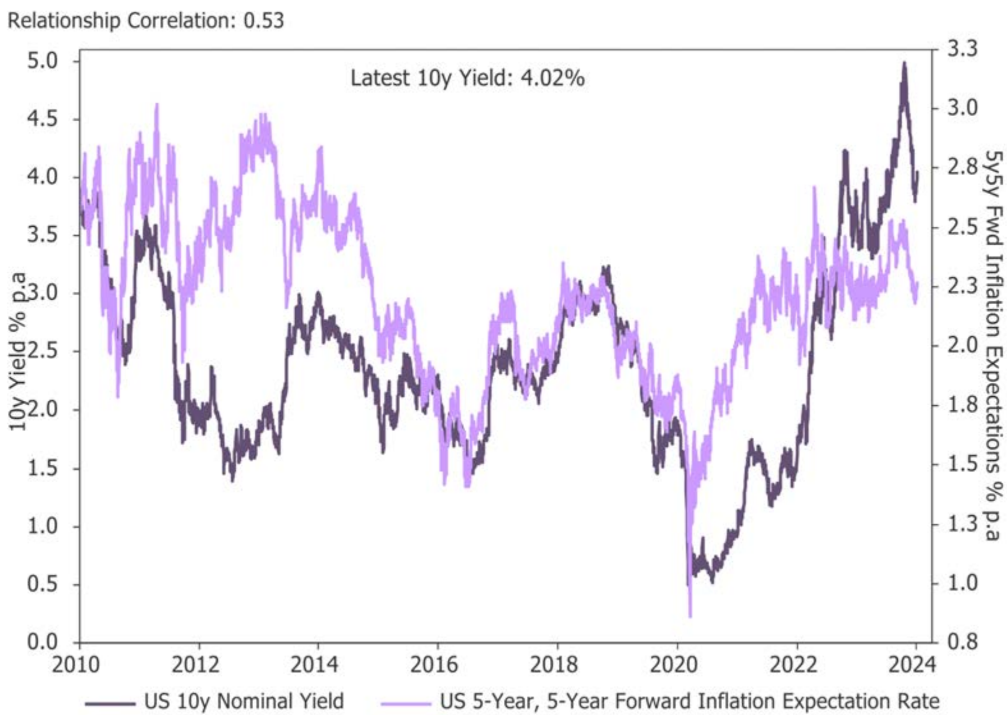
Angus Hui
Deputy CIO &
Head of Fixed Income
Fullerton Fund Management

2023 was a volatile, but positive year for global fixed income investors

The big surprise of 2023 was the large gyration in DM nominal 10y bond yields, up to extreme highs before falling significantly. Active investors enjoyed this sharp correction, especially for US treasuries, with 'windfall' capital gains as markets accepted that disinflation was taking shape faster than anticipated (see Figure 14).

Figure 14: The significant correction in US yields was driven by faster than expected disinflation

US 10y Yield and Inflation Expectations

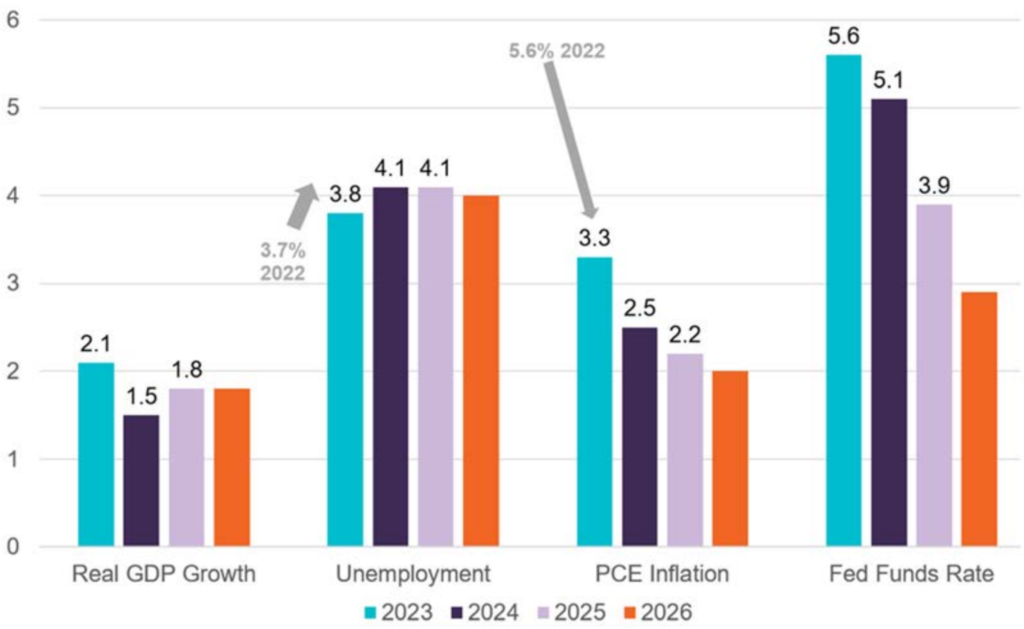


Source: LSEG Datastream, January 2024

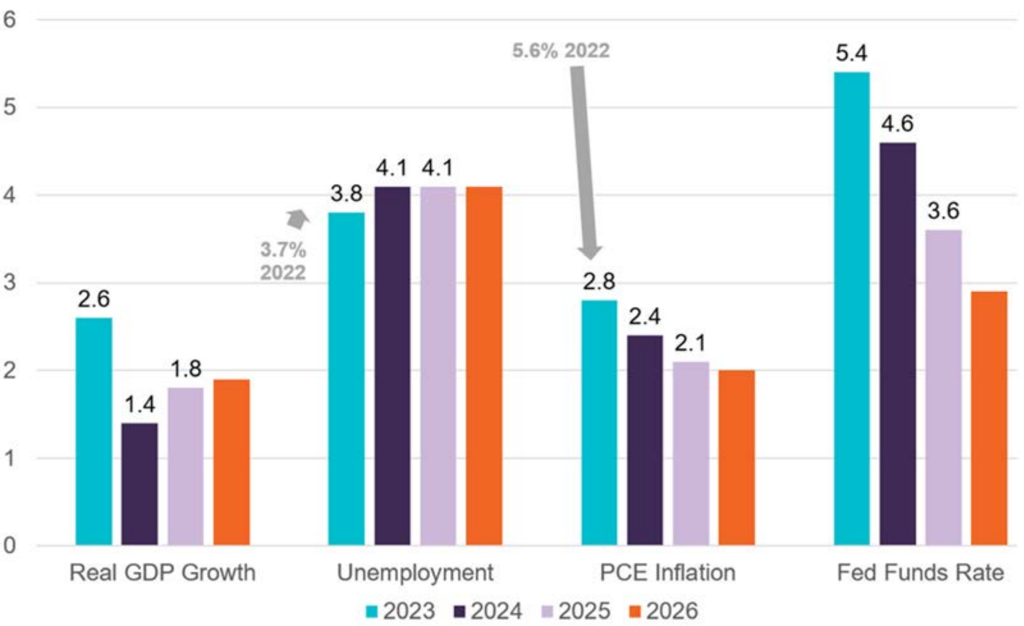
In September 2023 the Fed was not confident about rate cuts for 2024 (to its 5.5% policy rate), as it forecast inflation to end 2023 at 3.3%. However, just three months later (by December) the Fed realised that US inflation was coming down much faster, shifting its forecast to 2.8%, while growth surprised on the upside (see Figure 15). This Fed 'pivot' for rate cuts this year is driven by the large downside surprise in realised inflation, given that Fed expectations for US growth and inflation for 2024 have not changed materially.

Figure 15: US Fed forecasts: rate cuts are now signalled for this year because inflation surprised on the downside in 2023 (even as growth surprised on the upside)

US Fed Projections from Sep 2023 (%pts)



US Fed Projections from Dec 2023 (%pts)



Source: US FOMC Forecasts, Sep and Dec 2023

If the current pace of disinflation continues, then the Fed will hit its policy target faster than expected, making rate cuts this year inevitable. As we have emphasised, broad US liquidity growth remains very favourable, and financial conditions have eased significantly, even before the Fed undertakes the rate cuts it has signalled (see Figure 7). With much weaker growth across Europe, it is possible that the ECB cuts its policy rate by more than the Fed this year.

For 2024, Fullerton believes that returns on rates and credits will likely outpace those on cash, with a greater role for duration in portfolios.

We remain positive on global sovereign bonds

As the disinflation process is proving favourable it suggests that yields are unlikely to surprise again significantly on the upside which means active bond investors could potentially avoid capital losses. 'Hold-to-maturity' fixed income investors should enjoy attractive interest income streams from above average real yields, with some downside protection if growth unexpectedly slumps.

Singapore is no exception to the likely favourable blend of growth and inflation this year. We expect that Singapore Government Securities (SGS) yields will continue tracking US treasuries, but with some boost to performance given Singapore's more manageable supply conditions. Real bond yields across Asia, notably Indonesia, China, Thailand, Malaysia, and India, are still relatively high. Furthermore, if the US dollar remains weak as we expect then this can also be supportive to Asia's local currency bond markets.

We are positive on corporate credit, but remain selective

With global growth likely to be supportive, potential default rates across corporate credit should be contained and investors well rewarded. We expect that the total return from Asia Investment Grade Corporate Credit (IG) can be positive this year, driven by robust carry, but we remain selective.

Longer duration IG US-dollar denominated debt looks especially attractive across markets like China and Indonesia (notably its quasi-sovereigns). We are also constructive on the BBB-rated IG firms as further spread compression is likely. To enhance carry, our preference remains for SGD credits over SGD statutory board bonds.

We have a favourable outlook for High Yield (HY) issuers across Indonesia and India, due to robust growth in domestic demand and favourable (onshore) funding conditions. The peak of HY defaults across Asia may be past, which should help add to investor confidence. Strong liquidity growth across the region has facilitated HY companies to smoothly refinance debt and we expect this trend to continue. However, as we have emphasised since the middle of last year, we remain cautious on the China HY real-estate sector due to its painful deleveraging process, weak house sales, and significant over capacity (see Figure 12).

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

Across financials, we judge bank senior bonds as expensive and therefore prefer subordinated debt. We are more positive on non-financial corporates, especially 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 if growth surprises on the downside.