Staying the course in a 'goldilocks' environment

Fullerton Investment Views - Quarterly report

Q2 2024

FULLERTON FUND MANAGEMENT

Executive summary

- We remain bullish on global risk assets, namely Developed Market (DM) equities, and positive on Asia ex-Japan equities, and fixed income. For the next 12 months, we continue to expect positive returns from fixed income and equities (ex-China).

- With global growth likely to hold, corporate credit investors, especially across DM, should enjoy reasonable returns. We also remain positive on global sovereign bonds as real yields are attractive enough to generate favourable income-streams, while providing some cushion if growth unexpectedly slumps.

- Geopolitical risks have jumped above trend with the Israel-Hamas conflict broadening, but as emphasised previously, any adverse reactions to geopolitical shocks can 'wash-out' and risk assets may eventually return to positive trends.

- With geopolitical risks likely to persist, investors need to maintain active management to capture alpha opportunities across countries and sectors.

- While the latest sharp spike in geopolitical threats seems to be easing, it remains prudent for investors to defend their portfolios - from the ultimate 'known unknowns' - with some exposure to gold and bonds.

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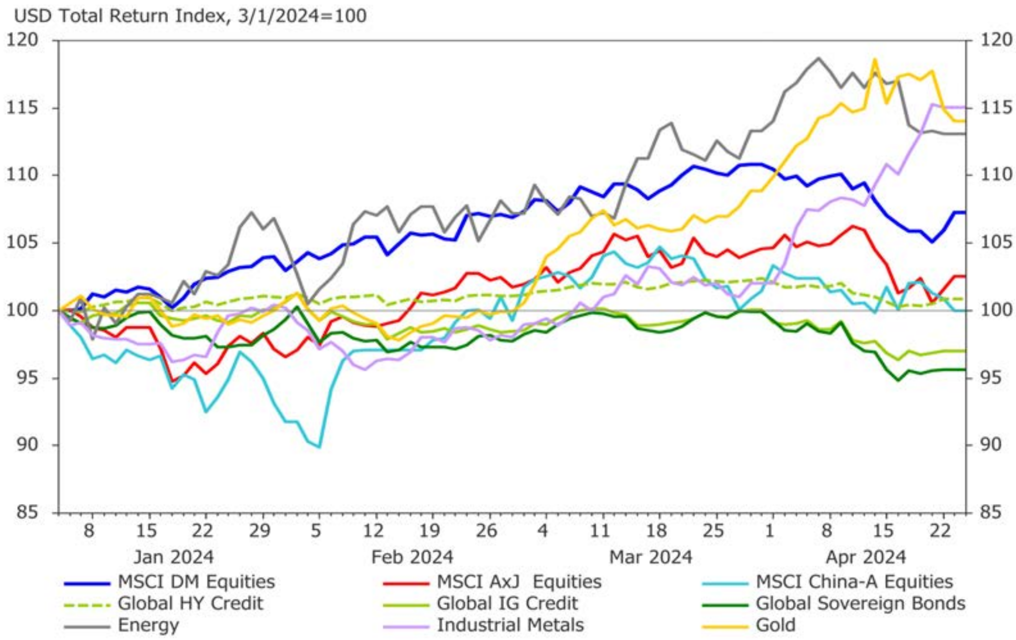
01 Risk-Asset Outlook

Q2 started with some 'risk-off' pull-back in key global risk assets

Figure 1: Risk asset performance YTD

Risk Asset Returns



Source: LSEG Datastream, April 2024

'Speedbumps' returned, as commodities outperformed

Gold and oil prices had been rising quite sharply, largely because of greater geopolitical risks (see Figure 1). After the events in April, as global markets became more confident that none of the sides involved in the Israel-Hamas conflict intend for it to escalate further, gold and oil prices fell.

Industrial metal prices, in contrast, remain robust largely because of stronger demand from the US, as its manufacturing sector rebounds, combined with some supply constraints (especially impacting copper). There are also pockets of demand strength across China's industrial firms, which has also helped push equity prices for its materials sector significantly higher.

For the next 12 months or so, we believe these trends may continue across commodities. Industrial metal prices can be supported by stronger global demand, while the easing of the cyclical surge in geopolitical risks should help reduce some upward pressures on oil and gold prices.

While other risk asset returns suffered

Into Q2, equities and fixed income returns suffered some 'risk-off' pull-back (see Figure 1). The stress on equities reflected investor fears that earnings growth may be threatened by geopolitical events and the rise in yields.

Bond returns struggled as yields increased, suggesting that the market may be less worried about potential risks to growth and more concerned about higher inflation (especially as commodity prices trend higher).

We believe the 'risk-off' pull-back, as equity and fixed income returns slipped, will prove temporary

Fullerton does not believe any intense risk-off stresses will be sustained. We maintain our view that global growth can hold-up this year, and robust earnings growth expectations will be realised, along with some potential re-rating of equity market valuations - especially across DM. We believe that the falls in gold and oil prices, which are most sensitive to geopolitical fears, suggest that financial markets are adapting (rather than panicking) to the uncertainties ahead. Because the fall in bond prices, especially in the US, has been driven mostly by higher real yields, we believe the market remains confident about the favourable growth outlook.

As the rise in yields seems to reflect greater inflation uncertainties, bonds may struggle to give investors protection. However, once yields stabilise, which could be around current levels - given that market inflation expectations are well contained, favourable income streams can dominate total returns again.

Fullerton believes that the favourable asset return trends from Q1 may be reestablished as Q2 unfolds, and can continue this year. We expect positive returns from both fixed income and equities (ex-China), with the strongest returns from DM equities, while Asia ex-Japan equities may outperform returns from last year.

We maintain our bullish outlook for global risk assets, dominated by DM equities

We have increased our conviction that US growth and earnings can remain above trend this year with sustained productivity growth, ample liquidity, and easy financial conditions. Across US households, financial wealth is very high, and this can continue to drive consumption spending, along with the robust labour market. For the US corporate sector, investment growth has been firm, and this can reinforce productivity gains in tandem with new developments over time from AI and IT-metaverse related technologies.

Consistent with our bullish view for US equity returns, especially strong productivity growth that builds competitiveness over time, we have revised our view to 'positive" on the US dollar. Additional factors that may also prove supportive to the US dollar are positive changes in the yield differential and the US terms of trade. Furthermore, over the last decade or so, investors have, on average, favoured being long the US dollar which may reflect its safe-haven demand status.

Contributions to DM equity performance from European equities can also be positive as activity indicators are showing signs of bottoming, and Europe is typically a key beneficiary of stronger US demand (given its high trade share, at around 25% of US imports[1]). European equity valuations are modest and the prospect that the ECB may lead the DM policy rate cutting cycle can give an added boost to investor sentiment.

DM equity returns are also likely to continue to be supported by Japan's performance, given its robust productivity (second only to the US). Its growth is also expected to hold above average again this year, along with Japan's very competitive real exchange rate (that is around 20% superior to Europe[2]).

We are positive on Asia ex-Japan equities

Key regional economies continue to decouple from the drag of China's weak earnings growth, while stronger demand from the US is proving positive – as Asia's export share is rising (to the US, ex-China, it is around 30%[3]). 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 and as consumer spending holds-up across the US and Japan.

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 could be rewarded for risk-taking. Returns from Asia Investment Grade (IG) Corporate Credit should be positive, while investors can continue to increase their diversification with global corporate credit. The latter may benefit, especially across the US, where company performance and balance sheets may remain relatively stronger.

For 'hold-to-maturity' bond investors the supportive investment environment can continue as yields are elevated, especially in the US and across key markets in Asia, like China, South Korea, India, and Indonesia. Sovereign bonds can also give some downside protection if growth unexpectedly slumps.

We maintain our negative outlook on China equities, but continue to monitor for signposts of when deflation may end and when earnings can rebound

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 continue to believe that more healing time will be required for earnings, producer prices, and the real-estate sector, before there is a sustainable and significant equity market rebound.

That said, China is of course an investable market and to uncover the most valuable alpha opportunities, investors have to be selective and nimble. For example, even as the trend decline in earnings growth has played-out, China value stocks and industrial materials have outperformed the broader equity market. We believe that the latter (industrial materials), may continue to benefit from stronger manufacturing supply-chain demands (across Asia and Europe), and from higher industrial metal prices.

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1. Source: LSEG Datastream, April 2024.
2. Source: LSEG Datastream, April 2024.
3. Source: LSEG Datastream, April 2024.

Summary of Fullerton's Views (12 months ahead)

	Bearish	Negative	Positive	Bullish
Risk Assets				✓
Asia ex-Japan Equity			✓	
China-A Equity		✓		
DM Equity				✓
Asia IG Credit			✓	
Global Sovereign Bonds			✓	
US Dollar			✓	

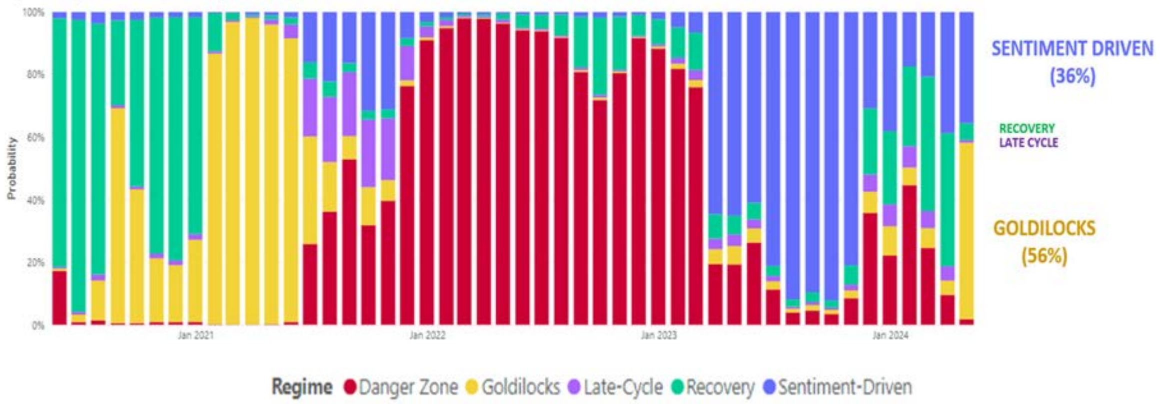
Source: Fullerton Fund Management, April 2024. Views may be subject to change without prior notice.

02 Investment Environment

Fullerton's Investment Environment Regime Indicator has moved to a more positive signal: 'Goldilocks'

We suggested in our Q423 Investment Views that our Environment Regime Indicator may progress into 'Recovery' for this year, which is positive for risk asset returns. That occurred over Q124, and as we move into Q2 the signal has transitioned to 'Goldilocks' - largely because global growth has surprised on the upside. For the rest of the year, provided global growth remains robust, liquidity positive (but slowing), and disinflation continues (but slowly), then the investment environment can remain positive for risk asset returns (potentially within a 'Goldilocks' or a 'Recovery' regime. See Figure 2).

Figure 2: Fullerton's Investment Environment Regime Indicator



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

Speedbumps returned, Goldilocks can continue, but decoupling remains stark

Decoupling forces continue to unfold and cross-country differentiation has become starker (see Figure 3). As we emphasised in our Q1 Investment Views, this year there are several key elections and investors will need to remain watchful if outcomes, especially in the US[4], increase the likelihood of tighter protectionist policies. While such developments may simply enhance the trade and decoupling shifts unfolding already, there is the risk that potential outcomes could create new hurdles for investors to navigate.

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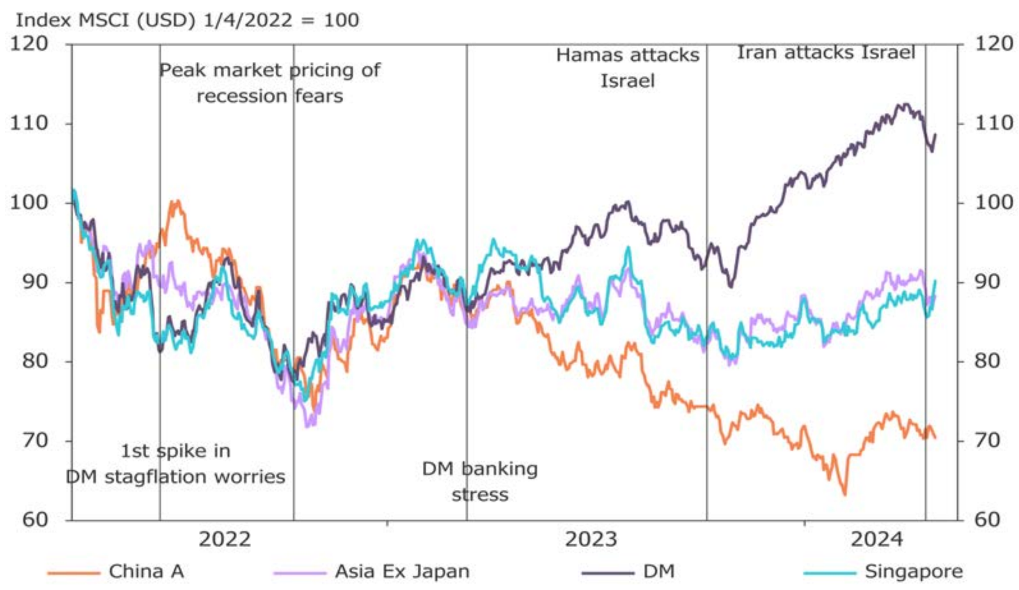
4. Also see https://www.fullertonfund.com/fullerton-insights/2024-us-elections-and-potential-investment-implications/

We have increased our conviction on a bullish US outlook

The US is benefiting significantly from strong productivity growth, low unit labour costs, and resilient domestic demand (see Figure 4). As such, we have increased our conviction that US real GDP growth and earnings can remain above trend this year (see Figure 5).

Figure 3: Goldilocks continues and decoupling remains stark (DM over Asia and China)

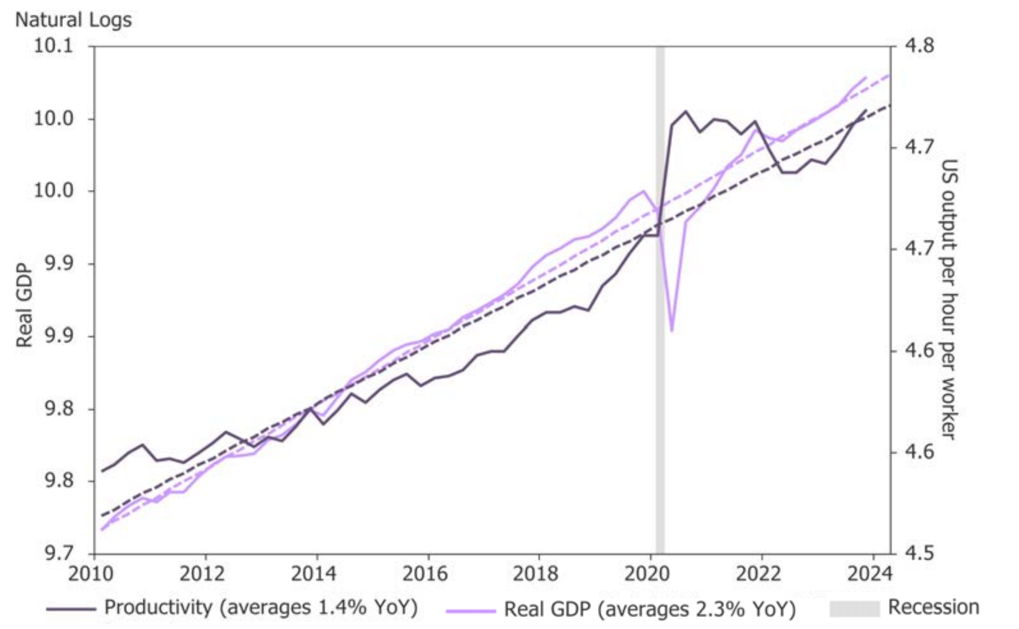
Key Global Equities



Source: LSEG Datastream, April 2024

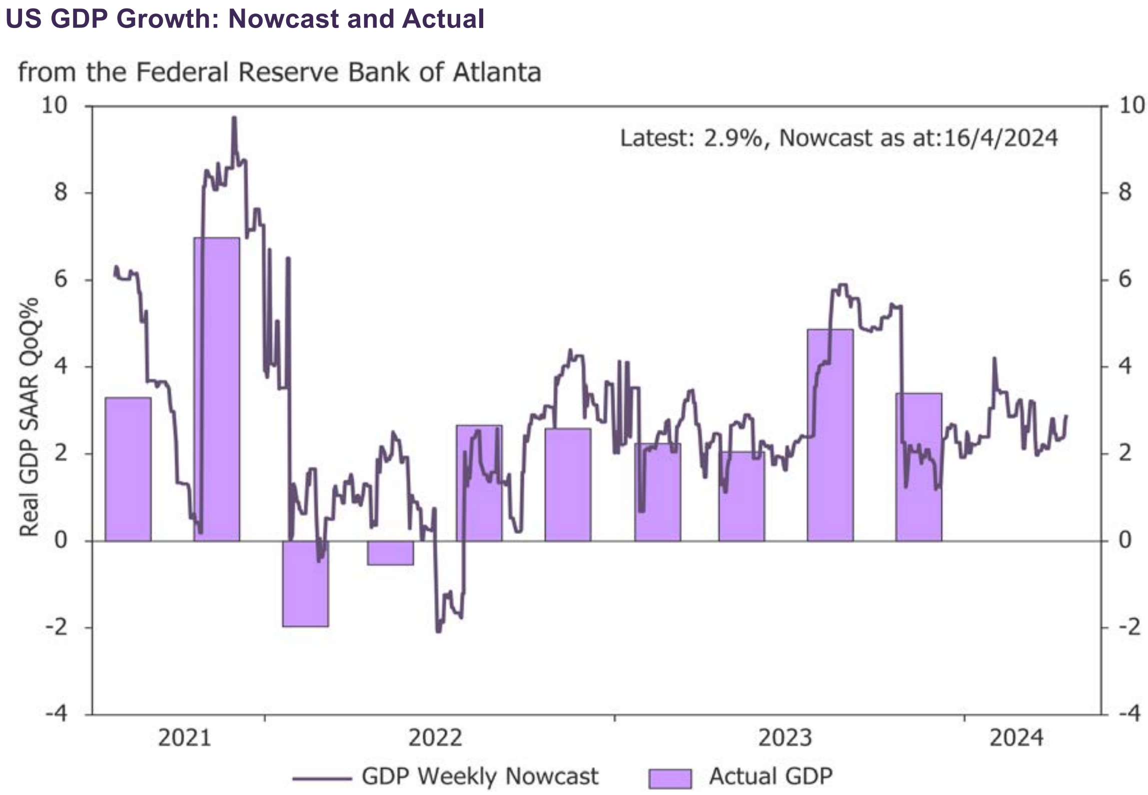
Figure 4: US productivity and GDP

US Real GDP and Productivity (with trends)



Source: LSEG Datastream, April 2024

Figure 5: US 'nowcast' of real GDP growth is tracking above trend



Source: LSEG Datastream, April 2024

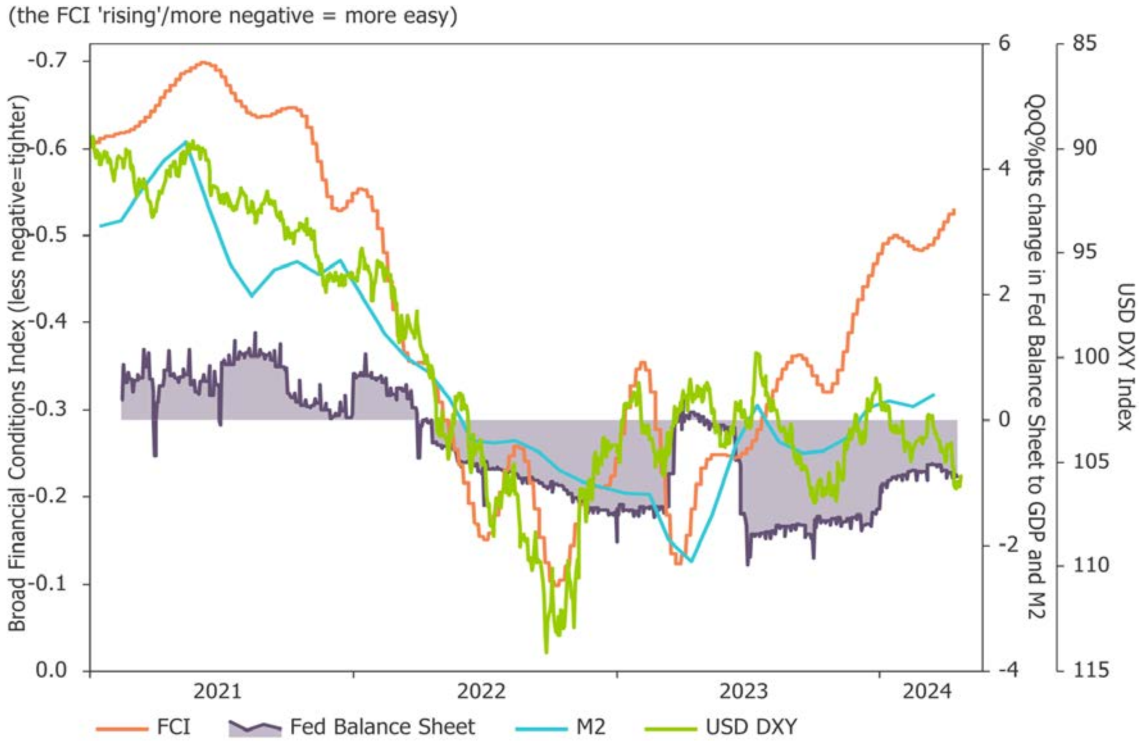
US liquidity and financial conditions remain easy, even with high interest rates

In addition, the US economy remains very well supported by easy broad financial conditions (the FCI index that is back around early 2022 levels. See Figure 6), reflecting reduced bank lending tightness, positive money growth, favourable financial markets, and robust domestic liquidity growth (Figure 7). Even as the Fed's balance sheet has continued to tighten, and the US dollar has been strong, broad monetary conditions have continued to ease.

Importantly, broad financial conditions remained supportive even as US 10y yields surged over Q423 and then again since late March. This suggests that US financial markets and economic activity may be resilient despite higher nominal yields (which have thus far not exceeded 5%), and even if the prospect of Fed rate cuts - as signalled for this year (in December 2023 and in March 2024) prove to be less than expected (or are postponed).

Figure 6: Indicators of US broad monetary conditions (FCI)

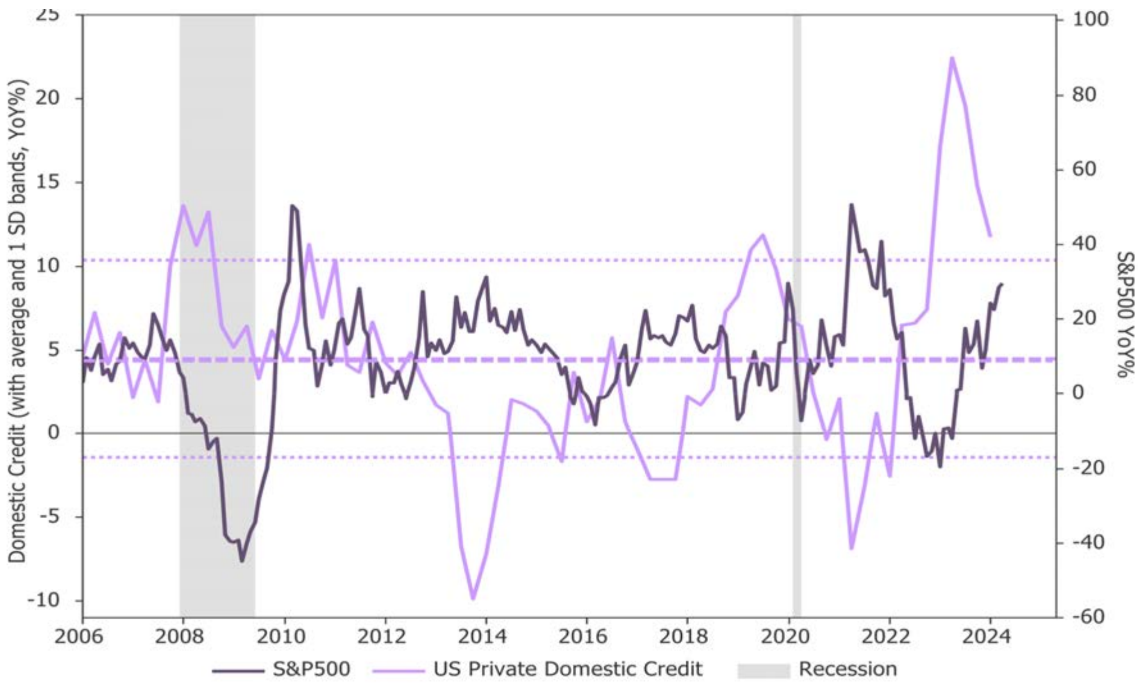
Monetary Conditions: FCI, Fed Balance Sheet, USD, and M2



Source: LSEG Datastream, April 2024

Figure 7: US domestic credit growth is slowing, but is still very strong

US S&P500 with Domestic Credit



Source: LSEG Datastream, April 2024

Macro factors across other DM markets should also support our bullish risk asset view

Europe's disinflation has weighed heavily on its growth, but the rapid decline in production cost inflation (compared to selling prices) has given some support to corporate profitability. Europe's activity indicators may be going through a bottoming process, and the region should benefit over time from stronger US spending. Japan has experienced stronger growth than its historic average, driven by robust productivity, greater consumerism and a very competitive real exchange rate. The BoJ may not need to tighten monetary conditions significantly to get CPI inflation back at its 2% target[5], which may reduce any potential headwinds to Japan's activity going forward.

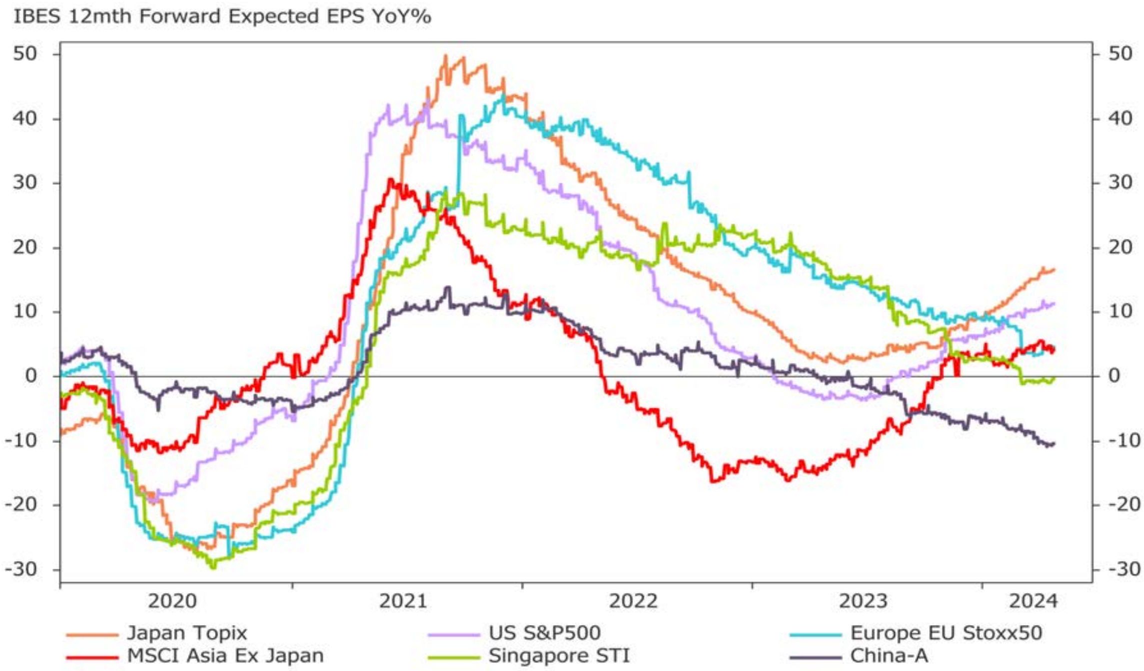
However, China remains a laggard, even with 5% GDP growth

At the other end of the spectrum, China faces headwinds from its overinvestment and deflation across output prices. China's policymakers have shown that they can provide enough stimulus to hit their 5% real GDP growth target[6], but for robust and sustained equity market performance the most important issue is to avoid deflation and boost earnings.

We are able to obtain a good summary of the 'real-time' macro backdrop across key countries by examining what the market is 'pricing-in' for earnings growth expectations over the next 12 months (see Figure 8). The US and Japan have strong and rising earnings growth outlooks, Europe has slowed (but may be bottoming), Asia ex-Japan (on par with Europe) is grinding higher, Singapore may have bottomed (and set to recover), while China is the laggard.

Figure 8: Summarising the 'real-time' macro backdrop across key countries (as reflected in forward earnings growth expectations)

Earnings Cycle



Source: LSEG Datastream, April 2024

5. This is the BoJ's indicated price stability target (https://www.boj.or.jp/en/mopo/outline/index.htm)
6. 2024 GDP growth target as outlined in China's 2024 Government Work Report

03 Equities

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Our conviction of a favourable investment environment has increased as we believe that US growth can hold above trend, Europe can avoid a painful recession, and Asia ex-Japan is getting stronger.

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

The equity sectors we like have not changed materially from what we discussed in detail in our Q1 Investment Views. We generally prefer growth over value, and sectors linked to consumerism, IT[7], new industrials and machinery, as well as ESG-leaders. These sectors are favoured as they are experiencing rising market share coupled with productivity gains containing costs. One typical exception is that value stocks have tended to outperform the broader market in China.

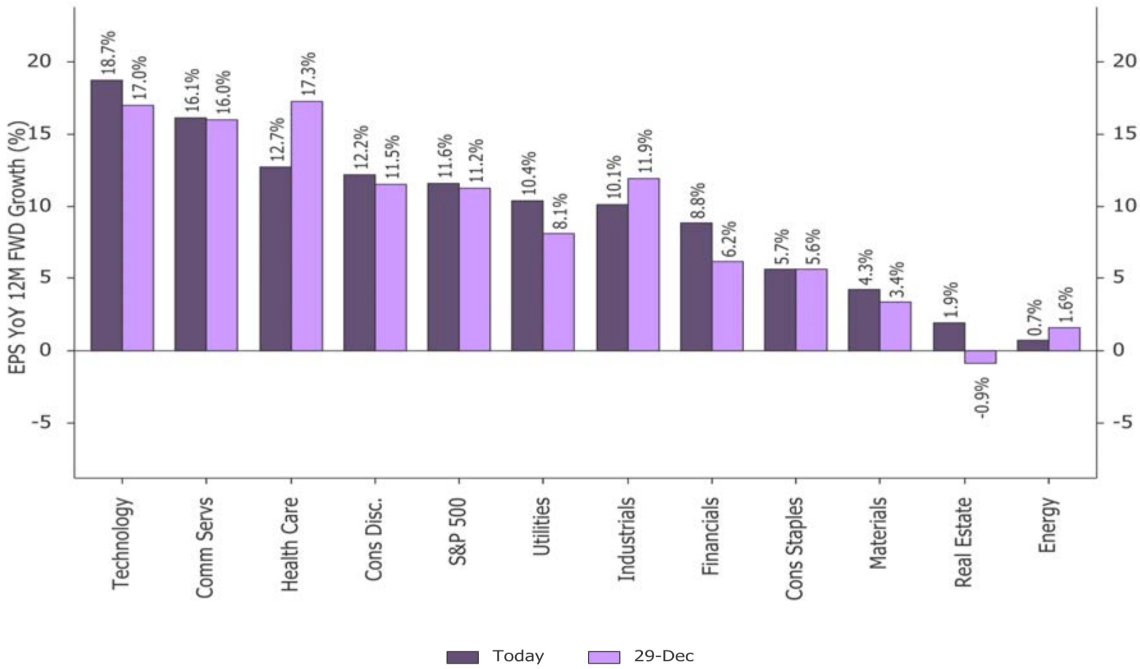
We have a bullish outlook on DM equities, dominated by the US

We have increased our conviction that US real growth can hold above trend which can be consistent with nominal earnings growth of at least 10-15% p.a. – market expectations (12-months forward) are within that neighbourhood at 12% p.a. (see Figure 9).

7. 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 In addition, 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.

Figure 9: US earnings growth expectations by sector

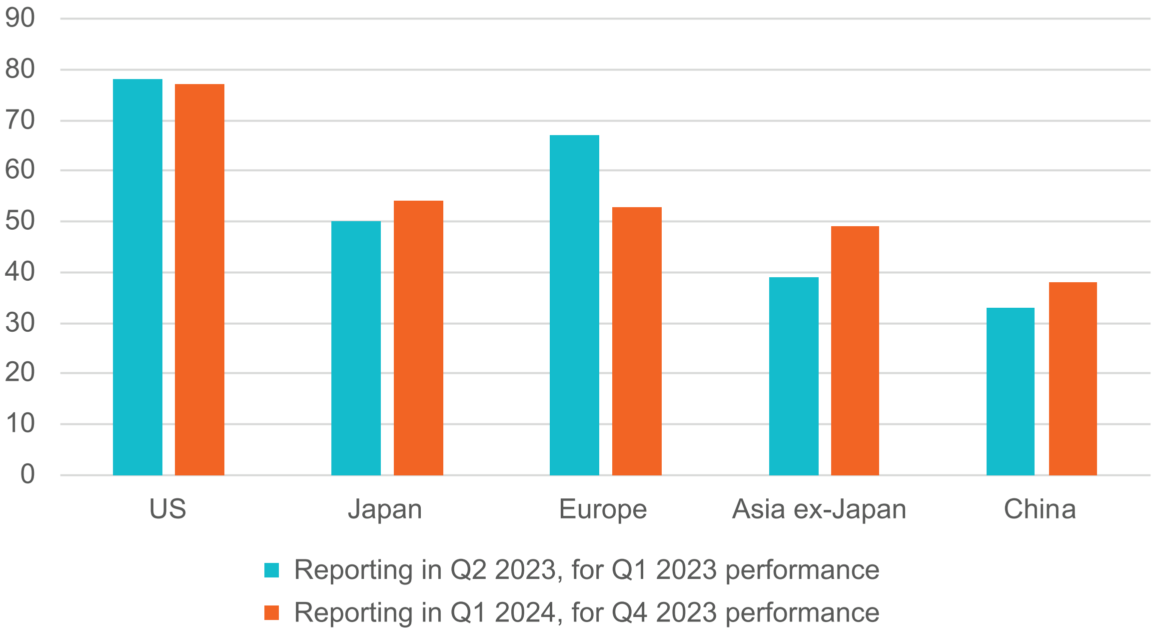
US S&P500 Earnings Growth Expectations



Source: LSEG Datastream, April 2024

Figure 10: Firms beating earnings growth expectations across key markets since Q223

% of firms beating earnings expectations



Source: LSEG Eikon, as at Q124

The robust US labour market is helping to sustain consumption, while US firms are making significant contributions with investment to help enhance productivity. What also remains very encouraging is that almost 80% of US firms (on average), well-distributed across all sectors, have beaten rising earnings growth expectations for a year already (see Figure 10). The current earnings season is very premature, but just as promising: 79% of all US firms beating expectations, with almost one-quarter of firms reported.

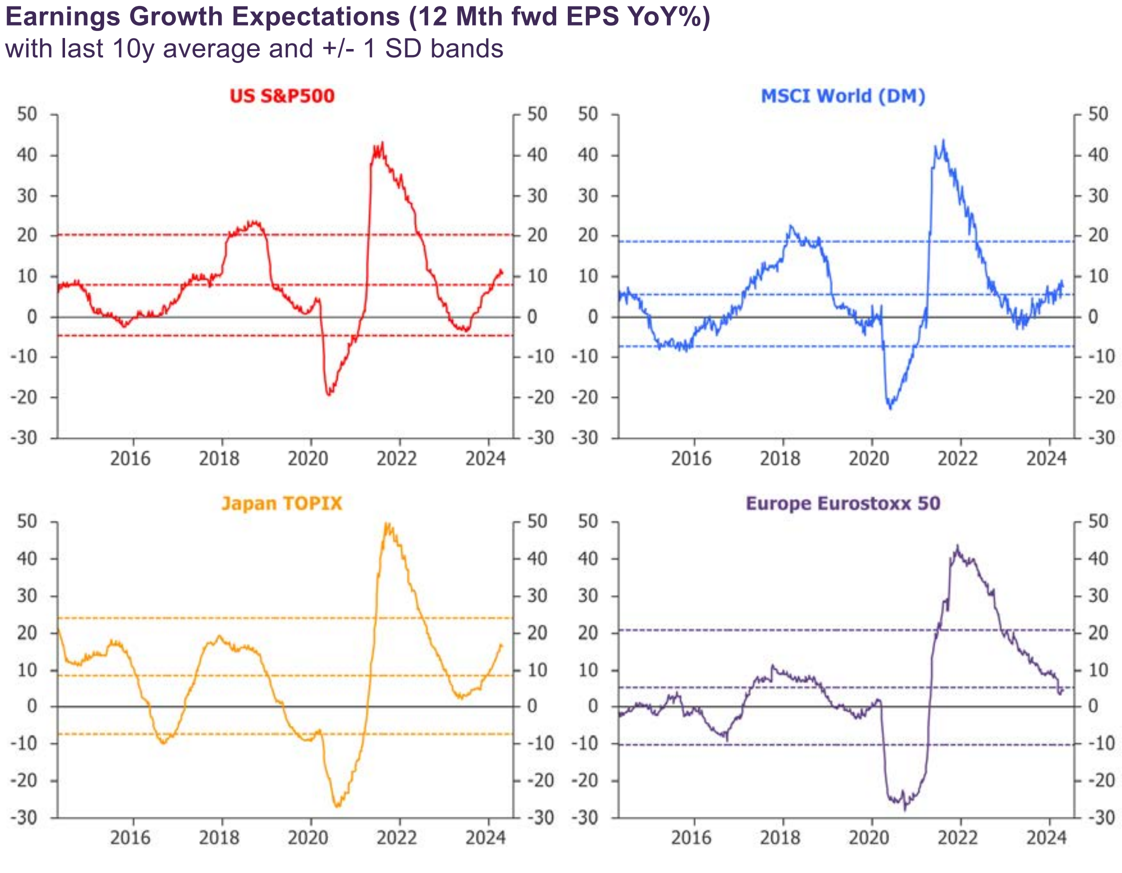
Fundamentals of productivity, competitiveness, and cost controls may be more important than Fed policy this year

Given the fundamental strength of US households and corporates, coupled with very supportive liquidity, we do not believe that the prospect of no Fed rate cuts this year would derail activity and earnings performance. US equities are already performing very strongly despite high interest rates. With trend disinflation in-play, reflecting very low real unit labour costs, Fed rate cuts will not be postponed indefinitely: unless the Fed changes its view to forecast materially higher inflation (in which case all assumptions will need rethinking).

Returns from Europe and Japan should contribute to our bullish DM equity view

Forward-looking indicators now suggest that Europe is likely to avoid a painful recession and earnings growth expectations may be bottoming (around their historic average, which given the environment, is a reasonable rate. See Figure 11). Earnings growth may get added support over time from stronger US demand and from ECB rate cuts (which could be on a larger scale than what the Fed may follow). Japan equities should continue to benefit from favourable margins as PPI inflation has corrected by more than its CPI inflation, and from the competitive real exchange rate of the Yen.

Figure 11: Earnings growth expectations across DM markets



Source: LSEG Datastream, April 2024

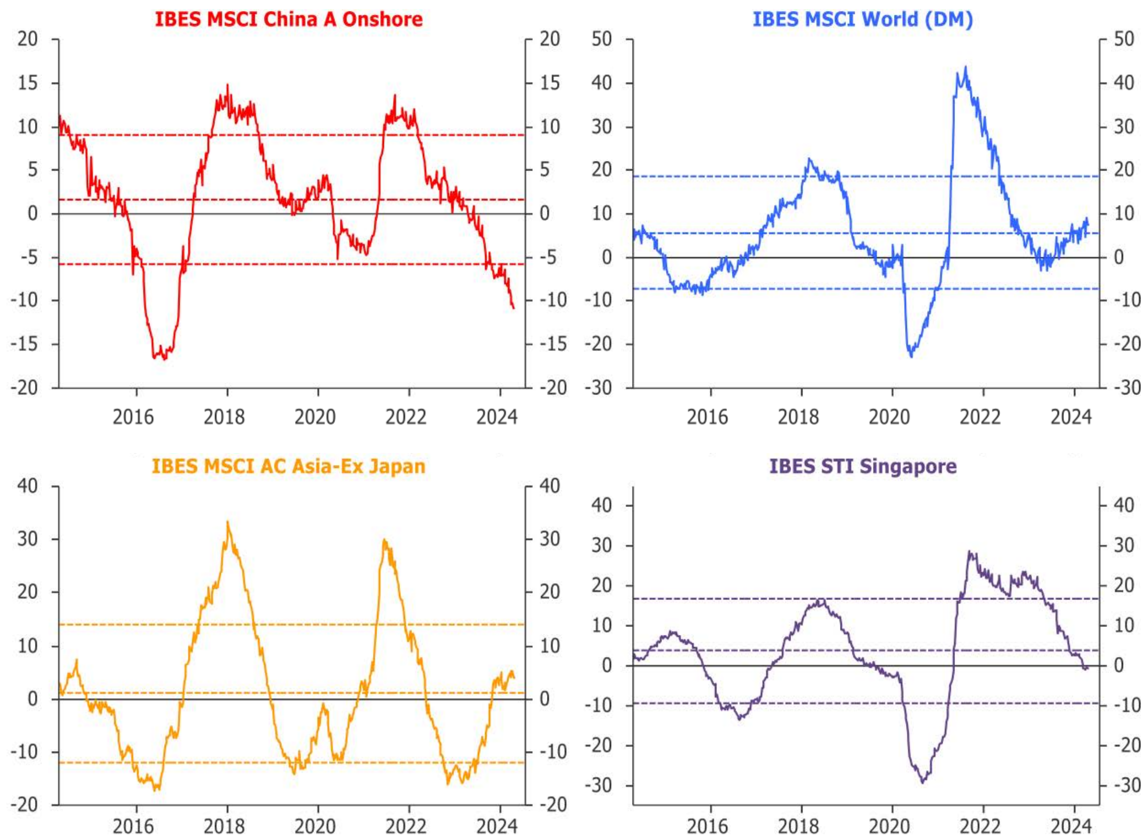
We are positive on Asia ex-Japan equities

Key regional economies seem to have decoupled from China, and earnings growth expectations continue to grind higher (see Figure 12). Strong demand from the US and Japan can be very supportive, while Taiwan and South Korea, in particular, can benefit from high-value added consumerism and capital-good demands. Fullerton has maintained a positive outlook on India equities for a while, as earnings growth continues to benefit from competitive production, rising spending power, favourable trade flows, and well-contained inflation.

We have become more optimistic on Singapore equities, as earnings growth expectations seem to be in a bottoming phase (see Figure 12). If recovery starts then there may be some opportunities for active investors, especially across sectors like high-end capital good manufacturing and industrials.

Figure 12: Earnings growth expectations across Asia (with DM)

Earnings Growth Expectations (12 Mth fwd EPS YoY%)
with last 10y average and +/- 1 SD bands



Source: LSEG Datastream, April 2024

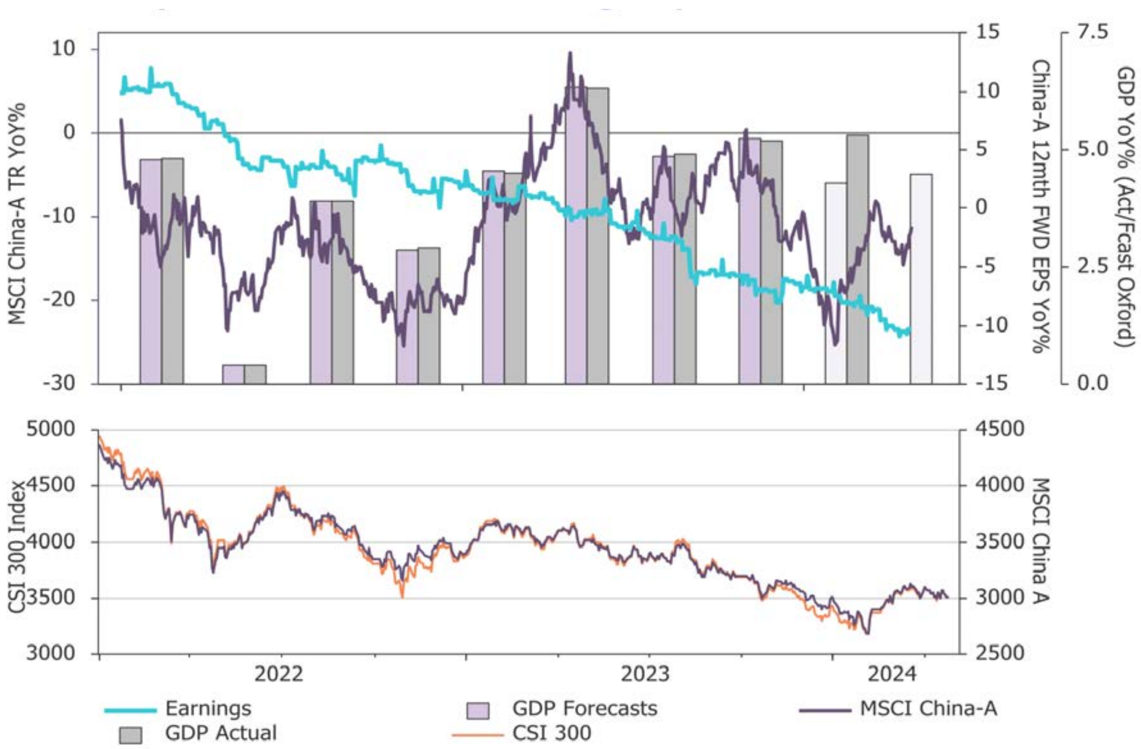
We maintain our negative outlook on China equities, and continue to monitor the prospect that deflation can be eliminated and earnings growth turns around

Even though China's policy stimulus seems well-equipped to achieve the government's target of 'around 5%' – with 5.3% YoY for Q124 (surprising many forecasters on the upside, see Figure 13) - earnings growth expectations continue to slide even as the market has rebounded (see Figure 13). China's corporate earnings may remain decoupled and depressed with deflation (especially across PPI metrics, see Figure 14), the very weak real-estate sector, and elevated unemployment (especially across the younger cohorts).

All that said, China is a 'trading market' (with 3 distinct cycles since last year - each with a lower peak, see Figure 13). Meanwhile, the return of GDP growth stability, along with stronger external demand, may further boost returns across the materials sector, which remains a key area of strength (see Figure 15).

Figure 13: China equities, earnings growth expectations, and GDP (actual and forecasts)

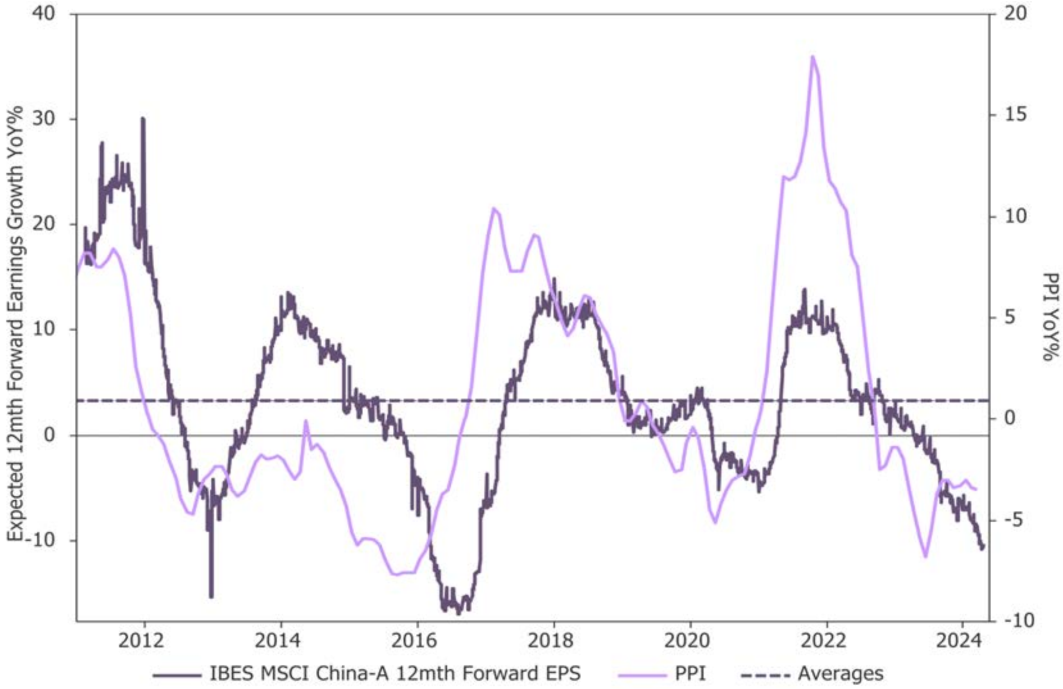
China-A Equities with Growth and Earnings Expectations



Source: LSEG Datastream, April 2024

Figure 14: China earnings growth with producer price inflation (PPI)

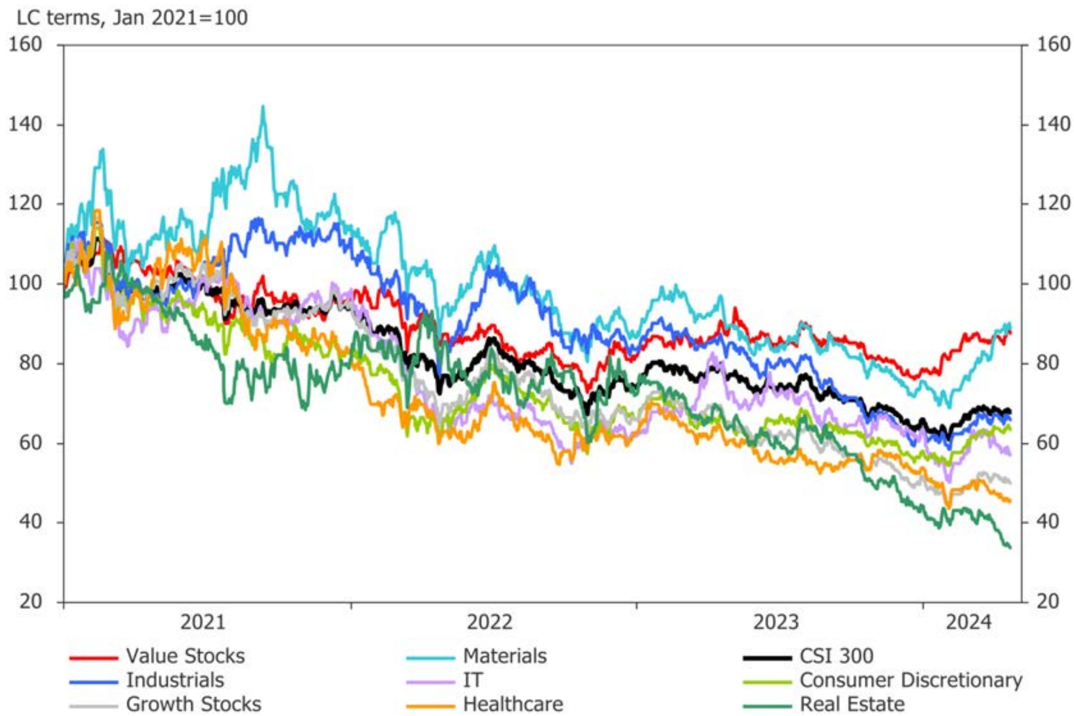
China-A Earnings Growth and PPI



Source: LSEG Datastream, April 2024

Figure 15: China equity sector performance (since 2021)

Key China Equities (CSI 300)



Source: LSEG Datastream, April 2024

04

Fixed Income

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Fullerton maintains the belief 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

Once bond prices gain back stability then active investors should be able to avoid capital losses (and if yields fall back, as we saw across DM in Q423, then there can be windfall gains). As we have emphasised since last year, 'hold-to-maturity' fixed income investors should enjoy attractive interest income from above average real yields, with some downside protection if growth unexpectedly slumps. The latter seems increasingly important given the trend rise in geopolitical risks.

We believe that yields for Singapore Government Securities (SGS) should 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, remain elevated.

We are positive on corporate credit, but remain selective

With global growth likely to remain robust, potential default rates across corporate credit should be contained and investors well rewarded. We are positive on Singapore corporate credits as the quality is good and supply remains tight, but the favourable environment has pushed-up valuations. 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. DM corporate credit may outperform, given relatively stronger profitability and balance sheets, while the US may also offer some attractive new primary market opportunities.

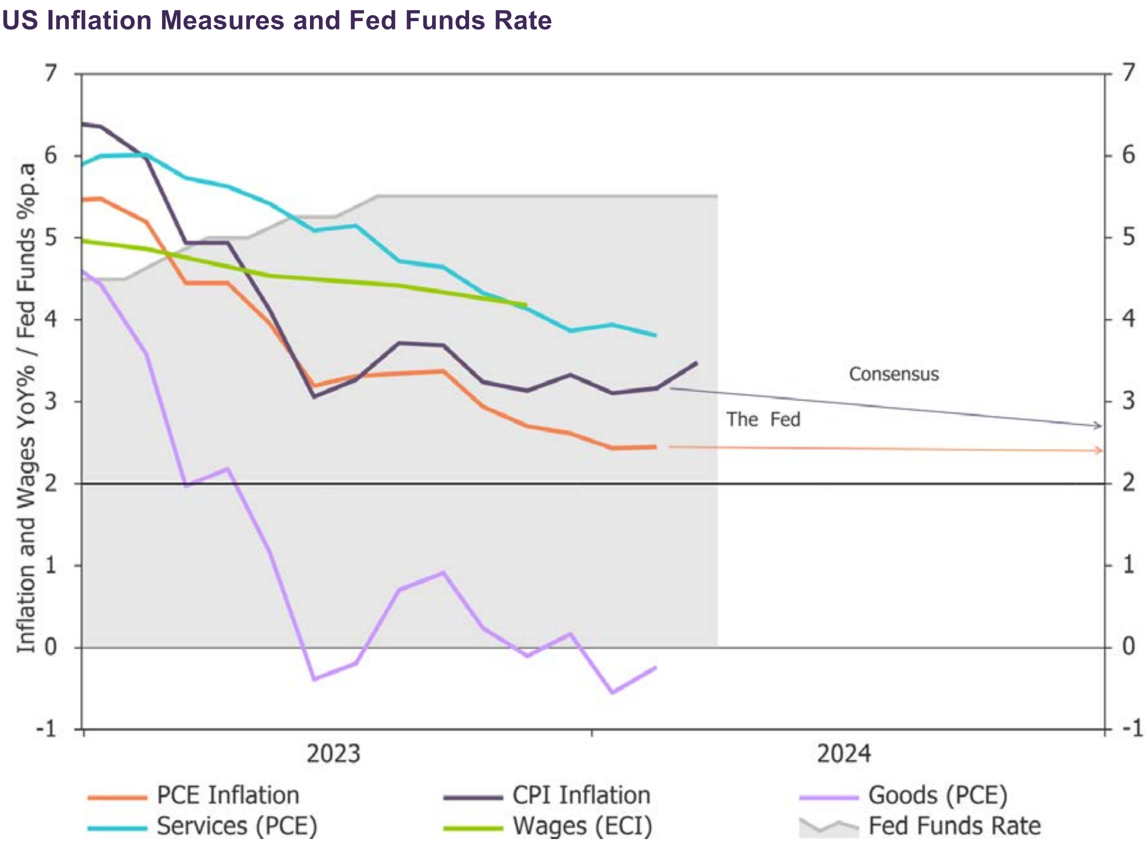
We are tactically bullish on Asia High Yield (HY) Corporate Credit, with favourable opportunities for active investors, especially across markets (and sectors) less impacted by any potential drag from China's weak real-estate sector and deflation pressures. For example, we maintain our favourable outlook for 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 continue to build investor confidence. Strong liquidity, and rising growth in corporate earnings, is allowing HY companies to smoothly refinance debt.

Markets may be more worried about inflation than growth

Into Q2, global bond returns struggled, especially across DM and the US, as yields increased - suggesting that the market may be less worried about risks to growth and more concerned about higher inflation (especially as commodity prices trend higher). The March US CPI inflation outcome was higher than the Consensus expected, and as a result, has increased fears that inflation may be reaccelerating and/or the Fed may change its mind on rate cuts (see Figure 16).

While US CPI inflation has diverged, the Fed implicitly maintains the belief that it will eventually fall back toward PCE inflation as changes in spending patterns are picked-up and shifts pricing pressures (see Figure 16. Note that for many reasons the Fed does not reveal CPI projections). The US Consensus and the Fed still believes that PCE inflation will hit the 2% target in late 2025/early 2026. From a starting-point of 2.5% YoY in Feb 2024 it implies a very slow adjustment path, with potential room for stickiness and perhaps some upside shocks along the way (disinflation seldom follows a straight-line. See Figure 16).

Figure 16: US Fed Funds Rate, inflation measures with stylised forecast paths



Source: LSEG Datastream, April 2024

The Fed's desire to start rate cuts this year fundamentally comes back to the distance that inflation is above the 2% target (now small, less than 1%pts, see Figure 16) versus the policy rate level (i.e. 5.5%) being above neutral (now large, as the Fed assumes 2.6%). It is important to remember that even with rate cuts unfolding disinflation pressure remains in-play until the policy rate normalises back to neutral which is years away (i.e. some time beyond the 2026 projection horizon).

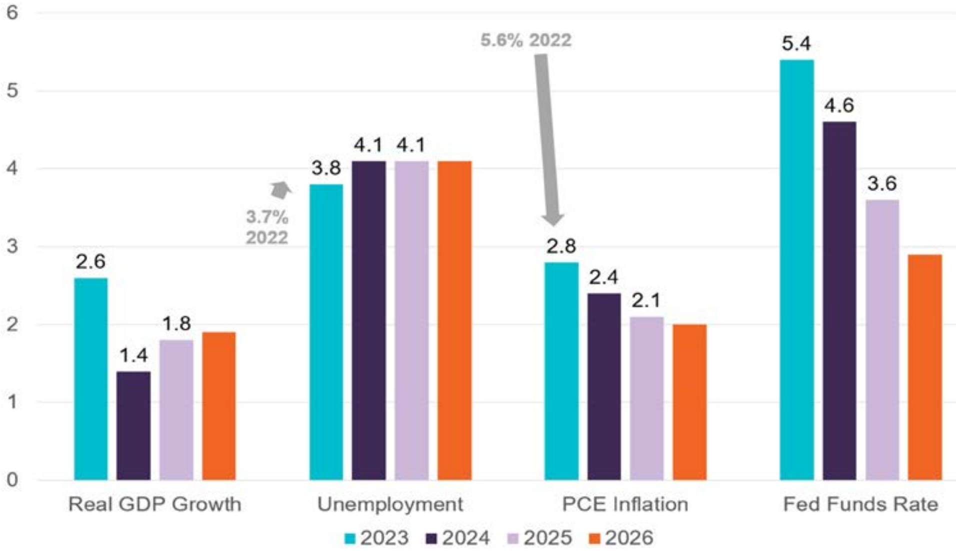
The prospect of no Fed rate cuts in 2024 has increased

If the Fed keeps forecasting inflation to return to its target, then they should signal a path of rate cuts over the same period. That is why the Fed has consistently stuck to the same message throughout 2023[8] and in March 2024 (see Figure 17).

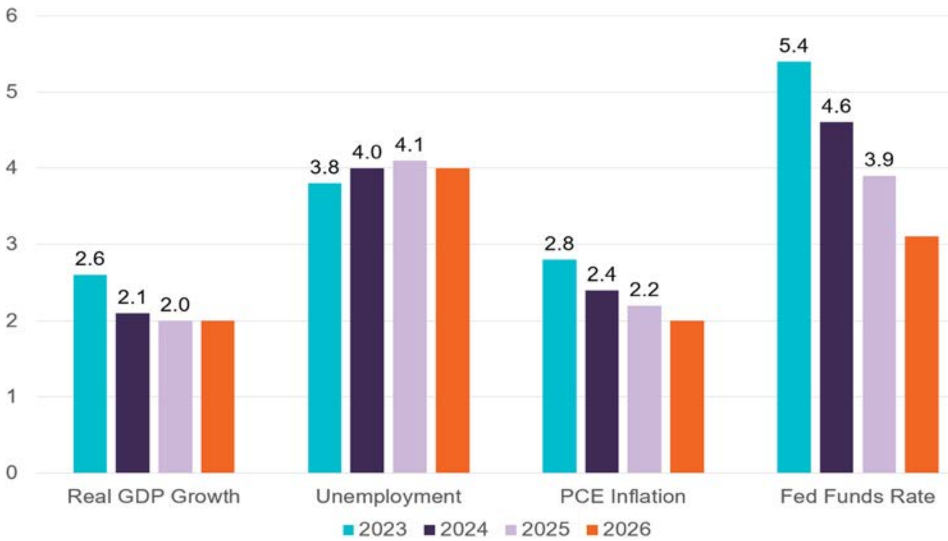
The risk with the latest inflation data is that the Fed will be forced to revise its projections in June toward higher inflation and/or a longer time period to reach the 2% target, and then rate cuts can be justifiably postponed.

Figure 17: US Fed forecasts (in Dec and Mar): the Fed reiterated the signal of rate cuts to start in 2024 even with the significant upward revision to its growth expectations (in Mar)

US Fed Projections from Dec 2023 (%pts)



US Fed Projections from Mar 2024 (%pts)



Source: US FOMC Forecasts, Dec 2023 and March 2024

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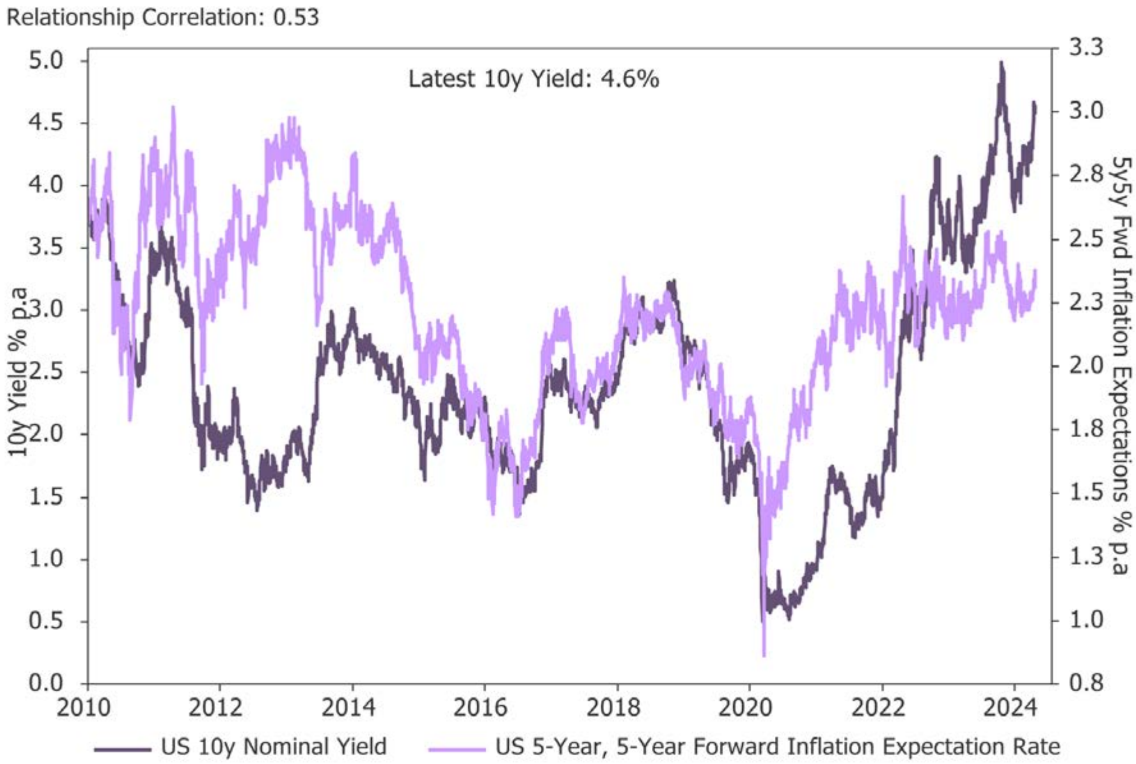
8. Three times. The Fed's Sep quarter 2023 forecast update was an 'outlier' set of projections suggesting no rate cuts in 2024, yet disinflation was expected to continue.

It is this inflation uncertainty that may be contributing to the rise in US bond yields and risk-off fears for some equity investors.

However, against this backdrop what remains encouraging is that even though US yields have increased significantly since the start of the year, US market inflation expectations remain contained in the 2.3%-2.5% YoY channel, suggesting that US nominal yields may lose pressure to rise significantly further (see Figure 18).

Figure 18: US yields rising again sharply, yet inflation expectations are contained: a potential rerun of Q423 - where nominal yield will eventually fall back?

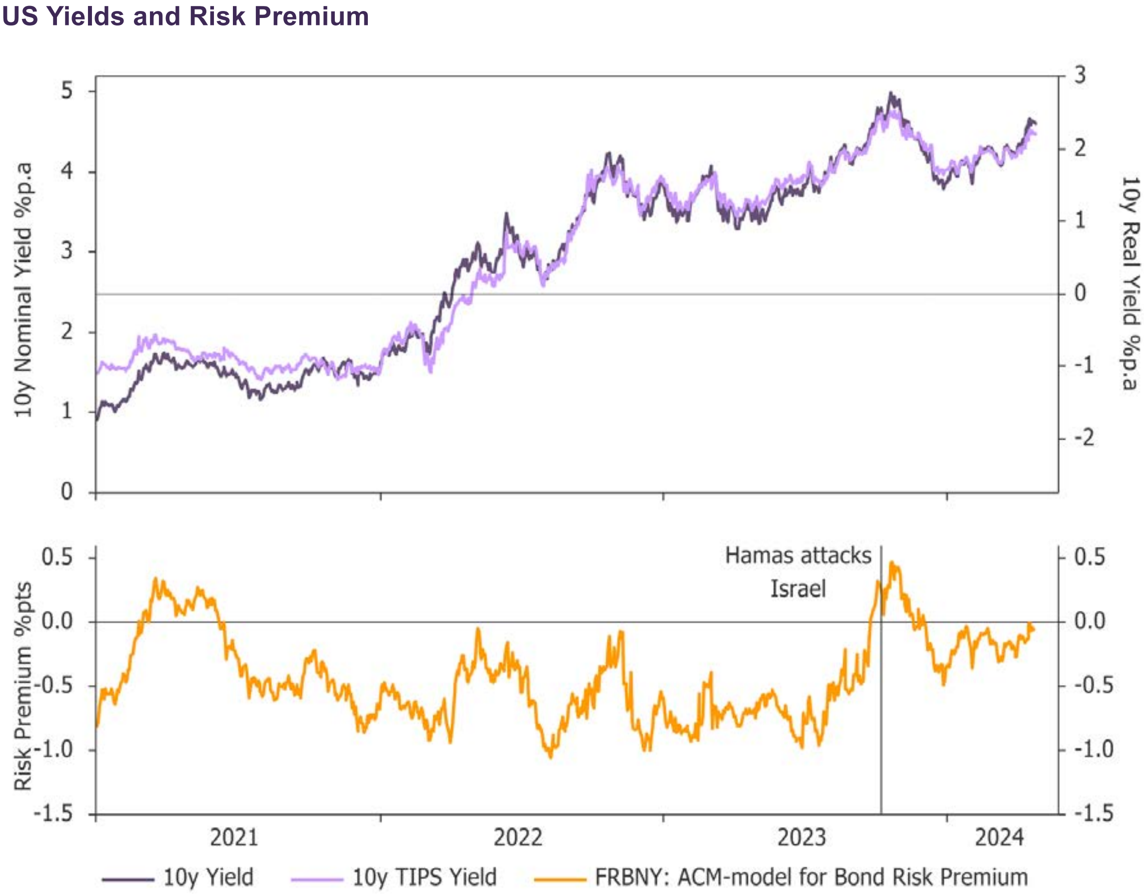
US 10y Yield and Inflation Expectations



Source: LSEG Datastream, April 2024

In addition, higher real yields have been a key driver, suggesting confidence in growth remains (which is good for equities) as the US bond risk premium is contained, and lower than it was over Q423 (see Figure 19).

Figure 19: US 10y real and nominal yields with the Fed's estimate of the risk premium



Source: LSEG Datastream, April 2024

For the Fed, any significant change in the FOMC's messaging - even when dictated by the data - can be damaging to credibility. For example, if it 'flip-flops' again with a set of projections like Sep 2023 i.e. with no rate cuts signalled a year or so forward, but disinflation is forecast to continue (as was presented in March 2024). Alternatively, which can be worse: the Fed concludes that they have misjudged inflation pressure and revise-up and push-out the expected time path to get back to target beyond 2026, for instance. A third option, that all central banks want to avoid if at all possible, because it can be a credibility disaster, would be to keep the existing back to target call of 2026, but hike rates beyond 5.5% because inflation is shocking materially to the upside.