Embracing a ‘different normal’: investment strategies for a changing world

Fullerton Investment Views - Outlook 2021

January 2021

FULLERTON FUND MANAGEMENT

Executive summary

- **The reflation trade of 2020 has proved strong and largely consistent with macro developments.** In our view, the world is evolving towards a ‘different normal’ investment environment. Inflation and interest rates will be low for a prolonged period and there are 3 key trends companies need to navigate: i) Lifestyle changes ii) New technology and innovation and iii) The ‘green engine’.
- **Fullerton’s regime framework is signalling a ‘sweet-spot’ for investors - we are bullish on risk assets, and especially Asian equities.** Global GDP growth is expected to be significantly above trend according to Consensus, and earnings growth should continue to improve, and the equity rally should broaden. We favour the sectors that are best positioned to navigate structural trends especially across consumer products, IT, communication services, healthcare and renewables.
- **We are negative on bonds and the USD, but positive on Asian corporate credit.** We remain negative on US bonds (underweight duration), and with strong Asian fundamentals (i.e. favourable growth differentials and real yields) investment inflows will rise and build pressure for currency strength (vis-à-vis USD weakness). We foresee some room for Asian credit spreads to tighten further, especially across High Yield (HY), with defaults contained and stronger investor confidence coming through.
- **Investors still need to actively manage with caution.** Key risks remain COVID-19 centric and geopolitical i.e. changes in China’s industrial policies (for its IT conglomerates) and further deterioration in US-China relations. Medium-term risks include valuations becoming too stretched, eventually leading to a risk-asset price bubble (that could painfully collapse).

Author

Robert St Clair
Strategist
Fullerton Fund Management

1. Macro backdrop continues to improve

Very strong returns across global risk assets in 2020

As the COVID-19 lockdowns eased, and the global recession ended over Q3 2020, a V-shape recovery was realised. The impact of the recession ending, and GDP increasing, combined with very strong liquidity growth, had very powerful effects. The performance of risk assets over 2020 was consistent with many of the macro forces at play that we had highlighted throughout the year.

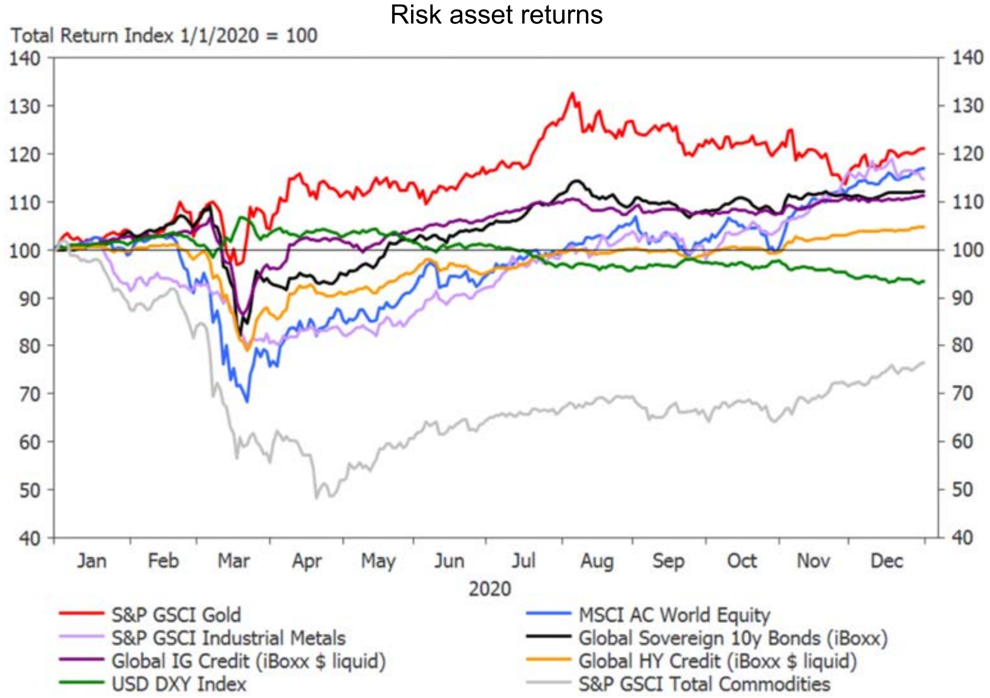
For example, equities and industrial metals, that are the most linked to GDP growth, have seen the strongest rebounds, ending 2020 with double digit returns. Corporate credit, especially Investment Grade (IG) firms that tend to have solid balance sheets, also performed well.

Global sovereign bonds rallied significantly over 1H 2020 because of the collapse in yields (vis-à-vis capital gains surge) and increase in central bank stimulus with the recession. As yields have now stabilised, and some markets have drifted up a bit (like the US), incremental returns have stalled.

Oil prices have remained weak, and decoupled from the global growth rebound, because tourism flows have not come back as yet (jet fuel demand has collapsed and energy has a 62% weight in the GSCI total commodity price index).

Finally, gold prices have appreciated very strongly, with returns over 20%, reflecting global central banks printing money, a weaker USD, and greater uncertainties associated with the COVID-19 lockdowns and geopolitical risks.

Figure: Risk assets have performed strongly in 2020

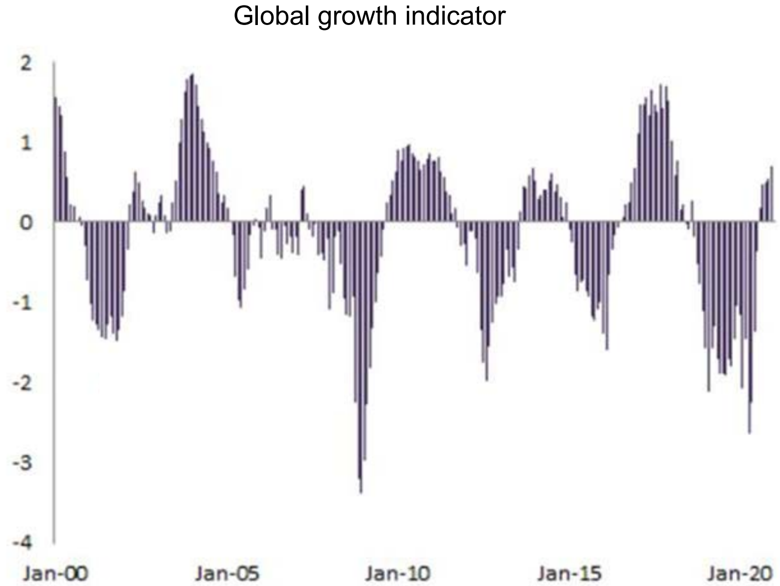


Source: Refinitiv Datastream, 1 Jan 2021

Bullish macro forecasts for 2021

As we outlined in our Q4 2020 Investment View, our aggregate global growth indicator has returned to positive, and as it continues to gain strength it is becoming even more supportive of risk assets.

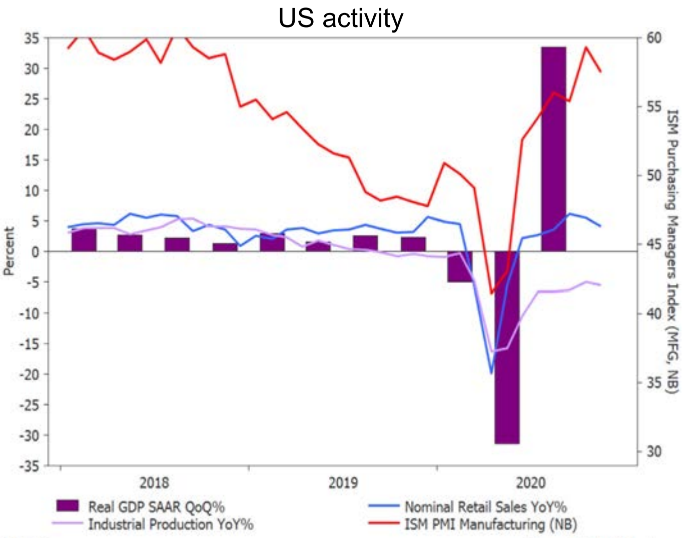
Figure: Fullerton's global growth indicator continues to gain strength



Source: Fullerton, 1 Jan 2021

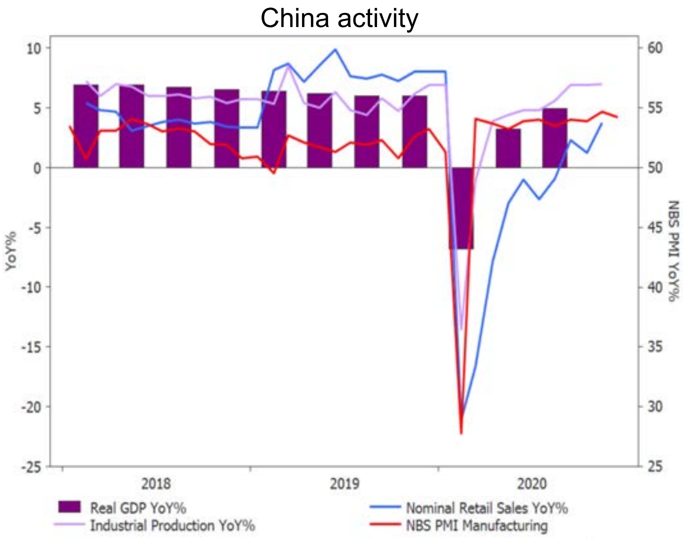
The recovery in China is being driven most by the rebound in its manufacturing, while across other major developed market countries retail sales growth is stronger than industrial production. Developed market industrial production growth should catch-up as investment growth continues to recover and as global trade rebounds.

Figure: US activity indicators



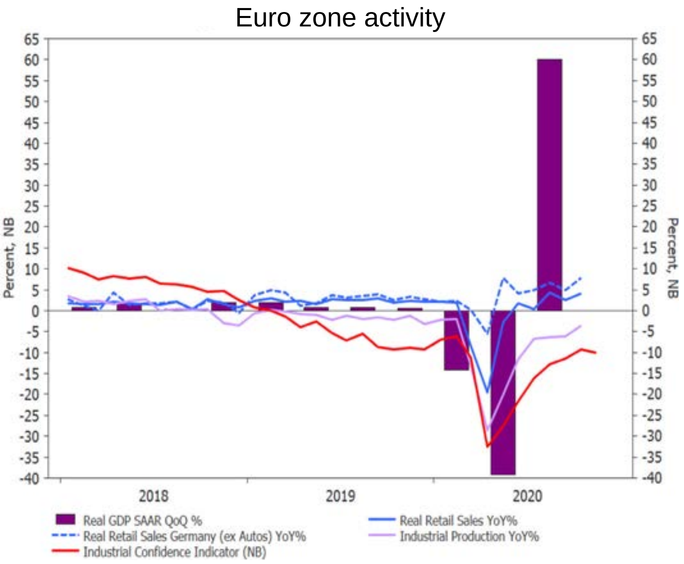
Source: Refinitiv Datastream, 1 Jan 2021

Figure: China activity indicators



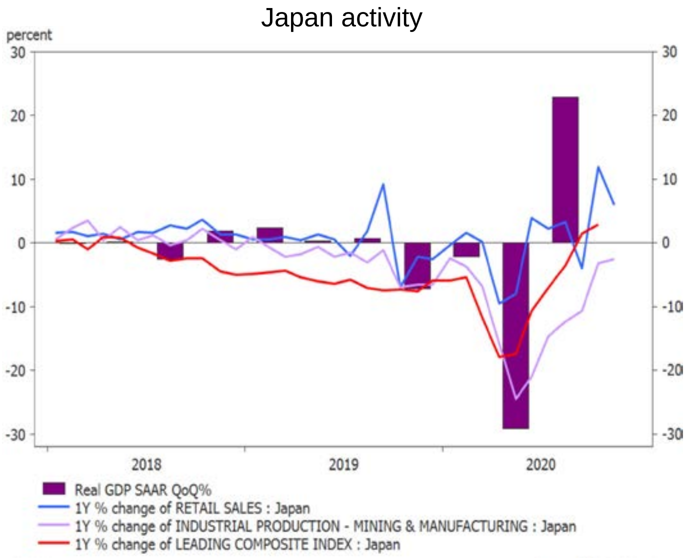
Source: Refinitiv Datastream, 1 Jan 2021

Figure: Europe activity indicators



Source: Refinitiv Datastream, 1 Jan 2021

Figure: Japan activity indicators

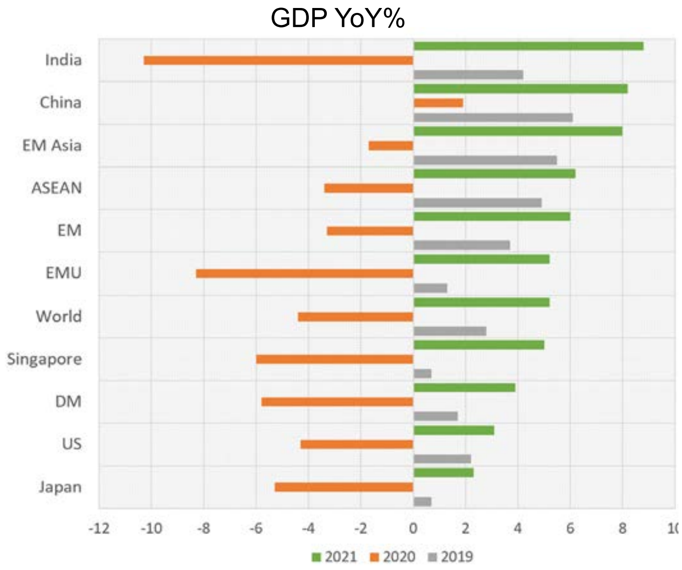


Source: Refinitiv Datastream, 1 Jan 2021

The growth outlook from Consensus and from IMF projections is very bullish. Global growth is forecast by the IMF to rebound significantly in 2021 to 5.2% YoY, which is much stronger than the growth over 2019 (at 2.8% YoY, before COVID-19 hit).

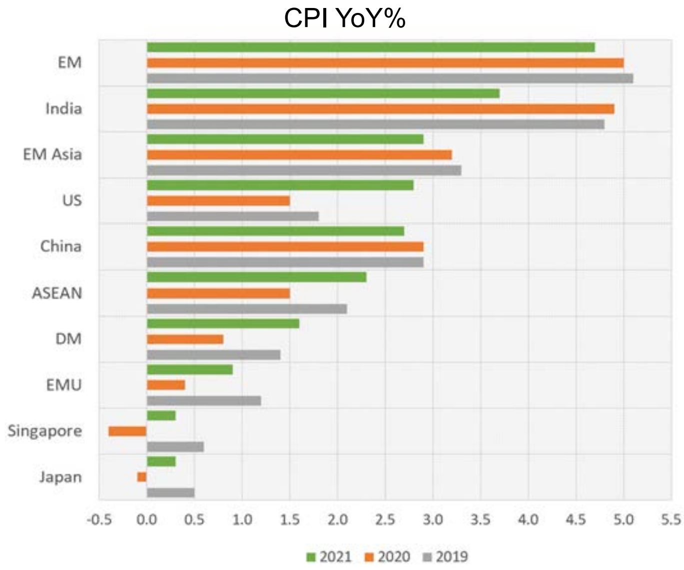
The IMF also expects that growth across Asia (8% YoY) can be much stronger than across developed markets (4% YoY), and this could help Asian equities to continue to perform strongly. Although growth is expected to be above trend for most countries over the next few years, inflation is expected to be low and contained.

Figure: IMF GDP growth outlook – Asia growth to outshine developed market peers



Source: IMF Projections October 2020

Figure: IMF inflation outlook – inflation to be low and contained



Source: IMF Projections October 2020

The IMF also projects global GDP growth to remain above its historic average growth rate (3.4% YoY since 1980) for the next four years. This bullish growth outlook suggests that global earnings growth expectations should continue to improve.

Figure: Global earnings growth expectations continue to improve

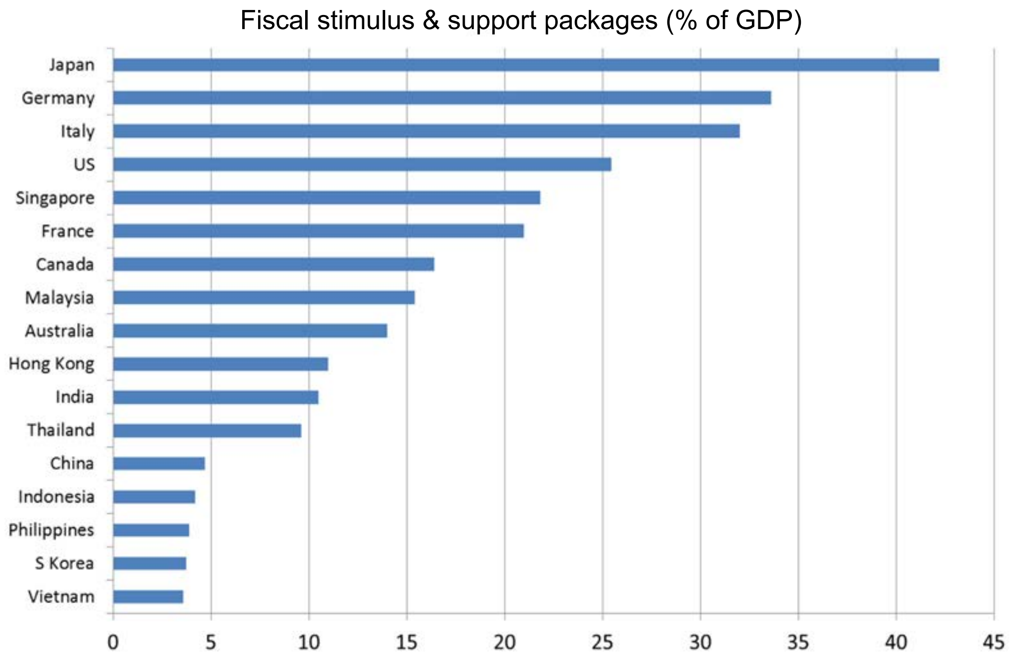
Source: Refinitiv Datastream, 1 Jan 2021

In many aspects, the global recovery and equity market rally is still in its early stages. For example, expectations of 12-month forward earnings growth (EPS YoY) have improved, but are still falling. When global earnings YoY growth expectations are positive again, around the middle of this year, then the rally should be broader, especially across sectors like industrials and those more dependent on global trade and investment.

While GDP growth is expected to be very strong in 2021, recoveries in economic activity and unemployment (back to pre-COVID-19 levels) will be much slower. But this has not been a headwind to global markets so far. Instead, what it does mean is that global central banks will be forced to keep interest rates very low for a prolonged period, and that is positive for risk assets.

The peak impact of policy actions have likely past, but as the lags work through economies, stimulus effects will likely continue to be supportive to growth and risk asset prices this year. Across most economies, fiscal stimulus has been huge and the US is the latest to approve another package on 28 December 2020 (which will have most of its impact in 2021).

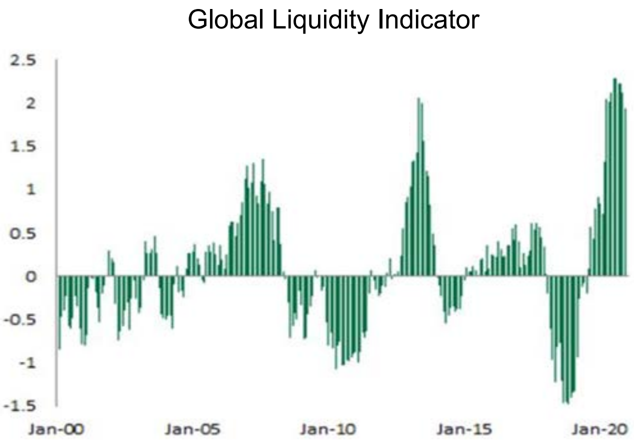
Figure: Government stimulus continues to support growth and risk asset prices



Source: IMF as at 20 Nov 2020. Also includes latest US fiscal package, as at 28 Dec 2020

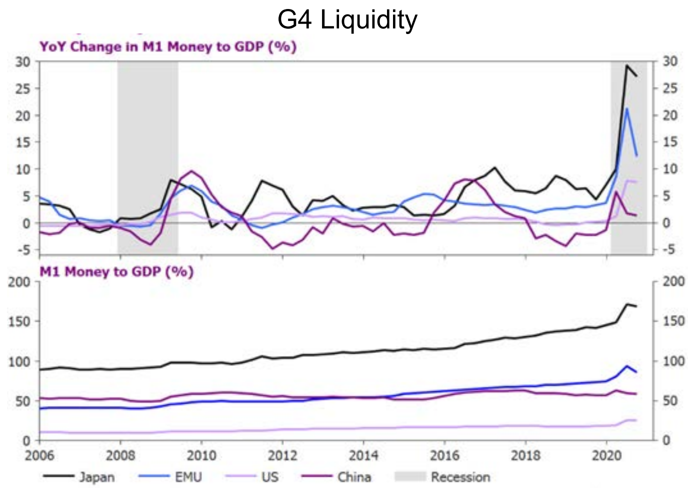
Central bank driven liquidity growth, although now slowing, will still likely remain stronger than GDP growth for quite a while (Fullerton's global liquidity indicator will also likely remain above trend). With global growth forecast, by the Consensus and by the IMF, to be above trend for the next few years, it is unclear that major economies will need any further stimulus.

Figure: Fullerton's Global Liquidity Indicator – liquidity levels to remain above trend



Source: Fullerton, 1 Jan 2021

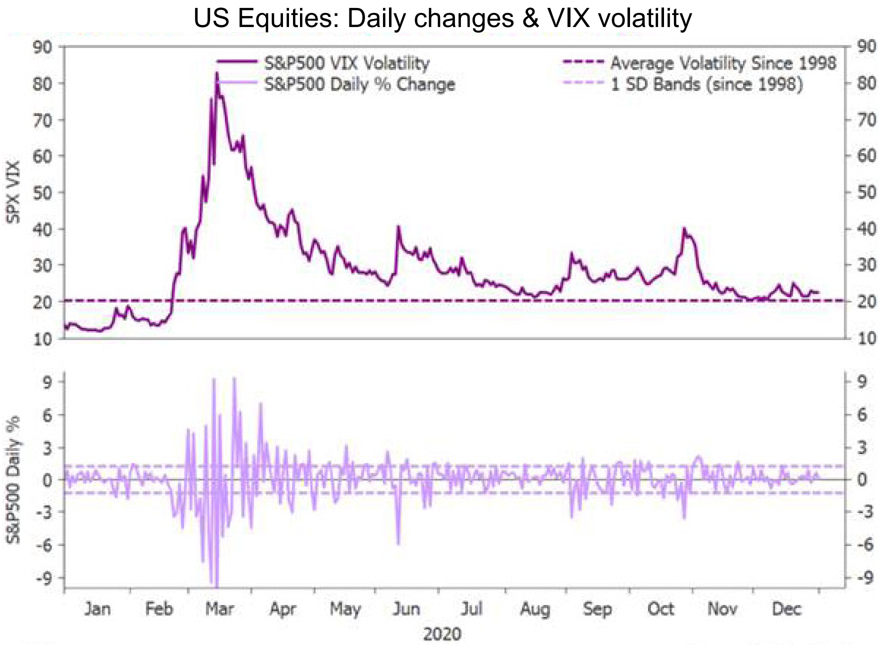
Figure: G4 Liquidity driven by its central banks is likely to remain stronger than GDP growth



Source: Refinitiv Datastream, 1 Jan 2021

In addition, the significant breakthrough in vaccine development have raised hopes of greater normalcy even in this year. All these positives have reinforced one another and as a result market volatility has normalised (i.e. US VIX has returned to its long-term average).

Figure: Market volatility levels have normalised



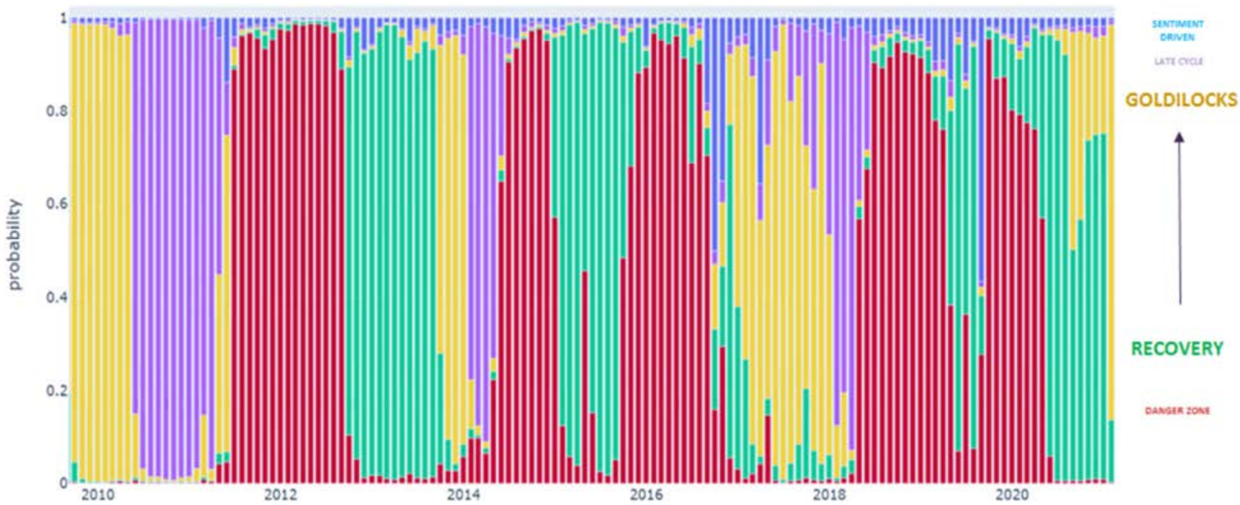
Source: Refinitiv Datastream, 1 Jan 2021

We continue to believe that the strength in global markets is sustainable, driven by the strong rebounds in growth that are unfolding, ample liquidity, and stimulus lag from significant policy actions.

2. Investment strategy – we remain bullish on risk assets in 2021

At Fullerton, one of our key tools is a regime mapping framework which tracks global economic data across factors like growth, liquidity, inflation, and investor sentiment. This regime indicator is signalling that the global economy has moved from a recovery phase into a 'goldilocks environment'. Such an environment is a 'sweet-spot' for investors – characterised by above average GDP growth, robust liquidity, coupled with low inflation and interest rates – which can be very supportive for risk assets.

Figure: Fullerton's Regime Forecast Model is indicating a 'goldilocks environment'



Source: Fullerton MA, Bloomberg, 31 Dec 2020

Equities – we are bullish, especially on Asia

In our view, a 'different normal' investment environment is unfolding where inflation and interest rates will be low for a prolonged period and it could be more difficult than otherwise for companies to grow their market share. Against this 'low-for-longer' backdrop, there are three key structural trends that companies need to navigate:

- **Lifestyle changes:** i.e how we work, live, and play in a 'different normal'. Rising consumer spending is a key feature driving choices, as stronger per capita incomes fuel middle-class spending growth, especially across Asia.
- **New technology and innovation** are driving costs down and helping contain inflation. It is also helping companies defend profitability, especially those best able to embrace on-line business models and efficient supply-chain management.
- **The 'green engine':** ESG is becoming much more important, and investors can be rewarded if they find companies improving their compliance to global ESG standards.

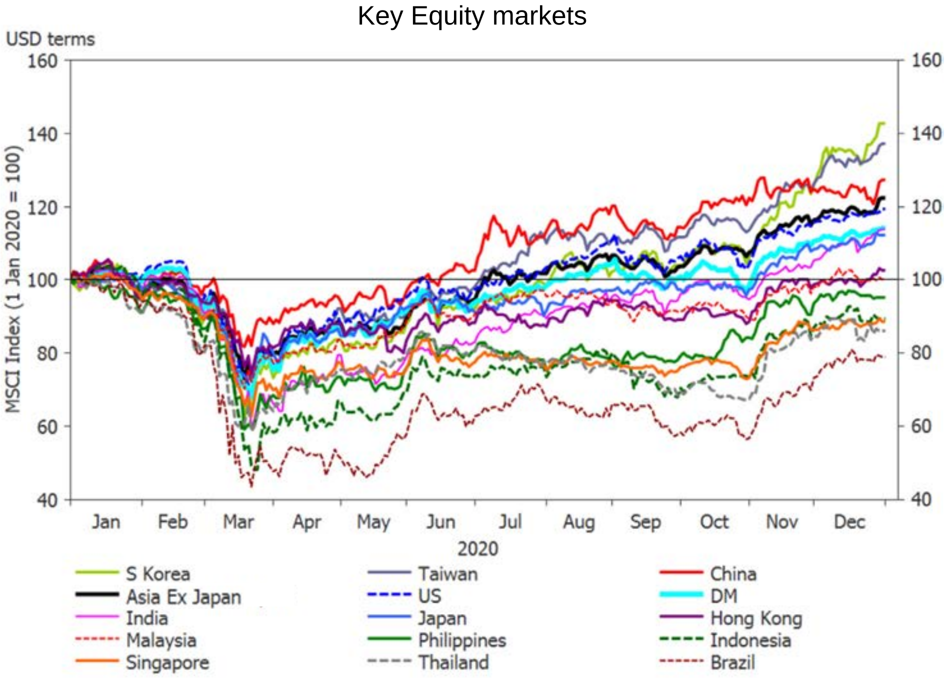
We continue to favour the sectors that are best positioned to navigate these key trends, especially across consumer products, IT, communication services, healthcare and renewables.

Global equities should be supported by ongoing improvements in earnings growth expectations that are tracking realisations and forecasts of stronger GDP growth. As the recovery continues to gain momentum, the rally should broaden further to other sectors that have been lagging, such as industrials, financials, fashion retail, and consumer durables.

North Asian markets have been leading the global recovery, and the rest of Asia will benefit from a stronger China, as intra-Asian trade growth has rebounded significantly. Most Asian countries should see significant rebounds in YoY GDP growth by Q1 2021.

Across developed markets, US equities should continue to get significant support from the growth rebound underway, the huge policy stimulus, and from the Fed keeping interest rates at zero for many years.

Figure: Key Equity markets have performed strongly



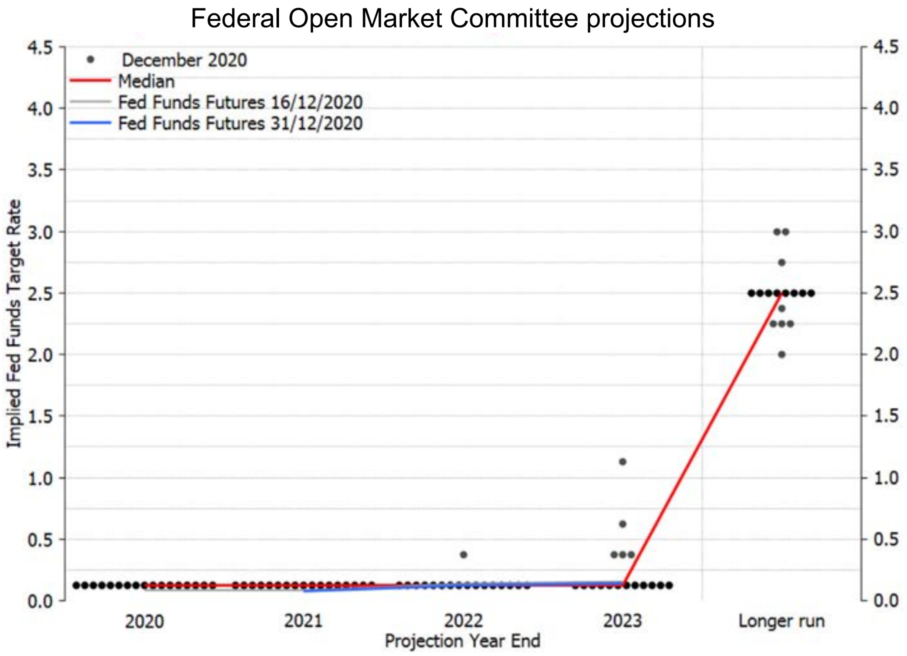
Source: Refinitiv Datastream, 1 Jan 2021

Bonds – we are negative on developed markets, but Asia offers opportunities

Ultra-low and negative (real) government bond yields across many developed markets reduce the attractiveness of Fixed Income investments. We remain negative on US bonds (underweight duration) as yields, from 'rock-bottom' rates, are likely to continue to slowly drift upward over time with stronger growth and rising inflation expectations.

With significant output gaps, inflation is unlikely to overshoot central bank targets, and the Fed is likely to keep its policy rate at zero for several years until the labour market normalises (which may take until 2024 - based on the time it took after the last recession for US unemployment to return to 4.5%). Without any significant inflation threat, the rise in US yields should be orderly and manageable, as the Fed's balance sheet is still rising and they will likely act with more liquidity if yields were to rise too much and too fast.

Figure: Federal Reserve likely to keep policy rate at zero for several years

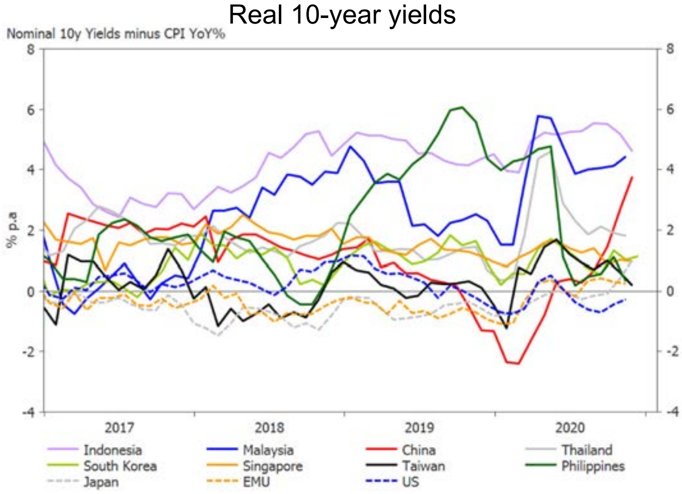


Source: Refinitiv Datastream, 1 Jan 2021

Figure: US market inflation expectations suggest yields will slowly drift upwards

Source: Refinitiv Datastream, 1 Jan 2021

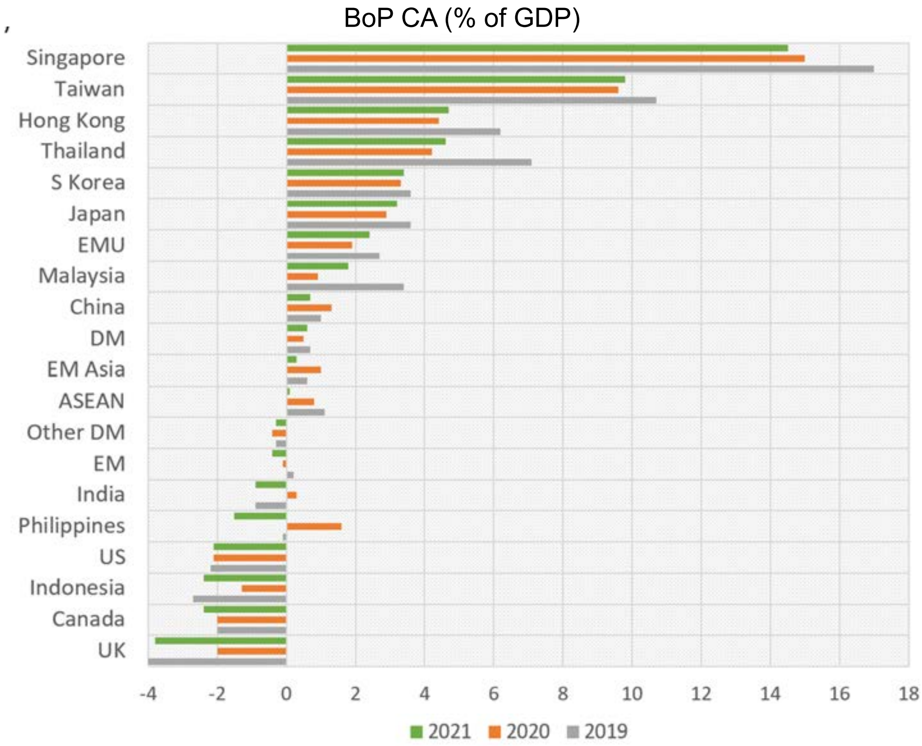
Figure: Real yields in Asia are attractive relative to developed markets



Source: Refinitiv Datastream, 1 Jan 2021

There is unlikely to be any further significant easing in monetary conditions across Asia, and coupled with strong Asian fundamentals (i.e. forecasts of a very favourable growth differential over developed markets and attractive real yields), pressure is likely to build for currency strength (vis-à-vis USD weakness). In addition, the IMF forecasts that external balances for many key Asian markets are likely to remain fundamentally strong.

Figure: IMF current account outlook remains healthy for key Asian economies



Source: IMF projections October 2020

Corporate credit – we are positive, especially on HY, and again Asia leads the way

We foresee some room for Asian credit spreads to tighten further, especially across HY, with defaults contained and stronger investor confidence coming through. That said, investors still need to continue to focus on balance sheet fundamentals to cherry-pick the strongest companies. Asian IG credits, where spreads are already around historical averages, are likely to offer less scope for further spread compression.

The pandemic-induced sector and country divergences are likely to fade over time. South Asian countries that have lagged the North Asian economies will also get a boost as vaccine development progresses and once tourism starts to recover. In particular, Indian and Indonesian corporates, which have been lagging due to difficulties in containing the virus outbreak in their countries, are likely to benefit significantly from greater investment flows. Cyclical sectors that have been lagging, like commodities, mining, consumer discretionary and gaming, should start to catch up as greater spread compression unfolds.

We also remain positive on China’s corporate credit. China’s real estate sector, in particular, is likely to continue to benefit from the domestic macro economic recovery. Regulators have put in measures to contain downside risk, which are positive for longer term sustainability of the property and financial markets.

In addition, lower bond supply headwinds with expected flat YoY net supply, particularly across high yielders, should be supportive for market technicals. As China’s offshore and onshore bond yield differential becomes more favourable, onshore bond investors may look to arbitrage between these two markets for relative value opportunities.

We think that another sector worth monitoring is China quasi-sovereigns which include state-owned entities and local government financing vehicles. Over time, government-linked issuers may benefit from the Biden presidency, given the likelihood of a less aggressive foreign policy regime and lower probability of escalating sanctions. While there have been significant headlines in onshore defaults, some of them involving government-linked entities, we do not believe the onshore default risk will be systemic, bearing in mind that China’s policymakers have resources to ensure financial market stability.

Commodity prices have rebounded on strong demand

Metal prices, especially copper, have rebounded as we expected as the global recession ended, and as China’s demand recovery has been strong. Not surprisingly, returns from the GSCI industrial metals index closely followed the rebound in global equities. In contrast, the recovery in oil prices will likely remain sluggish, as global demand growth is still very weak.

A lot depends on when global tourism (and jet fuel demand) will start to recover, which in turn depends significantly on the successful deployment of COVID-19 vaccines across countries.

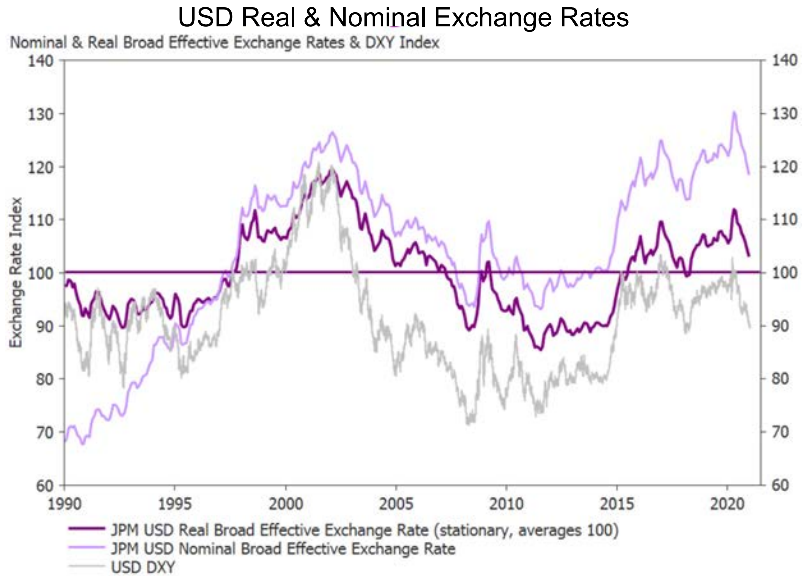
The improvement in US crude inventories has reduced some of the downside risk to oil prices. However, with structural changes across the energy sector still playing out, especially moves toward renewables, we could see a return to previous trends where oil prices are relatively stronger than traditional energy linked equities.

Further USD weakness is possible, while gold price gains may slow

We have noted for a while that the significant deterioration in the US current account deficit still forecast to come through, coupled with the Fed printing money, and less investor risk-aversion over time (motivating more capital outflows), should collectively allow the USD to depreciate further.

From a real valuation perspective, broad measures of the US TWI index may have about another 5% downside to play out. The USD DXY index has already depreciated by almost 10% and these forces have certainly contributed to the strength in gold prices over last year. However, if US yields continue to slowly drift upward over time then that could become a headwind for further strong appreciation in gold.

Figure: USD may see further weakness



Source: Refinitiv Datastream, 1 Jan 2021

Investors need to focus on fundamentals as valuations have increased significantly

With the strong rally in risk asset prices, valuation metrics for equities and bonds have increased significantly – in markets like the US bond yields and earnings yields are at record lows.

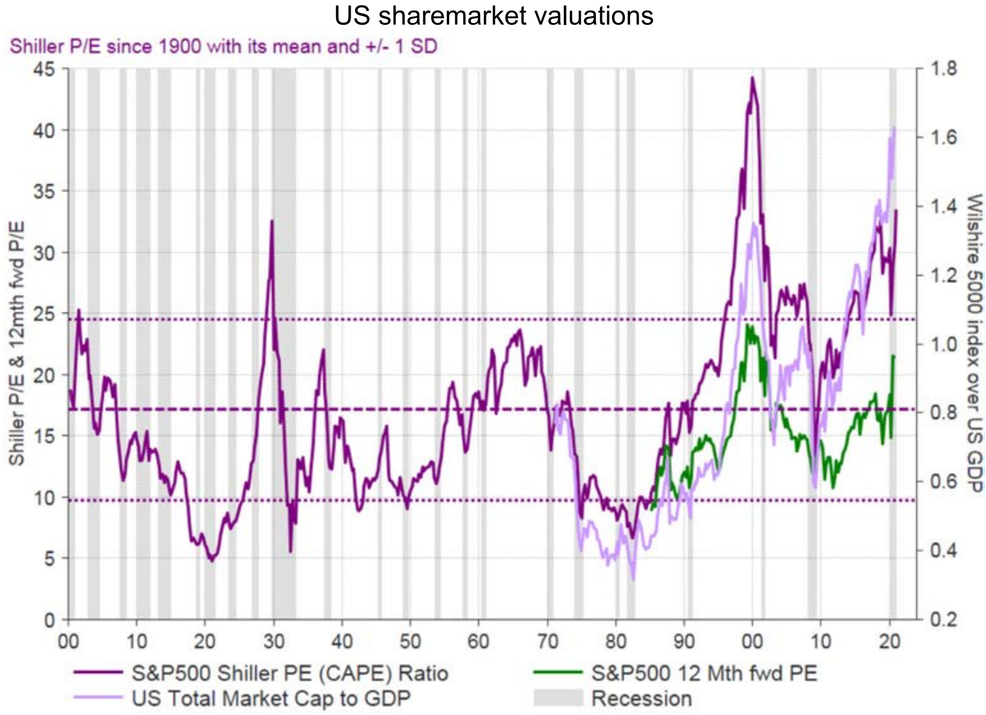
Figure: US bonds and US Equities are rich

Source: Refinitiv Datastream, 1 Jan 2021

What this means for equity investors is that they need to adopt a disciplined 'bottom-up' approach in valuing companies and they must focus on fundamentals: i.e. seek out companies with compelling or perhaps disruptive business models that are best able to deliver consistent upside earnings surprises. Equity investors are likely to find that they will have to pay a higher premium than otherwise for such companies.

The strong negative headwind from equity valuations rising too far too fast may be easing. Valuations may be reaching an inflexion point where they can stabilise, or slip back, as stronger earnings growth starts to come through. For example, in the US, more forward-looking valuation metrics for equities (e.g. based on the 12-month forward Price-to-Earnings) are not so stretched given expectations of stronger earnings growth. The most stretched valuation metrics, such as market cap to GDP, are significantly distorted by the temporary collapse in GDP.

Figure: US equity valuations could be at an inflexion point



Source: Refinitiv Datastream, 1 Jan 2021

In China, we also see that more forward-looking equity valuation metrics may be peaking as earnings expectations improve. That said, investors still have to be cautious and selective as China’s equity market has been prone in the past to significant pull-backs if valuations become too stretched.

Figure: China’s equity market valuations may also be peaking

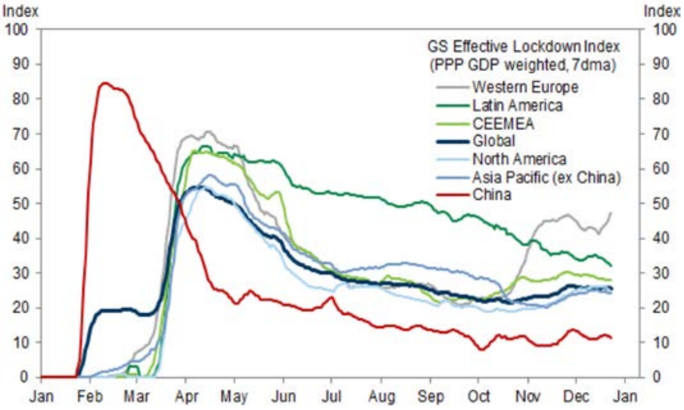
Source: Refinitiv Datastream, 1 Jan 2021

3. Key risks to the bullish outlook

Health risks and geopolitical concerns are more significant over the near-term

At this juncture key risks remain health-related, especially uncertainties surrounding the deployment and effectiveness of vaccines for COVID-19. For example, if successful inoculations are affected then it could slow the pace at which social distancing measures are removed. At the same time, there is the risk of resurgence in lockdowns if new COVID-19 cases surge and place renewed stress on health systems. This risk has become more concerning given the emergence of new strains of COVID-19 (e.g. B117) that seem more contagious. The key indicators to keep monitoring are lockdown indices, which have increased again across Europe, but are still less constraining than in Q2 2020.

Figure: Global lockdown indices: the concern is if they rise significantly



Source: Goldman Sachs December 2020

For Asian equities, in particular, geopolitical risks remain a key downside. China is in the process of re-examining market practice regulations that impact its large IT corporations, to make sure there are no significant monopolistic tendencies. So far, China’s policymakers have investigated Tencent’s music publishing business, and have modified some of the regulations covering micro-lending activities at organisations like Ant Group (which has forced the postponement of its scheduled IPO).

These events have increased the cyclical uncertainties surrounding what new regulations may imply for China’s IT/Fintech business models, and have likely hurt investor confidence to some degree. However, in the longer term, any enhancements to competitive regulations governing China’s IT/e-commerce landscape should make the industry more resilient and sustainable.

Geopolitics & risks from economic imbalances are potential medium-term problems

Other risks that could become more prominent in the medium term include the rise in global corporate debt. As we have highlighted before, with the cost of credit slashed to new lows, rising debt could ultimately lead to a painful deleveraging cycle when the next recession hits the global economy.

Another key medium-term risk is the prospect of an asset price bubble unfolding given cheap leverage and strong liquidity growth. If valuations eventually become too stretched, and stronger earnings growth does not materialise, then the risk of a painful asset price bubble bursting increases. In addition, the deteriorating US-China relationship could create headwinds over time for China’s companies to gain further global market share.