Recession to Recovery: Equities lead the way

Fullerton Investment Views

November 2020

Executive summary

- China is leading the global recovery, as our call of a painful but short global recession continues to play-out. Fullerton's aggregate global growth indicator has returned to positive, and as it continues to gain strength it will become even more supportive of risk-assets.
- Recoveries in economic activity and unemployment, back to pre-COVID-19 levels, will be much slower. However, this shouldn't be a headwind to global markets - what it will mean is that global central banks will keep interest rates very low for a prolonged period.
- With greater clarity that the end of the global recession is near, and as earnings growth expectations continue to improve, equities are performing very well. We now have a bullish view on global equities, and especially on China and Asian equities.
- Key risks remain a possible resurgence in COVID-19 lockdowns, greater geopolitical risks (including uncertainties surrounding the US elections), and valuations becoming too stretched and eventually leading to a risk-asset price bubble (that could painfully collapse).

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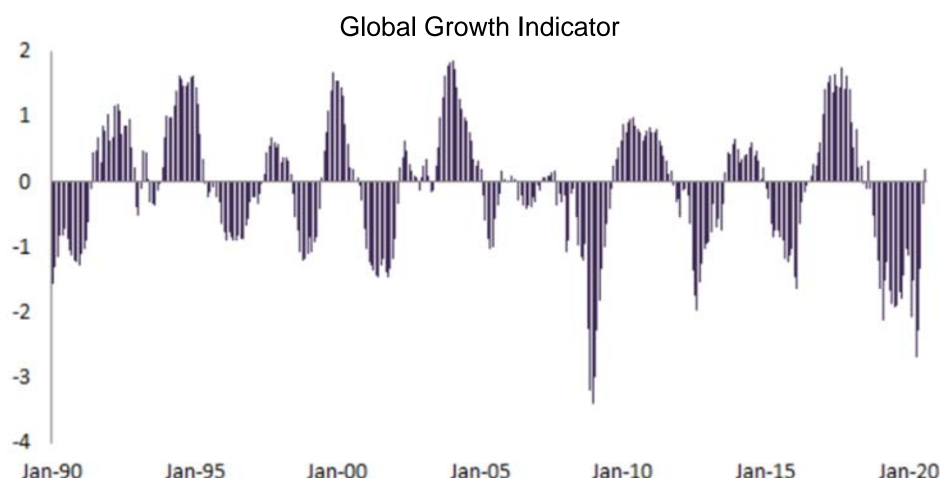
1. Macro backdrop continues to improve

Our baseline scenario that we outlined in our Q2 Investment View, of a painful but short global recession remains in-play. Our aggregate global growth indicator has returned to positive, and as it continues to gain strength it will become even more supportive of risk-assets.

Figure: Fullerton's global growth indicator

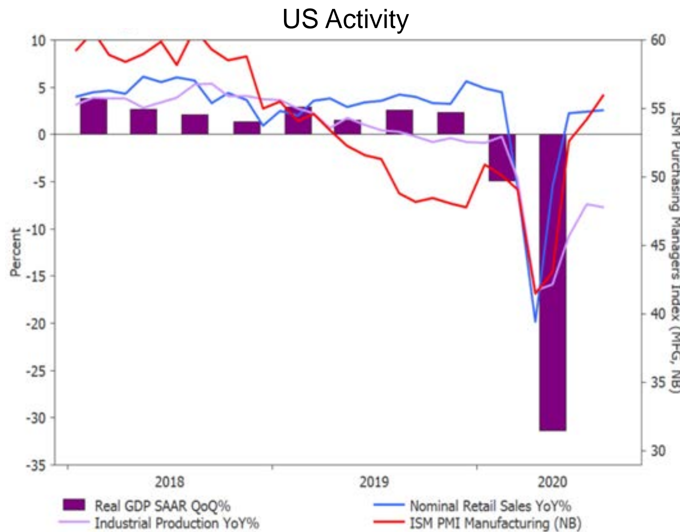


Source: Fullerton, October 2020. For illustrative purpose only. The information presented in the graphs above are calculated based on Fullerton's internal methodology and subject to changes. Past performance is not indicative of future returns.

China is leading the global recovery with its GDP rising again over Q2, while the rest of ASEAN is lagging as global trade growth is still very weak. Overall, we expect the global recession will end in Q3, when positive GDP growth should return for the US, Europe, and the rest of Asia.

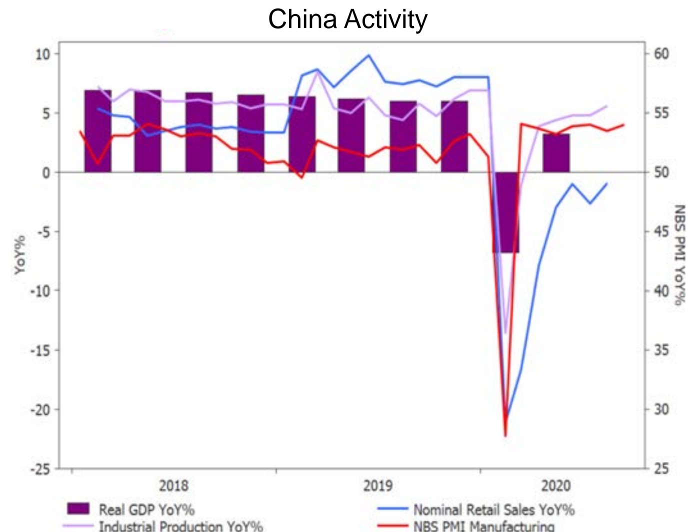
The recovery in China is being driven most by the rebound in its manufacturing, while across Developed Markets retail sales growth is stronger than industrial production. Developed Market industrial production growth should catch-up as Asian consumption rises, especially demands from China, and as global trade rebounds.

Figure: US activity indicators



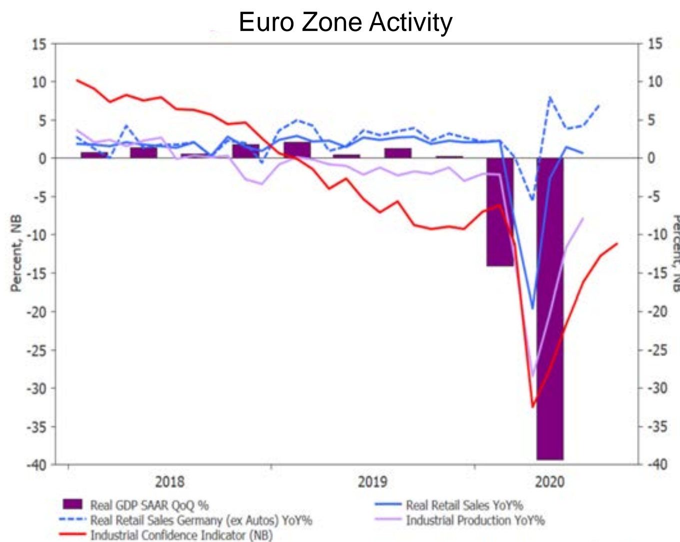
Source: Refinitiv Datastream, 30 Sep 2020

Figure: China activity indicators



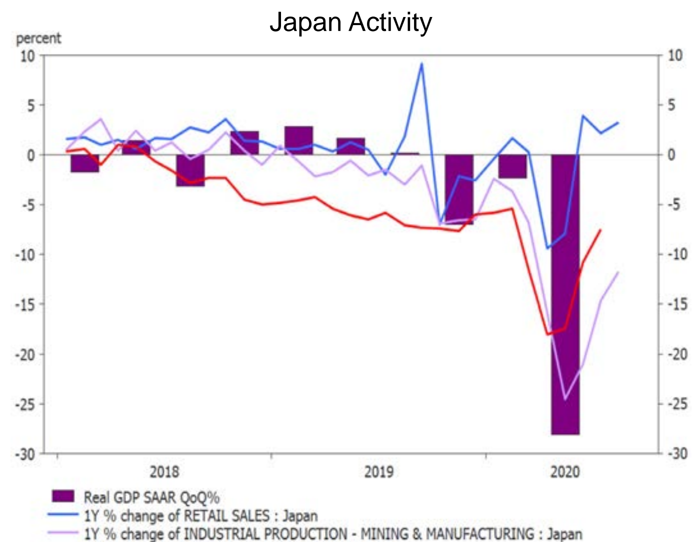
Source: Refinitiv Datastream, 30 Sep 2020

Figure: Europe activity indicators



Source: Refinitiv Datastream, 30 Sep 2020

Figure: Japan activity indicators



Source: Refinitiv Datastream, 30 Sep 2020

Forward expectations of global earnings growth continue to improve and markets have rallied significantly since April, driven by the stronger macro data and by the massive policy stimulus. The relative macro backdrop across the regions is reflected in the relative equity market performance this year: China and North Asian markets are leading, while ASEAN, and non-Asia Emerging Markets (EM) lag.

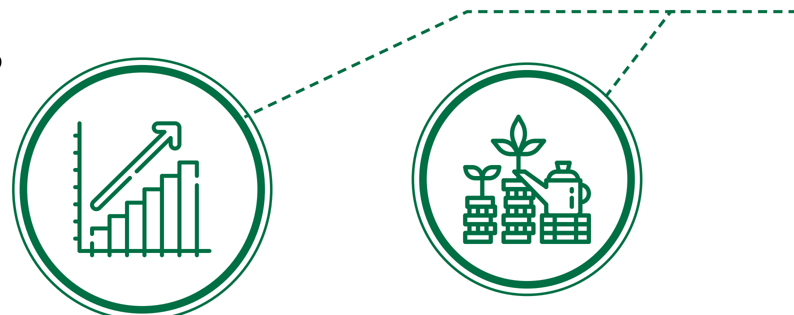
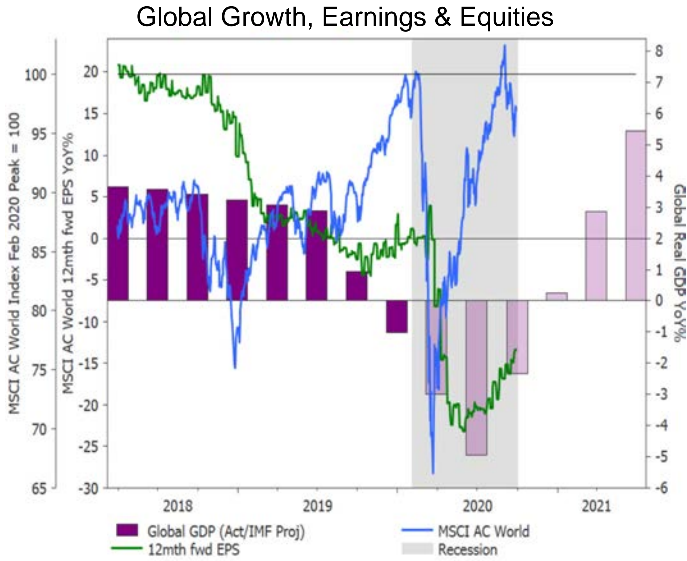
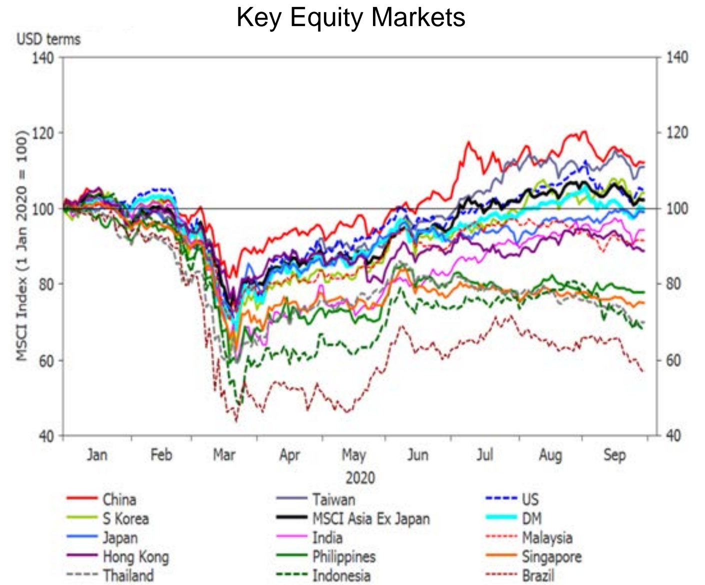


Figure: Global equities, forward earnings, and GDP growth forecasts



Source: Refinitiv Datastream, 30 Sep 2020

Figure: Key equity markets (YTD performance)



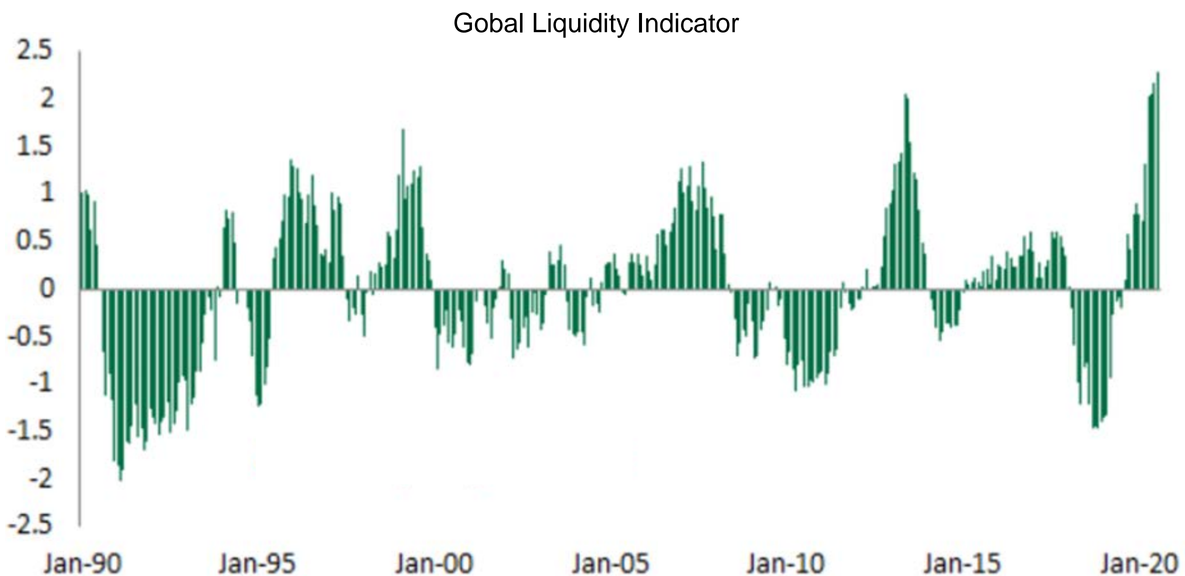
Source: Refinitiv Datastream, 30 Sep 2020

As we outlined in our Q3 Investment View, these recovery dynamics are not surprising – at the last recession (the GFC 2008-09) equity markets rebounded the fastest, with the aid of policy stimulus, and with the boost from positive GDP growth rates (when the recession ended). Earnings growth took a bit longer to rebound, while the labour market was very slow to heal. But the lagging weak labour market didn't really prove to be a significant headwind to stronger earnings growth and equity prices – because the return to positive GDP growth translated into a lot more spending.

Interest rates will likely be low for a long time, which is bullish for risk-assets

Fullerton's liquidity indicator remains very strong, and as we outlined in our "Below Zero" Investment Paper, such strong interventions by central banks can create an environment that is very favourable to financial markets and most risk-asset prices (click here to view).

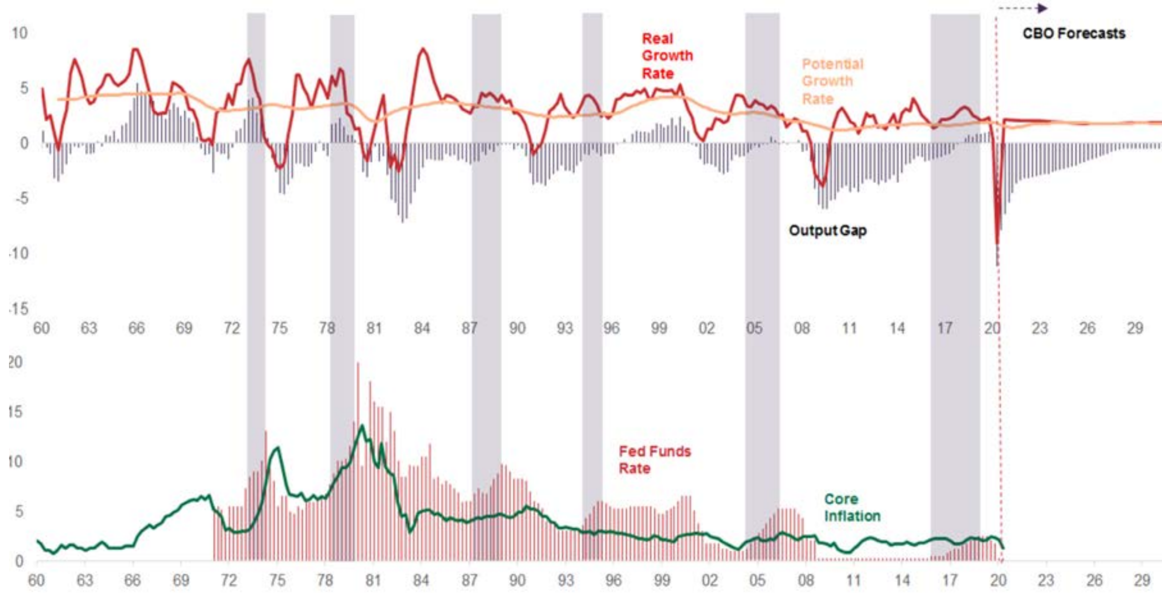
Figure: Fullerton's global liquidity indicator



Source: Fullerton, October 2020. For illustrative purpose only. The information presented in the graphs above are calculated based on Fullerton's internal methodology and subject to changes. Past performance is not indicative of future returns.

Since its dual-mandate era, the Fed tends to only hike rates when the US output gap is almost closed, when GDP growth is running above potential growth, and when core inflation is on an uptrend. Based on US output gap forecasts, the Fed is likely to keep its policy rate at zero for at least 5 years (if not more) which is longer than current forward-market pricing. Even then, when the Fed eventually tightens policy, interest rate increases are likely to be small and slow over time, with little threat to wider risk-asset performance.

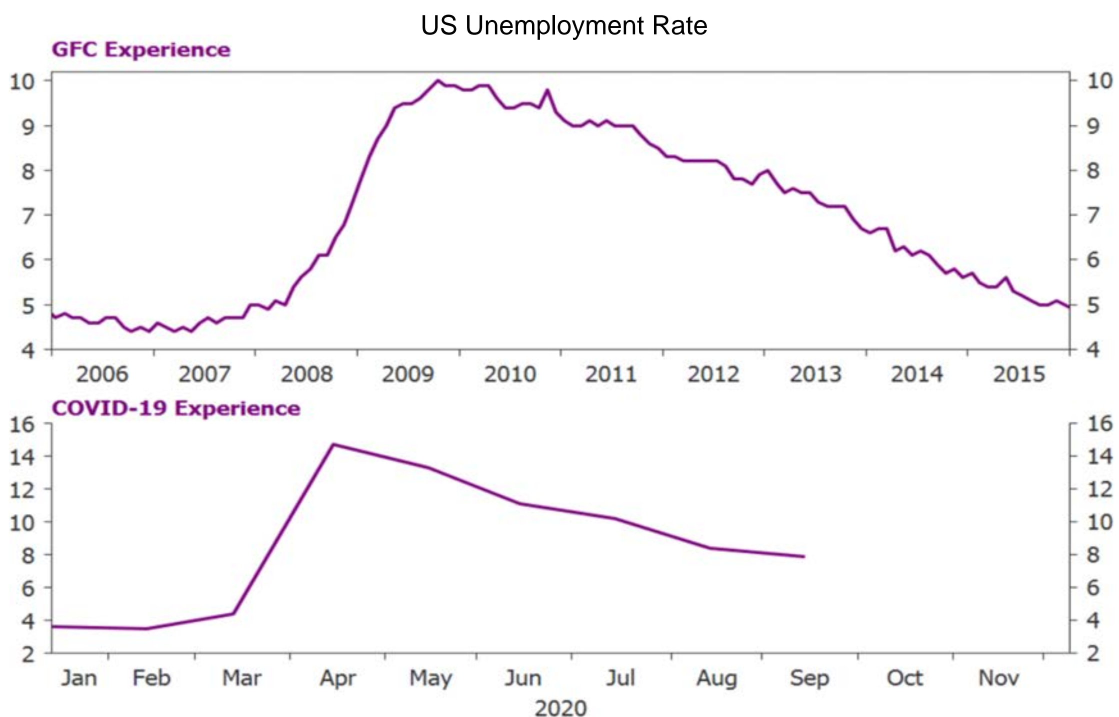
Figure: US GDP growth, potential growth, the output gap, core inflation, and the Fed Funds rate



Source: Fullerton, October 2020. Shaded-bars denote periods when the Fed is raising rates.

US unemployment has improved a lot since its high in April, which gives greater insights into the amount of job-losses that proved temporary as COVID-19 lockdowns eased. Further improvements in the unemployment rate will be much more GDP growth dependent, and if the dynamics of the last cycle (i.e the post-GFC experience) can be repeated it will take at least 4 years from now for the labour-market to normalise.

Figure: US unemployment rate



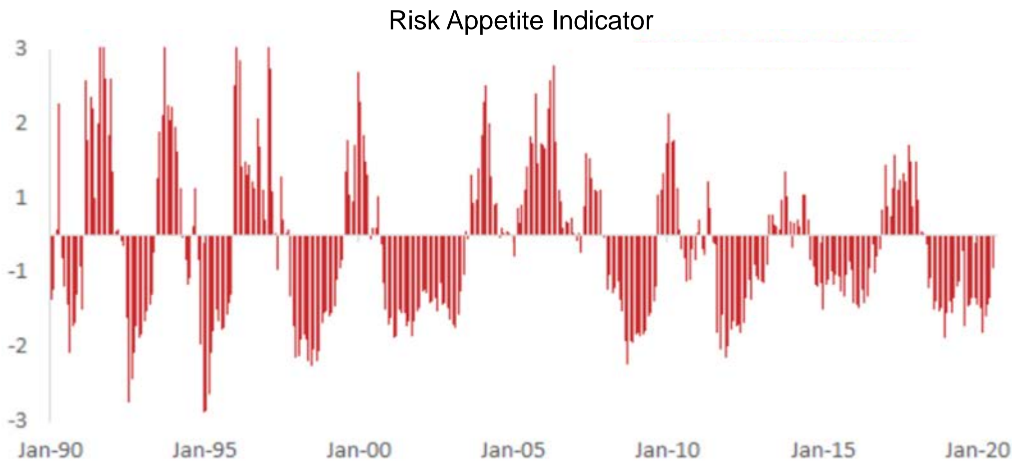
Source: Refinitiv Datastream, 12 Oct 2020

We believe the equity market rally is sustainable; but markets may be more sensitive to shocks, until risk appetite improves

We continue to believe the strength in global markets is sustainable, driven by the strong rebounds in growth that are unfolding, ample liquidity, and significant policy stimulus. Our risk appetite indicator is improving and is significantly stronger than during the collapse in equity markets over March.

However, while our risk appetite indicator is improving it is still negative and signals that many investors remain underinvested. The lack of participation tends to make equity markets much more sensitive than otherwise to shocks e.g. as we saw in June (when COVID-19 infections jumped significantly in the US) and again in September (with the US-led tech sector sell-off).

Figure: Fullerton's global risk appetite indicator



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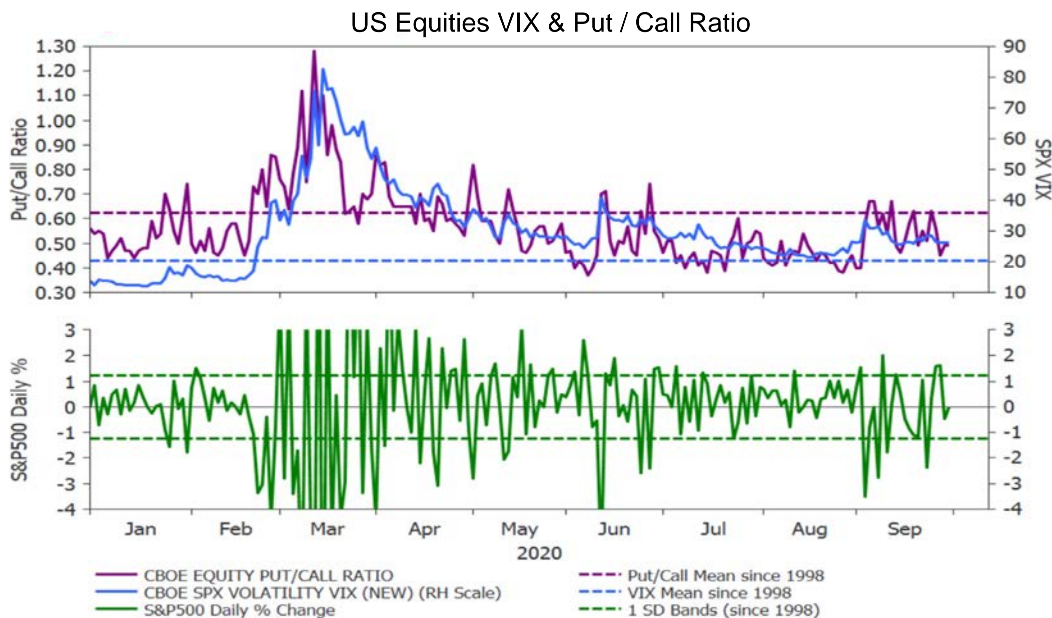
Such corrections are common as markets recover, and the latest tech-led sell-off seemed to be more a reflection of realignments in positioning rather than a broader fundamental shift. Significant flows into cash and options helped drive the Nasdaq to new highs at the end of August, and without further positive news, the market became too stretched which has now largely reversed. US equity market volatility has fallen back as measured by the VIX, while the put/call ratio has fallen back below its historic average.

Figure: Daily changes in US equities, the VIX, and Put/Call ratio



Source: Refinitiv Datastream, 30 Sep 2020

Markets may remain volatile for a while, until the rally broadens and uncertainties reduce

While VIX volatility has fallen, it is still above its historic average. Global markets may remain more volatile than normal, especially as uncertainties rise in the run-up to the US elections.

Markets are already trying to 'price-in' possible policy shifts. A Democrat victory increases the risk of tighter US fiscal policy next year, assuming some reversal of President Trump's tax-cuts dominates greater government spending, which could be a headwind for equities. However, a Biden win could also result in somewhat easier US foreign policy with less confrontational actions against China and lower trade war risks.

With just one month to go before the US elections, markets were further rattled by the news (2 October) that President Trump and his wife had contracted COVID-19. Fears eased as President Trump made a very fast recovery, and is keen to get his re-election campaign back on track.

On balance, investors should become more positive by year-end once the US election is over, and there is more clarity on US policy priorities going forward, and how the development of a COVID-19 vaccine is progressing.

It is also important to keep in mind that it is still early days in the global recovery. Expectations of 12mth-forward EPS YoY growth have improved, but are still falling. When global earnings YoY growth expectations are positive again then the rally should broaden further across industrials and sectors more dependent on global trade. However, other sectors, that are most dependent on social interactions, such as air-travel, may only recover strongly when a vaccine for COVID-19 is developed.

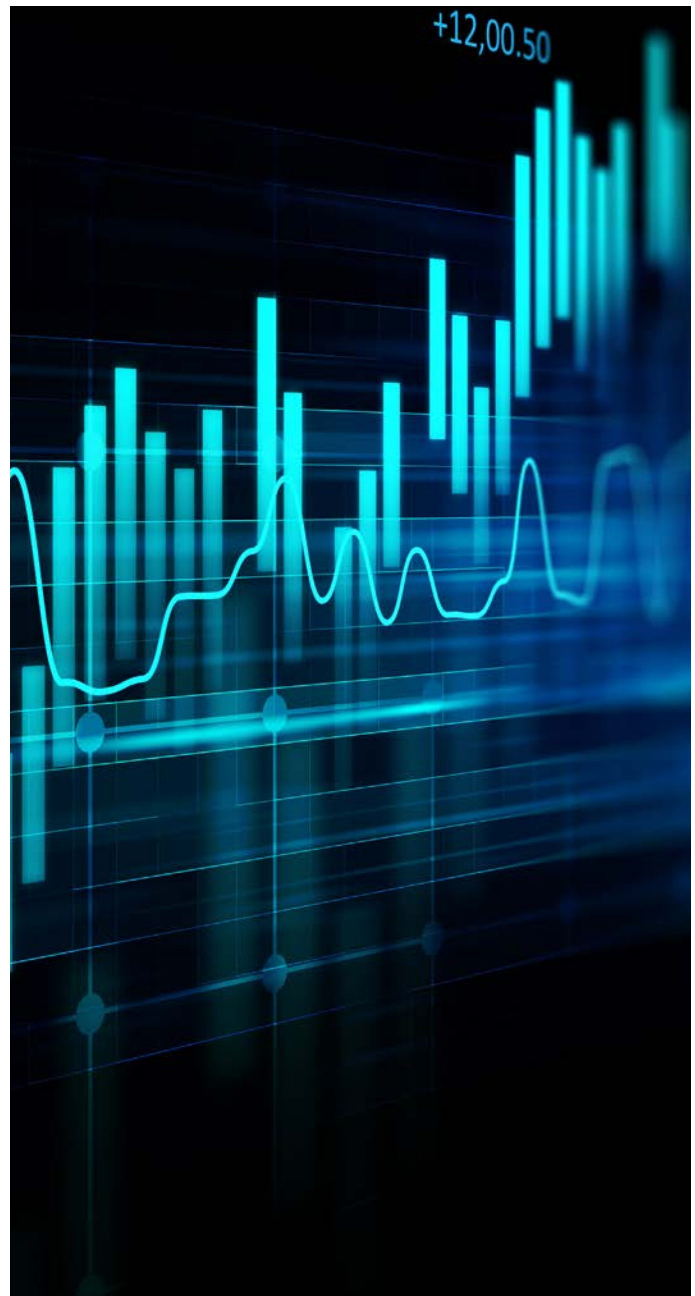
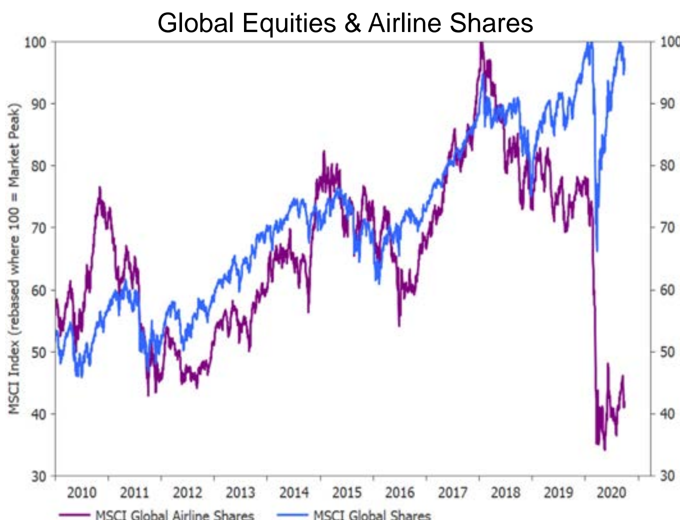


Figure: Global equities and airline shares



Source: Refinitiv Datastream, 30 Sep 2020

Investors need to focus on fundamentals as valuations have increased significantly

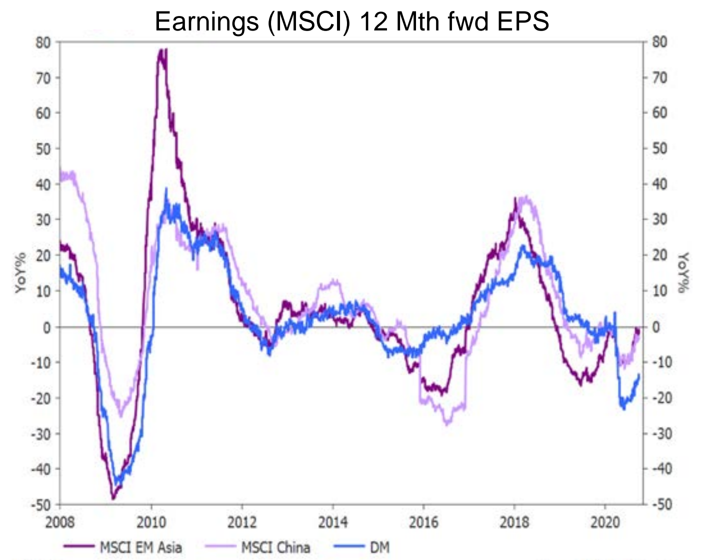
With the strong rally in equities, valuation metrics have increased significantly, which could become a key headwind for investors (not to mention exposing markets to potential bubble risks and associated corrections). Valuations can be harder to read in an environment where interest rates are very low, and so investors need to also focus on fundamentals: i.e companies with the strongest balance sheets, and those best able to expand their market share over time.

Investors may find they have to pay a higher premium for companies that can grow their market share. However, the strong negative headwind from valuations, rising too far too fast, may be easing. Valuations could be reaching an inflexion-point, where they can stabilise, or slip-back, as stronger earnings growth starts to come through.

Figure: Valuation across Asia & DM

Source: Refinitiv Datastream, 30 Sep 2020

Figure: Earnings growth expectations across Asia & DM



Source: Refinitiv Datastream, 30 Sep 2020

2. Investment strategy: stronger macro makes us bullish on risk assets

We are bullish on risk assets and the recovery has created the buying opportunities we expected (and outlined in our Q2 Investment View), but investors still have to be selective given the risk that the post COVID-19 environment is fundamentally different.

We continue to favour the sectors that are best positioned to navigate the post COVID-19 world e.g. technology, consumer staples, utilities, and health care. As the recovery continues to gain momentum, the rally should broaden further to other sectors that have been lagging, such as industrials, consumer durables, apparel retail, and financials.

Equities –we are bullish globally, and especially on China and Asian equities

We have revised-up our positive call on equities to bullish, and we especially like China and Asian equities. China is the growth engine of the region and its recovery, and rising middle-class spending, is driving solid investment returns from sectors like tech, healthcare, finance, e-commerce, and consumer brands (we also have a Box Item with more details on why we are bullish on China equities). These trends will likely continue for many years to come, and the rest of Asia also benefits as intra-Asian trade growth improves.

For Asian equities, geopolitical risks remain a key downside, as the deteriorating US-China relationship could create headwinds for China's companies to gain further global market share – especially if the US shifts its protectionist policies from trade, and further into industry, technology, and financials.

US equities should continue to get significant support from the growth rebound underway, the huge policy stimulus, and from Fed policy as it will likely keep interest rates at zero for many years.

Fixed income – we believe Asia and China offer investors solid risk rewards

Ultra-low and negative government bond yields across much of DM reduces the attractiveness of fixed income investments. In the US, bond demand will be supported by the Fed's significant policy stimulus, which will help to contain yields.

That said, US yields are likely to face some pressures to slowly rise from 'rock-bottom' rates over time, given the growth recovery, the strength of the equity market rally, and rising inflation expectations. Improvements in risk sentiment (especially after the US elections), and some investor rotation away from government bonds, could help US yields to slowly rise and recouple with the stronger macro outlook. Overall, we maintain our negative outlook on DM fixed-income.

Figure: US 10y yields and equities

Source: Refinitiv Datastream, 1 Oct 2020

Figure: US 10y yields and inflation expectations

Source: Refinitiv Datastream, 1 Oct 2020

Because of higher yields versus DM, Asia, and China's fixed income in particular, should be attractive to investors seeking solid risk-rewards with a desire to diversify away from DM. China's fixed income is also superior to most Emerging Debt markets because of China's strong sovereign fundamentals, its low correlations with global markets in general, and the likelihood of a favourable risk-reward balance.

We are positive on corporate credit, and especially so on Asian High Yield

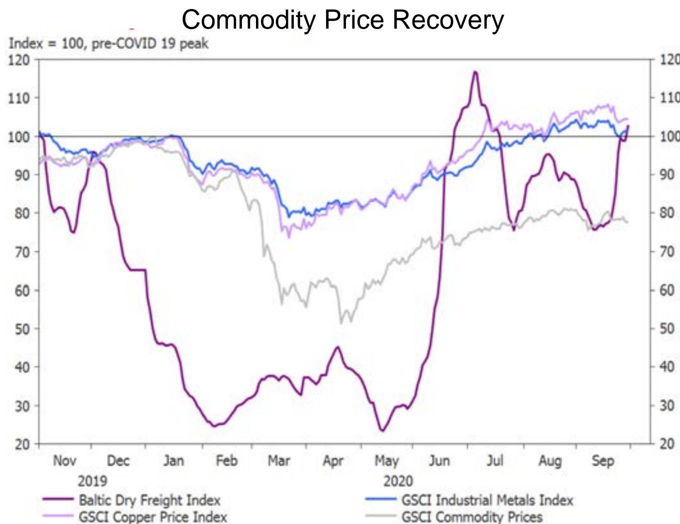
We remain positive on US corporate credit, and Asian Investment Grade, as spreads have tightened and default rates are unlikely to surprise too much on the upside. Further spread compression will likely be limited, so investors should expect coupon-carry to dominate returns.

We believe Asian High Yield offers a bit more scope for spreads to improve, and default events should remain largely idiosyncratic. As a result, investors still need to continue to focus on balance sheet fundamentals to 'cherry-pick' the strongest companies.

We remain positive on commodity prices, with strong support from China's demand

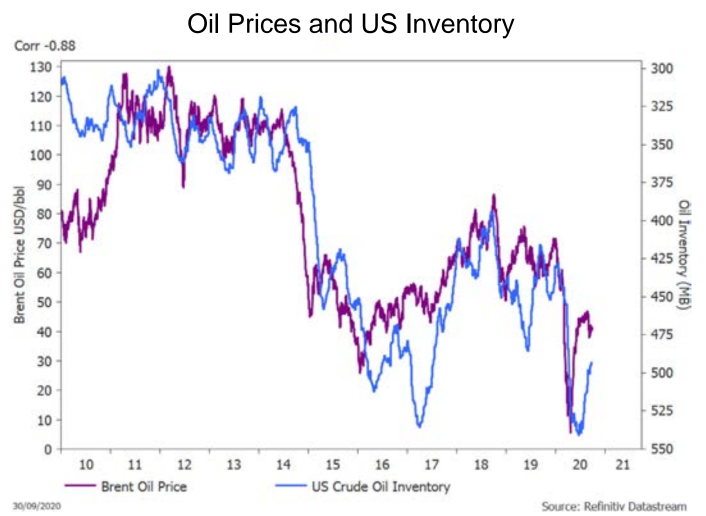
Metal prices, especially copper, have rebounded as we expected, as China's demand recovery has been strong (and as markets are much more confident that the US will avoid a prolonged recession). The recovery in oil prices will likely remain sluggish, as global demand growth is still very weak. However, the fall in US inventories has reduced some of the downside risks to oil prices.

Figure: Commodity prices and freight activity



Source: Refinitiv Datastream, 30 Sep 2020

Figure: Oil prices and US inventories



Source: Refinitiv Datastream, 30 Sep 2020

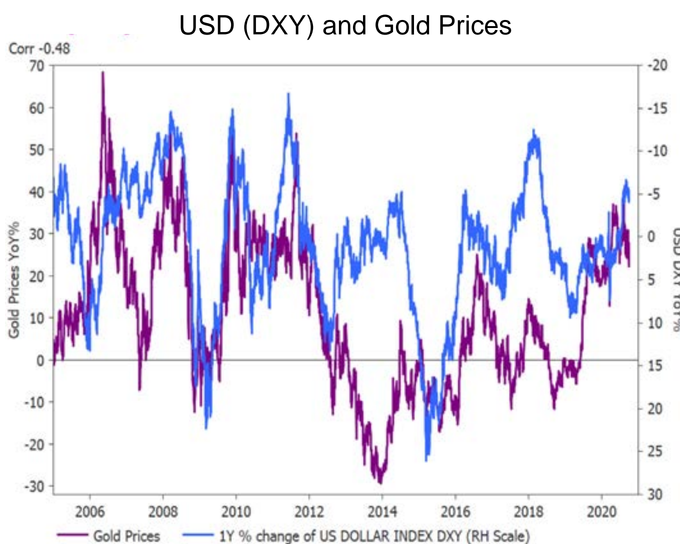
We believe a weaker USD is likely, which can create further upside for gold prices

The significant deterioration in the US current account deficit to come, 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.

The correlation between changes in the USD and changes in the US current account forecasts suggests that the market may have ‘priced-in’ about half of the USD correction so far. Dollar weakness may pause, however, given the uncertainties surrounding the US elections. After the US elections, US dollar weakness should continue given its weak fundamentals.

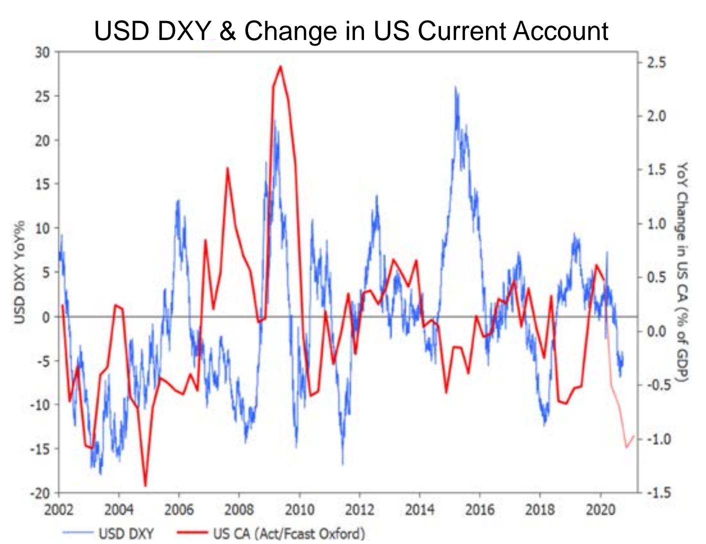
Gold prices can rally further given very low interest rates and the likelihood of a weaker USD. Further, with geopolitical risks likely to persist for a while, we believe there is more upside to gold prices than downside. However, if US yields start to slowly drift upward over time then that could become a headwind for gold price appreciation.

Figure: USD and gold prices



Source: Refinitiv Datastream, 30 Sep 2020

Figure: USD and US current account



Source: Refinitiv Datastream, 30 Sep 2020

A Bullish Case For China's Equities

A common misconception is that China is only an attractive investment destination when its GDP growth is strong. We have shown statistical evidence that there is no strong relationship between China's GDP growth rate and its equity market returns – what matters much more is the output gap or business cycle (click here to view).

China's equity returns have performed well during growth decelerations as long as realised growth is above or close to trend (e.g. over the last 10 years China's real GDP growth has fallen from 11.5% to 6.1% p.a. yet its equity returns were 5% p.a.). In addition, investing in China-A equities also gives some diversification away from Developed Markets, especially over the longer-term.

China is the growth engine of Asia, with many global-leading sectors

China is leading the global recovery from the COVID-19 recession and its rising middle-class spending can drive solid investment returns. We are most excited about China's attractive alpha opportunities, in particular across higher value-added consumer, technology, e-commerce, and healthcare sectors.

As China continues to rebalance itself away from its dependence on heavy industries, and pushes to be a global leader in hi-tech sectors under its "Made in China 2025 plan", spending on R&D from electronics to science is growing. Ahead of the US, China's 5G roll-out will immediately create the world's largest 5G network.

E-commerce is more significant in China than in many other countries. Technology and e-commerce giants such as Tencent and Alibaba are recognised today as global leaders and innovators in their field.

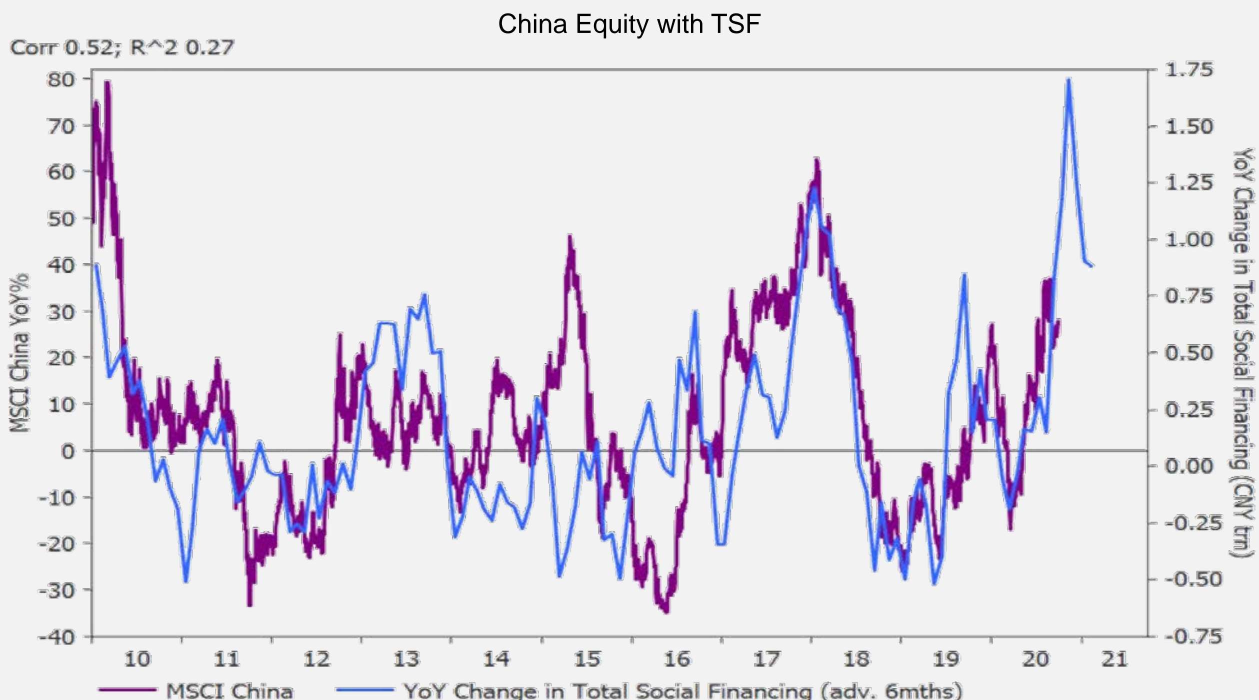
As China's middle-class continues to rise in its importance it is not just consumption-linked investments that can do very well but also investments linked to financials and to services, such as: healthcare, education, and renewable energy.

These positive trends in China will likely continue for many years to come, and the rest of Asia also benefits as intra-Asian trade growth has been significantly stronger than global trade growth for more than a decade now. Furthermore, with the deterioration in US-China relations, it becomes increasingly important for China to capitalise on its longer-term trading-bloc initiative (i.e. 'the belt and road') and the strength of its supply-chains domestically and across Asia.

Liquidity growth is very supportive to China's equities

What is proving to be very supportive to China's equities over this rally is its very strong liquidity growth. Growth in total social financing (TSF) is a significant leading indicator of China's equity market performance, and although TSF growth is slowing it still signals solid equity returns for the next 6-12 months.

Figure: China's equities and total social financing (TSF)



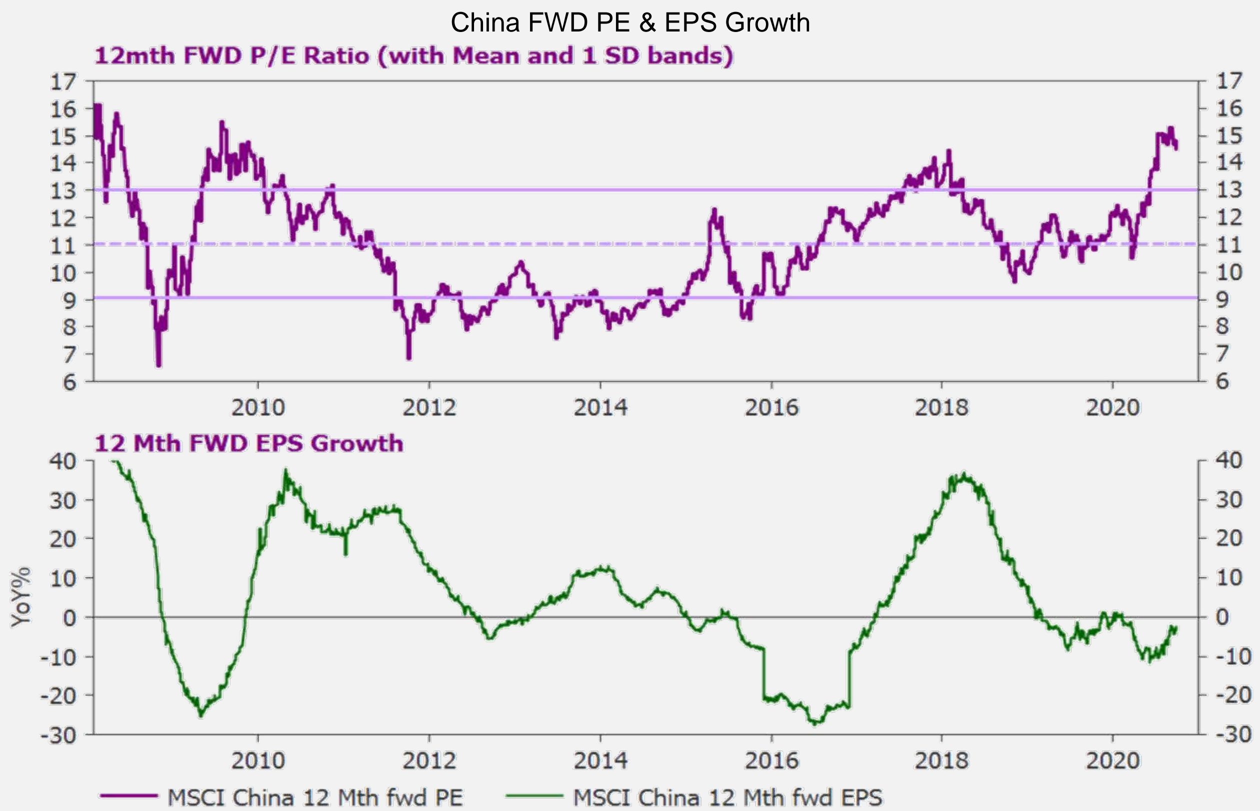
Source: Refinitiv Datastream, 30 Sep 2020

High valuations are a risk-factor to monitor

Valuations have increased significantly, which is understandable given the rebound in growth and the strength of the rally. In this environment, investors may have to pay a larger premium than otherwise for fundamentally strong companies that can increase their market share.

Valuations can stabilise, and perhaps slip-back, as stronger earnings growth comes through. 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 valuation and expected earnings growth



Source: Refinitiv Datastream, 30 Sep 2020

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