From 3G to the 3i's: Transitioning to innovation-led gains

Fullerton Investment Views - Quarterly report

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Executive summary

We remain bullish on global risk assets, namely Developed Market (DM) equities, and positive on Asia equities and fixed income.

- For the 12 months ahead we expect positive returns from both Asia equities and fixed income, with the strongest returns from DM equities.
- US GDP growth may be slowing and unemployment rising, but earnings growth expectations are still very strong which underpins our bullish outlook. In addition, liquidity conditions remain supportive and Fed rate cuts are likely to give an extra boost to risk asset performance over 2025.
- Japan equities should continue to benefit from robust earnings growth which reflects favourable productivity gains and competitiveness. Across Europe, it is lagging DM, but its earnings should gradually improve with stronger external demand (led by the US) and falling cost pressures.
- Within Asia, key regional economies can also benefit from stronger DM demand. Rising earnings growth expectations, especially across South Korea, India, Taiwan, and Singapore, underpins our positive outlook.
- As China's earnings growth expectations appear to be bottoming, along with its cyclical deflation stress, we have shifted to a positive outlook. Despite longer-term 'involution' headwinds, positive investment opportunities can be found across value stocks, materials, and consumer discretionary.
- As the global economy is expected to achieve its 'soft-landing', corporate credit investors, especially across DM, should enjoy reasonable returns. We 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.

01 Risk-Asset Outlook

Fullerton believes that the robust trends in investment returns over H124 can continue into 2025

We have a new thematic - investing under the 3i's (i.e. Industry 5.0, Innovation, and Involution) – that complements our 3G forces[1].

- Industry (5.0) is the 'AI-new technology-metaverse' driven global theme that we believe will create better products and new spending, with an additional boost to productivity and profitability, across many sectors over time[2].
- Innovation is a trend that has been unfolding for years, especially across the US, Japan, and Germany, which is driving greater productivity, lowering costs, and boosting earnings.
- Involution reflects China's longer-term headwinds as it searches for policy solutions to end weakness across the real-estate sector, resolve economic-wide deflation, and boost corporate performance[3].

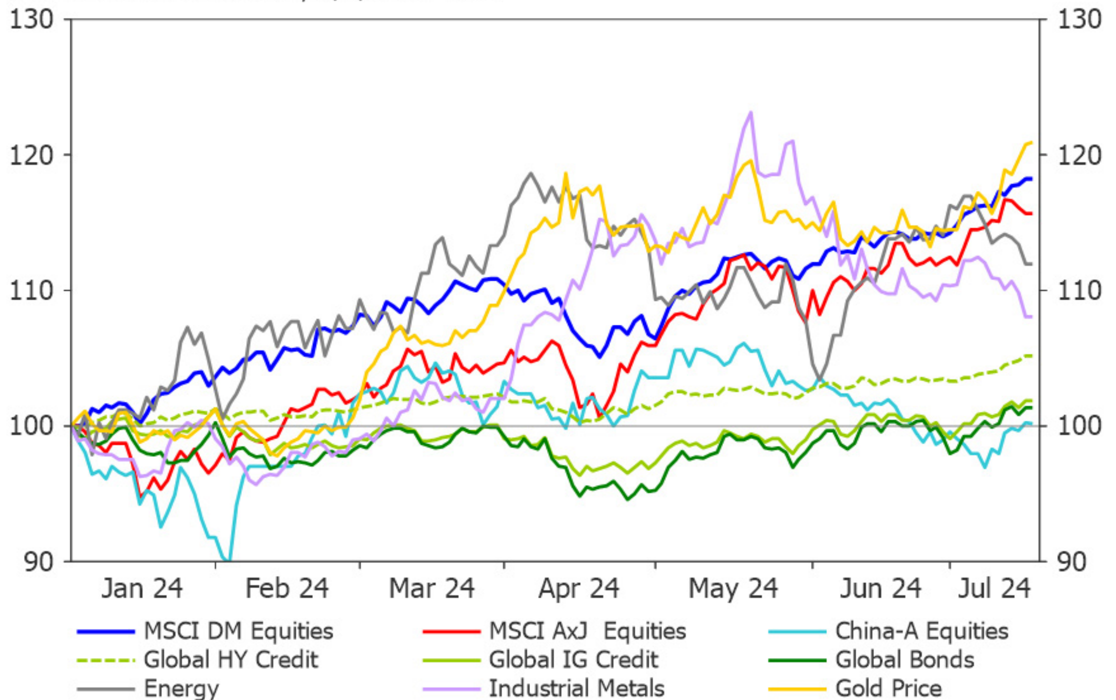
Industry 5.0 and innovation, driving DM's favourable economic environment, underpins our bullish outlook on DM equity returns. Adding China's involution to the mix, the '3i's' are contributing to the 'Great Decoupling' where DM equities continue to outperform Asia.

1. We first introduced our '3G' investment environment thematic back in November 2022 where the 'Great Decoupling' represented the deviation in market performance unfolding across DM versus Asia. The 'Great Reset' reflected our view that interest rates could prove high for longer. Lastly, the 'Great Volatility' suggested that investors would sometimes need to navigate bouts of 'risk-off' given the trend rise in geopolitical uncertainties.
2. Industry (5.0) and 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 is covered here: https://www.fullertonfund.com/fullerton-insights/investment-opportunities-in-the-age-of-artificial-intelligence/ We also explore how AI analytical tools have played a pivotal role in Fullerton's investment decision process https://www.fullertonfund.com/wp-content/uploads/2023/11/Using-Augmented-Intelligence-to-enhance-our-investment-process_Nov-2023_FINAL.pdf
3. Chinese "neijuan" 内卷 often translated as "involution". It matches Western ideas of diminishing returns: when putting more into something only results in getting less back.

Commodity prices remain buoyant as geopolitical uncertainties persist

Industrial metal prices (see Figure 1) are still high, but have corrected back from their unsustainable cyclical surge (driven by copper and aluminium prices). Beyond improving DM demand, industrial metal prices should also remain supported by pockets of strength across China's industrial firms (which has also helped push equity prices for its materials sector higher).

Figure 1: Risk asset performance YTD



Source: LSEG Datastream, July 2024

Oil and especially gold prices continue to be supported by elevated geopolitical risks and uncertainties (see Figure 1). Gold prices have also been boosted by strong demand from global central banks as they increase their reserve-asset allocations to more prudent levels. We maintain our view that gold is a useful asset for investors to hold in their portfolio as it can give some downside protection against adverse geopolitical shocks.

Elections this year, notably in the US, may add to investor uncertainties but outcomes should not derail the favourable fundamentals for risk asset returns - especially for US equities

As we emphasised in our Q1 Investment Views, this year there are several key elections around the world and investors will need to remain watchful if outcomes, especially in the US, increase the likelihood of tighter protectionist policies. Any significant tariff increases may simply accelerate the trade and decoupling shifts unfolding already e.g. the US trade deficit is already at record lows with China, and decade lows with Europe (as a percent of GDP). US policy shifts toward more intense protectionism, or driving geopolitical 'spillovers'[4], could prove positive for US stocks (especially those with domestic centric supply-chains and revenues) and negative for foreign equities (especially for firms that rely on US demand).

Global investors' expectations seem split on how the election of President Trump could impact the investment environment[5]. For example, surveys of reserve managers, central banks, and 'real-money' investors (i.e. the UBS Annual Reserve Manager Survey, July 2024) have suggested that a US Republican victory may be positive for US equities and bonds (i.e. lower yields). Global surveys of investors (i.e. BoA GFMS, 16 July 2024) also revealed expectations that a US Republican victory could be positive for US equities, but negative for bonds (i.e. higher yields). Almost by definition Republicans cannot be too inflationary for the US economy because that would push yields too high and become unambiguously negative for US equities (which is against the most common expectation).

The historical record suggests that Republicans tend to pursue legislation that favours US business, lowers taxes (i.e. easier fiscal policy), but also cuts social supports (i.e. tighter fiscal policy). Democrats have some bias toward more spending (i.e. easier fiscal policy) but favour higher taxes (i.e. tighter fiscal policy) for funding. Not surprisingly then, most of the time after a US election there always tends to be some offsetting forces with new government policies.

4. For example, Donald Trump said in an interview with Bloomberg Business week that Taiwan should "Pay the US for its defence. They did take about 100% of our chip business. We are no different than an insurance company. Taiwan does not give us anything". As a result, shares of Taiwanese chip manufacturer TSMC fell 2.4% on the news, with the Taiwan market down 1% and the US S&P500 up 0.6% on the day. Source: Reuters News, 17 July 2024.
5. On 21 July President Joe Biden's exit from the US presidential race could help to narrow the overall popularity gap between the Republicans and the Democrats over time. A closer than otherwise election race on 5 November could increase the chance of a divided US government remaining in power (i.e. a Republican House of Representatives and the Democrat-controlled Senate). The 'big-picture' key issues remain largely unchanged from what we presented at the start of the year. For more details on our assessment of the potential investment implications of the US election see: https://www.fullertonfund.com/fullerton-insights/2024-us-elections-and-potential-investment-implications/

As a result, on average over the cycle, US nominal GDP growth and inflation can hold trend and fiscal policy is neutral i.e. a zero fiscal impulse. While there is no sustained bias across Democrats or Republicans for net spending creating inflationary pressures, significant fiscal challenges will eventually hit the US which will require bold austerity actions around 2030.

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

Even if US GDP growth slows and unemployment rises, we maintain our conviction that earnings growth can remain strong, driven by robust productivity growth and low real unit labour costs. In addition, broad financial conditions are supportive to US equity returns and may get an added boost over 2025 from Fed rate cuts. Across US households, financial wealth is very high and this can continue to drive consumption spending. For the US corporate sector, investment growth is solid and this can reinforce productivity gains in tandem with new developments over time from IT-metaverse related technologies.

DM equity returns should also remain supported by Japan's performance, given its robust productivity growth (second only to the US) and its very competitive real exchange rate. Contributions to DM equity performance from Europe can also be positive as earnings growth should recover further with the benefit of robust US demand. Furthermore, Europe equity valuations are modest and as the ECB slowly cuts rates over time easier monetary conditions can give an added boost to investor sentiment.

We are positive on Asia equities

Key regional economies are benefiting from global demands associated with Industry 5.0, especially across new industrials, the technology sector, high-value added manufacturing, and consumerism. As a result, we maintain our view that the favourable performance across equity markets in South Korea, Taiwan, and India can continue.

We have upgraded our outlook for China equities to positive as its earnings growth expectations seem to have bottomed along with the worst of its cyclical deflation pressures. We have emphasised for a while that despite China's longer-term involution headwinds it is a 'trading market' that offers opportunities for nimble and selective investors. For example, even as weaker earnings growth has unfolded, China value stocks, consumer discretionary, and materials have outperformed the broad equity market. We believe that the latter, in particular, may continue to benefit from stronger manufacturing supply-chain demands (across Asia and DM) and high industrial metal prices.

Fullerton remains positive on corporate credit and global sovereign bonds

With global growth remaining supportive, default rates across global high yield (HY) corporate credit have been well-contained and investors, taking additional risk, have been rewarded with returns above investment grade (IG) corporate credit (see Figure 1). That said, returns from global IG corporate credit have rebounded positively, in harmony with sovereign bonds. What has helped is that DM yields have fallen on lower inflation and stronger investor sentiment that the Fed will join the ECB with policy rate cuts over time.

Fullerton maintains its view that returns from Asia IG corporate credit should hold 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.

As yields stabilise again at levels consistent with slower growth and lower inflation, then favourable income streams can dominate total returns again. For 'hold-to-maturity' bond investors yields are attractive in the US, and across China, South Korea, India, and Indonesia. Sovereign bonds can also give some downside protection if growth unexpectedly slumps.

Summary of Fullerton's Views (12 months ahead)

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

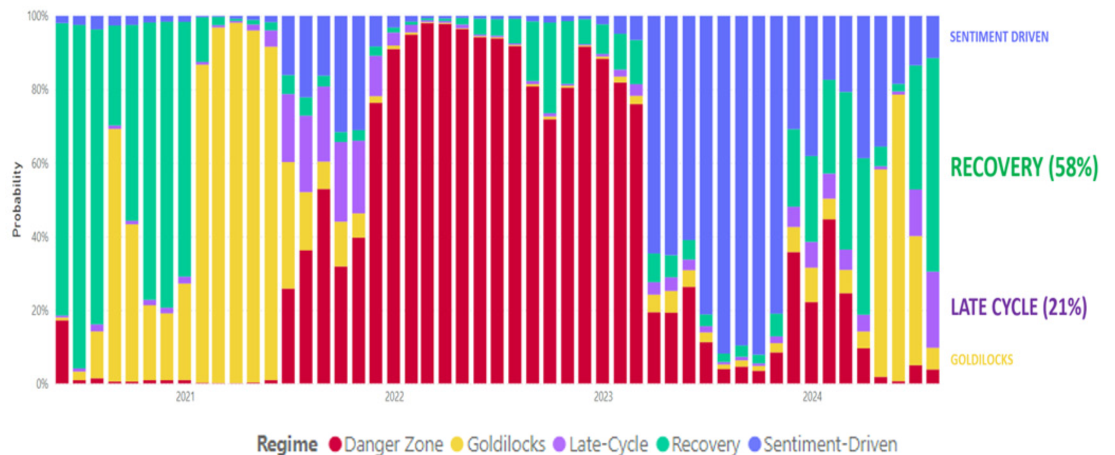
Source: Fullerton Fund Management, July 2024. Views may be subject to change without prior notice.

02 Investment Environment

Fullerton's Investment Environment Regime Indicator has moved back to 'Recovery' which can still be very supportive for risk asset returns

The transition from the 'Goldilocks' signal, in our Q2 Investment Views, reflected some slowdown in growth momentum across the US, Japan, and China, as well as some easing in risk appetite. For the rest of the year, provided global growth remains around trend, then the investment environment can be positive for risk asset returns. The probability of moving toward a 'Late Cycle' signal has increased, but it remains modest because liquidity growth is supportive and global central banks are moving toward easier policy (which should continue to keep the investment environment within a Recovery or a Goldilocks regime. See Figure 2).

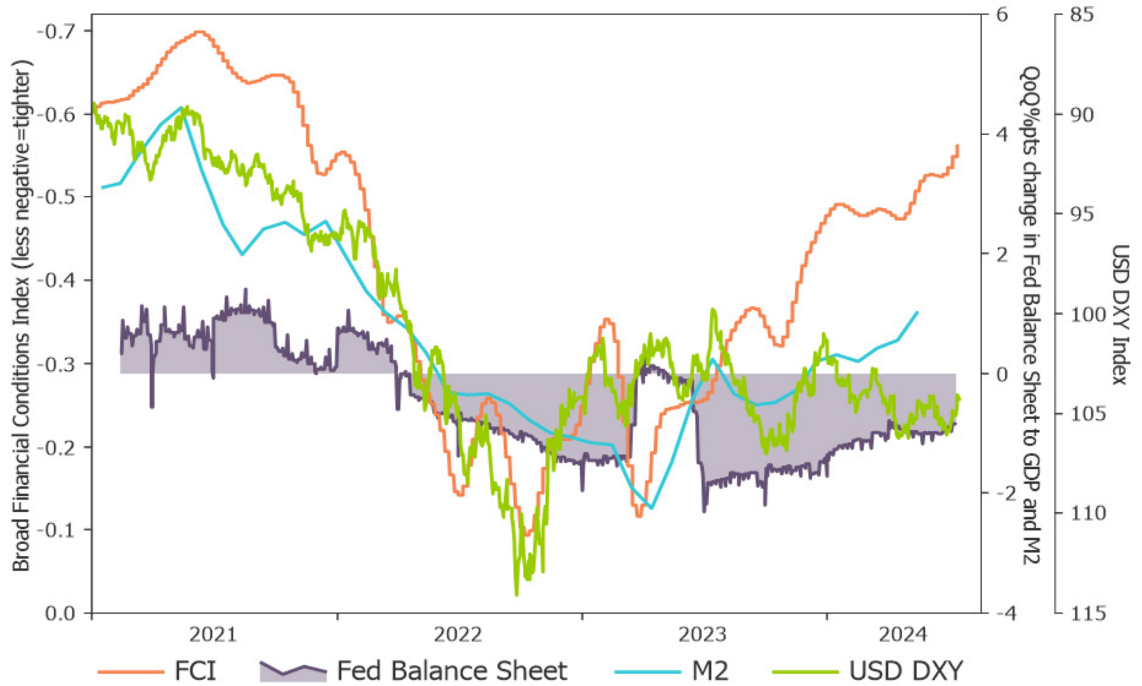
Figure 2: Fullerton's Investment Environment Regime Indicator



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

We have emphasised, ever since Q423, that the US economy remains very well supported by easing liquidity conditions (see Figure 3). This has been driven by positive money growth, robust domestic credit, and favourable financial markets. Most importantly, US financial conditions have continued to ease even with high interest rates, a falling Fed balance sheet, and a strong US dollar. It is these favourable liquidity conditions that are a key driver of Fullerton's Regime Model signal being in 'Recovery' (and not 'Late Cycle').

Figure 3: Indicators of US broad monetary conditions (FCI)



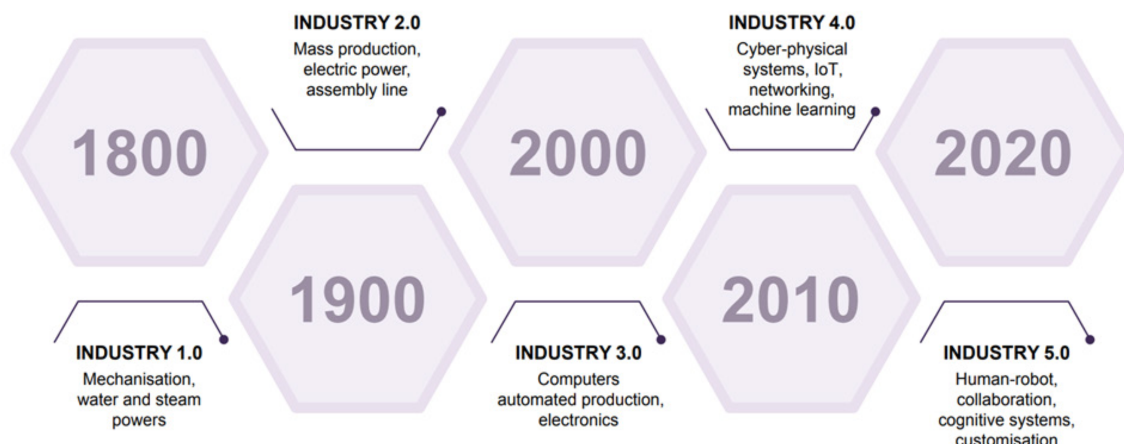
Source: LSEG Datastream, July 2024

Fullerton's 3i's lie at the heart of why we maintain our bullish outlook for global risk assets

Industry (5.0) is the latest development that can create new demand, further boost productivity, lower costs, and increase earnings

Industry (5.0) is the 'AI-new technology-metaverse' driven global theme that we believe will create better products and new spending, with an additional boost to productivity and profitability, across many sectors over time. Every generation has its own 'cutting-edge' technology and often we are too optimistic on shorter-term impacts, and too conservative on longer-term benefits (see Figure 4).

Figure 4: The waves of industrial revolution



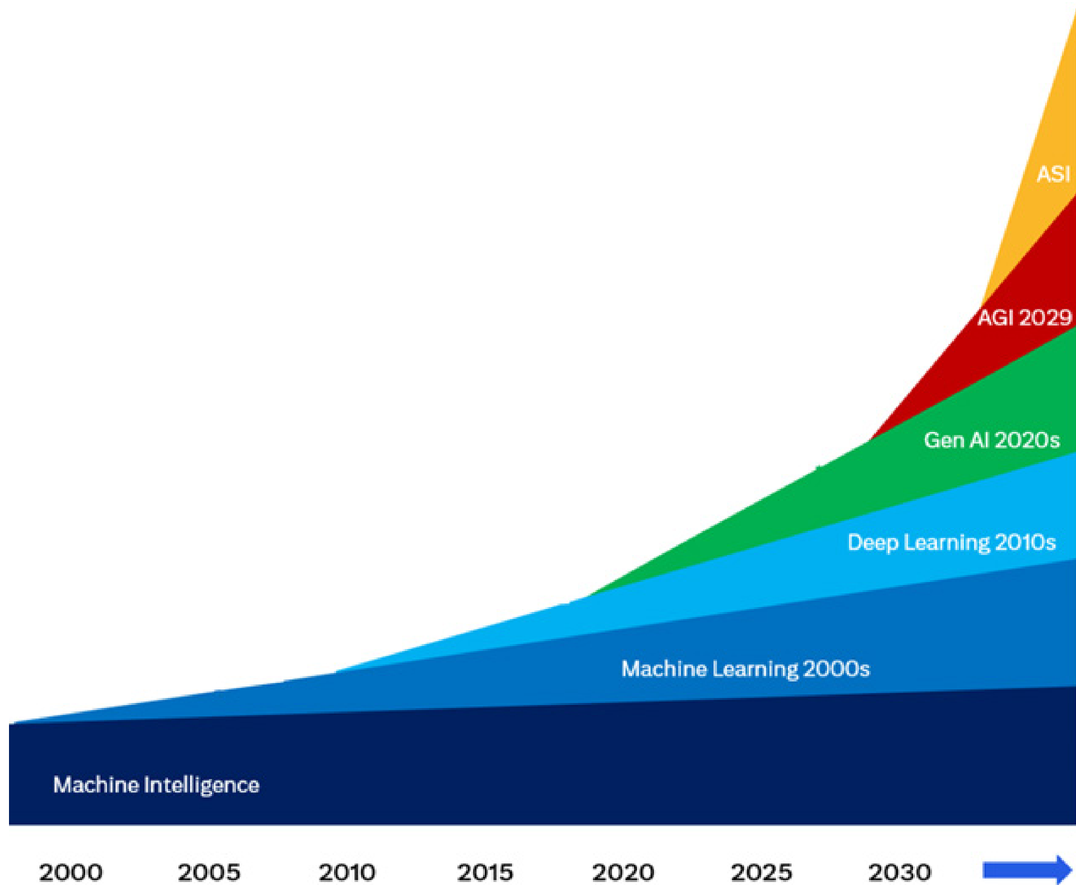
Source: Bank of America, "Me, Myself and AI", February 2023.

Also see Fullerton's views on the investment opportunities in the field of Artificial Intelligence at: https://www.fullertonfund.com/wp-content/uploads/2024/01/Investment-Opportunities-in-the-Age-of-Artificial-Intelligence_Oct-2023_FINAL.pdf

Firms, consumers, and investors all need to remain patient for the rewards to flow across different countries and sectors, and to be optimally monetised. For example, even the most obvious and relatively simple productivity enhancing technology - the tractor - still took decades to reach peak utilisation and impact[6]. Fast-forward to today and the best estimates for the impacts of AI, and related technologies, is from 2020 (i.e. the start of Industry 5.0) until well beyond 2030 (see Figure 5).

6. From its invention in 1892, peak deployment and utilisation of the tractor (in the US), replacing mules and horses, was not until 50 years later.

Figure 5: The process of innovation towards Industry (5.0)



Note: From 2030 onwards: Artificial General Intelligence (AGI) is a type of AI that matches human capabilities across a wide range of cognitive tasks. Artificial Super Intelligence (ASI) refers to AI technology that is expected to surpass the human mind.

Source: 'What machines can't master: human skills to thrive in the age of AI' (May 2024), Citibank.

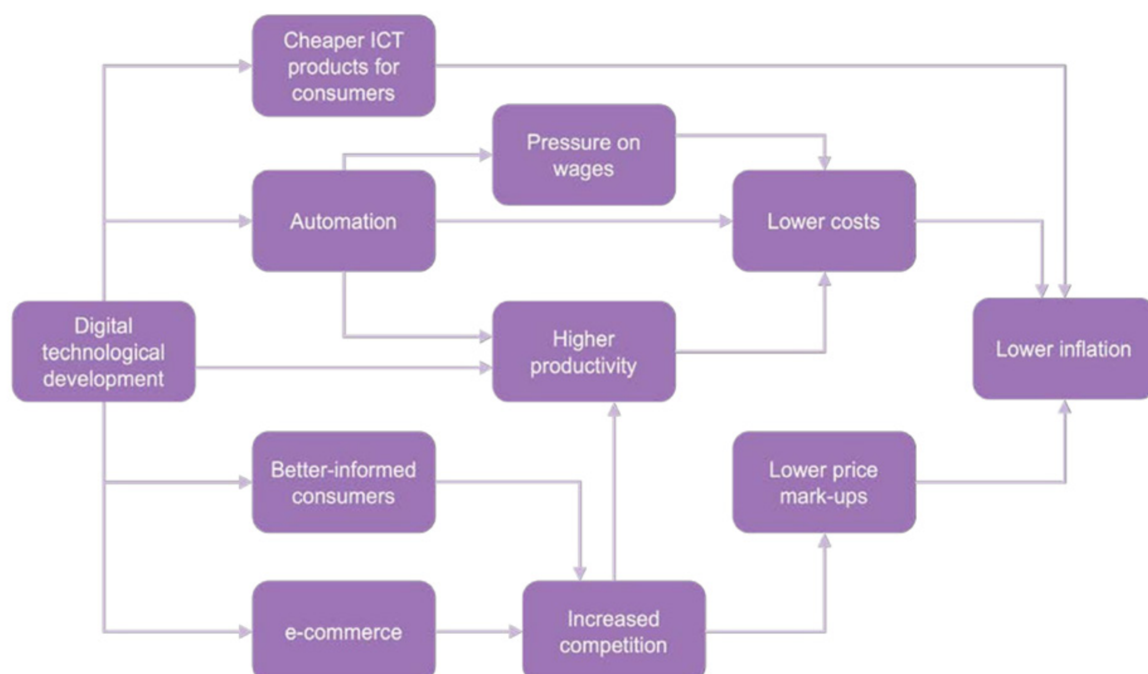
What new-tech can potentially create: Higher Revenues + Cost Savings = Greater Earnings

The positive impacts to come from AI and new related technologies may ultimately prove to be no different from the impacts of the internet or from electrification in the 1890s[7]. But what matters the most is the potential transformation on the core fundamentals of business operations (see Figure 6). That is likely to impact across many sectors in terms of - new demand created (by enhanced e-commerce and the 'metaverse' transition), higher revenues, and cost savings - which equals greater earnings.

7. For example, technical progress often 'rhymes with the past'. US productivity performance during Industry 3.0 (computers/automation, 1970) actually tracked that from Industry 2.0 (mass production/ electrification, late 1800s). Source: Syverson, the Economist (2013).

For example, corporate revenue can rise over time because IT-tech can drive a more rapid transmission of ideas, enhance e-commerce, and facilitate the production of higher-value added goods and services for consumers. Significant cost savings can be created as IT-tech increases automation and efficiencies. In turn, higher productivity can reduce raw material demands, costs of production, and better align wages to workers' value creation.

Figure 6: How new technology can feed-through the macro economy to increase consumer demand, productivity, lower costs, and boost earnings



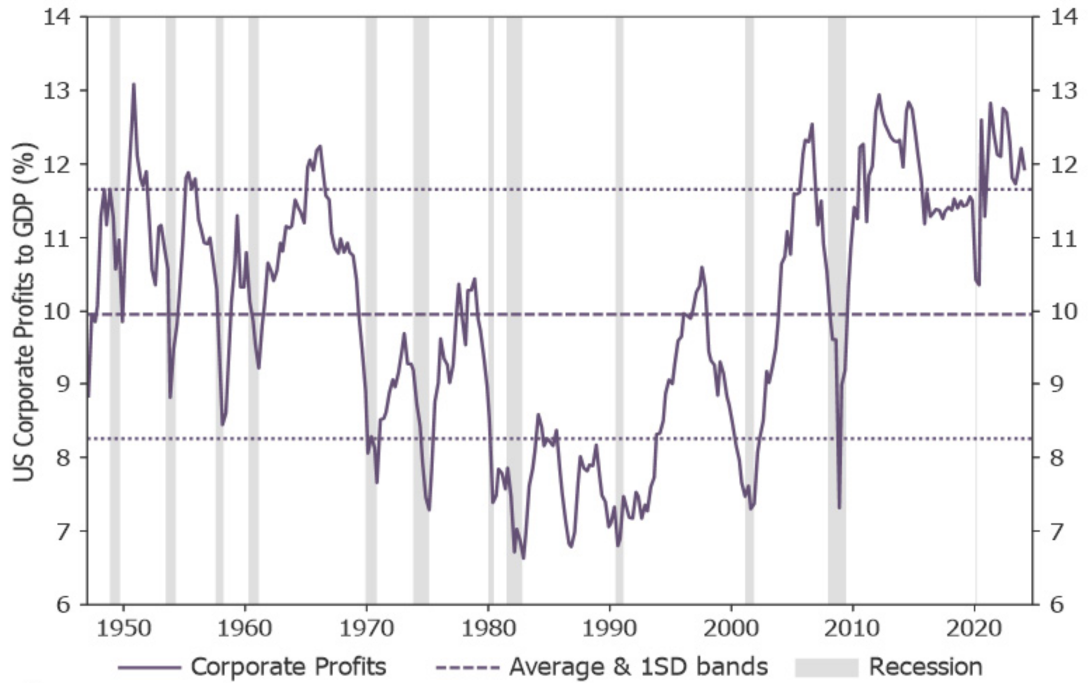
Source: Fullerton Fund Management Company Ltd, https://www.fullertonfund.com/fullerton-insights/investment-opportunities-in-the-age-of-artificial-intelligence/

Our second 'i' - Innovation will get a boost from Industry 5.0, but it is already a well-established trend since 2010 that has contributed to 'US exceptionalism', and more recently to Japan's strong equity returns

'Innovation' is a trend that has been unfolding for years, especially across the US, Japan, and Germany, which reflects greater productivity, lower costs, and higher than otherwise earnings.

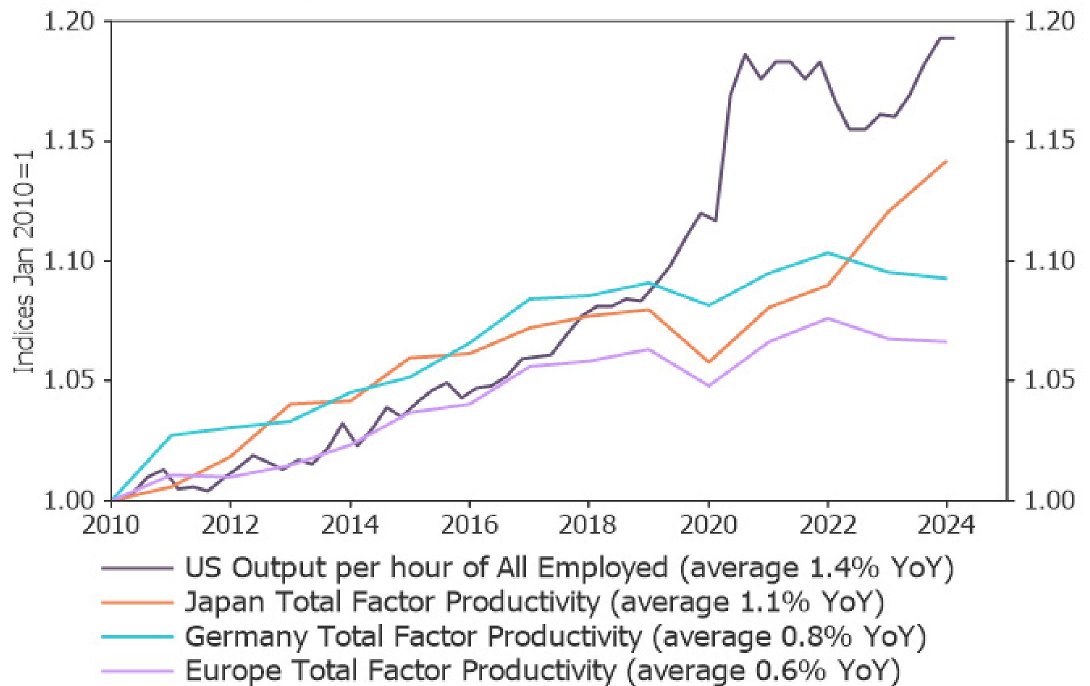
No time in the past, except perhaps the 1960s, has seen such a sustained lift in US corporate earnings (see Figure 7). That alone explains why many describe the environment today as one of US 'exceptionalism'. Japan has also performed well and rebounded strongly after the COVID-driven recession, while Germany is the productivity leader of Europe (see Figure 8).

Figure 7: US corporate profits (as a share of GDP)



Source: LSEG Datastream, July 2024

Figure 8: Productivity performance across the G3



Source: LSEG Datastream, July 2024

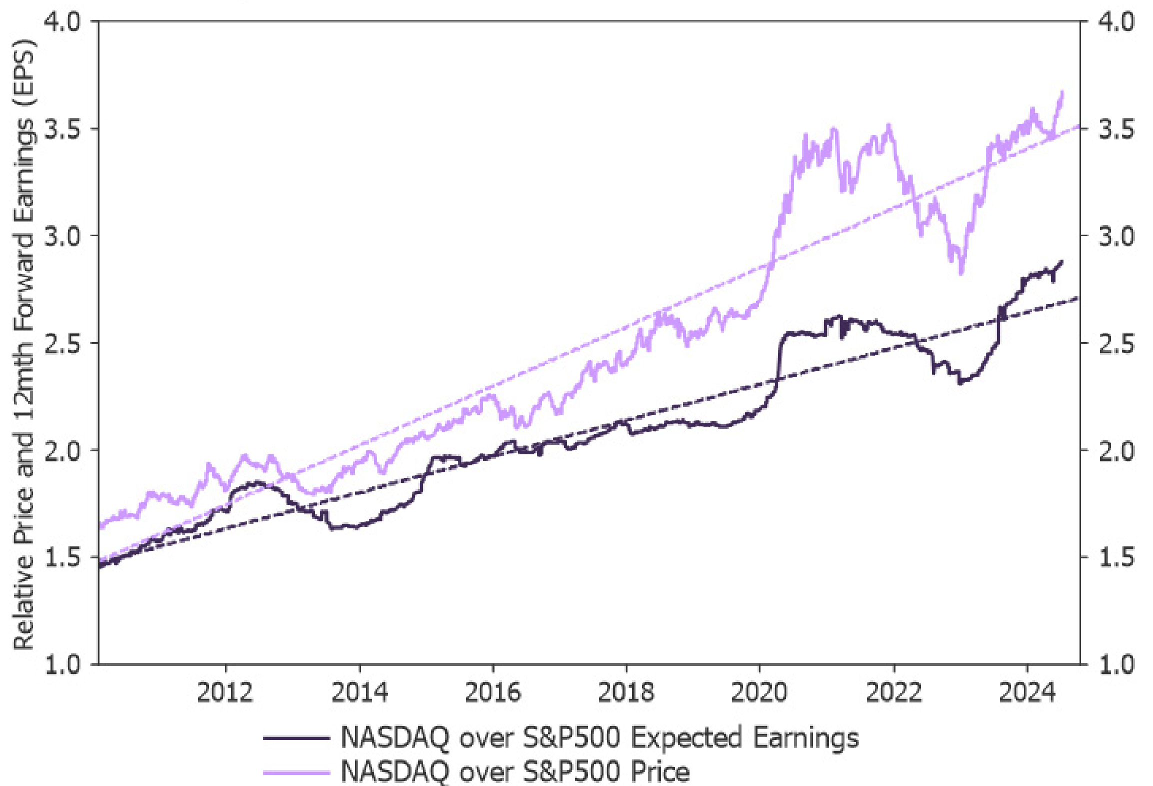
But isn't the tech sector today just a big bubble re-run of the late 90s?

Against this backdrop, many investors worry that a bubble may be unfolding because the hype surrounding the 'magnificent-seven' in the US just seems too excessive. However, strong performance of the US tech sector is not new, and it is quite different post 2010 than in the 1990s.

Ever since 2010 the US IT sector earnings performance and returns have followed similar positive trends and have outperformed the broad market (see Figure 9). Today, US IT sector earnings (relative to the market) remain a similar degree above trend as relative pricing. With IT sector returns in harmony with earnings growth fundamentals, it does not signal an obvious bubble at this juncture.

Figure 9: US IT sector performance relative to the US equity market

US NASDAQ 100 vs S&P500



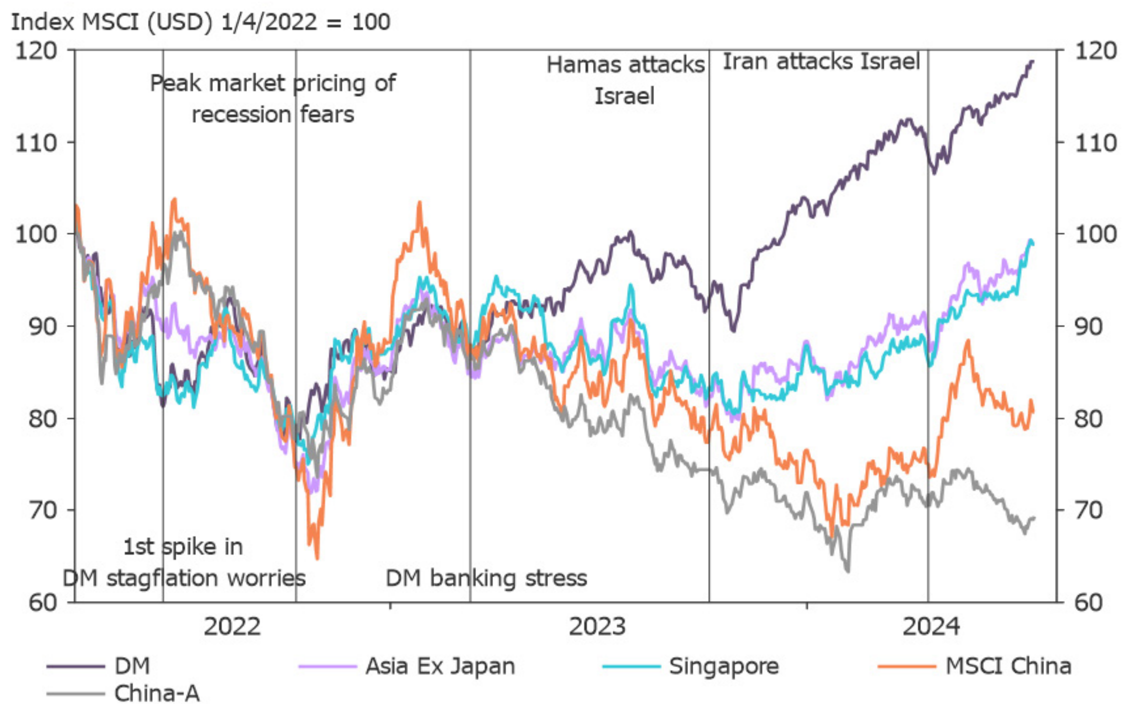
Source: LSEG Datastream, July 2024

The 3rd 'i' - adding China's 'involution' to the mix, drives the 'Great Decoupling'

The last of our thematic 3i's is 'involution', which reflects China's longer-term headwinds as it searches for policy solutions to end weakness across the real-estate sector, resolve economy-wide deflation pressures, and boost corporate performance. With a trend decline in potential GDP growth, policymakers' strategy has been to channel rising per capita incomes to try and boost the domestic economy with stronger consumption. But such rebalancing is proving a slow process: after 15 years the consumption-to-GDP ratio has only increased by approximately 5% pts[8]. To further strengthen the domestic economy, China's policymakers have also sought to improve R&D and public-sector (SOE) output efficiencies.

What this means is that while China equities may not transform into a robust 'trending market' until its long-term headwinds are resolved, it can still offer cyclical alpha. For example, as we have seen over the last few years, growth stocks have struggled but value stocks have outperformed.

Figure 10: the 3i's collectively driving the 'Great Decoupling' since 2023



Source: LSEG Datastream, July 2024

8. China's Consumption to GDP ratio was 35% in 2008 and 39% in 2023. Source: LSEG Datastream, 2024.

03

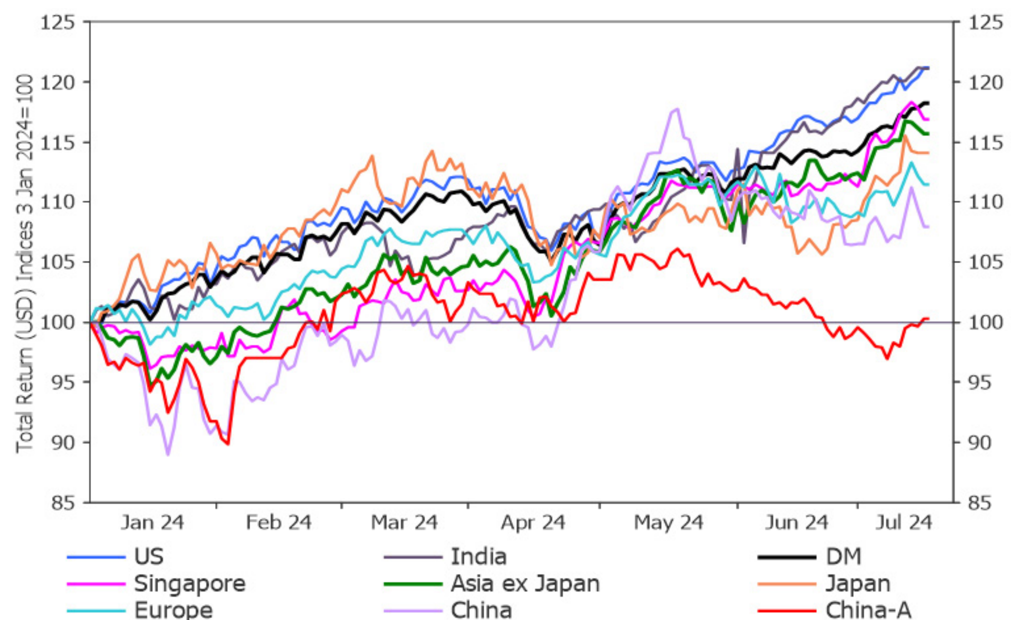
Equities

Dennis Lee
Head of Equities
Fullerton Fund Management

US exceptionalism - if earnings growth can remain robust, as we expect, then that is more important for positive equity returns than rate cuts or the threat of higher unemployment

Figure 11: Equity returns across key markets (YTD)

MSCI Equities Total Return



Source: LSEG Datastream, July 2024

We maintain our bullish outlook on DM equities, led by the US

While some indicators suggest US activity has slowed since Q124, we maintain our belief that the support to earnings from productivity and low unit labour costs will prove dominant for equity returns. US consumption spending is likely to remain robust given how strong household balance sheets are from the rise in wealth. On the supply-side of the economy, the rebound in investment spending by US firms is helping to enhance productivity performance. Overall, Fed nowcasts for US GDP growth are still tracking around 2-2.5% growth, which is consistent with the Bloomberg Consensus forecasts for 2024.

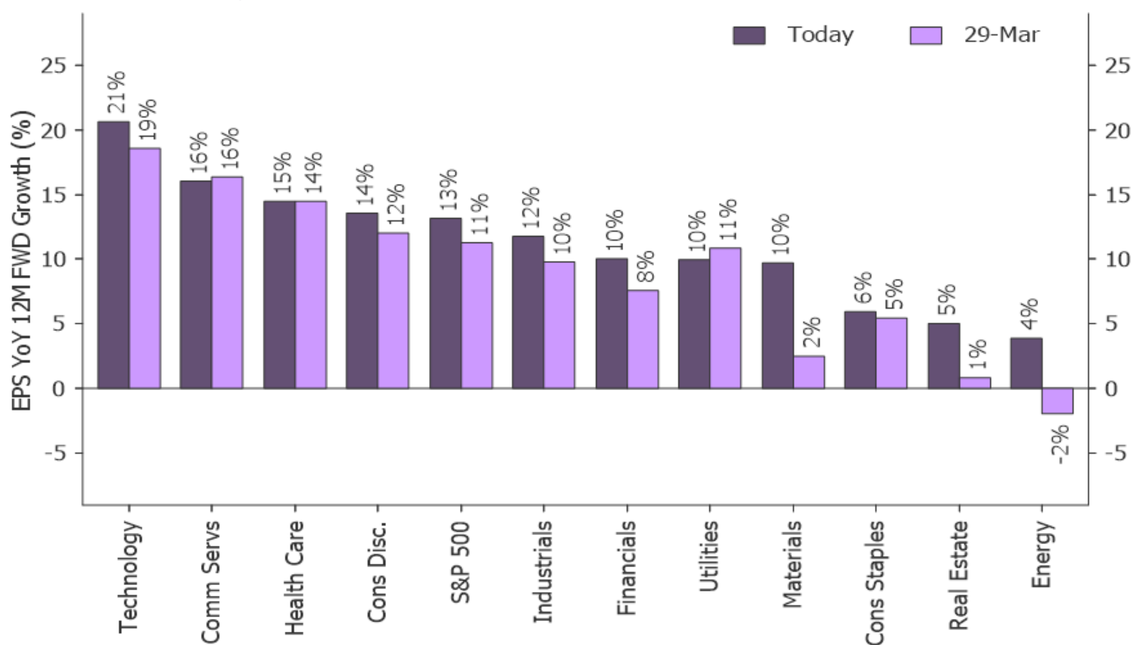
With very high US corporate profits and some debt deleveraging (since the COVID-driven recession), interest income has increased on cash balances to the extent that net interest payments by US corporates are at record lows. This is one reason high interest rates have not proved too stressful for US equity market performance. In addition, broad US financial conditions have eased significantly and stronger money growth has been an important driver. Favourable liquidity conditions, extended when Fed rate cuts unfold, are likely to motivate positive investor sentiment into next year.

US equity market performance is broadening

Robust equity market performance is broadening and the strongest push-back against any significant US slowdown risk is the strength (and upward revisions) in earnings growth expectations. For example, since end-March all US sectors (except utilities) have seen earnings growth expectations increase further (see Figure 12). From the Q1 reporting season 75% of all US firms are tracking to beat double-digit earnings growth expectations in 2024. In addition, with the majority of US firms (i.e. 50% or more) across all sectors beating earnings growth expectations, it reinforces how broad-based robust fundamentals are (see Figure 12).

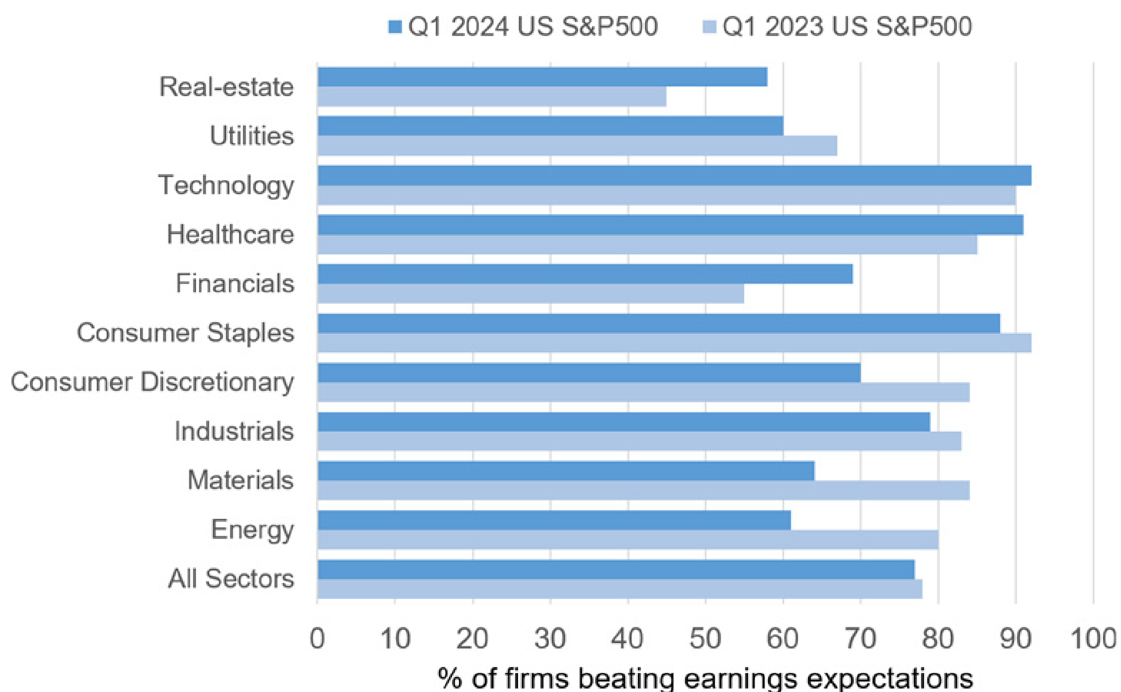
Figure 12: US S&P500 earnings growth expectations (17 Jul vs Q124) and realised earnings performance (for Q1 2024 and Q1 2023)

US S&P500 Earnings Growth Expectations



Source: LSEG Datastream, July 2024

Percentage of firms beating earnings expectations



Source: LSEG Datastream, July 2024

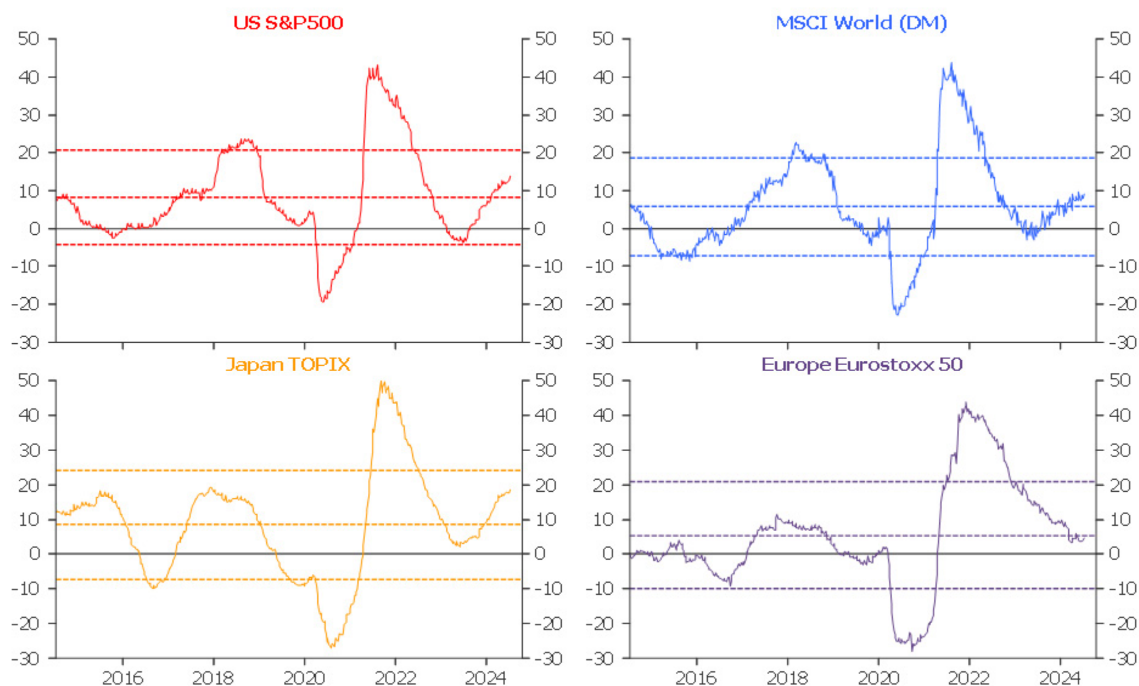
Returns from Japan equities should also remain strong, while Europe can improve with robust global demand and as earnings grind higher

We remain bullish on Japan equities as earnings performance is supported by significant productivity growth and competitiveness gains. The latter is being enhanced by the correction in Japan's producer-cost inflation (versus trading partners), and the weak yen, which will collectively boost earnings for exporters. Already Japan's exports, and productivity-enhancing corporate investment, are at record highs – when tracked as a percent of GDP. It is therefore not surprising that across all key global markets, Japan's expected earnings growth is the strongest (as it converges toward 20% p.a. See Figure 13).

Europe's earnings growth expectations seem to be bottoming (see Figure 13), and as activity slowly improves then profitability should grind higher over time. The EMU can benefit from stronger demand from the US (its largest non-EU export market) and Asia, especially for industrial capital goods and consumer products. On the latter, Europe may suffer some headwinds from weaker demand from China for luxury consumer goods. Germany remains the productivity 'engine' within the EMU, and combined with the sharp fall in producer cost inflation, its profitability rise may outperform its neighbours.

Figure 13: Earnings growth expectations across DM markets

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



Source: LSEG Datastream, July 2024

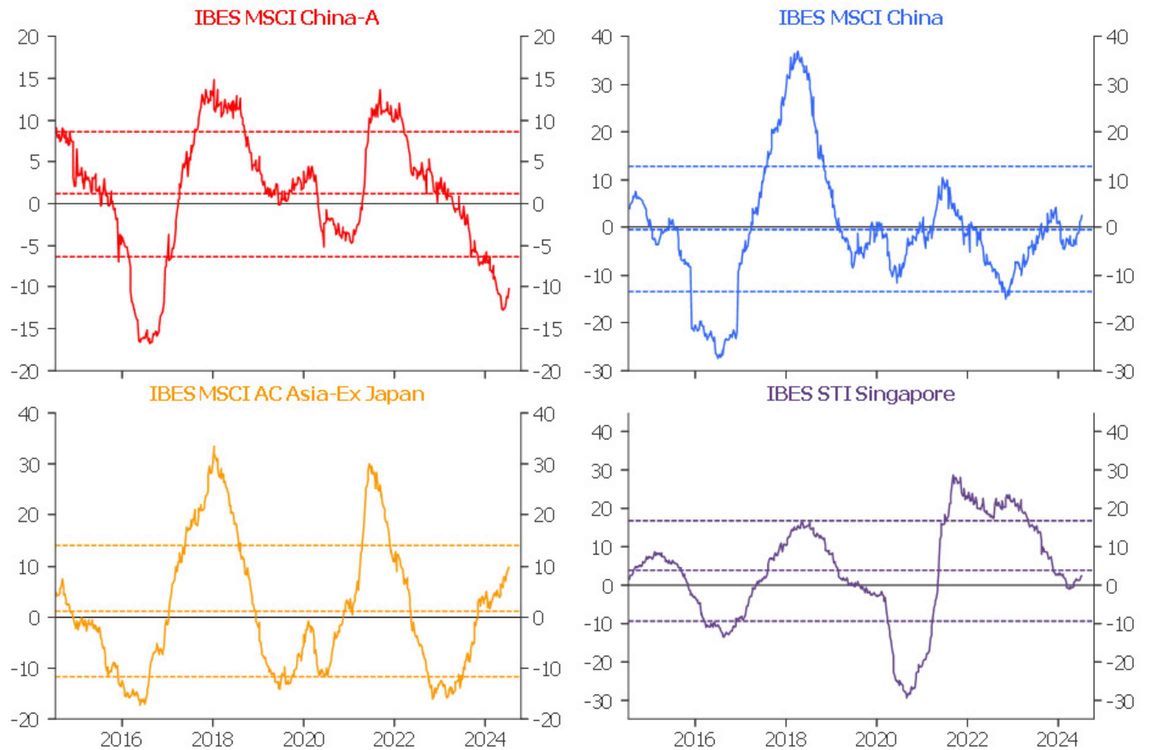
We are positive on Asia equities

Since our Q2 Investment Views, Asia has seen a significant increase in its earnings growth expectations, which have now surpassed Europe (see Figure 14). Taiwan and South Korea, as high-value added manufacturers, are benefiting from stronger global demands for new industrial outputs, IT and consumer products. Fullerton maintains its positive outlook on India equities, as we believe that favourable fundamentals are likely to remain on trend (with the election past). We are also positive on Singapore equities, as earnings growth expectations are recovering (see Figure 14). Singapore is also likely to benefit from stronger DM demand, in particular, for higher-end capital goods.

We have revised China equities to a positive outlook as its earnings growth expectations may finally be bottoming, as deflationary pressures in corporate selling prices ease (see Figures 14 and 15). However, China's 'involution' suggests that it will take time (beyond our 12mth forecast horizon) for overinvestment to be resolved, for the real-estate market to recover, and for further rebalancing toward consumption.

Figure 14: Earnings growth expectations across Asia

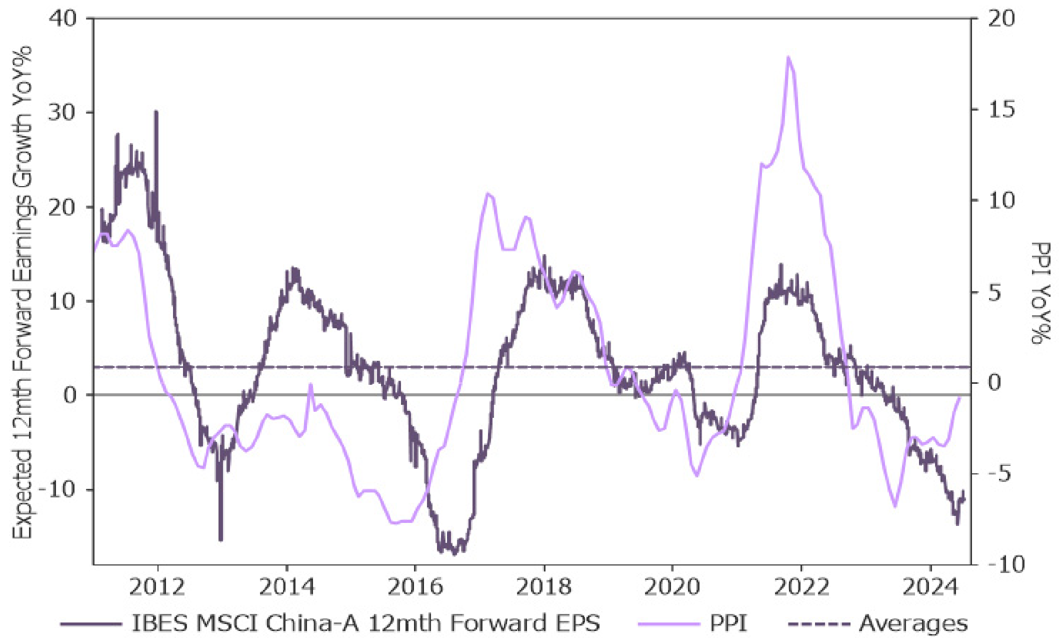
Earnings Growth Expectations (12Mth fwd EPS YoY%) with last 10yr average and +/-1 SD bands



Source: LSEG Datastream, July 2024

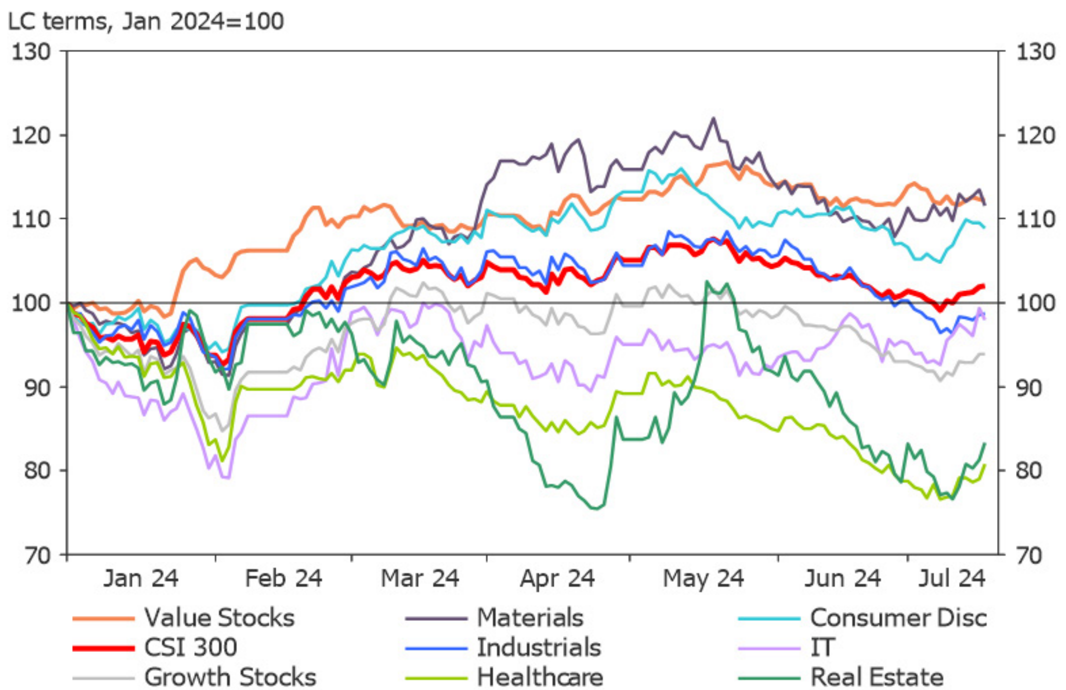
That suggests that while China equities may not transform into a favourable ‘trending market’ it will still offer cyclical alpha. In such an environment, growth stocks may struggle but value stocks can prosper. As we have highlighted before, there are positive investment opportunities across value stocks, materials, and consumer discretionary (see Figure 16). The latter benefits from robust on-line retail that is gaining market share (as it is more price competitive for consumers) over physical stores.

Figure 15: China-A earnings growth and producer-price inflation



Source: LSEG Datastream, July 2024

Figure 16: China-A equity performance by sector



Source: LSEG Datastream, July 2024

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

The global 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, new industrials and ESG-leaders. These sectors are favoured as they are experiencing rising market share coupled with productivity gains containing costs.

With very strong returns YTD in equities, investors will need to navigate rotations

Across DM, especially the US and Japan, as the rally broadens, and as yield curves are likely to steepen over time, stronger returns may unfold for sectors that are interest rate sensitive i.e. financials and real-estate. For example, in the US, both these sectors have seen significant upgrades in earnings growth expectations since the start of the year.

Because US equity returns are running at 20% YTD[9] there will be some rebalancing and rotation as earnings growth expectations tighten and converge across sectors i.e.

- performance laggards move up: like value stocks and small-caps; and
- leaders move down a bit: like large caps and growth stocks.

That said, relative performance orderings may not change dramatically i.e. US tech will likely maintain the strongest earnings growth expectations, while the energy sector holds the lowest ranking.

9. Source: LSEG Datastream, July 2024. YTD MSCI USA total returns to July 17 2024.

04 Fixed Income

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

Led by DM and especially the US, global fixed income markets have shifted from upside inflation concerns to downside growth fears

Our baseline view has always been that the rate cuts signalled by the Fed were appropriate as they aligned with our belief in solid US growth performance and disinflation continuing. We also highlighted that the most likely alternative scenario was no Fed rate cuts in 2024, if growth surprised on the upside and/or inflation proved sticky.

In our Q2 Investment Views we noted that global bond returns had struggled, especially across DM and the US, as yields increased - suggesting that the market was less worried about growth and more concerned about sticky inflation. This was unfolding as commodity prices were rising and as US Q1 inflation was higher than the Consensus expected. These events raised fears that inflation may be reaccelerating and/or the Fed may change its mind on the rate cuts it had signalled for 2024 (on 20 March).

Now into Q3, fixed income markets have flip-flopped to be much more concerned about the prospect of weak growth. From a top-down perspective, such shifts in expectations can be supportive for fixed income returns and especially for bond investors. Falling bond yields can provide significant gains to active traders, especially if growth falls sharply.

We are positive on global sovereign bonds

Yields for Singapore Government Securities (SGS) are likely to continue tracking US treasuries, but with some boost to performance given Singapore's supply conditions. For the rest of Asia, as we have noted for a while, real bond yields are favourable across India, Indonesia, China, Malaysia, and Thailand. Investors will be keen to see if China's policymakers can create a defendable floor, and thereafter with tangible upside, for the 10y yield to rise as the PBoC has announced intentions to sell government bonds (Source: Reuters News, 4 July 2024).

Given the variability we have seen in yields since Q423, especially across DM, the potential downside protection offered to investors from bonds (if growth unexpectedly slumps) is increasingly important. Once bond prices regain some stability then investment income streams should be favourable, while during this adjustment process there may be a greater likelihood of capital gains.

We remain positive, but selective, on corporate credit

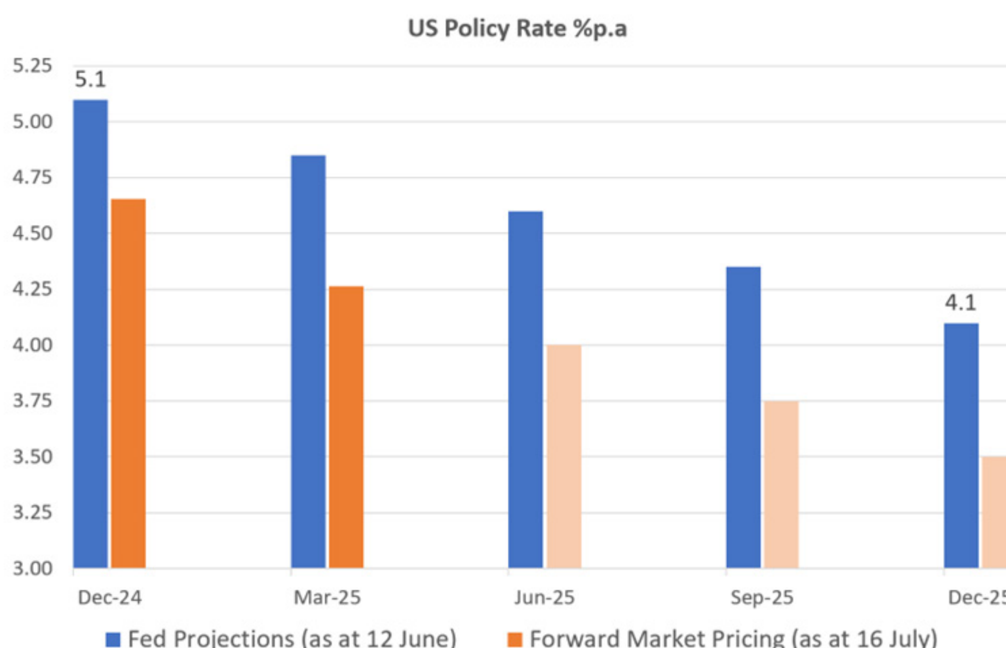
With global growth likely to achieve a ‘soft-landing’, potential default rates across corporate credit should remain contained and investors well-compensated. That said, we are cautious on US corporate credit valuations as spreads may have limited scope to tighten significantly further. We are constructive on Singapore corporate credits as the quality remains good and supply is tight. However, in tandem with the US trend, the favourable environment has pushed-up valuations. We are positive on Asia investment grade corporate credit (IG), as performance is stable and the market has strong technicals. Placing aside valuations, DM corporate credit has favourable supports from strong profitability and balance sheets.

We remain tactically bullish on Asia high yield (HY) corporate credit, but spread tightening will likely slow as carry becomes the dominant driver. Active investors have harvested significant alpha, especially across sectors less impacted by the drag from China’s weak real-estate sector. As we expected, strong liquidity and rising growth in corporate earnings is allowing companies to smoothly refinance. Returns over H124 have been robust across India, Korea, Hong Kong, China, and Singapore (while Sri Lanka’s exceptional return surge may have limited upside left).

The US forward-market may be too aggressive in its Fed rate cut expectations because it is too pessimistic on US growth prospects in contrast to views from the Fed and the economic Consensus

Over the last couple of months the ECB led the Fed with the first rate cut, and some key US activity indicators were weaker than expected e.g. PMI surveys of manufacturing and service sector activity (being below 50) and the unemployment rate (surprising on the upside). These factors have resulted in DM bond yields falling again, and for the US forward-market to expect a lower policy rate path than the Fed signalled (on 12 June). For example, the US forward-market expects the Fed Funds rate to reach 4.3% by March 2025 which is a more aggressive easing profile than the Fed presented in June with a policy rate of 4.1% only by December 2025 (see Figure 17).

Figure 17: US policy rate expectations from the Fed and the financial market



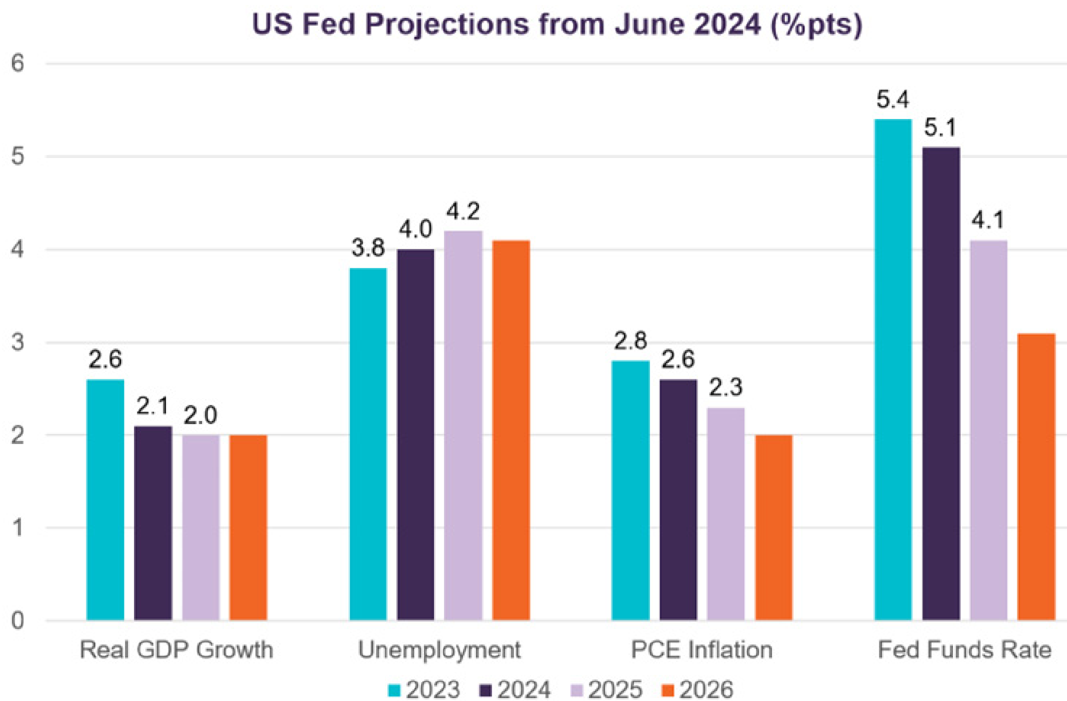
Source: The US Fed (June), LSEG Datastream (as at 16 July), Fullerton estimates. Forward Market Pricing (as at 16 July) is only available out to Q125. Therefore Fullerton extrapolated market pricing to end 2025, as well as interpolating Fed policy rate projections (as the Fed only reports the year-end policy rate).

Reasons why we think the rates market may be too pessimistic on US growth prospects

There are several reasons suggesting that the fixed income market may be extrapolating recent weak data too far, and more importantly, placing too much weight on potential downside risks to growth. First, even though nowcasts of US growth have been variable and have slipped, they still signal macro conditions around what the Fed assumed with its June rate cut profile i.e. US GDP growth of around 2-2.5% p.a. and PCE inflation at 2.5% p.a. (see Figures 18-20).

Second, the Bloomberg Consensus still expects US growth to end the year at 2.3% (which is marginally stronger than the Fed's forecast) and 1.8% next year. Third, it would be unusual for US economic activity indicators to become very weak and yet earnings growth expectations continue to revise-up (from Q1) as we observe in the latest data.

Figure 18: US Fed macro projections

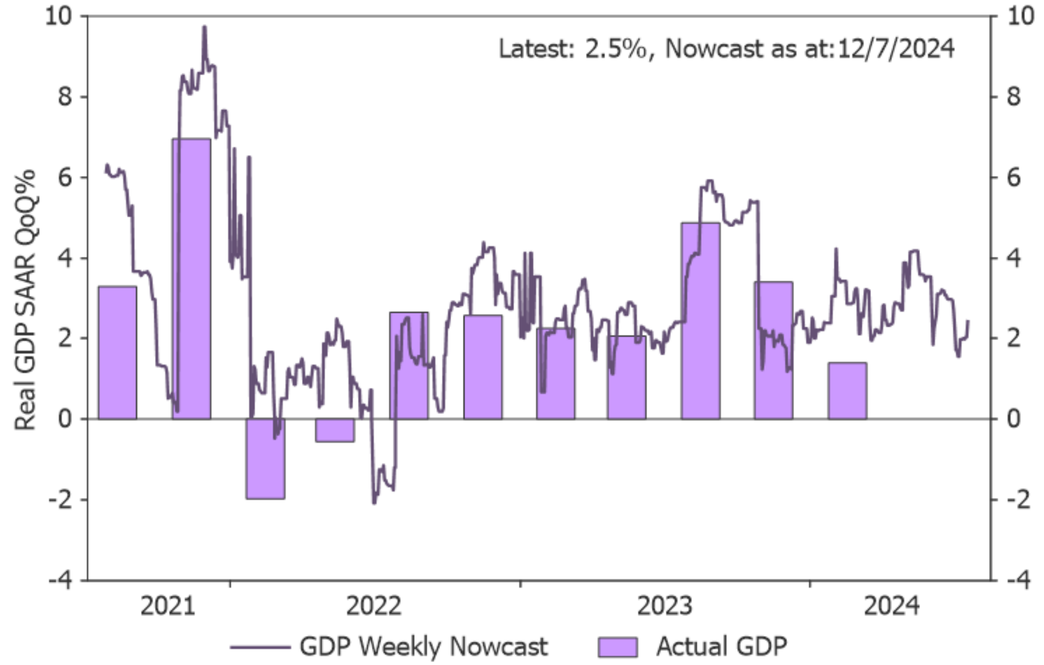


Source: US FOMC Forecasts June 2024

Figure 19: US GDP growth nowcast

US GDP Growth Nowcast and Actual

from the Federal Reserve Bank of Atlanta

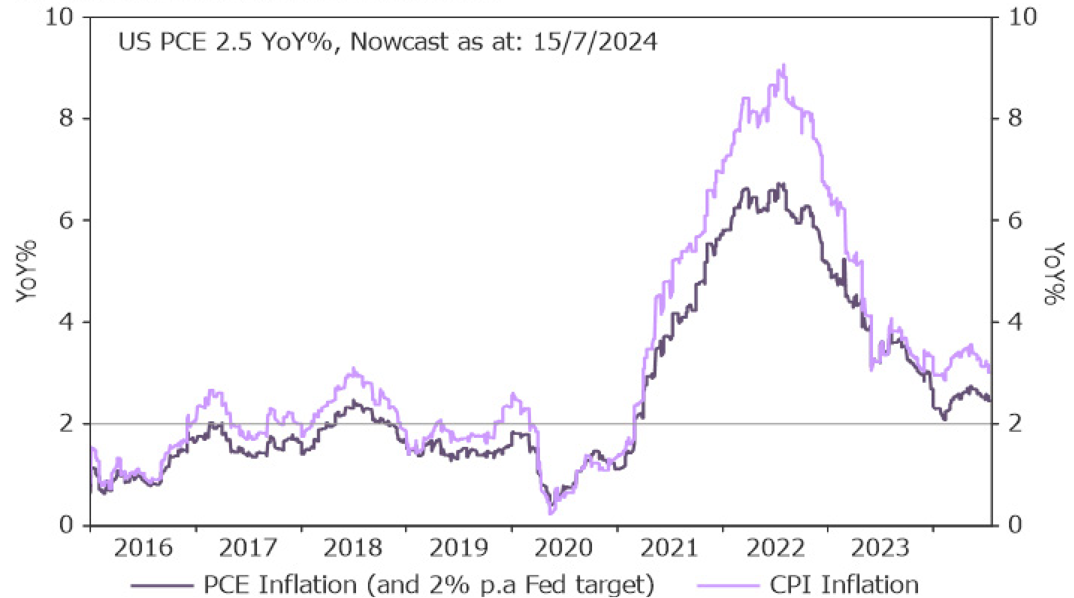


Source: LSEG Datastream, July 2024

Figure 20: US inflation nowcast

US inflation nowcast

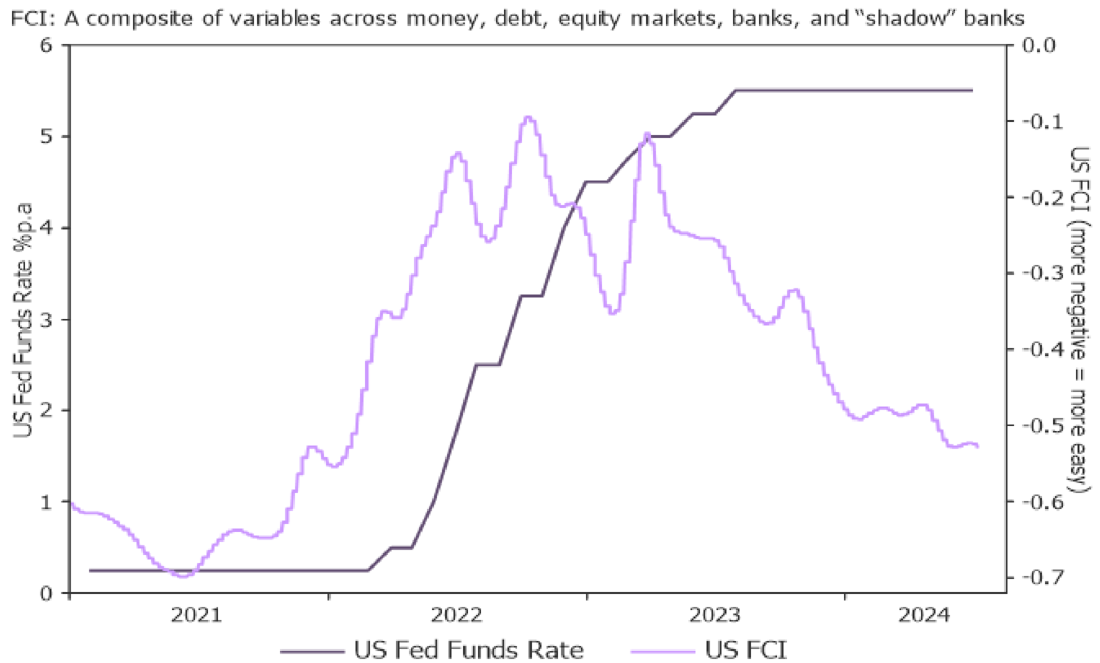
from the Federal Reserve Bank of Cleveland



Source: LSEG Datastream, July 2024

Fourth, driven by positive wealth effects from spending, liquidity, domestic credit, and money growth, financial markets do not seem to be giving enough weight to the growth supportive role stemming from easy broad financial conditions. For example, the US financial conditions index (which captures money growth, credit growth, interest rates, and financial market conditions) is as loose as late 2021 before the Fed's policy rate hikes began (see Figure 21).

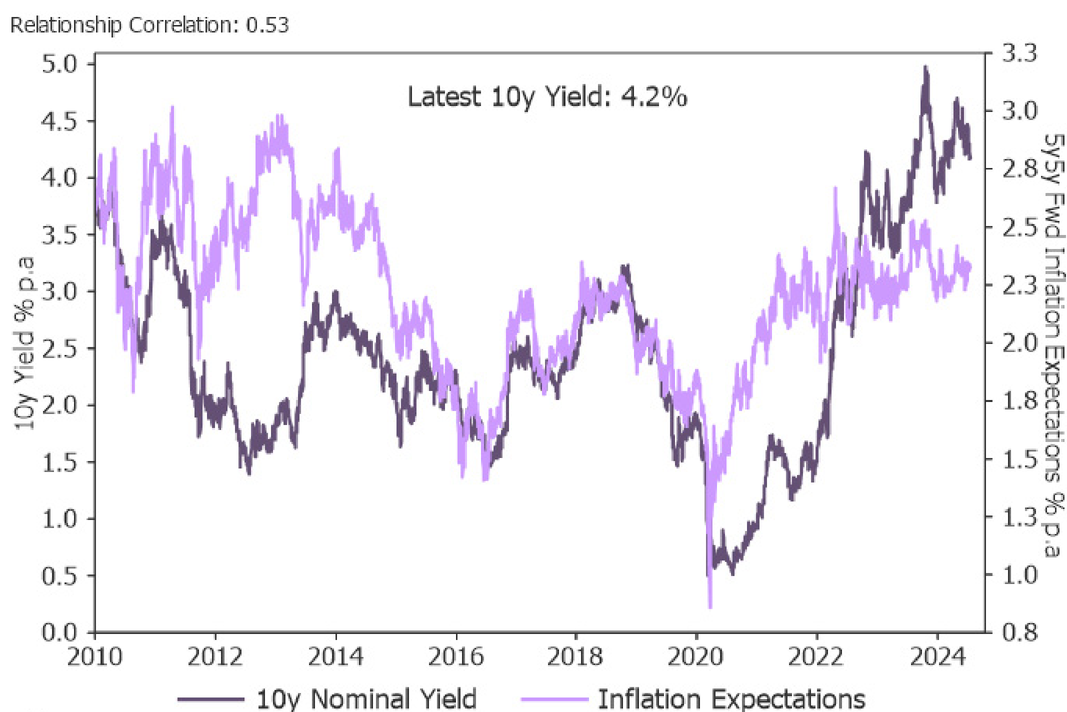
Figure 21: US Fed Funds rate and broad financial conditions index



Source: LSEG Datastream, July 2024

Lastly, the US 10y nominal yield can fall and growth can remain quite reasonable because a key factor that should pull yields down, to some degree over time, is well-anchored inflation expectations (see Figure 22). This is a key part of the Fed's monetary transmission mechanism that has not changed despite the painful cyclical surge in inflation. Investors should not panic yet that US yield slippage means growth is likely to collapse – the driving force may simply be fixed income markets realigning better with inflation expectations.

Figure 22: US yields falling again may reflect some realignment back toward well-anchored inflation expectations



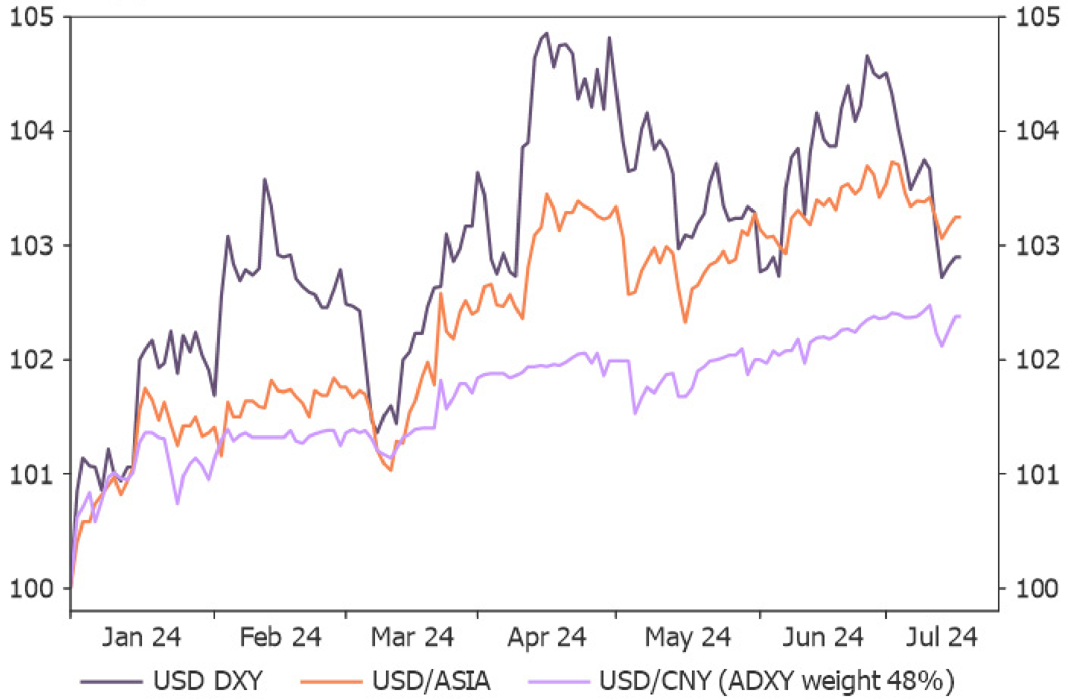
Source: LSEG Datastream, July 2024

The US dollar can hold its value

Driven by positive US fundamentals such as the bond yield differential, the terms of trade, and productivity, the US dollar has made steady gains this year as we expected (see Figure 23). The US real exchange rate is overvalued (7%), but the USD may have re-rated higher since the US became a net oil exporter from 2020 (see Figure 24).

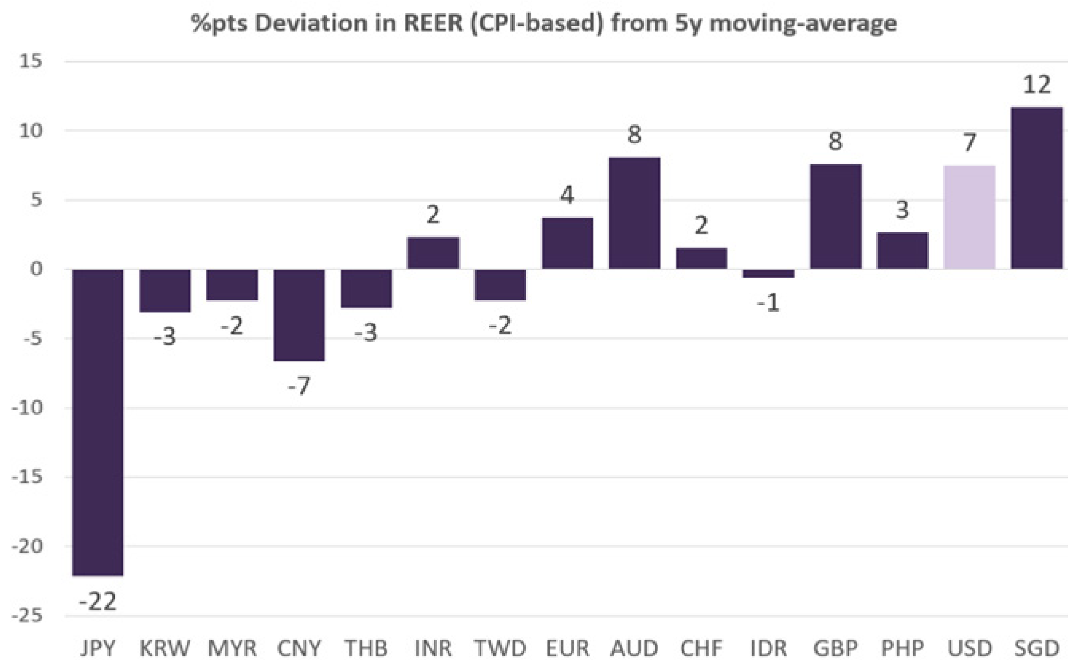
What is most concerning across currency markets is that the Japanese yen remains hugely undervalued. When the yen eventually rebounds (perhaps with expectations of higher yields in Japan) then it could prove painful for any investors that have taken excessive (and perhaps one-sided) risk.

Figure 23: US dollar moves against DM, Asia, and China (rise is USD appreciation)



Source: LSEG Datastream, July 2024

Figure 24: Currency valuations (deviations from the trend real exchange rate)



Source: LSEG Datastream, July 2024

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