# FUNDAMENTAL FLASH

# 2H'2021 Market Outlook: An Uneven Recovery

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*It's been a buoyant year for global markets so far in 2021 as the world gradually emerges from the COVID-19 pandemic. But rising Treasury yields which sparked inflationary fears also led to some jitters this year.*

*Should investors be worried about the inflation bug? And what should we expect for the rest of the year? David Ng, Deputy Managing Director & Chief Investment Officer shares his views.*

## Questions

**1. What are your thoughts so far for 2021 and how markets have performed this year?**

Global equities have performed reasonably well on a year-to-date (YTD) basis as the world regain its footing again post-pandemic.

The manufacturing sector is leading the way with official manufacturing Purchasing Managers' Index (PMI) figures hitting above the 50-point mark signalling expansion. This is especially in the US and Eurozone.

### Flashpoints

- Recovery is underway as vaccines are rolled-out globally. But it will be an uneven climb between developed and emerging markets.
- Taking the same view as the Fed, we expect inflation to be transitory as supply chain bottlenecks are resolved and prices normalise.
- Given lacklustre employment data, the Fed has signalled that it would maintain an accommodative monetary policy stance. Similarly, China is seen only tightening at the margins to curb speculation.
- Against a backdrop of economic recovery, ample liquidity as well as inflation unlikely to remain persistently high, global markets will continue to see support.
- The services sector will drive the next leg of growth as mobility restrictions are eased.

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The services sector which is typically linked with experiential consumption such as travel and hospitality is still lagging due to movement restrictions. But, we foresee the services sector to drive the next leg of growth as vaccinations continue to be rolled-out.

However, the global recovery we are seeing has been uneven as developed markets post stronger gains compared to the rest of the world. Developed markets have managed to administer the vaccine at a quicker pace and this has led to a corresponding increase in mobility.

For fixed income, the performance of bonds has lagged this year ironically due to the global recovery as investors turn risk-on. Expectations of higher inflation has also set in as the economy gradually reopens with supply disruptions causing sharp increases in commodity prices. Higher inflation would of course lead to expectations of policy tightening that would lead to a decline in bond prices.

**2. What is your current reading of global markets now?**

Earnings expectations are pointing in the right direction across all regions with the earnings revision ratio hitting above 1.0 which signals more upgrades than downgrades. US corporates are currently leading the way, but we expect Europe and Asia to also catch-up as vaccines are rolled-out.

However, expectations are currently high in markets. To no one's surprise, growth expectations have been revised strongly upwards especially coming off from a torrid 2020 when the pandemic first hit. But this pace of growth is unlikely to be sustainable due to the base-year effect.

As we enter the 2H'2021, this pace of growth will moderate as conditions normalise. But the important point to highlight is that so long there is still growth and we are not heading into a recession, equities will continue to see support. Another factor is liquidity which remains ample as global central banks embarked on a slew of easing measures last year to cushion the economy. Whilst liquidity might start to taper off due to the base-year effect again, there remains a high level of liquidity in the system still.

Based on recent signals by the US Federal Reserve (Fed), it is unlikely that the central bank would start tightening any time soon. The Fed is taking the view that inflation is transitory and will not prematurely raise rates. This is especially as employment and labour data have yet to recover back to pre-COVID-19 levels.

### 3. Inflation is on every investor's mind right now as rising Treasury yields sparked inflationary fears. Do you think inflation will be transitory or structural?

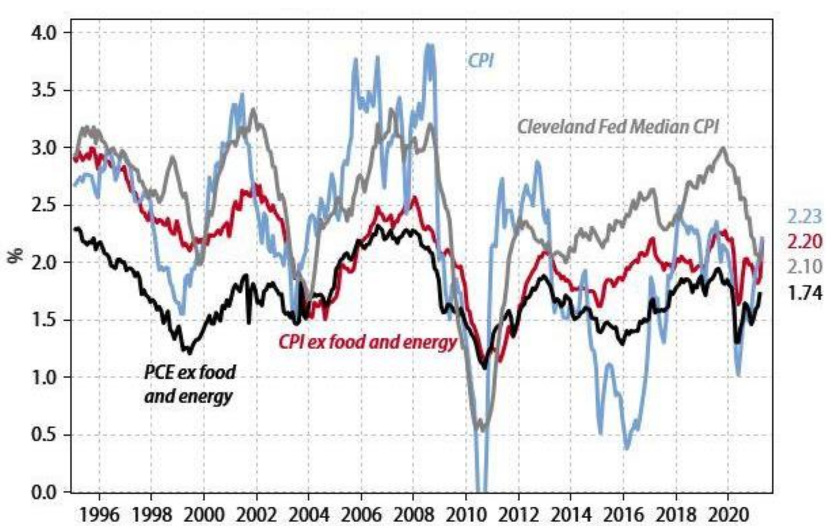
We saw a sharp spike in inflation during the month of April on a y-o-y basis and the same is expected in May. The reason for this is due to the sharp decline in prices in 2020 when the world went into lockdown especially commodity prices with futures in negative territory. From this low base effect, it should be expected that prices would rise this year.

This sharp rise in headline inflation numbers may have spooked markets, but the increase is largely mechanical and should be expected due to the low base effect.

Inflation has been a focus for us in recent months. This is because if inflation rises too sharply and remains unsustainably high, it will have a negative impact on the market as investors will then expect central banks to start tapering and raising interest rates. If interest rates rise too much, valuations in both the equity and bond market will decline.  Inflation is welcomed, but only if it's a gradual and gentle increase.

On whether inflation is transitory or structural, we share the same view with the Fed that inflation is transitory.

*Graph 1: US underlying inflation: what the Fed sees*




*Source: Gavekal Research/ Macrobond, as of May 2021*

A key reason is how COVID-19 disrupted production chains last year. The subsequent surge in demand when lockdowns were lifted created a backlog of orders in the manufacturing industry which perpetuated an increase in prices. We expect that once these supply bottlenecks are resolved, prices will come down as orders normalise.

Another point on inflation being transitory is that employment numbers in the US have yet to recover and are still well-below pre-COVID-19 levels despite rising wages. In blue-collar industries, employers have reported difficulty in finding workers due to welfare programmes such as the current American Rescue Plan Act 2021. Blue collar workers are receiving an additional US$300 on top of the base jobless claims of US$400. This inherently means for some, there is little incentive to return to work as they earn more from government handouts.

However, we expect this program will be rolled back gradually in June before ending entirely in September with some Republican states having halted this program already. From there, we will see a gradual increase in the workforce. Thus, we expect inflationary pressure to subside and for the Fed to maintain an accommodative monetary policy stance that should keep growth humming.

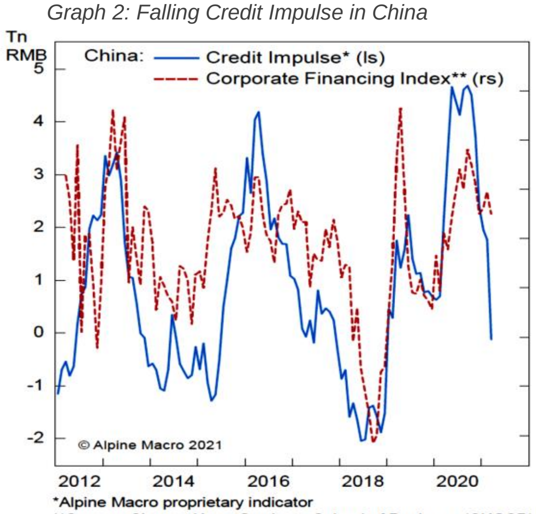
**4. First-in-first-out from the pandemic, China has rebounded strongly this year as it reboots its economy. Is this growth pace sustainable?**

There is increasing evidence to show that China's growth has peaked as seen in the fall in credit impulse and total social financing. We believe the country will continue to post positive GDP performance, but this pace of growth is likely to moderate.

In such an environment, it will be prudent to reduce exposure to credit sensitive sectors that have benefitted from the strong rise in credit impulse which we saw last year. The team is focused on identifying such ideas and we have explores some investment themes within the consumption, travel and tourism sectors.

However, we don't expect China to embark on any major policy shift and tighten aggressively. What policymakers have been doing is tightening at the margins to cool down the property market and curb speculation in the commodities space. Beijing has also reduced the scale of its bond issuances which suggest that it is reining in public spending.

*Graph 2: Falling Credit Impulse in China*




*Source: Alpine Macro, as of 20 April 2021*

There were hard lessons to be learnt for China in its experience in dealing with the 2008-GFC where it had to massively stimulate its economy which resulted in an increase in public debt and leverage. As a result, it had to deal with the after-effects and the resulting hangover from this overstimulation.

But this time around, China has been a lot more prudent by not going overboard and embarking on more targeted stimulus measures.

Whilst, the fall in credit impulse data and social financing may seem negative in the short-term. In our view, this is positive for the long-term sustainability and growth of its economy as well as stock market.

### 5. How are valuations at this juncture?

In the Asia ex-Japan market, the Price-to-Earnings (P/E) ratio is trading above the long-term average on a historical basis. The same can be said for other financial markets as well. If inflation is indeed transitory and markets start to believe this, then valuations can remain higher-for-longer, especially against the backdrop of continued economic recovery.

From a discounted cash flow or net present value basis which uses the risk-free rate, valuations could also see support if interest rates are well behaved. Low interest rates would theoretically lead to a higher net present value of future cash flows and vice versa.

### 6. What about technicals?

Technical indicators such as the Bank of America Bull/Bear indicator which is currently at 7.0 suggest that market sentiment is bullish but not extreme. We have seen strong inflows back into global equities, though the current pace is not likely to be sustainable.

A large chunk of the inflows went into value funds/sectors last year as opposed to growth or technology stocks. Inflows into these value strategies largely came from the reasoning that they would benefit from a reflation trade, particularly those invested in commodities, materials, and financials.

### 7. What is the strategy right now and how are you positioning the portfolios?

Our view is that markets could consolidate in the near-term on an index level due to a lack of catalysts as well as already high expectations. The key is to be selective as the easy money has already been made.

Given our house view on i)excess liquidity, ii)inflation being transitory and iii)different parts of the economy reopening, we believe there are ample investment opportunities. An uneven global recovery coupled with different sector beneficiaries from an economic reopening presents dispersed opportunities in the market.

Long-term growth stocks which have lagged in recent months may start to perform again as inflationary pressure eases. We could then see a rotation in the market from cyclicals back into growth this year.

In terms of portfolio positioning, we have increased exposure to cyclicals and reopening plays with some positions in defensive sectors as markets have done well.

We favour owning quality names with longer term-growth prospects as such companies have better growth visibility. From an investing philosophy perspective, we prefer to view investing as being owners of these respective businesses. As such, it is crucial to invest in quality names and in good management.

We will consider adding further into cyclicals in line with our macro view of global economic recovery. However, we will wait until there are better price points for us to deploy into the sector. This is given what we have seen in China's credit impulse data as a major consumer of commodities. If credit impulse continues to decline, we believe commodity prices will take a breather at which point we will consider increasing exposure to cyclicals.

We expect monetary policy to remain accommodative and that will lend support to markets as any sudden surge in inflation will be transitory.

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