arrow capital

3Q21 Outlook

EXECUTIVE SUMMARY

In our previous quarterly outlook, we stressed that the recent Growth underperformance does not mark the end for Growth stocks. Our views were validated as we saw Growth stocks staging a comeback, returning 12.18% and outperforming other styles such as Value, which returned only 4.72% over the quarter. Our favourite types of businesses remain those that can generate a high, sustainable return on operating capital employed, while growing steadily and predictably over time. These high-quality businesses often exhibit the twin virtues of scale and diversification. Our Asian equity exposure has given back much of its prior outperformance, but we maintain our overweight view. Investors should take advantage of the compelling fundamentals offered by the robust Asian corporate sectors, look ahead to earnings rerating, and embrace the long-term benefits of investing in Asia. We continue to favour our barbell approach comprising high quality Growth and Defensive stocks.

We remain mildly bullish on US markets, as we think they could still propel higher on the back of liquidity support and huge cash piles on the side-lines. Although valuation starts to look rich, we think that any taper tantrum would simply force the authorities to redouble monetary and fiscal support, as economies and markets remain (over) dependent on plentiful and cheap cash. As the timing of any fracture is inherently unknowable, we are positioned to benefit from a softer second half GDP narrative, with Central Banks rowing back from their recent hawkish pivot. We also advise our clients to diversify exposure across geographies, and Asia remains our top spot.

Our US 10-year Treasury Bond exposure delivered 3% over the quarter and recently traded at around 1.17%. Meanwhile, we are increasingly confident that some of the huge recent cyclical tailwinds, such as the fourth great credit bubble that China engineered in 2020, will become headwinds over the second half of this year. Indeed, the commodity price surge itself should put a break on growth later this year too. The long-term drivers of global growth, and indeed of global sovereign bond yields – namely steadily deteriorating demographics and sharply higher debt levels – will kick in again from next year. In the current low-rate environment, our preferred allocation in Fixed Income remains Asia Investment Grade and Asia High Yield.

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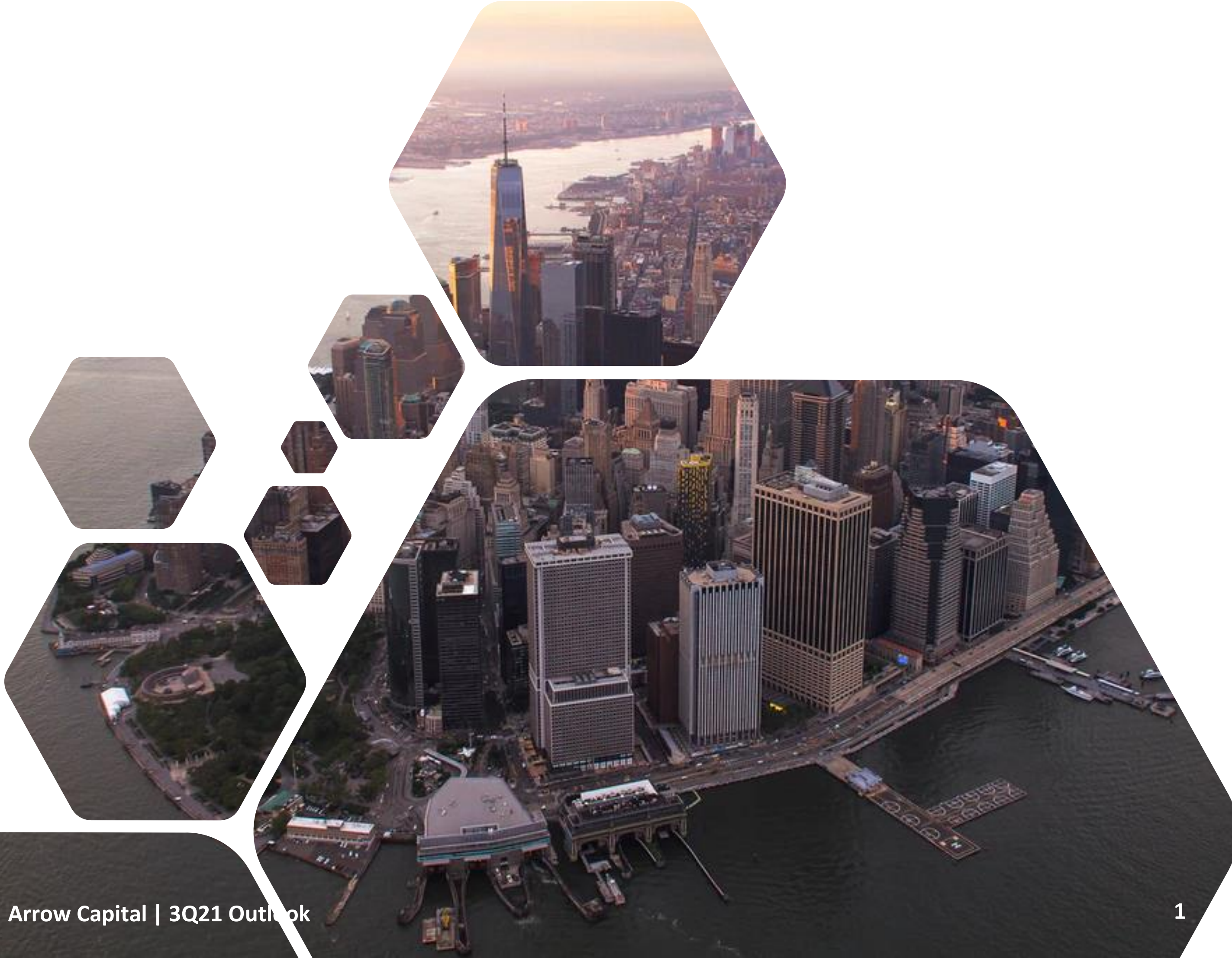


U.S. EQUITIES

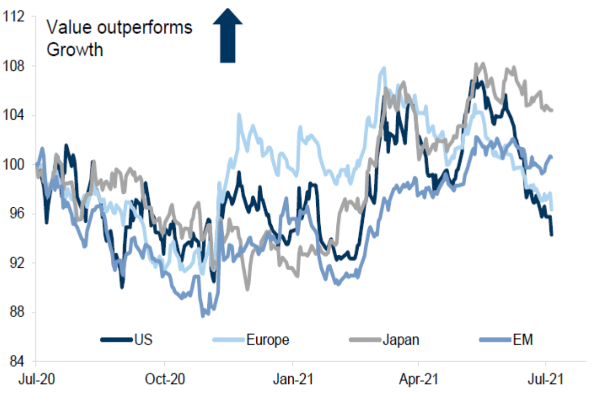
The Tug of War Between Value and Growth Stocks

Markets priced in a strong economic recovery in the first quarter of 2021. Bond yields spiked, triggering weakness in defensive assets, while cyclical "value" equities outperformed. Whilst this proved a temporary headwind for some of our core positions in Q1, our Q2 outlook reiterated that this trend is unlikely to sustain.

We increased our growth exposure at the beginning of Q2 and moderated our defensive and value exposures. As expected, growth (defensive) stocks staged a comeback in Q2 benefitting from a negative correlation with bond yields as the reflation sentiment started to moderate. Through our barbell strategy tilted towards growth, we benefitted from this run up.

In our Q2 outlook, we viewed the surge in growth and inflation as temporary. This has been confirmed with the normalization in long-term growth expectations, the moderation of outflows from low-vol funds, and the Fed's statement saying that inflation is transitory. Supply bottlenecks have been a key factor behind inflation surprises.

Value underperformed in Q2

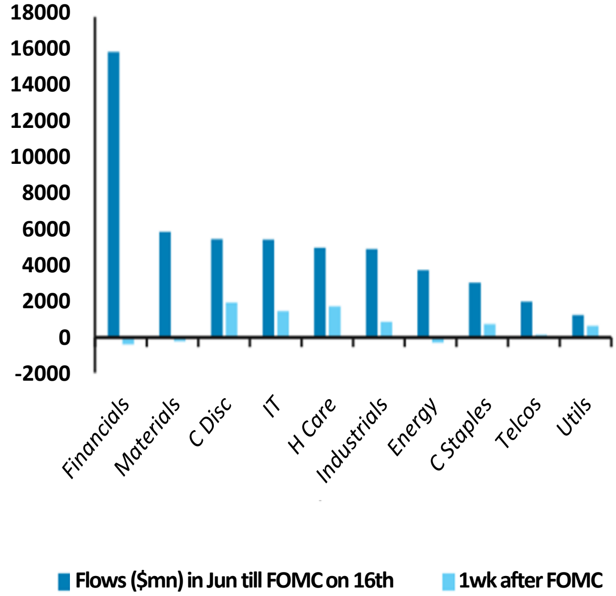


Source: Bloomberg

Growth EPS outlook is higher

Source: Bloomberg

In the aftermath of the June FOMC meeting, Energy, Financials and Materials saw outflows as investors added back to Quality/Growth.



Source: EPFR, Barclays Research

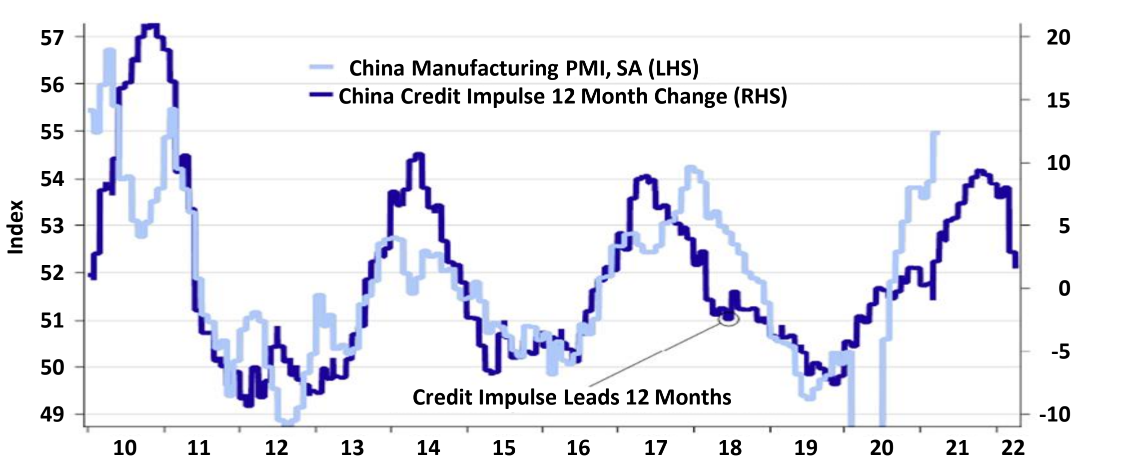
Value is still getting more consensus, but valuation differentials vs. growth are still high. A multifold of economic indicators pointed towards slower growth in the second half.

Many of the main manufacturing surveys have turned lower. The decline in China credit impulse does not bode well for global demand, which could be a headwind for the global manufacturing sector. We think this has been one of the best leading indicators for global macro trends over the last 10 years.

However, PMIs may be peaking, but that was typically followed by still positive, albeit lower, equity returns. Strong earnings recovery is taking over from valuations as the next fundamental driver of equities.

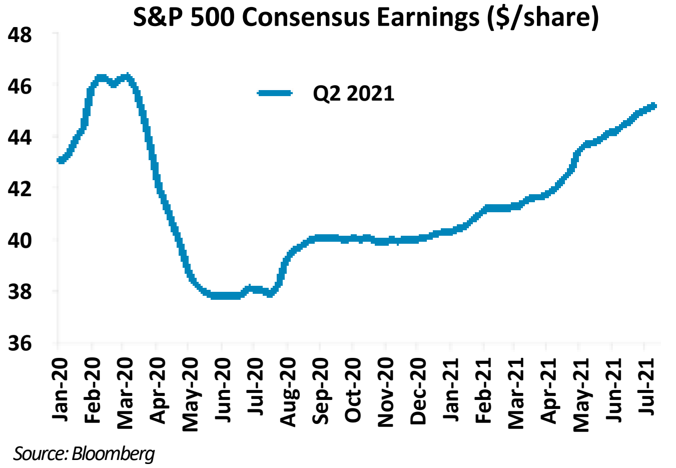
Source: MSCI Datastream, Bloomberg, Barclays Research

China's Credit Whim Leads Global Manufacturing PMIs.



Source: Macrobond and Nordea

We remain supportive of a further higher grind in equities. The private sector is in good shape, with both consumers and corporations eager to spend. Liquidity may be peaking, but it will only be reduced gradually because growth is strong enough. S&P 500 consensus estimates for the quarter are almost back at levels expected prior to the pandemic.



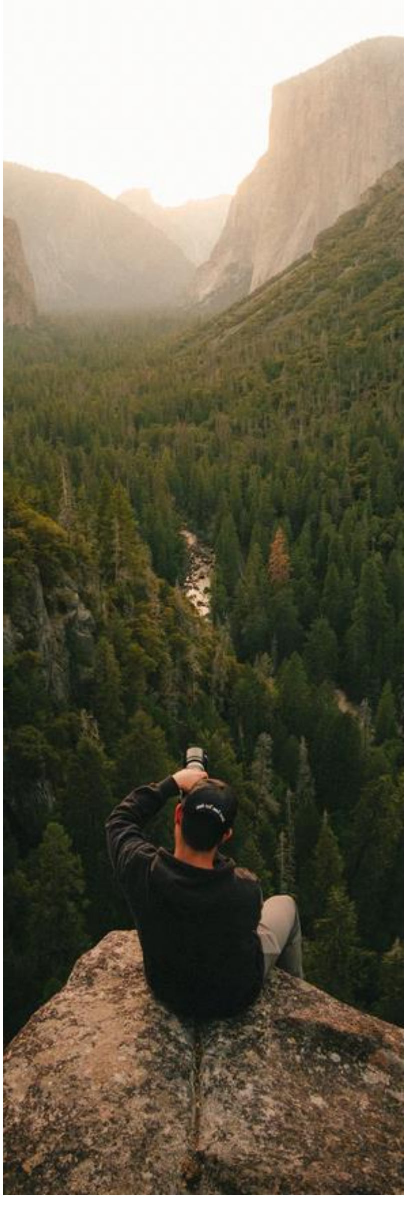
Source: Bloomberg

The June FOMC shifted the market focus from the Fed tapering asset purchases to the timing of central bank rate hikes. As the market-based inflation forecast for 5 to 10 years touched 2.5% p.a., the Fed indicated that its first-rate hike will come in 2023, a year earlier than previously forecast.

With slow monetary policy normalization, is the Fed behind the curve? The 2013 episode remains in market participants' memories. To avoid any sell-off on rates, as seen in the first quarter, the Fed will have to communicate wisely.

We are more in a normalization monetary position rather than tightening. This will offer investment opportunities with no major sell off.

The Green Focus

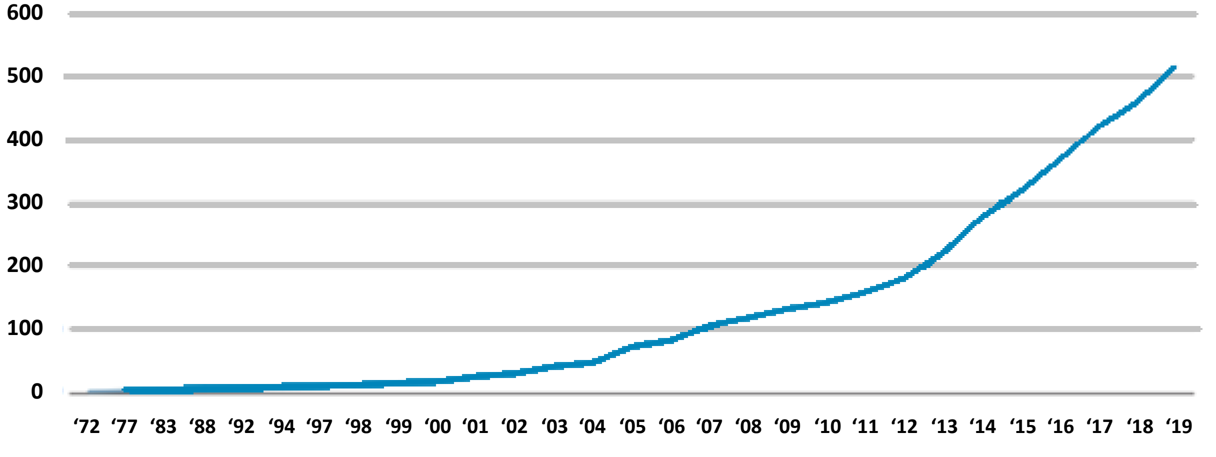


Our focus is turned towards a set of structural growth themes. Just like we favour the energy transition and fintech themes, health care also falls in that category. By the end of this decade, one-fifth of the US population is expected to be above 65 years old.

Even though unprecedented technological innovation has led to bull cases, huge government spending also contributes to part of it. G7's Cornish gathering was dominated by environmental policies last month.

We are at the start of a great energy transition, from a system based on fossil fuels to one based on renewable energy sources. Renewables accounted for nearly 72% of all new capacity globally in 2019, driven by cleaner, safer and cheaper sources of energy. Technologies involving renewable energies follow a learning curve, as an increase in installed capacity results to a fall in price per unit output. This inverse relationship has led to an exponential decrease in the cost of renewable resources, making them among the cheapest sources of power. On the other hand, fossil fuel-based or nuclear sources have no such learning curve, implying cost differentials will only inflate.

The Rise of Regulation – Cumulative Number of Sustainable Finance Policy Interventions per Year Globally



Source: PRI responsible investment regulation database

ASIAN EQUITIES

Consumer Spending – The Key Driving Force

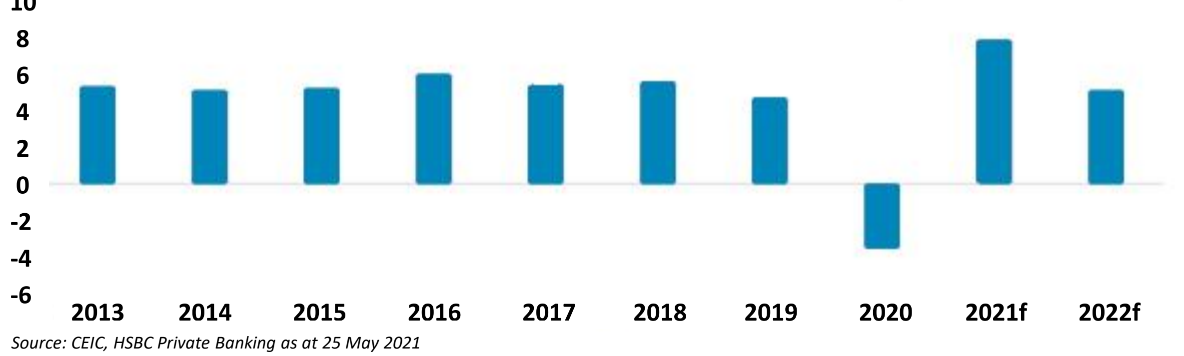
Asian economies are heading towards a more broad-based growth path, though at a moderated pace, amid fading base effects after a sharp V-shaped recovery in the first half of the year. Asia ex-Japan has been the leader when it comes to global recovery and its GDP is expected to grow at 7.8% in 2021. However, the resurgence of the pandemic and the emergence of new variants in Malaysia, Japan, India, Sri Lanka, Singapore, Thailand and Taiwan created further uncertainties and confirmed that worldwide vaccinations are the only way we can return to normality.

Even though the path to recovery and the pace of mass vaccination vary across Asian countries, consumer spending is expected to be the key driver to sustain the next phase of Asia's economic recovery. In fact, after contracting by 3.5% in 2020, a sharp cyclical rebound by 7.8% is expected in 2021, and tailed by a 5.0% rise in 2022, as economies reopen and people start spending the excess personal savings accumulated.

Further improvement is expected in the job market with improved wage outlook and unemployment rate falling from 3.9% in 2020, to 3.8% in 2021 and 3.6% in 2022.

Asian consumer spending is poised to rebound sharply in 2021

Asia consumption expenditure, in % YoY



Source: CEIC, HSBC Private Banking as at 25 May 2021

Asian Equities

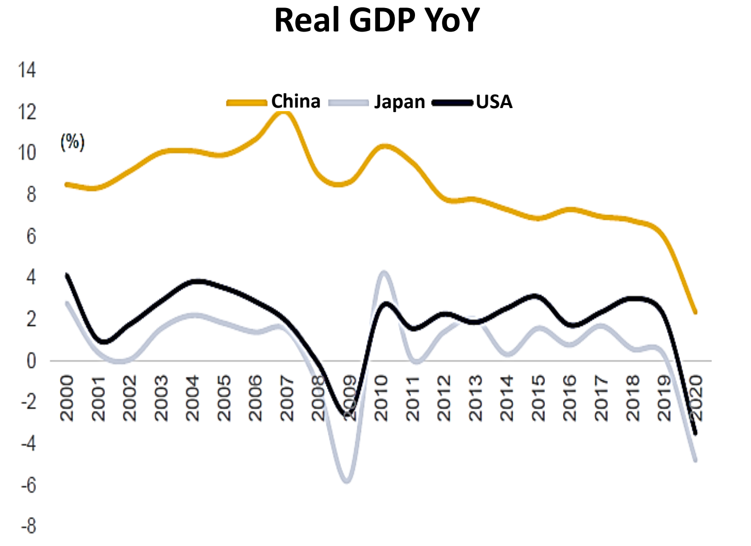
Asian equities did not lose their allure, even after underperforming in Q2 following the run up at the beginning of the year. Valuations remained attractive relative to peers and bonds. Further gain is expected in the 2nd half of the year due to a combination of strong earnings growth and a reopening of more economies.

The hawkish tone by the Chinese Central Bank and the concern over the impact of antitrust compliance guidelines on tech companies have led to a sharp contraction of Chinese equities. MSCI China and the Hang Seng Tech index are now trading around 17% and 28% below their respective February peaks, which are attractive entry points.

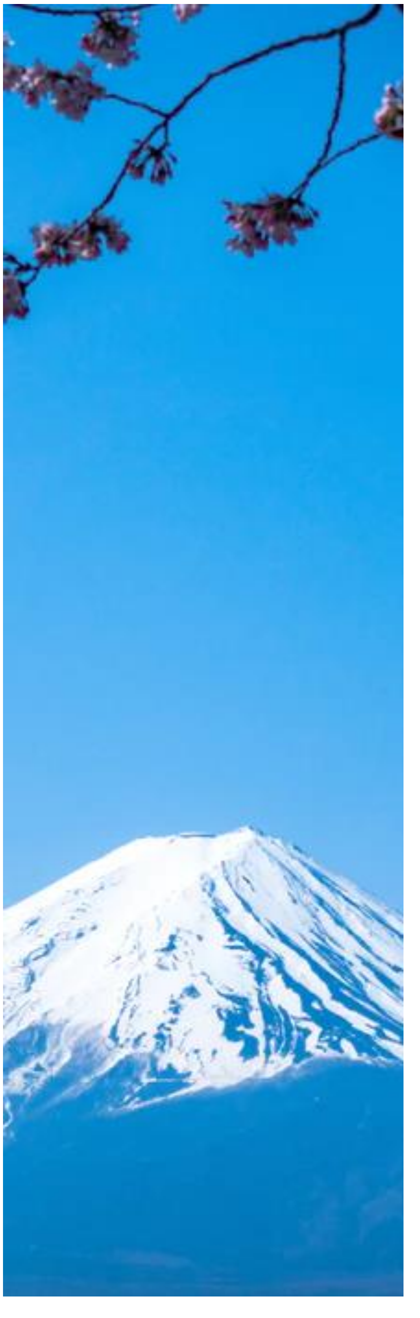
The Chinese market is positioned to maintain a long-term global growth engine, though investors are still underweight on this region. Earnings growth is expected to be at 17% in 2021 (USD terms) versus 8% globally. The PEG ratio (Price/Earnings to Growth) also looks attractive at below 1.0x. Any setback in Chinese equities is considered as an occasion to re-establish a longer-term position.

The Chinese digital economy is a main theme as the country is home to many key future themes, including health-tech, 5G, e-commerce and fintech – areas in which 20 to 40% CAGR is expected over the medium term. The digital payment penetration is more advanced in China than the rest of the world.

Japanese Underperformance



Source: Euromonitor



A slow vaccination rollout in Japan has contributed to the underperformance of Japanese stocks by 2% year-to-date. However, with the rapid increase in vaccination supply, 30% of the population is expected to be injected with at least one dose by the end of August (versus around 6% of the population as at now). Hence, this should support the reopening of the economy.

With 40% of revenue generated from foreign activities, the Japanese economy is well poised to benefit from the global recovery. Valuations are appealing for Japanese equities, given expectations of a 40% earnings growth in 2021.

FIXED INCOME

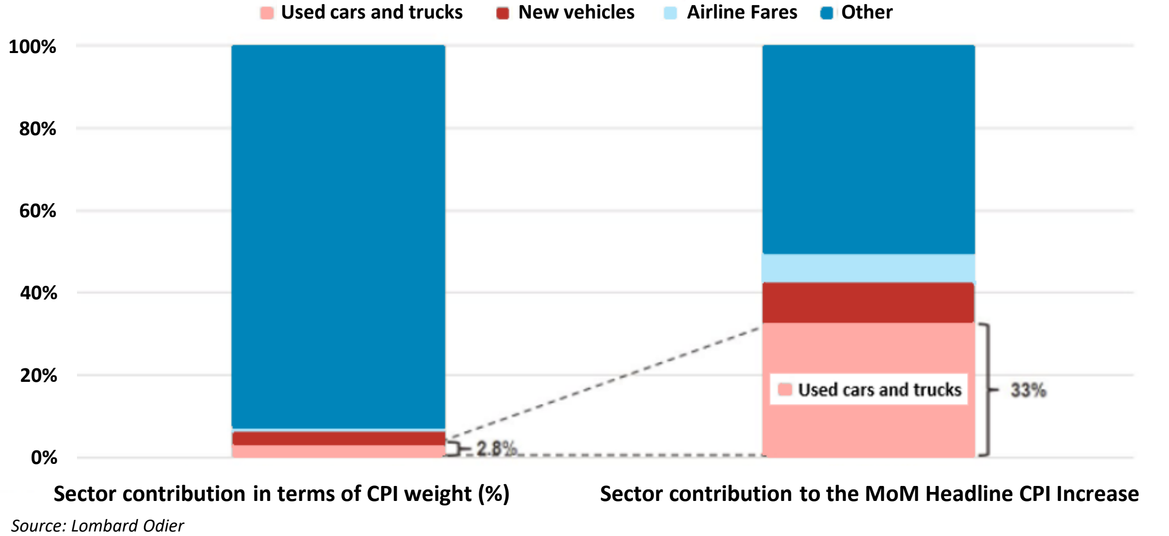
U.S. TREASURIES

Inflation in Focus

In Q2, cyclical and structural views of investors on inflation have continued to mold bond market performance. Fed members have broadly suggested that inflationary pressures in the US should remain transitory. An amalgamation of supply chain bottlenecks, pent-up demand from reopenings, and labour constraints should most likely keep U.S. price pressures high in 2021. However, these components should fade over time. The Federal Reserve's preferred measure of inflation, Core PCE, is expected to fall next year.

The Headline CPI surprised on the upside in May at 0.6% versus its 0.5% estimate. Nonetheless, this rise is still heavily inclined towards few particularly Covid-exposed subsectors. Used cars and trucks alone, which represent only 2.8% of the index, are responsible for 33% of the rise this month. We maintain our base case scenario that these inflation spikes are temporary.

US Consumer Price Index in weight and contribution to MoM increase in May

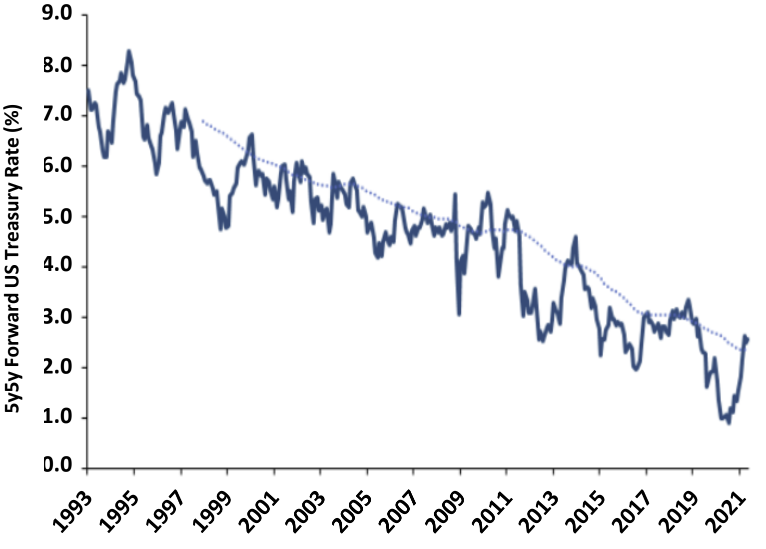


Source: Lombard Odier

However, with respect to inflation, we consolidate our position that base effects and volatile data should withdraw in the second part of the year. Global growth has roared back the last few months and inflation rates have blown out a lot higher. Longer-dated sovereign bond yields have intriguingly remained unchanged versus where they were in mid-March, which has left some investors puzzled.

If investors are of the view that long-term bond yields will continue their ascension, they need to believe that we are about to cross the threshold of a new paradigm of soaring inflation and/or growth. But as discussed in March, we view the surge in growth and inflation as transitory, since the fiscal stimulus will back-pedal, monetary stimulus will slowly reverse, supply bottlenecks will be subdued, and commodity prices will not treble every 12 months.

5y5 Forward US Treasury Rate & 5y Moving Average



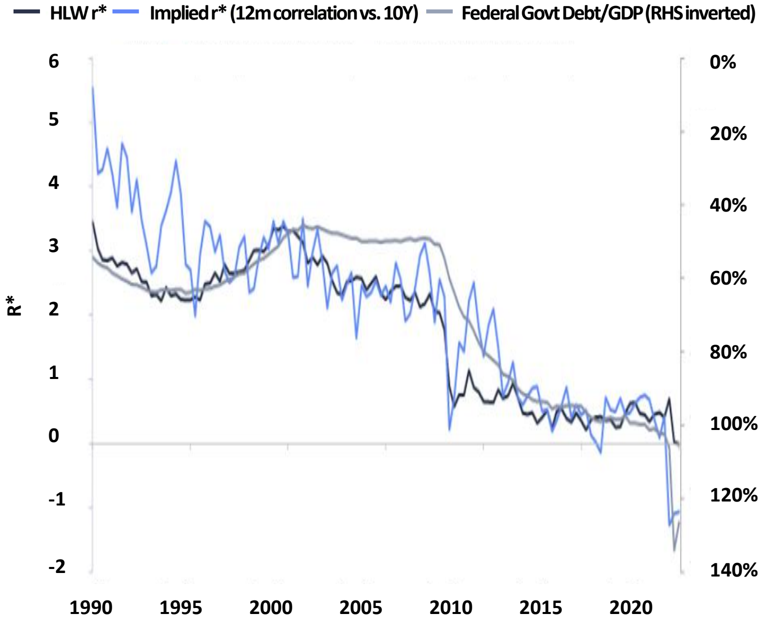
Source: Bloomberg

Growth is Hard to Generate in a Highly Indebted World

Our belief that the escalating level of inflation is transitory rather than structural is essentially due to the distressing amount of global debt. Global debt levels climbed by $40 trillion over the last 12 months alone. According to the IMF, in total, the world is sitting on a $280 trillion debt pile. This is 3.2 times more than global GDP which stands at $87.5 trillion. Generally, when government debt-to-GDP reaches 50-60% this starts to have a detrimental effect on growth and therefore eventually acts as a drag on inflationary pressures.

The figure below shows how this is reflected in the falling neutral rate of interest in the US, where government debt is around 130% of GDP.

Federal Government Debt-to-GDP vs Rates



Source: Deutsche Bank, US Federal Reserve, Haver Analytics

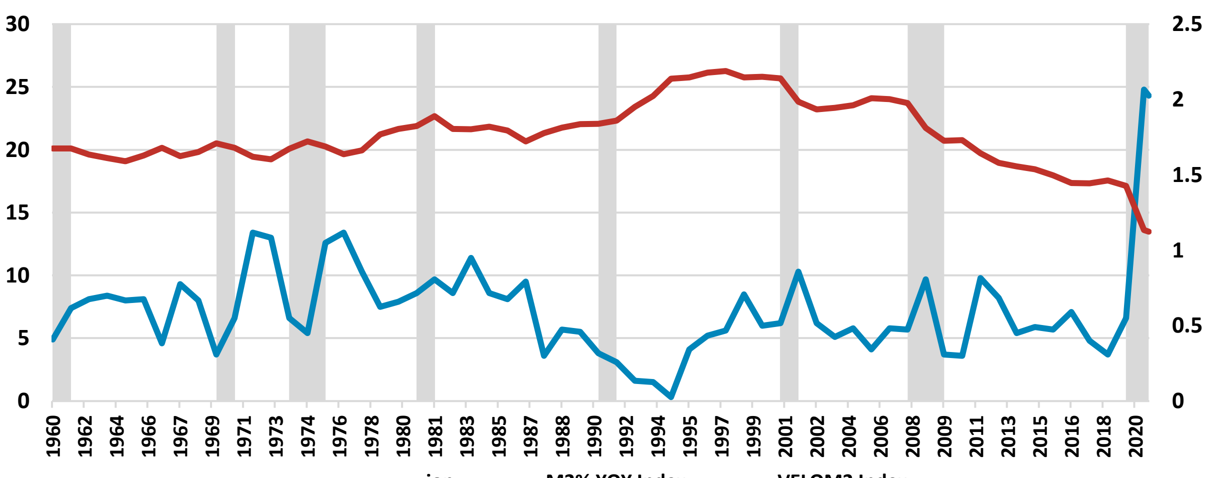
A better indicator of future inflation would be looking at this rise in money supply against the context of the velocity of money, which remains somewhat subdued. High money velocity – the rate at which money is exchanged within an economy – is associated with a booming economy, with businesses and consumers spending money and adding to GDP.

The overhanging global debt does not give room to a rise in money velocity in the near future. As the famed economist Irving Fisher wrote in 1933, highly indebted economies are likely to see a collapse in the velocity of money and therefore lower inflation.

What about the recent surge in M2 money supply – the total value of money available in an economy?

We do not agree with monetarist economists claiming that this presages a surge in inflation too. Much of this is most commonly due to companies straining down on bank facilities in order to stay solvent.

The velocity of money also tends to be hindered by demographic changes, such as an ageing population. The US is currently on course for one-fifth of their population to enter the 65+ years bracket by the end of this decade. With each passing year, the population in the US gets 1 month older.

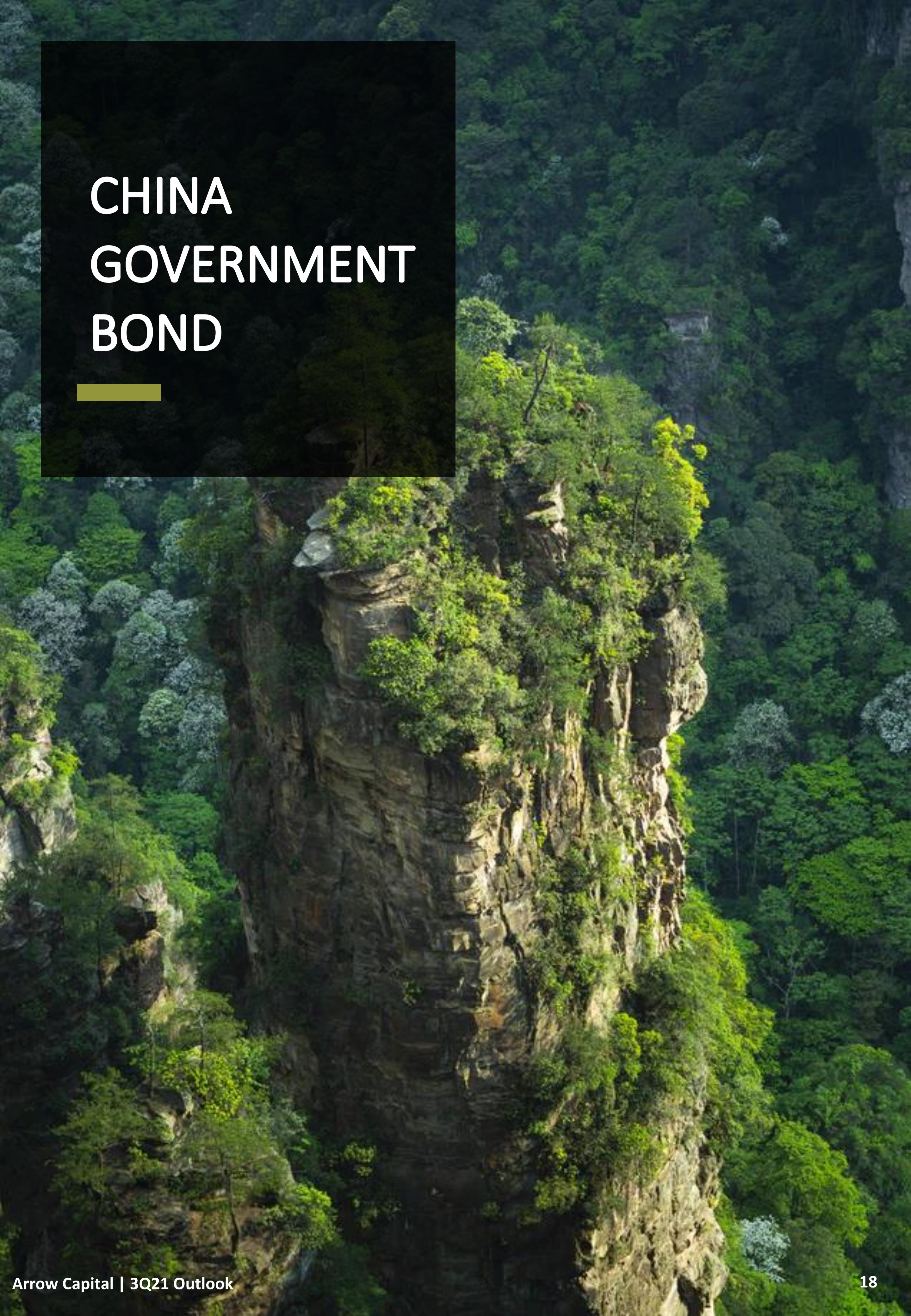


Source Bloomberg

Ageing Demographics & Consumer Spending

Ageing demographics affect consumer spending, which normally peaks in one's early 40s. When people hit their mid-70s, their spending almost halves. This is a key reason why we believe governments and central banks will need to step in through fiscal and monetary policy for some time to come, with the aim of backstopping economies, as the baby boomer generation continues to retire. Older populations simply save more and spend less of their income.

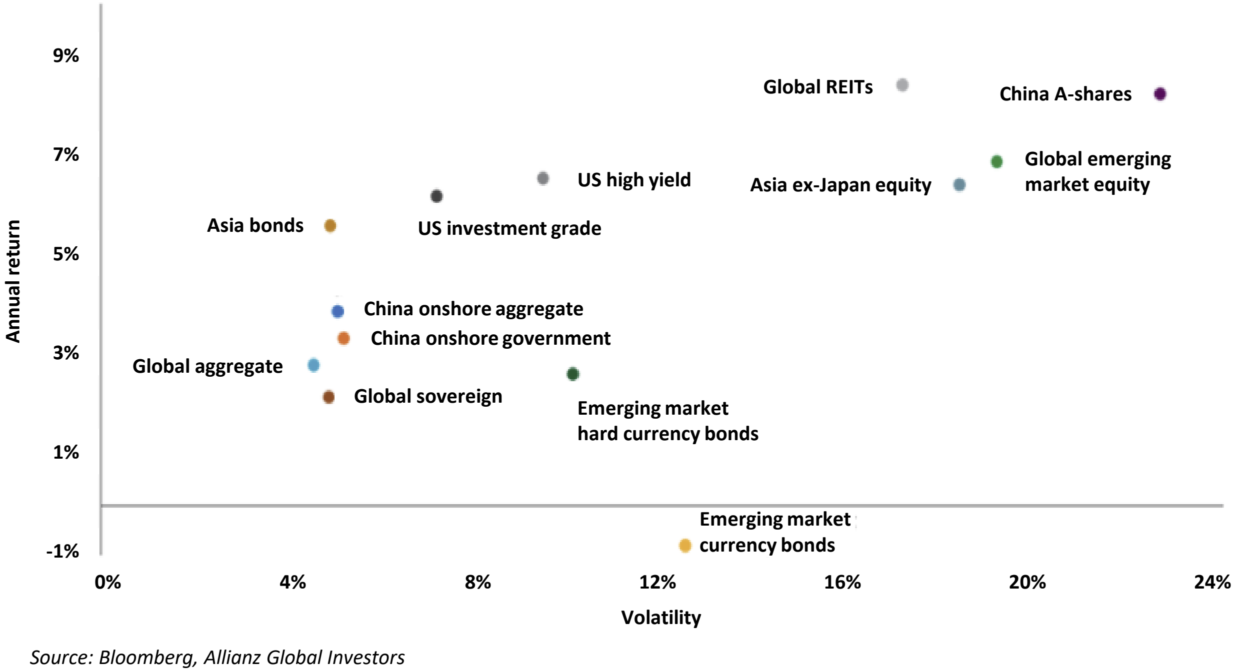
Weak wage growth is yet another component which we believe will continue to repress long-term inflation. The devolution of trade unions in conjunction with the increased power and influence of a handful of global monopolies signal towards continued downward pressure on wage growth. Disruption through AI, robotics and automation will most likely further entrench weak wage growth. For structural inflation to become an enduring concern, wage inflation needs to be embedded and accelerating.



CHINA GOVERNMENT BOND

The returns of onshore RMB bonds over time have been consistent. Additionally, their volatility has remained low, which indicates that there have been comparatively few large swings either up or down. These two metrics when taken together can be asserted as a “risk/return” profile. And, as the figure below shows, onshore RMB bonds have an attractive risk/return profile compared with other major asset classes. That can make onshore RMB bonds a helpful addition to a range of portfolios.

3-Year Risk/Return Profile (in USD)



Source: Bloomberg, Allianz Global Investors

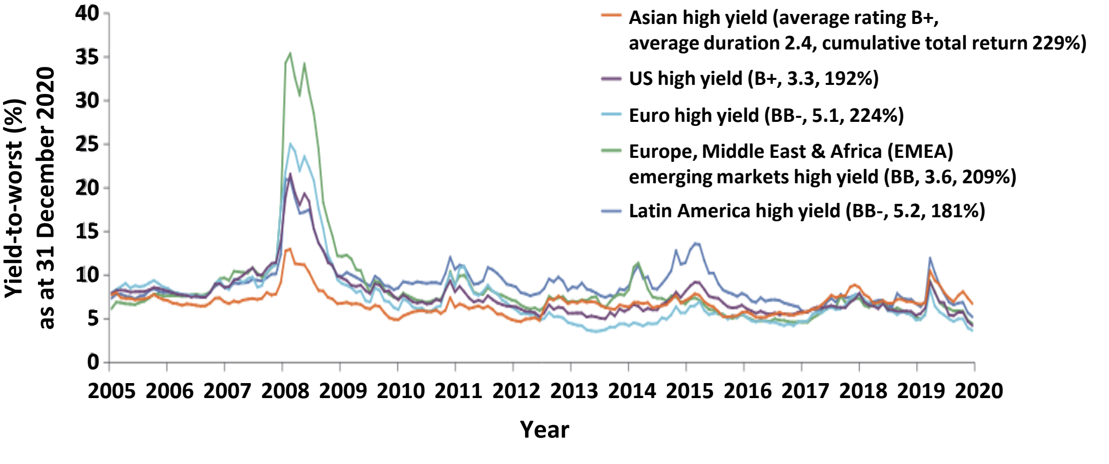
ASIA BONDS

The average credit rating of the Asian high-yield market is similar to its lower-yielding US counterpart. In spite of that, the yield pick-up which Asia proffers over other regions is at multi-year highs. As a matter of fact, the cumulative performance and resilience of Asian high-yield bonds (up 229%) has been a cut above that of other regions since 2005.

Asian high-yield bonds have lower average durations than other regional markets, which is normally indicative of low interest rate risk. This seems particularly attractive today, when corporate bonds seem to be more and more exposed to losses from sudden volatility in interest rate expectations.

Asia's Yield Pick-Up Over Other Regions is at Multi-Year Highs

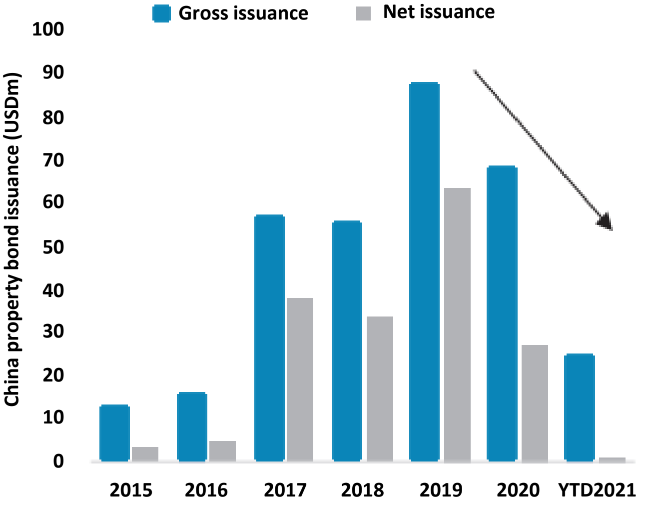
Yield-to-worst of major high-yield market indices



Source: JP Morgan and ICE BofA indices, Allianz Global Investors

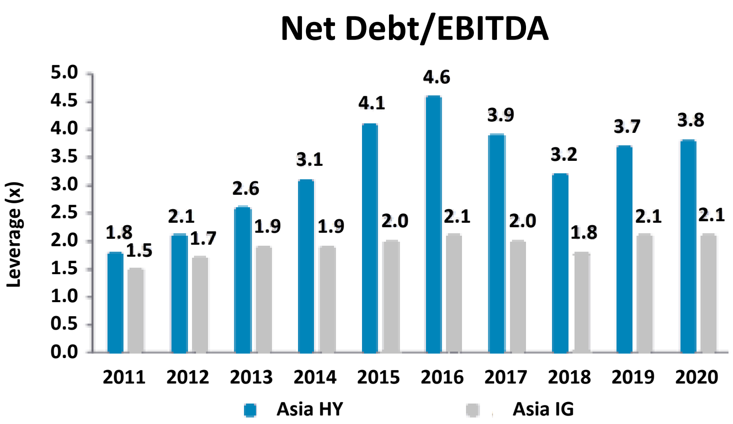
We had previously taken a positive stance on the China property sector, highlighting that the introduction of the “Three Red Lines” policy – which limits debt growth based on three balance sheet metrics (Liabilities/Assets 1x) – would lead to sectoral deleveraging and improved credit quality. As expected, this deleveraging shift had become more evident when comparing the 1H20 and FY20 results of major China property bond issuers in the USD space, which signifies that the sector has taken the directive both seriously and expeditiously. As such, China’s property bond supply continues to diminish. It is a necessary corollary of deleveraging that there would be increased scarcity of bonds, as gross issuances continue to taper while redemptions gather pace. As such, this would provide strong technical support for China property credits – which will be supportive of prices in the medium term.

China property bonds increasingly scarce

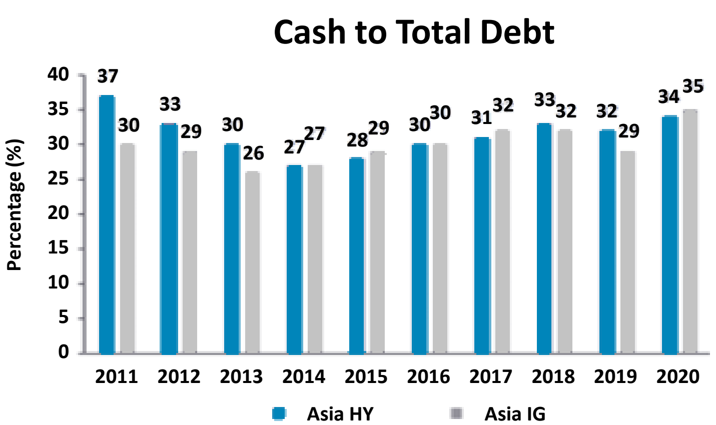


Source: Bloomberg, DBS

Overall, Asia HY corporates demonstrated resilience in the wake of the global growth shock. Net leverage moved up by 0.1x to 3.8x in 2020 versus 3.7x in 2019. EBITDA (earnings before interest, taxes, depreciation and amortization) margins showed improvement, closing the year at 20% versus 19% in 2019. Liquidity buffers have also remained in place, with cash to total debt closing the year higher.



Source: JP Morgan



Source: JP Morgan

Expectations for full-year 2021 Asia HY corporate defaults remains a benign 2.4%, 100 basis points (bps) lower than 2020 levels.

ALTERNATIVES: GOLD

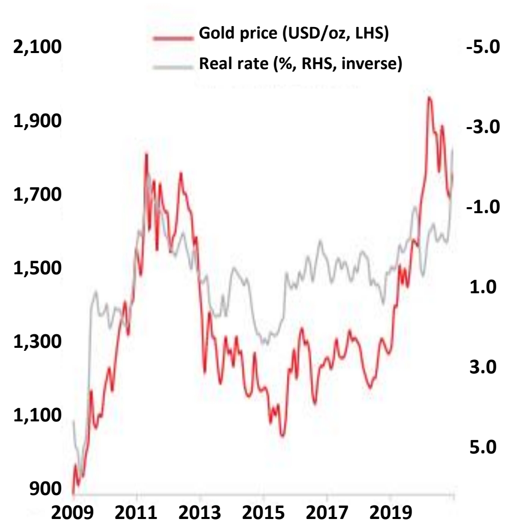
We expect gold prices to remain supported in 3Q21. Occasional spikes in yields may occur, and we look for bond yields to peak at 2% by the year's end. Importantly, surrounding the uncertainty over the yield spike is the outlook for the Federal Reserve's rate hikes, which we believe will be tamed. The Fed will likely be on hold till 2023.

Physical demand for gold is rising. Central banks continue to be positive on gold, with roughly the same number of central banks expected to buy gold compared to last year. According to the 2021 Central Bank Gold Reserves (CBGR) survey, 21% of central banks intend to increase their gold reserves over the next 12 months. Central banks are also increasingly valuing gold's performance during periods of crisis as this attribute now tops their rationale for holding gold. These results come amidst ongoing uncertainty stemming from the pandemic, a situation which has added significant complexity to central bank reserve management.

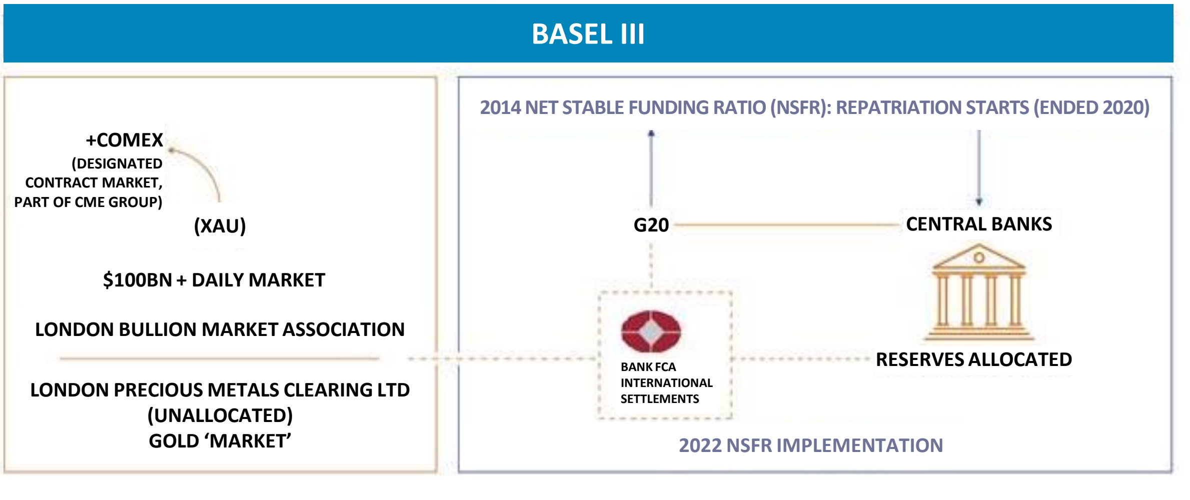
Similarly, in the aftermath of the GFC, real rates turned increasingly negative in 2011 as US yields fell and the yield curve flattened, in large part due the Eurozone debt crisis and the Fed's QE2 Operation Twist programme. At the same time, US CPI prints were rising through the year because of higher oil prices and post-GFC expansion. Gold prices were similarly going up. This indicates that the inverse correlation between real rates and gold price is tight. We are therefore of the view that gold should be doing a catch-up, with the expanding negative real rates in the coming months.

Within the Basel 3 framework, Gold also has an important role to play. The first important change in the Basel 3 framework is the amount of long-term funding banks are obliged to hold against their assets. The regulatory tool for measuring this requirement is in the Net Stable Funding Ratio (NSFR). Under Basel 2 rules, the LBMA banks were obliged to hold 50% in long-term funding against gold trading, however this is set to rise to 85% under Basel 3. Secondly, Gold has been upgraded from a Tier 3 to Tier 1 asset, placing physical gold holdings on par with cash and US Treasuries from a capital risk weighting perspective. These would be important structural changes for the gold market, and they would potentially boost demand for the precious metal, which is relatively supply constrained.

Real Rates and Gold



Source: Bloomberg, DBS



3Q21 GLOBAL TACTICAL ALLOCATION

Equities	
U.S. Equities	Overweight
Europe Equities	Underweight
Japan Equities	Underweight
Asia ex-Japan Equities	Overweight
Fixed Income	
U.S. Investment Grade	Underweight
U.S. High Yield	Neutral
U.S. Government Bond	Overweight
Europe Government Bond	Underweight
Europe Investment Grade	Underweight
Asia Investment Grade	Overweight
Asia High Yield	Overweight
Asia Government Local Currency	Overweight
Alternatives	
Gold	Overweight

IMPLEMENTATION OF STRATEGY

Category	Name	Performance				
		1W	1M	3M	1Y	3Y
Equities	**U.S.**					
	Morgan Stanley U.S. Growth Fund	4.32%	13.30%	8.61%	13.45%	60.88%
	Invesco QQQ Trust Series 1 ETF	1.92%	6.26%	13.10%	13.24%	43.96%
	Vanguard Health Care ETF	1.19%	3.27%	10.64%	11.08%	29.92%
	Vanguard Consumer Discretionary ETF	1.15%	3.06%	10.94%	14.30%	59.85%
	Consumer Staples Select Sector SPDR ETF	1.69%	-0.55%	11.84%	4.96%	22.48%
	Europe					
	BGF Continental European Flexible Fund	1.03%	3.20%	16.20%	17.15%	49.70%
	Asia ex-Japan					
	BGF Asian Growth Leaders Fund	1.50%	-1.35%	-5.01%	2.86%	37.35%
	UBS (Lux) Equity Fund - China Opportunity	2.60%	-3.52%	-9.15%	-5.24%	11.95%
	Morgan Stanley Asia Opportunity Fund	2.87%	-2.13%	-7.44%	0.07%	35.88%
	Allianz China A Shares IT USD	3.16%	-0.46%	6.05%	5.81%	57.61%
	Alternatives					
	VanEck Vectors Gold Miners ETF	-1.02%	-13.80%	9.16%	-5.66%	-6.88%
Fixed Income	**U.S.**					
	iShares 7-10 Year Treasury Bond ETF	0.30%	1.02%	0.02%	-3.41%	-4.45%
	Asia ex-Japan					
	BGF Asia Tiger Bond Fund	-0.19%	0.02%	-0.17%	-0.92%	4.76%
	iShares Emerging Asia Local Govt Bond UCITS ETF	0.02%	-0.88%	-0.26%	-4.17%	4.19%
	BGF Asian High Yield Bond Fund	-0.82%	-1.30%	-0.82%	0.00%	10.79%
	Global					
	Jupiter Dynamic Bond Fund	0.30%	1.27%	2.59%	0.34%	3.45%