The Way We See It

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Will the Bearish Consensus be Right ?

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A brief update report which serves to review recent developments, as well as offering our outlook for the near and medium-term future.

Review of Developments

Despite rising inflationary pressures, reduced monetary and fiscal incentives and persistent supply chain bottlenecks and geopolitical tensions, the global economy continued to grow at a modest pace. The US surprised with a negative GDP outcome in the March quarter, caused by the liquidation of excess inventories (domestic demand remained solid). Other countries showed a mild advance, boosted by a gradual return to normalcy and increased tourism. Inflation is high everywhere, caused by constrained supplies of energy, food, housing and labour. This forced major central banks to raise rates and reduce their quantitative easing programs.

A positive sign in the world economy is the easing of monetary policy in China, together with signs that major cities under lockdown, notably Shanghai and Beijing, have just begun to re-open.

With the above recent backdrop of global economies, what have we seen in global market?

After global financial markets saw off a challenging March quarter, investors were hoping for a more stable period. Unfortunately, the first two months in the June quarter had yet to signal a turn for the better:

- The US[1] and global equity[2] markets fell by 9.3% and 8.1% respectively in USD terms. Global Emerging Markets[3] fell by 5.1%.

- Similar to the trend in the March quarter, the US[4] and global aggregate bond[5] markets fell by 2.9% and 5.2% respectively. Global Emerging bonds[6] also fell by 5.6%.

- Commodities continued to power on, led by energy and agricultural prices. Gold declined.

- Flows and positioning data suggests that quantitative and algorithm-driven funds continued to be the main net sellers of risky assets (equity, long duration bonds, non-USD currencies), with proceeds going to cash. Fundamental investors appear to have recently joined the trend of reducing exposure to equities, in favour of bonds and cash.

In brief, in the first two months of the June quarter and year to date periods, equities and other risky assets have been sold down in favour of cash. Investors' sentiment remained poor. The "recession" scenario is fast becoming a central case.

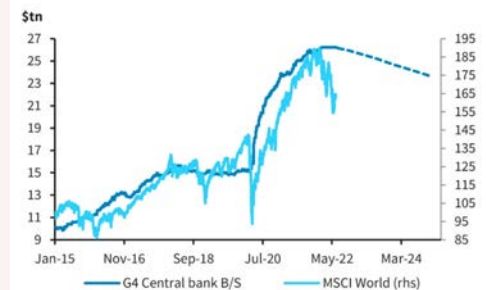
Thus, the question: *"Will the bearish consensus be right?"*

The section below outlines our views for the future ahead.

Outlook of World Economy

There are both positive and negative factors operating in the world economy in the next few months.

Positives include: the gradual re-opening of China's



1. MSCI USA index
2. MSCI World index
3. MSCI Emerging Markets index
4. Bloomberg Barclays US Corporate index
5. Bloomberg Barclays Global Aggregate index
6. JPMorgan EMBI Global Diversified index

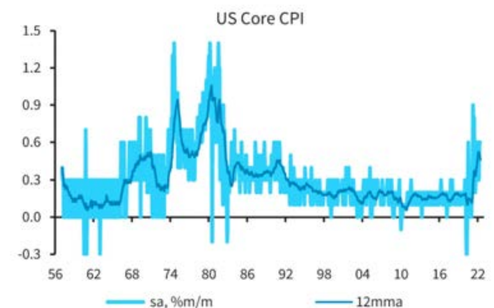
major commercial cities, following a strict lockdown. The latest stronger-than-expected export growth data from China attested to this development. In addition, while global economic growth has decelerated in the first half of the year, there is no visible sign of recession detectable in any major economy. In addition, as the majority of countries have started to re-open and encouraged tourists and foreign workers to return, this will add to growth and help to alleviate the shortage of labour in many countries. Regarding inflation, while the year-on-year rate in major economies remains high, the 3-month annualised rate has started to show a gradual decline, after peaking in March this year. Lastly, the US and Europe are engaging in internal debates to potentially lower the tariffs on certain imported goods, with the hope to lower inflation (where they politically and economically can).

Negatives include: the continuing supply-side bottlenecks (particularly sanctions against Russian exports), geopolitical tensions, gradual tightening of monetary policy by major central banks in the OECD bloc, and persistently high energy and food prices.

In brief, the world economy is likely to continue to grow, but exhibiting a sub-par pace, constrained by the above negative factors. Thus, while a recession can be avoided in the short-term, 'stagflationary' forces may dominate.

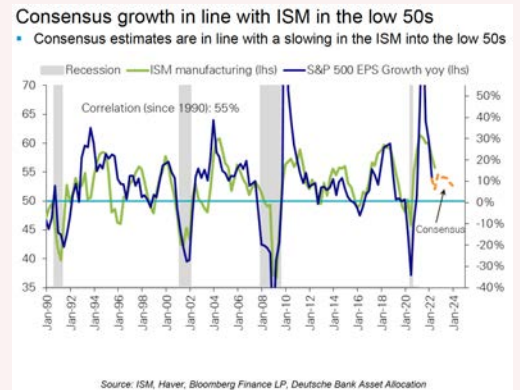
Global Markets and Investment Thematics

Against the above economic, monetary, and geopolitical unbalanced backdrop, in a not too dissimilar fashion through the first half of this year, global financial markets are likely to trade within a wide range, in a volatile manner. Consequently, it would be sensible for investors to continue to adopt a defensive strategy in overall terms, an investment stance that we had advocated since November of last year. This translates into a strong focus on quality and lowly-geared assets that can deliver predictable cash flows. In addition, as a number of growth stocks with a strong business franchise and good management have seen their share prices falling



significantly (due to the stop-loss liquidation-type of selling of the whole growth portfolio), long-term investors should take advantage of these opportunities to selectively add to their equity and bond exposures.

From an investor's sentiment and positioning perspective, we note that quantitative- and algorithm-focused funds appear to have reduced their exposure to risky assets relatively significantly. Fundamental investors, however, have continued to buy steadily, after a substantial buying binge last year. They remain the potential source of liquidation risk of risky assets, should newsflows worsen.



In brief, a sustainable bull market in equities and corporate bonds will return at some stage, but only when valuations are lower and, more importantly, when the US Federal Reserve and other major central banks switch from the current tightening to easing mode.

Back to the question, "Will the bearish consensus be right?". The way we see it, *"Yes, for the short term at least."*

Post-Script

Following the resurgence of inflation (+8.6% and +6% YoY at headline and core levels) in the May data in the US, the Fed raised rates by a high, but well anticipated, 75bps at the June FOMC held this week. They also announced that fighting inflation remains their highest priority, particularly when the US domestic economy, from the Fed's viewpoint, is perceived to be strong enough to absorb their policy tightening.

The Fed aims to achieve a cash rate of about 3.4%, and, ultimately, 3.8% p.a. by the end of 2022 and 2023, respectively. This means an additional 175 bps and 215 bps of rate hikes in the next 6 and 18 months, respectively. In addition, excess liquidity in the US financial system will be significantly reduced via the Fed's QT program (rising from -$45bn to -$90bn per month, from September onwards).

Our own view is that the above monetary trajectory appears to be too aggressive for a leveraged economy like the US. If implemented to the full, it will most likely cause the US economy to fall in a recession sometime next year.

We would also point out that the severe tightening of monetary policy will prove to be a blunt and ineffective tool to bring down inflation, particularly when it was essentially aggravated by "uncontrollable" factors, including geopolitical tensions and sanctions, together with the Covid structural disruptions in the workforce and global trade.

In brief, while a relief rally is occurring in the short-term, the above backdrop suggests that investors should continue to implement a defensive strategy, emphasising quality assets with predictable sales and cash flows growth.

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