The Way We See It

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INSIDE THIS ISSUE

How much market return has been borrowed from the future?

Global Economic & Investment Review to Sep'2021

Since the bottoming out of economic-sensitive markets in late March of last year, equity investors who remained invested and/or bought more during this 18-month period, have been pleasantly surprised by the out-sized returns. Global equities (developed markets) have risen by +67.1% since the end of March last year, +29.4% over the past 12 months and +13.4% in the year-to-date period to September 2021[1]. Global bonds did not fare so well, with total returns of +5.1%, -0.9% and -4.1% respectively[2]. For reasons given below, investors reduced their exposure to overvalued defensive assets (including gold) and switched to economic-sensitive or risky ones.

Reasons include cheap valuation, underweighted investors' positioning and, most importantly, an unprecedented amount of coordinated fiscal and monetary stimuli injected by all governments around the world, adding up to a staggering total of US$33 trillion. This resulted in a powerful global recovery in economic and earnings growth, and thus provided extremely potent catalysts for economic-sensitive asset classes.

[1] Returns of Global Equities refer to the returns of MSCI World (gross, in USD).
[2] Returns of Global Bonds refer to the returns of Bloomberg Barclays Global-Aggregate Total Return Index Value Unhedged USD.

While risky assets bottomed in the 3rd week of March last year, large institutional investors have only been starting to invest seriously since November, encouraged by three key factors: the breakthrough results of the Covid-19 vaccine trials by Pfizer and Astra Zeneca, the sustainable and robust economic recovery in the US and other global economies, and the neutral-to-positive US election results. It marked the beginning of an aggressive and consistent investment buying program in all economic-sensitive and risky asset classes, to date.

Consequently, equities, commodities, high yield bonds, luxury residential properties and the crypto market all rallied strongly. While the US and other developed markets enjoyed enormous out-sized gains and outperformed, emerging markets also recorded positive results. Sources of funds came from the low-volatility and more defensive assets, including the high mountain of cash, government and investment grade bonds, and, to a lesser extent, gold.

This brings us to an opportune time to ponder about the future: "Will 2022 be as good for risky assets as in the past two years?”, or, as the proposed discussion reflected in the title of this paper, "How much market return has been borrowed from the future?". We will also briefly discuss the relative prospects of the Chinese and emerging markets' economic and corporate profits versus their equivalent in the US and other global developed markets.

How much market return has been borrowed from the future?

Brief Outlook of Q4 and Year 2022

We offer below highlights of the outlook for Q4, and that of next year.

I. Q4 2021

As the US Federal Reserve is most likely to continue in keeping cash rates close to zero and pumping excess liquidity via QE (albeit at a reduced rate from the current US$120 billion per month) and that the US government may obtain approval to spend up to US$3 trillion in infrastructure projects and climate control improvements in coming years, the trend of global economic and corporate earnings growth is likely to continue to advance (though at a decelerating growth rate in the H2 2021 compared to the H1 2021).

In addition, the positive trend of key technical indicators, notably the ability of investors to accumulate more together with the strong price momentum of economic-sensitive assets, suggests that the bullish case for equities and other risky asset classes remains solid.

Based on the above positive assumptions and backdrop, several surveys of institutional and mutual fund investors' sentiment indicate that the consensus remains upbeat on the outlook for risky assets in Q4 and over the next 12 months.

Nevertheless, if one takes a deep breath and re-assess all key factors from a dynamic and forward-looking perspective, not everything is as rosy as the consensus would like us to believe.

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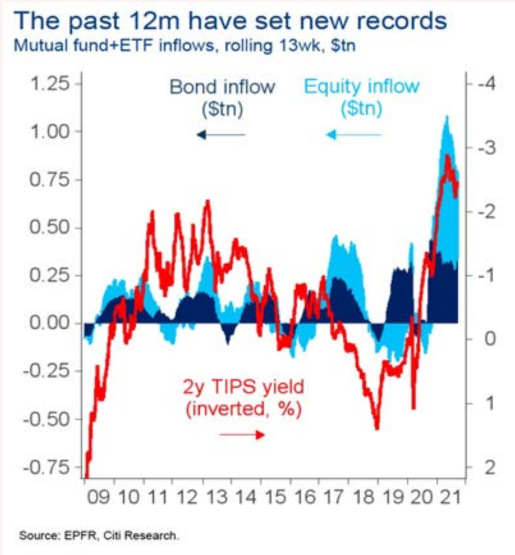
First, China, the locomotive of global growth over the past 20 years, has been slowing and is likely to grow at a sub-par rate. The government’s recent socio-economic measures, while necessary and important to address economic and wealth imbalances in the long-term, has caused adverse consequences on economic growth and corporate profits in the private sector in the short-term. This has exerted a detrimental impact on the risky asset classes of Hong Kong and China, notably equities, high yield bonds and luxury residential properties. At the time of writing, there is not yet any sign of reversal of the restrictive monetary and fiscal policies. As a result, while Chinese assets are relatively cheap as compared to the US and other markets, their relative under-performance vis-à-vis the US and global markets is likely to continue, until the restrictive policies are reversed. Lastly, as China constitutes a dominant share of the emerging markets' economic and investment universe, the above is expected to continue to detract investors' attention to this overall asset class.

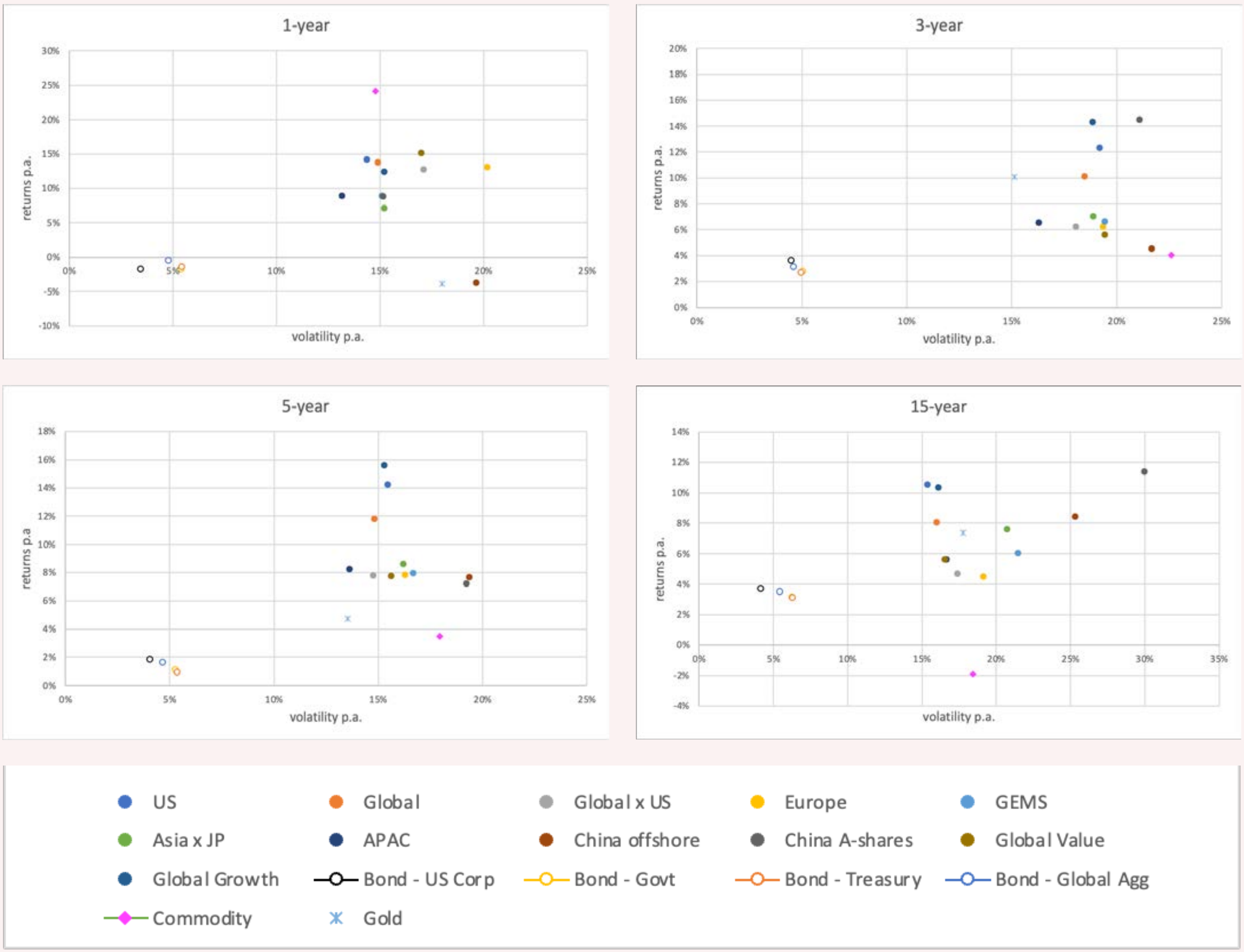
Second, forecasts of a continuation of strong economic and corporate profit growth in the US and the developed world have become a consensus view. Hence, economic-sensitive assets could be sensitive to any unexpected growth disappointment or interruption.

Third, the performance of equities and other risky assets (commodities, high yield bonds, luxury residential properties, etc.) is already very strong in the year-to-date period (as compared to their average annualised return recorded over the past 1, 3, 5 and 15 years). In addition, in 2021, investors poured a very substantial and unprecedented US$700+ billion in equity markets. This helped to push up equity valuations and other risky assets by at least 1 to 2 standard deviations above their long-term equilibrium levels.

EQUITY INFLOW



Risk/Return Quadrants of Major Asset Classes for the Past 1/3/5/15 Years to Sep'21



Source: Bloomberg, Goji Consulting

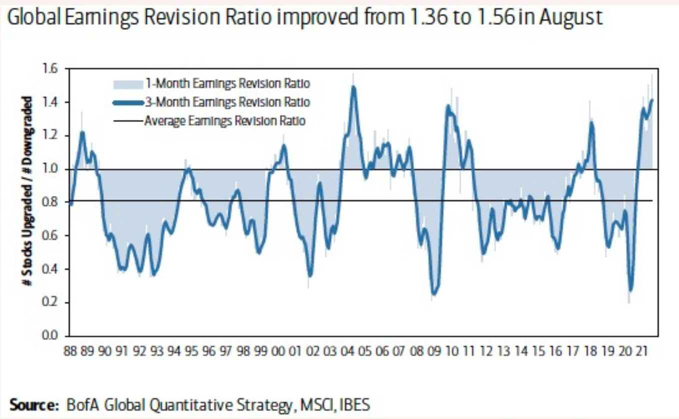
Lastly, while the technical long-term price trend of the US and other global equity markets continues to rise, there have been worrying signs of bearish divergences forming. In other words, the upward momentum of equity markets is no longer accelerating. If anything, several momentum measures have started to decelerate. If history is of any guide, this suggests that the probability of a large correction is rising.

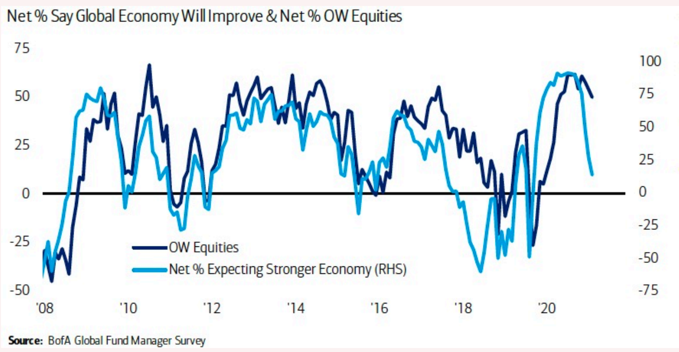
II. Year 2022

It is our strong view that next year will likely see many key positive catalysts, which have been driving the bull market of economic-sensitive assets over the past 18 months, decelerate or reverse.

First, the combined mix of a high starting base of comparison, together with a reduction of monetary and fiscal incentives in China and other G5 countries, as well as skyrocketing raw materials and other input prices (including wages and salaries), is expected to cause the rate of growth of the global economy and corporate profits to decelerate quite sharply.

CHANGE IN GROWTH RATE – GDP / CORP PROFITS



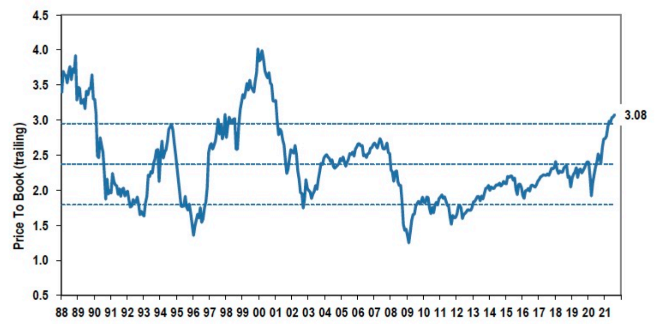


Second, the all-important US monetary policy settings are most likely to become gradually less easy. Soon, the high and generous “emergency” monthly QE program of US$120 billion will gradually be reduced, with some expecting it to be cancelled completely by June 2022, i.e. less than a year from now. In addition, depending on how “stubborn” inflation remains, the US Fed fund rate could be lifted, rising from the “emergency” zero-floor level, starting sometime in the 2nd half of next year. While small and gradual, the symbolic reversal of the super-easy monetary conditions is likely to cause disruption in the risky asset classes, particularly in areas where leverage is deemed high (equities, property, crypto, commodities, etc.). It is our opinion that the Fed and other G5 central banks have been implementing super-easy monetary policies for far too long.

Third, the valuation of the best performing risky assets and equity sectors is already considered as “expensive to very expensive” (US assets in general and US Tech in particular, plus the relatively insane valuation of crypto). Moreover, commodities, high yield bonds and luxury residential properties are also deemed overbought and overpriced.

VALUATION OF EQUITIES

Price-to-book for global equities is one-standard deviation above from long-term mean



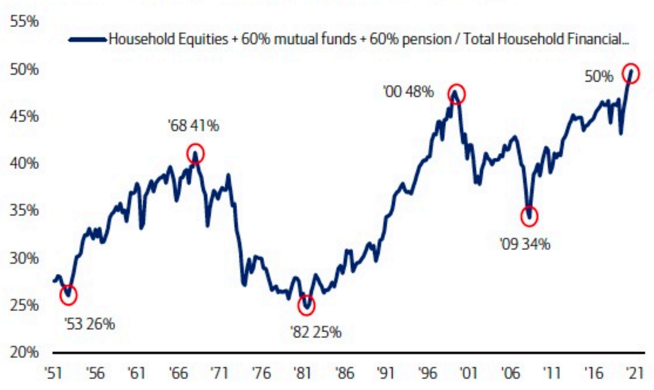
Source: BofA Global Quantitative Strategy, MSCI, IBES, FactSet, Worldscope

Current World Prospective PE is 19.6

Source: BofA Global Quantitative Strategy, MSCI, IBES

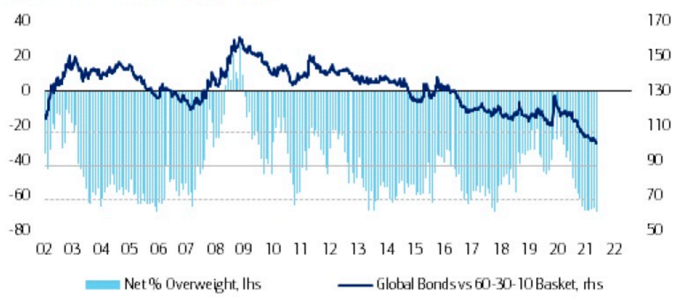
POSITION OF EQUITIES

US household equities % of total household financial assets



Source: BofA Global Investment Strategy, Haver

Net% of FMS investors overweight bonds



Source: BofA Global Fund Manager Survey

Fourth, and most importantly, investors’ positioning in risky asset classes is already relatively high (although not at peak historical levels), at a time when the super-easy monetary and fiscal policy backdrop in the US and elsewhere is expected to fade gradually.

Finally, one should also factor in the deteriorating political and technological tensions between the two super-powers in the world, the US and China. Tensions could unexpectedly flare up from time to time, causing volatility in risky asset classes.

Net-net, the year 2022 is likely to be affected by a softening or reversal of this year’s highly positive catalysts.

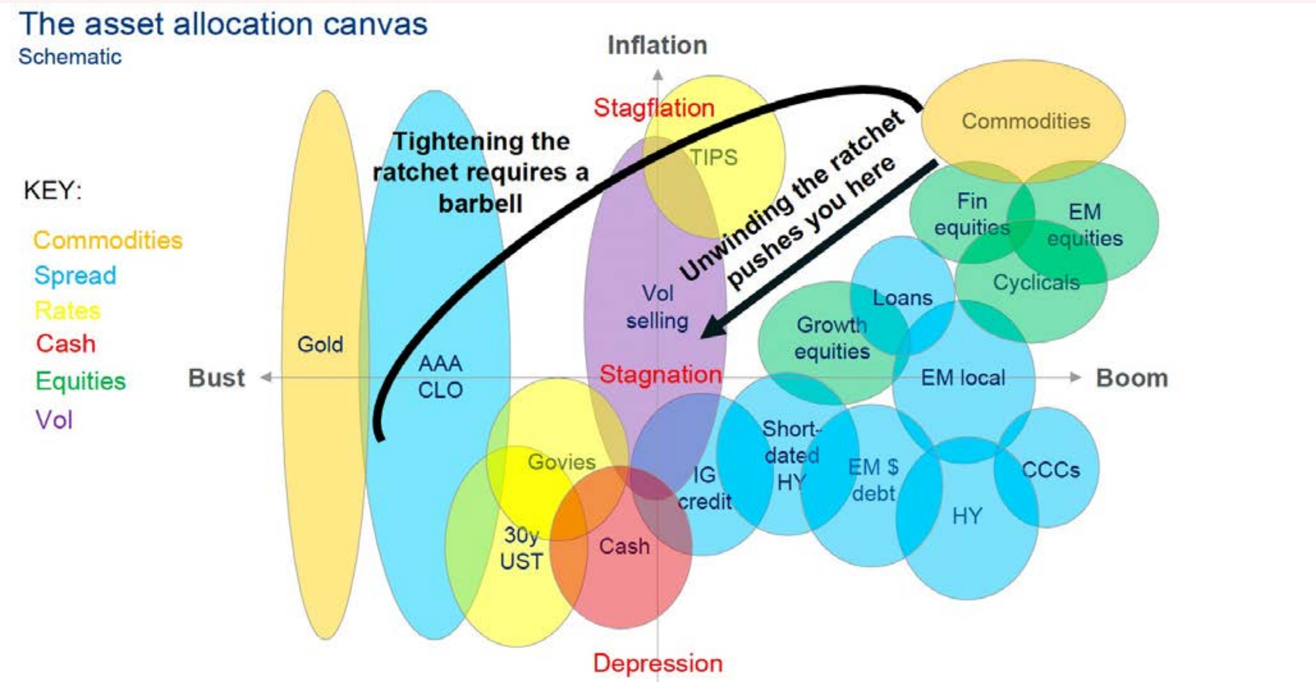
Concluding Remarks & Recommendation on Asset Allocation

In our opinion, based on the above and the dynamism of forward-looking markets, we believe that this year's very strong bounce in economic-sensitive assets has "borrowed" a substantial amount of market returns from those of next year and, possibly, the year after next.

Investors should consider starting to take profit gradually on parts of their risky asset classes, particularly those which are deemed overvalued relative to the past 3, 5 and 10 years. Depending on the type of portfolio one is managing, for investors who can and are looking to re-balance their portfolios, they should consider implementing this plan from Q4 of this year. While safe and low volatility asset classes have experienced a poor return performance year-to-date and may not offer much room for yield pick-up or capital growth, they can, and would most likely offer capital preservation in 2022. In brief, this suggests that a global balanced portfolio should look to reduce exposure to equities (particularly the hyped-up sectors), high yield bonds and commodities, and consider adding more defensive assets from Q4 onwards. Furthermore, while investors are feeling comfortable with the out-performing US and other developed markets at the expense of China and the emerging world, into next year, the (currently low) probability of a reversal of this trend could increase, if China were to unexpectedly loosen.

We include a chart from the Citigroup Strategy team below to reflect the current and future risks of a reduction in excess liquidity, rising inflation and slowing economic growth, and how this could drive investors toward more defensive assets in the future.

Lastly, we wish to point out that our relatively more cautious investment stance, when compared against the still-bullish view held by the majority of buy- and sell-side strategists and CIOs in the marketplace, may be construed as somewhat contrarian.



Source: Citi Research. Originally used in *Unsustainable investing: where to invest amid the bear market in trust*, M. King, Sep19.

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