

# Global markets outlook

## China: Restarting engine three

June 2022

# General overview

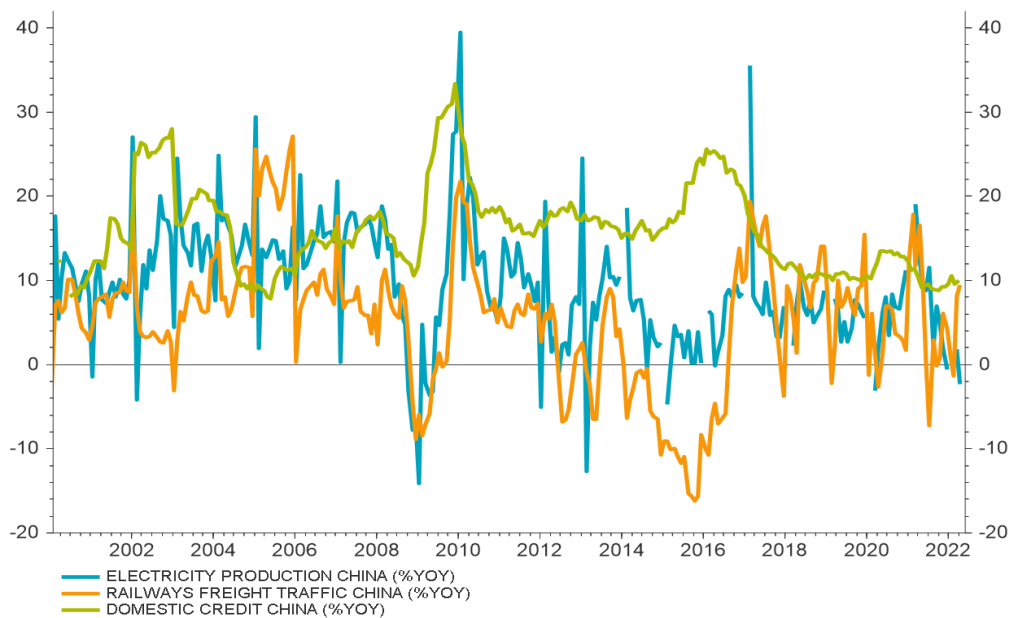
## Real yield sensitive assets took a beating

MULTI ASSET	1mo	3mo	YTD	1YR	3YR	5YR
Oil Index (USD)	11.2%	26.2%	64.3%	93.1%	6.8%	6.5%
GSCI Commodities (USD)	3.5%	27.0%	56.1%	85.9%	21.1%	14.1%
Global investment grade bonds (H, EUR)	0.1%	-6.7%	-11.2%	-10.6%	-1.1%	-0.2%
Cash (EUR)	0.0%	-0.1%	-0.2%	-0.5%	-0.5%	-0.4%
EMD local currency (UH, EUR)	-0.2%	-2.3%	-3.2%	-1.6%	0.0%	0.8%
Emerging Markets (LC)	-0.2%	-5.7%	-9.6%	-15.7%	6.5%	5.7%
MSCI World local currency	-0.2%	-4.2%	-11.4%	-1.4%	13.0%	10.0%
MSCI World (H, EUR)	-0.3%	-4.8%	-12.0%	-2.6%	11.4%	8.2%
Global high yield (H, EUR)	-0.5%	-5.0%	-9.5%	-9.5%	-0.1%	0.2%
Global Gov Bonds (H, EUR)	-0.6%	-5.7%	-8.2%	-7.9%	-1.8%	-0.6%
Emerging Markets (UH, EUR)	-1.1%	-2.8%	-6.3%	-8.5%	6.4%	4.8%
MSCI World (UH, EUR)	-1.4%	-1.1%	-7.6%	8.6%	14.1%	10.8%
EMD hard currency (UH, EUR)	-1.5%	-2.8%	-9.0%	-3.4%	-0.4%	1.1%
Gold (USD)	-3.6%	-3.1%	0.6%	-3.4%	10.5%	6.5%
Global inflation-linked bonds (H, EUR)	-3.8%	-8.3%	-9.9%	-5.3%	0.7%	0.9%
Global real estate (UH, EUR)	-7.5%	-1.4%	-9.0%	11.8%	4.2%	5.1%

The rise in commodity prices has been relentless this year, with oil prices again adding a double-digit monthly return of 11.2% (in US dollars) in May, bringing the year-to-date return to 64.3%. Although oil fundamentals have worsened since the lockdowns in China, commodity hoarding behavior against a backdrop of structural scarcity has sustained current pricing.

As 10-year real yields in the US rose another 10 bps, investor's fears have continued tilting towards growth concerns instead of inflation. Reflecting this, assets that are the most sensitive to real yield increases declined the most last month. Gold fell by 3.6% and global inflation-linked bonds by 3.8%, while global REITS slumped by 7.5%. Within the fixed income spectrum, US credits and high yield saw the best returns as spreads in the latter compressed below the 500 bp mark again. As the ECB adopted a more hawkish stance, indicating that APP net purchases will end "very early" in the third quarter, peripheral Eurozone spreads widened, with Italian government bonds losing 2% in value. Within equities, cheap regions that are net commodity exporters continue to outperform this year, as shown by Brazil, which outperformed the global benchmark last month by 3.4%, lifting its year-to-date return to 6.2%.

## China's activity indicators – not all bad news



Source: Refinitiv Datastream

Source: Refinitiv Datastream, Robeco as @30 May 2021

## China: Restarting engine three

The latest Covid threat to China's population's well-being and prosperity has led the authorities to implement severe lockdowns in Shanghai and other regions, while less draconian measures were implemented in Beijing. The economic outlook has been decimated, as happens with lockdowns everywhere, and consumers have been driven into hibernation (the Services PMI registered below 40), resulting in a desynchronization of domestic economy and monetary policy with the rest of the world.

Where other central banks have been raising rates and tightening financial conditions, the People's Bank of China (PBOC) has been cutting rates and easing reserve requirements. In addition, recent announcements on increasing infrastructure (USD 45 billion), airline industry support (USD 52 billion) and tax rebates (USD 20 billion) for the middle classes appear to be at the right time in the cycle to kickstart growth, unlike the US, which poured more money into an already overheated economy. Although using these previous levers to stimulate are subject to the law of diminishing returns, the package of measures will kickstart the economy coming out of lockdowns.

In the near term, the economy will trump the ideology and President Xi's vice-premier and prime minister are likely to step down at the 20<sup>th</sup> Party Conference, allowing the leadership to distance itself from recent dubious Covid-related policy decisions. We continue to believe that China is investible either through commodity and raw material demand proxies such as Latin America and Asia, or directly in Chinese companies. From our vantage point, we can see that these proxies have priced in a much better outlook for the Chinese economy – in fact, the factories kept running during lockdown. The consumer will exit the doldrums with 'revenge spending', helping the domestically focussed internet and consumer stocks to recover from historically low valuations levels. More broadly, we are experiencing a desynchronised economic cycle, so as China reopens, this should be a shot in the arm to global growth and unlock the value in the unloved assets that are pricing in a too-pessimistic outlook

## Theme of the month

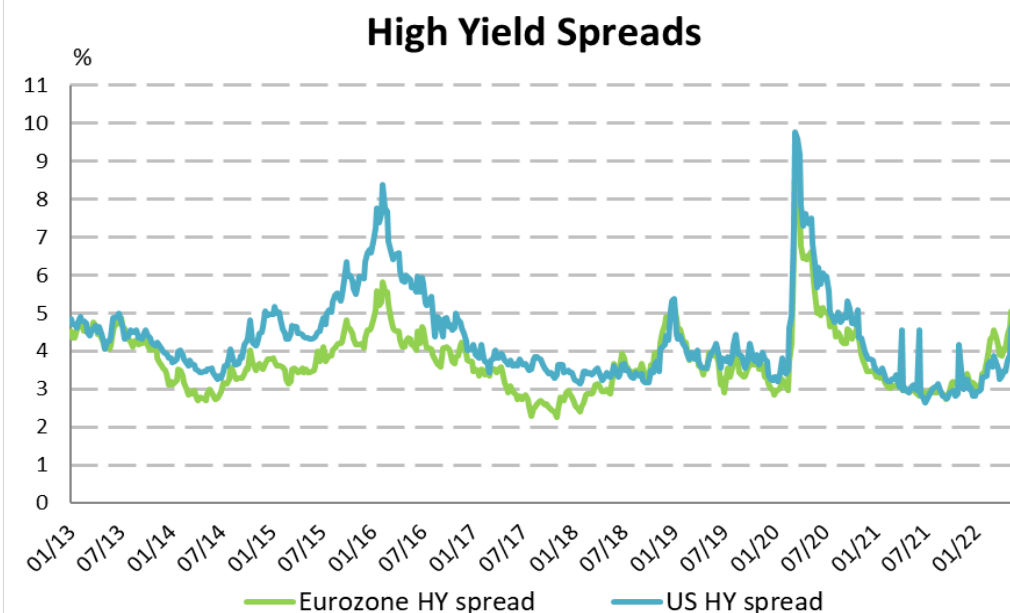
### Is US high yield sending a recessionary signal? Or is it just too pessimistic?

Recent macroeconomic data releases in developing economies have indicated slowing growth, and the inflationary scare is morphing into a growth scare, so we are watching the US high yield market with interest. Fears that the US Federal Reserve cannot engineer a soft landing are well founded in history, given current levels of inflation and employment, and we have some sympathy with that view. The counter argument is that the FOMC has leeway for some cooling of excess tightness in the jobs market without immediately endangering the cycle, so a small rise in unemployment could be positive to extending the cycle, and allow them to pause rate hikes.

The US high yield market composition has changed significantly, with consumer discretionary being the largest borrower below investment grade at 20%. Energy is still high at around 14%. So, high yield remains a very cyclical asset, although employment and consumer spending will be key drivers. High yield is the only major asset class that has seen net outflows over the last 12 months and in the year to date, while in equities only small cap companies have done this. These flows turned positive in the last week of May.

Outside a recession, the current levels of high yield look attractive, and the growth scare is being priced in. If we look at our core investment scenario, the balance sheets of both consumers and corporates are in good shape, and the excesses that we have seen in previous recessions are missing from the obvious places (except maybe government balance sheets), which leads us to think that recession risk is not elevated on a 12-month horizon. We assess that high yield risks are more symmetric than the recessionary skew reflected in current spreads; the default risks are still low; and the Federal Reserve will pause later this year.

### The recent spike in US high yield spreads reflects the growth scare



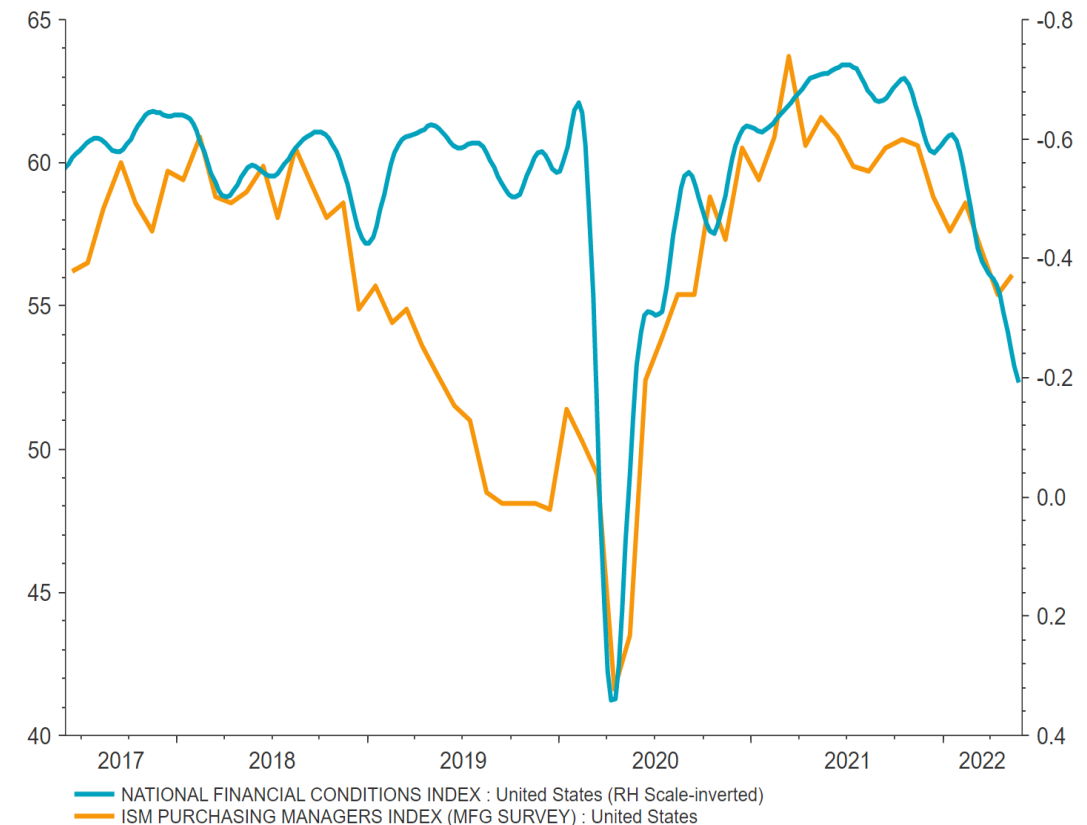
Source: Robeco, Bloomberg

## Economy (I)

May saw macroeconomic data releases increasingly surprise to the downside, with the notable exception of Japan, where macro surprises remained positive overall. Although leading indicators point to a continuing, broad-based expansion of economic activity, the general pace has been slowing for almost a year now. Our business cycle indicator signals that we have entered the slowdown phase of the business cycle. While headline inflation numbers in some developed markets like the US declined in May, the deceleration in inflation is far from synchronized, and underlying inflation pressures remain highly elevated.

The global economy is coping with several challenges that inhibit economic growth momentum, while the presence of a growth locomotive that offsets downside risks is lacking momentarily. First, one of the largest growth engines of the global economy is still sputtering. Although the official manufacturing PMI rebounded in May to 49.6 from 47.4 in April, Chinese growth is obviously contracting on the back of China's strict Covid lockdown policy, with the latest retail sales numbers down 11.1% y-o-y. Although lockdown restrictions in Beijing and Shanghai have been largely lifted, and more monetary stimulus is getting underway, an inflection point has not been reached because President Xi has prioritized his zero-tolerance Covid policy over reinvigorating economic momentum with local policymakers.

### Tightening financial conditions point to a further deceleration of real activity



Source: Refinitiv Datastream, Robeco

Source: Refinitiv Datastream & Robeco

## Economy (II)

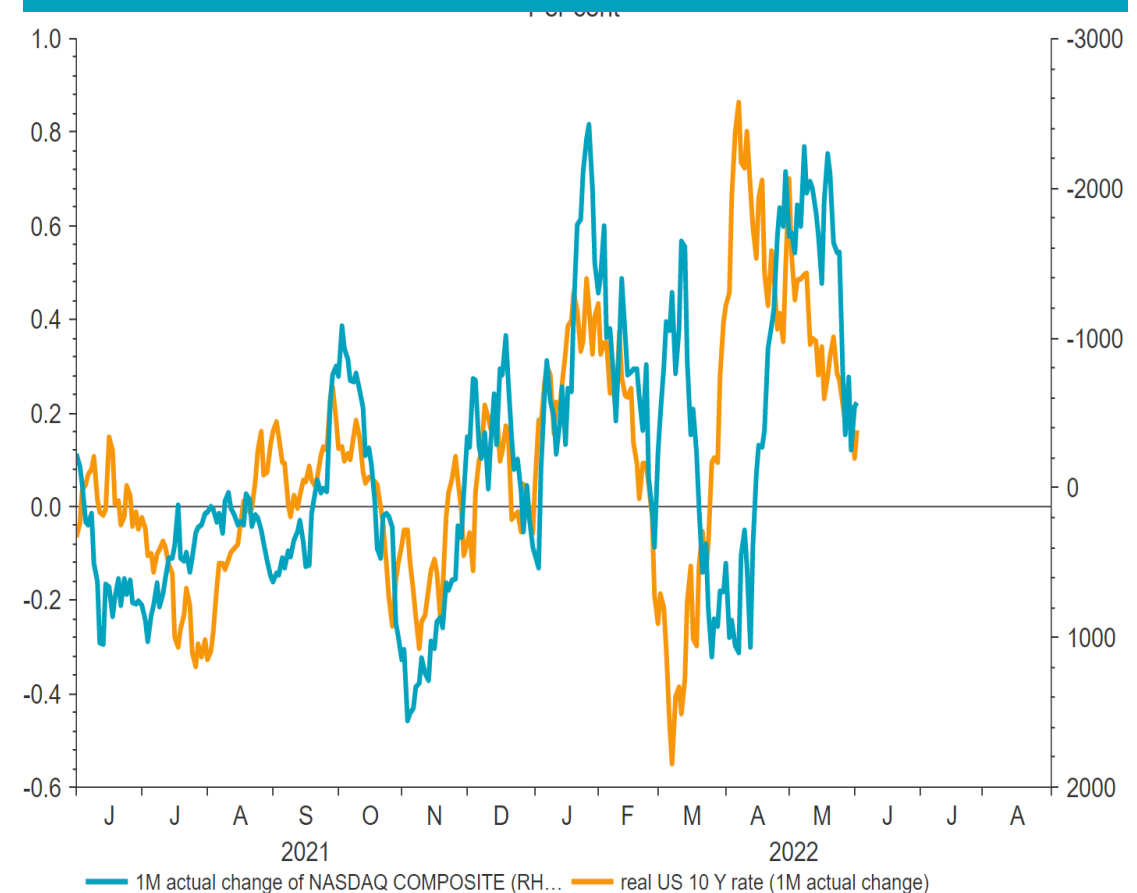
Second, the first cracks are appearing in the US housing market, as 30-year mortgage rates have surged above 5%, and new home sales plummeted last month (-26.9% y-o-y). Rising gasoline prices (now above USD 5 per gallon) are starting to constrain future purchasing power. This slows extended discretionary goods consumption, although services consumption is still benefitting from a re-opening effect, with demand converging to the pre-Covid trend in the US. Also in the Eurozone, services activity is rebounding, despite the earlier plunge in consumer sentiment. Yet, German retail sales slumped 5.4% m-o-m in May.

Third, the Russia-Ukraine conflict slows economic momentum as consumers (especially those in the lower income cohort) feel the pinch of high commodity prices. Fourth, rising real interest rates as central banks try to catch up with inflation pressures stymies growth momentum on the back of a stronger dollar, though the latter started to weaken in May. As inflation in the US declined in April (8.2%) compared to March (8.5%), expectations that inflation has peaked has led the Fed funds futures curve to flatten. Market participants now expect a more measured tightening pace by the Fed after September. The Fed funds futures curve now reflects market participants expectations for a peak in the policy rate in 12 months' time at 3.0%.

Source: Refinitiv Datastream & Robeco

6 All market data to 31 May unless mentioned otherwise

## The direction of travel for real yields matters for growth stocks

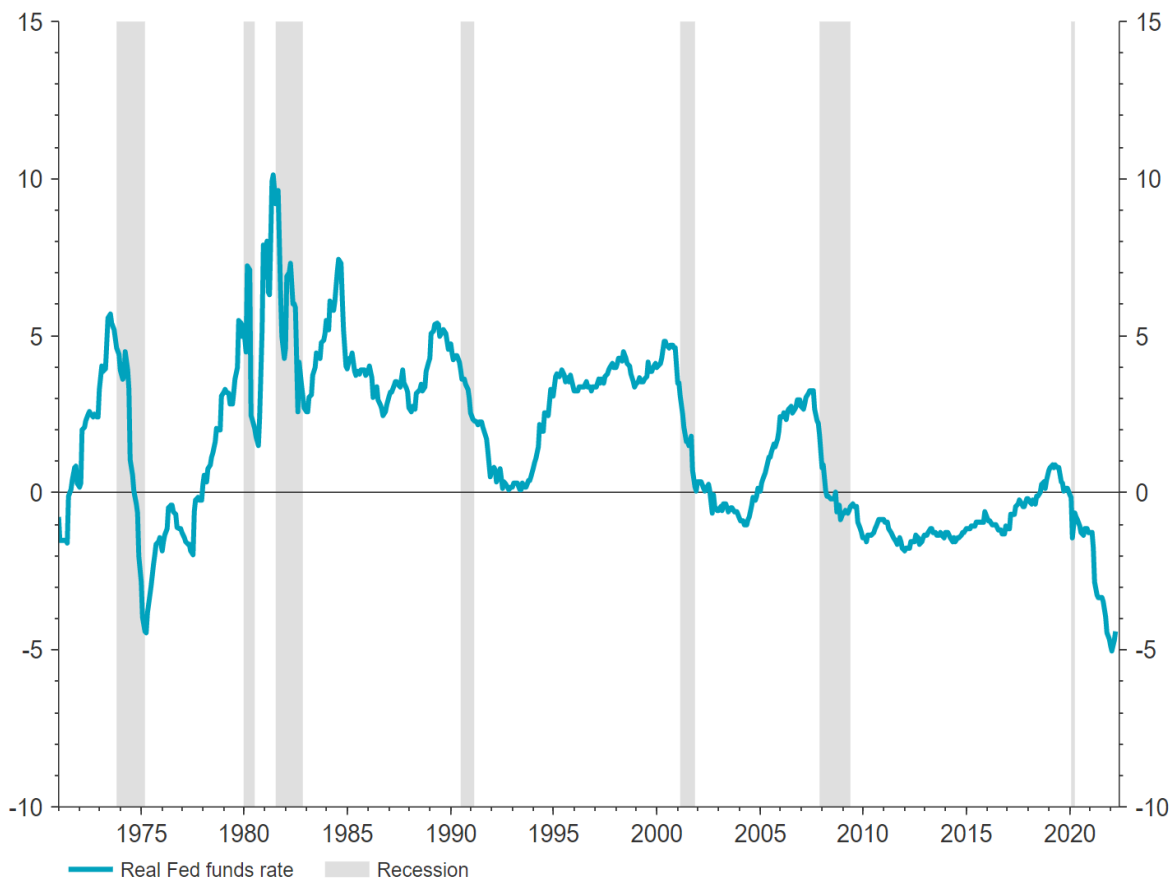


Source: Refinitiv Datastream & Robeco

Source: Refinitiv Datastream, Robeco

## Economy (III)

### The level of real Fed funds is still broadly accommodative



Source: Refinitiv Datastream, Robeco

Source: Refinitiv, Robeco

7 All market data to 31 May unless mentioned otherwise

Last month, we lowered the odds of our bull case to 10%, as we see fewer productivity gains materializing on the 6-12-month horizon. We increased our bear case probability of a US recession materializing in the next 6-12 months to 30%. A recession on a 6-12-month horizon is not our central investment case. We think the current growth pessimism among investors (US high yields spreads reflected a 45% recession probability in mid-May) to be somewhat overdone, as financial conditions have clearly tightened, but do not signal an outright contraction of the US economy in the near term. We also think the Fed will show some sensitivity to a further deterioration in financial conditions as the composition of FOMC voting members will become more dovish in the course of the year, and as inflation starts to decelerate in the third quarter.

In our view, the two necessary conditions for immediate recession risk are not flashing red yet; excess Fed tightening, and corporates and household running out of cash to spend. The real Fed funds rate typically enters positive territory before triggering a recession; it is still deeply negative at -4.4%. That said, the risks to our base case are clearly tilted to the downside given the growth challenges discussed in the previous section. Yet, there are upside risks as well, mainly stemming from China reprioritizing its objectives from a zero-Covid policy to boosting economic activity. Verbal guidance from policymakers like Li Keqiang and recent easing actions (lowering the 5-year loan prime rate for instance) suggest that Beijing is now willing to shift to a more forceful stimulus mode.

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