Delta variants, Fed tapering, China regulatory tightening jolt market

Investment Markets	BCT's Investment Views	Summary
Equities		
US		We are neutral on U.S. equities. We are seeing some hiccups in government's fiscal stimulus plans amid slowing vaccinations and the spread of virus variants. However, markets seem to be underestimating the will of the government to reopen the economy as hospitalisations remain low.
Europe		We are neutral on European equities. The region should witness robust growth but as we progress into the earnings season we will see future guidance (we think earnings should grow) on how companies will pass rising costs on to consumers to protect margins.
Japan		We are neutral on Japanese equities. Relative earnings trend suffered recently due to strong earnings in the U.S. and Europe. However, in the long term, global cyclical recovery and prospects of a weakening yen should be supportive for Japanese markets.
Asia ex Japan		We are positive on Asian equities. In our view, the long-term outlook for Asian equities broadly remains extremely positive, but sentiment may remain fragile in the near term until the length and breadth of a regulatory clampdown becomes clearer.
China & HK		We remain positive on Chinese equities. Given China's stable economic growth, its reorientation towards domestic consumption and continued government policy support (policy divergences from the U.S.) should benefit equities in the long term. We are neutral on Hong Kong equities. Marketability of initial public offerings of Hong Kong should benefit from the ban of American depositary receipt listing in the U.S. from China. However, the impact on average daily turnover still needs time to evaluate.
Global Bonds		
Government Bonds		We are cautious on government bonds. We remain defensive on U.S. Treasury due to the rising fiscal deficit, debt and our expectations that once the base effect-induced inflation cools it will still settle above pre-pandemic lows. We remain positive on credit. The economic backdrop is strongly in favour of the trade as global reopening should maintain supportive fundamentals.
Credit		

Scales of weighting			
	Underweight	Neutral	Overweight

U.S. EQUITIES

U.S. equities grounded higher in July and outperformed the rest of the world. The S&P 500 started the quarter well with a growth of +2.4% thanks to a stronger-than-expected second quarter reporting season which provided support for equities. Q2 gross domestic product (GDP) was up +6.5% quarter on quarter indicating impressive strength in domestic demand. The GDP reading was regarded as positive news for the markets as we believe the economy will grow at a strong pace. The U.S. Purchasing Managers' Index (PMI) was 63.4 in July, up from 62.1 in June and slightly higher than the estimate released earlier. The U.S. manufacturing index achieved a record high thanks to a sharp expansion in production linked to stronger client demand and efforts to clear backlogs of work. In terms of monetary policy, at its July meeting, the Federal Open Market Committee (FOMC) sent the first signal that quantitative easing tapering was approaching by acknowledging that the economy had made progress on tapering goals with the timing of tapering depending on labour market data.

We believe the recovery in the U.S. should continue amid low hospitalisations and the accompanying demographics demand will be supportive of a recovery in the medium term. As a result, the growth outperformance of the past month is unlikely to be sustained. While we like high quality cyclical value names, we focus more on businesses' strengths and strategies. We are exploring value stocks for higher margins and domestic value, and cyclical names as they tend to have better control over supply chains than the more global names. Fiscal stimulus plans in the U.S. are sizable. Even taking into account that there will be further lengthy negotiations, compromises and political hurdles, the bipartisan USD 1 trillion infrastructure bill and the Senate and the Democrats' 3.5 trillion budget plan in the pipeline will have an impact on long-term growth. From a more tactical perspective the growth lost a bit of momentum due to capacity constraints (note the bid drag from inventories in Q2 GDP which showed that the weighing on inflation were also capping growth). These constraints are likely to be temporary but normalization may take time, adding uncertainty regarding virus evolution and the variants' spread. We are neutral on U.S. equities. We are seeing some hiccups in government's fiscal stimulus plans amid slowing vaccinations and the spread of virus variants. However, markets seem to be underestimating the will of the government to reopen the economy as hospitalisations remain low. We believe this is not a time to reduce the cyclicality in portfolios, but to remain selective in light of growing consumer demand, expectations of an earnings revival and inflationary pressures on corporate margins.

EUROPEAN EQUITIES

The MSCI Europe went up +1.5% in local total return terms in July, Eurozone GDP expanded at a solid rate in Q2, benefiting from the easing of restrictions and progressive reopening. Eurozone inflation cooled in June and temporarily eased concerns that the economic reopening would fuel price growth. Eurozone PMI reading was 62.8 in July, up slightly from the earlier flash estimate of 62.6. After a record expansion during Q2, Eurozone manufacturing showed continued strength with a sharp improvement in the health of the production sector. From a monetary perspective, during the month of July, the European Central Bank (ECB) President Christine Lagarde confirmed the overall dovish tone. The ECB updated its forward guidance in light of the recent Strategy Review, taking into account their new symmetric 2% inflation target. The ECB expected interest rates to remain at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and remaining durably for the rest of the projection horizon. In addition, the ECB statement said that this “may also imply a transitory period in which inflation is moderately above target”. This implied that there is still a long way to go before rate hikes become consistent with the inflation outlook.

In Europe, we continue to believe in a recovery supported by vaccinations but we are also monitoring hospitalisations. This data may affect reopening in certain countries. We also believe in rotations towards quality value and cyclical equities, although we are aware that it will not be linear. On the other hand, we acknowledge the risks to some peak momentum and keep a balanced stance. We are neutral on European equities. The region should witness robust growth but as we progress into the earnings season we will see future guidance (we think earnings should grow) on how companies will pass rising costs on to consumers to protect margins. On the other hand, the market is fixated on inflation and the spread of virus variants amid reopening. The value/cyclical rotation will likely continue but will not be linear. We are increasingly focused on environmental, social, and governance (ESG) and dividend themes.

JAPANESE EQUITIES

Through the month of July, Japan delivered negative performance due to renewed uncertainty over COVID-19 resurgence affecting the markets, the TOPIX in total return terms fell by -2.2% during the month. The increase in global COVID-19 infections dominated stock market sentiment, especially driven by Delta variant. The number of infections in Japan had increased to approximately 10,000 on a daily basis. Considering the size of the population, the increment was still below the level of many developed countries, but it still caused growing public anxiety. The short-term prospects for a full recovery of the national economy depend more on the continued success of the vaccination launch, which has continued to accelerate since the end of May. Opposition to government practices continued to grow. In July, the public approval rate of Yoshihide Suga's cabinet fell to 33%, the lowest level since he took office in September last year. Tokyo re-entered a state of emergency in early July. Most Olympic events prohibited spectator participation and restrictions were extended to the entire month of August. This has led to slightly higher expectations for a short-term recovery.

In Japan, the reflationary momentum has been affected by growth concerns and the spread of virus variants. However, vaccinations are picking up and that serves as a confidence booster for the value/cyclical trade even if we continue to believe earnings growth will drive markets. In our view, the recent correction of value is not the end of the trade but provides better entry points for it. The important questions for companies now are how transitory price pressures are and what their ability to pass price rises on to consumers is. We are neutral on Japanese equities. Relative earnings trend suffered recently due to strong earnings in the U.S. and Europe. However, in the long term, global cyclical recovery and prospects of a weakening yen should be supportive for Japanese markets.

ASIA EX-JAPAN EQUITIES

Downward growth revisions have concerned South Asia countries on the back of high infection numbers and new or extended mobility restrictions. The STI in Singapore rose +1% month on month in July. Singapore reported new clusters of COVID-19 infections. However, we drew comfort from the high vaccination rate with over 60% of the population fully vaccinated, and 77% having received at least one dose. In Indonesia, the JCI remained resilient in July with a +1.4% month-on-month gain despite the imposition of emergency mobility restrictions in most cities and regencies across Java and Bali. The SET weakened by -4% in July. COVID-19 infections continued to break new highs with more than 17,000 daily new cases. Only 19% of the population has had one vaccination shot, with 5% fully vaccinated. The Philippines Stock Exchange Index weakened over concerns on the spread of Delta variant, as there was a rise in daily COVID-19 cases to 7,000 from 5,000. The anticipated optimism on reopening was dampened after concerns over the Delta variant's spread. In Malaysia, the KLCI recorded a decline of -2.5% month on month. Malaysia's market was experiencing record high COVID-19 cases and political instability.

We believe Singapore is on track to reopen borders by September. This would revitalize the travel and services sectors, which account for a significant portion of the domestic economy.

At this juncture, we believe the recovery theme in the near term is anticipated. In Indonesia, we expect the lingering concerns regarding COVID-19 and interest rates to continue to dictate market direction in the immediate term. However, over the longer term, it will benefit from structural tailwinds and the relatively quicker economic recovery from further fiscal support. For Thailand, export data recorded its highest level in 11 years due to a rise in global demand. This has led to strong data. Over the longer term, in the second half of 2021 with the vaccination rollout, the domestic economy should see recovery. In the Philippines, we expect to see weakness as it is still under lockdown in near term. As vaccination continues to roll out, we expect recovery theme to play out in the second half of 2021. In Malaysia, the vaccination rate is the highest among its neighboring countries but the political instability remains an overhang. The government targets to relax mobility restrictions by October for most states. We expect the recovery theme to pick up in Q4 2021. We are positive on Asian equities. In our view, the long-term outlook for Asian equities broadly remains extremely positive, but sentiment may remain fragile in the near term until the length and breadth of a regulatory clampdown becomes clearer.

CHINA & HONG KONG EQUITIES

In July, all eyes were on the tightening of regulations for technology and education companies by Beijing and on possible new measures that could affect other sectors. Under this regulatory pressure, the Chinese market underperformed both the MSCI developed markets and MSCI emerging markets indices following a strong performance in 2020. China's real GDP growth slid to 7.9% year on year in Q2 from 18.3% year on year in Q1. The MSCI Hong Kong went down in July by -2.9% in USD terms. Hong Kong's Q2 GDP (advanced estimate) growth was +7.5% year on year. Domestic consumption continued to recover by +6.5% year on year, while investment also picked up some momentum (+23.7% year on year). Regarding the pandemic situation in Hong Kong, the total number of new confirmed cases declined to 59 in July from 80 in June, for which no locally transmitted case was detected. The total number of vaccinations reached 5.7 million, with 2.5 million people fully vaccinated. From a monetary perspective, following a fast tapering in the first half of the year, macro policy started to adjust and tilted towards the dovish side in July. The People's Bank of China cut the reserve requirement ratio by -0.5%, while the total social financing growth stabilized.

In China, regulatory tightening has expanded from technology and housing sectors to education sector. Overall, the combination of dovish tilt in macro policy and selective tightening in sectors looks to continue for the rest of 2021. While resilient for now, export growth will inevitably normalise down given the reopening of other economies. With softer external demand growth, mixed investments and gradually improving consumption, China's growth should continue to drift downward towards its long-term trend. In Hong Kong, domestic consumption continued to recover (+6.5% year on year) and social distancing measures have relaxed as the number of COVID-19 cases stays low. As a result, the unemployment rate improved from 6.0% in May to 5.5% in June. We remain positive on Chinese equities. Given China's stable economic growth, its reorientation towards domestic consumption and continued government policy support (policy divergences from the U.S.) should benefit equities in the long term. We are neutral on Hong Kong equities. Marketability of initial public offerings of Hong Kong should benefit from the ban of American depositary receipt listing in the U.S. from China. However, the impact on average daily turnover still needs time to evaluate.

GLOBAL BONDS

Over the month, the U.S. yield curve flattened: the U.S. 2-year yield fell -0.06% from +0.25% to +0.19%, the U.S. 10-year yield started the month at +1.47% and finished at +1.22% in July. The spread between the 2-year yield and the 10-year yield tightened, moving from approximately +1.22% to +1.04%. The 10-year U.S. breakeven inflation rate, which started the quarter at approximately 2.3%, finished the month at 2.4%. With rates so low, financial conditions remain very accommodative, despite concerns about COVID-19 variants and fears that higher inflation may turn out to be more persistent than anticipated. The suppression of the term premia by central banks on the developed markets yield curves is a support for the equity market (as developed markets' real rates will remain negative in our central scenario) but the flattening movement of the yield curve is an headwind for cyclical/value trades. During the July meeting, the focus was to adapt the ECB's forward guidance on interest rates to the new price stability objective. The ECB said that there would be no rate hikes until the Eurozone exited its low inflation equilibrium and was on track to reach 2% on a sustainable basis. The ECB signalled that it was likely to maintain its very expansionary monetary policy for a very long time, underlying its commitment to maintain a persistently accommodative monetary policy stance to meet its inflation target. The J.P. Morgan Economic and Monetary Union Government short-dated bond indices had positive returns, as yields generally fell and investors eased rate hikes fears. The J.P. Morgan Emerging Markets Bond Index Plus Composite had a positive month rising by +0.6%.

We believe uncertainties remain in the form of the size of the U.S. fiscal package and slowing vaccinations. Thus, while staying agile, and tactically playing opportunities, investors should maintain long-term convictions. Investors should not chase the downside trend in U.S. bond yields, and should monitor the movement of real rates and the Federal Reserve's communication. We remain mildly positive and active on risk assets as the economic recovery continues. Going forward, the importance of Chinese assets will increase for global portfolios. Hence, we are now constructive on local government debt as it should benefit from positive sentiment and continued flows based on its inclusion in global indices. We are cautious on government bonds. We remain defensive on U.S. Treasury due to the rising fiscal deficit, debt and our expectations that once the base effect-induced inflation cools it will still settle above pre-pandemic lows. We also remain cautious on core Euro bonds. We remain positive on credit. The economic backdrop is strongly in favour of the trade as global reopening should maintain supportive fundamentals. Technicals driven by the ECB purchases represent another strong supportive rationale, despite overall long positioning. Despite a very rich valuation, spreads have continued their compression. Risk sentiment keeps being supportive as the asset class proved resilient to volatility in rates and risky assets.

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The content of this Market Outlook is contributed by Amundi Hong Kong Limited.