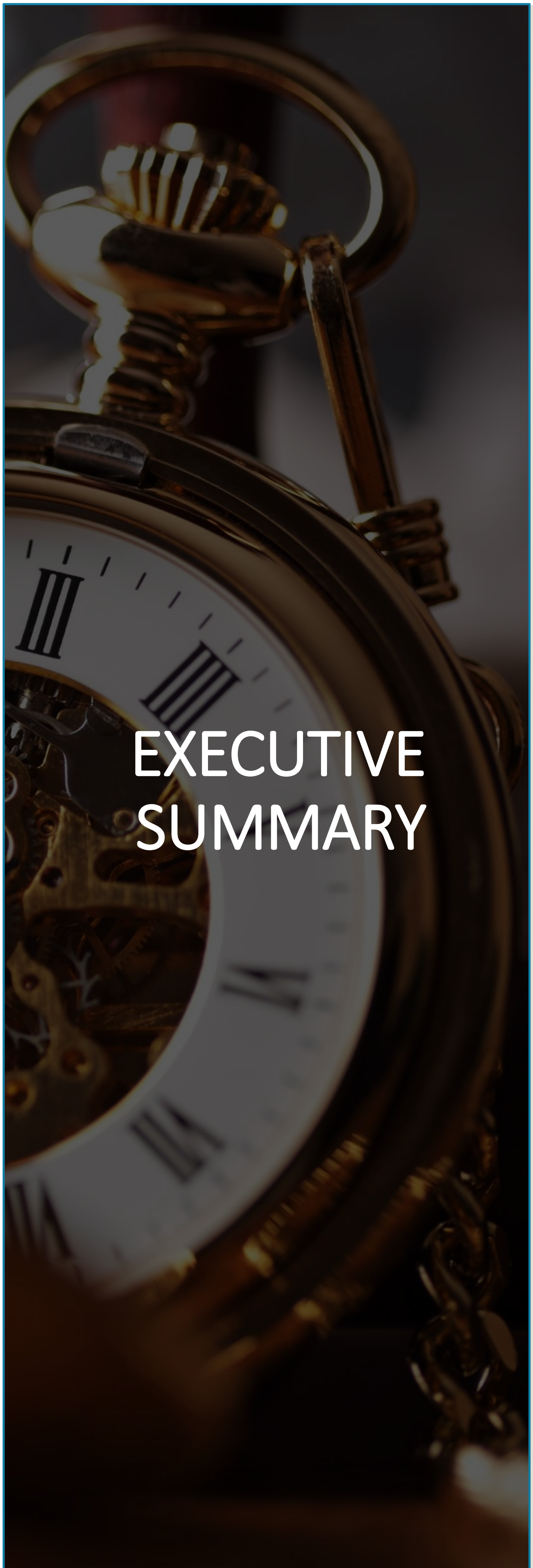
arrow capital

# 2Q21 Outlook



# EXECUTIVE SUMMARY

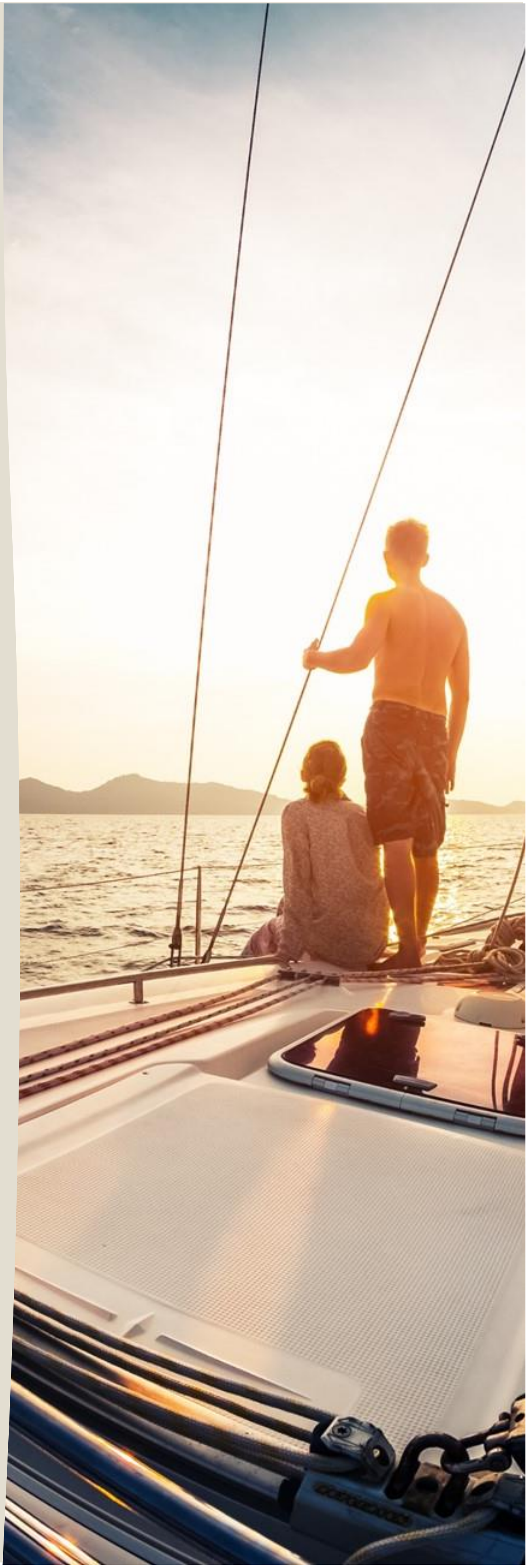
Our barbell approach comprising high-quality growth and value stocks has boded well for our clients for the past several years and has offered attractive reward with balanced risks over time. The investment strategy builds a robust, all-weather portfolio by integrating the relative strengths of both growth and value components.

We do not think the growth rotation to value, mark the end for growth stocks. We continue to maximize our efforts to hunt for structural growth opportunities. On the growth side of the spectrum, we like disruptors, innovators and companies that are reshaping industries or create new ones entirely. These ideas are derived from companies having powerful and persistent forces, such as in Fintech, E-commerce, the application of digital technologies, health care (Genomic revolution, Telemedicine), Energy transition and the re-emergence of China (Asia consumption). On the other end of our barbell spectrum we primarily focus on defensive businesses that we think can ride through an extended period of economic volatility.

In the current low rate environment our preferred allocation in Fixed Income are currently Asia Investment grade and Asia High yield.

# Contents





# U.S. EQUITIES

## Our Strategy

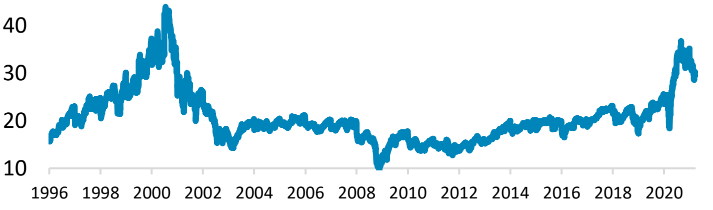
In equity we continue to favour a barbell approach with growth stocks on one end of the spectrum and value/dividend stocks on the other end. As much as we focus on the growth aspect of our portfolio, we also bolster our defense through value/dividend stocks. The effectiveness of a robust defense is evident in times of stress – when the world changes unexpectedly.

## What to expect

Value stocks rebounded strongly in the first quarter on asset reflation hopes. In the early days of the rebound from March's trough, the rally in US equities was led predominantly by growth stocks in the technology-related space. In fact, the gains for the Technology sector were particularly outsized as the pandemic accentuated the importance of online activities, such as work from home themes, e-Commerce and e-Sports. "Traditional" industries in the Financials and Industrials space were sold down given the economic sensitive nature of their businesses. But eventually the energy and financial sector rebounded strongly in the first quarter and ended as the best performing sectors respectively.

Whilst we agree with the forecast for a near term economic revival, since November last, markets have moved to price this in. However, we question the more extravagant predictions, given the headwinds of massive debt burdens, labour market slack and long-run disinflationary forces. We expect forward-looking growth and inflation estimates to ease as we head towards 2022, which could take the wind out of the sails. This would likely foster even more monetary and fiscal support, renewing the decline in real yields as inflation exceeds nominal yields. Whilst the timing and path to this reality are uncertain, we expect this trend to dominate for several years and have positioned our client portfolios to profit from it.

**Russel 1000 Growth Index P/E Ratio**




*Source: Bloomberg, Arrow Capital*

We continue to like quality growth stocks:

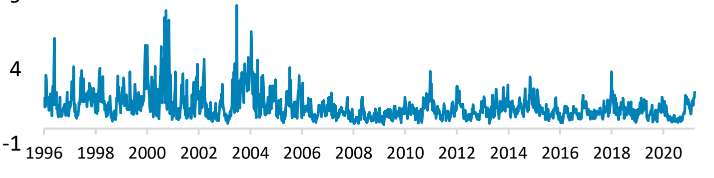
Although a number of the megatrends expressed in our portfolio are likely to have accelerated they are still at an early stage.

Forward P/E is not as stretched compared with the dot com bubble as shown in the graph above. The strong earnings momentum put a cap on forward P/E and this is why valuation is not as stretched compared to the dot com bubble.

Unprecedented support in the form of monetary and fiscal stimulus acts as a backstop to financial markets.

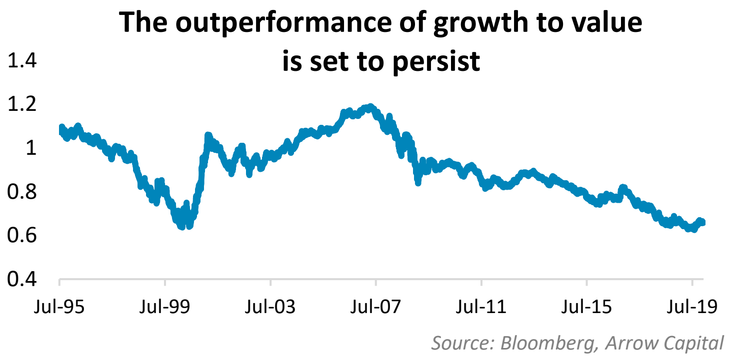
The current AAII Bull/Bear ratio* of 2.1 is broadly in line with the long-term average and this suggests sentiment is not at an extreme.

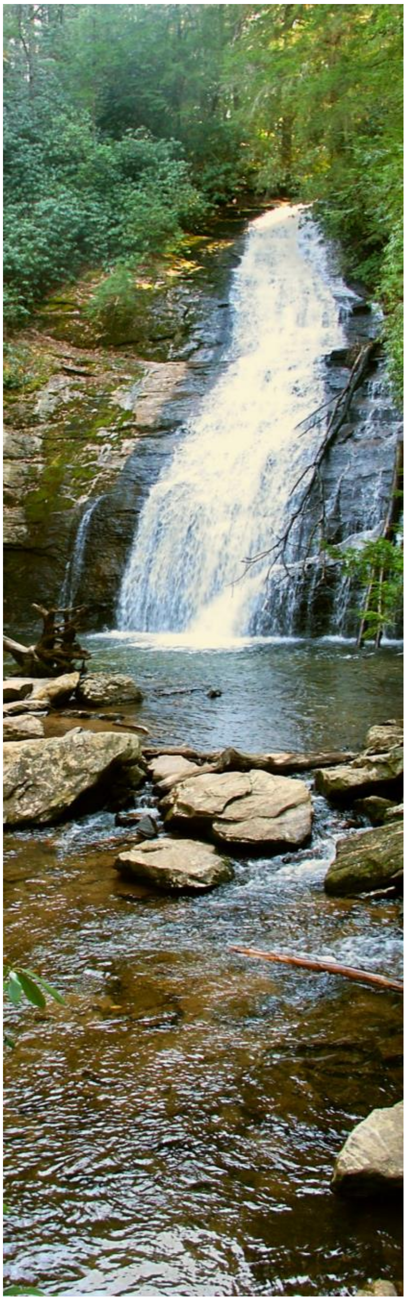
**US Investor Sentiment**
**Bullish / Bearish Readings**



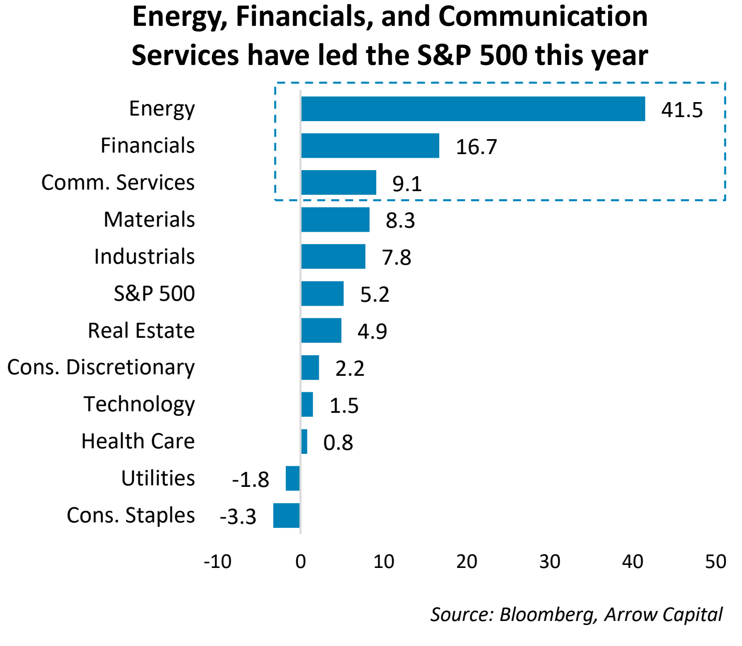

*Source: Bloomberg, Arrow Capital*

** The AAII Bull/Bear ratio reflects the sentiment of financial advisors. A reading above "1" connotes more bullish advisors relative to bearish ones, and a reading below "1" indicates a larger proportion of bearish advisors to bullish ones. Extreme readings on either end of the spectrum are often used as a contrarian indicator by investors.*



On the defensive side of our barbell portfolio we recently increased our Health care exposure which is currently trading at 17X earnings. As much as the coronavirus has stressed healthcare systems this year, the demand for healthcare innovation has long been clear and ubiquitous. The income and growth potential looks attractive with our pool of stocks offering an average dividend yield of 4%. The ageing population demographics is a major tailwind to the industry. The drug pipelines remain strong with EPS growth of 7-10% . Also, the current US administration is not hostile to the industry and the sector looks to deliver stable dividends as free cash flow, operating margin growth, and ROE all look healthy.



# ASIA EX-JAPAN

# Favorable Demographics

Our geographical allocation to equities also takes a barbell approach where on one end we have US and the other end Asia. Asia is home to around 60% of the world's population and the majority of global economic growth. China alone makes up about 1/3 of global growth; with its immediate trading partners across the emerging market that proportion climbs to almost 75%.

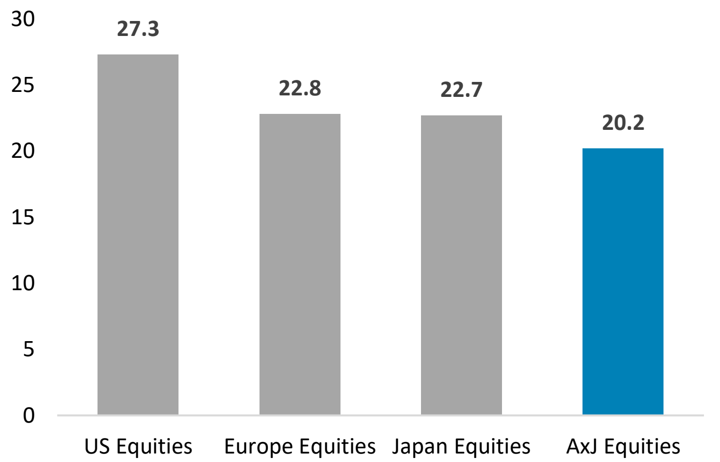
China and much of East Asia are benefiting from "first in, first out" dynamics in addition to an effective containment of the virus. China was the first to see activity and growth bottom in the first quarter of 2020. Its rebound was led by the industrial sector, helped by strong exports. More recently, China's recovery has broadened to services and consumers. In fact, domestic travel and tourism are well on their way to normalization, even without a vaccine.

Asia's middle class population is rising steadily, by 2030 the middle-class population is expected to rise to 3.5 billion. The net influx of the middle-class population was actually negative in the US, going back since 1971. We think that a booming middle class will support domestic demand and consumers tend to upgrade their purchases from basic goods to higher quality and discretionary goods and service. As such we are overweight in consumer discretionary as we think "premiumization" is a long term trend. Also, the RCEP free-trade deal will boost economic activity and will be positive for intra-Asia trade with simplified tariffs and regulation. The members signing for the RCEP trade deal accounts for USD26.2T (~30% of global GDP) of economic output and 2.27 billion people.

# Valuations are Attractive

Valuations for Asia-ex Japan equities are currently looking reasonable at a time when the economic cycle is turning and when other major asset classes are looking expensive compared to historical levels

**AxJ Equities trading at lower valuation to DM since the start of the year**



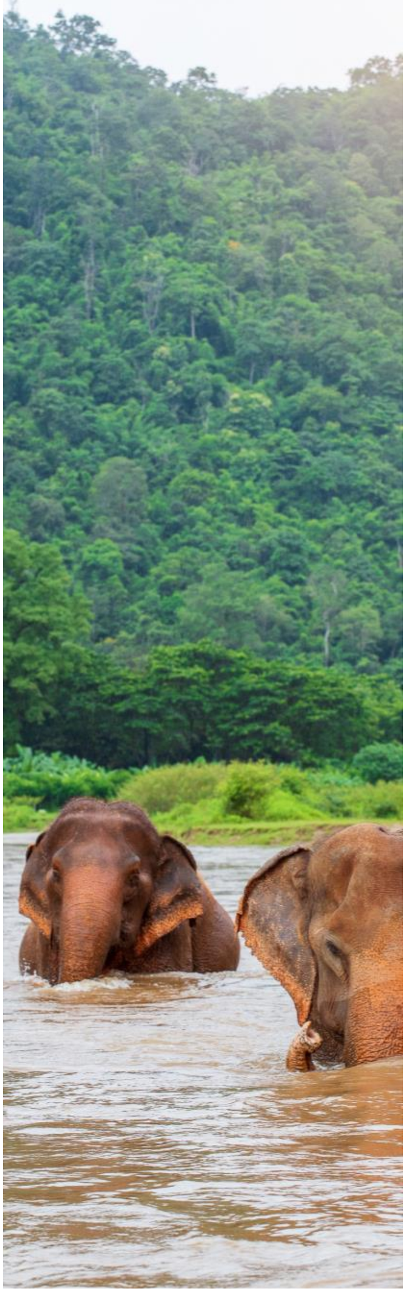

*Source: Bloomberg, Arrow Capital*

Asian companies are also in good shape from a balance sheet perspective. In terms of cash as a share of market cap and net debt as a proportion of equity, Asian companies are more defensive, especially when compared to the US and Europe.

# It’s Time to Look East

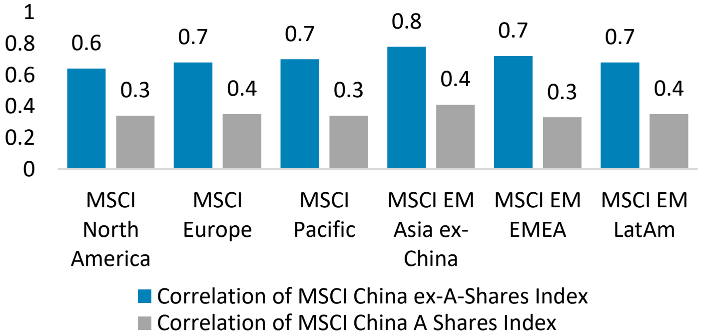
In Asia our main focus is China. We believe that a standalone investment allocation is increasingly warranted and an effective option for investors. In part that's because the size of the opportunity is just too big to ignore – China is the most significant driver of global growth and its onshore markets are rapidly surpassing other major global markets in terms of size.

More than that, China equities and fixed income asset classes offer investors diversification benefits compared to other widely-held portfolio allocations, as well as attractive opportunities for active management to add value (see figure below).

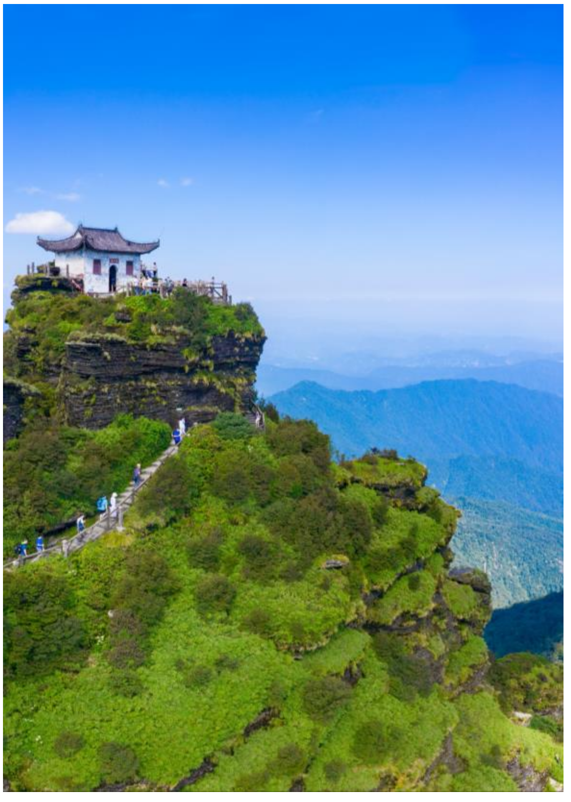


**Correlation of MSCI China ex- A- Shares & MSCI China A-Shares Indices with Global Benchmarks**

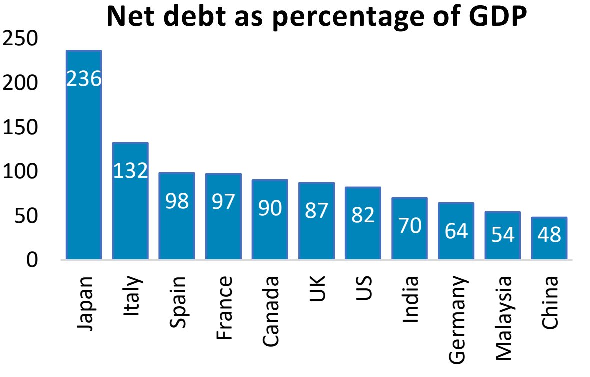
February 2002-December 2019 (USD)




*Source: Bloomberg, Arrow Capital*



Nearly half of China's leverage is contained within the financial system and government-owed debt, which is controllable in a command economy. Further, after taking into account the high savings rate in China, the ratio of net debt in China is only 48 percent of GDP, which is far lower than that of Japan, the U.S. and other major economies.

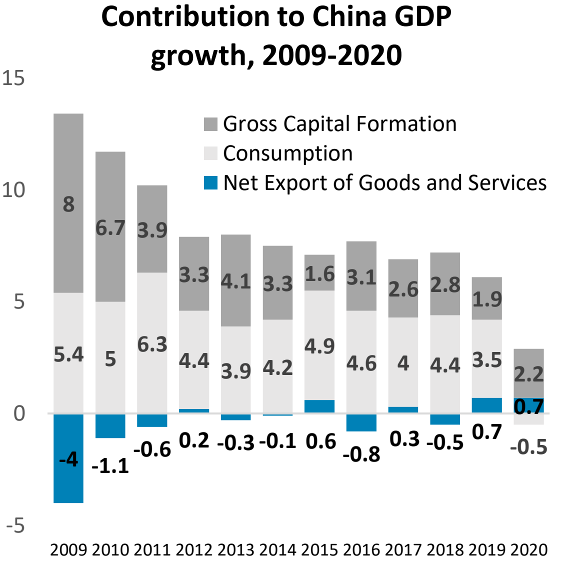



*Source: Bloomberg, Arrow Capital*

China's consumption growth provides investors with a baseline of what to expect from the economy going forward: even without the benefit of growth in investment or exports, the world's second-largest consumer will likely continue to grow faster than the developed world in the years ahead based on consumption growth alone.

China's economy is undergoing a massive transition from fixed asset investment in heavy industry and manufacturing to growth in consumption and services.

The contribution to GDP from consumption has averaged 4.6 percent over the past decade, as you can see in the graph below.




*Source: Morgan Stanley Research, Arrow Capital*

# CONCLUSION

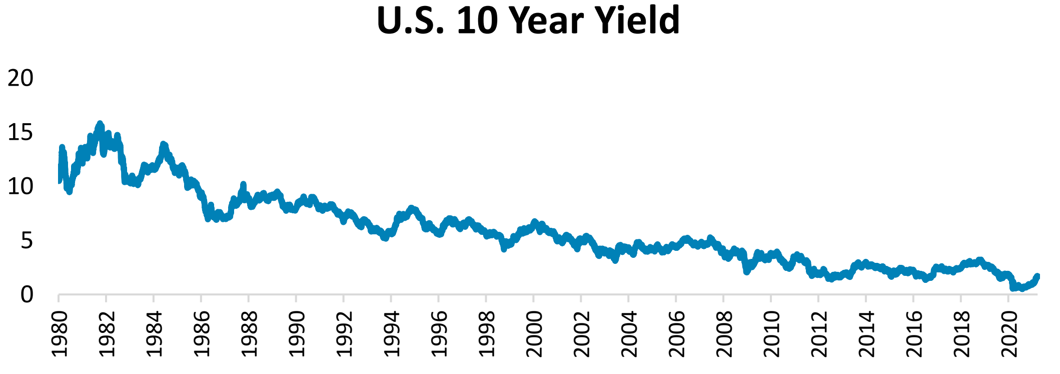
Drawing parallel to sports, we think growth stocks as our attackers and value as our defenders. We focus as much on the defense as on attack. In an investment context, that means dependable income plus real growth in both income and capital over time. The investment strategy builds a robust, all-weather portfolio by integrating the relative strengths of both growth and value components.

Instead of seeking fixed precision, we focus on thinking about how a business could look in five, ten or fifteen years' time. To do so, we focus on the key assumptions: how much revenue could the business generate at that point in time? How could its margins look? How capital intensive is the business? How will it fund its growth? While an investment approach based on 'reversion to the mean' may work during periods of stability, when this status quo is upended the gap between winners and losers can widen inexorably.

# FIXED INCOME

# U.S. TREASURIES

# U.S. 10Yr Trending Downwards Since the '80s

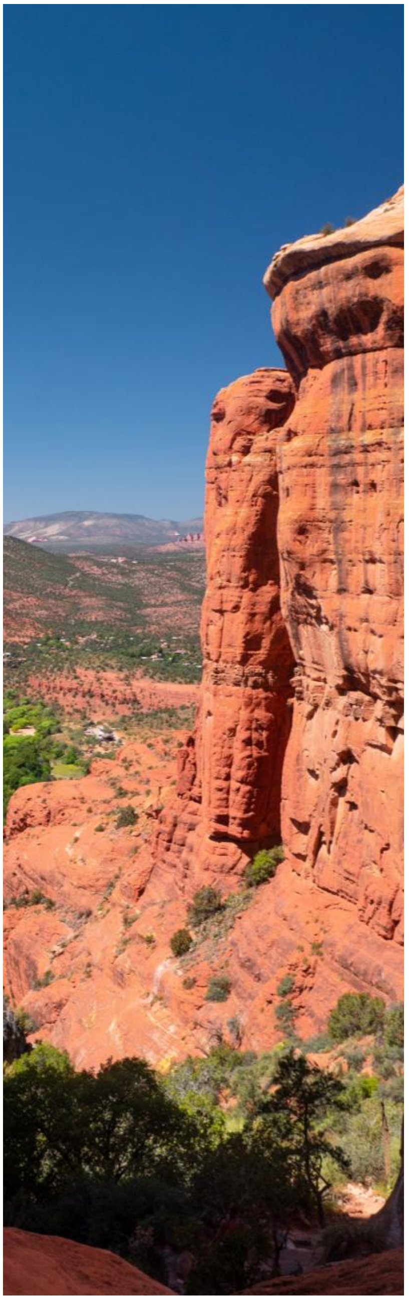



*Source: Bloomberg, Arrow Capital*

With economies starting to open up and fiscal spending announced, bond yields have risen sharply higher this year. But history shows it's too early and premature to assume yields will undergo sustained increases from here. While there will undoubtedly be a spike in inflation once economies reopen due to starting off from such a low base, we think that this will fade after a few quarters as growth eventually disappoints again. Since the GFC collapse of 2008, bond yields have previously undergone similar spikes, only to correct to lower lows in subsequent periods.

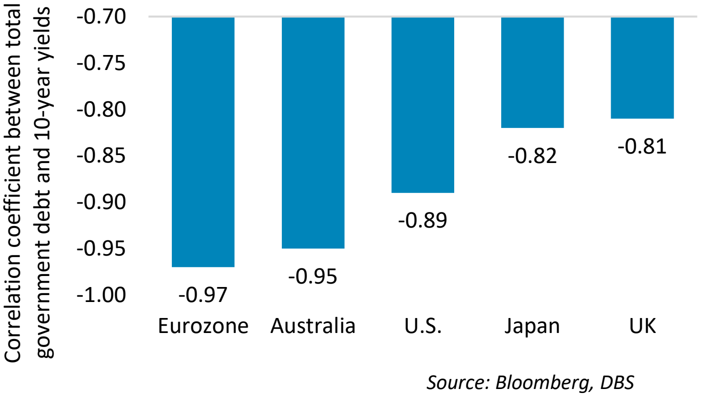
From a longer-term perspective, global bond yields have been trending south since the early 1980's and there are various reasons for this.

Structural inflation everywhere is being kept in check by the combined drivers of too much debt, 'zombification' of the corporate sector, ageing demographics, disruption from globalization, technology, and low-cost labor. The neutral rate of interest which functions as a "benchmark" for the Fed's decision-making process – is on a persistent downtrend.



Based on research by Fed economists Thomas Laubach and John Williams, the long-term neutral rate for the US has fallen from a high of 4.485% in September 1974 to 0.029% in December 2020. Much of this has to do with secular stagnation in the US, a situation where excessive savings (relative to investment capital) weigh on long-term rates. Forces weighing on the demand for capital (productivity and digitalization) as well as those boosting the supply of savings (demographics and risk aversion) are broadly structural in nature. The interplay of these factors is expected to exert sustained downward pressure on the neutral rate of interest in the long run.

**The larger the debt, the lower the yields**



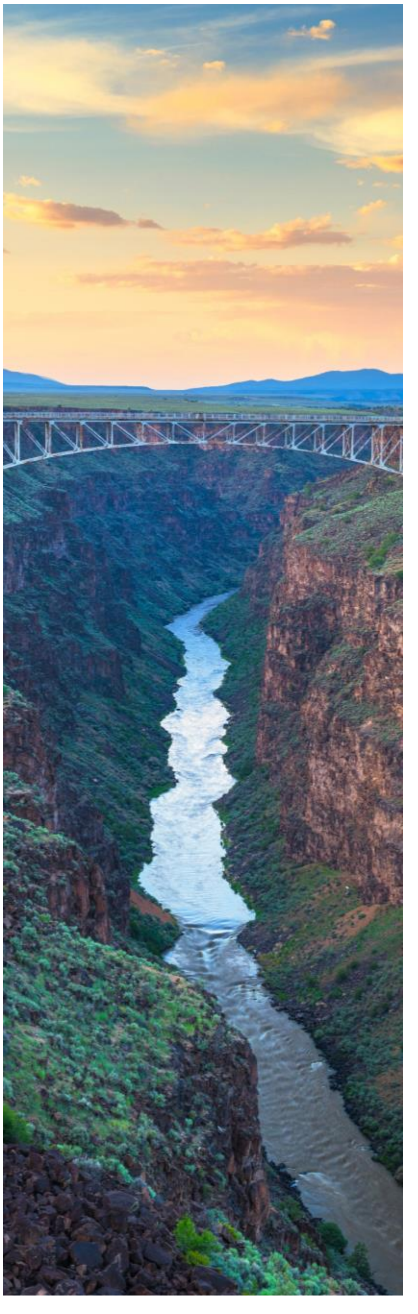

*Source: Bloomberg, DBS*

In the 2010's we had the longest economic boom in post-war history, with full employment, quantitative easing, and corporate tax cuts – yet inflation averaged only 1.6% in the US. Ultimately, it is all about wages. For structural inflation to become an enduring concern, wage inflation needs to be embedded and accelerating.

The excess capacity in the labor market and the public's expectations of price rises both point to prolonged low inflation. Labor has limited pricing power after 40 years of weak wage growth and the decline of trade unions. Given the ever-increasing shift to automation and the increased influence of global monopolies, the power of labor versus capital has diminished even further.

Some point to the surge in money supply as a reason to get excited about inflation but much of this is due to companies drawing down on bank facilities to stay solvent. We also doubt we'll see much productivity payback from government spending in the last year given it's been more about life support to the economy, rather than economic stimulus.

Governments around the world have taken on about USD15 trillion in debt in the last year or so. All this debt has a short-term 'sugar rush' effect and then eventually the structural problems outlined above come home to roost. Japan's central bank has tried everything that Europe and the US have implemented in the last decade or so in order to generate sustainable inflation, to no avail .



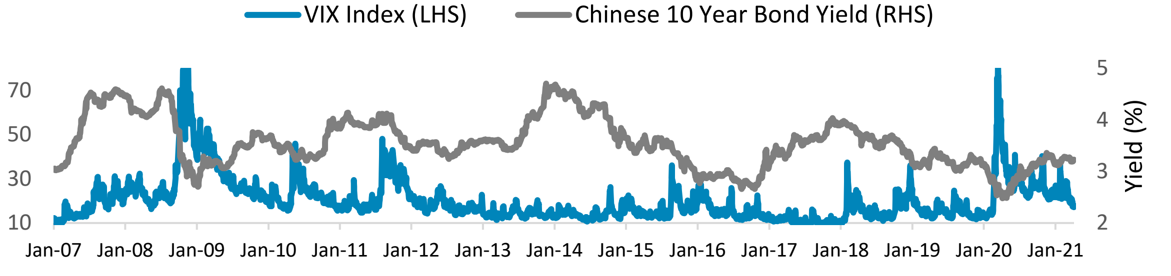
While it's reasonable to expect that some consumers will rush back to hotels, restaurants, theme parks and so forth post-pandemic, there are a few inconsistencies with this blanket approach. These candidates for pent-up demand release come to a total of just 8.5% of total consumer spending.

Those who got caught out last year for having little in the way of savings won't want to repeat that mistake again, particularly in a soft labor market with weak wage growth .

Durable goods purchases are a key component of consumer spending and over the last year with the world in lockdown there has been a durable goods boom that's unlikely to be repeated. Durable goods consumption (i.e., cars, furniture, and appliances) in the US rose to its highest share of GDP since early 2007 and was higher than the usual cyclical figures. Given the nature of durable goods is that you try to avoid buying the same items again, we don't see much scope for pent-up demand here.

# CHINA GOVERNMENT BOND

## Safe Haven In Times of Crisis

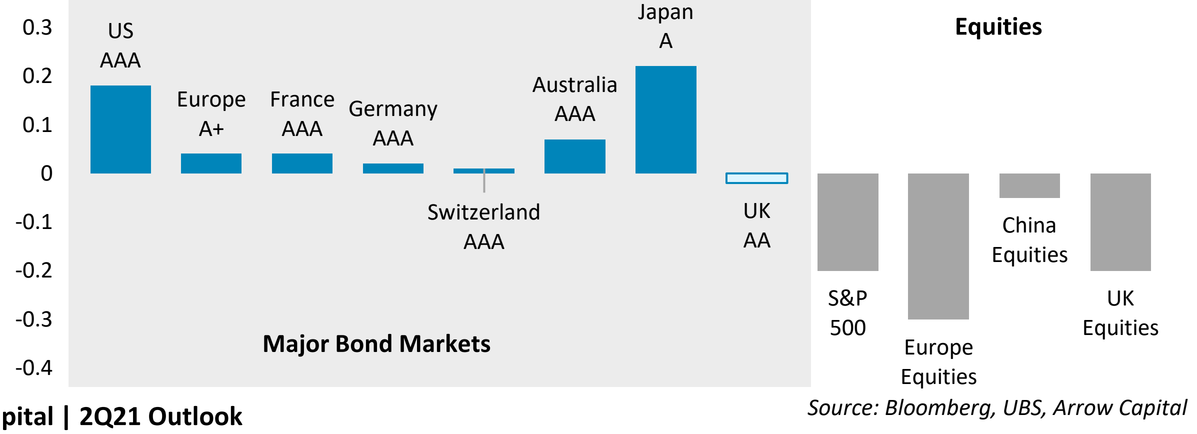



*Source: Bloomberg, Arrow Capital*

We reaffirm our positive view China Government Bond (CGB). Inflows to CGB appear to only be in their early innings. We note that global asset allocations to CNY-denominated bonds are still presently below 3%; very low considering China's share of world GDP, exports and the CNY's weighting in the SDR basket– weightings that are expected to rise with China's expanding presence on the global stage. As such, despite the already stellar run, we believe that there continues to be room for a structural increase in global asset allocation to China onshore bonds, and inflows will likely accelerate due to the current attractive valuations of China bonds against their global peers.

## Global benchmarks and correlation to China bonds,

Mar 2016-Mar 2020

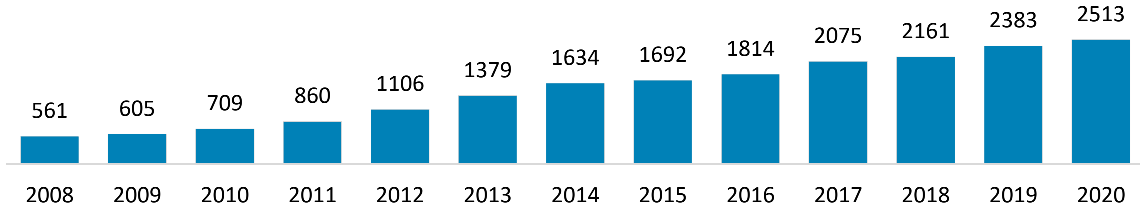



*Source: Bloomberg, UBS, Arrow Capital*

# ASIA BONDS

**Growth in external corporate debt stock**

(2008-2020, USD million)

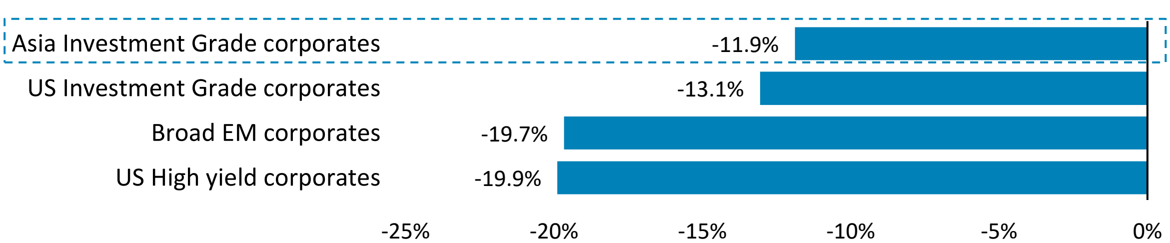



*Source: JP Morgan, Arrow Capital*

In the period between 2009 and 2019, the amount of outstanding EM corporate bonds grew by an astounding 294%, surpassed only by the growth in locally denominated EM corporates. Today, USD-denominated EM corporate bonds are a USD 2.5 trillion asset class; twice the size of the US high yield (HY) market and also twice the size of the EM USD sovereign bond market. In EM we continue to favor Asia as our preferred allocation.

Dovish policies of G3 central banks, low yields in core bond markets, increasing deficits in the United States and attractive relative valuations and strong balance sheet of Asian corporates drive our conviction in the corporate debt market. On top of the yield pickup vis a vis US IG, Asian debt has been very resilient in the March 2020 sell-off as shown in the data below.

**Performance during the March 20 Covid-induced stress**

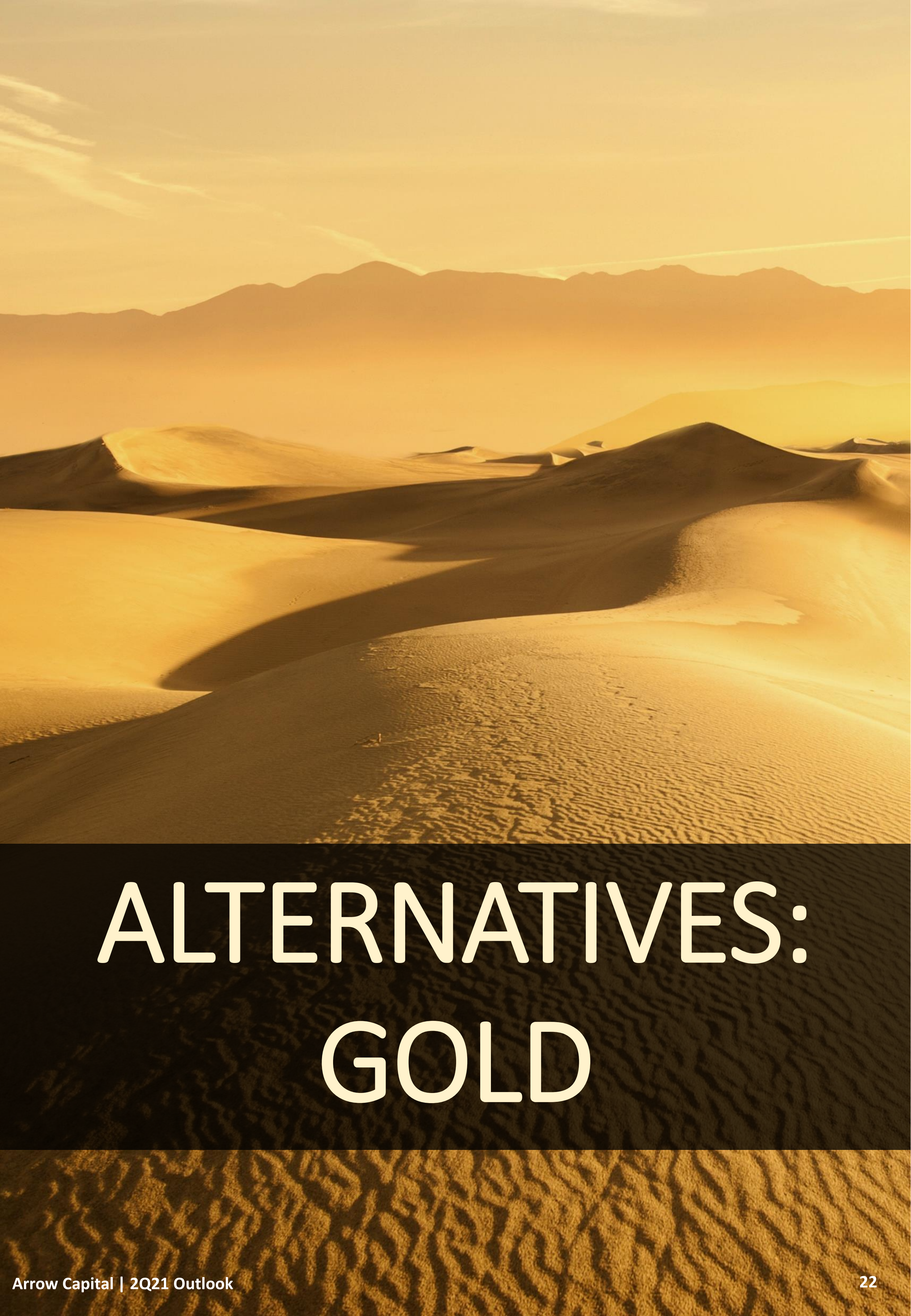





*Source: Bloomberg, Arrow Capital*


In Fixed Income we implement a barbell strategy with long dated high quality government bonds coupled with high-yielding, short-duration investments. On the longer duration end of the spectrum, we continue to hold a substantial position in AAA-rated government bonds as they still offer negative correlation to risk assets, act as a ballast and so have a strong place in our portfolio. On the shorter duration end of the spectrum, we like Asian corporate debt both investment grade and high yield.

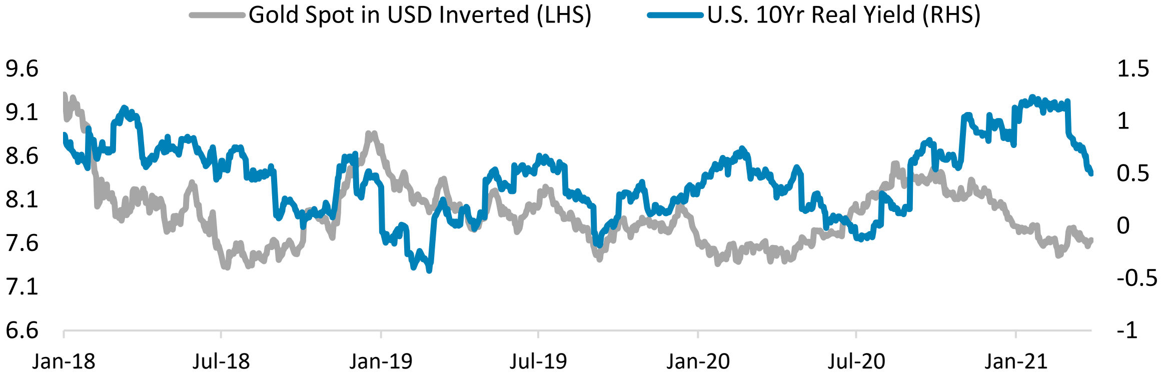
# CONCLUDING REMARKS



# ALTERNATIVES: GOLD

## U.S. 10Yr Real Yield vs Gold Price Inverted

(Last 5 Years)




*Source: Bloomberg, Arrow Capital*

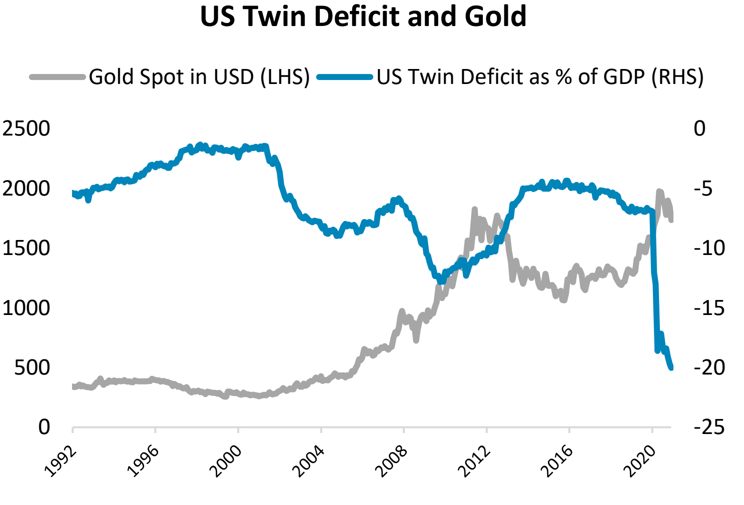
Gold had a rough quarter as rising yield hurt prices. Market are expecting the Fed to hike sooner than expected due to rising inflation fears despite the Fed Chairman Powell reaffirming a looser for longer stance

We draw comfort from gold's continued tight relationship with real yields as we believe the latter will soon resume their downward trend. This is the only politically-feasible way for the authorities to deal with their crippling debts; negative real yields effectively inflate away the nominal liabilities. We do not believe that we have seen the low in real yields for this cycle; indeed, they troughed around -5% post WW2 when similar policies were employed. We expect both our bullion and gold mining exposures to repay our patience. We reiterate our positive outlook on gold. In a world where fiat currencies are looking less reliable and politics and financial markets less stable, haven assets such as gold stand a very good chance of attracting more allocation.

# Insurance for Uncertain Times

We believe the place for gold as a hedge in uncertain times still stands. Past crises, including the one as recent as the pandemic crisis last year, prompted a renewed focus on risk management and an appreciation of uncorrelated, highly liquid assets such as gold.

Today, trade tensions, vaccine wars, geopolitical risks, domestic political upheavals, worries over runaway inflation, equity markets breaking new highs, high debt levels, liquidity driven systemic risk, and concerns over currency debasement as a result of money printing are all good reasons to hold gold as an insurance in these uncertain times.




*Source: Bloomberg, Arrow Capital*

# 2Q21 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 | -0.68% | -7.18% | -0.73% | 115.24% | 38.10% |
| | Invesco QQQ Trust Series 1 ETF | 2.33% | 1.71% | 6.84% | 68.66% | 28.37% |
| | Vanguard Health Care ETF | 2.14% | 2.12% | 6.79% | 39.64% | 16.02% |
| | Vanguard Consumer Discretionary ETF | 2.59% | 9.63% | 14.47% | 100.40% | 26.41% |
| | Consumer Staples Select Sector SPDR ETF | -0.87% | 7.07% | 2.96% | 27.23% | -0.87% |
| | **Europe** | | | | | |
| | BGF Continental European Flexible Fund | 1.98% | 3.72% | 8.22% | 62.13% | 20.20% |
| | **Asia ex-Japan** | | | | | |
| | BGF Asian Growth Leaders Fund | 0.90% | -4.05% | 12.92% | 69.31% | 9.34% |
| | UBS (Lux) Equity Fund - China Opportunity | -1.50% | -6.73% | -0.06% | 32.54% | 12.07% |
| | Morgan Stanley Asia Opportunity Fund | -0.25% | -6.97% | 6.42% | 69.03% | 20.49% |
| | **Alternatives** | | | | | |
| | VanEck Vectors Gold Miners ETF | 0.62% | 4.40% | -5.80% | 41.80% | 16.27% |
| Fixed Income | **U.S.** | | | | | |
| | iShares 7-10 Year Treasury Bond ETF | 0.58% | -0.73% | -4.92% | -5.22% | 5.70% |
| | **Asia ex-Japan** | | | | | |
| | BGF Asia Tiger Bond Fund | -0.54% | -0.88% | -0.35% | 11.56% | 4.74% |
| | iShares Emerging Asia Local Govt Bond UCITS ETF | -0.42% | -2.04% | -4.07% | 10.33% | - |
| | BGF Asian High Yield Bond Fund | -0.98% | -1.15% | 2.72% | 23.90% | 4.74% |
| | **Global** | | | | | |
| | Jupiter Dynamic Bond Fund | -0.36% | 0.03% | -1.90% | 6.27% | 4.73% |