Global markets outlook

How capex holds the key to a self-sustaining economic recovery

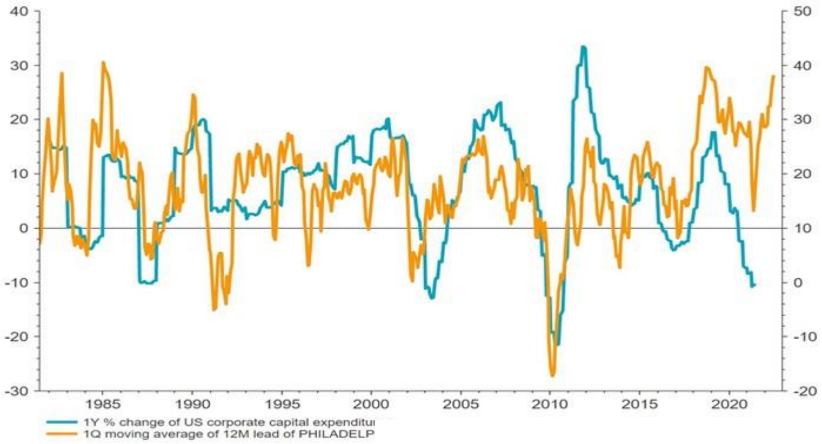
July 2021

For professional investors

Sustainable Investing Expertise by ROBECOSAM

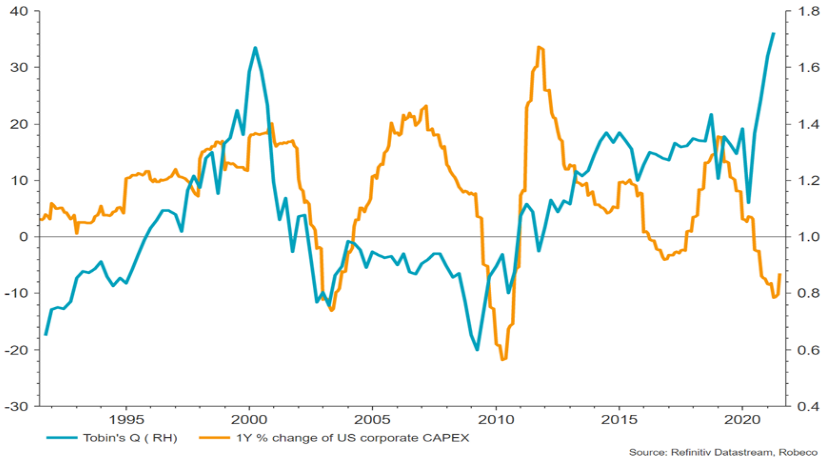
Theme of the month

Capex intentions lead capex itself by one year



Source: Refinitiv Datastream , Robeco

Tobin's Q favors capital expenditure



Source: Refinitiv Datastream & Robeco

How capex holds the key to a self-sustaining economic recovery (I)

> The world is emerging from Covid-19, and much of the focus has been on the release of huge pent-up demand for goods and services that have been inaccessible for the past year. But there is a bigger issue with the ability of companies to supply these goods and services, due to the supply side constraints that have emerged through economic reopening. This is powering a resurgence in capital expenditure by companies, and we believe those which are investing in new equipment to meet greater demand will be the more sought after investments in the coming years.

> This trend has already begun; the Fed's Capex Intentions Index, for example, already shows that year-on-year increases in capital expenditures are planned. The market has already picked up on that theme because you can see a clear outperformance of capex-intensive stocks compared to the broader market in the year to date.

> There are five elements that support our view that capex will rise from here onwards. The first is the overarching macroeconomic picture in that we are increasingly moving to an environment of fiscal dominance and away from one that has been monetary-led via quantitative easing. Central banks have pursued very easy monetary policies, but they have hit the lower bounds with regards to policy rates, and that is causing real rates to be not low enough to really trigger a sustained economic expansion.

> Fiscal dominance can be seen in the huge infrastructure spending planned in the US, with the USD 1.9 trillion American Rescue Plan already in motion, and the USD 2 trillion American Jobs Plan going through Congress. In Europe, the disbursement of the EUR 750 billion EU Recovery Fund is due to start later in July.

All market data to 30 June unless mentioned otherwise

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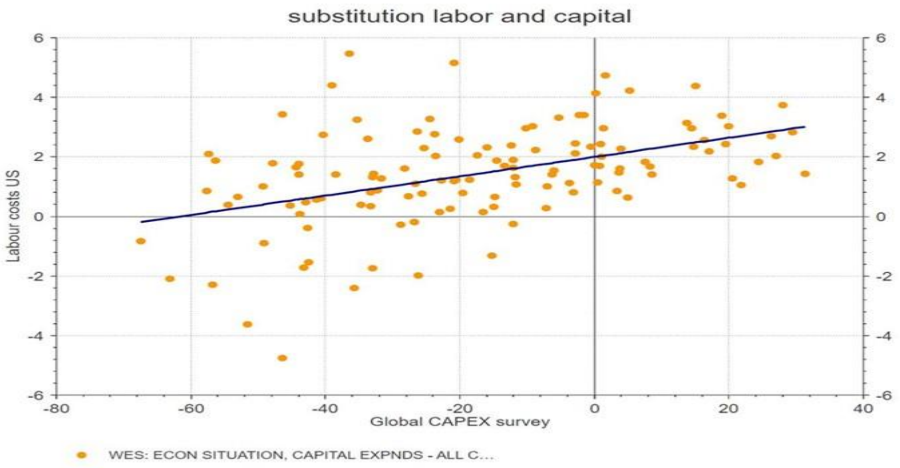
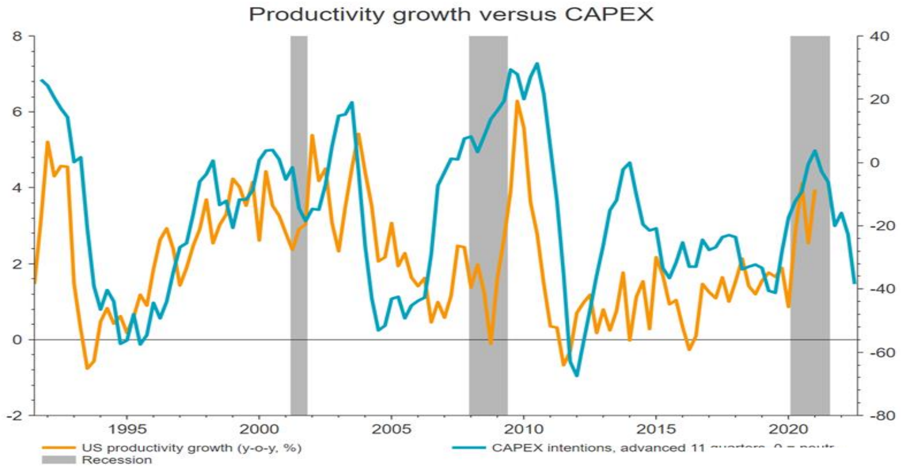
Theme of the month

Substituting labor with capex



Source: Refinitiv Datastream & Robeco

Productivity growth versus capex



Source: Refinitiv Datastream , Robeco

How capex holds the key to a self-sustaining economic recovery (II)

> An era of fiscal dominance is able to say goodbye to the secular stagnation thesis, which holds that the economy is suffering from under-investment. This in turn stems from insufficient demand, which was the biggest problem after the global financial crisis. This time around, that story is reversing: we’re seeing burgeoning consumer demand in the reopening phase.

> A third reason to expect higher corporate capex is driven by ‘Tobin’s Q’ – the market value of a company divided by its assets' replacement cost. This ratio is currently at 1.7 for the US, implying that the market value of corporates is 1.7 times higher than their underlying replacement value. So, it’s wiser for corporates to invest in the underlying capital goods rather than engage in expensive M&A.

> The fourth element is the severe supply-side constraints in the economy: this is reflected in the ISM prices paid index, which reached an all-time high in June, reflecting rampant shortages of raw materials and labor. Clearly the issue today following the pandemic is not demand related, but supply related. This will also trigger more awareness to push the productivity frontier and incentivize capital expenditure.

> The fifth element is the partial substitution from labor to capital in the US against the backdrop of lingering labor shortages. When the cost of labor becomes more expensive, substituting labor for capital becomes more attractive for employers. Typically, the inflection point for capex intentions becoming positive is when unit labor costs rise by more than 2% year on year, which is the case today.

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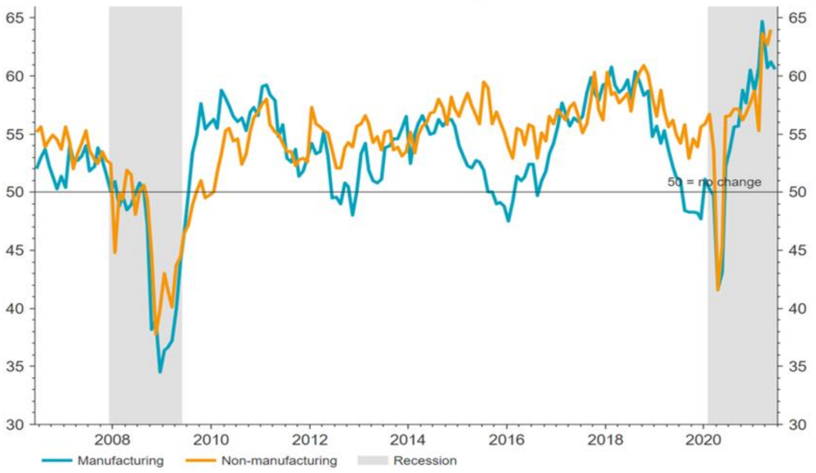
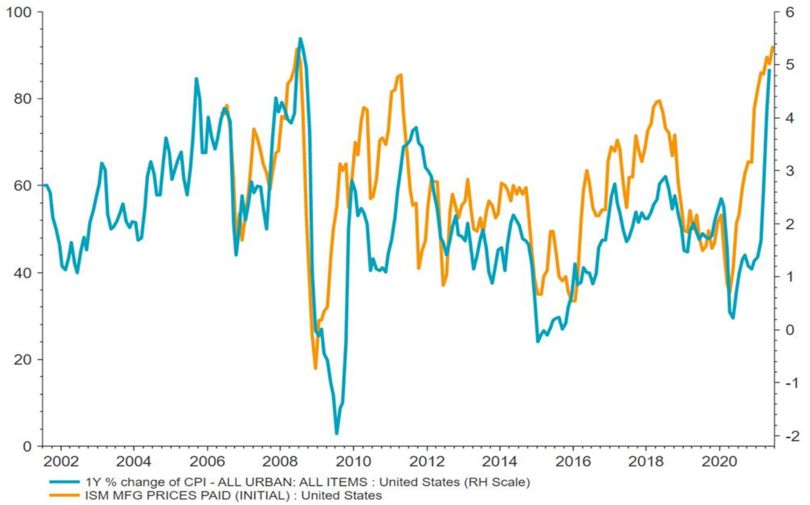
Economy (I)

US economy: ISM indicators still firmly point to expansion



Source: Refinitiv Datastream & Robeco

Eurozone: Economic momentum in the Eurozone is accelerating



Source: Refinitiv Datastream & Robeco

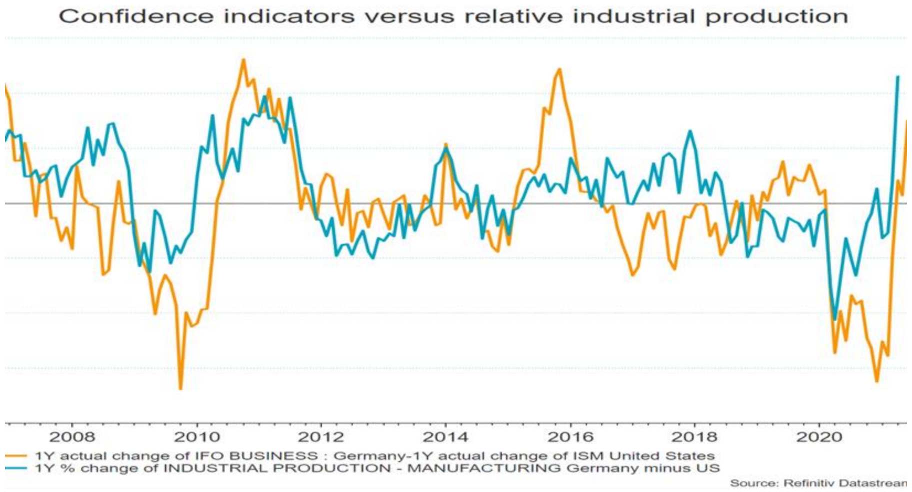
> Last month saw a further step in the reopening of developed economies, with a notable easing of lockdown intensities in the Eurozone, and a subsequent uptick in social mobility. However, new variants of Covid are still spreading. Overall, the policy trilemma between economic growth, solving the health crisis and maintaining personal freedoms has considerably eased thanks to vaccinations. UK data shows that despite a rise in Covid cases, hospitalization rates remain low.

> The manufacturing sector is still experiencing very strong growth on the back of burgeoning consumer demand, with the Eurozone PMI increasing to 63.4, a new record. Eurozone jobs growth hit new highs as well. In the US, the ISM manufacturing leading indicator eased a bit to 60.6 from 61.2. US manufacturing has now been in economic expansion for 13 months. In Japan, manufacturing activity remained in expansion, although a deceleration was visible in comparison with May, due to increasing lockdown intensity and supply constraints. Despite strong growth levels, declining inventory to sales ratios and increasing backlogs of work show that supply-side constraints became even more pressing in June for the global manufacturing sector, and this could potentially hamper output further down the road. However, shipping fees and port congestion numbers seems to have already peaked. The Chinese economy also continued to expand, but at a slower pace. The Caixin manufacturing leading indicator fell to 51.3 from 52.0 in May, due to declining export orders and a resurgence of Covid in Guandong province.

> Market sentiment was predominantly driven by central bank communications in June, with the shift in the dot plot of the FOMC causing a stir.

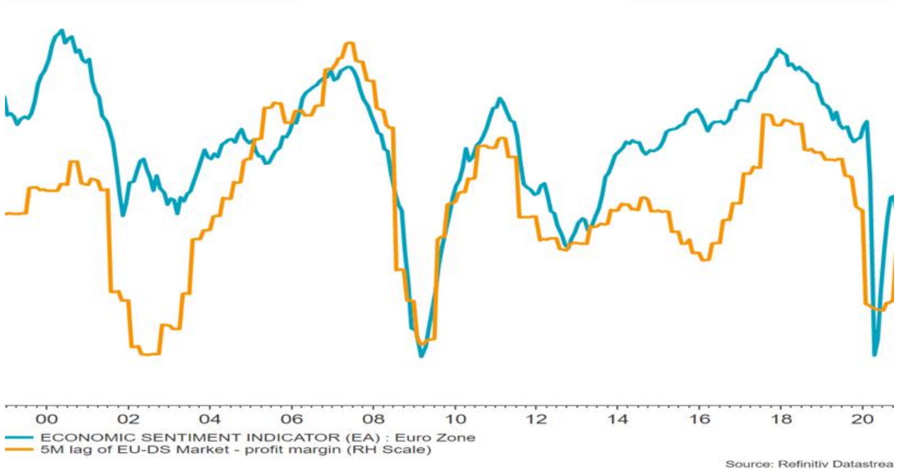
Economy (II)

Germany: Manufacturing is still solid



Source: Refinitiv Datastream & Robeco

Europe: Profit margins are expected to catch up with sentiment



Source: Refinitiv Datastream & Robeco

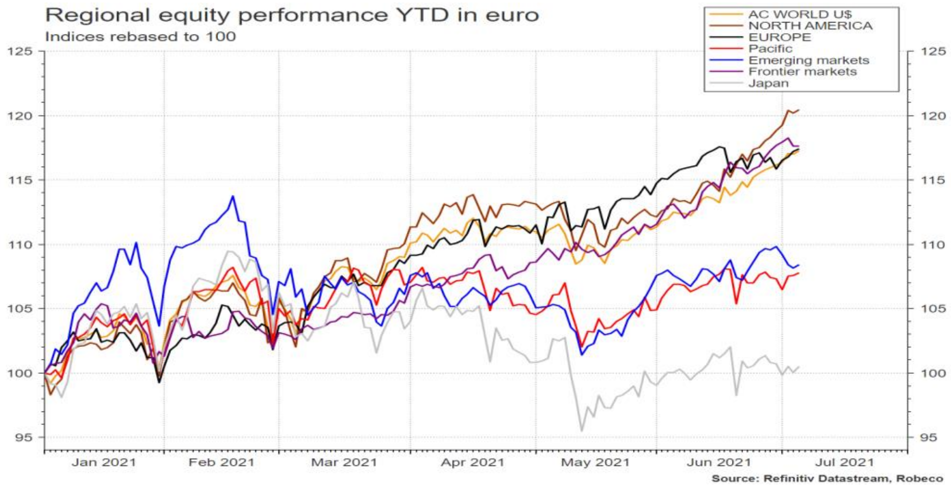
> The median FOMC expectation is now for two rate hikes in 2023, seen by the market as a notable hawkish shift. The Fed is also clearly not only 'thinking about thinking' of raising rates but is also ready to talk about tapering with some FOMC members, stating that the economy is not suffering from a demand-side deficit, but from a supply-side problem which is not solved by additional Fed balance sheet expansion. In contrast, the ECB managed to sound dovish by stating that its net PEPP purchases will continue to take place at a "significantly higher" pace during Q3.

> The so-called 'reflation theme' of above-trend economic growth and rising inflation still has legs in our view. The market has clearly grown more anxious about a hawkish shift in Fed guidance recently. We don't think the Fed has abandoned average inflation targeting given its strong focus on achieving maximum employment and its unwillingness to raise rates preemptively. At most, the recent hawkish shift in the FOMC 'dot plot' signaled that the FOMC members are cognizant of overheating tail risks.

> We expect greater volatility around central bank communications in the second half of 2021, although for equities the underlying earnings picture for companies remains rosy, given strong consumer demand. As supply constraints are expected to ease in the second half, cost push pressures for manufacturing industries could fade somewhat. Increasing demand for commodities from the industrial sector, along with much-needed investment in mining and the ability of commodities to keep pace with inflation is supportive for the asset class. However, a stronger US dollar, slowing industrial demand from China, import curbs and the release of strategic official metals reserves in China could weigh on commodities in the short-term.

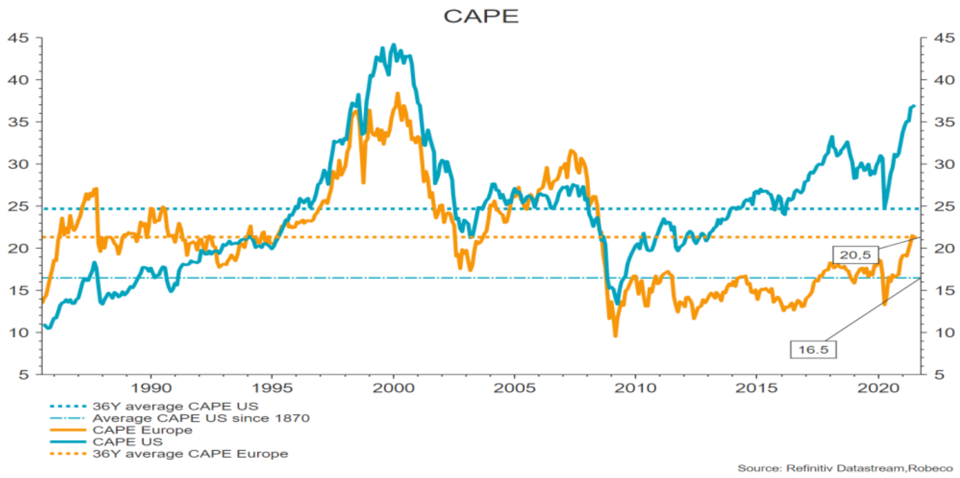
Equities (I)

Regional momentum: The force is with the US



Source: Refinitiv Datastream & Robeco

Valuation: US CAPE is ascending



Source: Refinitiv Datastream , Robeco

- In June, the positive momentum for global equities strengthened, with the MSCI World index in euros returning 4.6%. The upward leg was driven by a broad depreciation of the euro against peers, but also reinvigorated momentum in the US stock market, which saw a return of 2.4% in US dollars. Fewer stocks contributed to new highs in major US stock indices, but there was a continued catch-up for technology – and for growth stocks that had lagged value stocks in the first quarter.
- From a macro perspective, the likely peak in global activity momentum and decelerating inflation fears after the May 5.0% US CPI print, together with declining bond yields and market implied inflation expectations, were particularly helpful to propelling growth stocks.
- Central bank events were the main driver of equity markets last month, as evidenced by the stir that FOMC member Bullard caused by hinting about Fed rate hikes as early as 2022. Notably, ex-US stocks reacted more strongly compared to US equities on the potential withdrawal of excess dollar liquidity. Base rate effects are fading as the third quarter progresses, with many developed market central bankers and the majority of market participants viewing inflation as transitory. This view could be justified in the near term, but current labor shortages signal rising bargaining power for workers, while rising house prices have the potential to push up the owner equivalent rent component of US core CPI in the second half of 2021.
- Looking ahead towards the year end, the market could be surprised to see that there is another round of inflationary pressures that proves to be stickier. Awaiting major central bank events in August (Jackson Hole) and September (ECB Strategic Review) may lead the market to drift higher in a 'not too hot, not too cold' environment, with declining volatility pushing risk parity strategies to take more equity risk.

All market data to 30 June unless mentioned otherwise

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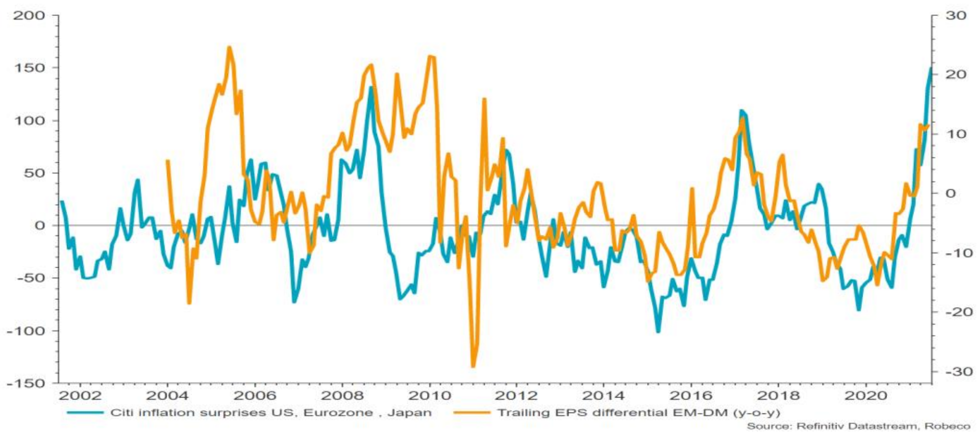
Equities (II)

EM/DM EPS growth differential: Upside left for further widening



Source: Refinitiv, Robeco

Market technical US: Mind the SKEW

SKEW >150	1M	3M	6M	12M
AVERAGE	1,4%	0,1%	0,7%	8,8%
MEDIAN	1,2%	1,1%	-0,9%	6,6%
Normalised SPX returns	0,75%	-1,90%	-3,42%	0,59%

Source: Refinitiv, Robeco

> The second quarter may prove to be a litmus test of how well corporate profitability has weathered the peak rise in input costs and the flattening of yield curves. Given the muted reactions on earnings beats during the first-quarter earnings season, there is some downside risk if earnings are not able to meet expectations in the second quarter. Looking further out to EPS expectations for 2022, there is still upside to current consensus views for the Eurozone, given our view of above-trend growth in the bloc for 2022, which could point to high double-digit EPS growth. Willingness to spend is high and household income growth will remain resilient on the back of improving employment numbers.

> A well-flagged risk for years has been that valuation levels are historically stretched in the US, with the US Shiller CAPE now at 37 closing in towards the IT bubble peak of 44. While this suggests equity returns below historical averages for the next five years, stretched valuation levels have not deterred markets from making new highs, and they could continue to do so near term. However, the market is cognizant of downside risk, as evidenced by the SKEW index making an all-time high. This index measures the 'third moment' in stock prices and is a proxy for perceived left-hand tail risk materializing in the next 30 days. Historically, the SKEW has not been able to flag recessionary sell-offs like the global financial crisis in advance, but it does signal flattish US stock markets on a subsequent six-month window.

> The summer holidays could see muted market volatility, though we will keep an eye on downside event risk in August/September.

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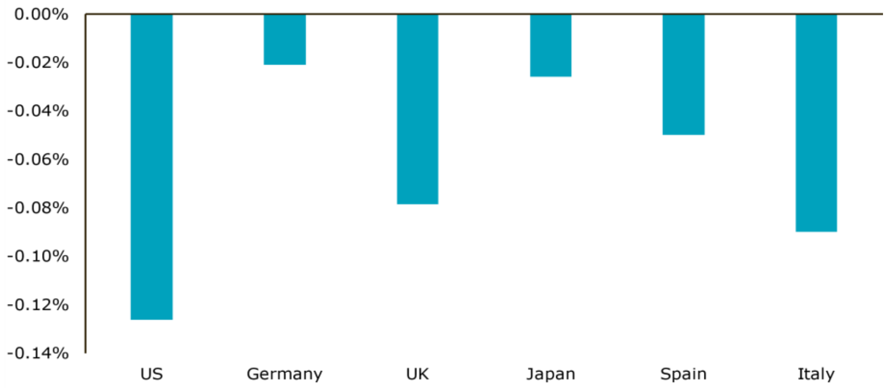
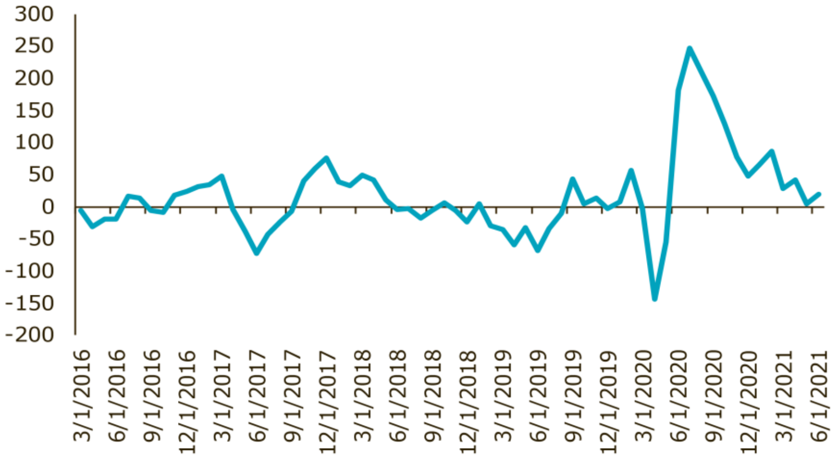
AAA Bonds

10-year yields: US rates lead the way down



Source: Bloomberg & Robeco

US economic surprises: Transitioning towards normality



>Source: Bloomberg & Robeco

> G-10 rates came under pressure in June. The way lower was led by US rates. Data surprises continue to moderate in the US, indicating that the rapid acceleration over recent months is coming to an end. This transition towards more normal growth rates is having an asymmetric impact on assets. While risky assets continue to push higher, the yields are moving lower.

> Europe's own dynamic, such as the release of the recovery fund monies and the move towards reopening, will have an impact on European yields. However, the main direction for yields will be determined by the US. The slide in US rates started before the June Fed meeting and accelerated after it towards a lower range. The market takeaway from the meeting was that the Fed had shifted slightly towards a more hawkish tone. While Powell did try to downplay this, the market preferred to look at the rate expectations of the individual FOMC members instead of listening to the chairman. The reaction to the perceived hawkish shift was a flattening curve. Changing rate hike expectations pushed up the short end as the perception that the Fed was now more inflation sensitive led to a lowering of the inflation premium in the long end of the curve.

> A major difference between the pre-pandemic Fed and the current one is that the current Fed will not preemptively tighten. Its focus remains on healing the labor market. To us, this by definitions means that it will let the economy overheat. We continue to think that a healing labor market will be accompanied by higher rates.

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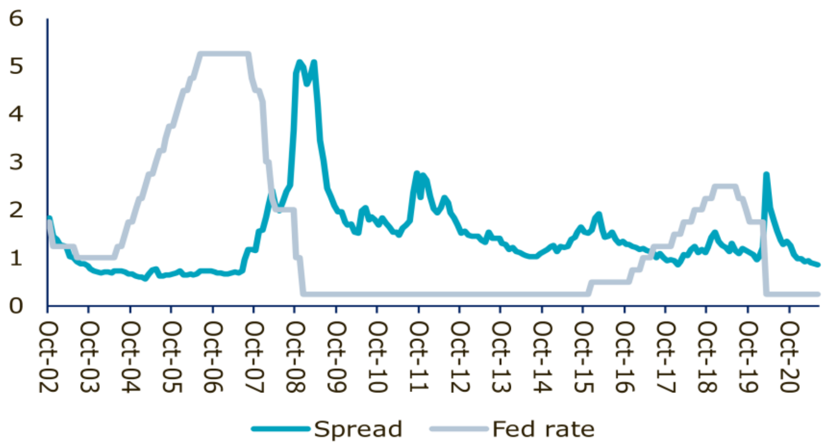
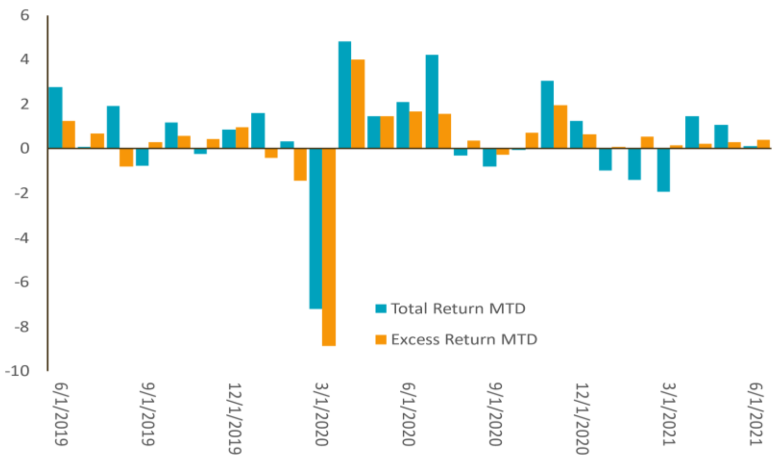
Investment Grade Credits

Investment grade credits are squeezing ever tighter



Source: Bloomberg & Robeco

Investment grade returns are driven by spread compression



Source: BofA Global Research, ICE Data Indices & Bloomberg

- Global investment grade bonds delivered a positive return in June of just 13 basis point unhedged and slightly more than 1% hedged into euros. The return was mainly driven by spread compression.
- Our view that government bond rates have not reached their peak yet was challenged during the month. A major trigger for this move was the latest Fed meeting. The markets' takeaway from it was that the balance within the Fed seems to have shifted towards a more hawkish tilt. While the Fed seemed to have instigated a small shift in policy, the ECB has not and remains a committed dove. This difference in central bank policies didn't lead to substantially different performances between European and US spreads.
- Spreads squeezed marginally tighter after the Fed meeting. Historically, when the Fed starts to tighten, spreads don't immediately widen, but further compression is limited. Given where spreads currently are, we see little room for substantial further compression. If the market correctly assumes that tightening by the Fed has been brought forward, it means the that the countdown has started for spreads to widen.
- We reman less constructive on credits due to their marginal ability to absorb losses at these levels. However, we must concede that spreads can still tighten by roughly 25 basis points before they reach their 19-year low seen in February 2002. Still, we think the days of spread compression are behind us, and the focus may shift to earning carry.

All market data to 30 June unless mentioned otherwise

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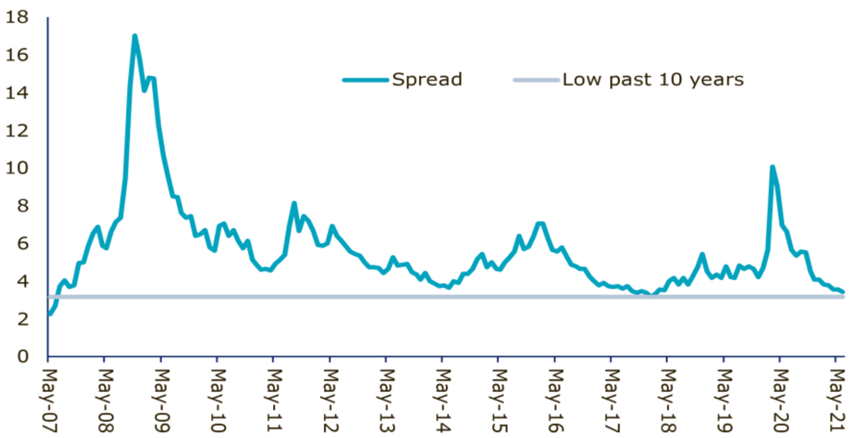
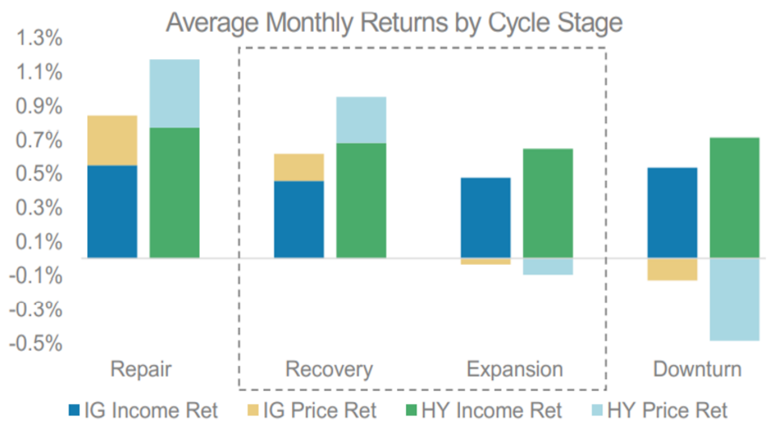
High Yield

Global high yield spreads continue to tighten



Source: Bloomberg & Robeco

Mid-cycle returns are driven more by income than compression



Source: Morgan Stanley Research, Bloomberg, ICE

> Global high yield bonds realized a positive return just shy of just 0.20% in June. The average spread level declined to 345 basis points, its lowest level in almost three years.

> In high yield, the grind towards lower spreads continued. The compression was mainly driven by CCCs, which indicates that the grab for yield theme remains firmly in place. In this regard, high yield is still attractive compared to investment grade corporates. On a standalone basis, this is clearly no longer the case. We fully accept that valuation is seldom a trigger, but it does give an indication of the risk/reward profile of an asset class.

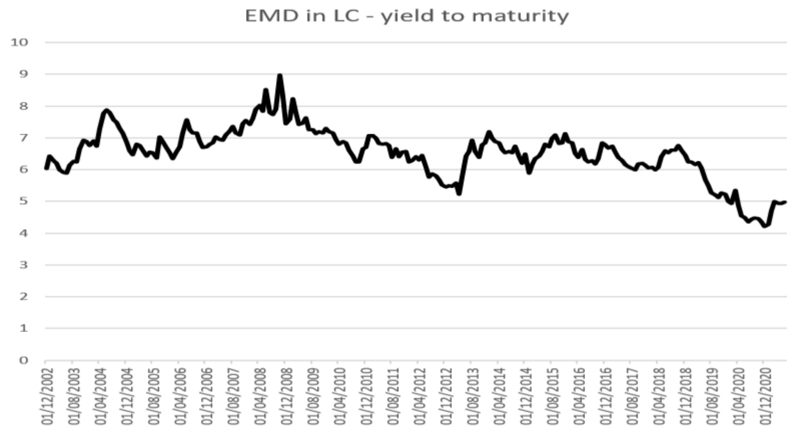
> One thing that does needs to be mentioned is that the overall quality of the high yield index has improved over the years due to the increased weight of BBs in it. Although the maturity off the BB segment has also increased at the same time, implying higher risk, the improvement in quality does allow for tighter spreads. Still, we need to be cognizant that a lot of good news is already priced in.

> We have passed the point of maximum liquidity support by centrals banks, the earnings recovery is well on its way, and looks fully discounted. We have transitioned to a different phase in the cycle. The recovery phase is behind us, and we are now more in mid cycle. With defaults still expected to come down and the economic backdrop still supported, we see no reason for spreads to widen. However, we think that further compression is limited.

All market data to 30 June unless mentioned otherwise

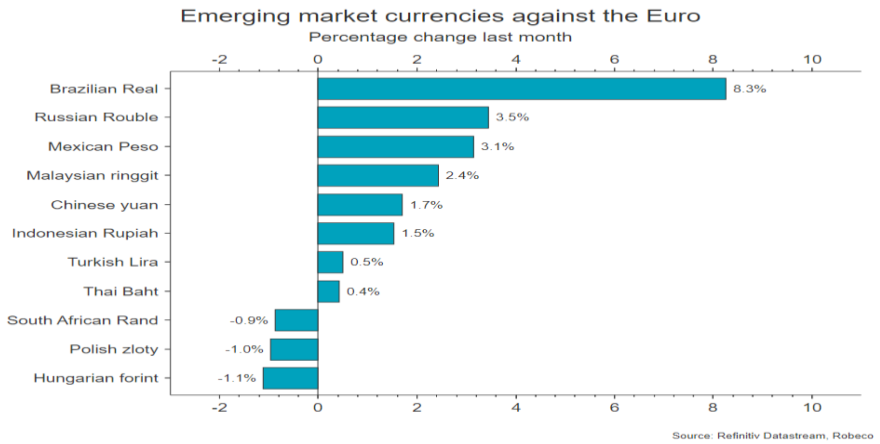
Emerging Market Debt

Emerging market debt in local currency: yield



Source: Bloomberg, Robeco

Emerging market currencies: a strengthening Brazilian real



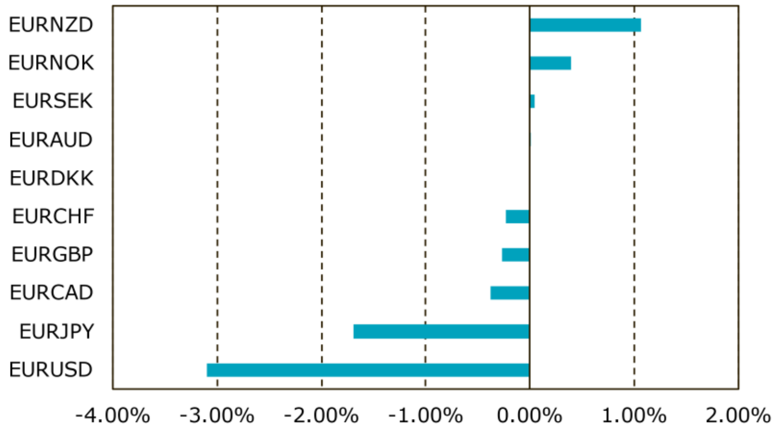
Source: Refinitiv, Robeco

- The yield on the JP Morgan GBI-EM Global Diversified index has traded tightly around the 4.9% level since March. The local currency index generated 2.1% unhedged in euros in June due to performance of the local FX market.
- The local sovereign debt market is experiencing two opposing forces. On the one hand, improving growth prospects have the potential to compress credit spreads, while on the other hand there has been a hawkish shift among EM central banks.
- Several EM central banks hiked policy rates in June, including Brazil, Mexico, Russia, Hungary and the Czech Republic. The hikes were on the back of the June FOMC meeting which has been perceived as being hawkish by the market, due to an earlier-than-expected lift-off date for Fed hikes. In addition, inflation surprises in emerging markets have become positive since the start of the year and have been rising since. Most emerging economies are struggling with record high food inflation, which carries a disproportionate weight in CPI baskets. This could create more tightening pressure for EM central banks and subsequently slow the pace of the recovery from the pandemic-induced recession.
- The currency performance of high yielding countries with deep value like Brazil has been strong versus the euro lately. This shows that high carry currencies in the EM universe can withstand a perceived taper risk, especially against a backdrop of healthy current account balances and FX reserves compared to the 2013 environment.

All market data to 30 June unless mentioned otherwise

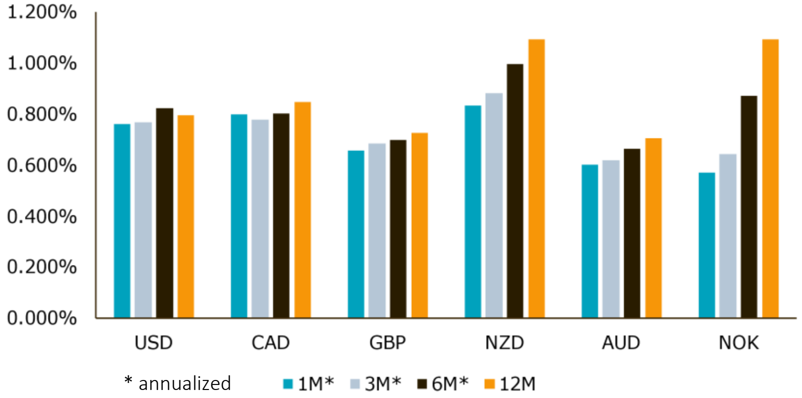
FX

G-10 currencies: The dollar is back



Source: Bloomberg, Robeco

Carry against the euro: High yielders will benefit



Source: Bloomberg, Robeco

> The US dollar was by far the strongest currency in June. This strength was triggered by the latest Fed meeting. The market concluded that a hawkish shift has taken place within the US central bank. In other words, the Fed doesn't seem to be completely insensitive to current inflation prints any more. This supported short-term rates and with it the US dollar. The assumption that the combination of deficits and ultra loose monetary policy would be a continues drag on the US dollar seems to be less valid than it was before the meeting.

> One thing to note with regards to the aftermath of the Fed meeting was that risky assets only briefly reacted and quickly recovered, while the impact on the US dollar and US rates was more lasting. It remains to be seen if the market is indeed correct that the Fed has become more hawkish. The way the Fed reacts to incoming data points will give us a clue if its reaction function has indeed shifted to be more hawkish and thus more dollar supported.

> Given the recovery we have seen across most of G-10, we are entering a phase in which the discussion about toning down monetary policy will start to dominate the debate. We expect changes in monetary policy to become the main driver of currencies in the coming period. In this regard we expect the Bank of Japan, the ECB and Swiss National Bank to be laggards. There is already a fair amount of policy divergence being discounted when one looks at the carry that can be earned across different tenors for different G-10 currencies against the euro. The market expects The New Zealand dollar and Norwegian krona to lead the tightening cycle.

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