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Below zero:
How low rates are reshaping the investment landscape

The Economist INTELLIGENCE UNIT

CEO Foreword

In 2020, the global pandemic took the world by surprise. To mitigate the impact of a global recession, policymakers launched substantial monetary and fiscal stimulus, adding downward pressure on interest rates.

Dealing with low interest rates is by far the most significant shift modern-day investors have had to adapt to, and frames the research behind this report.

Low interest rates are primarily the result of quantitative easing policies after the Global Financial Crisis (GFC) in 2008. They have led investors to chase better yield, and triggered a surge in alternative investment flows, especially into real estate, private equity, and private debt.

One of the greatest surprises in the last decade has been low inflation and very strong risk asset returns. However, low interest rates have not imposed poor equity returns as growth stocks outperformed. Those who had avoided equities since 2010 would have missed one of the strongest equity market rallies in history.

The current environment has led investors to rethink their investment strategies. There are several implications of a continued low interest rate environment on equities, bonds and alternatives. Amidst all of that, there are also opportunities, which are covered in greater detail in this report. Investors need to take a more active approach to their portfolios to navigate this environment.

Jenny Sofian
Chief Executive Officer
Fullerton Fund Management

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About the report

Below Zero: How Low Rates Are Reshaping the Investment Landscape is a report commissioned by Fullerton Fund Management, written in collaboration with the Economist Intelligence Unit.

Touted as a central bank emergency response tool, negative interest rates across much of the developed world are becoming an entrenched norm. Even before the coronavirus pandemic paralysed economies and sent markets into a tailspin, interest rates in Japan and much of Europe were below zero and negative yields had enveloped a quarter of the global bond market.

Since March 2020, central bank rates have been negative in either nominal or real terms across the Group of Seven leading economies: Canada, France, Germany, Italy, Japan, the UK and the US.

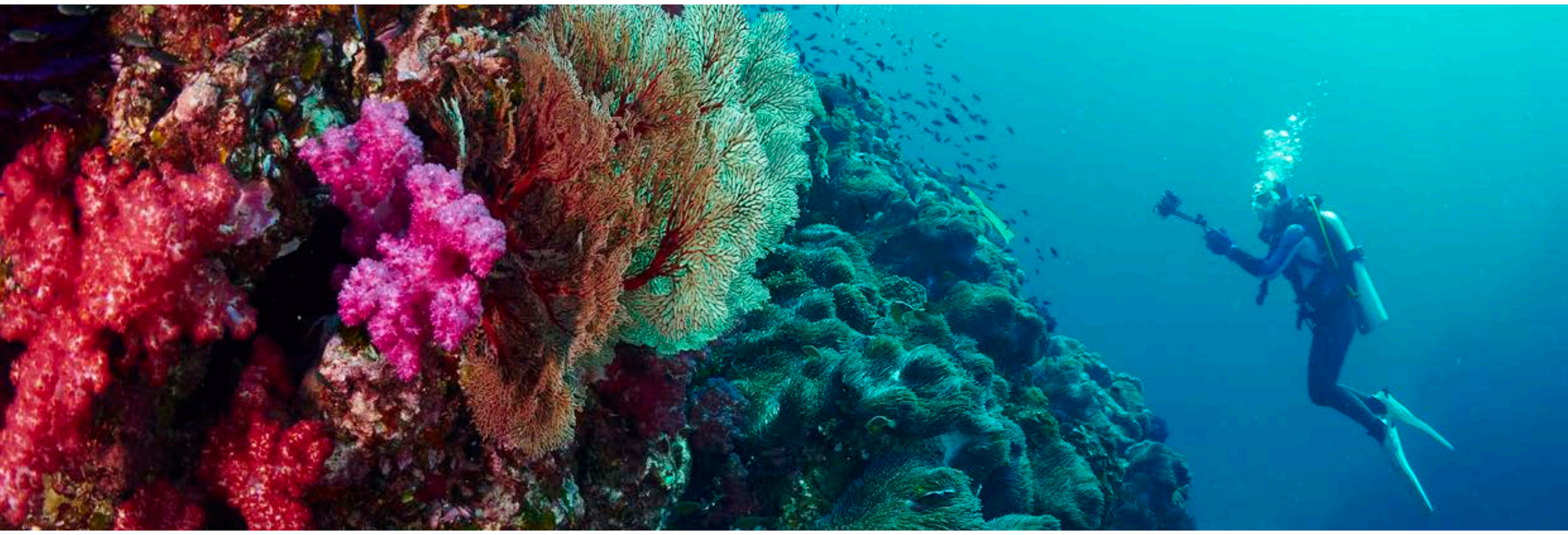
This report examines the impact of ultra-low rates on portfolio allocation, the changing economic backdrop and the risks and opportunities for investors in a world where monetary stimulus is being pushed to its limits.

The study is based on wide-ranging desk research and in-depth interviews with economists and investment managers. Our thanks are due to the following interviewees for their time and insights:

- Ruchir Agarwal, economist and low-interest-rate specialist, IMF
- Charles Bean, professor of economics, London School of Economics
- Tom Carr, head of private debt, Preqin
- Aswath Damodaran, professor of finance, New York University
- James Davis, chief investment officer, OPTrust
- Andrew Milligan, independent investment consultant
- Noorsurainah Tengah, head of absolute return and commodities, Brunei Investment Agency

The report was written by Christina Fincher and edited by Georgia McCafferty.

Executive summary



For the second time in little more than a decade, policymakers around the world have been forced to take extreme measures to avert a global economic collapse. The coronavirus outbreak has shut down swathes of international commerce, put entire countries in lockdown and left governments—even those ideologically opposed to state interference—propping up private industry.

Just as after the financial crisis of 2008, central banks slashed policy rates and printed money to fund asset-buying sprees. The aim is to lower market interest rates, making it easier for companies and governments to borrow.

The power of central banks to move markets is undisputed but their power to revive economies has never been more in doubt. Central banks' willingness to flood markets with cash and buy corporate as well as government debt has fuelled an astonishing rebound in risk assets. But for how long can asset prices decouple from economic growth? And what are the long-term implications for the financial system?

To examine these dynamics, this report draws upon extensive desk research and in-depth interviews with practitioners in the field. The key takeaways are as follows:

Quantitative easing has unintended side effects

Negative interest rates and quantitative easing are the biggest monetary experiments of modern times, and they have not worked exactly as policymakers intended. Negative rates have hit commercial banks' operating margins hard, curbing their ability to lend, and only a fraction of the money created by central banks has found its way into the real economy. By appearing to favour those with assets more than those without, quantitative easing has been blamed for exacerbating inequalities and fuelling populist sentiment.

Interest rates to stay lower for longer

The longer "emergency" rates are kept in place, the more likely they are to become a permanent fixture. Zero and sub-zero rates keep inefficient companies operating and allow debt to pile up. In a low-growth, low-inflation world, such policies can be hard to reverse—as Japan and the euro zone have already found to their cost. Extraordinary stimulus measures may help economies weather the coronavirus pandemic but they are coming up against a long-term downward trend in growth and inflation that shows no sign of abating.

Valuations are harder to interpret

Abundant central bank liquidity has buoyed asset prices and generated above-average portfolio returns over the past decade. Cheap credit has led to a flurry of debt-funded equity buybacks, mergers and acquisitions despite a lacklustre economic backdrop. “Growth” stocks have outperformed “value” stocks as investors have questioned the validity of traditional valuation metrics.

Alternative assets face coming-of-age test

The ultra-low interest rate environment of the past decade has spawned newer, less liquid asset classes, which the pandemic is sure to test. Investment in alternatives, such as private debt, infrastructure, real estate and private equity, typically requires long-term commitments. That timeframe may shield them from short-term market volatility and the broadening sector can offer flexibility in risk-return profiles.

Influence of fiscal policy mounting

With monetary policy options all but exhausted, fiscal policy will need to play a bigger role in economic management—and this expansion of the state may prove long-lasting. Government support for industry could come with conditions that are hard to shake off when the pandemic is over. Fiscal stimulus could lift public borrowing to levels not seen since the 1940s and necessitate a deluge of government bond sales. Conveniently, many of the same countries issuing bonds are also instructing their central banks to buy them.

Favouring asset holders

Unconventional central bank stimulus creates winners and losers just like government bailouts. Debtors are favoured over savers, as are the asset-rich over the asset-poor, while capital markets in powerful economies like the US, Europe and Japan benefit at the expense of those in smaller and developing economies. Fiscal policy can offset some redistributive effects at a national level but not across borders. Assets of emerging economies poorly equipped to deal with the spread of coronavirus are likely to be hardest hit.

Central bank rescues favour risk-takers

An entrenched belief that central banks will ride to the rescue whenever markets wobble is likely to encourage future risk-taking. Central banks buying corporate debt means directly supporting big business while buying “junk bonds” means tacitly supporting private equity companies that specialise in highly-leveraged buyouts. Public anger at the bank bailouts in 2008 will be exacerbated if authorities are seen to reward corporate raiders at a time when most incomes are being squeezed. Central banks set a difficult precedent if they are seen to be both a buyer and lender of last resort.

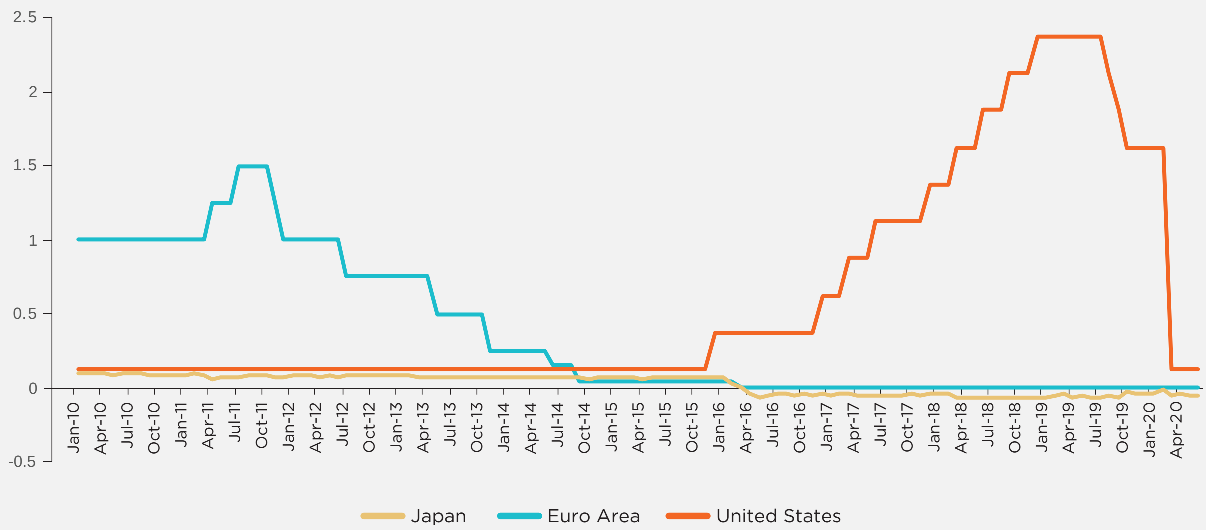
The negative rate experiment

Negative central bank interest rates and quantitative easing (QE) have been the biggest monetary policy experiments of modern times—and the jury is still out on their effectiveness. What is clear, however, is that once entrenched these policies become hard to unwind.

Since the financial crisis of 2008, central banks in the euro zone, Japan, Switzerland, Sweden and Denmark have all set policy rates below zero. As of this writing, only one—Sweden—has reversed the policy and returned rates to zero. The reason for the move was not because the economic situation in Sweden had brightened, but rather because it was feared that the five-year experiment with negative rates was doing more harm than good.

The coronavirus pandemic and the prospect of a sharp global recession have prompted another wave of monetary easing. Central banks across the developed world have slashed rates to within a whisker of zero, but opted to pump further stimulus into the economy through QE—buying assets with newly-created money.

Figure: Central Bank Interest Rates



Source: Federal Reserve, European Central Bank, Bank of Japan, 29 July 2020

The Federal Reserve's package of near-zero interest rates, unlimited QE and targeted measures to help companies access funding calmed frayed nerves in financial markets: credit spreads narrowed and after an initial plunge into bear market territory equity indices staged a breathtaking recovery.

However, the experience of the past decade shows that pumping liquidity into the financial system through rate cuts and QE is very effective at boosting asset prices but considerably less effective at getting economies back on track.

"The problem is that once rates get this low, central banks' power starts to fade," says Aswath Damodaran, professor of finance at New York University. "You're seeing US central bankers and European central bankers reach the same state of desperation that has been felt in Japan for the past 20 years."

The problem, says Mr Damodaran, is weak economic growth which central banks don't have much power left to address.

According to The EIU, the global economy grew by just 2.2% in 2019[1], the weakest rate since the 2008 financial crisis and well below the historical average. Lockdowns to halt the spread of coronavirus mean a painful recession this year looks inevitable.

"

Even when interest rates are at zero, central banks need to instil confidence in markets and that means being prepared to cut rates into negative territory if needed.

Ruchir Agarwal, who co-authored an IMF working paper on the use of sub-zero interest rates,[2] believes a better way for central banks to deal with a crisis is to have a short, sharp burst of deeply negative rates—as low as minus 3% for example—rather than a prolonged period of zero or mildly negative rates that becomes difficult to unwind.

"While a subject of active debate, one view is that short-lived but deep negative rates may be more effective than persistent, mildly negative rates which provide a drip, drip, drip of stimulus but are not enough to restore the economy to its potential," he says.

Even when interest rates are at zero, central banks need to instil confidence in markets, says Mr Agarwal, and that means being prepared to cut rates into negative territory if needed.

[1] The Economist Intelligence Unit, Global Forecasting Service

[2] Enabling Deep Negative Rates to Fight Recessions, R Agarwal and M Kimball, 2019

"If investors believe that central banks are constrained because of the zero lower bound, then their belief about future growth diminishes, and that in turn influences their investment decisions today," he explains. "It would be a bad idea for central banks to say openly that they have run out of ammunition."

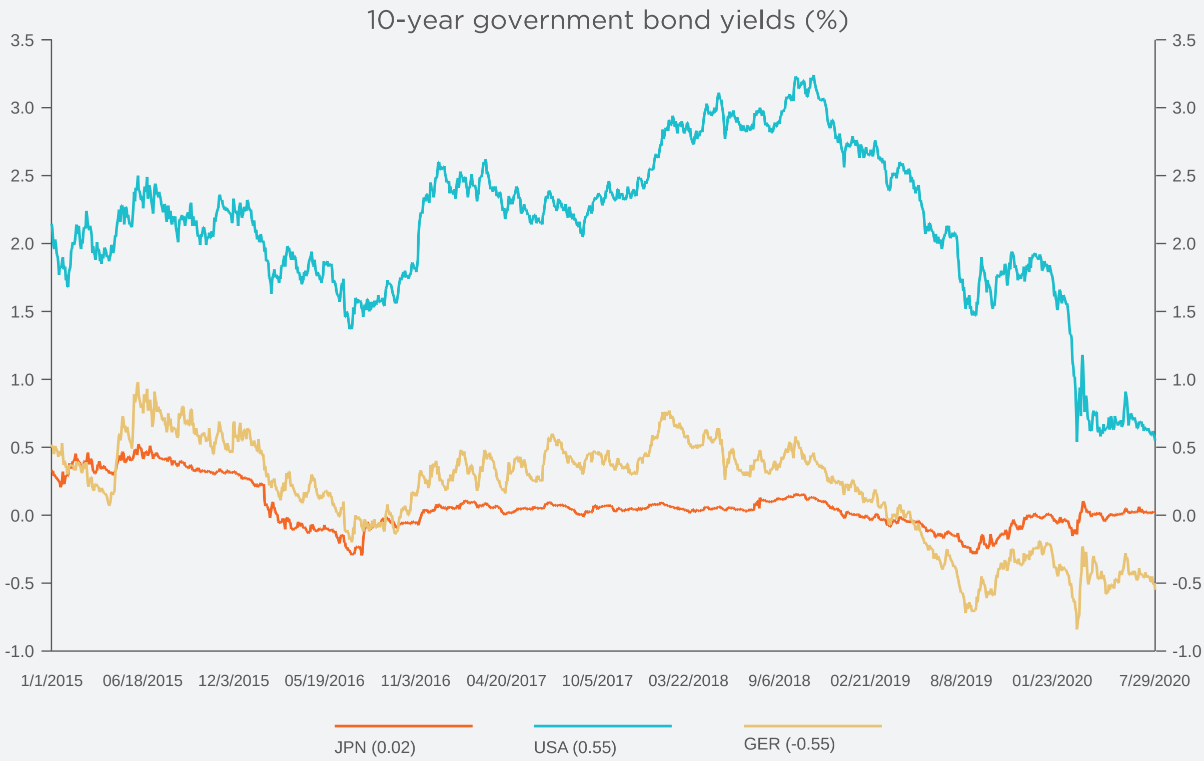
Blame the economy, not central bankers

The pattern of the past few decades has been deeper rate cuts with each recession and shorter tightening cycles with each recovery. US central bank interest rates peaked at 2.5% this cycle—less than half the previous cycle's high of 5.25%[3]. That itself was a full percentage point below the peak of 2000 and a fraction of the now almost-unimaginable highs near 10% in 1989 and 20% in 1980.

So where will it end? If countries are reluctant to join the euro zone and Japan by pushing rates into negative territory, will zero become the new normal?

Bond markets are certainly not pricing in higher rates any time soon. German and Japanese government bonds trade with negative yields up to 20 years. Even in the US market, yields are trading at rates well below inflation.

Figure: 10-Year Government Bond Yields



Source: Haver Analytics, Yardeni Research, Inc. 29 July 2020

[3] The Federal Reserve https://www.federalreserve.gov/default.htm

Negative rates are good for homebuyers and businesses. Denmark's Jyske Bank launched the world's first negative interest rate mortgage in August 2019, effectively paying homeowners 0.5% a year to take out a loan.

But they hit commercial banks and savers hard. In countries where saving is considered a moral virtue, such as Germany and the Netherlands, the backlash has been fierce. After the European Central Bank (ECB) cut rates from minus 0.4% to minus 0.5% in September 2019, Germany's Bild newspaper ran a front cover depicting the then ECB president Mario Draghi as "Count Draghila", a vampire sucking blood from savers.[4]

Since central banks set policy to meet an inflation target, Charles Bean, professor of economics at the London School of Economics, wishes media headlines would focus more on what's going on with price pressures and less on what's going on in central bank boardrooms.

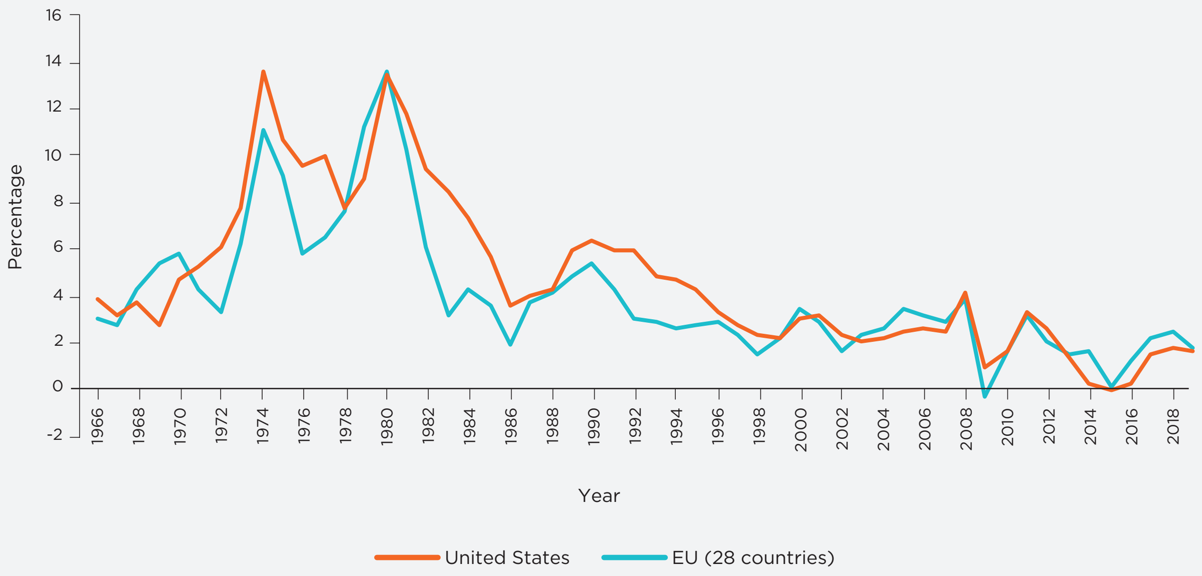
"People sometimes point the finger at central banks, but central banks are merely reflecting an underlying real phenomenon in the global economy which is the decline in the underlying real interest rate, or the natural real interest rate if you want to call it that," he says. "This has been unfolding since the middle of the 1990s, possibly even earlier."

Mr Bean, a former deputy governor of the Bank of England, believes the natural rate of interest—the rate needed for an economy to grow at potential—has fallen by around three percentage points over the past two or three decades to stand at "around zero" in most developed economies even before the virus outbreak, and almost certainly negative in much of Europe and Japan.

The inflation conundrum

So why has the natural rate of interest fallen so much? And why are policymakers, who struggled in the 1970s and 1980s to bring inflation down, unable now to get enough of it?

Figure: Annual inflation rate in the US and Europe, from 1966 to 2019



Source: World Bank, 2020

[4] "So saught Graf Draghila unsere Konten leer", Bild, September 13th, 2019

There is an abundance of theories but no single answer, says Mr Bean. Most economists believe it is the result of a confluence of factors: the demographic drag of ageing populations, a savings glut caused by the integration of China into the global economy and lower rates of innovation.

Prior to the 1990s most central banks were run as government departments. This meant monetary policy was often influenced by short-term political objectives and pre-election rate cuts were par for the course.

Since gaining independence almost all central banks have targeted an index of consumer price inflation—typically at an annual rate of 2%. The index is calculated using a weighted average of consumer goods and services, such as food, household items, transport and leisure activities. However, it does not include asset prices.

After a decade of sky-rocketing asset prices yet dismal economic growth, questions are being asked about the logic of an inflation index that takes account of the cost of everyday goods and services but not the biggest purchase most people make in a lifetime: their property.

> “Most economists believe it is the result of a confluence of factors: the demographic drag of ageing populations, a savings glut caused by the integration of China into the global economy and lower rates of innovation.

Both the Fed and the ECB are conducting reviews of their monetary policy strategies and may adjust the way in which they calculate inflation. However, central bankers are loath to give any impression that they are targeting asset prices, something that has gotten them into trouble in the past.

Investment Viewpoint

Adopt an active multi-asset approach

"We believe a static asset allocation mix is not a good solution. Economic and financial market cycles are likely to experience large swings as governments attempt to revive growth. A nimble investment approach is warranted and there are three key features."

In a post coronavirus world, investors are likely to experience a vastly different investment landscape characterised by de-globalisation, and structural adjustments that hasten the adoption of technology and online solutions. We expect a large-scale adoption of technology to be initially demand disruptive and deflationary as companies and labour compete aggressively. The high level of debt-to-GDP would also add headwinds to economic growth. A probable risk scenario is a global debt deflation with negative cash rates in Japan, Europe and the US.

In post-war modern economic history, only Japan has experienced debt deflation. Investors and investment theories are not adapted to a world of negative cash rates. How are traditional portfolios such as 60% Equity and 40% Fixed Income likely to fare? Financial market returns are likely to be low.

We believe a static asset allocation mix is not a good solution. Economic and financial market cycles are likely to experience large swings as governments attempt to revive growth. A nimble investment approach is warranted and there are three key features. Firstly, strong risk management is needed to navigate large swings in equity and bond markets. Secondly, asset allocation strategy needs to drill down to specific countries and sectors to invest in pockets of growth. Finally, we need to avoid passive investments such as passive index funds as structural adjustment will throw up few winners and many companies may struggle.

Vincent Chan
Head of Multi-Asset
Fullerton Fund Management

Turning finance theory upside down

> By favouring the asset-rich over the asset-poor and allowing companies to borrow cheaply, unconventional monetary policies have also been blamed for inflaming populist sentiment and allowing a build-up of debt.

Negative interest rates turn conventional finance theory on its head. Who would buy a bond if they knew for certain that when it matured they would get back less than they paid for it? And who would save money in a bank offering negative rates if they could simply stash their cash under a mattress?

Sales of home vaults did indeed rise when the ECB and Bank of Japan took rates negative, but this is hardly an option for businesses or commercial banks with large cash flows.

"The reason people don't take all their money out of the bank—or central bank if we're talking about commercial bank reserves—is essentially a security concept," says Mr Bean. "Having a load of cash on the premises is a motivation to be burgled."

Unintended consequences

By making banks pay to stash their cash with the central bank, negative rates are intended to encourage banks to lend to firms. However, they have the knock-on effect of eroding banks' profits at a time when the sector is struggling under the weight of regulations put in place after the 2008 crisis.

"One of the adverse feedback loops is that QE and negative rates have affected banks' ability to lend," says Andrew Milligan, an independent consultant with 40 years' investment experience. "I think we can very easily see in the valuations of Japanese and European banks that negative rates—which are in effect a tax on banks' profits—have materially affected their capacity to lend."

By favouring the asset-rich over the asset-poor and allowing companies to borrow cheaply, unconventional monetary policies have also been blamed for inflaming populist sentiment and allowing a build-up of debt. Global debt-to-GDP has risen to a record high above 320%,[5] driven by sharp rises in corporate and government debt even as tighter regulations of bank lending constrains financial and household leverage.

Another criticism of negative rates is that they prop up otherwise unviable companies. The Bank for International Settlements (BIS) has warned of the emergence of "zombie" firms—indebted companies that would be insolvent if rates were at more normal levels and which divert investment and workers away from other financially healthy businesses.

"Each time a crisis has appeared, the authorities have said 'we can't allow growth to slow too much', and we're now in a vicious circle," says Mr Milligan.

[5] Institute of International Finance April 2020 Global Debt Monitor

Case study

Private debt risks, retrenchment and opportunity

Once a niche area of the global asset management industry, private debt is fast becoming mainstream. Assets under management have trebled over the past ten years, driven by demand from yield-starved investors and a retrenchment in bank lending to smaller companies after the 2008 financial crisis.

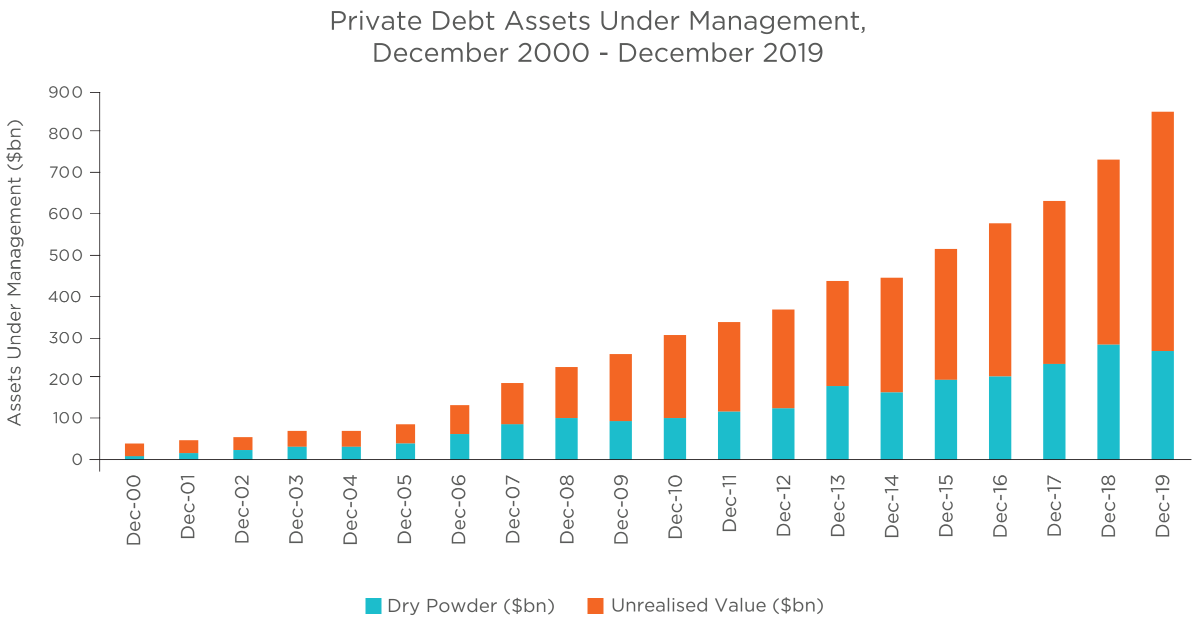
Its popularity as an investment is relatively simple. Private debt has more predictable cash flows than private equity, so it is particularly popular with investors like insurance companies and pension funds who are looking for higher-yielding alternatives to government bonds. However, the coronavirus crisis will be a major test of the industry's robustness, as most private debt investments have yet to be tested through a full market cycle.

"Private assets have some distinct advantages at times like these," explains Tom Carr, head of private debt at research provider Preqin. "Investors typically sign up for ten years in private equity and around seven years for private debt. This means it's easier to ride out some of the short-term fluctuations in equities."

Turmoil in the public debt markets could also be a double-edged sword for the private debt industry. On the one hand, investors who lent aggressively could find themselves over-exposed to highly indebted companies at risk of defaulting, particularly in sectors such as transport and tourism. On the other, further retrenchment by banks is likely to provide the new deal opportunities that the private debt market desperately needs.

In the last few years, so much money flooded in, it was hard to put it all to work," explains Mr Carr. "There was a lot of capital chasing limited opportunities so people started competing in terms of spreads and moving to 'covenant-lite' options." Covid-19, Mr Carr contends, will reveal more about the risk-reward dynamics of the asset class going forward.

Figure: Private debt assets under management



Source: Preqin, Dec 2019

Reshaping the investment landscape

Ultra-low interest rates force investors to take higher levels of risk to meet target returns. Since central banks began experimenting with negative rates and QE, several investment themes have emerged.

Going for growth

In a low-growth world, future cash flows are highly prized and the past decade has been dominated by the outperformance of "growth" stocks (particularly technology stocks) versus "value" stocks on major equity indices. Demand for emerging markets, which typically have higher growth rates than developed economies, has also risen.

"People have been happier about having a much larger weighting in emerging markets despite the political and currency risk," says Mr Milligan. "People justify this by saying 'Oh, it's the growth story. It's the middle-class of Africa. It's the Samsung tech story'—all of which is true. But part of it is 'I just can't cope with the low growth of Europe and Japan. I've got to be buying some growth assets for my portfolio'."

Companies gear up

Cheap credit has fuelled a flurry of debt-funded equity buybacks and acquisitions, lifting corporate debt to an all-time high of US$13.5trn at the end of 2019.[6] Yield-starved investors have proved eager buyers of sub-investment grade debt, allowing the leveraged loan market and the private debt market to expand rapidly.

Even the investment-grade sector is changing. In 2019, BBB-rated bonds (the lowest rating) made up more than half of the investment-grade market, up from less than a quarter in 2001.

With markets awash with liquidity, investors have been prepared to lend money while getting weaker covenants in return and regulators have warned that growing corporate leverage poses risks to financial stability.

Bonds and stocks trade places

While bonds have conventionally been bought for income and equities for price appreciation, a new dynamic has emerged—bonds that yield nothing but that gain in price and dividend stocks that provide a steady income stream.

As government bond yields have fallen below zero, capital appreciation becomes the motive for buying rather than yield. This has led to subtle changes in the investor base, with short-term buyers tip-toeing into a market that has traditionally been the preserve of buy-and-hold pension funds and insurers.

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[6] Organisation for Economic Cooperation and Development, Feb 2020

Investment Viewpoint

Seeking bond returns in a low interest rate world

"Low interest rates make it cheaper for companies to refinance and put a lid on default risks. At the same time, low interest rates will underpin demand for assets with positive yields."

In a "lower for longer" interest rate environment, investors could consider investing in Asia's high quality bond markets for better yields.

Asia's local currency government bond market is characterised by a 100% investment grade sovereign universe, with the ten major Asian bond markets[1] in investment grade territory. Although Asia's consolidated fiscal deficit is expected to widen this year, overall government debt levels are still low compared to developed markets, which give them more fiscal policy space. The current low inflation backdrop has also translated to attractive real yields. With the US Federal Reserve on hold and inflation still benign, most Asian central banks will be able to keep rates at current levels or ease further, should growth take another leg-down. Potential forex gains over the medium term against a weakening USD is also a positive.

The ability to rotate and allocate risks amongst the ten Asian countries – each with largely diverse economic drivers and asynchronous economic cycles, will be key in achieving higher risk-adjusted returns in a low-yielding interest rate environment.

Elsewhere, investing in high quality, attractively valued credit markets is also a worthwhile consideration. The Asian credit market is dominated by investment grade issuers[2]. It is also underpinned by strong regional support and tend to exhibit lower spread gyration as compared to other EM corporate blocs. The high yield sector where valuations are still compelling versus historical averages is also looking interesting, but security selection will be key. Low interest rates make it cheaper for companies to refinance and put a lid on default risks. At the same time, low interest rates will underpin demand for assets with positive yields.

Ong Guat Cheng
Head of Fixed Income
Fullerton Fund Management

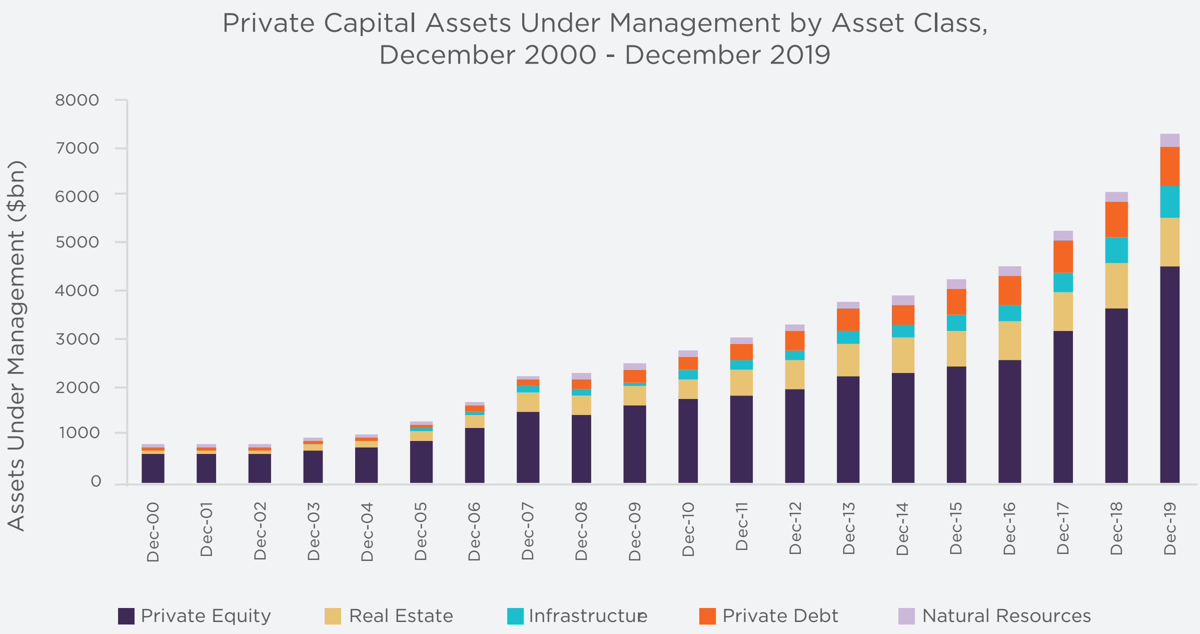
[1] China, Hong Kong, South Korea, Taiwan, Thailand, India, Indonesia, Singapore, Malaysia and the Philippines

[2] 78% based on JP Morgan Asian Credit Index as of 31 May 2020

Alternatives in the ascendency

Stretched equity valuations and negative bond yields have been a boon for alternative assets, which have the added appeal of diversification after a period of unusually high correlation between the major asset classes.

Figure: Private capital assets under management by asset class



Source: Preqin, Dec 2019

Global assets under management in the alternatives industry have surged to a record level above US$10trn, according to research firm Preqin. Private equity remains the biggest category, but private debt, real estate and infrastructure are expanding rapidly.

While the coronavirus pandemic may slow the pace of new deals, income and diversification arguments should continue to favour alternative assets, says James Davis, chief investment officer at OPTrust, which manages one of Canada's largest pension funds.

"We believe alternative assets are beneficial in all economic environments, primarily because they allow for more diversification and portfolio customisation," he says. "Alternative assets provide access to different risk premia and allow for more value creation potential than conventional asset classes."

The role of alternative assets in a low growth world

The Alternatives asset class encompasses a wide spectrum of sub-asset classes and risk-return profiles, making it suitable to a range of investors from risk-averse to risk-seeking.

As an asset class, Alternatives have unique attributes that present differentiated returns from public markets. Alternatives are able to use flexible investment structures to execute complex strategies, which are typically inaccessible to public investment vehicles, therefore providing an alternative source of return. For example, private equity managers have the ability to profit from operational and financial improvements of companies under their management – according to a report by Bain Capital, net asset value of buyouts increased 7 times from 2000 to 2018, while public equity market capitalisation increased by 2 times. Investments in essential core infrastructure provide uncorrelated yield from secured long-term contracts or operating revenues. Hedge fund managers also employ sophisticated trading strategies to capitalise on pricing dislocations, arbitrage and other market inefficiencies, to generate alpha and manage risk.

Figure: Global buyout net asset value vs. public equity market cap, indexed

Note: Buyout net asset value based on unrealised value
Source: Preqin, World Bank, Bain's 2020 Global Private Equity Report (24 February 2020)

In a new global normal of low interest rates we strongly believe that Alternatives will continue to grow quickly as portfolio managers and allocators become more sophisticated and recognise the ability of Alternatives in adding alpha, uncorrelated returns and diversification to their portfolios. This can be achieved by selecting the right managers with the track record that align with investors' requirements, such as investment horizons, liquidity and risk constraints.

Tan Huck Khim
Head of Alternatives
Fullerton Fund Management

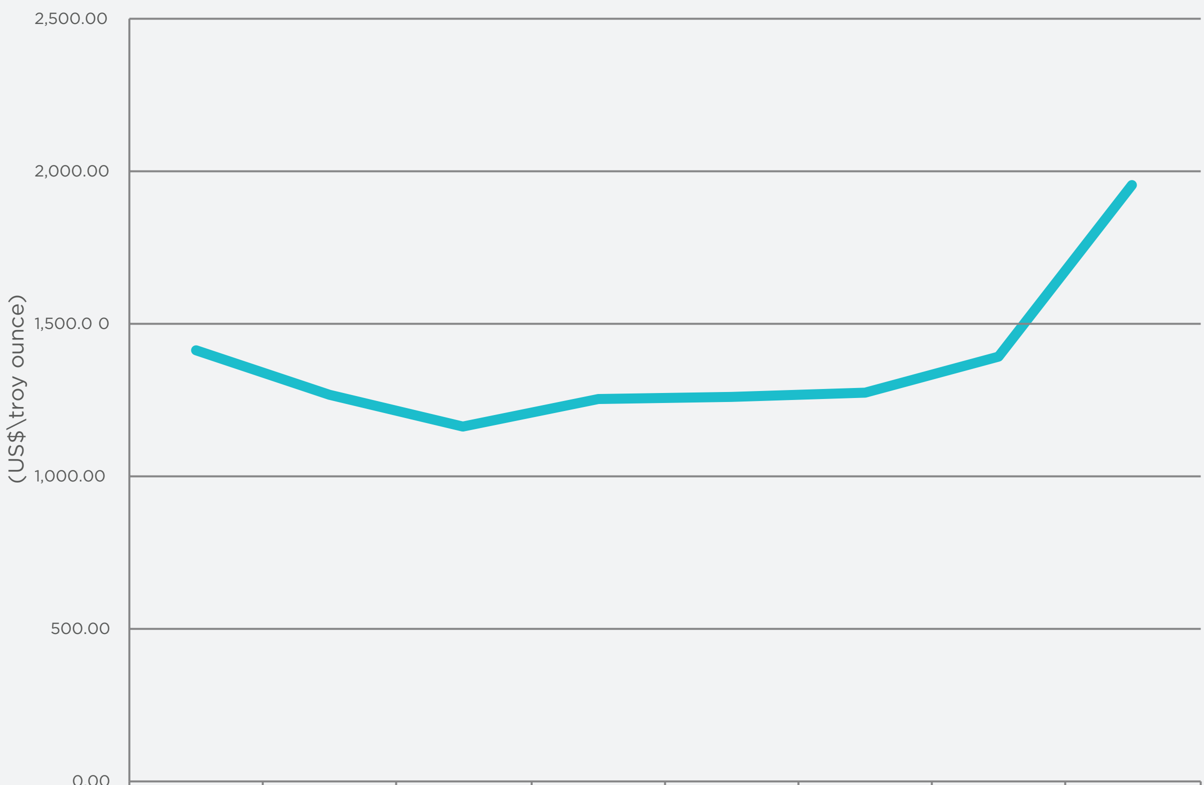
Gold surges to new heights

If buyers of government bonds are being asked to pay for the privilege of holding them to maturity, gold—which costs nothing to hold and offers the potential for price appreciation and diversification—becomes more valuable. Lofty equity valuations, an uncertain policy outlook and the potential for debt monetisation provide additional incentives for investors to choose the precious metal as a place to park their cash.

As this report went to press, gold jumped to a new record above US$2,000 a troy ounce in August, 2020 and has rallied by more than a quarter this year, making it one of the best performing mainstream assets.

"There's a fairly substantial segment of the market that believes the last decade has been an aberration created by crazy bankers with their hands on the levers," says Mr Damodaran. "If you believe that, you are going to go to the place people have gone for thousands of years when they have lost faith in currencies, which is gold.

Figure: Gold Prices



	2013	2014	2015	2016	2017	2018	2019	2020 *
US	1,411.46	1,265.5 8	1,160.66	1,248.99	1,257.56	1,269.23	1,392.50	1,950

Sources: LBMA; The Economist Intelligence Unit; *2020 up to 29 July

Investment Viewpoint

Adding value through stock selection

> With growth becoming scarce, investors should look to sustainable growth companies that will be on the right side of technological disruption with strong balance sheets and high return on equity."

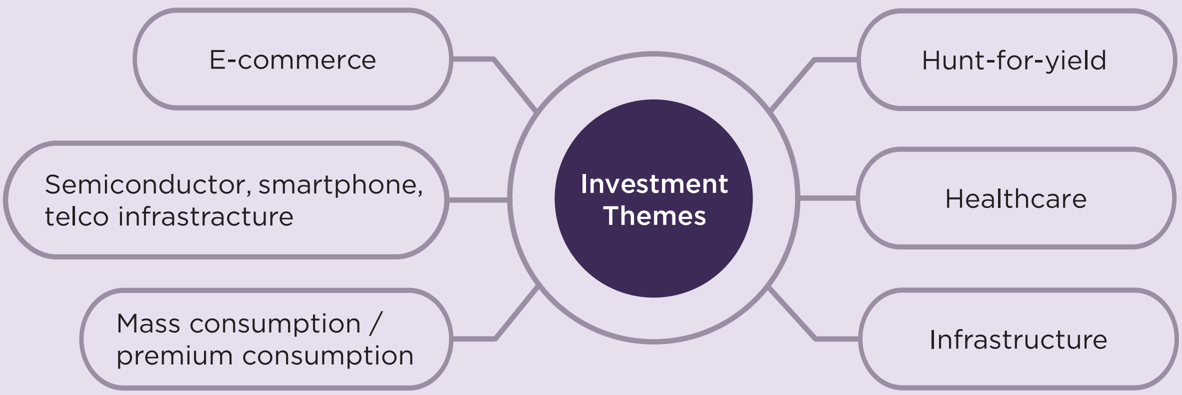
The range of possible outcomes for Equities in a low interest rate environment is wide, in terms of expected returns and observed valuation multiples. The reason is that mixed signals are sent by low interest rates – low rates will reduce discount rates in valuation models but may also imply low future growth rates of company cashflows. Although the implications for traditional valuation metrics such as P/E ratio multiples are inconclusive at the overall market level, there are clear valuation implications for stocks with different characteristics within the broad market.

With growth becoming scarce, investors should look to sustainable growth companies that will be on the right side of technological disruption with strong balance sheets and high return on equity. Companies with stable cashflows can benefit from the lower discount rates, while innovative companies that can generate revenue growth should also see higher multiples.

The attractive investment themes for investors over the medium-term are e-commerce, technology, healthcare, mass consumption/premium consumption, infrastructure and the hunt-for-yield. Buying stocks with attractive dividend yields is less straightforward today, as many companies with optically high dividend yields face cyclical growth headwinds and structural business-model challenges – banks and energy stocks come to mind. This calls for a focus on dividend growth over high dividend yield securities, for equity income strategies.

Stock selection will remain paramount in a low interest rate environment as economy-wide growth will not likely be sufficient to lift all boats, leading to a wider difference between stock market winners and losers. The winners will be those able to generate above-average sustainable growth. Be prepared for these stocks to trade at multiples that look elevated versus history.

Figure: Multi-year structural growth drivers



Source: Fullerton

Andrew Maule
Head of Equities Research
Fullerton Fund Management

Valuations are harder to interpret

Like a rising tide that supports boats of all shapes and sizes, central bank liquidity has buoyed all assets despite a gloomy economic backdrop.

Equities, commodities, government and corporate bonds all rallied in 2019 as the global economy slowed, and the divergence between asset values and GDP growth has become even starker since monetary stimulus was ramped in response to the covid-19 pandemic.

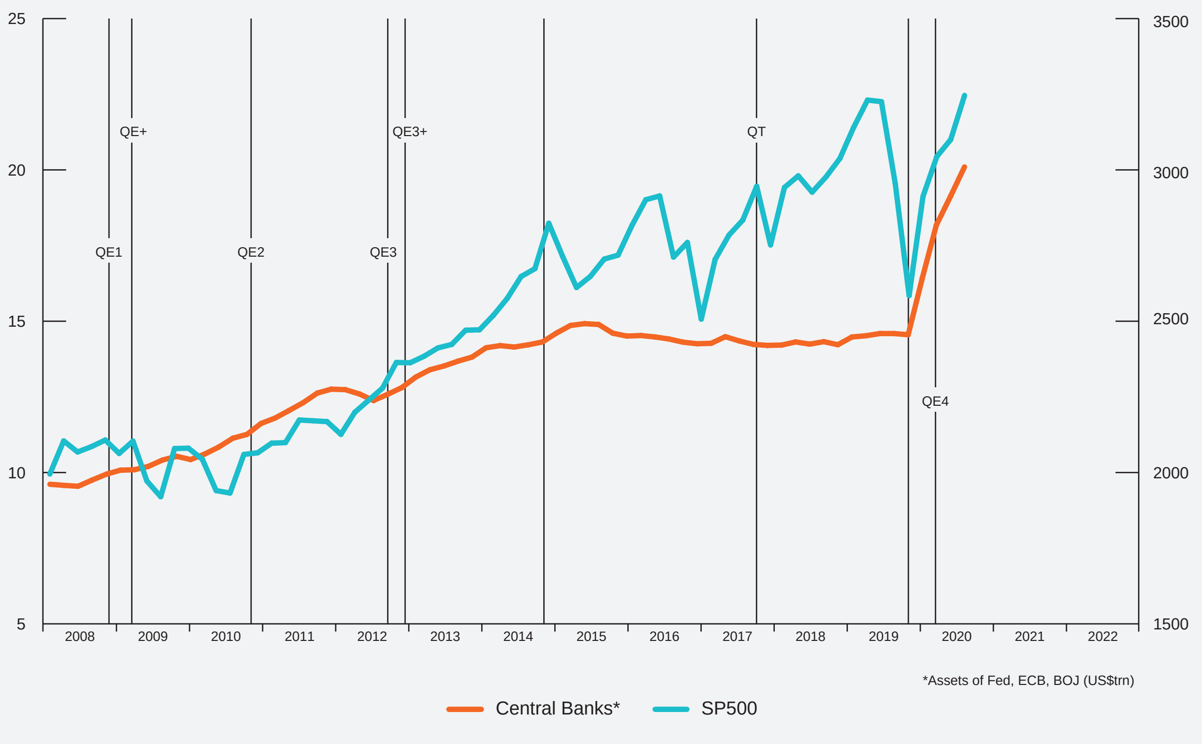
> With interest rates likely to stay at rock-bottom for years, many argue that historically-expensive valuations can be justified.

Since risk assets are priced off a "risk-free" rate—cash or government bonds—falling interest rates and central bank bond purchases support valuations across markets, both those that typically perform well in a recession and those that traditionally do not.

With interest rates likely to stay at rock-bottom for years, many argue that historically-expensive valuations can be justified. The corollary to negative real interest rates, however, is increasingly debt-driven growth that cannot be sustained forever.

"Lower interest rates typically lead to higher valuations, but higher valuations will ultimately lead to lower future expected returns," says Mr Davis. "There is no free lunch. If you want higher returns you must accept more risk but, like a game of musical chairs, eventually the music will stop and you may find yourself without a place to sit."

Figure: Equities get QE boost



Source: Yardeni Research, Inc., 29 July 2020

Interview

Valuing companies in a low interest rate world

Aswath Damodaran, professor of finance, New York University Stern School of Business

Q: How do low interest rates impact corporate valuations?

Mr Damodaran: "Low and negative interest rates are just a piece of a very big puzzle for me in investing and valuation. They're not going to fundamentally change the way I evaluate something or how I invest. So how I allocate assets, how I value stocks, has not changed even as rates have gone from 3% to -0.3% because the rest of the ecosystem has also changed. So today when I value companies, I do use a much lower interest rate to get myself started. But I also use much lower growth, much lower expectations of inflation. And guess what? It all cancels out."

Q: Will the recent market turbulence mean long-overlooked, traditional valuation metrics become a more important investment tool?

Mr Damodaran: "There's little to suggest that will be the case. The drop in the equity market meant those who argued it was overpriced felt vindicated, but the stocks falling the most were not the ones that were most overvalued on traditional valuation metrics. There was no clear relationship between price-to-earnings (PE) ratios and the extent of price falls. In fact, the best performing stocks during the second half of February 2020 and the first week of March 2020 were those in the top two deciles of PE ratios.

Q: Will the economic impact of the covid-19 pandemic have a lasting impact on valuations?

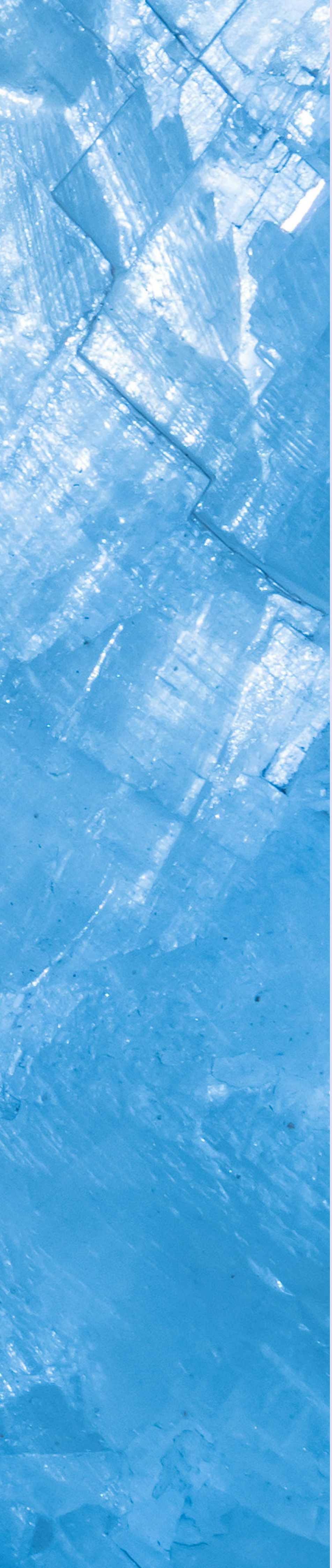
Mr Damodaran: "If you are an investor focused on value, you should be looking not so much at how the coronavirus will affect earnings this year—we all know that 2020 is going to be terrible—but on how much of that earnings drop will be permanent. If you believe the impact of the virus will be temporary, stocks look cheap even if earnings fall by 20% this year. If you think earnings potential is reduced for the long term then the value of the company needs to reflect that."

Q: Are you surprised by the scale of the covid-19 rescue packages that governments and central banks have undertaken?

Mr Damodaran: "Shutting down economies is a lab experiment that no one has tried before so I'm not surprised the response from central banks and governments was so big. They had to step in with liquidity to keep markets going when the economic machine had come to a stop. The test is going to be whether they know when to step back. They can't carry the economy for eternity. They can't keep stepping in with parachutes and protection. They need to have a plan to step away. That's what I'm going to be watching."

Q: Could zero and sub-zero interest rates become the new normal?

***Mr Damodaran*:** "We might get some move above zero, but the days of 4% or 5% interest rates for advanced economies are gone. That was the case even before the virus. Low interest rates are here to stay because they reflect a world reality, a world where inflation has become non-existent and real growth looking forward has become very low. It'll take a little longer for that to show up in emerging markets because they have a younger population. They have more growth.



Investment Viewpoint

Rethinking investment strategies in a low growth world

"Investors have to look beyond the prospect of a prolonged period of low interest rates and focus on how the recovery will play-out, and then what structural shifts may occur."

A key lesson from the last decade is that forecasting the future is often difficult, so what investors must do is have a suite of strategies prepared for different outcomes which reflect their risk and return preferences.

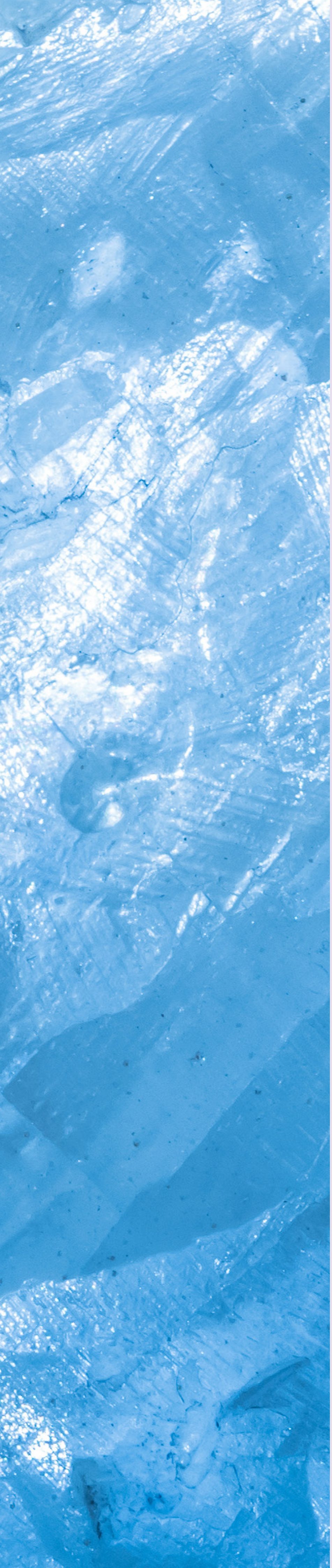
As the world emerges from the global pandemic, the recovery will be slow, and markets will be punctuated with volatility. Investors have to look beyond the prospect of a prolonged period of low interest rates and focus on how the recovery will play-out, and then what structural shifts may occur.

Diversification will be important, and investors are advised to consider multiple streams of alpha for their portfolios, as well as pay close attention to the timeframes for their expected returns.

Opportunities exist within traditional and non-traditional asset classes

The investment implications of prolonged low interest rates, especially across developed markets, suggest that bond investors need to consider other options. Asia offers attractive opportunities – with good credit quality and higher yields. Because corporate default rates will rise, we are more cautious about high yield credit exposures than investment grade credits (which have stronger balance sheets and fundamentals).

Equities may also offer attractive opportunities. Low interest rates do not necessarily equate to low returns, and valuation metrics do not necessarily indicate an equity bubble is building. Liquidity and stimulus will offer support to companies, but fundamentals will matter to determine the winners and losers that emerge from the crisis caused by the global pandemic. Asian equity markets will get support from the recovery in China, but countries more sensitive to weak global trade, such as Taiwan, South Korea, and ASEAN, will see a longer road to recovery.



Allocations to alternatives, like gold, are also attractive, with diversification benefits and protection from adverse geopolitical events and recession.

Important structural shifts warrant a more a selective approach

Investors will have to be cautious and selective given the likelihood that the post pandemic environment is fundamentally different. At least until a vaccine is discovered, there will be less globalisation and more social distancing.

Therefore, investors may need to reconsider their sector allocations given the likelihood of weaker performance from risk-assets linked to tourism, transport, and discretionary retail (especially branded and luxury goods) – but stronger performance from utilities, healthcare, technology, and consumer staples.

Several years down the road, investors will need to factor in the longer-term risk of moral hazard from the latest rounds of government and central bank rescue packages. With developed market central banks showing they will 'back-stop' stressed companies, by purchasing corporate debt in QE programmes, it may encourage imprudent borrowing by some firms (to support their cash-flows) and then increase the risk of a painful deleveraging in the future.

To navigate the environmental shifts, investors should avoid the temptation to take on too much risk and leverage in trying to chase their desired returns. A more prudent strategy would be to continue to focus on a fundamentals-driven portfolio, but consider allocations beyond the typical equity/bond mix – with alternative assets such as real estate, private equity, private debt, and gold.

Patrick Yeo
Chief Investment Officer
Fullerton Fund Management

Conclusion

The longer-term consequences of government and central bank rescue packages may be profound.

Central banks have a long-established role to intervene as lender of last resort in a liquidity crisis, but providing direct support to risk assets is a new departure. Some argue that the Fed's willingness to buy exchange traded funds and even "junk" bonds threatens the basis of capitalism—that risky companies should be allowed to fail—and could encourage debt to build up and cause an even bigger crisis further down the line.

If authorities intervene to support asset prices whenever markets wobble, there is little incentive for investors to moderate risk-taking behaviour or for companies to stop loading up on debt.

"Global debt is now US$87trn higher than at the onset of the 2008 financial crisis," the Institute of International Finance stated in its April report. "Finding the right exit strategy could be even more challenging this time around."

Coordinated fiscal and monetary policy

With central banks exhausting policy options and no prospect of a swift recovery, the coronavirus pandemic looks set to usher in an era of fiscal and monetary co-ordination more like the economies of the 1930s-1940s.

"If authorities intervene to support asset prices whenever markets wobble, there is little incentive for investors to moderate risk-taking behaviour or for companies to stop loading up on debt.

The result is likely to be unprecedented government borrowing over the next few years, matched by unprecedented central bank bond-buying and, in places, yield-curve control policies to keep short-dated interest rates low.

"The end game is significantly larger government deficits and ever-growing levels of government debt," says Mr Davis. "I believe this will ultimately lead to debt monetisation and a new monetary regime. This may take several decades and until then governments will have an incentive to keep rates low."

For now, QE looks set to be the main monetary lever.

Buying bonds with newly-created money was considered a leap into the unknown when it was first tried after the 2008 crisis, but since the virus outbreak Australia, New Zealand, Canada, South Africa, Columbia, Poland and Indonesia have all jumped on the QE bandwagon.

Just like government bailouts, QE creates winners and losers. Debtors are favoured over savers, the asset-rich over the asset-poor, and powerful economies like the US, Europe and Japan benefit at the expense of smaller and developing economies.

Diversification benefits

Diversification is likely to become even more important for investors as negative real interest rates upend traditional asset allocation strategies and policymaking enters a more unpredictable phase.

Alternative assets look set to move into the mainstream, with increasingly flexible risk-return profiles broadening their appeal. Geographic diversification will also be important as regions with growth potential become increasingly sought after in a low-growth world. China's ascent as an independent financial and economic centre of gravity will be an important diversifying force, providing a counterweight to a hitherto US-dominated world.

"We're excited that China is making a commitment to liberalise some of its markets," says Noorsurainah Tengah, head of absolute

> "With central banks resolved to protect financial markets and little sign that either inflation or interest rates will move higher, there are good reasons to believe we have entered a new investment paradigm.

return and commodities at the Brunei Investment Agency. "It's a once-in-a-generation opportunity to witness the opening up of a market as large as Europe."

The convergence of unprecedented economic conditions and unconventional policy responses is altering market structures, shaking traditional valuation metrics and broadening investment choices. With central banks resolved to protect financial markets and little sign that either inflation or interest rates will move higher, there are good reasons to believe we have entered a new investment paradigm.

"Developed world economies have been on a disinflationary path for nearly four decades," says Mr Davis. "This trend was exacerbated by the 2008 global financial crisis and will continue in the wake of the covid-19 pandemic. Low interest rates are likely to be with us for a very long time."