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# Taking Small Steps Towards Tapering

Following the conclusion of its scheduled meeting earlier this week, the Fed left policy unchanged - as expected. However, we denote a relatively more hawkish tone than what the market originally anticipated.

Board members revised economic projections upward for this year. Median real GDP growth estimate is now 7.0% vs. 6.5% back in March. Median headline PCE inflation estimate have been revised up by 1.0% to 3.4% while core PCE inflation forecast were increased to 3.0%.

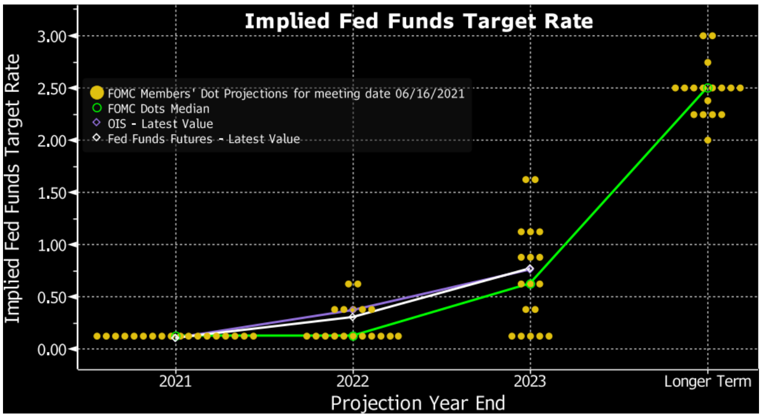
While chairman Powell offered an upbeat outlook on the state of the economy with a show for small steps towards an exit out of an ultra-accommodative policy, the lion share of the hawkishness came from the committee - specifically, the dots **(Chart 1)**. The median expectation is now for two rate hikes in 2023 and only two dots away from pricing a hike as early as next year. In line with these changes, the updated dot plot now shows a median forecast for the fed fund rate at 0.6% by end-2023.

Given the Fed's rate hike timeline hinges on the labour market reaching "maximum employment", the changes in economic forecasts and inflation expectation have little to no bearing on the timing of the first rate hike with the median unemployment rate largely unchanged relative to the committee's March projections. Instead, a brighter economic outlook and inflation risks will primarily impact the tapering timeline. We expect the Fed to provide a roadmap for Tapering at the September 2021 meeting.

The inflation debate is fully on. In the press conference, Powell acknowledged that the effect of supply bottlenecks on prices "have been larger than anticipated" and there is "the possibility that inflation could turn out to be higher and more persistent than we expect". He noted the committee "would be prepared to adjust the stance of monetary policy" in response to stronger inflation. Last but not least, Powell's comments hinted tapering talks have been initiated but underscored changes would be communicated "well in advance".

This Fed meeting truly was a surprise to us, and positive in the sense that it showed a pro-active Fed, fully aware of the situation and ready to act. This should alleviate the market concern inflation will explode higher. In fact, the immediate market reaction was quite telling.

**Chart 1**. US Federal Reserve Dot Plot




*Source. Bloomberg, MAM Research*

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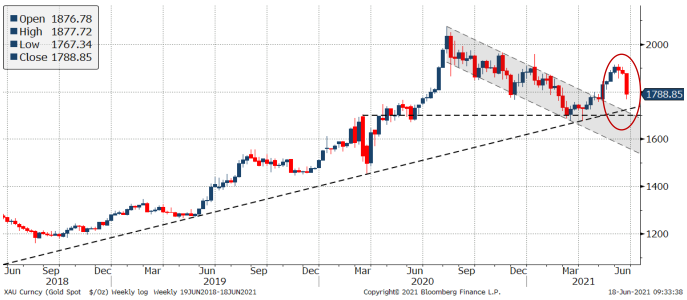
The US Dollar is breaking upward off a double bottom formation base **(Chart 2)**. We are watching for the dollar strength over the next couple of months based on both fundamental trends and technicals. For instance, the EUR-USD struggled to break above 1.22 despite several Euro-positive developments, suggesting long positioning in the union's currency was stretched. Increasing central banks divergence with the ECB holding its dovish tone, PBOC concerned about CNY appreciation, and the Fed edging closer to reducing the pace of its asset purchases all raise prospects of USD strength in the coming months.

**Chart 2**. US Dollar Spot Index (Weekly)


*Source. Bloomberg, MAM Research*

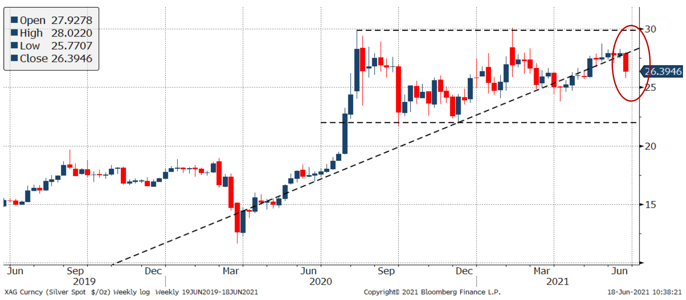
As a function of the rally in the dollar, precious metals such as Gold **(Chart 3)** and Silver **(Chart 4)** sold off. Industrial and energy commodities will find support in a supply constrained environment paired with an economic recovery, but the over extended long positioning means we could be in for a retracement in the short-term. While our recommendation is to take profits on our long positions in commodities, we will look for levels at which to buy back over the coming weeks.

**Chart 3**. Gold Spot Price (Weekly)




*Source. Bloomberg, MAM Research*

**Chart 4**. Silver Spot Price (Weekly)




*Source. Bloomberg, MAM Research*

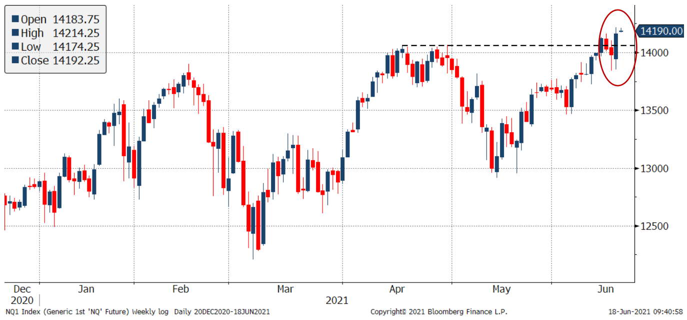
Elsewhere, the US 10-Year Treasury yields remained relatively stable within their 1.50-1.60% range **(Chart 5)**. Treasury yields are running substantially lower than their year-to-date highs driven by the Fed successfully containing market fears of a runaway inflation scenario and excessive short bond positioning. The tug of war between higher policy rates and lower long-term growth is at play. In the short-term, we expect yields to continue moving sideways.

**Chart 5**. US 10-Year Yield (Weekly)

*Source. Bloomberg, MAM Research*

Equity markets - notably the tech sector - reacted rather positively to the announcement **(Chart 6)** with the Nasdaq breaking out to an all time high the following day. Based on experiences from last year, when global growth trajectory is uncertain, "growth" equities has proven to be a safe haven asset for investors. As such, "growth" equities are likely to fare better in the near-term (2-3 months) and we could see the Nasdaq rallying as high as 15,000 (c.+5.6%).

**Chart 6**. Nasdaq Futures Prices Continuous (Daily)

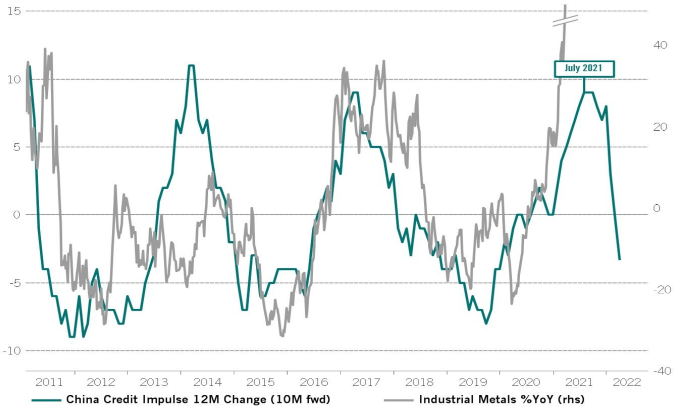



*Source. Bloomberg, MAM Research*

## Bottom Line

Market participants believe inflation - still considered as transitory - will not be preventing the US economy from outperforming the rest of the world in the short-term, putting upward pressures on the dollar. Long-term rates are stable mainly because the rates market has priced an overly positive outlook for inflation and long-term growth prospects are unclear. Furthermore, falling Chinese credit impulse **(Chart 7)** is throwing uncertainty on long-term economic activity and in the mix, all of this combined puts pressures on commodities in the short-term. Taking a step back, the bigger picture has not changed. In a nutshell, we could see a short-term (2-3 months) outperformance of equities relative to commodities and within equities of growth vs. value.

Chart 7. China Credit Impulse vs. Industrial Metals %YoY




*Source. Pictet Asset Management*

<u>Investment Implications</u>

Our core recommendations for portfolios are as follow.

- Add 3% of equity exposure through the purchase of an ETF on the Nasdaq such as the Invesco QQQ ETF.
- Sell all broad commodity exposure with a current view of investing back into the asset class later and lower.
- Sell 50% of the Silver holdings, replaced by the sale of put options on silver - 5% OTM September 2021 Maturity - to take advantage of higher volatility while cutting our beta exposure to the metal. We keep gold exposure constant for the time being.

As always, please feel free to reach out to us should you have any questions regarding this research.

Kind regards,

MAM Investment Team.

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