

MAM Insight No. 17

August 16, 2021

Walking The Line

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We believe the recent spread of the Delta variant, global economic growth, the all-too-familiar cacophony from the Fed, and the Chinese regulatory crackdowns contributed to global uncertainties since May. As a result, the rally in the dollar, fall in rates, and outperformance of growth equities have severely questioned our inflation thesis, which has been core to our portfolio allocation process. This period of macro uncertainty has created headwinds in terms of portfolio performance. Yet, we believe this is transitory. Q4 2021 will be an important period during which we believe the market will focus again on our inflation thesis.

We have not been passive through these challenging times. Over the past couple months, we attempted to mitigate what we believe was temporary headwinds to our non-transitory inflation thesis by increasing the dollar and growth equity exposure (e.g., Nasdaq) in portfolios. While this position helped, it could not offset the deflationary market environment of the last few months.

We have been warning of a bull market correction in risk assets since mid-July, yet popular indices kept surging. What are we missing? Arguably, the corrective phase has been underway for some time. The difference is the correction in the broad market that has been disguised by a continued rise of indices, led by mega-cap growth stocks and supported by falling long-rates.

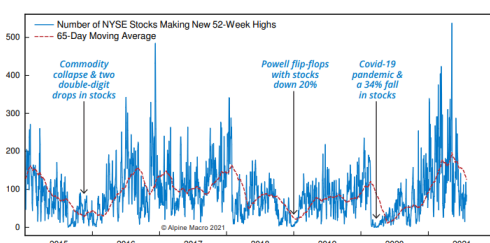
As indices continue to edge higher, we find a very different picture underneath the surface. Most stocks are trading below their 52-week highs, with many significantly so (**Chart 1**). The contrast is even more striking when comparing the S&P 500 to its equally weighted basket (**Chart 2**). Meanwhile, the Russell 2000 is down 4.7% from its March highs. Materials fell more than 10% a couple of weeks ago, before bouncing back.

Divergence is what defined financial markets last year, but the aggressive policy reflation narrowed the dispersion thanks to a powerful rally in cyclical assets and commodities. As the work economy resettled back to its steady state after the initial recovery surge, market divergence re-asserted itself in the past couple of months. The Fed turned somewhat dovish in July, the transitory inflation narrative took over, and long-term yields continued to decline.

FAANGM profit growth has been strong so far and market sentiment towards these names is giddy, even euphoric. As the long end of the yield curve remains anchored, the dispersion will continue to dominate market action. We think this will not last much longer. Two factors are likely to drive their decline: (1) higher regulatory pressures and (2) higher yields.

Fears of inflation often make themselves felt at the strangest times, but inflation is a cumulative process. Today, portfolios are structured to navigate an inflationary environment.

Chart 1. Number of Stocks sub-52W Highs



Source. Bloomberg, Alpine Macro

Chart 2. Hidden Correction



Source. Bloomberg, MAM Research

Inflationary Pressures To Persist

The Consumer Price Index (CPI) for July showed more cooling off with core CPI up a more moderate 0.3% MoM (4.2% YoY) following a string of elevated increases since April. The lower pace resulted in slower rates of increases for the more obvious transitory factors (e.g., used car). However, new car prices remained firm, up 1.7% after a 2.0% increase in June. In the meantime, an acceleration in the labour market recovery and permanent unemployment decline should put upward pressures on the shelter component, which accounts for a third of the basket.

The pandemic left a lasting imprint on labour. Both the supply and demand contracted by historic magnitude last year as businesses closed and workers stayed home. While the labour market begun to heal, unemployment benefits measures are still in place. As a result, the current slack in labour supply is forcing companies to bid up wages to fill the positions. Not only is this contributing to higher labour input costs for companies, but it gives workers bargaining power. This is an important factor considering many central bankers seem to prefer to discuss the Philips Curve and the NAIRU. These frameworks argue that inflation tends to emerge from the labour market. The idea is simple. As an economy grows faster and faster, it leads into a shrinking pool of unemployed workers. As the demand for labour increases and the supply for labour decreases, the price of labour goes up. Wages rise followed by prices. A very tight labour market can give rise to ever-spiralling wages and prices accompanied by persistent high inflation. However, to raise wages, workers need to have bargaining power against their employer. Today, extended unemployment benefits, large social safety nets, as well as pandemic fears are reasons to stay out of the labour force. We believe the power is coming back in the hands of labour and a few anecdotal stories are already hinting at it.

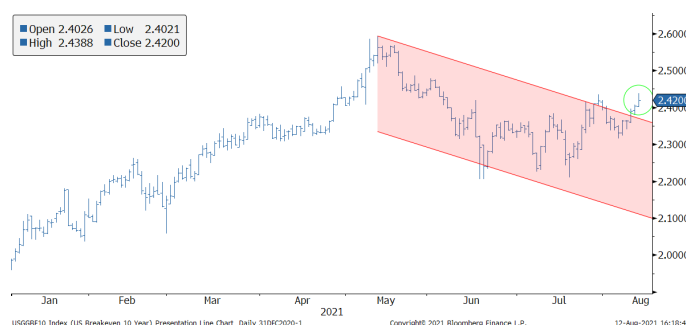
In response to the spread of the Delta variant, China closed some of its ports, including the partial close of the world's third busiest port. The Baltic Dry Index is at its highest in more than a decade. This shipping bellwether illustrates the high demand, consistent with our inflationary thesis.

Fiscal policies and infrastructure plans on both sides of the Atlantic are unlikely to abate demand pressures. Additionally, the transition towards a greener economy will require substantial spending on renewable energy, transportation, and more. All of this comes in after years of capex under investments, meaning the pressures and tightness on the supply side is strong and unlikely to come down any time soon, further supporting our inflationary thesis.

The US Services PMI beats expectations in July with the services prices-paid subindex rising to its highest level since 2005. The Producer Price Index (PPI) stayed hot with both headline and core PPI rising 1.0% MoM from 0.5% in June while "core core" PPI (excl. trade services) accelerated to 0.9% MoM from 0.5%. From food manufacturing to autos and passing by chemicals, all companies are saying input costs are rising faster than they can raise prices. The supply chain disruptions are affecting everyone. As such, all can pass along the costs without concern a competitor will undercut them. In many instances, the ability to even secure supply is important. If you have the supply, you can charge more than peers who do not have it.

Global investors have been talking about transitory inflation and are all in on it. Central banks and politicians are in constant sales mode. *"Have no fear, we can recklessly spend because inflation is not a threat. Don't be silly, inflation expectations are well anchored. There is no end to our free lunch. Let them eat cake."* Investors assuming the 2021-2030 economic cycle will reward the same investment playbook as the one from the last decade are in for a rude awakening. Oddly enough, the rates market and specifically US 10-Year breakeven rates are already reacting to the PPI print and breaking out of their recent downtrend (**Chart 3**), aligning with our view inflation is indeed not transitory. Currently, the implied inflation expectations in the 10-Year TIPS market is 2.4%, hence not painting a transitory inflation picture either.

Chart 3. US 10-Year Breakeven Rates



Source: Bloomberg, MAM Research

China Regulatory Reset

We stand at a significant crossroad in China's economic and capital market's history. After a decade-long journey to eliminate absolute poverty, Beijing is shifting governance priorities from growth to balancing growth and sustainability: social equality, data security, and self-sufficiency. China's new regulations on fintech, big tech, after-school tutoring, cryptocurrency, and carbon emissions underpin this major regulatory reset.

Under the new governance paradigm, China appears to be attempting to check the rise in corporate power and rebalance the share of the economy in favour of labour, which could result in a decline in corporate profit share. We see regulatory headwinds for sectors associated with rising tensions of social inequality, environmental sustainability, and data security risks, while the new framework provides policy support to advanced manufacturing, tech localization, and renewable energy. Data-heavy tech and platform companies and property could remain under pressure amid the regulatory reset, while semi-localization, cybersecurity, domestic brands catering to the mass market, innovative drugs, biotech, and green economy may enjoy support. We expect a longer and more profound impact from the current regulatory cycle on China's equity market valuations and Equity Risk Premium than has occurred in similar past cycles, as it is affecting a more substantial proportion of the market.

However, the regulatory crackdowns are not the headlines mentioning China today. There has been growing calls within academic circles and think tanks in the country for interest rate cuts as fresh Covid outbreaks dent the economic outlook. They argue that because Beijing tightened the regulatory screws elsewhere and reined in excessive debt growth, it can now cut rates without worsening long-term financial stability. Unlike traditional counter-cyclical adjustments where policy makers apply the brakes when things are running too hot and the accelerator when the economy needs a little juice, the new policy suggests a more nuanced approach where both the accelerator and brakes can be applied together. If July's weaker credit growth is replicated in the coming months, we expect academics to call for interest-rate reductions. In fine, this would stimulate economic growth in the country, but most importantly contribute to the supply-demand imbalances and exert further inflationary pressures.

A Fed In The Driving Seat

At its July meeting, the FOMC deepened its discussion on how to proceed towards tapering. New language in the statement gave a framework for the committee to express a consensus view on the progress incoming data has shown toward its goals of price stability and maximum employment. The way it is framed indicates the Fed moved closer to start tapering.

The economy is on track to reach major benchmarks of the recovery earlier than expected. Total employment shortfalls in 2020 relative to pre-pandemic levels will be cut by more than half by year-end, meeting the Fed's definition of "substantial further progress".

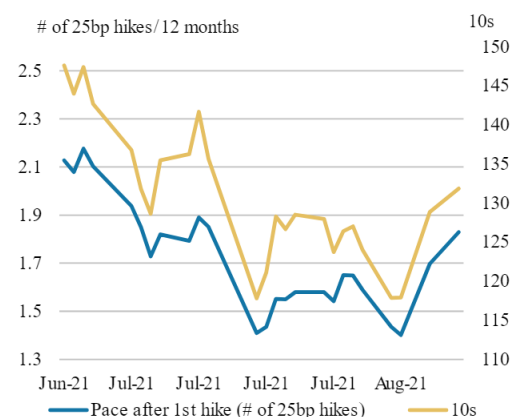
The first key date to watch is August 18 for the release of the minutes from the July FOMC meeting, which should detail a constructive conversation about the tapering process and detail how close policymakers are to making key decisions around the likely mechanics of the taper. Shortly after, Chair Powell will look to speak in the morning of Jackson Hall where we look for the speech to give some indication that tapering discussions are progressing. This will be followed a few weeks later by the September FOMC meeting at the conclusion of which we see the FOMC indicating a decision to taper its pace of asset purchases may be appropriate in "coming meetings". Given the delta variant risk and the change of chair overhang, we expect the Fed to be more reactive than proactive in its tapering approach, keeping real rates negative and anchored.

Market Calls

US Rates

We believe the inflationary and tapering debates are likely to impact the rates market through a second-order effect where a formal kick-start to tapering can serve as a powerful form of forward guidance about the rate-hike cycle that lies ahead. 10-Year yields were strongly correlated to the pace of hikes (**Chart 4**), a faster pace will be consistent with higher rates. We see 10-Year yields rising to 1.6-1.8% by year-end on the back of higher inflation expectation, but a more reactive than proactive Fed response should prevent swift moves to 2.0%.

Chart 4. US 10-Year vs. Market Implied Pace of Hikes



Source. MS Research

Corporate Credit

We think the inflation and Fed taper scenario outlined earlier does not have a direct impact on the corporate bond market. However, we remain wary of indirect market implications through Treasury yield moves and the risk appetite channel. Extended valuations, flat curves, and elevated durations all point to a repricing of credit risk premiums. On the balance, our current assumptions informs our preference for floating rate high yield strategies over investment grade credit.

US Dollar

On the FX side, at face value, the US Dollar impact of different tapering scenarios appear straightforward. Earlier and faster tapering is hawkish and therefore positive for the greenback. Slower and later tapering is dovish and thus dollar negative. Arguably, our above framework could be a bit more nuanced. The performance of real yields and breakeven rates is a good additional layer. Rising real yields and unchanged breakeven rates would support a dollar appreciation against low yielding currencies (e.g., JPY, CHF, and to lesser extent EUR). Gains should equate to +20-50bps per month versus low-yielders. So what will drive the dollar lower in the cycle? The most likely candidate for a weaker greenback is robust growth from outside the US. However, global growth expectations are re-rating lower on the back of renewed pandemic concerns. An earlier-than-expected Fed taper, coupled with robust global growth and foreign central banks outpacing Fed hawkishness would drive dollar weakness, not strength. We look for a shift to a more bearish dollar outlook as vaccinations pick-up globally and pandemic-driven (renewed) social restrictions outside of the US fade out.

Equities

To define the impact on equities, we essentially take our cues from our rates outlook. Faster or slower tapering will affect the long-end of the yield curve, the channel through which tapering will influence equities. The declining risk-reward in equities has driven us more cautious for the year-end with a tapering overhang. As a result, we have reduced exposure to the asset class to 35%, but through a put spread so we keep upside exposure should the market continue to climb.

Commodities

A lack of capex investments over the past decade at a time of surging demand, supply-chain imbalances, modestly stronger dollar outlook, and other fundamental factors will continue to support an appreciation in non-precious commodity prices.

Historically, precious metals and notably gold were negatively correlated with real rates. However, in recent months there has been a disconnect between real rates and gold prices. In our view, gold is primed to surge to fresh highs as the risks around central banks unwinding massive stimulus are under appreciated by investors. Gold is disconnected from some of the moves in Treasuries and real yields, but could get a boost from a risk-off event such as an equity market corrections. We think part of the reason gold has not yet been bid up is due to the strength in equities. In 2011, when real yields were at these levels, equities were falling so money managers rushed for an inflation hedge and gold kept surging. This same dynamic occurred when real yields plunged in 1973-74.

However, with stocks at all-time highs, money managers do not yet see the 'need' for an inflation hedge. If equities begin to fall, it should bring a wave of capital back into precious metals. Stocks are now very rich relative to gold with a decade-long view. The S&P 500 to gold ratio is back to levels not seen since the peaks in both 2007 and late 2018 (**Chart 5**).

Chart 5. Equity (S&P 500) to Gold Ratio



Source. Bloomberg, MAM Research

Investment Implications

As we enter the final stage of the year, we look to close the long Nasdaq positions that were tactically opened a couple of months ago and add back to commodities at a slightly lower level. We believe the risk reward in growth equity shed meaningfully over the past couple of weeks and the need to reduce risk is growing. The market is progressively concluding that a Fed tapering announcement will occur in December and could therefore be announced or pre-communicated upon at the September meeting. The event next month is of capital importance and will dictate whether we need to reassess our current strategy.

Supply chain disruptions, labour market tightness, higher input costs pressuring margins, and the potential for accommodative policies in China all contribute to our persistently high inflation outlook. The Fed is walking a tight line, but cannot be seen as too hawkish just yet. Ultimately, a higher growth, rising inflation expectations, and rising long rates could restart an outperformance cycle for value equities and commodities.

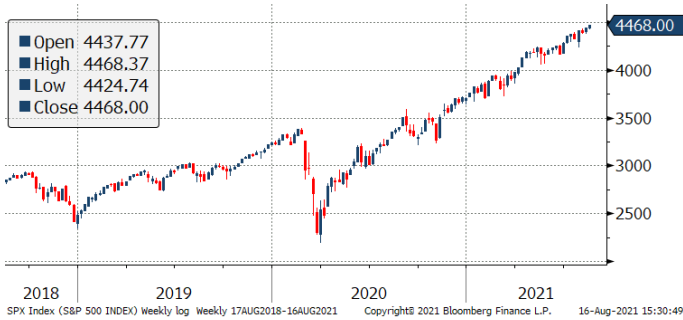
As always, please feel free to reach out to us if you have any questions regarding this research.

Kind Regards,

MAM Investment Team

Appendix - Market Chartbook

Chart 6. S&P 500 Index (Weekly)



Source. Bloomberg, MAM Research

Chart 10. Gold Spot (Weekly)



Source. Bloomberg, MAM Research

Chart 7. US 10-Year Yields (Weekly)



Source. Bloomberg, MAM Research

Chart 8. USD Index (Weekly)



Source. Bloomberg, MAM Research

Chart 9. Bloomberg Commodities Index (Weekly)



Source. Bloomberg, MAM Research

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