On the Mark – Multi Asset Strategy

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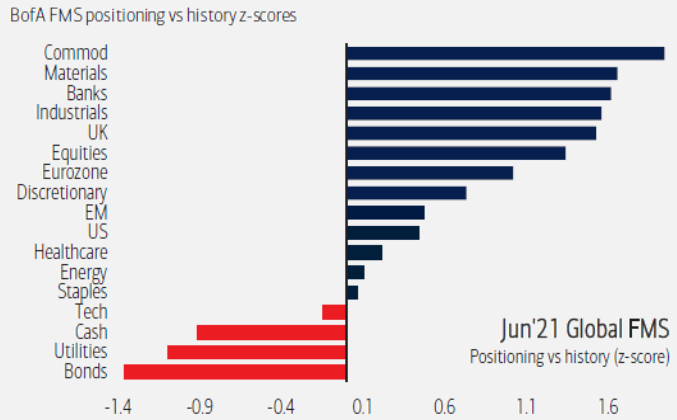
June 2021 – All Along the Watch Tower.

Inflation concerns continue to remain front and centre of a lot of discussions we have, with many arguing for sustained levels of higher inflation. Just as Jon Snow and Samwell Tarly watch closely over the wall, the market & the Fed are eagerly watching for confirmation that inflation is indeed transitory not sustained.

It is evident from several surveys that many investors have been positioned for such an outcome with large overweight position to commodities and large underweight position to bonds as per the Bank of America Securities Global Fund Manager Survey (BofA Global FMS - Figure 1). Equally a large short position had been built in 10-year US Treasury Bond futures. Despite this seemingly strong positioning, the majority (72%) of those polled in this survey thought it would be transitory.

Figure 1: B of A Securities Global Fund Manager Survey.



Source: Garraway, BofA Securities.

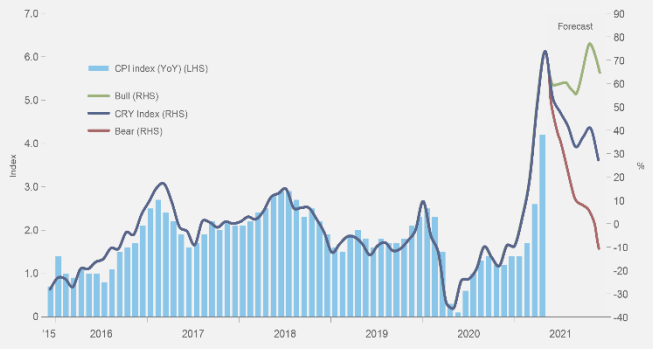
Indeed, pricing of the 5-year breakeven and the 5-year/5-year forward inflation expectations implied a sharp increase in inflation in the next few years, which would then be brought under control. For months, the Fed has been talking about its new inflation targeting regime and its more lenient attitude to letting inflation run above target for a while. Hence, it is interesting to look at the latest FOMC statement and the subsequent market reactions.

As expected by most commentators, the FOMC made no changes to the Fed Funds rate or asset purchases. However, the median growth projection for 2021 increased to 7% from 6.5% in March. Core PCE inflation was also revised up to 3% from 2.2% in March. Several Fed members upwardly revised their projections for the Fed Funds rate and the median projection now shows the Fed Funds rate at 0.6% in 2023 when the March median was for no rate increase in 2023. Put simply, rate rises were brought forward.

Whilst Jerome Powell said market participants should take the dot plot with a 'big grain of salt' it appears to us that the Fed blinked at almost exactly the wrong time. We say this for several fundamental reasons. We recently listened to several very interesting presentations from fund managers at Ashmore. They were full of interesting content, but there was one chart that really resonated. In Figure 2. we can see their scenario analysis for US inflation using the CRY Index (YOY) as an indicator for the future path of US CPI (YOY).

The CRY index is an arithmetic average of commodity futures prices with monthly rebalancing. The diverse index comprises 19 commodities including: aluminum, cocoa, coffee, copper, corn, cotton, crude oil, gold, heating oil, lean hogs, live cattle, natural gas, nickel, orange juice, silver, soybeans, sugar, unleaded gas, and wheat.

Figure 2: Ashmore US Inflation Scenario Analysis.



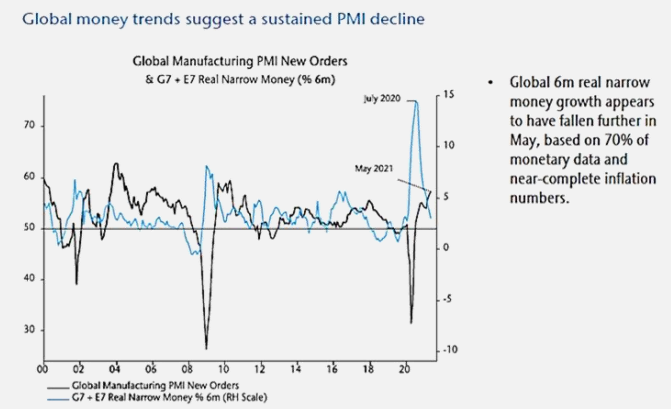
Source: Garraway, Ashmore, Bloomberg L.P.

As you can see the central scenario would peak around now as the year-on-year base effects from the pandemic roll out and start to fall back to levels just above pre-pandemic levels. In the case of their more bearish scenario, we would see US levels of inflation not much above 1% by year end. Interestingly in recent weeks several commodities have suffered marked price corrections from peak levels, with lumber (which is not in the CRY index) down some -48%, copper down

approximately -16% and corn and soybeans down circa -13%. All of this will feed into the CRY index and endorse the central to bearish forecasts. Obviously if the oil price were to correct more significantly then the bearish forecast would come into sharp focus. The peak in inflation concerns could soon come to pass.

Additionally, we have on numerous occasions pointed out Simon Ward's comments that that it would now be realistic to expect that the upthrust will give way and the global industrial momentum, as measured by the manufacturing PMI new orders index, is at or close to a peak, with a multi-month decline in prospect.' Figure 3 http://moneymovesmarkets.com/

Figure 3: Global PMI & Money Supply.



Source: Garraway, Simon Ward.

From the 11th to the 18th of June '21, the 10-year US Treasury (UST) yield tightened 1bps to 1.44% and the 30-year UST yield tightened 12bps to 2.02%. The UST yield curve flattened with the 5s30s spread tightening 27bps to 113bps. However, this yield move started in March prior to the Fed's comments, and this suggests that a constituent of investors have sniffed out that inflation may not be quite the threat some may be indicating, and that the pace of growth may be slowing. Whilst the Fed may 'row back' from some of its recent comments to assuage market fears we suspect that the trend for lower yields is in place.

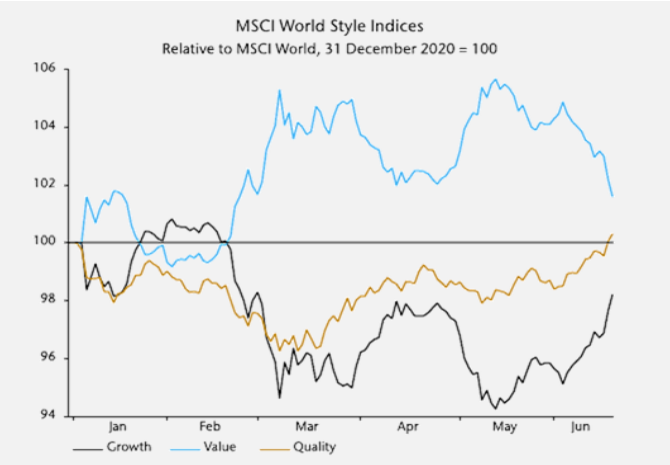
It is our view that the Fed have effectively signaled a change of attitude, just as the need for a more hawkish tone will fade. Indeed, it appears that the US Treasury market seems to have woken up to the idea that a Fed error is a very real possibility. Ray Dalio says he does not believe the Federal Reserve can tighten policy 'without a big negative effect' on markets. 'You saw the reaction in the markets when the Fed just even hinted at tightening.'

The observation we made in last month's missive from Bank of America: 'When we reach the levels of optimism, we have just seen what happens next is a big drop in rates'. Since 1994 every time we hit the 5 peaks in 'FMS optimism' it has been followed by 75bps drop in 10Y Treasury yield next 2 quarters... appears increasingly prescient.

On a linked note, John Authers of Bloomberg, amongst others, points out that 'if we look at the growth of money supply and the federal deficit in annual terms, we find that both are falling sharply. The change in the second derivative has already arrived, in a big way.' Authers also notes that 'Crossborder Capital Ltd. of London keeps indexes of central bank liquidity growth globally. This shows a global deceleration, which is most marked in the U.S., and which uncoincidentally peaked roughly when bond yields topped out in early April.'

Additionally, we can see in Figure 4 that value style equities, and especially those that are more cyclically orientated, have narrowed their outperformance relative to growth style equities from a peak of circa 12% to just below 3.5%. This move started before the FOMC minutes release and is yet another piece in the puzzle of how longer-term things will resolve themselves.

Figure 4: MSCI World Style Indices.



We continue to feel that inflationary pressures can be contained in the medium term and that many commentators are overlooking the still present factors that contributed to the disinflationary environment that persisted from the Great Financial Crisis in 2008. In this environment we expect a resumption of rewards to growth style equities and are positioned accordingly.

The Multi Asset Team.

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