On the Mark – Multi Asset Strategy

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May 2021 – Listen up

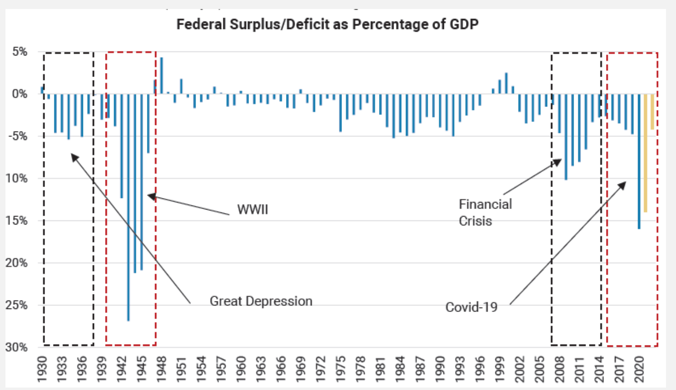
Given the shutdown and reopening of around the world, we have witnessed huge volatility within markets and economic data. This has meant that we are now in a particularly fascinating time for economics and asset markets.

Consequently, we can make a few observations:

- We should all appreciate that this cycle is unlike anything we have witnessed.
- Many unique features of this cycle mean that drawing too many parallels from previous cycles might be misleading.
- We should be acutely aware that the room for forecast error is large.

The first unusual feature of this cycle, and of clear importance, is the size and scale of stimulus. Fiscal and monetary stimulus amounts announced thus far total some US$12trn, circa. 26% of GDP. We can see from the chart below (Figure 1) that the only parallel that can be drawn to the fiscal deficit that will accumulate is the period directly after World War II.

Figure 1: US Fiscal Deficit and Short-term Treasury Yield.

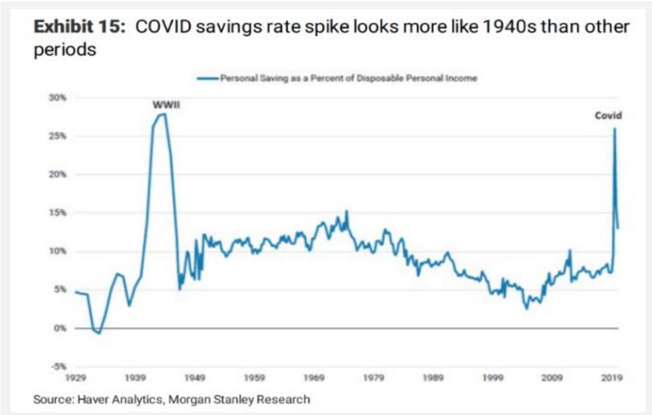


Source: Garraway, Morgan Stanley Research.

As Morgan Stanley point out – the speed and strength of the economic rebound since March 2020 is unprecedented. 'Our economists see real GDP returning to its pre-COVID growth path in 3Q21. By comparison, post the Global Financial Crisis, real GDP never returned to its pre-recession path despite a less severe contraction.'

Amongst other features we have never witnessed before is a falling US unemployment rate during a recession. If that were not enough, it fell at a record pace, with employment recovering almost 80% of the lost jobs in under a year, something that would normally take several years. Equally, US fiscal support has seen personal savings grow in this cycle to an extent only seen once before, around the Second World War (Figure 2). This looks like a mirror image of the government fiscal deficit. Evidently individuals are saving a sizeable part of the benefits/transfer payments they have received.

Figure 2: US Personal Savings Rate.



Source: Garraway, Morgan Stanley Research.

As a result, most market observers are agreed on one thing and that is the threat of inflation. The consensus is convinced that the selloff in US Treasuries and rise of inflation expectations in the last weeks of February and early March was just the start to a new regime. The recent Bank of America Global Fund Manager Survey shows that expectations of higher growth and inflation are at record levels, the highest since the survey began in 1994. Investors are heavily positioned in reflation areas, such as commodities, materials, banks, and industrials.

Chris Woods at Jeffries has gone so far to say that 'For now Greed & Fear's conviction remains that the financial markets are heading for the biggest inflation scare since the early 1980s.' In comparison, Martin Wolf at the FT offered a more balanced view in a recent article but concluded that 'both monetary and fiscal policy settings are, by historical standards, wildly expansionary, with near-zero interest rates, exceptional monetary growth and huge fiscal deficits'.

Against this, as we have previously stated, some commentators such as Simon Ward believe 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.' This pullback would be led by a Chinese growth deceleration http://moneymovesmarkets.com/.

A footnote to this is that China policy is likely to turn to a more neutral or even to an easing bias around the 1st of July when the Communist Party celebrates its 100th anniversary. We are hopeful that this may lead to Chinese/Emerging markets to regain their leadership over developed markets.

We observe that yet another unusual feature of this cycle is that spending on durables rose during the recession for only the second time since 1960. We note that US durable's consumption is now at a 60-year high, in terms of year-on-year percentage change. This is probably due to the benefits received, given that organic real incomes have declined. However, this likely means that a large element of consumption has been brought forward. Admittedly, demand for services will massively increase on opening of economies, but, given its size, it is unlikely to be the driver of the large increases in GDP growth from here, that many predict.

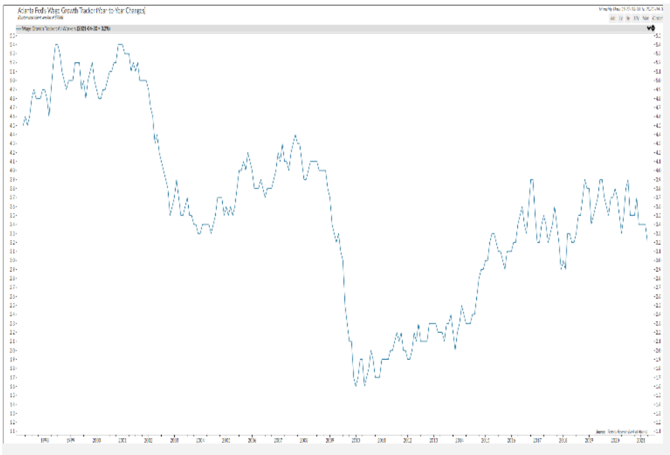
We recognise that numerous forces are in play; including the pace of recovery, supply side constraints and pent-up demand, that all contribute to fears of much higher inflationary outcomes. However, we feel that these can be contained and that many commentators overlook many of the factors that contributed to the disinflationary environment that persisted from the 2008 Great Financial Crisis. Amongst others Ned Davis Research point to technology, innovation, globalization, competition, and debt and argue that inflationary expectations remain anchored. They state 'Despite scattered reports of labor shortages in some industries over the past several months, wage growth remains subdued. Measures that are less distorted by the pandemic, such as the Employment Cost Index and the Atlanta Fed's Wage Growth Tracker, show that compensation growth has not moved much.' (Figure 3).

However, we maintain a watchful eye on a couple of threats to this more benign economic outlook. One in particular has caught our attention in that it appears to be targetted by the US administration and could permanently change the investment regime. Recent speeches by Jerome Powell (Chair of the US Federal Reserve) and Janet Yellen (US Treasury Secretary) and are illuminating in this regard.

Powell stated 'We view maximum employment as a broad and inclusive goal.' He continued, repeating the new priority the central bank has given to '***encouraging more job growth at the risk of higher inflation'.***

Janet Yellen recently stated that 'The administration's planned actions are not fiscal stimulus in the way we have seen in the past…' '…Workers, particularly lower-wage earners, have seen wage growth stagnate over several decades, despite overall rising productivity and national income.' 'We're proposing smart investments – to make our economy more competitive and sustainable, to provide opportunities for all families and workers, and to make our tax system fairer.'

Figure 3: Atlanta Fed Wage Growth Tracker.



Source: Garraway, Ned Davis Research.

At several levels this offers up positive interpretation, but it is also evident that policy is directed at enhancing the wage-earning capability of workers. This is a laudable ambition, but it must be carefully implemented and hopefully met with productivity gains. If not, it could have the unintended consequence of providing the fodder for an acceleration in worker compensation which in turn could lead to sustained wage pressure and unanchored inflation expectations. This may seem a leap, but it is worth monitoring closely.

We understand the threats posed by substantial and sustained inflation, but we feel we should also point out that modest inflation can be a good thing. The threat of deflation has been hanging over us for a long time, modest inflation would see this removed. We would see higher nominal growth and potentially corporate earnings. Whilst margins could come under some pressure, this in turn should encourage investment. As we can see from the chart below courtesy of Absolute Strategy Research (Figure 4), capex has been on a declining path for a long time and subsequently productivity has been sadly lacking in the last decade.

So its not all bad news and we expect that transitory inflation is just that, albeit we see a medium term trajectory closer to 2-2.5% core PCE rather than the sub 2% we have witnessed.

Figure 4: Companies have stopped investing.

Source: Absolute Strategy Research.

The push and pull of this argument will play out over the next three to six months, and the lack of resolution may mean more bouts of volatility. Investors should focus on the longer term. Should we be correct in our assertion that inflationary concerns abate in the next quarter, this will be very positive for growth style equities and government bonds. We are positioned accordingly.

But if you are at all skeptical of the inflation and growth outlook, we will leave you with this 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... although according to Hartnett it is less likely in '21 as Fed policy stance so uber-easy that FMS investors see inflation (35%) and taper tantrum (27%) as biggest 2 'tail risks'.

The Multi Asset Team.

Important Information