On the Mark – Multi Asset Strategy

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November 2021 – Slip Slidin' Away.

'Slip slidin' away,
You know the nearer your destination,
The more you're slip slidin' away.' – *Paul Simon: Slip Slidin' Away.*

Nearly every day I am now bombarded with emails on inflation and whether it will be persistent or transitory. Obviously, this is an issue uppermost in most investors' minds as they consider the outlook for different assets through 2022.

Amongst others, the Bank of America (BofA) have produced research on this issue together with some good graphical representations for US inflation. Currently their Persistent Inflation Meter (PIM) has surged up to 96 in September from 80 previously. The "historically elevated cyclical price pressures have been majorly driven by the increase in rents. The Transitory Inflation Meter (TIM) remains at 100 for the sixth straight month. This is of evident concern."

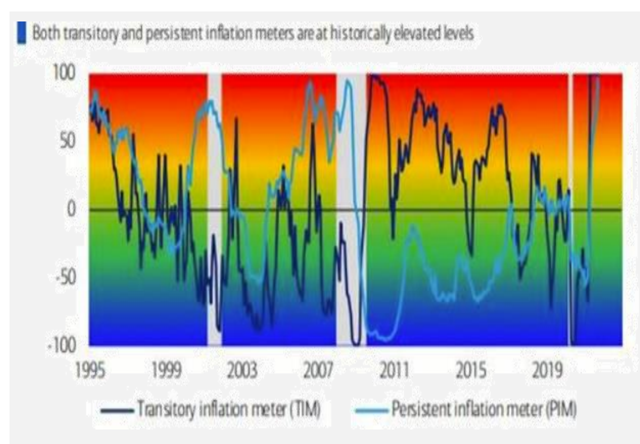
Work from other commentators on the topic of persistent vs transitory inflation measures (such as Auther's at Bloomberg) also point to elevated concern. Auther's points out that "the 5-year breakeven briefly topped 3% for the first time in its two-decade history. That implies investors think inflation will average more than the upper limit of the Federal Reserve's target for the next five years." However, he notes that despite the recent alarm in the markets, his inflation indicators remain finely balanced.

Whilst the debate will no doubt rage on, the following graphic from BofA (Figure 1) fascinated me. Although difficult to see the fine detail, the key takeaway is that never in the history of the data (which unfortunately only goes back to 1995) have both transitory and persistent inflation readings been at an all-time high at the same time.

We have mentioned on several occasions that this cycle (if it is indeed a cycle) has a number of characteristics that are quite distinct from normal cycles. In our opinion, this is yet another example of such a distinction and as my colleague Fred Coldham (Head of Fixed Income) always reminds me, be very careful in the way you interpret the data this time around.

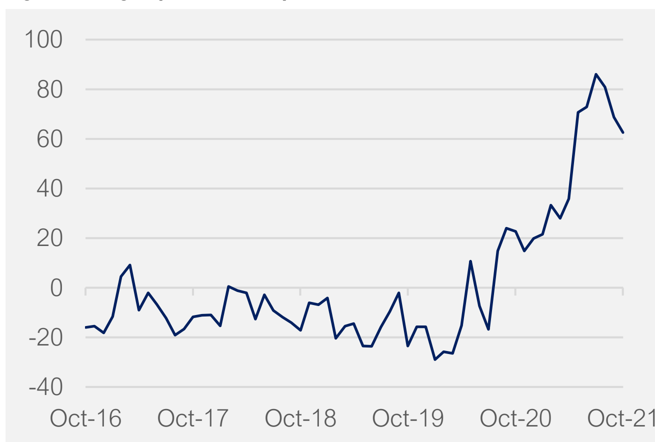
We appreciate that this is a very noisy environment for data as we recover from the Covid-19 shocks. However, we do take some short-term comfort in the fact that inflation surprises appear to have peaked and are moving downwards in the US (Figure 2).

Figure 1: BofA Global Research US TIM & PIM Measures. (+100 = Historically High Inflation, -100 = Historically Low Inflation).



Source: Garraway, BofA Global Research.

Figure 2: Citigroup Inflation Surprise Index – US.

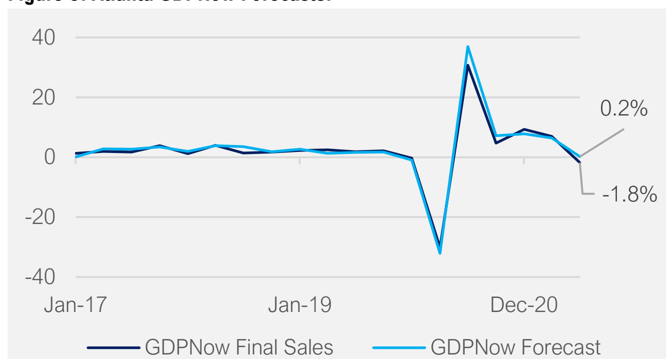


Source: Garraway, Bloomberg L.P.

Let's now turn our attention to the growth side of the US economy. On several occasions through this summer, we have pointed out the potential for a marked slowdown in economic growth. The evidence is now convincingly on our side in this respect.

On our last internal call between all the fund managers, Andy Seaman (Stratton Street) brought the following chart to our attention (Figure 3). This chart indicates that the US slowdown is extremely aggressive, especially when viewed without sales from inventory rebuilds.

Figure 3. Atlanta GDPNow Forecasts.



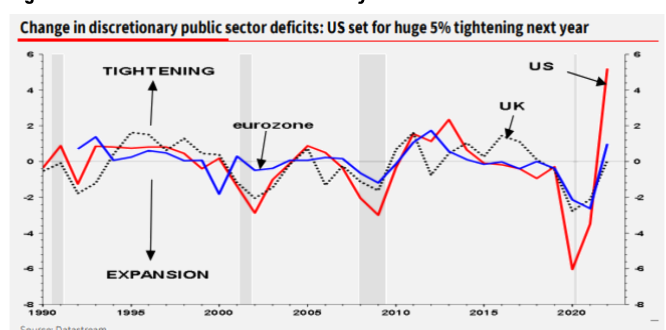
Source: Garraway, Atlanta/St. Louis Fed.

However, just before this missive was finished, US GDP numbers for Q3 came in at 2% vs expectations of 2.8%. Our worries on this front remain, albeit we can see that the worst outcome has been avoided. The pullback in Q3 real GDP growth was more than accounted for by weaker consumer spending growth. Personal consumption expenditures contributed a mere 1.09 percentage points to real GDP growth, down from 7.92 points in the previous quarter. Spending on durable goods sank at a 26.2% annual rate, the most since Q4 2008.

The outlook for spending growth remains positive, supported by continued employment and wage income growth, accumulated savings, as well as a strong household balance sheet position. However, some doubt is cast on this given the fall in real disposable incomes since the removal of transfer payments from the government stimulus packages.

Société Générale's (SG) Albert Edwards (Figure 4) goes much further, suggesting that "it is odd amid the current surge in energy prices that no-one seems to think this will all end in global recession. The US is particularly vulnerable with the OECD estimating a huge 5% fiscal tightening next year – in reality it is likely to be more around 2½% of GDP (i.e., still a lot)."

Figure 4. OECD Estimates of Fiscal Policy.



Source: Garraway, Atlanta/St. Louis Fed.

We can see in the chart from the Bank of America Global Fund Manager Survey (GFMS) for October (Figure 5) that fund managers have now recognised this threat and their expectations have fallen into negative territory. Bank of America's Michael Hartnett states that "GFMS Global GDP & EPS readings show macro momentum weakest since COVID shock of spring '20." By way of further concerns, a net 51% of respondents think margins will decrease which is down a massive 29% in the past month. So, whilst some of the evidence is of obvious concern and there are several puzzling features to the economic environment, here's some good news that we take from this difficult environment.

Figure 5. BofA GFMS Economic Expectations.

Source: Garraway, BofA GFMS.

Whilst inflation is higher than feels comfortable given its quiescence for over a decade, some respite in terms of negative surprises looks likely. Equally a marked slowdown in consumer spending could further reduce inflationary pressure, albeit the easing of supply chain disruption remains central to a good outcome. However, as we have shown, there's evidence to demonstrate that a lot has been priced.

Additionally, investors appear to have priced a dramatic worsening in the outlook for profit margins. In our opinion this concern is misplaced given strong growth dynamics, ability to pass on prices and the dominance of technology – which for the main part is less affected in the same way from rising input costs (the marginal cost of production of additional services being essentially zero). Thus, we believe that we will continue to see excellent earnings delivery and good margins from the secular winners.

Don't take our word for it, just look at the opening US earnings reports in Q3. Bloomberg report that "the S&P 500 has advanced 5% since JPMorgan Chase & Co. kicked off the earnings season nine days ago, in the best start to a reporting cycle since the dot-com mayhem 88 quarters ago." Robert Armstrong of the Financial Times offers a tentative summary of the results he examined as follows: "The consumer appears strong (but maybe not getting stronger); wages may be rising faster than the headline official data suggests; at many companies, there

is pricing power to offset rising costs; supply chain problems will be with us all the way through 2022; and - Business demand for technology and tech services is absolutely booming right now."

Whilst there are obvious threats and reasons to be bearish, we believe investors should keep with their equity weightings and look to the long-term winners. In this respect, this from Polar Capital technology team: "There is little doubt the pandemic has proven the centrality of technology, reflected in the deepening and broadening of technology disruption. The digital transformation imperative looks likely to sustain into 2022, with a recent Morgan Stanley survey revealing it (together with the cloud and security) remains at the top of CIO priorities."

The Multi Asset Team.

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