

# THE BIG PICTURE OF GLOBAL ECONOMICS



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April 5, 2021

## Bonds Hold their Breath

- More good news in the US economy - job gains a blow out in March
- Growth surge risks more inflation risk; supply lines under pressure
- Biden keeps adding to his spending plans - bond markets are worried
- Developed market equities had a good quarter, but Emerging markets struggled
- Fixed income markets had a very poor quarter burdened by higher yields in the US
- EM FI especially volatile as Covid response disappoints and local policy confuses

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The final week of the first quarter brought further confirmation that we are in for a US growth surge. There was upbeat news in the employment report and the ISM report of manufacturing sector confidence. To add to the growth positive mix, details of President Biden's \$2.25 trillion infrastructure spending package are starting to circulate.

**US economic data suggests growth uptick will look more like a surge:** Echoing the strong industrial confidence numbers seen earlier in the month in Europe, the US manufacturing index March data was strong. The survey spiked from an index level of 60.8 to 64.7, the highest since the '80s. Several sub-components recorded very high readings, including the prices paid component, which remained above 85 for the second consecutive month.

To add to the signs of economic strength the US payrolls rose a whopping 916,000 in March against expectations of 660,000. The February number was revised to 468,000 from 379,000.

**We see renewed upward pressure on US long term bond yields.** As Friday was a holiday in the US, the market will react to the payrolls number on Monday, having had the Easter weekend to digest the implications of the strong data. The market remains concerned that there are significant pipeline inflation pressures. Although the ISM survey's prices paid component has a less than perfect record of predicting inflation, it remains very high by historical standards. Also there are signs that global industry is not prepared with sufficient inventory to meet future demand. JPMorgan point out that the global manufacturing new orders/inventory ratio is at its highest level in a decade at a time despite recent weakness in global consumer spending.

**And then the further government spending.** The details of the Biden administration's infrastructure spending proposals have emerged, and it is another big-spending commitment. The Administration has earmarked \$2.25 billion is for infrastructure renewal and build. The package will likely be spent over the life of the Administration, and not all in 2021. The biggest line item is the \$621 to upgrade US transport infrastructure. The passage of the bill through Congress is almost certain to be with Democrat-only support. To ensure sufficient support of factions within the Democrat party, President Biden may have to temper some of the ambition to ensure full support from his party. We should expect the stimulatory impulse to GDP from infrastructure spending to start in 2021.

**Varying vaccine responses may continue to be reflected in the performance of asset prices:** As the US and UK accelerate the pace of vaccine roll-out and look to ease mobility restrictions, the effect of success versus no success may become starkly apparent. In Europe and Latin America, medical facilities remain very stretched with critical COVID cases. At least in Europe the government's finally appear to be in position to accelerate the vaccine roll out. As the pace of recovery increases in countries where there is freedom of movement and fiscal spending is higher, a two-speed recovery could become the norm as the laggards are left behind.

**With all the good news, developed equity markets (+4.9%) did broadly better than emerging markets (+2.3%) in the first quarter.** In USD return terms, the S&P 500 was up 7% for Q1, with key European equity indices like the EuroStoxx 50 up 10.7%. The Nikkei 225 in Japan followed suit with a rally of 6.8% in local currency but up only 1.6% in US dollars. Notable was the decline in China's Shenzhen Composite of 2.9% and the barely positive 0.3% for the Shanghai market

index. MSCI China was down 0.4% in dollar terms, having fallen 13% from its peak in mid-February. In Latin America, Brazil, Argentina, and Columbia posted losses of between 3% and 9%.

**The first quarter was very challenging for global bond markets.** The key headwind to bond returns was the rise in US Treasury yields. From a low of 0.91%, the US 10 year government bond yield rose to end the quarter at 1.72%. There may be additional immediate downside risk in bond yields, with last Friday's very strong employment report yet to be priced in. The 20Y+ sector of the US Treasury market lost 11.2% in the quarter, by far the worst outcome in bond markets. The rise in underlying yields likewise kneecapped corporate bond returns. Investment-grade indices were down between 1% and 5%, depending more on the underlying duration rather than credit quality. Credit spreads held up reasonably well as the economy's underlying growth momentum, coupled with strong demand in the primary market, kept undue spread widening at bay. US High yield bonds eked out a positive return (+0.8%) for the quarter. The carry of the high yield compensating for the impact of higher US treasury yields.

**Emerging market bonds had a challenging quarter as well**, driven by the global rise in yields, a firm US dollar, and a comedy of errors in some specific markets that kept investors nervous and fresh capital on the sidelines. In both USD and local currency terms, the losses were between 3% and 4%, as measured by the Bloomberg Barclays sets of indices. The disparity across regions was stark. Latam was down 10.1%, mainly driven by losses in Brazil (with an awful Covid record and political turmoil), EMEA dropped 5.7% as Turkey dragged it down (recycling Central Bank governors again), and Asia was down 2.2% for the quarter, all in local currency terms.

**Table 1: First Quarter 2021 Asset Class Returns**

Asset class	USD return	Asset class	USD return
US equities	6.2%	EM Equities	2.3%
Europe ex UK	4.2%	Global Agg Bond index	-4.5%
Japan equities	1.6%	US High yield Bond Index	+0.9%
UK equities	6.2%	EM bond Index	-4.7%
China equities	-0.4%	Gold (\$ oz)	-11.3%
Asia ex Japan equities	2.7%	Oil (Brent)	+22.7%
DM equities	4.9%	Dollar Trade weighted	+3.7%

Source: Bloomberg

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