Sanctum Wealth Management

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY **BY GARY DUGAN**

Sanctum View

July 5, 2021

More of the Same – Unfortunately

- **US nonfarm payroll data shows solid growth and inflation**
- **IMF forecasts a US 10-year yield of 1.9% by year-end**
- **Risks to the upside in oil prices and the energy sector**
- **Global warming still evidently out of control**
- **Our strategy–long equities, short duration, and long value**

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Global macro data continues to show solid growth and persistent inflation, which is sufficient to boost equities but indicates a pending sell-off in bonds. Global warming also remains persistent, with declining hopes for an early and acceptable solution to the problem.

There was something for both bulls and bears in Friday's US monthly non-farm payroll data, which beat expectations with 850,000 net new hires in June versus 720,000 expected, and up from an upwardly revised 583,000 in May. However, the unemployment rate disappointed somewhat, ticking up to 5.9% from 5.8% in May, against economists' forecasts of 5.6%. There were evident signs of wage inflation. Average hourly earnings rose 3.6% at an annualised rate, up from 2.0% in May. It was a sizeable increase and in line with other measures of recent price pressures seen in the economy.

The market interpreted the employment data as exerting no new pressure on the Fed to accelerate any tapering decision. The solid pace of new job creation counterbalanced the rise in the unemployment rate. The S&P 500 index continued its unbeaten run, notching its seventh-straight record close at 4352 on Friday.

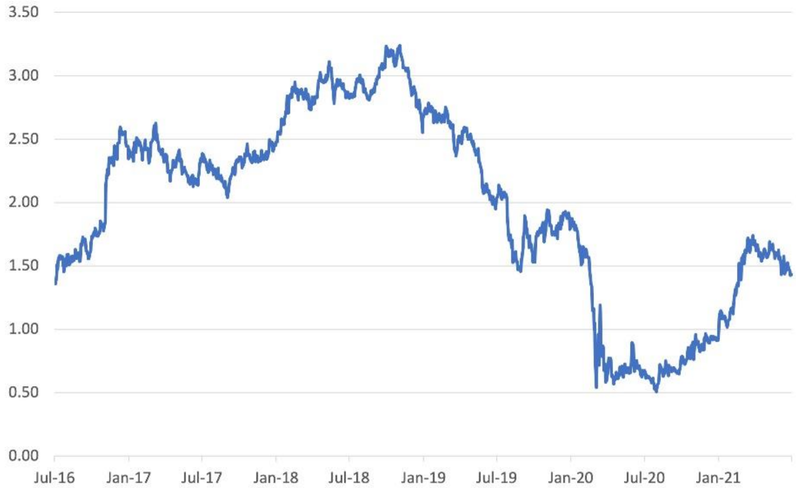
The bond markets took the numbers to somewhat support the "transitory" inflation narrative as the long end of the curve rallied in response to the jobs data. The US 10-year government bond yield dropped six basis points to 1.42%, and the 20-year bond yield fell back below 2%, to 1.97%.

IMF sees higher inflation and higher long-term interest rates

In this context, the IMF's most recent assessment of the US economic outlook, released last week, made for an interesting read. It forecasts that the average US 10-year bond yield will rise to 1.9% by the fourth quarter, a significant gain from the current level. It is also looking for PCE inflation to move to 4.3% in Q4 2021 from 1.2% in Q4 2020, before averaging 2.4% in 2022 and 2023. These levels are far higher than what the market currently discounts.

Of course, the IMF has no special access to information relative to anyone else with a data feed. But we need to pay attention when a body like the IMF predicts a significant sell-off in bonds and forecasts a persistence of inflation. Interestingly, the IMF's assessment of the underlying inflation picture leads it to forecast the US 10-year bond yield to be above 2% by 2022.

Chart 1: US 10 year government bond yield



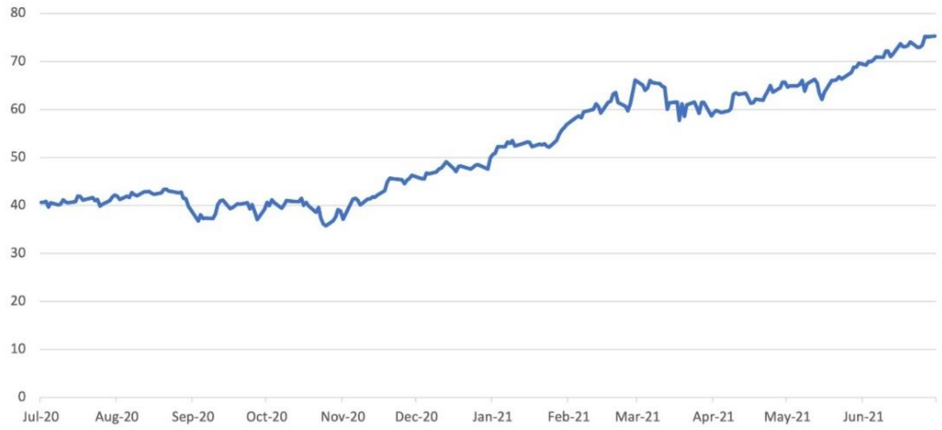
Source: Bloomberg

Oil likely to maintain upward pressure on inflation

The lack of agreement at the OPEC+ meetings may lay the ground for further upside on the oil price, more upward pressure on headline inflation, and possibly some better performance from the equity oil sector. It came as a surprise that OPEC+ failed to reach a consensus on new oil output targets this week. The proposed average monthly increase of 400,000 barrels was below market expectations. While the negotiations resume today to end the impasse, WTI crude climbed to $75.16 per barrel as it became clear that there might not be a short-term compromise to increase output. It is noteworthy that despite a rise of about 13% in the price of crude in June, the S&P 500 Energy sector has underperformed the broader market in recent weeks. Last week it dipped 0.5%, compared with a rise of 2.9% for the overall index.

It will be interesting to watch whether higher gas prices will lead to a squeeze on consumers' incomes in the coming months. The rise in oil prices in recent months has led to multi-year highs in several energy-related products. US consumers are paying the highest gasoline prices in seven years. The national average price for a gallon of regular gas was $3.12 last Thursday, $1 higher than a year ago. Asian LNG prices are at their highest in eight years. Japanese demand has risen 18% in June, and China LNG imports are up 26% year-on-year.

Chart 2: WTI Oil price pushes higher



Source: Bloomberg

Incessant global warming

While the world continues to battle a global pandemic, examples of a more significant threat to the planet in the form of global warming are still very much in evidence. A record high temperature of 49.6 degrees on one day at Lytton, British Columbia, sitting above the 49th parallel, turned into tragedy a few days later when 90% of the town burnt down. While Lytton's woes were hitting the global headlines, talks of an even bigger disaster were in the most recent draft report of the Intergovernmental Panel on Climate Change. The UN draft report believes that we remain on track to see global temperatures rise +3°C at best relative to the Paris Agreement's aim to keep global warming "well below" 2°C. A few months back, the Meteorological Organization projected a 40% chance that the Earth will cross the 1.5°C threshold for at least one year by 2026. As the report outlines, such a rise in temperatures could lead to events that displace 22 million people in SE Asia within the next five years.

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Central tenets of our portfolio strategy—long equities, short duration, value bias

Moving into the second half of the year, we have focussed our strategy on three central conviction positions. We remain overweight equities, we have reinforced our short duration positioning in bonds, and after a recent pullback, we have increased our value bias. We believe the Fed will have to relent at some stage and allow long-term interest rates to rise modestly. There is a fundamental mispricing of the US Treasuries, which can only lead to even greater market volatility in the future if allowed to persist through the current bout of solid growth and inflation. Much as the IMF reported this past week, a 10-year bond yield of 1.9% is consistent with the growth outlook, and we believe it would still allow equities to generate positive returns.

At the moment, we are spending less of our risk budget on regional equity overweights and underweights. To us, Asian equities look cheap; however, the slow pace of vaccinations in the region is worrying. China story appears complicated by a prudent economic policy mixed with regulatory interference in the internet stocks. US equities remain omnipotent with perennial outperformance. It is tough to bet against them even if our gut feeling is that there is an opportunity at some stage for significant underperformance vis-à-vis Asia when it recovers. It's all about timing!

Growth stocks have made a recent comeback, but we have a high degree of conviction that value will outperform in the balance of the year. Cyclical stocks that have pricing power and basic materials stocks we believe have a following wind of upgrades to earnings and still relatively low valuations.

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)