

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



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Bonds to Edge Equities

- The market is pricing a more aggressive Fed than previously thought.
- We expect Fed action and signs of a potential sharp slowdown in US growth to be more challenging for equities than bonds.
- Watch to see if institutional buying protects the 3.0% level on the US 10 year government bond yield.
- The recent equity rally could quickly unravel with an aggressive Fed and fears of sharp US economic slowdown for which there is some tentative evidence.
- The "quiet quitting" is another labour market phenomena to make us concerned about poor productivity in the labour force.

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We see that both bonds and equities are under pressure as the Fed remains committed to a more aggressive path for monetary tightening. However we suspect that Bonds will fare better in coming weeks.

Both equities and bonds were under pressure last week, with the weakness particularly noticeable in the US. After closing Friday in the red, US equities ended the week down 1-2%, and the US 10-year bond yields inched up close to 20bps.

Other major equity markets fared better in local currency terms. Yet, the dollar's strength was re-established, leading to dollar-based investors losing 3.5% on outperforming eurozone equities (at least in local currency terms) and a yen that weakened 3% against the dollar.

Market movements last week reflected the continued unease of investors. Although equities had rallied hard in recent weeks, we saw little investor conviction that the rally was built on any sense of a solid improvement in fundamentals. As it appears, this was merely a technical rebound. For all the points that we stressed upon in our previous weekly commentary, we believe very little has improved over the past six months, and the rally is at the risk of unravelling.

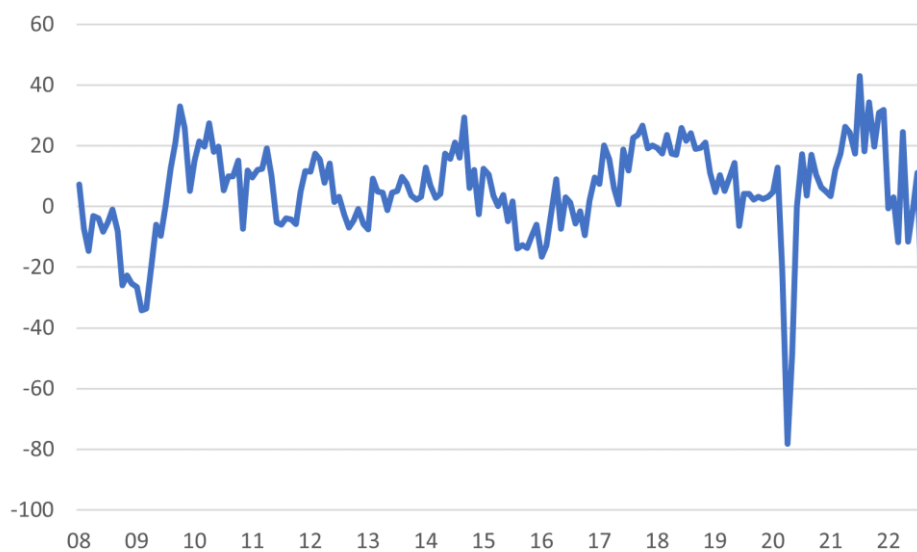
We remain concerned that equities could see further downside in the coming months. We expect the significant squeeze on real incomes to lead to a sharp setback in growth—to the point that investors start fretting about the risk of a global recession. While much of the attention is on the US, the scale of the potential setback in European growth will determine the (negative) global implications. Last week's inflation report for the UK, for instance, showed a frighteningly high inflation of 10.1%, ahead of expectations of 9.8%, and seemingly still accelerating with a tailwind of sterling weakness. Indeed Citigroup are on the wires suggesting a peak rate of over 16%!

On the flip side, we are more comfortable with bonds – less concerned that we will see a further remarkable rise in bond yields. While we have longer-term concerns about global inflation remaining sticky in the very near term, the risk of a marked weakening in global growth should at the very least mitigate some of the upside risks for government bond yields.

In recent weeks, we have noted more institutional investors appearing prepared to tactically buy US government bonds at close to the 3% level, suggesting that level to represent near-term value if inflation is on its way down and growth is weakening.

Last week's industrial confidence surveys and the housing market data releases supported the view that the US economy could be downshifting. Ordinarily, we do not quote the New York Empire survey as we consider it a noisy data point. Still, the report for August released last week was disappointing and indicated confidence had dipped to almost a two-decade low. The drop in the index to -31 from 5 was on par with the collapse of Q1 2009 and close to the worst seen during the COVID crisis. If other surveys replicate anything close to that scale of deterioration, economists will scramble to declare a recession. To be fair, the Philadelphia Fed survey was much better; however, forward-looking elements of the survey, particularly new orders, were weak.

Chart 1: New York Fed Empire Survey Down Very Sharply



Source: Bloomberg

The market's interpretation of Fed policy will determine whether the bond market can regain the momentum of previous weeks when we saw both government bonds and credit rally very strongly. The last set of the Fed meeting minutes released last week required a significant degree of market interpretation. Fed communication quite frankly remains very poor. While the minutes set out the scope for further Fed rate hikes to quell the inflation risk, the market could interpret some comments as the Fed standing ready to adjust its policy should growth stall. Investors, therefore, judged the report to be mildly dovish. The Fed still seems to want the market to believe that it is there to support the financial markets if the need arises.

The ambiguity about Fed policy is also evident in how it conducts its quantitative tightening (QT). While the Fed has been aggressively raising rates, it has seemingly backed off from its commitment to quantitative tightening. Despite what was supposed to be a QT programme starting on June 1st, the Fed's balance sheet is broadly at the same level as at the end of March. As Bloomberg reports, the Fed had an initial QT cap of \$47.2bn per month, but in July

the Fed only completed \$22bn of QT (bond sales). It will be interesting to see if anything changes in the coming months. In September, the Fed's QT cap rises to \$95bn. Quite frankly, the market at this stage doesn't believe the Fed will keep to its commitment; otherwise, bond yields would probably be higher.

Our advice at this stage is that if investors feel compelled to recommit cash that is sitting on the side lines, they would do well to invest in bonds than equities. Inflation should ease further going forward, and any sense that the economy is slowing more rapidly could provide scope for bonds to display some of the strength we saw just a couple of weeks back. JPMorgan expects global inflation to nearly halve by the fourth quarter as the year-on-year comparisons in price levels are not so extreme due to the moderation in energy and food prices.

Chart 2: Will institutional Buying protect the 3% level of US 10 year Government bond Yields?
(%)



Source: Bloomberg

From a technical perspective, the US high yield market dynamics have been positive. A marked global recession would damage earnings, but investors are sensing that there is enough time to comfortably extract some returns from the markets without taking any significant risk. July saw a 5.8% return from high yield, the highest monthly return since October 2011. The ratio of credit upgrades to downgrades for high yield has remained comfortably above one for more than 18 months. Also, default rates of less than 1% would typically signal that investors can grab some extra return without taking any significant risk at this juncture. Short-duration high-yield funds are an alternative for those wishing to de-risk their investment.

From "Great Retirement" to "Quiet Quitting"

The labour market is a source of concern for perpetuating inflation in the future. The great retirement has left a number of service sectors very short of workers and pushed up wage rate. Now comes news that even if there are workers, they may not be most the motivated.

As far as US unemployment is concerned, it is worth reflecting on some of the trends we have seen in the labour market post-COVID. The "great retirement" left labour markets short of available workers. Around 2.4mn more Americans retired in the first 18 months of the pandemic than expected. More recently, 1.5mn have come back, driven partly by opportunity as an improving economy created more jobs, and partly because of necessity, as rising inflation squeezed incomes. The next problem for the labour market looks less easy to solve. The latest phenomenon called "Quiet Quitting" is a growing trend of less than committed workers, particularly among the young (Source: Mike Shedlock via MishTalk.com). A recent Gallup survey of the US labour market found that more than 50% of those born after 1989 were not entirely engaged, meaning people that turn up for work but do the absolute minimum.

The lack of workers has been a factor behind the surge in wage rates and added to the inflation pressures. The additional 1.5mn retirees that have returned to the workforce will help mitigate the wage pressure to some extent, but the "quiet quitting" is concerning. Workers that are not engaged are less productive and weaker productivity reduces economic growth, ultimately affecting corporate profitability.

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