Sanctum Wealth Management

Sanctum View

June 21, 2021

Much Fuss About Dots

- **Markets reacted sharply to rising dots at the Fed**
- **We find it difficult to square the near-term moves in long term US government bond yields with the likely direction of the markets over the medium term**
- **Equities were overbought and vulnerable to the Fed news…but the medium-term still appears constructive**
- **More profit-taking in commodities, but supply shortages are real**

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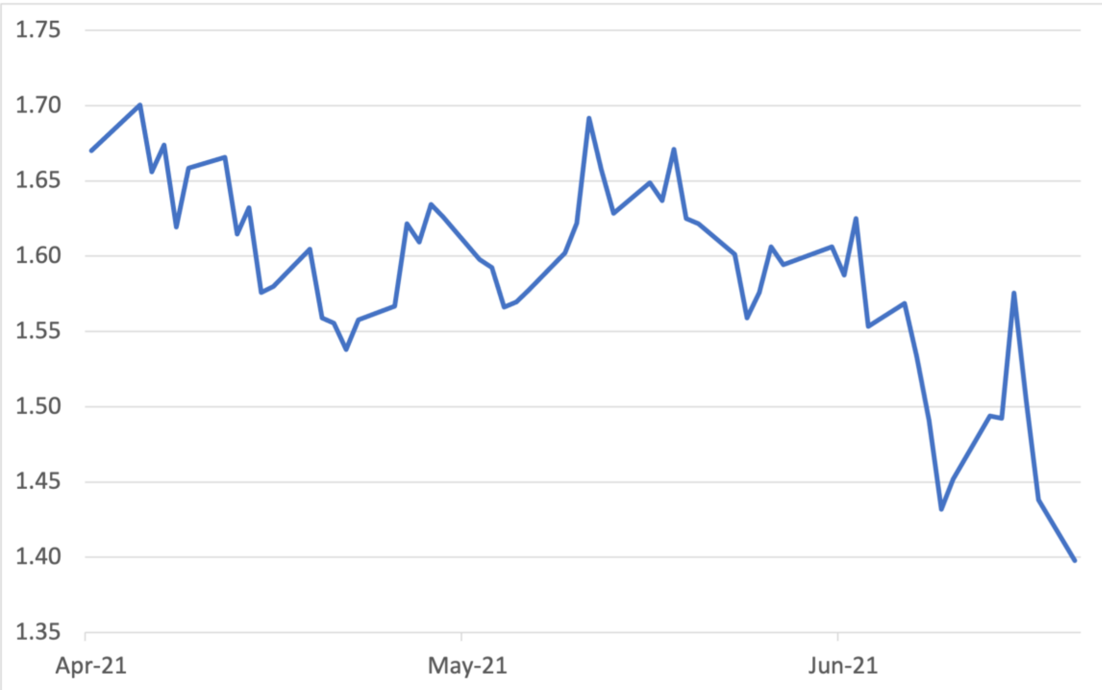
The Fed moved its dots, and surprised markets reacted sharply. But not many of the recent asset market moves really square with the likely path of the global economy in the medium term.

If market impact is the measure to go by, this past week's Federal Reserve policy meeting was a significant one indeed. With some shifts in the dots of the "dot plot" and subsequent comments from Chairman Powell and FOMC member Bullard, the markets went into a frenzy. The markets took it as a signal the Fed was that it sees the start of a tightening in monetary policy. To be exact, 13 of the 18 participants of the FOMC moved their dots (forecasts for interest rate moves) higher to show that they thought it would be suitable for the Fed to start raising rates by the end of 2023. That was up from seven at the previous FOMC meeting in March. Moreover, Bullard's comments after the meeting implied rates would have to start rising by the end of 2022, and not a year later.

In the Treasury market, the response was a sharp curve flattening. The long end of the curve (20-year maturities) rallied, with yields dropping faster than in the middle (5-year to 10-year) of the curve. At the very short end, rates moved higher. The 2-year treasury yield rose from 0.15% to 0.25% over the week. The 10-year yield dropped, by contrast, from 1.58% to 1.44%. The 20-year yield dropped the most in basis point terms, from 2.14% to 1.96%. Another way to frame the move is to look at the total return: on the week, the 20-year bond ETF was 3.4%; for a 5.6% month-to-date gain. Those are serious gains for bonds over such a short period. The returns of most bond funds in the high-grade credit and government sectors are still in the negative territory year-to-date, with long-dated bonds' returns lagging the most at around -7%.

Chart 1: US 10 year sinks to recent lows



Source: Bloomberg

The Fed's new dot plot was more hawkish than expected. This meeting came, of course, at a significant point in the market cycle. The recent slew of data releases has been pointing at higher inflation, and the debate is raging, now more than ever, whether the observed rise will be transitory. "Transitory" is a term very much of the Fed's own choosing and that's how the central bank has portrayed its view of recent inflation readings. For this reason, the market would view a shift towards a potentially earlier lift-off in rates as significant. The market was pricing in a scenario of easy policy almost for as far as the eye could see. A change in stance jarred that expectation.

Can we trust this flattening? Traditionally, a steep curve starts to flatten when the market perceives that the end of the growth cycle is in sight. That would be the point when monetary policy begins to tighten.

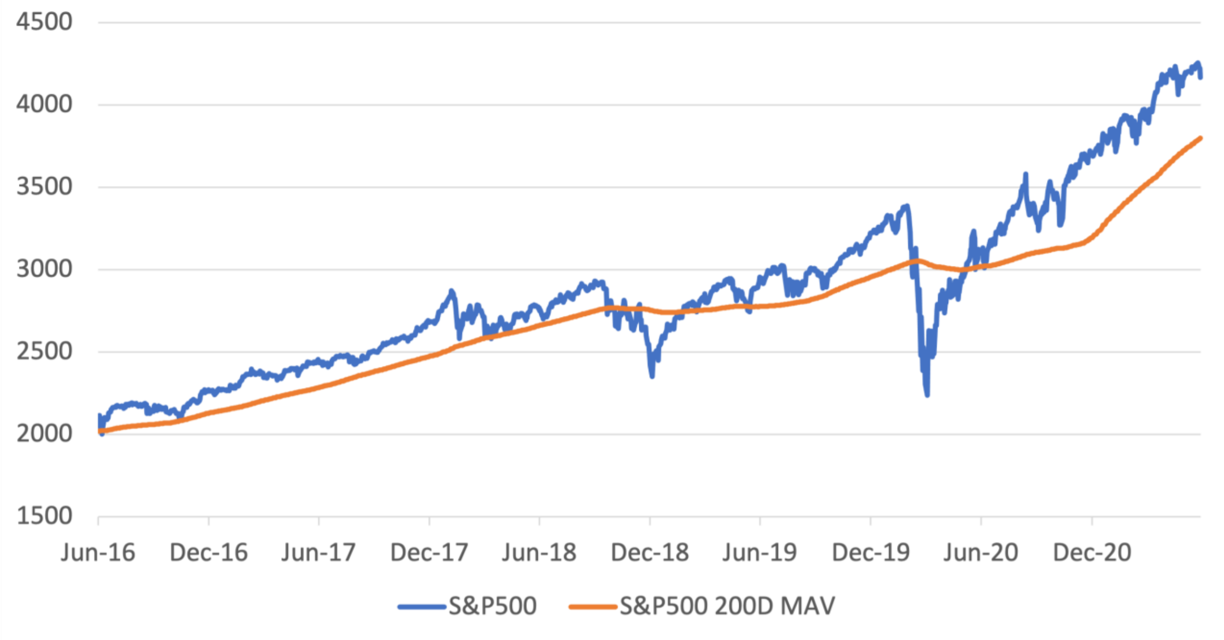
The shift this week in Fed policy is far from constituting a tightening, however. Objectively speaking, it was only a relatively subtle shift. Current monetary policy is arguably as loose as it has been for at least three decades, and fiscal policy promises to deliver spending not seen since the WWII. It is surprising to see a sharp flattening in this context.

Unchartered territory for the bond market. As we wrote last week, the bond market is subject to not just an unprecedented looseness in policy but also to technical factors. The speed of the price moves at the long end this week suggests that many leveraged players were still wrong-footed. At the same time, institutional investors grapple with an inflation picture that does not square with US yields below 2%, or even 3%, depending on one's view of the inflation outlook.

For the immediate future, the outlook may be for more volatility as markets look for clarity and the technical factors (flush liquidity at the short end, heavily short positions among many players). However, inflation is moving higher not just in the US but globally, and many of the factors behind it are far from transitory. Thus, even if the recent drop in the US inflation breakeven rate from 2.5% to 2.25% reflects the actual outcome in the future, it still leaves the entire US Treasury curve in the negative territory in real terms. Such a situation is not sustainable indefinitely.

Equities were vulnerable—technically overbought. We would characterise the sell-off in equity markets as more of a technical correction rather than the start of a significant collapse in prices. At the start of last week, the US equity market was at a particularly exaggerated technically overbought level. The index was 40% above its 200-day moving average (Char 2). The market had not seen such an extreme overbought level in the past 10 years. How far could the market fall? At an extreme we could see the 3700 level that would represent a 9% fall from the current levels. However, there are mitigants to a market sell-off. Analysts' forecasts for current year earnings continue to rise, and we are only a few weeks away from the pre-announcement season when we scope for further upgrades.

Chart 2: S&P500 a good measure above the 200 day moving average



Source: Bloomberg

We see the sell-off in commodities as market noise and not a change of direction. We firmly believe that many commodity prices are headed higher over the medium term. Nevertheless, commodity markets fell sharply last week. Copper, palladium, gold, and silver have all corrected by around 15% from their recent highs. The bad news for the asset class started with the previous week's decision by China to cut purchases of commodities and release some of its strategic reserves to force prices lower. The sell-off accelerated following the Fed's statement and the rise in the dollar.

Nevertheless, last week's market action does not diminish the positive medium-term outlook for many commodity prices. We expect the increasing commodity intensity of a global economy that is doing its best to reduce its carbon footprint to lead to a multi-year demand surge. On the supply side, despite China's best efforts, we expect the record low levels of LME inventories to push prices higher eventually. Also, we believe investors have still not appropriately discounted the likelihood of limits to supply growth in the future. Still, a significant part of the global supply of commodities could easily be left stranded as buyers seek out the most ethical suppliers. If the world only wants ethical supply, then the supply-demand imbalance in many commodity markets could be far more significant than currently priced.

Chart 3: Commodities see profit taking but look well supported

Bloomberg commodity index

Last week's sell-off in oil stocks also looks out of kilter with the fundamentals through the end of the year. While oil prices were rising, oil stock prices were falling. The WTI crude oil ended up 1.5% for the week, the fourth straight weekly gain to the highest price level since October 2018. Oil stock prices, by contrast, went down 5.7% on the week. Also, during the week, OPEC provided an update on the outlook for the oil market. Although it upgraded its estimate for global oil supply growth to 93.7m bbls a day, 6.4% higher than its estimate a year ago, it is still well short of the likely global demand of 102.4m bbls/d. The limited supply growth looks likely to force prices higher over the balance of the year. The current OPEC supply of 25.45m bbls/d is well short of the projected second-half demand of 29.0m bbls/d. To be sure, the level of inventories is around 34m bbls above the long-term average. However, that is likely to disappear quickly, given the supply-demand imbalance.

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