

THE BIG PICTURE OF GLOBAL ECONOMICS



WITH

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Back to Normal?

- Singapore leadership's vision of COVID as an endemic and not a pandemic gives us a glimmer of hope that we will finally overcome the challenges of the past 18 months
- Greater mobility and interaction between people could further facilitate the move to a more vibrant global economy
- Hopes of further momentum in reopening remain a positive for the equity markets
- Action in the bond markets normalises as the Fed seeks to clarify its stance
- Yield curves steepen modestly
- Emerging market central banks move in to prudently tighten monetary policy as inflation picks up

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Could we be finally on the cusp of a more enlightened path to moving back to the next normal after all the angst over COVID? Many have welcomed the comments from the Singapore COVID task force, which is drawing up a plan to characterise COVID as an endemic rather than a pandemic going forward. The three ministers that co-head the task force were quoted as saying in The Straits Times, *"The bad news is that COVID-19 may never go away. The good news is that it is possible to live normally with it in our midst."* Comparing COVID-19 to influenza, the ministers said many are infected by the flu every year, but the chances of falling severely ill are so low that people live with it and carry on with their daily activities while taking simple precautions.

The authorities in Singapore are holding out the prospects of a return to something approaching normal in the coming months. There are hopes of easier mobility in and out of the country and for the authorities to allow mass gatherings once again. The plan could be released in the coming days and provide a template for how other countries may plan for the future.

A change of perspective in seeing COVID as an endemic rather than a pandemic could materially alter people's ability to travel and move around normally again. However, the crucial gauge of which countries will join the club of 'endemic countries' rather than 'pandemic countries' would likely be the pace of vaccinations.

For risk assets such as equities, the marked change of tone in Singapore could bring about a more marked re-opening and acceleration in consumer spending growth if replicated in other countries. It would certainly reinforce the pick-up in the performance of cyclical stocks, something that was quite evident last week.

Equities have continued to eke out positive returns, but there is some trepidation about whether the outsize gains in corporate profit forecasts are already behind us. Recent industrial confidence surveys have shown cost inflation and order backlogs. Fragmented supply lines have meant that suppliers have not always been able to fulfil orders as missing components and delays in getting the product to the market have possibly pared sales growth. At this stage, defensive companies appear to have borne the more significant impact. Defensive stocks have seen outright falls in consensus corporate profit forecasts. Cyclical companies, meanwhile, continue to see upgrades to forecasts. Hence, value stocks and particularly cyclical stocks have reasserted their trend outperformance over growth stocks.

Chart 1: Global Value stocks start to recover from year of under performance versus Growth
MSCI Global Value versus MSCI Global Growth (Total return indices \$)



Source: Bloomberg

Bond markets normalising?

Bond markets looked a shade more normal last week with additional time to reflect on the previous week's Fed announcements and more input from Fed governors. The previous sharp flattening in bond yield curve (the 10-year Treasury yield spread over money market rates) partially reversed. From a low of 140bps after the last FOMC meeting, the spread widened again to 148bps, driven by the long end of the bond curve selling off; both the 20-year and 30-year government bond yields moved back above 2%. We expect the curve to further steepening steepen further driven by higher long-term interest rates. In our view, the long end of the curve is mispriced, given the likelihood of inflation well above the Fed's target rate of 2% for a period that may be too long for analysts – and the Fed – to label it "transitory".

For the yield curve flattening to make any sense, we would need to see signs that the drivers of inflation are either missing or moderating. This does not appear to be the case at present. Instead, economists continue to find reasons why inflation could post further positive surprises in the coming months. Some variables may be the impetus for a further increase in inflation globally, and not just in the US. JP Morgan estimates that global services sector inflation is still running significantly below the pre-COVID levels. If there is even a simple return to the previous pace from here, it could add another 1% to inflation globally this year.

Chart 2: Steepness of US Yield Curve

US 10 year bond yield less one month deposit



Source: Bloomberg

As we have discussed before, inflation is not just a US phenomenon. Indeed, central bankers increasingly see inflation in the emerging markets as a threat to economic stability. Last week, Mexico's central bank surprised the markets by hiking the policy rates by 25bps. There was a split vote amongst the policymakers, but a majority of three-two prevailed. The rate increase to 4.25% from a cycle low of 4.0% was in response to the vibrancy of growth and inflation. Inflation is currently running at 6.0%, against the central bank's target of 3% plus or minus 1%. A 2% rise in the peso against the dollar, the best performance in a year, was a ringing endorsement from the market of the move. The market now expects Banco de Mexico to hike rates a further 125bps by the year-end.

The scene is set for several more hikes in the emerging markets through the balance of the year. In Eastern Europe, rates hikes were announced in Czechia and Hungary, as the central bank policy-setting has moved from growth support to inflation containment. However, in Asia, poor vaccination rates in many smaller emerging countries are likely to hold back some central banks from raising rates. Among the major countries, Korea appears to be the only economy outside of China to tighten this year. Korea has markedly accelerated its pace of vaccinations in recent weeks, and upgraded consensus growth forecasts could drive even quicker monetary tightening.

Credit looks at risk from higher yields and tight spreads: The market is at that point of the economic cycle where the outlook is for limited credit returns. The immediate headwind is the upward trajectory of policy interest rates from here, whether they are moderate or sharp. Most high-yield indices have yields to maturity of below 4%. The only exception is emerging markets where a handful of very low-quality outliers are dragging yields above 5%. It means that the scope for poor returns is skewed to higher risk because the cushion to sustain losses is very small, with yields already low.

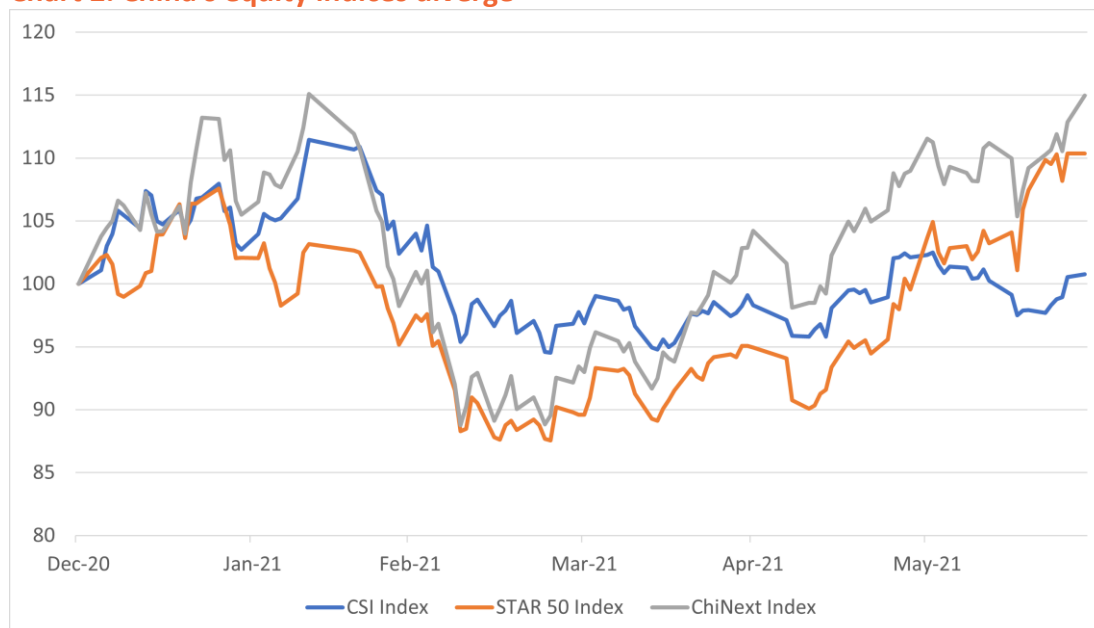
The next headwind for total returns is the tight level of spreads relative to Treasuries. In credit bull markets, it is almost always necessary to have substantial spread compression. Investors need to have the risk premium between corporate and government to narrow significantly. From where the market is today, this won't be easy to achieve. For example, the spread differential between the US Corporate High Yield and Treasury bonds of the same maturity now stands at the lowest (273 basis points) since the Lehman crisis.

Liquid credit is a seller's market: The conclusion is that despite the excellent fundamental backdrop, the conditions in the credit market appear to be much more favourable for issuers than investors. Low yields and ample liquidity have driven a strong market for new issues. As a result, new bonds continue to be issued at record-low coupons, and market volumes are steady at near-record levels too. With summer approaching, a brief lull is to be expected before the final part of the year most likely sees a continuation of the trend.

China's Communist Party anniversary

July 1st sees the 100th-anniversary celebration of the Chinese Communist Party. Chinese stocks have been disappointing at the aggregate level, with little to show year-to-date. However, there are signs that investors have not given up on the Chinese outlook and have instead repositioned their attention in a nuanced way. A broad measure of market performance, the CSI 300 index, is down 2.7% from the beginning of March this year. This coincides with marked underperformance of some well-publicised large-cap names. However, over the same period, two indices that capture small-cap stocks with a technology bent, the STAR 50 Index and the ChiNext Index, are up 12% and 13%, respectively (all numbers in CNY terms). Thus, while the large caps are under pressure from regulators, the smaller caps have had a comparatively free run of it and still appear to provide the exposure that investors are looking for access to the Chinese innovation theme.

Chart 2: China's equity indices diverge



Source: Bloomberg

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