

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



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Buy The Inflation Dips

- **US bond market rally reflects technicals and not a material change in the inflation view**
- **The Treasury uses cash not credit and floods the market with liquidity**
- **We look to buy the setback in inflation plays in the equity market**
- **ECB signals it wants to create more inflation**
- **China eases monetary policy but materially tightens regulation**

You might also like our [More Of The Same – Unfortunately](#) and [Review Of June And Q2 Asset Market Returns](#). Click [here](#) to read them for free.

This past week saw more evidence of market skittishness in the face of even minor challenges to the growth narrative. We think market pricing still does not fully reflect the risk of inflation in the medium term, despite what the Fed states. Market dips like the one seen this week represent opportunities for investors to align their portfolios with a view that inflation will persist.

Lower US 10 year yields due to technicals – inflation still alive

In the US Treasury market, the 10-year government bond yield was dropping all week and reached a low on Thursday of 1.29% before bouncing higher to close at 1.36%. There are several factors at work in the bond markets that have driven yields lower, many of which are technical. To be sure there was probably some short covering given that the consensus view is that yields should be higher. Short term traders were running short positions that they probably closed off as their trading losses mounted.

Chart 1: US 10-year government bond yield drops away



Source: Bloomberg

However, a more telling technical factor is the huge amount of liquidity moving into the bond market as the US Treasury runs down its balances with the Federal Reserve. Instead of issuing Treasuries to fund its spending the Treasury has been using cash. The cash enters the financial system driving down yields but also leaves a legacy of less issuance which means their shortages of bonds for investors to buy again pushing prices higher and bond yields lower. The US Treasury has already reduced its account by \$1 trillion but has further to go before the deadline of end of July. The current balance of the Treasury at the Federal Reserve is around \$700bn with a target of \$450bn by the end of July.

Also over time, the supply of new bonds must rise. The Biden Administration is committed to a large infrastructure spending to add to a very ambitious fiscal program to go with the generous Covid support already enacted. Lower supply is thus a temporary factor, not a new fundamental factor to take into account. On the contrary, even on the current robust growth

path, new supply will be growing as a percentage of GDP, not contracting. Clearly, this is a bearish impulse for the bond market.

The US 5-year breakeven as a measure of the markets expectation for inflation is still around the 2.50%. Yes, a good way away from the 2.77% level discounted in May but still healthy enough to suggest that nominal yields could be on track to be a lot closer to 2.0% by year end.

Equity inflation trades sell-off and then rally back

Equities initially followed the bond yield volatility with a sharp sell off. The market narrative was that the low yields reflected increasing concerns with global growth in the wake of the spread of the delta variant of COVID. On the same day as the 10-year treasury yield dipped to 1.29%, there was a sharp sell-off in equity markets, more or less across the board but with some notable losses in some of the cyclical sectors such as energy and materials. **The best strategy to follow under these circumstances more and more appears to be to buy the cyclical and inflation plays on such dips.** Just the following day, there was a major rebound in all of the sectors that previously sold off, as investors took some time to assess whether the actual underlying data warrant such sharp reactions. Energy and materials rose by 2% on the day, and financials spiked 2.7%. Financials stand to benefit from steeper yield curves.

ECB raises its inflation target

We continue to believe that inflation plays will profitable as long as centra bans are hell bent on creating inflation. In this vein, the ECB increased its inflation target this past week as a further sign of the determination of central banks to create inflation. In a sweeping reassessment of its policy approach, the ECB announced this week that it would move away from its approach of a set 2% inflation target to accept a more flexible strategy that will accommodate some overshoot of the target if policy is at its lower bound. The ECB is already debating extending its purchase program, so arguably, its policy is close but not at its lower bound. In the minutes of its recent meeting, board members showed they were unwilling to commit to reducing the financial assets purchase program, deeming it premature to change stance yet. The ECB will probably continue to run its “lower for longer” narrative for some time to come.

China eases monetary policy – a gentle support to a concerned market

China eases policy easing in China to counter the softening of growth: The PBOC announced a 50-basis point cut in its reserve requirement ratio (RRR). The policy in effect release around \$155 billion of long-term liquidity into the system. The PBOC’s last cut in the RRR was in April of last year. China’s cabinet stressed that the RRR cut would be a help to small businesses however the market also views it as helping to sustain some of the weaker state-owned enterprises.

The move by the PBOC to ease monetary policy may mitigate some of the possible market worries that this coming week’s release of Q2 GDP numbers for China could be weaker than expected. The forecast range is quite wide, between 5.5% to around 8% quarterly annualised growth down markedly from the previous quarter’s 18%. Further support for the PBOC’s came from data showing a muted rebound in inflation. The CPI was 1.1% year-on-year slightly below expectations.

Whether or not the easing of the monetary conditions will be sufficient to meaningfully

turnaround the performance of the China's equity market only time will tell. The market rebounded at the end of the last week but it is still nearly 10% off the levels of late June. Of course, the poor performance of the Chinese equity market has not just been about the lack of growth momentum but the fallout from DiDi IPO aftermath and subsequent government policies that target tighter regulation of tech stocks.

Chart 2: Chinese equities relative hits rock-bottom

MSCI China (TR) relative to MSCI Global Equity (TR) Index



Source: Bloomberg

It is also possible that the PBOC is trying to moderate the pace of defaults in the onshore bond market. It has been introducing a greater degree of transparency into credit risk pricing in the market. Until now, many issuers have been the beneficiaries of implied government support. Credit will be priced correctly by making it easier for such firms to default by not bailing them out or underwriting questionable quality issuance. In 2021 to date, however, the price has been the third-highest delinquency rate on record. Bloomberg reports that year-to-date there has been of \$19.6 billion of bonds that have gone delinquent, 21 private and 66 public entities. The PBOC has a track record of fine-tuning liquidity conditions in the credit markets, and the current action might be a signal that it is trying to moderate the credit tightening it has effectively been running of late.

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