

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



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**

You might also like our [Review Of June And Q2 Asset Market Returns](#) and [Back To Normal?](#) Click [here](#) to read them for free.

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.

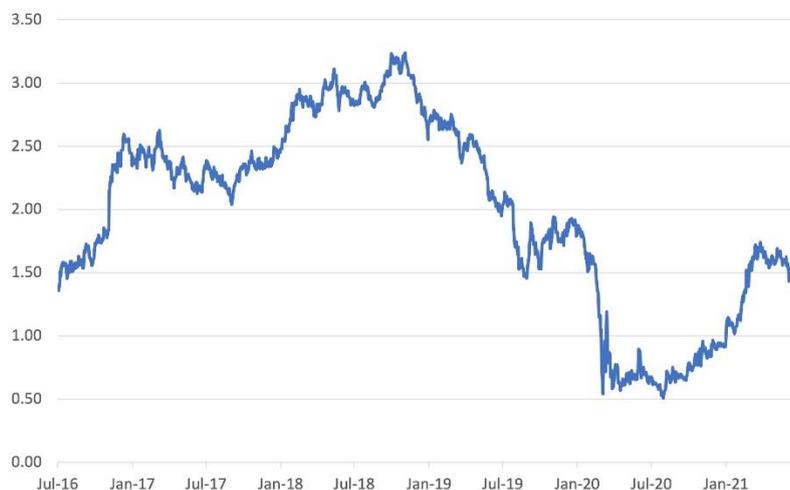
The bond markets took the numbers to somewhat support the "transitory" inflation narrative as the long end of the curve rallied in response to the jobs data. The US 10-year government bond yield dropped six basis points to 1.42%, and the 20-year bond yield fell back below 2%, to 1.97%.

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



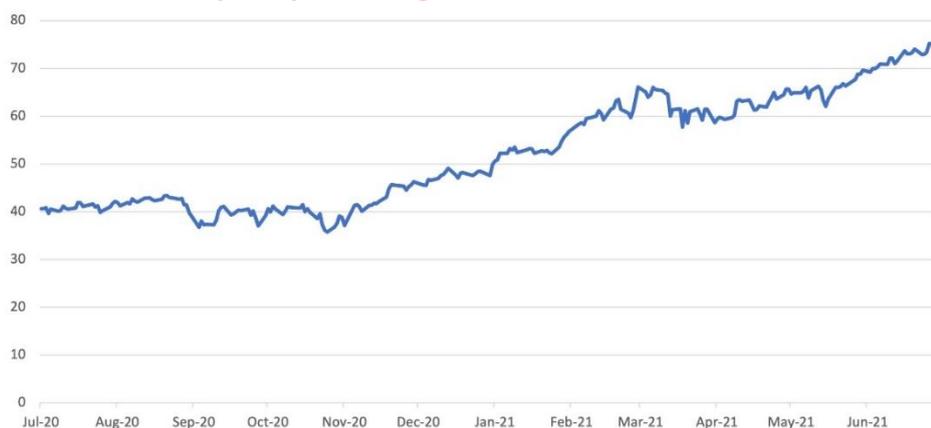
Source: Bloomberg

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.

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)

Disclaimer & Important Notice

FOR THE INTENDED RECIPIENT'S USE ONLY

The Global CIO Office operates under Purple Asset Management. This document has been prepared by Purple Asset Management Limited ("PAM" or the "Company").

The document has been prepared on the basis of accounting and non-accounting grade information extracted from within the Company and its affiliates; and of publicly available economic and market data sources. This information has not been verified by an independent third party and should be treated accordingly. It is furnished to you solely for your information, should not be treated as giving investment advice and is to be kept confidential and may not be copied, reproduced, distributed, published, in whole or in part, or otherwise made available to any other person by any recipient.

The facts and information contained herein are as up to date as is reasonably possible and are subject to revision in the future. Neither PAM nor any of its directors, officers, employees or advisors nor any other person makes any representation or warranty, express or implied, as to the accuracy or completeness of the information contained in this document or undertakes any obligation to provide recipients with any additional information. Neither PAM nor any of its directors, officers, employees and advisors nor any other person shall have any liability whatsoever for losses howsoever arising, directly or indirectly, from any use of this document.

Whilst all reasonable care has been taken to ensure that the facts stated herein are accurate and that the opinions contained herein are fair and reasonable, this document is selective in nature and is intended to provide an introduction to, and overview of, the business of PAM. Any opinions expressed in this document are subject to change without notice and neither PAM nor any other person is under any obligation to update or keep current the information contained herein.

Such information contains "forward-looking statements" which are not historical facts and include expressions about management's confidence and strategies and management's expectations about future revenues, new and existing clients, business opportunities, economic and market conditions. These statements are made on the basis of current knowledge and assumptions. Various factors could cause actual future results, performance or events to differ materially from those described in these statements. These statements may not be regarded as a representation that anticipated events will occur or that expected objectives will be achieved. The forward-looking statements in this document are only valid until the date of this document and ISI does not undertake to update any forward-looking statement to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. This document is not an offer to sell securities or the solicitation of an offer to buy securities, nor shall there be any offer or sale of securities in any jurisdiction in which such offer or sale would be unlawful prior to registration or qualification under the securities laws of such jurisdiction.