

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



September 15, 2021

Will This Time be Different?

- **Equity markets have downside risk as the S&P 500 drops very close to a key support**
- **A worst-case scenario could see the US market fall 23% and others would likely follow**
- **However underlying growth remains well-founded offset by short term supply disruptions**
- **Buying the dips could still be the strategy as supply bottlenecks and the labour shortages ease**

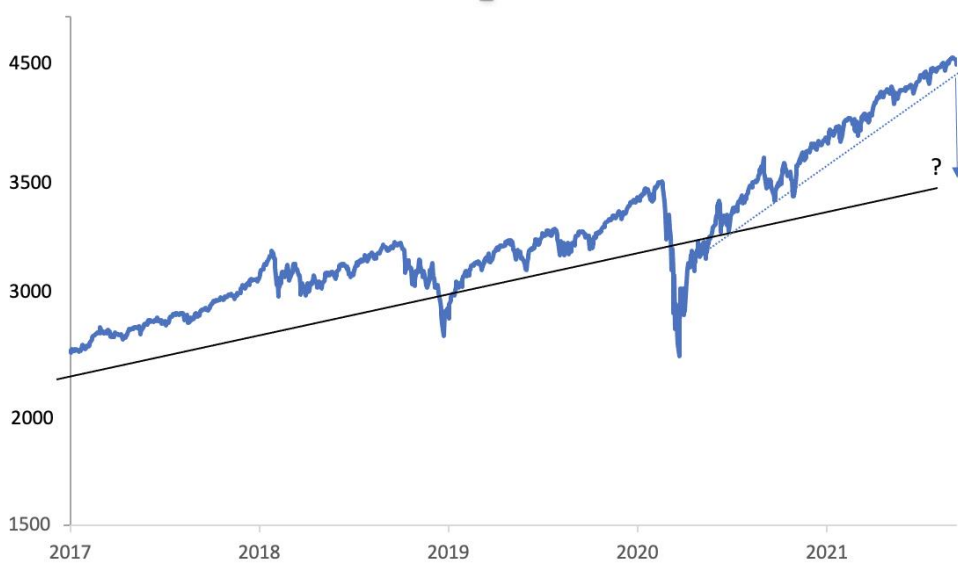
You might also like our [Looking to Asia For Help](#) and [Still a Long Way from Normal](#). Click [here](#) to read them for free.

Investors have stuck to the buy-the-dip mentality for many months now. But, this time, they are confronted with some pertinent questions: Will the complete faith in policymakers to make good any slowdown in growth hold on this occasion? With the US equity market sitting at its 50-day moving average volume increasing and the breadth of the previous market rise weak, the critical question is whether the market will hold its level or see a more significant downside. Will this time be different?

The US equity market looks vulnerable, but it may have the capacity to rebound quickly based on recent history. Over the past year, the US equity market has bounced off its 50-day moving average on numerous occasions. As we mentioned last week, there has been an almost unprecedented **lack** of volatility in the S&P 500 index. The market has risen on a steady, consistent line for the past 12 months. At 4458, the index is hovering close to its 50-day moving average of 4424. Hence, anything more than a further 0.8% drop in the index will see the index with downside risk to the next critical level of 4312, which marks the 100-day moving average. When the index went below the 100-day moving average in October, that was the only time in 18 months. Within a few days, the index rebounded, rising 10% over three weeks from its lows. The rebound reinforced the buy-on-the-dip mantra.

For those worried about a more severe sell-off, you need to keep the 3430 level in mind for the S&P 500. That would represent a drop of 23% from current levels. The 3430 level represents an extension of the trend line of the index that was in place before COVID-19 hit. Of course, the world is a very different place now, but it is difficult to argue that the trend growth of the global economy has materially improved. Indeed, the way globalisation has gone into reverse argues that trend global growth is impaired and equity markets shouldn't continue to climb at the trajectory of the past year. Plentiful liquidity from the four corners of the world have driven asset prices to excessive levels, and only if that liquidity is reduced will the bubble likely deflate.

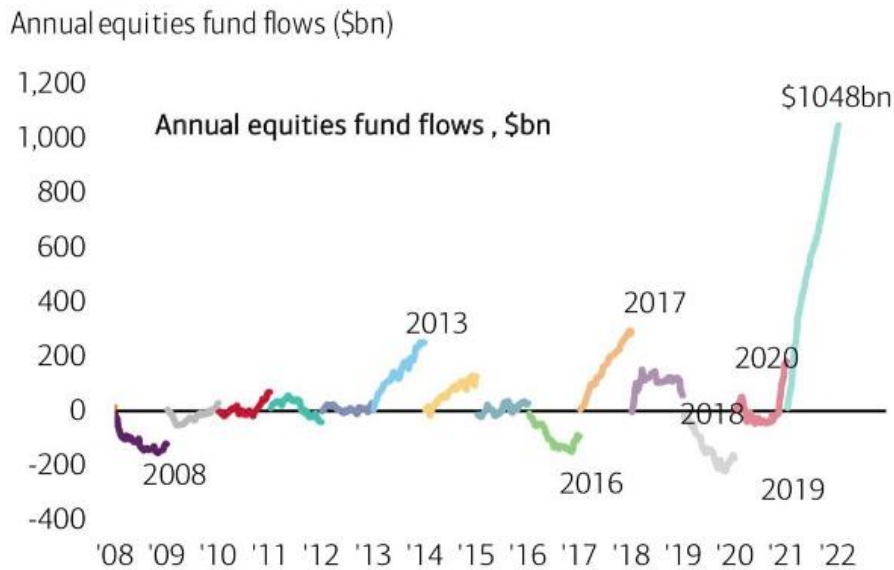
Chart 1: Worst case scenario for the S&P500 of reversion to the previous trend
S&P 500 on Log scale



Source: Bloomberg

This past week has seen several analysts focus on the extraordinary flows of capital into equities in the past year. It smacks of investors fearing losing out on opportunities in the equity bull market. BofA global strategists put an excellent graphic together that aggregates the equity flows from mutual fund data from EPFR. The data shows that 2021 has seen multiples of the usual flows of capital that go into equity mutual funds per annum (Chart 1). An aggregate flow of approximately 1 trillion dollars compares to a 13-year high of around \$300m.

Chart 2: Unprecedented Investor flows into equity mutual funds



Source: BofA Global Investment Strategy, EPFR

There are some key questions to gauge whether there could be a severe risk of more meaningful downside in equities in the coming weeks.

Global growth momentum lost? Global economic data has lost a good measure of momentum in recent weeks. The aggregate index of economic data surprises is at its lowest since June 2020, a level that we saw through the middle of a disappointing 2019. Economists' consensus forecasts are for a slowing of global growth from 8.5% year-on-year in Q2 to 5.3% in Q3. Economists have trimmed their estimates for Q3 by around one percentage point in recent weeks. Supply line disruptions, an inflation squeeze on households' real income growth, and selective lockdowns/worries about the delta variant have negatively affected growth. Nevertheless, a few of these issues look like they are solvable in the near term. Forecasts for growth solely based on reported data have a third-quarter growth rate of just 3.0% quarterly annualised for developed market economies.

Corporate earnings momentum lost? Over the last few weeks, there has been a loss of momentum in upgrades to corporate profit forecasts in Europe and the United States. Markets have already reflected that, declining around 1% over the past four weeks. Crucially, aggregate consensus earnings forecasts have remained stable, yet there are no signs of significant cuts in projections. In the next few weeks, at the end of the quarter, companies will

be assessing whether they need to provide any guidance to the market on earnings revisions as they end the quarter.

Monetary policy – a gradual tightening? If monetary conditions were measured just in terms of the rhetoric of central bankers, I think most commentators would admit that **global monetary conditions are on a slow, tightening path**. The Fed talks about tapering quantitative easing. The ECB last week announced that it would moderately slow the pace of its bond purchases in the next three months. Here, the swing central bank could be the Chinese central bank (PBOC). Given the recent very weak economic surveys, the PBOC may ease policy in the coming weeks. However, we suspect that PBOC easing will not be gung-ho. They are more inclined to offsetting the recent domestic weakness and the challenges in the bond market.

Investors will be on watch for signs of a policy mistake by the central bankers and or governments. Will the PBOC react quickly enough to a meltdown in the Chinese real estate debt market? Is the UK government too hasty in increasing taxes to pay for the impact of the pandemic on government debt?

After such a strong run, the global equity markets do look vulnerable, however, we believe that the balance of risks will be that investors will again buy the dip. Crucially global demand is still growing. It's just that suppliers are struggling to meet demand through a combination of supply line problems and shortages of labour, particularly in the United States. Demand growth for a product or service is failing to register as GDP growth due to these likely short-term challenges. As supply bottlenecks ease and people take up jobs, pent-up demand and low inventories will likely lead to a reacceleration of growth, which would be good news for the markets. Hence it feels that buying the dip will still likely be the right strategy.

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.