Market Insights & Strategy

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FAB Macro Strategy: Taking stock from the halfway line

- **Macro data offers us a relative check on the validity of reflation**
- **Risk asset sentiment buffeted by myriad socio-economic data**
- **Status quo warrants vigilant, idiosyncratic asset allocation and risk appetite**

Back in Q4 2020 the global macro outlook for 2021 was generally founded on cautious optimism. Rates were anchored, the fiscal policy sluice gates were wide open, particularly so in the wake of President Biden's election and the Covid-19 vaccination drive was well underway. Since then, financial markets have largely continued to price in a brightening horizon, notwithstanding a few road bumps and obstacles to risk asset sentiment along the way.

Consensus at the time was that the New Year would herald a turnaround in medical fortunes (a containment of coronavirus) and that global reflation would continue to gain positive momentum. Now that we have just past the half-way mark in 2021, it is appropriate to appraise where we are in that aforementioned reflation trade. Again, there is reason for optimism, but perhaps not to the extent that the world was holding its breath for back in late 2020.

The path of reflation so far

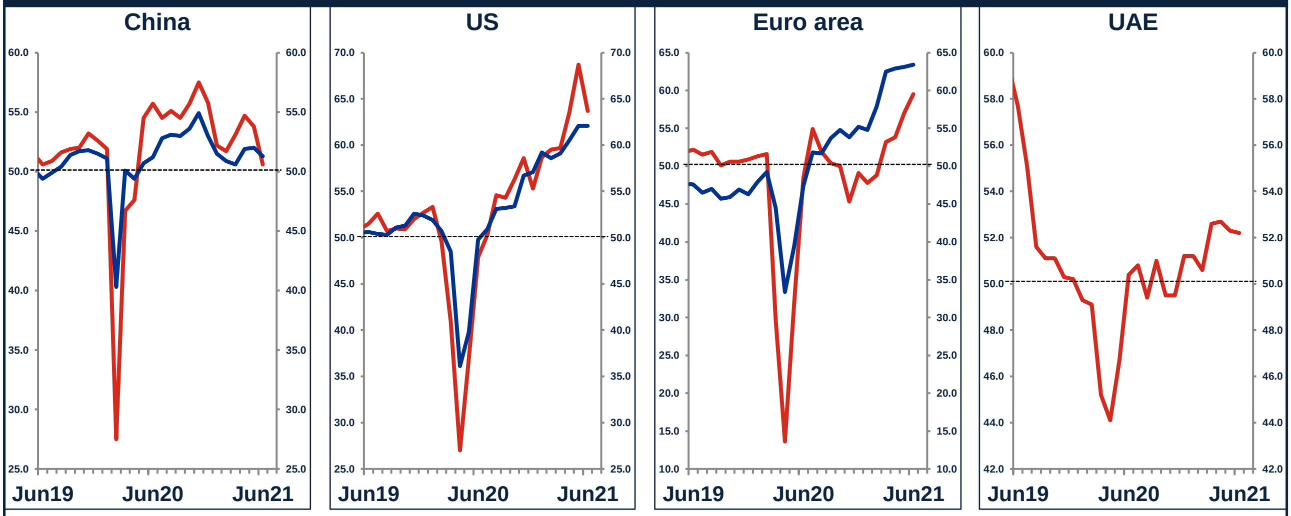
In this report we look at a broad selection of key macroeconomic and socioeconomic data points to highlight the relative strengths and weaknesses within the reflation narrative. With the data, albeit in no particular order, we will aim to corroborate or challenge the idea that the status quo will continue to reward the allocation of capital toward risk and incremental yield over the remainder of this year.

At the very best though, and as we have said previously, we resolutely maintain that current macro and interest rate uncertainties warrant a vigilant, idiosyncratic approach to asset allocation and risk appetite. This is no time for complacency.

PMI

PMI data continues to paint a picture of gradually improving macroeconomic conditions, with the indices for major geographies holding above the psychological 50 breakeven between economic contraction and expansion. That said, amid ongoing uncertainties over the path of economic activity going forward, elevated levels of Covid-19 globally and the spectre of new variants of the pathogen, the recent consolidation trend seen in China’s PMI data may suggest an easing of reflation momentum in the months ahead.

Tentative recovery

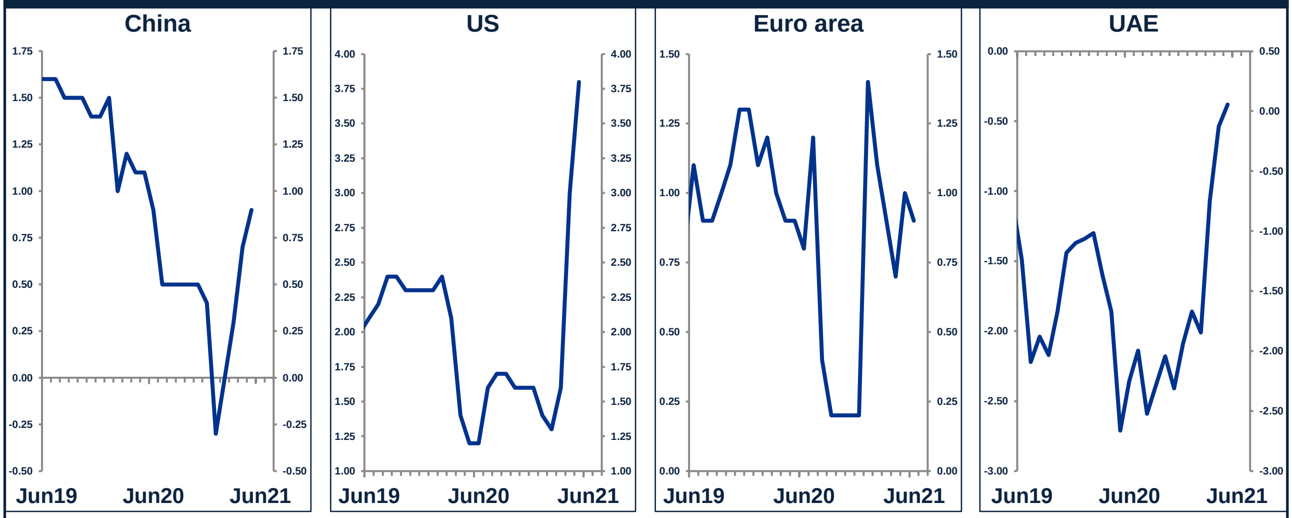


Reading above 50 indicates Expansion, below 50 indicates Contraction; Source: Bloomberg; FAB

CPI

Perhaps the key driver of robust and resilient investor sentiment over the past 18 months, in direct response to the pandemic-driven recession, has been the consistent loosening of monetary policy toward the zero bound. All major central banks have slashed interest rates in an effort to support and encourage economic activity. Of course, the natural first derivative cost of such ultra-accommodative monetary conditions has been inflationary price pressures, which in turn are fuelling concerns about possible policy tapering and then the future path of interest rates. With global CPIs running well ahead of the targeted 2% level, the debate in the near-term will focus on whether such price pressures prove to be ‘transient’ or become more structural. If the latter, the prospect of a return to central bank tightening could trigger a ‘taper tantrum’; it will all come down to how central banks communicate the policy transition.

The understandable cost of monetary stimulus



Source: Bloomberg; FAB

Labour market

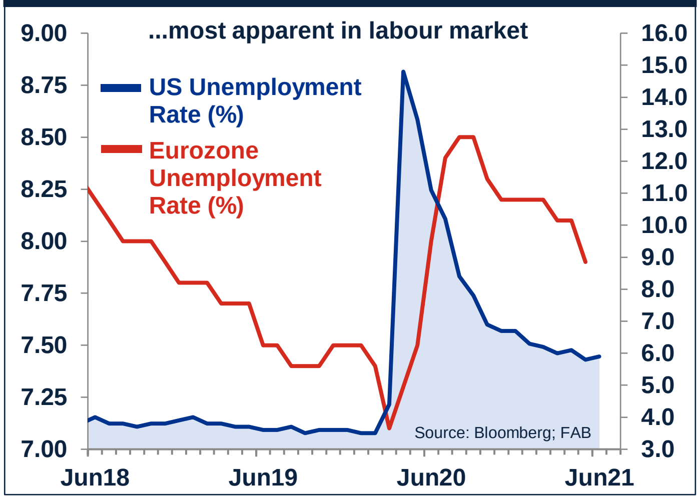
The global labour market was hit hard in H1 2020 by the lockdowns enforced across the globe in response to the pandemic in an effort to cauterise the spread of the Covid-19 disease. While recovery is underway current jobs market data highlights the structural fragility of the reflation narrative.

Both average hourly earnings and unemployment rates have begun the laborious recovery from the economic nadir in Q1 2020, but even while we are well off the spike in unemployment in April 2020 (U.S. unemployment hit a high of 14.8%) we are still a fair way off the historic lows seen in late 2019. The Fed among others will continue to chase - through careful monetary policy manipulation - the elusive holy grail of ‘full employment’ in the coming months.

Moreover, we would suggest that the world economy remains highly susceptible to downside correction risk, that could be triggered swiftly by any new ‘wave’ of infection requiring another bout of economic lockdowns. Bottom line: don’t get carried away in terms of pricing in reflation optimism at this stage.

Tightening jobs market...

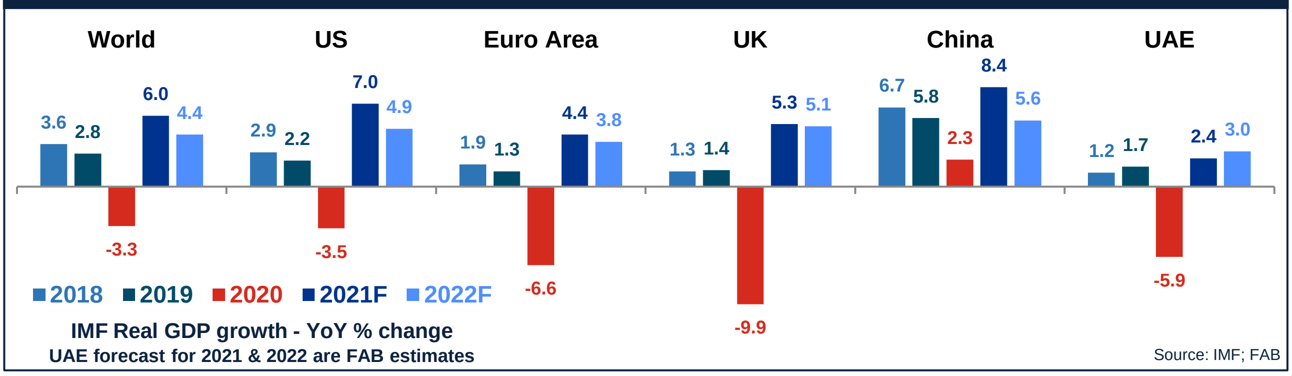
The structural impact of Covid...



Economic growth / GDP

The headline, go-to reference data in terms of economic conditions of course is Gross Domestic Product (GDP). The turmoil created by the pandemic during 2020 was highlighted by the implosion seen in GDP numbers around the world, with global GDP falling from around +3% trend growth in 2019 to a recession of around -3.5% last year. We expect the global economy to return to positive growth this year, with real GDP expansion of around +5.5%. Closer to home we also maintain our view that the UAE economy should return from (-4%) recession last year to positive expansion of +2.4% real GDP this year and +3.0% in 2022. This said, as discussed in our labour market analysis, the outlook for global GDP metrics remains highly susceptible to Covid-19 / economic downside risk. Discretion remains the better part of valour.

From feast to famine and back again



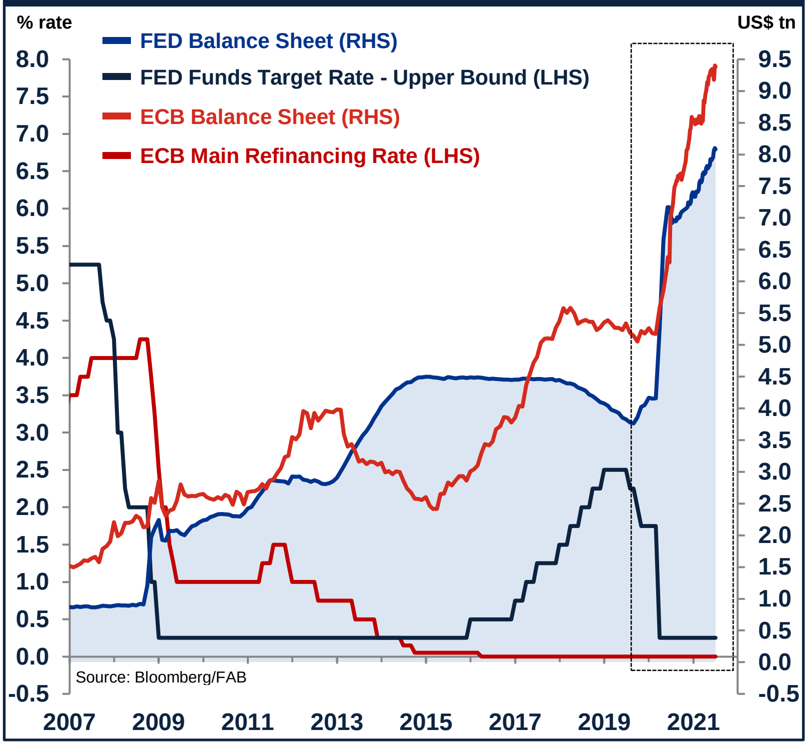
Monetary policy (conventional and non-conventional)

Central banks' key tool for encouraging or taming economic activity (and consequent inflationary pressures) comes in the form of interest rate setting. As discussed earlier, central banks around the globe slashed rates toward 0% in response to the pandemic. Since then, during 1H 2021, market debate has swung toward the possible timing of monetary policy beginning the 'normalisation' process, back to 'non-zero' territory. How central banks communicate this transition and the pace at which it is implemented will be key to how the market reacts; tantrum or otherwise.

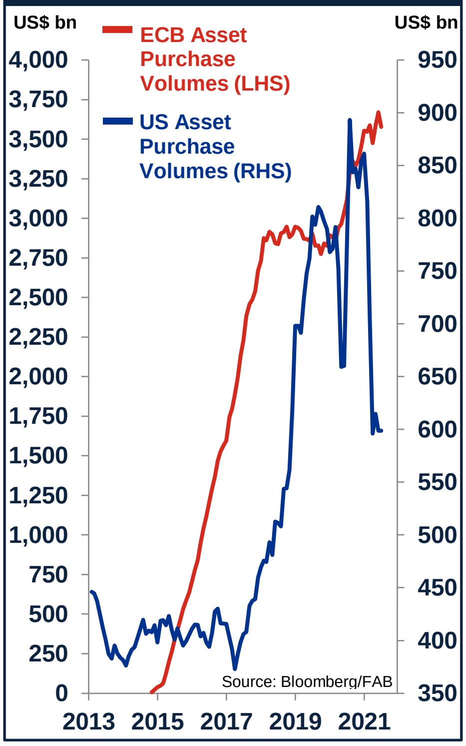
Central banks will be keen to normalise rates as soon as economic conditions allow, so as to return some ammunition to the chamber / liquidity to the wallet in case stimulus needs to be deployed again in the future as a result of a renewed surge in the pandemic and fresh economic lockdowns. But there is also widespread recognition of how disruptive a premature tightening bias could be. As such, while there is an acknowledgement that rates will need to creep higher over the coming quarters, the commitment to keeping rates 'low for longer' for now, until economic recovery has been proved to be sustainable, should continue to support investor sentiment and risk asset performance.

Given the latest evidence of reflation trends, as seen in aggregate macro data, we believe that the Federal Reserve could be in a position to tighten policy as soon as late 2022, although market pricing suggests the first Fed rate hike will come in Q1 2023. Other central banks may find themselves in a similar position, with the Bank of England perhaps in pole position to tighten overall given the recent strength of the UK recovery, albeit that the favourable year-on-year comparisons for (UK) data will like fade over the coming months, in turn easing some of that implied need to tighten policy.

Limbo dancing of central banks...



...amid commitment to recovery

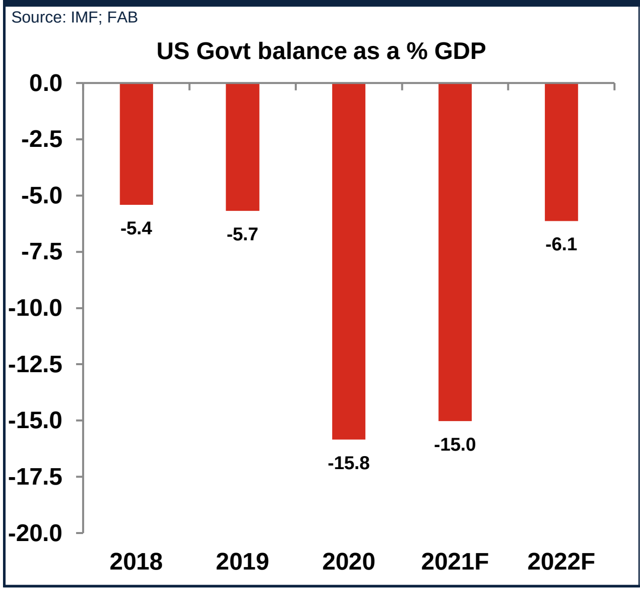


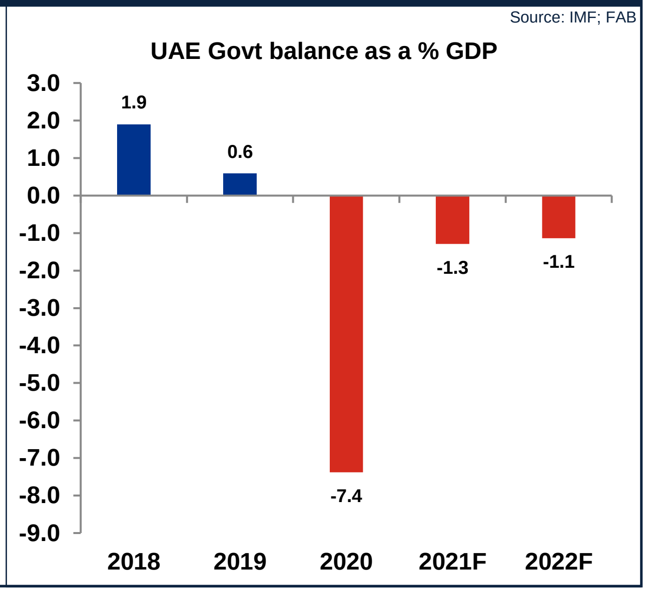
Fiscal stimulus

Government fiscal intervention designed to support socioeconomic conditions during last year's recession was historic and drove government debt toward record highs. The direct effect off this investment was to drive a sharp deterioration in government balances, from balanced to high single-digit deficits during the course of the pandemic. Returning government budgets back towards 'balanced' status is very much a work in progress and something that will not be fixed in sort order while the current macro and Covid uncertainties persist.

Nonetheless, budget deficits have begun to recede, in line with the favourable reflation narrative and that in itself must be seen as good news. The government budget here in the UAE will likely improve from a -7.5% deficit last year to a more modest -4% deficit this year before hopefully getting back toward balance budget territory in 2022 and 2023. This scenario corroborates the reflation story, but very much in line with a 'shallow-U-shaped' nature rather than a more hawkish 'V-shaped' evolution.

Emptying the government wallet



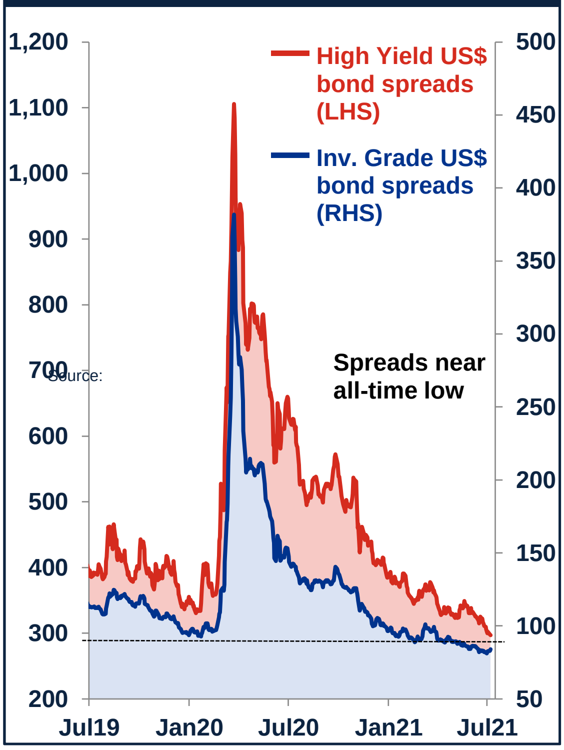


Equity & Credit market indicators/valuations

With equity benchmarks currently trading at record highs and credit market spreads having compressed toward their historic tights over the course of the last year - propelled ahead by loose monetary and fiscal policy - there is no arguing that strong reflationary trends are now being priced in to risk assets. Time will tell how sustainable this will be.

Full reflation optimism reflected in risk asset pricing

US quality curve

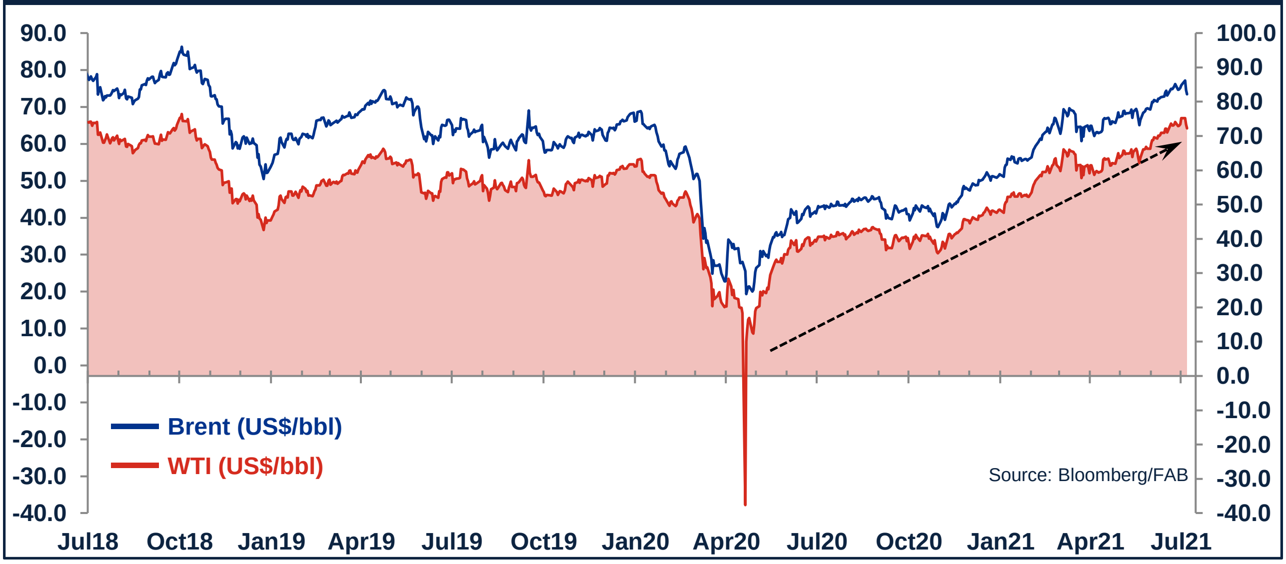


Oil prices

Oil prices have long been held as a key barometer of economic health. In times of economic fortune demand for oil, led in part by Asia's manufacturing base, generally helps to buoy the dollar price per barrel. Conversely, recessionary environments tend to see a deterioration in oil (and other input commodity) prices as economic activity - especially manufacturing - contracts. The trends seen in WTI and Brent crude prices over the past 18 months certainly sit with these scenarios, falling sharply in Q1 2020 as the recession took hold, before then staging a reflationary recovery over the past five quarters as central banks and governments flooded the world with liquidity to stimulate recovery.

Suggestions that OPEC+ may hold back additional supplies for longer than now required, have undoubtedly added to the recent strength in the oil price and to the extent that they may have propelled the sector to valuation levels beyond the value embedded in reflation alone. Nevertheless, with WTI and Brent currently trading in $70+/bbl territory, we would suggest that oil prices currently do corroborate rather than challenge the reflation narrative.

Corroborating the reflation narrative

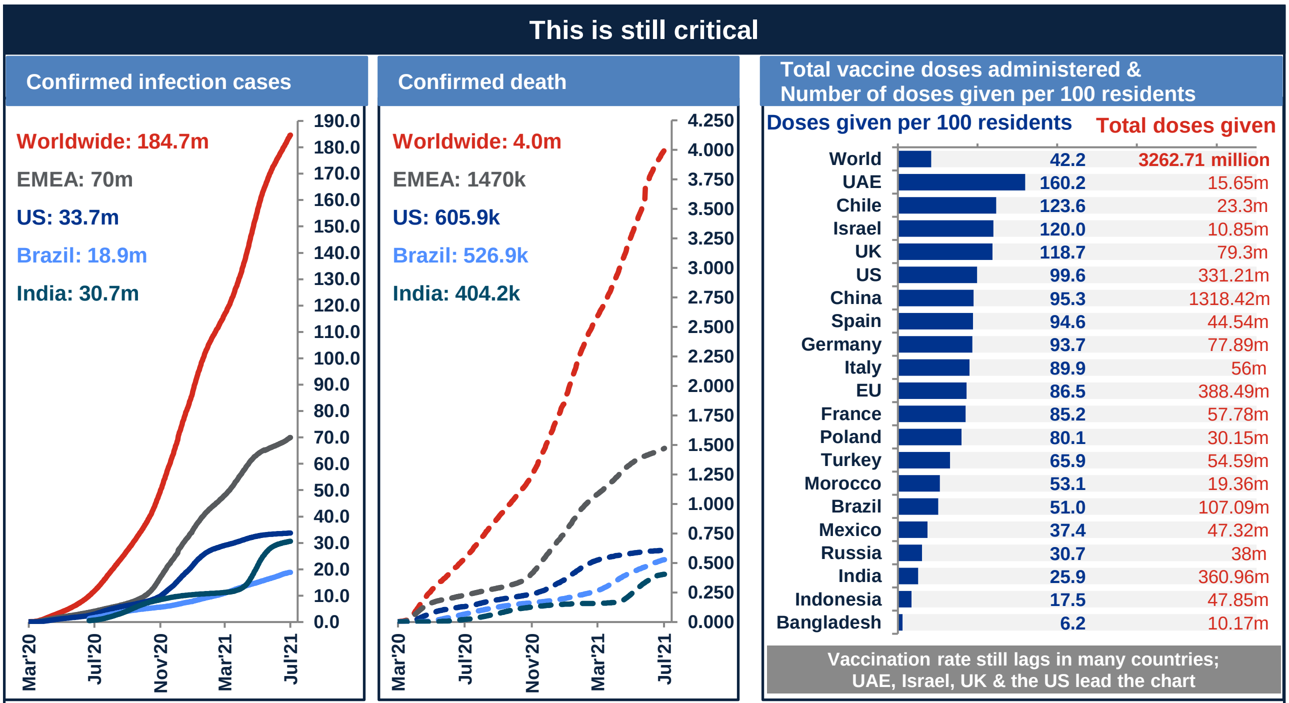


While interest rates anchored around the 0% bound and an improving macro backdrop would seem to vindicate the current strength in risk asset pricing for now, this situation is clearly highly susceptible to any correction in economic fortunes. Moreover, the flattening in the quality curve that we have witnessed over recent months means that the back end of the credit curve remains at greatest risk for any reversal in the economic outlook / renewed surge Covid-19 infection and spectre of fresh economic lockdowns. Playing devil's advocate therefore, one might suggest that current spread compression is a prime opportunity to scale up in quality and liquidity to hedge potential softening in the reflation narrative over the coming months as we move toward potential taper territory.

Covid-19

At the core of market direction over the past 18 months has been Covid-19. We can relate everything back to coronavirus. Indeed, the rollercoaster ride that we have experienced over the period has begun, ended and begun again with the pandemic and the discovery and implementation of an almost worldwide vaccination program. As such, while risk assets have been propelled higher in recent months by a strengthening global macro outlook, founded on the vaccine programs and subsequent declining hospitalisation and mortality rates, we are cognisant that we are susceptible to new (vaccine-avoiding) variants of the virus.

The evidence is clear. Across many parts of Europe (especially the U.K.) infection rates remain worryingly high, especially so given current government proposals to relax Covid restrictions as soon as possible in the coming weeks and months. We are mindful of the third wave of the pandemic currently striking the U.K., just eleven days ahead of the supposedly final (stage 4) easing of socioeconomic restrictions across England. Opponents of the government have called these moves as ‘reckless’. What does seem sure to us is that global markets will punish governments if they now get it wrong. In the context of the vaccine optimism-driven risk rally witnessed over recent months, if relaxing the restrictions now proves to be too far, too soon, thereby fuelling renewed, overwhelming infection levels and resulting in the need for renewed lockdown(s), the global market reaction would surely be sharp and violent.



Source: www.Oourworldindata.org / Bloomberg / Financial Times / FAB

It is therefore critical that we keep a close eye on the evolution of Covid-19 in the months ahead as governments begin the process of opening up their respective economies, but at the same time recognise the need to learn to live with the virus. Economic sentiment is right to rally on the current status quo, with global infection numbers appearing more manageable, but as discussed above we should be under no illusion that Covid-19 will be eradicated in the near-term; the U.K. is clear proof of that. Pricing in reflation, in the form of a ’shallow-U-shaped’ recovery as opposed to a sharper ‘V’ trajectory therefore seems most appropriate asset allocation strategy to us at this stage.

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