INVESTMENT STRATEGY
WEEKLY VIEW

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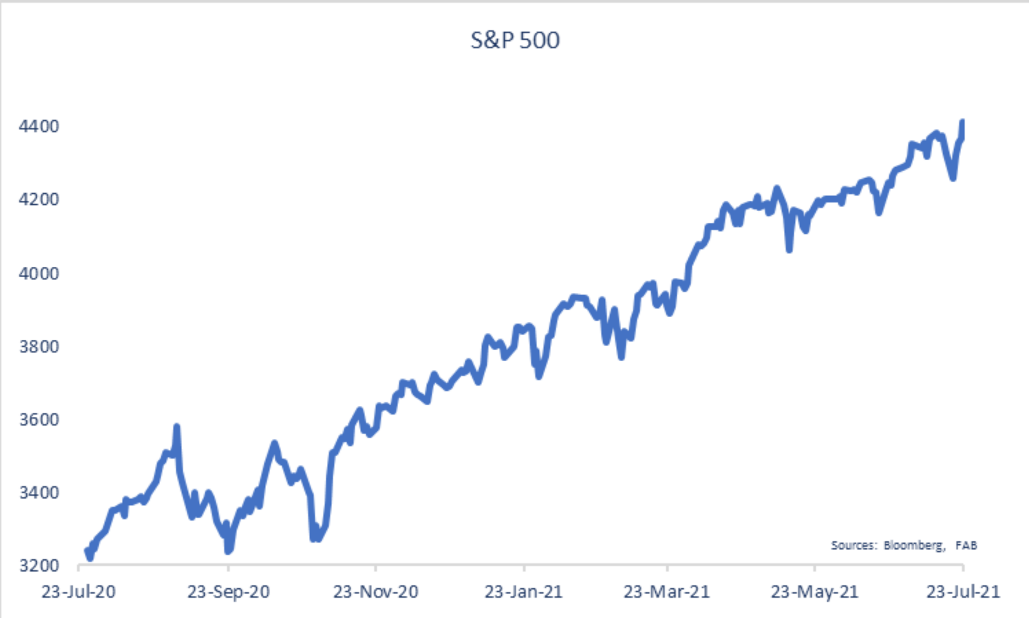
EQUITIES CONTINUE TO DISPROVE NAYSAYERS

July 25th 2021

- US stock indices closed the week at new records amid stellar earnings reports.
- So far, 87% of the companies that reported profits beat expectations.
- The S&P 500 closed at 4,411.79 on Friday, higher than the full-year forecast of 4,400 included in FAB's Global Investment Outlook.
- The FAB AAC is overweight in equities, IG and EM bonds. It is underweight cash and neutral in gold.



A long-running Wall Street joke says that bond analysts are constantly worried, while equity analysts are always upbeat. The mockery is not completely gratuitous: bond investors often focus on the broader economy and how that impacts a borrower's ability to pay back its debt, while stock-pickers tend to look more at the growth prospects of an issuer.

Sometimes both camps are aligned, but they often diverge, which is part of the reason why basic portfolio construction suggests splitting investments between both asset classes as a way to diversify risk. This year, however, has been one rewarding equity bulls, at least thus far.

The S&P 500 and the NASDAQ Composite both closed at new records last Friday, logging respectively 17.46% and 15.12% in year-to-date gains. The broader index closed at 4,411.79, breaching the 4,400 year-end forecast expressed in the FAB Global Investment Outlook published in January. That forecast was double the average Wall Street consensus of a 9% gain.

Perhaps more importantly, by the end of 2020, equity markets had rallied so much from their March lows that most analysts, unlike FAB, were incredulous about their ability to reach even higher ground. Those bearish forecasts, (more appropriate for bond investors), have been progressively crumbling.

Part of the reason the FAB forecast turned out right when most were bearish was because Clint Dove and Charles Marche, the forecast authors, recognized that this year's earnings estimates were too bearish, a view also espoused by the FAB Asset Allocation Committee. As these estimates were adjusted upwards, the market rallied to meet the new expectations.

The S&P 500 is up 17.5% year-to-date, and has breached FAB's 2021 forecast of 4,400

At the end of the year, the consensus estimate among Bloomberg analysts was for the average earnings per share of the S&P 500 to end the year at US$172.15. That number has been revised by more than 13% to US$194.62.

However, with nearly eight months of the year having gone by, investors are now looking at 2022 estimates instead. Those have not yet had such a severe rerating upwards. They started the year at US$199.16 for the S&P 500 and are at US$215.02, up less than 8%, but above the GIO assumption of US$210.

This suggests that, despite the strong rally seen so far this year, there could be room for more. In fact, analysts are again revising upwards their forecast for the next 12 months as a result of better than expected earnings in the US.

With nearly a quarter of the S&P 500 companies having reported earnings, 87% beat estimates, one of the highest beat -rates since Bloomberg began compiling them. The technology and the utility sectors have been leading the charge, but forecasts are proving too cautious in almost every sector.

It makes sense, since equities reflect the growth situation to some extent. This year could see the fastest global expansion since 2009, and even these forecasts have proven too bearish. In January, the IMF expected advanced economies to grow 3.9% this year. By April, it had revised that forecast to a 5.1% expansion. It may revise the number further upwards this week when it releases its July World Economic Outlook update.

Even economists at the Federal Reserve have been forced to come to terms with a much stronger-than-expected recovery. In December, the US central bank's summary of economic projections had a median estimate of 4.2% growth for the country in 2021. The latest update to those forecasts, in June, showed a median estimate of a 7% expansion this year.

This particular positive shift carries its own risks. If the Fed becomes convinced that economic growth is strong enough to spur lasting inflation, it could start tightening monetary policy earlier than expected, and this could stimy the recovery.

In fact, in the past, if the Fed changed its growth projections so starkly and predicted, as it did in June, that its preferred measure of inflation would average 3.4% this year (way above its 2% target), the central bank would have already started to tighten policy. However, last year the Fed changed its framework to allow shifting policy only when actual data starts to become a concern, instead of reacting to changes in its models and economic forecasts.

This means that, when the Federal Open Market Committee, the Fed's rate-setting body, meets this week, Chairman Jerome Powell is likely to continue to indicate that the Fed will keep policy as it is for now. Investors will still be watching for any change in tone, given that even the actual data is hot now.

US GDP data, for instance, is set to be released this week and is expected to show the US expanded at an 8.5% annualized rate in the second quarter. Core PCE, the Fed's preferred measure of inflation, is also due this week, and the median forecast among Bloomberg economists is for the measure to have risen 6% quarter-on-quarter, which would be its fastest rate since 1983, if confirmed. While the Fed's new policy framework allows it to look past such 'noise' in the data, the central bank is under increasing pressure to react.

It has, however, some support from the other side of the Atlantic. The European Central Bank announced this month that it adopted a similar framework revision to the Fed's, which allows it to react to the actual data instead of the signals given by its econometric models.

Growth there is also picking up, and the eurozone GDP data due this week is expected to reveal the bloc grew 1.5% quarter-over-quarter, which, if confirmed, would be its fastest quarterly expansion rate since it was created, excluding last year's anomalous third quarter.

The ECB's insistence in keeping monetary policy relatively easy regardless of this recent pick-up in growth is helping to fuel demand for US bonds too. The yield on the 10-year US Treasury has fallen 19 basis points so far in July, partly spurred by strong foreign demand for US government bonds.

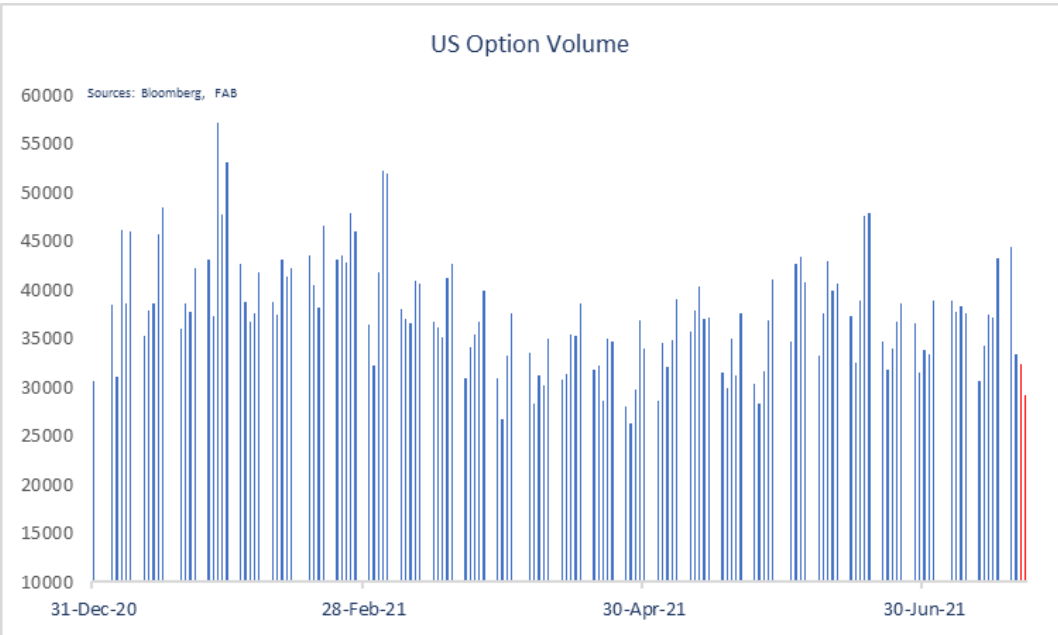
Between January and May (the latest available data), foreigners bought US$527.1 billion of US Treasuries, according to government data. That has more than reversed the US$155.3 billion of outflows the asset class had seen between June and November of last year. Strong demand for swaps suggests global investors are still buying US Treasuries.

This bond appetite, along with continued buying from the Fed, are helping keep US Treasury yields low, and the 10-year yield closed at less than 1.28% on Friday. However, unless inflation starts falling later this year, investors are likely to start demanding higher returns to lend to Washington.

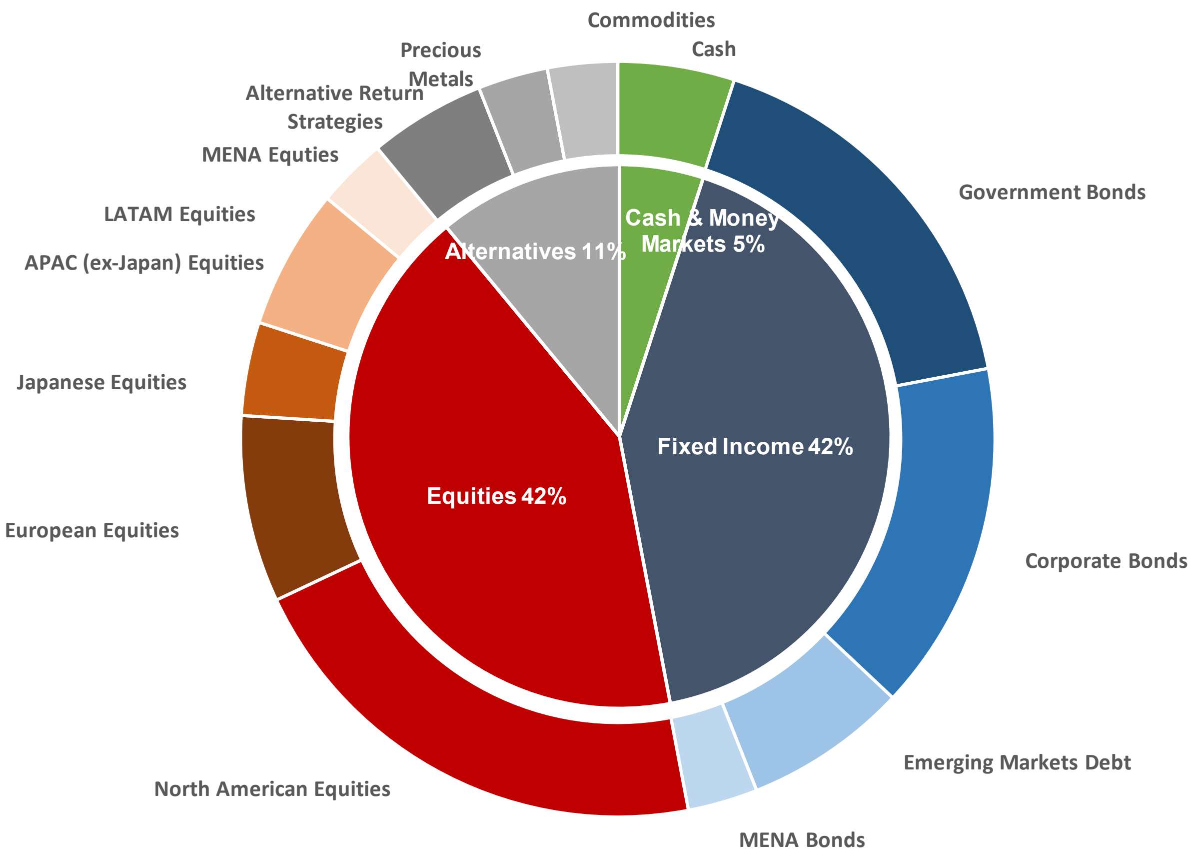
Another reason why Treasuries have moved so sharply in the past month has simply been due to lower-than-usual liquidity. Between the Fed and most other central banks, which are mostly buy-and-hold investors, a good part of the Treasury market is now 'captive'. The traders of those bonds that still float also seem to have taken their summer vacations, after having forgone them last year amid the pandemic.

This suggests a small note of caution: while there is plenty of reason to be bullish about risk assets and to expect yields to remain low, the markets have become so illiquid in recent weeks that short-term moves may not be indicative of where asset classes are headed for the rest of the year. Still, the US economy is stronger than ever, so equity bears should beware.

US option volumes have fallen to very low levels as traders seem to be on holidays



Asset Class	Positioning	Detail
Cash	Underweight	Putting cash to work in risk assets.
Fixed Income	Overweight	Keeping a slight overweight focused on EM dollar debt and on corporate investment grade bonds
Equities	Overweight	Slightly overweight in Asia ex-Japan and US markets.
Alternatives	Underweight	However, reducing the underweight in hedge funds



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