INVESTMENT STRATEGY
WEEKLY VIEW

بنك أبوظبي الأول
FAB
First Abu Dhabi Bank

For inquiries related to this article, please contact:
Christofer.Langner@bankfab.com

RISK ASSETS CONTINUE TO GRIND HIGHER

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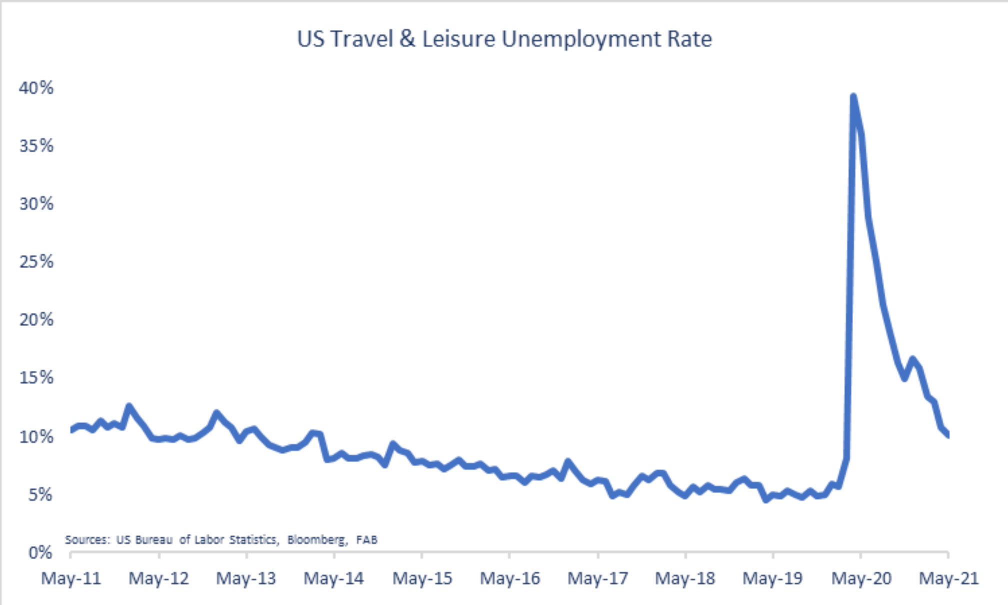
- US unemployment fell to 5.8% after 559,000 jobs were created in May and the numbers for April and March were revised higher.
- This week, the Bureau of Labor Statistics is expected to say year-on-year inflation was 4.7% in May.
- Amid the strong numbers, the Fed has started to talk about talking about tapering.
- The FAB AAC is overweight in equities, IG and EM bonds. It has also just increased its exposure to hedge funds.



The leisure and hospitality jobless rate has dropped but remains historically high

When everybody expects a surprise, it stops being a surprise. This platitude could be a good summary of where markets seem to be right now. Economic numbers in the US continue to show a quick recovery and higher inflation numbers are all pointing to the possibility that the Federal Reserve could start reversing some of its extraordinary monetary policy earlier than expected. Not only that, Fed officials have started talking about it more openly, too.

Before the 10-day blackout period that precedes the next meeting of the Fed's rate-setting Federal Open Market Committee, on June 15th and 16th, several officials, including the Vice-Chairman, Richard Clarida, suggested they are ready to start setting a timeline to cut down on asset purchases that increase monetary liquidity. So many comments suggest that the Fed could even begin that conversation officially in the next meeting. In fact, Fed officials probably found additional reason to do so in the latest economic numbers.

On Friday, the Bureau of Labor Statistics said that 559,000 new jobs were created in May, less than the 675,000 median forecast of economists surveyed by Bloomberg. The miss was far less severe than April's, when economists were hoping for 1 million jobs having been created but only 266,000 were. It was still big enough to indicate that forecasters are expecting the recovery to be faster than it has been. To be sure, the Bureau of Labor Statistics did revise the numbers for March and April higher by a combined 25,000 jobs. That is good news, but there still is an argument for the Fed to be cautious about reducing liquidity in the US economy by too much.

Considering the latest number, the US economy created on average 478,000 monthly jobs year-to-date. That would normally be a high average, but it means that, if the current pace were kept, it would take more than a year to bring total employment in the US to the level it was at before the pandemic. The trouble is that the current pace may not hold.

Job creation in the leisure and hospitality industry is already starting to slow down. Hotels, bars and restaurants were responsible for more than half of the 1.6 million jobs created over the past three months. However, they created 292,000 new positions in May, compared to 331,000 in April. Sounds like a lot, but there still are 2.5 million fewer jobs in the sector than there were before the pandemic.

Hence, while the Fed may start talking about adding less liquidity to the system, the central bank is unlikely to come even close to raising interest rates for at least a year. Fed officials have repeatedly said they want unemployment to fall back to 4% from the current 5.8% before they raise rates.

Inflation, however, is becoming harder to ignore. In the same employment report of Friday, the Bureau of Labor Statistics said that average hourly earnings increased 0.5% over the month of April. In normal times, any increases larger than 0.2% a month would raise red flags. Wage inflation is often seen by economists as stickier than rising goods and services prices, which could be increasing due to temporary factors.

Those fleeting elements are likely to come into focus this week again when the Bureau of Labor Statistics releases its monthly consumer price index. The median forecast of economists surveyed by Bloomberg is for the year-on-year increase in the index to be 4.7%, which would the highest print since 2008. Last month, economists had forecast that this inflation measure could come at 3.9% and it came at 4.2%.

Part of the reason why the print is expected to be so high is because the consumer price index fell in the months of April, May and June of last year, so this year's figure compared to that lower one becomes much higher, the so-called 'base effect'. Last month's print, however, was also high on a monthly basis, having increased 0.77%, the most since 2009.

The combination of accelerating inflation, even on a monthly basis, and bigger wage increases even as unemployment remains high has prompted some economists to suggest the risk that the US falls into a stagflation environment. That, however, seems unlikely. Much of the reason why unemployment remains high and prices are increasing faster is due to temporary supply shortages.

Last month, the rise in CPI was especially pushed by car and truck prices, which increased 10% month-on-month. The rise came as many automakers reduced output in recent months amid a chip shortage that has also impacted other industries. As a result, even some car rental companies (which usually sell their used cars) were buying used cars to replenish their fleets, and helped push prices higher.

A similar dynamic could be unfolding in the labour market as schools in many US states remain closed, forcing some parents to hesitate about going back to work. And because of the extra welfare checks, they probably can afford not to. If that is the case, then once school restarts in September, assuming kids will be allowed to go to classes in person, many more parents will go back to work. Especially because, at that point, the extra stimulus payments will have expired too.

In fact, the education industry alone could contribute 1 million new jobs when schools fully reopen, judging from the past numbers for the industry. The Fed's governors are seeing this and calculating these numbers and starting to consider whether it is time to begin tapering their monetary easing in their next meeting, on June 15th and 16th. In effect, the Fed has already started to unravel some of its extraordinary policy. Last week, the central bank said it would close the corporate credit facility, through which it bought high-yield bonds and ETFs.

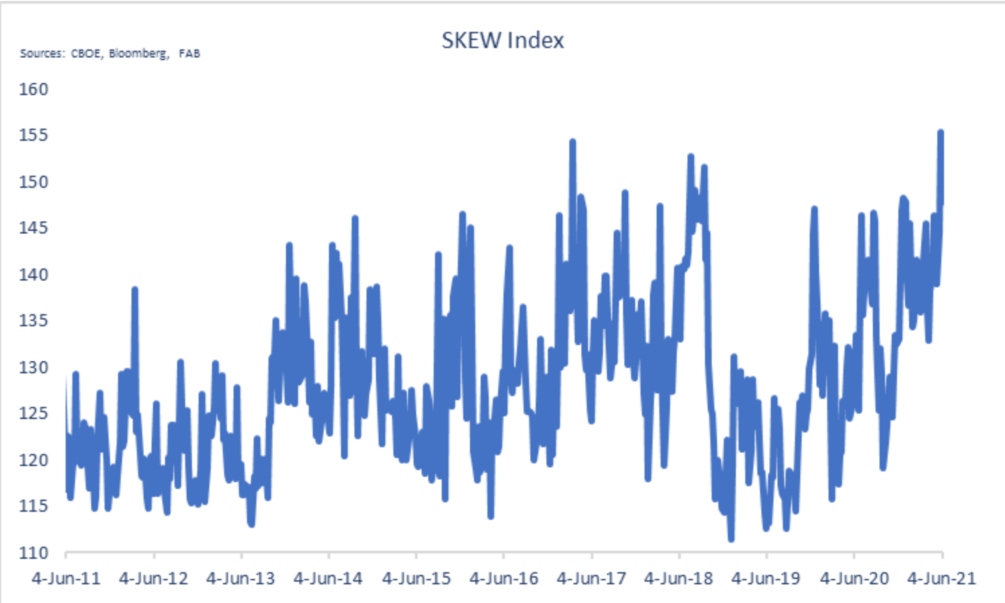
The Fed only had about US$13.6 billion in assets under this facility as of its last report, from April. Even if it sold its entire holdings, it would be a drop in the US$1.7 trillion ocean of the US high-yield market. Indeed, the yield premium of the Bloomberg US High-Yield index ended the week almost unchanged at 297 basis points, only 11 basis points higher than the lowest premium the index has ever registered.

While such an uneventful taper of these asset purchases would suggest investors should not be concerned about the Fed's decision to reduce monetary stimulus, money managers seem to be doing just that: worrying. The SKEW Index of the Chicago Board Options Exchange was near its highest in a decade last week. This index is seen as a measure of how much protection investors are taking against a large downward move in the US stock market and such a high level suggests there is a lot of fear of this happening.

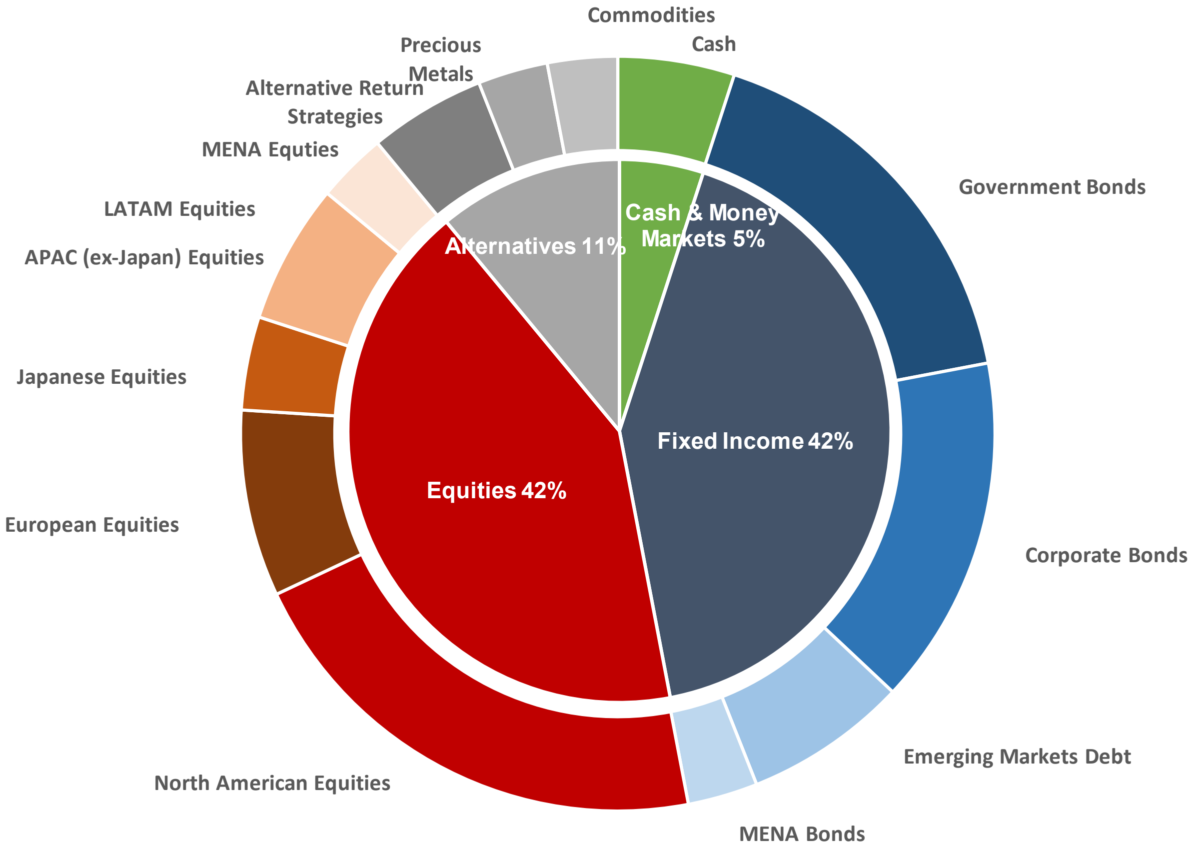
Other indicators are also showing this. Money market funds and reverse repo facilities have seen significant increases in assets recently, a sign that many investors are raising cash in preparation for a downward move in the market. It makes sense, given the usual low liquidity of the months of June and July and the potential for an announcement that the Fed will start tapering its asset purchases soon. Plus, the month of June is also when many funds close their quarterly positions and large numbers of options mature.

The trouble, however, is that it seems like everyone is prepared for a sudden market dislocation. Hence, if the market drops, many fund managers will be taking profits on their bearish positions and others will be deploying the cash they have set aside. That could curb any correction and help the market continue to grind higher.

A measure of protection against a big drop in stocks is near the highest in 10 years



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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