INVESTMENT STRATEGY
WEEKLY VIEW

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STOCK MARKETS KEEP MAKING NEW HIGHS

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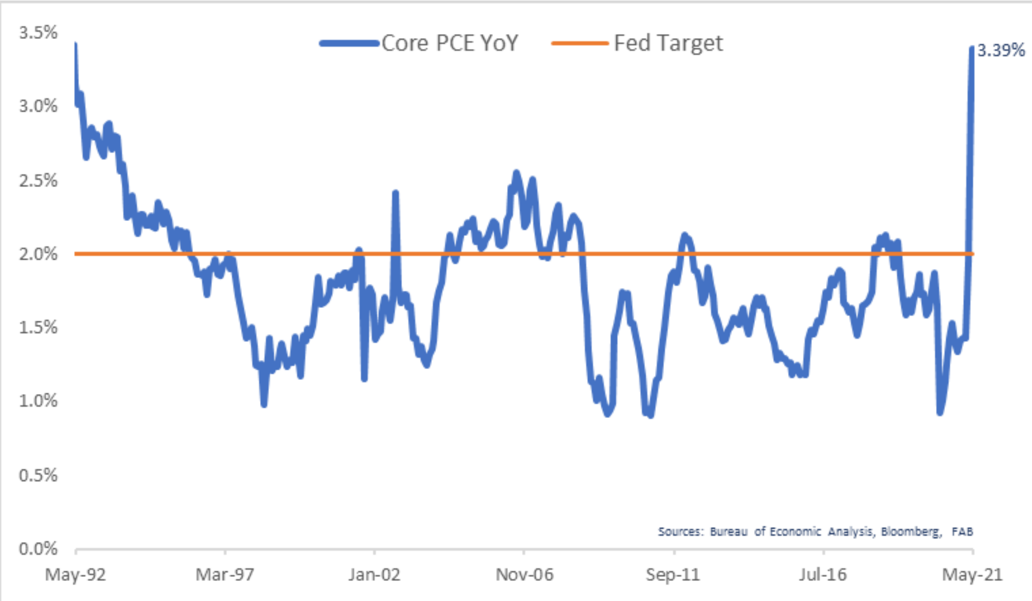
- The S&P 500 closed at a record on Friday while the NASDAQ Composite hit new highs last week.
- The 10-year Treasury yield began to rise again after inflation hit the highest in almost 30 years.
- This week will see if job creation in the US is keeping up with inflation.
- The FAB AAC is overweight in equities, IG and EM bonds. It is also underweight cash and neutral in gold.



The Fed's preferred measure of inflation hit the highest level in about 29 years in May

Inflation is often seen as something bad but it can also be a sign of something good. When prices are rising because people have money to spend, and the economy is growing strongly, inflation is actually good, as long as it does not stick and keep moving ever higher.

This is the conundrum facing the Federal Reserve. The policymakers in the central bank know that the inflation being seen in the US now is for a good reason. It means people are going to stores, to restaurants and getting on airplanes, and that jobs are coming back. However, the magnitude of the recent prints and the amount of fiscal and monetary stimulus currently in the global economy suggest some caution about the potential for the inflation to keep going.

Last week gave the latest warning salvo to the Fed. The core personal consumption expenditure deflator for May, the key inflation measure the Fed watches, came in at 3.4% year-on-year, the highest level since April, 1992. Much of the size of the figure can be attributed to the fact that May of last year was when the US economy, and prices, took the biggest tumble, amid strict lockdowns across most of the country.

The inflation figure was enough to rekindle some reflation trades that had become less popular in the month of June. The difference between the yield on the 10-year and the two-year US Treasuries increased by 3 basis points on Friday alone, after the release of the PCE numbers, following a month in which it had fallen by more than 20 basis points. The yield on the 10-year US Treasury alone increased by 8.6 basis points last week.

Investors had plenty to celebrate, too. On June 24, President Joe Biden announced that a group of senators had reached a bipartisan deal to pass a US$579 billion, five-year infrastructure bill. While far short from the US$2 trillion the President had originally envisioned, the additional spending is enough to boost growth further in the next five years in the US.

This, on top of the Fed's projected growth of 7% this year, and 3.3% next year, could boost corporate earnings further going forward. Investors reflected this on stock prices, giving a boost in particular to shares of companies that benefit when the economy grows faster. The Dow Jones Industrial Average rallied 3.44% last week, outperforming the tech-heavy NASDAQ Composite, which gained 2.35% in the week.

The boost to cyclical stocks along with the continued strength of technology-related shares pushed the S&P 500 up by 2.74% and the index marked a new high on Friday, closing at 4,280.7. Similarly, the more cyclical MSCI Emerging Markets index rose 1.35% last week too, reversing some of the 1.5% losses of the previous week.

In similar fashion, the US Dollar index fell 0.41% last week, its first weekly drop in five weeks. This helped to boost gold prices by 0.98% last week and fueled a 1.65% weekly gain for the broader Bloomberg Commodity index. Copper prices also rose 2.95% supported by the prospects of more demand from infrastructure spending in the US, along with a weaker dollar. However, oil prices were the big driver of commodity prices.

Brent crude prices rose 3.63% last week and closed at US$76.18, the highest level since October 2018. The move was buoyed by estimates from some investment banks that the recovery in oil demand has created a supply shortfall of about 3 million barrels/day.

Last week, the US Energy Information Administration reported that crude inventories in the country had fallen by 7.6 million barrels, the seventh week in eight that commercial oil reserves dropped. Total US inventories of oil have dropped 42.8 million barrels since the beginning of April, the biggest second quarter drawdown in at least 10 years, providing evidence that demand is outstripping supply.

Whether that will continue to be the case will become clearer this week after the monthly meeting of the OPEC+. The group had committed to start bringing back some of the nearly 5 million barrels/day of oil they are still holding back from producing. There is a soft commitment to bring back some 800,000 barrels/day, but some of the members have started to suggest it may be time to open the spigots a bit more.

Russia, for one, has indicated it would like to increase output. Prince Abdulaziz bin Salman, the oil minister of Saudi Arabia, which has been leading the effort to reduce global supply, indicated that he is amenable to some action to temper rising global prices, acknowledging the impact that energy can have on broader price movements.

However, Prince Abdulaziz bin Salman has also made an effort lately to keep markets guessing. While he has an inherent incentive to increase production especially in his country, — which has seen slightly weaker recent economic growth due to the curbs — he also probably is seeing value in the higher crude prices that the curbs have brought about.

Most oil-producing countries in the Gulf Cooperation Council have reaped significant benefits from the higher prices. Almost all of these nations had forecast that Brent crude would average US$45/barrel this year, which left many with deep gaps that would have to be filled with borrowing. Instead, Brent crude has averaged US$64.89/barrel so far this year.

This difference means that, all things remaining equal, most governments in the group, with the key exception of Kuwait, is probably running a healthy surplus so far this year, even when lower production is accounted for.

Some have started to boost spending but this is ultimately positive for the region too.

What is positive for the GCC countries, however, could have wider implications that may backfire, and this is what Prince Abdulaziz bin Salman has started to acknowledge.

While the Fed watches core PCE inflation, which excludes energy and food costs, oil prices eventually feed into everything else. Hence, if oil keeps rising, the inflation which now seems to be transitory could become stickier.

That could push the Fed into tightening monetary conditions, which could then curb demand for oil and have a broader impact on the economic growth of Middle-Eastern countries which have their currencies pegged to the dollar.

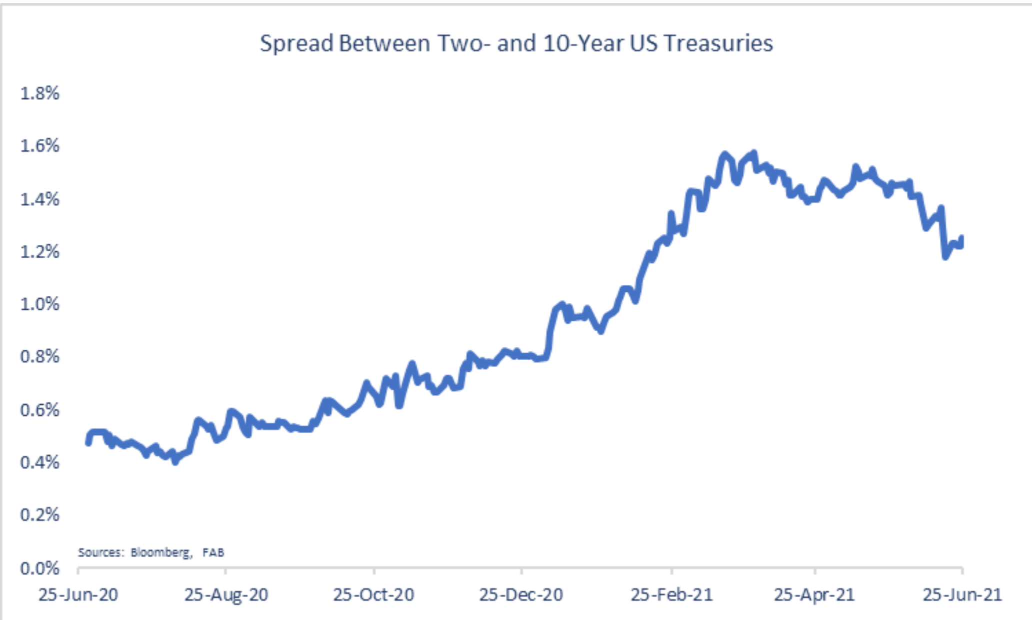
Hence, through a tortuous path, this week's decision by the OPEC+ may impact what the Fed does next. If the group decides to increase output and puts a cap on oil prices, it could allow the Fed to delay its monetary tightening decisions.

The kicker is that keeping oil prices under control could also boost growth in the developed world, as consumers would have to commit less of their wages to filling the gas tank and more to spending in goods and services. This scenario would see the kind of slow burning inflation that boosts growth but does not cause too many negative side-effects.

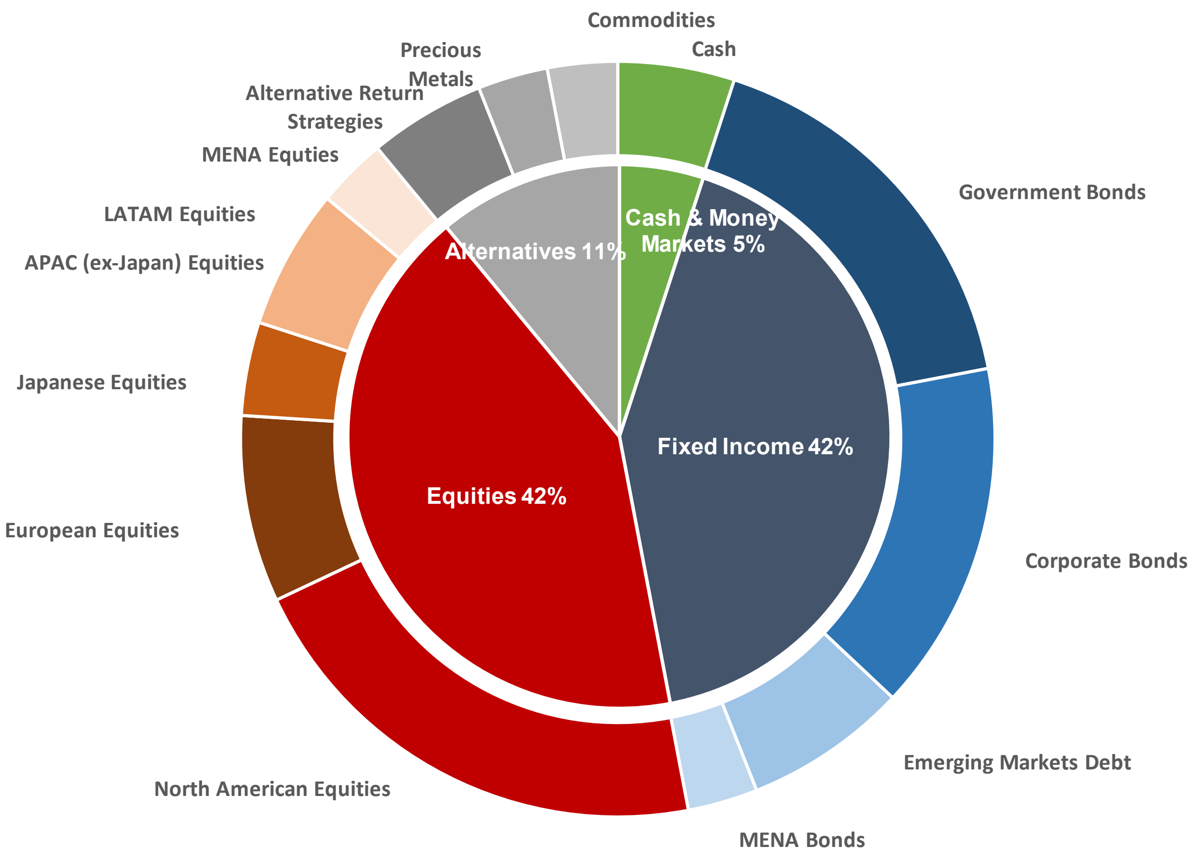
If, on top of that, rates remain low, then the world will have enough time to heal and highly leveraged companies will be able to fully recover, creating more jobs.

Independent of gas prices going up, however, the global reopening is bringing about strong growth that will increase the number of jobs available and increase profits across the globe, all of which suggests that investors should remain invested in risk assets.

The US Treasury curve has flattened by some 20 basis points in the month of June



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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