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First Abu Dhabi Bank

INVESTORS RECONSIDER WHEN THE FED SHOULD RAISE RATES

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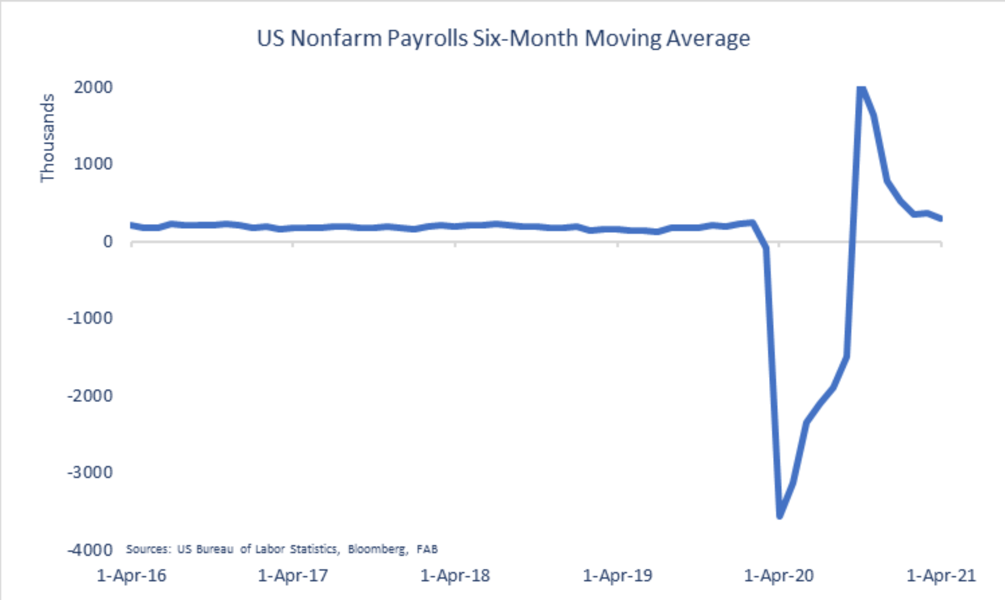
- The US created 266,000 jobs in April, far fewer than the 1 million economists expected.
- The S&P 500 and the Dow Jones Industrial Average hit records after the report.
- The less heady speed of job gains suggests the Fed is under no pressure to tighten its monetary policy.
- Inflation numbers this week, however, could prompt some reassessment of that.
- The FAB AAC is overweight in equities, IG and EM bonds and gold, and is underweight in alternatives and cash.



Since its inception in 1913, the US Federal Reserve has had the dual mandate of keeping inflation at a minimum and employment at the highest possible. The definitions of what these two mandates mean have changed over time, but the mandates have not. Over the past 40 years, following a period of accelerated price increases, there has been a lot of focus on the inflation part. Since the 2008 Global Financial Crisis, employment has come back into focus and, it could be argued, it is now taking precedence over the issue of rising prices.

This is why stocks rallied on Friday in the US after the nonfarm payrolls revealed that 266,000 jobs were created in April, far fewer than the 1 million median forecast of economists surveyed by Bloomberg. Normally, such a big miss would send stocks plunging, especially considering there are still some 8.2 million fewer jobs in the US than there were before the pandemic. However, the low jobs creation number means that the Fed will really be in no hurry to reduce monetary stimulus.

The central bank had already been signaling that stance very clearly, but investors were betting that a faster-than-expected recovery could force the Fed's hand into tapering asset purchases as early as this year. If job creation continues at the pace of April, however, that monetary tightening is thrown further into the future. The Fed does not emphasize the headline jobs or inflation numbers either. In the case of nonfarm payrolls, for instance, the Fed tends to look at the six-month moving average, instead of the volatile monthly figures.

Economists expected 1 million US jobs to be created in April, but only 266,000 were

Together with a 146,000 downward revision to the March figures, the April nonfarm payrolls pushed the six-month moving average job creation to about 294,000. Before the pandemic, that would have been amazing — very few times in postwar history has the US created so many jobs.

However, in February, 2020, there were 152.5 million people employed in the US, compared to 144.3 million at the end of April. The Fed wants that 8.2 million jobs gap to be closed and at the current six-month average rate, it will take more than two years for the US to go back to full employment.

This may be part of the reason why stocks rallied after the disappointing economic numbers on Friday. The S&P 500 closed at an all-time high of 4,232.6 and the Dow Jones Industrial Average hit a new record of 34,777.8. The NASDAQ Composite gained 0.88% on Friday to close at 13,752.2, still some 2.7% below its record of 14,138.8 reached on April 26th.

The tech-heavy index has underperformed the broader indices as investors focus on the global economic reopening. The NASDAQ Composite is up 6.7% so far this year, while the S&P 500 has risen 12.7% and the Dow Jones Industrial Average has gained 13.6%. A significant part of this difference could be attributed to investors weighing how much further technology companies can increase revenues in the short-term after benefiting from a global shift to online commerce and work last year. Meanwhile, traditional businesses should see their revenues increase in the coming months as the world reopens.

In fact, some of those dynamics were reflected in the nonfarm payrolls report. The employment category that saw the biggest losses was couriers and messengers, which saw jobs fall by 77,000. Meanwhile, employment in leisure and hospitality increased by 331,000.

Another indicator of the retreat of the pandemic environment back to a more normal economy was seen in the retail jobs section: there were 49,000 fewer jobs in food and beverage retail outlets, while 39,000 new jobs were created in sports, hobbies, personal care and clothing stores. These numbers could almost be translated into there being fewer people working in the supermarket aisles stacking toilet paper and more people getting jobs selling clothes and sneakers.

Looking at these numbers and comparing them to the market performances year-to-date suggests that investors have been right to put their money into 'value' stocks which are represented by the old economy. That, however, does not mean that technology shares will stop rising. The employment report noted that 18% of people employed were still working from home, which requires more technology. That compares to a negligible share before the pandemic. And while that is down from 21% in March, some of the shift is permanent.

The initial shift to working from home in the second quarter of last year caused the biggest spike in productivity of the US economy since 1970. While some of that is wearing off, investors have not, perhaps, considered the full impact of such a rise in productivity. For traditional economists, that usually means that potential economic output will increase in the future, meaning the US can grow faster without having to incur too much more price inflation. This is part of the reason why the FAB Asset Allocation Committee remains bullish on stock markets, particularly in the US, because higher economic output often translates into higher revenues over time.

In the meantime, however, investors could turn their attention to inflation again, even though the jobs number on Friday was a reminder that they should not expect the Fed to do anything for a while. This week the US will reveal its Consumer Price Index numbers for April. Economists expect the broad number to come in at 3.6% and the core number, which excludes food and energy costs, to come in at 2.6%. The Fed focuses on the less volatile core number. However, it does not look at the CP, but at the core Personal Consumption Expenditure rate instead, which is not published until May 28th. Still, even that figure is likely to be high this month due to the deflation of April, 2020.

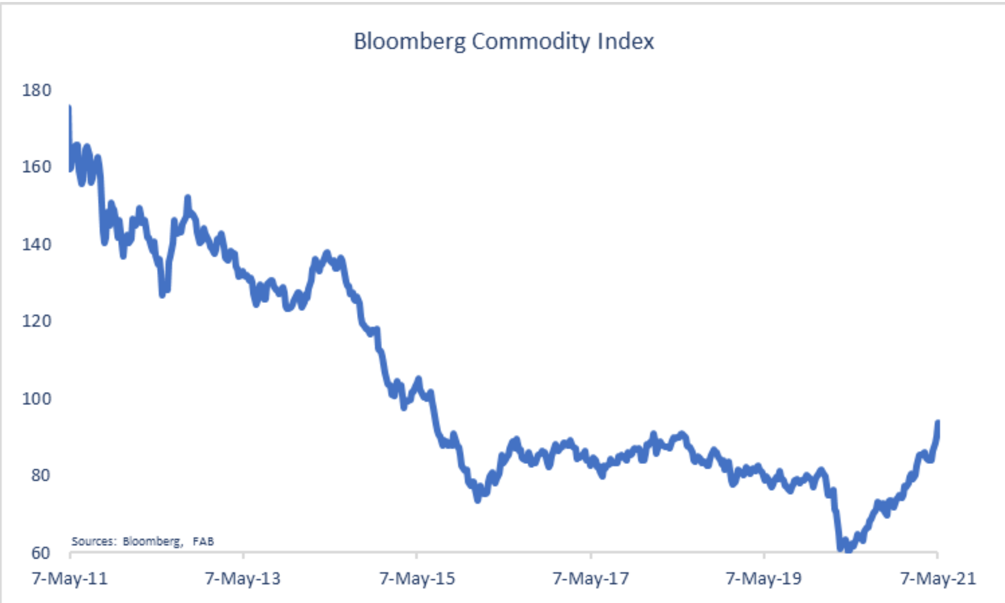
Economists are forecasting the core PCE could come in at 2.5%, way higher than the 2% target of the Fed. That still does not matter, however, because last year the Fed changed its framework and it now can allow inflation to run hot for several months as long as unemployment remains high.

What investors and economists are struggling with is just how hot inflation will be allowed to run and for how long. Part of the reason why the CPI this week will be so high is because the index fell in April and May last year, so a year-on-year comparison leads to a much bigger rise. There are other reasons, too, though, and commodity prices, for one, are signaling at accelerating inflation.

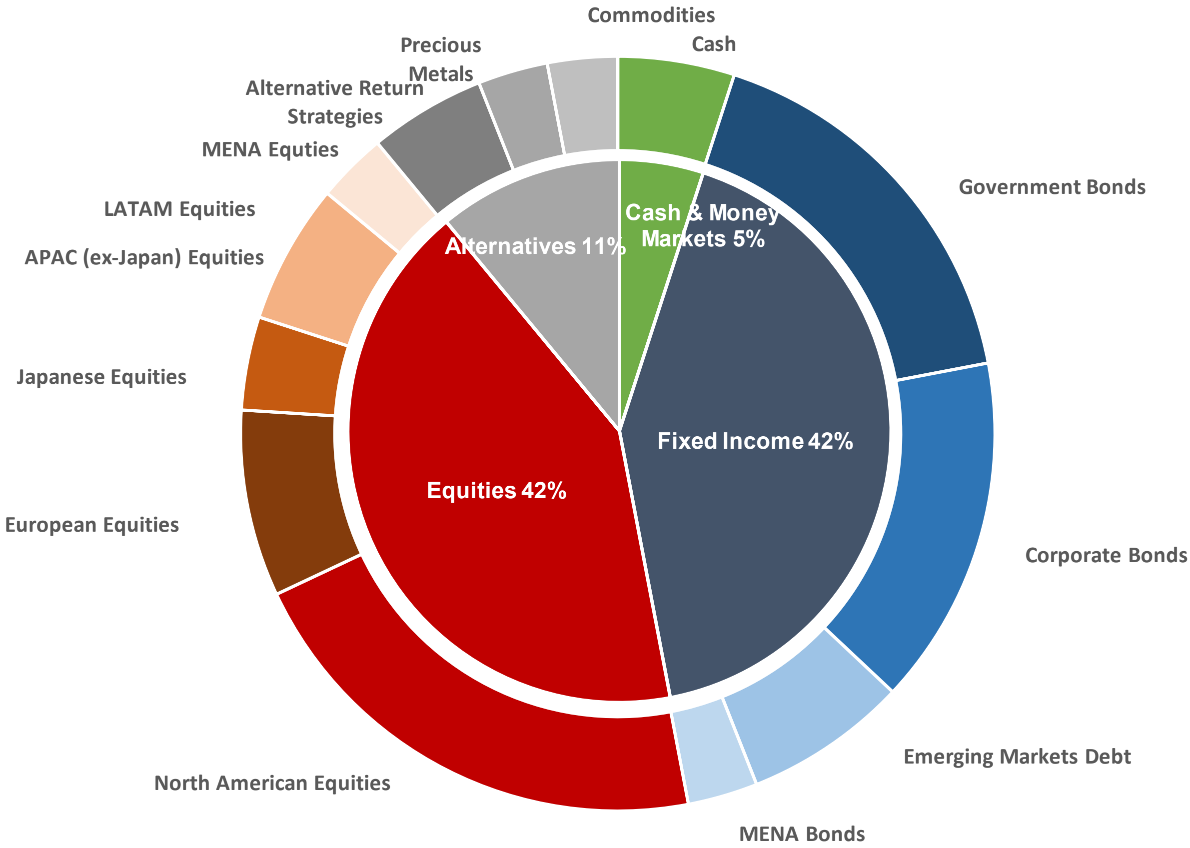
On Friday, the Bloomberg Commodity index hit its highest since July, 2015, amid soaring metals and grain prices. The index is up 20.1% year-to-date, outperforming global stocks. The move reflects quickly rising demand as the world reopens, which is unlikely to be met by additional supply following six years of underinvestment in new production of everything from iron ore to soybeans and corn.

Investors are also increasingly flocking into commodities as a hedge against inflation. After all, while the type of inflation that will be announced this week does not matter for central banks, it does eat into earnings and savings. This is true not only in the US, but across the globe where there is a clear acceleration in consumer price indices. Brazil, for instance, announced its highest broad inflation number in more than 20 years in March: 32%. India, Russia, Turkey — just to cite a few — are all experiencing accelerated inflation. In almost every case, central banks are ignoring the move, but investors are not, and an efficient way to hedge against consumer price increases in the short-run is to invest in commodities.

The Bloomberg Commodity index has hit its highest since 2011 as food prices soar



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 stock markets.
Alternatives	Underweight	However, still marginally overweight in precious metals



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