INVESTMENT STRATEGY
WEEKLY VIEW

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INFLATION COULD CONTINUE TO DOMINATE HEADLINES

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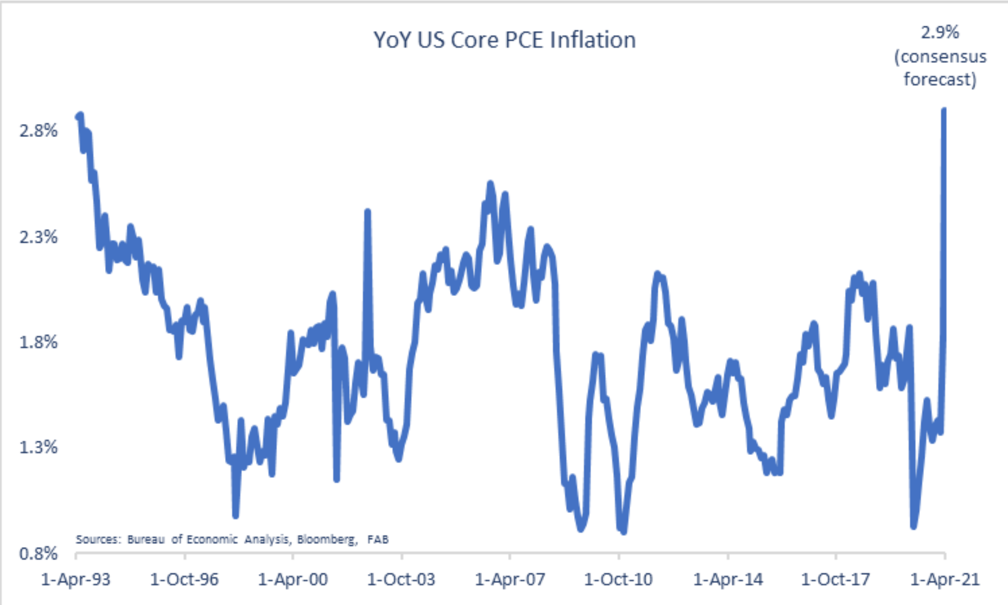
- The Fed's preferred measure of inflation, core PCE, is expected to come in at 2.9% year on year.
- If confirmed, the level would be the highest since 1992 and above the Fed's 2% goal.
- Some investors are starting to position themselves for monetary tightening earlier than previously expected.
- The FAB AAC is overweight in equities, IG and EM bonds. It has also just reduced its underweight in hedge funds.



In normal times, the benchmark interest rates in the US are among the most important inputs in any valuation model. In the current times of unusually low rates across the world, this input has become so meaningful that some commentators have started to suggest that any investment is ultimately a play on what the Federal Reserve is going to do next.

While that could be an exaggeration, the US central bank does arguably hold the key to the continuation or slowdown of several of the asset bull markets currently underway, including stocks. With global growth rebounding and record low interest rates in many countries, one of the biggest potential hurdles to the continuation of the stock bull market is a premature monetary tightening in the US and its potential ripple effects.

While Fed members have repeatedly said they will wait for inflation to overshoot the institution's target of 2% for a considerable period of time, investors are starting to question themselves how long that will be.

In fact, the minutes of the last meeting of the Federal Open Market Committee, the rate-setting body of the Fed, showed that some of the governors have begun calling for the central bank to signal that it is considering tapering its US$120 billion in purchases of Treasuries and mortgage-backed securities.

Philadelphia Fed Governor Patrick Harker went further on Friday and said that the Fed should start talking about reducing its asset purchases "sooner rather than later." This stands in contrast with Fed Chairman Jerome Powell's statement almost a year ago that the central bank was "not even thinking about thinking" about raising rates.

The key inflation gauge the Fed watches is about to hit the highest in nearly 30 years

The world has changed significantly since that statement, though, and market participants realize it. While there are still 8.2 million fewer people working than there were before the pandemic, the Bureau of Labor Statistics recently reported that there are 8.2 million job listings, the highest in the nearly 40 years of the so-called JOLTS job openings report.

This suggests that the US unemployment rate could drop back to 4% (the Fed's current target) from the 6.1% as of April easily, though it is not so simple. Meanwhile, this week is likely to show that the Fed's preferred measure of inflation, core personal consumption expenditures (core PCE), has already vastly overshot the bank's 2% target.

The consensus estimate among economists is that the measure will come in at 2.9%, which would be the highest since August 1992, if it materializes. There is, however, a chance that the number comes even higher than that. While the core PCE measure excludes food and energy costs, which have been soaring, it includes the costs of motor vehicles, which another inflation measure compiled by the Bureau of Labor Statistics showed two weeks ago to have risen by a record in April.

An upside surprise would embolden investors who believe the Fed will be forced to tighten monetary conditions earlier than expected. There are, indeed, numerous large positions being built around the idea that the Fed will announce a taper plan in its annual policy meeting in Jackson Hole, in August.

Besides that, the Commodity Futures Trading Commission reported that two weeks ago there was a record net short position in Fed funds futures, which would benefit if the central bank tightened monetary policy. The negative bias in short-end interest rates comes as investors seem to have reduced their short positions in 10-year and 30-year US Treasuries, according to the CFTC data.

The net positions in these bonds is still mostly short. This resonates with the idea that the loftier inflation prints expected in May and June could continue to push Treasury yields higher, particularly those that mature in 10 or 30 years.

Rising long-term yields may act as a headwind against big gains in stock markets, particularly for shares of high growth companies. This can be particularly true in the low liquidity period of June and July, when many investors and fund managers go away for the summer holidays.

Over the past 20 years, June returns for the S&P 500 were negative half of the time and positive the other half. June is also the only month of the year in this period which has recorded as many bad outcomes as good, with all the other months of the year having more positive ones.

The prospect of a high core PCE inflation print along with the impending arrival of the month of June, could weigh on market sentiment this week, given that it will have the last five trading days of the month of May. The past few weeks have already seen sharper movements in the US stock markets, a sign that investors were probably placing tighter stop-loss orders and increasing their short positions as hedges.

Even if there could be more volatility ahead, however, the underlying narrative that supports being invested in risk assets, and in equities in particular, remains unchanged. In fact, many of the recent data points only strengthened the argument in favour of owning more cyclical assets.

The May US composite PMI came in at 70.1, the highest print since IHS Markit began to compile the survey of purchasing managers, boosted especially by bullish responses from companies in the services sector. Any PMI number higher than 50 indicates expansion ahead, and the highest in a decade tells a story of strong growth.

This has also been confirmed in many other data points and could get even further support from the Conference Board's consumer confidence numbers due this week. Strong growth ahead and confident consumers are all good news for stock investors in the US.

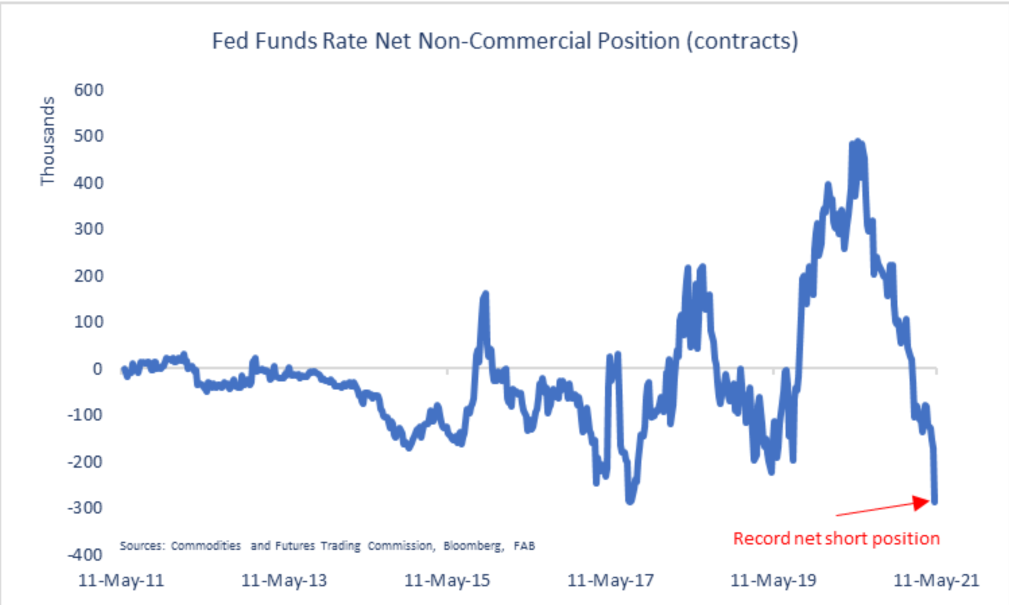
A faster growing US economy should translate into higher revenues for companies operating there, and that has already been confirmed in the first quarter results. Of the 446 companies in Standard & Poor's 500 that have announced results in the first quarter, 87% beat analyst EPS estimates, compared with 70% for the whole season a year ago, according to data compiled by Bloomberg. More than two thirds of the companies that reported their results also beat revenue expectations, one of the highest such ratios since Bloomberg began to compile such data.

Part of the reason for such a high beat ratio can be attributed to overly cautious analysts, which is also a result of scant management guidance last year. It is, also, however, a reflection of the economic momentum the US is enjoying, one that will help drive investment decisions in the months ahead.

After a nearly 103% rally in the S&P 500 between March 23rd, 2020, and last Friday, stock-picking is likely to become a more important driver of extraordinary returns between now and the end of the year. While the overall index can still continue its upward movement, there still is room for good money managers to outperform it in the coming months.

As a result, the FAB Asset Allocation Committee (FAB AAC) on Thursday decided to shift its overweight position in gold by a less-underweight stance in hedge funds. The FAB AAC has been heavily underweight hedge funds for several years amid a bullish risk-asset outlook and higher asset correlations amid low interest rates. That has proven prescient, however, members agreed that the potential for a period of higher volatility in the near future could create an environment that favours the best hedge fund managers.

There are some large positions that would benefit if the Fed tightens monetary policy



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