INVESTMENT STRATEGY WEEKLY VIEW

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DECELERATION IS NOT STAGNATION

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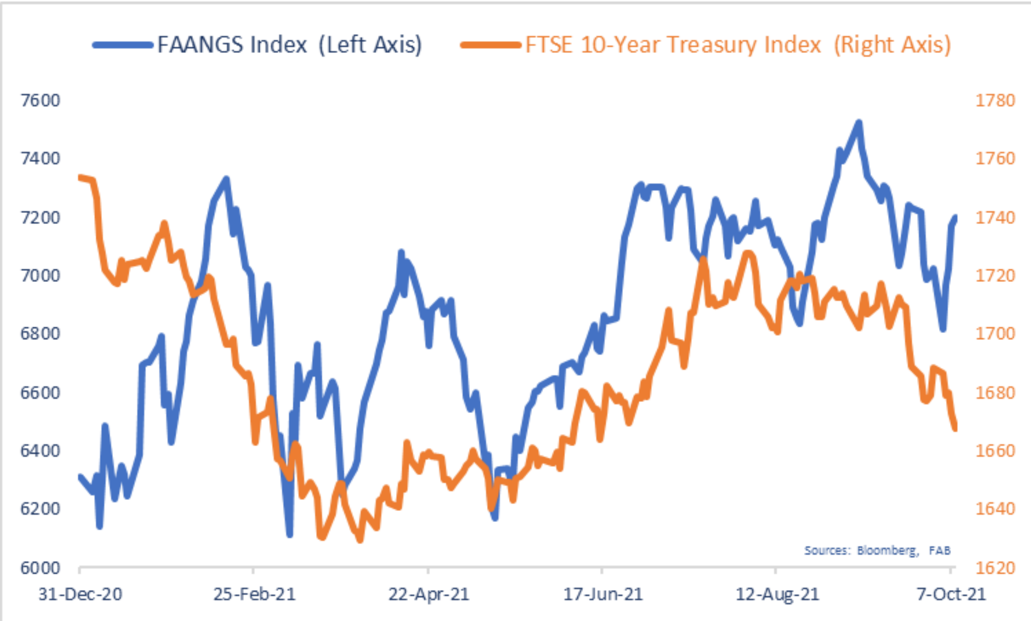
- The US created 194,000 jobs in September, the least so far this year.
- The low number, however, may not be enough to stop the Fed from tapering.
- Rising oil and gas prices continue to pressure inflation and are adding a drag to the economic recovery as well.
- The FAB AAC is overweight in equities, IG and EM bonds. It is underweight in cash and neutral in gold.



The US, the world's largest economy, is coming from a streak of bad numbers, and the jobs report on Friday just added to that with the worst employment survey so far this year. The country added 194,000 jobs in September, according to the Bureau of Labor Statistics, far short of the 500,000 median estimate of economists.

The number rekindled talks of a new 'stagflation' period like the one in the 1970s, especially as economists expect the broad consumer price inflation figure due this week to show a second consecutive month of 5.3% year-on-year increase. While the more recent numbers in the US — from factory orders and housing starts to the latest jobs report — have shown a marked deceleration, they do not point at a recessionary or even stagnant economic environment.

Even after the recent slowdown in activity, the median expectation of economists surveyed by Bloomberg shows the US growing 5.9% this year and 4.4% next year, far faster than the historic 2.2% average growth rate of the country. Such high growth is expected to continue into 2023, when economists see the US expanding at a 2.4% rate. Hence, it is hard to say that the US economy is stagnating or even shrinking.

As for inflation, it is indeed higher than the Federal Reserve is comfortable with, but it is likely to subside. The latest report on inflation in the country, in August, showed consumer prices rising at a 5.3% year-on-year rate, and economists expect the September numbers (due this week), to show a similar rate of increase. That is far higher than the 2% target of the Fed or than the 2.1% average recorded between 2001 and 2019.

Stocks of the US' biggest tech companies have been moving with Treasuries this year

These numbers have been skewed by temporary disruptions, though. Gasoline, rent and food prices were the main contributors to the rise in prices in August. The core index, which excludes more volatile food and energy prices and which the Fed favors, however, rose at a 0.1% month-on-month pace in August, the slowest pace so far this year. Still, some of the elements that had been pushing so-called 'core' CPI higher, such as car prices (in this case new cars) and recreation costs were the biggest contributors to the rise.

These items were all suffering from a temporary jolt in demand at a time when supply has remained relatively constrained by the disruptions related to the pandemic. Once these constraints are removed, there is reason to believe the pace of consumer price increases will revert back to its long-term trend, which may even mean a drop below 2% later next year.

Hence, even the inflation part of the 'stagflation' argument may be an exaggeration at this stage. There are some parts of the consumer price rises that could remind some people of the 1970s, to be sure. Quickly rising gas prices are the best candidates. Unlike the 1970s, however, oil output can be quickly ramped up nowadays.

Perhaps not quickly enough to control heating and gasoline prices during the winter in the Northern Hemisphere, but in time to control rising food and energy prices before the end of next year, and maybe even earlier.

Brent crude prices rose to US$82.39/barrel on Friday, their highest since 2014, after the OPEC+ last week agreed to continue with its current pace of supply increases, adding only 400,000 barrels next month. Meanwhile, Russia indicated that it might be willing to sell more gas to Europe if winter is colder than expected, but its biggest company in the space, Gazprom, said it might have to charge higher prices.

Given the ability that some power or heating plants have to convert from natural gas to oil derivates, high gas prices could increase demand for crude even more and push prices higher still in the coming months. At these prices, however, a lot of output capacity that has been idled in the past few years starts making economic sense, particularly in the shale sector.

Shale oil exploration can be ramped up relatively quickly, for instance. While drilling a new well of traditional oil can take years at times, most shale patches are accessed within three to six months. The life of a shale well is shorter too, but the point is that output can be increased very quickly.

Aside from the discipline OPEC+ members have shown, the drop in shale oil production in the US has been one of the main reasons for the supply-demand mismatch that is pushing crude prices back to levels not seen in seven years. According to data from the US Department of Energy, crude output in the US was at 18 million barrels/day in September, down from a peak of 21 million barrels/day in December, 2019.

Shale patches had also been partly responsible for the ramp up in natural gas production of the US in recent years, hence the fact that they had not gone back to previous levels of production may also be contributing to higher gas prices. The number of active rigs in the US, a proxy to shale oil activity, has been climbing steadily this year, but not fast enough to make up for the lost output.

That said, by this time next year, not only OPEC+ will have resumed production to its fullest, according to their current schedule, but shale oil and gas producers are likely to have ramped up production as well to take advantage of the current higher prices.

This is perhaps one of the key differences from the 1970s. Back then, a disruption in the production of crude could not be quickly corrected. It took years to find new wells and sometimes years more to start exploring them. The only way that the energy market — and broader inflation by proxy — could get to equilibrium when supply was lower was through higher prices.

Now, the idle output both of OPEC+ and the shale producers in the US suggest that energy prices, which are among the key drivers of higher consumer prices right now, may have reversed course by the fourth quarter of 2022, or even earlier. Add that to the high base of comparison, a further deceleration in the US economy, and the stage is set for inflation to be below the Fed’s 2% target by the end of 2022.

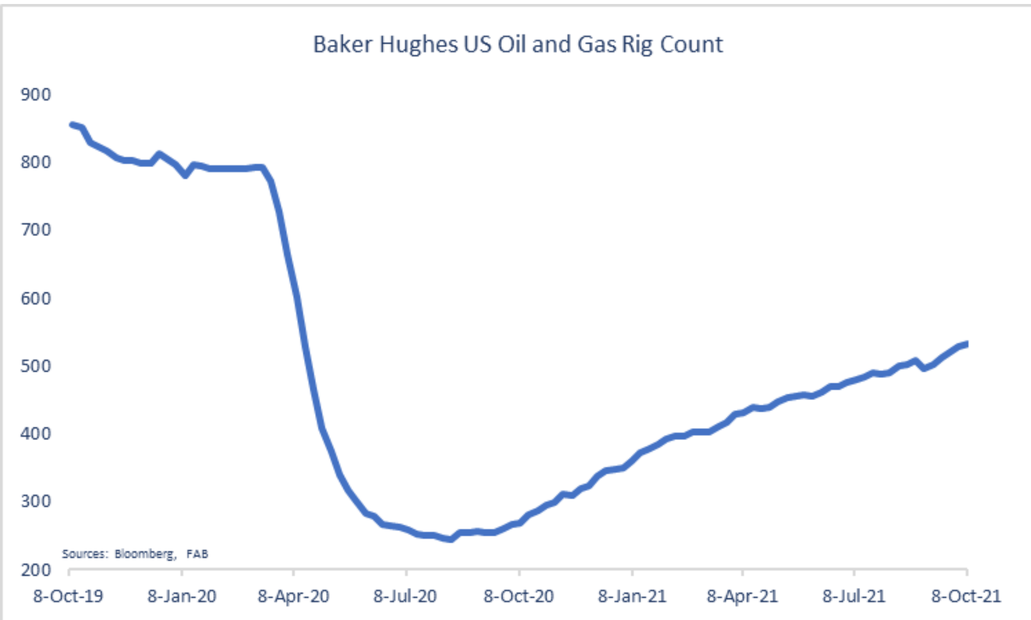
These assumptions are probably similar to the ones the Fed governors have been making when they talk about inflation being transitory. Until recently, it seemed, markets were buying that idea, but they seem to have become more skeptical of it lately.

Bonds, for instance, have plunged recently. The yield on 10-year US Treasuries has increased about 33 basis points in the past month alone. While part of that may be because of higher inflation expectations, some of the explanation may be more mundane, and related to supply and demand.

The US has been issuing almost three times more bonds in the past year than it did before the pandemic as it funds a rising deficit. Aside from the usual buyers, the Fed has been purchasing US$80 billion every month of these bonds. While US bond issuance is not likely to slow, investors now know that one of the big buyers of them is about to reduce its purchases. This, alone, could be a good reason for higher yields.

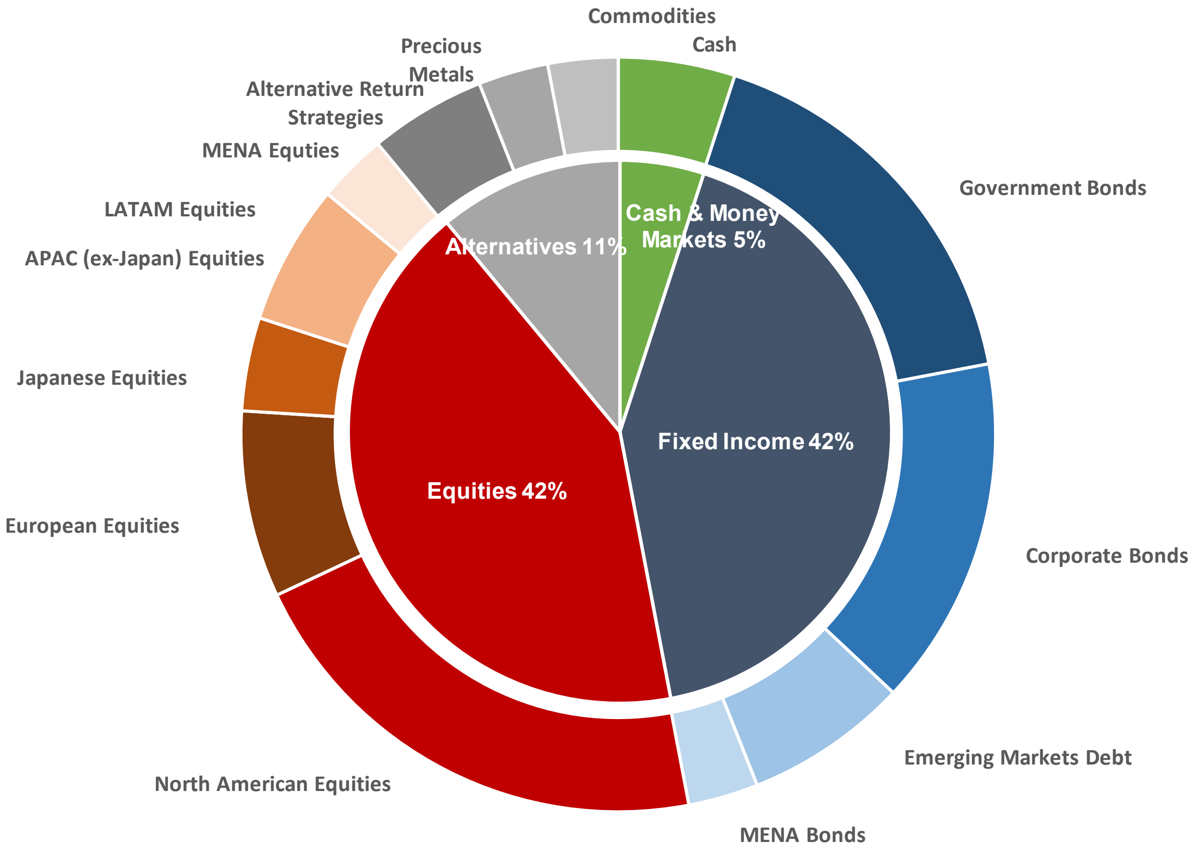
Eventually, though, Treasury yields are likely to become so attractive that buyers from the rest of the world will make up for the lost demand from the Fed. It may seem like things are moving too fast, but it also may just be the world adjusting to life after the pandemic, and in every adjustment period a few hiccups are bound to happen.

US shale producers have been shy about ramping up output despite high oil prices



Baker Hughes US Oil and Gas Rig Count

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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