INVESTMENT STRATEGY
GIO 3Q OUTLOOK

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A WALL OF CASH STILL APPEARS DESTINED FOR RISK ASSETS

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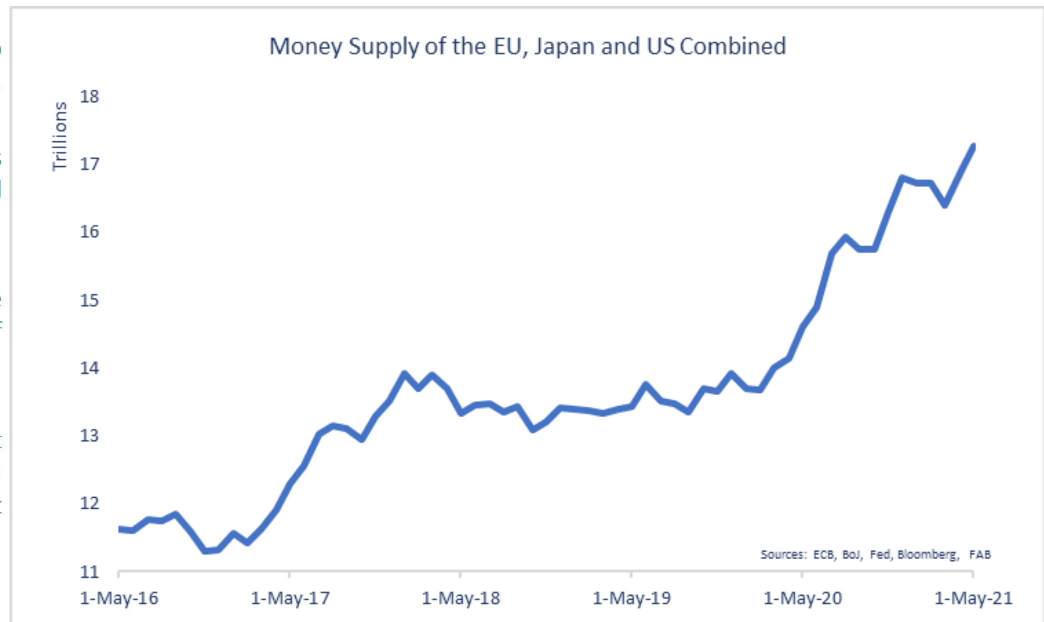
- Investors have started to look beyond the reopening.
- Accelerated inflation rates prompt some EM central banks to start hiking rates.
- All eyes will be on the Federal Reserve for signs of an early lift-off in its rates.
- The FAB AAC is overweight in equities, IG and EM bonds. It is underweight cash and neutral in gold.



Savvy investors look ahead, and only care about current events insofar as these help them frame the future. Shares of companies sensitive to faster economic growth began taking off last November, when it became clear that there were a few viable vaccines, and that the world could start to reopen within months. That prescience has been confirmed, as the US, Europe and other countries which have accelerated vaccine programs have started to operate increasingly as normal. In the wake of freer movement, jobs are returning, people are spending their savings, and risk asset prices have risen.

During the last few months investors who had foreseen these events have shifted their sights towards next year and beyond. One of the conclusions is that the accelerated economic expansion occurring in the wake of the deepest global recession since 1929 will moderate going into 2022.

Economists are still forecasting that many countries in the world should grow at an above-average rate next year. This year's growth is very unlikely to be repeated. The Federal Reserve, for instance, expects the US to grow 7% year-on-year in 2021, and by 3.3% in 2022. If confirmed, the first figure would be the fastest rate of economic expansion for the country since 1984. The 2022 expectation is still above the Fed's 1.8% long-term growth potential for the US, but it is clearly much slower.

The same out-turn will likely be repeated across most developed nations. Similarly, almost all countries have resorted to extraordinary stimulus in the past year. This has resulted in an unprecedented amount of money in circulation. The Fed, the European Central Bank, and the Bank of Japan have added a combined US$3.9 trillion in liquidity to their economies.

Since the pandemic began, US$3.9 trillion has been created by three central banks

This combination of strong post-recession growth, along with high savings and a lot of cash everywhere has started to translate into higher inflation, which was also expected by many economists and analysts. The key question now has become how central banks will react to this phenomenon.

There are already indications of what various of them plan to do. Some emerging market central banks are taking the more difficult path of hiking rates and stemming what could otherwise become runaway inflation now. Those that have reserve currencies, such as the US, Europe, Japan or the UK, can afford to wait longer to see whether this inflation is sticky.

The Fed had preempted this by revising its monetary policy framework last year. The revision, which began before the pandemic, resulted in a departure from its traditional way of operating. Before, the Fed would rely on the forecasts and models of its economists to try and prevent inflation from taking hold. Now, the Fed's new framework allows it to start tightening monetary policy only after annualized inflation has run above its target of 2% for a while. This approach means the Fed will sometimes allow a period of relatively high inflation to compensate for a period of low inflation, or vice versa.

The ECB completed its own framework revision last week and followed the Fed's path. It moved to a clear 2% target (unlike the 'close to, but below 2%' it adhered to before), and gave itself the flexibility to let prices run hot for a limited period.

Despite the recent framework alignment, the path of the two central banks has started to diverge. In June, when the Fed unveiled its quarterly summary of economic projections, seven governors indicated they expected interest rates to rise as early as next year. Chairman Jerome Powell also indicated that the US rate-setting body, the Federal Open Market Committee, had started "talking about talking" about tapering.

Around the same time, however, the ECB said it would accelerate bond purchases in the summer months, to support the European economy, which has been slower to reopen and with a less robust recovery than that of the US.

One major central bank increasing liquidity while another signals it will slow it tends to have an impact on their currency pairs. That may help explain why the euro fell in June, starting after the ECB's announcement that it would accelerate its bond purchases. That, in turn, has pushed the dollar higher.

The divergence has not been only among major central banks, though. Emerging markets have also taken different paths in tackling inflation. Brazil's central bank, for instance, has hiked interest rates three times this year to 4.25%, with a broad inflation measure in the country reaching 35.75% in June. Mexico surprised analysts with a rate hike in June, while Russia has also begun to increase its benchmark borrowing rates.

On the flip side, the Turkish central bank hiked rates to 19% in March, but that was not nearly by as much as the market expected, and inflation there has continued to accelerate, logging 17.53% In June.

The results, have, therefore, been divergent as well. While the Brazilian real has become the best performing EM currency since the start of April, the Turkish lira has fallen by 6.2%. Emerging markets, however, work differently from developed nations. While developing economies also tend to slow when interest rates rise, the ensuing currency appreciation tends to support their capital markets.

That makes sense: many of the largest companies in developing nations have foreign currency debt, which means when their home currency rises, their leverage drops, and the value of their equity increases.

Furthermore, that nation's assets become more attractive to foreign investors, who may factor-in potentially higher hard currency returns.

Commodity exporters in these countries, however, may see lower profits as the local currency value of their sales drops as the currency rises.

The commodities themselves also have an inverse correlation with the value of the currency against which most of them are priced: the US dollar. Since the start of June, around the same time the US dollar index appeared to bottom, the Bloomberg Commodity Index has been in a range. The index actually held up in the month of June, but that was mostly thanks to rising oil prices.

The London Metals Index, for instance, seems to have topped-out on May 7th, and has dropped 4.84% since. Copper, often seen as a bellwether of economic activity, saw its price peak on the same day, and has led losses in the metals sub-sector, down 9% over the same period.

There may be other elements at play, however, such as a coordinated effort by China and other countries to stem rising raw material prices. After all, the demand for metals is unlikely to have fallen significantly in the past month.

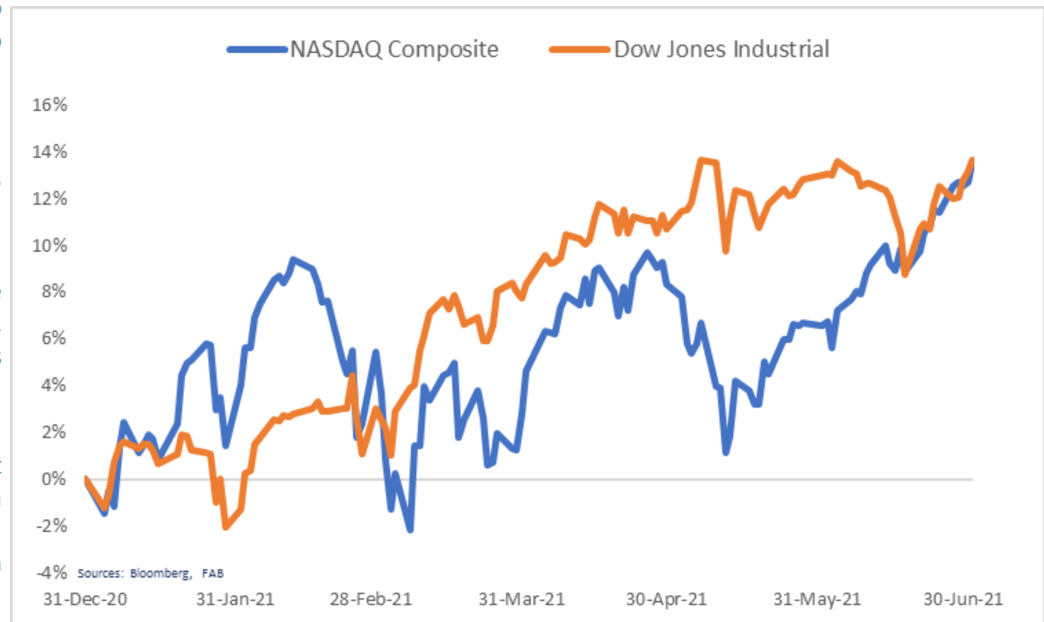
As mentioned earlier, although economic activity is likely to moderate during 2022, it will still be relatively strong for a while. By the end of this year, most of the world is likely to have reopened, and growth is likely to continue above trend next year.

This suggests that even if commodities and cyclical stocks may not be as attractive as they were back in November, they are still likely to continue to perform well for the remainder of this year, and perhaps next year. The difference is that investors are now also starting to look back at the areas to which they may have given less attention in the first half of the year. The risk asset rally, however, is likely to continue overall.

Global inflation has accelerated and is prompting some central banks to act early

GROWTH SHARES CATCH UP BUT VALUE STILL HAS ROOM TO RISE

- Investors have begun to shift their attention back to technology.
- The shares of so-called 'cyclicals' still have room to rally, however.
- EM should benefit from the recovery in global growth, especially those countries attacking inflation.
- The FAB AAC is overweight in equities, with a focus on Asia-Pacific ex-Japan, and a tilt towards technology in developed markets.



'Value' stocks have been a pain trade for the better part of the past decade as technology companies powered ahead. In the decade leading to December 31st, 2019, the S&P Growth index rose 235.29%, while the S&P Value index gained 144.87%.

This divergent performance began to reverse last year, as investors turned their focus to what was expected to be a period of strong economic expansion and potentially higher profit growth of cyclical companies compared to technology ones. In any case, technology companies' growth was destined to slow from the acceleration they saw during the pandemic.

Between the 30th of October and the end of May, the S&P Value index rose 36.05%, while its growth counterpart gained only 22.34%. Similarly, the tech-heavy NASDAQ 100 Index rallied 23.54% in the period, while the more cyclical Dow Jones Industrial Average advanced 30.64%.

The rationale behind the shift was that when the first vaccine neared approval by the US Food and Drug Administration, which happened in the first weeks of November, it became clear that the world was set for a rapid recovery. Companies which had been hurt hardest by the global lockdown were expected to be the most leveraged to a recovery.

On the flip side, digital companies which had seen record revenues in the work-from-home environment were expected to see their growth at least partially revert to a mean as people moved back outdoors and away from their screens.

This behavioural shift seems to be happening. In the first quarter of the current year, e-commerce was responsible for 13.6% of US retail sales, according to the Census Bureau, a reduction from the 15.2% of the last quarter of 2020.

In June, stocks of technology companies caught up with those of cyclical ones

The number is still a significant gain compared to the 11.2% of the first quarter of 2020. It also represents a jump in the pace of market share gain in addition to the previous acceleration.

For reference, in the first quarter of 2010, only 4.2% of US retail sales were made online, which means e-commerce had taken an average of 0.7 percentage point a year in the 10 years up to the first quarter of last year. During the past year that gain in market share of 2.4 percentage points was three times greater than over the previous decade.

It is fair to assume that such a rate of improvement cannot continue indefinitely. Having said that, e-commerce is now significantly more important than previously. The same can be said about technology utilization generally, by companies and people. Many people are expected to continue to work from home, at least part of the time, even after the pandemic subsides, as companies have found that oftentimes superior productivity has resulted. The second quarter of last year, when the practice became standard, saw labour productivity in the US jump 11.2%, its biggest improvement in half a century.

Such a structural shift will almost certainly lead to higher spending on technology in the future. Companies that were not sufficiently digital have in the past year found it can be costly to lag in technology adoption, and that as profits recover they must catch up with the times. Spending on technology will rise, although the overall payback should be substantial.

This is perhaps part of the reason why technology shares have started to catch up with cyclicals since the beginning of June. Investors seem to be calculating what growth rates could be enjoyed in the years ahead by technology, and in the more traditional sectors, and seem to be favouring the former.

Between the last day of May and July 9th the NASDAQ Composite rallied 6.93%, while the old economy-focused Dow Jones Industrial Average rose 0.99% in the same period. One of the arguments for the shift is in the strength of the recovery in the US, which could prompt the Federal Reserve to start tightening monetary policy earlier than expected, in turn curbing growth for cyclical industries.

In basic terms, the potential growth of profits for technology-related companies has more to do with the market share gains referred to above, and less with the overall growth of the economy. Even if the global economy is not growing so fast, the revenues and profits of technology companies should continue to increase at a healthy pace.

Cyclical companies, however, continue to be a proxy for the economic expansion, and if that is moving from a pace of 7% in 2021 to 3.3% in 2022 in the US, according to the Fed's own forecasts, then future profit growth for old-economy companies should slow from current levels. After all, equity investors tend to look at the rate of growth of profits as well as the profits themselves, and if that derivative is slowing, that warrants a lower P/E ratio, for instance.

This could help explain why the technology-focused NASDAQ Composite and 100 indices have re-gained momentum. Despite that, the traditional sectors likely still have room to perform – and part of their future gains will be facilitated by better and greater use of technology.

Emerging market stocks have underperformed those of developed markets for the year to date. The MSCI Emerging Markets Index rallied 66.26% between March 25th, 2020, and the end of May, however this was not enough to return the index to where it was before the pandemic. A complicating factor for the broad EM equity indices has been that about 34% of their capitalization is in Chinese stocks, whose performance has suffered from the government's clampdown on the largest national technology companies, also related to a wish to maintain control of the country's data.

There is an argument to be made in favour of cyclical industries and markets, though. For instance, as more people use electric vehicles, and countries favour renewable energy, there will be more demand for metals.

A single wind turbine uses more than 200 tons of steel, for instance, which means that if developed and emerging nations want to derive more of their energy from the air they will need a lot of iron ore and nickel.

Those minerals will, in their turn, have to be extracted using machinery produced by industrial companies. And those natural resources are mainly to be found in developing nations.

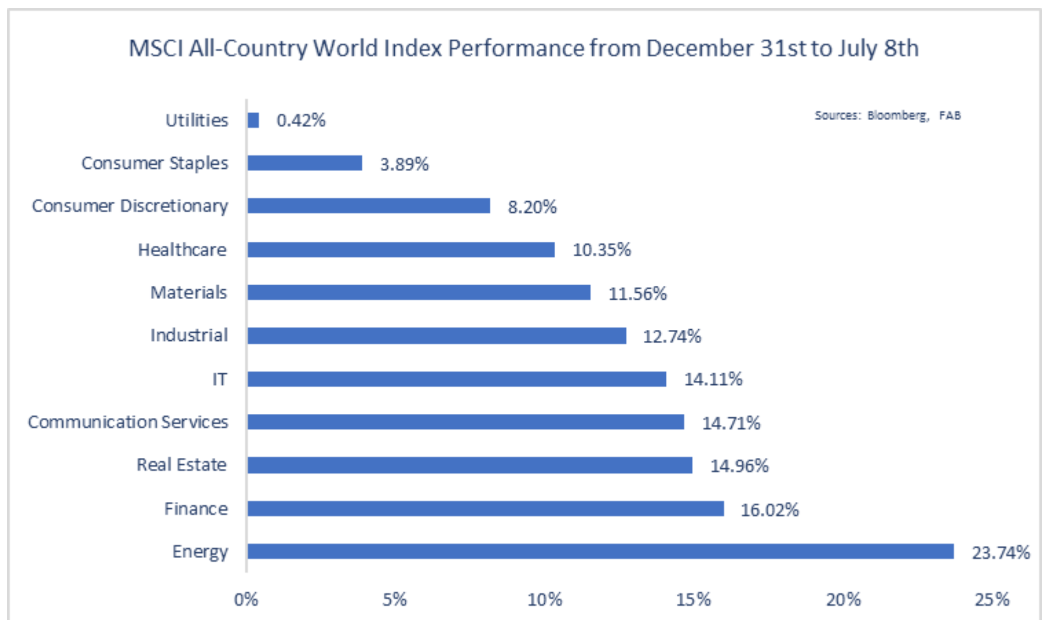
And even if the developing world is moving towards using less fossil fuel, it may be premature to expect renewable energy to replace it. In fact, the fastest growing nations still rely mostly on fossil fuels and are likely to continue to do so for decades.

As a result, even energy companies, which had been ugly ducklings before the pandemic, may still have some good days ahead. They have had a good run so far this year, as the sector was the best-performing in the MSCI All Country World Index, having gained 23.74% between December 31st and July 8th. The performance of the sector lagged that of crude oil, with the price of Brent rising by nearly 46% over the same period.

The discrepancy could be ascribed to the perception that even with higher oil prices, future profit growth for the sector will be limited by the shift away from fossil fuels.

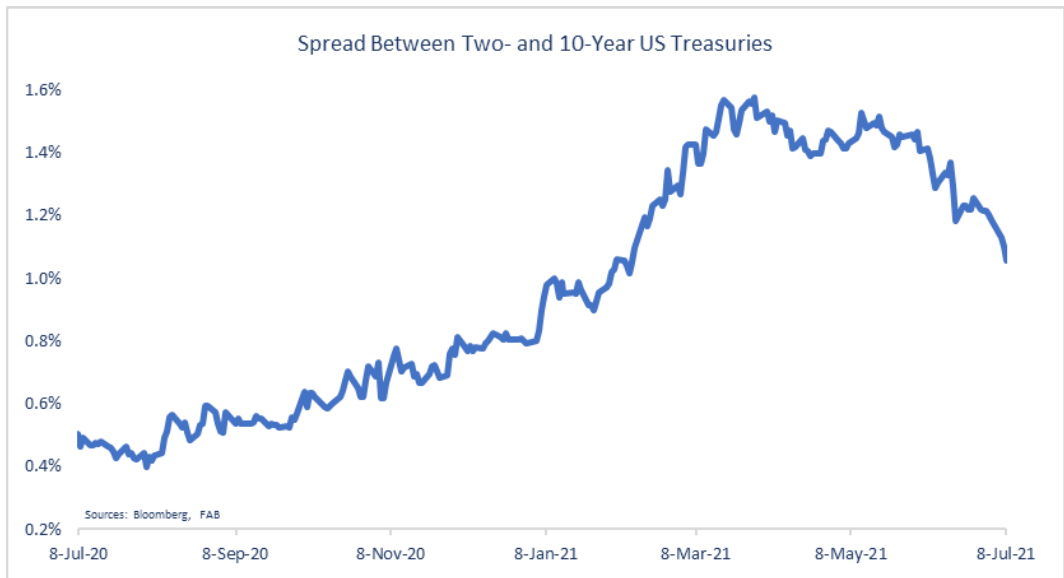
In conclusion, although technology and related stocks have made a comeback in recent weeks, it would likely be premature to move underweight in cyclicals. Economic growth is still likely to be quite healthy, and beneficial for cyclicals. Large parts of the emerging market universe should benefit from higher commodity prices.

The energy sector outperformed in the first half, as oil prices rose nearly 46%



THE LONG-TERM BOND RALLY MAY PROMPT MORE YIELD-CHASING

- Investors may continue chasing yield, potentially buying lower-rated debt.
- The sweet spot may be BB-rated credits, which will likely see more upgrades this year.
- EM continues to benefit from the hunt for yield, and China offers the best economics, despite fears of higher defaults.
- The FAB AAC is overweight in EM hard currency bonds, with a focus on MENA and Asia.



It is common sense that when inflation rises, so do bond yields, particularly for longer-term bonds, given that investors want to safeguard the value of their holdings. In June, the opposite happened to the most liquid and most important bonds in the world: US Treasuries.

A 68 basis point increase in the yield of 10-year US Treasuries between December 31st and May 28th reversed to a 23 basis point drop since the beginning of June. The move down in yields accelerated as the job numbers improved, and after the Federal Reserve indicated that it expected the US to grow 7% this year, and for 'core' PCE, its preferred measure of inflation, to average 3.4% in 2021.

This move sounds counterintuitive, but investors probably focused more on what the Federal Reserve will do, rather than on how much Treasuries could protect them from inflation. In June, the Fed started to "talk about talking" about tapering its asset purchases, and indicated rates could rise as early as 2023.

At first glance the prospect of rates rising earlier than recently expected could translate into higher 10-year US Treasury yields, but the opposite may be true, because of the potential impact on US economic growth. If the Fed increases interest rates too early, it may stymie the current recovery, and slow the economy sufficiently to warrant lower rates. Hence, longer maturity bond yields may yet fall.

Meanwhile, the likelihood of higher short-term rates in the next two years has increased, which helps explain why the yield on two-year US Treasuries has risen by 7 basis points since the end of May, counter to the fall in the 10-year Treasury yield.

The Treasury curve flattened during the second quarter, even as inflation was rising

High-rated corporate credit has followed the 10-year US Treasury, with the average yield on the Bloomberg Barclays USD Liquid Investment Grade Corporate index falling by 12 basis points since the beginning of June to 2.25% as of July 8th. Such low returns for the safest bonds could eventually push investors to seek riskier debt to get better yields.

Even among the lower-rated bonds, however, the pickings are slim. The average yield on the Bloomberg Barclays US Corporate High-Yield index dropped to an all-time low of 3.53% on July 6th. This has left investors having to look enen harder to find which portions of the corporate credit market still have room to rally.

Within the US, the riskiest credits have been among the best-performing, with the Bloomberg Barclays Caa US High-Yield index having gained 1.65% since the beginning of June, and being up 7.34% since the year-end. The higher performance, however, comes at a significantly higher risk, as roughly one in 10 CCC-rated bonds default within a year, according to rating agency statistics.

In that sense, investors may be better off looking at the BB-space. The universe of debt rated one or two notches below investment-grade grew significantly last year, as 52 companies lost their investment-grade ratings in North America.

Rating agencies produced the largest number of so-called 'fallen angels' since 2009 last year, amid expectations of a series of defaults in the wake of the lockdowns.

Defaults rose last year, but not nearly as much as rating agencies had expected. Close to 3.89% of the bonds in the Bloomberg Barclays Global High-Yield Aggregate index missed payments, the highest rate since 2009. However, that year, investors had losses in 11.25% of the bonds in the index, hence even though the number was high, it was not serious.

This was partly a result of the extraordinary monetary policy measures the Fed and other central banks took last year, which allowed companies that would otherwise have been unable to pay their bonds to refinance them.

The fact that the premise driving this high number of downgrades has been removed suggests rating agencies will have to upgrade many issues this year. This has already begun, and should accelerate going forward, with 21 companies returning to investment-grade in the first half.

Yields for BB-rated companies are historically low, but investors may be able to capture unusual gains if they manage to own the bonds of companies that move from junk to investment-grade, as such moves tend to produce large upward price moves in their debt.

Otherwise, investors may have to widen their geographic scope if they want higher yields. Dollar-denominated bonds in emerging markets are offering higher returns than those of developed countries. The dollar-denominated Bloomberg Barclays EM High-Grade index, for instance, is offering a yield of 2.40%, 15 basis points higher than its US counterpart, and with an average maturity of 11.6 years, compared to 14 for the US index.

The difference is even bigger in the high-yield space. The US Corporate High-Yield index is yielding about 3.66%, and has an average maturity of about 6.6 years, while the EM US Dollar High-Yield index offers an average yield of 6.16%, and has a maturity of 9.6 years.

This big difference is partly due to the weight of bonds from Turkey, China, and Argentina, which represent 10.85%, 7.51% and 5.21% of the index respectively. Turkish bonds have seen their yields rise in the past three years as the government has taken a more assertive stance towards the central bank.

Argentina defaulted in 2019, while China has seen the number of corporate defaults rise. In the case of China, however, there is more noise than an actual problem.

Last year indeed saw a record number of defaults of offshore Chinese bonds, with about US$6.3 billion of dollar-denominated high-yield notes from the country going unpaid. That number, however, represented just 0.7% of the US$906.49 billion in such bonds outstanding. Hence, while the default rate is indeed rising, it remains well below that seen in the US - where as stated earlier, 3.89% of high-yield notes went into default in 2020.

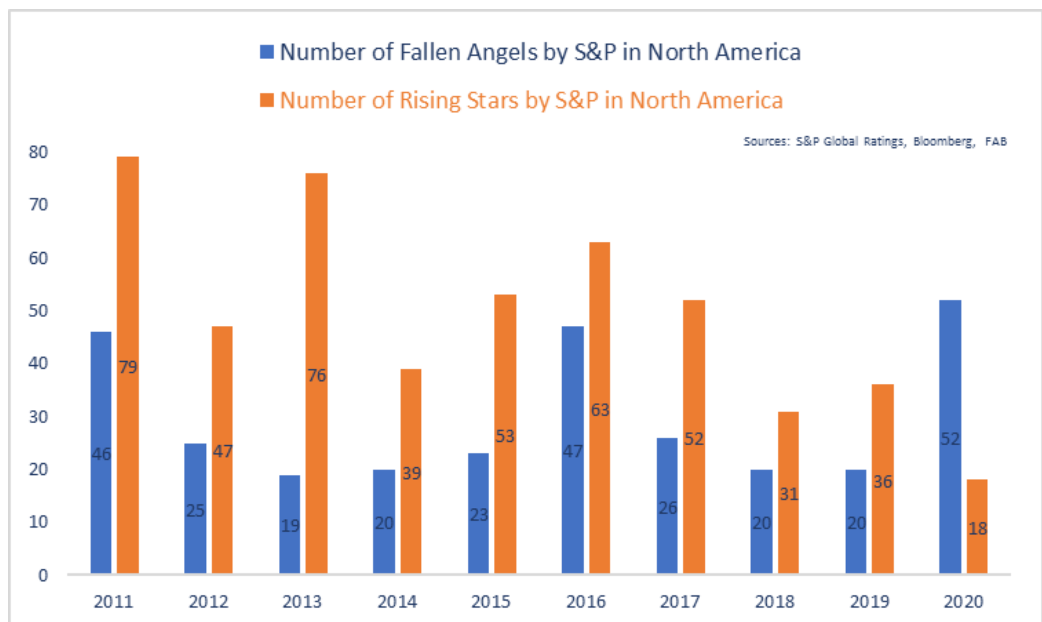
Meanwhile, the average yield on the ICE Bank of America Merrill Lynch China Corporate Credit index is 11.30% for an average maturity of 2.8 years, compared to a yield of 3.70% and a maturity of 6.6 years for the Bloomberg Barclays US Corporate High-Yield index.

The difference is perhaps explained by the growing number of headlines about Chinese defaults. However, while there is increasing uncertainty about the outcomes of Chinese high-yield bonds, and defaults have been rising, it seems as though investors are adequately compensated for the risk.

Eventually, too, investors facing very low yields in high-yield bonds of developed nations are likely to turn to emerging markets for better returns, and among these, Chinese debt still appears to offer the best risk-reward trade-off.

This suggests yields for Chinese bonds and other emerging market junk-rated debt is likely to outperform other segments in the credit markets. As in any asset class, it is unlikely that performance will be without some volatility, and there are a few highly-leveraged credits which could still provide the occasional scare. Ultimately, though, investors are likely to be attracted by some of the best returns still available in the credit space.

Last year, rating agencies moved the most American companies to junk since 2009



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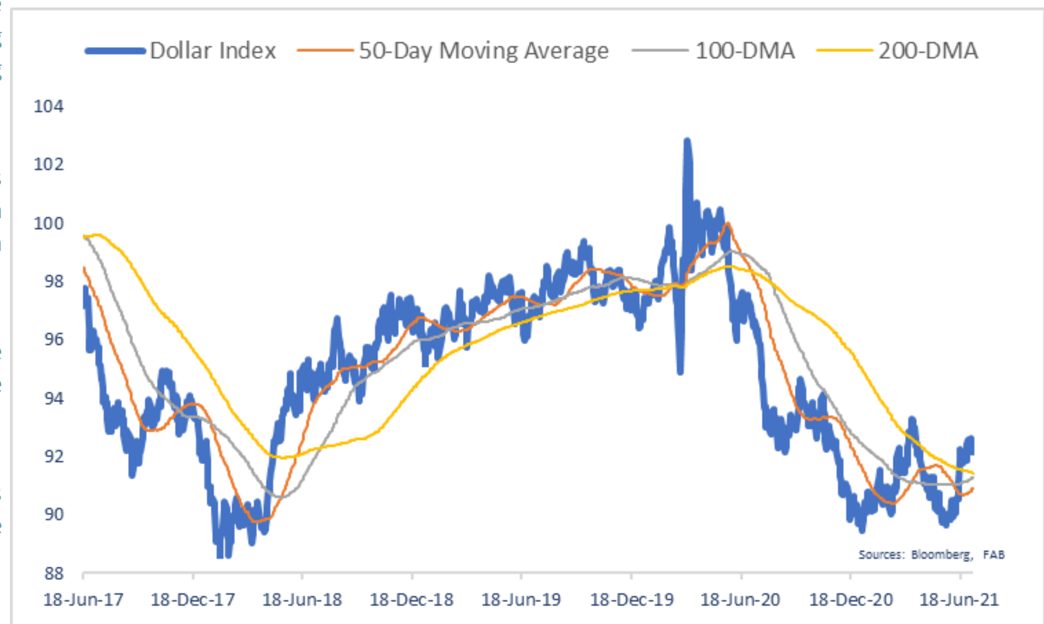
THE DOLLAR STRENGTHENS AS THE FED SIGNALS TIGHTENING

- The US dollar seems to be reversing its weakening trend thanks to diverging monetary policy paths.
- Some of the US dollar's gains could also be a reflection of the yuan having peaked.
- EM currencies of more hawkish central banks have started to outperform.
- The Bank of England's hawkish stance and the UK's vaccination program have buoyed the pound.



Predicting the direction of currencies is often fraught with risk. Most models tend to use the difference between real interest rates, although these are often inaccurate, given how complex currency flows can affect them, counter to the simple logic of inflation and benchmark interest rates. However, as central banks take different paths, the traditional approach of relative liquidity and interest rates has started to matter again.

The US dollar, for instance, has started to reverse a declining trend in place for the better part of the past year, as the Federal Reserve has begun talking about reducing the historic amount of dollar liquidity it created in the wake of the pandemic. The Bank of England is also giving indications that it could start tightening monetary policy as early as next year.

Meanwhile, the European Central Bank is seemingly taking the opposite path. Chairwoman Christine Lagarde recently announced a new framework that allows inflation to overshoot the its 2% target, and the ECB has indicated it will accelerate its bond buying program, and potentially continue some kind of asset purchases once the current program expires.

This policy divergence had an immediate effect, and the US dollar index began to rise on the day the ECB announced its acceleration of bond purchases. In the process, it breached several technical resistances, marking a potential new period of strength for the greenback.

The euro is the biggest component of the dollar index, but some of the other currencies that comprise it have also been under pressure as the central banks steering them show no sign of reducing their liquidity.

The US dollar index seems to have broken a downtrend that started about a year ago

The Japanese yen, for instance, has fallen more than 2% since it peaked against the US dollar on April 23rd. This has come as the Bank of Japan has continued to provide liquidity in the currency in an attempt to restart its economy.

Positioning has also started to shift. Futures positions in the US dollar were mostly bearish until the end of the first quarter, according to the Commodities and Futures Trading Commission. The net position in dollar index futures turned positive on March 16th, and were only negative for three weeks since. In fact, the net bullish position as of July 6th was the biggest in a year, in an indication that speculators are now betting on continued dollar strength.

They may have some support from short-term rates, as these have increased in the US even as long-term US Treasury yields have moved lower. This shift has helped the argument in favour of borrowing in negative-yielding currencies, such as the Japanese yen and the euro, and investing in US dollar assets.

Similarly, even though the Bank of England has kept its monetary policy unchanged, investors are increasingly convinced that benchmark rates in the UK may start rising as soon as next year. This has contributed to a 4.4% year-to-date appreciation of the British pound against the euro.

The direction of monetary policy matters even more for emerging markets, where some central banks last year resorted to unorthodox monetary policy.

Countries from Brazil, to India and Indonesia combined unprecedented fiscal stimulus (often in the form of handouts) with record low interest rates. Traditional monetary theory would say this is a recipe for inflation, particularly in fast-growing, young countries as these.

The inflation typically comes after a country starts to reopen, as Brazil has shown. The country's broader measure of inflation, the so-called Indice Geral de Precos (IGP-M), hit 35.75% in June, the highest since 1995, around the time the country adopted a semi-dollarization of its currency to stem hyper-inflation. Part of the reason for the year-on-year spike was the base effect — the index dropped in the second quarter of last year and therefore the comparison exacerbates the percentage change this year.

Another important aspect, however, has been rising commodity prices along with the unusual amount of liquidity added to the system. The Brazilian government initially created rescue plans involving welfare and wage replacement programs worth about 12% of GDP, and the central bank injected nearly US$235 billion into the local economy through the acquisition of certain bank loans and other assets.

Earlier this year, the government extended some welfare programs, but the central bank began to reverse the unusual monetary policy. Since the start of the second quarter, the Brazilian central bank has increased its benchmark interest rate three times.

The impact on inflation is yet to be fully felt, but the currency has reacted. The Brazilian real was the best-performing major emerging market currency in the second quarter, up by 8.53% between the beginning of April and the 13th of July.

On the other side of the EM currency spectrum, the Turkish lira has fallen 6.21% in the same period, as President Erdogan asserted his will with the central bank. Even though the new Governor, Sahap Kavcioglu, increased rates shortly after he took over in the second quarter, it has not been enough to move rates above inflation, which accelerated to 17.53% year-on-year in June.

Russia, meanwhile, has been in the same league as Brazil, one that has been joined by Mexico after a surprise hike in June, and Hungary. Chile is the next EM central bank expected to tighten its monetary policy.

Some countries have so far avoided hiking rates, although without seeing inflation run away, partly because they still face movement restrictions and rising Covid-19 cases.

Indonesia and India are in that group. While Bank Indonesia bought government bonds last year for the first time since the Asian Financial Crisis, it has not yet faced an inflation issue, with year-on-year prices rising only 1.33% in June, below the central bank's target. Unfortunately, the country had recently only administered some 5.1 million vaccine doses to its nearly 277 million population, and the number of new cases hit an all-time high of 40,427 on July 12th and remained on the rise.

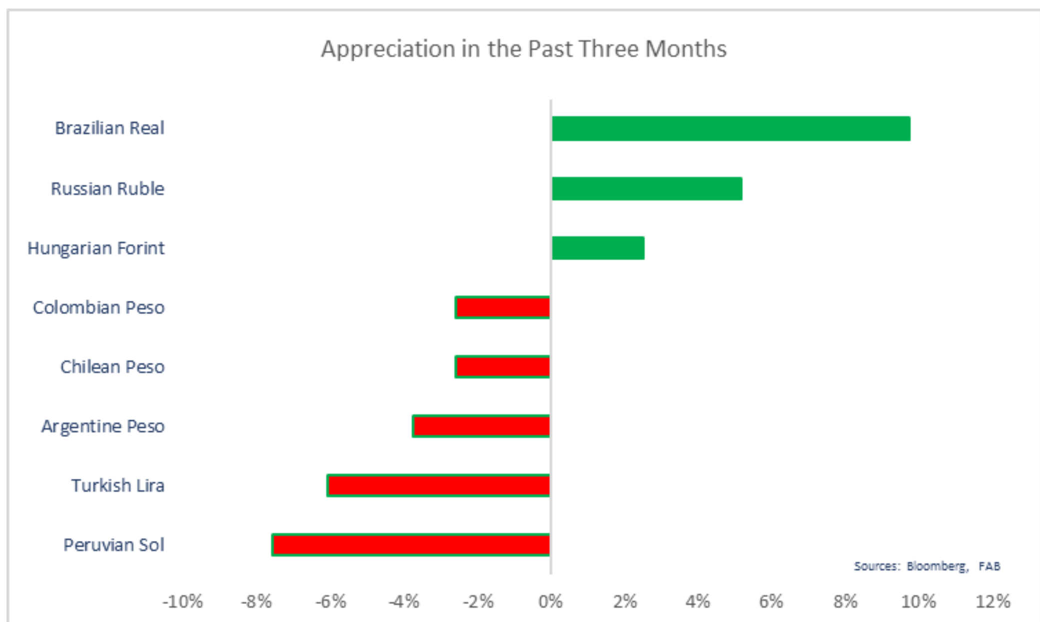
India has improved from the more than 400,000 daily coronavirus cases it saw in early May, to a tenth of this number now. It has accelerated its vaccination efforts and had administered 382 million shots by mid-July, but its inflation remains subdued at 6.26% in June.

In both cases, the test will come when the economies have fully reopened. The Reserve Bank of India is currently dominated by dovish officials, so it is unclear whether they will take action early enough to avoid inflation becoming stickier than it usually is. Indonesia seems to have less of an option as the rupiah tends to get very volatile once foreign investors start getting skittish.

For emerging market central banks, the currency impact is the most important transmission mechanism, given that many of these countries have low banking penetration and even lower levels of credit in their economies. When their currencies rise, however, import prices drop and exports rise, increasing purchasing power and curbing inflation.

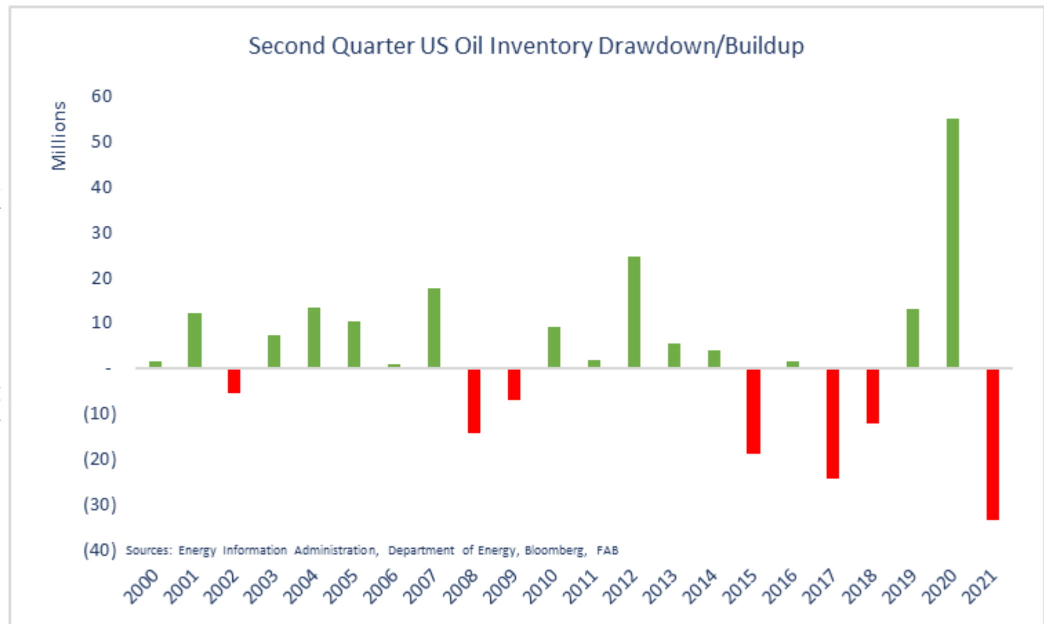
In this way higher rates in emerging markets often translate into rising asset prices. With growth still accelerating across the globe, how the various central banks react to the threat of rising consumer prices will be the key factor to watch.

Investors have favoured the currencies of countries with more hawkish central banks



DEMAND IS RISING FASTER THAN SUPPLY

- The gradual recovery in OPEC+ oil output supports prices as demand returns to pre-pandemic levels.
- The outlook continues supportive for oil prices, if US shale producers remain disciplined.
- China's clampdown on accelerated metals buying provided a halt to runaway prices, but demand continues to rise and strategic stockpiles will need to be rebuilt .



No other broad asset class says so much about the state of the global economy as commodities. In the first half of this year, rising commodity prices suggested a strong global recovery, driving the demand for almost everything, from copper, to wheat, to oil, and lumber. However, looking at the prices of these products at the start of the second half might give the impression that the economic recovery has actually peaked. This would not be accurate, though.

The price of lumber, for instance, had become a poster-child of the mismatch between quickly rising demand and short-supply. The price of the key raw material used in homebuilding in the US peaked on the last day of the first quarter, at US$1,725 per 110,000 board feet, and has since fallen 60.3%. Much of the drop was a result of a rapid catch-up by lumber producers in North America, who ramped up production, prompting a buildup in inventories.

The underlying driver for lumber demand, however, has shown no sign of slowing down. Housing starts in the US averaged 1.59 million in the first half, the highest six-month average since early 2007. This is also triple the level seen in 2009, when the metric last bottomed. Perhaps more important, the rise has accelerated. Whereas it took a decade for the six-month average in new housing starts in the US to go from 525,000 to 1.3 million, in December, 2019, the measure has jumped to nearly 1.6 million just this year.

Similar supply-demand dynamics are being repeated across the spectrum of commodities. Often key is how quickly producers can raise output to meet increases in demand. In mining, for instance, producers are usually unable to increase output at short notice. In fact, it could take years for them to do so.

The second quarter inventory drawdown in the US was the largest in at least 20 years

And with the prices of many metals at very low levels for the past six to seven years, most producers have not been able to invest heavily in new capacity.

Copper offers a good example. The price for the red metal peaked after hitting a record on May 11th of US$10,448/ton, and has fallen by 10.3% since. The drop coincided with the start of a Chinese crackdown on pollution caused by steel producers and copper refiners. These industries had reportedly been cranking-up output as margins for their products had reached multi-year highs. In the wake of it, copper imports — and local inventories — were at historic highs as well.

The price of the metal started to drop in tandem with iron ore after Beijing announced it was sending officials to monitor pollution at steel mills, and the State Council said more effort was needed to prevent commodity prices from rising faster, and to control producer price inflation. Shortly after that, Beijing sold some of its state reserves of key commodities.

The move has had a dampening effect on metal prices in the short term, but the underlying dynamics pushing prices higher remain unchecked. Production capacity remains limited after years of underinvestment and the demand for copper is on the rise as countries from Brazil to the UK promise to spend more on infrastructure. Housing is also driving up demand, with new home construction at historic highs not only in the US, but also in China.

Then there is the issue of a global shift toward using less fossil fuels. A single electric car uses more than 83 kilograms of copper, some 10 times more than a gasoline-powered car.

Electric cars currently comprise less than 2% of the global automotive fleet of nearly 1.5 billion cars. They are the section of the market with the highest growth, with sales having increased 40% year-on-year in 2020, according to the International Energy Agency. If the number of electric cars sold simply doubles over the next two to three years, that would mean some 7 million more electric cars, or 581,000 tons of copper. That is nearly a tenth of the total production of Chile, the world's largest producer of the metal.

Some of that potential shortfall will be filled by scrap, and China has liberalized both the import and processing of copper scrap in preparation. This suggests that, even if China has temporarily been able to curb prices, it is unlikely that they drop much further from current levels.

The supply-demand imbalance issue has become increasingly apparent in the oil market, where OPEC+ has curbed its output even as demand has started to rise again. There are no exact current figures available, but analysts reckon demand is outpacing supply by about 3 million barrels/day.

Inventory numbers support that assertion. In the US, which reports oil inventories on a weekly basis, the second quarter saw a drop of about 33.4 million barrels, the largest reduction in commercial reserves in the country going back at least 20 years. Gasoline inventories in the first week of July were also the lowest in five years, suggesting demand for oil will remain strong in the second biggest consumer nation.

Based on the views of the majority of most members of OPEC+, output would likely remain subdued. The group was recently trying to overcome disagreements about the level of output curbs, and these remain outstanding. However in the face of buoyant demand, the price for Brent, the international marker, is trading above $76/barrel.

The immediate wild card in the equation is the output from shale oil producers in the US. Tapping so-called 'tight' oil reserves briefly made the US the biggest global producer of crude oil.

Shale oil production rose significantly starting in 2016, taking total US output to a high of 20.9 million barrels/day in December, 2019. At the same time, OPEC's production dropped by about 5 million barrels/day over the same period.

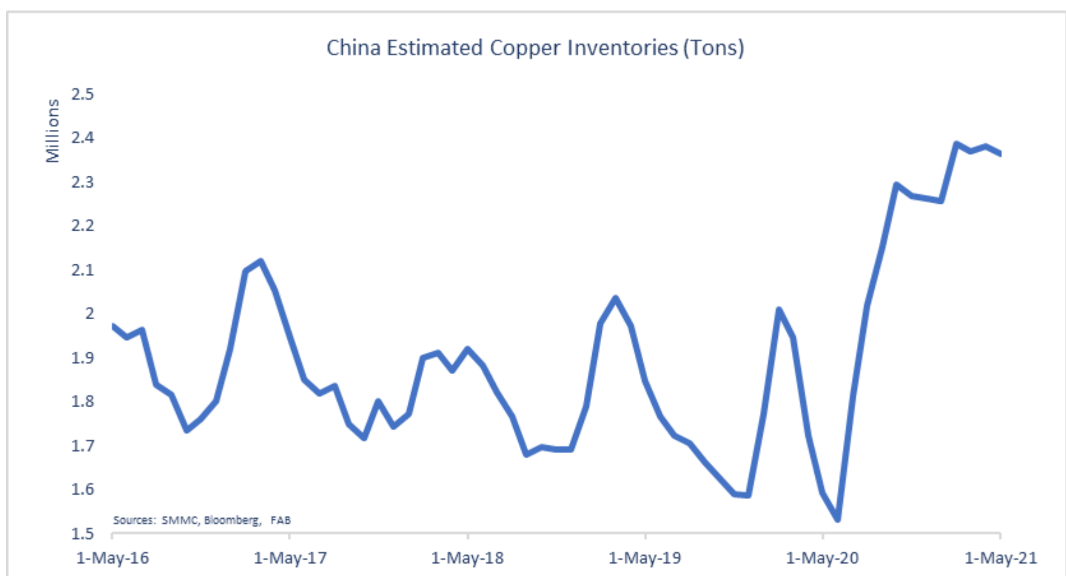
Since the start of the pandemic, however, the shale producers' output has been under control. In the past year, US crude output has only increased marginally, to 11.3 million barrels/day, according to the US Energy Information Administration. This may be attributed in part to the round of bankruptcies of shale oil producers which took place in 2020. Last year's plunge in oil prices also prompted some investors and banks to demand more investment discipline from independent oil producers, which curbed the growth of shale oil output.

However, the restructurings of 2020 have left many of the remaining producers in a healthier position. The debt-to-assets ratio of the energy sub-index of the Russell 2000, in which many of the independent oil producers sit, fell to 33.1%, the lowest in at least five years, in the first quarter. This means the surviving firms may in the future have an increased ability to increase output.

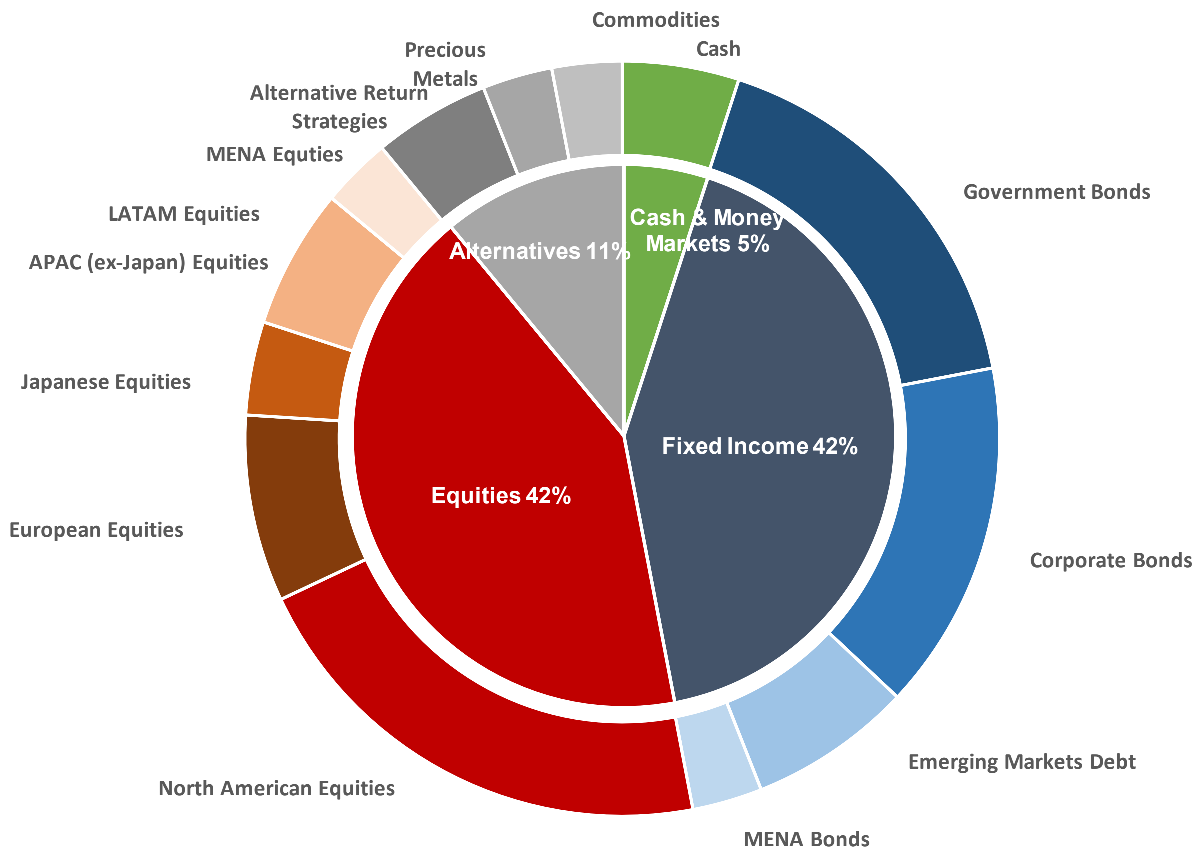
For now, global crude demand is increasing faster than supply. Air travel has started to recover, with for instance nearly 2.2 million passengers taking flights in the US in the 4th of July holiday weekend, according to the Transportation Security Administration. That is still short of the nearly 2.8 million that traveled on the same weekend two years earlier, but not by much.

The above parameters are broadly the case for many commodities. As people start enjoying meeting each other and going to restaurants or traveling, demand for raw materials is likely to rise faster than supply, and this suggests the prices for these materials will continue to remain supported for months to come, or even years in some cases. Also, it is worth noting that the Bloomberg Agricultural Price Index has risen by approximately 57% since the middle of last year.

Chinese copper inventories were at a high before Beijing cracked down on pollution



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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