Weekly Market Update

11 July 21

US Economy : Optimism Repriced -1/2

- The last week's economic data generally indicated strong growth but surprised modestly on the downside, which may have helped push both equities and Treasury yields lower.
- ISM gauge of service sector activity in June came in lower than expected, and the IBD/TIPP Economic Optimism Index fell back to its lowest level since February. Weekly jobless claims ticked higher, while May job openings rose a bit less than expected.
- In terms of labor, the friction could remain for some months as employers struggle to find all the help they need. Job openings notched another record high of 9.2 million in May , but the monthly gain (+16,000) was the smallest since the start of the year.
- Minutes from the Federal Open Market Committee's June meeting, released Wednesday, seemed to evoke little reaction from markets. The meeting summary revealed that policymakers do not believe the economic recovery has yet reached their goal of "substantial further progress" and suggested that most committee members are not eager to begin tapering the Fed's asset purchases.
- Sentiment seemed to swing back in a positive direction again on Friday, lifting S&P 500 and Nasdaq to new records and sending the 10-year Treasury yield sharply higher. Specific catalysts for the move were difficult to identify, but some pointed to expectations for the arrival of strong second-quarter earnings reports the following week.
- Analysts polled by both FactSet and Refinitiv are currently expecting overall earnings for the S&P 500 to have expanded by nearly two-thirds over the year before—albeit from a low base, given the shutdown of much of the economy last spring.

US Economy : Optimism Repriced -2/2

- The strong pace of demand amid strapped supply is bidding up costs and pushing earnings and non-wage incentives higher as firms are having to pony up to attract workers. Earnings are rising fastest among lower-paying sectors hardest hit from the pandemic.
- For example, average hourly earnings in the transportation & warehousing sector were up 17.7% at an annualized rate over the past three months through June, the most of any sector. Anecdotal evidence suggests a more competitive wage environment will keep price pressures elevated, and a respondent from the transportation & warehousing industry in the latest ISM services report noted, “wages have risen at an unprecedented rate... We are expecting a long-term effect on pricing of services.”
- The prices paid component of the ISM came in north of 70 for the fifth consecutive month in June as all but one industry (agriculture) reported higher costs during the month. These developments further support our view that inflation pressures will remain elevated.
- Considering the current labour situation, the modest pickup in initial jobless claims to 373,000 last week was more noise than a signal. The smaller gain in openings and the recent pickup in hiring over the past two months suggest reopening frictions are not meaningfully getting worse
- The trend in initial claims is falling and with labor scarce and more expensive for those looking to hire, businesses are likely increasingly reluctant to lay off workers. The pickup in wages does, however, bode well for workers weighing their options and suggests continued churn in the labor market.
- The quit rate remains above pre-pandemic levels, and higher earnings amid consumer perceptions that jobs are “plentiful” may continue to encourage job switching. A silver lining is that a higher wage environment may also serve as an additional incentive to draw workers back into the labour force.

Global Mfg PMI : Loss of momentum

- Global manufacturing PMI drops, but still at high level –On an aggregate level, the global PMI dropped for the first time in five months (to 55.5), after having reached an 11-year high of 56.0 in May. This drop was broad based, with the global subindices for output, new orders and export orders all coming down in June compared to May.
- The loss in momentum suggested by this drop could well be related to – amongst others – a rebalancing in global demand from goods to services (led by the US) as economies reopen and to various supply side bottlenecks
- However , according to the latest CPB data, in April global trade and industrial production were up 25.2% yoy and 18.2% yoy, respectively. This is in line with the view that global industry and trade would be much less hit by virus flare ups and new lockdown measures compared to global services sectors.
- There are signs that supply side bottlenecks are still an impediment to the recovery. These include the general scarcity of semiconductors in automotive and other high tech industries, constraints in global container transport, and – particularly in the US – labour market frictions
- After having risen to multiyear highs in May, the sub-indices for input prices (from 71.7 in May to 70.6 in June) and output prices (from 62.6 to 60.9) both came down. This marked the first decline for both sub-indices in fourteen months, and is an early sign of an easing in cost push pressures stemming from commodity prices and supply side bottlenecks.
- US Treasury yields slumped on this loss of momentum in the headline index as well as Prices

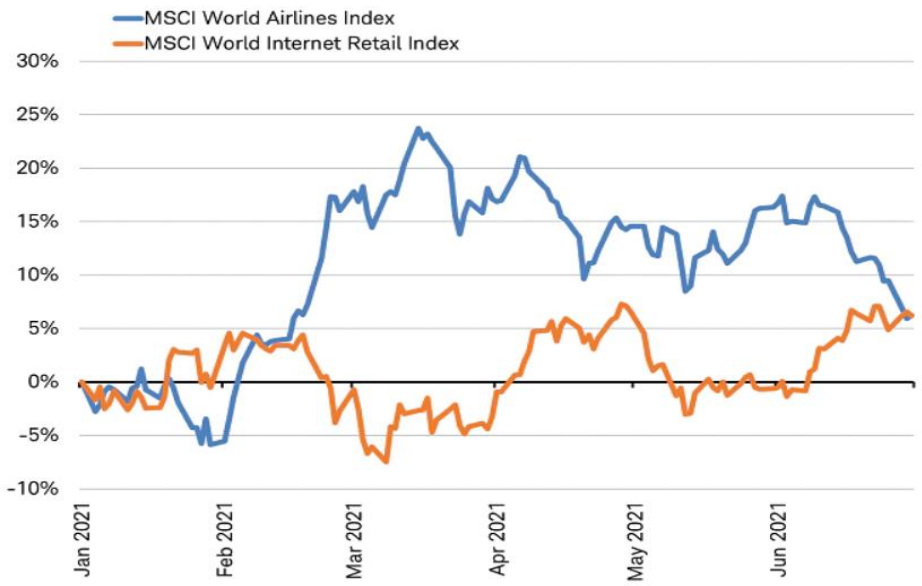
FOMC Minutes : More Questions

- Given that Fed raised its estimate for 2021 inflation, as measured by the PCE deflator, by a full percentage point to 3.4%, there was discussion about inflation.
- While a few members clearly appear to be more alarmed about the rapid and widespread acceleration in price increases, the majority of FOMC members still are clinging to the notion that the bulk of the acceleration in inflation will prove transitory. Supply-chain bottlenecks are clearly proving more pernicious and likely to persist longer than earlier thought, but the recent decline in lumber prices has bolstered those who still believe relief from higher inflation is just around the corner.
- Views on the path for economic growth were also divided beyond the burst provided by the avalanche of fiscal stimulus early this spring. FOMC cited the recent slowing in payroll growth (prior to the June report) as reason for patience in accelerating the winding down of QE.
- FOMC was also divided whether its purchases of mortgage-backed securities were contributing to the rapid run-up in home prices. In short, the minutes suggest Fed has only slightly pulled forward its expectations for when it would be appropriate to begin winding down their bond purchases, with the most likely timing of an announcement coming late this fall with implementation beginning early next year.
- That puts the timing of the first interest rate hike sometime in early 2023, consistent with the movement in the Fed's dot plot, which shows 11 of the 18 FOMC participants believe that at least two quarter-point hikes in FED funds rate would be appropriate by end 2023 and two others believe that one hike would be needed.
- Seven FOMC members feel the Fed should begin hiking rates in 2022, with five members believing one rate hike would be appropriate and two stating the appropriate federal rate at the end of 2022 would be half a percentage point higher than it is today.

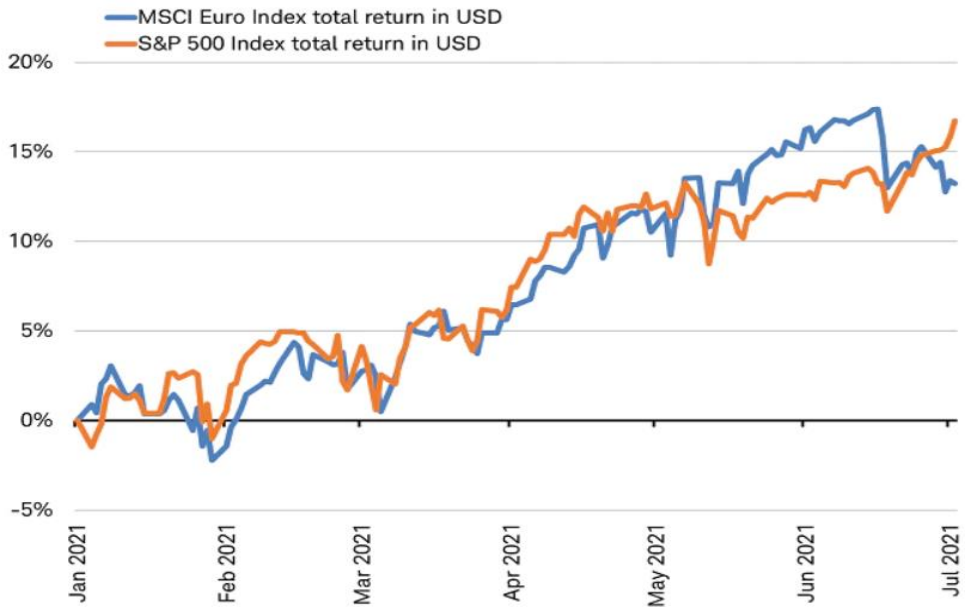
Equity outlook : Rotation holds key

- U.S. equity markets finished out a bumpy week in style, posting solid gains for the session and increasing its weekly winning streak to three.
- Financials led the way, with Information Technology a close second. The moves came despite palpable uneasiness regarding the potential impact of the spreading Delta coronavirus variant in the world, while investors appeared to shrug off Biden's executive order aimed at cracking down on anticompetitive practices among U.S. businesses.
- While cyclical stocks had been outperforming lockdown-era defensives for most of this year, the outperformance gap closed sharply in the last few weeks. When yields begin to rise again the rotation may reverse back to favoring cyclicals.
- This market rotation is not just across industries but can also be seen across countries. The tech-heavy U.S. stock market benefited from the defensive leadership rotation
- As the U.S. stock market continued to hit new all-time highs in June, the more economically sensitive Eurozone stock market gave back gains starting in mid-June and is now lagging the U.S. on a year-to-date basis.
- For a historic perspective ,
    - Since 1980, when the S&P 500 gained 15% or more in the first six months of the calendar year, the second-half return averaged 5.7%
    - Since 1990, U.S. large-cap equities have averaged a total return of 18.1% during the two years preceding the Fed’s initial rate hike. U.S. equities outperformed bonds by an average of nearly 6% during those periods

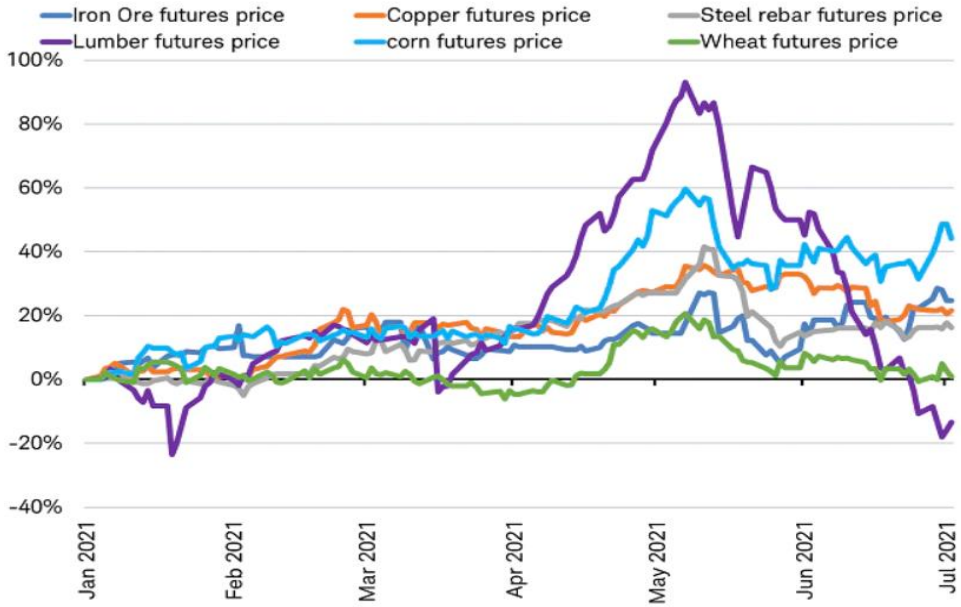
Airlines versus internet retailers year-to-date performance



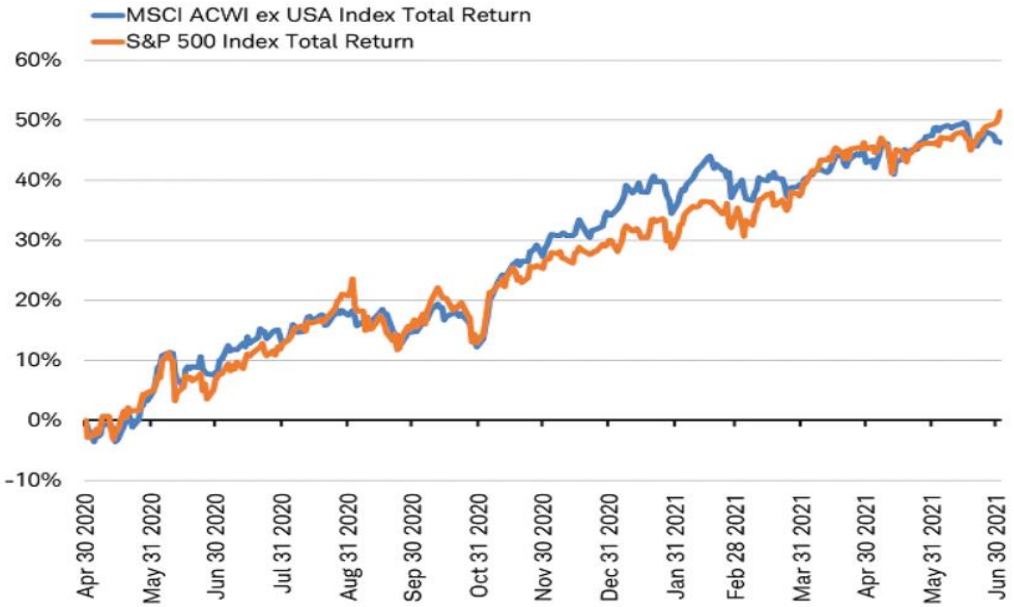
Eurozone lost its lead in late June



Commodity price surge fades



Non-U.S. stocks slip



Topic of the week : Global Home Prices

- The rise in house prices is global.
- It has taken place in North America, much of Western Europe, many parts of East Asia, and even Latin America and southern Africa.
- People stashed much of their income in their bank accounts and purchased assets, such as equities, commodities, crypto-currencies, and property. The case for property was helped by central bank policies that kept borrowing rates historically low, and also by people's desire to find larger homes from which to work remotely.
- In US the median sales price of an existing home was up 23.6% in May versus a year earlier, a stunning and historically unusual number.
- In UK, house prices were up 13.4% in June versus a year earlier. This was the largest increase since November 2004.
- Activity in the housing market has been helpful to economic activity, driving construction, demand for lumber and other commodities, as well as demand for home appliances, home electronics, and furniture.
- And yet there are concerns - One leading economist, Adam Posen of the Peterson Institute and formerly of the Bank of England, said, "I'm not happy about house price increases because real estate is the surest indicator, the most compelling indicator, for a crash."
- Indeed, the housing price crash of 2008-2009—the crash nearly brought down the entire global financial system—followed a massive surge in house prices in US . The dynamics are different and no two cycles are never similar.

ECB Watch: Overshoot Strategy

- **The new goal** – ECB has raised its inflation target to 2% from 'below, but close to, 2%' previously. ECB notes that 'price stability is best maintained by aiming for two per cent inflation over the medium term. The Governing Council's commitment to this target is symmetric. Symmetry means that the Governing Council considers negative and positive deviations from this target as equally undesirable'.

- **Overshooting** – In addition, the ECB has stated that it is prepared to allow periods of inflation overshooting the goal in circumstances where interest rates are close to the lower bound (as they are now) to prevent the dis-anchoring of inflation expectations. It notes that 'when the economy is close to the lower bound, this requires especially forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched. This may also imply a transitory period in which inflation is moderately above target'. Despite the fact that Lagarde was repeatedly asked about this point in the press conference, it is unclear exactly how this policy would look in practice. What is clear, is that given the current policy environment and low inflation expectations. ECB expects to be more frequently in situations where it makes sense to err on the side of doing too much than too little.

- **Housing** –ECB confirms that HICP is the appropriate measure of inflation to assess 'the achievement of the price stability objective'. However, the Governing Council would ideally like to see the inclusion of the costs related to owner-occupied housing (OOH) in the HICP over the coming years. In the meantime, the Governing Council will 'take into account inflation measures that include initial estimates of the cost of owner-occupied housing in its wider set of supplementary inflation indicators'. In earlier comments, ECB has suggested that the inclusion of OOH into HICP would add 0.2-0.3% to the inflation rate.

- **Lower for longer** – Overall, the changes put in place following the review imply an even longer period of accommodative monetary policy. This is because the gap, between where the ECB wants inflation to be over the medium term and where it is projecting that it will be, is now larger. In addition, given the current state is very close to the lower bound in interest rates and inflation expectations are historically low, ECB has signalled its willingness to see a moderate overshoot of inflation in order to re-anchor inflation expectations. The consideration of OOH in its inflation assessment only partially offsets the other elements in terms of the monetary policy direction

Eurozone : Sparks fly

- Eurozone sentiment indicators are surging as freedom from the pandemic looks to be within reach
- European Commission's economic sentiment indicator hit a 21-year high in June, with confidence now way above the long-term average in all sectors. The fear of second-round increases in unemployment is now rapidly fading away and we are starting to see, albeit still anecdotally, a lack of skilled labour in certain sectors. No wonder that consumer intentions to make major purchases over the next 12 months are close to the highest level in 20 years. So the markets remain comfortable with 4.5% growth forecast for this year and 4.0% for 2022.
- According to the accounts of the ECB meeting , the rift between hawks and doves, last seen in mid-2019, seems to be back with some ECB members arguing in favour of a small reduction of asset purchases. The minutes shed a somewhat less benign light on ECB's take on inflation than presented during the press conference after the June meeting.
- While members 'widely agreed' with the view of higher inflation being mainly transitory, there also seemed to have been concerns about a less sluggish pass-through from producer to consumer prices than in the past. Some member even argued that "there could be upside risks not only over the shorter term but also over the medium term". The results of the ECB's strategy review introduced more dovishness.
- For the time being, however, the markets price a very dovish ECB - no real tightening until late 23/24
- The holiday season is likely to spread the Delta variant more widely across the eurozone, though a rapidly advancing vaccination campaign will limit the fallout.

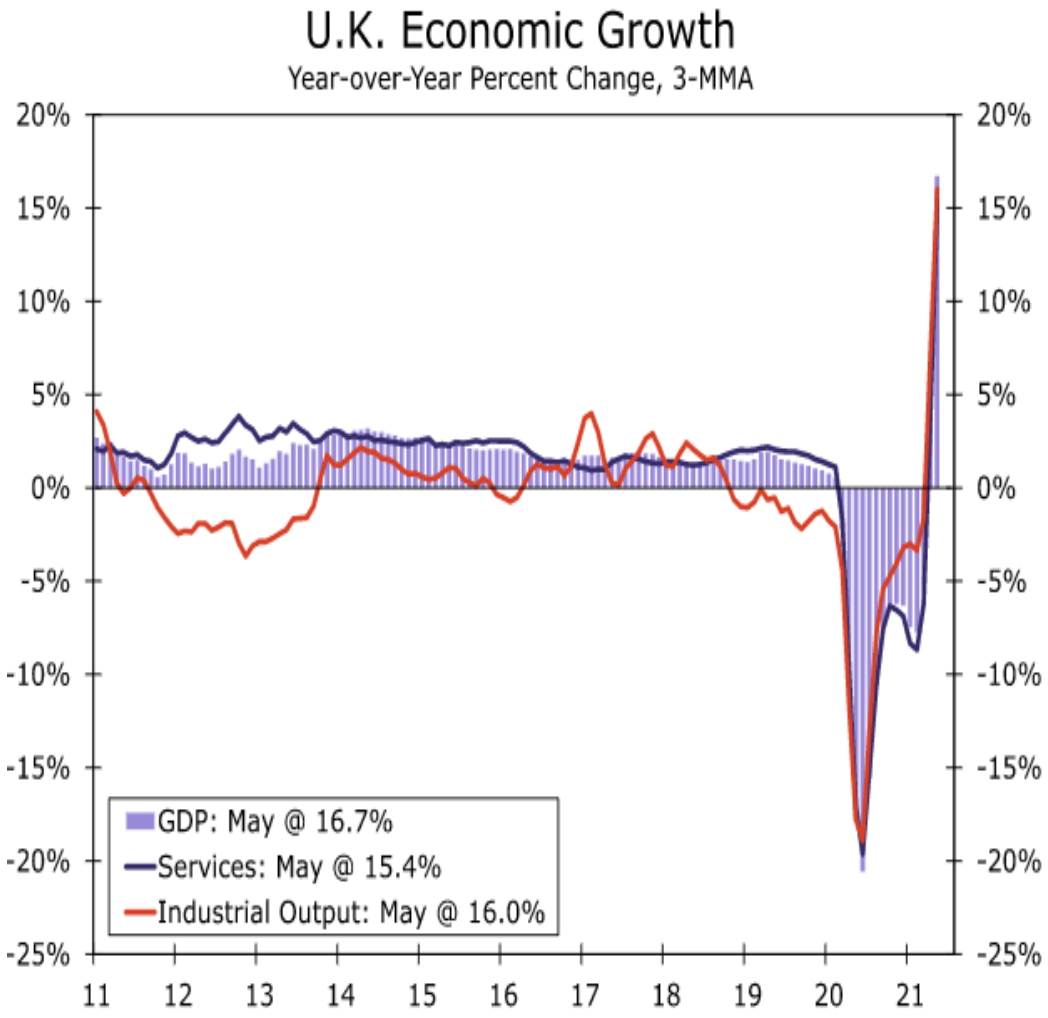
French Politics : Key for EURUSD

- French regional elections brought a first setback in Marine Le Pen's bid for the French presidency next year. Her far-right RN party performed worse than expected, and failed to secure its first regional government. Instead, it was a strong showing by incumbent candidates from the centre-right Republicans.
- However, with voter turnout at a record low 32% and still some 10 months until the presidential election, one should be cautious to completely write-off the risk of a Le Pen presidency.
- The National Rally's disastrous recent regional election results had many asking: Is this the end for Marine Le Pen? The answer from a party conference this weekend was an emphatic no.At the meeting in the southern town of Perpignan, there wasn't the faintest hint of mutiny. Instead, the party rank and file issued a chorus of support for their leader.
- A day before the party conference began, Le Pen had issued a reminder of her stance on the EU, signing a declaration along with the Continent's leading populist parties — including Hungarian Prime Minister Viktor Orbán's Fidesz, Poland's governing Law and Justice and Italy's League, led by Matteo Salvini — against the bloc's political direction.
- Merkel's departure will obviously leave a large void that no EU leader can credibly fill. Macron will certainly try, but in the unlikely possibility of Macron loosing his election , Europe will be without a strong political leadership and EUR could plunge below parity .
- Hence Successfully kick-starting the French economy after the pandemic will be crucial for President Macron's re-election chances and EUR's fortunes.

EUR: Overvaluation at record high

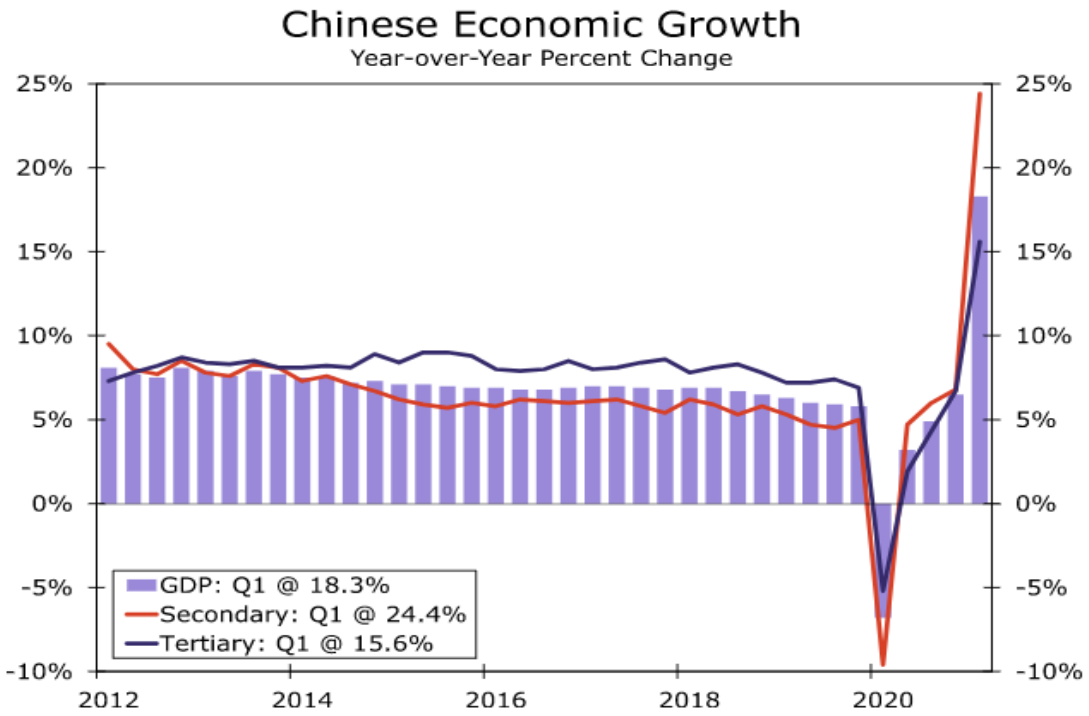
UK Growth : Firm Undertone

- The latest U.K. GDP figures indicated the country's economic expansion continued, albeit at a somewhat slower pace in May.
- U.K. GDP rose 0.8% month-over-month in May, less than expected, following sizable gains in both March and April.
- That said, with the May increase, the level of GDP for the first two months of Q2 is now 4.3% above its Q1 average.
- May services activity showed a steady gain of 0.9% month-over-month as the U.K. continued along the reopening path, while May industrial output rose a similar 0.8%. The release did show clear evidence of the reopening, as accommodation and food service activities rose 37.1%.
- Given overall encouraging economic signals, even with the brief delay in the final phase of the U.K. reopening, the markets remain constructive on the prospects for U.K. growth.
- Indeed, consensus lifted U.K. GDP growth outlook for 2021 to 7.5%, from 7.0% previously.



China : Admission of Stress

- A return to the piecemeal monetary easing approach that policy makers have adopted before. This should not be seen as the start of an aggressive easing cycle, given that policy makers are likely to stick to their overall goal of containing overall leverage (by capping overall credit growth to nominal GDP growth). This move would give some breathing space to companies that were faced with rising interest rates driven up by a rise in cost push inflation.
- China's Q2 GDP figures due this week should confirm an overall and ongoing slowdown in the economy. On a sequential basis, the consensus forecast is for Q2 GDP to rise 1.0% quarter-over-quarter. That would be better than the 0.6% increase seen in Q1, but still slower than the trend rate of growth typically seen prior to the COVID crisis. Meanwhile, on an annual basis GDP is forecast to slow markedly to 8.0% year-over-year, with both manufacturing and service sector growth expected to decelerate.
- Indeed, recent monthly activity data confirm that there has been a broad-based slowdown, a trend that is expected to continue with the release of June figures.
- The consensus forecast is for June retail sales to slow to 10.9% year-over-year, while growth in June industrial output is forecast to slow to 8.0%.



Note: The credit impulse is the change in new credit issued as a proportion of GDP.

OPEC : Emerging Probabilities

- OPEC+ postpones its meeting until further notice – During the OPEC+ Joint Ministerial Monitoring Committee (JMMC) consultations it already had become clear that it would not be easy to find an agreement on production levels. In particular, UAE, Iraq and Kazakhstan wanted an adjustment of the base level .
- The markets appear spooked, with oil futures charts in deep backwardation; in fact, oil prices for U.S. crude for delivery in December 2021 are currently trading at a $7/bbl premium to oil for delivery in December 2022, the highest spread on record.
- Separately Norway-based energy consultancy Rystad Energy recently warned that Big Oil could see its proven reserves run out in less than 15 years, thanks to produced volumes not being fully replaced with new discoveries.
- As the current production agreement runs until the end of July, there is still time to reach an agreement for August and beyond. There are likely three scenarios for the coming weeks:
- 1) OPEC+ come to an agreement in the coming days/weeks (before Aug 1). Oil production is increased as proposed and the deal is extended to December 2022. The production cut agreement would then be fully reversed by the end of 2022 and producers would then be producing at similar levels as before the April 2020 corona measures. The oil price would fall. (50% probability)
- 2) OPEC+ sticks to the current July 2021 agreement. This further increases scarcity in the market as oil demand continues to pick up. The oil price rises and breaks through the long-term downward trend that started in 2008. The upside price potential would then be high (at least to USD 86-87/barrel = 100% retracement level and highest level in 2018). (20% probability)
- 3) There is no agreement and the OPEC+ cooperation is dissolved. Each country will, as in March 2020, again produce at its own discretion. Oil production will increase rapidly and oil prices will fall sharply. (30% probability)

Indian Equity Markets

- Markets remained in a state of flux with global sentiment showing signs of fatigue on overvaluation and India experiencing a volatile session after FIIs exited equities in the latter half of the week.
- Net inflows into Equity Mutual funds in June marked the fourth consecutive month of positive inflows, after eight straight months of outflows prior to March 2021.
- Markets hovering around new highs have not only lured the FOMO retail to invest but have also persuaded promoters to come out with IPOs
- Markets make intermediate tops when they reach a state of excess.
- Nifty50 closed on a mildly negative note for the week, but it is still trading in a range .
- The index has established support at the 15500 zone, a break of which will raise a red flag . Till then the range 15600 15900 is likely to hold

Indian Bond markets : Free hit at last ?

- India's retail inflation is expected to rise to 6.7% in June from 6.3% in the previous month owing to a broad-based rise in prices. While the rise in food and fuel prices is widely considered to be led by supply-side issues, core inflation is also expected to remain elevated in June. Services inflation is seen rising to 7.6% in June–the highest in eight-and-a-half years. This may push core inflation even higher from May's multi-year high of 6.6%.

- At these levels, inflation would be breaching RBI target band of 2-6% for the second straight month. However RBI Governor almost stated what FED and ECB had maintained about the current inflation spike being transitory. Even if temporary, the large inflation prints will be more than sufficient for the trajectory to be substantially higher than the RBI's forecasts. If Jun CPI inflation does come in at 6.7%, it will take the average for Apr-Jun to 5.7%, which is 50 basis points above the central bank's forecast of 5.2%.

- The expected strong annual rise in May, however, would be hiding a slowdown in activity due to the restrictions imposed by several states to contain the second wave. As such, tracking sequential momentum would provide a better picture of industrial activity. Interestingly ,Under the current series, which goes back to April 2012, the general index of the IIP has never declined in May from April.

- Higher-than-expected coupon set by RBI on the new 10-year bond indicates that RBI may be finally comfortable with bond yields rising gradually, say towards 6.25 % considering the elevated inflation, expected increase in supply of dated securities, and higher global commodity prices.