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Asset Management

What to focus on in Global Macro for the week of January 3rd, 2022

Macro Themes on the Radar:

To get to the answers, we need to know what the questions are.

As we enter 2022, we face three looming macro questions:

- What is going to happen to interest rates and Treasury yields?
- Will the USD continue to strengthen or reverse course and weaken?
- How will China policy/growth play out from here?

Historically, they have been more connected than one might expect.

How these questions are resolved will have a huge impact on global asset allocation in the coming months.

First off, since 2008 there has often been a link between periods of dollar strength and falling Treasury yields. As the global reserve currency, dollar moves often have a reflexive nature and can be both the cause and the symptom of changes in global liquidity.

Will we need a lower USD from here to see meaningfully higher yields in the long end of the curve?

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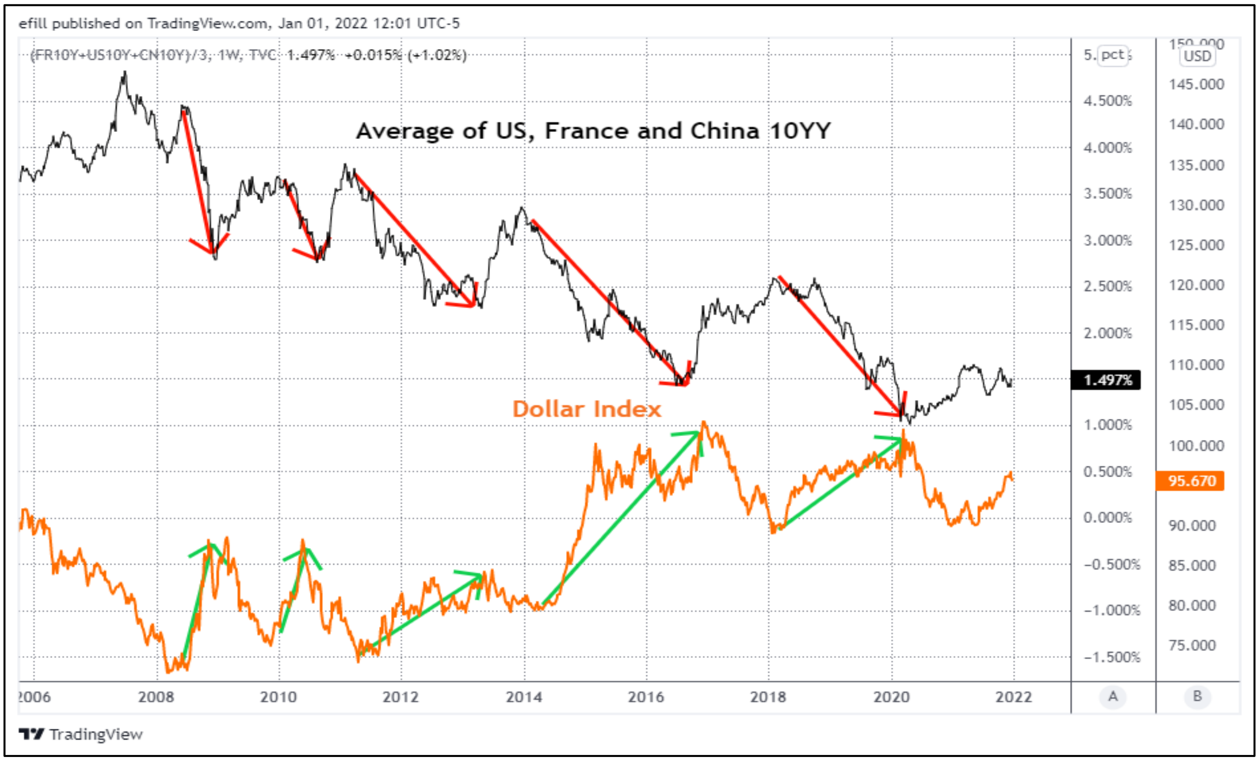
Here is the relationship expanded beyond just US yields, adding France as a good proxy for Europe, and China.



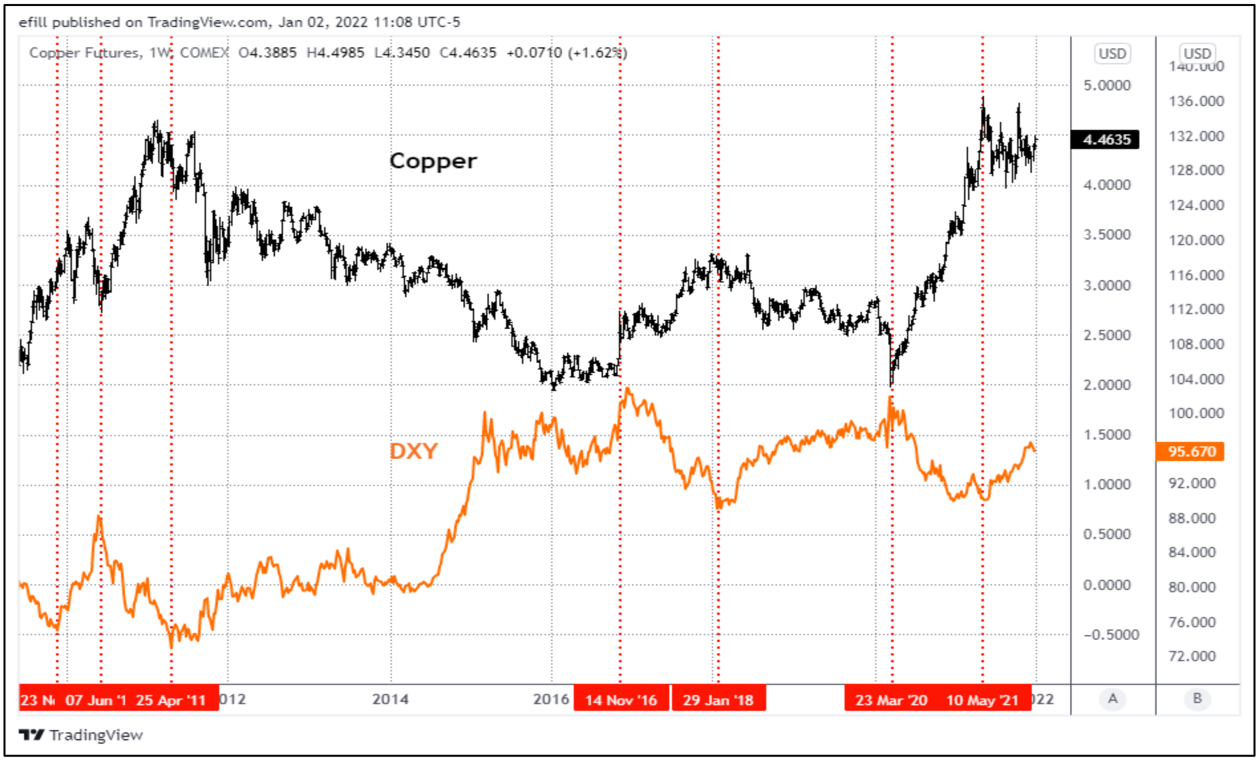
Druckenmiller recently wrote: *"Historically, once inflation reaches this level, it feeds into wages and corporate behavior in such a way that it does not fall until a recession. This happens after the Fed tightens financial conditions considerably. The Fed's belief that inflation will return to the 6.8% target over the next two years while unemployment will rise to 3.5% while federal funds will rise to 1.5% has no historical precedent. Indeed, the great inflation that occurred at the end of the 1970s was after [then-chairman of the Federal Reserve] Arthur Burns had a 5% federal funds rate in 1975 accompanied by an inflation rate of 6.7%. So I'm skeptical that inflation will behave as the Fed expects with the policy it is proposing over the next two years."*

Fair enough, but the one big thing that all the comparisons to the 1970's is missing, is the large fall in the USD that we saw after Nixon broke the link to Gold.

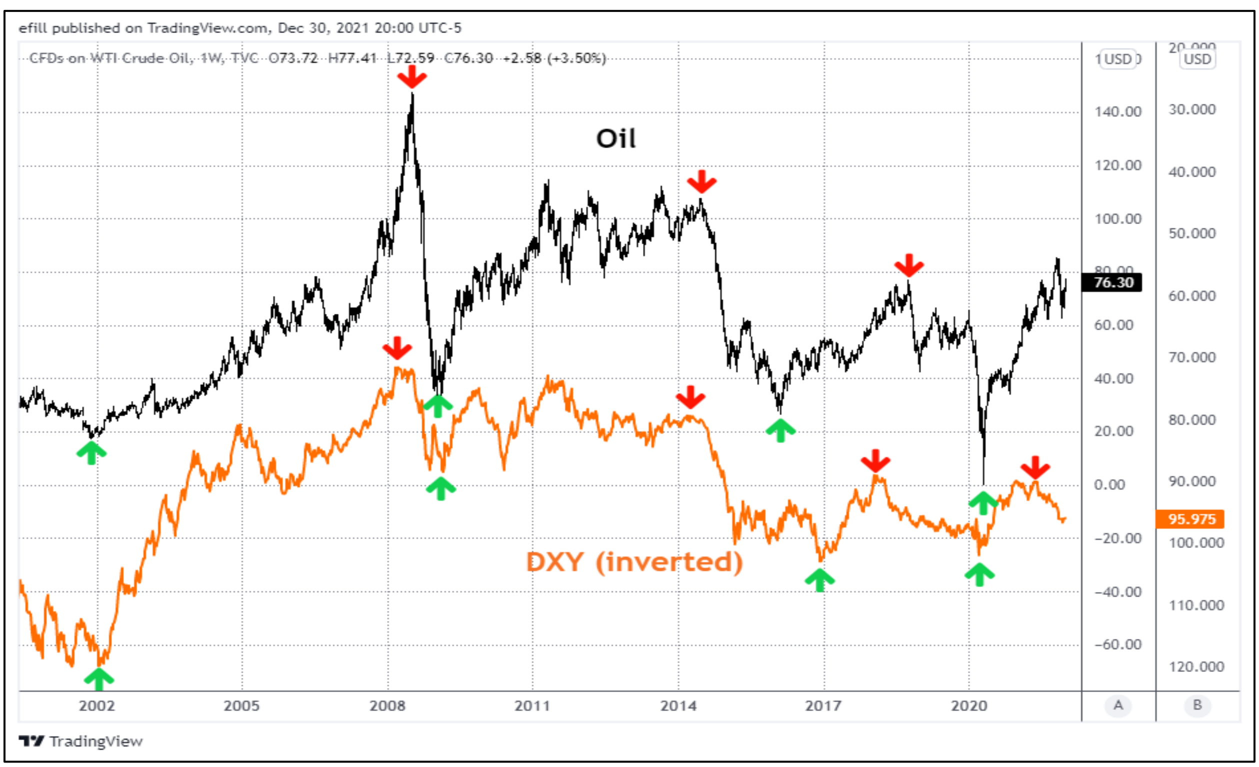
Yes, it is clearly different this time in that COVID and governments' reactions haven't left many historical comparisons intact. However, at least in commodities, there continues to be a mechanical link to the dollar. A falling USD remains a tailwind, while a rising USD is a headwind.

If we are to get another leg up in commodities as part of the supercycle many are talking about, we will likely need a weaker USD.

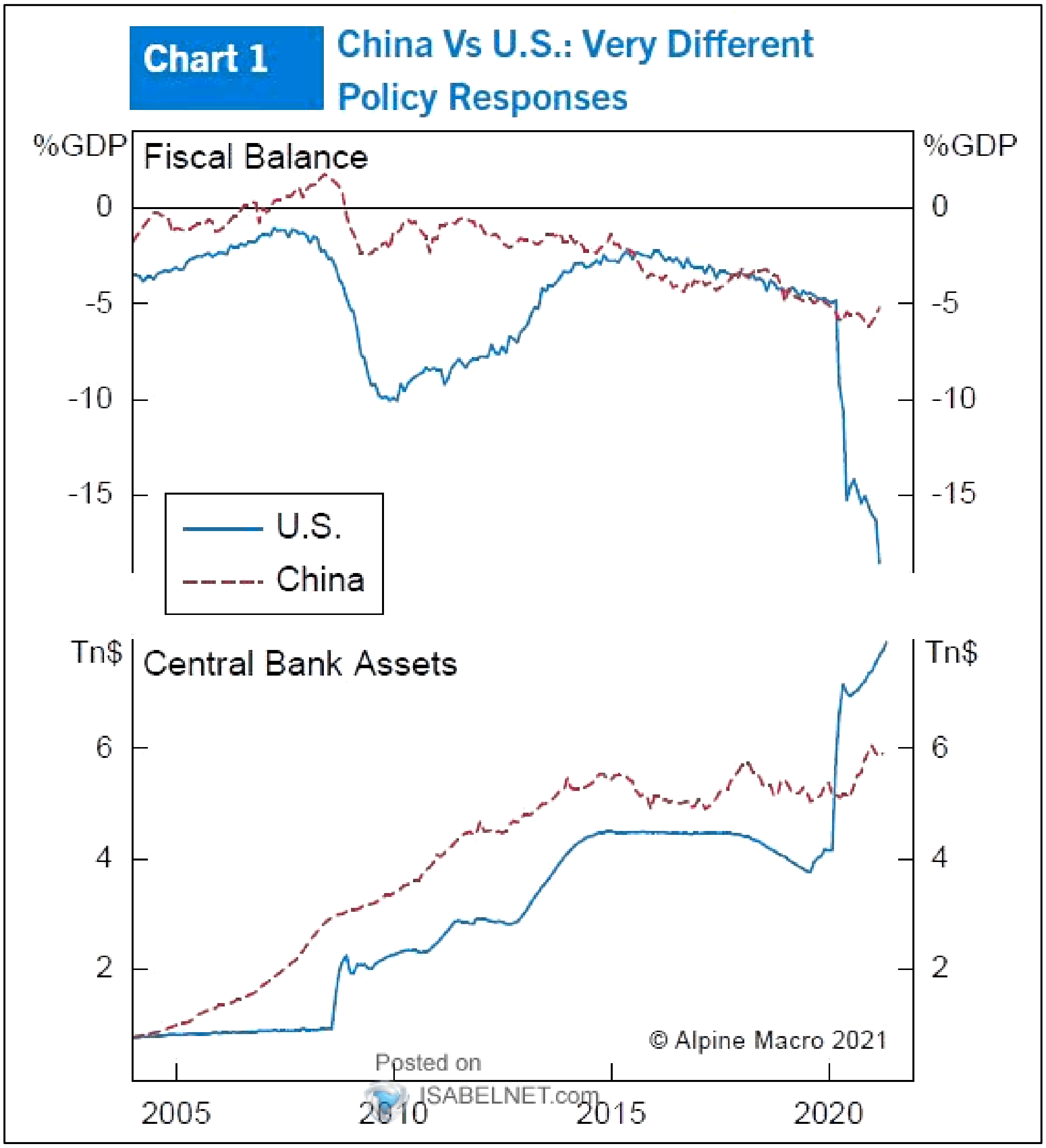
Headwind and tailwind in copper…



And in oil, this time with the dollar index inverted. Dollar leads on tops and lags on lows.



How the situation in China plays out this year will be very important to the global economy. Xi is heading for his third term (possibly for life) in the Fall. The mix of crackdowns and an attempt to de-lever the economy while maintaining zero-tolerance COVID policies have been challenging. Growth has slowed. While they have recently been adding liquidity and cutting both the RRR and the policy rate, US and China COVID responses have been very different.



We will see if that changes in the coming months, but I think the policy of seeking to maintain stability rather than goosing growth meaningfully will continue. This will likely disappoint many looking for sizable stimulus going forward.

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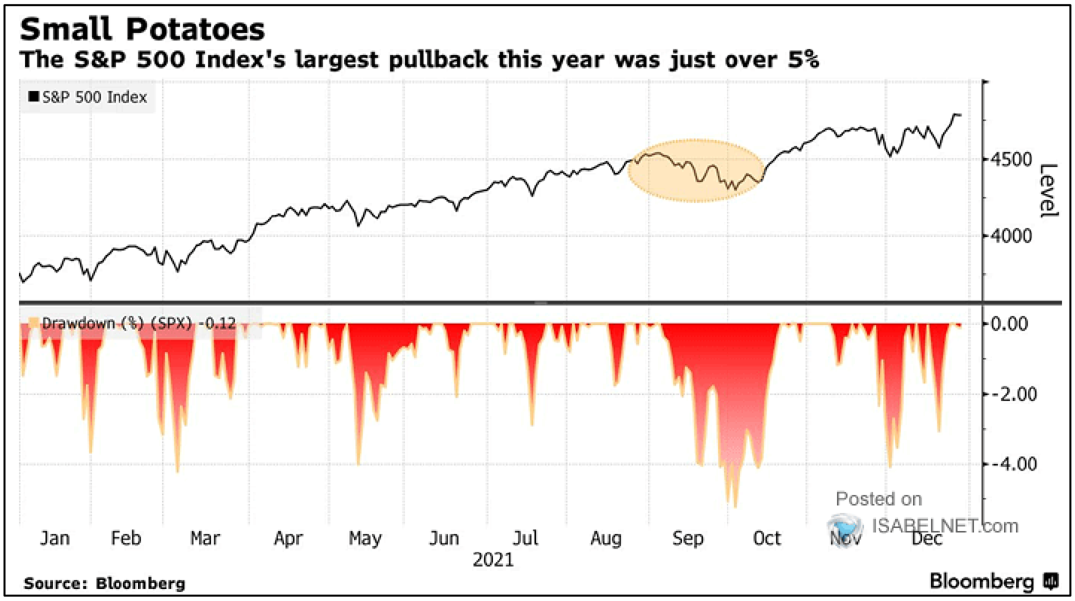
What to Focus on Now:

Last year was an unusual year for equities. Over the last 40 years the average max drawdown during the year was -14%, last year it was -5.2%. That in a year that returned 27% for the S&P.



In the last 70 years, when the S&P returned >25%, it never did better the following year. Having said that it was up 85.7% of the time the next year, with a median return of 13%.

Greater Than 25% Years Are A Good Sign For The Next Year
S&P 500 Index Returns After Big Yearly Returns

	S&P 500 Return	
Year	Return	Next Year Return
1954	45.0%	26.4%
1955	26.4%	2.6%
1958	38.1%	8.5%
1975	31.5%	19.1%
1980	25.8%	-9.7%
1985	26.3%	14.6%
1989	27.3%	-6.6%
1991	26.3%	4.5%
1995	34.1%	20.3%
1997	31.0%	26.7%
1998	26.7%	19.5%
2003	26.4%	9.0%
2013	29.6%	11.4%
2019	28.9%	16.3%
2021	26.9%	?
Average		11.6%
Median		13.0%
% Positive		85.7%
Average Year (1950 - 2020)		9.2%
Median		11.8%
% Positive		71.8%

Source: LPL Research, FactSet 01/01/22
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.
The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

Source: Topdown Charts

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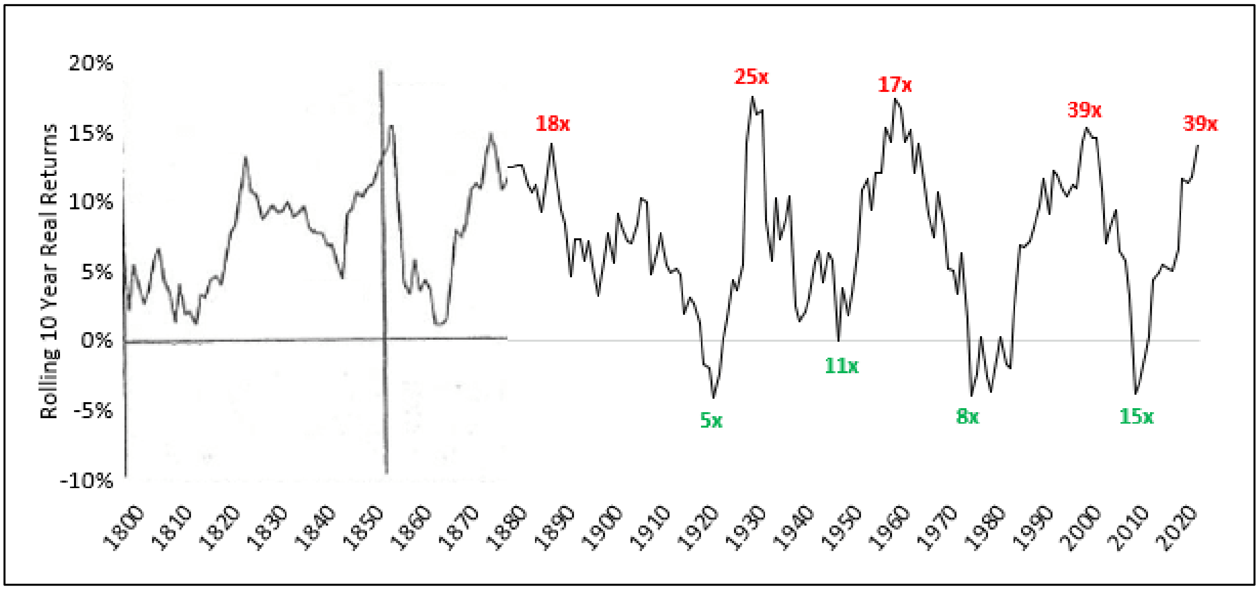
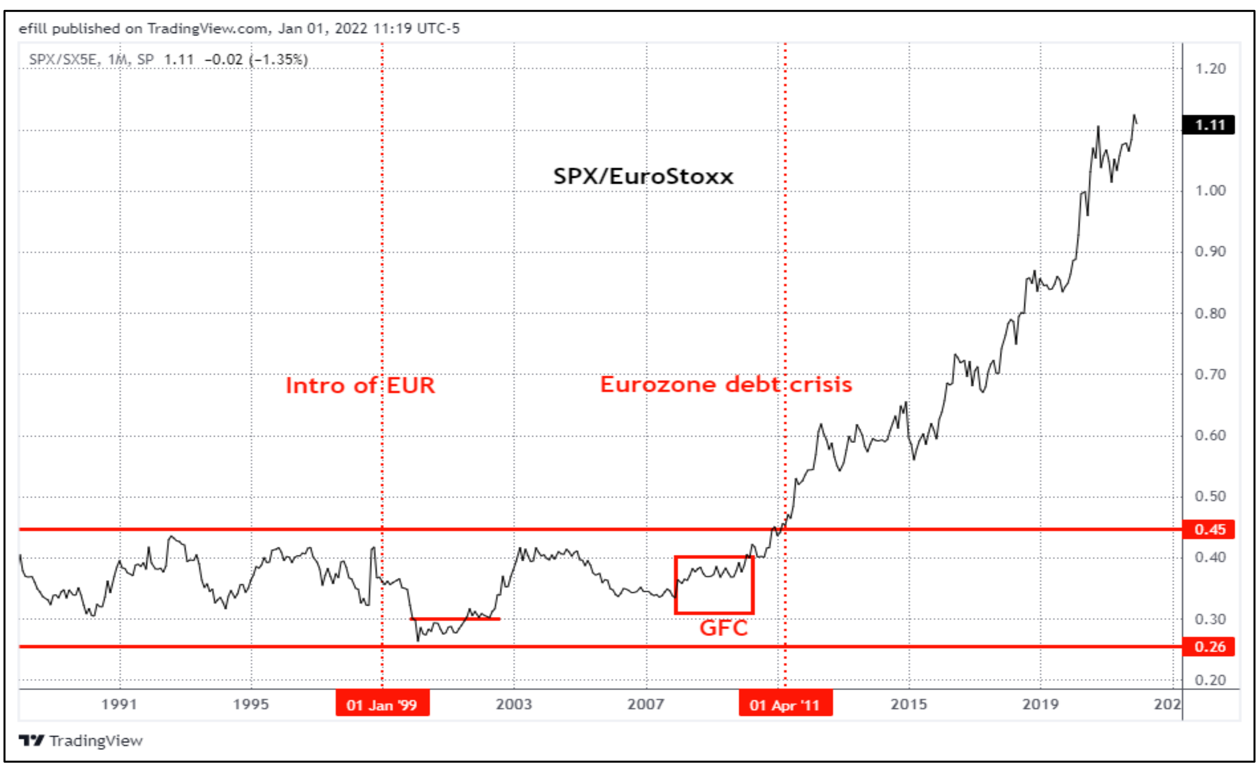
I thought this note from Kailash Capital was interesting… it illustrates the cyclical nature of rolling 10-year returns since 1800. It also has the Shiller PE peak and trough valuations.

10 Year Rolling US Stock Market Returns: It has been a good run



Source: Kailash Capital LLC, Robert Shiller Data, Yale University, American Economic Development in Historical Perspective

That "run" has been astounding on a relative basis as well. Here vs. Europe…



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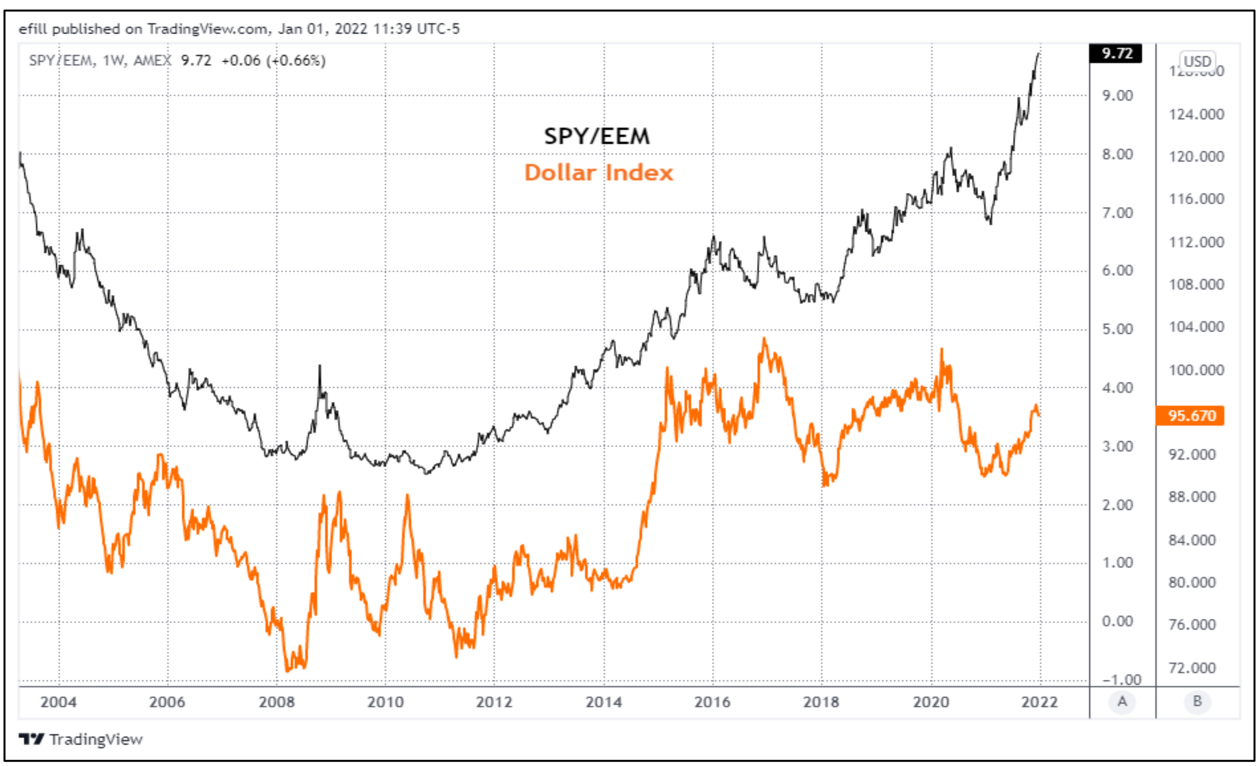
Japan…

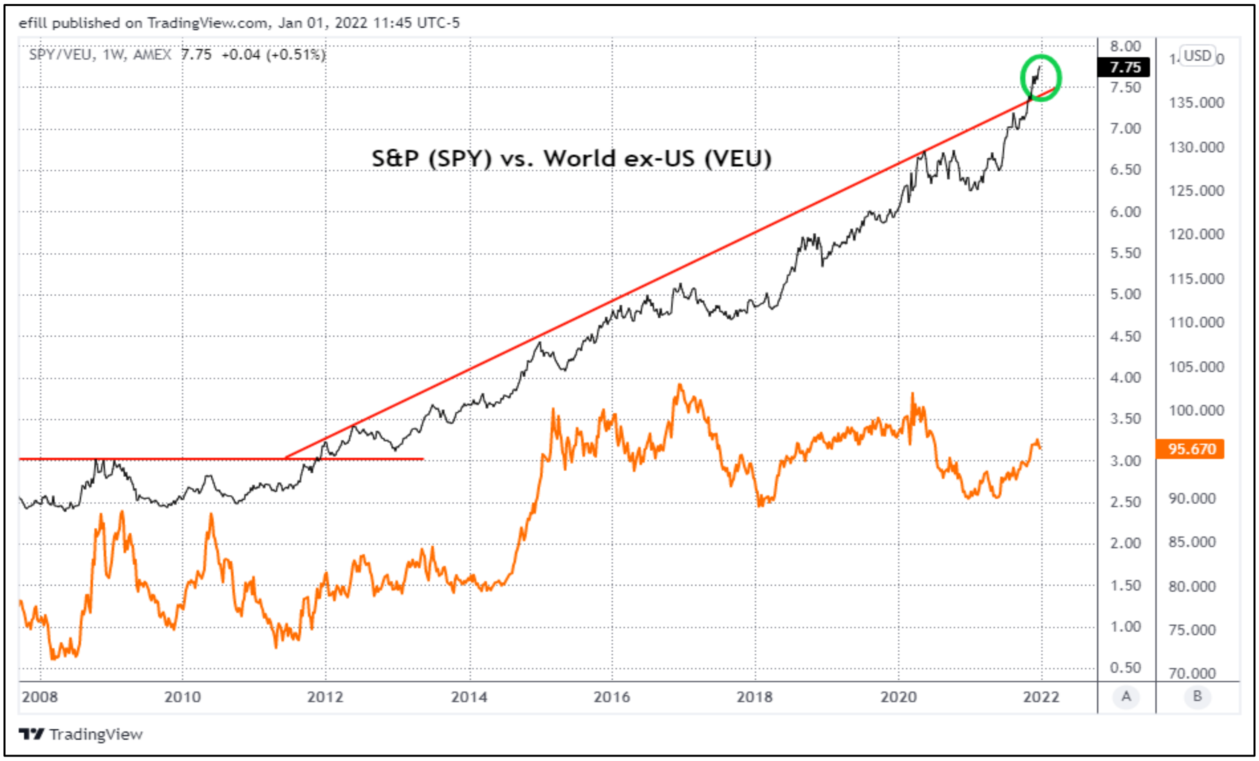
… and China.

Since the US really started outperforming in 2011, there has been a link between periods of highest outperformance and a rising USD. Here vs. other DM markets.

It has been similar vs. EM as you might expect.



And when you put them all together. The 2011 bottom in the dollar marks the acceleration point.



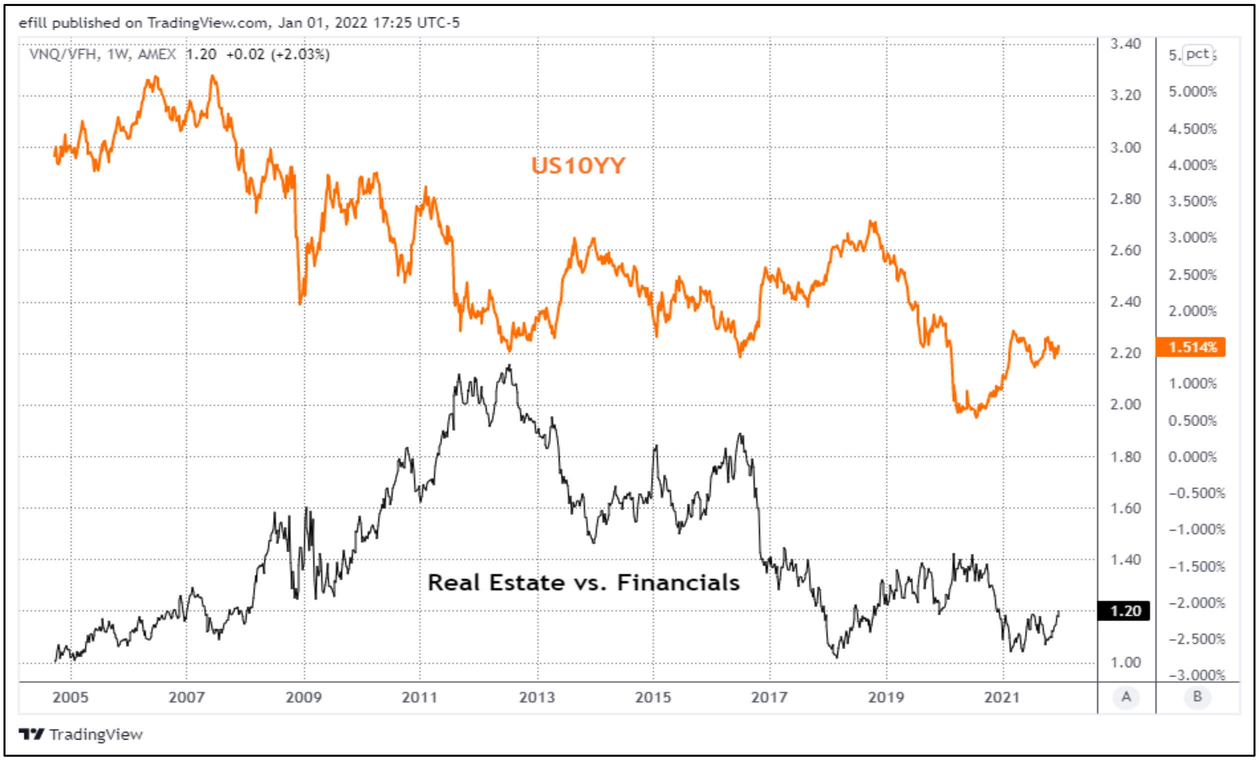
Recently the dollar has been in a range near the recent highs. Which way does it break?

Treasuries have been stuck too recently. US 10-year yields are still stuck.

While 3-month Eurodollar futures have priced 3 hikes for 2022.

With the flattening curve, banks have recently been underperforming the S&P, while real estate has been outperforming. Not really what you would expect it longer-end yields are set to move meaningfully higher. Again, dollar strength has coincided with the curve flattening.

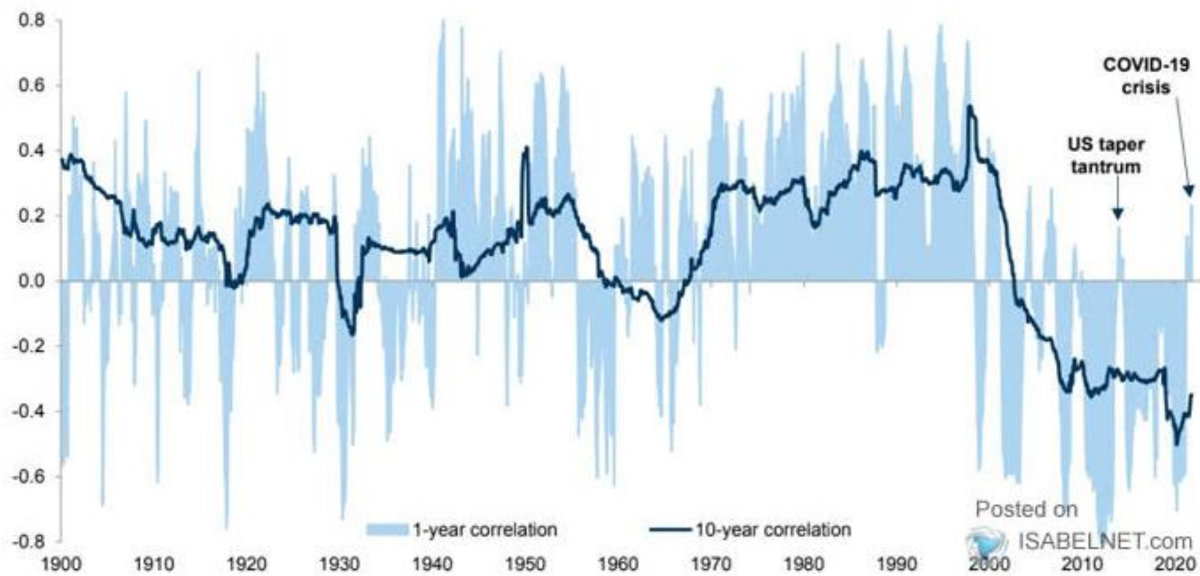
This paired trade might be worth keeping an eye on as a barometer for what equity traders are thinking regarding the long-end.



Two more items…

Before the inflation of the '70's, the relationship between equities and bonds was very unstable, sometimes they were positively correlated, at other times negatively. Starting in the late 1960's, bond and equity prices became consistently correlated as inflation fears would push both down together, and alternately push them up together when inflation temporarily subsided. With the advent of the triple-punch of the Asian crisis in 1997, LTCM and the Russia default in 1998 and the bursting of the internet bubble in 2000, the relationship flipped. Now, the markets feared deflation rather than inflation, as the greater danger. 2008 took this to a new level and since then the CB's have quickly unleashed a tsunami of liquidity when trouble hits, COVID saw them double down on this experiment. With inflation now potentially bottomed and many CB's still keeping rates at or below zero, are we on the verge of another durable correlation flip?

Exhibit 15: Negative equity/bond correlations have been prevalent only since the late 1990s
S&P 500 vs. US 10-year bond correlation (daily returns where available, otherwise monthly returns)



Source: Haver Analytics, Goldman Sachs Global Investment Research

Europe's energy crisis, which is largely of their own making, is finding some very European solutions. On Friday, it was announced that natural gas and nuclear investments are to be labeled "green". Change the label, problem solved.

https://www.reuters.com/markets/commodities/eu-drafts-plan-label-gas-nuclear-investments-green-2022-01-01/

Important Macro Data Releases and Events for the Week

Monday 1/3/2022
- Markit Manufacturing PMIs for US and Europe (Dec)
- Caixin Manufacturing PMI (Dec)

Tuesday 1/4/2022
- OPEC Meeting
- ISM Manufacturing PMI (Dec)

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Wednesday 1/5/2022	Markit Services and Composite PMIs for US and Europe (Dec)
	ADP Employment Change (Dec)
	FOMC Minutes
	Caixin Services PMI (Dec)
Thursday 1/6/2022	Initial Jobless Claims
	Initial Jobless Claims 4-week average
	Continuing Jobless Claims
	Factory Orders (Nov)
	ISM Services PMI (Dec)
Friday 1/7/2022	Consumer and Industrial Confidence, Business Climate
	CPI Headline and Core (Dec)
	Retail Sales (Nov)
	Nonfarm Payrolls and Unemployment Rate
	Labor Force Participation

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