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Asset Management

What to focus on in Global Macro for the week of July 26th, 2021

Macro Themes on the Radar:

ECB

As expected, the ECB's "interesting changes" were focused on forward guidance regarding interest rates and inflation, rather than the continuing asset purchases (QE).

They left themselves with plenty of flexibility, but essentially reenforced the 2% symmetric inflation target (rather than the old close but below 2%) Going forward, they would be "forceful and persistent" in maintaining very easy conditions until that target is achieved, especially when rates are at or close to zero (like now). Essentially, they won't hike until they get to 2% inflation and it is seen as durable. While they are still relying on forecasts, it is a step closer to the Fed's outcome-based framework. Openly dovish guidance tweaks meant to prevent them from mistakenly hiking "too early".

Fed

Next up is the Fed on Wednesday. Since their "hawkish shift" in June, when they brought forward rate lift-off expectations, inflation data has continued to surprise to the upside. Expect more transitory inflation talk, but also continued acknowledgment that it is running much hotter than expected. They will make an effort to bring the taper discussions and timeline into focus. I don't think we get an official announcement until September at the earliest. Potentially, it could be later. The recent bond market rally and curve flattening have people thinking it could be pushed back to November (DB's call) or even December (GS's call) with an actual reduction in asset purchases not starting until the new year.

Incoming inflation and employment data, concerns about the recent jump in global COVID cases, and the upcoming US debt ceiling fight will all influence the sequencing.

With the Fed effectively still easing, it is really getting harder and harder to justify continued asset purchases, especially MBS. They are feeling the pressure from all sides now as many asset prices continue to hit new highs, inflation has yet to back off, and financial conditions are incredibly easy. All that while the Fed's balance sheet heads for the $8T mark.

It is worth remembering that back in 2013, at the height of the taper tantrum, they were set to taper but held off at the last minute because of a spat of weaker data and a debt ceiling fight (sound familiar?).

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It is also interesting to note that long yields topped when they did start tapering. Initially falling outright and then not able to keep pace when the tightening cycle actually started, causing continued flattening of the yield curve.

The current curve flattening, before tapering is even launched, has people asking if it is just a pause (often happens during the larger steepeners) or a sign of late cycle. For now, I would still guess pause/moderation, after an explosive jump in growth expectations.

Exhibit 2: The yield curve tends to flatten in anticipation of, or together with, peaks in the ISM, i.e., when growth momentum is about to slow

US 10Y-2Y yield curve and US Manufacturing ISM

Source: Haver Analytics, Datastream, Goldman Sachs Global Investment Research

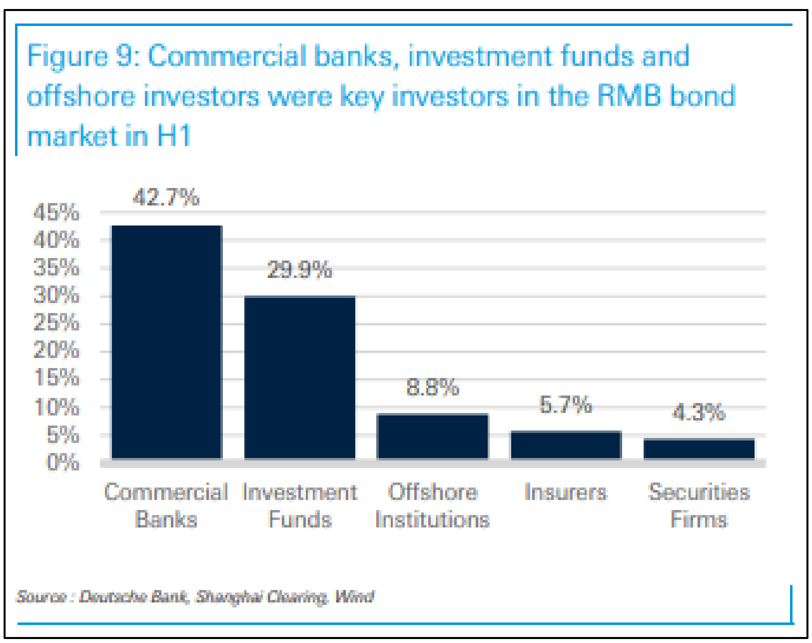
So, is the current fall in yields a deterrent or an inducement to taper? The deterrent argument would say the Fed can see the flattening yield curve too and will wonder, with everyone else, if that is signaling a growth moderation or setback (COVID resurgence, EM slowing, etc.). On the other hand, team inducement would argue that without yields moving higher and doing some of the heavy lifting, in terms of tightening financial conditions, the Fed will need to do so more aggressively, at some point.

The Fed is trying to thread a needle here, but the longer they wait the bigger the stakes will become and the higher the probability that they themselves become a big source of potential volatility. With the government such a big player in the market for its own debt, the information that prices used to convey is now much harder to read, leaving the market to pick from a dozen possible drivers for the recent fall in yields.

China

Yields in China have continued to fall as well. Given China's size in the global economy, you need to keep this on your radar.

Fiscal policy remains relatively tight in China. They have continued to push ahead with their deleveraging agenda and the crackdown on tech companies. Credit creation has remained soft.

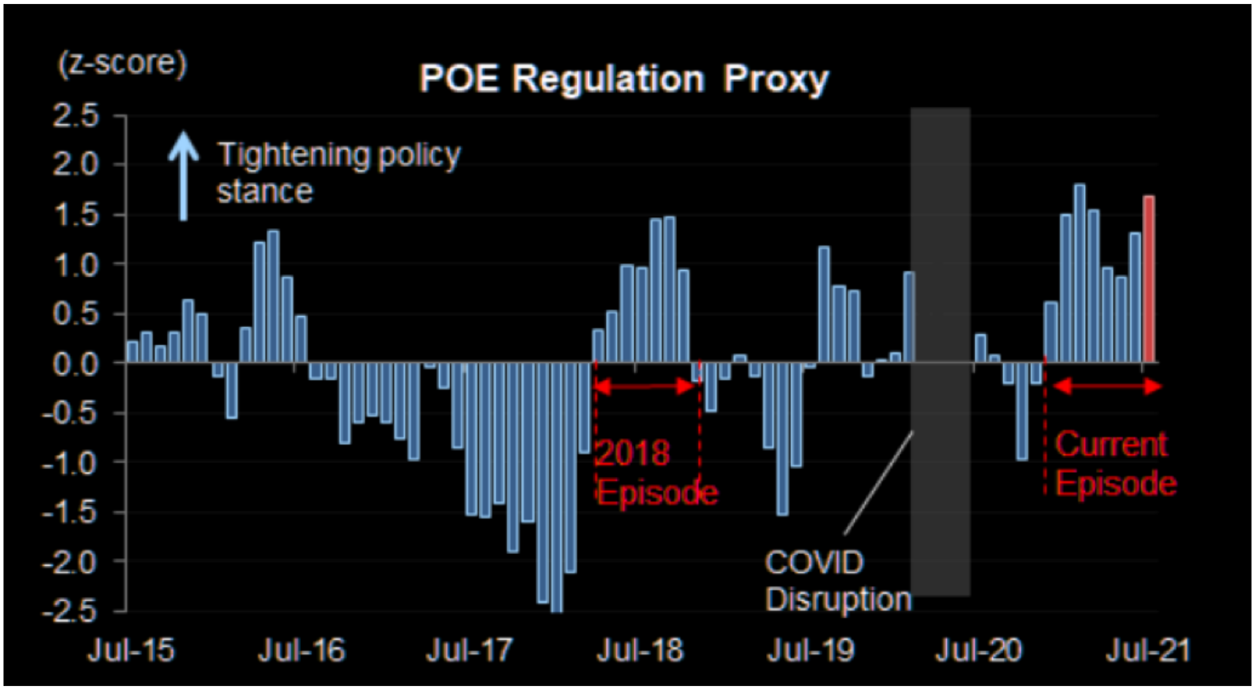


Are banks buying government bonds rather than lending? If so, the recent RRR cut won't do much in the near term.

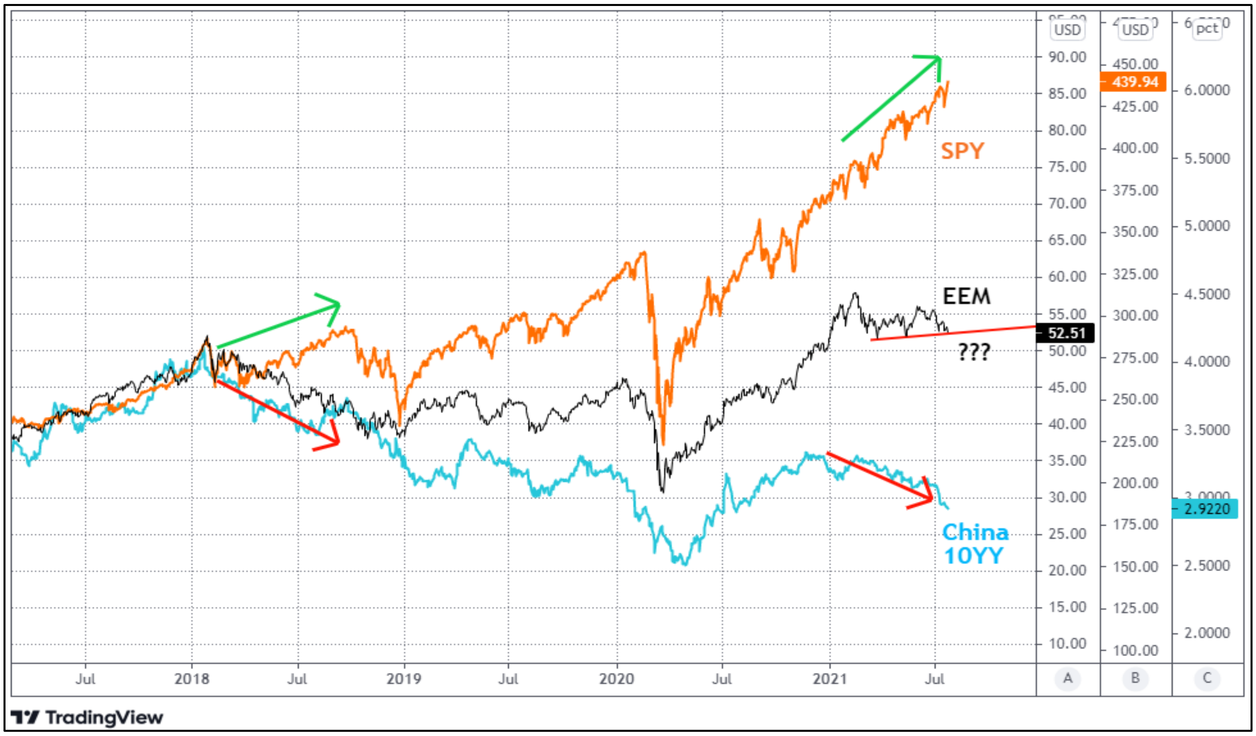
Again, is there a market signal here or just more government-induced demand/supply dynamics?

The upcoming Politburo meeting will be important to markets. Look out for indications that the current deleveraging and tech crackdown agenda remains in place, and what the overall monetary and fiscal policy is likely to look like for H2

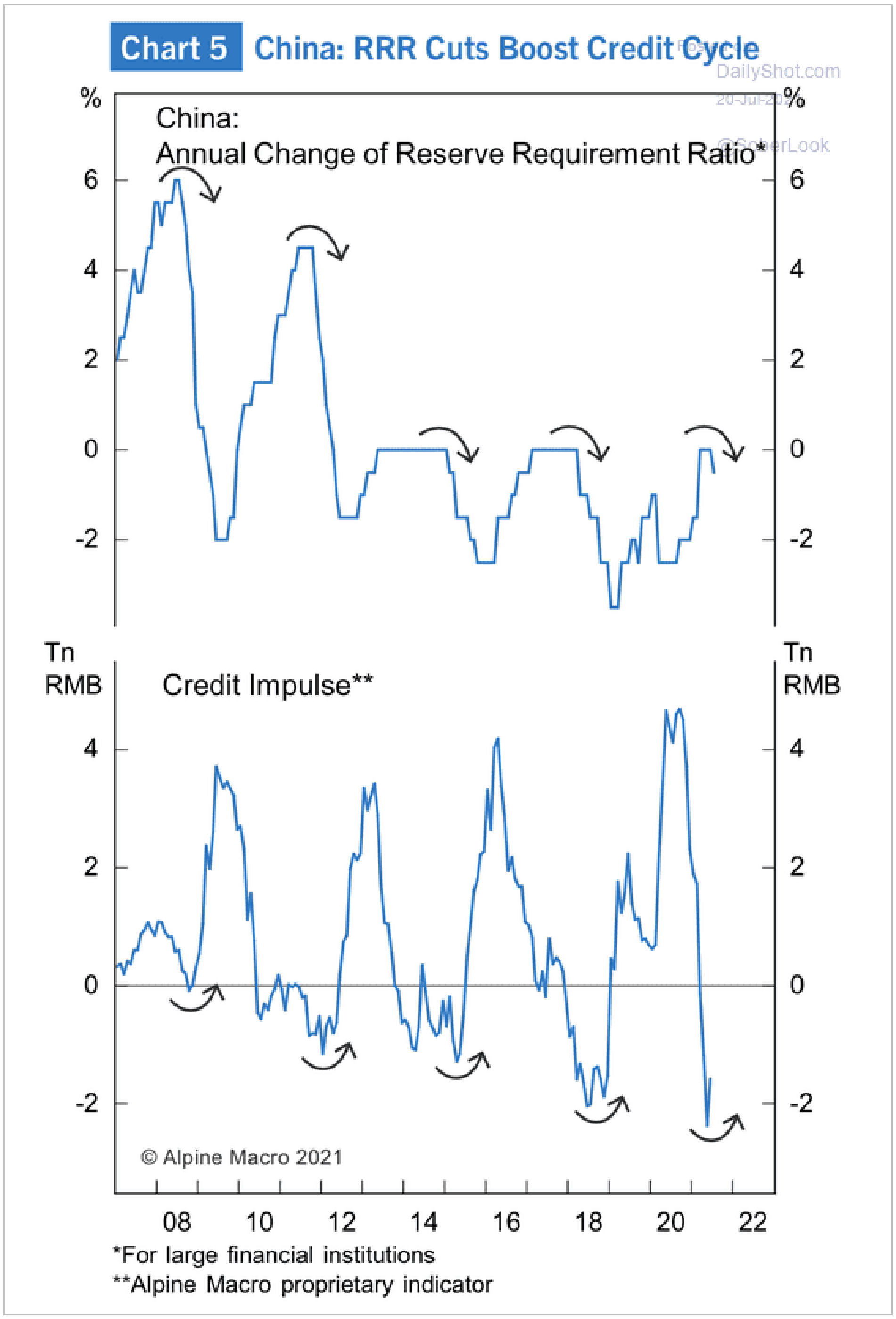
Goldman Sachs points out (chart below) that this regulatory crackdown period is akin to what we saw in 2018. In thinking about it that way, it might be easy to see it as idiosyncratic and isolated to China. However, as you know, things didn't go all that well for EM in 2018 or for global growth.



Like now, the US was the outperformer.



Longer-term, the team at Alpine Macro points out that the RRR does tend to negatively correlate with the credit cycle. However, it will likely take multiple cuts.



While there are early signs of stabilization, the Chinese credit cycle tends to move with and at times lead, overall global growth themes, and at this point, it still looks like a potential headwind.

With a lag…

Chart 4. The Chinese credit impulse points at lower long bond yields even if the inflationary outlook tells a different story

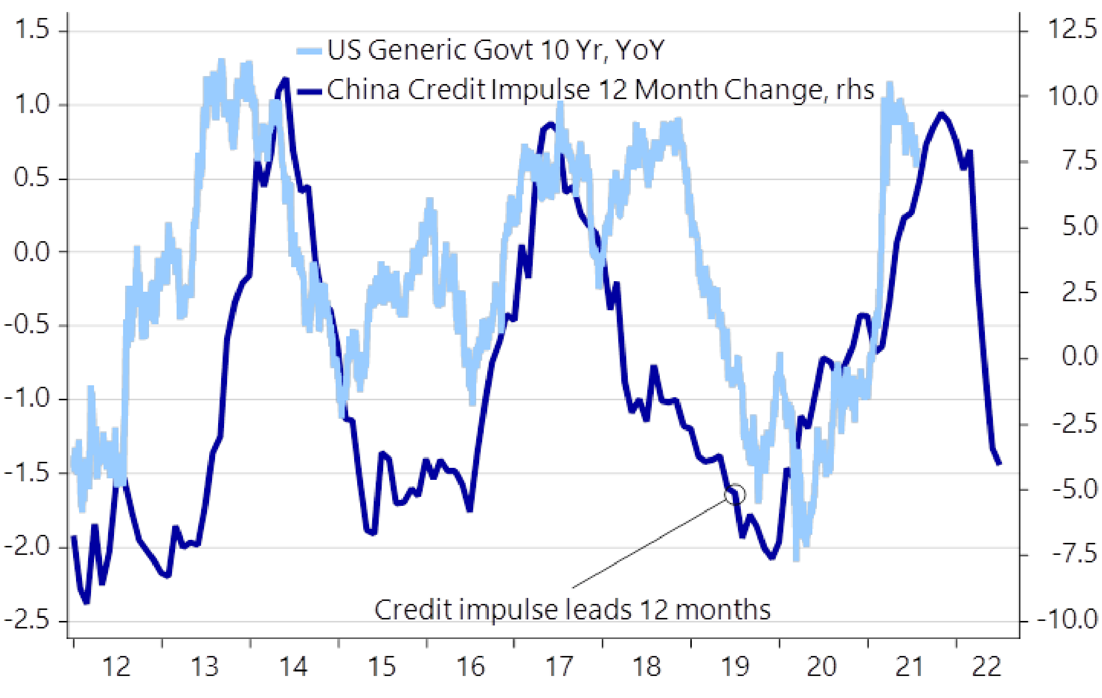
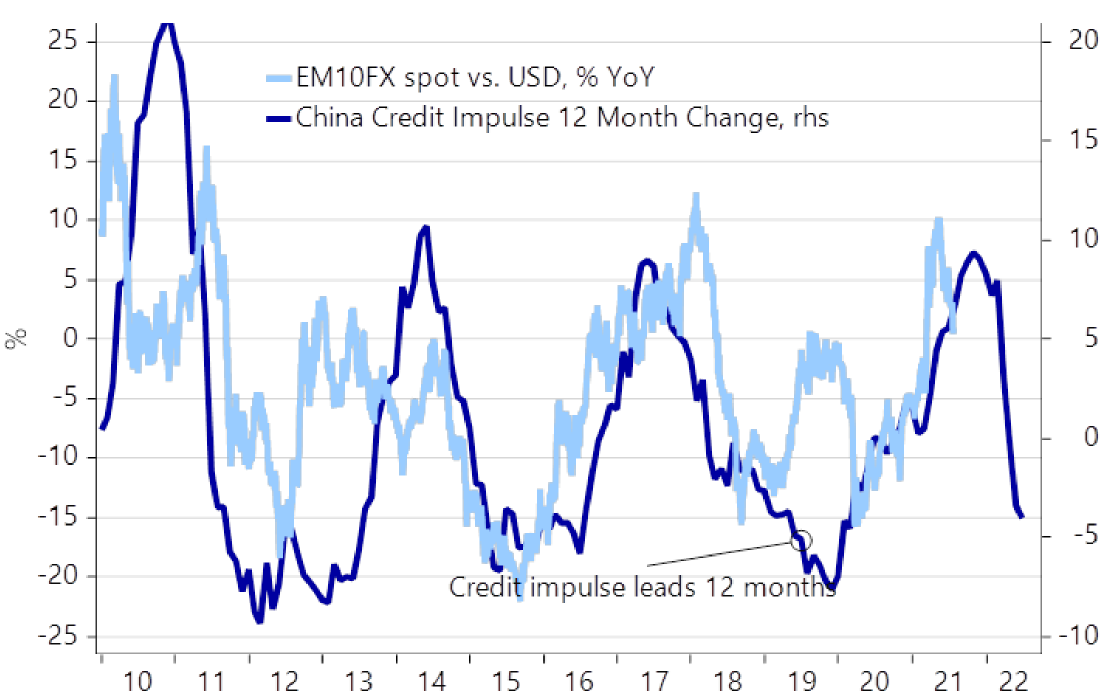
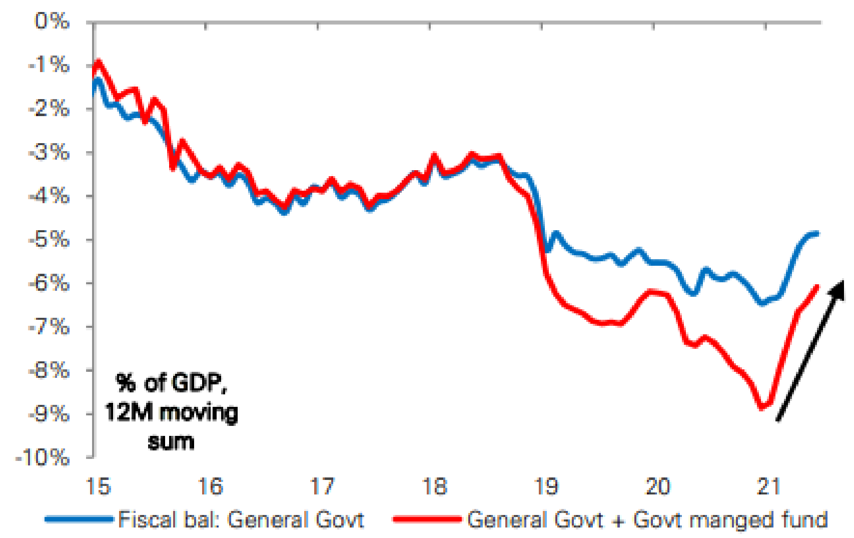


Chart 5. EM FX vs. the Chinese credit impulse. Time to underweight EM as an asset class?



Fiscal spending has been much less of a factor in China and is in fact contracting this year.

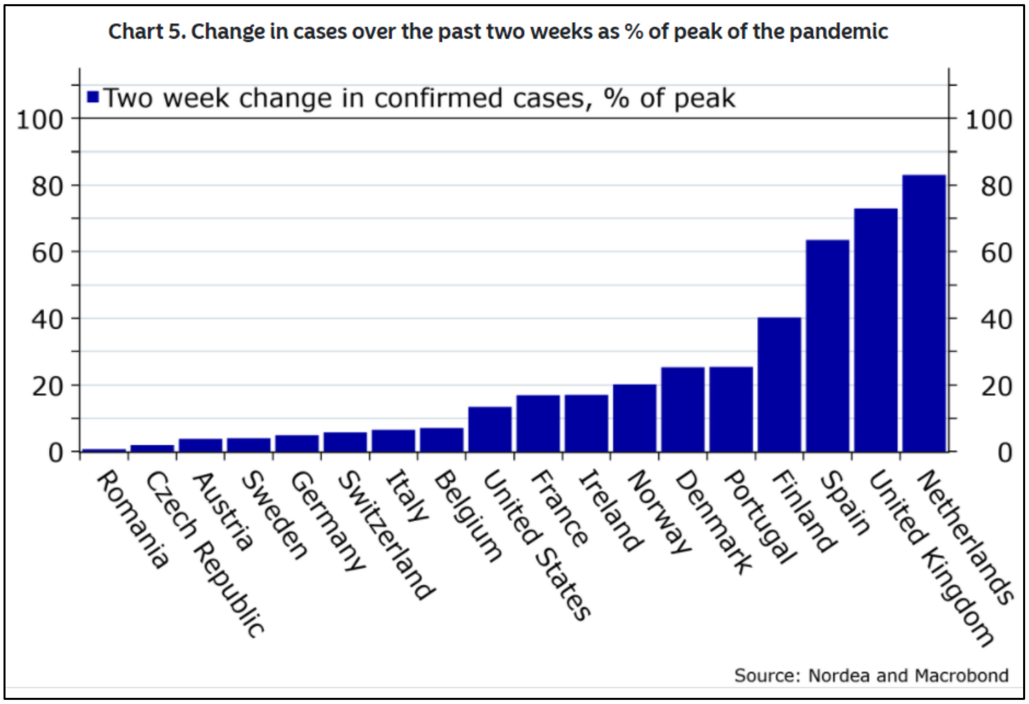
Figure 22: Fiscal deficit continues to contract due to slower-than-expected fiscal spending



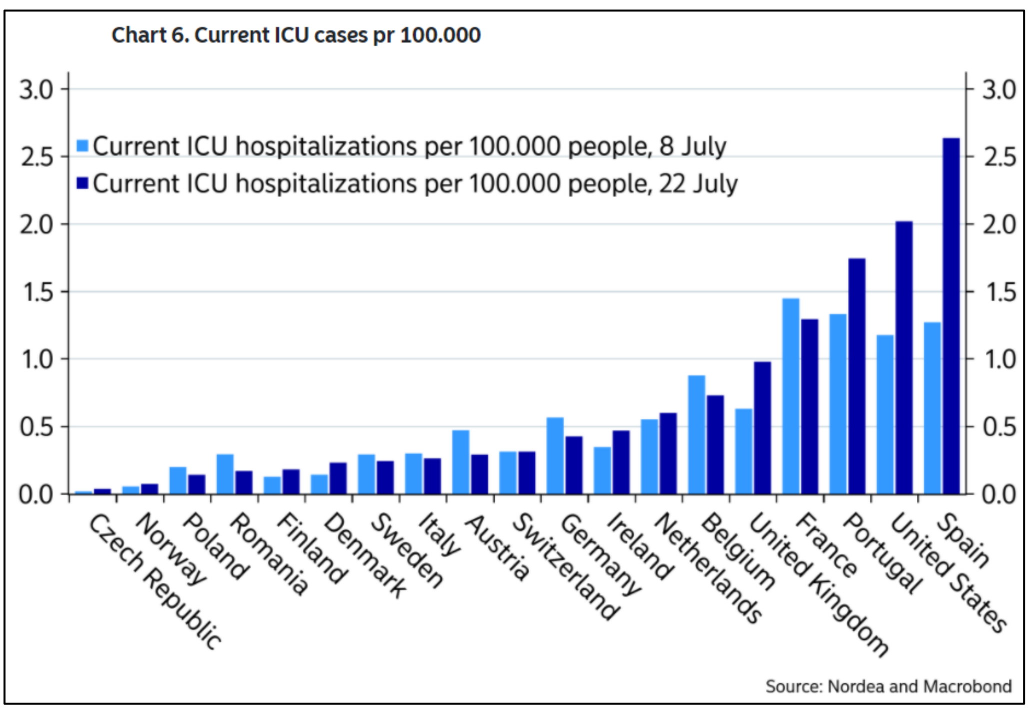
Source : Deutsche Bank, Wind

The internal war on tech companies is not helping the mood. Watch the Politburo meeting…

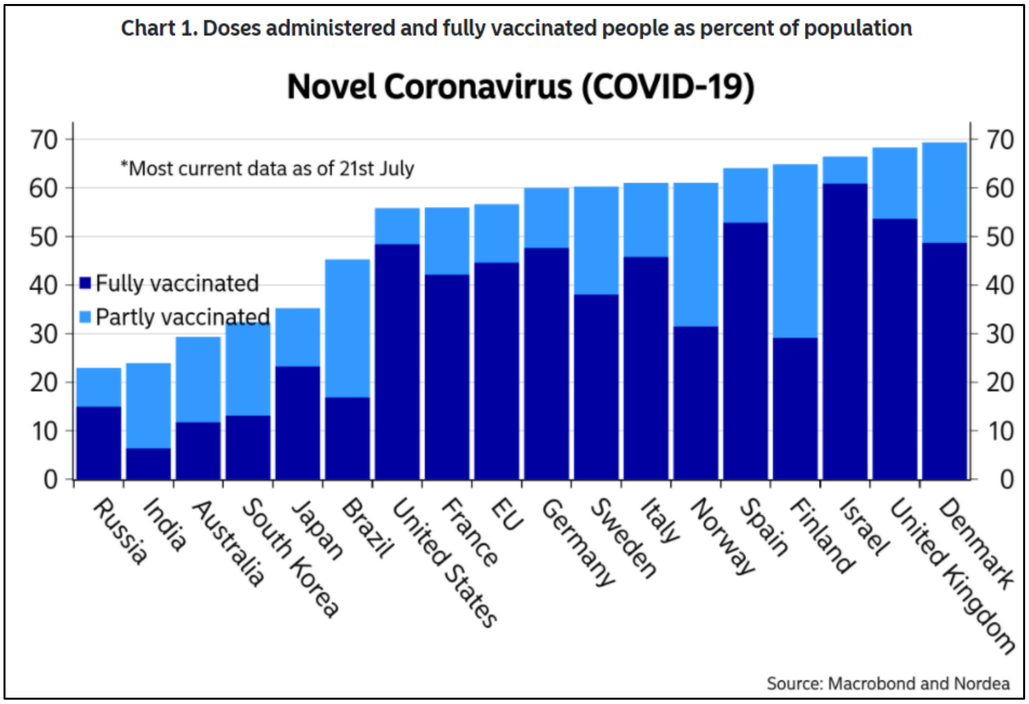
COVID – Here are a few noteworthy charts illustrating the difference between the current a previous wave. Over the last few weeks, we have seen a big surge.



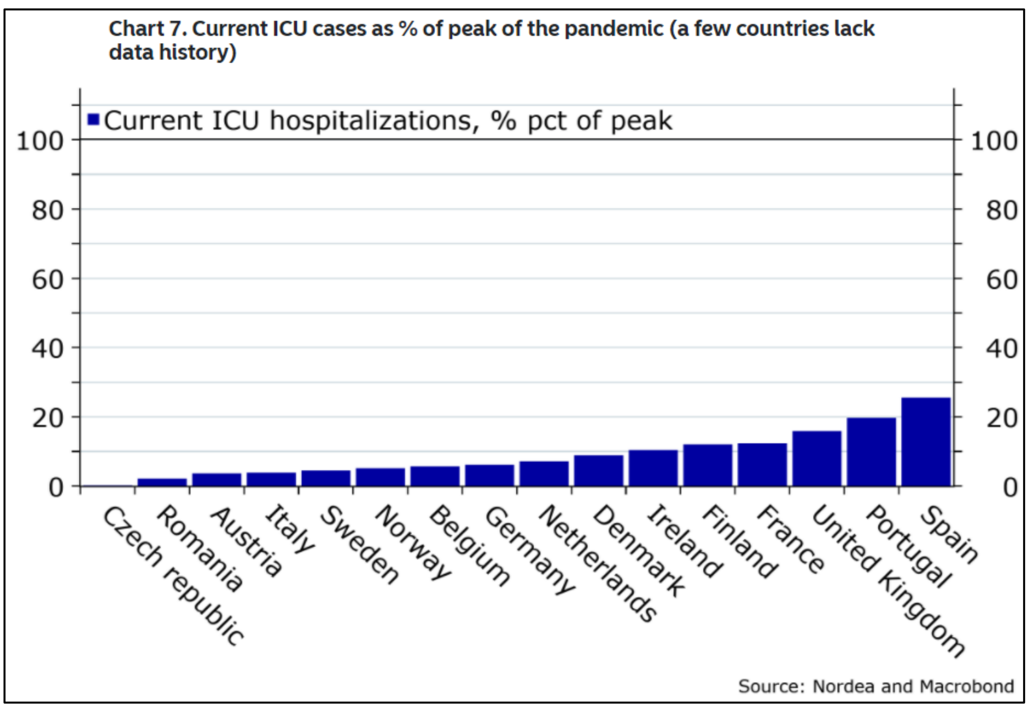
There has been some rise in hospitalizations as well…



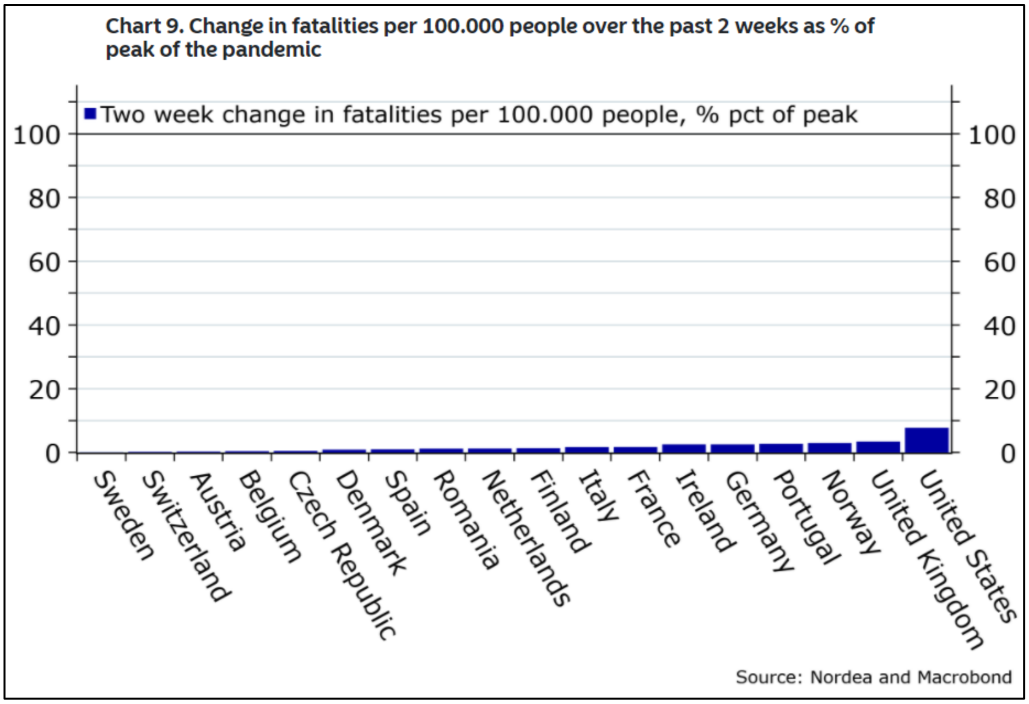
But, thanks largely to the vaccine and the most vulnerable being protected first…



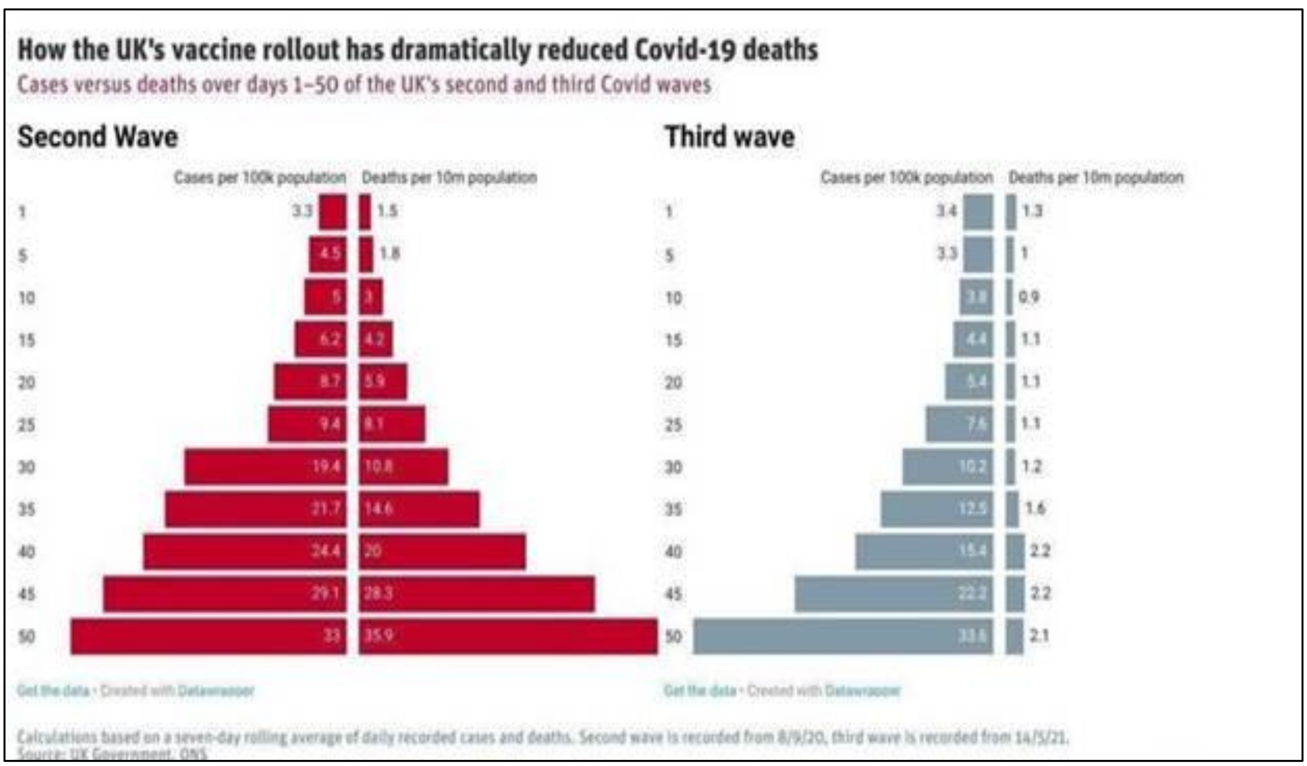
Current hospitalizations pale in comparison to the pandemic highs.



As do deaths…



This chart on the outcomes during the second vs. third wave is striking. Let's hope it holds.



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US Debt Ceiling

It is time for another round of the debt ceiling dance. Last week the CBO released a report saying: "if the debt limit remained unchanged … the Treasury would probably run out of cash … most likely in October or November".

Treasury Secretary Yellen followed up by saying that the Treasury is preparing "extraordinary measure" for August 2nd. They still have $700bln in the TGA so that will help initially.

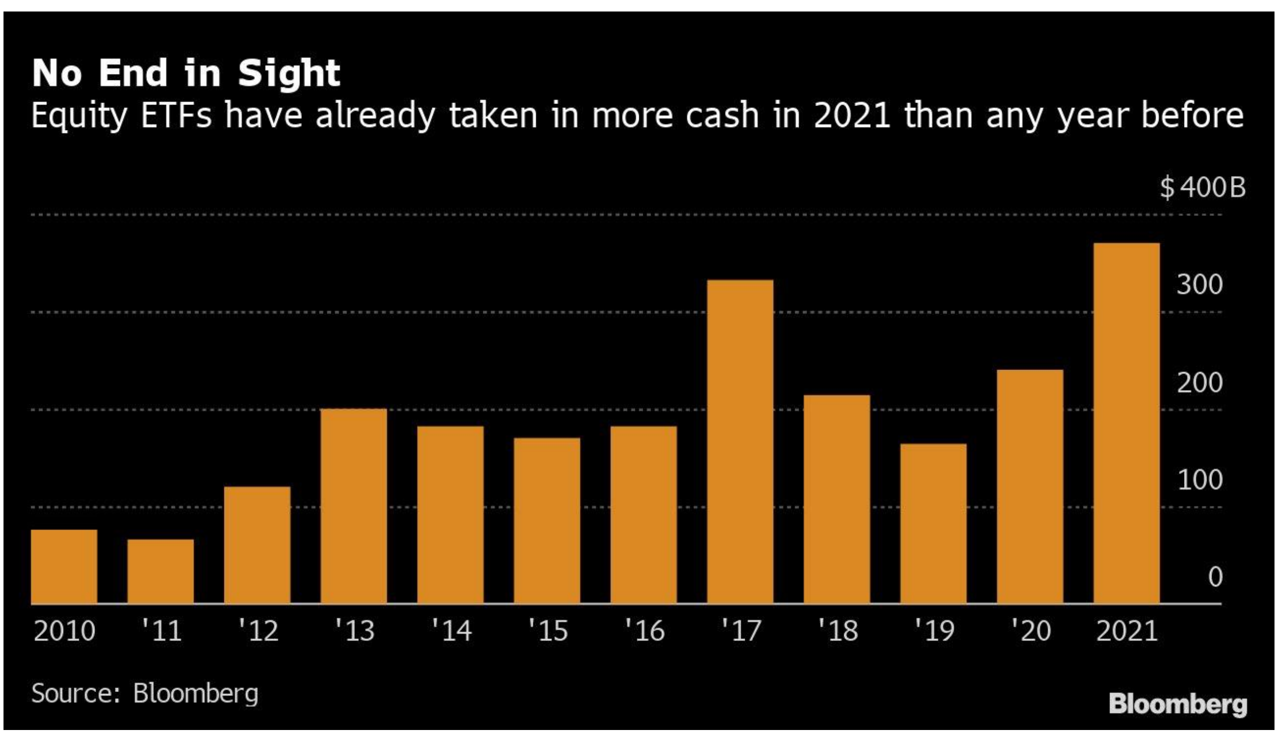
The Republicans are already digging in their heels and the Democrats are exploring passing a budget resolution followed up with a budget reconciliation package. Or, they could tie the debt ceiling to a must-pass funding bill at the end of September, which would force Republicans to decide if they'd want to vote to default and shut down the government at the same time. If Democrats did include the debt ceiling increase in reconciliation, lawmakers would still need to choose what the new borrowing limit should be in the legislation, given the special budget rules.

It will be a messy route to some kind of an eventual workaround, given the current level of animosity between the parties. It will be interesting to see how seriously potential tape bombs are treated by the market.

__What to Focus on Now:__

Equities – Last week's dip saw some of the heaviest retail buying ever. The dip didn't last long…

With the popularity of ETF only growing, the overall flows continue to astound.



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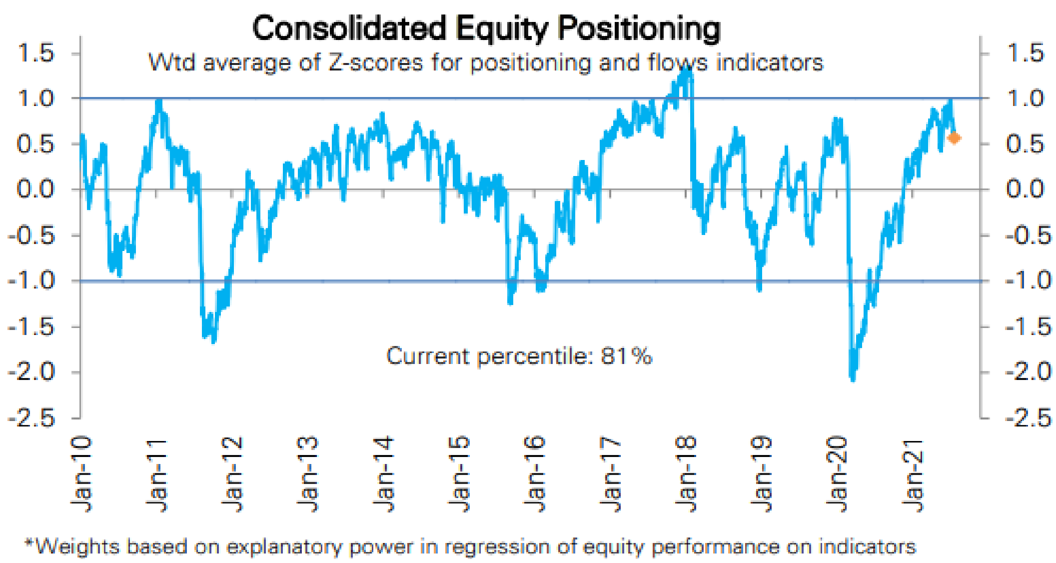
Positioning for professional AUM is still near the highs but off the peak.

Figure 5: Our aggregate equity positioning indicator fell a bit from the top of the range

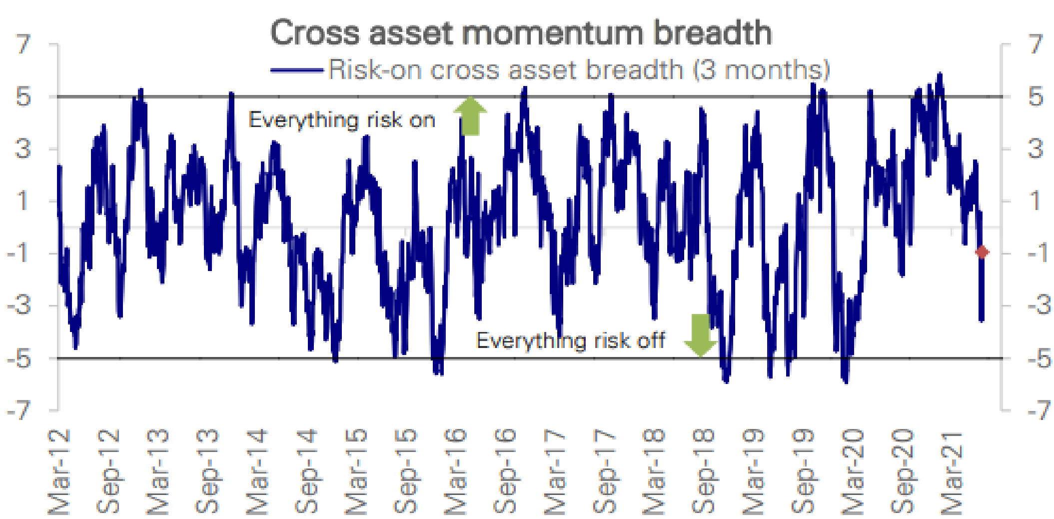


*Weights based on explanatory power in regression of equity performance on indicators

Source : EPFR, CFTC, Bloomberg Finance LP, Haver, Deutsche Bank Asset Allocation

US markets have been relatively narrow, but that is true for cross asset momentum as well now.

Figure 3: Our cross asset momentum breadth indicator remains in the lower half of its range

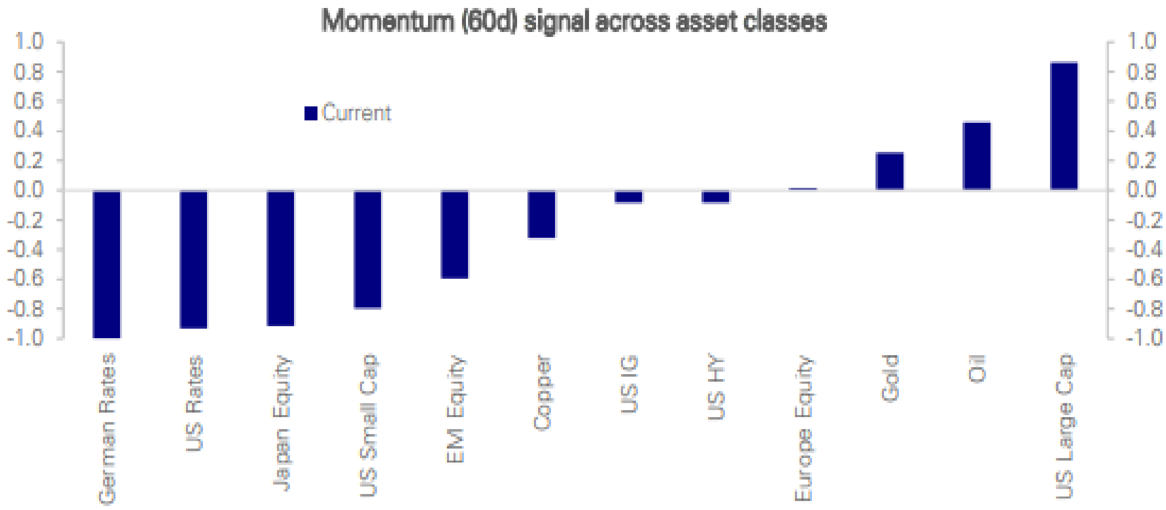


Note: Sign reversed for Gold, US rates and German rates

Source : Bloomberg Finance LP, Deutsche Bank Asset Allocation

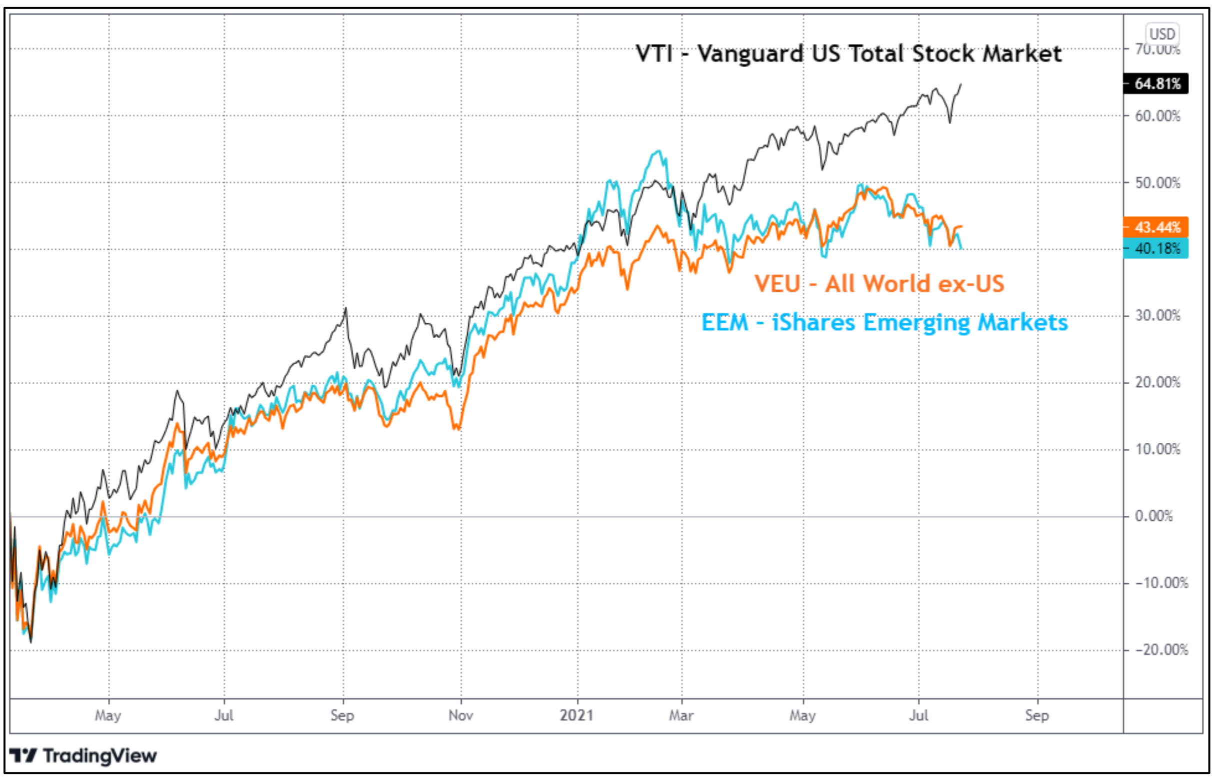
Synchronized “risk-on”, it is not.

Figure 4: US large cap equities remain an exception

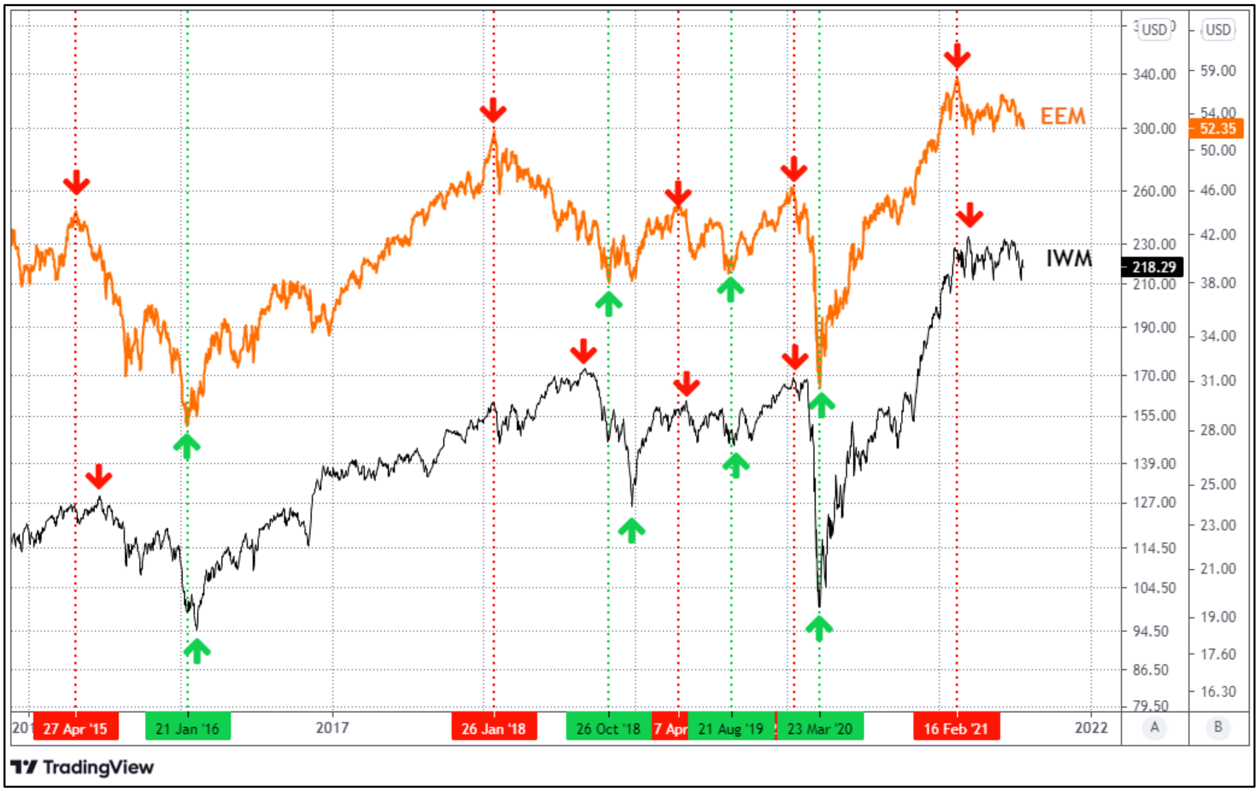


Note: Sign reversed for Gold, US rates, US credit and German rates

Source : Bloomberg Finance LP, Deutsche Bank Asset Allocation



Again, maybe everything is just being driven by the lower global yields we have seen, and those technical demand/supply dynamics are duping everyone into thinking there are other issues brewing. Unfortunately, that is hard to determine in real time. Historically, higher bonds prices and a higher USD are a safe haven trade, followed by lower EM and weakness in global value plays. We have seen this unfold, but is it real?



So far US earnings have been good, with many beating expectations. After this coming week, 60% will have reported. For the moment, the US continues to outperform, largely thanks to big cap tech, while Europe and Asia/EM remains more complicated.

Bonds

We may still have to wait a few months until we get real clarity on where yields should be. Continued high inflation prints could make the Fed nervous but at the same time, they will now largely stick to their "transitory" mantra. COVID is keeping markets on edge, as is the potential for the looming deficit ceiling battle. <u>A big jump in employment still has the potential to rock the boat in coming months.</u>

That leaves us with the charts as a signal for changing or accelerating trends in the near term.

They don't offer much yet. Although it is worth noting that we are now well below the levels post the "hawkish" Fed meeting in June.

FX

Currencies have been painful, going just far enough in ranges to suck people in just in time for a reversal.

With volatility now again very low, sub 6% in some of the majors, it might be time to look for some longer-term volatility trades going into Fall.

Commodities

China plans to sell 170,000 tons of non-ferrous metals in another round of auctions, state media Xinhua said on Wednesday. Reportedly, China will auction 30,000 tons of copper, 90,000 tons of aluminum, and 50,000 tons of zinc from state reserves in late July. They are certainly trying to send a signal. We will see…

With a stronger USD apparently overcoming the falling bond yields, precious metals have continued to languish.

The best outcome now for bulls might be to watch Gold vs. things like the EUR. After potentially putting in a nice bottom over the last few months, a break above recent highs in XAUEUR now would get me interested... but not yet.

This week's Wednesday Fed decision and press conference is the focal point. We will also have a first look at Q2's GDP reading for the US and the Euro Area, and earnings reports will include Apple, Microsoft, Alphabet, Facebook and Tesla.

Important Macro Data Releases and Events for the Week

Monday
7/26/2021

- EcoFin Meeting
- IFO-Business Climate (Jul) Forecast: 102.1, Prior: 101.8
- IFO-Current Assessment (Jul) Forecast: 101.6, Prior: 99.6
- IFO-Expectations (Jul) Forecast: 103.3, Prior: 104
- New Home Sales (Jun) Forecast: .792m, Prior: .769m

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Tuesday 7/27/2021		BoJ's Kuroda speech
		Durable Goods Orders (Jun) Forecast: 2.1%, Prior: 2.3%
		Nondefense Capital Goods ex Aircraft (Jun) Forecast: 0.6%, Prior: 0.1%
		Housing Price Index MoM (May) Forecast: 1.8%, Prior: 1.8%
		S&P/Case-Shiller Home Price Index YoY (May) Forecast: 15.4%, Prior: 14.9%
		Consumer Confidence (Jul)
Wednesday 7/28/2021		Gfk Consumer Confidence Survey (Aug) Forecast: -4, Prior: -0.3
		BoC CPI YoY (Jun) Forecast: 2.4%, Prior: 2.8%
		Fed Interest Rate Decision, Monetary Policy Statement/Press Conference
Thursday 7/29/2021		Unemployment Rate s.a. Forecast: 5.8%, Prior: 5.9%
		Initial Jobless Claims Forecast: 365k, Prior: 419k
		Initial Jobless Claims 4-week average Forecast: -, Prior: 385.25k
		Continuing Jobless Claims -, Prior: 3.236M
		Consumer Confidence (Jul) Forecast: -4.4, Prior: -4.4
		Business Climate (Jul) Forecast: -, Prior: 1.71
		Harmonized Index of Consumer Prices YoY (Jul) Forecast: 3%, Prior: 2.1%
		GDP Annualized (Q2) Forecast: 8.2%, Prior: 6.4%
		GDP Price Index (Q2) Forecast: 5.4%, Prior: 4.3%
		Core PCE QoQ (Q2) Forecast: 5.1%, Prior: 2.5%
		PCE Prices QoQ (Q2) Forecast: -, Prior: 3.7%

Friday
7/30/2021

- GDP QoQ (Q2) Forecast: 2%, Prior: -1.8%
- CPI YoY (Jul) Forecast: 2%, Prior: 1.9%
- CPI-Core YoY (Jul) Forecast: 0.8%, Prior: 0.9%
- GDP QoQ (Q2) Forecast: 1.5%, Prior: -0.3%
- GDP YoY (Q2) Forecast: 13.2%, Prior: -1.3%
- Core PCE MoM Forecast: 0.6%, Prior: 0.5%
- Core PCE Prices YoY Forecast: 3.7%, Prior: 3.4%
- Personal Income MoM (Jun) Forecast: -0.4%, Prior: -2%
- Personal Spending MoM (Jun) Forecast: 0.7%, Prior: 0%
- Chicago Purchasing Managers Index (Jul) Forecast: -, Prior: 66.1
- Michigan Consumer Sentiment (Jul) Forecast: 80.5, Prior: 80.8
- Non-Manufacturing PMI (Jul) Forecast: -, Prior: 53.5
- NBS Manufacturing PMI (Jul) Forecast: 50.8, Prior: 50.9

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