Weekly Market Summary

September 17th, 2021

Ready For Fed Tapering? Most Market Participants Aren't!

Fadi Nasser - Deputy Chief Investment & Treasury Officer

A total of six central bank meetings next week should offer a glimpse into the diverging monetary policy outlooks in the G-10 space. Indeed, whilst some officials will stick to their accommodative stance (Bank of England, Bank of Japan, Swiss National Bank and Sweden's Riksbank), others could start preparing the markets for the policy normalization ahead. In particular, the chances are high that the US Federal Open Market Committee (FOMC) will turn hawkish and announce a tentative agenda for its QE taper at its upcoming September 22nd meeting, with the updated staff economic projections and Fed Chair Jerome Powell's ensuing press conference conveying a message that the US recovery is becoming more solid and durable, therefore requiring reduced monetary support. Additionally, the updated Fed '*dot plot*' (which maps out policymakers' expectations for where interest rates could be headed over the coming three years) will be scrutinized for any signs of more aggressive monetary tightening in the medium to long-run.

Over the past two weeks, the release of the highly anticipated US jobs (Non-Farm Payroll) and inflation (Consumer Price Index) reports for August would have surely complicated the task of professionals having to navigate through the flood of economic data, be it the economists/analysts or retail investors and fund managers. With another set of data subject to divergent interpretations, the post-pandemic economic landscape remains both puzzling and uncertain. Add to that a US central bank that is vocal about tapering soon, yet not too willing to back its words with action (in other words speaking loudly and carrying a feather - in comparison to President Theodore Roosevelt's "speak softly and carry a big stick" mantra on foreign policy!)

Let us start with the main economic data takeaways:

Payrolls Data: Constituting a big miss relative to expectations, the headline number for US August employment report was a disappointing 235,000, compared with a median expectation of 733,000. The initial shock was partially offset by upward revisions to previous months, which took the three-month average to a more respectable level of some 750,000, given the updated 2 million jobs created in June and July. Additionally, the unemployment rate fell 0.2 percentage points to 5.2%, and hourly earnings rose more than consensus expectations (0.6% compared with 0.4%, month-on-month). Some of these indicators could be reconciled by incorporating the impact of the Covid-19 delta variant on the service sector, especially given the disappointing employment numbers for retail, leisure and hospitality. Others, including the headline job creation number, can be treated as temporary "noise" in light of a still solid multi-month average. Rather than clarify the situation, this latest jobs' report muddles the evidence for a decision under the Fed's new monetary policy framework, which is backward looking (employment / unemployment rate are lagging indicators that tend to improve two or three quarters after an upturn in the general economy) and pretty much focused on ensuring substantial further progress / restoring maximum employment whilst keeping rates low.

Inflation Data: On the heels of a disappointing August jobs report, consumer price data for the month were projected to be the focal point this week. Prices paid by U.S. consumers rose in August by less than forecast, snapping a string of hefty gains and suggesting that some of the upward pressure on inflation might be starting to wane. The consumer price index increased 0.3% from July, the smallest advance in seven months, according to Labour Department data released Tuesday. Compared with a year ago, the CPI still rose a sizable 5.3%. Excluding the volatile food and energy components, so-called core inflation climbed 0.1% from the prior month (4.0% YoY), the smallest gain since February and a reflection

of declines in the prices of used cars, airfares and auto insurance (surely impacted by softening demand during the month as a result of the more contagious delta variant!). "*The 'is it transitory debate' is far from over but at least, this more moderate gain in consumer prices will give the Fed some breathing room next week*," said Jennifer Lee, senior economist at BMO Capital Markets. "*But not for long*." It is quite bizarre that mainstream media / markets would unanimously cheer these four to five percent inflation prints, among the highest readings of the past three decades, at a time 10-year US treasury yields are hovering around 1.30%! What's more, these elevated inflation numbers appear to be impacting Americans' expectations; The New York Fed's August survey of consumer expectations showed the median expected inflation rate over the next three years is 4.0%, the highest ever in data going back to 2013. The central bank's measure of inflation uncertainty is also at an all-time high after declining gradually for most of the 2013-2020 period, which could hold back consumers and businesses alike.

Central bankers, much like investors, can sometimes fall into a trap. It shouldn't come as a surprise that, since the financial crisis, they have made it their mission to fight deflation, as a broad drop in demand threatened to pull down prices and profits, in what economists feared would become a vicious spiral. After years of holding key interest rates near zero and aggressive monetary stimulus, central bankers still seem reluctant till date to declare success. As a result, they have opted to maintain significant stimulus in place whilst realizing lately that their policies might prove damaging over the medium term – i.e. result in an overheated economy and fast rising inflation / inflation expectations. The latter would in turn create a quandary for the Federal Reserve, since one of the Fed's goals is to fight inflation.

In recent weeks, however, several Fed officials have suggested that they may need to start the tightening cycle sooner and potentially at a faster pace than is currently discounted. For now, this is still a minority view. More dovish members, including the majority of today's FOMC voters and chair Jay Powell, would prefer to wait for pandemic-related distortions to subside before judging whether inflationary pressures are persistent and whether labour markets are consistent with the Fed's goal of eliminating "*shortfalls*." These conversations are happening in the context of lessons learnt from the last few decades: Keeping monetary policy too tight and not being able to ease enough is seen as a bigger risk than allowing inflation to rise and needing to tighten and catch up later. With the Fed's newfound commitment to allow inflation to overshoot 2.0%, the more dovish perspectives are carrying the day for now. We expect the Fed will still have to eventually do more than "budge" on rates. More immediately, though, we think market pricing, data trends and the Fed's evolving reaction function underscore a very real need for investors to protect portfolios against higher, more sustained, inflation.

3 Main Risks to this Bullish Growth / Inflation Outlook

Covid-19 Delta Variant and/or Political Divisions: Many economists are growing much more negative about the prospects for a strong economic revival going forward. But why are they turning more bearish about the economy all of a sudden? The obvious answer begins with a Greek letter. The delta variant has plainly had an impact on the latest round of economic numbers, and it would make sense if it had also had an impact on economic expectations. As summer started, the general expectation was that North America and western Europe would be fully back to "*normal*" by now, and they aren't. But a look at the data on the virus suggests that rather than a reaction to the pandemic, we are instead witnessing one of the purest and most deadly expressions of political risk on record. The toll of the virus is increasing, and its progress has confounded much expert prognostication once again; But it is political differences, which generally have more to do with some kind of tribal allegiance than with any ideology, which are driving negative outcomes.

US Debt Ceiling Debate: Senate Minority Leader Mitch McConnell appears more determined than ever to hold the Republican line from breaking on the debt ceiling. In a recent interview with Punchbowl News, the Kentucky Republican fired a warning shot to Democrats as he dug in further on a view he is publicly expressed since late July. "*It's their obligation. They should step up. It's hard being in the majority. They are the ones who will raise the debt limit*," he said, adding, "*Do you guys think I'm bluffing?*" McConnell insisted that the US must never default on its debt payments and

pointed back to his previous support of raising the ceiling to cover spending that Congressional Republicans and Democrats had struck deals on. He said that wasn't the case this year as Democrats passed a $1.9 trillion stimulus law along party-lines. They [Democrats] are also drafting another spending package aimed at shoring up the social safety net. "*So the only issue is, whose responsibility is it to do it? A Democratic president, a Democratic House, a Democratic Senate,"* he added. McConnell's warning threatens to amplify a perilous showdown between Republicans and Democrats on renewing the nation's ability to pay off its bills, known as the debt ceiling. The Treasury Department is making emergency cash payments to keep federal operations running, buying lawmakers some extra time (until late November or early December). According to the Guggenheim Investments, the Federal Reserve may hold off on its tapering announcement as the two political parties spar on raising the debt ceiling, sending Treasury yields further down (how convenient that is for a central bank always looking for excuses to delay policy normalization ☹).

Evergrande Debacle: China Evergrande Group is quickly becoming the biggest financial worry in a country with no shortage of them. With more than $200 billion in liabilities and links to numerous banks, and more than 1,300 projects in more than 28 cities, Evergrande could send shock waves through the financial system and the broader economy should calamity strike! Its stock price has cratered and its bonds point toward potential default; Yet Hui Ka Yan, the billionaire owner, has sought to reassure bankers that the property company will pull through. Investors aren't sure how. They are also asking whether major Chinese companies are still considered too big to fail by the central (the Evergrande group now goes far beyond homebuilding, with investments in electric vehicles, an internet and media production unit, a theme park, a soccer club and a mineral water and food company among others). "*If Evergrande had to dump its inventory onto the market" it would "drag down property prices substantially,"* said Hao Hong, chief strategist at Bocom International. Without a social safety net and with limited places to put their money, Chinese savers have for years been encouraged to buy homes whose prices were only ever supposed to go up. Today, real estate accounts for 40% of household assets and buying a house (or two) is a cultural touchstone (many Chinese are more likely to protest falling home prices than spiking ones! 😊) Evergrande is also the largest high-yield dollar bond issuer in China, accounting for 16% of outstanding notes, according to Bank of America Corp. analysts. Should the company collapse, that alone would push the default rate on the country's junk dollar bond market to 14% from 3%, they wrote in a note this month.

In summary, the US economy today is about as strong as it has been in generations, with the tightest labour market and highest inflation rates seen in decades. That is even accounting for a recent moderation of growth driven by the spread of the Delta variant of Covid-19 during the month of August. Yet financial markets continue pricing in both that the inflation will prove transitory and that policymakers will barely need to budge in response. Whilst we don't know for sure whether the current dose of inflation will prove to be transitory or not and/or whether Fed officials are willing to remain on the sidelines for the remainder of 2021, we truly see this potential combination of outcomes as unlikely and are positioned accordingly. Are You?!

Disclaimer

It is important that you only use this report if you are the intended recipient of this report and you have satisfied yourself that you are eligible to receive such information. This report is provided to you because you are one of our esteemed customers and have previously shown interest in receiving the type of information contained in this report.

The Treasury and Investment Management department of Gulf International Bank B.S.C. ("GIB") have compiled the information in this report. GIB is incorporated in the Kingdom of Bahrain and is licensed by the Central Bank of Bahrain (the "CBB") as a conventional wholesale bank. GIB's head office is located at Al-Dowali Building, P.O. Box 1017, 3 Palace Avenue, Manama, Kingdom of Bahrain.

This report is intended for the accredited investors, as defined in the Investment Business Code of Conduct published by the CBB. This information has not been reviewed by the CBB or any other regulatory authority in any jurisdiction and neither CBB nor any other regulatory takes any responsibility for the correctness or accuracy for the information contained in this report.

The information contained herein is not directed at or intended for use by any person resident or located in any jurisdiction where (1) the distribution of such information is contrary to the laws of such jurisdiction or (2) such distribution is prohibited without obtaining the necessary licenses or authorizations by the relevant branch, subsidiary or affiliate office of GIB and such licenses or authorizations have not been obtained. The recipient of such information is responsible for ensuring that this information has not been received by it in breach of laws and regulations of any jurisdiction.

This report contains publicly available information only, which has only been complied by GIB. The information provided herein is on "as is" and "as available" basis and without representation or warranty of any kind. GIB hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall GIB or its subsidiaries, affiliates, shareholders or their directors, officers, employees, independent contractors, agents and representatives (collectively, "GIB Representatives") be liable (1) for any inaccuracy, delay, loss of data, interruption in service, error or omission or for any damages resulting there from, or (2) for any direct, indirect, incidental, special, compensatory or consequential damages arising from any use of information or arising from any error (negligent or otherwise) or other circumstance or contingency within or outside the control of GIB or any GIB Representative, in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any such information. The information here is, and must be construed solely as, compilation of information (unless expressly stated otherwise) and not statements of fact as to credit worthiness or recommendations or opinions of GIB.

This report does not provide individually tailored investment advice. Any materials contained herein have no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. The document is provided for information purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. GIB makes every effort to use reliable, comprehensive information, but we do not represent that it is accurate or complete. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the materials, nor are they a complete statement of the securities, markets or developments referred to herein. Recipients should not regard the materials as a substitute for the exercise of their own judgement. Any opinions are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of GIB as a result of using different assumptions and criteria. GIB is not under any obligation to update or keep current the information contained herein.

The value of, and income from, your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realised.

The information contained in this report is just for informational purposes. Information does not constitute a solicitation, an offer, or a recommendation to buy or sell any investment instruments, to effect any transactions, or to conclude any legal act of any kind whatsoever. GIB does not intend to provide investment, legal or tax advice through this report and does not represent that any securities or services discussed are suitable for any investor. When making a decision about your investments and business, you should seek the advice of professional advisors.

The report may contain statements that constitute "forward looking statements". While these forward looking statements may represent GIB’s judgment and future expectations, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from GIB’s expectations. GIB is under no obligation to (and expressly disclaims any such obligation to) update or alter its forward-looking statements whether as a result of new information, future events, or otherwise. The historical information is provided for information purposes only. Performance figures are calculated before tax (if any) and after deducting ongoing fees and expenses. The performance figures are historical and past performance is not necessarily an indication of future results. Certain amounts (including %ages) included in this document may have been subject to rounding adjustments. Accordingly, figures may not be an exact arithmetic aggregation of the figures to which they relate. The values and forecasts shown represent our current indicative valuations and forecasts of the relevant transactions, currencies, interest rates, commodities or securities as at the date shown. Any value or forecast shown herein is not an indicative price quotation. We expressly disclaim any responsibility for the accuracy of the values or forecasts shown, any errors or omissions in the report

With the exception of information regarding GIB and save as otherwise specifically indicated, the information set out in this report is based on public information. We have, where possible, indicated the primary source of information. We strongly recommend the recipients consult the primary source of information. Facts and views in this report have not been reviewed by, and may not reflect information known to, professionals in other GIB business areas.

This Report, and the information contained herein (save to the extent that such information is publicly available) is confidential and may not be disclosed by you to any other person outside of your organization without our consent.

GIB retains all right, title and interest (including copyrights, trademarks, patents, as well as any other intellectual property or other right) in all information and content (including all text, data, graphics and logos) in this document. All recipients must not, without limitation, modify, copy, transmit, distribute, display, perform, reproduce, publish, license, frame, create derivative works from, transfer or otherwise use in any other way for commercial or public purposes in whole or in part any information, text, graphics, images from this document (excluding publicly available information) without the prior written permission of GIB.