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# QUARTERLY INVESTMENT OUTLOOK

## OCTOBER 2021

**SUMMARY**


- Following a V-shaped recovery the global economy appears to be slowing. J.P. Morgan's Global Manufacturing Purchasing Manager's Index was at 54.1, a 6-month low. Several major markets recorded weaker readings above 50, including the U.S. and Euro area, with Asia slipping into contraction (below 50). Noteworthy is that global manufacturing has exceeded pre-covid levels despite widespread supply chain bottlenecks and labor shortages. The advent of the Delta variant is a "wild card" and adds considerable uncertainty to any economic forecast. However, based on 1) the availability of vaccines, 2) changing behavior (wearing masks) and 3) Israel's recent positive experience with booster shots, we remain optimistic.

- The U.S. Economic Surprise Index at -59 remains in a downtrend, but is close to levels which, since 2009, have signaled a bottom. Until the ESI turns higher bond yields could remain flat to slightly lower. By year-end 2021 we expect the ESI to trend higher along with bond yields. Rising yields would favor the value sector of the stock market and would be negative for growth stocks.

- Our research shows that durable inflation cycles are accompanied by an expansion in credit demand. This usually happens following the end of recessions. There is already early evidence that loan demand in the U.S. commercial banking system is turning higher.

- Asian growth is slowing led by China's zero covid policy. We believe China's policymakers will soon begin another round of both fiscal and monetary stimulus. The major negative for investors is their zero covid policy. This means that they will lockdown an entire factory/city in order to prevent the spreading of the virus.

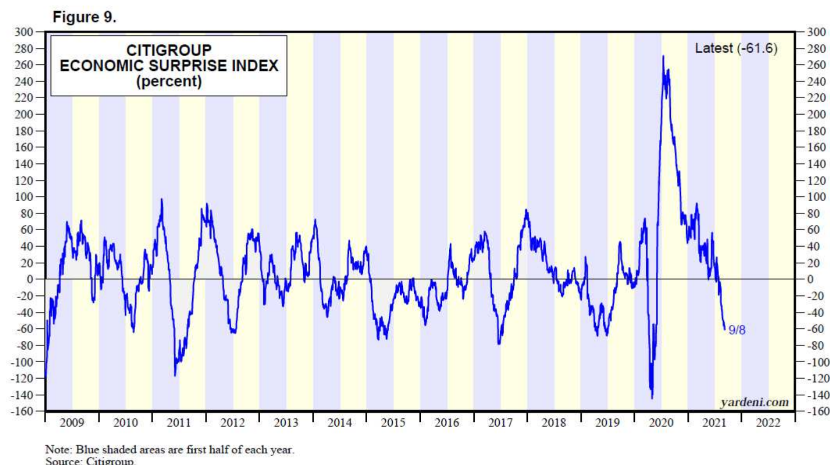
- Equity investors are paying an estimated 21x 2022 earnings. This valuation is at the high end of the 20-year range. Meanwhile, Fed Chairman Powell indicated that, assuming employment conditions continue to show improvement, and inflation flattens, then tapering their $120 billion asset purchase program could begin by year-end 2021. Analysts have long pointed to the high correlation between the size of the Fed balance sheet and the level of stock prices. Caveat emptor!

## MORE NEGATIVE SURPRISES COULD BRIEFLY BENEFIT TREASURIES

After recording an all-time high in early 2020, the U.S. Citigroup Economic Surprise Index, shown below courtesy of Yardeni Research, has retreated steadily to a current reading -55.6. The index measures the degree to which high frequency economic data exceed or fall short of analyst estimates. The trend in the index correlates positively with treasury bond yields. It usually bottoms (along with bond yields) when current readings decline into a range of -60 to -80.

Considering the weakness in the Surprise Index, we believe the 10-year U.S. treasury is likely to continue trending lower, before bottoming, possibly beneath1% in the Q4 2021. The G-10 Surprise Index at -30 is also weak, and it appears to be closer to bottoming.

Historically, stock market weakness often occurs when the surprise index is declining below zero.




## THE RISK OF A FED POLICY MISTAKE IS RISING

We are concerned that the Fed will begin tapering their balance sheet while the economy transitions to a slower growth trajectory. The Fed Nowcast calls for real growth to slow to a 3% annual rate in 3Q21, roughly half the rate in 2Q21. We expect growth to slow further into yearend at a 2% - 3% annual rate.

While growth slows there is a high probability that inflation will become intransigent, causing the Fed to eventually overreact. However, in the interim despite a more hawkish Fed board, the likelihood is the Fed remains accommodative keeping rates pinned down close to zero. This will only serve to foster higher inflation.

Fed Chairman Powell believes the recent rise in inflation will be transitory. The Fed relies heavily on pricing research published by the Dallas Federal Reserve Bank which calculates a "trimmed" mean inflation rate each month taken from 178 components detailed by the Bureau of Economic Analysis. The "trimmed" mean rate excludes the lowest 24 price percent changes and the highest 31 price percent changes in order to smooth out monthly volatility inherent in the basket of goods and services. The "trimmed mean inflation is running at a 2% annual rate versus 3.6% for the personal consumption expenditure price index (ex food and energy) and 4.2% for the PCE all items included. The Fed normally uses the "trimmed" mean index to construct monetary policy. The "trimmed" version supports Powell's view that inflation is transitory.

The chart to follow, courtesy of noted economist Danielle DiMartino Booth, shows the shelter component of the consumer price index, which at 33%, has the highest weighting in the basket of goods and services. It bottomed at 1.1% yoy early this year. Due largely to a combination of de-urbanization, coupled with the expiration of the moratorium on evictions, the shelter component (owners' equivalent rent) has been rising and is expected to continue increasing into 2022 eventually catching up with house prices (+20% yoy). By 2022 Booth's analysis shows OER at over 4% yoy, which if correct will add over 1% to the inflation rate. **We believe this data refutes the argument that inflation is transitory.**

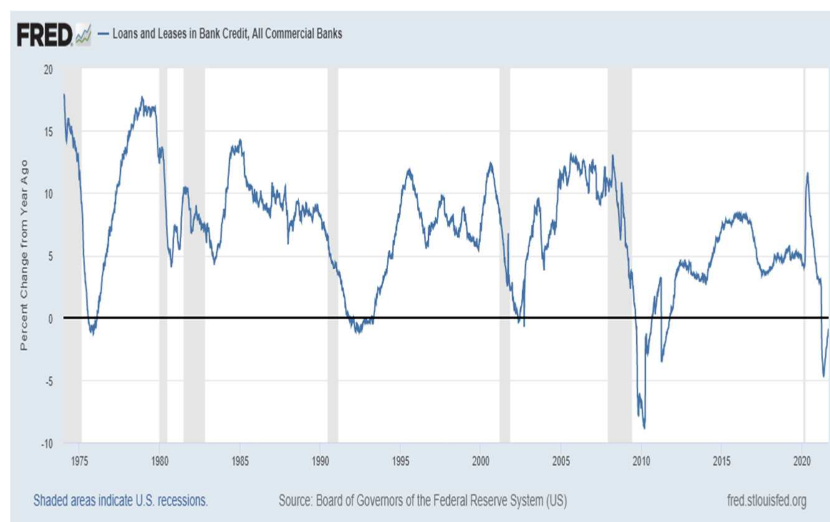
**AN INCREASE IN LOAN DEMAND SHOULD LEAD TO HIGHER INFLATION**

Transforming Irving Fisher's Equation of Exchange MV = PT we can derive a measure of money velocity i.e., $V = \frac{PT}{M}$ or $\frac{GDP}{M2}$ = money velocity. We believe that when velocity is positive – GDP is increasing faster than money supply – or a $1 of money supply is generating more than a dollar of GDP. Money supply growth is dependent on the banking system creating loans. The degree to which this occurs

influences money velocity. The higher the velocity the greater the rise in GDP (price times volume of goods and services). An increase in credit demand is a necessary condition for prices to rise (inflation).

The chart below shows the yoy change in total loans and leases in all commercial banks. The vertical shaded lines mark recessions as defined by the National Bureau of Economic Research. Note that loan demand bottoms, and begins a new cycle, following the end of a recession. We expect this has already started. Loan demand is currently expanding at a 4.7% annual rate over the past 13 weeks.

In a recent WSJ article on 8/5 it was reported that J.P. Morgan clients surveyed found that business confidence was at its highest level in 11 years. Forty-six percent of businesses surveyed said they expected to increase capital spending, while 38% said they expected to increase borrowing. Targeted areas for investment were automation and technology.




## AISA GROWTH SLOWING LED BY CHINA'S ZERO COVID POLICY

A sharp contraction in "fiscal thrust" along with a continuing decline in social financing in China is weighing heavily on growth. Factory activity measured by the Caixin Purchasing Managers Index slipped into negative territory at 47.4, the lowest reading in 18 months, as COVID-19 curbs, supply bottlenecks and high material prices weighed on output. The official survey released on 8/31 showed the index as 50.1 falling slightly from July but staying in the expansion territory.

Other major Asian exporters experienced slower activity. These included Japan, South Korea, and Taiwan. Meanwhile Vietnam and Malaysia witnessed contracting factory activity. These economies have been severely impacted by lockdowns implemented to curb the rise of the Delta COVID variant. Malaysia's Purchasing Index for August stood at 43.4.

Factories in the Eurozone have remained relatively strong. The Eurozone PMI stood at 61.4 in August. It has been reported that 70% of European Union's population is now vaccinated.

China's policymakers should soon acknowledge the need for more stimulus. They have lowered the bank's required reserve ratio in past cycles Chen Zhao, a leading macro strategist at Alpine Macro, believes effective monetary stimulus using the RRR as a policy tool would necessitate three reserve adjustments before the markets respond positively.

## RISKS

- The Fed tapers into a slowing U.S. economy.
- The COVID Delta variant mutates into other deadly viruses and/or continues to inhibit the recovery.
- Real interest rates move up faster than expected.
- Corporations, expecting higher taxes, refrain from hiring.

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July 2021

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