JUNE 18, 2021

GUT PUNCH

900 words – a 3.5 minute read.

Usually one sees stars when one is punched in the head, but its 2021 and all things are possible so the post Fed meet punch in the belly (of the curve) had folks seeing dots, moving dots.

Well, that's fine and it usually passes after a few seconds but in this case the moving dots have generated tons of press and a fair bit of cross asset volatility.

My question is why? The dot plot has been one of the most unreliable of indicators – it's simply various governors' guesses about where rates will be some time off in the pretty distant future. Compounding that is the fact that the current dot plot was generated in the midst of spiking economic indicators driven largely by base comparisons that are no longer valid (at least in CPI terms).

Notwithstanding Jay Powell's comment that one should "take the dot plot with a big grain of salt") it has been elevated to gospel showing the Fed had abandoned its FAIT strategy, will not be data dependent and will move aggressively to quench inflation. This in turn was taken to suggest inflation will indeed be "transitory" as the Fed has suggested. Talk about squaring the circle.

A 2nd question is why would the Fed act aggressively if inflation is indeed transitory? To me that smacks of a set up for my sharp US growth slowdown Bear Case.

This apparent conclusion has led bond investors to sell the 5 yr. belly of the curve and buy the long end. Real rates have rallied though still remain quite negative (-.8% on 10 yr.). Gold & steepener trades have been crushed. And the vaunted 10 yr.? Well, it's basically unchanged on the week.

Other assets moved as well; the equity reflation trade was deemed adversely affected even though there is little likelihood of a change in taper timing (pre meet, 72% of BofA FMS folks saw tapering announced in Sept and that is still the most likely case). Cyclical and Value have been sold while Growth stocks were bid. Nasdaq even hit a new ATH on Thursday. Rotation, rotation, rotation or as we call it at TPWA "the twin engine market".

European equities have been sold though that seems more like healthy profit taking given that the Euro Stoxx 600 had been on its longest winning streak since 1987! A little pullback here is good.

Commodities are off bigly with the grains having their worst few days since the GFC after having been on fire in the preceding weeks. Traders have pummeled the industrial metals in anticipation of China stockpile releases. Funnily enough, the commodity selloff is being seen as validating the transitory inflation thesis. In my view, commodities are the latest little bubblet to be popped before things get out of hand – that is healthy behavior.

Even the USD has gotten in on the act bouncing nicely against the majors as the big USD short position gets toasted. EMFX has held up pretty well with the Brazilian Real actually up vs the dollar as Brazil does more than plot dots – it actually raises rates. EM's Fragile Five are in much better shape than in the 2013 Taper Tantrum.

So what does it all mean – does one have to go into the concussion protocol and not play – take the summer off as it were?

I continue to expect a shift from a staggered reopening to a synchronized global recovery as we move through the 2H of 2021 and enter 2022. I see this as USD & UST bearish and bullish for non US equity, Commodities and thematics.

I do not believe the Fed has abandoned its AIT approach by any means and think the coming months will present a cleaner data set that will allow for further analysis & "testing times".

We are all macro investors now and the focus will shift to the passage of the Biden Jobs and Families plan which in turn will impact the inflation, rates & cross asset outlook. I expect passage along reconciliation lines.

Such passage would mitigate my bear case and unleash the potential for above trend US growth stimulated by procyclical Biden policy and a long overdue cap ex cycle (public-private cap ex/GDP at multi decade lows) supported by an incipient productivity surge that limits the inflation risk.

That is a pretty constructive outlook & one in which the Fed becomes more of a bystander than a major player but one with the capacity to throw a spanner in the works if it does tighten too soon and too aggressively.

Time will tell as it always does. In the interim, my suggestion would be to review the LT charts and note where we are in the leadership shifts (early), listen closely to the Fed speakers in the days ahead and observe next week's trading behavior after the weekend's thinking time.

I guess it comes down to if you think the Fed will act aggressively you can buy the long end of the UST curve, the dollar and Growth stocks. If you don't, then don't – buy the Value stocks, non US equity & Commodities that are being offered at some pretty nice entry points. I reviewed the technical positions in our two model portfolios & they remain sound. Supportive JPM work on stock – bond flows coupled with the GS Financial Conditions Index in uber easy territory supports my remaining in the latter camp.

TGIF & Happy Fathers Day to all the Dads out there!

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