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Weekly Market Flash

Is it time to think about thinking about tapering?

June 6, 2021

Friday's disappointing US payrolls report, which suggests that 7.6 million jobs are still missing since the pandemic hit, dampened tapering expectations in the US. The data reassured fixed income investors and all duration proxies – mainly tech stocks and precious metals. At the same time, this week saw Federal Reserve (Fed) talks, and material action, accelerate in the direction of policy normalization, with three Fed members suggesting the tapering discussion is coming soon. In particular, it was Patrick Harker who said "it may be time to at least think about thinking about tapering".

Highlights

- US stocks closed higher, with energy stocks performing the best on the back of OPEC+ extending output cuts. European equities benefited from continued inflows, especially Italy and France, bolstered by expectations that the ECB will maintain its pace of bond purchases.
- The average monthly payrolls creation in the US increased to 480k in 2021. At the current pace, 16 months are still needed before total employment gets back to pre-Covid levels.
- The Beige Book painted an overall strong picture for the US economy: from early April to late May, the economy grew at a "moderate pace", but somewhat faster than in the previous period.
- The Fed stated that it plans to start selling around USD13.7 billion of corporate debt and exchange-traded funds in its Secondary Market Corporate Credit Facility. They'll begin with exchange-traded funds next week, on June 7.
- Food prices are now back to levels close to the 2010/2011 food price bubble that led to the social unrest across emerging markets and the Arab Spring.

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Markets & Macro | Is it time to think about thinking about tapering?

Beige Book paints an overall strong picture.

In the US, 7.6 million jobs are still missing since the pandemic hit. The US economy lost 22.4 million in the first two months after the shock and has gained 14.7 million once the recovery started. The average monthly payrolls creation increased to 480k in 2021. At the current pace, 16 months are still needed before total employment gets back to pre-Covid levels. And we also have to consider the administration's determination to extend the recovery to the "left behinds".

That said, higher average earnings complicate the picture, reinforcing the evidence that it's hard to find employees at the right price. The possibility of a relatively slow jobs recovery with some degree of inflation should not be dismissed at this point, potentially facing the Fed with difficult choices in the coming months. Further light will likely be shed next week by the most relevant economic data of the year so far, namely the US CPI figure for May.

Our view: Overall, the continuation of very strong economic data in the US has contributed to raise expectations on the Fed's monetary policy this week – and this finally translated into some action in financial markets. This week, three Fed members suggested that the tapering discussion is coming soon. The more vocal was Patrick Harker who said "it may be time to at least think about thinking about tapering". He also added that the Fed's goal is to be boring, though, that "we will remove accommodation carefully and methodically as the economy continues to strengthen... Our goal here is to be boring."

The release of the Beige Book painted an overall strong picture: in the observation period (from early April to late May), the economy grew at a "moderate pace", but somewhat faster than in the previous period. Many Fed districts reported the positive impact from the vaccination campaign, and the negative impact of supply difficulties and capacity constraints. Price pressures have increased, especially on input prices but also somewhat on output prices, as some companies are able to pass on higher costs to customers due to strong demand. Employment is up and wages are also moderately up, with some companies offering sign-on bonuses and other benefits to attract or retain labor.

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Elsewhere, and in a controversial move, the Fed Board has indicated that it will gradually begin to liquidate its portfolio of corporate bonds purchased during the pandemic through its emergency lending program. According to last week's data, the Fed's outstanding corporate debt stands at about USD13.7 billion. Such bond holdings were not part of the Fed's QE policy, since their purchase was executed in order to prevent disorderly financial markets and ease financial conditions. Commentators were divided on whether to take this action as a material sign of tightening; we tend to lean toward the hawkish field. It is striking to note how afraid central banks are at signaling a change of direction in monetary policy. The memory of the end of 2018, or the taper tantrum of 2013, must indeed be very strong in their mind.

European equities: a haven?

European equity markets continued to outperform US equivalents this week, and the price action has shown international investors "hide in Europe" when tensions rise.

Our view: Multiple factors have contributed to this reality. For one, the acceleration in the vaccine distribution process has certainly played a major role. This week the European Union announced plans to lift all quarantine requirements starting in July, using a digital passport indicating vaccination status. In another sign the region is on track toward normality, Germany's Angela Merkel said she's ready to let the country's controversial lockdown law lapse.

The market's understanding that the European Central Bank (ECB) would never dare to anticipate the Fed on the tapering decision has further helped in our view, with the euro weakening versus the US dollar on the realization of diverging monetary policies. This notwithstanding, next Thursday's meeting should be full of insightful information, but probably not with tangible action. This could include: 1) new staff projections, with a likely upward revision of inflation forecasts (from currently 1.5% for 2021 and 1.3% for 2022); 2) an updated assessment of financial conditions, after the recent rise in European rates; 3) the actual discussion on tapering. The impression is that just a mention of such a discussion could push bond yields further up and undermine the economic recovery before it has developed sustainably.

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Another positive boost for equity markets came from the US, where the Washington Post reported that Biden has modified his proposal to increase tax rates, with a hypothetical establishment of a floor at 15% instead of raising the corporate tax from 22% to 28%. Deutsche Bank reported that 116 companies in the S&P 500 index paid an effective tax rate of less than 15% last year. The proposal provides a strong effort to close the gap with the Republicans' position to try to reach an agreement. Clearly, the market prefers it to the original plan.

Elsewhere, the price action in commodities, and in oil particularly, is certainly not contributing to easing price pressures, This could challenge investor sentiment in the coming months as the oil price, after moving sideways since March, rose further this week to USD72 per barrel, the highest level in two years.

The Fed is fueling higher food prices… again.

Food prices are now back to levels close to the 2010/2011 food price bubble that led to the social unrest across emerging markets and the Arab Spring. Back then, the Fed was criticized for having fueled the bubble. And even if Ben Bernanke vehemently denied any responsibility, this narrative was making headlines: Fed asset purchases as a strong catalyst for the food prices implosion.

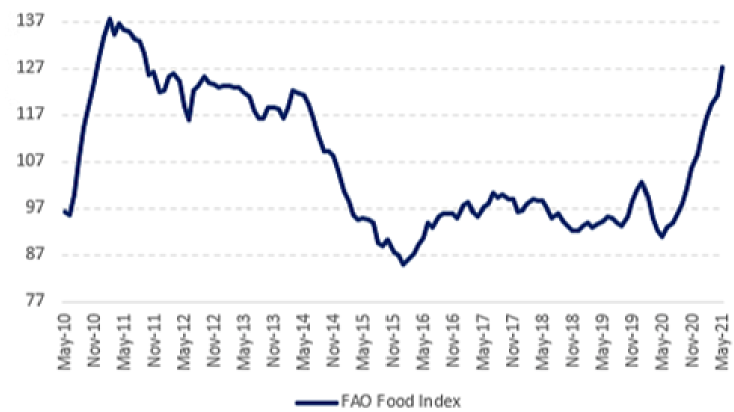
Our view: As highlighted by the Food and Agriculture Organization this week, there are certainly other catalysts, starting from a drought in key Brazilian regions crippling crops from corn to coffee, and vegetable oil production growth having slowed in Southeast Asia.

Still, it is clear that central bank policies, and the Fed specifically, have a role in food price dynamics. For example, the Fed's new inflation framework is very clear to investors: let's run the economy hot in order to absorb unemployed workers, and accept inflation overshooting... thus convincing investors to be overweight real assets over financial assets in their allocations. And commodities are now seen as the best "inflation hedge" at a time when the relevance of the traditional 60/40 (bond/equity mix) is questioned due to the lack of yield in fixed income markets.

"As a result of asset managers buying more commodities, commodity prices rise, contributing to amplify the inflation fears."

The Fed is once again playing an ironic role in this process. It is determined to fight poverty and inequality alongside inflation, yet is fueling them at the same time. The problem is that the dynamic is becoming self-fulling: as inflation concerns increase, investors allocate more capital toward commodities as an inflation hedge. As a result of asset managers buying more commodities, commodity prices rise, contributing to amplify the inflation fears. This then leads to further allocation into inflation hedges – commodities.

Figure 1: Food and Agriculture Organization Food Index



Source: Food and Agriculture Organization, as at June 4, 2021.

Equities | Retail activity drives equity positioning higher

Meme stocks dominate light trading week.

In a holiday-shortened week, US stocks closed higher, with energy stocks performing the best on the back of OPEC+ extending output cuts. Long-duration stocks welcomed the US nonfarm payroll report as a sign that the Fed would keep its highly accommodative monetary policy for longer.

"...European equities benefited from continued inflows, especially Italy and France, bolstered by expectations that the ECB will maintain its pace of bond purchases."

Meanwhile, European equities benefited from continued inflows, especially Italy and France, bolstered by expectations that the ECB will maintain its pace of bond purchases. Elsewhere, the extension of the COVID state of emergency in several cities across Japan, including Tokyo, dented sentiment. Chinese equities (the CSI 300 Index) also retreated after three weeks of solid gains. Overall, trading volumes were noticeably light, except for meme stocks, driven by the retail investor mania.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	34,756.39	0.69%	0.69%	14.55%
S&P 500	4,229.89	0.64%	0.64%	13.34%
Nasdaq	13,814.49	0.49%	0.49%	7.51%
Euro Stoxx 50	4,089.38	0.48%	1.25%	17.22%
Swiss Market	11,570.68	1.26%	1.82%	11.08%
FTSE 100	7,069.04	0.73%	0.73%	11.25%
CAC 40	6,515.66	0.52%	1.08%	19.36%
DAX	15,692.90	1.11%	1.76%	14.39%
FTSE MIB	25,570.46	1.59%	1.59%	16.61%
Nikkei 225	28,941.52	-0.71%	0.28%	6.20%
Hang Seng	28,918.10	-0.59%	-0.68%	7.39%
CSI 300	5,282.28	-0.60%	-0.81%	1.70%

Source: Bloomberg, as at June 4, 2021. Performance figures in indices' local currencies.

Our view: Weekly equity positioning data tracked by Deutsche Bank shows that equity positioning is back near the top end of the historical band, following a steady decline since mid-April. The sharp rebound in positioning was driven by a sharp increase in call volumes. Retail trading has been a key factor in this dynamic, which raises questions of the sustainability of this trend.

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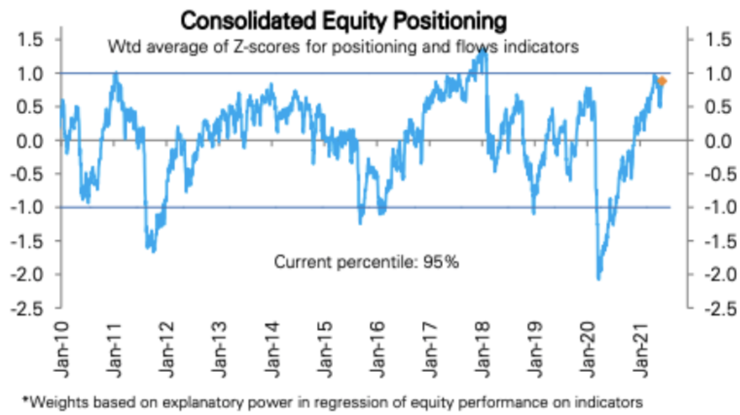
Figure 3: Equity Market Positioning



Source: Deutsche Bank.

Chart of the week

Buy the dip... but where is the dip? Markets have experienced an extraordinary period of calm over the last six months. The S&P 500 index hasn't experienced a 5% drawdown since November, which is the longest streak of calm since 2017. In the meantime, the cost to buy tail protection (the third panel) is at the highest since 2018, proving that investor anxieties do not translate into negative price action.

Figure 4: S&P 500 Index

Source: Bloomberg, as at June 4, 2021.

"The S&P 500 index hasn't experienced a 5% drawdown since November, which is the longest streak of calm since 2017."

Fixed Income & Credit | Will spreads widen as Fed sells ETFs?

Fed due to scale back support at a sensitive time.

During the month of May, sovereign bonds registered a flat performance. US Treasuries are still down -5.77% so far this year. European government bonds underperformed during the month, with Bunds down -0.2%. In the credit space, the high yield segment extended its record of sheltering fixed income investors from volatile rates. In Europe, total returns were 0.44% in May, stretching junk's winning streak to seven months. Meanwhile, investment grade bonds succumbed to rising Bund yields again, especially during the first part of the month when the Bund rose to -0.10%.

Our view: On June 2nd, the Fed stated that it plans to start selling around USD13.7 billion of corporate debt and exchange-traded funds in its Secondary Market Corporate Credit Facility, which was launched last year to help limit the impact of the pandemic on the US economy. They'll begin with exchange-traded funds next week, on June 7.

"...it could take "very little selling to convince investors the tightening cycle is underway," and push spreads wider."

Despite the clear communication that this unprecedented backstop was a "once-in-a-generation" step, investors are still convinced that the central bank will bail them out again if needed. In fairness, this selling will represent a minuscule portion of secondary trading volumes and will not likely have any material impact on spreads. The exit is also unlikely to change the overall valuations in the junk bond market.

Nevertheless, the announcement comes at a sensitive time for the Fed as markets are expecting the central bank to start debating scaling back its USD120 billion in monthly asset purchases in the coming months. Therefore, as a Bank of America strategist wrote, it could take "very little selling to convince investors the tightening cycle is underway," and push spreads wider.

Week Ahead | Key events to watch for

- **Next week will deliver several macro variables**: central bank meetings in Russia, Canada and Europe, and the May CPI print in the US. In particular, the US CPI print on Thursday will be one of the most watched data prints of all time.

- **Thursday will be a relevant day for European markets and the euro**, with the decision on PEPP purchases from the ECB. The following press conference from President Lagarde will also be highly scrutinized.

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