

SALT GLOBAL OUTLOOK

By Bevan Graham and Greg Fleming.

October 2021

Global growth slowing, but above trend

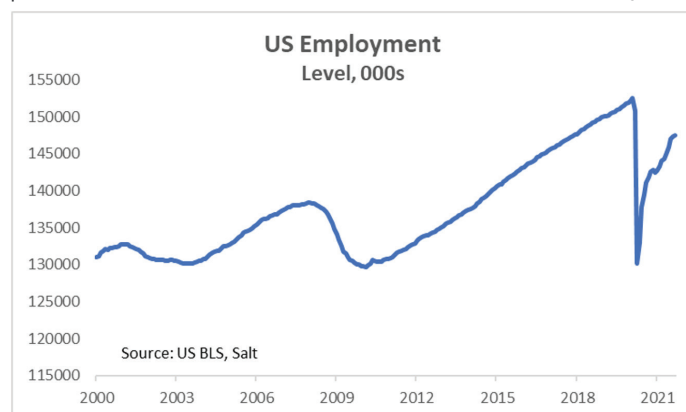
Economic growth continues to recover strongly, aided by the deployment of vaccines, the accompanying easing of social and economic restrictions, and strong and ongoing policy support.

Global GDP is now higher than its pre-pandemic level, though global economic activity is likely to be around 3.5% lower than it was forecast by the International Monetary Fund pre-pandemic to be at the end of 2021. That's a loss of around one year's annual average global output.

The recovery continues to be uneven from country to country due to a number of factors including the continued spread of the virus (particularly the more infectious and therefore problematic delta variant) vaccinations rates, differing approaches to containment, the degree of policy support and pre-existing structural challenges.

High vaccination rates in Europe, the United Kingdom the United States and, more recently, Denmark have allowed a return to some degree of normalcy. While Covid cases are rising, they are not being accompanied by the same degree of hospitalisations and mortalities.

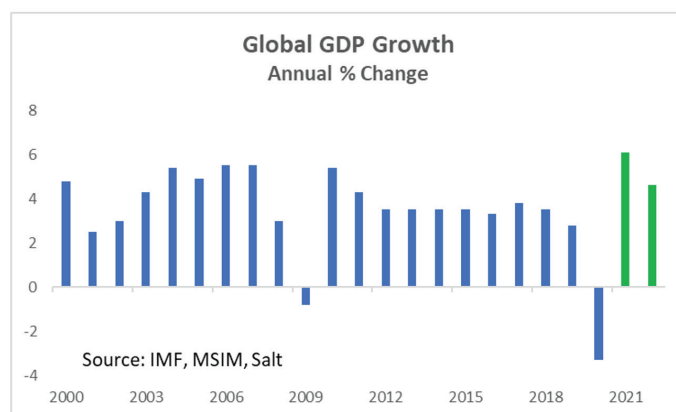
Different countries are being left with different challenges. In the US for example, while GDP has recovered its pre-pandemic level, there are still five million fewer jobs.



Meanwhile in Europe, the labour market has held up better, but GDP is still yet to recover its pre-pandemic level.

More recent partial activity indicators suggest a slowing of momentum across some of the world's major economies, the United States and China included. That was always to be expected as the pace of the re-opening bounce was unlikely to be sustained.

Where growth forecasts are being revised down in some countries, it is mostly due to supply constraints rather than deficient demand. In general, growth is expected to remain above trend. We see calendar 2021 global growth at 6.1%, followed by 4.6% in 2022.



Are central banks seeing the (inflation) light?

Importantly, Covid has been a global supply shock. This is quite different to previous shocks central banks have had to deal with; the Global Financial Crisis by comparison, was a demand shock. As economic and social restrictions have eased, demand has recovered, putting pressure on production, labour markets, commodity prices, business costs and inflation.

Regular readers will know that when it comes to the seemingly endless “transitory versus durable” debate about recently higher inflation, we have been firmly in the durable camp. We have also been of the view that over 2021, many central banks would be bringing forward the timing of ending asset purchase programs and starting to raise interest rates.

That said, our thinking has been a little more nuanced than whether it would be just one or the other. Of course, as some of the supply shortages and logistical supply chain issues were resolved, inflationary pressures would ease and yes, even reverse. As it has turned out, these supply constraints have proven to be more serious and longer lasting than anybody previously thought.

Our durable argument, however, was grounded in the fast economic recovery following the periods of social and economic restrictions, massive fiscal stimulus around the world that has morphed from pandemic response to general fiscal largesse and the pressure this would put on labour markets and ultimately wage inflation, especially in a likely lengthy period of constrained international travel and closed borders and the obvious implications for the mobility of labour.

Many central banks remain adamant about higher inflation’s likely transitory nature. The key information to watch, especially as we monitored their likely shifts in stance from the “dovish” to the “hawkish”, was their inflation projections in the latter part of 2022. That is in the window in which monetary policy decisions made today are assumed to have their greatest impact.

The Reserve Bank of New Zealand (RBNZ) view of that near term inflation outlook has changed dramatically over the last few months. In February, the RBNZ was projecting inflation to peak at 2.5% in mid-2021, but then fall back 1.4% by mid-2022. By August, the RBNZ was projecting a CPI peak of 4.1% in 2021, but to only fall back to 2.2% by late-2022, importantly still above the 2% mid-point of the target range.

Meanwhile, back at the Fed, Chairman Jay Powell continues to argue the transitory nature of current high rates of inflation. But our read of the Summary of Economic Projections (SEP) issued at the time of the September FOMC, including a near-forensic examination of the infamous “dot plot”, tells us there is more than a subtle shift underway at the Fed.

A failure to participate

In the latest SEP, the average expectation for the unemployment rate in the period ahead continued to decline, but the dispersion of the forecasts is narrowing. We read that as increasing confidence in the improvement in the labour market – the most likely source of durable

inflation pressure.

Recent US labour market reports have disappointed. After some solid gains in employment growth earlier on the year, results in August and September undershot expectations by some hundreds of thousands. The September result was the lowest payrolls increase for the year, and that’s with the total level of employment five million jobs lower than it was pre-pandemic.

At the same time, however, the unemployment rate continues to decline and at 4.8% in September, is closing in on the estimated full-employment rate of 4.5%.

And there is no shortage of jobs. Estimates from the Job Openings and Labour Turnover Survey (JOLTS) indicates there are currently 10.9 million job openings across the United States. With 7.7 million unemployed, that’s around 1.4 jobs for every unemployed person.



Importantly, we are also seeing a surprisingly slow improvement in labour participation. That makes issues in the labour market also supply rather than demand-side phenomena. Special unemployment benefits ended in September and with school holidays also ending, it was widely expected the participation rate would rise in the month, but it fell. Other factors are at play including the possibility that many people are still living off savings accrued during periods of Covid-related restrictions.

Unfortunately for the Fed, strong demand for jobs accompanied by a failure of people to participate is impacting on wage growth. The annual rate of change is running at 4.6%, well ahead of the 3.0-3.5% prevailing pre-pandemic that is also consistent with their 2.0% inflation target, assuming productivity growth of 1.0-1.5%.

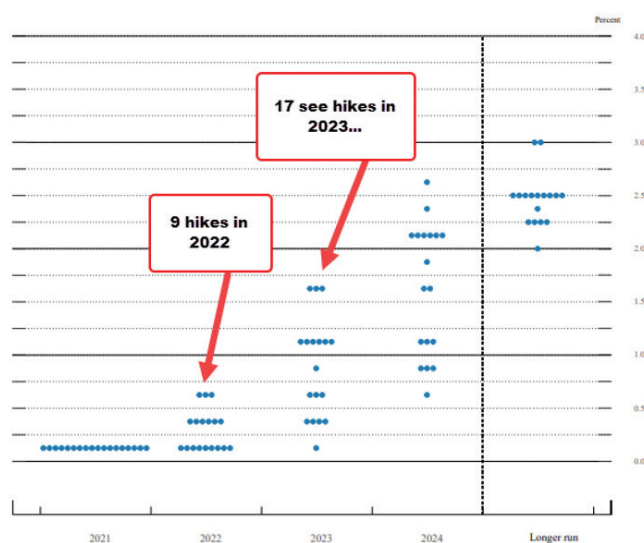
Inflation expected to remain above target

While there is an unusually high degree of dispersion in inflation forecasts amongst FOMC participants, the median expectation is for core PCE (personal consumption expenditure deflator, the FOMC’s preferred measure of

inflation) to be at 4.2% at the end of this year, but then sustained at above 2% right out to the end of 2024. We think that is a result of the increased confidence in the outlook for the labour market.

A look at the dots for the fed funds rate shows interest rate lift-off nudging slowly forward. In the June SEP there were seven FOMC participants expecting rate hikes to begin in 2022. The September SEP has seen that rise to nine participants (half of the FOMC), with three of them expecting two hikes next year.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



While Powell is still running the transitory line, there is more urgency about getting on with the job of withdrawing stimulus. At the press conference following the meeting he stated that conditions for sustainable improvement in the labour market had been “all but met”. He also signaled a tapering announcement was likely in November and that the asset purchase program could be expected to wind up around the middle of next year.

It is not only the Fed that is bringing forward tightening expectations. In the same week as the FOMC met, the Bank of England delivered a more hawkish-than-expected statement stating that “some modest tightening of monetary policy over the forecast period was likely to be necessary”, opening the door to a rate hike this year, though more likely early next year. Also, the central Bank of Norway, the Norges Bank, delivered the first interest rate hike by a developed central bank this cycle.

Adapting to the new world

Covid isn’t something that’s going away anytime soon, especially since the arrival of the delta variant. This has

led to many countries having to adapt their strategies, including here in New Zealand where an elimination strategy was being pursued, but is now impossible. Covid is something we are going to have to learn to live with, at least for the foreseeable future.

That means adapting to life with Covid. While rising vaccination rates are leading to a relaxation of restrictions and even perhaps the end of “hard” lockdowns, some countries are experimenting with or proposing a traffic light system as part of the transition to the new normal. So-called “vaccination passports” are also likely to play a key role in the future.

Many adaptations have been around for a while now. People have become used to working from home and using technology more. Consumers have become used to shopping, and businesses selling, online. Many of these trends were already evolving, but Covid has seen a significant step-change. The longer Covid lingers, the more these changes become embedded.

Border restrictions have led to a collapse of international tourism, business travel and migration. Vaccination passports will lead to some recovery, but businesses will more than likely be keen to “bank” a large proportion of the recent savings in travel expenses and consumer travel preferences were already changing on the back of climate change considerations.

Some countries have also taken the opportunity of the collapse in migration to think about resetting policy parameters. As we have found here in New Zealand, finding the right balance is challenging. Taking the pressure off the housing market is one thing but exacerbating labour shortages is another.

Structural challenges abound

Covid came along at a time when the world was already facing into significant structural challenges. Many developed and some developing (China) economies were already facing into stagnant or declining working age populations and moribund productivity growth.

Fresh Covid-related supply constraints are also hurting potential growth providing central banks with the unique (by recent standards) problem of downside risks to growth at the same time the risks to inflation are to the upside.

Both income and wealth inequality has been exacerbated by Covid as job losses were centered in predominantly low wage sectors such as hospitality, and even easier monetary policy contributed to higher asset prices, including housing. We have also seen a new inequality emerge – access to vaccines. The focus on inequality as the defining political challenge has only been temporarily displaced by the immediate challenges of the pandemic.

At the same time Governments are having to navigate their way through the necessary implementation of their commitments under the Paris climate change agreement.

Structural budget deficits and high public (and total) debt levels deteriorated sharply through the pandemic response but have now been “baked in” as governments all around the world have taken advantage of Covid to embrace fiscal largesse. To be fair, the trend towards bigger government was already underway, but as with other things, Covid allowed a step-change.

The good news is that much of this new spending is being directed towards key structural problems such as inequality and climate change. But in the absence of any ability to reprioritise other spending, bigger government needs to be paid for. That means some countries are turning to tax increases, the United States and the United Kingdom included. Margaret Thatcher and Ronald Reagan are turning in their graves.

After 13-years of over-reliance on monetary policy, regime change is underway. Fiscal policy is becoming the new stimulus poster-child, but from an already stretched position of high debt levels. Interest rates will remain low (by historical standards), but this will be challenged by higher inflation in a supply constrained world.

What the world needs now

With supply constraints ongoing and intensifying labour shortages, higher capital spending is an increasingly necessary and urgent part of the next phase of the cycle. Unfortunately, the economic uncertainties around Covid are in many cases a disincentive for many businesses to invest.

In normal times, higher capex is a normal part of the evolution of the economic cycle. As the growth cycle continues to mature, labour become more difficult to find and businesses turn to investment in plant and equipment to resource the ongoing growth for their goods and services. This has the added benefit of contributing to late cycle improvements in productivity, dampening inflation and supporting the longevity of the cycle.

The Covid pandemic has also resulted in an acceleration of or emergence of new structural trends, all requiring new public and private sector investment. This includes larger and stronger data centers and cybersecurity as more people work from home and different retail infrastructure as people have become accustomed to working from home.

Public investment is also important, so long as it aligns with the mitigation of structural challenges. The significant fiscal response to the pandemic is supporting climate change mitigation and adaptation efforts. It is important that this stimulus lines up with long-term strategic

priorities. Some fiscal spending is aimed at incentivising private sector investment in this important area.

At the same time, public policy in general needs to focus on improving labour participation, educational achievement, and skills development.

China’s “regulatory reset” – the complicated path to common prosperity

The recent trend towards regulatory tightening in China ushers in the next phase of the country’s challenging economic development. This has impacted several industries including technology, private tutoring, and online insurance. Even entertainment is within the scope of the pivot suggested by recent announcements, exhortations, and rule changes by the Chinese leadership.

This development marks a shift from the “growth first” priorities of the last decade, setting a more balanced and sustainable objective of “common prosperity”. We believe this is firmly focused on the Chinese middle-class, and particularly focused on containing undesirable and potentially destabilising shifts in income inequality.

We see this as a continuation of the drive to rebalance the economy towards higher levels of consumption, but now with more overt interventionist intentions. We expect to see more policy moves to support redistribution and more government spending on social welfare and education. This will be supported by higher taxation, though will also allow households to lower traditionally high precautionary savings to support higher consumer spending.

The industrialisation policies of the past meant that profits represented a far greater proportion of GDP than labour compensation. For consumption to rise as a share of GDP, the share of wages in GDP must rise first. It of course follows that the share of profits in GDP must decline. That means even if the economy is performing strongly, corporate profitability will struggle in the period ahead.

The Chinese economy does not exist in a vacuum, and other regional nations are quick to exploit rising Chinese production costs to attract promising industrial investment funds into their own polities, aiming at growing their domestic middle class too. Pakistan, Bangladesh, Vietnam, and recently Myanmar have allowed the Chinese planners to decommission older industry types and to enable the business areas where they identify high value-added growth.

Recent regulatory interventions are aimed at supporting this rebalancing. The growth of largely unregulated technology companies undermines the shift required in GDP from corporate profits to wages. The new moves in regulating delivery and indirectly, prices of online tutoring are aimed at keeping these services within the reach of the middle-classes.

This approach carries a few risks. The surprise moves create the risk in the eyes of potential investors in China that further politically driven moves are likely, making investment in China less attractive. It also potentially undermines entrepreneurship at a time when productivity growth in China has slowed and greater investment in technological innovation is required.

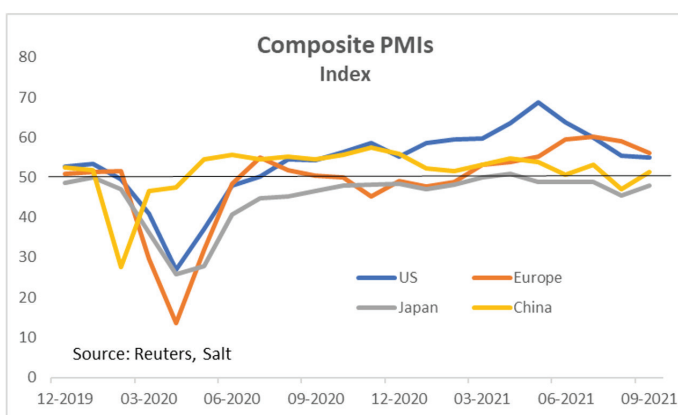
There are also policy implementation risks. We've seen instances in the past where Chinese policy interventions have been either poorly coordinated or poorly communicated which can lead to unnecessary disruption and market volatility.

Our greatest concern is that these regulatory interventions, while possibly well intentioned at achieving common prosperity, may do more damage to aggregate prosperity. For instance, the Chinese authorities have established a model of investment risk management, where some large enterprises with solvency problems have been rescued, by being re-structured via debt-for-equity swaps and the resulting securities have been steered into Chinese retail investors' retirement savings funds.

This essentially hides, rather than resolves, riskiness and mainly buys time. Whether that time is well used to further real productivity enhancement or is squandered because key players feel they have been let off the hook (moral hazard) may determine whether the policy pivot currently gaining pace in China really does placate popular concerns about the CCP's aim of transforming "growth with Chinese characteristics."

A quick trip around the world

- In the United States, data points to a moderation of growth in the economy but to a still respectable and, importantly from a monetary policy perspective, above trend pace. Recent payrolls reports have been disappointing, though the unemployment rate continues to close in on the level consistent with full employment. Consumer confidence has dipped in recent months, but August retail sales came in stronger than expected. Other survey data points to a solid ongoing pace of growth. The September Composite



PMI slipped further but is at a still respectable 55.0. GDP growth is expected to come in at 5.7% this year followed by 4.0% in 2022. Latest inflation data eased slightly but with the Fed now expecting above target inflation for the foreseeable future, both growth and inflation outlooks are strong enough for the Fed to signal it will soon start withdrawing monetary stimulus.

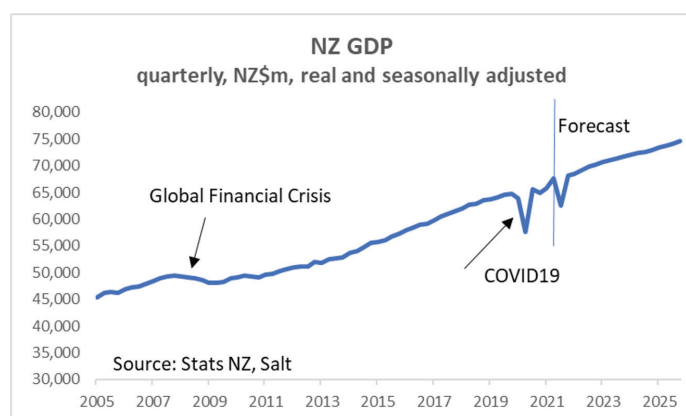
- The Eurozone economy saw respectable growth over the second quarter of the year with growth of 2.2% over the 3-month period and 14.3% over the year. As has become expected as Covid-related restrictions ease, consumption led the charge with 3.7% increase over the quarter. Third quarter data has been somewhat mixed with retail sales declining but industrial production rising. Medium term prospects look positive as an earlier spike in Covid cases has started to decline. Germany and France have reported solid gains in household disposable income over the second quarter which bodes well for ongoing recovery in consumer spending. The European Central Bank "recalibrated" its asset purchase program in September, though were at pains to point out this was not the beginning of a tapering process. To emphasise the point, ECB President Christine Lagarde channeled Margaret Thatcher by stating "This woman's not for tapering".
- The United Kingdom economy is going through a bumpy period. Activity data has generally disappointed, even as the economy has emerged from Covid-related restrictions. July GDP data was flat, retail sales continue to struggle and both manufacturing and service PMIs slipped in September (though remain comfortably in expansion territory). Employment growth has been steady, though it will be important to watch developments closely over the next few months as furlough schemes expire. Importantly, and correctly in our view, the Bank of England (BoE) is attributing growth issue to supply constraints. At its September meeting, and despite the softer data, the BoE signaled the possibility of an imminent tightening in monetary policy.
- Despite surprising strength in the second quarter of the year, the outlook for Japan's economy remains challenging. Most importantly the Covid-related state of emergency has been in place for most of the year and was extended again in September. Its GDP growth is likely to prove the lowest of the key developed economies for the foreseeable future. As well as subdued growth, inflation remains moribund. We see no change in monetary policy settings for the foreseeable future.
- The regulatory reset and problems at Evergrande aside, Chinese activity data continues to disappoint. The impact of Covid related restrictions is still being felt through the economy, particularly on retail spending, but also investment spending and financing conditions.

September's Composite PMI bounced higher to 51.4, reflecting the easing of some restrictions. Despite the recent weakness, GDP growth is still forecast to come in at around 8.0% this year, though that has been gradually revised down from around 9.5% at the start of the year. Problems at Evergrande are dampening confidence but claims this is China's "Lehman moment" are, in our view, wide of the mark.

- The Australian economy is struggling under continuing lockdowns in two key states. The Reserve Bank of Australia followed through with a reduction in bond purchases in September but has pushed out the time at which it would next review the program by three months to February 2022.

New Zealand economy proving resilient

If there was any doubt that New Zealand's negative output gap was closed following the spectacular March quarter of GDP increase of 1.4%, that was put to bed with an even more spectacular increase of 2.8% in the June quarter.



We didn't take the result at full face value. The reopening of the Aussie travel bubble appeared to have an out-sized impact on the result. That's because June is normally a weak quarter for international tourism, so the seasonal adjustment process probably inflated the impact to some degree. This will probably have an outsized negative impact in the September quarter as the bubble closed.

Data issues aside, the result was undeniably strong and reinforces the messages from various business surveys and increasingly the "hard" data that the economy was expanding rapidly at that point, the labour market was particularly stretched, and that supply constraints including logistical challenges were having a significant impact on costs and pricing intentions.

Then along came Delta and a new lockdown. One of the first, most significant implications was to delay a first interest rate hike by the RBNZ the statement released on the day indicated would have been delivered, if not for the new outbreak.

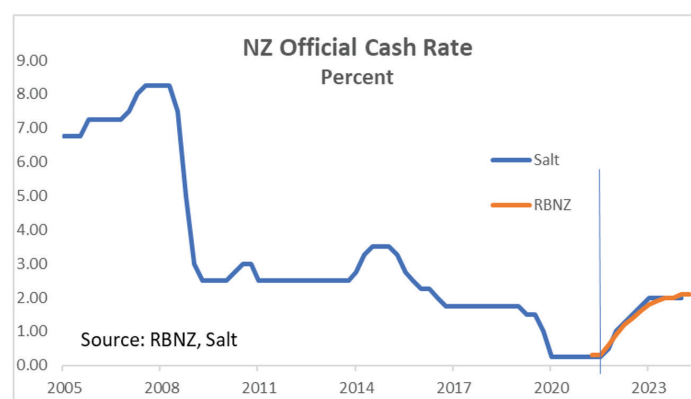
Seven weeks since the outbreak the country remains in various degrees of restraint with Auckland the hardest hit. However, the economy is proving remarkably resilient. While overall business confidence has softened, the ANZ's Business Outlook survey shows that firms remain surprisingly upbeat about the outlook for their own activity levels.

That likely reflects those businesses which have been able to pivot to online sales where possible, having learnt from earlier periods of restrictions. Another lesson from experience is that once restrictions ease, activity bounces back very quickly as pent-up demand and high household savings are released. Of course, there is also a growing cohort of businesses that simply won't make it through.

That optimism about future activity levels, combined with existing tightness in the labour means firms are doing the best they can to hold onto staff. This is being assisted by the government's wage subsidy scheme. Anecdotal evidence also suggests that firms that has recruitment process in place prior to lockdown are following through with those plans.

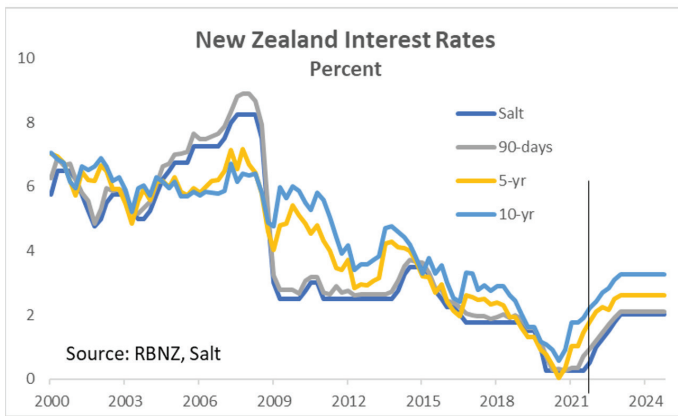
Interest rate lift-off – all systems are "go"

That was all sufficient for the RBNZ to deliver the first interest rate hike of this cycle in early October, lifting the Official Cash Rate (OCR) 25 basis points to 0.5%. We believe this move is entirely appropriate, even with the country still operating under varying degrees of restraint of mobility.



We know the economy was stretched prior to the latest outbreak and this will be exacerbated as restrictions are eased and pent-up demand and high household savings are unleashed on an even more supply-constrained economy. And while many firms are needing significant support right now, it's important that is targeted and coming from fiscal policy, which it currently is.

Tightening now is also a nod to the inherent lag between monetary policy actions and their impact on the economy which is generally assumed to be a 12 to 18-month



period. In hiking interest rates now, the RBNZ is looking at influencing inflation outcomes in the second half of next year, a time at which we are all enjoying far more freedom of movement.

It is true that risks to growth are to the downside, but these risks are mostly emanating from the supply side of the economy. The RBNZ has little to no ability to influence labour market participation or productivity growth. So, while the growth risks are to the downside, the inflation risks are, at the same time, to the upside.

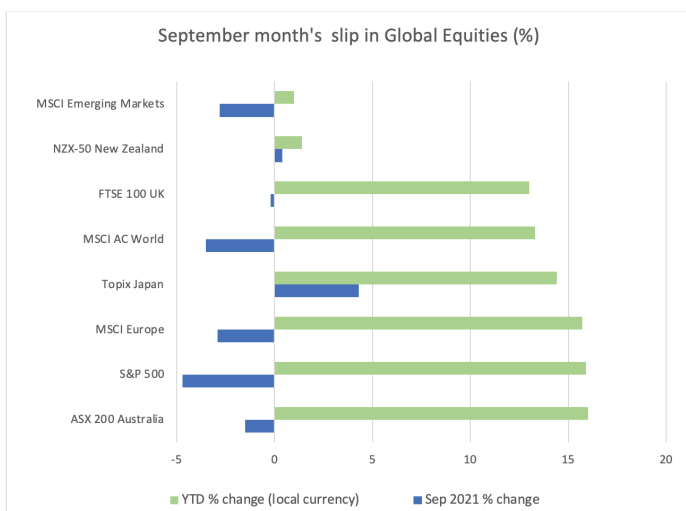
With interest rate lift-off now achieved, the next questions are how far do interest rates have to go, and how quickly. Our starting assumption is that the RBNZ is behind the curve and that interest rates will have to rise quite quickly. Expect ongoing regular increases that will, in the first instance, get the OCR to the RBNZ's assumed neutral rate which is currently 2.0% in the second half of next year.

Uncertainty about the economic outlook due to Covid is problematic and means the RBNZ may not hike as quickly as they would if the outlook was more certain. In a recent speech the RBNZ Assistant Governor Christian Hawkesby made just this point. The risk in a slower more incremental approach to tightening when you are already starting behind the curve means the RBNZ may struggle to get ahead of the problem and an OCR at neutral may not be high enough. As restrictions ease and uncertainty recedes, expect the RBNZ to play catch-up with the occasional 50 basis point hike along the way.

Implications for Investors

A classic “soggy September”

Following the very robust period for returns from growth-sensitive assets, the third quarter of 2021 played out according to a historically common pattern. Influenced by the market dynamics of the Northern Hemisphere summer months, the US equity market (S&P 500) logged gains from the index's end-June closing level, through July and August, which amounted to 5.25% as August ended. However, September is frequently a problematic month for market sentiment, particularly so following a strong prior performance period. That condition was satisfied this year, as the characteristic “September effect” came into play, triggered by renewed investor concern about the Congressional wrangling over US debt ceiling extension, the risk of inflation due to supply chain disruption and prior stimulus, the persistence of Covid-19 around the world, and the Chinese crackdown on business financial leverage, particularly in property companies. The month of September saw the key US index dip 4.75%, essentially erasing the July-August gains. A continuation of the less confident mood into early October meant the US market finally broke an eleven-month run during which there had been no single instance of a 5% dip in share market value.



Source: Salt, Morgan Stanley investment Management

Choppy market forecast was fulfilled

These legitimate concerns have triggered the “choppy market conditions” which we had anticipated, and which may continue for a little longer. However, the seasonal weakness we are currently observing should be kept in context. Despite the revival of a focus on negative influences, the S&P 500 was broadly flat over the third quarter. This means the US index was up by 28.6% over the full year to September. The conventional definition of a “correction” in equities is a fall in value of 10% from

their prior peak. So, the present period of uncertain market direction does not (as of 10 October) yet qualify as a corrective re-pricing. The prior instance of a down-move of 5% in the US market took place 227 trading days earlier, in late-October 2020, during the turbulent dying days of the Trump Administration.

That 11-month period was the seventh-longest unbroken market uptrend (so defined) on record. Since last October's instance, the US index has rallied by over 33%. This is the context in which commentators had indicated the likelihood of a near-term consolidation, with a preponderance of weaker days. September month saw negative total returns across major equity regions of around 3-5%, with Japan the only major region with a positive total return (4.3%) in the broad Topix index. In int MCSI AC World index, September saw Large Cap stocks fall slightly more than Small Caps (-3.6% vs. -2.2%, respectively) and Value stocks proved notably more resilient than Growth (-2.4% vs. -4.6%, respectively.) Energy and Financials sectors remained the clear leaders both during the month, and for 2021 to date.

Bond markets unable to offset equity weakness

Total returns were also negative from developed bond markets, with Investment Grade corporate securities declining by around 1% for the month. Sovereign bonds were a touch weaker than corporates in September. US 10 Year bonds slipped by 1.6% and are now down 3.4% Year-to-Date, while the so-called “Long Bond” – the 30 Year US maturity was sharply weaker on rising inflation concern, losing 2.9% for the month and now logging a rather outsized decline of -7.5% Year-to-Date. German Bunds were only slightly less vulnerable this year, with a Year-to-Date decline on 30 Year government bonds approaching -6.7%.

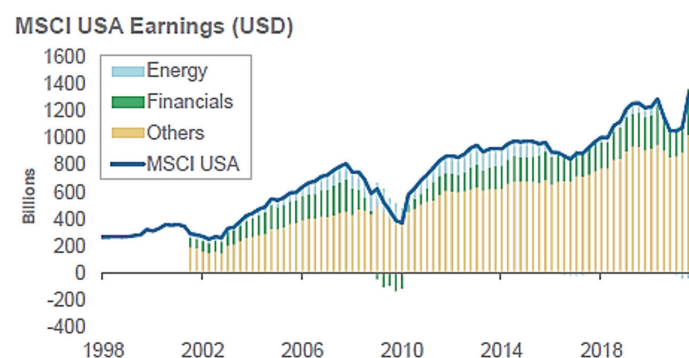
These reasonably sizable declines in the value of key Government debt securities are sobering and make manifest the long-discussed asymmetric risks in buying bonds at very low (or negative) nominal yields. As a result of simultaneous slippage in both equity and bond performance, it has been estimated that the typical “60/40” US Balanced Portfolio, holding 60% allocation to equities and 40% to Fixed Interest, declined in value by 3.5% for September month. In New Zealand the impact was more muted, but typical Balanced fund returns for a comparable 60/40 asset allocation have declined by up to 2.7% for the month, and turned in a flat performance for the third quarter as a whole. This was despite solid returns from equities in both July and August. New diversifiers, less reliant on Fixed Income assets, are needed. For portfolios where bond exposure is still a requisite, active selection is absolutely critical to performance now – a fact exemplified by noting that the Year-to-Date performance of Asian region Investment Grade dollar bonds was

a solid +3.6%, whereas the Global Investment Grade bond index is down by 2.4% this year: a six percent performance difference. Index weakness is also evident in the Bloomberg Global Aggregate Bond index' 2021 performance of -4.2% (as at 30 September.)

Markets still in a sensitive phase

Given that the extended period of low volatility accompanying the Biden Administration's opening year has been interrupted, it could take some time before investors' overall optimism is reasserted. The current raft of risks has not been resolved, but rather, deferred. The China / Evergrande bond coupon deferral and possible further defaults in the Chinese real estate sector are opaque and certainly not at an end. The best current US Congressional offer on the table is from the Republican leadership's willingness to extend a temporary bridging arrangement toward early December, rather than to craft an enduring solution. The size of the much-vaunted Biden stimulus package is still caught in a tug-of-war between Democratic Party factions. Meantime, September 6th saw the discontinuation of the US Pandemic Unemployment Assistance (PUA) program removed emergency payments from around 9 million American casual workers. There have also been partial economic indicators of late-summer slowdowns in major Northern Hemisphere economies. All of this has stalled out the bull market, rather than ended it, in our view.

US Sectoral Earnings Trend turning upwards



Source: Salt, Morgan Stanley investment Management

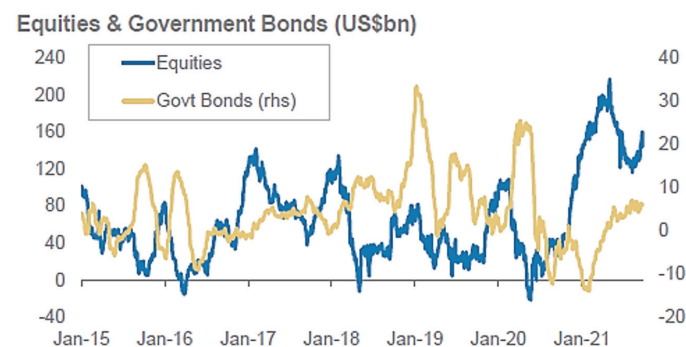
Support from corporate earnings and inflows is high

On the positive side of the ledger, the level and direction of global corporate earnings is still in an up-swing. This supports a resumption in investor interest in equities once present uncertainties abate. It is quite plausible that the last month or more of 2021 could witness a resumed demand for shares, given that current volatility is deflating the prior near-euphoria in share markets, and a more

measured and less momentum-prone set of investors will re-enter markets at scale later during the fourth quarter, or early in 2022. The US third quarter earnings season is commencing and should be strong: the estimated annual growth rate for the S&P 500 is 27.6%. If 27.6% proves to be the actual growth rate for the quarter, it will mark the third-highest (year-over-year) earnings growth rate reported by the index since 2010. This can support a resumption of "glass-half-full" optimism and encourage the dip-buying patterns to resume.

Many global equity markets continue to be driven by a torrent of "there is no alternative" inflows. Bank of America Merrill Lynch data recently showed that their private client allocation to equities was at a new record high of 65% versus a long-term average weight of 56%. Sensibly, bonds were at being held at 18% of total portfolio value versus a 27% historical average. In terms of the unprecedented value impact of current demand for equities, Goldman Sachs data shows that in the last eleven months, global equity inflows have been a cumulative USD 972 billion, while the Morgan Stanley chart below captures the USD 144 billion which has been directed into exchange-traded funds (ETFs) by US investors in the last three months alone. By dollar value, the quarter's equity inflow is 24 times the USD 6 billion routed into US Government Bonds for the same period, and three times the value of inflows into all US bond ETFs.

US Fund Flows (ETF): Equities versus Bonds



Source: Salt, Morgan Stanley investment Management

Bond outlook justifies investor skepticism

Indeed, the US 10 Year benchmark bond yield touched has worked its way up from an intra-quarter low of 1.17% on August 3rd to 1.60% barely more than two months later. This yield level is now the highest attained in during the second half of 2021, although not as high as at end-March, when the 10 Year bond yield touched 1.75%. The weakness has not been confined to the US, with UK yields touching 1.15% in early October – a two year high. Bond yields have risen as resurgent energy prices are likely to push up costs for businesses and consumers at a time

when central banks are moving incrementally toward scaling back, and ultimately removing Quantitative Easing (QE). Oil reached a seven-year high as October began, with a barrel of WTI crude having risen in price by 30 US dollars so far this year, from USD 48.5 per barrel to USD 78.5 / bbl at its recent peak. Natural gas prices have recently attained a ten-year record level.

There is therefore a tendency for interest rates to move modestly higher at present, and allocations to fixed interest securities need to be selective to minimize weak returns from debt securities. With real yields (adjusted for inflation) remaining substantially below zero, the realization is sinking in for investors that strong historical bond returns, plus diversification benefits at times of equity drawdowns, may be a thing of the past. At best, sovereign bonds can still offset some of the volatility found in the Growth-type asset classes, but this effect is now only relevant over fairly short time-periods.

The more adventurous types are now seeking diversification from other, unproven or illiquid assets like cryptocurrency, syndicated direct property pools, and leveraged private equity or venture capital. Professional investors are frequently offered participation in higher-yield global debt pools, but asset quality underlying advantageous yields has now deteriorated to a dangerous degree—China's Evergrande foreign currency bonds being a well-known current example. Even in New Zealand, the suppressed interest rate environment is playing out in a wave of undiversified offerings usually linked to rather speculative, or lockdown- and government policy-exposed, land development projects.

However, there are better-quality assets with positive real yield still accessible, and we find these in the Real Assets sectors of Global Infrastructure and Real Estate. These longer-term investments have been explored in two of our recent "Insights" papers, available on the Salt Funds Management website.

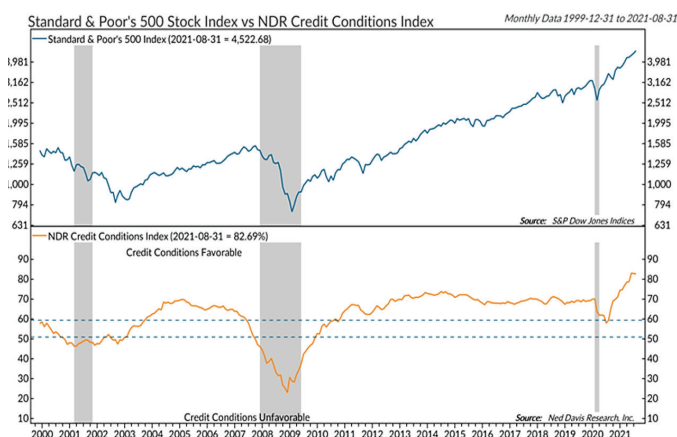
Focusing on the cliff face, missing the mountains

The risk-signaling role of market-determined interest rates continues to be distorted, by Central Banks pushing rates down by a variety of means, and the associated willingness of investors to hold lower-rated debt. The spread above the relevant sovereign yield at which corporate bonds attract investors continue to eke our historical lows, at a meagre +0.8% in the US and Europe for investment grade securities, while the risk reflected in the spread of High Yield (non- investment grade) securities is very low, as 2.9% for the US. This is reflective of optimistic investors who may be overlooking the risks that are masked by near-boom demand conditions in some countries accompanied by continued very easy credit.

As US credit conditions indicators such as the chart below

show, credit conditions are at multi-decade highs, in terms of their favourable status for businesses and consumers alike. This is a common condition in most major economies, and it is the ultimate objective of present monetary policy settings. It is important to note that while there is indeed a global "debt mountain" of unprecedented scale, easy credit does not by itself cause a crisis or a bear market. Another catalyst is required, which is not yet evident.

US Equities remained buoyant this year as credit conditions surge



Source: NBER, Ned Davis Research (shaded areas = recession)

The last two major multi-quarter recessions, in 2001 and in 2008, were preceded by marked deteriorations in credit conditions from their prior peaks, which were not countermanded by the Federal Reserve. This economic cycle, the Fed has stated repeatedly that it wishes to allow ample access to credit to continue, to offset the disruptions caused by Covid. An echo of that attitude can of course be found in New Zealand, with the Reserve Bank Governor exhorting consumers to "borrow and spend" in support of the economy, and the Government has certainly needed no encouragement in this regard.

Tapering: a faintly frightening form of tightening

Global investors are now focused on Jerome Powell's signals that the Federal Reserve will make an announcement in November, about the provisional timeline for the winding-down of US central bank's asset purchase programme which has run at USD 120 billion per month since shortly after the CoVid pandemic hit. This creates an uncertain climate for extreme bullish market sentiment, because there is widespread appreciation that with central banks buying debt securities, they are effectively underwriting credit risk, and that this may not be a permanent safety feature. While additional caution is warranted, the tapering process has been well-telegraphed so far, and could easily be paused in the event of market disruption. Powell has been clear that no interest rate rises are likely in the US until after tapering is finished. That means that were there to be pauses in the reduction of central bank

balance sheet assets, policy interest rate rises could potentially be deferred well into 2023. Such moves will be even later in the EU, Japan, and potentially even in our neighbor Australia. The October RBA outcome of retaining the policy rate at 0.1% and suggesting labour markets would not be sufficiently robust to allow rate hikes before 2024 was remarkably dovish, compared with the RBNZ stance. None of this suggests that NZ equities' 2021 flat year of returns to date, and our substantial lagging of international share market returns is likely to conclude quickly.

While gradually strengthening economies supports the "tapering off" of bond purchase plans in coming quarters, and some key yields have ticked up recently to reflect a rising probability of this development, this should not be mistaken for a meaningful tightening in global financial conditions. In interconnected capital markets, as long as any major central bank is holding borrowing rates below the inflation rate, large multi-national institutions are still able to access effectively "free" liquidity, which they can deploy around the world in a wide range of acquisitions and new holdings. This low-cost funding atmosphere is not substantially threatened at present, and although the rate of expansion in excess liquidity is now declining, its absolute quantum or monetary value is still extraordinarily high. That can be seen in the variety of novel destinations for investor and trader fund flows witnessed in the last two years. There is clearly no difficulty in obtaining (often-borrowed) cash, when the money supply in established currency blocs is sufficient to support a dizzying array of user-invented pseudo currencies traded on-line. Similarly, enterprises have very little difficulty obtaining credit to acquire other businesses or expand in other ways.

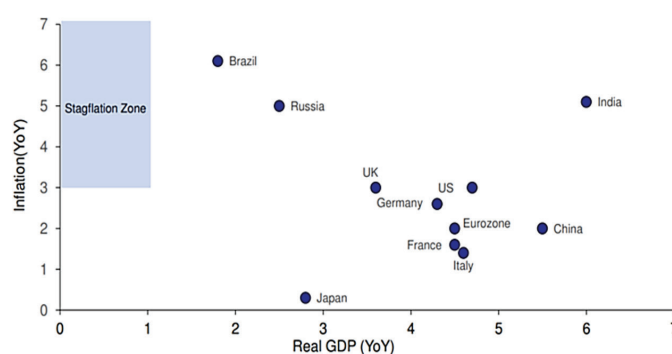
Stagflation fears seem somewhat overstated

High inflation in most economies, occurring simultaneously to the softer third quarter economic growth outcomes, has revived pessimistic forecasters to anticipate a prolonged phase of weak growth and high inflation, causing a "new-1970s" narrative to take hold of parts of the media. However, our view is that this mainly reflects the novelty of commentators having to discuss rising inflation at all, after a decade or more in which the path of consumer price aggregates has been largely either flat or downwards.

Stagflation is obviously bad for asset prices. It has become the current doom-scrollers' scenario of choice, in a world apparently avid for negative predictions. However, apart from the current coincidence of inflation stickiness with a well-predicted softening in activity after the surge running from mid-2020 to mid-2021, it is difficult to make the case that economic growth will cool drastically next year. The chart below is typical of mainstream economic forecasts for 2022 and indicates a re-acceleration of growth, albeit

at a higher inflation level than has been recent years' experience (when deflation was the most-cited threat to asset price gains.) Ironically, Japan – the country closest to sustained negative inflation – has seen its equity market break out of its multi-year torpor and log very strong returns in the last twelve months. In general, aging developed world populations tend to push inflation lower, but this has now been offset by the scale of disruption and de-globalization that are the pandemic's legacy, engendering price increases and the prioritization of security of supply, over strict minimum cost criteria, in the global supply chain

Growth forecasts see inflation but not stagnation



Source: Deutsche Bank

In opposition to imminent stagflation fears, global activity forecast by Purchasing Managers' Indices (PMIs) has recently turned upwards, inventories look to be in early stages of rebuild, and it is the clear view of our Sustainable Global Shares manager, Morgan Stanley, that the third quarter US GDP dip will prove to be an anomaly. Similarly, inflation appears likely to gently trend downward from current levels, but will probably settle at a new plateau of around 2.5%-3% rather than the 2% norm of recent years. If so, the inflation path is compatible with rising corporate profits but not with economic overheating.

Another "new reality" that needs to be acknowledged, is that in past decades, economic growth generation has been mainly driven by the private sector. Thus, a slowing in private sector activity has heightened fears that activity is bound to lose momentum and potentially, to stall altogether. The substantial fiscal impulse working its way into the US and global economy through public spending expansion, is unfamiliar to market participants as a source of growth. All the same, and even if it is "borrowed from the future" in terms of baking in elevated tax obligations, the projects now being funded by government largesse are sufficient to catalyze strong activity in private sector supplier businesses.

Stagflation, once it commences, is very hard to eradicate. Governments are unable to simulate growth with interest rate cuts, for fear of pushing inflation even higher and undermining their currencies and external positions. Tax take declines with low economic output growth,

sometimes necessitating unpalatable tax rate increases. For this reason, modern authorities tend to protect growth drivers (such as housing activity and immigration) even where they put strains on other aspects of their economies.

The proviso for full recovery and avoiding a slower-growth higher-inflation regime, presupposes that governments continue to up-the-ante with fiscal stimulus, that there is no major global debt crisis triggered by over-leveraged major entities, and that Covid itself gradually fades into an endemic but manageable societal and economic risk factor. If the worst-case-scenarios were in fact to gain traction, there could be a period of entrenched inflation alongside a sharp dip in growth.

Low sovereign bond exposure

Under that circumstance, history and logic would suggest that portfolios should continue to avoid low-yielding nominal bonds such as sovereigns, and particularly those with medium- or long maturities. While in the past, nominal yields could provide a buffer against rising inflation, now they are no longer a reliable source of income. Although accommodative monetary policies might then keep interest rates low for longer, the risk to hold these securities outweighs the benefits. The fact that there is so little possible scope for positive bond returns in an inflation / stagflation world makes the current cycle quite distinct from others in developed market history. However, there are analogies in the developing world. The increase in inflation rates in many countries where economic activity continues to decline—countries as otherwise different as Mexico, Saudi Arabia, South Africa, and Turkey—shows how this can play out.

In Brazil, even though output remains well below the pre-pandemic level and official unemployment is almost 15 percent, the central bank raised interest rates five times this year, with annual inflation surging to above 10% in September. Tightening monetary policy to attempt to choke off price spirals may lead to weakness in much needed productivity-enhancing investments. As well, intractable currency depreciation may help export sectors, but at the cost of the international purchasing power (including the ability of savers to acquire diversifying investment assets in offshore markets).

Under the headline turbulence, sector shift underway

A more interesting question than which assets might hedge against stagflation (quality equities, inflation-linked bonds and commodities) is, which sectors of the equity market can be expected to find support as inflation moves higher, growth resumes buoyed by massive government

spending programmes, and supply shortages as well as sporadic Covid outbreaks or potentially, further mutations persist.

Regardless of whether the large-cap benchmarks have further downside, evidence is indisputable that relative strength has transitioned from mega-cap Growth to small-caps and Value. While these short-term market activity metrics are different to medium-term sector bias shifts, they support a gradual shift in investors' economic risk calculus, and this if it continues should be positive for quality and defensive companies. Defensive sectors have underperformed the broader market since the March 23, 2020 Covid shock trough. While underperformance is common for low beta sectors following bear market bottoms, the magnitude this cycle's lag by defensives has been noteworthy.

Consumer staples, Financials, and Utilities stocks now enjoy valuation advantages, being "cheap" compared to history on a range of metrics. Utilities is considered a bond proxy sector because a relatively large portion of its total return is derived from dividends. That characteristic normally means that the sector is negatively correlated with interest rates, like a bond. Covid has disrupted that relationship recently, however. The one-year rolling correlation between Utilities' relative strength and the 10 Year US Treasury yield fell from -0.61 pre-Covid to -0.02 currently, showing effectively no immediate dampener of higher yields on sector returns. The implication is that if interest rates do continue to move higher, that doesn't guarantee Utilities sector underperformance. Other advantages such as inflation linked cashflows, steady and well-protected operating concessions, and the thematic transition to sustainable energy and waste management can offset the negative effects of higher bond yields.

Durability is still the dilemma for equities

At present, there is still sufficient confidence in recovery and profit growth for equity investors to buy into market dips, as has been seen in early October. How long the benevolent regime can remain in place is questionable, given indications by the US Federal Reserve that the lowering of QE support may begin before year-end, and persistent inflation will be a test for both central banks and investors' confidence in the stability of this expansion. If this tapering timeframe unfolds quickly, beginning in December, then reducing bond purchases by USD 15 billion a month would get the process down to zero in eight months, or by July 2022. For the remainder of 2021, US 10 Year yields may rise from their current 1.60% (as at October 10th) to 1.80% or even 2.0% by year-end. While this could prove to be an issue for the highly valued Growth stocks lacking in dividend-paying appeal, other economic sectors should be able to take yields at that level in their stride. It is generally considered

that a 10 Year bond yield in the US at around 2% would not have a significant adverse effect on borrowing costs for companies or individuals. Indeed, in New Zealand, 10 Year government yields are already above 2% and at a two-and-a-half year high. There appears to be limited impact on debt servicing costs as yet, and access to credit remains quite generous.

Determining whether a multi-year, secular bull market is underway, or whether the special conditions of the post-pandemic stimulus-backed rebound have generated excessive confidence in perceptions is the key question for the next quarter. Our view is that while there are considerable grounds for current positivity, the earnings gains being factored into current equity prices are likely near-fully reflected. As the profit reports come in for US third quarter earnings season, this will give investors a timely test of the robustness of this bull market. Additional major equity market gains would likely need a fresh catalyst, as the earnings resurgence and the eventual relegation of the Covid-19 threat is already largely priced in.

For now, the equity market “bull” narrative remains intact: Economies are opening as the pandemic is being managed with all possible means. Significant pent-up demand from government support programs, alongside the wealth effect of ongoing increases in asset prices, is being unleashed on a supply constrained global economy, though the resulting inflation is not yet clearly persistent. Fiscal policy will provide an extra boost to growth as fiscal policy eases and special government capacity building programs get properly underway. There are several quarters ahead in which these supportive factors will provide tailwinds to growth assets.

Investors’ reduced euphoria supports tilt toward quality assets

As Recovery remains the dominant story, it is likely that equities will continue to outperform other assets. But there are reasons to be wary. Inflation remains the biggest threat, and any multi-year persistence of high inflation will signal the end of central banks continuing to underwrite risk-taking by keeping interest rates artificially low, and by constantly providing new liquidity to the market.

Until September’s widespread (if shallow) market declines, investors were probably too complacent that any adverse global development will be rapidly offset by central bank “monetary paramedics” pushing exceptionally-cheap lines of credit out to restore confidence. However, it must be said that there has been scarcely any serious reversal in markets or economies in recent years, that have not been quickly cauterized by very active monetary counter-measures. The protection of accumulated wealth gains appears to be a clear priority for government and central

bank leaders, with debt sustainability and fiscal impacts taking being de-prioritized. The degree of determination to taper and then tighten has yet to face a test of a serious setback in equity markets or in corporate bond valuations, which remain close to record levels.

We consider it is prudent to take account of the current investor risk appetite, to orient our portfolios towards the quality and in places, more defensive companies and sectors where over-valuation is less challenging and which would be likely beneficiaries of any disappointments ahead, whether on the future course of the global pandemic, or on the precise timing of a global shift to lowering policy accommodation.

Risks lying ahead in late 2021

Our main scenario is still, that the key policy setting figures at the US Fed, the ECB, and elsewhere have an opportunity to begin slowing of the extraordinary stimulus level of the last year, though not yet an urgent necessity to do so. We stand by the comments made in our last “Strategy Outlook” in early July, when we wrote, “history suggests that September-October can be dangerous months for sharp shifts in market sentiment, a fact that we would hope policy authorities bear in mind. It would be better to begin a long lead-in of central banker hints that such massive stimulus may not be extended beyond 2022, so that investors can progressively digest the implications of a medium-term change for their portfolio holdings and can reallocate their exposures over a two-year horizon... Delicacy is required, in the process of suggesting the credit-conducive deep monetary “punchbowl” is not a permanent feature, but an extended emergency measure. The concern is that government measures introduced as temporary, often prove in practice to be difficult to wind down, and the pandemic response may ultimately be incorporated into an economic cycle management toolkit.

Without careful communications, backed up by small but credible incremental steps in the direction of normalization, arranged into a transparent timeline by the authorities, the extended equity valuations and pockets of outright speculation in some stocks and sectors could reverse disruptively late in the year.

Were such a choppy climate to develop, agility in active portfolio management will be critical in preserving and protecting the wealth gains of recent years. Similarly, securing a valuable real income stream from investment assets, in an increasingly inflation-prone period, is a challenge that active funds managers are best equipped to meet.”

The information in this paper has been prepared from sources believed to be reliable and accurate at the time of preparation but Salt Funds Management Limited, its officers and directors, make no representation or warranty as to the accuracy or completeness of any of the information contained within. All analysis, opinions and views reflect a judgment at the date of presentation and are subject to change without notice. This paper is provided for general information purposes only. To the extent that any of the information in this presentation does constitute advice, it does not take into account an individual investor's financial situation or goals. An individual investor should, before making any investment decisions, seek professional advice, having regard to the individual investor's financial situation and goals. Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance. This presentation is solely for the use of the person or persons to whom it is provided and must not be distributed or copied, in part or in whole, without the permission of Salt Funds Management Limited.