# Weekly Market update

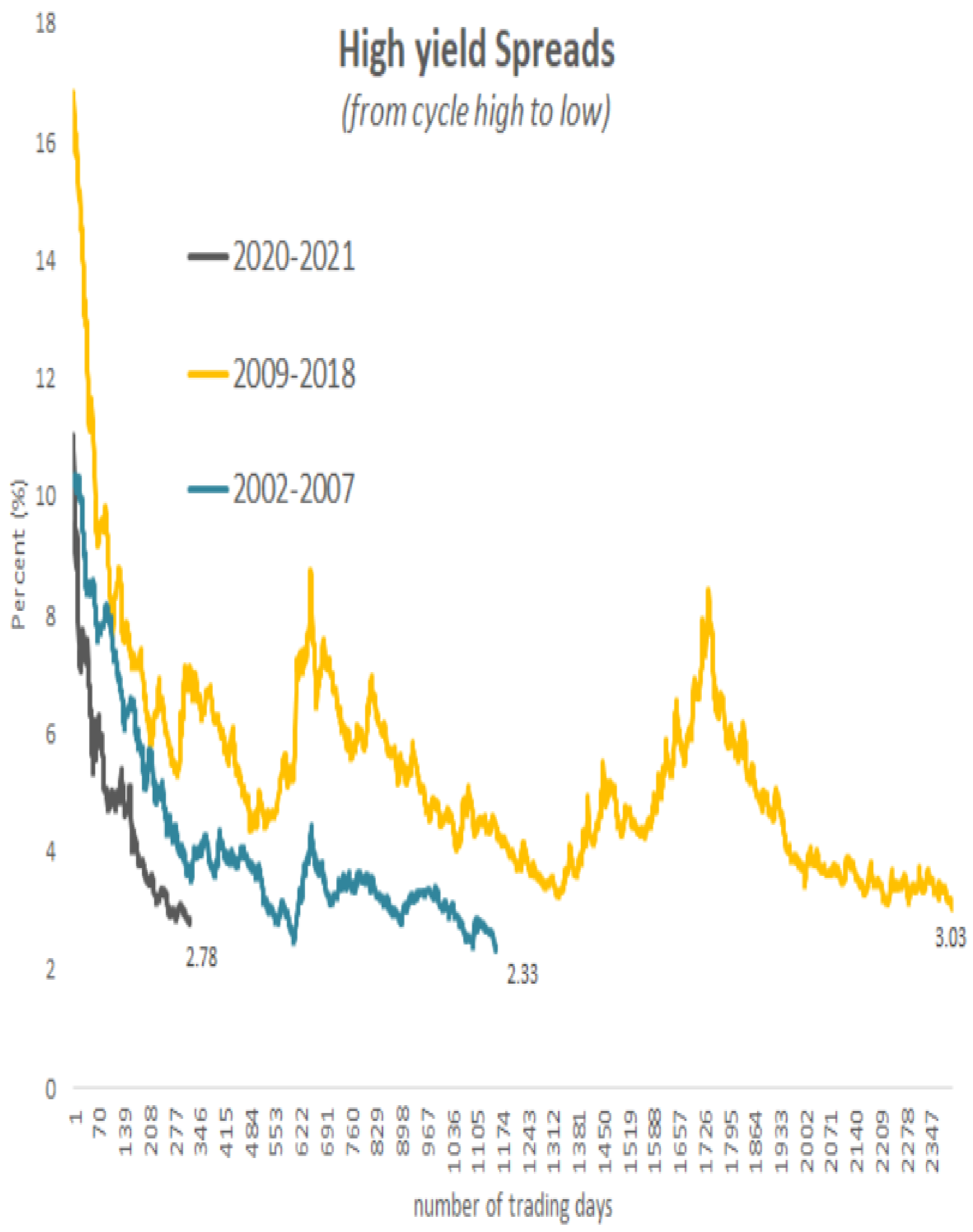
28 June  2021

# Some Lessons for the Broader Economy

- Home sales moderated further in May, but home prices continue to rise. The astonishing surge in prices has reduced affordability at a time when supply bottlenecks are limiting new construction.
- Advanced durable goods orders came in slightly below expectations for May, but revisions to the prior month's data put the level of orders and shipments at or above what had been expected.
- Jobless claims fell slightly in the third week of June, while personal income fell again, as the stimulus payments' impact unwinds. Wages and salaries rose solidly, while spending was unchanged for the month.
- US PMI services fell, but volatile transport services might have played a role .
- After a 'hot' summer the global manufacturing cycle is probably set to peak during Q3 as some of the strong tailwinds behind the boom are about to fade
- This week the key event for markets will be the June US jobs report, where the question will be whether "weak" jobs growth continues due to temporarily higher unemployment benefits. The June ISM manufacturing will also be monitored for any signs of accelerating/subsiding supply side constraints and inflationary cost pressures.

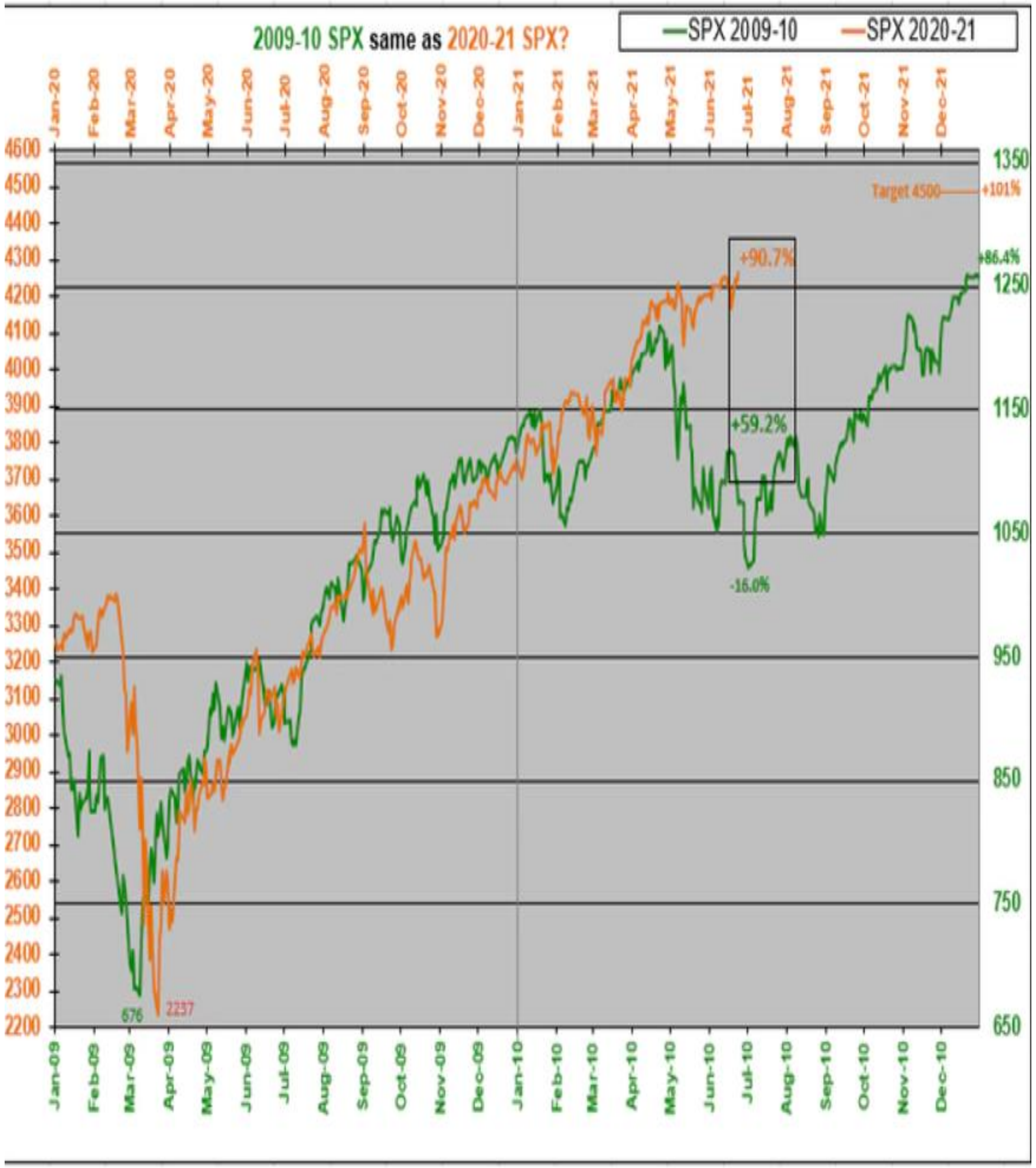
# US Equity – Up, Up and Away

- After moving sideways for most of the last two months,  S&P 500 hit a new high last week, the 33rd this year (an impressive 26% of all trading days in 2021) . This is  a reflection of a strong recovery and the easy financial conditions that have been in place for most of the past year.
- Corporate credit spreads – the extra premium over safer government bonds – are a good barometer of economic health and, at times, are a leading indicator to equity prices. Last week, spreads for high-yield bonds not only narrowed to a new post-pandemic low, but are also now lower than at any point since the post-financial-crisis expansion in 2008
- Moderating inflation fears may have factored in helping reverse the previous week's drop.
- Some signs emerged that supply chain pressures that had caused a spike in commodity prices were easing. Lumber prices continued a sharp decline from record highs, and metal prices came under pressure as China released stockpiles to cool the market.
- The wholesale used car auction market had peaked, suggesting that retail vehicle prices might soon follow. The sharp increase in used car and truck prices has contributed roughly one-third of the recent overall rise in consumer prices.
- FED released the results of its annual stress test, which is designed to test the resilience of large banks under severe global recessionary conditions.  The results showed that all 23 banks comfortably passed the stress test, clearing the way for lifting the pandemic-related restrictions on dividends and share repurchases



# 2009-10 Roadmap

- There is a case for 2020 -21 to be replicating the 2009-10 road map and if by 2 July , the index does not retreat , this equation may not hold further relevance .
- With the SPX hitting a new all-time high it is now an incredible 31 percentage points above the 2010 Roadmap.
- There have been a couple of other divergences such as September 2020 and February 2021, but both of those were only about 10 percentage points and lasted only about 4 weeks.
- This time however, the divergence has been going on for over 8 weeks, and is 3 times larger. Even if we get a pullback of that magnitude in the next few weeks, it will still leave a sizable gap between the two lines.
- Going by the hypothesis , It should test 2010 low point on 2 July , which is this Friday
- At this point the SPX is +90.7% since the pandemic low, +13.6% YTD, and it has gone 15 months without a correction or bear market.



# Bond Market – Tantrum less likely

- Why the apparent calm, at least at the long-end of the curve, when the first whiff of tapering roiled the market in 2013?
- For one, even though the dot plot signaled somewhat earlier policy tightening, the upward shift puts it more in line with markets.
- As last week's meeting kicked off, futures contracts had already priced two hikes by the end of 2023, which is now the median expectation among FOMC members.
- At the same time, Powell, and even more hawkish members of the committee, in subsequent public statements, have indicated that the FOMC is only easing into a discussion. It is clear that the committee is not about to make plans, let alone reduce purchases, imminently.
- The 2013 tantrum looms large in policymakers' minds. Officials across the spectrum have made clear they will give ample notice in an effort for a smoother tapering process.
- Once Powell or the FOMC gives a more concrete hint that tapering is nearing on the horizon, long-end yields will quickly move higher.
- However, the extent of the increase is likely to be more modest than in 2013.
- Market participants appear to be more dialed-in to the fact that the Fed eventually will scale back its purchases, having been through quantitative easing before.

# Eurozone : Growth Catches up

- Euro area recovery picked up pace at the end of Q2 according to June PMIs, with business activity growing at the fastest rate in 15 years thanks to a strong rebound in the service sector. The eurozone composite PMI jumped higher in June, rising to 59.2, up from 57.1 in May and reaching its highest level in fifteen years.
- The forward looking part of the services PMI suggests that this acceleration has further to go, with the expectations component jumping to 72.3 in June – its highest level in more than twenty years. The details of the composite PMI show that the job creation component increased as well (to 55.3, up from 53.8), but much less spectacularly than the total index. This suggests that employment is rising, but that companies will mostly increase the number of hours worked by employees that are in government subsidised short-time work schemes.
- The details of the manufacturing PMI reveal that suppliers' delivery times are still becoming longer, suggesting that bottlenecks in global supply chains have intensified.
- Although these bottlenecks are pushing up prices in manufacturing (the index for input prices in the manufacturing PMI increased to 88.0 in June, up from 87.1 in May and that for output prices increased to 71.1 from 69.1), we expect these price pressures to fade when the impact of the unsynchronized shocks to supply and demand in global manufacturing during the pandemic wanes.
- Discussions on the ECB strategic review are also gathering pace in the Governing Council. While ECB policymakers still remain apart on a new inflation strategy, there is growing consensus to include climate and owner-occupied housing in their decisions.

# UK – Stronger Growth impulse

- June PMI data reaffirmed that the U.K. is on track for booming economic growth in the summer months.  Both the manufacturing and services PMIs fell slightly, but they remained exceptionally high at 64.2 and 61.7, respectively.
- The composite PMI has now been above 60 for three consecutive months. . For some context, its highest reading in all of 2019 was 51.5.
- When the Bank of England's (BoE) Monetary Policy Committee met  last  week, it made no change to monetary policy, but it did revise up its expectations for the level of U.K. GDP in Q2 2021 by about 1.5% relative to what it expected in May.
- BoE noted that the recovery in activity has been most pronounced in the consumer-facing services, which loosened restrictions in April.
- The U.K. government delayed the fourth and final phase of its plan to ease pandemic rules in England by around one month, pushing it to July 19 from the previous June 21 date.
- U.K. may be restrained in the near-term given a brief pause in reopening and mildly unsettled global markets.
- However, as the U.K.'s steady economic recovery continues and inflation also firms modestly, Bank of England to continue along its path to less accommodative monetary policy.

# China : Growth concerns

- China’s sharp recovery from the covid-19 shock has been led by exports, industry and the property sector, with consumption lagging.
- China’s strong virus control has helped the economy to normalise relatively quickly, with flare-ups of the virus having been contained quickly due to stringent and targeted policies taming potential contagion.
- That said, consumers still seem to be a bit cautious, even though the official unemployment is back to below pre-pandemic levels. For instance, tourism spending and travel during two recent festivities (Labour Day break in May, Dragon Boat Festival mid-June) was around 25% lower compared to pre-pandemic levels.
- And while passenger transport has started to pick up again (in particular railway and air traffic), in April it still was at only 55% of the levels seen on average in 2019.
- Highway traffic was still at only 42% of 2019 levels in April, although that likely also reflects the fact that more people are working from home compared to before the covid-19 crisis.

# Yantian Factor behind Global inflation

- Recall that, when a container ship got stuck in the Suez Canal for six days recently, it created a major disruption to global shipping that has not yet been completely resolved. Yet there is a new disruption that is getting less publicity but might be more impactful.
- At the Port of Yantian near Shenzhen in southern China, a new outbreak of the virus is suppressing activity and causing significant disruption. Yantian is the largest and busiest port in China, accounting for about 10% of China's exports. In the first two weeks of June, 298 container vessels skipped the port, a 300% increase from the previous month. Skipping a port means that a ship avoids or cancels a scheduled visit to a port because it is not permitted to discharge or load cargo. This, in turn, has caused a big increase in backlogs, a shortage of inventory for manufacturers on both sides of the Pacific, and an increase in shipping costs.
- In fact, the Baltic Dry Index, a popular measure of shipping costs, is up about 200% since the start of this year and is significantly higher than the pre-pandemic level. Although the worst of this particular crisis is likely over, and although operations are beginning to go back to normal, it is expected to take several more weeks before the disruption is fully resolved.
- Meanwhile, the troubles at Yantian have led to bottlenecks at other ports. The disruption at Yantian is, indeed, just one of many such crises driven by the continued presence of the virus. Many industry participants have said that the situation in southern China is far worse than what happened at the Suez Canal. This crisis is happening at a time when global demand for traded goods is surging as the world comes out of the pandemic. It is one of the factors contributing to an acceleration in inflation in many countries.

# Impact of Chinese Wages

- It has been always argued that one of the key factors that contributed to the recent low global inflation scene was the introduction of China's vast labor force to the global economy. This boosted labor supply, putting downward pressure on global labor costs. In addition, China's favorable demographics of a rapidly expanding urban labor force put downward pressure on Chinese wages and therefore on Chinese export prices.
- But things are changing. China is now fully integrated into the global economy. Internal migration in China, which brought a huge number of rural workers to factories in the big cities, is waning. China's demographics have shifted, with the working age population now declining and the country facing a potential labour shortage. All these trends are contributing to a significant increase in Chinese wages. At the very least, this suggests that one of the important contributors to several decades of low inflation is going away.
- Does this mean that the world will now face a new age of higher inflation?
- Possibly. It depends, in part, on two things. First, will the increase in Chinese wages be offset by a rise in productivity? If so, then the wage increases will not necessarily boost the prices of exported goods.
- Second, as China moves up the value chain, will there be a massive shift of low value-added production to lower wage countries? The answer is that this has already started to happen.
- For example, as some apparel production moves from China to Vietnam, the impact of higher Chinese wages will be offset, and the price of apparel exported to the rest of the world needn't rise.
- Meanwhile, the recent rise in the value of China's renminbi will put upward pressure on export prices, thereby contributing to a rise in inflation in the rest of the world.

# Topic of the Week : Demographic challenge

- China has been in the news lately for rapidly easing restrictions on the number of children that families can have. This shift in policy reflects a recognition that China has a serious demographic problem.
- The low birth rate in the past has led to a shortage of labor, a decline in the working age population, the prospect of slower economic growth, and a decline in the ratio of workers to retirees. The latter creates stress for the country’s system of pensions and health care.
- China’s president said that an aging population is a threat to national security. In response to this crisis, the one child policy applied to urban households was first eased to two children several years ago and, more recently, to three children. Moreover, it is reported that the government is considering eliminating all such restrictions.
- And yet, despite these actions, the birth rate continues to fall. Last year the number of live births was the lowest since 1961. In addition, it is reported that the infertility rate in China has increased substantially, from 12% in 2007 to 18% in 2020. It is reported that 5.6% of couples are having difficulty bearing children.
- A government scientist said that “besides age-related infertility, infertility is probably affected by environmental exposures, chromosome abnormalities, lifestyles and unexplained factors.” The trajectory of China’s economy in the coming decades will be significantly influenced by the success or failure of policies meant to boost the number of children.

# Mexican Play book

- In a surprise move, the Central Bank of Mexico raised its official overnight rate 25 bp to 4.25% on Thursday afternoon.
- Consensus expected the central bank to hold rates steady, although we did expect Mexican policymakers to signal a more hawkish stance on monetary policy.
- According to the statement, policymakers have become more concerned over the path of inflation, citing more permanent price pressures than initially expected. Supply chain disruptions and higher commodity prices were highlighted as contributing factors to higher inflation, although Banxico also mentioned that a nationwide drought is pushing up prices as well.
- As of mid-June, bi-weekly CPI inflation topped 6%, well above the central bank's target of 3% +/- 1%.
- The decision to raise interest rates took financial markets by surprise as well. In the immediate aftermath of Banxico's decision, the Mexican peso rallied and closed over 1.5% stronger against the U.S. dollar.
- In addition, yields moved sharply higher as Mexican 10-year yields jumped over 10 basis points on the day. While policymakers did not commit to additional interest rate hikes, it is possible that the central bank looks to tighten monetary policy even further, especially if inflation remains above target for an extended period of time. Central bank inflation forecasts have been revised higher recently, and any additional commentary or indications that inflation remains elevated could result in further rate increases in the future.

# Bond markets :No Clarity

- There has been a peculiar situation in the markets as all the treasury managers are anxious about what should be the fair level for the 10-year benchmark government bond. Taking any call on credit, or on corporate bonds is becoming difficult unless market has any clear directional view as to where the gilts market will be two months from here .
- RBI disappointed participants by not announcing an open-market operation and due to a devolvement in the weekly gilt auction. While a devolvement in the 5.85%, 2030 bond was widely expected, the cancellation is a hitch in the borrowing programme, The result shows that there's absolutely no tradeability in the 10-year benchmark bond at the current price levels, even when RBI has specifically extended the lifetime of the bond.
- Markets refrained from placing fresh bets on the paper due to lack of free float of the gilt.
- Market was also wary of bidding higher due to lack of clarity on the RBI's roadmap to support the market before the next scheduled outright gilt buy, the government securities acquisition programme auction, which is expected in the second week of July,
- Overnight indexed swap rates surged as market participants continued to pay fixed rates on concerns that RBI may be prompted to act on policy normalisation earlier-than-expected.
- Loan growth continued to be muted due to lack of demand for big-ticket loans from corporates, and as banks remain cautious in anticipation of rising asset quality stress due to the second wave of COVID-19.

# Rising cash savings of Households

- Not only did the pandemic result in households increasing their saving rate, but the composition of these savings was of a particular nature.
- Keeping cash on hand became key due to the circumstances. In fact, such has been the precautionary demand for cash that as per the latest RBI data, households had saved up as much as 3.2 trln rupees in cash in the first three quarters of 2020-21 (Apr-Mar). To put this figure in context, household saving in the form of cash was 2.8 trln rupees in each of the last two years.
- But while the rise in savings in the form of currency during the pandemic is not unexpected, it has, curiously, been on the up for a while now.
- It was at the turn of millennium that currency as a percentage of net addition to households' financial assets hit a low of 7%. Since then, this percentage has steadily risen, with the five-year moving average rising to 15% in 2015-16 from 10% in 2000-01.
- Of course, demonetisation completely skewed the numbers in 2016-17. But currency as saving returned with a vengeance, constituting more than a third of the net addition to financial assets in 2017-18. This figure was down to 17% in 2019-20, but will likely rise this year, having stood at 18% for Apr-Dec.
- There can be many explanations for the steady increase in the proportion of currency added annually by households to their stock of financial assets. According to Credit Suisse's latest Global Wealth Report, financial assets as a percentage of gross assets has actually fallen for Indian adults to 23.3 % in 2020 from 24% in 2000.
- As at the end of December, 25.5 trln rupees of Indian households' financial assets were in cash. With this seeing a rise of 5.5 trln rupees in the last five quarters, becoming a cash-less economy remains a pipedream.

# Nifty : Weaker Bias

- Yet another week of whipsaws in the market but the broader sentiment continues to remain directionless in the absence of any significant developments in terms of macro-economic factors.
- The benchmark indices are more or less rangebound on lack of confidence around domestic growth
- Markets have largely remained undeterred in their upmove despite the rising concerns around headline and core inflation.
- While equities continue its joyride, a different narrative is brewing in the commodity space. The rally in metal commodities which started back in 2020, has taken a knock.
- Nifty 50 index has been trading sideways for almost three weeks now. It seems to be facing a temporary halt after a period of outperformance. Nifty 50 is trading at more than 20 times 1 year forward earnings, which is close to historic high
- Nifty is expected to trade 15400 15900 for the week