# Weekly Market Update

25 July 2021

# US Economy : Supply bottlenecks

- Supply bottlenecks continue to constrain activity in most industries, which is holding back a stronger rebound in economic growth.
- The LEI improved 0.7% during June - would have climbed even higher, however, were it not for the drop in building permits and a cutback in hours worked in the manufacturing industry, where supply chain disruptions have significantly curtailed activity. Still, most components of the index gained during the month.
- The improving labor market again boosted the overall index, as initial jobless claims declined throughout June.
- However, initial jobless claims, which rose to 419k for the week ended July 17, have been ticking higher so far in July. Considering that job openings remain near a record high, and as most industries continue to report difficulties staffing open positions, the upturn in claims is likely just residual noise surrounding the seasonal adjustment issues. Overall, the monthly rise in the LEI shows that the economic expansion, while showing signs of moderation due to supply constraints, is still fully intact.
- July's NAHB Housing Market Index slipped one point to 80. Housing starts beat expectations and rose 6.3% during June, Existing home sales climbed 1.4%. although building permits fell 5.1% dropping for the third straight month. However, permitting has been running well ahead of starts, and hence some easing is not surprising, as home buying activity has cooled off a touch and building materials remain hard to come by.
- The increases in new home construction and apartment development are nevertheless encouraging signs that home builders are pushing through the headwinds of soaring material costs, qualified labor shortages and scarce buildable lots

# US Equity Markets :  Growth Past peak ?

- Markets have been positive, but more volatile, as the economy passes peak growth. Increased worries that the economy has passed its peak are also likely to contribute to bouts of market anxiety.
- Stocks ended the last week higher, rebounding from a sell-off on Monday. The advance was somewhat narrow, however, with much of the gains concentrated in technology and internet-related giants—the so-called FANG+ stocks. Relatedly, growth shares handily outperformed value stocks for the fifth consecutive week, leaving them ahead for the year to date.
- Steep declines at the start of the week were on account of the   growing fears about the spread of the delta variant of the coronavirus. However, discussion of "peak" themes around growth, profits, and stimulus policies appeared  to be an overhang on sentiment. Besides inflation and the implications for Fed policy will take center stage over the balance of the year.
- The current expansion might be sustained for some time to come, but 2021's expected GDP growth of nearly 7% is likely to be the strongest year in this expansion, with the pace of growth moderating as the economy matures.
- Looking back at the last three expansions, the year of peak growth had an average stock-market return of 11%. The following year saw an average market gain of 5%, with an average of three 5% pullbacks along the way.
- **Declining market breadth, driven by gains in a more concentrated number of stocks, often accompanies temporary bouts of volatility.**

# US Equity : Base case

The proverbial bones of this market remain healthy.

i. The Fed is still accommodative – Despite the likelihood that Fed will begin winding down its bond-buying stimulus in the not-too-distant future, Fed policy will remain historically accomodative for an extended period.

ii. Economy still poised to grow at an above-average clip – GDP growth, though moderating from the best level in eight decades – should continue at an above-trend pace through next year.

iii. Corporate profits are rising – Earnings growth is a powerful driver of long-term market performance. Expectations for double-digit earnings growth this year and next should keep a wind at the market's back.

iv. the probability of a pullback has risen, but the favorable fundamental conditions mean a pullback or correction  may  at best be corrective  - not  long lasting

# Biden package in peril

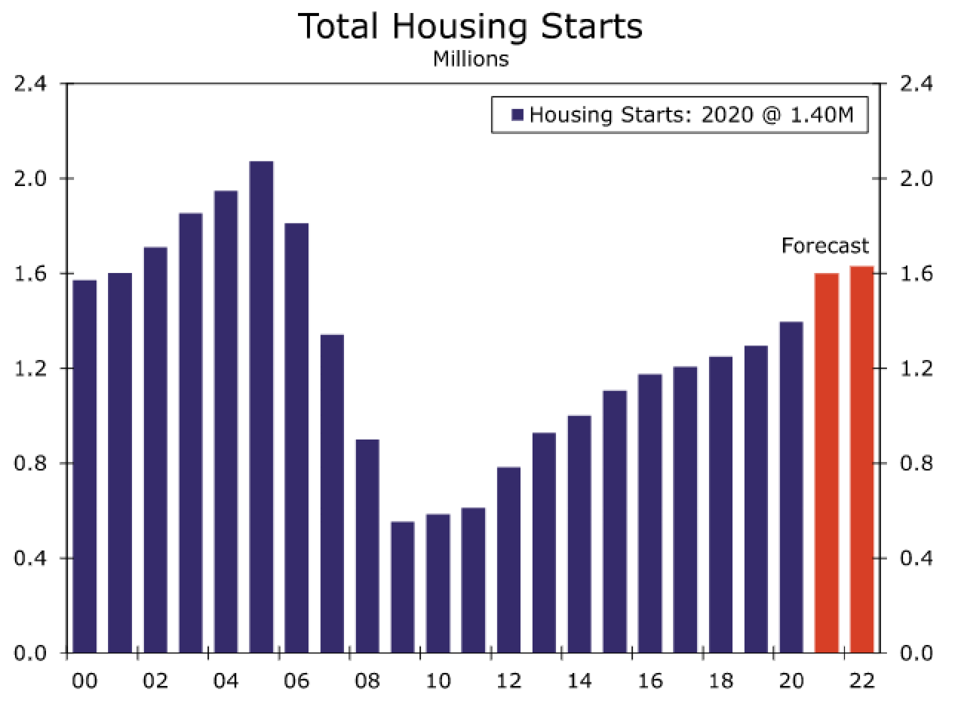
- Earlier this year, Biden proposed two large spending bills, totaling more than US$4 trillion over eight years, to be spent on infrastructure, health care, education, childcare, elder care, and climate-related investments among other things.
- At this point in time, there is some chance that a limited infrastructure bill, supported by some Republicans in the Senate, will pass.
- Regarding the other spending priorities, Democrats in the Senate have agreed on a US$3.5 trillion program to address the other issues, with the hope that this can be passed using the reconciliation process which restricts the ability of opponents to stop the legislation through a Senate filibuster.
- However, reconciliation will require unanimity among the Senate's 50 Democrats, a tall order, and near unanimity among House Democrats.
- In any event, the spending plan entails some tax increases to fund the program. Perhaps the most interesting of the tax proposals is one to tax imports based on the carbon emissions generated in their production. The idea is that, if the United States is to restrict domestic carbon emissions in production processes, then it must tax imports accordingly to avoid giving imported products an unfair competitive advantage. Notably, the European Union proposed a very similar carbon border tax recently as well.
- Thus, the major developed economies appear to be moving in a similar direction. It is by no means clear that this measure, as well as the larger US$3.5 trillion bill, will become law. However, there is some chance that a version of this proposal, perhaps watered down, will eventually pass.
- Regarding the geopolitics of this proposal, it is worth noting that the world's largest carbon emitters, in order, are China, US, EU, India, Russia, and Japan. Thus, if US and EU both implement carbon border taxes, the biggest impact will be on China.

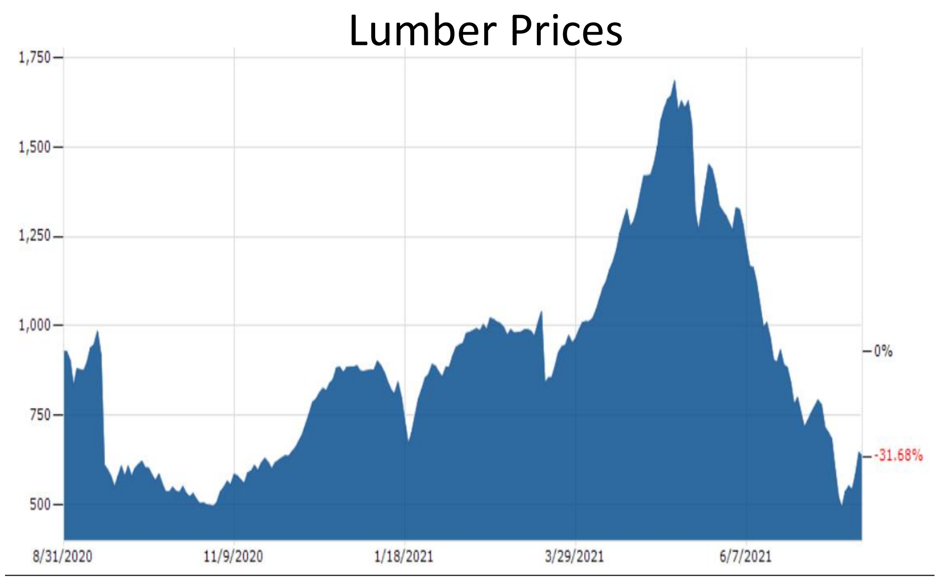
# US Yields : Long run factors at work

- Last week's swings in interest rates are a reminder that volatility is not just only for stocks.
- On March 31, the yield on the 10-year Treasury security finished the day around 1.75%, a sharp increase from roughly 0.90% at the start of the year. Since then, yields on longer-dated Treasury securities like the 10-year have fallen. At present, the yield on the 10-year Treasury is just 1.30%.
- More robust economic growth and inflation are not usually associated with lower yields, so perhaps a more dovish Fed is to blame.
- When 10-year Treasury yield peaked in late March, markets were pricing a Fed funds rate of roughly 2.25% for that one-year period five years out, not too far from the FOMC's "long-run" dot of 2.50%.
- Fast-forward to today and market pricing has tumbled to less than 1.50% for roughly the same period. Ultimately, 1.50% is a little too low for the nominal long-run rate, and longer-term yields will head higher over the next year or so to better reflect this fact.
- However, the past few months illustrate that it will probably not be a linear path higher.

# Housing :Still Strong

- Home sales and building activity had extraordinary momentum leading into this year.
- Low mortgage rates and shifting preferences toward more living space have sparked demand amid a shortage of homes available for sale.
- With supply and demand so off-kilter, home prices have surged to record levels this year.
- Meanwhile, sharply rising material and labour costs have pushed home builders to tap the brakes on construction.
- While declining affordability and supply shortages have pressured housing activity in recent months- the housing market is now beginning to come back into balance
- Lumber prices have plummeted around 70% since early May and may drop further as more sawmills reopen and boost shipments.
- Price appreciation for other key materials is also starting to ease up slightly, although it may take some time to flow through to builders.
- S&P CoreLogic Case-Shiller National Home Price Index to rise 12.6% this year, although the risk is tilted to the upside.



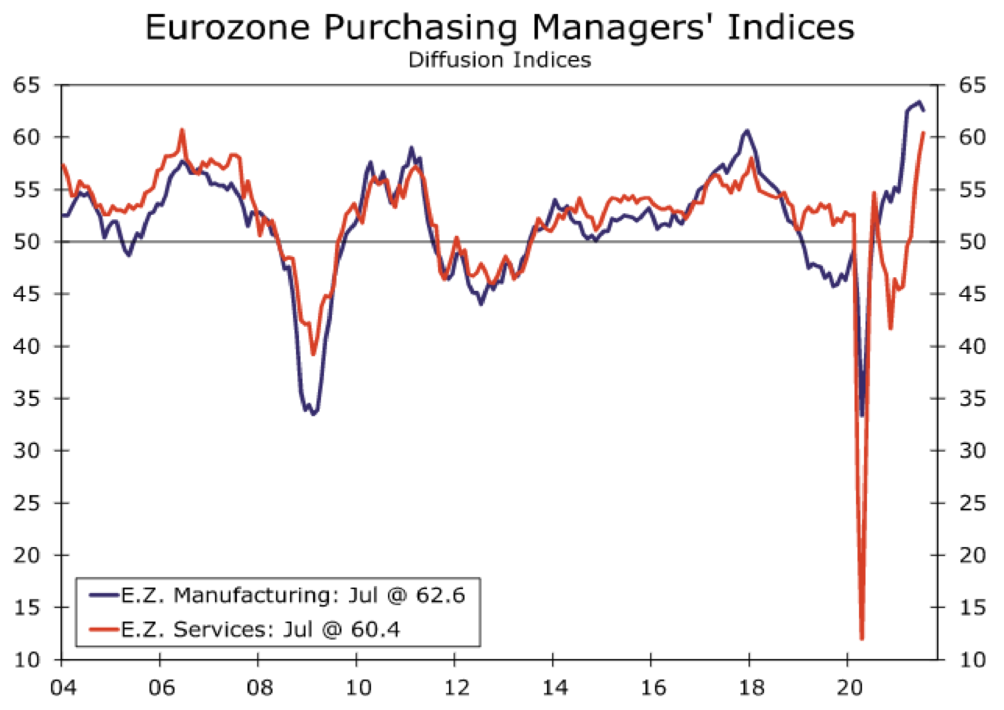



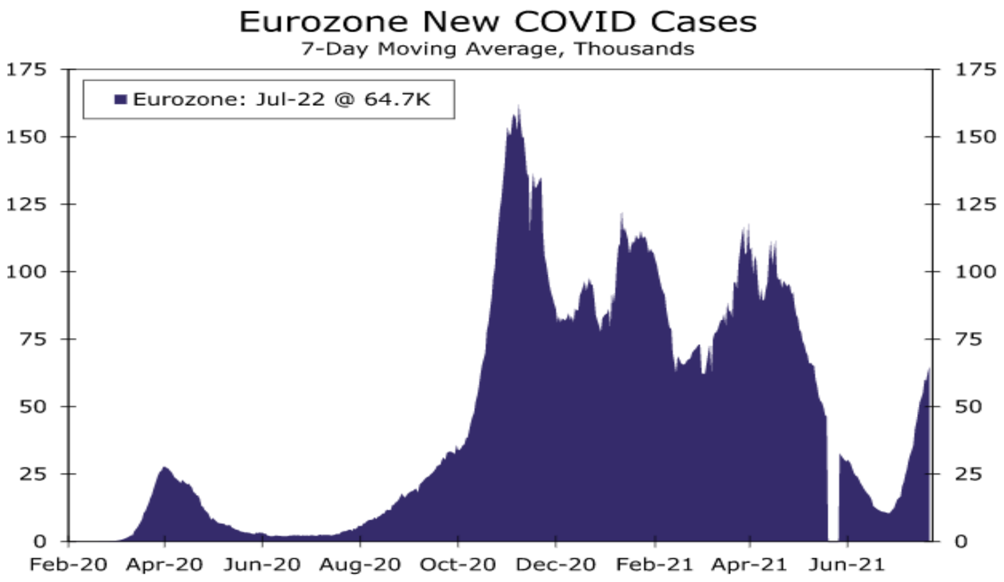
# ECB : Dovish lean

- ECB's first meeting since the new strategy took effect was mostly about aligning the language from the June decision to the review outcome.
- The main new element worth highlighting is the forward guidance on rates stating that inflation has to reach 'two per cent well ahead of the end of its projection horizon and durably for the rest of the projection horizon' which compares 'to the end of the forecast horizon' in June.
- This also means that the new strategy is more focused on the duration of the accommodative policy stance and not the size of the support.
- As policy rates have been close to the lower bound for some time and the medium term inflation outlook remains well below target, ECB has adjusted its forward guidance on rates, in an attempt to underline its commitment to maintain a persistently accommodative monetary policy stance.
- Policy rates are now expected to remain at their present or lower levels until ECB sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and that this is also confirmed by underlying inflation. This may also imply a transitory period in which inflation is moderately above target.
- Further, this also means that ECB wants to observe realised inflation printing closer to / at the target earlier in the forecast horizon (currently until 2023) compared to the earlier medium-term orientation (end of forecast horizon).
- The total PEPP envelope continues to amount to EUR 1850bn, with purchases conducted at least until March 22 and at 'significantly' higher pace in Q3 21 than compared to the start of the year, while APP purchases continue at a pace of EUR 20bn/month.
- Overall, the new forward guidance on rates is more dovish. Strategically favour more EUR/USD downside but this is much more a play on USD real rates, global inflation exposure and global cross asset moves than it is a play on ECB monetary policy.

# Europe : Rapid rebound

- It is not all doom and gloom in Europe.
- July's Euro-zone flash PMIs confirm that the economy is still rebounding rapidly - fastest economic growth for 21 years - and that price pressures are continuing to build.
- The preliminary PMIs for Eurozone showed that the manufacturing sector continues to boom. At 62.6, the manufacturing PMI remained above 60 for the fifth straight month.
- Services component was not quite as strong at 60.4, but it has increased every month of 2021
- Employment is rebounding quickly, new orders for manufacturing and services continue to grow and reported recent activity ticked up in general, meaning that July has been a solid start to 3Q.
- COVID cases are trending higher in the Eurozone and have spiked sharply in a handful of countries, such as Spain . The response to the Delta variant adds some uncertainty to the outlook, but expect the general direction of growth to be positive for now.
- This provides some promising real world evidence that, even if the vaccines are imperfect against Delta variant infections, they remain robust at preventing serious cases of illness.
- This in turn bodes well for the ongoing recovery in the Eurozone and elsewhere



# Social issues intersect

- Germany’s parliament took dramatic action in June meant to compel German companies not only to abide by high standards of human and labor rights, but to ensure that their global suppliers do the same.
- Specifically, the new German law, which will go into effect in 2023, compels German companies of a certain size to monitor, assess, and report on human and labor rights across their supply chains.
- They must ensure that there is no child or forced labor and they must create processes to assure compliance.
- A recent study conducted by the German Parliament found that many German companies have indirectly benefitted from forced labor
- Supporters of the law hope that it will help to reduce human- and labor-rights violations in many emerging countries.
- It is expected that China, might retaliate by limiting imports from Germany. That could be onerous given the German economy’s heavy reliance on exports of capital goods to investment-intensive countries, such as China.
- Meanwhile, the EU and China recently signed a Comprehensive Agreement on Investment (CAI) that is meant to set clear rules regarding cross-border investment. Critics worry that Germany’s new law, and a potential EU rule, could complicate implementation of the CAI.
- The new German law, as well as potential laws that might be passed by EU and US Congress demonstrates that ESG is increasingly a significant factor in supply chain design and operations. This trend suggests that global companies will increasingly be compelled to monitor their suppliers and attest to their suppliers’ compliance with global standards regarding human and labor rights. Such rules could also be extended to environmental and safety standards as well.
- Such might worsen relations between countries that could lead to restrictions on trade and investment.

# Bond market – Unprecedented Stress

- In an unprecedented move, RBI intervened in the when-issued market to manage expectations ahead of the auction of the new 10-year gilt earlier this month.
- The when-issued segment, which allows for a bond to be traded prior to its issuance, often ends up influencing the perception about the pricing of new securities.
- Until now, the RBI has never participated in the When-issued trading, introduced in 2006. The when-issued segment comprises securities that have been authorised for issuance but not yet actually issued.
- RBI stepped in as the new paper was quoted at yields as high as 6.15% in the when-issued segment, which was more than what the central bank was comfortable with. RBI appears to anchor the 10-year benchmark bond yield around 6.10
- Last Friday ,RBI ended up devolving 111.44 bln rupees of the 6.10%, 2031 bond on primary dealers at a cutoff yield of 6.15%.
- This was the second auction of the 10-year benchmark paper which had debuted on Jul 9.
- 6.15% (yield on the 6.10%, 2031 bond) will now be taken as a line in the sand, and there can be no clearer indication from the RBI that it wants to hold the yield here.
- Rates to remain in a narrow range until the bi-monthly monetary policy, scheduled for Aug 6

# Equity Market – Unprecedented Euphoria

- "Carpe diem" seems to be the most dominant thinking
- After delivering returns of about 7% in Apr-Jun, the Nifty 50 is trading at the higher end of its valuation range and a further rise in earnings is necessary to sustain the valuation.
- Apart from stretched valuations and inflation worries, the word on the Street is all about IPOs and how the subscriptions have hit the roof despite unreasonable valuation of certain companies.
- Aggregate net sales of Nifty 50 companies are expected to rise 59% on year, while net profit is set to more than double.
- Sequentially, the topline and bottom line is expected to drop 2% and 7%, respectively - Market breadth shows bullish signs but trading volumes are drying up.
- 15550-15950 consolidation yet again