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2H Outlook: The Pause That Refreshes
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As we approach midyear, Covid Speed's breakneck pace seems to have ebbed a bit. Whether it's the pause in cross asset markets: stable stocks, bonds, FX over the past month, or a sense of transition in the economic outlook: China growth rolling over, US growth peaking, Europe re-opening & EM trailing, or the state of Covid: vastly better in DM, still bad in EM, the pace seems to have slowed. JPM notes investors need to prepare for a multi speed world: from early cycle timing to mid cycle conditions to late cycle valuations. I concur.

Let's take advantage of this pause to pull back a bit & consider the 2nd H outlook. As we do let's keep in mind some of the dueling dualities I recently noted: physical price pressures vs the "digitalization of everything", ESG financing caps vs energy/mining expansion, twin engine Value & Growth led equity markets, surging Money Supply vs nonexistent Velocity…it's a growing list of intellectual and financial stimulation. How these resolve will help dictate market direction over the coming months. When summer ends & we head back to (in person) school & (in office) jobs, the markets will be focused on the year ahead and 2022 will loom large.

As we transition from liquidity driven markets to earnings driven (note China's credit impulse turning slightly negative), I remain constructive on risk assets. I view Equity and Commodities as being in early cycle bull markets, Sov debt as being in an early cycle bear market and remain cautious on the USD which looks to be breaking down. My broad asset allocation parameters remain unchanged: OW Equity, non US equity, Value, Cyclicals, SCs, OW Commodities including both old and new energy, metals both precious and base, UW Fixed Income, prefer Credit vs Sovereign.

I remain committed to the thematic space and believe an important near term direction "tell" occurred last week when Crypto Carnage led to Crypto's 2nd worst week ever – down 40% and yet ARKK, thematic's poster child, closed up on the week. The public market's reaction function is strong – nothing gets out of hand for long. Regulars know I like to let the market tell me and what it told me last week was that the selling pressure in the growth, hi beta names is exhausted. I think the public market "bubble talk" is misplaced and is better directed at the private market space (The Carrot & The Stick).

Speaking of thematic we introduced a new model portfolio this week; a 100% thematic global model portfolio – the TPW 20 – 20 ETFs covering the global thematic landscape as delineated by both MSCI and Ark Invst. Reach out to learn more.

Ok let's take a spin through what I expect to see in the remainder of the year. We will use our trusty Global Risk Nexus (GRN) set up with one change; as foreshadowed last month, I have dropped health as a component and replaced it with Climate. I no longer see Covid as a main driver to either economies or markets and view Climate, while perhaps more of a slow burn issue (no pun intended) than Covid, as a critical global issue and one both model portfolios have significant exposure to.

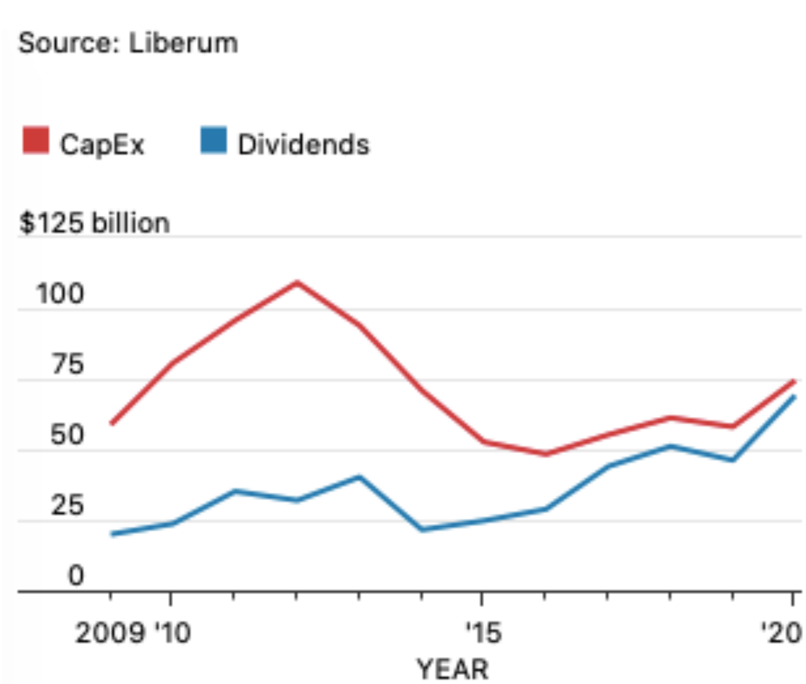
CLIMATE

There is so much going on in the Climate space it's hard to know where to start. From China's Crypto mining crackdown to its upcoming national Emissions Trading System launch to the G7's statement that it will no longer finance new coal projects to the IEA noting that in order to meet the Paris Accord targets demand for Lithium is expected to go up 40 x in the coming years, there is a lot happening and its happening fast. Here are two main takeaways.

First, we should expect this pace to continue given the near global commitment to dramatically reduce the world's carbon footprint by 2030. This goal is widely shared not only by Govts but also by corporations, their shareholders and customers. Some argue that we are at an ESG inflection point driven by rising Climate uncertainty, Stakeholder Capitalism and ESG disclosure. All of the above ensures that Climate will be an important investment theme for the current decade & beyond – as such investors need to understand it and invest accordingly. Covid was a one year event; Climate will be multi decade.

Second, I expect corporate stakeholders to increasingly challenge companies to disclose their carbon footprint and how they plan to lower it – if one has any doubt just check out Exxon's AGM and its new board As a result I expect the price of carbon to rise significantly in coming years together with the likely imposition of Carbon Border Adjustment Mechanisms (CBAM). I also expect a continued ESG push to reduce financing for various energy & base metal expansion – exploration efforts as suggested by the IEA's recent report advocating NO new oil/gas exploration efforts effective immediately. This will likely result in the perverse increase in the prices of many of these commodities as clean energy related demand and ESG impacted supply result in a S/D gap that only rising prices can close. Investing in both carbon and copper makes sense. See Chart One.

Chart 1 – Will ESG Financing Concerns Further Limit Miner CapEx?

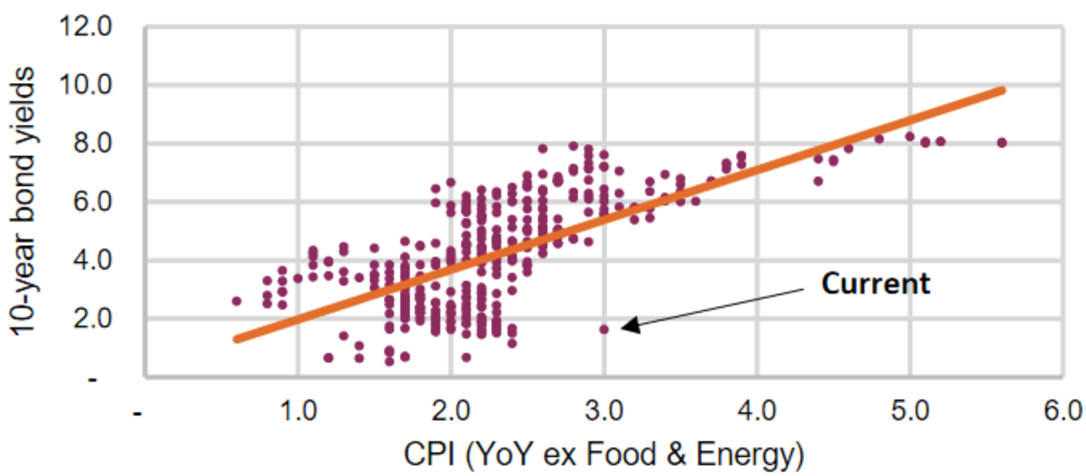


ECONOMICS

US inflation is the name of the economics game – how high will it go, will it become embedded in the wage cycle, will the Fed wait till its sees the whites of inflation's eyes etc. etc. I expect the Fed to stick to its AIT program and wait until the data supports a decision to begin raising rates. I continue to see higher rates as a good thing, some inflation way better than none and the likelihood of embedded inflation as low given a large labor pool, rising productivity, easing bottlenecks & peak US growth already upon us. Taper talk is underway while the velocity of money in the US remains at close to 61 yr. lows. As noted, I expect the digitalization of everything to act as a serious brake on physical price pressures.

The 1st in, 1st out, staggered nature of the globe's Covid reopening should help in this regard as well. China led the re-opening process last year and its growth rates have likely already peaked. Q1 GDP growth was only 0.6% Q/Q. Its government remains focused on ensuring financial stability and so the likelihood of prices getting out of hand seems very low (and most recent readings suggest little to worry about). The US is next in line; after a robust vaccination process its re opening is well under way with growth likely to peak this quarter. Housing is rolling over, retail sales have peaked and the various ISM/PMI data suggest the same. Most bond market indicators don't support inflation fears. See Chart Two.

Chart 2 – Bond Investors Aren't Buying the Embedded Inflation Story



source: Richardson Wealth

In the coming months & quarters, Europe and EM will follow the US, with Europe reopening as its vaccination process finally accelerates and EM struggling behind. More vaccinations should allow key EMs to follow the DM lead and gradually re open their service sectors as the goods producing space has already stabilized. This staggered re opening implies a robust global economy that remains growing above trend through 2022 and most likely 2023 supported by solid consumer & corporate balance sheets, consumption & cap ex growth as bottlenecks ease and fiscal & monetary accommodation is gradually unwound.

Net, net I expect a sustained & increasingly synchronized global recovery cycle that starts to look more normal as we exit 2021 and enter 2022. Inflation fears may be sustained but much should be in the price – who hasn't already positioned for the great inflation debate?

POLITICS

What a relief to be able to talk about something other than US politics. This Fall's action will be in Europe and Asia with Germany selecting a new leader and Japan deciding whether PM Suga deserves to stay in his post. One can't forget China's CCP July Centennial celebrations – suggesting across the board stability into Fall.

From no drama Obama to the tweeter in chief to Boring Joe Biden, the US political temperature has been dialed down at least insofar as in your face impact. Much remains to be done in terms of the Biden Admin's Jobs and Family Plans which themselves will likely have a big impact on the 2022 midterm elections.

Europe is moving forward on its Joint Recovery Fund (JRF) and monies should begin to be disbursed in the 2H of the year. The periphery is the big winner here and Italy & Spain in particular have an opportunity it to recast their economies. Germany is most interesting – after 15 years of Angela Merkle, Germany's next leader may well be another woman, Annalena Babcock, the Leader of the Greens. Finance Minister Olaf Scholz of the SDP has been gaining traction of late, suggesting how far Germany's pendulum has swung towards fiscal spending with a green focus.

Latin America's politics remain depressing but it's all in the price. The region has also suffered the biggest economic hit from Covid. Notwithstanding poor politics and economics, the region's FX and equity markets have stabilized and turned up.

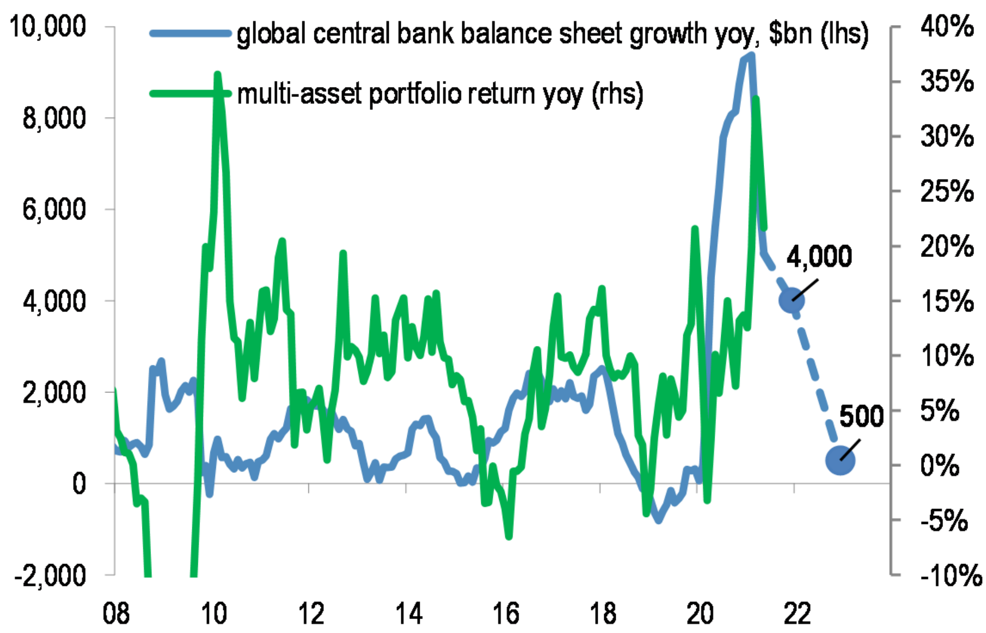
POLICY

Notwithstanding all the spilled ink to date (with more to come) policy is likely to take a back seat over the next few months – at least until we get to what I have termed "the testing time" of late summer, early Fall when clean inflation/economic data should provide more insight for policy makers & investors to judge exactly where the various economies are along their recovery paths.

Focus will be on the US as China never really pulled the policy levers to the same extent and Europe is further behind and thus is much less likely to have any significant policy changes on the monetary side. On the fiscal side as noted the JRF should begin disbursing funds and thus should act as a support. Its quite possible that Europe will grow faster than the US in 2022.

While the focus may well be on the US I don't expect much in the way of policy change. The Biden Admin is likely to get the bulk of its legislative program passed and the Fed will be very slow to move off its wait & see stance – especially if the bond market is not pushing it to do so. See Chart Three.

Chart 3 - Less Liquidity Doesn't Mean Negative Returns



Source: Jp Morgan

Climate policy will also take center stage as we enter the Fall given the upcoming UN Climate Change Conf (COP26) in November. One area to focus on is the potential for a multi-region Carbon Border Adjustment Mechanism (CBAM) to encourage China in particular to move away from coal burning. As most are aware coal is the one energy form that China has a fair amount of at home and so coal utilization in the energy mix is both an energy security as well as climate issue.

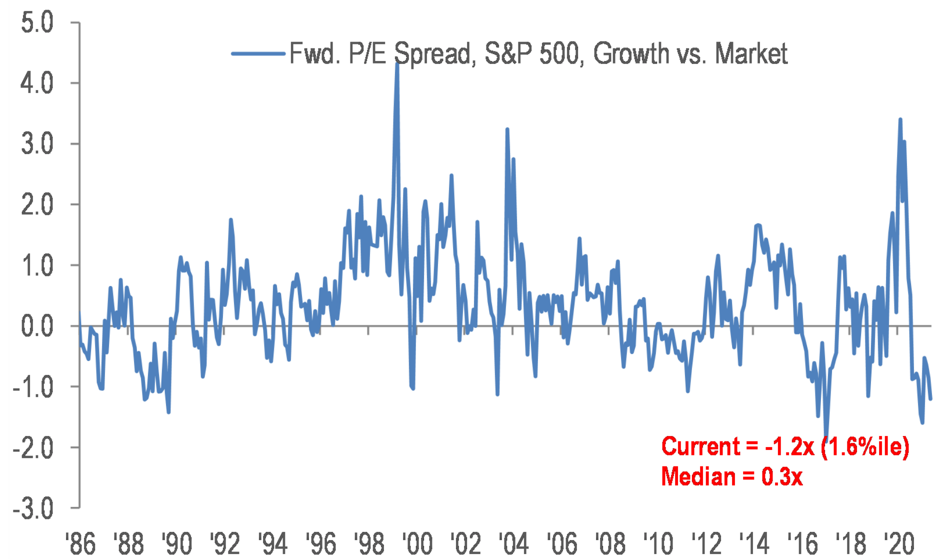
Speaking of China note the rapid expansion of its Covid vaccination process – now giving roughly 15M shots a day as it races to enable large scale celebrations for its Centennial – this stands in sharp contrast to Japan's inexplicably slow vaccination process amid the upcoming Olympics.

One longer term policy consideration is the potential for a sharp policy swing, especially in the DM, from fiscal stimulus to what some (Martin Sandbu of the FT) are calling the mother of all fiscal contractions looming in 2023 and beyond.

MARKETS

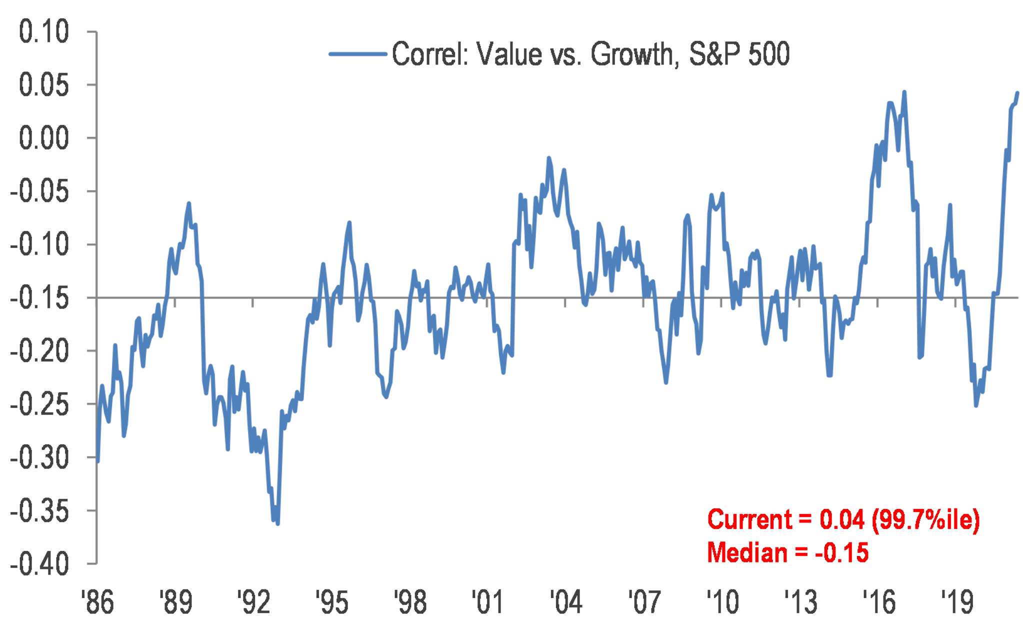
Staying invested and riding through the occasional market "pothole" has been the right approach; I expect this to remain the case in the months ahead. In fact I think the pause that refreshes is setting us up for another leg higher in global equity prices as the twin engine Growth and Value led markets continue to pass the reins back and forth. ACWX for example has been in a 10% range since January; I expect it to break higher in the 2nd H. As momentum swings to the Value segment, the large cap growth names have rerated to become much more GARPY. See Charts Four & Five.

Chart 4 – Growth At a Reasonable Price



Source: JPMorgan

Chart 5 – Twin Engine Equity Markets



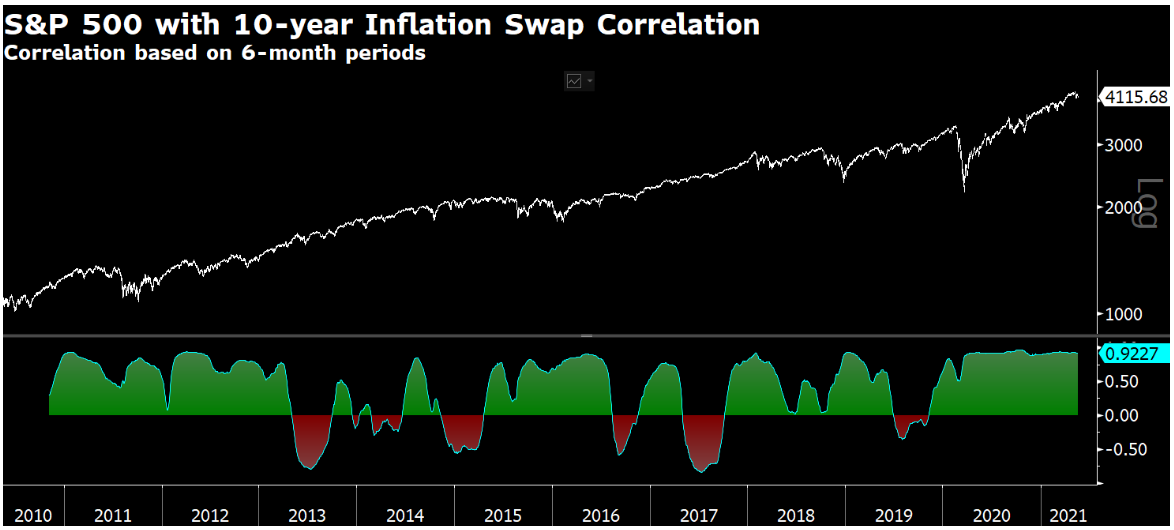
Source: JPMorgan

With the selling exhausted in the hi beta growth and thematic names, inflation fears overdone as signaled by 10 yr. UST rates, break evens, softening in the commodity space, USD weakness etc. further equity appreciation could be the path of least resistance and maximum pain given how many equity managers swear inflation is coming back big time. Those managers throwing in the inflation towel could provide the fuel for the next up leg.

In this scenario thematic names do well as the climate, cyber and fintech spaces among others continue to gain attention. Morgan Stanley notes for example that its unprofitable tech basket just had its worst relative performance vs SPY of any basket (out of 100 +) at any time period over the past decade. The thematic space has absorbed a punishing correction and has stabilized across the major segments of Climate, Cyber and Fintech. The growing number of ransomware attacks and the realization of minimal standards in US and I imagine other nations' critical infrastructure reinforces the Cybersecurity opportunity.

There may be some potholes around the Jackson Hole meeting or more likely perhaps the September Fed meeting as potential taper talk & thin markets could spur some volatility. Chart 6 suggest that the equity market focus is on longer term inflation risks.

Chart 6 – Equity Investors Focused on LT Inflation Risks



I expect US growth to downshift to a more sustainable pace aided by rising job gains, consumption and cap ex as Europe recovers with its tourism and service sectors regaining ground while select EMs follow suit. Company earnings should remain robust with JPMorgan calling for $225 in 2022 US EPS and $245 in 2023 with sustained operating margins as supply bottlenecks are worked out and pricing power provides support. The Firm also noted that notwithstanding V strong Q1 EPS beats, 2021's remaining Qs only saw a modest 2% increase in expected EPS, suggesting plenty of room for continued positive surprises. Note those 2022 EPS estimates puts the SPY at under 19x 2022 E – expensive perhaps but not bubbly.

Europe also is generating very strong company EPS and Morgan Stanley for one expects that to continue. In fact, the old Firm just came out with a 7 point bull case for Europe including said EPS growth, attractive valuations, under ownership, cyclical bias and more. Dividends & buybacks in both the US and Europe are running at high levels and provide further support.

I remain of the view that there is no bubble in public equity, Commodities or Crypto for that matter given its most recent selloff – down 40%, the 2nd worst weekly performance behind only last March's Covid collapse. Such volatility reinforces the need for proper sizing and risk management in a multi asset portfolio. One can't count BTC out however given how many major selloffs it has both endured and recovered from.

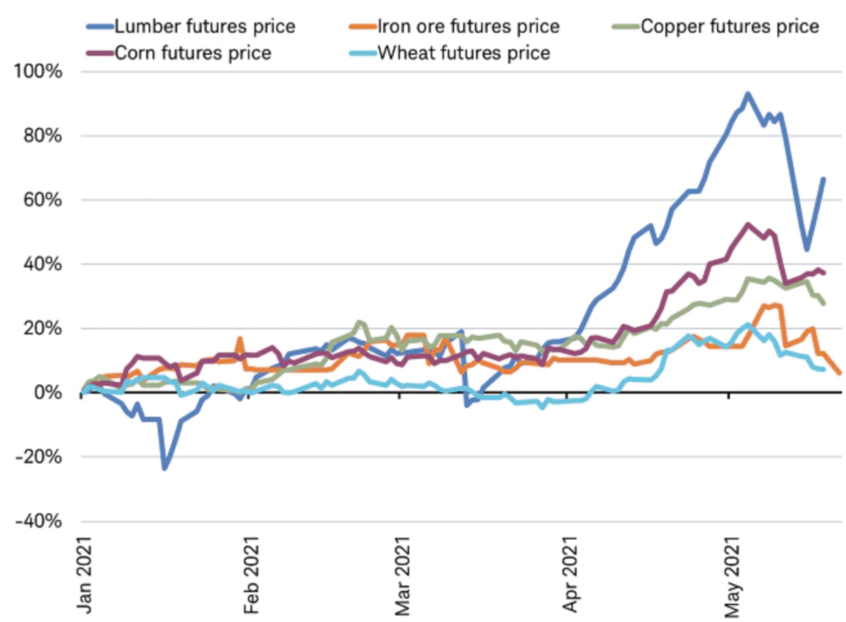
The volatility however is likely to put off institutional enthusiasm somewhat while perhaps accelerating the adoption of the blockchain related pick & shovel opportunity set.

Many equity segments remain well below the highs of recent years with some of my favorites: EU banks, Latin American equity, US energy, Airlines and batteries all 20-50% off 2018 or later highs. Latin American equities represent true laggards with the main regional ETF down over 30% from its 2018 high. The Lat Am markets just came in 1,2 and 3 in StoneX's latest ETF Country rankings however, suggesting some things are stirring. The region could have its day in the sun as it reasserts its traditional relationship with the Commodity space, re opens its economies & attracts new money.

Govt bonds are early in a bear market, expect the 10 yr. UST to work towards 2% as we exit the year and the German BUND to reach the zero bound at the same time (the Bloomberg consensus calls for Bunds to reach zero only in Q3 2022 – talk about behind the curve). For those wondering why the 10 yr. UST bond just broke 1.6% on the downside its worth recalling that thanks to QE, supply to the private sector has never been lower (JPM) while those same UST represent a large majority of the globe's positive yielding safe assets. Taper talk has already started and should be pretty well discounted, perhaps implying that even the late Summer, early Fall testing time may not be all that testing.

The recent pause in the Commodity space is healthy and allows for inflation fears to dissipate a bit while setting the stage for further gains in the years ahead as noted in my Commodities are the Boss Musings. While Commodities lead JP Morgan's YTD cross asset performance rankings, on a rolling one year basis they have just poked their head into positive territory for the 1st time since 2014. As more economies join the re-opening process I expect continued broad commodity price gains and remain of the view that one should invest in both old and new energy. Boomer rocks, aka gold, should continue to benefit from continued negative real yields.

Chart 7- The Pause That Refreshes



Source: Charles Schwab, Bloomberg data as of 5/21/2021.

On the FX front I expect further USD weakness as US exceptionalism gives way to the exceptional size of its twin deficits and shrinking yield gap vs European debt. China's Yuan continues to impress with its strength – now at a 3 year high vs the USD & five year high versus its trading basket. That is one way to offset soaring commodity prices. It's hard to see a major selloff of the USD vs the majors but there is room for significant pick up in some EM FX such as the Brazilian Real.