ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

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IN FOCUS: Economic Resilience Translates into Higher Bond Yields

The relentless rise in global equity prices appears to have stalled at the end of November, despite still generally favorable action at the long end of government bond markets. Rather, the rise at the short and middle parts of the yield curve in the U.S. and a few other countries is starting to weigh on risk asset markets. This rise reflects expectations for both earlier - and more - rate hikes than central banks had been anticipating. The long end of the yield curve is somewhat impervious to rising rate expectations, underscoring that many investors were betting that a shallow and short tightening cycle will address the inflation threat. Over the past several weeks we have solidified our expectations that the global economic expansion will prove stronger and more resilient than the consensus anticipates, and produce a more inflationary outcome than in the 2010s. The FOMC shift this week suggests that the booming liquidity backdrop may be somewhat tempered since their last meeting, as the Fed begins the path towards normalization. However, the sanguine market action at the long end of most global government bond markets is most likely unsustainable, and we expect higher bond yields over time, particularly once it is apparent that central banks will need to end emergency monetary conditions.

At some point, higher long-term bond yields may impinge on risk asset valuations, and potential asset price bubbles in selective sectors should begin to reprice. Until then, however, equity market corrections should be relatively modest, albeit more frequent than in recent times. We continue to note that key equity market drivers are still supportive, namely credit spreads have only recently edged up slightly and remain historically tight. Equities should stay buoyant until monetary policy appears headed to a more restrictive policy stance, which is unlikely in early 2022 despite our stronger-than-consensus view on growth and inflation for next year. This key risk factor, however, is expected to rise overtime, as the economic expansion progresses and inflation pressures prove much more resilient than was currently discounted in asset prices and central bank expectations. For now, we remain modestly pro-growth in our asset allocation strategy, primarily because of our significantly underweight strategy in bonds and duration.

Impact of COVID-19 Developments:

Aside from the growing likelihood of a less generous liquidity backdrop next year, risk asset markets have recently been buffeted by yet another up-surge in COVID-19 cases and the Omicron variant - even in areas where vaccination rates are fairly high. Thus, while directionally bearish for the regional economy, the impact of accelerating cases on investor and consumer sentiment has so far been rather muted. As we have noted for some time, the economic impact from rising COVID-19 cases has progressively diminished in most developed economies, because the authorities are not as willing to restrict mobility and activity to the same degree as they were in 2020 and the first part of 2021. The strategy is focused on supporting growth at almost all costs, and as a result investors have tended to look beyond the surge in cases in expectation of continued economic progress and higher corporate profits down the road.

U.S. Dollar Perspective:

The U.S. dollar has recently gained some steam, reflecting improved relative growth and interest rate expectations. Rate differentials, in particular, have supported the dollar with the Fed on track to start raising rates next year, while the ECB and the Bank of Japan are still on indefinite hold. An economic convergence phase is probable next year once the total impact of U.S. fiscal policy stimulus peaks, and assuming the euro area's key service sector more fully re-opens. The U.S. dollar is becoming overbought and many of the sentiment gauges have heated up considerably. A narrowing in economic growth differentials next year and increased confidence in the durability of the economic expansion outside the U.S. should cause the now-expensive U.S. dollar to soften in the months ahead. At that point, a shift in demand for non-U.S. assets should finally improve, helping to sustain U.S. dollar weakness and improved relative returns on non-U.S. equity markets. This should prompt U.S. portfolios to shift emphasis towards U.S. cyclicals. Meanwhile, gold prices are showing signs of stalling, after having received a boost from falling real bond yields.

While we anticipate higher *real* bond yields in the coming year, we remain unenthusiastic for gold. Moreover, the stampede into cryptocurrencies appears to provide a temporary alternative to gold. One of our themes for this decade is that the boom/bust cycles of the 2010s will not likely be repeated, with higher overall economic growth rates and inflation.

It is important to note that U.S. Treasury yields steadily trended higher in the middle part of the 2000s, as economic growth stayed fairly robust consistent with the ISM manufacturing index trending above 50 or expansionary. There has been a noticeable change in the normal relationship between U.S. bond yields and the ISM index this year - as long-term yields have stayed low and not yet responded to the strength in the U.S. and global PMI indexes. Investors are still banking on either growth faltering once the pandemic re-opening surge is over or, even if growth proves resilient, they still expect inflation to return to 2% or lower, and are willing to accept negative real yields. We do not expect either of these outcomes as 2022 unfolds.

CLOSE-UP:

The stable markets of the summer of 2021 have given way to greater volatility in recent weeks, and at historically high levels for the indexes. One main new economic development has been the revival of the lagging Japanese economy, which was slow to re-open after having massively lagged on vaccinations. Fears of a Chinese bust are significantly overblown, even though the economy continues to be buffeted by brief, targeted COVID-19 restrictions and a cooling real estate market. As we anticipated, the Chinese service sector PMI index has notably rebounded this autumn. Adding it up, the global expansion is broadening over time, both geographically and increasingly across the service sectors.

Excessive monetary and fiscal policies, significant pent-up demand, and elevated corporate profit levels (and parallel historically high hiring plans) paint a bullish picture for the next few years. To this end, U.S. consumers find confidence with inordinate amounts of excess personal savings accumulated during the pandemic (unspent government transfers and pent-up demand), record-high job security and hiring plans, a full unwinding of the pandemic-driven spike in layoffs. The picture should be quite positive for equities however, the uptrend in underlying inflation that emerged late last decade may resume and will be boosted by a number of new influences, some should prove transitory – but others will not.

We still believe it makes sense to lean in favor of cyclicals, but selection, diversification, and valuations will be of paramount importance in positioning equity portfolios. Our pro-cyclical stance favors the financial, energy, and healthcare sectors. Profit margins for the S&P 500 held up remarkably well in Q3, despite rising input costs, and they should remain resilient in a backdrop of solid nominal GDP growth of 3.5% next year.

However, we remain cautiously optimistic as macro headwinds are likely to act as a drag on relative performance once consumer spending on durable goods begins to normalize. Attractive relative valuations and solid underlying fundamentals make the health care providers & services sub-group an appealing defensive hedge and still warrant overweighting in portfolios.

To the extent that some economic headwinds develop during upsurges in new cases including new variants, spending may get deferred but the expansion is not being undermined. Given the robust pace of demand growth in large parts of the world, and ongoing supply problems, some deferral in demand is probably welcome, although the brunt is being felt in lagging service sectors. In summary, we remain positive on economic prospects for 2022 and beyond, in expectation that vaccinations and other medical breakthroughs will minimize periodic setbacks and keep the cycle rolling.

CONCLUSIONS - AND WHAT THIS MEANS FOR THE MARKETS:

Overall, the global economic outlook remains upbeat, based on forward-looking indicators and supportive monetary and fiscal policies. We do, however, expect the global recovery to slow somewhat in coming quarters as the initial post-lockdown rebound fades and policy support is reduced. At the same time, supply shortages are likely to persist into early next year coupled with rising inflation. This has caused us to revise down our 2022 growth forecasts for the U.S. and global economies. The silver lining is that a shift to a restrictive monetary policy still appears unlikely in 2022, partly because there should be some give-back from this year's surge in inflation and, more importantly, the strongly entrenched dovish bias of the major developed world central banks. As long as the long end of global yield curves stays calm, and central banks remain willing to lag the rise in inflation, then the equity markets will resume their upward trajectory and activity will ultimately return to its pre-virus path in most cases.

Equities may still be vulnerable to periodic growth concerns, as the pace of the economic and earnings recovery moderates in the year ahead. Nonetheless, 12-month forward earnings are poised to continue trending higher, which should provide important support for stocks and spur higher price levels. The resilience and overall strength of corporate earnings should win the day for now, and support equity prices until conditions develop that will force monetary policies to become more restrictive, although we would expect returns in the interim may be much more muted than in the past 12 months. We are maintaining our overweight stance on equity exposure in balanced portfolios.

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