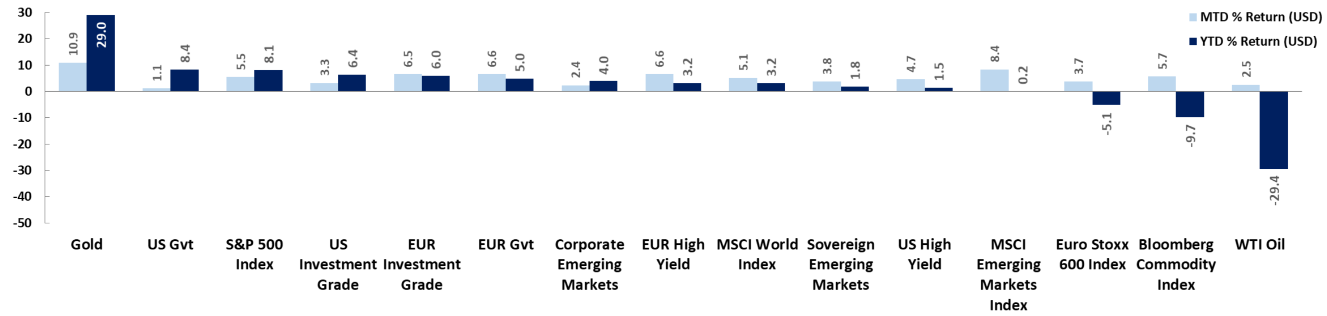
MAM Insights

The world and developed economies have been driven and dominated by a low inflation, low growth, and low rates economic environment for the better part of a decade now. The inefficacy of legacy monetary policies in recent years forced the major central banks to initiate a review of their policy framework to better fulfil their statutory mandates, support their economies, and serve the population. At the occasion of its Jackson Hole annual meeting, the Fed finally pulled the trigger and introduced a revisited version of its long-term goals and monetary policy with the new framework paving the way for inflation. To be clear, what Powell announced is an evolution and not a revolution in US monetary policy. That said, this is an event we find supportive of our view of higher inflation over the next quarters. In this note we expand on both the event and what it means for our core macro view.

Chart 1. Asset Class return YTD (USD Base)



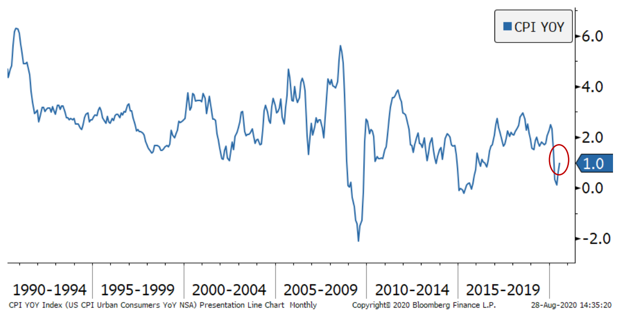
Jackson Hole: Fed's New Policy Framework

At the annual symposium traditionally held in Jackson Hole, Chair Powell delivered a long-awaited policy speech outlining changes to the Fed's monetary policy framework by releasing a new Statement on Longer-Run Goals and Monetary Policy Strategy ahead of the September FOMC meeting. The review is the result of a two-year assessment taking into account years of lower expected growth, depressed global interest rates, muted inflation, and the "best [pre-Covid] labor market seen in years". In a unanimous vote, the Fed adopted a new policy seeking to revive the US labor markets and target an average inflation rate of 2% over the long term.

On the inflation side, the chairman's concern was evident: "The persistent undershoot of inflation from our 2% **(Chart 2)** longer-run objective is a cause for concern. Many find it counterintuitive that the Fed would want to push up inflation. After all, low and stable inflation is essential for a well-functioning economy… However, inflation that is persistently too low can pose serious risks to the economy. Inflation that runs below its desired level can lead to an unwelcome fall in longer-term inflation expectations, which, in turn, can pull actual inflation even lower, resulting in an adverse cycle of ever-lower inflation and inflation expectations.".

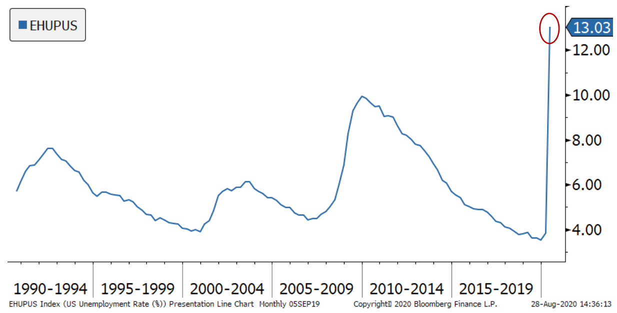
Powell also intently focused on reviving the US labor market. The Fed Town hall events that took place over the past year clearly had an impact in shaping policymakers' conception of what defines and constitutes full employment, but also the importance of the gains achievable in marginalized segments of the labor market late in the economic cycle. "One of the clear messages we heard was that the strong labor market that prevailed before the virus was generating employment

Chart 2. US Core CPI - Inflation Rate (Monthly)



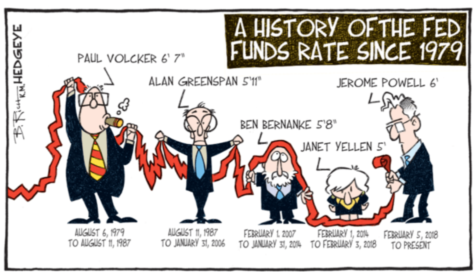
Source. Bloomberg, MAM Research

Chart 3. US Unemployment Rate (Monthly)



Source. Bloomberg, MAM Research

Reviewing the Policy Framework after years of low-interests rates…



opportunities for many Americans who in the past had not found jobs readily available. A clear takeaway from these events was the importance of achieving and sustaining a strong job market, particularly for people from both low and moderate income communities". In the new longer-run goals statement, the central bank emphasizes how "it would not be appropriate to specify a fixed goal for unemployment", but instead the FOMC will assess "shortfalls of employment from its maximum level, recognizing such assessment are necessarily uncertain and subject to revisions".

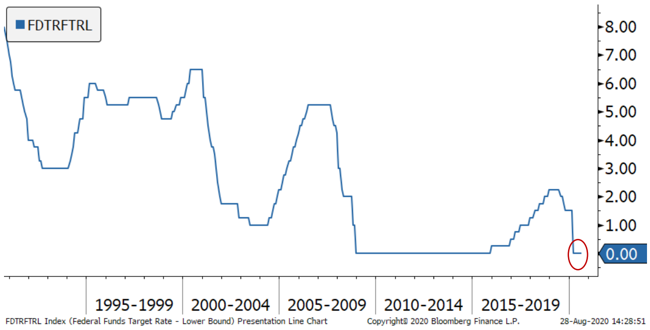
With the new statement released ahead of the upcoming FOMC meeting in September, there is now meaningful risk of an enhanced forward guidance as early as next month rather than in December, as initially expected. The new forward guidance is likely to follow course on the new framework. As a result, we expected the Fed to leave interest rates anchored at the current target range (e.g. 0.0%-0.25%) **(Chart 4)** up until inflation sustainably reaches 2%, on average, meanwhile the broad labor market recovers, consistent with the FOMC's revised maximum employment goal, or at least not before 2022 to 2023 should inflation really surge.

Powell's dovish comments drove rates higher across the yield curve. The US 10-2Yr yield curve steepened from 51bps to 59 bps **(Chart 5)** with US 10Yr bonds now yielding 0.762%, their highest level since mid-June 2020 **(Chart 6)**. Technically, the US 10yr bond yields have broken above the August highs, displaying a clear "higher highs/higher lows" pattern. In the medium-term, we expect US 10Yr bond yields to reach 1%.

A host of Fed officials and economists are also scheduled to speak as follow-ups to the Jackson Hole symposium over the coming days. There is no doubt in our view the Fed wants to control the rise in US yields, for which velocity could end up having negative repercussions on both financial markets and the economy. But, has the genie been out of the bottle yet? Only time will tell… The US 10Yr inflation expectations have moved up from 1.7% earlier this week to 1.82% **(Chart 7)**. US mutual funds and CTAs ownership of US long-dated bonds are close to record highs. This level of positioning was last seen in Q1 2009. Back then, US 10Yr bond yields doubled to 5% from 2.5% in a very short 6m period. While such move in yields cannot be ruled out today, it would create a fair share of market volatility and force some central bank intervention.

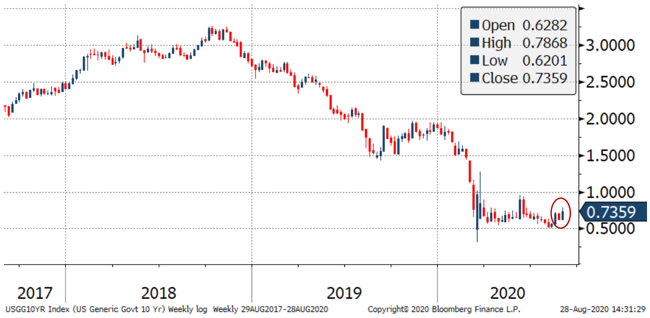
However, the situation today is very different to that of 2009. In equities, US stocks valuations are at record highs. More importantly, we are noticing some worrying market internals. Two days ago, the Nasdaq 100 Index rally was accompanied by an outsized jump on the volatility gauge. While it is not unprecedented for the two indices to move in tandem, the advance helped push the 10d correlation between the two into positive territory for the first time since October 2018 **(Chart 8)**. The period move later coincided with a collapse in

Chart 4. Fed Target Interest Rate (Monthly)



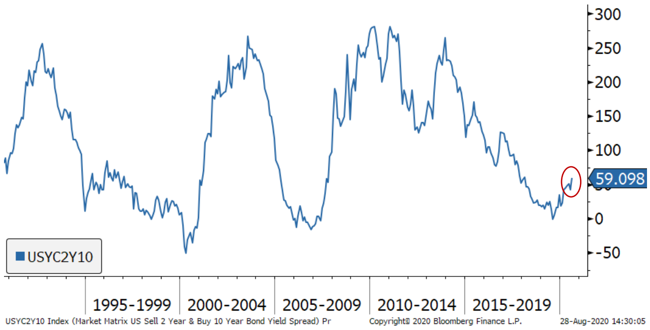
Source. Bloomberg, MAM Research

Chart 5. US 10Yr Bond Yields (Weekly)



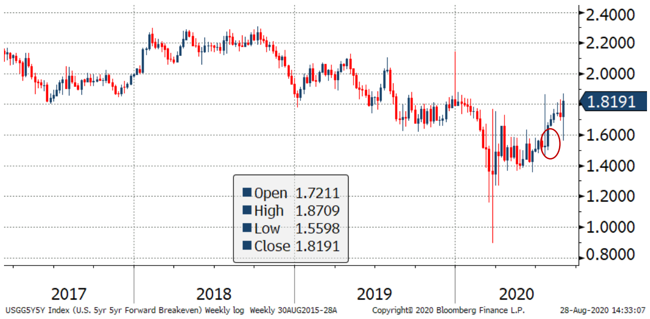
Source. Bloomberg, MAM Research

Chart 6. US 10-2Yr Yield Spread (Monthly)



Source. Bloomberg, MAM Research

Chart 7. US 10Yr Inflation Expectations (Weekly)



Source. Bloomberg, MAM Research

equity prices which saw the Nasdaq 100 plunge as much as 23% over the next three months. While correlation is in no way causation, this is something we are closely monitoring.

In fact, we are beginning to observe some early US market sector rotations which could have a lasting impact. Yesterday, "value stocks" such as REITs and Financials were leading the charge at the sector level. This came at the expense of growth and momentum stocks that were weighted down by weakness in technology related names as a function of the increase in longer-dated yields. With growth stocks up +36% YTD and value stocks down -53% YTD, similar moves could occur more frequently in the upcoming future. The table to the right **(Table 1)** is a good comparative summary of equity markets performance YTD and yesterday.

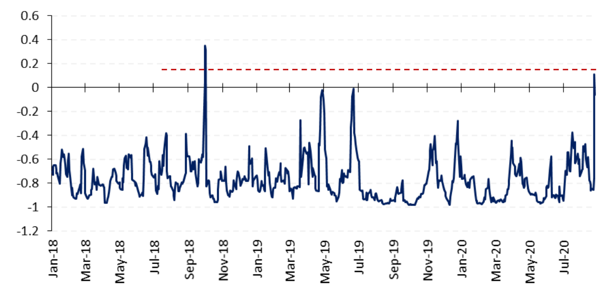
The trend followed through in Asia and Europe. Starting in Japan, Financials (+3.7%), Autos (+3.5%), and Tourism (+2%) were the lead gainers as value bid gained traction. In Europe, Financials (+1.9%) are powering higher at the expense of technology stocks (-0.8%). While a single day move does not make a trend, we and investors need to be conscious of the change in dynamics occurring in the market.

The dovish tone of the chairman's speech echoed all the way through the currency exchange universe with the dollar's continued weakness since then. The EUR/USD **(Chart 9)** is attempting to a meaningful break of the 12Yr resistance line at 1.19. Gold **(Chart 10)** and silver **(Chart 11)** are resuming their uptrend after a brief period of consolidation lasting through August. Indeed, both broke out of their triangle consolidation. This pattern suggests further upside for the precious metals. Our target remains set at 1.225 on the EUR/USD, $2,300 on Gold, and $35 on Silver implying a 3%, 18%, and 30% upside potential, respectively.

Investment Implications

The Jackson Hole meeting confirmed our view that inflation risk is making a comeback and will sooner or later carry its weight of market implications. We believe current portfolio allocation is adequate to weather the storm in such changing macro-environment (e.g. underweight credit and overweight commodities). Equity is a likely destination for international capital. However, investors need to remains conscious of the near-term headwinds the multi-year outperformance of US technology stocks is facing. Concretely, we continue to advise a 10%+ allocation to commodities with a 3%-4% exposure to silver. We recently initiated a short "US Growth Stocks" and long "US Value Stocks" trade in the MAM Macro Hedge fund which will perform well should yesterday's move becomes a sustained trend. We are also in the middle of pricing a dispersion note between value and growth stocks similar to what was initiated in the first quarter of 2019.

Chart 8. Nasdaq vs. Volatility 10d Correlation (Daily)



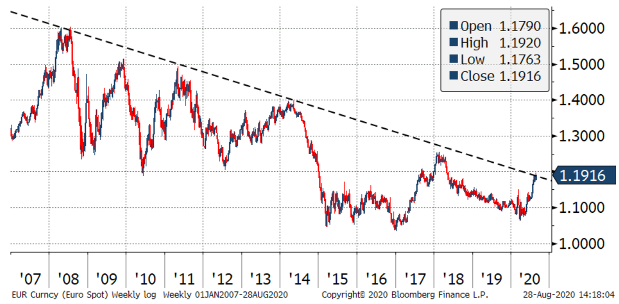
Source. Bloomberg, MAM Research

Table 1. Equity Factor Performance (YTD and 1D)

MS Factor Baskets	YTD % Return	MS Factor Baskets	1D % Return
US GROWTH	36.17%	US Beta	2.09%
US Momentum	22.89%	US Dividend Yield	1.13%
US Realized Vol	21.01%	US VALUE	0.94%
US Size	10.31%	US Leverage	0.58%
US Quality	5.64%	US Realized Vol	0.52%
US Beta	0.61%	US Size	-0.11%
US 3-Month Momentum	-4.71%	US Passive Factor	-0.33%
US 6-Month Momentum	-7.19%	US Quality	-0.70%
US Leverage	-14.59%	US GROWTH	-1.82%
US Passive Factor	-16.56%	US 3-Month Momentum	-2.91%
US Dividend Yield	-30.77%	US Momentum	-3.39%
US VALUE	-53.12%	US 6-Month Momentum	-4.02%
MS Factor Neutral Indices	**YTD % Return**	**MS Factor Neutral Indices**	**Today % Return**
MS Factor Ntrl US Mom	11.65%	MS Factor Ntrl US Size	0.63%
MS Factor Ntrl US Beta	8.02%	MS Factor Ntrl US Beta	0.07%
MS Factor Ntrl US Size	3.35%	MS Factor Ntrl US Mom	-1.30%

Source. MS Research

Chart 9. EUR/USD X-Rate (Weekly)



Source. Bloomberg, MAM Research

Chart 10. Gold Spot Prices (Weekly)

Source. Bloomberg, MAM Research

Chart 11. Silver Spot Prices (Weekly)

Source. Bloomberg, MAM Research

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