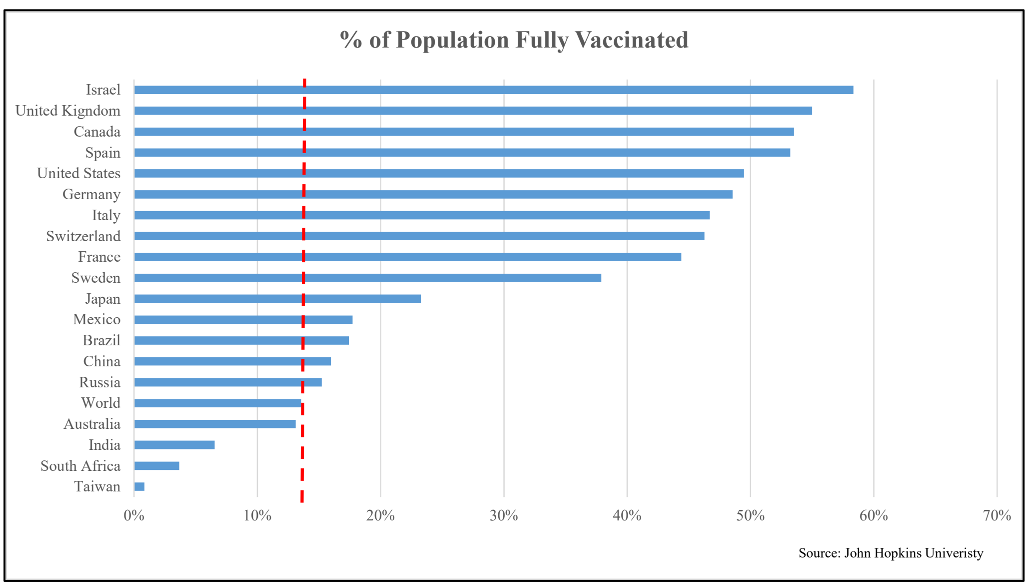
Second Quarter 2021 Review: International Equities Strategy

Economic and Capital Markets Commentary

Despite the initial enthusiasm for major economies moving towards economic expansion after unprecedented support with fiscal and monetary stimulus, the paths forward for different countries remain variable and tenuous. As we celebrate the opening ceremony for the Japanese 2020 Summer Olympics, the many uncertainties with resumption of "normal" activity become very clear. Aside from the obvious delay into 2021 due to the initial spread of the pandemic, the sudden change in attendance restrictions for the competitions exhibit the ongoing challenges with applying a single lens through which to view progress towards normalcy.

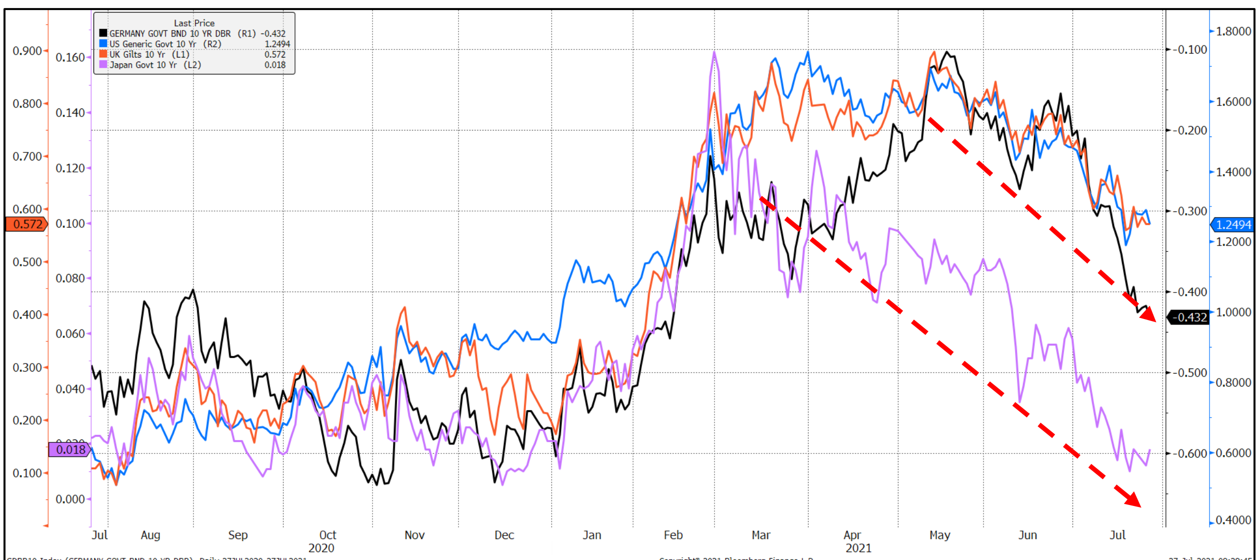
Watching competitions with empty stands over the weekend, I am reminded how Japan remains far behind the vaccination rate of many other developed countries (see chart), while the highly contagious Delta variant of Covid-19 drives another wave of infection. Even with the vaccine, there are discrepancies between vaccines in both their efficacy against and the severity of the illness as the Delta variant spreads. Given the discrepancies between the varying vaccines, one begins to question both their efficacy against and the severity of the illness as the Delta variant spreads. Though there is imperfect transparency, the Chinese vaccine developed by Sinovac is less effective against the Delta variant, and has only a 50% effective rate against symptomatic infection by the original strain, according to the WHO. This rate compares very unfavorably to the Pfizer and Moderna vaccines with over 90% efficacy for the original strain and still 64% efficacy against symptomatic Covid-19 caused by the Delta variant, according to an Israeli study in June. Unfortunately, Sinovac vaccines were distributed to some emerging markets, including Brazil. Some of the other vaccines – like Sputnik V – claim higher efficacy, but some controversy remains about the quality of the studies, as they were developed and promoted by state-controlled enterprises. The variability of vaccination rates and efficacy of various vaccines highlights the different levels of preparedness to weather health risks associated with the current wave.



There is a silver lining: all vaccinations appear to reduce the level of hospitalizations and fatalities. Breakthrough cases of the Delta variant appear to have very few deaths from fully-vaccinated adults relative to the mortality rate of unvaccinated adults. As the Delta variant spreads with an R naught 3-5x higher than the original strain, the key will be avoiding additional mutation into a more deadly strain. Our recent conversations with epidemiologists suggest that the base case scenario is Delta remains dominant globally, pushing us towards herd immunity with other mutations unable to create a meaningful host population.

Unfortunately, the susceptibility of unvaccinated individuals to the spread of the Delta strain risks the introduction of punishing restrictions and delays for economic recovery. Though unrest in Australia over the weekend exhibits a low tolerance for renewed restrictions, countries with low vaccination rates risk dramatically increased levels of hospitalization and mortality as this wave flows through the population. In order to assess the success of the vaccine in a more open market, we look to the United Kingdom, which has one of the highest vaccination rates and currently remains resolved to reopen despite fighting a wave of the Delta variant. If hospitalization and mortality rates remain low, then we look to other markets with higher vaccination rates resuming a trend of improving domestic, economic activity.

These pandemic waves and viral mutations likely contribute to market volatility, and forecasting the market is challenging with many mixed signals and shifting health policies. Interest rates in most markets slid during the quarter, and central bankers appear committed to accommodative policy. The European Central Bank's Christine Lagarde recently adjusted target inflation from "below, but close to 2%" to "2% inflation target over medium term," adding that the "target is symmetric, meaning negative and positive deviations of inflation from the target are equally undesirable." These echo Jerome Powell's commentary on inflation, explicitly guiding towards permissible overshoots above 2%. These actions codify an extremely dovish policy bias.

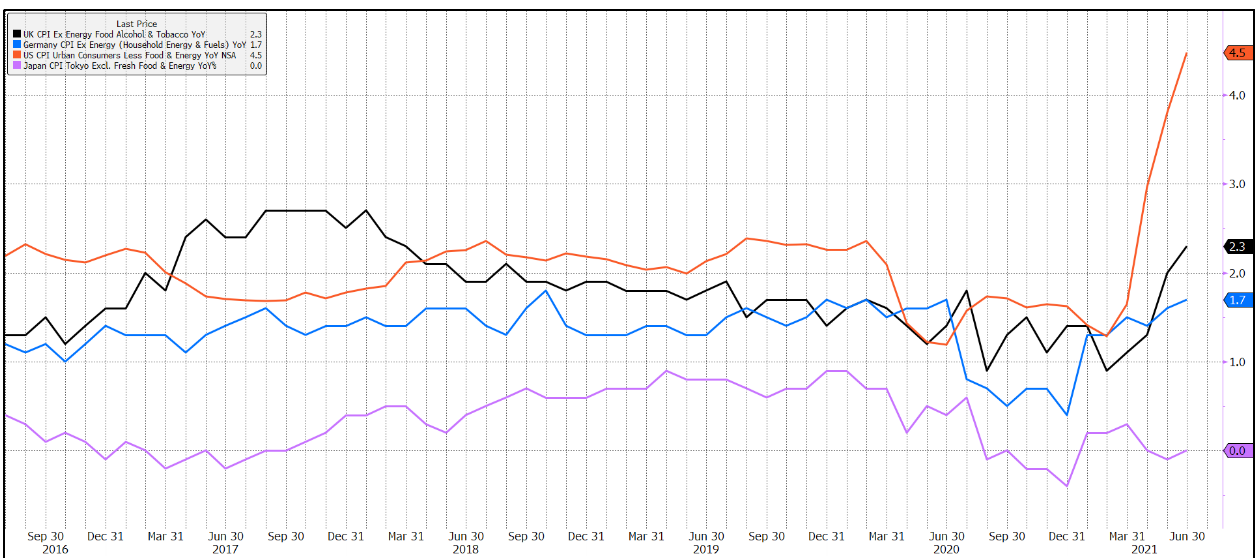


Source: Bloomberg LP

These changes drive market participants to explore unintended consequences of central banks after abandoning their former, single mandate: price stability at – or below – 2%. While supply chain disruptions and price volatility have contributed much to the current headline inflation numbers, forecasts for longer term inflation remain very inconsistent. As both elasticity of demand and supply constraints work towards a new equilibrium, many central bankers and economists contend that elevated inflation will prove transitory. Lumber prices could outline a pattern for future prices in supply chains as markets find an equilibrium as disruptions dissipate (see chart).

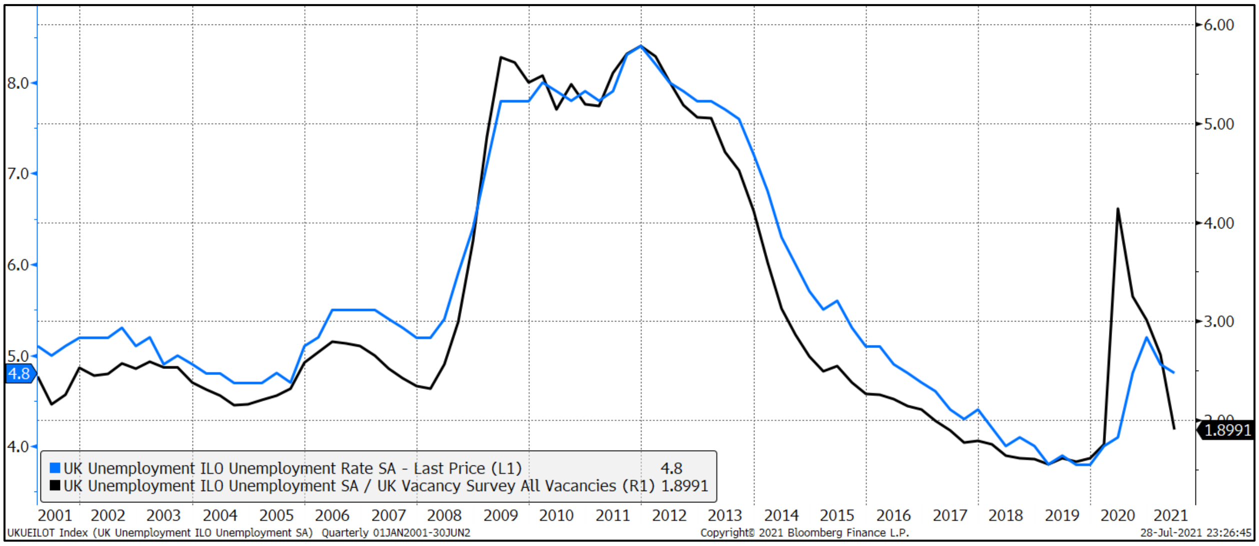
Source: Bloomberg LP

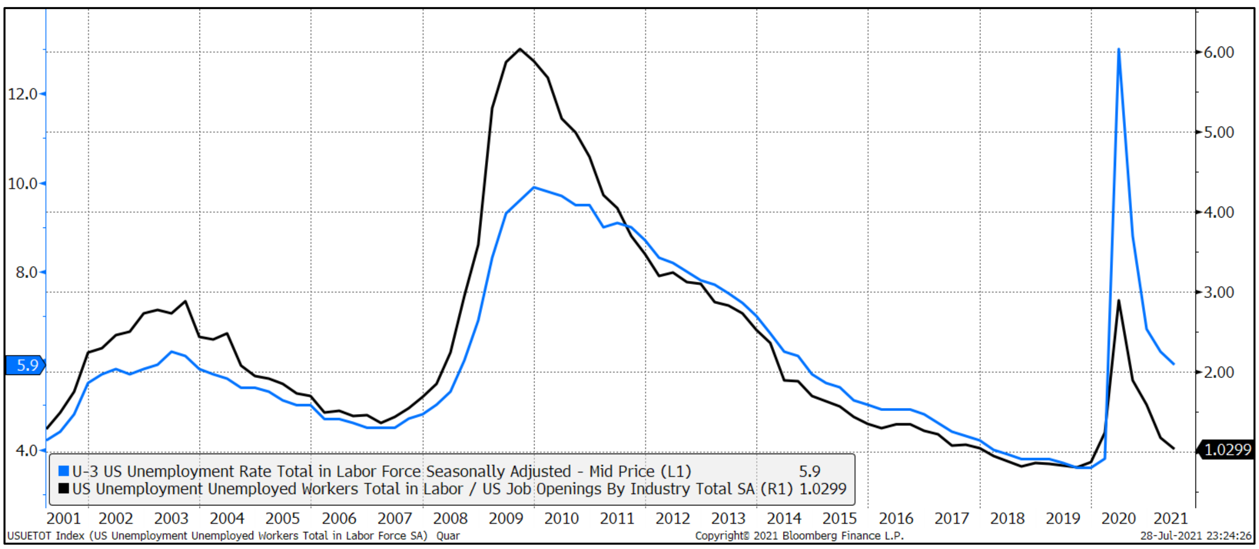
While lumber prices prices exhibit a case for inflation to cycle with supply constraints, we remain cognizant of the risks for more structural inflation entering markets. Currently, the United States' measure of core inflation leads its developed peers (see chart). The Federal Reserve continues to express their faith that inflation is transitory and remain committed to accommodative policy. Other central banks have adopted similar language, abandoning the Taylor Rule, which established in 1993 a mathematical relationship between interest rates, inflation, economic slack, and employment gap. The combination of fiscal and monetary stimulus – much still working its way through the major economies – exceeds the output gap and has already pushed the U.S. economy to new record GDP. Unemployment rate still appears cyclically high relative to yearend 2019, but the elevated rate may belie a tightness in the labor markets.

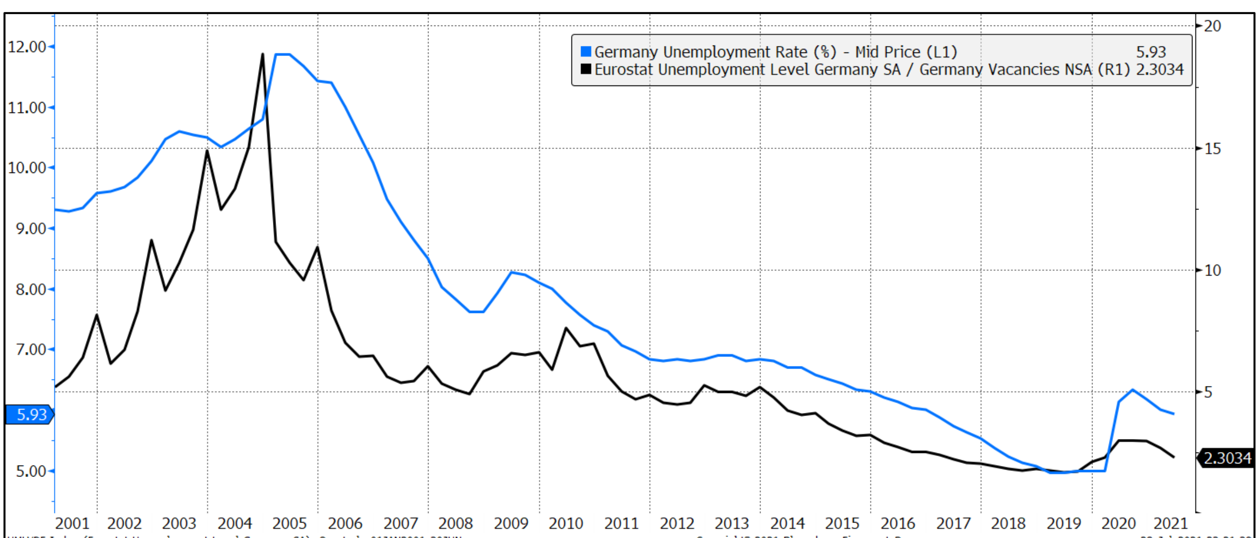


Source: Bloomberg LP

As companies respond to domestic demand and prepare for reopening, we regularly hear anecdotes of tightness in labor markets despite headline unemployment. While many of these are domestic contacts, it appears to echo in conversations with colleagues in the United Kingdom – particularly, in service industries. One method to adjust headline unemployment numbers is a ratio of unemployed individuals to job vacancies. In the U.K. the ratio has collapsed from 2.9x to 1.9x in six months, which is now close to the cyclically low ratio of 1.6x in December 2019 (see chart). The major move came through a 33% increase in unfilled job vacancies during the last few months. While labor cost inflation was largely absent during the last economic cycle, one risk is that fiscal and monetary accommodation creates an overshoot of the natural employment rate, leading to inflation driven by disequilibrium in labor markets.







Source: Bloomberg LP

There are varying theories as to the causes for inflationary periods, but many of the phenomena during the last few decades, such as globalization of trade and industrial automation, have acted as deflationary influences on cost. Though productivity could provide further offsets, globalization may not provide as much deflationary support as domestic job demand drives wages higher, introducing an esoteric risk of a wage-price feedback loop, which could cause structural (versus transitory) inflation not seen in decades.

Fixed income markets are currently sending a signal and dismiss these risks of persistent inflation. During the quarter, interest rates fell deeply into negative real rates. These current yields suggest that market participants both see a need for continued support of domestic markets and share a view that inflation will prove transitory. We hear the message from the prescient bond market but also acknowledge risks, as other indicators send conflicting messages. "Dr. Copper" is currently signaling continued economic strength, and the copper-gold ratio typically moves with interest rates. During the quarter, these two indicators moved in opposite directions.

Our job consists of challenging consensus views, and conflicting signals abound during these unusual circumstances making forecasts particularly vulnerable. As such, we assign an appropriate weight to the risks of persistent inflation, though our base case remains for inflation to work down to more manageable levels as economies reopen and market equilibrium returns. Though the pandemic will continue to create economic distortions, extraordinary stimulus from developed economies should lead to above trend real GDP growth over the next four quarters, as domestic consumption attempts to pass the baton to inventory, investment, and imports for a more sustainable expansionary cycle. Consumer core inflation should work to lower levels as supply chains and price equilibrium normalize. But, extraordinary stimulus and dovish policies may lead to structurally higher inflation as we overshoot a balanced market.

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July 30, 2021

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