RBC Global Asset Management

# Portfolio Manager Perspectives
# Mark Dowding's Global Macro Update

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## Should we worry about a return to secular stagnation?

We're maintaining a positive mindset while we wait on the data for clear guidance.

US Treasury yields continued to drive lower over the course of the past week, leading other global rates markets to rally in sympathy. Given that economic data remains relatively upbeat and there has been relatively little 'new' news, this price action has left market commentators reaching to explain moves that have seen Treasury yields reverse more than half of their rise in the first quarter of 2021, with the curve continuing to flatten aggressively.

To some extent, lingering concerns regarding Covid and the Delta variant, coupled with a slowing in economic activity in China, may have been factors driving markets over the past week. However, a bigger theme in play seems to be a swing in market sentiment to price in a return to the theme of secular stagnation, which saw growth, inflation and interest rates trending downwards over much of the past decade.

Those subscribing to this view of the world may point to a peaking in growth momentum during Q2, coupled with a belief that no matter how high inflation pushes up in the near term, it is destined to reverse this move as we head into 2022.

Consequently, if economic activity and price pressures abate of their own accord, there will be little need for the Fed to ever raise rates, with a 'Japanification' taking place and the natural level of interest rates permanently anchored around 0%. However, it is worth questioning whether this narrative stands up to scrutiny.

US growth momentum remains positive and accommodative fiscal and monetary policies continue to spur activity. Indeed, real interest rates are more negative than they were this time last year and as economies rebound from the Covid pandemic, most central bankers we meet are more concerned that the US economy risks overheating, rather than a sudden cooling.

Dissecting the elements of GDP, the outlook for consumption appears robust thanks to rising employment, wages and incomes, declining precautionary savings and positive wealth effects from rising asset and home prices.

The picture for investment also appears robust with construction spurred by rising real estate and industrial spending in response to demand.

The government sector also remains expansionary and agreement on further stimulus in the context of infrastructure spending appears set to be decided over the next couple of months.

Against this backdrop, a moderation in activity seems to rely on consumers and businesses applying self-restraint, such that positive momentum is short lived. However, a history of the US consumer suggests that this may be an irrational view to hold, in the absence of any policy restraint. Just as many commentators have been surprised at the move up in inflation during the past several months, we suspect they may continue to be surprised that these data continue to print above expectations, with next week's CPI report a potential case in point.

During the past quarter, higher inflation numbers have pushed yields lower, in a contradictory fashion. However, we doubt that such as pattern can persist. With fixed income markets capitulating on the reflationary theme and re-pricing secular stagnation, firmer data could well see a swing back in the opposite direction in the coming weeks and we continue to believe that if our projections for stronger US growth and inflation are met, this will set the stage for the Fed to taper its purchases in the autumn and for 10-year yields to rise above 2% by the end of 2021.

With the Federal Reserve following the data rather than taking a pre-emptive approach to policy, it strikes us that markets are left without a clear sense of leadership.

Consequently, swings in sentiment and positioning may prove to be powerful in both directions. But ultimately, the data will be key. Trying to anticipate market technicals and mood swings is proving challenging, but we remain confident that if we can correctly call the economy, then monetary policy and bond yields will surely follow.

## Europe

Away from the US, there has been relatively little new newsflow over the past week. In Europe, as expected, the ECB concluded its policy review, confirming a symmetric approach to the committee's 2% inflation target. Some ECB commentators have also been making dovish remarks, notwithstanding rising confidence and optimism with respect to the economic trajectory over the second half of the year. We doubt that the ECB will want to start tapering PEPP ahead of the Fed starting to reduce its balance sheet and the gaze of the governing council appears to have at least one eye on developments across the Atlantic.

UK prospects also seem to be firming. Government announcements appear to suggest that almost all Covid restrictions will be removed on 19 July, notwithstanding projections for a further rapid rise in infections.

There is now a firm belief that a vaccine wall should limit the number of those who become gravely sick, with the mortality rate from Covid dropping by 95% since the start of 2021. It is also thought that allowing the country to reach 'hybrid immunity' through infection and vaccination makes much more sense during the summer months, when pressure tends to be much lower on the NHS.

In a sense, this may be a somewhat risky strategy. Yet, we also have seen how the Delta wave can be virulent, but relatively short lived, in countries such as India, and so it may be realistically hoped that UK infections peak and then start trending down again during August.

European yields moved lower on the week, in line with Treasuries. Meanwhile, a retracement in risk assets saw credit spreads surrendering some ground as equities retraced a little lower.

A challenge to the reflation narrative saw multiples contract, notwithstanding the prospective benefit from more benign policy and lower levels of discount rates. Elsewhere, slowing activity and rising credit concerns saw China ease policy by reducing its reserve rate requirement (RRR).

## FX

The dollar remained relatively firm, suggesting that there may be some ongoing cleansing of consensus positioning. It appears that the consensus has tended to hold bets with respect to higher rates, steeper curves and a weaker dollar over the past few months, with many investors being caught on the wrong side of recent moves.

## Looking ahead

The US CPI report is the next major economic data point that could foreseeably lead to a re-appraisal in market thinking. Although recent strong CPI prints have only served to push yields down, not up, we can be confident that such a correlation won't be able to persist much longer.

Certainly, the Fed is unlikely to be nearly as dismissive as some market participants with respect to building price pressures – especially if evidence spreads that this is feeding into consumer and business expectations with respect to future price gains. In a broader sense, it seems that we continue to operate in a world where liquidity is so abundant that pretty much all asset prices have wanted to move upwards.

Elsewhere, we continue to be startled at the valuations applied to some small tech companies, with the implied valuation of USD30bn to UK internet bank, Revolut, a case in point this week. Valuations exceed many large traditional and profitable banks without such firms generating profits to this point. It feels that we may be living in a topsy turvy world but, ultimately, we are persuaded to believe that common sense will prevail.

Secular stagnation feels like an inappropriate diagnosis in the US right now, but we will need to wait for data to show us the truth. After all, even England fans are starting to learn that we need not be overly pessimistic with respect to the future…

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