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JULY MONTHLY COMMENTARY

22 July 2021

Since mid-June, financial market performance has been very mixed. Regional equity market performance has varied, US benchmarks have made steady gains (+2.5%) led by a rebound in the technology sector, whilst European and UK markets have slipped -2.5% and -4.0% respectively.

In the US, the yield curve has flattened, with US 10-year yields falling c. 0.32% to 1.25%, whereas the 2-year yield has edged up 0.07% to 0.20%. Corporate credit has made gains, but high yield has pared some of these gains in recent days. Since mid-June Gold is modestly higher (+1%), the US Dollar is stronger (+2.2%) and Brent crude has fallen -6.8% dipping below $70/barrel.

The main market drivers in recent weeks have been the US Federal Reserve’s (Fed) policy meeting and more recently renewed pandemic concerns. The Fed's June updated economic projections, rate dot-plot and language came as a surprise to many investors and unsettled consensus positioning. The Fed’s updated economic projections and dot-plot indicate its tolerance for “moderate” inflation overshoot. Under its new average inflation mandate this is lower than previously thought and the policy reaction function is less patient. The projections for unemployment were largely unchanged, suggesting the Fed’s willingness to talk about tapering (reducing the rate of monthly asset purchases) comes from the upward revisions to the inflation outlook in 2021 and a wish to exercise more control in anchoring inflation expectations. At the press conference following the meeting, Chairman Jerome Powell made less use of the “transitory” inflation mantra, that had previously bolstered expectations of policy inaction, and acknowledged the upside risks.

The earlier hawkish tilt removes the commitment to policy inaction in the face of higher inflation. Shorter dated government bond yields and monetary policy have been well anchored over recent quarters but following the Fed meeting, short-dated US yields and the US Dollar edged higher in anticipation of earlier rate hikes. Longer dated yields fell back on the expectation of cooling future growth and inflation. Although there will be no immediate change and policy will remain highly accommodative for some time, the Fed’s pivot is an important turning point in the direction of policy that has been so supportive of asset prices in the past year. We should now expect heighted volatility around upcoming Fed meetings and economic releases relevant to Fed decision making.

At their most recent policy meetings, the Bank of England (BoE) and European Central Bank (ECB) kept policy unchanged, however in early July the ECB approved a new monetary policy strategy, much like that implemented by the Fed last year. Under the new strategy the ECB adopts a symmetric inflation target of 2% over the medium term, as opposed to the maximum 2% target previously, thereby giving policy makers more leeway in their response to inflation pressures. After tightening policy conditions in recent months, policy makers in China sought to ease credit conditions by reducing the reserve requirement ratio for banks.

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Economic data releases over recent weeks point towards strong economic momentum and rising inflation. Inflation readings in the US and UK came in above market expectations and higher relative to May. The US Consumer Price Index (CPI) rose to 5.4% YoY versus 5% in May, however the market reaction was muted given the clear pandemic impacts in the underlying data and the earlier change in tone from the Fed. The UK CPI climbed 2.5% YoY. Business and consumer survey data in the US, UK and Europe remains close to recent highs and the labour market data continues to show improvement.

In the past week risk assets have pulled back as investors weighed the risk of the fast-spreading Delta variant disrupting plans to fully reopen economies and denting growth expectations. Although the rise in cases is a concern, unless there is a significant deterioration and unmanageable burden put on healthcare resources, the growth scare should be short-lived given the current strength of economic momentum and ample policy support.

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