



26<sup>th</sup> July 2021

## The Fear of Fear

- We worry that fear of what might happen, rather than what is happening, may hold policymakers back from re-opening and consumers from enjoying their newfound freedom.
- Delta variant of COVID is a challenge to the momentum gained in the global economy.
- Investors are watching for any signs of moderating growth after a slip in US economic data.
- We see the UK as a test case of what re-opening could look like.
- European equities to benefit longer-term from a dovish ECB and in the near term from re-opening.

Emerging and highly contagious variants of COVID-19 have worried politicians around the world, resulting in various new lockdowns measures and retractions of previous freedom. Our – and probably the markets’ – fear is that governments and populations are overreacting to the recent strains of the virus, causing the global economy to lose momentum. Certainly, the recent very low yields in the US government bond market and the strength of the US dollar seem to square with this fear of fear.

The Delta variant of COVID has led to another surge in new cases, with a clear upturn seen in Europe and the United States. The hope is that high levels of vaccinations will keep hospitalisations down to manageable levels allowing economies to continue to grow. Of course, much will depend on the tolerance level of policymakers.

**Recent global economic data has been weaker than expected.** The Citigroup Global economic surprise index has fallen from a level of 82.0 on June 15<sup>th</sup> to -4.0, a still healthy level but not what it was. The weakness has been led by the United States where the country surprise index was as high as 56.0 in June but recently slipped into the negative territory and currently stands

at just 9.0. Europe has seen a similar drop, however it has levelled off at an index value of 65.0, suggesting a generally vibrant economy relative to expectations.

**Chart 1: Economic surprises indices notably in the US**



Source: Bloomberg

Last week, some of the economic numbers from the US came in below expectations. New jobless claims jumped to 419,000 in the week against expectations of 350,000. And although the Markit Industrial confidence indicator for manufacturing was ahead of expectations, the service sector indicator fell well short at 59.8 (against consensus' 64.5).

Nevertheless, to be fair, the US PMI numbers at current levels are reflective of strong growth. However, if the market sees that growth is failing to meet expectations, bond yields could get anchored at these low levels. Equity investors may be less likely to pay up for stocks when there's a possibility of earnings downgrades.

**The world is watching the aftermath of the UK's bold move to substantially relax restrictions after a sharp increase in the percentage of the vaccinated population.** To date, the rise in daily COVID cases and the mortality rate have been well below experts' worst-case expectations. However, data suggests people have been reluctant to use their new-found freedom. Google mobility indices show that the level of activity in retail and recreation is still down 9% on its base line while visits to parks are up 96%! Retail and recreation in London are still down 29%, which may reflect the very low levels of tourism.

### **European equity markets supported by re-opening and the ECB**

The next few weeks will be critical for markets on several fronts. Firstly, the rise in cases caused by the Delta variant is spooking some countries, leading to stricter lockdowns. Parts of the

world where vaccination rates are high need to have the confidence to re-open and unleash some of the pent-up demand.

**Looking across regions, Europe seems to have the greater opportunity to spring positive surprises.** ECB's dovish stance in a session last week fuelled a sense of encouragement in Europe as the central bank was very clear in its commitment to keep interest rates lower for longer. Eurozone government debt was largely lower in yield terms for the week despite the near 10bps rise in the US 10-year yield. **The eurozone equity market has the scope to re-establish some near-term outperformance against the US equity market.** Of late, consensus earnings forecasts have started to gain some positive momentum probably helped by the weakness in the euro against the dollar

### **China - help and challenges from the authorities**

It has been difficult to see the positives in the emerging markets though, with still very low levels of vaccinations, and/or economies such as China that have remained averse to re-opening their borders while running generally tight fiscal and monetary policy. At the margin, however, there are signs of improvement. Stronger demand growth in the west has yet to fully pass through the disrupted supply chains. Orders remain high and unfulfilled, leading to the prospect of persistent strong demand growth for exports from the east.

**In China, there are further signs that the authorities will allow policy to ease in support of growth.** The recent cut in the reserve requirements was a modest start. However, there are signs that the government is willing to sanction some increases in spending. Economists at JPMorgan noted that Chinese government net bond issuance picked up sharply in June on the back of a sharp acceleration in fiscal spending in that month.

**Chinese equities** could do with some good news after the 22% fall from mid-February levels. **Broad macro news may be getting better, but investors have been besieged by regulatory changes that are hitting some of the leading stocks.** Late last week China banned for-profit school tutoring, hitting another portfolio business of stocks such as Tencent, Alibaba and Bytedance.

### **Fixed income markets jittery**

Fixed Income markets remain jittery: One measure of market stress is the quoted level of implied volatility, a key input into the cost of hedging with options. The MOVE index, which measures fixed interest rate volatility, has been on an upward trend since mid-June, rising to 70 from 55 during this period, before declining only slightly to end the week at 65.

**The rise in volatility matches the clean-up of short positions in the bond market, resulting in the steep drop in yields seen over the past six weeks.** It also shows that indigestion in the bond market is not yet a thing of the past, as participants remain willing to pay up for hedging interest rate risk. To add some further spice to the mix, Treasury Secretary Janet Yellen was on the wires this week, warning publicly and pointedly that the US needs to deal quickly with the debt ceiling issue overhanging the bond market. Failure to do so could result, in the extreme, in

the US going into default on its payments. That probability is small, given that the Democrats can force the issue through a process known as budget reconciliation. Under President Obama, the issue led to a downgrade in the US's credit rating from AAA and a temporary surge in yields.

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