



INSIGNEO | Market Commentary

Surfacing and Assessing the Mid- Year Landscape

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Surfacing and Assessing the Mid-Year Landscape

A submarine's military effectiveness has always depended on its ability to remain submerged and undetected. Surprisingly, the earliest vessels operated blindly under the sea, and until the twentieth century the only way for one to see was by surfacing. Of course, this revealed the submarine's location to nearby vessels and conceded its invisibility. Since 1903, however, naval submarines have used a tubular optical instrument known as a periscope to get a look at their surroundings. To do so, they would ascend to approximately 60 feet below the surface, deploy their periscope, assess the field of view, and then quickly descend beyond the reach of surface vessels. While at periscope depth, the submarine surrendered some maneuverability and tactical ability for the sea level surface information. This was a well understood trade-off.

depth for a look around, mindful that the 12-month view for global equities and other risk-on assets is still positive.

On the macroeconomic front, developed market economies have continued their inexorable march towards a post-pandemic world. Chinese growth is back above pre-pandemic levels, and the authorities there are tightening monetary policy on the margin. Though the credit impulse is declining, it is far from restrictive. Thus, the Mainland is managing a slowdown to prevent imbalances from forming in lending and the Renminbi. In the US, as fiscal stimulus fades from historical levels and the boost from vaccinations ebbs away, economic momentum should slow over the second half of the year. To be sure, the US will be slowing down from an exceedingly fast pace and the rest of the world is ramping up, so it will be relatively benign. Moreover, if the increase in inflation proves transitory, which is my base case, monetary policy will remain very accommodative. Yes, consumer prices are increasing at a faster pace than most anticipated,

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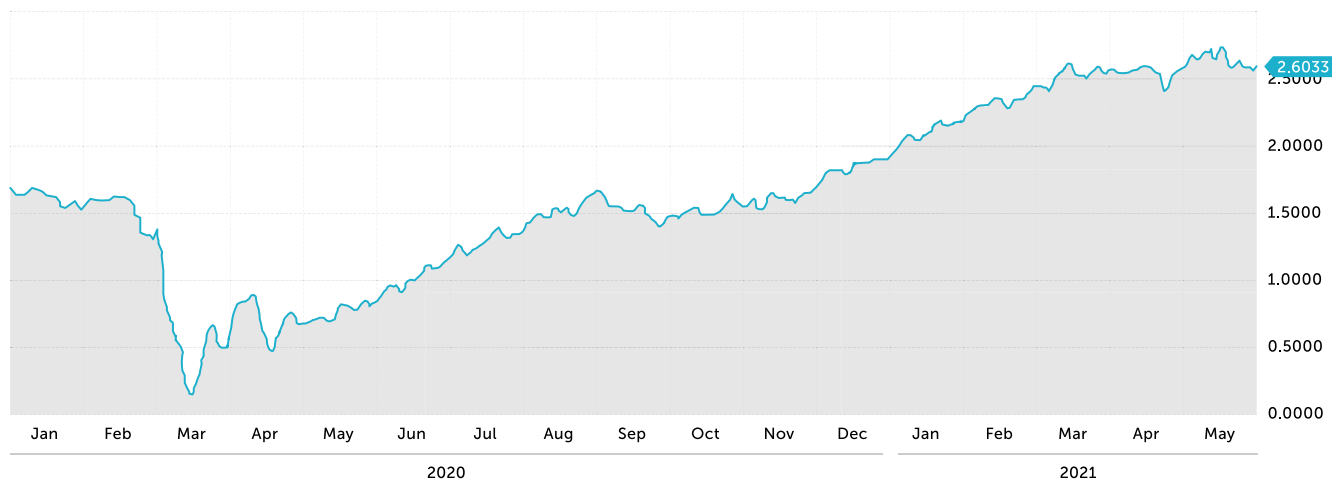
With the S&P 500 less than 2.5% away from my year-end price target of 4300, US growth probably past its peak, and global growth momentum likely slowing in the second half of the year, **investors who are very bullishly positioned in their portfolios should begin to pare back some risk on a tactical basis and wait to reassess the monetary policy framework and growth outlook in a few months.**

In other words, one should ascend to periscope

but so far, the empirical evidence points toward supply-side constraints that should ameliorate in the next quarter or two. Given the Fed's new average inflation targeting regime, one would need to see a large and persistent spike in inflation expectations for the US central bank to pivot away from easy monetary policy. As the next chart shows, that has not occurred yet. In fact, 5-year breakeven rates in the US have come down from the near-term May peaks and settled around the Q1 levels around 2.6%.

US 5-Year Breakeven Rates Have Stabilized

Source: Bloomberg (as of 06/02/21)



Going forward, the main driver of the Fed's reaction function will be when labor market conditions have reached its assessment of full employment. While I cannot completely rule out numerous, spectacular employment reports in the second half of the year bringing forward the first rate hike from current expectations in late 2022/early 2023, it is also not the most likely scenario. As April's disappointing jobs number reminded us, the damage to the labor market, especially in the low-income segments, was quite severe and could take some time to fully heal. More data is needed to reach that determination, and the summer and early fall will be crucial periods to watch.

Finally, bank lending since the pandemic began has been quite subdued despite the dramatic rise in broad money aggregates. This dearth of aggregate demand should further dull the short-term inflationary pressures in the economy. **In sum, I am less worried about the near-term inflationary pressures than the current market narrative suggests.** Nevertheless, I am more concerned about the medium-term inflationary panorama than what is currently priced in, as I wrote in [All Roads Lead to Inflation](#). But those concerns are

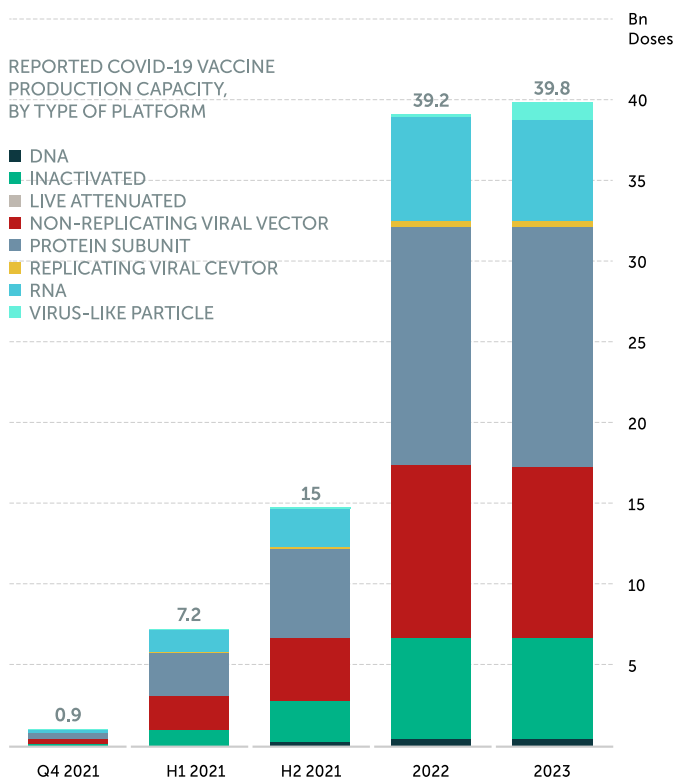
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beyond the 12-month investment horizon that guide the investment process. Turning now to the Eurozone, the Continent is where the US was 3 months ago, and its steady progress suggests that it will get there. In the developing world, the picture is more nuanced, and any fair assessment of the macroeconomic story must be addressed at the country level. India and South Korea, for example, represent a bifurcation of outcomes with the latter doing well while the former is still grappling with the pandemic.

For now, there are three main risks to this overall sanguine view, listed here in increasing order of potential disruptiveness. First, the appearance of a new, vaccine-resistant strain of the coronavirus. So far, all the new variants of Covid-19 have been neutralized by the existing vaccines, and, as this next chart demonstrates, vaccine production is increasing sharply.

Vaccine Production Capacity Looks Very Positive

Source: BCA Research; UNICEF Covid-19 Market Dashboard



Second, there is a risk stemming from the impact of higher taxes in the US on corporate earnings and long-term dividends. President Biden’s American Jobs Plan and the American Families Plan are currently mired in the highly polarized morass of the US Congress. But I expect some legislation to emerge, even if it is very

diluted from the original proposals. Interestingly, the biggest stumbling blocks come from the moderate voices within the Democratic caucus. Senator Joe Manchin of West Virginia, a deeply Red state, is perhaps now the most important person in Washington D.C. thanks to the political gridlock. In the end, I expect the corporate tax rate to settle between 24 and 25% and the dividend tax rate, in the unlikely event it passes, to be under 30%. Any outcome is likely to be less onerous than feared by many market participants, but the timing and planned selling that may accompany it may spook asset prices. Finally, there is the greatest risk of all – the aggressive withdrawal of monetary stimulus in China and other parts of the developed world. While China has been tightening on the margin, stimulus hovers near 8% of GDP, which surely is below levels observed elsewhere but far from “tight”. And while countries like Australia and Canada look primed for a hawkish shift in monetary policy, the chances in the US appear less likely even if they have increased recently. Like I mentioned earlier, the Employment Reports during the summer and early autumn months will be key indicators to watch for the Fed. So, while those maximally overweight risk should mildly reduce exposure on a tactical basis (0 to 3 months), none of the risks warrant paring back exposure on a cyclical basis (12 months). **A prudent approach might be to maintain slightly elevated levels of cash on hand to pursue any opportunities that arise after a market dislocation.** Like the submarine, we would be ascending to periscope depth and surveying our surroundings over the next few months to better gauge opportunities in the latter half of the year.

The following is a summary of our market and asset class views on a cyclical or 12-month horizon:

Maintain bullish positioning and overweight risk-on assets within multi-asset portfolios (reduce to moderately bullish or neutral on a tactical horizon)

Remain overweight equities over bonds in multi-asset portfolios, although returns should be more muted than they were to start the year. Expect single digit returns in global bourses in H2 2021.

Within equities, overweight global non-US stocks versus their US peers; overweight Europe versus emerging markets.

On a style basis, maintain overweight in Value versus Growth although dispersion should be less going forward; maintain overweight Cyclical versus Defensives; and Small Caps over Large Caps.

Within fixed income, moderately shorten duration on sovereign bond holdings; overweight high yield versus investment grade on spread product.

Maintain cyclical overweight in commodities, especially industrial metals as a multi-year commodity super cycle likely began late last year; reduce exposure to neutral on a tactical basis given recent strength and heightened chance of a correction.

Maintain inflation hedges in multi-asset portfolios through commodities (including precious metals), inflation-linked instruments, real estate, and farmland.

House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
US Equities¹	NEUTRAL	OVERWEIGHT
European Equities	NEUTRAL	OVERWEIGHT
Japanese Equities	NEUTRAL	OVERWEIGHT
Emerging Market Equities	NEUTRAL	OVERWEIGHT
Chinese Equities	NEUTRAL	OVERWEIGHT
US Treasuries²	UNDERWEIGHT	UNDERWEIGHT
Investment Grade Fixed Income	NEUTRAL	NEUTRAL
High Yield Fixed Income	NEUTRAL	OVERWEIGHT
Emerging Market Sovereign	NEUTRAL	OVERWEIGHT
US Dollar	UNDERWEIGHT	UNDERWEIGHT
Energy³	NEUTRAL	OVERWEIGHT
Precious Metals	NEUTRAL	OVERWEIGHT
Cash	OVERWEIGHT	NEUTRAL

¹ Relative to global equities in USD

² Relative to aggregate fixed income markets in USD

³ Relative to an overall commodity allocation

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