REDUCING SENSITIVITIES

A mid-year slowdown has not yet appeared in the global economy or equity markets. But we have seen a notable drop in interest rates, which is curious in the face of hotter-than-expected inflation reports. As shown below, rates have fallen steadily since a peak at the end of the first quarter, for reasons we think are as much technical as fundamental. Risk markets have handled the decline reasonably well, but it has led to a return of growth stock outperformance. With U.S. interest rates declining to the bottom end of our expected range, we did reduce interest rate sensitivity in our global policy model this month by reducing our investment grade fixed income allocation. Meanwhile, we also modestly reduced our emerging market equity exposure, partly due to the high-profile changes in economic and regulatory policy in China.

Inflation data is so varied that one can find a report to support any outlook. Recent U.S. inflation reports have been much hotter than expected, but Europe and China reports been much more subdued. Goods and services tied to the reopening have led price gains and there are some signs of normalization. Lumber prices have fallen 64% from their peak, now below their pre-pandemic high. Used car prices — a major contributor to the recent inflation spike — have now started to decline in the auto auction markets, portending less pricing pressures ahead. In some important respects, inflation only really matters to financial markets if it leads to a jump in interest rates or decline in corporate margins. So far, we haven’t seen those negative consequences.

China’s economy held up better than the West during 2020 and has slowed this year as policymakers have worked to reduce risks in the financial system. A pivot may be underway, as monetary policy looks to become less restrictive. Additionally, China’s economy remains highly leveraged to global growth. This is exemplified by the acceleration in Chinese export growth to 32% in June, while imports slowed to a still impressive 37% growth rate. Less well-received by the markets has been Chinese regulatory policy, including regulation of technology leaders and highly leveraged development companies. We expect these actions to be an anchor on valuations.

Our tactical reduction in investment grade fixed income (now further underweight our strategic allocation) and emerging market equities (now at strategic levels) funded our increased allocation to high yield bonds (reinstating a tactical overweight). High-yield bond spreads are historically low but high-yield bond credit quality is historically high. Meanwhile, high yield bonds do not show much interest rate sensitivity — as, historically, higher interest rates are generally offset by falling credit spreads.

BIG LITTLE MOVES
Rates have fallen noticeably since March 31, but aren’t expected to return to those levels in a year’s time.

U.S. YIELD CURVE - %

### BASE CASE

#### A Bumpy – but Shock-Absorbed – Reopening

It is becoming increasingly clear that reopening a global economy is harder than shutting one down. Pockets of supply/demand mismatches and uneven growth profiles will occur, but any growth disappointment helps reduce inflationary pressure, allowing for the positive market outlook to persist.

#### Market Laggard Runway

Those investments that most-underperformed during the pandemic — and, in many cases over the past decade (think non-U.S. equities, natural resources and value-oriented strategies) — have shown solid returns more recently. Momentum has slowed but valuations remain attractive and the fundamentals remain strong.

### RISK CASES

#### Stuckflation Tested – and Fails

Inflationary pressures during the recovery continue to build and overwhelm structural downward forces on inflation, forcing early central bank restrictiveness leading to risk asset headwinds.

#### Dropped Growth Baton

Handing off the baton from government stimulus to organic demand is a challenge, especially coming out of a pandemic-induced economic shutdown. A failed transition would disrupt risk-taking.