Q4 2021 | Capital Markets Outlook

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At the crossroads of pandemic, policy, disruption, and inflation

"The pandemic 'is a biological phenomenon, but it's also a political and social phenomenon.'" *

— **Erica Charters**

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Many folks in the developed world enjoying high vaccination rates may be done with the pandemic, but in many ways the pandemic is not done with us.

In the early part of the year, several epidemiologists were quick to compare the "second wave" of Covid-19 to the pattern of the Spanish Flu pandemic of 1918. It is a typical human desire to try and recognize patterns as an aid in decision making, but it should be clear by now that this is anything but a "normal" cycle.

Some forecasters suggest it is quite early in a new cycle. They cite that the corporate sector is only a couple of quarters removed from the maximum point of year-on-year earnings growth rates following the early Covid-19 lockdown-driven recession. Others say we are probably later in the cycle, citing that U.S. nominal GDP is now back above previous trend growth. The state of play for the global economy is likely much more nuanced than these broad descriptions of the path of a typical cycle.

Asset allocations

Shading in the table indicates the change from the previous quarter

	Underweight	Neutral	Overweight
EQUITY		●	○
U.S. large cap	●	○	
U.S. small cap			●
U.S. value			●
U.S. growth	●	○	
Europe			●
Japan			●
Emerging markets		●	○
FIXED INCOME		●	
U.S. government		●	
U.S. investment-grade corporates		●	
U.S. mortgage-backed			●
U.S. floating-rate bank loans		●	
U.S. high yield		●	○
Non-U.S. developed country		●	
Emerging markets	●		
COMMODITIES		●	○
CASH		●	

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro		○	●
£ Pound	○	●	
¥ Yen		●	○

* Source: "Here's What the Next Six Months of the Pandemic Will Bring," Bloomberg.com, September 12, 2021.

For use with institutional investors and investment professionals.

Health policy disparity disrupts supply chains

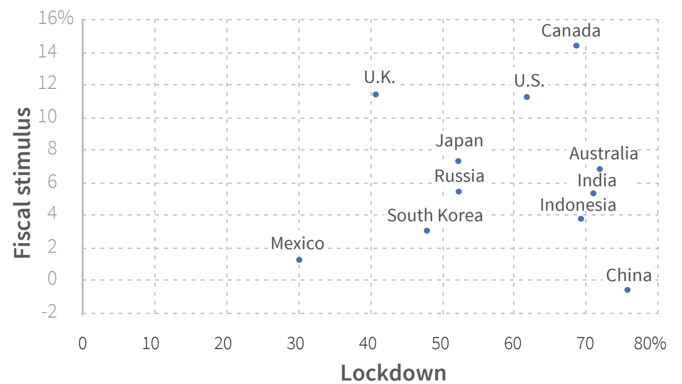
We wrote almost 18 months ago that progress on impeding the virus was likely to drive macroeconomic outcomes for quite some time, and we believe that continues to be the case. Wide disparity in vaccination rates, vaccination efficacy (as defined by the level and duration of protection provided by the various manufacturers), levels of natural protection granted by previous infection rates, and current healthcare capacity considerations on a country-by-country basis continue, as we rapidly approach the 2-year anniversary of the world's awareness of this pandemic. Many healthcare policy experts have coalesced around a view that Covid-19 is likely to become globally endemic like influenza. Even with all that we have learned about the virus and treating the disease, widespread disparity continues in how governments around the world respond.

These varied responses continue to drive behavior, which in turn has impact on the flow of goods and services in what continues to be an integrated global economy. While the trajectory of globalization may have peaked or even reversed, the knock-on effects of stresses to global supply chains continue to evolve in unexpected ways. Despite the best efforts of government leaders to rapidly decrease reliance on foreign suppliers in key strategic industries, we continue to see disruption. Policymakers routinely underestimate how long these transitions can take.

The incredible speed and composition of this cycle — rapid decline and recovery combined with a substitution for goods over services — has run headfirst into the relatively glacial pace with which governments change direction on strategic policy initiatives. Whether it is the United States and China trying to domestically source semiconductors, or Europe trying to decarbonize energy, it's messy. The collision of these two timelines at this point in history is reverberating across global supply chains and causing wild price swings in key markets.

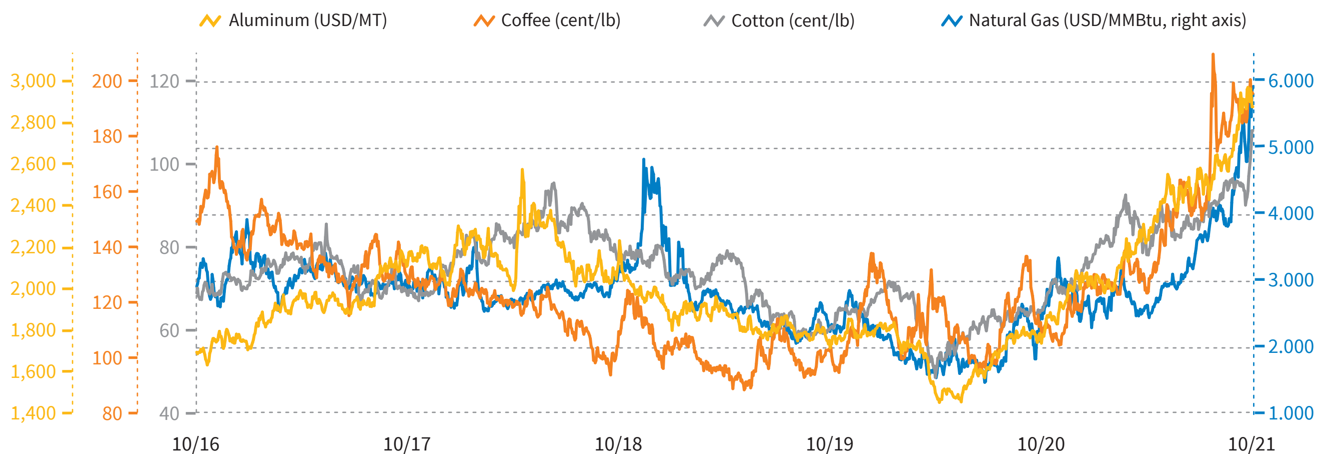
Variation in Covid-19 responses

Change in 2020 deficit as % of GDP vs. lockdown stringency



Sources: Bureau of Labor Statistics; Bloomberg.

Supply chain disruptions have pushed up key commodity prices



Sources: Putnam; Bloomberg.

U.S. housing costs could sustain inflation

We have been of the view that core inflation in the United States should continue to normalize into early 2022. However, our confidence in that view has deteriorated somewhat over the past several weeks (as has, it should be said, the Fed's). It still appears that prices in what Federal Reserve Chair Jerome Powell has referred to as "reopening related" sectors of the economy have continued to mean-revert. Used car prices are an example. This is, of course, welcome news, but we also need to be wary of the path of owners' equivalent rent (OER) over the coming quarters. This component of core CPI has an outsized weight in the Fed's preferred inflation metric. It has the potential to exhibit more volatility than we have seen in decades given what has gone on in house prices nationwide.

U.S. house prices reach records

Monthly FHFA House Price Index® for Census Divisions and U.S. (Purchase-Only)

Source: Federal Housing Finance Agency, FHFA.gov.

It is not a foregone conclusion that OER must follow house prices, but given its importance, it bears close attention. The speed with which the pandemic has changed trends in the physical movement of people, in their decisions to buy versus rent or to purchase second homes, and in the rate of household formation has been breathtaking from a macroeconomic perspective.

Slowing growth causes worry

Various measures of growth have slowed somewhat recently, a trend that has the fingerprints of the rise of the Delta variant. We believe that, with growth slowing and growth data surprising to the downside relative to expectations, the word "stagflation" has reared its ugly head as a credible risk for the first time in quite a while.

Financial policies in flux

The rate of change in financial markets has matched the rates of change in the economy. Liquidity growth has inflected, with the Fed signaling its intention to begin scaling back the pace of bond purchases. Other central banks around the world are further ahead in their path to tightening policy. Money supply growth rates have slowed rapidly. Germany will see its first new chancellor in 15 years, and Japan has a new prime minister. As we write, the U.S. Congress continues to grapple with prioritizing President Biden's key fiscal policy initiatives, government funding, and debt-ceiling expiry. Meanwhile, investors continue to display a voracious appetite for financial assets of all types, including less-liquid credit and private equity.

Pushing pause, temporarily

We have for the moment pushed the pause button on our risk taking and have adopted a tactically neutral posture. We believe the levels of volatility and sentiment priced into markets currently do not adequately account for the quantum of uncertainty across the many dimensions we have described above. Of course, there is no such thing as certainty, and the longer you wait for clarity, the more upside you can lose. But with a game of four-dimensional chess in front of us, and variables moving in time so rapidly, we think the cost of waiting for the ride to at least slow down a bit is low.

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