Market Letter

March 2021

As Global Growth Recovers, the Focus Turns to U.S. Inflation (and Monetary Policy)

Macroeconomic Developments

- Regime change: from a high economic growth / low interest rate to one of yet higher growth but higher interest rates. Rapid vaccine rollout and passage of the new administration's $1.9 trillion fiscal stimulus package have boosted the expected economic recovery. In anticipation, longer-term U.S. interest rates have started the normalization process, with the rate on 10-year Treasury securities going from under 1% at the start of the year to over 1.75%.

- A phase out from social distancing policies are leading to 2021-2022 above-trend global GDP growth. The months ahead will bring further evidence of a vaccine-led recovery, uneven though it may be the U.S. economy is on the path to reopening. Job growth is exploding, equities and RE are at all-time highs, U.S. Treasury yields are holding, the Fed promised not to touch Fed Funds until unemployment falls to 4%, and inflation has recovered to the highest in more than 25 years.

- The pandemic should end this year. Vaccines appear successful at curbing the spread of the disease and reducing its morbidities and fatalities. In the rapid vaccination countries new infections have fallen even as mobility has picked up, elsewhere mobility has gotten too high relative to the pace of vaccinations and the spread of new variants causing a new surge in outbreaks. The roll-out of vaccinations is patchy, and some countries may face new waves in the next few months, but social distancing should shrink over the coming year. The willingness of the U.S. to take on the risk of investing in multiple vaccine technologies before they were approved is why three times as many Americans have been vaccinated compared to Europeans.

- The sweet spot has moved away from China. The U.S. economy is poised for a significant jump in economic activity which will be accompanied by a spurt in inflation that will test the Federal Reserve's new policy framework. The Treasury bond market has just experienced its worst quarter in decades. U.S. 10 year Bond Yields have moved to a new cycle high. The increase in bond yields could be attributed to a more optimistic economic outlook that has led investors to reprice the path of monetary policy. Markets have therefore been upgrading their growth and

inflation forecasts. In addition, investors have likely reassessed the neutral rate higher as well, given reduced worries about permanent scarring. This is a testament to how much quicker the turnaround is now expected to be. The term premium has also risen, which reflects an upgrade in the risk assessment about inflation outcomes, but also higher uncertainty about the outlook. With inflation ramping up and job growth increasing robustly in the next few months, speculation will mount as to when the FOMC will signal it is considering tapering its $120 billion in monthly purchases.

- **The global economy has accelerated sharply during March/April and signal the start of a period of remarkably strong global growth**. The resiliency of global factory output speaks to underlying strength in global business spending as well as the continued recovery in stock-building. This is being reinforced by an impressive rise in the latest business sentiment readings. Likewise, virus containment should release pent-up demand and boost consumption in the coming months, reinforced by U.S. fiscal stimulus.
- The U.S. government is launching unprecedented fiscal stimulus, well beyond the scale seen in peacetime, and well beyond the scale seen elsewhere in the world that will have massive consequences. The market is following the debate over U.S. President Biden's $2.25 trillion infrastructure proposal, as Republicans expressed guarded support for a more limited plan.
- A second commodities super cycle this century? Governments and private companies are increasingly pledging carbon reduction measures, heightening demand for certain metals. Commodity super cycles are decade-long periods in which commodities trade above their long-term price trend. Many data points support the idea of a new cycle starting now, but it is still too early to say.
- Despite signs that China's domestic demand growth is cooling, EM Asia exports continue to boom. Taiwan's export orders jumped in February, pushing the quarterly pace of increase to an impressive 101% annualized rate. The March flash exports reading in Korea also was impressive and pointed to quarterly growth at an above 40% annualized rate. Tech continues to be the high flyer – Taiwan's tech orders surged at a remarkable 137% annualized return in the quarter ending in February –but the underlying message from the region is that there is broad-based demand for capital equipment and technology products.

Global Drivers

Global Growth

The staggered re-opening of economies should mean the global economy sees steady strong growth over the next few quarters. According to the IMF, it is believed global GDP will increase by 6% in 2021 and 4.4% in 2022. The upward revision reflects additional fiscal support in a few large economies, the anticipated vaccine-powered recovery in the second half of 2021, and continued adaptation of economic activity to subdued mobility.

Most developed economies would return to their pre-pandemic levels of GDP by early next year at the latest, a much faster recovery than in the aftermath of the 2008 financial crisis. Governments provided substantial income and other financial support to firms and businesses. Household incomes were sustained (or better)

during the pandemic. Consequently, corporate and household cash balances are remarkably high for the end of a recession, and unemployment rates remarkably low. Although some businesses and jobs will undoubtedly prove unviable as conditions normalize, the headwinds to recovery from insolvency, unemployment and restructuring should be much weaker than they were after past recessions. Consumer goods demand – which has fully recovered from the pandemic – will ease. Households, now likely saturated with durable goods after a year of online shopping, will shift spending back to services. The fulsome recovery in Asia over the past year was largely due to those countries' success in containing the virus. Yet, it was spurred on by strong demand for goods in the U.S. and Europe. As spending in developed economies rotates away from goods, export demand may soften in Asia.

Monetary Policy Outlook

The Phillips Curve will not govern monetary policy going forward. The Fed will be tested. On April 13th the Consumer Price Index (CPI) was released and the larger than expected increase in headline inflation could cause a hiccup.

Without a whole lot of fanfare, the Federal Open Market Committee has made a significant change in how the Federal Reserve will conduct monetary policy going forward. At the April 28th meeting the FOMC stated again that transitory factors have increased inflation and made it clear that the Phillips Curve will not govern monetary policy going forward. It will no longer increase rates based on projections of higher inflation, but instead will wait until inflation materializes, even though there is a risk the Fed could fall behind the inflation curve.

Inflation may increase more than expected during the next 6 months. Many factors are going to combine to push the headline CPI above 3.0% (maybe close to 3.5%) and make it look like a serious bout of inflation is beginning. However, Powell and other members of the FOMC will say this wave of inflation will be temporary so there is no need for the FOMC to overreact[1] by lowering the $120 billion in monthly QE purchases of Treasury bonds and Mortgage Backed Securities or increasing the federal funds rate. It may take some time but most of the factors that are contributing to the coming surge in inflation should gradually ease in 2H21.

USD: Fed's inflation tolerance opens room for a weaker dollar. By 2023, the median FOMC participant sees a 3.5% unemployment rate, three years with inflation at or above target, and still no increase in the fed funds rate. This seems to reflect a more dovish stance than currently discounted by markets.

Central banks of some developed economies such as the Euro area and Japan are unwilling to see tighter financial conditions without an accompanying improvement in growth prospects. So both central banks are engaged in yield curve control, either explicitly (in the case of the BoJ) or implicitly (in the case of the ECB). Crucially, both central banks are prepared to resist a rise in yields through more aggressive bond purchases. So far, those policies have successfully contained the rise in yields in Europe and Japan. Ongoing aggressive bond purchases by these central banks may limit the speed with

[1] Chair Powell has repeatedly claimed that the coming increase in inflation is likely to be temporary as he noted in this response to a question about the chip shortage during his March 23 appearance before Congress. "There will be a little bit slower growth and maybe some modest upward pressure on prices. But that should be something that is temporary. You know, a bottleneck by definition is temporary as the supply side adjusts."

which U.S. yields can rise, meaning that a stronger U.S. growth differential is reflected in a rising dollar rather than much higher yields. That could further shift some of the reflationary and inflationary consequences of the U.S. stimulus towards Europe and Japan. A Goldilocks outcome financed by European and Japanese central banks!

Commodities

The U.S. fiscal stimulus will play the same role in the post-COVID-19 recovery that China's investment surge played after the GFC. It will boost and extend the early-cycle rebound period in which manufacturing and trade growth is most rapid. This phase of the cycle is commodity intensive arguing for a stronger and longer duration period of commodity price inflation. Excluding energy and gold, 86% of commodities have produced a positive return over the past year, which is the highest percent since September 2011. The size of the extraordinary fiscal and monetary stimulus is driving inflation expectations which is driving commodity prices higher.

Oil: demand should continue to recover. OPEC+ coordination combined with U.S. Shale declining to ramp production creates a floor to WTI prices. Global balances are bullish: i) Global oil inventories are projected to continue drawing — especially as OPEC+ has committed to keeping barrels off the market (rolling over production cuts into May, with Saudi Arabia extending its voluntary 1 million barrel per day curb, and U.S. production will not materialize growth significantly until 4Q21 ii) Demand will only get better from here – vaccination stumbles / European headlines aside, the general trend for mobility and re-openings is pointing higher. Companies ranging from super majors to nimble shale producers have had to slash their exploration budgets, meaning that there are less new projects being developed. On the other hand, OPEC members have spare capacity to respond to stronger demand. Beyond oil, natural gas is a commodity that can act as a bridge fuel between coal and renewable energy. As coal plants are progressively taken off the grid in the U.S. and Europe, natural gas-powered generation could capture a larger share of the generation mix.

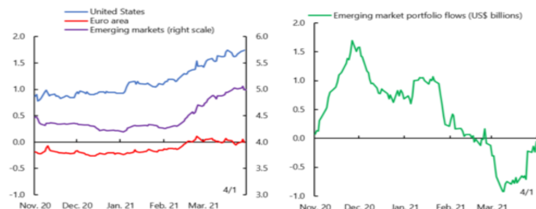
A whole new market for metals such as cobalt, lithium, or nickel sulfate used in high-performance batteries is emerging to support the transition to electric vehicles (EVs). The EV revolution applies to battery-focused materials but also to traditional metal products: aluminum is favored to build lower weight vehicles, and silver is widely used in photovoltaic installations. And of course, the move to electrification could provide higher demand for copper in the years to come. Food prices have also been ratcheting higher. The United Nations Food Price Index has jumped by more than 25% in the past year as grain prices soared.

EM Investment Outlook

Tug-of-war between rising growth and rates as we enter a quarter of U.S. growth exceptionalism. Despite short-term wobbles, risk assets have continued to hold up. The situation looks fragile.

Advanced economy interest rates are still low and could rise further. While a U.S. tightening resulting from a stronger U.S. economy tends to be benign for most emerging market economies, a surprise tightening triggers capital outflows from emerging markets.

Going up
Interest rates are up in advanced economies and emerging markets.
(percent per year; unless otherwise noted)



Sources: Haver Analytics; Institute of International Finance; and IMF staff calculations.
Note: Interest rates show 10-year government bond yields for the United States and euro area. In the euro area, these are averages across countries, weighted by purchasing power parity gross domestic product. The yields for emerging markets are the JP Morgan GBI-EM Global Diversified Index. Portfolio flows are 4-week moving averages and cover Brazil; China; Colombia; Hungary; India; Indonesia; Korea; Malaysia; Mexico; Pakistan; Philippines; Poland; Qatar; Saudi Arabia; South Africa; Sri Lanka; Taiwan, Province of China; Thailand; Turkey; Ukraine; Vietnam.

INTERNATIONAL MONETARY FUND

The upbeat global view is based on the premise that a tightening of EM financial conditions will prove limited in an environment of booming overall global growth. In addition, the anchor provided by stable low-for-long guidance from the Fed and other DM central banks will limit the pressure for EM central banks to tighten even as EM headline inflation moves higher. The equity market is likely to be supported by good economic news in the short run, but buffeted by the prospect of a less accommodative FOMC in the second half of 2021 and the prospects of higher taxes. Gold, silver, and gold stocks may get a lift in the coming months, as inflation jumps and the FOMC says no changes to policy are forthcoming.

Capital inflows to emerging markets have shown signs of drying up. The fear is of a repeat of the "taper tantrum" episode of 2013, when indications of an earlier-than-expected tapering of U.S. bond purchases caused a rush of capital outflows from emerging markets. Are these fears justified? Research finds that for emerging markets, what matters is the reason for the rise in U.S. interest rates. When the reason is good news about U.S. jobs or COVID-19 vaccines, most emerging markets tend to experience stronger portfolio inflows and lower spreads on U.S. dollar-denominated debt. Good economic news in advanced economies could lead to export growth for emerging markets, and the pick-up in economic activity tends naturally to lift their domestic interest rates. The overall impact should be benign for the average emerging market. When, however, a rise in advanced economy interest rates is driven by expectations of more hawkish central bank actions, it can harm emerging market economies. A mix of reasons are driving up U.S. interest rates. So far, "good news" on economic prospects has been the main factor. The subsequent rise in U.S. interest rates has generally been orderly, with markets functioning well. Even as long-term U.S. interest rates have risen, short-term U.S. interest rates have remained near zero. Stock prices remain high, and interest rates on corporate bonds and dollar-denominated emerging market bonds have not diverged from those on U.S. Treasury securities. Furthermore, market expectations for inflation seem contained[2] near the Federal Reserve's long-term target of 2% a year, and if they stay there, it could help stem the rise in U.S. interest rates. Part of the surge in U.S. interest rates came from the normalization of investor expectations of U.S. inflation. However, other factors seem to be at play, too. Much of the increase in U.S. interest rates is due to a rising term premium, which could reflect rising investor uncertainty about inflation and the pace of future debt issuance and central bank bond purchases. It is also unclear whether the large quantities of Treasury securities that the U.S. is expected to issue this year could crowd out borrowing by some emerging markets.

[2] https://blogs.imf.org/2021/02/19/structural-factors-and-central-bank-credibility-limit-inflation-risks/?utm_medium=email&utm_source=govdelivery

Strongest quarterly inflows ever into EM equity funds: inflows into **EM equities** have gone uninterrupted for the past 12 weeks, as investors have positioned towards a synchronized global recovery following last year's COVID-19 led growth shock. One point worth highlighting is the shift in demand towards 'value' and 'blend' from a style perspective, which seem to have outperformed 'growth' significantly, in line with the expected growth recovery. Meanwhile, **EM bond** funds also saw inflows though these were limited. Inflows have been largely denominated by fresh entries into Asia ex-Japan funds, possibly reflecting strong inflows into China now that China bonds will also be included in the WGBI. EM equities were the only asset class to end Q1 in positive territory.

The 1Q21 earnings season brings important messages: (1) significant expansion on the books for 1Q21, USD +45% yoy with both top line and EBITDA seeing double-digit growth; (2) LatAm to deliver the highest yoy earnings growth among regions. EM Asia also poised to deliver a robust growth but lagging the EM benchmark; (3) most sectors are expected to deliver strong positive 1Q21 yoy earnings growth and skewed towards cyclical/ Value ones: Materials, Real Estate and Industrials. The notable exception is Financials - still meaningfully underperforming its cyclical peers.

For the past year, long momentum has been synonymous with secular growth/COVID winners, and more recently some idiosyncratic themes like crypto, renewables, SPACs, Reddit favs, etc. However, due to the recent rotation out of growth into cyclical/value, coupled with the fact that the Feb '20 COVID sell off is dropping out of 12m momentum signals, the definition of momentum is evolving. 12m L/S momentum is becoming a lot less growth, shifting to more pro-cyclical/value. ENERGY will be the largest gainer in 12m L/S momentum (flipping from short to small long) with Industrials the second largest. Largest OW will now be Cons discretionary, while staples the largest UW.

Risks

- With the U.S. economy opening up a sizable growth differential with the rest of the world, a key risk is that the dollar strengthens further, thereby straining capital flows into EM. The growth differential between EM and U.S. is expected to remain large until 3Q21.
- An important medium-term issue relates to the projected slow recovery in the level of EM activity toward its pre-pandemic path. Slow vaccination and limited fiscal space, place EM ex-China still nearly 4% below its pre-crisis path at the end of next year. The economic consequences of projected EM scarring, against the backdrop of a political calendar that turns more active next year, is a major underlying risk factor;.
- Repricing of the U.S. 10-year yields leading to the de-synchronization of EM policy rate cycle vs. DM.
- Fiscal discipline and the ability of EM economies to rein in support while minimizing the impact on GDP growth.
- Virus variants spreading amid slow vaccination rollouts, which could short-circuit the consumer recovery. However, vaccines showed effectiveness where rollouts are advanced; there are indications that the pace of vaccination is picking up in Europe.
- High commodity prices can put pressure on some EM current accounts: the case for two major commodity importers – India and Turkey.

Country Updates

Argentina

Monthly pace of FX depreciation slows. President Fernandez's comments that there is no rush to negotiate with the IMF

Some of the stresses in the FX market have eased thanks to strong commodity prices. Martin Guzman, the Economy Minister, indicated that the monthly pace of FX depreciation may slow in the coming months (Bloomberg). Still, long-term issues are not about to dissipate, and while grain inflows and seasonal revenues are stronger in Q2, the second half of 2021 is still likely to be challenging, particularly on the fiscal side. In 1Q21, Argentina's fiscal position came in better than expected, led by higher tax revenues from soaring soybean prices and the effect of tax hikes. This allowed the Central Bank to reduce money printing, which together with exports, resulted in a lower blue-chip premium in the foreign exchange market compared to 2H20. With a more favorable external environment and a politically costlier price of a FX adjustment as we get closer to elections, it is more likely that we see more regulations rather than a devaluation. Still, after the midterm elections in Q4, the pace of official FX depreciation should increase. As midterm elections approach, it is likely that the blue-chip premium could be pressured.

Argentina must repay the IMF U.S.$1.8bn in both September and December 2021. The IMF is considering the issuance of SDRs, roughly tripling the number allocated to each country. The USD 4.35b available to Argentina would let the country make upcoming coupon payments. With the 2022 Budget presented to Congress in September (before the mid-term elections), there is a low probability of advancing on an IMF program before year-end. Thus, there is more probability on 1Q22. Market participants would look at an IMF program for some hope of an economic strategy that anchors expectations regarding medium -term sustainability.

Brazil

COPOM increased the SELIC rate by 75bp. Rising COVID-19 cases should weigh on activity in 1H. BRL looks fairly valued.

Sharp increases in commodity prices and a greater exchange rate pass -through to tradable goods, led the central bank to adopt a more hawkish stance by front-loading the monetary policy adjustment with a 75bps hike in March. The central bank may continue raising rates by 75bps over the next consecutive meetings. The inflation projection of the Board is now at 5% for 2021. BCB continued to mention this is a partial normalization of monetary policy, which suggests that they still believe that the policy rate should remain accommodative at the end of the cycle.

The pandemic is still a concern, as the second wave has been stronger than the first and the rollout of vaccines so far has been disappointing. However, March could be a turning point in the vaccination process, as local production is gaining traction. The priority (higher-risk) group is expected to be inoculated by the end of mid-2021 and the entire population by the final quarter of the year.

México

Commercial linkage to the U.S. and low fiscal risk but noise from electricity reform law.

Recently passed law prioritizes publicly owned CFE over private utilities and facing a number of legal challenges as to its constitutionality. If the government loses its qualified majority in the lower house and governorships at the June 6th

elections, it will likely impact AMLO's agenda going forward.

Chile

Strong vaccine distribution program should help the economy recover sooner. Positive long-term story for copper.

Stimulative monetary and fiscal policies. Congress has formally approved a law that may limit the frequency of pension portfolio recommendations by third-party financial advisories.

Colombia

Rise in oil prices. tax reform to come later in the year.

Wide current account deficit and fiscal pressures compared to the other oil-producing economies. The government recently revised the fiscal deficit target from 7.6% of GDP to 8.6%, though in part this reflects spending that was reallocated to 2021 from last year.

Russia

RUB is still undervalued

With oil prices back to their pre-pandemic levels, one would have expected a significant RUB appreciation. The currency's sensitivity to oil has decreased lately, which may be related to the deteriorating geopolitical situation. The decline in Russia's oil production and exports since the beginning of the pandemic has also contributed to weaker correlations and the RUB's lackluster performance. However, oil production is likely to return to pre-pandemic levels, supporting a positive current account balance dynamic. The CBR's has started a rate hike cycle on March 19th.

China

2021 annual GDP growth outlook remains at 7.1%. Softer sequential growth as most of the recovery has occurred.

Global demand began to recover; rising commodity prices continued to push up both input and output prices. Caixin manufacturing PMI edged down to 50.6, surprising on the downside, but remaining in the expansionary zone. Manufacturing is expected to be the leading contributor to fixed asset investment (FAI) growth in 2021, based on the following expectations: (1) the recovery to external demand for non-COVID-related goods should lead to higher Chinese goods exports in 2021; (2) the ongoing policy support for the high-tech manufacturing sector and solid foreign direct investment inflows; and (3) the overall economic rebound has revived corporate sales revenue and industrial profits. Authorities are adopting a policy stance tighter than 2020 but looser than 2019.

USD-RMB should see more two-way movements this year as opposed to a steep one-way decline because: 1) the eventual availability of vaccines globally should slowly reduce the growth and yield advantage that mainland China has over the US and the rest of the world; 2) the PBoC's FX policy is trying to prevent excessive RMB appreciation – there could be more outbound outflows following the PBoC's recent RMB internationalization efforts; and 3) there could be a temporary slowdown of bond inflows during the gap between the WGBI inclusion date (October 2021) and completion of the BBGA and GBI-EM inclusion processes (November 2020).

Turkey

Vulnerable lira. CBRT hikes again… then the governor is fired. Changes at the Central Bank suggest an early return to policy easing in a bid to boost growth. Short-term external debt remains high, and central bank's reserves low

The Turkish central bank unexpectedly hiked its policy rate by 200bp to 19% on 18 March. The policy statement highlighted significant upside risks to the inflation outlook. On March 19th, Naci Agbal was replaced by Sahap Kavcioglu as the governor of the central bank. Turkish assets came under pressure, though in the short-term TRY volatility may be managed via FX interventions by the CBRT and state-owned banks.

Contrary to the consensus view that higher interest rates tame inflation, the Turkish president believes they push it higher by increasing firms' borrowing costs. This is probably why he dismissed Mr. Agbal, who tightened policy again. The newly appointed governor, Mr. Kavcioglu, agrees with Mr. Erdogan and may lower rates again. He has written that the lira has been kept too strong and undermined Turkey's competitiveness. Turkey's foreign-exchange reserves stand at $18 billion, though that is all borrowed: They are at negative $20 billion excluding swaps with banks and other governments.

South Africa

Terms of trade gains and improvement of the current account balance

The budget deficit for FY20/21 is likely to be 11.4%[3] of GDP. The fiscal shortfall could narrow at a quicker pace going forward, supported by a bigger tax base. Fiscal challenges remain significant. The recent better-than-expected fiscal numbers should not hide the fact that fiscal deficit as a percentage of GDP is in double digits and the debt level continues to rise at a fast pace.

We thank you for your continued support.

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