September 2021
Jackson Hole: Dovish Fed reassures markets

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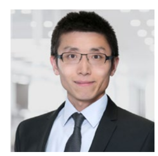

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The much-anticipated Jackson Hole Economic Symposium took place on 26 - 28 August, with pricing immediately prior to the event suggesting that markets were expecting a dovish statement from the Federal Reserve. Chair of the Federal Reserve, Jerome Powell, did not disappoint markets, opting for an even more dovish statement than expected. The Chairman pushed any prospect of interest rate rises far down the line, stating they will only increase once maximum employment is reached and inflation ‘is on track to moderately exceed 2% for some time’[1]. Whilst he acknowledged that inflation is a concern, ‘the elevated readings are likely to prove temporary’[1].

That said, Chairman Powell indicated that the Fed’s monthly bond purchases could be reduced this year. Therefore, tapering continues to be well telegraphed in contrast to the 2013 Taper Tantrum, a repeat of which the Fed is clearly trying to avoid. The markets reacted positively and the US 10-Year Treasury yield fell further from its already low point, to below 1.28.[2] The S&P 500 also reacted positively, up 0.9% on the day of the speech (27 August 2021) and overall ended the month positively returning 3.0% (USD). The S&P 500 once more

1. Speech by Chair Jerome H Powell, 27 August 2021. Board of Governors of the Federal Reserve System. www.federalreserve.gov/newsevents/speech/powell20210827a.htm
2. Bloomberg US 10-Year Treasury Yield, 30 August 2021.

outperformed the MSCI Europe Index, which nevertheless returned a positive 2.0% (EUR). The MSCI Japan Index returned 3.2% (JPY)[3].

However, August was not without its challenges. Earlier in the month (18 August), the Federal Reserve minutes led the market to expect tapering to start between November 2021 and January 2022. At the time, there was a broad-based decline on the news. Whilst tapering is not a surprise, the Fed's language that valuations are too high and loose monetary policy supporting this is causing instability, was a surprise. Chairman Powell also communicated at the time that rate hikes may start as early as 2022. This, compounded by virus news, was not enough support on the upside and pushed the S&P 500 down in mid-August. The S&P 500 rebounded subsequently, with most of August's positive return coming in the second half of the month.

Is the Fed making a policy mistake?
We are still concerned as we were last month, that the Fed appears to be excessively dovish and we believe that this is due to fears that signalling of tightening could spook markets. One explanation for the drop in yields generally seen of late is the supply and demand dynamics. By maintaining bond purchases, despite Treasury issuance being down, on a net basis, the Fed is effectively loosening monetary policy. In the face of a strong and growing economy, we believe the Fed should have kept monetary policy the same or even tightened. It also appears that developed markets may be dealing with the Delta variant of COVID-19 better and it will not necessarily derail the economy. It is worth noting that the sharp rise in reverse repos by the Fed result in returning T-Bills back to the economy, however the Fed is simultaneously taking these out of the economy with its bond buying programme. This means the Fed has actually been effectively "tapering" – buying a net smaller number of T-Bills – even while it has not "officially" tapered.

Government actions globally are disrupting markets
Government intervention in the markets has been increasing in many regions. Notably in China, but the US and European governments have also increased their focus on climate change, antitrust and data privacy. This has both pros and cons, but with respect to antitrust, if pursued aggressively, it may constrain business, creating potential headwinds and volatility spikes.

Q2 2021 earnings season review – as good as it gets?
The US earnings season was exceptionally good, but the same could not be said of the market response. Companies with earnings beats had muted price reactions and were not rewarded in some parts of the market, suggesting that a lot of the good news had already been priced in. However, companies with earnings misses were punished severely. This, and the fact that it is hard to find areas of the market which are not overvalued, indicate that cautious positioning is warranted.

Investment Implications
We are maintaining prudent risk exposure as we are concerned that there is a substantial degree of complacency, despite high valuations and the interest rate outlook. As mentioned in our last outlook, we are monitoring any potential catalysts which could cause volatility, including antitrust and geopolitical risks. In

3. Bloomberg, 31 August 2021. Index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

August, within equities we removed our overweights to Germany (DAX) and the UK (FTSE 100). We describe the rationale for these changes below:

The DAX and FTSE 100

We moved to neutral on both the DAX and FTSE 100, having been overweight since August 2020 and January 2021, respectively. Our initial thesis on the reflation and cyclical trade has played out to a certain extent. With respect to the FTSE 100, the initial valuation discount gap has narrowed as markets have since rebounded. Both the DAX and FTSE 100 still trade at a discount to the US and MSCI ACWI. However, at the industry, sector and single stock levels, the valuation discount gap seems to be fairly priced, as we do not expect outperformance from those laggard industries such as insurance (a substantial proportion of the financials in the DAX), in addition to a lack of conviction in certain idiosyncratic developments.

Tactical positioning

We have provided our latest tactical views as follows:

Asset Class	--	-	=	+	++
Equity					
US			■		
US Value				■	
US Growth		■			
Eurozone			■		
Germany			■		
UK			■		
Japan			■		
Asia ex Japan			■		
Emerging Markets			■		
LatAm			■		
Global Infrastructure			■		
Global Property			■		
Global Financials				■	
Global Energy				■	

Asset Class	--	-	=	+	++
Fixed Income					
IG Credit		■			
US High Yield			■		
European High Yield			■		
EM Sovereign Debt HC			■		
EM Sovereign Debt LC			■		
US Treasuries		■			
US Inflation			■		
German Bunds		■			
EU Peripheral Bonds			■		
JGBs			■		
Commodities					
Gold			■		
Industrial Metals			■		

Source: MSIM GBaR team, as of 31 August 2021. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation, or specific needs of any individual investor.

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DAX: Deutscher Aktien Index represents 30 of Germany's largest blue chip companies.

FTSE 100: Financial Times Stock Exchange 100 Index represents the top 100 companies by market-cap listed on the London Stock Exchange.

MSCI Europe Index: The **MSCI Europe Index** captures large and mid-cap representation across 15 Developed Markets (DM) countries in Europe.

MSCI Japan Index: The MSCI Japan Index is designed to measure the performance of the large and mid-cap segments of the Japanese market.

MSCI All-Country World (ACWI) Index: The Morgan Stanley Capital International (MSCI) All Country World Index (ACWI) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

VIX®: This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

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