With Growth and Policy, Which Matters More: Level or Change?

Pandemic risks, persisting inflation pressures, and levels of growth and policy support are driving the economic outlook.

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The pandemic's path remains the key to the economic outlook, and what we've learned about it since last quarter is concerning: Additional variants are possible (and potentially more transmissible and virulent), vaccine protection could wane over time, and a significant percentage of the population may remain unvaccinated. This new reality is reflected in reduced economic activity (**FIGURE 1**), the resurgence of growth stocks over value (as measured by Russell 1000 Growth Index[1] vs. Russell 1000 Value Index[2]), and a return to record lows in long-maturity yields. On a more positive note, growth is still strong, economies are unlikely to go back into lockdown, and stimulus remains supportive. All of this leaves markets caught between two narratives: The pace of growth seems poised to slow, but the level of growth is likely to remain above par.

Against this backdrop, we continue to seek a pro-risk stance over the next 6–12 months, preferring equities to bonds. But relative to last quarter, our optimism is tempered somewhat by a slight downgrade to our macro and policy outlook—including the potential for modestly slower growth, a slight reduction in policy support, and inflation that's more persistent than the market expects. Within equities, we prefer Europe, which we continue to believe is on the cusp of economic outperformance, and we have reduced our emerging market (EM) view to neutral given the high costs of COVID-19, high inflation, and political volatility. We remain moderately bearish on government bonds in Europe in particular, as yields seem too low given our macro forecast. Credit spreads[3] are generally rich, but we find some value in bank loans and EM debt.

FIGURE 1
Delta Variant Causes Services to Dip
Travelers passing through US TSA checkpoints (millions per day)

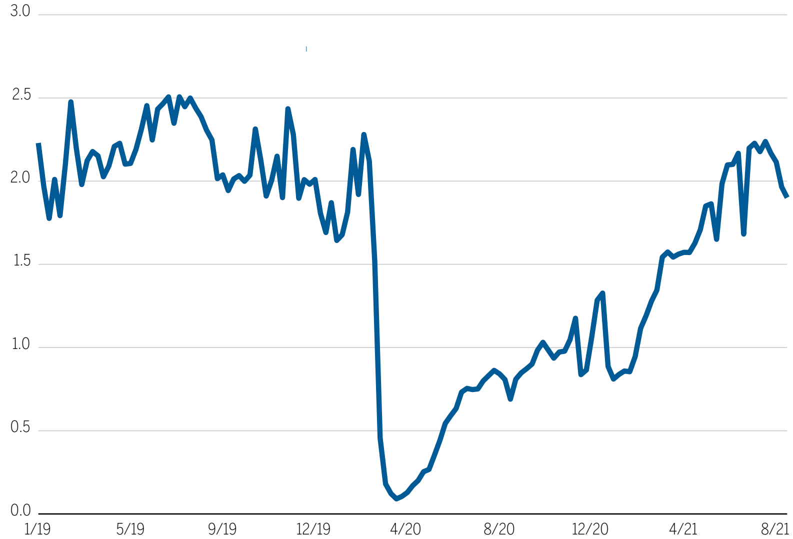


Chart data: 1/6/19–8/29/21. Source: Bloomberg.

Key Points

- The level of growth and the level of policy support remain supportive but have declined marginally, leaving us pro-risk but less so.
- Within equities, we prefer Europe, where economic fundamentals are improving and German elections may pave the way for stronger fiscal stimulus.
- Inflation pressures are likely to persist, and commodities may benefit.
- Interest rates are vulnerable to higher or more persistent inflation.
- Downside risks include a spike in interest rates, COVID-related lockdowns, or a policy mistake. Upside risks include a lift in inflation-capping productivity or a broader and more sustainable reopening than expected.

[1] Russell 1000 Growth Index is an unmanaged index which measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.
[2] Russell 1000 Value Index is an unmanaged index measuring the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values. Indices are unmanaged and not available for direct investment.
[3] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

We have been advocating value-oriented exposure from a sector, market-cap, and regional perspective. However, given the slightly less favorable fundamental and policy backdrop, we think asset allocators should be more balanced between growth and value. We continue to think commodities are supported by our inflation outlook, and we favor energy and industrial metals, which have historically been more sensitive to rising inflation than equities and can potentially help hedge against a rise in interest rates.

Equities: Optimistic on Europe

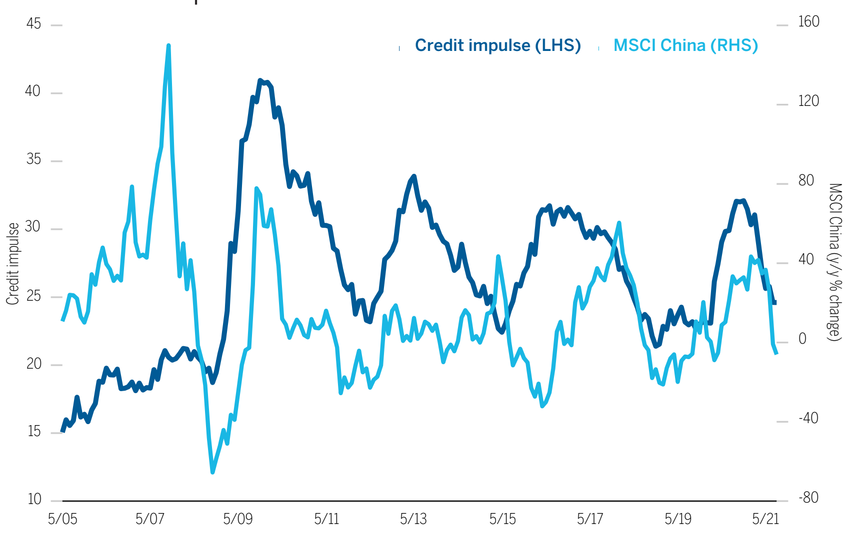
We are moderately bullish on European equities due to attractive valuations, the sharp increase in vaccinations, and high savings levels, which should allow for more robust spending if consumer confidence increases as we expect. We are also optimistic that Germany's elections this fall could lead to a more supportive fiscal environment and one that may influence the broader European stance. While Europe has evaded the Delta variant's wrath better than the US thanks to higher vaccination rates, we are wary of the variant's unpredictability and the potential for further spread on the continent.

We've downgraded our view on EM equities to neutral as many countries are experiencing expanding fiscal deficits and high inflation, and central-bank rate hikes could slow domestic economies. Pockets of value persist among commodity exporters and countries less dependent on tourism, but differentiation is key. We would be selective in China given potential weakness in the cycle and uncertainty related to the government's regulatory push and deleveraging in the property industry (**FIGURE 2**). Within Asia, we are neutral on Japanese equities. We see tailwinds from cheap valuations and Prime Minister Suga's resignation, which should bode well for the business-friendly Liberal Democratic Party. But we are concerned about China's slowdown, which may feed through to the broader region.

FIGURE 2

Credit Clampdown Is Slowing China

China's credit impulse and MSCI China Index



Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. Credit impulse is the change in new credit issued (the flow of credit) as a percentage of GDP. MSCI China Index is a free-float adjusted market-capitalization index that is designed to measure equity market performance in China. Source: Bloomberg, chart data: May 2005–August 2021.

We maintain a neutral view on the US. We think the US economy will slow somewhat but stay strong, and consumers are in great shape. While policy support is slowly declining, it remains highly supportive. Indeed, the Federal Reserve (Fed) seems convinced that inflation expectations will remain anchored at low levels even as

Our Multi-Asset Views

Asset class	View	Change
Developed market equities	**Moderately bullish**	—
US	Neutral	—
Europe	Moderately bullish	⬇
Japan	Neutral	—
Emerging market equities	**Neutral**	⬇
10-year rates	**Moderately bearish**	—
US	Moderately bearish	⬇
Europe	Moderately bearish	⬆
Japan	Neutral	—
Credit	**Neutral**	—
Investment-grade	Moderately bearish	—
High yield	Moderately bearish	—
Bank loans	Moderately bullish	—
Emerging market debt (external)	Moderately bullish	—
Securitized assets	Neutral	—
Commodities	Moderately bullish	—

Views have a 6–12 month horizon and are those of the authors and Wellington Management's Investment Strategy Team. Views are as of September 2021, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

it keeps its foot on the stimulus pedal. Our view is that inflation could be more persistent than expected, given challenging supply shortages, rising wages, and a hot housing market, which tends to lead to sticky shelter inflation. Higher, more persistent inflation could unsettle equity markets, and valuations are expensive. Thus, we prefer a quality bias and a balance between growth and value.

Commodities: Strong Fundamentals and a Unique Portfolio Role

We are bullish on commodities given the inflation dynamics discussed, as well as supply/demand imbalances across energy, metals, and agriculture. Capital expenditures have been very weak for the past decade following a free-spending period focused on growth rather than profitability. More structurally, environmental concerns are feeding into higher costs and potentially lower supply. Our research shows that commodities have historically been the only asset with a materially positive beta[4] to inflation, so from a portfolio-construction standpoint, we see a case for at least some commodities exposure.

Low Rates, Tight Spreads: What to Do in Fixed Income?

We agree with market consensus that the Fed may likely begin tapering around year end. We see the European Central Bank (ECB) as more hawkish relative to the nominal growth picture in its economy, and we think sovereign rates in Europe are likely to drift upward. In credit, valuations are rich, with most spreads well inside of median levels. However, defaults are likely to stay very low, and demand technicals are strong as demographics and pensions generate huge demand for yield.

Within credit, we prefer EM debt to US high yield as EM spreads are considerably wider (**FIGURE 3**). Credit valuations have been a reliable indicator of forward excess returns—a dynamic we continue to trust. We think Mexico, Russia, and EM countries in Central and Eastern Europe are attractive. We also prefer bank loans, which offer attractive valuations vs. US high yield and could benefit from the Fed beginning to tighten.

We find securitized credit attractive relative to investment-grade corporates from a valuation and risk perspective, given the abundance of asset types. We continue to favor US residential housing, where millennials should be a growing tailwind for demand. Securitized credit also offers floating-rate structures, which are appealing from a duration[5] perspective. The updated risk factors adopted by the National Association of Insurance Commissioners may increase demand for AAA- and AA-rated bonds.

[4] Beta is a measure of risk that indicates the price sensitivity of a security or a portfolio relative to a specified market index or inflation.

[5] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

FIGURE 3

EM Debt Looks Cheap Relative to High Yield

EM debt spread vs. US high-yield spread

Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. Bloomberg EM Debt Index option-adjusted spread (OAS) to Treasury, Bloomberg US High Yield Corporate Index OAS to Treasury. Bloomberg EM Debt Index is an unmanaged index that tracks total returns for external-currency-denominated debt instruments of the emerging markets. An OAS (Option-Adjusted Spread) is a measurement tool for evaluating yield differences between similar-maturity fixed-income products with different embedded options. Bloomberg US High Yield Corporate Bond Index is an unmanaged broad-based market-value weighted index that tracks the total return performance of non-investment grade, fixed-rate publicly placed, dollar-denominated, and nonconvertible debt registered with the Securities and Exchange Commission. Source: Bloomberg, chart data: 9/19/19–9/3/21.

Risks

Our base case is that central banks have clearly communicated their intentions to taper slowly, but a policy mistake remains a risk given the amount of liquidity in the system and its importance to markets. Bumps could occur if the Fed or ECB are perceived to be too hawkish, or if their plans don't change quickly enough in the face of a new variant or other COVID surprise.

COVID remains the boogeyman. Its impact on consumer preferences (more saving/ less spending) could last longer than expected. And with more than five billion people unvaccinated worldwide, the potential for new, more dangerous variants requires investors to stay nimble and monitor portfolio risks carefully.

In addition, China's opaque system is difficult to analyze, and government priorities aren't easy to infer. Although not our base case, China's renewed focus on socializing wealth via regulations could continue or even increase. China's housing market and debt levels are also concerns, as highlighted by Evergrande's recent turmoil.

On the upside, two major market drivers, the Delta variant and China's regulatory approach, could both ease in the coming months. EMs could benefit if China's policymakers temper their tightening of the property market, boost infrastructure spending, and loosen climate controls—moves that could be spurred by politics ahead of the National Congress in November 2022.

Markets may also be positively surprised by the patience of central banks and find themselves awash in liquidity for several more quarters to come. Interest rates may stay low for an extended period, despite the economic recovery, and risk assets[6] could appreciate further.

Finally, our inflation concerns may be ameliorated by a pickup in productivity, something that many economic models predict and that could be boosted by government spending on traditional and technological infrastructure after many years of underinvestment.

About the Authors

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[6] Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

Investment Implications

- **Consider sticking with European equities** — Europe's economy could likely emerge from the Delta surge first and with higher vaccination rates than other regions, including the US. Politics also seem to be at a tipping point with Chancellor Angela Merkel's term ending and other German parties intent on loosening fiscal constraints. We believe asset allocators may find yield, quality, and cyclicality in Europe at more attractive valuations than in the US, particularly in industrials and banks.
- **Get more selective in credit** — Most spreads are rich, but we don't see a catalyst for them widening much. We see the best risk/reward potential in sectors such as bank loans, collateralized loan obligations, and residential-housing-oriented structured credit. We think select EM sovereign and EM corporate debt opportunities could also offer better upside potential from a spread perspective than US corporates and high yield.
- **Seek potential inflation protection with commodities** — Inflation may reach higher levels or be more persistent than many asset allocators expect. While value-oriented equities may provide some protection, commodities (excluding precious metals) have historically been the most inflation-sensitive asset class.
- **Maintain fixed income for diversification** — While our views tilt toward an economic recovery, we think it's still prudent to consider an allocation to high-quality bonds in case of a sharp equity sell-off. A global fixed-income universe gives investors more opportunity to add value. We think municipal bonds can play a strategic role for taxable investors, especially given the trend toward greater federal spending. Precious metals and option strategies may provide additional ways to supplement bond exposure.

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