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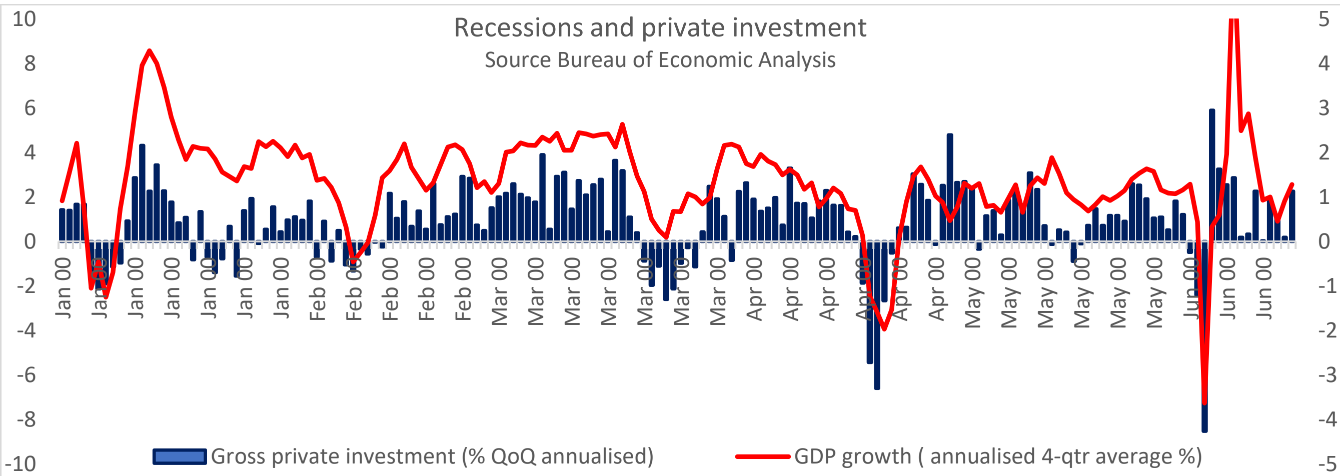
31st July 2023

"it would be a mistake for central bankers to take comfort in the notion that inflation and rates will automatically go back to the low levels we saw before the pandemic".
Megan Greene writing in the FT on July 3rd before joining the BoE's MPC

The tightening of monetary policy by central banks of the advanced economies has so far failed to bring growth to its knees, and the recession that was widely predicted has been postponed once again. Powell disclosed in his press conference that even the Fed staff that had earlier projected a US recession had changed their minds, and no longer expect a significant slowdown this year. Declining inflation is raising consumers' purchasing power which will help sustain spending and maintain the demand for labour. The longer-term issue is that service sector inflation will become the dominant problem once the declines in goods and energy prices that are pulling headline inflation lower have run their course.

US data last week showed growth accelerating from a 2% annualised rate in Q1 to 2.4% in Q2 with little distortion from inventory changes and net trade, leaving the average annualised growth rate over the past four quarters at 2.6%. Gross private investment surged at a 7.7% rate, spurred by federal tax incentives and subsidies in President Biden's Inflation Reduction Act and his Chips Act. Recessions rarely occur without a decline in private investment, and this second quarter surge shows how wrong many analysts have been with their dire predictions.



Friday's release of June US personal income and spending data reflected solid gains in real personal income. Private sector wages and salaries are still growing a strong pace while headline PCE inflation had slowed from 3.8% to 3%, leaving consumers with greater discretionary spending power.

Real personal spending jumped .4% in June, exceeding estimates by a tenth with an upward revision to May, as the quarter ended with healthy momentum in consumption and income. The only crumb of comfort for a Fed attempting to slow the economy and bring inflation back to target was a core rate of PCE inflation that slowed to 4.1% against estimates of 4.2%, but these data would have already been included in Thursday's second quarter growth and consumption estimates.

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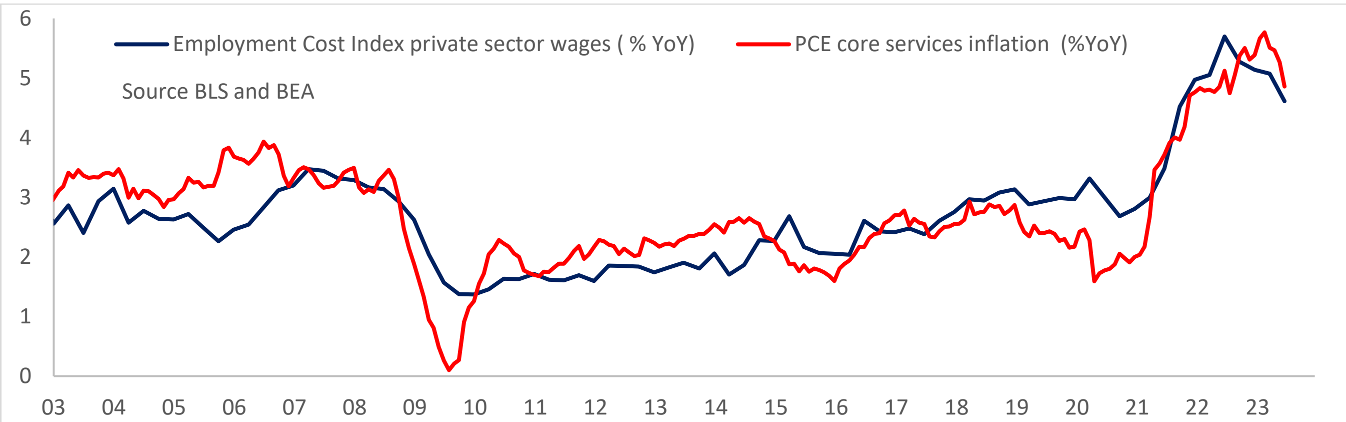
The Quarterly Employment Cost Index was also released on Friday, which the Fed views as the most comprehensive measure of pay and benefits, free from the distortions of a changing mix of workers in the sample. Compensation costs for civilian workers increased 1% in the three months to June – a slightly slower pace than estimated- to bring the year over year increase down from 5.1% to 4.5%. Growth in private sector wages and salaries slowed from 5% to 4.6%, and while the Fed will welcome this progress, pay growth like this is still too fast to be consistent with the 2% inflation target.

Europe
Despite the depressing business surveys in the eurozone, the hard data releases show the eurozone keeping its head above water. First quarter growth was recently revised higher and showed the economy avoided a technical recession after all, following upward revisions to the volatile Irish data, but Friday's GDP releases from three of the big four economies painted another blurry picture of growth.



France produced a significant upside surprise with Q2 growth of .5%[1] compared with estimates of .1%, but it was boosted by a surge in exports. Net trade contributed .7% to the growth figure, offset by inventory changes and a decline in household consumption which each shaved a tenth from growth. Spain's economy shows continued solid momentum with quarterly GDP growth of .4% that matched estimates, but German GDP was flat against estimates for a .1% quarterly increase.

Friday's national HICP inflation releases for June were also mixed. Headline inflation in France slowed to 5% and in Germany it fell from 6.8% to 6.5%, with both a tenth below estimates. Spanish inflation unexpectedly rebounded to 2.1% - a huge half a percent above estimates – although none of these countries report the core rates of HICP inflation, which the ECB will mostly be focussing on when the eurozone figure is released later today.

Inflation in many Eastern European states is still in double digits, and Governing Council members Simkus of Lithuania, Vasle of Slovenia and Kazimir of Slovakia spoke on Friday to dampen hopes for a pause at the next ECB meeting. The battle lines between the hawks and doves on the are hardening ahead of the

[1] Note that EU growth figures are quarter on quarter rather than the annualised quarterly rate which is quoted for US growth – so .5% quarterly growth is just over 2% annualised.

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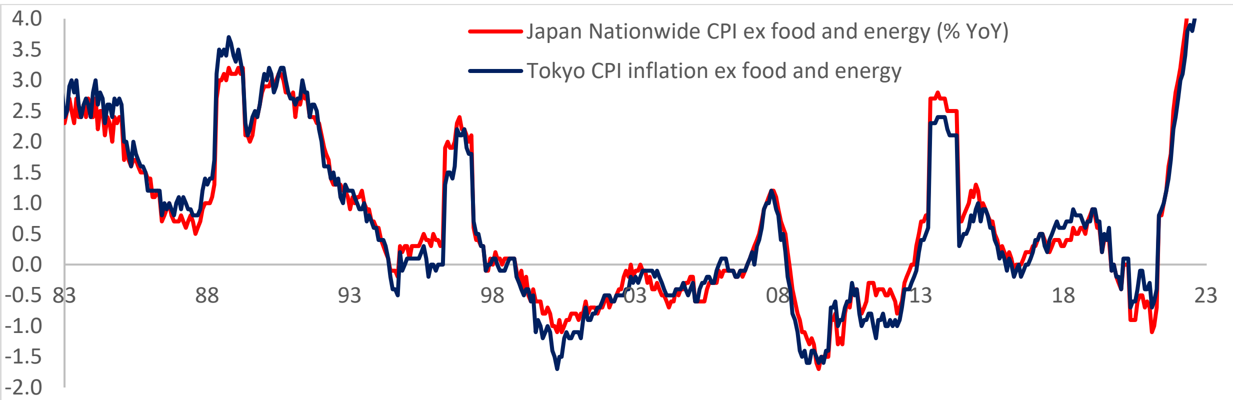
September meeting, but the doves currently have the upper hand, with rates markets on Friday lowering the odds of a further hike to less than 50%.

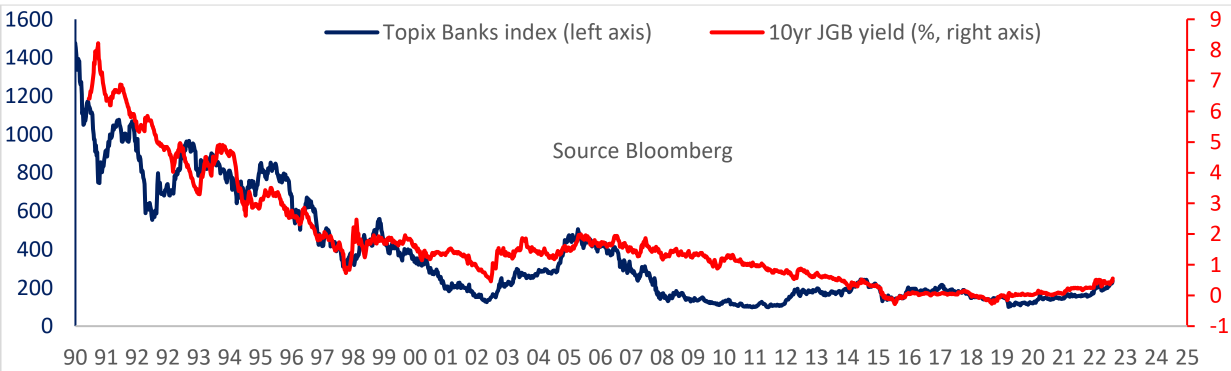
Japan

The BoJ played down its decision on Friday, limiting the market reaction to what likely marks its first step after ten years of QE towards policy normalisation. The central bank downgraded its former .5% YCC limit to a "*reference*" rather than a "*rigid limit*", with a pledge to support ten-year JGBs if necessary, with purchases at a yield of 1%. The overnight rate was left at negative .1% and the target 10-year bond yield at zero, but with the BoJ no longer stepping in to support the JGBs at a .5% yield, the market will likely test the new effective cap at 1%.

The BoJ also upgraded its inflation outlook for this year from 1.8% to 2.5% and warned of upside risks to next year's forecast of 1.9%. On the same day, July Tokyo CPI inflation – which provides a reliable guide to the national rate due for release in 3 weeks – printed three tenths above estimates at 3.2%. The core rate excluding food and energy accelerated to 4% - also 3 tenths above estimates and ***the highest in over forty years***.



Friday's events should have rung alarm bells, but the market bought Ueda's claim that "*This isn't a step toward normalization*". The yield on the ten-year JGB closed just 12 bps higher at .57% and the Nikkei-225 slipped .4%, while after a brief period of intense volatility, the yen surprisingly closed 1.2% weaker against the dollar. The TOPIX Banks index jumped 4.6% on the day, but viewed from a longer-term perspective, it marks a small step on the path towards recovery from three decades of crushed interest margins.



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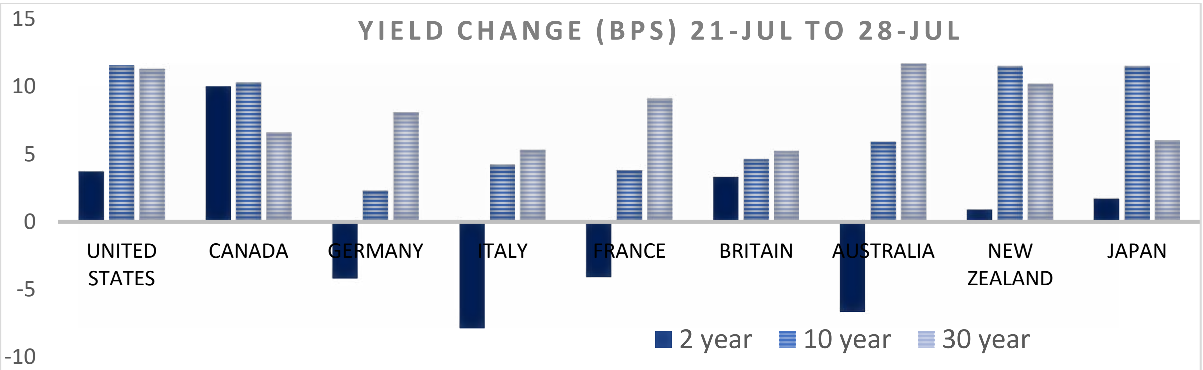
UK

There were no major economic releases from the UK last week, and by now most of the MPC would have seen enough evidence of strong pay growth in a tight labour market to pull the trigger on another hike. Meghan Greene has now replaced Silvana Tenreyro who voted against hiking at almost every meeting she attended, and markets are priced for at least 25bps, with a roughly 13% probability of 50bps.

Markets

The SuperMacro portfolio first went short of treasury futures in the summer of 2021 when the yield on the ten-year note was less than 1.3%. The position was leveraged up to five times the portfolio capital and reduced to zero on occasion, but the expectation has always been that the post GFC era of zero rates and flattened yield curves will not return. The events of last week could mark a major new chapter in this transition, with what may have been the final hikes by the Fed and ECB in this cycle while the BoJ made its first, tentative, tightening move.

Yield curves steepened across the G7 as the market reduced the odds of further hikes from the ECB, keeping rates at the front end stable/lower, while the long end took the strain from fading recession fears.



Tighter Fed policies have so far had far less effect on consumers and businesses than many expected. Adjustable-Rate Mortgages are a thing of the past and most homeowners with mortgages are paying a fixed rate less than 4%. Nonfinancial corporates are less leveraged, and credit spreads are approaching the lows of the past two decades. With equities closing in on their highs and credit so well-behaved, the Chicago Fed Financial Conditions index is near its lowest point in 16 months, suggesting much of the Fed's tightening has had less economic impact than during previous cycles.

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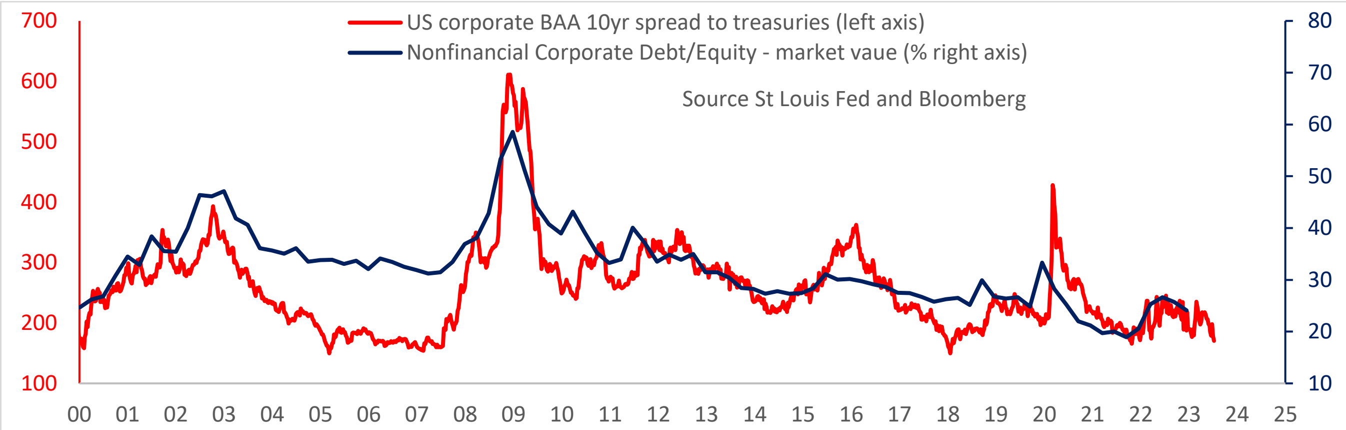
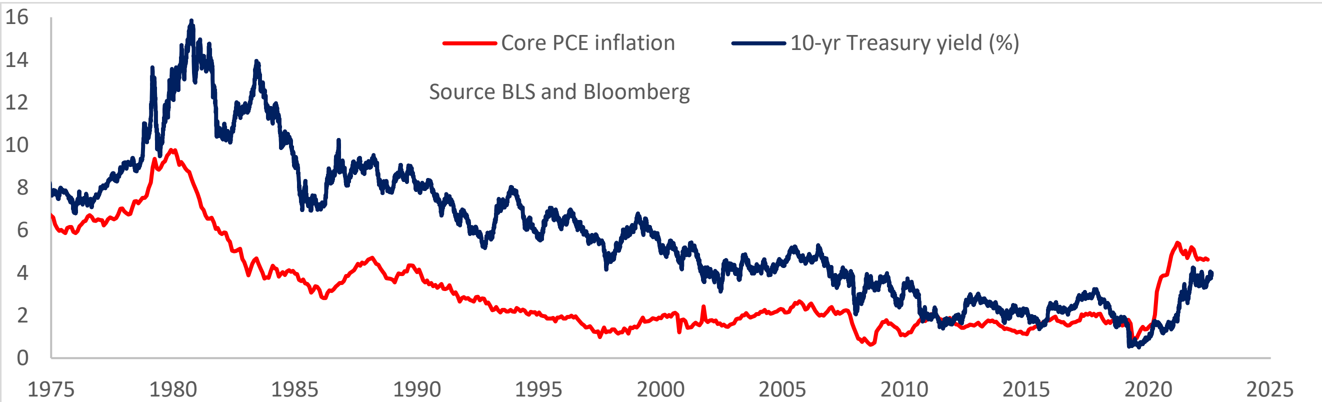


US consumption growth is now being supported by real income gains, a remaining stock of excess savings, and a wealth effect from buoyant asset markets. Companies faced with higher wage bills have pricing power to preserve margins from continued strong demand, raising the risk of a higher structural level of inflation. The expected rate cuts that are priced into fixed income markets may take a lot longer to arrive, and the long end of yield curve is at risk from breaking higher. Prior to the Financial Crisis, the ten-year treasury yield traded several percentage points above the level of core PCE inflation, and that term premium could make a comeback.



The ten-year treasury yield last week hit its high of 4.04% soon after the BoJ announcement on concerns the upward pressure on Japanese yields would force some unwinding of relative value trades. Investors could only dream of locking in a yield much higher than 3% in the period from the GFC till last year, and any time it has traded above 4% since has been met with a wave of buying that drove the yield lower again. With the US economy and its labour market showing surprising resilience, the BoJ policy change may be the catalyst that finally puts the ten-year treasury yield on a new big figure.

SuperMacro has been wrong about the impact that higher rates would have on the S&P 500, and the relentless rally of the Super-7 large cap tech stocks has been unstoppable. Since the start of this month when all but two have reported earnings (Apple and Amazon are due this week) three have made double-digit gains and contributed roughly a third of this month’s 3.1% index return.

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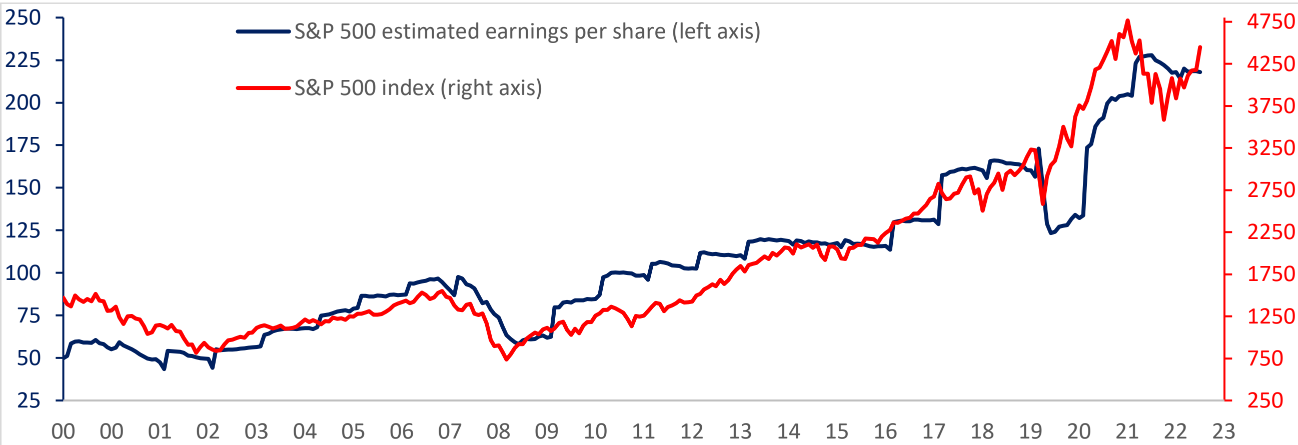
Ticker	Name	Est. PE	Mkt Cap ($bn) 30-Jun	Mkt Cap ($bn) 28-Jul	price 30-Jun	price 28-Jul	price move	mkt cap chng ($bn)
AAPL US	APPLE INC	31	3,051	3,089	194.0	196.4	1.3%	38
MSFT US	MICROSOFT CORP	31	2,532	2,520	340.5	339.1	-0.4%	-12
GOOG US	ALPHABET INC-CL C	20	1,528	1,687	121.0	134.0	10.7%	159
AMZN US	AMAZON.COM INC	43	1,338	1,363	130.4	132.8	1.9%	25
NVDA US	NVIDIA CORP	50	1,045	1,158	423.0	469.2	10.9%	113
TSLA US	TESLA INC	69	830	846	261.8	266.7	1.9%	17
META US	META PLATFORMS INC-C	21	735	836	287.0	324.8	13.2%	100
NFLX US	NETFLIX INC	31	196	189	440.5	426.4	-3.2%	-7
			11,254	11,688				434

Half the stocks in the S&P 500 have now reported Q2 earnings with the average sales per share exceeding estimates by just 1.7% - the lowest sales beat in over two years. Earnings per share are running 5.9% above estimates that were sharply lowered, and according to FactSet, the quarter-on-quarter decline in earnings is likely to be -7.3%. Equity investors are driving multiples higher on the prospect of sustained economic growth and a central bank that may soon be easing.



There is little point standing in the way of this freight train when options are so cheap. Single stock realised volatility is not low, but correlation has plunged, depressing one-month realised index volatility into single-digits and dragging implied volatility towards lows that rarely last long.

Portfolio Update

As discussed last week, the remaining short S&P 500 futures position was closed out at a significant loss and replaced with regular August expiry puts. The Portfolio is up 95% since inception in June of 2021 but is down 4.45% for the year to date. The closed-out trades have lost 12.35%, with over 11% of that represented by the S&P short, while the live trades are up 7.9%.

We have been wrong to stick with Value this year by holding the FTSE-100 position on a hedged basis, but the FTSE continues to plod along making steady returns and we need protection against a reversal of the S&P. The August puts are doing a fine job by losing a lot less than an outright futures position would have last week, but at some point, the strikes will need to be rolled higher.

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Over the next week, we will look to increase the size of the treasury short if we can acquire upside protection at a reasonable price ahead of this Friday's payrolls.

This week's macro agenda

Monday 31st
China official manufacturing and services PMIs July
Japan retail sales June, industrial production June
Italy and EU Q2 GDP, Italy and EU CPI July, Germany retail sales June
UK consumer credit and mortgage approvals June
US Chicago manufacturing PMI July, Dallas Fed manufacturing index July, Fed Senior Loan Officer Opinion Survey Q2

Tuesday 1st
China Caixin manufacturing and services PMIs July
Japan jobless rate and jobs-to-applicant ratio June
UK Nationwide house price index July
Germany unemployment July, Italy and EU unemployment June, Italy and Spain HCOB manufacturing PMI July
US ISM manufacturing index July

Wednesday 2nd
US ADP employment change July, MBA weekly mortgage applications

Thursday 3rd
Germany trade balance June, Italy and Spain HCOB services and composite PMIs July and final EU July composite PMI, Italy retail sales June
UK BoE Bank Rate decision
US ISM services index July, Q2 unit labour costs and nonfarm productivity, weekly initial and continuing claims

Friday 28th
Germany factory orders June, France and Italy industrial production June EU retail sales June
UK new car registrations July
US nonfarm payrolls and average hourly earnings July

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LARGE CAP ($>70bn) EARNINGS CALENDAR

Date		Ticker	Name	USD Mkt Cap		EPS Est	Time
1/8/23	GBp	HSBA LN	HSBC HOLDINGS PLC	**164,033**		0.56	05:00
1/8/23	JPY	7203 JP	TOYOTA MOTOR CORP	**266,979**		55.50	05:25
1/8/23	JPY	8306 JP	MITSUBISHI UFJ FINAN	93,655		31.22	08:00
1/8/23	USD	CAT US	CATERPILLAR INC	**134,214**		4.54	11:30
1/8/23	USD	MRK US	MERCK & CO. INC.	**269,831**	-	2.20	Bef-mkt
1/8/23	USD	PFE US	PFIZER INC	**203,626**		0.59	Bef-mkt
1/8/23	GBp	BP/ LN	BP PLC	**105,761**		-	Bef-mkt
1/8/23	GBp	DGE LN	DIAGEO PLC	99,151		1.65	Bef-mkt
1/8/23	USD	MO US	ALTRIA GROUP INC	81,201		1.30	12:00
1/8/23	USD	AMD US	ADVANCED MICRO DEVIC	**181,906**		0.57	Aft-mkt
1/8/23	USD	SBUX US	STARBUCKS CORP	**116,073**		0.95	Aft-mkt
2/8/23	USD	CVS US	CVS HEALTH CORP	95,652		2.11	Bef-mkt
2/8/23	USD	QCOM US	QUALCOMM INC	**144,241**		1.81	Aft-mkt
2/8/23	USD	PYPL US	PAYPAL HOLDINGS INC	82,541		1.17	Aft-mkt
3/8/23	EUR	ABI BB	ANHEUSER-BUSCH INBEV	**119,055**		1.34	06:00
3/8/23	JPY	8058 JP	MITSUBISHI CORP	71,975		146.87	06:00
3/8/23	EUR	CS FP	AXA SA	71,216		1.80	06:00
3/8/23	EUR	BMW GR	BAYERISCHE MOTOREN W	77,334		4.39	06:30
3/8/23	USD	COP US	CONOCOPHILLIPS	**140,493**		1.93	Bef-mkt
3/8/23	USD	SO US	SOUTHERN CO/THE	78,971		0.75	12:30
3/8/23	USD	AAPL US	APPLE INC	**3,080,152**		1.20	Aft-mkt
3/8/23	USD	AMZN US	AMAZON.COM INC	**1,356,521**		0.35	Aft-mkt
3/8/23	USD	AMGN US	AMGEN INC	**126,299**		4.48	Aft-mkt
3/8/23	USD	GILD US	GILEAD SCIENCES INC	95,984		1.64	Aft-mkt
3/8/23	USD	BKNG US	BOOKING HOLDINGS INC	**111,253**		28.59	21:00
5/8/23	USD	BRK/A US	BERKSHIRE HATHAWAY I	**765,667**		5,552.76	Bef-mkt