newnormal **Insight**

A last hurrah for Dr Pangloss as investors ignore growing market risks

12 April 2021

The bulls were out in force over the Easter period, supported by the relatively low level of trading. But under the surface, problems are building with US tax hikes on the horizon – and major issuance of new Treasury bonds due in the next fortnight

Oil

Brent slipped to $63.05/bbl, after the brief bounce caused by the Suez Canal disruption

✦ HIGHLIGHTS

- Mainstream analysts have assumed that OPEC+'s decision to increase production means that demand is likely to see a significant increase
- But in reality, OPEC is responding to the combined impact of its budget deficits and political pressure from the USA for lower oil prices
- Oil demand remains very shaky as the lockdowns continue and vaccine rollouts disappoint in many oil-consuming countries
- US airline passenger numbers are still down 30% from 2019 levels, and European flight numbers are down 64%
- Meanwhile, OPEC's competitors are ramping up output in response to today's high prices, with the US rig count up 23% since New Year
- Refiners continue to struggle with low demand, with the UK's Stanlow refinery now looking for financial support

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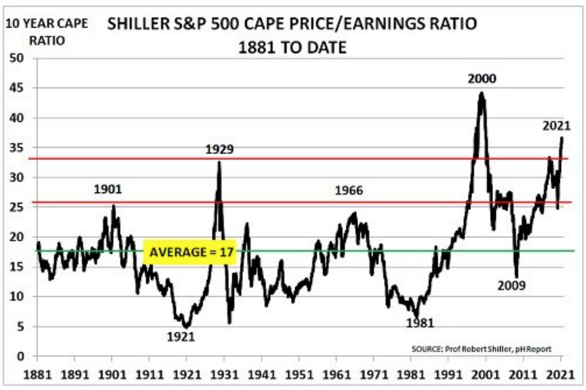
Continued weakness in demand to pressure oil producers and refiners

S&P 500

The S&P ended at an another record at 4129, with the VIX volatility index lower at 17.



✦ HIGHLIGHTS

- The S&P is now at its second-highest level in terms of Shiller's CAPE (Cyclically Adjusted Price/Earnings) ratio, with only the dot-com 2000 bubble period higher
- Upbeat outlooks from the IMF and JP Morgan cheered the market, with investors taking on record levels of margin to increase their leverage
- They chose to ignore news that Biden's proposed tax hikes would only require 50 votes in the Senate, denying the opportunity for filibuster
- Tech investors similarly ignored the growing global consensus on the need for a minimum tax rate, with the Nasdaq outperforming the S&P again
- Expectations for Q1 earnings buoyed sentiment, with investors hoping Q2 comparisons will be easy due to the impact of 2020's Q2 lockdown
- In essence, investors are choosing to focus on the obvious good news, and to ignore potential major downsides ahead

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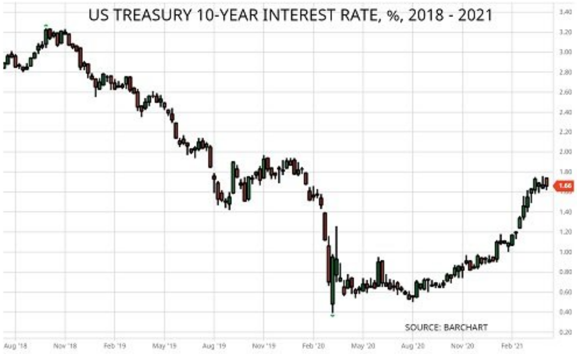
Tax policy and a return to rising bond yields to challenge markets' bullish mindset

Interest rates

The 10-year rate closed slightly lower at 1.66%, with the MOVE volatility index stable at 61.



✦ HIGHLIGHTS

- ✦ The Easter period was relatively quiet in terms of new bond issuance
- ✦ But a flood of new Treasury bonds is due in the next two weeks
- ✦ Today sees $38bn of 10-yrs and $58bn of 3-yrs, followed by $24bn of 30-yrs on Tuesday
- ✦ Next week sees $183bn of total issuance: $60bn of 2-yrs, $61bn of 5-yrs and $62bn 7-yrs
- ✦ One warning sign for market sentiment was the 48% decline in purchases of Investment Grade corporate bonds, suggesting rising concern amongst individual investors

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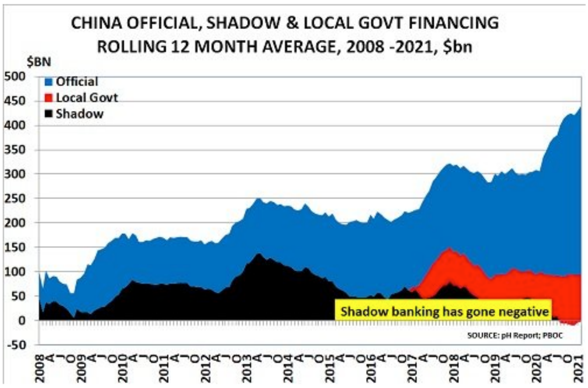
The scale of new issuance to restore upward pressure on yields, supported by inflation data vs low comparators in Q220

China

The IMF has increased its China GDP growth forecast for 2021 to 8.4%, assuming the government will allow a major increase in shadow bank loans to support the SME sector.



✦ HIGHLIGHTS

- ✦ An alternative view circulating in Beijing suggests momentum from last year's recovery will provide the government with an opportunity to rebalance the economy
- ✦ There are already signs the government is starting to cut credit growth in a robust way;
- ✦ The important SME sector (which employs 200m people) is heavily dependent on government support from tax exemptions, rent cuts and one-off loans
- ✦ Companies have also relied on the so-called shadow banking sector, which is slowing sharply
- ✦ They seem likely to struggle if credit tightens, even though the large State Owned Enterprises will still obtain the credit they need from state banks
- ✦ Consumer demand remains weaker than pre-Covid, and so today's cost increases and credit cuts will lead to severe cash-flow constraints for many SMEs.

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An "unexpected" slowdown in GDP as as SME's struggle to adjust to the new lending rules

Summary

Holiday periods rarely provide accurate readings of market conditions, as trading volumes reduce. The next 2 weeks will provide a more realistic view of underlying sentiment.

	Oil	S&P 500	Interest rates
Market view today	Some concerns	All news is good news	Expecting inflation
Our current view	Negative	Reversion to mean inevitable	Expect long-term deflation
Positioning began	March 2021	March 2021	December 2020
Confidence level			
Initial			
Today			
Relevant positioning	Reality starting to dawn	Waiting for reality to dawn	Expecting higher rates for the 10-year and longer-dated Treasuries

Confidence level: = 100%, = 75%, = 50%, = 25%

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