June 2021

BUDGET WARS

Key macro themes

Expenditure shifts – The US economy is benefiting from rising mobility, improving confidence and high excess savings. Yet despite stronger consumption, **demand for contact services remains 15% below its pre-COVID trend**. We expect improved safety perceptions (F1) to boost the expenditure share allocated to away-from-home services.

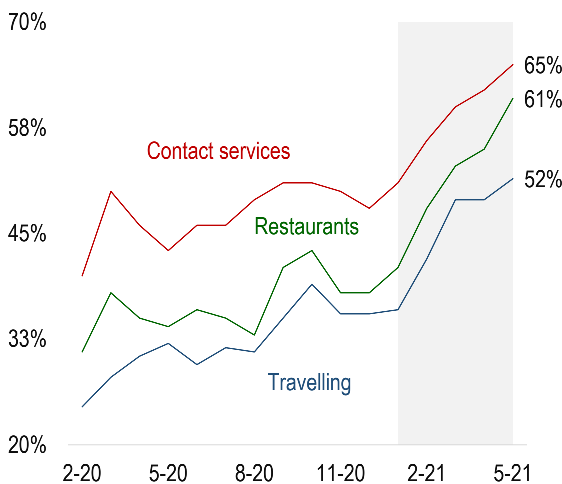
Inflation – A normalization in budget shares has important implications for the inflation outlook. Substitution towards AfH services will make it easier for producers in 'flexible' industries to satisfy consumer needs, mitigating supply-demand imbalances. **This increases the likelihood of a transitory spike in inflation**, as currently expected by financial markets (F2).

Investment strategy

Tech vs. reopening – Technology stocks outperformed in June, benefiting from a sizeable drop in long-term interest rates. **We expect the tech rally to prove short-lived**, as strong growth, falling health risks and above-target inflation benefit reopening stocks and deep cyclicals. Similarly, we continue to favour 'value' over 'growth' strategies.

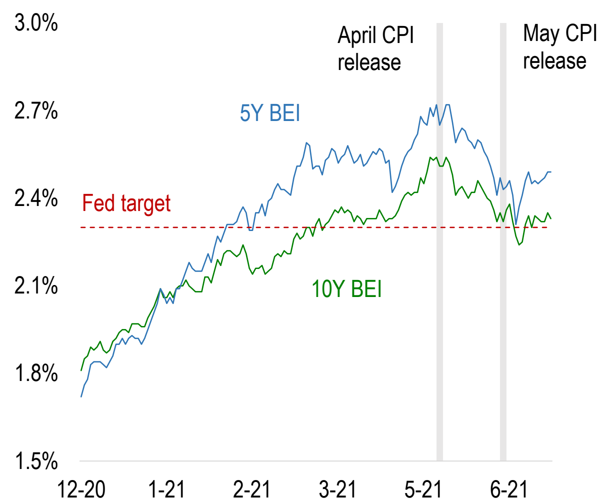
Charts of the month

F1: Vaccines reducing health concerns
Safety perceptions on AfH activities



Note: The chart shows the % of individuals feeling safe in conducted selected away-from-home (AfH) activies. Source: Deloitte Global State of the Consumer Tracker.

F2: Long-term inflation beliefs normalizing
US 5Y and 10Y break-even inflation (BEI)



Note: Break-even inflation is the average CPI inflation rate expected by financial markets over a given forecast horizon (e.g. 10Y). Source: Macrobond.

Economic activity:

- **Growth** – *Reflation*. A high vaccine coverage, rapidly improving confidence and high personal savings all support the recovery in consumption. Growth should accelerate during the summer months, eliminating the output gap by Q3/20 and expanding 7%+ in 2021. There is a 70% chance that the US will outpace other DMs this year.

- **Inflation** – *Rising*. Inflation hit a multi-decade high in May, reflecting soaring gasoline prices and supply constraints in goods-producing sectors (see F7). The most likely outcome is for PCE inflation to exceed 3.5% this year, but limited wage pressures and anchored inflation expectations limit the risk of an inflationary spiral.

- **Fed policy** – *Expansionary*.Fed officials surprised markets by signaling a faster-than-expected normalization of monetary policy. The FOMC's latest projections match our views on the US economy. Specifically, we currently expect one rate hike in H1/22 and a second one two-years out, but a prolonged hiking cycle remains unlikely.

Equity strategy:

- **Stock market** – *Overweight*. Strong growth boosts the risk-reward balance for US stocks, even as high inflation creates uncertainty over Fed policy. Given still weak employment levels, we expect a single rate hike over the next 12M. While the policy shift could weigh on valuations, higher yields should be more than offset by strong earnings.

- **Sectors** – *Overweight value*. Although falling long-term yields caused tech stocks to outperform this past month, reopening sectors and late cyclicals should regain the upper hand over the next 12M. Similarly, above-target inflation and strong GDP growth should favour 'value' investments over 'growth' stocks during this period.

Bond strategy:

- **Treasuries** – *Underweight*. 10Y yields are down 30 bps since hitting 1.75% in March. Stronger demand for long-dated bonds has pushed prices above their 'fair' value, weakening their appeal in a context of strong growth and inflation. We expect bonds to underperform, and recommend favouring golds and TIPS in balanced portfolios.

- **Corporate bonds** – *Neutral*. Strong growth reduces the likelihood of defaults, in turn improving the risk-reward balance of corporate bonds versus sovereign debt. Nevertheless, a high probability of above-target inflation over the next 12M increases downside risk versus earlier in the pandemic, calling for a prudent absolute stance.

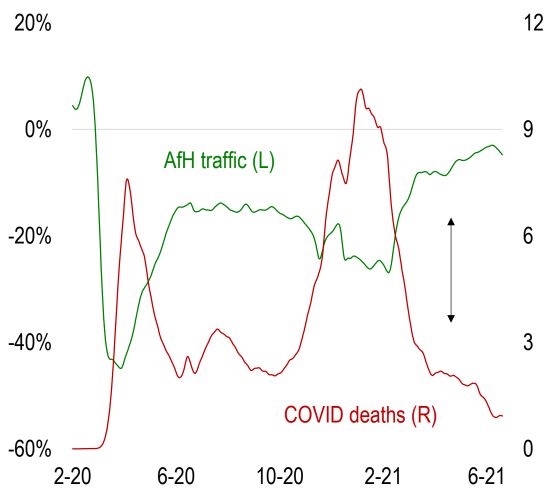
In this section:

- Will consumer expenditure patterns normalize? (p. 3–5)
- Expenditure shifts and the inflation outlook (p. 5)

A new normal? – Despite a weak May reading, US consumer spending is up 6% since December, nearly eliminating last year's unprecedented expenditure shortfall. The recovery in consumption reflects a variety of mutually reinforcing forces. Perhaps most importantly, the rapid initial vaccine rollout – and subsequent drop in deaths and hospitalizations – has **increased households' willingness to engage in away-from-home activities** (see F3 below).

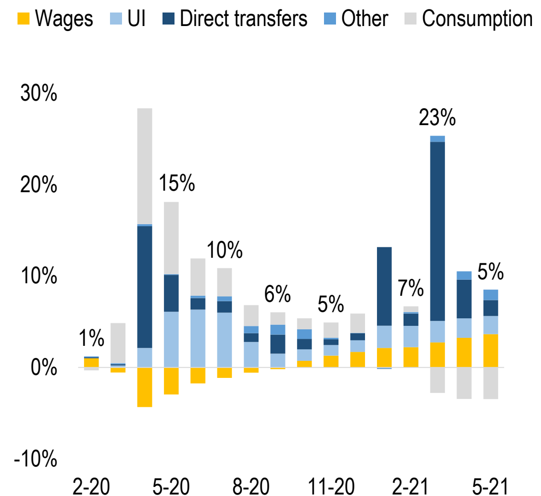
The high vaccine coverage has also boosted confidence and reduced economic uncertainty, increasing the propensity to spend. Importantly, rising confidence also amplifies the multiplier effect of one-time government transfers. Stimulus checks often have a limited impact on consumption, since recipients use most of these funds to repay debts or build precautionary savings. Currently, the combination of rising confidence and postponed purchases makes households much more willing to allocate a reasonably high portion of this 'extra' income to consumption.

F3: Rising mobility boosting consumption
AfH traffic vs. daily COVID deaths



Note: Chart plots change in retail and recreation traffic (vs. 01/20) against daily COVID deaths per million people. Source: Google Mobility, WHO; Numera calculations.

F4: Still significant upside to spending
Excess savings by source (% GDP)

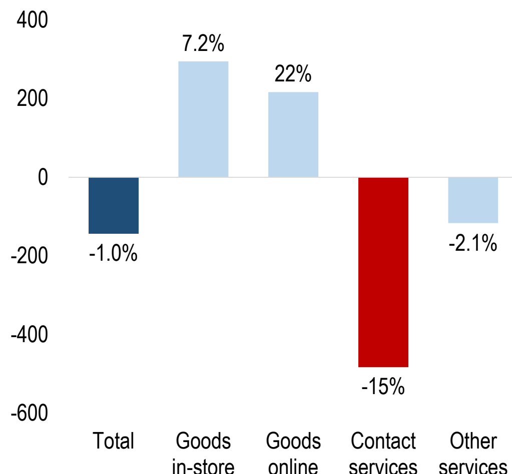


Note: Difference in personal savings versus 01/20 (as a % of GDP). Bars break down the change by income / expenditure source. Source: BEA; Numera calculations.

Although the Delta variant could result in a third wave of infections, a high (mRNA) vaccine coverage makes it unlikely for critical cases to rise sharply. In this context, **spending should keep strengthening** – especially given still high excess savings. US households hold an additional $1T in unspent income, about 5% of GDP (F4). Even if only 15% of this amount were spent, this alone would push spending back to pre-COVID levels.

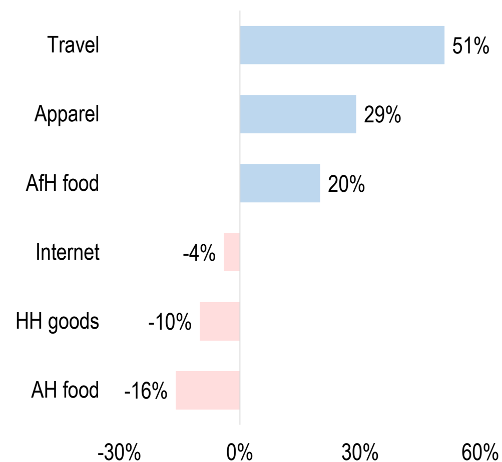
While total consumption should fully recover, a far more contentious question is whether falling health risks will result in a normalization in expenditure patterns. So far, the combination of social distancing and ample income support

F5: Extreme differences across segments
Consumption shortfall by category - 05/21



Note: Chart breaks down the overall consumption shortfall for May 2021 by expenditure category. Source: Numera Analytics on BEA data.

F6: Expect shift towards AfH services
Change in spending intentions (vs. 05/20)



Note: Chart compares the change in net spending intent (% of individuals planning to spend more) between 05/20 and 05/21. Source: Deloitte Global State of the Consumer Tracker.

has proved extremely beneficial to goods and at-home (AH) services. Faced with reduced choice, consumers altered their shopping habits and directed a significant portion of their budgets to sectors facing limited health risks.

We can see this in F5, which breaks down the US consumption shortfall by expenditure category. In May, total consumption was 1% below its pre-COVID path ($150B). Yet while online goods purchases are 22% higher, demand for contact services remains 15% below pre-crisis levels. In terms of expenditure shares, households now allocate 21% of their budget to AfH services, only 1-point higher than last summer and 4 points lower than before the pandemic.

Moving forward, **rising mobility and increased choice should reverse the current trend**. F6 shows the results of a recent survey by Deloitte on spending intent. While a high portion of US consumers is willing to spend more on contact services, most Americans plan to spend less on AH goods and services than last spring.

T1 shows our latest projections for spending on AfH services. Our base scenario is for demand to rise 13% or more this year, and 9%+ in 2022. **This would push the expenditure share near 23%**. Note, however, that the probability

T1: AfH expenditures	Baseline				2022 probabilities	
	2019	2020	2021f	2022f	> 2020	> 2021
Consumption growth	1.6%	-19%	13%	8.9%	100%	38%
Expenditure share	24.6%	20.5%	21.1%	22.5%	82%	72%

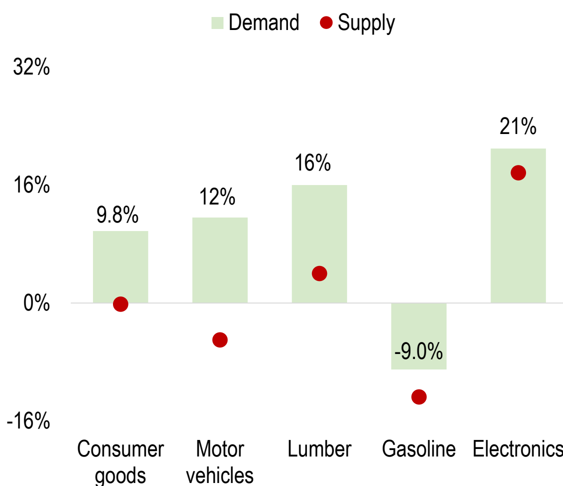
Note: Away-from-home (AfH) includes transportation, entertainment, food & accomodation, education, personal care and outpatient services.

Source: History: BEA; Numera calculations; Forecast: Numera Analytics

of a full reversal remains low, with only a one-in-five chance of the AfH budget share exceeding its pre-COVID level by Q4/22. Intuitively, this reflects a long-lasting shift in preferences, for example in flexible work schedules (reducing transport demand) or in forms of entertainment (e.g. online streaming over cinemas).

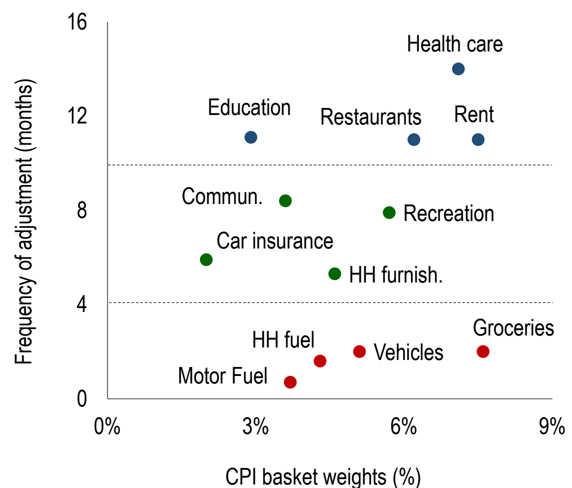
Budget shifts and inflation – This partial rotation towards AfH services has important implications for the inflation outlook. As explained above, the pandemic caused an unprecedented rotation in household budgets towards goods and AH services. In some sectors, this **created a 'decoupling' between demand and supply** as firms were unable to adjust production rapidly to satisfy these excess wants.

F7: COVID caused large S&D imbalances
Deviations from pre-COVID path (5M 2021)



Note: Chart shows demand and supply proxies by sector as deviations from their pre-COVID path. A positive demand/supply gap indicates excess demand. Source: Numera Analytics.

F8: Inflation driven by flexible sectors
Price stickiness in CPI basket



Note: Chart shows frequency of price revisions by sector, versus their importance in the CPI basket. Dashed lines denote sectors with high, medium and low price flexibility. Source: Atlanta Fed.

We can see this in F7, which compares demand and supply proxies for total consumer goods, motor vehicles lumber, gasoline, and consumer electronics so far in 2021. With the exception of electronics, the increase in sales was much stronger than the equivalent production response, causing inventories to plummet. Since these industries undergo frequent price adjustments (F8), **producers have reacted to these shortages by lifting prices aggressively**.

Unsurprisingly, most of the increase in headline inflation in April and May reflected rapid price growth in 'flexible price' sectors facing excess demand. The likely shift towards AfH services is important because it should make it easier for suppliers to meet consumer needs without facing capacity constraints. Lumber prices, for instance, are down 45% since mid-May as consumer are now allocating their extra income to AfH activities and not home renovation projects.

Consistent with this rotation, **long-term inflation beliefs have eased markedly** over the past month (see F2 in p.1). Falling long-term expectations limit inflationary risks by reducing the likelihood of significant price revisions by 'sticky price' sectors, with very high weights in the consumer basket (F8).

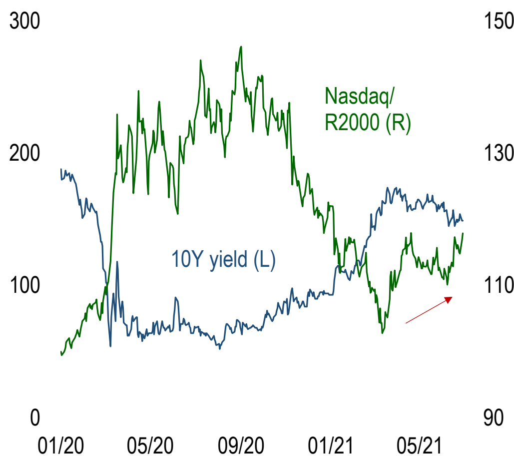
In this section:

- Why did tech stocks outperform in June? (p. 6–7)
- Will the tech rally prove short-lived? (p. 7)

Tech rallies back – Stock returns accelerated over the past month, even as the Fed moved forward their projected timeline for interest rate hikes. Importantly, **most of the June gains stemmed from tech-heavy industries**, with IT stocks posting their strongest monthly returns since November. This is in stark contrast to the first five months of the year, in which US tech firms (as proxied by the Nasdaq 100) trailed the overall equity market by over 6%.

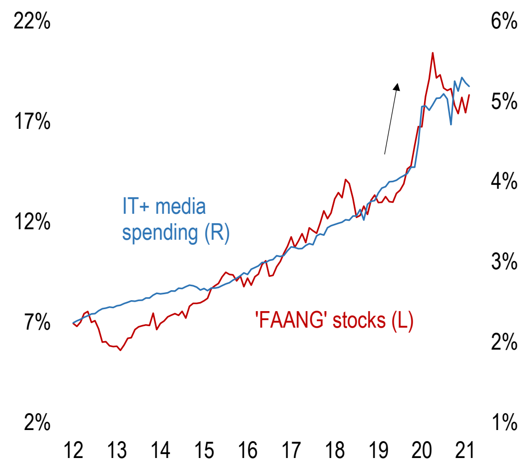
As we can see from F9, **tech stocks are benefiting from a decline in long-term yields** as inflation beliefs normalize. Falling long-term rates have a disproportionate impact on tech given their reliance on multiples expansion as a source of returns. As a result, lower discount rates usually benefit 'new economy' stocks over other segments. Last month was no exception, with falling yields offsetting the drag of rising mobility on demand for online services.

F9: Falling long-term yields boost tech
Nasdaq / R2000 vs. 10Y Treasury yields



Note: Chart shows evolution of tech (Nasdaq) vs. small-cap (Russell 2000) stocks against the 10Y Treasury yield. Source: NYSE, Russell, Federal Reserve; Numera calculations.

F10: Budget shift favoured market leaders
FAANG stocks vs. IT and media spending



Note: Chart plots share of household spending allocated to IT equipment and software, online media and internet services (blue line) versus the S&P market share of 'FAANG' stocks (red line). Source: BEA, NYSE, S&P; Numera calculations.

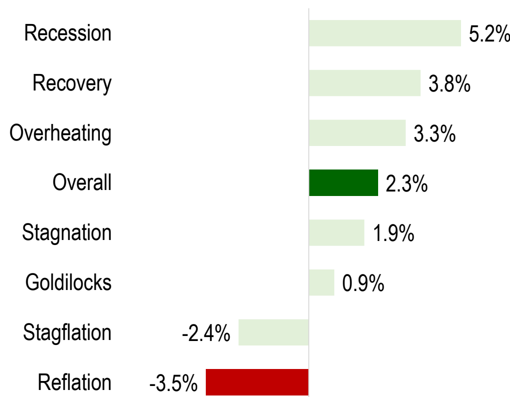
Whether or not the June reversal proves short-lived, therefore, depends in part on the interest rate outlook. Although we do not expect a Fed hiking cycle, strong growth and above-target inflation should lift 10Y rates by at least 20 bps over the next 12M. Everything else constant, this limits the upside for tech against more cyclical industries.

Long-term rates, however, are not the only factor behind the relative performance of technology stocks. As we can see in F10, the success of IT, communication service and e-Commerce stocks also depends on the **weight of IT and online services in the real economy**. During H1/20, for instance, a surge in expenditure shares drove equity flows into already dominant technology sectors, widening sectoral differences.

Betting on reopening – As we discussed in the previous section, rising mobility and declining public health risks should reduce the time spent home, **favouring deep cyclicals and reopening stocks over stay-at-home industries**. Although preference shifts will likely prevent a full reversal in expenditure shares (see T1 in p.4), even a partial rotation would cause earnings growth in tech-heavy industries to decelerate.

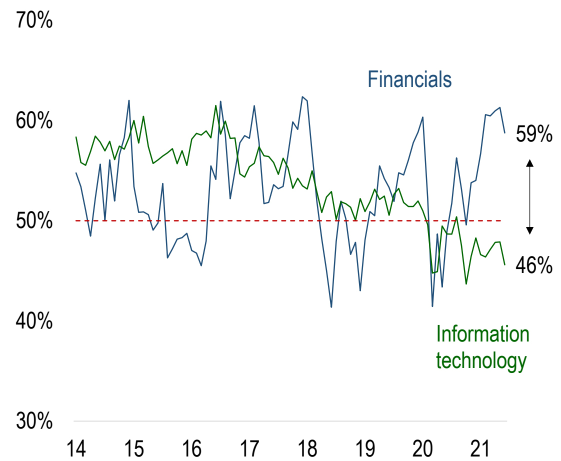
More generally, **the current reflationary environment also favours 'old economy' stocks over tech**. F11 compares the relative performance of 12M investments in technology stocks across US macro regimes. We base these regimes on the interaction between headline inflation and unemployment. For instance, reflation refers to a situation in which high or above-target inflation coincides with high but falling unemployment (as is the case today).

F11: Reflation favours cyclical stocks
Excess tech returns by regime (1980-2021)



Note: Chart compares median excess returns on 12M investments in tech (Nasdaq) versus the S&P 500. Regimes are defined on the interaction between the level and direction of unemployment and yearly headline inflation. Source: Numera Analytics.

F12: Tech stocks will likely underperform
12M outperformance probabilities



Note: Chart tracks the probability that investments in financials and IT outperform overall US stocks over a 12M holding period. Source: Numera Analytics.

While tech outperforms in most regimes, reflationary periods clearly benefit the broader equity market. Intuitively, this happens because rising inflation typically depresses valuations, while strong economic growth boosts the earnings potential of cyclical industries like banking or industrials. Given a high probability that the US economy remains in reflation until at least H2/22, this reduces the likelihood that tech delivers excess returns over the next 12M.

F12 compares excess return probabilities for 12M investments in IT and financials. As expected, **IT carries a much lower probability of outperformance than banking and insurance stocks** (46% versus 59%). Notice also that this is the widest difference in (projected) performance over the past half-decade, reflecting a high probability that the economy remains in reflation, and a gradual normalization in expenditure patterns.

In general, we recommend rebalancing towards deep cyclicals and sectors that unequivocally benefit from stronger mobility. For 12M holdings, we favour overweight positions in financials, industrials, energy, and consumer services. In addition, we suggest rebalancing towards 'value' and small-cap stocks, both highly responsive to GDP growth.

1. Investment recommendations

Position:

Overweight	Neutral	Underweight
🟢	🟡	🔴

US investment calls[1] Asset class	Absolute	Relative[2]	Downside risk[3]	Comments[4]	Last change[4]
Equities *S&P 500 TR*	🟢	-	High	Falling downside	Feb. 21
IT	🟡	🔴	Moderate		May. 21
Financials	🟢	🟢	Moderate		Sep. 20
Cons. Discretionary	🟢	🟡	High		Jan. 20
Industrials	🟢	🟡	High		Jan. 20
Health Care	🟡	🟢	High		Nov. 20
Comm. Services	🟡	🔴	Moderate		Feb. 21
Cons. Staples	🟡	🔴	High	Upgraded (abs)	Jun. 21
Energy	🟢	🟡	High		Feb. 20
Fixed income *10-year Treasury*	🟡	🔴	High		Jul. 20
Investment-grade	🟡	🟡	High		May. 21
High yield	🟡	🟡	High		Dec. 20
Cash	-	🟢	Low		Feb. 20
US dollar *USDX (ICE)*	🔴	-	Moderate		Jul. 20

1. Investment recommendations for 12-month holding period (June 2021 - May 2022).

2. In every case, relative performance versus S&P 500. Please see charts on p. 9 for a full asset comparison.

3. Downside risk compares to historical probabilities of specific asset class undergoing extreme losses (left tail risk).

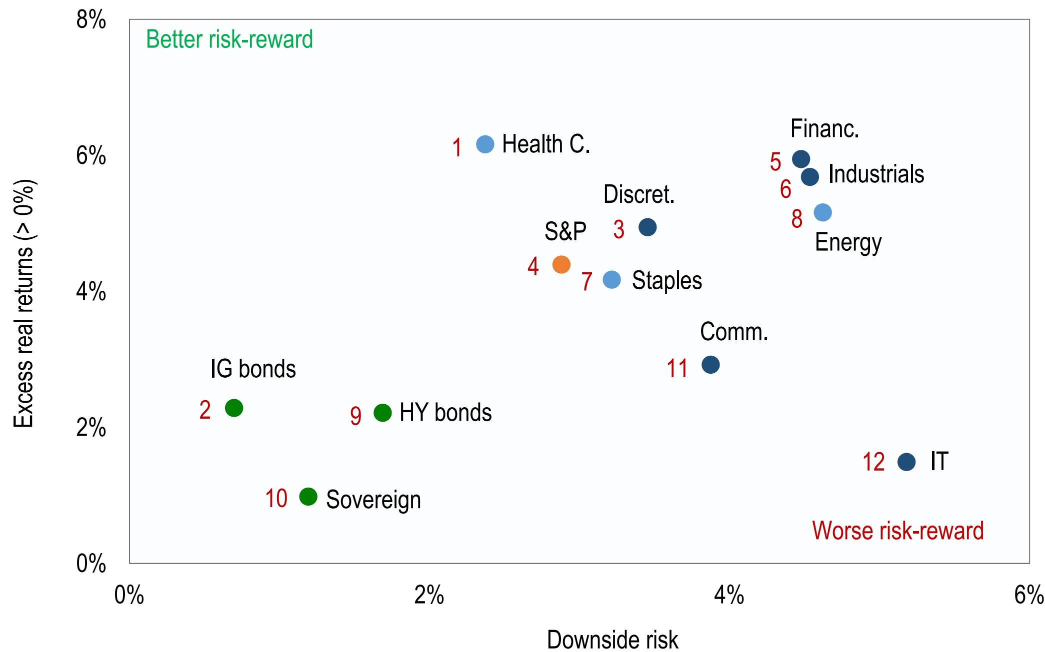
4. Indicates change in position and warns of potential changes; last column tracks changes in absolute position.

Note: Click here for our sector-specific commentary and underlying probability forecasts.

2. Asset comparison

Charts compare expected gains to potential losses for individual assets over a 12M holding period. Numbers in red rank assets by their risk-reward ratio. To rank investments, we divide excess returns (against a minimum acceptable rate) to the downside risk measure. The resulting metric is the 'Omega ratio', a measure of investment quality that explicitly considers risk preferences. The investment calls on p.8 depend on the evolution of the Omega ratios over time, which signal whether investors should increase, maintain or reduce their exposure to a given asset. The top panel is the ranking for balanced investors, who attach greater value to assets with a low likelihood of undergoing extreme losses. For balanced investors, the minimum acceptable rate are positive real returns. The bottom panel ranks assets for growth investors, with a higher risk tolerance. For growth investors, real returns below 2% are considered losses.

a. Balanced investor



b. Growth investor