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Confused or determined central bankers?

Capital markets continued over the past week to recover just as gradually from the September/early October downdraft as they declined then. Many commentators put it down to the continued strong Q3 corporate earnings announcements, which with 20%-40% year on year growth between Europe and the US has indeed provided a positive for stretched equity valuations. On the other hand, less than 20% of companies have reported so far and as we have written here before, corporate results are the rear-view mirror of the economy, with only the outlook statements providing a bit of a glimpse of what may lie ahead.

Companies outlooks is perhaps where the currently unusual constellation of the economy begins to take shape, and provide some evidence for the broader market thinking that the current economic woes will prove to be short-lived. So far companies have warned that supply constraints will hold their businesses back for a while yet, while at the same time stating that they expect demand to remain robust throughout, given the strength of consumers' and companies' post-pandemic financial position. This may also explain why their margins have until now not suffered under higher input prices, with demand strong enough to allow them to pass on input price rises through price rises on their own products.

The business sentiment barometer of the purchasing manager indices (PMIs) seem to paint a similar picture. They have hardly declined from their previously dizzying heights earlier in the year and in the case of the UK have even exceeded expectations, despite all the supply chain disruptions and labour shortages business have had to endure. Even more surprising perhaps is that this came against the backdrop of declining retail sales numbers over September.

Taking a step back is it perhaps that not only businesses but also consumers are indeed smarter than the central banks' and the wider economists' community factor in? Ordinarily, during inflationary periods consumers are tempted to make purchases sooner rather than later, given any deferring costs money.

Despite all the clamour about inflation becoming engrained, this type of behaviour does nevertheless not seem to be taking hold (with the exception of car fuel in the UK perhaps, but then there are other forces in play than price with car fuel). Whether this deferment of purchases is simply a result of a lack of availability, or is based on the expectation of a return of lower prices down the road, is not entirely clear. But what is clear is that the wider media has reported widely that there is an expectation that supply chain constraint will ease over the coming months.

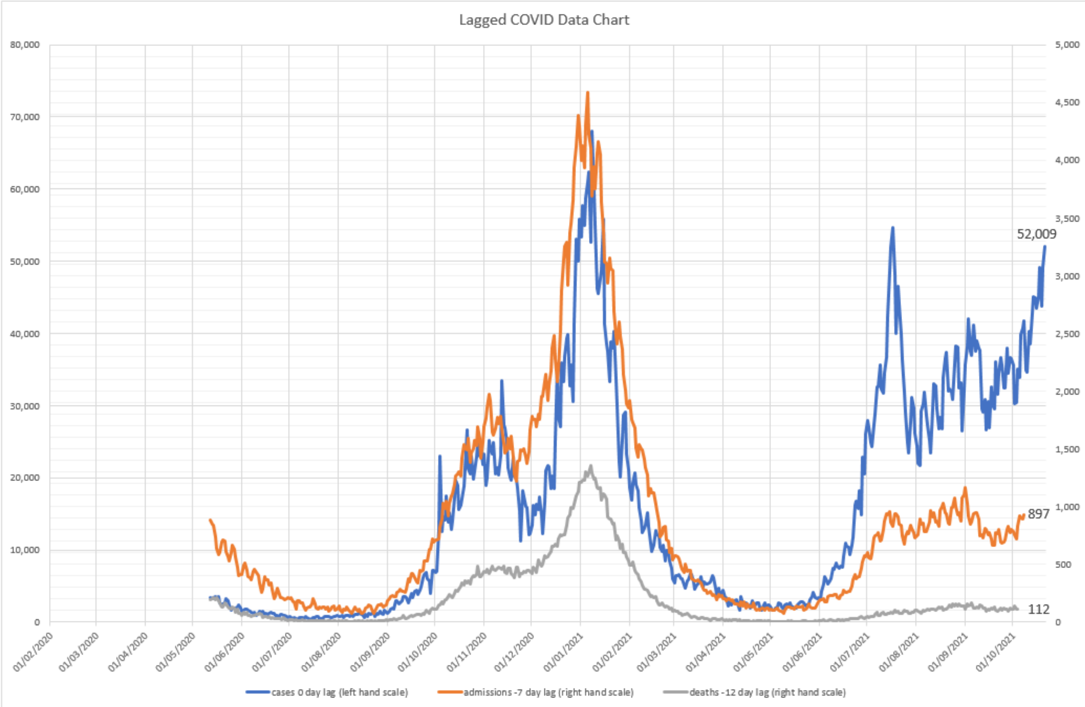
Against this background, last week's growing indications from the UK's Bank of England that they are likely to raise rates sooner rather than later, to quell any inflationary tendencies from becoming engrained, sound even more counter intuitive. Andrew Bailey, the bank's governor himself stated that interest rises are not the tool to ease supply shortage driven price rise pressures. What they do is reduce gushing demand that's driven by cheap credit and the lack of return on savings. However, at this point, consumers appear to have already taken that step and deferred their demand, as the decline in retail sales tells us. Is Bailey's "have to act" rhetoric to keep a lid on inflation aiming at preventing wage rises – and thereby in juxtaposition to the UK's PM stated aim? Well, given he has stated himself that there are only key worker specific upward pressures observable but that at large, real wage growth (after inflation) remains negative, there does not seem to be any urgency here either.

It is therefore perhaps not surprising that the wider economists' community has decreed that a UK rate rise now would amount to a policy mistake of premature tightening. It would therefore not even support the argument of achieving lower import prices through a strengthening of £-Sterling, given currencies tend to fall when central bank errors are suspected to lead to weaker economic results. We have dedicated a separate article to the topic for more insight, but feel reminded by Bailey's rate rise scare strategy of his previous station's (the FCA) repeated use of the 'putting the frighteners on' approach to push it's subjects in the direction they wanted them to go. We look forward to finding out whether the broader UK public will prove as subservient to the central bank's whims under his leadership as the financial services sector had to by necessity to its regulator.

In other important news the Chinese government continued its de-escalation (or is it de-frightening?) course it entered the previous week, when it removed the energy price cap for heavy industrial users. Last week it enabled Evergrande to settle its overdue bond coupon payments before the 30-day grace period expired, thereby buying the company time until November to find buyers for valuable assets, and continue on the course of what increasingly looks like an orderly wind down of the erstwhile second largest Chinese property developer.

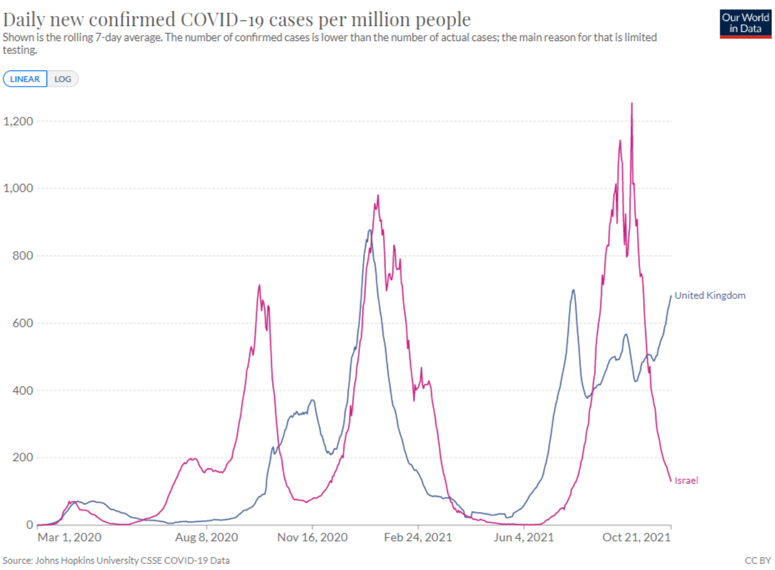
While the Chinese development clearly cheered markets up, the fast rise in COVID infections through the Delta variant in the UK and eastern European countries is doing the opposite. Talk of renewed restrictions from mask wearing to movements and public gatherings does feel as undesirable as the Halloween comparison cartoon at the top suggests. Yet there are valuable insights to be gained from this latest wave and how countries like the UK and Israel with high, early mass vaccination campaigns have fared. To this end a few more charts than usual in this week's summary article:

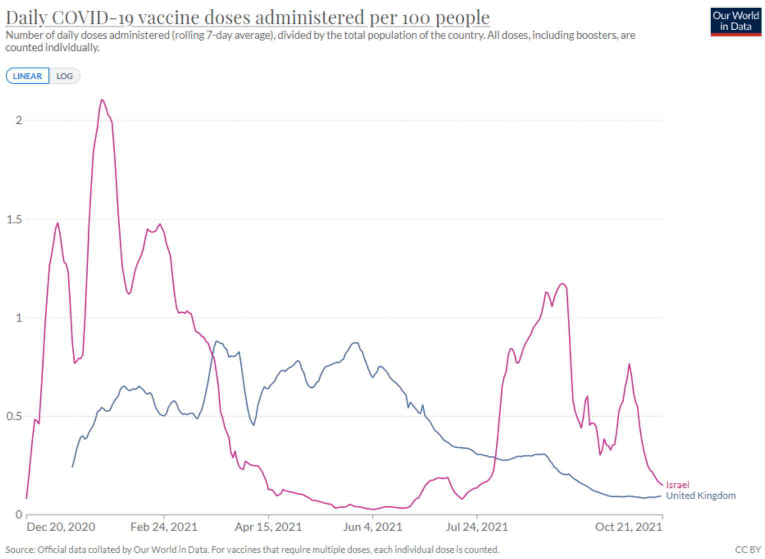
The UK's status of a highly vaccinate population appears to have broken the previous close link between infection numbers, subsequent hospitalisation and eventual fatalities



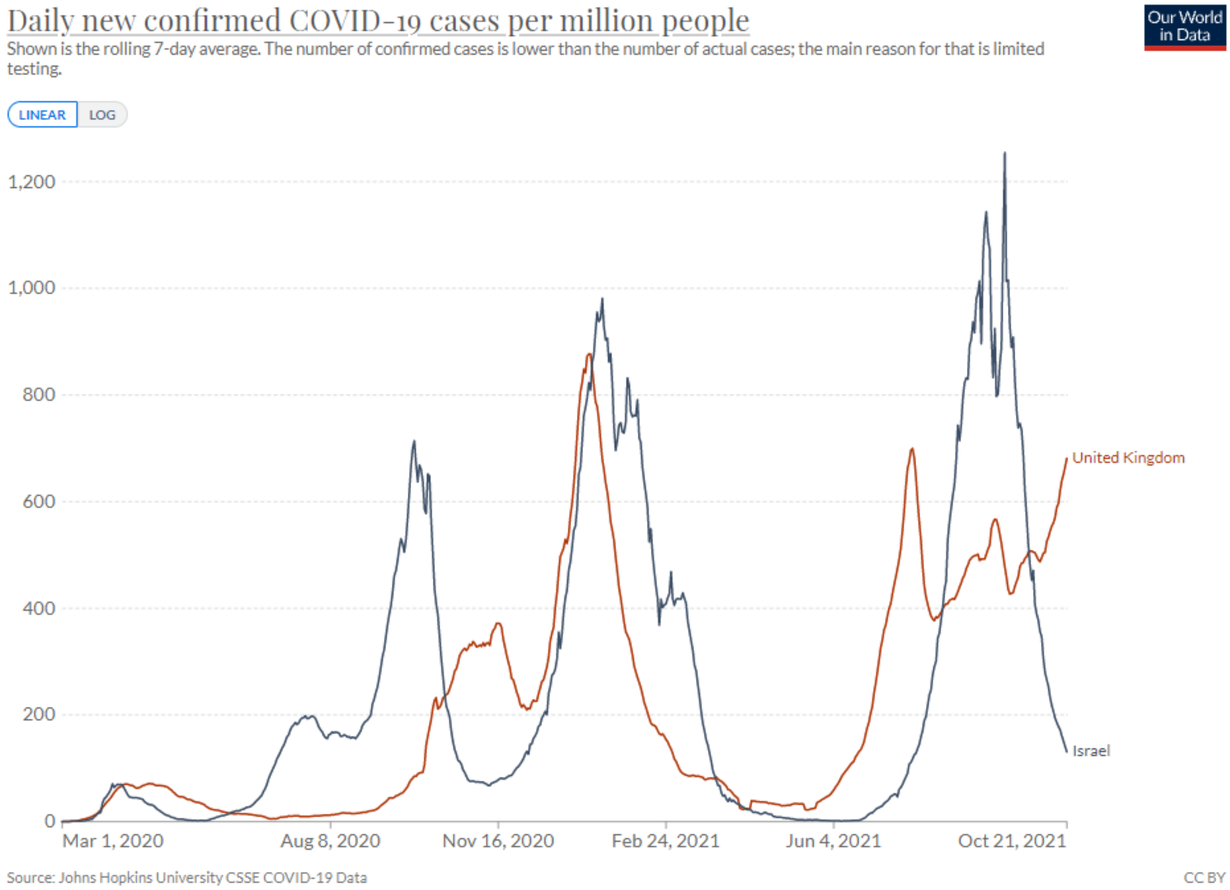
Source: UK Government, Tatton IM, 21 October 2021

Israel, which was a good two months ahead of the UK with its mass vaccination campaign, shows how to bring a resurgence of infections as the UK is currently experiencing under control with a booster shot campaign.





Back in July/August Israel was – just like the UK now – the global leader in new infections (see left panel above). However, thanks to a decisive booster shot campaign (right hand panel), infection rates have now come right back down to being one of the lowest again (chart below).

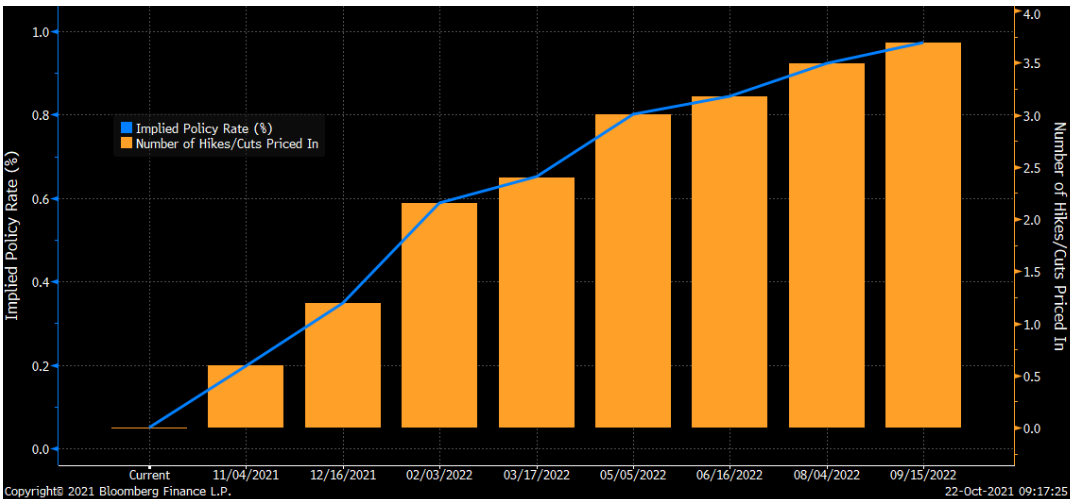


On the basis of these evidential insights, we remain confident that COVID related headwinds to the economy will continue to subside, even if further public health efforts will be required to achieve this.

Has the Bank of England blinked under the threat of inflation?

The Bank of England (BoE) seems to be getting ready for Halloween early. Governor Andrew Bailey decided to give investors quite the fright at the beginning of last week, confirming that it may indeed raise interest rates soon. Markets reacted quickly, pricing in a rate hike for December and more to come in the first few months of next year. Implied market expectations put UK interest rates at 1.25% by the end of 2022, well above the current 0.1%, and the highest level in well over a decade. This all comes only a few months after the BoE put markets and financial institutions on notice for the possibility of negative interest rates.

According to Bailey, the BoE "will have to act" against spiking inflation – a phrase which amounts to a policy announcement by central banker standards. Prices are rising rapidly in the UK, causing a hit to purchasing power and risking destabilisation of the economy. Clearly, the BoE feels swift action is needed to quell the danger that brings.



As many commentators have argued, though, this reasoning seems a little off. At times of concern overheating is being caused by buoyant demand outstripping the supply capacity of the economy, higher interest rates combat inflation by encouraging more saving and less borrowing, leading to less spending, lowering overall demand levels to balance out prices. But, as we have noted many times, the main drivers of the current inflation bout are on the supply side. These bring up two points that go against the traditional monetary response: first, it is likely that extreme inflationary pressure will subside naturally, as supply comes back onstream, and second, it is not clear how effective a rate hike would be at taming supply-side-driven inflation anyway.

Supply problems will clearly put upward pressure on prices in the short term, but for inflation to 'catch on' and become sustained and structural, consumers and businesses need to expect and accept the inevitability of higher prices, and adjust their wage demands and spending patterns accordingly, creating the vicious cycle of price rises leading to wage rises, leading to price rises. As Michael Every of Rabobank succinctly put it in a recent article: "If something isn't available, is it cheap or expensive?". Wages certainly are rising in the UK but, as the BoE readily admits, the headline-grabbing figures touted for lorry drivers are far from representative. Average increases are actually below inflation (resulting in a loss of real purchasing power) and many workers have seen little to no pay rises.

Britain's current experience owes a lot to specific domestic factors too. Brexit and pandemic effects have teamed up to leave the country with higher bills for imports and fewer workers to keep the supply chain moving. Panic buying has also turned some supply bottlenecks into full-on blockades.

The BoE likely feels that some of these problems could be mitigated by a higher sterling value (which a rate hike should bring about). But inflation is far from just a British problem. There are well-documented supply shortages all over the world, from computer chips to oil and gas. In Europe, a lack of energy supply is threatening to cause rolling blackouts. In China, those blackouts have already been a reality – caused by a sharp coal shortage and inability to keep factories running (as we discuss in the next article).

These factors are pushing up prices everywhere, but central banks across the developed world are being much more cautious about tightening policy. In contrast to the BoE, the European Central Bank (ECB) and US Federal Reserve (Fed) have affirmed their commitment to keeping rates low and liquidity flowing. Accompanying this has been a belief that much of the current inflation pressure is 'transitory', and will normalise once the economic recovery matures and short-term issues are sorted out.

One point worth highlighting is that the BoE, in contrast to the ECB and Fed, does not have a recent history of undershooting its inflation goals (we recall UK inflation at almost 4% in 2011), and is therefore not sitting on a low inflation buffer from the past decade. Of course, neither did the BoE embark on a strategic review of its policy framework (unlike the ECB and Fed,) which could have resulted in a more dovish BoE programme. Despite this divergence, it seems the BoE's current agenda is not so much pre-emptive monetary policy tightening with a potential rate rise, but more a mindset of policy normalisation. Speaking to the FT last week, Chief Economist Huw Pill was quick to point out that inflation approaching 5% was "uncomfortable", but also suggested: "…we don't need the emergency settings of policy that we saw after the intensification of the pandemic". The Fed and ECB may have more room to watch the effect of tighter labour markets unfolding – even if some Fed rate setters may believe the US is approaching that point, and that global inflation may not be so transitory after all. Nevertheless, both the ECB and the Fed are showing no sign of hitting the rate rise 'panic button' at the moment.

The divergence in policy responses is an interesting point, even beyond the BoE vs. the Fed and the ECB course of action. While markets are on board with the Fed and ECB's dovish stance (preferring lower rates), it does go against both global and historical trends. In contrast, central banks within emerging markets have mostly kept policy tight throughout the pandemic, and even reverted to tightening, prioritising inflation containment. This is because emerging markets generally do not have the same luxury of a 'wait and see' mentality when it comes to inflation. But more interesting is the historical comparison: In the 1970s (the last time a global supply shock sent prices higher while growth dwindled), raising interest rates was the norm. The rationale for this was that prices needed to be stabilised and inflationary behavioural tendencies needed to be quashed, even at the cost of growth. This is the thinking that the BoE seems to share now.

For the most part, other central banks are favouring a different approach. Last year, the Fed changed its policy framework to prioritise employment more heavily – effectively taking a structurally more dovish position. This came from a recognition that the old framework was not conducive to growth, and was likely inspired by the experience of the last decade. Since the Global Financial Crisis, central banks have persistently kept policy extremely loose but, despite long-term falls in unemployment, growth and inflation remained stubbornly low.

Whether central bankers will stick to that promise is another matter. Even without strong growth, supply shocks will have an impact on consumer expectations and wage demands. This could entrench inflation pressures, which would then present a real challenge to policymakers. Should they act to quell price hikes while growth is still fragile, it could be very damaging to the global economy.

In our view, that is one of the main risks to economic outlook. Investors are in good spirits now, but underneath that optimism is a plethora of risks (as outlined in our other article). It might not take much to make markets fearful rather than hopeful, and a premature rate hike from the Fed or ECB would likely do the trick. Already the BoE has blinked in the face of global inflation; now we wait to see if others do the same.

China's problems are of its own making

China's post-pandemic recovery is not going as planned. Last year, it initially looked like the world's second-largest economy would get a head-start on global growth after containing COVID much more effectively than the rest of the world, while also loosening fiscal and monetary policy. Instead, the People's Bank of China (PBoC) has been the only major central bank to tighten monetary policy over the course of the pandemic. Meanwhile, Xi Jinping has used the global crisis as an opportunity to crack down on everything from corporate leverage to 'effeminate' celebrities. These moves have constrained Chinese growth. To make matters worse, recent power shortages have put the country's growth – and Xi's target of 'common prosperity' – at serious risk.

The crisis surrounding property giant Evergrande is emblematic of Beijing's crackdown. Evergrande has more debt than any other property developer in the world, and its inability to meet bond yield payments on time has caused share prices to plummet. There have been huge concerns over the risk of domestic or global contagion should the company go under. But Evergrande's slow-motion collapse is looking increasingly like a controlled demolition.

The real estate group had planned to sell its property services unit – one of its few healthy ventures – to a competitor for around $2.6 billion, but officials announced the deal's collapse last week. The sale was seen as a last-ditch attempt to stave off default, but early last Friday the company defied the doomsayers and bought itself some more time by finding the $83.5 million necessary to stave off default until the next overdue payment reaches the end of its grace period at the beginning of November (Bloomberg). Friday's news came just as Evergrande reopened trading in its stock – which had been suspended since 4 October. Evergrande shares initially tumbled 12.5% before rallying back 4.5% on news of the payment, but have still lost close to 80% of their value so far this year.

The pain has already spread to other parts of the sector. Yields on dollar-denominated bonds for Chinese issuers soared after Evergrande's first missed payment. Chinese developers now face their highest borrowing costs in more than a decade, and two other real estate groups have defaulted on a combined $425 million worth of bonds.

Fears of China's so-called 'Lehman moment' have not spurred Beijing to rescue Evergrande, though. The Communist Party instead seems happy to let it become a cautionary tale about corporate excess. The property sector has been one of the main sources of China's decade-long credit binge, and authorities clearly intend to use the opportunity to squeeze out speculative practices and confirm the *caveat emptor* principle in their financial markets by making an example of Evergrande.

This means that, while they will almost certainly not allow a Lehman-style collapse, officials effectively endorse the revaluation of the property sector. That will slow demand right across the economy and put a dampener on growth, as has already become apparent with last Monday's release of last quarters GDP growth figures, the lowest for two decades (although still running at an enviable annual rate of 4.9%). And, given how important Chinese growth is for the global economy (China has contributed more than America's share of incremental global growth every year since 2001) this is a concern. Investors seem nonplussed for now, but that could change as we head into another difficult winter.

Speaking of which, the colder weather will be particularly harsh on China. Not only are COVID cases rising, and restrictions being reimposed, but a massive fuel shortage has also left swathes of the country without energy. 70% of China's electricity comes from coal, which has been in tight supply, causing prices to soar. Rising costs have made it impossible for many coal plants to turn a profit due to strict price caps. Beijing has eased these controls recently, and ordered producers to keep the lights on, but officials said last week they would take "specific measures to intervene" if prices kept rising.

The energy crisis is inspired by global events, but in many ways is also a problem of Beijing's own making. Despite China's reliance on coal, little investment has gone toward production in years. The Chinese government has closed coalmines and power plants to help meet its environmental commitments, but the issue is compounded by a string of recent policies: anti-corruption campaigns in coal-producing regions, plant closures for national events and new rules enforcing harsher punishments for safety violations. At the top level, production is being explicitly encouraged – but the myriad of policies below encourages the opposite.

Beijing's import strategy exemplifies this confusion. The government wants to increase coal imports to ease the crisis, but the sanctions placed on Australia – its main source of coal – last year cut off a potentially vital source. The Australian spat is a masterclass in self-sabotage. China was angered by Australia's call for an investigation into the origins of COVID-19, so much so that politicians banned imports – only to find themselves in desperate need of those imports some months later.

Ripples from China's energy crisis are being felt across the world, and could grow larger. Factory shutdowns have introduced even more supply constraints for industrial metals, pushing up prices across the world.

Magnesium, which comes almost exclusively from China, is in dangerously low supply across Europe. The raw material is needed for aluminium alloy – used to build cars and other machinery – and the shortage adds to Europe's auto industry woes.

Closures and shortages are expected to have a substantial impact on Chinese growth. That will greatly lessen China's demand for global goods – a vital part of the global economy since the financial crisis. The end-result is one of the world's most important economies becoming a source of both tightening supply and slowing demand. That is a recipe for the dreaded 'stagflation' – a prolonged period of high inflation and low growth – that keeps investors awake at night.

Fortunately, we do not expect things to reach that level. One of the impressive things about China's economy over the last two years is that it has fared surprisingly well while policy has been surprisingly tight – the opposite of what many expected. Supply shortages and tighter credit are negatives for growth, but they are unlikely to become overwhelming.

Nevertheless, we should not underestimate how these trends change China's impact on global growth from a net highly positive contribution over the last decade to a neutral (or even negative) one in the near future. Markets seem unfazed by China's gloomy headlines for now, but that could quickly change – especially if investors' other sources of optimism fade. Beijing's problems are of its own making, but they are the world's problems, nonetheless.

Global Equity Markets

Market	Fri 16:34	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7215	-0.3	-19	→	⬀
FTSE 250	22925	-0.3	-59	↘	↗
FTSE AS	4114	-0.2	-10	→	⬀
FTSE Small	7438	+0.2	+12	→	↗
CAC	6739	+0.2	+12	→	↗
DAX	15554	-0.2	-33	→	↗
Dow	35548	+0.7	+254	→	↗
S&P 500	4537	+1.5	+65	→	↗
Nasdaq	15038	+0.9	+141	⬂	↗
Nikkei	28805	-0.9	-264	→	→
MSCI World	3152	+1.4	+43	→	↗
CSI 300	4960	+0.6	+28	→	⬂
MSCI EM	1293	+0.7	+9	→	⬂

Top 5 Gainers

Company	%
Renishaw	+9.6
Fresnillo	+8.2
Polymetal Internationa	+6.8
Hargreaves Lansdown	+5.5
Croda Int'l	+5.4

Top 5 Decliners

Company	%
Int'l Consol Air	-14.6
Whitbread	-7.5
Rio Tinto	-6.9
Barratt Devts	-6.8
Rolls-Royce	-6.5

Currencies

Pair	last	%1W
USD/GBP	1.377	+0.1
GBP/EUR	0.845	-0.1
USD/EUR	1.16	+0.3
JPY/USD	113.62	+0.5
CNY/USD	6.39	+0.8
Bitcoin/$	60,905	+2.5

Commodities

Cmdty	last	%1W
Oil	85.00	+0.2
Gold	1785.7	+1.0
Silver	24.24	+4.0
Copper	448.5	-5.2
Aluminium	2910.5	-6.6
Soft Cmdties	223.5	-2.6

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	15.6	12.7	14.2
FTSE 250	2.4	15.3	19.7	16.0
FTSE AS	3.7	15.4	13.4	14.4
FTSE Small x Inv_Tsts	2.0	12.8	16.6	15.5
CAC	2.2	21.5	16.1	15.0
DAX	2.1	15.6	15.1	13.5
Dow	1.7	19.2	18.7	16.5
S&P 500	1.3	25.2	22.2	17.7
Nasdaq	0.6	29.5	33.1	23.1
Nikkei	1.5	15.5	17.8	17.7
MSCI World	1.7	21.9	20.1	16.7
CSI 300	1.8	16.2	15.5	12.5
MSCI EM	2.3	14.1	13.7	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.16	+0.06
UK 15-Yr	1.34	+0.04
US 10-Yr	1.64	+0.07
French 10-Yr	0.24	+0.07
German 10-Yr	-0.10	+0.07
Japanese 10-Yr	0.10	+0.01

UK Mortgage Rates

Mortgage Rates	Oct	Sep
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.20	1.23
3-yr Fixed Rate	1.20	1.37
5-yr Fixed Rate	1.29	1.37
10-yr Fixed Rate	2.59	2.59
Standard Variable	3.61	3.61

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values

** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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25th October 2021

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel