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The US Gives Thanks while Europe Worries

- Economic growth remains hot in the US, but worryingly it is causing inflation, which remains stubbornly high
- Despite surging COVID infections across Europe and parts of the US, full-scale lockdowns are unlikely and any impact on growth should be "transitory"
- Nevertheless, the fresh wave of infections in Europe has prompted some economists to sharply cut their GDP forecasts for the current quarter
- Meanwhile Chinese assets are finding favour with global institutional investors who see the weakness as an opportunity to buy

The incoming economic data shows that growth is running hot in the United States. Worryingly though, the hot growth is evidently leading to greater inflation risk. The latest Philly Fed US industrial confidence numbers showed growth but with unprecedented inflation pressures. At the headline level, industrial confidence continues to improve. The 10-point increase in aggregate confidence index for October was well above market expectations.

However, it is now quite evident that inflation is a problem. The prices paid component of the survey rose a massive 10 points, while the prices received component rose 12 points. The prices received element in the survey is at its highest level since 1974. It would suggest that companies can expand margins by pushing up prices higher without really worrying for input cost inflation. We only get transitory inflation because customers are unwilling to pay higher prices; hence, demand drops, forcing companies to reduce prices. At this stage, we see quite the opposite; customers are seemingly very willing to pay up in the face of higher prices from companies.

The current robust inflation news is not lost on the bond market. The yield on the 10Y Treasury rose above 1.60% in the week before settling lower at 1.54%. Some concerning news about renewed COVID waves in Europe and parts of the USA may have been behind the sudden rethink. Inflation numbers remain firm, but a fresh spate of movement restrictions had the market wondering if a weak spell in growth might help moderate the inflation surge.

Experience suggests such concerns are misplaced. Extended full-scale lockdowns, 2020-style, are unlikely, and the impact on growth should be "transitory". Once the bond market aligns with the same view, a retest of the 1.80% level on the 10Y Treasury will be likely.

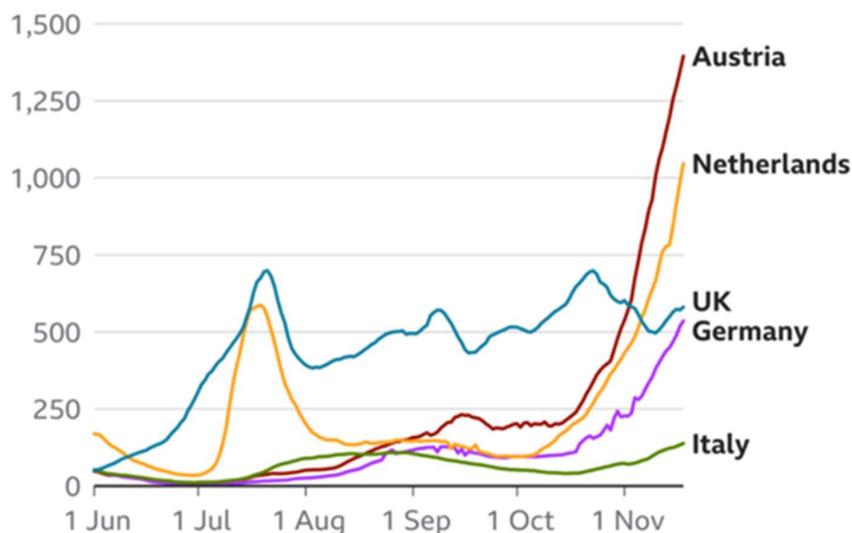
Europe's COVID problems spooked the financial markets last week, leading to a sell-off in the more cyclical sectors. The S&P Materials Sector, for example, fell 2% on the week.

Smaller European countries such as Austria and the Netherlands are in the news following civil disorder after the governments announced lockdowns and, in Austria's case, mandatory vaccination! The markets will also be watching news flow from Germany and France to see if the lockdown could become more problematic. The number of daily cases in Germany has risen to above 65,000, which is a new high. This week, Chancellor Angela Merkel will speak to the leaders of all of the German states, a meeting that could lead to a potential countrywide lockdown. In France, daily cases have risen above 20,000 for the first time since August; however, at this stage, there is no indication that the government is going to reimpose any form of lockdown.

Chart 1: Fresh COVID Wave Blows through Europe

Case rates rising sharply in parts of Europe

Daily cases per million people - rolling seven-day average



Source: Johns Hopkins University, gov.uk dashboard, data to 18 Nov



The fresh COVID wave in Europe has prompted some economists to sharply cut their GDP forecasts for the current quarter. JPMorgan, for example, has pared its forecast for euro area growth to an annualised rate of just 2.0% from 4.0% previously.

Like the US, the UK saw strong retail sales growth in October (+0.9% month-on-month against consensus' +0.5%). The strength of demand put upward pressure on prices – inflation hit 4.2% again ahead of expectations. **In all likelihood, the Bank of England will raise rates at their meeting in December.** Sterling is showing little consistent strength against the dollar and

indeed may suffer further downside risks. However, with the euro area facing fresh COVID challenges, sterling could be in for a further phase of strength against the euro.

Chinese economic data surprised to the upside last week with October data for industrial production, retail sales and investment all coming in ahead of expectations. We have seen an increased appetite from global institutional investors for Chinese assets recently. Several asset managers have used the weakness as an opportunity to buy. In particular, we've noted several newsletters from Asian fixed income managers citing potential opportunities in the bond market, particularly in shorter-dated bonds.

While we are sympathetic to the view that there is a building opportunity in Chinese asset markets, nothing is that easy and timing remains everything.

Chinese high bond yields have spiked, and prices slumped: The investment opportunity looks particularly attractive from a simplistic price-only perspective. Market estimates for default rates in the property sector range between 20% and 30% for 2021 and are only mildly lower in 2022. It leaves the Chinese high yield index trading at a price that is appropriate for a distressed asset. Many of the underlying bonds trade as low as 25 cents to the dollar.

Some experienced institutional players made headlines last week, either expressing interest in the bond market at these levels or making it known that they are starting to take an exposure. Doing so requires good local knowledge and the willingness to become involved in bankruptcy proceedings should it be necessary. For less well-versed investors, caution and patience are advised. It looks very likely that the market's stress will abate only slowly, leaving investors with enough time to assess the opportunity as it develops. **There are still many moving parts to the whole property market reset in China, and we judge it to be too early to commit in any significant way.**

The search is also on for the low point in the Chinese equity market; however, risks still abound. The Alibaba quarterly results came as a big negative surprise to the market. Alibaba's shares fell 17% after the company reported numbers well below analysts' expectations for revenues and earnings. Analysts believe there's a read-through for the broader market with disappointing revenue growth and a rather dismal outlook for 2022. The share price retouched the lows of a couple of months ago when government announcements were hitting the stock thick and fast. Alibaba may continue to struggle and now faces a downturn in profits and revenue in 2022, with analysts expecting earnings to only recover back to the 2020 levels by the end of 2023.

Investors may be waiting for more emphatic support from the authorities for the Chinese economy. Policy support looks likely to remain modest. Most of the support has come in the form of day-to-day management of lines of credit. There should be some increase in government bond issuance and social financing but nothing that could be characterised as providing immediate boost to the economy. Indeed, policy making continues to be based on the structural aims of cooling the property market and greening energy both of which are likely to remain a drag on growth.

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