Monthly Macro Insights

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Rothschild & Co
Asset Management

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The recovery continues, but momentum has slowed sharply as persistent bottlenecks and Delta-wave infections have depressed activity, while consumers have been hit particularly hard by surging inflation. Although central banks continue to foresee lower inflation rates next year, a global energy crunch could jeopardize this scenario. Monetary policy in advanced economies could start pivoting to a less accommodative posture quicker than expected, which would spark a debate on a possible policy mistake.

Marked deceleration in China

The latest economic data point toward further downward revisions to Q3 2021 global GDP growth, particularly in China where uncertainty introduced by the authorities over regulatory changes, flooding and efforts to contain the recent resurgence of COVID-19 cases have impacted activity.

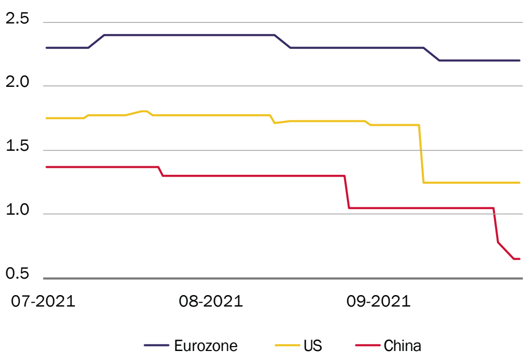
Since the Great Financial Crisis, bad economic news in China was perceived by investors as good news because weak data would significantly strengthen the case for central bank and government policy support. However, with a private sector already plagued by one of the highest debt service ratios on record, Chinese authorities might instead stick to their approach of short-term pain in order to seek long-term gain, i.e. to seek lower financial risk by refraining from adding more credit.

Financial stress stemming from Evergrande, the country's largest property developer, illustrates the limits of using credit leverage to boost economic activity. Housing is expected to contract this year amid the unwinding of government supports and credit tightening, ramping up the pressure on the sector's highly leveraged firms.

The property sector is a pillar of the Chinese economy and will have a significant impact on the macroeconomic outlook through different channels. First, construction and real estate services contribute to almost 15% of GDP, up from 10% in the early 2000's, and they are a major source of fixed investment. Land sale revenues have also become an important funding source for local governments, and lower sales would trigger fiscal difficulties

World - GDP forecasts

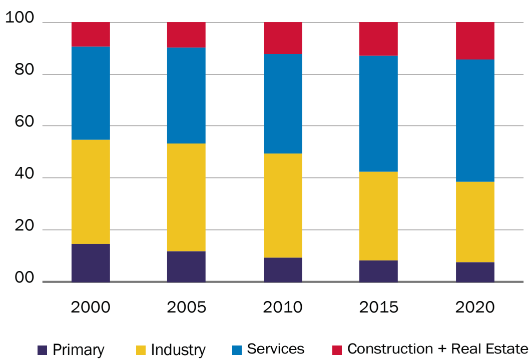
in %, q/q, Q3 2021



Source: Bloomberg, Rothschild & Co Asset Management Europe, October 2021.

China - GDP per sector

in % of value added



Source: Macrobond, Rothschild & Co Asset Management Europe, October 2021.

and public expenditure cuts, thus weighing on GDP growth.

Correspondingly, given the importance of the sector and recent market turbulence, policymakers are unlikely to stay put, especially if the deterioration in financial and macroeconomic sectors begins to reinforce each other. The current policy, however, aims to contain imbalances and the risk of a future house price correction, as housing is the most important asset in household wealth, accounting for nearly 60% of their assets, compared to 30% in the US.

Overall, housing tightening may be fine-tuned, but it is unlikely to be reversed, and while the Chinese government should be able to contain risk from Evergrande, there are uncertainties related to the authorities' risk tolerance and the types of actions envisaged.

Energy hurts activity...

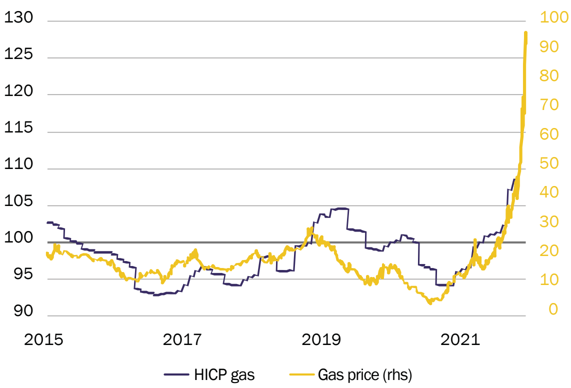
Meanwhile, at least 20 provinces and regions in China – representing more than two-thirds of its GDP – have announced some form of power cuts amidst a mismatch between supply and demand, and consumption is now poised to increase further in the run-up to the peak winter season. These cuts will undermine China's GDP growth and add concerns over global supply chain disruptions, thus adding to global inflationary pressure.

More broadly, a key near-term uncertainty is the extent to which the Delta variant and the power shortages raise risks of persisting shutdowns in some Asian economies. This would entail adverse downstream consequences for the availability of supplies and the pace of the global recovery. What's more, oil prices continued to increase, reaching their highest since 2014, following OPEC's decision to maintain a gradual supply hike even as the natural gas crisis boosts crude demand.

Europe is particularly badly hit by the energy price shock, with regional natural gas prices surging over the past three months. Demand for natural gas has increased for several reasons, including a colder winter coupled with a phasing out of coal and a bad year for wind production. The supply side also has several issues, including less fields maintenance during the COVID-19 crisis and weak investment amid low levels of inventories, while Russian exports to the EU were down from their 2019 levels.

Since electricity, gas and heat energy constitute around 6% of the euro-area's current consumer price basket, the recent spike represents a huge consumer tax that will intensify during the winter. In addition, the impact of surging energy costs could ripple through the economy, spreading the price impact to different industries.

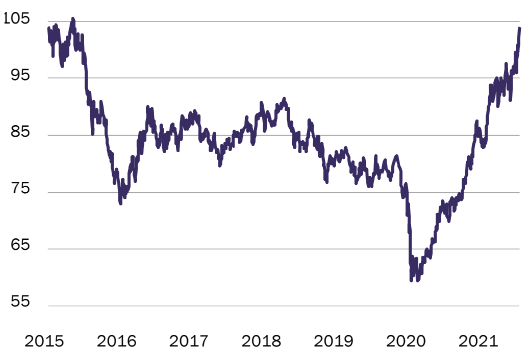
Eurozone - Gas prices



Source: Macrobond, Rothschild & Co Asset Management Europe, October 2021.

World - Commodity prices

Bloomberg index



Source: Bloomberg, Rothschild & Co Asset Management Europe, October 2021.

... and potentially trigger a policy response

Overall, the mix of supply chain frictions and rising commodity prices – especially energy – has pushed up inflation across many countries, putting central banks on the defensive. Although central bankers generally view this year's inflation increase as transitory, their response to persistent overshoots in prices has varied and will likely continue to do so.

Earlier this year, outside of Turkey and China, a broad move toward pre-crisis norms started across several emerging countries (EM), hastened by rising inflation.

In advanced economies, only Norway and New Zealand have followed the EM wave. However, the debate has shifted as upside inflation risks have increased. In the US, the Fed signalled it could start paring its massive bond-buying as soon as November. In the UK, the Bank of England hinted for the first time that it may raise interest rates in the next few months.

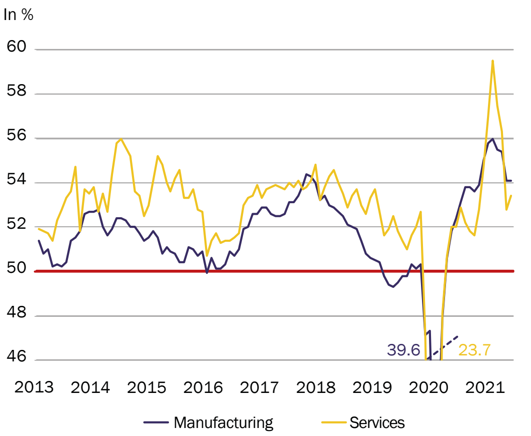
As the expansion slows, recent data has also complicated the task of central bankers. Business confidence stabilized in September after three straight months of decline, although the survey still points to ongoing supply constraints weighing on the manufacturing and services sectors.

What's more, central bankers are ill equipped to solve supply side shocks. Liquidity originating from quantitative easing programs might have added to the rise of some commodities, but monetary policy cannot produce semi-conductors for the automobile industry, cannot produce natural gas, nor can it instantly improve mismatches in the labour market.

Although supply-side bottlenecks are lasting longer than previously expected, central banks might draw their weapon too quickly in order to fight a rise in consumer prices, especially as inflation would only move sustainably upward from the pre-pandemic low rates if wage growth were to increase substantially, or if inflation expectations drifted upward. In fact, the current situation could ironically become disinflationary in the medium term if it leads to the erosion of demand as households' purchasing power is significantly impaired. ■

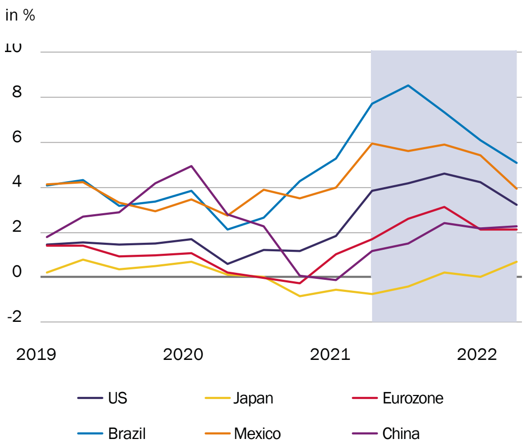
Completed writing on 6 October 2021

World - Markit business confidence



Source: Macrobond, Rothschild & Co Asset Management Europe, October 2021.

World - Inflation rate



Source: OECD, Rothschild & Co Asset Management Europe, October 2021.

Performance of the indices and interest rate levels

	Price as of 30/09/2021	1 month % change	2021 % change
Equity markets			
CAC 40	6 520	-2.4%	17.4%
Euro Stoxx 50	4 048	-3.5%	13.9%
S&P 500	4 308	-4.8%	14.7%
Nikkei 225	29 453	4.9%	7.3%
Currencies			
EUR/USD	1.16	-1.9%	-5.2%
EUR/JPY	128.88	-0.8%	2.1%

		Price as of 30/09/2021	1 month bp(1)	2021 bp(1)
Interest rates				
3 months	Eurozone	-0.76%	-12	1
3 months	United States	0.03%	0	-3
10 years	Eurozone	-0.20%	18	37
10 years	United States	1.49%	18	57

(1) Basis point.
Source: Bloomberg. data as of 30/09/2021. Performances in local currency.
Past performance is not a reliable indicator of future performance and is not constant over time.
Index's performance is calculated on the basis of net dividend reinvested.

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