27th June 2022

One Swallow Does Not Make a Summer

- **A positive week in the markets provides some stability but does not indicate that all is well**
- **Growth data remains weak and inflation threatening**
- **Central banks remain hawkish and vigilant**
- **Government bonds in US and Europe find support and sit in a defined trading range**
- **We are on wage inflation watch as strikes and wage demands suggest an un-anchoring of inflation expectations**
- **Chinese asset markets have momentum and help from policy makers**

After the recent battering that the markets received, it is quite tempting to see positive asset market activity as a signal that things are getting better. At least last week's constructive market performance appears to indicate so. US equities surged 6% on the week while government bond yields tumbled 10bps in the US and 30bps in Europe. However, it is still far too early to declare the central banks victorious in the battle against inflation or brush off the talks of the global economy entering a recession. One swallow doesn't make a summer goes the saying. And one good week in the markets doesn't make the central banks' job any easier in taming inflation.

We retain our positive view of both Chinese equities and bonds.
Nevertheless, we want to start with positive news from China, a market we have been highlighting for some time now. If the authorities in China can hold off from imposing any further those draconian lockdowns, the recovery in the Chinese economy could be an important prop for the rest of the world, which is fighting a tough battle against inflation. Last week's export orders data showed a +9.5% growth month-on-month and 6.0% year-on-year, well ahead of expectations. The data suggests that China is getting back to work. This week's (Markit) industrial confidence data is expected to show a further improvement in the headline index reading to 49.0 in June from the April low of 46.0 and May's 48.1.

Comments from Chinese President Xi Jinping grabbed the headlines last week and helped the Chinese asset markets. In a prepared speech for the opening of the annual BRICS Summit, the president noted that, "We will step up macroeconomic policy adjustment, and adopt more forceful measures to deliver the economic and social development goals for the whole year and minimize the impact of COVID-19". The speech was interpreted as a signal of the Chinese government's commitment towards the 5.5% growth target for the year. However, private sector economists remain highly sceptical of China achieving that growth target, with most of these forecasts ranging between 3.5% and 4.4%. However, even an attempt to push growth anywhere close to that target could be a big positive for the Chinese asset markets, in our view.

Chart 1: Chinese equities maintain momentum

Source: Bloomberg

Wage growth is crucial to determining the scale of monetary tightening

While China looks likely to deliver a more consistent set of policy measures to support its economy, we see only retrenchment in the West. The central banks in the US and EU remain determined to tighten monetary policies and, in the circumstances, the governments can do little to mitigate the impact of that tightening.

The outlook for labour markets will be crucial to how the markets perform over the medium term. Some commentators point to still-robust labour markets and a benign wage growth. However, bear in mind that global economic growth has only just started to fall away. Also, it takes time for wage earners to push for higher salaries after a burst of inflation.

Some increase in unemployment looks inevitable given the spiralling inflation. With demand easing off, companies will at first pull their vacancies and then at a later stage think of retrenchment. Hence, we don't expect unemployment to increase immediately, although that doesn't mean it won't happen. There are some visible signs of wage inflation starting to pick up. In some economies, the battle lines are already more apparent than in others. In the UK, for instance, the government will be under intense pressure to give in to the public sector demand for higher wages. In fact, there are reports that the UK government is considering a 5% wage increase. The poor showing by the Conservative Party in the recent by-elections puts them under pressure to 'buy' votes through a positive outcome for public sector workers. The train drivers' union is asking for an 8.8% wage increase. In the private sector British Airways staff have turned down a 10% one-off bonus. Wage increases of 5-10% can only further reinforce inflation risks.

France and Germany are two other countries in Europe that could be vulnerable to wage pressures in the coming quarters. Both have vulnerable political leaderships, and labour forces in both countries can be quite radical. Already giving in to the wage demands, the German government has agreed to hike its minimum hourly wages to Euro 10.45 from Euro 9.82 from July 1st and Euro 12.0 from October, reflecting a collective 22% pay increase.

Bonds appear to have found their trading range…. at least for the moment

With the uptrend in commodity prices losing some momentum on recession fears the markets moved swiftly to squeeze bear positions in both bonds and equities. Government bond yields fell sharply with the US 10-year bond yields trading in a 20bps range and ending the week at 3.13%, at the lower end of the range. Brent oil prices retreated from a peak of $125 and ended last week at $113. However, supply and inventory fundamentals still remain stacked in favour of higher prices. JP Morgan calculates that the oil market is still quite susceptible to supply shocks, and suggested that oil prices are moving about $25/bbl for every 1 mbd variation in supply or demand, which is nearly double the $15 reaction before Russia's invasion of Ukraine. The EU remains intent on banning Russian oil and the provision of insurance to transport Russian oil which suggest upside risk in the medium term.

US 10-year bods yields look capped at around the 3.5% level until the market takes the view that the Fed will have to continue to increase interest rates into 2023. The markets, with greater fear of recession, have moved to price minimal Federal Reserve action beyond the end of the year. There was heavy institutional buying of 10-year bonds as yields moved close to 3.50%. Such a level of bond yields represents a positive outcome from the Fed’s battle with inflation. However, we believe it is too early to hold such a positive view of the inflation risks.

Interest rates must be less effective in taming inflation this time round. A good part of the inflation risks is linked to supply constraints. The supply issues are partly structural—perennial underinvestment in extractive industries and partly due to the Ukraine war. Fed policy can only fight the demand side of the equation. Peak rates of 13% in 1974 remind us of the challenges of fighting supply side inflation with demand side tools.

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