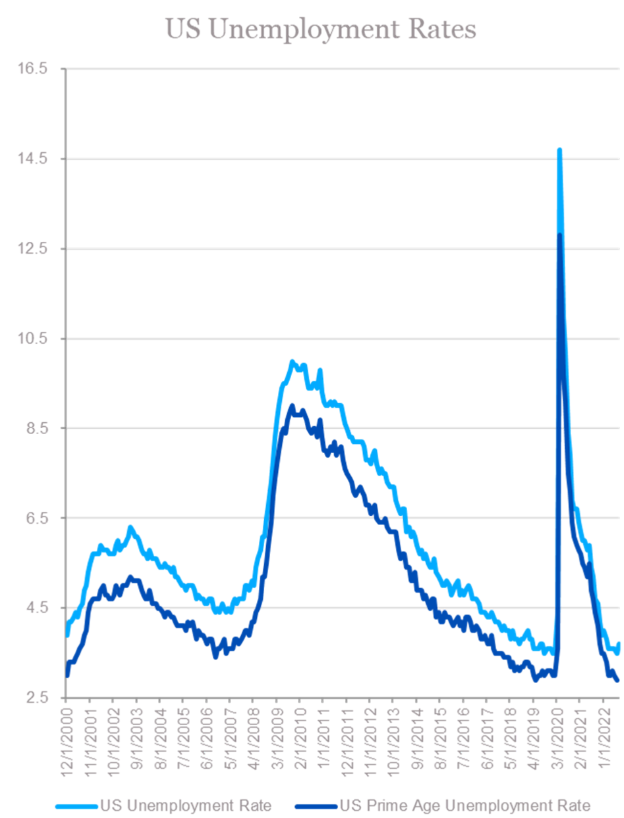
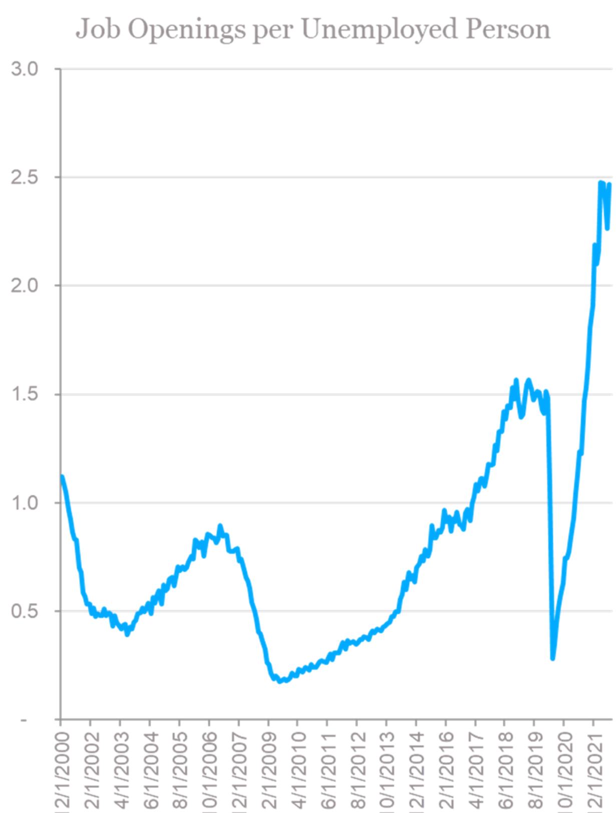
SEPTEMBER 2, 2022

BYE-BYE SUMMER

The summer rally for investors was brought to a sharp halt by Federal Reserve Chair Jerome Powell a week ago. Today's jobs report for August – close to Goldilocks, according to one commentator – lifted spirits. The latest data for pricing, and now for jobs and wages, suggest a soft landing is still possible. But investors should keep Chair Powell's message in mind. He deliberately kept his remarks at Jackson Hole short, if not sweet, so there could be no mistaking it. Fed policymakers are determined to raise interest rates to a level that hurts growth – above the "neutral rate" – and to keep rates high until there is no doubt that inflation is coming back to 2%.

The decision on whether to raise rates by 50 or 75 basis points later this month is finely balanced. Markets tilted slightly toward the lower number after the jobs report. But this week's data show that the labor market remains tight. Payrolls climbed by 315,000 in August – down from July's extraordinary increase, but still a robust showing. The tick up in unemployment to 3.7% came as more workers joined the labor force – a sign of strength, rather than weakness. And vacancies are still far above the number of job seekers. Chair Powell and colleagues may see the continued strength as an opportunity to demonstrate their "unconditional" commitment to fighting inflation, opting for a bigger rate rise now.





Source: RockCreek, Bloomberg

There will be another inflation print before the Fed has to decide its next move. This week's wage data were helpful, with no sign of acceleration. Hourly earnings rose 0.3% from July, and at an annual rate of 4.8% over the past three months. The August consumer price number will also be helped again by falling gas prices. Looking further ahead, the G7 this week set out its plan to cap global oil prices, while also pressuring Russia. The plan is to restrict insurance, shipping, and financial services for Russian sales of crude at prices above a yet-to-be determined cap. In theory, the plan is neat. It remains to be seen if it can work in practice – and at what price level.

Even if inflation has peaked, it will be some time before the Fed and fellow major central bankers feel confident that they have rebuilt credibility and re-anchored expectations of price stability. Until then, financial conditions will continue to tighten.

Hot August Night – Cool September?

Markets finished the summer on a downward spiral as the mood and investor sentiment changed dramatically from June to August, and was only slightly cheered by the positive labor market news as September opened. Bullishness from mid-June lows gave way to worries over higher interest rates after a stark reminder from Jackson Hole of the risks that remain to the economy. Despite some positive economic indicators showing a resilient US consumer and stronger corporate earnings than expected, US markets finished lower for the month with the S&P 500 down 4.3%. Interest rate sensitive sectors, including technology, real estate, and consumer discretionary were among the bottom performers, while energy and utilities stood out to the upside.

It was not surprising to see the latest equity market rally fizzle out, particularly after the reinforcing inflation message from Chair Powell last week. Many institutional investors have not been aggressively increasing risk and instead maintaining a cautious positioning as uncertainty on the direction of markets and the economy continues. Hedge funds, often a barometer of market sentiment, remain at historically low amounts of capital deployed, and net market exposures remain low, despite a fair amount of short covering in July and into the first part of August.

Across the pond, Europe continued to struggle. The evolving energy crisis helped push Eurozone inflation to 9.1% in August, weighing down European markets. The STOXX Europe 600 closed 2.5% lower for the week and down 5.2% for August. Russia shut down its Nord Stream gas pipeline on Wednesday, placing further pressure on European nations to store up supplies ahead of the winter. British energy bills are now set to rise by 80% this fall. German power prices are 16 times higher than they were pre-Covid. Uniper, Germany’s largest importer of Russian gas, asked for an additional €4 billion of support, having already burned through a €9 billion credit facility from Germany’s national development bank KFW.

EU leaders pledged to take steps to offset skyrocketing prices, but that could have the negative consequence of encouraging businesses and consumers to consume more than they otherwise would. Soaring natural gas prices are one thing, but actual supply shortages are quite another. Industrial consumption has already been sacrificed to help achieve natural gas storage targets, but worsening shortages could have an even more devastating effect on economic activity. Investors need to ask whether markets are properly pricing in the odds of a worse-case scenario. There is a heightened risk that the second half of the year incurs even more pain for European markets as investors face a worsening situation.

Markets were happy with the labor market report headed into the US holiday weekend, as they should be. Fears of recession in the first half of this year were clearly overblown. But with central bankers willing to accept some pain – in Chair Powell's words – as policy tightens to curb inflation, the economy is set to slow down. Investors will be eagerly watching several data releases and the FOMC meeting into the start of Fall wondering if a soft landing is possible.

China lagging for longer

With eyes focused on the US and Europe – where monetary tightening is the story and recession fears abound – the troubles of the world's second largest economy have attracted less attention. But they are concerning.

China's main challenge is very different from that facing the West – slow growth and depressed consumer spending, rather than high inflation and a tight labor market. So far, the government does not seem to have the tools to address the problems – or the willingness to use them. Indeed, as we have noted before, today's economic difficulties arise to a large extent from the government's own actions. The extreme response to Covid – exemplified again this week as a mere 42 cases in the Shenzhen province have led to a lockdown of 40% of this large region's productive capacity – has depressed output and encouraged foreign businesses to think of moving at least some of their sourcing elsewhere. At the same time, last year's regulatory attack on the real estate sector and private tech companies curbed growth and left consumers worried about their financial future.

There is little danger of a full blown financial or debt crisis, even as real estate bankruptcies spread. Rather, Chinese households that put money into property as an investment – often buying apartments that were not yet built and which they expected to rent or sell at a profit – now face losses they can ill afford. This week brought bad news about output as the August Caixin manufacturing PMI sends the worrying signal that the export sector, which has led the economy's post-lockdown recovery, may have lost some momentum lately. Optimists hope that President Xi may be ready to loosen policy constraints once he is assured of a tradition-breaking third term as President. This will happen at the Party Congress, now set for October 16. Not too long to wait, but we see big changes as unlikely any time soon. One thing to watch: who fills the other Politburo seats.

What's bad is good – sometimes

China's weakness has an upside: softening commodity prices, including for fuel and food. That is a relief for politicians and citizens in Europe and the US. After seeing energy and grocery bills climb rapidly this spring and early summer, the trend shifted in July. In the US, falling gas prices held the average consumer price index (CPI) flat, offsetting increases in other goods. The prospect of weakening global demand has continued to push oil prices down in recent weeks, as well as commodity prices more generally. Headline inflation may then continue to come down from the June 9.1% peak in the US. But what matters most to the Fed will be core inflation – influenced by wages and rents, and services more generally, rather than energy and food prices.

In Europe, the price pressures have been just as strong as in the US. But the European economy is both weaker and more impacted by the energy supply shock from Russia's invasion of Ukraine. On both sides of the Atlantic, there is some schizophrenia about how effective they want sanctions on Russia to be. So far, Russian revenues have risen since President Vladimir Putin ordered the invasion of Ukraine in February. No one in Western governments likes this. But as policymakers consider when to tighten sanctions – including by restricting insurance and shipping – and at what price, they have worried that moving too soon will push prices back up again. The G7 leading nations will need cooperation from others, such as India, that have been importing from Russia if the new price cap scheme is to work.

Group think in Wyoming?

In addition to Powell's strong message in Jackson Hole, Isabel Schnabel, German central banker and member of the European Central Bank (ECB) policy making group, minced no words in her commitment to fighting inflation when she spoke last weekend. "Central banks need to act forcefully. They need to lean with determination against the risk of people starting to doubt the long-term stability of our fiat currencies," Schnabel said. "Regaining and preserving trust requires us to bring inflation back to target quickly. The longer inflation stays high, the greater the risk that the public will lose confidence in our determination and ability to preserve purchasing power."

There were few dissenters in the gathering. The inflation shock of the past twelve months has made central bankers and most private economists wary of any encouragement for loosening policy. Markets may have hoped before last week that evidence of a slowing economy would cut short the tightening cycle in advanced economies. There would appear to be little analytical support for any major central banker willing to do that anytime soon, although some of those in Wyoming worried that what they saw as group think could lead to too much tightening in Europe. ECB President Christine Lagarde will have a tricky meeting to manage next week, with a decision on the next rates' move due on Thursday, September 8.

New ideas come from new firms

The vibrant tech sector in the US has been the envy of many other nations. Innovations are critical for driving productivity over time, as well as solving problems. Today's tech behemoths started small and some wonder if they were better at innovation then.

An interesting new paper from NBER shows that start-ups are actually better at innovating than larger firms – or academia – as measured by patent developments. But, as we know, the successful ones then grow big. As the authors put it, "Startup innovation is both more original and more general than innovation by incumbent firms. Moreover, startups that survive to become 'scale-ups' quickly grow to dominate their regional innovation ecosystems."

Does the growing domination of once innovative start- ups matter? That is a question for the tech giants that want to stay on the cutting edge as well as for governments.

Emerging Markets

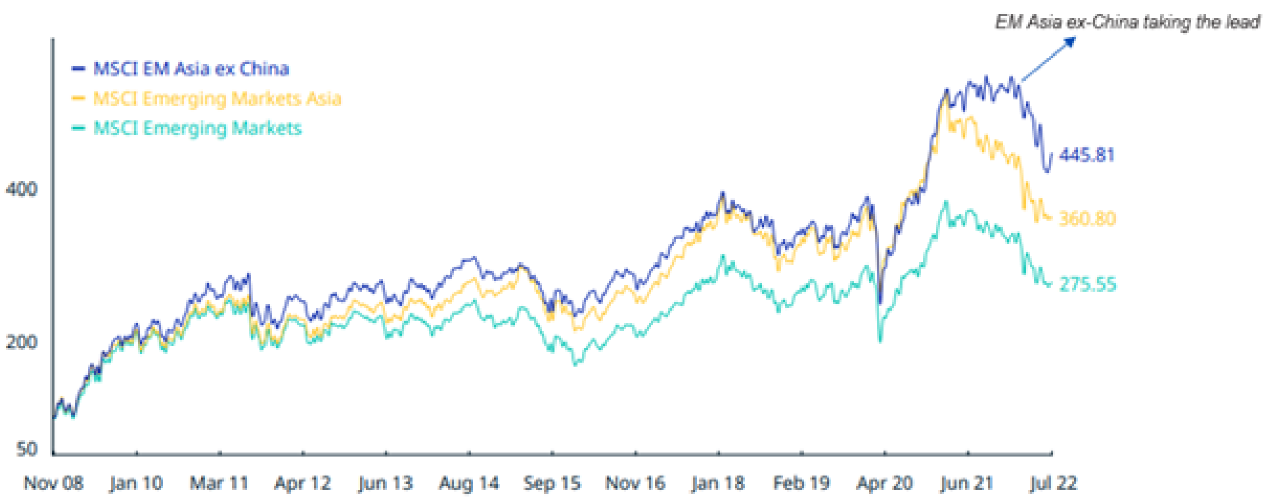
The month of August came in muted for emerging market equities, with the MSCI EM Index and MSCI EM ex-China index up 0.42% and 0.50% respectively. Not that there was a shortage of news – to the contrary, the saber rattling between China and Taiwan reached new highs, a series of lockdowns in Chengdu and Shenzhen again underscored China's slow growth prospects, and the expectation of higher rates for longer in the US gave investors plenty to worry about.

China's ongoing obsession with keeping a lid on the spread of Covid is beginning to permanently skew the trajectory of the world's second largest economy, something that, perhaps, has taken time for students of the markets to appreciate. The statistics speak for themselves. Since the start of the pandemic, China has lost tens of millions of jobs, bringing the official unemployment rate up to 5.4% from 4.5% pre-pandemic and the youth unemployment rate to a near record 20%. This has turned China into a supplicant of foreign direct investments, and the country is in the unprecedented position of having to export excess energy imports due to the slack in economic activity.

A turnaround, if there is one, won't happen quickly and will need the buy-in of the rest of the world – a given this is not. In a society psychologically scarred by three-plus years of restrictions with no end in sight, it's difficult to see how and if economic growth and better living standards will return to the fore.

As is often the case with the Middle Kingdom, change will be slow. But, as is often said, one man's misfortune is another man's fortune, and perhaps in a sign of things to come, it was the economies of South Asia that have been shining as of late.

EM Asia ex-China Taking the Lead



Source: MSCI

India and the economies of the ASEAN block are well positioned to take leadership roles away from China in several sectors, from tech-related consumer companies to medical equipment, to low- and high-end manufacturing. In the most recent GDP forecast released by the IMF, India and the ASEAN block are expected to grow by 7.4% and 5.3% respectively in 2022 – this compares to 3.3% for China and 3% for Latin America.

The promise of India and the ASEAN region, we believe, is also rooted in a demographic dividend that will pay off for a generation and has the potential to materially transform the economic landscape of South Asia. China's remarkable emergence as an economic superpower over the last 20 years was driven by a young, skilled, and seemingly inexhaustible labor force. Now, however, the legacy of the country's one-child policy, as well as the passage of time, leaves China with a rapidly aging population. Over the next 20 years, the country's working population is forecast to fall by 11%; this compares to a rise of 12% in ASEAN's working-age population over the same period. India is expected to command a whopping 24% of the global workforce over the next decade.

Labor costs are also increasingly propelling investment flows away from China. The annual cost of a factory worker in China now exceeds US$10,000. By comparison, the same worker in Indonesia, the Philippines or Vietnam costs approximately US$5,000. India and the ASEAN block are approaching long-term economic changes that will put them in a strong position to benefit from the rapidly changing political and financial global alliances.

RockCreek Update

The energy transition in Africa

Afsaneh Beschloss moderated a conversation at the Center for Global Development with Nigeria's Vice President Yemi Osinbajo on faster sustainable growth in Sub-Saharan Africa as Africa invests in renewable energy, using local natural gas as a transitional fuel. They also discussed how to mobilize private and public capital, including innovative finance from the World Bank and other multilateral institutions.

"Our approach is to seek the sorts of funding that will assist in creating efficient energy markets," Vice President Osinbajo said. "This can become a dynamic situation where the energy market itself tells the world why it is important to invest in our energy transition."

Watch the discussion here.

Happy Labor Day

Nearly a century and a half ago, Peter J. McGuire, general secretary of the Brotherhood of Carpenters and Joiners and co-founder of the American Federation of Labor, suggested setting aside a "general holiday for the laboring classes" to honor those who "have delved and carved all the grandeur we behold."

To all celebrating on Monday, we wish you a very happy Labor Day.

With more to come,

Team RockCreek