

Supply shock a threat to global recovery

Monthly Commentary

For wholesale or professional investors only

When COVID-19 forced the global economy to shut down in 2020, policy makers focused their immediate efforts on addressing the negative demand shock. Massive fiscal and monetary stimulus meant that aggregate household balance sheets barely took a hit in many advanced economies and even strengthened in the US. The legacy of the Covid crisis however will not be one of weak demand. It is the negative supply shock, exacerbated by excessive stimulus, which is now threatening the global recovery and pushing up prices for goods and labour. When freight rates doubled for certain routes at the beginning of the year, few could foresee how much further the trend would continue. Now it costs almost \$16,000 to transport a 40-foot container from China to the US west coast, a 10-fold increase relative to pre-pandemic levels. Importantly, experts argue that the problem is not disappearing any time soon.

Shortages are acute in the UK, which has been doubly hit by Brexit and the pandemic. According to a survey by the Confederation of British Industry (CBI), UK manufacturers' stock levels are the lowest since 1977. Retail inventories relative to expected sales are the lowest since 1983. Furthermore, meat and farming industries are suffering from severe labour shortages. EU nationals make up 60% of poultry meat workers in the UK, many of whom have returned to their home since the pandemic. A shortfall of around 100,000 truck drivers has also affected a number of fast food chains and supermarkets. The shortages have not yet affected economy-wide growth, at least according to the latest data. Second quarter GDP grew an expected 4.8% but is likely to cool off in the third quarter. The Markit Services PMI fell below expectations from 59.6 to 55.5, still in expansion. Retail sales also declined by 2.5%.

In the US, unfilled job vacancies are at an all-time high despite the fact that unemployment has fallen considerably since last year to 5.4%. There are a few explanations behind this. The generous unemployment benefits keeping workers on the sidelines, which we have pointed to previously, are only one piece of the puzzle. In fact, a number

of researchers have seen little difference in employment growth between states that reduced benefits early and those that maintained them. Additionally, research this week at the Jackson Hole Symposium highlighted the risk that loose monetary policy is hampering the much-needed reallocation of labour by stimulating activity in sectors that might not be viable in the future. In other words, supporting zombie firms. Furthermore, part of the decline in the labour force participation rate includes 1.5 million workers who identify as caregivers. This group is more likely to return to the labour force once schools return and are fully in-person. They would also be boosted by proposed legislation that gives greater child-care assistance to low- and middle-income families. However, the other significant group responsible for the shrinking of the labour force are the 3 million retirees that dropped out since the onset of the pandemic.

Inflationary impact forcing central bank action?

The problem for central banks is that unlike the demand shocks of previous recessions, the negative supply shock of the Covid crisis is inflationary. The price pressures as a result of goods and labour shortages have accelerated the 'taper talk' and could force the hand of central banks to act earlier than expected. Average wage growth in the UK grew by a record 8.8% in June and the Bank of England now forecast annual CPI to end the year at 4%. Although remaining highly accommodative, the BoE signalled the need for 'modest tightening' over the next few years. Similarly, Chair Powell this week reinforced plans to begin tapering bond purchases before the end of the year. In any case, as we have continuously argued, asset purchases have had little to no effect on goods inflation and in stimulating growth in the real economy. Rather they have primarily fuelled asset prices and rising inequality. We therefore expect tapering of bond purchases to also be impotent in the face of rising inflation in the real economy, but key in stopping the meteoric inflation in financial markets.



Chief economist of the IMF, Gita Gopinath also warned of the potentially crippling effects on emerging markets as a result of an unexpected taper. Emerging economies have seen debt to GDP levels increase since last year by an average of 8 percentage points, a comparable level to advanced economies. The divergence in growth between emerging and developed economies was highlighted last month. Since then, the IMF has injected a record package of \$650bn of SDR's to its 190 members. Emerging economies ex-China will receive around \$200bn. The G7 also agreed to allocate \$100bn of new reserves to lower-income countries. Although much more needs to be done to alleviate the pressures faced by EM's, the SDR injections can provide an extra buffer to stabilise reserves in the case of a taper tantrum or to accelerate the vaccine take-up, which will benefit the entire global economy.

Markets at risk of complacency

Global equity markets rose over the month despite a sharp sell off over the middle of August led by growth and momentum. From the 19th August onwards, markets rebounded strongly with growth and quality leading the rebound. As we've highlighted previously, these equity market moves mirror the change in yield of the US 10-year which tightened over the middle of the month, supporting a rebound in growth and momentum. Over the month the US 10-year troughed at 1.19% and peaked at 1.36%, ending the period broadly unchanged to 1.29%.

Despite the remarkable move higher in equity markets, not all is rosy. Investors have ridden the recovery from the pandemic, but clouds continue to gather on the horizon. Key amongst concerns is the rampant nature of the Delta variant and the disparate rollout of vaccine programs with emerging and low-income economies lagging developed economies. The reopening trade that has seen the hospitality, travel, hotel and energy industries recover would suffer heavily should restrictions be reintroduced.

Should global growth continue to recover, the prospect of central bank stimulus being withdrawn becomes ever more likely. Risk assets have benefitted significantly from ultra-low borrowing costs that have helped equities, and other risk assets, perform strongly. Higher rates would hit the most expensive pockets of the equity markets and long duration fixed income the hardest.

Finally, the base effect of the recovery in company earnings needs to be acknowledged. Recent quarters have seen companies report record earnings, with the vast majority beating analyst expectations. Such strong earnings announcements will not continue. Is the market pricing this in?

Pyrford International

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