Weekly Market Summary

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Lie to Me Pinocchio, Lie to Me … Inflation is Transitory!

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When the woodworker Geppetto sees a falling star, he wishes that the puppet he just finished, Pinocchio, could become a real boy. In the night, the Blue Fairy grants Geppetto's wish, but the naive and trusting Pinocchio falls into the clutches of the wicked Honest John who leads him astray to the corrupt Pleasure Island. In punishment, Pinocchio's nose grows every time he lies up to a point where he finds himself with such a long nose that he can't even run from the house to hide his shame (his nose growing to such enormous size that it won't fit through the door!)

In real life, and judging from Fed officials' latest FOMC economic projections, central bankers continue to err on the side of optimism ("*deceiving*" or "*misleading*" are better words that come to mind!) with regards to price pressures. They prefer to continue projecting inflation will fall back close to 2.0% in 2022 (from the most recent reading of 3.6% for annual core PCE deflator and 4.0% for annual core CPI), even as supply chain disruptions, energy costs and rising rents threaten to make the current price surge bigger and longer lasting than expected. And they expect inflation to keep decelerating in 2023 and 2024, even though the unemployment rate will have fallen below the level consistent with stable inflation by late next year. Obviously, such an optimistic outlook allows a dovish approach to monetary policy. Even though half of Federal Open Market Committee (FOMC) participants expect the central bank to start increasing short-term interest rates from zero in the second half of 2022, the estimated pace of tightening is very slow; The median projection for the federal funds rate in the fourth quarter of 2024 is 1.8%, still well below the 2.5% "*neutral*" rate considered to neither stimulate nor slow the economy.

Such dovishness, however, also raises the risk of a major policy error. If the economic outlook evolves in unexpected ways, Fed officials will almost certainly be slow to respond because their new framework (focused on hitting an inflation rate of 2.0% on average over time that in turn allows prices to run moderately higher in coming months to make up for past misses of inflation to the low side of the target) demands patience and because they think the negative consequences of delay are very modest. Hence, if inflation proves more persistent than anticipated and even accelerates as the economy pushes beyond full employment, they will have to tighten much more aggressively than they expect. The result could more resemble what happened from 2004 to 2006, when the US Federal Reserve raised its short-term interest-rate target by 4.25 percentage points, to 5.25% from 1.00%, with 25 bps increases in 17 consecutive policy-making meetings. A faster pace of tightening this time around, with current elevated debt levels and hefty bond/equity valuations, would come as a shock for financial markets and surely tip the world back into severe recession. That is the danger of fighting the wrong war at present!

That said, the global economy is entering the final quarter of 2021 with a mounting number of headwinds threatening to slow the recovery from the pandemic recession as well as prove policy makers' benign views on inflation wrong. The delta variant, as well as President Biden's vaccine mandate, continue to disrupt schools and workplaces. U.S. lawmakers will continue fighting over the debt ceiling (latest bipartisan agreement to raise the government's borrowing ability by $480 billion is expected to set stage for another debt showdown in early December) and spending plans. China is suffering an energy crunch and pursuing a regulatory crackdown, while markets remain on edge as China Evergrande Group struggles to survive. Fuel and food costs are soaring worldwide, combining with congested ports and strained supply chains to elevate price pressures while labour shortages continue to plague some employers. Although the expansion seems intact for now, such a backdrop is fanning fears of a mix of weaker growth and faster inflation to come (also known as stagflation), threatening to further complicate nascent efforts by central banks to dial back stimulus without rattling markets. "*Expectations of a swift exit from the pandemic were always misplaced*," said Frederic Neumann, co-head of Asian economic research at HSBC Holdings Plc in Hong Kong. "*Full recovery will be measured in years, not quarters*" (surely not an excuse to maintain significant stimulus in place, Mr. Neumann!)

Nouriel Roubini, a professor of economics at New York University's Stern School of Business renowned for foreseeing the mortgage collapse that helped produce the 2008 financial crisis, believes the Federal Reserve may find it tough to tighten policy if growth slows and markets sell off like they did in the fourth quarter of 2018. "*They are going to wimp out,"* the chairman and chief executive officer of Roubini Macro Associates, said in an interview with Bloomberg Television last Tuesday. "*They are going to postpone any finishing of tapering or raising rates*." Supply chain bottlenecks and labour shortages are fuelling a significant increase in core and headline inflation and at the same time hurting economic growth, Roubini said. If growth slows, "*it becomes a very tough dilemma for central banks*" and the Fed will "*end up being dovish*." Slower U.S. economic growth will mean the Fed is unlikely to raise interest rates next year, even though the tapering of asset purchases is expected to be announced at its next policy meeting, Jan Hatzius, Goldman Sachs Group Inc.'s chief economist, also noted this week.

Below, we leave our readers with a coverage of major stories that have shaped our world/markets this week:

- ***Oil Set for Best Run of Weekly Gains Since 2015!*** Oil is headed for an eighth weekly gain, the longest such run since 2015, as a global energy crunch tightens the crude market. Futures in New York edged higher toward $82.30 a barrel this morning after advancing 1.1% on Thursday. Shortages of natural gas and coal in Europe and Asia are boosting demand for oil products, the International Energy Agency said. Crude has rallied to the highest since 2014 as the energy crunch coincided with rebounding demand as major economies open up after the pandemic. Saudi Arabia's energy minister reiterated the need for OPEC and its allies to take a gradual, phased approach to restoring supply hikes even as banks including Citigroup Inc. raised their price forecasts due to fuel switching. The U.S. is engaged in diplomacy with OPEC+ members over energy supply and is "*expressing in private our concerns*," State Department Spokesman Ned Price said on Thursday. U.S. natural gas prices have more than doubled this year, with the peak winter demand season still weeks away.

- ***Fed Officials Saw Taper Starting in Mid-November or Mid-December:*** US Federal Reserve officials broadly agreed last month they should start reducing emergency pandemic support for the economy in mid-November or mid-December amid increasing concern over inflation. "*Participants generally assessed that, provided that the economic recovery remained broadly on track, a gradual tapering process that concluded around the middle of next year would likely be appropriate,*" minutes of the September 21-22nd Federal Open Market Committee meeting released Wednesday said. "*Participants noted that if a decision to begin tapering purchases occurred at the next meeting, the process of tapering could commence with the monthly purchase calendars beginning in either mid-November or mid-December*."

- ***Could US High Inflation Become More Permanent?*** There is a bit of a pivot happening at the Fed where there is a worry that transitory inflation could prove to be much more sticky and structural. Even the doves on the FOMC Committee want to make sure that inflation expectations and financial conditions don't start to cause alarm. In addition, Fed staff said risks had worsened, including the possibility that "*longer-run inflation expectations would move appreciably higher and lead to persistently elevated inflation*." Federal Reserve Bank of St. Louis President James Bullard said this year's surge in inflation may well persist amid a strong U.S. economy and tight labour market. "*While I do think there is some probability that this will naturally dissipate over the next six months, I wouldn't say that's such a strong case that we can count on it*," Bullard said Thursday. "*I would put 50% probability on the dissipation story and 50% probability on the persistent story.*" Elsewhere, Federal Reserve Bank of Atlanta President Raphael Bostic said this year's inflation surge is lasting longer than policymakers expected, so it's not appropriate to refer any longer to such price increases as transitory. "*Transitory is a dirty word*," (naughty Powell, who uses it a lot! 😊) Bostic said in a virtual speech to the Peterson Institute for International Economics on Tuesday.

- ***HSBC Bond Bull in Retreat with Inflation in Driver's Seat***: The surge in inflation is forcing HSBC Holdings Plc's renowned bond bull Steven Major to raise his year-end yield forecasts. But he and his team still maintain that any rise will be short-lived, sticking to the long-term view that ultra-low rates are here to stay. HSBC today raised its year-end forecast for U.S. 10-year Treasury yields to 1.5% from 1.0%, after holding that call since February (10-yr UST yield last around 1.55%). But the bank kept its end-2022 forecast at 1.0%. The longer-term outlook doesn't change. "*With end-2021 in sight, growth expectations are lower, and inflation expectations are in the driving seat,*" Major said. "*But our forecast and our methodology are very much looking at the longer-term drivers. There's a difference between predicting climate change and a weather forecast*." (Makes total sense! Tell that to a corporate client who refrained from hedging his interest rate exposure earlier this year on the back of the previous, more dovish projection 😊).

- ***ACWA Power Surges in Riyadh Trading Debut:*** ACWA Power International surged on its debut in Riyadh after raising more than $1.2 billion in the biggest Saudi Arabian listing since Aramco's two years ago. The utility jumped by the 30% daily limit to 72.80 riyals on Monday (stock ended the week at SAR 66.50) as investors flocked to a business seen as key to Saudi Arabia's efforts to diversify from oil. ACWA, which aims to play a major role in the transition to greener energy by producing renewable electricity and hydrogen, offered shares at 56 riyals each. The initial public offering attracted more than $300 billion in orders. The government has said ACWA will help develop 70% of Saudi renewable energy projects. It's part of a consortium developing a $5 billion plant that will export green hydrogen from the new city of Neom. The fuel will be made using solar and wind power. ACWA also runs water desalination plants. The listing comes amid a surge in Saudi stocks, with the main exchange in Riyadh up 34.6% this year. The kingdom's economy and markets have been boosted by oil prices jumping more than 63% in 2021.

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