SYFX Treasury Foundation
(Registered under Section 8 of Companies Act 2013)

Weekly Market Update

- 10 Oct 2021

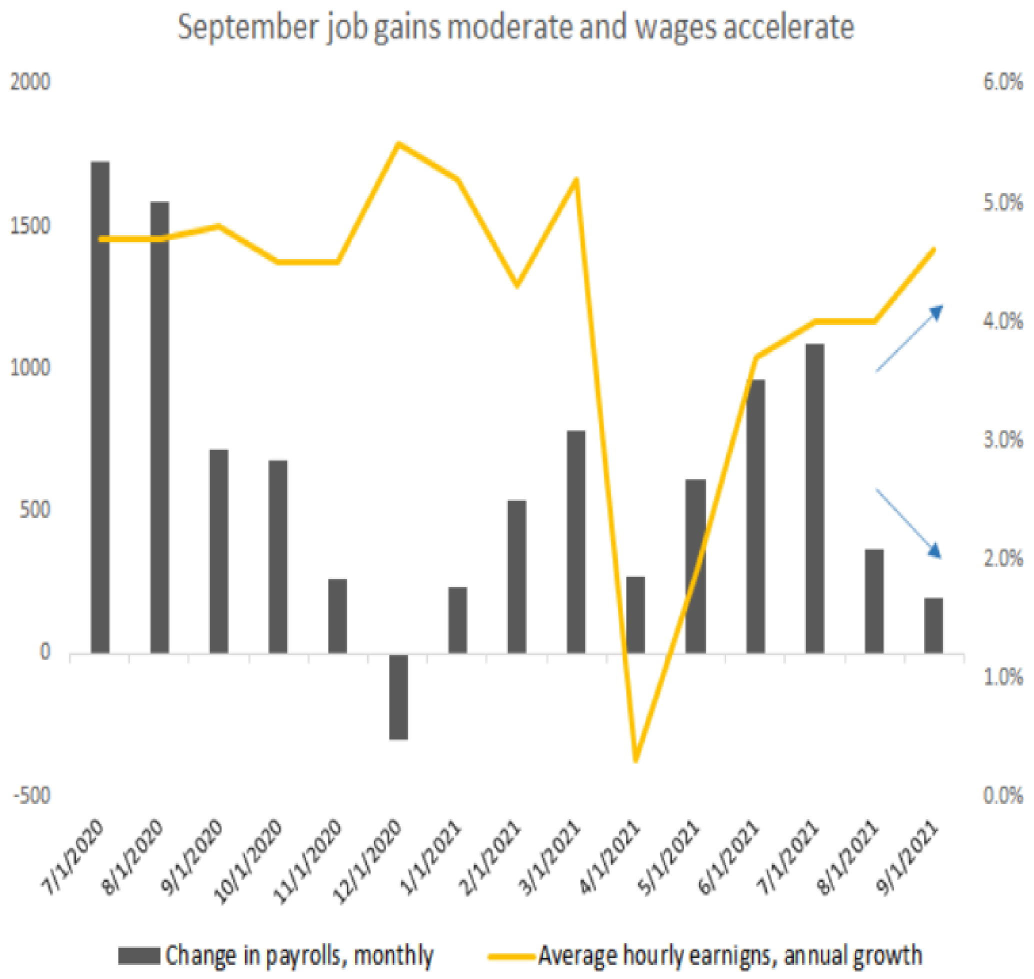
V Thiagarajan
thyagoo@syfx.org

US Economy : Supply Snags

- September's disappointing employment report clearly takes center stage over last week's other economic reports.
- ISM Services index rose to 61.9 in September, modestly up from 61.7 the month prior. As in the manufacturing industry, supply chain constraints appear to be the biggest constraint on growth in the service sector today.
- Logistic constraints were evident in the August trade report. Tangled supply chains and severe transportation bottlenecks continued to pressure the U.S. trade deficit, which widened to $73.3 billion in August.
- Durable goods consumption peaked at 26% above the pre-pandemic trend in March, and having since steadily declined, is now 7.6% above trend.
- There is high probability of further declines, with Michigan consumer sentiment survey suggesting consumers are balking at high prices following the inflation we have seen in goods this year; the share of consumers saying it is a good time to buy durables fell to the lowest since 1980
- Given that services makes up a much bigger share of private consumption in the US than durable goods – at 64% vs 13% – this recovery in services should comfortably offset the decline in goods consumption.
- Consumer credit increased $14.4B in August, its weakest monthly increase since February.
- Simultaneous labor and material shortages are causing snags in supply chains, constraining economic activity, and driving prices higher.

Payroll : Disappointment

- U.S. economy added 194,000 jobs in September, the smallest gain this year
- More encouraging was that the August numbers were revised meaningfully higher and the miss in private-sector jobs was less severe. Employment in leisure and hospitality increased by 74,000, even though it remains about 10% below its pre-pandemic level.
- The biggest disappointment came from the 180,000 decline in education (90% in the government sector), which was likely impacted by seasonal factors.
- The report underscores that labour availability remains the biggest challenge to hiring right now. The labor force participation rate fell in September, while the unemployment rate tumbled to 4.8%.
- With businesses still struggling to find workers, average hourly earnings rose 0.6%.
- With job openings at record levels, the expiration of pandemic benefits, and improving delta-variant trends, hiring will pick up in the coming months, but the path towards returning to full employment will not be a straight line.
- At this point additional liquidity does little to address the fast-rising wages and widespread reports of labor shortages



US Equities : Soft Rebound

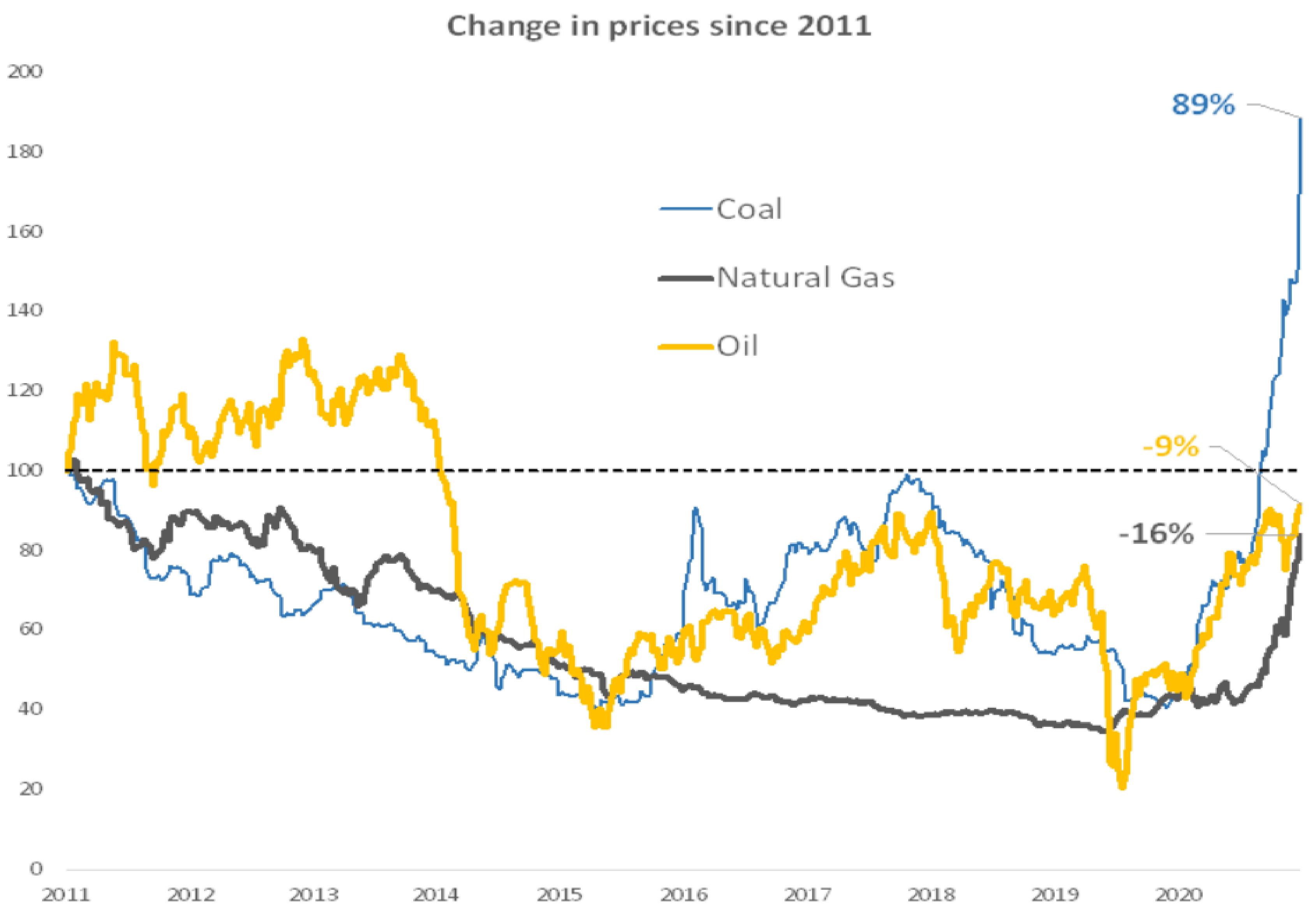
- The first full week of October and Q4 finished with a gain but in less convincing way with multiple large swings above and below the unchanged mark. However sentiment has been bolstered as Congress passed an extension of government funding until early December.
- Moreover, the Delta variant continued to show signs of rolling over and economic data was mostly upbeat, headlined by stronger-than-expected September services sector reports and a larger-than-expected deceleration in initial jobless claims which snapped a string of three weeks of acceleration.
- However, the global supply chain disruption continued to hamper economic activity and inflation pressures remained elevated, while expectations persisted that global monetary policies are heading down the tightening path.
- The price action in commodities was in the spotlight last week, contributing to the elevated volatility in equity and fixed-income markets.
- Among the eye-catching moves are that oil rose to a seven-year high, natural gas prices briefly spiked to 2008 levels after having doubled this year, and coal rose to record highs.
- The rocketing prices have triggered an energy crunch in Europe and China, hitting factory output and adding another complication in the long list of supply-chain issues that are holding back the global economic recovery.

Resolving the Disconnect

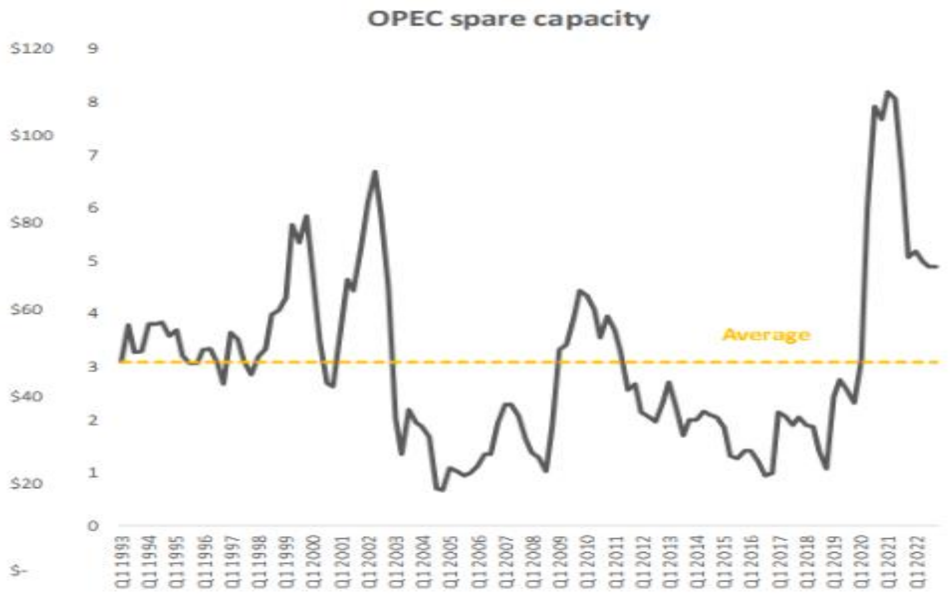
- Markets have been jittery after an extended run higher in risk assets.
- The upmove in Yields naturally causes some uneasiness in the equities and risk assets
- It is particularly important to have an anchor in such a noisy market environment, such as the dominant view that it has been an economic restart rather than a typical business cycle recovery.
- U.S. growth momentum has already peaked, given the nature of the restart.
- New normal theme – Short-term yields will likely stay lower than they would have in similar past periods as central banks keep policy accommodative, and longer-term yields will gradually rise on the back of a revival of term premia and higher medium-term inflation.
- This is why the recent Treasury yield spike is not alarming – does not impact a pro-risk stance although one should stay broadly underweight government bonds, particularly for longer maturities.
- Simply put ,U.S. Treasury yield spike is resolving a disconnect between the restart and low yields, and not reflecting a hawkish pivot by central banks

Europe : Stagflation

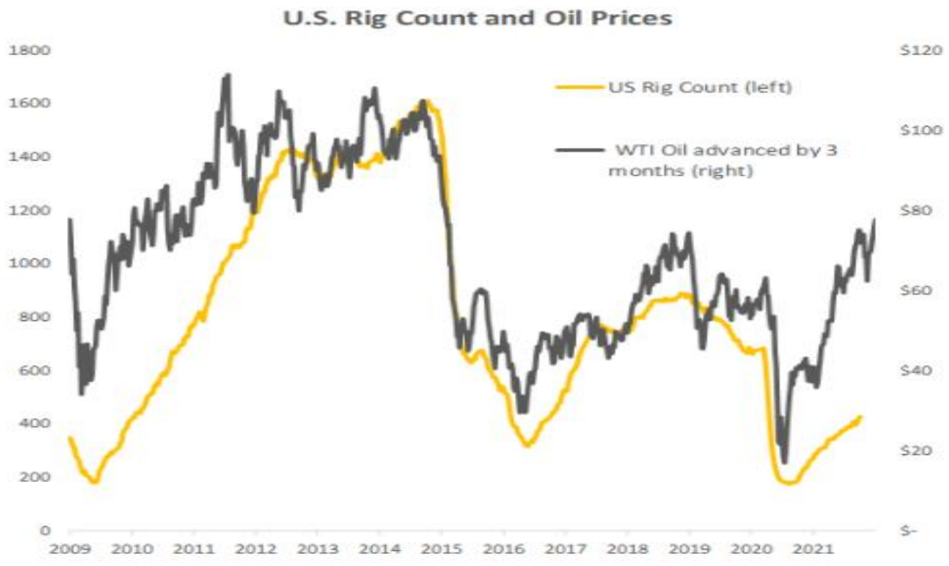
- September brought more signs that the 'economic tide' is turning in the Euro area.
- While manufacturing and service PMIs remained well in expansion territory - signalling quarterly growth of ca. 1-2% - the slowing growth momentum is increasingly visible and likely to extend into Q4.
- Business surveys also point to rising 'stagflationary' risks. Supply constraints are no longer just a manufacturing problem and have started to weigh on demand, with new order growth slowing and year-ahead expectations dimming to the lowest levels since February.
- In contrast, the 'inflation tide' is still on the rise, with German CPI inflation rising to the highest level since 1993 in September.
- Both rising energy prices and base effects from last year's German VAT cut continue to put upward pressure on inflation.
- With negotiated wages growing by only 1.7% in Q2, inflation rates in excess of 3% point to an increasing erosion of purchasing power, which we expect to weigh on private consumption growth during Q4.
- German data on orders and industrial production disappointed last week. Orders dropped 7.7% m/m and industrial production plunged 4.0% m/m. Supply chain issues in the car sector are still an important factor for the weak industry performance, but signs of weakening demand in survey indicators suggest that more downside might lie ahead for Q4.


Change in prices since 2011
200
180
160
140
120
100
80
60
40
20
0
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
Coal
Natural Gas
Oil
89%
-9%
-16%

Firmer Oil ..



- Per OPEC's own estimates, they would not have enough spare capacity beyond 3Q2021 to serve global demand growth..
- Over the last decade the U.S. rig count, an important barometer for the oil-drilling industry, has closely followed oil prices.
- However, following last year's collapse in oil and amid pressures from investors to exercise capital discipline, U.S. shale producers have been very cautious in adding supply.
- U.S. Department of Energy was walking back previous comments that it was considering a release of the Strategic Petroleum Reserve and a ban on crude oil exports.
- Some are switching from gas to oil derivatives, as the latter have become cheaper than natural gas.



.. As gas crunch continues

- The gas crunch is another example of extreme events—soaring gas prices—exposing vulnerabilities in complex systems.
- The Financial Times columnist Izabella Kaminska compares the effects of rising gas prices to the 2008 financial crisis. When faced with an extraordinary shock the financial system, which was thought to be highly efficient, proved frail.
- Like the financial crisis and the pandemic, the gas crunch highlights the primacy of resilience over efficiency in a crisis.
- Europe's gas demand stands at 604 billion cubic meters (bcm), whereas gas production is only 260bcm. 344bcm is sourced in global markets.
- Gas storage in Europe is around 76% full, compared to a five-year average of around 90%. But the situation in some countries is even worse. In the Netherlands for example, storage facilities are half empty on average.
- The resolution of the gas crunch will depend heavily on the weather.
- A mild winter would alleviate heating demand and faster wind speeds would increase wind power and ease demand for gas.
- The official version of events is that rising energy demand coincided with tight energy supply.
- The unofficial version has to do with Europe's energy transition agenda and the possibility it may have rushed to it without enough long-term planning.

.. Endgame not in sight

- Europe currently has some 220 GW in wind power, according to Wind Europe. Solar capacity stood at close to 131 GW at end-2019
- If neither weather nor the gas supply picture improves, there is a likelihood of “non-negligible risk” of power outages in Europe .
- There is also little sign that Gazprom which supplies 35% of European gas needs — is attempting to pump more gas to Europe’s spot buyers via existing routes, and overall given its small room for manoeuvre, it is unlikely that Gazprom could deliver more than around 190bcm (billion cubic meters) to Europe this year. European prices are unlikely to cool substantially in 2021.
- The 55 bcm Nord Stream 2 pipeline was designed to increase gas exports from Russia to Europe, but has faced some delays due to fierce opposition from US . Gazprom finished construction last month and the German regulator, the Bundesnetzagentur, now has four months to certify the pipeline and to comply with EU standards and regulation. If parties speed up the process, the pipeline could be operational before January or February, which are typically the most severe winter months.
- However ,Russian domestic gas market currently remains tight, with its inventories running low, output already near its peak and winter looming in Russia as well, limiting gas export capacity
- The production ceiling of the Dutch Groningen gas field, the largest field in Europe, was reduced from 42bcm in 2014 to 7-8bcm currently, which is considered in line with the safety level of around 12bcm to prevent earthquakes.

UK Energy crisis

- The 2021 energy crisis is a textbook example of a contest between supply and demand – a fundamental principle of the free market.
- Typically, UK relies on onshore wind (11.1%), offshore wind (13%), and natural gas (37%) to produce approximately 60% of its energy. However, each of these has been drastically affected in the past year.
- For most of the last 50 years the country enjoyed abundant, instantaneous supplies of North Sea gas. However, it failed to invest in gas storage capacity, creating new vulnerability as supplies from the North Sea dwindled and spot prices soared. (The Financial Times estimates UK gas storage capacity at 2% of annual gas demand compared to 20–30% for its European peers).
- An obvious alternative is liquefied natural gas, which is shipped from US, Qatar, or Russia. But demand from Asia has bid up prices and redirected supply away from Europe. Meanwhile, a fire at one of the two interconnectors that provide UK with electricity from France has disrupted energy imports.
- National Energy Action says 1.2 million to 1.5 million additional households will be plunged into fuel poverty. (Households that spend a high proportion of their income on energy bills are considered to be in fuel poverty).
- Industry leaders have warned the government that factories across the country could stop production due to rising energy costs.
- Govt has assured that it would keep the energy price cap for consumers in place throughout the winter but said that they would not "bail out failing energy suppliers", though did not rule out a cap for firms.

China – Looming Slowdown

- Evergrande crisis is not taking place in a vacuum.
- Combined real estate and construction activity accounted for 28.4% of China's GDP in 2015 (It is likely even higher now.)- increased from about 10% of GDP in 2000 to 20% in 2010 to 28% in 2015.
- In the same year, this figure was 16.5% for US, 20.0% for UK, 18.7% for Spain, and 10.1% for Ireland.
- The latter two are important because their property markets experienced a major crisis a decade ago.
- Spain's real estate and construction industries peaked at 28.7% of GDP in 2006 while Ireland's peaked at 21.6% in 2007
- With the enormity of the impact of real estate production and property services on GDP rivaling Ireland and Spain at their pre-financial crisis peaks—it is hard to see how a significant slowdown in the Chinese economy can be avoided even if banking problems were contained.
- China now faces several other headwinds that will likely cause a deceleration in economic growth.

Monetary Policy round up

- Reserve Bank of New Zealand (RBNZ) became the second developed economy central bank to hike interest rates during the current cycle, raising its policy rate by 25 bps to 0.50%. RBNZ was somewhat balanced regarding the pace of future tightening, saying that "further removal of monetary policy stimulus is expected over time, with future moves contingent on the medium-term outlook for inflation and employment.“
- That said, the central bank's assessment of the economic outlook was relatively constructive overall and, as a result, another 25 bp rate increase is likely at the November monetary policy
- Meanwhile, in Australia, the central bank held monetary policy steady at its meeting this week. The Reserve Bank of Australia (RBA) kept its policy rate at 0.10% and maintained the pace of its bond purchases at A$4 billion per week until at least February 2022.
- There is a high probability of Bank of Canada moving towards less accommodative monetary policy at its late October announcement. Bank of Canada might reduce the weekly pace of government bond purchases by C$1 billion to just C$1 billion purchases per week, and expect the central bank to end its quantitative easing program by early 2022.
- Mexico's September CPI highlighted still-elevated inflation and indeed some further quickening in the latest month. The headline CPI firmed to 6.0% year-over-year, from 5.6% in August. The central bank raised its overnight rate by 25 bps in both August and September to currently stand at 4.75%. Given persistent inflation pressures, there will be another 25 bps rate hike by the end of this year, and a cumulative 125 bps of tightening within the next 12 months

Transitory to Gradual

- In a repeat of August, MPC voted to retain the accommodative stance of policy by 5 votes to 1 for as long as necessary to revive and sustain growth, while ensuring inflation remains within the target going forward.
- In keeping with what has been by now established guideline by FED , MPC did not use either 'transitory', 'transient', or 'temporary' to characterise the current supply-side shocks and elevated inflation prints. This is a marked shift from August, when 'transitory' and 'temporary' were used four times.
- The new found phrase is being gradual and not rocking the boat when its reaching shore
- RBI acknowledged that the recovery of demand has gained traction and expects it improve further with the festival season. Its growth projection stood firm at 9.5% for the current financial year, led by early signs of recovery across all sectors of the economy.
- Taking note of easing food prices and a favourable base effect, the apex bank slashed its CPI projections to 5.3% from 5.7% earlier for 2021-22 (Apr-Mar).
- Government bonds, especially the longer-maturity papers, slumped after RBI refrained from announcing further outright gilt purchases under the government securities acquisition programme it had started in April.
- Centre's ongoing borrowing is particularly concentrated in the 10- to 14-year maturity segment, which was set to rise to around 46% in Oct-Mar from 41% scheduled in Apr-Sep, according to its calendar.

Equities : Ignoring the negatives

- The index has managed to shrug off the negativity arising out of record highs in Oil prices and the implications of global energy crisis and rallied higher.
- RBI stood by its accommodative stance and there have been strong business updates by companies for Jul-Sep quarter
- The Energy intensity of the economy is at elevated levels and there is a risk that this negative factor is being ignored by the euphoric markets
- The index should get confined within 17600 17900 range

Disclaimer

- As nothing in this document should be taken to be advice, we encourage you to seek independent advice on these matters and you should reach your own conclusions and decisions, in consultation with your own advisors.
- The information in this document might change and we are not undertaking to update it.
- This information is published solely for information purposes. It is not to be construed as a solicitation, an offer or recommendation.
- As this information has been prepared without considering your objectives, financial situation or needs, you should before acting on the information, consider its appropriateness to your circumstances.
- It must not be relied upon as investment research.
- SYFX Treasury foundation believes that the information is correct and any opinions, conclusions or recommendations are reasonably held or made, based on the information available at the time of its compilation, but no representation or warranty, either expressed or implied, is made or provided as to accuracy, reliability or completeness of any statement made