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Weekly Market Flash

Fed: Choosing growth over inflation

September 5, 2021

The US labor market report revealed that the economy produced a far lower-than-expected number of jobs in the month of August. The most relevant detail was the sudden halt in hiring in the leisure and hospitality sectors – these sectors added no new jobs after adding 350,000 per month on average in the six months prior. Meanwhile, a sensational acceleration in hourly wages, up twice as much as expected, cannot fail to raise a few eyebrows at the FOMC, where the prevailing view is that inflation is largely temporary. The central question that the report now raises is whether hiring has collapsed because the Delta variant is impacting economic activity, and, as wages in the leisure and hospitality sectors aren't high enough to attract workers back into the labor market, will companies continue to increase wages?

Highlights

- The US labor market report showed that the number of new jobs created in August was not even a third of the consensus, coming in at 235k against 725k.
- At Jackson Hole, Fed Chairman Jay Powell delivered a dovish speech, downplaying expectations for an imminent announcement of tapering and marking a hard line between tapering and interest rates hikes. This dovish intervention lent strong support to markets and weakened the US dollar.
- US equities were mixed, as were European indexes – in particular on the back of hawkish comments from some ECB policymakers and as the August Eurozone inflation surprised to the upside to 3%. Meanwhile, Chinese stocks ended in the green, despite a volatile week.
- The latest PMI readings in China revealed the extent of the damage that the Delta variant measures have inflicted on the economy – both recessionary readings of the official non-manufacturing PMI and the Caixin services PMI were 47.5 and 46.7, respectively.
- While gold experienced a tough month of August, the renewed Fed's dovishness and the unclear inflation environment should now warrant some upside.

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Markets & Macro | Fed: Choosing growth over inflation

US equities supported by structural factors.
The US labor market report showed that the number of new jobs created in August was not even a third of the consensus, coming in at 235k against 725k. In particular, the leisure and hospitality sectors added no new jobs, after adding 350,000 per month on average in the six months prior. Out of the 5.3 million jobs still needed to be created to recover to pre-Covid levels, 1.7 million refer to these two labor intensive areas of the economy. In addition to this, hourly wages have significantly accelerated to 4.3% year-on-year. This raises the question: has hiring collapsed because the Delta variant is impacting economic activity, as wages in the leisure and hospitality sectors aren't high enough to attract workers – suggesting companies will have to keep increasing wages?

Our view: Sustained wage growth seems to lean toward the second hypothesis, namely that companies are failing to hire. In essence, the report indicates that labor market normalization has slowed, which we believe makes a tapering announcement at the FOMC meeting on 22 September unlikely. Admittedly, the report's weakness (coupled with a few other strong economic data releases in August, namely the Michigan University Consumer sentiment and retail sales) at least partly justifies the Federal Reserve (Fed) Chairman's extremely cautious stance in Jackson Hole. At the most anticipated event of the summer, Jay Powell managed to deliver a dovish speech, downplaying expectations for an imminent announcement of tapering and marking a hard line between tapering and interest rates hikes. This dovish intervention lent strong support to markets and weakened the US dollar, despite inflation currently running well above the 2% target in the US and in most developed countries.

For the moment, inflation is well accepted by financial markets, which are satisfied with the steady rise of the stock markets and the resilience of bonds. However, it is less tolerated by consumers, who will go to the polls again in 2022. The US administration is clearly aware of the risks to consumers' purchasing power, and some recent decisions seem to take this dynamic into account. In fact, the reopening of negotiations with Iran is aimed at lowering energy prices, while food subsidies have been increased by 20%, directly benefiting 42 million US citizens.

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However, the Fed may soon find itself in a less than comfortable position. On the one hand, inflation, although it has recently stopped rising with the removal of unfavorable base effects, remains well above its stated targets (2%). On the other hand, the global economy is certainly still recovering, but in 2022 the boost from the fiscal stimulus will turn into a headwind, due to the normalization of government balance sheets. Many emerging countries that are not lucky enough to have commodities would suffer if the Fed were to start tightening, pushing the US dollar up. But even in industrialized countries, the prospect of a return to normality is receding if it is true that vaccines offer limited coverage – as is becoming apparent in Israel, where new cases of Covid have increased exponentially over the summer – and that controls and restrictions will be prolonged.

In any case, so far, it seems clear that the Fed's line, when it has to choose between growth and inflation, seems oriented toward growth. This is one of the main reasons why we remain overweight US equities market compared with Europe. We tend to regard the extremely positive performance of European stock markets this year as an exception, as they have been buoyed by the cyclical recovery brought about by the arrival of vaccines. The latest interventions by European Central Bank (ECB) members suggest that the start of the reduction in securities purchases (the PEPP program) may begin in Europe even earlier than in the US. The tone from ECB members has definitely soured in recent weeks, with the classic North-South divide once again in evidence. In fact, inflation is expected to remain above the ECB's new 2% symmetric target for the remainder of this year; northern countries' members in the ECB's Governing Council have become more explicit against inflationary risks and the need to slow bond purchases. This implies that next week's ECB meeting will probably see a heated debate before the press conference held by President Lagarde.

In terms of asset allocation, we took advantage of the summer weakness in the markets to fully restore our equity exposures. In fact, the market only saw two small corrections over the summer months, one in late July and one in mid-August, where the buy-the-deep mentality clearly prevailed. As mentioned, we maintain our structural preference for the US market. In addition to the Fed's increased focus on economic performance at the expense of inflation, we believe there remain other structural issues that favor this market – such as higher liquidity, the presence of the tech sector, less government intervention in the economy and a lower taxation regime, which may deteriorate slightly with the Biden administration's social spending plan, but hardly radically.

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Moreover, the crisis in Afghanistan will unfortunately have the effect of once again pouring a wave of migrants at the borders of Central and Southern Europe in the coming months, with consequent costs and domestic political tensions. Especially in the context of elections in Germany (in October) and especially France (in spring 2022). At this point, with the main stock indices up by over 20% since the beginning of the year, it seems reasonable to assume a consolidation or even a retracement phase in the coming weeks, which would create the ideal conditions for the classic end-of-year rally in November/December.

Equities | Chinese stocks shrug off volatile week

Policy reversal likely in China, sooner or later.

US equity indexes ended the week mixed, with the real estate sector taking the lead while financials underperformed the S&P 500 index. As mentioned earlier, the highly-awaited US non-farm payroll report released on Friday came at 235k compared with an expected gain of 750k. This slowdown in employment led to a mixed market reaction as the average hourly earnings leaped to 0.6% in August, or double the expected figure. Together with the low weekly jobless claims figure released on Thursday, this seemed to suggest that a labor shortage was leading to inflationary wage pressure. US Treasuries corroborated this interpretation, initially tightening to roughly 1.26% on the NFP report release but then widening above 1.3% on the hourly earnings figure. Whether this pressure is transitory as extended unemployment benefits come to an end in the coming weeks remains to be seen.

European indexes were also mixed on the back of hawkish comments from some ECB policymakers and as the August Eurozone inflation surprised to the upside to 3%. Elsewhere, Japanese equities rallied following news of Prime Minister Suga's resignation, which gave hope of further economic stimulus. Chinese stocks ended in the green, despite a volatile week.

"Ever since the failed IPO of Alibaba's Ant Financial, the regulatory crackdown on internet and education companies has left investors uncertain about the path forward for Chinese equities."

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	35,369.09	-0.14%	0.05%	17.10%
S&P 500	4,535.43	0.62%	0.31%	21.94%
Nasdaq	15,363.52	1.57%	0.70%	19.77%
Euro Stoxx 50	4,201.98	0.28%	0.15%	20.74%
Swiss Market	12,351.84	-0.70%	-0.48%	18.58%
FTSE 100	7,138.35	0.03%	0.43%	13.73%
CAC 40	6,689.99	0.12%	0.15%	22.90%
DAX	15,781.20	-0.45%	-0.34%	15.03%
FTSE MIB	26,064.78	0.22%	0.21%	19.60%
Nikkei 225	29,128.11	5.43%	3.70%	7.05%
Hang Seng	25,901.99	2.08%	0.21%	-2.71%
CSI 300	4,843.06	0.33%	0.78%	-5.51%

Source: Bloomberg, as at September 3, 2021. Performance figures in indices' local currencies.

Our view: Over the past two weeks the most frequently asked question by our clients was about Chinese equities and whether it was time to increase the allocation materially to this part of the market.

Ever since the failed IPO of Alibaba's Ant Financial, the regulatory crackdown on internet and education companies has left investors uncertain about the path forward for Chinese equities. The CSI 300 and Hang Seng indexes are both roughly 17% below their February 2021 highs and are -7% and -4.9% year-to-date, respectively. At the same time, the liquidity tightening from the People's Bank of China (PBOC), which began in February of this year and coincided with the peak of the equity market, has so far showed no sign of abating. Moreover, the latest PMI readings revealed the extent of the damage that the Delta variant measures have inflicted on the economy – both recessionary readings of the official non-manufacturing PMI and the Caixin services PMI were 47.5 and 46.7, respectively.

"The latest PMI readings revealed the extent of the damage that the Delta variant measures have inflicted on the economy..."

One area of concern to the Party has been the poor state of the SME sector, which was impacted negatively by the tightening measures. In response, President Xi Jinping announced the launch of a new stock exchange aimed at providing financing to SMEs. Also, the PBOC announced that it would provide RMB300 billion in low-cost funding to banks for lending to SMEs. But whether these actions are to be taken as a sign of policy reversal or not remains to be seen. The targeted focus on SMEs, a long standing objective for the PBOC, demonstrates the Party's intention not to revert back (at least not yet) to the broad-based easing tools of the past.

Whether targeted or not, we believe that the Party will sooner or later have to reverse policy to mitigate further damage to the economy. This, however, may not coincide with the easing of regulatory pressure. Thus, for now, we still prefer concentrating our China exposure on the domestic sectors that stand to benefit directly from the policy reversal, without the regulatory overhang.

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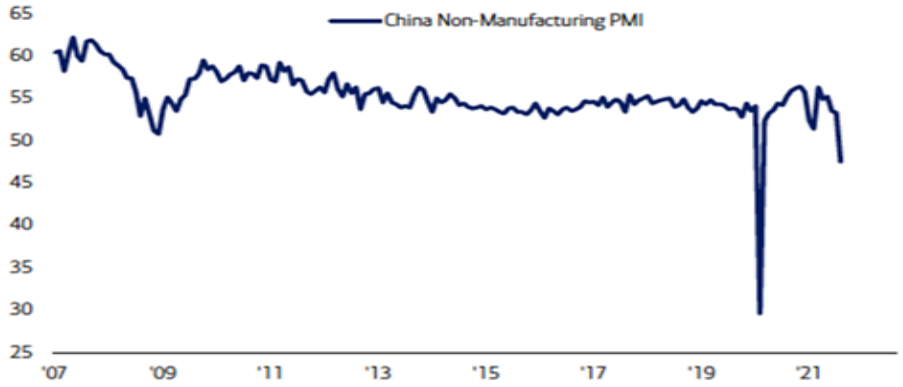
Figure 2: China Macro Data Turns Recessionary



Source: BofA Global Investment Strategy, Bloomberg.

FX & Commodities | Gold should restore bull trend

Chart of the week

Gold experienced a tough month of August after the strong labor market report of July. A fat finger event in Asia during the first week of the month pushed the metal to revisit the lows of the year at 1'760. This certainly cleared the market with many speculators being stopped out of the trade.

In our view, the renewed Fed's dovishness and the unclear inflation environment should now warrant some upside, with the 1'830 resistance level to be broken in order to restore the bull trend.

"The renewed Fed's dovishness and the unclear inflation environment should now warrant some upside..."

Figure 3: Gold Price

Source: Bloomberg, as at September 3, 2021.

Week Ahead | Key events to watch for

- **The main focus of the week will be on central banks:** Thursday's ECB meeting takes center stage, with a possible asset tapering announcement. Monetary policy decisions are also expected in Canada, Australia and Russia. Meanwhile, US President Biden could announce the name of the next Fed Chair, with a consensus being created around current chairman Powell.

- **As usual, the economic calendar is muted in the second week of the month**, so volatility should remain low unless central banks surprise to the hawkish side.

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