The Questions that Matter

By Louis-Vincent Gave

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Heading into the Jackson Hole symposium, investors are waiting with bated breath on the prepared remarks of Jay Powell. Will the Federal Reserve chair come out hawkish and so confirm the recent strength in the US dollar, the rollover in US equities and the sell-off in treasuries? Or will his speech be taken as dovish, triggering a rally in beaten-up precious metal plays, emerging market assets, deep cyclicals and industrials?

For what it's worth, I tend to think that Powell's remarks will err on the dovish side since US data has materially softened. But does his pronouncement really matter in the longer term? If one thinks that today's high Western inflation rates are solely the responsibility of the Fed, then perhaps so. Yet, if one thinks that a diverse range of factors spawned inflation—as I argued in Clash of Empires and Avoiding the Punch—then Powell's speech is unlikely to give much visibility on longer-term price trends, and thus financial markets. In fact, the key questions for investors may be addressed thousands of miles away from Wyoming's idyllic setting, specifically:

1) What will be the outcome of the Chinese Communist Party's upcoming congress? In the past 30 years, China has never recorded such low growth, nor been the source of such uncertainty. For the first time since the early 1990s, China cannot be counted on to boost growth at a time when the global economy is losing steam. This is due to (i) the collapse in animal spirits after heavy government interventions in the tech sector and multiple Covid lockdowns (ii) political uncertainty, as China seems to move away from "rule by Party" to "rule by man", and (iii) a sharp real estate slowdown. So how the Party ends up addressing these issues will matter not only for China, but also for the rest of the world.

Of particular interest will be whether Xi Jinping ends up confirmed as ruler for life, or whether the CCP decides that no individual is more important than the Party. Any return to a "rule by committee" framework would likely be bullish for Chinese asset prices. Another key question is whether some kind of "insurance fund" for property deposits, analogous to a bank deposit insurance scheme, can be adopted. Hopefully, an "insurance common fund" for property developers would stop the real estate sector rot and help stabilize demand more generally. Finally, most investors will look to the CCP congress for indications that China is willing to join the rest of the world and start living with Covid.

2) How will Europe handle an unfolding energy crisis? As winter looms, Europe's main economies are set to adopt energy rationing. This begs the question: who will bear the brunt of Europe's failing energy policies? If the answer is industry, then investors should brace for more supply chain dislocations, and thus more inflation. If European consumers bear the brunt, there is likely to be more strikes and (you guessed it) more supply chain dislocations. A marked decline in living standards could spur big protest movements, raising political risk. This uncertainty is weighing down the euro, which cannot rally even when weak US economic data allows investors to imagine a less hawkish Fed emerging. This European uncertainty is also starting to impact markets, as shown by Italian government bond yields surging some 70bp in the last two weeks.

3) Will energy prices make new highs this winter? Most people equate oil with energy, and since February crude has mostly range-traded between US$90 and US$110 a barrel. Yet looking at the wider complex, big price rises are the order of the day; those for European gas have rocketed, along with electricity (see Europe's Electric Power Problem). Even in the US, piped gas prices are making new highs; coal is well bid globally. So despite weak economic news from the major economies, the US releasing petroleum from its strategic reserve and president Joe Biden eating crow and flying to Riyadh to make nice with Mohammed bin Salman Al Saud, the broader energy space has remained in a roaring bull market. And in a bull market, prices tend to continue grinding higher unless something important stops the trend. So far, the threat of a recession has not killed the energy bull market, begging the question of what will.

It is not that hard to paint a bearish picture for global risk assets due to a hawkish Fed tightening into a global slowdown and a severe real estate bust unfolding in China. In this case, investors would want to be long the US dollar and even long treasuries. Yet a contrary scenario is equally possible, wherein oil prices break out to new highs, even as European industry has to shut down, just as occurred in China last summer. In such an environment, inflation would likely stay high. In addition, if developments at the upcoming CCP congress manage to rekindle animal spirits, there could be an unexpected rebound in Chinese growth and risk asset prices. In such an event, most industrial commodities, along with emerging market assets, would join in the relief rally. Such assets would also get a kicker if the Fed duly comes out less hawkish than currently expected.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US non-defense, ex-air cap. goods orders rose 0.4% MoM in Jul, from 0.9% in Jun	Above 0.3% expected	Outlook for capex has darkened with the rise of real borrowing costs
US pending home sales fell -1.0% MoM in Jul, from -8.9% in Jun	Above -4% MoM expected; YoY, sales fell -19.9%, from 20.2%	Housing affordability still very poor; more pain in the housing sector ahead
German IFO business expectations dipped to 80.3 in Aug, from 80.4 in Jul	Above 79.0 expected; IFO current assessment fell to 97.5, from 97.7	Expectations close to all-time lows; recession almost certain, EZ without growth engine
Bank of Korea hiked policy rate by 25bps to 2.5%	As expected	Governor Rhee signals slower pace of tightening given risk of record household debt

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