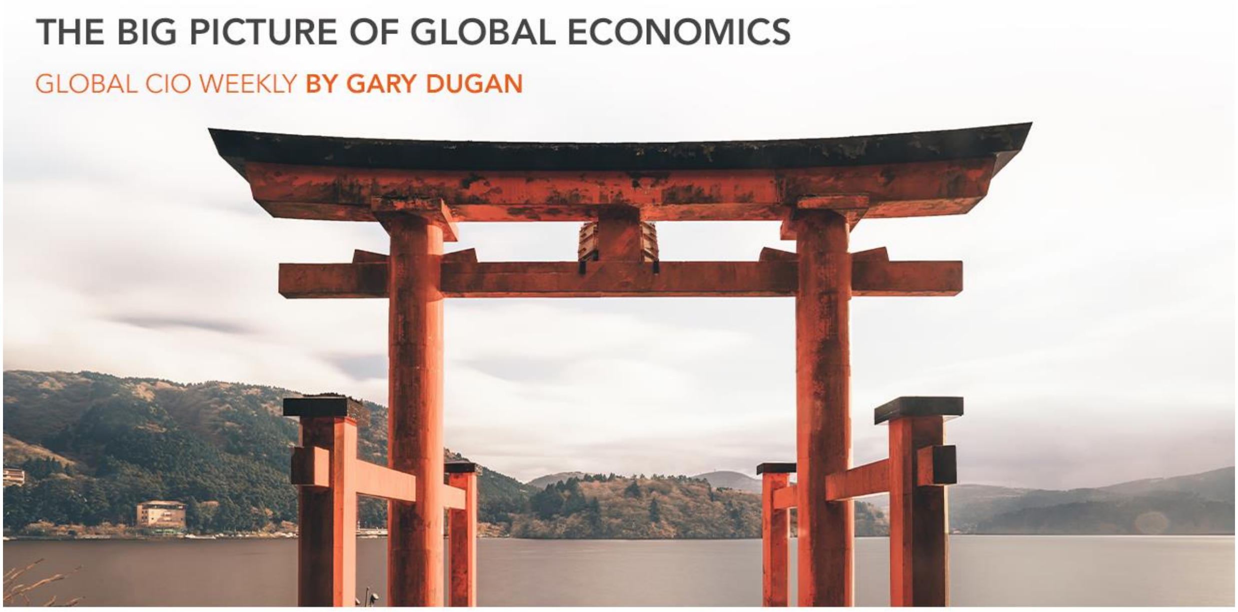

September 7, 2021

Looking to Asia for Help

- **The US economy loses some momentum, but it may be just noise**
- **The bond market shows some concern about wage inflation**
- **ECB may discuss the tapering of bond purchases, but its implementation is unlikely for some time**
- **The resignation of Japan's PM could be another positive for the equity market**
- **China policymakers stand ready to support their economy, but the scale and timing remains uncertain**

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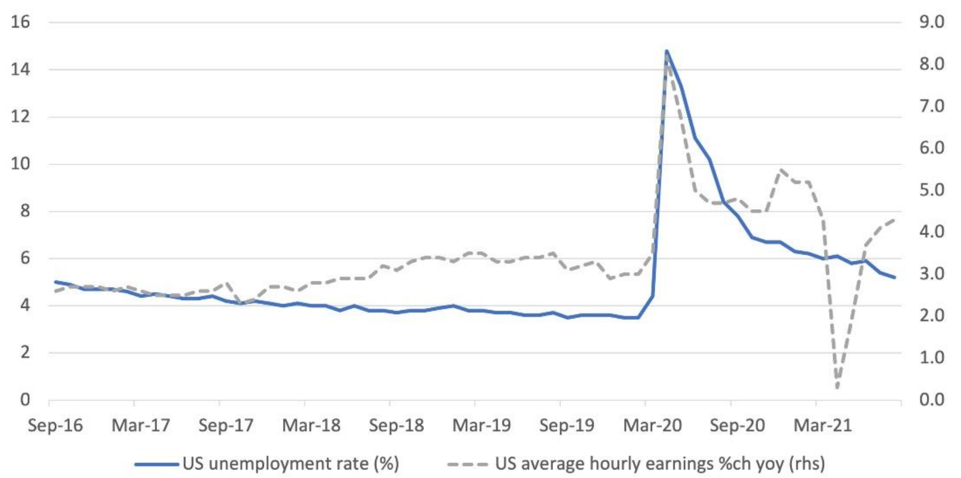
It may be easy to feel lost amidst the noise of US economic data releases. The Delta variant and perennial supply disruptions have slowed growth to some extent. However, nothing that we see suggests that the trends of reasonable levels of economic growth and higher-than-expected inflation are going into reverse. The good news is that Asia may start to bring some positive surprises that may make up for the malaise in the US.

Last week's US employment report was weaker than expected, but the weaker sectors were those that have been the most affected by the worries resulting from higher COVID cases. The underlying strength of the US economy was evident though, with the unemployment rate falling to 5.2% from 5.4%, but inflation remains elevated.

Despite the lower-than-expected jobs growth, average hourly earnings growth at 4.3% was well ahead of market expectations. Economists argue that the US federal and state government handouts have disincentivised people to return to work. Hence, those in existing jobs have to work longer hours, but they have benefitted from increased salaries because of labour shortages. With no shortage of job openings, though, more people could be returning to work in the coming months. The incentives for people to stay at home with their feet up to have been rolling off and are set to end in the coming months. In fact, federal government handouts for the unemployed will end this coming week. Many states have already ended their pay-outs, and others will end their schemes in the coming weeks.

Chart 1: US unemployment down and average earnings growth accelerates



Source: Bloomberg

It was telling that the US government bond yields ended the week marginally higher with losses on US Treasuries and US high-grade bonds. High-yield bonds, by contrast, again did well, with the global high-yield bond index returning 35bps on the week and US high yield 26bps. Despite the implied marginally weaker growth in the economy, investors believe there is better news ahead. However, investors are also concerned that inflation is less transitory than the Fed believes, hence the selloff of Treasuries. A US 10-year yield of 1.33% is around the average of the past six weeks.

For asset allocators, the challenge is in determining whether the aggregate of central banks' policies and government fiscal policy is sufficient to drive further growth surprises. On the monetary policy front, many central banks appear inclined to reduce at least some of the stimulus of the past 18 months. This week there are eight central banks meeting. Russia and Ukraine may raise rates as they both battle the pick-up in inflation. Economists are not sure whether there will be a shift of policy given the recent surprisingly high inflation in these two economies. We would judge that the ECB will not want to disturb the current recovery. Hence, they are more likely to remark that they see good progress in establishing inflation and maintaining the economic recovery. At worse, the post-meeting communique may tip its hat to those on the committee who favour reducing the pace of bond buying.

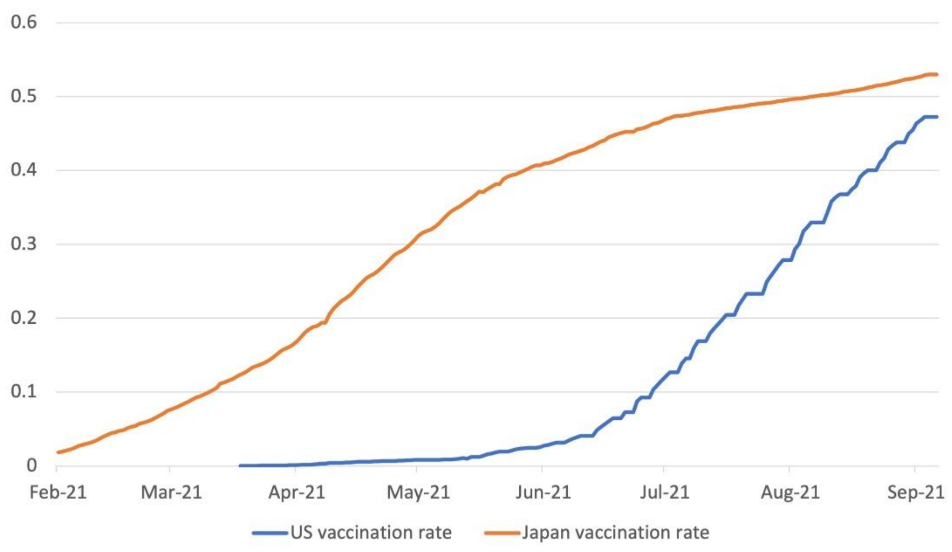
The US faces a mini stutter on the growth front, and European policymakers may work less hard to stimulate the economy. It could therefore well be that investors turn to Asia for the next stimulus to global growth.

Japan- better times at hand

The resignation of Japan's Prime Minister Suga was a big surprise to the markets. The stress and strain of leading a major nation through the COVID situation finally culminated in Suga's resignation. The equity market's immediate interpretation of his resignation was anticipating a significant fiscal stimulus ahead of the general elections. Nevertheless, Japanese equities ended the week up 5.4%. The TOPIX rose to its highest level in 30 years. We have remarked in previous weeks that the mix of significant upgrades to corporate profit forecasts and higher vaccination rates were grounds for optimism. Now throw in the more favourable political backdrop and increasing hopes for an expansive fiscal policy, and Japanese equities appear set to outperform further.

Chart 2: Japan sees Significant Increase in the Rate of Vaccinations

The proportion of the population fully vaccinated



Source: Bloomberg

There were already grounds for enthusiasm for Japanese equities. In two months, the country has gone from 14% of the population fully vaccinated to 47%, just six percentage points short of the United States. Over the same time frame, the consensus forecast for corporate profit growth has risen by seven percentage points. Higher vaccination rates support the increased optimism for a quicker reopening of the economy and the consequent improvement in corporate profitability.

We expect further positive performance from Japanese equities. Foreign investors are underweight the market versus a typical benchmark and may rush to cover their positions. After being net sellers for much of the past year, foreign investors have been net buyers of Japanese equities very recently. It’s also worth reflecting that the Nikkei 225 index is still languishing 25% below its level back in 1989. A year ago, Warren Buffet made significant investments in Japanese trading houses, which many investors thought was foolish. Mr Buffett has already been proven right in his more positive view of the value in the market, and we are sure he believes there is more return to come.

China – waiting for the easing

A further easing of Chinese monetary policy could be a source of good news for the global economy. While the Chinese government continues on its path of resetting the framework of several industries, growth has slipped. Industrial confidence surveys out last week were at some of the lowest levels since March 2020.

The Chinese central bank gives every indication of providing further liquidity. Government bond issuance increased in August and should increase further in September. Last week’s state council meeting statement pointed to likely support for the small and medium-size corporate sector. The challenge for the policymakers is that they are also trying to rein in some of the excesses of the property sector and take down some of the worst polluting industries.

At a big policy level, the central bank is likely to ease the reserve requirement ratio in the coming months. Investors will also be hoping for a significant easing of fiscal policy. COVID lockdowns, global supply chain disruptions, and the domestic reform programme have been an exceptional cocktail of drags on China’s economic growth.

Given the many uncertainties for investors in the Chinese equity market, we are not sure that investors will take the prospect of policy easing on trust. China’s equity indices are bouncing along the bottom of a trading range, but it may be some time before a more positive upward trend can be established.

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