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MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
By Brunello Rosa

Supply Bottlenecks Are Proving To Be More Persistent Than Expected

In March 2020, the world economy came to a standstill as half of the global population was forced into partial or total lockdowns. Economic activity collapsed by double-digit percentages. Oil prices went negative for the first time in history, as the price of storage soared while the use of energy sunk. Market dislocation at that time was unprecedented, with US Treasuries temporarily losing their safe-haven status.

Given the scale of the shock, the disruption in real economic activity and in financial markets that followed could be expected, as could have been the swings in GDP growth and in the prices of assets, goods and services, not just on a quarterly basis but also on a year-on-year basis, given base effects. Central banks have been keen in pointing out the temporary nature of these shocks, and in asserting that because of this temporary nature they needed to be patient, and not react precipitously.

As we approach the end of the second year of the pandemic (if we assume November-December 2019 as the starting point) we see that some of the imbalances created by the pandemic are being re-absorbed, as testified by the fall in unemployment rates throughout emerging markets and advanced economies. On the other hand, other types of disruptions are starting to emerge.

Globally, the shortage of semiconductors for microchips is causing a temporary stoppage in the production of automobiles. Supply bottlenecks in general have increased over time, given the temporary closure of factories and mines in some key emerging markets, such as China, and in developed economies. These supply shortages so far have resulted in higher costs, but may soon result in slower economic growth, a sort of stagflation that could derail the global recovery from the pandemic.

In the UK, the effects of supply bottlenecks are added to those of Brexit: shortages of truck drivers have resulted in a dearth of fuel, with cars queuing for hours to get their tanks filled. In mainstream supermarkets it is hard to find bottled water. The government has asked the army to intervene, and does not seem inclined to allow a higher number of visas to be granted to foreign workers in order to alleviate the labour shortages.

We are not particularly worried about this short-term disruption of supply chains. Rather, we fear the balkanization of global supply chain that is likely to occur over the medium term, induced by the ongoing process of de-globalisation (even if such de-globalisation means making certain supply chains more reliable). But a shorter supply chain most likely means higher prices in the medium term, as we discussed in a recent column. The recent case of Australia cancelling its submarine order from France is an example of how supply chains may suddenly change in this post-pandemic, post-Brexit, bi-polar world, with the increased rivalry between US and China.

Clearly, if central banks realise that these supply shortages are more persistent than is currently believed, they may decide to react accordingly and reduce the amount of policy accommodation they are now providing earlier or by a greater amount than is currently envisaged. This in turn would have serious repercussions throughout financial markets.

Our Recent Publications

- Global Outlook Update - Market Views - Q4-2021 Strategic Asset Allocation, *by Alessandro Magnoli Bocchi, Fawaz Sulaiman Al Mughrabi and Karmen Meneses, 1 October 2021*
- Policy Compass: Iran and Saudi Arabia's Perspectives on Post-US Afghanistan, *by Giorgio Cafiero, 29 September 2021*

Looking Ahead

The Week Ahead: In The US Factory And Non-Farm Payrolls Orders Are Expected To Increase, And Unemployment To Fall

In the US, August's factory orders are expected to increase to 0.9% (*p*: 0.4%). In September, non-farm payrolls are seen rising to 500k (*p*: 235k), and unemployment is expected to fall to 5.1% (*p*: 5.2%).

In the EZ, August's retails sales are projected to fall to 0.4% y-o-y (*p*: 3.1%).

The Quarter Ahead: Pandemic Hits Factory Market; Manufacturing Remains Strong In UK And EZ; Talks Among EU, US and Australia

Factories struggle as supply constraints hit, and costs rise. Global supply-chain bottlenecks and escalating costs, driven by pandemic-induced factory shutdowns in Asia, and China's waning economic momentum, have created uncertainties surrounding the region's growth prospects. While countries where outbreaks of the COVID-19 Delta variant receded see an improvement in activity, growth shrank in other countries as microchip shortages and supply disruptions impacted output.

In the EZ, and UK manufacturing growth remains strong, but activity suffers from: *i)* logistical issues; *ii)* product shortages; and *iii)* a labor crunch that are likely to persist and keep inflationary pressures high.

Biden signs temporary funding bill to prevent government shutdown. Congress prevented a government shutdown before a midnight deadline. President Biden signed a bill that funds the government through December 3, but passing a funding plan will resolve one crisis while lawmakers try to deal with a looming threat of default unless Congress raises or suspends the debt ceiling.

EU and Australia postpone trade talks as a row with France deepens. Australia has cancelled a USD 27.5bn deal with France to build a fleet of conventional submarines, and instead it will build at least eight nuclear-powered submarines with US and UK technology. The decision angered France, which called the deal a *"stab in the back"* by the US and Australia.

US-EU agree to target China on trade and tech. After a recent strategic dialogue between Chinese and EU top diplomats, the US wooed EU on the first US-EU Trade and Technology Council (TTC) meeting, in which "curb China's non-market trade practices" was raised. Chinese Foreign Ministry said that the statement by a US official once again exposes the true intention of the US to contain and suppress China's development by all means.

Inflationary pressures weigh on CB policies. US Fed Chairman Powell told lawmakers that the CB still expects a recent spell of high inflation to reverse, but said it was difficult to pinpoint when that might happen. A surge in prices this year "is a function of supply-side bottlenecks over which we have no control," Mr. Powell said at a House Financial Services Committee hearing, where he appeared alongside Treasury Secretary Janet Yellen.

Last Week's Review

Real Economy: Supply Constraints Lower Growth Outlook; Inflationary Pressures Remain Elevated

In the US, Q2 GDP advanced an annual 6.7% q-o-q (*c:* 6.6%; *p:* 6.3%), boosted by vast federal support for the recovery from the 2020 pandemic recession. However, Q2 GDP marks a high point for the economy's expansion this year, as: *i)* the COVID-19 virus slows some activity; *ii)* government support programs wind down; and *iii)* manufacturing supply-chain issues persist. In August, orders for non-defense capital goods excluding aircraft – a closely watched proxy for business spending plans – increased (*a:* 0.5% m-o-m; *c:* 0.4%; *p:* 0.3%), amid strong demand for computers and electronic products. *Inflation concerns intensify.*

In the US, August's PCE inflation rose to 4.3% y-o-y (*c:* 3.9%; *p:* 4.2%), reflecting steady price growth, as the Delta wave slowed the economy, while core-PCE – the Fed's preferred inflation gauge – remained unchanged at 3.9%.

In the EZ, preliminary data for CPI-inflation surged to 3.4% y-o-y in September (*c:* 3.3%; *p:* 3.0%), reaching the highest rate of inflation since before the GFC in September 2008, while core-CPI inflation data accelerated to 1.9% y-o-y (*c:* 1.9%; *p:* 1.6%) – raising concerns about the ECB's narrative that recent price spikes are seen as temporary and the economy requires depressed borrowing costs.

Financial Markets: Global Stocks Pull-Back; Bond Yields Up; USD Strength Weighs On Commodities

Market drivers: investor sentiment weakened, hampered by: i) a jump in interest rates – reflecting inflation concerns; and ii) expectations for the US Fed to begin tapering this year.

Global equities fell w-o-w (MSCI ACWI, -2.5%, to 712). In the US, the S&P 500 lost ground (-2.2% w-o-w to 4,357), as declines within the index were broad-based, with only energy shares notching a gain. In the EZ, shares fell sharply (Eurostoxx 50, -3.0% to 4,035), amid fears that the economy might be sliding into a period of low growth and high inflation. In EMs, equities fell (MSCI EMs, -1.5%, to 1,247), as Chinese stocks fell (Shanghai Comp., -1.2%, to 3,568). Volatility rose to historical averages (VIX S&P 500, +3.4 points to 21.2, 52w avg.: 21.1; 10y avg.: 17.2).

Fixed Income: w-o-w global bonds fell (BAML Global, -0.2% to 294.9), while UST yields rose (+1 bps, to 1.47%), amid growing expectations that the Fed will start tapering in November, and hike rates next year.

FX: w-o-w, the US Dollar Index rose (DXY, +0.8%, to 94.035; EUR/USD -1.0%, to 1.159). In EMs, currencies fell against the USD (MSCI EM Currency Index, -0.3% to 1,724).

Commodities: Oil and gold prices rose (Brent, +1.5% to 79.3. USD/b; Gold, +0.6% to 1,760 USD/Oz), amid: i) USD strength; ii) rising bond yields; iii) and expectations that the US Fed will start to taper next month.

@RosaRoubini Rosa & Roubini Rosa&Roubini Associates

For more information, please call us on +44 (0)207 1010 718 or send us an email to info@rosa-roubini-associates.com

www.rosa-roubini-associates.com

118 Pall Mall, London SW1Y 5ED

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Abbreviations, Acronyms and Definitions

a	*Actual*
AKP	*Justice and Development Party, Turkey*
ann.	*annualized*
ARS	*Argentinian Peso*
avg.	*Average*
bn	*Billion*
BoC	*Bank of Canada*
BoE	*Bank of England*
BoJ	*Bank of Japan*
bpd	*Barrels per day*
bps	*Basis points*
BS	*Balance sheet*
c	*Consensus*
C/A	*Current account*
CB	*Central bank*
CBB	*Central Bank of Bahrain*
CBK	*Central Bank of Kuwait*
CBT	*Central Bank of Turkey*
CDU	*Christian Democratic Union, Germany*
CNY	*Chinese Yuan*
CPI	*Consumer Price Index*
DJIA	*Dow Jones Industrial Average Index*
DJEM	*Dow Jones Emerging Markets Index*
d-o-d	*Day-on-day*
DXY	*US Dollar Index*
EC	*European Commission*
ECB	*European Central Bank*
ECJ	*European Court of Justice*
EIA	*US Energy Information Agency*
EM	*Emerging Markets*
EP	*European Parliament*
EPS	*Earnings per share*
EU	*European Union*
EUR	*Euro*
EZ	*Eurozone*
Fed	*US Federal Reserve*
FOMC	*US Federal Open Market Committee*
FRB	*US Federal Reserve Board*
FX	*Foreign exchange*
FY	*Fiscal Year*
GCC	*Gulf Cooperation Council*
GBP	*British pound*
GDP	*Gross domestic product*
IMF	*International Monetary Fund*
INR	*Indian Rupee*
IPO	*Initial public offering*
IRR	*Iranian Rial*
JPY	*Japanese yen*
k	thousand
KSA	*Kingdom of Saudi Arabia*
LN	*Northern League, Italy*
M5S	*Five Star Movement, Italy*
m-o-m	*Month-on-month*
mb	*Million barrels*
mb/d	*Million barrels per day*
MENA	*Middle East and North Africa*
MHP	*Nationalist Movement Party, Turkey*
mn	*Million*
MPC	*Monetary Policy Committee*
NAFTA	*North-American Free Trade Agreement*
NATO	*North Atlantic Treaty Organization*
OECD	*Organization for Economic Cooperation and Development*
Opec	*Organization of Petroleum Exporting Countries*
p	*Previous*
P2P	*Peer-to-peer*
PBoC	*People's Bank of China*
PCE	*Personal Consumption Expenditures*
PE	*Price to earnings ratio*
PM	*Prime minister*
PMI	*Purchasing managers' index*
pps	*Percentage points*
pw	*Previous week*
QCB	*Qatar Central Bank*
QAR	*Qatari Riyal*
QE	*Quantitative easing*
q-o-q	*Quarter-on-quarter*
RE	*Real estate*
RBA	*Reserve Bank of Australia*
RRR	*Reserve Requirement Ratio*
RUB	*Russian Rouble*
SWF	*Sovereign Wealth Fund*
tn	*Trillion*
TRY	*Turkish Lira*
UAE	*United Arab Emirates*
UK	*United Kingdom*
US	*United States*
USD	*United States Dollar*
USD/b	*USD per barrel*
UST	*US Treasury bills/bonds*
VAT	*Value added tax*
VIX	*Chicago Board Options Exchange Volatility Index*
WTI	*West Texas Intermediate*
WTO	*World Trade Organisation*
w	*Week*
w-o-w	*Week-on-week*
y	*Year*
y-o-y	*Year-on-year*
y-t-d	*Year-to-date*
ZAR	*South African Rand*
2y; 10y	*2-year; 10-year*