Research & Strategy Insights

Pandemic Guerilla

103 – 6 September 2021

Key points

- Even if it may be a "blip" the disappointing figures for US job creation in August validates Powell's prudence
- We take a good look at the global shortage in semi-conductors
- On Thursday the European Central Bank (ECB) will probably reduce a bit the pace of Pandemic Emergency Purchase Programme (PEPP) for the next 3 months but that's not "tapering" Key points

In hindsight, Jay Powell is probably very happy to have been so elusive at Jackson Hole on the timeline for "tapering" after the disappointing US job numbers for August. It is not the first time this year that payroll data surprises to the downside without altering the positive underlying trend. Statistical accidents happen. It is however going to be tempting to read the job data in combination with other recent prints – such as the decline in consumer confidence – to make the case for a confirmed slowdown in the US economy.

While this data configuration makes it likely the Fed will remain non-committal on "tapering" at the September meeting, the key question is whether there is enough to derail the expected trajectory of a reduction in purchases at the end of this year. We think the bar for this is high. Instead of strong and stable growth which could be envisaged in a full return to a "Covid-free" world, what we may have to deal with is a form of "pandemic guerrilla", putting up with flare-ups now and then, denting consumption and causing disruptions in the global value chain, but still consistent with decent economic growth in the absence of lockdowns (the "open warfare"). Enough to warrant maintaining accommodative monetary conditions for long, but not enough to justify the continuation of unconventional policies.

The global shortage of semi-conductors is one of the key sources of "disruption". We look at this in some detail this week. Even before the pandemic any issue on global manufacturing supply was routinely solved by creating more capacity in China. Still, even in the face of grave global supply issues, it is doubtful Washington DC will allow Beijing to seriously threaten the current configuration of such a key industrial resource, which up to now has been firmly in the hands of the US and two of its closest allies, South Korea and Taiwan.

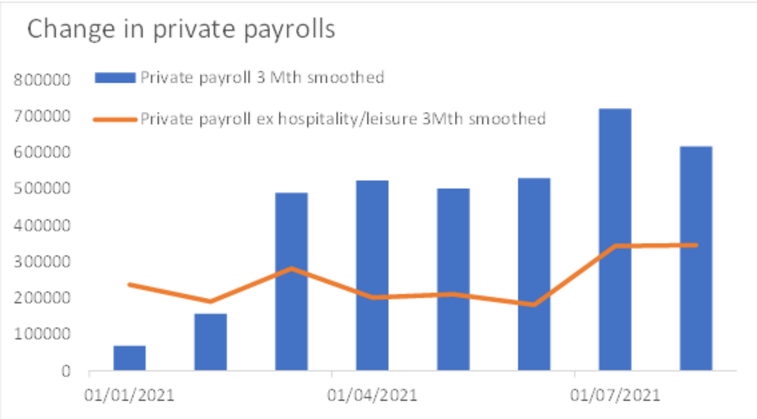
To a lesser extent than in the US Euro area inflation is now rising fast, reflecting in particular these global disruptions. This is playing into the hands of the ECB hawks and is raising questions on an ECB tapering. While this week we expect the central bank to announce a small reduction in the pace of PEPP for the next three months, this would not qualify as "tapering" proper since it would not tell us anything about the final "landing zone" for the quantitative programmes. For this, we continue to think we'll have to wait until December.

When in doubt…

It is quite problematic that the US monthly payroll report constantly attracts so much attention when it is also plagued by significant volatility and a well-known propensity for spectacular revisions. **True, job creation in August came out very far away from expectations (235,000 versus 725,000), but it is not the first time in the current recovery phase**. In April 2021 already, while the US economy was being pushed into red-hot territory by the combination of the lift-off in sanitary restrictions and another massive fiscal push, payroll rose by a meagre 269,000, when the market was forecasting one million new jobs to be created. The picture was made even dimmer by the downward revision in the March data. This fortunately proved to be a "blip" and a month later job creation resumed a brisk pace (614,000).

This should act as reminder that some "smoothing" of the data is required to get any sense of the underlying trend. Actually, **the three-month average to August 2021 hit its second highest level since the beginning of the year**, partly thanks to an upside revision in the July print. When excluding the impact of the hospitality and leisure sectors – which continue to be affected by the ebb and flow of the pandemic in the US – job creation in the US in the 3 months to August remained at its highest since the beginning of the year (see exhibit 1). Finally, while the federal top-up to unemployment benefits has been terminated at the beginning of the summer in roughly half the states, the scheme fully folds in September alone, which means that it was still affecting the August report.

Exhibit 1 – Underlying trend remains strong



Source: BLS, AXA IM Research, September 2021

It is however going to be tempting to read the August print in connection with other sources, creating a "bearish cluster". The employment component of the manufacturing PMI fell in contraction territory in August. In isolation it would probably be ignored (it did so in June as well before rebounding, and the job component of the dominant services survey remained solid in August), but household confidence declined steeply in August according to the Conference Board survey. The Covid-related concerns we noted last week in the NBC poll have clearly made their way to the survey. A case for an "organic deceleration" in the US economy, beyond the "mechanistic" slowdown which would be in any case unavoidable after the strong rebound since late 2020, can be made.

We discussed in our "back-to-school" issue of Macrocast last week when highlighting the Fed's prudence on its timeline to "taper". The Fed has been singling out labour market developments in its forward guidance. While in normal circumstances the Fed would probably largely ignore the message from the August Payroll, sending too clear a warning about "tapering" at the September meeting now looks difficult, let alone announce it altogether, which the market in any case was not expecting. When in doubt about the message from the latest macro indicators, abstaining from too committal utterance is probably wise. In hindsight, Jay Powell is probably very happy to have been so elusive at Jackson Hole.

From a market point of view, none of this may matter much in the short run. In principle, equities should be negatively impacted by the clouds gathering on the demand side, but this is likely to be offset by a confirmation that the Fed is not going to rush its taper, keeping the liquidity tap fully open. This may explain why the S&P500 did not react too much on Friday to the payroll release after some preliminary jitters (-0.03%at close). The fact that tech companies – the most sensitive to the expected monetary stance – outperformed (Google rose by 0.3%, Apple by 0.4%) strengthens this interpretation.

The crucial issue of course in the medium-term is whether the dataflow will do more than merely validate the Fed's prudence on the timeline to alter the overall direction of travel, i.e., constrain the Fed to give up on taper and maintain its current stance well into 2022. We think the bar for not at least *announcing* the taper in 2021 is high. True, the delta variant is clearly impacting the US economy more than what could be expected before the summer, but the extent of the damage should remain limited, given the allergy of most US local authorities to re-engage with far-reaching sanitary measures and the possibility to "tailor" the response to individual vaccinal status. Beyond its overall decline last month, the details of the Conference Board consumer confidence survey continue to suggest the appetite to spend remains well above its long-term level. This would suggest that what we are dealing with is a resurgence in "generic anxiety" around the pandemic, with a limited impact so far on actual economic decisions of households.

Another issue of course to take onboard is the message on the inflation side. In Jackson Hole, Powell's speech came out exactly when the Michigan survey confirmed that the consumers' long-term inflation expectations were still anchored. However, he needs to compose with the hawks in his committee and the strong print for wages in August (4.3%yoy after 3.9% in July) probably fuelled their concerns. Again, disentangling the signal from the noise is no easy feat given the compositional effects still at work here. The lack of job creation in low-wage sectors such as hospitality may have once again artificially pushed average wages up. The doves will easily counter that the total volume of employment in the US is still 3.5% below its pre-pandemic level in the private sector, which does not bode very well for aggregate wage growth, beyond the sectoral bottlenecks. The case for the "transitory inflation shock" is intact in our view, but at the moment the "mood music" is playing for the hawks.

While the pace of economic growth has clearly abated, it would probably take a proper reversal to convince a majority of the committee to back a continuation of Quantitative Easing (QE) into 2022 given the inflation risks. **Instead of strong and stable growth which could be envisaged in a full return to a "Covid-free" world, what we may have to deal with is a form of "pandemic guerrilla" instead of "open warfare".** We would need to put up with flare-ups now and then denting consumption and causing disruptions in the global value chain, but still consistent with decent economic growth. Enough to warrant maintaining accommodative monetary conditions, but not enough to justify the continuation of unconventional policies. This is where Powell's message on policy rates remaining very low for long after "tapering" – a key plank of his Jackson Hole speech - matters.

In any case, judging by the bond market reaction on Friday – US 10-year yield ended the day at 1.33%, up 4 basis points on the day – the market does not seem to radically revise its expectations of the Fed's trajectory. We agree.

What will you have with your chips?

The global shortage in semi-conductors is one of the key ingredients in the disruption in global value chains. So far in Macrocast we have focused on its impact on inflation but this week we want to change the angle slightly and focus on the determinants of said shortage.

The first point to make is that **the global production of semi-conductors has never been so high**. What we are dealing with here is not the consequence of pandemic-driven disruptions in the output of the sector. Even at the peak of the last year's Covid wave, production in the US dipped only very marginally (see exhibit 2) while exports from South Korea did not even flinch. As of July 2021, US production was 14.3% above pre-pandemic levels, and shipments from Korea were 23% higher. Yet, this massive output upgrade was not enough to keep up with demand. Korea maintains data on inventories in the semi-conductor industry: the latest data suggests pressure continues to build up (see exhibit 3).

Exhibit 2 – US chips production boom

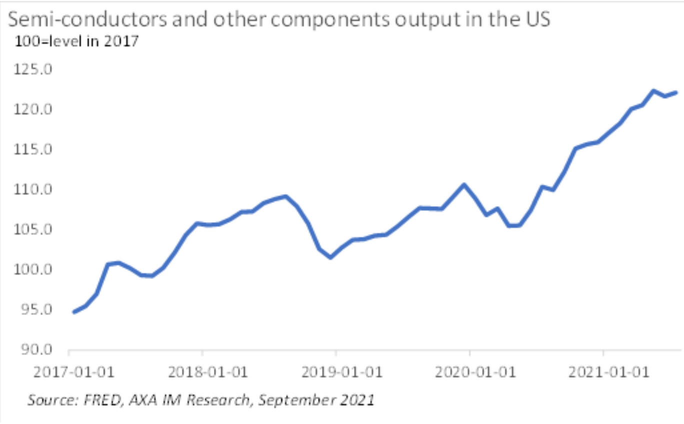
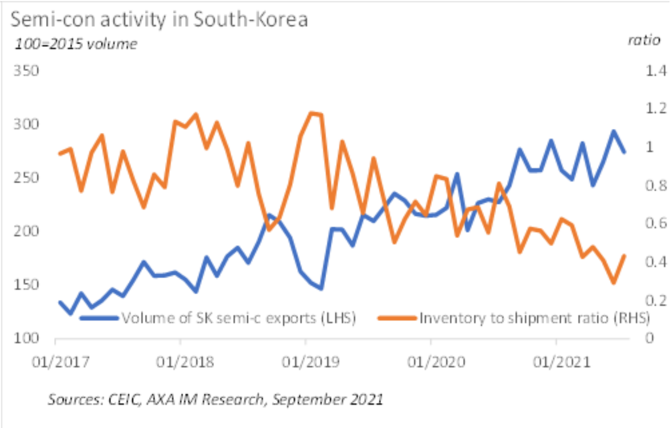


Exhibit 3 – Still under pressure



While the market for semi-conductors has been rising exponentially for years, the industry's structure is conducive to production bottlenecks which give it an inherently highly cyclical outlook. **At the beginning of the century, there were 25 manufacturers of chips in the world. Today, only three companies only can supply the most advanced ones.** The intense concentration of the sector can be largely explained by the high capital expenditure needed to stay at the technological frontier in this industry. But such concentration comes with limits: **in time of high demand, customers cannot easily "shop around" for chips when their usual supplier cannot produce enough**. The ensuing pressure on capacity results in price hikes, and when finally, production becomes plentiful enough, customers are incentivized to pile up inventories to protect themselves against future shortages, prolonging the upswing but of course sowing the seeds for the eventual slowdown in demand. To add a complication, customers do not all need "cutting edge" technology chips and may actually not be technically able to use newer ones. However, manufacturers may face difficulties in continuing to raise capital capacity in these older products and invest in the new ones at the same time.

A year before the pandemic struck, demand for chips had eased, essentially because of a lull in the release of new smartphones. Chip manufacturers had understandably no strong incentive to accelerate their capex in those conditions. This proved problematic when demand exploded again in the midst of the first pandemic wave. The issue was quite simply that the focus of global consumption shifted from "experience" (services) to "stuff" (goods), in particular those goods which are particularly intensive in semi-conductors, such as computers and gaming consoles.

There are basically three avenues to resolve the shortage: (i) raise the global production capacity; (ii) wait until consumption patterns normalize as the global reopening gathers steam and demand shifts back away from micro-chips-intensive goods; (iii) count on "price-clearing" mechanisms and wait until the inflation spike reduces demand.

The first avenue would obviously be the most beneficial to collective welfare. The global shortage has made Governments are now even more aware of the strategic nature of the semi-conductor industries and state-sponsored projects are emerging everywhere. The European Union (EU) for instance, through the IPCEI framework ("Important Projects of Common European Interest") wants to scale up its share of global semi-conductor output from 9% today (e.g., through the Intel factory in Ireland) to 20% in 2030, but **beyond the unavoidable lags between investment decisions and actual production, geopolitics can complicate matters**.

China is of course interested in reaching self-sufficiency on this crucial market and is working towards a USD9bn new plan in Shanghai, with a 25% capital participation of the local authority. Yet, the Chinese company SMIC ("Semiconductor Manufacturing International Corporations") has been put last year on the US Commerce Department's "Entity List", which bans the unlicensed exports of American technology to the company. The management of SMIC publicly confirmed that this was hindering their project.

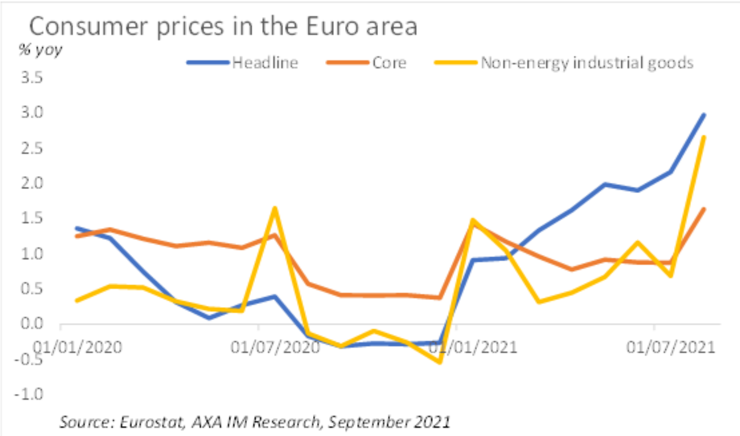
We have already highlighted in Macrocast that since the beginning of the pandemic, China has operated as the global "producer of last resort", offsetting some of the output disruptions experienced in the rest of the world, and even before the pandemic, any issue on global manufacturing supply was routinely solved by creating more capacity in China. Still, even in the face of grave global supply issues, given the intensity of the rivalry between the US and China, **it is doubtful Washington DC will allow Beijing to seriously threaten the current configuration of such a key industrial resource, which up to now has been firmly in the hands of the US and two of its closest allies, South Korea and Taiwan**.

Beyond all the lingering pandemic flare-ups, it is likely that consumers will shift back some of their expenditure to services and ease the pressure on chip-intensive products, but on trend, global demand for micro-chip is very unlikely to abate. The development of 5G – by allowing the transition to the "internet of things" – is likely to trigger another upgrade in the "micro-chip" intensity of advanced economies. Unfortunately, it may well be that a sizeable part of the "resolution" of the chip shortage, from a macroeconomic point of view, takes the form of "price deterrence". According to the latest JD Power survey, car manufacturers are reserving their scarce microchips to the upper end vehicles in their range, while reducing their rebates: a significant share of the drop in transaction volume is offset by higher margins. This works as long as customers are ready to put up with the prices. At some point, demand will fall. This would not be a great result from a collective welfare point of view, since it would combine higher prices, lower aggregate demand and lower output.

How to say "taper" in Eurospeak?

Global price pressure is also affecting the Euro area. Even if the acceleration in consumer prices remains quite tame there relative to the US, headline inflation rose to 3.0% year-on-year in August, from 2.2% in July and by more than expected (2.7%). "Non-energy industrial goods" accelerated significantly (see Exhibit 4) and they are a key contributor to the movement in core inflation. Item-level data is not yet available for August, but the rise in global transport prices, value chain disruption and shortages are probably working their way through the European price complex for tradable goods. While most ECB speakers mentioned their expectation that this is transitory**, the hawks are making themselves heard and are now directly discussing the intensity of QE, raising questions in the market about a "European tapering". On this subject, we think we have to be precise on the definition of that word.**

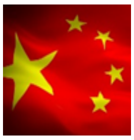
Exhibit 4 – Watch the price of "stuff" in Europe as well



The ECB's quantitative easing is the combination of the "ordinary programme", the Asset Purchase Programme (APP) and the Pandemic Emergency Purchase Programme (PEPP). The PEPP itself is defined by an envelope (an overall quantum) and a "soft deadline" (it is intended to continue until March 2022 "at least"). A complication is that the PEPP's envelope has always been indicative (it may not prove necessary to spend it all). The crucial next step for the ECB is to calibrate the combined quantum of APP and PEPP once the "soft deadline" is met. We do not expect any announcement on this before December 2021 (we expect an APP at EUR40bn/month).

There is another feature of QE, which is the monthly pace of PEPP. Its status is ambiguous. Initially, the ECB did not communicate ex ante on this, and reserved the right to fine tune the pace according to market conditions in full discretion and without the need to get clearance from the Governing Council. Then this year the ECB started communicating on this on a quarterly basis, but it is unclear if this should be understood essentially as a monetary policy signal, or essentially as a technical device. Overall, we think the recent communication from members of the Governing Council suggests the ECB will announce on Thursday a small reduction its pace of purchases for the next three months, responding to the "improvement in market conditions", but this is not "tapering" proper in our book, because it doesn't inform on the intended "landing zone" of the ECB (how much more net purchases we could expect in total).

We listed last week the "ambiguities" of the ECB's new forward guidance, and we would be surprised if we had any clarification on this at the press conference this week. The ambiguities – e.g., on the policy rate/forward guidance linkage – reflect a lack of consensus at the Council which in our view will take months to sort out.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Payrolls rose by just 235k in August – far short of consensus 725k. Unemployment fell to 5.2% as participation remained subdued • ISM index (Aug) rises to 59.9 (59.5) despite softness in most regional surveys • Conf Bd consumer conf (Aug) fell unexpectedly reflecting delta and inflation concerns. Weekly index continues to improve • Vehicle sales (Aug) fell to 13.06m – a 14 month low – as chip shortages still weigh	• Fed publishes Beige Book, watch for labour market and inflation pressures easing at a regional level • JOLTS survey to give additional indication of demand for labour, post payrolls report • PPI inflation (Aug) – core measure expected to slow to March level, but weak base effects will push annual rate higher again
	• EC sentiment surveys slightly declined but remain high in both mfg and services as well as for consumer confidence • EMU Aug CPI jumped to 3%yoy due to strong base effect from energy, German VAT & sales • July retail sales dropped by 2.3%mom	• The ECB should revise on the upside both GDP and CPI, raising the debate on the pace of PEPP net purchases • July German Industrial output may slightly rebound after three months in neg territory • Sept German ZEW economic sentiment
	• BoE announced Huw Pill to become Chief Economist from 6 Sept. Pill has a hawkish reputation • Nationwide house prices +2.1%mom in August (11%yoy). Mortgage lending fell in July and approvals slowed towards pre-Covid level • Services PMI (Aug, f) revised lower to 55.0	• Monthly GDP (Jul) – we expect a figure close to flat compared with consensus 0.7% as activity appeared to slow in face of delta spread • July's output by sector also due • BRC retail sales monitor (Aug) for steer to Aug spending fell sharply in July • RICS housing survey after solid data this week
	• Y. Suga resigns and won't lead the LDP during the General elections in October • July IP declined by 1.5% mom after +6.5% in Jun • Aug Svc PMI dropped to 42.9 (-4.5p) • Aug cons confidence slightly declined to 36.7	• Q2 GDP growth should be revised up in the 2nde estimate as capex has been underestimated • August bank lending to gauge credit demand • August Economy Watchers poll to assess the views on the impact of the state of emergency
	• Beijing sees "some results" of regulatory changes, pledges to balance growth and equality. Hints intensity of crackdown may subside as the economy slows • PMI (Aug) shows the economy slowed due to COVID flare-up and growing macro headwinds	• Export growth may ease further. PPI inflation should come off the boil while CPI inflation stays muted
	• Q2 GDP growth fell in Brazil (-0.1%qoq) on agriculture. India growth rose to 20.1% (yoy) • Manufacturing PMI worsened in Brazil, Mexico, Russia and India • The Delta wave continues to disrupt Asia, with the Philippines and Vietnam showing rising infection cases	• CPI figures for August across EMs • Retail sales should slow in Czech Republic

Upcoming events	**US :**	Mon: Labour Day; Wed: JOLTs survey (Jul), Beige Book; Thu: Weekly jobless claims (4 Sep); Fri: PPI (Aug)
	Euro Area:	Mon: Ge manu orders (Jul); Tue: Ez GDP (Q2), Ge ind output (Jul), Ge ZEW surveys (Sep); Thu: ECB announcement, Ge trade & current account (Jul); Fri: Fr It & Sp ind output (Jul)
	UK:	Mon: Parliament returns, new cars (Aug), Construction PMI (Aug); Tue: BRC retail sales (Aug), Halifax HPI (Aug); Thu: RICS survey (Aug); Fri: GDP (Jul), sector output (Jul), Trade balance (Jul)
	Japan:	Tue: Leading index (Jul,p); Wed: Final GDP (Q2), Trade balance (Jul), Current account balance (Jul)
	China:	Tue: Exports & Imports (Aug), Trade balance (Aug), Forex reserves (Aug); Thu: CPI (Aug); Expected: Total social financing (Aug), New yuan loans (Aug), M2 (Aug)

DISCLAIMER

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date.

All information in this document is established on data made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document.

Furthermore, due to the subjective nature of these opinions and analysis, these data, projections, forecasts, anticipations, hypothesis, etc. are not necessary used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

Issued in the UK by AXA Investment Managers UK Limited, which is authorised and regulated by the Financial Conduct Authority in the UK. Registered in England and Wales No: 01431068. Registered Office: 22 Bishopsgate London EC2N 4BQ.

In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826