Asian stocks are mixed this morning, with China and South Korea shut for holidays, following the S&P 500 most negative session since May yesterday, though US equity futures are recording some gains.

The flavor of the day is that investors all of a sudden have woken up to the possibility of Evergrande’s collapse, the highly leveraged property developer close to defaulting on interest payments this week, and grown concerned about the tapering of asset purchases looming relentlessly larger. This spurt of awareness would be the reason behind the global stock rout, with US equities down a little less than 2% yesterday and the European markets tumbling the most in two months. These alleged flashes of insight would have also precipitated a flight to the safe havens of the US dollar and the Treasury bonds. Aren’t markets rational and shouldn’t investors be able to discount future events, rather than their wits being suddenly turned on by those events approaching? The narrative is a bit more complex than what is rushed through the news, where the dots are connected according to the flavor of the day for the sake of cutting a long story short.
Large institutional investors have seen the Evergrande event looming for a couple of years to say the least, and the stock has been in a bear market in the last four. The large institutional base of international bondholders can be explained with the search for yield triggered by the extraordinary financial repression of central banks and the wrong investor calculations that the company, being of systemic importance, was too big to fail. As for the Fed’s tapering, never has a decision been better telegraphed. Actually ex PIMCO’s CIO Mohammed El Erian, to mention just one prominent investor out of many urging action, recently said that the window is closing for an orderly reduction of stimulus, referring to much improved economic conditions and no-longer-so-temporary inflationary pressures.

The matter of the fact is that, after a plethora of market-supportive conditions - from unprecedented monetary to fiscal stimulus, to the ensuing fastest recovery in history accompanied by explosive earnings growth - September and October will see the clustering of some negative factors for the first time in the post-pandemic period. Congress will have to approve a budget for the new fiscal year, which starts on October 1, otherwise the government will shut down, and will have to raise the debt ceiling, otherwise the government will be unable to meet past obligations as soon as this November. Intertwined with this are the $550bn infrastructure package, in limbo in the House, and the larger $3.5tn social expenditure bill, whose details must yet be filled in by Congress and should be funded by taxes nobody has yet agreed upon. In the increasingly polarised world of US politics an agreement, though ultimately likely to be found, will come down to the wire, causing quite some market volatility, especially when the delicate question of the debt ceiling is held hostage to the deep rift between Democrats and Republicans.

All of this is happening against the backdrop of smouldering inflation pressures. Indeed, supply-chain constraints and labor shortages are by nature temporary, hence the price pressures they come along with. But the persistence of elevated inflation suggests that the imbalances wrought by the Covid crisis could last much longer than initially thought. Leaders of the top US industrial companies gathered virtually last week for the annual Morgan Stanley Laguna conference. General Electric CEO Larry Culp said that those pressures are “increasingly getting structural in nature”, and the CEO of lock maker Allegion, David Petratis, expected inflation to be sticking around for a period of two to three years.

Markets could remain choppy until they are through the settling of the debt ceiling issue and have gained visibility on how the Chinese government is going to handle Evergrande’s restructuring, which could have systemic implications in the unlikely event that it is left to itself. Meantime US economic surprises would be bottoming and the Chinese authorities have supported their economy with adequate stimulus measures to reverse the protracted slowdown phase. It would not be the end of the world, but, still, a volatile ride.

Stay safe.

MAURICE GRAVIER
Chief Investment Officer
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