

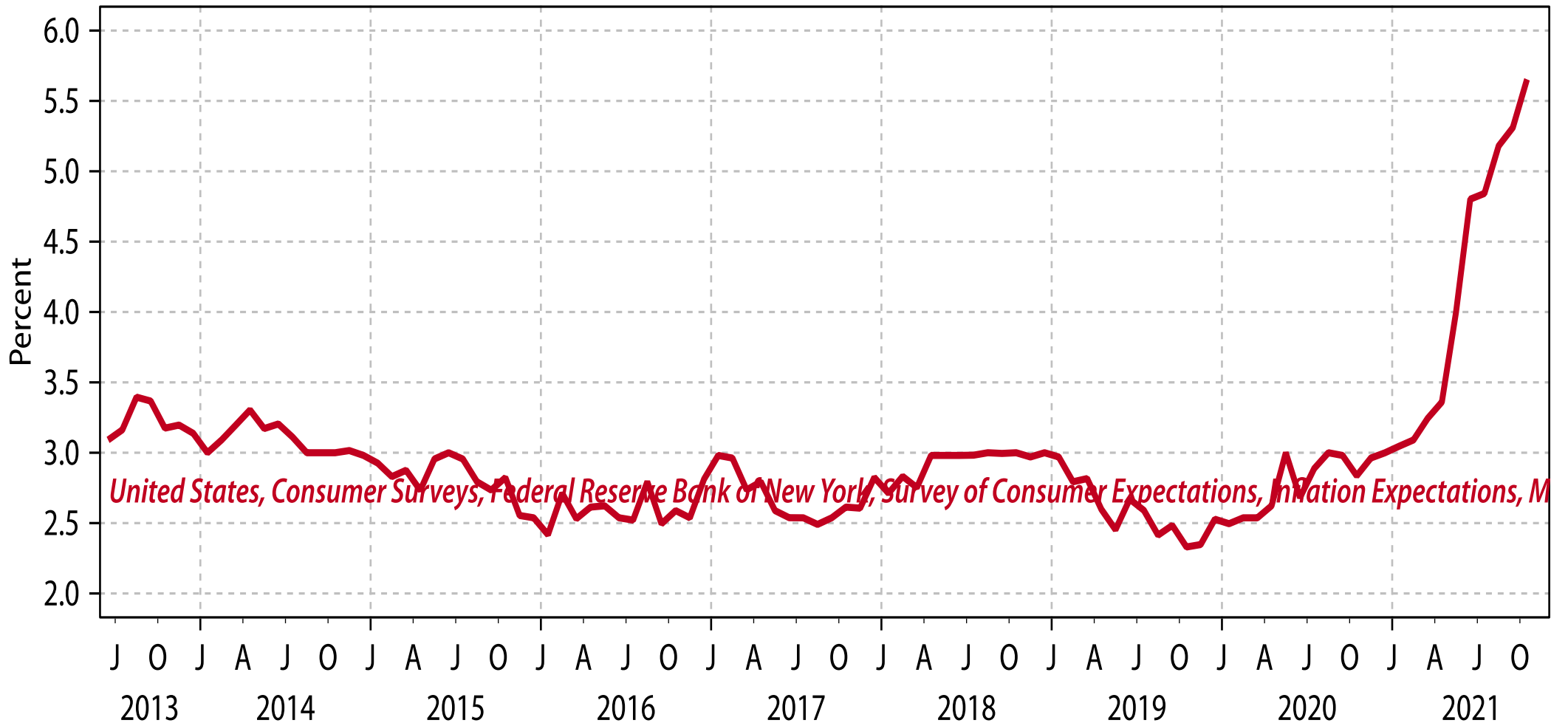
December 2021

The inflation dilemma

By Louis-Vincent Gave

What if inflation had come in as the consensus expected a year ago?

United States, Consumer Surveys, Inflation Expectations, Median 1-Year Ahead, SA



Gavekal Research/Macrobond

The macro environment has changed, the investment environment has not

USA MSCI Value Relative to USA MSCI Growth (total return, in US\$)



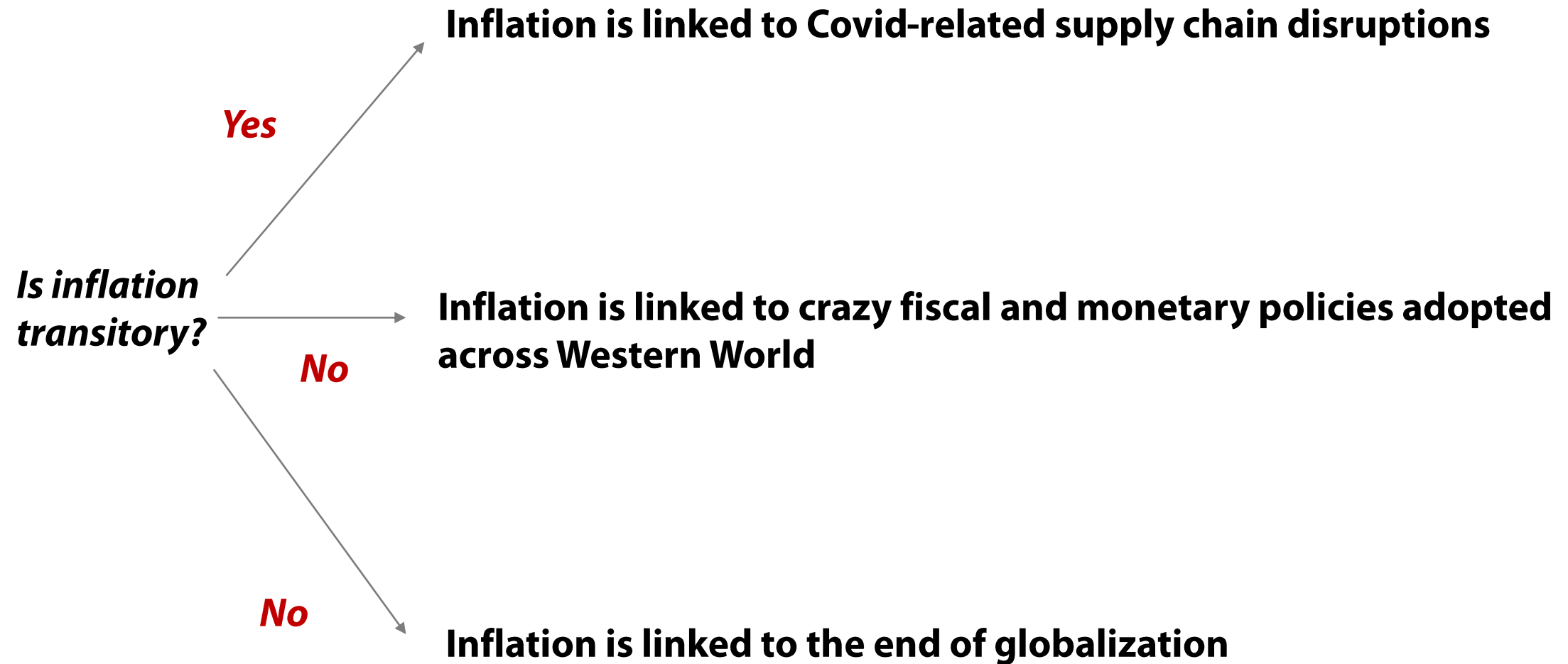
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Three possible scenarios looking forward

- **Scenario #1:** Inflation is transitory
- **Scenario #2:** Inflation is NOT transitory, and policy-makers attempt to put the inflation genie back in its bottle.
- **Scenario #3:** Inflation is NOT transitory, but policy-makers maintain easy fiscal and monetary policies.

Will inflation prove to be transitory?

Three ways to look at the inflation problem

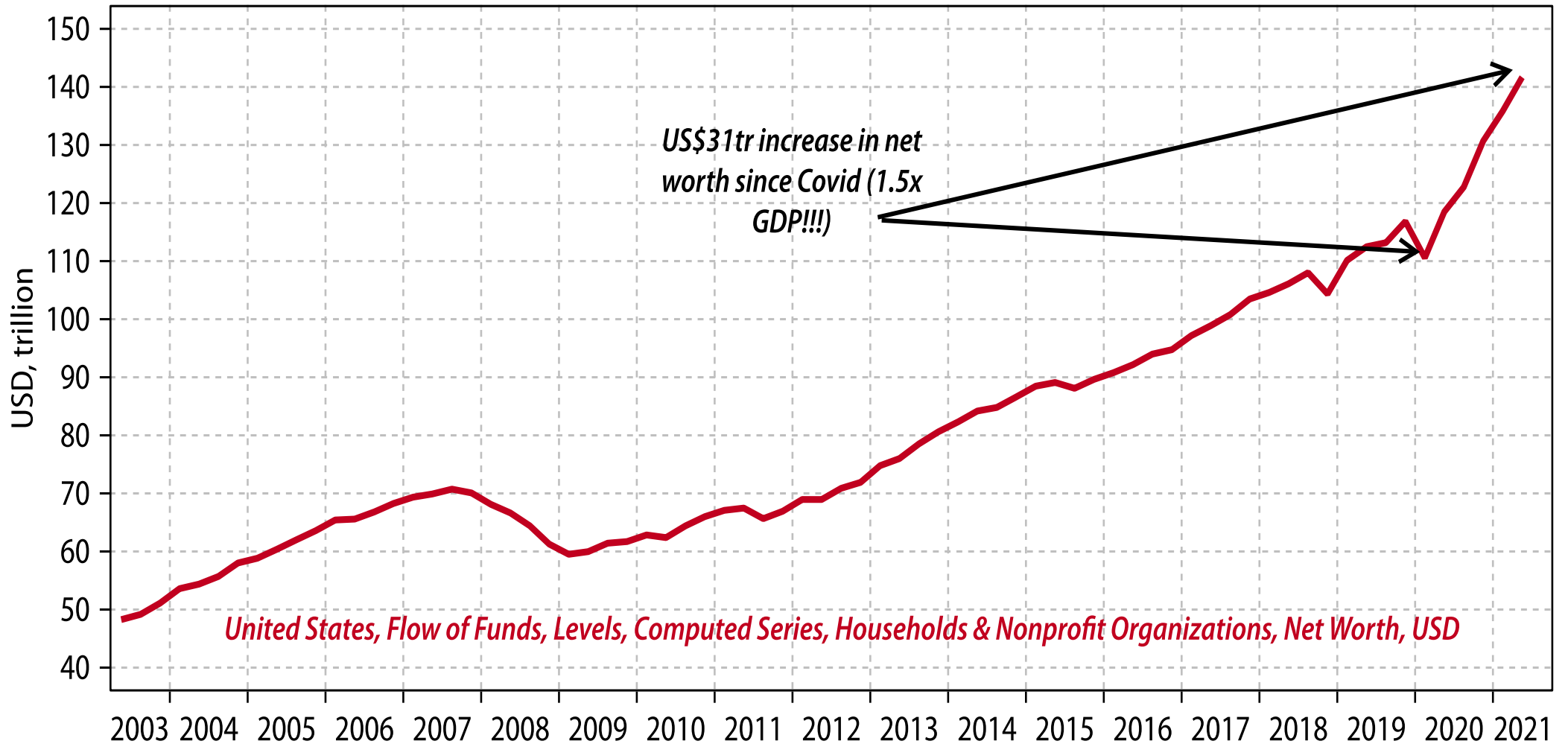


The problem with the transitory hope

- **Is China set to re-open?** No. at least not until after the Beijing Olympics and perhaps even the Oct 2022 CCP Congress.
- **Is the semi shortage linked to Covid?** No. The seeds for today's semiconductor shortages were planted when the US-China trade war morphed into a tech war.
- **Is the energy shortage linked to Covid?** No. Today's energy shortage has more to do with the capital destruction that went on in energy for the 2011-2021 decade, the ESG push, the energy transition rhetoric etc... Even today, with prices surging, the top 50 US energy companies are not planning any increase in capex (as an aggregate).
- **Is the ships/port infrastructure/truckers/logistics breakdown linked to Covid?** Probably not. At stake are new regulations (USMCA, IMO 2020...), changes in logistics (new very large container ships creating issues for ports), local regulations etc...
- **Is today's labour shortage linked to Covid?** Yes. Though part of it is also the demographic transition and the continued bull market (asset owners retiring early). One open question is whether today's vaccine mandates are making labour shortages better (i.e: people feel more comfortable getting back to work) or worse (a significant minority refuses the jobs). Worse seems to be the likeliest outcome...

If Americans consume 20% of their GAINS => a 43% increase in consumption!

USA Households & Nonprofit Organizations, Net Worth, USD

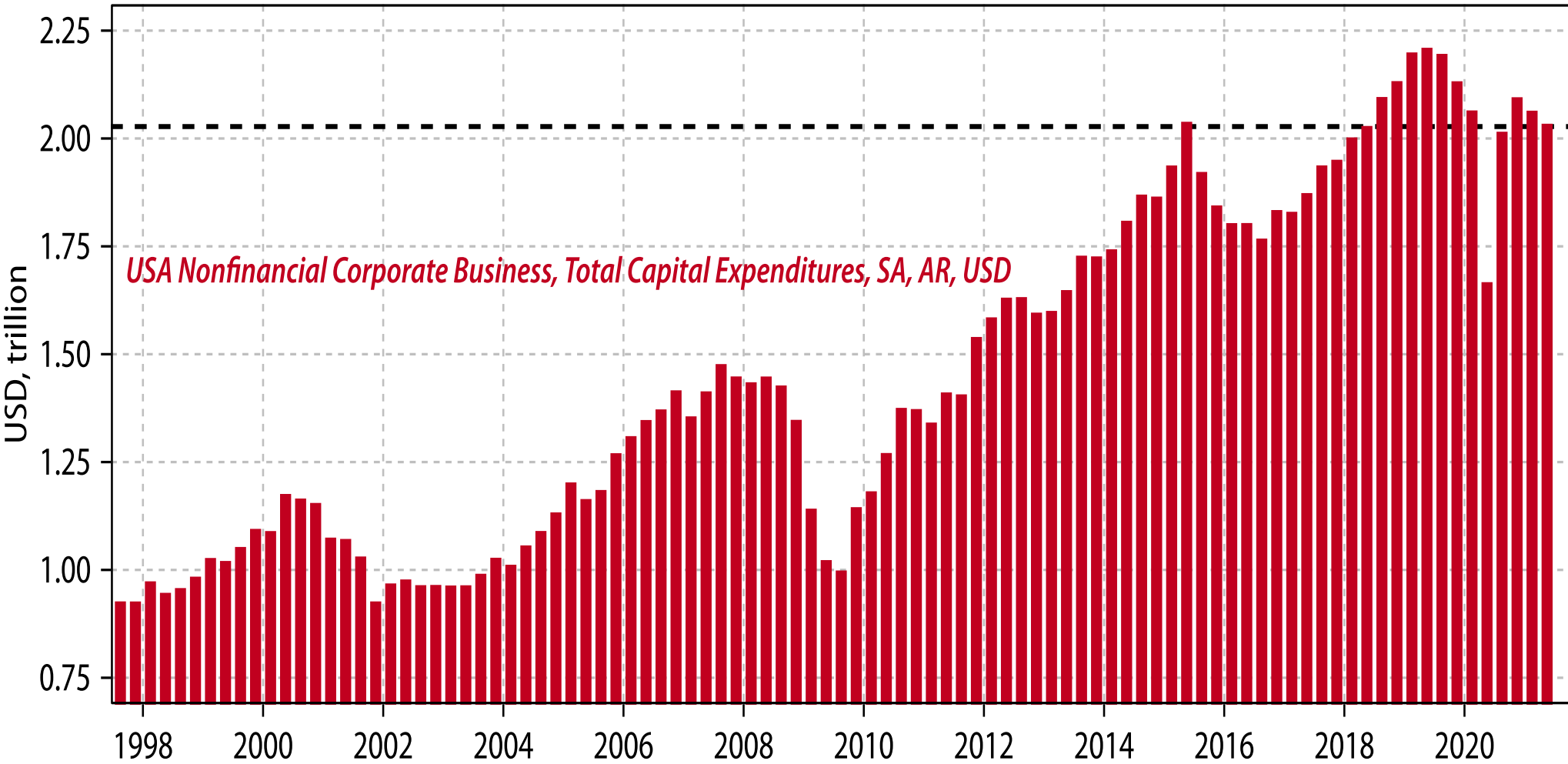


United States, Flow of Funds, Levels, Computed Series, Households & Nonprofit Organizations, Net Worth, USD

Gavekal Research/Macrobond

Capital spending is still below pre-Covid levels, same level as 2015!

USA Nonfinancial Corporate Business, Total Capital Expenditures, SA, AR, USD



Gavekal Research/Macrobond

Where will the next deflationary hit come from?

USA CPI, YoY % Change



Gavekal Research/Macrobond

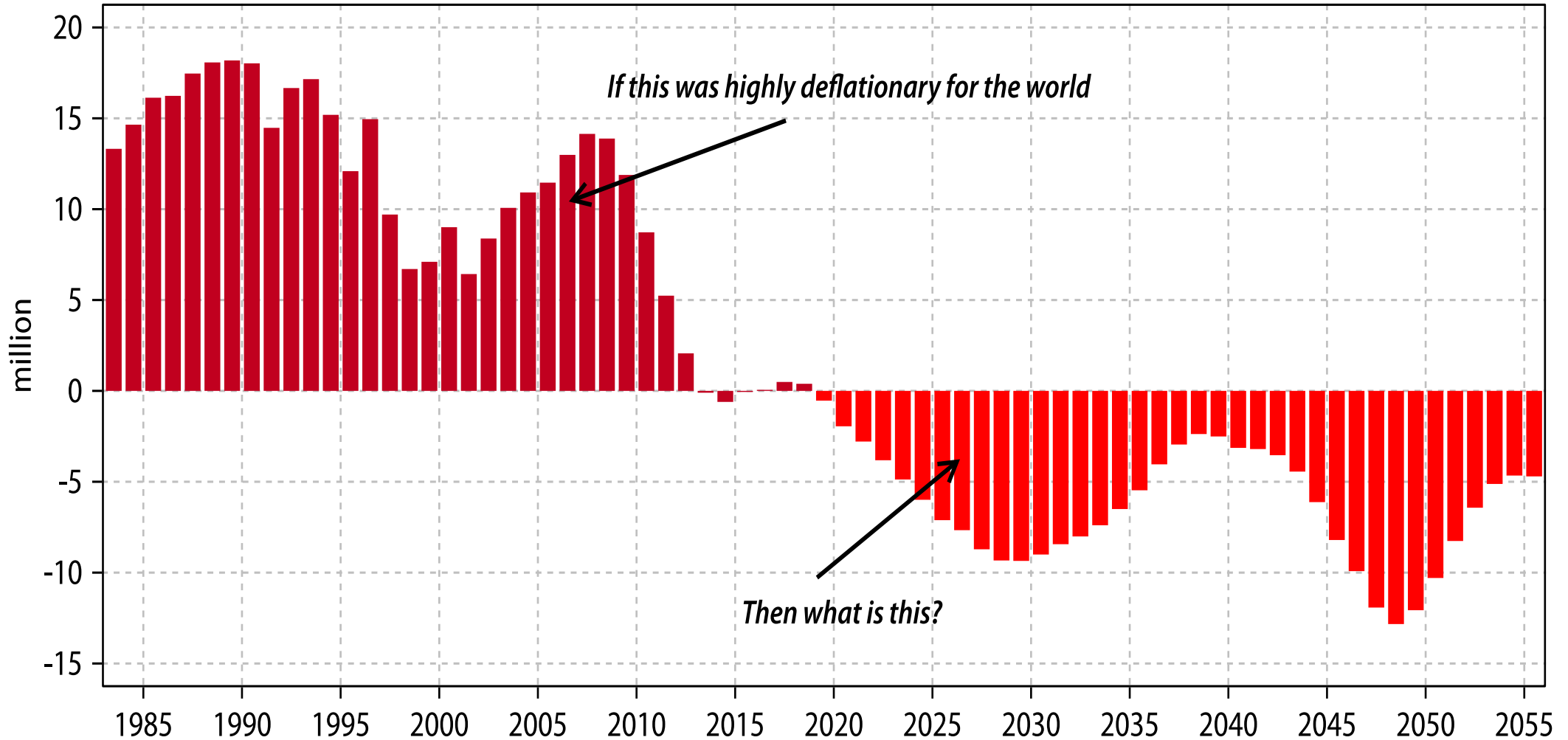
**China moves from being an deflationary force to a
inflationary force for the world**

A sudden shift in policy goals

- For two and a half decades, one of the primary concerns of the Chinese leadership was making sure that the 15m~20m young Chinese moving from the countryside to the cities would find jobs.
- This meant that local policy makers were judged/rewarded on their abilities to generate growth and create jobs; ***“show me the incentives and I will tell you the outcome”***.
- At the business level, this meant that the default business model was the ‘too big to fail’ business model. Every business would invest, regardless of returns or cost of capital, on the premise that when the cycle rolled over, they would be the ones to be saved with bank loans, subsidies etc...
- In a world in which China has already urbanized faster than expected, in which the population is ageing much faster than expected, and in which the US aims to clip China’s wings, the business model changes from ‘too big to fail’ to ‘small is beautiful’ (or at least small enough to stay under the government’s radar!)

The political priority no longer is job creation

Annual increase in the Chinese Working Age Population (20 to 59 years old)



Gavekal Research/Macrobond

The new political priority is reducing dependency on a hostile US

**US takes down of Huawei/morphs
'trade war' into 'tech war'**



**Fuels CCP paranoia that the
US is out to keep China
under its thumb**



CCP has to address and remedy China's main geo-strategic weaknesses



**Dependency on
foreign
technology,
most notably
semiconductors**



**Dependency on
energy (oil,
coal...) imported
through US
controlled oceans**



**Dependency on
US\$ to settle
almost all of
China's foreign
trade**

Political priority now is to address structural weaknesses US could exploit

U.S. needs to work with Europe to slow China's innovation rate, Raimondo says

PUBLISHED TUE, SEP 28 2021-9:27 AM EDT | UPDATED TUE, SEP 28 2021-2:10 PM EDT

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KEY POINTS

- Commerce Secretary Gina Raimondo said Tuesday that the U.S. will rally allies in order to mount pressure on the world's second-largest economy.
- "If we really want to slow down China's rate of innovation, we need to work with Europe," Raimondo said.
- On Wednesday, Raimondo alongside Secretary of State Antony Blinken, Deputy Secretary of State Thomas D. Shannon, and U.S. Trade Representative Katherine T. Tai...

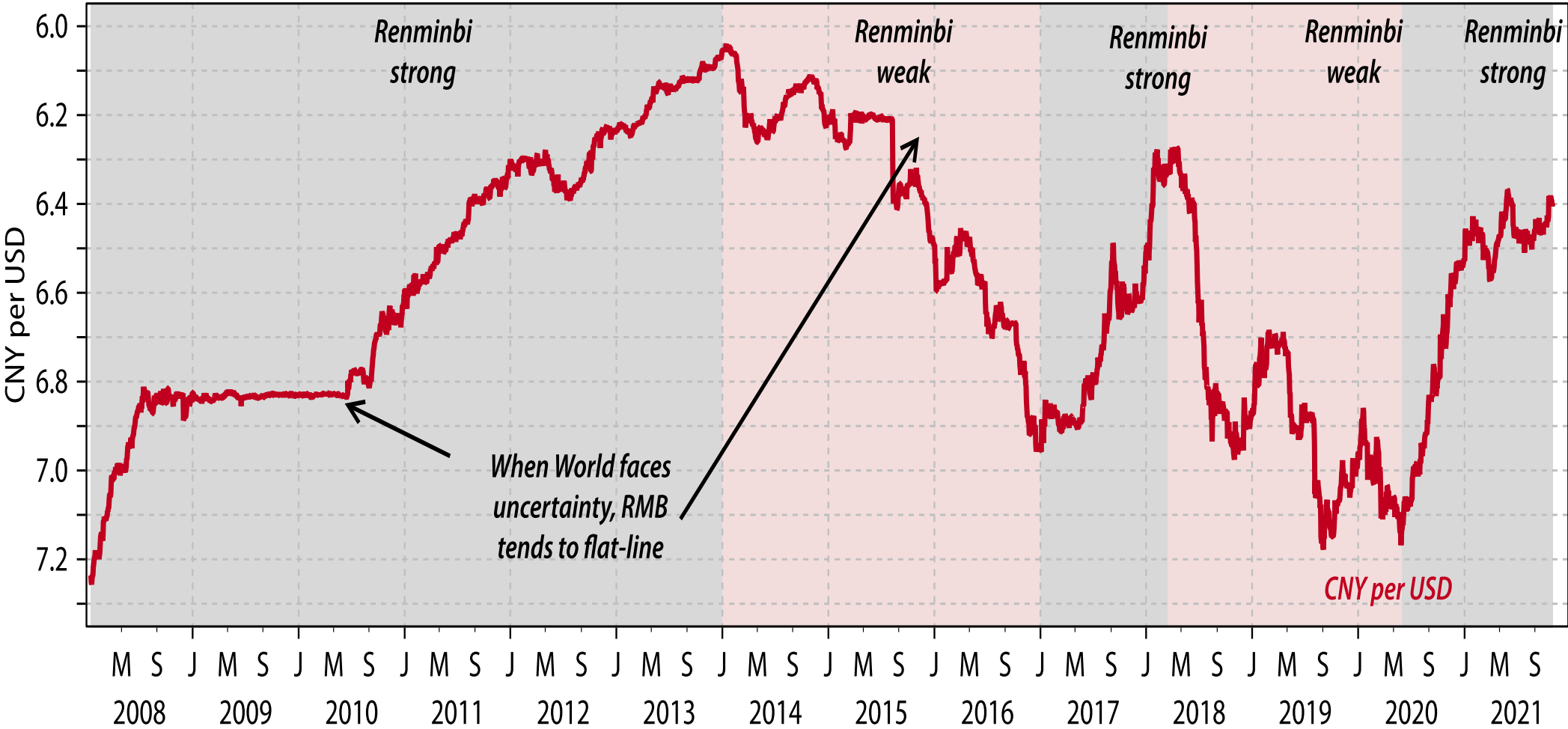
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12°C 2:06 PM 6/10/2021

Important message in RMB's strength in the face of weakness

Periods of renminbi strength and weakness since the financial crisis



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China today is where France was in 1991

Total Return on Long Dated Government Bonds, China vs USA (BofAML, 10-15 Year Index)



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Chinese policies are deflationary for China, inflationary for the world

China CPI vs China PPI



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Everything about China is inflationary for the rest of the world

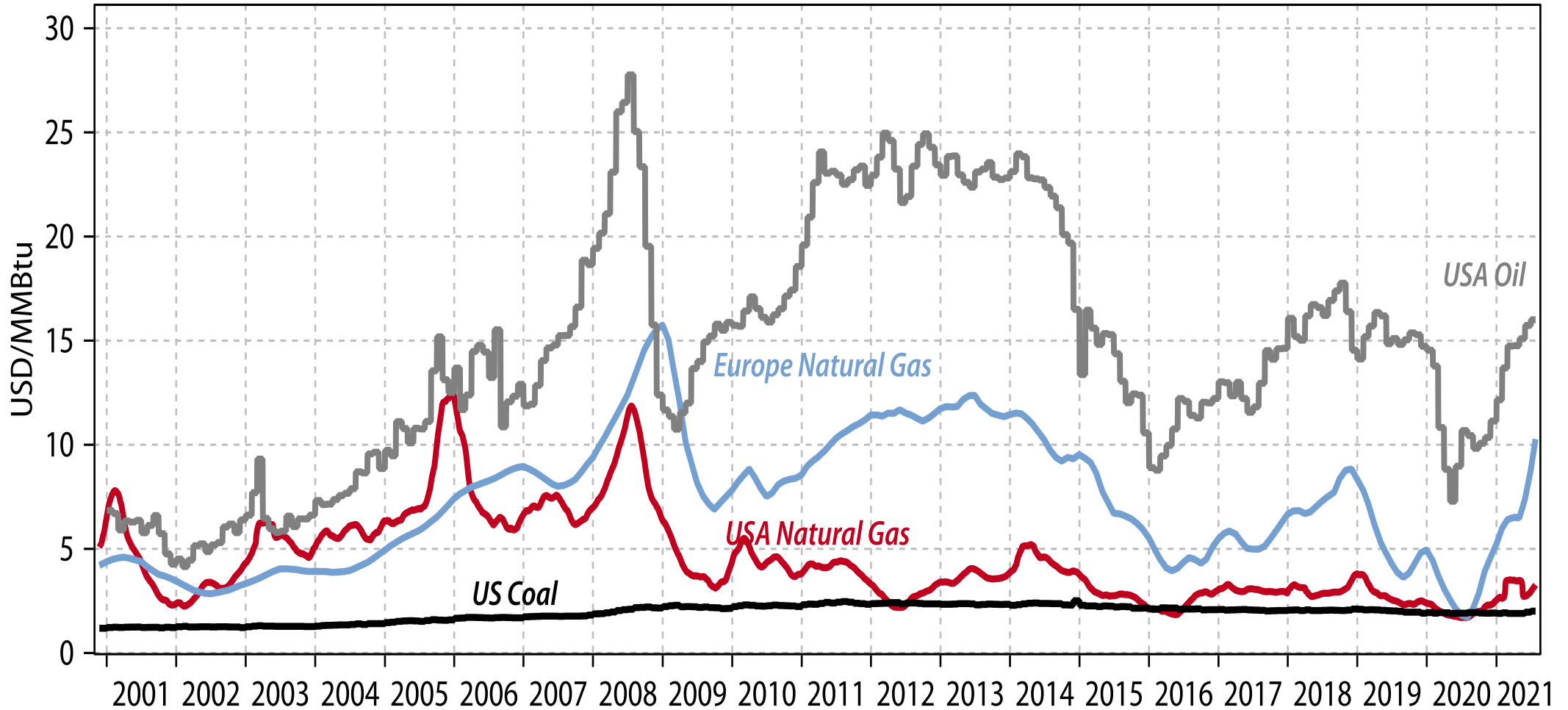
- Is China trying to boost growth by adding excess capacity => No longer
- Is China unleashing millions of additional workers unto the global economy => No longer
- Is China bidding up energy, and the metals needed for the energy transition (copper, lithium, cobalt...) => Yes. Though China is also signing long term deals with the likes of Russia, Qatar etc... that ultimately could bring prices down. On this front, the departure of Western troops from Afghanistan opens up many potential opportunities (Afghan Lithium? Iran pipeline?...)
- Is China currently rationing energy, creating supply chain disruptions because of shortages in primary materials (steel, aluminum, petrochems...) => Yes
- Is China continuing its 'zero-Covid policies', hereby contributing to supply chain dislocations => Yes
- What is the primary goal of Chinese policy makers => de-dollarizing Asian trade, which entails sacrificing everything on the altar of the strong RMB

China has moved from being a large deflationary force for the world, to being an inflationary one

The inflationary hit too few are thinking of

First a simple reality: coal is cheaper, and more stable, than anything else

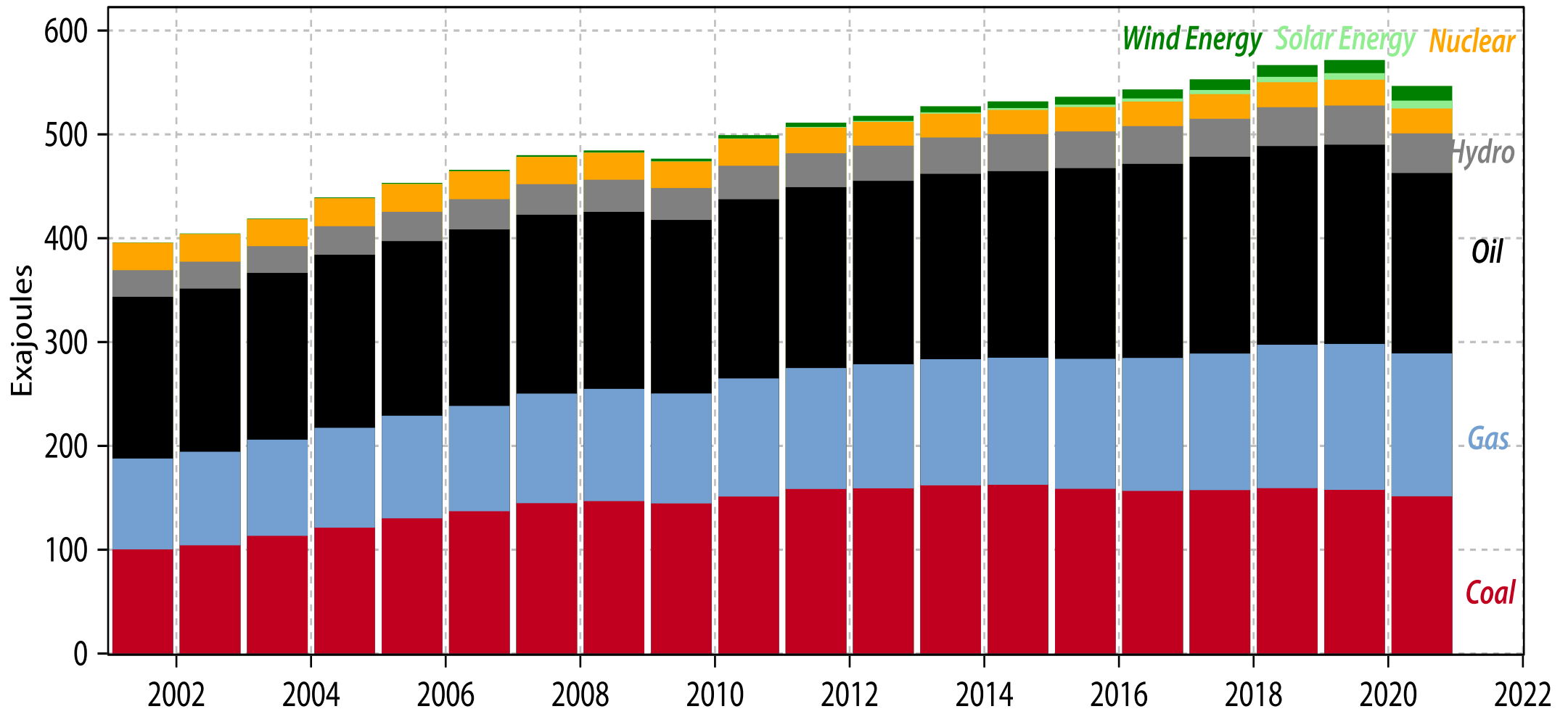
The Cost of Producing Electricity, USD/MMBtu



Gavekal Research/Macrobond

Replacing coal is a daunting task

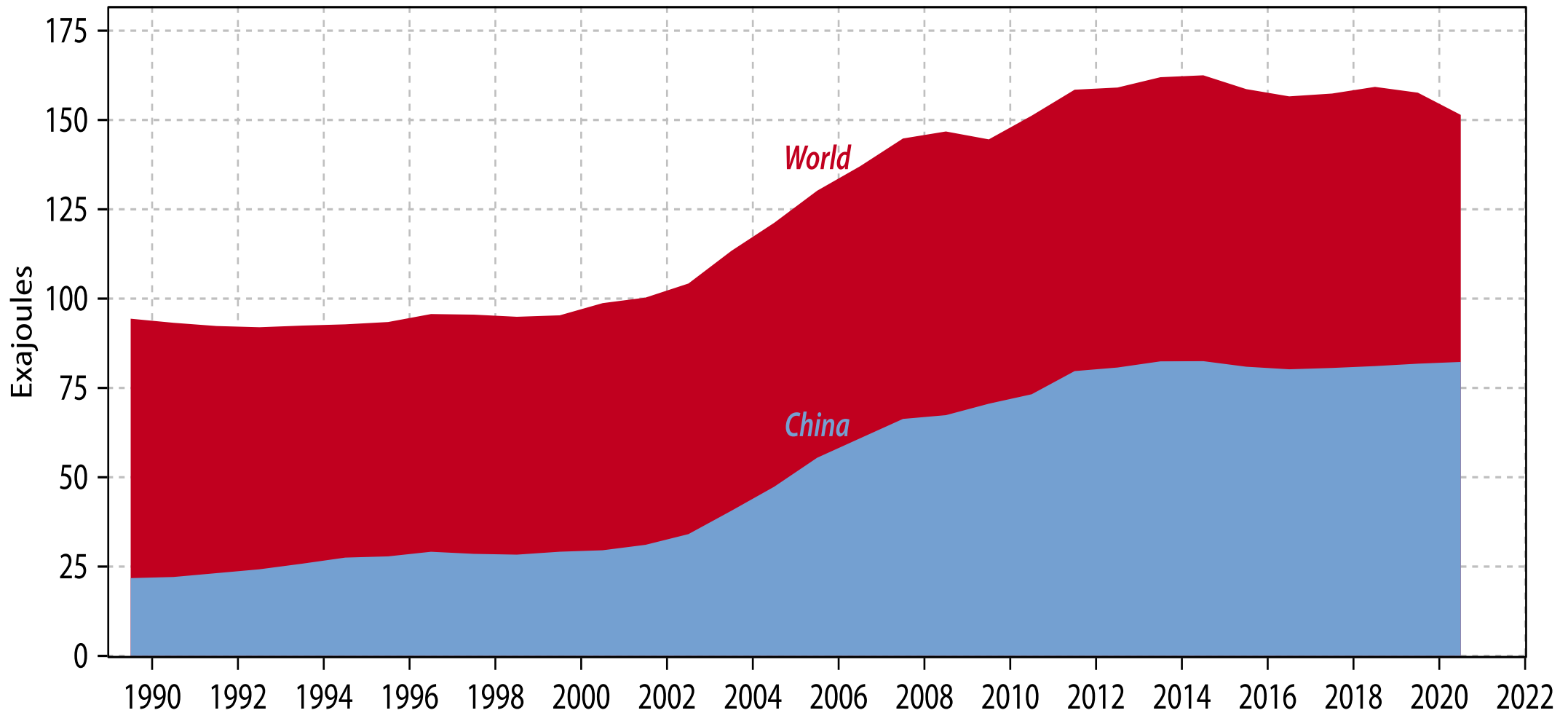
World, BP Statistical Review of World Energy, Consumption, Exajoules



Gavekal Research/Macrobond

West did not get cleaner – West moved polluting coal usage to China

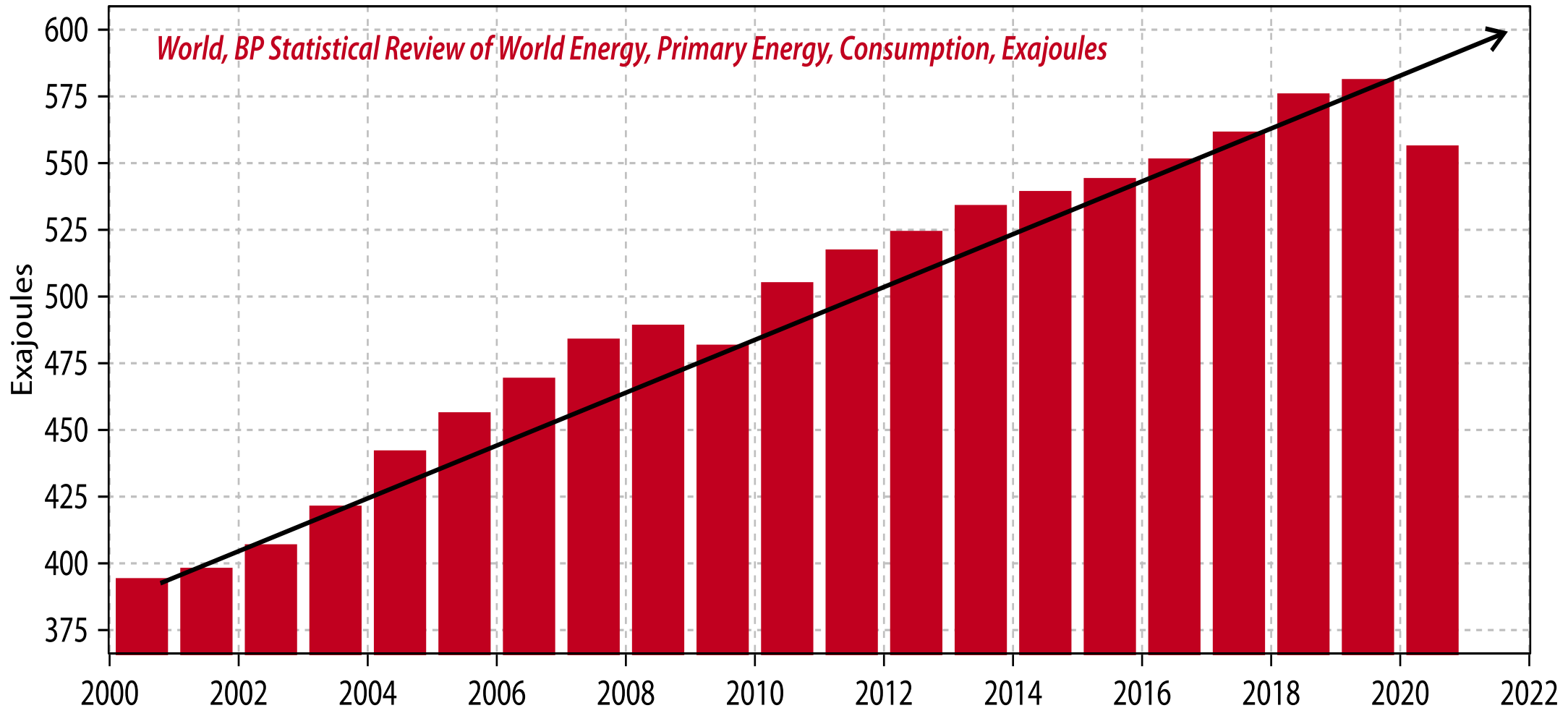
BP Statistical Review of World Energy, Coal, Consumption, Exajoules



Gavekal Research/Macrobond

Where will the world get the next 80 exajoules from?

World, BP Statistical Review of World Energy, Primary Energy, Consumption, Exajoules



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We are entering into an energy crisis

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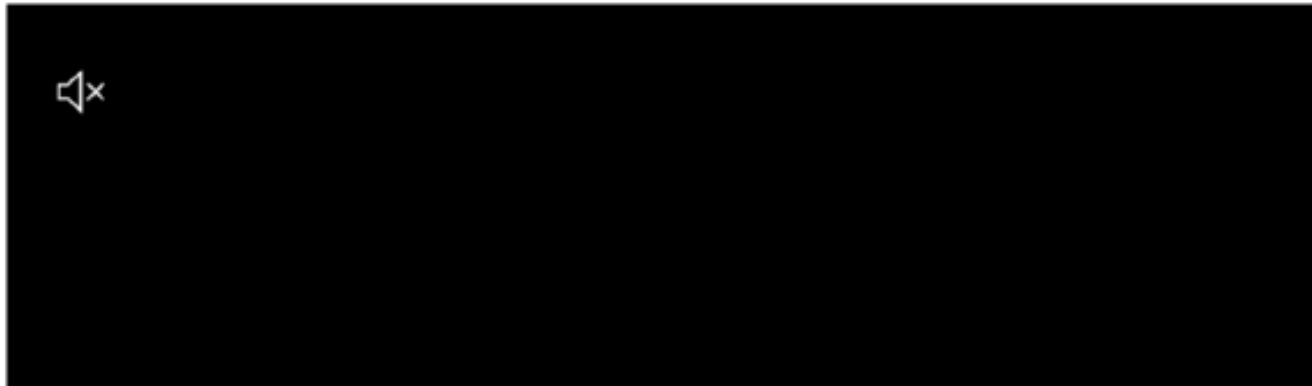
Markets

China Orders Top Energy Firms to Secure Supplies at All Costs

By [Alfred Cang](#) + Follow

September 30, 2021, 8:01 AM PDT Updated on September 30, 2021, 5:05 PM PDT

- ▶ Emergency meeting held this week on the energy-supply crisis
- ▶ Directive came from a vice premier to coal, power, oil chiefs



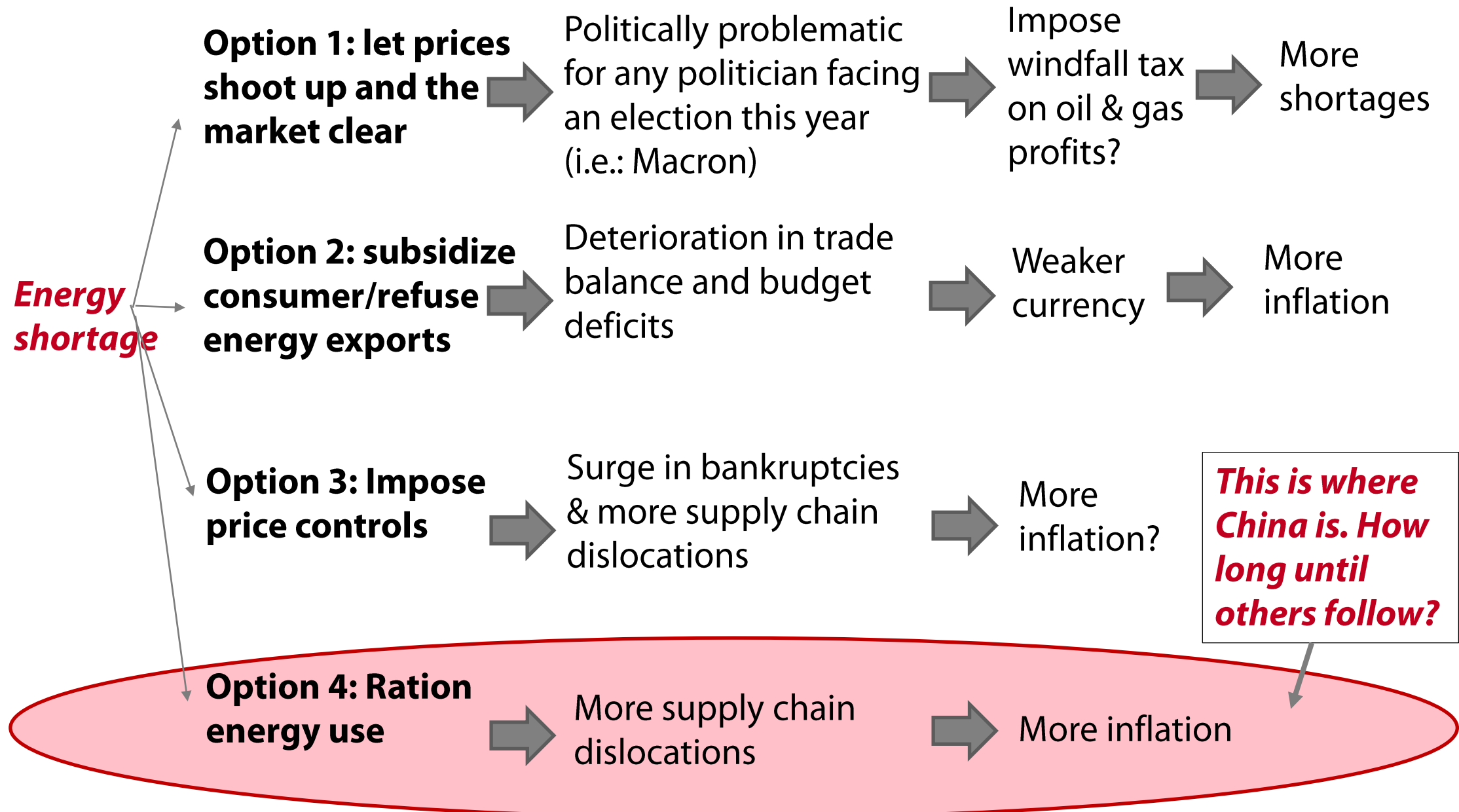
What is surging Chinese coal price in the middle of a downturn telling us?

China, Coal, Bohai-Rim Steam Coal, CNY



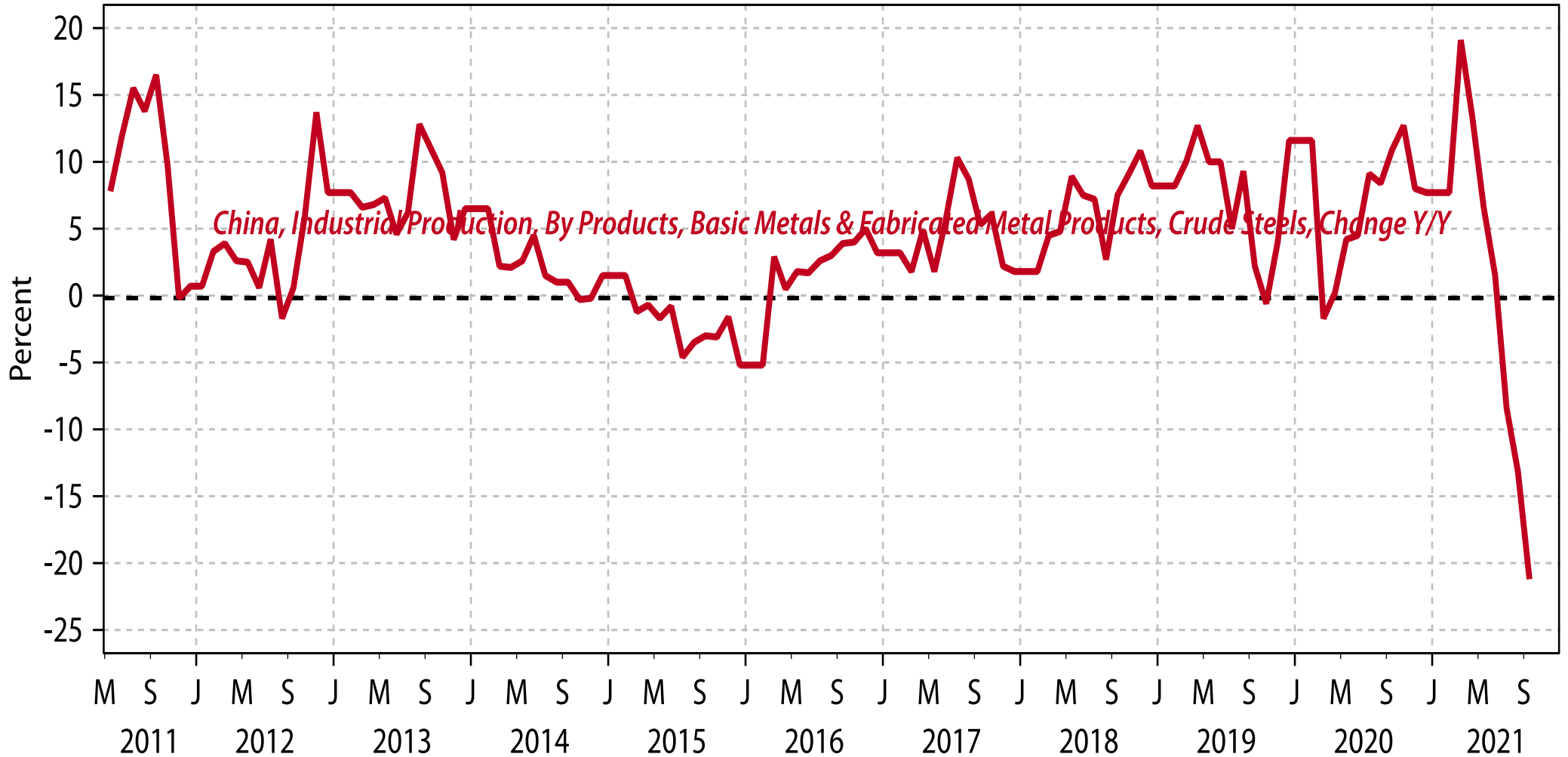
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How to deal with an energy shortage?



So you end up with charts like these

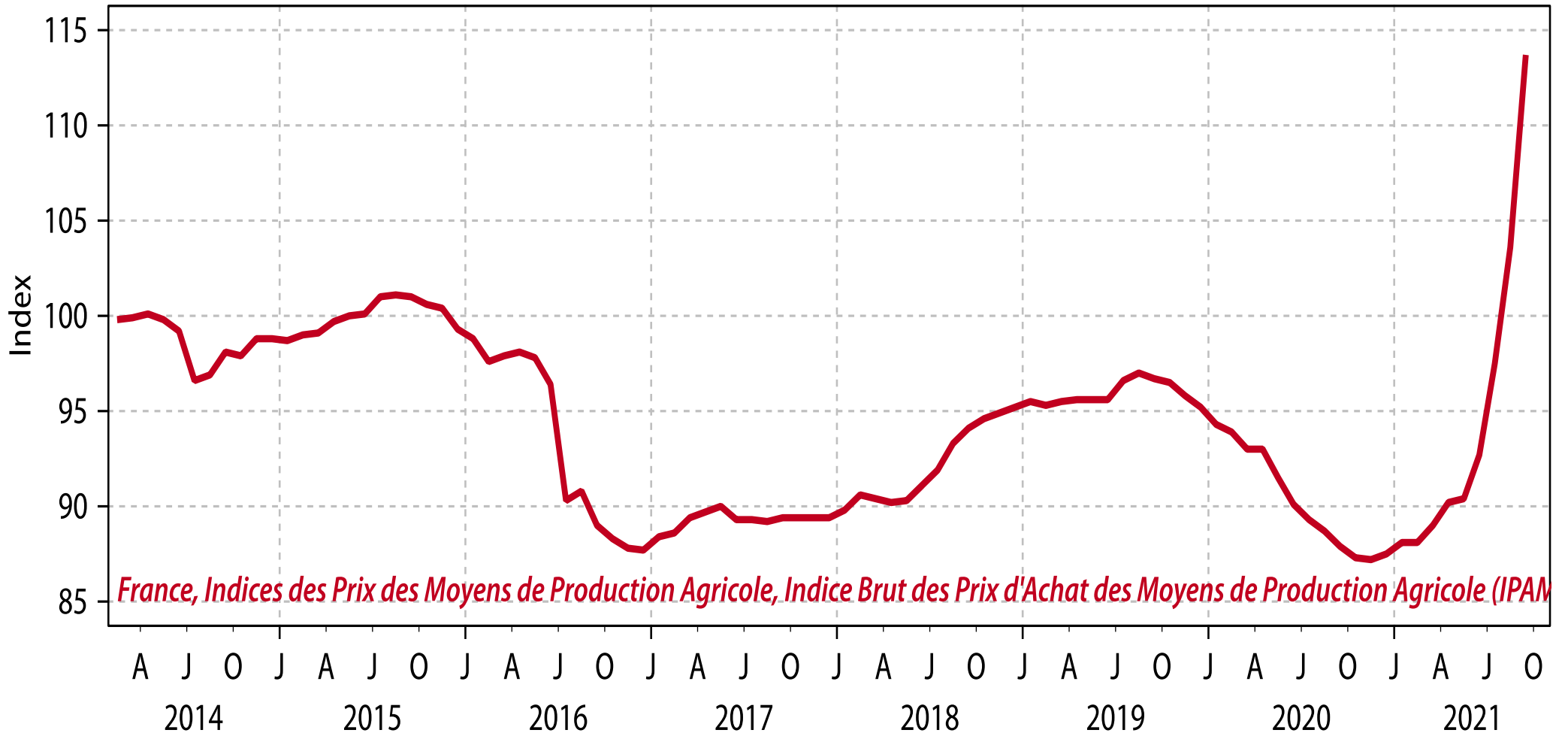
China, Industrial Production, Crude Steels, Change Y/Y



Gavekal Research/Macrobond

And charts like those

Price of Fertilizer in France



Gavekal Research/Macrobond

Ends up pushing many prices higher...

World, Commodity Indices, S&P GSCI, Wheat Index, Price Return, Close, USD



Gavekal Research/Macrobond

The problem with rising energy & food prices

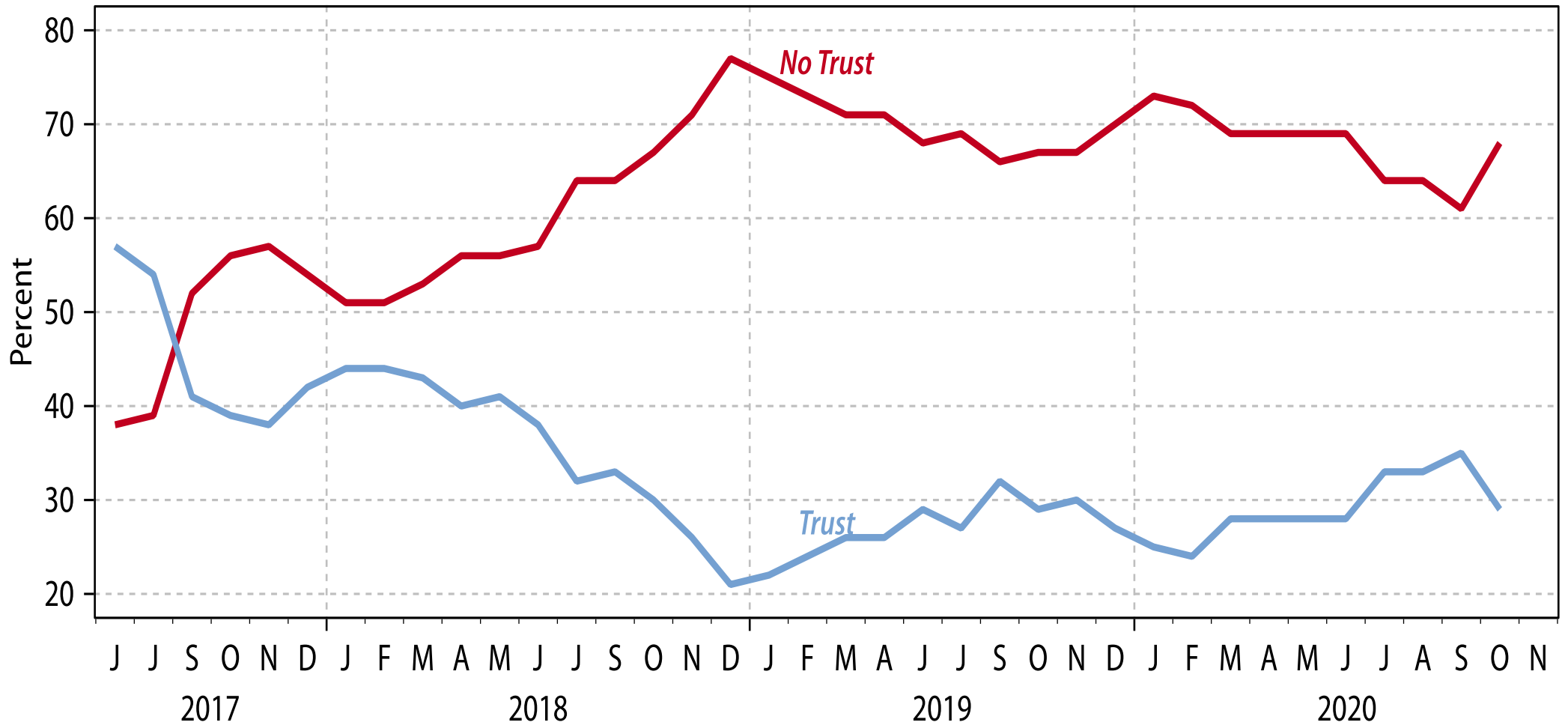
The scope for a political shock in the EU is rising

- Rising energy prices
- Rising food prices
- Likely surge in immigration (Afghanistan, problems in the Maghreb, problems in Western Africa...)
- Divided society on Covid policies (vaccine mandates, lockdowns...)
- Possible over-run hospitals (staff shortages following vaccine mandates)

=> That's a tough environment to run for re-election

Especially if one isn't liked in the first place

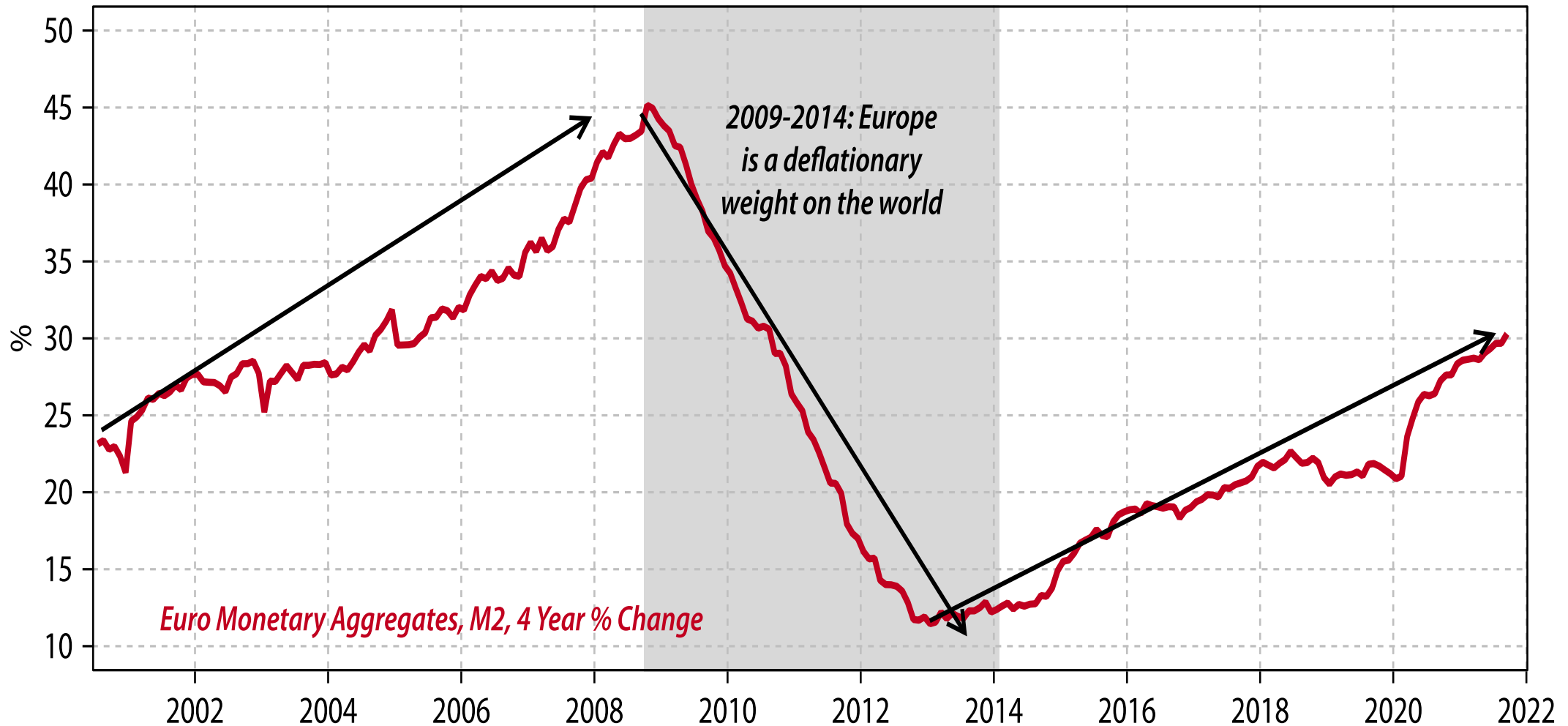
France, Political Polls, Kantar TNS, Presidents & Prime Ministers, Emmanuel Macron



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Europe's fiscal and monetary policy settings remain very loose

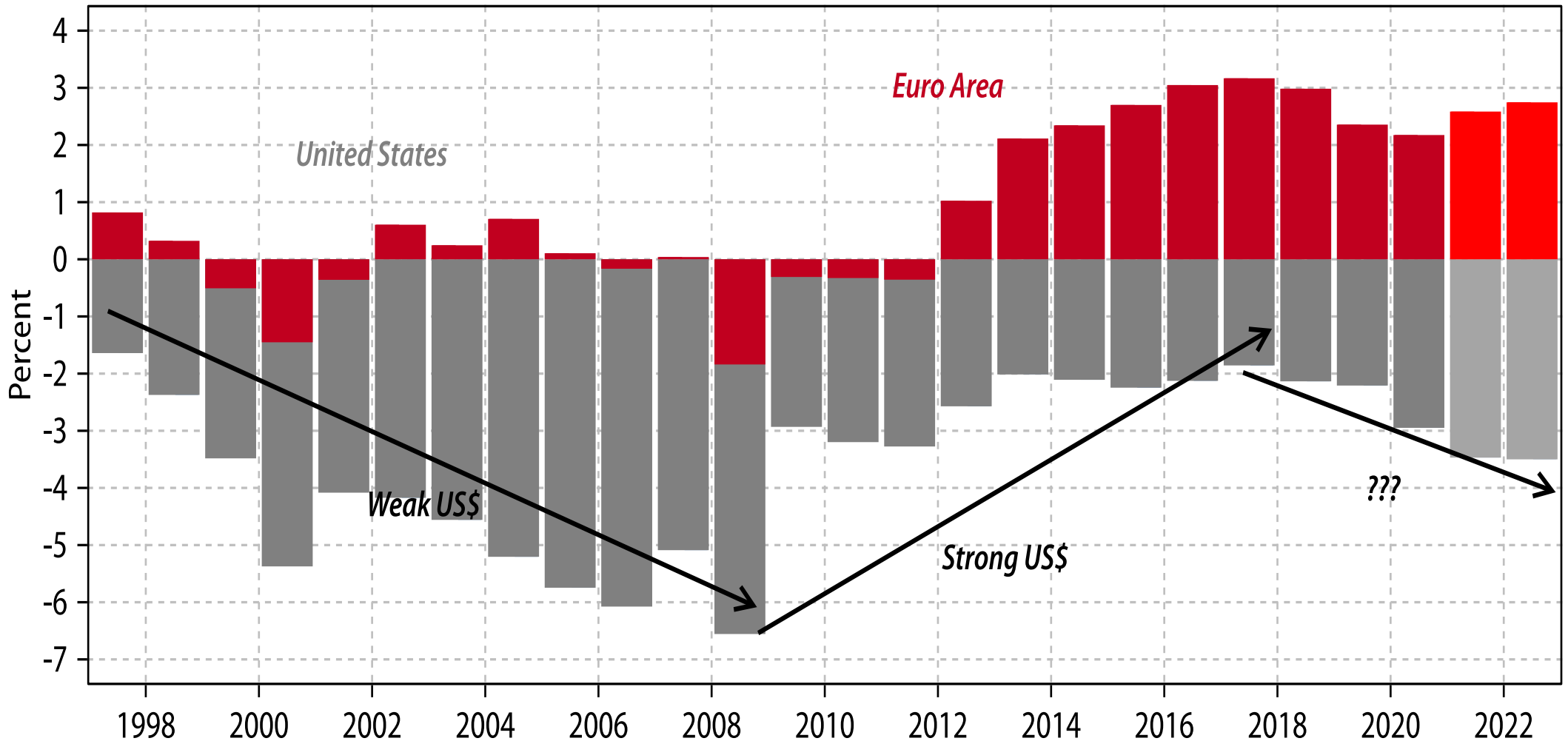
Euro Area, Four Year Rate of Change of M2



Gavekal Research/Macrobond

With current account surpluses of 3% of GDP, Euro should not collapse

Current Account Balance, IMF WEO, Estimate, Percent of GDP



Gavekal Research/Macrobond

Investment conclusions

So which way will it go?

- Right now, the PBOC continues to follow a 'strong RMB' policy, major EM central banks (Brazil, Russia...) have started to tighten, central banks of commodity producers have given up on yield curve controls, while the 'Big 3' central banks are still by and large very dovish. **This feels like an unstable equilibrium.** So what happens next?
- **Option 1:** China abandons strong RMB policy and unleashes deflation on the world. Commodity prices fall. EM central banks are proven wrong and "big 3" are proven right. Sell commodity currencies and buy two year bonds in AU, NZ, CA hedged back into US\$. Buy US growth stocks. My take: low odds.
- **Option 2:** Europe experiences another political crisis. US\$ shoots up, commodities tank, emerging markets struggle. Capital flows back into US Treasuries and US growth stocks. My take: Not a base case scenario but a risk nonetheless.
- **Option 3:** Inflation continues and 'big 3' central banks have to catch up on the trail blazed by EM. **This makes for a tough environment as the combination of rising energy prices and rising interest rates seldom leads to happy outcomes.** Especially when valuations are stretched. At the very least, this should trigger serious rotation away from growth and into value, and away from OECD government bonds and into EM bonds. My take: for now, this is where we seem to be heading.

Investment recommendations

1. **Avoid businesses that are highly energy intensive** (utilities, construction, some industrials...).
2. **Avoid business models that depend on large number of low-end workers** (distribution, retail, airlines, consumer electronics manufacturing...).
3. **Overweight beneficiaries of steeper yield curves** (banks, insurance companies, asset managers...). The rise in interest rates is only just starting...
4. **Be wary of a potential problem in the Eurozone** –maybe the region is best avoided with capital re-oriented towards tightening emerging markets, and a stimulating Japan?
5. **Overweight business that will profit from labour shortage** (Robotics, non-China EM producers, logistics,...).
6. **Look for anti-fragile assets outside of OECD government bonds.** Obvious choices might be pipelines, infrastructure plays, Asian government bonds (for inflationary boom) and precious metals (for inflationary bust).

Contact and disclaimer

Thank you!

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