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"The past few decades have seen the share of GDP earned by 'Capital' increase, while the share earned by 'Labour' has decreased. But, at least in the US, it looks like this trend will turn."

Dino Kos

"Until we see a relief in supply shortages, the European recovery will likely remain challenged. At the same time, the ECB is as dovish as it has ever been and is insisting that inflation is transient; the risk, however, is that price pressures could linger longer than many expect."

Eric Chaney

"Despite Evergrande, China's property sector is not as bad as many feared and will overcome the current challenges. The regulatory clampdown in China is not widespread: while some sectors will be restricted, others will be supported, and will likely attract investment and generate growth."

Jiming Ha

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Abstract

With the global economy largely re-opened, despite the advance of the Delta variant, the main challenge facing the world economy today is how the markets will find a new equilibrium, in what has been a highly uneven global recovery. Though the shock that hit the world economy in 2020 was unique, the policy responses and the impact of the pandemic across the various industries could not have been more asymmetric. As a result, the world is grappling with acute imbalances between the demand and supply of almost all economic variables, from goods and services, to energy, technology and workers. Across countries and sectors, we are seeing leaders and laggards, as the world carves out this 'K-shaped' recovery. Most critically, these imbalances have led to surging prices, as well as to a renewed political debate about inequity, and about the role and size of the government. **Given this convoluted backdrop, the key question for investors will be whether these market frictions will soon fade; or whether a more prolonged period of inflation and of big governments might be in train.**

To address some of the most challenging issues faced by investors today, Dino Kos, Eric Chaney and Jiming Ha, who are thought leaders in the global macro space, give their take on current macroeconomic and policy-related affairs. We also feature a panel session between the three advisors and the senior members of Eurizon Capital's investment committee.

Our key takeaways: **Inflationary pressures might be more widespread and persistent than many central banks expect; and policy stimulus will continue to be withdrawn from the global economy. Meanwhile, new sources of growth are sparse, as China continues to slow, and as the focus in the US shifts away from unchecked capitalism and in favour of greater wealth redistribution. This backdrop is inauspicious for corporate profits, and investors should take note. In this convoluted environment, portfolios with reduced risk and increased cash should be preferred; and the dollar will likely stand out.** ■

Dino Kos

- **The US has seen a strong recovery, but this is now levelling off; and despite an initial burst of spending, the second derivative of fiscal policies in the US is going to start to roll over fairly soon;**
- **Rising inflation may be more persistent than expected: though supply chain bottlenecks are driven by temporary factors, we are now seeing migration of these higher prices into higher wages;**
- **Employers increasing worker compensation is of course good for the workers, but not good at all for company margins;**
- **In the 2022 congressional elections, expect Republican gains, leading to a longer-term political impasse;**
- **The Fed's emergency policies remain, despite the emergency itself receding. But as we look ahead, Fed is going to be much less friendly towards markets, which could be a recipe for volatility;**
- **The past few decades have seen the share of GDP earned by capital increase, while labour's share has decreased. But, at least in the US, it looks like this trend might be turning; for equities, this would be a recipe for lower returns;**
- **Risk of US-China decoupling? Wolf Warriors in Beijing and hawks in Washington are pushing for this. Implications for risk premiums.**

"Forecasts for 2022 remain robust, and GDP now exceeds its pre-pandemic peak."

A year ago, in the midst of the Covid crisis, the US economy looked set for a very slow and difficult recovery. But fast forward to today, and the US economy has seen a clear lift off; although growth might be starting to level off now, the economy is still performing quite well, much better than expected. **Forecasts for 2022 remain robust, and GDP now exceeds its pre-pandemic peak.**

One result of this strong growth momentum is the broadening of supply chain issues, with bottlenecks looking set to persist. But while some of the drivers of these issues are indeed pandemic-related, some are also due to a mismatch between supply and demand.

Because businesses did not anticipate the level of demand we see now, many have not ensured they have enough inventory. There are also mismatches in labour, especially in the sectors that require skilled and specialist workers, where companies are unable to fill positions. **All of this is putting upward pressure on prices.**

Meanwhile, US policy, both fiscal and monetary, remain stimulative in the short run: the emergency backdrop has receded, yet emergency policies have not. **The Fed has maintained zero interest rates and an abundance of asset purchases, even if we will soon witness the beginning of the tapering of the QE programme.** And on the fiscal front, the Biden Administration's plan is to pass two different bills, one with a bigger infrastructure component, and the other with a broader 'human capital' or 'soft infrastructure' component. There is currently substantial debate and political infighting about the magnitude and contents of the latter bill, but I expect that something will pass, and it will be sizeable.

"We will soon witness the beginning of the tapering of the QE programme."

But there is one consideration that investors should take note, which is that, at some point, after this initial burst of spending, **the second derivative of fiscal policies in the US is going to start to roll over fairly soon.** In specific, I think **it is difficult to see how very much can get done politically in the US after 2021.** 2022 is an election year for Congress, and it is widely expected that the Republicans are going to gain at least one House, which would guarantee a complete gridlock over the two years that follow. So, **while in short term, we may see these packages approved and the spending begin, this expenditure is likely to plateau fairly quickly.**

In the meantime, however, none of this additional spending is going to help ease the current inflation backdrop, because implementing such large fiscal packages would be akin to stepping on the accelerator of aggregate demand, precisely at a time of when global supply is lagging.

And many of **the sectors that would specifically benefit from this fiscal package, such as the construction of roads, bridges, housing, are already facing shortages of both materials and labour.** It therefore remains unclear how much progress can effectively be made on such construction projects, but nonetheless it will keep the pressures high on both the labour and commodities markets.

"We might need to consider the risks of inflation persisting longer or going higher."

Indeed, all measures, including CPI and PCE, remain elevated and above target. Yet the Fed still seems to be presuming that it can control the inflation process and that the current price pressures will prove to be transitory. The Fed has argued very strongly on this point, and this view seems to be shared by other central banks. In fact, at a recent European financial conference I attended, there was a heated debate between two ECB Governing Council members and myself, because I put forward the view that **we might need to consider the risks of inflation persisting longer or going higher.** In my view, these are real dangers that could lie ahead, because inflationary pressures are migrating to new areas. The shortage of labour is driving goods prices higher: energy, commodities and semiconductors are key examples of rising prices. But **while these are short-term issues, driven by temporary factors in the supply chain, we are now seeing migration of these higher prices into higher wages.** This is especially evident in transportation and parcel delivery companies such as UPS and FedEx, where demand for their services is much stronger than their ability to hire enough staff and get past other logistical bottlenecks. **Employers increasing worker compensation is of course good for the workers, but not good at all for company margins.** So, to me, these inflationary pressures may not be so transitory after all.

The Fed's strategy for dealing with these issues is well known. Flexible Average Inflation Targeting allows inflation to run above the 2% target, and we have seen an initial **move to signal a slowdown in asset purchases, or a tapering.** There also seems to be a belief that there is more slack in the labour market than the unemployment rate might imply, and that the supply chain bottlenecks will resolve themselves.

But in any case, I think that the forward guidance in the language of the Fed is going to be much less friendly towards markets, which would be a recipe for volatility for equities and other risky assets. From a Sharpe ratio perspective, this is not the optimal kind of environment, because we would see lower returns than what people have become used to, and also more volatility.

To dive deeper into what is going on, I would suggest the explanation lies in the dichotomy of labour versus capital. **The past few decades have seen the share of GDP earned by 'Capital' increase, while the share earned by 'Labour' has decreased. But, at least in the US, it looks like this trend will turn.** The legislative priorities of this Congress and this president are very different to those seen previously, with a much **stronger focus and drive to attempt to address the issue of inequality.** This will likely be evident in regulatory and non-fiscal measures, for example future spending plans which favour labour over capital. And I would suggest there is a high likelihood of tax increases on the rich in the US in coming years. Indeed, given current trends and rhetoric, that is almost guaranteed. But **for equities, this would be a recipe, perhaps not so much for *negative* returns, but for *lower* returns**, compared to what the world has gotten used to, with margin compression being a key part of that.

"It is the US-China relationship that will be key."

Looking ahead, geopolitical risks abound, and, in my view, **it is the US-China relationship that will be key.** Globalisation has been a dominant theme over the last 40 years, and China has been very much a part of that. There has been, at least economically, a very tight relationship during this period between the US and China, and one view is that **countries are less likely to fight if they are tied together through trade and investment. But the 'Wolf Warriors' in Beijing and the hawks in Washington seem to be pushing for a decoupling.** If that comes to pass, it is likely that the geopolitical risk premium would be higher. That would be yet another factor that would weigh on the level of returns that one could anticipate over the coming years. ■

Eric Chaney

- **The formation of the German government will be key for Europe, as many key decisions in Brussels will be contingent on the inclinations of the new German leadership;**
- **The current (and self-inflicted) energy crisis is something we'll have to live with for many months and possibly years; until we see a tempering in the demand for energy, the recovery in Europe will likely remain challenged;**
- **Many underlying pressures on core measures of inflation suggest inflation will linger longer than the ECB would like or would admit;**
- **The ECB is as dovish as they've ever been, and insist on the view that the current inflationary pressures are transient;**
- **Wages are more likely to accelerate than profits; I'm not very optimistic on companies' margins;**
- **While the tensions build up between China and the US, Europe has remained on the sidelines; the political challenge for Europe will be how to side with the US, without jeopardizing its business relations with China.**

I am quite struck by the **similarities between all the regions in the world: there is a broad slowdown in growth; inflation looks set to be higher and longer than expected; and there are rising risks, with energy being is a critical global issue.**

In Europe, the economic recovery has been notable. Back in May 2021, Europe was really lagging its global peers, especially as the US and the UK, due to its delayed rollout of mass vaccinations. But if we fast-forward to early October, many European countries are even ahead of the US and UK in terms of vaccination; it's amazing to see how countries like Portugal, Spain, Denmark and Italy have performed. This is important because of consumer and business confidence: **countries with high vaccination rates are at much lower risks of having lockdowns. The high rates of vaccinations in Europe are certainly a reason for optimism, as we look forward.**

"Countries with high vaccination rates are at much lower risks of having lockdowns."

However, what has happened in recent months is that the sharp recovery that accompanied the reopening of the European economy at the end of the spring and during the summer is now waning. **There is a slowdown, and this slowdown is caused by the bottlenecks that we see not only in Europe, but across the world. For Europe, one of the most important dimensions of these shortages is the energy crisis. Not only has the price of natural gas, coal and oil increased, but electricity prices are rising very fast. I don't see how this could improve in the next few months.** I think we will only see a relief after the peaking of demand for energy, so only after the winter, around Q2 2022; and a lot will depend on the weather. But **until we see a tempering in the demand for energy, the recovery in Europe will likely remain challenged.**

"Not only has the price of natural gas, coal and oil increased, but electricity prices are rising very fast."

Given these circumstances, I think the delays we are seeing in the funding of the EU fiscal programs are, ironically, positive: if the tightness in the supply chains means that production is not able to increase, then providing further stimulus would lead to even higher prices, rather than boosting income.

This context makes it particularly intriguing to observe the bias of the ECB because **the Governing Council is as dovish as they've ever been.** There is now a majority of dovish members on the ECB's board. The result has been an insistent indication by ECB members that the Bank view the current inflationary pressures as being transient. Indeed, I even find it suspicious how often they are repeating that same message; perhaps they are not genuinely convinced themselves! In any case, if we consider this unison dovish stance, I think if inflation does rise, there might start to be some dissident views coming from the Netherlands, Austria and Germany – the usual suspects. However, they will be a minority.

Another important consideration for Europe will be the **formation of the next German government.** The SPD have won slightly more seats than the CDU, but neither party can form a coalition without both the Greens and the Liberal party, which is the FDP. Given that the Greens will not want to form a coalition with the CDU, the FDP are going to be the kingmakers. Nobody knows exactly what will happen, and I am not a specialist in German politics, but this will be a critical development for the whole of Europe: the strategy of Europe regarding China and Russia remains a key issue; the prospective renegotiation of fiscal rules in Europe is another contentious issue. And **whether Germany will have sympathy for such changes will depend on who is going to be in charge of its Finance Ministry. Another critical political issue for Europe will be the agreement on objectives on the energy transition, even more so given the current energy crisis.** All these issues, which are very important not only for Europe, but also in terms of its relationship with the rest of the world, will depend a lot on the priorities of the new German government.

"The recovery in Europe has been very uneven."

These political developments in Europe are taking place against a complex global macro backdrop. We know that, in 2020, China was the 'shock absorber' for the world, given how quickly its economy reopened very quickly. The reduction in Chinese imports in 2020 was very limited compared to the trends we saw around the world. This year, these trends have sort of reversed, as Europe and the US are steaming ahead, and contributing more to the recovery in global trade than China. But there are many glaring discrepancies within Europe, because the region is very heterogeneous. As a result, **the recovery in Europe has been very uneven.** Belgium, Poland, the Netherlands and Sweden, for example, have seen significant recovery in manufacturing, while Spain, Germany and France have lagged. The explanation is, in my view, sectoral: Germany and France, for example, are highly specialized in the automotive and aerospace industries. These were the sectors hardest hit by the crisis.

"Many governments are now concerned that our energy system in Europe is inadequate."

The challenges to the recovery in manufacturing will likely remain. In specific, I think **the current energy crisis is something we'll have to live with for many months and possibly years.** Energy prices have gone through the roof. Perhaps one somewhat overlooked element in this crisis is that many countries, mostly Germany, but also France and Belgium, have shut down their nuclear power plants. This has removed fifteen gigawatts of electric power, which is quite a lot. Also, there has been some substitution towards solar and wind, and this has also left supply vulnerable to weather, including overcast skies and low levels of wind. **This resulting vicious circle puts Russia and to some extent the Gulf producers, in the driving seat. They are benefitting from their oligopolistic position, and do not really have an interest in boosting production. This is really what I would call a self-inflicted energy crisis in Europe: supply is simply not going to increase in the next two to three years. The consequence is that it will be demand that will determine the market. Thus, only when aggregate demand for energy starts to ebb, which will be in the spring, there might be a better market equilibrium for the economy in terms of energy.** Moreover, this energy crisis might well repeat itself next year. Of course, **many governments are now concerned that our energy system in Europe is inadequate**, and leaders must make some decisions, such as big investments in nuclear energy, for example. And we are not going to have battery storage at the scale that would be needed to use wind or solar as a reliable source of energy any time soon. Such large investment decisions and this type of technological progress will all take time. This means that this problem is going to stay with us for the foreseeable future.

For many reasons, including the energy market, I think inflation is going to continue to accelerate in Europe. By the way, we got an interesting statistic for the Euro area: the **owner-occupied housing rent. This measure is not included in the Euro area's HICP; but if it were, it would have added forty basis points to core inflation in the EMU.**

“Wages are more likely to accelerate than profits.”

These underlying pressures on core measures of prices means that we’re going to continue to have higher inflation. Thus, while all this rhetoric from the ECB, that this inflationary process is transient, will likely continue, it is becoming less and less convincing. The second issue is related to the bottlenecks linked to shortages, especially in terms of transportation; these pressures are transitory. All these container ships waiting in Rotterdam, San Diego and Shanghai will eventually be sorted. So, the impact of these frictions will be temporary. But at the same time, **wages are accelerating almost everywhere, in Europe, and there is a slow passthrough into the economy.** Given this backdrop, and the situation with commodities, I think **inflation will linger longer than the ECB would like.** This is a negative sum game for companies. **Wages are more likely to accelerate than profits.** This outcome can also be seen as a sort of ‘compensation’ after the Covid crisis. In recent history, the post-war period saw a political balance that was tilted in favour of ‘Labour’, as opposed to ‘Capital’. **So, if we had a war against Covid, I think ‘Labour’ will now have its increased share of income.** The result is that **I’m not very optimistic on companies’ margins.**

At the same time, **my view is that global trade tensions are more likely to increase than to subside**, over the medium to long term. The backdrop of slower global growth and supply shortages is not really one that encourages cooperation. That is also not a good sign for inflation. It is clear that the leadership in China is extremely cautious about the risk of bubbles in the financial market and property sector. But from a risk management perspective, if the debt bubble in China is pricked, one way or another, that could become a global deflationary force.

Apart from those risks, I think it is notable that, **while the tensions build up between China and the US (and the newly denominated ‘AUKUS’), Europe has remained on the sidelines.**

"The political challenge for Europe will be how to side with the US, without jeopardizing its business relations with China."

It makes sense that Australia will strive to have strong military alliances, but for Europe, AUKUS does not really matter, despite all the exaggerated reactions to the announcement, especially by the French leadership. Crucially, **the political challenge for Europe will be how to side with the US, without jeopardizing its business relations with China.** European companies want to continue to do business with China, but they want to have some safeguards when doing so. For Germany, it's obvious that It doesn't make any sense to think that we could fully decouple from China. So, this is not going to be easy. And it is evident how important the new German leadership will be in setting the direction, as we move forward.

Looking at the asset allocation, I remain negative on cash. **On government bonds, I'm definitely negative,** because I think that this transitory inflation story will not continue to convince the markets. On spread markets, I would like to highlight the **Euro periphery, on which I am very positive.** Italy, for example, is doing the right things; with an exceptional leadership and abundant funds to spend, the reforms are going to be done, in my view, and in a way that is more efficient than it was in the past. The dovishness of the ECB is also a key factor supporting this view. All of this is very positive for the Euro periphery, but much less positive for emerging markets in terms of risks.

On global equities, I'm turning towards neutral. This is the consequence of what has been said about profit shares. And finally, in terms of currencies, **I remain bullish on the US Dollar.** The ECB is incredibly dovish, and the FED will clearly have to react earlier. I think this backdrop is positive for the dollar. ■

Jiming Ha

- **China's economy continues to slow, driven by weak domestic demand;**
- **The disruption of global supply chains might prove inflationary, but this will likely be temporary: ultimately the outlook for inflation will depend on the world overcoming the pandemic;**
- **Beijing might adjust its policies to support growth in the run up to next year's all-important 20th National Party Congress;**
- **Despite Evergrande, China's property sector is not as bad as many feared, and will overcome the current challenges;**
- **The regulatory clampdown is not widespread: while some sectors will be restricted, others will be supported, and will likely attract investment and generate growth;**
- **China will aim to contain but not to prick asset price bubbles: this is the key lesson Chinese officials have taken away from the Japanese experience of the 1980-90s;**
- **China will address its imbalances by nurturing its economy, boosting the denominator to mitigate the debt problem over the long run;**
- **There has been a marginal improvement in the US-China relationship;**
- **On Taiwan, it is a clear, but not present danger that China will invade Taiwan; but two key hurdles remain: technology and energy.**

"Whether inflation will persist or not will depend on the outcome of the pandemic."

The world has enjoyed low inflation for decades because of globalisation and the free flow of trade. But the pandemic has changed that backdrop. The lockdowns around the world disrupted global supply chains, adding further impediments to the trade flows that had already been disrupted by US trade tariffs under Trump. To me, **these developments are inflationary. But whether inflation will persist or not will depend on the outcome of the pandemic.** In China, though headline CPI is still very low, producer prices have continued to rise. In part, I think this reflects China's less expansionary monetary and fiscal policies during the pandemic, especially compared to the policies in the West.

“This growth slowdown in China, coupled with high producer prices, is not great for company profits.”

At the same time, **China’s economy continues to slow. While the export sector has remained buoyant, domestic demand, in contrast, has been weak.** Industrial production has decelerated sharply, and retail sales have slowed to just 2.5% in August. This is important, because China used to enjoy very high rates of growth in retail sales. The September PMI has underscored this slowdown, with the first reading since the start of the pandemic which was below the 50 mark, at 49.6. Even new export orders plunged. **This growth slowdown in China, coupled with high producer prices, is not great for company profits.** Energy and material costs have risen significantly. In my view, **this backdrop could trigger some form of policy response in China. In specific, I think the government might adjust its policies to support growth, in the run up to next year’s 20th National Party Congress.** The National Party Congress is a very important event for the government and for the Chinese leadership.

Over recent weeks, the situation with Evergrande has captured global financial headlines. **Evergrande is one of the biggest, if not the biggest developer in China. And it is heavily indebted, with many complex financial issues. But despite the angst in the market regarding the situation with Evergrande, I do not think the Government would allow property sector in China as a whole to be overwhelmed by this single company.** There are many political factors that I will not elaborate on, but I will list a few considerations that I think are key. First, Chinese households are heavily reliant on the property sector. Housing accounted for 60% of total household wealth, which is much higher than most other large countries. If the property market tumbles, it would have a devastating impact on the Chinese economy. Second, consumer loans have increased significantly over the past two decades, particularly due to mortgages, which now stand at over 60% of GDP. If housing prices collapse, households would have to carry a negative equity position. Third, the property sector contributes significantly to China’s GDP growth. If we include both downstream and upstream sectors, the real estate sector accounts for over 20% of GDP.

This means that government revenues also rely heavily on a healthy property market. For example, about 40% of local government revenues depend on land sales; and we know that local government revenue is not in the best shape, and that revenue is badly needed to support the economy across China's various regions.

"The housing sector is healthy, and I don't think Evergrande will be a big issue."

Thus, when it comes to the Chinese government's intentions, I do not think Beijing will willingly prick the property market bubble. But **could the property sector collapse, despite Beijing's implicit support? I doubt it.** If you look at the largest 80 developers in China, most of them have complied with the so-called 'three red lines' that Beijing established in early 2020. The first line was the cash-to-short-term-debt ratio, which would have to be above one: most developers have met that requirement with a comfortable margin. The second line, that debt-to-equity should be below 100%, was also mostly met. And the third line, the leverage ratio, would need to be below 70%, and many companies improved this ratio over the past year, even if they are still slightly above that threshold. So, in general, **the housing sector is healthy, and I don't think Evergrande will be a big issue, as we look ahead.**

Apart from the management of the property sector slowdown, another key concern for China today is the power crunch, amidst rising energy prices, and particularly coal, which accounts for 70% of power generation in the country. There are a number of factors behind this, but the most important one is the reduction in imports, especially from Australia, due to geopolitics. Coal imports from Australia, which accounted for around 40% of coal imports in 2020, fell to nil in 2021. However, despite the increased costs, electricity tariffs have remained flat, due to regulation. This implies that, the more power generators produce, the bigger their losses will be. Of course, something is going to have to change. There are already signs that the government wants to increase coal imports from other countries.

In fact, there have even been countries that took advantage of this spat between Australia and China and imported coal from Australia and re-exported to China; but this means China paid higher prices. **So eventually, I think power tariffs will likely be adjusted upwards, to reduce these pressures.**

"Whether China is 'investible' depends on what sector one looks at."

Another recent issue that has dented investors' confidence is Beijing's tighter control and management of certain sectors. People have even started to ask whether it is worthwhile investing in China. My thinking is that these campaigns are very selective. So, **whether China is 'investible' depends on what sector one looks at.** Beijing's ambition is to reorient China's economic development and to adjust the balance between the various sectors. Some sectors, such as real estate, education, tutoring, entertainment, internet gaming, digital finance, are indeed going to be controlled or restricted, because the government doesn't want to see a so-called disorderly expansion of private capital. But at the same time, there are other sectors that are key for China to attain self-sufficiency, for China to become economically independent and self-reliant. These sectors are going to be nurtured and encouraged by the Chinese government. These sectors are the industries that produce computer chips, semiconductor engines, new materials, object digital machinery, electric vehicles, etc. Thus, **the regulatory clampdown in China is definitely not widespread. Some sectors might be restricted, but others will be supported and will likely generate growth.** This means that there are indeed many opportunities in China, from an investment perspective.

But there is one more important aspect, which is **Beijing's income and redistribution policies.** We know that, over the past four decades, the main feature of China's rise in the global economy has been its huge size and very high levels of economic growth. So, how will these new re-distribution policies impact China and the world? In my view, these new policies, focused on 'equitable' or 'inclusive' growth, have some similarities to the pre-1978 policies in China.

“It’s useful to split China’s economic rise into three main periods.”

I think **it’s useful to split China’s economic rise into three main periods**: ‘Communism’, before 1978; ‘Capitalism with Chinese characteristics’, between 1978 and 2012; and, since 2012, I would suggest an appropriate description might be ‘Socialism with Chinese characteristics’. The ideological basis of the first period can be described as ‘Marxism-Leninism’: there were no clear long-term goals, and the legal system was simply ‘rule by gun’. As far as foreign policy was concerned, China was isolated from the West, and by the West. There were no capital markets, and property rights were inexistent. But from 1978, everything started to change, both in terms of the Chinese economy and its political system. Deng Xiaoping is very pragmatic. In a famous quote, he put it quite succinctly: **‘Black cat or white cat, as long as it can catch a mouse, it’s a good cat’.** So, in the economy, controls were loosened. And the political system, rather than a being a pure ‘dictatorship’, became more of a ‘collective leadership’. But at the same time, the development of the economy and of particular industries was heavily influenced by the so-called **Guanxi**, or personal relationships. There is a fascinating new book that describes the relationship between power in money in China in the past two decades or so, Red Roulette, which I highly recommend. In that same period, China’s relationship with the West also improved, and the political system became more tolerant. The period was marked by fast economic growth and market development. But asset prices inflated, and this deepened wealth inequality within the population. If we fast forward to the regime **under Xi Jinping, I would suggest the ideology is not really Marxist-Leninist; in my view, and it is purely more like nationalism.** The control of the economy is techno-authoritarian. If you go to China, you will see there are so many surveillance cameras, and that you are being monitored all the time. You can even say it is ‘rule by law’, because China introduces laws when the government wants to achieve a certain political objective. Some people say it is actually ‘rule by disinformation’, or ‘rule by censorship’, or ‘rule by fear’.

But in any case, **if we look at China now, under Xi Jinping, the fact is that controls are being tightened, and capital markets are more managed.** It's not like in Deng Xiaoping's time, but it's also not like in Mao's time, right? **The development of capital markets will depend on what the government's objective is.** In my view, Beijing does not have the appetite to inflate or prick asset price bubbles; I think **China will address its imbalances by trying to develop its economy, to make the denominator larger, so that the debt problem will be mitigated in the long run.**

"There has been a marginal improvement in the US-China relationship, or at least signs of improvement."

Meanwhile, geopolitically, **China's relations with the US have become more challenging over that period.** And absent a big leadership change in China, which is highly unlikely, we will not go back to the relations that we had during Deng Xiaoping's time. However, in the very short term, I believe **there has been a marginal improvement in the US-China relationship, or at least signs of improvement.** First, the intelligence report on the origin of the COVID 19, which was highly anticipated for August, turned out to be uneventful and inconclusive. This was one signal, but it was followed by many others. For example, in August, the former Goldman Sachs president, John Thornton, who is a good friend to China, spent six weeks in the country, including in Xinjiang. This may signal some improvement in the relations between the US and China, not only in finance, but potentially also between the two governments. Then, in September, the Huawei CFO was released, and in that exchange, the two Canadians were also released; this seemed to provide a sort of nod to China's hostage diplomacy. I think for China, it was seen as an important signal, that if you are tough and persistent, foreigners will give up. In my view, this release was sort of a gift to China. Then finally, the US Commerce Secretary and US Trade Representative made a somewhat dovish remark on US-China relations, particularly regarding trade. Given these developments, it wouldn't be surprising if we see **China increase its imports of agricultural and energy products from the US, and the US reduce some of the tariffs they had put on China's consumer goods.** Such progress, and a resumption of high-level trade talks, would be beneficial to both countries in the short run.

Now, **regarding Taiwan, it is a clear, but not present danger that China will invade Taiwan.** When Xi Jinping took power 10 years ago, in 2012, he laid out the 'China Dream'. I think one important element of that dream is the reunification of Taiwan. Xi Jinping wants to leave an important legacy in Chinese history. But I think there are some preparations that China needs to complete, before it could pursue such a reunification. The first **major challenge is technology.** China cannot produce its own computer chips. I cannot imagine China would be able to win a war when it is heavily reliant on imports of semiconductors. So, technology is an important hurdle for China to invade Taiwan and for China to conclude that it could win such a war. **The second major challenge is energy.** Even in the absence of a war, the Chinese government is already having a difficult time managing energy supply and prices. I cannot imagine what would happen if a war is waged and energy supply plunges because of trade embargos. This would really strangle China's military and the country.

"There are clear signs that the Chinese economy is slowing."

To sum up, **there are clear signs that the Chinese economy is slowing.** But considering that we are in a critical period running up to the National Party Congress in 2022, it is possible that **this slowdown might trigger a policy change**, even if it is only a fine-tuning of policies. At the same time, **China has been trying to reduce income inequality**; however, there is a risk that Beijing's efforts and its ever-changing policies could undermine confidence and lead the private sector to perceive that the efficiency and buoyancy of the Chinese economy could be at stake. Indeed, these risks can continue to build, and can eventually raise doubts about innovation and entrepreneurship in China; but these are concerns for a longer-term horizon. In the near term, **I don't think China will either prick or contribute to inflate asset bubbles.**

This is the key lesson Chinese officials have taken away from the Japanese experience. There are two elements to it; first, asset price inflation in Japan was very high in the 80s; second, and more importantly, the Japanese central bank pricked the asset bubble in the early 90's, and over the ensuing decades, the Japanese economy and its financial markets had a very poor performance. In addition to these considerations, I think it is very important to note that there are **signs of improving short term relations between the US and China; this would be beneficial to both sides.**

"I think the current backdrop calls for more conservative portfolios and for a greater allocation to cash."

And to conclude, my thinking on **asset allocation is that valuations are currently high, and there are many uncertainties regarding the US fiscal policies. I think the current backdrop calls for more conservative portfolios and for a greater allocation to cash, and particularly for more cautious exposure to equities.** Monetary policy in the US is likely to be tightened. As for the US and EM currencies, I think **US dollar will likely appreciate further**, alongside the less accommodative US policy. ■

What are your further thoughts on inflation?

Panel discussion

Dino Kos: When we talk about inflation and the trade-off between labour versus capital, these factors work on different time horizons.

The labour versus capital split is a very broad and slow-moving concept that takes decades to play out. It is not something that will impact equities on any given day or any given week; it is more something that one can see in hindsight.

Inflation, however – and in particular the spike in inflation that we see now – is more of a medium-term factor, more of a cyclical element. And while this current spike will likely stabilise and start to recede over the over the coming quarters, it **will create a lot of noise because it will force the central banks to speak about their plans.** Central banks will have to shy away from some of their more aggressive plans and there is probably an element of central bankers trying to convince themselves that inflation is transitory - the principle being that if you say it to yourself enough times, it must be true. What this means is that if inflation does continue, and the prints continue in the same vein in the months ahead, there may be a very sudden shift. If I were in risky assets aggressively, that would make me very concerned because there could be a lot of short-term volatility as a result. ■

Did the Eurozone take the 'green transition' too far, perhaps resulting in the self-inflicted energy crisis? Will the same situation play out in the US? And are green transitions simply too costly?

Dino Kos: On the green transition in the US, my view is that the country is on the right track, and that that will continue.

Announcements of very aggressive electric vehicle development programmes by US car manufacturers have been impressive, particularly as the three traditional US car companies - GM, Ford and Chrysler - have historically resisted any such innovations. Their pivot has likely been triggered by the incredible success of Tesla, which is now worth more than the rest of the US automakers combined.

Thus, we see this **'green transition' beginning in the US auto industry, and clearly driven by commercial considerations, rather than by government mandate.**

There is also a lot of momentum towards a 'green transition' in different US States with respect to power and the source of power generation. Again, market forces are a key driver. For example, as the price of coal has risen, compared to natural gas, we see transitions at play.

It is true that such transitions may be costly to implement in the short run, but I do not see that this green trend is going to change.

Eric Chaney: Regarding this European 'self-inflicted crisis', it is not a question of being 'too green'; rather, the problem is the way in which these green transitions have been implemented. **The issue lies particularly with Germany, and the decision to close the country's nuclear power plants; this sowed the seeds of the current crisis across Europe.**

But the transition is afoot and will continue. There will be a much higher need for electricity, and this demand will be a core issue. To illustrate this, Dino's point about the US auto industry is also true for Europe: all the car makers are moving toward electric vehicles. But of course, if you have electric vehicles, you need to have power – and not enough is being done to ensure there is sufficient supply. ■

Will the current political impasse in the US over Biden's two key bills impact the Fed's near-term decisions? For example, might the Fed postpone its decision on tapering due to the current uncertainty within the Democratic Party?

Dino Kos: There is an argument in the US Congress currently over the order that the Biden Administration's different bills are going to be passed (the USD1 trillion and USD3.5 trillion packages), with threats and counterthreats from both sides about the debt ceiling and default. I would ignore most of this - it is par for the course in US politics, mostly political brinksmanship that will ultimately be resolved. There may be a day or so where the government is 'closed'; this merely means that national parks shut, as well as some government offices. The headlines are scarier than the reality.

I am doubtful that this situation will have an impact on the Fed. The Fed is on track to start buying less in terms of assets - that is the taper. **There is no suggestion that the Fed will be raising interest rates any time soon; it just is not on the cards for the next 12 months. Right now, the point is not about shrinking the balance sheet, just about buying fewer assets. But from the market's perspective, that is the second derivative rolling over, and so that could have an impact, even if the Fed is still buying assets. ■**

When will the US' two fiscal plans start impacting the economy?

Dino Kos: The first step is to get these bills passed, and the situation is moving in that direction. Regarding the infrastructure plan, there does seem to be agreement that that will be a little over USD 1 trillion. The other plan, which had been as high as USD5 trillion, is being negotiated down as we speak, due to Republican opposition, and there is also resistance from some moderate Democrats.

Once these bills are passed, some of the spending begins immediately because some aspects – such as tax provisions – are retroactive. The infrastructure provisions will of course take longer to have an impact, because we are talking about things such as roads, bridges, and broadband. So, this **impact will likely be felt starting in 2022, and then continue for the next several years.**

What needs to be remembered is that this level of spending, which is higher than the current baseline, is going to increase and then stay steady over time. There is not going to be another big spending plan in the three years that follow; this is it. ■

What if US growth begins to slow; will the Fed be able to tighten?

Dino Kos: The answer is, probably not. I can see that the Fed is going to taper, and I can see that it might even at some point start to shrink its balance sheet. **But it is hard for me to see how the Fed pulls itself out of the zero interest rate conundrum any time soon.** If there is any hint that the economy is in a slowdown or that there is volatility in markets, then the Fed probably gets really gun shy about moving on its interest rate tool. ■

In Europe, wages are not yet rising. Is this significant, when thinking about whether or not the ECB will keep its current forecasts on interest rates?

Eric Chaney: This is one of the critical points. There is no such thing as a Euro area labour market. In some countries, such as Germany, wages were accelerating before the Covid crisis, and they are re-accelerating now. This is also likely to be the case for France eventually, where the unemployment rate is falling very fast.

But we have learnt that the Phillips curve, while still there, has become very flat due to a change in the composition of jobs – where there is a higher share of what economists call ‘fluid’ jobs, and less ‘routine’ jobs.

As I mentioned previously, there is a slowdown, but it will not last; my view is that this was a shock, and that there will be a sharp acceleration of growth next year, once energy prices start to decline, which should be favourable to wage growth. **I see significant wage increases ahead in 2022. In the meantime, purchasing power of consumers will be dented.** ■

What are your thoughts on a EURUSD target?

Eric Chaney: I am bullish USD, and so my target would be 1.10.

Jiming Ha: I do not have a specific target, but my view is that **the dollar will appreciate against the euro** on the US' relatively strong economic growth and earlier monetary withdrawal.

Dino Kos: There will be a **small appreciation of the dollar against the euro.** ■

Eurizon Advisory Board

Dino Kos

Dino Kos, *former Head of Markets, Federal Reserve Bank of New York.*
He is Executive Vice President at CLS Bank International, New York. In 2011 he was a co-founder of Hamiltonian Associates Ltd. New York, a specialised macro advisory research firm. He worked in Hamiltonian Associates between 2011 and 2013, giving advise to hedge funds, mutual funds and other buy-side investors on global economic, currency, and fixed income markets.
Previously, Dino Kos was Managing Director at Portales Partners LLC New York (2008 – 2011) and Managing Director & Global Head of Central Banks and Sovereign Wealth Funds at Morgan Stanley Investment Management Hong Kong (2007 – 2008).
Between 1985 and 2007, Dino Kos worked for the Federal Reserve Bank of New York, where he became Executive Vice President for Markets Group in 2001.
He started his professional career in 1982 as Claims Representative at Home Insurance Company San Francisco and Los Angeles. ■

Eric Chaney

Eric Chaney *is advisor on macroeconomic and geopolitical issues at the French Institut Montaigne and via his own company, EChO. He was global Chief Economist for the AXA Group since 2008 to 2016. Between 2000 and 2008, he was Chief Economist for Europe at Morgan Stanley, which he had joined in 1995. Previously, he headed the forecasting unit of the French statistical office (INSEE) and he was responsible for global economic forecasts and analysis at the French Treasury. He is member of Scientific Council of the Autorité des marchés financiers (AMF). Since 2014, he is Vice-Chairman of the Board of IHES (Institut des Hautes Etudes Scientifiques).* ■

Jiming Ha

Jiming Ha *is a visiting professor at Darden Business School of University of Virginia and an independent director of the board of Lufax China. He was a senior fellow of China Finance 40 Forum in 2018. He was vice chairman and chief investment strategist of the Investment Strategy Group for Private Wealth Management (PWM) within the Investment Management Division of Goldman Sachs (Asia) from 2010 to 2017, focusing on macro-economic research in China. He joined Goldman Sachs in Investment Banking Services as a managing director in 2010. Prior to joining the firm, Jiming Ha was chief economist at China International Capital Corporation from 2004 to 2010. Before that, he was a senior economist at the International Monetary Fund (IMF) from 1993 to 2004. Jiming Ha worked at the Hong Kong Monetary Authority within the IMF from 2001 to 2003 and served as the IMF resident representative to Indonesia from 1999 to 2001. He earned a PhD in Economics from the University of Kansas and an MS and BS from Fudan University in Shanghai.* ■

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