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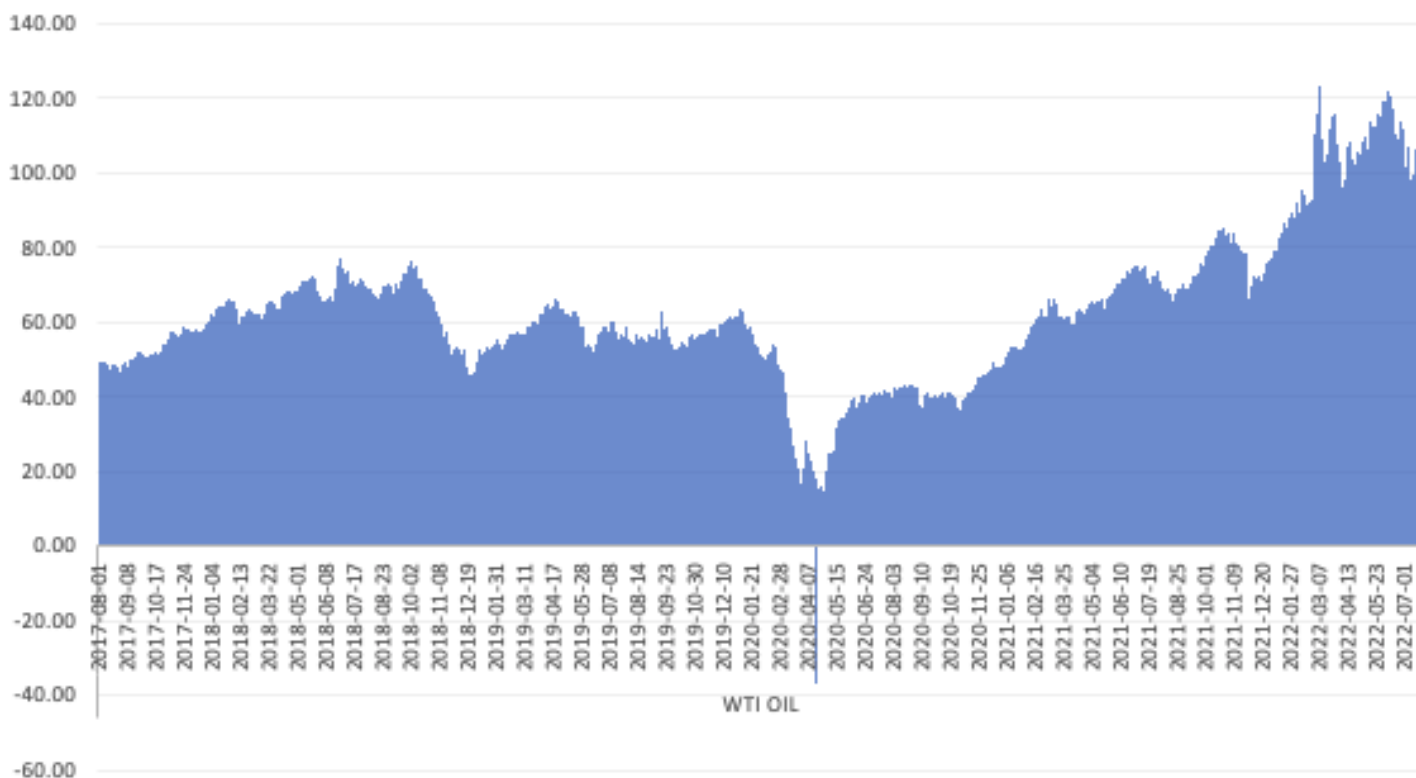
August 3, 2022 Keith Grindlay

Global Instability – August

In July, the IMF released a report entitled ‘Gloom and more uncertainty’, having lowered their baseline forecast for growth to slow from 6.1% last year to 3.2%; since February, we have forecast 3%, but with warnings. However, there is a scenario, which central banks and the IMF may be missing, in which we may need to raise our growth forecast. Nothing will have an impact on inflation faster than the cost of oil, and since oil accounts for 50% of food inflation, food prices should improve, but agricultural problems are likely to get worse over the second half of the year, while geopolitical tensions between China and the US may bring global manufacturing to a complete full stop.

Following the June OPEC meeting we said that oil prices could end the year where they started, and since that forecast WTI oil has fallen from \$120 to \$90, just over \$10 higher than the price on January 2. This fall couldn't have happened at a better time for retailers, where over 50% in the US fear closure during the second half of the year, but the price reduction has to be passed on.

As at their June meeting, OPEC raised their production target by a smaller size than had been expected, however with Libya increasing its output to 1.2mio bpd recently and demand forecasts being lowered, markets reacted by moving another leg lower. Some are suggesting OPEC+ is at maximum capacity, but we suspect commentators are underestimating the deals that have been done, particularly since the beginning of the Ukraine war.



The reaction to such a drop in oil prices can be expected to start to be reflected in more stable economic data, more specifically survey data, as an improving cost of living will create more optimism that inflation has peaked, but only if the drop in prices is being passed on.

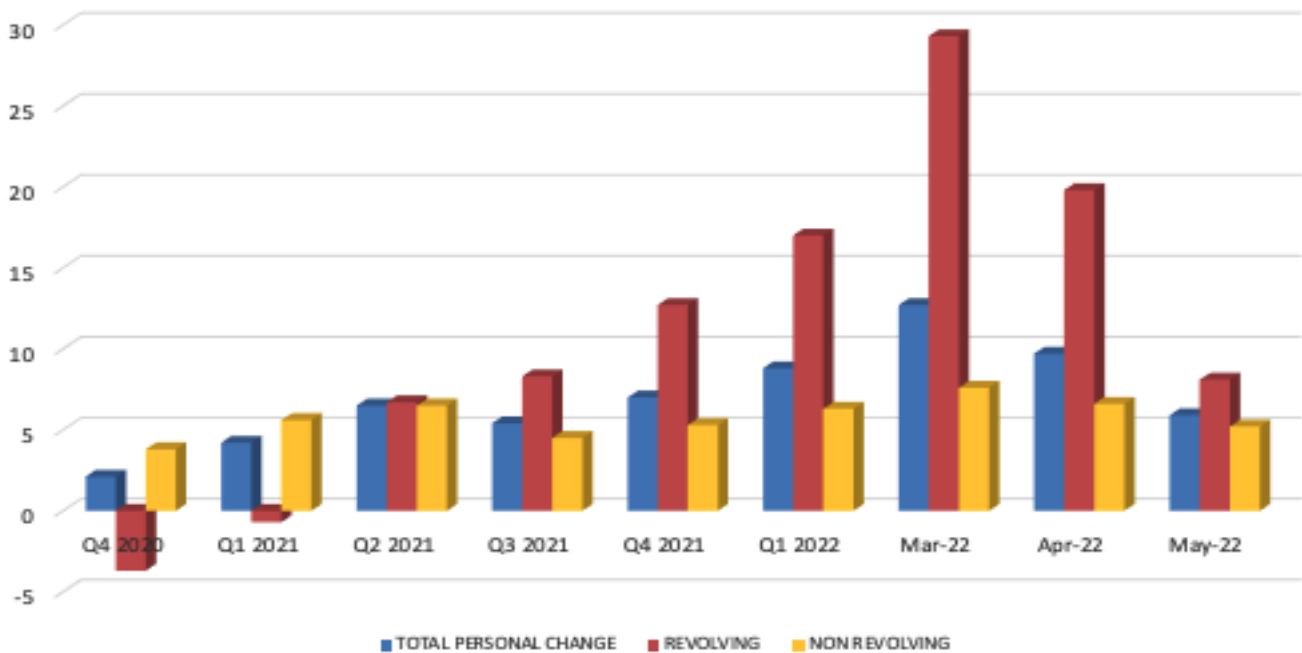
If the impact of the rise in oil prices on growth was the equivalent to a 1% rise in interest rates, then the drop by \$30 in less than two months will have an even greater impact on consumer and producer confidence, and with the Dollar

easing, there should be an almost immediate impact on prices and expectations. At some point, this will be realised by the Fed, however, members have come out in force in talking down market moves, and there is no recognition of markets pricing the possibility of a recession, and markets are rarely wrong.

All the oil companies have had windfall profits during the first half of the year, and few have put their prices down to the same extent or at the same speed that they went up. In the US, the average price for Gasoline and Diesel has fallen to \$4.20, but is still more than \$1 higher than a year ago, despite the strength of the Dollar.

Natural Gas prices on the other hand have been rising since the beginning of July and as Russia halted exports to Latvia over the weekend prices again rose, following cuts to Poland, Finland, Bulgaria, the Netherlands, and Denmark, whilst there has been a severe reduction in flows to Germany. Germany's Rheinenergie will double gas prices from October, despite energy use being reduced by 3.5% in H1.

US CONSUMER CREDIT



Over the next few months, the rise in food prices will become more of a political issue globally, not least for Biden, with US mid-term elections in November, while Italian elections are in September, as is the result of the UK Conservative Party leadership vote.

As the Fed outpaced with rate increases, the Dollar appreciated, globally, and the drop in oil prices was offset by weaker currencies. The more dovish reaction in markets to July's FOMC meeting has helped currencies to appreciate; in the UK, GBP bounced off a key level at 1.19, and has recovered to 1.22, though European politics continue to put pressure on the Euro.

US Household debt has risen above \$16tn, having increased by 2%, \$312bn, during Q2. Credit Card debt (relied on by families to help manage the rising cost of living) has risen by 13% yoy, and even though Mortgage Applications are falling, Mortgage balances rose 1.9% in Q2, \$207bn, and the total is getting closer to \$11.5tn as the Fed tightens financial conditions.

CPI may fall, but inflation is still a problem

It is estimated that around 10 million Ukrainians have been displaced since the conflict with Russia began at the end of February (Ukraine's President Zelensky has ordered all Ukraine civilians living in the Eastern Donetsk region to evacuate). Over that time, no Ukrainian exports have been able to leave the country, until the first grain shipment left Odesa this week, which has now arrived on the Turkish coast, carrying 26,527 tonnes of corn to Lebanon. Ukraine says 10 grain ships are ready to depart.

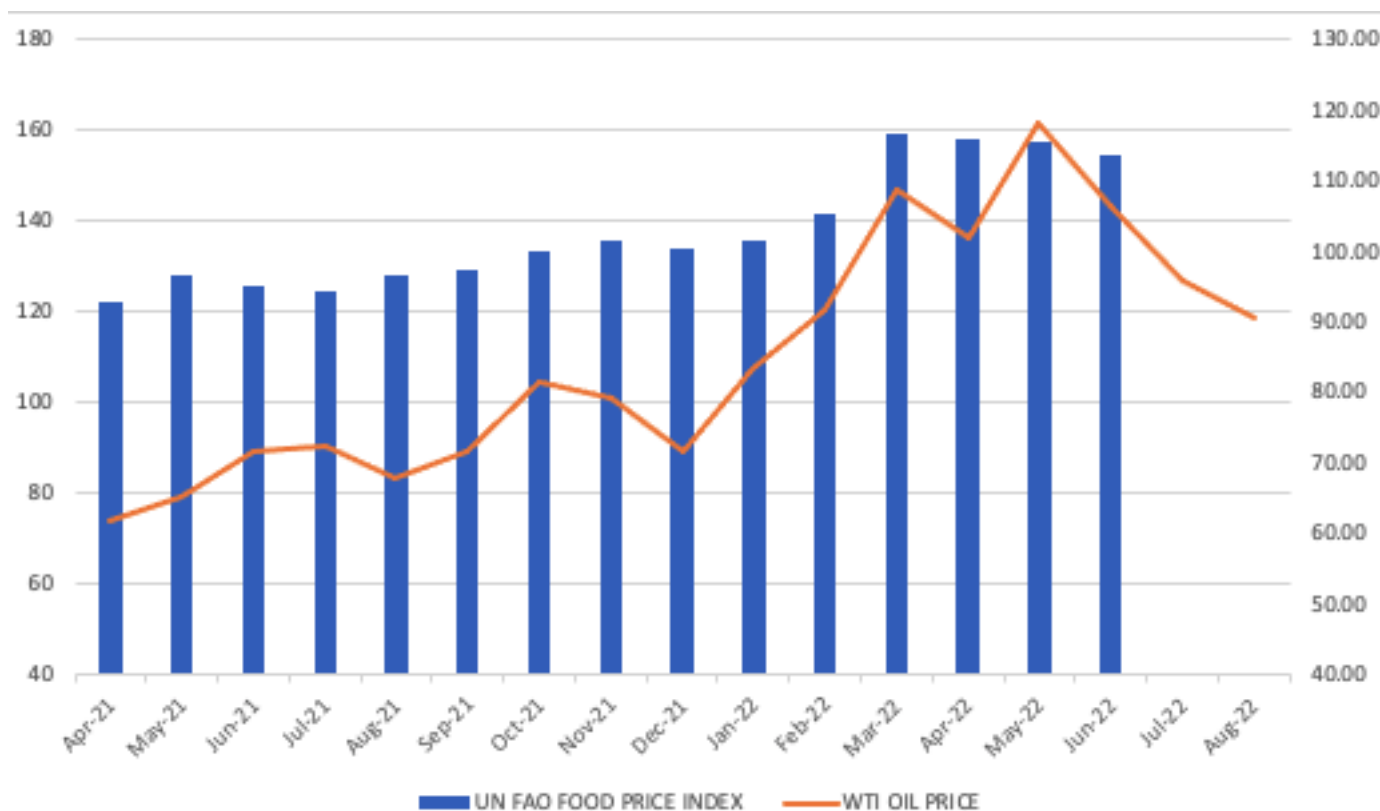
While this is clearly a breakthrough, it should be considered that Russia is on a PR drive to gain support in the Middle East and Africa, and one shipment is very small, when millions of tonnes are needed. Russia and Belarus are major fertiliser exporters, accounting for 38% of potassic fertilisers, 17% of compound fertilisers, and 15% of nitrogenous fertilisers.

At the end of July, the World Bank released their report giving an update on global food security. Their agricultural price index is 19% higher than in January 2021; we would suggest prices are higher in the real world and can be expected to continue to increase.

The World Bank has given loan support to countries hardest hit by rising food prices, such as Tunisia, Ghana, Chad and Sierra Leone. Egypt is part of the Emergency Food Security support project and \$2.3bn has been approved for the Food Systems Resilience programme for Eastern and Southern Africa. Numerous other projects are being introduced, as the poorer nations struggle to feed populations.

But, as of mid-July, 18 countries have implemented 27 food export bans, and seven have implemented 11 export-limiting measures.

In May, India, the world's second largest wheat producer, restricted wheat exports and since then the trade deficit has increased by \$10bn to above \$31bn, in part because of oil imports and also because of the weakening of the currency. Foreign Currency Reserves have fallen to \$571.5bn, compared with \$630bn in Q2, and over \$600bn in June. As economic pressures mount, the Modi government now plans to scrap the LPG subsidy under PAHAL, which was first launched under the UPA government in 2013. India imports 83% of its oil use.



In our March 17 report, Risks for the Baltic States, we highlighted the importance of Ukraine's industries, as well as agriculture, and warned that Russia's intentions may well extend further than just Ukraine, because of an economic need, and asked is 'Putin's target to stretch Russia's influence the length of its Western border, from the Black Sea to the Baltic Sea?'

As we highlighted in our March report, Baltic countries had started to build relations with the EU, and move away from Russian influence, and this helped to antagonise Putin. Ukraine's exports to the EU amounted to Eur24.1bn in 2021, a considerable increase of more than 47% compared to the previous year.

The EU is Ukraine's largest trading partner, accounting for 39.5% of its trade in 2021. Ukraine is the EU's 15th biggest trading partner, accounting for around 1.2% of the EU's total trade, however the significance for industries as a producer, for example car parts for German automakers, means that its significance goes beyond just trade numbers. Ukraine's main exports to the EU are iron and steel, 20.8% of total exports, and ores, slag and ash, 12.5%, while animal and vegetable fats and oils are smaller, being 8.5%, electrical machinery 7.8% and cereals 7.3%.

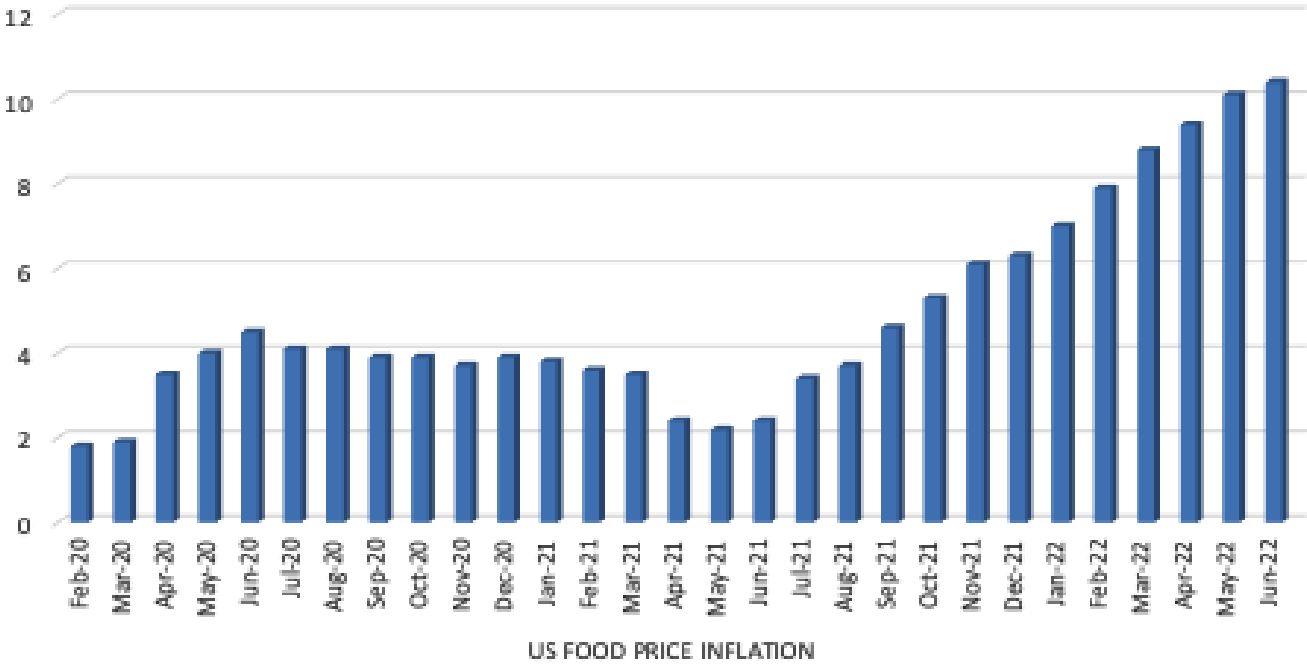
Wheat prices on the wholesale market have been coming down since mid-May, along with corn, and this has been reflected in the UN FAO Food Price Index, where the Cereal Price Index average fell 7.2bp month-on-month in June (4.1%) to 166.3bp, after reaching a near-record level in May.

The index for Vegetable Oil averaged 211.8 points in June, down 17.4 points (7.6%) month-on-month, driven by lower prices for palm, sunflower, soy and rapeseed oils. Palm oil prices have declined for the third consecutive month, due to the rising output of major producing countries coinciding with prospects of increasing export supplies from Indonesia and as large domestic inventories have built up from the freezing of exports. Rising prices have also dampened demand for sunflower and soyoil, however, the price of Soybean, where the US is the largest producer, has rebounded since mid-June, and expectations of hot and dry weather in parts of the US Midwest could hamper soybean plants in the pod development season.

Higher costs, particularly for fertiliser, have meant famers have lowered their planting and reduced livestock through the winter, while extreme weather conditions globally will raise doubts over a second crop in 2022.

India is the largest exporter of rice, accounting for 40% of global exports, and this year the total amount of rice planted by area has shrunk 13% due to lack of rainfall; over the past few weeks, prices have increased by over 10% and may exceed \$400 a ton by September, from current levels of around \$360. In 2021, India exported around 22mio tons, compared to the next largest exporters, Thailand and Vietnam, which export around 7mio, while China, Iran, Saudi Arabia, Indonesia and the Philippines are the larger importers.

Although Wholesale food price indexes have fallen, domestic retail prices remained high in June, largely because of transport costs, as gasoline prices for hauliers remained high over the first half of June. Food inflation in the US has been above 10% yoy in May and June (the food at home index increasing by 12.2%) and has increased for thirteen consecutive months. All six major grocery store food groups increased, with five of the six rising more than 10%.



In the US, over 40 million poultry bird flu cases were recorded in January and the numbers have escalated since then. In an effort to curb the outbreak, 94.2m farmed poultry have been killed and disposed of, compared to 54.4m last season. In March, the Centres for Disease Control and Prevention said Bird Flu ‘posed little risk to humans’, but cases were recorded in April and May.

There is also an increase in foot and mouth diseases. Indonesia aims to get their problem under control, but not until the end of the year, while there has been a report of a case in Norfolk, England (an outbreak in the UK in 2001 led to 6 million animals being put down). While this has an influence on farmers, there is a second derivate that impacts on agricultural machinery and even tourism, as restrictions on movement are introduced.

In Europe this year, there have also been cases recorded for swine fever, in countries such as Italy and Poland. The outbreak in China in 2018 led to 50% of its herds being put down; all the production outside of China could not cover the loss and, at the time, pork prices rose by over 100%, per month.

While it may be the summer and a long way from winter needs, weather conditions across the world have meant wildfires and floods, reducing crops and putting pressure on food prices, and the political fallout may just be beginning.

Already pressure is on European politicians and extremist groups are starting to add their influence. Draghi has been forced to resign and ahead of the September 25 early Italian election, current polls suggest an extreme right-wing coalition has the lead, comprised of the Brothers of Italy party, the League, and Berlusconi's Forza Italia, but two reported incidents involving contact between right-wing party chiefs and Russian diplomats have damaged support for Georgia Meloni, leader of the Brothers of Italy party.

Despite Italy's political uncertainty, BTP yields are now more than 1% lower than in mid-June, following the ECB's TPI announcement, although markets may still be overpricing rate increases in Europe. Italian Debt to GDP is over 150%, and although yields are lower, the ECB may be tested nearer the election.

In May, the European Parliament dropped a lawsuit against the European Commission to immediately enforce a new power allowing it to slash funds to countries such as Hungary, Poland or Bulgaria, because of rule of law infringements. This week, US President Trump, who has his own ambitions for a second term, met with Hungarian PM Orbán, the far-right nationalist and close ally of Russian President Vladimir Putin, and in January, Trump endorsed Orbán, in his race to win a fourth term in office.

While in the UK supermarkets are starting to take advantage of lower petrol prices and the small rise in the value of Sterling, this can only partially deflect from the rise in food prices. While energy price rises can be deleterious, bleeding household bank balances, there is a last ditch option to choose food or energy. Many will turn off heating and use the car less, especially during the warmer months, but basic food inflation has a direct, unavoidable hit.

As COVID lockdowns started to impact, we highlighted the rise in the necessity to use food banks, where long queues in the US needed traffic control and jams included expensive SUVs.

According to the UK's BRC Shop Price Index, July saw the highest rate of shop price inflation since the index began in 2005, led by food prices rising 7%, with headline products such as Lurpak butter being sold at £10.40 a kilo, and fish fingers now £7 for 30, while a pint of beer in London might cost £8.

We remember a meeting with the BRC during the disinflation period, and their leaning then was towards higher inflation, yet between 2013 and the end of 2021, the index had been negative for all but one year (2018), as discount supermarkets and home delivery company competition kept prices down.

Global Industrial Production could collapse, moving the global economy from recession, to depression, and mass unemployment

If you want to make a clear statement in the world of global diplomacy, few can be stronger than the third in line for the US Presidency travelling half way across the world to one of the most important, politically sensitive regions.

House Speaker Nancy Pelosi's visit to Taiwan had been preceded by Biden's call with Xi Jinping, where little progress seems to have been made between the two largest global economies. In an historic meeting with Taiwan's president, Tsai Ing-Wen, the US has pledged full support, directly in the face of China's aggressive stance on Taiwan, in the full knowledge of the developments in Hong Kong over recent years.

Economic sanctions and tariffs are not anything unusual, though will naturally slow growth; however, there are further consequences that need to be considered.

In our end of year review for 2020, we highlighted the risks of an escalation in frictions between Taiwan and China, and while Ukraine may be the 'bread-basket' of the world (as well as a significant industrial provider), Taiwan, which is the largest semiconductor maker, is the support of almost every industry globally. **The world has experienced semiconductor shortages at a time when Taiwanese semiconductor producers were working full out; if China invades, all production will stop, and global industrial production will stop.**

Taiwan and South Korea are world leaders in the semiconductor industry; Taiwan Semiconductor Manufacturing Co. (TSMC) is virtually unrivalled in its expertise, as it specialises in the smallest chips, the equivalent of two strands of human DNA, and semiconductors are now vital national security assets. TSMC produces over half the world's contracted semiconductor chips and is market leader in the technology, being the supplier of chips found in iPhones, Amazon cloud computers, graphics processors that power popular video games, and military drones and fighter jets, like Lockheed

Martin's F-35. The number of transistors on a chip doubles every two years, allowing producers to pack more processing power into less space. It's why the iPhone 12 is 50% faster than the iPhone 11 and will be at the centre of the development of 5G. In a move towards the US, perhaps in fear of China's aggression, TSMC has approved a plan to open a \$12bn operation in Arizona by 2024.

'While around the world focus is on COVID-19, at the end of last week, China took advantage and established two administrative districts on the South Sea Islands of Parcel and Spratly, effectively putting them under official Chinese control, in the knowledge that it would raise tensions with countries in that region, including Malaysia, Vietnam and the Philippines, as well as the US and Australia', Macro Thoughts, April 20, 2020.

When the Cloud is on the seabed - Macro Thoughts, May 15, 2020

Internet communication and the Cloud are generally associated with satellites, however 98% of global internet connection is transmitted through fibre optic cables on the seabed. In 2016, Google and Facebook announced the development of a new fibre optic undersea cable network that would be the first direct undersea cable to connect Hong Kong and the USA.

The two companies reported in February 2020 that they were seeking permission from America's Federal Communications Commission (FCC) to route data via undersea cables landing in Taiwan and the Philippines, after attempts to activate links to Hong Kong and China faced security hurdles.

Along the Luzon Strait in the South China Sea, between the Philippines and Taiwan, as well as the Paracel and Spratly Islands, are 19 fibre optic communication cables, forming a super highway that connects Asia with the West and Japan. In 2006, an earthquake hit the highway, cutting off communications with the US stock markets, disrupting international business and financial markets, wreaking havoc on neighbouring countries, including Japan, Singapore, Indonesia and Australia, and took 3 months to be restored to full operation.

If China is able to control this area, they will control the ability of the whole of Asia to communicate with the West, including financial markets and banking, making it as strategic as Djibouti is for trade from the Red Sea and East Africa.

Equity markets will react to the impact on semiconductor production; whilst TSMC is building plants in the US and Europe, these aren't due to come on line until 2024. Throughout 2021, the Yuan appreciated against a Dollar that was appreciating against all other currencies - the pattern for 40 big figure moves has been obvious since 2014.

As US yields have been falling over the past month or so, so the Dollar has weakened slightly; however, central banks' Forex Reserves have also continued to fall, even in China and India. Any invasion will be a boost to the Dollar, especially because of the correlation of the Chinese and German economies - Sterling might also benefit. Our end of June report, 'BRICS Built', discussed whether the Yuan could challenge the Dollar.

Domestically, Xi Jinping's policies have been decidedly unpopular, particularly with the middle classes following the closure of private tuition schools, especially as many students are from one-child families.

China is also experiencing the impact of foreign companies moving business away from China, even before the COVID lockdowns in Shanghai. Foreign Direct Investment into China increased 17.4% yoy to CNY 723.31bn (\$112.35bn) in the first half of the year, but this will have been impacted by rising producer and consumer prices. Global oversupply during the late part of H1 has built up inventories in China and globally, and as recession expectations increase, so trade with China will continue to decrease.

With the property market in crisis (at the end of 2020 we said China's property market was a greater risk to the global economy than subprime), the 90 million members of the Chinese Communist Party may have a few more Xi dissenters within the party, but with no successor in place and any opposition dealt with in 2017, Xi is expected to be power long after Biden.

It was clear as COVID lockdowns began in the west in 2020, that China's foreign policy has become more aggressive and perhaps even then Xi may have thought about moving on Taiwan. Interestingly, he also virtually ended any foreign travel for himself, so perhaps something did happen at that time to destabilise his position and confidence. However, the Russian invasion has become an education in how quickly things can unravel, as Russia would have discussed Putin's intentions, even to get China's blessing, before tanks crossed the border.

Since February, relations with 'enemies of the US' have grown, including with Iran and Venezuela, as 'your enemies have become my friends'.

The joint association of BRICS hasn't always been on friendly terms and, only two years ago, China and India were fighting their own battles in the Himalayas, but that doesn't deter from the importance and size of the economies of BRICS members and their influence on the global economy. **In the long term, could the Dollar's position be threatened?** *At their end of June meeting, there were commitments to form a Reserve Currency and although that might be easier said than done, working on setting up a joint payment network to cut reliance on the Western financial system would seem plausible. China is also joining with Indonesia, Malaysia, Hong Kong, Singapore and Chile, to build a Yuan currency reserve as an alternative to the Dollar, and each will contribute about \$2.2billion worth of Yuan.*

But if China does continue to pursue their intention in Taiwan, and tensions with the US get worse, or China invades, Japan, Australia and the UK will side with the Americans and other regions will be engulfed. This will include countries with Belt and Road projects, the Middle East, Russia and Europe, India and Pakistan and Africa.

Doubts will be raised over China's holding of US assets, there may be a run to the Dollar, and equity markets around the world could drop by as much as 25% overnight.

However, the Chinese themselves may have had enough; in May, COVID lockdowns provoked mass demonstrations – and the rubber stamping of Xi's position at the 20th NCCP in the autumn may raise more tensions internally.

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