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MAKING SENSE OF *THIS* WORLD — *11 October 2021*

R&R Weekly Column
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Interest Rate Normalisation Begins in the G10 Economies

The Reserve Bank of New Zealand (RBNZ) increased its main policy rate by 25bps last week, to 0.50%. This move was its first rate increase since 2014, and marked the end of the policy easing cycle that began in 2019, back when the US Federal Reserve implemented its three "precautionary rate cuts", before the Covid-19 pandemic was even on the horizon. As we said in August, the RBNZ was already ready to increase its policy rate this summer, but the sudden decision by the government to impose a national lockdown following a new Covid outbreak in Auckland convinced the central bank to postpone the announcement until October.

What is interesting in the decision by the RBNZ is not just the recognition that the lockdown will lead to a localised contraction in economic activity, but also that the government has the tools to cushion its economic impact, and that the economy will be able to rebound quickly after these periods of contraction. As such, the Bank's Monetary Policy Committee decided to carry on with the planned tightening of monetary policy, to counter the impact on inflation of rising capacity constraints.

The RBNZ is the second central bank among the G10 economies to increase its policy rate during this cycle. The first was Norway's Norges Bank, which increased its key sight deposit rate by 25bps at the end of September, to 0.25%. The Norwegian central bank had already telegraphed its intentions to do so in June, when it explicitly said that if the economy performed in line with its policy committee's expectations, the central bank would have to increase its main policy rate by 25bps. In this case, the Norwegian economy was benefiting from the rise in oil and energy prices as well, being a net exporter of oil.

These central bank decisions are coming after the ECB decided to "recalibrate" its Pandemic Emergency Purchase Program (PEPP) in September, and, most significantly, after the US Federal Reserve pre-announced its intention to taper its asset purchases by the end of the year.

Some analysts are now wondering whether the weak US employment report in September, showing only 194,000 new jobs being created compared to the 500,000 that had been expected, may delay the decision to taper QE. During his latest press conference, Chair Powell said that he needed to see a "decent" employment report to be satisfied with the condition that further progress had been made towards achieving the Fed's employment target. It is difficult to know whether an increase of less than 200,000 jobs fits the bill, even as the unemployment rate falling to 4.8% (vs. the 5.1% that had been expected) is certainly an upward surprise.

If the RBNZ example can be of any guidance for what the Fed may decide to do, it may show that central banks are not likely to be disturbed by short-term volatility of economic variables, and will carry on with their stated intentions. At the same time, central banks want to err on the safe side so long as the pandemic continues and there is still a risk of new variants emerging.

In any case, as we discussed in previous columns, the direction that G10 central banks are heading in seems to be well established. In the coming months, most central banks will start to withdraw the extraordinary stimulus provided since the beginning of the pandemic, while continuing to provide the necessary backstop to governments and their expansionary fiscal policies.

Our Recent Publications

- *Flash Review: RBNZ Raises Interest Rates, Second G10 Central Bank In This Cycle, by Brunello Rosa, 6 October 2021*
- *Economic Recovery On Track, But Volatility Rises, by Alessandro Magnoli Bocchi, Fawaz Sulaiman Al Mughrabi and Karmen Meneses, 1 October 2021*
- *Iran and Saudi Arabia's Perspectives on Post-US Afghanistan, by Giorgio Cafiero, 29 September 2021*
- **GEOPOLITICAL CORNER:** *The EU's Suez Moment: The Stunning AUKUS Alliance Makes It Clear The Anglosphere Is Rising, As Europe Falls, by John C. Hulsman, 5 October 2021*

Looking Ahead

The Week Ahead: Retail Sales and Economic Sentiment To Decline In US And EZ Respectively; Inflation To Stay Unchanged in US

In the US, in September, retail sales are expected to fall to 9.0% y-o-y (*p:* 15.1%).

In the US, September's headline and core inflation are expected to stay unchanged at 4.0% y-o-y, and 5.3% y-o-y, respectively.

In the EZ, in October's economic sentiment is projected to fall to 20.0 (*p:* 31.1).

The Quarter Ahead: Global Corporate Tax Agreed; Geopolitical Risks Remain High; CBs Start Tightening Policies

OECD announces major breakthrough on corporate tax rates, after years of disagreement. The group of developed nations agreed to a global minimum corporate tax rate of 15%, marking a huge shift for smaller economies, such as the Republic of Ireland, which have attracted international firms – to a large extent – via a lower tax rate. The deal, agreed by 136 countries and jurisdictions representing more than 90% of global GDP, will also reallocate more than USD 125bn of profits from around 100 of the world's largest and most profitable MNEs to countries worldwide – ensuring that these firms pay a fair share of tax wherever they operate and generate profits.

US-China trade talks take first steps in re-engagement. The Biden administration kicked off its trade-policy engagement with China via a virtual meeting between US Trade Representative Katherine Tai, and Chinese Vice Premier Liu He. In the meeting, Ms. Tai raised a range of concerns including what the US says have been China's *"state-led, nonmarket policies and practices"* and its failure to live up to the commitments it made under the 2020 Phase-1 trade pact signed with the Trump administration. The resumption of trade policy discussions come as the two nations prepare for a long-awaited virtual summit meeting between Biden and Xi. ***UK China-Taiwan tensions: Xi Jinping says 'reunification' must be fulfilled.*** China's rising military might and demonstrated willingness to ignore agreements it once made over Hong Kong's one-country-two-systems formula are changing the US strategic outlook for Taiwan. Recently, China has dispatched nearly 150 warplanes into Taiwan's defense zone – part of what the State Department describes as a series of *"destabilizing"* actions in the Taiwan Strait that risk resulting in *"miscalculations."* Taiwan's defense minister has also warned that China will have the capacity within four years to mount a *"full scale"* invasion.

CBs to begin tightening. In the *US,* despite a disappointing September jobs report, Fed officials have signaled the gains are likely to satisfy the thresholds they have laid out to start reducing their bond buying at their policy meeting next month.

Last Week's Review

Real Economy: Economic Recovery Gains Ground, While CBs Start To Ease Pandemic-Era Stimulus

In the US, September's labor market data showed: *i)* nonfarm payrolls increased below expectations by 194k (*c:* 500k; *p:* 366k); *ii)* average hourly earnings rose in-line with market forecasts (*a:* 4.6% y-o-y; *c:* 4.6%; *p:* 4.0%); and *iii)* the unemployment rate dropped more-than-expected to 4.8% (*c:* 5.1%; *p:* 5.2%) – well above the pre-crisis level of 3.5% – due to ongoing labor shortages, but is seen declining further in the coming months as: *a)* companies fill widespread vacancies; and *b)* more workers are expected to go back into the labor force.

In the EZ, retail sales in August remained mute at 0%, easing from a 3.1% increase in July, and missing forecasts of 0.4% growth.

In Australia, the RBA kept its cash rate unchanged at 0.1% during its October meeting, but continued plans to trim the purchase of government bonds to AUD 4bn a week until at least mid-February 2022.

In New Zealand, the RBNZ raised its OCR by 25bps to 0.5% during its October meeting, marking the first rate hike since June 2014, with policymakers saying the decision was appropriate to: *i)* maintain low inflation; and *ii)* support maximum employment.

Financial Markets: Global Stocks Gain; Bond Yields Spike; USD Strength Weighs On Gold Prices

Market drivers: investor sentiment strengthened, as: *i)* the US reached a deal to raise the debt ceiling into December; and *ii)* worries over a spike in inflation prompted by soaring energy prices eased.

Global equities rose w-o-w (MSCI ACWI, +0.7%, to 717). In *US*, the S&P 500 gained the most since August (+0.8% w-o-w to 4,391), as energy stocks led the gains, while the small real estate sector lagged with modest losses. In *EZ*, shares ended higher (Eurostoxx 50, +0.9% w-o-w, to 4,073), as natural gas prices surge to record highs. In *EMs*, equities advanced (MSCI EMs, +0.8%, to 1,257), as Chinese stocks rose (Shanghai Comp., +0.7%, to 3,592). *Volatility* fell below averages (VIX S&P 500, -2.4 pts to 18.8, *52w avg.:* 20.9; *10y avg.:* 17.2).

Fixed Income: w-o-w global bonds plunged (BAML Global, -0.6% to 293.0), while UST yields spiked (+15 bps, to 1.61%), reaching the highest in 4 months, as investors digest the latest US labor report.

FX: w-o-w, the US Dollar Index was mute (DXY, 0%, to 94.067; EUR/USD -0.2%, to 1.157). In *EMs*, currencies fell against the USD (MSCI EM Currency Index, -0.3% w-o-w, to 1,719).

Commodities: Oil prices rose (Brent, +3.9% w-o-w, to 82.4. USD/b), as major oil exporters decided not to increase production more than their modest previously agreed-upon amount. Gold lost its safe-haven appeal (-0.7% w-o-w, to 1,757 USD/Oz), driven by a stronger USD, and dropping more than 4% since its August highs.

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Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*