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CIO Viewpoint

The path to normalisation via shortages and volatility

Investment Solutions

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Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

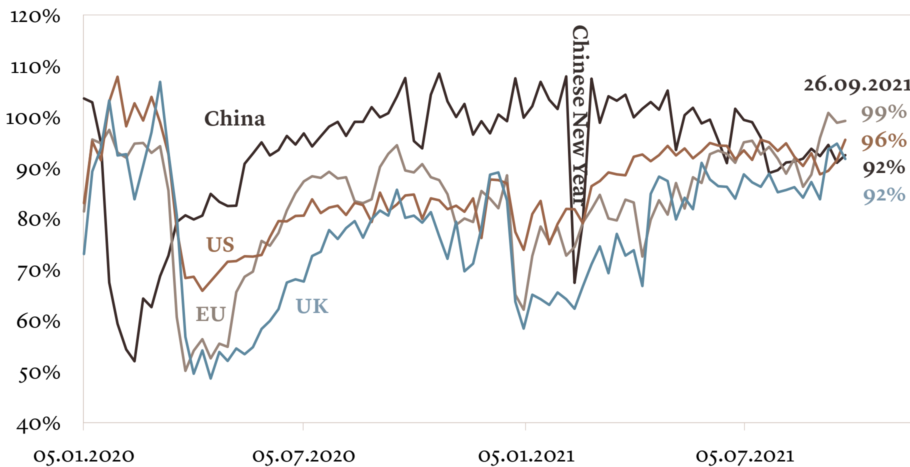
Shortages from energy to shipping and labour threaten the pace of the global recovery as low inventories and bottlenecks collide with recovering demand. One of history's biggest economic shocks and strongest rebounds leaves us without a precedent to chart a course to normalisation. Nevertheless, we believe that the current supply disruptions will prove transitory, but continue to create short-term market volatility.

The underlying strength of the economic recoveries is prompting central bankers to continue with their plans to withdraw asset purchases, to be followed by interest rate hikes. Despite challenges to global logistics, world trade flows are recovering and the wave of Delta-variant Covid infections appears to have peaked. This underlines the solidity of the world's cyclical fundamentals, supported by commitments for additional public fiscal spending from the US, to China and Europe (see chart 1).

However, there are multiple examples of inflationary pressures and shortages. The price of 40-foot shipping containers has risen seven-fold since before the crisis and shipping delays are impacting consumer sales. Clothing retailer H&M for example,

1. Normalisation of activity in US, Europe and China

Normalisation indicator



Source: Lombard Odier calculations

Key takeaways

- Low inventories and labour shortages are interrupting supply chains and challenging growth momentum
- Economic fundamentals remain sound and recoveries are supported by government and consumer spending
- Central banks expect inflation pressures to remain temporary and monetary policy to stay on a predictable track
- For the most part, the current disruptions do not look structural. As activity normalises, we see growth returning to its long-term potential.

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said last week that it saw poorer sales for September when supply fell short of demand.

Natural gas prices in Europe have reached record levels, and inventories are 11% below their five-year average ahead of the northern hemisphere's winter. Russia and Norway, which together account for more than half of Europe's already-low gas supplies, have suffered interruptions and slowdowns. That has forced the continent to bid for natural gas against buyers in Japan and China, where stocks are also low.

China's purchasing managers' index showed a contraction in September for the first time since February 2020. Sixteen of China's 31 provinces have imposed electricity rationing, and manufacturing activity slowed in September as energy shortages and local Delta-variant Covid outbreaks paused production. In addition, China, which is already the world's biggest gas importer, is switching from coal to gas ahead of the February 2022 Winter Olympics.

Perfect storm

In oil markets, Brent crude opened this week close to three-year highs of USD 80 per barrel. In contrast with gas however, oil supplies are more easily increased as the Organisation of Petroleum Exporting Countries (OPEC) has spare capacity to raise supplies in line with demand. OPEC is meeting as we publish and investors are anticipating additional steps to calm oil markets. In gas markets however, where shale remains the swing producer, production increases are limited by companies' commitments to return capital to shareholders.

Energy shortages are especially acute in the UK, which has fewer physical gas pipelines than the rest of Europe, little gas storage and depends on its neighbours' electricity. Petrol deliveries began to dry up because of a shortage of truck drivers rather than a shortage of petrol, thanks to changes to tax rules for self-employed drivers, a backlog in licence testing and lack of EU drivers post-Brexit. In April, the UK's Road Haulage Association warned that "a perfect storm is brewing in logistics." The UK government is offering an additional 5,000 three-month work visas for EU drivers and the option of employing 150 military personnel, but the measures will not plug the 70,000 shortfall of drivers recorded this year.

Risk of a slowdown?

A key question is whether high energy prices can translate into slowing growth. There are two scenarios in which this would be feasible.

The first would be if households, faced with these higher energy prices, cut back on their overall levels of spending and so slow economic activity. With the US experiencing record job openings and an unemployment rate of 5.2%, this does not look likely. Furthermore, while in some environments lower spending may be a possibility, consumers now have record levels of savings. Some households will undoubtedly suffer, but globally there is more than enough cash to cope, and so maintain high spending levels.

The second scenario is that central banks, spooked by higher prices in some sectors, decide to reverse course and tighten policy. We do not see this happening, even in Europe where energy prices are spiking.

Central bankers are counting on these inflationary pressures to prove temporary, and both inflation and economic growth to return to their long-term averages as supply chains and inventories normalise. That would leave monetary policy on a predictable and well-flagged track.

The Fed is set to wind down its emergency spending by reducing monthly asset purchases, starting late this year or early 2022. The US central bank has made it clear that it is watching the broad labour market for signs that the economy has returned to full employment, although it is also wondering what that measure will now look like, given the mismatch between job opportunities and unemployment. "I've never seen these kinds of supply-chain issues, never seen an economy that combines drastic labour shortages with lots of unemployed people," Fed Chairman Jerome Powell said after meeting with businesses. The changing economy "is going to be quite different from the one before."

Long-term potential

For now, the disruptions do not appear structural. The US experienced a shortage of lumber as its economy rebounded and prices doubled in May compared with the start of the year. That did not cool the housing market, and as stocks rebuilt, lumber prices have normalised (see chart 2).

2. Evolution of lumber prices

Source: Bloomberg

Supply chains are still working through their bottlenecks and until they do, inventories across many commodities and goods will remain low. In the meantime, we will also see some inflation, including in wages, as the mechanical and base effects of rebounding economies play out. Overall, we expect inflation to prove transitory before settling at its longer-term average.

Inflation should not prove more persistent unless it infiltrates every part of an economy, and is also sustained by excessive levels of credit. So far, commercial banks have shown lending discipline, and households have limited appetite for borrowing. We continue to watch for indications that more profound shifts are happening in developed economies.

While investors face short-term volatility, economies should prove resilient, leaving them positioned to weather any slowing growth as central banks prepare for asset tapering and a new rate-hike cycle. As a result, we see growth returning, over time, to more normal levels, consistent with its long-term potential. We therefore recommend staying invested in risk assets.

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SWITZERLAND

GENEVA
Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
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Lombard Odier (Europe) S.A.· UK Branch[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
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Lombard Odier (Europe) S.A.
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Lombard Odier Funds (Europe) S.A.
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MILAN
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MOSCOW
Bank Lombard Odier & Co Ltd · Representative Office Moscow
Letnikovskaya st. 2, bld. 1 · 115114 Moscow · Russian Federation · moscow@lombardodier.com
Under the supervisory authority of the Central Bank of the Russian Federation.

PARIS
Lombard Odier (Europe) S.A. · Succursale en France[2]
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Bank Lombard Odier & Co Ltd · Representative Office Dubai
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
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Israel Representative Office · Bank Lombard Odier & Co Ltd
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JOHANNESBURG
South Africa Representative Office · Bank Lombard Odier & Co Ltd
4 Sandown Valley Crescent · Sandton · Johannesburg 2196 · South Africa · johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Lyford Cay House · Western Road · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
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Lombard Odier (Singapore) Ltd.
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