Global equity markets enjoyed another month of stellar gains in August, buoyed by Covid-19 vaccine and economic recovery hopes, commitment to loose policy from the US Federal Reserve and support for large tech stocks. US markets led the way with the S&P500 up 7% – its best August since 1984 and back above pre-Covid levels, albeit further fueling concerns about a disconnect with economic conditions which remain weak if improving. The benchmark US 10-year bond yield also backed up significantly reflecting recovery prospects, though at 0.69% remained historically low. The more ‘risk-on’ investment climate combined with the loose monetary policy have weakened the US dollar, which hit a two-year low on a trade-weighted basis.

**Stronger US data fuels rebound hopes**

Some strong economic data and a steady fall in new virus cases through August have boosted US recovery hopes, despite continued worries over labor market weakness and a lack of fresh fiscal stimulus. GDP in 2Q20 was revised slightly up on the second reading but still registered an historic annualized drop of 31.7%, on weakness in private consumption (-34.1%) and investment (-28.9%). However, surveys show activity bouncing back strongly in Q3, with ISM activity indices standing at robust levels for both manufacturing (56.0) and non-manufacturing (56.9) in August thanks to strong order books. (Chart 1.) Consumer spending by July had recovered close to pre-Covid levels boosted by business reopenings and government income-support measures. Meanwhile, housing activity has surged to 13-year highs helped by pent-up demand but also – less positively – reports of a virus-driven exodus from larger cities. The consensus view is for a record-breaking rebound in economic growth of 20-30% in Q3, but beyond that the path is less clear.

The strength and durability of the recovery will partly depend on the labor market, which although improving remains very weak. Non-farm payrolls rose a consensus-matching 1.4 million in August but have still dropped a net 11.5 million since February, while the unemployment rate – although falling steadily – remained high at 8.4% despite millions of people exiting the workforce since February and therefore not captured by the jobless statistics. Notably too, consumer confidence has failed to bounce back meaningfully in recent months, which implies that household spending could fall back as the boost from previous stimulus measures fades. Democrats and Republicans have so far failed to agree a new stimulus bill that would provide fresh support to consumers including via enhanced unemployment benefits (the previous batch expired in July). The Democrats are
looking for a $2.2 trillion package on top of the $3 trillion of measures that have already been passed. The Republicans are looking for a deal of $0.5-1 trillion, cutting out in particular aid to state and local governments from their rivals’ proposal.

Meanwhile in a subtle but significant policy shift, Federal Reserve chairman Jay Powell announced that the bank will replace its current 2% inflation objective with one that targets the same rate but on average over time. In the current circumstances, with the core PCE inflation rate (the Fed’s preferred price gauge) at 1.3% y/y in July and averaging just 1.6% over the past decade, this implies the need for inflation to run above 2% over the medium term. (Chart 2.) The move underscores the Fed’s intention to keep policy loose for a long period ahead, though with inflation already below target it is unlikely to affect its near-term decisions very much. One criticism of the change is that while it provides for some additional flexibility, the ‘average’ target is more difficult to interpret and could lead to confusion. In another policy tweak, the Fed will in future address ‘shortfalls’ from maximum employment rather than ‘deviations’, again implying a bias towards looser policy over time.

**Europe’s recovery momentum hit by virus surge**

After Q2’s dismal drop of 12.1% q/q, GDP in the Eurozone is expected to see a solid post-lockdown bounce back of around 8% in Q3, but the recovery is being threatened by a surge in virus cases in various ‘core’ countries especially Spain and France. The former for example has seen fresh restrictions imposed in Madrid and on travel from other European countries, hitting both business confidence and its summer tourism season and its composite PMI score fell back into contraction territory in August at 48.4. Even in Germany, whose economy has benefited from relative strength in manufacturing, less severe lockdowns and strong government support, the recovery may have lost some steam with industrial production rising a less-than-expected 1.2% m/m in July and retail sales falling 0.9% despite the 3% cut in VAT effective from that month. Still, the German government has revised up its forecast for GDP this year now showing a contraction of -5.8% from -6.3% before, thanks partly to the resilience of the labor market and the success of its Kurzarbeit furlough/wage-replacement scheme.

Meanwhile inflation in the Eurozone plunged into negative territory in August at -0.2% y/y while the core rate fell to an all-time low of 0.4%. (Chart 3.) The drop was partly linked to delayed summer sales and the temporary cut in German VAT, as well as general Covid-19-related softness. But inflation is also coming under pressure from the strengthening euro, which is up more than 10% versus the US dollar since mid-May to a two-year high of nearly $1.20.

**Record decline in Japan’s Q2 GDP; PM Abe departs**

Figures released in August revealed the severity of Japan’s economic contraction in Q2Q0. Output declined by a record 27.8% q/q (annualized) as lockdowns hammered consumer spending, investment and exports, the latter also battered by weak external demand. (Chart 4.) More recent high-frequency data, however, appears to show a modest recovery in retail sales and factory output, a fact that may lead to the Bank of Japan looking for a deal.
(Boj) to upgrade its economic growth assessment for the remainder of the year.

August was also significant for the resignation due to poor health of Shinzo Abe, Japan’s longest-serving prime minister. Abe leaves a legacy that was, on balance, positive and transformative, even if he came up short in several of his stated goals. ‘Abenomics’ sought to reinvigorate a Japan suffering from ‘lost decades’ of deflation and low growth against a backdrop of an ageing population through radical structural, productivity-enhancing reforms and expansive fiscal and monetary policy. Signature initiatives included massive asset purchases by the Boj, fiscal stimulus, the expansion of female labor force participation and significant reforms to corporate governance. Under Abe, Japan posted annualized average growth of 1.1% between 2012 and 2018 and the lowest unemployment rate in decades while the Nikkei surged to highs not seen since the early 1990s. Still, there were missteps, notably two increases in consumption tax that pushed the economy into recession, a failure to hit the 2% inflation target (though inflation did turn positive), and the rise in public debt to an enormous 238% of GDP, the world’s highest. Abe’s successor, likely to be from his ruling Liberal Democratic Party, is expected to carry on with many of the same policies.

**Chinese service sector leads economic recovery**

China’s post-pandemic economic recovery continued in August, with services taking the lead from manufacturing, according to the latest PMI data. The headline NBS non-manufacturing index increased sharply to its highest level since early 2018 (55.2, from 54.2 in July) as the easing in internal travel restrictions helped boost domestic tourism. The official manufacturing gauge slipped a little in August, though still remained in expansionary territory (51), helped by increased new orders, exports, however, remained down (49.1) for the eighth month in a row due to still-weak external demand amid persistent global coronavirus infections. A similar picture of stronger domestic consumption helping to offset weak external demand was evident in the Caixin/Markit manufacturing survey of smaller Chinese businesses. The index beat analysts’ expectations in August, rising to 53.1 from 52.8 in July and recording the biggest rate of expansion since January 2011.

China’s friction with the US on the trade front and the country’s reliance on external demand, which the Covid-19 pandemic has, once again, highlighted, is helping to accelerate the authorities’ reorientation of the economy towards domestic consumption. President Xi’s policy of ‘dual circulation’ – increasing self-reliance coupled with investment and new technology – is likely to be elaborated some more in the coming months.

**India’s GDP sinks by record amount in Q2**

India’s GDP growth in 2Q20 (1Q of FY20/21) contracted at the sharpest pace on record as the pandemic weighed heavily on activity. GDP fell by a huge 23.9% y/y, affected by sharp declines in consumption (-27%) and investment -47%, which comprise the bulk of national output, while net exports were positive thanks to a large decline in imports. Meanwhile, government spending surged by 20% as the government maintained its relief measures in a bid to counter the negative effects of the pandemic. However, in a sign that economic pressures may be easing, the August composite PMI contracted at the slowest pace since March (46), though remained in contraction for the fifth consecutive month on still weak new orders and elevated unemployment. On the policy front, the Reserve Bank of India, against expectations of a rate cut, kept its key policy repo rate on hold at 4% amid rising inflation, while maintaining an accommodative policy stance.

India’s economic recovery hinges upon how soon the pandemic subsides, with an imminent recovery becoming increasingly unlikely given the increasing number of daily cases, reaching 3.9 million as of September 4 and roughly doubling from just one month prior. This could lead to an extension of lockdowns and a much slower-than expected economic recovery. A further concern is the rising fiscal deficit (24.6% of GDP in 1Q FY20/21), limiting the scope for further expansionary fiscal policy. GDP is expected to contract 5% (revised down from 4%) in FY20/21 and to grow by 7.6% in FY21/22, which is optimistic in our view given the longer-term nature of the pandemic.

**Oil prices gain in August but demand continues to weigh**

Oil prices increased for a fifth consecutive month in August, with Brent futures posting gains of 4.6% m/m to end the month at $45.3/bbl and ranging around highs last seen in early March. (Chart 5) Trading was range-bound ($44-46/bbl) for the entire month, however, with periodic price gains proving temporary against the backdrop of rising global coronavirus infections and the specter of broader economic weakness that could follow. China, importing record volumes of crude in June and July (>12
mb/d), was an important contributor in the recovering demand narrative, even if much of it was opportunistic.

In early September, however, prices were again on the back foot, with demand worries resurfacing amid coronavirus flare-ups, an uptick in weekly US oil rig counts for the second time in three weeks and returning OPEC+ supply. August saw the producers’ group taper their 9.7 mb/d of production cuts and open the taps for the first time since April, by a minimum of 1 mb/d. With demand uncertain and US crude inventories still at a more than 10-year seasonal high, the market remains saturated. Official selling prices for regional oil producers have had to be cut for the second month in a row in order to stimulate purchases and ahead of the onset of the northern hemisphere refinery maintenance season.
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