Investment Clock – Economic Update

Issue #22, May 2021

Multi asset views from RLAM

Royal London Asset Management manages £147.2 billion in life insurance, pensions and third party funds*.

We have six Global Multi Asset Portfolios (GMAPs) across the risk return spectrum with a full tactical asset allocation overlay.

*As at 31 March 2021

This month's contributor

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US: The US economy is set to regain pre-crisis levels of output shortly. Higher inflation also looks more of a risk, as does a housing boom.

China: China should see strong annual growth in 2021, but policy 'normalisation' is likely to help calm growth rates.

Eurozone: A Q1 Covid wave and slow vaccine rollout have held back the Euro area recovery. Prospects are better for H2. Policy is set to remain supportive.

Japan: A slow vaccine rollout threatens the pace of recovery, but the policy backdrop and stronger external demand should keep a 2021 recovery on track.

UK: Recovery prospects have improved with a successful vaccination drive and forecasts have been revised up. The UK economy has a lot of ground to make up though.

Please visit **www.investmentclock.co.uk** for our blog and information about our multi asset range.

For further details, contact: **multiassetsupport@rlam.co.uk**

Returning to recovery

The second half of 2021 is set to see strong economic growth as vaccine rollouts permit more and more countries to return to 'normal' levels and patterns of activity, fuelled by a strong consumer and pick up in business investment and, for now, supported by fiscal and monetary policy too. The US is likely to regain pre-crisis output levels soon, the Euro area not until 2022. Moving into 2022, less supportive fiscal policy will help tame growth rates. Virus mutation remains a substantial downside risk, a booming consumer the main source of upside risk. Higher inflation may prove stickier than expected.

Summary

Still bumpy: The global recovery remains uneven as Covid trends diverge. While vaccine rollouts or continued tight border controls help lower the threat in some parts of the world – enabling easing in social distancing restrictions, in others, Covid continues to rage. Fiscal and monetary policy are more of a support to the recovery in some countries than others.

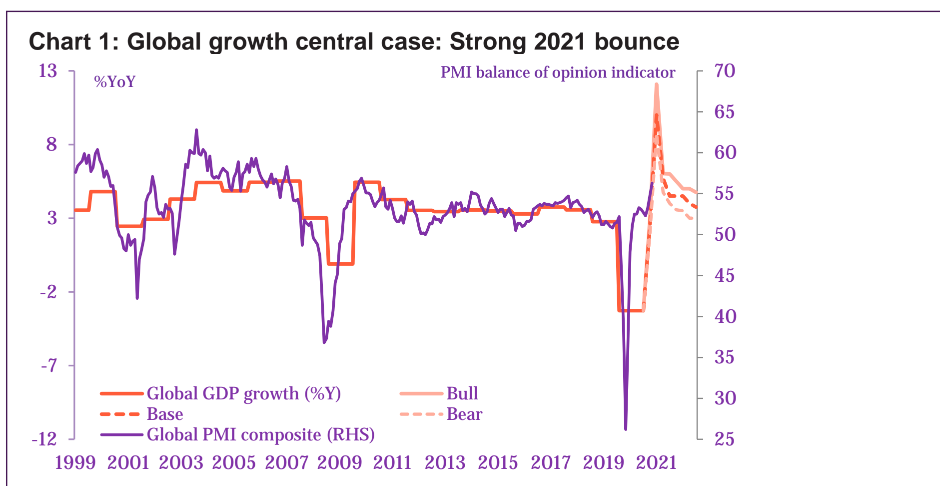
Better second half: As vaccine rollouts progress, the picture across the developed world at least is likely to look more even. Growth is likely to be more synchronous, albeit with levels of activity and employment closer to full recovery in some economies than others. The differences in vaccination programmes are more likely to start reflecting levels of residual vaccine reluctance than rollout speeds. Into 2022 and the withdrawal of fiscal support measures will act as a drag.

Risks on both sides: For as long as Covid rages in large parts of the world, the risk of vaccine evading mutation will be enough of a threat that swift reimposition of travel restrictions and social distancing measures will remain a real possibility. On the upside, a consumer-driven recovery could morph into a boom given the extent of savings/cash built up both by households and corporates.

Inflation climbs: Inflation is not high, but is rising on energy base effects, global supply chain problems and reflecting the re-opening of economies. Supportive fiscal policy and new stimulus, alongside consumer and corporate spending power threaten to keep it elevated and push it higher. However, self-sustaining higher inflation rates would be more of a threat with sharply higher inflation expectations, more balance of power shifting towards labour and with a sea-change in monetary policy regimes. The evidence does not suggest that is where we are yet. Interest rates are likely to rise in the medium-term, but rate rises are likely to be gradual and limited.

Our multi asset team maintains overweight positions in stocks, commodities, and high yield bonds versus government bonds as we expect the global vaccine roll-out to support a cyclical recovery through 2021. As the global reopening continues, we expect value sectors like financials, energy and industrials to do better and continue to tilt our funds towards these sectors and away from more expensive growth stocks. See www.investmentclock.co.uk

Chart 1: Global growth central case: Strong 2021 bounce



Source: IMF, IHS Markit, RLAM forecasts, May 2021.

Economic forecast summary

May 2021 base case

Region	2019 GDP growth	2019 CPI end Q4	2019 Policy Rate Q4	2020 GDP growth	2020 CPI end Q4	2020 Policy Rate Q4	2021 GDP growth	2021 CPI end Q4	2021 Policy Rate Q4	2022 GDP growth	2022 CPI end Q4	2022 Policy Rate Q4
US	2.2	2.1	1.75	−3.5 (−3.4)	1.3 (1.3)	0.25 (0.25)	6.8 (6.0)	2.8 (2.0)	0.25 (0.25)	3.9 (3.5)	2.2 (2.4)	0.25 (0.25)
China	6.0	4.3	–	2.3 (2.3)	0.1 (0.1)	– –	9.3 (8.0)	2.4 (1.9)	– –	5.2 (5.2)	1.9 (1.9)	– –
UK	1.4	1.4	0.75	−9.8 (−10.0)	0.5 (0.5)	0.10 (0.10)	6.8 (4.1)	2.3 (1.6)	0.10 (0.10)	5.0 (6.0)	2.0 (1.9)	0.10 (0.10)
Euro area	1.3	1.0	0.0	−6.7 (−6.8)	−0.3 (−0.3)	0.0 (0.00)	4.1 (4.1)	2.1 (0.9)	0.0 (0.0)	3.7 (3.6)	1.3 (1.1)	0.0 (0.0)
Japan	0.3	0.5	−0.1	−4.9 (−5.2)	−0.9 (−0.9)	−0.1 (−0.1)	3.0 (3.2)	0.4 (0.4)	−0.1 (−0.1)	2.5 (2.3)	0.6 (0.6)	−0.1 (−0.1)
Global	2.8	–	–	−3.3 (−2.9)	– –	– –	6.1 (5.5)	– –	– –	4.5 (4.5)	– –	– –

Source: National Statistics offices, RLAM forecasts; Jan 2021 estimates in brackets. US policy rate shows upper bound of US Federal Reserve (Fed) Funds target range. Euro area shows refi rate

Key economic policy forecasts

- With many economies taking until mid-2021/2022 just to regain pre-crisis output levels, and with inflation not expected to be sustainably above target, major central banks don't raise rates in 2021.
- We assume the US Federal Reserve (Fed) will be first of the major developed economy central banks to raise rates (early-2023), but that no central banks will raise rates rapidly.
- Asset purchase programmes are likely to continue through 2021, but more central banks are likely to signal a start to tapering before the end of the year, including the Fed. Asset purchases are expected to continue, but at a reduced rate, by the ECB and Fed into 2022.
- Fiscal support is expected to reduce dramatically in 2021/2022 as Covid-crisis related programmes and funding are wound up. However, sharp non-Covid related spending cuts are not in the central case, partly as spending to tackle longer-term challenges (e.g. climate change) steps up.

Global economic scenarios 2021-22 (Chart 1)

Upside scenario (20% probability): Consumption-fuelled boom

- Compared to the base case, vaccines are delivered faster globally, and consumer spending accelerates as households rapidly reduce savings rates and spend savings built up over the crisis. GDP quickly regains and exceeds pre-crisis levels.
- Policymakers remain cautious, however, and do not start removing stimulus much earlier than in the base case.
- Inflation is higher in this scenario as growth runs above potential.

Base case (60%): Robust recovery

- Activity remains bumpy in the near-term as Covid case numbers fluctuate, alongside social distancing regulations, but vaccine rollouts continue and over Q2-Q3, activity in major economies picks up significantly. By the end of the second half of 2021 social distancing restrictions are largely gone. Activity levels recover to pre-crisis levels at different rates. Businesses investment picks up steadily and consumers save less but reduce 'excess' stocks of savings only gradually.
- Inflation rises sharply during 2021, but isn't high by the end of the forecast horizon. Underlying inflationary pressure rises somewhat as the output gap closes. However, there is no big jump in inflation expectations and it takes longer than GDP for labour market tightness to reach pre-crisis levels.
- Fiscal policy becomes rapidly less supportive, but non-Covid public spending is not cut significantly over the coming twelve months or taxes raised significantly over 2021-22.

Downside scenario (20%): Recovery disrupted again

- Relatively strict forms of social distancing are re-imposed periodically throughout the profile, as vaccine resistant strains gain ground. Business investment and consumer spending are more subdued than in the base case, unemployment stubbornly high.
- Although government support programmes remain in place, damage to balance sheets means that it takes much longer for the level of GDP to sustainably exceed pre-crisis levels in advanced economies.
- Inflation is below central bank targets by end-2022, despite ongoing stimulus from governments and central banks.

Probabilities are subjective and indicative such that we'd broadly see a 20% chance that the economy performs in line with/better than the upside case and a 20% probability that the economy performs in line with/worse than the downside scenario.

Global economy: Set for strength

Covid permitting, the second half of 2021 is set to see strong economic growth as vaccine rollouts permit more and more countries to return to 'normal'. Virus mutation remains a substantial downside risk, but upside risks have been increasing. Monetary policy remains accommodative, though less supportive fiscal policy will help tame the boom. Inflation risks are rightly a talking point.

Stop-start recovery

The global recovery lost pace in Q4, into Q1. New waves of Covid-19 (Chart 2) – and different official responses to those waves– have meant relatively de-synchronous progress over Q4 2020 into Q2 2021 (see, for example, business survey output measures in Chart 3). Vaccine rollouts have also been uneven, as has the degree of near-term fiscal stimulus.

A more sustained leg of recovery in H2 2021

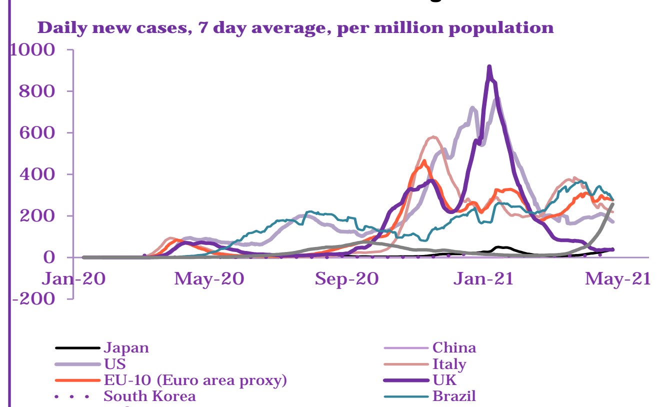
The key driver of the global recovery from here is likely to be the vaccine rollout and normalising of social distancing rules and practices once it is safe to do so. The forecasts on page 2 still pencil in the second half of 2021 for a period of more substantive normalisation. The probability of a strong second half for the global economy remains high, with vaccine rollouts ongoing (Chart 4). The pace of those rollouts is an important differentiator for growth prospects in Q2, into Q3, likely enabling some countries to feel confident enough to reduce social distancing restrictions earlier and more dramatically. By the latter part of the year, differences in vaccine coverage in many developed economies will likely be more about residual levels of vaccine scepticism in those economies than rollouts.

Fiscal policy is still a significant support to the recovery, especially in the US, though set to become less supportive in many economies later this year as Covid support measures roll off. The forecasts pencil in further recovery in consumer spending and capex and risks are to the upside, on balance, for both.

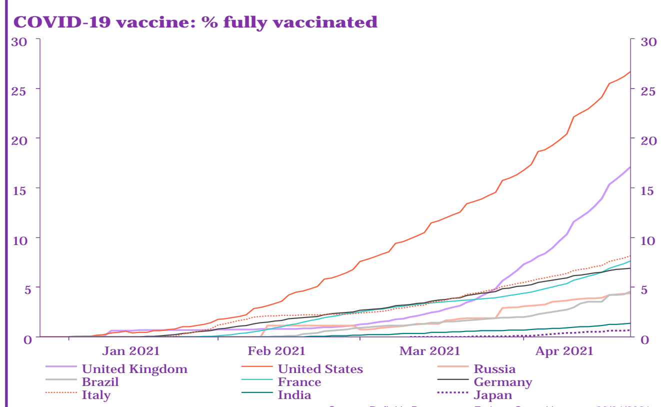
Risks to the forecasts increasingly to the upside

Ongoing vaccine rollouts continue to dull the threat of Covid for the outlook beyond the near-term, though significant vaccine-evading virus mutation remains a significant risk while levels of immunity are – so far – insufficient to stop the virus circulating. Consumer savings, corporate cash piles and US fiscal policy are set to help fuel global growth in the next phase of recovery. Whether that will mean a short-lived 'sugar-high' or something more sustainable is less clear and partly depends on longer-term damage done by the crisis and on what happens to inflation.

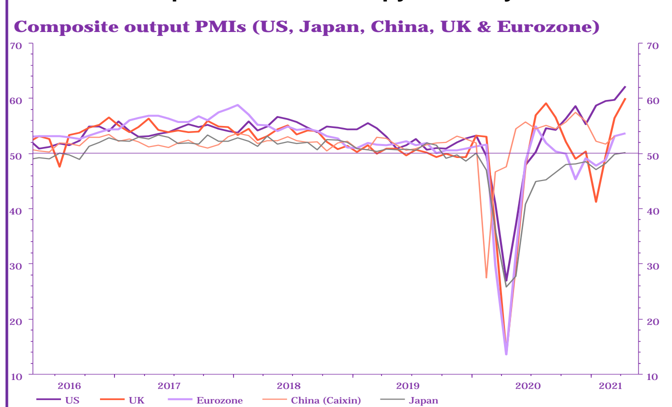
Consumer savings: The potential unlocking of consumer savings remains a significant source of upside risk. Consumer spending could be boosted significantly if savings rates return to pre-crisis levels and households decide to run down much of their unexpectedly accumulated savings deposits. The likelihood has grown since the turn of the year as the US government have sent out another round of cheques to households and as overall consumer confidence has risen across regions, likely tied to vaccine rollouts and a feeling of 'light at the end of the tunnel' (Chart 5).



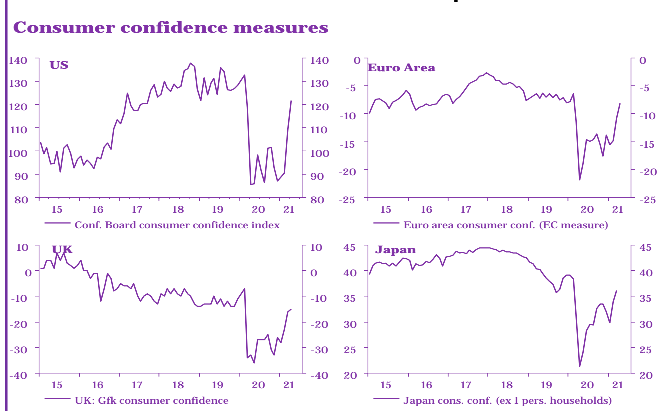
Source: Refinitiv Datastream, WHO, RLAM as at 26/04/2021.



Source: Refinitiv Datastream, Fathom Consulting, Our World in Data, as at 26/04/2021.



Source: Refinitiv Datastream, IHS Markit as at 15/04/2021.



Source: Refinitiv Datastream, Conference Board, GfK, European Commission, Japan Cabinet Office as of 15/04/2021

Corporate cash piles: Corporates have also built what appear to be excess levels of liquid assets (Chart 6). This could provide funding for investment in the recovery phase, as well as help firms adapt to any more lasting structural change post-Covid. Prospects for investment spending have improved as levels of business optimism have risen (Chart 7). Survey measures of capex intentions have also improved (e.g. Chart 20)

US fiscal policy: Compared to expectations at the turn of the year, the first Biden fiscal package was much larger than expected and boosts prospects for both US and global growth in 2021, even if part of the spending was to extend Covid-relief provisions already in place. The Biden administration, however, have further fiscal plans that could support both US and global growth over the next several years if well-designed and assuming that, as signalled, tax increases accompanying the packages won't fully offset spending in the initial years.

Holding back the boom

A rapid run down of 'excess' household savings is not built into the forecasts for two main reasons: First, an assumption that household savings preferences will have changed. This second-in-a-decade 'once in a lifetime' economic shock may jolt a substantial proportion of households into raising their desired stocks of precautionary savings. Second, the build in savings has been skewed towards the already wealthy. Wealthy households are more likely to use those excess savings to buy assets rather than consume, relative to low income households.

Not all corporates will have cash or will use 'cash piles' for capex. Corporate cash levels rose during the crisis, but so did bank lending to businesses. Some companies may have acquired debt during the crisis just to enable them to survive and may be more cautious on hiring and investment in the recovery. Larger companies may well have taken advantage of robust corporate bond markets during 2020 to refinance at lower rates and or longer maturities, but that will not have been an option for smaller firms. Other forms of debt accumulated by firms will include tax deferrals and loan payment deferrals –easing cash flow pressures during the crisis, but which may now absorb accumulated cash.

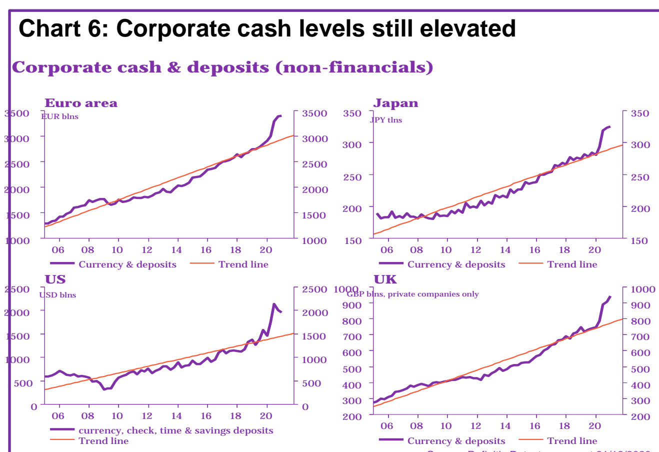
Fiscal boost turns towards fiscal drag: After the exceptional levels of fiscal support in 202o, fiscal policy is expected to be less supportive in 2021 into 2022 (Chart 8). Much of this shift in stance will reflect Covid-relief schemes rolling off as they are no longer needed. Higher consumption and investment will be *needed* to offset the shift. There will be risks around timing too, e.g. cutting support before a plausible Covid flare-up in the Northern hemisphere in Q4 when cold weather returns.

Central bank policy outlook

Monetary policy remains very accommodative (Charts 9 and 10). Major central banks are signalling that rates will remain on hold for years. That does not of course mean that, as circumstances change, central banks won't tighten policy sooner. Some emerging market central banks are already raising rates and the Bank of England and Bank of Canada have both at least announced tapering of asset purchases. The forecasts on page 2 assume that the Federal Reserve raise rates before the 2024 policymakers are effectively signalling in their forecasts.

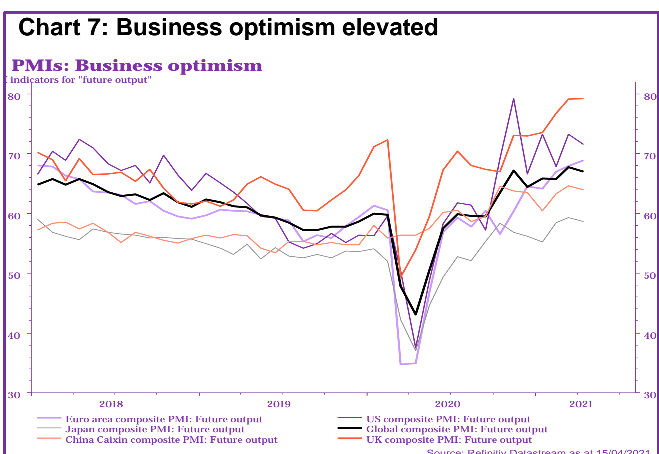
Eventual rate rises are likely to be gradual and limited. Equilibrium interest rates have fallen in recent decades, reflecting multiple factors including demographics. Debt levels are elevated in some sectors and economies, heightening sensitivity to higher interest rates (more can be done with smaller rate changes). Government financing could also become more of an issue in a high rate/yield environment.

Chart 6: Corporate cash levels still elevated



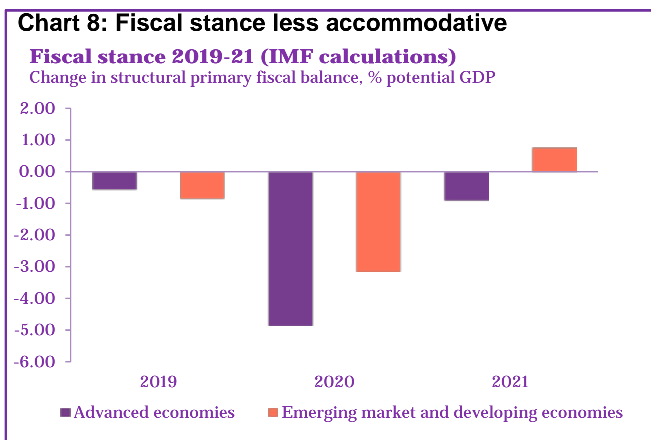
Source: ECB, BoJ, Federal Reserve, ONS, Refinitive Datastream. Data as of Q4.

Chart 7: Business optimism elevated



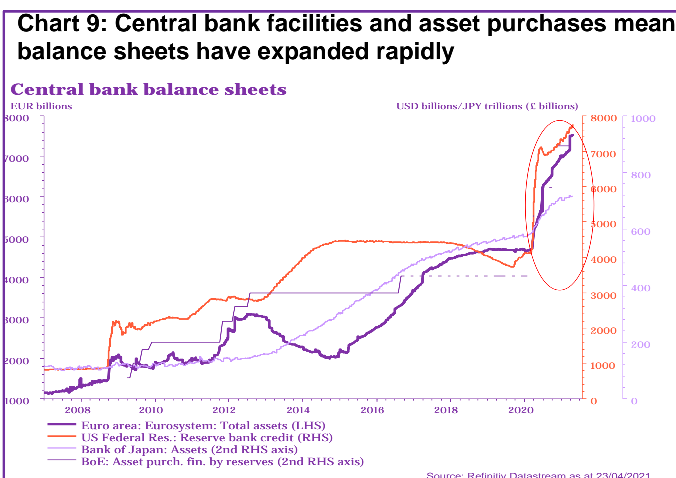
Source: Refinitiv Datastream, Markit as at April 2021

Chart 8: Fiscal stance less accommodative



Source: International Monetary Fund (IMF), April 2021.

Chart 9: Central bank facilities and asset purchases mean balance sheets have expanded rapidly



Source: Refinitiv Datastream, ECB, Federal Reserve, BoE 23/04/2021

Future inflation

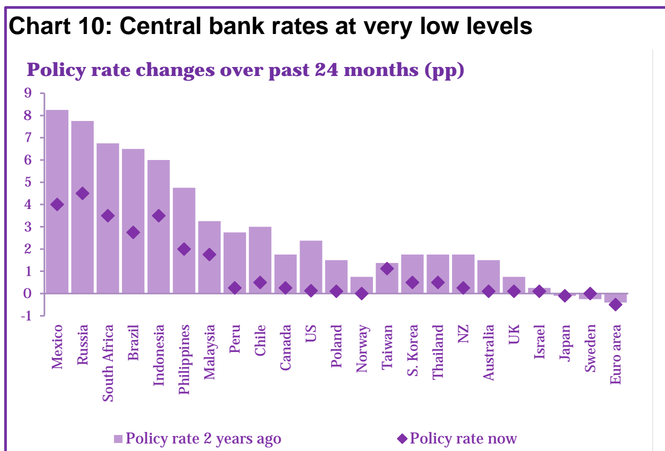
Inflation spike: Although the de-synchronous nature of the recovery should help limit some of the upward global inflation pressure for a time, most countries' headline inflation is getting a mechanical boost as low energy prices drop out of year on year comparisons. Surveys also indicate global increases in input and output price pressure, partly linked to supply chain problems (Chart 11). Parts of the economy hit hardest by Covid restriction may see price increases as re-opening occurs (seen in the US). Indicators of core/underlying inflation, however, remain much more subdued (e.g. Chart 12).

Looking more to 2022-23, there are upside risks to the forecasts. Spare capacity in major economies is likely to shrink dramatically into 2022 as economies return to some kind of functional normality. The recovery may be very strong, especially in the US. Further supply side constraints may become apparent as economies normalise (e.g. around available labour supply, where hiring difficulties are already being flagged by US firms despite still high unemployment). Over 2022-23, there is every chance that the monetary policy stance stays very accommodative for longer than necessary.

Higher, but probably not high (medium to longer term): The medium to longer term outlook for inflation is higher, but probably not high. Many of the factors that have likely weighed on inflation in recent years, from the growth of internet shopping, the growth of China as an exporting powerhouse, to greatly weakened power of labour, are only likely to shift direction over many years – if at all. Without a permanent regime shift from central banks towards 'fiscal dominance' and an abandonment of inflation targeting as the core of most central banks' mandates, it is hard to see longer-term inflation expectations picking up substantially. In parallel, if longer-term inflation expectations were to pick up substantially, with central bank mandates as they are currently, central banks are likely to start tightening policy significantly. The Federal Reserve have signalled that 'all bets would be off' in that scenario.

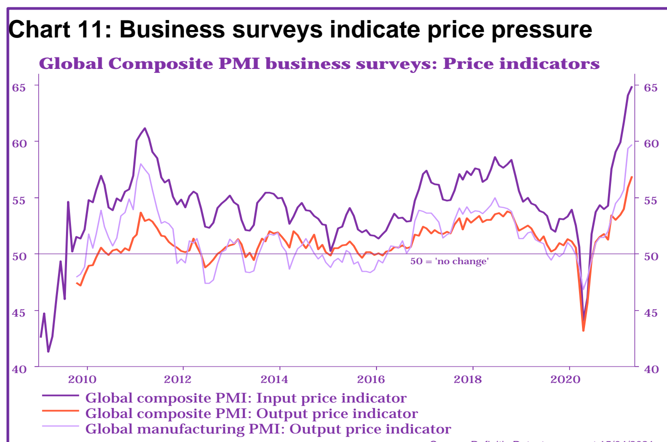
Wildcards: **Demographics and climate change**: Climate change may herald an era of more volatile prices through more regular supply chain disruption and volatile agricultural commodity prices. Climate change spending may also help usher in a longer-period of fiscal expansion. As for demographics, many of the world's major economies are starting to age rapidly. That may usher in a period of greater rebalance towards worker power as working age populations shrink relative to the overall population.

Chart 10: Central bank rates at very low levels



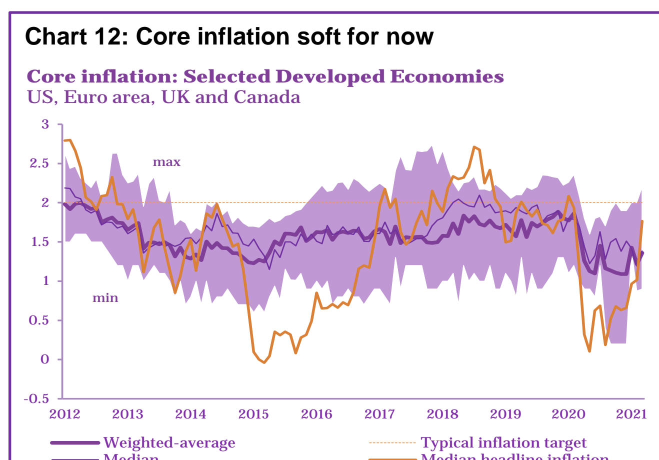
Source: Bloomberg as at 10/04/2021

Chart 11: Business surveys indicate price pressure



Source: Refinitiv Datastream, IHS Markit as at April 2021.

Chart 12: Core inflation soft for now



Source: Refinitiv Datastream, national statistic offices, RLAM as at March 2021.

United States: Fiscal boosters

The US economy is set to regain pre-crisis levels of output shortly. A strongly stimulative fiscal stance helps. Higher inflation also looks more of a risk, as does a housing boom. The Fed still seems unlikely to wait as long as it signals it will, before raising rates.

Near-term: Resilient

Fiscal boost helps recovery resilience: GDP growth rose 4.1%Q annualised in Q4 2020 and 6.4% in Q1 2021. Those growth rates were more pedestrian than the Q3 bounce (Chart 13), but still strong by pre-crisis standards as the economy continued its recovery. They also came despite new waves of Covid cases over the turn of the year and a weather-related hit in February (apparent in Chart 14). The economy has clearly been boosted by December and March's fiscal packages, including rounds of cheques for households. Social distancing restrictions have been eased, the US vaccine rollout continues to power on and the Biden administration plans at least two more major fiscal packages. All of that should help the US surpass pre-crisis levels of output in the current quarter (i.e. Q2 2021).

Business surveys suggest that the US economy continues to grow at a robust pace (Chart 13). Non-farm payrolls support the view of a robust underlying recovery too.

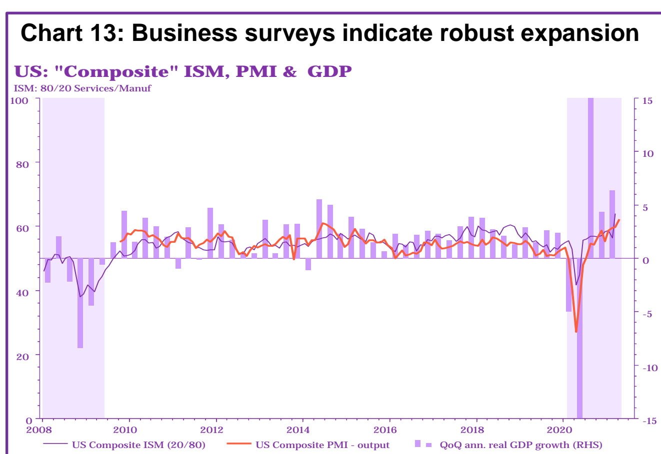
Consumer: Stimulus and savings

Consumer confidence has started to pick up more noticeably with the vaccine rollout well underway and more fiscal stimulus (Chart 5). Households, as they feel more secure about the future, are more likely to both save less and spend down stocks of savings boosted by successive rounds of fiscal support (Charts 15 and 16). However, those additional savings have skewed towards already wealthy households in the US (Chart 17) who will, on average, have a lower propensity to spend from income.

Direct cheques/deposits to households as part of the Biden stimulus package will have arrived late March/early April, supplementary unemployment benefit will continue until September and new child tax credit payments will start from July – effectively another dose of direct stimulus for many lower and middle income families.

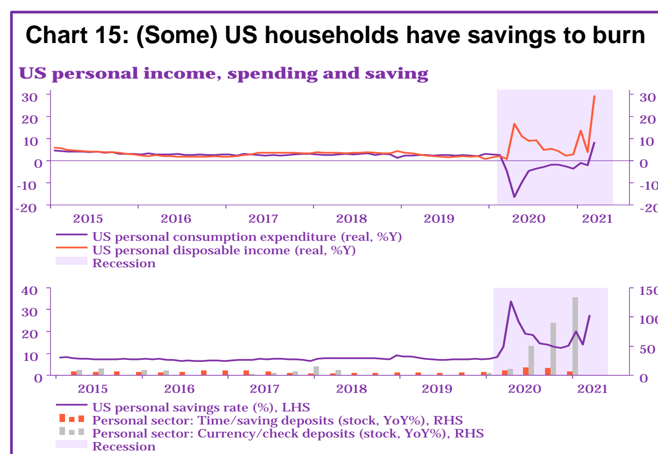
Housing boom? Wealthier households look in possession of a substantial stock of excess savings. Rather than consumption, those savings may find their way more into other financial assets and the housing market. Housing indicators – putting aside the February weather-related dip – look relatively strong already and mortgage rates remain well below pre-crisis levels (Chart 18), though higher than at the start of 2021. A US housing boom looks a relatively high probability at this stage.

Chart 13: Business surveys indicate robust expansion



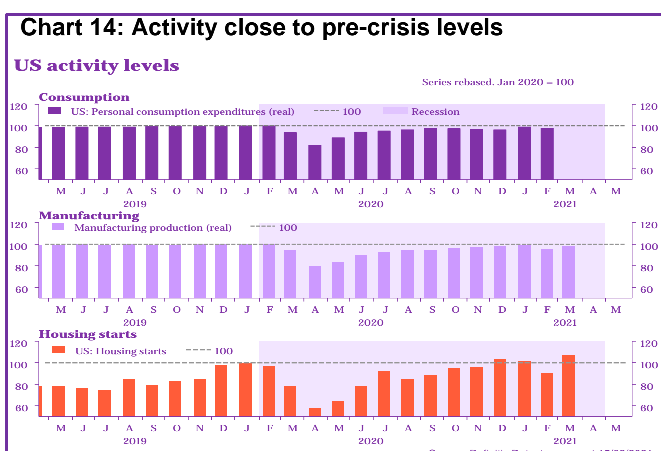
Source: Refinitiv Datastream, BEA as at Q1 2020, IHS Markit (April 2021), ISM (March 2021)

Chart 15: (Some) US households have savings to burn



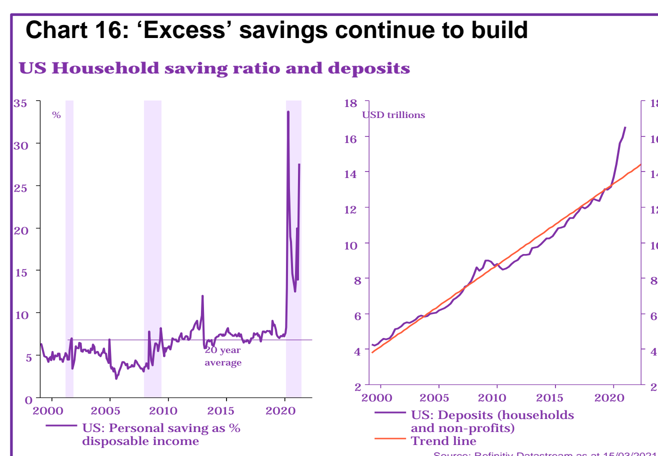
Source: Refinitiv Datastream, BEA, as at 15/03/2021.

Chart 14: Activity close to pre-crisis levels



Source: Refinitiv Datastream, BEA, Federal Reserve, Census Bureau as at 15/02/2021.

Chart 16: 'Excess' savings continue to build



Source: BEA, Federal Reserve, RLAM, Refinitiv Datastream as at March 2021.

Investment prospects brighten further

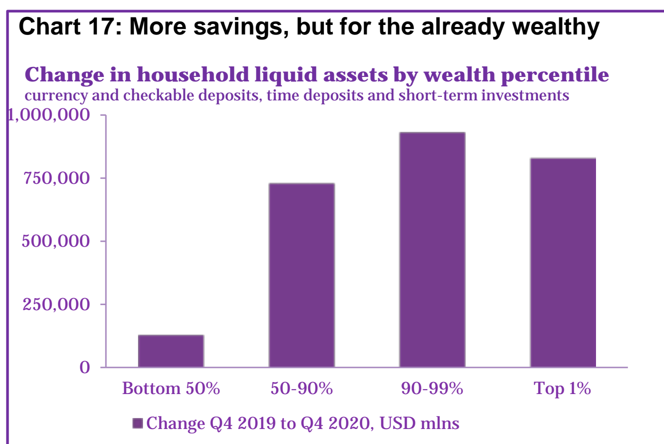
Business have been growing more confident as the vaccine rollout has progressed. The level of US economic policy uncertainty continues to fall (Chart 19). Survey measures of investment intentions are at pre-crisis levels (Chart 20). Meanwhile, President Biden has launched plans for a very large, multi-year infrastructure spending programme. However, as elsewhere, corporate debt is high and could weigh on the strength of the investment recovery (Chart 21).

Fiscal support, but how much new stimulus?

The larger than expected $2.1 tln package in March has improved prospects for 2021 US growth, but partly by avoiding a sharp fiscal cliff as previous stimulus measures rolled off. The further round of cheques to households boosts prospects for strong consumer spending growth. The child tax credit payments are not intended to be permanent but may be difficult to remove. Most of the March spending package will be dispersed by October though, keeping the fiscal stance expansionary through most of 2021 (Chart 22, see IMF forecast), but implying some tightening in 2022 depending on the pace and scale of eventual spending from the planned multi-year American Families Plan and the Jobs Plan.

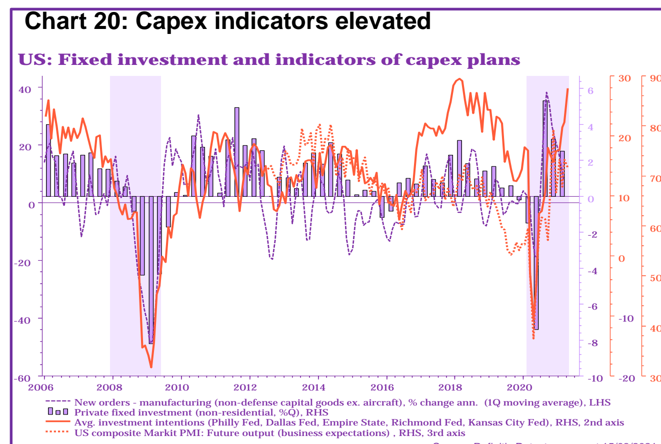
These next two stages of Biden stimulus seem likely to soften the expected change in fiscal stance in 2022, but not reverse it. They are multi-year packages – they are not intended to provide instant stimulus to the economy. The headline figures are very large, but spending will be spread over several years. They will also – at least eventually – be at least part funded by tax increases, reducing the amount of net stimulus to the economy.

Chart 17: More savings, but for the already wealthy



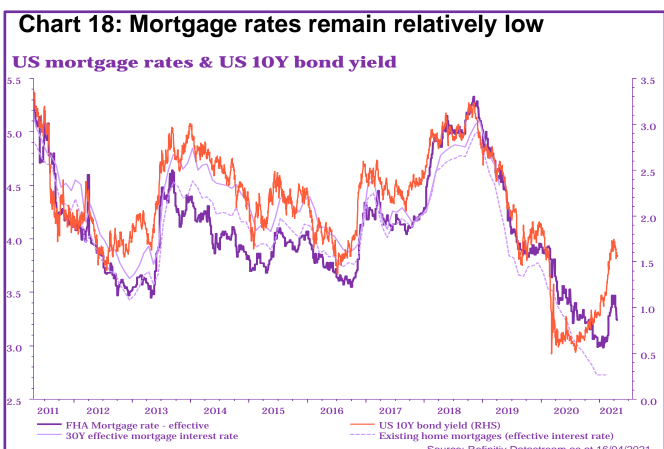
Source: Federal Reserve Bank of St. Louis, RLAM, as at Q4 2020.

Chart 20: Capex indicators elevated



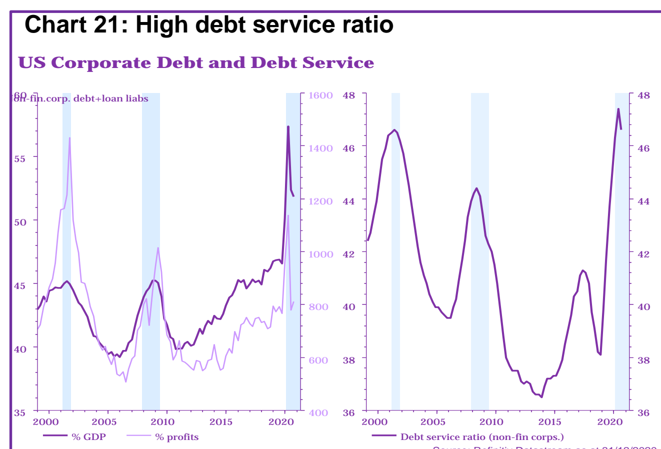
Source: Census Bureau as at 15/03/ 2021, BEA (Q1), survey sources as listed (April 2020)

Chart 18: Mortgage rates remain relatively low



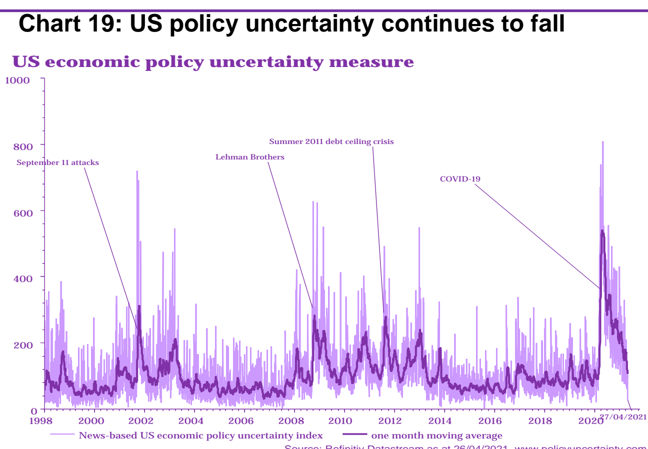
Source: Refinitiv Datastream, MBA, FHFA, NAR as at 16/04/ 2021.

Chart 21: High debt service ratio



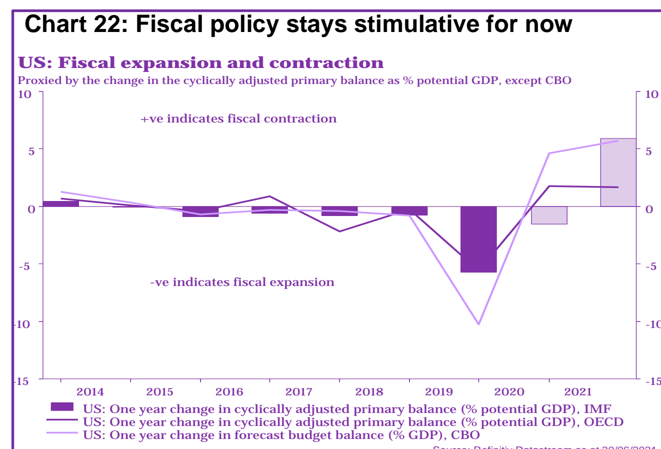
Source: Refinitiv Datastream, Federal Reserve, BEA as at 31/12/2020

Chart 19: US policy uncertainty continues to fall



Source: www.policyuncertainty.com; Refinitiv Datastream 26/04/ 2021.

Chart 22: Fiscal policy stays stimulative for now



Source: IMF (as at 07/04/2021), OECD (as at 01/12/2020) and CBO (as at 04/03/2021).

Monetary policy: Countdown to taper

The Federal Reserve (Fed) continue to buy assets and the policy rate remains extremely low. Official guidance from the FOMC and their own forecasts remain consistent (on the face of it) with no rate rises until after 2023.

The bar to prompt tapering asset purchases has been set much lower than that for raising rates. Chair Powell has emphasised that “substantial further progress” was needed towards their maximum employment and price stability goals to consider tapering. FOMC commentary suggests that it will be difficult for inflation to become a concern this year, already expecting inflation to “pop”. The labour market, however, may well tighten much faster than expected, given the US economy is set to reclaim post-crisis output levels soon. The FOMC forecast for the unemployment rate this year – at 4.5% – looks achievable, though lower than consensus expectations (4.8% in Q4 2021). However, some business survey measures already suggest a surprising amount of tightness in the labour market (Chart 23).

The central case baked into the forecast on page 2 is that tapering starts at the turn of this year, and for a rate rise in early 2023. The rate rise path is likely to be very gradual, however, partly reflecting likely higher levels of economic sensitivity to higher interest rates given high levels of corporate borrowing. Any concerns arising from a housing boom are expected to be met by regulatory measures rather than the too blunt tool of rate rises.

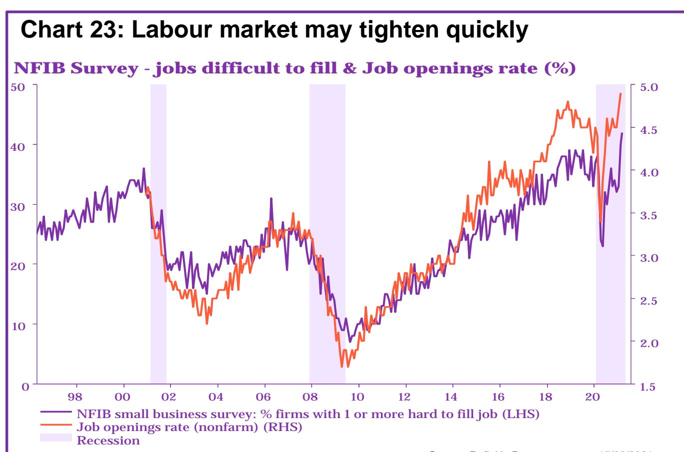
Why will the Fed hike rates before they say they will? Fed policy signals are not set in stone and inflation and/or labour market trends are likely to be enough to prompt a rate rise by 2023. As of March 2021, 7 out of 18 participants already expect a rate rise before 2024 (from 5 in December).

As well as the likelihood of reaching a relatively tight labour market relatively quickly (considering planned fiscal spend and economic resilience to date), the Committee’s views on inflation look vulnerable to challenge. Despite a very different fiscal policy backdrop and a new framework for monetary policy, they assume that underlying inflation dynamics are unchanged and that, even with a tight labour market, it will be hard to generate sustained above target inflation.

Inflation risks

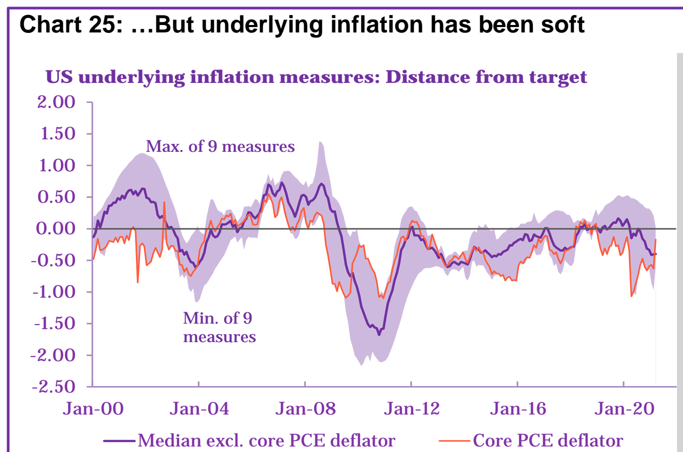
Survey-based measures of pricing continue to suggest a significant build in pipeline inflationary pressure, partly reflecting supply chain disruption (Chart 24). Added to significant energy price base effects, CPI inflation is likely to spike above 3% in 2021. Underlying inflation, however, has been subdued (Chart 25). Beyond this year, upside inflation risks look higher in the US than in Europe. The Fed’s inflation averaging framework also runs more risk that inflation expectations re-anchor at a higher level as the Fed tolerates a period of above target inflation. The US simply does not have the same low inflation problem that the Euro area does. Work by the Atlanta Fed continues to show that when a wide range of underlying inflation measures are used, the persistent below target inflation narrative is weaker (Chart 25). Fiscal policy has been strongly supportive over the crisis and non-crisis related fiscal spending is set to rise significantly beyond the crisis. If well designed and implemented effectively, the planned packages should stimulate supply as well as demand, softening the inflationary impact.

Chart 23: Labour market may tighten quickly



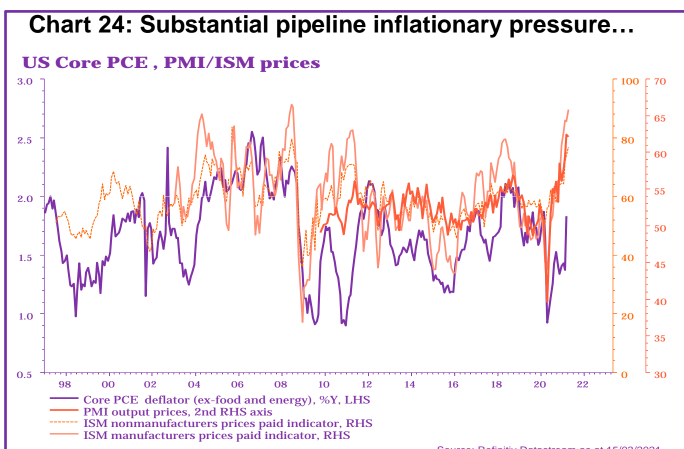
Source: NFIB, BLS, Refinitiv Datastream as at 15/03/2021

Chart 25: …But underlying inflation has been soft



Source: Atlanta Fed, RLAM. Data as at March 2021. March 2021 uses 8 measures on data availability issues. Distance from target is percentage point difference between measure of underlying inflation and- as calculated by the Atlanta Fed - the level equivalent to the FOMC 2% target for core PCE deflator.

Chart 24: Substantial pipeline inflationary pressure…



Source: Refinitiv Datastream, ISM, IHS/Markit, BEA, survey data as of April 2021, PCE deflator as of March 2021.

China: First in, first to lose a bit of steam?

China should see strong annual growth in 2021, as elsewhere, but the recovery has slowed and with less scope for gains given the extent of 'normalisation' already and as policy support fades somewhat.

Out of synch, losing steam

China's recovery has lost some steam. A stronger leg of the global recovery in H2 may not be so positive for China.

First-in, first-out recovery: China's level of GDP is already back above pre-crisis levels, helped by being first in-first out of the crisis, able to provide items demanded by the rest of the world as consumers spent on goods rather than services and as the world fought back against Covid (e.g. PPE). Keeping Covid numbers consistently low since Spring 2020has also helped the domestic recovery, as did policymaker support.

Running out of steam? Now, however, activity is already close to 'normalised', the industrial sector is already running 'hot' (Chart 26) and policymakers are pulling back somewhat. Recent data suggests further cooling in recovery momentum, including below peak PMI business survey readings (Chart 27). We may be in for a strong second half in developed economies but, if that sees widespread substitution from goods to services by consumers, external demand might become less of a support for China's economy than expected.

Policy less accommodative: Monetary policymakers have been emphasising policy continuity but, as global economic conditions improve, the policy stance may become less accommodative and total social financing growth decline further. The PBoC want to stabilise the macro leverage ratio, so it makes sense to expect overall credit growth to drift back more in line with nominal GDP growth. At the recent National People's Congress, some adjustment towards normalisation was signalled for the fiscal policy stance, but no U-turns. More financial regulation and a less stimulative fiscal stance seem likely as China heads through 2021, though that is in the context of what has been a relatively robust recovery.

External risks to recovery

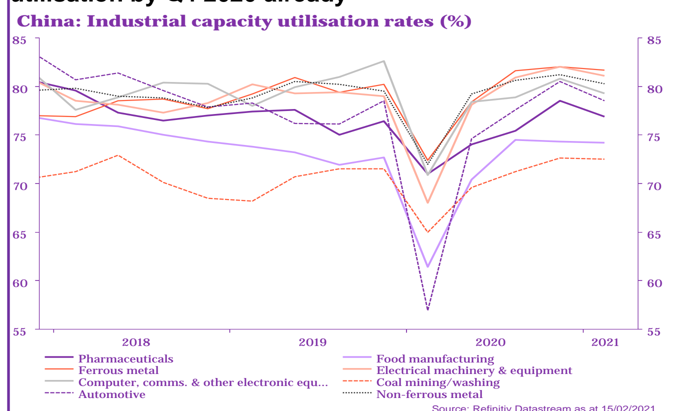
Beyond the risk of somewhat weaker external demand for consumer goods in H2, global supply chain issues may become more of an issue for China. Lengthening delivery times and shortages may cause more problems for the manufacturing sector in the short term. In the longer term, it may increase some overseas companies' willingness to review and simplify supply chains, bringing more production home.

There is little expectation that US tariffs on China will be significantly rolled back and relations are likely to remain tense. In his speech to the Munich Security Conference in February, Biden said that "We have to push back against the Chinese government's economic abuses and coercion that undercut the foundations of the international economic system". Taiwan could still be a trigger for US-China tension during the Biden administration.

Long-term challenges

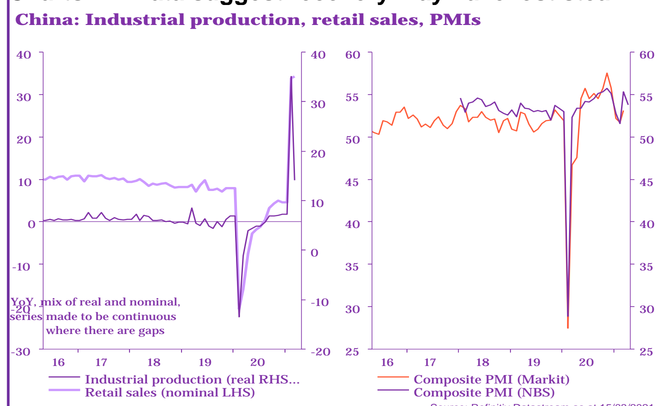
With corporate debt levels high in China and poor demographic trends, China's economic outperformance still looks at risk longer-term. Working age population growth has already been negative for several years, though higher retirement ages and productivity gains still have scope to limit the impact.

Charts 26: Industry was back to/above pre-crisis capacity utilisation by Q4 2020 already



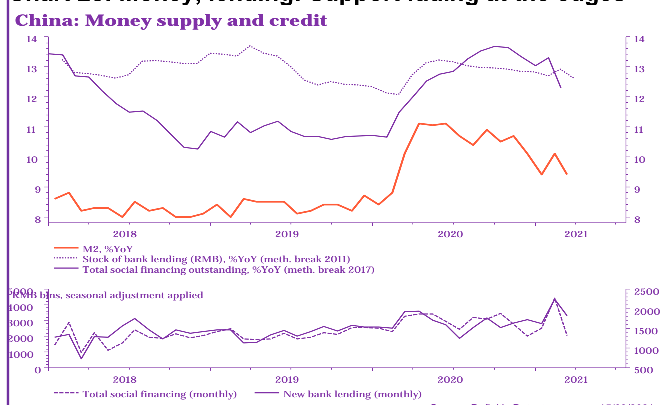
Source: Refinitiv Datastream, NBS as at Q1 2021.

Charts 27: Data suggest recovery may have lost steam



Source: Refinitiv Datastream, IHS Markit, NBS, as at March/April 2021.

Chart 28: Money, lending: Support fading at the edges



Source: Refinitiv Datastream, Peoples Bank of China as at 15/03/2021.

Euro area: Ready to rebound

A Q1 Covid wave and slow vaccine rollout have held back the Euro area recovery, although recent data have been surprisingly resilient. Prospects are good for a strong 2H. Policy is set to remain supportive. Political risks to the outlook include a worsening in UK-EU relations and this year's German elections.

Recent lockdowns less damaging

Overall levels of activity had not fully recovered to pre-crisis levels before the second round of lockdowns, let alone made up for lost ground in the spring. *Parts* of the economy had, however, reached or were close to pre-crisis levels of activity by the turn of the year (Chart 29). The Q4 2020 and Q1 2021 data confirmed relatively modest economic damage from the Q4 into Q1 lockdowns. Q4 and Q1 GDP each fell less than 1% quarter-on-quarter (Chart 30). A resilient manufacturing sector has helped, effectively shrugging off the last two Covid waves.

March and April business surveys suggest a significant pick up in activity going into Q2 2021 (Chart 31), despite still substantial Covid case numbers, lingering tight social distancing restrictions in some parts of Europe and evidence of some supply chain disruption for the manufacturing sector.

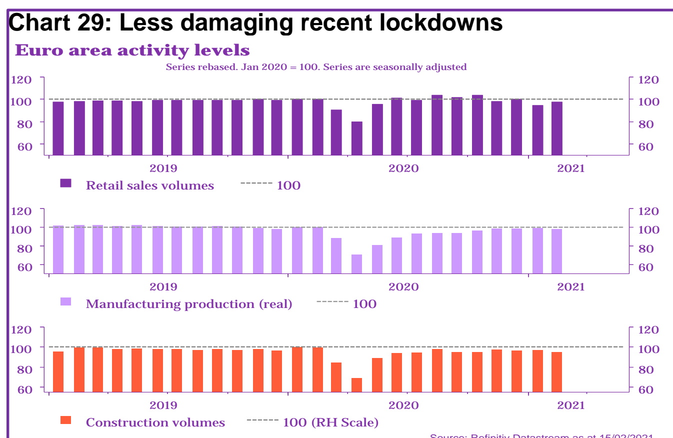
Slow vaccine rollout unhelpful for economy

The recovery will likely be held back for as long as Covid remains a substantial threat – through lingering social distancing (mandated and voluntary). In contrast to the UK and US, Euro area new Covid case numbers rose from the middle of February, through March. As the trends in new case numbers diverged, the easier it has been to make the link, exaggerated or not, between that and the difference in speed of vaccine rollout. By end-April, some 29% of the US population had been fully vaccinated against Covid. The equivalent figure for Germany was 7%.

A better H2 2021

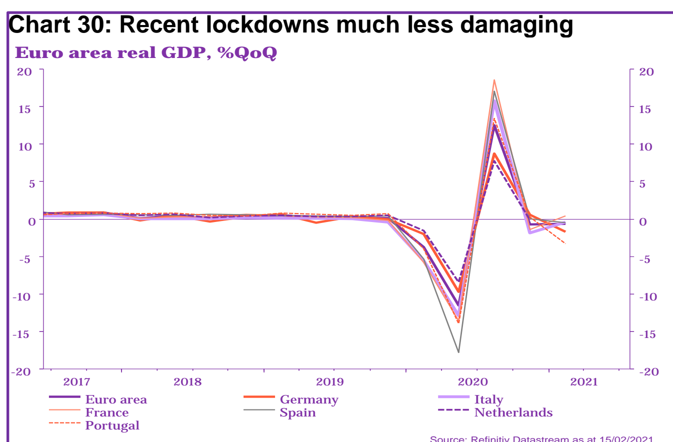
The EU's vaccine programme is now making more progress. By Q4 2021, the speed of vaccine rollout should matter less, with any differences between UK, US and Euro area vaccination data then reflecting residual vaccine reluctance more than speed of rollout. Vaccine programmes in the EU are likely to accelerate further in Q2 as vaccine delivery schedules step up. Once a large proportion of the population is vaccinated, governments will be more able to contemplate a substantial and sustained reduction in social distancing restrictions. The forecast on page 2 still builds in a strong rise in GDP in H2 2021 reflecting the assumption that EU vaccination targets will be met; that, as elsewhere, the consumer looks well placed to recovery strongly; and that the region stands to gain indirectly from a strong US economy.

Chart 29: Less damaging recent lockdowns



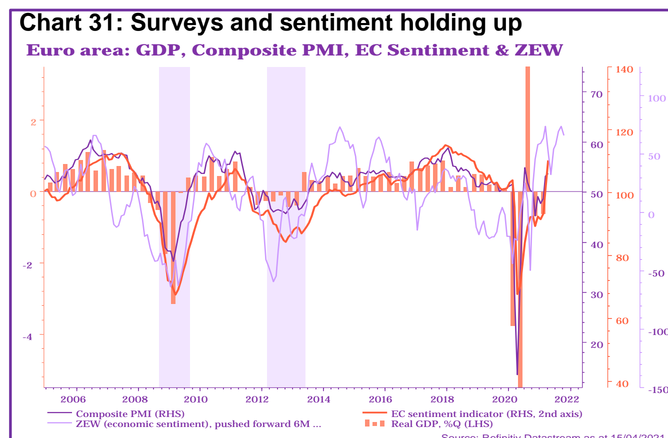
Source: Refinitiv Datastream, Eurostat as at 15/02/2021.

Chart 30: Recent lockdowns much less damaging



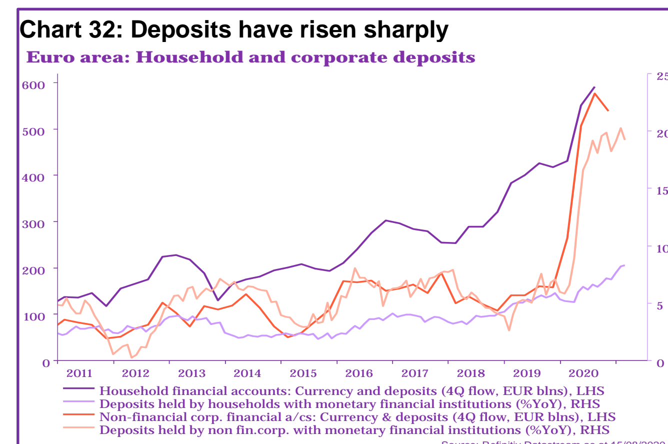
Source: Refinitiv Datastream, national statistics offices as at Q4 2020.

Chart 31: Surveys and sentiment holding up



Source: Refinitiv Datastream, IHS Markit, ZEW, European Commission, Eurostat as at 15/04/2020.

Chart 32: Deposits have risen sharply



Source: Refinitiv Datastream, ECB. Deposit flow data as of Q3, deposit growth as of Feb 2021.

Storing up issues or fuel for recovery?

As elsewhere, household finances look robust in aggregate, with potential firepower for the recovery in the shape of the partly involuntary build in savings over the period of social distancing restrictions. While a build-up in corporate deposits is also visible (Chart 32) – and strong – that has been accompanied (partly driven) by some companies borrowing more (Chart 33). That leaves firms with resources to fuel investment, but some – especially smaller firms - are also likely to be left mired in debt acquired to survive Covid.

Indicators of investment intentions have been strengthening, but still indicate a relatively weak bounce in year-on-year capex given the scale of the decline in Spring 2020 (Chart 34)

External demand supportive

Export exposure to the US and China should bolster the Euro area recovery. Trade with the UK has been disrupted by Brexit, but the UK looks set for a relatively strong economic recovery too. The resulting increase in external demand for euro area goods and services is likely to make up for some of the border disruption. A strong euro remains something of a threat, as do supply chain problems and UK-EU tensions that threaten to upset the chance of dealing swiftly and pragmatically with any problems arising from the implementation of the new trading relationship between the two regions.

Economic policy: Remaining supportive

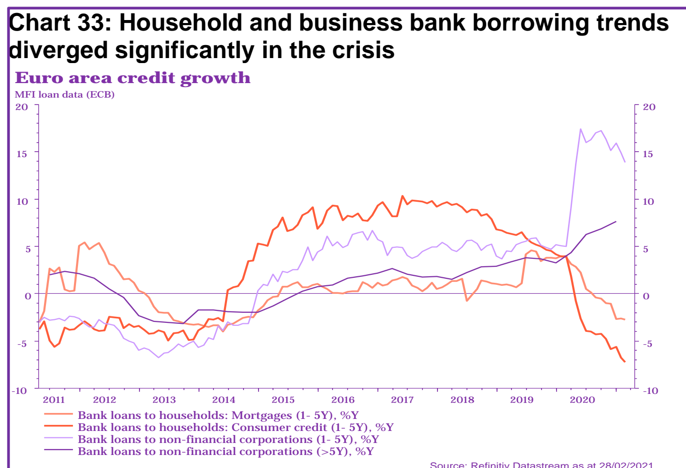
Fiscal policy is set to become less supportive as some Covid crisis support measures roll off. However, the EU's Recovery and Resilience Fund only kicks in this year and provides some offset, leaving the transition in fiscal policy stance set to be less sharp than in the UK for example. Distributions from the programme are tied to structural reform targets, hence the programme might also help improve the Euro area's medium-term growth prospects.

ECB President Lagarde continues to describe financial conditions as the "compass" for asset purchases. The rise in bond yields earlier in the year was duly met by increased asset purchases. The forecasts on page 2, however, do not assume a further expansion in the overall size ('envelope') of the asset purchase programme given prospects for a strong H2 2021 Euro area recovery look intact for now.

Political risk

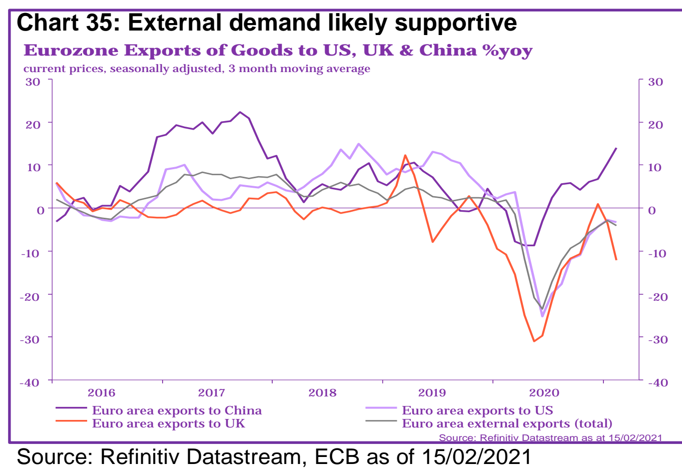
Elections this year include a general election in Germany in September. On current polls, the next German Chancellor may be from the Green Party. That would likely raise expectations of more fiscal spending and a more sustained looser fiscal stance. Italy has become less of source of risk under Draghi, who garnered support across the political spectrum.

Chart 33: Household and business bank borrowing trends diverged significantly in the crisis



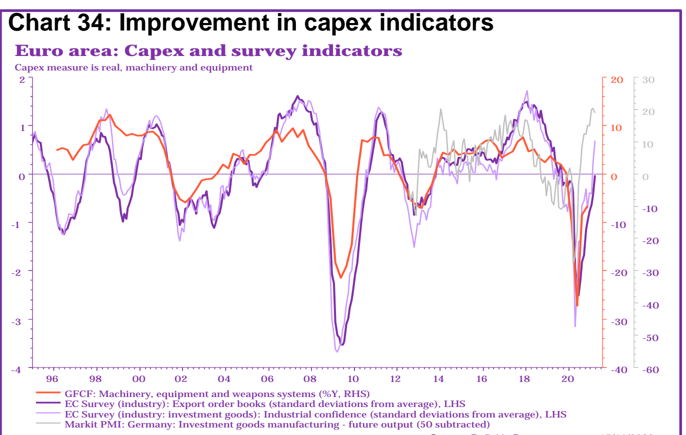
Source: Refinitiv Datastream, ECB as at 28/02/2021

Chart 35: External demand likely supportive



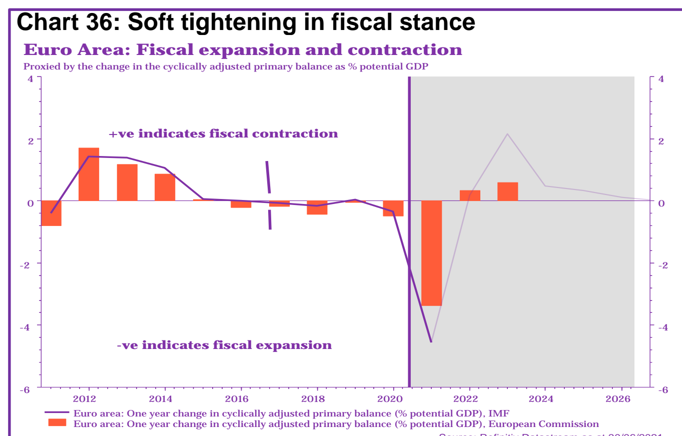
Source: Refinitiv Datastream, ECB as of 15/02/2021

Chart 34: Improvement in capex indicators



Source: Refinitiv Datastream, Eurostat, European Commission, Markit. Gross fixed capital formation (GFCF) as of Q4 2020, survey data is for March/April 2021

Chart 36: Soft tightening in fiscal stance



Source: Refinitiv Datastream, IMF (updated 07/04/21), European Commission (5/11/20)

Japan: Vaccine hold up

A slow vaccine rollout threatens the pace of recovery, but Japan is nevertheless likely to reach pre-crisis 2019 GDP levels in 2022 against a supportive policy backdrop and stronger external demand.

Bumpy recovery

Japan's economy has recovered relatively well so far from the Covid hit, helped by sustained relatively low Covid case numbers and fiscal support. Japan has nonetheless struggled to get on top of its more recent Covid wave and state of emergency declarations have caused some volatility in the data. After 11.7% QoQ annualised GDP growth in Q4, above consensus, the forecasts on page 2 assume a contraction in Q1 2021 as state of emergency restrictions were re-imposed. However, that contraction looks likely to be mild. Industrial production bounced in March (Chart 37), consumer confidence remains well off the lows, labour market data has improved and business surveys don't look consistent with much of a hit to GDP in Q1, for example the Economy Watchers survey has improved sharply (Chart 38).

As elsewhere, consumption and capex seem likely to pick up as the year progresses, alongside the vaccination programme and better external demand. The GDP level looks likely to exceed 2019 levels in 2022.

Risks around vaccines, Olympics

The vaccine rollout has, so far, been relatively slow, raising the risk that Japan fails to avoid another Covid wave in coming quarters. Alongside a globally very uneven vaccine rollout, that raises the risk too that restrictions on tourism will be extended. Spectators from overseas have already been barred from the Tokyo Summer Olympics and domestic spectator levels may yet be strongly limited, all limiting any expected gains to consumer spending from ticket sales and tourism.

Policy backdrop remains supportive

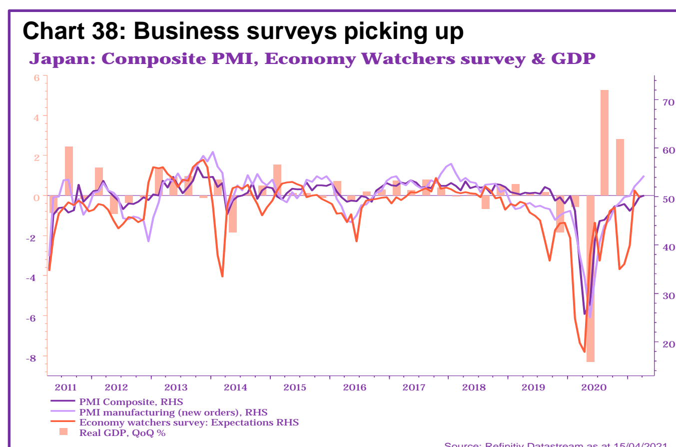
Bank of Japan policy settings remain very accommodative, even after policymakers increased some of the flexibility around policy settings after their policy review, allowing a slightly wider band for JGB yields. As with other central banks, the BoJ are expected to look through any boost to headline inflation driven by temporary energy price base effects. Core inflation remains subdued and given the difficulty in emerging from past periods of deflation, it seems likely that the policy stance remains very accommodative for the horizon of the forecasts on page 2.

Government policy remains supportive and the 'Go To' travel supplements are likely to resume in coming months. Another supplementary budget later this year looks less likely assuming that Japan's recovery remains roughly on track. The third supplementary budget was only passed in January and should already limit fiscal drag later this year after a strong year of fiscal stimulus in 2020.

Long-term prospects not as bad as they look

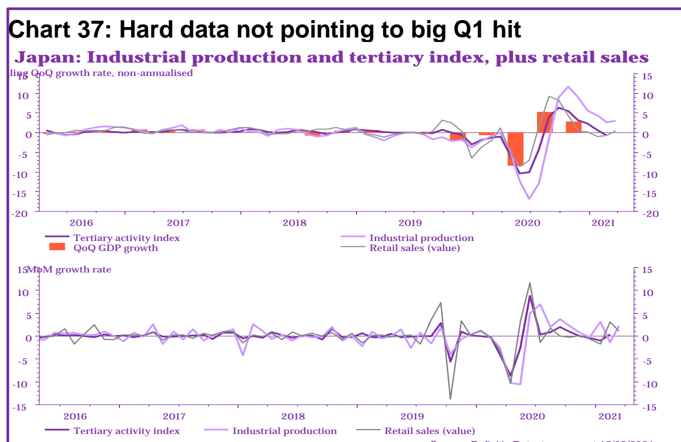
Japan still faces a severe demographic challenge. However, more immigration, higher female labour participation and high labour force participation from the over 65s, have helped to limit the implications for the labour force (Chart 39). Japan's productivity growth needs to improve to sustain growth rates, but there is some prospect for upside if the government's reform agenda succeeds.

Chart 38: Business surveys picking up



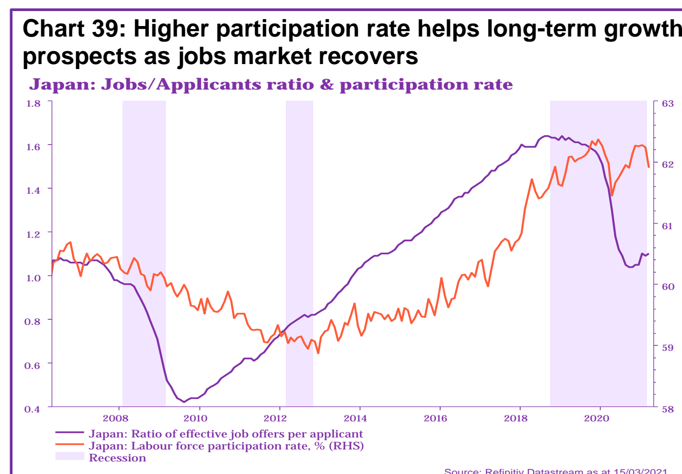
Source: Refinitiv Datastream, IHS Markit, Cabinet Office. GDP to Q4, Economy Watchers data as of April 2020.

Chart 37: Hard data not pointing to big Q1 hit



Source: Refinitiv Datastream, METI, Cabinet Office as at 15/2/2021.

Chart 39: Higher participation rate helps long-term growth prospects as jobs market recovers



Source: Refinitiv Datastream, Japan institute for Labour Policy and Training, Statistics Bureau – Ministry of Internal Affairs & Communication as at 15/02/2021

United Kingdom: Looking up

UK recovery prospects have improved with the very successful vaccination drive, and the 2021 UK GDP forecasts has been revised up, building in a more front-loaded recovery. The forecasts on page 2 assume that UK GDP gets back to pre-crisis levels in Q1 2022, earlier than previously forecast. There are clearly still risks and the UK economy has a lot of ground to make up. Policy is set to get less supportive and inflation may rise more than expected.

Ready to bounce

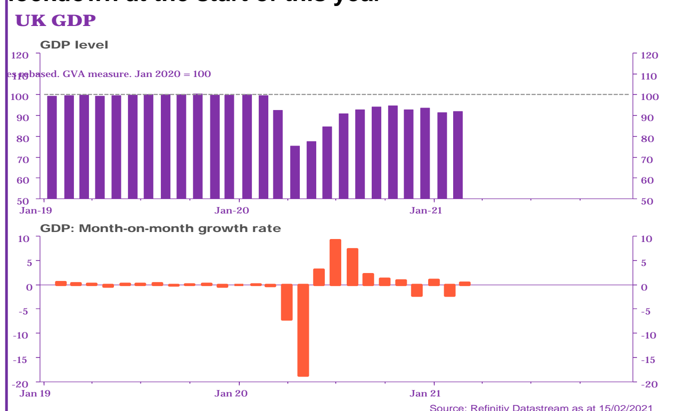
After yet another lockdown, the government's "roadmap" for easing social distancing restrictions – combined with a surprisingly successful vaccination drive (Chart 4) and a sharp fall in Covid case numbers – are consistent with an earlier and stronger 2021 bounce than previously forecast. GDP growth surprised on the upside in December and January (Chart 40). Business surveys have bounced strongly (Chart 41). The UK economy has plenty of room to grow, with GDP still nearly 8% below pre-crisis levels as of February and, as elsewhere, households, in aggregate have built up substantial stocks of savings that could fuel a boom.

Business survival and debt: Concern lessened

The outlook for business investment has improved. That reflects a growing ability to see the 'light at the end of the tunnel on COVID, combined with short-term incentives to bring forward investment in the March 2021 Budget and the extension of COVID relief grants (and the furlough scheme). Business optimism has risen since the Autumn (Chart 7), likely helped by the UK's vaccine rollout and the government's 'roadmap' for exiting COVID restrictions – which, so far, looks on track given the fall in Covid case numbers (Chart 2).

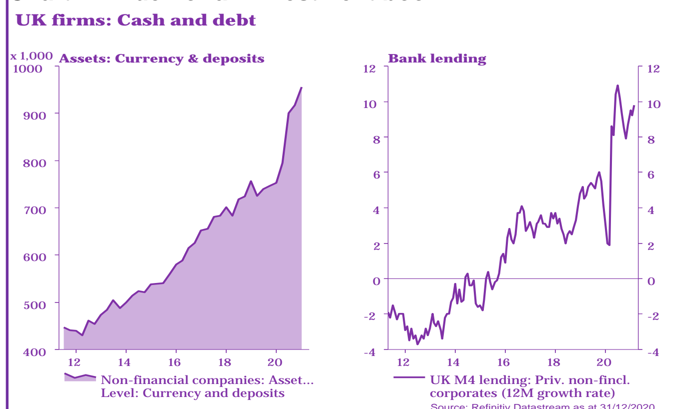
Some firms will have built up sizeable cash reserves that they can deploy in 2021/22 (Chart 42). The distribution of that cash is unclear, but ONS data suggest companies in the food services/accommodation industry, as well as construction and arts/recreation were more likely to say they had less than 3 months of cash reserves and that small businesses are more likely to have low levels of cash reserves. Changing trade relations with the EU may continue to inhibit some investment decisions, as may debt levels at some companies. However, the Chancellor introduced a temporary investment incentive at the March Budget. Firms can offset 130% of investment spending against profits (expected to cost the UK £12bn a year in lost tax revenues) which should bring forward some investment from later years.

Chart 40: Activity weak and bumpy as the UK went back into lockdown at the start of this year



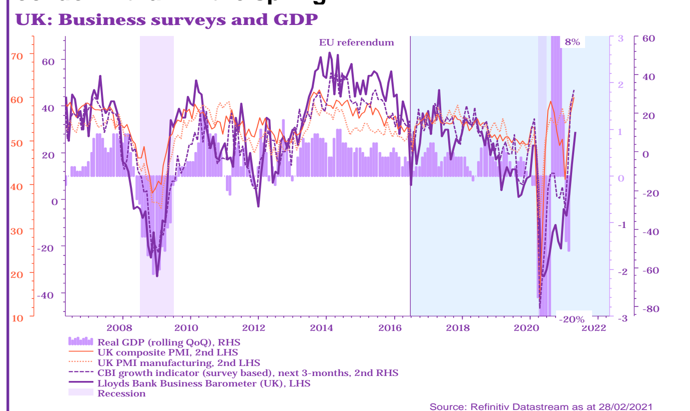
Source: ONS, Refinitiv Datastream (data to February 2021).

Chart 42: Fuel for an investment boom?



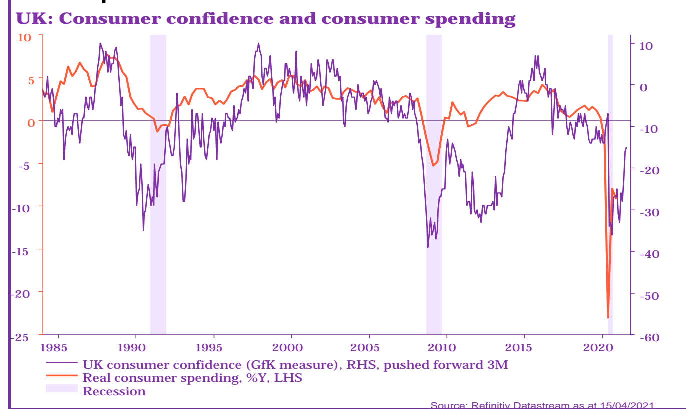
Source: Refinitiv Datastream, ONS, BoE, RLAM. Assets to Q3, bank lending to Jan 2021.

Chart 41: Surveys suggest firms adapting better to this lockdown than in the spring



Source: Refinitiv Datastream as at 28/2/2021; IHS/Markit PMI data to April 2021

Chart 43: Consumer confidence becoming less of a drag on consumption



Source: Refinitiv Datastream, ONS. Spending to Q4, consumer confidence to 15/04/2021.

Consumer a source of upside risk, as elsewhere

A damaged labour market, let alone only partial ease of social distancing, are likely to work against a full consumer recovery for now. However, by the second half of the year, the vaccine programme expected to have reached most of the adult population. Social distancing is on track – for now at least – to have been almost fully eased by late June 2021. Consumer confidence seems likely to rise further, having already risen close to pre-crisis levels (Chart 43).

Beyond re-opening, the biggest source of potentially strong consumer spending growth comes from the likelihood that UK households will start to save less and the chance that they run down some of substantial stock of savings built up over the crisis (Chart 44). The amounts involved are not small. The distance to the trend line of the stock of household currency and deposits shown in Chart 44 for the UK is now equivalent to some 3% of GDP. However, the forecasts on page 2 assume that households do not substantially spend down deposits:

- From a worker perspective, some will have been subject to very high levels of income uncertainty with not just their workplaces, but whole industries shutdown with little notice. That may have a lasting effect on spending and saving preferences.
- This build in savings has been skewed towards wealthier households, such that any unwind may find its way into asset markets and housing more than consumer spending.
- Bank of England survey data suggest that more than half households that have increased their savings say they will save some and only a quarter say they will spend some.

2021 – the downside risks to recovery

The largest threat to a sizeable 2021 bounce in activity – as elsewhere – remains the virus. The UK government is signalling a full easing of social distancing restrictions by late June before the adult population is fully vaccinated (on current targets). Arguably, that runs some risk of more vaccine-resistant variants gaining ground, especially alongside a very incomplete vaccine rollout globally and with hotel-based quarantine only required for travellers that have visited a 'red list' countries.

As elsewhere, business investment may recover more slowly than expected given the build-up of debt. For the UK, there is also still the added dimension of Brexit, which will be disruptive for the economy as businesses continue to adjust to new EU-UK trading arrangements.

There are significant sources of uncertainty for the consumer outlook too. The underlying state of the UK labour market, for one, is unclear. Government intervention – largely via the furlough scheme – has been so significant that headline unemployment and employment data tell us little about any long-run damage to the labour market (or what the ultimate effect of the Covid-crisis will be on supply).

Policy getting less supportive

For now, policy stimulus is still being added to the economy, but the fiscal stance is set to tighten later this year (Chart 45) as Covid programmes like the furlough scheme roll off. Additional fiscal tightening is planned by the government from 2023. The Bank of England is starting to taper its asset purchases and expects to complete its QE asset purchase programme this year.

Plenty of support for now: The Chancellor added significantly more near-term fiscal stimulus than expected in the March 2021 Budget (£60bn, or ~3% GDP). He extended various Covid relief schemes, including the furlough scheme which will now end in September (rather than April).

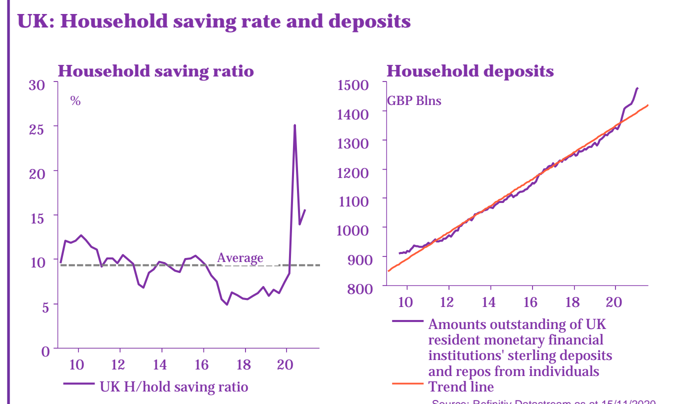
The Bank of England, meanwhile, has been buying government bonds in volumes that are equivalent in size to a very large proportion of government issuance (Chart 46), helping to keep government funding costs contained.

Next BoE move likely a tightening: BoE guidance wording is loose enough that a rate rise is plausible for 2022 ("clear evidence" of "significant progress" in eliminating spare capacity and achieving 2% inflation "sustainably), though early 2023 is assumed in the page 2 forecasts. The forecasts on page 2 assume no further QE extension once the current purchase programme finishes this year.

The MPC have also asked BoE staff to review guidance on tightening policy. It currently says rate rises come first, with the stock of asset purchases unchanged until rates reach a level from which they can be cut materially, pegged at 1.5%. Presumably, once negative rates are firmly in the toolkit, as they are expected to be by the summer, that 1.5% will be lowered. However, it is possible that they move away from signalling rate hikes come first at all. Either change would alter (lower or delay) the expected rate hike path.

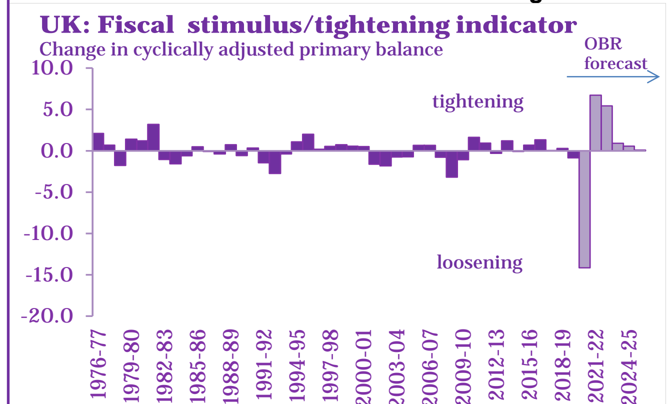
The interaction of public sector finances and QE is among factors limiting any rise in rates: Public sector finances have become more sensitive to short term interest rates thanks to QE, where BoE purchases of government bonds have been financed by the creation of central bank reserves that are paid the policy rate. Long maturity government debt has effectively been refinanced with short-term debt. The OBR now estimate that, as a result, a 30bp increase in the BoE's policy interest rate would add £6.3 billion to the government's interest bill.

Chart 44: Fuel for a consumer boom?



Source: Refinitiv DataStream, ONS, BoE, RLAM. Saving ratio to Q4, deposits to January 2021.

Chart 45: Sizeable shift in fiscal stance coming



Source: OBR, March 2021

Fiscal policy set to become less supportive this year: The Chancellor has developed a habit of extending Covid relief measures, including the furlough scheme, when the economy suffers a set-back. It is hard not to assume that the Chancellor will be pragmatic and extend again if the economy is struggling. However, with a strong recovery in GDP growth likely over the rest of the year another extension is not central case. Some increase in unemployment is therefore likely with the furlough scheme starting to roll off in the summer, before the economy is likely to be operating at pre-crisis levels and able to support the return to work of all those on furlough.

Itching for further fiscal tightening? In the March 2021 Budget, the Chancellor announced tax rises from 2023, further signalling an intention to improve the fiscal finances. By the end of fiscal year 2025, however, the OBR's (Office for Budget Responsibility) forecast deficit is still around 3% and debt still above pre-crisis norms. With OBR longer term forecasts continuing to suggest that the UK is on an unsustainable fiscal path (largely driven by demographics), there is every chance that more planned tightening measures are announced.

Brexit drag

The change in EU-UK trade relations, with accompanying barriers to trade and potential for these to worsen as standards diverge, is expected to be a relatively long-term drag on GDP and to cause a larger permanent loss in output than the Covid crisis. However, the annual effect on growth is likely to be small on average. The Q1 2021 effects of Brexit are expected to have been more significant though, as the worst of the transition effects were likely experienced alongside substantial port delays and global supply chain problems. The BoE, for example, had been expecting a short-run hit to output in Q1 of 1% of GDP. January data showed a big hit to UK-EU trade with goods exports from the UK to the EU down around 40%, though that will have partly reflected activity having been brought forward to Q4 2020.

Disagreements around the implementation of new trade rules in Northern Ireland have already caused some additional EU-UK tension. A broad deterioration in trade relations could worsen the effects of Brexit further, hampering attempts to find pragmatic solutions to issues as they arise.

Inflation: Added risk in a strong recovery

The forecasts assume that inflation rises in the near-term but does not stay sustainably high, assuming it will take time to return to a fully tight labour market and that many of the long-run drags on inflation remain (see global section). On balance though, risks are on the upside to that view.

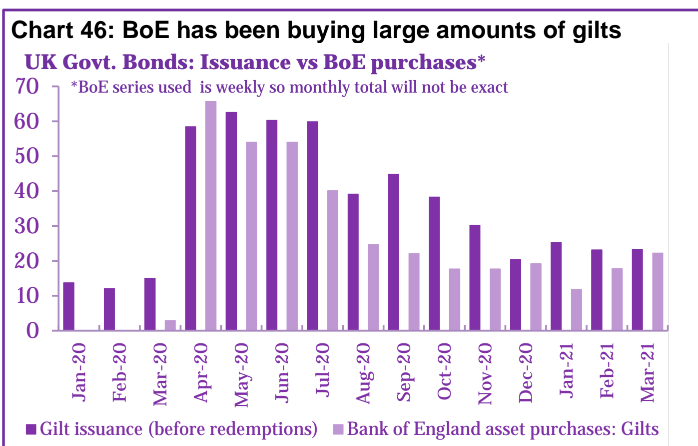
The UK doesn't have a low inflation problem: CPI inflation has averaged 2%Y since the early 1990s. Even focusing on the period after the financial crisis, headline CPI inflation has averaged a little above the Bank of England's 2%Y target and even core inflation has averaged 2%Y.

But inflation not as resilient as it looks: However, until the 2016 Brexit referendum, core inflation had drifted steadily lower since 2011 and appeared to be stabilising just above 1%Y. The sharp sterling devaluation that followed the referendum, helped core inflation rise above 2% after a year. Since 2018, however, core inflation has been on a downward trend (Chart 47) and our measure of core services inflation has been declining on average since before the financial crisis.

Phillips curve is alive – a strong recovery would matter: With the level of GDP significantly below pre-crisis levels for now and the unemployment rate above the pre-crisis average even with the flattering effects of the furlough scheme and increase in inactivity, a strong return of domestic underlying inflationary pressure isn't an obvious risk for the next 12-18 months. However, the negative relationship between the unemployment rate and pay growth was reasserting itself strongly in the five years before the Covid crisis. A strong economic recovery that saw the unemployment rate rapidly return to the 3-4% rates prevailing before Covid could be expected to see strong sustained pay growth re-emerge (headline pay growth looks strong now, but figures are flattered by the lower proportion of low paid workers).

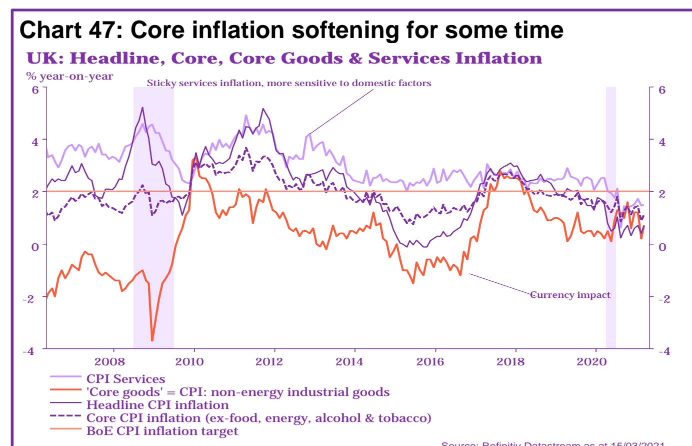
Immigration accelerator: Meanwhile, evidence suggests that large numbers of overseas workers have left the UK during the crisis. The UK has also overhauled its immigration regime. These changes look likely to make the UK's labour market less flexible, less market-driven and less responsive to changing economic conditions. Without the 'escape valve' of unrestricted migration to and from the EU, it is plausible that the UK's equilibrium unemployment rate may shift and pay growth become more responsive to domestic economic conditions in coming years – a source of potential upside inflation risk in periods of robust economic growth.

Chart 46: BoE has been buying large amounts of gilts



Source: BoE, DMO, IHS/Markit, Refinitiv Datastream as at March 2021.

Chart 47: Core inflation softening for some time



Source: ONS, Refinitiv Datastream as at March 2021.

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Derivative Risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both Fund losses and gains. The impact to the Fund can be greater where they are used in an extensive or complex manner, where the Fund could lose significantly more than the amount invested in derivatives.

Credit Risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

EPM Techniques: The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

Exchange Rate Risk: Changes in currency exchange rates may affect the value of your investment.

Interest Rate Risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity Risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Emerging Markets Risk: Investing in Emerging Markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

Fund investing in Funds Risk: The Fund is valued using the latest available price for each underlying investment, however it may not fully reflect changing stockmarket conditions and the Fund may apply a 'fair value price' to all or part of its portfolio to mitigate this risk. In extreme liquidity conditions, redemptions in the underlying investments, and/or the Fund itself, may be deferred or suspended.

Liquidity and Dealing Risk: The Fund invests indirectly in assets that may at times be difficult to value, harder to sell, or sell at a fair price. This means that there may be occasions when you experience a delay in being able to deal in the Fund, or receive less than may otherwise be expected when selling your investment.

Investment risk: The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

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