Investment Clock – Economic Update

Issue #23, September 2021

Not so fast

Delta looks set to dent growth, but reasonable, though slower, rates of growth look likely over the rest of this year into 2022. That reflects supports in place – from accommodative monetary policy and strong aggregate household balance sheets to significant vaccination coverage in developed economies. However, central banks in the US and UK are edging closer to tightening monetary policy; fiscal policy is set to become less supportive. High inflation is still assumed transitory, but strong short-term inflationary pressure may persist well into 2022 as supply chain problems and labour market shortages linger.

Summary

Delta dents, rather than derails recovery…: Despite delta's dampening effect on growth, there are still reasons to expect reasonable, albeit slower growth in the second half of this year into 2022 in major economies. Vaccine rollouts should permit more and more countries to return to 'normal' patterns of activity. Monetary policy remains supportive. The consumer is likely to be a driver of growth. Business investment is also likely to become a more supportive part of the global recovery story.

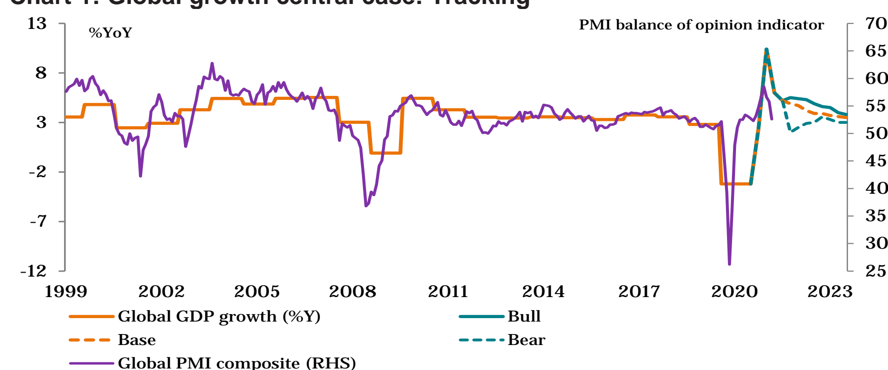
…but supply chain problems biting: Supply chain issues appear to be a significant and inflationary drag on output. For now, supply seems not able to keep up with demand for reasons that seem to largely trace back to Covid. This may ease as continued recovery sees a switch in demand towards services, away from goods. However, Covid is also hindering labour supply (from the UK's so-called 'pingdemic' to fear of taking up employment in sectors requiring more face-to-face interaction). Supply chain problems and labour market shortages may remain problematic – and inflationary – well into 2022.

Still sanguine on inflation: Inflation is already stronger and lingering at high levels longer than expected. *Underlying* inflationary pressures are likely to grow, even as Covid-driven inflation fades. There is still a risk of a lingering sustained rise in inflation expectations given loose policy combined with current high inflation. However, sustained high inflation would likely see central banks tighten much more strongly than in the base case.

Where in the cycle? Current late-cycle features e.g. high inflation and labour market shortages should ease, but it is hard to envisage the global economy in 2022 looking like it is in the early stages of recovery instead. It may turn out that we are just in a short cycle compared to the rather long cycles we've gotten used to in recent years. In which case, we may be closer to cycle-slowing central bank tightening too. For more on how to position for that possibility, see the July Investment Clock Strategy update.

Our multi asset team hold a small overweight in stocks, which continue to face two-way risk. Strong earnings could see equities grind higher but fears of policy tightening or negative virus developments could see markets pull back. The team are modestly overweight commodities and underweight bonds, given the expectation of further recovery and central bank tightening ahead. See www.investmentclock.co.uk

Chart 1: Global growth central case: Tracking



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

Multi asset views from RLAM

Royal London Asset Management manages £153.4 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 30 June 2021

This month's contributor

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US: Delta is a significant risk to growth, but with little to no prospect of lockdowns, growth is expected to remain robust, if slower. Asset purchase tapering approaches by year-end.

China: Delta, and China's zero tolerance approach to it, has damaged the recovery. Looser policy settings should help.

Eurozone: High vaccine rates have bolstered recovery resilience, though policy is set to get less supportive in 2022.

Japan: The recovery has been hampered by repeat Covid waves amid a lagged vaccination rollout. Prospects are improving. Politics in focus in H2.

UK: The delta variant remains a threat to the outlook but seems to be a diminishing one with the UK achieving relatively high levels of vaccination. Fiscal support is about to be cut though.

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

Economic forecast summary

Chart 1: September 2021 base case

Region	2020			2021			2022			2023		
	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4
US	-3.4	1.3	0.25	6.0	5.1	0.25	4.0	2.2	0.25	2.6	2.4	0.75
	(-3.4)	(1.3)	(0.25)	(6.0)	(2.0)	(0.25)	(3.5)	(2.4)	(0.25)	–	–	–
China	2.3	0.1	–	8.9	2.4	–	5.3	1.9	–	5.1	–	–
	(2.3)	(0.1)	–	(8.0)	(1.9)	–	(5.2)	(1.9)	–	–	–	–
UK	-9.8	0.5	0.10	6.7	3.3	0.10	4.8	2.1	0.10	1.6	2.0	0.50
	(-10.0)	(0.5)	(0.10)	(4.1)	(1.6)	(0.10)	(6.0)	(1.9)	(0.10)	–	–	–
Euro area	-6.5	-0.3	0.0	4.7	3.0	0.0	3.7	1.4	0.0	1.9	1.5	0.0
	(-6.8)	(-0.3)	(0.00)	(4.1)	(0.9)	(0.0)	(3.6)	(1.1)	(0.0)	–	–	–
Japan	-4.7	-0.9	-0.1	2.5	0.8	-0.1	2.6	0.5	-0.1	0.9	0.3	-0.1
	(-5.2)	(-0.9)	(-0.1)	(3.2)	(0.4)	(-0.1)	(2.3)	(0.6)	(-0.1)	–	–	–
Global	-3.3	–	–	6.0	–	–	4.5	–	–	3.7	–	–
	(-2.9)	–	–	(5.5)	–	–	(4.5)	–	–	–	–	–

Source: National Statistics offices, RLAM forecasts; May 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 regaining or close to regaining pre-crisis output levels, and with inflation above target in many cases – even while not expected to be sustainably so, rate decisions become 'live' in 2022.
- The forecasts assume that the Bank of England and US Federal Reserve (Fed) will raise rates well ahead of the ECB (by early-2023), but that no developed economy central banks will raise rates rapidly.
- The forecasts assume that asset purchase programmes continue through 2021, ending this year for the BoE, and within the first half of 2022 in the US, while continuing for longer at the ECB.
- Fiscal support is expected to reduce dramatically 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 2021-23 (Chart 1)

Upside scenario (20% probability): Consumption-fuelled boom; 'Goldilocks' outcome for inflation

- 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.
- Policymakers remain cautious, however, and do not start removing stimulus much earlier than in the base case.
- Inflation is somewhat higher in this scenario as growth runs above potential, but a faster recovery of supply and higher productivity growth help to contain inflationary pressure.

Base case (60%): Reasonable recovery

- The delta variant dents growth in 2021. However, the second half of 2021, into early 2022 is expected to see reasonable – albeit slower – rates of economic growth in major economies as vaccine rollouts support more and more countries returning to more 'normal' activity patterns. That recovery is supported by robust consumer spending and a pick-up in fixed investment.
- 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 sustained jump in inflation expectations and it takes longer for labour market tightness to *sustainably* hit pre-crisis levels than it does for GDP.
- Fiscal policy becomes rapidly less supportive, but non-Covid public spending is not cut sharply over the coming twelve months or taxes raised significantly in 2021-22.

Downside scenario (20%): Recovery disrupted again by vaccine-resistant variants

- More vaccine resistant strains become dominant, and outbreaks lead to more (and lingering) social distancing measures than in the base case. Consumer spending and business investment growth are substantially weaker than in the base case.
- Government support remains in place for longer, even if somewhat less generous than in the first wave of the crisis. Central banks keep policy settings loose.
- Inflation struggles to stay above central bank targets, though supply chain problems recur.

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 case.

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Global economy: Not so fast

The recovery's progress has become increasingly marred by the rise of the delta variant, working against a rapid shift to normal patterns of economic behaviour – whether in the shape of social distancing restrictions or voluntarily more cautious behaviour. Partly related supply shortages are also hindering the recovery and making it more inflationary. The forecasts on page 2, however, still envisage a relatively robust end to the year as vaccine rollouts help more countries move away from the threat of lockdowns. Delta is ultimately expected to dent, rather than derail the global economy. Supply chain problems may remain problematic though – and inflationary – well into 2022.

From optimism to caution (again)

The global recovery gained pace in late Q1 into Q2, H1 GDP growth stronger than expected at the time of the last set of forecasts in May. European economies reopened after lockdowns, the US embarked on another big round of fiscal stimulus. Vaccine programmes progressed, raising hopes of a 'return to normality' in the second half of the year.

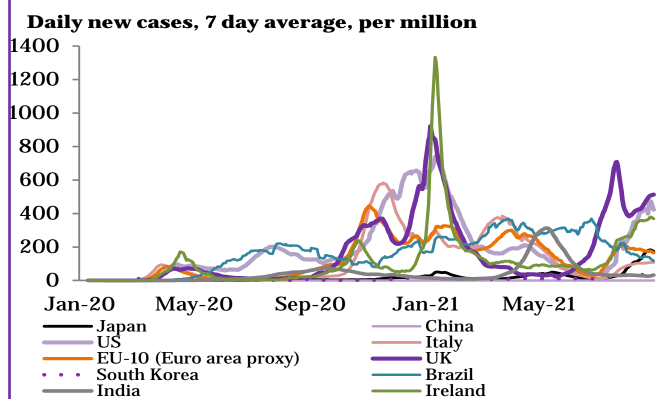
Progress has become increasingly marred, however, by higher Covid cases (Chart 2) alongside the increasing dominance of the delta variant, working against a rapid shift to normal patterns of economic behaviour – whether in the shape of social distancing restrictions or voluntarily more cautious behaviour. The US vaccination programme appeared to hit a wall (with a sizeable proportion of people reluctant to be vaccinated), see Chart 3. Supply chain problems and labour market shortages are also holding back the recovery and adding inflationary pressure in a way more usually associated with being at the late stages of a business cycle recovery (before policy tightens and a downturn follows).

Google mobility data (Chart 4) suggest that in the UK (June), US (August), Germany (August) and France (July), movement associated with retail and recreation areas dropped off somewhat, consistent with more cautious behaviour in light of higher Covid cases (though the lack of seasonal adjustment limits interpretation). Business surveys indicate a slowing in global growth from June (Chart 5).

Still reason to expect a robust H2

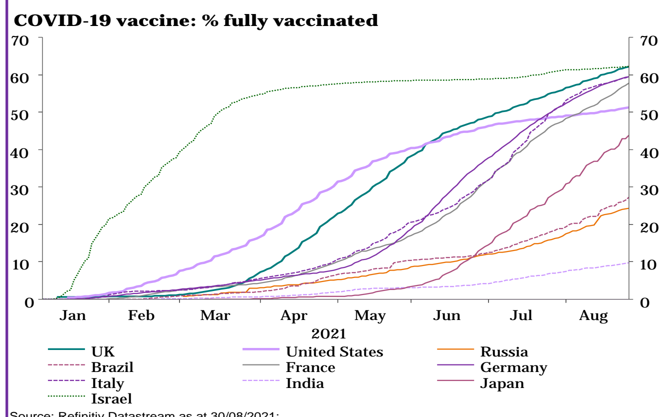
The forecasts on page 2 still envisage a relatively strong H2. The delta variant is a threat, but at this stage the second half of 2021 is set to see reasonable rates of GDP growth as vaccine rollouts permit more and more countries to return to/stay at more 'normal' levels and patterns of activity. Data suggests that the vaccines are effective against the delta variant, especially at preventing serious illness and death. Monetary policy remains supportive. The consumer is likely to be a sustained support; data show that developed economy households built bank deposits at pace during the crisis, and as fear of Covid falls again and confidence rises, there is potential spending power to fuel a rise in consumer spending. Business investment is also likely to become a more supportive part of the global recovery story; indicators of investment intentions look strong (Charts 13, 26 and 37).

Chart 2: Covid making a (another) comeback



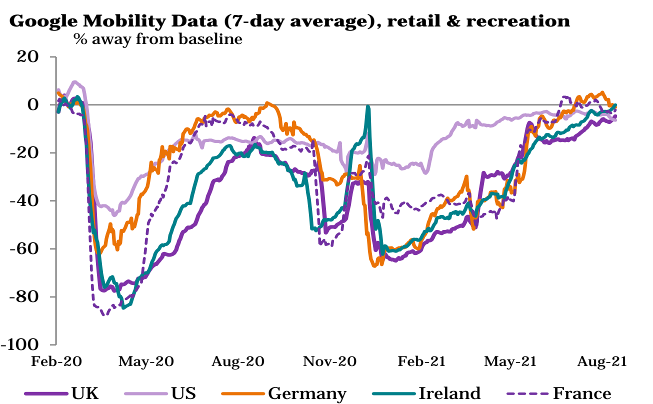
Source: Refinitiv Datastream, WHO, RLAM as at 30/08/2021.

Chart 3: Vaccine rollouts progressing, but uneven



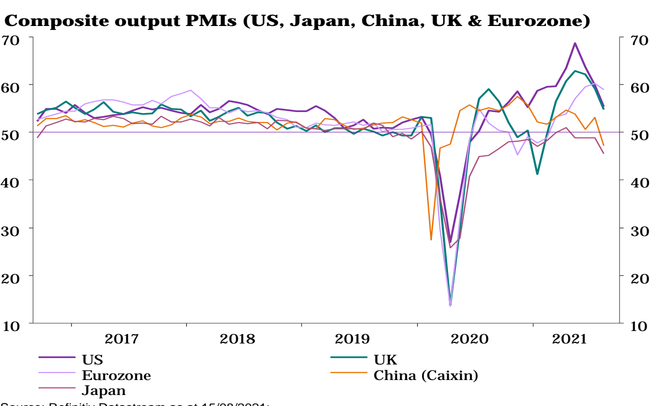
Source: Refinitiv Datastream, Fathom Consulting, Our World in Data, as at 30/08/2021.

Chart 4: Mobility data still suggests some reaction to covid rates outside of lockdowns



Source: Google, Our World in Data, as at 28/08/2021.

Chart 5: Composite PMIs – dent from delta, supply chain problems (and probably some growth normalisation)



Source: Refinitiv Datastream, IHS Markit as at 15/08/2021.

The threat from delta

The World Health Organisation describe the pandemic as “far from finished” and have been expecting the delta variant to become the dominant variant globally this year. Earlier this summer they suggested that “the increased transmissibility associated with the delta variant is likely to result in substantial increases in case incidence and greater pressure on healthcare systems, particularly in contexts of low vaccine coverage”. Despite this summer’s Covid wave, social distancing restrictions have generally eased since the Spring and increasing vaccine coverage should help prevent the need for lockdowns in more regions.

Denting the outlook: Despite continued opening-up of restrictions in some parts of the world, people may anyway restrict mixing with each other in the face of rising Covid numbers. However, this wave of Covid seems likely to slow growth, rather than cause deep damage to the recovery. Even in the face of lockdowns at the start of 2021, there was no repeat of the Spring 2020 collapse in activity. US authorities remain reluctant to impose significant social distancing restrictions and with vaccination rates high, European economies look unlikely to do so either. But that reluctance to lockdown means the current wave may linger, potentially stretching out the likely dip in economic growth. For those economies with little herd immunity and lagging vaccine programmes, tighter social distancing restrictions are still hard to avoid.

Supply shortages, bottlenecks – not so transitory

Supply chain issues (e.g. Chart 6) continue to be cited in business surveys as a drag on output and, in some cases, business optimism too. They are also likely to have been one of the reasons for a mid-year spate of disappointing industrial data in several economies (the UK statistical office was explicit in blaming a fall in car production in May on micro-chip shortages).

For now, supply seems not able to keep up with demand. That partly reflects several key exporting countries struggling with outbreaks that go on to affect port capacity and production lines. Chip delays seem to have been exacerbated by working-from-home and government stimulus raising demand for computers and geopolitics leading to some chip-hoarding, with subsequent impacts on a wide variety of other industries using semiconductors, including the car industry. Industries reliant on just-in-time models seem likely to have found lengthening delivery schedules more disruptive.

Paradoxically, some of these issues may ease because the recovery in global demand continues. If some of the shortage issues are being exacerbated by changing consumer trends relating to Covid – e.g. working from home or buying a car to avoid public transport – these issues may ease as consumers spend more on services instead and as people return to the office. However, with Covid still disrupting a full return to normality for services demand and affecting staff availability, supply chain problems look set to remain problematic – and inflationary – well into 2022.

Fiscal policy: Boom or bust?

IMF data suggests that the fiscal stance is becoming much less supportive for advanced economies on average and that a net fiscal tightening is in progress/prospect in emerging markets (Chart 7). Much of the 2020/21 government support was *designed* to be temporary. The UK’s furlough scheme ends shortly, while US stimulus cheques for households were a series of one-offs.

Fiscal policy looks set to be more of a differentiating factor for growth in 2022. Government support has so far done a good job of limiting longer-term damage from the crisis, but the fiscal outlook differs by country. The focus in the US and Euro area has now moved to fiscal spending beyond 2021 to support sustainable growth. The bipartisan infrastructure bill is working its way through Congress (~$600bn of new money). That bill is expected to be accompanied by a very large additional spending package incorporating many of US President Biden’s other spending priorities (e.g. childcare provision). However, there is still uncertainty around the annual trajectory for fiscal policy in the US with neither of these promised fiscal spending bills passed yet, beyond the Covid relief package in March. The EU’s ‘Next Generation’ fiscal programme completed the ratification process in Q2 and is now in the disbursals stage. These additional multi-year spending plans are set to soften the net economic impact of ending emergency support programmes but benefit some countries much more than others. The UK, meanwhile, is set to see a significant tightening in fiscal stance into 2022/23.

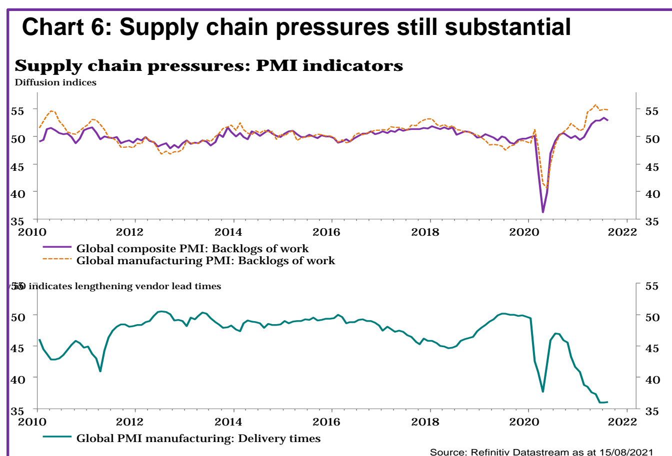
In general, a plunge into austerity is not on the cards in developed economies, despite a sharp rise in fiscal deficits and debt over 2020-2021. But some countries are preparing to rein in finances more than others.

Consumers and corporates: Still set for growth

We’ve already seen a strong consumer spending recovery as economies have opened-up. In the UK and US, for example, retail sales are well above pre-pandemic levels (Chart 8). Arguably, stronger consumer spending wouldn’t be the key sign of pandemic recovery at this stage, but rather a further rotation from consumer goods consumption back to consumer services.

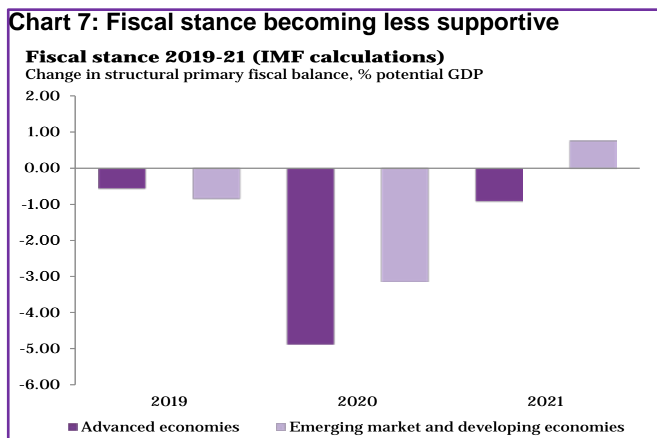
Policymakers have likely done enough to ensure a continued robust consumer in developed economies, but may have ensured more than that. Household bank deposits climbed substantially over the crisis and remain at elevated levels (Chart 9). So far, there is little sign of households reducing

Chart 6: Supply chain pressures still substantial



Source: Refinitiv Datastream, IHS Markit as of 15/08/2021

Chart 7: Fiscal stance becoming less supportive



Source: IMF (April 2021)

their stocks of deposits in aggregate. Household savings ratios remain above pre-crisis norms too (Chart 10). Consumers have built up high levels of savings over the crisis as governments have provided support and households haven't been able to spend money – all those missed holidays and meals out mean that *some* families are financially *better off* after the pandemic. This remains encouraging for the prospect of a strong recovery; there is theoretical firepower there to fuel a post-pandemic consumer boom as consumer confidence returns – which, to a significant degree, it already has (Chart 11).

However, much of the stock of 'excess savings' looks unlikely to end up being consumed:

1) Households may decide after facing a pandemic - the second once-in-a-lifetime economic shock that households have lived through in just over 10 years that they'd like to keep those savings in case they need them for another crisis; the crisis could prompt a long-lasting shift in attitudes to risk;

2) Data for the US and UK show that those households who have been able to save the most – that have built up the most spending power- are those who were already the wealthiest. Those households are less likely to spend from any additional income. Instead, that money may find its way into asset markets and housing rather than fuelling a consumer boom.

3) UK survey data points towards households not planning to spend much of the additional savings.

Housing market risk: Year-on-year house price inflation already looks to be in double-digits in several economies, including the UK and US (Chart 12). Interest rates remain low and households in aggregate have been able to build savings (or deposits for a house purchase) over the crisis. Banking systems remain relatively healthy given the response of authorities to the crisis, meaning that availability of loans for house purchase seems to have held up relatively well. Lockdowns and new abilities to work from home mean that the desire to relocate has also increased for some. Supply chain issues, meanwhile, may also constrain housing supply. In combination, house prices look at risk of a boom, potentially increasing financial stability risks.

Business investment – multiple incentives for more: The forecasts on page 2 assume robust business investment growth into 2022. Investment indicators look strong (Chart 13). Aggregate cash levels are high and borrowing costs low. With vaccines, there is more certainty around the outlook than a year ago. There are also significant incentives to invest more, including low carbon transition and a likely desire to be less reliant on labour post-pandemic.

As with households, however, it is likely that the build in corporate cash is uneven. For some companies any cash build will have been enabled by higher overall debt levels. It also seems likely that uncertainty lingers around the outlook, potentially hindering investment decisions, thanks to the delta variant and potentially some uncertainty around the policy outlook (from future US tax rises to when developed central banks will start hiking rates). Business optimism seems to have peaked (Chart 15).

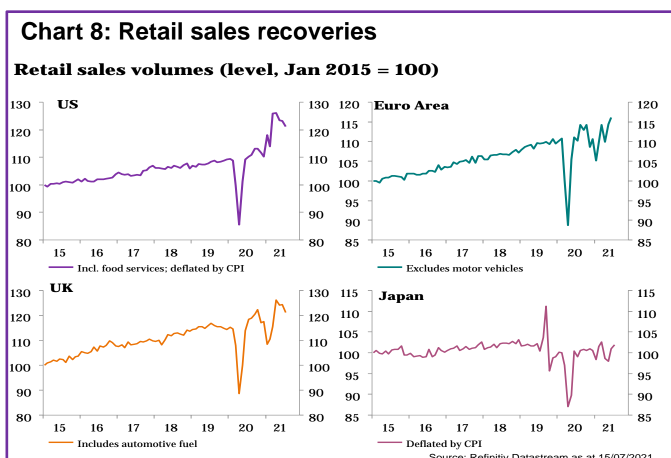


Chart 8: Retail sales recoveries

Source: Refinitiv Datastream, US Census Bureau, BLS, Eurostat, ONS, METI, Ministry of Internal Affairs & Comms. Japan as of 15/07/2021

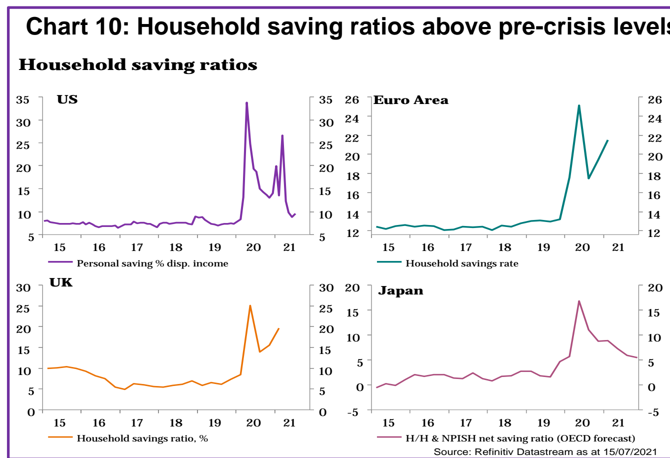


Chart 10: Household saving ratios above pre-crisis levels

Source: BEA, Eurostat, ONS, OECD, Refinitiv Datastream, Markit as at Q2 2021

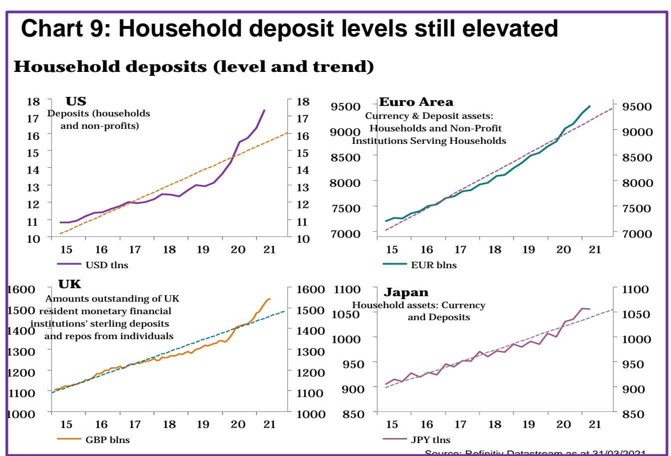


Chart 9: Household deposit levels still elevated

Source: ECB, BoJ, Federal Reserve, BoE, Refinitive Datastream. Data as of Q1 2021

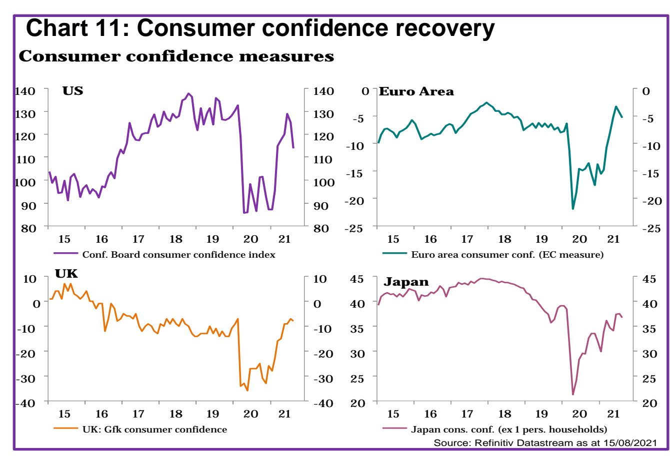
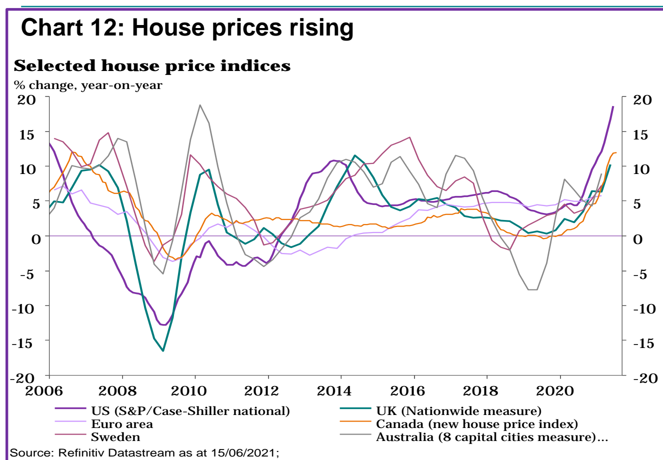


Chart 11: Consumer confidence recovery

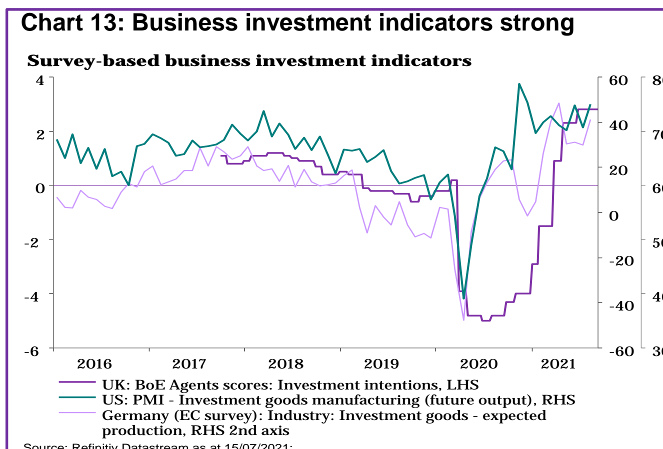
Source: The Conference Board, European Commission, GfK, Cabinet Office. Data as of August 2021

Chart 12: House prices rising



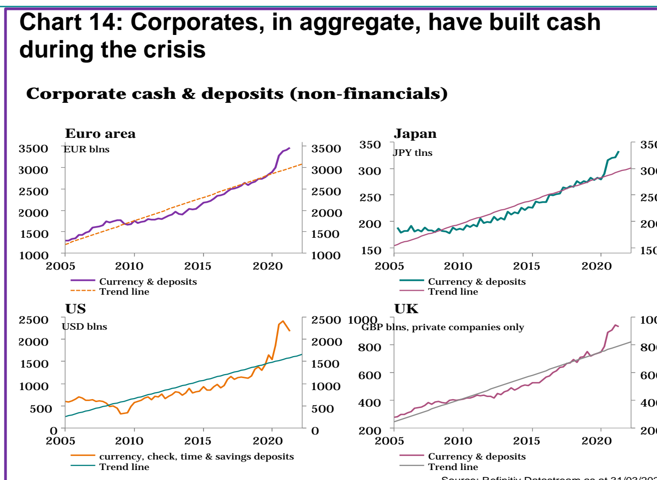
Source: Refinitiv DataStream, S&P, Nationwide Building Society, Eurostat, CANSIM, ABS; As at June 2021.

Chart 13: Business investment indicators strong



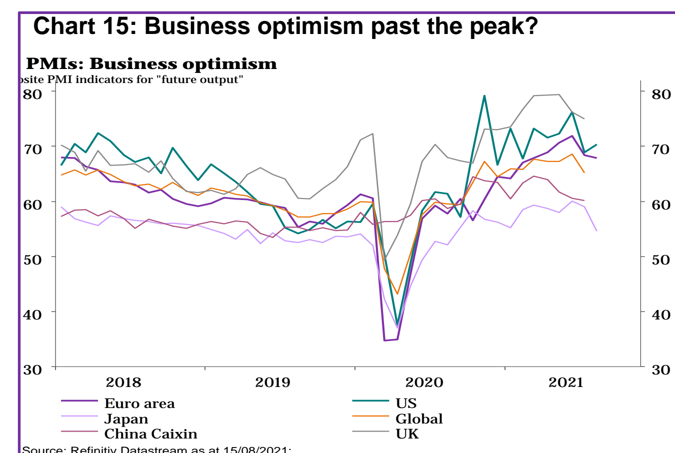
Source: Refinitiv DataStream, Bank of England, IHS Markit, European Commission. Data as at July 2021.

Chart 14: Corporates, in aggregate, have built cash during the crisis



Source: Refinitiv DataStream, ECB, BoJ, Federal Reserve, ONS, as at Q1.

Chart 15: Business optimism past the peak?



Source: Refinitiv DataStream, IHS Markit as at August 2021

Where are we in the cycle and why does it matter?

Early or late cycle? Coming out of recession the previous year, an economy might be expected to still be in the early stages of recovery. In the early stages of recovery, you might expect growth to pick up above trend; output gaps start to close; unemployment rates start to decline from high levels; inflation and wage growth remain subdued given that there is still significant slack to work through. Instead, certain features look decidedly 'late cycle', including supply chain constraints, difficulties hiring and above-target inflation.

The policy 'recipe' is different depending which stage of the cycle we are in. Policymakers are mostly treating the economy as if it is in the early stages of recovery. If they are wrong to do so, then they may be making a policy error that fuels overheating and more persistently high inflation.

From 'head-fake' to short-cycle? Current late-cycle features don't look likely to last. Demand growth is likely to calm as fiscal support rolls off and supply growth pick up as Covid-related disruptions ease. As supply and demand find a better balance, inflation is likely to slow too. However, given the underlying case for strong consumer demand and business investment (see above) it seems hard to envisage the global economy resembling the early stages of recovery in 2022. As Trevor Greetham argues in the July Investment Clock Strategy update, it may turn out that we are simply in a short cycle compared to the rather long cycles of recent years. In which case, we may be closer to cycle-slowing levels of central bank hiking too.

Inflation: Still sanguine, but at what cost?

From transitory to lingering? Inflation has been driven to relatively high levels by Covid (Chart 16) – whether energy price base effects, re-opening effects (sectors suffering in the pandemic, later increasing prices), or supply chain problems. This is likely to prove transitory but is already lingering longer than expected. There is a strong case too for thinking that supply chain problems may linger into next year. With vaccine rates uneven and coverage far from universal, supply chain constraints arising from Covid disruption may linger. Specific issues around microchip shortages might not resolve themselves rapidly either (Intel's CEO said in July that the global shortage could potentially stretch into 2023).

Underlying inflationary pressures are likely to grow over the next year or so, even as Covid-driven inflation fades. Underlying inflation can be expected to build as the global recovery progresses further, output gaps shrink, and labour market slack recedes on a more sustainable basis. Year-on-year pay growth – at least, average earnings type measures – has been artificially pushed up over the crisis through mixed effects as workers in lower paid sectors have been disproportionately pushed out of the workforce (e.g. hospitality industry workers). 2022 is likely to see weaker pay growth inflation as those effects reverse and negative base effects kick in. Beneath all the volatility, however, further recovery in the economy should build the basis for sustainably tighter labour markets and higher pay growth. Data suggests that the link between unemployment and pay growth was alive and well in the US and UK pre-pandemic, for example, even if the relationship between pay growth and consumer price inflation is much less convincing.

Lingering labour market issues could accelerate the rise of underlying inflation: Labour market shortages may linger problematically in a number of economies. Some of the sources of labour market disruption may prove more lasting, even if initially prompted by Covid, e.g. where people have left the country or taken early retirement.

From lingering to lasting? If inflation expectations rise significantly, then what were temporary shocks to inflation can become more permanent. US inflation expectations have picked up (Chart 18) and the Federal Reserve have moved towards an inflation averaging framework indicating that they will tolerate a period of above target inflation. The ECB have raised their inflation target too and have also signalled some tolerance for above target inflation (albeit in a more caveated and 'softer' way than the Federal Reserve).

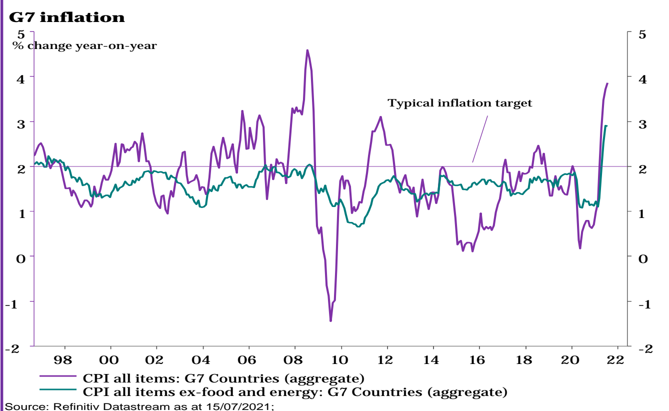
Still sanguine, but at what cost? Probably the main reason I am relatively sanguine about the risk of high sustained inflation is that I don't think central banks have changed – that that this time is different *institutionally*. Inflation targeting is still at the heart of central bank mandates – sustained high inflation should see central banks tighten. Policymakers have been clear that their tolerance for high inflation will have limits. However, believing that central bankers will hike rates significantly if/once they fear inflation is heading *sustainably* north of target is of limited comfort for the economic outlook when public and private debt levels are relatively high in many countries.

Central bank policy outlook

Rate rises approaching: The forecasts on page 2 envisage rate rises in the US and UK from early 2023, with a relatively high probability of H2 2022 instead as inflationary pressures linger somewhat and assuming that the recovery remains relatively robust (Chart 19). Major central bank signalling has shifted somewhat over the quarter. While ECB forward guidance signals that rate rises are unlikely over the horizon of their forecasts (out to 2023), signals from the FOMC have become more 'hawkish'. In the space of a quarter, individual FOMC interest rate projections went from no interest rates out, to the end of 2023 to two rate hikes in 2023 and with 7 out of 18 participants projecting a rate hike in 2022. Several central banks (including the Bank of Canada, for example) are already signalling 2022 rate rises and at least one developed economy central bank – the Norges Bank – is signalling 2021 rate rises.

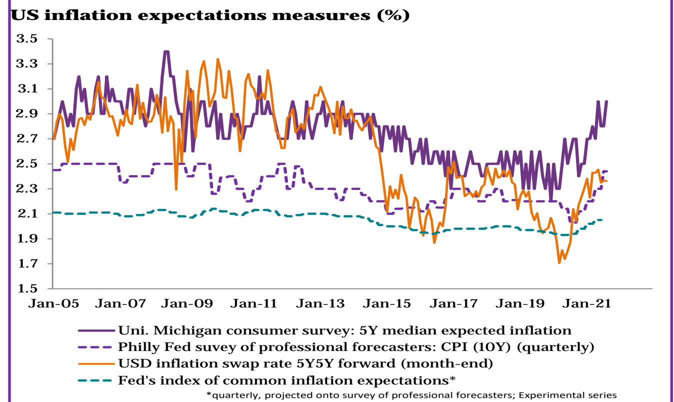
Eventual rate rises are likely to be gradual and limited. Equilibrium interest rates have fallen in recent decades, reflecting multiple factors including demographics. The forecasts on page 2 currently assume a 5-10 year ahead equilibrium interest rate of (only) around 2% in the US, 1.75% in the UK and 1.5% in the Euro area. Debt levels are elevated in some sectors and economies, heightening sensitivity to higher interest rates (more can be done with smaller rate changes). After the two big economic shocks of the last decade and a bit, the economy in a broad sense may look riskier to people than before – that should also lower equilibrium interest rates; crudely, households will value a safe asset more highly when there is a higher chance of very bad outcomes. Government financing could also become more of an issue in a high rate/yield environment.

Chart 16: Covid has helped drive inflation to high levels



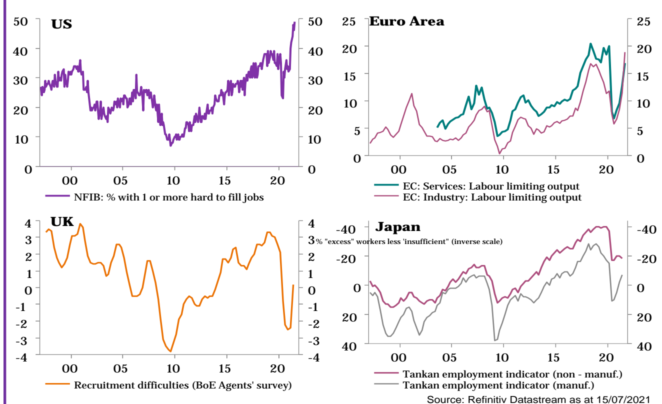
Source: Refinitiv Datastream, OECD as at 15/07/2021.

Chart 18: US inflation expectations have risen



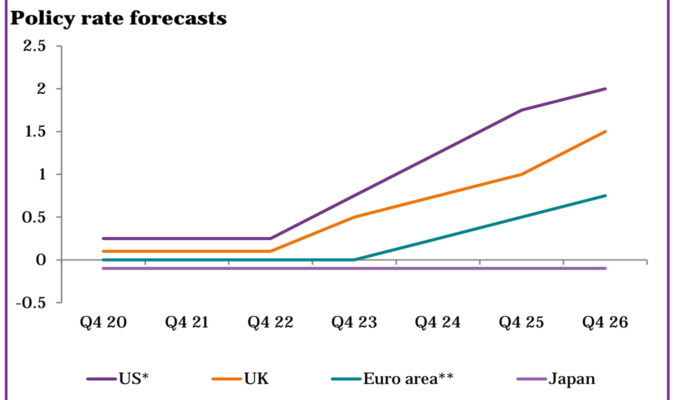
Source: University of Michigan, Philly Fed, Bloomberg, Federal Reserve as at June (index of common inflation exp.), August 2021 (other series).

Chart 17: More labour market tightness everywhere



Source: Refinitiv Datastream, European Commission, BoE, BoJ, as at July 2021.

Chart 19: Expecting rate rises…



Source: RLAM economics forecast as at August 2021. **Euro area forecast is for the refi rate.

United States: Softer, but strong

Vaccination rates are lower than much of Europe and delta has taken hold. However, with lockdowns a very low probability, growth prospects remain reasonable. Supply chain issues may linger, however, and some of the labour availability issues persist longer-term. Inflation risks are heightened versus the Euro area. Monetary policy tightening edges closer.

Near-term: Softer, but still strong

The business surveys remain relatively upbeat (Chart 20). The PMI composite and the ISM business surveys have cooled, but remain at levels consistent with robust US GDP growth rates. Some slowing in US growth should be expected after the front-loaded March fiscal stimulus and with the US being largely beyond the 're-opening' stages of recovery; as of Q2 2021, US GDP surpassed pre-crisis levels, with both manufacturing output and consumer spending volumes above pre-pandemic levels (Chart 21). However, there is also significant evidence from the surveys that activity in the US is being held back by supply chain problems and labour market shortages.

Hard data has become more mixed, likely reflecting some of those constraints on supply. Consumer confidence is well above its lows, but has drifted lower (Chart 22). Payrolls data has disappointed in August, likely reflecting the Covid resurgence and reported difficulties hiring.

More at risk of delta

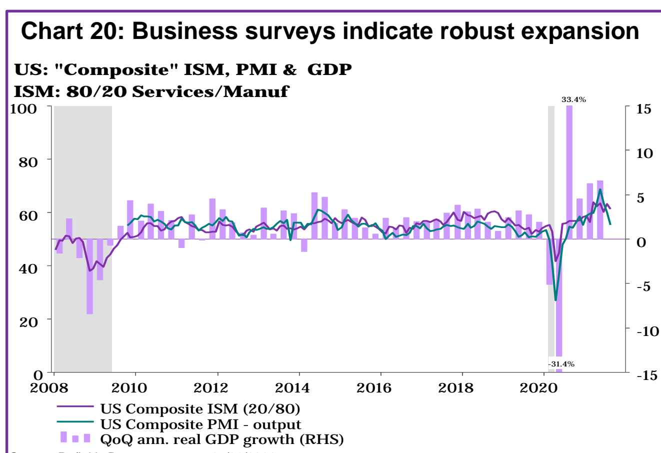
Vaccination rates appear to have hit a wall in the US, slipping behind European countries in terms of vaccine coverage. That leaves the country looking more vulnerable to delta and any variant that follows it. However, the potential impact of this on the forecasts is largely offset by the assumption that US authorities will remain very resistant to re-imposing significant social distancing measures, beyond mask mandates.

Consumer: Real resilience

The forecasts on page 2 assume that consumer spending remains relatively robust through the forecast, albeit slowing significantly from Q1 and Q2 2021 levels (11.4%Q annualised and 11.9%Q annualised respectively) as the impact of the March 2021 stimulus fades. That reflects expectations of further extra fiscal spending, loose monetary policy, current strong job availability and relatively healthy-looking aggregate household finances.

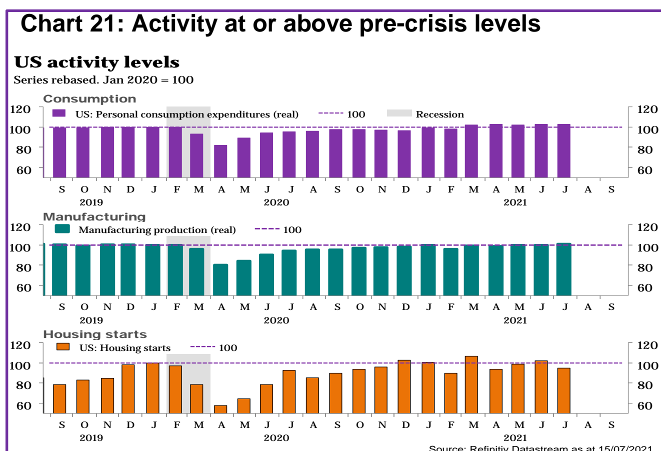
Savings to burn as confidence returns: US deposits and the savings rate still look elevated compared to pre-crisis levels (Charts 9 and 23) reflecting fiscal stimulus and more limited spending opportunities during the pandemic. The boost to savings has been skewed to the already wealthy, limiting the likely impact on consumer spending, but middle-income households also look to have benefitted (see May Economic Update) and the new July child tax credit payments should have benefitted a wide number of families.

Chart 20: Business surveys indicate robust expansion



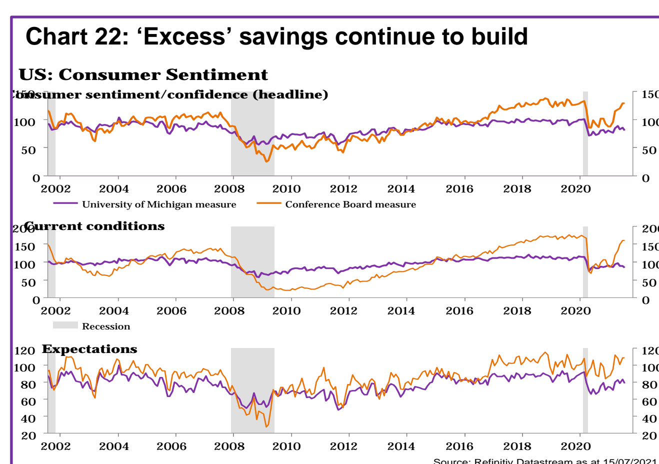
Source: Refinitiv Datastream, BEA as at Q1 2020, IHS Markit, ISM (August 2021)

Chart 21: Activity at or above pre-crisis levels



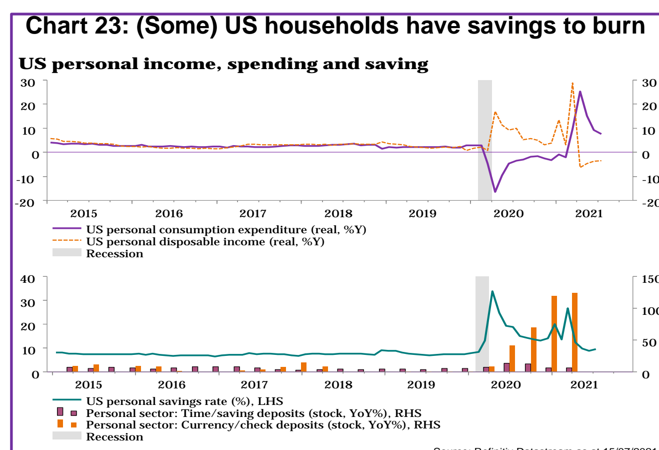
Source: Refinitiv Datastream, BEA, Federal Reserve, Census Bureau as at 15/07/2021.

Chart 22: 'Excess' savings continue to build



Source: University of Michigan, Conference Board as at July 2021.

Chart 23: (Some) US households have savings to burn



Source: Refinitiv Datastream, BEA, as at 15/07/2021.

Plenty of jobs? Evidence suggests that issues in the US labour market come from insufficient willingness to take up employment, rather than a lack of jobs available. The Conference Board consumer survey measure of jobs hard to get compared to jobs available is at very low levels (Chart 24). The small business NFIB survey measure of jobs difficult to fill is at high levels (Chart 17) and job openings are at very high levels (Chart 25). Anecdotally, this appears to be leading to higher sign-on bonuses and pay growth too, in isolation a positive for consumer spending.

Wealth effects: Stock market performance has been strong in the last 18 months and house price inflation is high too (Chart 12). That implies that many middle income and wealthier households will have seen a significant increase in wealth (in addition to higher cash balances). Household propensity to spend from wealth is lower than from income, but should still be an additional support for consumer spending.

Investment: Likely to be a source of strength

US investment intentions indicators are (mostly) still consistent with strong growth in business investment spending (Chart 26). Although the future output PMI has deteriorated, to the extent that this relates to supply chain problems it could incentivise domestic capex rather than indicate much slower growth. The same indicator, but for the investment goods manufacturing sector, remains at high levels (Chart 13).

The means to accelerate capex look present, from high levels of cash in aggregate across companies (Chart 14) – albeit with the significant caveat that the cash may not be spread very unevenly. Lending conditions look supportive too (Chart 27).

Multiple incentives/drivers to boost capex: As for incentive, alongside a general desire to meet end-consumer increased demand in a cyclical recovery, low carbon transition and a desire post-pandemic to reduce reliance on labour are likely to support capex in the US too. Reshoring may play some role, with tariffs still in place between the US and China. The planned infrastructure bill should also boost broad capex spending. News-based measures of policy uncertainty (uncertainty being a disincentive to invest) have dropped dramatically from pandemic highs, albeit only to around 2019 levels (which admittedly, given China-US tension and tariffs, wasn't a period of especially low policy uncertainty).

Fiscal policy drag

The US fiscal stance is set to turn much less supportive. Proxy measures suggest that the US faces c5% of GDP of fiscal tightening in 2022 (Chart 28). However, this largely reflects no further one-off cheques to households and an end to support measures like more generous unemployment benefit – withdrawn, in theory, because they are no longer needed, rather than marking a lurch into austerity. Chart 9 suggests that a significant amount of stimulus has been saved (and therefore could still be spent). Still, in isolation, fiscal policy looks set to be a drag on growth in 2022.

The picture is complicated, however, by the fiscal spending packages still to be finalised. For now, these are an infrastructure package (around $600bn of new money) and a $3.5tln reconciliation bill including President Biden's other spending priorities. However, 1) there is no guarantee the packages will remain this size. Although the reconciliation bill only needs Democrat votes, it wouldn't survive even a small moderate Democrat rebellion given an evenly split Senate and small House majority. 2) The year-by-year fiscal impact is unclear. These packages are set to be at least part funding by tax rises and multi-year, hence the net annual fiscal impact may be quite small. Infrastructure spending, in particular, often involves long lead times. However, assuming that tax increases are phased in, the net stimulus effect over the first year or two could be substantial.

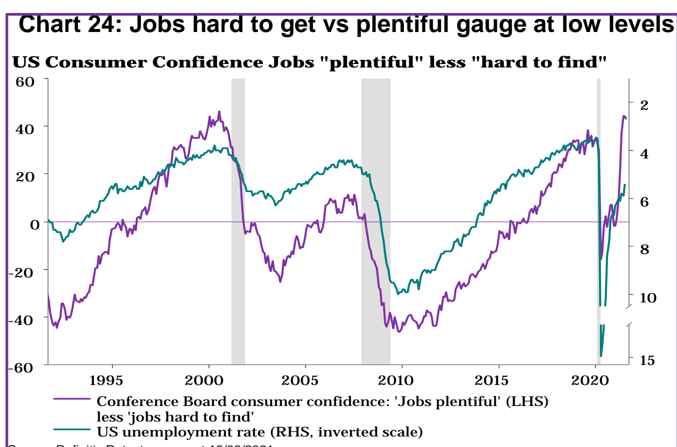


Chart 24: Jobs hard to get vs plentiful gauge at low levels

Source: Refinitiv DataStream, BLS, Conference Board as of August 2021

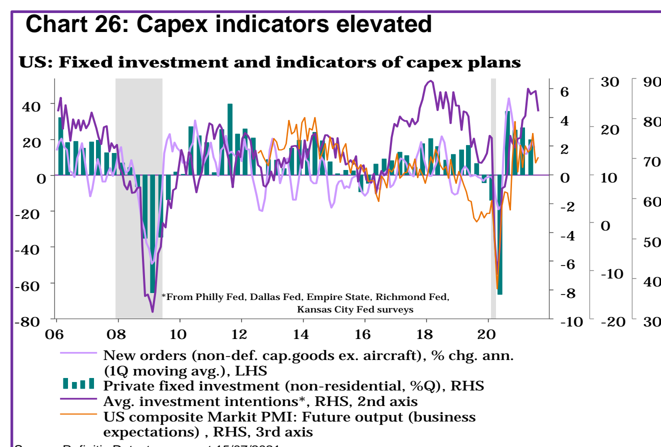


Chart 26: Capex indicators elevated

Source: Refinitiv DataStream, Census Bureau as at 15/07/2021, BEA (Q1), survey sources as listed (August 2021)

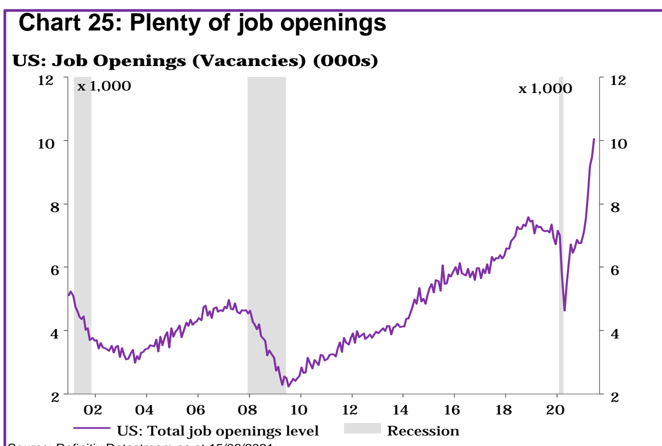


Chart 25: Plenty of job openings

Source: Refinitiv DataStream, BLS as at June 2021.

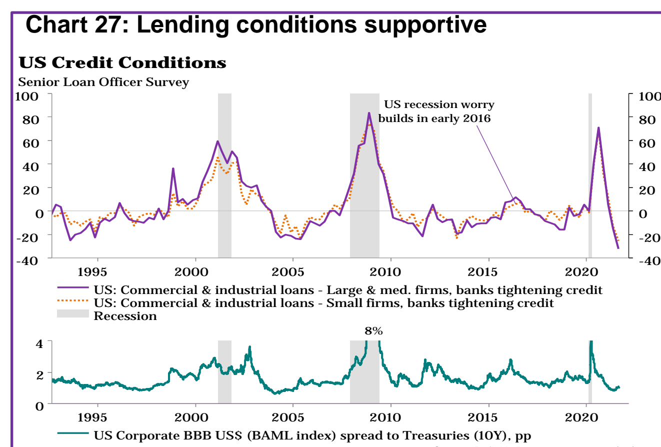
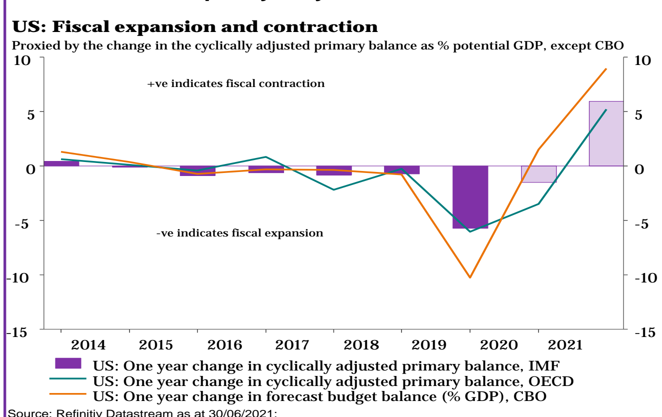


Chart 27: Lending conditions supportive

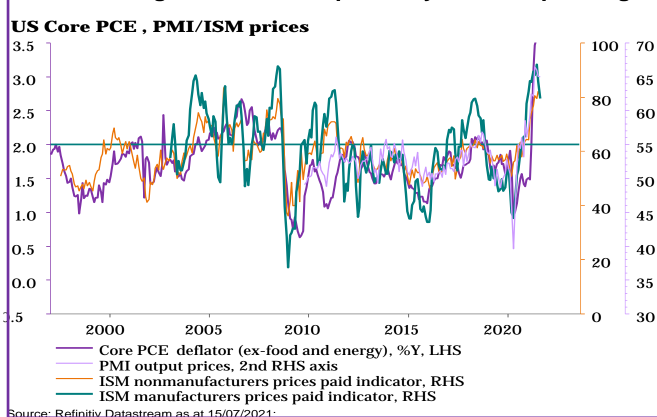
Source: Federal Reserve (as at Q2 2021), BAML, Refinitiv Datastream (as at August 2021)

Chart 28: Fiscal policy stays stimulative for now



Source: IMF (as at 07/04/2021), OECD (as at 31/05/2021) and CBO (as at 29/07/2021).

Chart 29: High US inflation, probably close to peaking



Source: Refinitiv Datastream, ISM, IHS/Markit, BEA, survey data as of August 2021, PCE deflator as of July 2021

Monetary policy: Tightening creeps closer

The forecasts on page 2 assume two 25bp rate rises in 2023, starting in Q1. The median FOMC participant rates projection shows 0.6% in 2023 – i.e. two 25bp rate rises. These forecasts have changed a lot since the start of the year, but still don't indicate any hurry to start raising rates. Messaging is still that current high inflation is transitory and that the maximum employment goal is still some way off. However, there are already significant differences in view on the FOMC with a significant number expecting a rate rise in 2022. While the unemployment rate may still be well above pre-crisis lows, even Chair Powell said in the June meeting that they expect to be looking at a "very strong labour market" one to two years out. Labour market developments could yet bring forward a first rate rise. In the coming months, they expect some of the things currently holding back labour supply to fade. Several more months of significant employment gains towards the 'maximum employment' goal would make a 2022 rate rise much more likely.

On tapering, the expectation built into the forecasts on page 2 is that there is advanced warning at the September meeting and tapering starts by the end of the year.

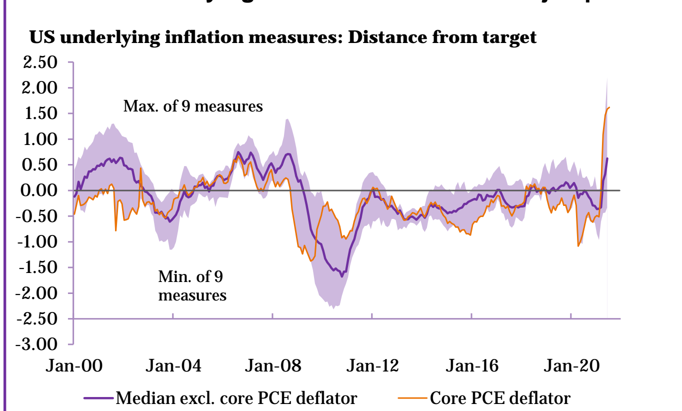
Inflation risks heightened for the US

Inflation patterns and risks outlined in the global section look more acute in the US. First, headline inflation is already that much higher than in Europe (let alone Japan). Second, big fiscal spending packages are planned, despite surveys suggesting that output is already being constrained by supply chain problems and labour shortages. Third, already recovered inflation expectations combined with a more inflation tolerant inflation targeting framework increase the risks of inflation expectations de-anchoring. Fourth, measures of underlying, not just headline inflation have jumped (though re-opening effects and supply chain shortages will account for a lot of this too), see Chart 30.

Base effects mean that US inflation is likely to fall sharply in 2022, but whether inflation will settle at levels consistent with meeting the inflation target is still up for debate. US labour market shortages already appear more acute than elsewhere (Chart 17). Whether that remains the case could be a key differentiator for the inflation picture.

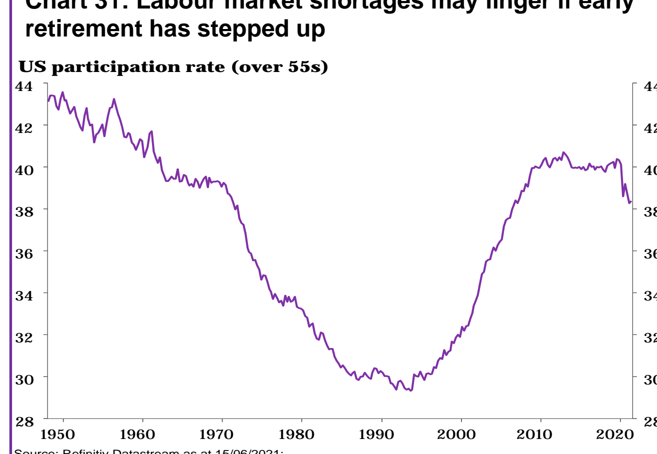
Labour market risks for lingering high inflation: Part of the reason for labour supply shortages appears to be an apparent reluctance to take up work. Surveys suggest a number of explanations, from being unwilling to risk Covid exposure to insufficient childcare options. Temporarily more generous unemployment benefits may have played a role, but so may all the one-off direct cheques to households by reducing the urgency for some to return to work. These factors should ease as the Covid crisis eases, schools fully re-open and out-of-work benefits become less generous. However, to the extent that early retirement will have been the result of all this for many workers, these shortages may be more lasting; the labour market participation rate dropped nearly 2 percentage-points for the over 55s in the US between February 2020 and February 2021 (Chart 31).

Chart 30: Underlying inflation measures have jumped



Source: Atlanta Fed, RLAM. Data as at June 2021. June 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 31: Labour market shortages may linger if early retirement has stepped up



Source: BLS, as of June 2021

China: Policy shifts

Covid has dented the recovery – with a wave of infections meeting China's zero tolerance approach, bringing tight social distancing restrictions and a hit to the economy. Macro policy is becoming more accommodative again, though regulatory policy tightening may work against a policy-driven boost to growth.

Growth dented

GDP rose more strongly than expected in Q2, picking up pace from Q1 at 1.3%Q. Output in China was quick to return to pre-crisis levels, so some slowing in growth momentum in coming quarters wouldn't be a surprise. Recent business survey data suggests that China's recovery is moving through a slow patch (Chart 32) with Covid outbreaks and travel restrictions playing a role. Covid cases have been low, especially adjusted for population size, but climbed over the summer. Vaccine progress has been good, but using vaccines that are considered lower efficacy internationally. Given China's success in containing outbreaks, levels of herd immunity are still likely to be low enough that it was been unsurprising to see localised lockdowns and travel restrictions put in place quickly as Covid cases rose in the summer. Prospects for Q4 look better assuming Covid case numbers can stay at recent lower levels.

Policy: Macro versus micro

The broad direction of policy has become more accommodative. In a statement published in June, the PBoC seemed to move towards a more accommodative stance and that was followed quickly afterwards by a cut in the reserve requirement ratio (RRR), Chart 33, increasing incentives for banks to lend (even if the PBoC's official line was that this did not represent a change in monetary policy stance). Further modest easing seems likely in coming months, including lower interest rates.

However, policies targeting the property sector have tightened. Unexpected regulatory crackdowns, including on tech companies and the private education sector in China have led to stockmarket turmoil and seem likely to lead to some foreign investment hesitancy. China's 'common prosperity' agenda has also raised questions among investors.

There is logic to China's recent decisions, for example wanting to reduce the cost of education to encourage a higher birth rate, lowering social inequality and improving competition or evening the playing field for SMEs, but some of these changes – and the abrupt nature of them – may prove economically damaging in the shorter term.

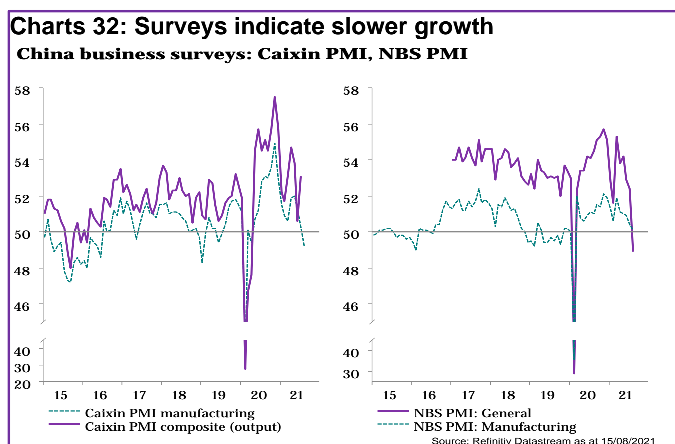
Linkages

External factors continue to add risk to the growth outlook. Stronger overseas demand may be a more limited boost to Chinese growth if one of the main features is a swing away from demand for goods towards demand for services. Taiwan remains a potential flashpoint in relations with the west. Although the US and China have now had high level talks under the Biden presidency, it is clear that there is a big gulf between the two on many issues and there are no signs of any change in stance on tariffs from the US. China's relations with the EU may also take another turn for the worse with the EU moving ahead with their Carbon Boarder Adjustment Mechanism (CBAM) which would charge an extra fee on imports from countries with lower emission standards than the EU.

In turn, China looks set to be less of a driver of the global growth story than pre-pandemic. Links with the US seem to be gradually loosening – albeit tightening with China's ASEAN neighbours partly via the recently signed Regional Comprehensive Economic Partnership (RCEP). Having been 'first in first out' of the pandemic and with something of a two-way policy push in China, it is also less likely that China will play a leadership role in driving the global economic recovery from here.

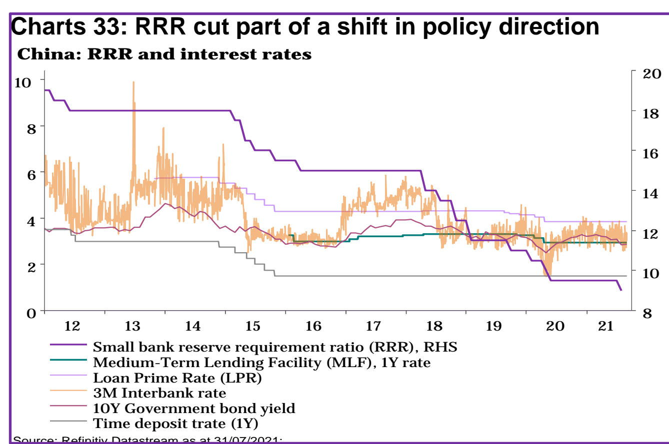
Future challenges

With corporate debt levels high in China and poor demographic trends, China's economic outperformance still looks at risk over the 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. Demographics appear to have become a key focus for China's policymakers recently and the 2020 census showed a fertility rate of only 1.3 births per woman. Policy plans include restrictions lifted on having a third child, increasing government support for childcare and more employment protections for pregnant women. Related concerns are seemingly part of the reason for the crackdown on the private tuition sector too. However, such measures work with a very long lead time and are unlikely to make much difference to the potential growth over the next few years.



Charts 32: Surveys indicate slower growth

Source: Refinitiv Datastream, NBS, IHS Markit as at August 2021.



Charts 33: RRR cut part of a shift in policy direction

Source: Refinitiv Datastream, PBoC, as at 01/09/2021.

Euro area: Alright (for) now

Robust growth is expected over the rest of this year, despite the threat from the delta variant. Consumer spending and business investment should both strongly support the recovery. However, the policy environment is set to become much less supportive in 2022. Inflation is expected to fall back below target and the ECB not to tighten, but the fiscal policy stance shifts. Upside risks include potential political change in Germany towards a more stimulative fiscal stance.

Business surveys indicate robust growth

Q2 GDP growth was 2.0%Q (non-annualised), more than expected (Chart 34), as the economy re-opened after earlier lockdowns and as social distancing restrictions more generally were eased and vaccine delivery improved. Supply chain problems remain disruptive, but surveys still signal relatively strong GDP growth by Euro area standards (Chart 35). There was a solid improvement in the composite PMI over June and July with the composite output measure hitting a 21-year high. Improvements in the European Commission economic sentiment indicator saw it hit another record high in July, though both surveys deteriorated a bit in August. Consumer confidence also remains well above pre-crisis levels. GDP looks on track to exceed pre-crisis levels by the end of the year.

Vaccine versus delta

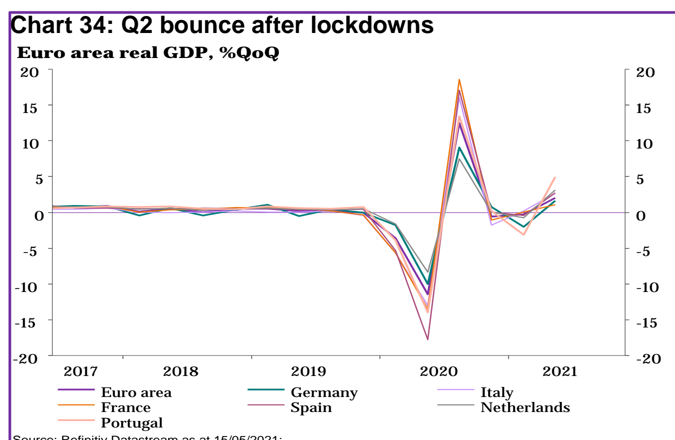
The vaccine rollout is going well with the proportion of population fully vaccinated higher in the likes of Germany, Italy and the Netherlands than in the US, signalling less vaccine reluctance in many major Euro area economies. The spread of the delta variant remains a threat. However, the high rate of vaccinations should help prevent a sharp rise in hospitalisations and deaths compared to Spring and keep lockdowns at bay even assuming case numbers have further to rise. The response of the economy to the early 2021 lockdowns is also consistent with Euro area economies having become much better at managing through tight social distancing restrictions even should those become necessary again (not part of the forecast central case on page 2).

Consumer spending and investment to support the recovery

As elsewhere, household savings/deposits and corporate cash levels rose sharply over the crisis and could, in theory fund strong business investment spending growth and consumer spending (Chart 9 and Chart 14).

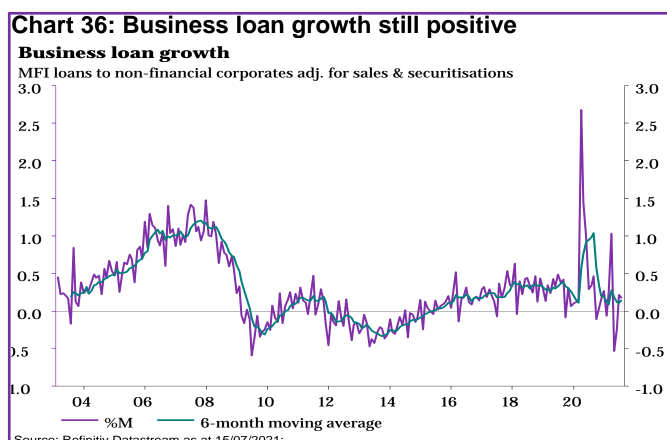
Positive business investment prospects: The ECB's credit conditions survey indicates a loosening in credit standards for corporates and, smoothing for volatility over lockdowns, business loan growth has been positive (Chart 36). Investment indicators look relatively strong (Chart 37). Arguably incentives for more investment are higher too, particularly related to the transition to a low carbon economy where commitments to limiting carbon emissions have been increased. European pandemic wage support schemes may have dulled the incentive to invest in order to reduce reliance on labour relative to the US, but the retention of the link between employer and employee should help continue to limit some of the labour shortage problems that the US is currently coping with.

Chart 34: Q2 bounce after lockdowns



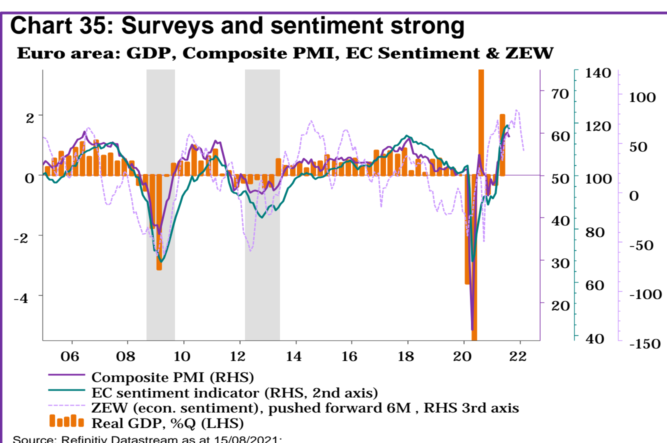
Source: Refinitiv Datastream, Eurostat as at Q2 2021.

Chart 36: Business loan growth still positive



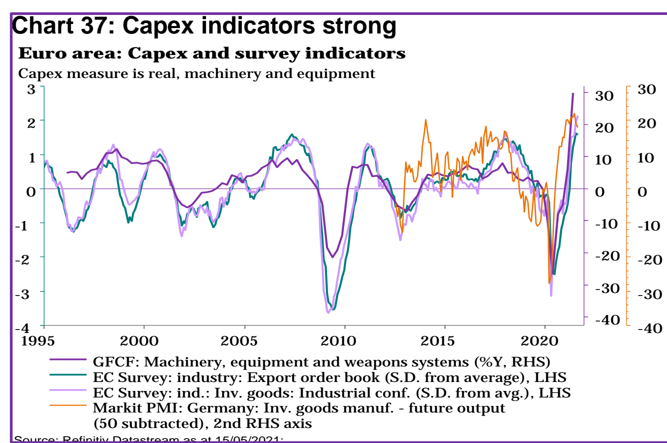
Source: Refinitiv Datastream, ECB, RLAM as of July 2021.

Chart 35: Surveys and sentiment strong



Source: Refinitiv Datastream, IHS Markit, ZEW, European Commission, Eurostat as at 15/08/2020 (GDP for Q2 2021).

Chart 37: Capex indicators strong



Source: Refinitiv Datastream, Eurostat, European Commission, IHS Markit, as of Q3 2021 (GFCF) and August 2021 (surveys).

Consumer spending progress and prospects positive: The level of real consumer spending remained some 6% below pre-pandemic levels (Chart 38) in Q2, compared to around 3% above in the US, indicating more scope for H2 'catch-up' growth. After Q2's re-opening driven bounce, prospects for the rest of the year and into 2022 are relatively positive, despite the threat of the delta variant. Consumer confidence remains sharply off the lows (Chart 39), boding well for lower saving and higher spending levels, though the pattern of consumer spending over the rest of 2021 will also depend on the evolving threat from Covid. The underlying strength of the labour market is still somewhat uncertain given the widespread use of wage support programmes in the EU through the pandemic. However, indicators of labour market tightness have risen (Chart 17) suggesting that insufficient supply rather than lack of demand is becoming more of an issue, boding well for wage growth.

Economic policy gets less supportive

Fiscal policy set to become less supportive, unevenly: The latest European Commission and IMF projections suggest that 2022 will see quite a sharp tightening in fiscal stance after two years of fiscal expansion (Chart 40). In theory, much of that will reflect the end of emergency support, e.g. wage support schemes, at a point where they should no longer be needed. The shift in fiscal stance should also be softened by disbursements from the NextGenerationEU programme. However, these disbursements look set to be very uneven, with some countries set to see a sharp tightening in fiscal stance, e.g. Germany, and some, e.g., Spain, potentially seeing a more supportive stance.

Expecting PEPP to end in March: ECB President Lagarde has described financial conditions as the "compass" for asset purchases. The rise in bond yields earlier in the year was duly met by increased asset purchases. With financial conditions a 'compass', it is not obvious it makes sense to expect a straight line slowing in asset purchases from here. However, the ECB will need to make a decision soon on the future of the PEPP (Pandemic Emergency Purchase Programme). Given a central case where the 'emergency' is over by March 2022 (at least as far as the risk of coronavirus to the Euro area economy goes), recent strength of economic data, prospects for further recovery and some upside inflation surprises, the forecasts on page 2 assume that the PEPP is not extended beyond March 2022. However, they do assume that the ECB retains the right to revive it should they feel that is necessary and that they introduce some form of enhanced flexibility for the rest of their asset purchases.

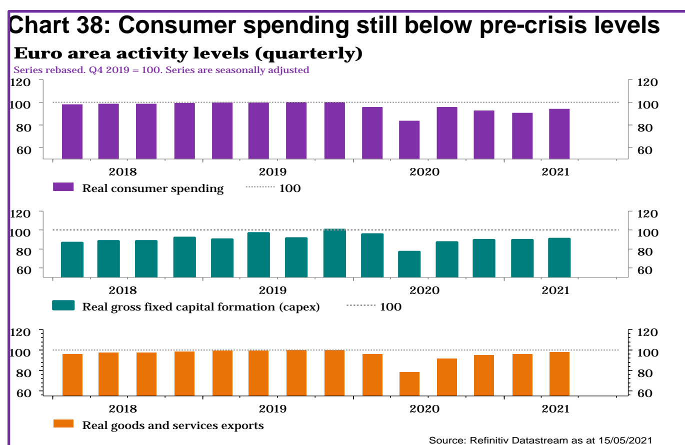
As for contemplating rate increases, the ECB's inflation forecasts are likely to stay too far below target in the medium-term and the Strategic Review resulted in a higher, symmetrical 2% inflation target. The ECB's and our own forecasts don't project the ECB sustainably reaching 2% year-on-year inflation over the forecast horizon (through 2023). The forecasts on page 2 do not assume a rate rise from the ECB until 2024.

Inflation outlook: a struggle to hit the target

There are clearly some significant upside risks to inflation this year – as in many economies around 're-opening effects' and supply chain problems that still seem a way off being solved. Evidence of labour market tightness is also building. However, these are unlikely to support Euro area inflation at a persistently higher level.

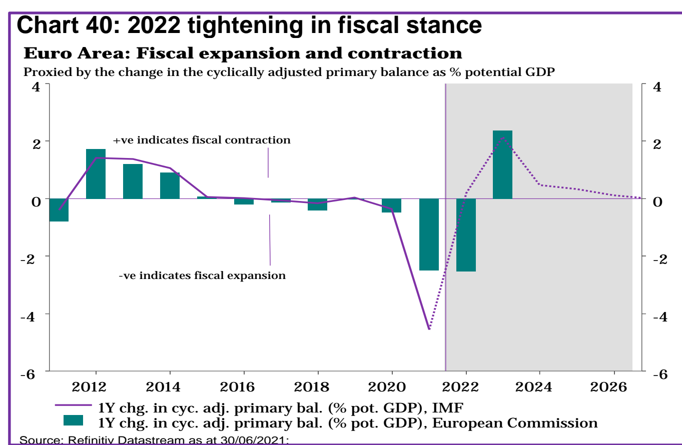
Inflation has struggled to sustainably hit even the previous "close to but below 2%" ECB inflation target since 2010/2011 and core inflation since 2007/8 (Chart 42). Reasons include a period of relatively weak wage growth and likely low longer-term inflation expectations.

Chart 38: Consumer spending still below pre-crisis levels



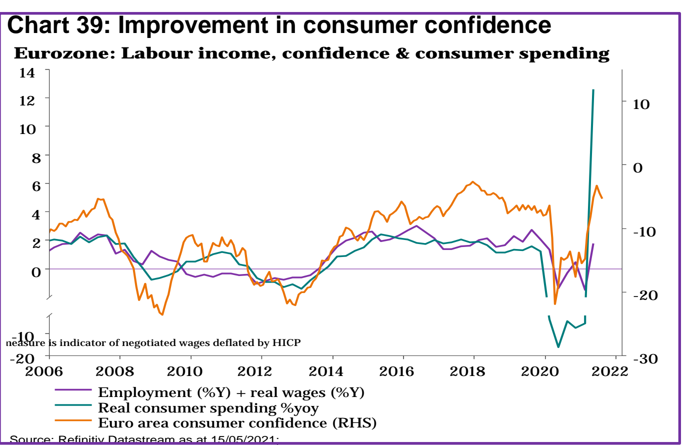
Source: Refinitiv Datastream, Eurostat as at Q2 2021

Chart 40: 2022 tightening in fiscal stance



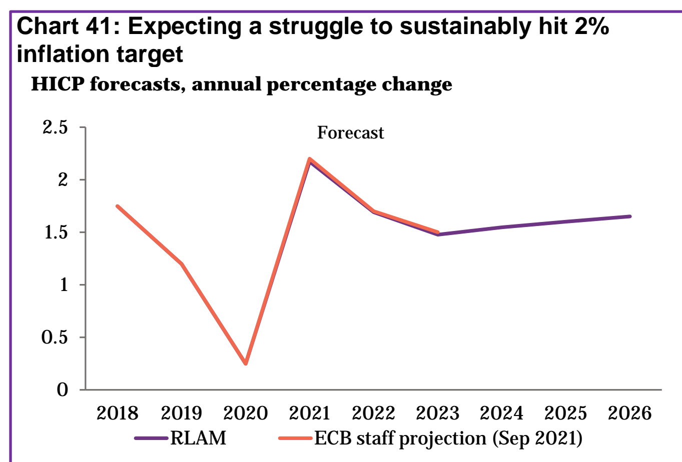
Source: Source: Refinitiv Datastream, IMF (updated 07/04/21), European Commission (12/05/21)

Chart 39: Improvement in consumer confidence



Source: Refinitiv Datastream, Eurostat, ECB, European Commission. Consumer spending, employment and wages as of Q2 2021, survey data is for August 2021

Chart 41: Expecting a struggle to sustainably hit 2% inflation target



Source: Refinitiv Datastream, Eurostat, ECB, RLAM

Short-term inflation expectations have perked up, but the ECB's survey of professional forecasters, for example, shows what looks like a trend decline in 5-year ahead inflation expectations over the last 10 years in the Euro area (Chart 43). A period of running the labour market hot could help – though seems more of a short than long-term probability in the euro area given the coming end of wage support programmes and approaching shift in fiscal stance. Inflation expectations could conceivably shift higher following the ECB's change in inflation target and if the NextGenerationEU programme was widely interpreted as a permanent and significant shift in fiscal orthodoxy. However, the ECB inflation target change was relatively small on the face of it and was not accompanied by a new set of tools to meet the goal. With the NextGenerationEU programme set to be felt very unevenly, it seems unlikely to cause a big shift in inflation expectations either.

Trend growth jump start?

There is some probability that the NextGenerationEU funding and accompanying reform programme helps jump start some improvement in Euro area trend growth. The funding framework used for the programme could expand in coming years, allowing for a higher level of public investment across the EU. However, the EU isn't known for having a quick dynamic ability to reform so, for now, the forecasts reserve judgement and do not assume an uplift to potential growth in the base case.

Political risk

German election in focus this year: This year's German federal election (September 26th) seems likely to result in a new coalition from the current CDU/CSU – SPD arrangement. Polls (Chart 44) may move significantly between now and then, but on current polling a few different combinations look plausible. Since the 2017 election, support for the previously biggest party – the CDU/CSU has fallen and support for the Greens has increased particularly dramatically (though no longer maintaining a clear lead over the SPD at the time of writing). There are particular contrasts between the parties' fiscal policy stances. A left-leaning coalition or one involving the Greens could usher in a less restrictive fiscal stance (Chart 45) and a shift in attitudes on EU fiscal rules more broadly.

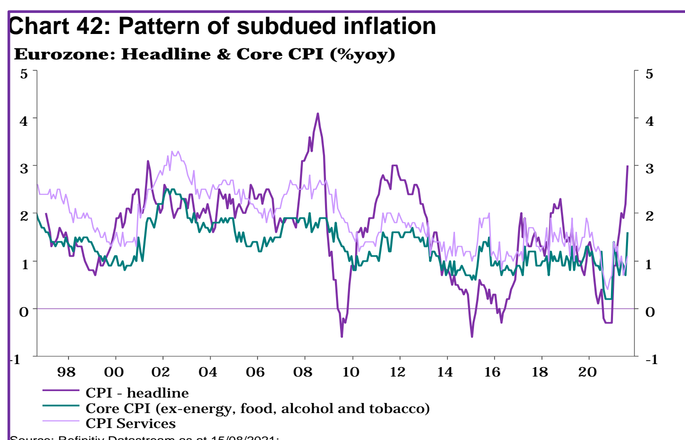


Chart 42: Pattern of subdued inflation

Source: Refinitiv Datastream, Eurostat as at August 2021

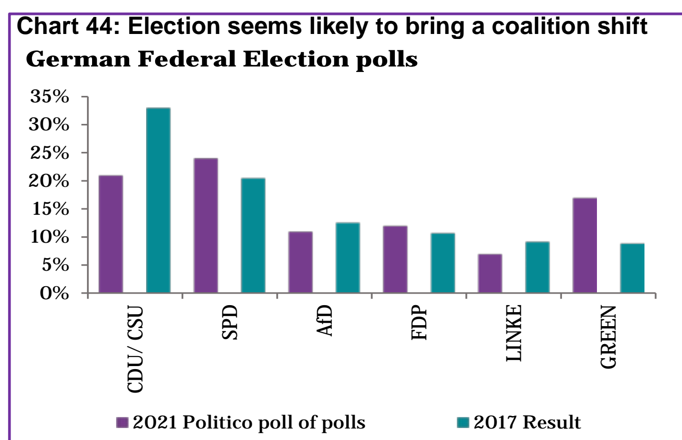


Chart 44: Election seems likely to bring a coalition shift

Source: Politico as of 31/08/2021

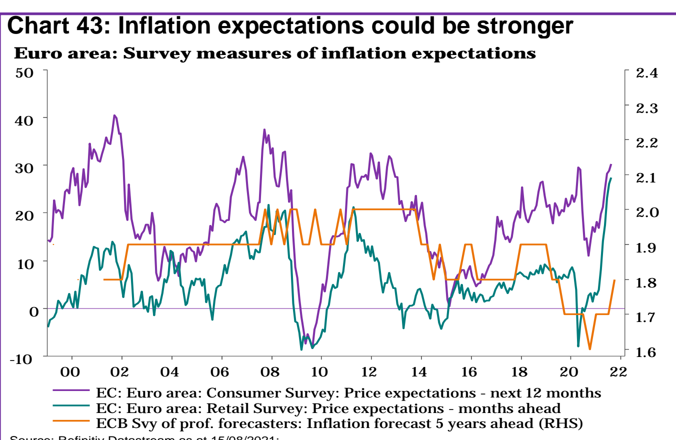


Chart 43: Inflation expectations could be stronger

Source: Refinitiv Datastream, European Commission, ECB as at August 2021

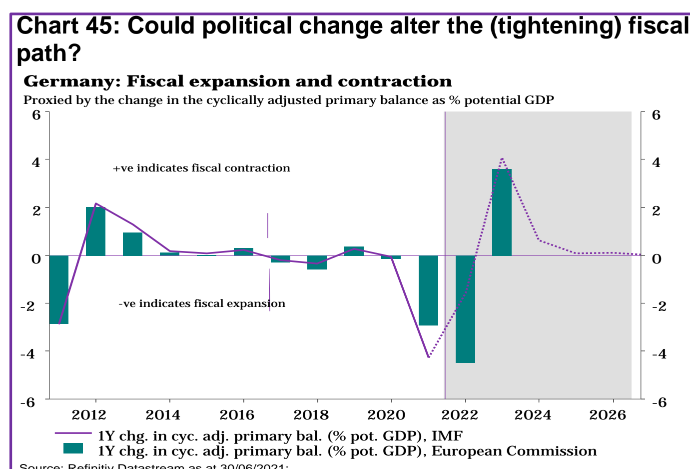


Chart 45: Could political change alter the (tightening) fiscal path?

Source: Refinitiv Datastream, IMF (updated 07/04/21), European Commission (12/05/21)

Japan: Bumpy

Repeat doses of fiscal stimulus have yet to result in a strong, sustained recovery. Japan's progress has been hampered by repeat resurgences of Covid and a very slow vaccine rollout. Prospects for the second half are better, despite a prospective period of political uncertainty. The longer-term outlook remains challenging.

Covid-related ups and downs

Bumpy data: Month on month growth in key hard data like industrial production and retail sales have been bumpy (Chart 46), partly reflecting the ups and downs Japan has experienced with Covid with case numbers falling in January, rising in March, falling in May, rising in July… although, adjusted for population, Japan's case numbers haven't come close to echoing the kind of experience that the US or UK have had. Japan has seen changes in social distancing guidelines and the Google mobility data hint at swings in consumer/social behaviour even without Japan resorting to European-style lockdowns (Chart 48).

Soft surveys vs elsewhere; better coming soon? Business surveys have been on a bumpy, albeit improving trend since the depths of Spring 2020. What we haven't seen in Japan in the business surveys, compared to many other developed economies, is a period of very strong business surveys during the recovery period despite repeat fiscal stimulus doses and strong growth in some key overseas markets. Part of that may reflect repeat Covid waves, combined with Japan's delayed vaccine rollout. However, Japan's vaccine programme is now making very strong progress, boding better for business confidence over the rest of the year into 2022 (Chart 48). A change in political leadership (see below) may well usher in a new fiscal package too.

Politics gets more interesting

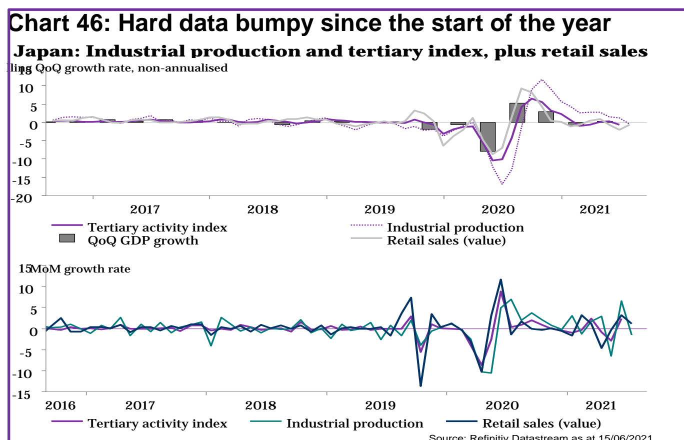
A general election needs to be held later this year. PM Suga has already said he will resign the LDP leadership, so there will be a change in PM no matter what the election result. The Olympics (despite a 'gold rush') and Covid seem to have weighed in the polls. With Covid patterns unpredictable, plenty could change between now and then. Political *upheaval* seems unlikely, though a loss of outright majority by the LDP (though it already rules in coalition), in addition to the change in LDP leadership, looks plausible. A change in PM is unlikely to lead to a wholesale economic policy shift, but may increase or reduce commitment to reforms for example and alter the probability of a further fiscal stimulus package.

A better second half

Despite prospects for political uncertainty, the forecasts do not assume slower GDP growth in the second half (in contrast to the US for example), assuming further progress of the vaccination programme and relatively robust external demand. That reflects Q1's contraction in activity and Covid/repeat states of emergency rulings having dampened growth in Q2 (0.3%Q non-annualised). Still, Japan looks set to disappoint our previous annual forecast.

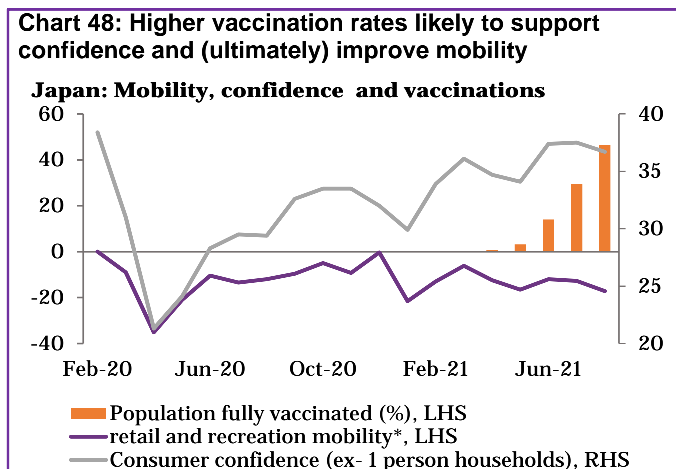
Longer-term prospects for Japan still look hampered by demographic challenges and unimpressive productivity growth (Chart 49).

Chart 46: Hard data bumpy since the start of the year



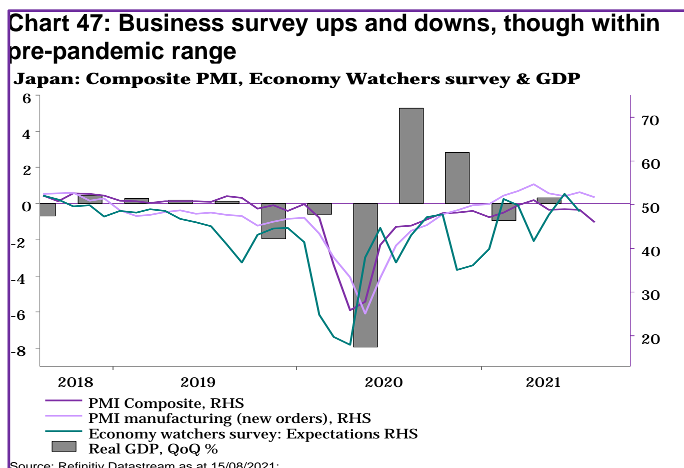
Source: Refinitiv Datastream, METI, Cabinet Office as at 15/6/2021.

Chart 48: Higher vaccination rates likely to support confidence and (ultimately) improve mobility



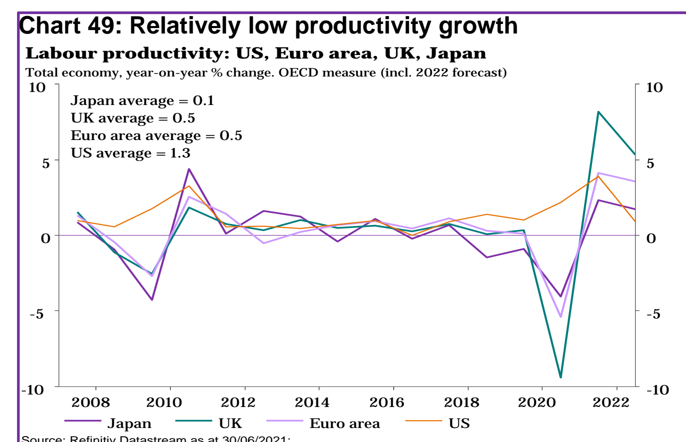
Source: Google, Our World in Data, Cabinet Office (Japan), data as of August 2021.

Chart 47: Business survey ups and downs, though within pre-pandemic range



Source: Refinitiv Datastream, IHS Markit, Cabinet Office. GDP to Q2, Economy Watchers data as of August 2021.

Chart 49: Relatively low productivity growth



Source: Refinitiv Datastream, OECD as at 30/06/2021

United Kingdom: Betting on the vaccine

Growth is set to slow after Q2's impressive bounce. Delta is a threat to the outlook, but a limited one given high vaccination rates limiting the likelihood of any return to strict social distancing rules. Prospects for the consumer and business investment to drive further recovery still look good. The labour market will be an important driver of the monetary policy outlook in coming months and, ultimately for inflationary pressure. Some of the factors constraining labour market availability are likely to prove sticky. Risks include the economy responding more strongly than expected to the withdrawal of fiscal stimulus and resurgent EU-UK tensions.

Q2 bounce, followed by something slower…

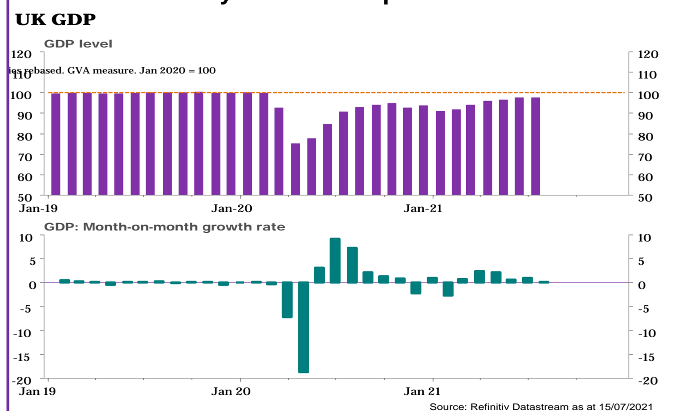
The UK economy grew strongly in Q2 (+4.8%Q non-annualised) reflecting re-opening after Q1's lockdown. After a strong bounce in March and April, the pace has slowed, see Chart 50. Despite further (near-complete) reopening, growth slowed to a near standstill in July and may not have been much stronger in August. Business surveys have cooled a bit (Chart 51), supply chain problems have hurt manufacturing and construction in Q2 and have likely persisted in Q3, and the UK is living with a relatively high level of Covid infection resulting in a significant number of individuals needing to self-isolate, adding to labour market shortages. That and some Covid-related voluntary restraint in terms of social activity may dampen the bounce that might have expected from the recent final stage of re-opening. However, Google mobility suggests that retail/recreation activity did pick up again in the second half of July, into August.

Delta threat, but outlook good

The delta variant remains a threat to the outlook, but seems to be a diminishing one. Case numbers have remained high over the summer, but hospitalisations and death figures have remained low relative to previous Covid peaks (Chart 52). The exceptional progress of the vaccine programme has clearly helped here, though reaching the remainder of the unvaccinated adult population is likely to be harder work. At this stage, the second half of 2021 into 2022is expected to see robust, albeit slower, economic growth. Consumer spending and business investment should be growth supportive given healthy aggregate finances (Charts 9 and 14). Data continue to show that UK households in aggregate have a high savings rate and built bank deposits at pace during the crisis. As fear of COVID falls again and confidence rises (Chart 53), there is potential spending power to fuel a further rise in consumer spending.

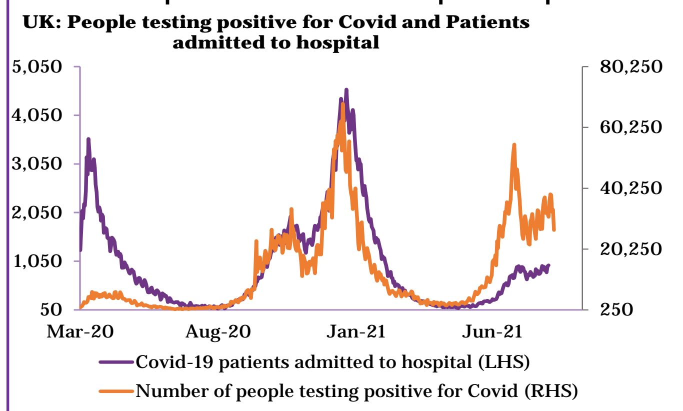
Downside risks include the current wave of Covid lingering quite some time given social distancing restrictions are largely removed, continuing to disrupt supply chains and labour availability. With vaccine distribution to emerging markets not being prioritised by developed economies and high levels of virus circulation globally, the risk of the UK re-importing another more vaccine-resistant variant is present too. More UK-specific risks include from the tightening fiscal stance and the potential for even shakier EU trade relations (see below)

Chart 50: GDP 'only' 2.1% below pre-crisis levels



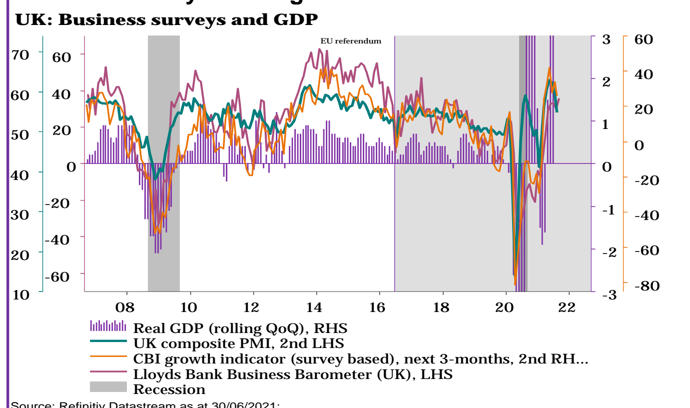
Source: ONS, Refinitiv Datastream (data to July 2021).

Chart 52: Hospitalisations well below previous peaks



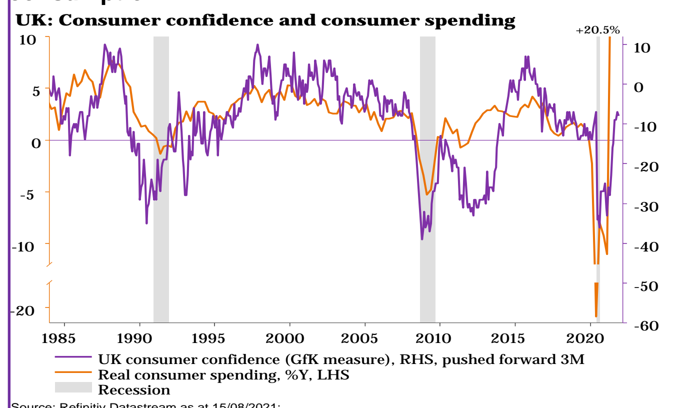
Source: UK government, data to 30th August 2021.

Chart 51: Surveys cooling off a bit



Source: Refinitiv Datastream as at 30/6/2021; IHS/Markit PMI data to August 2021

Chart 53: Consumer confidence becoming less of a drag on consumption



Source: Refinitiv Datastream, ONS. Spending to Q2 2021, consumer confidence to 15/08/2021.

The labour market nexus

Understanding the labour market outlook is key for understanding how much capacity to grow the UK economy has in coming quarters, to understanding how underlying inflationary pressure is likely to evolve and to understanding the outlook for monetary policy. However, the current unemployment rate (Chart 54) is an unreliable guide to underlying slack and strength of the labour market, especially while the furlough scheme runs. With the furlough scheme ending in September, we should get a cleaner picture within a few months.

There is now much less expectation of a big jump in the unemployment rate when the scheme ends. That follows data showing strong recent gains in payroll employment in the UK and high levels of vacancies as well as surveys like the KPMG/REC Report on Jobs suggesting that demand for labour continues to rise as the economy reopens but that supply is increasingly constrained (Chart 55). The August report cited "a reluctance among employees to switch roles due to the pandemic, fewer EU workers, furloughed staff and skills shortages" as driving a lack of candidate ability. The first factor is likely to ease over coming quarters, but the second may not since there is a low probability of wholesale change in the immigration regime. In Australia, which has also seen a sharp change in immigration regime thanks to very tight pandemic rules on travel to Australia, the end of their furlough scheme (the JobKeeper scheme) in March 2021 was followed by an unexpectedly sharp fall in the unemployment rate, not a rise.

The forecasts on page 2 still assume a rise in the unemployment rate later this year, into 2022, but a relatively modest one. The balance of risk at present is tilted towards that forecast being too pessimistic.

Policy about to get much less supportive

Fiscal policy is set to become less supportive in the UK (Chart 56). Several key elements of UK emergency fiscal support are set to end by the Autumn, including the furlough scheme and additional Universal Credit payments. In theory, the unwind of fiscal support comes at a point when it is now longer needed – social distancing restrictions are at an end. In reality, some bits of the economy are still seeing lower activity than pre-pandemic (e.g. office-work related industries like conferences, or even dry cleaning and some tourism-centric businesses) and the end of the furlough scheme may still reveal some underlying labour market dislocation. Over the next two years – tax increases kick in too in 2023 – the shift in fiscal stance is sharp.

Monetary policy remains accommodative, but 2022 rate hike in play: The Bank of England decided to slow the pace of asset purchases in May (which they do not regard as a change in monetary policy stance). They are set to end asset purchases altogether at the end of the year. Unlike the Fed then, the key questions aren't around tapering or ending asset purchases, but already around when the first rate hike will come. After the financial crisis, it was seven years before the Bank of England adjusted interest rates, and that was a cut. After that 2016 rate cut and accompanying increase in asset purchases (which followed the UK vote to leave the EU), Chart 57, the cut was reversed only just over a year later. Given the post-pandemic lack of banking crisis and strong recovery so far, the Bank of England's monetary policy tightening is likely to be closer to the post-2016 than post-2009 experience. For now, the forecasts on page 2 assume a first rate rise in early 2023 (two in that year), but that could easily be late 2022 instead. Some analysts though are expecting something much earlier – a first hike in the first half of 2022.

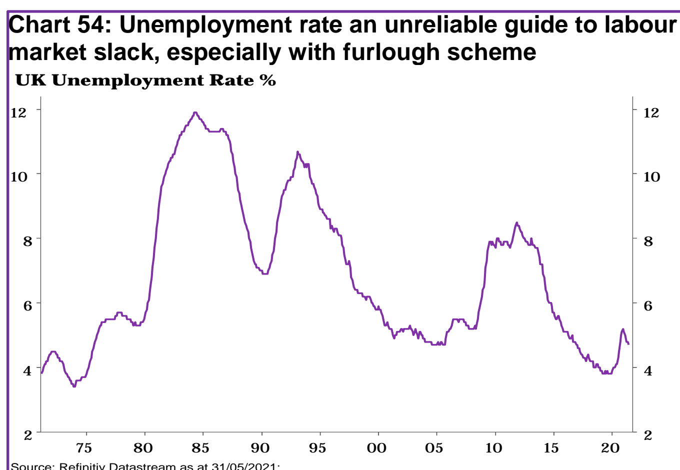


Chart 54: Unemployment rate an unreliable guide to labour market slack, especially with furlough scheme

Source: Refinitiv DataStream, ONS, to May 2021.

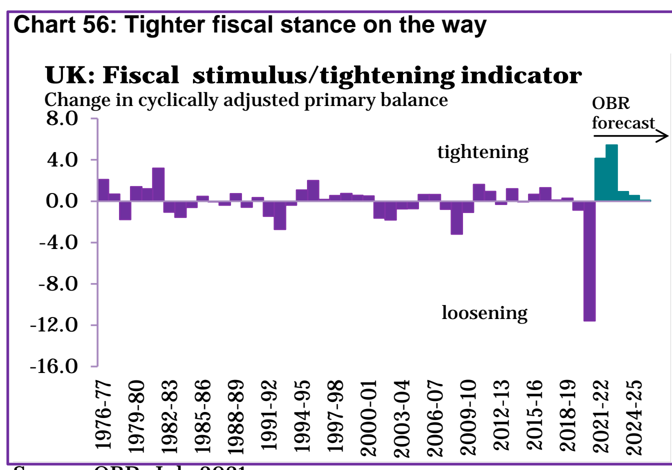


Chart 56: Tighter fiscal stance on the way

Source: OBR, July 2021

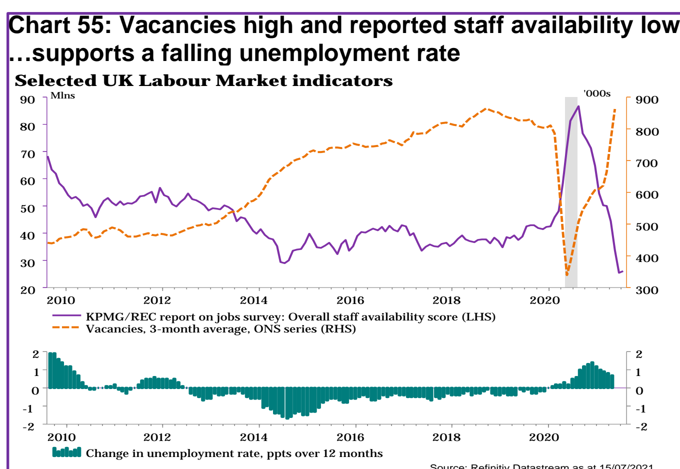


Chart 55: Vacancies high and reported staff availability low …supports a falling unemployment rate

Source: ONS, Markit/KPMG/REC. Vacancies data to June 2021, staff availability to July 2021, unemployment change to May 2021

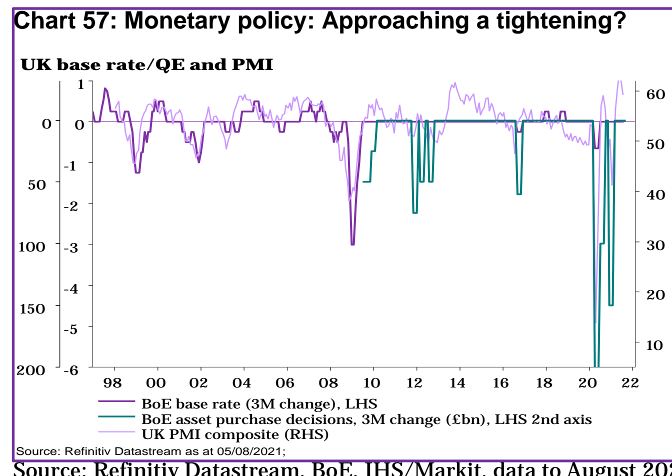


Chart 57: Monetary policy: Approaching a tightening?

Source: Refinitiv Datastream, BoE, IHS/Markit, data to August 2021

The Bank of England's economic forecasts don't support a rush to hike: The Bank's current forecasts for inflation have below target inflation at the end of their profile after a very modest sequence of rate increases starting (very modestly) with a 10bp increase by Q3 2022 with an optimistic set of near-term economic forecasts that already assumes no rise in the unemployment rate as the furlough scheme ends. Their forecasts assume, however, that slack in the economy re-emerges by 2024.

However, according to the minutes for the August meeting, some MPC members think that (necessary but not sufficient) conditions for a monetary policy tightening have already been met. A few things might tip the balance towards an earlier than expected rate rise. The first thing that needs to happen is for some of the uncertainties they face to dissipate, including around the reaction of the labour market to the end of the furlough scheme. An Australia-style fall in the unemployment rate as the furlough scheme ends could well be a game-changer for the policy outlook. A stronger than expected upward push from domestic inflationary pressure with stronger average earnings growth than expected in the first half of next year could be another driver and/or the government deciding to scrap much of the planned tightening in fiscal policy (assuming that decision wasn't a result of a worsening in the Covid situation).

Rate rises are likely to be relatively gradual, partly reflecting lower equilibrium interest rates, the likely sensitivity of the economy (including government finances to higher interest rates (see Returning to recovery for more), as well as the new tightening guidance which envisages the stock of asset purchases starting to be run down as early as when the policy rate reaches 0.5%.

Inflation: More to come

Consumer price inflation climbed over the quarter, on base effects, supply chain issues and re-opening effects. UK CPI inflation reached 2.5% year-on-year in June – well above the Bank of England's 2% inflation target. The Bank of England adjusted their own expectations over the quarter and signalled that they expect inflation to peak above 3%. RPI inflation finished Q2 at 3.9%Y, its highest level since the start of 2018. Higher energy prices, re-opening effects and supply chain problems have all played a role in the rise in UK inflation, as they have elsewhere. The same uncertainty as elsewhere exists over how long supply chain problems in particular will linger for (see global section).

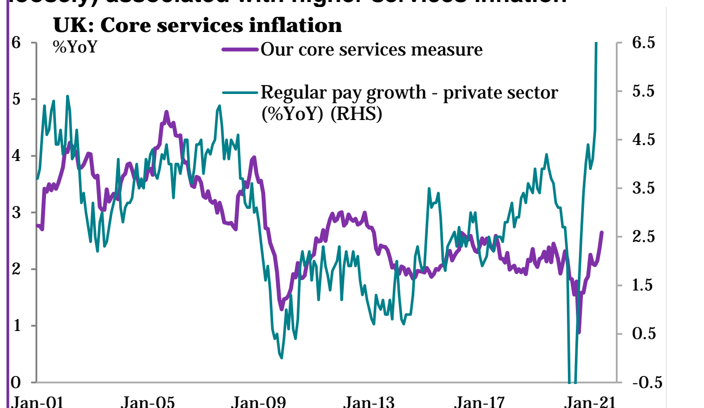
The UK is also experiencing significant pay growth, likely adding to underlying inflationary pressure. The labour market is also showing significant signs of tightness in the shorter-term. Much of this is likely to be Covid related, but some factors behind the current tightness are likely to linger (e.g. tighter immigration), see above. Recent relatively high rates of pay growth are exaggerated by mix-effects, but are still relatively high excluding that. Over the medium term, a recovering economy and less overall slack in the economy *should* lead to rising pay growth and higher general underlying inflationary pressure (pre-pandemic, the wage Phillips Curve at least where lower unemployment brings higher pay growth, was alive and kicking in the UK). Some of that is likely to get absorbed by margins, just as it seemed to pre-pandemic, but higher pay growth does seem to be at least loosely associated with higher core services inflation in the UK (Chart 58).

Still a case for worrying more about US than UK inflation: At least in the short term – UK consumer price inflation is expected to rise through to Q4 2021/Q1 2022 while US inflation is likely to stary falling back. Much of this relates to technical factors e.g. how prices for some sectors were recorded during the peak of the pandemic (see, for example, Chart 59) and the UK will see positive base effects related to last year's VAT cut on hospitality and the Eat Out To Help Out scheme. In the medium-term, it may also be that lower immigration leads to more frequent periods of labour market tightness. However, the US still gives more cause for concern. Household inflation expectations appear to have risen more in the US and tighter fiscal policy is likely to act as a bit of a counterweight in the UK.

Back to Brexit

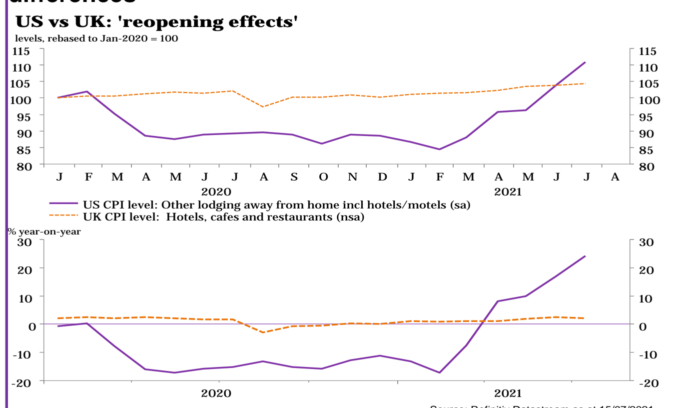
Tensions between the UK and EU on post-Brexit trade relations have been tense for much of this year so far. The two sides have agreed to more talks to resolve issues around trade in Northern Ireland. A serious deterioration in relations could damage business confidence and trading conditions. For now, the forecasts on page 2 assume that, even if both sides continue to struggle to resolve disputes around the Northern Ireland protocol, both sides would utilise processes built into the treaty relationship around settling trade disputes rather than leap to impose tariffs for example.

Chart 58: Pay growth currently exaggerated, but (at least loosely) associated with higher services inflation



Source: Refinitiv Datastream, RLAM calculations, ONS as at June 2021.

Chart 59: Technical factors exaggerating US-UK inflation differences



Source: ONS, BLS, Refinitiv Datastream as at July 2021.

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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.

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