Investor Insight

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A SHOT IN THE ARM FOR GROWTH
Vaccination programmes will allow growth to recover, with a consumption boom expected.

A SUMMER SURGE IN INFLATION
Strong growth will lead to higher inflation, at least in the short-run.

THE POLICY PREDICAMENT
Should higher inflation emerge, central banks will be faced with a difficult conundrum.

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What's in store for the global economy?

As the global economy emerges from the coronavirus pandemic, investors have three questions that matter for markets.

1. How quickly can the economy reopen and recover?
2. Will this cause a sustained rise in inflation?
3. How will monetary policy makers respond?

A SHOT IN THE ARM FOR GROWTH

Vaccination programmes will allow growth to recover, with a consumption boom expected.

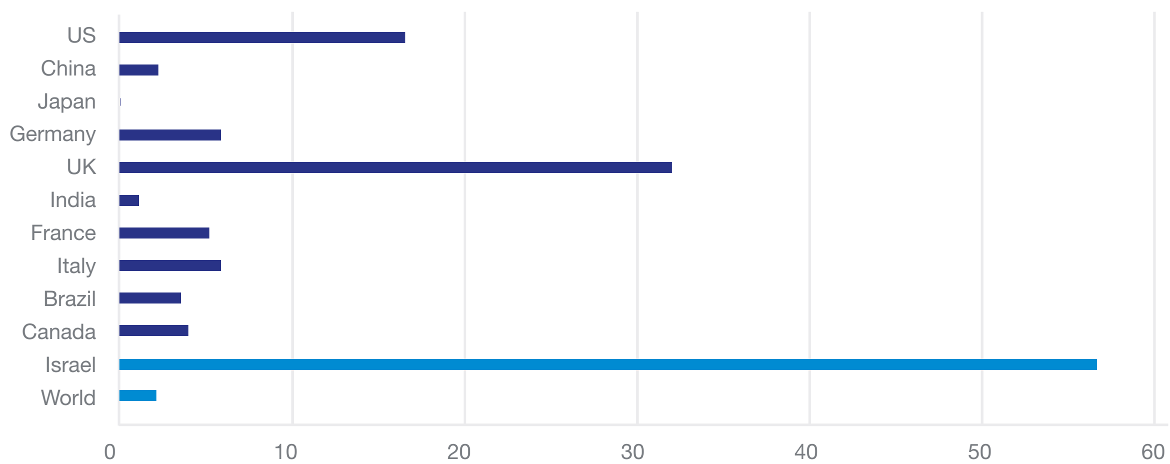
Over the first quarter of 2021, economic growth expectations have risen, as investors grow more confident that the rollout of Covid-19 vaccines will allow the global economy to reopen. Vaccination programmes are progressing at varying rates in different countries, with supply and distribution constraints the most significant factor (see Figure 1). To some degree, this is a question of a country's willingness and ability to pay a premium for priority access to doses – explaining why vaccination rates in the world's poorest countries remain virtually non-existent. However, decisions made by governments and regulators have had an impact too.

While the UK administered its first Covid-19 vaccine in early December, having fast-tracked approval based on trial data, Japan did not begin vaccinations until the second half of February. The delay was due to Japanese regulators opting to run their own trials in Japan, in order to combat low public confidence in vaccines following a number of historical vaccine scandals. European countries which chose to implement their own trials have faced similar delays.

Because the efficacy of health policy remains the main constraint on a country's economy, we are now seeing the pace of vaccine rollouts have a powerful effect on economic expectations, with economic activity expected to rebound in the second and third quarters as social restrictions are withdrawn.

In the US, the vaccination programme is now progressing well, with 15% of Americans having received at least one dose as of the beginning of March, while an additional increase in doses is expected to facilitate further roll-out acceleration. States are already withdrawing remaining social restrictions, such as restaurant capacity constraints, which have hurt the economy. Restaurants,

Figure 1: People vaccinated with their first dose as a percent of total population



Countries ordered by nominal GDP (descending), with Israel and World as comparators.

Source: Datastream as at 5 March 2021.

entertainment, and hospitality are significant sectors for US employment, and jobs data already indicates that the renewal of social consumption is drawing workers back into the labour market, which will help to drive down unemployment.

Assuming US consumers are willing to, they are well able to spend. A combination of deferred consumption and income support measures has resulted in high household savings rates – surging to as much as 20.5% in January. Savings have also been boosted by two direct transfers to qualifying households, totalling a total of $2,600 per person.

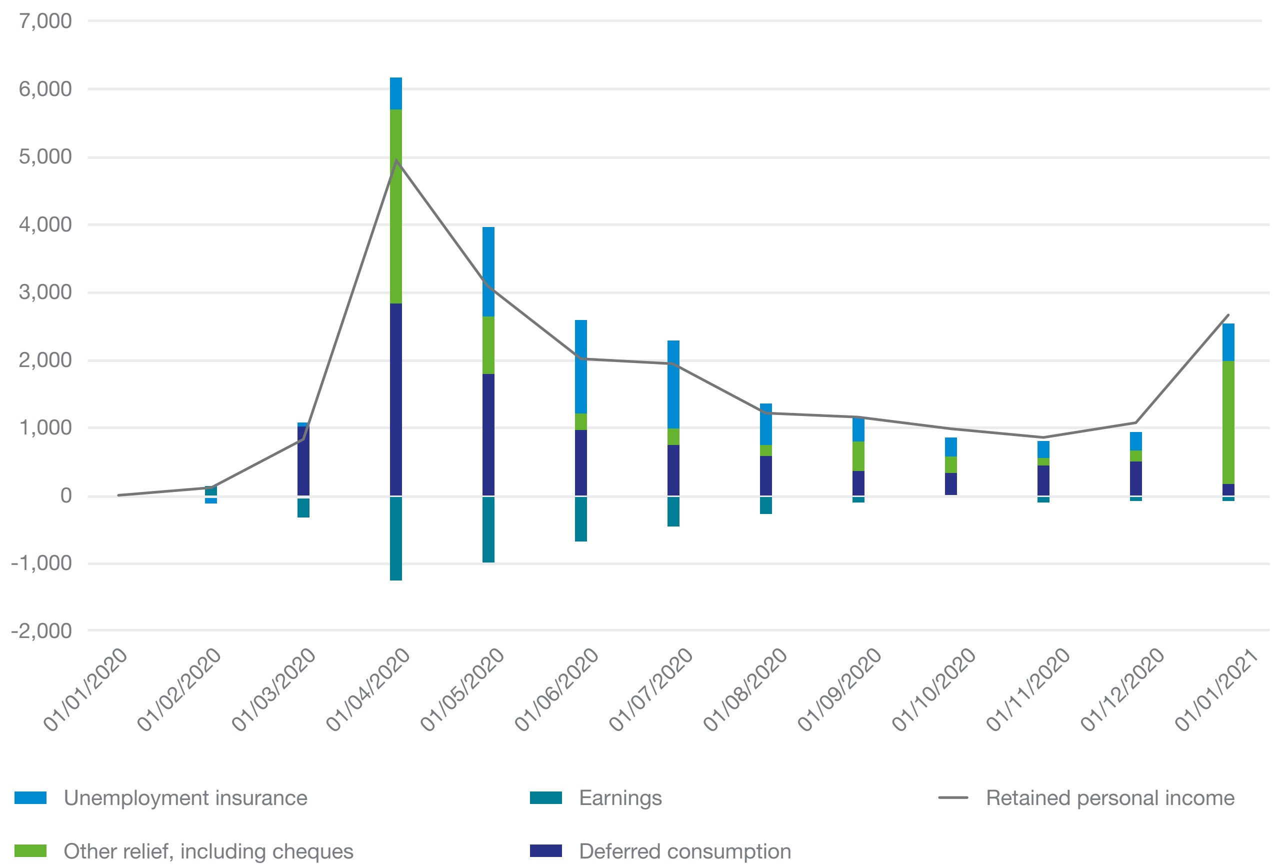
In April, when the first round of $2,000 relief cheques hit bank accounts, we saw a dramatic increase in household disposable incomes, enhanced further by a lack of spending opportunities, but offset somewhat by a loss of wage-earnings (see Figure 2). The net effect was that the majority of households were better off, and some low-paid workers were much better off. This translated to relatively resilient consumption spending, especially on goods (many of which were imports).

The December round of $600 cheques – part of a package designed to extend many expiring benefits as the second wave of the virus raged – has also boosted spending, with retail sales up 5.3% in January.

Congress have now passed a third support package of up to $1.9trn, which will include $1,400 cheques direct to eligible households. This double dose of stimulus should turbo-charge the economy, with additional funds expected to hit just as the services sector reopens.

The combination of higher disposable income from savings, better employment prospects, and new opportunities to spend money on services is likely to give the US economy a significant boost. As a result, the US economy is expected to grow by 10.9% year-on-year (YoY) in the second quarter of 2021. We also expect to see similar dynamics in other countries, though the magnitude and timing of rebounds may differ, based on how soon services can resume, the degree of fiscal support households have received and how long employment takes to recover.

Figure 2: US incomes, annualised $Bn



Source: Datastream

A SUMMER SURGE IN INFLATION

Strong growth will lead to higher inflation, at least in the short-run.

The expected improvement in the global economy, with the resumption of services activity boosted by a catch-up in deferred consumption, is likely to lead to several quarters of higher growth. This period of catch-up growth is also likely to lead to a period of higher inflation, as demand surges to overtake supply, supply-chain bottlenecks hit, and year-on-year comparisons flatter prices. Recall that a year ago the price of a barrel of oil briefly went negative.

Just as the crash in inflation caused by the pandemic did not last forever, a post-pandemic spike could pass just as quickly. If households use higher savings to increase their consumption over several quarters, eventually those savings will be exhausted, and year-on-year comparisons the following year would make GDP growth and the rate of inflation look lower in comparison.

For this inevitable inflationary ripple to translate into sustained inflationary pressure the post-pandemic recovery needs to deliver a significantly stronger labour market. High unemployment limits workers' ability to negotiate higher wages. Suppressed wage growth, in turn, constrains households' ability to increase consumption, or to maintain consumption and absorb price increases. Persistent inflation likely needs the support of rising wages or goods prices, or both.

As well as these cyclical inflationary dynamics, other changes that could have an impact on inflation may be afoot in the global economy. Structural shifts including the aging population, increased automation, a move to a greener economy, and de-globalisation may all play a part.

THE POLICY PREDICAMENT

Should higher inflation emerge, central banks will be faced with a difficult conundrum.

What does the prospect of higher inflation mean for monetary policy? As a rule of thumb, when inflation is above a central bank's target, monetary policy is tightened. With today's suite of monetary tools, that generally means higher interest rates, or a cut to the rate of asset purchases (known as Quantitative Easing) by the central bank.

Expectations of a sustained inflationary revival remain muted in Europe and Japan (where inflation had concerned central bankers by its absence prior to the pandemic), partly because the vaccine rollout is happening more slowly and fiscal policy is less supportive. However, in the US, where unemployment was low before the pandemic and fiscal stimulus looks set to boost the post-pandemic rebound, expected rates of inflation and interest have risen in recent weeks.

The members of the US Federal Reserve Open Markets Committee (FOMC) appear to disagree. The Committee has hitherto said that it will not tighten monetary policy in response to a period of higher inflation, arguing that many of the inflationary factors may be transitory and may not translate to higher inflation on a sustained basis, while past experience suggests that tightening too quickly can snuff out a nascent recovery.

Under the Federal Reserve's (Fed) average inflation targeting framework (introduced last year), the FOMC has stated that it will not tighten monetary policy until inflation shows signs of being sustainably above 2% for some time, and until employment has recovered across socio-economic groups. Crucially, Fed Chair Jerome Powell has emphasised that, prior to the pandemic, US unemployment was at very low levels and yet inflationary pressures remained limited.

The market is signalling that it thinks the Fed is behind the curve – the recent increase in bond yields and steepening of yield curves suggests that the market expects inflationary pressures to be more lasting, possibly requiring a tightening of monetary policy. Three possible outcomes present themselves:

1. Inflation may rise and then fall back once excess demand has worked through the system, in which case the Fed is unlikely to tighten monetary policy.

2. Fiscal and monetary stimulus may translate into a stronger labour market and sustained inflationary forces, causing the Fed to respond by tightening monetary policy, and cooling the economy.

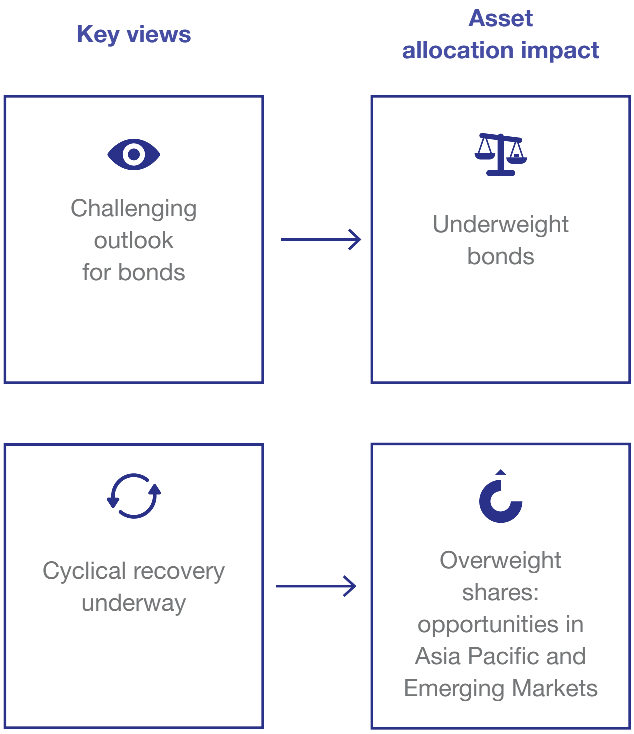
3. Stimulus may translate to sustained inflation, but the Fed could (in a policy error) fail to respond with sufficient tightening, resulting in high growth and high inflation, and the need for a more dramatic tightening of monetary policy down the road.

POSITIONING PORTFOLIOS

Market speculation as to the path of inflation has caused some turbulence in recent weeks. Bonds tend to underperform when inflation expectations are rising because they pay a fixed, nominal return that does not increase with inflation.

Whether or not the Fed responds to inflation is as important for markets as whether that inflation eventually appears. The price of US government bonds has fallen of late, as investors factor in an increased likelihood that interest rates rise sooner. This has had a knock on impact on certain equity market sectors, because interest rates are used to value the future earnings of companies. Companies in growth sectors have been more sensitive to these movements, as a higher proportion of the value of such companies is due to high growth expectations in the future.

Movement in the US has also spilled over to overseas markets, pushing up bond yields around the globe. Given that the rest of the world is, for the most part, not as advanced in its recovery as the US, this may have the effect of tightening liquidity conditions prematurely.



Conclusion

While the outlook for growth points firmly to a recovery, and we anticipate inflation to rise in the near-term, the dynamics that would support a more sustained change in the inflationary environment are not well understood. With this in mind, we consider it prudent to acknowledge the risk that the period of low inflation, which has persisted since at least the financial crisis, could end. This presents an opportunity for investors to hold equity sectors that are geared to the economic cycle and will prosper from any upswing in growth, and a reason to be cautious on bonds.
At the same time, we continue to believe that a number of structural changes are at play within the global economy, and that businesses exposed to these themes can make attractive investments. Moments of market turbulence, when stocks in these often richly valued sectors are repriced lower, may present a buying opportunity.

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