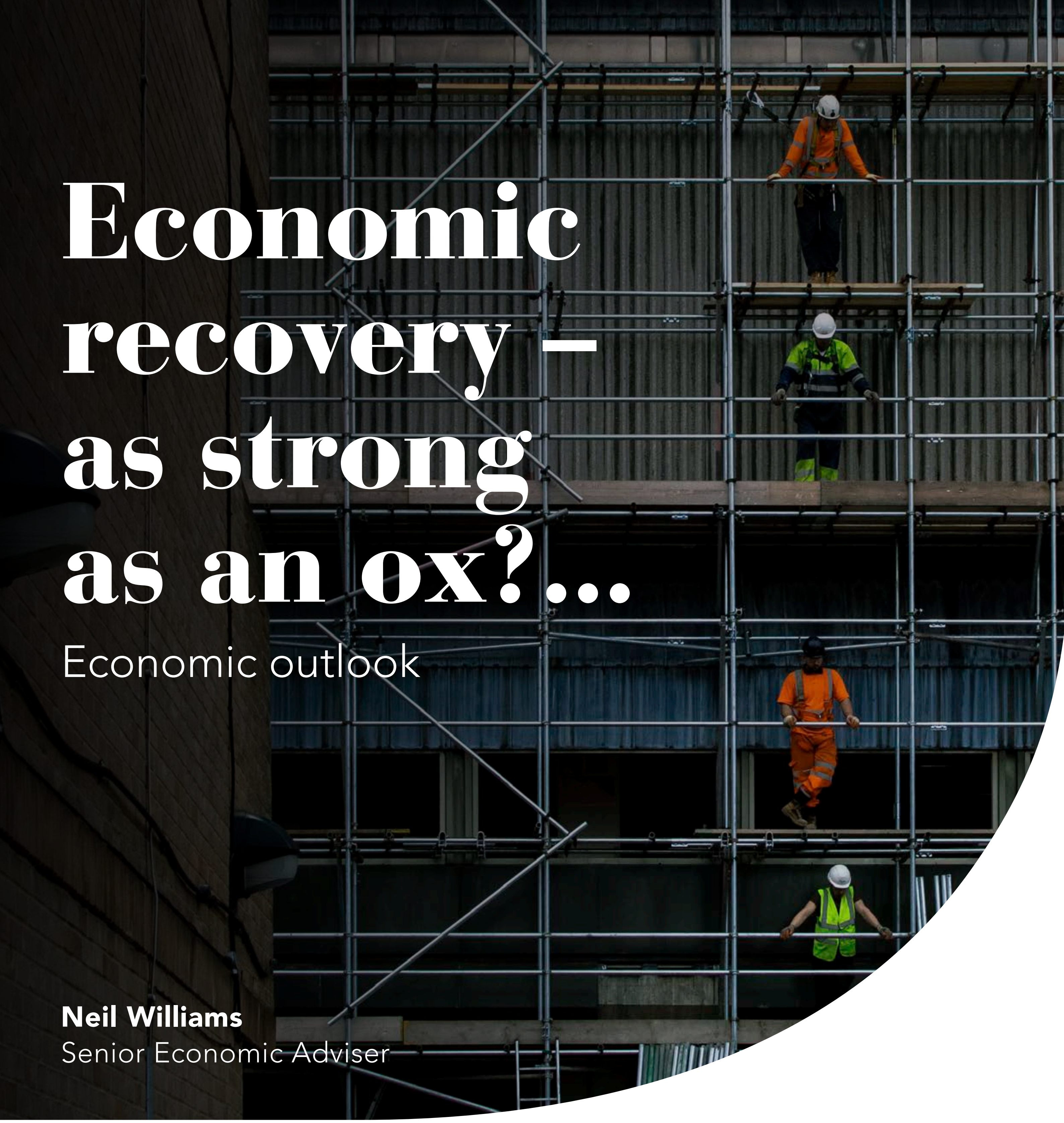

Economic recovery – as strong as an ox?...

Economic outlook

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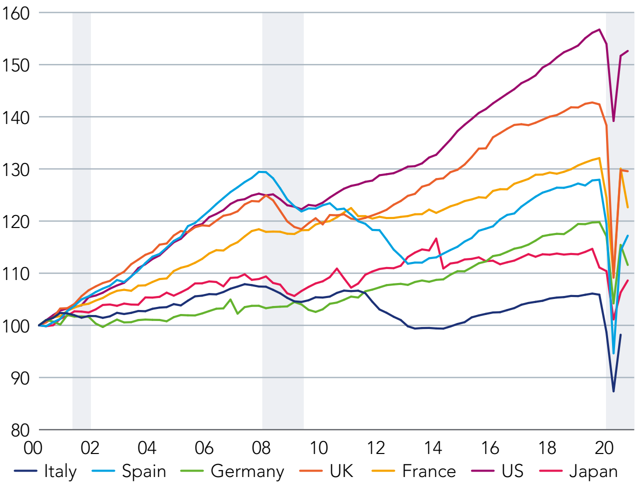
Main points

- Looking at the rest of 2021 through a macro lens feels a bit like 2009, in that 'it can only improve on the year before'. Which, surely it must. Stimulus extensions, accelerating vaccine roll-out (notably in the UK), base-effect, and expectations of more are all raising confidence, supporting risk-assets and promising macro improvement.
- The US and UK have so far claimed back about three quarters and one half respectively of their real activity, with a similar bounce in household consumption. But, with lockdowns slow to phase out, vaccines facing mutant strains, and households and firms potentially tending to balance-sheet repair, it may be another two-three years before economies can sustain their pre-Covid trajectories.
- This leaves central banks, bereft of inflation, reaching for variants of the tools that failed them. None of these suggests tighter conditions, validating money-markets and forward-curves pricing out meaningful rate and yield rises within central banks' forecast horizons. And while this exposes risk of a 2013-style 'taper tantrum', they would be loathe to tolerate it for long.
- We expect growth to ebb and flow through 2021 and 2022, channelled by medical (vaccine success) and macro factors (stimulus, political distrust). The by-products being continued monetary accommodation (US/UK real rates stay negative), profligate governments, and yet, given international tensions, the shine taken off assets that overestimate the speed of recovery, and underplay the importance of stimulus.
- The importance of employment shifts to risk assets has risen as labour markets deregulate. They typically now pre-empt changes in QE by up to three months, and in employment by a year. Given hopes of a 'V-shape', in the US at least, maintaining the risk-on trade will be predicated to a large extent on further employment gains. But, with these likely to lag, more fiscal help may be critical.
- Given the headwinds (medical and macro), policymakers cannot be complacent. The economic 'scaffolding' (global stimulus) needs to stay up, with efforts focusing on growth, restoring jobs and generating demand-inflation. For central banks and governments, the alternative - deflation - is deemed unthinkable in a high-debt world. As in 2007-2009 rapid employment downturns do not guarantee the sharpest recoveries.
- In which case, the risk to markets comes not from central banks and policy tightening, but protectionism and distrust, especially if the international 'blame-game' for the virus intensifies. This could be heightened if employment-scarring, for example, starts to be used as political capital.
- Either way, risk assets, cushioned by liquidity, will assume that if macro recovery cannot be sustained, stimulus will have to fill the gap. Which surely it must if we're to see demand-inflation. So, in the 'Lunar Year of the Ox', recoveries need to start strongly, if we're to kick away the strains from the 'Rat Years' 2008 and 2020…

Chart 1. Consumers are starting to claw their way back...

Real household consumption re-based (Q1 2000 = 100). Grey is US recession



Source: Refinitiv Datastream, based on national data

Chart 2. But, a 'V'-shape recovery is not for everyone

Consensus Economics forecast for UK economy.
Rate & yield projections are for May '21 & Feb '22

% yoy unless stated	'16	'17	'18	'19	'20e	'21p	'22p
Real GDP	1.7	1.7	1.3	1.3	-9.9 (-5.4)	4.2 (4.7)	5.6
Household consumption	3.7	1.0	1.3	0.8	-11.4 (-5.8)	4.3 (4.3)	6.6
Fixed investment	4.4	2.8	0.4	1.5	-8.7	3.4	7.0
Manufacturing production	0.3	2.3	1.2	-1.7	-9.9	5.1	3.7
Consumer prices	0.7	2.7	2.4	1.8	0.8	1.5	2.0
Unemp, ILO rate (3m av, %)	4.9	4.4	4.1	3.8	4.6	6.6	6.0
Govt budget balance (% GDP)	-3.2	-2.6	-1.8	-2.5	-19.6	-9.4	-5.9
10-year Govt bond yield (yr-end %)	1.2	1.2	1.3	0.8	0.2	0.5	0.7
3-month rate (yr-end, %)	0.4	0.5	0.9	0.8	0.0	0.1	0.1

Source: National data, & Consensus Economics (Feb '21) projections (p). April '20 in parentheses

Comment

Looking at the rest of 2021 through a macro lens feels a bit like 2009, in that 'it can only improve on the year before'. Which, surely it must. Extensions of last year's record stimuli, accelerating vaccine roll-out (notably in the UK), and expectations of more are lifting confidence and supporting risk-assets. These, together with base-effect after last spring's 'eye of the storm' wiped out six and seventeen years of US and UK GDP-growth, all promise macro improvement.

Encouragingly, the US and UK have so far claimed back about three quarters and one half respectively of their real activity lost. A similar bounce is seen in household consumption, which, at 60-70% of GDP for major economies, will determine the speed and durability of recoveries. But, with lockdowns slow to phase out, vaccines facing mutant strains, and, once support lifts, households and corporates potentially tending as much to balance-sheet repair as re-leveraging and spending, it may be another two-three years before economies can sustain their pre-Covid trajectories.

Like 2009: 'it can only get better'...

A release of higher precautionary saving would help. In the UK, the BoE is watchful of the leap in the savings ratio (personal savings to disposable income), from near 7% in 2019 to 18% (Q1-Q3 2020 average). Yet, with their forecast model assuming the bulk of this higher net worth (mainly bank deposits) is held by those with lower marginal propensities to spend (middle and higher-income earners, pensioners), they're not convinced that unleashing it would spark overheating. Following March's Budget announcement that personal tax thresholds, for example, will be frozen from 2021/22 till 2025/26, any reluctance to scale-back on saving may have increased.

Elsewhere, even before 2020, consumers in Japan (with deflation) and Italy and Spain (locked in the euro) had yet to recover their post 2008-09 losses. Covid meant having to restart from 2001 and pre-euro levels (chart 1). This, together with the disproportionate hit to – and representation in GDP data of – services (tourism, leisure etc), now herald a disparate pace of national and sector recoveries.

Economic consensus seems again to be for a swift V-shape recovery in the US, where overall stimulus has been deepest, and (state-led) lockdowns seemingly less severe. But, for the UK (chart 2), initial hopes last April of a 'V'-shape have morphed into something closer to a 'W' or even more divisive 'K'. The same is true for Japan and the euro-zone. China may be the most notable exception. But, its state-led GDP bounce could yet be eroded by beggar-thy-neighbour policies, especially if the international 'blame-game' intensifies.

This leaves central banks, bereft of inflation, reaching for variants of the tools that failed them. Their relief in the short-term depends on the interplay of which factors re-adjusts first – higher demand or repaired supply-chains. Reflecting the former, inflation expectations have been turning back up (e.g. US 2-year break-evens having cut 2.5%). This looks right given a likely demand-release once lockdowns lift. But, unless this is sustained, any inflation will surely be the 'wrong sort' (like 2011 with oil): cost-push led by shortages and potential mark-ups, rather than wage-led demand-pull.

With employment running behind output and labour markets deregulated, central banks should be able to look through such short-term inflation bouts, remaining conscious of the underlying *disinflation* from balance-sheet repair, demographics, and automation (see our *Under pressure? Five dynamics shaping the inflation outlook*, January 2021). This is a long way from early/mid 1970s Britain, for example, where wage-price spirals contributed to a near three-quarters fall in the FT 30 Index between 1972 and 1975.

None of their variants suggests tighter conditions further out, which validate still relaxed money-market and bond forward-curve assumptions. These, rightly, are easily pricing out meaningful rate and yield rises within central banks' typical two-year forecast horizons. Clearly, this exposes unexpected risk of a 2013-style 'taper tantrum'. Yet, with central banks' even higher 'skin in the game' now via bloated balance sheets, they would probably be loathe to tolerate it for long.

In its March Statement, the US FOMC pledged to continue buying US Treasuries and MBS "*until substantial further progress has been made toward the committee's maximum employment and price stability goals*". With inflation yesterday's problem, and employment gains likely to be slower, expectations that tapering will not be announced before 2022 (Bloomberg) look feasible.

Back in 2009, recovery was signposted mid-year by the (NBER-defined) end of US recession. Employment and core inflation, much like now, lagged output, deferring central bank tightening: the US Fed till 2015; the BoE in 2017. A difference this time is fiscal expansions. While these vary in scale, it's difficult to see how they can be quickly reversed without unintended consequences.

With G7 government default-risk close to zero (debt denominated in local currencies), and inflation sought now by governments too, there's every incentive to overshoot on growth, and address imbalances later. In which case, the bigger market risk might ultimately be a 1994-style correction as a 'hands off' US Fed scurries from 'behind the curve', rather than an earlier 'taper tantrum'.

In the meantime, our base-case is one where growth ebbs and flows through 2021 and 2022, channelled by both medical (vaccine success) and macro factors (stimulus, political distrust). The by-products being continued monetary accommodation (US/UK real rates stay negative), profligate governments, and yet, given international tensions, the shine taken off assets that overestimate the speed and duration of recovery, and underplay the importance of stimulus.

But, stimulus will have to be kept on…

Prior to vaccine discovery, the strong recovery in equity markets looked driven more by record fiscal stimulus, ultra-low bond yields, the prospect of extended monetary loosening, and hope they could propel future growth, rather than any signs of economies returning to normal. With vaccine providers suggesting early summer before receipt by other than front-line workers and the most vulnerable, 'normality' still seems unlikely before the autumn. In which case, relief measures, such as the UK's furlough scheme, may have to be extended.

Charts 3 to 5 reflect the importance to markets of keeping the economic 'scaffolding' (global stimulus) up. Chart 3 reminds us that the damage to equities in early 2020, prior to fiscal packages, was both outright, and relative to 'safer' government bonds. This relative hit dwarfed that of 2008-'09, presumably reflecting the clamp on bond prices that a decade of QE has since established. Yet, equities' relative recovery since Q2 2020 and lower expected volatility have been impressive, much of which must be owed to further monetary expansion and, especially, successive fiscal packages.

Chart 3. Elevated equity markets power back…

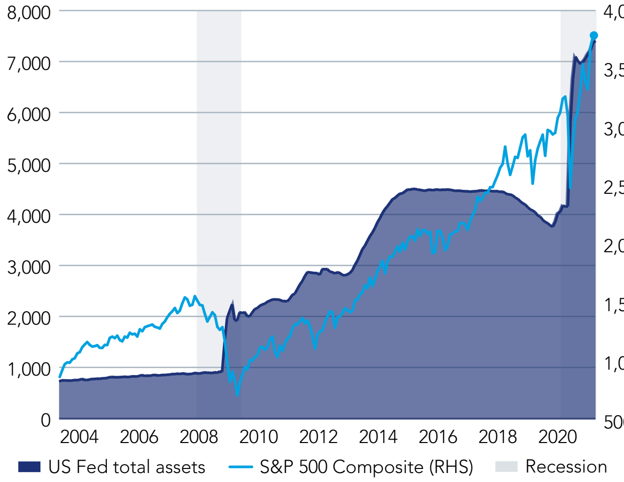
US equity-bond yield gap (using DJ Industrials & 10-year Treasury), vs VIX volatility index. Grey is US recession

Source: Refinitiv Datastream

Reflecting this, comparison of the US Fed's balance sheet and the S&P 500 since QE's start in 2008 Q4 yields a simple correlation as high as 0.86 (chart 4). The relationship is strongest with a 10-week lead, suggesting the S&P on average pre-empts QE changes by two-three months. A noticeable difference now, though, is the positive contribution of stimulus (it was negative in 2008-09) through this 'belt and braces' approach, as fiscal packages this time augmented monetary stimulation.

Chart 4. As central banks' balance sheets balloon

US Fed balance sheet into & since QE/QT ($bn), vs S&P 500 Composite (RHS). Grey is US recession



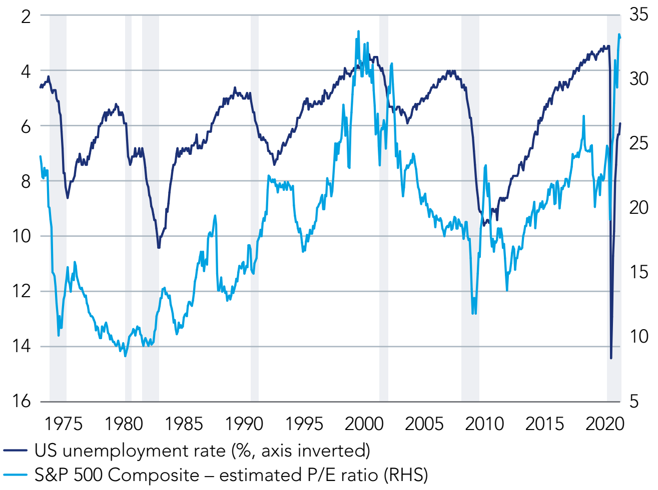
Source: Refinitiv Datastream, based on Federal Reserve data

Though, critical, of course, for macro recovery will be the extent to which this stimulus feeds, directly or indirectly, the real economy. Taking the US unemployment rate as a long-term proxy for global activity, our analysis since 1964 throws up a simple correlation with the S&P 500 of just -0.23, revealing a nine-month lead. Restricting this, though, to the QE-period since 2008 Q4 renders a stronger, -0.83, with the same lead. To make sure, chart 5 again maps the unemployment rate, but with the S&P's estimated price-equity ratio, which exhibits far more long-term fluctuation than the equity index itself. This similarly offers rising correlations of -0.55 and -0.67 respectively, for the 1975-2021 and 2008 Q4-2021 periods, with an 11-12-month lead.

This comes even with the short-term relationship breaking down in 2020, as US job losses reached eye-watering levels. Despite these, the ability of the S&P and p/e ratio to scale new highs during a recession suggests, prior to vaccines, that record stimulus was sufficient to reassure markets that recession and job losses would prove temporary.

Chart 5. Risk assets are pre-empting macro improvement

Estimated P/E ratio for S&P 500 Composite (RHS), vs US unemployment rate (inverted axis). Grey is US recession



Source: Refinitiv Datastream, based on BLS data

On this basis, these observations suggest: *(i)* the importance to risk assets of employment as a demand-indicator has risen over time, presumably as labour markets became less regulated; *(ii)* these assets typically pre-empt changes in QE by up to three months, and in employment by a year; and *(iii)* given hopes of a swift V-shaped recovery, in the US at least, maintaining the risk-on trade will be predicated to a large extent on further employment gains. Or, failing those, more stimulus, especially from the fiscal side.

What could go wrong?...

Given the headwinds, medical and macro, policymakers cannot be complacent. Efforts need to focus on overshooting on growth to restore jobs and generate demand-inflation. For central banks and governments, the alternative – Japan deflation – is deemed unthinkable in a high-debt world.

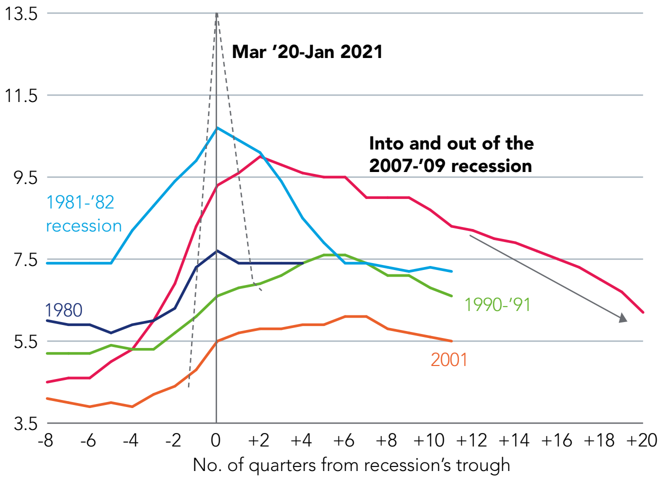
First, as in 2007-09, rapid employment downturns do not guarantee the sharpest recoveries (chart 6). In the US, the labour data last summer improved as furloughed workers returned, but then stalled. Thankfully, they are now springing back, driven predominantly by returning leisure and hospitality workers. If US jobs continue to be clawed back at February's pace (379,000), the nine-and-a-half million workers displaced by the virus could in theory be returned by the November 2022 mid-term elections. But, given the headwinds, medical and macro, and typical lags between employment and output gains, this may be a tall order.

The 'underemployment rate' (U6), which includes those not searching but wanting to work or work more, at 11.1% versus 7.0% a year ago, may be slower to fall. This delay may not be helpful to a new President seeking favour in a split Congress and looking to heal social divides. It remains to be seen how spendthrift returning 'furloughers' can be.

While in the UK, the unemployment rate, though rising during Covid from 4.0% to 5.1% (December), has so far been limited. Measured differently to the US, this stands to rise when furloughing lifts, reinforcing BoE governor, Bailey's warning that "*The labour data at the moment are the hardest to interpret*" (4 February). It also offers little hope that UK real-wage growth (having been stagnant for the first decade since the 1860s) can sustain its recent base-assisted gains.

Chart 6. Unemployment in US recoveries

US unemployment rate (%) into & out of recessions. Years shown are recessions



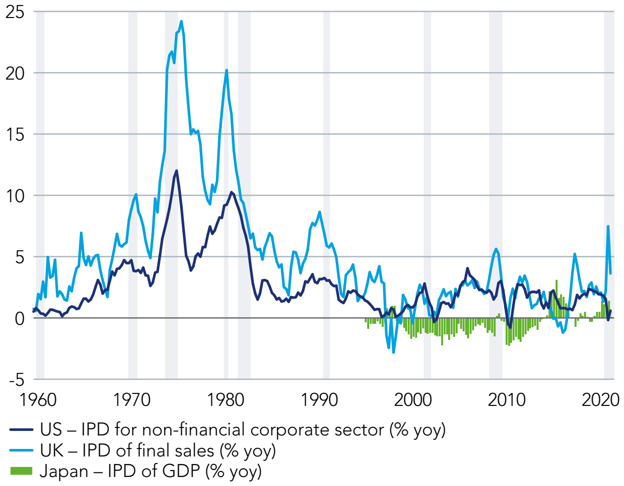
Source: Federated Hermes, based on BLS, & NBER

Second, President Biden may not over time prove *unambiguously* positive for risk assets. In the near term, his pledges to promote recovery, and conciliate on international trade and climate change should be accommodating for growth. But, while setting a more collaborative tone on trade, he looks unlikely to unilaterally roll back existing restrictions. This could include relying more on allies to help resist China, assuaging, though not removing, the global protectionism risks that keep us cautious on world recovery. It remains to be seen how vehement he can be, given his need to tap into Republican core bases, and China's 'chest puffing' ahead of its 2022 National Congress.

On the surface, his pledge to raise both the main corporate (from 21% to 28%) and top personal tax rates (from 37% to 39.6%) make him look hawkish. Independent estimates suggest first-round revenue-increases from these centred on $3.6trn over a decade. This would effectively take back last year's fiscal stimulus. Given economic, social, and political considerations, though, implementation may be kept for after the mid-terms.

Chart 7. Even US pricing-power is still modest

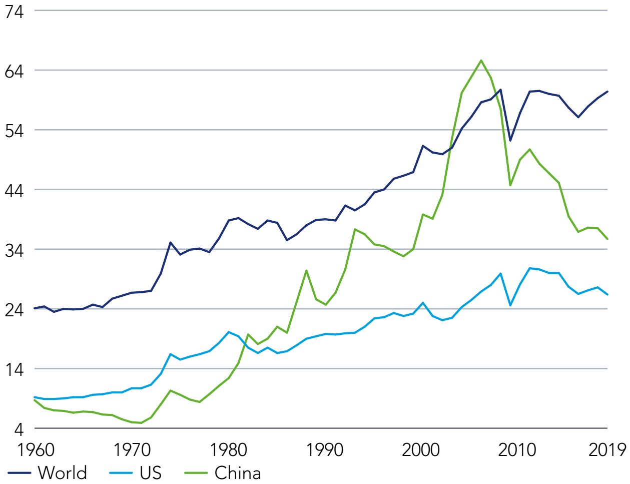
Implicit price-deflators (%yoy). US's is for private sector, non-banks. Grey denotes US recessions



Source: Refinitiv Datastream, based on national data

Chart 8. World trade is assumed to be largely unabated

Trade (exports plus imports)* as a share of respective GDPs



Source: World Bank data (*goods & services)

Third, QE may be part of the problem, not the solution. With inflation craved by governments *and* central banks, QE will be harder to kick. As it continues to boost asset prices over wages, this could further widen wealth disparities. With even more bond supply, Japan, after 23 years, is having to run QE just to 'stand still'. In 1951, the US Treasury-Federal Reserve Accord was the reason for stopping US QE after 14 years. This could even be questioned, formalising the dependence QE-governments have on their central banks. In an even-higher-debt world, a challenge will be avoiding the impression that central banks are becoming the 'Monetary Departments' of government. And, especially as the former consider more closely using digital currencies.

And even if green shoots show in the cluster of spring pay claims (*e.g.* IG Metall, Japan's *shunto*), they may be trampled underfoot unless corporate pricing-power builds. Chart 7 uses implicit-price indices from GDP data to suggest recent improvements in economy-wide inflation have reflected cost increases (Japan's tax hikes, sterling depreciation, and a statistical quirk in measuring the UK's public-sector deflator), more than demand.

Fourth, political distrust and beggar-thy-neighbour policies globally may continue to build, the effects of which appear outside most official macro forecasts. Implicit to the IMF's January forecast, for example, is a hefty acceleration in world-trade, assumed to average +7.2%yoy in 2021 and 2022, after -9.6% in 2020, across advanced economies (+6.8%yoy) *and* emerging markets (+8.0%yoy).

In the US, the Senate would probably oppose a general approach to trade akin to the Smoot-Hawley reforms of 1929-30, but as we know from previous trade conflicts, there are no real winners. Admittedly, we seem now to have a less confrontational US President. For markets, trade frictions may thus (like Brexit) be more a 'crack-in-the-ice', than a 'cliff-edge', event, with a disparity, at least initially, between goods and service sectors, and broadening out to countries whose 'cheaper' imports can fill the gap. This potentially offers a reversal of the goods-services rotation under Covid. Either way, as chart 8 suggests, the world is overall now more than two times trade-dependent (goods and services) than during the Bretton Woods era up to 1971, for example.

But, direct vulnerability lies not with the US (whose dependence is limited) and China (where dependence is falling), but smaller, open economies. These include South East Asia (Malaysia and Thailand's trade ratios exceed 100% of GDP, Vietnam's 200%, Singapore's 300%), Australia and New Zealand (46% and 56%), UAE (160%), and core Europe (Germany 88%, UK 64%, Netherlands 150%). Should stagflationary forces build from stand-offs, the inflationary flame will surely snuff itself out.

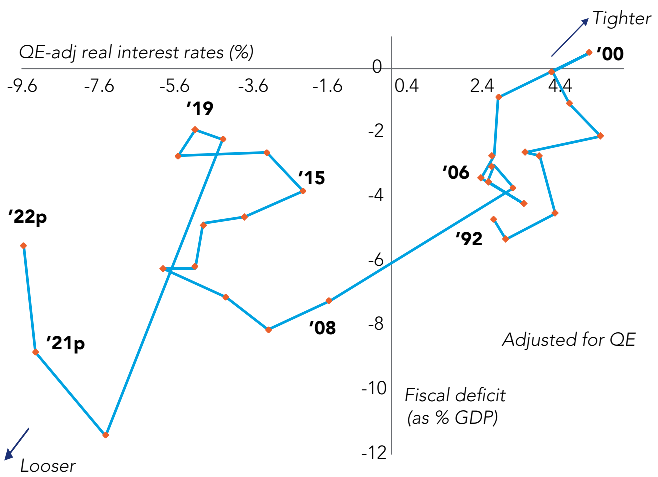
Even looser macro policy?...

Policy will, thus, have to stay abnormally loose. Central banks, long frustrated by inflation's absence, now question their traditional reaction functions, such as CPI targets and Phillips Curves, which have remained 'inexplicably' flat relative to the business cycle. Recent tilts, though - including the US Fed's move to average, rather than fixed, inflation targeting, the BoJ's explicit yield-targeting since 2016, and a BoE now considering negative rates and QT before eventual rate hikes - may all herald more widespread paradigm shifts. The ECB's review should conclude by mid-year.

None of these would, meaningfully, tighten conditions. Based on the US Fed and BoE's own metrics, we estimate the US and UK are already running *true* policy rates as low as -8% and -6.5% when QE is fully considered (-10% and -7.5% in real terms). The UK's policy-map is shown in chart 9. Together with record fiscal packages, this confirms by far the loosest overall stance in nearly three decades of data, probably post-War, and points to even lower real rates in 2021 (-13% and -9.25%) as inflation rises temporarily. It also questions the need to follow the ECB and BoJ onto negative 'headline' rates.

Chart 9. Monetary policy (UK example) could become even looser

Using QE-adjusted Bank rate, BoE's CPI projections, & cyc-adj fiscal balance as % GDP. Projections also based on latest Bank rate



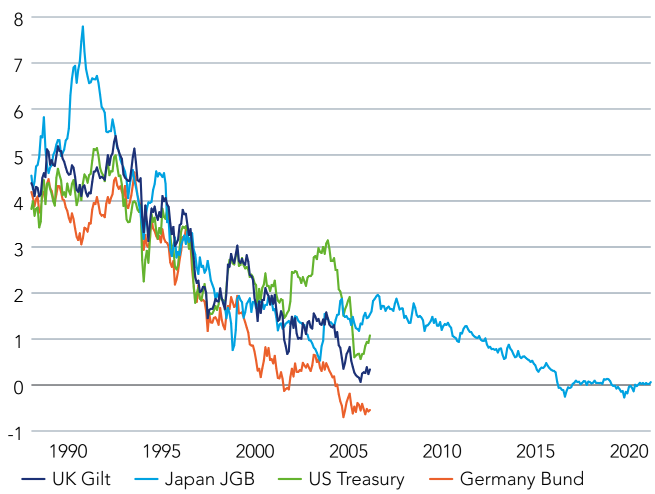
Source: Federated Hermes, based on OBR, ONS, BoE, OECD, & Bloomberg data

Implicit to chart 9 is the consensus expectation that any policy correction in 2021 and 2022 will come from the fiscal side. Chancellor Sunak set out the bones of this in his Budget, with measures to address the deficit (e.g. frozen personal tax thresholds, higher corporation tax rate) loaded for after 2021/22. Yet, with GDP below trend, any further measures may have to be subtle (e.g. massaging down public expenditure relative to current plans) or more back-end loaded, rather than via early, widespread tax hikes. One palliative might be to tailor future fiscal withdrawals (or stimuli) to environmental performance. (See our *Building back better: why climate action is key to a resilient recovery* report, May 2020.)

Should long-end gilt investors then be disappointed by a soft withdrawal, the spectre of a 'taper tantrum' is raised. And, as chart 10 suggests, there's room for bond yields to rise even in a 'Japan-style' scenario. But, with all main central banks now running QE, not just the BoJ, there's likely to be at least as-finite-a-cap on yields as growth-recovery builds. One option might be for others to try Japan-style yield-targeting, as a means of keeping debt-costs down, and yet varying the amount of, and maturities under, QE.

Chart 10. Is Japan still leading the way?

Ten-year JGB yields vs other 10-year bonds, lagged 15 years (%)



Source: Federated Hermes, based on Refinitiv Datastream

So, all in, the sensitivity of markets to vaccine-success and macro-recovery, coupled with political risk, protectionism, and new policy-thinking suggest renewed volatility. In which case, the risk to elevated markets comes not from central banks and fiscal tightening, but protectionism and distrust, especially if the international 'blame-game' for the virus intensifies. This could be heightened if employment-scarring, for example, becomes used as political capital.

Either way, policy has to stay loose for want of not 'throwing out the baby' (recovery) with the 'bath water' (tax/rate rises, spending cuts) - with QE, and economic distortions persisting. Risk assets, cushioned by liquidity, will assume that if recovery cannot be sustained, stimulus has to fill the gap. Which surely it must if we're to see, then sustain, demand-inflation. So, in the 'Lunar Year of the Ox', recoveries need to start strongly, if we're to kick away the strains from the 'Rat Years' 2008 and 2020.

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