24 May 2021

Investec Bank plc (UK)

Economics

Global Economic Overview

A hope for economic sunshine, a risk of an Indian monsoon

Global

Despite the recent decline in daily infections, the biggest risk to the global recovery remains the evolution of the Covid-19 pandemic. The rapid spread of the B.1.617 lineage, first detected in India, illustrates the threat that new variants of Covid can pose, and how vital an extensive global vaccination campaign is to tackling the virus. Reflecting on these concerns, we have opted to maintain our global growth forecast at 6.2% in 2021, with slight downgrades to China and Japan offset by upgrades to the UK and the eurozone. For 2022, we have uplifted our forecast by 0.1pp to 4.8%.

United States

Ongoing progress on vaccinations, at least for now, leaves GDP on track for strong growth in 2021; our forecast of 6.9% is unchanged. Markets' attention has, instead, centred on inflation, spooked by a 39-year high in monthly price growth on the core CPI measure. Beyond some temporary supply/demand mismatches causing immediate bottlenecks, we doubt the labour market will be strong enough for some time to come to generate sustained price pressures. In any case, the Fed will also have to determine and communicate how long and how much of an inflation overshoot relative to target it is willing to tolerate under its new policy strategy.

Eurozone

Vaccinations got off to a slow start in the Euro area, but the situation has improved through the course of this year, contributing to lower infection rates and consequently the gradual lifting of social restrictions. This bodes well for the economy with a number of indicators pointing to a pick-up in activity. Our forecasts envisage Q2 marking the start of a sustainable recovery, with 2021 GDP forecast at 4.5% and 4.9% in 2022. A key question for the ECB at its June meeting will be over the pace of asset purchases. We suspect that the stepped up purchase pace will not be extended, reverting back to the Jan-Feb levels. However the phasing out PEPP purchases may instead be a topic pushed by the hawks.

United Kingdom

The UK economy continues to show signs of resilience - GDP rose by 2.1% on the month in March - 0.5% pts of this reflected the re-opening of schools. Further Covid relaxations in April and May are set to give output a further boost. We have nudged our 2021 GDP forecast up to 7.7%, but maintain that growth could easily exceed 8%, especially bearing in mind our estimate that 'excess' household savings reached £135bn in March. The B.1.617.2 strain of the coronavirus does seem to pose some threat to the reopening of the economy. However latest expert thinking suggests that its additional transmissibility (relative to the B.1.1.7 variant) is not as great as feared. With the SNP failing to get an overall majority at the recent Assembly elections, we have raised our end-year cable forecast to $1.44 from $1.40. We still see the first Bank rate hike occurring in mid-2023.

Please click here for a summary of our economic and market forecasts

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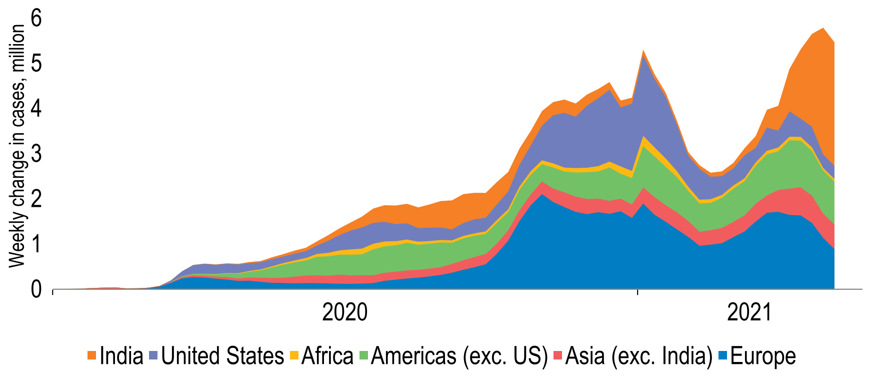
Global

Global new cases of Covid-19 have ticked down as of late, as social restrictions and the deployment of vaccination programmes have limited the spread of infections in prior hotspots such as Continental Europe. There are also early signs that India, currently the largest contributor to the daily case count (Chart 1), has reached the peak of their second wave, with daily infections beginning to trend downwards, albeit from a very high level. Despite this encouraging direction of travel, the situation is extremely fluid and significant risks remain. As a result, we have held our 2021 global growth forecast steady at 6.2%, nudging 2022 up by 0.1pp to 4.8%.

Chart 1: Global new weekly Covid-19 cases begin to ease



Source: Investec, Macrobond

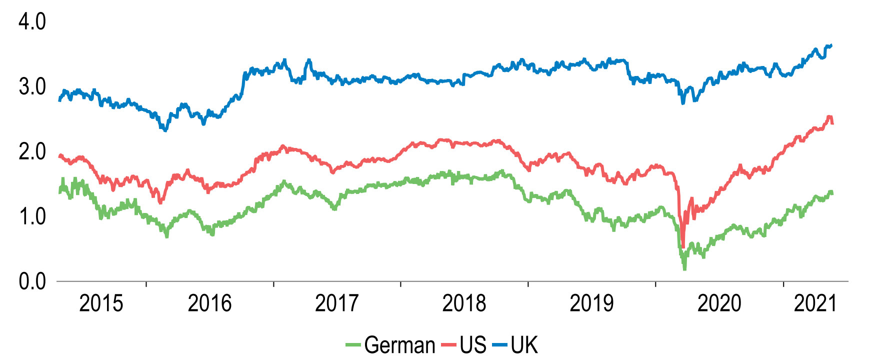
One of the key risks to the global recovery is the danger of potential new strains of the virus presenting itself across the globe. The WHO is monitoring this risk, compiling a list of 'variants of concern', to which B.1.617.2 was recently added, after the sharp increase in Covid-19 cases in India was attributed to it. At this early stage it is believed that vaccines are effective against this new variant, preventing serious illness in those studied. However, there is a high chance that it is more transmissible, posing a threat to healthcare systems across the globe. This is particularly concerning given the already extensive spread of the B.1.617 lineage, having been identified in at least 50 nations across the world.

Chart 2: The B.1.617+ lineage of Covid variants are spreading globally

Countries in blue have reported occurrences of the B.1.617+ variants as of 17 May Source: Investec, GISAID

Whilst Covid has remained a market concern, the last month has seen interest turn to inflation, with market measures of inflation expectations edging higher. Rising inflation prospects are also being borne out in economic data. Surveys such as the PMIs have recorded sharp price rises, the April Global PMI recording a record high in output prices (56.9). Meanwhile national statistics have recorded a rise in inflation too, in April US CPI hit 4.2%, the UK 1.5% and 1.6% in the EU19. Broadly inflation is expected to rise this year as it recovers from its pandemic induced weakness in 2020. However the key question is whether this rise is a temporary phenomenon or something more persistent. Our view and the one which is shared by the major central banks is that it is the former.

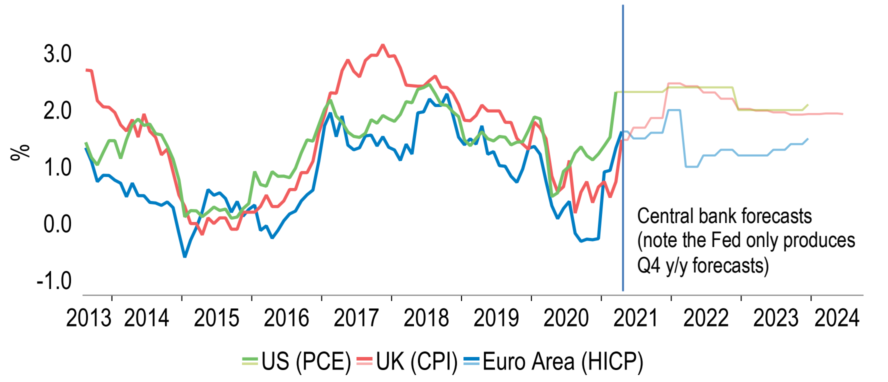
Chart 3: 10 year breakeven rates



Note US and German breakevens represent CPI, in the UK they represent RPI expectations Source: Macrobond

This view is based on several factors, linked to the pandemic. Firstly, mismatches in demand and supply are an issue, evident in indicators such as the PMIs' backlogs of uncompleted orders measure. This has been caused by the surge in demand thanks to the reopening of economies, but supply being more constrained, consequently pushing up prices. Secondly, base effects are also set to push annual rates of inflation higher. Thirdly, the sharp rise in commodity prices will also push inflation higher this year. However given the make-up of these factors we would expect these upward influences to dissipate as supply catches up and the distortions from base effects and higher commodity prices fade away. For markets the focus is on the…

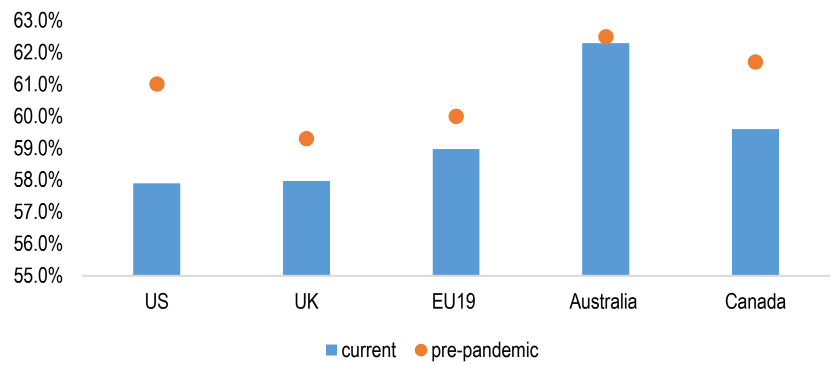
Chart 4: Historic inflation and central bank forecasts



Source: Macrobond, Federal Reserve (March projections), BoE (May projections), ECB (March projections)

…risk that the rises are more sustained. A point we would make here is that persistently higher inflation is rarely seen without sustained higher wage growth. Given the pandemic has created a significant degree of spare capacity in the labour market, this will likely take some time to achieve. For example looking across various economies, employment remains significantly below pre-crisis levels (Chart 5) and whilst the recovery should see labour market slack eroded, merely recovering the lost jobs is unlikely to close the output gap sufficiently to generate sufficient wage pressures. A factor here is the continued growth of the working population over the pandemic period who also need to find employment.

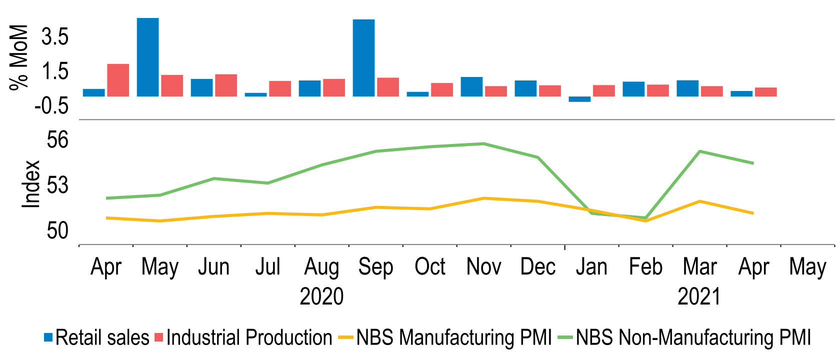
Chart 5: Employment to population ratios



Source: Macrobond

Although China was one of the few economies to post economic growth in 2020, there are signs that this remarkable recovery has lost some steam. Retail sales and industrial production data for April were weaker than headlines would imply, with the widely quoted annual rates distorted by base effects. The more representative monthly rates of growth suggested a stagnant economic environment in April, a narrative supported by the official PMI data. In light of these developments, we have decided to alter the time profile of our growth forecasts, shifting the intensity into the latter half of the year. Arithmetically this results in a 0.2pp downgrade to 2021 and a 0.1pp boost to 2022, to 8.6% and 5.8%, respectively.

Chart 6: Monthly data reveal an uninspiring economic rebound in China

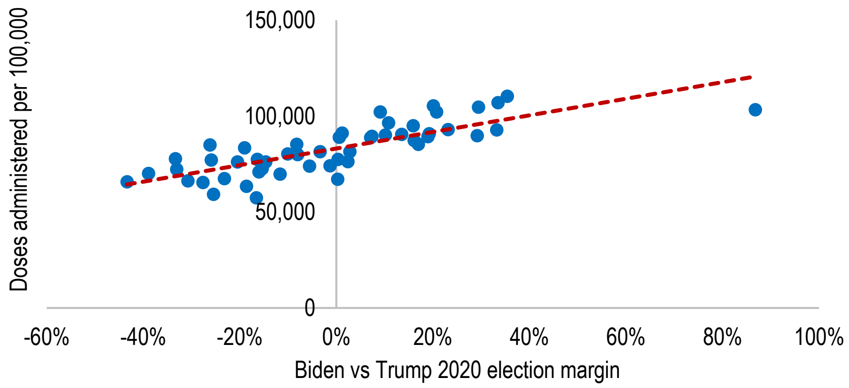


Source: Investec, Macrobond

United States

Latest Covid vaccination figures show close to 50% of the total population having received at least one shot, allowing further easing of social restrictions. But rollout seems to be stalling in some states with take up correlated with political affiliation – inoculation rates in pro-Trump states are lower. Party line divisions also remain in the Senate over President Biden's $2.3trn infrastructure bill- the GoP is suggesting a total of $589bn, but there are still hopes for a bi-partisan approach. Given the longevity of the package, and different approaches to funding via tax hikes, short-term growth prospects should not be too sensitive to the precise outturn. Our 2021 GDP forecast remains at 6.9%.

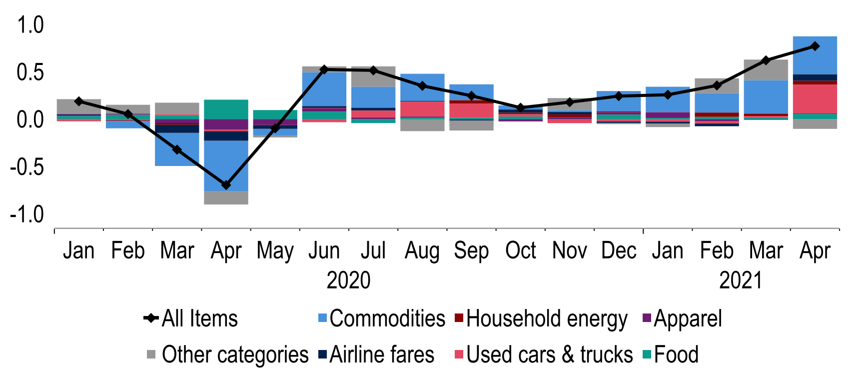
Chart 7: Vaccine take up rates are lower in Trump (2020) supporting states



Election margin = Biden total vote % - Trump total vote %. Source: Federal Election Commission

Markets have remained on alert to inflation news. April's CPI rose by +0.8% (m/m), the core measure by 0.9% - the latter the strongest monthly increase for 39 years. Commodity price pressures in world markets have been in evidence recently - indeed this was confirmed by April's CPI print. But as Chart 8 shows, the majority of the remainder of the jump can be explained by used cars & trucks, plus airfares. Typically inflation arises as a result of an overheating economy with insufficient spare capacity to raise supply. We would argue this does not apply now, as at 6.1%, the (U3) unemployment rate is 2.6% (pts) above its lows in 2019. Instead the biting constraint (especially…

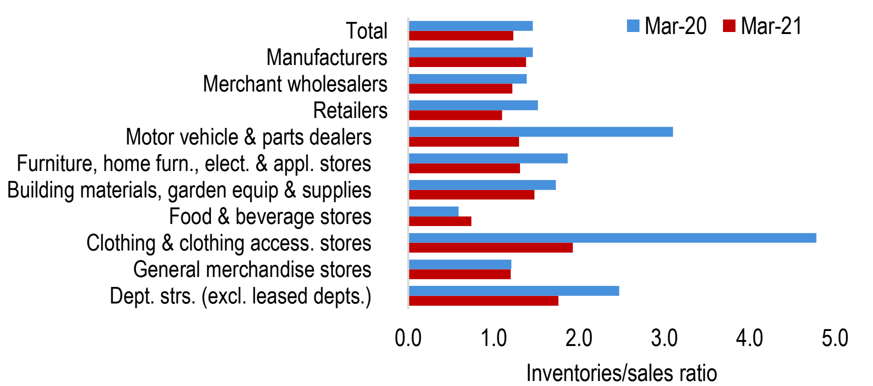
Chart 8: Contributions to monthly movements in the headline CPI (%)



Source: Macrobond

... in car markets) is that stock levels cannot match the huge burst in demand. Data show that total business inventory levels (in March) are at similar levels to a year earlier. But stock sales ratios are much lower, especially in the auto sector (Chart 9), forcing prices up. In due course, demand should moderate and output will rise, alleviating a bout of transient price pressure. Of course, we cannot be certain things will play out this way. There are risks that demand will be more persistent and of an outsized wage response, despite a relatively high jobless rate. Indeed the Atlanta Fed's Raph Bostic hit the nail on the head when he remarked that it will take 'a couple of months' to understand underlying inflation dynamics.

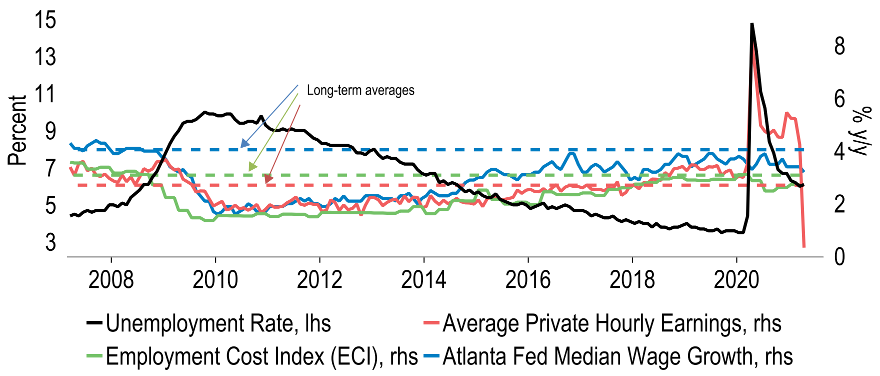
Chart 9: Inventory/sales ratios in various sectors – now and a year ago



Source: US Census Bureau

The more fundamental question, and arguably the key one for the Fed, is whether inflationary pressures will persist once the immediate demand bottlenecks are overcome. This will hinge on the labour market. We doubt wage pressures will spiral. The unemployment rate is still 2.6pp up from February 2020, and participation 1.7pp lower. And even in what was a much tighter labour market in late 2019, when the unemployment rate stood at a 50-year low of 3.5%, which the FOMC members regarded as below its long-run level, wage growth undershot its long-term mean on most measures (Chart 10). In addition, weighted by population, hikes in state minimum wages this year are 4%, 1pp lower than last year.

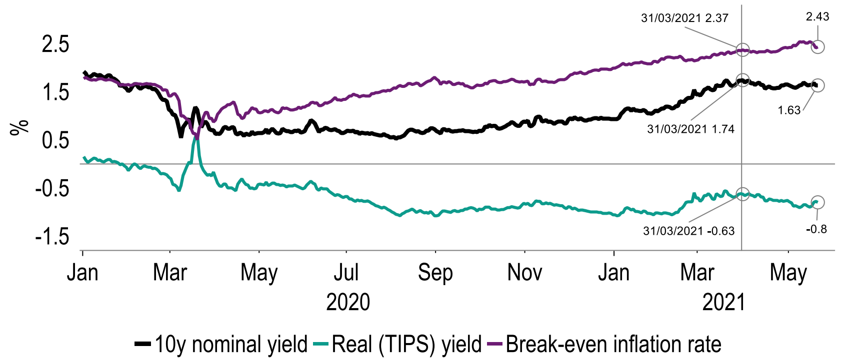
Chart 10: Even a 50-year low in the unemployment rate did not trigger high wage growth



Source: Macrobond and Investec

Gauging how inflation expectations have evolved, which ought to influence wages, is not simple. In financial markets, implied breakeven rates of expected future inflation can be derived as the difference between nominal and real (TIPS) bond yields. But if there is greater demand for TIPS relative to nominal bonds, for technical reasons, then implied breakeven inflation rates rise and implied real rates fall, as nominal yields stay steady. This broadly characterises trends in Q2 so far (Chart 11). With little news to warrant a downward adjustment to long-term real growth prospects, which may have provided a fundamental justification for such moves, it is not clear that 'true' inflation expectations have in fact risen.

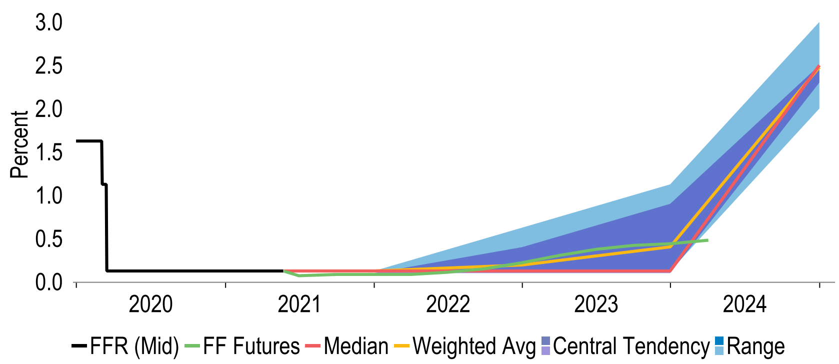
Chart 11: Does the recent rise in the US break-even rate reflect higher inflation expectations?



Source: Macrobond and Investec

So far, despite concerns voiced by some FOMC members as noted in the latest meeting's minutes, the majority argued that near-term price pressures will be transient. By how much inflation can go above target, and how long for, to make up for past short-falls, is not explicitly defined under the Fed's new flexible average inflation targeting monetary policy strategy adopted in August 2020. The current set of circumstances will put this to the test. Through the 'dot plot' in the FOMC's quarterly projections (Chart 12), the next of which will be made available on 16 June, individual members can exercise a quasi-vote on future tightening, which may put pressure on Chair Powell.

Chart 12: Market Fed funds expectations exceed the median & weighted ave 'dot plot' projections

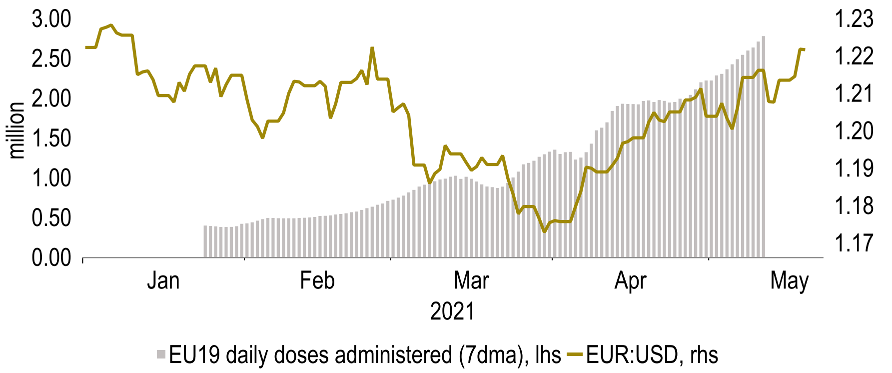


Source: Macrobond

Eurozone

Q1 saw a weaker euro as coronavirus infections surged, alongside a relatively slow vaccine rollout. However since the start of April, the pace of vaccinations has picked up significantly – helped by a new supply deal with Pfizer/BioNTech, and a shift towards vaccinating younger people, who are more easily accessed. Meanwhile, falling Covid-19 infections have allowed much of the zone to begin easing restrictions, prompting a return to some normality and boosting the growth outlook. These factors have inspired some Euro strength in Q2, which we see continuing as the economy unlocks further. We forecast €:$ reaching $1.25 by the end of this year, and $1.30 by the end of next year (see back page).

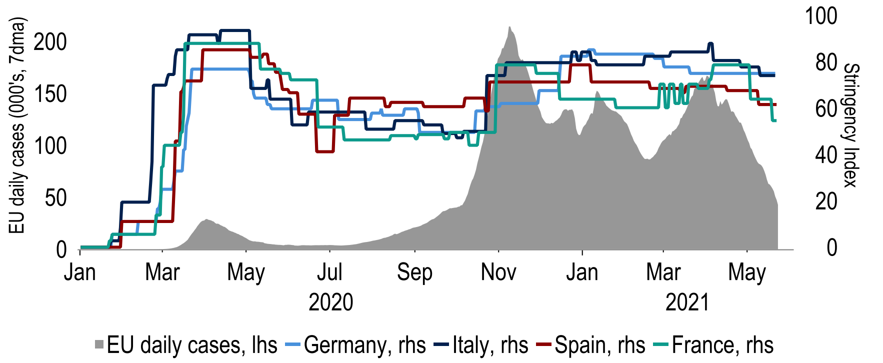
Chart 13: The EU's quickening vaccine rollout to drive economic growth and a firmer Euro



Source: Macrobond

Vaccinations have contributed towards declining infection rates across European countries. Indeed total EU daily cases now stand at 43k, the lowest since October 2020. The easing of social restrictions across Euro area member states that has followed the turn in Covid cases has been widespread. For example Spain has lifted its state of emergency; France has taken gradual steps to ease its lockdown, whilst Italy has allowed a partial reopening of the service sector. The positive economic implications have been evident in high frequency data, such as Google mobility, which points to a rebound in EU19 retail and recreation, now at -25% vs -35% in early-April.

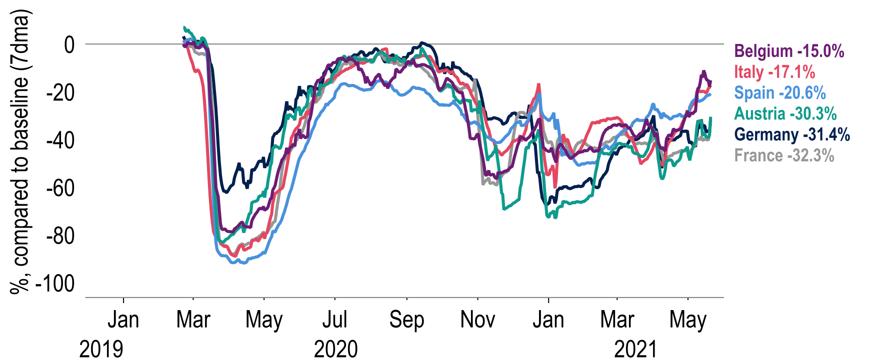
Chart 14: Social restrictions have eased as Covid infection rates have fallen



Source: Macrobond

We see this as marking the start of a more sustained rebound in Euro area economic activity. Our forecasts for GDP stand at 4.5% (4.4% previously) 2021 and 4.9% in 2022. We suspect that the ECB will upgrade its view at its June meeting, which could have a bearing on the pace of asset purchases. March's meeting saw the ECB pick up the pace of PEPP buying to prevent a tightening in financial conditions. This has been evident in the data with purchases averaging €77bn/month versus the €56bn average in Jan-Feb. We envisage the ECB reverting back to its previous purchase pace rather than extending the current pace. Moreover there are now also voices calling for a phasing out of purchases from Q3. Notably, when questioned President Lagarde did not rule it out…

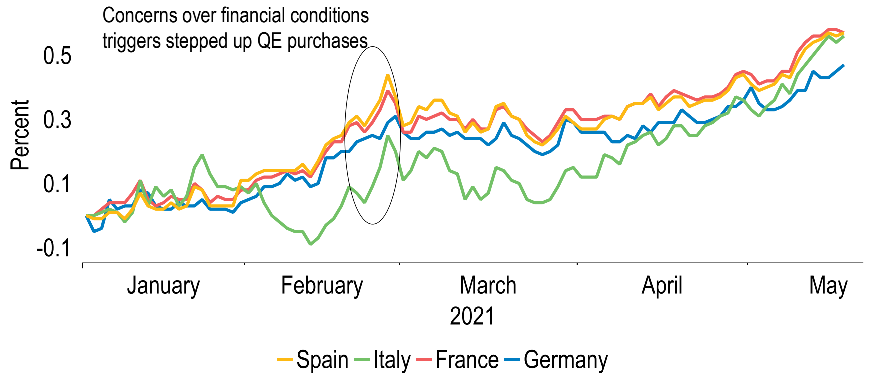
Chart 15: Google mobility data points to pick up in activity



Source: Macrobond

…simply stating that it was too early to discuss. Ultimately we suspect that the entire €1.85trn PEPP envelope will not be used, with our current forecasts putting total purchases at €1.7trn in March 2022. However if the recovery takes hold and a Q3 phasing gains support, this total could be smaller. Hence the ECB could possibly slow purchases before the FOMC, given we do not expect a Fed taper until Dec-2021. A further factor which could suggest that the ECB may be open to phasing is the relatively little it has said on the recent rise in European yields. 10yr German Bunds reached -0.09% on 19 May, exceeding the rise to -0.25% in February which prompted concerns over financial conditions and triggered the stepped up pace of QE.

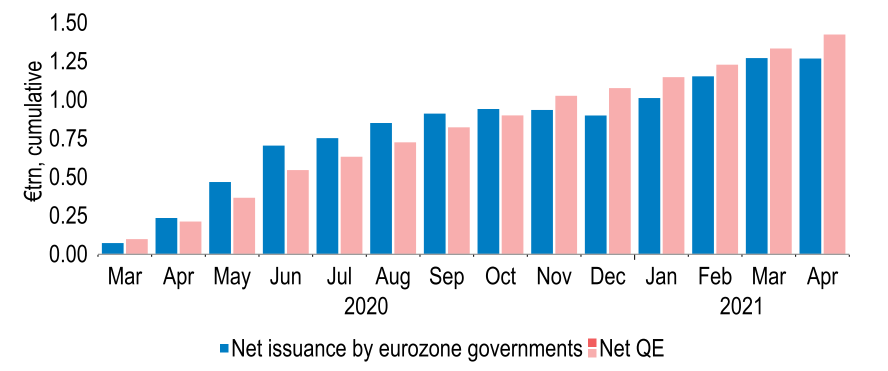
Chart 16: Year to date change in 10 year sovereign yields (bps)



Source: Macrobond

As regards monetary policy further out, concerns have been voiced by all three previous ECB Chief Economists – Otmar Issing, Jürgen Stark and Peter Praet – that, in the event of inflation rising too much and staying there, the ECB may be too slow to react. One worry is that forward guidance might restrict the Governing Council's nimbleness, even without it constituting a binding policy commitment. Another, more fundamental, concern is whether the ECB would politically be able to tighten as needed: the surge in debt levels, currently more than absorbed through QE (Chart 17), has raised sensitivity of the public finances to interest rates- tightening could threaten some governments' solvency.

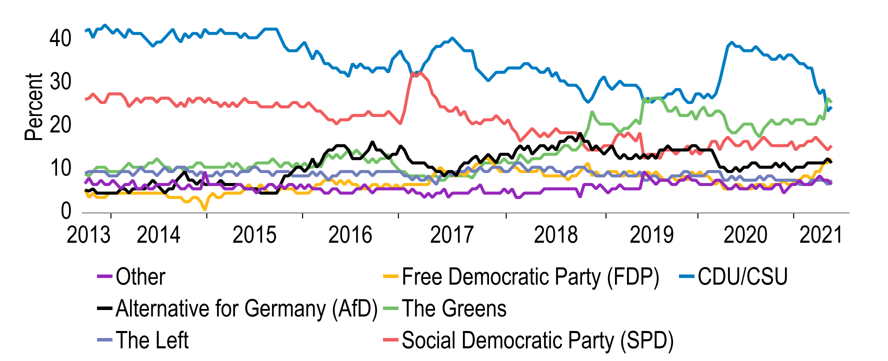
Chart 17: QE has more than absorbed all of the governments' net debt issuance since Covid



Source: ECB Statistical Data Warehouse, Macrobond and Investec

Turning to other areas of policy, Germany's parliamentary elections on 26 September are garnering attention. Recent polls indicate the current 'grand coalition' between the CDU/CSU and the SPD will fail to gain a majority, and that the race between the CDU/CSU, the party of current Chancellor Angela Merkel, and the Greens is neck-and-neck (Chart 18). Germany's electoral system in the Bundestag is one of Mixed-Member Proportional Representation, akin to that used in the Scottish and Welsh parliamentary elections. The Chancellor is elected by the Bundestag by absolute majority. Annalena Baerbock (Greens) or Armin Laschet (CDU) look best placed to succeed Angela Merkel.

Chart 18: The Green party may well gain the most seats, but several coalitions are possible

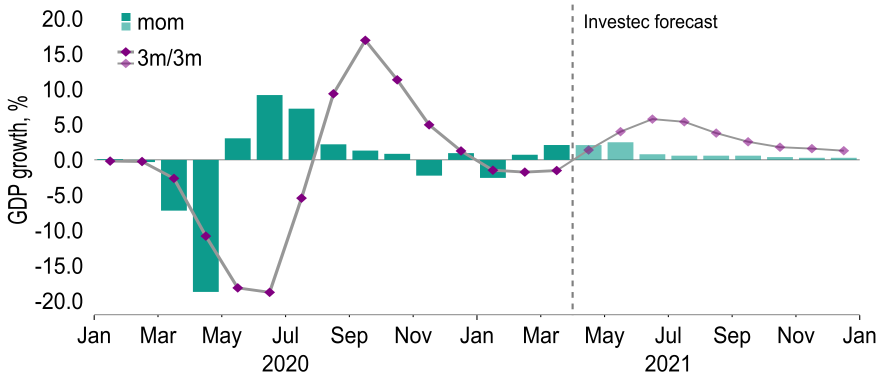


Source: Infratest Dimap and Macrobond

United Kingdom

Further signs of economic resilience have been evident, as GDP rose by 2.1% on the month in March. Over Q1 as a whole, output fell by 1.5%, with a net decline in Q4 and Q1 of 0.3%. This contrasts with many expectations at the end of last year of a double dip recession. The reopening of schools in early-March accounted for 0.5% pts of the gain during the month, but the 12 April (Step 2) relaxation of restrictions is likely to have propelled the economy further, helped by high levels of excess household savings, which we estimate totalled £135bn in March. We have nudged up our GDP forecast for 2021 to 7.7% (from 7.5%), but this could easily exceed 8%. 2022 stays at 5.5%.

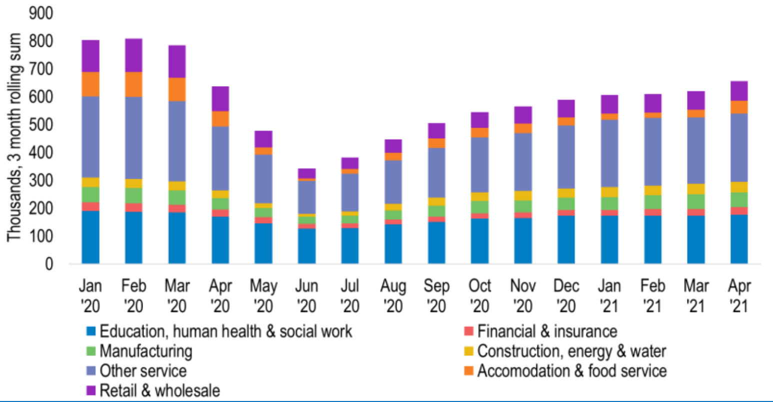
Chart 19: Economic activity continues to gain momentum



Source: Macrobond, Investec forecasts

The labour market has also shown flexibility, with vacancies in the 3 months to April hitting their highest level in a year. Unsurprisingly, much of this increase can be attributed to industries reopening following the easing of restrictions, such as in retail and hospitality. However, one concern for the labour market is a dwindling supply of available workers to fill vacancies, as shown by data from KPMG and REC. Any resulting wage pressures are, however, likely to be short-lived with the expiry of the furlough scheme in September expected to add to the supply of available workers. Indeed, we project the unemployment rate to peak at 5.8% in Q4 of this year.

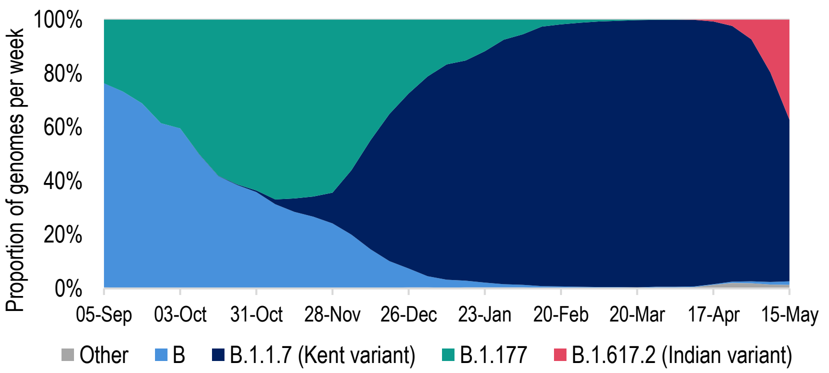
Chart 20: Vacancies are on the rise as the labour market recovers



Source: Investec, ONS

The latest Covid threat is the so-called Indian variant of the virus, B.1.617.2. Total daily infections remain low and broadly stable, but the variant's apparent high transmissibility has seen it gaining ground in parts of the UK, amid fears that it will soon become the dominant strain. Work presented to the Scientific Advisory Group for Emergencies (SAGE) suggests that, were its transmission rate 30% higher than the 'Kent' variant (B.1.1.7), hospitals may be overwhelmed, despite Britain's high vaccination rate. Fortunately first signs are that its transmissibility is not as high as feared. Hence the Step 4 relaxation on 21 June may well go ahead as planned and preventative measures such as local lockdowns be avoided.

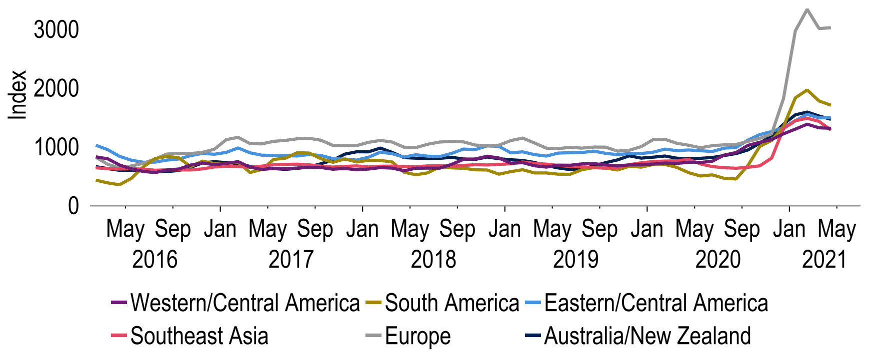
Chart 21: The so-called Indian strain (B.1.617.2) has been taking hold recently



Source: Wellcome Sanger Institute

Adding to inflation worries, shipping container costs have soared, especially between China & Europe (Chart 22). The reasons are complex, mostly involving the burst in demand and limited increases in supply post-financial crisis. Covid has left many containers 'in the wrong place' too, with little economic incentive for the empties to be picked up. Also, delays at ports have meant more containers are required for any given level of cargo. Container losses at sea have risen materially as well, including by the ONE Apus, which lost a record 1,816 containers, with many others damaged. Poor weather and perhaps ship design and stowage techniques have contributed towards a perfect storm.

Chart 22: Shipping container costs from China



Source: Macrobond

In the May monetary policy meeting the MPC voted unanimously to maintain Bank rate at 0.1%. With regards to asset purchases, there was a shock dissent, with outgoing Chief Economist Andy Haldane voting to lower the targeted stock of purchases to £845bn from £895bn, causing some volatility in sterling in the immediate aftermath. Being considered a more hawkish member of the MPC, his late-June departure tilts the committee towards more favourable views on accommodative monetary policy, making the choice on his replacement an interesting one. Regardless of who steps up to the helm, we do not expect a hike in Bank Rate until mid-2023.

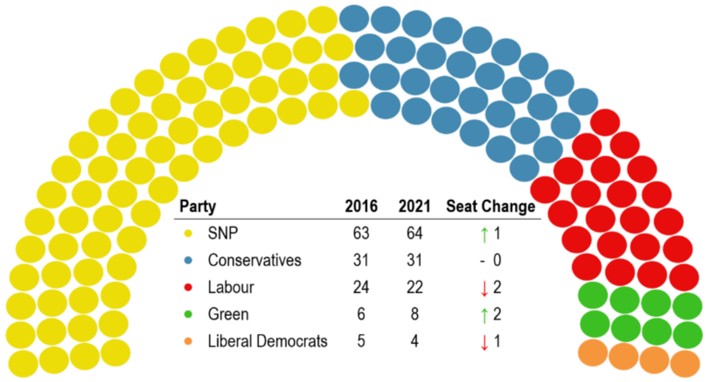
Chart 23: Bank of England Monetary Policy Committee – who are the dissenters?

		Bailey	Broadbent	Cunliffe	Ramsden	Haldane	Haskel	Saunders	Tenreyro	Vlieghe
	Role	Governor	Deputy governor	Deputy governor	Deputy governor	Chief economist	External member	External member	External member	External member
Rates	**Status quo**	11	103	73	31	66	21	31	33	51
	Dissent – higher	0	0	0	0	1	0	6	0	0
	Dissent – lower	0	0	1	1	0	3	3	0	1
Total asset purchases	**Status quo**	11	41	41	32	39	23	39	33	41
	Dissent – higher	0	0	0	0	0	1	1	0	0
	Dissent – lower	0	0	0	0	2	0	0	0	0

Source: Investec, voting intentions data and images from Bank of England

The SNP has continued its hold on Holyrood, winning a record 48% of the constituency vote, but fell short of the 65-seat majority by one seat (Chart 24). With an increased pro-independence movement, supported by the Greens, the timing of a proposal for 'IndyRef2' remains to be seen, with First Minister Nicola Sturgeon stipulating that her current focus is on the response to Covid-19. Thus, the prospect of a proposal for 'IndyRef2' in the short term and the associated downside risks to sterling appear muted. We have therefore raised our £:$ forecast for 2021, now looking for it to end the year at $1.44. However, £:$ pressures certainly remain in the medium/long term if 'IndyRef2' gains traction.

Chart 24: SNP one seat short of an outright majority in the Scottish Parliamentary election



Party	2016	2021	Seat Change
SNP	63	64	↑ 1
Conservatives	31	31	- 0
Labour	24	22	↓ 2
Green	6	8	↑ 2
Liberal Democrats	5	4	↓ 1

Source: Investec, Visualisation tool: Flourish

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Global Forecasts

GDP Growth (%)

	Global	US	Japan	China	UK	EU19	Germany	France	Italy
2016	3.3	1.7	0.8	6.9	1.7	1.9	2.2	1.1	1.3
2017	3.8	2.3	1.7	6.9	1.7	2.6	2.6	2.3	1.7
2018	3.6	3.0	0.6	6.7	1.3	1.9	1.3	1.9	0.9
2019	2.8	2.2	0.3	5.8	1.4	1.3	0.6	1.5	0.3
2020	-3.3	-3.5	-4.8	2.3	-9.9	-6.6	-4.9	-8.2	-8.9
2021	6.2	6.9	2.9	8.6	7.7	4.5	3.6	6.9	4.1
2022	4.8	4.9	2.4	5.8	5.5	4.9	5.1	5.1	4.0

Source: IMF WEO, Macrobond, Investec forecasts

Key Official Interest rates (%, end quarter):

	US Fed funds	Eurozone refi rate	Eurozone deposit rate	UK Bank rate	Australia cash rate
Current	0.00-0.25	0.00	-0.50	0.10	0.10
2021					
Q1	0.00-0.25	0.00	-0.50	0.10	0.10
Q2	0.00-0.25	0.00	-0.50	0.10	0.10
Q3	0.00-0.25	0.00	-0.50	0.10	0.10
Q4	0.00-0.25	0.00	-0.50	0.10	0.10
2022					
Q1	0.00-0.25	0.00	-0.50	0.10	0.10
Q2	0.00-0.25	0.00	-0.50	0.10	0.10
Q3	0.00-0.25	0.00	-0.50	0.10	0.10
Q4	0.00-0.25	0.00	-0.50	0.10	0.10

Source: Macrobond, Investec

10-year government bond yields (%, end quarter):

	US	Germany	UK
Current	1.62	-0.13	0.82
2021			
Q2	1.75	-0.25	0.75
Q4	1.75	-0.25	0.75
2022			
Q2	2.00	-0.25	1.00
Q4	2.00	0.00	1.25

Source: Refinitiv, Investec

FX rates (end quarter/ annual averages)

		Current	2021				2022				2020	2021	2022
		24-May	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	average	average	average
Euro	€:$	1.220	1.18	1.22	1.22	1.25	1.26	1.26	1.28	1.30	1.14	1.21	1.27
Sterling	€:£	0.862	0.85	0.86	0.86	0.87	0.88	0.86	0.85	0.85	0.89	0.86	0.86
	(£:€)	1.160	1.17	1.16	1.16	1.15	1.14	1.16	1.17	1.18	1.13	1.16	1.16
	£:$	1.416	1.38	1.42	1.42	1.44	1.44	1.46	1.50	1.53	1.28	1.41	1.47
Yen	$	108.8	111	108	105	104	104	104	104	104	107	107	104
	€	132.7	130	132	128	130	131	131	133	135	122	130	132
	£	154.0	152	153	149	150	150	152	156	159	137	150	153
Aussie Dollar	$	0.773	0.76	0.77	0.78	0.80	0.80	0.80	0.80	0.80	0.69	0.77	0.80
	€:AUD	1.578	1.54	1.58	1.56	1.56	1.58	1.58	1.60	1.63	1.66	1.57	1.59
	¥	84.09	84.2	83.2	81.9	83.2	83.2	83.2	83.2	83.2	73.6	82.7	83.2
	£:AUD	1.831	1.81	1.84	1.82	1.80	1.80	1.83	1.88	1.91	1.86	1.81	1.84
Swiss Franc	€	1.096	1.11	1.10	1.11	1.12	1.12	1.14	1.14	1.16	1.07	1.10	1.14
	$	0.898	0.94	0.90	0.91	0.90	0.89	0.90	0.89	0.89	0.94	0.91	0.89
	£	1.271	1.30	1.28	1.29	1.29	1.28	1.32	1.34	1.37	1.20	1.28	1.32

Source: Refinitiv, Investec