Investec
Investec Bank plc (UK)

23 July 2021

Economics

Global Economic Overview

Global economy marches on despite Delta blues

Global

The evolution of the Covid-19 pandemic continues to be a key risk to the economic outlook, with global cases once again starting to pick up. Despite these risks, for now, there are few signs of global growth faltering, with the vaccination rollout where carried out, providing a good degree of protection against serious illness. As such we have kept our global forecast relatively stable, at 6.2% for 2021, with upgrades to the US largely offset by downgrades to the UK and China, and 4.9% for 2022.

United States

Amid signs of strong economic momentum, we have brought forward our forecast for peak growth in the US to Q2, which raises our full-year growth forecast for 2021 by 0.4%pt to 7.3%. Most questions, however, centre around the labour market, and specifically on whether the participation rate will rebound once schools return and enhanced unemployment benefits end. Initial signs do seem to support the latter. We remain of the view that it will take until December for the FOMC to deem progress on the labour market to be sufficient to start tapering QE. But even if the current high inflation is temporary, it should still lift the average inflation rate and hence bring forward the point at which rate hikes become appropriate. We have therefore compressed the expected QE tapering phase to nine months, and now expect a first Fed funds rate hike already in March 2023 rather than in December.

Eurozone

The spread of the 'Delta' variant has added a new headwind to the Euro area economy, with infection rates rising sharply in some countries. However, despite this, activity metrics have showed no sign of deterioration. As such our GDP forecasts remain unchanged at 4.8% (2021) and 4.7% (2022). One supporting factor is the EU's €750bn Recovery and Resilience Facility. Many individual country spending plans have been approved in recent weeks, meaning fund disbursements should begin in the coming months. Meanwhile ECB policy is set to remain accommodative; a new policy framework and updated forward guidance reinforces the view of lower rates being maintained for longer. Our central view is that the ECB will not raise rates until the end of 2023.

United Kingdom

With a somewhat disappointing May reading, Q2 output growth looks to have been a little less stellar than we previously thought. This has prompted us to pull down our 2021 GDP growth forecast by 0.7pp to 7.2%. Whereas GDP growth will likely slow from Q3, as the exit from lockdown is now complete, we still see underlying momentum as solid. A risk, however, which is not factored into our baseline case, is that the 'pingdemic' will prove sizeable enough to make a visible dent into Q3 growth. Still, with inflation set to stay above target for a while – albeit temporarily – and a remarkable rebound in the labour market too, we have brought forward our expected timing of a first (largely symbolic) BoE rate hike from +0.10% to +0.25% to May 2022, to coincide with its first actions to reverse QE.

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

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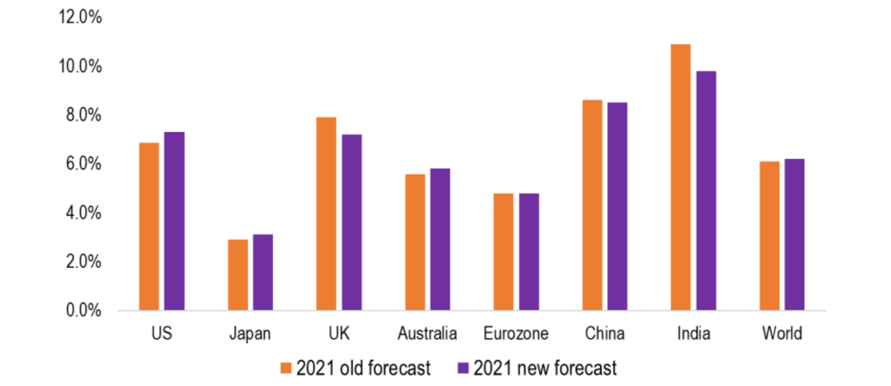
Global

The global economy has exhibited signs of a strong rebound in the first half of the year, and we expect this robust recovery to continue. Although it is likely that peak growth has passed, we deem current global growth concerns to be overstated, and as such have held our GDP growth forecast relatively steady at 6.2% for 2021 – a 0.1%pt upgrade – and 4.9% for 2022. The largest revisions to 2021 growth stem from an upgrade to the US, reflecting our expectation of an earlier peak in GDP, slightly offset by a downgrade to the UK following weaker-than-expected GDP in May. However, risks to this forecast do remain, most acutely in terms of the evolution of the Covid-19 pandemic.

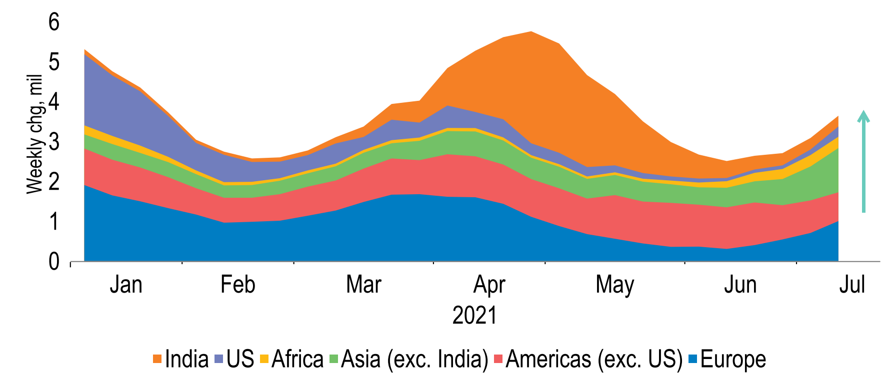
Chart 1: Investec global GDP growth forecast driven slightly higher by US



Source: Macrobond, Investec

As the spread of the more transmissible 'Delta' variant intensifies across the world, we have seen an uptick in global Covid infections, with scientists at the World Health Organisation warning that the world is moving further away from the end of the Covid pandemic. Despite the increase in cases, some nations, such as the UK, are reluctant to impose further social restrictions, owing to the vaccination rollout weakening the link between infections and hospitalisations. However, allowing Covid-19 to run unchecked comes with risks, with greater social interaction potentially creating a breeding ground for new variants, which may further threaten the global recovery.

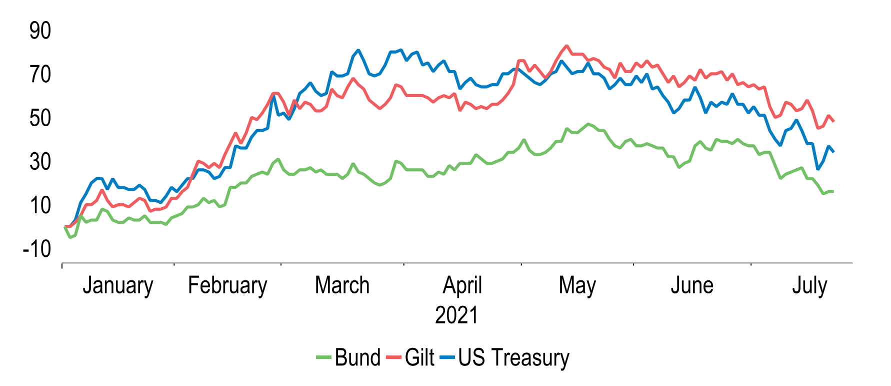
Chart 2: Global Covid-19 cases begin to rise once again



Source: Macrobond, Investec

Against this backdrop the USD has firmed and a rally in government bonds that began in May, has continued: 10yr US Treasury yields now stand at 1.28%, 48bps lower than the 1.76% seen in April. Some technical US Treasury market factors have been at play, but the latest movements would also suggest markets are pricing in the some concern over Covid putting a potential brake on economic activity and central banks remaining cautious in withdrawing stimulus. Clearly these are risks, but not our central case. Yes the Delta variant's spread is a concern, but the growing vaccination rates should provide some protection. Additionally there are few signs that global growth is faltering. As such we have maintained our Q4-2021 forecasts, our 10y US Treasury and gilt forecasts standing at 1.75% and 0.75%.

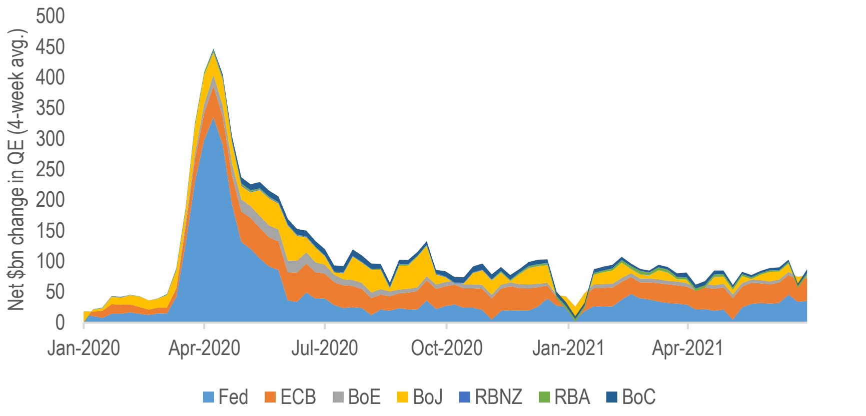
Chart 3: 10yr bond performance year to date (change in 10yr yield, bps)



Source: Macrobond, Investec

Central banks themselves, whilst citing risks, have certainly given no sign that views on policy are shifting. If anything it has been the hawks at the Fed and BoE making the headlines, particularly in light of the recent strength of inflation readings. Indeed away from the major central bank trio of the Fed, ECB and BoE, others have made a more marked shift towards tighter policy. The RBNZ announced the end of QE this month and joined the Norges Bank in signalling a possible rate hike this year. Additionally the RBA announced a tapering of asset purchases, following in the footsteps of the BoC. All told, in an unusual sequence it appears to be the smaller G10 central banks stepping forward with a shift to tighter policy first.

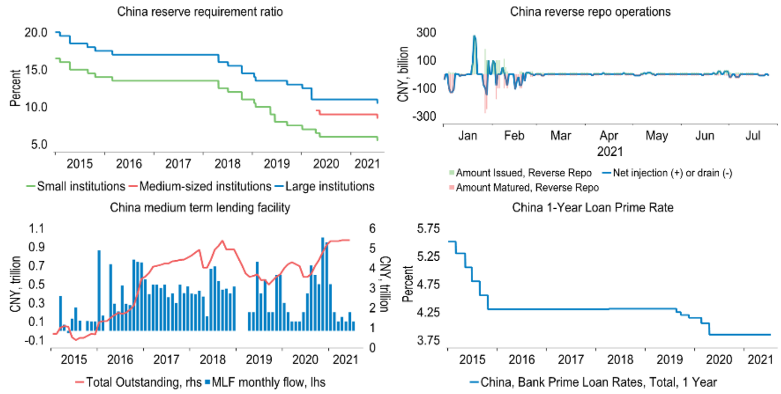
Chart 4: Global QE: Major 4 set to continue, but RBNZ, RBA and BoC announce a taper or end



Source: Macrobond, Investec calculations

In contrast, the People's Bank of China surprised markets by cutting the Reserve Requirement Ratio (RRR) for all banks by 50bps, injecting CNY1trn of liquidity into the system. Prior to the announcement, the State Council suggested a cut could be on the horizon, targeted to small banks. In the event, the PBoC embarked on a broad-based cut for all banks, citing that the funds released should be used to repay the CNY4trn of MLF loans maturing this year, easing liquidity pressures. Given that a cut to the RRR is rarely a one-off, it has been proposed that this is the start of an easing cycle. However, with other monetary tools remaining stable, the argument that the move was simply to counter maturing loans is gaining traction.

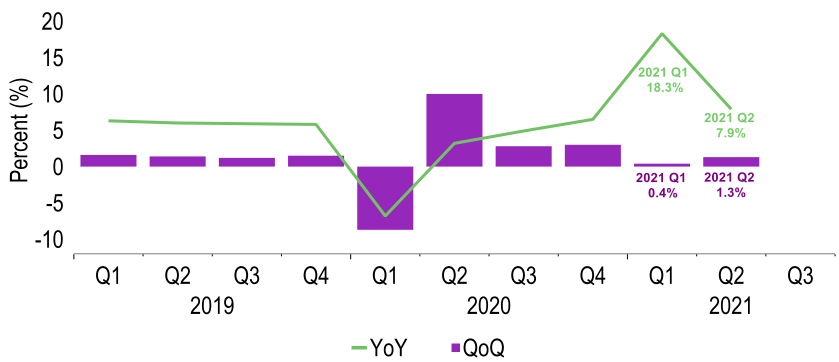
Chart 5: The PBoC cuts the RRR but other monetary tools have remained stable



Source: Macrobond, Investec

Still, this tilt to easing where many central banks are considering tightening did raise concerns about the strength of the Chinese economy ahead of the Q2 GDP report. In the event, the report was relatively robust. Although on a YoY basis growth slowed significantly, this stemmed from distorting base effects, with the quarterly comparison illustrating a faster pace of growth relative to Q1. Furthermore, monthly retail sales and industrial production data are pointing to a balanced recovery. As such, despite the monetary easing, we maintain that there is still some economic momentum left to run, and have pencilled in growth of 8.5% and 5.9% for 2021 and 2022 respectively.

Chart 6: Despite the monetary easing, on a quarterly basis China's Q2 GDP was robust

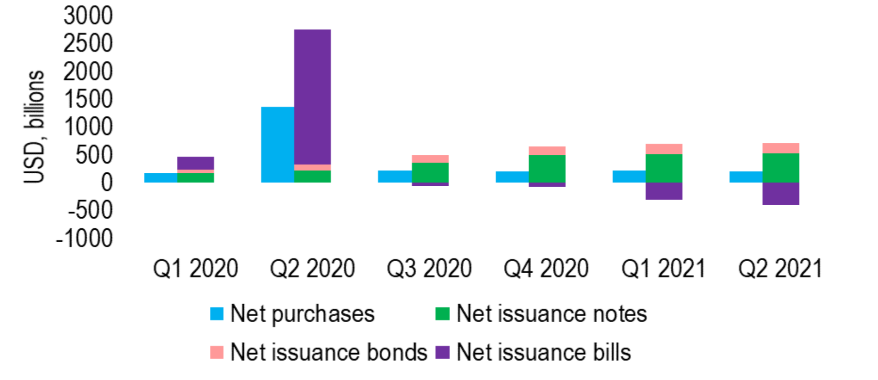


Source: Macrobond, Investec

United States

Over the past month, 10y Treasury yields collapsed as far as 1.13%, a low not seen since February. While the dynamics are not clear cut, we consider this to be related to supply. In Q2, net issuance continued to exceed Fed purchases, but this gap continued to close, even more so if bills are included. Meanwhile Q3 issuance looks set to be limited, at least for a while, by the restoration of the debt ceiling on 31 July. On our sanguine outlook for US and global growth, yields should rise as supply normalises. This could occur via a debt ceiling suspension included in an autumn reconciliation bill. On this assumption, we are keeping our 10y yield forecasts for end-2021 at 1.75% and 2.00% for end-2022.

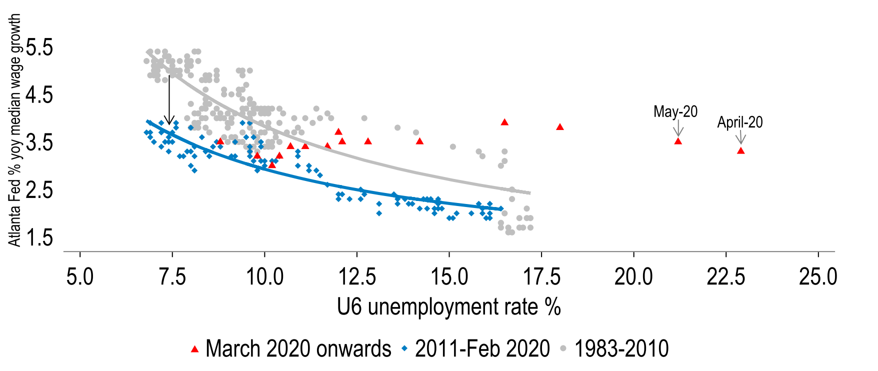
Chart 7: Net Treasury issuance continues to exceed Fed purchases, but the gap is closing



Source: Investec, Macrobond

Pay growth is the key to whether price pressures are transitory or permanent. Assessing this is complex. Jobs growth has been rapid – 1.7m over the past three months — but at 5.9%, unemployment (U-3), is 2.4% (pts) above 2020 lows. Also the participation rate (61.6%) is 1.8% pts lower and in our view likely to rise as the recovery proceeds, raising labour supply and keeping wages in check. Our pre-pandemic work on the labour market implied a stable Phillips curve using the broader U-6 measure of joblessness (Chart 8) in the post-GFC era. But with more potential mismatches between unemployment and vacancies post-Covid it is difficult to tell whether this relationship will be re-established, or if pay growth will be higher for any level of joblessness.

Chart 8: Will the wage/unemployment relationship shift again?

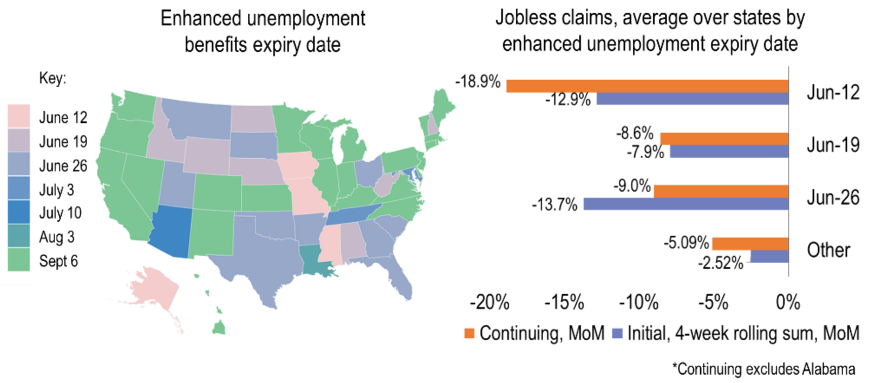


n.b red triangles indicate post-pandemic observations - excluded from the curves

Source: Investec, Macrobond

In the US there have been political & economic debates over the appropriate time to end the enhanced unemployment benefits introduced in response to the pandemic. Given the reports of a rapidly improving labour market and labour shortages, many States (particularly Republican-led ones) have opted to end this support early, before the September 6 expiry date. The rationale behind this is that it would reduce the incentives to remain unemployed, boosting labour supply. Academic literature on the matter is mixed, but early data would suggest that states that have ended support early have seen a larger drop in jobless claims – both initial and continuing (Chart 9).

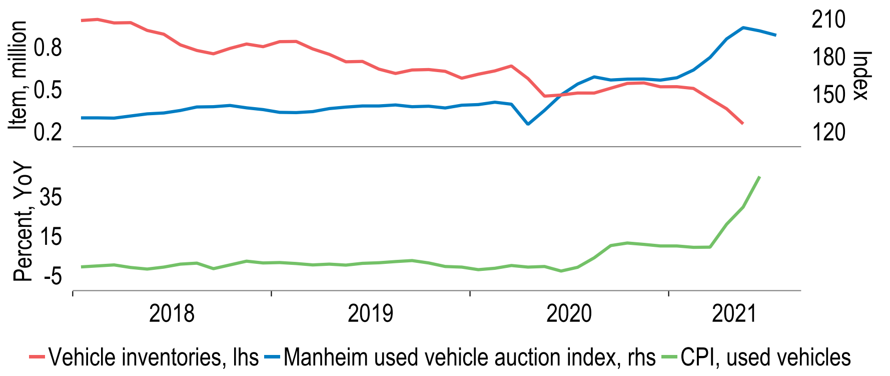
Chart 9: States with an early expiry of enhanced benefits have seen jobless claims dive



Sources: Enhanced unemployment expiry dates: USA today; Data: Macrobond; Illustration: Investec

Whether the recent surge in prices is transitory is another hot topic for debate. US CPI hit 5.4% on an annual basis in June – the largest gain in 13 years. Although we have seen some broadening in price pressures, some 3% pts of June's inflation rate reflect second-hand car and gasoline prices, each rising by 45% (yoy). Low inventory levels of the former prompted this, as semi-conductor shortages delayed the supply of new cars. However, timelier Manheim auction data have pointed to the start of a slowdown in price growth, which would likely dampen CPI in the coming months, supporting our view that price pressures are unlikely to persist over the longer term.

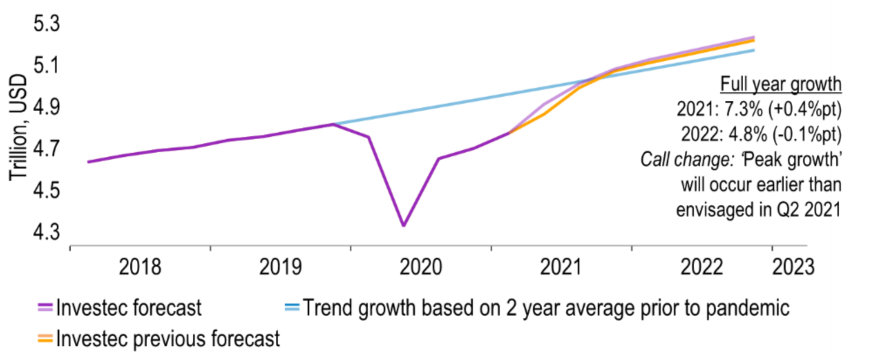
Chart 10: Used car prices are driving CPI higher, but the foot should come off the gas soon



Source: Macrobond, Investec

Overall, despite renewed Covid concerns, economic momentum in the US remains strong; we now see 2021 growth of 7.3% (from 6.9%). Expectations of additional stimulus are likely to buoy sentiment further, in regards to the proposed $1.2trn bipartisan infrastructure bill and the $3.5trn budget resolution framework. However, with GOP Senators voicing their disapproval over the size of the combined stimulus, the passage of the bills is unlikely to be plain sailing. Recent research by the CRFB* estimating that the $3.5trn bill could in reality be upwards of $5trn over the next decade, through a 'budget gimmick' in which permanent policies are inputted as temporary, will no doubt add fuel to the fire.

Chart 11: US 'peak growth' – no time like the present…

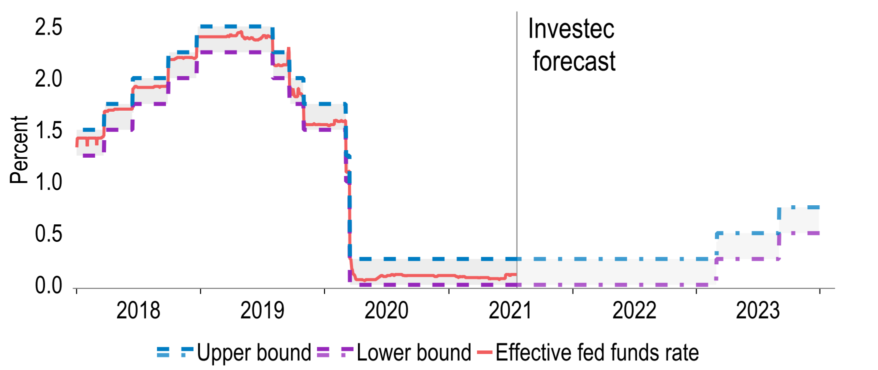


*CRFB – Centre for a Responsible Federal Budget

Source: Macrobond, Investec

Inflation angst across Fed members has risen – more favour tapering the $120bn pm QE purchases promptly. Chair Powell, who needs to be renominated by Joe Biden to serve beyond February, has stood firm against early action, insisting high inflation is transitory. Unless Covid trends put the economy under pressure, broad talk over tightening will continue, even if inflation drops below 2% next year, as key prices correct. Also in principle, a period of high inflation should bring a rate hike forward, bearing in mind the FOMC's averaging strategy. We still expect tapering to begin in December, but now to last 9 months (not 12) and for the Fed to make its first move on the Fed funds target in Mar 2023 rather than Dec 2023.

Chart 12: The Federal funds target rate range, plus Investec forecasts

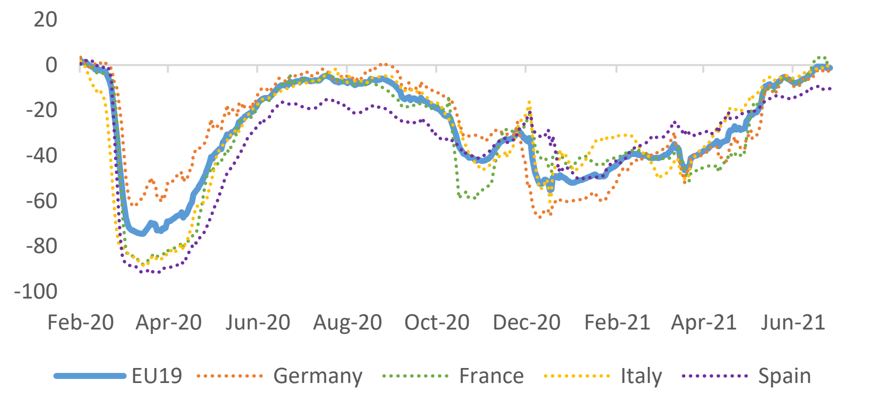


Source: Macrobond, Investec

Eurozone

The pandemic continues to pose a headwind to the EU19, the Delta variant driving a surge in new cases: in the Netherlands and France daily infections have risen to 10k and 11k (7day average), respectively, from less than 1k at the end of June. This has prompted some retightening of restrictions in a number of countries, these being particularly focused on hospitality. But so far there has been no discernible impact on activity. For example, a GDP-weighted average of Google mobility's retail and recreation measure for the Euro area has continued to rise, to 0%, having seen activity 46% below baseline levels in April. As such our central view still holds, with our GDP forecasts standing at 4.8% 2021 and 4.7% 2022.

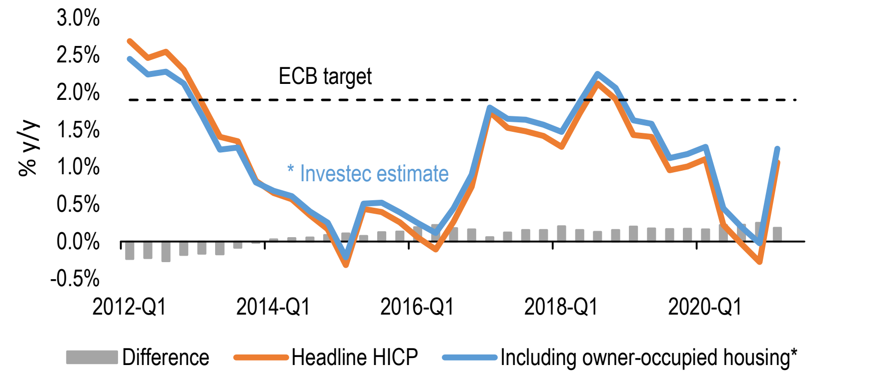
Chart 13: Fast indicators point to a continued rebound in activity despite rising Covid cases



Google mobility's retail and recreation measure - % from baseline
Source: Macrobond

This month saw the ECB complete its long-running strategy review. The key outcome was an update to the inflation target, which now stands at 2% over the medium term, as opposed to 'below, but close to 2%' previously. Additional points to note are that i) the target is now symmetric; ii) 'especially forceful or persistent monetary measures' are appropriate when interest rates are close to the lower bound; iii) inflation is temporarily permitted to run above target, although President Lagarde has been keen to point out that this did not represent an average inflation target like the Fed; iv) and lastly that the ECB will undertake a multiyear project to include…

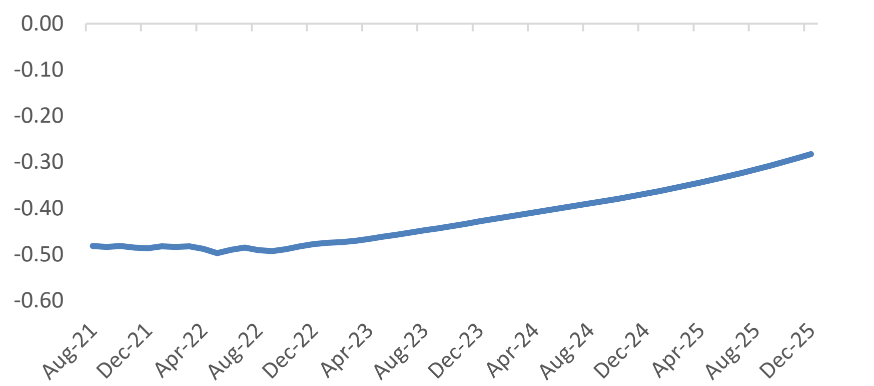
Chart 14: Including owner-occupied housing costs would lift inflation a little closer to target



Source: Eurostat, Macrobond and Investec

…owner occupied housing costs in HICP. This, we estimate, would currently add 0.2ppt to inflation. The key question is what this means for policy. In the near term we do not expect this to lead to any major changes in rates or QE. However it has resulted in an update to forward guidance. This now states that interest rates will remain at their current or lower levels until, i) inflation is forecast at 2% at the midpoint of the ECB's forecast horizon, ii) inflation is also expected at 2% at the end of the forecast horizon, iii) and that realised underlying inflation is consistently converging to target. Our broad take on this is that it implies rates will be lower for longer. We expect that the Deposit rate will not rise until Q4 2023.

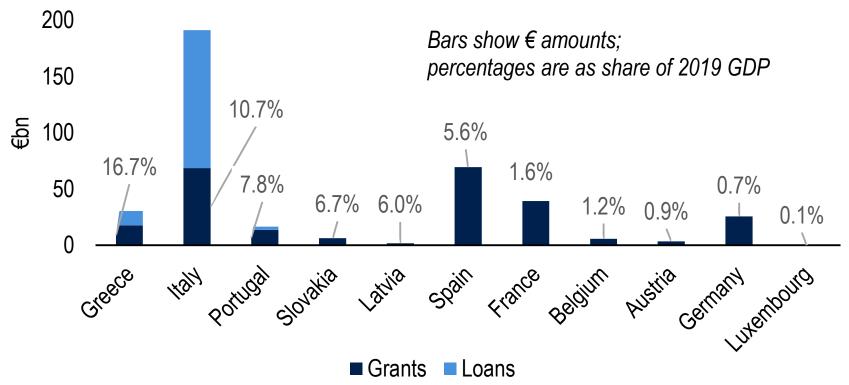
Chart 15: EONIA forward curve – no ECB rate hike priced in until 2024



Source: Macrobond

Fiscal and monetary policy are beginning to pull together in the Eurozone. On 13 July, the EU Council gave the green light for twelve EU countries to receive first disbursements under the EU's Recovery and Resilience Facility – the cornerstone of the Next Generation EU package – following positive assessments by the EU Commission of their plans. In euro terms, the largest disbursements will be made to Italy; relative to GDP. However, it will be Greece that will receive the largest initial payouts (Chart 16). Once the member states sign bilateral financing agreements with the Commission, they will receive the pre-agreed financing within two months. Greece and Italy stand to benefit the most.

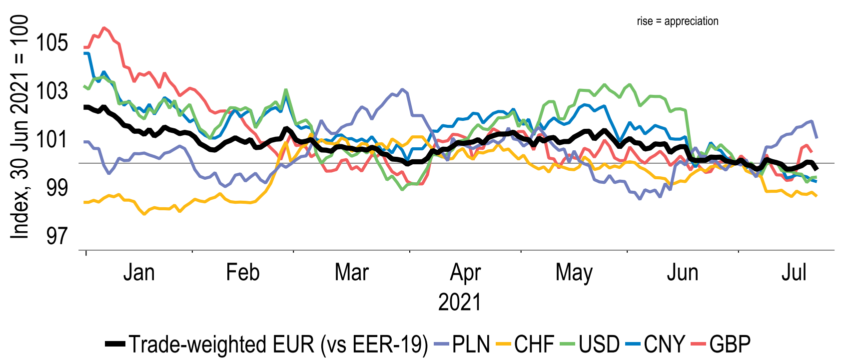
Chart 16: EU recovery and resilience fund receipts are most significant for Greece and Italy



Source: EU Commission, Eurostat and Investec

The euro is virtually unchanged in trade-weighted terms over the past month, with a fall against CHF but a rise against the zloty largely offsetting in net terms (Chart 17). Although inflation has risen in the euro area, it is still just below target, for the time being, in contrast to the overshoots in the UK and especially in the US. A less pressing need to adjust policy rates may therefore see interest rate differentials move against the euro for a while, which could hold back the single currency. As a result, we have lowered our EUR forecasts: we now expect EURUSD to hit 1.22 by the end of 2021 and 1.26 by late 2022. Against GBP, we forecast 0.86 and 0.82, respectively.

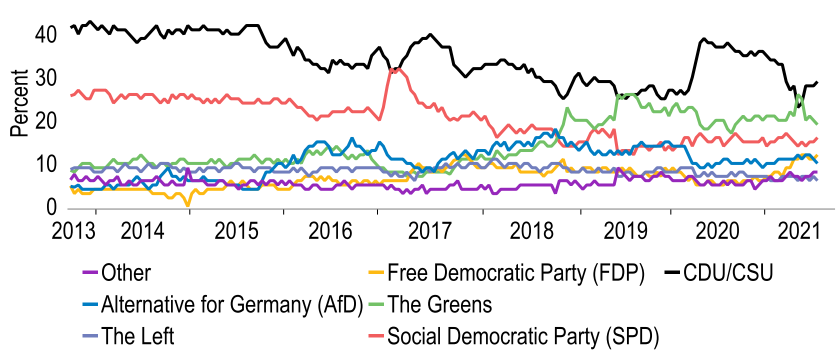
Chart 17: EUR is steady so far in July, with offsetting moves against its main trading partners



Source: Macrobond and Investec

Having topped the polls in early May, Germany's Green party has since slipped back to second place, clearly behind the CDU/CSU, the party of current Chancellor Angela Merkel (Chart 18). This may reflects recent controversies regarding their candidate for Chancellor in the 26 Sep parliamentary elections, Annalena Baerbock: there have been accusations of plagiarism in a book ghostwritten for her, outlining her political vision, and she is said to have stretched the description of her legal qualifications. But perhaps it is mainly a modest 'vaccine bounce' to the benefit of the CDU/CSU. German first-dose vaccination rates now exceed those in the US, and case rates, although rising slightly, are still very low.

Chart 18: The CDU/CSU is leading the polls again in Germany, but its support is fairly low

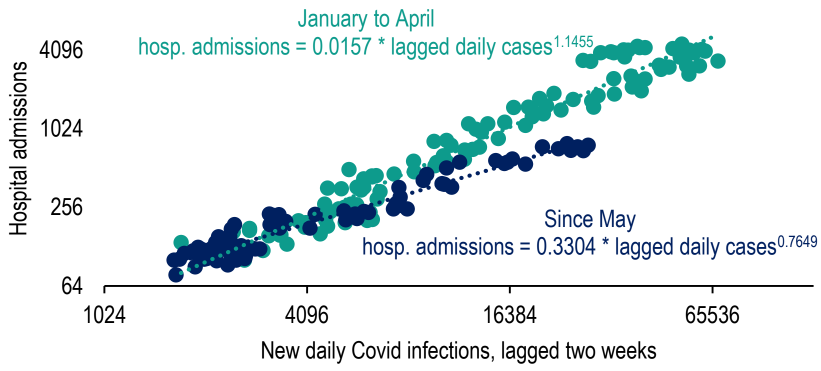


Source: Infratest Dimap and Macrobond

United Kingdom

19 July saw the UK government deliver the delayed final step in its roadmap out of lockdown. The government has shifted most of the responsibility for containing the virus onto individuals, scrapping the vast majority of legal restrictions. This has come despite the high and rising Covid infection rate in light of the spread of the more transmissible Delta variant, which has likely boosted the vaccination rate at which 'herd immunity' is achieved – some scientists suggest to perhaps 85%-90%. Underpinning the easing of restrictions has been the expectation that vaccination also will curtail the share of Covid cases requiring hospitalisation. This appears borne out by the data so far, despite Delta taking hold since May (Chart 19).

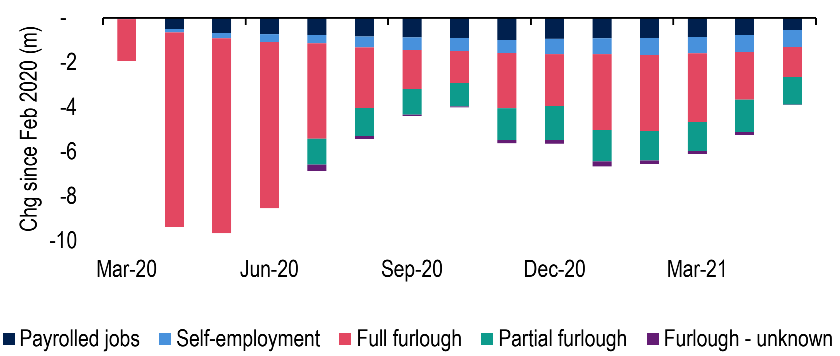
Chart 19: The same number of Covid cases of now seems to lead to fewer hospitalisations



Source: Coronavirus dashboard, Investec and Macrobond

With restrictions to activity fully removed, the government is beginning to taper the (very costly) financial support provided to the labour market: employers need to contribute 10% towards the 80% of the wage bill paid to employees on furlough from July, and 20% from August; the CJRS scheme is to be withdrawn entirely from the end of September. The number of jobs supported by CJRS has dwindled from its peak. Even so, as of May, at 2.6m, far more people were on full or partial furlough than the net number of jobs lost over the pandemic (1.3m; Chart 20). Whether those furloughed return to or lose their jobs by Q4 will make a huge difference to the tightness or looseness of the labour market.

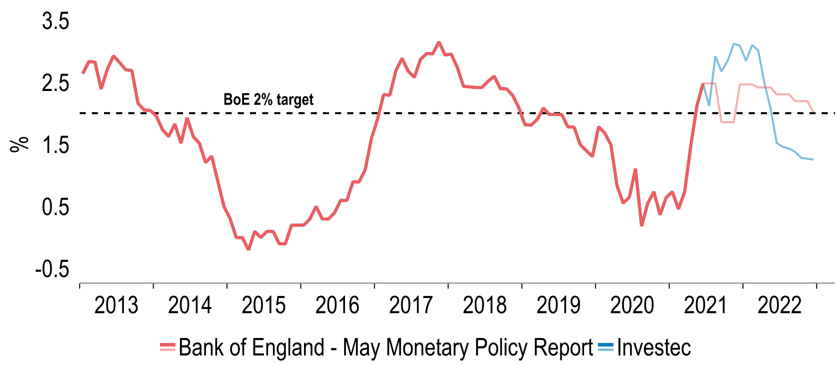
Chart 20: Will those still on furlough return to their jobs or be made redundant as CJRS ends?



Source: ONS, HMRC and Investec

In turn, that is one of the main factors that stands to affect the inflation outturn. But is not the only one, certainly in the short term: as elsewhere, that UK inflation has risen to above target lately can be largely attributed to bottlenecks on synchronised demand surges depleting inventory levels, as well as to base effects from sharply lower energy prices last year. Further base effects stand to push around monthly inflation substantially in the coming months, particularly around the anniversary of 'Eat Out to Help Out' (Chart 21). But we envisage inflation to subside markedly from Q2 2022. Our full-year inflation forecasts for 2021 and 2022 are near target, at 2.1% each.

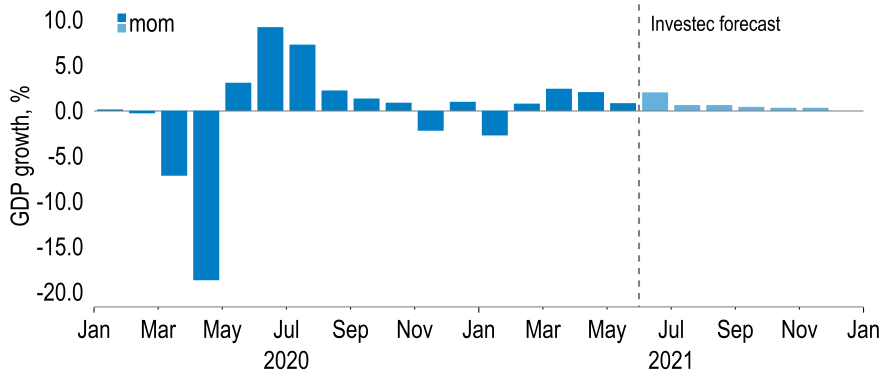
Chart 21: Inflation looks likely to rise further above target before falling back again



Source: ONS, Bank of England, Macrobond and Investec

GDP rose by a relatively modest 0.8% on the month in May, following increases of 2% plus in March and April. Three factors may have constrained growth. First, households seem to have substituted retail sales for hospitality activities, given the 17 May easing of restrictions. Second, a cold, wet May probably discouraged some economic activity (e.g. construction fell 0.8%). Third, semiconductor shortages resulted in car output plunging by 27%. We do not consider this to be a fundamental loss of economic momentum. Indeed retail sales in June rebounded by 0.5% after May's 1.3% fall. Even so, we have cut our 2021 GDP forecast to 7.2% for 2021 from 7.9%.

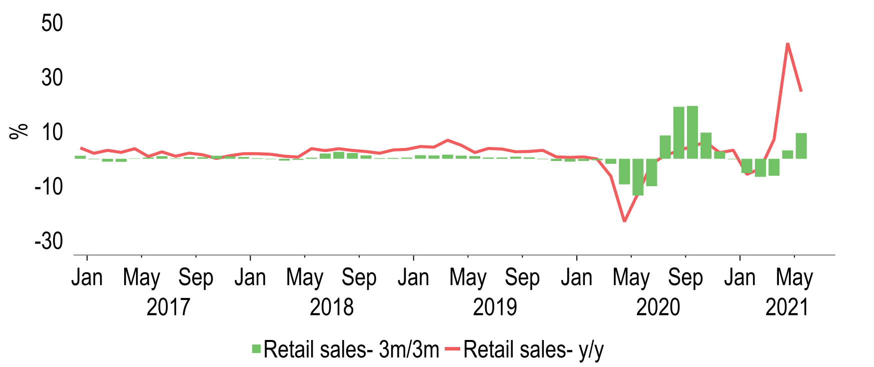
Chart 22: Monthly GDP profile, historic and forecast



Source: Macrobond, Investec

Amid rising Covid cases, 619k people over the past week have been told to self-isolate by the NHS Covid-19 phone app. While we have not factored in an effect, it is feasible that this '*pingdemic*' disrupts output until 16 August, when the rules are relaxed. On monetary policy, the MPC's direction of travel is towards caution, given the latest inflation data. Members Ramsden, Vlieghe and Saunders either favour a prompt end to QE or/and are mulling an early tightening. With the MPC down to 8 (former Chief Economist Haldane is yet to be replaced), August's decision on QE might depend Governor Bailey's casting vote. On tightening, the MPC's guidance states that it wants to see how the…

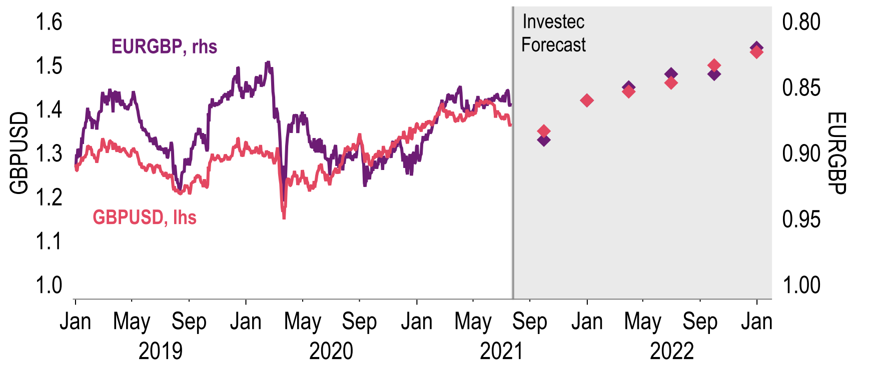
Chart 23: Retail sales dipped in May but recovered partially in June, making for a strong Q2



Source Macrobond, Investec:

… labour market reacts to the end of the furlough scheme in September. The BoE's sequencing review (raise rates/reverse QE first) is not yet complete. A House of Lords committee recently labelled QE a 'dangerous addiction'. Indeed we still suspect the MPC will prefer to slim the BoE's balance sheet first. But it may judge that raising the Bank rate provides more transparent signalling. As such, we have tweaked our view to expect a concurrent 15bp hike (to 0.25%) i.e. accompanying the reversal of QE in Q2 2022, bringing the rate profile forward by one year. Our end-2021 cable forecast is now 2 cents lower at $1.42, reflecting the stronger dollar, and we expect short-term sterling softness due to Covid concerns.

Chart 24: Covid concerns are hitting sterling, but we still see a rally…



Source: Macrobond, Investec

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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	7.3	3.1	8.5	7.2	4.8	3.5	6.0	4.8
2022	4.9	4.8	2.3	5.9	5.4	4.7	5.0	4.6	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	0.25	0.10
Q3	0.00-0.25	0.00	-0.50	0.25	0.10
Q4	0.00-0.25	0.00	-0.50	0.25	0.10

Source: Macrobond, Investec

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

	US	Germany	UK
Current	1.29	-0.41	0.59
2021			
Q2	1.49	-0.18	0.74
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
		23-Jul	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	average	average	average
Euro	€:$	1.177	1.18	1.19	1.20	1.22	1.23	1.23	1.26	1.26	1.14	1.20	1.24
Sterling	€:£	0.857	0.85	0.86	0.89	0.86	0.85	0.84	0.84	0.82	0.89	0.87	0.84
	(£:€)	1.167	1.17	1.16	1.13	1.16	1.17	1.19	1.19	1.21	1.13	1.15	1.18
	£:$	1.373	1.38	1.38	1.35	1.42	1.44	1.46	1.50	1.53	1.28	1.38	1.47
Yen	$	110.5	111	111	108	106	104	104	104	104	107	109	104
	€	130.0	130	132	130	129	128	128	131	131	122	130	129
	£	151.7	152	153	146	151	150	152	156	159	137	149	153
Aussie Dollar	$	0.737	0.76	0.75	0.77	0.80	0.80	0.80	0.80	0.80	0.69	0.77	0.80
	€:AUD	1.597	1.54	1.58	1.56	1.53	1.54	1.54	1.58	1.58	1.66	1.56	1.55
	¥	81.41	84.2	83.3	83.2	84.8	83.2	83.2	83.2	83.2	73.6	83.2	83.4
	£:AUD	1.863	1.81	1.84	1.75	1.78	1.80	1.83	1.88	1.91	1.86	1.79	1.84
Swiss Franc	€	1.084	1.11	1.10	1.10	1.12	1.12	1.14	1.14	1.16	1.07	1.10	1.14
	$	0.921	0.94	0.93	0.92	0.92	0.91	0.93	0.90	0.92	0.94	0.92	0.92
	£	1.264	1.30	1.28	1.24	1.30	1.31	1.35	1.36	1.41	1.20	1.27	1.34

Source: Refinitiv, Investec