Investec
Investec Bank plc (UK)

29 March 2021

Economics

Global Economic Overview

Speed bumps on the road to recovery

Global

Some countries are immunising their populations rapidly against Covid, but the pandemic is sweeping through others again, especially in India, Brazil and parts of the EU. But the broad direction of travel is still one of optimism over world growth in 2021, as markets eye a gradual loosening of restrictions. We concur, but we have pulled our 2021 global GDP forecast down by 0.3ppts to 6.2%, principally as China uses space to deleverage its financial sector. But China's official 'above 6%' GDP target could be achieved with near-zero growth through 2021 and we suspect expansion is likely to be some 9.0% (down from our previous forecast of 9.8%). Against rising short-term interest rate and inflation expectations, government bond yields have risen sharply. For example, 10y Treasury yields are up by 74bps on the year so far. Note though that market predictions have tended to overestimate the level of yields since the financial crisis, which has nudged us to make relatively modest changes to our own forecasts.

United States

March saw President Biden sign his $1.9trn American Rescue Plan into law, adding to Donald Trump's $900bn Covid Relief package (Dec 2020). Taken together this represents an unprecedented fiscal boost worth 13% of GDP. But further stimulus is on the horizon, with the White House considering a multi-trillion dollar infrastructure plan. As such we forecast growth of 5.9% in 2021, but a figure over 6% is entirely possible. Meanwhile we have revised 2022 upwards to 4.8%. For markets the critical question is what the upgraded outlook means for Fed policy, with a Q1 2023 hike now fully priced into the curve. Given the Fed's desire to make up for periods of low inflation, we suspect that the first hike in the Fed funds target rate range will come slightly later in Q4 2023. Ahead of a move in rates we expect the Fed to announce a tapering of asset purchases at the end of this year.

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

Eurozone

Attention remains firmly focused on the race between the spread of the newer and more contagious strains of Covid-19 on one side and vaccinations on the other. So far, the pace of inoculations has been too slow to contain, let alone diminish, the incidence of the disease. As a result, social restrictions have had to be extended in several countries. This will hold back the economic recovery in Q2, and explains the ECB's insistence on countering any tightening in financial conditions for the time being – including its decision this month to front-load QE bond purchases. But if vaccinations take the planned step up during the second quarter, then activity should rebound strongly before long. Still, we have cut our 2021 GDP growth forecast from 4.6% to 4.4%, and our 2022 forecast from 5.2% to 5.0% as a result.

United Kingdom

Domestically, the economic outlook has brightened. Monthly GDP for January revealed that economic activity was more resilient to the third national lockdown than expected, contracting by 2.9% on the month, relative to a consensus forecast of -4.9%. In light of this new information, we have upgraded our 2021 Q1 forecast to -1.8%, which lifts our annual 2021 growth forecast by 0.9pp to 7.3%. On monetary policy, we have opted to shift our first rate hike forward by a period of 6 months to mid-2023. This reflects the optimism regarding the strength and timing of the economic recovery, underpinned by the impressive pace of vaccine rollout enabling a faster move towards normality than once envisioned.

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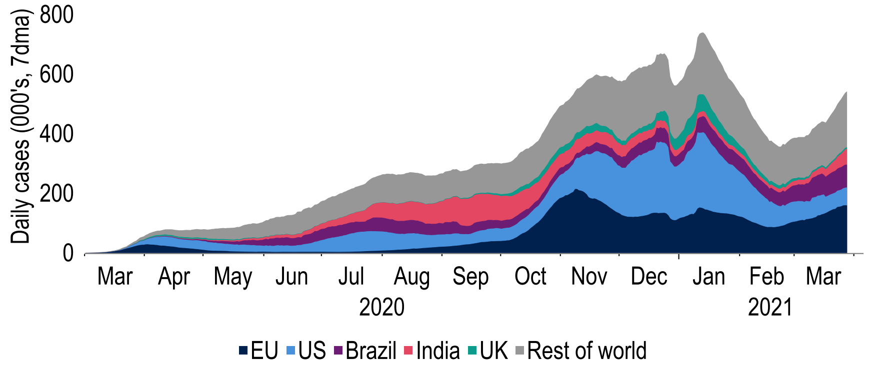
Global

Markets have been looking towards the end of the Covid pandemic, encouraged by the fast pace of vaccinations in various countries. Israel still leads the way, while the UAE and the UK have also immunised more than half of their adult populations. Impressive though this is, new waves of the virus are sweeping through other countries. India and Brazil are now topping the list of daily cases, but there is also a resurgence in various western and eastern European nations, France and Poland in particular. The net result is that the number of global daily cases is now climbing more rapidly and fatalities are increasing as well, resulting in periodic nerves in equities and supporting the USD.

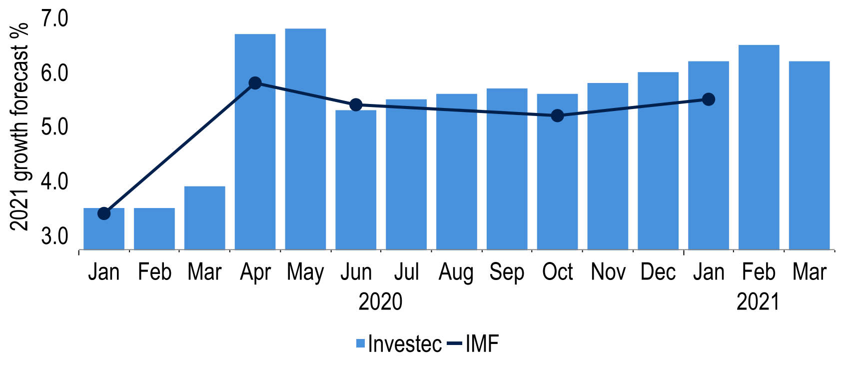
Chart 1: Daily global Covid-19 cases by broad country/region (7-day moving average)



Source: Macrobond

That said, in last month's *Global* we noted that a number of economies had performed better than expected in Q4 last year. Economies appear to have gained resilience under lockdown with activity holding up impressively – the UK in January is a good example. Mapping out our own forecasts of world GDP for 2021 (Chart 2) reflects growing optimism since the back end of last year, although this is partly due to by the magnitude of the US's fiscal packages (see US section). However our latest growth forecasts are a touch lower this month, mainly on the back of our view on China (see below). We now look for 6.2% and 5.1% this year and next from 6.5% and 5.2% previously.

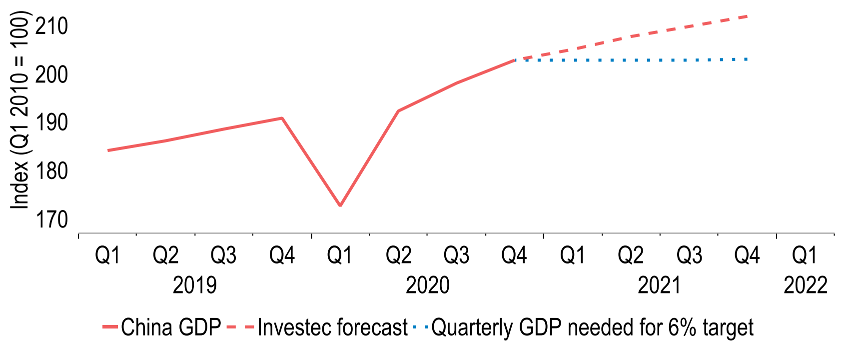
Chart 2: Evolution of 2021 world growth forecasts (IMF and Investec)



Source: IMF, Investec estimates

At China's recent NPC*, policymakers set a 2021 growth target of 'above 6%' – an unambitious goal given it can be reached on base effects alone with near zero quarterly growth. Premier Li Keqiang himself admitted that China may achieve a faster pace of growth, and that the focus is more on guiding expectations. Indeed, with China set to benefit from US stimulus, we expect growth to be closer to 9% in 2021. This is a 0.8pp downgrade on our last forecast, as we are mindful of the room the lower target leaves for Beijing to implement a policy of reducing financial risk, having already ordered all levels of government to lower their debt levels, and banks to trim their loan books this year.

Chart 3: Does China's unambitious growth target leave room for financial targeting?

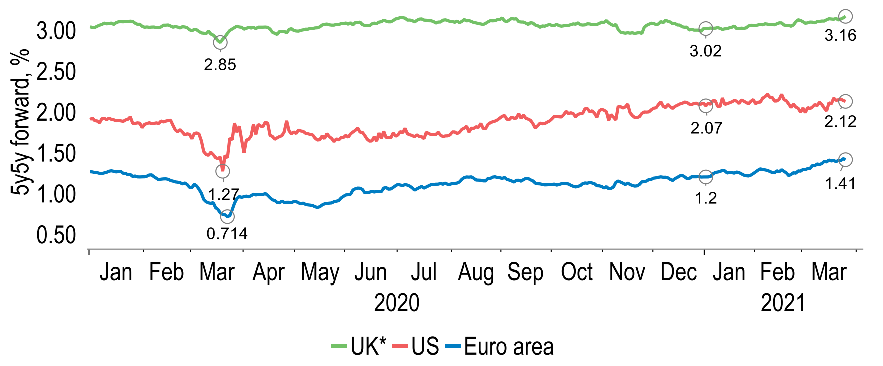


*NPC – National People's Conference

Source: Investec, Macrobond:

A common global theme in markets since the start of the year has been the rise in inflation expectations. A combination of large fiscal stimulus, ultra-loose monetary policy and renewed economic optimism has led market spectators to debate the potential for a rise in future inflation. This can be seen in 5y5y inflation swap rates – a market measure of where investors believe five-year inflation will be in five years' time. In the US, UK and the Euro area, markets have upgraded their medium-term inflation expectations. Euro-area expectations have risen the fastest of the three since the start of the year, but expectations are still firmly below the ECB's 'below, but close to' 2% target.

Chart 4: Markets reassess medium-term inflation outlook

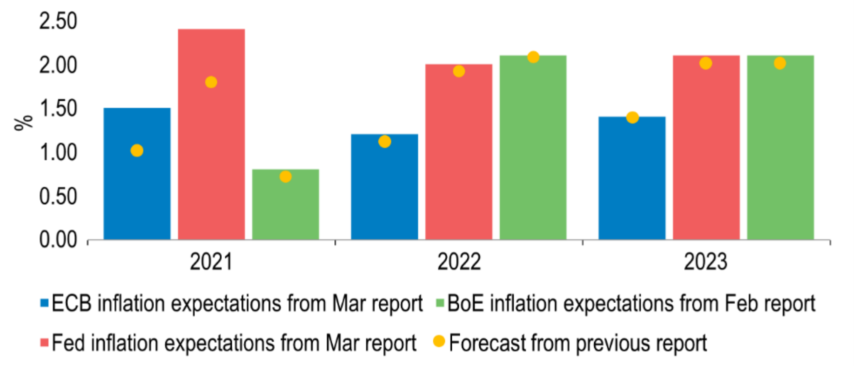


*UK measure is based on RPI, which is typically 1% higher than the CPI

Source: Investec, Macrobond

In the most recent forecast round, the ECB and the Fed made large upward revisions to their inflation outlook for 2021, with the BoE making a more modest upgrade. Indeed, the Fed increased their PCE inflation estimate from 1.8% to 2.4%, significantly above their 2% target, in light of the $1.9trn US fiscal stimulus package. In comparison, the inflation outlook beyond 2021 was left relatively unchanged, with only minor upward revisions made across the three central banks. This reinforces the narrative reiterated by both Fed Chair Powell and ECB President Lagarde that any increase in inflation this year will be a purely transitory rise, which is somewhat at odds with market expectations.

Chart 5: Central banks upgrade inflation outlook for 2021

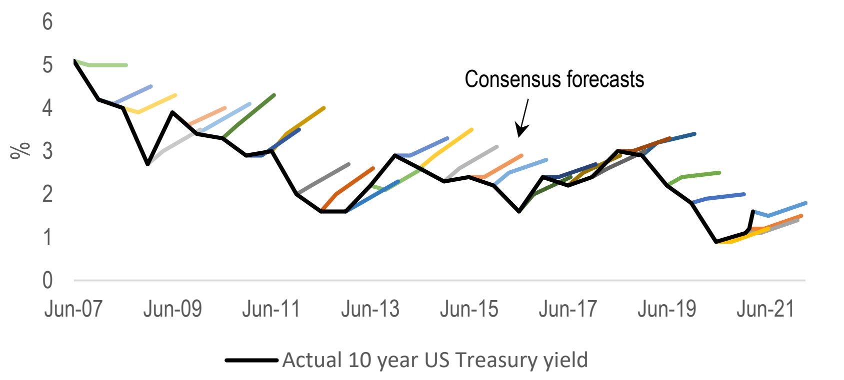


Federal Reserve forecasts represent Q4 each year.

Source: Investec, ECB, Fed, BoE

One consequence of recovery trades has been the steepening of yield curves. This has been led by the US, where 10-year Treasury yields have risen by 74bps over the year so far, but other markets have followed e.g. gilts +57bps, Bunds +23bps. It might seem tempting to extrapolate these increases looking ahead. But although we consider some upward revisions to be justified, we are cautious on the extent of any forecast changes. One reason is that one of the biggest forecasting mistakes in the post financial crisis era was to overestimate bond yields. Chart 6 shows the extent to which outturns undershot consensus over a long period. Although significant fiscal stimulus might be a game changer this time, it still seems right to be prudent.

Chart 6: US consensus bond yield forecasts have tended to overestimate actual outturns

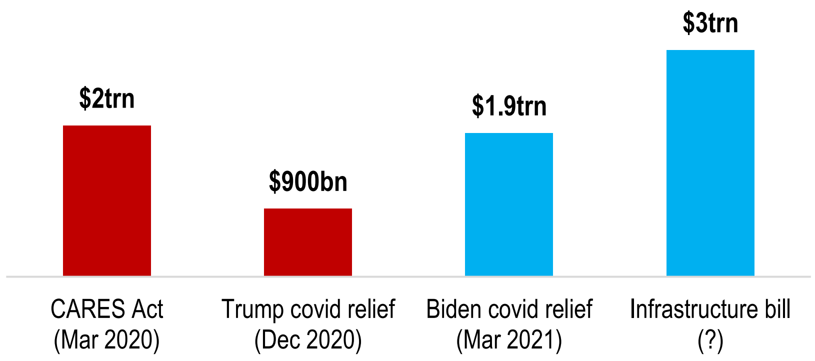


Source: Investec, Consensus Economics

United States

President Biden's $1.9trn American Rescue Plan was signed into law, passing the Senate via the Vice President's casting vote. This year's total fiscal boost is now $2.8trn i.e. 13% of GDP, and while we are sticking with our 5.9% 2021 GDP forecast, growth well in excess of 6% is possible. Next will be the administration's infrastructure plan, which looks as if it will be a $3trn package, perhaps spread over 10 years. The Democrats aim to part-fund it with tax hikes, but the knife-edge party balance in the Senate casts doubt on the feasibility on sanctioning any tax rises, which would maximise the total fiscal stimulus. On this basis, we are raising our 2022 GDP forecast to 4.8% from 4.2%.

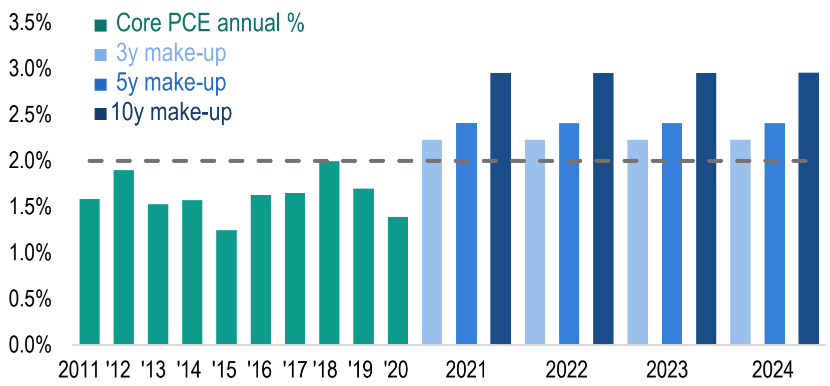
Chart 7: A comparison of recent/proposed US fiscal packages



Source: Various

Markets are scrutinising Fed comments for changes in signals over the likely timing of the winding down of its stimulus measures. The FOMC maintained the Fed funds target at 0%-0.25% this month and its median 'dot plot' view was that it would be kept there until after end-2023. Markets disagree – the curve is fully factoring in a 25bp hike in Q1 2023. No-one can be confident about timing, including FOMC members. While fiscal policy will likely pump-prime demand, it is not clear how much wage inflation will ensue. For now unemployment is still elevated at 6.2% and we note that wage growth (ECI basis) failed to reach 3.0% in the post-financial crisis period, even when the jobless rate fell below 4%. Also, as …

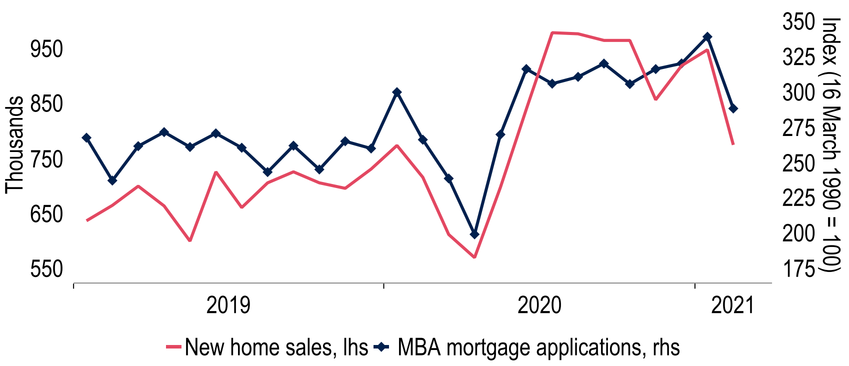
Chart 8: Fed 'makeup' strategy - inflation hotter over the next 4 years? (Investec calculations)



n.b. Blue bars show inflation required over 4 years to compensate for past undershoots Source: Macrobond

… we pointed out last month, PCE inflation has been running 0.4% pts below the 2% objective over the past 10 years, giving the FOMC licence to aim for inflation above 2% for a while, via its 'makeup' strategy (Chart 8). But overall we are now looking for an earlier Fed hike in Q4 2023 (was 2025), partly reflecting the view that the FOMC will leave balance sheet contraction until later. With Fed members reticent to push back against a steeper yield curve, we see 10y Treasury yields rising faster – we have raised our end-2021 target to 1.75% from 1.25%. But higher mortgage rates may dampen housing activity and slow the economy, acting as a brake on curve steepening.

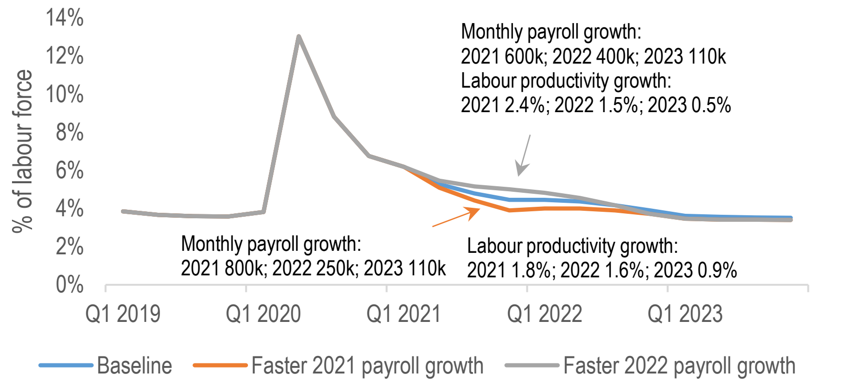
Chart 9: Mortgage activity can dampen housing (and possibly the wider economy…)



Source: Macrobond

Important for Fed policy will be how the labour market evolves. The FOMC's projections envisage the unemployment rate falling to 4.5% in Q4 2021, 3.9% in Q4 2022 and 3.5% in Q4 2023 – the latter two being "full employment", below the long-run estimate of 4%. Assuming trend population growth and a swift rebound in participation to pre-pandemic levels, this would require monthly payroll growth to average 700k for the rest of this year, 300k in 2022 and 120k in 2023. With our GDP forecasts, this would imply labour productivity growth of 2%, 1¾% and ¾%, respectively. But labour productivity and participation rates may evolve differently, altering the speed of unemployment falls.

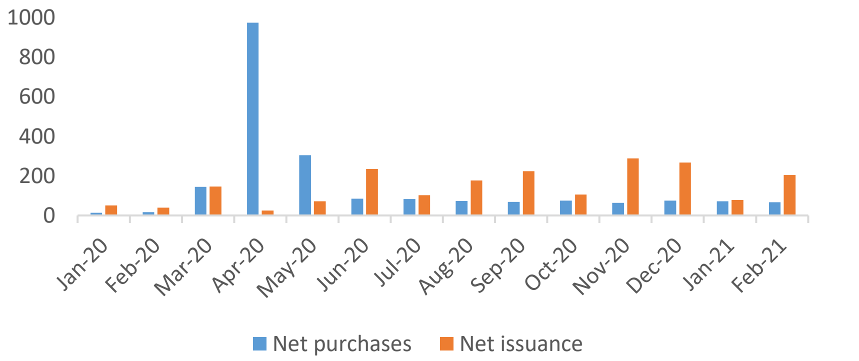
Chart 10: How the unemployment rate evolves will depend on labour productivity



Source: Investec, Macrobond

The Fed's $80bn/month in asset purchases has been a notable presence in the Treasury market. However it is also worth considering net issuance, where supply has outstripped purchases in every month other than March-May 2020. Looking forward this is set to continue, with the possibility of 2021 net Treasury issuance reaching $2.8trn, should H2's issuance match H1's. This figure could rise even further should a proposed multi-trillion dollar infrastructure plan pass Congress by then. This begs the question whether this might impact market conditions later this year should the Fed taper purchases. To date the market has absorbed supply, but one or two weak auctions raise concerns.

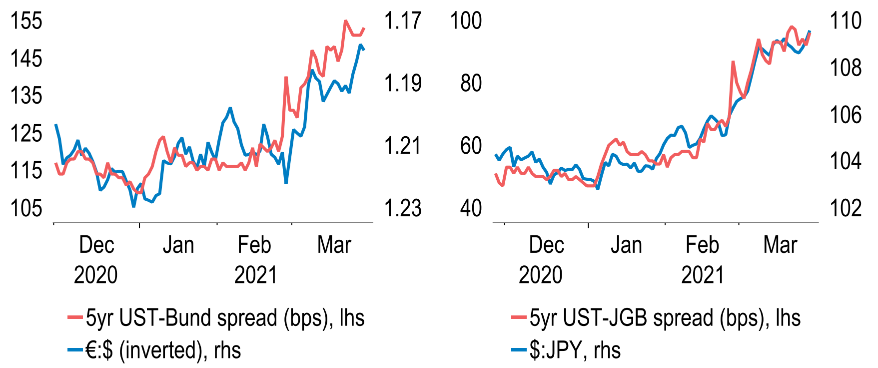
Chart 11: Fed net asset purchases vs net issuance (US treasury notes and bonds, $bn)



Source: Macrobond, Federal Reserve, SIFMA

Looking ahead, one question is whether we are potentially facing a stronger US dollar. Chart 12 clearly shows a correlation recently between the widening in 5yr yield spreads and a firmer dollar, suggesting that rate differentials are a key FX theme at present. However there are a multitude of other considerations, which can quickly change in their importance. For example risk sentiment and safe-haven demand were the key drivers last year. At present we are not minded to radically change our forecasts, but given the potential US economic recovery, fiscal stimulus, possible Fed taper and our own expectations of a faster rise in US Treasury yields relative to other G10 markets, there is a risk is that the USD strengthens rather than weakens as currently embodied in our forecasts.

Chart 12: Selected 5yr sovereign yield spreads vs the USD

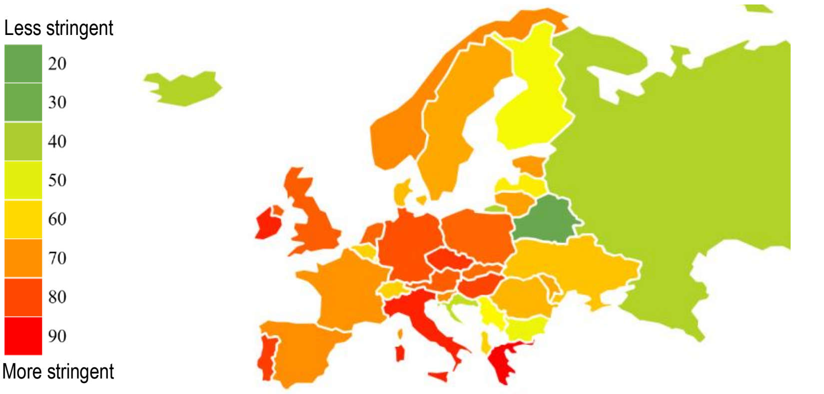


Source: Macrobond

Eurozone

An upturn in cases over the last month has prompted European governments to reassess their coronavirus restrictions as Easter approaches. German Chancellor Merkel pinned the recent surge on the more infectious variant originating in Kent, whilst announcing a 3-week extension to Germany's lockdown until 18 April, but reversing plans for further restrictions from 1 to 5 April. Italy's zone system will see the whole country abide by the strictest (red zone) rules from 3 to 5 April. In France, although President Macron has been keen to keep France 'open', new measures have been brought in, namely, local lockdowns for 19 *Départements*, including Paris, to last until 18 April.

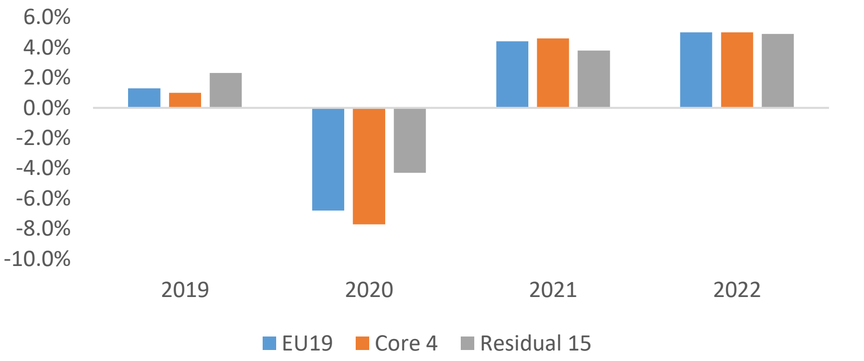
Chart 13: Oxford stringency indices are relatively high across Europe



Source: Investec, Macrobond

These rising infections and tighter social rules represent a renewed headwind to near-term economic activity. As such we have downgraded our GDP forecasts for 2021 and 2022 to 4.4% and 5.0%, respectively. However whilst we have nudged the H1 2021 outlook lower, we see this as a short delay in the recovery and expect progress in vaccinations and an unwinding of social restrictions towards the end of Q2 to prompt a significant rebound in activity in Q3. In terms of the distribution of economic growth it is notable that the four core countries are expected to see a faster pace of growth than the remaining 15 countries, which is unusual. This reflects the differing severity of the downturn in 2020 and hence the likely size of the rebound.

Chart 14: EU19 GDP growth still expected to rebound in 2021

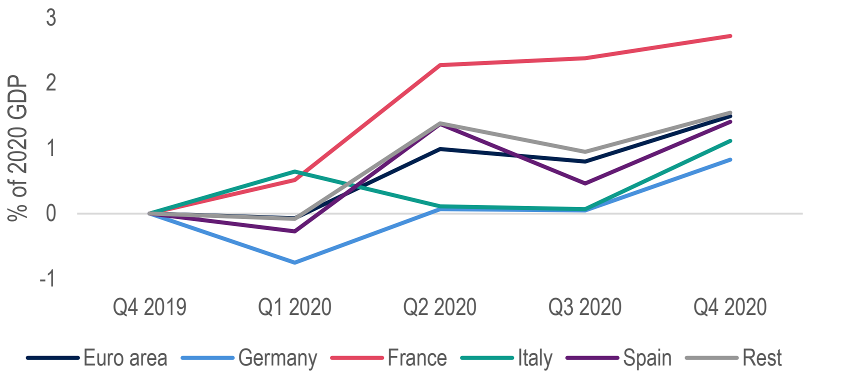


Core 4- Germany, France, Italy, Spain; Residual 15- remaining member states

Source: Macrobond, Investec

Like their counterparts in the UK and the US, Euro area households have boosted their savings during the pandemic, providing scope for boosting spending once social restrictions ease. But we estimate excess savings relative to past trends to have been lower than in those two economies – perhaps partly because services have a lower weight in consumer spending in the Euro area to begin with. Moreover, there have been significant divergences between the major Euro area countries: France stands out as having accumulated a relatively large amount of excess savings, at 2.7% of GDP, whereas Germany finds itself at the other end of the spectrum, at just 0.8% of GDP.

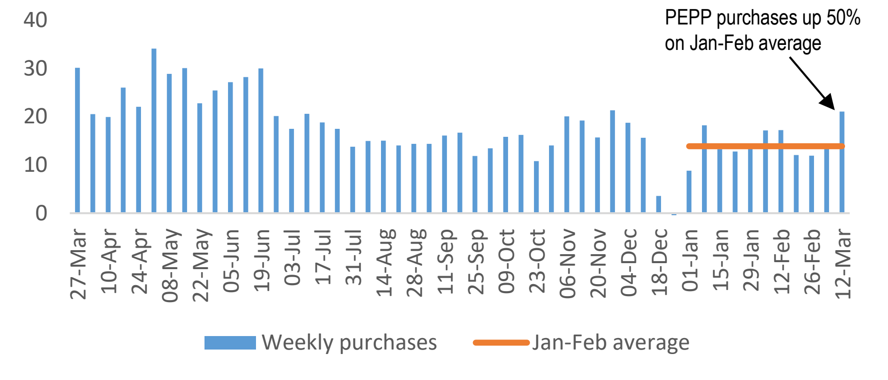
Chart 15: There are sizeable divergences in "excess" household savings across the euro area



Source: Investec, Macrobond

March's ECB meeting saw the Governing Council commit to a significant pick-up in the pace of asset purchases over the next quarter in response to rising sovereign yields. No specific guidance was given on the exact size of purchases, but the first week's data has shown an uptick to €21bn, 50% higher than the average in January and February. We estimate that monthly purchases will lie in the €70-€100bn range. But this will be flexible and influenced by broader financial conditions. Note that this is in addition to the €20bn per month purchased under the original APP. More broadly our views around ECB policy envisage PEPP ending as planned in March 2022 and APP running to the end of 2022, before the first rise in rates coming in Q4 2023.

Chart 16: ECB weekly purchases under PEPP (Pandemic Emergency Purchase Programme)



APP- Asset purchase programme Source: ECB

This decision to adjust bond purchases was clearly aimed at the recent rise in sovereign yields and to prevent an '*unwarranted tightening in financial conditions*'. However yields are not the only variables taken into account when determining the tightness of financial conditions. A working paper by ECB authors last year outlines some other major factors. In the simplified model (Chart 17) long-term yields carry the largest weight, but other variables are clearly influential. More recently Chief Economist Lane and President Lagarde have elaborated further, noting a focus on both broad market conditions (yields and OIS swaps) and bank based lending.

Chart 17: What other variables might the ECB look at when measuring financial conditions?

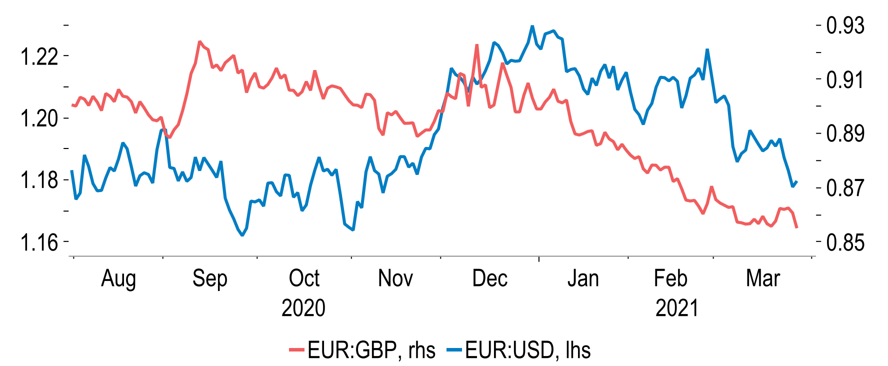
Weighted Average Financial Conditions Index, advanced economies

Component	Weight	Sign
Short-term yields	8.5%	+
Long-term yields	38.5%	+
Price/Earning ratio	23.5%	-
Nominal effective exchange rate (NEER)	23.5%	+
Corporate spread	6.0%	+

Note this model is for a simplified financial conditions index for advanced economies in general, and does not represent the official view of the ECB. Source: ECB, Investec

Over the last month the euro has fallen foul of a stronger US dollar, dropping 3.2% to $1.177 since 23 Feb. But against sterling it has been more stable, falling just 1.4%. Given the more negative Covid developments in the Euro area and the ECB announcing a front loading of asset purchases, it is somewhat surprising that the euro has not weakened more significantly against the pound, particularly given the generally more positive news from the UK. That said we have made some marginal near-term revisions to our €:£ forecasts, but this is a consequence of a slightly pushed up cable view, whilst our €:$ forecasts remain unchanged at $1.25 end-2021 and $1.30 end-2022.

Chart 18: Euro performance against the USD and sterling

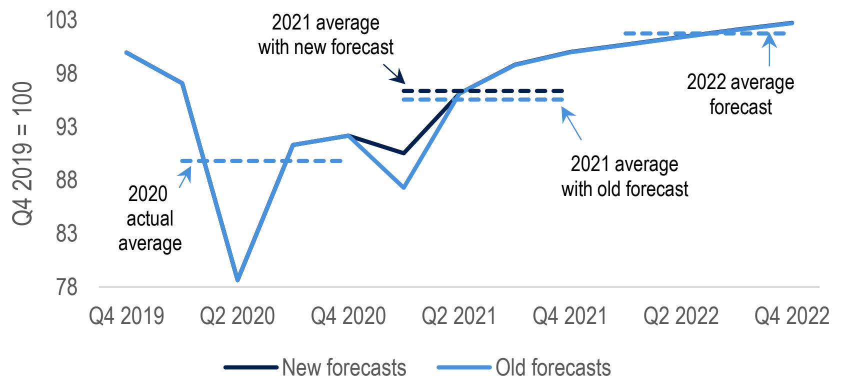


Source: Macrobond

United Kingdom

There have been mounting signs in the monthly indicators that the UK economy has withstood its Q1 lockdown much better than had been anticipated. We now estimate a quarterly drop in GDP of just 1.8%, a tenth of Q2 2020's plunge. The roadmap to reopening the economy gradually should, if all goes to plan, bring about a sharp rebound in output in Q2. Still, the scope for recovery is less than if Q1's drop had been larger. So, we have lowered our Q2 GDP growth forecast. At this point, we see no need to revise our forecasts for the level of output from Q3 2020 onwards. Mathematically, this lifts our 2021 annual growth forecast to 7.3%, but cuts our 2022 forecast to 5.6%.

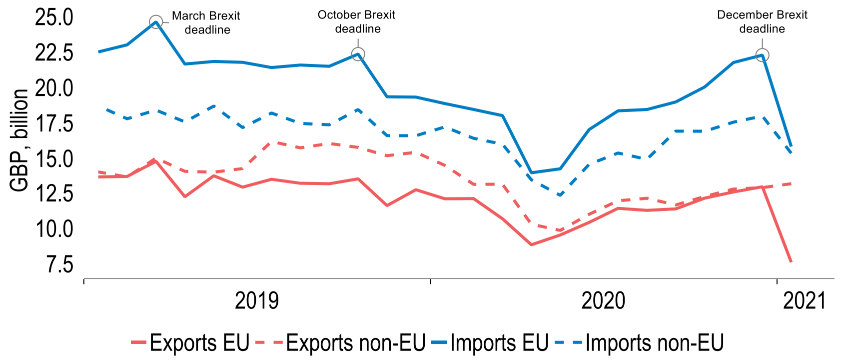
Chart 19: We now expect a shallower V-shaped profile in UK Q1/Q2 real GDP levels



Source: Investec, Macrobond

The UK's trading relationship with the EU following the end of the transition period has got off to a shaky start, with January's imports and exports of goods plummeting by 28.8% and 40.7% on the month, respectively. Although stockpiling ahead of the deadline is a significant contributing factor, our own rough estimates suggest that it can only fully explain the decline in imports – exports to the EU would still be some 34% lower even without stockpiling effects. This indicates that other factors, such as new regulations are also limiting trade. Indeed, a February BCC survey confirmed that since the start of the year, 49% of UK-based exporters had reported difficulties in adapting to new protocols.

Chart 20: UK goods trade* with the EU takes a tumble – stockpiling can't solely be to blame

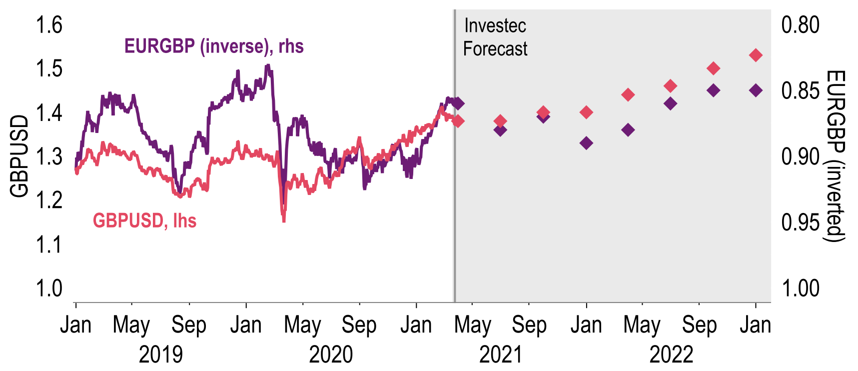


* Trade in goods mentioned excludes erratics

Source: Investec, ONS, Macrobond:

Despite the imposition of a third national lockdown, sterling has had a strong start to the year, reacting positively to the vaccine rollout and the sense of economic optimism, with the BoE narrow trade weighted index strengthening by over 3% since the start of the year. As Chart 21 illustrates, GBP has made significant gains against the EUR, reflecting the contrast between positive domestic news and the third Covid wave in continental Europe. Looking ahead, as the economy bounces back, we anticipate GBP to continue to thrive this year, with cable ending the year at $1.40. EURGBP is expected to rise slightly. However this is more of a EUR recovery story.

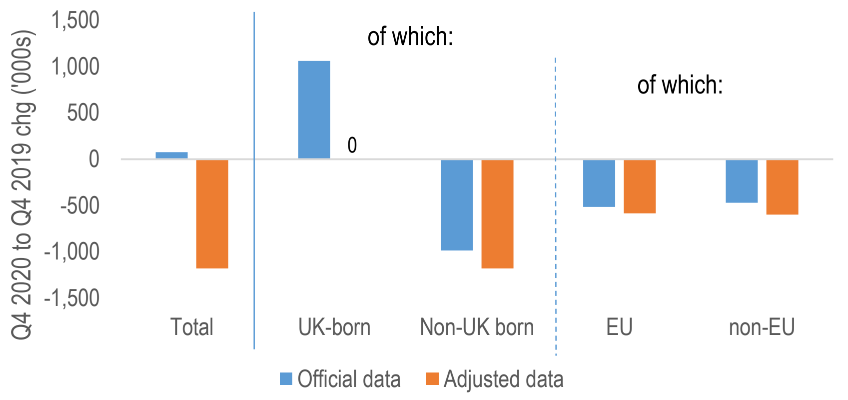
Chart 21: Sterling shoots and scores amid strong performance this year



Source: Investec, Macrobond:

UK labour force data are derived from a survey of households; results are scaled up based on population projections. With unexpected large population swings, this can lead to odd results: currently, official data show a jump of over 1m in the UK-born working-age population between Q4 2019 and Q4 2020. If, instead, one assumes the number of the UK-born people to have been steady, the data imply, tentatively but more plausibly, large net migration out of the UK, and a fall in the total working-age population to the tune of 2.8%. It is not clear how many of such migrants would return in a post-pandemic recovery, particularly from the EU. If so, the pre-pandemic level of GDP may not be a good yardstick by which to gauge spare capacity.

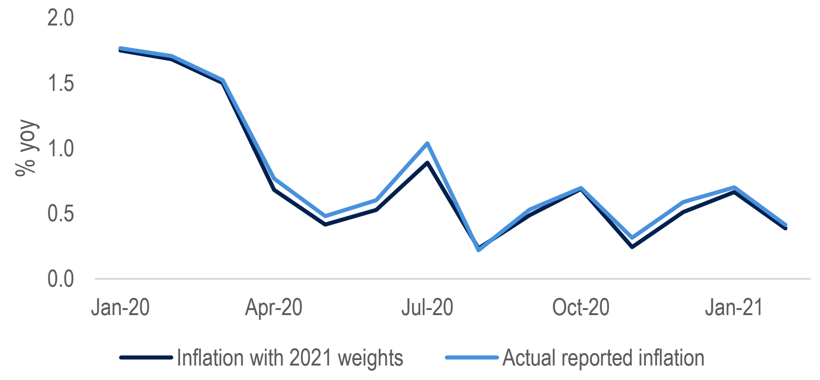
Chart 22: There are tentative hints that the UK's working age population may have shrunk



Source: Investec, ONS

Another, and more certain, impact of the pandemic has been to alter significantly the composition of the goods and services bought by consumers, as social restrictions have limited the availability of certain services, such as hotel accommodation, and boosted demand for some goods, such as computer games. The ONS has taken steps to reflect this changed basket in its CPI figures, which has altered the weights used to calculate inflation in 2021 considerably. Had this year's weights been applied already last year, we calculate that inflation would on average have been 0.1pp lower last year than actually reported.

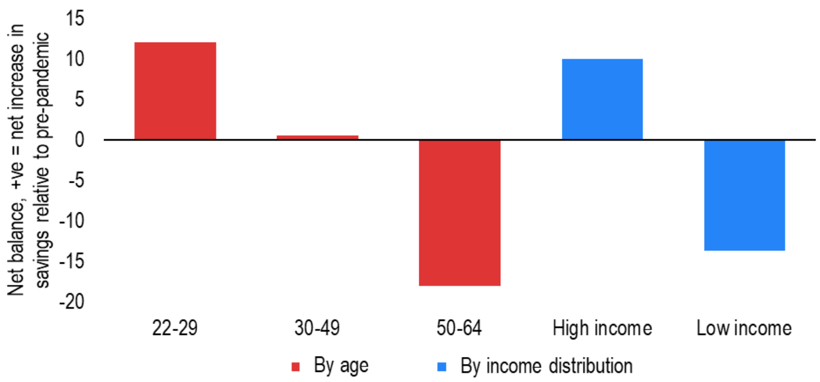
Chart 23: UK 2020 CPI inflation would have been a little lower had 2021 weights been applied



Source: Investec, ONS, Macrobond

According to our own estimates, in January UK consumers had amassed £108bn in excess savings since the start of the pandemic. However, this improvement in personal finances has not been seen universally across society, causing concerns regarding widening inequality. Indeed, lower income groups, who are more likely to be employed in industries hit hardest by the pandemic, on balance have decreased savings. More surprising is the age breakdown, with younger cohorts, who typically have a larger marginal propensity to consume, building up a stock of savings, whereas the 50-64 age group have on balance reported a net decrease in savings.

Chart 24: Increased pandemic-related savings are not seen universally*



*Survey conducted by Resolution Foundation/YouGov in May

Source: Investec, Resolution Foundation:

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Global Forecasts

GDP Growth (%)

	Global	US	Japan	China	UK	EU19	Germany	France	Italy
2016	3.3	1.7	0.5	6.8	1.7	1.8	2.1	1.0	1.4
2017	3.8	2.3	2.2	6.9	1.7	2.7	2.9	2.4	1.7
2018	3.5	3.0	0.3	6.8	1.3	1.9	1.3	1.8	0.8
2019	2.8	2.2	0.7	6.1	1.3	1.3	0.6	1.5	0.3
2020	-3.2	-3.5	-4.9	2.2	-9.9	-6.8	-5.3	-8.2	-8.9
2021	6.2	5.9	3.8	9.0	7.3	4.4	3.1	7.0	3.1
2022	5.1	4.8	2.1	5.7	5.6	5.0	5.3	5.0	4.0

Source: IMF, 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	1.65	-0.35	0.75
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
		29-Mar	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	average	average	average
Euro	€:$	1.178	1.18	1.20	1.22	1.25	1.26	1.26	1.28	1.30	1.14	1.21	1.27
Sterling	€:£	0.852	0.86	0.87	0.87	0.89	0.88	0.86	0.85	0.85	0.89	0.87	0.87
	(£:€)	1.173	1.17	1.15	1.15	1.12	1.14	1.16	1.17	1.18	1.13	1.15	1.16
	£:$	1.381	1.38	1.38	1.40	1.40	1.44	1.46	1.50	1.53	1.28	1.39	1.47
Yen	$	109.7	109	107	105	104	104	104	104	104	107	106	104
	€	129.3	129	128	128	130	131	131	133	135	122	128	132
	£	151.5	150	148	147	146	150	152	156	159	137	147	152
Aussie Dollar	$	0.764	0.76	0.77	0.78	0.80	0.80	0.80	0.80	0.80	0.69	0.77	0.80
	€:AUD	1.542	1.55	1.56	1.56	1.56	1.58	1.58	1.60	1.63	1.66	1.56	1.59
	¥	83.83	82.8	82.4	81.9	83.2	83.2	83.2	83.2	83.2	73.6	82.1	83.2
	£:AUD	1.809	1.82	1.79	1.79	1.75	1.80	1.83	1.88	1.91	1.86	1.79	1.83
Swiss Franc	€	1.106	1.10	1.10	1.11	1.12	1.12	1.14	1.14	1.16	1.07	1.10	1.14
	$	0.939	0.93	0.92	0.91	0.90	0.89	0.90	0.89	0.89	0.94	0.91	0.89
	£	1.297	1.29	1.27	1.27	1.25	1.28	1.32	1.34	1.37	1.20	1.26	1.31

Source: Refinitiv, Investec