Sunday Wrap

Happy Sunday and Happy 4th of July,

It’s US Independence Day. Congratulations to all my American friends and readers! Such a great country and leader of the free world. Had it not been for the disturbingly large part of the US population and elected officials who continue to dispute the (court verified) outcome of the election, hence keeping the questions about US democracy alive, I think most of us Europeans would be more than ready to forgive you for the 2016-2020-scare.

And the Chinese communist party is celebrating its 100-year anniversary and the immense economic success it has achieved during the past 40 years, while accelerating its clampdown on the free media in Hong Kong. The Economist magazine captured it well with its “Power and paranoia” headline. But it’s also in breach of the handover agreement with the UK, as far as I understand.

Meanwhile in Europe, the EU’s 6-month rotating presidency moved on from Portugal to Slovenia, where Prime Minister Janez Janša decided to kick-start his country’s presidency with a bizarre attack on the EU’s increasingly explicit insistence on respect for European values, including the rule of law and free media. Lots of media coverage of the sad spectacle in Ljubljana, if you are interested, but the bottom line – when it comes to European politics - was well articulated on Friday by Politico’s Florian Eder: “The EU will survive six months of Janša’s presidency”.

But before politics – and policies – get in the way of the good times, let’s enjoy the sweet spot in which markets continue to bask. The post-lockdown economic recovery is gaining strength and policies across the OECD remain highly accommodative – as they should be since we are not out of the hole yet. As economic life starts up again, bottlenecks and other factors are pushing inflation a bit higher, but it’s transitory, as recognized by almost all policymakers. Not surprisingly, therefore, the first half of the year delivered near-record returns in equities and fixed income investors had a hard time, unless they were inflation-hedged.

**But it’s early July and therefore time to look ahead to the second half of the year:**

In today’s note, I’ll argue that we are very likely to see a continued economic recovery, particularly in the developed world, while big parts of emerging markets continue to struggle due to the slower roll-out of vaccination. Also of concern, within the OECD area, the growth divergence between the US and Europe, and within the eurozone, will become increasingly prominent.

Apparently seduced by the strong growth rates, incognizant of the still incomplete economic recovery, and undisturbed by Europe’s underperformance relative to the US, an increasing number of European policymakers are intensifying their determination to begin the withdrawal of stimulus. On balance, this is likely to lead to some reduction in fiscal stimulus next year, to be announced as we also may end up getting troublesome news on the return of EU fiscal rules with only marginal (if any) modifications to address their well-proven deficiencies. And it’ll likely lead to the ECB announcing a decision to taper the PEPP without being able to fully compensate with other measures for the withdrawal of stimulus and flexibility.

**Below, I’ll explain in a bit more detail:**

- **The outlook for strong – but diverging - growth in the second half of the year, and the teeing up of the withdrawal of policy stimulus in Europe.**
- **My two key questions for European policymakers.**
- **What this is likely to mean for markets during the next six months.**
1. **Strong but diverging recoveries; inflation is transitory.**

This past week, we published our regular mid-year economic forecast, including only small changes from the previous set of numbers, reflecting mostly the slightly stronger-than-expected growth and inflation numbers during the first half of the year. In spite of the unusually large uncertainties stemming from the severity of the lockdown, the path of the pandemic, the impressive policy responses and the large amounts of excess savings among households, all of us economic forecasters continue to be in surprising agreement about the general outlook.

In a nutshell, our global GDP growth forecast for 2021 moved up to 6.1% (from 5.8%), reflecting stronger near-term consumption growth in several advanced economies. In contrast, the recovery in most major emerging markets has slowed. We kept our estimate of 2022 global growth at 4.6%.

The US economy is expanding rapidly, as illustrated most recently by Friday’s 850k new jobs in June and upward revision of the May number. GDP growth will probably be around 6.6% this year (revised up from 6.4%) and 3.8% next year. US GDP has already surpassed its pre-pandemic level, and is on track to surpass the extension of its pre-pandemic trend before the end of this year, reflecting the US administration’s determination to use the crisis to build an even stronger and better economy.

We have raised our US inflation forecast for this year, to 3.9% from 3.3%, reflecting higher recent outturns and ongoing demand-supply imbalances into the autumn. However, inflation will likely return to just above 2% by end-2022. The Fed turned a bit hawkish at its June meeting, as reflected in the changed dots by some of the regional FOMC members, but – like at the ECB – the hawks do not control the balance of power, leaving huge influence in the hands of central bank leaders. At the Fed, Powell will be looking to Biden’s decision whether or not to renew his mandate as president when it comes up in February. Either way, the Fed will remain on a dovish path. On balance, we continue to expect very gradual tapering during next year and the first rate hike in late 2023.

We have also revised up our 2021 eurozone GDP growth forecast to 4.5% (from 4.0%), leaving the estimate for 2022 at 4.3%. This means that eurozone GDP should reach its pre-pandemic level in the first quarter of next year, although that’ll disguise big differences between Germany and big parts of Northern Europe, as well as several CEE countries, including Poland, Hungary and Romania, which will get there before year-end, while most of Southern Europe is unlikely to have restored their pre-pandemic GDP levels until late summer or autumn of 2022.

Getting the GDP level back to the (modest) pre-pandemic trend line continues to look like a hopeless dream for the eurozone, let alone achieving something better than we had in the pre-pandemic years. The European policy talk is now turning to the timing of the withdrawal of stimulus (answer: 2022, if still modestly so).

Why European fiscal policymakers display such lack of ambition for European income levels is something I don’t understand, apart from the two issues I have discussed in the past, namely an over-reliance on questionable output gap estimates, and an analytically wrong focus on debt stock numbers (instead of debt service obligations) as an indication of debt sustainability. The unquestionable conclusion will – almost certainly – be several years of lower income, higher unemployment and sub-target inflation rates in Europe than what could be achieved with more ambitious fiscal policy. The NGEU will help some, but apart from Italy and some of the CEE countries, it’s not big enough to make a material difference.

Eurozone inflation is particularly troublesome. Again, higher inflation is desperately needed to restore the power of monetary policy, and to facilitate the relative price changes which drive the resource reallocation in a dynamic economy. We forecast inflation at 2% on average this year, with a peak at 2.5-3% in the autumn, but we remain confident that it’ll be followed by a slowdown in 2022, probably to about 1.5%. The temporary spike in inflation has been enough to get some of the (national) hawks to warn of inflation risks, which – along with a peculiar definition of the economic impact of COVID, which the PEPP was designed to address – has led to an increasingly vocal call for its phasing out.

As a result, the future of the PEPP hangs in the balance as Lagarde decides whether to accommodate the hawkish minority with a phasing out at the indicated time in March, or whether to accept a public disagreement with particularly Bundesbank President Weidmann, who has already called for the end of PEPP and – apparently – no additional flexibility for the existing asset purchase program.
I don’t know where Lagarde will land on this issue, but I was heartened this past week reading her saying, “We will maintain our measures [the PEPP] until we judge that the coronavirus crisis phase is over.” She surely cannot have in mind that just restoring GDP to pre-pandemic levels would indicate an end to the crisis, thereby implying that without the crisis, the eurozone would have had two years of zero growth! If so, this would need to be explained to the (mostly vulnerable) millions who lost their job these past two years and haven’t yet returned to employment.

And once the PEPP is being phased out, assuming the inflation outlook at that time remains well short of the target, the ECB would have to substantially beef-up the standard QE program, increase its flexibility along the lines of the PEPP, and enhance forward guidance for reinvestment to avoid an undesirable monetary tightening. I’m very skeptical they can pull this one off.

For our detailed forecast and discussion of the country-specific outlooks, please take a look at this week’s Chartbook: The UniCredit Economics Chartbook: Recovery strengthens, price pressures won’t last and the CEE Quarterly: CEE Quarterly: The reopening

2. My two key questions for European policymakers.

On the back of what we know about the first half of the year and the generally agreed outlook for the second half of 2021 and for 2022, I have two key questions to European policymaking, both fiscal and monetary, as they look to their policies going forward. Ultimately, both questions relate to vision, ambitions and courage, as well as their assessments of the consequences of getting it wrong in either direction.

As illustrated, on present forecasts, including by all the official institutions and consensus, the US will bounce back this year with a growth rate of 6.5%-7.0%, following a dip of just 3.5% last year. In sharp contrast, the eurozone stands to bounce this year by a much more modest 4.5% in spite of having been in a much deeper hole (-6.7%) last year. Next year, on our forecast, the eurozone will then reduce the gap a bit with a 4.3% growth rate vs. the US 3.8%.

The first question is why?

Yes, the US didn’t lock-down to the extent Europe did, but voluntary social distancing, as well illustrated by, e.g., google mobility data, was probably as (the IMF argues) more important than the government-mandated restrictions themselves in terms of the impact on economic activity.

And yes, the US was faster at rolling out its vaccination than in Europe, but we are talking about a difference of only six weeks. And yes, at 10% of GVA, the US is a bit less exposed to the most vulnerable sectors in hospitality, etc., than Europe, but we are talking 2-3pp difference only. And yes, the stronger US stock market probably lifted the US mood and boosted household wealth, but then again, maybe US stocks outperformed Europe due to the policy message?

I’d love to be proven wrong, but I cannot escape the conclusion that the difference in fiscal response, particularly this year, provides the key explanation for the much slower European recovery.

This, in turn, raises the question of what type of monetary impulse we’ll receive from the more successful US. In the good old days, the answer would surely have been via the exchange rate, but EUR/USD is putting in an amazing degree of stability these days, leaving the key transmission to yields. So, with a very high probability, we’ll be back at the ECB and its struggle to keep European sovereign yields in line with European fundamentals – or at least its reluctance to admit that this is what they are doing. (As I argued a few weeks ago in my note on the ECB’s Strategy Review, the ECB should get more vocal in its call for help from the fiscal side, and commit to yield curve control until inflation is back at its target.)

This leads me to my second and related question: Why the divergence in growth inside the eurozone and what will be the consequences?

On the latest available numbers (Q1), GDP was still more than 9% below the pre-crisis level in e.g. Spain and Portugal, while the hole was a more modest 5% in Germany and 6.5% in Italy. The harder hit in Southern Europe than in the north can of course be explained by the timing and severity of the pandemic and on the relative dependency on vulnerable sectors (at 12%-
18% of GVA in the south versus 9%-10% in the north), but it surely also reflects the difference in fiscal response. I have discussed it ad nauseam: Germany was the fiscal-response-star of 2020 and into this year as well, and after a brief waverings, Italy stepped up forcefully as well. In contrast, I still recall the Spanish PM excuse the mediocre Spanish fiscal response with a (misguided) reference to the debt level.

Whatever the perceived fiscal capabilities, the substantial divergence in growth across the eurozone raises an additional problem for the ECB at a time when pressure is building to end the PEPP, the one and only instrument which can deviate from the capital keys over a longer period of time.

I can think of few other times (actually only once) when strong leadership at the ECB, and a willingness to confront a vocal minority, will be more important than during the next six months. For now, I take comfort in what looks like an elegant stealth approach by Lagarde, from the timely photographed meeting with Chancellor Merkel early this week to Friday’s interview with the La Provence, well tweeted by the ECB. I hopeful, but still not sure...

3. What it means for markets.

So far, 2021 has played out in markets as a growth recovery year – and my money is on a continuation of that theme in general during the second half of the year, but with some important caveats, and quite a bit of fear that policy noise may end up challenging the performance of risky assets.

Given the truly extraordinary first half, let me first remind you of the beautiful H1 we have just completed:

Reflecting the economic growth story, commodities did very well these past six months (oil is up 50% and the CRB commodity index 25%), as did equities (roughly +15%, with Euro STOXX 50 putting in its second-best H1 performance in two decades), while fixed income is in the red (except where credit risk was offering high carry).

The negative performance in fixed income markets was particularly pronounced at the long end. The 7-10Y Bund index is down 2%, while the 10Y+ is down 7%. The picture is slightly worse in the US. If you had to be in fixed income, staying invested on the short end would have saved you losses, but it wouldn’t have earned you any money. BTPs outperformed Bunds on a mix of the new politics and policy winds in Rome, and the better policies and prospects with that, as well as EU support and generally improving growth - but still not enough to generate positive returns. Inflation concerns and higher inflation have supported inflation-linked securities, which achieved a positive performance at the end of H1 to the tune of 2.5%.

In FX, price action has been lackluster: Despite all the attention in markets (and among us economists) to the stronger US recovery, the USD strengthened by only 3% versus the EUR, also at odds with the picture of improving risk appetite. As the divergence in growth between the US and Europe is likely to get more pronounced, the relative FX stability, and likely trans-Atlantic transmission in yields instead, will make life complicated for the ECB, as I discussed above.

Oh, and one more thing about markets in the first half of the year: Bitcoin took a roundtrip from 30,000 to almost 63,000 and back (investable asset, anyone?) It’ll be a bumpy road also ahead as it – ultimately - will move towards its fair value (which - in case you wonder - is zero for the investor and highly negative for society because of its energy consumption and facilitation of payments of illegal activities.)

So, with that, here is what my strategy research team, led by Luca Cazzulani and Elia Lattuga, thinks about the next six months - with which I agree:

The past six months’ negative return in sovereign bonds will almost certainly continue. In the US, 10Y real yields at around -0.90% are too low considering the recovery phase. In Europe, the ECB – in spite of the noise and protestation against the description of yield curve control – will, and should, seek to keep real yields well anchored. That said, yields are negative and the uncertainty around the PEPP will continue to raise questions whether the ECB will be successful in insulating European curves from what’s happening in the US.
As a result, our preferred choice in fixed income remains credit risk exposure, in the euro area with a particular focus on HY. Inflation-linked bonds, which were a relatively good investment in H1, are likely to face a more challenging environment. Breakeven inflation has already risen significantly, while rising real yields pose a threat.

The equity recovery is not over yet, but the headwinds are becoming increasingly visible. On balance, we expect another roughly 5% from current levels for European stocks and a little less for US stocks. The main driver will be the earnings recovery. In Europe, which is likely to benefit from its tilt toward cyclical and value stocks as the economy strengthens further, the key risk will be policy signals of pre-mature withdrawal of stimulus. In the US, potentially higher taxes, regulatory risks and rising bond yields may create some headwinds for growth stocks - remember that, e.g., Information Technology and Communication Services have a 40% share in the S&P 500.

Finally, we are bearish on oil. Contrary to the prevailing super-cycle arguments for still higher oil prices, we think a likely pick-up in supply, including by the release of reserves, will outweigh the demand story and push prices lower – to something like USD 66 for Brent by year-end. For a detailed discussion, see my colleague Edoardo Campanella’s note from this past week, here: Oil Update: How good is the market at predicting oil prices?

And on that note, I’ll begin to clean up after last night’s party while looking forward to Wednesday: Look out, England! We are coming, and as we say: “Vi skal ikke hjem. Vi skal videre.”.

So to my Italian friends, see you next Sunday – at Wembley!

Best

Erik

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