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Falling economic momentum is not bad news

Gerhard Winzer



One of the most important economic indicators, the global purchasing managers' index for the manufacturing sector, fell from 56.0 in May to 55.5 in June (source: JP Morgan). The national versions of the indicator in the USA (from 61.2 to 60.6; source: ISM) and in China (from 51.0 to 50.9; source: NBS) were also down on the month. Is this bad news for risky asset classes like equities?

Different stages

The time series of economic activity shows a unified picture.

1. A sharp decline in the period of shock is followed by
2. an equally sharp increase during the loosening of policies; this is then followed by
3. declining, but still above-average growth for several quarters.

Stages 2 and 3 can be subsumed under "recovery". This trend continues until full employment has been achieved.

Depending on what country we are talking about, we are either at the transition from stage 1 to stage 2 (some emerging economies like India and Brazil which shrank in Q2), in stage 2 (continental Europe), at the transition from stage 2 to stage 3 (USA), or in stage 3 (China).

Political strategy is decisive

The political strategy is the decisive explanatory factor of the differences between the various countries. A crucial factor is the vaccination rate. USA and the UK got off to a quick start, but continental Europe has caught up in the meantime; the emerging economies are clearly lagging behind the developed economies. The increasing vaccination rates have led to a decline in new infections and the gradual lifting of restrictions and subsequently an increase in mobility and economic activity. This resulted in a significant decrease in downside risks for economic growth. Of course, new variants that might compromise the effectiveness of the vaccines do represent a risk that we have to be aware of.

Three political factors driving the difference in development among the various countries are the containment measures (shrinking GDP in the Eurozone in Q4 2020 and in Q1 2021), the monetary policies (ultra-expansive in the developed economies; rate hikes in more and more emerging markets as we speak), and the fiscal policies (fiscal packages in the USA; the European Recovery Fund will start distributing money in the second half of 2021; and less capacity in the emerging markets).

Surprisingly strong growth

Real global GDP growth clearly exceeded estimates as early as in Q4 2020 (+1.8% q/q; source: EAM) and Q1 2021 (+1% q/q). The economic indicators published for Q2 2021 suggest an acceleration of growth (+1.25%), especially in the USA, the UK, and continental Europe. Even if the USA and China are recording weaker rates of growth in Q3, the global recovery is widening out (i.e. more countries) and gaining depth (e.g. recovery in the service sector due to the lifting of restrictions). This means we should see the peak of global real GDP growth in Q3 (estimate: +2% q/q).

Is the falling momentum of some monthly economic indicators that suggests a decline in growth rates, followed by deceleration, disadvantageous for risky assets (global peak in Q3, USA Q2)?

Support for equities is becoming less pronounced

Practically speaking, the support for equities has fallen on four levels:

1. It has become harder for growth indicators to exceed expectations (which have been adjusted upwards).

2. From a theoretical angle, it is clear that economic growth cannot keep accelerating like this for long; the global phase of acceleration will soon come to an end.
3. More and more central banks in the developed economies are thinking about – albeit cautious – exit strategies from their ultra-expansive stance. The focus is on the Fed policy. The reduction of the substantial bond purchase programme will be announced once “considerable” progress has been made on the labour market (currently: USD 120bn per month; source: Federal Reserve). This might happen from the end of summer onwards. Once “maximum” employment has been achieved, the (very low) key-lending rates can be raised (N.B. EAM expects Q4 2022).
4. Valuations are elevated as prices have already come a long way, which is why disappointments are now more likely.

The outlook remains constructive

Just to remind the readers: the phase the economic cycle is in is called recovery (not downturn), and it will last for a few more quarters, even though growth rates will (probably) start falling from Q4 onwards. At the same time, the monetary policies of the big central banks remain very supportive, despite the fact that the extent of the expansive stance will be reduced slightly. This combination in our most-likely scenario should suffice for a constructive outlook for risk assets. Any decline in the effectiveness of the vaccine due to new variants of the virus still constitutes the biggest risk.

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