Pandemic year three: what are the challenges ahead?

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We are now into the third year of the pandemic. But since the spring 2020 collapse, economic activity and markets have shown exceptional resilience. This is not to be taken for granted. After all, the list of potential negative influences (the “challenges”) is long.

Recovery

At the macroeconomic level, the coronavirus has created stagflationary tendencies. Without the virus, output would be higher and inflation lower. However, despite the ongoing pandemic, the global economy remains in the recovery cycle phase.

Real GDP growth can remain above potential until full employment is reached if the headwinds are not too strong. At a somewhat more granular level, evidence for an acceleration in GDP growth has increased from the third to the fourth quarter of 2021.

Both private consumption growth and industrial production growth have improved in many countries. Car production in particular is showing a significant increase. The latter is also an indication of a decline in supply bottlenecks.

Overall, a (deliberate) buildup of low inventories is likely to have contributed significantly to GDP growth in the fourth quarter. In China, in line with the emphasis on stability by policymakers, purchasing managers’ indices have risen.

After the contraction in the third quarter, China will show growth in the fourth quarter.

Rivalry

There is no easing on the geopolitical level. The rivalry between the USA and China and the conflict between the West and Russia as well as Iran could become relevant for the markets, unlike last year.

Climate change

A similar situation applies to climate change. The measures announced are likely to be too small to achieve the envisaged targets for CO_2 emissions. This means, among other things, too little investment in climate-friendly technologies and infrastructure, and an increasing intensity of natural disasters. Both have a stagflationary effect (higher energy and food prices in trend).

Omicron

The pandemic is not over yet. New infections are again showing a rapid increase. The Omicron variant is more contagious than previous variants but also less virulent. Because more people are affected, the health care system remains challenged.

The negative correlation between new infections and economic activity has not (yet) been broken because global vaccination coverage is too low. Uncertainty about the strength of the stagflationary impact is considerable. A renewed slowdown in global GDP growth is assumed for the first quarter.

The contact-intensive areas in the service sector are particularly affected. However, growth in the base scenario remains above potential. Whether production and logistics will be curtailed as in the previous year, with increasing price pressure, depends heavily on whether the zero tolerance policy in China is continued.

Externalities

Both a climate-friendly environment for people and a functioning health care system are public goods. By definition, the provision of these goods is the responsibility of society as a whole (the state), because externalities are insufficiently taken into account in the decision-making process of individuals (market failure).

Strictly speaking, these are global public goods, but there is no global state, which is why externalities will probably never be satisfactorily internalized.

The 26th Climate Change Conference in Glasgow (COP26) was not particularly convincing and emerging market economies are short of vaccines. Complicating this environment are populist movements taking advantage of increased anti-establishment and anti-science attitudes, and rivalries between nations (especially between the U.S. and China).

The presidential election in France and the midterm elections in the U.S. will also be good barometers of the extent of these attitudes.

Inflation

At the price level, consumer price inflation probably peaks at around 5% on an annual basis at the global level in the fourth quarter 2021. Energy prices have been a major contributor to the rise in inflation in the second half of 2021.

However, since the price peak in October, energy prices have fallen in the aggregate. Overall, the high inflation rates were mainly caused by the fact that in some sectors supply could not keep up with the rapid increase in demand (goods, energy, labor market) and inflation in the service sector did not fall even though demand collapsed (ratchet effect). In addition, supply has also been affected in some areas due to containment measures (closure of ports in China). Moreover, as demand increased, inflation in the service sector also picked up in the fourth quarter.

The extent and duration of the high inflation rates has surprised many economists. In addition, some pass-through effects can be identified. Food prices in particular have risen because the cost of energy and transportation has increased.

Whether this is a one-off effect (higher price levels) or a phase of sustained high inflation rates depends on whether long-term inflation expectations, which are thought to be firmly anchored, drift upward and/or whether economic growth remains above potential, even if the negative output gap is closed (the unemployment rate is low).

Already now, a tightening in the labor market can be observed in more and more countries.

Dilemma

Monetary and fiscal policies are in a dilemma. Should more emphasis be placed on economic recovery (employment) or on inflation? In any case, striking key interest rate hikes have already taken place in the Emerging Market Economies.

In the Developed Market Economies (DME), key interest rates have also already been raised in three countries (New Zealand, UK and Norway). In general, central banks in the DME have started to reduce bond purchase programs and have prepared market participants for key rate hikes.

Ultra-accommodative monetary policies are being scaled back. However, a swing toward a restrictive monetary policy will only take place if inflation rates remain too high.

Known Unknowns

Over the past year, some risky asset classes, especially US equities, have seen extraordinarily strong total returns. The economic recovery has been priced in to a large extent, while the numerous risks have played a subordinate role.

The pandemic, the climate crisis, the geopolitical conflicts, the problems in the real estate sector in China, the production and supply bottlenecks and inflation could gain in intensity, and central banks could come under pressure to raise key interest rates sharply.

If all these risks do not gain in importance, only two classic risk factors remain: Rising (real) government bond yields would put pressure on equity valuations. Significantly rising wage growth would diminish earnings prospects.

Conclusion: In the most likely scenario, risky security classes (exception: emerging markets) remain attractive. However, a somewhat more cautious approach to investing is recommended.

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