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Rapid recovery in the developed world

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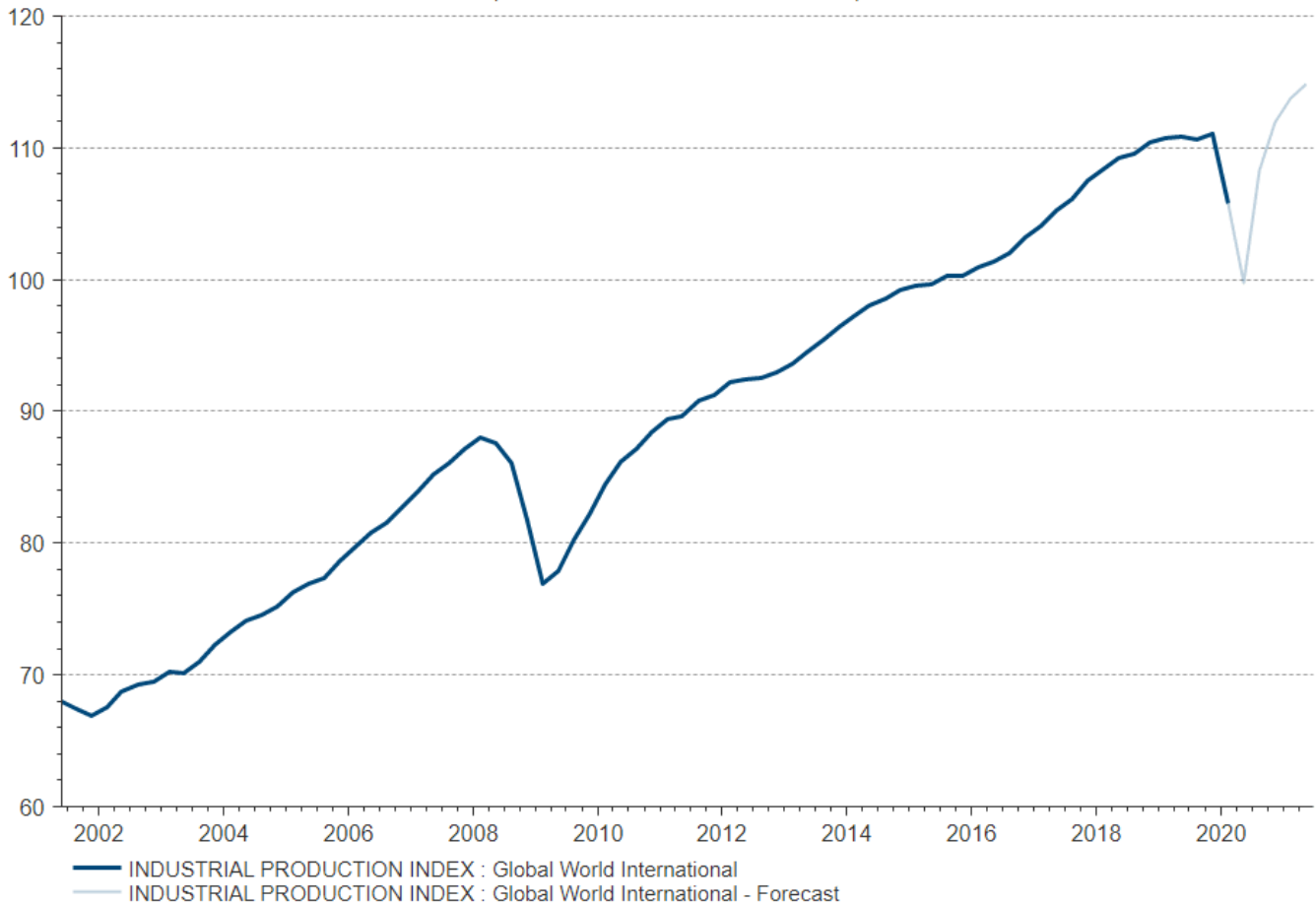
At the moment, the market participants are finding themselves faced with the challenge of having to differentiate between the underlying trend (signal) and random fluctuations (noise). In recent weeks, some economic indicators have been below expectations, some inflation indicators have been above expectations, and central banks have sent out signals that might suggest the abandonment of their expansive stance. A stagflationary environment (no growth, high inflation) would indeed be negative for numerous asset classes. But the underlying trend suggests a different, more positive environment.

In theory, the development over time of the indicators is following an economic shock, this time triggered by the pandemic. A sharp decline is followed by an equally sharp increase during recovery; the initially mercurial recovery caused by the re-opening measures is then followed by declining, but still above-average growth for several quarters. In the right environment of supportive economic policies and the absence of new virus variants, this trend can continue until full employment has been achieved.

Chart: sharp recovery of industrial production

Sharp recovery of industrial production

(Index and Outlook 2001-2021)



Source: Refinitiv Datastream

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Note: Past performance is no reliable indicator for future performance.

While reality sometimes deviates from theory, the indicators by and large support this narrative.

Robust profit development of the companies

Resilience: in numerous countries, the impact of the lockdown measures on GDP was less significant than expected in Q4 2020 and Q1 2021. The earnings development of Q1 2021 in the corporate sector came also as a positive surprise in many cases.

Optimism: the global and survey-based leading indicators are largely positive and thus suggest accelerating growth.

Heterogeneity: growth does not accelerate equally across all countries, nor by an equal degree. The differences are due to the pandemic development (high case numbers in India, third wave in Europe in spring), economic policies (fiscal packages in the USA), the economic structures (i.e. the ratio of contact-intensive and cyclical sectors), and the different capacities in healthcare management (i.e. lower in the emerging markets) and in economic policies (i.e. necessary interest rate hikes and less fiscal wiggle room in some emerging markets).

Distortions: some US economic indicators were weak in April. This was the result of the very strong March indicators due to the fiscal stimulus measures (i.e. normalisation in April) and of the bottlenecks in production (i.e. increase in order backlog).

Bottlenecks: the swift recovery has led to a situation where in some sectors supply cannot keep up with demand. This has resulted in increased prices for industrial metals, wood, energy, maritime transport, in lower production in supplier segments (cars), labour shortages in partial segments, and longer delivery times. Indeed, producer input and output prices have increased drastically on a global scale according to survey-based indicators. In accordance, producer prices have increased above average as well. The often-quoted rise in inflation in the USA in April (+0.9% m/m, core rate) was mainly due to the re-opening measures (hotels) and supply shortages (automotive sector).

Chart: higher input and output prices in the corporate sector (diffusion index)



Source: JP Morgan

Note: Past performance is no reliable indicator for future performance.

Transitory rise in inflation: in the most-likely-case scenario, these price developments are of a temporary nature. The necessary requirements for a structural rise in inflation are sustainably high economic growth rates after reaching full employment (N.B. expansive monetary and fiscal policies create a positive output gap) and rising inflation expectations from consumers and companies setting off a wage-price spiral. At the moment, even the USA is far from reaching full employment (N.B. employment 8.2 million below pre-covid levels). While the long-term inflation expectations have increased, they really represent a normalisation.

Weakening in China: the signs of an underlying weakening are becoming more plentiful. In particular, credit growth is falling. The negative credit impulse will weigh on domestic economic activity and also affect global export activity. This is counterproductive for a global recovery.

Soft versus hard indicators: the survey-based (soft) indicators have already increased to very high levels, suggesting a drastic improvement or hard indicators such as GDP and employment. While falling soft indicators in the coming months would not come as a surprise, they would not indicate an economic decline, but the normalisation of the initially high growth rates in Q2 and Q3.

Conflict of goals: the central banks in the developed economies are faced with a conflict of goals. They want to keep their foot on the gas for as long as possible (i.e. low key-lending rates, bond purchase programmes) in order to support the economy. The goals of the US Fed are maximum employment and an inflation rate of slightly above 2% to ensure the long-term inflation expectations remain stable at 2% (and do not fall). However, a sustainably expansive stance increases the risk of a bubble on the financial markets. The solution: slow and cautious tapering of the expansive policies.

Abandonment of expansive stance: more and more central banks (Bank of England, Bank of Canada) are indeed signalling the tapering of their bond purchase programmes via forward guidance. Even the Fed is talking about it and may make an announcement in summer. The big central banks remain cautious on key-lending rates in their forward guidances. The general stance seems to be: let's wait until the goals (2% inflation, full employment) have been reached. This means the focus is on the past, not on projections. The initial interest rate hike in the USA could happen at the end of 2022. In contrast, some smaller central banks (Hungary, Czech Republic, Norway) have indicated interest rate hikes for this year already. Brazil, Russia, and Turkey are in a different ballpark altogether. Elevated inflation risks have already led them to step up key-lending rates significantly. **Fundamentals:** the vaccine programmes and the resulting re-opening measures, the high private savings ratio, catch-up effects, the fiscal stimuli (especially in the USA), and the expansive monetary policies will lead to high GDP growth rates in the coming quarters. The catch is that a lot of the good development has been priced into the low risk premiums of the various asset classes and that the government bonds will probably (continue to) rise. Generally speaking, as long as yields rise less significantly than profit growth rates, equities will remain attractive. However, high asset valuations lead to elevated volatility.

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