Building back without foresight

Advanced Economies Outlook Q2 2021

Joeri de Wilde

More than a year into the global lockdowns, there is finally light at the end of the tunnel as vaccination campaigns are gathering speed. For advanced economies, the combination of ample vaccine availability and excess household savings sets the scene for a strong economic recovery. We expect this recovery to shift into full gear over the course of this summer. However, divergence between advanced economies implies vastly different economic recovery prospects. This may ultimately lead to diverging policies as well.

Although the near-term economic outlook seems bright, the lack of focus on the longer-term recovery has so far led to policy measures that merely target a bounce-back to the old economy. Measures that steer towards a green and inclusive recovery have been almost non-existent. Policy makers still have time to change course, but the window of opportunity is closing fast as the recovery gains strength.

Developed Markets Outlook Q2 2021

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The good news is that the recovery of advanced economies is gaining speed. We have made an upward revision to our growth projections, as the pickup in economic activity has materialised earlier than we anticipated, and the total amount of implemented global fiscal stimulus has exceeded our expectations. In our base scenario, which assumes a gradual easing of lockdown restrictions in advanced economies with a return to 'normal' in the final quarter of 2021, we expect global annual economic growth rates of 6.2% in 2021 and 4.5% in 2022. In our alternative scenario, where the effectiveness of the vaccines is hampered by new virus mutations and vaccination campaigns are delayed, requiring prolonged restrictions throughout the year, we expect global annual economic growth rates of 4.7% in 2021 and 3.5% 2022.

Based on our fundamental approach, we maintain our cautious asset allocation stance and remain underweight in equities and neutral in bonds. We do not think that the current valuations accurately reflect underlying fundamentals and assume central banks can't keep financial assets inflated forever. We prefer high-quality names as the negative effects of the collapse in economic activity are likely to materialise at a later stage once emergency support is lifted.

In the grip of reflation trade

Since the start of the year, rising inflation expectations have dominated financial market sentiment, both in a positive and negative way. At first, equity investors assessed the rising inflation expectations as a signal of the anticipated strong economic recovery: inflation would gently march higher in the medium term, and any potential surges later this year would only be temporary COVID-19-related anomalies. This train of thought meant that government bond yields and share prices could rise in tandem, which is exactly what happened. Equity investors rotated from growth stocks to energy and financials, as these sectors usually benefit the most from an economic recovery and rising long-term interest rates.

However, as the sell-off in the government bond markets continued, investors got increasingly worried about the possibility of a more permanently high inflation. The enormous USD 1.9 trillion US fiscal stimulus package which was signed into law in March was an important reason for this growing concern, as it could lead to a global economy running in overdrive. This would mean inflation above central bank targets for a prolonged period, potentially forcing central bankers to retreat on their ultra-loose monetary policy stance. Tightening financial conditions and higher interest rates imply lower equity valuations and stocks becoming less attractive compared to bonds. As this story gained traction, equity markets started to fall, while government bond yields continued to rise. Overall, equity markets did move higher during the quarter, as positive investor sentiment prevailed.

Despite the huge US fiscal stimulus package, the Federal Reserve (Fed) continued to view the expected rise in inflation in 2021 as transient and therefore signalled to maintain its accommodative stance. It also did not feel the need to act on the rising government bond yields. The European Central Bank, on the other hand, pledged to increase the pace of its asset purchases to address the rising borrowing costs within the eurozone. It expects inflation to remain well below its 2% target in the coming years.

We also see more reasons for inflation to remain around (US, UK) or below (eurozone, Japan) central bank targets in the medium term. A lagging global recovery in labour markets, persistently weak global demand and continuing digitalisation will remain strong disinflationary forces. In the short term, we do expect some inflationary pressure due to base effects and a sudden increase in spending once restrictive measures have been lifted. Temporary supply chain difficulties could add to this upward pressure. More permanently higher inflation could potentially materialise in case the huge amount of money in the financial system finds its way into the real economy. This is not our base scenario, however.

Global economy holding up well

Last year, the global economy shrank in a way never seen before in peacetime. However, the yearly contractions were generally smaller than we expected a few months ago. As a result, the current state of the global economy is exceeding our previous expectations. This has mostly been the result of adaptation of households and businesses to the new ‘lockdown reality’, ongoing effective emergency support policy, and a remarkably resilient manufacturing sector, thanks to a surge in online demand.

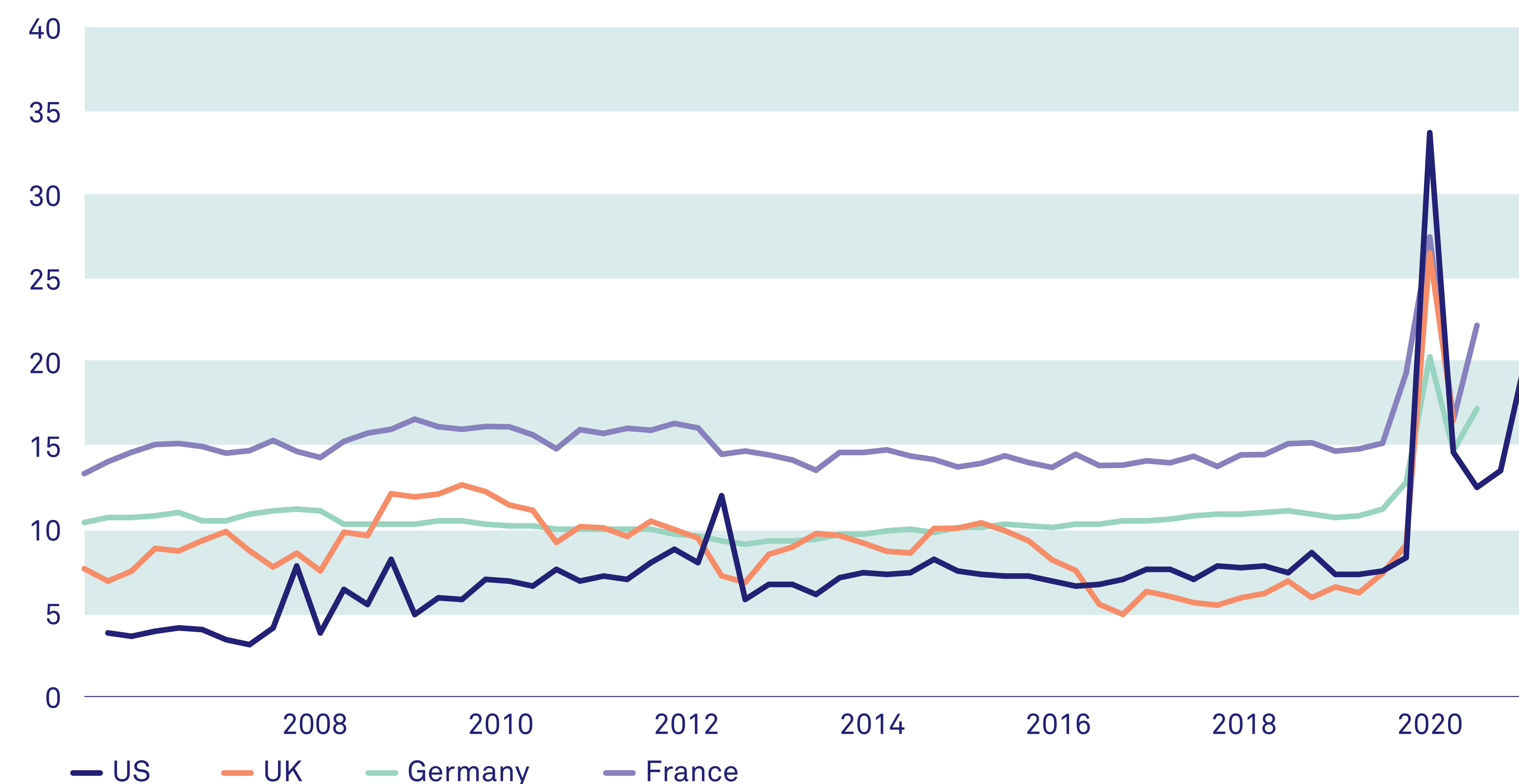
We have now entered a new phase in the pandemic, in which vaccination campaigns are rapidly being rolled out in most advanced economies. As the effects of these vaccinations start to show in declining infection and hospitalisation rates, restrictions can gradually be lifted. Most advanced economies aim to administer vaccines to all their citizens in the first half of 2021. The coming months will therefore be a transition phase, in which restrictions can gradually be lifted and economic activity can start picking up.

Excess household savings predict strong global recovery

In the summer we expect restrictions to be substantially eased, making way for a strong global economic recovery on the back of excess household savings and pent-up demand. Since the start of the pandemic, household savings have skyrocketed in all major economies. This is the direct result of the massive global fiscal stimulus that focused on income support and job retention. Households were therefore able to build up buffers, as they were not able and/or willing to spend what they normally would due to restrictions and the ongoing uncertainty. This does not mean that all households were able to increase their savings, as the COVID-19-induced recession disproportionately impacted low-income households and the self-employed.

As it stands, average household saving levels are still elevated across advanced economies (see figure 1), and the savings rate in the US will likely even get an additional push from the upcoming cash transfers that are part of the stimulus package of the new Biden administration. In addition, job retention schemes have made sure that unemployment rates have stayed relatively low (see figure 2 on the next page).

Figure 1 Household saving (per cent of disposable income)

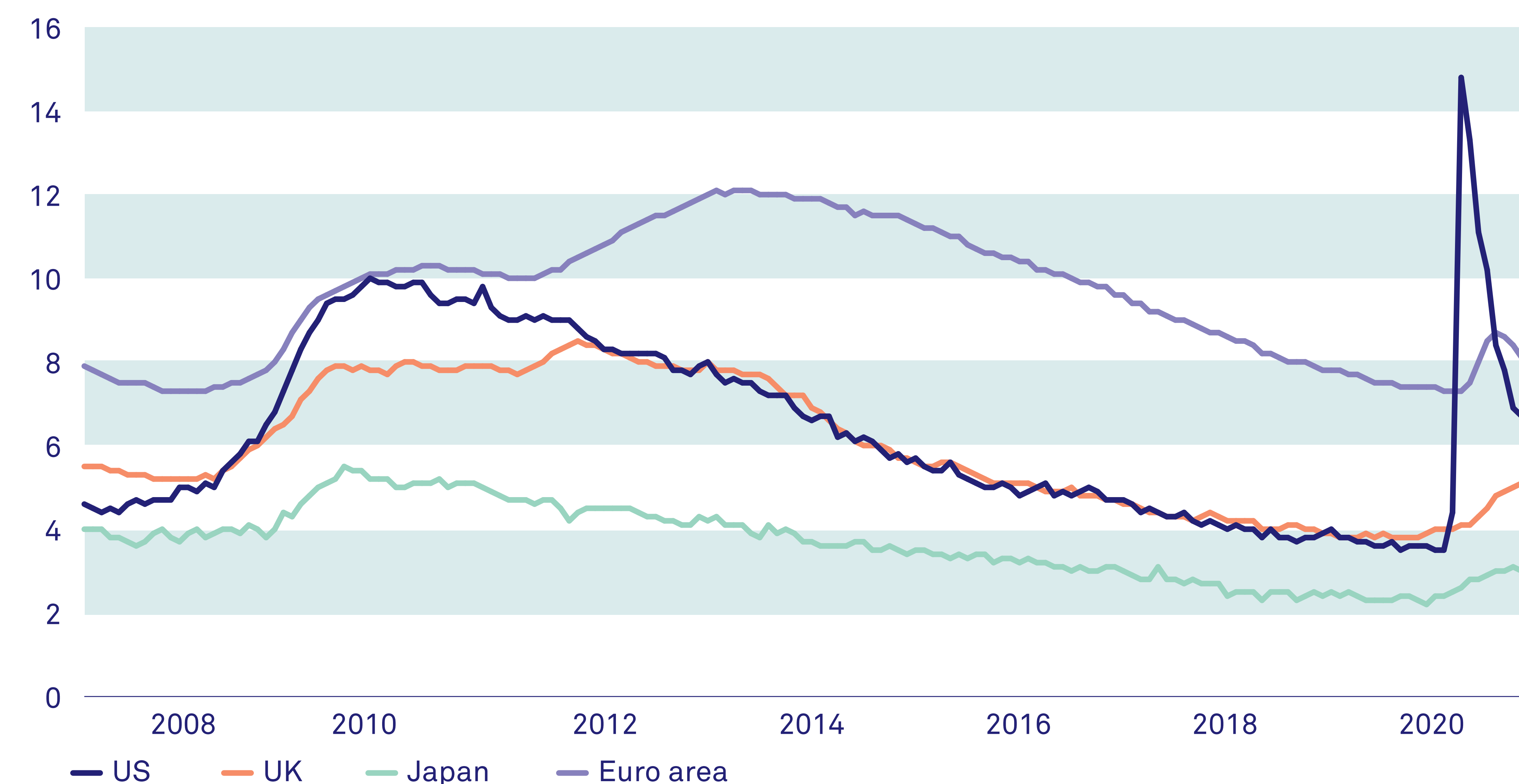


Source: Refinitiv Eikon, Triodos Investment Management

In the US, where policies have not focused on job retention, the unemployment rate has already decreased significantly. This should lead to further improvements in the still relatively low consumer confidence and give people less reason to hold back on spending due to joblessness or job insecurity. Households are therefore well positioned to start spending once restrictions are lifted. Saving levels will likely remain somewhat elevated, due to loss aversion (people experiencing the spending of additional savings as a loss) and precautionary motives. Private debt levels in the meantime also increased, which may be an additional reason for some reservations in spending patterns.

There are a few downside risks to our base scenario of a relief rally that drives a strong global recovery. The major risk relates to vaccination speed and effectiveness. Vaccinations might be delayed due to production or distribution issues, or due to unforeseen side effects that might force temporary suspension (as recently happened with the AstraZeneca vaccine). Vaccines might also prove to be less effective against new virus mutations, thereby forcing governments to keep certain restriction in place. Premature withdrawal of emergency policy support to households and businesses could also pose a risk to the anticipated strong recovery. From a more technical point of view, the relatively strong starting point of the economy could also mean that the strength of the rebound might somewhat disappoint, as goods consumption is already surging and losses in economic activity from services will not be completely recouped during a relief rally (e.g. people will not completely make up for all lost restaurant visits).

Figure 2 Unemployment rate (per cent of the labour force)



Source: Refinitiv Eikon, Triodos Investment Management

US to drive the global recovery, eurozone clear laggard

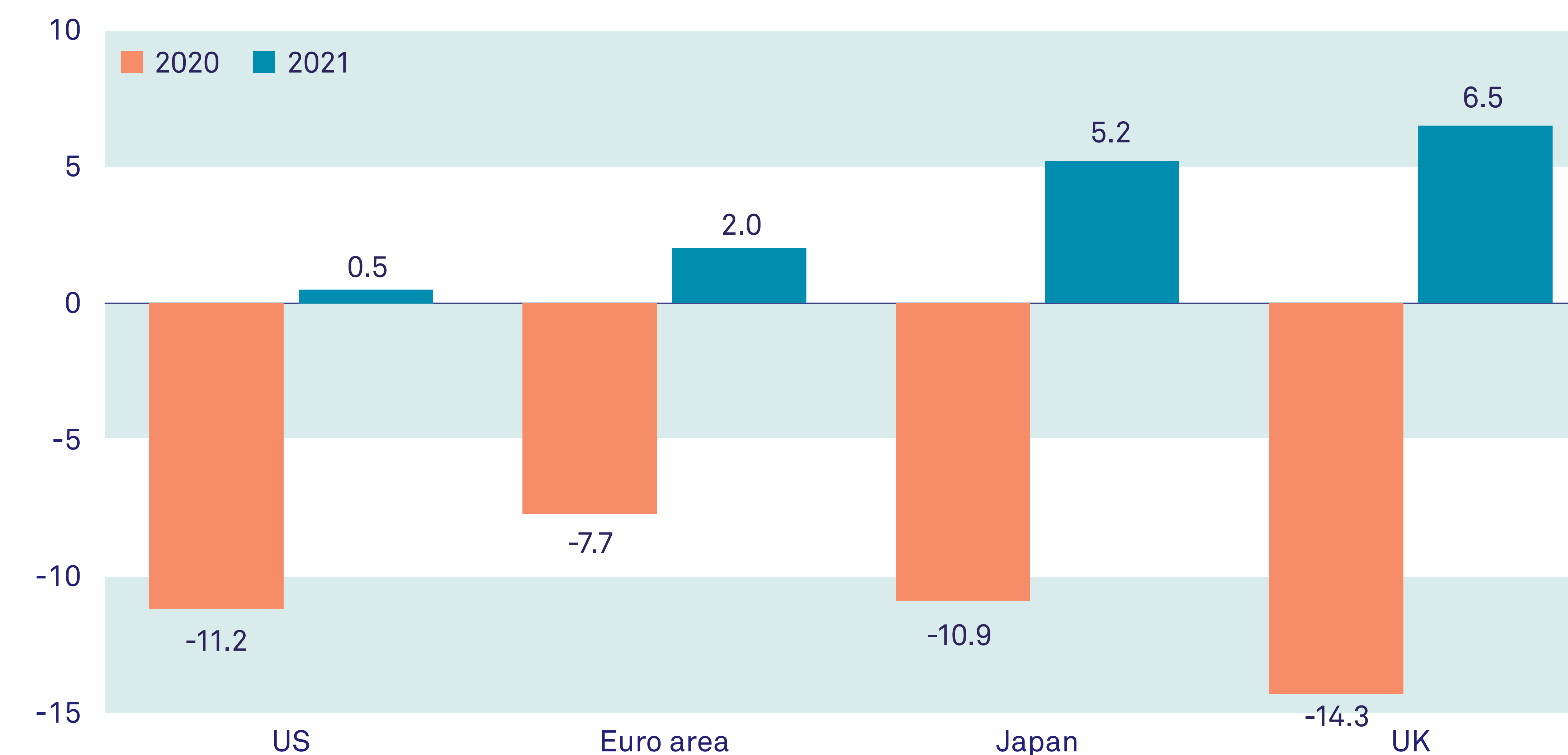
Although we expect a strong global economic recovery, near-term recovery prospects across advanced economies vary greatly. Divergence between countries is already clearly visible and will likely continue. The root causes for this divergence are threefold:

- **Lockdown stringency and duration:** The eurozone and the UK have opted for very stringent lockdown measures, while the US chose to be more flexible. As a result, overall business activity levels in the UK and eurozone have fallen over the last few months, as strong manufacturing growth was offset by near inactivity in the services sector. The US, on the other hand, has experienced a boom in overall business activity, as robust growth in the manufacturing sector was accompanied by accelerating services activity. Although stringent lockdown measures were not necessary in Japan, business activity still failed to substantially pick up due to persistently weak (global) demand conditions.

- **Extent of fiscal support:** The extent of the fiscal support in both 2020 and 2021 significantly differs across advanced economies. The US has outsized most of its counterparts, and the eurozone has been the clear laggard (see figure 3). Because last year's economic contractions in the eurozone and UK were much deeper than those in the US and Japan, the changes in general government balances as depicted in the figure even understate the fiscal differences. The recently implemented USD 1.9 trillion US fiscal stimulus package means the fiscal support in the US will continue to outsize support in other advanced economies in 2021, further separating the near-term growth prospects.

- **Vaccination rollouts:** The speed of the vaccination campaigns also varies greatly across advanced economies. Of the major economies, the UK is the clear front runner, followed closely by the US. The eurozone has fallen behind due to a slow start, and so far, has not been able to catch up. Japan only started with vaccinations in late February, but due to successful virus containment this does not greatly impact its near-term economic outlook.

Figure 3 Change in general government balances (% of GDP)



Source: UBS, Triodos Investment Management

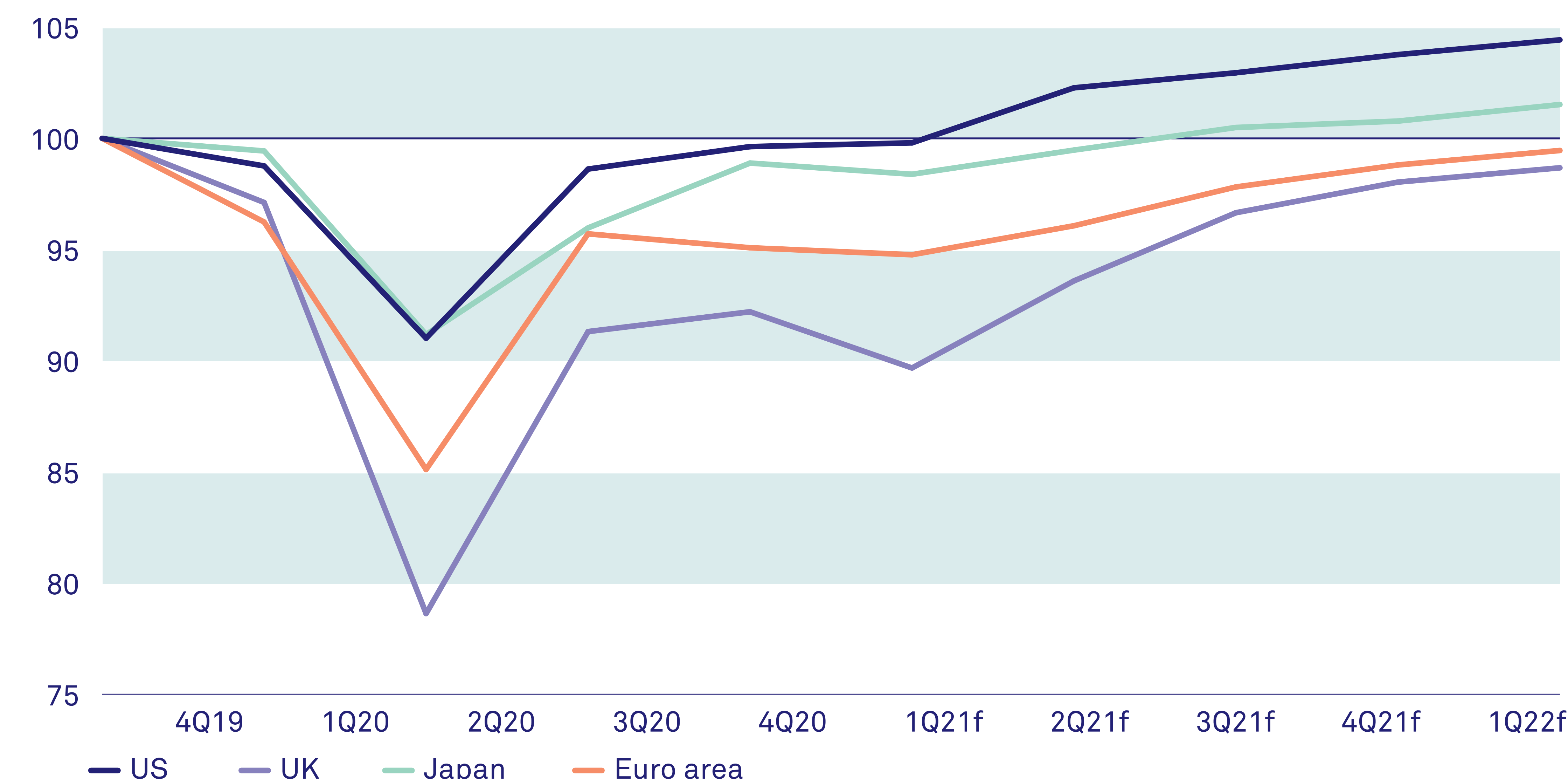
The US seems well positioned to reach pre-pandemic levels of economic activity before the second half of 2021 (see figure 4). It will therefore be the main driver of the global economic recovery. Japan will reach pre-pandemic levels shortly after the US, while both the eurozone and the UK are unlikely to reach pre-pandemic activity levels before the second quarter of 2022. Between the UK and the eurozone, we expect that the UK's pace of recovery in the next few months will likely be stronger due to its more successful vaccination campaign.

Window of opportunity is closing fast

More than a year into the global lockdowns, we come to the sobering conclusion that most of the implemented fiscal policy measures fail to steer towards a green and inclusive recovery; they merely aim for a bounce back to the old economy. In 2020, only **2.5% of USD 14.6 trillion** in fiscal spending by governments of the 50 largest economies could be classified as having green characteristics, like reducing greenhouse gas emissions or protecting natural capital. Urgent calls from numerous institutions like the **IMF** to include existential threats such as climate change and biodiversity loss into COVID-19-related policy support considerations have been largely ignored. This is a missed opportunity, as the United Nations Environmental Program concludes that green fiscal spending can bring stronger economic growth than traditional spending, while at the same time helping to meet global environmental targets and addressing structural inequality.

It is not too late to steer towards a different recovery pathway. But since the focus of fiscal policies will increasingly shift from emergency support towards longer-term recovery spending, the coming months will be crucial in determining the direction of the upcoming recovery. In order to achieve a **sustainable, inclusive and climate-resilient recovery pathway**, governments should focus on early CO_2 mitigation and achieving the UN Sustainable Development Goals (SDGs), instead of focusing on old-fashioned metrics like GDP growth. Implementation of the IMF recommendations for public investment in green infrastructure, adequate carbon pricing and compensation for lower income households would be good first steps. At the same time, as long as emergency support measures are necessary, we fully agree with **OECD recommendations** that these measures should be conditional on environmental improvements where possible.

Figure 4 Real GDP (index 4Q19=100)



Source: Société Générale, Triodos Investment Management

Allocation: cautious stance

Despite the improved growth outlook, we expect monetary and fiscal policies to remain extremely accommodative in the near-term. In the longer term, the diverging economic growth prospects may lead to differences between the major central banks: The Fed might be tempted to tighten earlier due to a strong economic recovery in the US, certainly when this is accompanied by a prolonged overshoot of its inflation target. The ECB, on the other hand, will likely be forced to remain very accommodative as the eurozone economic recovery is expected to be slower and inflation will likely remain well below the ECB's target.

Although government bond yields have been rising due to the anticipated economic recovery and increasing inflation expectations, eurozone government bonds are still expensive. The ECB seems committed to prevent any significant rise in the borrowing costs for governments, meaning the low yield environment will likely continue for quite some time. At the start of the coronavirus crisis, corporate bond yields moved up sharply, but since then spreads have narrowed again. The growth environment makes us cautious when it comes to credits. We prefer high quality names as the collapse in economic activity is bound to lead to financial difficulties further down the road, certainly once stimulus measures are being lifted. Overall, we remain neutral in bonds.

We remain cautious with equities. Broader market valuation is still elevated. The US equity market continues to look expensive relative to Japan and Europe. We think that current earnings expectations are still relatively high. Negative earnings surprises are lurking, in which case lower equity prices and valuations would be entirely warranted. Rising inflation expectations resulting in sudden rises in bond yields are an additional risk to equity markets. Overall, we do not think that the current valuations accurately reflect underlying fundamentals and assume central banks can't keep financial assets inflated forever. We therefore remain underweight in equities.

Growth projections

		Baseline		Alternative	
GDP growth (%)	2020	2020	2021	2020	2021
Global	-3.3	6.2	4.5	4.7	3.5
US	-3.5	6.5	3.3	5.3	2.7
Euro area	-6.6	4.2	4.0	2.2	3.3
UK	-9.9	5.4	4.9	3.9	4.2
Japan	-4.8	3.1	2.8	1.6	1.8
China	2.3	8.5	5.7	7.2	5.1

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For more information about our impact investment strategies, please contact our Investor Relations team at:

+31 (0)30 694 2400
TriodosIM@triodos.com
www.triodos-im.com/impact-equities-and-bonds

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Joeri de Wilde,
Triodos Investment Management

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Via Bertha, Utrecht

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Absolutvision