A mind-blowing recovery, but at what cost?

Advanced Economies Outlook Q3 2021

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Triodos Investment Management

Rapid vaccination campaigns in most advanced economies have paved the way for a remarkably fast global economic recovery. We expect a further acceleration of economic activity in the second half of the year as advanced economies continue to loosen restrictions. Increased household spending will continue to be the main driver of this rebound. A key threat to this consumption-driven recovery is a sustained pickup in inflation, certainly if the major central banks act too late.

Despite this year's strong pickup in economic activity, we have so far clearly failed to reset our economic system. Perpetual ultra-loose monetary policy and soaring public debt levels have allowed multinationals and high-income households to ride the recovery waves, while many small businesses and low-income households still struggle to survive. In the meantime, we continue to rely on carbon-intensive industries. To achieve a truly sustainable long-term global recovery, fiscal policies should urgently turn to sustainable investments, rather than fixating on the short-term boost coming from consumption.

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The near-term prospects for the global economy are rosy: we find ourselves in an exceptional economic recovery. Rapid vaccination campaigns in most of the major advanced economies have allowed governments to loosen restrictions, in some cases faster than expected. This has already led to a significant pickup in economic activity, and this trend will continue in the second half of this year. As a result, we expect the global economy to recover at record-speed when compared to previous post-recession periods. Almost all advanced economies are expected to reach pre-pandemic levels of GDP by the end of 2022 at the latest.

In our base scenario, which assumes a near to complete removal of restrictions in advanced economies by the time we enter the final quarter of 2021, we expect global annual economic growth rates of 6.2% in 2021 and 4.6% in 2022. The most important downside risk to this base scenario remains the possibility of new virus mutations that would hamper the effectiveness of the vaccines, thereby requiring reimplementation of restrictions after the summer.

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 properly 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 may still arise further down the road when stimulus measures are being lifted. The possibility of a sudden sharp rise in interest rates resulting from rising inflation expectations also makes us cautious.

The household spending party has only just begun

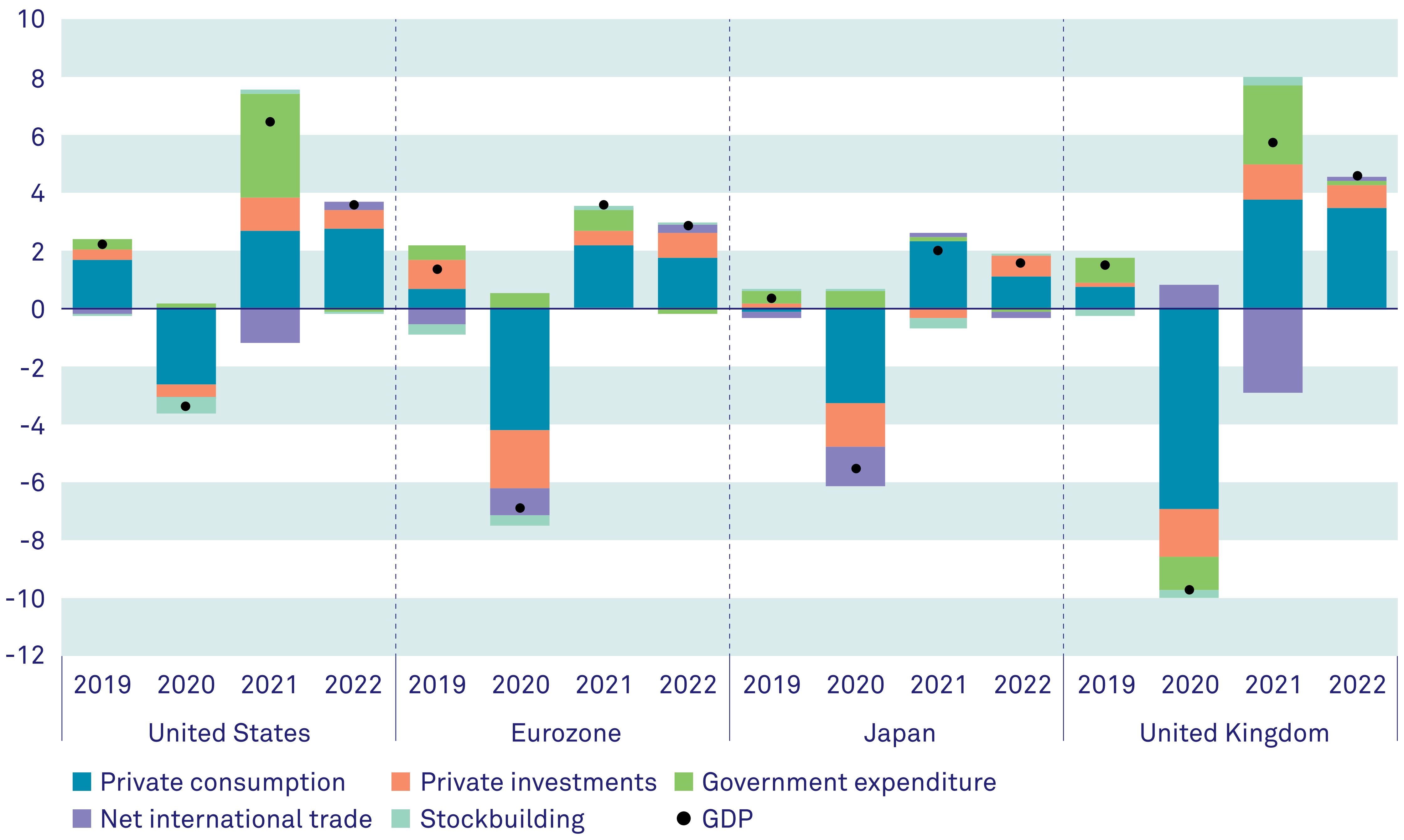
As it stands, most advanced economies aim to administer vaccines to all their citizens by autumn 2021 at the latest. This means a significant loosening of restrictions in the coming months. Consequently, the third quarter will likely be characterised by the sharpest quarterly rebound in economic activity that the aggregated advanced economies will experience in the period 2021-2022. Household spending will be the main driver of the economic rebound during this period. In 2021, sizable government spending is also key to our expectations for a strong recovery.

Household spending did already substantially pick up since the initial freefall in economic activity last year, as spending on goods partially substituted for the inability to spend on contact-intensive services. Now that restrictions are further removed, pent-up demand and elevated savings rates mean households are more than ready to further accelerate their spending. In the US and the UK, this increase in services consumption has already been going on for some months, and the eurozone and Japan have recently followed suit as restrictions are gradually lifted. On top of that, this year's newly announced fiscal measures (the USD 1.9 trillion American Rescue Plan in the US) and extensions of emergency support schemes throughout the summer (in the eurozone and the UK) will underpin this development through continued income support. As services consumption increases, spending growth on goods will likely slow, but evidence so far shows that pent-up demand for goods still isn't completely satisfied either, meaning some additional growth in goods spending could still materialise in addition to the increase in services consumption, mostly in regions where lockdowns still have to be substantially eased.

Household spending growth will likely somewhat moderate towards the end of the year, but we expect it to remain strong as households continue to regain confidence, labour markets further improve, and the currently still elevated savings rates gradually return to normal levels. If savings rates are reduced faster than is usually the case after a recession, or if households tap into their accumulated excess savings, the consumption-driven recovery might even be stronger than currently foreseen. This is the most important upside risk to our baseline scenario. The most important downside risk still relates to possible new virus mutations that require reimplementation of restrictions after the summer. Another important downside risk is a sustained pickup in inflation (see page 7 for further details).

Looking at the major advanced economies, we can still see diverging recovery paths. In 2021, the differences in the strength of the recovery can mainly be attributed to differences in government spending growth (see figure 1). The US has by now gotten back to pre-pandemic levels of economic activity, and, spurred by government spending, will be the engine of this year's global economic recovery (together with China). The head start in the global vaccination campaign and the

Figure 1 **Yearly GDP growth (%), expenditure components**



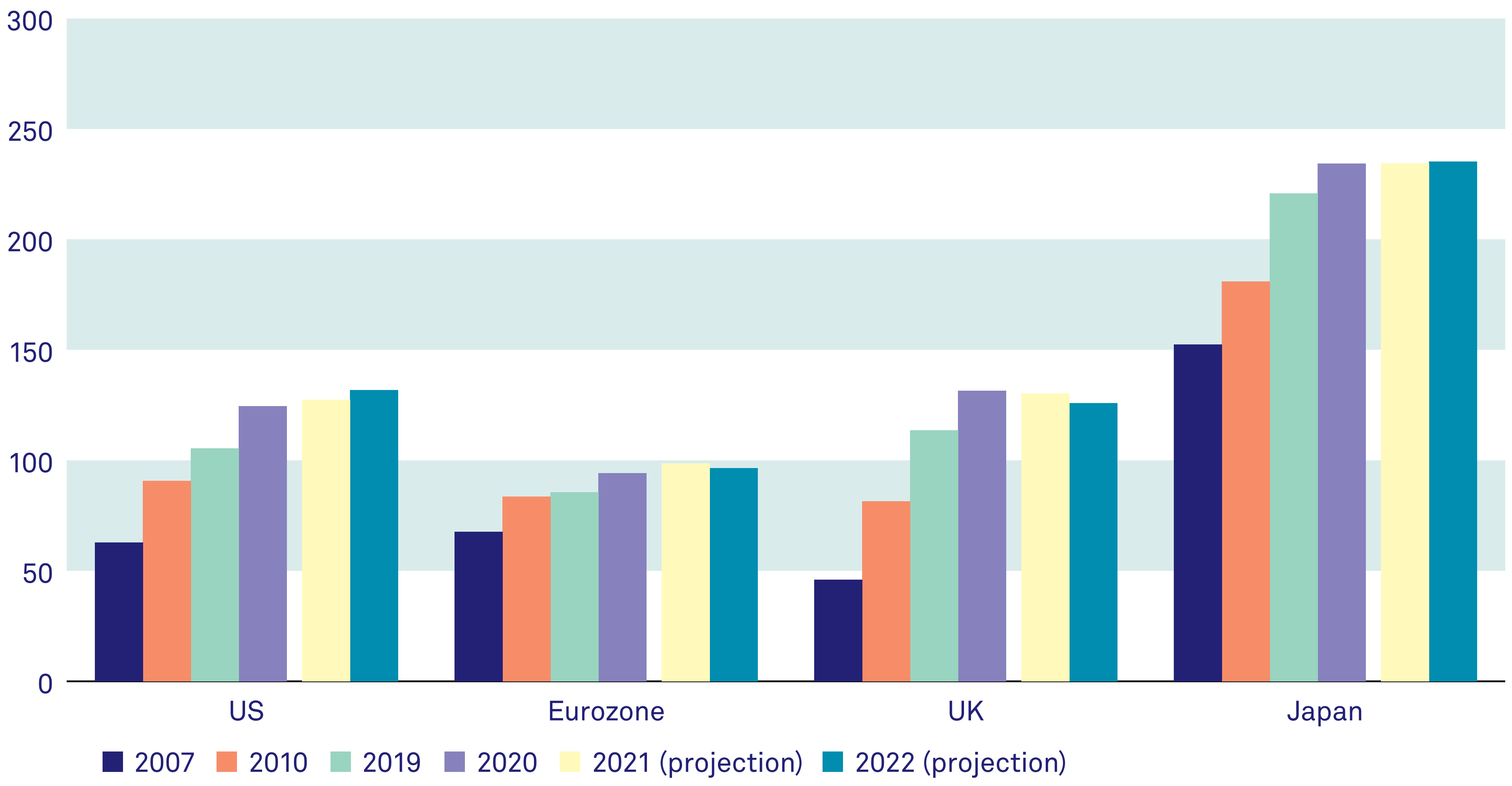
Source: NiGEM, Triodos Investment Management

choice to only implement moderate restrictions have also been important for the US's economic success story. Japan will reach pre-pandemic GDP levels towards the end of this year, and its recovery will depend almost entirely upon the recovery in private consumption. The eurozone and the UK will only get back to pre-pandemic GDP levels in the second half of 2022, as these regions have experienced the longest and strictest lockdown measures. This year's recovery in the UK will get an additional boost from sizable government spending growth, while the eurozone recovery relies for a larger part on growth in private consumption.

Consumption-driven recovery serves the status quo

Although the strength of the global economic recovery at first sight looks promising, a closer look warrants less optimism. An unparalleled amount of money has been spent to counter the effects of the COVID-induced recession: public debt levels soared to new highs, and central bank balance sheets exploded. This has increased the vulnerability of our economic system, although the emergency support to households and businesses was certainly necessary to prevent more permanent economic scars. The stimulus also created the conditions for a speedy recovery once economies were able to reopen. However, the policy choices that have been made in the process have predominantly been in favour of our old economic system, focusing on the short-term boost from consumption. The much-needed reset, which should have been spurred by large-scale sustainable investments that focus on the longer term, has not taken place. As a result, the boost in economic activity that materialises this year will likely only be of a temporary nature, as the money has not been spent to facilitate structural improvements that increase overall wellbeing. In the meantime, we have made our system more vulnerable through rising public debt levels (see figure 2).

Figure 2 Major economies general government debt (% of GDP)



Source: Refinitiv Datastream, Triodos Investment Management

A continued reliance on carbon-intensive industries

The failure to implement policy measures that focus on long-term wellbeing can clearly be observed on the environmental front. Since the start of the pandemic, **more than half** of the total support provided by G7 countries to energy-intensive sectors has been received by coal, oil, and gas companies. Unfortunately, this wasn't part of a well-thought plan to accelerate the transition of the fossil fuels industry towards clean energy and a reduction in pollution, since over 80% of the support was provided without any 'green strings' attached. Only 10% of the total support was provided to the cleanest energy measures.

That the current efforts are nowhere near enough, was recently also highlighted in a **new report** by the International Energy Agency (IEA). The IEA assessed that all emissions pledges to date would fall well short of reaching goal of net zero emissions by 2050 and limit global warming to 1.5 °C. The report also shows that an enormous amount of investments in low-carbon technologies would be required to make the necessary energy transformation, with total energy investments rising from USD 2 trillion per year today to USD 5 trillion in 2030.

This huge need for investments means the involvement of the private sector will be vital, but that can only happen once public policies are designed to facilitate this transition. Governments should invest in green infrastructure and first-of-a-kind projects to reduce the perceived risks to private investors.

Inequality has increased

Taking stock of the social component within advanced economies, the COVID-induced recession has obviously increased the existing disparities by gender, age, income, and wealth. Women, people under 25, and low-income households are disproportionately represented in the sectors that have been completely shut down for an extended period (e.g. leisure and hospitality sectors). People with flexible working contracts were also worse off than their fixed contract counterparts. In combination with the forced (and probably partially permanent) shift towards digital services and telecommuting, this has exacerbated inequalities between low and high-income households.

At the same time, inequality between generations has also increased. Young people lost out on education and suffered social and psychological distress by school closures. On top of that, they are the ones who at some point in time must pay back the huge amount of debt that has been taken on to fight the recession. Since most of this debt has been used to merely boost short-term growth through consumption, it favours the older generations. Indeed, much of the monetary and fiscal stimulus has predominantly benefited the older generation, owning (financial) assets (e.g. houses or company shares). The importance of income through assets as opposed to wages has increased.

Sustainable investments and policy measures are urgently needed to counter this increase in inequality. Redistribution of wealth through tax reforms is key here, as is investment in education and (digital) infrastructure.

The European Green Deal and President Biden's recently agreed USD 1 trillion infrastructure investment plan in the US, which focuses on (green) infrastructure investment rather than consumption, are (very) small steps in the right direction. The same goes for the deal amongst G7 countries to agree upon a minimum global corporate tax rate of 15%.

Inflation remains hot topic

Over the last three months, global equity markets again found new highs. This was despite continuing worries about the elevated inflation numbers over the last few months, especially in the US. Investors fear that the excessive fiscal stimulus targeted at a consumption-driven recovery will lead to an economy running in overdrive. This could result in a sustained pickup in inflation to above central bank targets and earlier-than-expected tightening of monetary policy, which would eradicate hopes for perpetual low interest rates and huge asset purchase programmes that over the past few years have inflated asset prices to unrealistic highs.

However, as it stands, investors seem to believe central bankers' claim that inflation will only be transitory. We also still believe this is the most likely scenario, as the causes of rising inflation - supply bottlenecks, base effects and a temporary rise in demand caused by sizable fiscal stimulus - will most likely prove to be transitory. On top of that, longer-term structural trends such as ageing populations, continued inequality and low productivity growth point towards lower inflation pressure in the longer run. On the other hand, the COVID-induced deglobalisation movement leading to the relocation of supply chains and increased labour costs poses a realistic more structural threat to inflation. The same goes for the scenario in which the current integration of fiscal and monetary policy finally leads to money flowing into the real economy, instead of into (financial) assets.

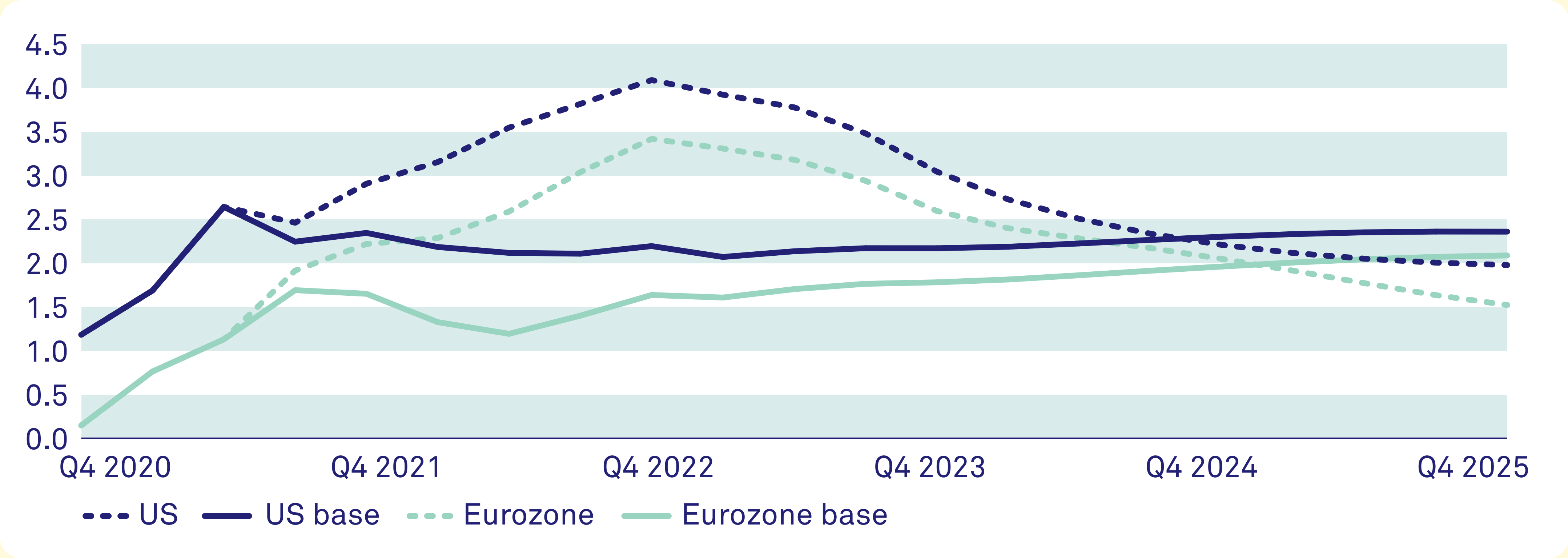
In its latest policy meeting, the Federal Reserve (Fed) officials indicated that they expect to start raising their policy interest rate in 2023, instead of 2024. This is a first indication of a shift in the policy stance of the major central banks, but it did not disrupt markets. The Fed once more indicated that it would maintain its ultra-loose monetary policy until the labour market has made significant further progress. In the meantime, the US government bond market stabilised over the last three months, with 10-year yields even coming down a bit, in line with the recent movement in US inflation expectations. Eurozone government bond yields somewhat increased, while eurozone inflation expectations remain broadly stable. This makes sense, as the rise in eurozone yields implies recent improvement of economic growth prospects due to the belated easing of lockdowns compared to the US and the UK. Overall, central banks seem to have a firm grip on inflation expectations for now.

Non-transitory inflation - new blow to global economy

The huge amount of implemented fiscal and monetary stimulus across advanced economies, which has spurred the consumption-driven recovery, could potentially result in a global economy running in overdrive. This is a key risk to our baseline scenario, as it could lead to a more sustained pickup in inflation, certainly if central banks act too late and inflation expectations become unanchored. Therefore, in our inflation scenario, we simulated a global, non-transitory pickup in commodity, food and metal prices (see figure 3) and assessed the potential impact on economic activity for the major advanced economies (see figure 4). In our scenario, we assumed that the Fed would respond with policy rate hikes in 2023, while the European Central Bank (ECB) and Bank of Japan (BoJ) would start hiking in 2024. We also assumed that the risk perception of investors and businesses would increase because of this rise in inflation: therefore, we increased the term premium, equity risk premium and investment risk premium by 100 basis points.

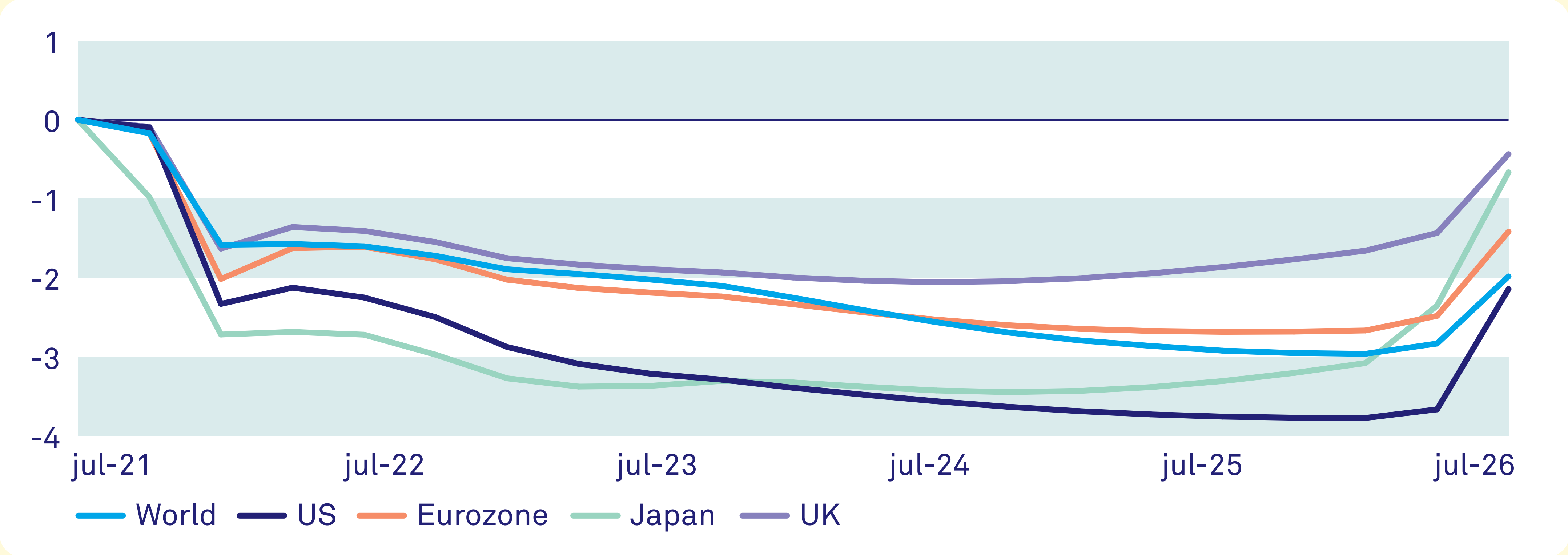
As can be seen in figure 4, a sustained pickup in inflation to above central bank targets combined with an increased risk perception would lead to a 3% cumulative loss in global economic activity by 2026. The maximum cumulative loss for the major advanced economies would be 3.8% for the US by 2026 and 2.7% for the eurozone by 2025. Japan and the UK would lose 3.4% and 2.1%, respectively, by 2024.

Figure 3 Inflation (%)



Source: NiGEM, Triodos Investment Management

Figure 4 Cumulative loss real GDP growth compared to baseline (%-points)



Source: NiGEM, Triodos Investment Management

Cautious allocation stance

Although the Fed recently indicated that it may raise interest rates in 2023 instead of 2024, we still don't expect the major central banks to break away from ultra-low policy interest rates any time soon. The Fed is likely to be the first major central bank that will start tapering, but we don't expect this to happen before early 2022. For now, we still assume central banks will be able to keep inflation expectations firmly anchored.

Although eurozone government bond yields have been rising this year due to the (anticipated) economic recovery and rising 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. As for eurozone corporate bonds, spreads are still narrow, as the accelerating economic recovery continues to positively affect risk sentiment. We expect this story to continue for some time, but nevertheless remain cautious and prefer high quality names. Financial difficulties may still arise further down the road when stimulus measures are being lifted. The threat of rising interest rates due to a sustained pickup in inflation also makes us confident in our cautious approach. Overall, we remain neutral in bonds.

We apply the same caution with equities. Broader market valuation is still unattractive. The US equity market continues to look expensive, both historically and relative to Japan and Europe. Due to weak performance, Japan is now the cheapest developed market. We believe margin pressures are building, and as we gradually enter the next stage of the recovery, are leaving behind the period of sharply upward earnings revisions. Looking ahead, we believe 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 continue to pose an additional risk to equity markets. Overall, we do not think that the current valuations properly reflect underlying fundamentals and assume central banks can't keep financial assets inflated forever. We therefore remain underweight in equities.

Growth projections

		Baseline	
GDP growth (%)	2020	2021	2022
Global	-3.3	6.2	4.5
US	-3.5	6.8	3.3
Euro area	-6.6	4.4	4.5
UK	-9.9	7.1	5.7
Japan	-4.8	2.9	2.7
China	2.3	8.5	5.7

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