July 8, 2021

Mid-year Update 2021

As good as it gets

The global recovery has been remarkable on many levels, not least in terms of the power of science and the resilience of societies. Mass vaccination and highly supportive fiscal and monetary policy has catapulted economic activity to a level few thought possible at the start of the year. Prospects remain bright, with a broadening in vaccinations giving freedom of movement. Headwinds are building, however, and while growth should remain elevated, the pace may be as good as it gets.

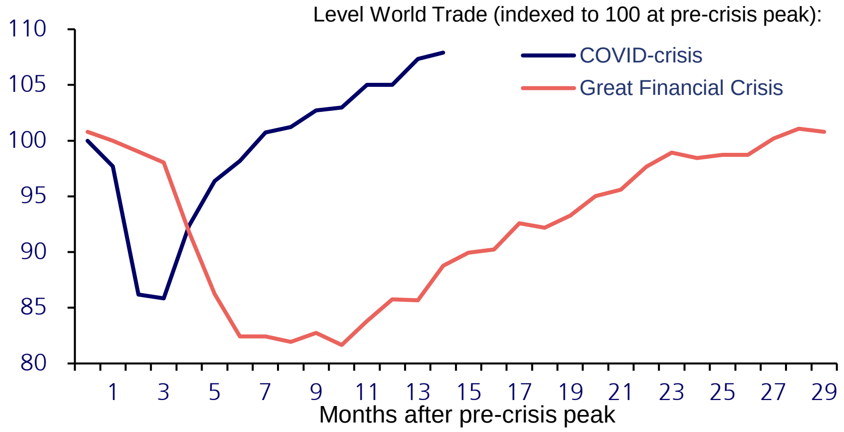
Source: iStock by Getty Images

The 'Great Expectations' that we used as the title of our 2021 Outlook may not have been great enough as the first half of the year concludes with global growth surging, financial markets booming and mass Covid vaccination a reality. There have been many twists and turns along the way and while it has not all been plain sailing, a number of decisive events gave credence to our optimism. In addition, a combination of longer-term fiscal initiatives, a turn in the capital spending cycle and further commitments to net-zero investment have made us more confident that the cycle has longer to run, rather than simply burning short and bright.

As ECB President Christine Lagarde has acknowledged that lessons from the past have been learned, including the need to 'water the green shoots' of expansion. Provided that several critical transitions are achieved in the second half of the year, global growth can broaden and financial markets prosper. New challenges will need to be overcome, however, as furlough schemes and supplementary unemployment benefits are withdrawn, fiscal headwinds rise, monetary support diminishes, and we move past peak growth in some key economies.

As we take stock and ponder the remainder of the year, a number of unforeseen developments are shaping our view.

Dramatic recovery in global trade as economic activity surges



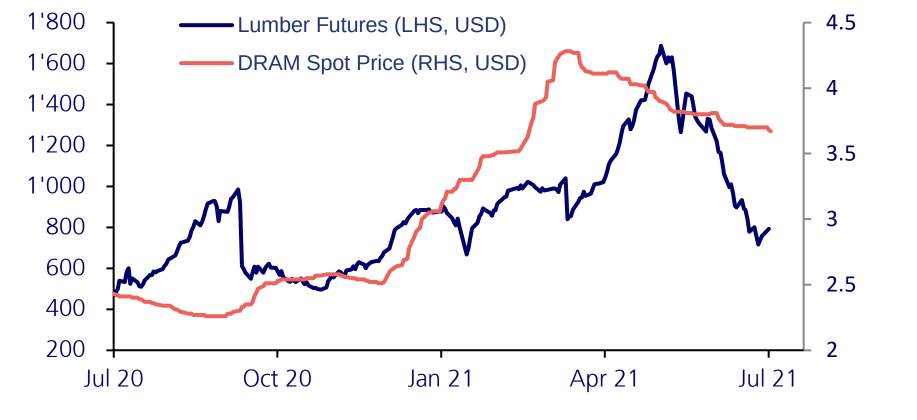
Source: Bloomberg

US policy shows vigour and intent

The US Senate election in Georgia back in January marked a fundamental shift in the balance of power in Washington. The surprising victory, giving the Democrats two senate seats, provided the slimmest of majorities to the Biden administration. Hardly the blue-wave some had hoped for in the national election, it was still sufficient to alter

msme@zurich.com

Commodity prices have begun to abate



Source: Bloomberg

the course of policy in what would have been an otherwise stymied presidency. This emboldened the administration to push through the USD 1.9tn American Rescue Plan and propose the currently debated American Jobs Plan with its focus on rebuilding the crumbling infrastructure. While the proposed USD 4tn in spending over the next eight years will likely be heavily scaled back, the US economy has undoubtedly benefited from the potent combination of monetary and fiscal support that has been lavishly applied so far.

Policy makers have yet to blink

Encouragingly, fiscal support has been maintained globally. In contrast to the response following the financial crisis, austerity has been shunned, deficits tolerated, and debt breaks suspended in a bid to keep the recovery on track. While countries such as the US, Australia and China have seen activity return to pre-crisis levels, others, notably most emerging markets, the Eurozone and Japan are still some distance from achieving this. However, policy makers are setting their sights high, with a growing focus on closing the gap to where national economies should have been were the crisis not to have happened and growth had continued. As a result, growth continues to be bolstered to close output gaps and erase some of the scarring caused by the pandemic.

Lest we forget the importance of science

Perhaps the most underappreciated development since the start of the year has been vaccine production and distribution. While the timing of mass vaccination is close to our original guestimate, the process has been smoother than expected and there have been few operational disruptions - a quite remarkable achievement given the enormity of the task. Though Covid continues to wreak havoc, particularly in poorer regions that are in urgent need of vaccination support, economic reopening and freedom of movement continues to broaden. This is particularly important for our base case to hold up as we maintain that growth will increasingly transition from the goods and manufacturing sector to services. This should ease production and distribution bottlenecks and allow economies to rebalance.

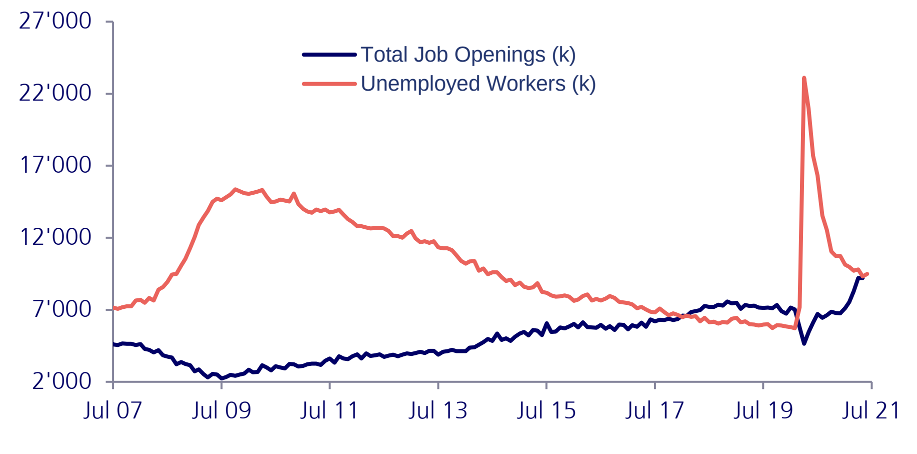
Inflation returns, complacency should not

Inflation has certainly surged more than anticipated and, although we continue to believe that it will prove transitory, uncertainty about future levels and the policy response has clearly increased since the start of the year. The base effect of commodity prices over the past 12 months is well recognised and should run off in the coming months. Some pricing pinch points, that are the result of component shortages and higher shipping rates, are also likely to fade as additional capacity is brought on and demand shifts to other areas. There are some tentative signs this is beginning to happen. Lumber prices, for example, having fallen by more than 50% since May, following a 380% gain over the prior 12 months, and semiconductor DRAM prices have also peaked and eased by around 13% since March. For us to become more concerned about inflationary pressures proving disruptive, we would need to see more evidence of it becoming embedded in wages as well as inflation expectations. So far, this has been modest and when we look beyond the US, inflationary pressures are limited with large output gaps still evident.

Transitions ahead

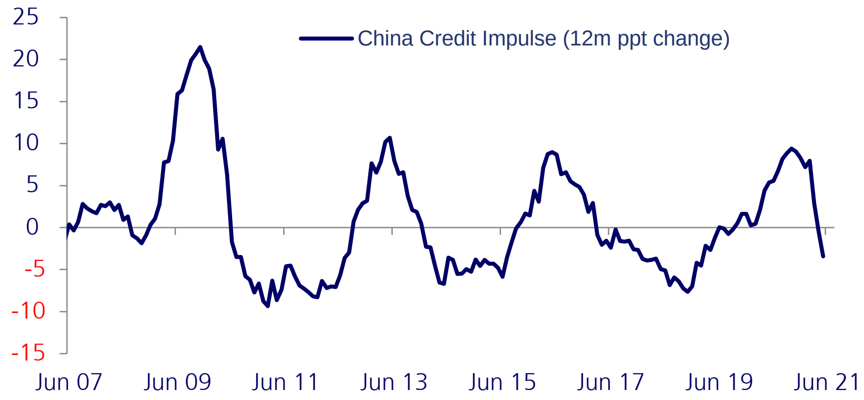
These important developments have helped lift our economic forecasts for the year and made us more confident in the duration of the expansion ahead. As the recovery ages, transitions will need to occur both within and across economies, and the composition of growth will change. While the US and China will continue to post impressive, above-trend, growth numbers well into next year, the pace is moderating. The baton of growth is now being taken by the Eurozone, with Japan and many Emerging Markets likely to regain momentum towards the end of the

US job openings suggest unemployment will fall appreciably



Source: Bloomberg

Growth slows in China as credit availability is restricted



Source: Bloomberg

year. This slightly desynchronised pattern is healthy and should mean that global momentum remains robust and broad-based.

US growth to enter a more mature phase

The US economy has been more ebullient than even our optimistic views implied at the start of the year. The fiscal support not only bolstered consumer and business confidence, but resulted in the US savings rate spiking back up to 28% at the end of March - not quite the 34% high of last year, but considerably above the long run average of 7%. The latest data show it has been worked down to just over 12% as spending has been brisk. The jump in savings has been a key feature in many regions, but the US has been particularly striking as it was pushed higher largely by direct fiscal cash injections to households. From here, we suspect that the pace of consumption growth will ease. Future demand for durable goods and housing has probably been brought forward given lockdowns and easy funding, though services consumption should quicken.

The main challenge for the US will be adapting to the withdrawal of supplementary unemployment benefits and increasing the labour force participation rate. As the number of job openings now match the official levels of unemployed workers, this will be critical. We suspect that as vaccination becomes increasingly widespread and unemployment benefits decline, side-lined workers will return to work. US GDP growth will likely slow from here, but the expansion will remain brisk. We continue to believe that rate hikes are still a couple of years out as the Fed dot plot now also implies. 2023 is still our lift-off point when two rate hikes seem likely.

Rebalancing in China tempers expectations

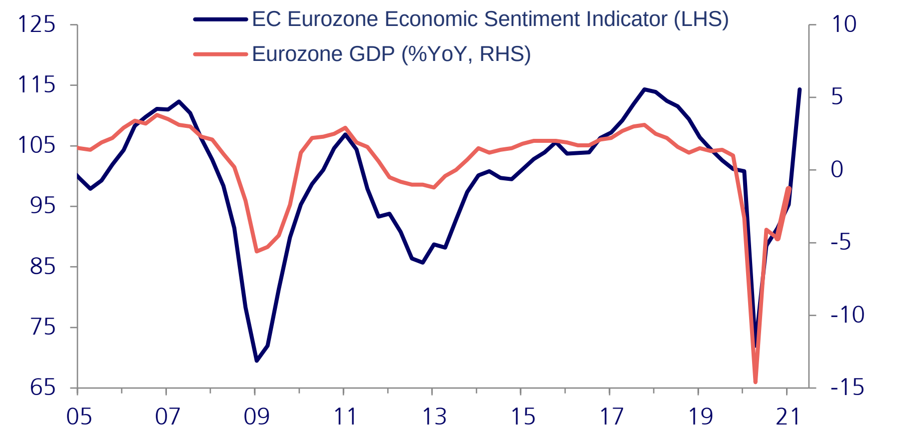
China has already entered a period of more modest growth, and this is one of the few regions where we have lightly trimmed our forecasts for this year. While industrial production and the export sector continue to boom, it has been on the domestic side where consumption and aggregate demand has been lower than expected. Although China has taken over the mantle of having the highest percentage of vaccinated citizens, it has struggled with sporadic Covid outbreaks. Various holidays and festivals have been adversely impacted and spending has been markedly lower than pre-Covid levels.

Part of the slowdown has been by design in a bid to contain imbalances. Financial conditions have been progressively tightening and the credit impulse has moved into contractionary territory. Shadow banking is again in focus and is being constrained through the strengthening of lending standards. Part of the aim has also been to rein in housing market speculation and perceived excesses in some parts of the equity markets. Consequently, we are expecting slower reported GDP growth for the remainder of this year and next, but to still robust levels supported by new targeted stimulus programmes.

The Eurozone is having its time in the sun

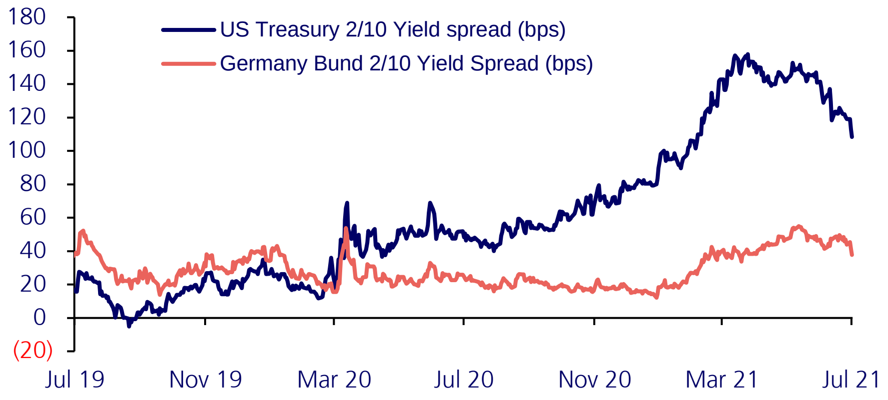
While the US and China have passed peak growth, Japan and particularly the Eurozone are entering a potential boom phase. Despite the technical recession the Eurozone experienced in Q1, a number of conditions are coming together in the region that potentially offer the best opportunity to revitalise its economy since its inauguration back in 1999. A powerful combination of short-term support measures and more profound developments as part of the Next Generation EU (NGEU) initiative, that we outlined in detail in our Next Gen EU Topical Paper, have set the stage for resurgent growth. Monetary and fiscal policy are finally working together. The ECB has increased the pace of its Pandemic Emergency Purchase Programme to around EUR 80bn per month, keeping yields supressed and funding costs low, while national government spending has been impressive. This has helped business confidence surge, with the outlook for the services part of the economy particularly encouraging. Vaccination success and a reopening of economies for the important summer season should see a dramatic pickup in activity in the

Confidence in the Eurozone spikes, which bodes well for growth



Source: Bloomberg

Yield curves have flattened recently, particularly in the US



Source: Bloomberg

second half of the year and into next. While the region has a habit of shooting itself in the foot just as things are getting better, the agreement on the new fiscal architecture and the success of the EU's mutual bond issue, combined with constructive investment plans, offer a watershed moment for the region which must not be lost.

Japan down, but not out

Prospects for Japan have also brightened, despite the current challenges around Covid and lacklustre domestic demand. We are encouraged by a combination of vaccinations being ramped up, high savings and pent-up demand, and the robust export environment. Should the Olympics prove even moderately successful and the economy allowed to re-open soon, the outlook is good. This may play into PM Suga's hands, with Lower House elections in the autumn, but it also bodes well for the global economy as Japan is still the third largest economic power.

Savings and consumption intentions bode well for the UK and Australia

Elsewhere, the UK and Australia are on very solid footing and are expected to see growth significantly above trend for some time to come. Employment is recovering and high levels of household savings in both countries bode well for consumption as freedom of movement is eventually achieved.

Resilience of emerging markets

The fortunes of emerging markets are more opaque and idiosyncratic. The APAC region has been the prime beneficiary of the robust trade cycle and demand for technology but now has to grapple with sporadic and disruptive bouts of Covid infections. We believe that this can be overcome with prospects improving towards the end of the year. That noted, if we are correct regarding a transition towards services for global consumption, many industrial and manufacturing sectors are likely to see slowing external demand. LatAm has had a torrid first half in terms of Covid, but economic growth has been remarkably resilient, and with growth strong and inflation rising, policy normalisation is underway. Brazil has already hiked rates 225bp since March, with further tightening ahead, while Chile is now also on the cusp of tightening policy. There, the output gap has shrunk appreciably as fiscal initiatives and changes to pension rules have encouraged consumption.

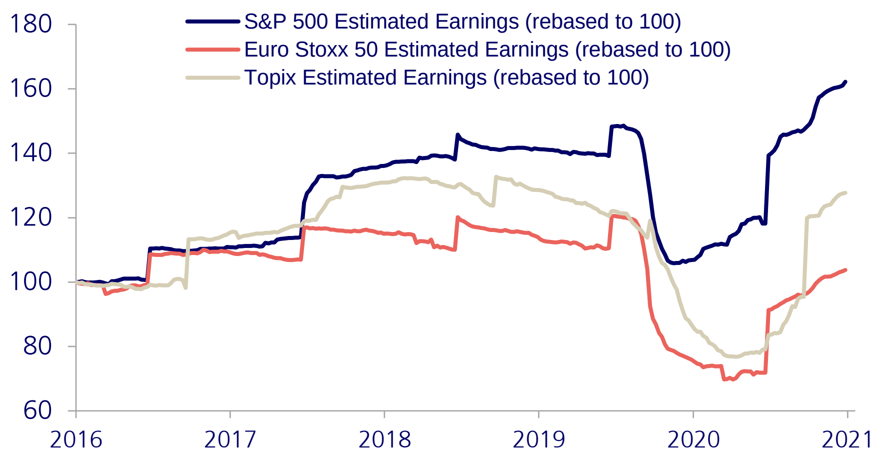
Bond yields are stretched with risk to the upside

One conundrum this year has been the government bond markets.

Following notable gains in Q1 yields have been subdued and unresponsive more recently, despite improving economic prospects and the surge in inflation. Our expectation of an upward trajectory for yields this year has transpired but has been more modest and lumpier than expected. US 10yr yields hit a high of 1.75% back in March, up from 0.9% at the start of the year, but have eased back since despite a more hawkish Fed projecting higher growth and inflation. The Fed dot plot now implies two rate hikes in 2023, in line with our own views, but a change from the consistent messaging they had been giving over the past 12 months that rates would be on hold at least until 2024.

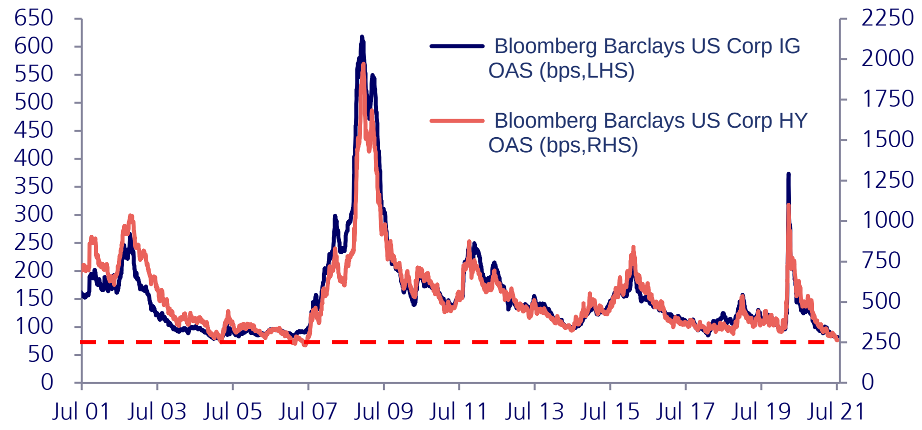
While the story has been similar in other bond markets, with yields only marginally higher since the start of the year, it is the flattening of the US yield curve that is an unsettling development. Although this can be interpreted as rising concerns about growth prospects, we suspect it also has to do with market technicals and positioning, though it gives pause for thought and requires further investigation and monitoring. Currently, however, we see the robust growth environment continuing and inflation more elevated than we have become accustomed to in recent years, despite transitory effects wearing off. This should keep upward pressure on bond yields over the remainder of the year, while the sensitivity of elevated debt levels and continuing quantitative easing programmes are likely to cap that trajectory.

Rising corporate earnings expectations support the equity rally



Source: Bloomberg

US credit spreads closing in on record lows



Source: Bloomberg

The equity bull market continues to charge

The double-digit gains in many equity markets this year reflects the improving macro picture and better earnings prospects, with low rates and abundant liquidity keeping momentum strong. We see little change to this backdrop in the near term and believe that further notable gains are still in the offing. The up track for stocks remains compelling, with volatility surprisingly subdued. Any market pullbacks have been extremely modest this year, even by bull-market standards. Investors continue to buy on any wobble, and this is likely to continue until we approach the point where monetary policy becomes less predictable, or the rate of economic growth turns notably lower. Neither state seems imminent. Multiple expansion is unlikely from current elevated levels, but nominal earnings growth in a mildly inflationary environment is attractive, offering investors better return prospects than either credit or government bonds. Stock repurchases and accelerating M&A activity offer the potential for additional market support as the cycle begins to mature.

We suspect that the broad rotation into cyclical and value parts of markets has further to run, but that growth and technology stocks will also move higher into the end of the year. This is also likely to be reflected in regional patterns. As we have pointed out many times, betting against the US market is generally a painful experience, but economic and market conditions are likely to provide some other regions cause for optimism. The Eurozone and the UK markets have attracted investor favour in recent months, but for good reasons and offer further upside given rising expectations for earnings and dividend growth, and further fund flows. Japan has yet to hit the spotlight, but also offers a similar dynamic and the potential to play catch-up following a notable period of underperformance.

The clock is ticking for credit markets, but time remains for a further squeeze

Credit markets have performed well. Demand has been strong despite tight spreads, largely due to the relative income pick up from even lower yielding government bonds. US credit is now closing in on pre global financial crisis spreads of 16 years ago, while volatility has been particularly subdued. This is arguably a bit of a concern and may be an indication of investor complacency as further high levels of issuance are gobbled up. While corporate fundamentals are generally improving and there have been some rating upgrades from the agencies, an inherent vulnerability persists with still elevated debt and leverage positions.

Encouragingly, companies are engaging in productive capital spending rather than unproductive financial engineering, which we think provides further upside to economic growth and can elongate the cycle. Rating downgrades and defaults are expected to stay low this year and, consequently, we can envisage yet further spread tightening in the investment grade space that may verge on the bubbly-side over time.

High yield is now looking stretched, though funds continue to be raised and repayments termed out. This is deemed to be positive, but there is a growing risk of unproductive zombie companies being kept alive by the hunt for yield.

We maintain our stance that while the credit cycle has further to run and spreads could set new record lows, equities remain favoured from a risk reward perspective.

Conclusion

Growth in 2021 is proving to be even greater than we had expected, as a potent mix of fiscal and monetary stimulus has combined with medical marvel and the pent-up demand of resilient societies to deliver a remarkable recovery. While scars from the pandemic still show, commitments to long-term, sustainable growth offer hope that they will fade.

Numerous challenges remain, geopolitical tensions persist and the needed transitions that we have alluded to will not be easy. As we pass the mid-point of the year it seems that, at least from a rate of growth perspective, this could be as good as it gets.

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001631 (01/16) TCL

ZURICH®