# US growth outlook strong but inflation spike triggers overheating concern

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## Highlights

- **The US is heading for a rapid economic recovery with GDP rising 6.4% in Q1 and now only just below pre-pandemic levels. Indeed attention has shifted to inflation, which spiked in April though the Fed still sees price pressures as transitory.**
- **Eurozone GDP by contrast fell slightly in Q1, though is showing signs of recovery as the latest virus wave fades and vaccination rollout gathers steam. The ECB is unlikely to be under much near-term pressure to dial back policy support.**
- **In China, growth surged to 18% y/y in Q1 helped by a base effect. However, some recent key indicators including retail sales and industrial output have come in weaker than expected, which hints at a softening trend.**

While expectations for a strong rebound in global economic growth this year remain in place, the underlying picture remains mixed, with a rise in worldwide virus cases in April led by India contrasting with surging optimism and continued reopening measures in the US and Europe as virus incidence falls and vaccination rollouts become more advanced. Indeed, in the US especially, market attention is shifting to inflation, which spiked in April on strong growth and reopening pressures, leading to questions over how long the Fed's current ultra-loose policy stance should be sustained. This risk weakened equity markets in early May and pushed benchmark bond yields higher. Meanwhile, Brent crude oil prices saw strong gains in April on reflation pressures before edging back on news of a possible easing of sanctions on Iran that would boost supply.

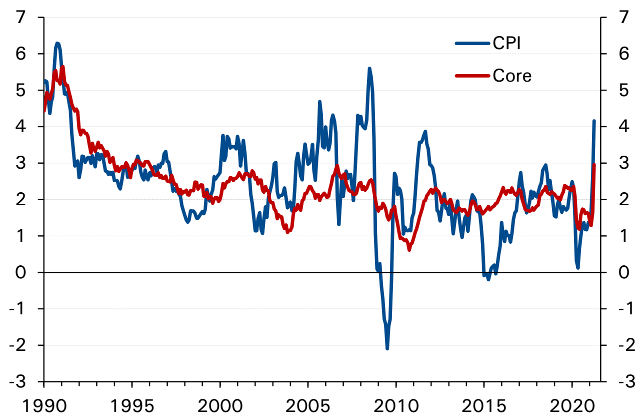
### US growth strong but inflationary pressures mount

Hopes for a rapid economic recovery in the US are broadly on track, backed up by a robust 6.4% annualized rise in GDP in 1Q21, roughly in line with expectations. Key strength was seen in private consumption (+6.3%) helped by reopening, stimulus measures, pent-up demand and rising confidence due to vaccine rollout. Private investment was strong too (+10.1%), reflecting a booming housing market. The level of GDP is now just 1% below pre-pandemic levels, which given the strength of latest survey indicators should easily be reached in Q2 (although GDP is still below its projected pre-virus path). The labor market recovery however continues to lag somewhat behind, with a well-below consensus 266,000 jobs (0.2%) created in April amid a suspicion that temporarily more generous welfare benefits are discouraging a return to work for some individuals – a claim rejected by Treasury Secretary Janet Yellen. Jobs growth should accelerate in coming months so long as the recovery remains on track, but it could still be well into 2022 or beyond before the remaining 8 million or so jobs lost to the pandemic are recovered.

The elimination of spare capacity in both output and the labor market will be closely watched for its implications for inflation, concerns about which are gathering pace. CPI inflation surged to a more than 12-year high of 4.2% y/y in April from 2.6% in March and way above expectations. (Chart 1.)

**Chart 1: US Consumer price inflation**

(% y/y)




Source: Refinitiv

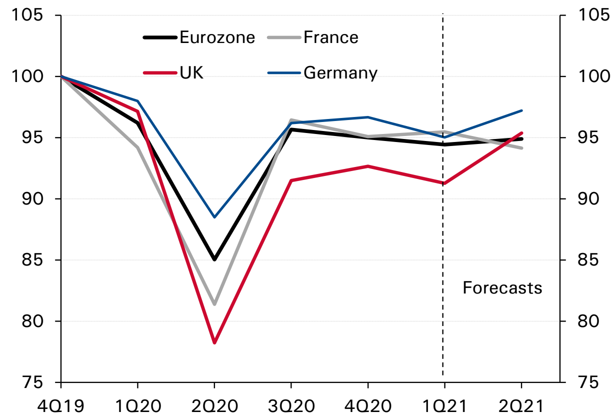
The jump was partly driven by base effects – particularly from energy – reflecting falls in prices a year earlier as the pandemic fallout began. However, month-on-month rises are running increasingly hot too and the core rate, which excludes both food and energy, reached its highest since 1996 at 3.0%. The Federal Reserve continues to describe these pressures as transitory, reflecting both base effects and temporary demand and supply mismatches that will fade as the economic reopening proceeds. However, the combination of rapid economic growth, aggressive fiscal and monetary stimulus policies, possible frictions in the labor market and also the Fed's stated tolerance for above-2% inflation for a while are clearly pushing up the risk of price pressures becoming more permanently established. This worry is starting to weigh on the US dollar, which has slipped nearly 4% since late March on a trade-weighted basis.

## Eurozone entered double-dip recession in Q1

GDP in the Eurozone slipped back in 1Q21 by 0.6% q/q as countries struggled against a new Covid wave. (Chart 2.) This confirmed a double-dip recession in the region, following a drop of 0.7% in 4Q20. Survey measures point to growth now picking up, though at a somewhat tepid pace, helped also by a vaccination rollout that is finally gathering steam. The composite PMI edged up to 53.8 in April, with manufacturing booming but services only finally creeping back into growth territory though set to benefit further from an easing of Covid restrictions. Like in the US, firms are reporting cost increases and CPI inflation picked up to 1.6% y/y in April from negative territory at the end of last year. However, given the less buoyant growth climate versus the US, the fact that inflation is still below the near-2% target (core inflation is even lower at 0.7%), the strengthening euro and indeed lingering concerns over new virus variants, the European Central Bank is unlikely to start even discussing plans to dial back its ultra-loose policy stance for several months.

**Chart 2: Eurozone GDP**

(index, 4Q 2019=100)




Source: Refinitiv, third party forecasts

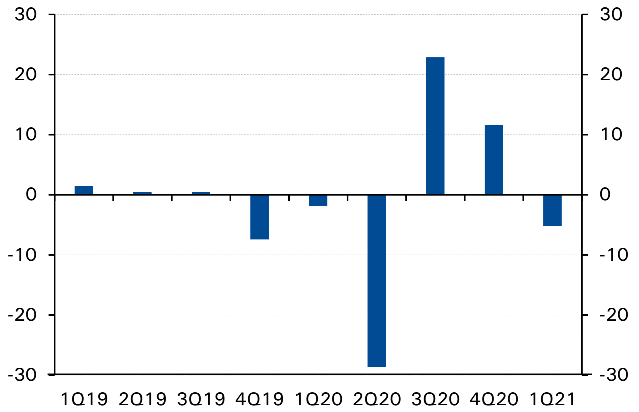
Meanwhile in the UK, GDP fell a more modest-than-expected 1.5% q/q in 1Q21 amid the re-imposition of tough lockdown measures at the start of the year. With most of these measures since lifted and activity measures now rebounding, growth is set to recover strongly in Q2 perhaps by around 5%.

## Japanese GDP sees renewed drop in first quarter

Japan's economic growth turned negative in 1Q21, declining by an annualized 5.1% (-1.3% q/q) from +11.6% in 4Q20, as private consumption and investment (both -1.4% q/q) weakened markedly amid a state of emergency that has remained in place since January. (Chart 3.) Export growth (+2.3% q/q), though positive, also slowed, due in part to a shortage of semi-conductor chips. With the state of emergency recently extended to the end of May and expanded to include two other prefectures as well as Tokyo due to rising infections of new Covid-19 variants, the outlook for 2Q21 GDP growth is looking weaker than even the downwardly-adjusted consensus annualized figure of 1.7% (from 4.7% in April).

**Chart 3: Japanese GDP**

(% q/q annualized)




Source: Refinitiv

The services PMI at 49.5 in April edged up from March but continued to point to contraction, with firms citing the negative impact of the emergency measures on consumer demand. In contrast, the manufacturing PMI expanded in April at the fastest pace in more than three years (53.6 from 52.7 in March). The improvement was due to stronger domestic and overseas orders. Meanwhile, Bank of Japan (BOJ) policymakers agreed to keep interest rates low. Core consumer prices (which exclude fresh food), fell for the eighth month in a row in March, by 0.1% y/y (from -0.4% in February), with the pace of decline easing slightly due to a rebound in fuel costs. Expectations of a y/y base effect-boost to the CPI in April could be tempered by cuts to mobile phone fees. The BOJ also recently estimated that inflation is unlikely to reach its 2% target until after FY2024 as growth is only expected to pick up gradually amid persistent pandemic-linked stresses to the economy.

## Chinese growth rebounds, but some indicators ease

GDP surged by 18.3% y/y in 1Q21, helped by the base effect from restrictions implemented early last year, which saw activity drop sharply. However, some leading indicators suggest that demand is still fragile. Industrial output, for example, grew 9.8% y/y in April, slower than the 14.1% recorded a month earlier, while retail sales growth decelerated to 17.7% y/y in April, down from the 34% jump seen in March, and much weaker than expected. This softening trend reflects the fading of the favorable base effect, and activity dropping back to its pre-virus trend following the withdrawal of policy support and fiscal stimulus. Still, the composite PMI increased to a four-month high of 54.7 in April from 53.1 in March but remained below the

December level of 56.

Meanwhile, inflation in April jumped to its highest since September 2020 at 0.9% y/y, up from 0.4% in March. The central bank has left its benchmark interest rates for corporate and household loans unchanged (1-year 3.85%, 5-year 4.65%) since May 2020. However, policymakers are tightening credit by directly targeting some sectors, most notably the property sector, in a bid to balance growth and debt concerns.

## Resurgent virus could delay India's recovery

The recent severe wave of virus infections across India has led to the imposition of renewed restrictions in select areas of the country, negatively affecting confidence and threatening to hinder the economic recovery that had started to emerge earlier this year. Encouragingly, business activity has remained quite resilient, with the composite PMI edging down only to 55.4 in April from 56 in March, mostly on a slower rise in new orders. However, of concern is the continued decline in employment (falling for 14 consecutive months), albeit at a slower pace, and the rising inflationary pressures stemming from reported supply constraints and higher input prices: wholesale price inflation reached an 11-year high of 10.5% in April (though consumer price inflation eased to 4.3% from 5.5% in March).

Looking ahead, a weak labor market, which continues to undermine sentiment, could delay the recovery in domestic demand, and is therefore a downside risk to the economic outlook. Furthermore, higher food, fuel and other commodity prices could drive inflation to exceed the central bank's target of 4-6%, making a potential policy rate cut less likely, while a high level of public debt implies limited room for sizeable fiscal support. In light of these headwinds, the IMF's previous projection of 12.5% growth for FY21/22 may be optimistic, especially if the current virus wave in India is prolonged (though there are signs that it may have peaked in mid-May). In this regard, Moody's recently slashed India's FY21/22 growth estimate to 9.3% y/y from an earlier estimate of 13.7%.

## Oil prices gain on recovery optimism

Brent futures gained 5.8% in April to close at $67.3/bbl, buoyed by signs that the economic recovery is progressing in the US, Europe and China and despite surging Covid cases in Brazil and, more seriously, in India. (Chart 4.) Positive momentum carried through into May, with Brent just breaking through $70 in intraday on the 17th of the month. In the US and Europe, road and air traffic data point to greater consumer mobility after restrictions were eased and vaccination efforts accelerated. In China, meanwhile, crude refining rates in 1Q21 surged 17.8% y/y to 14.2 mb/d, following a quarter of strong crude imports. Oil has also benefitted by a broader rally in commodities, with post-pandemic demand for metals and foodstuffs surging amid supply-side constraints.

**Chart 4: Brent crude oil price**

($ per barrel, end of month*)


Source: Refinitiv * Latest figure is for May 19

Both OPEC and the International Energy Agency (IEA), in their monthly oil market reports, forecast substantial supply deficits opening up in 2H21, with demand outpacing supply by more than 1 mb/d in 3Q21 and by as much as 2 mb/d by 4Q21. This is despite more than 2 mb/d of additional OPEC+ supplies returning to the market by end-July and despite Covid-linked oil demand weakness in India. Citing worries over India, along with weaker-than-expected oil consumption in advanced economies in 1Q21, the IEA reduced its 2021 overall oil demand growth forecast slightly to 5.4 mb/d. Prices could see some support at higher levels going into 2H21, though the likelihood of Iranian barrels returning to the market and imparting a bearish spin on proceedings could be strengthening following news that the reconfigured JCPOA nuclear agreement talks were progressing.

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