Economic Update

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International Scene

Faster global economic recovery expected but virus path still a risk

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Highlights

- **The slow pace of vaccine rollout and vaccine efficacy worries pushed benchmark equity markets mostly lower in January. Still, global economic growth this year should be stronger than expected a few months ago.**
- **Following soft US jobs numbers, President Biden looks more determined to push through most of his $1.9 trillion stimulus package. Its huge scale is drawing criticism that it could lead to economic overheating and inflation later this year.**
- **The Eurozone entered a double-dip downturn in 4Q20 and recent restrictions will likely see output fall again in 1Q21. The Bank of England kept policy on hold in February but stuck to its largely upbeat economic outlook for later this year.**

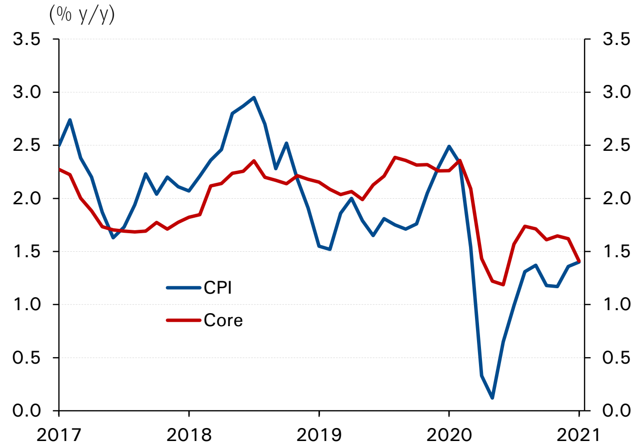
Benchmark equity markets were mostly weaker in January as worries over the economic impact of new restrictions in some countries, the slow pace of vaccine rollout and vaccine efficacy against new virus strains partially clipped earlier risk appetite, overshadowing the prospect of large US fiscal stimulus likely to be implemented by the end of the quarter. This came as the IMF revised up its forecasts for world economic growth this year – to 5.5% from 5.2% in October – incorporating a more positive post-pandemic recovery story due in large part to stronger US growth (up 2% to 5.1%) relative to its previous pre-vaccine projections. The path of the virus of course remains key to the global recovery story, with developing markets potentially lagging due to lower vaccine access and less capacity for policy support. Meanwhile, Brent crude oil rallied to above the $60/bbl mark for the first time in a year, helped in particular by large, unilateral if time-bound cuts in oil output by Saudi Arabia.

Biden digs in on ambitious stimulus proposal

President Biden's first weeks in office have focused on tightening health measures to cope with the virus pandemic and advancing his huge proposed fiscal stimulus package to support an economic recovery showing signs of waning. The latter risk was underlined by another soft month for the labor market in January, which saw a rise of just 49,000 (mostly government) jobs with layoffs in the virus-exposed leisure and hospitality sectors continuing. Biden's team now looks more determined to push through most of the $1.9 trillion (8% of GDP) stimulus including individual checks of $1,400, even if it means abandoning a bipartisan deal with congressional Republicans who want a smaller boost. Criticism of the Biden plan has even come from former (Democratic) Treasury Secretary Larry Summers, who argued that it is excessive, potentially inflationary and a risk to financial stability. The Biden team continues to argue that given the precarious economic picture and stress on household finances, the risk of too much stimulus is smaller than the risk of too little. The aim is to approve the deal by mid-March when key unemployment benefits are set to expire.

The Federal Reserve continues to add its voice to calls for further fiscal support, despite a growing debate about the prospect of a pick-up in inflation later this year as the vaccine rollout gives way to a sharp recovery in economic activity as restrictions are loosened. Indeed, these concerns have helped push 10-year treasury yields up 25 bps year-to-date by early February to an 11-month high of 1.17%. CPI inflation picked up to a post-pandemic high of 1.4% y/y in January and will rise further in coming months as a result of both year-on-year base effects and higher commodity prices. (Chart 1.)

Chart 1: US CPI inflation



Source: Refinitiv

But the more material concerns are for later in the year when demand recovers, stimulus has fully kicked in, a possible new higher minimum wage is in place and both structural shifts and scarring effects from the pandemic may lead to supply bottlenecks. The Fed has already committed to allowing inflation to run above the 2% target for a while and will also be keen to avoid a repeat of its approach to the post-financial crisis period, when it was accused of tightening policy too early.

Eurozone economy enters double-dip downturn

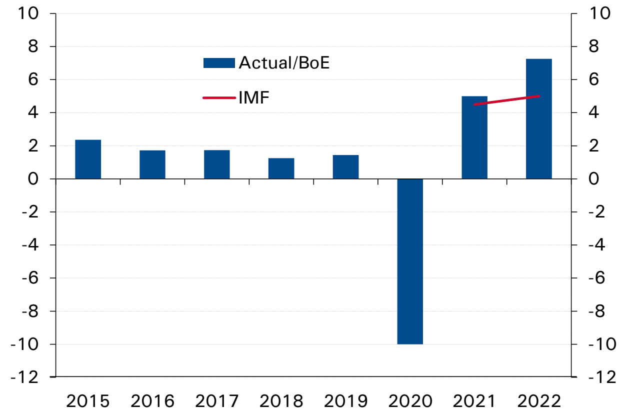
Lockdown and curfew measures imposed across much of the Eurozone since December have seen new virus cases fall significantly, but the economic cost has been large and may now be extended due to sluggish vaccine rollout and as governments threaten to keep restrictions in place to address new virus strains. The Eurozone economy entered a double-dip downturn in 4Q20, although GDP contracted a less-than-feared -0.7% q/q with Germany (+0.1%, helped by a temporary VAT cut) and Spain (+0.4%, which suffered the largest drop in Q2) managing to eke out small gains. GDP in 1Q21 is expected to decline again, with the PMI falling further below the 'no change' 50 mark at 47.8 in January and some countries suffering Brexit-related disruptions to trade. Regional output is unlikely to reach pre-pandemic levels until mid-2022, with the IMF recently lowering its 2021 growth forecast to 4.2% from 5.2% before.

Despite the weak conditions, the European Central Bank (ECB) kept policy unchanged in January (deposit rate at -0.5%, PEPP asset purchases of €1.85 trillion), preferring to give previous stimulus more time to play out. The prospect of additional loosening has been slightly clouded by a very sharp jump in core inflation to a more than five-year high of 1.4% y/y in January from 0.2% in December, bringing it closer to the bank's near-2% target. But the rise was partly driven by technical factors, including a shift in subcomponent weights, delays to winter sales and the ending of Germany's temporary VAT cut – the impact of some of which will be reversed in coming months, bringing inflation back down. The ECB has argued that with plenty of slack in the economy from the current recession, it will look through any temporary upward pressure on inflation when setting policy. However, continued volatility will make the underlying signals more difficult to read.

In the UK, the Bank of England as expected left policy on hold in February (Bank rate at 0.1% and total asset purchases of £895 billion), though warned banks to prepare for a possible move to negative interest rates no sooner than six months into the future if the recovery needs supporting. The Bank lowered its 2021 growth forecast to 5.0% from 7.3% three months earlier due to the impact of the latest lockdown which began early January and will hit growth hard in 1Q21. (Chart 2.) However while stressing the uncertainties, it remained optimistic in its baseline outlook, forecasting a strong pick-up from mid-year as the UK's relatively rapid vaccine rollout bears fruit, consumers' spending appetite returns helped by accumulated savings and as initial frictions caused by new trading arrangements with the EU (including customs checks and additional paperwork) dissipate. Growth in 2022 could reach an even faster 7.3%.

Chart 2: UK GDP

(% y/y)



Source: Refinitiv / BoE / IMF WEO October 2020

Japan factory and services output declines in December

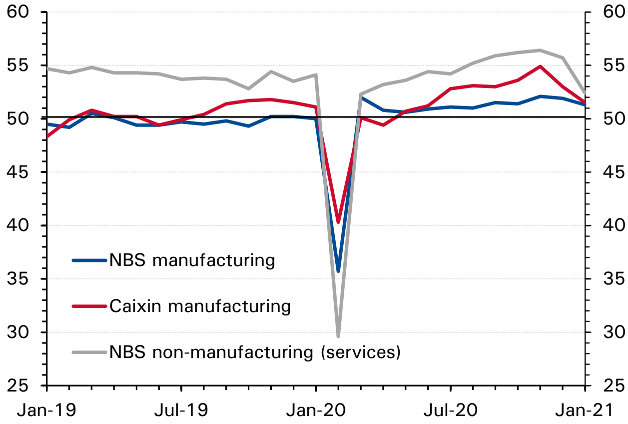
Japan's factory output declined further in December, falling 1.6%, as dwindling production of general machinery and cars offset strength in inorganic and organic chemicals. Meanwhile, household spending fell 0.6% y/y in December for the first time in three months. For 2020, household spending was down 6.5%, the worst decline on record, adversely affected by the coronavirus pandemic and the October 2019 sales tax hike. The services sector PMI was also down, falling to 46.1 in January from 47.7 in December on a fall in new business orders due to weaker demand amid the recent spike in Covid-19 infections. The latest figures suggest that the economic recovery was easing even before restrictions were tightened – and recently extended by another month by Prime Minister Suga. This has heightened concerns about a double-dip recession and piled further pressure on the PM, who has seen his support slide more than 30% according to recent polls.

Chinese activity cools ahead of New Year

The Chinese manufacturing PMI dipped in January, to 51.3 from 51.9 in December, according to the National Bureau of Statistics. (Chart 3.) The slowdown in activity, though the second in a row, was attributed to the onset of the slow 'off-season' for firms ahead of the Chinese Lunar celebrations (The Spring Festival). The recent appearance of some Covid-19 cases was also a factor. Activity in the services sector also cooled. The IMF, in its January WEO Update, pegged China's growth at 8.1% this year, following 2020's increase of 2.3%, which was the lowest in more than 40 years. Nevertheless, China was the only major economy to avoid a contraction last year, capitalizing on successful virus containment, strong public investment and ample central bank (PBOC) liquidity.

Chart 3: Chinese PMI activity indices

(50=no change)



Source: Refinitiv

Still, worries that loose liquidity could be causing asset bubbles remains a key PBOC concern; the China Securities Index (CSI 300), for example, in January hit its highest level since the financial crisis, buoyed by sizeable investor flows. The authorities have already moved to address this, removing RMB78 billion ($12 billion) of liquidity through open market operations recently. The authorities' also tightened bank-lending rules to property developers in December after the property market, which has seen prices soar in recent years, put in another strong performance in 2020, leading the economic recovery along with industrial production and exports.

India releases FY22 budget with further signs of recovery

India's economy continued to show signs of recovery in January amid improving sentiment due to the loosening of Covid restrictions, lower virus cases and the rollout of vaccines. The manufacturing and services PMI's reached three and four-month highs of 57.7 and 52.8 respectively, extending the improvement observed during 4Q20. This follows two consecutive quarters of steep GDP contractions in 2Q and 3Q as the pandemic and high virus infection rates brought the economy to a near halt. Looking forward, the economy may receive a boost from an expected pickup in government spending of about 3.4% of GDP according to what remains of the FY20/21 (ending April) budget, though total stimulus spending over the year remains muted compared to EM peers.

The budget for FY21/22 details a notable rise in public spending mainly on large infrastructure projects in the health and industrial sectors, which should help support the projected GDP rebound of 11.5% for FY21/22, from an estimated 8% contraction in this year, according to IMF forecasts. Also of note is the government's adoption of a softer fiscal deficit target of 4.5% of GDP (from 3%), suggesting greater room for future spending, though persistently high debt levels and high debt service obligations could be a lasting constraint on public spending. Further, still high, though easing inflation (4.6% in December) continues to limit the room for looser monetary policy. Looking ahead, the economy faces headwinds from still relatively weak foreign demand, stagnant wages and a continued, though easing, decline in employment, weighing on private income and spending. The pace of recovery will mostly depend on new virus cases remaining low, the vaccine rollout, and a continued improvement in the global economy.

Oil tops $60 on vaccine optimism and tighter supply

Vaccine rollout optimism and OPEC+ supply cuts continue to underpin the oil market rally, helped to a lesser extent by US stimulus hopes, seen as supporting overall demand, and US dollar weakness. Brent crude is up more than 20% year-to-date at $62.4/bbl (as of 12 February), recently topping the $60 level for the first time in just over a year, following a gain of 8% in January. (Chart 4.) This is due mainly to Saudi Arabia's surprise decision in early January to unilaterally cut crude production by 1 mb/d in February and March over and above the general trend of OPEC+ compliance in 2020 (101% in December). Additional compensatory cuts from non-compliers such as Iraq could also help firm the market.

Chart 4: Brent crude oil price

($ per barrel, end of month*)

Source: Refinitiv   * Latest figure is for February 10

Meanwhile, US shale production has declined by 100 kb/d (to 10.9 mb/d in the w/e 29 Jan) since the start of the year, according to weekly EIA figures, even while oil rig counts continue to rise. US commercial crude stocks also continue to draw down (to 475.7 mb in the same week, the lowest level since last March).

On the demand side, things may also be improving even if top line fundamentals allude to a weaker picture due to the latest lockdowns caused by the more virulent Covid-19 strains. The number of oil supertankers heading to China jumped to a six-month high last week, a positive sign for consumption. Saudi Arabia also raised its Official Selling Prices for March crude loadings. On the downside, the International Energy Agency cut its oil demand growth estimate in 1Q21 by a sizeable 580kb/d from its last report to 100 kb/d. But the agency forecasts that growth will accelerate in 2H21 in line with the IMF's recent growth upgrade, and average 5.5 mb/d in 2021 (versus -8.8 mb/d in 2020).

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