Economic Update
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International Scene

Economic recovery hopes – and inflation worries – trigger a sharp rise in bond yields

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Highlights

- **Hopes are growing that a gradual easing of virus-related restrictions alongside loose policy will fuel a strong economic recovery later this year. But this has also triggered a sharp rise in bond yields that central banks may need to address.**
- **President Biden signed into law a huge $1.9 trillion stimulus package, around half of which could filter through to the economy quickly. The labor market recovery is back on track, but well short of pre-pandemic levels.**
- **Rising virus cases and a slow vaccine rollout are pushing the Eurozone into a double-dip recession. The UK's near-term prospects are more upbeat, but there is evidence of a hit from the new post-Brexit trading arrangements.**

The past month has seen increasing optimism on the global economic outlook, particularly in the US, amid hopes that a gradual easing of virus-related restrictions alongside very loose monetary and fiscal policy will fuel a strong economic rebound in the second half of 2021. With this has come sharp volatility in financial markets and especially bonds, which have started to price in higher rates and potentially higher inflation. Central banks are alive to the risks of higher yields choking off the recovery before much more progress has been made in reducing still-high unemployment rates, and may look to address these movements in their upcoming policy meetings (the ECB already made a start on this in March). Meanwhile, oil prices have continued their now four-month rally, with Brent even briefly touching the $70/bbl mark in early March boosted not just by rising economic growth hopes but also a Saudi Arabia-led effort to extend earlier supply cuts.

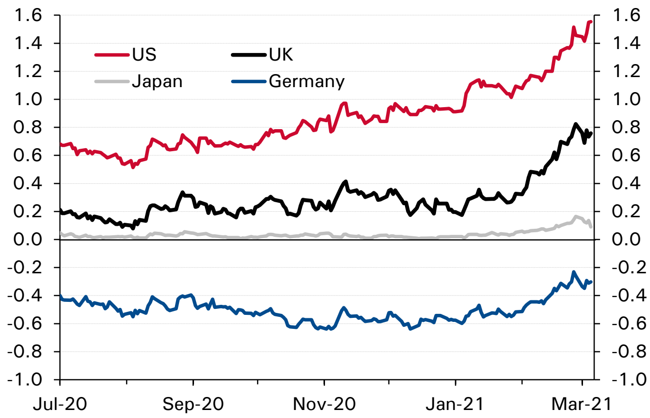
Huge US stimulus deal nears final approval

In a major boost to the economic outlook, President Biden's huge $1.9 trillion (8-9% of GDP) stimulus package was signed into law in mid-March. Not all of the injection will take place this year, but more than half – including the $1,400 checks for individuals and the $300/week extension to unemployment benefits until September – will filter through quickly, benefitting consumer spending in particular. Confidence in the recovery was already starting to gather momentum, with new daily virus cases falling to five-month lows in early March, most of the elderly now vaccinated and some state-level restrictions easing. The labor market recovery may also be back on track with non-farm jobs rising an above-consensus 379,000 in February after falling in December, with gains especially strong in the virus-sensitive hospitality sector. Still, almost 10 million of the 22 million jobs lost to the pandemic have yet to be recovered.

Meanwhile, government bond yields made rapid gains as recovery expectations have grown, with the 10-year yield jumping to 1.55% in early March from 1.0% in late January. (Chart 1.) This is potentially a source of both hope and concern for the Federal Reserve, signaling market confidence that economic conditions are normalizing but also risking a premature tightening in financial conditions that the bank is unable to control.

Chart 1: Government 10-year bond yields

(%)



Source: Refinitiv

The rise also reflects worries that inflation (1.4% y/y on the core CPI measure in January) will resurface as the economy improves, leaving bond investors with losses. If the rise in yields continues or threatens to become disorderly, the Fed may take action to bring yields back down, either through verbal commitments, faster or targeted asset purchases or even potentially direct yield targeting – though the latter seems unlikely for now. Fed chairman Jay Powell may further address the issue by talking down the inflationary threat at the bank's March 16-17 meeting.

Rising virus cases, post-Brexit trade frictions hit Europe

In the Eurozone, the number of new virus cases in some countries including Italy, France and Germany has moved up over the past month and combined with a relatively slow vaccine rollout threatens to see the lifting of current restriction measures delayed or even reversed, hampering the economic recovery this year. Still, latest data show that activity levels have held up much better to the 2021 restrictions than those of 1H 2020 amid better business adaptation and with support policies including for consumers still in place. The composite PMI stood at 48.8 in February representing a shallow overall contraction, with weakness focused on the services sector (45.7) while manufacturing (57.9) hit a more than three-year high. Overall, this still looks consistent with a double-dip recession and the consensus view is for Eurozone GDP to fall around 1.0% q/q in 1Q21 after a 0.7% decline in 4Q20. GDP would be around 6% below pre-pandemic levels.

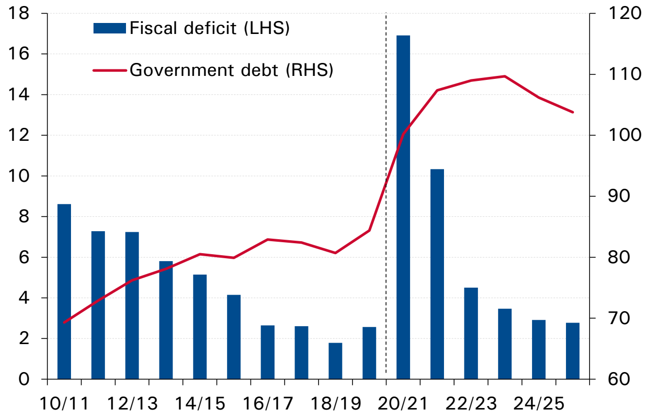
The ECB as expected left policy broadly unchanged, but promised to ramp-up the pace of its bond purchases over the coming quarter to counter the recent rise in government bond yields and underpin the economic outlook. The announcement helped bring yields down a little, but it stopped short of offering more definitive support such as targeting yields or increasing the size of the €1.85 trillion bond-buying program and implies that current purchases will end sooner. The bank also revealed updated economic forecasts, with growth in 2021 upgraded fractionally from December's 3.9% to 4.0% due to a stronger-than-expected outcome last quarter and inflation revised up a more meaningful 0.5% to 1.5%.

In the UK, optimism surrounding the economic recovery has continued to improve in recent weeks, with virus case numbers plunging, the vaccine rollout proceeding quickly, activity restrictions starting to ease from mid-March and Brexit now completed. This has been reflected in not just sharply higher government bond yields but also a strengthening in pound sterling to a three-year high of $1.40 in early March. GDP in January fell following the reintroduction of tough new virus containment measures but by a less than feared 2.9% m/m. Finance minister Rishi Sunak's budget offered further near-term economic support – including extending the worker furlough scheme from April to September – while postponing the issue of huge fiscal deficits for the future. Tax rises will include a freeze on personal tax allowances in 2022 and a rise in corporation tax to 25% in 2023 from the current 19%. The fiscal deficit will reach 17% of GDP this year before narrowing to 3% by FY25/26, while debt will peak at 110% of GDP in FY23/24. (Chart 2.)

Despite the broadly positive UK activity outlook there are signs that the transition to the new post-Brexit arrangements with the EU from January has hit cross-border trade. French exports to the UK dropped 13% in January from the average of the previous six months, and imports 20%, while German exports to the UK fell 30% y/y. Falls have been attributed in particular to delays caused by new customs requirements, though the disruptions could also be linked to new UK virus-related activity restrictions that were applied at the same time, as well as pre-Brexit stock building at the end of last year. Pressures should ease over coming months as the new system beds in. But a potentially more serious longer-term issue for UK-EU relations could be the sustainability of the Brexit arrangements for Northern Ireland, with the UK unilaterally extending the grace period for implementing new NI-Rest of UK trade arrangements and the EU threatening to retaliate through legal channels. A climate of acrimony or dispute could make further deals in important areas such as services and especially financial services trade less likely over coming months.

Chart 2: UK fiscal deficit and government debt

(% GDP, projections by Office for Budget Responsibility)



Source: UK OBR March 2021

Japan posts reasonable growth in 4Q20

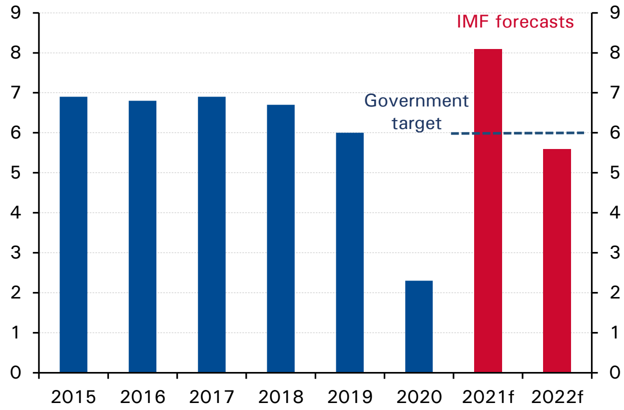
Japan's economic growth gathered pace in 4Q20, with GDP up by an annualized 11.7% (+2.8% q/q), supported by a rebound in goods exports, capital investment and consumer spending. Earlier estimates had put growth at 12.7% annualized (+3.0% q/q), but this was revised down due to lower capital spending and a decline in private inventories. Nevertheless, business investment increased, especially in manufacturing, helping to temper the pandemic-related contraction in annual GDP in 2020 to an estimated 4.9% – the country's first decline since 2009. Expectations were high that this positive momentum would carry through into 2021, but the re-introduction in January by the Suga government of a state of emergency to control rising infections – recently extended for a further two weeks until 21 March for the greater Tokyo area – has dampened those prospects to a certain extent. Household spending, for example, fell 6.1% m/m in January while the services PMI in February remained in contraction territory (46.3) for a 13th consecutive month, though the rate of decline eased somewhat compared the previous month. Manufacturing held up better in February (51.4 versus 49.8 in January) amid a pick-up in business orders.

Chinese government eyes growth rebound

Following GDP growth of 2.3% in 2020 and a relatively successful containment of the pandemic, the Chinese government is targeting GDP growth of at least 6% this year according to its recently published five-year plan (2021-2025), lower than the IMF's projection of about 8.1%. (Chart 3.) It also aims to lower the fiscal deficit-to-GDP ratio to 3.2% versus a target of more than 3.6% in 2020, withdrawing stimulus measures gradually, with a focus instead on reining-in debt and heading off an emerging bubble in the real estate market. The government also plans to create 11 million new jobs this year, up from the 2020 target of 9 million, and to cap the urban jobless rate at 5.5% in 2021, down from 6% in 2020. For the coming years, it expects to keep the economy running "within a reasonable range", without giving a specific target, against a previous target of "more than 6.5%" in the 2016-20 plan.

Chart 3: Chinese GDP

(% y/y)



Source: National Bureau of Statistics, IMF WEO

Meanwhile, manufacturing activity remained in expansion territory in February (PMI at 50.6), but at a slower pace compared with January (51.3), while services sector activity grew at its slowest pace in 10 months (51.5). The slowdown was mainly due to the impact on production of the Spring Festival holidays. Separately, exports jumped 61% y/y in the January-February period, well above analysts' expectations and the highest in over two decades, while imports rose 22%, beating market consensus of a 15% increase, boosted by improving domestic demand, continued fiscal stimulus, and higher commodity prices.

India returns to modest economic growth in 4Q20

Following two consecutive quarters of steep contraction, India's GDP grew at a much improved 0.4% y/y in 4Q20 (3Q FY20/21) as the domestic economy continued to recover amid the loosening of Covid restrictions. The return to growth was largely driven by much softer contractions in private consumption (-2.4% versus -11.3% in Q3) and government spending (-1.1% versus -24% in Q3), while fixed investment rose to 2.6% from -6.8% in Q3. On the external side, exports fell -4.6% from -2.1%, though still a vast improvement from the sharp drop of Q2, while the decline in imports moderated to -4.6% from a steep -18.2% in 3Q, reflecting an ongoing recovery in both foreign and domestic demand, though still far from historical norms. More recent data from February points to a continued recovery in business activity, with the services PMI reaching a one-year high of 55.3, while the manufacturing PMI edged down slightly but remained firmly in expansion territory at 57.5, driven by higher new orders and output.

The IMF sees India's GDP rebounding by 10% in FY21/22 from a contraction of around 8% in FY20/21. However, growth prospects could be weighed down by inflationary pressures stemming from reportedly higher input costs and the recent surge in oil prices, likely to negatively affect India's terms of trade. Moreover, employment remains in decline, adversely affecting household income, which may in turn cap a potential rebound in private spending. Growth prospects also naturally continue to depend on a favorable virus-control backdrop (vaccine rollout/low cases).

OPEC+ supply restraint sends Brent towards $70

The Saudi-inspired decision by OPEC+ to restrain April crude output for at least one month sent oil prices surging to their highest levels since 2019. Brent closed at $69.4/bbl ahead of the Houthi missile attack on Saudi oil facilities in early March which pushed the marker temporarily over $70 in intra-day trading. (Chart 4.) Brent gained of 10% in February alone, its best performance since last May reflecting the prospect of a vaccine-driven economic and oil demand rebound this year underpinned by OPEC+ supply cuts and global economic stimulus. Under the terms of the OPEC+ agreement, all OPEC+ producers with the exception of Russia and Kazakhstan (+150 kb/d collectively), opted to roll over their 8 mb/d of aggregate supply cuts – equivalent to 8% of pre-pandemic supply – for an additional month into May.

Chart 4: Brent crude oil price

($ per barrel, end of month*)

Source: Refinitiv * Latest figure is for March 9

The decision completely wrong-footed the markets, which were expecting the group to respond to market tightness and falling inventory levels by opening the taps. At the very least, 500 kb/d of additional supply was expected, with the only uncertainty being whether Saudi Arabia would return its additional 1 mb/d of supply cuts in April all at once or gradually. Saudi energy minister Prince Abdulaziz had been urging caution for months as oil demand growth remained uncertain while the coronavirus pandemic still raged. The outcome was by far the most bullish among the range of scenarios being considered ahead of the meeting. The group anticipates in the near term a period of oil demand weakness and crude stock builds associated with the Spring refinery maintenance season before oil demand growth recovers ahead of the summer. Oil price expectations for the year have been raised upwards to the $65-$75 range, though these favorable conditions may not persist beyond the near-term given the near-certainty of higher OPEC and non-OPEC supplies.

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