Quarterly economic and market outlook

Emerging from the winter of discontent

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Fidelity INTERNATIONAL

Emerging from the winter of discontent

Executive summary

- As we move through the second quarter of 2021, over a year since ‘the great lockdowns’ began across regions, the global economic recovery continues, though signs of increased divergences are strengthening. Economic damage was less severe than expected following the winter surge in virus cases in many regions. Effective vaccine roll-outs will be critical in the next phase of the pandemic, but the Covid-19 story is far from over yet, as variants start to become increasingly problematic.

- The role of central banks and monetary policy remains important, but fiscal policy has taken centre-stage, and will dominate the macroeconomic and market outlook over the coming years.

- Looking ahead through Q2 and beyond, we see the broad reflation story moving closer to a reality as economic reopening approaches across major economies.

- In the US, unprecedented fiscal policy and questions around stimulus funding via taxation shape the outlook, against a backdrop of strong consumer savings and the impact of their deployment as reopening begins.

- In Europe, slower vaccine roll-outs to date challenge economic reopening, although the vaccine campaign looks to have accelerated as of late. Fiscal stimulus will be a key factor in European economic outcomes in the coming months as monetary policy remains very easy.

- China’s story is panning out differently versus other major economies, where a relatively less severe economic outcome from the pandemic so far has led to a modest slowdown in Q1 this year. We expect China’s policy stance to turn moderately more hawkish as authorities return their attention to controlled deleveraging and rebalancing from quantity to quality of growth. We are monitoring the case of a major onshore asset management company (AMC) getting into trouble closely.

- Overall, market volatility has picked up, with ‘mini tantrums’ testing central bank credibility, and asset classes continuing to price in the expected reflation narrative. Valuations are stretched in certain areas, looking almost late-cycle in some cases, and style rotations are starting to embed themselves. In this context, Fidelity Solutions & Multi Asset remains broadly pro-risk for now, but is taking a highly selective approach to asset allocation in the context of the evolving market and macroeconomic backdrop.

Entering 2021: the market and macro journey so far

Economic damage through winter was less than expected

It is now over a year since the 'great lockdowns' began around the world, responding to the Covid-19 pandemic which disrupted nearly every element of life and wrought immense human tragedy. Following the turmoil in markets and the global economy early last year, unprecedented global policy intervention - both fiscal and monetary - cushioned the economic blow of the pandemic to a large extent, leading to a sizeable recovery across the board as economies began re-opening around the middle of last year. As mobility restrictions tightened again in response to second waves of the virus in the latter part of 2020, the loss of economic momentum through the winter was significantly less dramatic compared to the first wave, given generally lower stringency measures, better adaptation among populations and continued policy support.

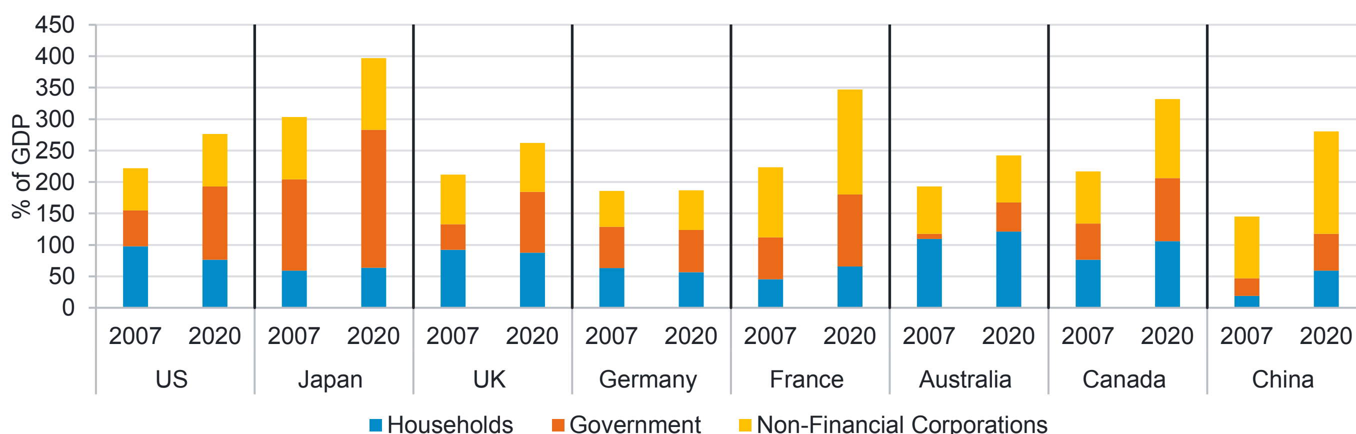
As a result, the economic damage suffered in Q1 2021 was less severe than expected. The latest global manufacturing and services PMIs for March continued to rise into expansion, with developed market manufacturing PMIs now at all-time highs. Mobility restrictions and the roll-out of vaccination programmes across the world have helped ease pressure from the virus, with the second wave peaking at the start of the year. However, as we enter Q2, there are signs of a third virus wave, particularly in those countries that have so far lagged in terms of vaccine roll-out, with a number of key emerging markets, such as Brazil and India, being hit particularly hard. The race between the virus and vaccine is clearly set to shape the rest of the year.

Fiscal policy taking centre stage

In terms of policy, the Covid-driven recession set the stage for a historic pivot towards sustained fiscal spending in the US, a sea-change further aided by the Democratic sweep of the White House and Congress in late 2020/early 2021. As we covered in a recent Global Macro Insights publication, the result is a sustained fiscal impulse supporting the US, and by extension much of global growth, for the remainder of 2021 and potentially beyond. This follows an unprecedented flood of governmental relief payments during the lockdowns, amounting to $5.6trn or 26% of US 2019 GDP. Including the $3trn of infrastructure, green investment and social spending that President Biden has proposed in the Build America Back plans, total discretionary fiscal spending in the US over a several-year period could amount to a staggering $8.6trn, or 40% of 2019 GDP.

The logical outcome, and we believe the most lasting legacy of the Covid crisis, is the burgeoning public debt issued to fund this fiscal spending worldwide (Chart 1). This much higher debt burden, not seen in the US and other developed markets since WWII, will require major central banks (including the US Federal Reserve) to implicitly target negative real interest rates for the foreseeable future in order to maintain debt sustainability. The conflict between pressure to keep rates low and a growing need to confront increasing inflation expectations on the back of unprecedented fiscal stimulus poses a serious challenge for the Fed and other central banks, which will define the post-pandemic landscape.

Chart 1: Evolution of country debt across economic sectors

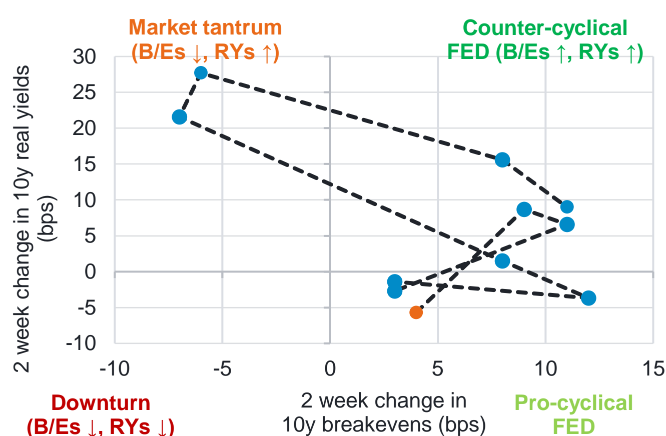


Source: Fidelity International, Refinitiv DataStream, BIS, March 2021.

Credibility of central banks will be key as risks begin to materialise

Given this conflict and the delicate task of major central banks, we entered 2021 with central bank credibility at front of mind. Indeed, market risks began to materialise in mid-February with a 'mini-tantrum' in bond markets (Chart 2), and liquidity in credit markets has remained somewhat constrained since then, both in the US and the Eurozone. Despite the Fed's commitment to keep rates at low levels, we expect markets to continue testing this commitment, especially as re-opening later in the year combined with fiscal stimulus is likely to fuel a very strong economic rebound in our view. While the Fed has bought itself some time with its Flexible Average Inflation Target (FAIT) framework, its reaction function remains uncertain.

Chart 2: Fidelity's bond market tantrum barometer



Source: Fidelity International, 2 April 2021.

Volatility in Treasury markets in February spilled over into government bond markets around the world. We noted a stark divergence in reactions between the Fed and other central banks, with the likes of the European Central Bank (ECB) and the Reserve Bank of Australia (RBA) responding more aggressively to the rise in yields and overall tightening in financial conditions. The ECB significantly stepped up the pace of PEPP purchases in order to maintain 'favourable financing conditions' in the Euro area. The RBA resumed its yield curve control programme and set a new record in quantitative easing via bond purchases in an effort to mitigate the tantrum shock emanating from the US.

China's story of financial tightening and loss of growth momentum

While China's pandemic challenges continue to be less severe, the economy also lost some momentum in Q1, as confirmed by the PMI readings and Q1 growth data. This slowdown was partly a result of travel restrictions during the Chinese New Year holiday and less supportive domestic policy at the margin. That said, the slowdown appears relatively moderate, with strong recovery in exports and robust industrial production as offsetting factors. Over the course of 2021, we expect China's policy stance to turn moderately more hawkish as the authorities return to pursuing controlled deleveraging and rebalancing from the quantity of growth towards the quality of growth through tech innovation, environmental policies and supply chain security among other goals emphasised in the 14th Five Year Plan.

For markets, today's narrative is about expected reflation and the ebbs of the business cycle

Given the unprecedented nature of the recession, recovery and the size of policy support globally, reflation has become a dominant theme across markets. However, as we move through Q2, a more differentiated and divergent picture is taking shape, with virus and variants leading to a third virus wave in countries where vaccination roll-out has been slow (for example, in Europe and some key emerging market countries).

The reflation theme in markets has triggered a style rotation from higher growth stocks to value and cyclicals. Rising inflation expectations are reflected in higher yields, which translate to higher discount rates on future corporate earnings. This means lower duration sectors that benefit from rising yields, such as financials and energy, led markets in Q1 while technology and high growth sectors lagged. The growth-to-value rotation has been a global phenomenon, with Chinese equity markets being impacted the most after a stellar 2020. The sell-off in China has been most pronounced in 'New China' stocks, including notable internet, healthcare and electric vehicle companies, while 'Old China' cyclical and value stocks recovered significantly.

Finally, among other notable Q1 market events, it is worth highlighting the retail investor euphoria around Gamestop and a basket of similarly traded stocks. The huge price swings in these stocks caused wider market volatility, heavily driven by retail investor stock and option volume. The events brought into the spotlight a number of issues in financial markets from a regulatory and oversight standpoint but had no impact on wider market fundamentals. We believe the power of the retail investor will remain a key theme in markets, particularly given the rise in household savings rates seen over the course of the pandemic.

Looking ahead: Q2 and beyond

Reflation closer to becoming a reality as reopening nears and fiscal policy deployed

As the full reopening of economies draws nearer (albeit at different rates across countries), we expect reflation to take hold, turning from a dominant market theme into economic reality. In the near term, pent-up demand funded by consumer savings supported by Covid relief to households will likely fuel strong growth and higher inflation. Upcoming spikes in Q2 inflation, driven mostly by base effects, are likely to be transitory, though risks around sustainably higher inflation have risen. Looking beyond Q2, the combination of re-opening, further fiscal plans and more patient central banks points to an upside skew in inflation risks, especially in the US. Moreover, the recent rallies in energy and agricultural prices will add to headline inflationary pressures, revealing a tricky growth-inflation trade-off for emerging market central banks in particular. But while emerging market central banks will have to tighten policy to protect credibility, those in developed markets are very likely to stay patient for the time being, despite markets continuing to test their credibility.

Indeed, it’s clear that significant fiscal spending, particularly in the US, will continue to feed through over the coming months (Table 1). The Build Back America infrastructure and social spending plans from the Biden White House are expected to inject at least $3 trillion, including $2.25trn in the initial tranche, into longer-term investments, in the form of conventional and green infrastructure, plus social programmes such as free community college, elderly and child care. This spending is associated with relatively high and long-lasting fiscal multiplier effects and may also support longer-term productivity. If successfully legislated, the steady drip-feed (or firehose) of fiscal stimulus into the US should benefit the global economy too, via trade and financial channels, and could become a powerful reflationary engine over the next several years.

Fiscal plans in Europe and China will also provide a positive, albeit more modest, boost. The EU has committed to invest €750bn (8% of GDP) through the Recovery and Resilience Fund (RRF), with disbursements initially planned from H2 2021. This timeline, however, is currently at risk of being substantially delayed, with potentially dramatic consequences for economies coming out of the pandemic, given the ongoing German legal challenge arguing the RRF is in breach of EU treaties and violates German constitution. However, at this stage we are expecting a minor delay, with the first tranche likely to be disbursed some time in Q4 2021.

At the same time, China is expected to run a fiscal deficit of 10-11% of GDP in 2021, roughly 2-3% below 2020. The country’s more conservative stance on fiscal stimulus compared with its actions during the GFC reflects both its milder economic hit from Covid and a policy pivot towards dual circulation strategy and macro stability over the last several years.

Fiscal policy and questions on tax will continue to drive US story

Given US policy is an important driver of global markets, a key question for investors is about the funding plan for the Build America Back programmes. Biden’s proposal, which matches that in his campaign platform, supports an increase in corporate taxes from 21% currently to 28%. This would represent a 50% clawback of the tax cuts passed in the 2017 Tax Cuts and Jobs Act in the Trump Administration, and the position advocated by the Obama Administration in previous tax reform efforts. Other corporate tax increases may include the global intangible low-taxed income (GILTI) tax on foreign earnings and elimination of corporate tax shields. The timing of these tax increases has yet to be defined, but we would expect implementation to be delayed at least to 2022 to help job recovery and reflation take hold. The proposed tax increases could allay some concerns in the market on unmitigated deficit spending, but may also pose a headwind on corporate earnings as well as valuations, especially if tax hikes accompany the next rounds of fiscal expenditures.

Table 1: The great fiscal pivot (US, Europe and China)

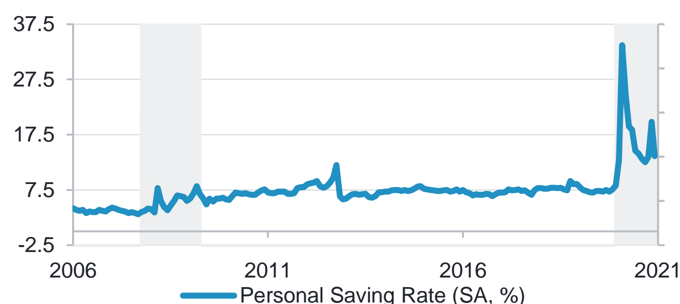
	US			EU			China		
	Policy	Action	Impact	Policy	Action	Impact	Policy	Action	Impact
Global Financial Crisis	American Recovery & Reinvestment Act of 2009	$787bn (5% of GDP)	1.84% avg. GDP growth; 1.6% avg CPI (2009-19); full employment reached in early 2020	European Economic Recovery Plan	EUR 200bn stimulus (1.5% of GDP);	1.02% avg GDP growth and 1.33% avg inflation (2009-19)	Infrastructure investment (RMB 4 trn)	RMB 4 trn ($585bn) (12.5% of GDP)	7.8% avg GDP growth and 2.3% avg CPI (2009-19)
Covid Recession	Build America Back	$2-3trn (est) (10-14% of GDP) over 4 years	High single digit GDP growth expected in 2021; possible return to full employment by end 2022	Recovery and Resilience Facility	EUR750bn (8% of GDP) over a 6 years	Expected to result in GDP and inflation growth	None announced	Reduction of fiscal deficit of 2-3% expected in 2021	High single digit GDP growth expected

Source: Fidelity International, March 2021.

Consumer savings: the key business cycle shaper and inflation determinant

In addition to questions around taxation, the health of the US consumer is a key bellwether for the US and global economy and remains one of the crucial focal points to watch. US households entered the Covid recession in a healthy state, with consumer debt ratios at their lowest level in 11 years. While incomes were hit during the recession, households were broadly insulated from economic loss through large scale fiscal intervention, whereby government transfers exceeded aggregate income losses by $617bn in 2020. This has meant that households are in a strong position coming out of the recession, having accumulated large amounts of excess savings, only set to increase with further stimulus (Chart 3).

Chart 3: US personal savings rate



Source: Haver Analytics, March 2021.

Once economies begin to re-open in Q2, we are likely to see the unwinding of this excess saving bringing about a surge in consumer demand. The size of excess savings suggests that the boost to spending could last into 2022, further driving our growth expectations for next year. Those sectors most impacted by the pandemic will likely see the biggest increases in demand, such as restaurants, catering, travel and tourism sectors. As consumer demand rebounds, so will hiring, given 78% of recession job losses have been in the Covid-sensitive sectors. We believe this has the potential to kick-start a virtuous cycle in which a demand pick-up leads to job and income gains, which in turn drives further rounds of consumer spending growth. However, on the negative side, the spread of different virus variants and the vaccine efficacy will be important to monitor, when it comes to the reopening theme.

Watching China's business cycle closely, plus challenges for key emerging markets

The increasingly important role of emerging markets in the global economy, particularly China, means economic and policy activity must be monitored carefully. We are watching the China business cycle closely for signs of excesses in credit that would necessitate additional policy tightening. Here, the current focus is on the case of a major onshore asset management company (AMC) which got into trouble recently.

We also highlight potential risks that could emanate from other emerging markets, including the ongoing relapse in Covid infections as the southern hemisphere enters its winter season, leading to potential new mutations and vaccination roll-out challenges. The UK, South Africa and Brazil mutations continue to spread outside of their originating countries, and the high transmissibility and severity of the Brazil mutation in particular are already leading another surge in infections in other countries in LatAm, even in Chile despite its high success in vaccine

roll-out. The double variant mutation emerging in India may pose additional risks, as well as supply issues such as the availability of vaccines produced in India to the rest of the world.

Furthermore, we note that inflationary pressures driven by higher energy and food prices as well as weaker currencies are resurfacing across emerging markets, triggering rate hikes in Brazil, Russia and Turkey, along with President Erdogan's replacement of the head of the Turkish central bank, indicating incidence of domestic political risks in key emerging markets. As inflation picks up further, policy tightening - essential to protect emerging market central bank credibility - is likely to continue, potentially undermining growth prospects as countries emerge from the pandemic.

Fidelity's bottom-up perspectives

Analyst survey indicates inflationary pressures in the pipeline

To build upon our macro insights, bottom-up perspectives from Fidelity analysts are critical in driving our analysis. Fidelity's equity and fixed income analysts were surveyed this quarter, providing insight into their research across the broad universe of securities and sectors.

In line with our broad market outlook, their responses indicated broad confidence globally amongst corporate management teams, but also that cost inflation is emerging as a key concern. When surveyed, companies across almost all regions and sectors indicate that they anticipate a rise in both labour and non-labour costs, reflecting rising commodity prices, continued supply chain constraints and upward wage pressure. Analysts believe that companies will raise prices by 2.5% on average over the next 12 months, while per unit costs should rise by 2.8%.

However, there is variation between regions (Chart 4). Expectations of higher non-labour costs accelerated in March for China, Latin America and other emerging market regions. Japanese companies now also anticipate increasing cost pressures, bringing this region in line with the rest of the world. Meanwhile within sectors (Chart 5), Fidelity's analyst team observed:

- **In the Industrials sector, higher spending will raise prices** and 81% of Fidelity analysts believe inflationary pressures on company cost bases will increase this year. This will decrease margins for some companies, as pricier fuel and raw materials hurt auto and airline earnings.
- **In the Materials sector**, as with the Industrials sector, rising prices will also affect costs, and 85% of analysts think that inflationary pressures will increase for the companies they cover

> *We are seeing more of a cyclical rotation in equity markets at present, with expected earnings increasing to more than offset their 2020 declines... We are expecting a very powerful cyclical rebound.*
>
> **Romain Boscher**
> Chief Investment Officer, Equities

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Chart 4: Non-labour costs by region

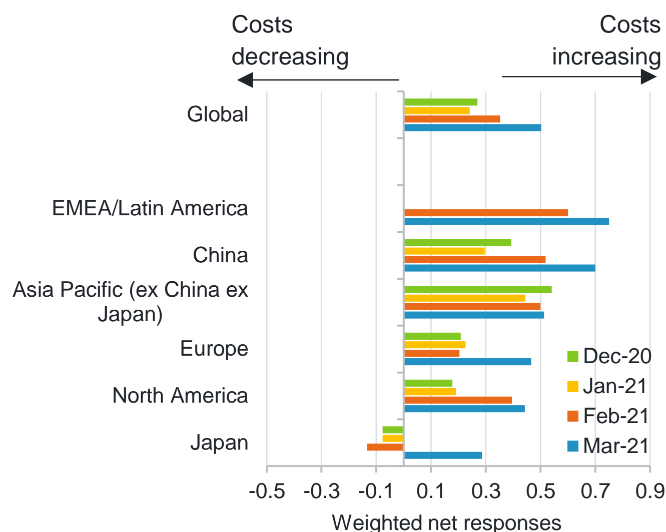
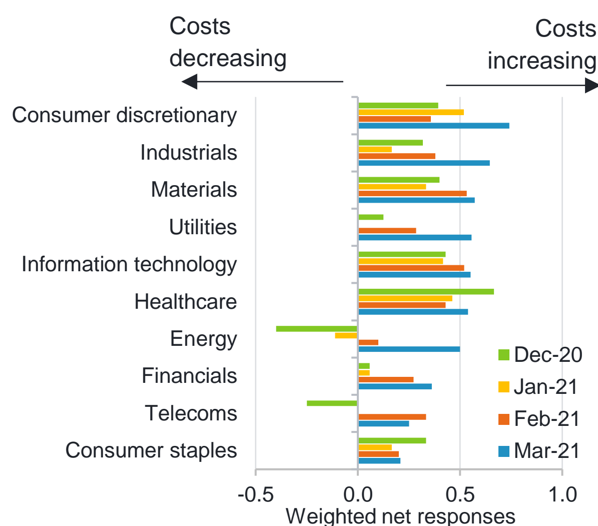


Chart 5: Non-labour costs by sector



Source: Fidelity International, March 2021. Chart shows proportion of responses reporting costs are increasing minus those reporting costs are decreasing; significant increases and significant decreases receive a higher weighting. Question: "What are your expectations for total non-labour input costs over the next 6 months compared to current levels?"

The reflation theme and style rotation are now starting to embed in markets

The unique nature of the Covid recession has meant the recovery has been speedy, already moving through the mid phases of the business cycle in some cases. Through 2020 H2, we saw the hallmarks of an early cycle recovery with asset classes pricing it in accordingly: equities and credit rallying, yield curves steepening, and cyclicals and commodities performing strongly. Markets have been leaning into early-cycle reflation trades which have already rallied significantly leading to mid to late cycle type concerns arising. Also, with volatility picking up, there are signs we are passing through mid-cycle in terms of pricing. However, based on our analysis, we still believe the reflation trade has more to go.

Coming into Q2, we remain positive on equities given strong earnings and the prospects for strengthening global growth, and more negative on duration and cash. Within fixed income, high yield assets look more attractive than investment grade counterparts due to falling high yield default projections and tightening credit spreads. Meanwhile, we prefer equity regions more geared to the cyclical upswing such as Japan and emerging markets. UK equities will also be a beneficiary given their highly cyclical sector composition and the better than anticipated vaccine roll-out.

However, we are focused on the risks of tighter financial conditions particularly through rising bond yields which can become an impediment to global recovery and risk-on sentiment. As central banks are navigating a razor thin margin of accommodating stronger growth and higher inflation while managing market expectations of an early exit from very accommodative policy, the risk of a policy mistake in such an unprecedented environment is particularly high.

Real rates have risen sharply on the long end

The sharp rise in US bond yields (accompanied by the steepening of the curve) has put a sharp focus on macro policy credibility as the Biden administration accelerates the ongoing quantum jump in fiscal easing. In the context of potential consequences of the stimulus for growth and inflation, this market reaction is certainly not surprising. Our analysis suggests that the relationship between real rates and inflation breakevens has become a critical global risk factor - a dynamic which was also visible during the taper tantrum of 2013. As such, with fiscal policy easing escalating in 2021, the continued ultra-accommodative stance currently adopted by the Fed would need explanation, presenting a complicated challenge for the central bank.

What will the Fed do to stem the tantrum risk?

We believe the Fed may ultimately need to call upon its full suite of tools as it is unlikely that jawboning will be sufficient to keep real rates in negative territory over the next several years. In addition to verbal interventions, we believe the Fed could extend the duration of asset purchases, expand its purchases and/or bring back Operation Twist, which would have the dual benefit of flattening the curve. At the more extreme end, the Fed could reach back to its toolkit from the last century e.g. interest rate targeting similar to strategies deployed in the 1940 and 1950s during and post-WWII. However, we believe there is a low chance the Fed will have to resort to yield curve control for the time being.

While credit outperformed equities during the ‘mini-tantrum’, the asset class is susceptible to several risks, including underperformance of duration particularly in investment grade credit, vulnerability of emerging market debt to rising US Treasury yields and technical headwinds in the form of outflows. Nevertheless, we see attractive pockets of value in Asian high yield and inflation-linked securities. On the currency side, strength in the US dollar, reflecting rising growth expectations and yield differentials versus the rest of the world, poses a short-term risk to the global picture. Over the medium term, we continue to anticipate a weakening dollar on historic overvaluation and rise in twin deficits.

> *The reality is that the Fed has to keep this situation under control and not allow real yields to move sharply higher. My belief is that if we get more tests of the Fed’s resolve and inflation is coming into the system, central banks will have to drive real yields more negative. Ultimately, this will be an important year for real yields, as this represents the cost of capital - this can’t go much higher.*
>
> **Steve Ellis**
>
> Chief Investment Officer, Fixed Income

Looking forward

Asset allocation implications for Q2 and beyond

As we discussed in detail in our January Global Macro Insights publication, 'Mapping the New Abnormal', given the high and rising debt burdens, the global economic system is highly exposed to a steep rise in interest rates. Keeping real rates in negative territory, in our view, has become a monetary policy goal. However, given the parameters still to be cleared when it comes to the new FAIT framework, bond market tantrum risk remains top of mind for investors. Ultimately, we think the Fed and the ECB (which may see spill-over pressure) can successfully manage challenges to their credibility, but this may require additional easing action. With economic re-opening drawing nearer and massive fiscal easing in the US putting upward pressure on cyclical inflation, having a strong anchor on the relationship between breakevens and real rates (based on lessons from 2013 and 2018) will be critical in shaping our views on risk assets.

From a strategic asset allocation standpoint, we believe it is imperative to re-think the current core asset mix (Table 2), and in many cases accept that a traditional 60/40 approach may no longer meet the needs of investors over the coming years (especially, when looking at European and Japanese government bonds).

As investors, we must therefore also be open to designing portfolios using a different framework and developing new toolkits to build robust portfolios against this evolving backdrop. When it comes to designing strategic asset allocation, we must acknowledge the profound changes in the evolving macroeconomic landscape and move towards a more flexible approach to mapping the investment implications of the 'new abnormal'.

Table 2: rethinking SAA when bonds become a policy tool

Nominal summary statistics (1920 – 2020)

	Annualised returns (%)	Standard deviation (%)	Sharpe ratio
Cash	3.44		
S&P composite	10.20	15.54	0.44
10y treasury	5.22	6.24	0.29
60/40 portfolio	8.54	9.78	0.52

Nominal summary statistics (1995 – 2020)

	Annualised returns (%)	Standard deviation (%)	Sharpe ratio
Cash	2.32		
S&P composite	9.86	13.00	0.58
10y treasury	6.23	7.35	0.53
60/40 portfolio	8.77	7.42	0.87

Real summary statistics (1920 – 2020)

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Source: Fidelity International, Bloomberg, GFD, Shiller, September 2020.

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