Market Insights & Strategy

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Key Macroeconomic Risks In 2021

- **Legacy costs of the coronavirus pandemic form the foundations of uncertainty**
- **Covid-19 vaccines are not silver bullets**
- **Inflation is a clear and present danger to be tolerated**
- **Paradoxically, debt and corporate earnings optimism now at risk of the recovery they chase**

Introduction

After the disruption and volatility felt across the global population and financial markets during 2020, because of the Covid-19 pandemic, there is increasing consensus, to which we also subscribe, that a strong global economic recovery will evolve over the coming quarters. Indeed, one might argue that such a rebound is inevitable in the context of Covid-19 vaccination programs now being rolled out, interest rates having been slashed toward the zero bound by major central banks and governments around the planet embarking on significant fiscal easing.

The latter of course is being spearheaded by U.S. President Biden's proposed $1.9 trillion American Rescue Plan. Moreover, fiscal and monetary policy is set to remain highly accommodative over the coming quarters with more central banks beginning to lean toward the U.S. Federal Reserve's flexible average inflation targeting (FAIT) policy.

But as we have argued previously, this is no time for policy-makers to be complacent. As World Bank Group President David Malpass recently noted, 'Our response to the pandemic crisis today will shape our common future for years to come. We should seize the opportunity to lay the foundations for a durable, equitable, and sustainable global economy'.

1. Covid-19 vaccine

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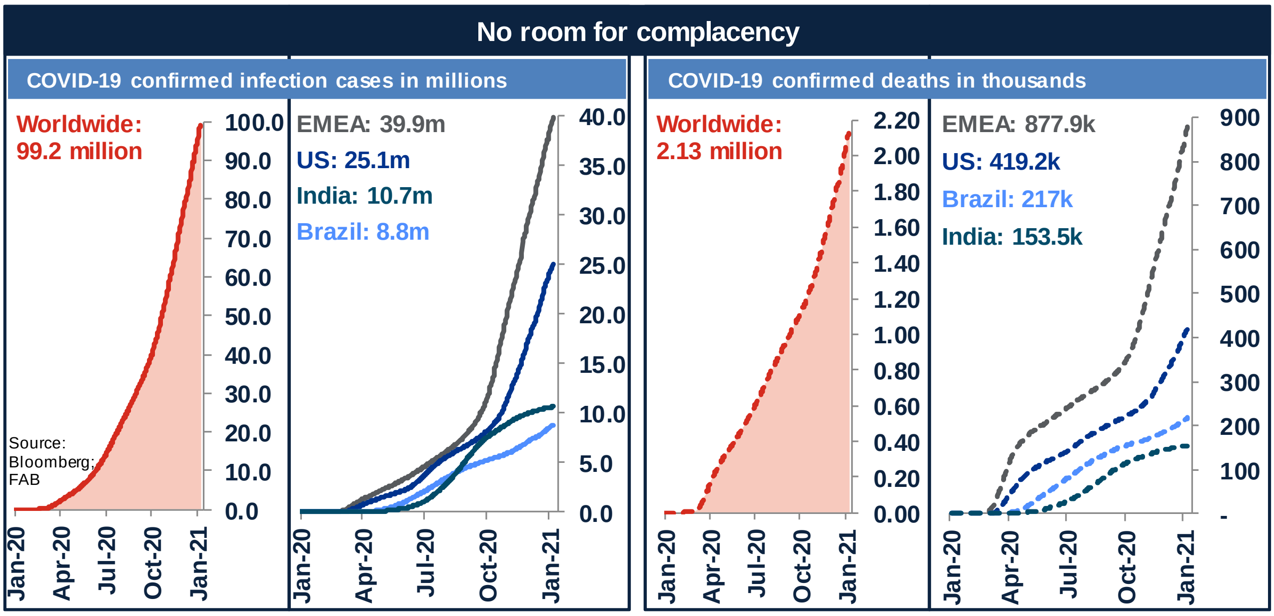
Transitioning out of the pandemic may be slower and more painful than many foresee, with several key macro risks still overhanging the market in 2021. Over the following pages we list what we perceive as being the major macroeconomic risks facing the status quo this year, albeit that this list is far from exhaustive and is, of course, highly subjective.

Covid-19 vaccine

The discovery of Covid-19 vaccines and the prompt distribution of the inoculations is heralded by many as a silver bullet for the global macro outlook. The widespread hope is that a vaccination program, once it hits herd immunity volume, will allow economic and social distancing lockdown rules to be eased, which in turn will help countries return toward a degree of ’normalcy’. This said, we would suggest that while the vaccine is a huge positive in general, it could also be a major threat for global markets in the months ahead if we get carried away.

On the positive side the argument is clear. A successful vaccine will help to cauterise the spread of the pandemic, bring down the mortality rate and allow economies to ‘open up’ again. Social mobility will also recovery and mental health strains will recede.

But on the flip side we would advocate a degree of caution. Vaccines will not eradicate the pathogen. This is no time for the global population to let its guard down; even after immunisation, social distancing measures and face mask usage will still be critical. If we become too relaxed, too quickly we will risk triggering further - perhaps more violent - spikes of the virus and new variants thereof.



New variant Covid-19 spikes

Future spikes in coronavirus infection rates and the appearance of new variants of the virus will remain key risks for global markets over the coming months. Risk assets will be buoyed by any positive vaccination news and falling infection and mortality rates, but as we are experiencing currently, the risk of new variants - especially any that are resistant to current vaccines - will have the potential to swiftly dampen market sentiment and trigger a renewed bid for haven assets.

Deeper than expected legacy costs of coronavirus

Global markets are optimistically pricing in reflation, based on the expectation that Covid-19 vaccines will allow the global community to ‘get back toward normal’ and that economies will experience a marked rebound from recession to expansion. For the record, we are among the subscribers to such an outlook.

Playing devil’s advocate though, given the depth of the economic damage that was done around the nadir of the economic cycle in Q1/Q2 last year, there is a not insignificant risk that recovery will be less impressive than currently hoped. In particular, labour market scars could prove to be far more persistent than anticipated, proving to be not only deep, but also structural, which would carry negative implications for changing consumer habits and ongoing social distancing. Such a scenario suggests that re-employment could be a slow process and economic recovery forecasts could prove overly optimistic.

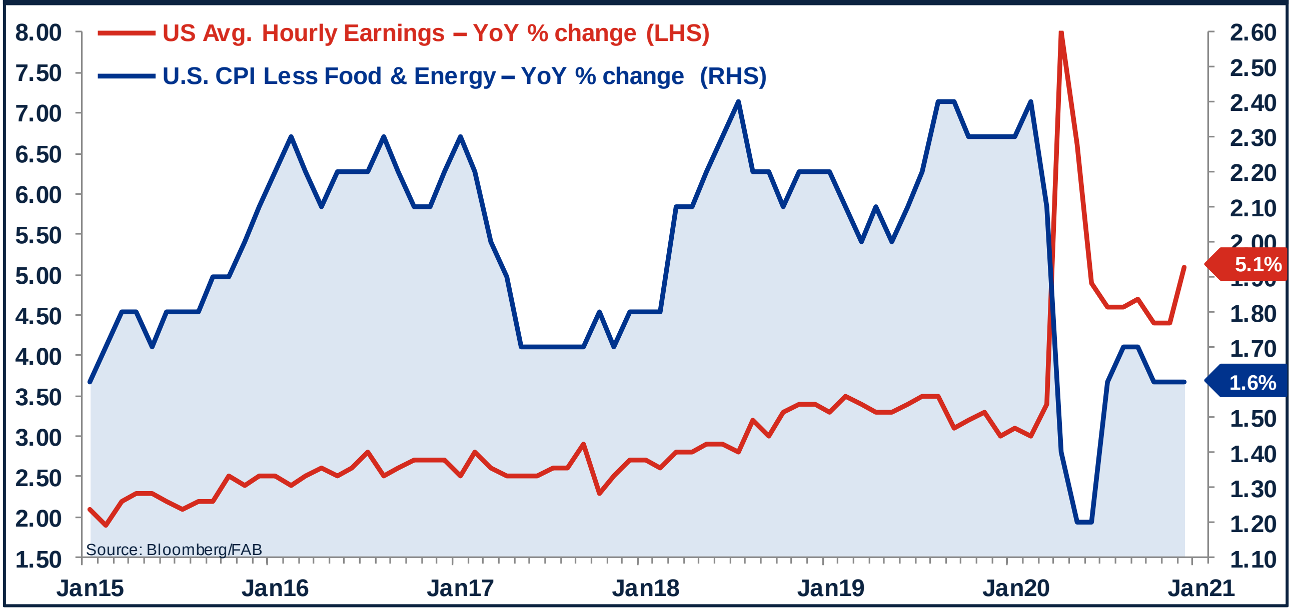
Inflation / tightening bias

There is a broad assumption that interest rates will be held low for the foreseeable future, with the market not pricing in any rise in U.S. rates until the end of 2023. It is hoped that this low rate environment will create a fertile landscape for longer-term economic recovery, conditions under which yield curves will (continue to) bear steepen.

However, the less favourable derivative of this situation for global markets is that the longer policy remains loose, the greater may be the longer-term inflationary pressure. We expect this to remain an evolving story during the course of 2021.

Admittedly, inflation is proving to be of limited concern for now thanks to the Fed's current 'flexible average inflation targeting' (FAIT) policy and also the structural damage that has been felt across labour markets during the pandemic, which we believe will contain near-term wage growth pressures. The spotlight remains firmly on ensuring economic recovery for now, but over the coming quarters as economies shift from recession to positive growth territory, and labour market wounds begin to heal, we are cognisant that rising inflation could quickly dampen risk appetite and reverse credit markets' recent positive performance.

Wages are key as labour market recovers

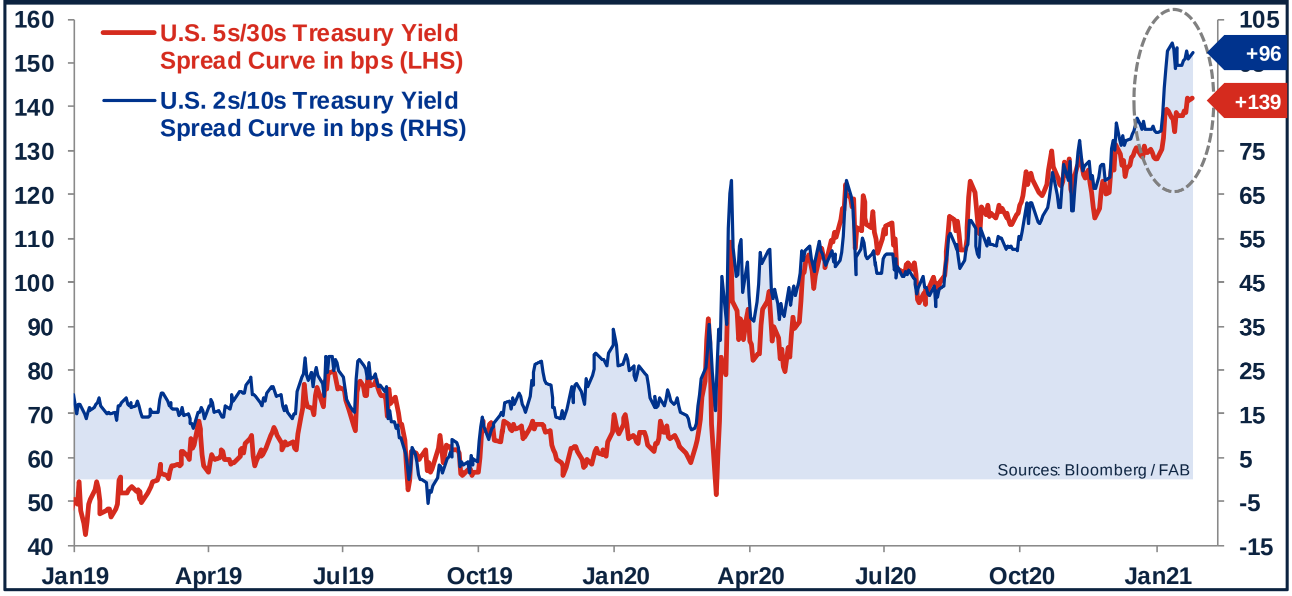


Rates market taper tantrum

The current subliminal message from the Fed - and indeed other major central banks around the globe - is that interest rates are set to remain well anchored for the foreseeable future, with base rates now widely fixed around the 0% bound. The broad assumption among investors is that rates will be 'low for longer' and it is this optimism that has driven the burst of euphoria across risk assets in recent months.

But with equities setting new historic highs on the back of this implied central bank 'put', we are cognisant that global markets will be highly sensitive to monetary policy rhetoric going forward. Moreover, the yield curve bear steepening trend that we have experienced over the past year – driven by the assumption of eventual economic recovery – but which has been restrained by central banks' quantitative easing efforts, would also be at risk of more dramatic moves if the Fed were to take a step back. As far as the Fed is concerned, any hint from Powell that he is looking to take the punch bowl away, would surely be punished by investors across rates and equities.We would conjecture that the market needs reassurance that the Fed currently plans to maintain its asset purchase program around the status quo ($120 billion/month); anything less could trigger a classic taper tantrum which we would expect to disproportionately impact the long end of the rates market.

Keeping the bear caged for now



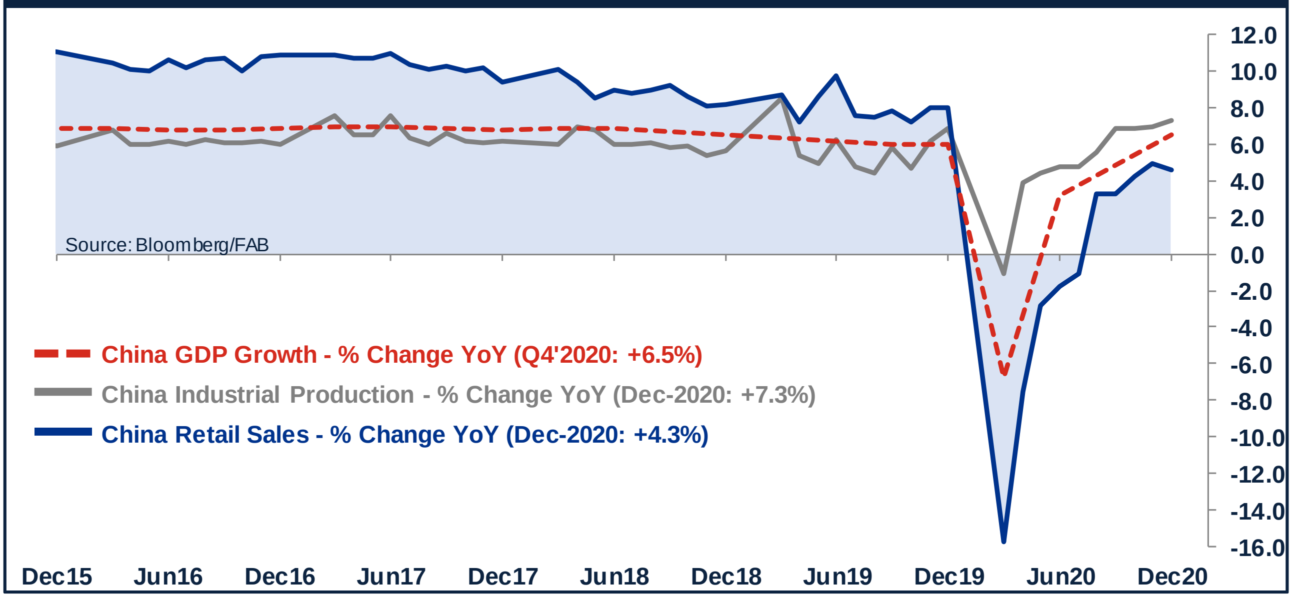
Brexit trade deal collapse

The 11th hour Brexit trade deal agreement struck between the UK and the EU in late December was interpreted by the market as removing near-term risk from the UK macro outlook. There was a notable sigh of relief that the UK had avoided crashing out of the EU without a deal and cable rallied accordingly to above $1.3700. However, many questions remain over the fabric of the 'deal' and the extent to which the compromises that were required from both parties to get the accord over the line will prove workable over the coming months. With UK macro conditions remaining anaemic at best, we would caution over the risk of a collapse of the Brexit deal. If this were to happen, economic recovery would be choked and cable would surely be hit hard.

Weaker-then-expected China growth

Post pandemic recovery is underway in China, as evidenced by the latest Q4 and December 2020 macro data, and this has been a fillip for global recovery aspirations. Any sign of weakening momentum in the China rebound story would be a severe shock for global market sentiment. There will be a very sharp focus on January 2021 and subsequent Q1 data as it is released.

The road to recovery



Global debt crisis

Covid-19 rescue fund spending, especially in developing economies, has followed a path of exponential growth. Estimates suggest that global debt increased by $15 trillion in 2020 in the fiscal fight against the pandemic and that it could extend to $277 trillion, or 365% of world GDP by the end of this year. This may be manageable while interest rates remain close to 0%, but as bear steepening of yield curves continues, implying a structural shift higher in debt servicing costs, so the financial burden of meeting interest obligations on the aforementioned debt could rapidly prove unsustainable. With several weaker nations having already defaulted in 2020, such an increase in financial distress, if it were to intensify, could be the trigger for a broader global debt crisis.

Corporate defaults

From the perspective of corporate fundamentals, we would caution that there is a risk in 2021 that authorities will struggle to contain and cushion the widespread financial stress caused by spikes in risk aversion as a result of deteriorating pandemic infections and mortality rates and that this could trigger widespread corporate bankruptcies. Amid more challenging financial conditions and vulnerabilities, financial crises could erupt in several countries.

Corporate earnings

There is a great deal of optimism baked into equity markets at current levels, with many bourses trading close to, if not at, record highs. This buoyancy is being fuelled by economic recovery assumptions and subsequent bullish forecasts for corporate earnings growth. With the Q4 2020 earnings season having kicked off on a solid footing, equity analyst consensus for FY2021 is now for (S&P500) earnings growth of over 20%, albeit that such a growth rate is flattered by the weak year-on-year base effect of the FY2020 recession. The key risk going forward therefore, is that if the pace and breadth of recovery should fail to meet expectations, or worse still a resurgent pandemic should lead to an economic double-dip, risk appetite and equity markets would likely be punished.

We continue to subscribe to the broader reflation story for 2021 overall, but at the same time recognise that those sectors that were disproportionately impacted during the economic malaise of last year – hospitality, airlines, retail and consumer discretionary – will likely be the laggards during the recovery. As global markets balance all the elements of the macro outlook, there is likely to be a greater sensitivity than usual to corporate earnings headlines."

Conclusion

The depth of the global recession that we experienced in early 2020, as a result of enforced Covid-19 economic lockdowns, was met with unprecedented fiscal and monetary stimulus. While the policy responses and the discovery of Covid-19 vaccines have fuelled widespread optimism that 2021 will be a far more favourable year, there are still several potential clouds on the horizon. We are not completely out of the coronavirus woods just yet. This is no time for complacency.

We remain optimistic, but also realistic. Our suggested top 10 macro risks for 2021 are offered as initial talking points, not firm predictions and the list is certainly not exhaustive. Everything centres around Covid-19 for now and government and central bank policy initiatives that might follow either an easing of the pandemic or a re-intensification of efforts to battle a resurgent virus. For now, with the global macro outlook looking brighter, there is light at the end of the tunnel that we hope is continued progress on the vaccination front and not a new damaging variant coming hurtling towards us. We believe that investors need to carefully hedge for some of the aforementioned challenges and obstacles that we could encounter in the near-term.

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