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Holger Schmieding, Chief economist | holger.schmieding@berenberg.com | +44 20 3207 7889

RAPID REBOUND IN 2021: BUT WHAT COULD GO WRONG?

Berenberg Macro View

Trade tensions contained, the pandemic is brought under control, Brexit will be sorted one way or the other. The economic outlook for 2021 is unusually positive for advanced economies and many emerging markets. After a still dark winter, spring and summer should be bright once seasonal factors help to contain the spread of the Sars-CoV-2 virus in the Northern hemisphere. Thanks to vaccines and other medical progress, Covid-19 will – hopefully – not come back to depress economic activity badly again next autumn. As a result, a rapid rebound from the 2020 mega-recession that gains momentum from April onwards, a calmer US trade and foreign policy and a record monetary and fiscal stimulus in the early stages of a new global cycle should add up to sustained strong economic growth and risk-on investment opportunities for 2021. But what could go wrong with this outlook?

As always life is full if risks. In the economic sphere, we have to keep an eye on four key risks.

First, confidence matters. Economic activity snapped back rapidly from the first wave of the pandemic. The Eurozone recouped almost the entire Q2 plunge in real GDP (-11.8% qoq) with a 12.6% qoq surge in Q3. Based on this experience, we look for a solid recovery next spring from the damage which the second wave of the Covid-19 pandemic will now inflict on economies in Q4 2020 and – to a lesser extent – in Q1 2021. But what if consumers and businesses, twice bitten by the pandemic, stay much more cautious for much longer after the second wave than after the first? While we cannot rule it out, we consider this unlikely. The second wave has come as less of a shock than the first wave. More importantly, the damage to economic activity and employment looks set to be much smaller than during the first wave. Helped by online sales, retail sales seem to be holding up reasonably well in Europe. Restrictions are less harsh than they were in March and April. In the US, economic activity will likely to continue to expand modestly throughout the winter. In the Eurozone, the Q4 drop in GDP (we project -3.4%) should be far below the Q2 calamity (-11.8% qoq). We thus look for confidence and activity to recover well from spring onwards from the comparatively mild blow. If the coming rollout of vaccines were to lift confidence significantly in early 2021 already, the rebound may gather pace before April already.

Second, the dark winter may leave scars. The number of insolvencies will likely surge in 2021. Despite a further decline in under- and unemploment, the number of people who have been out of a job for a year or longer – or who have not been able to enter the labour market at all – will rise in 2021. This could constrain the supply potential of economies. However, policy makers are well aware of the risk. We expect ongoing support from monetary and fiscal policy to contain the risks of such long-term hysteresis effects so that they do not hold back the pace of economic rebound by much.

Third, a premature removal of stimulus could weaken the recovery. So far, we see no sign that central banks and governments are backing away from their "whatever it takes" attitude in a

meaningful way. Instead, a major part of the monetary and fiscal stimuli announced in 2020 is still in the pipeline. Key central banks, notably the US Fed and the European Central Bank, have made it clear that they will err on the side of supporting the economic recovery more strongly for longer than in previous cycles. Expect the **ECB** to announce a significant expansion of its asset purchase programme and offer even more generous long-term refinancing to banks at its 10 December meeting. On the fiscal side, support will remain sizeable. The **EU** has given member states the green light for another sizeable fiscal stimulus in 2021. Despite a potential delay to some payouts, the EU's €750bn recovery fund will add to that. Whereas the size of a follow-up **US** fiscal package is unclear, it need not be as big as the 2020 stimulus because the labour market has already improved significantly. Even if the new support package – likely to be decided in January – falls short of $1trn, a separate long-term infrastructure spending programme will likely add to that over time. Both Democrats and Republicans support such a programme.

Fourth, an early surge in inflation could spoil the outlook, at least for markets. Our call that most of the advanced world as well as many emerging markets can enjoy the sweet spot of the new business cycle with rapid growth at low inflation and record support in 2021 rests on one fundamental assumption: we do not expect inflation to soar to such an extent as to force central banks into an early tightening of policy. Whereas core inflation will likely bottom out in the next few months in major parts of the advanced world, we expect inflation to rise only gradually thereafter. Slack in labour markets should prevent a major rise in wage pressures for the next two years. An inflationary consumer spending boom seems unlikely. In addition, after the mega-recession of 2020, central banks are more tolerant of inflation than they were before. They want financing costs to remain low until the recovery has advanced enough to reach the disadvantaged groups in the labour market. Central banks will allow some increase in bond yields. But if need be, they would would use verbal or actual intervention in markets to prevent an excessive rise in yields that could slow down the pace of the recovery. Central bank support will not last forever. In two to three years, central banks will need to and want to row back amid a further rise in inflation. This should not be an issue yet for 2021, however.

Beyond the economic risks, we need to watch politics: how stable is the Italian government (probably stable enough as long as Rome receives some EU grants to distribute); how serious is the threat that Marine Le Pen may win against Emmanuel Macron in 2022 in France (far too early to tell); what happens after Merkel in Germany in late 2021 (most likely similar policies pursued by different people, possibly in a conservative-green coalition); and will the EU's big €750bn pandemic support programme clear the final hurdles (most likely yes as the EU could find ways to circumvent objections of Poland and Hungary if need be). Outside the EU itself, Putin could always cause trouble, as may other aspects of geopolitics (China/Taiwan, North Korea, Iran, Turkey, etc). At the moment, these risks do not look acute enough to shape our economic and financial outlook for 2021. In addition, with Biden at the helm in the US, the risk of geopolitical accidents could be lower than it was under erratic Trump.

In addition, we have to watch the **medical situation** very carefully. Despite clear medical progress, negative surprises cannot be ruled out. We based our calls on the assumption that the pan-

demic will not be a dramatic drag on economic performance again next autumn. This is an assumption which we will need to monitor closely throughout 2021.

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Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7889
www.berenberg.com
holger.schmieding@
berenberg.com