25 January 2021

Periodical

Global Macro Jottings

Recovery focus

This week's focus is on the World Economic Forum (WEF) meetings and the IMF's latest update of its 'World Economic Outlook'. The FOMC concludes its regular policy meeting on Wednesday, as equity market investors react favorably to President Joe Biden's USD 1.9tn package, and the US GDP data for the fourth quarter of last year is published on Thursday.

Global equities are at record highs and the week has started with a risk-on theme out of Asia, with investors focusing on Asian tech stocks and upcoming IPOs. EM Economies saw more than USD 100bn of local currency outflows after the onset of the COVID pandemic last year, but then recovered quite significantly. The *FT* reports this morning that EM portfolio inflows into EM economies in the first three weeks of this month remained firm, at USD 17bn (USD 360bn in the last nine months of 2020). The BoA Fund Managers Survey found a record 62% of fund managers were overweight EM equities in the month.

The Chinese economy grew 2.3% last year, the only major economy to register positive GDP growth in 2020. Recent economic indicators remain positive and the latest reading on Chinese industrial profits growth features strong cyclical readings. President Xi Jinping speaks at the WEF this morning and might reflect on US-China trade tensions under the Donald Trump presidency, hoping for improved relations under President Biden. President Xi has his own economic challenges, which remain how to deleverage China's burgeoning debt, especially in the corporate sector, where rising bond defaults have been a key issue recently.

Balancing the challenge of debt deleveraging against securing sustainable economic growth is going to be difficult. However, the Chinese authorities appear to want some moderation in the credit cycle, as well as less stimulus from monetary policy. It is also worth noting that the appreciation in CNY has stalled, and the PBoC might want to see a period of exchange rate stability.

In its previous assessment of the global economy, published last October, the IMF warned of a "long, uneven and uncertain ascent" in establishing a meaningful economic recovery. Back then, the IMF forecast global GDP growth of 5.2% for this year, with China accounting for a third of that. Advanced economies were forecast to expand 3.9%, with EM economies showing GDP growth of 6.0%. The World Bank's recent Global Economic Prospects takes a more circumspect view of the global economic recovery and predicts just a 4% increase in global GDP for this year, which is still 5% (USD 4.7tn) below pre-pandemic projections. EM ex-China GDP growth is forecast by the World Bank at 3.4%.

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The World Bank noted the impact of the pandemic on investment and human capital in eroding EM growth prospects. More generally, the World Bank thinks that once the pandemic has subsided, the global economic landscape is unlikely to return to its previous state. The pandemic will leave lasting scars on productivity, including through its effect on the accumulation of physical and human capital in exacerbating the downward trend in potential GDP growth.

After this year's recovery in global GDP, the IMF expected global GDP growth to slow gradually to 3.5% over the medium term. The IMF projected cumulative output losses relative to pre-crisis levels of USD 11tn, climbing to USD 28tn over 2020-25. The IMF observed that EM economies were having to manage the crisis with fewer resources, as many are constrained by elevated debt and borrowing costs. The World Health Organization (WHO), in a report published today, warns that advanced economies will face a significant hit to their economies of up to USD 2.4tn in output losses (3.5% of their annual GDP) if the vaccine roll-out does not speed up.

The IMF also advised that the global easing of monetary policy should be complemented with measures to prevent a build-up in financial risks over the medium term (the IMF did not specify just what these measures might be). In other words, epic and unprecedented policy easing can come with a cost of potential financial instability. The IMF noted that global sovereign debt levels are at a record 100% of global GDP, but since last October, the debt–GDP ratios have increased further. While debt servicing costs are extremely low, this cannot be relied on to last, should inflation unexpectedly increase, causing government bond yields to increase. The World Bank notes that, while banking systems are generally well-capitalised, a wave of bankruptcies could erode bank buffers, putting some countries at increased risk of a financial crisis.

The World Bank says that EM government debt is to increase by 9% points of GDP in 2020, the largest increase since the 1980s, when EM economies experienced a series of debt crises. A new wave of global debt accumulation started in 2010 for the broadest-based debt increase in five decades. The World Bank highlights that previous waves of debt have ended with widespread financial crises, such as the Latin American debt crisis of the 1980's and the East Asia financial crisis in the late 1990s. These debt waves share similar characteristics of low interest rates and financialisation, accompanied by weak investment and slower growth. Over time, debt increases seem to be inversely correlated with economic growth i.e. the higher the debt, the slower economic growth.

The FOMC meeting this week is expected to keep US monetary policy on hold. More recently there has been some investor concern that the Fed might start to 'taper' the size of its balance sheet i.e. start to 'quantitatively tighten'. Investors will recall that the last time the Fed tried to 'taper', there was a sharp sell-off in US equities (December 2018) which compelled the Fed to resume loosening policy. Fed Chair Jerome Powell has pushed back against the notion of an early tightening of monetary policy, but investors are alert to signs of a pick-up in inflation, that is evident in service sector prices. Commodity prices are also generally firmer. Market-based measures of inflation expectations have been rising. Many Wall Street US GDP forecasts look for annualised GDP growth of 5-10% for the first and second quarters of this year in response to another round of fiscal reflation.

In addition, US financial conditions are ultra-loose and US equity markets are at record highs, with historically elevated valuations and margin debt. The Fed is in a trap of its own making. If it stops providing liquidity via QE, then equity markets face a stiff correction or crash, which could push any economic recovery back into recession. However, more monetary reflation on top of even more fiscal reflation puts financial stability at risk and leaves any prospect of 'policy normalisation' somewhat distant.

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Neutral	4	36.36%
Underperform	1	9.09%
Long	0	0.00%
Short	0	0.00%
Under Review	0	0.00%
	11	

Ratings Distribution for Investment Banking Relationships		
Outperform	3	54.55%
Neutral	1	36.36%
Underperform	0	9.09%
Long	0	0.00%
Short	0	0.00%
Under Review	0	0.00%
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Source: VTB Capital Research as at 31 December 2020

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