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Economic forecasts

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Third-quarter (Q3) rebounds in activity across developed economies were impressive, particularly in the US, where lockdowns were the least coordinated across states. Momentum has since faded, however, as Covid-19 infections reaccelerated, and a number of support programmes rolled off in the US. In considering how economies may fare, we set a framework around potential paths, then weighted the chances of V-, U- or L-shaped recoveries.

A V-shaped recovery, where an economy recaptures its closing 2019 GDP level by the end of 2021, seems increasingly likely in the US following the robust bounce in Q3, the acceleration of the vaccine rollout, and the promise of another sizeable fiscal package, now that the Democrats control the Senate. At this stage, end-2019 GDP levels returning by the end of 2022 in a U-shaped recovery, or later in an L-shaped recovery, seem more likely across Japan, Europe and particularly the UK. In the latter case, we expect scarring to be deeper in addition to the drag from Brexit.

Governments have stepped in with unprecedented levels of fiscal support, but relief programmes rarely capture all eventualities. Millions of jobs have been furloughed, and some lost for good as companies fall through the safety nets. Travel, entertainment and hospitality are among the hardest-hit sectors, and these will be the last to reopen as the vaccine rollout boosts confidence. We expect pent-up demand for services to drive growth in the second half of the year, leading to bouts of inflationary pressure, which central banks will likely look through.

Having successfully backstopped financial markets with huge quantitative easing (QE) programmes, central banks will continue to grow balance sheets over the coming quarters and these should stay elevated over the long term. Governments will need extended support to manage increased levels of debt, which will further weigh on the potential growth of economies, capping inflationary pressures.

The US: Brighter days ahead in a new normal

The hit from the Covid-19 shutdown came hard and fast. The worst of the contraction occurred early in the second quarter, but the initial bounce back was impressive. Rapid monetary and fiscal support arrested the slide, lifting financial markets and leaving households with additional liquidity even as unemployment rose. Given consumers' limited ability to spend on numerous 'contact' services, consumption of goods has surpassed pre-Covid levels.

Figure 1: US forecasts

	2019	2020	Current	(T) End 2021	(Cons) End 2021	(T) End 2022	(Cons) End 2022
GDP (year/year)	2.3	**-3.5**		**5.0**	4.1	**3.75-4.25**	3.5
Headline Inflation (year end)	1.8	**1.2**	**1.4**	**2.0**	2.1		
Core Inflation (year end)	1.6	**1.4**	**1.4**	**1.7**	1.7		
Official Rates (year end)	**1.5-1.75**	**0.0-0.25**	**0.0-0.25**	**0.0-0.25**	0.05		
10-year bond yield	**1.90**	**0.91**	**1.10**	**1.15**	1.30		
EUR/USD (year end)	**1.11**	**1.22**	**1.21**	**1.27**	1.24		
USD/JPY (year end)	**109**	**103**	**104**	**100**	102		
Earnings Growth	1.0	**-7.3**		**20-25**	20.7		

Source: Threadneedle Asset Management Limited, Bloomberg, January 2021. Notes: (T) = TAML forecast, (Cons) = consensus forecast * denotes interim change. Changes to Threadneedle forecasts: GDP 2021 5.0 from 3.3; Headline Inflation 2021 2.0 from 1.5; Core Inflation 2021 1.7 from 1.3; 10-year bond yield 2021 1.15 from 0.75; EUR/USD 2021 1.27 from 1.20.

City centres are witnessing the slowest recovery in mobility, as working from home remains a realistic and preferred option for many – a trend likely to be in place for some time. Increased remote-working is stimulating the desire for larger dwellings, which can be seen in rising rental vacancies in metropolitan areas and greater demand for housing in the suburbs. This shift is further fuelling a housing market that had shown marked improvement over the previous year or so, driven by low mortgage rates, easy credit conditions and high employment. While the recovery of over half of all job losses was initially swift, momentum then tapered off as Covid hospitalisations reaccelerated and some support programmes waned.

The outlook is brighter, however, now that the Democrats narrowly control the Senate, which opens the way to sizeable, additional fiscal stimulus. In conjunction with an increase in vaccine rollouts, the reopening of the service sector should see a surge in demand, funded by stimulus and a historically high savings rate. Growth should be robust enough to return the dollar level of GDP back to levels last seen in 2019 by year end. This increase in activity will no doubt lead to bouts of inflationary pressure, which the central bank has already indicated it will look through.

Continued support for the economy remains crucial. The Federal Reserve is acutely aware that the pandemic has disproportionately hit low-income, minority households. Chairman Powell has stated his intention to leave rates low for however long it takes to aid the repair. Support packages will be long term. The level of borrowing will reach previously unimaginable levels, further impeding potential growth and, in turn, capping inflation

Euro Area: Take-off delayed

The growth momentum achieved during the Q3 sweet spot in between Covid spikes could not be maintained into the final quarter. Growth at the start of 2021 also looks likely to fall victim to the viral upsurge and the mandated closure of large parts of many Eurozone economies. With the vaccine in sight, but with the initial rollout beset with delays and supply difficulties, governments are likely to extend lockdowns through much of Q1. Though the impact of restrictions on activity seems somewhat milder than during April and May last year, the risks around the outlook for the first half of the year are skewed to the downside as the consumption recovery is postponed.

Figure 2: Euro area forecasts

	2019	2020	Current	(T) End 2021	(Cons) End 2021	(T) End 2022	(Cons) End 2022
GDP (year/year)	**1.2**	**-7.2**		**4**	4.3	**3.75-4.25**	3.9
Headline Inflation (year end)	**1.2**	**0.3**	**-0.3**	**1.0**	0.9		
Official Rates (year end)	**-0.5**	**-0.5**	**-0.5**	**-0.6**	-0.5		
10-year bond yield	**-0.2**	**-0.5**	**-0.6**	**-0.25**	-0.5		
EUR/USD (year end)	**1.11**	**1.22**	**1.21**	**1.27**	1.24		
EUR/JPY (year end)	**122**	**126**	**125**	**127**	126		
Earnings Growth	**2.4**	**-26.6**		**35**	31.8		

Source: Threadneedle Asset Management Limited, Bloomberg, January 2021. Notes: (T) = TAML forecast, (Cons) = consensus forecast * denotes interim change. Changes to Threadneedle forecasts: EUR/USD 2021 1.27 from 1.20; EUR/JPY 2021 127 from 120.

The dichotomy between the manufacturing and services continues to widen, as those sectors most exposed to mobility restrictions fall further behind. This is especially apparent in Germany, where the manufacturing PMI and Ifo business climate measures are both consistent with a robust recovery, aided by a rebound in export orders centred in Asia. In services, restrictions on travel will weigh heavily on economies such as Spain if they are extended beyond Q1.

The recovery in global trade offers hope for levels of Eurozone investment, although poor corporate profits and tightening financing conditions for businesses are likely to keep capex well contained; after an upsurge in Q3, net lending to non-financial corporations has all but stopped.

While household finances are in good shape in aggregate with high savings rates, the fate of the consumer may hinge on the labour market's ability to reabsorb those transitioning from short-time work schemes: the risk of sectoral misallocation remains high.

Inflation should recover from historic lows in the coming months mainly thanks to base effects. Demand-led price pressure remains elusive and should keep the ECB's policy stance highly accommodative.

UK: A cyclical boost ahead but structural headwinds await

The UK lags further behind in the global recovery to pre-pandemic GDP levels, as it sits in the middle of yet another economically punitive lockdown. More positively, the rapid approval of vaccines in the UK, along with a healthy supply pipeline and successful logistical delivery, mean it looks set to be the first major country to immunise the entire population. This should result in a wider and earlier end to Covid-related social and economic restrictions in the UK, and allow the country to make up some of the economic ground lost to peers.

Figure 3: UK forecasts

	2019	2020	Current	(T) End 2021	(Cons) End 2021	(T) End 2022	(Cons) End 2022
GDP (year/year)	**1.4**	**-10.6**		**4.0**	4.6	**5.5-6.0**	5.9
Headline Inflation (year end)	**1.8**	**0.9**	**0.3**	**1.5**	1.5		
Official Rates (year end)	**0.75**	**0.1**	**0.1**	**-0.1**	-0.05		
10-year bond yield	**0.85**	**0.20**	**0.3**	**0.25**	0.45		
GBP/USD (year end)	**1.31**	**1.37**	**1.35**	**1.40**	1.38		
EUR/GBP (year end)	**0.85**	**0.89**	**0.89**	**0.91**	0.90		
Earnings Growth	**-4.7**	**-36.5**		**37**	38.1		

Source: Threadneedle Asset Management Limited, Bloomberg, January 2021. Notes: (T) = TAML forecast, (Cons) = consensus forecast. Changes to Threadneedle forecasts: GDP 2021 4.0 from 5.0; GBP/USD 2021 1.40 from 1.35; EUR/GBP 2021 0.91 from 0.89.

However, several factors leave us concerned that this bounce back will be less complete than elsewhere:

1. Remote working – The UK ranks second globally, in terms of the proportion of jobs able to be done remotely. We think that a return to pre-pandemic working patterns is unlikely and more remote working is here to stay, to the detriment of office space, city centres and the ancillary services that have been so badly affected.

2. An uneven split of incomes – Savings rates in the UK have gone up, but the data suggests this has come solely from people on higher incomes, who have a lower propensity to consume. Meanwhile, those with earnings less than £55,000 a year have seen savings decline over the course of the pandemic. This indicates a mixed outlook for consumption.

3. Brexit – The EU-UK trade agreement imposes significant non-tariff barriers on exporters and the shipping data we have shows a significant drop in the volume of trade, as well as an extremely large increase in the number of empty lorries returning to the continent. A hit to net exports in 2021 seems likely.

4. Migration – 2020 was a record year for redundancies, yet the official unemployment rate moved only marginally higher, indicating a large drop in the labour force. It has been suggested that as many as 1.3m non-UK nationals may have left the UK, many of whom may find it hard to return under the post-Brexit immigration regime.

Following the rollout of vaccines, there will be a period this year when the UK economy will likely outperform , fuelled by an earlier reopening. However, the structural and idiosyncratic factors faced by the UK will ultimately cap this growth and keep us cautious on the outlook.

Japan: Heading into a second domestic dip

We continue to stick to our above-consensus 4% GDP forecast for 2021. This forecast can still be met despite an anticipated contraction in Q1, due to ongoing support from external demand. Indeed, leading indicators such as machine-tool orders continue to trend higher and consumers are in a strong financial position to lead a domestic demand recovery when the current SoE (state of emergency) is lifted.

Figure 4: Japan forecasts

	2019	2020	Current	(T) End 2021	(Cons) End 2021	(T) End 2022	(Cons) End 2022
GDP (year/year)	**0.7**	**-4.8**		**4.0**	2.6	**2.5-3.0**	1.9
Headline Inflation (year end)	**0.5**	**0.0**	**-0.9**	**0.5**	0.1		
Official Rates (year end)	**-0.1**	**-0.1**	**-0.1**	**-0.1**	-0.06		
10-year bond yield	**0.0**	**0.0**	**0.06**	**0.0**	0.1		
USD/JPY (year end)	**110**	**103**	**104**	**100**	103		
EUR/JPY (year end)	**126**	**126**	**125**	**127**	126		
Earnings Growth	**-14.6**	**-11**		**30**	28.3		

Source: Threadneedle Asset Management Limited, Bloomberg, January 2021. Notes: (T) = TAML forecast, (Cons) = consensus forecast. Changes to Threadneedle forecasts: EUR/JPY 2021 127 from 120.

While Japan's management of Covid-19 continues to be one of the best in the world, cases and deaths have spiked triggering the announcement of a second SoE. This has cut off the mobility index and the domestic demand recovery that had been under way in the second half of 2020. Prime Minister Suga has been criticised for acting too late in terms of increasing restrictions and his approval rating has fallen below his disapproval rating.

Our base case is that he survives this, but his handling of the vaccine rollout and the Olympics will be key things to watch here. In contrast to the softening domestic indicators, trade data remains encouraging and points to another strong contribution by net exports to GDP in Q4. In addition, machine-tool orders, which lead global and Japanese industrial production by around one quarter, continue to trend upwards.

Although domestic demand is anticipated to drag the economy into contraction again in Q1, it is worth noting that, as in other developed markets, policy support has prevented disposable income taking the usual hit over this recession. This sets up the potential for well-funded consumers to lead a strong recovery once restrictions are lifted. Suga's key policies such as digitalisation and lowering emissions could also lend a boost to domestic activity through capital investment. Japan's labour market remains tight, with the jobs to applicant ratio increasing again, and having remained above one throughout this crisis so far.

However, as previously flagged, wages rather than the employment level that tend to move over the economic cycle in Japan. These usually lag earnings, which also appear to have bottomed, suggesting that the labour market could potentially start to act as a tailwind rather than a headwind from here.

Overall, we expect a fall in domestic activity to push the economy into contraction in Q1, which will likely be less severe than last year thanks to ongoing support from the external component. Once restrictions are lifted, we expect a strong rebound in domestic activity to coincide with the ongoing strength in the external component of the economy.

China: No sharp shifts in either direction in monetary policy

China is expected to have a positive tilt this year. The Communist Party of China will commemorate its 100th anniversary in July, which generally means Beijing will do its best to avoid any negative news domestically if possible. Overall, growth is unlikely to significantly outperform or underperform expectations, as the government looks to ensure domestic consumption (as an indicator of people's livelihoods) returns to normal while juggling its concerns over China's long-term debt sustainability.

Figure 5: China forecasts

	2018	2019	2020	(T) End 2021	(Cons) End 2021	(T) End 2022	(Cons) End 2022
GDP (YoY)	**6.7**	**6.0**	**2.1 (cons)**	**8.0**	8.3	**5.5**	5.5
CPI (YoY)	**2.1**	**2.9**	**2.5**	**1.2**	1.6	**1.9**	2.3
Current Account (% 0f GDP)	**0.2**	**1.0**	**1.7 (cons)**	**1.4**	1.3	**1.1**	1.0
Fiscal Account (% 0f GDP)	**-4.1**	**-4.9**	**-6.7 (cons)**	**-5.8**	-5.8	**-5.0**	-4.3
Official Rates (Year End)	**2.6**	**2.5**	**2.2**	**2.2**	2.3	**2.4**	2.5
10-Year Yield (Year End)	**3.3**	**3.1**	**3.2**	**2.9**	3.3	**3.2**	3.2

Source: Threadneedle Asset Management Limited, Bloomberg, January 2021. Notes: (T) = TAML forecast, (Cons) = consensus forecast.

To date, China's rebound has led the rest of the world, but growth has not been broad-based across categories. The bulk of the growth has been driven by real-estate investments and pandemic-related exports, while manufacturing investments and retail sales have lagged. As the world creeps closer towards vaccination-driven herd immunity, demand for pandemic-related exports is likely to wane. Policymakers have also recently implemented rules to address the increasing debts of property developers and mortgages. As such, the economy is dependent on manufacturing investment and retail sales to play catch-up. Manufacturing investment is likely to achieve this given increasing industrial profits and low inventories. However, catering services sales remain uncertain, held back by the recent resurgence of Covid-19 into the Chinese New Year.

Policymakers also needs to contend with their commitment to managing China's debt composition and debt ratio. Easy monetary policy spurred off-balance sheet lending and structured deposit growth between March and June 2020 and saw the People's Bank of China (PBoC) withdrawing liquidity from the system, which quickly led to higher money-market rates, bond yields and also corporate defaults. The PBoC was quick to re-inject liquidity into the banking system to help stabilise it. A similar cycle was repeated in November 2020.

Given the still uncertain growth environment and recovery in livelihoods, the PBoC is unlikely to want to be the cause if this current recovery derails. As such, sharp shifts in either direction in the PBoC's monetary policy are unlikely. In addition, the official MLF rate will stay stable, despite more targeted movements via open market operations or relending to keep liquidity in the banking system stable.

Emerging markets: Vaccine access/rollout, the differentiating factor

While initially constrained by a lack of fiscal space, emerging marktets (EM) excluding China have seen a rapid improvement in growth momentum in recent months led by the manufacturing sector as developed-market fiscal stimulus increased demand for EM goods. This has led to growth in Asia ex Japan and CEEMEA outperforming Latin America.

Figure 6: EM forecasts

	GDP		GDP		CPI		CPI		Policy Rate		10-year Yield	
	2021		2022		2021		2022		2021		2021	
	T	Cons	T	Cons	T	Cons	T	Cons	T	Cons	T	Cons
Brazil	3.5	3.5	2.0	2.5	4.0	4.9	3.5	3.5	4.0	5.3	8.0	7.5
Mexico	3.5	3.5	2.3	2.5	3.0	3.5	3.0	3.5	3.75	3.8	5.4	6.1
China	8.0	8.4	5.5	5.5	1.2	1.6	1.9	2.3	2.2	2.8	2.9	3.2
India	-7.8	-9.0	11.0	9.2	6.2	6.4	4.4	4.6	4.0	4.5	6.0	6.0
Russia	3.0	3.0	2.5	2.5	3.5	3.8	3.5	3.8	4.0	4.9	5.5	6.0
Turkey	3.25	3.7	4.5	4.1	10.0	12.2	10.0	10.0	15.0	14.3	12.5	14.4

Source: Threadneedle Asset Management Limited, Bloomberg, January 2021. Notes: (T) = TAML forecast, (Cons) = consensus forecast. Changes to Threadneedle forecasts: China GDP 2021 8.0 from 8.2; India GDP 2021 -7.8 from 8.0; Turkey GDP 2021 3.25 from 3.5; Brazil CPI 2021 4.0 from 3.3; Mexico CPI 2021 3.0 from 3.5; China CPI 2021 1.2 from 1.7; India CPI 2021 6.2 from 4.0; Russia CPI 2021 3.5 from 3.0.

Growth across EMs is expected to recover further as vaccines become available, with potential upside from the recent improvements in commodity prices and trade. Vaccine access/rollout may be a differentiating factor in 2021/22 across different countries, not only from a domestic demand recovery perspective, but also from an external demand perspective. EM countries with a higher export dependency on developed markets that are rolling out vaccinations faster will benefit more quickly.

As domestic demand improves, so, too, will imports, which will see current accounts “normalise” this year from the surpluses seen in 2020 due to weak domestic demand. However, the normalisation should be slow, given that EM domestic demand recovery is still expected to lag developed markets.

Furthermore, the remaining monetary and fiscal policy space in EMs is increasingly limited by low or negative real rates and high leverage. The monetary policy response has been strong, with many EM central banks easing rates as growth and inflaton rates collapsed. However, 2021 will be less straightforward for policymakers, with non-core inflation rising (while transitory) due to tradables (increases in food and commodity prices) and pass-through from FX depreciation, in addition to low base effects from 2020. While transitory, some countries see a higher degree of sensitivity for inflationary expectations to feed through into actual inflation.

EMs have also experienced large fiscal deteriorations in 2020, where large fiscal deficits are coupled with rising debt to GDP ratios, especially as growth slumps. Liquidity positions have been flattered by both market access and multilateral support given the value put on survival, but differentiation is starting to increase as medium-term growth and fiscal trajectories are reassessed as vaccines are rolled out.

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