Video Transcript: Global Macro Webcast – 2Q 2021

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The pandemic has dominated investment trends for over a year and will continue to for a while. Looking through the admittedly narrow lens of the macroeconomy, there have been two phases to the public health crisis, each marked by the trajectory in world gross domestic product (GDP).

The first macro-phase was the bust, which ended last June. The biggest, fastest free-fall in modern economic history was caused by fear and worldwide government lockdowns of people and businesses. Economically devastating, it also proved to be the shortest-lasting contraction in modern history.

The second phase was the V-shaped global recovery, which started a year ago and probably ended this quarter. Real GDP came flying out of the economic hole created during the first phase, pulled up by re-openings and propelled by staggering and coordinated monetary and fiscal reflation back to pre-pandemic levels of activity.

China's real GDP was the first to return to pre-pandemic levels last October. The U.S. achieved this milestone during the second quarter. Europe is close behind. The world economy looks set to finish 2021 on a strong note with growth tapering off.

Capital markets have followed this sequencing to the letter. After bond yields fell sharply during the bust, they returned to pre-pandemic levels first in China last August, then the U.S. in March, and finally mid-May for Europe.

A third phase, again led by the trend in GDP, is unfolding. The challenge to discerning the trajectory of GDP for this phase is the forces driving it. The first two phases created some massive distortions in the economic and compositional profile of the global economy and macro policy. And how these distortions evolve will determine phase three. What's not obvious is whether they are permanent or temporary or how fast or slow they unwind.

For example, here are 6 major distortions:

1. We know global fiscal policy is set for a major contraction from last year's extraordinary stimulus. China has already cut back. The Organisation for Economic Cooperation and Development (OECD) projects a fiscal impulse of -3% of GDP across the association. In the U.S., the fiscal cliff has arrived and could turn out to be as big as 5% of GDP.
2. Global monetary reflation has already peaked and should also retreat from the extraordinary situation from last year. Several emerging countries have already raised rates. There has been no M1 growth in China since October, the annual change in its credit impulse has gone negative and is dragging down the global credit impulse. (**CHART 1)** And the Federal Reserve (Fed) has started the conversation about tapering.

3. Inflation has been distorted by the supply-side damage caused by the pandemic colliding with re-opening demand pressures. It is unclear how long-lasting these imbalances may persist. But the big increases in energy and commodity prices lifting inflation normally act as a drag on activity by depressing real incomes.
4. Another distortion is the U.S. labor market. The labor force has fallen sharply during the pandemic, and it is unclear whether this is a short- or long-term problem.
5. And again in the U.S., the balance between spending on goods and services is anomalous. Personal consumption expenditures on goods have risen almost 20% above pre-pandemic levels while personal spending on services remains 7% below. It is possible that a pivot back to services as the world emerges from the crisis could slow spending on goods, which would affect the demand for commodities as well as China's recovery, which has benefited greatly from goods exports.
6. Perhaps the biggest anomaly of them all is private sector savings, which have risen sharply around the world. Excess savings was cited as a cause for low nominal and real interest rates in the pre-pandemic world. If valid, that problem got much worse during the pandemic. In the U.S. alone, there is an estimated $2.5 trillion in cumulated savings held mainly by high- and middle-income earners and a trillion dollars in corporate cash holdings. There is $3.6 trillion more money in M2 bank deposits than there was before the pandemic. (**CHART 2)** This amounts to 16% of GDP, an extraordinary source of inflationary firepower *if* it were to be deployed on spending. The probability of a hot 2022 would increase significantly if some of this money were to be spent and households were to re-leverage their balance sheets.

So as these distortions evolve or unwind, what will phase three look like?

- Will the world run hot enough that GDP flies through inflationary levels of potential?
- Or, will we get a soft landing with GDP's trajectory converging with the pre-COVID-19 trend?
- Or, will we get a harder landing with GDP leveling out below potential?

At the moment, markets seem to be pricing in a soft landing, but unfortunately, there is no post-pandemic roadmap to read from as a guide on which way things will play. China is probably well advanced in stage three, so it's worth noting what's going on. The authorities supported companies rather than providing relief income to people, and they retreated from stimulus measures as soon as the pandemic was brought under control. So far, the household savings rate has not retreated, economic surprises have been negative, and at this juncture, trends in social credit suggest slower growth this year and into 2022. Producer price inflation is soaring because of commodity prices, but consumer price inflation is stable. Bond yields have been drifting lower since November, the Shanghai Composite is up less than 5% since August, and the authorities don't want a stronger currency.

All of this suggests that a "hot" macro outcome for phase three requires a significant private sector spending agenda, particularly with China coming off the boil and assuming no lingering after-shocks from the pandemic or its variants. With the Fed struggling to keep nominal short rates from going negative and the dollar stable, the latter has not arrived, yet.