Monthly Macro Insights

February 2021

Rothschild & Co
Asset Management

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The launch of vaccination campaigns and additional policy measures announced at the end of 2020 – notably in the US and Japan – have raised hopes of a turnaround in the recovery later this year after the expected soft patch in Q1 2021. However, new variants of the virus, logistical problems with vaccine distribution and uncertainty about take-up suggest caution. Meanwhile, the rise of inflation could cause bouts of volatility in financial markets.

The world is in the grips of the second wave of the COVID-19 pandemic. New cases and deaths recently reached record highs, forcing several governments to impose tighter restrictions, although the health situation has started to improve in some countries.

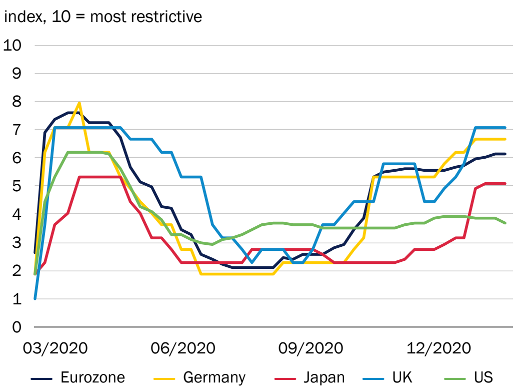
In the absence of timely and broad-based official data regarding the impact on the economy, economists have relied on alternative high-frequency measures to track growth, in part based on Google mobility data. Through the first three quarters of last year, these indicators proved useful in tracking global growth momentum. However, the link between mobility and GDP growth has weakened recently as restrictions are impacting activity in a more limited manner.

Germany is an emblematic example of a striking contrast between a sharp drop in mobility producing only a small drag on economic activity. Flash estimates showed German GDP increased 0.1% q/q in Q4 2020, while GDP in Spain (0.4%) and France (-1.3%)[(1)] also surprised to the upside, even though each of the countries was in varying stages of lockdown.

In fact, several businesses hit hard by coronavirus-related restrictions, shutdowns and customer unease seem to have adapted to the new normal by creating entirely new services, shifting how they deliver products or replacing in-person appointments with video conferences.

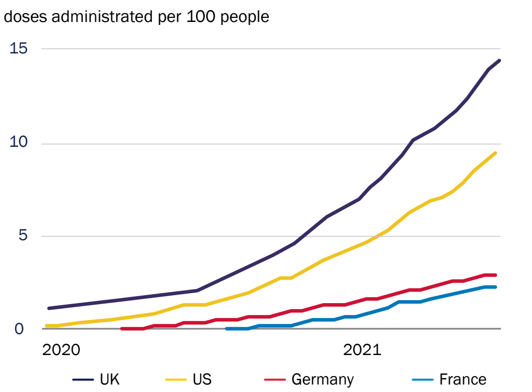
Although the relationship between mobility and growth is shifting, it remains nonetheless a relevant indicator when assessing trends in global activity.

World - Covid-19 restriction rating



Source: UBS, Rothschild & Co Asset Management Europe, February 2021.

World - Covid-19 vaccination



Source: OurWorldinData, Rothschild & Co Asset Management Europe, February 2021.

(1) Source: Eurostat, 29/01/2021.

The trajectory of the latest monthly data clearly points to a loss of momentum at the end of last year.

As mobility plummeted and both US and European consumers pulled back into their homes, retail sales dipped in November. The drop in US December private service-sector employment and global Markit business confidence index in January are another indication of the broader imprint of the economic consequences of the second wave.

Yet, the sharp slowdown is expected to give way to rising momentum in Q2 2021 as vaccines become more readily available, allowing contact-intensive activity to strengthen and pent up demand to roll in.

After a slow start to the global vaccine deployment, investors are now debating how fast advanced economies can vaccinate the most vulnerable and start returning to normality. Governments are expected to probebly start lifting restrictions once the most vulnerable 20%-25% of the population are vaccinated, which might be reached by March in the UK, April in the US and May in continental Europe and Canada.

However, inequalities are likely to grow across countries as the strength of the recovery will depend, among other things, on the extent of domestic disruptions to activity – which is related to the structure of the economy and its reliance on contact-intensive sectors – and on the effectiveness of policy support to limit persistent damage.

In its latest World Economic Outlook, the IMF predicted global GDP would return to its 2019 level by the end of this year. Yet, China, and to a certain extend the US, explain most of this return to square one, whereas most countries will still exhibit a significant loss in output two years after the shock.

Furthermore, uncertainties regarding the vaccines remain high as widespread hesitancy could hamper vaccine take-up. Immunity could also turn out to be shorter than anticipated, while new variants – from the UK, South Africa or Brazil – remain a wild card. Were the recovery to be delayed, liquidity pressures could re-emerge and insolvencies could rise and become rampant, probably entailing repricing of risk in credit markets and a tightening of financial conditions.

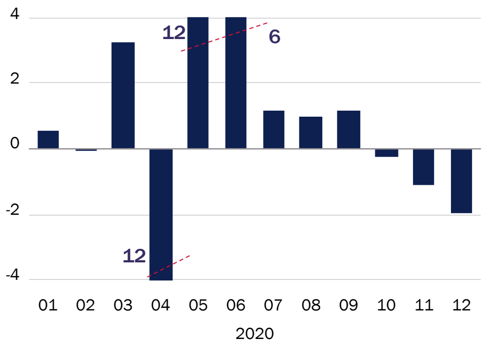
In this still highly uncertain environment, monetary policy should remain very accommodative. As expected, the Fed has kept its monetary policy steady and maintained its current guidance and pace of asset purchases, i.e. USD120bn per month, as it acknowledged that the recovery has moderated in recent months, especially the labour market.

During his press conference, Chair Powell stressed downside risks to the economic outlook and reiterated it was premature to contemplate tapering, implying that Fed policy changes remain a long way off. He also downplayed significant price increases in the housing market, noting that some of the tightness in the resale market that has led to price increases is likely a passing phenomenon. Yet, if that uptrend were to continue, the Fed might find itself between a rock and a hard place, especially as financial markets' valuations are perceived as frothy and inflation will start to rise.

Indeed, price pressures are expected to be volatile in 2021. Over the past weeks, inflation reports

US - Retail sales

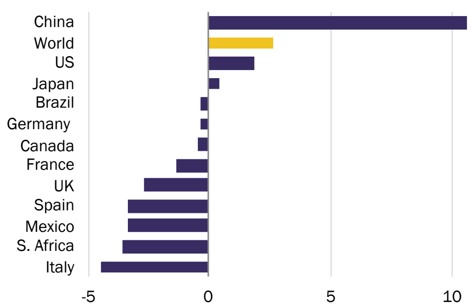
in %, m/m, ex volatil components



Source: Macrobond, Rothschild & Co Asset Management Europe, February 2021.

World - GDP gap

in %, Q4 2019 vs Q4 2021



Source: IMF, Rothschild & Co Asset Management Europe, February 2021.

from the US, Germany, and Spain have all surprised to the upside. Turbulent inflation data is likely to continue, and to distinguish between signal and noise on an expected gradual reflationary path will undoubtedly cause debate among investors. Price levels will be pushed higher in the first part of 2021 given the large drop at the start of the pandemic, with energy being one of the usual suspects, making the year-over-year comparison favourable.

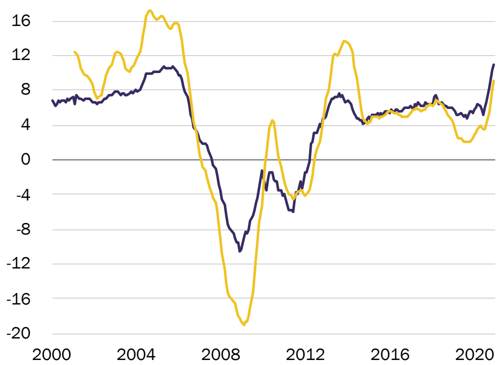
In the Eurozone, this bounce is being reinforced by the removal of Germany's VAT cut and the introduction of a carbon tax in January, as well as the reweighting of the harmonised basket away from sectors where demand – and prices – are depressed.

What's more, global manufacturers continue to face COVID-related supply constraints (e.g. shortage of truckers and dockworkers, as a result of which freight ships have formed traffic jams in ports across the US and the EU) and are also facing uncertainty, particularly regarding the policies of the new Biden administration and the handling of the post-Brexit new procedures. While this year's economic recovery is likely to be focused on services, especially in the travel, leisure, hospitality, entertainment-related spending, there is also a potential for upward pressure in services inflation.

However, even with the anticipated growth rebound in 2021-22, output gaps are not expected to close until well after 2022. Consistent with persistent negative output gaps, still elevated unemployment rates and significant underutilisation in the labour market, inflation is thus likely to remain subdued. Its volatility might nonetheless spoil investors' optimistic scenario as financial markets may try to push bond yields higher, especially if they interpret transitory inflation rises as a sustained surge. In fact, looking ahead, one of the main challenges will be exiting extreme stimulus without disrupting financial stability. ■

US - Housing prices

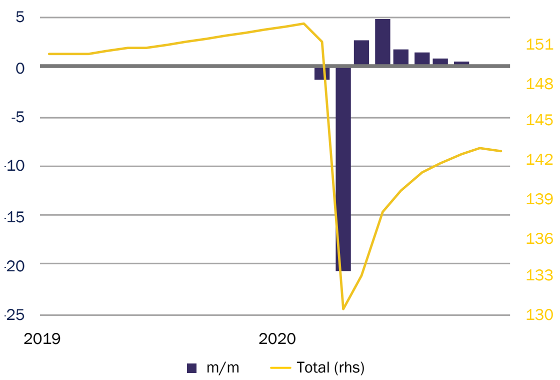
index in %, y/y



Source: Macrobond, Rothschild & Co Asset Management Europe, February 2021.

US - Job creation

in million



Source: Macrobond, Rothschild & Co Asset Management Europe, February 2021.

Performance of the indices and interest rate levels

	Price as of 29/01/2020	1 month % change
Equity markets		
CAC 40	5 399	-2.7%
Euro Stoxx 50	3 481	-2.0%
S&P 500	3 714	-1.1%
Nikkei 225	27 663	0.8%
Currencies		
EUR/USD	1.21	-0.7%
EUR/JPY	127.13	0.8%

		Price as of 29/01/2020	1 month bp
Interest rates			
3 M	Eurozone	-0.62%	14
3 M	United States	0.05%	-1
10 Y	Eurozone	-0.52%	5
10 Y	United States	1.07%	15

(1) Basis point.
Source: Bloomberg, data as of 29/01/2020. Performances in local currency.
Past performance is not a reliable indicator of future performance and is not constant over time.

About Rothschild & Co Asset Management Europe
As the specialised asset management division of the Rothschild & Co group, we offer personalised asset management services to a broad client base of institutional investors, financial intermediaries and distributors. Our development is focused on a range of open-ended funds, marketed under four strong brands: Conviction, Valor, Thematic and 4Change, and leveraging our long-term expertise in active management with conviction as well as in delegated management. Based in Paris and established in 10 European countries, we manage more than 21 billion euros and employ nearly 170 people. More information at: www.am.eu.rothschildandco.com

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