BARINGS INVESTMENT INSTITUTE

October 2021

The Brave New World

MONTHLY MACRO DASHBOARD

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October Outlook – The Brave New World

Supply chain disruptions persist, making the global reopening much less smooth than we expected when effective COVID vaccines were first approved earlier this year. Contagious variants still weigh on activity, and vaccination levels in major emerging markets have progressed only marginally. An energy price shock has added to the unpleasant mix.

While wage and price expectations remain well-anchored and base effects point towards inflation normalizing over the next few months, there's no denying that uncertainty over its future path has risen. Periodic bouts of anxiety have hit investors who are still unsure just when disruptions will dissipate and how transitory inflation will prove to be. **This is no longer the "Best of All Possible Worlds!"**

China's recovery also faces challenges. The government continues to restrict overinvestment in real estate and environmentally damaging export industries while trying to boost domestic purchasing power and consumption. This has sparked fears of a property market slowdown and triggered energy shortages that weigh on output. New restrictions in the tech sector have soured investment sentiment, too. It all looks managed, but it is still a managed slowdown that will affect the post-pandemic global recovery.

Our central scenario for the next 12-18 months still envisions a period of **limited inflation pressures and strong growth**. We call it a **Brave New World** and assign it a 60% probability. All of the ingredients for a lasting expansion (healthy household and corporate balance sheets, high consumer confidence and saving buffers, buoyant investment plans, and supportive policy) remain in place. But it may take months for more normal supply chains and China's slowdown to stabilize.

We also recognize that the recovery will bring **inflation that is higher than recent averages**. Central banks will likely wait for disruptions to dissipate without moving to raise rates prematurely, but tight supply of goods in some markets and ample slack in others will continue to deliver a confusing inflation picture until supply chains normalize over the next few months.

As disruptions and energy shocks subside in the next two quarters, our scenario will be favorable for risk assets, credit, and private markets. Emerging Markets should do well as vaccines finally contain COVID fears. Demand will be marginally slower and new post-pandemic patterns will emerge. Money will be marginally more expensive and investment choices will require a sharper eye to identify balance sheets and business models that can adjust.

The central risk to this scenario involves disruptions that last longer or high energy prices that persist. In this case, either investors will start pricing in persistently higher inflation or policymakers will be forced into brisk rate hikes. Or both. **Markets challenging the Fed's credibility, a sharp rise of short-term rates, dwindling confidence, and an equity market drop bring all the ingredients of a Perfect Storm.** This scenario would eventually turn disinflationary just as the "Stagflationary" 1973 oil shock did, but only after a fresh bout of inflation, causing financing conditions to tighten and ultimately a sharp slowing of growth, towards the end of next year. Inflation poses little risk in Europe or Japan, but U.S. price dynamics admittedly look less benign and predictable, creating risks for Fed policy and market expectations more globally. We thus attach a 30% probability to this scenario.

Both of these scenarios entail a departure from everything the world has experienced since at least 2008, when declining growth and inflation rates built a case for "secular stagnation." Headwinds to long-term growth from demographics, technology, and globalization persist and may return faster than we expect. For now, however, we keep the odds of the **Gravity Prevails** scenario, in which government bonds look like the best haven, at 10%.

-- Matteo Cominetta

What Changed in September

WHAT'S NEW

- **Energy prices jumped** more than expected
- **Inflation is proving stickier**; also driven by higher food prices in EMs where they compose a large share of the consumer basket
- **Consumer confidence is weakening** in Europe, the U.S., and China
- **U.S. Q3 growth is burdened by Delta**
- **Brexit disruptions are weighing on inflation**
- **New downside risks to Chinese growth** come from regulatory tightening and energy shortages
- **Japan's new Prime Minister Fumio Kishida** brings new fiscal focus on redistribution

WHAT WE LEARNED

- **Supply side disruptions** have proven more persistent and inflation anxiety has increased
- **Central banks are responding to inflation** in most EMs, Australia, and New Zealand. The Fed is on track to begin taper before year-end and the Bank of England is ready to act
- **Growth uncertainty** has increased; many workers remain on the sidelines for now
- The **Delta wave** is receding as the world learns to live with COVID

WHAT WE ARE HEARING FROM OUR TEAMS

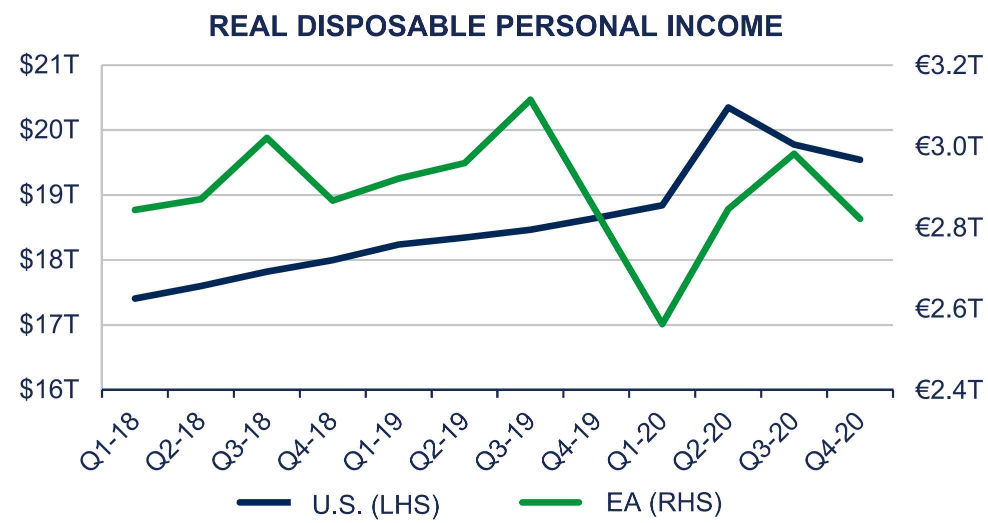
- Valuations look more attractive in **IG**
- Uncertainty around inflation and growth may weigh on **HY**
- **Equities** are reviewing portfolios for the "green transition"
- China's property selloff presents opportunities in **corporate bonds**
- Strategies that were underweight energy have disproportionately underperformed

WHAT WE ARE WATCHING

- **Vaccinations rollout** in EMs
- The speed of **U.S. savings deployment** and spending patterns, particularly the recovery in services
- The impact of inflation pressures and wages on **corporate margins and earnings**
- **China's slowdown management** by the government
- U.S. Congressional action on infrastructure spending and the **debt ceiling** in December

Gas Shocks Hurt, But Not For Long

Impact of a 100% Increase in Energy Prices on Household Consumption								
	U.S.				EA			
	Direct Effect	Indirect Effect	Total	GDP Impact	Direct Effect	Indirect Effect	Total Impact on C.	GDP Impact
Average	-0.9%	-0.2%	-1.1%	-0.8%	-1.6%	-0.3%	-1.9%	-1.5%
Bottom 20%	-1.8%	-0.4%	-2.2%		-2.3%	-0.4%	-2.7%	
Top 20%	-0.4%	-0.1%	-0.5%		-1%	-0.2%	-1.2%	



Rising gas prices could slow the recovery but are unlikely to derail it.

- The estimated direct, adverse effect on disposable income from the doubling of natural gas, electricity, and fuel prices is limited, as utility bills represent only 3.3% of total U.S. household expenditures. It would result in a 0.9% reduction in consumption for the average U.S. household (see table above). Since energy feeds into the prices of most other goods and services, the full impact of the shock is higher, reducing average household consumption by just over 1%. As consumption represents 67% of GDP, growth could fall almost 1 percentage point, all else equal.

- Energy in Europe, at 3.8%, represents a slightly higher share of average household expenditures than in the U.S. The direct adverse impact of a doubling of gas prices is thus higher: a 1.6% hit to consumption. We estimate the total adverse impact on consumption to be 1.9% for the average household; this translates into a 1.5 percentage point loss in GDP growth.

These estimates should be considered an upper bound of the potential slowdown in consumption and GDP. Involuntary savings owing to the government-imposed restrictions and fear of the virus led to a decline in consumption while disposable income increased (see chart above).

- Euro area households could cover the extra costs generated by the gas shock, using 8% of the extra bank deposits accumulated during the pandemic. Policy interventions should limit consumer price increases.
- U.S. households would have to use just 2.5% of aggregate excess savings to cover extra costs. Moreover, many companies locked in prices before the spike, so they will not be able to change prices immediately. This will likely reduce the hit to consumption.

The projected impact on GDP is thus a worst-case scenario that would only materialize if governments do not take sufficient aid measures and uncertainty motivates consumers to reduce consumption in the wake of the gas shock. For now, accumulated gas reserves, government controls, and ample savings will go a long way to mitigate the shock. At this stage, the shock does not materially affect our expectations for growth next year.

Source: Haver, U.S. Bureau of Labor Statistics and Barings calculations. As of September 30, 2021.

United States

Protracted SUPPLY CHAIN BOTTLENECKS are keeping supply from meeting demand. But there are signs they may be easing.

ANCHORED CONTAINERSHIPS IN PORTS OF LA/LB

- Supply chain bottlenecks have lasted longer than expected, keeping supply from catching up with demand. This has weighed on consumption and is keeping prices elevated for longer.
- The ports of Los Angeles and Long Beach saw a record 73 anchored container ships in September. There are signs this may be easing, as it is down 10% over the month.
- Easing congestion, stabilizing container prices, and an increase in port operating hours suggest pressures are getting better, rather than worse.

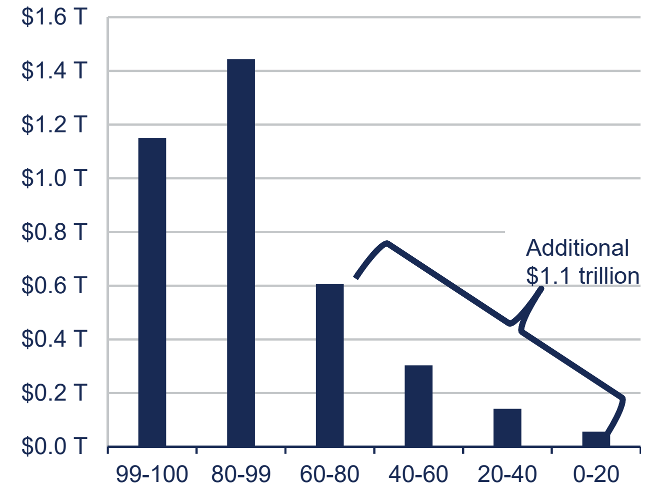
Supply chain issues and the Delta wave WEIGHED ON THIRD-QUARTER GROWTH.

REAL CONSUMER SPENDING, SAAR

- Goods spending was weighed down by longer-lasting supply chain bottlenecks and the shift away from durable goods as the world reopens. Meanwhile, elevated COVID cases weighed on services spending in Q3.
- Adjusting for inflation, real consumer spending has been largely flat. Given that consumption accounts for about 70% of U.S. GDP, this suggests Q3 growth is set to slow notably from the strong Q2 pace.

However, excess savings, labor market recovery, and falling COVID cases should aid stronger Q4 CONSUMER SPENDING.

Change in Liquid Asset 1Q21 vs. 4Q19, by Income Percentile



- As of 1Q21, excess savings totaled $3.7 trillion—roughly three months of U.S. consumer spending.
- However, 70% of excess savings is concentrated among the top 20% richest households—who have a much smaller marginal propensity to spend. Excess savings among the bottom 80% was $1.1 trillion in 1Q21—or just under a month of consumer spending.
- These savings should support consumption amid an improving labor market and rising wages, as long as COVID cases continue to decline.

Source: Marine Exchange of Southern California & Vessel Traffic Service, Bloomberg, and the Federal Reserve. As of October 18, 2021.

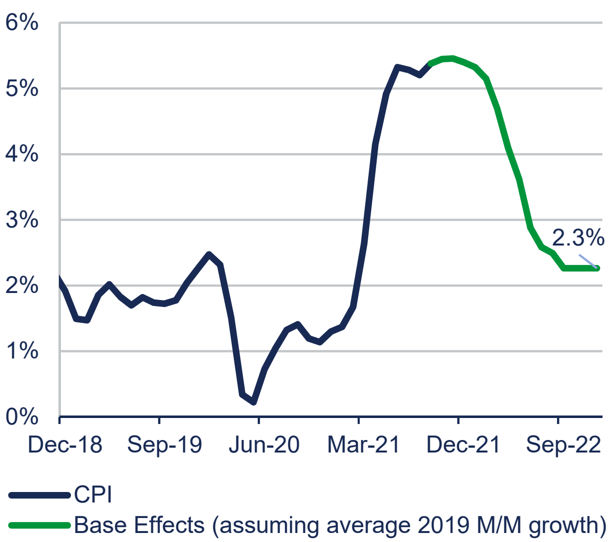
United States

Headline CPI surprised to the upside in September, but base effects still point to easing in 2022 as bottlenecks disappear.

Slower Q3 growth and stickier inflation are STOKING FEARS OF STAGFLATION—which is not our base case.

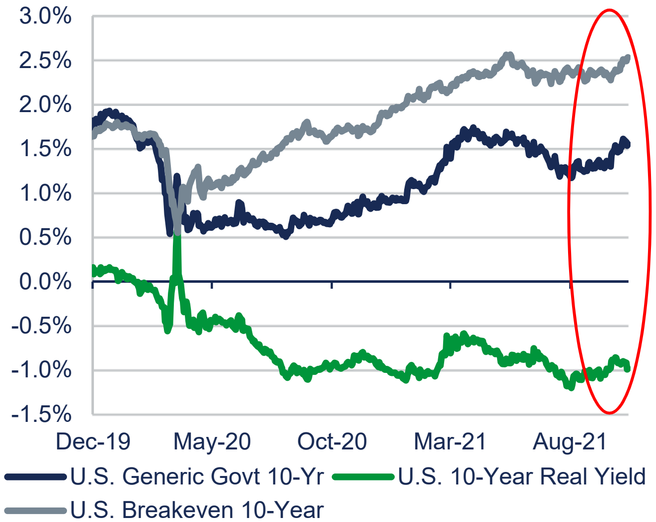
Meanwhile, the FOMC REMAINS ON TRACK TO TAPER and is still supportive of a full recovery.

CPI, Y/Y%



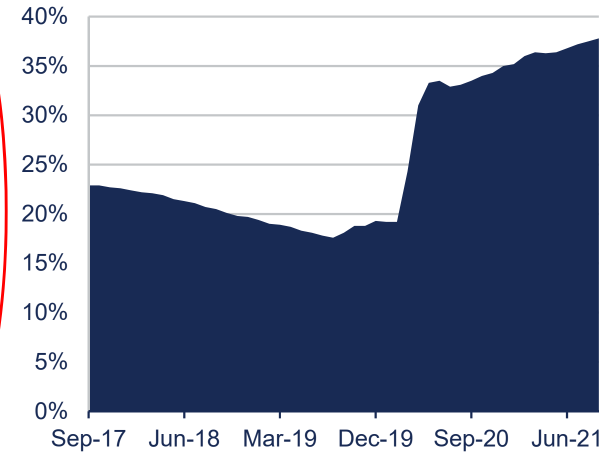
- Inflation pressures are proving stickier than anticipated a few month ago, given supply constraints and higher energy prices.
- With demand outstripping supply, price pressures are likely to remain elevated this year. However, as supply disruptions subside and base effects reverse, inflation should ease in 2022.
- Assuming average 2019 M/M CPI growth, base effects suggest CPI would end 2022 at 2.3% Y/Y.

U.S. 10-YEAR TREASURY YIELD



- Higher energy prices, protracted supply chain bottlenecks, and stickier inflation pressures are boosting worries of stagflation.
- In October, inflation expectations have moved higher, while real yields edge lower—suggesting lower longer-term growth expectations.
- However, strong growth is expected to return in Q4 as Delta recedes, and inflation pressures are expected to ease in 2022 as supply chains heal.

FEDERAL RESERVE BALANCE SHEET AS A % OF GDP



- Despite an underwhelming September Employment Report, the FOMC will likely announce tapering of asset purchases in November.
- The September meeting minutes suggest a taper pace of $15 billion per month—$10 billion in Treasuries and $5 billion in MBS—aiming to be completed in mid-2022.
- However, the Fed continues to disconnect the timelines of tapering and rate hikes. Dovish leadership suggests it will refrain from hiking too soon, preferring to allow some overheating in order to support a full labor market recovery.

Source: Bloomberg and Barings calculations. As of October 13, 2021.

United States

CONSENSUS FORECAST

- Our view is largely in line with consensus for growth and inflation in 2021. However, our baseline outlook for inflation in 2022 is slightly lower as supply chains heal, demand normalizes, and base effects reverse.
- We see a stronger labor market recovery than consensus due to elevated labor demand, easing constraints on supply, and improving COVID trends.

Economic Growth	10/15/2021	12/31/2018	12/31/2019	12/31/2020	2021 (E)	2022 (E)
Real GDP (Y/Y %)	12.2	2.9	2.3	-3.4	5.8 ▼	4.0 ▼
Inflation						
CPI (Y/Y %)	5.4	2.5	1.8	1.2	4.4 ▲	3.3 ▲
Core PCE (Y/Y %)	3.6	2.0	1.7	1.4	3.2 ▲	2.8 ▲
Labor Market						
Unemployment (%)	4.8	3.9	3.7	8.1	5.5 --	4.2 ▼
Rates						
Fed Funds	0.13	2.38	1.63	0.13	0.25 --	0.35 --
2Y Treasury	0.38	2.52	1.57	0.12	0.30 ▼	0.68 ▼
10Y Treasury	1.57	2.72	1.92	0.92	1.59 ▼	1.99 ▼

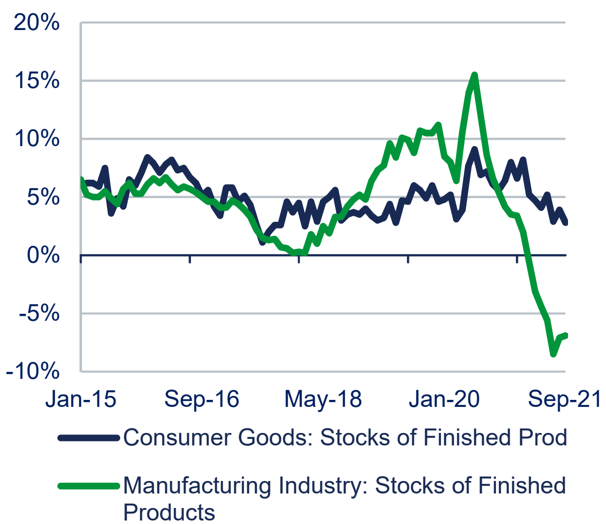
Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of October 15, 2021. (E)—Bloomberg private market consensus estimates.

Europe

SUPPLY-SIDE DISRUPTIONS are not dissipating in Europe.

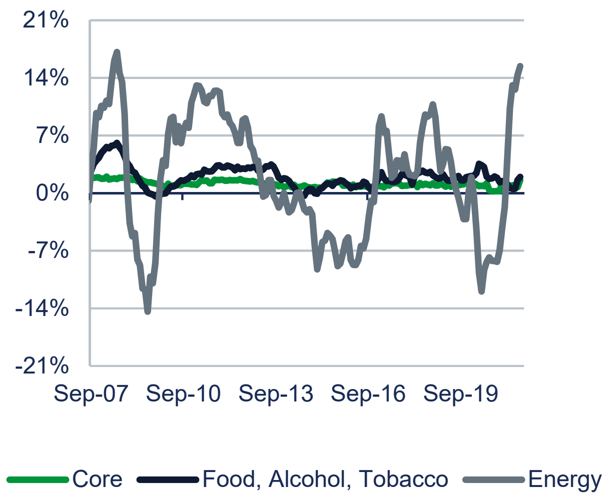
EA INVENTORY GROWTH



- Disruptions in global supply chains are proving more severe and lasting than expected.
- Euro area manufacturers' stocks continue to decline, particularly for intermediate goods (green line).
- This is keeping above-average inflation for longer than expected.

The ENERGY SHOCK may slow the recovery, but it will not stop it.

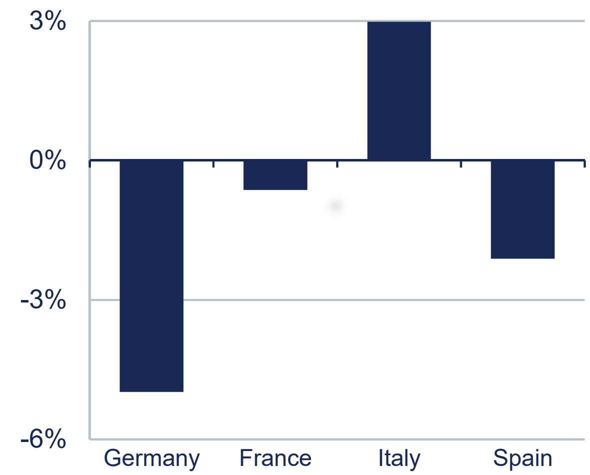
EA ENERGY PRICE INFLATION Y/Y%



- The jump in energy prices is adding to inflation pressures and hurting household purchasing power.
- With fixed energy bills, state subsidies in many countries and ample saving buffers accumulated through the pandemic, we estimate that the energy shock will only slow the recovery, not derail it.
- Winter temperatures and Russia's gas supplies will determine whether gas prices can rise further.

REAL WAGES are declining in Europe…

REAL WAGE GROWTH (% CHANGE FROM FEBRUARY 2020)



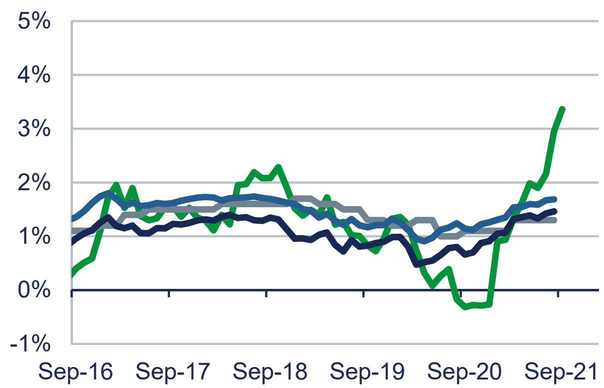
- Inflation is outpacing wage growth in most EU countries, pushing real wages down and reducing workers' purchasing power.
- Negotiated wages have so far not shown any upward pressure.
- All this suggests high inflation is still seen as temporary by workers and is not feeding into higher inflation expectations, a key ingredient for temporary inflation to become persistent.

Source: Bloomberg and Haver. As of October 15, 2021.

Europe

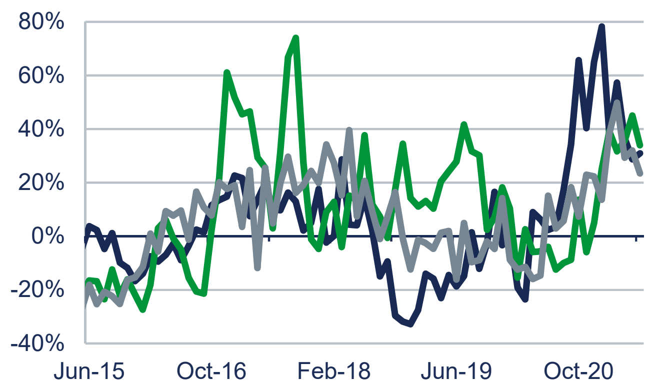
…keeping **INFLATION EXPECTATIONS** anchored for now.	**COUNTRY DIVERGENCE** is becoming more and more marked.	The ECB will fight **IMPORTED TIGHTENING** with unwavering accommodation.

EA INFLATION EXPECTATIONS STILL ANCHORED



- Consistent with subdued wage requests, survey and market measures of inflation expectations show no sign of overheating.
- Expectations have normalized after the steep COVID-induced drop and are now close to their long-term average.
- Together with subdued wages, they support the view that, once supply-side disruptions and base effects dissipate, inflation will trend down fast.

EXPORTS TO CHINA Y/Y%



- Disruptions are hurting Germany, the country most tightly linked to global supply chains and trade, as it is underperforming its EU peers.
- A slowdown in Germany's major export destination, China, could add to its short-term headwinds.
- Exports to China are slowing down particularly for intermediate goods produced by Germany, while raw materials from Australia are proving more resilient.

IMPORTED TIGHTENING OF FINANCING CONDITIONS

- Notwithstanding benign inflation dynamics in Europe, government bond yields are rising on the back of U.S. Treasuries.
- BTP-to-bunds spreads have however remained stable during this volatile period.
- The ECB will counteract what it will likely see as unwarranted tightening, as the growth outlook in the euro area cools off and U.S. inflation dynamics look more worrying than in the euro area.

Source: Bloomberg and Haver. As of October 15, 2021.

CONSENSUS FORECAST

- We maintain our above-consensus call of 6% euro area growth but recognize risks have tilted to the downside as the jump in gas prices adds to already stronger-than-expected inflation outpacing wages.
- Brexit-related disruptions compound the impact of supply-side disruptions, leading us to expect the U.K. economy will grow 6% in 2021, below consensus.

Economic Growth	10/15/2021	12/31/2018	12/31/2019	12/31/2020	2021 (E)	2022 (E)
EZ Real GDP (Y/Y %)	14.3	1.9	1.5	-6.3	5.0 ▲	4.3 --
U.K. Real GDP (Y/Y %)	23.6	1.7	1.7	-9.7	7.0 ▲	5.3 ▼
Inflation						
EZ CPI (Y/Y %)	3.4	1.8	1.2	0.3	2.3 ▲	1.8 ▲
U.K. CPI (Y/Y %)	3.2	2.5	1.8	0.9	2.2 ▲	2.7 ▲
Labor Market						
EZ Unemployment (%)	7.5	8.2	7.6	7.9	8.0 --	7.8 --
U.K. Unemployment (%)	4.5	4.1	3.8	4.4	4.9 ▼	4.7 ▼
Rates						
EZ Central Bank	0.00	0.00	0.00	0.00	0.00 --	0.00 --
EZ 2Y Note	-0.68	-0.62	-0.61	-0.72	-0.65 ▲	-0.57 ▲
EZ 10Y Bond	-0.17	0.24	-0.19	-0.57	-0.20 ▲	0.00 ▲
U.K. Central Bank	0.10	0.75	0.75	0.10	0.10 --	0.30 --
U.K. 2Y Gilts	0.56	0.74	0.53	-0.17	0.16 ▼	0.45 ▲
U.K. 10Y Gilts	1.09	1.27	0.82	0.19	0.85 --	1.16 ▲
Currencies						
EUR/USD	1.16	1.14	1.12	1.22	1.17 ▼	1.17 ▼
GBP/USD	1.38	1.27	1.33	1.37	1.38 ▼	1.41 ▼

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of October 15, 2021. (E)—Bloomberg private market consensus estimates.

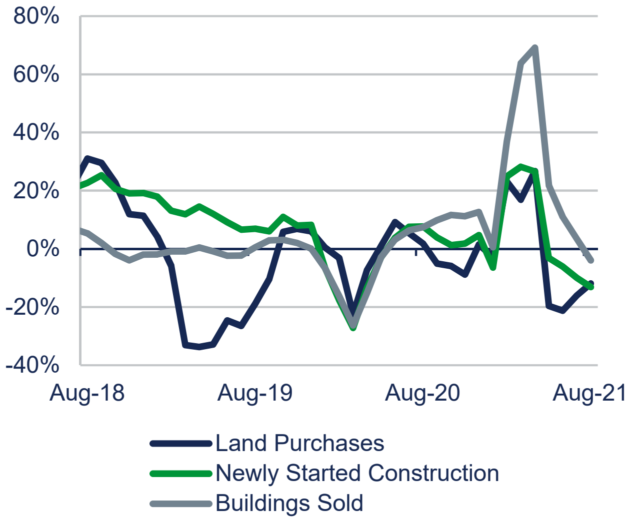
Asia Pacific

Regulatory tightening is leading to weakness in CHINA'S ROPERTY SECTOR…

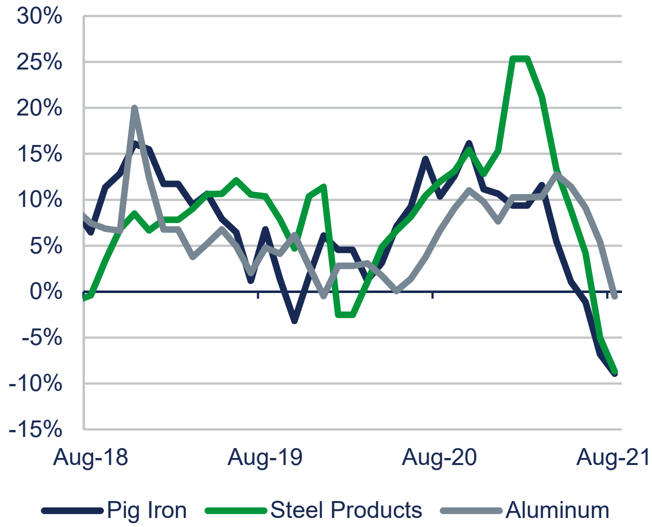
…while decarbonization and the energy shortage are adding further downside risk to INDUSTRIAL ACTIVITY.

The PBOC's easing bias has not yet translated to lower BORROWING COSTS.

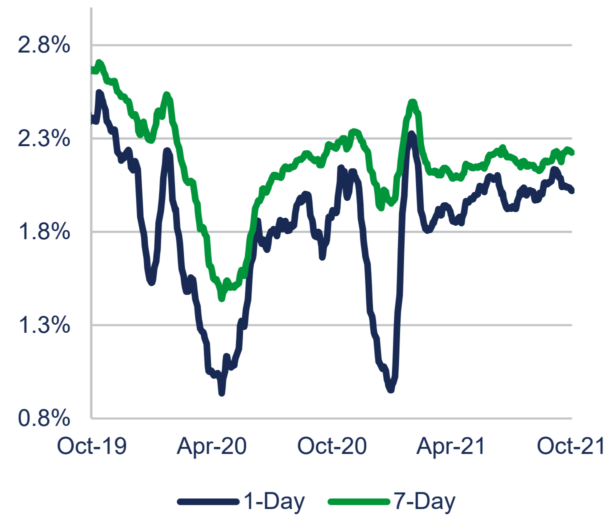
CHINA BUILDING ACTIVITY INDICATORS (Y/Y%, 3-Month Average)



CHINA INDUSTRIAL PRODUCT OUTPUT Y/Y%



CHINA INTERBANK REPO RATE



- Residential property and related sectors account for about 15% of GDP, including property investment (6.5% of GDP), property-related services (7.3%), and property-related consumption (1-1.5%).
- A pullback in real estate activity would translate into slowing investment and construction activity, but it could also spread to consumer sentiment, as residential property represents 60% of household assets.

- Output for metal products has already started to moderate (compared to earlier in the year) as global demand gradually eases, but the energy crunch threatens to further exacerbate the trend.
- Energy consumption in the manufacturing sector has also rolled over.
- Fortunately, exports have not yet been impacted, likely due to the inventory buildup since the start of the year.

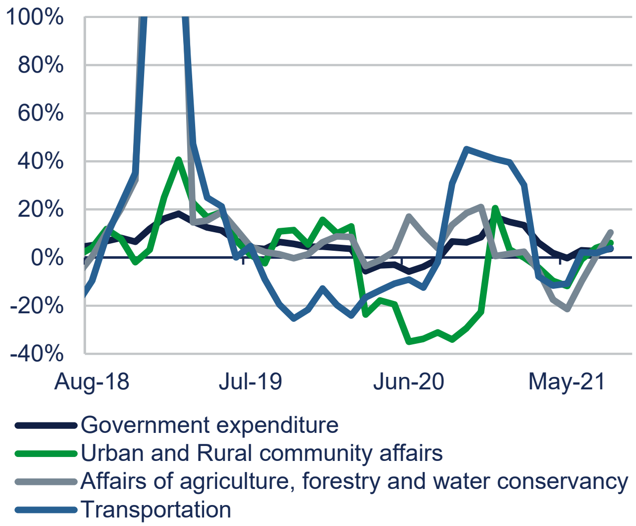
- In light of growing downside risks to growth, authorities have attempted to cushion the blow by providing very targeted support.
- Broad-based easing is unlikely, as policymakers want to avoid a repeat of the post-GFC period, which led to excessive inflation and asset bubbles.
- Other key reference benchmark rates such as one- and three-month SHIBOR have also been flat.

Source: Bloomberg, Haver. As of October 14, 2021.

Asia Pacific

But, FISCAL SPENDING should continue to pickup, translating to increased infrastructure investment.

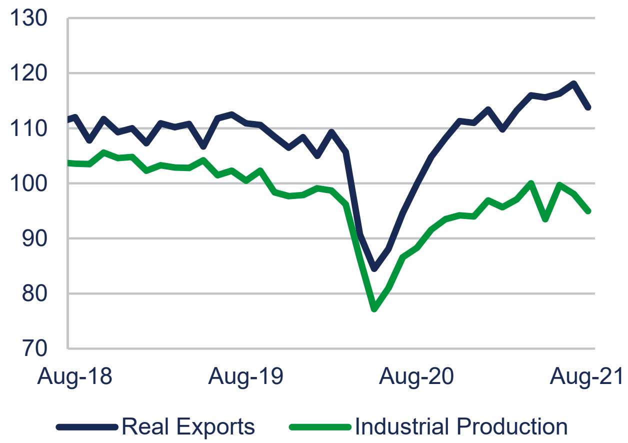
CHINA FISCAL EXPENDITURES (Y/Y%, 3-Month Average)



- Government special bond issuance has picked up in recent weeks but is still well below its annual quota, especially relative to prior years.
- While it has not yet translated into a pickup in investment, fiscal expenditures (notably infrastructure related) have stabilized and slowly increased.
- Both monetary and fiscal policy are working in tandem to support growth.

EXTERNAL DEMAND is still supporting Japan manufacturing, but risks are rising.

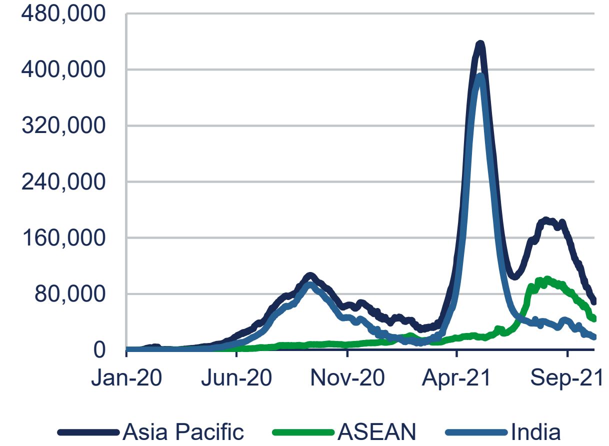
JAPAN MANUFACTURING INDICATORS (Index 2015=100)



- Strong exports should help support private capex, which has slowly picked up.
- However, risks from supply shortages should be noted—particularly in auto production, due to the semiconductor shortage and subdued auto part imports from Malaysia and Vietnam amid recent COVID shutdowns.
- A China slowdown would also be a drag, with exports to China making up 5% of Japan GDP and 30% of total exports.

CASES in Southeast Asia have rolled over as vaccinations slowly improve.

7-DAY AVERAGE DAILY NEW COVID CASES



- The Delta-induced wave has begun to recede and economies are taking steps to loosen restrictions.
- Vaccination coverage is slowly improving but still lags other regions due to supply constraints. But, hope is rising amid increased supply from both the U.S. and India.
- Most economies in Asia could reach 70% vaccination rates by H1 2022, but it may take longer for ASEAN.

Source: Bloomberg, Haver. As of October 13, 2021.

CONSENSUS FORECAST

- Given mobility restrictions that have lasted longer than expected, we now anticipate 2021 GDP growth for Japan will come in at the bottom of our prior forecast range, but still slightly above consensus. We continue to expect a rebound of activity in Q4 and into next year.
- We downgrade 2021 GDP growth for China again amid growing downside risks given the tightening regulatory environment and decarbonization. We remain constructive on 2022 growth.

Economic Growth	10/15/2021	12/31/2018	12/31/2019	12/31/2020	2021 (E)	2022 (E)
Japan Real GDP (Y/Y %)	7.6	0.6	0.0	-4.7	2.4 --	2.5 --
China Real GDP (Y/Y %)	7.9	6.7	6.0	2.3	8.2 ▼	5.5 ▼
Inflation						
Japan CPI (Y/Y %)	-0.4	1.0	0.5	0.0	-0.2 ▼	0.5 ▼
China CPI (Y/Y %)	0.7	2.1	2.9	2.5	1.2 ▼	2.2 ▼
Labor Market						
Japan Unemployment (%)	2.8	2.4	2.4	2.8	2.9 --	2.7 --
China Unemployment (%)	3.9	3.8	3.6	4.2	3.9 --	3.6 --
Rates						
Japan Central Bank	-0.10	-0.10	-0.10	-0.10	0.00 ▲	0.00 ▲
Japan 2Y Note	-0.12	-0.15	-0.13	-0.13	-0.10 --	-0.06 --
Japan 10Y Bond	0.08	-0.01	-0.02	0.02	0.09 ▲	0.13 ▲
China Central Bank	4.35	4.35	4.35	4.35	4.30 --	4.30 --
China 2Y Note	2.50	2.75	2.75	2.75	2.41 --	2.30 --
China 10Y Bond	2.98	3.30	3.13	3.14	2.88 ▼	2.95 --
Currencies						
USD/JPY	114.37	110.27	108.61	103.25	111.00 ▲	112.00 --
USD/CNY	6.44	6.86	6.98	6.52	6.48 ▲	6.40 --

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of October 15, 2021. (E)—Bloomberg private market consensus estimates.

Central Scenario: Brave New World (60% Odds)

In this Brave New World, the future looks promising after short-term hurdles are overcome, although it will require a sharp eye to understand how changes to the way we live, work, and consume will impact the world of "after." Some changes will be positive for total factor productivity, but shifting patterns will deliver surprises. Growth will remain above trend, but so will inflation.

Supply chain bottlenecks as the economy restarts after 18 months of lockdowns are proving more lasting than originally expected. Vaccination coverage remains a principal driver of fault lines in the global recovery. For this and a variety of other reasons, labor is missing at work, both in advanced and developing economies. Also, commodities prices are rising in an already-tight market. As it takes longer for supply to adjust to pent-up demand, inflation pressures are lingering for longer.

This central scenario takes the view that these pressures will progressively subside. Vaccinations, the run-down of accumulated savings, and a rebuild of inventories will reduce pressures on prices. In some sectors, excess demand may even turn into excess supply, and overcapacity could accelerate a disinflationary process during the next 12-18 months.

The world's central bank for global liquidity, the Fed, remains patiently accommodative: it may taper but will not hike in the short run. It prefers to let inflation follow its own adjustment path so as to maximize employment and not hamper the final stage of the expansion.

Consumers will spend their savings over time, with less uncertainty, lower inflation, and fewer shortages. Investment and real rates will pick up, even if new post-pandemic patterns and declining liquidity present rising risks for firms.

In the background, productivity is on the rise because of the accelerated technology diffusion during the pandemic. New public investments also hold the promise to upgrade production, particularly through modern infrastructure, new-generation capital goods, and digitization.

The longer-run green transition will prove to be another major driver of change, resetting energy prices higher as governments introduce a price for pollution. Along the way, the switch to expensive energies will add inflation volatility. It will also provide fantastic new opportunities for investment in the modernization of the economy, even if the full impact of this trend goes beyond the 12-18 months of this scenario.

U.S. Treasuries: 2% over 12-18 months

Market Implications: Risk on

- Risk should perform well in this environment of low rates, increasing structural change, and above-trend growth, especially after disruption-induced volatility subsides.
- The scenario favors equities, HY, and commodities. Meanwhile, materials, industrials, financials, and energy should be supported.
- U.S. dollar should remain subdued as the global recovery continues.

Conditions

- Continued policy support
- Control of the pandemic

Indicators to watch

- Labor market dynamics, savings, capex

Scenario risks

- Geopolitical risks and trade wars
- Meaningful Chinese slowdown

The above represent the views of Barings as of October 15, 2021, and are subject to change at any time. These predictions may not come to fruition.

Alternative Scenarios

PERFECT STORM (30% ODDS)

Inflation takes hold as the result of a "perfect storm" of economic pressures, leading to demand destruction in the face of rising prices and faltering growth.

As in the previous scenario, bottlenecks are lasting for longer. In this case, however, inflation takes on a dynamic of its own and stays very elevated, potentially triggered by separate shocks:

- China's shift in growth model, with a focus on boosting domestic rather than external growth.
- An extended energy price shock, related to a combination of geopolitics and the further green transition.
- Vaccination delays in emerging and developing economies, which decouple and contribute less to global supply and growth.

Investors and central banks become convinced that the output gap has been closed by a structural fall in supply. They price higher expected inflation into tighter financing conditions. This may turn into a policy mistake, if advanced economy central banks follow the EM path and start tightening early, but it need not be one. Inflation may indeed turn persistent. Markets may also preempt central banks and price in higher inflation in interest rates, steepening the yield curve.

The path of the yield curve will have a direct impact on economic growth. As short-term interest rates rise from a policy hike or the pricing in of it, the 10-year U.S. Treasury rate may shoot above 2% for three to six months. However, higher financing conditions will handicap growth, and the long end of the curve will self-correct downward. Toward the end of this scenario, the 10-year U.S. Treasury rate should drift lower toward 1%.

Conditions

- Persistent bottlenecks, limited U.S. labor supply
- High commodity prices

Indicators to watch

- Rising inflation expectations
- High savings/weak demand

Scenario risks

- Central banks may lose control and inflation could accelerate even further. If wages do not keep track of inflation, however, demand will collapse and growth will be impacted more than necessary.

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GRAVITY PREVAILS (10% ODDS)

Excess demand in the face of supply restrictions raise inflation temporarily. Midway through our 12-18 month horizon, lower growth turns deflationary, and demand and supply both adjust down. Both growth and inflation fall back to lackluster levels, typical of the pre-pandemic era.

As the pandemic recedes, the rebound in demand is short-lived. There may be renewed uncertainty, perhaps due to a new variant. A lack of consumer confidence and a run-out of accumulated savings spurs the return to work of those low-income households that had exited the labor force. Changes in consumption patterns fail to revive those sectors that lag behind. In this context, firms do not want to invest. Also, costs associated with the regulatory regime shift in China depress growth. A slowdown starts in 2022, and developed market growth drifts back to pre-crisis levels.

Technological progress and globalization continue to keep prices down. Aging is causing dissaving but without an impact on inflation, as there is little demand for goods, like in Japan. Inflation falls way below targets.

Monetary policy remains accommodative. At the lower bound, however, its capacity to relaunch demand turns out to be limited. Low real rates fail to spur investment when expected demand remains weak. Only fiscal policy has the power to make a difference.

Governments make it difficult for further funding to be discussed. In the U.S., the early recovery momentum drains the urgency from meaningful infrastructure investment. Without it, corporate capex stalls, too. In Europe, early discussions of fresh fiscal discipline keep the savings rate high, in preparation of future tax payments. Any implementation issues with the Recovery and Resilience Plan worsen the scenario. Arm wrestling on the appropriate conditionality required for the disbursement of funds could take place and result in the delay, or cancelation, of public investment plans. This has the worst impact in the weakest countries that need the money most, and divergence reappears.

Social unrest could easily flare-up. A sense of inequality, police brutality, poverty, and youth anger would add to downside risks, as would a lingering pandemic, new variants, or vaccination delays. A trade war with China, and other geopolitical risks, would also hurt badly. Elections in France, potentially Italy, as well as mid-term races in the U.S. could see the expression of anger and radicalism, with nefarious results for the medium-term.

Conditions
- Little further spending in the U.S.
- Talks of significant tax increases that affect the middle class

Indicators
- Service PMIs, bankruptcies
- Private savings and investment
- Labor market slack
- Policy announcements

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Scenario Matrix—Economy

		Scenarios						
		Brave New World		*Perfect Storm*		*Gravity Prevails*		
		2021	2022	2021	2022	2021	2022	Comments
U.S.	Growth	6%*	4.5%*	5.5%	3-4%	5.5%	3%	Growth should remain strong as U.S. household balance sheets stay healthy, vaccines are set to support a return to services, and policy remains supportive. However, protracted supply constraints may elongate the recovery.*
	Inflation	4-4.5%*	2-2.5%	4.5%*	3%*	4-4.5%*	1.5-2%*	
	Unemployment	4.5%	3.5%	5%	4%	5%*	4.5%	
Euro Area	Growth	6%	4.5%*	5.5%*	3%	5.5%*	3%	A decisive turn downward in 2022 inflation allows the ECB to wait until disruptions subside, financing conditions remain supportive, and the recovery gets a second wind.*
	Inflation	2%	1.5%	2%*	2%*	2%*	1-1.5%	
	Unemployment	7%*	6.5%*	7%*	7.5%*	7%*	7.5%*	
Japan	Growth	2.5%*	3.5%	2%	2.5%	2%	2%	With vaccinations improving and the latest COVID wave receding, an economic bounce should be expected in Q4 and through next year. Supply chain constraints remain a prominent risk to the industrial sector.*
	Inflation	0%*	0.5%*	0.5%*	0.5%	0%	0.5%	
	Unemployment	2.5%	2.5%	3%	2.5%	3%	3%	
China	Growth	8%*	6%	6.5%*	5%*	6.5%	5.5%	Increased fiscal spending should boost investment growth and an easing bias from the PBOC should cushion downside risks. Nevertheless, risks remain tilted to the downside given the tightening regulatory stance.*
	Inflation	1.5%	2.5%	2-3%	2%	1.5%	2%	
	Unemployment	3.5%	3.5%	4%	3.5%	4%	3.5%	

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Scenario Matrix—Central Bank Policy

	Scenarios			
Central Bank	***Brave New World***	***Perfect Storm***	***Gravity Prevails***	***Comments***
FED	Fed Funds Rate: 0% Taper expected to begin in 4Q21 as long as recovery remains intact	Taper begins in 4Q21. Higher expected inflation leads the Fed to liftoff early, which slows growth*	Fed Funds Rate: 0% Balance sheet remains accommodative and may need to grow	The Fed is likely to respond very slowly to any upside or downside risks to inflation given its new average inflation targeting (AIT) framework and focus on labor market recovery.
ECB	Inflation declines in line with expectations, it will not cause any tapering, only some unease with Governing Council hawks*	Upside inflation surprises heighten disagreement in the ECB, possibly limiting its ability to further accommodate as needed*	Unwavering accommodation in the form of more QE and generous liquidity provisions; worries return on the ineffectiveness of monetary policy	Except for the Perfect Storm scenario, inflation will trend down fast from the turn of the year, and the ECB remains under no pressure to tighten.*
BOJ	Policy rate stays negative; Balance sheet stays neutral	Policy rate stays negative; balance sheet stays neutral with emphasis on YCC to keep financial stability in check	Policy rate stays negative; balance sheet stays neutral with emphasis on YCC to keep expectations in check	The BOJ is going down a narrow path, with YCC the only way to enable policy exit in the future; it has managed the process well, so far.
PBOC	Attempting to cushion downside risks via incremental easing, though broad-based easing or policy rate cuts unlikely	Continued tightening bias via macroprudential measures	Incremental easing, though broad-based easing or policy rate cuts are unlikely*	Policymakers are focused on financial de-risking, but attempting to hedge downside risks to growth by easing incrementally and in a targeted manner.

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Scenario Matrix—Markets

	Scenarios			
Markets	***Brave New World***	***Perfect Storm***	***Gravity Prevails***	***Comments***
Rates	Policy rates unchanged; 10Y UST around 2%; curve bear steepens	Sharp bear flattening at first, from rising short rates, with the 10-year rate jumping to 2.5% for 3-6 months; it then turns down toward 1.2% as growth falters*	Policy rates unchanged; 10Y UST rally to around 1%; the curve bull steepens*	Volatility in the curve likely to be driven by short rates as rate hike expectations shift.*
Corporate Credit	Spreads move tighter, benefitting loans over HY bonds, which would outperform IG amid higher rates	Spreads widen, though duration assets less impacted, amid tightening financial conditions and credit risks in focus*	Spreads range-bound	Spread changes should largely be a function of rates.*
Equities	Commodities and materials, industrials, financials, and energy should be supported*	Unfavorable environment for equities, with defensives such as utilities and real estate doing less poorly*	Rotation back into growth and tech	Bifurcated outcomes depending on whether equity markets believe inflation is taking hold or not.*
FX	USD remains subdued*	Supportive of USD given USTs benefit after the initial selloff*	USD strengthens in flight to safety as growth stalls	A desynchronized growth outlook has been supportive of the USD, but expect this to end toward H2 2021.
Commodities	Supportive of industrial metals and energy*	Commodities do not perform*	Oil and copper fall from current levels; gold range bound*	Further sustained cyclical upside in commodities likely to only be fueled by a continued global economic recovery.*

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As of March 31, 2021.