BARINGS INVESTMENT INSTITUTE

December 2020

Darker Tunnel, Brighter Light

MONTHLY MACRO DASHBOARD

BARINGS

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December Outlook: Darker Tunnel, Brighter Light

Financial markets pivoted quickly from the U.S. election – especially considering a vote-count that took so long to call – back to COVID-19 in November. The broad flow of economic data has been stronger than expected across Europe and the United States, even as much of Asia continues to recover. The good news, of course, has been the announcements around vaccines that may allow a return to fuller levels of activity much sooner than expected. The bad news is that the fresh waves of coronavirus infections in Europe and the United States have triggered tighter restrictions that will aggravate the scars from the pandemic, perhaps in labor markets, company balance sheets and confidence.

The prospect of **a darker tunnel leading to a brighter light** gives us more confidence in our **"Not Quite Recovery" scenario**, which foresees continued progress next year, but slowing momentum as government stimulus stalls in the United States, higher unemployment delays the revival in demand and stretched balance sheets trigger further defaults and bankruptcies. U.S. unemployment numbers continue to improve, but rising numbers of initial jobless claims and permanent unemployed suggest the next 3% decline will be much harder than the last 3%. Meanwhile, our recent work on corporate balance sheets (see the **Monthly Spotlight**, p 5) suggests that U.S. and European firms have ample liquidity to withstand almost any shock, even if some sectors and firms face significant stress. In Europe and elsewhere, the sectors that are most affected by new lockdown measures account for a disproportionately large part of the labor force. The picture in Asia continues to improve, even contributing to an important revival in global trade, but that depends on a durable recovery in global confidence, which is harder to envision as current COVID cases continue to rise in many areas. It's a steadily improving picture, but still a long way from 2019. **For investors, it still suggests a healthy outlook for risk assets, including equities, credit and private markets. U.S. government bonds and duration bets may face headwinds as rates edge slightly higher and close to 1%, but central banks in Europe and Japan seem committed to keeping rates pinned near current levels.**

The vaccine news, however, has led us to eliminate our darkest "Kitchen Sink" scenario, which envisioned an extended pandemic and a collapse of growth that would trigger massive new fiscal and monetary responses. We replace it with a low-probability but much more positive path.

This **"Escape Velocity" scenario** carries a 10% probability, in our view, assumes a pace of vaccine distribution that is fast enough to restore confidence, a surge of pent-up demand that compensates for current lockdowns and continuing fiscal support, including in the United States. Even Asia, which has managed to contain COVID-19 case numbers, would see a further boost in activity as global trade recovers. This scenario would offer even more support to risk assets, but it may see markets begin to price in future reductions in central bank balance sheets and a mild drift higher for government bonds.

A more likely, alternative scenario is what we have labeled the **"Fiscal Cliff,"** which repeats the mistakes of the last crisis when governments withdrew fiscal support too soon and undercut the pace of the recovery. We assign a 20% probability to this outcome. Fiscal policy in Asia has been generally supportive, including in Japan as the new Suga government takes office. For next year, European governments have already committed to large spending programs as well as substantial commitments to joint European Union borrowing and spending. The main risk that government support may disappear too soon remains in the United States, especially with the elections likely to deliver a divided government. The new Biden administration will enter office with ambitious plans for fresh stimulus, as well as infrastructure and climate investment. Senate Republicans have signaled their intention to resist these plans and focus on bringing the deficit into balance, which could undercut the recovery as similar policies, especially in Europe, did following the Global Financial Crisis.

Under all these scenarios, investors will soon begin to think about the key challenges to the post-pandemic global economy: continuing friction between Washington and Beijing, prospects for investment in U.S. infrastructure, and post-crisis cohesion of the European Union. Even if the U.S. Congress avoids a "fiscal cliff," markets will also focus intensely on just how quickly different forms of global policy support should be withdrawn, which will likely shape our next set of scenarios.

What Changed in November

WHAT'S NEW

- Two vaccines are under review for emergency-use authorization
- Joe Biden has won the U.S. election with promises of more cooperation with allies
- Europe has been put back under partial lockdown and the recovery faces a double-dip, while greater regional restrictions have begun being implemented across the U.S.
- As China's recovery thunders ahead, policymakers are signaling they may gradually withdraw accommodation

WHAT WE LEARNED

- In the U.S., the central bank remains the only game in town, as fiscal stimulus talks continue to be pushed out
- There is still one more page to add to the Brexit novel

WHAT WE ARE HEARING FROM OUR TEAMS

- With risks finally abating, it may be time to reduce duration in safe haven countries
- Cyclicals, high yield, and emerging markets look attractive
- Market volatility lies ahead as good vaccine news mixes with rising case numbers

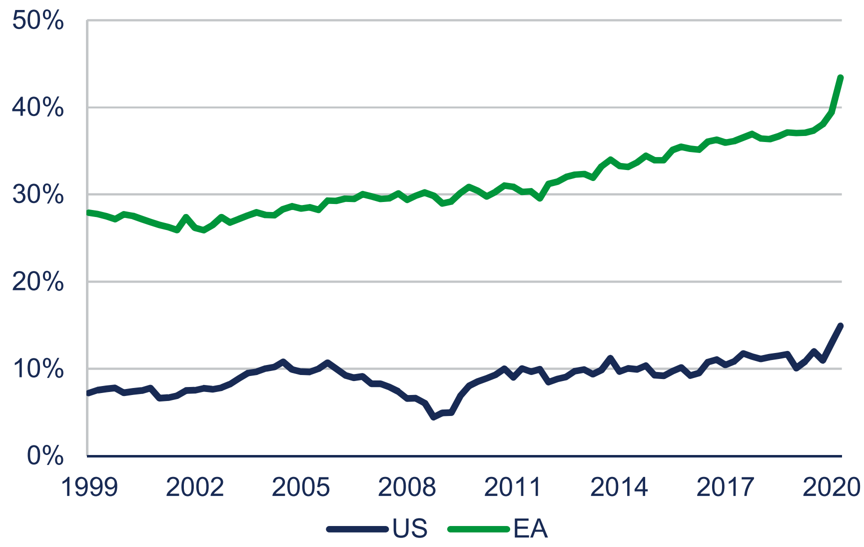
WHAT WE ARE WATCHING

- Delays in vaccine approval and distribution policy
- Unexpected policy moves in the final month of the Trump administration
- Late lockdowns in the U.S. that could interfere with the favorable momentum from reopenings in Europe and the dynamism in Asia, delaying the global recovery
- ECB's additional quantitative easing expected in December
- Rising China-Australia tensions, confirming that trade relationships remain difficult

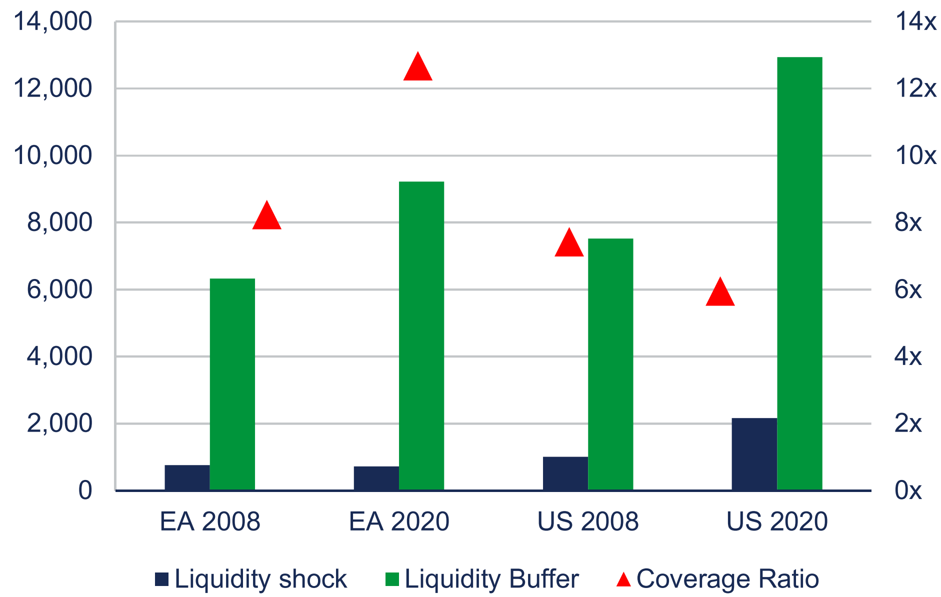
Monthly Spotlight: Corporate Liquidity in Europe & the U.S.

Corporate balance sheets have never been so liquid, providing a war chest against a crippling credit crunch.

DEPOSITS OVER SHORT-TERM DEBT/LOANS AND RECEIVABLES



LIQUIDITY SHOCK VERSUS BUFFERS



The fast deployment of loan guarantee schemes and ultra-cheap bank liquidity have allowed credit provision to remain easy for non-financial corporations in both the euro area and the U.S. Unusually for a recessionary period, credit to firms accelerated sharply in 2020.

Importantly, the majority of the new credit obtained by corporations has been used to shore up their liquidity: overnight deposits jumped on both sides of the Atlantic. As a result, liquid assets (deposits and short-term assets such as securities and loans) now cover 45% of short-term liabilities in the euro area and 15% in the U.S. As these short-term liabilities are those at risk of not being rolled over, this shows that corporates have been strengthening their liquidity war chests.

To gauge how long corporates could fare if credit dried up, we estimate the amount of liabilities that would not be rolled over in the next four quarters if a shock similar to that hitting firms in 2008 was repeated now. We compare this liquidity shock with the liquidity buffer firms currently have (see chart above).

Compared to 2008, both euro area and U.S. firms raised their buffer substantially (green bars). In Europe, liabilities have grown little, so that the potential liquidity shock is similar to 2008 and buffers are enough to cover it more than 12 times (red triangles). In the U.S. both liabilities (and thus the potential shock) as well as the buffer grew substantially, leaving coverage similar to that in 2008. The findings suggest that a wave of bankruptcies is unlikely. That said, not all is fine, as firms' toplines will remain under pressure, and this aggregated data does not tell whether some pockets of illiquidity and fragility are there.

Source: Haver. As of November 23, 2020.

CONSENSUS OUTLOOK

Economic Activity	2017	2018	2019	2020 (E)	2021 (E)	2022 (E)
Real GDP (Y/Y %)	3.8	3.5	2.8	-3.9 --	5.2 ▼	3.7 ▲
CPI (Y/Y %)	3.2	3.6	3.5	2.2 ▼	2.6 --	2.8 ▼
Trade Volume (Y/Y%)	5.6	3.9	1.0	-10.4 --	8.3 --	8.3 --
Inter-Bank Rates						
3-Month USD Libor	1.69	2.81	1.91	0.26 ▼	0.34 ▼	0.50 ▼
3-Month Euribor	-0.33	-0.31	-0.39	-0.49 ▼	-0.45 ▼	-0.39 ▼
3-Month GBP Libor	0.52	0.91	0.79	0.09 ▼	0.14 ▲	0.25 ▲
3-Month JPY Libor	-0.02	-0.07	-0.05	-0.11 ▼	-0.08 ▼	-0.07 --

Arrows indicate consensus estimate change compared to one month ago

CENTRAL BANKS remain on the sidelines as the burden of the recovery shifts firmly toward fiscal policy.

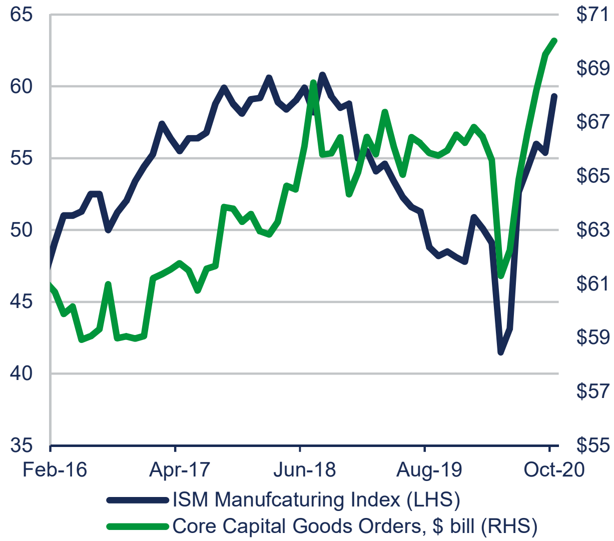
Economy	Policy Rate (%)	Next CB Meeting	Implied Policy Rate (%)		
			3M	6M	1Y
U.S.	0.13	12/16/2020	0.12	0.11	0.11
Eurozone	-0.50	12/10/2020	-0.52	-0.54	-0.57
U.K.	0.10	12/17/2020	0.08	0.06	0.02
Japan	-0.03	12/18/2020	-0.05	-0.06	-0.07
China	2.20	—	2.33	2.29	2.43

Source: Bloomberg and IMF as of November 30, 2020. (E)—Bloomberg private market consensus estimates for GDP, CPI and rates. Trade volume data is a projected figure from the IMF.

U.S.

A rebound in MANUFACTURING AND CAPEX will help keep the recovery intact.

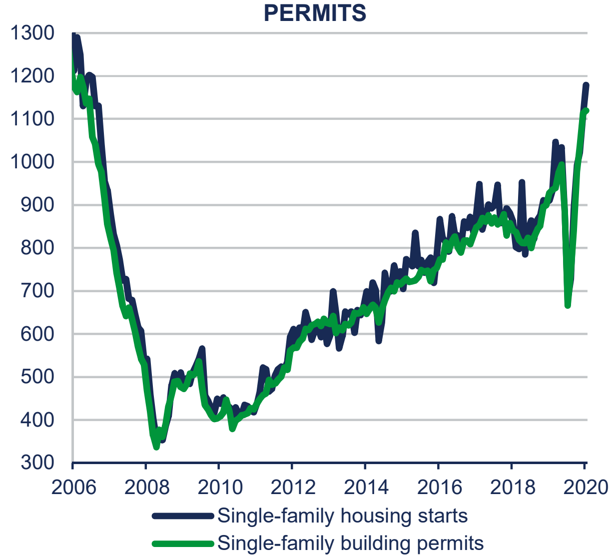
ISM MANUFACTURING AND CORE CAPITAL GOODS ORDERS



- U.S. manufacturing continues to expand amid a strong performance in goods demand, restocking of inventory, and rising capex. Strong new orders point to continued improvement.
- A capex rebound is being aided by investments in technology and business equipment. This will act as a boon for both the productivity and labor market recovery.

And a strong HOUSING MARKET will support growth.

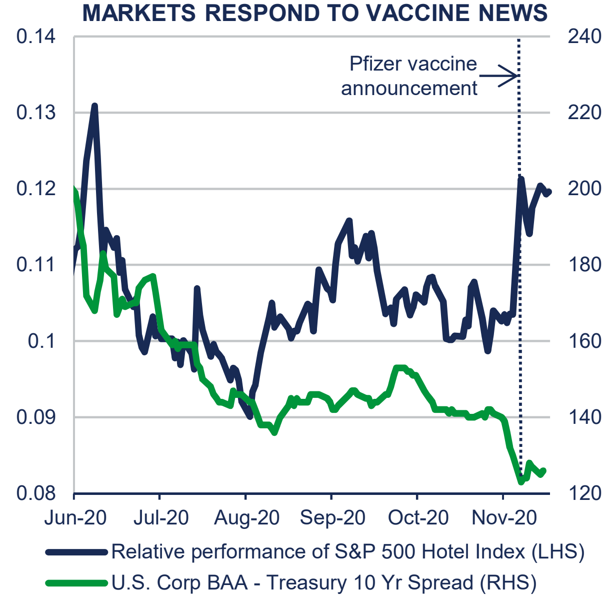
SINGLE-FAMILY HOUSING STARTS AND PERMITS



- Strength in the U.S. housing market continued into the fourth quarter amid record-low mortgage rates, return in high-wage jobs, millennials entering the market, and shifting preferences for single-family housing.
- As the housing market has high employment and GDP multipliers, strength in this sector will aid overall growth even as many services industries continue to feel the pain.

Vaccine progress is leading MARKETS to look past possible near-term volatility.

MARKETS RESPOND TO VACCINE NEWS

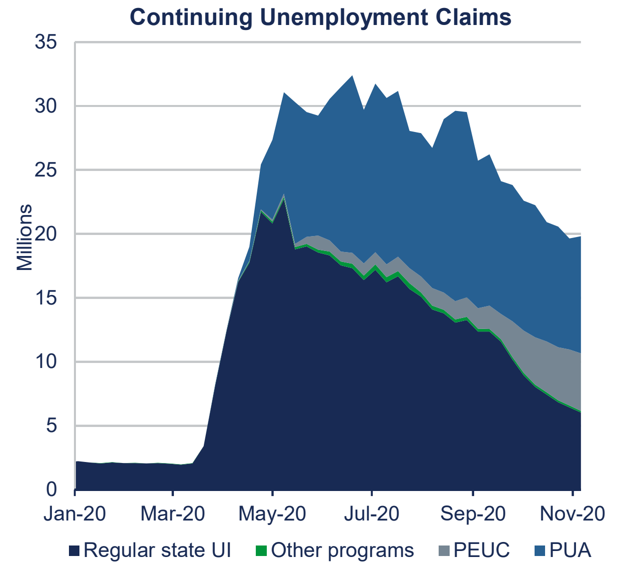


- Corporate bond spreads narrowed on the positive vaccine news, providing upside for growth in 2021.
- While activity in the hardest COVID-hit services industries, such as leisure and hospitality, will still take some time to return, markets are increasingly looking forward to a better rebound next year in tandem with largely expected wide-spread vaccination.

Source: Bloomberg. As of November 30, 2020.

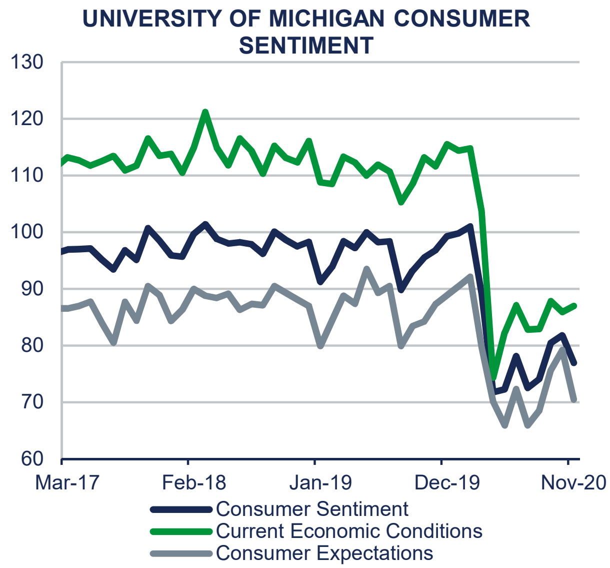
U.S.

Additional FISCAL STIMULUS is needed and remains a risk, but negotiations continue to be pushed out.



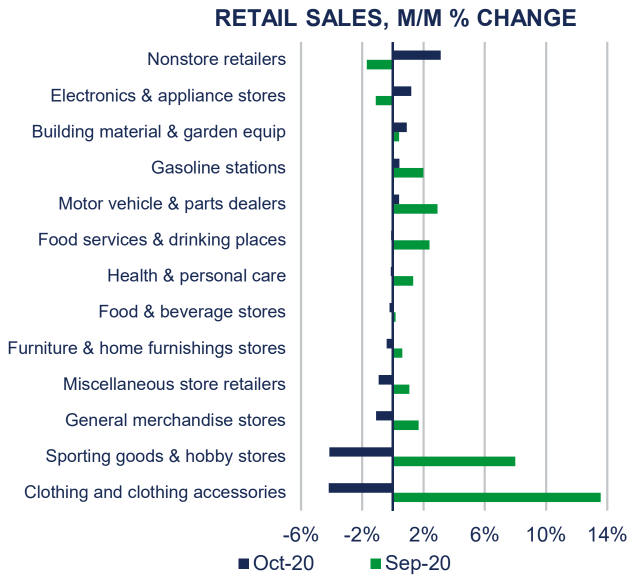
- 13 million people risk losing unemployment insurance on December 26 without further fiscal support—when both the PUA and PEUC programs are set to expire. This would take a large toll on personal income and likely spending.
- With Senate control up in the air pending Georgia runoffs, White House attention focused elsewhere, and several Congressmen in quarantine, it is increasingly likely that additional support won't pass until next year, which would weigh on near-term consumer spending.

Rising cases, restrictions, and lack of additional stimulus is weighing on CONSUMER SENTIMENT.



- Near-term risks are weighing on consumers' expectations, leading overall consumer sentiment to decline in November, nearing pandemic-lows.
- This could weigh on spending in the near-term, particularly among the lower-income cohort, who have been depleting their pent-up savings.

After an impressive rebound, CONSUMER SPENDING will likely slow in the near-term.



- After a solid rebound heavily aided by fiscal stimulus, consumer spending will likely turn lumpy as lower-income consumers wind down their pent-up savings and greater restrictions are imposed. Spending at restaurants and bars fell in October as temperatures cooled, and low-income consumers are shifting spending back to necessities.
- On the upside, higher-income consumers—whose employment has held up better—should help counteract some of the near-term weakness, and more stimulus next year is set to provide a medium-term lift.

Source: Bloomberg, Haver. As of November 30, 2020.

CONSENSUS FORECAST

- Our view is in line with consensus for growth, inflation and unemployment for 2020
- For 2021, though, we see a slightly stronger labor market recovery due to the strong initial policy response

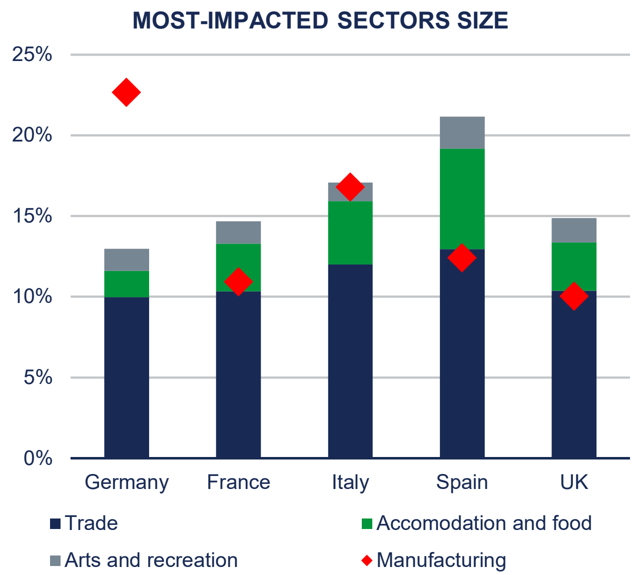
Economic Growth	11/30/2020	12/31/2018	12/31/2019	2020 (E)	2021 (E)	2022 (E)
Real GDP (Y/Y %)	-2.9	3.0	2.2	-3.6 ▲	3.8 --	3.0 ▲
Inflation						
CPI (Y/Y %)	1.2	2.5	1.8	1.2 --	1.9 --	2.0 --
Core PCE (Y/Y %)	1.4	2.0	1.7	1.4 --	1.7 --	1.8 ▲
Labor Market						
Unemployment (%)	6.9	3.9	3.7	8.2 ▼	6.3 ▼	5.0 ▼
Rates						
Fed Funds	0.13	2.38	1.63	0.25 --	0.30 --	0.35 --
2Y Treasury	0.15	2.52	1.57	0.19 ▼	0.35 ▼	0.59 ▼
10Y Treasury	0.85	2.72	1.92	0.85 ▲	1.20 ▲	1.53 --

Arrows indicate consensus estimate change compared to one month ago

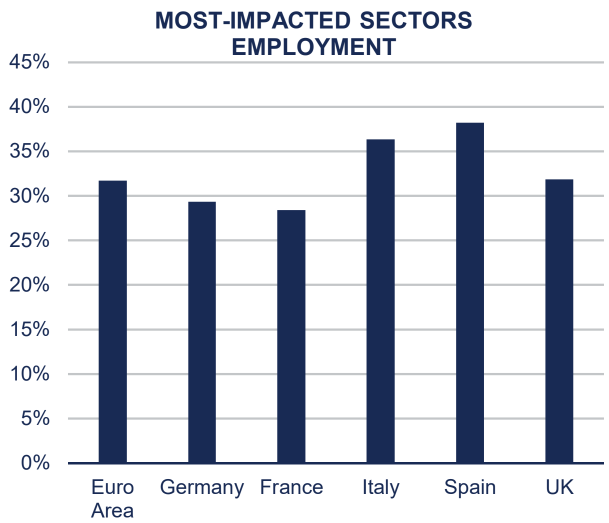
Source: Bloomberg. As of November 30, 2020. (E)—Bloomberg private market consensus estimates.

Europe

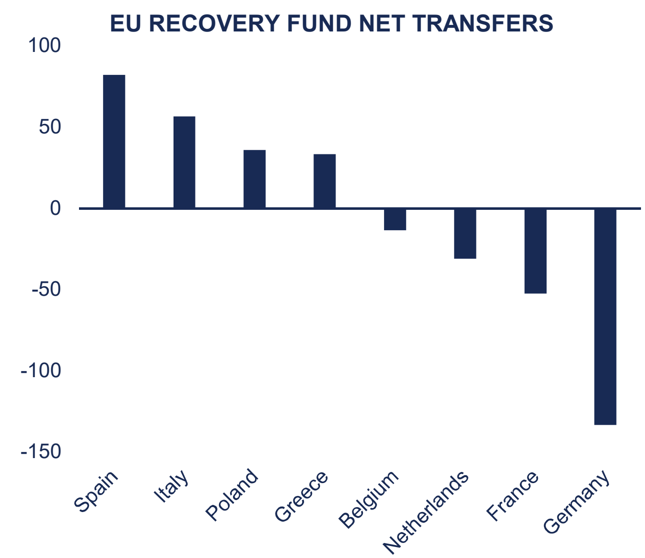
NEW LOCKDOWNS will impact countries' growth…	…and DELAY THE RECOVERY.	POLICY will continue support the economy fully.



- Containment measures announced across Europe have been less restrictive than the full lockdowns seen in Q2. Restrictions were concentrated on retail, accommodation and entertainment sectors.
- A mix of the larger portions of these sectors and smaller manufacturing suggests growth in Spain and the U.K. will continue being the most affected.



- The most-affected sectors are employing roughly one-third of the workforce.
- While disruptions are smaller than those brought by the lockdowns in spring, which affected the vast majority of the workforce, the hit on employment cannot be avoided.
- Current "Lockdowns Lite" should thus bring less damage to GDP growth but still delay the recovery.

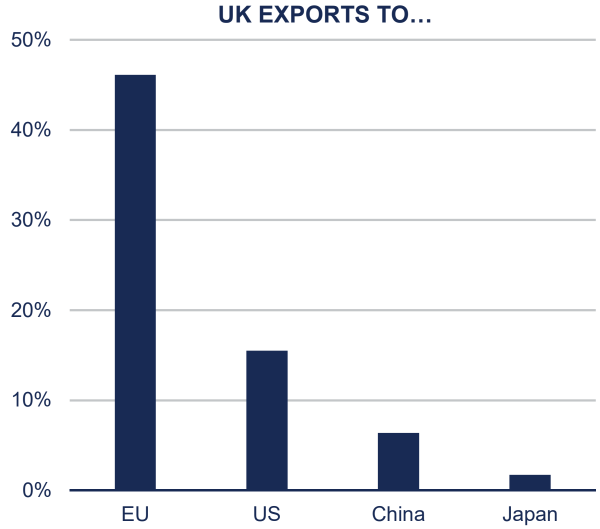


- Governments have extended fiscal support in order to limit the damage of "Lockdowns Lite."
- With hiccups, the EU Recovery Fund is still progressing towards completion and should generate substantial intra-EU transfers (see chart).
- We expect it to be operational in April as planned, although the risk of further delay has increased.

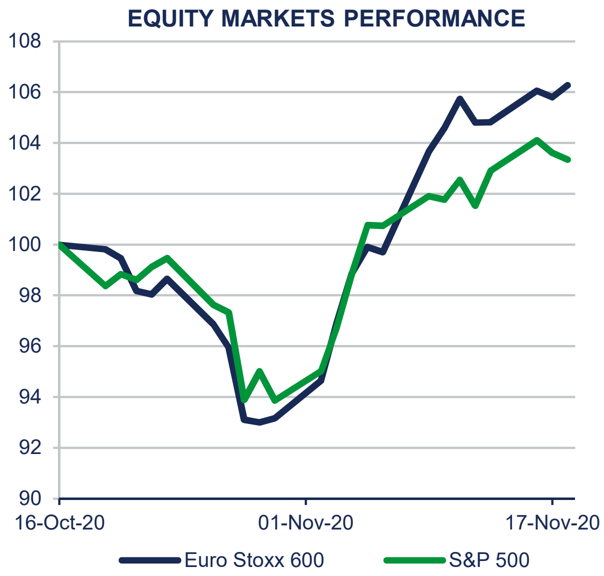
Source: Bloomberg and Haver. As of November 18, 2020.

Europe

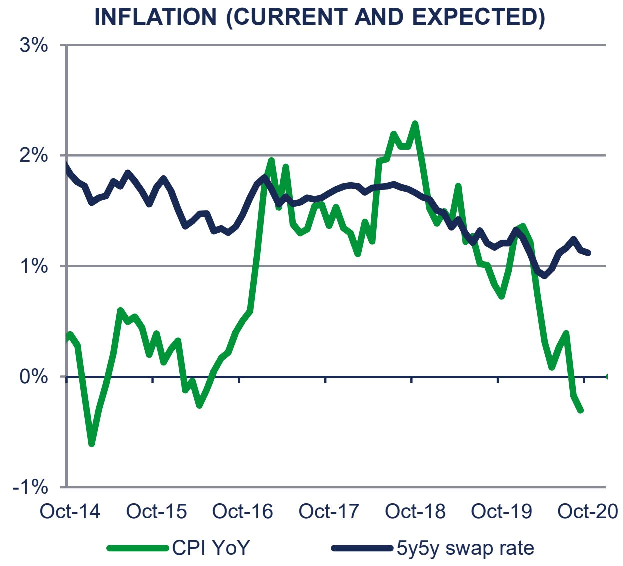
BREXIT will impact U.K. growth, deal or no deal.	**STOCK MARKETS** are turning relatively more sanguine on Europe.	**FALLING INFLATION** gives the ECB 'carte blanche.'



- From January 1, trade with by far its biggest buyer will become more expensive for the U.K., hindering growth.
- Even with a deal maintaining the current no-tariff regime, border checks and sizeable paperwork will become a costly reality for U.K. exporters to the EU.
- The U.K. Audit Office estimates that U.K. firms will need to complete an additional 200 million custom declarations a year.



- Vaccine news, electoral uncertainty in the U.S. and "Lockdowns Lite" tentatively working have spurred an unusual outperformance of EU stock markets compared to those in the U.S.
- Lack of progress on the expected fiscal stimulus package, as well as accelerating cases in the U.S., may be weighing on investors' minds.



- Euro area inflation has collapsed and is expected to remain very subdued in the future (see chart). This gives the ECB complete freedom.
- The central bank is expected to announce a sizeable package at its December 10 meeting, including more QE, lower rates and more enticing terms for banks to continue provide credit as strongly as they did during the pandemic.

Source: Bloomberg and Haver. As of November 18, 2020.

CONSENSUS FORECASTS

- We share the consensus view for what remains of 2020
- Faster-than-expected resurgence of COVID-19 tilts the risks slightly to the downside for 2021

Economic Growth	11/30/2020	12/31/2018	12/31/2019	2020 (E)	2021 (E)	2022 (E)
EZ Real GDP (Y/Y %)	-4.4	1.9	1.3	-7.3 ▲	4.6 ▼	3.5 ▲
U.K. Real GDP (Y/Y %)	-9.6	1.2	1.3	-11.2 ▼	5.4 ▼	4.4 ▲
Inflation						
EZ CPI (Y/Y %)	-0.3	1.8	1.2	0.3 --	0.9 ▼	1.2 ▼
U.K. CPI (Y/Y %)	0.7	2.5	1.8	0.9 --	1.4 ▼	1.8 --
Labor Market						
EZ Unemployment (%)	8.3	8.2	7.6	8.0 ▼	9.0 ▼	8.7 ▼
U.K. Unemployment (%)	4.8	4.1	3.8	4.7 ▼	6.8 ▼	5.9 ▲
Rates						
EZ Central Bank	0.00	0.00	0.00	0.00 --	0.00 --	0.00 --
EZ 2Y Note	-0.75	-0.62	-0.61	-0.72 ▼	-0.61 ▼	-0.45 ▲
EZ 10Y Bond	-0.58	0.24	-0.19	-0.52 ▼	-0.29 ▼	-0.02 ▲
U.K. Central Bank	0.10	0.75	0.75	0.10 --	0.15 ▲	0.40 ▲
U.K. 2Y Gilts	-0.03	0.74	0.53	-0.04 --	0.08 ▲	0.25 ▲
U.K. 10Y Gilts	0.30	1.27	0.82	0.19 ▼	0.40 ▼	0.66 ▲
Currencies						
EUR/USD	1.20	1.14	1.12	1.19 ▲	1.22 ▼	1.25 ▲
GBP/USD	1.33	1.27	1.33	1.31 ▲	1.36 ▲	1.40 ▲

Arrows indicate consensus estimate change compared to one month ago

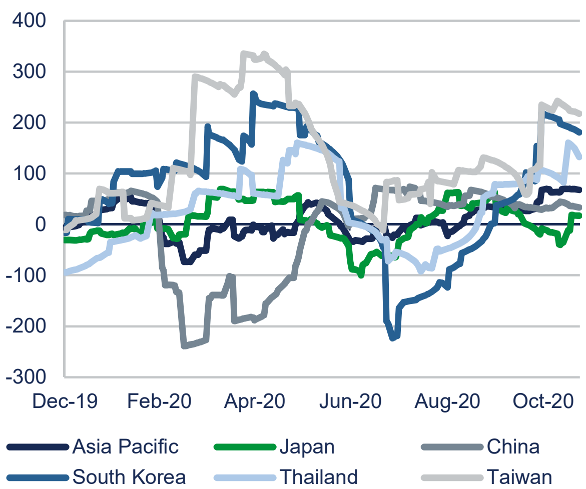
Source: Bloomberg. As of November 30, 2020. (E)—Bloomberg private market consensus estimates.

ECONOMIC MOMENTUM is still biased to the upside, suggesting the recovery is very much intact for the region.

IMPROVING TRADE is signaling a recovery in global corporate earnings…

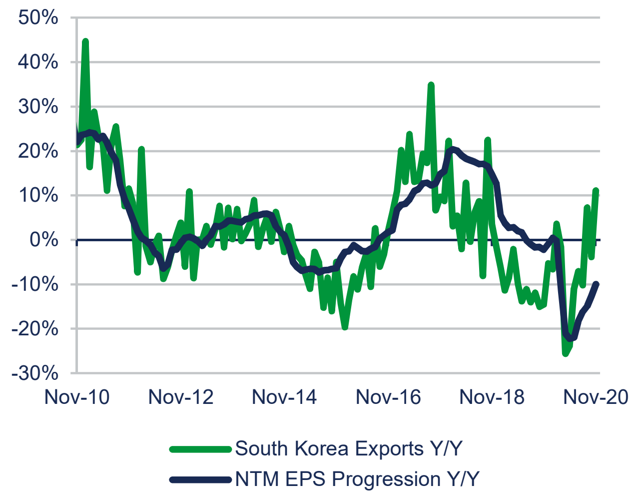
…and also supports the continued CURRENCY STRENGTH for exporters in the region.

CITI ECONOMIC SURPRISE INDEX



- Lagging the region in general, Japan has likely seen an inflection point following strong Q3 GDP. While there are signs of a bottom in industrial production, led primarily by durable consumer goods, the recovery is precarious given still-subdued internal demand.
- A measure of government-mandated mobility restrictions continues to decline across the region as contagion risks decline, with the exception of Malaysia.

SOUTH KOREA EXPORTS AND GLOBAL EARNINGS OUTLOOK



- The strong rebound in South Korean exports—a leading indicator of world trade—has persisted in November amid strong goods consumption globally.
- Exports have recovered across the region as well, with China, Hong Kong, Malaysia, Taiwan and Vietnam seeing the largest gains; year-over-year growth for these countries is now in positive territory.

ASIA FX INDEXED PERFORMANCE

- The export-led recovery has continued to improve the balance of payments of many Asian economies and has driven currency strength. This gives additional fiscal space should governments choose to roll-out additional support.
- The Japanese Yen may not be benefiting as much from this tailwind, however, as global safe haven flows abate (roughly measured as an increase in U.S. real yields and term premiums).

Source: Bloomberg and Haver. As of November 18, 2020.

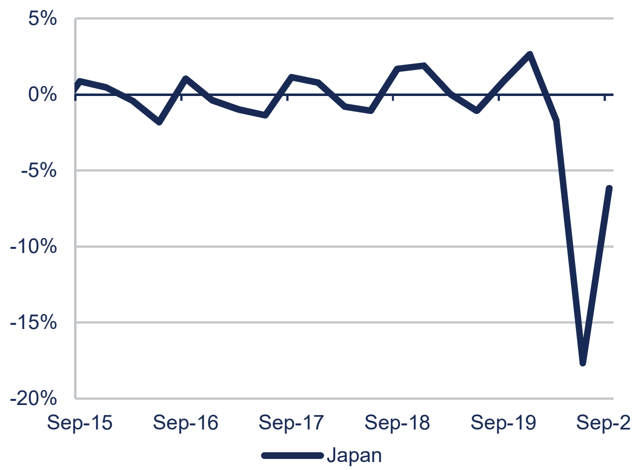
Asia Pacific

FISCAL SUPPORT is helping reduce downside risks for Japan growth, especially with more stimulus on the way.

The pace of POLICY ACCOMODATION in China, while still expansionary, is at risk of being withdrawn.

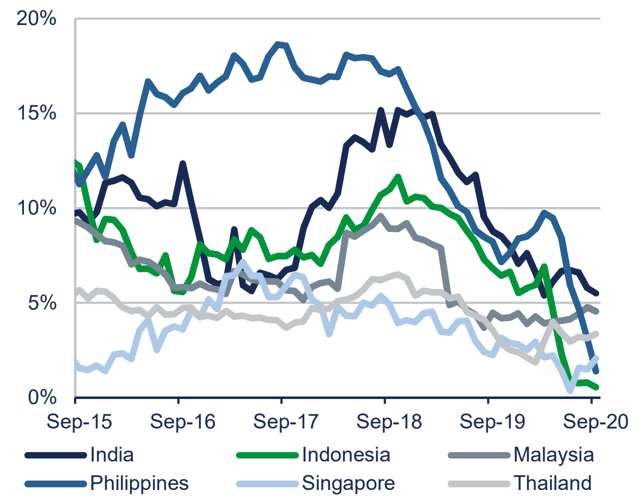
PRIVATE SECTOR CREDIT GROWTH remains anemic in South Asia.

GENERAL GOVERNMENT BALANCE AS A % OF GDP



MONETARY EXPANSION

PRIVATE SECTOR CREDIT GROWTH Y/Y



- The Suga government plans another round of economic stimulus, worth around 2% of GDP, before the end of the next fiscal year in March. While the expected ¥10 trillion package dwarfs the ¥234 trillion injected so far this year, it should aid the recovery and help offset still-sluggish private investment.
- This comes as growth continues to be heavily supported by government spending.

- Policy conditions may be biased lower as policymakers return to their pre-crisis deleveraging stance. Indeed, policymakers have signaled a more "balanced" approach going forward.
- While it poses some risks to the domestic economy, its primary impact would see China as less of a dominant driver of regional and global growth.

- Enhanced global liquidity conditions have yet to translate into meaningful credit growth in South Asia as banks remain cautious.
- Though the recovery has so far been unencumbered by headwinds in domestic credit availability, it does put into question its lasting momentum, especially as business confidence and capex remain depressed in South Asia.

Source: Bloomberg and Haver. As of November 23, 2020.

CONSENSUS FORECAST

- Our view is in line with consensus for growth, inflation and unemployment for 2020
- We see inflation running slightly higher than consensus in Japan for 2021 on stronger demand fueled by the lagged effect of substantial government stimulus

Economic Growth	11/30/2020	12/31/2018	12/31/2019	2020 (E)	2021 (E)	2022 (E)
Japan Real GDP (Y/Y %)	-5.8	0.3	0.7	-5.3 ▲	2.5 ▲	1.8 ▲
China Real GDP (Y/Y %)	4.9	6.7	6.1	2.0 --	8.1 ▲	5.5 --
Inflation						
Japan CPI (Y/Y %)	-0.4	1.0	0.5	0.0 --	0.1 ▼	0.5 ▼
China CPI (Y/Y %)	0.5	2.1	2.9	2.7 ▼	1.8 ▼	2.3 --
Labor Market						
Japan Unemployment (%)	3	2.4	2.4	2.9 --	3.2 --	2.8 ▲
China Unemployment (%)	3.8	3.8	3.6	3.8 ▼	3.6 ▼	3.7 ▲
Rates						
Japan Central Bank	-0.10	-0.10	-0.10	0.00 ▲	0.00 ▲	0.00 ▲
Japan 2Y Note	-0.13	-0.15	100.45	-0.12 --	-0.09 --	-0.06 ▲
Japan 10Y Bond	0.03	-0.01	100.71	0.01 ▲	0.05 ▲	0.08 ▲
China Central Bank	4.35	4.35	4.35	4.35 --	4.35 --	4.25 ▲
China 2Y Note	2.97	2.75	99.45	2.94 ▲	2.70 ▲	2.43 ▲
China 10Y Bond	3.26	3.30	95.19	3.16 ▲	3.09 ▼	3.10 ▲
Currencies						
USD/JPY	104.20	110.27	104.20	104.00 ▼	106.50 ▲	105.00 ▲
USD/CNY	6.58	6.86	6.58	6.70 ▼	6.57 ▼	6.50 ▼

Arrows indicate consensus estimate change compared to one month ago

Source: Bloomberg. As of November 30, 2020. (E)—Bloomberg private market consensus estimates.

THE NOT QUITE RECOVERY (70% ODDS)

Fast and effective policy response from mostly key central banks and finance ministries have shielded the cash flows of households and firms. Unlike 2008, firms and households also entered this year with strong balance sheets.

The world economy will recover steadily, but slowly and unevenly. Some firms continue to tap credit markets and enjoy strong demand; others will suffer from permanent changes in consumer behavior or run out of liquidity before demand returns.

In this scenario, spending and investment are expected to rebound over the next 12 months but remain below 2019 levels because:

- Not all household and corporate income was (or will be) protected by policy support
- Lingering uncertainty on global demand
- Firms may cut labor costs to afford future investments, including in green and digital infrastructure

Conditions

- Continued policy support, especially in the form of direct government payments to households and businesses
- COVID containment succeeds so that consumer confidence steadily returns

Indicators to watch

- Personal income, spending and savings
- Non-performing loans, downgrades, bankruptcies
- Unemployment dynamics and labor force participation rates
- Consumer surveys and capex intentions

Analysis

Even in China, where the downturn was most shallow and the recovery is most advanced, the **picture is mixed**, as retail spending lags the recovery on the supply side. Also, income loss has been substantial for poorer urban and migrant workers. The government-driven investment boom needs to be accompanied by a recovery of world trade for a return to full capacity.

In Europe, furlough schemes protect 70-80% of **employees' income**, but independent workers are less protected and firms' revenues have declined considerably. In the U.S., the CARES Act raised private incomes, but that support has now expired and savings are being drawn down.

The COVID-19 shock hit a **global order** that was already in transition to address the challenges of climate change, rising inequality and tremors in geopolitical alliances. The shock may accelerate some long-term changes in behavior already underway: digitization has made a quantum leap, teleworking has become a credible alternative, and travel and leisure seem likely to find new patterns.

This points toward new **winners and losers** across sectors and countries. The job prospects of the millions in temporary layoffs are unclear. Out of precaution, households are cutting spending for now. If vaccines emerge over the next six months, as now seems likely, will consumers forget about all the uncertainty and jump back to spending and investing? Hope is not a plan. Government support remains essential even to achieve a "not quite recovery."

The above represent the views of Barings as of November 30, 2020, and are subject to change at any time. These predictions may not come to fruition.

FISCAL CLIFF SCENARIO (20% ODDS)

If public support is withdrawn prematurely, either in the U.S. amid rising partisan tensions or in Europe as public debt worries return, a central pillar to the recovery will disappear. With unemployment benefits and furlough schemes fading, the depletion of household savings and firms' liquidity buffers will lead to another recession in 2021.

A second wave, in this context, would be devastating.

Conditions

- Policymakers reduce fiscal support, notwithstanding persisting labor market fragility (lower employment, falling wages)

Indicators

- Cuts in furlough schemes and unemployment benefits
- Rising long-term unemployment
- COVID-19 hospitalization and fatality dynamics

Analysis

Initially in the crisis, politicians of all stripes stood united around large and lasting public support. There was talk of largely unchecked public spending supported by central banks in a world of low inflation and low growth.

But with the initial stages of recovery, the **traditional debate** returned. In the U.S., the extra unemployment benefits have been left to expire, while presidential executive orders provide a limited offset. In Italy and Spain, furlough schemes will expire by year-end. Surely governments will be forced to spend more as the final stages of recovery slow. But what if they don't and start trying to balance the budget the way they did in the wake of the Global Financial Crisis?

ESCAPE VELOCITY (10% ODDS)

Effective vaccines against COVID-19 are expected to be widely available by the 2H21, so that full normalization of economic and social life could be achieved by end-2021. If however the vaccine rollout is faster than expected, a faster normalization in employment, growth, and inflation would ensue, bringing euphoria in the markets.

Conditions

- Having the majority of vulnerable populations in the U.S. and EU vaccinated by end 2Q21.
- If the same is achieved in Emerging Markets, the synchronized rebound will include EMs.

Indicators

- Timeline of vaccine roll-outs and vaccination take-up
- Infrastructure development for vaccine storage (in DM and EM)

Analysis

EU and U.S. governments have already booked enough doses to vaccinate the entire U.S. and EU elderly population, as well as front-line health care staff. Still, the logistics of distributing and inoculating the doses are highly complex, and questions on efficacy and safety remain unanswered.

In the rosiest scenario, vaccination programs start in January. If vaccines prove to be as effective as they appeared in trails and take-up is high, vulnerable groups' immunity will make lockdowns and restrictive measures unnecessary. Anticipating this, investment and durable consumption will pick up solidly from early 2021, accelerating growth and bringing normalization in labor markets. Markets will power higher.

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Scenario Matrix—Economy

		Scenarios						
		1. Not Quite Recovery		*2. Fiscal Cliff*		*3. Escape Velocity*		
		2020	**2021**	**2020**	**2021**	**2020**	**2021**	**Comments**
U.S.	Growth	-3.5%*	4.0%	-3.5%*	1.0%	-3.5%	6.0%*	The U.S. economy faces near-term headwinds, but the 2021 forecast could accelerate further if Congress passes a larger fiscal agenda.
	Inflation	1.0%	1.5%*	1.0%	1.0%*	1.0%	2.0%*	
	Unemployment	6.5%*	5.0%*	6.5%*	7.0%*	6.5%*	4.0%*	
Euro Area	Growth	-7%*	4-5%	-7%*	3%*	-7%*	6%*	While the second wave of lockdowns is hurting growth, the medium-term outlook has improved substantially as a result of vaccine progress.
	Inflation	<1%	<1%	<1%	<1%	<1%	1.5%*	
	Unemployment	8.5%*	7.5%*	8.5%*	8%*	8.5%*	7%*	
Japan	Growth	-6%	2–3%	-6%	0–1%	-6%	3-4%*	Yoshihide Suga will continue the reflationary policies of his predecessor and supports current monetary policy, which backs fiscal expansion efforts.
	Inflation	0%	0.5%	0%	0%	0%	0.5%*	
	Unemployment	3%	3%	3%	4%	3%	2.5%*	
China	Growth	2–2.5%	8%	2–2.5%	3–4%	2–2.5%	8-9%*	The recovery in key economic drivers remains uneven. Exports are robust, retail sales are recovering, but targeted tightening is being seen in the real estate sector.*
	Inflation	2–3%	2%	2–3%	2%	2-3%	2-3%	
	Unemployment	4%	4%	4%*	4–5%	4%*	3.5%*	

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*Asterisks indicate updated estimates from one month ago.

Scenario Matrix—Central Bank Policy

	Scenarios			
Central Bank	***1. Not Quite Recovery***	***2. Fiscal Cliff***	***3. Escape Velocity***	***Comments***
FED	Fed Funds Rate: 0% Balance Sheet: Accommodative	Fed Funds Rate: 0% Balance Sheet: Very accommodative	Fed Funds Rate: 0% Balance Sheet: Less accommodative	In the Fed's new framework, tightening only begins after balance sheet reduction, perhaps in 2H22 or 2023, when inflation rises consistently above 2%.*
ECB	Further accommodation in the form of more QE and generous liquidity provision to counter the damage of second lockdowns.*	No change from scenario 1*	Some acceleration in inflation may create disagreement on accommodation within the Governing Council but no tightening action until 2022 at least*	Except for scenario 3, Escape Velocity, inflation will remain subdued and far below its 2% policy target, the ECB remains under pressure to do more.*
BOJ	Policy rate stays negative; Balance sheet: Accommodative	Policy rate stays negative; Balance sheet: Very accommodative	Policy rate stays negative; Balance sheet: Accommodative	Maintain easing, with bias toward loans rather than asset purchases, to support economic growth and elusive inflation target.*
PBOC	Accommodation slowly withdrawn through 2021*	Cautiously accommodative*	Accommodation slowly withdrawn through 2021*	Policymakers have signaled a more "balanced" approached, with policies focused on sectors that need long-term support.*

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Scenario Matrix—Markets

	Scenarios			
Markets	***1. Not Quite Recovery***	***2. Fiscal Cliff***	***3. Escape Velocity***	***Comments***
Rates	Policy rates unchanged; 10Y UST range bound around 1%*	Policy rates unchanged; 10Y UST lower	Policy rates unchanged; 10Y UST biased higher, averaging 1.5%*	Short rates anchored by central bank policy, watching the long end to gauge steepening.
Corporate Credit	Spreads grind tighter	Spreads widen some	Spreads move tighter, benefitting HY over IG amid higher rates*	Liquidity environment supportive of credit conditions.
Equities	Modestly higher	Likely lower	Greater acceleration with value benefitting amid steeper curves*	We expect some moderating of valuations through next year as more clarity on the vaccine is priced in.*
FX	USD weakness continues	USD steady	USD weakness accelerates*	A vaccine-led global synchronized recovery should sustain the USD downtrend.*
Commodities	Oil, copper and gold generally higher	Oil, copper and gold generally range-bound	Oil, copper and gold move higher*	Supported by weaker USD and continued global economic recovery.

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