ICG

Macro Views
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Economic and Investment Research

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A changing economic landscape

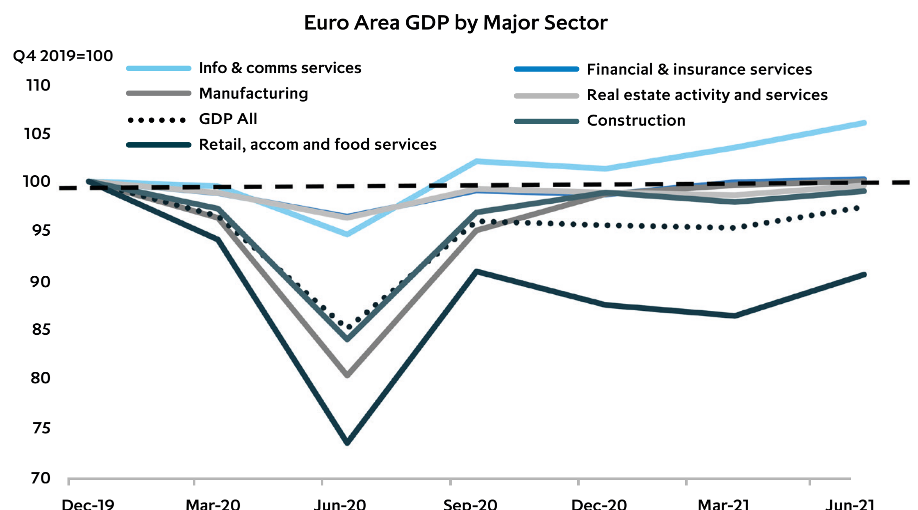
Key Points

- **Most economies have experienced strong V-shaped economic recoveries** over the past year as the rapid roll-out of highly effective vaccines has reduced the lethality of Covid-19 and allowed economies to reopen.
- **Highly accommodative monetary and fiscal policies have added to the momentum**, helping push asset prices higher – with a number of equity benchmarks hitting all-time highs.
- **The landscape is now changing**, however. Global supply chain disruptions together with a strong rebound in demand, have led to shortages of a wide range of goods, driving prices of key inputs and commodities higher. The shortages and sharp price rises have led to concerns about central bank monetary tightening and the sustainability of the recovery.
- **We expect recovery to continue, but at a more moderate pace** as, in our view, most of these issues are manageable and will eventually be resolved, as we describe in more detail in this report.
- **We also think the "central bank put" remains alive and well**. If financial markets and/ or economies wobble sufficiently, major central banks have made it clear they will quickly step back in and "do whatever it takes" to shore up economies and markets.
- **A continued positive operating environment**. Although economic and earnings growth momentum is likely to slow, and companies in some of the more supply-constrained sectors may see further pressure, strong consumer demand and continued accommodative monetary policy should provide a positive operating environment for most companies – particularly those in high value-added services sectors.
- **Demand for private capital will continue to grow**. With government fiscal support rolling off and market volatility likely to rise, we think demand for private capital will remain strong. Private debt and equity, with their medium to long-term investment horizons, ability to provide flexible capital and close partnerships with portfolio companies are particularly well suited to help extend the economic recovery in our view.
- **What does the new environment imply for asset allocation?** Given higher inflation and interest rate risks, we think real assets such as real estate, infrastructure and asset-backed strategies with predictable cash flows should continue to see strong demand, as well as strategies with exposure to floating rate loans. Strategies with debt elements that can provide downside protection in a more uncertain economic environment should also play a growing role in allocations. And finally, in our view, flexible strategies that can take advantage of increasingly divergent market, sector and company performance based on some of the trends outlined in this report, should continue to see excellent opportunities in this rapidly evolving economic environment.

Watch the video

Author of this research Nicholas Brooks interviewed by Fiona Laffan, Global Head of Corporate Affairs

A strong V-shaped recovery – but wide performance variation



Source: Bloomberg

Overview

Most of the world's major economies experienced strong V-shaped economic recoveries over the summer months as the rapid roll-out of highly effective vaccines has reduced the lethality of Covid-19 in countries with high vaccination rates and allowed economies – to varying degrees – to reopen. Highly accommodative monetary and fiscal policies have added to the momentum, helping push asset prices higher – with a number of equity benchmarks hitting all-time highs.

The economic landscape, however, is now changing. The bulk the normalisation phase of the recovery is behind us, with the GDP of most major economies now close to or above pre-Covid levels. Gains from here will be harder work. Supply chain bottlenecks are constraining growth across a number of goods sectors, substantially increasing delivery times and pushing up the prices of a number of intermediate and final goods. Insufficient labour supply in some market segments has pushed up wage costs. Energy prices have soared, adding to costs and inflationary pressure. China's crackdown on property developers is leading to distress in the sector, potentially weighing on the country's broader growth momentum. Monetary and fiscal policies are becoming less accommodative as central banks start reducing QE programmes and governments roll back emergency fiscal support. All of these factors have led to growing concerns about the sustainability of the recovery.

As we describe in more detail in this report, in our view, most of these issues are manageable and will eventually be resolved. Supply bottlenecks should gradually diminish in 2022 as ports and manufacturing facilities re-open and logistics backlogs are worked through. Although monetary policy may become modestly less accommodative, we expect interest rates to stay near historically lows levels and liquidity to remain ample.

Importantly, we also think the "central bank put" remains alive and well. Major central banks have made it clear that if financial markets and/or economies wobble sufficiently they will quickly step back in and "do whatever it takes" (including re-opening the liquidity taps) to shore up economies and markets. China also does not want a financial crisis on its hands and has the resources and policy levers to prevent one in our view.

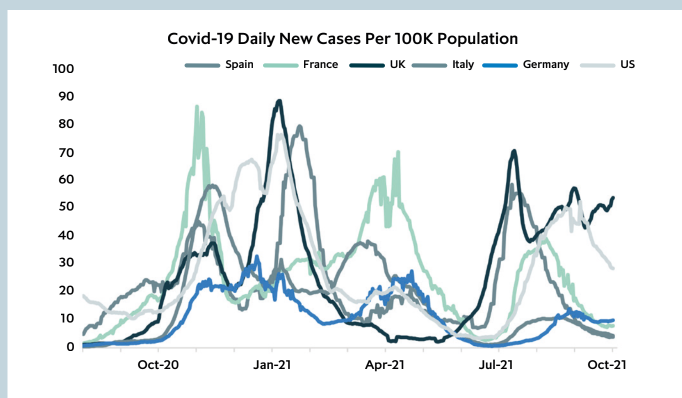
Looking forward we expect recovery to continue, but at a more moderate pace as the initial V-shaped reversion to pre-Covid levels of activity begins to level out and monetary and fiscal policy stimulus starts to be rolled back. Public market volatility may increase and companies with high exposure to the inputs most affected by supply chain disruptions (e.g. semiconductors, construction materials, food supplies) and scarce low wage labour may remain under pressure.

But most sectors and companies – particularly in the higher value-added service sectors that make up the largest part of most developed economies – will continue to thrive as economies continue to re-open, pent up savings are spent, inventories are rebuilt and stronger companies consolidate and expand their market share.

We believe this will continue to provide a positive environment for private debt and equity investors, where an emphasis on rigorous bottom-up analysis, close partnerships with portfolio companies and longer-term investing horizons should be particularly helpful for navigating the new and evolving economic landscape.

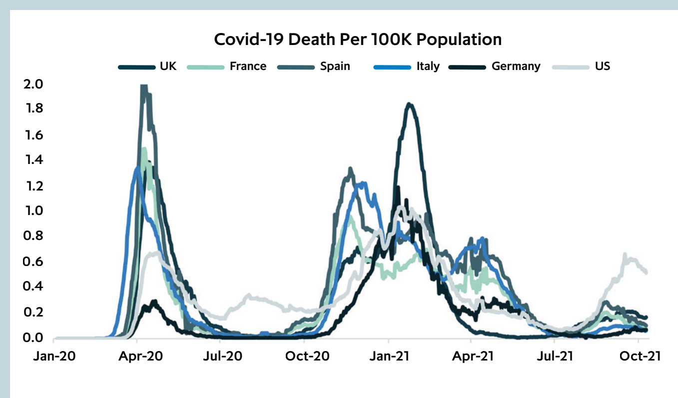
In the following section we highlight some of the key issues affecting the economic landscape and our take on their potential implications for the economic and investment outlook.

Covid-19 cases are under control in most countries



Source: Bloomberg, Our World in Data.

Covid-19 vaccines have been a game-changer



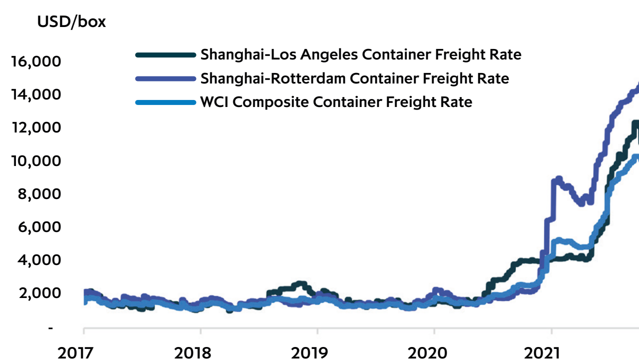
Source: Bloomberg, Our World in Data.

Supply chain disruptions: Increasingly bifurcated performance

Supply chain disruptions caused by Covid-19 have been larger and more prolonged than most analysts and companies expected. Manufacturing facilities and ports closed due to Covid cases, shipping container shortages due to misallocations, shortages of transport and logistics workers, reduced flights for air cargo, stricter border controls and semiconductor shortages have all contributed to the upheaval.

So far, most affected companies have found ways to manage the disruptions without sustaining too much damage. However, the risk is that if the worst of the bottlenecks aren't resolved in the coming months, companies affected by shortages of key inputs may run out of short term fixes and will start to see a deterioration in top-line growth and margins.

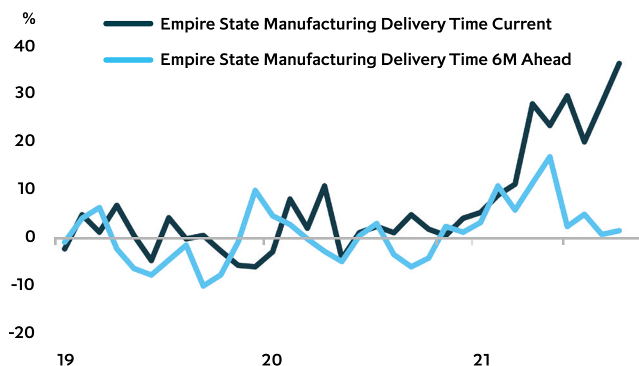
Container freight rates have soared



Source: Bloomberg

Services businesses, on the other hand, have mostly been unscathed by the manufactured goods supply chain disruptions and this is likely to lead to increasingly bifurcated performance between the manufacturing and services sectors over the coming quarters.

Delivery times highest on record



Source: Bloomberg. US Empire State survey of New York state manufacturing executives. Diffusion index.

The good news is that most of these bottlenecks should be resolved eventually. As vaccination levels increase globally and countries reopen, most of these issues should naturally dissipate. The Empire State survey of manufacturing executives indicates manufacturers believe delivery times should adjust back to normal in the next six months. But in the interim, companies in affected areas may start to show more strains. Some key indictors to monitor to gauge manufactured goods supply side developments include freight rates, supplier delivery times, inventories, manufacturing PMIs and intermediate product price developments.

China property developer distress: Not another "Lehman moment"

Evergrande, China's second largest property developer by sales and with over $300bn of liabilities, is struggling to meet interest payments on its debt and is widely expected to default and/or face a major restructuring with significant losses to equity and credit holders. A number of other developers are also under severe stress, with many analysts expecting defaults and/or restructuring across the sector. Some investors are concerned this may be China's "Lehman moment", leading to a collapse of (or at least a severe hit to) China's financial system with ripple effects through global financial markets and economies.

There are two main reasons we think this risk is still relatively low. The first is that unlike Lehman Brothers, which was a highly levered financial institution at the heart of the US financial system with large and highly complex linkages to other major financial institutions, Evergrande is a property developer with relatively transparent liabilities. Most of Evergrande's liabilities are trade and other payables, with domestic bank loans making up a relatively small share of total liabilities. This should make ring-fencing financial contagion from Evergrande and other potential developer defaults from the rest of China's financial system much more straightforward.

China investment grade yields steady

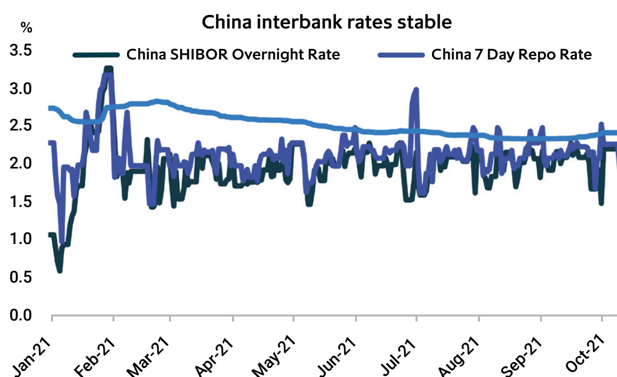
Source: Bloomberg

The second, and perhaps even more important reason why substantial wider financial contagion seems unlikely is that China's government and policymakers don't want large-scale financial disruption at home and likely have the resources, regulatory and other tools to avoid it. While they have indicated they want Evergrande creditors and equity holders to face losses to reduce the entrenched problem of moral hazard in the Chinese financial system and encourage markets to price risk appropriately, they also don't want a major financial crisis on their hands. Of course, there is a risk they miscalculate. But their track record in containing contagion from corporate failures is good. Despite the many inefficiencies it causes, one advantage of China's relatively

closed financial system and "hybrid" market economy, is that in situations like this, the authorities have far more control and policy levers than the Fed and Treasury did during the Lehman period. Therefore, while a policy mistake is possible, it seems that a controlled restructuring is the most likely outcome.

Of course, weakness across China's property sector has the potential to weigh on China's economic growth going forward, with implications for companies, sectors, commodities and economies highly dependent on China investment demand. However, unless the slowdown is far more severe than is currently anticipated, it is unlikely to be sufficient to derail the global economic recovery.

China interbank rates stable

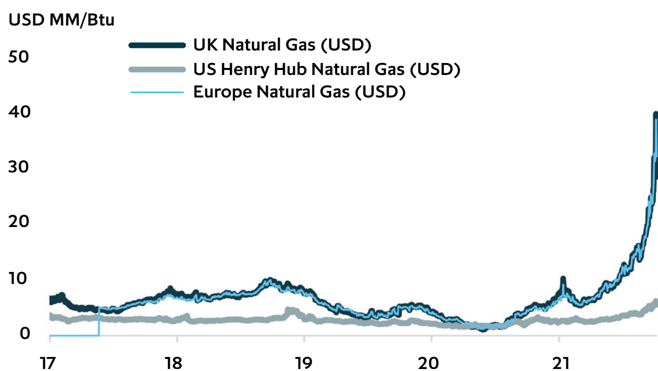


Source: Bloomberg

Key barometers to watch for signs of wider stress are short term interbank market rates and spill-over into investment grade and other markets. So far, with the help of large liquidity injections by the People's Bank of China (PBOC), China's interbank lending markets have remained calm and investment grade and non-property related company spreads have remained stable.

Energy price spike: A difficult winter ahead

Natural gas prices have soared

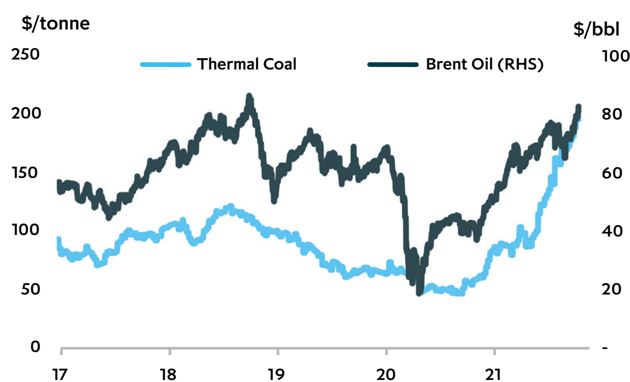


Source: Bloomberg

Another recent development that has come onto the radar of investors is the extremely sharp rise in natural gas and other energy prices this year, and in particular, the past month or so. In Europe and the UK natural gas prices are up around 7x since March and have nearly doubled over the past month. The US has seen around a 2x rise since March. The rise in natural gas prices has spilled over to oil and thermal coal prices on substitution effects. With natural gas inventories at more than 10-year lows in Europe and the UK and well below the five-year average in the US, barring very mild temperatures, shortages and high prices are likely to last through the northern hemisphere winter months.

While the immediate impact of the price rises is inflationary, ultimately the impact is likely to be deflationary as higher energy prices cut into disposable income, corporate profits and government budgets. While our base case scenario is that prices normalise before they do permanent damage to growth, commodity prices are notoriously difficult to predict and this remains a key risk monitor in the coming months.

Oil and coal prices rising too



Source: Bloomberg

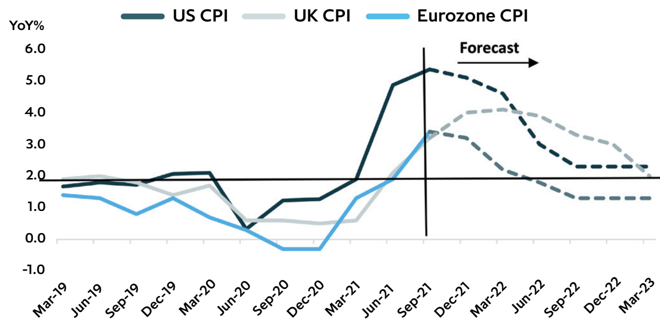
Inflation and Monetary policy: "Central bank put" alive and well

The sharp rise in inflation has caused investors and central banks to re-evaluate the interest rate outlook. Headline inflation is now running over 5% in the US, is expected to rise above 4% in the UK and above 3% in the Eurozone. As described above, the main driver of the pick-up in inflation are supply side shortages. Most of these shortages are related to supply chain disruptions caused by the Covid-19 pandemic and other factors that are likely to be transient

Supply of a wide variety of materials and manufactured goods has been restricted by factory and commodity production site shutdowns due to Covid cases, transport bottlenecks caused by port closures, transport and logistics worker shortages, and reduced air travel. It is also likely that higher than usual demand for manufactured goods as spending has been diverted from services has played a role.

Assuming vaccines and natural immunity allow most economies to continue to reopen over the next year, most of these factors should fade naturally. To the degree that the rise in inflation is primarily due to supply shortages, not structural excess demand, there should be little reason for central banks to raise rates in a significant manner.

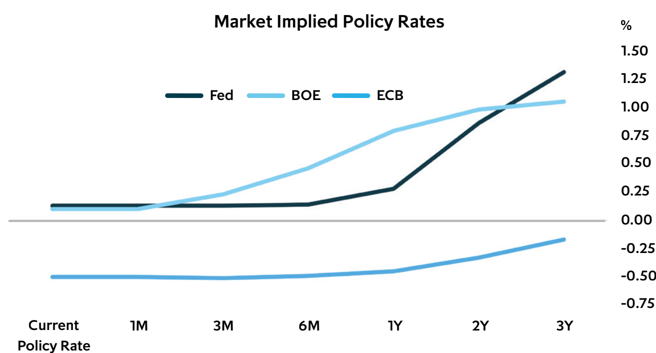
Inflation should subside in 2022



Source: Bloomberg. Private sector consensus forecasts.

One risk highlighted by some central bankers and analysts, however, is the potential for higher inflation expectations to drive a self-fulfilling wage/price inflation spiral. While a recent NY Fed paper[1] indicates this risk is low in the US, stickier than expected inflation and rising longer term inflation expectations could trigger pre-emptive central bank moves. The Bank of England has appeared more hawkish on this front than the Fed or ECB, with futures markets at the time of writing implying the BoE will raise rates around 70bps over the next year. Market expectations are that the Fed will start raising rates at the end of 2022 and the ECB in 2023. However, if growth continues to lose momentum, central banks might start to change their tone and rate hike expectations may be pushed further out again.

Market policy rate expectations have increased



Source: Bloomberg

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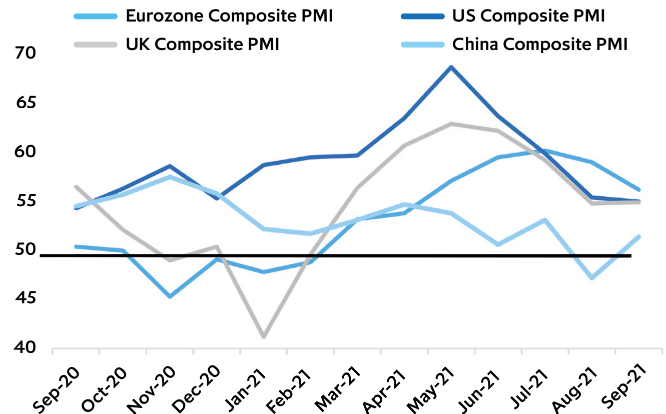
Economic slowdown: Slower but still positive growth ahead

After experiencing strong V-shaped recoveries, most developed market economy recoveries are showing some signs of losing steam. With most economies above or close to pre-Covid levels, the bulk of the easy growth catch-up gains have been made. Supply side bottlenecks, higher prices and labour shortages appear to be weighing on the growth of some sectors. China's economy has been slowing on the back of tightening government regulations and periodic re-imposition of containment measures. Over the next year, fiscal policy in most countries will tighten (or become less stimulative), tax increases are planned, and monetary policy is becoming less stimulative. These factors indicate that investors will likely have to adjust to more moderate levels of economic and earnings growth.

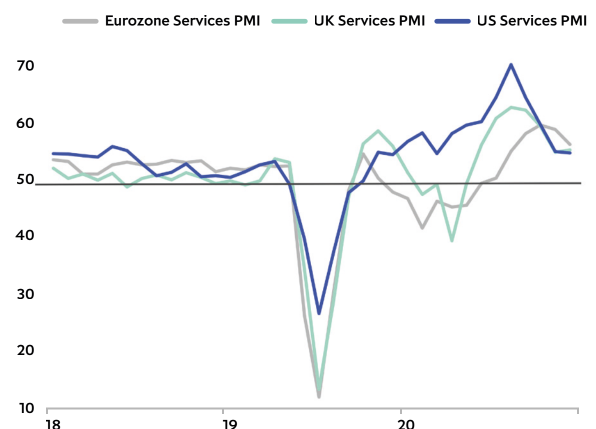
Signs growth momentum is slowing



Source: Bloomberg

However, there are a number of factors that should continue to support growth and, if our base case assumptions are correct, should keep the recovery on track in our view. Barring a new untreatable strain of Covid-19, economic opening and the business activity that comes with it has much further to go. The release of pent up demand, supported by high levels of saving, should provide a firm underpinning to consumer spending – particularly in the services sector. Inventories across most sectors remain extremely low relative to history and rebuilding should provide an additional tailwind to growth. Monetary policy, while likely to become less stimulative than it has been over the past 12 months, is expected to remain highly accommodative and interest rates low relatively to pre-Covid levels. Central banks remain flexible, with the Fed, ECB and BoE emphasising that they stand ready to ease again if the economic recovery falters. Therefore, while growth and earnings may slow from recent highly elevated levels, they should remain sufficiently strong to provide a positive investing environment in our view.

Service sector growth still healthy



Source: Bloomberg

[1]NY Fed: "Have Consumers' Long-Run Inflation Expectations Become Unanchored?"

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