2021 Outlook

Big picture: normal service may be resumed

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Key points

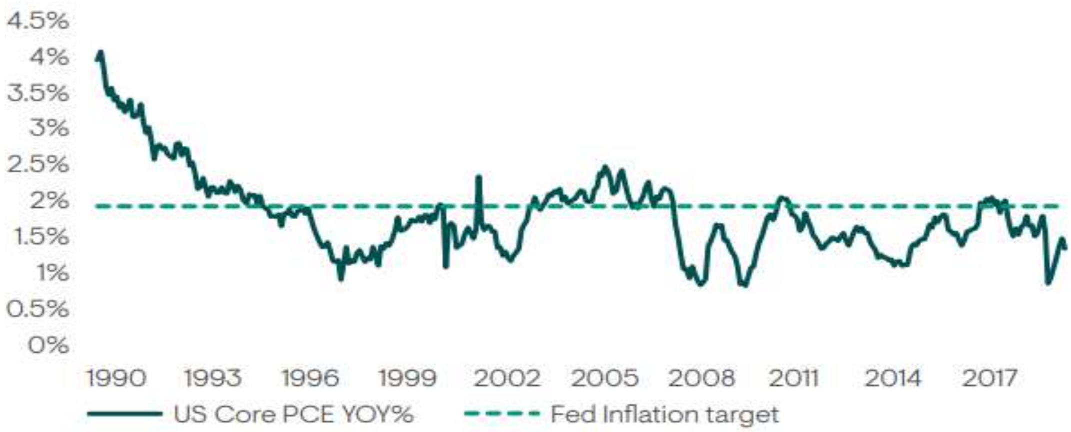
- Inflation rates are set to rise
- US real interest rates are likely to continue to fall, supporting global recoveries
- Geopolitical tensions may moderate but won't disappear
- 2021 could see an emerging market comeback, particularly in Asia

After an extremely abnormal year, 2021 promises to be a year of normality. The speed of the vaccine response and efficacy of the leading treatments have confounded the sceptics. In the coming months, the deployment of vaccines and mass testing will pave the way for a return to a more familiar way of life.

In fact, there is a risk of having too much of a good thing by the second half of the year, as savings – which have rocketed in key economies – get run down, monetary and fiscal policies remain extremely stimulative, and a synchronised global expansion gains traction after some loss of momentum in the early part of the year. Inflation rates are set to rise quite briskly from their depressed COVID-19 lows, primarily due to base effects but also increasingly due to a weaker US dollar, supply bottlenecks and a sharp tightening of service prices. The market, however, still seems to be pricing in 'Japanification' (deflation and weak growth). But conditions in the wake of the pandemic are fundamentally different to those that prevailed after the Global Financial Crisis (GFC), and the inflation outcome following the present crisis may turn out to be quite different.

Western central banks are likely to keep official interest rates and the short end of bond yield curves pinned down. They are also likely to persist with quantitative easing, not wishing to risk snuffing out nascent recoveries. This continuation of 'financial repression' will allow governments to put off any fiscal reckoning well beyond 2021.

Inflation is set to rise beyond its depressed levels in 2021 as the cyclical recovery gains strength



Source: Bloomberg and Ninety One, 31 October 2020.

Financial conditions will stay loose, supporting recoveries

Given the pre-eminent role of the US dollar in global markets, the US Federal Reserve Board (Fed) will continue to set the policy tone internationally. The Fed policy review, which ran from late 2019 to August 2020, has led to the Fed taking a much more asymmetric approach to its inflation target. That is to say, it now tolerates overshoots of the target but not undershoots. The review shows belated acceptance that attempting to normalise interest rates pre-emptively – which had characterised Fed policy since Paul Volcker's chairmanship in the early 1980s until 2015 – was counterproductive in a post-GFC world. The US economy will therefore be allowed to be run hot. As a consequence, US real interest rates are likely to continue to fall, keeping global financial conditions loose and supporting international recoveries.

The one (important) exception is China, where the People's Bank of China (PBoC) has stuck to its more orthodox monetary guns. The renminbi has been allowed to strengthen and although policy has been supportive of growth – the Chinese credit impulse as a percentage of GDP has exceeded the deliberate and material boost to growth in 2015-16 – a full-scale recourse to quantitative easing has been avoided. Indeed, China remains committed to addressing its structurally high indebtedness by continuing to focus on improving capital productivity. This is likely to be the major area of macro policy divergence.

The recurrent geopolitical flare-ups of recent years are likely to moderate somewhat, but will not go away entirely. President Trump's approach was unorthodox, but he succeeded in fundamentally changing US policy towards China from one of 'partner' to 'adversary'. Although the incoming administration is likely to use more conventional diplomacy, a Biden presidency will probably be less comfortable for China because US policy should be implemented in a more structured and internationally collaborative way. In the meantime, China is likely to tone down 'wolfwarrior diplomacy', and concentrate on its priorities of domestic growth and technological self-sufficiency.

2021 is potentially the year of a sustained emerging market comeback, particularly in Asia, given depressed real rates, a weaker US dollar and vaccine-driven cyclical recoveries. Notwithstanding US attempts at containment, China is already acting as a powerful regional and global locomotive.

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Source: Ninety One

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