PGIM MARKETS

Insights on Events Moving the Financial Markets

THE GLOBAL ECONOMY IS CLEARED FOR TAKE-OFF

John Praveen, PhD
Managing Director and Portfolio Manager, QMA

VIEW BIO

Manoj Rengarajan, CFA
Principal and Portfolio Manager, QMA

On the June PGIM Global Partners CIO call hosted by QMA, chief investment officers and senior investment professionals from PGIM's international businesses, PGIM Fixed Income and QMA discussed the acceleration of global growth, the outlook for inflation and the prospects for global equities.

The global economic recovery is shifting into a higher gear as the Eurozone and Japan join the US with solid GDP growth in the second quarter of 2021 after contracting in Q1 when renewed restrictions on activity dampened growth. US Q2 GDP is on track to strengthen to around 9.0% annualized, with upside risks, after solid 6.4% growth in Q1. The economy continues to benefit from unleashed pent-up demand stemming from the fiscal stimulus approved in the first quarter of this year and most of the states removing their COVID-19 restrictions. The upcoming infrastructure bill is also likely to support the economy in the second half of 2021. Eurozone Q2 GDP is expected to rebound by 5.6% quarter-over-quarter annualized after falling -3.6% in Q1 as countries started to slowly remove COVID-19 restrictions. With the acceleration of vaccine rollout, growth is expected to improve in the major Eurozone economies. Japanese real GDP contracted -5.1% quarter-over-quarter in Q1. The economy is on track to a slow recovery in Q2 as COVID-19 cases are close to record highs, and a smaller percentage of the population has been vaccinated thus far. However, the government has opened mass vaccination sites in Tokyo and Osaka, so vaccine administration is expected to accelerate.

Chinese GDP growth is expected to remain strong in Q2 (around 8% year-over-year), slowing from the 18.3% growth in Q1 2021. China's activity data for April was mixed as industrial production and retail sales slowed, while fixed asset and real estate investment were robust. In Taiwan, near-term risks to economic growth have increased as the government has imposed mobility restrictions amidst the surge in COVID-19 infections and due to uncertainty around drought and electricity supply. However, export demand remains very strong with increasing demand for electronic components and semiconductors. The Taiwan team maintains its constructive view on Taiwan's manufacturing given its critical position in the global chip supply chain and believes growth momentum can be restored in H2 2021. India's GDP grew 1.6% year-over-year in Q1 2021. India's economy was on a path to recovery, but momentum has slowed as states re-imposed restrictions in Q2 as COVID-19 cases soared. Lockdowns have been extended into June and are likely to have a significant negative impact on Q2 growth.

The Organization for Economic Co-operation and Development (OECD) in its May 2021 Economic Update has a much-improved outlook for the global economy for 2021 and 2022, in sharp contrast to its earlier gloomy prognosis. However, like the International Monetary Fund, it expects the recovery to be uneven across economies. In the developed economies, the progressive rollout of vaccines has begun to allow more contact-intensive activities to reopen gradually, after being restrained to contain infections. In addition, aggressive fiscal stimulus is helping to boost demand, reduce spare capacity and minimize the risks of significant scarring from the pandemic.

The OECD now expects global GDP to rise by 5.75% in 2021 and around 4.50% in 2022. Growth in developed economies is expected to increase by about 5.25% in 2021, led by a strong upturn in the United States, and strong private spending in most countries. The strong growth pace of 2021 is seen moderating to 3.75% in 2022. While GDP in China has already caught up with pre-pandemic levels and is expected to remain solid in 2021 and 2022, other emerging-market economies, including India's, might continue to have large shortfalls in GDP relative to pre-pandemic expectations and are projected to grow strongly only after the impact of the virus fades.

The Inflation Debate: The inflation debate continues with central banks taking a more benign view, i.e., that the current rise in inflation is "transitory," while markets worry that the rise in inflation could be the start of a new phase of higher inflation after decades of low inflation and deflation fears in 2020. Headline inflation started to rise in early 2021 across most developed markets, primarily due to rising energy prices and base effects from declines in 2020. However, the base effects are expected to peak soon. US inflation jumped 4.2% year-over-year in April from 2.6% in March, largely due to rising energy prices and base effects. Core inflation rose to 3.6% from 1.6% previously. Eurozone inflation was up 2.0% in May from 1.6% in April, also largely driven by energy prices. Eurozone core inflation also increased slightly to 0.9% from 0.7% previously. However, in Japan, nationwide inflation edged down to -0.4% year-over-year in April from -0.2%, while core inflation decreased to -0.2% from 0.3%. Looking ahead, inflation is expected to peak in late Q2 as that was the lowest level of price declines in 2020. Thereafter, base effects will have an offsetting impact, limiting the rise in annual inflation.

As with other central banks in the developed countries, the US Federal Reserve and the European Central Bank expect that much of the sharp rise in inflation will turn out to be transitory. Several Fed officials commented that the chief causes of rising prices are temporary shortages of key supplies and labor tied to the reopening of the economy. Nevertheless, they have indicated that they are monitoring the evolution of inflation closely. One difference, however, between periods of rising prices in the past versus today is the changed mindset and operative framework of the Fed. In the past, the Fed has been preemptive and committed to simple inflation targets, which helped anchor inflation expectations, while now it is committed to maximizing employment and is being "reactive" rather than "proactive" on the inflation front.

The debate about whether elevated inflation is transitory or may persist longer than what the central banks believe continues, but Ellen Gaske, a senior economist at PGIM Fixed Income, and QMA Portfolio Manager Ed Keon agree that while we might not see 1970's-style run-away inflation in the US, there is still a possibility that inflation may persist a little longer. This would be due mainly to the shortages that will likely persist for some more time, both from supply-side bottlenecks that are impacting industries such as semiconductors, as well as labor market shortages, which could take longer to normalize. However, Mike Collins, senior portfolio manager at PGIM Fixed Income pointed out that several companies are responding to the shortages by ramping up production and increasing supply. This raises the risk that there might be an oversupply in many of these areas six to 12 months down the line and that we could see some negative month-over-month inflation readings as shortages start to moderate and demand side adjustments pay-off. There is already some evidence of demand side adjustments as people delay purchases of houses and cars due to rising prices. There are also signs that consumers have started postponing travel or planning alternatives as airline ticket prices rise sharply. This supports the view that inflation pressures could ease later in the year and into 2022.

In its May update, the OECD acknowledged that signs of higher input cost pressures have appeared in recent months, but sizeable spare capacity is likely to prevent a significant and sustained pick-up in underlying inflation. The recent upturn in headline inflation rates reflects the recovery of oil and other commodity prices, a surge in shipping costs, the normalization of prices in hard-hit sectors as restraints are eased and one-off factors such as tax changes. These, should ease in the near term. With unemployment and employment rates unlikely to attain their pre-pandemic levels until the end of 2022 in many countries, there should be only modest pressures on capacity over the coming 18 months. According to the OECD, prolonged high or rising inflation is unlikely if central banks take necessary measures to keep inflation expectations anchored to their target and if structural changes that limited pressures on inflation during the past three decades continue. However, there is still uncertainty about their evolution, which could pressure inflation higher over the longer term.

Policy Backdrop: Developed central banks remain on hold as they consider rising inflation to be "transitory." The Fed is set to meet in mid-June, when it is expected to leave policy unchanged. While the Fed is expected to remain on hold, Fed officials are coming around to the view that it is time to start thinking about QE taper. In Gaske's view it would be appropriate for the Fed to begin tapering QE purchases by the end of the year as the recovery continues, especially with liquidity in the banking system rising to the point of becoming excessive and ample evidence that this flood of liquidity is starting to come up in the short-term market. The ECB is next set to meet in mid-June; it is not expected to make any changes to policy. However, market expectations are for the ECB to tweak its monetary policy statement pledging to maintain favorable financing conditions but not renewing its pledge to keep Pandemic Emergency Purchase Programme (PEPP) purchases at the recent "significantly higher" pace for the next three months. This would prepare the ground for a very gradual taper beginning in Q3 and for net PEPP purchases to end in March 2022. The Bank of Japan left policy unchanged at its last meeting in April. The BoJ may potentially reduce the JGB purchase amount further to improve the sustainability of the current policy measures. However, that is unlikely as the economic recovery remains fragile with the government declaring the state of emergency again.

Among emerging markets, there is a split between central banks that have begun down a normalization path as the recovery gains strength and financial stability concerns move to the fore and other central banks still grappling with virus-related downside risks. Tightening of credit and housing policies already is underway in China, which was the first to exit the pandemic. The Bank of Korea took its first steps toward normalization at its latest meeting, with a more hawkish tone in its statement and press conference. By contrast, in the wake of a large second wave of infections in India, the Reserve Bank of India could continue to add to its accommodative measures with additional bond purchases and by relaxing regulatory controls and enhancing liquidity measures. Latin American central banks are turning more hawkish in the face of rising inflation expectations. The Brazilian central bank has signaled another 75 basis-point rate hike in June after a widely anticipated hike of 75 basis points in May that brought the Selic rate to 3.5%. The odds of the Mexican central bank hiking rates this year has also risen with Banxico increasing its inflation forecast path in its quarterly report. The Russian central bank surprised with two rate hikes totaling 75 basis points in March and April and is expected to hike modestly further in the rest of the year if inflationary pressures remain high.

Bottom-line: The June CIO Call participants expressed confidence that stock markets are likely to add to the solid gains thus far in 2021. Markets remain supported by broadening global growth as widespread vaccine administration is reducing infection cases, allowing for reopening of economic activity and unleashing pent-up demand. The earnings outlook remains strong as more companies are beating expectations. However, a by-product of the growth rebound is rising inflation, which is fueling an active debate as to whether the rise in inflation is "transitory" or more long-lasting. This, in turn, is raising concern that global central banks may have started to "think" about ending the ultra-easy monetary policy that provided the liquidity for the rally. Further, with the solid market gains thus far, equity valuations have become rich. These cross currents are likely to keep markets volatile.

IN OTHER NEWS…

PGIM Fixed Income contributed the following analysis.

- One question leading up to this week's European Central Bank (ECB) policy meeting centers on whether it will taper its Pandemic Emergency Purchase Programme. As euro area government yields rose in 2021—from a GDP-weighted 10-year average of about -0.2% to a recent high of about +0.4%—PEPP purchases rose slightly in Q1 and increased notably in Q2. While they may be poised to decline in Q3, we regard the PEPP as more of a sideshow relative to the steps the institution will need to take in order bolster its policy credibility over the medium term.
- Indeed, the ECB's upcoming framework review, which is set to conclude in September, may address the steps needed to meet its inflation target over the longer run. For example, we believe the combination of a new flexible, symmetric 2% inflation target, a significant increase in its open-ended Asset Purchases Programme, and forward policy guidance tied to the inflation outlook are some potential preconditions that may anchor inflation expectations at the target level. Fiscal spending in the area of 3% of euro area GDP would also support a return to an improved pre-crisis growth trend.
- Although the US payroll report for May was weaker-than-expected, we continue to see further signs of healing in the labor market. For instance, average weekly payrolls for private industries has climbed from a pre-virus level of about 34.5 hours per week to the cusp of 35 hours per week. With a rule of thumb that 0.1 of an hour increase in weekly hours equates to 400,000 job vacancies, about 2 million jobs could be landed in the months ahead. That said, labor market performance remains highly bifurcated with the subdued payroll gains in recovering industries, such as vehicle manufacturing, retail, and food and lodging, offsetting the continued gains in expanding industries, such as warehousing and storage and residential construction.
- Developed market debt levels coming out of the pandemic may become a topic of concern, particularly if interest rates move higher. For example, the US Congressional Budget Office estimates a total deficit of -4.3% of GDP in 2022. It also assumes an average interest rate of 3.5% over the next 30 years, which could indicate that net interest costs account for most of the total deficit in the 20 years leading up to 2051 when the total deficit is expected to reach -13.3% of GDP. Yet, research shows that higher debt levels are associated with lower interest rates in developed market economies, thus an average interest rate of less than 3.5% could indicate capacity for additional fiscal expenditures in the future.

QMA-20210607-158

1049289-00001-00 PI6643 ID 12312021