Mid-year Outlook 2021: Recovery before winding down the pandemic stimulus

- Although the pandemic era has not yet passed, the global economy has embarked on a road of vaccine-led recovery, and macroeconomic policy is at the crossroads of returning to normality.
- COVID-19 vaccines have proven to be effective in the real world. Since the start of COVID-19 vaccination, the infection rate, hospitalization rate and mortality rate in developed countries have declined significantly, and economic activities have been quickly restored.
- China's economy, being "first in first out" in the pandemic, is the first to recover. Other economies will enter a sequenced recovery subject to vaccine availability. Among them, the United States is the first echelon, Europe is the second tier, and most developing countries and underdeveloped countries are the third echelon.
- Although commodity prices are likely to remain high in the second half of 2021, the year-on-year growth rate will tend to decline due to the fading of the low base effect. We expect US CPI inflation to be inverted V-shaped, with an annual mean of 3%. China's CPI inflation is likely to remain low.
- As before, the Fed will lead the way in policy normalization, which can be regarded as a three-step process. The first step is to adjust administered rates to drain excess liquidity. Step two is to taper quantitative easing. Step three is interest rate hikes.
- We revised our economic projections for 2021. In particular, compared with the forecasts at the end of last year, US GDP growth estimate has been raised from 4.5% to 6.8%, while China's economic growth forecast has been slightly lowered from 8.8% to 8.6%.
- China's stock market will be dominated by positive factors. On one hand, liquidity conditions are stabilizing as the PBOC will likely retain a supportive stance. On the other hand, corporate earnings are expected to improve in the second half of this year.

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Introduction

We have slightly lowered our full-year forecast for China and significantly raised our outlook for the United States. The reasons are worth exploring. Among them, three major themes, vaccine effects, re-inflation and policy normalization are fulfilling their heavy impacts on financial markets.

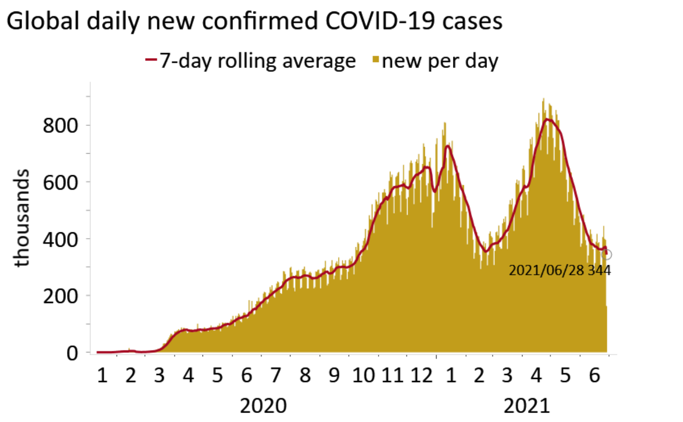
Although the pandemic era has not yet passed, the global economy has embarked on a road of vaccine-led recovery, macroeconomic policy is at the crossroads of returning to normality, and the monetary tide is about to recede. If history is any guide, the road ahead is bound to be bumpy.

I. Realization of Vaccination Expectations

Since the emergency use of COVID-19 vaccines at the end of last year, the cumulative global vaccination has exceeded 2.8 billion doses in half a year. This unprecedented public health action is now in a race with virus transmission and strain mutation.

According to the global new confirmed cases, the first half of the year showed a steep curve of rise and fall, indicating that medical interventions have had a substantial impact on the evolution of the epidemic (Figure 1). COVID-19 vaccines have proven to be effective in the real world. A study by the US Centers for Disease Control and Prevention (CDC) showed that mRNA vaccines made by Pfizer and Modena achieved 90+% protection 14 days after receiving the second dose. The infection of fully vaccinated people, or breakthrough infection, occurs in less than one in ten thousand.

Figure 1: The number of new Covid cases falls rapidly



Source: Macrobond, China Merchants Bank Institute

However, the cruel fact is that restricted by the production and distribution of vaccines, coupled with vaccine politics and hesitancy, it seems impossible for human beings to achieve "herd immunity" in epidemiological sense through vaccination in the short run.

First of all, even if vaccine supply is abundant, the willingness to vaccinate greatly restricts the increase of the vaccination rate. With the completion of vaccination in the high-risk population, the upward slope of the vaccination rate slows down significantly. This is already the case in countries such as the United States and Israel. Secondly, vaccination in developing countries obviously lag behind, and the virus mutates dramatically in these areas. Breakthrough infection may destroy the vaccine defense line constructed by developed countries. True herd immunity is still a long way off.

The recent rapid spread of the Delta variant brings great uncertainty. The good news is that several major vaccines still prove to be effective, while scientists are still working day and night on vaccine development in order to introduce more effective medical solutions.

Since the start of COVID-19 vaccination, the infection rate, hospitalization rate and mortality rate in developed countries have declined significantly, the pressure of the medical system has been greatly alleviated. With the fear for the virus subsides, people's lives have gradually returned to normal, and economic activities have been quickly restored.

II. Sequenced Global Recovery

China, being "first in first out" in the pandemic, is the first to recover. Other economies will enter a sequenced recovery subject to vaccine availability. Among them, the United States is the first echelon, its economy is expected to return to normal in the third quarter as the vaccination rate hits the upper limit. Europe is the second tier, with its economic recovery one quarter later than that of the United States. Most developing countries and underdeveloped countries are the third echelon, due to the lack of funds, vaccines, technology and medical professionals.

The path of a sequenced recovery would follow a certain pattern: first, production and employment restarts, then service consumption gradually warms up, and finally macroeconomic policy returns to normal. China has almost completed the whole process. The United States, Europe and other economies will also enter different stages of this process.

First, look at China. China has lead the world in production recovery, and hence played a substitute role in the global supply chain, which is obviously reflected in its high export growth. In particular, cash transfers to households in the United States and Europe have pushed up consumption demand, in turn boosting China's exports. However, as other economies enter the production recovery phase, the substitution effect of China's production and export will begin to fade.

Second, look at the United States and Europe. As vaccination rates increase, their production activities will accelerate. As a result, their supply gap will narrow, and the demand spillover will subside.

Finally, look at developing countries. At present, the epidemic in India, Southeast Asia and Latin American countries is still grim. It takes time for production and supply chains in these countries to repair. China's export substitution will therefore persist for some time. However, with the help of vaccines, the global supply chain will eventually return to its pre-pandemic normality. This turning point may occur as early as in the fourth quarter of this year.

III. Inflation Concerns

Global inflation rapidly entered an upward channel early this year. There were three main factors supporting the rise of inflation. First, as the global economy kept recovering, commodity prices rose significantly. Second, cash transfers in major developed countries boosted household disposable income. Third, the optimism brought about by vaccines pushed up inflation expectations.

Inflation in the United States has attracted the most attention. As most assets are priced in US dollars, rising inflation in the United States will almost definitely spill over to other countries. US CPI rose rapidly year-on-year, from 1.4% in January to 4.9% in May. As a leading indicator of real inflation, the US 5-year break-even inflation rate has risen from around 2.0% at the beginning of the year to about 2.6% now.

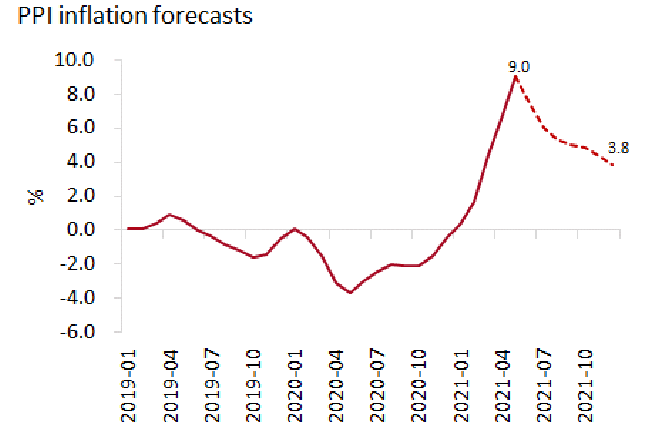
The rise of commodity prices has its particularity in the pandemic era. First, the economic recovery as well as policy stimulus has pushed up the demand for commodities, while the pandemic has restricted the supply. Secondly, abundant liquidity has led to higher risk appetites. Third, the weakness of the US dollar has raised commodity prices.

Looking forward to the second half of the year, although commodity prices are likely to remain high, the year-on-year growth rate will tend to decline due to the fading of the low base effect. As the Fed has signaled tapering, speculative demand for commodities will fall. Therefore, commodity price growth is likely to slow down.

We expect CPI inflation in the United States to be inverted V-shaped, but the annual rate will still rise to about 3% this year. As Jerome Powell said, US inflation may be "temporary" rather than "persistent". We expect that US CPI inflation peak in May, and then gradually fall, but remain above 2% in the second half of the year.

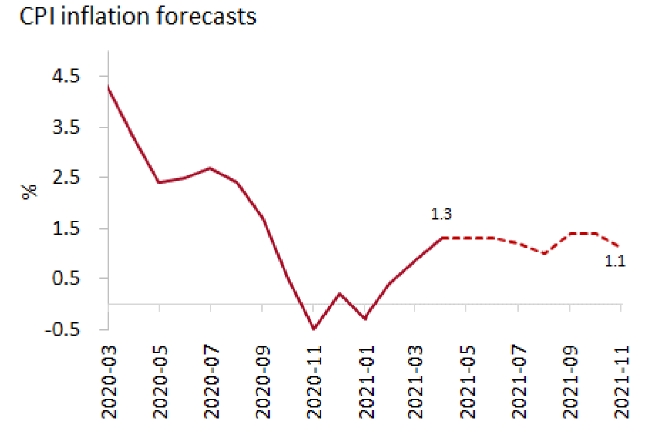
For China, the inflation pressure is more reflected on PPI, but remain subdued on CPI. While service consumption will likely drive core CPI up, the increase of pork supply will lead to a sharp drop in food prices, keeping CPI at a low level year-on-year. We expect that China's CPI inflation exhibit an M-shaped trend, with an annual mean around 1.2%, far below the policy target of 3% (Figure 3).

Figure 2: China's PPI inflation tends to decline



Source: Wind, China Merchants Bank Institute

Figure 3: China's CPI inflation: M-shaped



Source: Public information, China Merchants Bank Institute

IV. Road Map for Policy Exit

With the acceleration of vaccine recovery and concerns for inflation, the tide of loose liquidity will gradually recede. The turning point of policy exit is not remote. The Fed will lead the way in policy normalization, and the ECB will follow later on.

The Fed's consideration lies in the balance between its employment and inflation "dual mandate". In May, while the 12-month moving average for PCE continued moving towards 2%, non-farm payrolls fell short of expectations consecutively. With the end of cash transfers and the reopening of schools, non-farm employment will likely to surge in the third quarter.

The road map of the US monetary policy normalization is gradually clear, which can be regarded as a three-step process:

The first step is to adjust administered rates to drain excess liquidity. After the June FOMC meeting, the Fed announced an increase in the interest rate on excess reserves (IOER) and the overnight reverse repurchase rate (ON RRP) by 5bp. The Fed's use of overnight reverse repo facilities has risen sharply lately, with its balance reaching a record $744 billion, in an effort to drain excess liquidity.

Step two is to taper quantitative easing. We expect the Fed to issue forward guidance on reducing bond purchases as early as in September, begin tapering next year and end quantitative easing by the end of next year.

The third step is interest rate hikes. At present, the dot plot implies 2-3 interest rate increases in 2023. The Fed may adopt a slow-start but fast-acceleration strategy, i.e. delaying the first interest rate hike in order to encourage a "broad and inclusive" recovery of the job market, and then raising interest rates relatively quickly to curb inflation.

V. Economic Forecast Adjustments

We have adjusted our economic projections for 2021. In particular, compared with the forecasts at the end of last year, US GDP growth estimate has been raised from 4.5% to 6.8%, while China's economic growth forecast has been slightly lowered from 8.8% to 8.6%.

The reasons for the increase in US economic forecast include huge fiscal stimulus packages, higher vaccination coverage and stronger rebound of services.

The main reason for cutting China's economic forecast is that the fiscal expenditure so far has been quite slow, the progress of new infrastructure projects is not as smooth as planned, and the recovery of consumption is not as good as expected. Another negative factor is the recent sporadic new COVID-19 cases in southern China, especially in Guangdong, a major export powerhouse, which triggered stringent social distancing measures.

VI. Strategy: Positive Factors Still Dominate

In the first half of this year, the US stock market significantly outperformed the world. The rationale is obvious. US vaccination is progressing well and economic recovery is accelerating. Biden's new fiscal deal is huge. Households are saving more. Business inventories are low. Earnings forecasts are positive. Although stocks are not cheap, with interest rates at historic lows, valuations are unlikely to fall. We expect that the bull market driven by earnings performance to continue for the United States.

Since the beginning of the year, China's stock market has underperformed globally, but commodity-related stocks have outperformed the market. Looking forward to the second half of the year, although uncertainties persist, positive factors will still dominate the market.

On one hand, liquidity conditions are stabilizing. The People’s Bank of China (PBOC) has no intention of disturbing the market, as growth and inflation are within its desired range. If the economy shows signs of weakening, PBOC may consider loosening.

On the other hand, the earnings improvement seems obvious. Since the beginning of this year, the rapid rise of PPI has led to the rapid expansion of the PPI-CPI growth gap. As a result, the profits of the upstream industries squeezed that of the downstream ones. In the second half of this year, however, the PPI-CPI growth gap will gradually narrow. Market investment styles will be more balanced. In particular, we favor small and medium-sized growth stocks.

In short, we are at an important crossroads now. Despite all the uncertainties, the global economy has embarked on a road of speedy recovery. For the stock market, positive factors will prevail.

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