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Economic and Strategy Viewpoint

December 2020

To all readers, we are moving to a quarterly publication schedule for the Economic and Strategy Viewpoint. Regular updates on our views and research pieces will be published in between and will be distributed directly. We hope this will enhance and increase the timeliness of our analysis in the digital marketplace.

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Waiting for the cavalry

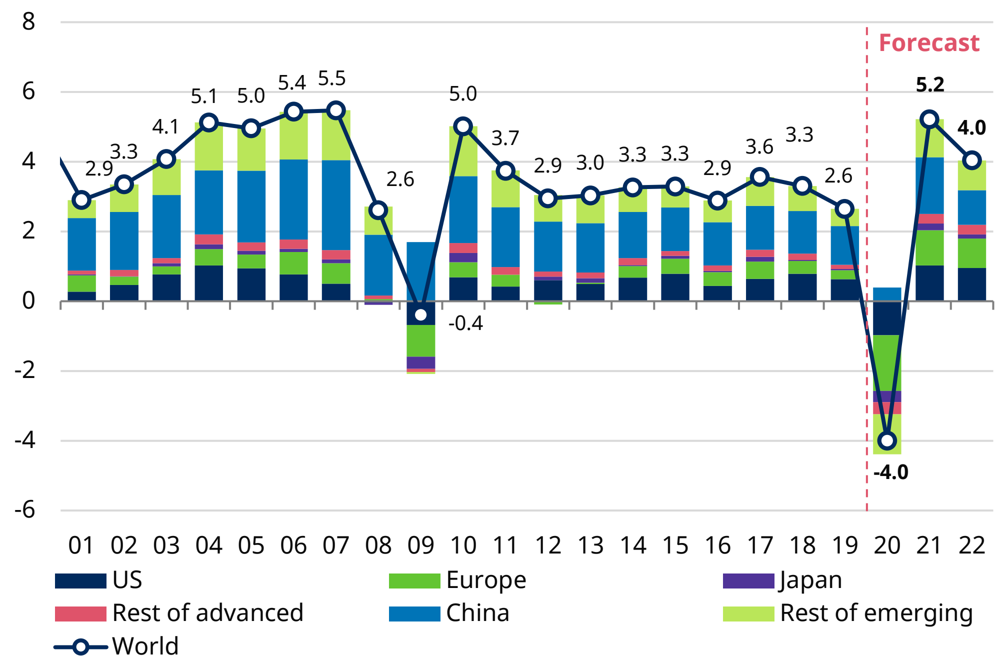
– News that a Covid-19 vaccine is on its way has provided a boost to the outlook for the world economy and spurred a significant rally in equity markets. There is, at last, some light at the end of the tunnel as the vaccine should eventually bring a return to normal social behaviour and an end to the restrictions which remain in place in many parts of the world.

– In the near-term, the virus's re-emergence has forced a return of restrictions, especially in Europe. Most countries in the continent are almost certain to double dip in Q4, and possibly Q1 if lockdown restrictions remain. The good news is that restrictions are lighter than earlier in the year, and so disruption to activity should be reduced and temporary.

– In the US, a deal in Congress for the next fiscal package is likely to follow in early 2021, but the delay and smaller than previously expected deal alongside rising infection rates mean there is a danger of following Europe into a double dip.

– Amongst emerging markets, China is leading the way and, after expanding this year, is likely to grow by around 9% next year. With the exception of China, which is likely to experience a short bout of deflation, most EMs are likely to experience a transitory period of higher inflation led by food. But once this passes and growth settles to more normal rates few central banks will be in a rush to tighten policy, particularly if governments begin to repair fiscal positons.

Chart: Contributions to global growth



Source: Schroders Economics Group, 30 November 2020. Please note the forecast warning at the back of the document.

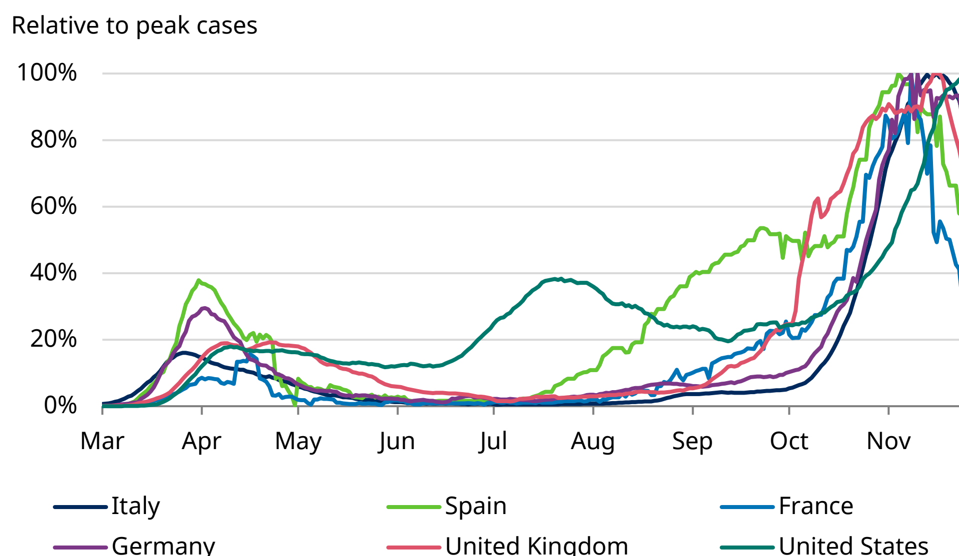
Waiting for the cavalry

Vaccine brings renewed hope as pandemic continues

News that a Covid-19 vaccine is on its way has provided a boost to the outlook for the world economy and spurred a significant rally in equity markets. There is, at last, some light at the end of the tunnel. The vaccine should, eventually, bring a return to normal social behaviour and an end to the restrictions which remain in place in many parts of the world.

At this stage though the pandemic continues with a second wave in Europe which is just beginning to come under control, whilst a third wave is still building in the US (chart 1).

Chart 1: New Covid-19 cases reach new highs



Source: John Hopkins, Schroder Economics Group, 23 November 2020.

Our forecasts factor in a difficult winter before the vaccine brings a stronger recovery in activity in the second half of 2021. We see the recovery extending into 2022 as fiscal and monetary policy remain loose whilst activity normalises. Growth is expected to continue at an above trend rate throughout the forecast. Meanwhile, inflation remains relatively contained with only a modest pick-up in response to higher commodity prices.

Such a pattern is typical of the recovery phase in the cycle. Our forecast for the next two years looks very similar to the bounce back from the Global Financial Crisis (GFC) in 2010 and 2011 (see chart on front page).

Here are the key points in our global outlook:

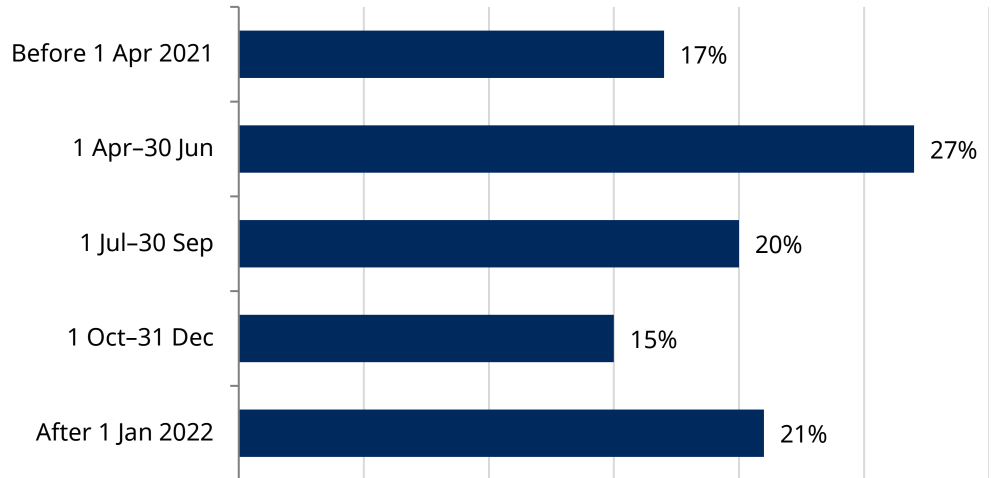
1. Global GDP growth in 2020 has been upgraded to -4.0% from -4.3%, driven by a revision to the emerging markets (from -2.7% to -1.9%) reflecting better growth outside China

We would have revised up by more on the vaccine news but we face a period of weaker activity in the near term. We anticipate more restrictions in the US and expect the second wave in Europe to result in a negative quarter of growth in Q4. These effects roll into Q1 next year. In addition our central assumption of distribution and sufficient immunity for more normal activity to resume in the second half of 2021 remains intact. There is, however, a possibility that the vaccine may arrive and be distributed earlier.

This is similar to the outcome predicted by the 'superforecasters'. They put the odds on a vaccine being distributed to 200 million people in the US in 2021 at 79%. They say that there is a 44% probability this target will be achieved in the first half of the year (see chart 2).

Chart 2: Odds on timing of distribution of vaccines

When will enough doses of FDA-approved Covid-19 vaccine(s) to inoculate 200m people be distributed in the US?



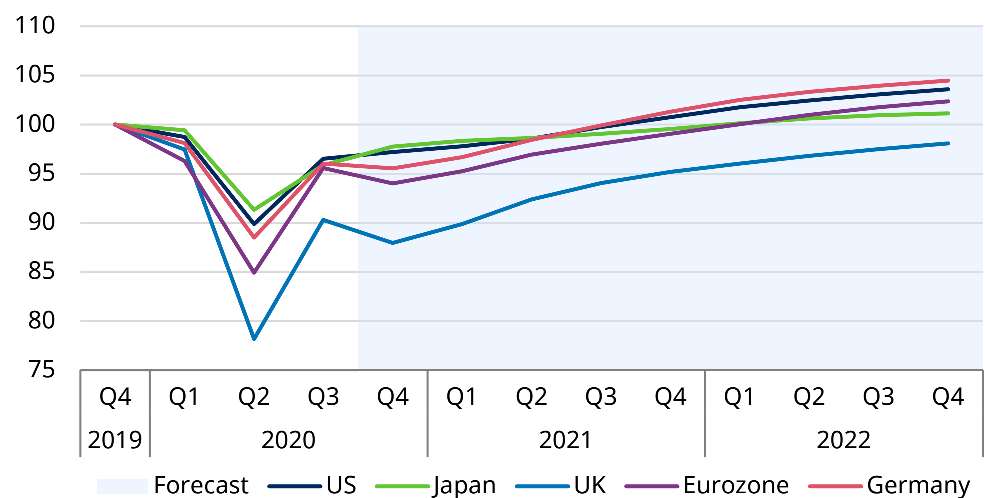
Source: Good judgement project, 25 November 2020.

2. Near-term the forecast path for growth resembles a square root sign, overall it is still a 'U'

The path for growth is shown in chart 3 below for a range of countries. It is similar to our previous forecast which we described as a U-shape. However at this stage we are levelling out due to Covid restrictions – completing the square root sign, which began earlier this year (chart 3). Looking further ahead, amongst the advanced economies, Germany is the leader, closely followed by the US, whilst the UK is the laggard.

Note that we do not get enough weakness to re-label the forecast a 'W' due to ongoing growth in the US and China. Their contributions keep global growth pushing ahead through the turn of the year.

Chart 3: Schroders forecast path for developed markets



Source: Schroders Economics Group, 30 November 2020. Please see forecast warning at end of document.

3. We assume a fiscal stimulus in the US of $1 trillion, while central banks keep the monetary taps on through the forecast

Central banks to keep liquidity flowing

Another factor behind our more cautious view in the near term has been the failure of Congress to agree a deal on fiscal stimulus. We had expected a package would now be supporting the economy with enhanced unemployment benefits and help for state and local governments. Disagreement between Republicans and Democrats on the scale of the package has prevented anything being done beyond an executive order from the president.

Our assumption that a $1 trillion deal is struck in Q1 is based on the view that president elect Biden can strike a deal with Mitch McConnell the leader of the Senate. The two men have struck deals before (when Biden was vice president) and concern about the impact of the third Covid wave should be sufficient to persuade the Republicans that something needs to be done.

Meanwhile, the Federal Reserve (Fed), European Central Bank (ECB), Bank of Japan (BoJ) and Bank of England (BoE) keep rates unchanged through the forecast period. We expect inflation to be low and stable and central bankers remain wary of the threat of deflation. As we have argued before, the Fed's new framework means that we will need to see a period of 2%-plus inflation to hit the average inflation target. That means zero interest rates and continued quantitative easing (QE).

However, as we warned last quarter, the recovery will also mean that QE will moderate. QE continues around the world with the result that the Fed balance sheet soars to around $9 trillion by the end of the forecast period. This is an increase of nearly $2 trillion from today, however the pace of QE will moderate to around $100 billion per quarter by 2022 compared with its current pace of $360 billion. This may trigger another taper tantrum (see scenarios, below).

4. The US dollar weakens even further

Two factors are expected to soften the dollar further. The first is the arrival of president Biden and the reduction in US-China tensions, which reduces the attraction of the US dollar (USD) as a safe haven. The second is the likely return of the twin deficits. The US budget deficit is on track to reach $3.5 trillion, or 17% of GDP this year and although it should narrow as economic activity recovers in 2021, the overall current account deficit will increase. Given that a significant portion of the budget deficit is structural (around 5.5% of GDP) the US looks to be heading for a twin deficit problem. This would herald a spell of dollar weakness as the economy becomes dependent on external funding. We have a scenario which takes this further – see section below.

Regional views

Europe: double dip

Europe to double dip as virus cases surge and restrictions return

The forecast for Europe has been upgraded for this year thanks to a better outturn for growth in the third quarter of the year. Real GDP has been revised up from -7.8% to -7.1% in 2020, with Germany seeing the biggest upwards revision (-5.7% to -5.4%), along with several other smaller member states. However, France, Italy and Spain were all downgraded. We've seen the return of national and regional restrictions in the effort to stop the spread of the coronavirus. These are likely to cause most member states to experience a further fall in GDP in the final quarter of the year. For the three mentioned earlier, this more than offsets the better-than-expected outturn of recent data.

As they did earlier in the year, the restrictions vary significantly across the monetary union. The harshest to economic activity amongst the largest member states can be found in France. Here non-essential retail is closed, along with restaurants and other eateries, arts, sports and leisure facilities, public events and hotels for non-business

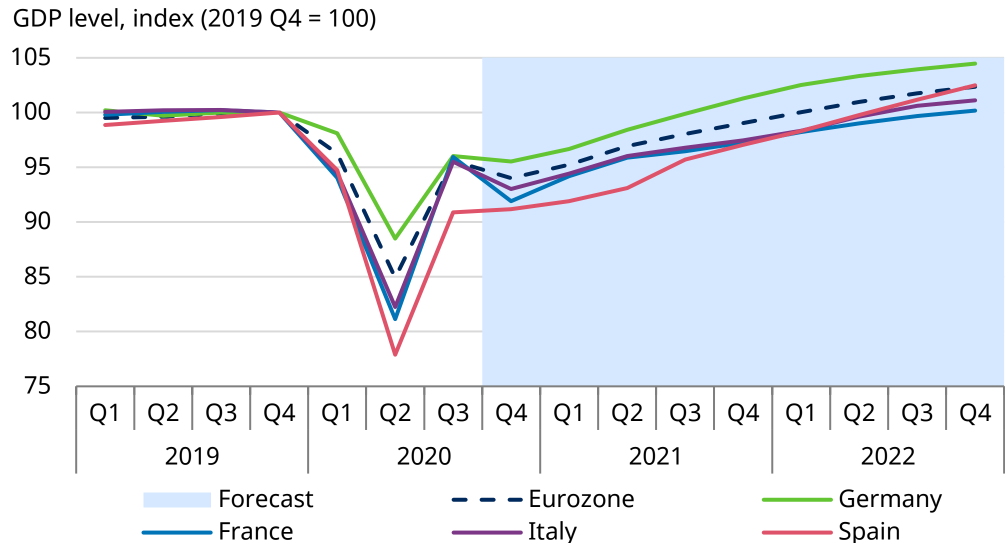
activity. In addition, households have been banned from mixing, and there is a 1 kilometre restriction on travel. However, importantly, schools remain open (with some distance learning) along with factories and businesses, where working from home is not possible. This is less restrictive than earlier in the year and should mean a far smaller impact. However the economy is forecast to contract by 4.2% in the final quarter of the year, before rebounding over the first half of 2021.

In Germany, the same applies except non-essential retail remains open and some public events are permitted, subject to safety requirements. Groups of 10 are allowed to meet, and there is no curfew. As a result, the forecast only has a small contraction of 0.5% for the final quarter of the year, which is also helped by the robust outlook for German manufacturers, as they report very strong order books relative to inventories.

Despite a high number of cases and deaths, the least restrictive at a national level is Spain. Here there is only an 11pm curfew, and restrictions on group meetings to a maximum of six people. Spain is one of the most vulnerable member states in terms of the share of GDP, with sectors that tend to be targeted to reduce the spread of the virus. This may have prompted a reluctance to lockdown the economy, but also the weak coalition government has failed to come together to agree restrictions. Some regions have taken it upon themselves to apply local restrictions, but these remain light.

Some member states will fare better than others, depending on the level of restrictions

Chart 4: Second virus wave and restrictions lead to double dip



Source: Eurostat, Refinitiv, Schroders Economics Group. 30 November 2020.

The contraction in GDP in the final quarter of the year will inevitably cause a drag on the 2021 average. The 2021 forecast has been brought down from 6.2% growth to 5.2%, but it nonetheless remains a solid recovery.

Though Poland and Hungary are currently holding up progress on the EU recovery fund, we continue to expect disbursement in the second half of 2021, leading to increased investment activity in 2022. The fiscal package is expected to total 5.4% of GDP, which should help boost growth substantially. Growth is forecast to slow in 2022 to 4%, but this is well above trend growth of around 1.5%.

Inflation across Europe is likely to remain low, paving the way for more monetary support

Table 1: Schroders GDP forecast for Europe

	2019	2020			2021			2022
Eurozone	1.2	-7.1	↑	-(7.8)	5.2	↓	(6.2)	4.0
Germany	0.6	-5.4	↑	-(5.7)	4.8	↓	(5.3)	4.1
France	1.5	-9.3	↓	-(8.4)	5.7	↓	(6.1)	3.5
Italy	0.3	-8.8	↓	-(7.6)	5.3	↑	(3.0)	3.9
Spain	2.0	-10.8	↓	-(8.6)	6.5	↓	(7.4)	6.4
UK	1.4	-11.3	↓	-(10.4)	5.0	↓	(6.2)	4.5

Source: Eurostat, Refinitiv, Schroders Economics Group. 30 November 2020.

Inflation is unlikely to be an issue over the forecast horizon. Headline HICP inflation is due to average just 0.3% for 2020, rising to 0.8% in 2021 (revised down from 1.1%) and to 1.4% in 2022. These projections are unlikely to satisfy the ECB which is currently gearing up to announce fresh stimulus for its December meeting. Our previous call for an additional €500 billion of QE has now become the consensus, and so it is likely that the ECB will seek to surprise the market to the upside by announcing a larger package. Therefore, we have increased the figure to €750 billion, and assumed that purchases continue to the end of 2021. This would take the size of total purchases to €4.5 trillion. All interest rates are forecast to remain on hold.

UK: free spending era will continue for now

The UK government is in no rush to cut its huge deficit, thanks to BoE QE

The forecast for the UK is not too dissimilar to the rest of Europe, but it ends 2020 on a weaker footing (-11.3% GDP growth) due to the initial length of lockdowns earlier in the year. It too is likely to double dip given restrictions over November, and may yet still face some restrictions in early 2021. However, fiscal policy is likely to remain very loose over the forecast horizon, backed by additional QE. The Bank of England recently announced a further £150 billion of purchases over 2021.

The UK government is forecast by the Office for Budgetary Responsibility (OBR) to run a deficit of 19% of GDP in the financial year 2020/21. This falls to 7.4% of GDP in 2021/22 and 4.4% of GDP in 2022/23. The cyclically adjusted budget deficit is forecast to be 3.9% of GDP at the end of our forecast, signalling that the recession is not to blame for the large deficit, but active fiscal policy. This should help achieve strong growth over 2021 (5%) and 2022 (4.5%), but other challenges remain.

Despite the approaching end to the UK's Brexit transition period, both parties have yet to agree a trade deal. Talks have certainly intensified in recent weeks and an agreement is expected in the near-future. The deal is likely to cover trade in most goods, but not all, and certainly not much of services. There is still a possibility (20% chance in our view) that both sides walk away as key areas of contention end up irreconcilable. But in our view, the bigger risk is now ratification risk.

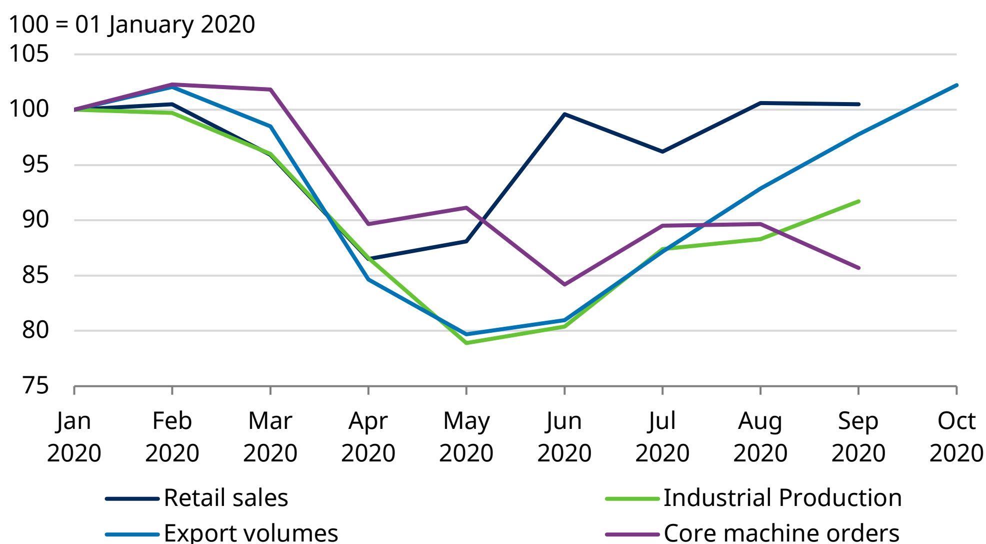
Unlike the Withdrawal Agreement last year, trade deals in Europe require unanimous backing. This presents a rare opportunity for small, regional parliaments to favour or extract rents from the rest of the EU, but in doing so holding up the trade deal. Therefore, there is risk that the over-run in talks may not have left enough time for the agreement to be ratified by the end of the year, potentially meaning chaos at borders in early January.

Japan

The consumer drove the early stage of the Japanese economic recovery. However, the recent sideways moves in retail sales suggests that short-term pent-up demand has now been largely exhausted. The baton has now been handed over to exports and the industrial sector to drive growth (chart 5). Net exports already gave an impressive three percentage point (pp) boost to GDP growth in the third quarter (which itself was 5% q/q).

Japanese exports have helped lift industrial production and are now the main driver of the recovery

Chart 5: Exports are now driving Japanese recovery



Source: Schroders Economics Group, Refinitiv, 23 November 2020.

Looking ahead, the pick-up in global trade should continue to support the Japanese recovery in the fourth quarter. This should also help lift capital expenditure, which continued to fall in the third quarter despite the wider recovery. The pace of growth should then slow further into the first half of next year. We expect growth to pick-up by the end of the year driven by a stronger demand following the roll-out of a vaccine and support from fiscal stimulus. The latter we expect to be approved by the Diet early next year at around 3-4% of GDP. Finally, 2022 should also prove a good year for Japan as global trade is strong. We pencil in GDP growth of 1.8% year-on-year(y/y), well above our estimate of potential growth of 0.8% y/y.

Near term, the main risk is that of restrictions on activity both at home and abroad given the rise in Covid cases in Japan and the US. The US is an important export partner for Japan. While both will be unhelpful for GDP growth, the latter has the ability to cause more havoc for the Japanese equity market given its cyclicality.

Headline inflation should turn negative in the fourth quarter, driven by a combination of base effects and energy prices. We expect mild deflation to continue until the second half of next year, when energy inflation should rise, partly offset by weaker food and core inflation. Meanwhile, the BoJ should stay in perennial easing mode, expanding the balance sheet at similar rates to today (JPY40 trillion per quarter) until the middle of next year. This should then fall to around JPY25 trillion per quarter.

Emerging markets

We have revised up our forecasts for emerging market (EM) GDP growth for both this year and next. Meanwhile we expect a solid – albeit slower – expansion in 2022.

Upgrades for EM growth in 2020

In the near term, our stronger forecast for 2020 is driven by upward revisions to our expectations for many major EM economies. These have contracted by less than we had initially feared despite terrible outbreaks of Covid-19. For example, while new infection rates remain elevated in Brazil and India, the relaxation of restrictions on activity earlier this year released a wave of pent-up demand. This appears to have driven a strong rebound during the third quarter.

The natural consequence of shallower recessions in 2020 is that most EMs will have less room to rebound in 2021. As a result we have cut back our growth forecasts for some economies next year. And many will have to face up to dealing with the large increase in public debt that has been accumulated during the crisis. One obvious exception is China, where we have revised up our projection for growth to 9%, from 7% previously and above the consensus for a 7.9% expansion. However, much of this

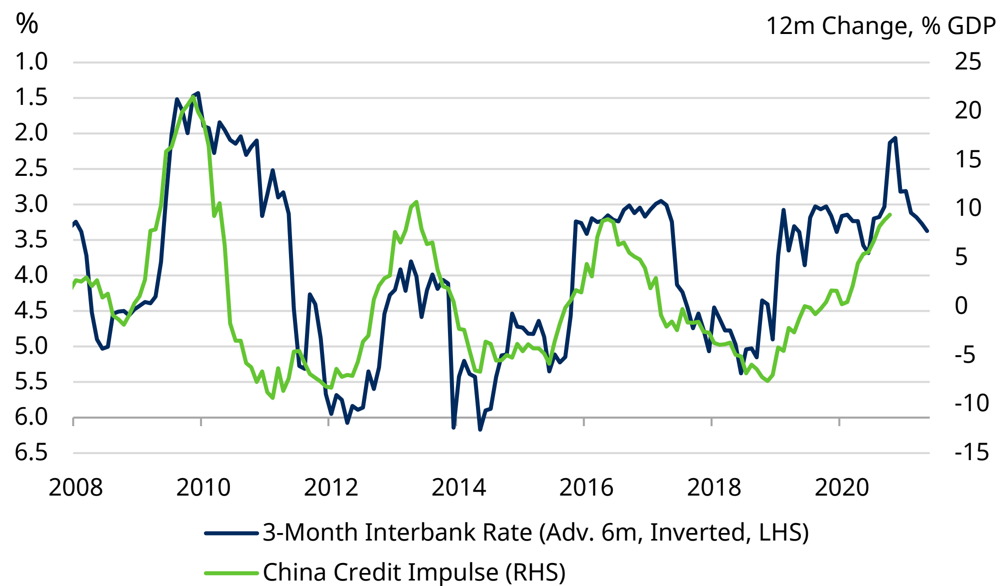
is due to what looks set to be an exceptionally strong first quarter, driven in part by favourable base effects. We expect growth to ease back to more 'normal' rates during the course of next year and into 2022.

China

China's economy has outperformed the rest of the world during the course of 2020 as the authorities handled the outbreak of Covid-19 relatively well. They were also able to deliver an effective economic support package. The lagged effects of these stimulus measures look set to drive a further recovery in growth into the first half of next year. For example, the credit impulse (an important driver of China's highly leveraged economy) tends to lead activity by around six months and continued to rise in October. Meanwhile, we anticipate very strong base effects stemming from the steep decline in activity in the first three months of 2020. These base effects coupled with the lagged effect of the credit impulse are likely to see GDP growth climb to somewhere in the region of 15-20% y/y in Q1 2021.

Strong recovery in China to gradually slow in second half of 2021

Chart 6: China's credit impulse may peak around the turn of the year



Source: Bloomberg, Refinitiv Datastream, Schroder Economics Group. 24 November 2020.

However, growth should then decelerate to more normal rates during the course of next year. Base effects will become less supportive, while policy is likely to be far less accommodative. As evidenced by movements in short-term interest rates, the People's Bank of China began to gradually reverse some policy support earlier this year. The bank did this as it became clear that the economy was recovering strongly. This suggests that the peak in the credit impulse is on the horizon, which would usually be the high water mark for the current growth cycle. And the fact that the government allowed a state-owned company to default on a bond in November suggests that deleveraging will come back onto agenda in 2021. This may see the authorities rein in credit growth.

One issue that may deter policymakers from normalising policy in the near term is a bout of deflation in early 2021. We expect the annual rate of headline inflation to turn negative as the spike in food prices earlier this year – mainly pork after an outbreak of swine fever decimated China's stock of pigs – washes out of the annual comparison. This should prove transitory, while the strength of the economic recovery should ensure that core inflation gradually picks up during the course of 2021. However, fears of deflation at a time when debt is very high may still perturb policymakers and markets alike in the near term.

Beyond all of this, in 2022 we expect China's economy to resume the trend deceleration that has seen GDP growth rates gradually decline during the past decade. Relatively strong growth in developed markets, driven in large part by the services sector, is likely to offer only marginal support through the trade channel. We have pencilled in growth of around 5.5%.

India

A second wave of the virus is the greatest risk for India

The vaccine is particularly good news for India, where new Covid-19 cases have slowed significantly but risks of a second wave are high. Compared to its EM counterparts, India is relatively well prepared. It ranks highly in the number of pre-ordered vaccines per capita, ability to manufacture vaccines and also in terms of the willingness of people to take one. Activity data suggests the recovery is now well underway; industrial production is now growing y/y, the PMIs are well above 50 and retail mobility continues to improve. We expect GDP to fall by 5.4% y/y in the final quarter of the year and to turn positive in the second quarter of next year, taking 2021 as a whole to 10.9%. But as the impact of (the little) fiscal and monetary stimulus wears off and bad asset quality continues to hamper credit growth, we expect growth to slow to 6.3% in 2022.

Relative to our forecasts, inflation has surprised on the upside, reaching 7.2% y/y in October. Though predominantly driven by food prices, this is uncomfortably outside the 2-6% target band of the Reserve Bank of India (RBI). The RBI has now kept rates on hold at 4% for three consecutive meetings but maintain an accommodative stance. Due to elevated food prices, we expect inflation to remain stubbornly high (above 7%) until the end of Q1 next year. As food and core inflation moderate, the former due to fewer supply-side constraints, overall inflation should come down. We expect 4.5% y/y for the year as a whole. Nonetheless, high inflation is likely to act as a constraint on the RBI. We now expect it to keep rates on hold at 4% throughout our forecast horizon.

Brazil

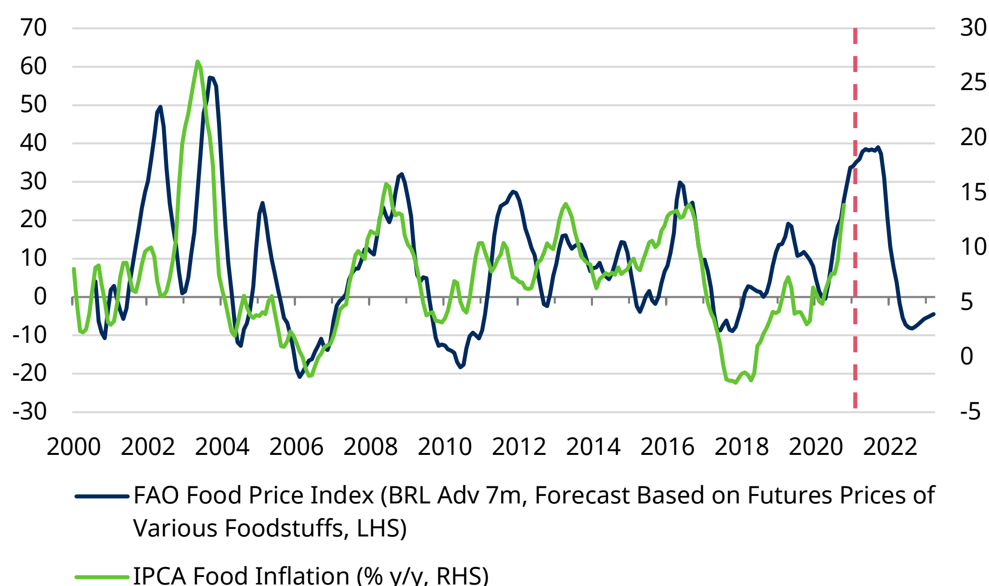
Brazil has been one of the hardest hit countries by the Covid-19 pandemic, but its economy has recovered surprisingly well after the crisis saw the Bolsonaro government shelve plans for fiscal austerity. We've seen a relatively large stimulus package worth about 5% of GDP with additional financial guarantees. This appears to have underpinned a rapid rebound in activity in the third quarter, despite new Covid infections remaining elevated. Our activity tracker suggests that GDP expanded by around 10% quarter-on-quarter (q/q) in Q3, largely reversing the 9.7% decline in the second quarter.

Private business surveys suggest a strong end to 2020 for growth in Brazil...

Strong October PMIs, including robust new orders, suggest that the good momentum is likely to spill over into the fourth quarter. Meanwhile, base effects will lift annual rates of growth into double-digits in the middle of next year. However, beyond the current strong rebound in activity, we expect underlying q/q GDP growth to return to more normal, subdued rates in the next couple of years for three reasons.

First, the Covid crisis has compounded what had already been a prolonged period of weak economic growth in Brazil. GDP growth has averaged just 1.4% in the decade since the GFC and the unemployment rate stands at over 14%. Widespread unemployment will weigh on the recovery in Brazil's consumer-driven economy. Second, household incomes look set to suffer a further squeeze in the coming months from a bout of inflation on the back of higher food prices. Futures prices imply that food inflation will peak at about 20% in mid-2021, enough to add about 1pp to headline inflation, before falling away in the second half of next year.

Chart 7: Brazil may suffer a nasty bout of inflation in the first half of next year



Source: Refinitiv Datastream, Schroder Economics Group. 24 November 2020.

...but challenges remain which are likely to return growth to more subdued levels

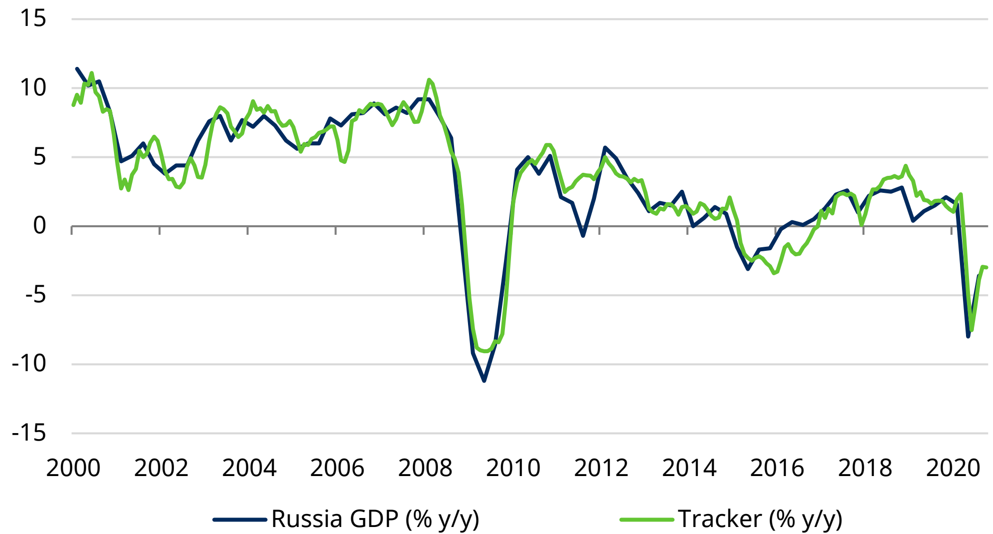
Third, and perhaps most importantly, the government will have to significantly tighten its belt next year. Gross government debt is heading towards 100% of GDP after what is likely to have been a double-digit budget deficit this year. The government fought hard in 2019 to push through reform to the pension system in a bid to start the process of dealing with Brazil's poor debt dynamics. The authorities will need to reverse this year's emergency deficit if they are to retain credibility with investors and avoid a major sell-off in the bond market.

All of this will set up a difficult year for the monetary policy committee (COPOM) at Brazil's central bank. We think that underlying growth in Brazil's economy will return to relatively subdued rates next year. However, a combination of rapid annual rates of economic growth, above-target inflation and loose fiscal policy may put COPOM under pressure to raise interest rates. Rates are currently at historically very low rates that are negative in real terms. We assume gradual rate hikes of 250 basis points to a peak of 4.5%, beginning in the second half of 2021. That is less aggressive than the tightening currently priced into the market, but rates are likely to rise much further if the government fails to deliver on the fiscal front.

Russia

Russia's economy also recovered more quickly than we had initially anticipated in the third quarter. As a result we have revised up our full-year forecast for GDP to a contraction of -3.2% y/y in 2020, from our previous projection of -8.6% y/y. However, the rebound in activity already appears to have been truncated in the fourth quarter by a second wave of Covid infections, mirroring those that have forced many parts of Western Europe into renewed lockdowns. The authorities in Russia have been reluctant to re-impose lockdown measures, but that did not stop the rebound in our activity tracker from stalling in October. The tracker may move sideways or even reverse in the remainder of the fourth quarter.

Chart 8: The rebound in Russia's economy appeared to stall in October

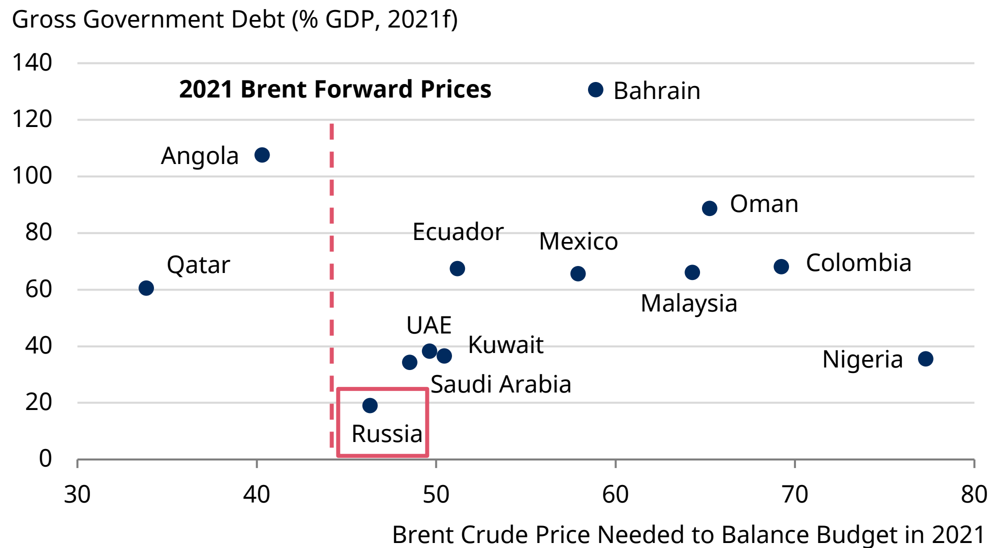


Source: Refinitiv Datastream, Schroder Economics Group. 24 November 2020.

Like all other major economies, growth in Russia will rebound in 2021 after GDP contracts in 2020. However, the upside is likely to be capped by broadly stable oil prices. Our baseline scenario assumes that Brent crude will average $44.8 per barrel in 2021. As chart 9 shows below, that is slightly below the level that we estimate would be needed to balance the government's budget next year.

Chart 9: Low oil prices are likely to cap the recovery in Russia

Low oil prices are likely to hold back the recovery in Russia and other oil exporting nations



Source: IMF, Refinitiv Datastream, Schroder Economics Group. 24 November 2020.

Low public debt means that running budget deficits is not a major concern like it is in Brazil. However, the steep decline in oil prices during the Covid crisis did appear to curb the government's enthusiasm for fiscal stimulus in 2020. And persistently low oil prices are likely to prevent public spending and a general improvement in terms of trade from driving faster growth in the next couple of years.

Finally, relatively conservative monetary policy means that the central bank will probably be able to ride out any increase in inflation in the first half of next year. Inflation is set to pick up on the back of higher food prices. Our assumption is that Russia's policy interest rate will remain unchanged at 4.25% until late 2022, but the authorities are likely to retain an easing bias if the economic recovery falters. All of this ought to be supportive of the bond market.

Scenario analysis

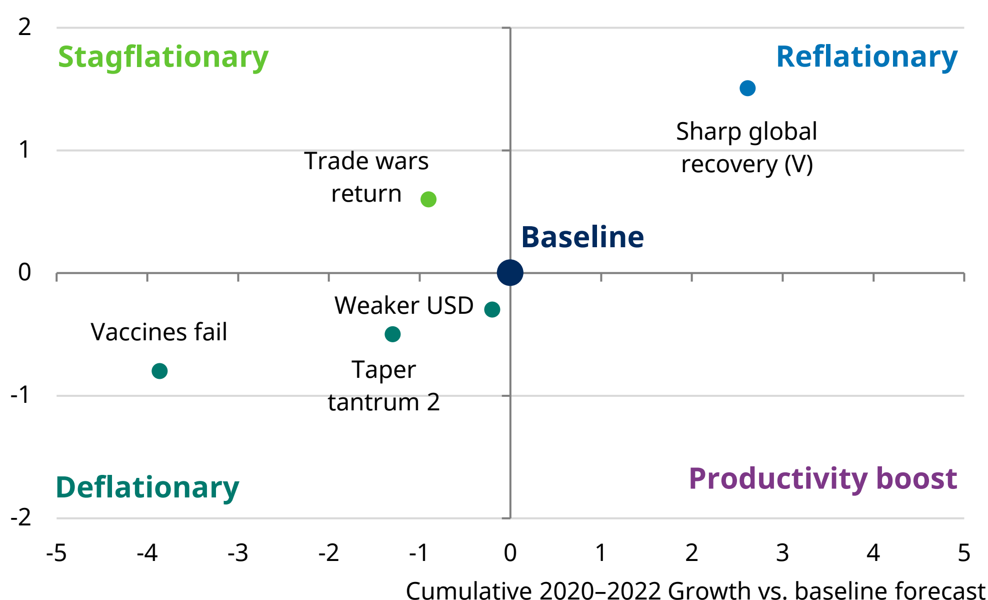
We have updated our scenarios to reflect the shifting balance of risks. The election result has removed the Democrat sweep scenario

We continue with the V-shaped recovery which is now based on a faster vaccine delivery than the baseline and less scarring than in the baseline. New scenarios are 'trade wars return' (Biden pulls together an international alliance to call China to account and tariffs go up in Q4 next year), 'weaker USD' (based on a greater focus on the US twin deficits by investors who become reluctant to fund), 'taper tantrum' (where markets react adversely to a moderation in QE) and the nightmare 'vaccines fail' (speaks for itself and causes another recession at the end of next year).

Full details of the scenarios can be found in the table at the back of the document (page 17). In terms of the impact on activity, our scenario grid shows the variation in growth and inflation compared to our baseline (chart 10).

Chart 10: Scenarios growth and inflation vs. baseline forecast

Risks scenarios are skewed in a deflationary direction relative to the baseline



Source: Schroder Economics Group, 30 November 2020. Please see forecast warning at end of document.

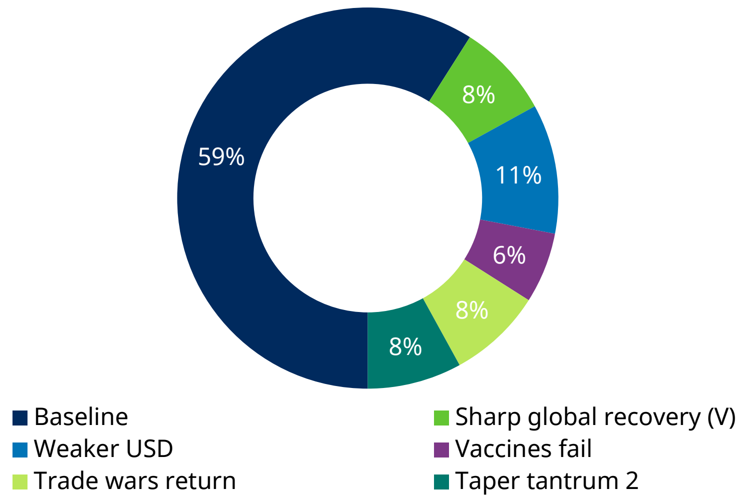
Our most likely risk scenario is now a weaker dollar. The US dollar (DXY index) has already weakened 6% year-to-date helped by Biden's victory. But conventional currency valuation models suggest the currency is still overvalued, particularly versus EM currencies, suggesting this has some room to run. The scenario has the dollar falling 10% against all currencies in 2020 and a further 10% the following year on a smooth trajectory. This leads to improved exports for the US, at the cost of most other countries. However, world trade and risk assets are lifted in the scenario.

While not an immediate risk to the economic outlook, a second taper tantrum receives a relatively high probability. The Fed's latest move to an Average Inflation Targeting (AIT) policy has reinforced investors' expectations that policy will stay loose for longer. The 10-year US Treasury yield stands close to historic lows, while credit spreads in the US have come down significantly. Our new trade wars scenario has equal probability. The relatively muted official reaction from China to a Biden presidency perhaps indicates that relations between the two countries are expected to remain frosty. Finally, the 'sharp global recovery (V)' scenario continues to receive a relatively high probability as spending in parts of the economy surpass pre-Covid levels.

The weaker USD scenario has the highest probability

Overall, taking account of our other two scenarios, the balance of risks has shifted in a deflationary direction led by the switch in our scenarios and high probabilities of a weaker dollar and taper tantrum which outweighs the chance of a V-shaped recovery.

Chart 11: Scenario probabilities



Source: Schroder Economics Group, 26 November 2020. Please see forecast warning at end of document.

Schroders Economics Group: Views at a glance

Macro summary – December 2020

Key points

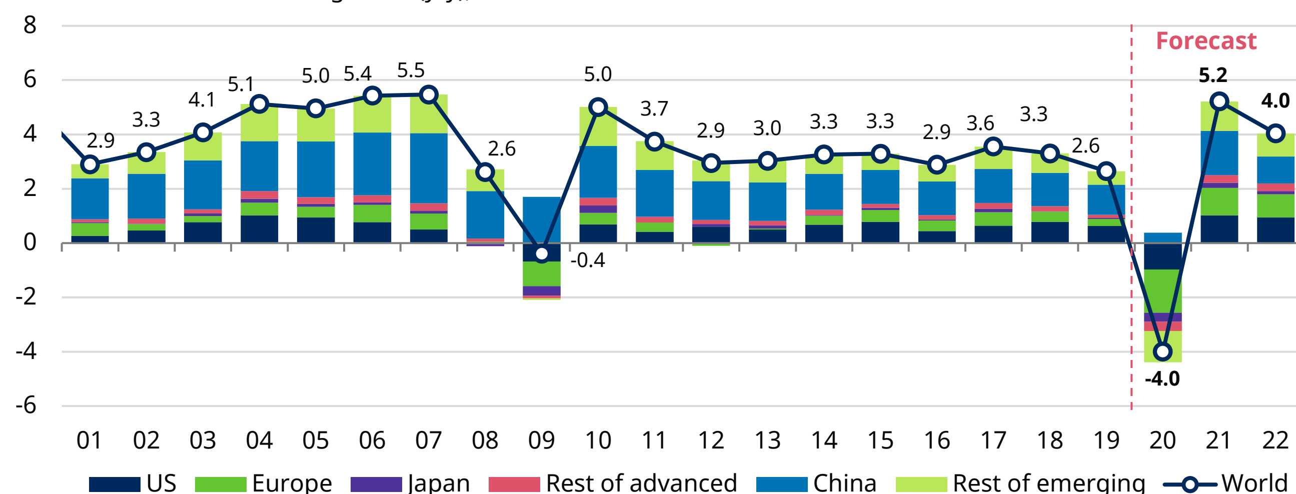
Baseline

- **Global:** In the near term, less than expected fiscal stimulus in the US and restrictions on activity in Europe should weigh on growth. We expect global GDP to fall by 4% in 2020 for the year as a whole. Growth should pick up in the second half of next following the arrival of a vaccine, which is distributed in the third quarter and should revive spending on services. We expect global growth to be strong at 5.2% in 2020. US-China tensions should ease somewhat, although remain high as China falls short of its phase-1 commitment on purchases from the US. On the inflation side, firmer oil prices and stronger activity push global inflation up slightly to 2.2% in 2021 and 2.4% in 2022.
- **US:** We expect a period of weaker activity in the near term as we anticipate more restrictions in the US. Growth should slow to 2.8% and 2.4% (q/q annualised) in Q4 and Q1 next year. Despite a split Congress, we assume that a $1 trillion fiscal stimulus deal is struck in Q1. Our expectation of strong growth following the vaccine means that activity is expected to return to its pre-Covid level in the second half of next year. Low oil prices and a significant output gap keep inflation below target over the forecast period allowing the Fed to keep interest rates at 0.25% (upper limit) and add more than $1tn in QE, though the pace will likely slow from Q3 next year as the economy recovers. We expect the dollar to weaken further.
- **Eurozone:** Second lockdowns should mean another dip (of -1.6% q/q) for Eurozone growth in Q4. Though restrictions going into the new year will drag on 2021 growth, we expect a solid recovery of 5.2%. The EU recovery fund (worth 5.4% GDP) should be disbursed in H2 2021, leading to increased investment activity in 2022. Growth is forecast to slow in 2022 to 4%, though well above trend growth of around 1.5%. Headline inflation is due to average just 0.3% for 2020, rising to 0.8% in 2021 and to 1.4% in 2022. Unlikely to satisfy the ECB, we expect an additional €750 billion of QE and purchases continue to the end of 2021. All interest rates are forecast to remain on hold.
- **UK:** The forecast for the UK is not too dissimilar to the rest of Europe, but it ends 2020 on a weaker footing (-11.3% GDP growth) due to the initial length of lockdowns earlier in the year. It too is likely to double dip given restrictions and may yet still face some restrictions in early 2021. However, fiscal policy is likely to remain very loose over the forecast horizon, backed by additional QE, as the Bank of England recently announced a further £150 billion of purchases over 2021. This should help achieve strong growth over 2021 (5%) and 2022 (4.5%), but other challenges remain. We still expect a deal on Brexit, likely to cover trade in most goods and not much of services. We assign a 20% chance of no deal.
- **Japan:** A recovery in exports and the industrial sector should continue to drive the Japanese recovery in coming quarters. A boost in demand from the vaccine and fiscal stimulus should help growth reach 2.9% in 2021. 2022 should prove a good year for global trade, which should help Japan grow at 1.8%. The BoJ should stay in perennial easing mode, expanding the balance sheet at similar rates to today (JPY40tn per/q) until the middle of next year when this should fall to around JPY25tn per/q.
- **EM:** We expect emerging market economies to contract by 1.9% on average in 2020, but with most rebounding strongly in the second half of the year we expect aggregate GDP growth of 6.9% in 2021. China is leading the way and, after expanding this year, is likely to grow by around 9% next year. With the exception of China, which is likely to experience a short bout of deflation, most EMs are likely to experience a transitory period of higher inflation led by food. But once this passes and growth settles to more normal rates few central banks will be in a rush to tighten policy, particularly if governments begin to repair fiscal positons.

Risks

- The overall balance of probabilities are skewed in a deflationary direction, largely as a result of relatively high probabilities of a weaker dollar, vaccine fails and a taper tantrum.

Chart: World GDP forecast



Source: Schroders Economics Group, 30 November 2020. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2019	2020		Prev.	Consensus	2021		Prev.	Consensus	2022
World	100	2.6	-4.0	↑	(-4.6)	-4.3	5.2	↑	(5.1)	4.9	4.0
Advanced*	60.9	1.7	-5.3	↑	(-5.7)	-5.4	4.1	↓	(4.6)	4.0	3.6
US	26.9	2.3	-3.6	↑	(-4.1)	-3.7	3.8	↑	(3.7)	3.8	3.5
Eurozone	16.8	1.2	-7.1	↑	(-7.8)	-7.3	5.0	↓	(6.2)	4.7	4.1
Germany	4.8	0.6	-5.4	↑	(-5.7)	-5.5	4.8	↓	(5.3)	3.8	4.5
UK	3.6	1.4	-11.3	↓	(-10.4)	-11.0	5.0	↓	(6.2)	4.7	4.5
Japan	6.4	0.7	-5.1	↓	(-4.6)	-5.5	2.9	↓	(3.6)	2.5	1.8
Total Emerging**	39.1	4.1	-1.9	↑	(-2.7)	-2.5	6.9	↑	(5.9)	6.4	4.7
BRICs	26.2	5.0	-0.4	↑	(-1.6)	-1.3	8.2	↑	(6.6)	7.4	4.9
China	18.1	6.1	2.1		(2.1)	2.0	9.0	↑	(7.0)	7.9	5.5

Inflation CPI

y/y%	Wt (%)	2019	2020		Prev.	Consensus	2021		Prev.	Consensus	2022
World	100	2.5	1.8		(1.8)	1.8	2.2	↑	(2.0)	2.1	2.4
Advanced*	60.9	1.5	0.7	↑	(0.6)	0.7	1.2	↑	(1.1)	1.4	1.5
US	26.9	1.8	1.2	↑	(1.1)	1.2	1.6	↑	(1.4)	2.0	1.9
Eurozone	16.8	1.2	0.3		(0.3)	0.3	0.8	↓	(1.1)	0.9	1.4
Germany	4.8	1.3	0.5	↑	(0.3)	0.5	1.4	↓	(1.5)	1.5	1.7
UK	3.6	1.8	0.9	↑	(0.3)	0.9	1.7		(1.7)	1.5	2.1
Japan	6.4	0.5	0.0	↑	(-0.3)	0.0	-0.2	↑	(-0.4)	0.0	0.4
Total Emerging**	39.1	4.0	3.6		(3.6)	3.6	3.7	↑	(3.5)	3.3	3.7
BRICs	26.2	3.3	3.3	↑	(3.2)	3.3	3.2	↑	(2.7)	2.5	3.1
China	18.1	2.9	2.6	↓	(2.9)	2.8	2.2	↑	(2.1)	1.9	2.8

Interest rates

% (Month of Dec)	Current	2019	2020		Prev.	Market	2021		Prev.	Market	2022	Market
US	0.25	1.75	0.25		(0.25)	0.24	0.25		(0.25)	0.25	0.25	0.39
UK	0.10	0.75	0.10		(0.10)	0.05	0.10		(0.10)	0.01	0.10	0.12
Eurozone (Refi)	0.00	0.00	0.00		(0.00)	-0.52	0.00		(0.00)	-0.53	0.00	-0.50
Eurozone (Depo)	-0.50	-0.50	-0.50		(-0.50)		-0.50		(-0.50)		-0.50	
Japan	-0.10	-0.10	-0.10		(-0.10)	-0.05	-0.10		(-0.10)	-0.03	-0.10	-0.01
China	4.35	4.35	4.35	↑	(3.50)	-	4.35	↑	(3.00)	-	4.35	-

Other monetary policy

(Over year or by Dec)	Current	2019	2020		Prev.	Y/Y(%)	2021		Prev.	Y/Y(%)	2022
US QE ($Tn)	4.0	4.2	7.5	↓	(8.1)	0.8	8.4	↓	(9.0)	0.1	8.8
EZ QE (€Tn)	2.4	2.4	3.0		(3.0)	0.3	4.5	↑	(4.3)	0.5	4.5
UK QE (£Bn)	422	435	745		(745)	0.7	895	↑	(745)	0.2	895
JP QE (¥Tn)	557.0	573	731	↓	(739)	0.3	854	↑	(829)	0.2	903
China RRR (%)	13.50	13.00	12.50	↑	11.00	-	12.50	↑	10.00	-	12.50

Key variables

FX (Month of Dec)	Current	2019	2020		Prev.	Y/Y(%)	2021		Prev.	Y/Y(%)	2022	Y/Y(%)
USD/GBP	1.32	1.32	1.32	↑	(1.30)	-0.4	1.35	↑	(1.34)	2.3	1.35	0.0
USD/EUR	1.18	1.12	1.18	↓	(1.20)	5.1	1.21	↓	(1.22)	2.5	1.21	0.0
JPY/USD	105.2	108.7	105		(105)	-3.4	107		(107)	1.9	107	0.0
GBP/EUR	0.89	0.85	0.89	↓	(0.92)	5.5	0.90	↓	(0.91)	0.3	0.91	1.6
RMB/USD	6.60	6.97	6.60	↓	(7.10)	-5.3	6.50	↓	(7.10)	-1.5	6.25	-3.8
Commodities (over year)												
Brent Crude	43.7	64.2	42.4	↓	(43.0)	-33.9	44.8	↓	(46.0)	5.7	43.5	-3.0

Source: Schroders, Thomson Datastream, Consensus Economics, November 2020

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.

Market data as at 10/11/2020

Previous forecast refers to August 2020

* **Advanced markets**: Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.

** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Schroders Forecast Scenarios

Scenario	Summary	Macro impact	Cumulative 2020-2022 global vs. baseline		
			Probability*	Growth	Inflation
Baseline	In the near term, less than expected fiscal stimulus in the US and restrictions on activity in Europe should weigh on growth in developed markets in the fourth quarter and going into the first quarter of next year. We expect global GDP to fall by 4% in 2020 for the year as a whole. As the economic recovery continues, we expect global growth to be strong at 5.2% in 2020. Growth should pick up in the second half of the year following the arrival of a vaccine, which is distributed in the third quarter and should revive spending on services. US-China tensions should ease somewhat, although remain high as China falls short of its phase 1 commitment on purchases from the US. On the inflation side, firmer oil prices and stronger activity push global inflation up slightly to 2.2% in 2021 and 2.4% in 2022.	Most developed market economies surpass pre-COVID-19 levels of activity around Q3 21 though the Eurozone takes slightly longer. The UK stands out as a laggard. Inflationary pressures are contained allowing monetary policy to remain easy. The Fed, ECB, BoE and BoJ are expected to keep interest rates on hold through the forecast horizon and continue QE. We expect the Fed to begin tapering in the second half of 2021. The PBOC and RBI are expected to keep rates on hold at 4.35% and 4%, respectively. The RRR also expected to remain at 12.5% through to the end of 2022 although there may be tightening through other channels. More fiscal stimulus is expected in light of the hit to growth and employment. The USD is expected to weaken over the forecast period.	59%	-	-
1. Sharp global recovery (V)	Global growth rebounds sharply as a vaccine becomes available at the end of 2020 allowing activity to normalise. Fiscal and monetary policy prove more effective in boosting growth once economies open up. Business and household confidence returns rapidly with little evidence of scarring and government policies are successful in preventing output being lost permanently. This is the closest scenario to a "V shape" recovery.	Reflationary: Economies see output surpassing pre-COVID19 levels in the first half of 2021 and inflation also rises as commodity prices pick up. In most countries, monetary policy is tightened by the end of 2021 and fiscal policy support is reined in.	8%	+2.6%	+1.5%
2. Weaker USD	The US dollar depreciates smoothly against all currencies by 10% in 2021 and another 10% in 2022.	Deflationary / neutral: The increase in external competitiveness supports US growth, which is boosted by 0.4% in 2021 and 0.8% in 2022. Stemming from the dollar dominance in trade, the weaker dollar itself along with higher US growth helps lift global trade. Emerging Markets also benefit from easier financing conditions, which support growth by allowing monetary policy to be looser. The ECB and BoJ cut rates to offset the tightening of financial conditions. Exports in these countries become more expensive and the knock to confidence and profits also leads to a pull-back in capital expenditure. A stronger currency also shaves off some export growth in China. All of this more than offsets the boost to growth from the US and Emerging Markets. Though deflationary for the rest of the world via lower imported inflation, higher growth and inflation in the US allows the Federal Reserve to increase rates at the end of 2022.	11%	-0.2%	-0.3%
3. Vaccines fail	Despite the vaccines, the population is unable to reach herd immunity and coronavirus continues to rise as a variant of the virus returns. Governments across the world are forced to lock-down for the whole of Q4 2021 and half of Q1 2022.	Deflationary: Growth is badly hit in the final quarter of 2021 and as lockdowns ease, the recovery in 2022 is more fragile due to the hit to confidence to both firms and businesses. Inflation is also dragged lower owing to further weakness in demand and falling commodity prices. Policy makers loosen fiscal and monetary policy further, the latter through QE. As in 2020, the authorities in China are able to effectively control the fresh outbreak of Covid and deliver a large and effective economic support package, ensuring that the economy gets back on track during the course of 2022. However, many other EMs such a Brazil and India are left with little room for manoeuvre meaning that they suffer badly and are slow to recover.	6%	-3.9%	-0.8%
4. Trade wars return	Once President-elect Biden has settled in and rekindled the United States' relationship with Europe and other allies, he leads a multilateral stance against China's anti-competitive trade policy. China's failure to reach purchasing commitments of US goods agreed in the phase 1 deal add to tensions. Tariffs on Chinese goods are hiked in Q4 2021 by the US, Europe and Japan. China retaliates in kind and tariffs then remain at these levels through 2022.	Stagflationary: Higher import and commodity prices as countries attempt to stockpile push inflation higher. Weaker trade weighs on growth. Capital expenditure is also hit by the increase in uncertainty and the need for firms to review their supply chains. Central banks focus on the weakness of activity rather than higher inflation and ease policy by more than in the baseline. In China, the renminbi is allowed to weaken in order to absorb some of the increase in tariffs, however more punitive levies and supply chain disruption cause economic growth to slow. Small, open EMs in Asia also suffer from weaker trade, but the negative impact is less on the relatively closed EMs such as Brazil and India. Some EMs may in the long-term benefit from re-orientation of supply chains. Oil producers such as Russia receive some short-term benefit from higher crude prices as energy-importing countries stock up.	8%	-0.9%	+0.6%
5. Taper tantrum 2	As the Fed starts tapering in Q3 2021, US Treasury yields spike and this triggers an increase in risk aversion. This then leads to a credit event as investors pull back from funding risky assets.	Deflationary: Central banks do their best to step in, reversing course but the higher risk premium persists. The tightening in financial conditions for the government and corporates hurts growth as confidence takes a hit and there is a pull back in corporate capital expenditure. An increase in bankruptcies pushes unemployment higher. A "sudden stop" and reversal of capital flows to the emerging markets causes exchange rates to depreciate sharply, forcing central banks to raise interest rates. Capital flight forces current account deficits to close in EMs such as Brazil and India, matched by declines in domestic demand that weigh on overall GDP growth. Weaker growth would also cause inflation to be lower than in our baseline scenario.	8%	-1.3%	-0.5%
6. Other			0%	-	-

*Scenario probabilities are based on mutually exclusive scenarios. Please note the forecast warning at the back of the document.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

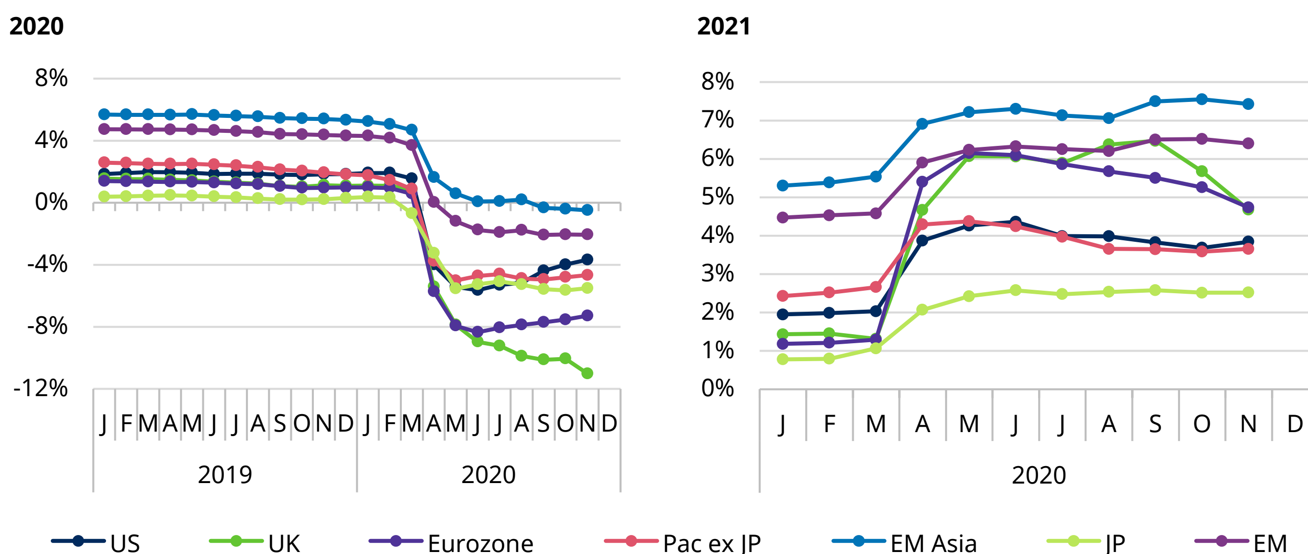
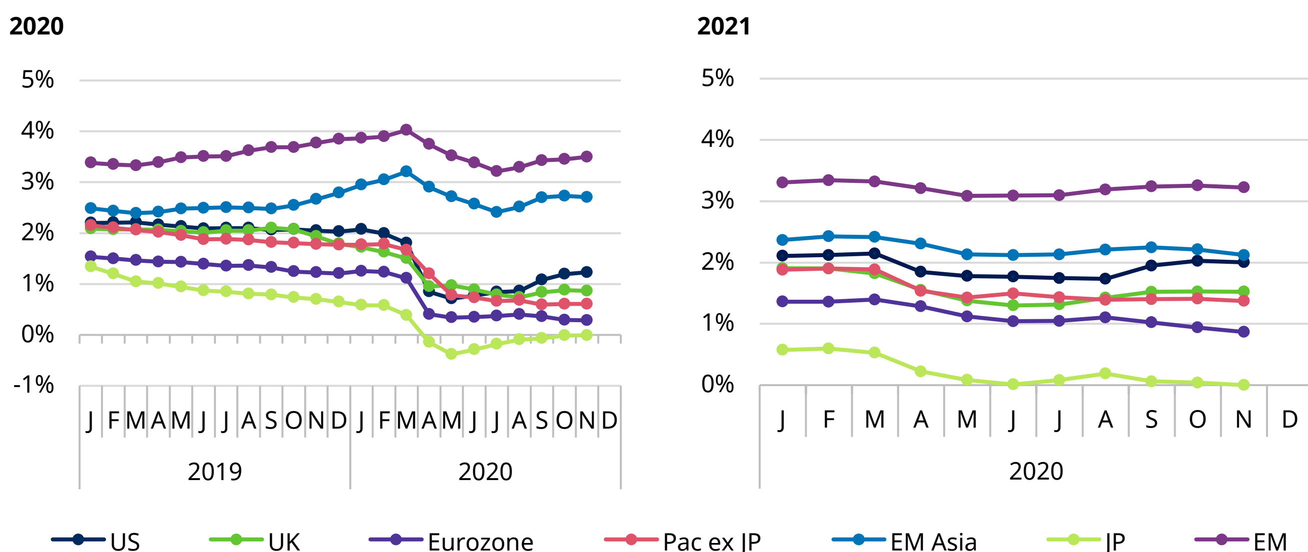


Chart B: Inflation consensus forecasts



Source: Consensus Economics (30 November 2020), Schroders.
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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