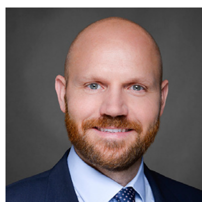
The Imminent Peak in Growth Does Not Spell Doom and Gloom

It is likely to remain above the potential rate for a while.

June 2021



Nikolaj Schmidt
Chief International Economist

After some wobbles on the back of the bond market sell-off, risk assets have performed strongly over the past month or so. Equity and corporate bond indices are broadly higher, risky currencies are stronger, commodity prices have risen, and implied volatility in options markets has largely fallen (in other words, the market demands less premium to help ensure investors against adverse outcomes). Can this rosy state of affairs last—or is something more somber lurking in the shadows?

The core building block of any investment thesis is the business cycle. I believe the global economy is currently at the beginning of the "expansion" stage of the business cycle. During this stage, the release of pent-up demand keeps growth above potential, and, as the economy operates below full capacity, idle resources keep inflation pressures at bay (persistent wage pressures do not build when unemployment is high). In the absence of inflationary pressures, monetary policy remains accommodative and the central banks are relegated to the role of spectators on the sidelines. This environment is conducive for the performance of risky assets.

Stealth Stimulus Has Helped Line Investors' Pockets

The current situation has been sweetened even further as the Federal Reserve's quantitative easing (QE) program has been accelerated by stealth: In tandem with sending out checks to households, the U.S. Treasury has drawn down its cash balance at the Federal Reserve to the tune of roughly USD 250bn per month. Consequently, the Federal Reserve's scheduled QE of USD 120bn per month was augmented by an additional USD 500bn through the months of March and April. This explains why investors have generally found themselves with more cash than they can spend on genuinely compelling investment opportunities, which has created a strong bid for risky assets.

Clouds are gathering, though. The second quarter of 2021 will likely turn out to be the one where stimulus and growth peak. The U.S. Treasury-led QE by stealth will likely continue throughout the quarter, but as we reach midyear, I believe the Treasury's cash account at the Fed will be exhausted. Similarly, the disbursement from the fiscal support packages of the Trump and Biden

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administrations will likely peak sometime during the second quarter of the year. Thus, from a monetary and fiscal perspective, this is probably as good as it gets.

Additionally, in tandem with the successful rollout of vaccines across the U.S., the associated growth recovery is likely to trigger some subtle changes in the mood music at the Fed. By midyear, it will probably be time for the Fed to change its message to indicate that it has begun to discuss the timing and mechanics for some reduction in the pace of quantitative easing. I do not expect the Fed to make any tangible steps in this direction before 2022, but from a financial market perspective, talking about tightening is almost the same thing as tightening.

An additional wrinkle on the fiscal angle is that, as President Joe Biden has presented the broad contours of his next and (hopefully last) fiscal package, the discussion will turn to how to pay for it. It is no secret that the Democratic party sees a need to increase the progressiveness of the U.S. welfare system: Taxes on dividends and capital gains, which mostly accrue to the wealthiest Americans, are set to rise. Never in history has a tax on capital gains served to increase the attractiveness of equities and other risky assets, and this time should be no different. I expect the volume on this discussion to be increased as we move toward the summer months.

Growth Will Likely Peak Midyear

On the growth front, I expect global growth to peak soon—probably sometime around the middle of the year. The timing of the peak will depend on the reopening of economies, and the middle of the year seems to be the sweet spot where the growth impact from the U.S. reopening likely overlaps with the growth impact from the belated European reopening. Growth and policy support peaked long ago in the world's most populous economy—China—and as we progress through the middle of the year, I expect the policy tightening in China to become an increasingly large headwind to global growth. It is important to note that growth peaking does not spell doom and gloom, in my view: I expect the global growth rate to settle much above the potential growth rate throughout the second half of 2021.

I am less concerned about the widely anticipated acceleration in inflation. First, in line with the communication from the Fed, I expect the looming increase in inflation to be driven by some one-off factors and base effects. I do not see a persistent wage-price spiral that would trigger an outsized response from the monetary authority. More importantly, from a markets' perspective, as the Fed remains cool and has proactively communicated both its expectations and its planned response to the rise in inflation, I do not expect the market to develop an inflation scare that will trigger a disorderly adjustment in asset prices.

So, putting the pieces together, the macro environment looks supportive for the performance of risky assets through the summer. It is not entirely obvious when the market will become concerned about policy support and growth peaking, but my guess is that the Fed's accelerated QE program will keep these concerns manageable until around the middle of the year. Will there be a few minor bumps in the road along the way? Almost certainly, but my expectation is that these wobbles, with the benefit of hindsight, will turn out to be opportunities rather than the beginning of something more ominous.

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