SALT GLOBAL OUTLOOK

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By: Bevan Graham: Economist, Salt Funds Management

Aspiring to a better normal

The COVID pandemic is an event that has taken a considerable human, social and economic toll around the world. The economic and social scars will likely persist for many years.

The resultant recession was like no other. It was on us very quickly and it was very deep. Importantly, it was not borne of the usual build up in imbalances that take time to be corrected. That meant a swift recovery was likely as economic and social restrictions were lifted, but it will take a long time for a full recovery, especially in the labour market.

We have been relatively lucky in New Zealand. Going hard and early has been the right strategy.

Around the world, many still yearn for a return to normality. That assumes "normal" is something we should aspire to return to. There was plenty wrong with the old normal; a lack of commitment to reversing the impact of climate change, widening inequality, poor social cohesion, and political disruption, even in the world's most powerful democracy.

But as Benjamin Franklin once said; out of adversity comes opportunity. If what we are currently going through is a catalyst for change, there is cause for some hope that we can create not just a new normal, but a better normal.

It seems to us that the pandemic has created a greater awareness of the challenges facing humanity, and given its global scale, can become that change catalyst towards a new inclusive, sustainable and environmentally friendly model of how the world works.

On the economic front, we expect the pandemic to lead to an acceleration in new engines of job creation and economic growth. These include clean and renewable energy, transformation of transportation, digitalization and, more generally, faster adoption of sustainable and eco-friendly production methods. We may even see faster changes in consumer behaviour.

Some of those will exacerbate pre-existing challenges like labour displacement, just at a time when the pandemic has taken its greatest toll on low-skilled workers. Job creation and skills development will be key areas of focus for policy makers in the period ahead.

Creating a better normal will require a collaborative effort. The good news is we have seen collaboration on a global scale through the pandemic. Importantly, with the change in leadership in the United States, we are seeing the return of the US as a global citizen.

Furthermore, efforts to stimulate economies in the face of the pandemic have come at a time of a growing acceptance of the need to invest in change though there are challenges with respect to how this will be funded.

Growth conditions "mixed"

In the meantime, a global economic recovery is underway, though it is mixed in pace and nature around the world. A key driver of that recovery has been

the relaxation of various economic and social restrictions imposed in the early days of the pandemic while the rollout of the various vaccines will add impetus during 2021.

The outlook for the US economy is for a solid recovery in GDP growth over 2021. Recent data has been on the better side of expected. The vaccine is being rolled out which will lead to a rapid decline in COVID cases and a recovery in consumer spending aided by the spending of previously accumulated savings and a continued recovery in jobs growth. Fiscal policy will continue to support activity through already announced measures with a further package of support measures expected in March.

Recoveries in Europe and the United Kingdom have been stymied by the resurgence in the virus which has these economies lagging the recovery in the US. While activity data held up better than expected in the latter part of 2020, further weakness is expected in the early part of 2021. Their recoveries will likely catch-up as the vaccine is deployed.

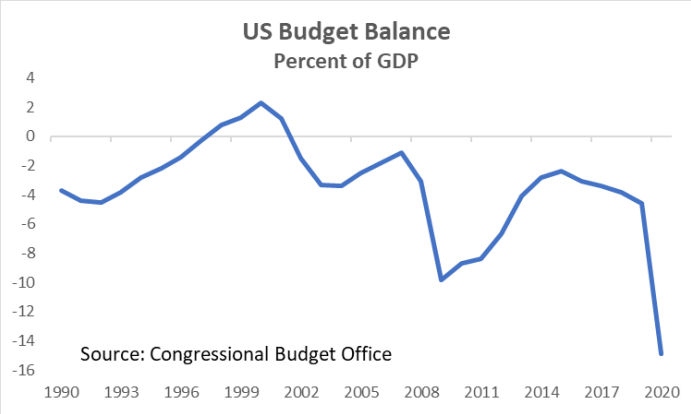
China and broader Asia experienced the shock from the pandemic first and have been generally more successful in combating the spread of the virus more recently. Indeed, China is the only major global economy to post positive global growth of just over 2.0% in 2020. A rebound to a solid 9% growth appears on the cards in 2021.

The International Monetary Fund is expecting global growth of 5.5% in 2021 following the estimated 3.5% contraction in 2020. Private sector forecasts are for a faster recovery of around 6.0% and are being revised up as the COVID vaccine is deployed.

Powerful responses from monetary and fiscal policy, holding the fort until vaccines are rolled out

Central bank action was swift and powerful. Further bond purchases, liquidity programs and rate cuts have taken already unconventional monetary policy settings into the even more unconventional. Monetary conditions have shifted from the very accommodative to very very accommodative.

The fiscal response has also been significant amongst the major developed economies, especially in the United States, Japan, the United Kingdom and many countries within the Eurozone. The IMF estimates that across the G20, the average budget deficit has deteriorated from 4.5% of GDP in 2019 to 13.9% in 2020. That is significantly more expansionary than the 8% of GDP at the height of the global financial crisis.



These monetary and fiscal measures have played a critical role in helping fill the demand gap created by the pandemic until a more lasting resolution in the form of a vaccine could be found.

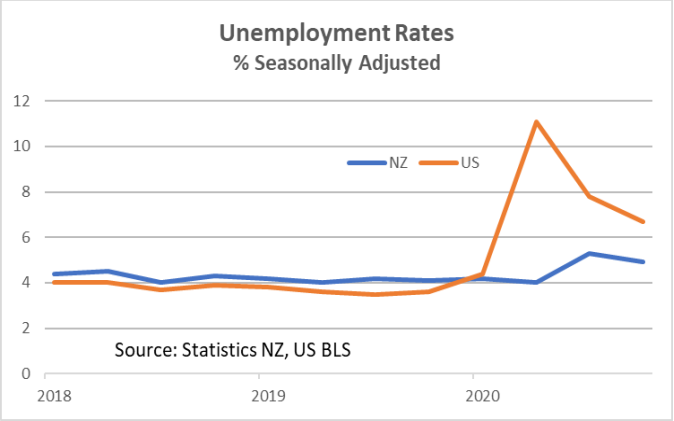
Vaccines are being rolled out in a number of countries with all eyes now on proof of their efficacy, especially against the recent UK, South African and Brazilian variants of the virus. Further mutations of the virus into a form resistant to the new vaccines is one of the biggest risks to the outlook.

Labour markets in better-than-expected shape

Labour markets have performed significantly better than expected. That is largely thanks to significant fiscal support directed towards businesses, most notably wage subsidies.

This staved off the darkest unemployment premonitions. Some projections had the US unemployment rate reaching 30%, while in New Zealand, there were many forecasters expecting unemployment rates well north of 10%.

That is not to trivialise the cost, which has been significant. In the United States for example, the number of employed remains well below its pre-crisis level. In New Zealand the unemployment rate rose from a pre-crisis low of 4.1% to a peak of 5.3% in September 2020 and then back down to 4.9% in December 2020.



It is through the labour market where we can also see the impact on industries, regions and different groups of people. Here in New Zealand for example, job losses have been most significant in tourism and hospitality, sectors that are unfortunately dominated by low skill, minimum wage jobs. Construction, on the other hand, is booming and constrained by skills shortages.

Even more unfortunately our hardest hit sectors tend to also have a higher proportion of low-skill, low-wage employees. That in turn means a higher proportion of Maori and Pasifika workers are impacted by the pandemic.

While the overall unemployment rate is 4.9%, the rate for European New Zealanders has fallen to 3.7%, while the rates for Maori and Pasifika are 8.0% and 9.6% respectively and are still rising. Recessions are never fair but this one has been particularly brutal.

That makes job creation and skills development key political priorities in the period ahead, not just in New Zealand, but around the world.

Is an inflation surprise coming?

Since the Global Financial Crisis, many economists (including myself) have been surprised by the lack of inflation, especially as labour markets tightened. That has become known in the jargon as the flattening of the Phillips curve, whereby very tight labour markets, most noticeably in the US and New Zealand, failed to generate any significant wage pressure or inflation.

I tend to attribute the lack of wage pressure to the disempowerment of labour with respect to wage bargaining. This has been achieved through the de-unionisation of the labour force since the 1970s and 80s.

Combine that with the ever-faster adoption of technology alongside the competitive pricing pressures that have come with globalisation and you have a recipe for structural disinflation. The structural nature of these forces has deemed monetary policy somewhat impotent in generating higher inflation.

But there are a number of reasons to believe a period of higher inflation may be on the cards:

- central banks have been tireless in their efforts to raise inflation expectations, which are now on the rise;
- unemployment rates are higher than before the pandemic, though the low-skilled have been disproportionately affected. Skills shortages are rife, in fact we would argue the skilled labour market is tighter than it was before the pandemic, putting upward pressure on wages;
- while the pandemic and the political response too it created a significant decline in demand, the pandemic was also a supply shock as firm's ability to produce goods and services was also curtailed. Some of this damage to supply is likely to prove permanent;
- globalisation is being wound back, partly due to populist political causes that see global trade as the cause of developed world middle-class real income stagnation, but also as businesses rethink global supply chains in the wake of the supply disruptions induced by the response to the pandemic. Cheap may not always be best if it's subject to supply disruption;
- yawning budget deficits will accelerate the closing of output gaps and put more pressure on skilled labour and wages. This is the first time since the GFC that we have seen both monetary and fiscal policy this stimulatory. Much of the period since the GFC and definitely since the Eurozone debt crisis has been characterised by fiscal austerity which has proven to be disinflationary;
- monetary policy was accommodative before the pandemic, but is even more accommodative now.

While there is a heightened risk of resurgent inflation over the next year or two, don't expect central banks to respond immediately.

Firstly, some of the higher inflation we are seeing now could be temporary in nature. Not all supply constraints will remain unresolved. Central banks will only respond to what proved to be sustained upward pressure on prices.

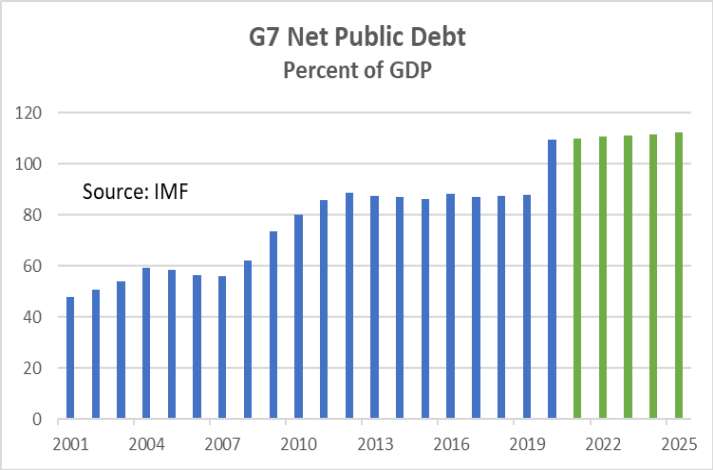
Also important is the recent tweak in the US Federal Reserve's policy framework; from flexible inflation targeting to flexible average inflation targeting.

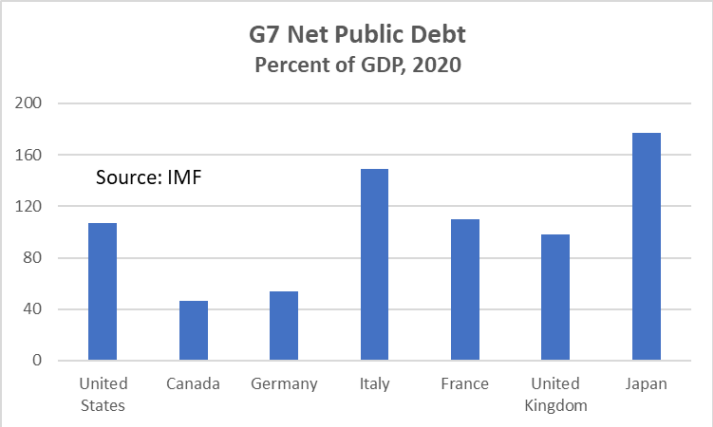
That change may seem small, but in reality its potentially quite meaningful. Essentially it means that inflation history is no longer just history. The Federal Open Market Committee will now consider their policy response to emerging higher inflation in light of the fact that inflation has run below their mandated 2% for a considerable period of time. That means they will now be prepared to let inflation run higher than 2% until the average is restored. How this will operate in practice is yet to be determined.

Rebuilding crisis buffers

The need to "normalise" monetary policy has been a theme for a few years now. Of the major developed markets, the United States made the most progress in restoring normality to monetary conditions, the Eurozone and Japan the least.

The good news, at least for some was that while monetary policy had remained close to its stimulatory limits, fiscal policy still had room to move. That has now been stretched with the response to Covid-19 with significantly wider budget deficits around the world, with negative public debt implications.





G7 net public debt is estimated at 110% of GDP at the end of 2020. This includes the United States at 107% of GDP, France at 110%, Italy at 149% and Japan at 177%.

Add to that the rapid rise in private debt on the back of ultra-low interest rates and ample liquidity, private debt has also risen sharply.

The International Institute of Finance estimates total global debt at 365% of GDP at the end of 2020, up from an already worryingly high 320% a year earlier.

Solutions to high levels of debt are relatively limited. There are essentially three choices: pay it back, inflate your way out of it, or default. None of them are easy. But while debt levels remain high, we can't ignore the systemic risks.

The first step is to reduce large budget deficits. Some of this will happen naturally as economies (and tax receipts) recover and the need for fiscal support declines.

But COVID has come at a time when many governments were already fiscally constrained and worrying about already large structural issues such as meeting climate change commitments, replacing old and failing infrastructure and reducing inequality.

Just as important is getting ready for the next crisis. In New Zealand the Government's go-hard-and-early strategy was in part due to the fact that we were in good fiscal shape, thanks to previous government's commitment to restoring fiscal buffers.

That fiscal headroom needs to be restored and it will not be easy. Existing expenditure needs to be reduced at a time when there are increasing calls on government resources and/or taxes will need to be increased via higher tax rates or a broadening of the tax base.

US politics: Normal service has resumed

The reasons for Donald Trump's elevation to the US presidency have been well traversed. Suffice to say he managed to hit some popular messages during the 2016 election that contributed to his ultimate success.

But the ultimate political test, especially for politicians elected on a populist platform, is whether they have any real and enduring solutions to the problems they have identified. The answer is usually "no" and this was President Trump's ultimate fate. That said, he still won 47% of the popular vote on election day.

The Trump legacy will be a deeply divided country. That is not to say the US wasn't divided before, but those divisions are now more overt. Who will ever forget the storming of the Capitol building by Trump supporters on January 6th.

The election of President Joe Biden will see a reset of US politics, albeit from a markedly worse place than it was four years ago. Biden has got off to a solid start, reversing many of Trump's decisions, in much the same way – by Executive Order.

Any President's success or otherwise in implementing their policy program is determined by the shape of Congress. At least until the mid-term elections, the Democrats will enjoy the political trifecta of holding the White House along with majorities in both the House of Representatives and the Senate.

Both majorities are slim however which means the President won't have policy carte blanche as he eyes the mid-terms. That means a watering down of both the new fiscal stimulus plan and proposed tax increases.

Importantly diplomacy is now back in the US. This is critical from a global perspective as the US is now back in the Paris Climate Change Agreement. They have also re-joined the Iran nuclear deal.

New Zealand in Focus

Few would argue that going hard and early wasn't the right strategy. At the time it seemed like a big call: its success or otherwise would only be measured by a faster and sharper recovery as pay-off after a deeper but hopefully shorter recession. Right now, most of us would rather be in New Zealand than anywhere else in the world right now.

Economic activity has rebounded sharply and the labour market has performed much better than expected as outlines above. It is important to note that we are not completely out of the woods yet. The combination of firms continuing to fail with others locking in productivity gains means further job losses are still likely.

The housing market has also come through significantly better than expected; we have simply swapped one demand supply/demand imbalance for a slightly different supply/demand imbalance.

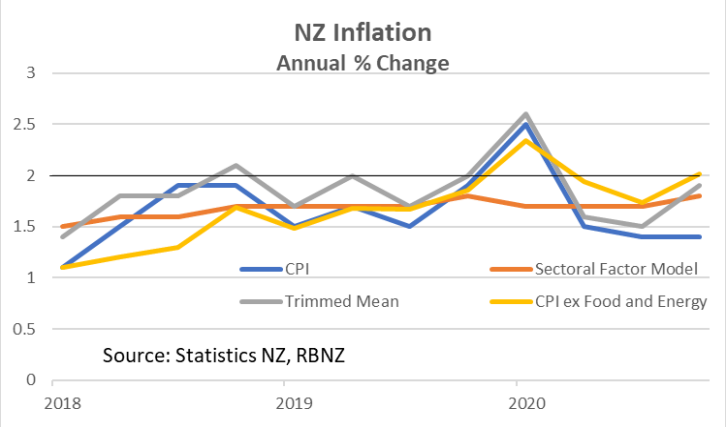
Pre-pandemic we saw high demand through inward migration into a housing market with too little available supply. Right now we have little immigration, but high numbers of Kiwi's coming home into the same supply constrained market exacerbated by lower than usual stock of existing homes on the market.

While housing supply remain constrained, loan-to-value ratios have been reintroduced which should cool demand and take the heat off house prices, but won't address the fundamental supply issues.

We are not reading too much into the recently higher than expected CPI inflation result that saw the annual rate up to 1.4%. In fact inflation is likely to head higher over the next few quarters reflecting current supply constraints, many of which will prove transitory.

But as outlined above, we do see the risk of more sustained inflationary pressure in the period ahead. The New Zealand specific risks include recently higher inflation expectations, wage pressure emanating from skills shortages and the more permanent shifts in global supply chains that may result in more sustained price increases.

Add to that the fact that many of the core inflation measures the RBNZ monitors are closer to 2% and heading higher, there are sound reasons for them to be less dovish and more neutral in the period ahead.



Fiscal policy is easier with significant budget deficits and a sharp rise in public debt. The challenge now is to restore the fiscal headroom so that we can be ready to respond to the next crisis, whatever that may be.

Politics is always fascinating, but it is made all the more interesting this parliamentary term given we have our first single-party government since MMP was introduced in 1996.

This comes at a time when the political challenges are quite clear: post-COVID recovery (especially jobs), housing affordability, restoring fiscal buffers and meeting the climate change challenge.

With quite clear but also daunting challenges, being a single party government is both a blessing and a curse; a blessing because there are no (at least political) constraints to implementing your plan, but its potentially a curse in that there will be no excuses for not delivering.

Market Implications and Risks

Equities continue to offer good return prospects given the broad support of very loose monetary conditions and continued fiscal easing, especially in the United States.

Continued low interest rates means investors earn nothing in term deposits and so there are no alternatives other than assets such as equities or houses. Furthermore, the significant earnings slump in 2020 will prove transitory as economic recovery build through 2021.

Equity market valuations such as price-to-earnings ratios remain elevated compared to long-term historical averages. This is in large part due to ultra-low interest rates which have been reinforced more recently by forceful central bank action as a result of the pandemic, bringing risk-aversion down.

In theory, higher bond yields could ultimately undermine the attractiveness of equities, because the yield on shares, though higher than the yield on risk-free bonds, may not be sufficient to offset the additional risk carried by equity investments. However, though longer-term bond yields have indeed risen sharply recently , the leap was from such a low prior level that equity earnings yields still remain substantially advantaged.

Thus, while the so-called Equity Risk Premium is diminishing somewhat as future inflation risk and current bond yields rise, investors are still receiving adequate compensation from equities. This is mainly because inflation that is due to cyclical recovery also suggests rising corporate profits are possible as economic activity will have picked up commensurately.

Late-cycle overheating concerns have been pushed out as a result of the pandemic and the ensuing recession, but also by apparent central bank tolerance for higher inflation. The US Federal Reserve's "tweak" to its policy framework is the key example, thought it remains to be seen exactly how this will operate in practice.

As always there are risks. Perhaps the biggest is still COVID. We have already seen a number of virus variants emerge, but at this stage the various vaccines still appear effective. Any further mutation of the virus that challenges the efficacy of the vaccines and pushes the world back into stricter lockdowns would be negative the economic and earnings recoveries.

Higher inflation remains a risk, especially if the nascent pressures we have identified take hold more quickly than expected forcing central bank responses and a wall of money rushing for a very small exit door.

For now, bond market reactions to the improving economic outlook are reflected in steepening yield curves as the front-end remains anchored by central bank inaction that is likely to persist for some time yet.

We also remain concerned about the systemic risks posed by inexorably higher debt levels. Options to reverse the rise are limited and none of them are easy. This is especially critical as the call on government finances to meet the challenge of climate change and inequality grow ever louder.

At any given time there are a number of geo-political issues that are bubbling away. Some of the issues we are keeping a particularly close eye on include US-China relations, Taiwan and growing calls for independence from China, the recent coup-de-tat in Myanmar, domestic US political tension given a significant proportion of the US electorate believes the 2020 election was "rigged", and rising global inequality concerns as the COVID vaccine is slower to be deployed through the developing world.

With respect to real assets, the economic recovery and continued historically low interest rates will be generally favourable for real estate. However, Covid means it is perhaps more important than ever to have a sectoral lens. Lockdowns have seen a surge in e-commerce and working from home which will have a negative impact on office and retail space, while the industrial and logistic sectors are likely to benefit from the changed environment.

The outlook for the infrastructure is also positive. All around the world, infrastructure projects are being accelerated as policy makers support economic growth and jobs in the wake of the pandemic. Furthermore, the growing awareness of the need to act on climate change will have a significant impact on this sector.

This is especially the case in the US where President Biden will enjoy the support of both houses of Congress in accelerating projects and a further stimulus package is on the way. Given Biden's fundamental belief in green energy, expect projects in renewable energy generation to be developed and expedited. Princeton's Net Zero America report sees this as a US$10 trillion opportunity in the period out to 2050.

Finally, both the property and infrastructure sectors will be sensitive to rising interest rates but are often seen as natural hedges against inflation risk. In real estate higher inflation increases the cost of building new assets which is positive for existing assets as occupancy rates increase along with pricing power. In infrastructure cash flows and asset values typically have either direct or indirect links to inflation, such as rate escalators tied to inflation rates often seen in utilities and toll roads.

Many of the services and amenities provided by property and infrastructure are usually not particularly discretionary (in economists' language, they have low price elasticity.) People will continue to rent or buy buildings, use airports, trains, roads, water utilities and electricity, even as the price of these amenities rise with inflation.

These sectors almost always remain able to engineer revenue growth, as global mega-trends drive demand for them inexorably upwards. The experience of East Asian Emerging Markets in recent years is the classic case in point, showing how well-chosen real assets can generate high cash flows and positive underlying asset re-valuations, despite periodic bouts of inflation in their host economies. For that reason, many of Asia's wealthiest families and conglomerates remain today, as they always have been, very active participants in both property and infrastructure investing.