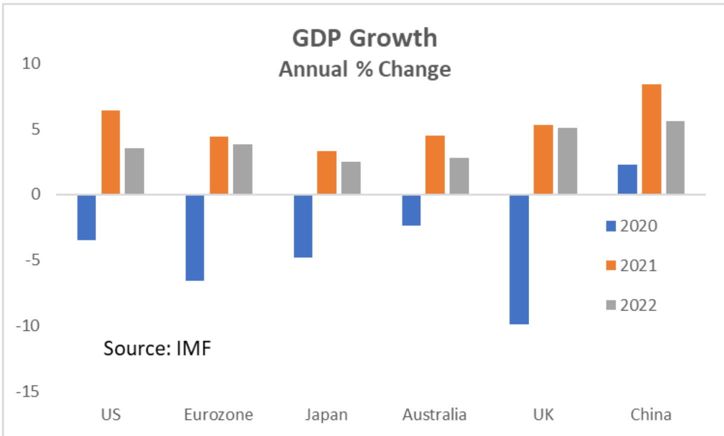

# Global growth revised up, risks evenly balanced

Global growth forecasts are being revised up as the various COVID vaccines are rolled out and as economies continue to open. The International Monetary Fund's April World Economic Outlook report revised the extent of the contraction in 2020 from -4.4% in their last full set of forecasts in October last year to -3.3%. That is a modestly better (less bad) starting point, though a contraction in activity that was still four times worse than the worst year for global growth during the Global Financial Crisis – the -0.8% recorded in 2008.


The IMF sees growth recovering to 6% this year as vaccines roll out and economies open up, but also reflecting the enormous amount of stimulus that has already hit the ground, and more in the pipeline. They see growth of 4.4% in 2022 then returning to a more sustainable 3.6% in 2023.

The outlook is quite mixed by country. Individual countries have had various degrees of success with respect to the initial containment of the virus, the roll out of vaccines along with differing degrees of monetary and fiscal support.



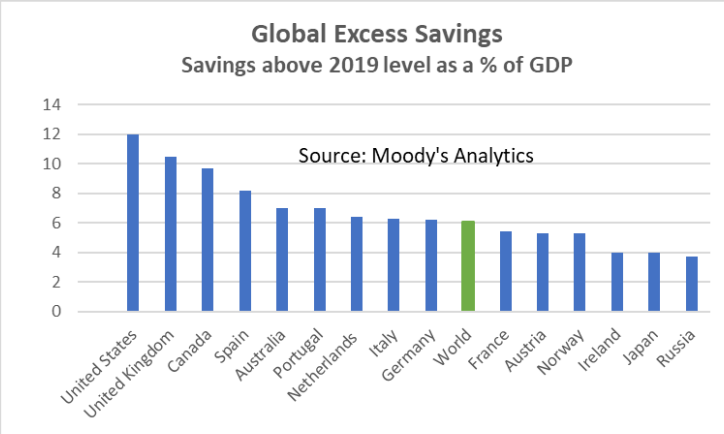

## Upside and downside risks

The key downside risk is a resurgence of the virus, especially if new variants prove to be resistant to the range of currently-available vaccines. As we publish this report, there is a worrying escalation of active cases in India that has brought the country's health system to breaking point.

On the economic upside, assuming the general trend towards containment and vaccination and the resultant relaxation of economic and social restrictions continues, there is considerable pent-up demand.

A recent report from Moody's Analytics suggests that households are sitting on considerable excess savings (higher savings due to lockdowns in 2020 over and above the normal level that householders set aside) which was built up as economic output dropped dramatically, while household incomes were largely protected by government economic and job support packages.

This excess saving will more than likely be spent as economies continue to open. Moody's put the value of this "demand flood" as high as 12% of GDP in the United States and 6% of GDP globally. If households globally spend just a third of this in the period ahead, that will add 2% to global GDP.




### Fiscal policy: from emergency support to supporting growth and jobs

As fiscal policy shifts from supporting the economy through the pandemic, governments need to align ongoing fiscal support with their longer-term objectives and with meeting long-term challenges.

In this respect the new US President is off to a solid start. Following on from his $US1.9 trillion Covid relief plan, President Biden has announced two further longer-term focused fiscal packages.

The first – the "American Jobs Plan" is a $US2.25 trillion, 8-year fiscal support package focused on climate change, infrastructure development, the care economy along with support for skills development and training.

The second – the "American Families Plan" is a $US1.8 trillion 10-year program which includes a major expansion in spending on childcare, paid leave and education.

Taken together the President's plans are both comprehensive and ambitious. Students of history will notice similarities with Franklin D. Roosevelt's "New Deal" and Lyndon Johnson's "Great Society" programs. These initiatives are clearly intended by the Administration to be seen as a clear break with Post-Reagan fiscal orthodoxies, and to transform the American economy in enduring fashion.

Along with the White House, the democrats also hold (slim) majorities in both houses of Congress. But that doesn't guarantee the passing of the President's fiscal plans into law. There will be concern on the Republican side that the President is partly funding his program through tax increases, while some Democrats may balk at the tax increases and may have different priorities for the substantial additional spending.

But the new President is wasting no time. He will be concerned that come mid-term elections at the end of next year, it may be even harder to get his legislative program through if he loses his majority in the Senate, or even the House. A spluttering stimulus program with little in the way of lasting transformation would make the Democrats vulnerable at the polls to Republican ridicule, and potentially the rebound of the "Right."

### New engines of growth

Managed well, the pandemic could lead to an acceleration in new engines of job creation and economic growth – and with that, new opportunities for investment.

As fund managers, our focus is always on quality businesses with sustainable cash flows. But we are also looking for firms that are committing to building or transitioning to more sustainable and eco-friendly business practices and production methods.

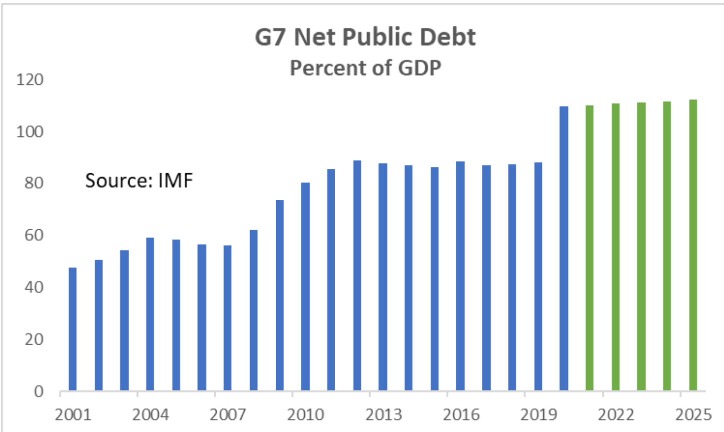
More specifically we see significant opportunities emerging in decarbonization, clean and renewable energy, digitization, the transformation of transportation and logistics.

### But fiscal sustainability is important too

COVID has ushered in a new age of fiscal expansionism, but as fiscal policy shifts from economic support through to meeting long term structural objectives, we remain wary of persistent budget deficits, rising debt levels and governments needing to have the discipline to reprioritise low value spending, or to find new sources of revenue.

While it is important that fiscal policy lines up with longer-term policy objectives, it must not lose sight of fiscal sustainability itself. Budget balances and public debt levels have deteriorated sharply since the onset of the pandemic. Longer-term objectives must include managing a return to prudent debt levels and rebuilding fiscal buffers, to prepare for the next crisis.

Our concern is this will prove difficult. The voting public are becoming increasingly impatient for progress on key issues such as climate change and reducing inequality, but politicians lack the discipline to reduce expenditure in other areas. That means the maintenance of fiscal prudence can only be achieved by raising revenue, whether by open taxation, by stealth taxation and new charges, or both.



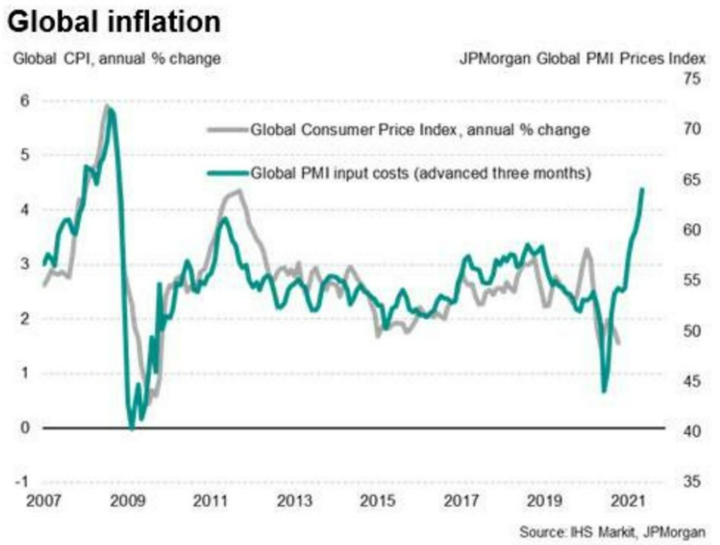

Indeed, both of President Biden's stimulus packages rely on tax increases to fund them. Are we witnessing the beginning of the reversal of the fundamental neo-liberal belief that lower taxes are better, regardless of the apparent public preference set?

The lasting legacy of the new President's jobs plan will be a higher corporate tax rate. That is a negative for business investment and productivity growth. Poor productivity growth has been a feature of the developed world since the Global Financial Crisis. It seems destined to remain a problem.

Whatever else it's social merits may be, higher taxation has never been associated with meaningful productivity growth, unless it is spent on massive educational up-skilling, sustained over many decades (as can be argued, was the case in the post-War Scandinavian Model.)

**Inflation: Transitory or fundamental? That is the question…**

Forward indicators of inflation are pointing sharply higher. These include market-based inflation expectations and pricing intentions from business surveys.

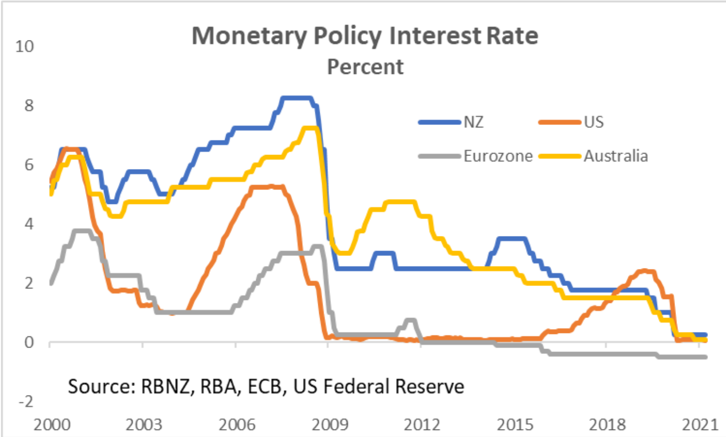



Actual inflation readings are starting to rise and will continue to do so over the next few months. This will be a result of base effects (low numbers from a year ago dropping out of the annual calculation) and higher inflation now.

The debate is the extent to which this higher inflation is the transitory effects of COVID-related supply chain bottlenecks or is borne of something more fundamental and therefore, permanent. It is too early to make that call.

In the meantime, and in the absence of firm evidence to the contrary, central banks will continue to point to the likely transitory nature of the current rise in reported inflation.

All recent central bank statements, including those from the European Central Bank, the US Federal Reserve and the Reserve Bank of New Zealand, have all reinforced their intention not to adjust monetary conditions until they are certain of the sustained achievement of their respective mandates. In the case of the RBNZ they believe this will take "considerable time".




That said we do believe this time could be different. As we noted in our last report, there are reasons to believe inflation could prove to be more sustained this time around. These include:

- inflation expectations are rising sharply;
- monetary AND fiscal policy are both highly stimulatory;
- globalisation is in retreat;
- some current supply chain constraints/disruptions will likely prove permanent;
- skills shortages are likely to push wage inflation higher despite higher unemployment levels; and
- commodity prices are rising.

But it will be some time before we, and central banks, can make that judgment. Latest inflation data across most jurisdictions has done nothing to dissuade central banks from their current course of sitting on their hands. It is not until later this year that we will be able to make any robust judgment on the either transitory or fundamental nature of inflation out-turns.

It could also be that central bankers have no incentive to risk compromising the global recovery track, and the consequences of unleashing somewhat higher medium-term inflation than has been possible in recent times would not be of particularly great concern to the current crop of monetary officials around the world.

**Could central banks be making a policy mistake?**

In our view the economic recovery, particularly in the US, is sufficiently robust to warrant the Federal Reserve signaling their intention to start tapering their asset purchase program now. Instead, the Fed seems intent to wait for higher inflation to be evidenced before changing their policy stance.

We believe in the event, they won't be able to wait quite that long, unless they are happy with the market leading the charge on tightening conditions, a strategy that could prove disorderly.

Its notable that Robert Kaplan, President of the Dallas Fed (admittedly a known "hawk" and currently a non-voting member on the FOMC) is publicly pointing to financial market imbalances and excesses that warrants at least talking about adjusting the Fed's asset purchase program.

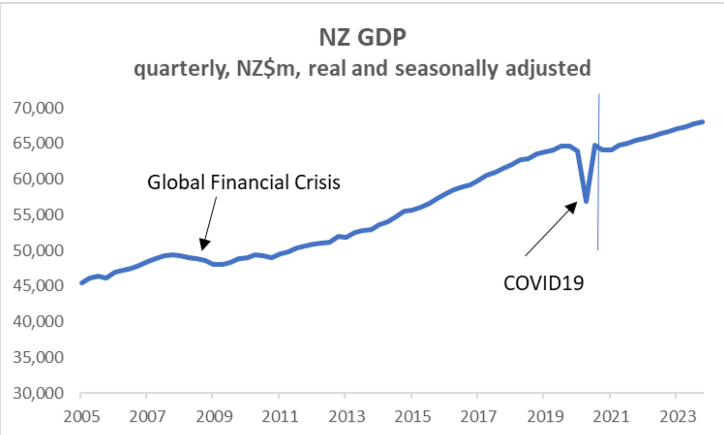
Furthermore, the Bank of Canada has already started the tapering process. At their most recent meeting the Bank of Canada took the decision to reduce its regular monthly bond purchase program by a quarter, a move that other central banks won't be as far away from as they are currently indicating.

Failure to act to pre-empt fundamental inflation pressure risks an inflation overshoot and the more challenging and disruptive process of trying to get inflation back in the can. However, the willpower of central banks remains to be tested, particularly if QE tapering triggers any unpopular or sentiment-toxic asset market volatility, as has happened on previous occasions.

## New Zealand growth hits a soft patch

Growth in the New Zealand economy has hit a soft patch. Following a much stronger than expected bounce back in the September quarter of last year, GDP growth went into reverse in the last quarter of the year. This reflects the absence of the normal spring and summer boost to the economy that usually comes from international tourists, but also intensifying capacity constraints in sectors that have come through the pandemic relatively unscathed, most notably construction.

Growth is therefore likely to remain soft until we get to the second half of the year when an improving global economy, the beginning of the opening of borders, strong commodity prices, ongoing strength in the construction sector and highly stimulatory monetary and fiscal policy will all contribute to a stronger performance.




Capacity constraints will remain a key feature in the period ahead. While activity has recovered more quickly than expected, so too has the labour market.

March quarter employment data was much stronger than expected and shows a labour market this is in pretty good shape given everything we have been through over the last 12 months. The unemployment rate fell to 4.7% in March, from 4.9% in December, better than market and RBNZ expectations of a result around 5%.

Employment was up 0.6% over the quarter and 0.3% over the year, and that's with a further increase in the participation rate from 70.2% to 70.4% over the quarter. The all-time high for the participation rate is 70.7% just prior to the outbreak of the pandemic. It fell to 69.9% during the worst days of the pandemic, but has been recovering steadily as the economy has opened up.

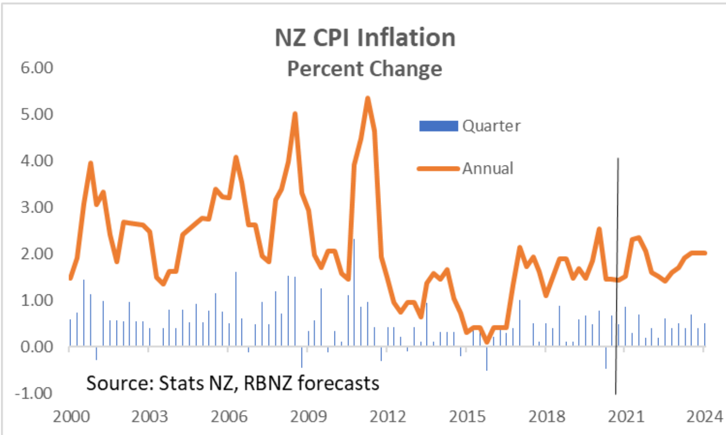
It is looking increasingly likely that the unemployment rate of 5.2% in September last year will prove to be the Covid peak. That is a far better outcome than anyone expected a year ago. Back then the consensus was the unemployment rate would likely rise above 10% and probably take years to recover.

But here we are with a labour market that by many measures is now tight. Firms are increasingly citing skills shortages as the major constraint on their business and it will be some time before borders are open to skilled migrants. That suggests the labour market is only going to get tighter from here.

In its last set of projections the RBNZ had the unemployment rate remaining at around 5% for the next couple of years. We are already below that level and we expect the unemployment rate will continue to edge lower from here.

Of course from an inflation perspective the RBNZ is most concerned about wage growth and there was no course for alarm in the March data, the Labour Cost Index was up 0.4% for the quarter and 1.6% for the year, below the level that would be consistent with 2% inflation.

Indeed inflation came in at 1.5% in the year to March 2021, below the mid-point of the RBNZ's target range. But a mixture of base effects and higher inflation prints will see the annual rate rise to around 2.5% by June and then to closer to 3.0% by the end of the year.




The debate remains about the transitory or fundamental nature of that near term inflation outlook. Much of it will prove transitory. But if we are right that the labour market continues to tighten from here, we would expect higher wage pressures to emerge in the data in the next quarter or two.

That reinforces our expectation the RBNZ won't be able to wait as long as they are currently indicating to start withdrawing monetary stimulus. We think the Bank will be looking to signal the wind up its asset purchase program later this year and that we will be looking at OCR increases from the second half of next year.

### Housing policy changes

In March, the Government announced some changes to housing policy, most notably to the tax treatment of property investors. Changes to the so-called "brightline" test and the removal of tax deductibility of interest costs will be a game-changer for many investors.

There are a number of moving parts to this and its difficult to come up with a definitive view of the overall impact. What seems likely though is that the changes will have current investors assessing their portfolios, and potential new investors into the market reassessing their intentions.

This will see investors less prevalent on the buy side of the market and others looking to sell, so potentially an increase in supply of existing houses on the market and less competition from investors on the buy side.

This package has been designed to take some heat out of the market that has seen an acceleration of already unsustainable house price increases in recent months. We were already expecting softer price increases later this year as changes to LVRs impacted, but also as we saw some at least temporary relaxation of supply demand pressures given softer migration and strong increase in residential dwelling consents.

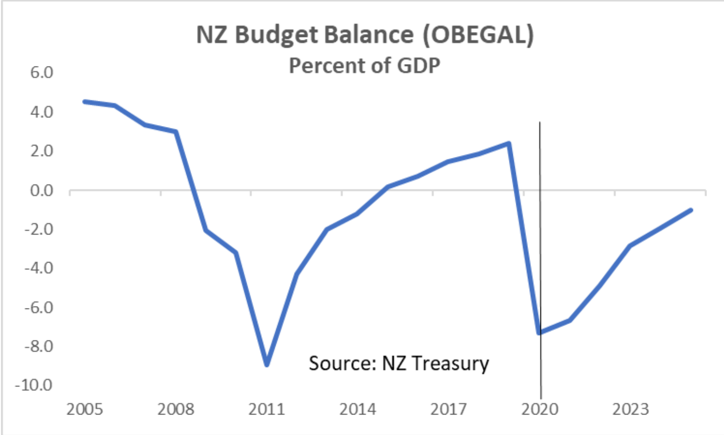
This package will add further impetus to that reduction in house price inflation – whether it leads to house price falls remains to be seen. In that regard it is important to keep things in perspective. Any declines in prices needs to be put into the context of the very rapid increase in house prices we have seen in house prices recently. Even if prices were to fall 10%, that takes them back merely to where they were late last year.

From a monetary policy perspective, weaker house price inflation or even house price falls will have an impact on the RBNZ's growth forecasts through the wealth effect on consumer spending, though we think, not dramatically so. The reopening of borders will be a bigger boost to retail spending than weaker house price inflation will be a negative.

While this package is a game changer in some respects, it falls short of dealing with the key structural factors that have led to such a demand supply imbalance in the market over time. On the supply side that's land availability and on the demand side its population growth or more specifically immigration policy.

### Budget – May 20th

The economy has performed far better than expected. That means government spending has been lower and revenue higher resulting in a less bad outcome for budget deficits and Crown debt. That said, the governments accounts are still in a markedly worse position than prevailed pre-pandemic with public debt still expected to rise sharply in the period ahead.




As we are seeing around the rest of the world, particularly in the United States, the fiscal priority has shifted from managing economies through the crisis to reinvigorating growth and job creation. A bout of old-fashioned Keynesian fiscal "pump-priming," after three decades in which this was generally taboo.

More specifically the New Zealand government has a raft of policy priorities and now, as a majority government, no excuses not to make significant progress on these issues, which are impacting an ever-larger proportion of the electorate.

Looking ahead to the 2023 election, it seems likely to be a referendum on the Government's commitment to and delivery of solutions to affordable housing, climate change, reducing inequality, reducing child poverty.

The electorate is impatient for results. The Government needs to demonstrate that it has a plan and that it can deliver. The Government is clearly anxious about its ability to deliver on its priorities. A new "task force" led by Finance Minister Grant Robertson, has just been assembled to keep ministers and officials on track to achieve real results, not to simply take the national temperature through consultation.

### Implications for investors

For now the equity market "bull" narrative remains intact: Economies are opening up as the pandemic is contained and the global population attains herd immunity as vaccinations roll out. Significant pent-up demand from government support programs, alongside the wealth effect of ongoing increases in asset prices, is being unleashed on a supply constrained global economy, though the resulting inflation will prove only transitory. Fiscal policy will provide an extra boost to growth as fiscal policy eases further and special government capacity-building programs get properly underway.

As this remains the dominant story, it is likely that cyclical stocks will continue to outperform the broader market.

But there are reasons to be wary. Inflation remains the biggest threat, the re-emergence of which will signal the end of central banks continuing to underwrite risk-taking by keeping interest rates artificially low, and by constantly providing new liquidity to the market.

Arguably, some investors have become too complacent that any adverse global development will be rapidly offset by the central bank "monetary paramedics" pushing exceptionally-cheap lines of credit out to restore confidence.

Global bond yields bottomed in late 2020, selling off through 2021 as economic prospects brightened on the vaccine rollout, re-opening hopes and rising inflation expectations. Equities wobbled briefly, but there has been no lasting damage as yields have remained low by historical standards and staunch central banks are showing no sign of signaling a deliberate removal of excess liquidity any time soon.

The key risk for equities would be continued rises in inflation expectations and in bond yields. We thus remain attuned to the outlook for inflation, and any change of tune from central bankers. Our main scenario is that the key policy setting figures at the US Fed, the ECB, and elsewhere have ample time to signal a slowing of the extraordinary stimulus level of the last year. However, it is possible that with the degree of vigor recently seen in the US economy, Jerome Powell at the Fed might be expected to begin some advance verbal signaling in the second half of the year.

History suggests that September-October are dangerous months for sharp shifts in market sentiment, a fact that we would hope policy authorities bear in mind. It would be better to begin a long lead-in of central banker hints that such massive stimulus may not be extended far beyond 2022, so that investors can progressively digest the implications of a medium-term change for their portfolio holdings, and can reallocate their exposures over a two-year horizon.

Otherwise, extended equity valuations and pockets of outright speculation in some stocks and sectors could reverse disruptively late in the year. If such a climate develops, agility in active portfolio management will be critical in preserving and protecting the wealth gains of recent years.