ARTICLE FOR THE EDGE

IS ECONOMIC OPTIMISM REALLY ALL THAT BAD FOR MARKETS?

High hopes for a stronger than expected upturn in the global economy have rattled financial markets. Once it was clear that the US Congress was set to approve President Biden's massive USD1.9 trillion stimulus package without reducing its scale, expectations of economic growth in the US – and the world economy – soared. But, as these same expectations also drove bond yields and commodity prices higher, investors became skittish about inflation and whether central banks would be prompted to tighten monetary policy. Prices of bonds and equities have become much more volatile as a result.

So, are markets over-reacting, pricing in higher inflation and other risks when they should not? In essence, our view is as follows: There is a good chance that the world economy will enjoy a strong revival later this year. Despite this, the major central banks will still keep monetary policy ultra-easy because they are fixated on reviving growth. Combine vibrant growth with very loose monetary conditions and surely, there must be more imbalances. However, we also believe that inflation is not the risk that we need to worry about most for now – other risks such as external imbalances, protectionism and financial market turbulence are more pertinent. For the next year or so, there are sufficient countervailing forces to contain most of these risks but things could get dicey beyond that.

Global growth prospects will be boosted by pent-up demand which is under-estimated

There is little doubt in our minds that global economic activity will rev up much faster than what the World Bank and the International Monetary Fund have been forecasting.

First, the release of pent-up consumer demand is likely to be very strong. In the US, for example, the personal savings rate has shot up to an astounding 20.5% in January, up from 13.4% in December and compared to a pre-crisis average of around 5%. People have been saving a lot more because there was so much uncertainty and, anyway, the lockdowns did not give them much opportunity to spend much. Our bet is that the vaccine roll-outs and the fact that governments are learning to better manage spikes in virus infections will reduce the restraints on citizens' spending, unleashing a huge wave of demand by the third quarter of this year in all the major developed economies.

Second, we detect a strong yearning among ordinary folks to resume normal activity and that governments, sensing this, are likely to work hard to restore normal activities – even in areas such as travel and tourism which many feel will recover only very slowly. In other words, as vaccination programmes gradually cover the bulk of the population, the trade-off in public policy between protecting public health and supporting the economy will shift towards more emphasis on reviving the economy.

Third, there are powerful reasons to believe that investment will bounce back much more vigorously than anticipated:

- Recall that capital spending had lost momentum well before the pandemic because of the uncertainties thrown up by President Trump's unpredictable measures such as disproportionately aggressive trade and technology measures against China. That caused global businesses to hesitate about where to make risky investments and how much to commit. That lacklustre urge to invest turned into a rout as the pandemic hit, outside the technology areas which benefited from the pandemic. So, there are two sets of pent-up capital spending that could soon be released – one arising from the pandemic and the other resulting from having a US administration that is steadier and pursuing more rational policies. The Biden Administration may well be tough on trade issues but it will act within the rules-based world trading order and so provide the business sector with a better ability to judge risks and returns to investment.

- In addition, the pandemic has accelerated technological transformation, not just in the info-communications areas but also in other areas such as pharmaceuticals and bio-medical engineering. There are also other areas where the pace of innovations has been dramatic – such as renewable energy and new materials. Our assessment is that companies have no choice but to substantially raise their capital spending if they are to maintain their competitive positioning in the face of all these new technologies.

Recent economic data support our bullish view

Indeed, the economic data we have seen in just the last few days has been overwhelmingly positive:

Purchasing manager surveys give us a good finger-on-the-pulse feel for where the global economy is currently. Several encouraging patterns leap out from the PMI surveys that were just released this week. First, global manufacturing activity is gathering momentum at the fastest pace in many years, with several countries seeing PMIs at multi-year highs. Even Japan, which has had a rough few years, is seeing manufacturing at its most vigorous pace since December 2018. In Europe, long-suffering Italy's manufacturing activity is at its strongest level in three years. Second, the forward-looking indicators within the PMI surveys are pointing to continued improvement – new orders are rising and business confidence is overwhelmingly positive.

Beyond the PMI surveys, other lead indicators are also alerting us to a substantial pickup in activity later this year. The OECD composite lead indicators, for example, have been rising in recent months despite the renewed lockdowns in the US, Europe and parts of the Asia-Pacific. What is encouraging about the OECD indicators is that the improvement is across the board while the lead indicators for some countries such as China and South Korea have gone well above their historic levels. Similarly, the lead indicator we have developed for how world trade drives demand for Asian exports has also improved.

Finally, the data also provides support for our hypothesis that capital spending is poised to surprise positively. Core capital goods orders have been rising steadily in the US, for instance.

Core machinery orders in Japan have also been encouraging. In Germany, the German Machine Tool Builders' Association is upbeat about 2021 because it sees a strong urge on the part of customers to make up ground after several years of restrained investment. The German IFO Business Climate survey for the capital goods industry supports this view as well.

Strong economic growth could crystallise risks but these go beyond inflation

If the global economy is really going to turn around so swiftly, could that lead to central banks "taking away the punchbowl" by stepping away from their ultra-easy policies? Could we see inflation come roaring back?

These are questions are much more complicated than they appear and no one really has all the right answers to them. But, this is how we would look at these issues:

First, too much of the discussion these days centres around a resurgence of inflation – that is too limited a perspective. The quite valid concern of many observers is that the combination of extremely supportive monetary policy and large fiscal spending will cause excess demand. However, in an open economy with dynamic financial markets, excess demand could cause not just consumer price inflation but also a surge in imports and therefore current account imbalances. It could also lead to asset price inflation rather than consumer price inflation.

Second, it is therefore probably not right to focus so much attention on inflation causing central bankers to tighten policies. Note that even the vigorous recovery we are expecting will not remove all the slack in the economy. Unemployment will still remain above pre-crisis levels because it will take a while before businesses feel confident enough to hire permanent staff again. Without tight labour markets, wage inflation will be weak and without wages stirring, it is unlikely that one will see an alarming acceleration in inflation.

This is why leading central bankers in the US and Europe have continued to press the case for maintaining very loose monetary policies. Just this week, Lael Brainard, a governor of the US Federal Reserve Bank showed barely any concern about inflation or the need to tighten policies despite sounding upbeat about American economic prospects. Clearly, it would take a lot more convincing evidence of recovery and data showing that inflation has actually risen well above their tolerable levels before monetary policy is tightened. We do not see this happening for at least another year.

Third, a spike in inflation is less likely because excess demand could be channelled into a surge in imports instead of raising prices of domestic goods and services. The risk is therefore not rising inflation but a big uptick in imports causing the American external deficit to rise. Rather than inflation, what really worries us is that, if that happens, the US could turn protectionist, accusing its trading partners of pursuing unfair practices such as "manipulating currencies" as the US has done many times before.

Fourth, what if a sharp recovery in the global economy boosts commodity prices? That is indeed likely as the recent rise in oil prices and spikes in the prices of some metals show. A rise in the prices of some goods is not the general rise in prices which is what inflation is all about. Still, it can cause problems. In particular, if oil prices continue their upward march, there are some countries such as India whose external accounts are highly vulnerable to higher oil prices and whose currencies could be hit if oil prices spike.

Finally, the other risk to consider could be what happens to financial asset prices. Even with central bankers continuing to provide high levels of liquidity, financial markets will face many a headwind.

- As a resurgent real economy revives the animal spirits of companies, the demand for credit from businesses will recover as companies borrow more to fund expansion. That means more of the cash banks have to allocate will tend to go to real businesses rather than into financial assets. If you believe that a good part of what sustains today's valuations of equities such as technology companies is plentiful liquidity, you should be very worried.

- Even if central banks keep interest rates close to zero, market-based interest rates could still rise as economies revive and as inflation looks likely to return to normal over time. History and financial theory tell us that higher rates tend to deflate asset prices. We have seen some of that lately, with the 10-year US bond yield rising from below 1% at the end of last year to around 1.4% now. However, if we are right about the rise in inflation being contained and if central banks implement measures to keep monetary conditions loose, then long term interest rates will rise gradually. There could be episodes of financial market stresses like what we have seen in recent weeks but not a full-blown painful correction.

The bottom line: strong economic revival, more financial market turbulence

In the coming months, we should see the global economy regain vigour as consumers and businesses release their pent-up demand. This revival will come with some risks but we do not think an alarming rate of inflation is the most pertinent risk for now. But there will be other concerns – protectionism as imports spike in some countries, higher oil prices hurting a few vulnerable economies and certainly greater volatility in financial markets and occasional sharp corrections in financial asset prices.

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