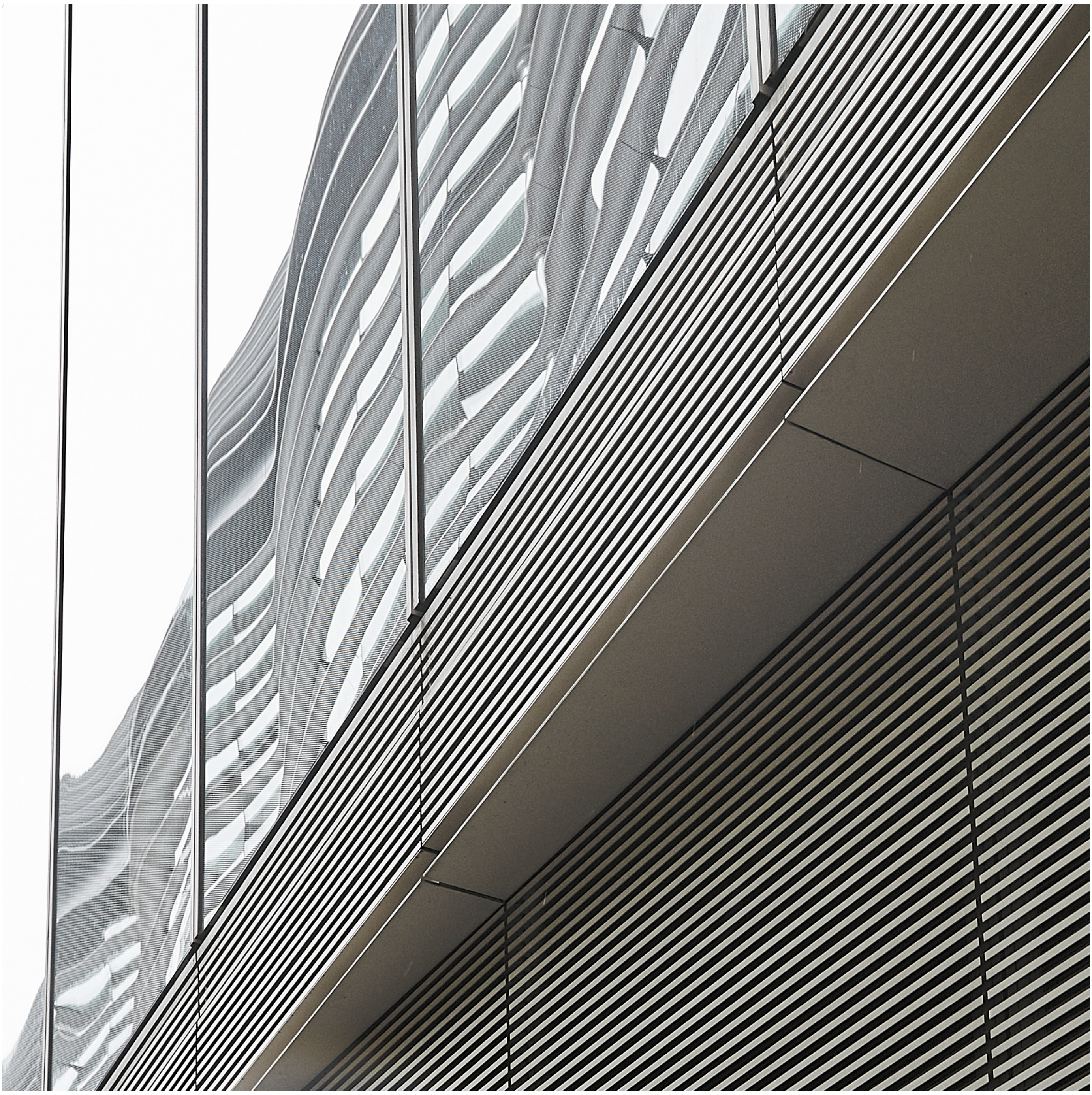
Monthly Macro Insights

March 2021



Rothschild & Co
Asset Management

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The reflation trade narrative is gathering strength. While short-term interest rates are pinned at historically low levels amid very accommodative central banks' forward guidance, long-term government bond yields have risen in most countries. However, an abrupt increase in real interest rates on the back of improving global growth prospects could trigger volatility episodes and jeopardise financial stability.

The House of Representatives has approved a US$1.9tn coronavirus relief package, which includes direct payments of US$1,400 for millions of Americans, as well as an extension of federal top-ups to unemployment insurance. Subject to Senate approval, the stimulus bill comes at a time when financial markets have started to price in a stronger economic rebound and higher inflation in 2021.

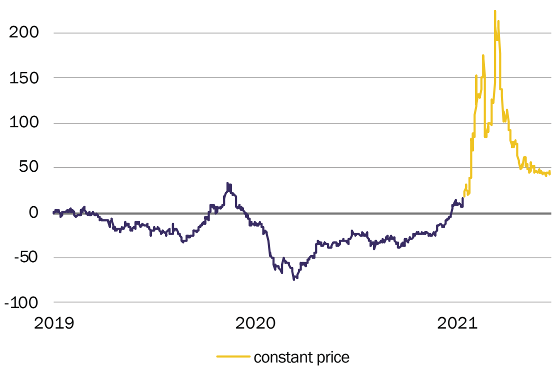
Indeed, many investors have bet the strength of the rebound could surprise on the upside, as economic activity benefits from a burst of post-crisis optimism, unleashing pent-up demand and previously postponed investment projects, thanks to historically high household savings, low financing costs, and supportive fiscal policies.

What's more, a large-scale increase in stimulus measures could quickly close the output gaps – especially in the US. A positive output gap is consistent with actual GDP being greater than potential GDP, and, accordingly, prices tend to rise in response to demand pressure. The jump in commodity prices and higher transportation costs could also spur inflation.

Furthermore, global manufacturers continue to experience supply constraints linked to the pandemic. For instance, automakers are facing a shortage of semiconductor chips, a situation that's expected to worsen as companies battle for supplies of critical parts. In the latest ISM survey, several US manufacturers complained they were also facing a shortage of truckers

Oil - Brent price

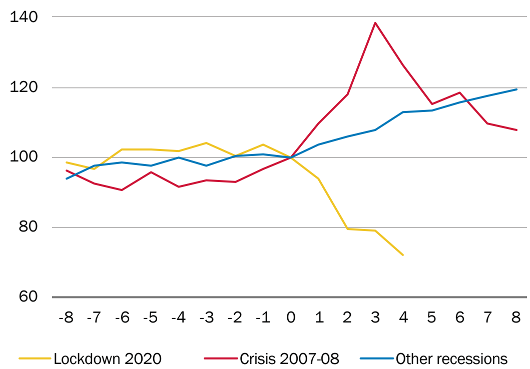
in %, y/y



Source: Macrobond, Rothschild & Co Asset Management Europe, March 2021.

World - Bankruptcies

last prerecession quarter = 100



Source: IMF, Rothschild & Co Asset Management Europe, March 2021.

and dockworkers, as ports across the US and the EU have problems with freight ship traffic jams.

In the near term, the supply and demand imbalance is likely to continue putting upward pressure on certain input prices, which is reflected by the ISM prices paid sub-index rising to 86 in February, the highest level since the Great Financial Crisis.

However, several factors challenge the raising concerns about an overheating economy that could push inflation well above the comfort zone of central bankers. While inflation rates will rise in the next few months, this is primarily explained by base effects in the energy sector and temporary elements, such as the elimination of last year's tax reductions.

In addition, considerable slack in the global economy remains, according to the latest IMF estimates, over 150 countries are projected to have lower per capita incomes in 2021 compared to 2019. Bankruptcies have fallen during the pandemic crisis unlike during past recessions, in part reflecting moratoria on bankruptcy filings implemented in some countries. Yet, this artificial decline masks an upcoming deterioration in the labour market as these moratoria are lifted, following country-by-country normalisation strategies. The already elevated capacity underutilisation in the labour market is therefore expected to worsen and a return to pre-crisis employment levels could be many years away.

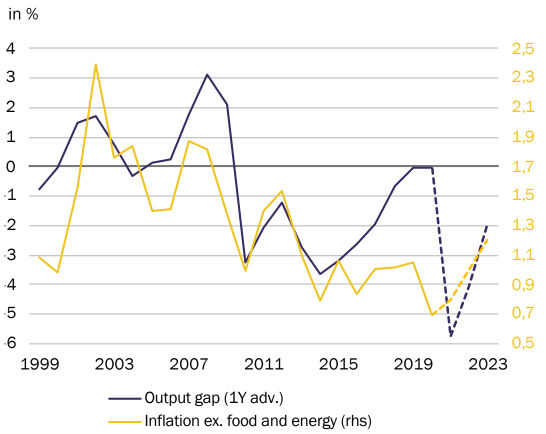
Automation is another factor which, in the past decade, along with relative declines in capital goods prices, has largely kept higher wages from being passed through to prices. The pandemic is likely to accelerate automation and reduce the bargaining power of workers, thus weighing on wage growth.

On the whole, the debate on inflation has intensified over the past weeks and interest rates have risen accordingly. Over the coming quarters, the US recovery is expected to outpace the rest of the world, including China, and the fallout from rising US rates on global financial markets is likely to raise tensions.

While the second wave of Covid-19 has impacted growth less compared to the first, the Eurozone is nonetheless in the midst of a second consecutive quarter of contraction. With underlying inflation expected to remain well below the target for a prolonged period, it comes as no surprise that recent ECB commentaries have emphasised that the increase in bond yields is being monitored closely, especially since the health situation remains challenging.

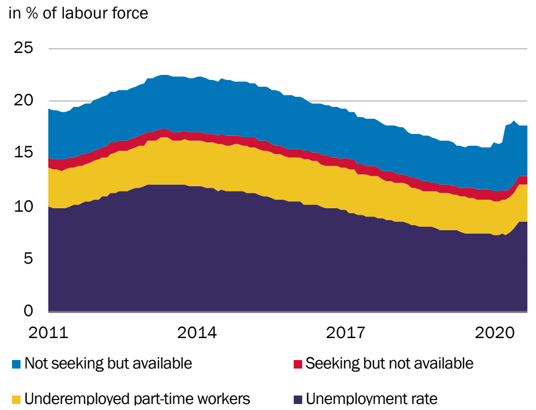
Although case counts continue to slide in much of the region, France and Italy reported renewed rises in cases, sparking concern of a variant-driven third wave that could result in renewed lockdowns. While the evidence has yet to point clearly to a new variant that is able to evade existing vaccines, it remains a material risk.

Eurozone - Output gap and inflation



Source: Macrobond, Rothschild & Co Asset Management Europe, March 2021.

Eurozone - Labour market



Source: Macrobond, Rothschild & Co Asset Management Euope, March 2021.

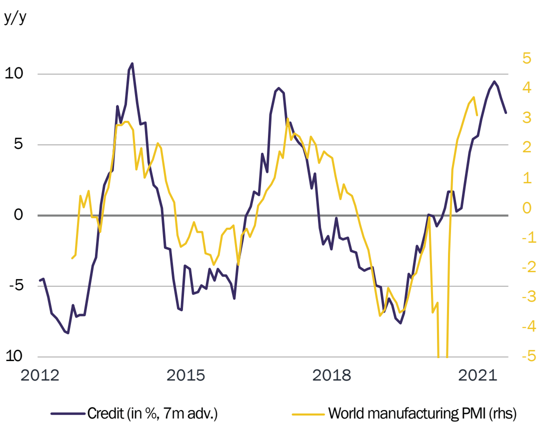
The recent rise in US rates also adds to an already hawkish leaning across some emerging countries (EM), particularly for high-yield economies like Russia, Turkey, and South Africa. Russia's central bank has hinted it could hike interest rates this year, while Turkey has increased reserve requirements by 200bp in a move designed to temper banks' appetite for lending, but it was also a response to the recent tightening in global market conditions that complicated financing of wide current account deficits. The increase in EM interest rates has also been exacerbated by concerns over a repeat of the financial instability that characterised the 2013 'taper tantrum'[(1)], although this time EM economies are not as vulnerable, in part because of less pronounced external imbalances.

In China, policymakers are navigating a difficult course. Household consumption remains fragile whereas a boom in global goods demand is fuelling a surge across export industries, and the real estate and infrastructure sectors are both overheating. In fact, Guo Shuqing, Chairman of the Banking and Insurance Regulatory Commission, has warned of the risk of bubbles in international financial markets and within China's own real estate sector. The comments are especially relevant as they come ahead of the National People's Congress on March 5 and indicate that Chinese policymakers view asset bubbles as the primary risk to the Chinese economy, therefore implying that some policy tightening might continue. Indeed, the authorities have decided to slowdown credit growth, which in part explains the fall in Chinese business confidence over the past months. The global industrial sector could also be impacted by Beijing's decision to take its foot off the accelerator.

Overall, after the expected Q1 2021 soft patch, investors anticipate the outlook to turn decisively brighter. The combination of a more-rapid-than-expected reduction of slack, increasing optimism on virus containment, and greater confidence in commitments for sustained policy support have sparked a debate regarding the drift of inflation. Yet, the stance of central banker around the world reflects concerns that economic activity has not fully recovered, that economic scars could linger, and that the factors behind higher inflation expectations were temporary. According to the latest Fed minutes, the financial vulnerabilities of the US financial system is "notable", and volatility might spoil investors' optimistic scenario as markets try to push bond yields higher. ■

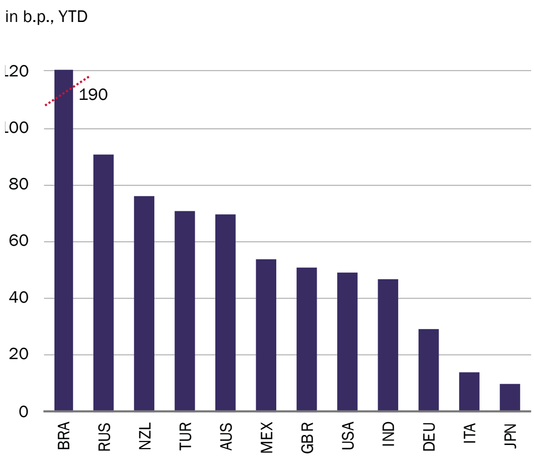
Completed writing on March 3, 2021

China - Credit impulse and Markit



Source: Bloomberg, Rothschild & Co Asset Management, March 2021.

World - 10Y Sovereign bond



Source: Macrobond, Rotschild & Co Asset Management Europe, March 2021.

(1) The expression "taper tantrum" was used in 2013, when the Fed announced that it would taper its QE, causing US Treasury yields to soar.

Performance of the indices and interest rate levels

	Price as of 26/02/2021	1 month % change	2021 % change
Equity markets			
CAC 40	5 703	5.6%	2.7%
Euro Stoxx 50	3 636	4.5%	2.4%
S&P 500	3 811	2.6%	1.5%
Nikkei 225	28 966	4.7%	5.5%
Currencies			
EUR/USD	1.21	-0.5%	-1.2%
EUR/JPY	128.67	1.2%	2.0%

		Price as of 26/02/2021	1 month bp(1)	20201 bp
Interest rates				
3 M	Eurozone	-0.60%	3	17
3 M	United States	0.03%	-2	-3
10 Y	Eurozone	-0.26%	26	31
10 Y	United States	1.40%	34	49

(1) Basis point.
Source: Bloomberg, data as of 26/02/2021. Performances in local currency.
Past performance is not a reliable indicator of future performance and is not constant over time.

About Rothschild & Co Asset Management Europe
As the specialised asset management division of the Rothschild & Co group, we offer personalised asset management services to a broad client base of institutional investors, financial intermediaries and distributors. Our development is focused on a range of open-ended funds, marketed under four strong brands: Conviction, Valor, Thematic and 4Change, and leveraging our long-term expertise in active management with conviction as well as in delegated management. Based in Paris and established in 10 European countries, we manage more than 21 billion euros and employ nearly 170 people. More information at: www.am.eu.rothschildandco.com

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