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Macroeconomic Comment

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Global Economic Recovery

February 16, 2021, Peter von Elten

The significant economic recovery expected for this year will be delayed by several weeks because the second and in some cases third wave of the pandemic will lead to longer-lasting restrictions while virus mutations are urging a cautious reopening. Nevertheless, the International Monetary Fund (IMF) has revised its growth forecast for the global economy slightly upwards to 5.5% for this year, more than making up for the 3.5% downturn in the previous year.

Globally, daily reported covid case numbers have more than halved since their peak. At the same time, vaccination activity is expected to increase sharply as the supply of vaccines from various manufacturers gains significant momentum. Combined with extremely expansionary monetary and fiscal policies and large pent-up consumer demand, the recovery is set. Historically, recessionary phases are followed by several quarters of economic recovery, so the upswing should continue into 2022. Only when the government rescue programs have expired and market forces dominate again will it become clear how much the base unemployment rate has increased and which companies were forced to close down. Growth rates had already been declining for years before the pandemic began, despite historically low interest rates, an exuberant supply of liquidity, and rising government debt. Two years sacrificed to the pandemic, with the destruction of jobs and national wealth, will weigh on future trend growth, as will soaring government debt and further aging. So while economies as a whole have been set back, companies may emerge stronger, to the extent that they have used the recession to drive the structural change that often accompanies economic downturns.

The rise of China-led Asia remains the most important trend, and one that has been accelerated by the pandemic. While China as a whole will grow by more than 10% and the USA by around 1.5% in these two years marked by the pandemic, the euro zone will probably still be more than 3% behind its pre-pandemic levels.

Europe

In its fight against the pandemic, Europe has thrown off the shackles of austerity policy and suspended the "Maastricht criteria" for an initial period of three years. Once the pandemic has subsided, the EU will have to adopt new, more relaxed criteria in order to ensure that the euro area continues to hold together. The €750 billion reconstruction program recently ratified by the European Parliament is another step toward a transfer-and-debt union. The 27 member states are already liable in proportion to their capital shares in the ECB for the policies of the central bank, which has expanded its balance sheet from about €1.2 trillion before the 2008 financial and economic crisis to about €7 trillion by the end of 2020 through massive bond purchases and other support programs. So while the ECB has expanded its balance sheet by about 580%, the EU economy has only grown by about 25% over the same period. This money glut has contributed significantly to negative interest rates and to the inflation of tangible assets. Political circles in Italy have already proposed erasing the debt accumulated during the pandemic by cancelling the ECB's claims on debtor countries. Now, 110 signatories to a call by economists have recommended writing off €2.5 trillion of debt or converting it into perpetual interest-free debt to give indebted countries more financial leeway. These people argue that 25% of European sovereign debt is held by its own central bank and that it would not be a problem if the ECB operated with negative capital. This is vehemently opposed by the ECB and some countries such as Germany. But such proposals also show that there is hardly any realistic chance of consolidating public debt by applying conventional means - higher growth, sharply rising productivity, budget discipline. In Germany, too, there is now a heated debate about whether the debt brake enshrined in the German constitution is still appropriate in today's world.

Precisely because Europe is lagging behind Asia and the USA in its economic recovery, monetary and fiscal policy in the EU area will remain very expansionary. Even a significant temporary increase in inflation will hardly change this. The President of the Bundesbank believes that an inflation rate of over 3% is possible by the end of the year, but this would be largely due to base effects such as a sharp rise in oil prices, the return to a higher VAT and CO_2 taxation.

Italy

The broad political support for Mario Draghi as Italy's new prime minister has great significance for stability within Europe. He is taking responsibility at a time of a severe health and economic crisis in the country. With over 2.7 million confirmed covid cases and 93,000 deaths, Italy has been hit particularly hard. In 2020, gross domestic product contracted by 9%. This year, it is forecast to rise 4%. The debt ratio is moving toward 160% of GDP. However, Italy now has a unique opportunity to implement necessary structural improvements as the largest beneficiary of the European Recovery Plan, obtaining an allocation of over €200 billion. The allocation guidelines for this money stipulate that the majority will be used for digitization, climate protection and infrastructure improvements. Draghi has filled the 23 ministries with 15 party politicians and 8 non-party experts, entrusting all strategic portfolios for the use of the European Recovery Fund to outstanding non-party experts. These include Roberto Cingolani, physics professor with industrial experience and director of an elite institution for research and development, as the future "super-minister for the ecological transition," with interdepartmental powers. Vittorio Colao, formerly of McKinsey and former group CEO of Vodafone, becomes minister for digitalization. The ministries of justice and education, which Draghi considers most structurally relevant, have also been filled with experienced nonpartisan experts. Draghi has already conceded that, in addition to the resources of the recovery fund, a substantial increase in public debt will be part of the solution to the current economic crisis.

USA

Looking ahead to the midterm elections in 2022 and Trump's still large following, the majority of Republican senators voted against an "impeachment" of the former president because they saw a risk that Trump could form his own party. The proceedings, however, leave a divided Republican party, as 7 Republican senators voted against Trump and Mitch McConnell, the previous Senate majority leader, also declared Trump guilty and voted for Trump only on procedural grounds. President Biden must now expect further disruptive maneuvers from Trump. A first big test will be the new president's $1.9 trillion bailout package, which has cleared key hurdles in the House and Senate and now heads to hearings. Observers expect Democrats and Republicans to ultimately agree on a reduced volume of $1 to $1.2 trillion. Even economists close to the Democrats, such as Larry Summers and Olivier Blanchard, fear overheating and see inflation risks because the output gap caused by the pandemic is much smaller than the sum of the support programs already passed and still planned. In addition, the Biden Administration also wants to push through a stimulus program of a similar size, with a focus on improving infrastructure. These fiscal stimulus measures will further increase annual government deficits, which already accounted for 5% of GDP during President Trump's administration. Combined with an extremely expansionary monetary policy and a large pent-up consumer demand, the dangers of overheating and rising inflation cannot be dismissed. The rise in yields on long-term US government bonds already reflects higher inflation expectations. Rising commodity prices and sharply higher freight rates also point in this direction. Furthermore, the Federal Reserve will need to keep an eye on speculative overheating in the equity markets. In the week of February 8 alone, a record $58 billion flowed into equity markets. JPMorgan describes equity and bond market valuations as above average by all measures, and Bank of America sees the equity exposure of its high net worth clients at an all-time high of 63%. The large number of initial listings of SPACS (Special Purpose Acquisition Companies), which came to the market at an average of about 40% above issue price, and the speculative wave recently triggered by millions of new US retail investors also point to the danger of bubble formation. However, the inflationary forces in the short term are countered in the longer term by a number of deflationary factors such as increased unemployment and an aging society. The Chairman of the Federal Reserve Bank has announced that he will continue the expansionary monetary policy even if inflation is expected to overshoot in the short term.

Peter von Elten

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Belvoir Capital AG, Macro Advisor

Mr. von Elten has decades of experience in the banking industry. Since 2008 he has been a member of the advisory board of BSZ AG, which took over IFP AG in 2014 and thus became Belvoir Capital AG. He enjoyed an international career at JP Morgan for close to 30 years. He returned to Switzerland as General Manager of Schroder & Co Bank AG from 1995 to 2003. Furthermore, Mr. von Elten's passion is art; he is a co-founder of the gallery Elten & Elten.

CONTACT

BELVOIR CAPITAL AG
Beethovenstrasse 9
CH-8002 Zürich
+41 (0) 44 206 30 40
info@belvoircapital.com