LAZARD
FRÈRES GESTION

ECONOMIC AND MARKET OUTLOOK

September 2021

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In a context where central banks remain very accommodative and vaccination is helping to limit the severity of the Delta variant, we are convinced that the economic recovery will remain strong and above growth potential in the coming quarters. However, the rebound in activity raises the question of inflationary pressures in the production system. If the current surge in inflation proves to be more sustainable and, above all, linked to an acceleration in wages, central banks will have to normalize their monetary policy further, at the risk of slowing growth. In the absence of clarity on this issue, we will have to keep a close eye on upcoming inflation and labor market data.

The environment is still favorable for risky assets: strong growth, abundant liquidity, patient central banks. Equity markets, especially in Europe, still offer attractive risk premiums in the face of low interest rates. On the bond markets, the context remains favorable for carry, particularly in High Yield and subordinated financial debt, where spreads are again tight but present a low risk of widening. However, this allocation is accompanied by greater vigilance given the valuation levels and the growing probability of a poorly contained inflation scenario.

Economic Outlook

Health Situation

After a complicated winter and an improvement in the spring, the spread of the Delta variant led to a rebound in contagion in several countries, particularly those where the population had been massively vaccinated (Chart 1). Vaccines, however, remain effective in reducing the risk of being infected and preventing serious forms of the disease. In France, in mid-August, hospitalizations for Covid-19 were six times more numerous among non-vaccinated persons than among vaccinated persons, with a comparable population size, and this despite a very unfavorable 'age effect'. The increase in vaccination in Western economies should provide sufficient levels of protection against hospitalizations and deaths to avoid the reintroduction of lockdown measures, provided vaccines remain effective.

What is the trajectory after the growth peak?

Q2 GDP growth has reached one of the highest levels in the past 50 years. This means that the level of pre-Covid activity is already catching up in the United States, and will do so by the end of the year in the other developed economies (Chart 2). Monetary and fiscal policies have been used massively in this crisis, helping to preserve the balance sheets of economic agents and create the conditions for a dynamic recovery.

However, the very high level of surveys is difficult to sustain over the long term. Thus, after a strong surprise on the upside, economic publications are now below expectations.

The fiscal stimulus is also expected to be very negative in 2022, particularly in the United States. However, a good part of these measures is linked to the improvement of automatic stabilizers: the reduction in support therefore has no impact on growth. In the United States, Democrats are moving forward to vote on the budget requested by the White House, which would make a significant part of the increase in public spending sustainable (Chart 3). Similarly, disbursements of the European aid plan have begun and will continue to produce their effects. The German elections could lead to a government that is more focused on public spending.

In China, the economic recovery has been rapid, but the peak in growth has passed and data points to a slowdown in the third quarter, especially in services. The normalization of these factors points to a rebound in the coming months. Economic policy could also become more pro-growth.

Chart 1

COVID-19: Incidence rate for 100,000 inhabitants over seven days

Source: Johns Hopkins, Public Health England, Public Health France, Ministry of Health of Israel

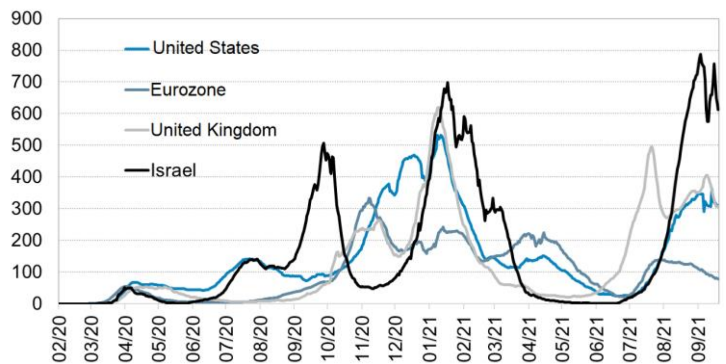


Chart 2

GDP in volume, basis 100 as of Q4 2019, Bloomberg consensus for Q2 and Q3 2021

Source: Bloomberg

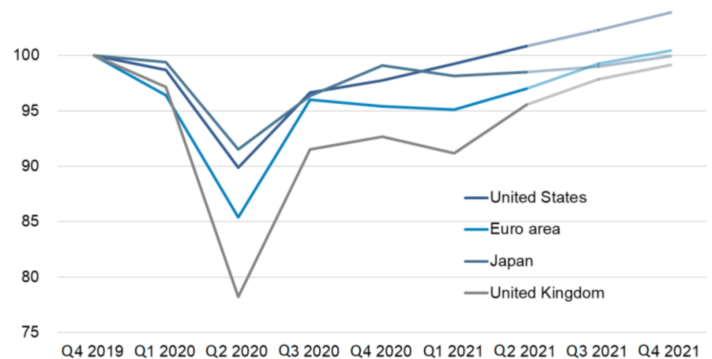
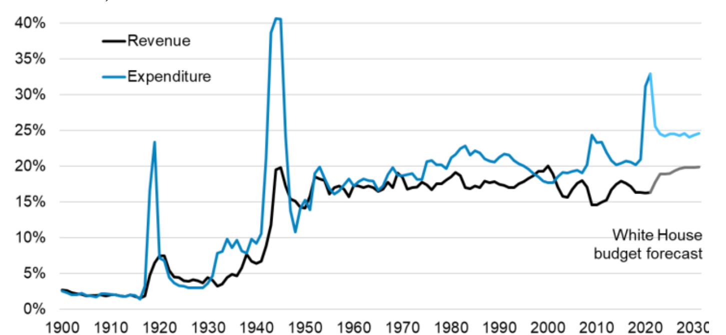


Chart 3

United States: government expenditure and revenue as a percentage of GDP

Source: CBO, White House



INFLATIONARY PRESSURES?

Due to the scale of the support measures and the rapid recovery, the output gap (the difference between the level of actual activity and the potential level) has closed much faster than in recent recessions, suggesting earlier inflationary pressures.

In the United States, although certain categories of goods explain most of the increase in inflation (real estate, used cars, energy), almost all consumer segments have recorded price increases above their historical average (Chart 4). This macroeconomic observation is confirmed at micro level: surveys of companies' intentions also indicate a desire to increase prices.

In the euro zone, the acceleration in inflation is lower and is largely due to the base effects of 2020. However, the figures for the last few months are slightly stronger than in the past.

LABOR MARKET TENSIONS?

In the United States, the recovery led to a rapid decline in the unemployment rate, which returned to 5.2%, from a low point of 3.5% before 2020. However, employment data is showing conflicting signs. While there are only 3 million more unemployed than before the crisis, it is interesting to note that in the absence of a health crisis, following the trend at work from 2010 to 2019, the US economy would ordinarily have about 8 million more jobs than currently (Chart 5). Should we conclude that 5 million job seekers exist, but are not represented in the statistics? In fact, the number of people not included in the working population, but looking for a job, is just 1 million higher than at the end of 2019 (Chart 6).

Not only does the US economy have few job seekers, but job supply is particularly dynamic (Chart 7). The US economy thus has 4 million more jobs to fill than in 2018–2019. Households' assessment of the labor market has also returned to the high point of 2000 and companies are reporting hiring difficulties not seen in 40 years. The JOLTS survey shows historically high levels of resignations and a historically low level of layoffs. These pressures have passed on to wages: over the past 12 months, hourly wages have risen at their highest rate since the early 1980s. The most common explanation for this tension in the labor market is the presence of very generous unemployment benefits, which are now reaching maturity. Some people were also able to delay their return to the labor market for childcare reasons, and the return to school should resolve this issue.

In Europe, the unemployment rate is only 0.2 points above its previous low, excluding the outlier point of March 2020. In most countries, the number of open offers has reached or is approaching all-time highs.

Chart 4
United States: Contributions to price increases between February and July
Source: Bloomberg

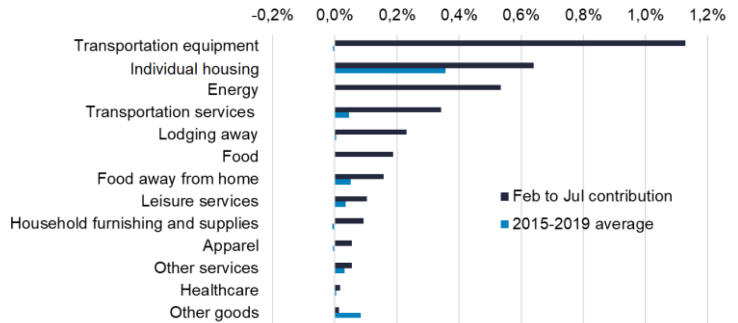


Chart 5
United States: Total employment (millions of people)
Source: Bloomberg

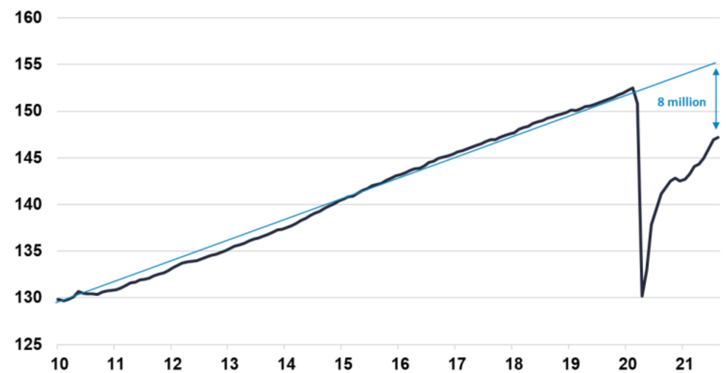


Chart 6
United States: Inactive people seeking employment (millions)
Source: Bloomberg

Chart 7
United States: JOLTS survey on published job offers (millions)
Source: Bloomberg

Market Outlook – Bond Markets

Toward a reduction in the Fed's support, the ECB's continuation

After the sharp rise in yields seen between August 2020 and March 2021, long yields gave back some of their increase until July, before stabilizing (Chart 8). The announcement of tapering by the Fed, which was widely communicated in advance and disconnected from the issue of rising yields, failed to have a significant impact on the bond markets.

Central banks have maintained their monetary support with an increase of nearly $500 billion in their balance sheets over the past two months (Chart 9). The Fed's purchases accounted for nearly half of this amount. Their gradual reduction would imply the maintenance of significant amounts of purchases.

In Europe, the ECB's action will continue to limit the risk of spread slippage. Although some hawkish voices (favorable to a more restrictive monetary policy) are against this, the PEPP program is likely to be fully used. If inflation remains low, a new program is possible.

The timing of the increase in key rates according to the markets remains roughly identical to the expectations of the last quarter (end 2022, early 2023), but the market has lowered the final point of the next cycle of monetary policy normalization, which is weighing on long yields.

However, long-term market inflation expectations remain in the region that has prevailed since 2015. As a result, the recent downward movement in yields has mainly occurred along real rates, with new all-time lows (Chart 10).

Credit: Tight but still attractive spreads in a low interest rate environment

Spreads are stable at low levels, in line with a favorable business environment, liquidity, and the corporate financial situation (Chart 11). Over the next few months, this situation is likely to continue, but we will need to monitor the developments mentioned above. Bank lending conditions continue to ease, which provides support for corporate credit.

Against this backdrop, the lack of major changes in market rates should enable High Yield to offer a performance close to carry, which is still attractive in the bond universe. Subordinated financial debt is also one of the most attractive assets in the bond market because the default risk associated with bank loans is partly absorbed by the public authorities.

Chart 8
United States: Long term Treasuries' bond yields
Source: Bloomberg

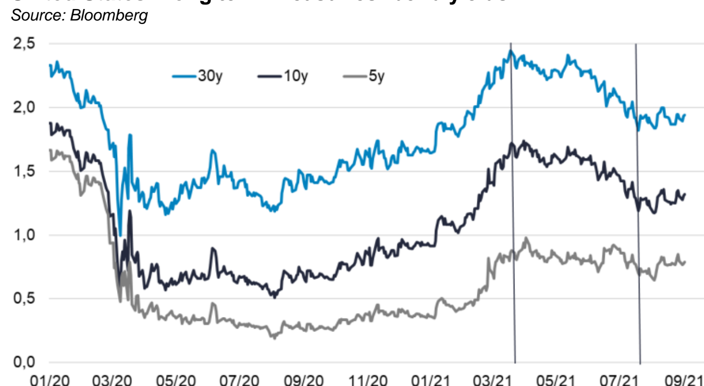


Chart 9
Aggregate balance sheet of the main central banks (Fed, ECB, BoE, BoJ) in billions of euros
Source: Bloomberg

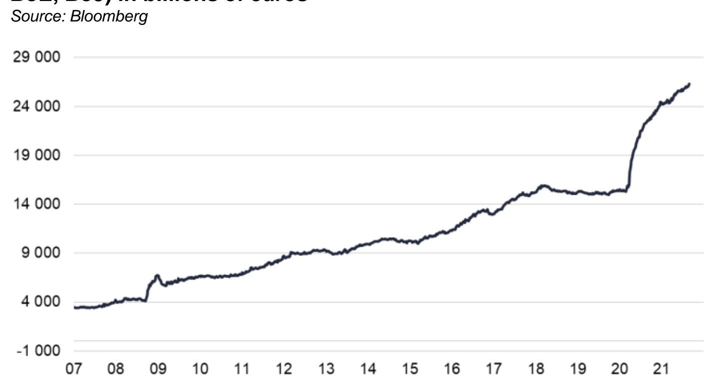


Chart 10
Real rates: 10-year bond yield – 10-year inflation swap
Source: Bloomberg

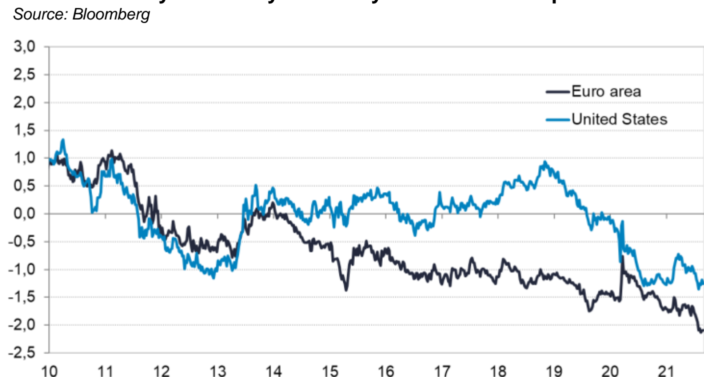
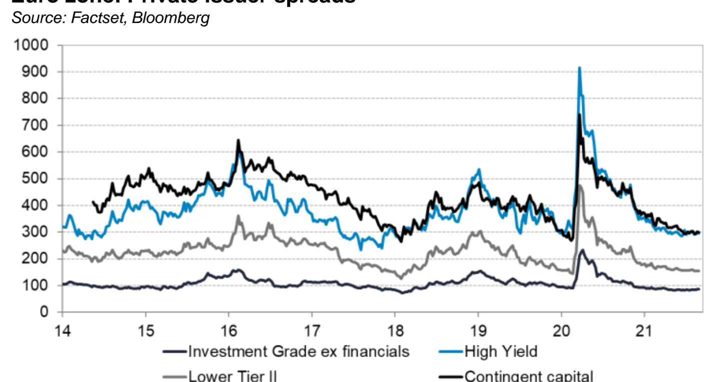


Chart 11
Euro zone: Private issuer spreads
Source: Factset, Bloomberg



Market Outlook – Equity Markets

An increase driven by earnings forecasts

Equity markets have risen sharply since the beginning of the year, driven by strong earnings forecasts. The rise in earnings, which has been even stronger than that of share prices, has led to a contraction in P/E multiples (Chart 12). Among other reassuring factors, it is of note that relative to risk-free bonds, the return on equities remains historically high.

However, some measures indicate higher valuation levels than at the peak in 2000, such as the price to sales (Chart 13). Moreover, earnings forecasts are based on high margin assumptions in the US and the pace of upward revisions will be difficult to maintain over the long term. A rise in rates could weigh on the overall level of the markets, but value stocks could then outperform the market.

Emerging markets penalized by China

Emerging equities have underperformed year-to-date. This is mainly due to the contraction of Chinese equities (Chart 14). In addition to signs of a slowing economy in China, there have been a number of sector-specific announcements linked to a new emphasis on 'shared prosperity'. These measures have been interpreted as the CCP taking control of the economy and causing an economic slowdown. The authorities have referred to several areas of work, but the reforms are expected to be implemented only gradually. Moreover, maintaining a good level of growth remains a priority because it is a condition for access to this shared prosperity.

Glossary:

ECB: European Central Bank.

Fed: The US Federal Reserve, the central bank of the United States.

GDP: Gross domestic product is the economic indicator that quantifies the total value of the annual 'production of wealth' by the economic agents residing within a territory.

PEPP: Pandemic emergency purchase program, a plan to buy debt on the markets in order to lower the financing costs of governments, companies, and households.

P/E: The price/earnings ratio (PER or P/E) is the ratio between the stock market valuation of companies and their accounting profits.

Price to sales: Ratio between a company's market value and its sales.

Risk premium: The equity risk premium is the additional return on investment offered by a stock or bond in relation to a risk-free investment. This additional return compensates investors for their greater risk-taking.

JOLTS (Job Openings and Labor Turnover Survey): Monthly study conducted in the United States on new job offers, new hires, and contract terminations. These measures provide a detailed view of the US labor market.

Value: In equity markets, it is common to contrast growth stocks with value stocks. These are 'cheap' stocks relative to their fundamentals, usually from cyclical sectors (banks, industrials, oil, automotive).

Chart 12
Equity valuation: Earnings multiples (12-month forward P/E)
Source: Bloomberg

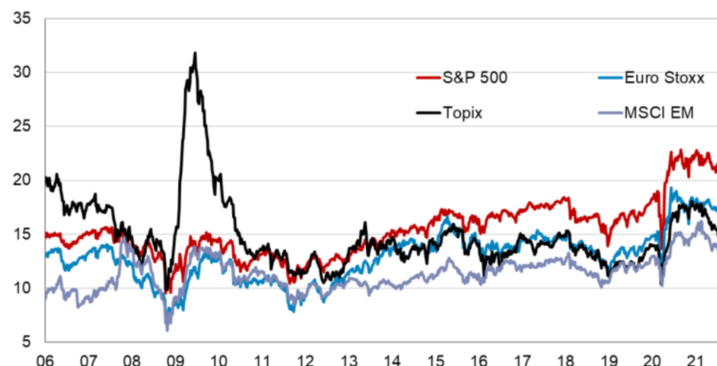


Chart 13
12-month forward price to sales (US and Europe)
Source: Factset

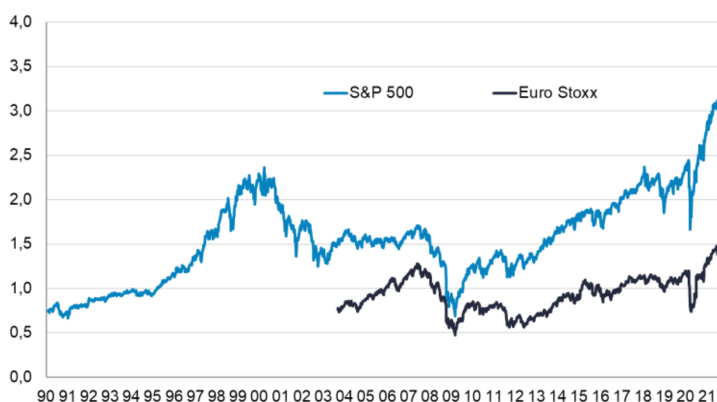
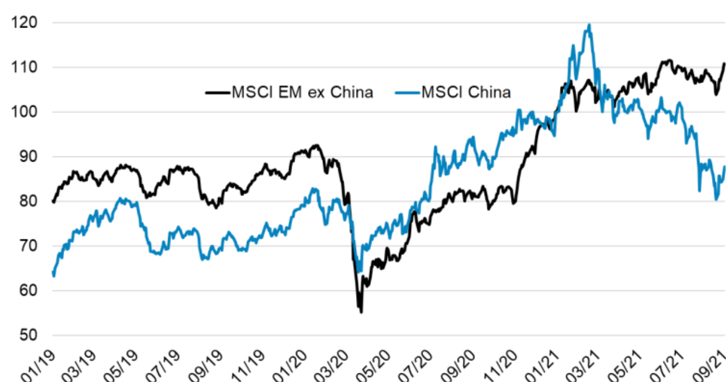


Chart 14
Emerging equities, base 100 on December 31, 2019
Source: Bloomberg



Conclusion

New cycle or extension of the previous cycle?

The Delta variant does not seem likely to cause a return of lockdown measures in countries that have reached a high level of vaccination. The economic recovery will continue and even though we have passed the peak in growth, it will remain strong and above growth potential in the coming quarters. Demand is dynamic, but the 'supply' side of the economy seems to be weighing on economic activity. The very specific nature of the 2020 recession, and the exceptional recovery that followed, has enabled the economy to maintain unusually robust fundamentals in times of an exit from the crisis:

- a lack of destruction of private sector wealth, or even an increase in household savings (Chart 15),
- a backdrop that is not conducive to the adoption of austerity measures,
- a rebound in activity, which means that the production system does not have very significant excess capacity.

The first two factors are very positive for the continuation of the growth cycle, but the third raises the question of inflationary pressures in the production system (Chart 16). Whether the current acceleration in inflation and wages is a transitory phenomenon, or the result of huge demand support measures, remains an open question. If the current rise in inflation proves to be more sustainable and, above all, linked to an acceleration in wages, central banks will have to normalize their monetary policy further than currently anticipated, and potentially slow down growth. In the absence of clarity on this issue, we will therefore have to keep a close eye on upcoming inflation and labor market data.

Market Outlook

In the short term, we maintain a favorable allocation to risky assets, but are more vigilant given valuation levels and the growing probability of a poorly contained inflation scenario.

For now, growth remains strong, liquidity abundant, and central banks patient. Equity markets offer attractive risk premiums (Chart 17). However, there is a growing probability of a negative scenario where the recovery in the economy would be stronger than expected, more inflation-generating, with more persistent inflation expectations. The reaction of central banks in such a scenario remains uncertain.

Chart 15
United States: Net wealth per income quintile (dollars)
Source: Bloomberg, Fed

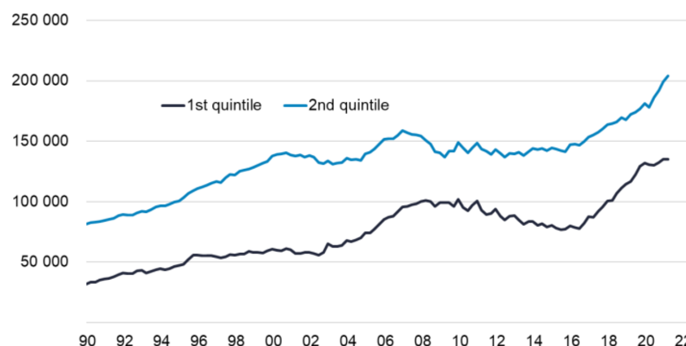


Chart 16
United States: Consumer prices excluding food and energy, excluding extreme variations
Source: Dallas Fed, Bloomberg

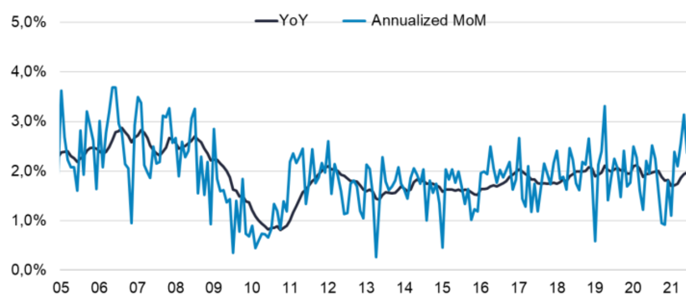
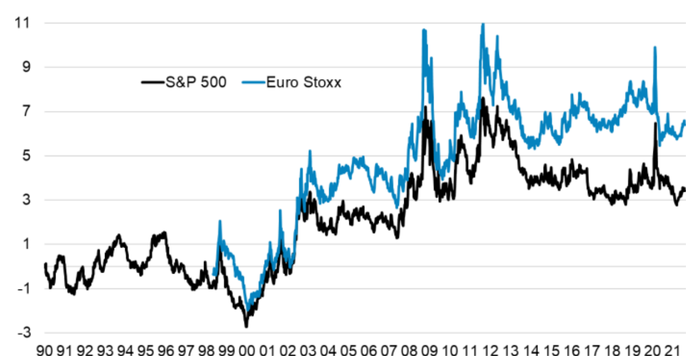


Chart 17
Equity market risk premium
Source: Bloomberg



The opinion expressed above is dated September 2021 and is subject to change. Most recent data at the date of publication.

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