Manulife Investment Management

Market Note

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In periods of uncertainty, having a good working knowledge of the key macro drivers influencing global growth dynamics can be helpful to understanding where financial markets could head next. In this market note, Frances Donald, Global Chief Economist and Global Head of Macroeconomic Strategy, shares her outlook.

Macro anchors shaping the global growth outlook

A delicate global economic recovery

The current global economic recovery is delicate. For the recovery to continue at its current pace, many things need to go right: a successful handoff from the public to private sector, a smooth transition from manufacturing to services activity, continued robust consumer and business confidence, and much more. In our view, the global economy risks slowing at a faster pace than expected if these pieces don't fall into place in a timely fashion.

The surge in the Delta variant creates even more vulnerability in this recovery as it forces us to question if the latest outbreak might be the final wave during which demand is simply *delayed*, or are we stuck in a holding pattern characterized by new variants, rolling supply chain disruptions, and a more sustained reduction in aggregate consumer spending as demand *destruction* takes place? We simply don't know.

In periods of heightened uncertainty, we anchor ourselves to our core macroeconomic views. As the waters become more turbulent, creating tidal waves of two-way volatility (and therefore pinpointing the importance of staying nimble), these anchors help ensure that we won't be swept away by the latest data point or headline.

Based on current information, our anchors lean toward more negative consensus, but as information changes, our views will too. We also believe that these evolving macrodynamics are likely to play out in a way that could have more of a negative effect on the fixed-income space than the equity space, although the situation may evolve.

Tactical macro anchors: 3 to 6 months

Early taper, late interest-rate hike

We expect the U.S. Federal Reserve (Fed) to announce plans to scale down its asset purchase program in the autumn (a formal announcement is likely between September and December). In our view, the quality of the economic data in the coming months is more likely to determine *how* the taper is conducted as opposed to *when* the taper takes place. Similarly, how the Fed communicates its plan and how the taper will be implemented will likely determine the market reaction. We expect the first interest-rate hike to occur in the second half of 2023, but it could happen later.

Technically, we expect inflation to be transitory in nature but stagflationary dynamics will remain at play

Headline inflation globally will likely decline and keep market-based measures of inflation contained. However, pockets of price pressures—exacerbated by the Delta variant—are likely to remain and it could take time before they unwind. In our view, these price pressures pose a growing risk to consumer demand, particularly with respect to housing, autos, and durable goods. In addition, we believe price hikes should increasingly be viewed through the growth lens as opposed to the inflation lens. Crucially, the Fed—and for that matter, global central banks—can't alleviate these supply-side price pressures by tightening monetary policy. This will continue to produce a seeming disconnect between inflation statistics and bond yields.

Peak macro is priced, but peak pessimism isn't

While the concept of peak macro is well understood and priced, we see some scope for further downside modest to moderate disappointments into year end, particularly related to the consumer. This is primarily important to the fixed-income market and should keep bond yields contained.

China represents a significant global growth headwind in H2 2021

We expect Chinese growth to be downgraded in the face of more stringent shutdowns and the delayed effects of tighter fiscal, monetary, and regulatory policy. In fact, we believe the Delta variant could slow Asian growth sufficiently to weigh on global growth and international trade.

Policy uncertainty amplifies the range of likely outcomes

Elevated uncertainties globally necessitate lower conviction on both macro expectations and market outlooks. From an investment perspective, scenario analysis and tactical approaches will likely make more sense in this environment.

Source: Manulife Investment Management, August 17, 2021.

Strategic macro anchors: 12 months+

The coming U.S. fiscal cliff is sizable	There is a sizable U.S. fiscal tightening taking place in 2022/2023 that even the infrastructure bill won't be able to offset. The task of making up for the steep fall in fiscal spending goes to the private sector. We see some scope for capital expenditure within the private sector to accelerate to fill some of this gap, and this presents an upside risk to our forecast.
Absence of a synchronized global growth recovery	The global recovery is likely to be uneven and the likelihood of additional lockdowns—which may be introduced in different places at different times—could hurt any global growth momentum.
Inflation roller coaster	We expect 2022 to bring about a material deceleration in headline inflationary pressures as manufactured goods enter a deflationary phase (in year-over-year terms); however, longer-term inflationary pressures should begin to show up in late 2022 and into 2023. We expect post-COVID-19 inflationary pressures in the United States to settle slightly above the 2.0% level due to rising rents (in the 4.0% to 4.5% range), higher levels of government spending, growing expectations for businesses to improve pay conditions for low earners, and deglobalization. We call this slightly above 2.0% inflation the *new inflation* because it's compositionally different from prior periods. That said, the journey to arrive at *new inflation* could be bumpy.
Where are we in the growth cycle?	As the global recovery began, the view that we might have headed into a compressed/short growth cycle that started in early 2020 gained traction. Having had the opportunity to reflect on recent economic data, we're increasingly of the view that we're still in the same growth cycle as before the pandemic. Put differently, the COVID-19 outbreak didn't force a growth-cycle reset—it was more of a pause. Crucially, there's no evidence suggesting that we've entered *end-cycle territory* and it's likely that we'll remain in mid-/late-cycle dynamics for some time.
U.S. yields are unlikely to break out of long-term down trends	For U.S. bond yields to break out of long-term range, we need to see—in fairly short order—some combination of a strong Fed commitment to average inflation targeting, persistent fiscal spending that's significantly above current expectations, and/or significant productivity improvements. Unfortunately, we don't expect these developments to take place. By extension, this suggests macro conditions are likely to continue to be more supportive of equities and alternative assets and higher-yielding debt instruments.
Deglobalization	The shift away from globalization is likely to continue. We expect this to spur investments in local/regional supply chains, creating some inflationary pressures. This could also lead to heightened geopolitical risks.
Accelerating adoption of ESG factors	The growing focus on environmental, social, and governance (ESG) factors will likely distort traditional macro signals, keep a lid on global interest rates, and drive an increase in fiscal spending in a sustained manner. It'll become increasingly necessary to apply an ESG lens to formulating investment views.

Source: Manulife Investment Management, August 17, 2021.

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