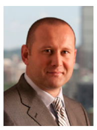
A Temporary Crisis But a Permanent Fiscal Response?

In the short run, some level of economic deterioration can be expected. But with a COVID-19 vaccine in sight, the focus of recovery will shift to fiscal policy. The details will matter.

Insight from sub-adviser Wellington Management



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THE GLOBAL ECONOMY REMAINS CAUGHT BETWEEN OPPOSING FORCES. On the negative side is renewed cyclical weakness; on the positive side is hope that a COVID-19 vaccine may allow economic activity to return to more normal levels over the coming quarters. Uncertainty about the scale and duration of the COVID-related slowdown has persuaded households and, particularly, firms to postpone spending and run a much higher level of precautionary savings. If an effective and widely distributed vaccine is coming, markets can probably look through a jagged global cycle over the next few quarters with greater confidence that any new rise in private-sector savings will just be deferred spending.

The global cycle is likely to deteriorate over the next three to six months as restrictions are imposed in response to rising COVID-19 case counts, keeping uncertainty hanging over the markets. That deterioration is likely to force another response from the US Federal Reserve (Fed) and the European Central Bank (ECB) at the end of 2020. But I think there is now a greater chance that markets will overlook this near-term uncertainty and focus on future growth.

Strong Growth Likely in 2021

After a tough start to the new year, global growth is likely to be strong while inflation remains low. In my view, global GDP could expand by 5% in 2021 as confidence in an effective vaccine pushes households and firms to run a lower level of savings. Yet, given the disruption to activity in 2020, most countries are unlikely to see GDP return to pre-COVID levels until late 2021. For some, it could be well into 2022 or even 2023.

While that excess capacity is being absorbed, I expect inflation to remain low despite strong GDP growth. In this environment, monetary policy is likely to remain very supportive. One legacy of this crisis is that central banks have explicitly changed their reaction functions and will need to see, rather than simply expect, higher inflation before taking back the stimulus. So the expansion in central bank balance sheets is likely to be huge in 2021 at around US$3 trillion, second only to 2020's US$6 trillion.

Positive developments on the vaccine front are a game changer for the global economy. Although it is still early days and many hurdles need to be overcome, the upbeat vaccine news should allow for greater confidence that the pandemic crisis will be temporary. In that environment, equities can rotate to more cyclical leadership. Also, bond yields can rise, as the timing of when central banks will ultimately hike interest rates is pulled forward modestly. But, with inflation still low and central-bank purchases still high, the moves are likely to be gradual rather than abrupt.

Key Points

- Positive developments on the vaccine front are a game changer for the global economy and should allow for greater confidence that the pandemic crisis will be temporary.
- After the world has adjusted to news of a vaccine, the market will turn its focus to fiscal policy: what form it will take and how persistent it will be.
- Countries will likely choose from three fiscal approaches: (1) fiscal "prudence," (2) economic redistribution policies, or (3) an emphasis on investment.

The US election, like recent elections in Europe and the UK, suggests that the electorate has decided against a sharp leftward lurch toward an aggressive policy of redistribution.

All Eyes on Fiscal Policy

The policy response so far, though large, has been designed to fill a hole, not stimulate growth; to avoid deflation, not generate inflation. The measures were intended to soften some of the blow caused by the private sector's forced saving. And central banks' asset purchases have been more effective at driving up equities than convincing households or firms to spend.

After the world has adjusted to the news of a vaccine, I believe the market will turn its focus to fiscal policy: What form will it take and how persistent will it be? This will determine whether the global cycle simply returns to pre-COVID behaviors—with low growth, high debt, low productivity, low inflation, and ongoing central bank-balance sheet expansions—or takes a fundamentally different path.

Countries face three broad fiscal options:

1. **Take back what they gave during the crisis.** This would be like Japan in the 1990s or the euro area in 2011–12. I think this is an unlikely option, given excessive debt. Bond yields would remain close to zero, with inflation expectations stuck well below target. The outlook for equities would depend again on the willingness of central banks to keep expanding their balance sheets.
2. **Use fiscal policy to redistribute within society and raise the labor share of income at the expense of profits.** This would mean higher taxes and even higher spending, with an effort to narrow income inequalities through lowering the cost of being out of work. The result would be an environment of stagflation, similar to the late 1960s to 1970s, with much higher bond yields, some credit problems, and declines in equities.
3. **Use fiscal policy to promote a large investment surge.** From 1945 to 1965, a fiscal expansion allowed technologies developed during the Second World War to be rolled out as economies were rebuilt. Could investment in energy and transportation be today's equivalent? That could be the path to a golden age. In that case, the market would project stronger growth, productivity, and returns, as well as a higher-equilibrium interest rate. As a result, bond yields and equities could rise together for an extended period.

The option chosen will vary from country to country, depending on the electorate's political inclinations. At an aggregate global level, fiscal prudence (option 1) seems unlikely. So, for much of 2021, it will probably feel as if the policy shift is permanent. But I'm currently unsure whether fiscal redistribution or investment is more likely. The US election, like recent elections in Europe and the UK, suggests that the electorate has decided against a sharp leftward lurch toward an aggressive policy of redistribution. Equally, though, we have not yet seen many concrete plans for fiscal investment.

Conclusion

I believe positive developments on a COVID-19 vaccine can give us more confidence that this crisis will prove temporary, even though the near-term outlook is deteriorating. For me, the key unknown is whether the change in fiscal policy will prove permanent—and, if so, what form it will take. Each country faces a choice on fiscal policy between prudence, redistribution, and investment.

Over a horizon of five to 10 years, this dominance of fiscal over monetary policy is a key theme for me. During the past 10 years or more—and especially in 2020—central-bank liquidity has been the one factor driving markets globally. But this fiscal era will be really exciting for investors, because it's more about idiosyncratic country stories. Every country's policy will be different.

For example, countries with aging populations and low savings rates have far less incentive to really push for inflation, as Japan has shown in recent decades. But countries such as the US and the UK may be more willing to persist with fiscal stimulus until inflation comes through. That implies much more risk premium being priced into markets over the next five to 10 years, with important consequences for bond and equity markets.

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