6 September 2021

Big Picture

Delta delayed recovery

Key takeaways

- **The delta variant will continue to create headwinds for the global economy amid slow vaccination roll-out**
- **Global macro momentum is set to ease further amid fading boost from stimulus and stalling re-opening of economies amid continuing virus challenges.**
- **The balance of risk to our growth outlook is to the downside, while supply side problems could lead to more persistent inflation problems stoking stagflation concerns.**

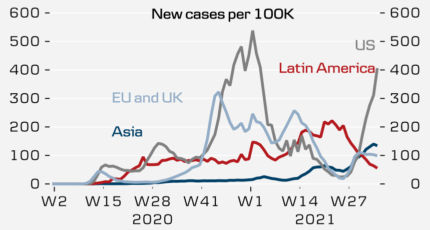
COVID-19 remains a big problem for the world economy

The more contagious delta variant continues to spread fast in most of Asia and in various US states. In contrast, the situation in Europe has improved following the Delta variant wave and steady roll-out of vaccine, with Euro Area seeing lower new infections while UK cases are rising again following widespread re-opening of its economy. Overall, for Europe and other regions that have vaccinated large parts of their populations, hospitalizations and deaths remain clearly below earlier levels, which is not the case in the US at the moment. Another exception is Israel, which has seen a surge in hospitalised COVID-19 patients, as vaccines appear to have lost their effectiveness earlier than thought.

Roll-out of vaccination has stalled in the US where a large part of the population remains sceptical about the vaccines. In most of Asian countries, roll-out of vaccines is also advancing slowly given the lack of available vaccines, logistical problems in rolling out vaccines and significant vaccine scepticism, while vaccines are being steadily rolled-out in most Latin American and European countries.

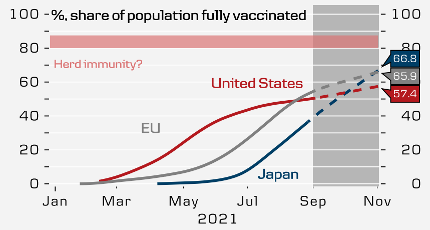
At the current pace, it will be difficult to reach the necessary vaccination level before the cold winter period in the US and Europe, where the contagious Delta variant will have better conditions to spread. Hence compared with our assumptions in our spring forecast that by the fall some degree of herd immunity would be achieved, countries like the US and in Asia, but even in Europe seems vulnerable to renewed virus problems which could trigger select lockdowns especially in the service sector. **This also means that we are most likely still discussing and talking about COVID-19 next year.**

Delta variant spreading in the US and Asia



Source: European centre for Disease, World Bank, and Macrobond Financials

Very difficult to reach herd immunity at the current pace



Note: Projections are based on a continuation of the current trend

Source: Our World In Data and Macrobond Financial

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Global growth moderation set to continue, as boost from policy support and re-opening fades

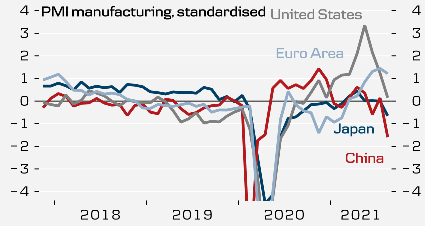
The developments have so far been broadly in line with the trajectory projected in our last Big Picture update from March (*Big Picture forecast update - Divergent fortunes*, 23 March). At that time, we expected the US economy would power ahead amid a faster vaccine roll-out allowing a faster re-opening of its economy and sizeable fiscal stimulus compared with the rest of the world. The euro-area would see a more muted and later rebound as the slower vaccine roll-out made it vulnerable to new virus waves that would delay the re-opening of the economies. Meanwhile China would see waning economic growth momentum given policy tightening. In terms of growth outcome, the US growth turned out to be weaker than expected mainly as companies ran down their inventories, but underlying growth was very strong in line with expectations. Growth in the euro area surprised to the upside, especially in the Q2, as the economic activity responded more strongly to the lifting of restrictions with GDP expanding by 2.0% q/q. The Chinese slowdown has been slightly more pronounced than we projected.

After the strong economic rebound in the spring, the momentum in the global economy is moderating. Both the global manufacturing and service PMIs have started to decline. This comes as the boost from the US fiscal stimulus, Chinese credit expansion and re-opening is fading while the spreading of the delta variant is also making consumers and companies more cautious. Supply chains bottlenecks are also starting to weigh on production. The supply chain challenges are further enhanced by the spread of the delta variant especially in Asia. The recovery in the service sector seems to have stalled amid the virus flare up, as we see e.g. restaurant bookings in the US moving sideways. In the euro area, the business and consumer surveys have rebounded well above the pre-crisis levels but are now also levelling off.

Looking ahead, we expect economic growth to remain solid despite further moderation in growth momentum. First, the immediate boost from reopening of economies are now behind us and may even reverse if renewed virus problems hit countries over the flu season. In fact, the combination of weaker growth in the first half of 2021 and the impact of the Delta variant has forced us to lower our growth forecast slightly for the US, China and euro area in H2 2021. Japan is a bit of an outlier in this regard, as the slower roll-out of vaccines means that re-opening is yet to boost private consumption, which we expect will happen later this year. Second, the rise in inflation is eroding consumer purchasing power. Third, the policy environment is also turning less supportive for economic growth with the US March fiscal stimulus package, which gave a massive boost to consumption in H1 21, continuing to fade near-term as well as from the central bank side. Overall, economic growth will continue to be driven by private consumption and to some extent investment. However, in the US and the euro area, we expect companies to rebuild inventories, which boosts headline growth numbers but the underlying growth rate is definitely weakening.

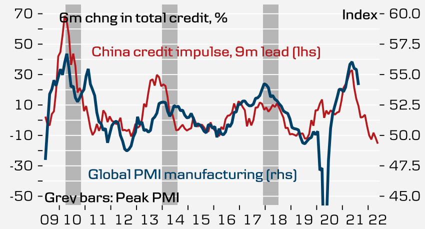
We expect the Fed to soon start winding down QE bond buying and we expect tapering to be concluded in mid-2022. The Fed should start hiking rates in H2 2022 (probably Q4 22). We expect the ECB to slowly exit its crisis mode, phasing out the PEPP programme in March 2022. However, in light of stepped up inflation ambitions with the new symmetric 2% target and a still rather muted outlook on euro inflation, we expect gradual ECB balance she et normalisation to start in 2023 at the very earliest and more likely in 2024-25.Given the slowdown in China, we expect some easing providing a modest boost to growth.

Peak in PMI manufacturing



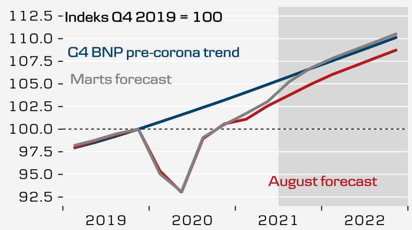
Sources: IHS Markit, Macrobond Financial

Chinese credit tightening to weigh on global manufacturing



Source: Macrobond Financial, PBoC, Markit, Danske Bank

G4 growth outlook weaker



Sources: Macrobond Financial, Danske Bank forecasts

New G4 GDP forecasts: G4 growth set to slow towards potential growth in 2022

	2021				2022						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2020	2021	2022
	% q/q				% q/q				% y/y		
G4	0.5	1.5	1.2	1.1	1.0	0.8	0.8	0.8	-2.0	6.2	4.2
United States	1.5	1.6	0.8	1.2	0.8	0.5	0.5	0.5	-3.4	5.6	3.3
Euro Area	-0.3	2.0	2.3	1.0	0.8	0.6	0.6	0.5	-6.5	4.9	4.2
China	0.4	1.3	1.0	1.2	1.4	1.4	1.4	1.4	2.4	8.3	5.2
Japan	-0.9	0.3	0.5	1.2	0.9	0.3	0.4	0.4	-4.7	2.4	2.6

Sources: Macrobond Financial and Danske Bank

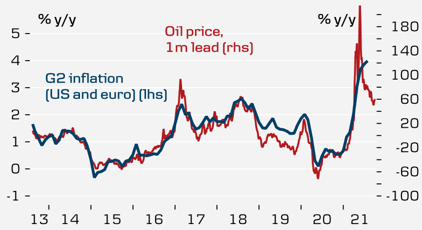
In 2022, as the impact of the re-opening of economies is behind us and economic policies turn less expansionary, economic growth is expected to moderate further toward its potential rate. The infrastructure and welfare packages that are under discussion now in US Congress at the moment will provide a moderate boost to growth in 2022 and onward. However, the growth impact will be more limited than the December/March packages as they will be financed by higher taxes and spend over several years. While the US and China have now recovered the pandemic GDP losses, the euro-area and Japanese economies will first reach their pre-crisis trend GDP trend by late 2022 at the earliest.

Prolonged transitory inflation pressures

One of the most prominent macro-developments in 2021 has been the rise in inflation rates across advanced economies and emerging markets. Zooming in on the US and euro area, the rise in inflation has mainly been driven by higher energy prices following the rebound in oil prices. Another significant positive contribution has been from service prices following the re-opening of service- and travelling businesses. Goods shortages relating to supply chain problems and continuing strong demand have also caused some goods price inflation, especially in the US, where core inflation has surged over 4% while in the euro area the core inflation has increased to more modest level of 1.6%, which is still high by historical standards.

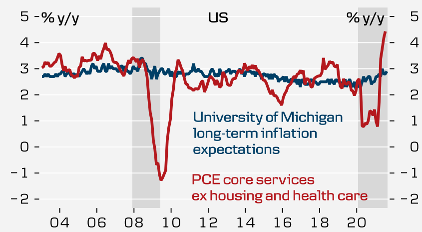
Our base case remains that inflation pressure is transitory, although inflation may stay high for the remainder of 2021 going into 2022. The higher inflation the rest of this year will mainly be driven by both shelter and wage inflation in the US while the German VAT base effect is the primary reason for continuing high core inflation in the euro-area. We see the inflation pressures waning for a number of reasons: First of all, energy related inflation will fall as the impact from higher oil prices wane (see chart) with the stabilisation in oil prices. Secondly the supply-chains obstacles will in our view normalise, as goods demand slows while the COVID-19 related obstacles on the production and delivery of goods should also ease. This should moderate transportation costs and increase supply of goods, putting downward pressure on goods price inflation. Despite the rise in inflation, we also assume that inflation expectations will continue to remain well-anchored, despite the temporary surge in inflation and hence we will not see significantly higher wage inflation on a sustained basis that could give rise to wage-price spirals (see graph for the US). For more on US inflation dynamics read *Research US - Higher inflation but not spinning out of control due to still well-behaved expectations*, 14 June. Nevertheless, we think that core inflation will above 2% throughout 2022 but this is in line with where the Fed wants to see inflation for some time.

Impact from oil price inflation has peaked – high headline inflation will soon start to roll over



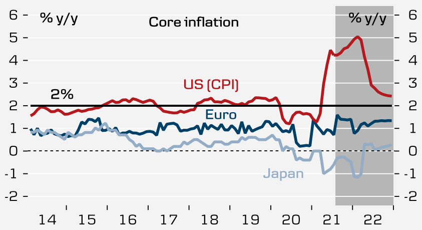
Source: Macrobond Financial, Bloomberg, Danske Bank
Note: Past or current performance is no guarantee of future performance.

Inflation expectations suggest PCE core service inflation is not spinning out of control



Note: Grey areas are recessions (NBER definition)
Sources: BEA, University of Michigan, NBER, Danske Bank calculations

Core inflation will decline in early 2022



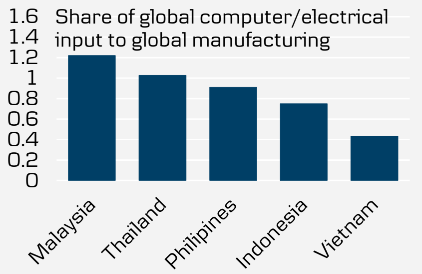
Source: Macrobond Financial, Bloomberg

The balance of risks to our inflation forecast is to the upside. Continuing global supply challenges, high freight rates and input shortages are primary risks, overall the effect should remain limited given that core goods has only 20% weight in the US inflation basket, but also possibly second round effects on wages are possible.

Downside scenario: stagflation (30%)

The contagious Delta variant could accelerate over the winter period in Europe and US given lack of vaccine-led herd immunity and waning vaccine effectiveness, which could lead to renewed COVID-19 fears and/or new lockdowns causing a new economic setback (especially in the service sector) as confidence plummets. The uncertainty would weigh on investments. At the same time, continuing widespread virus problems in Asia and in the US (and even in Europe) would prolong global supply chains problems, leading to higher global goods price inflation, also because goods consumption is likely to remain elevated in this scenario. Higher goods price inflation may lead to even lower demand, as consumers' purchasing power declines. The risk is, that supplies of particularly semiconductors will be hampered due to COVID outbreaks in South East Asia. Here manufacturing activity has already slowed significantly over the summer. In 2015 the share of the total computer and electrical input from Indonesia, Malaysia, the Philippines, Thailand and Vietnam (all severely affected by lockdowns due to COVID) to global manufacturing amounted to 4.3 per cent. In particularly Malaysia, the input has likely grown significantly since then. If inflation continues to run high then inflation expectations could also move higher leading to higher wage growth down the road. The combination of an economic setback and high price pressure would put central banks notably the Fed in a dilemma but the Fed would likely to become more hawkish to dampen inflation fears, which could lead to significant negative impact on global risk sentiment.

Significant South East Asian electrical input to global manufacturing

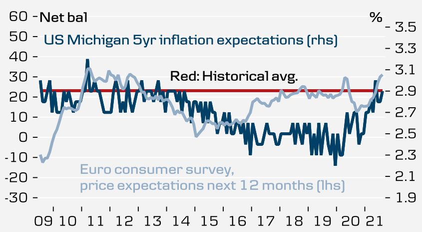


Source: OECD TiVA database, Macrobond Financial,

Upside scenario: Sharp recovery with risk of overheating (20%)

If the virus problems cease quicker than we think (this could be the case if it turns out vaccine protection remains stronger for longer than indicated by some Israeli studies, which remain outliers, if booster shots are administered quickly or if vaccine uptake increases), then we could see a stronger than expected rebound in the global economy, especially as private consumption of services is boosted by sharp falls in unemployment rates when the economies reopen and vaccines continue to keep the COVID-19 virus in check. The stronger demand will likely ignite stronger inflation pressures, which lead to rising inflation expectations especially in the US, forcing the Fed to hike rates sooner. This is not necessarily a problem, as it reflects a stronger economy.

US and euro consumer price expectations - still anchored so far

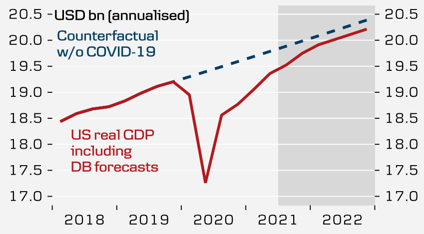


Source: Macrobond Financial, Uni. Of Michigan, EU Commission

US macro outlook: Recovery is set to continue but delta is a risk

GDP growth in Q1 and Q2 was slightly lower than we anticipated. Private consumption and private investments in equipment and intellectual property were actually stronger than we pencilled in but inventories were a major drag on growth in both Q1 and Q2, most likely reflecting the distortions we have seen in manufacturing globally. Given the very low level of inventories (based on several surveys), we expect inventories will start contributing to GDP growth again in H2 21 and early 22, as businesses need to build up inventories again.

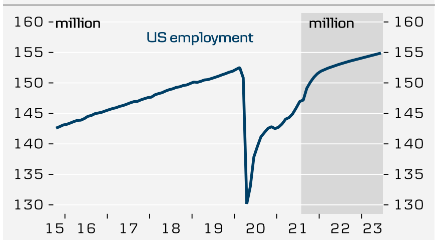
New US macro forecasts



Sources: BEA, Macrobond Financial, Danske Bank forecasts

Private consumption was very strong in Q1 and Q2 due to a combination of fewer restrictions, less COVID-19 fears and stimuli checks. Savings remain high and consumer confidence is high as well, so we expect private consumption growth will remain decent in H2 21 but not as strong as in H1 21, although private consumption has moved sideways lately due to a combination of delta fears and no support from new checks. We expect the normalisation of the consumption pattern (i.e. more money spent on services and less on goods) will continue although goods consumption is likely to remain elevated for longer than we previously thought. We also expect decent investment growth ahead, as business confidence remains high, but growth is set to be slower compared to H1 21. Residential investments have taken a hit from lower activity in the housing market but growth should remain positive. Fiscal policy will continue to support growth in coming years but not to the same extent as in early 2021.

Employment will return back to pre-covid levels in H2



Sources: BLS, Macrobond Financial, Danske Bank forecasts

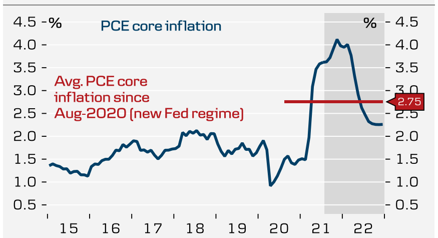
Overall we expect GDP growth of 5.6% this year and 3.3% next year. We previously thought the US would soon exceed the old GDP trend path but that seems too upbeat right now, as we have been caught by surprise by e.g. the delta variant.

One risk to the outlook is indeed the spreading of the delta variant, which in particular has hit states with low vaccine uptake. Risk is that the outbreaks get worse over the autumn and winter, just like we saw last year, during the flu season. While states may be reluctant to tighten restrictions, we may see people staying away from e.g. restaurants in order not get infected.

The labour market recovery is ongoing but has not been as strong as in other countries despite very high labour demand. One reason is probably that the temporarily higher unemployment benefits reduce the incentive to work (which is likely also the reason why wages in “leisure and hospitality” have risen faster than usual). They expire no later than on 6 September on a federal level and we expect stronger employment growth after that.

Inflation (also core) has been high for some time now. We think there are many reasons to believe that inflation will peak in early 2022. The main explanation is that inflation expectations remain well-anchored and do not suggest that inflation is going to spin out of control. Especially core services (the most important part of actual inflation) are, historically, fluctuating around inflation expectations and we see no reasons why this relationship should not continue. Still, we see PCE core inflation above 2% throughout 2022.

US core inflation is set to peak in early 2022 before moving lower



Sources: BEA, Macrobond Financial, Danske Bank forecasts

Our expectation of still strong growth, stronger employment growth and inflation above 2% implies that we expect the Federal Reserve to soon start tightening monetary policy. We expect the Federal Reserve to start tapering in Q4 and to conclude the process by summer 2022. We expect the first 25bp rate hike in H2 22.

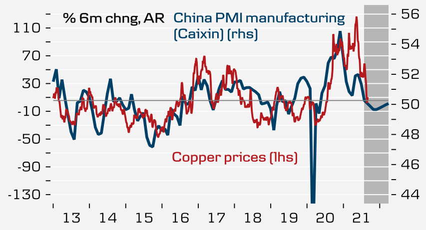
China's slowdown to trigger more easing

Chinese growth was softer than expected in H1 and we have revised our GDP forecast for 2021 down to 8.3% from 8.5%. The forecast for 2022 is unchanged at 5.2%. Chinese credit tightening points to a clear slowdown in infrastructure investments and construction, whereas exports have held up due to strong growth in exports to not least US consumers.

We look for a moderate decline in PMI's in H2 as the lift from exports is expected to come down as US goods consumption fades. We expect credit growth to increase during the second half from very low levels, which is needed for China to meet its implicit target of credit growth for the year around 8-9%. The Reserve Requirement Ratio (RRR) was surprisingly cut over the summer and we look for further easing in coming months through a further cut in the RRR and a small adjustment to fiscal policy. We therefore look for credit growth to recover during H2, which is needed for China to meet its' implicit target for credit growth at 8-9%. The slower growth in China – especially in the commodity intensive sectors of infrastructure and construction – will work to dampen global inflation pressures in H2.

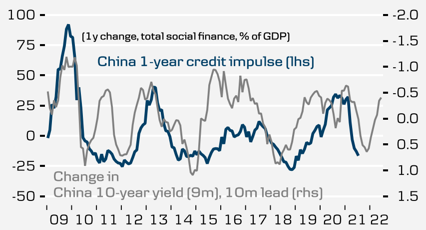
China saw a stock market rout in July linked to a crackdown on certain companies. The crackdown has aimed at different targets, though. First, data security has become a matter of national security and on this background Didi saw intervention from the state as they were asked to take down many apps following a listing on the New York stock exchange, as they failed to provide assurance that the data of 500 million users were properly protected. Second, anti-trust regulation has been high on the agenda targeting big tech companies such as Alibaba and Tencent. The companies have been accused of abusing market power and the new regulation aims at protection small and medium sized companies from this and thus improve free competition. While spooking investors in the short term and hitting the stock market where the biggest companies are listed, it should be good for innovation in the longer term as it improves conditions for smaller companies. We believe stocks have fallen too much compared to fundamentals and once the storm has passed, we expect Chinese stocks to move higher going into 2022.

China: We look for more weakness short term, recovery in early 2022



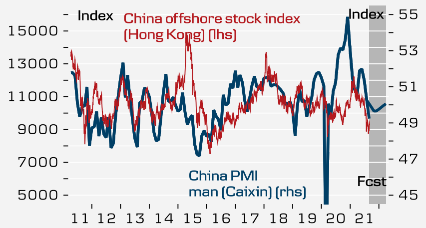
Note: Past performance is not a reliable indicator of current or future results.
Source: Macrobond Financial, Markit, Danske Bank

Chinese credit growth should recover in H2



Note: Past performance is not a reliable indicator of current or future results.
Source: Macrobond Financial,

Chinese stock market taking a big hit – we look for rebound into 2022



Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.
Source: Macrobond Financial, Danske Bank, Bloomberg.

Euro area: Back in the fast lane, but with bumps on the road

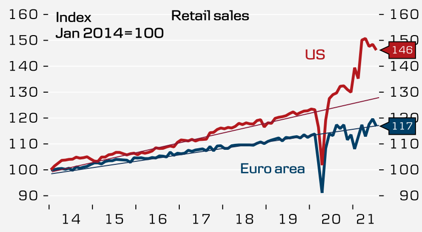
After a contraction of 0.3% q/q in the first quarter, euro area GDP expanded by a strong 2.0% q/q in Q2 21, confirming that the economy has now firmly arrived on the road to recovery. Helped by the lifting of lockdowns in April and May, business and consumer confidence has surged, standing well above pre-crisis levels and unemployment has fallen back to 7.6% in July (from a peak of 8.6% last year). However, in contrast to the US and China, euro area GDP remains still some 3% below its pre-pandemic level and bumps on the road could still create setbacks in the European recovery. Hard data released during Q2 have generally failed to live up to upbeat survey data. While households have built up significant excess savings during the pandemic, retail sales have failed to rebound significantly above pre-crisis levels. *ECB research* suggests that excess savings remain concentrated among older and higher-income households that are less likely to spend. The discrepancy between hard and soft data leaves upside potential for H2 21, but a gradual phasing out of furlough schemes combined with accelerating inflation could on the other hand start to weigh on real disposable income and consumer spending. The continued spreading of the delta variant also poses a headwind that could hit the tourism, travel and hospitality sectors. High frequency data already point to somewhat stalling activity in retail and recreation. That said, we do not expect renewed lockdowns with 70% of the EU adult population now having received at least one vaccine shot. Instead, an increasing impediment to growth could stem from worsening supply chain bottlenecks that have started to weigh on production levels despite full order books. Industrial output was still languishing below pre-pandemic levels in Germany and France during June. German manufacturers - in particular carmakers - have struggled to keep up with rising global demand due to shortages of many materials, including semiconductors, as well as bottlenecks in container shipping. Severe flooding during July has also adversely affected production capacity in some German regions.

A key question will be how the economic expansion continues in 2022 when government's emergency measures are gradually scaled back. Bankruptcy filings in the euro area fell by a fifth in 2020 and remain below pre-pandemic levels this year, but businesses might face substantial repayments as tax and rent deferrals begin to lapse. A decisive factor will also be what happens to the EU's fiscal rules which will likely apply again in 2023. The European Commission is expected to make reform proposals later this year, but the tone of the debate will be very much determined by the outcome of Germany's parliamentary election in September (see also *Research Germany - End of the 'era Merkel' leaves German politics in unchartered territory*, 27 April).

Overall, we expect the euro area recovery to continue in H2 21 at a solid pace, thanks to services returning as a more important growth driver. We also see scope for Europe's manufacturing boom to extend into H2, with the turn of the cycle slightly lagging China and the US, but we do not think that Europe's manufacturing cycle can escape abating global momentum for long (see also *Research Euro Area - Tide is slowly turning for European manufacturing*, 22 June). **We forecast euro area GDP growth at 4.9% in 2021 and 4.2% in 2022 and German GDP growth at 3.4% in 2021 and 4.4% in 2022.**

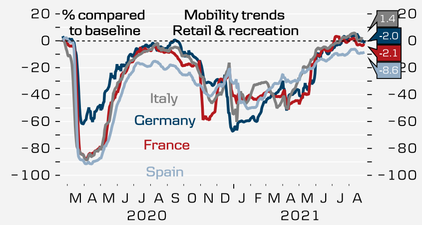
Despite its new monetary strategy (see also *ECB Research - Strategic Review: Striving for symmetry*, 8 July), we expect the ECB to slowly exit its crisis mode, phasing out the PEPP programme in March 2022. However, in light of stepped up inflation ambitions with the new symmetric 2% target and a still rather muted outlook on euro inflation (see *Research Euro Area - Mind the inflation gap*, 8 June), **we expect gradual ECB balance sheet normalisation to start in 2023 at the very earliest and more likely in 2024-25.**

European goods consumption still muted relative to US



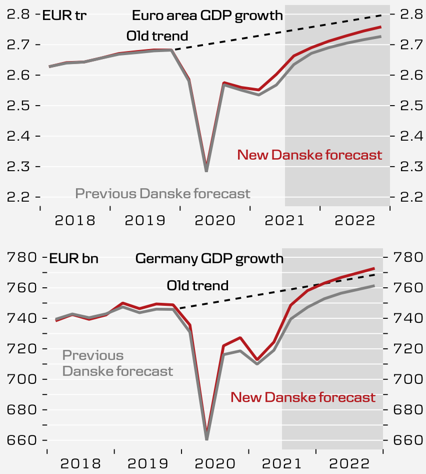
Source: Eurostat, U.S. Census Bureau, Macrobond Financial, Danske Bank

Activity in retail & recreation has flattened out



Note: The above shows mobility trends for places such as restaurants, cafes, shopping centres, theme parks, museums, libraries and cinemas
Source: Google Mobility, Danske Bank

Euro area GDP to reach pre-pandemic levels by end-2021



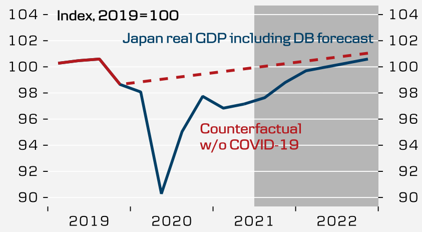
Source: Eurostat, Macrobond Financial, Danske Bank

Japan: Delayed recovery

The economy is still struggling with COVID-19 as the number of cases has reached new highs in August amid a slow start to the vaccine rollout. 56% of the population is fully or partly vaccinated now, though, and progress is rapid with the US not far ahead in the vaccine race. For now, the government has prolonged the “state of emergency” to 12 September for Tokyo and 12 other prefectures and added another eight prefectures.

Following a rough start to the year with a 0.9% GDP decline in Q1, the economy recovered modestly in Q2 with GDP growth of 0.3% qoq as private consumption actually picked up reflecting a relatively soft lockdown by global standards. However, private consumption remains 3% below pre-pandemic levels and 6% below the 2019Q3 level before the government hiked the VAT rate. The Tokyo Olympics was a closed event with no spectators and no tourists and thus has not added much to demand in Q3, which is likely to be another weak quarter showing only modest growth on the back of strong exports and public spending. We expect a significant pickup in private consumption in Q4 and Q1, as benefits of the strong-paced vaccine uptake begins to kick in and GDP growth is expected to end up at 2.4% this year, 2.6% in 2022 and 1.4% in 2023.

Slow vaccine rollout has been costly for the economy



Sources: Japanese Cabinet office, Macrobond Financial, Danske Bank forecasts

Disclosures

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