Medium-term economic and financial market outlook

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Medium-term trends in the global economy

In recent years, the world economy has been characterised by historically slow growth. While there is a risk that onshoring and streamlining of supply chains (and thus de-globalization) and rising costs of risk management will weigh on productivity in the coming years, these risks are likely confined to a few segments of the economy and negligible economy overall. What appears clear, however, is that the pandemic will accelerate the trends towards e-commerce and digitisation. There are already some signs that many companies will emerge leaner and with higher profit margins after the pandemic.

With interest rates near zero in the US and Western Europe, the most effective monetary policy tool, the price of credit (i.e. interest rates), will not be available in the coming years, now for the first time also in the US. Nevertheless, central banks will continue to take an important role when it comes to securing the proper functioning of financial markets in a crisis.

Fiscal leeway is becoming ever more limited, with debt levels jumping in the wake of the pandemic, especially against the background of government debt rising already strongly in the financial crisis and the euro area in the wake of its debt crisis. Debt levels in Southern Europe could once again become a stability risk for the euro area.

The global economy is expected to remain characterised by moderate but positive real growth. US growth gets a lift from unprecedented stimulus programs (a further US dollar 1.9 trillion was approved in March, with GDP expected to reach 24 trillion dollars next year) and government spending – latest estimates suggest that the Biden administration is considering US dollar 3 trillion – on improving infrastructure, fighting climate change and reducing economic inequities dollars in the coming years, with these outlays only in part financed by higher taxes. Compared to the past decade, economic momentum in China (the most important global growth driver) will slow, and global demographic factors will have a moderately higher negative impact. In analogy to the inflation trend after the financial crisis, low inflation remains the most likely scenario. In the event of an economic downturn, economic policy options would be more limited than at any time in recent decades, however.

Components of the economic growth potential

The sum of the increase in labor productivity and hours worked (proxy variable: persons of working age) determine the medium-term growth of an economy (GDP growth potential).

Productivity, labor market and economic growth potential (change, % p.a.)

	Labor productivity				Working age population				Total hours worked			GDP growth potential			
	1991-2000	2001-2010	2011-2020	2021-2030	1991-2000	2001-2010	2011-2020	2021-2030	1991-2000	2001-2010	2011-2020	1991-2000	2001-2010	2011-2020	2021-2030
Western Europe	**2.1**	**1.4**	**0.7**	**0.7**	**0.3**	**0.4**	**0.0**	**-0.3**	**0.2**	**0.7**	**0.5**	**2.5**	**1.8**	**0.7**	**-**
Germany	2.8	1.6	1.1	1.1	0.2	-0.4	-0.5	-1.1	-0.8	0.1	0.7	3.0	1.3	0.6	0.0
France	1.8	1.3	0.7	0.7	0.4	0.5	-0.1	-0.1	0.3	0.6	0.2	2.2	1.8	0.6	0.7
Italy	1.6	0.3	0.2	0.2	0.0	0.3	0.0	-0.4	0.1	0.9	-0.9	1.6	0.7	0.2	-0.2
Spain	1.2	0.7	1.1	1.1	0.7	1.3	0.5	0.2	1.8	2.4	-1.3	2.0	2.0	1.6	1.3
United Kingdom	2.6	1.8	0.4	0.4	0.3	0.7	0.2	0.1	-0.1	0.7	1.7	2.9	2.5	0.6	0.5
Switzerland	1.0	1.8	0.2	0.2	0.4	0.7	0.5	0.1	0.2	0.5	1.4	1.5	2.6	0.7	0.3
Emerging Europe	**0.7**	**4.9**	**1.9**	**1.9**	**0.6**	**0.6**	**-0.1**	**-0.2**	**-0.5**	**0.3**	**0.2**	**1.6**	**5.5**	**1.6**	**-**
United States	**1.8**	**2.2**	**0.5**	**0.5**	**1.3**	**1.1**	**0.3**	**0.2**	**1.6**	**0.3**	**1.7**	**3.1**	**3.3**	**0.8**	**0.7**
Latin America	**1.5**	**1.5**	**0.9**	**0.9**	**2.0**	**1.7**	**1.3**	**0.7**	**1.7**	**2.2**	**1.0**	**3.7**	**3.2**	**2.1**	**-**
Brazil	1.8	1.8	0.2	0.2	2.3	1.6	1.1	0.4	0.8	2.1	0.7	4.1	3.4	1.3	0.5
Japan	**2.0**	**1.6**	**1.0**	**1.0**	**0.0**	**-0.6**	**-1.0**	**-0.7**	**-0.7**	**0.1**	**-0.1**	**2.1**	**0.9**	**0.0**	**0.3**
Asia (excl. Japan)	**5.5**	**6.8**	**5.5**	**5.5**	**1.9**	**1.7**	**1.0**	**0.5**	**1.7**	**1.5**	**-3.4**	**7.5**	**8.4**	**5.7**	**-**
China	9.3	10.1	6.7	6.7	1.3	1.3	0.0	-0.4	1.7	1.2	0.4	10.7	11.6	6.2	6.2
India	4.1	6.0	5.1	5.1	2.3	2.0	1.6	1.1	1.7	1.7	1.6	6.5	8.1	6.8	6.2
Indonesia	2.7	2.7	4.1	4.1	2.3	1.5	1.3	0.6	1.8	2.6	0.9	5.0	4.2	5.5	4.8
World	**2.2**	**2.5**	**2.1**	**2.1**	**1.7**	**1.6**	**1.0**	**0.7**	**0.6**	**0.7**	**-0.1**	**3.1**	**3.3**	**2.3**	**-**

Data productivity/hours worked exclude severe recession years 2008-2009, with forecasts starting 2011 based on data reported for the years starting 2011. Estimated economic growth potential = sum of growth working age population and productivity (regions/world: GDP-weighted average). Source: U.S. Census Bureau, Conference Board, World Bank, own calculations

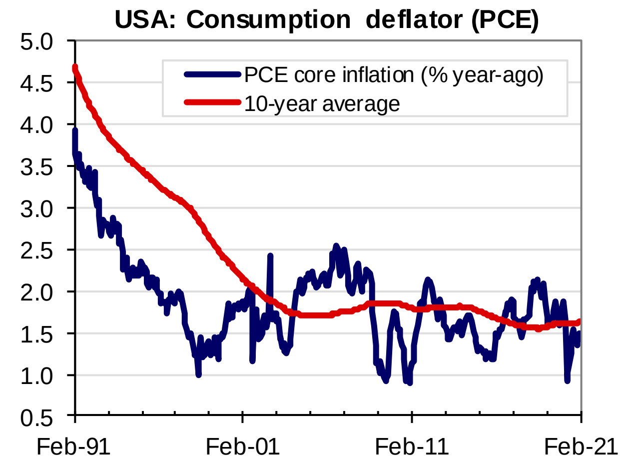
Fed policy and inflation

In 2020, the Federal Reserve decided to change monetary policy so that it will refrain from pre-emptive interest rate hikes in the future. Therefore, monetary policy will no longer be tightened when real economic indicators (such as a very low unemployment rate) point to an advanced economic cycle and inflation risks, but only when these are also evident in rising inflation rates. Since inflation (measured by the personal consumption deflator PCE) has rarely been above the Fed's target of 2% since the mid-1990s (and on average even below that), inflation is now targeted to average 2% over an economic cycle.

If pre-emptive rate hikes are abandoned, there is a chance that the unemployment rate could fall far more than previously thought possible before inflation starts to rise (note that the Fed's mandate includes both full employment and price stability).

Since inflation generally reacts with a lag to capacity constraints, the risk of the new strategy is that any necessary tightening of monetary policy takes place too late and thus has to go further than under a pre-emptive regime.

Since the US economy will not reach full employment until 2022 at the earliest,, the results of the Fed experiment will only become evident (and relevant to investment policy) much later. In the meantime, there may nonetheless be speculation in the capital markets (especially fears over rising inflation) regarding the results of the new monetary policy regime.



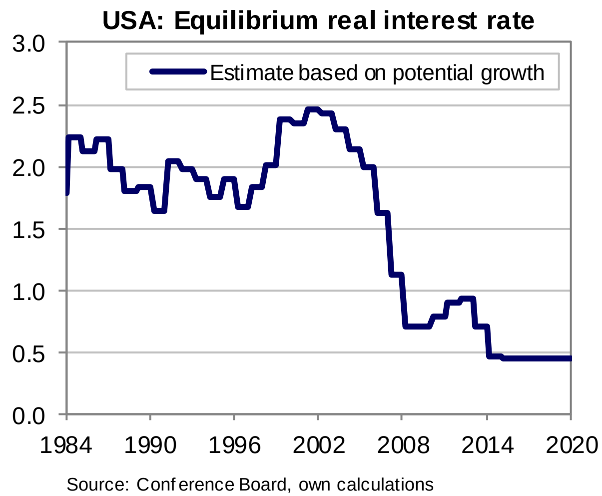
Source: Bureau of Labor Statistics

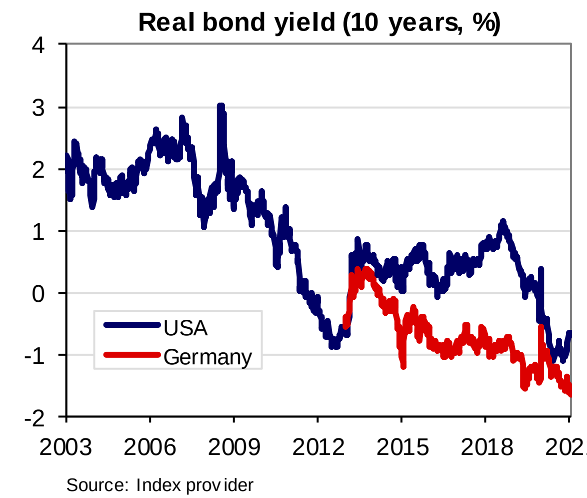
Interest rates: Structurally lower

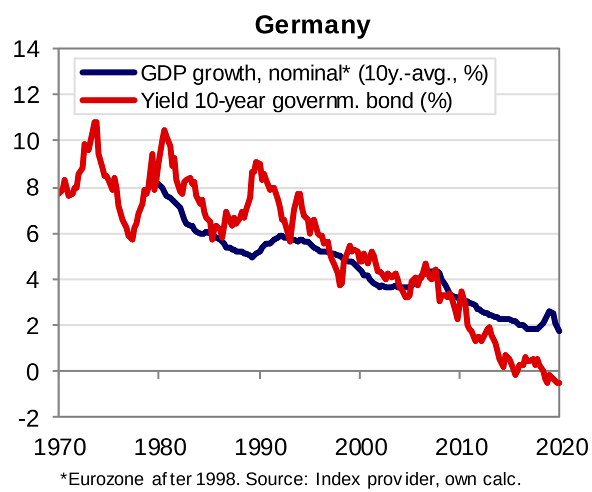
The growth potential is a key driver of interest rates.

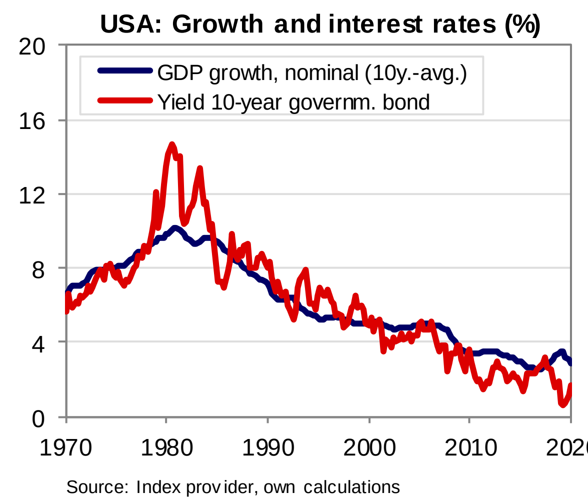
Our analysis suggests (the San Francisco Fed has reached similar conclusions), that the level of real short-term interest rates compatible with current economic growth potential is close to zero, both in the eurozone and the USA. Before the 2008 financial crisis this rate was 2% or higher in the USA and around 1.5% the eurozone.

If growth potential remains at the current level in the long run, which is our baseline scenario, interest rates will remain at a structurally lower level for an extended period.









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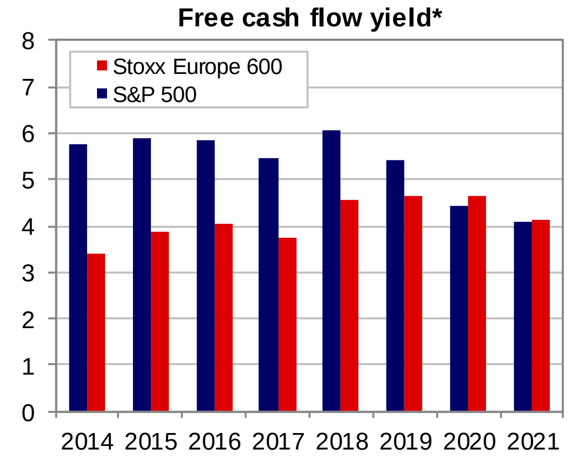
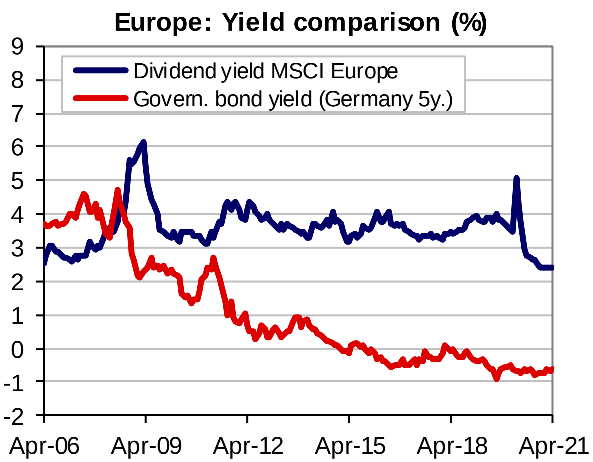
Attractive equity yields

Total returns for shareholders are comprised of dividends and capital gains, with the latter generated by retained (i.e. not paid out as dividends) earnings and their growth over time. Over long periods of time, dividends and capital gains each account for about half of total returns.

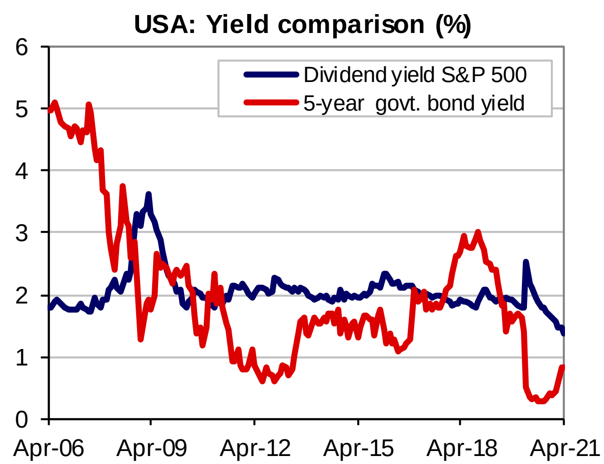
Free cash flow yields – the basis for sustainable dividends – are currently around 4% in Europe and the USA. When adding 2% nominal growth p.a. over the medium term (a conservative estimate for real economic growth plus inflation) we get to a total return of about 6% - 7% p.a. This constitutes an attractive value proposition, particularly when compared to low bonds yields.



*Key sectors. Source: Own calculations



Source: Index provider



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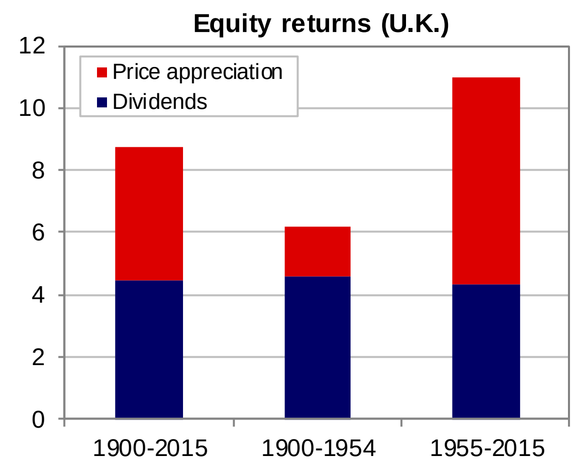

Source: Barclays

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