Active is: Anticipating what's ahead

2021 mid-year outlook: post-Covid, should investors worry about inflation?

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The economic outlook is positive at the mid-year point, thanks in large part to the significant economic stimulus packages over the past year, but all this growth may come at a price. Investors need to think broadly to navigate an environment of uneven global growth and higher inflation expectations.

Four investor takeaways for the rest of 2021

1. In the post-Covid boom, investors must navigate diverging economies, high valuations and higher inflation

The global economy continues to reaccelerate after last year's severe slowdown. While the Covid-19 pandemic isn't over, vaccines are helping some parts of the world turn the corner and the hope is that risks will decrease as the year progresses. Looking ahead, investors need to navigate uneven levels of economic growth across countries and sectors, and the diverging amounts of fiscal and monetary stimulus around the world. And they need to factor in higher inflation.

- The United States will power the global economy in 2021, largely thanks to its successful vaccine drive and massive stimulus packages. Some forecasts show upwards of 6% year-over-year US GDP growth. US equities – while quite expensive – have continued to enjoy a strong rebound since the market lows of early 2020.
- China already enjoyed its strongest post-coronavirus rebound, posting 18.3% year-over-year GDP growth in March 2021, before slowing to a more moderate rate. Equity markets have consolidated after a strong 2020. We consider the pullback a healthy development that sets a more solid foundation for the future.

Key takeaways

- Higher inflation is one of the main risks at the mid-year point, making it important to preserve purchasing power and guard against market volatility
- We still have a bias towards risk assets, albeit with some caution, so consider a more neutral position along the risk/return spectrum – at least for the short term
- Consider keeping durations short and managing positions actively: bond markets may get nervous about inflation and central bank action
- The case for sustainable investing continues to strengthen in the post-pandemic recovery, and ESG factors will be critical for assessing a new array of risks and identifying previously unknown opportunities

- The European Union is having a slow economic recovery from the coronavirus-induced recession. Some EU countries are still struggling to contain the spread of the virus and vaccinate their populations. It may be some time until Europe turns around fully, but European equities are cheap. This may be a good time to consider increasing allocations.

- Emerging markets are suffering the most – particularly India and Brazil – with the coronavirus exposing long-running problems with economic inequality. Developed nations will need to make a concerted effort to help other countries with virus containment and vaccinations.

Investment implications

Overall, economic growth has returned forcefully, bringing a boost to capital markets, though growth will likely remain below the pre-Covid growth trend for years (see **Exhibit 1**). This boom in the economy and markets also comes at a potential price, and we expect to see policymakers respond in a way that investors will want to factor into their strategies.

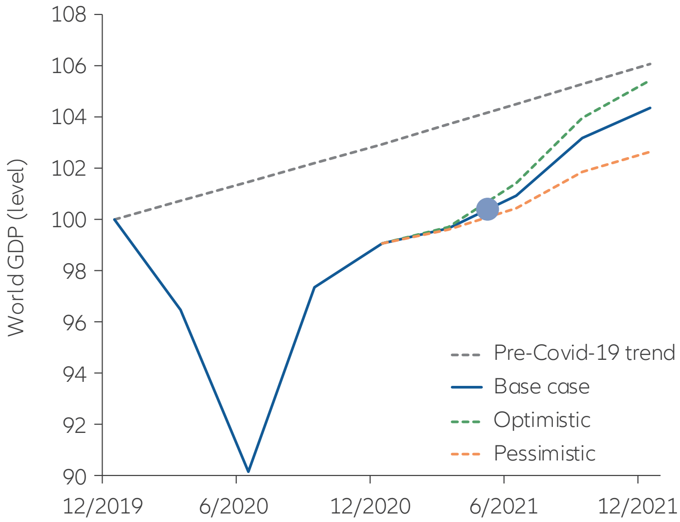
- A spike in inflation this year – and potentially beyond – makes it important to preserve purchasing power with additional sources of return.
- The US Federal Reserve plans to slightly raise rates in 2023 in response to stronger-than-expected economic data and rising inflation. Markets could become more volatile depending on how these moves are telegraphed and enacted.
- We still have a bias for risk assets – albeit with some caution. As such, we don't think investors should "de-risk" their portfolios, but rather consider a more neutral position along the risk/return spectrum – at least for the short term.

2. In this "lower for even longer" environment, keep an eye on inflation

Economic stimulus will continue to be a major investment story in the second half of 2021. The overall level of global economic stimulus (in the form of fiscal and monetary policy measures) will be lower than the record-setting levels implemented last year. This is because recovering economies require less stimulus, and because governments don't want to add to their debt levels unless it's absolutely necessary. Indeed, some emerging markets will be reining in their fiscal spending and tightening their money policy by hiking rates.

Exhibit 1: despite a sharp rebound, global growth is below the pre-Covid trend – which was already subdued

GDP forecast (2020-2021)



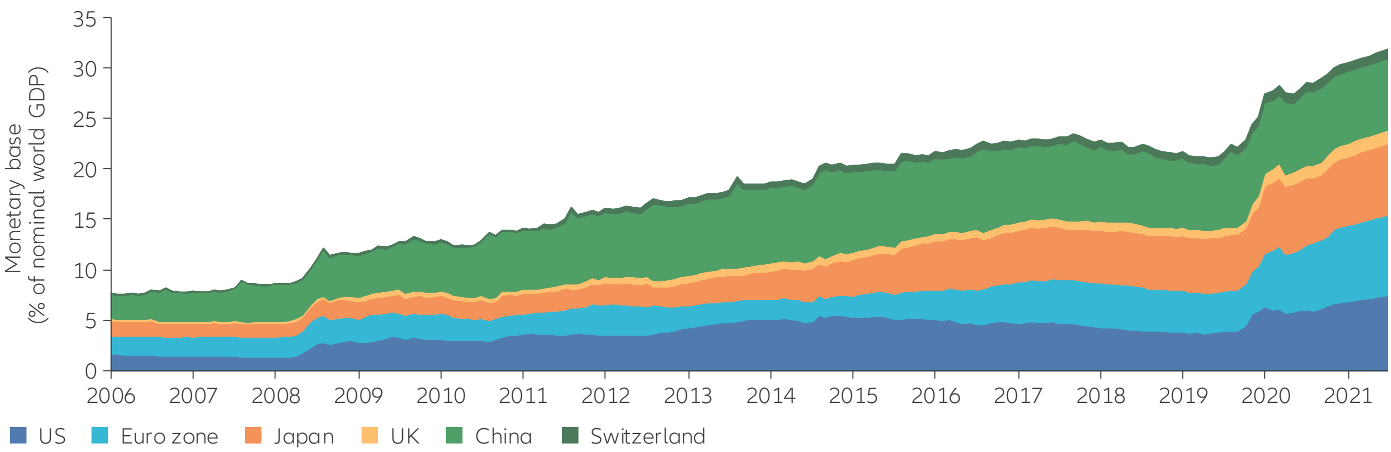
Source: Bloomberg, Allianz Global Investors. Data as at May 2021.

But the picture is different in developed markets – particularly the US, where we expect to see some additional fiscal spending programmes and tax cuts this year. All this spending is raising concerns about "nanny capitalism", with central banks effectively beholden to their governments by funding this spending. Major central bank balance sheets are at all-time highs and projected to push up further in the coming quarters (see **Exhibit 2**).

One consequence of this massive policy stimulus, both fiscal and monetary, has been a notable spike in inflation that started in the second quarter following the swift economic recovery and shrinking global output gap (meaning there's less spare capacity in the economy). Other contributing factors include the ongoing supply chain disruptions for companies around the world and the "base effect" of commodity prices, particularly energy costs, that have risen notably from last year.

Exhibit 2: central banks have ramped up already massive asset purchases

Monetary base (bank reserves + money in circulation) as a % of GDP



Source: Bloomberg, Allianz Global Investors. Data as at May 2021.

There is also evidence that the rise in inflation is not purely transitory. For example, monetary aggregates – the amount of money circulating in an economy – have skyrocketed during the Covid-19 crisis in response to unprecedented monetary stimulus. Furthermore, a continuation of the deglobalisation trend – as countries seek to be self-sufficient with essential goods – would further drive inflationary pressures. There are also tentative signs of rising pressure on wages, which gets passed on in the form of higher prices.

Given all these factors, it's possible that inflation may be even higher than expected beyond 2021 – or at least the markets may price in a rising probability of this outcome. And if this scenario is on the cards for next year, we expect the markets would begin pricing it in much earlier. The financial markets will closely watch how central banks react to inflation and stronger-than-anticipated economic growth – particularly the US Federal Reserve. The Fed has been following an "average inflation targeting" approach, which means it will be comfortable with a temporary overshooting of its 2% goal. But the recent spike in inflation has already gotten the Fed's attention, prompting officials to announce their plans for small rate hikes in 2023. The market has also been expecting the Fed to start "tapering" its bond-buying, probably in 2022. Both these moves could trigger some volatility depending on how they are managed by the Fed.

So with inflation going up, at least temporarily, and with central banks set to tighten monetary policy sooner or later, bond yields have risen since the beginning of the year. But we continue to believe that over the long term, real interest rates (which have been adjusted for inflation) will stay low compared with their long-term averages given that certain structural trends – including shifting demographics, low productivity growth and high debt levels – will keep economic growth low as well. And all else being equal, economic growth and interest rates historically track each other relatively closely.

Investment implications

- **Fixed income:** We have a bias for keeping durations short. Many bonds are expensive, and not just sovereign debt: investment-grade and high-yield debt is pricey. If bond markets get more nervous about inflation and central bank action, yields may rise (and prices fall). Investors will want to manage their positions actively in this environment, but lower prices may also present an attractive opportunity. Income replacement will continue to be a challenge in today's low-yield environment.
- **Equities:** Central bank liquidity and a general "risk-on" attitude have pushed up the prices of equities. US stocks are expensive – perhaps they're even in bubble territory – but they may "bubble up" further in the next six to 12 months. European and Asian equities are cheaper and moderately priced compared to historical levels. We favour the value style of investing over growth currently, but – in the long run – tech stocks also have an important role to play. Focusing on companies that emphasise sustainable business practices – including environmental, social and governance (ESG) issues – can help investors navigate a possibly bumpy road ahead.
- **Risk management:** Consider agile risk management strategies. In a low-yield environment, many investors acknowledge that they will need to take more risk to achieve their objectives. The key is to take this risk in a managed way.

3. Consider any setbacks in Chinese equities as an opportunity to re-establish a longer-term position

This year has been a case study in the exciting potential and stress-inducing volatility that have long characterised China's capital markets. After China's authorities successfully managed the country out of the Covid-19 crisis last year, and reported stellar year-over-year GDP numbers in early 2021, China's equity markets sold off dramatically in February and March. The authorities' clampdown on the internet sector earlier this year played a notable role, as did profit-taking among previous stockmarket winners. Since then, China's equity markets have been relatively calm but moved mostly sideways.

Throughout it all, corporate China has been doing well, with most companies meeting or exceeding expectations and many companies reporting strong underlying demand. The internet sector remains under a cloud, however. Anti-trust regulators have now met with all major internet platforms to warn them about illegal business practices. In the long term, we believe these companies will continue to deliver faster growth than the overall economy, but the growth will likely be achieved in a different way than was historically the case. Valuations are set to remain under some pressure for the time being.

China's economic policies during the pandemic have been arguably the most orthodox of any major central bank around the world. Indeed, as the post-Covid recovery has taken hold, China alone among the major economies has acted to tighten fiscal and monetary policy. While the natural inclination of China's policy makers is therefore to take proactive steps to prevent the build-up of inflationary pressures and asset bubbles, the extent of any policy tightening for the rest of the year will likely be constrained.

Investment implications

In the short term, we would not be surprised to see a further period of consolidation in China's equity markets. Stocks have rallied strongly over the last year and some profit-taking would be entirely natural. In addition, as China takes prudent steps to normalise monetary policy, the very strong liquidity environment may become more moderate. In fact, we think the recent pullback was a healthy development that helps to set a more solid foundation for the future. It remains extremely important to be selective and ESG factors can be a good lens through which to identify companies that will continue to thrive in this environment.

In the fixed-income space, "onshore RMB" bonds (those traded in mainland China and denominated in CNY) offer an attractive opportunity to international investors. This is primarily thanks to their higher yields, compared with bonds from other major economies, and the diversification potential provided by their low correlations with other asset classes. Investors can also benefit from longer-term trends in China's bond markets. For example, China is the second-largest bond market in the world, and Chinese bonds are steadily being added to international benchmark indices. Increased investor interest can give early entrants the potential to benefit from price appreciation.

Over the longer term, we continue to see compelling reasons to invest into China. It is, of course, a relatively volatile asset class, so it's important for investors to have a long-term perspective and consider their comfort level with drawdowns.

4. Sustainable investing is the new standard

In the past year, global ESG assets under management reached USD 1.7 trillion, according to Morningstar. Already, over a third of global AuM now applies ESG criteria (see **Exhibit 3**), and this growth is set to continue. In fact, rather than diverting attention from sustainable investing, the Covid-19 pandemic – and its knock-on effects for society and economies – have accelerated this shift. Investors are increasingly convinced of the essential role that sustainable approaches play in driving investment performance and helping to manage risk. In particular, independent data shows the outperformance of actively managed ESG funds over their passive counterparts during the start of the pandemic, underscoring the value of an active approach to sustainable investing.[1]

As we head into the second half of 2021, the case for sustainable investing will continue to strengthen. In the post-pandemic recovery, ESG factors will be critical for assessing a new array of risks and identifying previously unknown opportunities. This should make investors more comfortable taking a "risk-on" stance, but we also urge caution. Economic growth paths – and monetary policies – are diverging. And multiple factors are dampening real economic growth: global fiscal policy is becoming less uniform and accommodative, supply chain and trade disruptions are pushing up inflation, and the number of "zombie" firms (businesses with low productivity, high debt and a high risk of default) is rising.

Assessing companies across the spectrum of ESG factors – and actively engaging with them to influence change – will be critical to test their resilience against this backdrop. The key is to identify those factors that are most influential for each individual company – such as greenhouse gas emissions, workers' rights and executive pay – and encourage them to increase transparency.

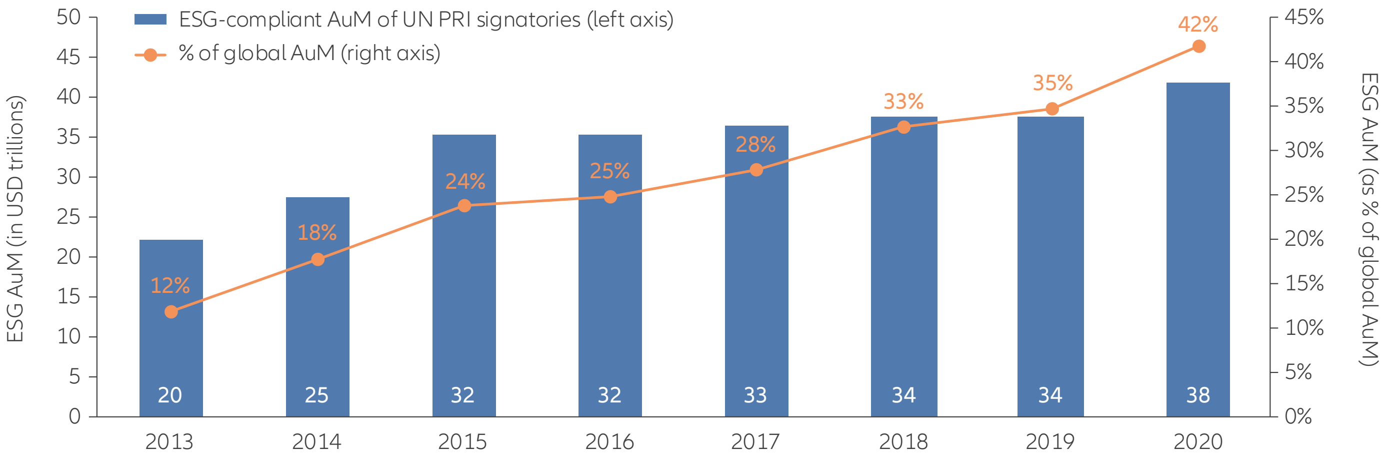
What the substantial growth in ESG assets indicates is that the case for sustainable investing – in terms of balancing risk and reward – is proven in many investors' minds. The priority now for investors is to see how these investments can create demonstrable, real-world change.

Investment implications

- Post-pandemic, many governments are pledging to "build back better" with a focus on areas such as green infrastructure and addressing social inequalities. Greater global cooperation on climate change and other key issues will also spark an array of projects that require funding. At Allianz Global Investors, we're committed to helping position our clients for these emerging long-term investment opportunities.
- Incorporate ESG factors into everyday decision-making to test companies' resilience in a challenging investment environment, and to drive change on urgent issues.
- Consider investments aligned with one or more of the United Nations sustainable development goals (SDGs). These 17 focus areas represent a call to action to address challenges facing society, representing potential market opportunities of USD 12 trillion.[2] These may include investments that address the implications of climate change for our "planetary boundaries", such as clean water and food security.

Exhibit 3: Over a third of global AuM now applies ESG criteria

ESG-compliant AuM of UN PRI signatories vs global AuM



Source: UN PRI (United Nations Principles for Responsible Investment). Data as at 2020.

[1] 2022: The growth opportunity of the century, PwC

[2] UN Secretary-General's Strategy for Financing the 2030 Agenda, United Nations Sustainable Development

- Explore growing opportunities in green debt. The pandemic and green infrastructure spending likely provide scope for new issuance.
- Many institutional investors are using impact investing in the private-markets space, in areas such as renewable infrastructure and development finance. It's a highly effective way to promote inclusive and sustainable growth in emerging and frontier markets.

Our 2021 mid-year regional outlooks

United States

The successful vaccine rollout and a decline in Covid-19 cases – in addition to low interest rates and ongoing fiscal stimulus – have driven improved economic and earnings figures so far in 2021. However, several potential headwinds could threaten an otherwise benign outlook for the second half of the year:

- The US economy hitting "peak reopening" growth – which will likely have occurred in the second quarter (see **Exhibit 4**).
- Rising inflationary pressures, which have prompted the Fed to consider hiking rates – and possibly tapering asset purchases – earlier than anticipated.
- Potential increases in corporate and personal taxes implemented by President Joe Biden's administration.

After a strong start to the year for US financial markets, we would expect bouts of volatility, albeit with an ongoing bias towards value/cyclical sectors throughout this year. Sectors such as financials can do well in a higher yield/steeper yield-curve environment, while energy and commodities should continue to perform given the pick-up in demand as the global economy reopens. Parts of infrastructure, clean energy and 5G are all supported by the Biden policy agenda.

Given strong growth and rising inflation, yields may continue to grind higher as well; we would expect the 10-year US Treasury yield to move towards the 2.00%-2.25% range over time. This dynamic may also continue to put downward pressure on long duration assets/sectors, including investment-grade corporate bonds and sectors such as growth and technology, as well as bond-proxy sectors.

Euro zone

After a weak start to the year, sentiment indicators suggest economic activity has already moved up a gear, signalling that a strong and broad-based rebound is possible once virus-containment measures are eased more markedly in the second half of the year.

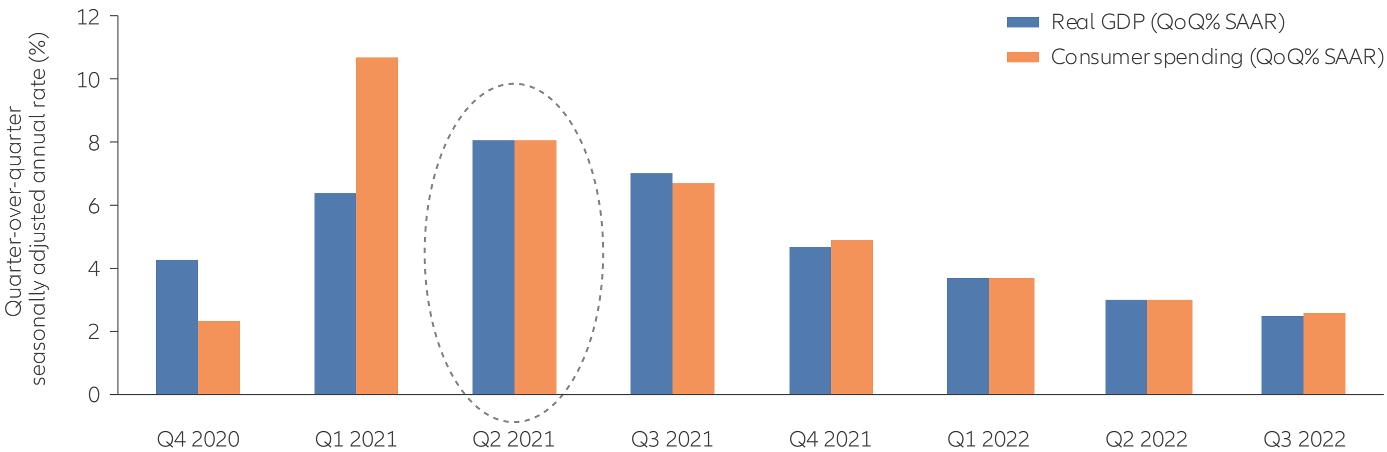
Private consumption is set to drive the recovery, together with a revival in investment and a stronger external environment, including robust US growth. Euro-zone inflation looks set to peak in 2021 before moderating in 2022. This will likely be due to rising energy prices and several transitory factors, including supply bottlenecks, tax changes and the "base effect" of a large jump from last year's lows.

Any economic recovery will continue to depend on economic policy support. The European Central Bank's monetary policy remains accommodative overall – even if its pandemic emergency purchase programme (PEPP) may not be extended beyond March 2022.

Amid continued pandemic-inspired uncertainty, accelerating growth should help corporate earnings – which will likely be the main driver of equity returns in 2021. Although we expect longer-term government bond yields to rise moderately, led by the US, rising inflation may be temporary and the overall low-yield environment should remain intact.

Exhibit 4: US expected to have achieved "peak reopening" growth in Q2 2021

Change in GDP and consumer spending through 2022 (estimated)



Source: Bloomberg, Allianz Global Investors. Data as at May 2021.

United Kingdom

We expect the UK economy to continue to rebound thanks to a swift vaccine rollout and the broader reopening of the economy. This will enable a catch-up in consumer spending – unleashing the high levels of household savings accumulated during the pandemic. Fiscal policy should remain supportive even as post-pandemic stimulus fades towards the end of the year. Inflation is expected to rise during the second half, but underlying cost pressures are mounting only gradually.

Post-Brexit trade frictions (particularly non-tariff barriers) continue to weigh on exports, despite the trade deal agreed with the EU at the end of 2020. There is little evidence yet that the slump in trade with the EU will be offset by stronger trade with the rest of the world.

China

Thanks to effective containment of Covid-19, China's economy has largely returned to its trend growth rate. The balance of growth remains uneven, however, spearheaded by a manufacturing sector that benefits from strong export and domestic investment demand, while also relying on still-recovering levels of consumption.

Fiscal and monetary policy support have begun to normalise, which could be less helpful for risky assets, but China's authorities will remain vigilant to prevent any issues from arising. From a broader geopolitical perspective, strained relations with the US may yet have an impact on the outlook for China's trade and finances.

The recent pullback in China's equity markets should be viewed as a healthy development, bringing valuations to more attractive levels. In recent months, markets have had a calmer feel as the extreme profit taking of previous winners has subsided. This trend is reflected in the performance of growth stocks in the China A-shares markets (stocks traded in Shanghai and Shenzhen), which have made up lost ground on value stocks (see Exhibit 5).

China's fixed-income markets also offer investors the kind of yields that are hard to find in other major economies, where rates could remain lower for even longer. Still, China's markets are volatile, so investors should keep a long-term perspective.

Japan

Despite a recent rise in new Covid-19 cases, Japan has begun its vaccination programme and the delayed Olympic games are scheduled to take place in Tokyo this summer. Against this backdrop, we expect domestic demand to recover gradually during the second half. Meanwhile, Japan's external demand (the sum of exports minus imports) looks set to remain firm thanks to a continued recovery in global capital expenditures.

Price pressures remain muted despite an improved growth outlook, so the Bank of Japan has sought to make its monetary policy framework more sustainable.

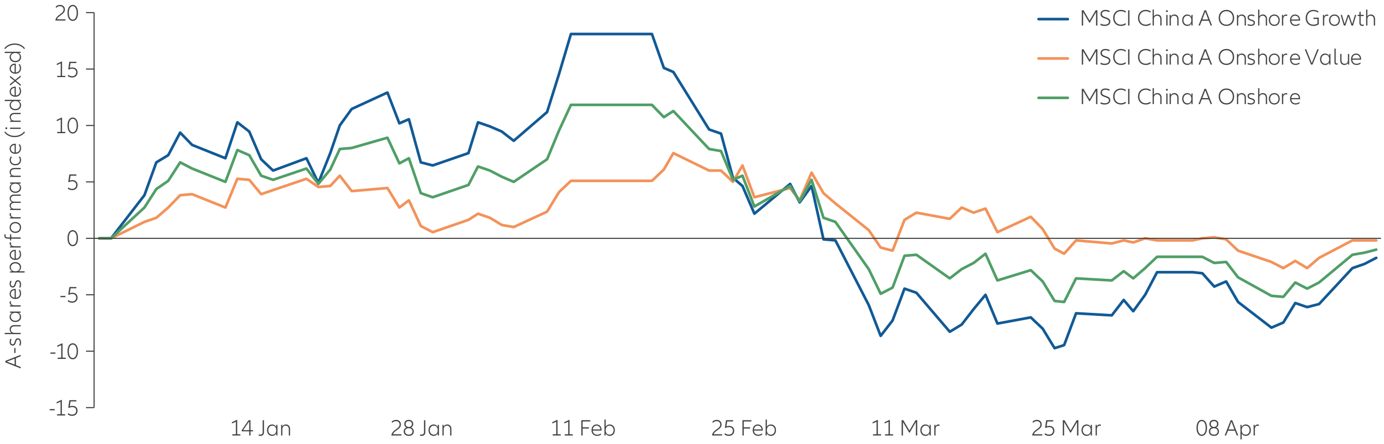
Emerging markets

A global economic recovery and modestly weaker US dollar are helpful conditions for most emerging markets. While the world's major central banks have pledged to maintain their broadly accommodative stance through a temporary rise in inflation, some EM central banks have begun to tighten. Indeed, central banks in Turkey, Brazil and Russia have already started to raise rates, and the expected increase in inflation may lead others to do the same.

The threat of a renewed pickup in Covid-19 infections is particularly acute in emerging markets. While their progress in tackling the pandemic continues to lag developed markets, they are set to make more progress on this score towards the end of 2021. We continue to expect the recovery in emerging markets to be both fragile and unevenly spread. Generally, those countries that have been most successful in containing the pandemic – such as South Korea and Singapore – look to be best positioned.

Exhibit 5: China A-share growth stocks have made up lost ground

MSCI China A Onshore Index – growth vs value (2021 year to date; in USD; indexed)



Source: Refinitiv Datastream, Allianz Global Investors. Data as at 21 April 2021. The MSCI China A Onshore Index is an unmanaged index that captures large- and mid-cap companies listed on the Shanghai and Shenzhen exchanges. Investors cannot invest directly in an index.

Allianz Global Investors is a leading active asset manager with over 690 investment professionals in 23 offices worldwide and managing EUR 598 billion in assets for individuals, families and institutions.

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Data as at 31 March 2021

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