LOOKING BEYOND PEAK GROWTH

The first half of the year has seen a broad-based improvement in business and consumer sentiment in advanced economies but elevated levels of business surveys reduce the likelihood of further significant increases. The third quarter is expected to see the peak in quarter-over-quarter GDP growth this year. Nevertheless, over the remainder of the forecast horizon – which runs until the end of next year – quarterly growth is expected to stay above potential. This favourable outlook for the real economy brings challenges for financial markets. Surprising to the upside in terms of earnings will become more difficult. Moreover, there is the question of the inflation outlook. For the time being, both the Federal Reserve and markets are relaxed about it but we should expect that over the coming months, the market sensitivity to growth and inflation data will be higher than normal in view of what they would imply for the Fed's policy stance.

The first half of the year has seen a broad-based improvement in business and consumer sentiment in advanced economies on the back of vaccination campaigns that were gathering speed, a declining number of new infections, the easing of Covid-19-related restrictions as well as ongoing policy support, both monetary and fiscal. International spillovers also played a role as reflected in the upbeat assessment of export order books.

In the US, first quarter real GDP growth has been strong but the second quarter should see an even better performance. The Eurozone has been lagging thus far, although after a contraction of GDP early on in the year, growth should be positive in the second quarter, but still lower than in the US. This should change in the third quarter, with a particularly strong performance in the Eurozone expected to outpace the US. How good can it get? Elevated levels of business surveys reduce the likelihood of further significant increases. Sectors that have seen an unleashing of pent-up demand – leisure, hospitality, retail, etc. – when restrictions were lifted, should gradually see a return to a more normal activity. In other sectors – the car industry, the construction sector – supply constraints may act as a headwind to growth.

Looking at advanced economies in general, the third quarter is expected to see the peak in quarter-over-quarter growth this year, with the increase in GDP slowing down thereafter. Nevertheless, over the remainder of the forecast horizon – which runs until the end of next year – quarterly growth is expected to stay above potential. Several factors should underpin this performance. Better company profitability and rising capacity utilization should boost corporate investments and lead to the creation of new jobs. Hiring plans of companies have already picked up, which bodes well for the employment outlook. As a consequence, households will feel less uncertain about the future, which should support spending, all the more so considering the savings accumulated during the lockdowns. Fiscal policy should still provide support, in particular in the Eurozone, with the gradual deployment of the Next Generation EU funds. Finally, ongoing easy monetary policy will facilitate the financing of private and public spending.

However, this favourable outlook for the real economy – activity, demand, employment – comes with challenges for financial markets. Slower GDP growth makes it more difficult for listed companies to surprise to the upside in terms of earnings. Another issue is what happens to inflation, in particular in the US. Inflation has spiked to 5% on the back of base effects – last year prices were subdued in many sectors due to the drop in GDP and lockdowns – and imbalances between supply and demand. The percentage of manufacturing companies reporting higher input prices is getting close to reaching record levels. The Federal Reserve argues this should be a temporary phenomenon considering that demand growth should slow and supply should pick up, although the number of FOMC members advocating a rate hike next year has increased. Rather than causing turmoil in the bond market, this has actually reinforced the credibility of the central bank, witness the recent decline in breakeven inflation. Nevertheless, we should expect that over the coming months, the market sensitivity to growth and inflation data will be higher than normal in view of what they would imply for the Fed's policy stance.

REAL GDP GROWTH

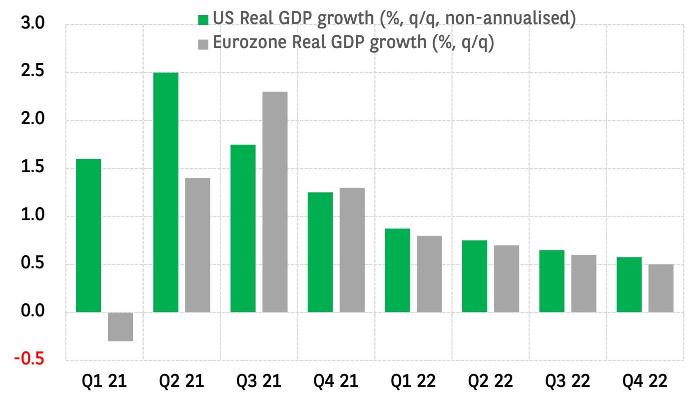

CHART 1 SOURCE: BLOOMBERG CONSENSUS (JUNE 2021), BNP PARIBAS

PRICE PRESSURES

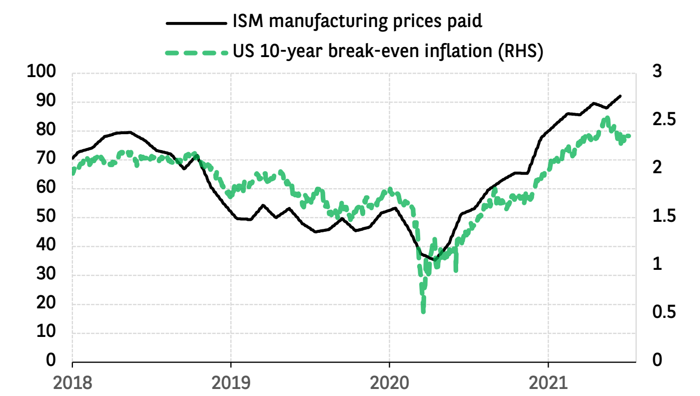

CHART 2 SOURCE: ISM, REFINITIV, BNP PARIBAS

William De Vijlder
william.devijlder@bnpparibas.com