EDITORIAL

UNDERLYING STRENGTH, BUT GATHERING CLOUDS

Recent data show business and consumer sentiment has peaked and real GDP growth is expected to slow down whilst remaining well above potential. A key factor in this respect is the self-reinforcing interaction between spending, company profits and employment, against a background of easy monetary and financial conditions. In using the popular metaphor, until recently, the economic sky looked quite blue but clouds have been gathering. The message of central banks should become a bit more hawkish, in the US, political disagreement influences the economic agenda of the Biden administration and China is going through a major adjustment phase. Most importantly, supply bottlenecks continue to weigh on growth whereas the jump in gas and energy prices is raising concerns that inflation might stay high for somewhat longer.

The first half of the year has seen a broad-based improvement in business and consumer confidence in advanced economies but recent data show sentiment has peaked. Depending on the country, the second or third quarters should see the peak in quarter-over-quarter GDP growth this year. Subsequently, growth should slow down. The 'mechanical' recovery in sectors that initially had suffered from restrictions and later on benefitted from the lifting of these constraints, has run its course. Supply bottlenecks weigh on growth in a large number of sectors, in particular in the construction sector and the automobile industry. They act as a speed limit to growth but also exert an upward pressure on prices. This can in turn act as a headwind for consumer spending, through its impact on real disposable income, and corporate investments, through downward pressure on profit margins. In many countries, corporate capital formation has been very dynamic during the recovery and this accelerator effect may also start to lose some steam. Finally, a less expansionary fiscal policy implies that, as of next year, private demand will be called upon to sustain growth at a high level. Despite these various factors, real GDP growth should remain well above potential, underpinned by low interest rates, easy access to financing, increased resilience – thanks to high vaccination levels – to potential new waves of infections and the self-reinforcing interaction between spending, company profits and employment. In using the popular metaphor, until recently, the economic sky looked quite blue.

Clouds have been gathering however. We have moved from a monothematic world –centered around the sanitary situation- to a multi-thematic world, which is even more difficult to come to grips with in view of the number of moving parts. The message from major central banks is changing. Norway, South Korea and New Zealand have already seen rate hikes and the Bank of England is also sounding more hawkish. The Federal Reserve is expected to start tapering its asset purchases in November – an operation that should go smoothly – but, more importantly, an increasing number of FOMC members project a first rate hike next year. This prospect should put upward pressure on Treasury yields – with global spillover effects – and might also weigh on the risk appetite of investors globally, leading to a more volatile market environment. This in turn can have repercussions in the real economy. The importance of political factors is also on the rise. In the US, the prospect of next year's mid-term elections will complicate the task of the Biden administration to implement its economic policy agenda. In Germany, forming a new government will probably take considerable time. Its composition should influence the fiscal policy stance in Germany but also the debate on new fiscal rules at the European Union level. The Chinese economy is experiencing major adjustments following tighter regulations in various sectors and an effort to address the problem of elevated debt levels of certain state-owned and private enterprises. Slower Chinese growth will have global repercussions, via commodity markets and trade flows. Finally, a succession of supply-side shocks have increased uncertainty about the outlook and created upward pressure on prices. Business surveys in manufacturing and services continue to point to very high pressure in terms of input prices, despite a slight recent easing, and selling price expectations have also increased markedly. Delivery lags are still very long. In the euro area, the shortage of material and equipment are key factors weighing on production. Demand is not an issue considering that the vast majority of sectors have well-filled order books, compared to the long-term average but also compared to the pre-pandemic level. Supply-side bottlenecks reflect strong demand but also ongoing supply disruptions higher up in the global supply chain, causing significant increases in shipping freight rates and long delivery lags. Recently, another type of supply shock has emerged with the huge increase in gas prices, with knock-on effects on the price of electricity. Strong demand – on the back of the economic recovery, efforts to rebuild inventories that had dropped to very low levels and low production of wind energy – as well as supply issues play a role. Higher energy prices should weigh on household spending but they may also contribute to inflation staying high for longer. This has fueled a stagflation narrative, although this looks more like a description of a downside risk rather than a base scenario. Indeed, inflation should decline next year due to base effects and the easing of supply pressures, whereas growth should stay above potential.

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US AND EUROZONE BUSINESS SURVEYS

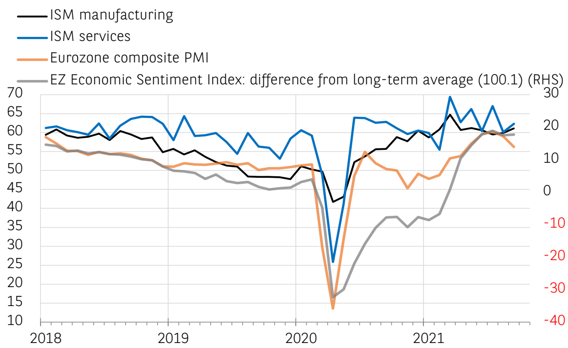

CHART 1 SOURCE : ISM, IHS MARKIT, EUROPEAN COMMISSION, BNP PARIBAS

STAGFLATION WORD COUNT IN BLOOMBERG ARTICLES (7-DAY MOVING AVERAGE)

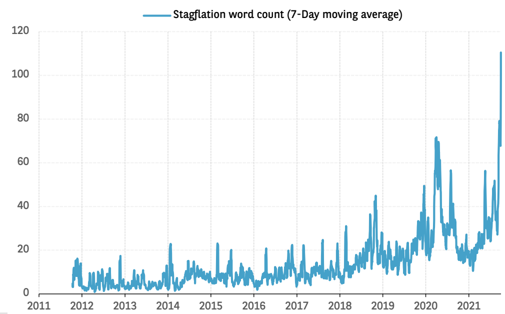

CHART 2 SOURCE: BLOOMBERG, BNP PARIBAS