

THE (UNWARRANTED) STAGFLATION NARRATIVE OF 2021

Strong US and Eurozone GDP growth in the second and third quarters should be followed by a gradual slowdown. Due to the 'acquis de croissance' going into the fourth quarter, the perceived slowdown versus the third quarter could be much bigger than what shows up in the current forecasts. In the US, the current elevated inflation will take time to decline. In conjunction with slowing growth, this could boost the stagflation narrative. Such a depiction of the economic environment seems unwarranted however, considering that inflation should decline further in the first half of next year and that the US economy should continue to grow above potential.

As we move into the second half of the year, what is to be expected in terms of economic growth? The question matters for businesses, households and governments – is there need for additional stimulus – but it should also influence the communication and decisions from central banks.

During the course of the second quarter, household and business confidence have continued to improve in a large number of countries. Concerning the latter, we have reached multi-decades highs in the US and are close to previous peaks in the Eurozone (chart 1). When business surveys have reached elevated levels, the likelihood of moving significantly higher goes down, implying a loss of growth momentum.

According to the Bloomberg consensus, the peak in quarterly real GDP growth has probably been reached in the second quarter of this year in the US and, in the euro area, this is expected to occur in the third quarter. Subsequently, growth is anticipated to slow down gradually over the rest of the forecast horizon, which stretches until the end of 2022. By then, growth should still be above potential, but far less so than is currently the case.

This slowdown shouldn't come as a surprise as it will follow a big growth acceleration that, to a large degree, has been mechanistic, triggered by the lifting of Covid-19-related restrictions that has been made possible by rapidly rising vaccination numbers. In many countries, Google mobility data for the retail and leisure sector have already converged back to the pre-pandemic reference point taken at the start of 2020. When activity and demand have to a large degree normalised, inevitably, monthly and quarterly growth is expected to slow. Whether this is an issue first and foremost depends on the extent of the slowdown. The Bloomberg consensus is projecting a rather gentle deceleration in the US and a somewhat bigger decline in the Eurozone.

However, one should keep in mind that part of the growth in the fourth quarter will reflect an 'overflow effect' (*acquis de croissance*) from the previous quarter. This effect can, relatively speaking, be quite sizeable. Suppose that GDP, after having grown linearly throughout the third quarter, remains stuck for the remainder of the year at the level reached in September. In such a scenario, quarterly growth in the fourth quarter would still be around 0.6% (non-annualised). It implies that of the current Bloomberg consensus forecast, approximately half is explained by this statistical effect. This could mean that the perceived slowdown would be much bigger than what shows up in the forecasts.

Whether this matters depends on the perspective taken. Households and businesses may very well focus on the ongoing improvement in the labour market, in sales numbers, profits, etc. Financial markets on the other hand may be more concerned because they are far more sensitive to changes in the pace of growth. As shown in chart 3, German Bund yields tend to decline once the European Commission's economic sentiment index for the Eurozone has peaked. Charts 4 and 5 show the sensitivity of financial analysts to growth momentum. When business surveys in the US and the Eurozone start to decline, net revision activity of earnings for the next 12 months is impacted. Upward revisions still dominate downward adjustments, but far less than before. This may weigh on the risk appetite of investors.

ISM, PMI & ECONOMIC SENTIMENT INDICATOR

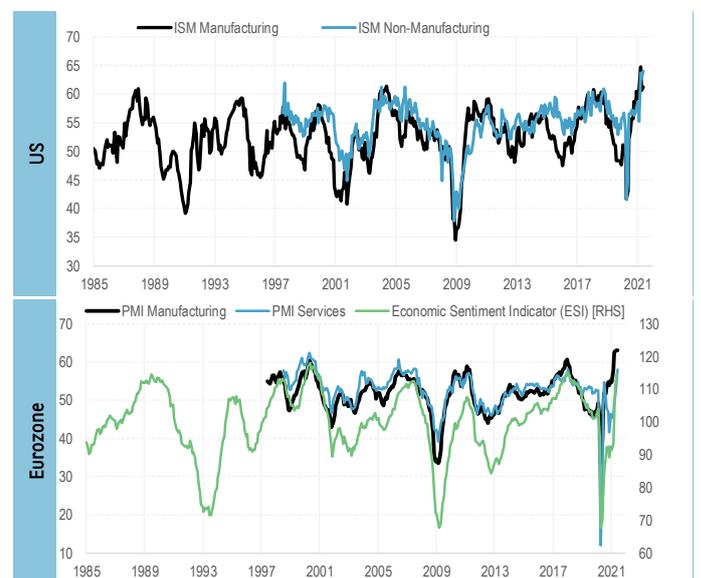


CHART 1

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

Due to the 'acquis de croissance' going into the fourth quarter, the perceived slowdown versus the third quarter could be much bigger than what shows up in the current forecasts.



The extent of the growth slowdown is also relevant from another perspective. During the press conference after the latest FOMC meeting, Fed chairman Jerome Powell was asked by a journalist "doesn't it seem like there's a risk of [...] stagflation. If you're going to go from 7 percent and down, that means the economy's really [...] dropping in some way"¹. Due to base effects – comparison with prices that, last year, were particularly low due to the lockdown measures – and temporary factors – supply bottlenecks –, the decline of annual inflation in the US in the second semester will probably be rather slow. In conjunction with slowing growth, this could boost the stagflation narrative. Such a depiction of the economic environment would be unwarranted however, considering that inflation should decline further in the first half of next year and that the economy should continue to grow above potential.

William De Vijlder

1. Source: Federal Reserve, Transcript of Chair Powell's Press Conference, 16 June 2021. The name of the journalist is Gregg Robb from MarketWatch.

BLOOMBERG CONSENSUS

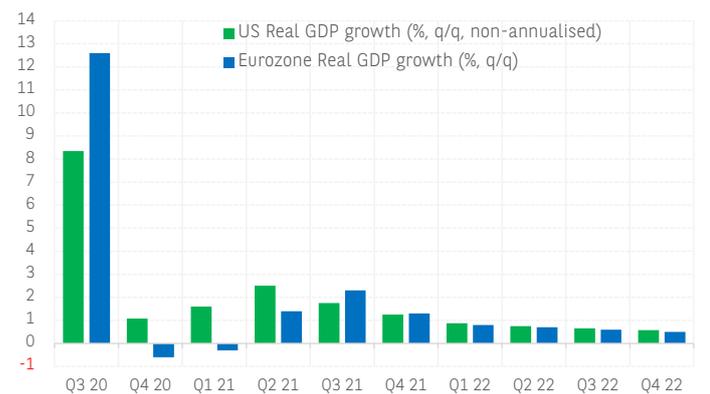


CHART 2 SOURCE: BLOOMBERG CONSENSUS (24/06/2021), BNP PARIBAS

UNITED STATES: EARNINGS REVISIONS & ISM

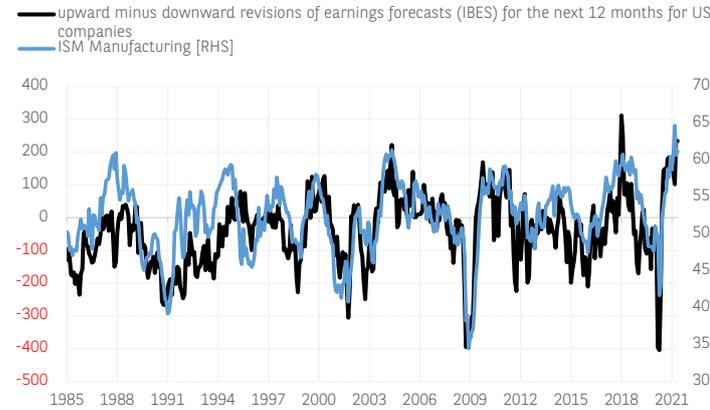


CHART 4 SOURCE: ISM, IBES, REFINITIV, BNP PARIBAS

EUROZONE ESI AND 10-YEAR BUND YIELD

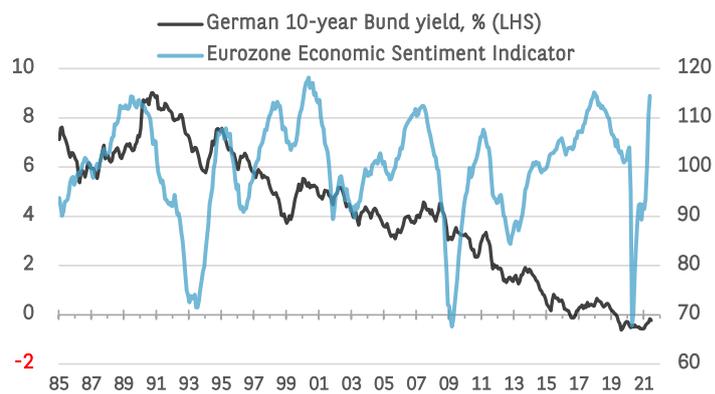


CHART 3 SOURCE: REFINITIV, EUROPEAN COMMISSION, BNP PARIBAS

EUROZONE: EARNINGS REVISIONS & ISM



CHART 5 SOURCE: EUROPEAN COMMISSION (DG ECFIN), IBES, REFINITIV, BNP PARIBAS