On the Minds of Investors

May 2021

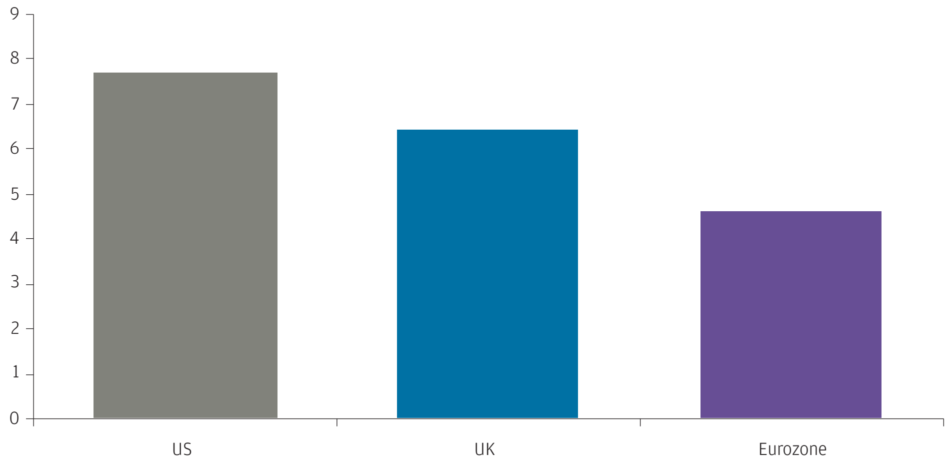
It's getting hot in here: Growth and inflation are heating up

The great unlock is underway and economic activity is surging back in major developed economies. Successful vaccine rollouts have paved the way to what looks like a sustainable reopening for the UK and US economies. In continental Europe, the vaccine rollout has proved more challenging, but vaccinations are now accelerating and Covid-19 cases are falling. This sets the scene for a stellar second half of the year for global growth, with two key sources of fuel: excess household savings and US fiscal stimulus.

Excess savings accumulated during the pandemic are vast. While the hardship that the pandemic has brought to many should not be understated, the swift and forceful action of policymakers to support businesses and consumers has successfully limited the damage to household incomes. With restrictions limiting households' ability to spend, monthly savings soared to levels far above those observed in a "normal" recession. Totting up the excess household savings for 2020 – the amount saved last year above what consumers normally put away – the numbers are extraordinary (**EXHIBIT 1**).

EXHIBIT 1: 2020 EXCESS HOUSEHOLD SAVINGS

% of nominal GDP



Source: BEA, Bloomberg, Eurostat, ONS, Refinitiv Datastream, J.P. Morgan Asset Management. Excess household savings are defined as the aggregate amount that the consumer saved in 2020, in excess of typical annual savings for a given economy. Data as of 30 April 2021.

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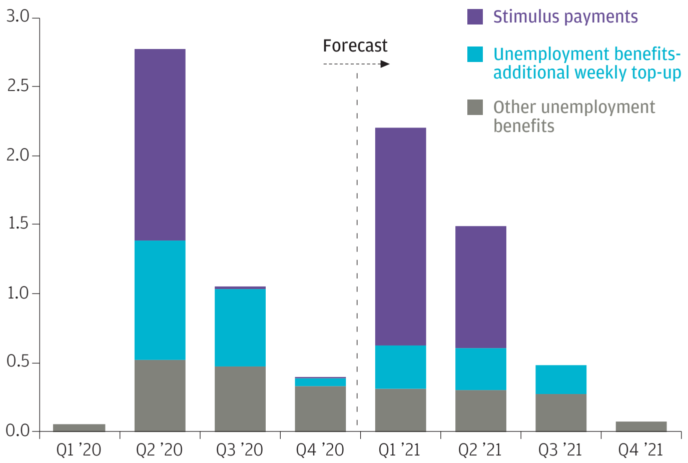
On top of the excess savings accumulated in 2020, US consumers also benefit from the recently announced USD 1.9 trillion stimulus package, which is extraordinary in four ways. First, its size: it is worth about 9% of US GDP. Second, its speed. About 5% of GDP will be doled out before the end of September. Third, its timing. The stimulus is being delivered when the economy is recovering, rather than contracting. And finally, its nature. USD 400 billion of the stimulus is in the form of cheques in the post. For example, a family of five with a total income of under USD 150,000 will receive a combined USD 7,000 in stimulus cheques. The package will boost household incomes enormously in the first half of this year (**EXHIBIT 2**).

EXHIBIT 2: SELECTED US GOVERNMENT BENEFITS

% of nominal GDP



Source: BEA, Congressional Budget Office, Joint Committee on Taxation, Refinitiv Datastream, J.P. Morgan Asset Management. JPMAM forecast from Q1 2021 onwards. Data as of 31 March 2021.

ROARING GROWTH AND THE RISKS

Disagreement among forecasters about whether these pots of excess household savings will be spent is leading to significant dispersion in forecasts (**EXHIBIT 3**).

The unique nature of this crisis and the policy support that followed means that history provides little precedent. Some argue savings won't be spent because they are concentrated in higher income groups, where the marginal propensity to spend is less. But this is a highly unusual situation in which consumers have been *forced* to save rather than *choosing* to save, so normal propensities to consume may not hold. We suspect the outcome will be towards the top end of estimates.

Is this a US or a global story? The US will almost certainly see more spectacular growth than its developed world peers this year. However, we expect it to be a global story by the end of the year. Not only are other regions reopening with considerable pent-up domestic savings, but some of the US fiscal stimulus will boost growth elsewhere.

As the saying goes, when the US sneezes the rest of the world catches a cold. But it is also true that when the US has a party the rest of the world gets an invite, so we expect this US spending to help fuel growth in regions where stimulus has not been so generous. European and Asian economies are both major beneficiaries of a pickup in US growth, accounting for over a fifth and over a third of total US goods imports, respectively.

EXHIBIT 3A: US REAL GDP QUARTERLY GROWTH FORECASTS

% change quarter on quarter (annualised)

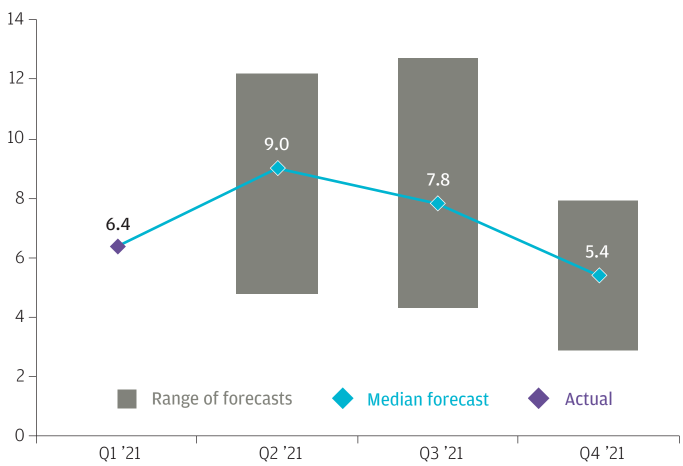
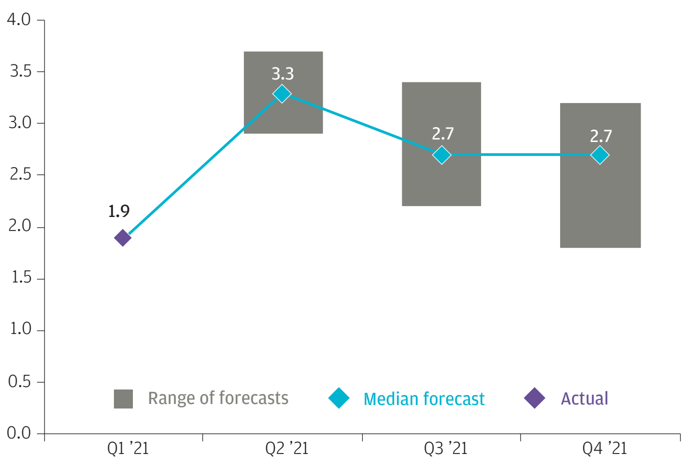


EXHIBIT 3B: US HEADLINE CPI FORECASTS

% change year on year, quarterly average



Source: Bloomberg. J.P. Morgan Asset Management. CPI is consumer price index. Data as of 30 April 2021.

INVESTMENT IMPLICATIONS

How will markets react to roaring growth? It depends whether the bounce back is even more spectacular than the market already expects.

Consensus expects S&P 500 earnings to grow nearly 30% this year, and a further 14% next year. The fact that the S&P 500 sits on a forward price-to-earnings ratio of 22 may suggest that investors are more optimistic about the prospect for earnings than the analysts who provide estimates of forward earnings. Should 12-month forward earnings continue to rise as we expect, the market could climb higher. Declining valuations would moderate some of that upside, leading us to expect a more gradual pace of gains than we have seen so far this year.

The bond market is potentially more vulnerable to repricing, particularly if the bounce back is in inflation as much as growth.

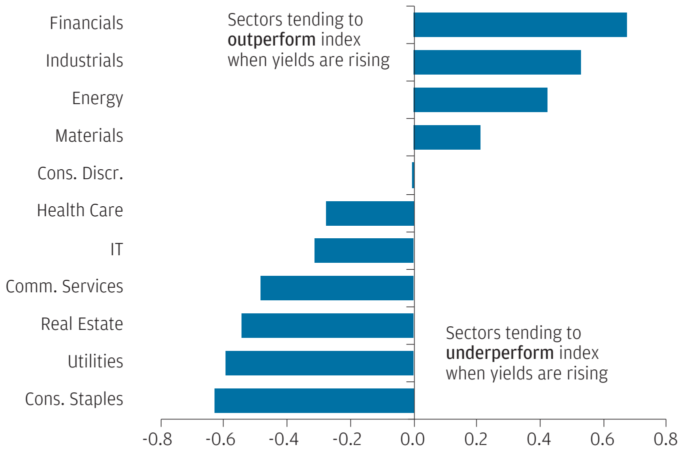
The Federal Reserve (Fed) has already said it will tolerate what it expects will be "transient" inflation, but indications of a more persistent pickup would test its resolve. Under its new average inflation targeting scheme, the Fed has said it will not raise rates until three conditions are met: inflation has risen to 2%; is on track to moderately exceed 2% for some time; and the labour market has reached maximum employment. While the first condition is clearly objective, the other two contain a good deal of ambiguity.

Rising yields may generate broader asset market volatility and can also drive the equity market leadership. Periods of rising yields tend to occur when cyclical sectors outperform the broader index, while the more defensive sectors are prone to struggle. In particular, rising yields help financials that benefit from increased economic activity and improving net interest margins (**EXHIBIT 4**). However, areas of the market that have benefited most from low bond yields may struggle.

In summary, we believe the stage is set for a spectacular growth recovery in the second half of the year. This might suggest some caution about duration in fixed income. Within equity markets, we would expect to see an ongoing rotation towards cyclical sectors and value stocks.

EXHIBIT 4: CORRELATION OF S&P 500 SECTORS TO US 10-YEAR TREASURY YIELD

10y correlation of sector rel. performance with US 10y Treasury yield



Source: Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. Correlation is calculated between the six-month change in US 10-year Treasury yield, and the six-month relative performance of each sector to the S&P 500. Past performance is not a reliable indicator of current and future results. Data as of 31 March 2021.

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