

# 2021 Outlook: From Pandemic to Pandemonium?

A Publication of BMO Capital Markets Economic Research • Douglas Porter, CFA, Chief Economist, BMO Financial Group

Sometimes the stars align, and everything just goes right—then there is 2020. After a year in which very little went right, perhaps it's encouraging that Jupiter and Saturn are moving into alignment next week. Apparently, the conjunction between the two planets on Monday—which is also the Winter Solstice—will be the closest in almost 800 years. But that's not a key plank in our above-consensus call for the global and Canadian economy in 2021. We believe that there are many, more compelling, signposts that activity is coiling for a powerful rebound in the coming year after an incredibly challenging spell.

The **global economy is expected to rebound 5.5% in 2021**, and then advance another 4.0% in 2022, after plunging 4.0% this year. To put those figures into some perspective, the prior worst recorded year in the post-war era had been a drop of 'just' 0.1% in 2009, while a typical year for the world economy in recent times would see growth something just a bit above 3%. A keen observer would note that even with our call of a strong rebound in the coming two years that the level of activity would still be well below its underlying trend by the end of 2022. Part of that shortfall reflects the simple fact that some of this year's loss on spending in the service sector—such as on travel, entertainment, restaurants—may never be recouped.

The other part of the shortfall, though, may also suggest that even our relatively upbeat view on the next two years is **actually understating the potential for growth to snap back**. Insofar as vaccines are rolled out effectively, and there is a strong take-up, there is a case to be made that we are underestimating growth in the second half of next year and into 2022. Incredibly supportive fiscal and monetary policies, robust financial conditions (i.e., lofty asset prices), heavy-duty pent-up demand, and the build-up of excess household savings in many economies point to the possibility of a serious burst in spending later next year.

**China** serves as a clear example of how forcefully things can bounce back as conditions return to something approaching normality. Both retail sales and industrial production have carved out nearly a perfect V-shaped recovery in the world's second largest economy. Famously, it will thus be one of the few nations to post any growth this year; some of the other lucky few will include Taiwan, Vietnam and Ireland. We look for China to build on this year's constrained 2% rise with a robust 8% surge in 2021, before easing back to a more trend-like 5% in the following year. The three-year average growth rate of about 5% will pale only somewhat compared with the pre-virus trend of just over 6%. The sturdy rebound is a major reason why non-oil commodity prices—particularly base metals—have seen such a remarkably fast recovery even amid the deepest global downturn in decades.

One implication of the relatively robust recovery in commodity prices, as well as the deep dive in interest rates and strong financial markets, is that **emerging markets held up relatively well overall**. Despite a vicious drop in global GDP and the wild

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financial market turmoil in the spring, most emerging market economies avoided the worst. While there were some very specific cases of financial strains—Turkey—most were able to slash borrowing rates, capital flows resumed after a brief stall, and currencies began to recover as the U.S. dollar faded through the second half of the year. This is not to minimize the severe challenges many emerging economies face, especially those heavily reliant on tourism. But, the resiliency of the developing world and a crisis averted on this front is a case of the dog that didn't bark.

In the **advanced economies**, sectors that were able to re-open did see a rapid V-shaped recovery in Q3 from the spring shutdowns, and that provides comfort for the call for strong gains in 2021. However, large portions of the economy have still been left behind, and the furious second wave has seen broadening and deepening restrictions across much of the OECD more recently. Amid the patchwork of varying and constantly changing measures, it's incredibly difficult to assess the economic damage from the second-wave containment steps. It appears that financial markets are all but ignoring the mounting bad news and focusing on the post-vaccine world. But that doesn't get around the fact that we are about to face a wave of tough economic statistics in coming weeks, most likely including an outright drop in European GDP in Q4, and a near-miss in other economies.

The **Euro Area and the U.K.** are going to report some of the biggest economic declines in the world for 2020, owing to both their especially challenging experience with the virus but also due to a heavy reliance on the service sector (notably tourism). The flip-side is that these economies may also be poised for the biggest snapbacks. After a near-7% drop in the Euro Area, we look for a 5.5% rebound in the coming year, and then a 3% advance in 2022. The U.K. was hit even harder with a massive 11% setback this year, with Brexit uncertainty weighing on top of everything else. With just days to go, the prospects for a trade deal with the EU are fading, but a partial recovery is still likely in 2021 even in a no-deal world. (On a technical note, the dive in U.K. GDP appears to be exaggerated by an unusually large reported drop in government spending, which may also set the stage for an unusually big rebound in 2021.)

Elsewhere, **Japan** saw a somewhat lighter hit than other major developed economies with a drop of just over 5% this year—everything is relative—even though it entered the year already in recession after last year's sales tax hike. Given that nation's weak underlying growth and a milder setback in 2020, we expect a more modest 3.5% recovery next year, even with the delayed Tokyo Olympics. **Australia** also was relatively less hard-hit, despite the massive wildfires at the start of the year, a one-sided trade fight with China, and a strong lockdown in Victoria. While the RBA is trying to hold it back, the Australian dollar is now up more than 10% from a year ago and not far from parity with the loonie at around 76 cents(US).

When the final numbers are in for 2020, one truly unusual development (among the many) is that the **U.S. economy** is likely to print one of the smallest declines in the advanced world. We have chopped this wood before, but the short story is that the U.S. benefited from some of the strongest policy medicine in the world as well as its outsized tech sector. However, we also have to point out that restrictions were relatively light in the U.S. compared to others—even now, with some of the highest virus caseloads in the world on a per capita basis—and thus the direct economic hit

was lighter. As the year draws to a close, markets are almost fully anticipating that a new round of fiscal support of \$900 billion (or a hefty 4% of GDP) is nigh, including direct payments of \$600 per individual. If enacted in a timely fashion, this could add to our upgraded call of 4.5% GDP growth for next year; we have also bumped up our 2022 call by half a point to 3.5%. Yes, one could say that the vaccine has moved the needle on growth, pardon the awful pun.

We have also tweaked our call on **Canadian growth** over the next two years. However, unlike the U.S., this revision is not one-sided to the high side. Full disclosure, we have been relentlessly on the high side of consensus for more than six months now, and remain there even with these revisions. Still, the deepening restriction measures in Canada, with the clear prospect of more in coming weeks—including new school closures in some provinces—have prompted us to trim our Q1 call to close to zero. Even with a stronger second-half rebound, courtesy of the vaccine (first injection just this week in Canada as well), this will clip the full-year estimate for GDP growth by half a point to 5.0%. But, at the same time, we are also lifting the view on 2022 on the upbeat vaccine developments by half a point to a sturdy 4.5%, leaving activity at the same spot as we had expected before by the end of that year. While we have trimmed our 2021 call, note that the risks appear evenly balanced; that is, there is still some serious upside risk to this forecast, and the recent strength in commodity prices, and financial markets in general, are certainly pointing in that direction.

Beyond the growth outlook, of course there are many, many other economic issues and concerns swirling in this tumultuous environment, which are mostly covered in this week's Focus publication. But one pressing question we have fielded almost since the first days of the pandemic response is whether there is a **risk that inflation could return** amid the tidal wave of stimulus. These concerns may well grow louder in the coming year, especially if growth comes close to the upside possibilities. And the Fed has essentially told us that they will tolerate a bout of above-target inflation. As if on cue, Canada printed a high-side surprise for CPI of 1.0% y/y in November, and the spurt in oil to \$49 points to further headline pressure. But also note that Japan, China and the Euro Area are all still posting outright declines in headline prices, while core inflation is effectively stuck in neutral in North America. Ultimately, while the tail risks for inflation have fattened, we believe that even in a world of a potentially rapid recovery, overwhelming slack in many sectors, and an overhang of unemployment for years, any burst in headline inflation will simply not be sustained.

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