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Light at the End of the Tunnel?

PROFESSOR ANDREA BOLTHO

Duff & Phelps Real Estate Advisory Group (REAG) Advisory Board Member
Emeritus Fellow, Magdalen College, University of Oxford

JANUARY 2021

Medical science has made some amazing progress in recent months and at least two COVID-19 vaccines began to be administered in some countries in December of last year and more are in the pipeline. Such very welcome developments gave a shot in the arm to stock markets and, more importantly, led to widespread upward revisions to the economic outlook for 2021 and beyond. There are, of course, still numerous uncertainties: how powerful are the vaccines? for how long will they provide immunity? will they protect against new variants of the virus? what share of a country's population will be vaccinated?, etc. All this notwithstanding, there is a palpable feeling that there may be light at the end of the tunnel.

The tunnel, however, is still here and the world economy is still stuck in it. Across most advanced economies and many emerging ones as well, the much feared second wave of COVID-19 infections is rampant. Indeed, compared to what happened in the spring, the autumn-winter outbreaks look more like a tsunami than a wave. An inevitable consequence has been a new round of confinement directives and travel bans in numerous countries which are bound to have hurt activity in the last quarter of 2020 and will continue to do so in the current quarter as well. Following the sharp upsurge witnessed almost everywhere in the middle of last year, which led to hopes of a V-shaped recovery, the present outlook is, instead, for a W-shaped cycle. From the second quarter of this year onwards, however, most forecasters predict a renewed upswing followed by a period of above average growth.

The outlook looks like being most favourable in the world's two largest economies: the U.S. and China. In both, developments last year turned out to be better than had initially been feared, particularly so in America. At mid-year, US GDP had been forecast to drop by some 6 per cent in 2020; at present, the decline is put at "only" 3½ per cent. 2021 should see a return to positive growth in excess of 4 per cent, helped in part by the recently approved fiscal package. In addition, America has avoided the danger of gridlock in congress. That should help President Biden's efforts at stimulating the economy in the longer run via very necessary infrastructure and green economy spending. As for China, thanks no doubt to its very early and very drastic lockdown, growth has remained positive through last year and could rebound to some 8 per cent this year. Indeed, such is the economy's present strength that the authorities are introducing some mild fiscal and monetary tightening.

Most emerging markets, other than China, were hard hit by the epidemic. Output in 2020 may have declined by some 3 to 4 per cent overall, with countries such as Algeria, Argentina, India, Mexico, the Philippines, South Africa, Tunisia, etc., particularly hard hit. Eastern Europe and Russia have, on the whole, suffered less than Western Europe and some countries may even have been able to grow, if modestly (e.g. Egypt, Taiwan, Turkey, Vietnam). Recovery is in sight almost everywhere and growth for the emerging world outside China could return to some 5 to 6 per cent this year. Such a forecast, however, might yet turn out to be overly optimistic should widespread vaccination campaigns stumble in the absence of sufficient vaccine supplies.

Western Europe remains a weak economic link. Growth last year was marginally stronger than had been anticipated earlier on, but the year on year output drop will still be of the order of 7 per cent in the Eurozone and of as much as 10 per cent in the United Kingdom. Even with a rapid recovery from the 2nd quarter onwards and into 2022, a return to the 2019 output levels will have to wait for late 2022 at the earliest for most countries.

Policies will remain supportive for the foreseeable future. The European Central Bank has announced that it will maintain, indeed reinforce, its accommodative stance. There will be more asset purchases (mainly government bonds) and banks will be offered additional liquidity at a negative interest rate. On the fiscal front there is clearly no appetite for a return to austerity. Budget deficits will be reduced somewhat from their record 2020 levels, but this will mainly reflect the expected upswing in activity. And the EU's Next Generation Fund may be able to start disbursing funds to member countries towards the end of this year. Growth will also be helped by the savings which many households have accumulated in the recent past. This could lead to an uptick in inflation at mid-year as booming demand encounters some bottlenecks or outstrips a hesitant recovery in supply, but a return to long-lasting inflationary pressures is highly unlikely.

Within Western Europe, the sharpest falls in activity (of the order of -9 to -11 per cent) were recorded by the UK and by the tourist dependent economies of Greece, Italy, Portugal and Spain, with France also suffering more than proportionately. Germany did significantly better with an estimated decline in GDP of 5¼ per cent and should see a return to 2019 levels of output by mid-2022. The best performances were recorded in Scandinavia (including Finland). For that area as a whole (as well as for Switzerland), GDP may have declined by barely 3 per cent.

Manufacturing has performed better than services through the year. Interestingly, however, one service activity (real estate) has gone against the trend. In the United States and in China house prices have been rising reflecting, perhaps, relatively strong economies. House prices have, however, risen, at times quite sharply, also in the UK and other West European countries (Spain being a lonely exception). Very low interest rates are clearly one reason for this. Another may be linked to rising demand for larger housing consequent upon confinement measures and a move towards work at home.

The 2021 recovery is likely to be less uneven than was the 2020 recession. France and Spain could see growth rates of 5 to 6 per cent, with Germany and Italy expanding by 3½ to 4½ per cent. Britain's expected growth of 4½ per cent is disappointing given last year's sharp drop in GDP. But the country is being hard hit by a new COVID variant and by Brexit. The agreement with Brussels that was painfully reached as 2020 came to a close is, of course, better than the "hard" Brexit that a "no deal" would have entailed, but it will still restrict trade, significantly reduce immigration from the EU and stifle productivity growth.

	GDP GROWTH RATES (%)				
	2019	2020	2021	2022	2023
Eurozone	1.3	-7.1	4.3	4.9	2.1
United Kingdom	1.4	-10.3	4.5	6.4	2.3
United States	2.2	-3.5	4.2	3.5	2.1
China	6.1	2.1	8.1	5.0	4.9
World	2.5	-3.9	5.0	4.3	3.1

Source: Oxford Economics.