
# The Atlantic gap widened

# 89 – 3 May 2021

## Key points

- While the US GDP is less than 1% below its pre-pandemic level, the Euro area fell back in recession. The outlook is improving in the latter though, as a gradual reopening is within sight. Still, we are disappointed that the time it took to set up the Recovery and Resilience Fund means that the EU may have missed a chance to lock in negative yields for its first big, mutualized issuance.

Last week the first estimate for Q1 GDP was released for both the US and the Euro area and the contrast was striking. While GDP is now less than 1% below its pre-pandemic level in the US after a 1.5% qoq expansion in the first three months of 2021 – even before the full effect of Joe Biden's emergency stimulus materialized – the Euro area fell back into recession, with two quarters in a row of negative growth. The quality of growth in the US is also impressive. True, as expected the biggest contribution to GDP in Q1 came from consumer spending as the economy is re-opening, but the most "forward-looking" components of investment are also very robust. Taken together, capex on software, R&D and information processing equipment contributed more than 1% to US GDP growth over one year for the first time ever. Businesses seem to anticipate Biden's investment programme.

Still, the European outlook is brightening as well. In April, the services PMI in the Euro area has moved back in expansion territory for the first time in 8 months, a change confirmed by the European Commission survey. We look at the potential for a spectacular rebound in consumer spending when the economy reopens. France seems to be in favorable position, judging by the saving behavior there in the summer of 2020: it's the only big country of the Euro area where the savings' ratio came back very close to its long-term average after the Q2 peak. Incidentally we note that since the beginning of the crisis, the contraction in GDP has been larger in Germany than in France, although the difference is slim.

On both sides of the Atlantic, the pandemic remains of course the main risk. We are concerned by a deceleration in vaccination in the US, which may reflect resistance from a significant share of public opinion, jeopardizing swift progress towards collective immunity. There was a slight deceleration in France as well.

Yet, despite Jay Powell's renewed efforts last week at reassuring on the Fed's stance, real yields in the US rose again last week. We suspect the constant flow of new fiscal announcements from the US administration is fueling this. Meanwhile, in the Euro area long-term yields continued to rise despite the ECB's acceleration in bond purchases. Financial conditions remain supportive, but we note that the EU is missing a chance to lock-in negative yields for its multi-annual mutualized Recovery and Resilience Fund.

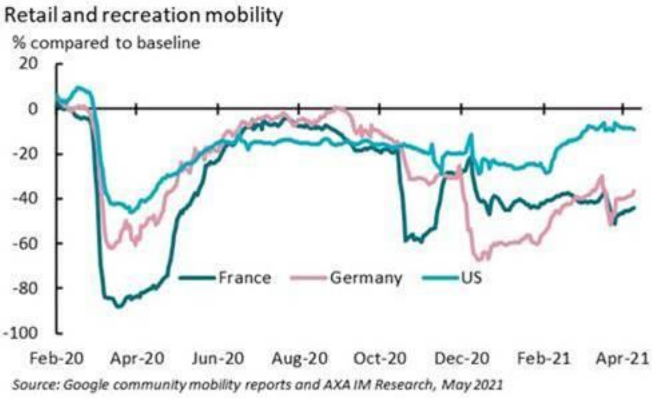
## Seeds of strong growth ahead in the US Q1 GDP

With GDP growing by 6.4% in annualized terms in Q1 2021 (1.5% quarter-on-quarter as we usually look at it in Europe), **the US economy is now less than 1% below its pre-pandemic level even before the full impact of the additional fiscal stimulus launched by Joe Biden has materialized.** Unsurprisingly, consumer spending performed very well, last quarter bringing a contribution of 1.8%qoq to GDP, thanks to the reopening of the economy combined with the government transfers. Interestingly, when looking at the latest Google reports, there is not much difference on mobility around the workplace between the US and Europe (see Exhibit 1), still around 20% below its normal level in both cases. “Working from home” has clearly taken hold on both sides of the Atlantic. But mobility around locations where spending takes place (retail and recreation) has shot up in the US (see Exhibit 2).

What households have been spending on is interesting. Consumption of goods has been consistently exceeding its pre-pandemic level since Q3 2020 (in Q1 2021 it was a whopping 12.5% above the Q4 2019 level), as US households were reallocating their spending away from services (still down 5.7%). The shift back towards services as the reopening unfolds should help reduce the steep acceleration in imports which has inflated the US current account deficit and has shaved off GDP growth in this rebound (net exports brought a negative contribution of 0.3%qoq in Q1 2021). Also encouraging is the fact that the change in inventories contributed negatively to GDP in Q1 – possibly because producers were surprised by the strength of demand, which bodes well for further growth in output in Q2 beyond the impact of a more complete re-opening and the remainder of Biden’s fiscal push.

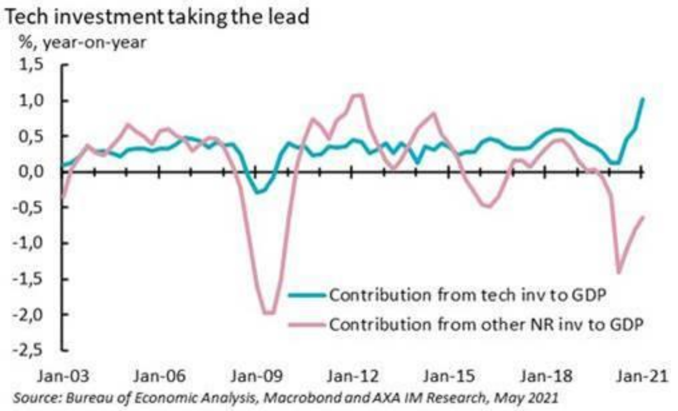
Exhibit 1 – No return to the office


Exhibit 2 – But Americans know where to spend….




**Investment is a key area of interest given its long-term impact on the economy’s growth potential, and the signals there are encouraging**. In Q1 2021, the three most “forward-looking” components of non-residential investment (software, information processing equipment, Research & Development) for the first time brought a contribution to US GDP growth of more than 1% over one year, more than offsetting the decline of the more traditional forms of capex - the rest on non-residential investment is still contributing negative to GDP growth (see Exhibit 3).

Exhibit 3 – “Good investment” is in the driver’s seat



These three items now stand more than half of total non-residential investment in the US. A surge in this type of spending – in particular software – was not surprising at the height of the pandemic in Q2 2020. That it was confirmed in the following quarters would suggest that **digitalization is not a "flash in the pan".** The US corporate sector is pre-empting the "Biden push" on tech spending.

The US is ticking quite a few boxes these days**. On the pandemic front, the news flow is quite positive, with virus propagation abating significantly despite reopening** after a transitory hump at the beginning of April. New cases stood at 149/million in the week to May 1stl from 205/million two weeks before, and mortality is down as well (from 2.15/million to 2.04 during the same period). **An issue to watch though is the recent deceleration in the pace of vaccination.** True, as of May 1st 43.7% of the population had received at least one shot, but at a weekly pace consistent with covering 75% of the population in early August only, while two weeks ago this threshold was on course to be met in late June already. So far, the US has had one of the most seamless programmes in the world, eschewing logistical issues and relying on vaccines which have proved the most efficient against variants. It may be difficult to "cover the last mile" though, since the recent deceleration may well reflect the resistance of the "anti-vaxxers". Reluctance to get vaccinated in the US is often correlated with political leaning, and the Republican strongholds in the South-East are among the states lagging behind on vaccination.

## Fed unfazed, but market is not sure

**The improvement in the data was saluted by the Fed last week, which among other tweaks removed the notion that "considerable" risks remain to their outlook. But this does not alter their overall dovish communication stance.** Powell put to bay very early in his statement market concerns over "early tapering", and his narrative is unchanged: yes, inflation is going to continue accelerating in the coming months, but this is likely to be the product of base effects and momentary bottlenecks while slack is still ample enough of the labour market to keep any proper self-sustained acceleration in consumer prices under control. Powell made of course the nearly mandatory point that should they be wrong in their assessment they would do what's needed to stop an inflationary spiral.

Where do we go from here? Investors have collectively pushed further the expected timing of the first Fed Funds hikes – even if market pricing is still far ahead of the Fed's dot plot and its take-off in 2024 – which suggests that Powell and the FOMC in general have been quite persuasive, but **the rise in long-term yields since Joe Biden's election is only partly the result of market expectations regarding the trajectory of monetary policy**. At the end of last week, and despite Powell's dovish comments, 10-year US yields were at 1.64%, still below the 1.74% recent peak on April 5th but retracing half of their mid-month slide (1.52% on April 15th). We know we may sound like a broken record but supply and demand of US treasury securities are key ingredients and given the almost daily fiscal announcements by the US administration, supply is likely to continue being revised up.

**The latest on the US fiscal front is the American Families Plan (AFP) of social spending worth USD1.8trn. to be funded by an increase in the capital gains and dividends tax**. Some key aspects of the AFP are extensions in scope and duration of the tax cuts/family credits targeted at the low- and median-income Americans in the emergency package launched two months ago, but there are also some new elements which go beyond wealth redistribution and tackle well-known shortcomings of the US educational system, e.g. making two years of community college free for all. No pure transfers then, but an effort which beyond supporting social mobility could benefit the US growth potential by improving human capital. Still, the cost of the package is staggering, and we have doubts as to the capacity of the planned tax increase to "plug the hole".

**Indeed, many Democratic lawmakers are finding themselves in a complicated position**. Donald Trump had antagonized many wealthy individuals in high-tax Democratic strongholds such as New York and California by limiting the capacity to remove from the federal tax base municipal and state tax payments. Relying on such wealthy donors in future campaigns might become more difficult for Democrats if they unleash another round of tax hikes. While it would probably be politically thorny for Democrats in Congress to completely reject Joe Biden's flagship tax initiative – widely supported by activists – but repealing the "double taxation" moves by Trump could be very tempting, ultimately reducing overall federal resources.

## Meanwhile, in the Euro area…

**While the US GDP has grown by 2.5% cumulatively in Q4 2020 and Q1 2021, the Euro area fell back in recession** with two quarters in a row of negative growth, -0.6% in Q1 2021 after -0.7% in Q4 2020, leaving GDP more than 5% below the pre-pandemic level (Q4 2019). In Q1, the decline was particularly acute in Germany (-1.7%qoq) while France managed to eke out a positive number (0.4%). **The cumulative GDP loss since the start of the crisis is now higher in Germany (4.9%) than in France (-4.4%).**

Early estimates of the impact of the pandemic on GDP have to be taken with a pinch of salt and precision within 0.5% may well be spurious at this stage. Still, if confirmed, Germany's underperformance would be counter-intuitive given the specialization of the two countries: manufacturing-intensive economies should do better than the ones dominated by services. The level of sanitary restrictions does not seem to provide an easy explanation either. The timeline since the beginning of the crisis differs, but according to the "stringency index" created by the Blavatnik School of Government, on average since February 2020 restrictions have been very similar across the two countries (60.2 for France and 62.1 for Germany). The German federal statistical office never releases a quantified breakdown of its first estimate of quarterly GDP, but its qualitative comments mentioned a particular weakness of consumer demand, which coincided with the normalization of the VAT rate after the temporary cut last year. Still, this would suggest that on the whole this fiscal measure has been perfectly useless, as we suspected.

**Fortunately, Q2 is already looking better as an easing of mobility restrictions now looks like the general direction in the Euro area. Confidence in the services businesses is already improving**, albeit tentatively, with the PMI in this sector edging above 50 in April (50.3) for the first time in 8 months. This was confirmed by the European Commission business survey for the same month, with a positive services confidence index for the first time since the beginning of the crisis.

**Germany has taken the lead on vaccination after a hesitant start. Taking the pace of inoculations of the week to April 29 as a reference, Germany is on course to cover with at least one shot 75% of its population by mid-July**. France is now lagging behind, in slight deceleration in the last week, and at the current pace the 75% threshold would not be met before the end of September. Reaching collective immunity in the EU as a whole this summer thus remains a challenge. A key issue to watch in the coming weeks is whether the deceleration in the vaccination programme in France was mere statistical noise or if it is already starting to reflect a reluctance in segments of public opinion to take part although only 22.9% of the population has received at least one dose as of May 1st.

This would go against the message from the latest polls though, since support for the vaccines has been rising in France over the last 5 months. Odoxa has been regularly polling on this issue. In December 2020 only 42% of respondent were certain to get vaccinated. This rose to 56% in January, 61% in February and 70% in April, with only 14% remaining absolutely hostile. On that basis, the recent slowdown in inoculations would be more easily explained by the continuation of logistical issues combined with, possibly, some "strategic behaviour" to try to secure the vaccines which so far have been assessed as more efficient and least prone to secondary effects.

**From a macro point of view, the magnitude of the immediate rebound upon reopening in Europe will depend on the normalization of saving, since no massive short-term fiscal boost is likely.** Everywhere in the Euro area the level of saving today is significantly above what it was before the crisis. The readiness to spend it may differ. We look to the summer of 2020 for clues. After the Q2 peak, France was the country where the savings' rate came back closest to its long-term average in Q3 (see Exhibit 4), which explains how spectacular the recovery was then. It is also the country where savings rebounded the most in Q4. We do not have data yet for the savings' rate in Q1 2021, but the meagre 0.3% growth in French consumer spending would suggest that little of the "saving reload" of late 2020 has been spent. If France manages to lift most of the sanitary restrictions, we could expect a very strong rebound. The normalization of saving was much less complete in the other countries last summer.

The gyrations in household saving strengthen a point we have been making since the beginning of the pandemic: it is going to be very difficult to assess the underlying strength of the economy, and the possible need for some additional stimulus, immediately upon reopening. Detecting a potential "demand deficit" will take time.

Exhibit 4 – France nearly normalized its savings ratio last summer


## ECB: are the "relativists" winning?

**Looking through a potentially "data rally" when the economy re-opens is going to be difficult to navigate for the ECB and they are already laying the ground for a very prudent assessment**. Philip Lane in his latest interview last week expressed his belief that the Euro area has reached an inflexion point and sounded fairly positive but still cautioned that *"the fact we're rebounding from the worst of it does not mean there's a full recovery"*. Christine Lagarde had also taken pains to avoid "accentuating the positives" upon reporting on the last Governing Council meeting.

Yet, we continue to think the central bank is divided between "absolutists", who want to keep financial conditions where they were at the end of last year, when the last expansion in PEPP was decided, and "relativists" who would tolerate some tightening as long as it reflects an improvement in the economic outlook. The latest market developments would suggest that the latter group is winning. True, the ECB has effectively raised its weekly quantum of purchases (within an unchanged PEPP envelope), but they could have pushed the programme to the point that yields are capped, which would be de facto yield targeting. As Exhibits 5 and 6 suggest, paradoxically after the ECB's March announcements of an acceleration in PEPP Euro area yields continued to rise even though they had retreated in the US.

Exhibit 5 – softly softly it's rising…

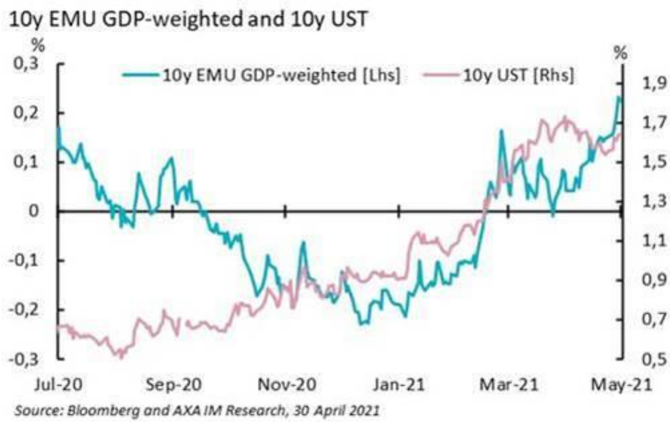
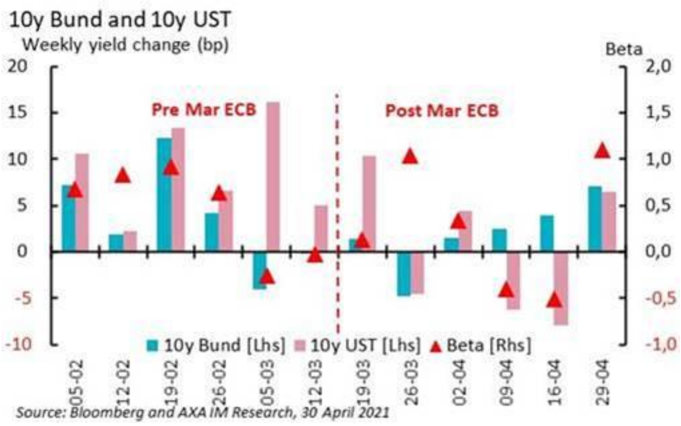
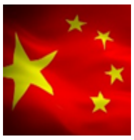



Exhibit 6 – …even when US yields fall




Arguably, that GDP-weighted 10-year yield are now at +0.25% in the Euro area instead of -0.2% does not contradict the notion that financial conditions are supportive, and the ECB would probably step up again its programme if the rise went on too far (we suppose that German Bund yield back in positive territory would trigger some alarm bells). Still**, the EU is missing a chance to lock-in negative yields for its multi-annual mutualized Recovery and Resilience Fund.**

Member states are unveiling their national programmes, which still need to be endorsed by the European Commission (see this blog post on Bruegel website for a first overview). We find it interesting **that Italy is the only big country which so far has decided to "max out" its allowance and use both the transfers and the loans' components** (to a total of EUR 205bn, i.e., more than 11% of its 2019 GDP, 60% of it as debt). Of course, this fits well with Draghi's "Rimini platform" we discussed on February 8th and his belief in "good debt" when it serves the purpose of lifting potential GDP growth. But there might be another reason: it is in Italy's interest to socialize its public debt within the EU institutions at ultra-low interest rate as much as possible to limit its dependence on fickler and profit-motivated private investors. Italy's 10-year yield is currently historically extremely low at 0.9%, but it has already risen by 45 basis points since a trough in February. Still, the funding cost of the expanded EU budget is also rising with core rates. The time it is taking to make the recovery and Resilience Fund effective – and we would not expect effective disbursements before the end of this summer – is already generating an additional cost for the overall framework.

| Country/Region | What we focused on last week | What we will focus on this week |
|---|---|---|
|  | • President Biden announced $1.8trn American Families Plan, part paid for by capital gains tax increases. Total spending plans now $6trn<br>• Q1 GDP rose by 6.4% (saar) – softer than our forecast, with inventory down and household spending less robust than forecast in March<br>• FOMC no policy change; inflation seen as transitory and "some time" before tapering<br>• PCE inflation (core) rose to 2.3% (1.8%) in March | • Non-farm payrolls (Apr) forecast to rise by close to 1m. Unemployment to dip to 5.8%, but this still underrepresents labour market slack<br>• ISM manufacturing and non-manufacturing surveys (Apr), both expected to remain robust around mid-60s<br>• Vehicle sales (Apr) could be a big beneficiary of pent-up demand and excess saving<br>• US trade (Mar), exp'd to show ongoing deficit widening<br>• MBA mort apps suggest sliding housing activity |
|  | • EA preliminary GDP dropped by 0.6%qoq, dragged down by Germany (-1.7%qoq), while France posted moderate growth (0.4%qoq)<br>• EC surveys echoed April Flash PMIs, showing rising confidence (hope) on the outlook<br>• EA flash headline inflation rose to 1.6%yoy on energy while core slowed to 0.77% on services | • German March factory orders and industrial production will be worth watching. Rising confidence signal further improvement, but impact of supply shortages may be negative (in particular on auto production)<br>• April Final PMIs to confirm confidence boost on reopening hopes |
|  | • Electoral Commission announce investigation into PM Johnson<br>• EU ratifies post-Brexit trade deal<br>• Nationwide HPI posts 2%mom gain, annual rate rises to 7.1% and highest since 2004<br>• BRC shop price index rises in April, consistent with further gains in CPI inflation | • MPC meeting and Monetary Policy Report. BoE to revise up GDP outlook, but inflation outlook lower. No policy change, but expect hints of tapering asset purchases over coming months<br>• Mortgage apps (Mar) ongoing housing strength<br>• Scottish and Welsh Parliamentary elections, England locals elections |
|  | • The government has imposed the state of emergency in Tokyo, Kyoto, Osaka and Hyogoas to curb a new wave of cases<br>• The BoJ's monetary policy remains on hold<br>• March IP surprised on the upside: +2.2%mom<br>• April consumer confidence decline | • The efficacy of the restrictions to curb the number of new cases and any acceleration in the vaccination campaign<br>• April Services PMI is unlikely to provide any improvements as restrictions have been reimposed |
|  | • PMIs came in mixed, with the NBS measure easing off the March high while the Caixin gauge continued to strengthen<br>• Accelerating vaccination saw China surpass the US in total inoculation, but still lags as % population | • Export growth continues to moderate on a yoy basis, but sequential momentum should improve from Mar's soft patch |
|  | • Daily new infection in India reached almost 400,000 by 29th April<br>• Q1 2021 GDP yoy recovered strongly to 1.7% in Korea, 8.2% in Taiwan. Mexico Q1 2021 GDP topped expectations at -3.8%yoy, +0.4%qoq<br>• Hungary, Colombia on hold last week | • CB meeting: Thailand, Malaysia, Poland, Turkey (on hold) but Brazil (to hike +75bp)<br>• April CPI in across EM<br>• April PMI surveys across EM<br>• Q1 2021 GDP in Indonesia |

| Upcoming events | | |
|---|---|---|
| | US : | Mon: ISM manu (Apr); Tue: Trade (Mar), factory orders (Mar); Wed: ISM non-mfg (Apr), ADP employment (Apr); Thu: Weekly jobless, ULC and productivity (Q1); Fri: Payrolls (Apr) |
| | Euro Area: | Mon: Manu PMI (Apr, f), Wed: Serv PMI (Apr, f), EA PPI inflation (Mar), Thu: EA retail sales (Apr), Ge manu new orders (Mar), Fri: EA ECB's Lagarde speaks, Ge current account (Mar), Ge, Fr, Sp IP |
| | UK: | Mon: Manu PMI (Apr, f); Tue: Lending data (Mar), M4 (Mar); Wed: New cars (Apr): Thu: Scottish & Welsh elections, England locals, Services PMI (Apr, f), MPC meeting and Monetary Policy |
| | Japan: | Golden Week |
| | China: | Tue: Caixin manu PMI (Apr), Thu: Caixin serv PMI (Apr), Fri : Trade (Apr) |

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