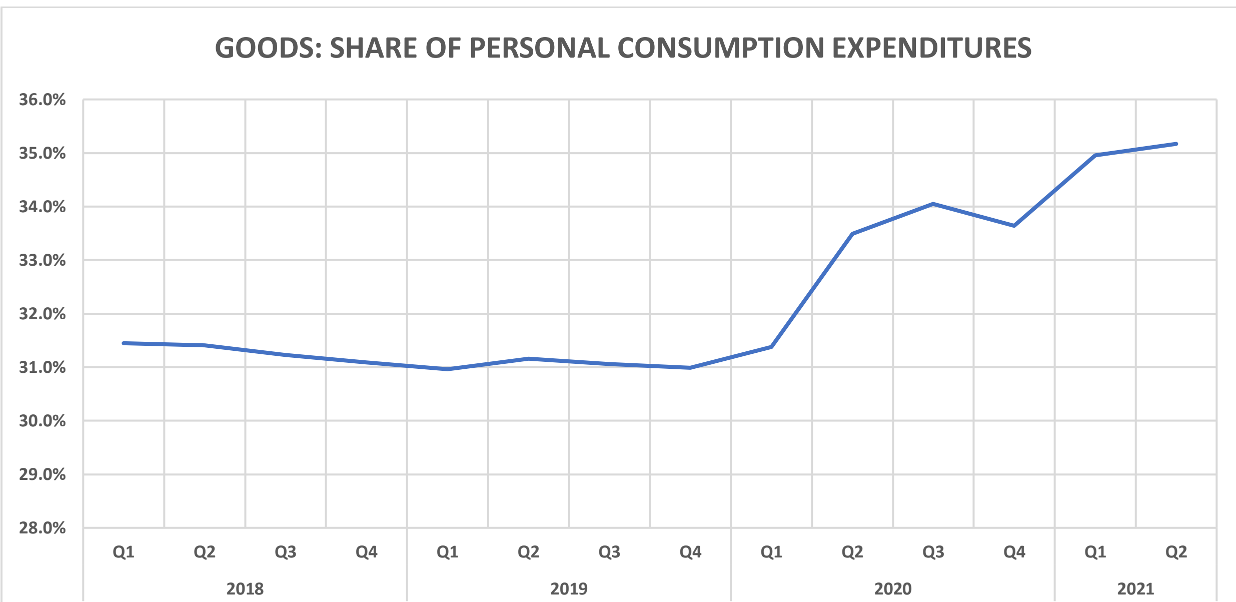
WORLD ECONOMY: PROSPECTS FOR THE SECOND HALF OF 2021.

There is sufficient evidence including high frequency data to suggest, as predicted, that there will be a sharp deterioration in the world economy over the second half of the year as stimuli runs out and debt and unemployment reasserts itself. Not that you would hear such things from Wall Street or the City of London. These "perfect markets" are still high on Central Bank pixie dust.

The latest US GDP for the previous quarter disappointed despite the infusion of Biden's Covid Relief Funds in April. Economists were expecting up to 8.4% growth, but growth came in at 6.5%. The figure of 6.5% is the inflation adjusted figure. The BEA used a deflator of 6.12% compared to the Bureau of Labour Statistics CPI-U index which stood at 9.68%. Even splitting the difference would have meant that growth would have come in at 4.7% meaning that the economy was no larger than at the start of the pandemic rather than being marginally larger.

The driver for GDP was of course personal consumption expenditures which added 11.8% compared to 11.4% in the first quarter. These PCEs were driven by the third Covid Relief Fund and continued capital gains on Wall Street. What significantly changed with consumption in recent times, was the switch over to goods consumption as the service sector closed or could not deliver. During the course of the first two quarters of 2021, goods expenditures added an average of 20% per quarter to GDP, while services added 8%. This trend can be seen in Graph 1 below.

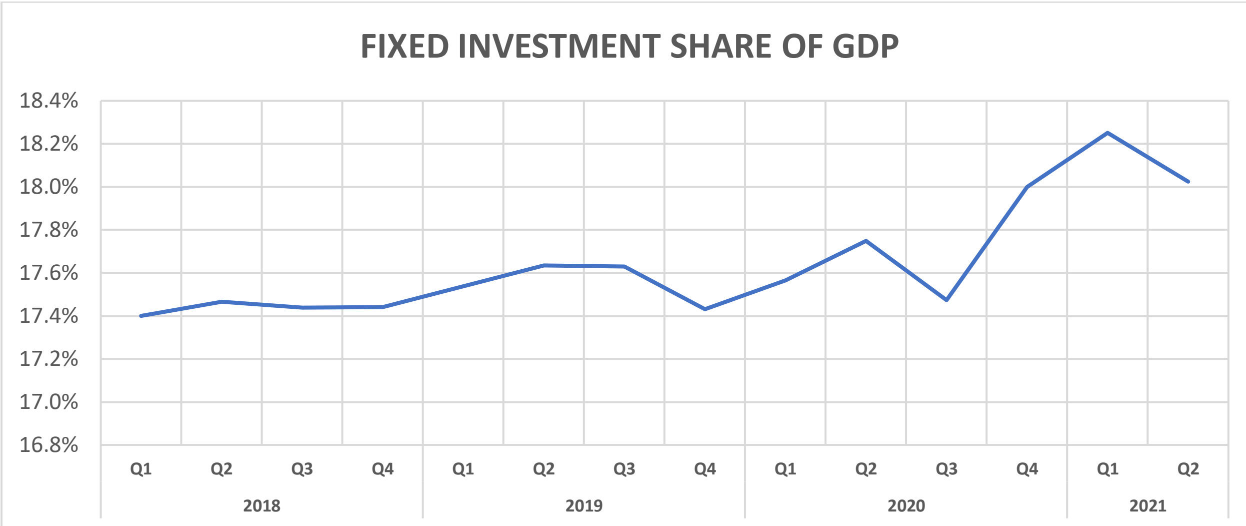
Graph 1.



(NIPA Table 1.1.5. Gross Domestic Product)

The growth in goods consumption spurred a revival in investment. Goods production generally has a much higher composition of capital compared to the misnamed service sector, which means that every dollar of revenue requires a proportionately higher investment in means of production. This is illustrated in Graph 2 below. The fall between the two quarters this year is entirely due to a fall in the investment in structures (buildings etc) and not in machinery and equipment.

Graph 2.



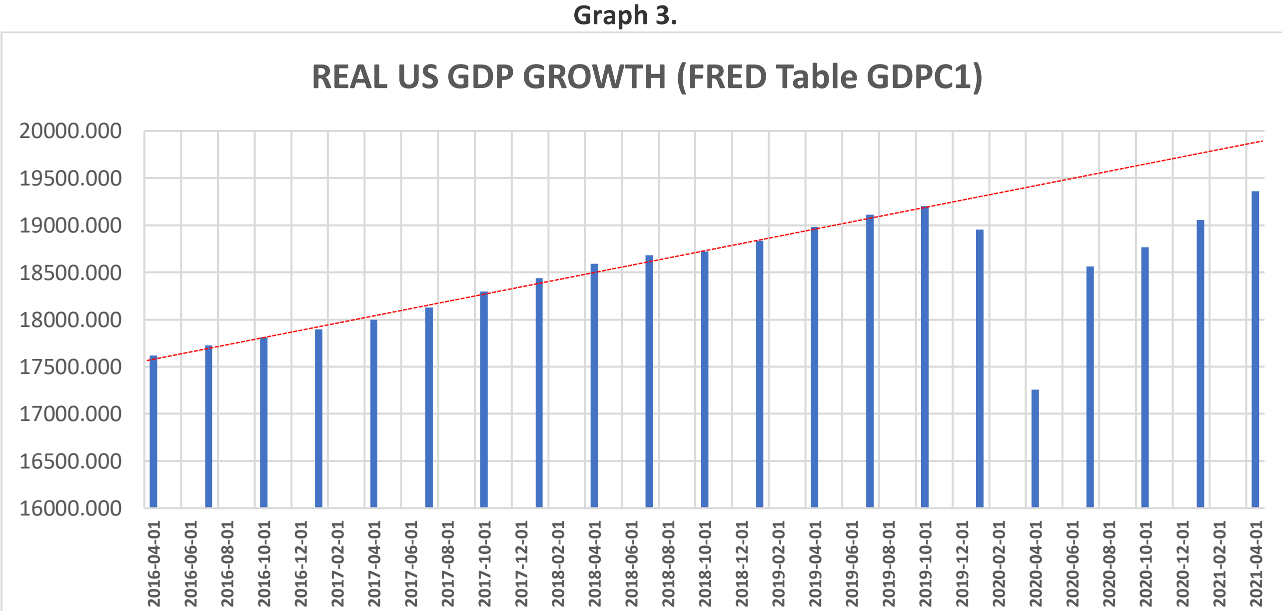
(NIPA Table 1.1.5. Gross Domestic Product)

It's worth repeating, the bulk of profits in the share markets, including the S&P 500, originates in the goods producing sector, not in the service sector. Thus the surge in demand for goods has led to a corresponding surge in profits for the S&P 500 which is the most representative market for US corporations. According to the most recent FactSet Earnings Insight released on 30th July, earnings per share compared to the second quarter of 2020 increased by 61% against a 29% increase in revenue. (59% of corporations on the S&P 500 have now reported.) This represents a substantial increase in profit margins. Inflation has been very kind to these corporations despite all their whining over supply bottle necks.

However, this data needs to be qualified. These profit figures include subsidies from the third Covid Relief Fund, so we will have to wait for the third quarter to obtain a true reading of profitability.

Quantifying the real costs of the Covid Pandemic.

Graph 3.



In the graph above the dotted red line represents the potential path of GDP in the absence of the pandemic. Most economists list the losses purely on actual losses and not on losses including lost growth. On this basis, the total loss in GDP on an annualised basis was $1.1 trillion in 2020. Add in lost growth of $0.54 trillion and the combined loss in 2020 amounts to $1.64 trillion, equal to 7.5% of GDP. This compares to the usual figure of 3.5% which is arrived at by comparing GDP at the end of 2020 to that of 2019.

Add in the net increase of $2.4 trillion in federal debt and the figure rises to $4.04 trillion or 19% of GDP. Add in the loss of GDP in the first half of 2021 (including potential growth) of $0.31 trillion and Debt of $1.3 trillion and the additional loss of $1.61 trillion is equal to a further 6.7%. This brings the cumulative loss to over 25% of annual GDP, a figure suggested last year. (Methodology. In the fiscal year ended Sept 2019 the deficit amounted to $757 billion. Since then and over the last two financial years, the average annual deficit was around $3 trillion. By deducting this $757 billion from the actual deficit in 2020 and the expected deficit in 2021, the figures of $2.4 trillion for 2020 and $1.3 trillion for 2021 were arrived at.) https://www.cbo.gov/system/files/2021-07/57288-MBR.pdf

On a further methodological note, the loss in GDP and the rise in Debt go hand in hand. Without the Fiscal Stimuli which led to the rise in this Debt, GDP falls would have been much larger. In this sense Fiscal Stimuli subsidised GDP through increasing consumer spending and filling corporate coffers. And of course, some though not all this debt, will have to be repaid in the future, so it will be mortgaging future growth.

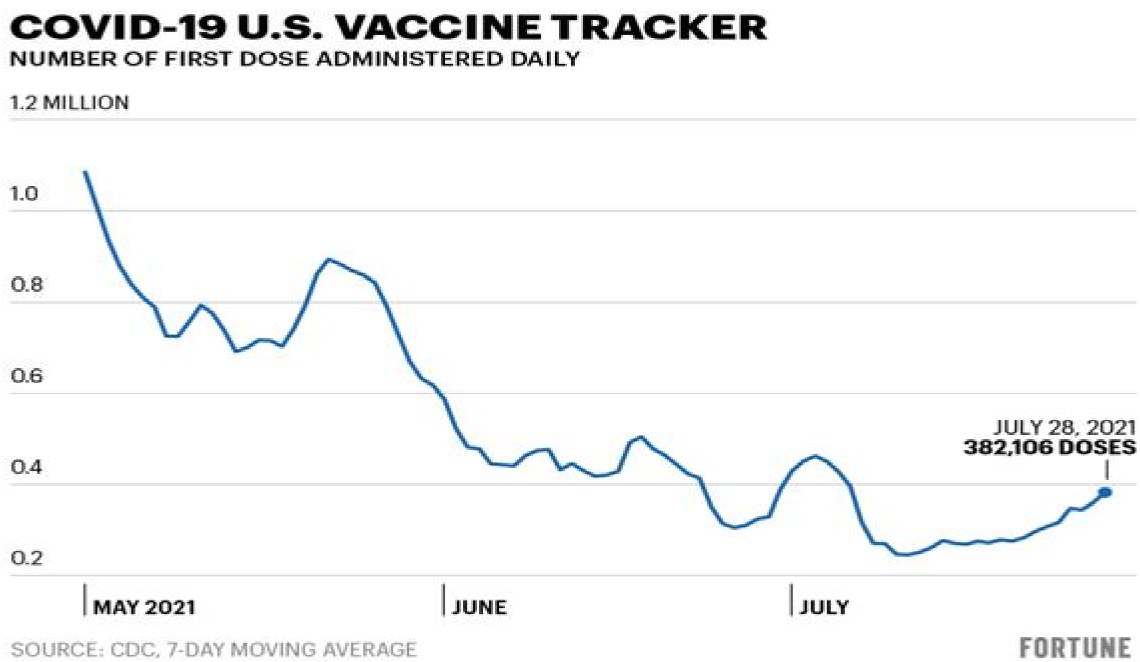
And it appears that the US economy may succumb to a further wave of Covid, this time the express train or Delta variant. It seems the Republican Party is not only seeking to suppress Democratic voters, but to eliminate their own voters through pandemic misinformation. Biden is correct to say this pandemic is the "pandemic of the unvaccinated" and it is centred on those Republican states whose leaders have minimised the threat in the name of short-term profits at the cost of longer-term losses. This is the story of the $5.6 trillion loss Covid has caused to date because of the short-sightedness and ineptitude of capitalism. It seems the greatest threat to the USA is not China but Trump and his acolytes in the Republican Party. This is not so much a party that keeps on giving but one which keeps on taking lives.

The outlook.

Three months ago, it appeared that the US was better placed than the EU to take advantage of the post-pandemic period. That has now been reversed. The EU may have been a late starter with vaccinations, but their more functional governments have allowed these countries to catch up and even overtake the US and now the UK in terms of doses per head of population. Not that you would hear it from the anti-EU gutter press. The fall-off in US vaccinations can be seen in the graph below. Infection rates in the EU are one tenth that of the USA per head of population. The infection rate in the US will hit 100,000 this week and is likely to jump to 150,000 next week. Florida, one of the hardest hit states saw daily hospital admissions exceed the winter peak.

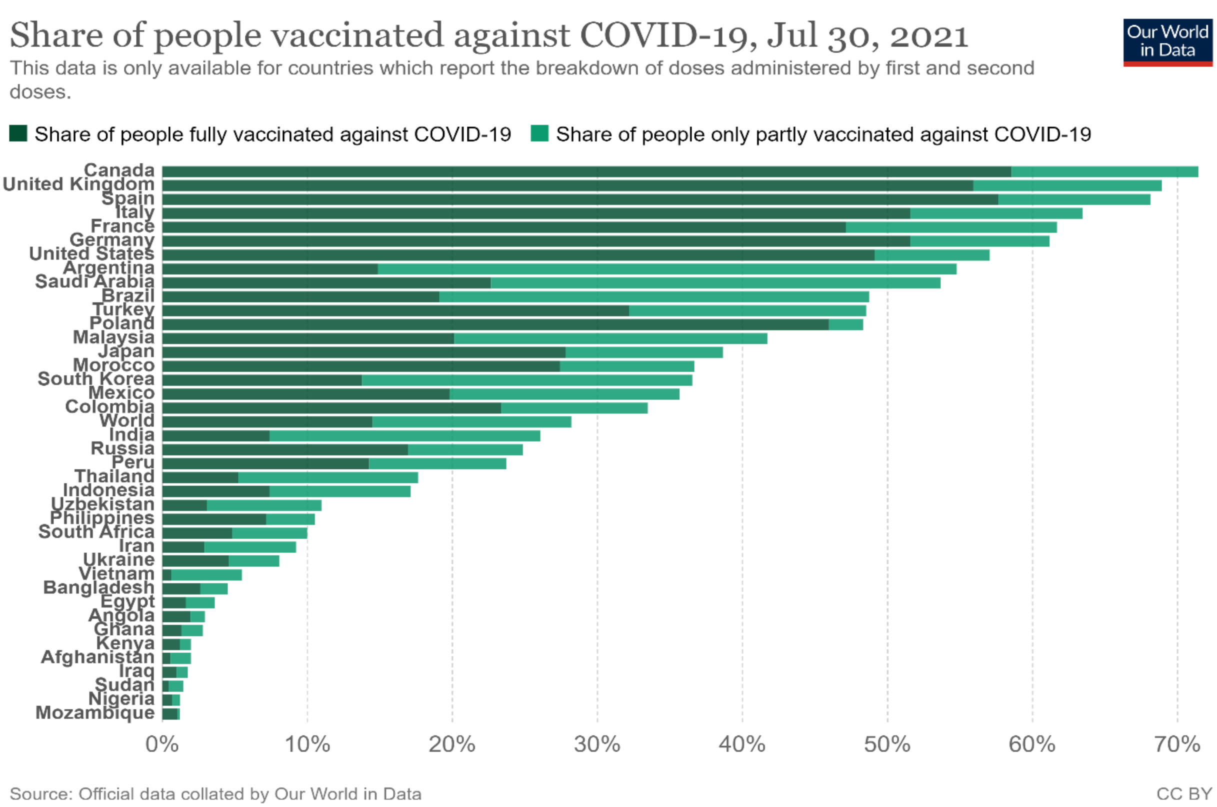
In addition, the efficacy of the vaccines against the Delta variant varies. Lowest are the Chinese vaccines, not because they are bad vaccines, but because they are based on the denatured Alpha variant. In between is the Astra Zeneca vaccine, and most efficacious are the mRNA vaccines which have modelled the entire horn of the virus and its attachment sites. However, even the best vaccines have a lower efficacy rate than anticipated according to recent Israeli data. Although these vaccines provide a high rate of protection against severe illness and therefore hospitalisations, they only provide a 39% protection against infection.

Graph 4.



Looking at the Pacific region, the problem with low rates of vaccination is visible. (Graph 5.) Only Malaysia has vaccinated more than 40% (single doses) and no country there has doubled dosed over 30%.

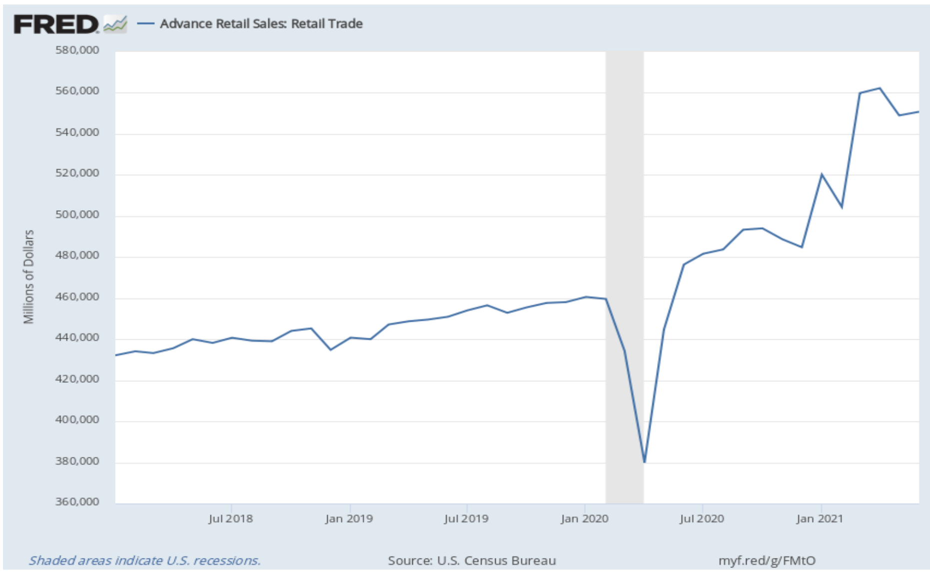
Graph 5.



Thus the whole region remains vulnerable to the rampaging Delta variant, and that includes China. From having contained the Alpha variant better last year, this time it is the West with the exception of the USA, which is now better placed to deal with the Delta variant.

Looking at the current economic data from the USA immediately before the surge in infection rates. Retail sales while up for the recent quarter nevertheless showed a 4% decline on a monthly basis from their peaks in March and April when the final Relief Fund was in full flow. There won't be another.

Graph 6.



While data from July is not due until mid-August, the University of Michigan consumer sentiment report which covers July has gone negative as the table below shows. While up on the year, July saw sharp falls in all categories from June.

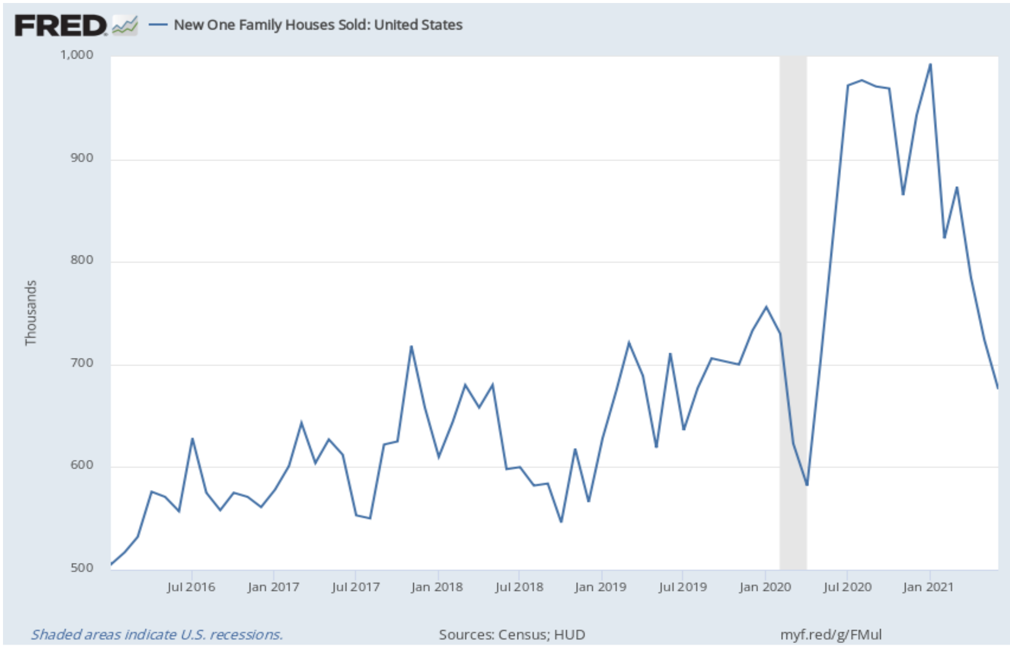
Final Results for July 2021

	Jul **2021**	Jun 2021	Jul 2020	M-M Change	Y-Y Change
Index of Consumer Sentiment	**81.2**	85.5	72.5	-5.0	+12.0%
Current Economic Conditions	**84.5**	88.6	82.8	-4.6%	+2.1%
Index of Consumer Expectations	**79.0**	83.5	65.9	-5.4%	+19.9%

http://www.sca.isr.umich.edu/

Amongst the sharpest falls are spending intentions on houses, vans and large household durable goods. We have to go back to the 1980s to find lower intention to spend on large ticket items. Then the reason was high interest rates, now they are soaring prices, particularly houses. During the darkest days of the pandemic, housing was one of the outliers, as purchases and prices soared. No longer. Despite falling mortgage rates, both the sales of new homes as well as permits issued, have fallen back to levels prior to the pandemic and even below these levels. Little wonder the price of lumbar for housing has fallen from $1,700 per thousand board feet at the height of the pandemic and the housing frenzy to $600 currently, despite all the wildfires.

Graph 7.



In a number of ways the economy has now normalised itself. Real per-capita annualized disposable income decreased by $4,584 between the first and second quarters of the year as the impulse from the Relief Funds waned. The result is that the much-vaunted savings hoard, which stood at $2.5 trillion, has now reduced to $1.7 trillion not far off the average $1.3 trillion pre-Covid rate. Thus a portion of the growth in consumer spending in the second quarter was due to this draw down in savings. There is now much less to boost third quarter spending.

Next we turn to forward looking guidance by bell weather corporations such as Amazon. Amazon benefitted hugely from the pandemic as brick-and-mortar shops were closed, and or people fearing the virus, were reluctant to shop in them. However, Amazon's revenue for the most recent quarter missed expectations as it came in at $113 billion rather than $115 billion expected. Worse its forward guidance for the next quarter disappointed projected to fall below the current qaurter. "*For the third quarter, Amazon said it currently expects sales of between $106 billion and $112 billion, representing growth of 10% to 16% compared to the same period last year. Analysts polled by FactSet are currently expecting revenue of $119.3 billion."* As a result Amazon's share price plunged 7.5% on these results shaving $130 billion off its market capitalisation equal to the market cap of the smallest 435 corporations in the S&P 500 according to Bloomberg.

Apple and Facebook both offered softer guidance as well. Facebook the influencer sought to influence its investors guiding them back to the old normal. "*In the third and fourth quarters of 2021, we expect year-over-year total revenue growth rates to decelerate significantly on a sequential basis as we lap periods of increasingly strong growth. When viewing growth on a two-year basis to exclude the impacts from lapping the COVID-19 recovery, we expect year-over-two-year total revenue growth to decelerate modestly in the second half of 2021 compared to the second quarter growth rate*." https://investor.fb.com/investor-news/press-release-details/2021/Facebook-Reports-Second-Quarter-2021-Results/default.aspx

China v the USA

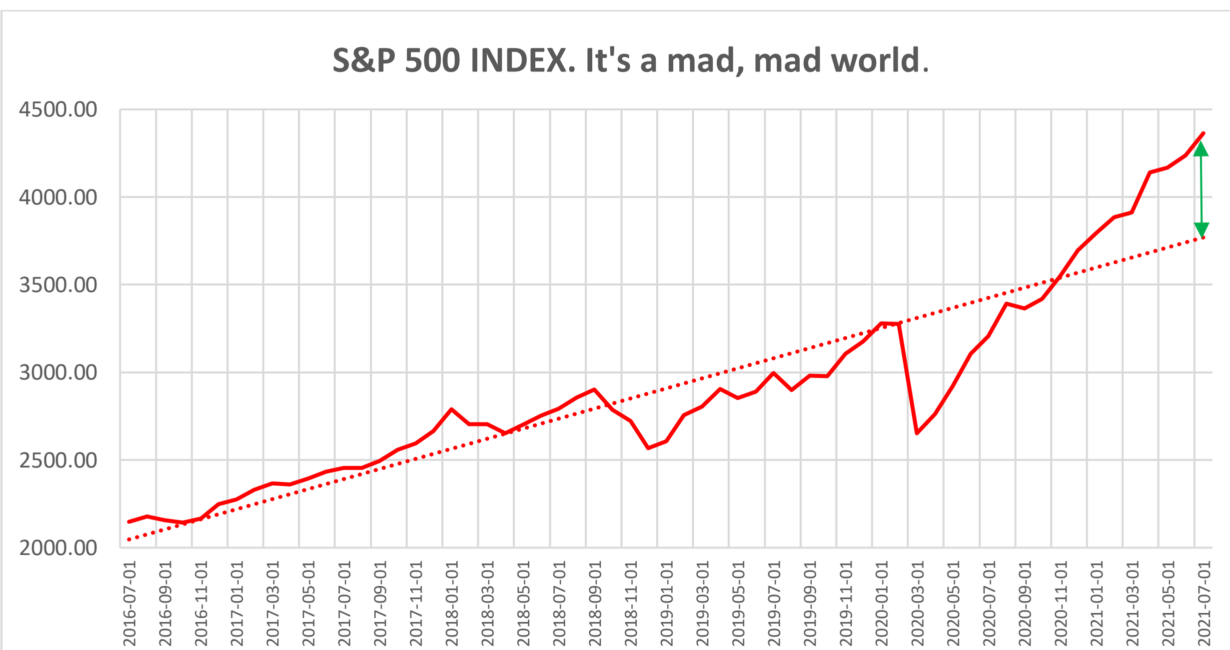
It is said that Prime Minister Johnson stands in front of mirrors trying to emulate Churchill's expressions and mannerism. Whether he has succeeded is unknown. What is known is that Johnson is getting better at emulating Churchill's military follies. Whether it was Churchill's failed Dardanelle's Campaign in 1915, his racist underestimation of Japanese soldiers which led to the fall of Singapore, his sending of two battleships (The Prince of Wales and the Repulse) to the Pacific and their doom, or almost losing North Africa because he diverted troops to Greece, the list of his tactical brilliance or not, goes on and on. Similarly with Johnson. He has hurled the flagship of the Royal Navy, the aircraft carrier Elizabeth at the Chinese, as a shining emblem of Global Britain flexing its muscles. However, to do so he had to borrow a destroyer from the Dutch and another from the Americans to escort the carrier, eliciting a broadside from the US who suggested Britain's fleet is more suited to waters closer to home. Perhaps he should have waited for the £250 million Royal Yacht to be built whereupon he could have outfitted it with a number of Vickers machine guns and turned it into a world beating escort.

Away from this farce, the US wargaming is getting more serious. The US air force is relocating its stealth fighters including the feared F22 to the Pacific. A number of small island runways are being upgraded so that planes can hop between them in case China manages to take out large military bases such as Guam or bases in the Philippines, South Korea or Japan. While the US escalates and threatens to start military fires on an overheating planet, John Kerry goes around the world begging countries to restrain their carbon emissions. You cannot make this up.

Conclusion.

We are a fortnight away from data relating to July coming out. It is likely to be the first in a series which paints a deteriorating picture of the world economy. Will this fry the Stock Markets. This is the $64 trillion question.

Graph 8.



The reader's attention is directed towards the green arrow which points to the widening gap between the index and its recent trend. Since the low point in early 2020 the index has risen by two thirds and from its pre-pandemic peak it has gone up by one third. Put another way it took 50 months for the index to rise 1129 points between January 2016 and February 2020, but it only took 15 months to rise by the same amount between February 2020 and July 2021 despite the swirl of the pandemic. All hail the central bank. There are tens of trillions of Dollars at risk. If the US goes, so too will all the other stock markets around the world. The situation is far more precarious and loaded than in 2008.

And it is clear that QE is failing. This week saw the first daily $1 trillion reverse repo as the FED mopped up all the money lying around or at least tried to. The FED is giving with one hand and taking away with the other. Any hurricane watcher will tell you that the tighter the funnel the faster the rotation the more powerful the wind, and the financial funnel is tightening.

It is about to get really interesting once more.

Brian Green, 31st July 2021.