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A second-half surge, or pause?

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Introduction

Stephen Dover, CFA
Chief Market Strategist
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The growth and inflation argument continues

Our macro economists agree that developed world economies seemed to be on the path to economic normalization in the first half of 2021, but the question remains: what's next? Critical variables in play include potential impacts from inflation, the pace of vaccination rollout globally and central banks' approach to monetary easing policies.

In this edition of *Macro Perspectives*, we highlight views from five of our specialist investment teams on inflation, interest rates and growth.

Inflation, especially inflation expectations, continues to be a significant focus for our investment teams. Inflation figures continued to rise in several countries in June and July, driven by a combination of factors that included cyclical upswings associated with either resurgent sustainable economic activity or pent-up demand paid for by the spending of excess savings. Because of this, there is a debate among our economists on whether inflation will remain transitory or continue to remain at high levels into 2022. Alternative measures such as the volume of news stories on shortages in categories such as autos, furniture, electronics and apparel peaked in April/May, indicating that there may be evidence of inflation abating in the future.[1] However, reported data continue to show sharply rising prices, which put pressure on fiscal and monetary authorities to adjust policy to prevent economic overheating.

Our contributors' views also diverge on what economic growth will look like in the second half of the year. The global economic recovery rolled forward through the second quarter, most notably in developed markets, as business activity reopened, coordinated monetary and fiscal policy provided a healthy tailwind, and growing levels of vaccine coverage moved parts of the world closer to normalization. However, there is uncertainty about the pace of economic recovery for countries that lag behind in vaccinations or experience the proliferation of various COVID-19 variants. The initial expectations for how economies would recover based on the shape of the COVID-19 peaks have been tested even in countries with high vaccination rates. For example, Israel has seen cases and hospitalizations rise even with high levels of vaccinations (93% of adults with nearly all receiving the Pfizer vaccine) and has already ordered boosters for its citizens.[2] The volatile nature of how governments and consumers will respond from a policy and behavioral perspective creates a wide range of potential outcomes. Below are summaries of our economists' current views:

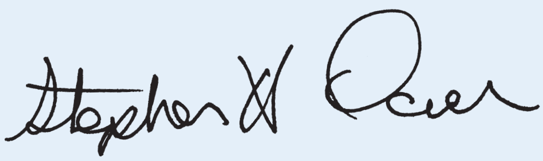
- We expect to see a meaningful pickup in global growth in the second half of 2021 as economies continue to reopen; however, we are cautious about extrapolating short-term cyclical boosts into a presumption of a higher secular trend rate of growth or inflation.
  Western Asset
- Optimism and consumer confidence have rebounded sharply, with a sustained global recovery now the baseline expectation. Uncertainty remains as the pace of economic recovery is diverging between those countries that have been able to bring infections

under control, have accelerated vaccination campaigns, and have supported the economy with ample amounts of liquidity via exceptionally loose fiscal and monetary policy, and those that continue to lag behind. We believe investors should be prepared for increased volatility as the market tries to interpret the changes in policy regime.
Sonal Desai, Ph.D., Chief Investment Officer of Franklin Templeton Fixed Income

- We expect inflation figures to remain elevated in 2021 in many countries, driven by a combination of factors that include cyclical upswings associated with resurgent economic activity, supply bottlenecks in certain sectors and base effects off of the pandemic shocks in 2020. These factors should be largely transitory, in our view, with inflation levels eventually moderating to secular trends in 2022, given elevated unemployment and automation factors that continue to dampen wage pressures.
  Michael Hasenstab, Ph.D., Chief Investment Officer of Templeton Global Macro

- We remain confident that a stimulative mix of easy monetary policy and generous fiscal support should build an increasingly synchronized global expansion—certainly among developed markets. However, this move may be close to its peak. In absolute terms, the strongest period of expansion may have been in the second quarter of this year. The United States may be approaching the point of “peak fiscal stimulus” and is perhaps on the downslope for quarterly growth in gross domestic product (GDP).
  Gene Podkaminer, Head of Research, Franklin Templeton Investment Solutions

- The normalization of the world’s major economic regions—at least in terms of real GDP levels—marks the end of the second phase and peak economic growth. The current trajectory should moderate, and growth should slow; what is ambiguous is by how much. Currently, markets seem priced for the middle road—a soft landing. If there is any tilt to the bias in the outlook, it is probably that the world runs too hot.
  Francis Scotland, Director of Global Macro Research at Brandywine Global



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Western Asset

Executive Summary

- We expect to see a meaningful pickup in global growth in the second half of 2021 as economies continue to reopen; however, we are cautious about extrapolating short-term cyclical boosts into a presumption of a higher secular trend rate of growth or inflation.

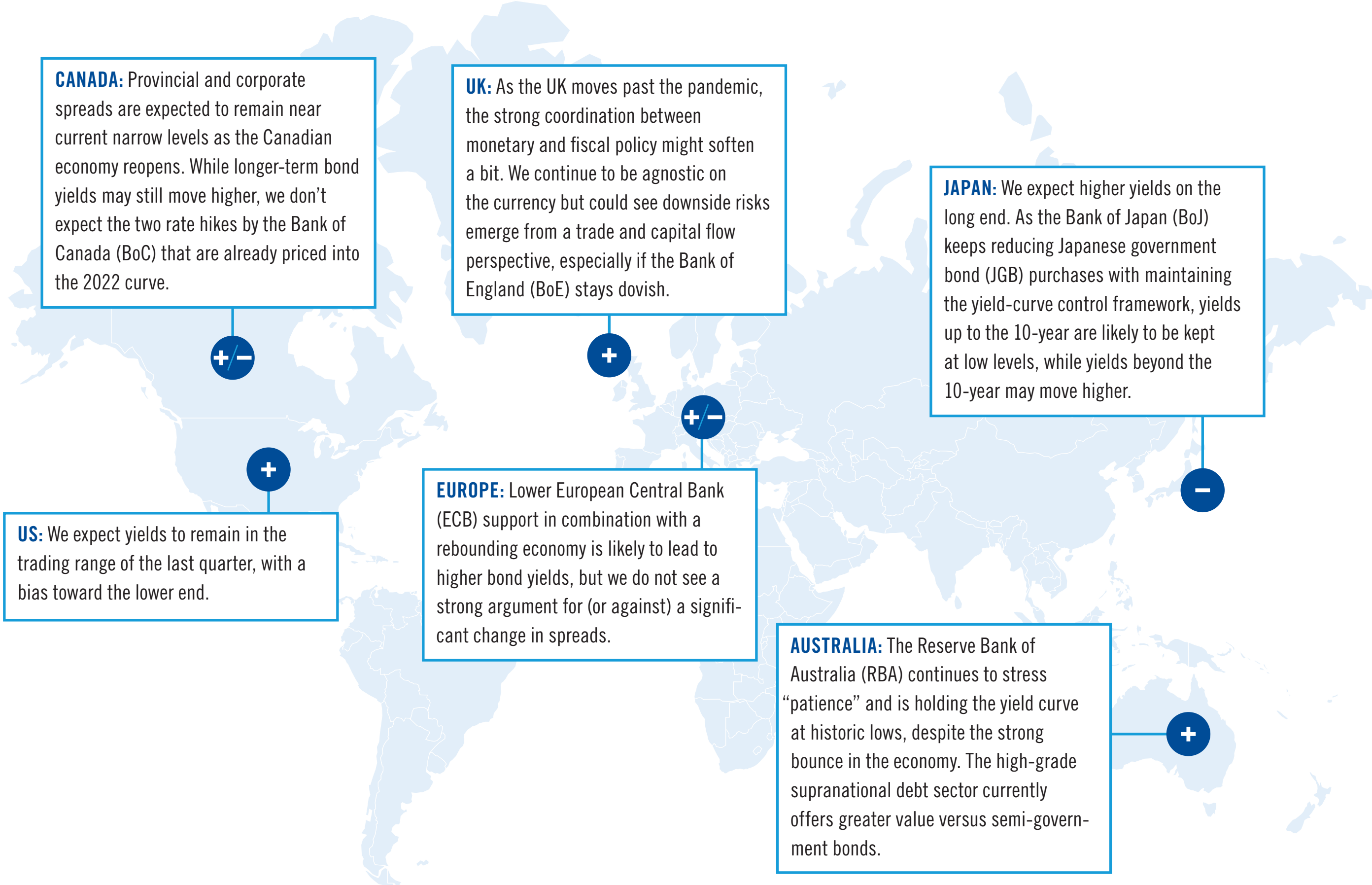
- In the United States, we expect growth in the service sectors to continue to disappoint relative to consensus expectations; meanwhile, growth in the manufacturing and construction sectors will likely be muted as the recovery there is already complete, in our view.

- We expect the European growth rebound to kick into high gear in the second half of the year as the vaccination drives across the continent approach herd immunity toward the end of the third quarter and workers currently on furlough and related schemes rejoin the labor market.

- Having been boosted by an early recovery post-COVID-19, we expect growth in China to trend back to its long-term average.

Below, we provide a summary of the key drivers behind our global outlook and describe where we see value across global fixed income by country.

DEVELOPED MARKET RATES: RELATIVE VALUE BY REGION



Note: The + and – symbols represent relative value by region.

US	We expect growth in the service sectors to continue to disappoint relative to consensus expectations; meanwhile, growth in manufacturing and construction sectors will likely be muted, as the recovery there is already complete, in our view.
Canada	The recovery downshifted early in the second quarter due to restrictions, but growth was better than expected. Rate hike expectations have accelerated, though we think the BoC will emphasize patience as core inflation remains below the top of the 1% to 3% range under circumstances of uncertainty.
Europe	National fiscal support to continue into next year, albeit at a slowing pace compared to this year, increasingly requiring economies to build momentum. We see NGEU* support slowly building over the next few years, while increasing the pool of supranational safe-haven assets. Monetary support is likely to slow as the ECB may reduce asset purchases into the ongoing rebound, but the Strategy Review is a focal point over the next months.
UK	The UK is very likely to end pandemic restrictions in third quarter but we expect only a comparatively limited marginal impact on the economy from that. The main risks are a higher inflation trajectory than currently envisaged by the BoE driven by a rapid absorption of currently furloughed workers and continued uncertainty in the UK's relationship with continental Europe.
Japan	We expect that the Japanese economy will continue to recover as the vaccine rollouts have finally accelerated. The BoJ's commitment to the easy monetary policy and the Japanese government's flexible fiscal stance to support the recovery remain intact.
Australia	As a result of strict COVID-19-related restrictions, the economy has outperformed most developed countries, with both employment and growth now above pre-pandemic levels. A delay in securing vaccines could crimp the current pace of growth. The RBA and government remain committed to supporting the economy through super easy monetary policy and fiscal support until inflation and, importantly, wage growth return.

*Next Generation EU (NGEU) fund is a European Union recovery package to support member states hit by the COVID-19 pandemic.

Read Western Asset's "Third Quarter 2021 Global Outlook" for more.

A sustainable global economic recovery is taking hold

Sonal Desai, Ph.D.
Chief Investment Officer, Franklin Templeton Fixed Income

The global economic recovery roared ahead in the second quarter as wide-scale economic reopenings and growing vaccine coverage paved the way for another large step toward normalization. With 3.9 billion vaccine doses administered worldwide as we approached the end of July, covering about 27.3% of the total global population, and the share of people with at least one dose exceeding 50% in the United States and several other developed markets, signs the pandemic is coming to an end can be seen across mobility and economic indicators across various regions—alleviating concerns that consumer behavior and economic activity would be permanently altered from the crisis.[3] As we stated a year ago while still in the throes of the crisis—"If you open it, they will come."[4] People are inherently social beings, and after over a year of various social distancing restrictions, they are proving eager to return to normal life.

Optimism and consumer confidence have rebounded sharply, with a sustained global recovery now the base-line expectation—the International Monetary Fund, for example, retained its global growth projection of 6.0% for 2021 and once again upgraded its 2022 forecast to 4.9%, following increases in October, January, and April.[5] We continue to forecast 2021 growth in the United States and the euro area to be the strongest in decades, despite growing uncertainty in the current macro environment.

Accelerating vaccination campaigns are helping bring the pandemic under control and allowing US states and governments around the world to reopen their economies. This is paving the way for a robust, synchronized global economic rebound given the strength of underlying economic fundamentals. However, uncertainty remains as the pace of economic recovery is diverging between those countries that have been able to bring infections under control, have accelerated vaccination campaigns, and have supported the economy with ample amounts of liquidity via exceptionally loose fiscal and monetary policy, and those that continue to lag behind. New virus variants and a resurgence of coronavirus cases in some countries have also hindered the full economic recovery. We believe investors should be prepared for increased volatility as the market tries to interpret the changes in policy regime.

Risks to inflation and yields are skewed to the upside

Inflation pressures are rising globally as economic normalization has spurred a consumption-led recovery. Supply bottlenecks, rising commodity and input prices, labor shortages and wage increases, an ever-growing stockpile of excess savings, ultra-low borrowing costs, and massive fiscal stimulus are all contributing to a rapid increase in inflation. While we do not believe inflation will get out of hand, in a situation where markets and the US Federal Reserve (Fed) appear convinced that it will soon drop back under 2% by itself, with no need for policy action, the risks seem very much skewed to one side—namely that we might be underestimating inflation.

It will be difficult to keep inflation subdued as prices continue to rise—as we saw in June, when the US Consumer Price Index (CPI) jumped by the most since 2008 and topped even the most aggressive forecasts—and policymakers maintain a very loose policy stance. The Fed in its June policy meeting acknowledged inflation risks are now skewed to the upside but continued to insist that higher inflation will prove "transitory." High inflation readings, however, will have a significant degree of inertia: even if month-on-month inflation were to drop from the June CPI reading of 0.9% to its pre-pandemic average of 0.2% by the July reading, annual inflation would still hover around 5% until March 2022. At that stage, inflation will have averaged 5% for a full 12 months. We also might not have seen the worst; higher month-on-month readings would push annual inflation even higher by the end of the year. This could well have an impact on both inflation expectations and price-setting behavior. While financial markets and central bankers are convinced that higher inflation will be short-lived, businesses and consumers appear considerably less sanguine—and they are the

> “Despite (a now weakening) consensus that inflation will be transitory, sharply rising prices are putting pressure on fiscal and monetary authorities to adjust policy to prevent economic overheating.”

ones who are feeling the bite most directly and who will be making wage and pricing decisions.

While monetary policy will undoubtedly remain accommodative over the near term, there are signs that policymakers are growing more concerned about the potential inflationary impact of the unprecedented onslaught of policy stimulus since the crisis began, and rising inflation may force central banks to tighten monetary policy faster than market expectations to rein in prices. Despite (a now weakening) consensus that inflation will be transitory, sharply rising prices are putting pressure on fiscal and monetary authorities to adjust policy to prevent economic overheating. Meanwhile a continued extremely loose monetary and fiscal policy stance, with markets largely priced to perfection, has already resulted in significant volatility in both bond yields and stock prices—and this volatility is likely to persist and even increase in the months ahead.

Rich valuations are increasingly a concern

Markets have been moving well in advance of economic data points, and many fixed income sectors are now trading at valuations reflecting a close to best-case recovery scenario, exposing investors to downside risk if there are any disruptions to this optimal outcome. Conversely, with central banks suppressing yields around the world, investors are pushing out the risk spectrum in order to generate returns, and low interest-rate costs have enabled issuers to strengthen balance sheets and service elevated levels of debt—providing strong technical and fundamental support for many spread sectors. While we are constructive on the fundamental backdrop and the health of the underlying economy, the risk/reward balance is getting more unfavorably skewed in many areas of the fixed income universe.

We continue to expect an above-consensus rise in yields, and limiting duration remains one of our main underlying strategy themes. We retain a slightly optimistic outlook on risk assets given the potential for a further steepening of the yield curve and continue to favor shorter duration and floating-rate fixed income assets with relatively less sensitivity to rising rates while seeking out exposures to sectors more highly leveraged to the improving economy.

Selectivity and active management are of the utmost importance

With valuations a growing concern and the risk of rising rates, we believe the only way to navigate through this challenging market environment is to focus on in-depth, fundamental research to uncover attractive opportunities. Pockets of value remain, primarily exposures most directly affected by the pandemic and issuers that have had to extend themselves to get through the crisis. However, given the deterioration in fundamentals for many issuers, not all of these will ultimately rebound, and we believe active managers are best positioned to conduct a rigorous, fundamental assessment of each prospective investment to find opportunities and avoid losses.

Read the latest Franklin Templeton Fixed Income Views, “The Fed’s Long, Hot Summer” for more, as well as Sonal Desai’s latest piece, “On My Mind—Inflation: Nothing To See Here, Really?”.

Regional risks surface within the recovery

Michael Hasenstab, Ph.D.
Chief Investment Officer, Templeton Global Macro

We expect macroeconomic conditions in much of the world to continue to improve in the second half of 2021. However, economic recoveries are likely to remain uneven as countries are at different stages of containing the pandemic and vaccinating their populations. While conditions appear broadly supportive of strategic rotations into risk assets, it remains crucial to be highly selective at the sovereign level given significant variations in economic conditions and policy responses. Risks to the global recovery include potential setbacks in vaccine distributions, particularly in emerging markets, as well as COVID-19 variants (notably the Delta variant) that have the potential to extend the duration and damage of the pandemic.

We anticipate global growth above 6% for 2021, with emerging markets outpacing developed markets, though that gap has recently narrowed due to resurgent cases of COVID-19 and other economic headwinds in certain developing countries. While the growth outlook for China and India is still among the strongest in the world, we have moderately scaled back those growth projections from their previous forecasts, along with other areas of Asia. Concurrently, our growth forecasts for the United States and other advanced economies have improved.

Regionally, Asia was at the forefront of the cascading recoveries in the first half of 2021, with the US rapidly making up lost ground in the second quarter. Areas of Europe generally lagged during much of the first half of the year due to delays in vaccine distributions, but now appear headed into stronger economic activity in the third quarter. Regional economic expansions are likely to remain largely on track through the second half, barring a significant shock, but should see a deceleration later in the year.

Looking ahead, we expect world GDP to moderate in 2022 but to remain considerably above its historical average of the past decade as the reopening surge begins to revert to more normalized growth patterns while also remaining buoyed by lingering stimulus and cyclical strength. The growth rate for emerging markets is likely to continue to outpace developed markets in 2022, led by Asia. Overall, we remain optimistic for the global recovery, but continue to monitor ongoing risks.

“We anticipate global growth above 6% for 2021, with emerging markets outpacing developed markets, though that gap has recently narrowed due to resurgent cases of COVID-19 and other economic headwinds in certain developing countries.”

Inflation

We expect inflation figures to remain elevated in 2021 in many countries, driven by a combination of factors that include cyclical upswings associated with resurgent economic activity, supply bottlenecks in certain sectors and base effects off of the pandemic shocks in 2020. These factors should be largely transitory, in our view, with inflation levels eventually moderating to secular trends in 2022, given elevated unemployment and automation factors that continue to dampen wage pressures. Additionally, a handful of sector components are having outsized impacts on the US inflation prints, such as new and used car prices, energy, air fares and lodging, etc. As these component effects normalize, we would expect the headline figures to come down.

Nonetheless, excessive monetary accommodation and massive fiscal stimulus in the United States, compounded with surging growth and an acceleration in the velocity of money, present inflationary risks that bear monitoring. The true test will be whether these factors become persistent enough to feed into longer-term inflation expectations, which would create self-sustaining price pressures. Our base case sees inflation expectations stabilizing as near-term spikes in the figures eventually wane. US inflation should moderate from current levels later in the second half of 2021, in our assessment, and head closer to the 2.5% range in 2022 as transitory factors eventually subside.

Interest Rates

In the second quarter, many central banks began considering when and at what pace to begin normalizing policy. Specific countries with inflation concerns have already begun raising rates, such as Brazil and Mexico, while others are looking toward normalizing policy to keep ahead of the curve, given strengthening economic conditions. A number of countries are indicating that rate hikes and/or asset-buying program adjustments could arrive in the second half of 2021. We expect a growing divergence on the monetary policy front as certain developed market central banks trend toward policy normalization ahead of others, while certain emerging market central banks are compelled to tighten policy to contend with rising inflationary pressures.

At the Fed's June policy meeting, a majority of Fed officials brought forward their projected expectations for the first interest-rate hike to 2023, from 2024. However, Fed Chair Jerome Powell cautioned that the dot surveys do not reflect forward guidance from the committee and that any discussion about raising rates is still "highly premature." Powell also continued to reaffirm the committee's view that currently elevated inflation figures largely reflect "transitory factors" that would not affect the course of monetary policy. We expect the Fed to remain on hold with its zero interest-rate policy until at least 2023. More importantly, the pace of anticipated rate hikes would have greater implications for fixed income valuations than the specific timing of when the first rate hike occurs. A patient and protracted tightening schedule of just one to two hikes per year would be significantly less impactful to duration exposures than an aggressive tightening schedule of three to four hikes, or more. Forward guidance on the expected timing and pace of rate hikes remains more than a year away, in our view.

EMERGING MARKETS

Certain countries continue to stand out on a fundamental basis compared broadly with emerging market peers. Specifically, China is the only major economy not to contract in 2020 and is poised to see above 8.0% growth in 2021, in our estimation. China's outward expansion should continue to have a substantial effect on the global economy through the Belt and Road initiative, financing of capital markets in other parts of the world, expansion of trade and growing territorial influence. Financial market liberalization and initiatives to digitalize its currency should also advance the long process of renminbi internationalization. Regional trade and asset ownership are increasingly denominated in the yuan, as China moves toward reserve currency status. Recurring geopolitical tensions with the United States and other trade partners remains an ongoing risk but does not appear likely to disrupt China's near-term economic momentum.

In South Asia, India's longer-term economic trajectory appears on track, despite devastating pandemic conditions in April and May. Fiscal stimulus is increasingly moving beyond the previous emphasis on consumption to supporting growth-generating investment. Improvement in the balance of payments position is visible, driven by strong capital flows and an improved current account balance. However, the medium-term outlook remains dependent on ongoing fiscal consolidation and market reforms.

In Southeast Asia, Indonesia has grappled with surging COVID-19 cases in recent months; however, the country's fundamentals remain on a strong footing. We expect Indonesia to regain its lost growth from 2020 in 2021. Importantly, Indonesia has implemented ambitious structural reforms over the past decade to strengthen its economic fundamentals, balance growth and accelerate its development goals. The country also continues to benefit from low levels of debt (around 30% of GDP).

In Latin America, Brazil faced deepening risks earlier in the year, as COVID-19 cases surged, inflation escalated and debt levels rose. However, political compromises in the spring led to crucial fiscal reforms. Better-than-expected economic figures in the second quarter and a strong central bank policy response now support an improved outlook for the second half of 2021 into 2022. Banco Central do Brasil has maintained its independence and credibility, responding assertively to inflation pressures by hiking its policy rate 75 basis points (bps) three times from March to June, and another 100 bps in August to 5.25%, helping to stabilize the country's financial markets and bolster its currency.

Has global economic growth hit its peak?

Gene Podkaminer, Head of Multi-Asset Research Strategies
Franklin Templeton Investment Solutions

When we entered the second quarter of 2021, we thought that "this is perhaps one of those times" when the themes that drove markets in the first quarter of 2021 might continue into the next period. Looking back, we were at least partially correct. The global economy continues to benefit from a strong cyclical expansion, which supported further gains during the second quarter, even with elevated valuations in equity markets. We remain confident that a stimulative mix of easy monetary policy and generous fiscal support should build an increasingly synchronized global expansion—certainly among developed markets. However, this move may be close to its peak. In absolute terms, the strongest period of expansion may have been in the second quarter of the year.

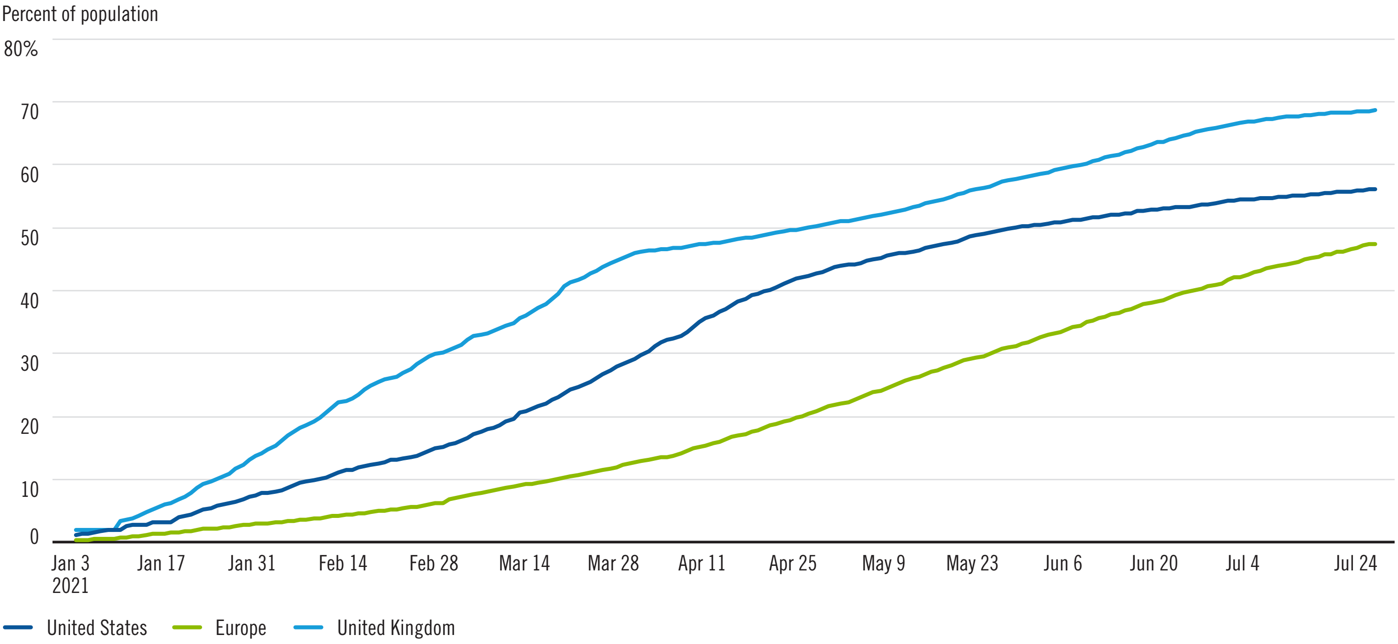
As we begin the second half of the year, which aspects of the current environment should we expect to persist, and which might change? One of the drivers of this decision, in our view, is the progress toward controlling the impact of the ongoing global pandemic. As we have noted in recent months, Europe is playing catch-up with the larger leading vaccine nations such as the United States (see chart below). Others will likely follow, even if supplies for many emerging market economies remain deficient at this time. This leaves us with a marked preference for countries that are experiencing the "point of inflection" in the vaccine rollout.

During the next few months, that likely includes Japan, perhaps Australia and other parts of developed Asia. Similarly, the contribution of fiscal stimulus remains a key driver of growth prospects. Here, the United States remains in the lead, with infrastructure spending potentially adding to the mix, but may also be closer to the high-water mark than many have imagined. At the point where analysts fully discount additional spending in the

GROWTH EXPECTATIONS ACCELERATE AS COVID-19 VACCINATIONS RAMP UP

Percent of population that has received one dose of COVID-19 vaccine

As of July 24, 2021



Source: Our World in Data, Macrobond.

"The United States may be approaching the point of "peak fiscal stimulus" and is perhaps on the downslope for quarterly growth in GDP. For now, however, we retain a moderate preference for US stocks. Equally, China's economy has seen a deceleration in credit growth, and since February of this year, its equity market has lagged the gains seen in the broader global indexes."

longer term, even if its delivery runs out over many years to come, it raises the bar against which growth will be judged.

The United States may be approaching the point of "peak fiscal stimulus" and is perhaps on the downslope for quarterly growth in GDP. For now, however, we retain a moderate preference for US stocks. Equally, China's economy has seen a deceleration in credit growth, and since February of this year, its equity market has lagged the gains seen in the broader global indexes. We see this trend as one that is most likely to persist and continue favoring developed equity markets in general. Thus we have moved to extend our more cautious stance toward China and emerging market equities more broadly.

We anticipate a period of increasingly synchronized global growth during the second half of this year. This is the culmination of the great reopening story that has dominated financial market discussions for many months. This is likely to be one of the features of the market environment that will persist into the second half of the year. However, despite the announcement of some exceptionally robust economic data and company results, the impact of each announcement seems to have become less powerful. This could be evidence that the "good news is already priced in." We continue to see a stronger medium-term return potential for stocks than bonds and believe that they should continue to earn their equity risk premium over time. While we favor risk assets generally and maintain a notable asset allocation tilt toward stocks over bonds, our equity preference is more modest. This reflects the observation that markets may already largely reflect the initial burst of much-improved economic data.

Read more in Franklin Templeton Investment Solutions' latest "Allocation Views."

The pandemic's next phase

Francis Scotland
Director of Global Macro Research, Brandywine Global

The influence of the pandemic has dominated investment trends for over a year and is likely to continue. There have been two clearly defined macro-economic phases through this public health crisis, each marked by the direction and pace of change in world GDP. The first phase ended in June 2020. The second phase is winding down this quarter. A third phase is unfolding.

The first macro-phase was the bust: the biggest, fastest free fall in modern economic history. More like a natural disaster than a conventional recession, it was a by-product of fear and worldwide government lockdowns of people and businesses. Economically devastating, it proved to be the shortest-lasting contraction in modern history.

The second phase was the V-shaped global recovery that started a year ago. Real GDP came flying out of the economic hole created during the first phase, pulled up by reopenings and propelled by staggering and coordinated monetary and fiscal reflation. China's real GDP was the first to return to pre-pandemic levels last October. The United States achieved this milestone during the second quarter of this year. Europe is close behind. The world economy looks set to finish 2021 on a very strong note but with growth tapering off. The normalization of the world's major economic regions—at least in terms of real GDP levels—marks the end of the second phase and peak economic growth.

The third phase determines what happens next for capital markets. Like the first two phases, this stage will be dominated once more by the trajectory of global GDP. What is obvious is that the current trajectory should moderate, and growth should slow; what is ambiguous is by how much.

- Will the world run hot enough that real GDP flies through inflationary levels of potential?
- Or will GDP's trajectory level off to the pre-COVID-19 trend and produce a soft landing?
- Or will there be enough setbacks that the global trajectory levels out below potential and fosters a harder landing?

What makes the third phase GDP trajectory especially ambiguous are the forces driving it. The first two phases created some massive distortions in the economic and compositional profile of the global economy and macro policy. Rarely have these profiles been so anomalous. It also is unclear which of the distortions are permanent or temporary. This uncertainty is problematic for discerning the trend of the next stage, because whether these distortions unwind and how fast if they do are set to be the primary influencers of the third phase.

Distortions and disentanglements

Extraordinary monetary support should gradually retreat over the next 12 months. Several emerging countries have already raised interest rates. There has been modest M1 money supply growth in China since October, and the annual change in the credit impulse has turned negative. The Fed has started the conversation about tapering, and discussions will become more intense as unemployment rates fall sharply during the remainder of this year, particularly if current inflation rates linger.

Supply-side damage caused by the pandemic has collided with reopening demand pressures, producing a spike in inflation. It is unclear how long these imbalances may persist, which, in turn, is related to broader spending patterns.

Historically, rising energy costs, commodity prices, and long-term bond yields act as depressants on economic growth, robbing personal income of spending power elsewhere. This kind of natural growth tax works with a long lag but would normally suggest setbacks come next year, other things being equal.

Another distortion is the US labor market. The labor force has fallen sharply during the pandemic, and it is unclear whether this contraction is a short- or long-term problem.

Which way will the new trajectory lean?

Currently, markets seem priced for the middle road—a soft landing. The trajectory of global GDP is expected to converge toward the pre-pandemic potential trend; growth is expected to be stable and long-lasting, inflation

> "Unfortunately, there is no post-pandemic roadmap to follow. However, China is furthest along, so its experience is worth noting. The authorities provided modest stimulus to the economy during the pandemic, choosing to support companies rather than provide income to people"

transitory, and retreats from policy stimulus are not expected to be turbulent. This benign outlook is dead center in the distribution of possible macro outcomes that could result in phase three, which probably says more about uncertainty than conviction given the distortions. If there is any tilt to the bias in the outlook, it is probably that the world runs too hot.

Unfortunately, there is no post-pandemic roadmap to follow. However, China is furthest along, so its experience is worth noting. The authorities provided modest stimulus to the economy during the pandemic, choosing to support companies rather than provide income to people. They retreated from stimulus measures as soon as the pandemic was brought under control. In other words, the Chinese economy has been in phase three for a while.

Western central bankers are unlikely to turn off the taps prematurely, especially with fiscal policy in retreat. Instead, they are emphasizing the underemployed as well as the new data-dependent frameworks. They want inflation higher than in the past. Supporting this new bias is a mission creep in monetary policy, which links the monetary policy outlook to things like income inequality, diversity and inclusion, and climate change—in other words, fiscal policy. For example, the BoJ is providing direct funding support for climate-friendly corporate spending initiatives.

The pandemic may have super-charged developments affecting the supply side of the economy that were beginning to unfold before the crisis. Productivity usually rebounds during this phase of an economic recovery, but developments in the industrialization of technology suggest the digitization trend will only grow.

Read Brandywine Global's quarterly publication, "Macroeconomic Update—Second Quarter 2021" for more.

Endnotes

1. Source: BofA Global Research, "Alternative Data Insights: Queuing for Concert Tickets, not Cabinets," July 12, 2021.
2. Source: Our World in Data, Macrobond. As of June 30, 2021.
3. Sources: Franklin Templeton Fixed Income Research, Our World in Data (CC BY 4.0). As of June 18, 2021.
4. Please see Sonal Desai's "On My Mind: If You Open It, They Will Come," June 4, 2020.
5. International Monetary Fund, World Economic Outlook. "Managing Divergent Recoveries," April 2021. There is no assurance that any estimate, forecast or projection will be realized.

About Macro Perspectives

Macro Perspectives allows the Franklin Templeton Investment Institute to feature economists from across the firm dissecting key macroeconomic themes driving markets. The mission of the Investment Institute is to deliver research-driven insights, expert views, and industry-leading events for clients and investors globally through the diverse expertise of our autonomous investment groups, select academic partners and our unique global footprint.

Two related Franklin Templeton Thinks publications of note are Allocation Views, produced by Franklin Templeton Investment Solutions, which offers you our best thinking on multi-asset portfolio construction; and, Global Investment Outlook, from our Investment Institute's strategists, highlighting managers' views on markets across the firm.

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WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Investments in foreign securities involve special risks, including currency fluctuations, economic instability and political developments. Investments in emerging market countries involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year. China may be subject to considerable degrees of economic, political and social instability. Investments in securities of Chinese issuers involve risks that are specific to China, including certain legal, regulatory, political and economic risks. Actively managed strategies could experience losses if the investment manager's judgement about markets, interest rates or the attractiveness, relative values, liquidity or potential appreciation of particular investments made for a portfolio, proves to be incorrect. There can be no guarantee that an investment manager's investment techniques or decisions will produce the desired results. There is no assurance that any estimate, forecast or projection will be realized. Past performance is not an indicator or a guarantee of future results.

Notes

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