This is what the end of an emergency looks like

Global financial markets are extremely fast moving. Share prices hit their pandemic lows in March 2020, but the related economic contraction took much longer to truly hit home. It follows, then, that while financial markets recovered in record time, the economic recovery took a little longer to emerge.

Today, while we believe that the recovery still has momentum, we also feel that we may already have passed the peak level of growth for this particular cycle (see our next article, *Where are we in the economic cycle?*). This is at least partly because some of the positive factors boosting economic growth in the wake of the initial COVID-19 crisis are now beginning to fade.

Central banks and governments are beginning to step back

The policy decisions taken by governments and central banks, who have pumped unprecedented levels of stimulus into the economy over the past two years, set the foundations for both financial markets and economies to recover. But these were emergency measures, and cannot go on forever.

Today, many major governments are beginning to step back from their ultra-supportive programmes, such as the 'furlough' and employment protection schemes that were so vital during the darkest days of the pandemic. Importantly, any action policymakers take at this point is increasingly unlikely to have a major positive impact on economic growth, and governments are also looking at ways to tackle the huge bills incurred by fighting the human and economic costs of the pandemic. Higher taxation is one obvious solution, but the key would be managing this without harming consumer spending (and by extension the economic recovery).

Meanwhile, financial markets are keeping a close eye on central bank decision makers. Interest rate rises are on the horizon, alongside not merely the removal of ultra-accommodative policies like quantitative easing (central banks purchasing financial assets in the open marketplace), but also the prospect of quantitative tightening (central banks reducing the level of liquidity in the financial system).

Significant shifts like these in central bank policy must be communicated clearly, and executed prudently. Without this, financial markets will take fright, potentially leading to a disorderly rise in the costs of borrowing and doing business. In turn, this could put the household and corporate sector recovery under threat. Such a negative scenario is, we think, unlikely. However, even the spectre of a disorderly transition could cause bouts of short-term volatility along the way.

For now, both household and business balance sheets are in fairly rude health – an indirect benefit of the economic stimulus enacted by global policymakers. This means that both companies and consumers should be able to manage a gradual rise in the cost of capital as ultra-supportive emergency policies are slowly withdrawn.

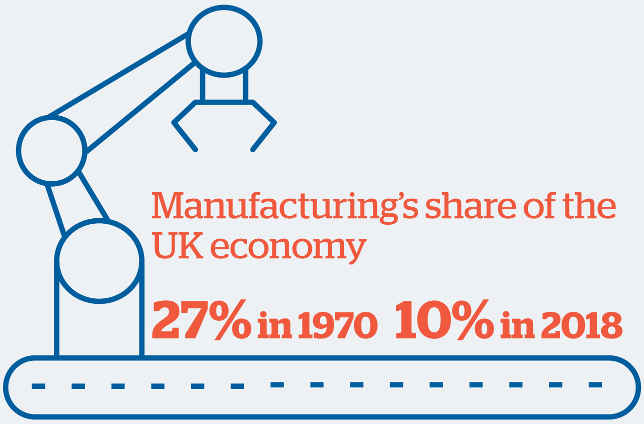
Inflation is distracting, but should begin to fade in 2022

Inflation is a headline-grabbing topic at the moment. We have even heard some market commentators using terms like ‘stagflation’, referring to the phenomenon of falling economic growth alongside rising inflation and rising unemployment. Is this feasible in 2022?

Put simply, we doubt it. Statistically, stagflation is a very rare occurrence – last truly experienced in the 1970s. We think a return to these conditions in the near future is extremely unlikely, least not because the global economy today looks very different to the 1970s. Forty years ago, manufacturing accounted for a much higher percentage of the economic landscape, which made the world economy very sensitive to commodity price changes. Union membership in the workplace was also much higher, creating upwards pressure on wages.

So, stagflation is unlikely, but what about plain old inflation? Our view is that the current inflationary pressures (created by a cocktail of factors including supply chain constraints and heightened commodity prices), are likely to persist in the very near term. However, over the course of 2022, these pressures should fade as supply chains normalise, commodity price rises ease off, and wage inflation in COVID-19-sensitive areas begins to fade. It is also worth noting that inflation is measured by comparing prices in the most recent time period to prices in a previous time period. This means that prices in 2022 will be compared to the elevated prices seen in 2021, which should automatically create lower inflation readings ahead.

There are, of course, risks to our relatively sanguine view on inflation. Rising housing costs and wages can often set the scene for a more durable inflation scare, and both are going up at the time of writing. We are watching closely, but we are also mindful that central bank reactions are key in this scenario, and we do not believe that policymakers will act aggressively in response to inflationary pressures over the coming months. In the coming years, though, expectations of inflation among consumers and financial markets are likely to be higher than in recent history.



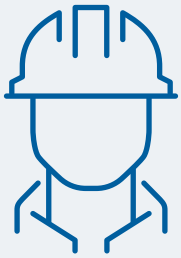
Manufacturing’s share of the UK economy

27% in 1970 **10% in 2018**

Gross Value Added (GVA) data. This is a measure of the contribution to the economy of the production of goods and services.

Source: UN, ONS.

Number of workers in the US manufacturing sector



July 1979
19.6million

October 2021
12.5million

Source: US Bureau of Labor Statistics

Where do we go from here?

As we enter 2022, we see a world of positive (if slowing) economic growth, with policymakers gradually stepping back from their ultra-accommodative emergency measures. Meanwhile, though the inflationary backdrop will continue to write the headlines in the near term, it should begin to fade and become less relevant as 2022 progresses.

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> David Absolon, Investment Director

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2021 Wealth Briefing European Awards

Winner: High Net Worth Team

Commended: Tax Team

Commended: Marketing or PR campaign

2021 PAM 50 Most Influential

Tracey Davidson, Chair of Handelsbanken Wealth & Asset Management has been named in the 2021 PAM 50 Most Influential list

FT Adviser – Top 100 Financial Advisers 2020

Handelsbanken Wealth Management was placed in the top 25 of FT Adviser's Top 100 Financial Advisers 2020 (17th)