THINKING**ahead**

2021 Economic and Financial Outlook

DECEMBER 2020

Our 2021 outlook highlights the continuing ripple effects of COVID-19 and considers possible long-term outcomes.

CPP Investments

In 2021, we expect COVID-19 to continue to be the biggest factor in the global economy. The ripple effects will be far-reaching, from the adequacy of governments' response to impacts of this shock on the workforce to changes in the pattern of global trade.

In our outlook for 2021, we highlight several of these knock-on effects and consider possible long-term outcomes.

Outlook for 2021

THEME 1

Evolution of COVID-19 and its impact on the economy

- It's tempting to think the rapid arrival of effective vaccines will mark the beginning of the end of the pandemic. Instead, it's more likely to mark the beginning of a long transition back to something approaching normal as people only gradually gain confidence they can resume customary activities without endangering themselves or others.
- Advanced economies are likely to experience wide variation in real GDP growth during the recovery, based on three factors: the spread of the disease, the pre-existing structures of economies and local policy responses.
- COVID-19 will accelerate changes that were already underway in the world economy, from global inequalities to transformation of logistic networks to technological innovation.

THEME 2

Productivity, scarring and implications for potential growth

- The COVID-19 shock could have a continuing adverse impact on productivity growth, scarring economies far into the future.
- Faced with greater uncertainty about potential structural changes in the economy and weak demand, some firms may postpone or cancel their investment plans. On the other hand, the rapid policy response, low interest rates and relatively robust recovery in equity markets and the economy could also encourage a faster resumption of original plans for business investment.
- The labour market recovery has been uneven across industries, workers and genders, with women bearing a heavier burden from the shock. A failure of female workforce participation rates to recover to their pre-pandemic trends would have long-term negative effects on potential growth.

THEME 3

Monetary and fiscal policy and debt sustainability

- The policy response to COVID-19 has been unprecedented. Within weeks of the WHO declaring COVID-19 a pandemic, every major developed market central bank had lowered its policy rates to, or near, their effective lower bounds.
- New government fiscal measures in 2020 amount to over US$5 trillion, or 6% of global GDP. The fiscal response will likely push the global public debt-to-GDP ratio above 100%.
- As the recovery continues, we will pay close attention to the evolving stance of fiscal and monetary policy and possible modifications to policy frameworks, particularly on the monetary side.

THEME 4

Deglobalization, trade and the trade war

- The decades-long process of increasing the integration of economic activity through international trade had lost momentum, even before the pandemic.
- Despite the setback in trade globalization, the pace of trade and value-chain integration has accelerated at a regional level, particularly in Asia. This trend of regional integration could further accelerate, with additional regional trade agreements being finalized.
- Emerging markets, most notably China, have increased their share of global exports since the 1990s.

THEME 1

Evolution of COVID-19 and its impact on the economy

The evolution of the COVID-19 pandemic was the biggest global story of 2020 and will remain one of the most important considerations in shaping the outlook for 2021 and beyond. As of the beginning of December, nine months after the World Health Organization (WHO) characterized COVID-19 as a pandemic, the number of confirmed cases has continued to grow across the world, accompanied by over 1.5 million deaths. The increase in global case numbers reflects the natural spread of the disease as well as increased testing capacity in many countries. Medical progress has contributed to a decline in the rate of fatalities, thanks to a better understanding of the virus, a broader set of treatments and improvements in hospital procedures.

Key COVID-19 Vaccine Challenges Remain

- Efficacy and side effects
- Distribution and allocation
- Global adoption

One of the most important developments to watch over the coming months will be progress towards production and broad-based uptake of COVID-19 vaccines. Vaccines typically take 10-to-20 years to develop. But, given the unprecedented global push to make one available to counteract COVID-19, the world has produced multiple effective vaccines within one year of the discovery of the virus. Despite this good news, many uncertainties remain. For instance, more data from clinical trials will be required to offer a better sense of the long-term efficacy and possible side-effects of the vaccinations. Logistics for distribution and allocation of the vaccines will also be challenging: the world has never undertaken a universal vaccination campaign on such a large scale and rapid timeline.

Over the coming months, we will continue to watch the impact of contact tracing, social distancing and other public health measures—all of which will remain the first lines of defense against COVID-19. While many believe the arrival of an effective vaccine will mark the beginning of the end of the pandemic, the transition to normalcy will only come as people have confidence that they can resume customary activities without endangering themselves or others.

Seated diners at restaurants worldwide

⇩ 50%

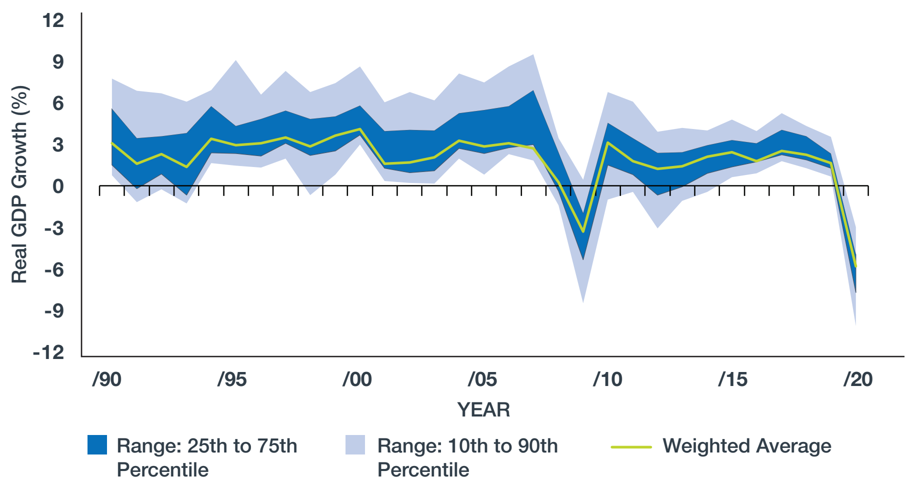
below last year's level

Finding the bottom

The supply and demand shocks related to COVID-19 contributed to the most substantial and synchronized global recession in living memory. The depth and speed of the downturn, and subsequent recovery, have varied widely across industries and countries. Goods production bounced back relatively quickly and retail sales in advanced economies reached their pre-pandemic levels by June. Service sector output is still well below its pre-pandemic level, especially in lines of business that involve face-to-face interactions with customers. As one example, the number of seated diners at restaurants worldwide remains 50% below last year's level.

While the economic slump caused by COVID-19 has been global in nature, with the International Monetary Fund (IMF) projecting a drop in real GDP in 2020 in every advanced economy except Taiwan, the cross-country variation in real growth is also expected to be relatively wide **(SEE CHART 1)**.

Chart 1: Distribution of real GDP growth in advanced economies



Source: IMF, CPP Investments

The variation between countries can be attributed to three factors—the **spread of the disease**, the **pre-existing structures of economies**, and **local policy responses**—which will continue to have a significant bearing for the economic outlook in the short-to-medium term.

Controlling the spread: Countries that emphasized testing and contact tracing, and slowed the spread through quarantines, have done a better job at controlling transmission of the virus and are in a better position to return to their pre-COVID-19 trajectory. China was the first to experience the pandemic, and it was also among the earliest countries to control its spread. We will be paying close attention to the efficacy of China's exit strategies and their interdependencies with the ongoing recovery, which could also serve as a helpful case study for policymakers in other countries. Elsewhere, much will depend on the extent to which other effective measures and judiciously chosen restrictions are applied to mitigate the viral spread while minimizing their economic impact.

Influence of pre-existing structures: The underlying structure of economies is also affecting the shape of recovery from the COVID-19 shock. Countries with more employment in retail and hospitality often experienced a larger economic impact from the spread of COVID-19; the shape of their recoveries will depend to a greater extent on the progress in dealing with this disease. In contrast, countries with large manufacturing sectors have generally been less susceptible because operating factories under social distancing can be easier than running service-oriented businesses, which often rely on the congregation of large numbers of people. These countries will tend to have a faster normalization of activity.

Local policy response: Governments in advanced economies generally responded to the COVID-19 shock with swift and sizeable changes in fiscal and monetary policies. To try to limit the consequences of the shock, key central banks responded with large liquidity injections, along with cutting interest rates to generational lows. Very low nominal interest rates are likely to last for a substantial period, reducing the costs associated with prolonged deficit spending. In comparison, emerging economies reduced policy rates in many cases, but generally had less fiscal flexibility and deployed a much smaller fiscal stimulus. As discussed below, the trajectory of these various emergency policy responses will have ramifications for 2021 and beyond.

The pandemic has affected virtually everyone, but not equally.

A 10% contraction in global income or consumption could increase the number of people living in poverty by

180-280

MILLION[1]

Exacerbation of global inequalities

The pandemic has affected virtually everyone, but not equally. The economic crisis caused by the pandemic has exacerbated global inequalities, with social distancing and lockdown policies disproportionately hurting those who are more economically disadvantaged. For example, either new restrictions or outright prohibitions on incoming immigration, as well as the general inability to travel for work, has led to a significant loss of income for the working poor in developing countries, a group who tend to depend on casual work and a daily wage.

The United Nations estimates that, in the case of a 10% contraction in global income or consumption, the number of people living in poverty in the world could increase by between 180 and 280 million.[1] Even in the U.S., many elements of the stimulus packages which helped bring millions of working-poor families above the country's poverty line have expired, and poverty rates have returned to pre-pandemic levels.[2] The consequences for poor children will become apparent years from now in the form of reduced formal education, earnings and opportunities. As covered in our second theme, the erosion of human capital is one of the channels through which the pandemic could leave a lasting scar.

Transformation of global supply chains

The shock from COVID-19 could catalyze other changes in the world economy. Heading into the pandemic, international trade was already noticeably affected by the trade war between China and the U.S. The spread of COVID-19 coincided with, and to an extent exacerbated, a further escalation of tensions between the two nations. Trade disputes are now part of a broader strategic competition that might remain particularly intense, even with a new administration set to take charge in the U.S.

Prior to the COVID-19 shock, increased U.S. tariffs and a rise in protectionism had already fueled concerns about global supply chains. COVID-19 has forced firms to reevaluate and transform their logistical networks, as the hidden costs of single-source dependencies and inflexibility in adapting to real-time shocks have been laid bare by the pandemic. We will be watching whether this recent experience with supply disruptions due to COVID-19 increases firms' emphasis on resilience and diversification of suppliers, as compared to efficiency in production. Our fourth theme offers a deeper dive into what we are watching in terms of supply chain linkages and regionalization.

THEME 2

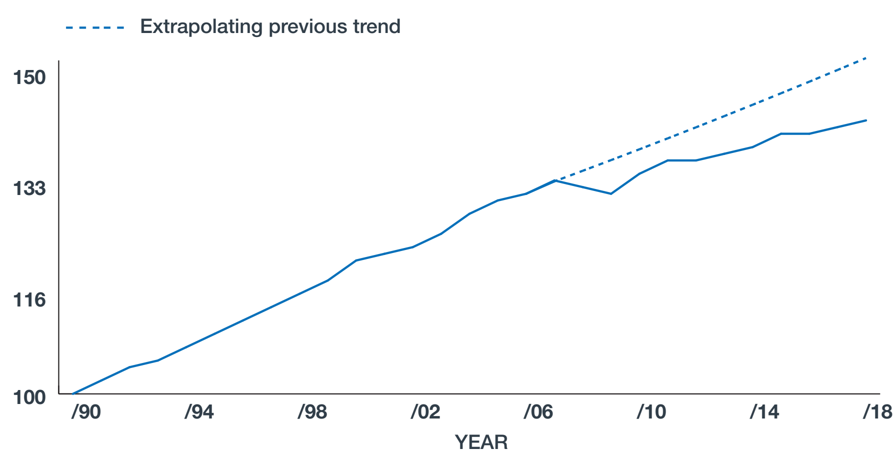
Productivity, scarring and implications for potential growth

Drivers of productivity growth

- Technological innovation
- Investment in physical capital
- Improvements in quality/availability of education

Technological innovation, investment in physical capital, and improvements in the quality and availability of education are the main drivers of productivity growth. Over the last decade, productivity growth slowed sharply globally and has not caught up to its previous trend **(SEE CHART 2)**. Potential sources of this slowdown remain a subject of debate, with explanations ranging from lower marginal gains from innovation, inadequate diffusion of productivity gains within economies, and depressed investment if the natural rate of interest is below the effective lower bound for interest rates (secular stagnation). We will be closely monitoring whether the COVID-19 shock will have a similar effect on productivity growth and leave scarring effects on the economy through the channels discussed below.

Chart 2: Productivity level in advanced economies (indexed to 100 in 1990)



Source: World Bank, CPP Investments

Weaker investment growth

In the past, business investment has been an important driver of productivity growth. However, faced with elevated uncertainty about potential structural changes in the economy and weak demand, some firms may postpone or cancel their investment plans. In the energy sector, investment growth is further depressed by low oil prices. Moreover, a potential decline in Foreign Direct Investment could contribute to a slower pace of technological progress in emerging markets. On the other hand, the rapid policy response, low interest rates and relatively robust recovery in equity markets and the economy following the initial COVID-19 shock, could encourage a faster resumption of original plans for business investment.

Erosion of human capital

How would businesses classify their current situation?

27%

of survey respondents say "bad"[3]

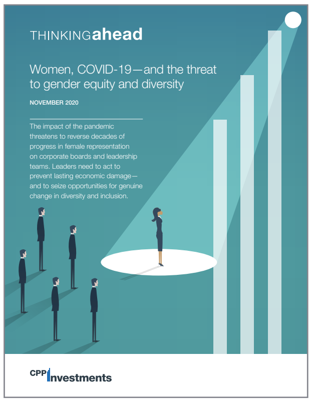
Small businesses represent

65%

of total employment in Canada[4]

As governments across the world introduced lockdowns to contain the spread of COVID-19 in the first half of 2020, hours worked dropped sharply. While employment losses have started to reverse as economies have reopened, the recovery has been uneven across workers and industries. Unlike in previous recessions, activity in the service sector contracted abruptly during the downturn, with lower-wage workers tending to be hit the hardest. The nature of the shock could lead to a resource reallocation across regions and industries. Further, the associated restructuring of firms and retraining of workers will not happen immediately, and related labour-market frictions could result in higher unemployment, skill erosion and lower participation rates over the next few years.

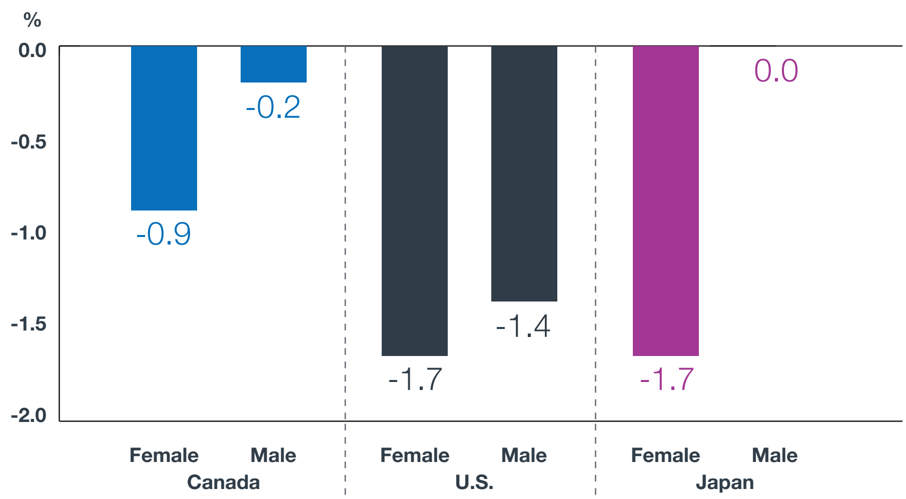
The pandemic-induced shock has been especially challenging for small businesses. For example, based on the November survey conducted by the Canadian Federation of Independent Business, 27% of businesses would classify their current business situation as "bad."[3] With small businesses representing 65% of total employment in Canada in 2019,[4] according to Statistics Canada, the capacity for small businesses to recover and adapt while confronting an unprecedented set of circumstances will have a significant impact on the labour market in general.



Read [Women, COVID-19—and the threat to gender equity and diversity]() for recommendations on how to preserve the pipeline of women business leaders.

The labour market recovery has also been uneven across genders, with women bearing a heavier burden from the shock. Since the onset of the pandemic, more women than men have dropped out of the labour force, setting back a long-run trend of rising female participation **(SEE CHART 3)**. A failure of female workforce participation rates to recover to their pre-pandemic trends would affect potential output. Another source of a potential erosion of human capital would be pandemic-related disruptions to education. Access to education is also the key source of social mobility. Because children from lower-income families may have fewer resources for remote learning, closures of schools and universities could widen income gaps and increase social inequality.

Chart 3: Labour force participation rate (change between 2019Q4 and 2020Q3)



Source: OECD, Haver Analytics, CPP Investments

A slowdown in global trade

Historically, greater economic integration through trade has boosted productivity. While the slowdown in global trade preceded the COVID-19 shock, the pandemic has called into question the structure of existing supply chains, as discussed in our fourth theme. An adverse impact on supply chains and global trade could impair productivity growth.

THEME 3

Monetary and fiscal policy and debt sustainability

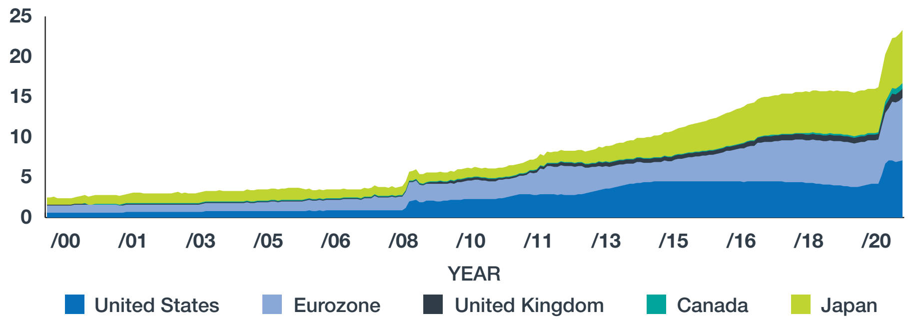
The policy response to COVID-19 has been unprecedented. Since the beginning of the pandemic in March 2020, there has been a dramatic increase in temporary government spending and monetary stimulus. As the recovery continues, we will pay close attention to the evolving stances of fiscal and monetary policy and possible modifications to policy frameworks, particularly on the monetary side.

Monetary policy response

Within weeks of the WHO declaring COVID-19 a pandemic, every major developed market central bank had lowered its policy rates to, or near, their effective lower bounds. This was followed by new or expanded quantitative-easing programs, which rapidly expanded central bank balance sheets **(SEE CHART 4)**.

Chart 4: Selected central bank assets

$US trillions converted using last exchange rate, monthly



Source: CPP Investments, Haver Analytics

Central banks in emerging markets entered the crisis with higher policy rates and more room to maneuver; as a result, they have typically lowered rates more than in developed economies. However, concerns about inflation in some cases have kept rates from reaching lower bounds and, in general, use of quantitative easing has been much more limited in emerging markets.

Takeaway

Central Bank Views

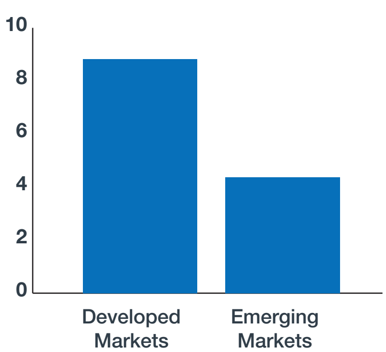
As central banks responded to the COVID-19 shock, many were already conducting lengthy reviews of their frameworks, objectives and tools. In August, the Federal Reserve announced that, in setting policy, it will now "be informed by assessments of the shortfalls of employment from its maximum level." The Fed also adopted an average inflation target of 2%, which means that, following periods of persistent inflation undershoots, they would allow inflation to moderately overshoot the target for some time. In 2021 the European Central Bank is expected to conclude its strategy review and the Bank of Canada will renew its Monetary Policy Framework. The central banks of New Zealand and the U.K. are exploring the introduction of negative interest rates. In these cases, and others, we are watching for whether framework changes will entail a more accommodative inclination in future policy setting. While the COVID-19 shock has proved disinflationary thus far, and comes after a decade where most advanced economy central banks fell short of their inflation objectives, we will be looking for evidence of whether adjustments to central bank frameworks are associated with more robust rates of inflation as economies recover.

Fiscal response

Monetary policy stimulus has been accompanied by an unprecedented fiscal response. New government measures in 2020 amount to over US$5 trillion, or 6% of global GDP. In addition to new measures, automatic stabilizers and liquidity supports further increase the fiscal cost. Support varies markedly by country, reflecting available fiscal space. To date, developed economies and large emerging markets have delivered the lion's share of stimulus. As the pandemic has continued, the pace of fiscal easing has begun to slow. Further action in the U.S. has been impeded by political obstacles, and balanced-budget requirements at the state level are generating a contractionary fiscal impulse. Further discretionary easing in Europe is constrained by national politics and high debt in the periphery. Discretionary fiscal easing in emerging markets has been more limited than in developed markets **(SEE CHART 5)**.

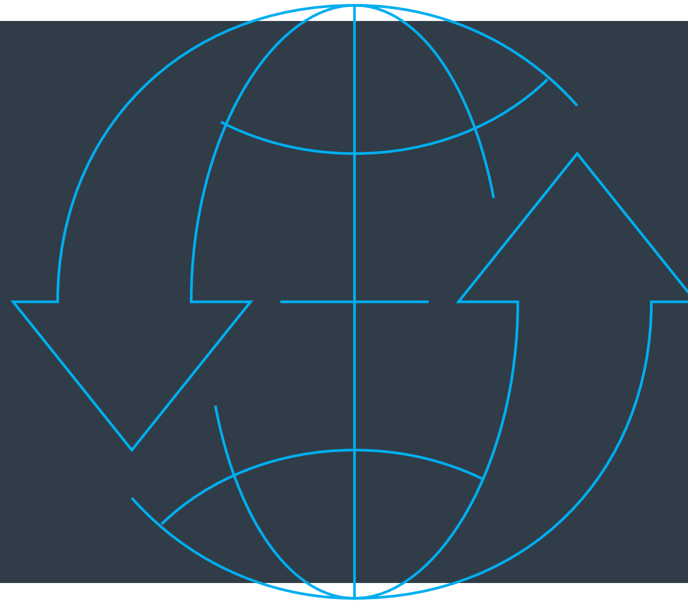
Chart 5: 2020 fiscal policy expansion in response to COVID-19

% of GDP, excluding automatic stabilizers, revenue losses and loan guarantees



Source: Goldman Sachs, CPP Investments, Haver Analytics

The fiscal response will likely push the global public debt-to-GDP ratio above 100%. These levels of public debt should be manageable for countries with control of their own monetary policies. We will be watching for fiscal tightening that could slow the pace of the recovery. For countries without control over their own monetary policies, or those that issue sovereign debt in foreign currency, fiscal contraction over the medium term may be unavoidable as sluggish growth and high debt levels raise questions about fiscal sustainability. We will be watching for changes to fiscal frameworks, particularly in Europe where increased fiscal transfers among member states featured prominently in the policy response.



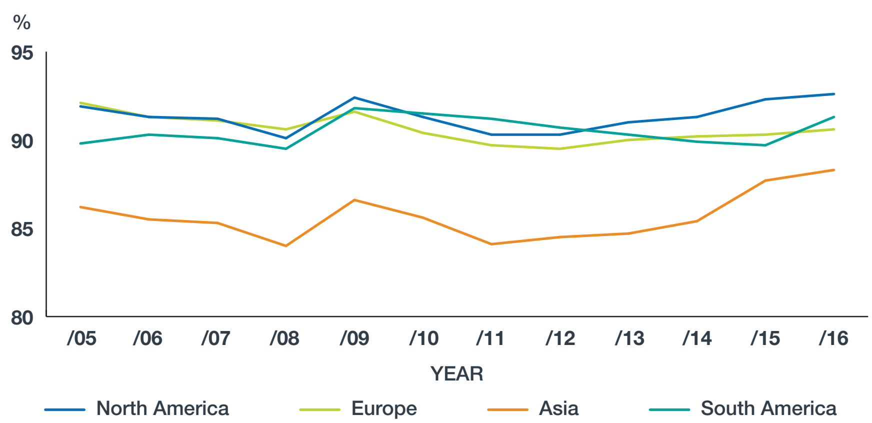
THEME 4

Deglobalization, trade and the trade war

The decades-long process of increasing the integration of economic activity through international trade had lost momentum, even before the pandemic.

The Organization for Economic Cooperation and Development's (OECD) estimates of domestic value added as a share of gross exports helps identify a country's contribution to global value chains. It can be used to measure the degree of globalization or regional integration. Increases imply a shortening of supply chains (decreasing economic integration through trade). The trend of less integration is evident for some geographies. Several sizeable regions have become more insular over the last decade **(SEE CHART 6)** due either to increased local production at the country level—that is, more closed economies—or increased intra-regional integration.

Chart 6: Domestic value-added share of gross exports



Source: OECD, CPP Investments

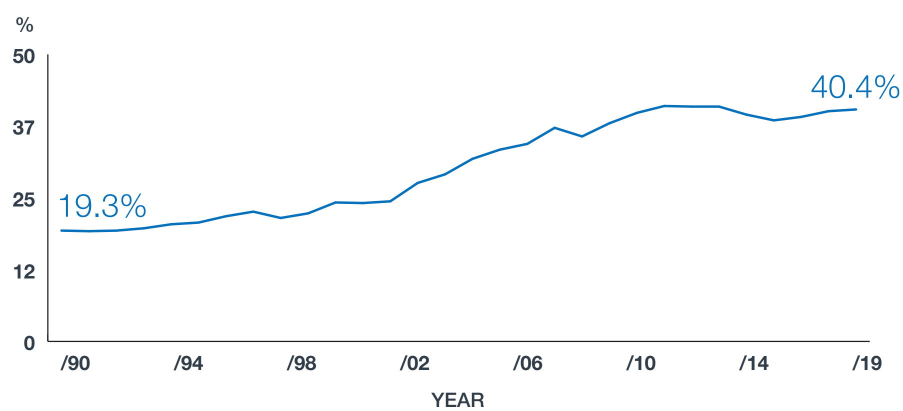
Despite the setback in trade globalization, the pace of trade and value-chain integration has accelerated at a regional level, particularly in Asia. Asia's intensity of participation in regional value chains relative to global value chains has increased since 2000, suggesting that a relatively larger portion of production is being relocated into the regional production network. In North America, the regional value chain linkage between the U.S. and Canada has continued to strengthen.

This trend of regional integration could further accelerate, with additional regional trade agreements being finalized. In Asia-Pacific, a mega regional trade deal—the proposed Regional Comprehensive Economic Partnership—was recently signed. This deal covers an economic bloc representing around one third of the world's GDP and population, and potentially more if India eventually joins. Separately, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, a free trade agreement involving 11 countries in the region, would potentially create a free-trade zone accounting for 13% of global GDP. We will closely watch the new U.S. administration for a possible re-engagement with international institutions, such as the World Trade Organization and the WHO, as well as its participation in other global initiatives, such as the Paris Agreement on climate change mitigation.

Finally, in the past few decades, there has been a shift in the center of gravity of international trade. Emerging markets, most notably China, have increased their share of global exports since the 1990s **(SEE CHART 7)**. Meanwhile the shares of several large advanced economies have fallen, including Japan and Germany.

Whether, and how, this shift will be affected by the combination of trade deglobalization and regionalization remains an important area of focus for long-term investors.

Chart 7: Emerging markets' share of world exports



Source: IMF, Haver Analytics, CPP Investments

CONCLUSION

Looking back and thinking ahead

Looking back at 2020, two defining attributes made a notable mark that we believe will continue to impact the outlook for 2021 and beyond.

Looking back at 2020, two defining attributes made a notable mark that we believe will continue to impact the outlook for 2021 and beyond. First, the world experienced an unprecedented shock, with the significant downturn largely owing to the difficulties in containing the global pandemic. Second, there was a marked increase in uncertainty, which is also a reflection of the extraordinary set of circumstances the world still faces at the end of the year. The short- and medium-term arcs for the world economy are uncertain on several dimensions.

The recovery from the COVID-19 shock could be relatively vigorous if the vaccine roll-out is successful and policy actions continue to facilitate a faster rebound to the pre-pandemic trajectory for growth. There is, however, a significant risk of scarring effects that could have a more protracted impact on productivity and economic potential.

Modifications to monetary policy frameworks, combined with accommodative fiscal policy, could lead to modest but temporary increases in rates of inflation in the near-to-medium term and spur a rebound in employment rates and business investment. On the other hand, a failure of policy to evolve, along with unexpected weakness in global growth, could lead to continued below-target inflation. This would raise the risk that real neutral interest rates will remain near zero and that business investment will remain weak.

Global trade will likely rebound significantly in 2021 as economies recover from the COVID-19 shock. Beyond 2021, more emphasis on resilience as compared to efficiency in production could reinforce tendencies towards intra-regional linkages, with both contributing to increased balkanization of international trade.

We will closely monitor these various cross-currents in our assessment of economic and financial developments in 2021 and beyond.

Sources

1. **United Nations Working Paper.** Estimates of the Impact of COVID-19 on Global Poverty. 2020.
2. **Columbia University.** Monthly Poverty Rates in the United States during the COVID-19 Pandemic. 2020.
3. **Canadian Federation of Independent Business.** Business Barometer November 2020 SME business outlook survey results. 2020.
4. **Statistics Canada** via **Haver Analytics.** Data retrieved December 2020.

At CPP Investments, we are always thinking ahead about global issues and trends as we invest for generations of Canadians. Explore more of our latest insights at www.cppinvestments.com/thinking-ahead.