February 2021

Global Economic Outlook

A strong rebound, but scars will remain

Global Overview

A strong rebound, but scars will remain

Two forces will drive a strong rebound in the global economy over the next three years: widespread vaccine rollout allowing a progressive easing of lockdowns, and additional large scale US fiscal stimulus. These tailwinds mean we have revised up our global GDP forecasts for 2021 (5.7%) and 2022 (4.6%), and we also envisage above-trend growth in 2023 (3.8%). Nevertheless, the crisis will leave deep and long-lasting scars on parts of the global economy.

Admittedly, vaccine rollout has not been without its challenges. Intermittent supply and (especially in Europe) low take-up have hampered the initial rollout, with the US and UK notable exceptions. But we think vaccine coverage in the major economies will build rapidly over 2021, allowing restrictions to ease and activity to rebound. Unfortunately, many poorer economies will take much longer to achieve herd immunity, delaying their recoveries and forcing countries more advanced in their inoculation drives to keep international travel restrictions in place well into 2022 and perhaps beyond.

Meanwhile, we now expect a $1.5-1.9 trillion US Covid relief plan to pass in March. Although the fiscal multipliers associated with this package are likely to be below one, it will still boost US growth considerably over the next few years. There will also be a positive spillover into the rest of the world, though these may be smaller than usual as demand rotates away from internationally traded goods and towards services.

Indeed, the coming shifts in the composition of activity during re-opening are likely to have wide-ranging implications. The share of goods consumption rose during lockdowns amid a dearth of service spending opportunities. This is likely to partially reverse during re-opening, which means EM exporters may not be as large beneficiaries of strong global growth as historical parallels suggest.

The strong cyclical outlook does not mean that the global economy will shrug off the Covid crisis without lasting scarring. Supply-side damage may be limited in China thanks to the superior handling of the pandemic, and in the US by the sheer size of the fiscal impulse.. But in places like the UK and Europe where the contraction was deeper, initial policy responses tentative, and the recovery more gradual, a lasting hit to both the level and growth rate of potential GDP seems probable, although it may only become evident once the initial rebound plays out.

Turning to inflation, headline rates are being pushed higher by a combination of energy base effects, higher commodity and food prices, expiring tax cuts associated with the crisis, and re-weighting of inflation baskets to reflect lockdown consumption patterns. These drivers could push headline inflation well in excess of central bank targets in many economies by the middle of this year. However, most of these drivers are temporary in nature, and inflation will drop back as they fade through H2 2021.

Admittedly, the scale of coming US fiscal stimulus has increased speculation that a more lasting and damaging inflationary impulse may be on its way. But we think this narrative understates the magnitude and breadth of the longer-term disinflationary forces acting on the US and global economies, and forgets that economies will need to run hot for a substantial period of time if inflation targets are to be met. In any case, central banks have plenty of room to contain inflation if needed.

The upshot is that while markets have brought forward the expected date of monetary policy lift-off in a number of economies, we think this overdone. The Fed has welcomed a hot economy and we do not expect QE tapering to begin until early 2022, and the first rate hike until late 2023. For most other DM central banks, tighter policy is further away still, while few DM or EM central banks will welcome the recent rise in yields because it is unduly tightening financial conditions. The ECB's mantra of "maintaining favourable financing conditions" has already seen it push back against market expectations of tighter policy, and we don't envisage any actual tightening or even tapering over our forecast horizon.

In China, monetary policy and broader financial conditions are shifting in a more neutral direction, given the rebound in the economy and policymakers' concern with medium-term financial stability risks. While the Chinese financial cycle is unlikely to tighten to the extent that it represents a major headwind to global growth, it will certainly not provide the enormous boost it did during the recovery from the Global Financial Crisis.

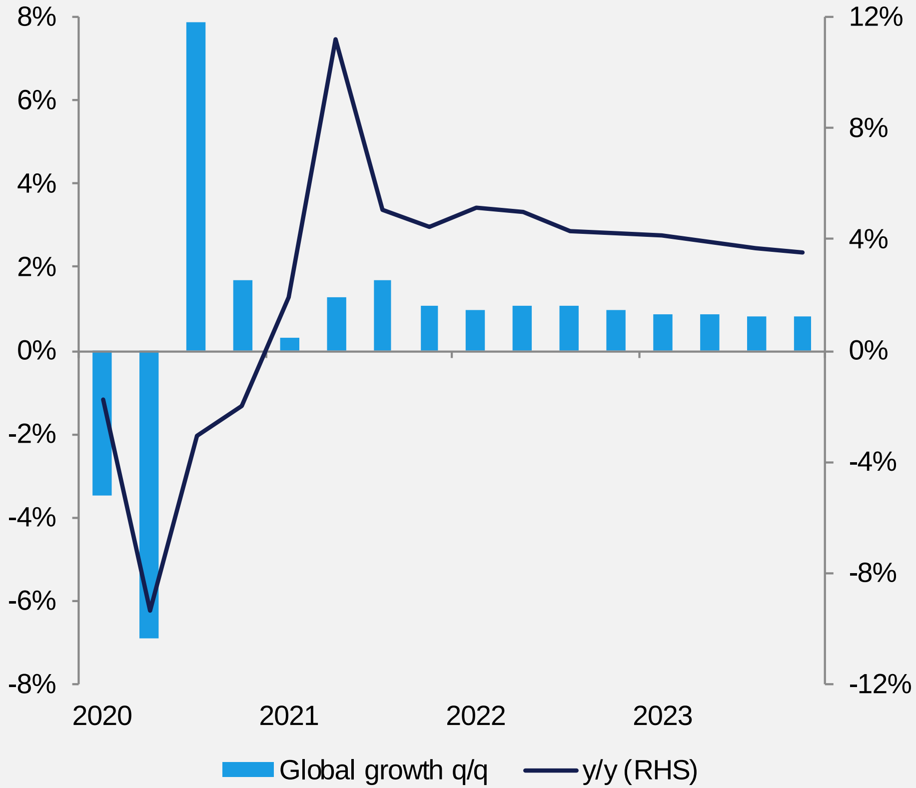
Geopolitically, a Biden Presidency in the US, a Brexit trade deal agreed between the UK and EU, and a new Italian government formed under Mario Draghi might suggest a calmer global political environment in 2021. However, the deeper forces which have driven political risk over the past decade have not gone away, and may become more acute during the uneven recovery from the Covid crisis. The US and China are still engaged in a strategic rivalry and trade tariffs won't unwind anytime soon; vaccine nationalism is a potential cause of geopolitical tension; the UK may soon face another referendum headache in the form of a Scottish independence push; and a contentious debate about reform of the EU fiscal rules is looming.

Finally, it continues to be the case that there are wide confidence intervals around our forecasts, and focusing on ranges and scenarios is more useful than point forecasts. The size and scale of US fiscal stimulus, the cautious assumptions we have made about multipliers, and the gradual path of lockdown easing we are conditioning on, mean that the risks around our baseline global forecasts are probably skewed to the upside. Indeed, we have added some probability mass to an upside scenario in which the lasting damage from the crisis is very small. However, there are still downside risks posed by fast-spreading variants of the virus, which may yet escape the current crop of vaccines, as well as from a potential tightening in financial conditions that isn't justified by the underlying economic environment.

Global Forecasts

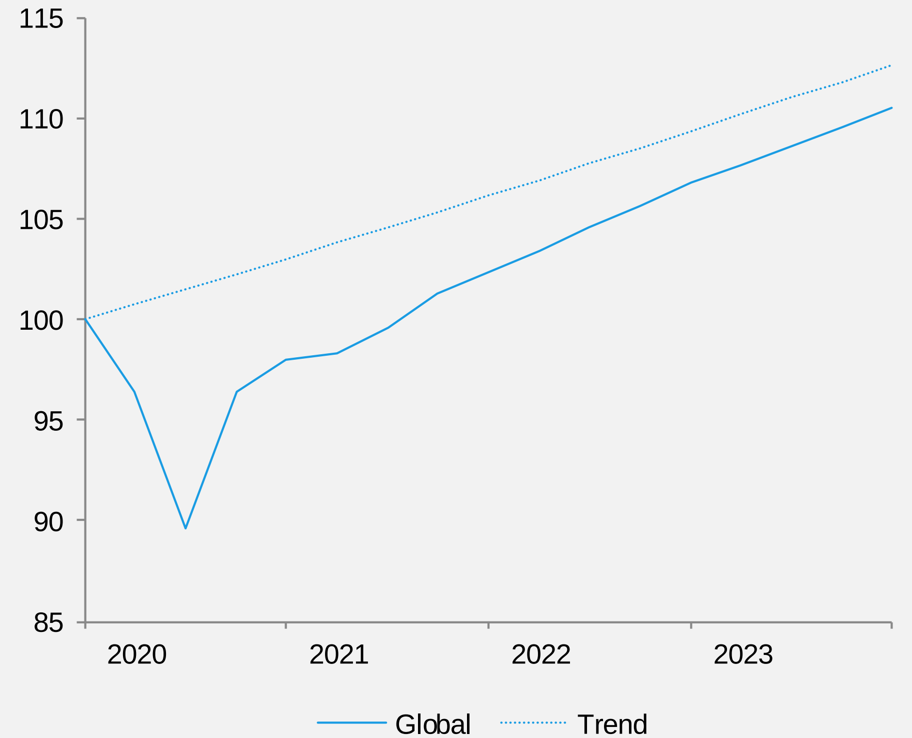
Growth to re-accelerate but activity likely to remain below the pre-Covid trend path

Global GDP growth forecasts



Source: Aberdeen Standard Investments, Haver, February 2021

Implied global GDP levels by forecast date (Q4 2019 = 100)



Source: Aberdeen Standard Investments, Haver, February 2021

*Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.

AberdeenStandard Investments

Global Economic Scenarios

A modest increase in our upside skew, as further fiscal stimulus and vaccine rollout gather pace. But new variants still pose risks, and we retain some probability on the extreme downside scenario amid potential for mutations to render vaccines ineffective

Scenario	Description	Probability*
Rapid and complete recovery: Deep recession then rapid recovery back to or even above the pre-crisis trend path	Virus & vaccine: effective vaccines rolled out rapidly over early-2021, with most of the G20 inoculated by end 2021, removing strain on health systems. Economic openness: second wave is very quickly brought under control, allowing lockdown restrictions to ease rapidly. Behavioural response: lower viral prevalence allows resumption of pre-Covid socially intensive activity. Policy: monetary, fiscal and structural policies remain proactively focused on supporting a rapid recovery. Economic impact: rapid rebound in activity, helped by excess savings, so that all the output lost relative to the pre-Covid trend is made up by end 2021.	**10%**
Rapid recovery with modest long-term scarring: Deep recession, but with recovery helped by highly successful global vaccine roll-out, leading to limited permanent loss	Virus & vaccine: several hundred million doses of vaccine administered over early 2021, reducing strain on health systems. Economic openness: lockdown is phased out across major markets through Q1-Q2 as vaccine rollout gathers pace. Behavioural response: economic activity supported by gradually more confident consumers and corporates. Policy: generous programmes for economies sustained through 2021. Economic impact: recovery continues through 2021 as uncertainty declines. Most sectors return to normal function, but some permanent damage from weaker potential output (1-2% permanent hit to global growth).	**25%**
Strong recovery but significant long-term scarring: Deep recession, followed by strong but incomplete recovery as global vaccine rollout and lockdown lifting takes time, leading to permanent loss	Virus & vaccine: virus persists over much of 2021, but declines from current levels from Q2 onwards. Vaccines rolled out with good take-up across major markets by mid 2021, while therapeutics reduce mortality and strain on health systems. Economic openness: lockdown is phased out slowly through 2021, but some measures remain in place even by year-end. Behavioural response: economic activity gradually returns, but incomplete vaccine coverage and uncertainty continue to create some caution among corporates and consumers. Policy: policy helps avoid a worse outcome by bridging some of the liquidity issues faced by households and firms. Economic impact: double-dip recession in some economies in short term, with more gradual recovery and lasting damage resulting in the permanent loss of 3-5% of global output.	**27.5%**
Renewed contractions: Deep recession very uneven recovery amid multiple waves driven by mutations and stuttering vaccine rollout, leading to deep permanent loss	Virus & vaccine: more infectious variants of the virus are persistent over 2021, with vaccine rollout delayed & hampered by poor take-up. Economic openness: tight lockdowns stretch well into 2021, and are periodically re-imposed across multiple major markets. Behavioural response: ongoing outbreaks and lockdowns lead to weak business investment and consumer caution. Policy: policy mistakes occur in key major markets as politics trumps economic need. Economic impact: economic and financial volatility amid persistently depressed activity with permanent output hit 6-9% versus previous trend.	**20%**
Deep and long-lasting slump: Deep, protracted, post-GFC-like permanent loss of output, amid vaccine escape	Virus & vaccine: further virus mutations mean that current crop of vaccines either fail or see dramatically reduced efficacy. New vaccine research efforts are required, but don't bear fruit until 2022. Economic openness: extreme lockdowns persist throughout 2021 and into 2022. Behavioural impact: this yields significant behavioural changes and makes it much harder to mend broken cash flow cycles. Policy: premature fiscal tightening in key markets/ loss of faith in ability of central banks to act or fears of politicisation. Economic impact: recovery looks more like the post-GFC pattern with much larger permanent losses worth around three years of global growth (10%).	**5%**

Source: Aberdeen Standard Investments (February 2021)

*The probabilities assigned to these scenarios do not add up to 100%. This reflects the wide range of alternative potential outcomes that cannot be captured in this exercise. Importantly, missing scenarios are assumed to be evenly distributed to the upside and downside relative to the base case.

Quantitative Indicators

Latest high frequency data point to divergence at start of 2021

Our suite of quantitative indicators points to a softening of activity in Q1 in a number of economies, with some set to contract. Looking further ahead, some of our models suggest that some economies may quickly display "late cycle" characteristics once the initial recovery has played out.

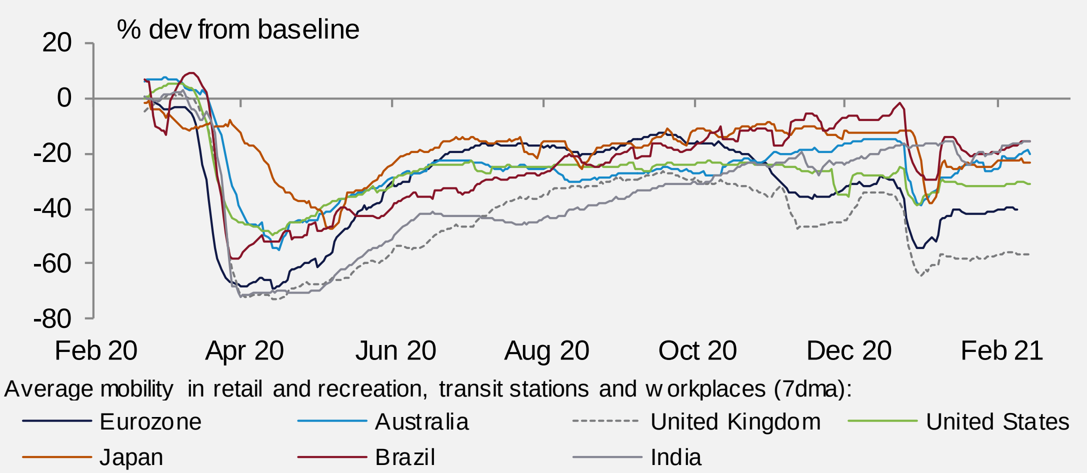
High frequency activity measures such as Google mobility data, traffic flows, retail footfall and electricity demand have been particularly useful in tracking the economy in near real-time during the pandemic. The UK stands out with mobility particularly depressed amid a still-tight lockdown, although Eurozone mobility also remains subdued. The largest normalisations in mobility have occurred in the United States, India and Brazil.

Confirming these signals, our more traditional nowcasting models suggest that the UK and Eurozone economies will contract in Q1 2021. The latter would herald a technical double-dip recession in the Eurozone. US growth is expected to moderate, but remain positive, before re-accelerating as fiscal stimulus kicks in.

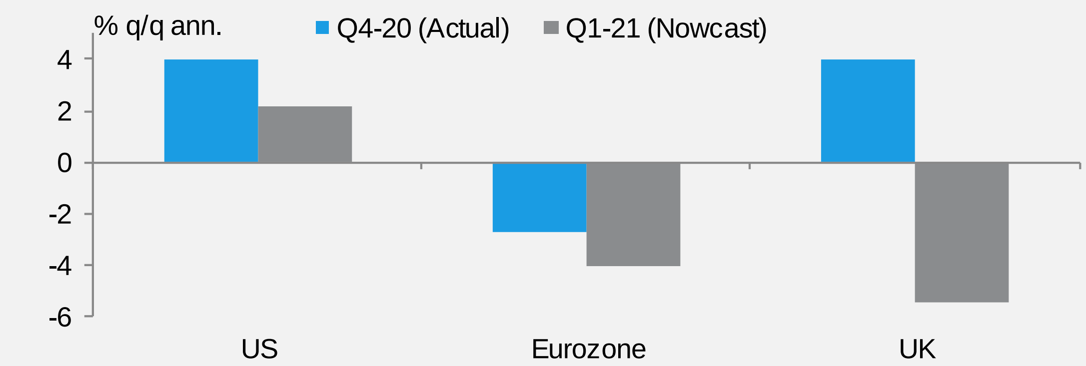
There are also marked sectoral divergences in the last economic data. Industrial activity has continued to grow strongly in many economies, as factories adapt to operating under restrictions and goods demand remains strong. But activity in the services sector has been more mixed. US service sector output continues to improve, but ramped up restrictions in Europe and Japan have weighed on the retail sectors. This pattern is reflected in the most recent round of PMIs, with services PMIs lagging well behind manufacturing, and in contractionary territory in many economies.

While the focus in the near term is on the virus, vaccines, and an expected economic recovery, we are also considering the risks to this new cycle. Going into the pandemic our US recession risk models were signalling elevated risks of recession due to traditional macroeconomic imbalances (we cannot capture tail risk events such as the pandemic in a formal modelling framework). Updating these models with the latest data suggests that the overall risks of recession are low, but pockets of "late cycle" risk remain in the labour market and the consumer sector, with series like vehicle sales and consumer confidence at the most stretched levels by historical standards.

Google mobility highlights diverging outlooks



Nowcasts suggest wide dispersion of Q1 GDP numbers



Source: Google Mobility Reports, Haver, Bloomberg, Aberdeen Standard Investments (February 2021).

Early vaccine experience suggests huge regional variation

Strong efficacy signals encouraging, but manufacturing and rollout creating issues

We have learned a lot from the first few months of global vaccine distribution. Vaccines have now been approved in the major markets, efficacy is generally better than we initially expected, and survey data show upward trends in willingness to take vaccines. However, large manufacturing orders have disappointed in term of follow-through for H1 delivery – particularly in Europe – although our expectation is that these delays are mostly temporary. Meanwhile, our baseline vaccine expectations do not incorporate the risk of vaccine-resistant strains, but we are watching carefully for signs that this tail risk affects efficacy.

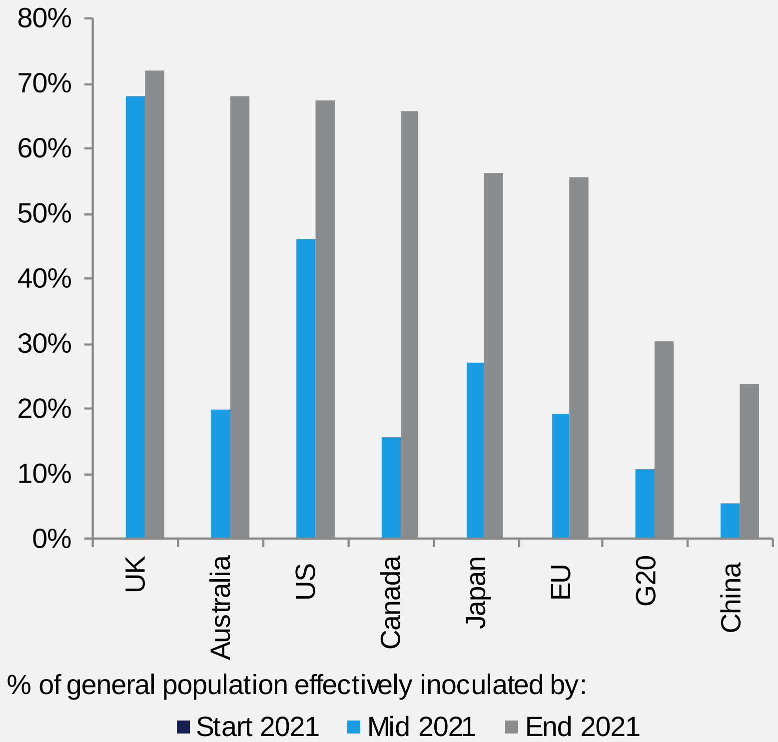
Teething issues rolling out the vaccine have been common in these early stages, but countries that moved earliest seem to show that challenges are partly temporary due to set-up issues, which makes the outlook for H2 better in most countries. Nonetheless, some countries will struggle more than others, with key indicators for success including: a digital, centralised health system; population density; supply predictability/domestic supply; and red tape related to vaccine approvals and vaccine infrastructure.

While we retain our estimate of 1.4bn effective inoculations in the G20 by end 2021, the distribution of vaccine success is highly disparate. Our expectations for US vaccine coverage have been boosted versus November thanks to confirmed approval, better than expected rollout early on, more vaccine orders under Biden, and better efficacy given the reliance on Pfizer and Moderna. The UK has also moved quickly on vaccines, and we continue to expect high effective inoculations by mid-2021. In the EU, we expect a kinked rollout – later approval, and early manufacturing and rollout issues, will weigh on H1, but H2 is set up for a strong bounce back as rollout issues improve and EU benefits from its massive stockpile of vaccine orders. Japan, Canada and Australia are also set to have kinked rollout due to late approval, rollout and supply issues.

Where our vaccine expectations are more downbeat is in emerging markets. In China, we have revised down our expectations for 2021 effective inoculations, because vaccination targets have been missed (authorities had been hoping to hit 50m before the lunar new year, but only managed 30m), while reports of supply bottle-necks and commitments to providing vaccines to other countries seem to be impacting manufacturing for the domestic market. We've also revised down our expectations of the rest of the G20, because we expect the challenges of access and vaccine rollout to be more extreme in less developed markets.

Finally, an important known unknown is the emergence of new strains that may be vaccine resistant. For the most part, this is not reflected in our *baseline* vaccine projections, but it is a crucial risk which may lower the efficacy of vaccines and delay their delivery as new formulations have to be tested and manufactured.

Regional variation among major markets will lead to uneven inoculation rates across DM and EM



*General population includes vulnerable population.

Source: Aberdeen Standard Investments (February 2021)

Projecting lockdown stringency

Lockdowns lifting over 2021, but residual measures to remain in place much longer

In addition to conditioning our macroeconomic forecasts on our expectations for the path of the virus and vaccine rollout, forecasting during the pandemic also requires us to think about the path of lockdown stringency. We expect vaccine rollouts to lead to a decline in stringency over 2021, but at different paces in difference economies, and with some meaningful restrictions in place for much longer.

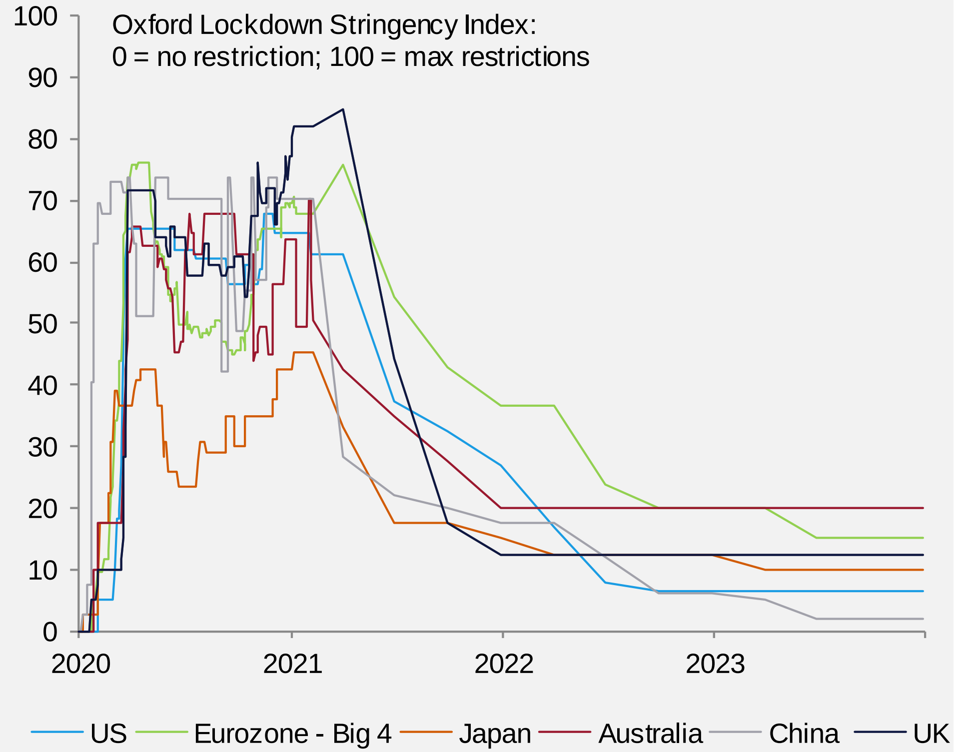
One way to quantify lockdown is the Oxford Stringency Index (OSI), which aggregates school and workplace closures, limits on public gatherings, closure of public transport, stay at home orders, restrictions on internal movement, international travel controls, and public information campaigns. We've augmented the OSI to include hospitality restrictions, and also take account of the proportion of an economy covered by measures. We then forecast every element of lockdown in each of the major economies over our forecast horizon. The result is a full path for lockdown stringency, which forms an important conditioning factor for our macroeconomic forecasts.

A number of messages emerge from this exercise. First, we are expecting a substantial easing of lockdown restrictions over 2021, amid vaccine rollout efforts. By the end of 2021, we think all the major economies will have lifted the toughest restrictions, such as school and shop closures. Moreover, vaccine coverage by the end of the year should be sufficient that the pausing of easing over winter 2021 that we previously envisaged is no longer in our projections.

Second, however, there is substantial regional divergence in the path of lockdown stringency. In Europe, we are expecting tighter aggregate restrictions during much of 2021-22, reflecting slower vaccine rollout but also a more cautious approach to re-opening. In China and Australia, by contrast, we are expecting the use of very regionally targeted restrictions, allowing the majority of the country to enjoy much looser restrictions. In the UK, the re-opening roadmap presented by the government is consistent with a fairly rapid easing in restrictions.

And third, even well into 2022 and 2023, we expect a residual layer of restrictions in parts of everyday life. Some of these have little to no measurable economic impact – things like continued mask wearing, and ongoing public information campaigns. But one area of long-lasting restriction could be on international travel – with immunity passports, pre-travel Covid tests, and bans on travel from areas at high risk of new variants sustained for the foreseeable future. This will remain a drag on growth, particularly in those countries most dependent on the cross-border movement of people related to travel, education and permanent migration.

Stringency to be lifted at different paces, but ultimately large declines across regions by end-2021



Source: Aberdeen Standard Investments (February 2021)

United States

Too much of a good thing?

President Biden's stimulus plans have kicked off a vigorous debate in markets. The sticker price of the latest $1.9tn package, equating to around 9% of GDP, has prompted concerns that the US economy could be set to overheat, unleashing a surge in inflation. Should we share these fears?

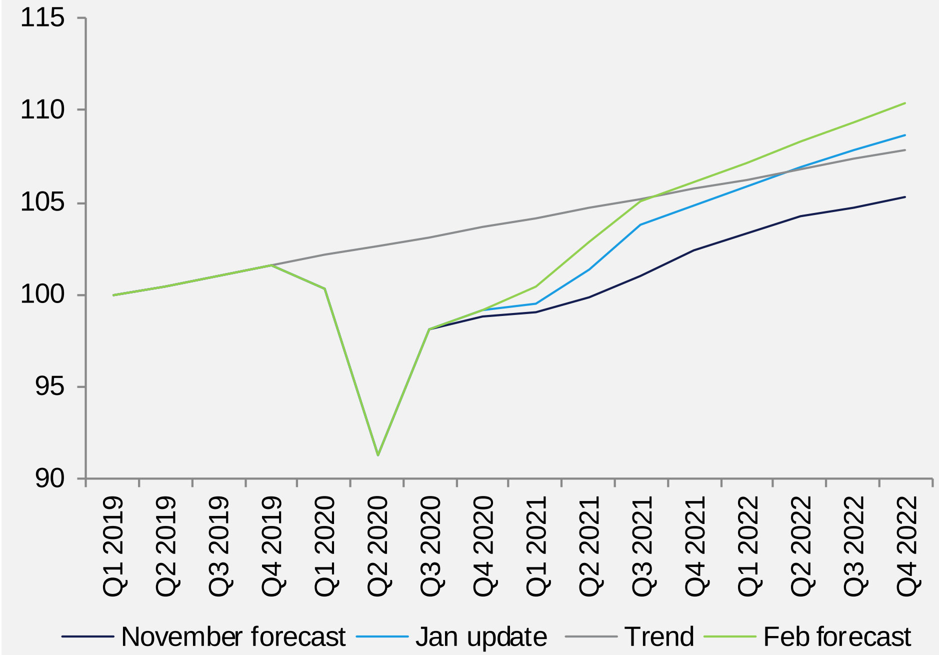
First, it is worth breaking down what we expect to pass, and what this means for the US recovery. With Democrats going it alone in Congress through the reconciliation process, we now expect a $1.5-1.9tn Covid relief plan to pass in March, containing enhanced unemployment insurance, additional stimulus checks, state and local government funding, and provision for a range of other priorities. Moreover, this bold plan is not expected to stand in the way of a long term green infrastructure investment deal later this year, financed by higher taxes and increases in the deficit of between $500-$1000bn.

Parsing the impact of this stimulus requires a judgement on what the multiplier effect of this spending will be through the economy. We have drawn heavily on CBO estimates for the impact of the 2020 CARES stimulus package here, which imply a moderate weighted multiplier of around 0.7 for the latest effort. Nevertheless, this cautious assumption still pushes our growth forecast up to a robust, and well above-consensus 6.6%y/y this year and 5% in 2022. And the risks seem to be tilted towards even stronger growth should the multipliers from this spending turn out to be higher.

This growth is clearly well above potential, and will quickly eat into spare capacity. Our modelling suggests the recovery will push unemployment rates to pre-crisis lows by the end of next year. However, while inflation is likely to bounce back strongly in 2021 driven by transitory effects, we are less convinced that the rapid recovery will translate into aggressive price pressures as base effects fade. Certainly, the experience of the past decade tells us that it has been hard to generate inflation at target, even when the cycle is well advanced, let alone the overshoot that the Fed is aiming for. We have therefore raised our inflation forecast to reflect the improved growth outlook, but only see these sustainably hitting levels consistent with the Fed's target in 2023.

Admittedly, we could be too cautious here and it is possible that the combination of sustained monetary and fiscal stimulus generates much stronger and more persistent inflation. However, in this case we think that the Fed would tighten policy and has the tools to prevent a damaging rise in inflation. But absent this, we expect the Fed to move slowly on policy, delivering a tapering in its asset purchases in 2022, before hiking rates for the first time towards the end of 2023.

Fiscal policy to supercharge the recovery



	2018	2019	2020	2021	2022	2023
GDP (%)	2.9	2.2	-3.6	6.6	5.0	3.1
CPI (%)	2.4	1.8	1.2	2.3	2.1	2.3
Fed Funds (%)	2.4	1.6	0.1	0.1	0.1	0.35

Source: Haver, Aberdeen Standard Investments (February 2021)

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China

Mind the gap

China has made an impressive recovery: it is one of only two G20 countries to record positive (official) growth in 2020. A zero tolerance approach to Covid has allowed the economy to achieve a large degree of normalisation, but it continues to pay a cost: Q1 growth may slow, reflecting the curtailment of travel around the lunar new year. China is well placed amongst EMs to inoculate its population, but some gap remains with DMs and as these countries re-open, demand for Chinese goods may suffer.

China ended 2020 on a very strong note, with activity continuing to be supported by a strong external environment and evidence that services is also contributing to growth. 2020 Q4 GDP growth came in above expectations at 6.5% y/y, up from 4.9% y/y in Q3. Official data therefore suggested that GDP was back to – or in our own estimation slightly above – its pre-COVID trend path, reducing the risks of long-lasting damage to potential output.

Heading into Q1, growth will likely dip below trend once again, reflecting the hit to transport and hotels as the 'stay put' policies led to travel around the lunar new year being 70% lower than normal. A faster resumption of manufacturing and construction should limit the impact, but on net we expect official GDP growth to slow to +0.7 q/q, about 0.8pp lower than it would have been otherwise.

This sectoral shock should unwind over the following quarters; hence, it's unlikely to worry policy makers too much. But at the margin it could lead to a slightly more supportive stance – the authorities will want to ensure jobs and economic prospects appear rosy ahead of the 100 year anniversary of the Chinese Communist Party in July.

The substantial loosening of US fiscal policy since November should push up on the level of Chinese GDP by around 0.75%, but for China and emerging markets more broadly a key judgement is the extent to which normalisation in the composition of consumption (goods vs. services) in developed markets will reduce the impact from stronger growth. Assuming that the rotation to goods unwinds as DMs lift restrictions, this suggests that goods consumption may plateau, muting the boost via trade.

Finally, China is ramping up vaccine production. But recent vaccination targets have been missed, while reports of supply bottle-necks (lack of vials) and commitments to providing vaccines to other countries also seem to be impacting manufacturing for the domestic market. We now expect Chinese herd immunity to be achieved in Q1 2022.

China is particularly exposed to the outlook for global goods

*Greater China = China, Hong Kong and Taiwan; APAC trade data comprised of: India, Indonesia, Korea, Japan, Malaysia, Philippines, Singapore, Thailand, Vietnam and Australia.

	2018	2019	2020	2021	2022	2023
ASI GDP (%)	6.6	6.1	-1.7	9.3	6.8	6.1
Official GDP (%)	6.7	5.9	2.1	9.8	7.2	6.1
CPI (%)	2.1	2.9	2.4	1.3	2.3	2.5

Source: Haver, Refinitiv, Aberdeen Standard Investments (February 2021)
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Eurozone

Doubling dipping amid slow vaccine rollout

The Eurozone economy is in the midst of a double-dip recession, although this looks less severe than we previously anticipated. A cyclical recovery should get underway from Q2 onwards, but slow vaccine rollout will constrain the speed of the rebound. In the long-term, we still envisage substantial lasting damage from the coronavirus crisis.

Recent activity data suggest that, while the Eurozone economy is back in contraction amid tighter winter lockdowns, the drag has been less severe than we previously expected. Construction and manufacturing output are still expanding, although the services sector is once again suffering deeply from restrictions to suppress the virus and will drag the economy into a double-dip recession.

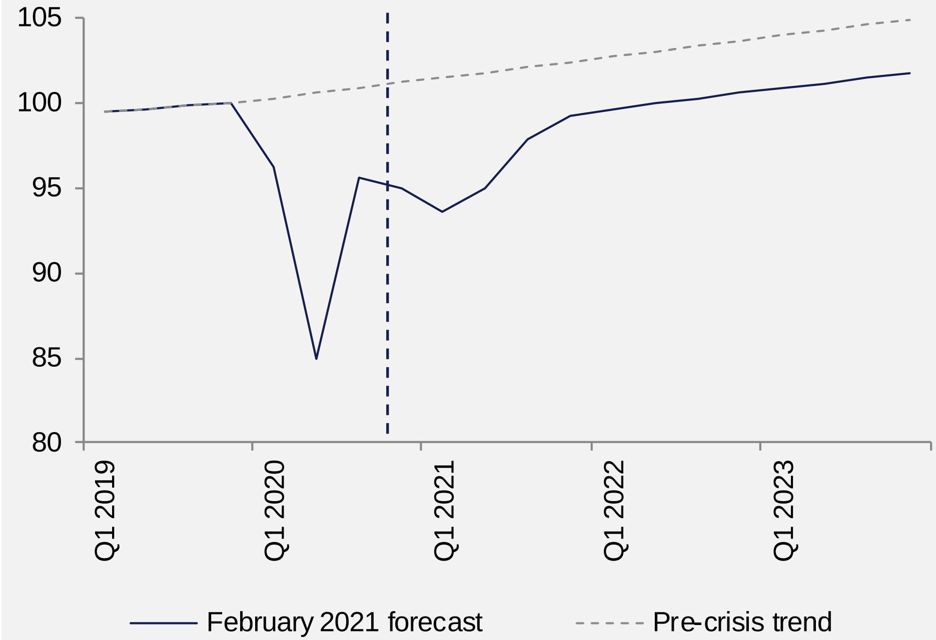
Looking further ahead, the economy should recover from Q2 2021 onwards, as some restrictions are eased amid lower case numbers and better weather. However, Europe's stuttering start to vaccine rollout – which, even if supply issues are sorted, will be held back by disparate healthcare systems and worryingly low take-up willingness – will constrain the speed of the rebound phase. Moreover, in the long-term, the Eurozone is likely to suffer among the largest long-term scarring effects of the crisis, given the depth of the contraction and the psychological scarring of a renewed contraction.

Inflation, which turned negative to 2020, will be higher in 2021 amid both base effects and index re-weighting issues. Energy and other base effects are a temporary driver, which will see headline inflation peak above the ECB's target by April-May time, and then fall back into year-end. Re-weighting is more complicated, by probably also a temporary boost. The bottom line is that we don't expect underlying inflation to robustly converge to target anytime soon.

The upshot is that monetary policy will remain very supportive. The ECB's current mantra is "maintaining favourable financing conditions", which means something like containing market stresses and strains and allowing credit to continue flowing to the real economy. In practice, it probably means occasional tweaks to the run-rate of asset purchases within the existing envelope, and no end to asset purchases or negative-interest rates within our forecast horizon.

Finally, Eurozone fiscal policy will remain very loose in 2021 as the fiscal rules are suspended, but a debate is looming about the long-term future of the fiscal framework. The new Italian government under Mario Draghi may argue for reform of the framework, but the more likely option is to kick the issue into the long grass by extending the current suspension of the rules.

Double-dip recession and then an incomplete recovery



	2018	2019	2020	2021	2022	2023
GDP (%)	1.9	1.3	-6.8	3.7	3.9	1.2
CPI (%)	1.8	1.2	0.3	1.4	0.9	1.1
Depo rate (%)	-0.40	-0.50	-0.50	-0.50	-0.50	-0.50

Source: Thomson Reuters Datastream, Aberdeen Standard Investments (February 2021)
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Japan

Slow but steady vaccine progress ahead

Japanese Covid infection rates have declined swiftly, despite a fairly "light" State of Emergency compared to the severity of global lockdowns. Nonetheless, we expect a contraction in Q1, and the subsequent recovery path to be mired by the slower pace of vaccine rollout.

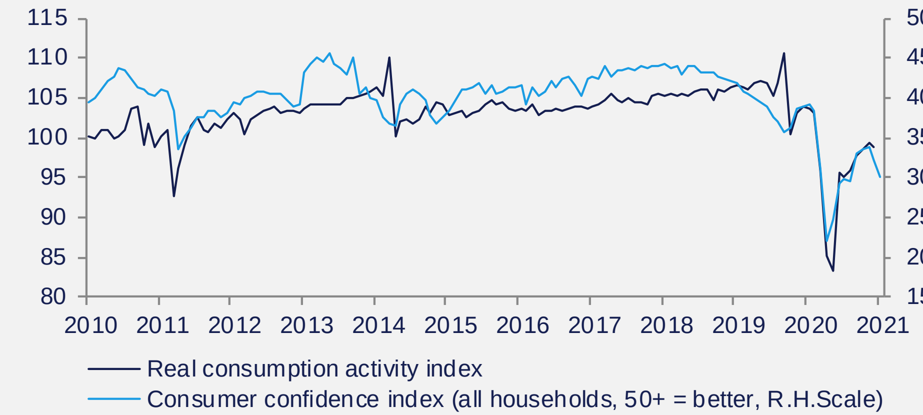
Japan had secured more than enough vaccine contracts to cover the entire population. However, approval has been slow compared to the rest of the G7, and so far only one vaccine, Pfizer/BioNtech, has been approved. In addition, there is a higher degree of vaccine scepticism compared to other countries, with perhaps only 60% saying they would take a vaccine in Japan. We assume that approvals, supply, and take up will all improve over the year. But overall, vaccine supply and demand dynamics suggest only 30% of the adult population will be inoculated by June.

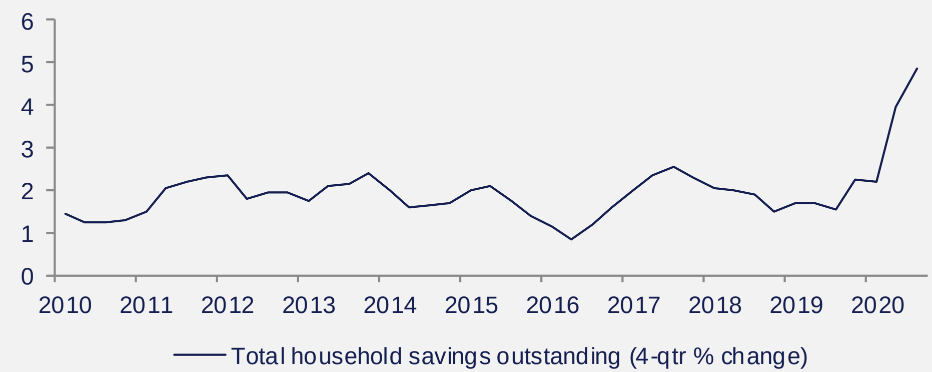
The initial government plan had been to vaccinate the entire population ahead of the Tokyo Olympics, the fate of which currently hangs in the balance. A decision needs to be made by the end of March, and the IoC have said it will not be possible to postpone the Olympics a second time. This is politically very difficult for Prime Minister Suga, especially considering the geopolitical backdrop, with China holding the Winter Olympics a year from now. Even if it is held primarily as a TV event, the economy will receive a limited boost from Olympic-related tourism and consumption. We expect the economy to trough in March, and for the recovery to be stronger in Q3 than in Q2.

Longer term, we expect Japan to experience less permanent scarring than the average global economy. The virus was much better contained early on, restrictions to mobility were less onerous, and the labour market impact is limited with the unemployment rate unlikely to exceed 3.5%. Furthermore precautionary savings surged to far greater levels than previous recessions, with emergency support cheques largely saved rather than spent last year. Admittedly, we expect confidence and spending to remain lacklustre over 2021. However, even a partial unwind of these excess savings is likely to help fuel consumption growth.

Inflation will be dominated by technical factors. The "Go To" campaign travel subsidy had placed downward pressure on accommodation prices, and the temporary suspension of this will briefly relieve this impact until the campaign is reinstated, most likely during Q2. Mobile phone tariff cuts are now expected to start in spring. These drivers are likely to counteract the rising oil price base effect and we continue to expect deflation to be sustained throughout this year at least. The upshot is that target-consistent inflation remains as distant a prospect as ever and with it BoJ normalisation.

Confidence needs to improve for the savings bubble to meaningfully unwind





	2018	2019	2020	2021	2022	2023
GDP (%)	0.8	0.7	-4.9	3.1	2.3	1.5
CPI (%)	1.0	0.5	-1.2	-0.4	0.5	0.2
Key rate (%)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1

Source: Haver, Aberdeen Standard Investments (February 2021)

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United Kingdom

A roadmap to recovery

The UK government has announced its roadmap for the lifting of lockdown in England. The plan sees schools re-opening on the 8th March, followed by non-essential retail no earlier than 12th April, indoor hospitality no earlier than 17th May, and then all remaining domestic restrictions will end no earlier than 21st June.

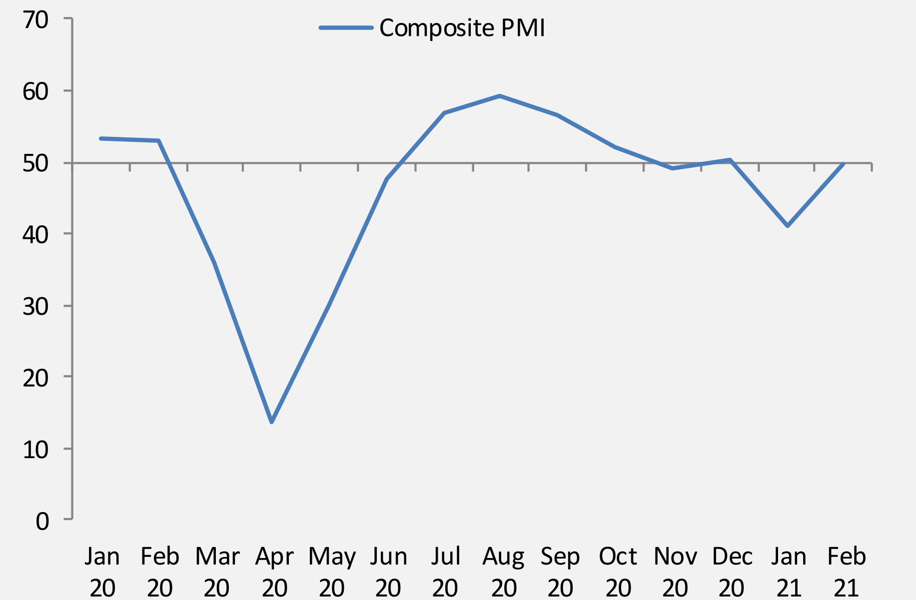
These dates depend on progress across the government's four criteria: 1) the successful deployment of the vaccine; 2) evidence of the impact of the vaccine on health capacity; 3) risks to NHS capacity; and 4) the risk posed by potential mutations. International travel is likely to be restricted longer, in part to reduce the risk of mutations and vaccine escape. Overall, the announcements represent an obvious base case for thinking about the path of restrictions from here, and should mean a significant rebound in activity across Q2 and Q3 this year. Before then, the economy will suffer a sharp contraction in Q1, but will avoid a technical recession after posting positive growth in Q4 amidst evidence that lockdowns are hurting activity less now than they did last year.

Furlough has been extended until March 2021,and it is likely it will be extended again at the forthcoming Budget. While the risk of an extremely rapid turn to fiscal tightening in the name of "embracing structural change" has diminished, we remain concerned about the medium term outlook for fiscal policy given that the Chancellor has signalled multiple times he is worried about long run fiscal sustainability and is already signalling a desire to raise taxes. In light of the UK's perennial structural growth problem and outlook for very low interest rates, this would be a mistake.

UK inflation will move sharply higher over the next few months, topping out above 2% in late summer. This is due to the large fall in energy prices at the onset of the pandemic and the impact of policies like the hospitality VAT cut and the Eat Out to Help Out Scheme dropping out of the annual comparison. After this mechanical spike, inflation is likely to turn sharply lower for much of the second half of this year and into next year as weak underlying inflation – driven by spare capacity – reasserts itself. In this context, monetary policy is likely to remain highly accommodative, although negative interest rates have been taken off the table as a policy option in the short to medium term.

Our assessment that UK GDP will be around 5-7% smaller than it otherwise would have been by 2030 as a consequence of Brexit is largely unchanged by the passing of the UK/EU trade deal. Indeed to the extent that the deal facilitates further divergence over time, this is likely to push the losses towards the top of this range, with the risk that the cost is even greater.

Lockdown seems to be biting much less hard this time



	2018	2019	2020	2021	2022	2023
GDP (%)	1.2	1.4	-9.9	5.3	5.7	2.1
CPI (%)	2.1	1.8	0.9	1.6	1.3	1.5
Bank rate (%)	0.75	0.75	0.1	0.1	0.1	0.1

Source: Bloomberg, Aberdeen Standard Investments (February 2021)

*Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.

Emerging Markets (ex-China)

Caught in the cross-currents

Differing exposure to the US and China, combined with variation in domestic policy support and viral trends, looks set to drive divergence across the EM landscape. The US outlook is considerably stronger, but the spillover impact on EM may be muted as DM demand rotates towards services.

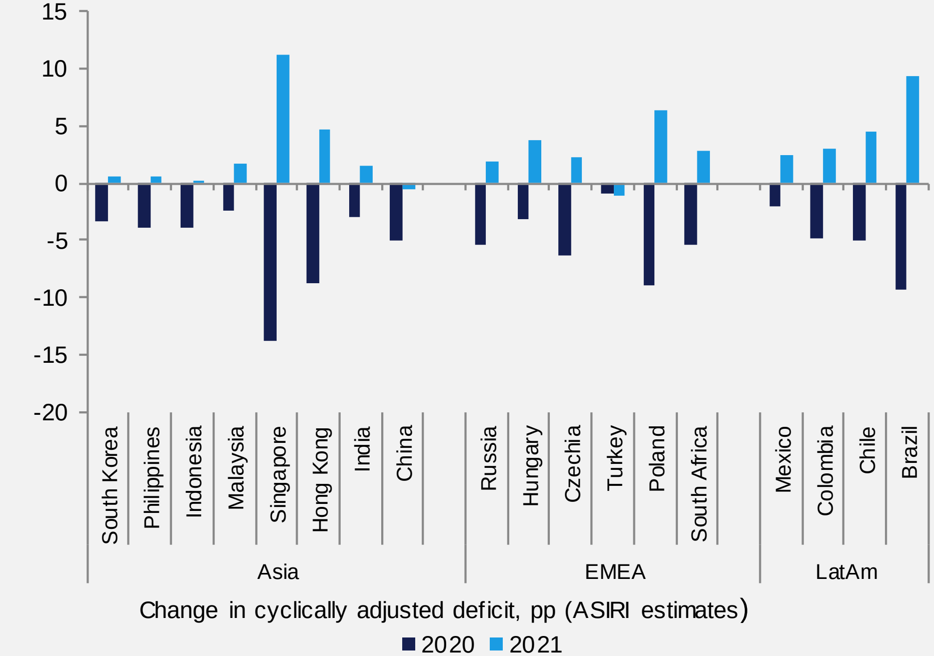
Previous global recovery cycles have been supported by Chinese policy easing, but this is unlikely to be the case this time around as China's rapid recovery results in a more neutral policy stance. Finally, a higher burden of Covid cases and more constrained fiscal policy is setting Latin America economies on a different path to those in Asia.

New strains of coronavirus and still elevated case numbers – particularly in LATAM – suggests that restrictions will need to remain in place at a somewhat tighter level and for longer in EMs. Slower vaccination drives continue to imply that major EMs will lag DMs by around 9-12 months in achieving herd immunity. Lower income EMs are likely to lag even further behind, with many having not yet secured enough vaccine doses to inoculate their whole populations.

This suggests that the Covid-shock will last longer for EMs and ideally countries would adjust their policy support accordingly. Moving into 2021 however, some countries are hitting constraints in their ability to provide further support, despite adverse viral trends remaining. Most Asian economies have committed to maintaining an accommodative fiscal stance in 2021, but elsewhere most policy makers are unwinding fiscal support. Central banks also face a more difficult set of trade-offs. Higher oil prices and a recent surge in food prices will put some upward pressure on headline rates of inflation. Moreover, the improved outlook in the US has pushed up US yields, which could act to curtail EM policy space.

For most EMs, core inflation rates remain below or consistent with their inflation targets and they should be able to look through temporary commodity price effects. Moreover, substantial labour market slack implies only modest underlying pricing pressures further out. But for some, such as the Brazilian Central Bank, more elevated rates of core inflation, fears that the fiscal framework is being eroded and uncertainty about the domestic reform agenda (caused by the ousting of the head of Petrobras) are driving expectations of rate hikes.

Fiscal policy set to become less supportive outside of EM Asia



	2018	2019	2020	2021	2022	2023
Russia GDP (%)	2.4	1.3	-3.1	1.5	2.7	1.2
India GDP (%)	6.8	4.9	-7.8	12.9	5.6	7.5
Brazil GDP (%)	1.2	1.1	-4.7	3.3	2.2	2.4

Source: Haver, Refinitiv, Bloomberg Aberdeen Standard Investments (February 2021)

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Australia, Canada, Sweden

Mixed fortunes in the fight against Covid

Australia, Canada and Sweden have had quite different Covid experiences. In part this reflects different strategies for fighting the virus, with Sweden taking a famously light-handed approach, while Australia has pursued something closer to an eradication strategy. All will benefit from re-opening in 2021, but monetary policy is set to remain highly accommodative.

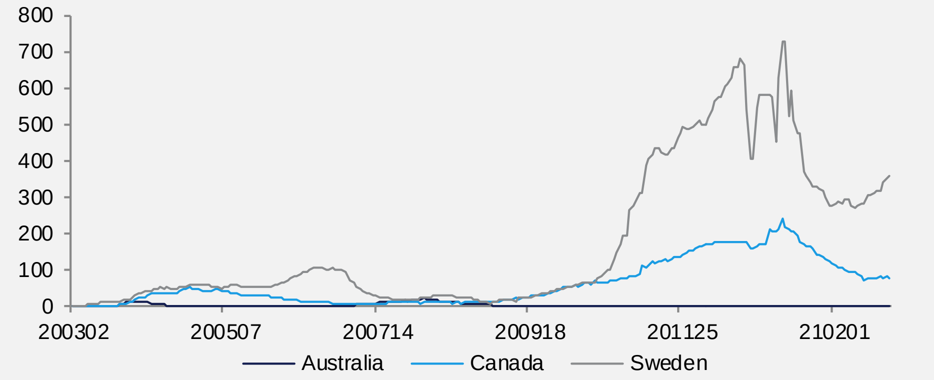
Australia continues to stand out among the developed countries for its handling of the pandemic, which has kept its per capita fatality rate 40 times smaller than the US. Although periodic lockdowns are likely to continue, they will remain regional and short-lived. This, together with a vaccine drive set to gather pace through the year, will facilitate solid, above-trend growth through the next two years. The housing market is also springing back to life, but the country's long road back to target-consistent inflation should stop the RBA from lifting the cash rate during our forecast horizon.

Tighter restrictions in early 2021 have helped curb Canada's winter Covid wave, with new cases down 70% from peak. However, PM Trudeau has warned that it is too early to relax restrictions given new strains and vaccine shortages. While these disruptions will weigh on short term activity, the outlook from the spring looks brighter, helped by sustained fiscal support, rising commodity prices and spillovers from booming US growth. This recovery is not expected to prompt a rethink at the BoC, with Governor Macklem promising to keep support in place for a "considerable period".

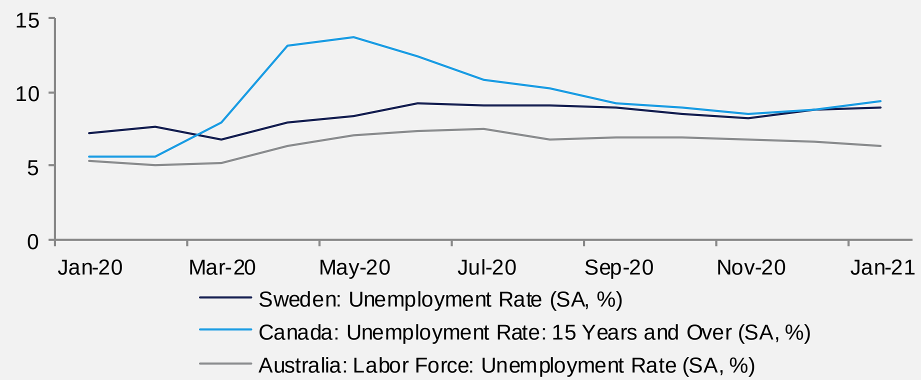
In Sweden, our 2021 GDP growth forecast has been lowered to 2.7% due to the containment measures extended into 2021, which will continue to take a toll on the economy in the near term. But we still expect vaccine roll-out to allow a greater normalisation of activity and rapid growth in H2 2021. The crisis brought a major fiscal response that is set to continue well into 2021, with a stimulus of 2% of GDP. The Riksbank has launched a new round of QE, purchasing assets equal to 14% of GDP, but we do not expect it to cut the policy interest rate below its current level of zero.

	2018	2019	2020	2021	2022	2023
Australia GDP (%)	2.8	1.9	-3.0	4.5	3.2	1.9
Canada GDP (%)	2.0	1.5	-5.4	4.9	4.5	2.8
Sweden GDP (%)	2.1	1.4	-3.0	2.7	3.0	2.4

Average new daily Covid cases per million people



The Canadian labour market has been badly hit



Source: Haver, Aberdeen Standard Investments (February 2021)

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The coming rotation in activity

Services spending to drive the recovery

An important features of the Covid recession, as well as the early stages of the recovery, was the rotation in consumption away from services and towards goods. In the US, the jump in the goods share of total consumption unwound all of the trend decline since the global financial crisis, while similar patterns have been evident in most of the other large economies.

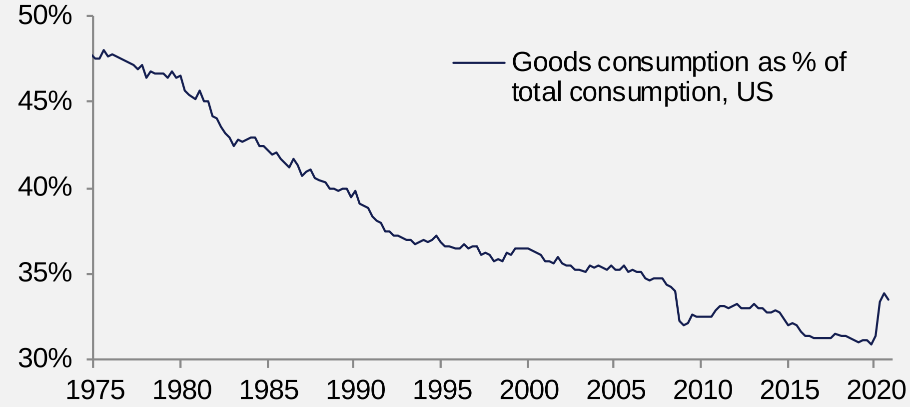
This rotation has had large effects to other sectors of the global economy dependent on goods consumption, including manufacturing production, capital goods investment and international goods trade. The reasons for this large spending rotation are obvious – social distancing has a much larger effect on services demand than goods demand, while the pandemic itself has created new demand for goods required to manage the pandemic, with the impacts amplified by fiscal stimulus programmes that have supported household incomes.

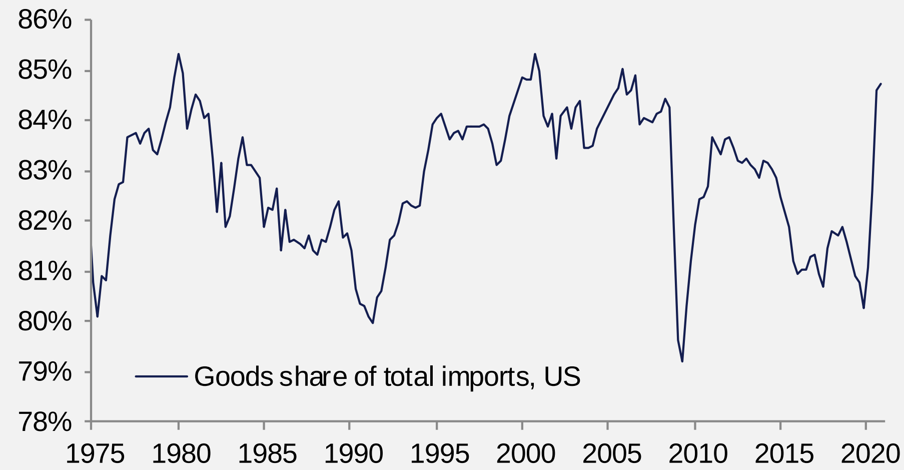
Our global growth forecasts are built on the assumption that the rollout of effective vaccines in the largest economies will allow most social distancing measures to be progressively relaxed, and that some of the forced savings that has occurred will be unwound. This sets the stage for a rapid rebound in global services spending in particular over the next two years. But should we expect services spending shares to return to the levels that prevailed before Covid? And what are the consequences for activity in other sectors that were boosted by the boom in goods spending?

We do not believe that there are compelling reasons to think that people's underlying desire to spend on services will be altered over the longer term. However, at least some restrictions on parts of the services sector are likely to remain in place for several years (international tourism for example), while others (such as the volume of business travel and commuting-related services spending) may be permanently dampened as firms make greater use of virtual meeting and presentation technologies. On the other hand, we expect the crisis to lead to higher health and social care spending over the longer term, above what was already implied by population aging.

All this implies that global spending on goods, and the components of activity closely tied to it, are likely to slow *relative* to spending on services over the next few years. However, the strength of the global rebound and size of household savings buffers, makes it unlikely that goods spending will contract outright. Slower trend growth until most of the spike in the goods share has been unwound is likely to be the order of the day. This in turn will weigh on growth in the countries that have most benefited from meeting stronger goods demand in the rest of the world. The main risk to this view for a rotation back to services is vaccine escape forcing countries to keep restrictions in place for considerably longer. But at present we see this as a tail risk rather than a driver of our forecasts.

Vaccines set the scene for a rotation back to services





Source: Haver, Aberdeen Standard Investments (February 2021)

Near-term inflation

A bumpy profile ahead…

The profile for global inflation will be volatile over the next year. Transitory drivers will push headline inflation to a peak by the early summer in most economies, after which rates will likely trend back below target. The second half of the year will also be characterised by shifts in relative prices, as the service sector reopens and relative goods demand declines. Second-round effects are likely to be limited given the scale of output gaps and the anchoring of inflation expectations globally.

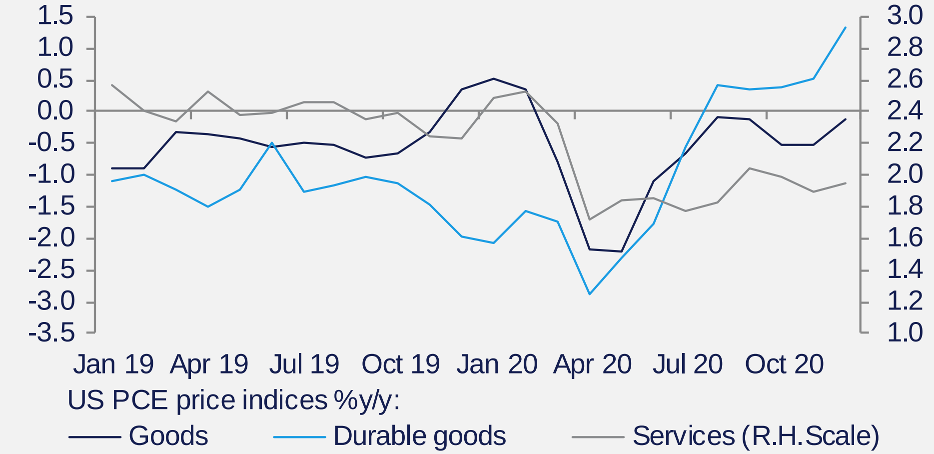
Energy base effects will be one of the main drivers of headline CPI this year. Though prices have rallied 60% since October, following colder than predicted weather across many countries, supply cuts by Saudi Arabia, and strong manufacturing demand, prices doubled over May and June last year. Energy base effects on headline inflation should therefore peak by the end of Q2. Weather also hit the production of maize, vegetable and palm oils during Q1. But traded food prices are often a poor guide to national food inflation, as price controls mean pass through can be modest.

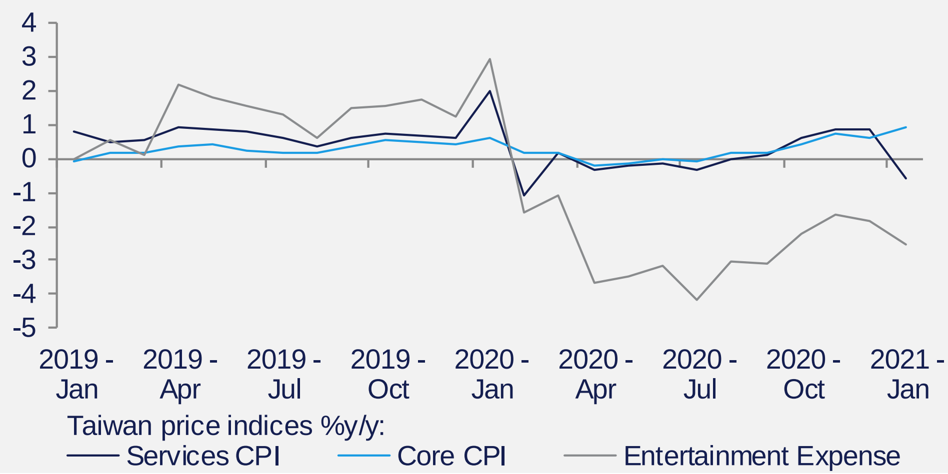
Base metals have also rallied sharply over the past few months, with copper prices breaching historic highs. Longer term structural trends such as decarbonisation may keep copper prices elevated. However, metals prices mostly affect industry, with limited pass-through to consumer price indices. This impact may be reduced further as economies start to rotate away from goods to service sector consumption as lockdowns are eased.

Inflation during the second half of the year and 2022 will be driven by reopening and the relative shift in consumption patterns. In the US, the sharp increase in goods consumption is already reflected in subcomponents of the PCE indices, where service sector prices have barely recovered from the initial lockdown driven collapse, but durable goods prices jumped from deflation to exceed 1%. This trend is likely to be reversed as restrictions lift. For example, in Taiwan, which reopened much earlier thanks to successful virus containment, core inflation picked up alongside the rise in services prices, but the chart suggests this trend may have peaked already.

The scale of labour market slack and the transitory nature of base-effects driven price moves should limit the extent to which all this feeds into household and corporate inflation expectations, wage negotiations, and has second round effects on core inflation. Admittedly, the scale of US fiscal stimulus and its potential inflationary impact has triggered much debate, but as we discuss in the next slide, this merely reduces the probability of low inflation regimes transpiring and does little to trigger high inflation paradigms.

A relative price shift likely in H2 as the service sector reopens globally





Source: Haver, Aberdeen Standard Investments (February 2021)

Aberdeen Standard Investments

Longer-term inflation

…but US fiscal fireworks bolster the inflation outlook

We can use our inflation paradigms framework to understand what the impact of the swing towards further fiscal policy loosening in the US might mean for long-term inflation dynamics. Through the prism of this approach, we think that coordinated and sustained policy support reduces the risk of very low inflation outcomes, but does not signal a greater possibility of the very high inflation we would expect under fiscal dominance.

We have made a number of changes to the assumptions underlining our long-term inflation paradigms model in the wake of the shift towards looser policy in the US this year. The Biden administration has shown a willingness to use fiscal policy as a much more aggressive countercyclical tool, which should work alongside supportive monetary policy settings to generate a stronger rebound in the US economy and a sustained positive output gap from 2022 onwards. Incorporating this into our model pushes the probabilities for both the deflation, and low inflation, scenarios noticeably lower compared to our expectations when a split congress seemed likely.

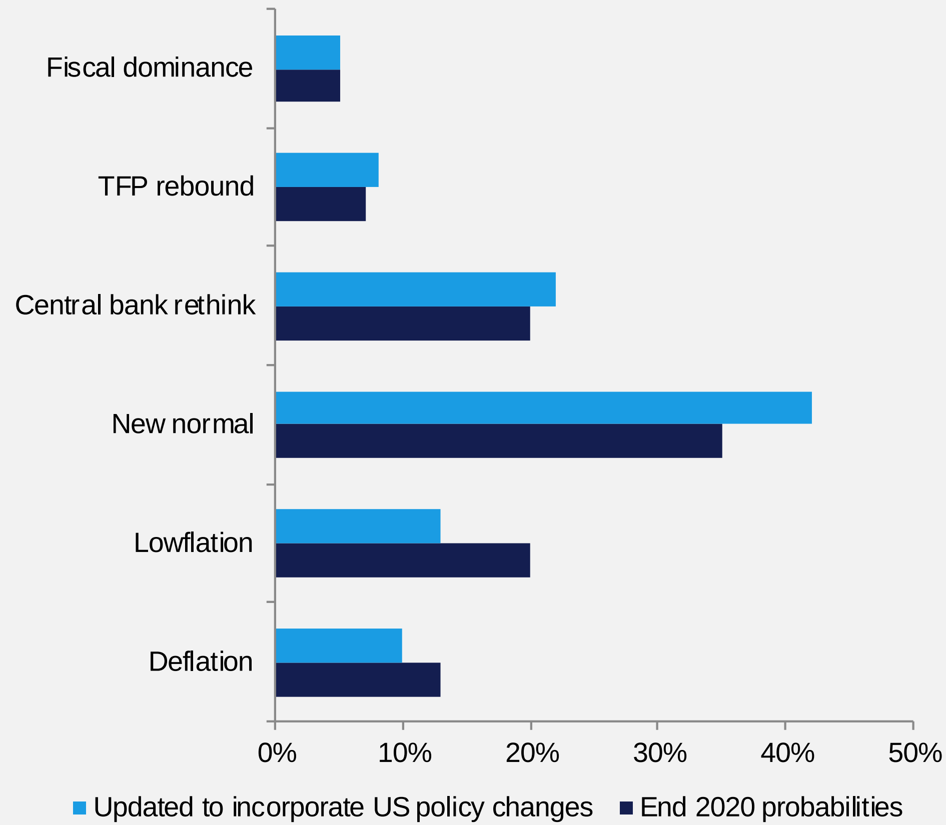
The main beneficiary of this has been our 'new normal' scenario, which incorporates inflation at, or slightly below central bank targets. The Fed has committed to a temporary overshoot in inflation, to generate average inflation in line with its 2% target over the course of the business cycle. The stronger growth and inflation profile created by fiscal stimulus should make this easier to achieve.

The change in the political environment also implies a slightly higher likelihood of a rethink at the Fed. Biden will have the opportunity to reshape the leadership of the FOMC in the early part of his term and could push for more progressive candidates, who might make more ambitious changes to the policy framework than delivered under Powell. However, we do not think that these politics, or the more aggressive fiscal stance, should be interpreted as a slide towards fiscal dominance, in which the Fed's independence is threatened and it is forces to accommodate persistently higher government spending. Indeed, President Biden is likely to put less political pressure on the Fed than his predecessor, who tried to appoint openly partisan candidates to the Fed board.

Finally, we also think that the likelihood of a productivity rebound has increased slightly . This reflects the benefit of strong short term growth and higher public infrastructure spending, which could unlock a virtuous cycle of investment and innovation. This supply-side boost would help lower inflationary pressures, allowing the economy to run stronger for longer. However, this also remains more of a tail risk given longstanding disappointments in economy-wide productivity across both developed and emerging markets.

Source: Haver, Aberdeen Standard Investments (February 2021)

Likelihood of low inflation paradigms has declined



Monetary policy

Some like it hot

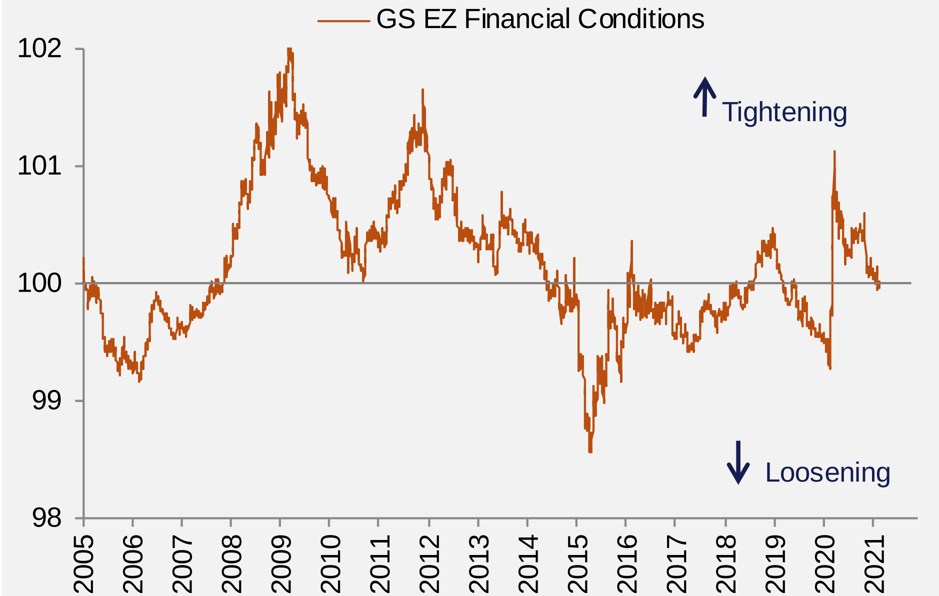
With US fiscal policy set to remain highly accommodative, investors have started to anticipate a more rapid withdrawal of US monetary accommodation. The response from the Fed has been to push back strongly on these expectations, with Chair Powell signalling that that tapering or tightening more generally is unlikely to start anytime soon. Indeed, we do not expect Fed asset purchase tapering to begin until early 2022, and the first rate hike in late 2023.

The Fed's new average inflation target should give it the flexibility to look through both the temporary spike in inflation we expect over the next few months, as well as above-trend growth in the economy more broadly. In fact, precisely what an average inflation targeting framework requires is letting the economy run hot for some period of time, to allow inflation to run above target to make up for successive years of falling short of the inflation target previously. As such it is not surprising to see Powell welcoming the prospect of running the economy hot, and discussing the potential benefits of a tight labour market on labour supply and economic potential more generally. He has also suggested – at least so far – that the Fed is relatively sanguine about the recent increase in long rates, as this represents the market pricing an improved economic outlook.

Rising yields is more problematic for other central banks, for whom much of the recent increase in yields represents an exogenous tightening in financial conditions, rather than an endogenous pricing of a better economic outlook. Indeed, the ECB has recently announced a new framework around "maintaining favourable financing conditions", rather than necessarily buying a particular quantity of bonds via QE. This is in effect a yield and spread target, although institutional constraints within the Eurozone mean that it is difficult for the central bank to commit explicitly to yield targets. Comments from Lagarde that the ECB is "closely monitoring" the recent increase in yields suggest that it is prepared to shift policy and intervene in the market if it feels financial conditions are tightening for reasons not warranted by the underlying economic and inflation outlook within the Eurozone.

In China, fears that the PBOC was positioning to tighten policy have largely abated as money market rates fell back. We are expecting only a very gradual increase in its main policy rates, but the authorities may use other levers to remove accommodation and refocus attention back on medium-term financial stability issues. The boundaries of fintech regulation – with ANT potentially becoming a financial holding company – is arguably more pressing.

ECB focused on maintaining favorable financing conditions



Policy rates	2021	2022	2023
US	0.10%	0.10%	0.35%
UK	0.10%	0.10%	0.10%
Japan	-0.10%	-0.10%	-0.10%
Eurozone (depo rate)	-0.50%	-0.50%	-0.50%

Source: Haver, Aberdeen Standard Investments (February 2021)

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Fiscal policy

Democrats to deliver shock and awe stimulus

One of the major criticisms of policymakers in the wake of the financial crisis was that fiscal support was too timid and fleeting. Many governments seem to have at least partly learned this lesson, taking advantage of fiscal space to deliver large stimulus efforts last year, and broadly maintaining this support for the time being at least. However, the new Biden administration is using US fiscal policy even more aggressively, delivering a further round of stimulus which should help supercharge the recovery.

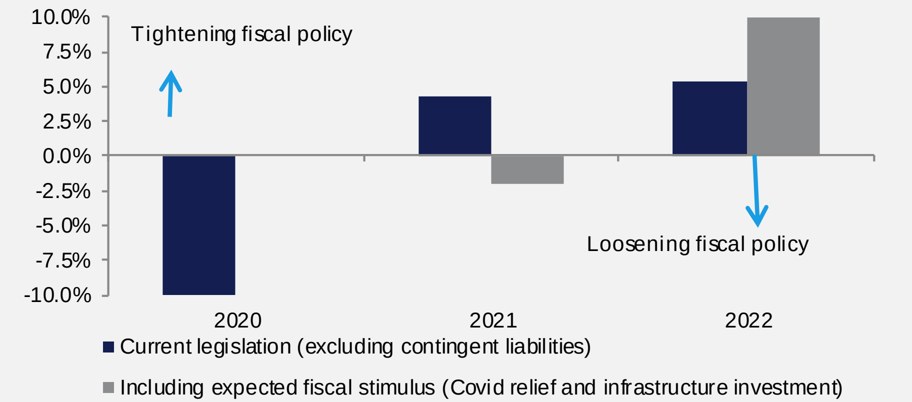
Democrat wins in the Georgia Senate runoff races have given President Biden a unified Congress to work with, and he is wasting little time. A Covid relief plan costing between $1.5-1.9tn is moving swiftly through Congress and comes hot on the heels of the $900bn package in December. This will deliver an additional loosening in fiscal policy of nearly 3% of GDP this year, on top of the 10% 2020 stimulus, and provide sustained support for the recovery. Moreover, we do not expect this to be the final major piece of fiscal legislation from Biden's administration – with a green tinted infrastructure package expected to pass later this year. This will be only partly funded by tax hikes and add a further stimulus of between $500-1000bn to the US economy - albeit spread over a number of years.

At present it looks unlikely that other developed markets will be as bold as the US. However, there are few signs that policymakers are rushing to aggressively tighten policy either. In the Eurozone, the Stability and Growth Pact (SGP) remains de facto suspended, and governments are in large part maintaining support, with deficits forecast to narrow only modestly. Further forward, It seems likely that the SGP will remain suspended, creating space for a gradual tightening in policy as the recovery proceeds, but we will need to watch carefully for signs that political pressure is building for a faster consolidation in deficits. In the UK the noise around near term policy tightening looks to have receded, though the Chancellor's repeated concerns around fiscal sustainability suggest that these could return sooner rather than later, which could risk a premature withdrawal in support.

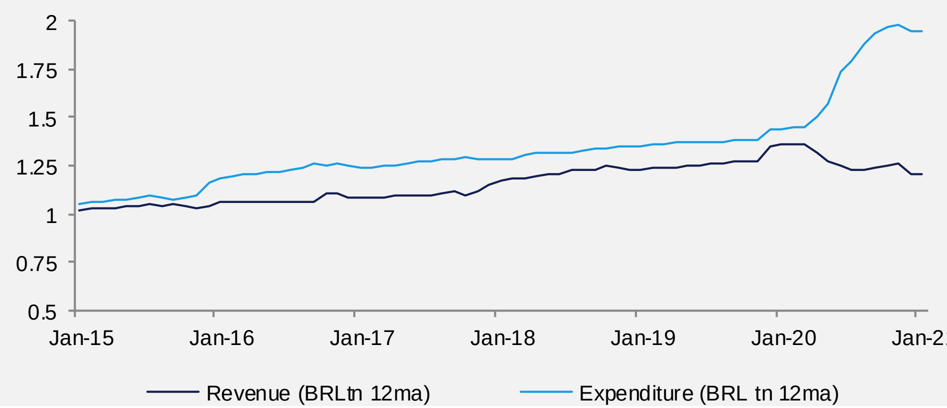
China's fiscal support has been smaller than other major economies and there is already chatter around scaling this back given a strong domestic recovery and concerns over debt burdens. However, policymakers are expected to remain attentive to the risks of a slowdown. Elsewhere in EM the picture is more mixed, especially in those countries with concerns over fiscal space. For example, Brazil has attempted to reinstate its spending cap rule this year against the backdrop of a building debt burden. However, political pressure to temper the huge tightening in fiscal policy implied is already building as Covid cases surge again.

Source: (Haver, Aberdeen Standard Investments (Feb 2021)

Change in US structural budget deficit (y/y % of GDP)



Brazil will struggle to curb its Covid expenditure



Economic scarring

Lasting GDP damage unavoidable for many economies

Even with a strong cyclical recovery over our forecast horizon, the coronavirus crisis is likely to result in permanent damage to the trend path of GDP in many economies. Balance sheet repair, labour market and 'belief' scarring, and policy errors are all channels for this long-term damage to occur. Long-term damage is probably largest in economies where the initial hit was deeper and the recovery has been slower, such as Europe, whereas the US and China could see little if any permanent scarring.

There is a substantial literature on the lasting damage inflicted to economic output by financial crises. No doubt there was a risk of the coronavirus crisis cascading into financial crisis at various points, but decisive central bank action has largely prevented that threat. Nor was the eve of this crisis characterised by large macro imbalances in the way that pre-financial crisis periods often are.

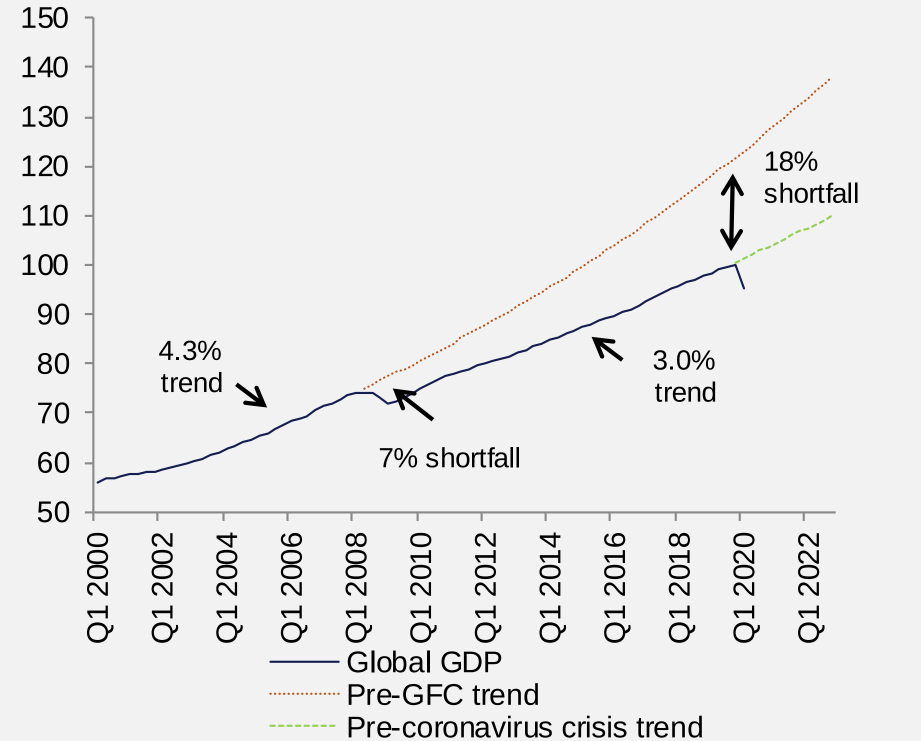
However, none of this means that the global economy can necessarily avoid lasting damage. A number of channels of long-term damage are likely to operate this time around. First, a period of balance sheet repair may stifle bank lending and business investment. Debt taken on by both firms and sovereigns during the crisis may have this effect well into the future. Loan guarantee schemes could also contribute to the 'zombification' of the firm structure, weighing on productivity growth.

Second, 'belief scarring' as economic agents experience a traumatic event and reassess the distribution of risks can increase desired saving and lower desired investment, weighing on long-term output. Vaccines may limit belief scarring, but we think some damage is likely. Third, labour market scarring can have hysteresis effects which live on well beyond a crisis. The huge increase in unemployment in the US will have permanently broken labour market matches. By contrast, short-time work schemes in Europe should limit long-term labour market damage.

Fourth, structural reform momentum can stall during a crisis, as governments have little time for anything but crisis fighting. The EU Recovery Fund, or the introduction of labour market support schemes, suggest structural reform momentum has actually been positive this time around. But there is still time for political cleavages opened up by this crisis to be a headwind on economic output, with support for further trade liberalisation likely to be an especially high profile casualty.

Finally, while monetary and fiscal policy have been deployed successfully so far, there remains scope for policy error. Should the Eurozone fiscal rules be prematurely re-imposed, or central banks fail to remain highly accommodative, then lasting damage could be inflicted.

The GFC caused lasting damage to the trend path of global GDP. The coronavirus crisis will do the same, although to a lesser extent and in a subset of economies.



Source: Thomson Reuters Datastream, Aberdeen Standard Investments (February 2021)

A subtle foreign policy regime shift under new US administration

Biden more conciliatory with allies, but challenges and tensions to persist

The tone of US foreign policy and trade relations is likely to be calmer and more strategic under the new Biden administration than under his predecessor. Overall, political multilateralism and the rules-based international order should be bolstered in this environment. However, a calmer approach does not necessarily mean a more generous or conciliatory trade policy stance from the US, particularly vis-a-vis China.

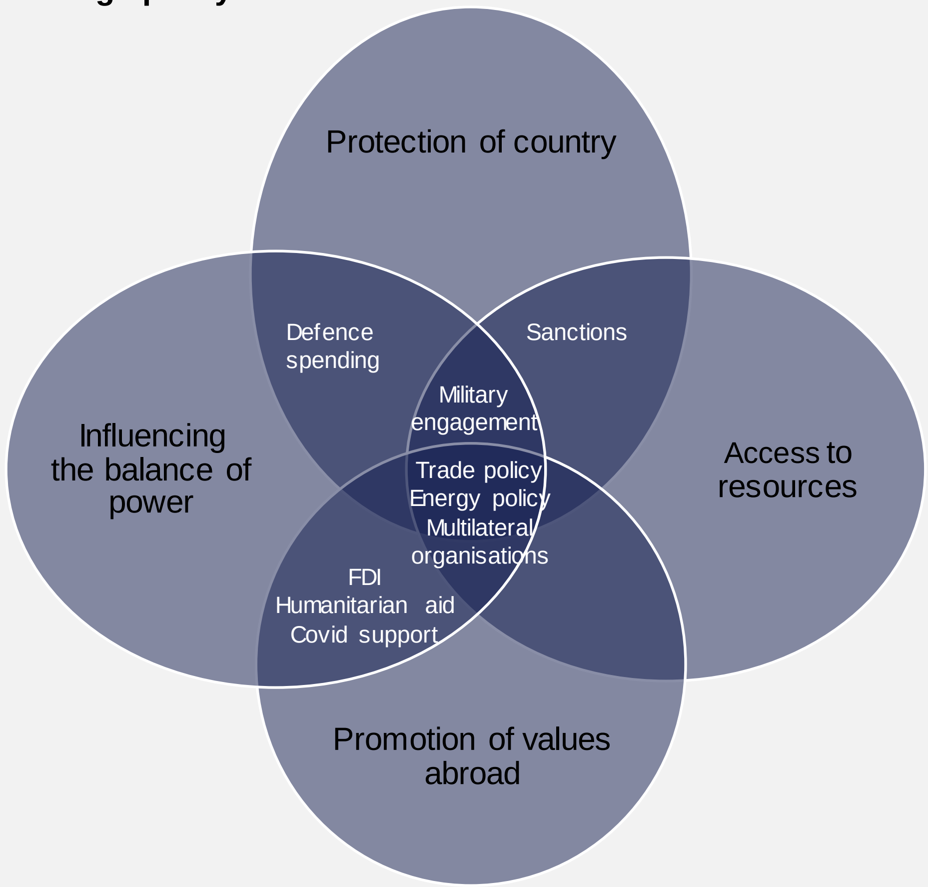
Stepping back, the main foreign policy objectives of the major powers tend to be the: (1) protection of the country and its citizens – both at home and abroad; (2) maintenance of access to resources and markets – for consumers, businesses and the government itself; (3) promotion of the country's/regime's values abroad; and (4) influencing the balance of power in the world consistent with (1); (2); and (3). Trade policy can be a powerful tool in achieving these objectives, but other key policies include foreign direct investment; energy policies, military intervention and defence policy; and humanitarian action. We will track these policies through the year for signs of growing tensions.

President Biden was partly elected on a "Build Back Better" mandate to boost US manufacturing and jobs. While we do not expect any sudden tweets announcing tariffs, most US-China tariffs are likely to remain in place, and non-tariff barriers will continue to rise. If anything, Biden cares more about issues of human rights and transparency in China than did Trump, who was much more transactional. This could yet open up a new front for conflict as Biden's term progresses.

Meanwhile, the EU looks set to forge it's own path with China in trade policy and engagement, evidenced by its decision to sign the US-China investment deal just before Biden was inaugurated. This may have driven a wedge between EU leader Von der Leyen and President Biden from the outset. Admittedly, concerns about human rights abuses provide opportunities for western powers to align in political messaging and possible sanctioning of China. COP26 at the end of the year might also provide an opportunity to build a united front *with* China. But EU "strategic autonomy" means that US and Europe may not always be perfectly aligned on these issues.

Post-Brexit, the UK's approach to foreign policy will be fundamentally linked to it's identity outside – but still closely linked to – the EU. There may be opportunities for the UK to align with the US on China issues, while the UK has applied to join TPP to bolster its access to APAC markets, but the likelihood of a substantive US-UK trade deal remains low under the Biden administration. A sovereign UK energy policy will be needed now that the UK has left the EU's climate orbit; hosting COP26 will allow the UK an opportunity to set out its new climate stall.

A framework for understanding the incentives in US foreign policy in 2021



Source: Aberdeen Standard Investments (February 2021)

As one referendum's impact is felt, the threat of another looms in the UK

Brexit effects starting to hit activity, while Scottish independence push accelerates

The Brexit deal - zero tariffs and zero quotas for goods, but essentially zero provision for services - confomed to our long-standing base case. However, key aspects of the deal – particularly on goods – have caused more initial disruption to UK industry than was anticipated. Rather than producing mainly 'teething problems', the early signs are that trade disruptions are deep and enduring. Moreover, both sides appear to be preparing for a competitive rather than cooperative relationship post-Brexit. The Northern Ireland border will remain the main flashpoint, particularly if security concerns were to escalate.

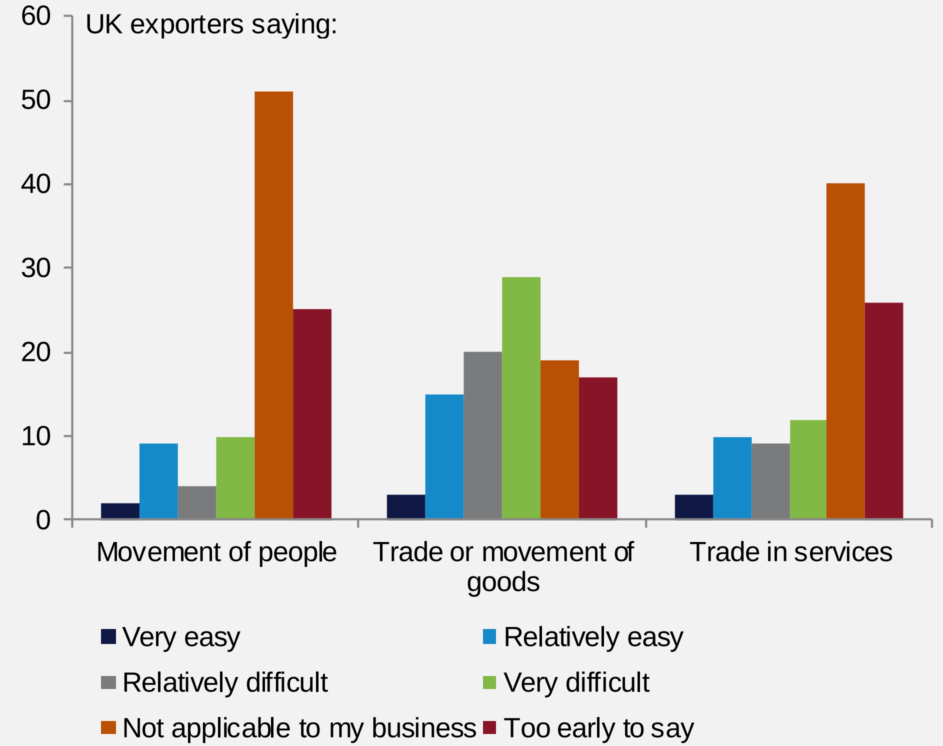
Our longstanding assessment that UK GDP will be around 5-7% smaller than it otherwise would have been by 2030 as a consequence of Brexit is largely unchanged by the nature of the trade deal. Indeed, to the extent that the deal facilitates further divergence over time, this is likely to push the GDP losses towards the top of this range.

Admittedly, to the extent that it was pure uncertainty about the risks of no deal that was causing firms to defer investment and households to postpone large economic transactions, then the deal might help to unleash some pent up demand. But this deal does not foreclose all future uncertainty in the UK's relationship with the EU. Moreover, there is growing anecdotal evidence of trade frictions rendering certain businesses with low margins such as food exports unviable, and this is likely to be born out in official data in time.

Meanwhile, as the Conservative government continues to firefight the impacts of the last referendum result, a fresh referendum challenge is brewing in Scotland. Calls for a second Independence Referendum have been growing due to Brexit and now Covid, and are set to be amplified by the upcoming Scottish Parliamentary elections on 6th May. If the SNP wins a significant majority in these elections, the political backlash to Westminster striking down an opportunity for Scots to vote on the independence could be substantial.

This will raise the risk of court battles between Holyrood and Westminster, and even possibly more extreme moves such as holding an illegal Scottish independence referendum. The latter is a tail risk for now, but we do expect a significant political and legal battle to break out in the second half of the year if the SNP wins the Scottish election.

The struggle is real: Brexit impacts hitting UK exporters is a warning sign for the future of UK trade relations with it's largest trading partner



Source: Aberdeen Standard Investments, British Chamber of Commerce (February 2021)

2021 will lay the groundwork for European political challenges to come

Political and policy decisions and debates this year will drive Eurosceptic risk later

With Brexit resolved, a Draghi-led Italian government in place, and the European Recovery Fund about to start disbursing funds, 2021 should be a quieter year for European political risk. However, it will be a crucial year in laying the groundwork for political pressures to come – with important elections in Germany, pre-campaigning ahead of 2022 elections in France, and the beginning of a fractious debate on the EU fiscal rules.

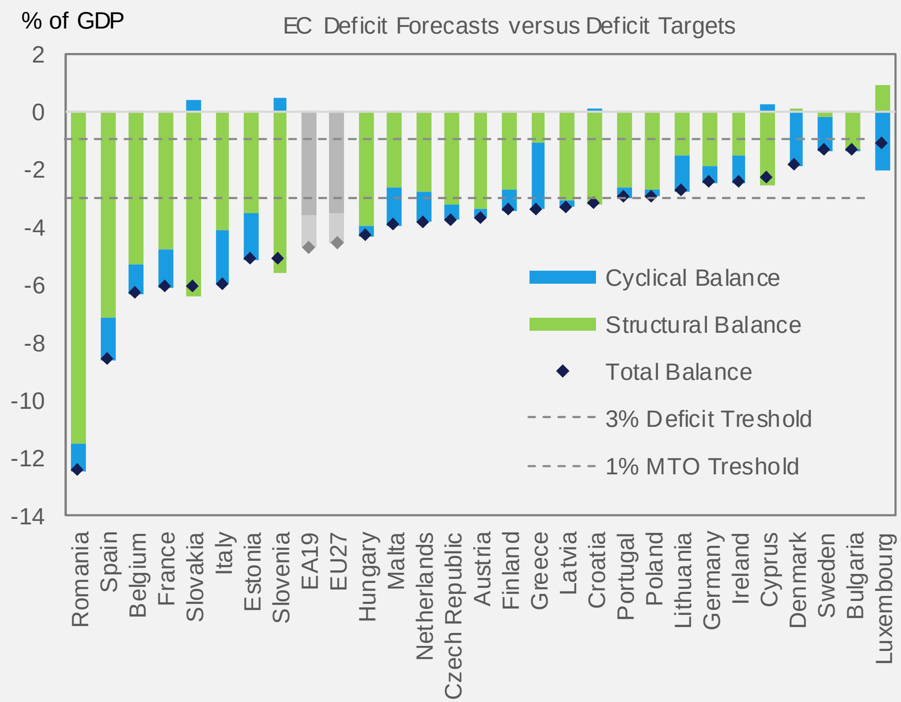
The beginning of 2021 has seen some key political challenges resolved – for now. The UK-EU trade deal came into force in January, freeing up some political capital in Brussels to focus on progress elsewhere. Of course, while the initial deal is done, Brexit issues will rumble on as the two sides reconcile a more competitive relationship with ongoing trade and political relations.

In Italy, a political feud resulted in Conte stepping down as Prime Minister and a new, unity government led by Mario Draghi being formed. If anyone can bring stability and even some policy progress to Italy, it should be Draghi. However, he will still need to navigate the fractured Italian partisan environment and is rumoured to eyeing the Italian Presidency in early 2022. If Draghi takes this role, it seems likely that either a new government is installed within twelve months or snap elections are called. Current polling suggests that a right wing Eurosceptic coalition is best positioned to form a government, so Italian politics is unlikely to be quiet for long.

The big political question for Europe in 2021 is who replaces Merkel as German Chancellor. While the new CDU Chair Armin Laschet would represent continuity of the Merkel approach, his main rival CSU candidate Markus Söder is more conservative and occasionally uses Euroscepticism for political point scoring. We are not worried that Söder would fundamentally challenge EU stability, but he wouldn't provide markets the same sense of stability and continuity as Laschet. He also seems likely to push a harder line on issues like risk sharing and fiscal union. Latest polls show Laschet is ahead of Söder heading into leadership elections to be held around Easter. This will tee up the German federal election in September, which we expect to produce a coalition of the CDU-CSU and Green party.

In Brussels, the key issues will be ensuring smooth and effective rollout of the European Recovery Fund, and beginning the challenging task of reviewing the European fiscal rules. Draghi will be an important voice for Southern European interests in these talks, and will likely advocate for much looser fiscal rules. However, root and branch reform of the fiscal architecture will be challenging. All this matters for political risk, as post-crisis austerity was a key driver of Euroscepticism over the past decade.

New leadership in Germany and Italy may prove crucial to the outcome of the fiscal rules review, an underlying source of Eurosceptic risk



Source: Aberdeen Standard Investments, Goldman Sachs (February 2021)

Aberdeen Standard Investments

Global Forecast Summary

	GDP growth				CPI inflation			
	2020	**2021**	**2022**	**2023**	**2020**	**2021**	**2022**	**2023**
Global	**-4.1**	**5.7**	**4.6**	**3.8**	**3.2**	**3.2**	**3.1**	**3.1**
DM	**-4.9**	**4.8**	**4.3**	**2.4**	**0.6**	**1.5**	**1.4**	**1.6**
US	-3.5	6.6	5.0	3.1	1.2	2.3	2.1	2.3
UK	-9.9	5.3	5.7	2.1	0.5	1.6	1.3	1.5
Japan	-4.9	3.1	2.3	1.5	-0.3	-0.4	0.5	0.2
Eurozone	-6.8	3.7	3.9	1.2	0.3	1.4	0.9	1.1
EM	**-3.4**	**6.3**	**4.8**	**4.8**	**5.1**	**4.5**	**4.3**	**4.2**
Brazil	-4.7	3.3	2.2	2.4	3.2	5.0	3.2	3.3
Russia	-3.1	1.5	2.7	1.2	3.4	4.5	3.0	3.0
India	-7.8	12.9	5.6	7.5	6.6	4.1	4.5	4.3
China	-1.7	9.3	6.8	6.1	2.4	1.3	2.3	2.5

Source: Aberdeen Standard Investments (February 2021)

*Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.

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