OUTLOOK 2021: SUSTAINING THE OUTPERFORMING COVID RECOVERY

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Against a backdrop of the continuous health crisis, the economic recovery has decisively outperformed expectations globally. Now facing setbacks as the pandemic accelerates once more, will the recovery resume its vigorous path in 2021?

We think so. Looking past the intense dataflow that spread too much economic gloom this year, we have emphasized the nature, drivers, and context of the shock in analyzing the recovery. Though uniquely intense, the Covid recession lacks the structural overhangs from excesses in prior years – and policy audaciously prevented the shock from creating its own structural downside. Instead of structural scarring, which weighs down recoveries, we have seen tight V-shapes in capex which lays the foundation for subsequent growth.

All of this amounts to predisposition for continued bounce growth, particularly as service sectors have yet to follow other sectors back to pre-Covid levels. And vaccines – another area of outperformance – are set to remove many obstacles in the service economy in 2021. Fiscal policy, though prospects of the supersized version have dimmed, is unlikely to become a crippling headwind. Still, risks abound. Hidden vulnerabilities may yet surface as tapered policy support may reveal credit losses in the real economy. Yet, our 2021 base case is both strong and unusually broad, owing to the structural narratives we have stressed.

We also look past 2021 and sketch the contours of the post-Covid cycle: the pathway to a tight labor market will be much shorter than in prior cycles, which, together with easy policy, points to the risk of financial imbalances. Before long, we expect a young expansion with an old-cycle risk profile. For now, however, we take comfort that these are concerns beyond 2021 and look with optimism to a strong 2021.

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WHAT 2020 TELLS US ABUT 2021

Though we would agree that an economic outlook is naturally forward-looking, we think that the past nine months hold many clues about the economy's path in 2021. The vigorous rebound from the depths of the Covid recession was widely missed this year and understanding the drivers of that outperformance will continue to provide insight next year (see also: [HBR: Why the Global Economy is Recovering Faster than Expected (11/3/2020)]). While nothing ever extrapolates cleanly from past to future, we start by looking at the evidence of outperformance, its drivers, and their relevance for the path ahead.

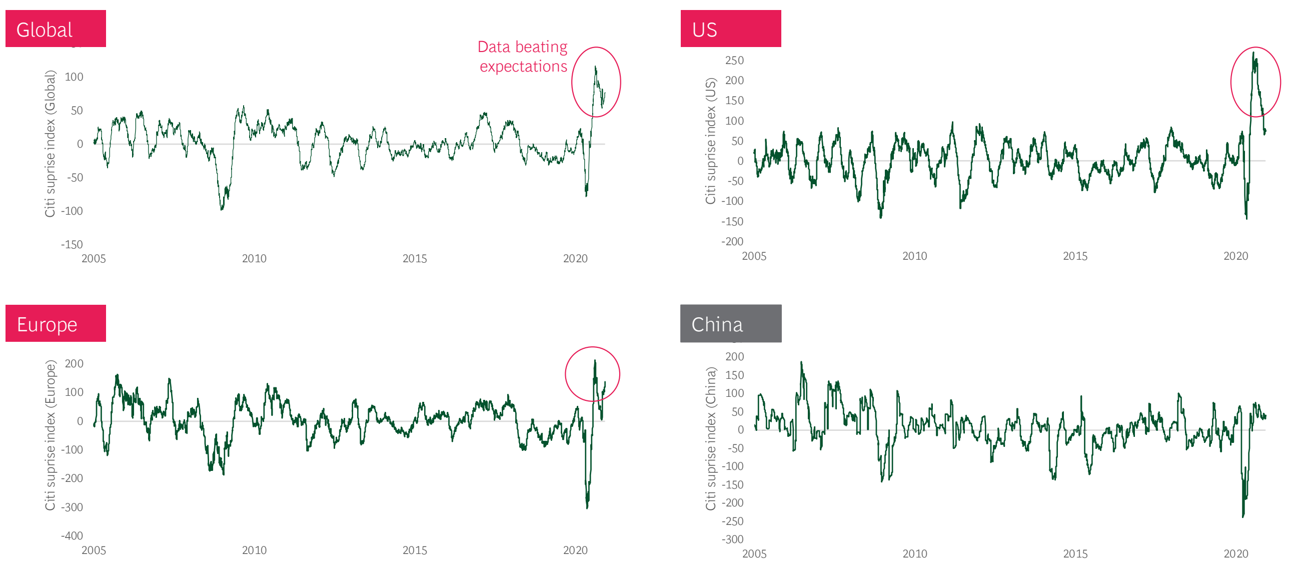
The Covid recovery has broadly outperformed expectations

Nine months into the crisis, it's fair to say that the Covid recovery has decisively beat expectations from both a tactical and structural perspective.

Exhibit 1 illustrates the *tactical* outperformance of the recovery. Economic surprise indexes compare predicted and realized macro data and we can see the resounding beating of expectations globally, in the U.S. and in Europe. In China, which entered and contained the crisis much sooner, expectations were never set so negatively, hence the China index does not outperform dramatically.

It's also worth noting the *structural* outperformance. In April, May and well into summer there were widespread fears about systemic risks – a deflationary depression, sovereign debt crises, and the return of inflation were prominent narratives – none of which have come to pass (see also HBR: The U.S. is not Headed Towards a New Great Depression (5/1/20))

EXHIBIT 1 | COVID RECOVERY OUTPERFORMS GLOBALLY (ECONOMIC SURPRISE INDEXES)

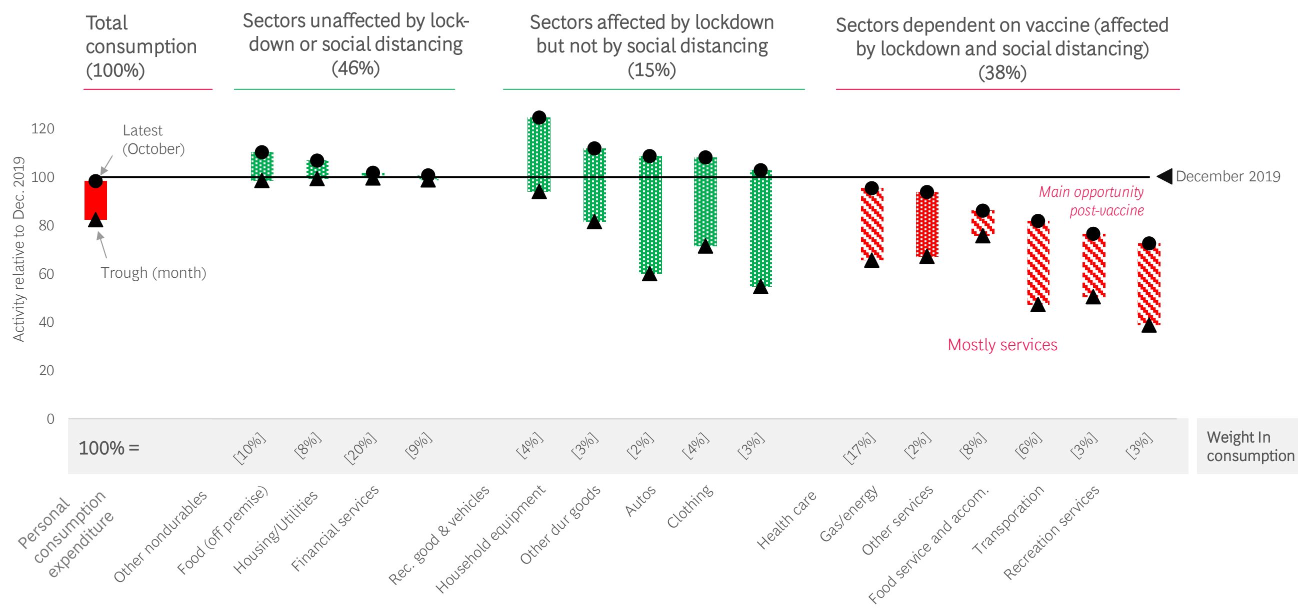


Source: Citi, Bloomberg, BCG Center for Macroeconomics

This outperforming recovery can also be seen from the more granular perspective of the consumption economy. Taking the U.S. as an example, where consumption is around 70% of GDP, Exhibit 2 looks at consumption sectors, the depth of their fall, and the recovery to date for each – all relative to December 2019. Three distinct groups emerge here:

- **Unaffected sectors**. A first group of consumption sectors never took a serious hit from Covid. Think of these as "fixed cost" of a household budget. A systemic meltdown aside, food will be eaten (as distinct from eating out), housing will be consumed, and utilities will be utilized. The drawdown in these sectors was small or nonexistent and they represent nearly 46% of total consumption.
- **Sectors compatible with social distancing.** A second group of sectors took a severe hit from lockdowns, but when lockdowns gave way to social distancing they rebounded vigorously and are now above December 2019 levels. This includes autos and other durable goods which together make up 15% of consumption in the U.S. The learning is that that when conditions for spending are restored households are willing to do so.
- **Vaccine-dependent sectors.** Third, are areas of consumption where graduating from lockdowns to social distancing is not sufficient for a full recovery. They are predominantly services sectors, such as transport and food services, where face-to-face interaction is the limiting factor. In other words, this third engine of consumption is vaccine dependent. It represents 38% of consumption and will be the core of the next phase of recovery in 2021.

EXHIBIT 2 | U.S. EXAMPLE: TWO ENGINES OF CONSUMPTION BACK ONLINE, THIRD ONE NOT YET



Source: BEA, BCG Center for Macroeconomics

Why the recovery has outperformed

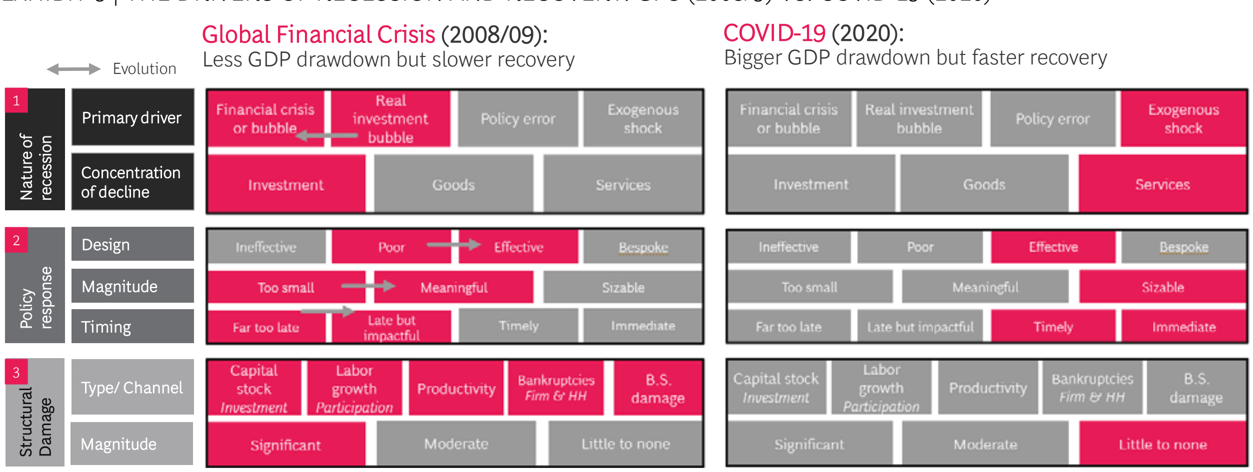
The above data speak to a significant misreading of the Covid recovery path – why was this missed?

First, a typical gut reaction was to equate intensity with recovery (and, separately, with post-Covid legacy). Because the shock was so intense, breaking many (negative) economic records, the extrapolation was to an equally negative recovery and structural legacy. And while the economic recovery has done far better than expected, that has done little to alleviate the enormous human tragedy, naturally reinforcing perceptions of perpetual crisis.

Second, amid the crisis there was an intense focus on *data flow* – again the negative headlines – and too little focus on the *drivers* of the crisis. But that was misleading. To illustrate, watching U.S. unemployment climb to 15% was an astonishing crisis and illustrates the intense hardship of the shock -- but held little information about the recovery's prospects. Current U.S. unemployment is below the level that the consensus forecast (in May) had *for the end of 2021*.

By contrast, thinking through the drivers and context of the Covid recession held more information about the path ahead -- and continues to do so, we think. In Exhibit 3, we use a recovery framework to juxtapose the 2008 and 2020 recessions and to bring out the current recovery's predisposition for strong recovery.

EXHIBIT 3 | THE DRIVERS OF RECESSION AND RECOVERY: GFC (2008/9) VS. COVID-19 (2020)

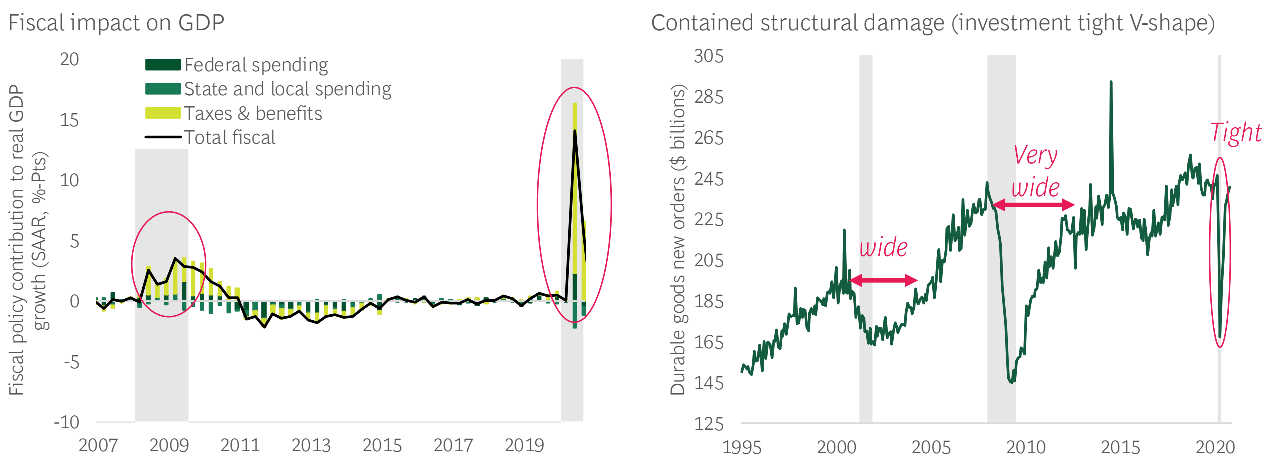


Source: BCG Center for Macroeconomics

There are three dimensions to consider:

- **The nature of a recession**: rather than crisis intensity what matters for recovery are the underlying drivers and nature. Big investment or financial busts produce large "overhangs" – think crippled household balance sheets or overbuilding in housing or capital goods that have to be worked off (or rebuilt) and thus weigh down a recovery. Financial crises lead to credit freezes that impair financial conditions and the prospects for recovery. 2008 (and 2001 also) are epitomes of that, but 2020 is an exogenous shock with no such overhangs going into the recession – the *lack of such overhangs was and continues to be a powerful predisposition for a strong recovery*.
- **The policy response**: though the Covid recession lacked the bubble or overbuild from the preceding cycle, an exogenous shock such as Covid could *create* its own such burden, for example if the real economy had been left to its own devices. It was plausible to see real economy bankruptcies proliferating and defaults infecting the financial system (HBR: What Coronavirus Could Mean for the Global Economy (3/3/2020)). But economic policy was fast, large, and well designed – in total contrast to the slow and initially timid response of 2008 – as shown in Exhibit 4 below (left side).
- **The structural damage**: ultimately the path of recovery is determined by the extent of structural damage, which comes through various channels but chiefly through a missed window of capex growth and structural damage to the labor market. All that was pronounced in 2008. In 2020, given both the nature and the policy response, little structural damage has emerged so far. In Exhibit 4 we compare the very tight V-shape for investment (durable goods new orders) with the much wider recovery paths after 2008 and after 2001.

EXHIBIT 4 | ENORMOUS POLICY AND CONTAINED STRUCTURAL DAMAGE (CAPEX)



Source: Brookings, NBER, US Census, BCG Center for Macroeconomics

What to take away from 2020 to think about 2021

Taking the above observations – which we've written about in continuous publications since March 2020 (see also HBR: Understanding the Economic Shock of Coronavirus (3/27/2020)) – we approach our 2021 analysis with a few principles in mind:

First, the intensity of crisis does not equate its recovery potential. The intensity is intimidating but does not predestine the path of the recession. This is an important reminder as Q4 and the colder weather in the northern hemisphere push caseloads and death rates back up and invite an overly negative economic outlook once more. The prospects for a step backwards on the recovery path is real (even likely in some places) and this winter will be dark. Yet, even so, the outlook analysis should be rooted in the broader context we sketched above.

Second, the relationship between health outcomes and economic recovery is overshadowed by the outsized influence of economic policy. Perhaps counterintuitive, but more successful virus control (e.g. Europe had far fewer cases and deaths per capita than the U.S.) does not predestine economic outcomes (in fact the U.S. had significantly better economic outcomes) because the influence of economic policy is outsized in this crisis (see also HBR: Taking stock of the Covid-19 Recession (8/14/2020)).

Third, dataflow matters, but when it becomes the analysis it is deceptive. Watching the data is treacherous in the best of times and often can come at the expense of insight. In times of crisis it's particularly important to be rooted in the structural world of drivers and the relationship of economic variables.

THE 2021 RISK PROFILE

Turning towards 2021, we review the economy's risk profile first. Ordinarily that involves an assessment of imbalances (financial, real, or policy) and the vulnerability to shocks. Now in the middle of a global crisis, the exercise is different.

The basic 2021 risk profile is a continuity from 2020 (Exhibit 5, left side). All risks remain, but their probabilities have fallen markedly. The nature of recession could still turn into a systemically threatening situation – but the odds are now much lower. The all-important stimulus dimension could fall victim to politics, yet a crippling policy headwind remains unlikely. Structural damage – particularly in capex – could still arise if a wave of bankruptcies materializes as stimulus rolls off. Of those, the policy dimension remains the Achilles heel of the 2021 risk profile.

EXHIBIT 5 | ALL THAT CAN GO WRONG FROM HERE – RISK PROFILE OF THE NEXT PHASE OF RECOVERY

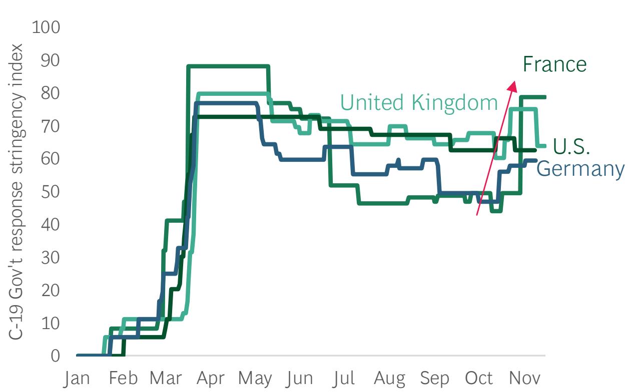
Basic risk profile		Idiosyncratic risk profile	
Nature of recession	• Unlikely, but residual risk of "systemic" contagion • Real economy collapse infecting banking system can change the "nature" of Covid recession into a financial recession	Health policy restrictions	• Steepening case and death curves trigger renewed strict and broad lockdowns • Would force activity of already recovered sectors to retreat
Policy response	• As the crisis ages, risk of stimulus fatigue. • Young crisis catalyzes political willingness, older crisis enters a politicized environment and struggles to pass stimulus. • Policy less than ideal, but not insufficient	Vaccine timelines and efficacy	• Despite strong upside surprises, remaining hurdles could prove difficult (roll-outs and distribution, efficacy) • Negative surprises remain possible (side-effects, virus resistance, …)
Structural damage	• Less likely, but structural damage of economic potential could still emerge in a negative scenario • Driven by capex collapses and labor market structural damage	Non-Covid risks	• Other risks have been largely forgotten during the pandemic, but they still weigh in an accounting of the risk profile • Geopolitical shocks, financial conditions shock, etc.

Source: BCG Center for Macroeconomics

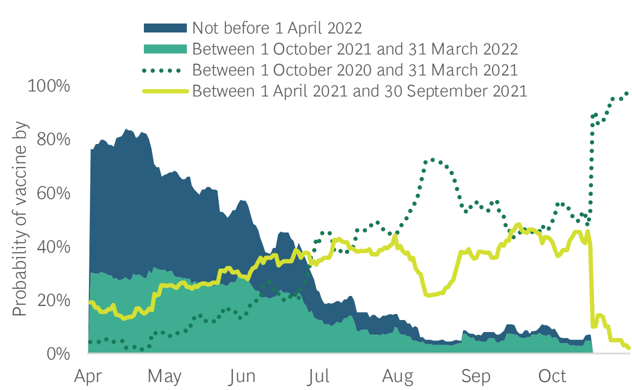
Additionally, the health dimension brings idiosyncratic risks. Q4 of the current year highlights the headwind from resurging infections and lockdown measures to contain the spread of the virus, particularly in Europe (Exhibit 6, left side). Indeed, the disease's path – including unforeseen problems in disease properties incl. mutations – remains risky. The roll-out of vaccines could run into logistical and other challenges – though we emphasize that the vaccine timeline is an area of outperformance in its own right. Relative to expectations, which originally saw a vaccine not before 2022 (see Exhibit 6, right side) the vaccine timeline must be seen as a tailwind, even if the roll out should run into obstacles. Finally, there are non-Covid exogenous risks – the customary longlist of shocks which will re-emerge in significance as the Covid crisis passes (yes, "global pandemic" did feature on that list last year and years before – along with solar flares, geopolitical crises, and other shocks).

EXHIBIT 6 | RENEWED LOCKDOWNS ARE TACTICAL DOWNSIDE RISK, BUT VACCINE TIMELINE A LARGE TAILWIND

Covid-19 response stringency index show restrictions tightening in some places



When will enough doses of FDA-approved COVID-19 vaccine(s) to inoculate 25 million people be distributed?



Source: Oxford University/Blavatnik School, Good Judgment Project, BCG Center for Macroeconomics

2021 IS POISED TO BE A YEAR OF STRONG GROWTH

Having looked at the nature of the Covid recession, its predisposition for a strong recovery, and the risk profile, we turn to 2021 growth prospects more explicitly. Thinking in scenarios, we stress two points: first, our base case sees strong growth globally in 2021, and, second, we have unusually broad conviction in that base case, flanked by weak downside and upside scenarios. We also point to some pitfalls in interpreting 2021 growth rates and provide a high-level impact translation to asset classes.

An unusually broad base case

Exhibit 7 summarizes our 2021 scenarios and emphasizes the dominance of the base case. Yes, there are downside and upside scenarios to either side, but we see them as comparatively minor in the probability distribution.

The base case revolves around our earlier analysis (Exhibit 2 above) – much of the consumption economy has already bounced back and the next phase of recovery hinges on the lagging services sectors doing the same. Thus, in many economies, including the U.S., there is still potential for fast "bounce" growth back to pre-crisis levels as 2020 has demonstrated households' and firms' willingness to spend if and when conditions allow (not structural overhang). Both vaccine deployment and continued policy support play a role in our base case.

That said, we don't see 2021 performance *predominantly* as a function of vaccine timeline outperformance, nor do we think that strong growth depends on outsized stimulus. They both matter, but most of the upside potential on the vaccine front is already realized and while policy will be important we don't think that in the U.S., where the election has dimmed the prospect for outsized stimulus, a smaller stimulus package would scupper a strong 2021. However, beyond its *economic* impact, stimulus has a critical role to play in protecting vulnerable populations and counteracting the regressive impact of the crisis.

Our conviction in the base case rests on the structural recovery dynamics that we argued to be predisposed for strong bounce growth: the lack of overhangs, the concentration in services, the avoidance of deep structural scarring.

EXHIBIT 7 | HIGH-LEVEL SUMMARY OF BASE CASE, DOWNSIDE AND UPSIDE IN 2021 (GLOBAL VIEW)

	Downside *Nature of recession decays*	Base case *Strong recovery continues*	Upside *Return to tight economy*
Summary	▪ Renewed health crisis, policy support fails ▪ Hidden vulnerabilities show as policy support tapers (eg. credit losses) ▪ Crisis infects the financial system ▪ **Renewed recession, systemic risks return**	▪ Vax success starts to end health crisis – at least enough so that even services sectors operate at prior levels of capacity. ▪ Levels of economic activity surpass pre-crisis levels but not yet regain pre-crisis trend ▪ Renewed policy support can help deliver an even stronger recovery ▪ **Return to pre-crisis output level in mid or late 2021 (for those not already there)** ▪ **Distance (for most) remains to pre-crisis trends.**	▪ Extraordinary renewal of policy support ▪ Vaccine outperformance ▪ Confluence of low rates, wage gains, HH wealth and dissaving ▪ **Tight labor markets** ▪ **Extraordinarily strong recovery**
Conviction	▪ Low conviction (10%) ▪ Window of vulnerability is narrow and policy would likely step up	▪ High conviction (80%) ▪ Foundations for a strong year due to the potential for bounce back and tailwinds of comprehensive reopening	▪ Low conviction (10%) ▪ Tight labor market remains high bar ▪ XXL stimulus unlikely
What it would take	▪ Policy support fails ▪ Banking system hobbled	▪ Vaccine distribution allowing services sectors to open more fully ▪ Households returning to consume strongly (facilitated by high saving rate and healthy balance sheets) – and low rates ▪ Fiscal policy does not become a significant headwind	▪ Supper-sized stimulus accelerates the recovery ▪ HH spend extra strong

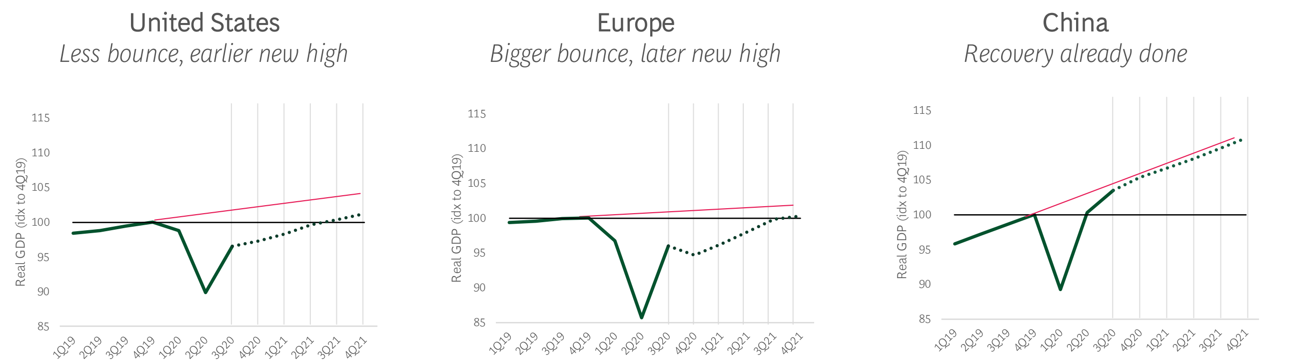
Source: BCG Center for Macroeconomics analysis

How the base case could play out in the U.S., Europe, and China

In the main economic regions – comprising about 70% of world GDP – the base case could play out as shown in Exhibit 8:

- In the U.S., Q4 of 2020 is set to see flatter growth but a contraction is not the base case (although the immediate path will be challenged by the spread of the virus). Successful vaccine roll-out should push the virus replication rate below 1 as the year progresses. We think that aggregate output could come back to pre-crisis levels by the middle of the year, a view that is somewhat more bullish than consensus. 2021 growth could be near 4.1% on a 4q/4q basis.
- In Europe, Q4 is likely to be contractionary again (delivering a "W-shape"), which however sets up 2021 for a stronger bounce. We think it's plausible that Europe could return to pre-Covid levels by the end of 2021, though a delay into 2022 is possible. Given the weak base period we expect growth of around 5.9% in 2021.
- In China, the levels recovery is already done, having gone into and having contained the crisis far earlier. High trend growth in the Chinese economy points to perhaps 5.3% growth next year.

EXHIBIT 8 | 2021 BASE CASE: U.S., EUROPE, CHINA



Source: China National Bureau of Statistics, BEA, Statistical Office of the European Communities, BCG Center for Macroeconomics

Pitfalls of interpreting 2021 growth: levels vs trend recovery, bounce vs. organic growth, and base effects

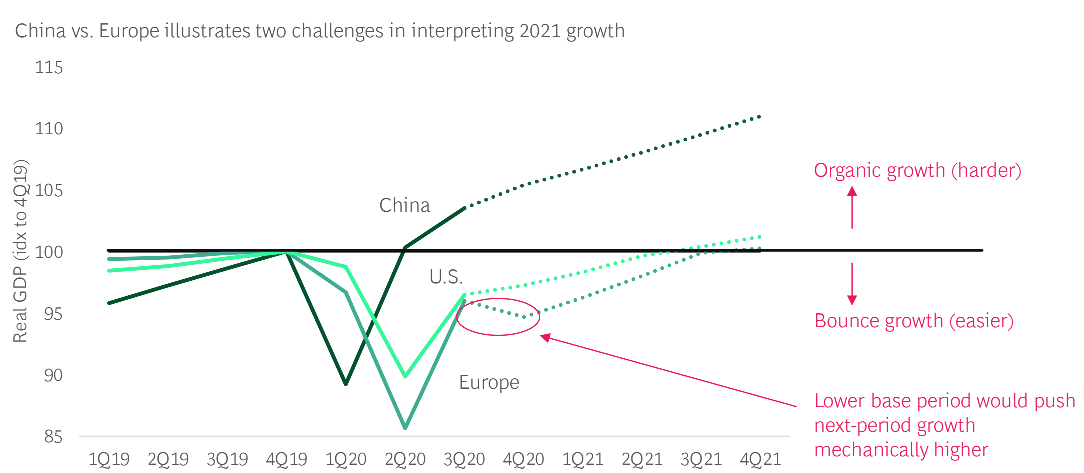
Interpreting growth numbers is never straightforward, but 2021 will be especially challenging, particularly in cross-section.

First off, we stress the difference between returning to pre-crisis *levels (the horizontal lines)* vs. returning to *trend* (the red lines in Exhibit 8). Bar China, returning to trend is out of reach in 2021 and may never fully happen. While we emphasized the contained structural damage at the start of the piece – capex has held up well – it's too soon to say what will be the extent of structural damage. While a V-shape remains the most convincing geometric description of what is playing out, the inability to return fully to trend remains a real risk (partial U-shape), though the gaps would be much smaller than looked likely at the bottom (see also [HBR: Understanding the Economic Shock of Coronavirus (3/27/2020)]).

A second technical aside concerns the *types of growth* that are in store. Consider looking at growth as being of two kinds – "bounce" growth and "organic" growth. Bounce growth is growth that brings activity back to levels that was previously achieved – this can be fast because the productive capacity consistent with such levels is already installed – whereas organic growth is growth that moves output to new levels previously unobtained. In ideal economic environments all countries are driven by organic growth – and that would make growth rates more comparable. 2021 is not one of these environments.

This is best illustrated by comparing the major regions we just reviewed. It may seem startling that Europe is set to grow faster than China next year – but China's growth will be all organic and Europe's mostly bounce growth (the U.S. will likely be a mix of bounce and organic). Added to this is the fact that a meaningful piece of European's higher growth will be driven by negative growth in the 4th quarter of 2020 as the lower base period gives mechanically more room to bounce back. **Thus, in 2021 having the highest growth rate is more likely to be a sign of weakness rather than strength.**

EXHIBIT 9 | BOUNCE GROWTH, ORGANIC GROWTH, AND BASE EFFECTS: THE CHALLENGES OF READING 2021 GROWTH



Source: China National Bureau of Statistics, BEA, Statistical Office of the European Communities, BCG Center for Macroeconomics

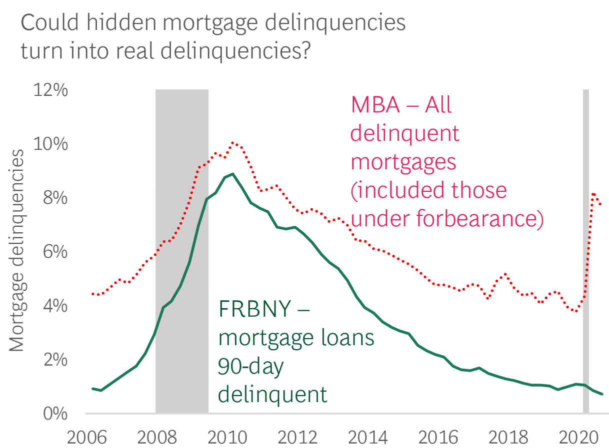
How it could all go wrong (downside case)

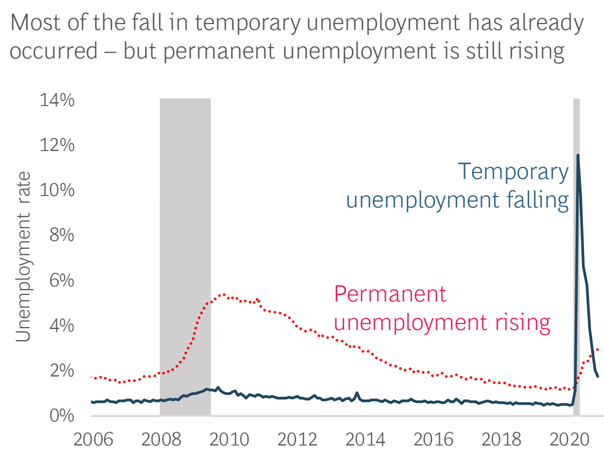
Despite the conviction in the base case it would be remiss not to consider the downside. We see two possible paths to a disappointing 2021 in growth terms.

The first path is that the health crisis re-emerges, say because of virus mutations, *and* that policy will fail to respond effectively as stimulus stamina wanes and crisis fatigue grows. This is the downside which we have previously discussed and has a systemic escalation if policy allowed the re-engaged crisis to infect the financial system. We find this very unlikely – both because the crisis is unlikely to re-emerge that way and policy makers would step up again.

A second, more plausible, pathway concerns **hidden vulnerabilities**. While policy has done a tremendous job mitigating structural economic damage, it may have only hidden and delayed problems rather than truly bridging the economy over a void. We illustrate this by looking at mortgage delinquencies (Exhibit 10) – they never moved higher during the crisis (aided by innovative forbearance programs), but as forbearance ends will mortgage credit issues surprise? This could induce credit tightening and undermine the exceptional strong housing market – a fast road to the downside path. While we view this path as unlikely, as banks remain very healthy, the housing market (price) is strong, and the labor markets have rebounded remarkably quickly, it cannot be dismissed. Additionally, the fast fall in the unemployment rate has been driven entirely by temporary unemployment. As this fall is nearing its limit, permanent job growth will need to take over – an area where the unemployment rate continues to rise (Exhibit 10).

EXHIBIT 10 | HIDDEN VULNERABILITIES: CREDIT LOSSES AND PERMANENT UNEMPLOYMENT





Note: Recession shading assumes Covid recession ended when headline unemployment began to fall
Source: MBA, NBER, Federal Reserve Bank of New York, BLS, BCG Center for Macroeconomics

How it could go really well (upside case)

The other side of the stress test is to consider outperformance of the base case. Here too there are two (relatively unlikely) paths.

First, upside stimulus surprises. In the U.S. there was some prospect for that coming out of the U.S. election as a Democratic sweep could have delivered enormous and sustained stimulus driving an accelerated recovery. While this is still possible (requiring Democrats to win two senate seats in Georgia's runoff elections) it is not likely, leaving the prospects of overwhelming and sustained stimulus dim, even if another round of stimulus is delivered (as is likely).

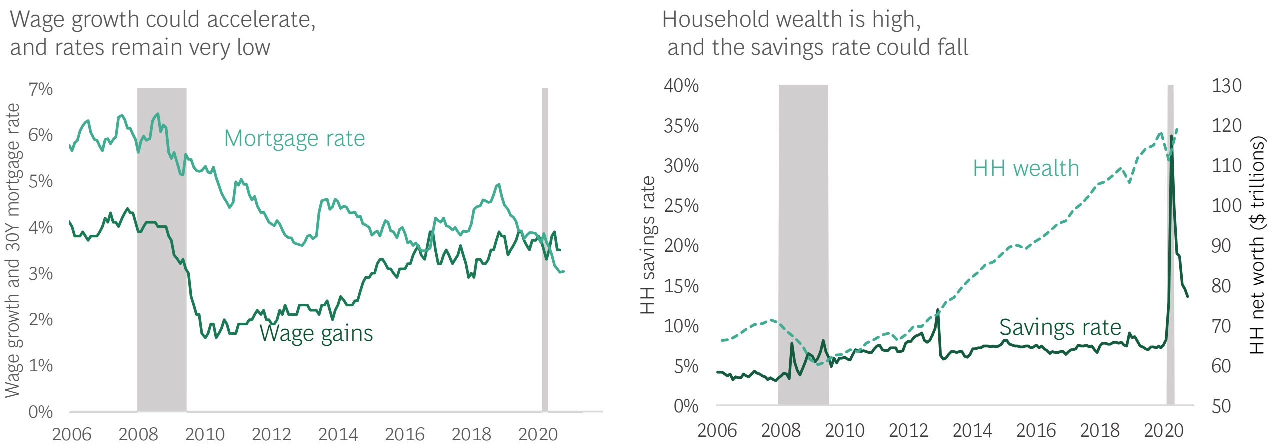
Yet there is another – less politically dependent – path to an upside surprise. Household consumption and investment could deliver such a surprise if there were an overwhelming confluence of the following factors:

- Mortgage rates, which are an all-time low level, can help drive even stronger housing activity (both sales and construction).
- Wage growth may remain resilient as the recovery in the labor market has beaten expectations and pockets of labor market tightness could re-emerge.
- Household wealth remains at a high level as key asset classes (e.g. housing and equities) remain near peak levels helping push up household confidence and strengthening household balance sheets.
- High household savings rates have provided a reservoir from which spending can accelerate – as all categories of spending re-open in 2021 a shift to household dissaving could push growth more than expected.

- Monetary policy is to remain remarkably easy – having set a high bar to move policy tighter – providing a sustained tailwind to financial conditions.

Each of these positively impact even our base case but a strong confluence of strong upside surprises in each could drive an overall upside scenario. That said, these tailwinds are unlikely to deliver a tight economy (i.e. unemployment rate below u*, or the “natural” rate of unemployment) in 2021 as the distance to cover remains too large for even a very robust recovery.

EXHIBIT 11 | POTENTIAL CONFLUENCE OF TAILWINDS: RATES, WAGES, WEALTH, AND SAVINGS



Note: Recession shading assumes Covid recession ended when headline unemployment began to fall
Source: Federal Reserve Bank of Atlanta, Haver, BEA, Federal Reserve Board, BCG Center for Macroeconomics

How the base case translates to asset classes

The growth backdrop we describe above points to a favorable environment for investors in risk assets, though we note the geographic disparities and the potential to misread 2021 growth, which in many cases speaks to underlying weakness in the base period and more catch-up potential. At a high level, we summarize the likely implications of our base case for a range of asset classes in Exhibit 12. In short, a strong path helps provide a tailwind to risk assets, however the tailwind is modest as asset markets have proved extraordinary resilient in 2020. They will be aided by monetary policy that will remain easy despite a temporary early 2021 overshoot in inflation as inflation expectations remain below where policy makers would like them to be.

EXHIBIT 12 | ASSET CLASS IMPLICATIONS: HIGH-LEVEL FLYBY

Asset Class	*2021 base case outlook for major asset classes*
Short rates	Remain at zero bound as inflation expectation too low and policy unwilling to move
Long rates	Long rates move modestly higher as the economy improves, but remain low
Inflation BE	Inflation breakeven moves modestly higher as inflation inches higher
Real rates	Real rates move modestly higher yet remain negative
IG credit	IG credit spread narrows modestly to even lower levels
HY credit	HY credit spreads narrow modestly to even lower levels
USD	USD weaker as shorter-term interest rate differential remain close to zero
Oil	Oil price stable as excess capacity caps gains despite recovery
Real estate	Real estate remains strong as interest rates support prices

Source: BCG Center for Macroeconomics analysis

CODA: THE VIEW BEYOND 2021

Though strictly speaking outside the scope of a next-year economic outlook, we feel compelled to look past 2021 as the anomalies playing out now raise questions about the entire post-Covid cycle. And despite being in the early days of the new cycle, we think there are contours emerging regarding the path to a tight economy, the risk of bubbles, and post-Covid structural legacy.

The new cycle has already begun – what do we know about it?

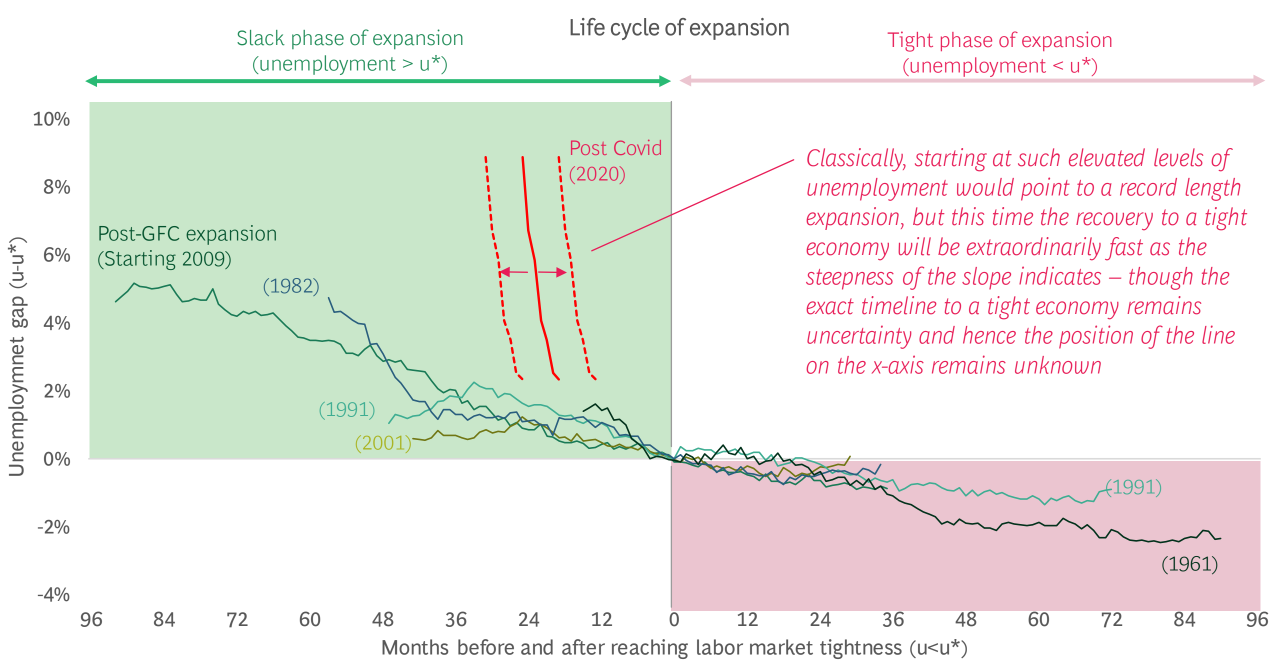
The end of the Covid recession has not been officially called in any economy we're aware of, but the end will likely be dated close to the inflection in labor markets. In the U.S., where unemployment peaked in April, that suggests we may already be eight months into the new cycle.

The "modern cycle" has a structural predisposition for longevity. The record length of the last expansion was not a fluke but in line with the structural conditions of the macroeconomic regime: inflation is low and stable, which allows monetary policymakers to let cycles run much longer in recent times; many economies have shifted from volatile real goods and investment to more stable service consumption (even if this crisis turned that relationship on its head), and fiscal policy remains able and willing to push on the cycle – each driving the proclivity for long cycles. The flipside is that long expansions allow imbalances to build, particularly financial ones.

Yet, there is something remarkably different about the post-Covid cycle that we can already point to: the path to a tight labor market will be unusually short. In Exhibit 13 we show the path of select U.S. expansions since the 1960s in terms of labor market tightness. Initially, a cycle has room to run because high unemployment (u is greater than u*, the natural rate of unemployment) allows labor to be drawn into the economy fueling growth. Eventually, the economy becomes tight (u<u*), growth slows, and the cycle becomes increasingly vulnerable – to imbalances that build, to policy pushing back against price pressures, and yes, to exogenous shocks.

Classically, a cyclical starting point with high unemployment points to a long cycle, but as we see in Exhibit 13, the post-Covid cycle is making its way towards tightness very rapidly – the line is much steeper than anything before it. To be sure, we do not know the exact position of the post-Covid expansion (red line) relative to the x-axis but we're confident the distance to tightness is short relative to other cycles (dotted red lines show faster and slower scenarios). That means the new cycle will have the risk profile of an old expansion at a relatively young age.

EXHIBIT 13 | POST-COVID CYCLE WILL LIKELY REACH LABOR MARKET TIGHTNESS IN RECORD TIME



Note: Assume current expansion began when the unemployment rate started to fall
Source: BLS, NBER, CBO, BCG Center for Macroeconomics (CME)

Easy monetary policy and the predisposition for bubbles

While the economy is thus poised to become tight relatively early in the cycle, the prospects for monetary policy (i.e. short rates) remain low regardless. This is part a risk calculation on the part of policy makers trying to provide as much stimulus today as possible by lower expectations of short rates into the future (and thus pulling down long rates). But it is also based on monetary policy makers' relatively new operating philosophy that they will need to see inflation move above their target (and do so in a way that makes up for past undershooting) before they tighten policy in a meaningful way.

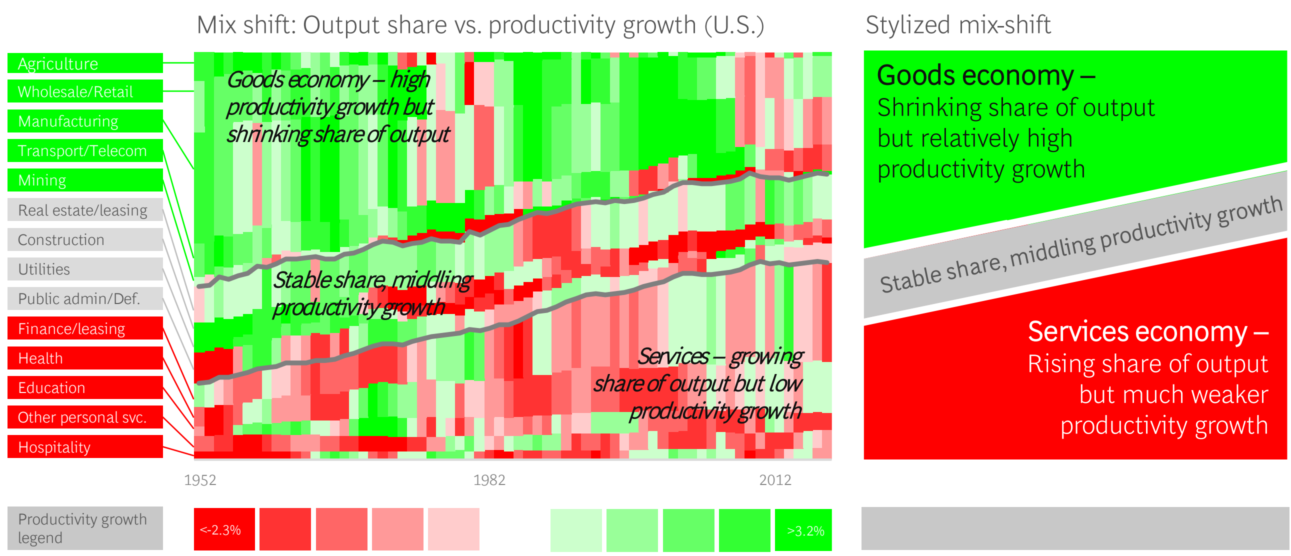
Aside for inflation's likely temporary overshoot in early 2021, the prospects for above target inflation remain modest in the medium run and thus sustained policy ease – short rates near zero and negative real rates – remains very likely. This provides a tailwind to the economy, but also to risk assets which structurally increases the risk of financial bubbles – a key source of cyclical risk from a structural prospective in modern cycles.

Covid-19 structural legacies – will everything really be different?

What other structural legacies, aside from lower interest rates, will this crisis leave? The dimensions of impact and potential legacy is vast as the crisis touched nearly everything and with a heavy hand. Yet, we've argued in the past that legacy will vary widely. In many ways, extrapolating from the shocks intensity to legacy faces the same problems that arose from equating intensity with recovery. Consider its legacy across three dimensions:

- Macroeconomic regimes: The macroeconomic "operating software", while stressed by the crisis, was not fundamentally altered. The low and stable inflation regime remained intact, significant fiscal capacity was shown and arguably strengthened, even if some of the weaker elements, such as the global trade order, continued to weaken. The broad contours of the global macroeconomy that underpin the structural risk profile of modern cycles and the high valuation environment remained intact. (Coronavirus and the "Good Macro" Regime (6/9/2020))
- Structural damage: This is a question of where economic activity ultimately ends up relative to its pre-crisis trend. We have already stressed in this outlook the contained nature of structural scarring but the return to pre-crisis *trend* level is far less certain (Full V-shape vs. partial U-shape). While we think a continued strong recovery will make up much ground, it will take years to see a clear picture whether the trend growth path was impaired and to what extent. (HBR: Understanding the Economic Shock of Coronavirus (3/27/2020))
- Microeconomic legacy: This is the area with the strongest and clearest legacy in our view – as new ways of doing things were forced on firms and households. Yet, the question remains what behaviors stick and in what ways (i.e. work from home, digital learning, …). Over the longer term, we're inclined to see a silver lining here in that the crisis accelerated the adoption of digital technologies throughout the economy, but particularly in the service sector – which has long been resistant to technological disruption (see Exhibit 14). To the extent that adoption is able to nudge up productivity growth within the service sector (something that has been notoriously weak and has been dragging down overall productivity as the service sector has grown) it will provide a tailwind to potential growth – which, even if modest, is important in economies with low potential growth. (Will COVID Be a Catalyst for Services Sector Productivity? (7/29/2020))

EXHIBIT 14 | COVID LEGACY: WILL SERVICES SECTORS POST STRONG PRODUCTIVITY GROWTH IN THE FUTURE?



Source: World KLEMS, EU KLEMS, BCG Center for Macroeconomics

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