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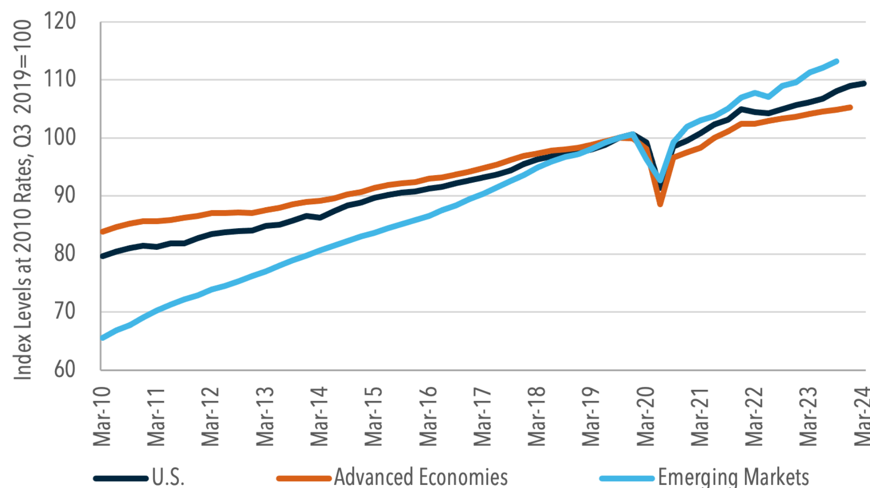
# Who Has—And Does Not Have—Long Economic COVID

The U.S. growth recovery continues to substantially outpace other developed market (DM) economies. There have been few lingering scars on the output side, as GDP has essentially reverted to its pre-COVID growth path. Other DMs have performed less well, with Eurozone growth clearly well behind the U.S. Japan has also lagged, while other developed markets (DMs) look more mixed. Emerging markets (EM) as a whole have been more similar to the U.S., with a strong recovery and output, on balance, catching back up to the pre-COVID trend. The path of price levels looks more similar across DMs, with a leap in the aftermath of COVID, a pattern shared across DM economies. Though the U.S. exhibits somewhat higher inflation, it's not an outlier—inflation rose substantially in all DM and most EM economies, regardless of the precise policies pursued. The one key exception was China, where inflation was actually lower since the onset of the pandemic.

> ***"It may happen that small differences in the initial conditions produce very great ones in the final phenomena"***
>
> – Henri Poincaré

**FIGURE 1: U.S. and EM growth outpaces other DMs**




Analysis as of 24 May 2024, using latest available data. Sources: Haver Analytics, Bureau of Economic Analysis. For illustrative purposes only.

U.S. growth has been very strong coming out of COVID. Real output is essentially back to its pre-COVID trend. In particular, the labor market has had several years of extremely solid performance despite the massive disruptions from COVID. This robust recovery is a huge contrast to the post-2008 experience, when output was low and the labor market was underutilized for years.

EM performance has been similar to that of the U.S. EM output recovered fairly quickly, then settled back to trend after the fast rebound. Sharp interest rate hikes in 2022 shortened the duration of that rebound. In some EMs, GDP actually started contracting in late 2022 or 2023, but on average, overall growth held up well, as several EM countries remained remarkably resilient despite the higher level of global real interest rates.

However, the strength exhibited by the U.S. output is not shared by other DMs. Compared to 2019, 2023 U.S. GDP was nearly 10% higher. In contrast, the Eurozone's GDP is only up about 4%, a gap of about six percentage points. Japan's real output has been even weaker, with essentially no growth in output, as GDP is essentially only back to its pre-COVID level.

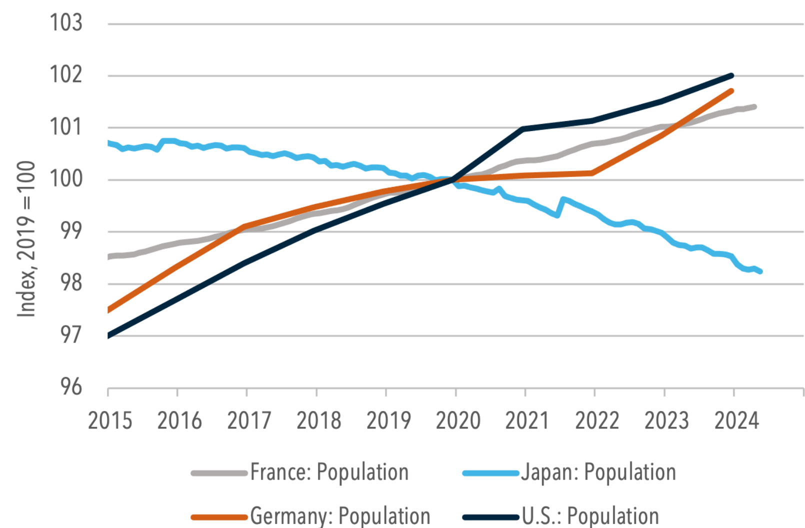
What accounts for U.S. outperformance? Differential population growth—faster in the U.S.—drives some of the U.S. GDP outperformance. As Figure 2 shows, U.S. population growth has been more rapid than most other DM economies, especially the larger ones. Moreover, that stronger population growth is based on the current government estimates, and actual population growth could be well above that. The Congressional Budget Office (CBO) has argued convincingly that actual U.S. population growth has been faster than current estimates, driven by immigration. And, there's some secondary evidence consistent with more rapid population growth. For instance, the establishment survey shows payroll employment growth that has been more rapid than the estimate for the household survey. Given how those estimates are constructed—a count of a sample versus a percentage of a fixed sample—the more rapid establishment survey growth is consistent with the CBO's mooted more rapid population growth.

On the other hand, population growth in the Eurozone is generally much more muted, which translates into slower GDP growth. For instance, relative to 2019, France's 2023 population had increased by about a percentage point less than the U.S. Germany grew even more slowly through 2021, though population growth has accelerated since then. And, if we turn to Japan, we don't even find population growth. Over the post-COVID period, despite somewhat more immigration, the population has continued to shrink. Indeed, Japan's population has contracted by over 2% over the past decade.

Per capita GDP growth shows how population growth is an important factor but not the whole story (see Figure 3). U.S. performance has been solid, with per capita GDP also broadly returning to the pre-COVID trend. Now, the more rapid population growth posited by the CBO would pull down U.S. GDP per capita somewhat, though not enough to get it down toward what we see out of other DMs. But, what really stands out when we look at this is just how poor Eurozone per capita GDP performance has been. Indeed, looking at France and Germany we see essentially unchanged GDP per capita from 2019—a terrible performance. Japan is not strong, but is at least positive.

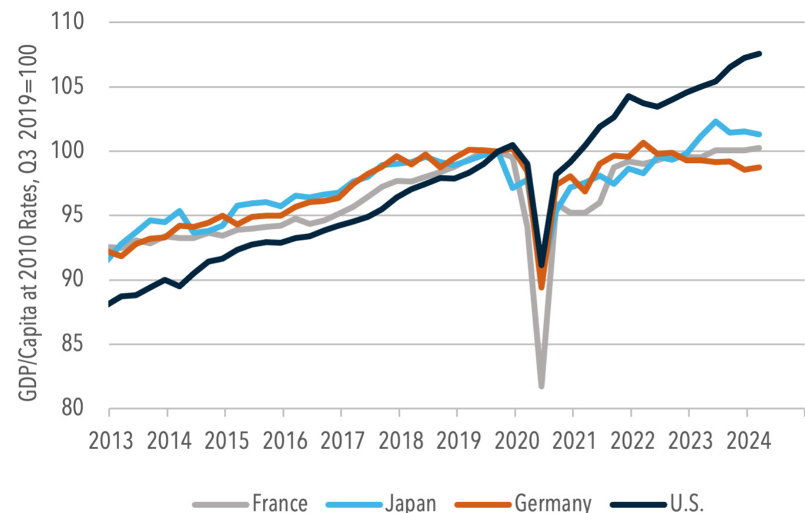
In EM, we continue to see some quite divergent developments. China's growth rate has declined as population growth has turned negative. However, the process of urbanization, though slower now, continues and is keeping per capita GDP growth high—not quite as high as in the past, but still about 5% per annum over the past five years. In many other EMs, especially outside of Asia, growth is actually driven more by population growth and less by per capita gains.

**FIGURE 2: U.S. shows the most rapid population growth**




Analysis as of 24 May 2024, using latest available data. Sources: INSEE, StBa, MIC, CENSUS/Haver Analytics. For illustrative purposes only.

**FIGURE 3: Eurozone GDP per capita growth has stagnated since 2019**




Analysis as of 24 May 2024, using latest available data. Sources: CAO/H, BEA/H, Bbk/H, INSEE/Haver Analytics. For illustrative purposes only.

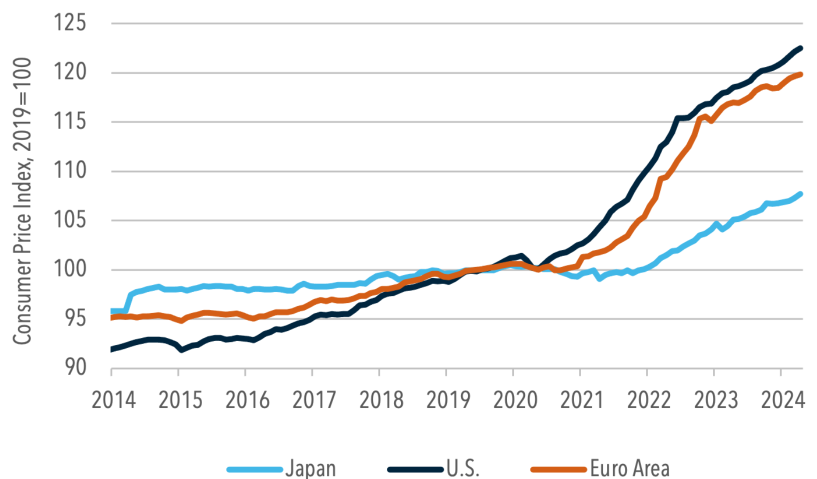
Another way to say the above is that the U.S. has seen ongoing productivity growth that has been substantially more rapid than other DM economies, especially the Eurozone. Here the aftershocks of the Russian invasion of Ukraine are likely playing a role. The Eurozone, and particularly Germany, had to drastically reorient their energy supply and distribution. And, they actually did so, with some of the potential worst-case outcomes avoided. Still, there are tell-tale signs that the effects still linger, particularly the weakness in industrial production and especially German industrial production. That negative supply shock has very likely dragged down productivity, which helps explain the terrible GDP per capita performance.

In EM, Asia stands out with continued very high per capita GDP growth. China is still around 4.5-5.0%, Indonesia is at 4%, and India is around 6%. Looking through the pandemic-related disruptions, we see very little meaningful change in trends. The rest of EM is more mixed. Some countries show high and little-changed real per capita growth (e.g., Turkey, with 3.5-4.0%), some keep struggling (e.g., South Africa, with little to no real per capita growth), and some actually improved recently, notably Mexico (2-3% over the last three years.)

In contrast to the GDP divergences, inflation outcomes have actually had much more commonality across the globe. Put simply, it spiked massively everywhere. Figure 4 shows the cumulative increase in the overall price level, including food and energy, for DM economies—the total amount of accumulated inflation since the start of COVID. The price level increases for the U.S. and the Eurozone are similar, though the timing of the rises was different, with the U.S. leading. In total, the U.S. has seen a bit over 20% increase in the price level and the Eurozone saw just a bit under 20%. That's not a big difference. Japan's price level increase is much smaller, a little less than 10% as of now. However, it's worth noting that it came from a very different starting point, as there was essentially no increase in the price level over the previous five years, a period where the U.S. saw its price level increase by about 8%.

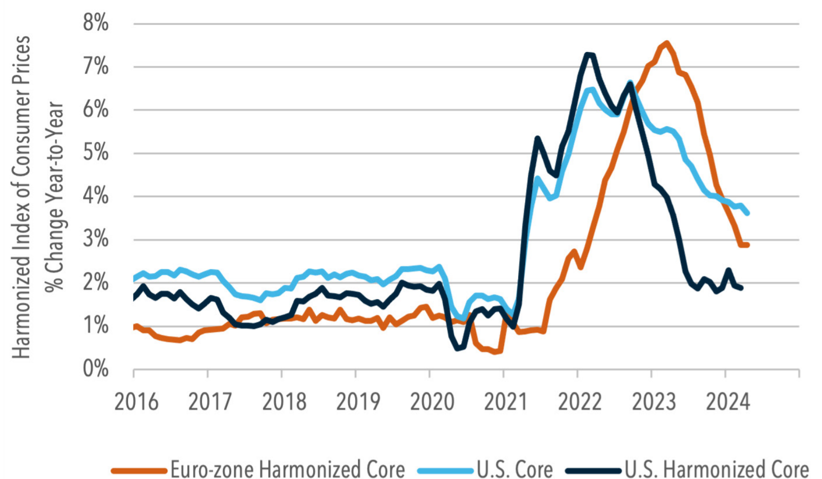
Recent inflation performance has diverged between the U.S. and other DMs, at least on the surface. As Figure 5 shows, year-over-year inflation for the Eurozone as measured by the core Harmonized Index of Consumer Prices (HICP) has continued to decline into 2024, while inflation reduction in the U.S. core CPI has stalled out. Since the start of the year, the Eurozone core HICP rate has dropped over a percentage point, from 4.0% to 2.9%. In contrast, the U.S. CPI only dropped 0.3 percentage points, to 3.6%. Some of the divergences are driven by methodological differences between these indexes. Luckily, the U.S. Bureau of Labor Statistics also produces a core HICP index for

**FIGURE 4: DM economies see their price levels move higher**




Analysis as of 24 May 2024, using latest available data. Sources: MIC/H ES/H, BLS/Haver Analytics. For illustrative purposes only.

**FIGURE 5: A like-for-like inflation comparison shows more U.S.-E.Z. convergence**




Analysis as of 24 May 2024, using latest available data. Sources: BLS, ES/H, Haver Analytics. For illustrative purposes only.

the U.S. which uses the same methodology as the Eurozone. That allows us to make a like-for-like comparison of inflation. On an HICP basis, U.S. inflation dropped back to close to 2% by mid-2023 and has mostly stayed there. A big driver of the difference is that HICP doesn't use the owner's equivalent rent in the same way and, since that has a very large weight in core CPI, that helps to restrain HICP inflation for the U.S.

Inflation in EMs has normalized fairly quickly, following very proactive rate hikes. With some exceptions by countries facing instability and sharp devaluations (Argentina, Turkey, Nigeria, Egypt), EM inflation has already normalized back to pre-pandemic averages. China stands out as it faces deflation threats, and some EMs are still lagging in terms of disinflation (e.g., Colombia), but on average, inflation has fully normalized.

The behavior of inflation will remain central to assessing the course of central bank actions and economies. However, potential significant policy shifts, both domestically and internationally, are coming to the fore and we expect the markets' assessment of the likelihood of these changes to be a major driver through the rest of this year. These potential policy shifts come along several fronts. Perhaps the most important is trade policy, where the risk of very significant tariffs could disrupt and reorder trade linkages. Tensions between the U.S. and China have remained high, but could escalate further, and other countries are also at risk of tariffs. Relations between Europe and Russia are also not returning to the status quo but could shift further, while there is a risk of the U.S. pulling back from European engagement. U.S. domestic policy could also shift substantially—and potentially disruptively—across immigration, immigration enforcement, and tax policy. With the potential for policy to go different directions, we incorporate some of the main potential divergences into our scenarios. Note that to incorporate these we have dropped our scenario that has a rate-increase-led recession. That's not because we think such a result is impossible or even very unlikely, but we want to look at what we think drives risks around our portfolios, and these potential policy shifts loom large.

| Scenario | Assumptions |
|---|---|
| **Gradually Declining Inflation and Policy Continuity (40%)** | • The Q1 bounce in inflation fades over Q2. Readings surprise to the downside, again, in Q3 and Q4, some of which is due to ongoing moderation and some to residual seasonality.<br>• Activity is moderate, with growth dipping from the past year, but remaining solid. Rate sensitive sectors continue to lag.<br>• Fed starts to cut rates in the summer and continues to do so at a steady pace. By spring 2025, the fed funds rate is 100bp lower, as inflation pushes back toward target. Markets price in further gradual easing. Balance sheet runoff continues at slower pace before pausing in early 2025.<br>• Continuity in U.S. fiscal and foreign policies. Tensions with China remain quite elevated, but don't increase sharply. Nearshoring continues, particularly boosting Western hemisphere economies.<br>• DM growth broadly remains sluggish, but positive. German activity continues to move sideways.<br>• Growth in other EMs is supported by rate cuts in the second half of 2024 and solid domestic demand in some EMs, offsetting the drag from low DM growth. Commodity exporters still benefit from supportive terms of trade.<br>• Rate cuts across many EMs, following lower inflation pressures.<br>• China continues gradual monetary easing. Some fiscal stimulus measures are being rolled out, but high debt levels restrain the aggressive use of credit policies. Large-scale bailouts or debt restructurings are avoided due to moral hazard concerns. |
| Gradually Declining Inflation Interrupted by Trade/Tariff Wars (25%) | • Through 2024, inflation and growth gradually decline as described in the scenario above.<br>• In the aftermath of the election, U.S. policy swings substantially. Trade and tariff wars. Latent executive authority used to substantially raise tariffs on all countries, with tariffs on Chinese imports increased even more.<br>• Domestic policy also shifts substantially. Proposals for extension of expiring tax provisions and further tax cuts that would substantially increase the deficit.<br>• Step up in enforcement at the U.S.-Mexico border, combined with threats to Mexico aimed at forcing them to curtail trans-migration. Potential for a substantial domestic crackdown on immigrants.<br>• Growth into 2025 hurt by disruption of trade and sharp cost increases for intermediate goods. Partial offset from deregulatory impulse.<br>• Imposition of substantial tariffs on imported goods starts to flow into inflation. Inflation progress reverses into 2025, as the sharp goods price increases are passed on. The Fed pauses rate cuts to assess the flow-through of inflationary pressures.<br>• Expectations that higher inflation will continue, as the policy changes continue to flow through. Potential for modest further growth drag, but considerably higher uncertainty on growth than inflation effects.<br>• Political pressure on the Fed for resumption of rate cuts. Fed resists, but markets still price in a somewhat higher inflation risk/credibility premium for the U.S.<br>• Other DMs see a modest growth drag from the ratcheting up of tensions and resulting supply chain disruptions.<br>• EM growth slows down sharply, as investment and exports drop. China hurt most directly, but other manufacturing countries and even commodity exporters impacted by global linkages. |
| Sticky Inflation and Policy Continuity (15%) | • U.S. growth remains solid, notably over current estimates of the potential growth rate (~1¾%).<br>• The ongoing firm growth outlook, despite substantial rate increases, does two things. First, it keeps upward pressure on inflation rates, which fail to fully moderate from the Q1 increase. Run rate remains around 3% for core PCE. Second, it supports upward reassessments in markets where interest rates are neutral.<br>• The Fed holds rates at the current level so as to put more downward pressure on growth and inflation. Longer-term rates move higher with the higher expected future neutral rates.<br>• Eurozone growth firms further and inflation follows the U.S. in rebounding higher. Solid U.S. growth provides some support to other DMs.<br>• Continuity in policy as in first scenario. |
| Sticky Inflation Exacerbated by Return of Trade/Tariff Wars (20%) | • Inflation remains sticky at around 3%, so the economy enters 2025 without any rate cuts.<br>• Trade, tariff, and domestic policies shift substantially following the U.S. election as in second scenario.<br>• Expectations for policy changes to continue substantial upward pressure on inflation and downward pressure on growth over the second half.<br>• The combination of already sticky inflation and the policy shifts push expected short-term rates higher.<br>• Pressure on the Fed to be accommodative is even more substantial than in the prior scenario.<br>• Longer-term rates increase substantially on the combination of 1) potential Fed hikes and 2) increased inflation and fiscal risk premia further out the curve.<br>• China and manufacturing countries hurt by trade wars and high U.S. rates. Relative outperformance of commodity exporters. |

| | **Gradually Declining Inflation and Policy Continuity (40%)** | Gradually Declining Inflation Interrupted by Trade/Tariff Wars (25%) | Sticky Inflation and Policy Continuity (15%) | Sticky Inflation Exacerbated by Return of Trade/Tariff Wars (20%) |
|---|---|---|---|---|
| **U.S. Real 4Q GDP (%)** | 1.75 | 1.50 | 2.50 | 2.00 |
| **Fed Funds (%)** | 4.38 | 4.88 | 5.38 | 5.38 |
| **U.S. Core PCE (%)** | 2.25 | 2.75 | 3.00 | 3.50 |
| **2yr Treasury (%)** | 3.75 | 4.75 | 5.10 | 5.50 |
| **10yr Treasury (%)** | 3.75 | 4.25 | 4.75 | 5.50 |
| **10yr Bund (%)** | 2.00 | 2.75 | 3.00 | 3.50 |
| **China 4Q GDP (%)** | 4.75 | 2.50 | 5.00 | 2.75 |
| **EM 4Q GDP (%)** | 4.00 | 2.75 | 4.50 | 3.00 |
| **Oil (WTI/Brent)** | $75/80 | $70/75 | $85/90 | $95/100 |

## STONE HARBOR INVESTMENT PARTNERS

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