

INSIGHT

QUARTERLY MARKET REVIEW

Q4 2021

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PODCAST



Rebuilding
after the
pandemic

OVERVIEW

Rethinking growth

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wealthy and frugal

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different type of bubble

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High inequality and low
real interest rates

OVERVIEW

Concerns about China will overshadow global growth prospects in the rest of the year. Around the world, however, massive infrastructure spending is needed for a sustainable post-pandemic recovery.

From Sputnik and 'Japan as Number One' to China today

In 1961, as Soviet cosmonaut Yuri Gagarin became the first man to orbit Earth, Nobel prizewinning economist Paul Samuelson predicted that the Soviet Union would overtake the US to become the world's largest economy. Its economy was only half the size of the US at the time, but Russia's superior technology and its planned economy (considered a benefit at the time) meant it would overtake the US as soon as 1984, Samuelson thought. That didn't happen. Today, Russia's GDP is only a fifth of that of the US (even at purchasing power parity, a measure which boosts the Russian level); its GDP per capita is less than half the US level.

In 1979, Harvard professor Ezra Vogel predicted in his book *Japan as Number One*, that Japan would overtake the US in terms of GDP per capita by 1985 and in overall GDP by 1998. That didn't happen either. Today, Japan's GDP per capita is two thirds of the US level and its overall GDP around one quarter of the US.

Starting in the early 2000s, many predicted China would soon overtake the US. Indeed, in our own EFGAM 2014 *Outlook* publication, we argued that China's GDP would, at purchasing power parity, overtake the US by 2020. That did happen. Today, China is 20% bigger than the US on that measure although GDP per capita is only around a quarter of the US level. But, quite suddenly, concerns about China's growth model have arisen and intensified. Could it be another Russia or Japan?

The IMF's latest predictions are that it will not. China will grow at an average rate of 5% p.a. in real terms in the next five years (lower than the 8% average of 2010-2019). That implies it will still make one of the largest contributions to global

economic growth (see Figure 1). Indeed, on the IMF's forecasts the pattern of world growth (that is, split between the US and China and other emerging and developed countries) will be similar to that which followed the global financial crisis.

Not a 'Lehman moment' for China

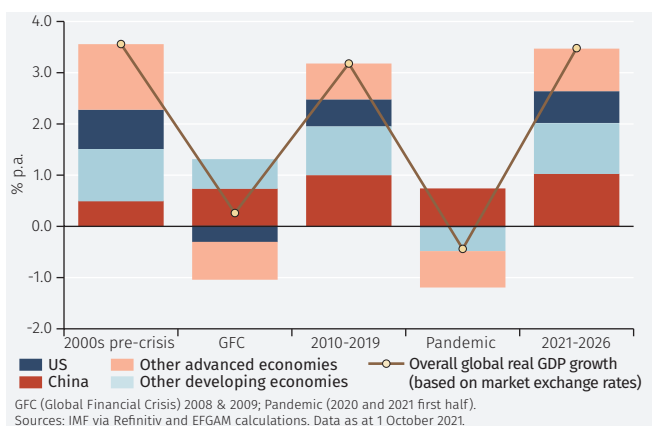
The robustness of China's growth has been questioned for many years. One of its main vulnerabilities – the importance of a credit-fuelled residential property sector (see Asia section on page 9) – has recently come into sharp focus. But we doubt this will be China's 'Lehman moment': that is, a dislocation which threatens not just the Chinese, but the global financial system and economy. The main reason is that China's predominantly state-controlled banks are likely to facilitate a restructuring of property-related debt with some form of government assistance.

However, there are other concerns. The way in which the government has curbed activities such as online tutoring and gaming raises questions about what might be next. And various interpretations of what is meant by the new approach of "common prosperity" are clearly possible.

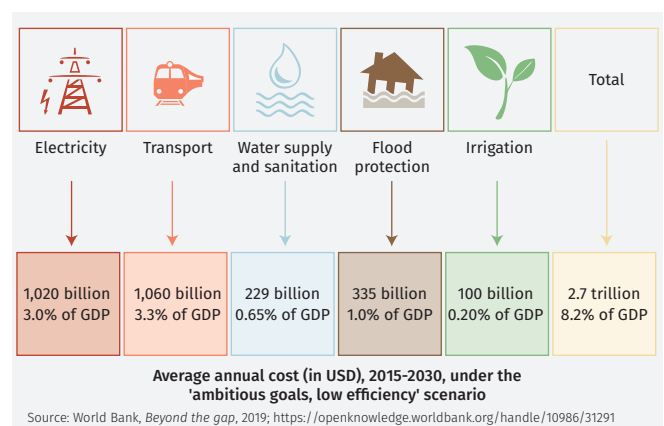
A post-pandemic infrastructure

Despite these China concerns, other factors clearly support global growth. The World Bank estimated, pre-Covid, that the investment needs of emerging economies to meet climate change and sustainable development goals could amount to more than US\$3 trillion per year (see Figure 2). Given the disruption caused by Covid, that annual amount is now even higher. In a similar vein, Mark Carney has estimated that global new energy infrastructure spending to meet net zero objectives (for advanced and emerging economies together) could be up to US\$2.5 trillion a year.¹

1. Contributions to world real GDP growth



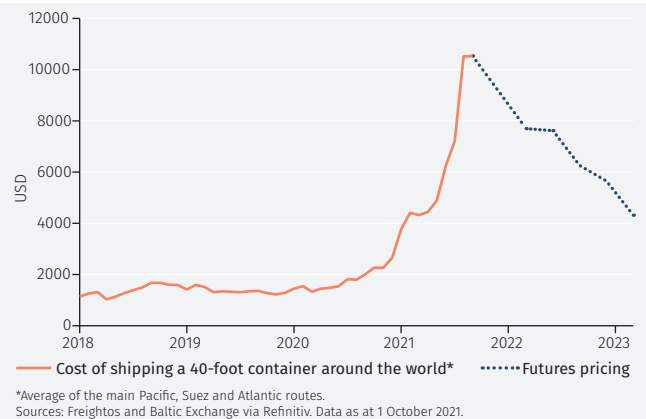
2. Infrastructure needs in emerging economies



¹ In a Bloomberg Television interview on 23 September 2021.

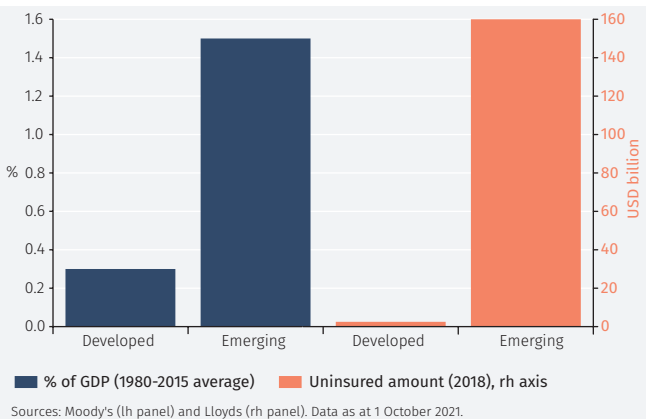
OVERVIEW

3. Freight rates



Such huge spending requirements may seem daunting, especially in a world still mired in the difficulties of post-Covid recovery: supply chain disruptions, higher freight costs (see Figure 3), shortages of many key industrial components and, as a result of these changes, higher inflation. The world's focus is, however, changing. The growing frequency of natural disasters, the consequences of which are often uninsured, and their particularly large effect on emerging economies (see Figure 4), are driving the need for much improved infrastructure.

4. Natural disaster losses



Some will argue that such plans are unaffordable, but with low borrowing costs – even for very long periods – still in place and likely to remain so, that argument does not seem very well founded (see *Special Focus* on page 11).

Corporate profitability

It would be unreasonable to expect the building of the new global infrastructure to be a job of governments alone. Indeed, the finances of many governments are already stretched as a result of the cost of Covid. The private sector around the world will clearly need to play an important role. There are grounds for optimism that it will rise to the challenge. First, in many respects it is the corporate sector that is taking the lead in

5. US S&P 500 companies' profit margins

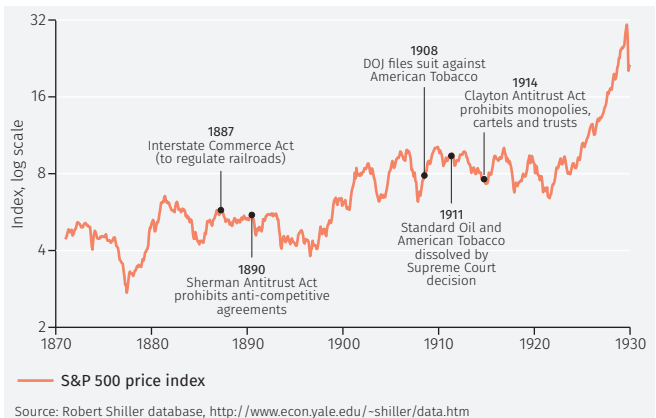


new technologies to address climate change and improve sustainability: electric vehicles, solar and wind power, big data and other new technologies may be helped by government support but are largely products of private enterprise.

Second, corporate profit margins are high and, we think, will be maintained (see Figure 5), meaning companies have the ability to finance new investment spending. One concern raised by high profitability is, of course, that it may reflect anti-competitive practices. Greater regulation may be inevitable. But as far as the equity market is concerned, history suggests that may be no bad thing.

During the US Gilded Age (from around 1870 to the late 1890s) the US experienced a massive economic transformation, but many markets were characterised by monopolies. These may have been to the benefit of individual firms, but not for the broader economy and the S&P 500 index was essentially flat in that period (see Figure 6). The Gilded Age was followed by the Progressive Era, and a shift toward government regulation of business to ensure competition and free enterprise. Stock prices rose sharply during this period – an encouraging lesson for today's times.

6. US S&P 500 index 1870-1930



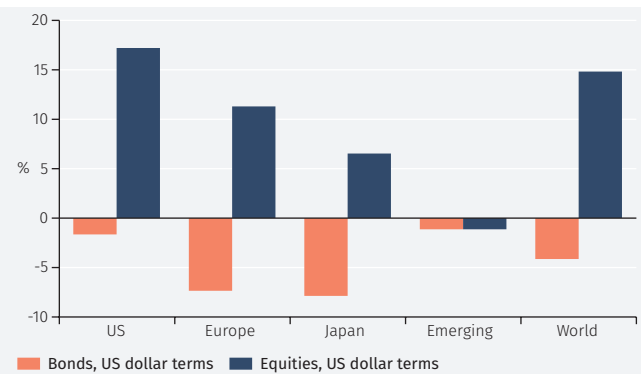
ASSET MARKET PERFORMANCE

The first three quarters of 2021 saw a broad rise in developed world equity markets, but China's market was weak. Bond markets were under pressure from a rise in yields, reflecting concerns about inflation.

Asset market performance

World equity markets saw gains of 14.7% in the first three quarters of 2021 (see Figure 7) as measured by the total return from the MSCI World Index in US dollar terms. Global bond market returns, in contrast, were negative, at -4.0% on the basis of the Bloomberg Barclays Global Aggregate Index.² In almost all markets local currency returns were undermined, in US dollar terms, by currency depreciation.

7. Asset market performance

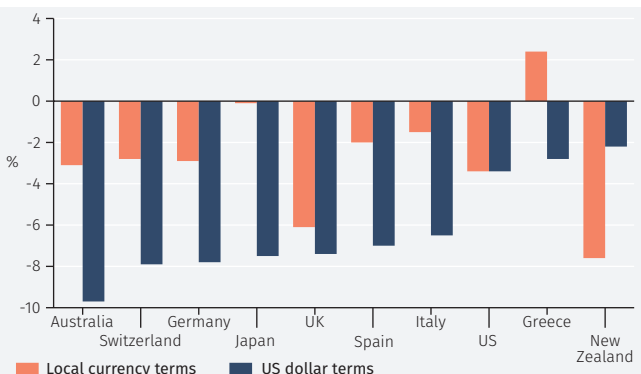


Sources: Barclays Bloomberg (bonds); MSCI (equities). Data for nine months to 30 September 2021. Past performance is not necessarily a guide to the future.

Bond markets

There was a general rise in longer-dated bond yields (and a consequent decline in prices) in the first three quarters of the year. A notable rise in yields occurred at the end of the third quarter as concerns about the persistence of higher inflation and future tightening of monetary policy took hold. That meant that in the US market the total return

8. Bond market returns



Source: Refinitiv, 10-year benchmark bond total returns. Data for nine months to 30 September 2021. Past performance is not necessarily a guide to the future.

from 10-year government bonds (shown in Figure 8) was -3.4%. In the UK, local currency returns were weaker than in the US, reflecting uncertainty about the economic recovery (notably multiple supply shortages) and worries about inflation being more persistent. Sterling also showed renewed weakness against the US dollar. The weakness of the Japanese yen, partly reflecting political concerns, meant that returns in US dollar terms were sharply negative.

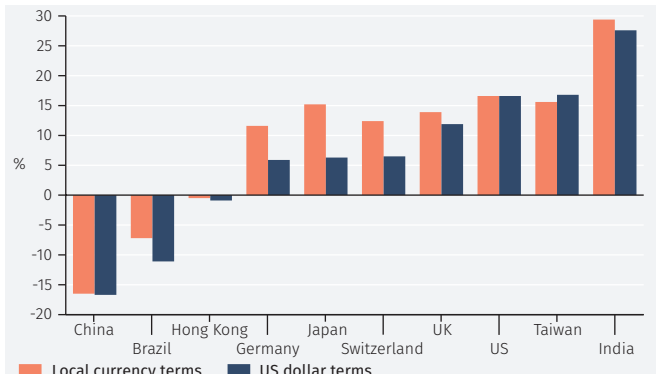
In the eurozone, Greek 10-year bonds produced modestly positive returns as confidence in its post-crisis recovery (notably based on tourism) built. However, across all eurozone bond markets and, to an even greater extent in Switzerland, returns in US dollar terms were undermined by local currency weakness.

Equity markets

The Indian equity market produced one of the strongest returns in the first three quarters of the year (see Figure 9). This reflected a growing optimism about the performance of the economy and the potential for further progress with restructuring. Taiwan, which benefited from continued strong performance of technology companies also did well. Although returns from Japanese equities were over 15% in yen terms for the first nine months of the year, the yen's weakness meant these were reduced to just 6.3% in US dollar terms.

Concerns about the direction of government policy and the prospects for the property sector have weighed on the Chinese market throughout 2021 to date.

9. Equity market returns



Source: MSCI. Data for nine months to 30 September 2021. Past performance is not necessarily a guide to the future.

² The Bloomberg Barclays Global Aggregate Bond Index is a benchmark of government and investment grade corporate debt from developed and emerging markets issuers in 24 countries.

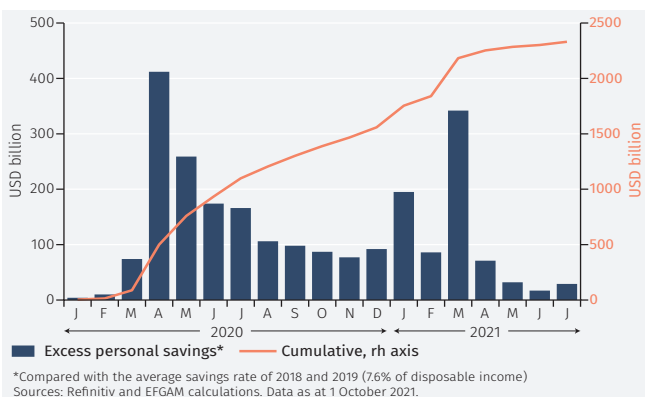
UNITED STATES

The US economy is being pulled in different directions: accumulated savings mean consumers can spend more; but the end of fiscal support measures, lingering Covid concerns and supply bottlenecks are restraining.

Cross-currents on consumption

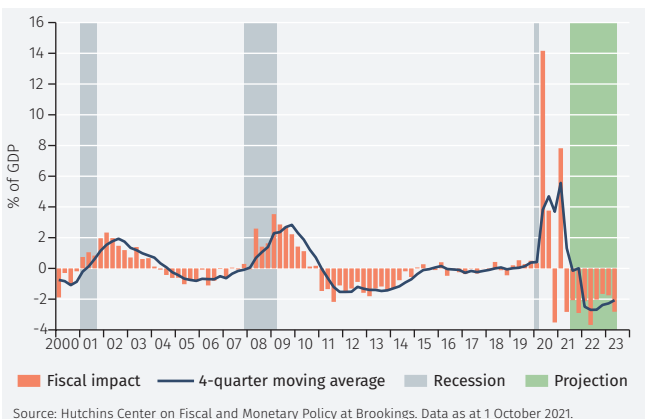
Consumers have accumulated, according to most estimates, in excess of US\$2 trillion in 'excess savings' since the start of 2020 (see Figure 10). Many expect the savings to be run down relatively quickly, boosting economic growth. In practice, however, several factors act to restrain consumers' ability and enthusiasm to spend.

10. US excess savings



First, not all the savings above the pre-Covid trend are truly 'excess'.³ Some consumers have lower job security and may save more for precautionary reasons. Some have used the increased savings to pay down debt and may be reluctant to increase this again. And concerns about Covid continue to restrain spending on many services. Additionally, supply shortages mean that even if consumers were inclined to spend, the opportunities to do so are constrained (the car market is one of the most widely-cited examples).

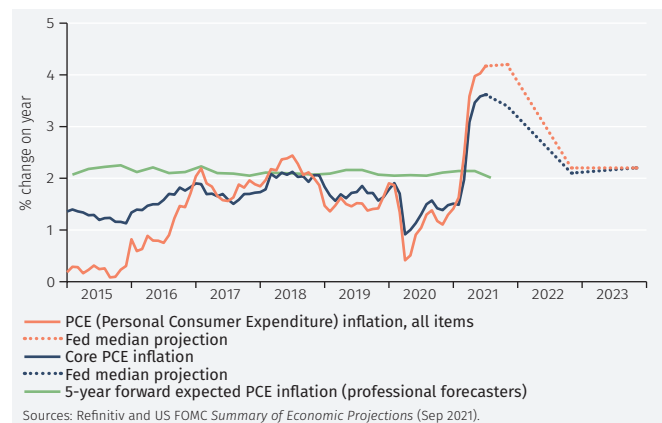
11. Fiscal policy impact on GDP growth



The stimulus provided by direct government support is also now coming to an end. The impact of fiscal policy on growth is shown in Figure 11. It considers federal, state and local government spending as well as the direct impact on consumer spending of government measures. It shows that after the massive support given to the economy in 2020 and the first quarter of 2021, the fiscal impact turned negative in the second quarter of 2021 and will remain a drag on growth (on current policies) until mid-2023.

Given that consumer spending is the main driver of US GDP growth, it is no surprise that forecasts for overall GDP growth in 2021 and 2022 have been trimmed back recently: to around 6% for 2021 and 4% for 2022.⁴ These are still very satisfactory growth rates.

12. US inflation and forecasts



Watching the paint dry again?

Meanwhile, inflation has remained at an elevated level for longer than the Fed previously expected (see Figure 12). On the basis of what some may see as tortured logic – a higher recent inflation rate has compensated for the persistently low inflation pre-Covid – that means Fed chair Powell has been able to say there has been “substantial further progress” towards stable inflation. With “clear progress toward maximum employment” also being made that means a gradual withdrawal of monetary stimulus, particularly a lower rate of asset purchases, can commence.

Janet Yellen, former Fed chair, described a similarly gradual 2017 approach to Fed balance sheet reduction as “like watching paint dry”; we will see if that is the case.

³ For a detailed analysis, see EFGAM *Infocus*, ‘Excess’ savings and the outlook for consumption, June 2021. https://www.efgam.com/doc/jcr:e04cf127-86b2-49a0-a33d-8c3396b7f23a/Infocus_excess_savings.pdf/

⁴ Source: Consensus Economics via Refinitiv; 1 October 2021. The Fed’s median expectations in the September Summary of Economic Projections are 5.9% for 2021 and 3.8% for 2022.

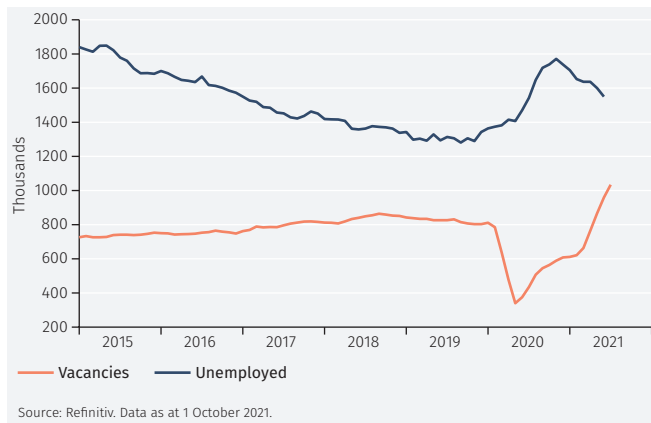
UNITED KINGDOM

Although the UK economy is hampered by a series of difficulties, the post-Covid recovery is progressing. However, inflation concerns remain and restoring order to the public finances will take years.

A series of unfortunate events

The UK economic recovery has been hit by a series of unfortunate events. Shortages and price increases are widespread. Among them are shortages of: delivery drivers for food supplies (leaving gaps in shop shelves); fuel tanker drivers (making for long queues for petrol); hospitality staff (restaurant bookings can be cancelled at short notice); border control staff (bringing long queues at the airport); and health care workers. The number of unfilled job vacancies now exceeds one million (see Figure 13).

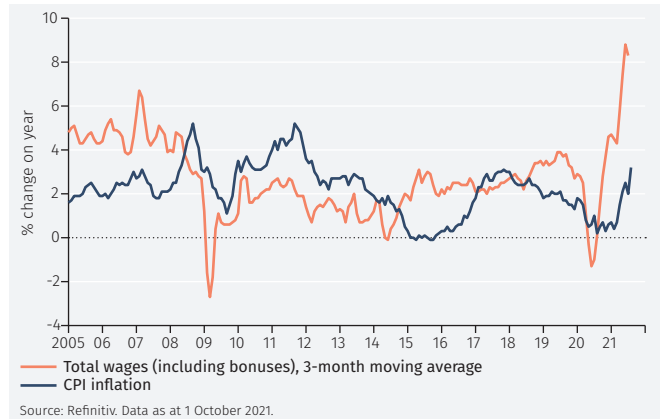
13. UK labour market



What is behind this? There are five main culprits – Brexit (leading to some workers from the EU returning home); the fact that several aspects of the post-Brexit UK-EU relationship are still unsettled (particularly involving Northern Ireland); Covid (because of the disease itself, its ‘long’ variant, the pingdemic (alerts to self-isolate) or a concern about taking jobs with face-to-face contact); the furlough scheme (which has discouraged some from working – although that scheme ended on 30 September); and structural weaknesses that were not apparent until these temporary factors occurred (there has been a shortage of lorry drivers for many years, apparently). It is very hard to identify just one cause. As in Agatha Christie’s *Murder on the Orient Express*, it seems they all did it.

For workers, these shortages mean that total pay (including bonuses) is rising at rates not seen for a very long time (see Figure 14) and there are clearly continued upward pressures. Companies are passing on many of the price increases associated with supply shortages and wage increases. The Bank of England acknowledges that the CPI inflation rate will

14. UK wages and prices

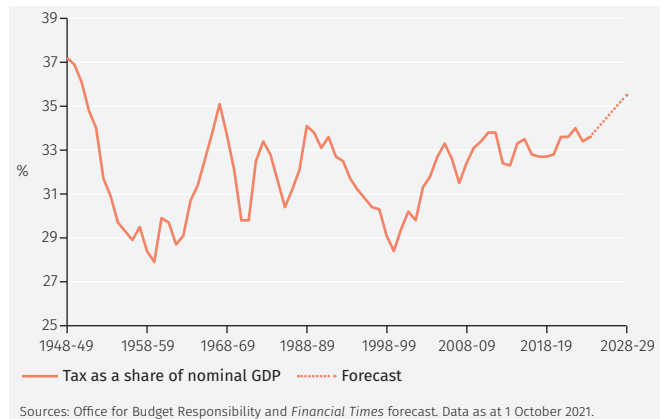


likely be above 4% at the end of 2021. It remains to be seen how long it takes for these (perhaps) ‘temporary’ pressures to recede.

Rising inflation and UK financial markets

The government has taken action to address one key long-term issue: the rising costs of social care. That has led to an increase in National Insurance contributions (a form of tax) meaning that the UK’s tax burden is set to reach the highest level since 1950 (see Figure 15). Inflationary pressures and higher government spending seem likely to put further upward pressure on government bond yields. Ten-year yields have seemed anomalously low for some time (below equivalent US rates, for example). The equity market, however, still remains relatively cheaply valued, an indication of which is the strong foreign interest in buying UK companies.

15. UK tax burden



EUROZONE

The post-Covid recovery has been less vigorous in the eurozone than in many other advanced economies. It has been impeded by three main factors. Monetary policy accommodation is likely to continue well into 2022.

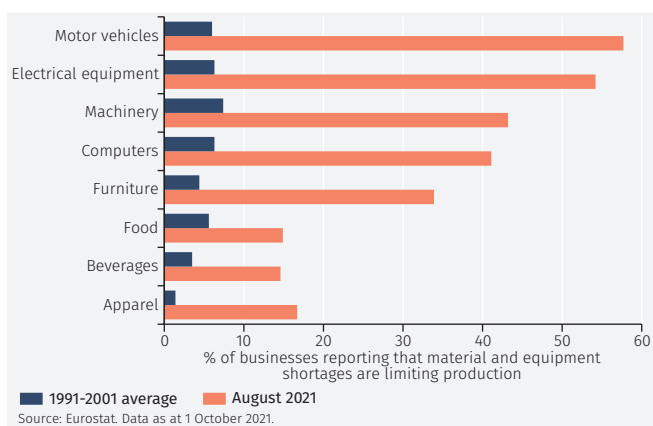
Slower recovery than other advanced economies

The economic recovery in the eurozone has been less vigorous than in many other advanced economies (notably the US but also Japan and Switzerland). Overall eurozone GDP in the second quarter of 2021 was 2.5% below the pre-pandemic peak. The recovery has, however, been uneven: Ireland, Finland and the Baltics are all above pre-pandemic levels, while the larger member states have lagged. Three factors have impeded recovery.

Three factors

First, supply shortages, especially for motor vehicles and electrical equipment, have impeded production, according to a Eurostat survey (see Figure 16). These will surely ease, but maybe not until well into 2022.

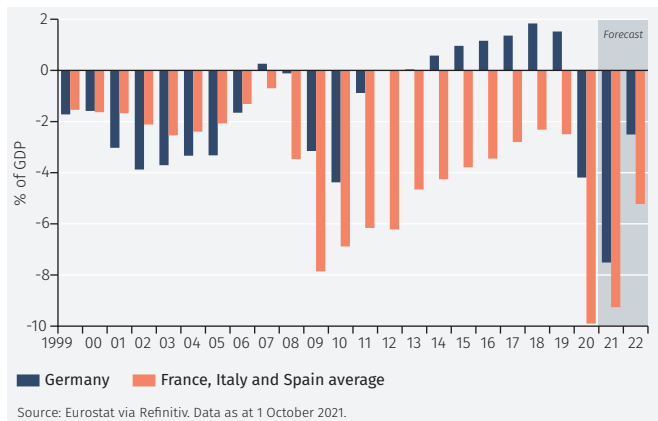
16. EU material and equipment shortages



Second, eurozone fiscal policy has not been as expansionary as in other advanced economies. The Covid fiscal easing, on the IMF's preferred measure, amounted to 4.6% of GDP in the eurozone, but over 6% in the US. Government budget balances did swing into deficit, but only to 4% of GDP in Germany and no more than 10% in the other large economies (see Figure 17).

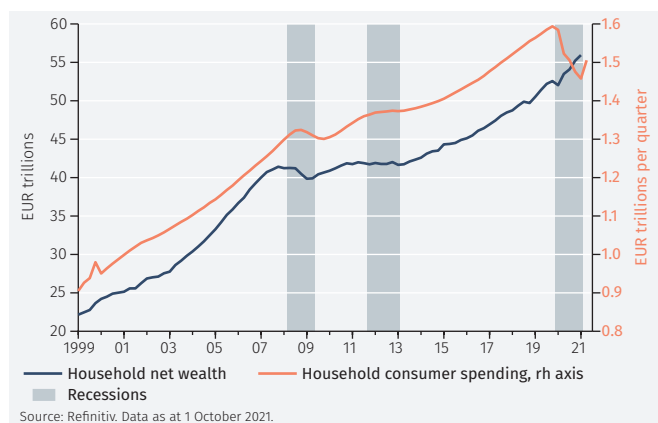
Third, while the ECB's asset purchases have been of the same magnitude as those by the US Fed (US\$4.4 trillion), there are grounds for thinking the ECB's purchases have been less effective in stimulating the economy. One reason lies in the impact of the asset purchases on household wealth. US Fed asset purchases have contributed to increased valuations of bonds, equities and residential housing; and US household wealth has increased by 21% since the end of 2019. Eurozone households, in contrast, tend to hold less in equities and housing and more in bonds and money market instruments:

17. Eurozone government budget balances



household wealth has increased by just 6% since the end of 2019. Over time, household wealth has trended higher, declining only modestly in the global financial crisis (see Figure 18). While household wealth and consumer spending have both risen over time, this reflects common factors influencing each rather than causality. Indeed, according to ECB estimates a €1 increase in wealth leads to not much more than a few cents increase in consumer spending.⁵

18. Eurozone households: wealthy and frugal



The lady's not for tapering

It seems likely, therefore, that the ECB will retain its accommodative monetary policy well into 2022, after the end of the PEPP (Pandemic Emergency Purchase Programme). This has been 'recalibrated' but ECB President Christine Lagarde has declared "The lady isn't tapering".⁶ It seems right to take the lady at her word.

⁵ ECB Economic Bulletin, January 2020. <https://tinyurl.com/596vjx5t>

⁶ <https://www.youtube.com/watch?v=ijvsW8dzm8g>

SWITZERLAND

The Swiss economy has gained momentum and inflation has risen but interest rates are likely to remain negative for an extended period. It seems very unlikely to us that Swiss rates will rise faster than euro rates, as markets currently expect.

Bottlenecks constrain production

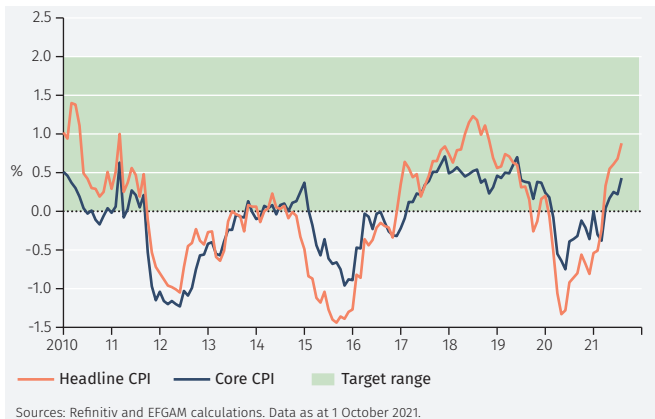
The Swiss economy is recovering strongly. GDP rose by 1.8% in the second quarter and is now only slightly below its pre-pandemic level. Growth would have been even stronger if it had not been for bottlenecks in the global supply chain.

These constraints are seen in the surge in the delivery times and orders backlog in the PMI survey (see Figure 19). As these bottlenecks are overcome in the rest of the year, Swiss GDP should be supported. Foreign demand is recovering, driven by the strength of the EU and the US; and the domestic economy is benefitting from the progress with vaccinations and the easing of restrictions on social activities.

19. Swiss manufacturing hit by bottlenecks



20. Swiss inflation rate



Swiss and euro rates compared

Looking further ahead, the SNB's monetary policy will be influenced by the ECB's new strategy. The latter targets inflation around a central rate of 2% (so, in that sense, is a looser target than the SNB's target).

The new ECB target is seen by most commentators as a signal that eurozone interest rates will remain negative for longer than previously anticipated.

It is therefore surprising that, in the futures market, a steeper rise in short-term rates in Switzerland than in the eurozone is priced in (see Figure 21). That seems very unlikely to us.

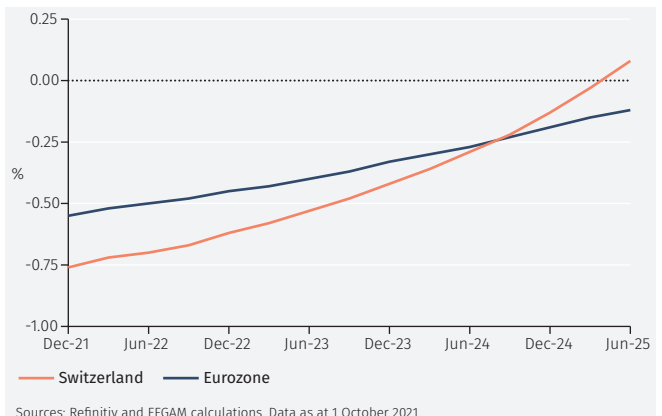
The positive outlook also reflects the favourable financing conditions guaranteed by the SNB's ample liquidity provision and the improved job market. However, the large output gap registered since the onset of the pandemic will keep a lid on wage inflation, at least for several more quarters.

Inflation at the low end of target

The recent increase in inflation (see Figure 20) has been mainly driven by imported goods and services prices. Since commodity price inflation and the global supply chain bottlenecks should be temporary and the Swiss franc remains highly valued, inflation may well fall again in 2022, possibly below the SNB's target range of 0-2%.

That means the SNB is unlikely to change course on interest rates any time soon, with the policy rate remaining at minus 0.75%.

21. 3-month interbank rates implied by futures contracts



ASIA

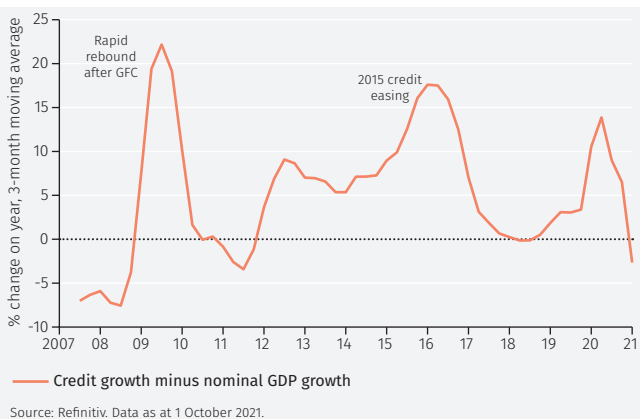
The problems in China's residential property sector will remain a key focus in the remainder of 2021 and into next year. This may distract attention from two more positive developments – in India and Japan.

China: slowing after a swift recovery

The residential property market has been important for Chinese economic development for many years. In three respects it has had a big impact on the economy. First, home ownership is over 90% for the total of 276 million urban households, one of the highest in the world (the US rate is 65%).⁷ Second, because of that and limited ownership of equities and other assets, housing accounts for 78% of household wealth, much more than in the US (35%). Third, real estate plays an even bigger role in China's economy today than it did in the US economy on the eve of its 2008/9 financial crisis. The impact of real estate-related activities amounted to 18.9% of US GDP in 2005, its pre-crisis peak. The equivalent figure for China in 2016 was 28.7%, the same as in Spain at the start of the eurozone crisis.⁸

Concerns about China's property market are, however, nothing new. Empty, newly-built apartment blocks were first commented on in the early 2010s. But when the property market and the economy have slowed in the past, credit conditions have been eased, bringing a reasonably prompt recovery (see Figure 22). The difference in the current slowdown is that such a credit easing has not occurred, even though construction spending growth has stalled (see Figure 23).

22. China: credit growth relative to nominal GDP



Almost certainly, some form of restructuring of property companies' debt, supported by their lenders and the government will be found. But given the opacity that still characterises many aspects of the Chinese economy and financial markets, this is unlikely to be a solution which completely reassures foreign investors.

23. China: new construction spending



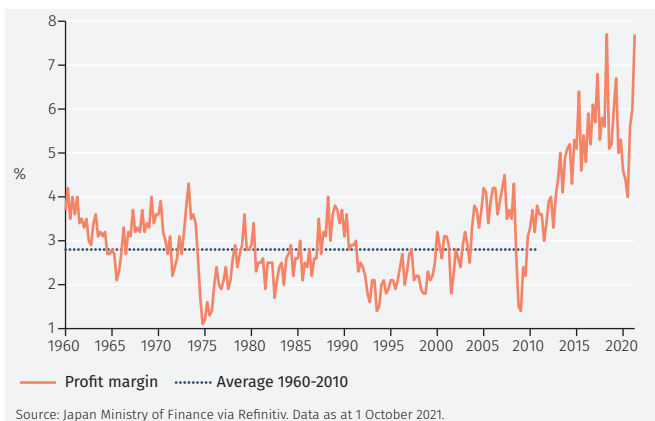
India: out of China's shadow

If investors cool on China exposure in the coming years, their attention may well turn to India. The IPO market has been active in 2021 and further listings of companies in e-commerce, online food delivery, EdTech, online gaming and SAAS (software as a service) are in prospect. India is well placed in these areas – tech-related services have, for many years been a strength of the economy. Moreover, the chance of Chinese-style restrictions on the activities of online gaming and tutoring companies looks low.

Japan: a reassessment

The Japanese economy has been overshadowed by issues surrounding the Olympics and the political uncertainty over Mr Suga's resignation. The stock market, however, has done well. As in the US, we think the fundamental support for this comes from much stronger corporate profits (see Figure 24).

24. Japanese companies: profit margin



⁷ Rogoff and Yang, Peak China Housing, NBER Working Paper 27697, August 2020.
⁸ Ibid

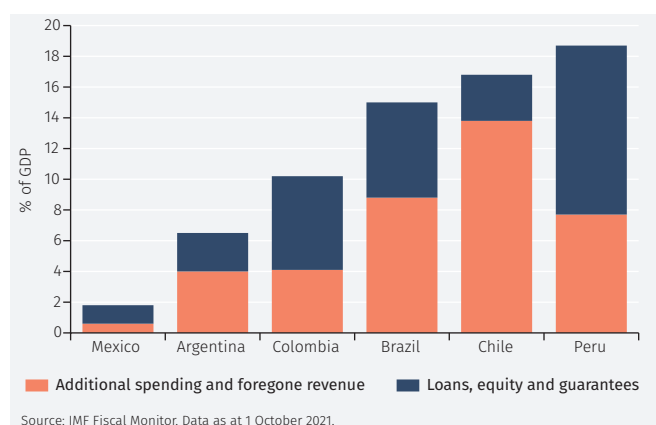
LATIN AMERICA

The outlook for the Latin American economy, buoyed by recovering world growth and commodity prices, has improved. Political uncertainties have receded in Peru but remain a concern in Brazil.

A welcome rebound

Latin America was one of the regions worst affected by Covid in 2020, with GDP contracting by around 7% in real terms. It was badly hit by the pandemic itself and the generally poor response of healthcare systems. Some countries (notably Peru) had much higher death rates than would be expected (even when taking into account key vulnerability measures).⁹ The regional fiscal policy response was also relatively weak (see Figure 25), notably in Mexico.

25. LatAm: Fiscal measures in the pandemic



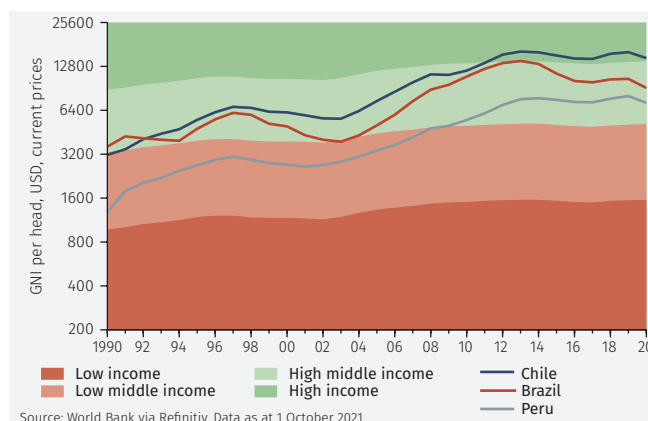
The more welcome news is that the rebound in activity in 2021 now looks stronger than many expected earlier in the year. It seems likely that regional GDP will expand by around 6%, higher than the IMF's forecast (of 4.6%) made in April. One of the main reasons is the beneficial effect on the region's exports of faster world growth. Peru and Chile, the world's leading copper exporters, are expected to grow by 8-10% in real terms.

Policy in Peru

In Peru, initial concerns about the direction of policy under new President, Pedro Castillo, who had campaigned on a platform of nationalisation, increased government intervention and tax hikes for the rich, have been eased by the more market-friendly stance of his finance minister. This involves prudent fiscal policy (Peru has a low burden of government debt, 40% of GDP, compared to over 100% in Brazil) and public-private partnership plans to boost the infrastructure.

Peru has made steady progress towards high income status, as defined by the World Bank (see Figure 26), over the last

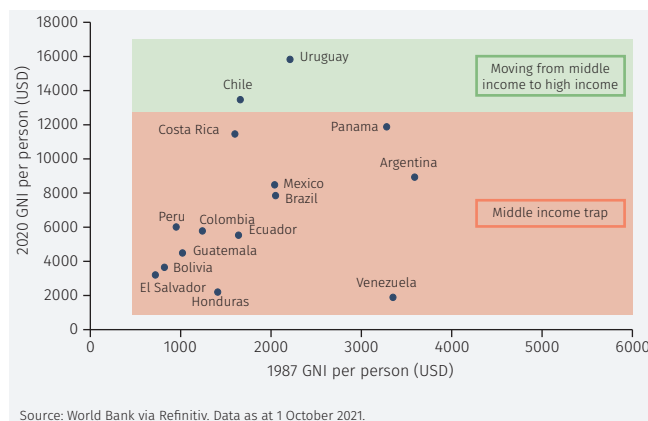
26 Latin America income levels: Chile, Brazil and Peru



three decades. Market-friendly policies, fiscal restraint, an improved infrastructure and a move away from over-reliance on commodity exports are the keys to that continuation. A note of caution is that Brazil – after almost achieving high income status in 2010 – has moved backwards since then. That means the outcome of the 2022 election, when former president Lula will likely stand, is as important as it is unpredictable.

If Peru's progress continues, then it will be able to join Chile and Uruguay as an economy that has successfully transitioned from a middle- to a high-income economy. All others in the region have remained stuck in the 'middle income trap' (see Figure 27), unable to compete on the basis of high-end services and technology – like Uruguay – or as a successful free-market economy, albeit one with high inequality – like Chile.

27. Latin America: middle income trap



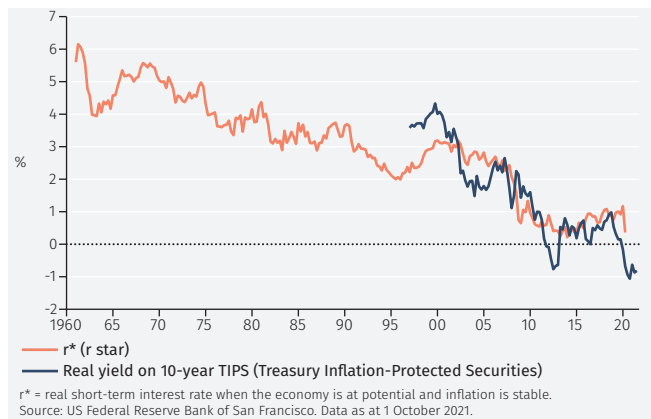
⁹ See EFGAM *Infocus*, Country characteristics and Covid-19 mortality, September 2021. https://www.efgam.com/doc/jcr:a72d9b3c-6d81-4341-a858-4173b73e75ee/Infocus-Country_characteristics_and_Covid_mortality.pdf

SPECIAL FOCUS: INEQUALITY AND BOND YIELDS

The persistence of low long-term government bond yields has surprised many in financial markets. A new explanation suggests this may be due to rising inequality and could be more permanent than many expect.

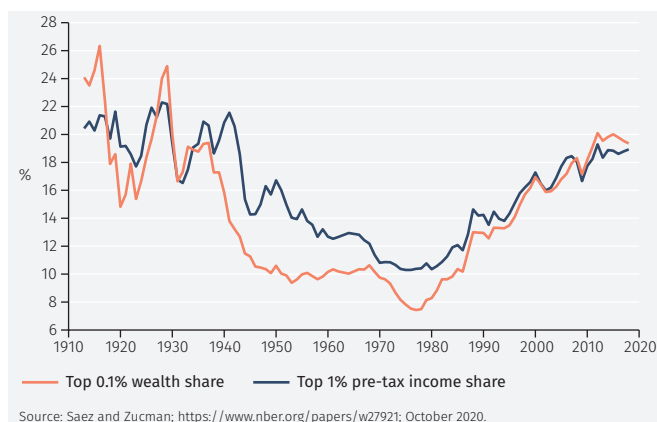
The persistently low level of US and world real bond yields has surprised many. The real yield on US TIPS (Treasury Inflation-Protected Securities) has been in a range of +/-1% for the last ten years (see Figure 28). Measures of the equilibrium real interest rate (r^*) currently stand at close to zero, after having trended lower for the last 60 years. (r^* measures the real short term interest rate when the economy is at potential and inflation is stable.)

28. US real natural rate of interest, r^* (r star)

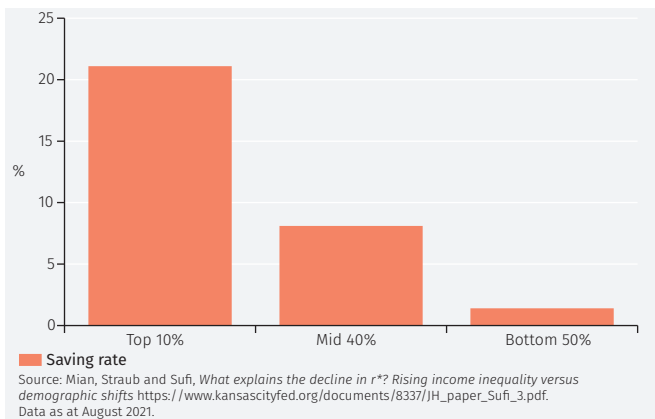


Previously, there have been two main explanations of the low level of real interest rates: the persistence of a global savings glut, first identified by Ben Bernanke in 2005 and 2007;¹⁰ and a view that the global economy is in a period of secular stagnation, with growth prospects materially lower than in the past.¹¹

29. US inequality



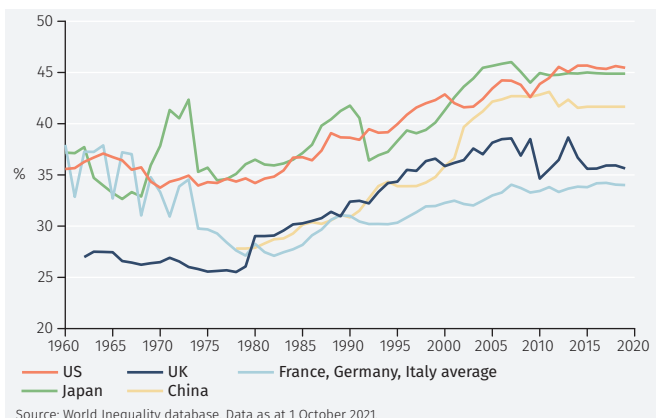
30. US saving rates across income groups



A new explanation focuses, instead, on rising inequality.¹² In the US there has been a steady rise in income and wealth inequality since the mid-1970s (see Figure 29). Higher income groups tend, however, to have a much higher savings rate (see Figure 30). Such high savings by the wealthy tend to depress the real interest rate. Moreover this inequality effect is more important than demographic shifts due to the aging of the baby boom generation.

Some may see this as a US phenomenon, but rising inequality has been seen around the world (see Figure 31). That implies that a reversal of the trend for greater inequality would be needed for real rates to rise.

31. The top 10%'s share of total income



¹⁰ <https://www.federalreserve.gov/boarddocs/speeches/2005/200503102/>

¹¹ See, in particular *The Rise and Fall of American Growth*, Robert Gordon, Princeton (2016) and *The great stagnation: How America ate all the low-hanging fruit of modern history, got sick and will (eventually) feel better*, Tyler Cowen, Penguin ebook (2011).

¹² *What explains the decline in r^* ? Rising income inequality versus demographic shifts*, Mian, Straub and Sufi. Paper presented at Jackson Hole Economic Symposium, August 2021

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