MACROECONOMIC OUTLOOK

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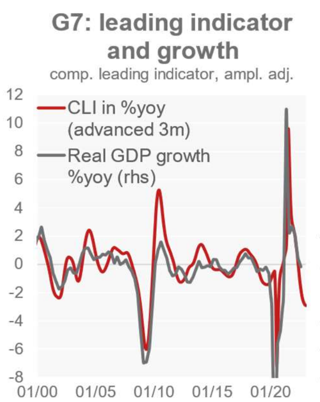
- **Headwinds to the global economy are set to intensify before they give way to a more synchronized rebound by late 2023. The energy and confidence shock from Russia's invasion of Ukraine will cast a long shadow over the winter.**
- **The drag from high inflation and energy prices will continue to erode real incomes in Europe. The monetary squeeze is likely to also send the US into a (mild) recession while complicating the European recovery from the winter lows.**
- **Supply chain bottlenecks are losing their sting, helping to ease price pressures in manufacturing. Yet high energy costs, tight labour markets and adaptive expectations keep feeding through the economies. The pace of disinflation will thus prove painfully slow.**
- **The Fed and ECB will continue to prioritize their inflation fight over cyclical support in early 2023. Yet easing price pressures and mounting economic headwinds (recession in Europe) will slow the pace of tightening. Peak rates may be reached by end-Q1, with the Fed likely to eye first cuts in Q4 as recession bites over the summer.**
- **China has started the reopening process from its very costly zero-Covid strategy. A choppy path over winter amid still low vaccination will be followed by a stronger reopening bounce in the spring.**

It will be a tough start into 2023 as the spectre of stagflation keeps haunting Western economies. Headwinds to the global economy will intensify into winter. Europe is dipping into recession as the war in Ukraine and curtailed energy supply hit confidence and constrain production. Central banks' unfinished fight against inflation will draw on demand over 2023 while sticky inflation keep eroding real income.

Global inflation is past peak - but central banks' uphill battle is not finished as price pressures will ease only very sluggishly

The inflation descent will prove painfully slow

Global inflation is past peak, but its descent will prove very sluggish. Encouragingly, supply chain disruptions are losing their sting fast as global bottlenecks ease and new orders plummet, curtailing price pressures for goods more lastingly. Yet risks to energy costs are tilted to the upside, while tight labour markets keep underpinning wage growth. Central banks still face an uphill battle in preventing inflation overshoots from becoming entrenched. Inflation is unlikely to reach targets by year-end 2023.



Source: OECD, Datastream, GIAM calculations

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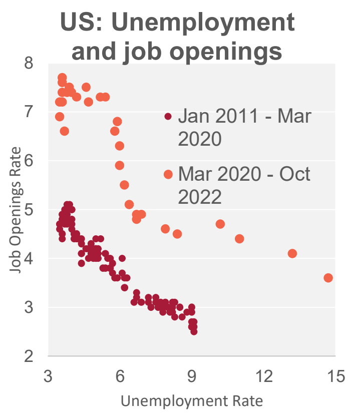
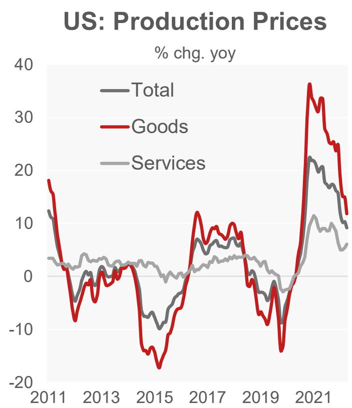


Source:BLS, Refinitiv, GIAM



Source:BLS, Refinitiv, GIAM

Declining exports, tight global financial conditions and a strong USD still weigh on emerging markets (EMs) near term. But China's prospective spring reopening and a weaker US dollar will help further into 2023. Inflation pressures (ex CEE) are already easing helping EM central banks to fade their tightening cycles, while some (incl. China, Russia, Turkey) keep eyeing further monetary easing.

Downside risks to our base case prevail, with an escalation of Russia's war in Ukraine and cracks in the financial plumbing ranking high

Substantial risks surround our outlook. A surprising road to negotiations between Ukraine and Russia, a smooth reopening of China and a swift easing of disruptions on energy and goods markets may herald a faster recovery. Yet overall risks are skewed to the downside. First, an escalating war in Ukraine plus cold weather could send Europe into a deep recession. The hands of policy makers would be tied by mounting energy prices and fading fiscal space. Second, tighter financial conditions and the euro area recession may trigger deeper cracks in the financial plumbing. Banks would suffer from rising provisioning needs and larger vulnerabilities may be hidden in the non-bank sector. Drained liquidity and slumping sentiment would force central banks to reverse their tightening course, but the scope for fiscal support would be much more limited given higher public debt and rates.

US: mild recession, but risks are tilted to the downside

Tight money leads to a mild contraction of US activity in mid-year. The unemployment rate will exceed 5% by year end, with core inflation still above 3%.

We expect barely positive US growth (0.3%) in 2023, with even a mild contraction over the central quarters of 2023. Cooling activity amid higher interest rates and a difficult global environment will bring inflation back on a downward path, consistent with the ensuing moderation in producer price inflation. Still, we expect core CPI inflation to end 2023 slightly above 3% yoy. The contraction in the most rate-sensitive parts of the economy, like construction, will continue, non-residential capex will remain flat (also due to falling margins), and consumption growth will drop from 3% in 2022 to around 0.7%. The large pool of savings accumulated during the pandemic is shrinking fast, and at some point, consumers will prop up their savings rate, which has dropped in autumn to a record low of 2.5%.

The labour market will be crucial: in H2 2022 job openings have decreased without boosting unemployment, in line with the Fed's plan of a "softish" landing. Yet thus far the labour market remains tight, with nearly 1.8 job openings per unemployed. A more significant drop in job availability is needed to moderate wage growth: It will be hard to accomplish without a rise in the unemployment rate. The 4.4% year-end 2023 forecast posted by the Fed looks too rosy, we expect a figure above 5%.

After lifting rates to 5% by Q1, the Fed will likely start cutting in Q4. A harsher downturn could lead to a pause or early halt of QT

The Fed will continue to hike in Q1 2023 to peaks at 5% (upper bound). Yet the Fed is unlikely to keep rates at this level throughout the year. More fragile activity and the downward trend in inflation should convince the Fed to cut rates by 50 bps in Q4. Risks to the growth outlook are tilted to the downside, as the economic impact of monetary tightening could prove more damaging, which may trigger earlier and deeper rate cuts but also pausing of even halting the quantitative tightening before the expected end date (mid-2024).

Euro area in a winter recession

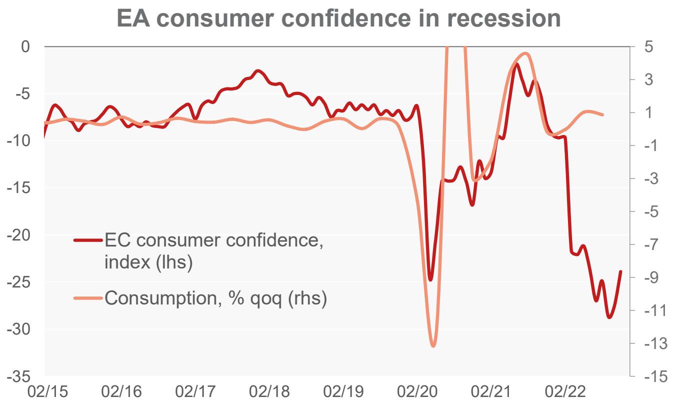
Euro area economic activity held up well so far. It expanded by +0.3% qoq in Q3. Latest sentiment indicators showed signs of improvement. The labour market stayed solid; consumer confidence detached from its lows. Still, we caution to become too optimistic and think that a more significant downturn is ahead. Key indicators remain in clearly recessionary territory and real M1 growth even heralds a worsening.

High inflation and tighter financing conditions will restrain recovery after winter recession

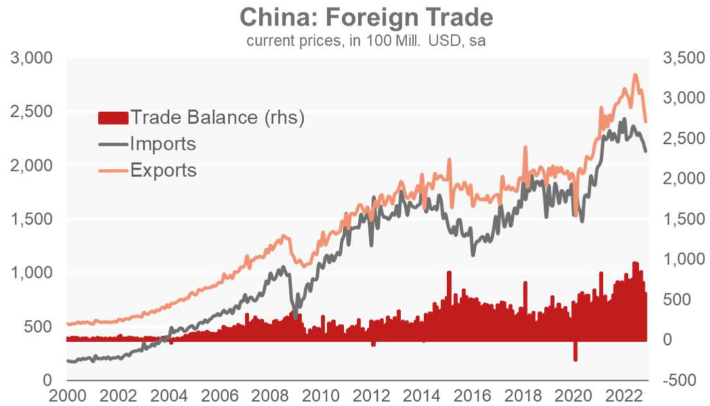
Stubbornly high inflation remains a drag on activity. While the 10.6% yoy October 2022 inflation rate likely marked the peak, we expect readings to come down only slowly and to still average 6.0% in 2023, after 8.5% in 2022. More importantly, underlying inflation will prove sticky as past input prices increases keep feeding through the economy and wage growth will remain high. But for consumers, wage increases will fully compensate for inflation, thus denting real income. Consumption is still supported by the deployment of pandemic-related excess savings. But the jury is out to which degree that can be maintained in 2023.

ECB policy tightening to continue in spite of recession but QT to become more important

The ECB will lift rates further into restrictive territory to a peak at 2.5% in Q1 and keep it at this level through year-end. The risks are tilted towards an even higher peak. Moreover, the ECB announced already that it will start reducing the stock of purchased assets. We expect this quantitative tightening (QT) to start in Q2 – confined to not reinvesting maturing bonds bought under the asset purchase programme (APP). We think that the volume will amount close to € 30 bn from April onwards. Hence, financing conditions will further deteriorate thereby also dragging on activity. All in all, we look for a recession in the 2022/23 winter half and see the economy recovering only moderately thereafter so that output shrinks by -0.1% in 2023.



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations

China is pivoting away from its strict zero Covid policy

China's Covid strategy is fraught with uncertainties

Despite near record-high fresh infections, China recently pivoted away from its strict zero-Covid policy amid public protests, but also due to the damage widespread lockdowns as well as the ailing real estate sector have done to the economy. The last politburo meeting clearly signalled that the policy focus has shifted to prioritising growth, as domestic demand has been contracting and export support is vanishing quickly.

Amid a global cyclical downswing, China is set to concentrate on reviving domestic demand. Steps to support private consumption have been incorporated in the relaxation of Covid restrictions. Help for the real estate sector is also underway. The PBoC laid out a 16-point plan for financial institutions in mid-November to greatly support the property sector's access to funding. The central bank also injected liquidity via a cut in the reserve requirement ratio (RRR) by 25 bps. We expect a slight reduction (10 bps) of key rates, followed by another RRR cut by 25 bps early next year. We see the winter to remain bumpy in China. Especially the Covid development is fraught with uncertainties. An adverse scenario could involve a strong Covid wave with a heavy death toll and a back-and forth of Covid restriction. To avoid this, a fresh vaccination campaign plays a crucial role, and seems to have already started. Thus, we expect more Covid easing steps in spring which would allow growth to subsequently rebound, with an average of 4.8% in 2023.