MACROECONOMIC OUTLOOK

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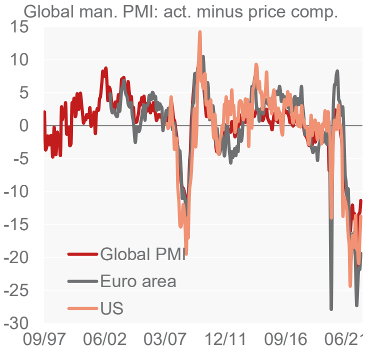
- **With the summer boost from reopening services fading, the EA is headed for a recession amid a looming energy crunch, curbed production, tighter financial conditions and eroded real incomes. Outright gas rationing would mean a deeper and longer recession.**
- **A US Q3 growth bounce will prove short-lived as financial conditions tighten, the housing sector cools, and consumption softens. China's growth will struggle to recover as the zero-Covid policy and the ailing property sector curb the effectiveness of fresh policy stimulus.**
- **Despite easing supply chain bottlenecks, price pressures will not ease quickly amid a red hot US labour market and soaring energy prices in Europe.**
- **Central banks (CBs) will further front-load monetary tightening as the Fed and ECB doubled down on their pledge to bring down inflation. Both CBs are likely to deliver another 75 bps 'jumbo' hikes at their next meetings.**

A global slowdown is looming amid strong headwinds from inflation, tightening financial conditions and risks to energy supply in Europe

The global economy is headed into a chilly autumn and winter. While the boost from reopening services is fading, the headwinds keep mounting. Runaway inflation keeps eroding real disposable incomes, with Europe hammered by soaring gas and electricity prices. Central banks are slamming on the brakes to deliver on their inflation pledges. Rising risk aversion exacerbates the tightening of financial conditions from higher rates, which are yet to feed through the economy via lower investment. Energy supply uncertainties add injury to insult, with a slump in consumer and business confidence pointing to a marked global slowdown in Q4.

A tricky growth/inflation mix

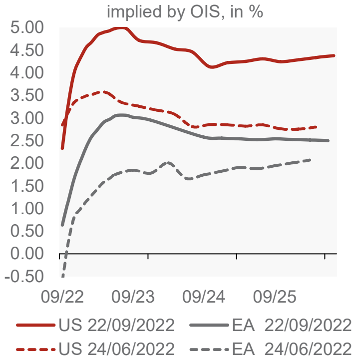
Global man. PMI: act. minus price comp.



Source: Markit, Datastream, GIAM calculations

Key rate expectations for US and EA

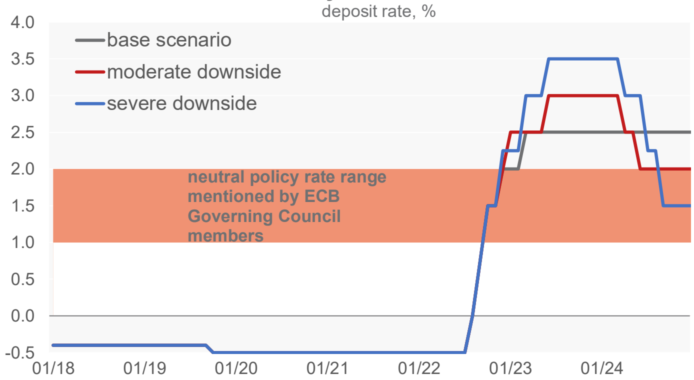
implied by OIS, in %



Source: Refinitiv, GIAM calculations

ECB key rate scenarios

deposit rate, %



Source: Datastream, ECB, GIAM calculations

Global headwinds to mount further into autumn

The US economy is mostly indirectly exposed to the geopolitical and energy uncertainties from the Russian war in Ukraine and thus far showing striking resilience. Yet a mild economic contraction still looks more likely than not for early 2023. The euro area is much more directly involved and is headed for at least a moderate recession, which could turn into a severe one on further gas supply cuts, an unusually cold winter or a military escalation. China keeps struggling to recover from the H1 Covid slump, with adherence to zero-Covid policies and property woes rendering fiscal and monetary stimulus much less effective. Other emerging markets (bar energy exporters) are feeling the headwinds from weaker external demand, a sharp deterioration in global financial conditions. The strong USD is burdening highly indebted EMs and those with a high exposure to global trade.

Major central banks keep front-loading their monetary tightening with jumbo hikes as high inflation threaten to trigger second-round effects via rising wages and inflation expectations. The risks to the bleak outlook are titled to the downside. Further gas supply disruptions may send Europe into a much deeper recession, while the risks from a military escalation in Ukraine remain high.

Euro area in the eye of the storm

High inflation and energy shortages key for our expectation of a euro area winter recession

The euro area's high pre-war reliance on cheap Russian energy makes it particularly vulnerable not only to energy shortages but also to the energy-induced price shock. Headline inflation soared to 10.0% yoy by September. This looks close to peak (acknowledging for higher uncertainties from planned gas price caps), but we expect only a very gradual easing. Elevated inflation averaging 8.2% in 2022 and 5.0% in 2023 will dent real incomes. Encouragingly, EU gas storage has currently reached a level of about 88% of capacity, covering energy needs for about two winter months. Gas demand will need to be curtailed further, but with average weather conditions the euro area may be able to just muddle through winter amid curtailed gas supply from Russia, though the margin of error is small. Elevated uncertainty will further drag on confidence and investment spending. Especially energy-intensive firms will suffer sharply from higher input costs. Forward-looking indicators have come down into recessionary territory. Notwithstanding a solid labour market and government measures to cushion the fallout from high energy prices, we expect the euro area economy to fall into recession from Q3/22 to Q1/23. While in 2022 our growth expectation of 3.0% benefits from a strong first half of the year, the forecast growth rate of -0.3% in 2023 reflect the winter recession and an only sluggish recovery afterwards.

Further ECB rate hikes above the neutral policy rate and a shift to quantitative tightening in 2023

Unlike to previous downturns, the ECB will not come to the rescue. With about 75% of the items in the ECB's consumer price index reporting inflation rates above 2.5% and ongoing strong pressure in the pipeline, the focus has narrowed on bringing inflation down. To contain price pressures, the ECB is clearly focused on dampening demand, keeping inflation expectations contained and avoiding second-round effects. After having lifted the key rate by cumulatively 125 bps in July and September we look for further big rate hikes of 75 bps in October and 50 bps in December, bringing the deposit rate to 2.0% by year-end. That would be the upper end of the neutral policy range. In 2023 policy tightening is set to shift after a further 50 bps hike toward phasing out the reinvestments if purchases made under the Asset Purchase Program (APP). The expiring of a large TLTRO of around € 1.5 tr by mid-2023 will also contribute to ECB balance sheet reduction and help to tighten the policy stance.

We see the euro area activity risks clearly tilted to the downside. But as they primarily relate to increased bottlenecks amid an energy crunch, we see inflation even higher and unabated need for ECB action. In such a risk scenario, the policy rate would then be lifted above the 2.5% envisaged in the base case in 2023. However, due to increased spare capacity, rate cuts would come on the table in 2024 (see graph above).

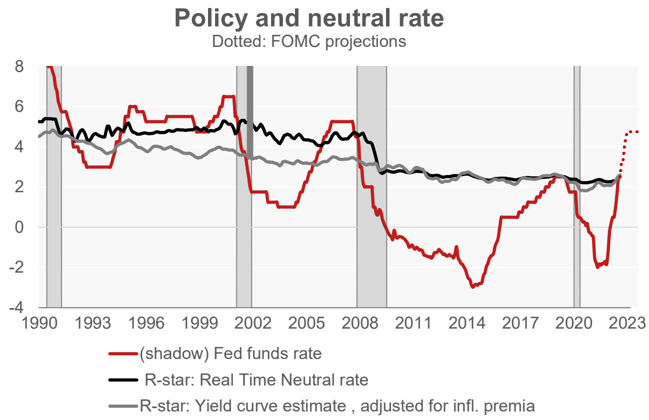
US: Fed turns even more hawkish despite clear recession risks

US recession increasingly likely in H1 2023 as tighter monetary conditions weigh on demand…

After a weak H1 and a tentative rebound in Q3, growth in the US is set to slow markedly starting from the last months of the year. We have revised down our forecast for 2023 to 0.4%, and we see a higher than 60% probability of a recession in H1. Despite a still solid labour market and wage gains, the surge in energy prices will dampen consumption. The most interest rate-sensitive parts of the economy are already feeling the pinch from tighter monetary conditions. Non-residential investment will remain weak and construction will continue to shrink, as mortgage rates are back to 2007/2008 levels and curbing house sales and building permits. This is already affecting house prices: over summer the Case-Shiller index stabilised, and its annual growth rate eased to 16%, off the historical high of just above 20%.

The moderation in house prices rise will only gradually feed though the important rent component of the CPI index. Its acceleration is one of the key drivers for the unsustainable level of core inflation (6% yoy in August), only in part offset by the decline in goods prices inflation, as demand decline and global supply bottlenecks start unclogging. While the headline rate has already peaked and is moderating thanks to lower oil prices, core inflation will remain sticky. It is unlikely to fall below 5% before the first months of 2023. This outlook has pushed the Fed to another hawkish twist at the September meeting, as it seems determined to raise the Fed funds rate to 4.5% by the end of the year. Despite acknowledging that this vastly increases the risk of a hard landing, the Fed flagged that the policy rate is set to remain well above the neutral level by around 200 bps until 2024, as a prolonged period of below trend growth is the price to pay to rein in inflation. The tension between the Fed's front-loaded tightening and a slowing economy will be a key theme over the coming months, but a pivot seems unlikely over the remainder of this year. We expect that the rebalancing between labour demand and supply and a downward trend of inflation will allow the Fed to start cutting rates in H2 2023, to prevent too big a spike in unemployment.

…but this will not deter the Fed from keeping a restrictive stance



Source:Federal Reserve Board, Atlanta Fed NY Fed, GIAM

Source: Datastream, GIAM calculations

China: Headwinds not easy to overcome

China's macro data have been volatile amid local Covid lockdowns and a weak real estate sector. We do not expect a change in China's Covid policy in the near term as the medical system could be quickly overwhelmed. We neither expect the Covid policy to change much after the Communist Party Congress (starting October 16) where President Xi is likely to be re-elected for the third time as general secretary – a historical event that underpins Xi's powers. As Xi backs the Covid strategy, a Covid policy U-turn seems unlikely and thus the macro development is likely to stay bumpy.

Unlike to previous downturns, Beijing's economic support comes at a measured pace, most likely in order to limit non-financial sector debt.

The second cause of concern is the real estate sector. On top of the debt and funding problems of developers, sales failed to recover. The problems could evolve into a vicious circle with a large impact on growth. Help is coming at local levels while centrally, the PBoC lowered mortgage rates slightly via the 5-year Prime Lending Rate. Beijing also provided (among others) funds to foster finishing stuck projects and to thus mitigate the "mortgage strike". However, all in all these initiatives look underwhelming. We expect more help at a measured pace. A debt restructuring could also come into focus. Measured support is also the name of the game for the overall public stance. The PBoC lowered rates once and we expect cuts of the MLF by 15 bps in Q4. We expect another fiscal package, whose size may be similar to the latest one (RMB 1 tr or 0.8% of GDP). We see GDP growth at 2.7% this year and 5.2% in the next. Risks are on the downside. Headline inflation may temporarily surpass the 3% threshold, but core inflation is low (0.8% yoy) amid weak domestic demand.