MACROECONOMIC OUTLOOK

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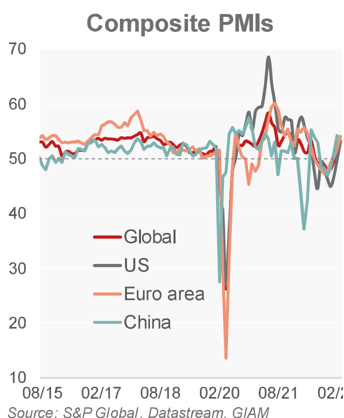
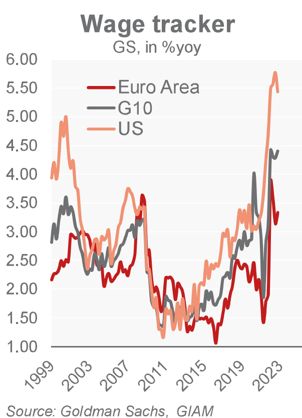
- **The global economy is headed for an early spring warming. Europe will benefit from the relief on eased energy worries, and – like the US – from still sizeable excess savings and a tight labour market. China's fast reopening will accelerate its economic rebound near term, with Asia and Europe partially benefitting.**
- **Yet sharply increased banking sector woes are casting long shadows over the outlook. Stress at US banks (SVB) has quickly spilled over to Europe. Even if a severe banking crisis is avoided (as we expect), a credit crunch is on its way, intensifying the drag on growth from past rate hikes. A much tougher H2 is looming.**
- **The previously expected mild US recession will prove deeper and likely start already in Q2. With the strains having having crossed the Atlantic, activity is set to decelerate markedly also in the euro area.**
- **Meanwhile, the inflation 'monster' (Lagarde) keeps showing its ugly head, as easing headline inflation is overshadowed by stubbornly high core inflation and wage pressure. The disinflation path is still intact, but will prove bumpy and require restrictive monetary policy for longer.**
- **Torn between inflation fighting and financial stability uncertainties, we see the Fed and ECB largely done hiking rates, even if the risks in the euro area are tilted towards further hikes.**

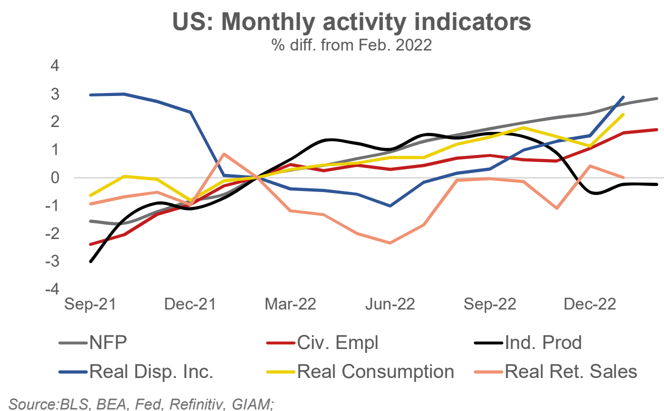
Eased energy worries and China's reopening make the global economy headed for an early spring bounce. Low unemployment, strong wage growth and excess savings continue to underpin the economic resilience. China's reopening is supporting ailing global manufacturing and trade. Yet do not get carried away by robust indicators as much of the relief in Europe is owing to receding energy prices.



Source: S&P Global, Datastream, GIAM



Source: Goldman Sachs, GIAM



Source:BLS, BEA, Fed, Refinitiv, GIAM;

Pain from drastic monetary tightening still to be felt

Cracks in the banking sectors are complicating central banks' tasks

However, the Western economies are still to feel the full pain of the sharp monetary tightening, with US rates up by almost 500bps in just one year, and ECB rates by 350bps. The resulting lagged effects will cause substantial headwinds into H2 2023. The fast tightening has also laid bare the cracks in the financial plumbing, with two mid-sized banks in the US (SVB, Signature) failing. As shown by the domino collapse of Credit Suisse in Europe, the banking sector as a whole is suffering on intensified market scrutiny, higher funding costs and deposit flight especially from weaker institutions. This will severely curb bank lending over the coming quarters. This complements central banks' inflation fight and substitutes for further rate hikes we had in our books before the recent crisis. Yet this form of tightening is much riskier and less

predictable, with central banks facing a delicate balancing act of inflation fighting and preserving financial stability.

Fortunately, bank failures so far are mostly due to idiosyncratic issues. Banks are much better capitalized and can resort to stronger liquidity buffers than in 2008, notably so in Europe. Also, bank stress from rising yields is partially self-correcting amid safe haven flows and a reversed rates outlook. That said, there is no scope for complacency as high rates may cause further casualties, with less regulated mid-sized US banks and commercial real estate particularly exposed. And while central banks, governments and regulators stand ready to provide quick and massive liquidity support, the broad tools of central banks are severely constrained by the inflation fight.

US: projected slowdown will lead to rate cuts in Q4

The looming credit crunch will trigger an outright US recession in H2

We lowered our US growth forecast for 2023 from 1.1% to below-consensus 0.4%. The SVB collapse will lead to an additional tightening in lending standards, on top of the impact of the interest rate increase. The data for Q1 issued so far mostly surprised to the upside. Consumption remains resilient, as the impact of high inflation is cushioned by the stock of excess savings. Household purchases are increasingly tilted to services which explains the relative weakness of manufacturing. Yet tighter credit will lead to a steep slowdown with growth slowing from 2% annualised in Q1 to an outright contraction in Q3 and Q4, followed by well below mean growth in H1 2024.

Employment growth decelerated, but remains strong, also helped by unusually warm weather in January and February. Labour market participation is starting to edge up responding the rapid rise in wages, with the notable exception of older workers. This may reduce supply persistently, contributing to a labour market that by almost any metric (unemployment rate, quits, jobs available) remains extremely tight. This will dampen the impact of slower activity on employment and wages. Inflation surprised to the upside, too, with core CPI still at 5.5% yoy in February. Weakening import and producer price inflation will help a deceleration of core good inflation. Shelter costs are still increasing at a fast pace. However, rents on recent leases decelerate markedly and will moderate this part of core inflation. Inflation in the rest of services remains remarkably persistent, driven by increasing labour costs and high markups. Therefore, disinflation will be slow, with the core rate likely to be still at around 4% yoy by year-end

The banking woes further complicate the Fed's task making a soft-landing a 'mission impossible'. The Fed's March meeting showed a marked shift in the forward guidance, after the aggressive communication seen in February. The FOMC now sees it appropriate to rise rate by just another 25 bps, to a peak in the 5% to 5.25% range, and – importantly – does not envisage any cut this year. This is in sharp contrast with markets' expectations, which entail rate cuts already starting in the summer, based on the view of a swifter decrease in inflation. In our projections, the deterioration of the economy in Q2 will prevent any further rate hike, but cuts will start only at the end of the year (-50bps in Q4).

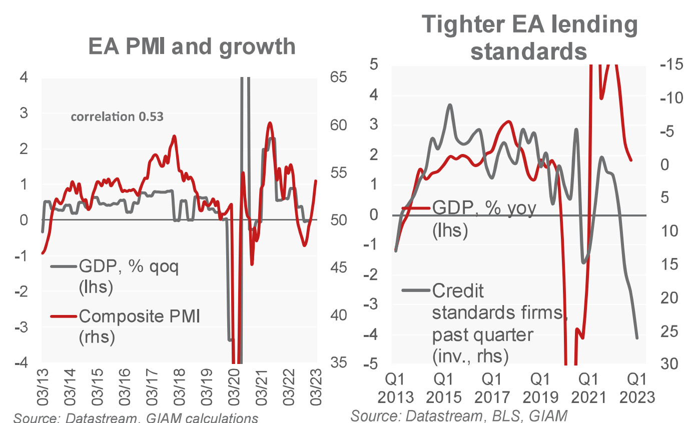
Euro area to avoid recession but to suffer from banking woes

Euro area growth to lose momentum

The euro area economy started very well into the year. Key sentiment indicators like the PMIs clearly herald an expansion of activity in the first quarter, following stagnation in the quarter before. With the unemployment rate staying at the low of 6.7% and plenty of excess savings still on the shelve, key ingredients for a sustained recovery are in place. Moreover, the reopening of the Chinese economy will boost activity in spring.

High uncertainty surrounding ECB outlook due to banking sector woes

However, looking further ahead, lagged effects from one year of decisive monetary policy tightening will leave their mark. A huge uncertainty concerns the effect of the latest banking woes. While we do not think a GFC like crisis is on the cards, banks will in the end substantially need to tighten their lending standards. Therefore, we look for a deceleration of activity in H2 while the supporting factors likely shield the euro area from a recession. All in all, we somewhat reduced our growth expectations but still see output growing by 0.7% in 2023 (cons.: 0.4%), mostly due to a strong Q1.



Source: Datastream, GIAM calculations

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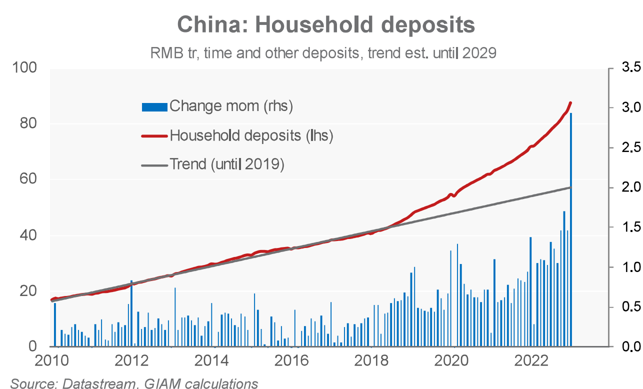

Source: Datastream, GIAM calculations

The banking sector woes complicate the ECB's life further. While headline inflation came down from the peak of 10.6% yoy in October to 6.9% yoy (flash est.) in March, it is still way above target and broad based. Underlying inflation showed no signs of moderation yet and with strong wage growth ahead it will only slowly recede. ECB Governing Council members made clear that the fight against inflation is not yet completed and see it as "too high for too long". That said, there are mounting signs that inflation pipeline pressures ease and energy inflation became disinflationary. Huge uncertainty emanates from the banking sector fallout. The ECB therefore adopted a truly data dependent policy approach. We deem it likely that tightening lending standards will substitute for rate hikes. Following a 50-bps rate increase to 3.0% (deposit rate) in March we have no further hikes in our books. Yet amid high uncertainties, the risks are tilted towards further tightening.

China: Post-Covid recovery underway

China likely not strongly affected by banking woes as recovery driven by domestic factors.

China's post-Covid recovery is underway. The rebound has been so far most visible in PMIs. We expect private consumption, especially services, to support the rebound on the reduction of excess savings (see graph) which we estimate at least of about 2% of disposable income. The rebound will likely be less driven by investment. Infrastructure investment growth is expected to decelerate as the official general government budget deficit will increase only slightly (3.0% of GDP vs. 2.8% in 2022). The real estate sector showed first signs of stabilisation and is expected to generate overall a small plus in 2023. Credit supply was ample at the outset of the year and the PBoC unexpectedly cut the RRR by 25bp. The monetary impulse turned positive again. We see another RRR cut in Q2, with the PBoC not very much restricted by inflation. February inflation dropped to 1.0% yoy, but the consumption-driven recovery will likely induce higher rates of around 3% yoy by the end-2023. We see inflation to average 2.4% in 2023 and GDP growth at 5.4%.