Investment Clock – Economic Update

Issue #28, May 2023

Multi asset views

Royal London Asset Management manages £150.8 billion in life insurance, pensions and third party funds*.

We have six Global Multi Asset Portfolios (GMAPs) across the risk return spectrum with a full tactical asset allocation overlay.

*As at 31 March 2023

This month's contributor

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Senior Economist

US: A number of recession indicators are still flashing. For now, the forecasts assume a modest technical recession in the next 12 months and one more rate hike, but there are risks on both sides of the forecasts.

China: Data doesn't indicate a super-strong bounce-back so far. More policy support seems likely though.

Eurozone: Strong domestically-driven inflation and ongoing rate hikes dull the outlook, even if the euro area seems to have escaped recession.

Japan: Inflation remains high by Japan standards and the odds of a policy tightening at some point in the next 12 months remain high.

UK: The outlook is still lacklustre in the UK but looks better than just a few months ago (credit conditions permitting). However, rate hikes are still feeding through, and high inflation is still at risk of becoming more embedded and therefore requiring significantly more rate hikes.

Please visit **investmentclock** for our blog and information about our multi asset range.

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Yes, We Could Still See Recessions

Despite more rate hikes, recessions look a lower risk than just a few months ago. Bank lending conditions have tightened, but not as much as feared. The peak impact of rate hikes may even already be behind us in some major economies. Developed economy business surveys look more consistent with robust positive activity growth than recession. But, if lags of monetary policy really are longer than usual and bank lending conditions continue to tighten, recessions in some major economies can't be ruled out. Beneath headline level, inflation looks stubbornly sticky; more resilient than expected inflation would bring higher rates for longer and potentially delayed but deeper recessions. For now, modest technical recessions still look a reasonable probability for the next 12 months in some developed economies.

Summary

Not quite revising away recessions: European economies haven't been growing much and a relatively small back revision would have both euro area and UK economies in technical recessions over the turn of last year. In both economies, it now seems we are in for a few more rate hikes too. A number of recession indicators in the US are still sending warning signals. My growth, inflation and interest rate forecasts have been revised up for 2023, but recession still looks a risk in the US and parts of Europe and, with more rate hikes to come, US and Europe GDP forecasts for 2024 are revised down.

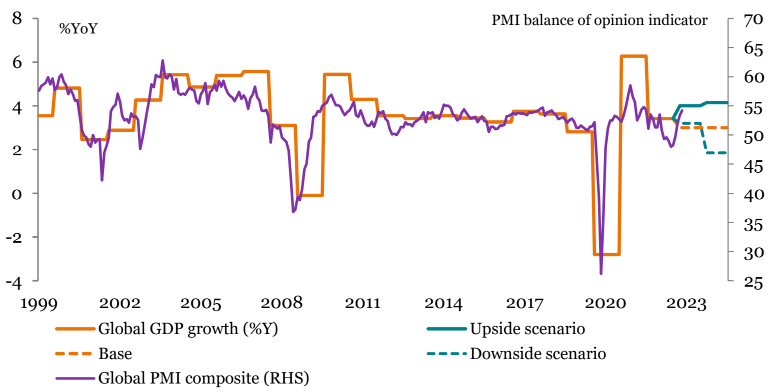
Consumer prospects – not great, but better: Rate hikes continue to feed through to mortgage payments, likely to be a rolling drag on consumer spending in economies like the UK. However, consumer confidence has generally risen, unemployment rates in major developed economies remain remarkably low. Meanwhile lower *headline* inflation means real income growth should improve.

Inflation –not so transitory: Even as headline inflation has fallen, core and services inflation have been surprisingly sticky in the US, Europe and Japan. It is far from clear yet that central banks have done enough to stop higher-than-target inflation from becoming embedded. The forecasts pencil in more rate hikes. As for rate cuts, those still look more like a 2H 2024 story than a 2023 story to me.

China – not an engine of global growth: China's recent activity data has been disappointing. That raises the likelihood of more policy support. However, with authorities likely unwilling to risk stoking financial instability or inflation especially given the recent examples of the US and Europe, China is unlikely to stimulate so much that it becomes a strong global growth engine soon.

Our multi asset team are overweight equities, but ready to reduce. The run of solid business survey data and lower headline inflation supports being overweight equities and underweight bonds and commodities on our Investment Clock approach. However, conscious that economic conditions may yet deteriorate again, and that tighter central bank policy may still lead to a recession, the team would not be surprised to see conditions become less supportive for equities later this year.

Chart 1: Global growth central case: Not great, not bad



Source: IMF, S&P Global (past data); RLAM (forecasts). Past data is to April 2022

Economic forecast summary

May 2023 base case

Region	2022 GDP growth	2022 CPI end Q4	2022 Policy Rate Q4	2023e GDP growth	2023e CPI end Q4	2023e Policy Rate Q4	2024e GDP growth	2024e CPI end Q4	2024e Policy Rate Q4	2025e GDP growth	2025e CPI end Q4	2025e Policy Rate Q4
US	2.1	7.1	4.50	1.2 *0.6*	3.6 *3.1*	5.50 *5.25*	0.7 *1.1*	3.0 *2.5*	4.75 *4.50*	2.3 *2.2*	2.6 *–*	4.00 *–*
China	3.0	1.8	– *–*	5.2 *5.4*	– *–*	– *–*	4.6 *4.8*	– *–*	– *–*	4.6 *4.6*	– *–*	– *–*
UK	4.1	10.8	3.50	0.3 *−0.7*	4.3 *2.8*	5.25 *4.50*	0.7 *1.0*	2.7 *2.4*	4.50 *3.75*	1.0 *1.3*	2.4 *–*	4.00 *–*
Euro area	3.5	10.0	2.50	0.2 *0.4*	3.0 *2.1*	4.50 *3.75*	0.6 *0.6*	2.6 *2.4*	3.75 *3.25*	1.6 *1.6*	2.5 *–*	3.00 *–*
Japan	1.0	3.9	−0.10	1.0 *0.8*	3.4 *2.0*	0.00 *−0.10*	1.1 *1.1*	1.6 *1.4*	0.00 *−0.10*	1.0 *1.0*	2.0 *–*	0.00 *–*
Global	3.2	– *–*	– *–*	3.0 *2.5*	– *–*	– *–*	3.0 *3.0*	– *–*	– *–*	3.4 *3.4*	– *–*	– *–*

Source: Refinitiv DataStream, national statistics offices, Bloomberg Finance L.P. for past actual data. All forecasts (e) are RLAM. Current data and forecasts are in black. Forecasts from the February 2023 forecast update are grey and in italics. Note: US policy rate is the upper end of the Fed Funds target range. Euro area policy rate is the refi rate.

Key economic policy forecasts

- With taming inflation still the priority for central banks, the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) raise rates a bit further in 2023.
- The forecasts assume a peak upper limit to the Fed Funds target range of 5.50%, that the BoE hikes rates to 5.25% and that the ECB hikes (the refi rate) to 4.50%. The forecasts also (tentatively) assume that Japan raises rates (slightly) over the forecast profile.
- Fiscal policy is generally expected to become less supportive over the forecast. However, sharp spending cuts are not in the central case, partly as assumed spending to tackle longer-term challenges (e.g. climate change) steps up.

Global economic scenarios (Chart 1)

Upside scenario (20% probability): Inflation falls sharply, recessions are avoided and the consumer booms

- Inflation falls much faster than expected, helped by contained inflation expectations, commodity price falls and lower pay settlements (themselves partly driven by falls in headline inflation). The participation rate increases faster than in the base case, also helping to keep a lid on domestically driven inflationary pressure via an improvement in labour supply. Central banks signal modest rate cuts for late-2023/early 2024 as they become more relaxed about inflation risks.
- GDP growth is stronger than expected as real income growth rises and as corporates and households dig further into their aggregate cash/deposit stocks.
- China rebounds strongly, helped by an increased in policy stimulus, but largely through higher consumer services activity which limits the impact on global inflation.

Base case (60%): Modest recessions in some economies on tighter monetary policy and credit conditions

- 2023 sees the global economy record unspectacular GDP growth with the high cost of living, economic uncertainty, higher interest rates and tighter bank lending conditions a drag on growth. Some developed economies experience modest technical recessions.
- Inflation falls further over 2023 at headline level. Domestically driven inflation pressures ease somewhat by the end of the year.
- Monetary policy tightens further before modest rate cuts starting in 2H 2024 and fiscal policy becomes less supportive over the forecast.

Downside scenario (20%): Deeper recessions with a delay

- Inflation falls much slower than expected. Central banks continue to tighten policy into 2024, as inflation expectations and domestic inflationary pressure fail to ease as hoped. Bank lending conditions tighten further.
- Economic activity slows sharply by early 2024. Recessions are deeper and last longer as firms and households respond with a lag to central bank tightening more strongly than in the base case.
- Higher inflation than the base case in 2023 is, however, followed by substantial falls in the later years of the forecast reflecting greater economic slack and bigger falls in inflation expectations after central bank tightening tips economies over the edge into more significant downturns. Rates are cut to below central case levels in later years.

Probabilities are subjective and indicative such that we'd broadly see a 20% chance that the economy performs in line with/better than the upside case and a 20% probability that the economy performs in line with/worse than the downside case.

Global economy: Surprisingly resilient…but for how long?

Major economies still look surprisingly resilient in light of substantial monetary policy tightening, the high inflation period and – more recently – the period this Spring of worry around financial markets and banks. The forecasts on page 2 now only assume modest technical recessions for the US and UK, less pessimistic than just a few months ago. With headline inflation falling, wages are likely to stretch further. That should help to offset much of the impact on consumer spending from tighter credit conditions. However, with central banks having hiked so much and credit conditions having tightened substantially over the last 12 months, recessions remain a significant risk more broadly. Meanwhile, the stronger the consumer and more resilient the economy, the longer tight labour markets are likely to last and the stickier domestically driven inflation pressure could prove. That seems likely to prompt more central bank tightening than expected too.

Activity: Survey data signals that global growth is powering on

Using the global composite PMI business survey as a proxy for what is going on with global GDP growth (Chart 2), the global economy appears to have turned around remarkably since late last year. The rebound in China's economy post-Covid restrictions, a healthier European energy backdrop and falling headline inflation after the peak in energy prices will all have helped. The failure of US bank SVB and subsequent banking system worries appeared to dent business confidence a bit in the Spring, but not substantially (Chart 3). However, not everything looks rosy. Post-Covid normalisation is probably still helping services (while not being a sustainable source of growth) while manufacturing has been dented by factors including an inventory unwind (Chart 4). Central banks have continued to hike rates, inflation remains high (Chart 5) and even within the PMI surveys some countries have shown more negative trends recently (particularly China).

Summary outlook: Central case of a few more rate hikes and modest recessions could easily be upturned

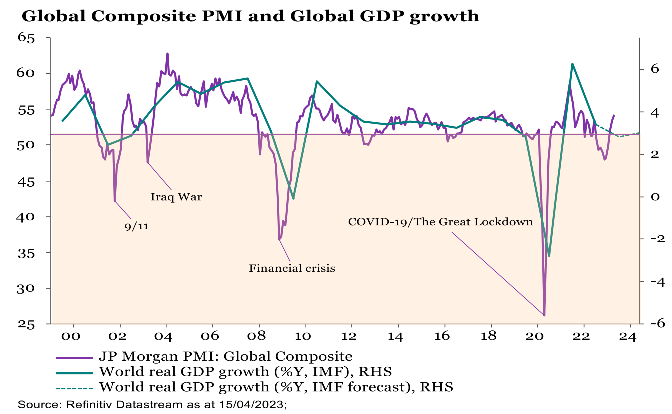
The forecasts on page 2 still envisage modest technical recessions in some economies. The forecasts for GDP growth have generally been revised up a bit for 2023 reflecting a better start to the year than expected and surprising resilience in the face of shocks. With domestic inflation pressure still looking relatively strong though, the forecast also assumes more rate hikes in 2023 and assumes that cuts are a late 2024 story, not a 2023 one.

Financial volatility and tighter credit conditions: Not out of the woods on real economy impact

It is difficult to estimate the likely impact on global economic activity from the financial market volatility in the Spring and from already tighter bank lending conditions (Chart 6). That reflects a number of uncertainties, including how much further central banks hike rates and how continued economic uncertainty affects bank behaviour.

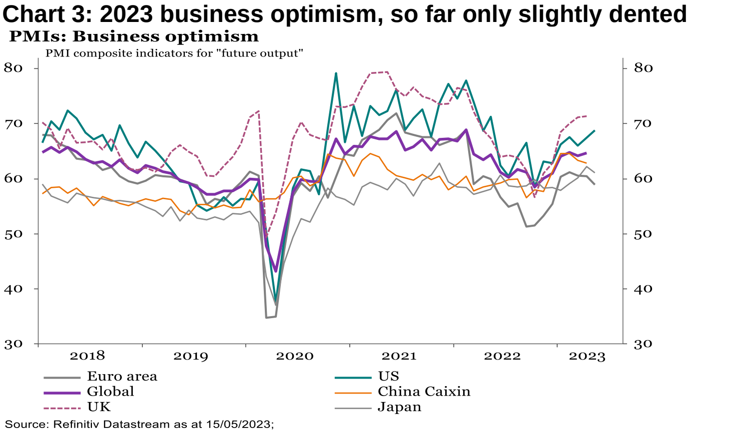
Past the point of peak stress: Both US and euro area composite systemic stress indicators, produced by the ECB, indicated that we are past the point of peak stress (Chart 7). However, over the last six months, average systemic stress levels on these indicators have been relatively elevated.

Chart 2: Global PMI out of recession zone again…



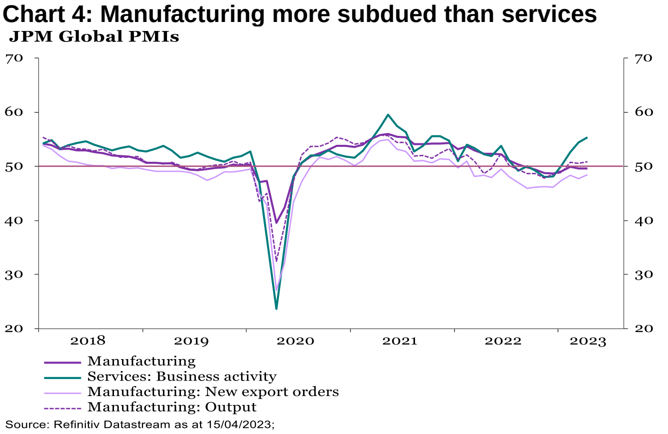
Source: Refinitiv Datastream, S&P Global as at April 2023. IMF forecasts from Spring 2023 update.

Chart 3: 2023 business optimism, so far only slightly dented



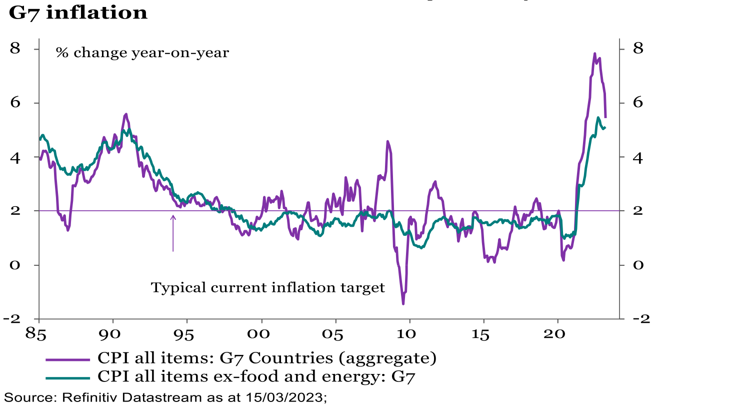
Source: Refinitiv Datastream, S&P Global. Data as at April (Global, China)/May 2023.

Chart 4: Manufacturing more subdued than services



Source: Refinitiv Datastream, S&P Global. PMI figures are to April 2023.

Chart 5: Lower headline inflation a key development



Source: Refinitiv Datastream, S&P Global. Data as at March 2023.

Expecting modest additional dent to growth: Looking at the crude relationship with PMI/ISM surveys (with the caveat that observations of financial stress will be dominated by the 2008-9 financial crisis), the level of financial stress seen over the past month or so would be associated with just above-50 PMIs – i.e. with positive, albeit not strong, private sector activity growth (Chart 8). However, because recent financial stress has not been met by even a pause in monetary policy tightening, it may be that activity growth is hit more than in some past episodes. Focusing on the US, there is no clear lead-lag relationship between the indicator of US systemic stress and indicators of credit conditions for the US from the Senior Loan Officers survey. However, the two series tend to move together. For now, credit conditions remain at 'recessionary' levels, associated with GDP growth weakening into mildly negative year-on-year territory (Chart 9).

Consumers and corporates: Lower inflation will help; tighter credit conditions won't

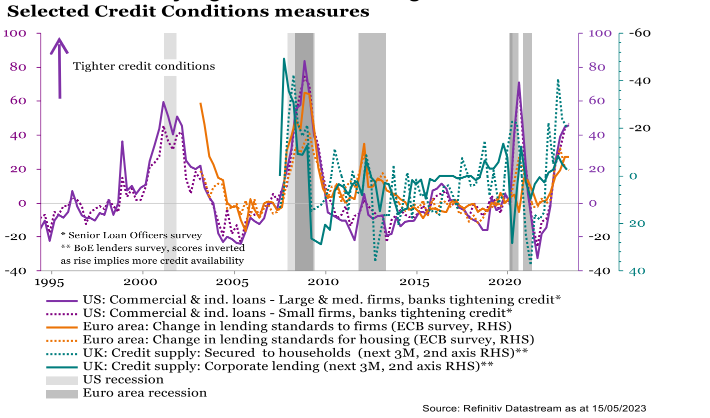
Challenges for the consumer remain significant… Inflation remains high in major developed economies, even if it has fallen significantly and continues to run ahead of pay growth (at least in year-on-year inflation terms, Chart 10). Meanwhile, higher interest rates mean higher mortgage payments (albeit with lags). Wealth effects are also likely to be weighing somewhat as higher interest rates have fed through into falls in house prices in some economies. Consumer confidence has risen in many economies, but remains weak (Chart 11).

…but things are arguably getting better for consumers not worse: Government support has helped households weather the worst of energy price increases in Europe. Meanwhile, the real income growth picture has improved as pay growth picks up relative to inflation. In the US, month-on-month real disposable income has been positive for several months. In the UK, helped by temporary government energy bill support, real disposable income increased in Q4 2022. In the meantime, lower natural gas prices have helped the outlook for European energy bills even as government support rolls off. Meanwhile, unemployment rates remain low and employment growth indicators from the PMI business surveys look consistent with robust job gains again (Chart 12) helped by the recovery in services output. The forecasts assume shallower consumer spending slowdowns than previously.

Fixed investment is likely to fall a bit: In the US, euro area, Japan and UK various measures of private non-residential investment (shown in Chart 13) have seen a substantial recovery, even if not back on pre-crisis trend lines. Now, however, post-pandemic cash deposits have been substantially eroded by inflation (Chart 14), bank lending conditions have tightened and policy interest rates have risen further. Meanwhile, residential investment has seen a substantial fall in the US for example, and remains vulnerable for the same reasons listed above. In some economies, however, government policy may offset some of that impact. In the US, for example, the Inflation Reduction Act incentivises re-shoring.

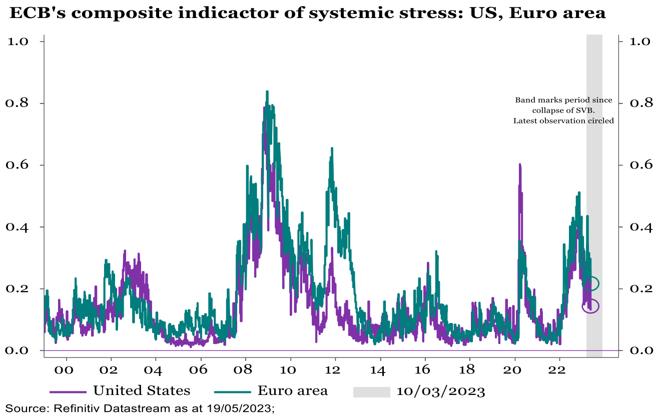
Seeing an inventory-driven drag? One of the ways the global economy may differ post-Covid is in a shift away from a just-in-time approach to production and away from complex global supply chains. That may mean shorter, more inventory driven business cycles prone to bouts of inflation (see The 3 Rs: Recession, rate hikes and really high prices, September 2022). However, firms seem to be unwinding some of the stocks built up temporarily during the period of acute supply chain problems. Global PMI indicators have been showing inventory series below the 50 'no growth' score since late 2022 (Chart 15). These inventory series now look more in line with orders trends compared to the 'excess' inventory build that was signalled by these survey indicators post-pandemic.

Chart 6: Already tighter bank lending conditions



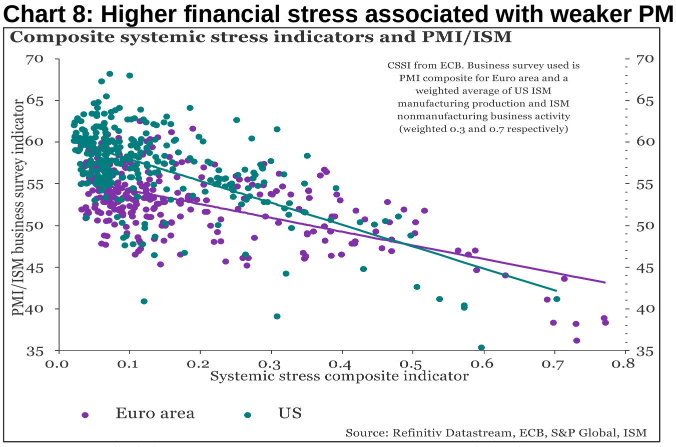
Source: Refinitiv Datastream, Federal Reserve, ECB, BoE as at Q2 2023 except BoE which is to Q1 2023.

Chart 7: Financial stress still elevated



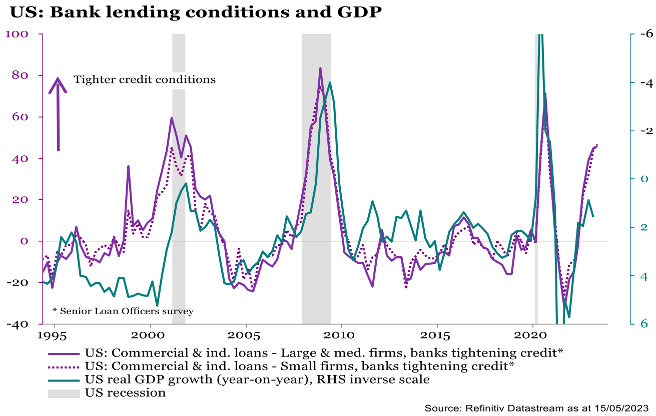
Source: Refinitiv Datastream, ECB as at May 19th 2023

Chart 8: Higher financial stress associated with weaker PMIs



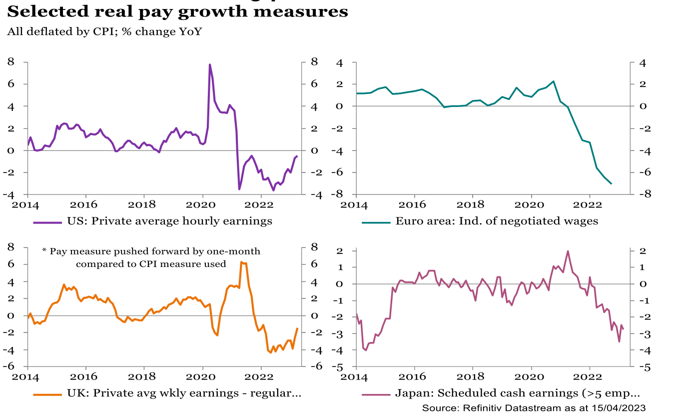
Source: Refinitiv Datastream, ECB, ISM, S&P Global as at May 2023.

Chart 9: US credit conditions consistent with recession



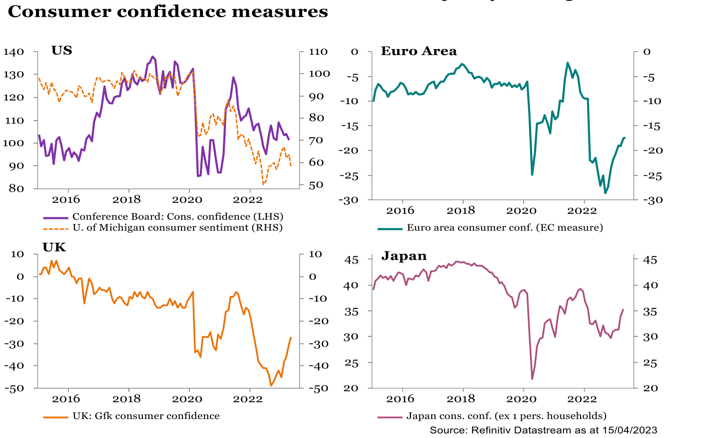
Source: Refinitiv Datastream, Federal reserve, BEA. Data is to Q2 2023 except GDP which is to Q1 2023.

Chart 10: Cost of living pressure eases a bit



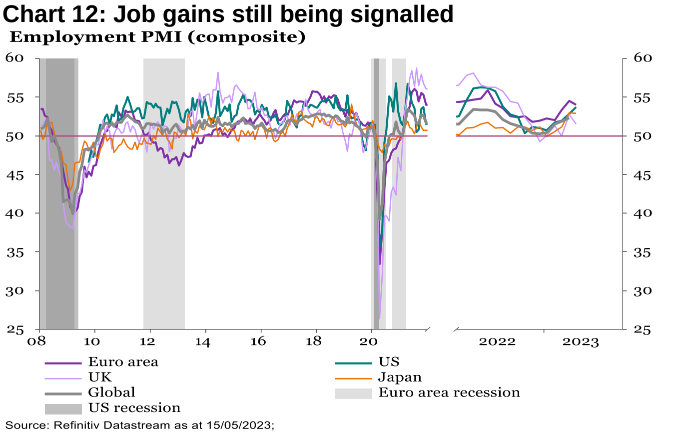
Source: Refinitiv DataStream, BLS, ECB, Eurostat, ONS, Ministry of Health, Labour and Welfare, Ministry of Internal Affairs & communication. Data to April 2023 except euro area (Q4 2022) and Japan (March 2023).

Chart 11: Consumer confidence: Mostly improving



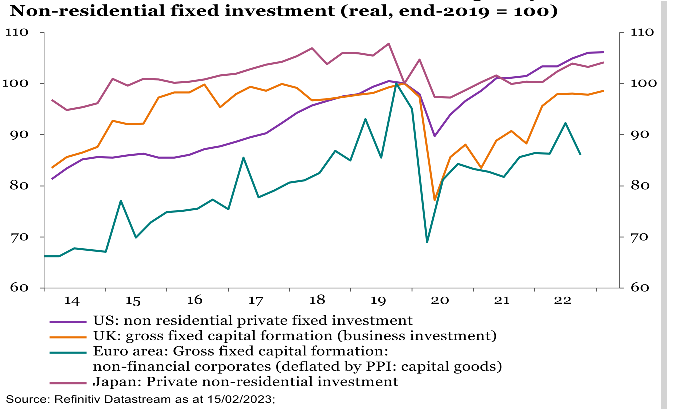
Source: Refinitiv DataStream, Conference Board, University of Michigan, European Commission, GfK, Cabinet Office (Japan). Data to May 2023 except Conference Board and Japan (April)

Chart 12: Job gains still being signalled



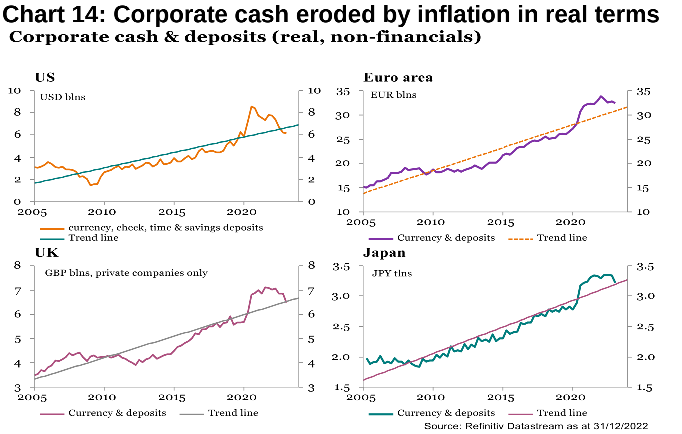
Source: Refinitive DataStream; S&P Global. Data to May 2023 except global (April 2023).

Chart 13: Non-residential investment caught up, now what?



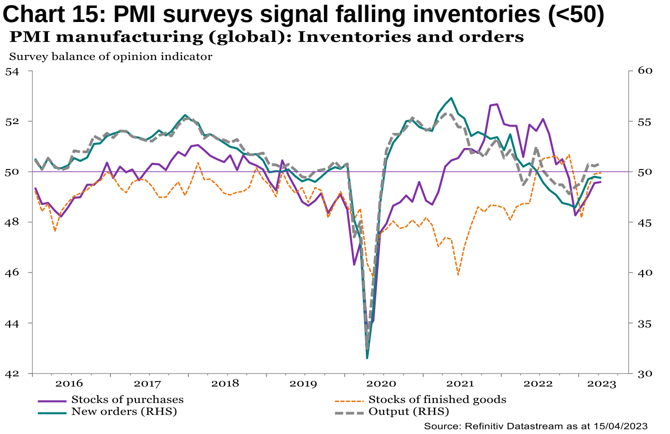
Source: Refinitiv DataStream, BEA, ONS, Eurostat and Japan Cabinet Office. Data as at Q1 2023 except euro area (Q4 2022).

Chart 14: Corporate cash eroded by inflation in real terms



Source: Federal Reserve, BLS, ECB, Eurostat, ONS, BoJ, Ministry of Internal Affairs & Communication. Data to Q4 2022

Chart 15: PMI surveys signal falling inventories (<50)



Source: Refinitiv DataStream, S&P Global. Data to April 2023

Inflation: How far will it fall and will it get 'stuck'?

Bits of inflation were (eventually) transitory: Externally driven inflation is finally dropping away, leaving year-on-year headline consumer price inflation lower. Much of that is coming from lower energy inflation as the biggest jumps in energy prices seen in 2022 move to being more than 12 months ago (Chart 16). Commodity prices more broadly have fallen since the middle of 2022, also helping lower inflation and with more to go (Chart 17). Food prices should follow a similar pattern, but a down-trend in agricultural commodity prices is not quite so apparent.

***Core* inflation *tends* to follow** non-core inflation with a lag (Chart 18). That makes sense since commodities will ultimately be key inputs for many 'core goods'. Lower *headline* inflation should also help moderate wage demands/settlements. Separately, easing supply chain tensions should help lower core inflation too.

However, some lags are starting to look long when it comes to core goods inflation. Looking at a crude relationship between what businesses in the manufacturing industry are saying is happening to input prices (seeing less inflation pressure) to what is happening to inflation in 'core' consumer goods prices shows a diverse picture (Chart 19). In the US, the lag looked longer than usual but lower goods price inflation has followed; in the UK, the lags anyway look relatively long. In the euro area, the relationship looks weak and there is little sign yet of a big fall in inflation in this category. That might reflect some attempt by firms to widen margins after a period of very high input price inflation.

So far too, the most core/domestically driven bits of inflation aren't slowing much. In the US, euro area and UK, services inflation remains strong (Chart 20). US so-called 'super-core' inflation (core services ex-housing) is not showing a clear weaker trend (Chart 33). As input price inflation cools, this should feed through into services inflation too (with a lag). Energy prices, for example, will make up a portion of the costs of most services. However, if companies remain more willing and able to pass on cost increases and if wage dynamics stay strong, these measures of inflation can stay high. Inflation expectations are important for these dynamics. Recent data suggests inflation expectations of consumers and professional forecasters in the US, euro area and UK are below their recent peaks, but on the high side compared to trends of recent years (Chart 21).

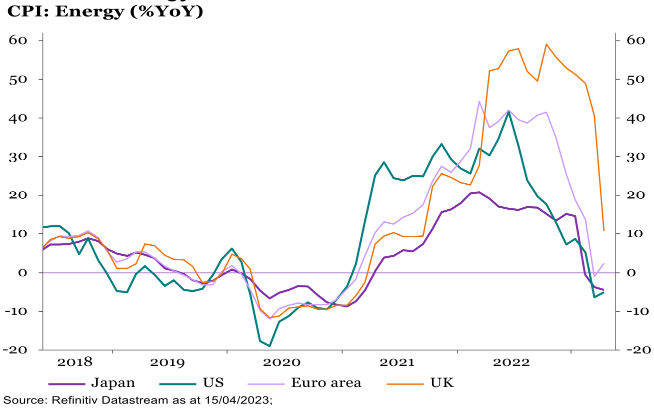
Tighter monetary policy vs tight labour markets: Both further rate hikes and the lagged effects of past hikes should be a drag on growth and therefore inflation in 2023 into 2024. *How much* will partly be a function of the labour market. 'Excess demand' for labour still looks high in many economies looking at the high levels of job vacancies. Firms are still saying labour is difficult to get hold of or a constraint on output (Chart 22). That could mean pay growth is relatively supported even in the case of continued subdues or modestly negative GDP growth. The overlap with the post-Covid recovery could be important here too. Services activity has still not fully normalised (again, to highlight the UK, consumer-facing services activity was still 8.9% below pre-pandemic levels as of February 2023); a more consumer-services intensive output mix also seems likely to be a labour-intensive mix. Tight labour markets can help keep wage growth too strong to be consistent with inflation returning to target.

Hence the risk scenario is sticky inflation and 'later landings': Just because many economic models assume that inflation will return to the central bank target, doesn't mean that won't need to take quite a bit more monetary policy tightening. With substantial risks here that the fall in headline inflation is not as dramatic or sustained as hoped for or even in line with my central case (Chart 23), inflation targeting central banks may end up hiking more than expected. That could push economies into a downturn later, even if they continue escaping even modest recessions for now.

Fiscal policy: A mixed picture

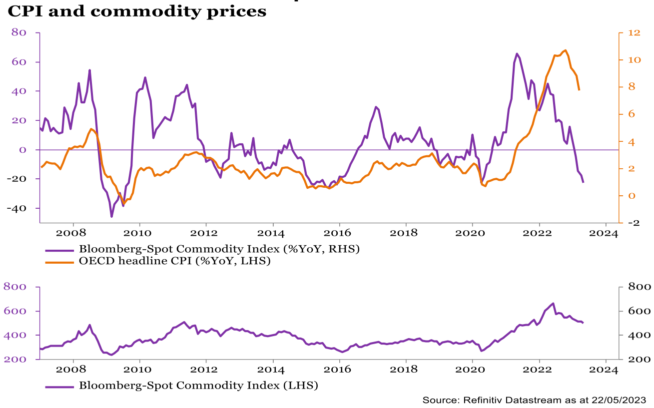
Fiscal support looks set to be more of a help in the coming year in some economies than others. The UK government added near-term fiscal support in their March Budget; in the US, the Inflation Reduction Act may have more impact on the US economy than it appears from estimates of net cost. Officials in China continue to signal a supportive stance. In general though, compared to the pandemic period, fiscal stances look more neutral. Pandemic-related spending and the associated increase in government debt has also left governments with less fiscal "room for manoeuvre" and population ageing remains a long-term fiscal challenge facing many economies.

Chart 16: Energy inflation has fallen



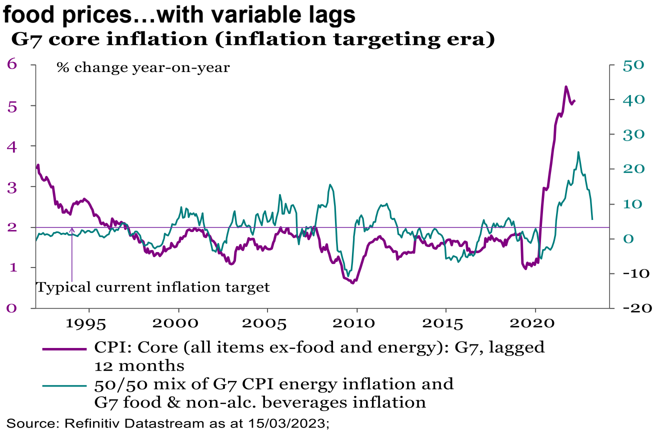
Source: Refinitiv DataStream, Ministry of Internal Affairs & Communication, BLS, Eurostat, ONS. Data as of April 2023

Chart 17: More downside pressure for CPI to come



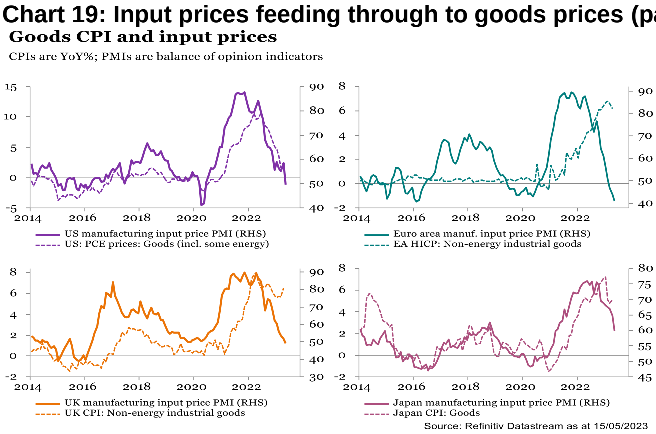
Source: Refinitiv Datastream, Bloomberg Finance L.P., OECD. Data as of 22nd May 2023, except CPI which is to March 2023

Chart 18: Core tends to follow peaks and lows of energy and food prices…with variable lags



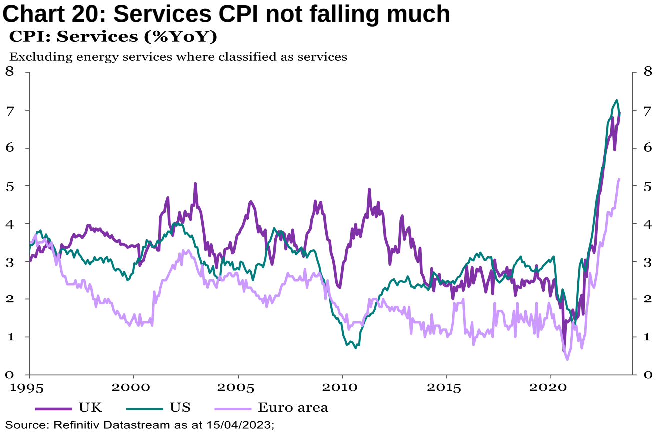
Source: Refinitiv DataStream, OECD, RLAM. Data to March 2023.

Chart 19: Input prices feeding through to goods prices (partly)



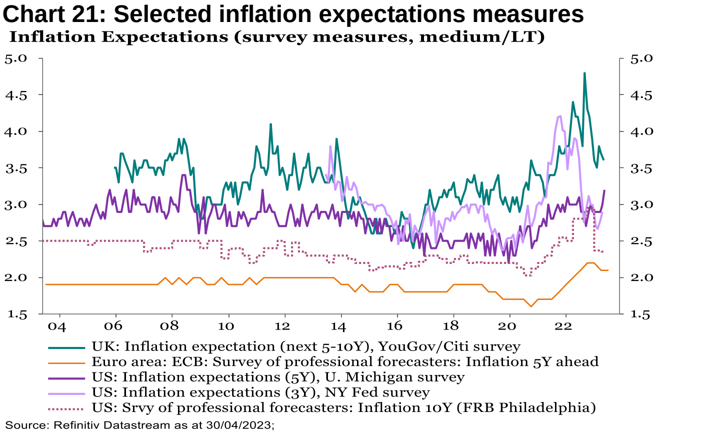
Source: Refinitiv Datastream, S&P Global, BEA, Eurostat, ONS, Ministry of Internal Affairs & Communication. Data as of May 2023 (PMI data and April 2023 (CPI data).

Chart 20: Services CPI not falling much



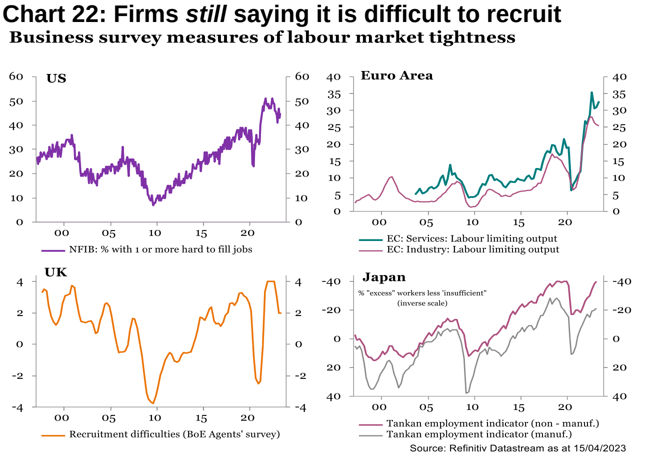
Source: Refinitiv DataStream, ONS, BLS, Eurostat as at April 2023

Chart 21: Selected inflation expectations measures



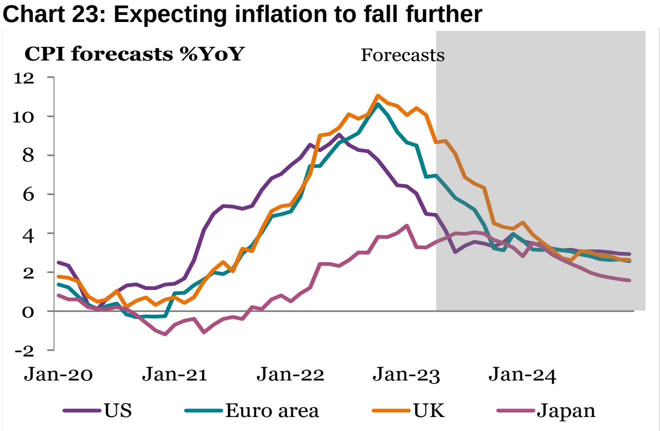
Source: Refinitiv DataStream, YouGov/Citi, ECB, University of Michigan, FRB New York, FRB Philadelphia. Data to Q2 2023

Chart 22: Firms *still* saying it is difficult to recruit



Source: Refinitiv Datastream, NFIB, European Commission, BoE, BoJ. Data to Q2 (UK, euro area), April (US), Q1 2023 (Japan).

Chart 23: Expecting inflation to fall further



Source: Past data: Refinitiv DataStream, BLS, Eurostat, ONS, Japan Ministry of Internal Affairs and Communications. Forecasts are RLAM, consistent with forecasts on page 2.

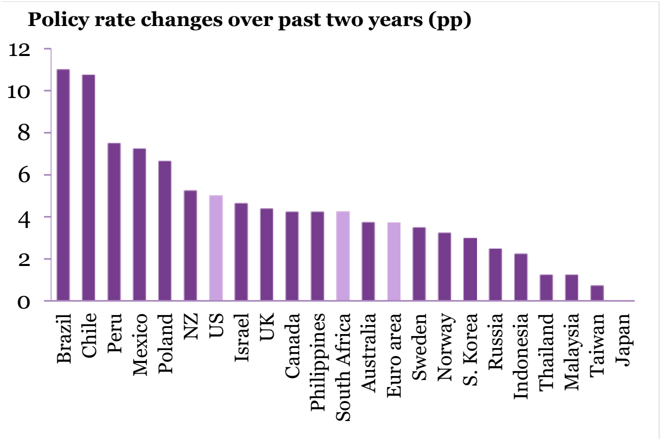
Central bank policy outlook: Done or nearly done…but there are plausible paths to either more hikes or cuts

Inflation is still high. However, having hiked a lot (Chart 24), there has also been more recognition by central banks that they need to at least go slower to give policy tightening a chance to work. The impact of policy tightening is visible in interest rate sensitive areas of economies and credit conditions have tightened significantly in recent quarters (Chart 6). The forecasts on page 2 assume that we are close to peak rates in the US, but that the BoE and that the ECB will have to hike 75bp further (Chart 25). These are upward revisions to previous forecasts in light of more robust than expected activity data and a stubbornly strong domestic inflation picture, alongside central bank commentary.

Rate cuts more of a 2024 story: Monetary policy has taken longer than I'd have expected to have an impact. It may be that longer loan terms and tight labour markets, alongside savings stocks built up during Covid have helped slow the transmission mechanism. Perhaps central banks aren't being patient enough and end up overtightening and we then do get rate cuts by the end of the year. However, with domestically driven inflation pressure looking robust, for me rate cuts will be more of a 2H 2024 story and more about returning interest rates towards neutral once central banks are confident that inflation is going to sustainably return/stay at target. My estimates of a medium-term nominal equilibrium/neutral interest rate (r* plus the inflation target) are currently (only) around 2.5% in the US and UK and 2.25% in the euro area, arrived at by averaging several different methodologies/sources.

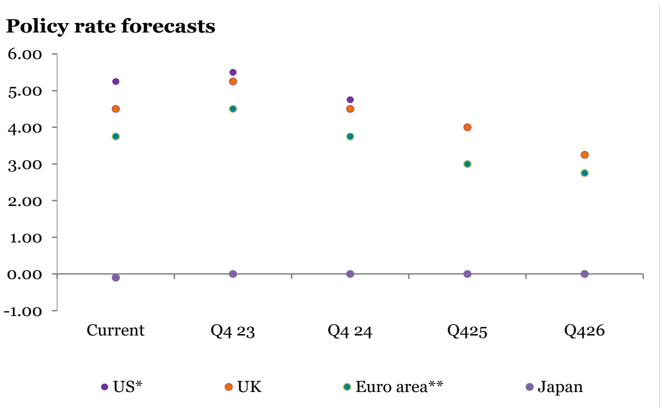
Careful of QT: With the ECB speeding up quantitative tightening (QT) and QT ongoing at the Fed and BoE, it is worth considering whether the effects might be larger than assumed. Considerable amounts are being done and policymakers continue to sound uncertain on the likely impact of QT.

Chart 24: Central banks have hiked a lot



Source: Bloomberg Finance L.P.. Data to 24th May 2023

Chart 25: Nearly there on rates…



Source: National central banks/Refinitiv DataStream (past actuals). All forecasts (from Q4 2023 onwards) are RLAM estimates.

United States: (Modest) technical recession still pencilled in

In the US, there are a number of recession indicators still flashing, especially the credit conditions indicator from the Senior Loan Officers Survey, the weakness of residential investment and yield curve inversion. Credit conditions have tightened a bit further. However, the vulnerability of the US economy to tighter credit conditions may be less now than in previous recessionary episodes. Fiscal policy, meanwhile, may be providing more support than it appears. For now, the forecasts assume a modest technical recession in the next 12 months and one more rate hike, but there are risks on both sides of the forecasts.

Activity: Still a mixed picture, but no dive into recession yet

Q1 real GDP growth was slower than in Q4 2022 at only 1.1% annualised (2.6% in Q4 2022). The most recent Atlanta Fed nowcast suggests that growth is likely to pick up again in Q2 (so far, consensus is more pessimistic). Q2 data has so far been mixed. April business surveys signalled relatively robust growth on the PMI measure, but subdued growth on the ISM measures (Chart 26). Employment gains remain robust on the non-farm payrolls data, but levels of housing-related activity remain subdued. Measures aiming to capture sentiment/expectations in different sectors are mostly off their recent lows (Chart 27). Overall, however, this does not look like an economy that is diving into recession.

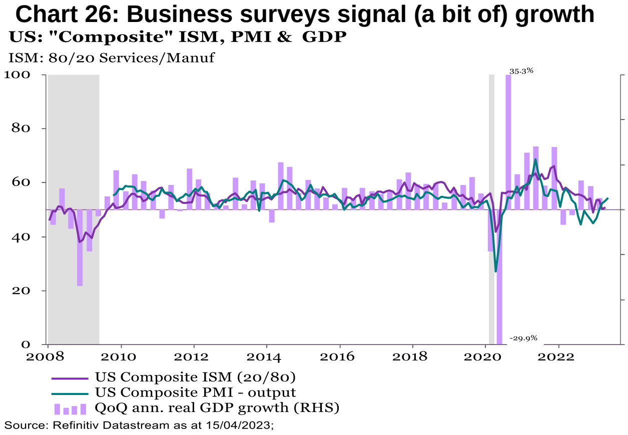
Credit conditions: Not looking great…but how important?

Credit conditions already looked tight enough to send a recessionary signal before the events of March (Chart 28); key indicators from the Fed's Senior Loan Officers Survey were similar to the kind of levels seen before past recessions. However, the Bloomberg indicator of US financial conditions, which is driven by market rather than bank metrics, is not signalling particularly tight financial conditions. The stock of market-based debt financing is substantially larger than loan financing for US corporates (Chart 29). However, looking at flow-of-funds data, the relative importance of loan financing has increased rapidly since around 2017. Small and mid-sized banks, the category most affected by the failure of SVB and its aftermath, are particularly important for commercial real estate and smaller businesses. Even if worryingly tight credit conditions are limited to loans, that should still emerge as a significant drag on the economy, especially for fixed investment.

Consumer

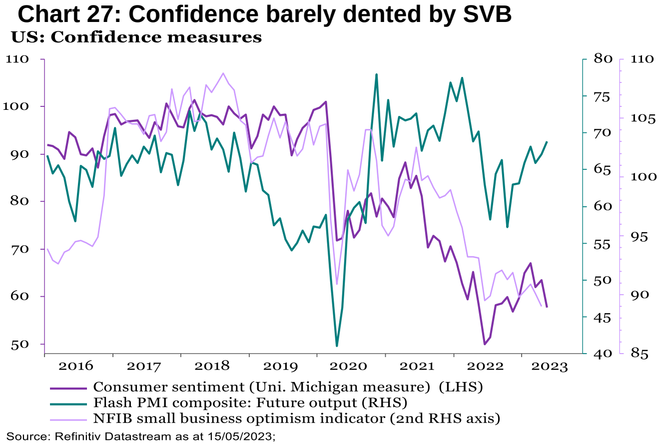
For now, employment gains remain robust and mortgage rates are off their highs. However, consumer confidence levels are still below where they were pre-pandemic. US households have also eroded their stocks of savings built up post-pandemic (especially in real terms). However, real income growth remains positive month-on-month as inflation has fallen back and real personal spending growth has been surprisingly resilient for several months (Chart 30).

Chart 26: Business surveys signal (a bit of) growth



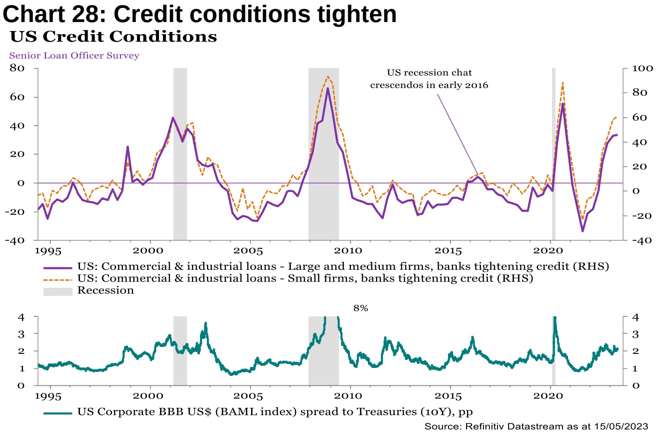
Source: Refinitiv Datastream, BEA, S&P Global, ISM. Data to Q1 2023 (GDP), May 2023 (PMI), April 2023 (ISMs)

Chart 27: Confidence barely dented by SVB



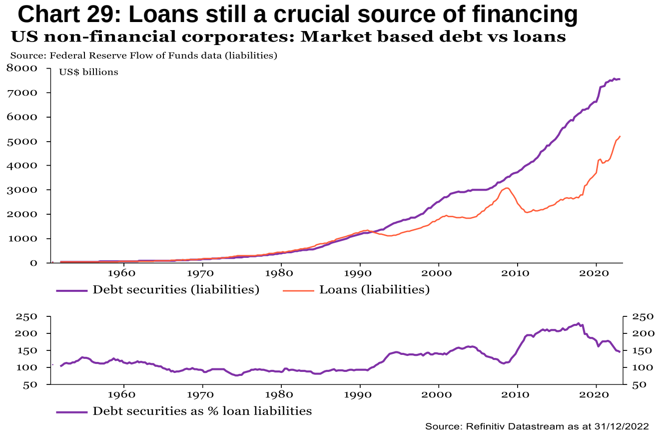
Source: Refinitiv Datastream, University of Michigan, S&P Global, NFIB. Data as at May 2023 except NFIB which is to April 2023.

Chart 28: Credit conditions tighten



Source: Refinitiv Datastream, Federal Reserve, BAML. Senior Loan Officer survey data is for Q2 2023; Corporate bond spread figures are to 24th May 2023

Chart 29: Loans still a crucial source of financing



Source: Refinitiv Datastream, Federal Reserve. Data as at Q4 2022

Recession indicators still flashing

The US economy's relative resilience so far (unemployment remaining very low and OK-ish GDP growth) has been reassuring. However, recession warning signs in the data are numerous, from the strong inversion of the US yield curve (Chart 31), to credit conditions (Chart 9), to the degree of weakness seen in residential investment (Chart 32) and even indicators like the gap between the University of Michigan and Conference Board measures of consumer confidence (which tends to be quite wide before recessions, as it is currently). The Federal Reserve simply doesn't have a stellar record at achieving soft landings either.

Inflation: Less headline inflation, but more stubborn core services measures

US inflation is falling: Headline CPI has fallen every month since June 2022. However, to gauge underlying inflationary pressures, it is useful to look at various measures of core and core services inflation. Those measures continue to send somewhat less reassuring messages. So-called super-core inflation (core services ex-housing) which the Fed seems to put a considerable weight on when thinking about where inflation will settle, remains elevated (Chart 33). However, core measures are showing some signs of shifting lower month-on-month and measures of pay growth have mostly slowed.

Base effects, lower commodity prices and easing supply chain problems mean US inflation still has a bit further to fall this year and slower pay growth should help support lower core inflation..

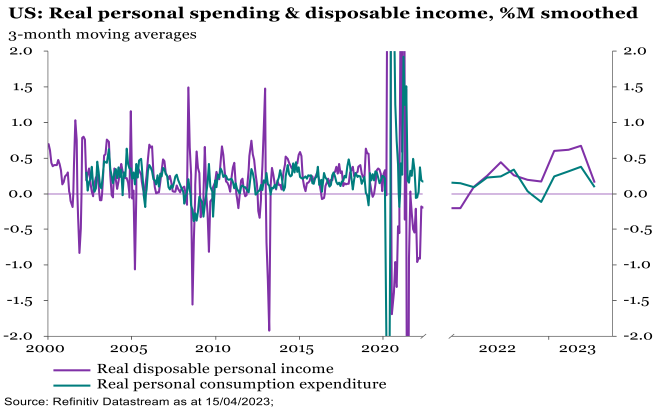
Monetary policy: Lingering in the restrictive zone

The forecasts on page 2 assume the Fed is almost done raising rates. The inflation picture is a bit more reassuring than it was (see above). US pay growth at close to 4% on some measures, also looks closer to the kind of levels the Fed should be able to 'live with' (that level, crudely in my view, is a reasonable forecast of productivity growth plus the 2% inflation target). With a further tightening in credit conditions still feeding through, I assume that this rate hike cycle ends after one more 25bp hike, potentially after a June pause. However, I see risks to that view as being skewed in the direction of more rate hikes rather than fewer.

US fiscal: A source of risk

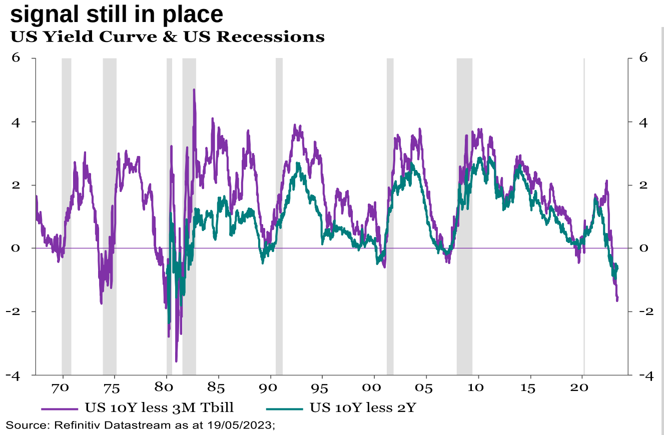
Beyond the short-term concerns caused by the latest debt ceiling stand-off/negotiations and more positively, although the US fiscal stance appears relatively neutral, the Inflation Reduction Act may be having more of a macro impact than perhaps expected with tax credits combined with local content rules enhancing the fiscal impact through the supply chain (see, for example, Reuters: 'How companies are reacting to the US Inflation Reduction Act, February 2023). Local content rules risk significant inefficiencies by pushing companies towards sourcing more expensively. However, for now we may see an impact on US activity driven by the Act that belies the overall fiscal stance.

Chart 30: Stronger real income = stronger spending



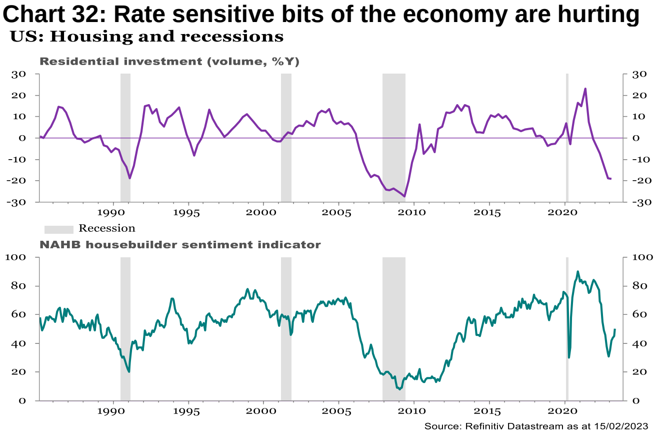
Source: Refinitiv DataStream, BEA. Data to April 2023

Chart 31: Yield curve inversion – classic recession signal still in place



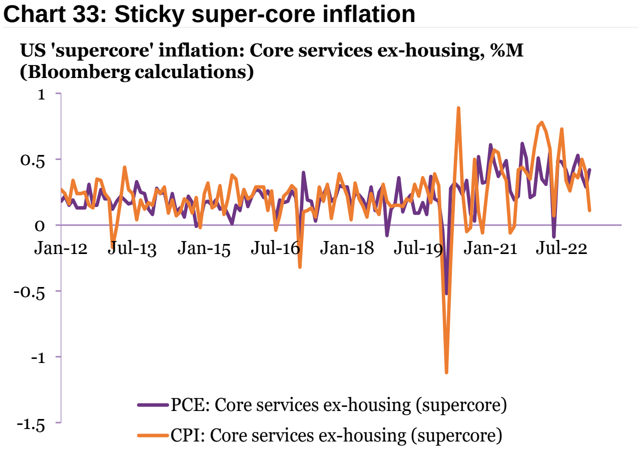
Source: Refinitiv Datastream, as at 19th May 2023

Chart 32: Rate sensitive bits of the economy are hurting



Source: Refinitiv DataStream, BEA, NAHB. Residential investment to Q1 2023 and NAHB indicator to May 2023

Chart 33: Sticky super-core inflation



Source: Refinitiv Datastream, Bloomberg Finance L.P. as at April 2023

China: A disappointing bounceback

China's economy continues to bounce back from the period of zero tolerance Covid restrictions. However, recent data has disappointed. Policy support hasn't been as strong as seen in many other countries coming out of Covid restrictions, but may step up in light of fading activity growth. Worries about financial stability and inflation are likely to limit policy support, however. Unless China's recovery becomes significantly more capex and property-centric, a recovery that significantly boosts global inflation seems unlikely either.

Activity: A disappointing bounce

Q1 GDP figures suggested a decent bounce in growth (2.2%Q) after abandonment of the Covid-zero tolerance policy, after a subdued Q4 2022. However, late Q1 and early Q2 2023 activity data have disappointed. Recent business surveys – both April composite NBS and Caixin PMIs – were consistent with rising output, but fell compared to March and were weaker than expected (Chart 34). Aggregate financing and loans data was weaker than expected in April and April's retail sales and industrial production releases both showed lower than expected growth. Although the unemployment rate appears to be falling, youth unemployment has emerged as a substantial problem in China (see, for example, New York Times).

Recovery dampeners

There are a number of things that matter for the character of China's recovery – and the impact it has on the global economy. One will be how capex intensive that recovery is. Actual fixed asset investment figures look relatively solid, but are not spectacular by China standards. Loan growth does not look especially strong by China standards either. Meanwhile, tense relations with the US – alongside increased tension across the Taiwan Strait – might hold some export-oriented firms back from making longer-term investment decisions. There has been significant political change in China too over the past year (again, by China standards), which might also leave some firms less clear on the likely operating environment over coming years for private enterprise.

Another factor will be the reluctance (or otherwise) of Chinese consumers to ramp up their spending. China's households built substantial savings in aggregate over the Covid period when spending was supressed. However, a combination of factors may work against a consumer boom: Falls in house prices may have dented both household wealth; Chinese consumers may prefer to run with higher saving stocks after the Covid shock; The unemployment rate had become relatively elevated by China standards and some of the business survey measures of employment growth have been subdued for a significant period (Chart 35).

How inflationary? If developed economy growth remains relatively modest, even a strong China recovery seems unlikely to be as inflationary in terms of creating supply chain bottlenecks. Monetary policy is not particularly loose in China either and authorities seem to remain reluctant to cut interest rates, though the required reserve rate has fallen further in 2023. In the central case, growth is driven by the consumer services sector which is less resource intensive than spending on goods. However, the more capex and property intensive China's growth, the more upside risk to global inflation via the impact on commodity and manufactured goods prices.

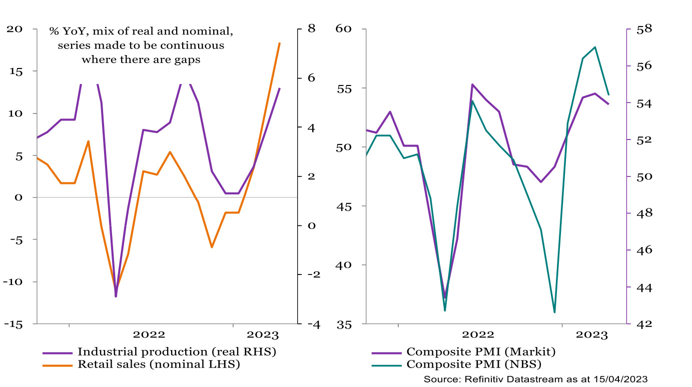
Policy: Likely to get more supportive

China's policymakers continue to signal accommodative policy. Fiscal policy looks set to be supportive and the PBoC's reserve requirement ratio has been cut further. However, the forecasts continue to assume that there is a limit to how far the authorities are willing to go. They continue to appear unwilling to generate very strong credit growth in the economy. However, with the recovery losing steam already, there is a good chance of another dose of fiscal policy support later this year. With inflation low, there is scope to add monetary policy stimulus, but authorities haven't seemed keen to do so to date and, given recent experience of very high inflation in the US and Europe, they may be reluctant to risk the same outcome by running with overly loose policy settings.

Long-term challenges remain substantial

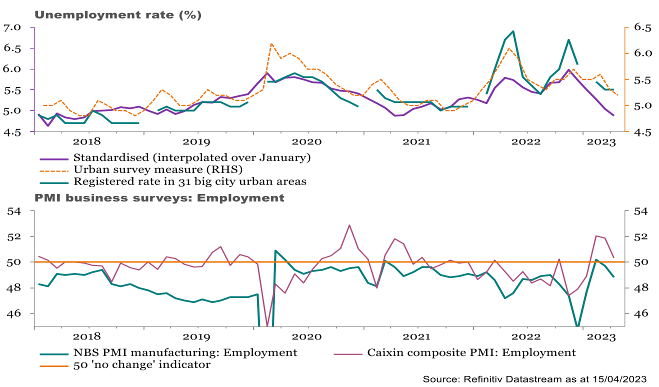
Long-term challenges facing China still include an overhang of private sector debt and population ageing. Working age population growth has been negative for several years (though there is arguably substantial room to raise the retirement age, see WSJ) and overall population growth was negative in 2022. China's stance towards Taiwan also presents a threat to China's growth outlook. Any military action against Taiwan would likely (at least) result in substantial sanctions against China with serious repercussions for both the domestic and global economy with Taiwan in and of itself a key player in tech industry supply chains in particular.

Charts 34: In a fading recovery



Source: Refinitiv Datastream, NBS, S&P Global. Data is to April 2023

Charts 35: Labour market indicators not strong



Source: Refinitiv Datastream, NBS, S&P Global. Data to April 2023

Euro area: Not so bad

The outlook for the Euro area economy remains less worrying than at the start of the winter. A few months ago, prospects were brightening as the worst fears around energy supply failed to come to pass. Business surveys suggest that growth in economic activity has been relatively robust into Q2. A technical recession looks less likely than it did and is no longer central case, but the growth forecast isn't strong either. High domestically driven inflation and continued monetary policy tightening dull the outlook. Credit conditions will need monitoring for risks of a more serious downturn and I still worry about the chance of recurrence of some of Europe's energy supply problems (albeit to a lesser degree than in late 2022).

Activity: Economy remains surprisingly resilient, but isn't exactly flying

GDP growth was slightly negative in Q4 2022 and slightly positive in Q1 2023 (i.e. activity levels have been roughly flat since Autumn 2022). Admittedly though, that is better than the recession that was widely forecast for the same period with the euro area last winter facing high inflation, ECB rate hikes, and the risk of needing to curb energy demand further. In the event, policy action (and lack of a very cold winter) helped the region avoid energy supply trouble. Since Q1, the PMI business survey composite indicator has remained above the 50 'no growth' level, although the European Commission's economic confidence indicator continues to signal a weaker picture (Chart 36).

Tighter credit conditions: A drag on growth

Though no longer expecting a recession later this year, I am still pencilling in continued lacklustre growth into 2024. That largely reflects the scale of monetary policy tightening seen so far and the tightening already seen early this year in credit conditions as reported by lenders in the ECB's Bank Lending Survey (Chart 37).

Business optimism has improved and has seen only a modest dent in light of March's financial volatility. Meanwhile the latest crop of capex indicators look consistent with relatively robust business capex growth. However, business loan growth has slowed substantially and bank lending remains the dominant source of debt financing for firms in the euro area – especially smaller ones – although the average share of bonds in debt financing has risen.

According to the ECB's Lane, by February 2023, euro area firms were paying 250bp more in interest on new bank loans than at the start of 2021. This is something central banks generally want to see – indicating that the transmission mechanism of monetary policy is working. As deposit rates rise (with a lag), that should also reduce the incentives for firms to invest (rather than put funds on deposit). Banks have generally tightened their requirements for loan approvals. Meanwhile, the forecasts do not assume we've seen the end of ECB monetary tightening either.

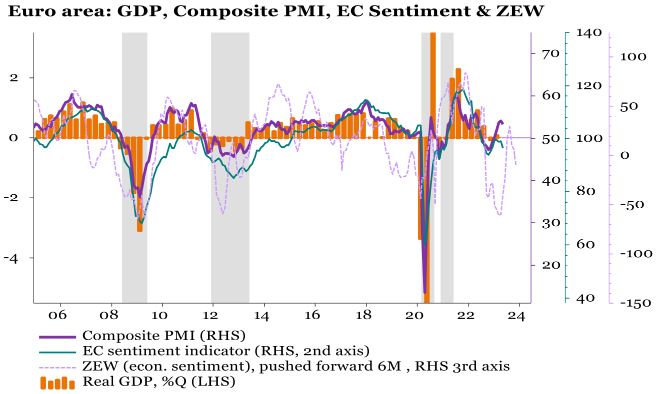
Consumer spending growth – on the brink of better?

Though credit conditions may squeeze both employment and consumer spending more directly, stronger wage growth and still low unemployment against a background of falling headline inflation should help. My proxy real labour income growth measure is likely to have bottomed in Q1 and consumer confidence is now well off its lows (Chart 38). The resilience seen in consumer spending so far has already been somewhat surprising though and with central bank rate hikes ongoing, a *strong* bounce in consumer spending in 2023 seems unlikely too.

Inflation: Off its peak, but more of a domestic story…

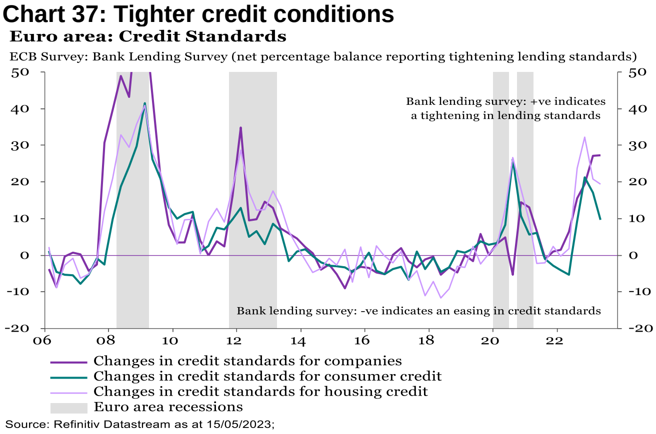
Euro area inflation remains at very high levels (Chart 39), but has fallen from its peak, helped by sharply lower energy inflation, and looks set to have fallen further based on the preliminary May data. However, the euro area inflation story is looking more and more domestically driven. Services inflation – a proxy for more domestically driven inflation pressures – remains at very high levels relative to its history (Chart 39). Pay growth has also been rising (Chart 40). Profit margins may also be playing a role where lower input price inflation has not been followed by lower core goods inflation in the same way as elsewhere (Chart 19). Inflation expectations measures have been mixed lately, rather than uniformly reassuring.

Chart 36: Surveys consistent with positive growth



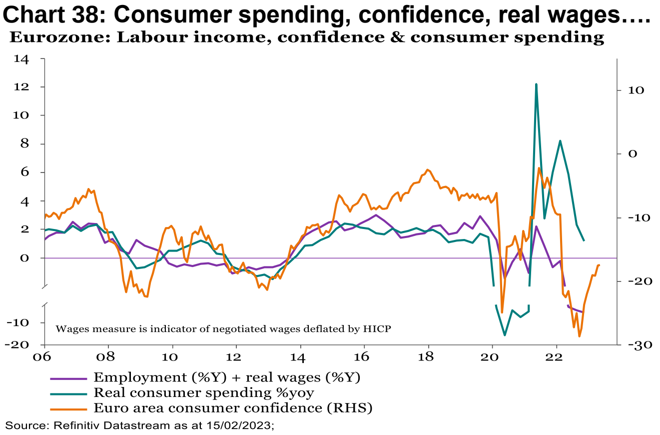
Source: Refinitiv Datastream, S&P Global, ZEW, EC, Eurostat. Data to May 2023 (except GDP which is to Q1 2023).

Chart 37: Tighter credit conditions



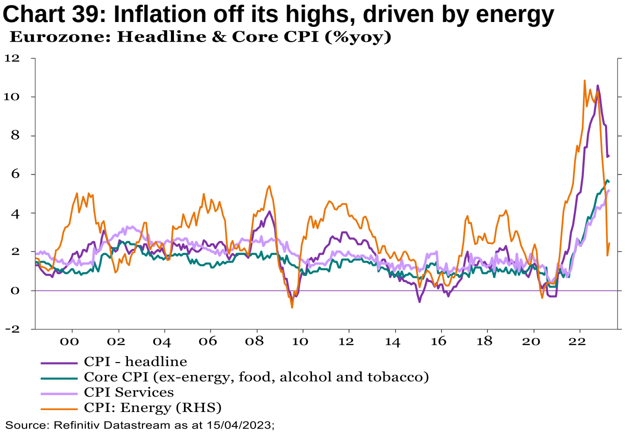
Source: Refinitiv Datastream, ECB (data to Q2 2023)

Chart 38: Consumer spending, confidence, real wages….



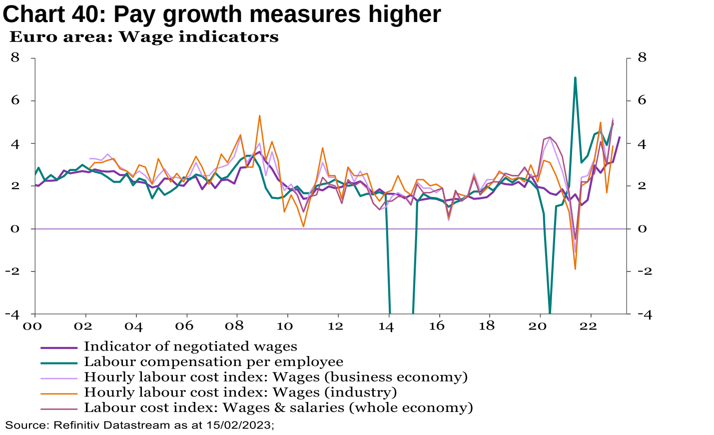
Source: Source: Refinitiv Datastream, Eurostat, European Commission. Consumer spending and labour market data is to Q1 2023; consumer confidence is to May 2023.

Chart 39: Inflation off its highs, driven by energy



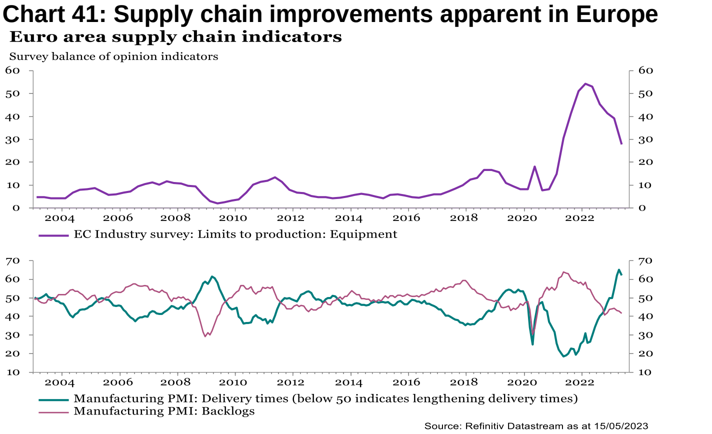
Source: Refinitiv Datastream, Eurostat. Data to April 2023

Chart 40: Pay growth measures higher



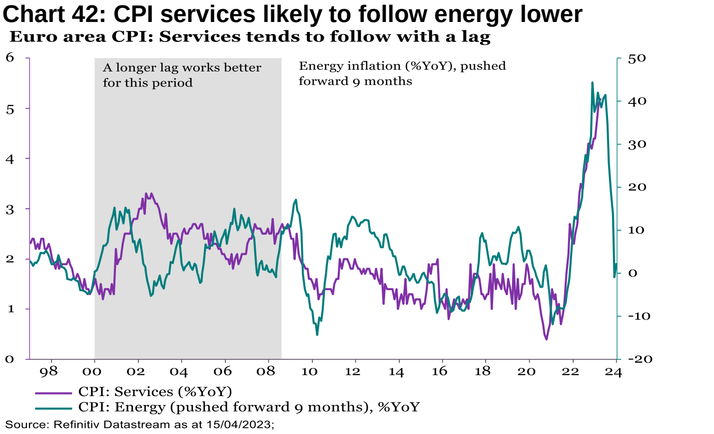
Source: Refinitiv Datastream, ECB, Eurostat. Data is to Q4 2022 except negotiated wages (Q1 2023).

Chart 41: Supply chain improvements apparent in Europe



Source: Refinitiv Datastream, European Commission, S&P Global; data to May 2023 (PMI), Q2 2023 (EC)

Chart 42: CPI services likely to follow energy lower



Source: Refinitiv Datastream, Eurostat. Data is to April 2023.

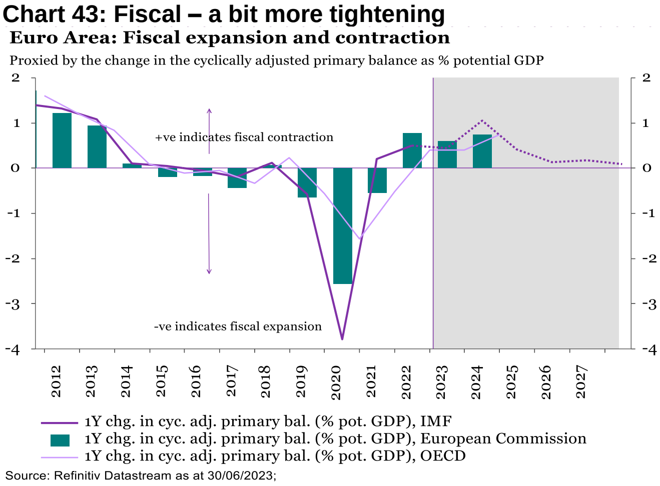
Core (helped by eased supply chain problems – Chart 41) and more domestically led inflation should follow energy/food inflation lower with a lag (though as Chart 42 shows, this lag with services CPI has not been stable over time). The forecasts on page 2 assume that inflation falls in 2023 driven by base effects and supply chain improvements but does not assume that the ECB get headline inflation to settle sustainably below 2%.

Policy: Industrial policy steps up, but will the ECB overdo it?

Tightening, but industrial support: Aggregate proxy measures for fiscal tightening or loosening are consistent with fiscal tightening over the next couple of years (focusing on the change in the cyclically adjusted primary balance) (Chart 43). The overall fiscal stance doesn't tell the full story either. EU policymakers have been responding to the US Inflation Reduction Act in recent months. That act not only provided subsidies in the form of tax credits but also tied those to local content rules in terms of production and sourcing. The European Commission has, for example, loosened its state aid rules to make it easier for member states to support sectors re. the transition to net zero. They have also set targets for EU manufacturing capacity for "strategic net zero technologies". The fiscal rules could become more of a source of tension though too. France stands out with the government's projected deficit above 3% GDP until *2027*.

More ECB tightening: The ECB have hiked a bit less than either the BoE and Fed despite also sitting with tight labour markets and uncomfortably high inflation. Several ECB members were openly considering or advocating for a 50bp hike in May still. Given the more domestic inflation story, the more resilient than expected demand story and recent relatively hawkish central bank communication, the central forecast now assumes the ECB hikes 25bp three times more - more than previously forecast.

Chart 43: Fiscal – a bit more tightening



Source: Refinitive DataStream; IMF (updated April 2023), European Commission (updated May 2023), OECD (updated November 2022)

Will the ECB end up overdoing it? We have likely not seen the peak impact of previous tightening on the economy yet. There remains a significant risk that the ECB ends up hiking too much and that the impact, with a lag, on the real economy and inflation prove stronger than expected. The ECB might, for example, overestimate the sustainability of strong wage growth; it is unclear to me to what degree stronger wage growth is being driven by changing inflation expectations, lagged actual headline inflation or a tight underlying labour market. On the latter, for example, business survey measures of labour market tightness from the European Commission have eased a bit (Chart 22).

The risk of 'overdoing it' could also work through peripheral bond yields. Countries with especially high debt levels, look relatively more vulnerable in a higher yield environment. Although the ECB now have more tools to tackle a widening in peripheral spreads to avoid damaging the monetary transmission mechanism, these tools are largely unproven

Japan: Inflation story still building

Growth in Japan is dented by sluggish developed economy growth in the central case, but will benefit if China grows relatively strongly and should also gain from loose domestic policy settings. Risks of a near-term shift in monetary policy seem to have receded in light of new BoJ Governor Ueda's messages of policy continuity. However, inflation remains high by Japan standards and the odds of a policy tightening at some point in the next 12 months remain high. Some attempt to reform yield curve control (YCC) seems likely. The forecasts still assume that YCC ends at some point this year and now assume that there is a move away from a negative policy rate amid a forecast of decent GDP growth and strong inflation (by Japan standards).

Inflation – more and more domestic?

Some core measures of inflation have continued to rise in Japan (Chart 44), even while headline inflation has fallen back a bit following energy subsidies. Notably, services inflation has continued to rise. As elsewhere, services CPI should better reflect domestically driven inflation pressure than headline inflation. At 1.7%Y in April 2023 (2.4%Y ex-imputed rent), services inflation is still at very low levels by say recent European standards. However, that is the highest rate of services inflation since 2015 when the VAT hike boosted inflation and, before that, 1998. Encouragingly from a BoJ perspective and coming after a very long period of very low inflation, inflation expectations on the Tankan measure showed a renewed pick up in the Q1 2023 figures (Chart 45). Wage growth will clearly be important in assessing underlying domestically driven inflation pressure. News on wage negotiations signal higher pay growth and (unlike in the US and Europe) BoJ Governor Ueda has made it clear they *want* faster wage growth to ensure they hit their inflation target.

Outlook shielded by loose monetary policy and China recovery

The picture coming from business surveys and some of the hard data has become more upbeat of late with generally stronger business surveys and Q1 GDP growth stronger than expected (Chart 46).

Japan faces some of the same challenges to growth as elsewhere. Real pay growth is negative, however indications from wage negotiations suggest a welcome step up in pay growth is coming and headline inflation remains lower than in many other major economies and has been temporarily supressed by increased energy subsidies. Consumer confidence seems likely to recover further against that backdrop. Meanwhile households have a high stock of savings and real rates are negative.

China's recovery should be a support for growth and Japan is not experiencing the same tightening of monetary policy as elsewhere. The risk of Japan slipping into a recession looks less than in several other major economies. The forecasts assume that Japan doesn't experience recession, but given how low Japan's trend growth is, the chance of at least one negative GDP growth quarter in 2023 nevertheless looks high.

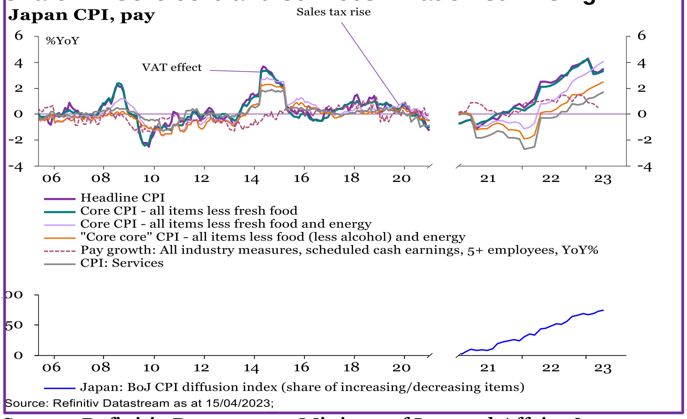
Longer-term prospects for Japan remain hampered by demographic challenges. The 'working age' population aged 15-64 continues to decline and average productivity growth has not been strong in recent years (see More rate hikes, less growth).

Ueda: BoJ continuity…for now

The BoJ continues to reiterate its accommodative policy message, but December's widening of the target range for the 10-year bond yield, while being framed as being about market functioning, was seen by many observers as a precursor to abandoning yield curve control (YCC). New BoJ Governor Ueda has said that the BoJ must consider normalising its yield curve control policy if the price outlook improves, but his overall message has been one of policy continuity so far.

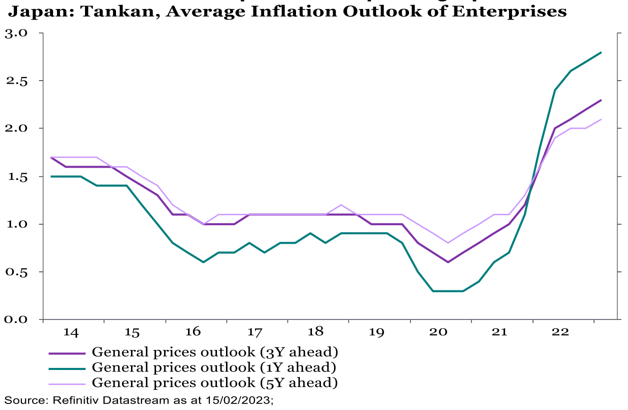
The end of YCC or a substantial degree of YCC reform looks a high probability in 2023, especially given the recent path of core/services inflation, but a move out of negative territory for interest rates also looks a significant probability in the next 12 months. By October, CPI will likely have been above target for two years. I would assume that the BoJ would want to provide more hawkish forward guidance before a rate move and I have *tentatively* pencilled in a rate rise in late 2023. However, the BoJ's core CPI forecast is below 2%Y in 2025 and there remains a good chance that little changes on the monetary policy front this year.

Chart 44: Core core and services inflation still rising



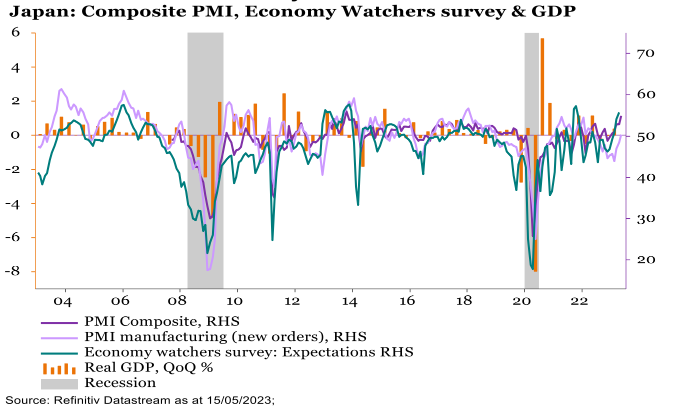
Source: Refinitiv Datastream, Ministry of Internal Affairs & Communication, Ministry of Health, Labour and Welfare, Bank of Japan as of April 2023.

Chart 45: Inflation expectations picking up



Source: Refinitiv Datastream, Bank of Japan as of Q1 2023.

Chart 46: Business surveys mixed



Source: Refinitiv Datastream, S&P Global, Cabinet Office. GDP data is to Q1 2023, Economy Watchers to April 2023, PMI to May 2023

United Kingdom: Going nowhere fast

The outlook is still lacklustre in the UK, but looks better than just a few months ago. A technical recession is still assumed for the UK in the next 12 months, but a modest one. There are still risks from the housing sector, however, and risks to the business investment outlook. Rate hikes are still feeding through to the consumer. High inflation is also still at risk of becoming more embedded in the UK and therefore requiring significantly more rate hikes.

Activity: Flat-lining

Q1 GDP growth came in at 0.1%Q and March GDP contracted. It remains the case that UK GDP has barely grown at all since late 2021 (Chart 47). The UK has managed to escape a technical recession so far, but not in a way that distinguishes the economy much from having been through a modest technical recession. UK payrolls data suggest that job numbers fell in April, but April (and May) business surveys (Chart 47) were consistent with a relatively robust growth rate in private sector activity.

Is the UK really still bottom of the class?

A lot about starting point: Continuing a narrative from late last year, consensus forecasts still suggest that the UK will perform among the worst of major economies (except perhaps Sweden). Is the UK really in a worse place than elsewhere? Low UK forecasts partly reflect a weak starting point. The UK economy shrank in Q3 2022 then recorded only a slight amount of GDP growth in Q4. With UK GDP so flat (Chart 48), mechanically, that means that it is easier for the UK to record a full year of negative GDP growth than it would be for an economy (like the US for example) which came through the turn of the year with relatively robust GDP growth rates. The UK also continues to face a substantial list of challenges. Consumer confidence remains at low levels (even if off the lows). Fiscal plans still indicate future tightening and mortgage rates have still risen sharply over the last year (which will weigh on successive cohorts of households as fixed rate mortgages steadily roll off). The housing market has slowed – both in terms of prices and activity and the level of mortgage approvals is now relatively low. Brexit remains a challenge for businesses. Inflation remains high. Business insolvencies have risen.

The UK still faces significant long-term challenges including an ageing population, unsustainable-looking fiscal finances (last year's longer-term fiscal estimates from the OBR still describe UK finances as on an unsustainable path in the long term) and sustained weak productivity growth. The UK also seems to be facing at least a medium-term challenge around labour force participation where multiple issues – from post-Brexit immigration policy to an underperforming health service – may be playing a role.

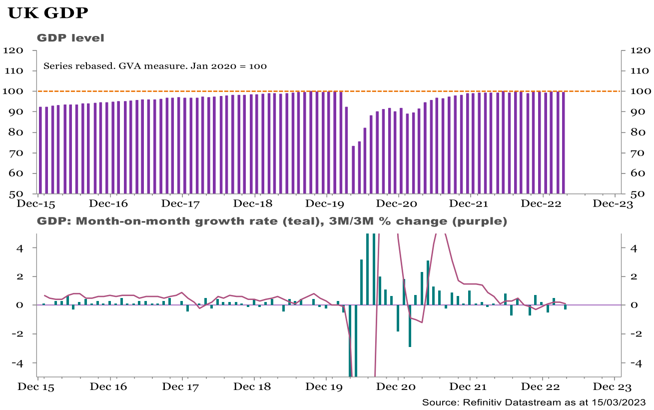
***However*, the outlook has improved rather than worsened over recent months**. The UK was not at the heart of worries around banking stability and financial volatility in the Spring. The UK's vulnerability to higher mortgage rates is significant but, given the very high proportion of fixed rate mortgages now in the UK, that impact will be spread over several years. Fixed mortgage rates have also fallen from their October 2022 (post mini-Budget) highs (Chart 49). Fiscal tightening continues to be pushed out and near-term stimulus was added at the March Budget. Lower headline inflation over 2023 should also alleviate some of the financial pressure on households. Energy bills should fall in H2 2022. A sizeable proportion of households will also benefit from the strong recent uprating in benefits and pensions and nearly 10% increase in the minimum wage. The political backdrop is more stable than it was last year and sources of Brexit-related uncertainty for businesses have arguably eased with the government abandoning its plan to review or scrap all retained EU law by the end of this year.

A gradual hit from higher rates

More of a hit from mortgage rates to come – but spread out and softer than looked likely a few months ago: The BoE track the percentage of households with high mortgage debt burdens and expect them to increase over 2023 to levels comparable with the start of the financial crisis. However, as of Q4 2022, the rise in household debt service burdens looked small in aggregate (Chart 49). The percentage of GDP which is residential investment appears to have risen though, implying that GDP growth may now be more vulnerable to changes in new build trends. According to government data, housing starts have fallen and Chart 50 suggests that could be a precursor to a significant fall in at least the dwellings portion of fixed investment.

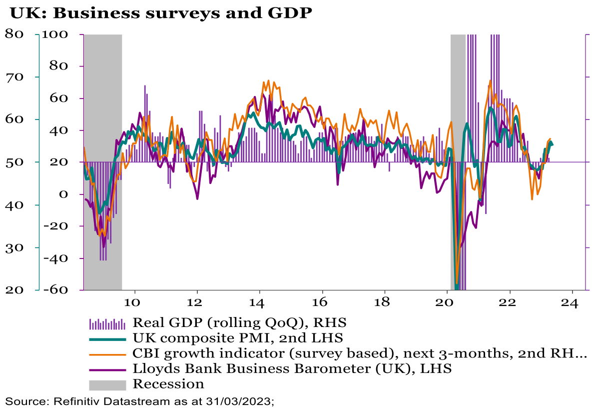
Businesses have been hit by higher energy bills and interest rates too and there was a notable jump in insolvencies in 2022, see Chart 51 (though some of these were probably 'delayed' from the pandemic period, that seems unlikely to account for all of the rise). Although business optimism has improved, investment intentions have been weak on some measures. The capex super-deduction may have brought forward some business investment. With that tax incentive now withdrawn, we may see some pullback in investment. The government has put in place some temporary tax adjustments that could smooth the adjustment. However, the new measures were not announced with much prior warning, likely limiting any potential smoothing effect.

Chart 47: UK economy flattish since late 2021



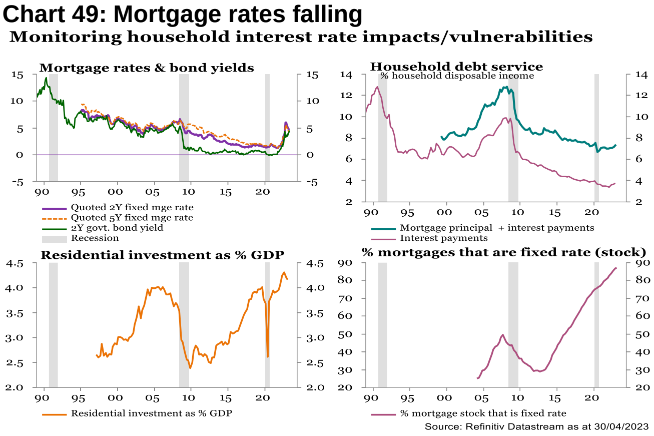
Source: Refinitiv Datastream, ONS. Data is to March 2023.

Chart 48: Surveys no longer signal recession



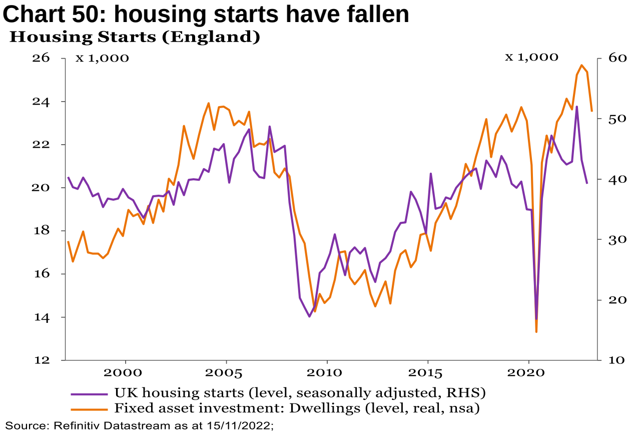
Source: Refinitiv Datastream, ONS, CBI, Lloyds, S&P Global. Data is to April 2023 except PMI which is to May and GDP which is to Q1 2023.

Chart 49: Mortgage rates falling



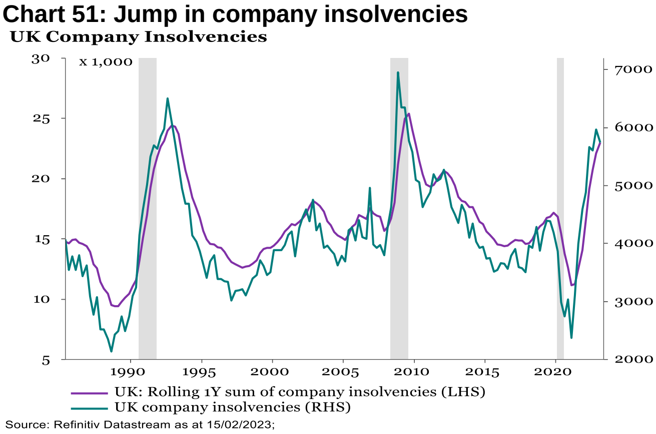
Source: Refinitiv Datastream; Bank of England, ONS. Mortgage rate data to April 2023, bond yields to 30th May 2023. Debt service data to Q4 2022. Other data to Q1 2023

Chart 50: housing starts have fallen



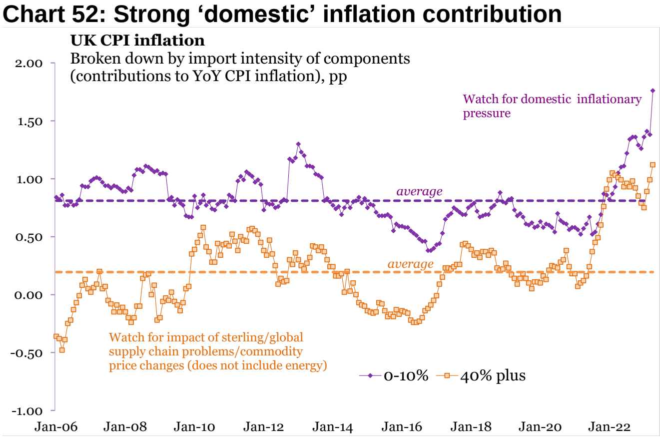
Source: Refinitiv Datastream; Department for Communities and Local Government, ONS. Data to Q1 2023 (residential investment) and Q4 2022 (starts)

Chart 51: Jump in company insolvencies



Source: Refinitiv Datastream; The Insolvency Service. Data to Q1 2023

Chart 52: Strong 'domestic' inflation contribution



Source: ONS. Data to April 2023

Watch credit conditions: Credit conditions tightened over 2022. As elsewhere, in light of financial volatility and US and European banking worries in the Spring, let alone additional BoE rate hikes and quantitative tightening, a further tightening in credit conditions looks a risk for 2023. A sharp further tightening of credit conditions could trigger a significantly worse recession than in the central case

Inflation: Risk of high inflation becoming embedded

The forecasts still assume that CPI falls significantly at headline level over 2022, but the central forecast also assumes some problems for UK inflation settling as low as the 2% inflation target. That reflects a remarkably resilient picture for domestically driven inflation pressure despite significant BoE monetary policy tightening. With the labour market still looking tight and forecasts for GDP growth less negative than they were, core inflation is likely to be a little more supported than previously expected (although in the forecast that is assumed to be partly offset by the stronger sterling seen over the last few months). Wage growth remains strong for now and companies expect substantial wage growth in 2023. The UK's labour market issues may also have a stronger structural element than in the US or euro area. While all three saw drops in the labour force over Covid, the UK stands out for not having seen a recovery back to pre-Covid levels although levels of inactivity have fallen in recent months.

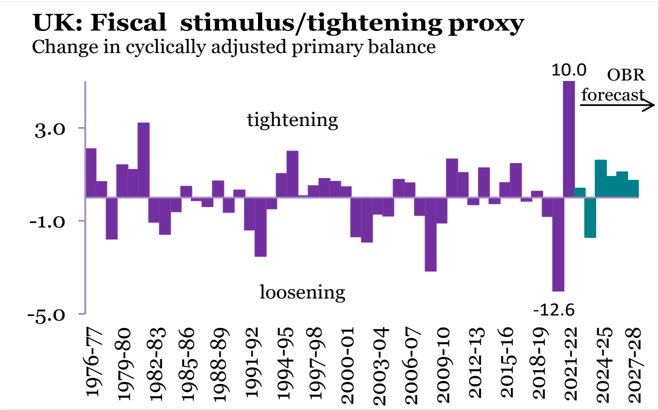
The contribution to CPI of the least import-intensive bits of inflation has been rising in recent months (Chart 52). Although household and corporate inflation expectations appear to have fallen somewhat, corporate CPI inflation expectations for example remain well above the 2% inflation target. I also take seriously the risk highlighted by the MPC's Mann that the number of backward-looking participants in the economy may have increased (in terms of the way they form inflation expectations), increasing the risk that high inflation proves harder than expected to eliminate.

Policy: Fiscal vs monetary

Fiscal gets more supportive: Although fiscal plans are still for tightening in the years ahead, the March Budget added significant fiscal easing to the near-term economy (Chart 53), including in the form of extended energy bill support.

Meanwhile, the Bank of England continues to hike, despite their central forecasts showing inflation below target 2-3 years ahead. They seem to be putting less weight on those central views and more weight on the upside skew of risks that they see to their inflation forecasts. Although not clearly guiding for further rate hikes, the Bank appear to be responding meeting by meeting to evidence of strong domestically driven inflation data. After a big upside inflation surprise in April and with domestically driven inflation looking so strong (Chart 52), the forecasts on page 2 pencil in another three 25bp rate hikes.

Chart 53: Fiscal tightening planned after near-term help



Source: Refinitiv Datastream, OBR. Data to March 2023

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Credit Risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

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Fund investing in Funds Risk: The Fund is valued using the latest available price for each underlying investment, however it may not fully reflect changing stockmarket conditions and the Fund may apply a 'fair value price' to all or part of its portfolio to mitigate this risk. In extreme liquidity conditions, redemptions in the underlying investments, and/or the Fund itself, may be deferred or suspended.

Liquidity and Dealing Risk: The Fund invests indirectly in assets that may at times be difficult to value, harder to sell, or sell at a fair price. This means that there may be occasions when you experience a delay in being able to deal in the Fund, or receive less than may otherwise be expected when selling your investment.

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