Investment Clock – Economic Update

Issue #29, October 2023

Multi asset views

Royal London Asset Management manages £154.7 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 August 2023

This month's contributor

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Senior Economist

US: Q4 looks set to see a few growth challenges; monetary policy is restrictive; employment growth has slowed. A number of recession indicators are still flashing, though the forecasts only assume a mild pullback.

China: China's economic data has disappointed, as has the policy stimulus response. More policy support seems likely, but the forecasts assume GDP growth slows rather than picks up in coming years.

Eurozone: A mild recession continues to look likely to me. Tighter monetary policy is feeding through to the real economy, but I assume rates have peaked.

Japan: Growth in Japan looks more resilient for now but faces challenges. Robust inflation will likely bring a rate hike in coming quarters.

UK: I assume a modest recession in the next 12 months, but peak rates are very close (or potentially already here) assuming no big burst of fiscal support and more labour market slack.

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

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Peak rates…probably

Things look a lot better than feared at the end of last year, but global growth seems to be spluttering again amid a disappointing bounce in China activity, slow-to-no growth in Europe and against a backdrop of restrictive monetary policy. The US still looks at risk of recession too, even if activity data to date has been fairly robust. Inflation has fallen a lot and, although higher energy prices threatened a revival in headline inflation, I expect other factors – including a soggy economic activity backdrop –to pull inflation lower. Policy interest rates have therefore likely peaked (or very nearly) in most major developed economies. There is more than one plausible direction the global economy could leap in next though.

Summary

Still assuming (modest) technical recessions: The lagged impact of monetary policy and associated tightening in bank lending conditions is still assumed to be enough to tip several major economies into mild recessions over the next 12 months.. Still, inflation is a lot lower than it was and, combined with robust pay growth, should support household spending and help economies avoid bigger downturns.

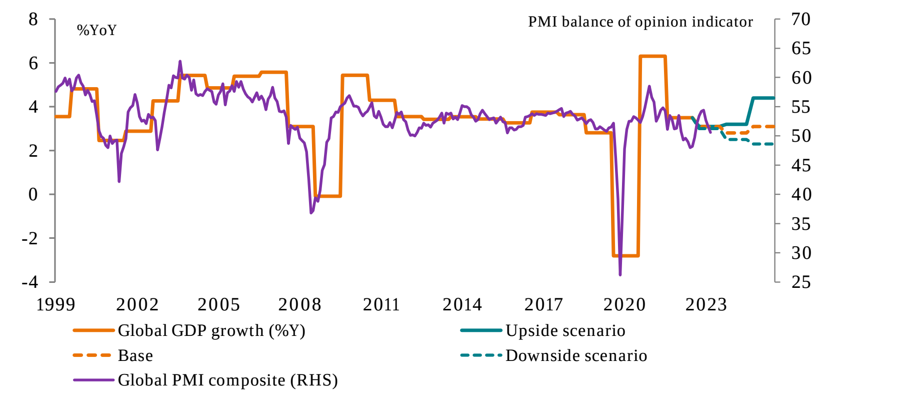
Plausible alternative scenarios: Lower externally driven inflation could still see inflation fall faster than expected, without the need for recessions and supporting a much stronger consumer. On the other hand, businesses and consumers may prove much more sensitive to higher interest rates than in my central case.

Inflation is key: How far and fast inflation falls will be important in determining the path of the economy. Higher oil prices in late Q3, look set to have delayed the return of inflation to target-consistent levels rather than derailed it. Sticky domestically driven inflation would risk renewed rate hikes (and a later, perhaps bigger fall in economic activity down the line).

Rate cuts a late-2024 event…in the central case: Given the experience of the last couple of years, it is likely to take a number of months and a lot of inflation data (including wage figures) before the likes of the Fed and the ECB will feel comfortable cutting rates. In the central case, rates are cut in H2 2024 as central banks build confidence that inflation is sustainably returning/returned to target. Significant recessions would speed things along. In Japan, the BoJ raises rates (a touch) in 2024 in the central case.

Our multi asset team have moved to only hold a modest overweight in equities. The macro backdrop has become less supportive and momentum has become less positive for the asset class as investors move to worry about the prospect of policy remaining tighter for longer than previously anticipated. More of the same would see them add to cash and bonds. Volatility normally rises in October, but a muddle-through economy would see the team expect to add to equities. For more, see the team's 'ClockWise' blog at www.rlam.com.

Chart 1: Global growth central case: Mild recessions



Source: IMF, S&P Global (past data); RLAM (forecasts). PMI data is to August 2023

Economic forecast summary

October 2023 base case

Region	2022			2023e			2024e			2025e		
	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4
US	1.9	7.1	4.50	2.1 *1.7*	4.0 *3.4*	5.50 *5.50*	0.7 *0.4*	2.7 *2.9*	5.00 *4.75*	1.3 *1.8*	2.3 *2.5*	4.00 *4.00*
China	3.0	1.8	– *–*	5.0 *5.4*	– *–*	– *–*	4.4 *4.8*	– *–*	– *–*	4.4 *4.6*	– *–*	– *–*
UK	4.3	10.8	3.50	0.5 *0.3*	4.6 *4.4*	5.50 *5.50*	0.3 *0.3*	2.4 *2.7*	5.00 *5.00*	1.1 *1.1*	2.5 *2.6*	4.50 *4.50*
Euro area	3.4	10.0	2.50	0.4 *0.1*	3.4 *3.2*	4.50 *4.50*	0.5 *0.4*	2.5 *2.5*	3.75 *3.75*	1.4 *1.4*	2.3 *2.4*	3.00 *3.00*
Japan	1.0	3.9	-0.10	1.9 *1.5*	2.6 *2.6*	-0.10 *0.00*	1.2 *1.1*	1.6 *1.7*	0.00 *0.00*	1.0 *1.0*	1.5 *1.6*	0.00 *0.00*
Global	3.2	– *–*	– *–*	3.1 *3.0*	– *–*	– *–*	2.8 *3.0*	– *–*	– *–*	3.1 *3.2*	– *–*	– *–*

Source: LSEG 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 July 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 risk is for further rate hikes from the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE), but the central case is that peak rates have been (largely) reached with real rates now well into positive territory. In Japan, the forecasts assume that 2024 sees a rate hike (finally) from the BoJ with further reform of yield curve control likely too.
- The forecasts assume modest rate cuts in late 2024 in the US and Europe, but primarily driven by confidence in the inflation outlook rather than a deterioration in the real economy/recessions. In isolation, a sharper than expected downturn and a worse than expected profile for the labour market would likely see further and faster cuts than in the base case (partly by increasing policymaker confidence that they have done more than enough to tame inflation and by sharply increasing concerns around over-tightening).
- 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

- Headline inflation falls much more than expected to below target rates in the near-term, driven by lower core goods prices and the lagged impact of lower energy inflation, boosting real household incomes. Exported deflation from China, looser supply chains and a lack of further energy or food driven supply shocks all help. Higher labour market participation than in the base case also helps restrain services inflation somewhat.
- Consumer spending is much higher than in the base case and unemployment much lower.
- Central banks prove less willing to cut rates and more inclined to keep rates high for longer as both pay growth and services inflation remain higher than pre-crisis norms.

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

- The forecasts show relatively slow 2024 GDP growth with recessions in major economies generally pencilled in for late 2023 or mid-2024, driven by monetary policy tightening. The forecasts assume that bank lending conditions remain relatively tight well into 2024 and the lags of monetary policy are assumed to be a bit longer than usual. Moving into the second half of 2024 and into 2025, consumer spending is likely to be supported by lower headline inflation alongside still relatively robust wage growth.
- Inflation falls further at headline level. Domestically driven inflation pressures ease somewhat through 2024. Rate cuts (gradual, modest) follow in late 2024.

Downside scenario (20%): Lagged impacts of rate hikes stronger than expected

- Monetary policy tightening in the developed world has a lagged, but much stronger than expected impact on economies. Growth is lower and unemployment higher than in the central case.
- Inflation falls, with differences against the base case driven more by services and measures of underlying inflation than in the upside scenario.
- Monetary policy abruptly changes course in 2024 and rate cuts are more rapid and go further than in the central case. Interest rates, though lower than in the central case, do not fully return to pre-pandemic levels in most developed economies.

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: Room for disappointment

Things look an awful lot better than feared at the end of last year, but they don't look great either. China's bounce has disappointed, developed central banks have hiked rates even further. Even if they are probably now at around peak rates, the risks looked skewed towards 'high for longer' while economies continue to dodge recessions. Bank lending conditions look tighter than they were and the impacts of restrictive monetary policy are still being felt in the real economy. The central case assumes that neither the US, UK nor the euro area escapes recession, but that stronger real pay growth and a bit of fiscal help mean that those recessions are 'technical' and modest with the European economies giving more cause for concern for now than the US.

Status update: Global economy stumbling again

Using the global composite PMI business survey as a proxy for what is going on with global GDP growth (Chart 2), after a strong start to the year, global growth appears to have faded fast and is now toying with the kind of territory where economists start to at least mention recessions at a global level. Disappointing growth in China has met recessionary signals in Europe and a subdued growth signal coming from the US PMI too (though other US data paint a less downbeat picture). Business optimism/future expectations have been dented too, looking at other signals from the PMI data. Both manufacturing and services have played a role in the deterioration, with de-stocking playing a role in the former and tighter monetary policy likely playing a role in both. The more recent deterioration has been more about services than manufacturing. Central banks have hiked rates substantially year-to-date albeit major central banks policy rates are now generally widely felt to be at or close to their peak. Inflation remains (too) high. It has cooled dramatically from the peaks, but higher oil prices are threatening a renewed bout of higher headline inflation (Chart 9).

Summary outlook: The slumpy muddle-through

The forecasts on page 2 still envisage modest technical recessions, with consecutive quarters of modestly negative GDP growth pencilled in for the US, euro area and UK, despite continued surprising resilience in the face of shocks. The forecasts continue to see rate cuts as a late 2024 story, rather than a 2023 one though with insufficient progress being made so far in subduing domestically driven inflation. In the central case, rate cuts are more a response to confidence in a lower trajectory for inflation than as measures to fight recessions and job losses.

There are still more and less benign ways that current conditions of tight labour markets/high inflation can resolve. Lags of monetary policy and the path of externally driven inflation remain important determinants of which path the economy will take. On the more benign side, lower externally driven inflation and higher labour market participation can see inflation fall sustainably without the need for recessions and/or even tighter monetary policy while bolstering consumer spending. On the other side, it remains plausible that central banks have already done more than enough and that – with a lag – businesses and consumers will prove more sensitive to higher interest rates than most economists assume. In that scenario domestically driven inflation could drop abruptly.

A key driver of a slower economy: Bank lending conditions

Tighter bank lending conditions have followed in the wake of rate hikes (likely not helped by regional bank worries in the US earlier in the year) and are an important channel for the transmission for monetary policy. In the US, for example, the Senior Loan Officers Survey measure of bank lending conditions remains at 'recessionary' levels, associated with GDP growth weakening into mildly negative year-on-year territory (Chart 3). In both the US and Europe, this backdrop is more of a constraint on households and small businesses.

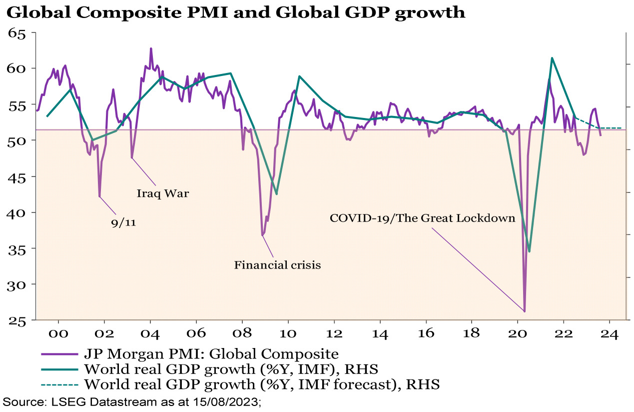
Consumer can be a key factor staving off deeper recessions

Challenges for the consumer remain significant... 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 is off its lows in major developed economies, but remains weak. 'Excess savings' built up during the pandemic have been seriously depleted too, especially in real terms.

...but things getting better on some measures: So far, it is still the case that unemployment rates remain very low in major developed economies. In Europe, pay growth has picked up, while headline inflation has fallen (Chart 4); the real income growth picture has improved rather than deteriorated (Chart 5). In the US, where inflation fell earlier, month-on-month real disposable income was positive for the 12 months to July 2023 (Chart 24).

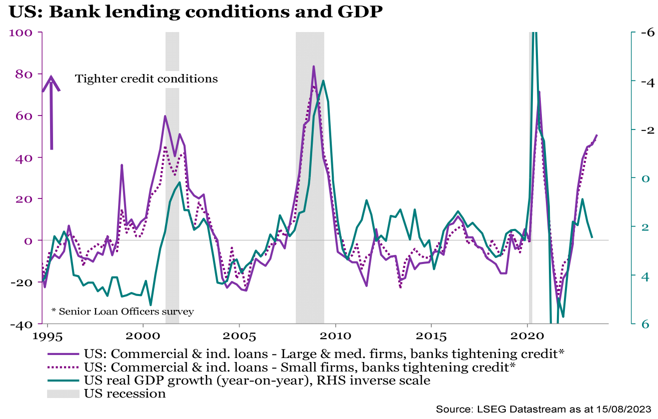
What happens to inflation from here then, is key to the global economic outlook: Further falls in headline inflation (crucially, not driven by recessions and job losses) can be part of a much more positive picture for global growth by helping consumer pay packets stretch further.

Chart 2: Global PMI entering recession risk zone again…



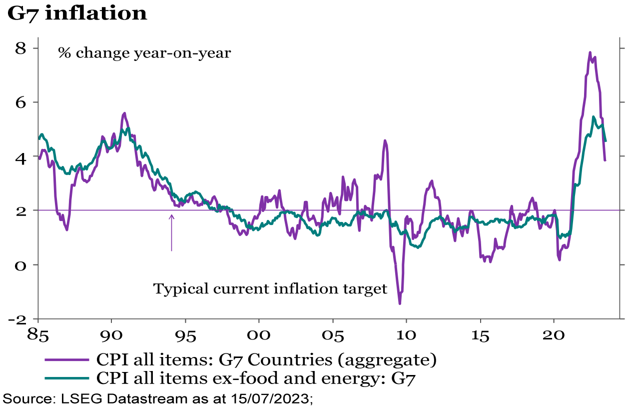
Source: LSEG Datastream, S&P Global as at August 2023. IMF forecasts from July 2023 update.

Chart 3: US credit conditions consistent with recession



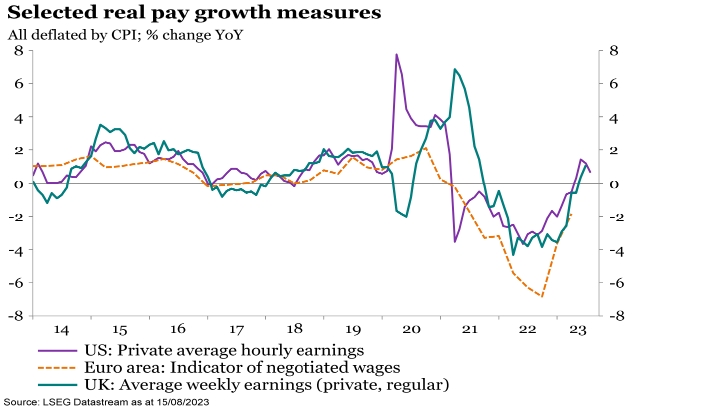
Source: LSEG Datastream, Federal Reserve, BEA. Data is to Q3 2023 except GDP which is to Q2 2023.

Chart 4: Lower headline and core inflation



Source: LSEG Datastream, OECD. Data as at July 2023.

Chart 5: Real income growth improves



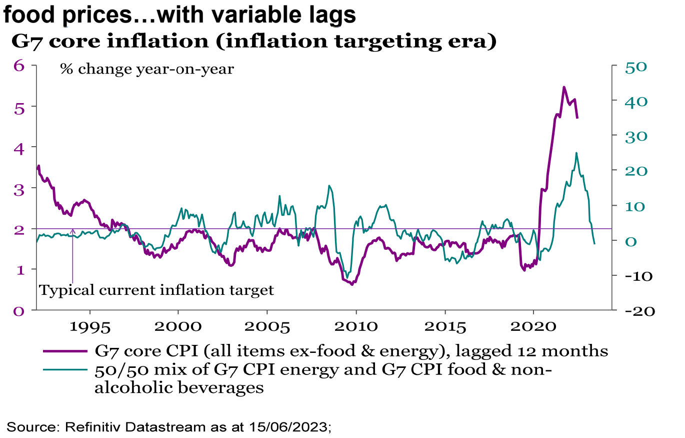
Source: LSEG Datastream, BLS, ONS, ECB, Eurostat. Data is to August 2023 (US), July 2023 (UK), Q2 2023 (euro area).

Inflation #1: Externally driven inflation has further to fall

Oil prices started to rise again in the summer, leading to increases in headline inflation in the US for example. **Could this have derailed the falling inflation story** (at least, the externally driven bit) or just delayed it? I think **more delayed rather than derailed**::

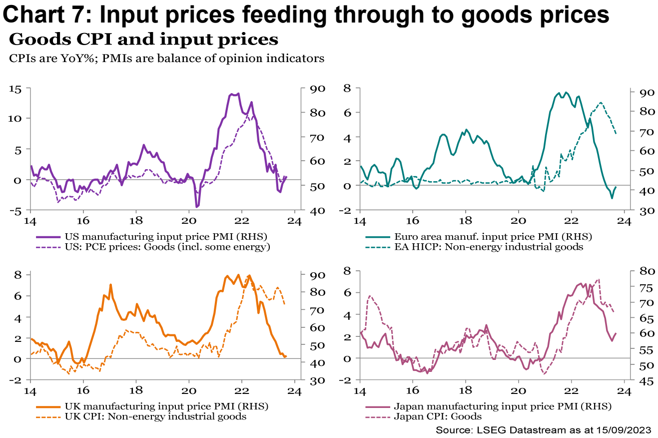
- First, past falls in energy inflation likely still have further to feed-through into lower core CPI inflation. Core inflation tends to follow non-core inflation with a lag (Chart 6). That makes sense since commodities will ultimately be key inputs for many 'core goods'. Lower headline inflation should also help moderate wage demands/settlements. Separately, easing supply chain tensions should help lower core inflation too.
- Second, based on survey measures of input prices of manufacturers, core goods inflation should fall further (Chart 7) in Europe in particular – though the lags are starting to look long lags are starting to look long when it comes to core goods inflation and may partly reflect that many 'core goods' in Europe will be imported rather than manufactured. However, even looking just at consumer goods *import prices* suggests European core goods CPI has a bit further to fall (Chart 8).
- Third, even if the oil price stayed at/returned to levels seen in very early October, year-on-year oil price inflation doesn't look set to rise enough to drive a big further leap in headline inflation (Chart 9). For the UK in particular, there is also still a powerful fall in year-on-year inflation set to come in October when last October's natural gas driven jumps in energy bills aren't repeated.

Chart 6: Core tends to follow peaks and lows of energy and food prices…with variable lags



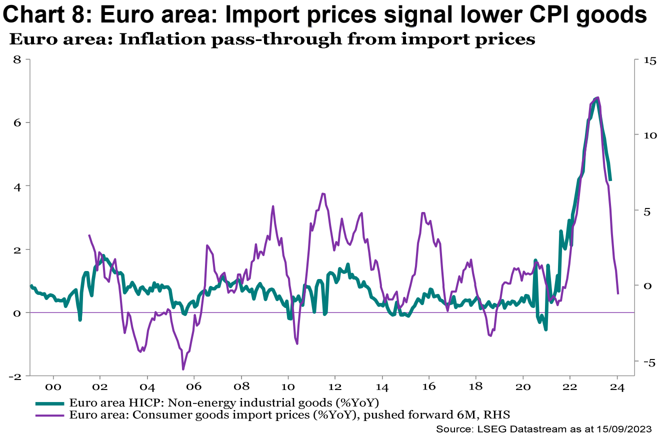
Source: LSEG DataStream, OECD, RLAM. Data to July 2023.

Chart 7: Input prices feeding through to goods prices



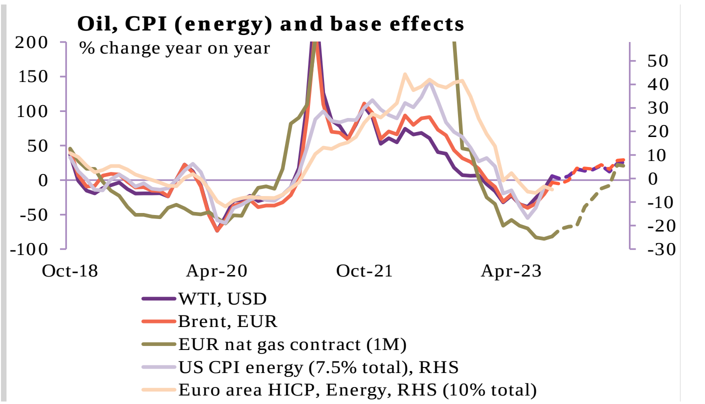
Source: LSEG Datastream, S&P Global, BEA, Eurostat, ONS, Ministry of Internal Affairs & Communication. Data as of August 2023 (CPI except euro area) and September 2023 (PMIs and euro area CPI).

Chart 8: Euro area: Import prices signal lower CPI goods



Source: LSEG Datastream, Eurostat. Data as of September 2023

Chart 9: Oil base effects



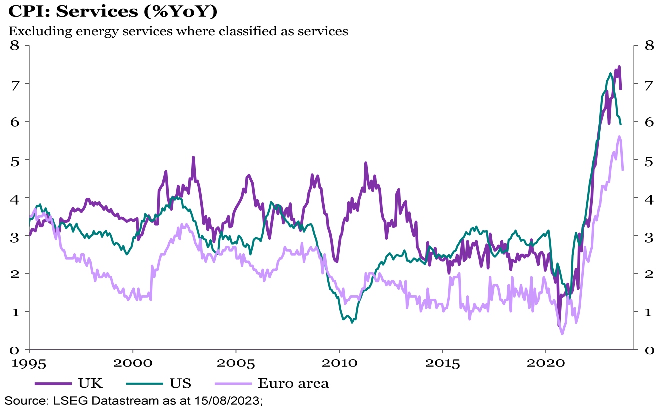
Source: LSEG Datastream, BLS, Eurostat, RLAM. Chart shows path for commodity price inflation if levels remain at spot rates as of 2nd October 2023. CPI data as of August 2023 (US) and September 2023 (Euro area)

Inflation #2: Domestically driven inflation can fall without big recessions, but risk is that it doesn't

The most domestically driven bits of inflation aren't slowing much. In the US, euro area and UK, services inflation remains strong (Chart 10). US 'super-core' inflation (core services ex-housing) is not showing a clearly established inflation-target consistent trend either (Chart 25). For central banks to seriously contemplate rate cuts, this needs to change. Lower energy, food and goods price inflation (as inputs) should feed through to services inflation with a lag. Lower headline inflation (see previous section) should lower pay demands too.

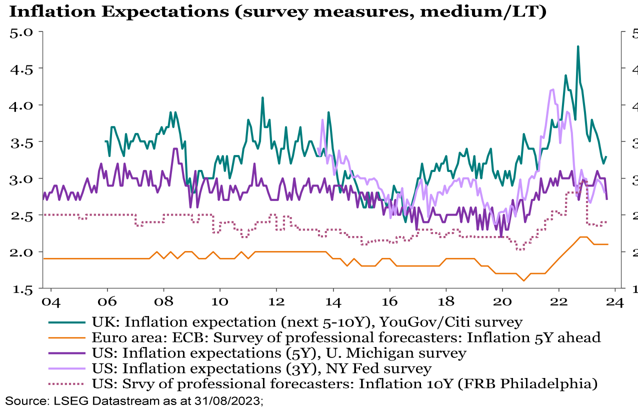
Tight monetary policy and looser labour markets should help: If wage dynamics stay strong and companies are confident they can pass costs on, these measures of inflation can stay high. Well-behaved inflation expectations would help; Survey-based measures in the US, euro area and UK look below their recent peaks (Chart 11) and rate hikes should have helped reinforce these expectations. Meanwhile, the point of maximum labour market tightness appears to have passed (again likely partly reflecting rate hikes): Job openings have fallen significantly in the US and UK; fewer firms are saying labour is difficult to get hold of or a constraint on output (Chart 12). However, the relationship between labour market slack and pay growth can vary over time and at recent levels of the unemployment rate has appeared to become detached from past relationships in the UK (Chart 13). Pay growth still looks stronger than central banks are likely to feel comfortable with (Chart 14). Services activity has still not fully normalised in a number of major economies either post-Covid. Increased services activity and ageing populations are likely to raise the demand for labour-intensive hospitality and care for example which could re-intensify tight labour markets. For now, **the risk feels skewed towards a shallower fall in inflation** than in my central case (Chart 15),

Chart 10: Services CPI, falling but still high



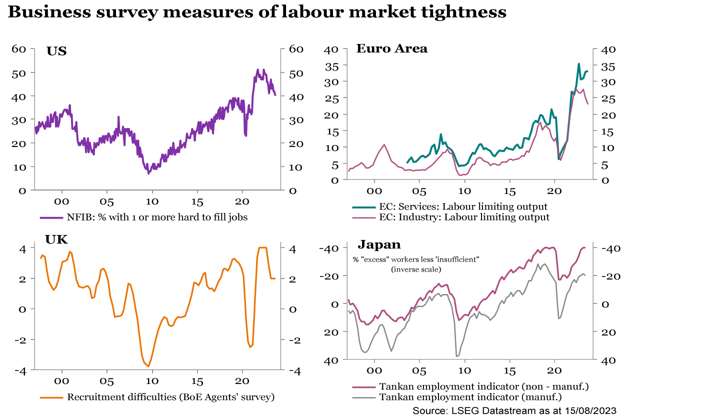
Source: LSEG DataStream, ONS, BLS, Eurostat as at August 2023 (September 2023 for euro area)

Chart 11: Selected inflation expectations measures



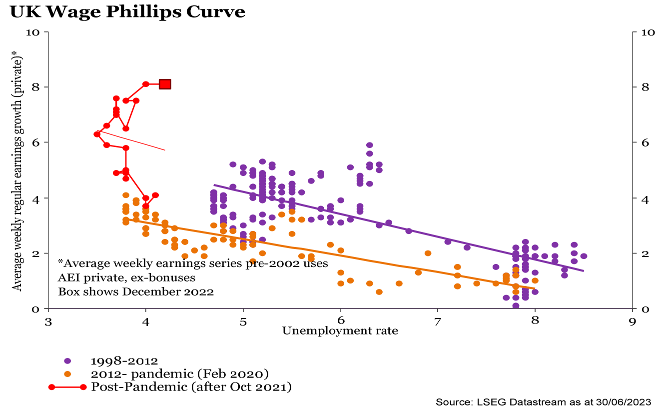
Source: LSEG DataStream, YouGov/Citi, ECB, University of Michigan, FRB New York, FRB Philadelphia. Data to Q3 2023

Chart 12: Difficult to recruit, but getting easier



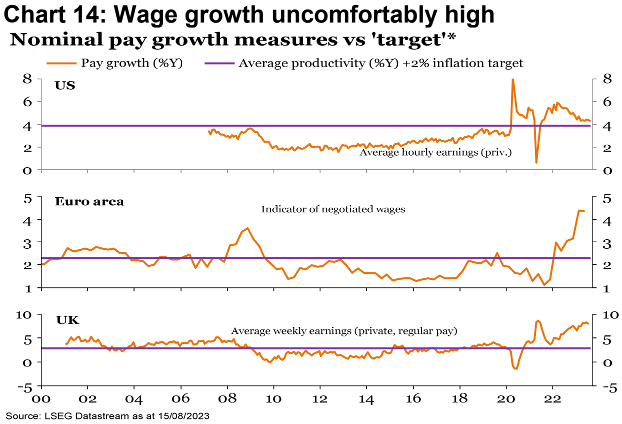
Source: LSEG Datastream, NFIB, European Commission, BoE, BoJ. Data to Q3 (UK, euro area), August (US), Q2 2023 (Japan).

Chart 13: Unemployment not the downward force on wages it used to be? UK wage Phillips Curve



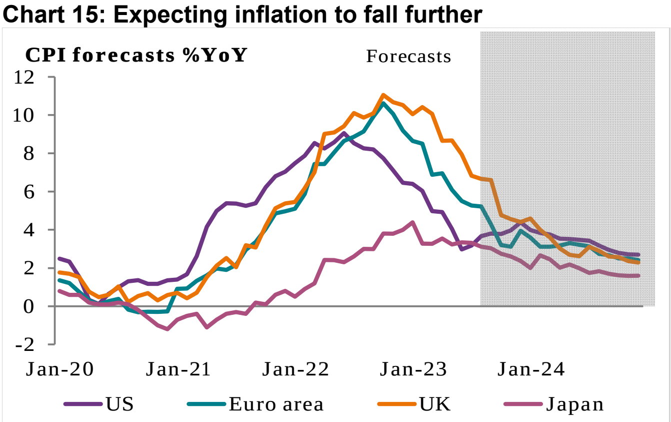
Source: LSEG Datastream, ONS as of July 2023

Chart 14: Wage growth uncomfortably high



Source: LSEG Datastream, RLAM, BLS, ECB, ONS. Pay data to August 2023 (US), Q2 2023 (Euro area) and July 2023 (UK). *Productivity measures used are output per hour (US), Total economy labour productivity (euro area), Whole economy output per worker (UK) and series are averaged from 2000.

Chart 15: Expecting inflation to fall further



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

Central bank policy outlook: Have they already done too much and when will they cut?

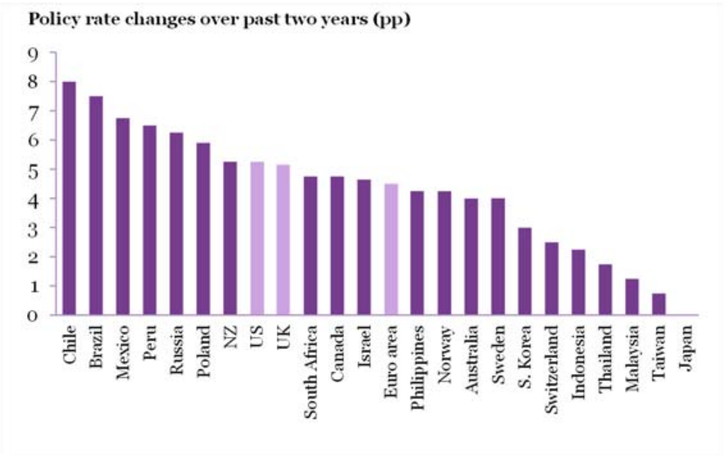
There is widespread recognition that policy rates in most major developed economies are likely at or near their peak. Inflation is still high, but it has fallen. Importantly (especially in light of higher oil prices) core inflation is off the highs too and the global economy more broadly appears to be slowing (see Chart 2). Central banks have hiked a lot (Chart 16) and the transmission mechanism appears to be working, loan and saving interest rates have risen, bank lending conditions have tightened and rate sensitive sectors like housing have been hit (Chart 17). With lags appearing longer than they used to be there is also some recognition by central banks that policy tightening needs time to work and that the impacts of policy tightening are still feeding through. The forecasts assume that we are at peak policy rates now in the US, euro area and nearly there in the UK (Chart 19), but with the balance of risks still skewed towards "high for longer" for now compared to the base case.

Have they done too much already? If the lags of monetary policy are longer than they used to be (see How Long are the Lags, June 2023), there must also be a case for thinking that central banks have done more than enough and part of the reason for the surprising resilience of the global economy to rate hikes over the past 18 months has been that the worst of the impact has yet to hit us. I have some sympathy for this, but see it as a reason why economies are likely to slow further before strengthening and why when the rebound comes, it won't be strong. My GDP forecasts are fairly subdued for the coming few years. Using the UK as an example, as successive cohorts of households roll off existing (low) fixed rate mortgages, that will act as an ongoing drag on the consumer. But it matters for GDP growth *when* the worst of the *incremental* impact is. In the UK, for example, based on Bank of England analysis around the number of mortgages set to experience jumps in mortgage payments in coming quarters, the increase in numbers was forecast to be bigger in 2023 than in 2024 or 2025 (Chart 18). However, there is clearly a plausible risk scenario where the impact on household and firm behaviour of monetary policy tightening is stronger than expected, perhaps if combined with falling confidence around the economy and fears around job security.

Rate cuts more of a (late) 2024 story: With domestically driven inflation pressure still looking robust, I believe rate cuts will be more of a H2 2024 story (Chart 19) 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 2.75% in the UK, 2.50% in the US and 2.25% in the euro area, arrived at by averaging several different methodologies/sources.

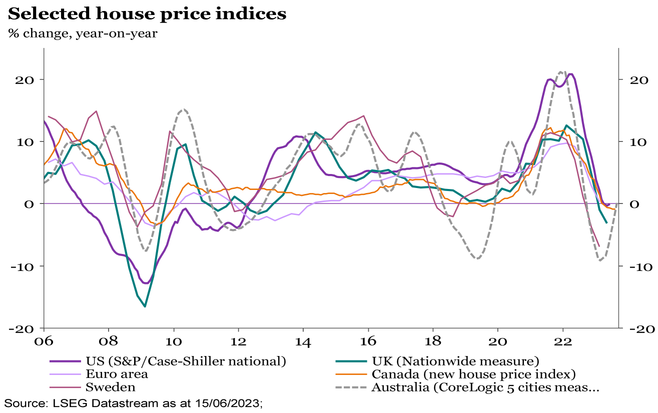
Careful of Quantitative Tightening (QT): With QT set to be ongoing next year, into the face of what I expect to be a sluggish global economy, there are risks that QT turns out to be more impactful than widely assumed especially in economies where a lot of government issuance is also taking place. Central banks, however, seem to remain determined to make QT as ineffective as possible by making the process gradual and predictable (for more on this, see Quantitative tightening – not just drying paint, September 2023).

Chart 16: Central banks have hiked a lot



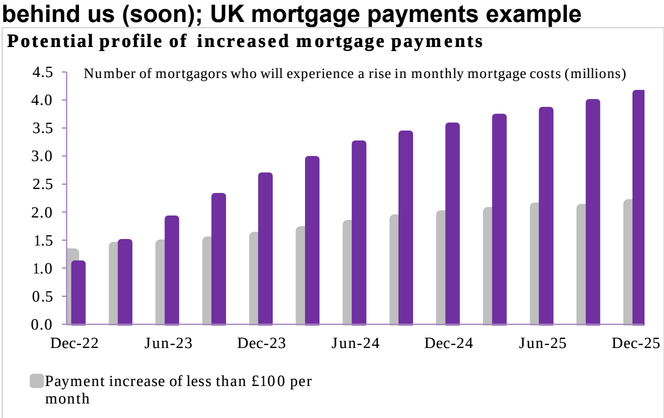
Source: Bloomberg Finance L.P.. Data to 25th September 2023

Chart 17: House price inflation has weakened broadly



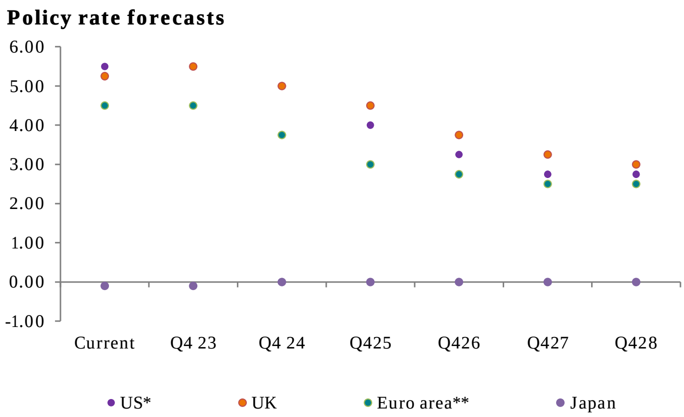
Source: LSEG Datastream, S&P, Nationwide, Eurostat, Statistics Canada, Core Logic.

Chart 18: Worst of the hit to GDP growth (not GDP) might be behind us (soon); UK mortgage payments example



Source: Bank of England, December 2022

Chart 19: Pretty much there on rates



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

China: Force for deflation?

Inflation in China is low. CPI has been pulled low by food prices in particular, but core isn't particularly strong either. Meanwhile PPI indicators have been weak too. To the degree that China exports this weak inflation/deflation pressure that will support likely lower headline inflation in developed economies in 2024. You can make a case for at least some relationship between China manufacturing PPI and global inflation (Chart 20).

Fiscal policy: A mixed picture

Fiscal support looks set to be more of a help in the coming year in some economies than others. China seems likely to add some further stimulus. In the US, the Inflation Reduction Act looks to be having more impact on the US economy than it appears from estimates of the net fiscal stance. Disbursements are ongoing in the EU under the NextGeneration programme. In general though, compared to the pandemic period, fiscal stances (unsurprisingly) look more neutral. Pandemic-related increases in government debt have also left governments with less fiscal 'room for manoeuvre' and more unsustainable looking fiscal paths, especially once demographic challenges are thrown into the mix (see below).

Politics to play more of a role

Into and through 2024, elections seem likely – or will happen – in a number of major economies including in the US (Presidential election) UK (a general election must be held by end-January 2025), Japan (Upper House and Lower House elections are set for 2025, but a snap election could be called before then), Taiwan (with potential geopolitical implications) and the EU (European parliament).

Elections always have the potential to bring about economic (and other) policy change. As a central case, however, 2024 elections are not assumed to be potential triggers for a big shift in fiscal stance in either the US or UK.

Watch out for demographics

The second half of the 2020s looks set to be something of a turning point. At least on UN estimates, working age population (crudely defined as the population aged 16-64) is dropping or expected to start dropping soon in China, Japan and Western Europe (Chart 21). Even in the US, which has a *relatively* favourable demographic profile, working age population growth is projected to be relatively slow in coming years. Without productivity miracles, a lot of immigration, and likely even with efforts to keep people working for longer, we aren't going to sustainably return to the kind of trend GDP growth rates we've been used to.

Unless labour productivity moves significantly above the rates we've seen in recent years, even at modest GDP growth rates labour markets look likely to get rapidly tight again in coming years and economies hit their 'speed limits' earlier. Using the euro area as an illustration: By 2030 Eurostat population projections see the euro area population age 15-64 (on a 20-country basis) slightly smaller than in 2023. Even assuming a bit of an increase in the participation rate (not a given, since participation rates already look high by European standards), productivity growth is going to be the main determinant of potential growth. Euro area labour productivity growth has averaged only 0.3% year-on-year since January 2000.

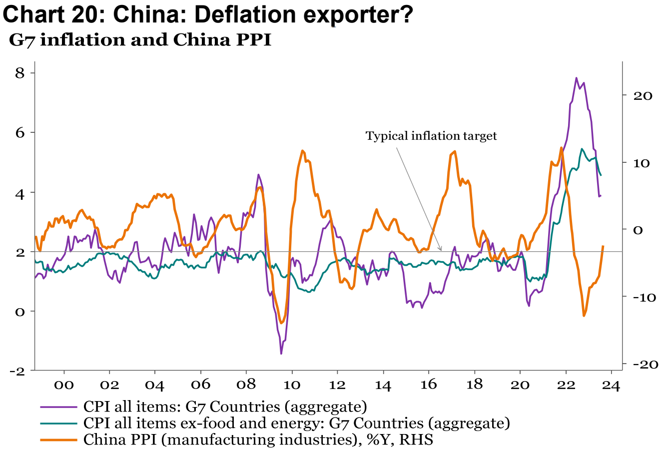
There are clearly a number of policy levers that could be pulled here, but sustainably boosting productivity is a complex task requiring long-term planning where structural labour market reforms, infrastructure spending, education policies technology and management quality can all play a role. I remain reluctant in my central case forecasts to assume a productivity miracle in developed economies with that in mind. The chances of some form of productivity miracle have arguably improved with developments in AI, but so have the risks of significant economic disruption (see below).

Meanwhile, demographics may prove to be inflationary. Goodhart and Pradhan argue persuasively in their book "The Great Demographic Reversal" that ageing is inflationary (first, they argue that dependents add only to demand while workers add to supply and demand hence ageing should be inflationary as the balance between the two shifts; second that a shrinking labour force will increase the bargaining power of labour; third that rising fiscal deficits as health/pension costs rise is unlikely to be fully offset by unpopular deficit reduction measures). That should result in higher inflation (and higher nominal interest rates) than were typical pre-pandemic.

AI – Disruptive or transformative?

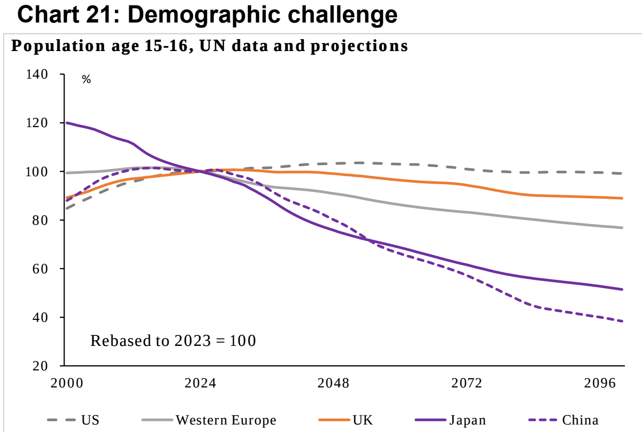
AI could well be both transformative and disruptive for the global economy. I don't have strong views on how pervasive and how quickly that will be the case though and which of those will dominate at different time horizons. The slower the technology spreads, potentially the less disruptive -- allowing those whose jobs are affected time to better understand how to harness the technology, retrain or do something else where necessary. Most companies will presumably need time to absorb the technology to understand how to use it and the possibilities it represents. The regulatory structure could be especially important in speed of transformation and extent of transformation in some industries. AI could be a productivity enhancing development and vehicle that speeds up developments in all sorts of fields. But much will likely depend on the policies, regulation and training, that get put in place around it.

Chart 20: China: Deflation exporter?



Source: LSEG Datasteam, OECD, China National Bureau of Statistics. Data to July 2023 except China PPI which is to August 2023

Chart 21: Demographic challenge



Source: LSEG Datastream, UN population projections. Data updated 2022

United States: Looking a little less resilient

In the US, the real economy has been surprisingly resilient in the face of tighter credit conditions so far. However, Q4 looks set to see a few growth challenges, monetary policy is restrictive and employment growth has slowed. A number of recession indicators are still flashing. The forecasts assume a mild technical recession but assume that the Fed won't cut rates until the Fed feels much more reassured on the domestic inflation picture (an H2 2024 story in the central case).

Status update: Activity data pointing in different directions

Real GDP growth has remained surprisingly robust (though some US analysts expect downward back revisions) and Q3 looks set to be solid looking at various 'nowcasts'. Business survey data paints a mixed picture, with the PMIs for example consistent with flattish growth while ISM surveys look more upbeat (Chart 22). Employment gains have slowed on the non-farm payrolls data and job openings have fallen a long way from their highs consistent with a less tight labour market. Housing-related activity remain subdued. Overall, however, this does not look like an economy that is diving into recession.

Still assuming that the US does not escape a modest technical recession

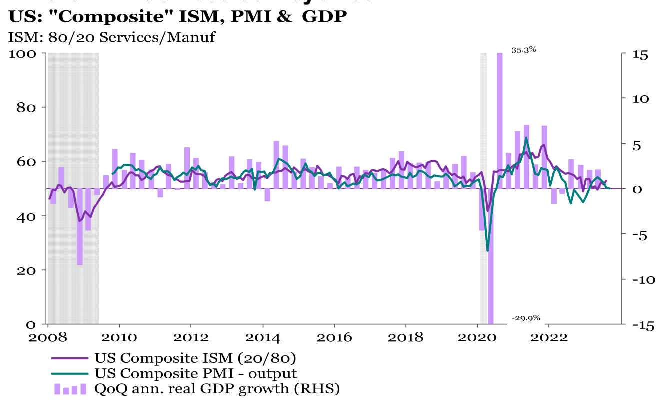
Bank lending conditions continue to look tight enough to send a recessionary signal (Chart 23). Though the stock of market-based debt financing is substantially larger than loan financing for US corporates, the relative importance of loan financing has increased and banks remain important for the financing of SMEs. Real disposable income growth remains positive for now (Chart 24), supporting consumers, but consumer (and small business) confidence levels are still below where they were pre-pandemic; inflation has risen again; student loan repayments restart in October; and the labour market is cooling. 'Excess savings' built up during the pandemic look seriously depleted too. Recent US GDP growth has been resilient and 'nowcasts' suggest Q3 was solid. The factors above, business surveys and, potentially, government shutdown later in the quarter and the UAW strike, look consistent with a much weaker Q4, however.

The forecasts still assume a modest technical recession, but not the depth of recession likely to be recognised *formally* as a recession by the NBER (the body generally relied on to date recessions in the US). That view reflects that many households and corporates are not feeling the effects of high interest rates having termed out debt.

No rate cuts while domestic inflation picture fails to soothe

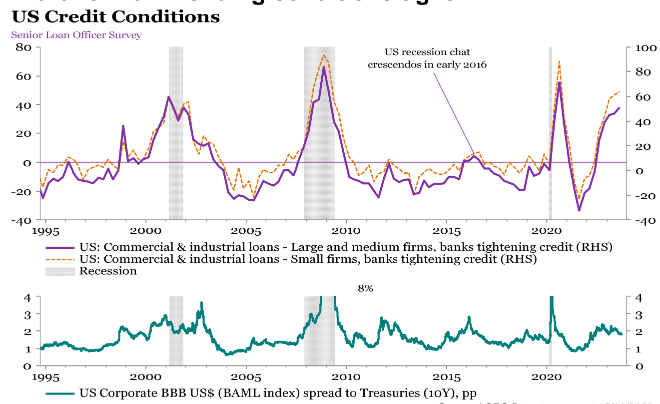
The US central bank has a dual mandate, but with the unemployment low, its focus remains on the inflation part of the mandate. The domestically driven bit of US inflation continues to paint a more reassuring picture than in the UK, for example. At what point, having hiked rates so much, can the Fed turn its attention to rate cuts in the US? In my central case that point is still dictated by inflation rather than the labour market. In the case of a modest technical recession, job losses are unlikely to be sufficient to dominate the Fed's agenda. More likely, the Fed experience enough months of inflation-target consistent core/super-core inflation (Chart 25) figures (around or below 0.2%M) that they feel confident enough to start lowering the Fed Funds target rate back (gradually) towards neutral from restrictive. In the central case, however, that is not a story until the second half of 2024.

Chart 22: Business surveys flat



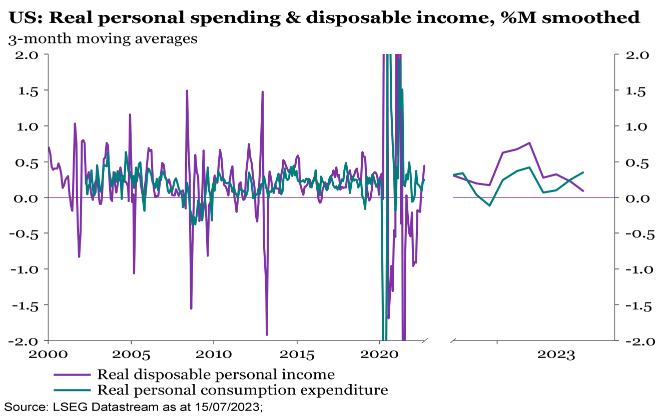
Source: LSEG Datastream, BEA, S&P Global, ISM. Data to Q2 2023 (GDP), September 2023 (PMI), August 2023 (ISMs)

Chart 23: Bank lending conditions tight



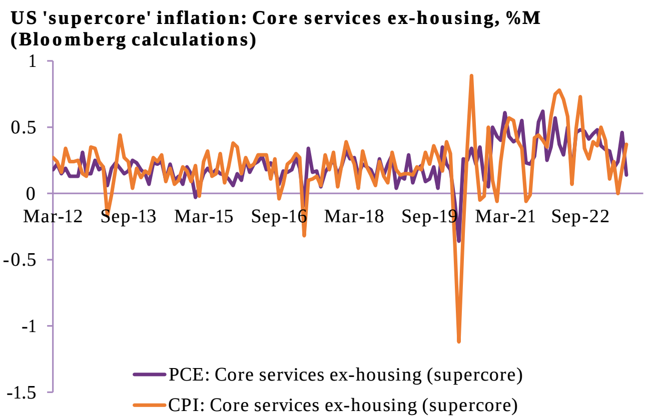
Source: LSEG Datastream, Federal Reserve, BAML. Senior Loan Officer survey data is for Q3 2023; Corporate bond spread figures are to 25th September 2023

Chart 24: Stronger real income = stronger spending



Source: LSEG DataStream, BEA. Data to July 2023

Chart 25: Super-core inflation



Source: LSEG Datastream, Bloomberg Finance L.P. as at August 2023

China: Still a worry

China's economic data continue to disappoint, as does the policy stimulus response – albeit China's drip feed of supportive policy measures is starting to amount to something substantial Policy support has stepped up in the wake of weaker than expected growth, low (to negative) inflation and high youth unemployment rates, but remains relatively restrained relative to past stimulus episodes. Meanwhile, worries around a more prolonged period of slow growth appear to have stepped up. More policy support seems likely, including monetary policy support, but the forecasts do not assume that the pace of support steps up substantially given what has been seen so far.

Status update: A tendency to disappoint

China's economic activity data has generally tended to disappoint in recent months. Q2 GDP figures showed a sharply slower pace of quarter-on-quarter growth at 0.8%Q after 2.2%Q, with the post-Covid bounce seemingly fizzling out quickly (Chart 26). Activity data have disappointed for much of the year. Taking retail sales as an example, almost all of the data points since April have come in below consensus expectations. Recent business surveys have shown some improvement and the composite NBS and Caixin PMIs are both above 50, but aren't especially strong. Aggregate financing growth picked up only very slightly in August 2023 with year-on-year growth trending lower if anything for much of the year. Loan growth has also slowed.

Plenty of short- and longer-term challenges

Consumer key? A key factor for the strength of China's economic growth picture will be the reluctance (or otherwise) of Chinese consumers to ramp up their spending. After an initial bounce post-Covid, retail sales growth has tended to disappoint consensus. Lower mortgage rates and deposit rates would help. China's households built deposits over the Covid period when spending was supressed but household debt ratios also increased in the years before Covid. The recorded unemployment rate seems to be off its lows, but survey-based indicators of employment are mixed and the youth unemployment rate has been uncomfortably high (Chart 27). A combination of other factors may work against a consumer boom: Falls in house prices may have dented household wealth (albeit, alongside policy measures, made downpayments more affordable). More generally, market volatility, troubles in the property market and geopolitical shifts, combined with Covid, may have combined to make Chinese consumers more risk averse.

Deflation: China's year-on-year CPI inflation turned briefly negative again in July 2023 following periods of deflation after the financial crisis and briefly during the pandemic. The step into negative territory may have been temporary, but the inflation picture remains weak. Much of this is being driven by food prices, but core inflation is relatively subdued too and likely partly reflects the demand and unemployment backdrop. A deflationary backdrop in China is, however, helpful to developed economies still dealing with high inflation rates to the extent it is exported. It also adds to pressure/room for policy easing from the Chinese authorities.

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 room to raise the retirement age and more scope to urbanise more of the rural population). China's stance towards Taiwan continues to present 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.

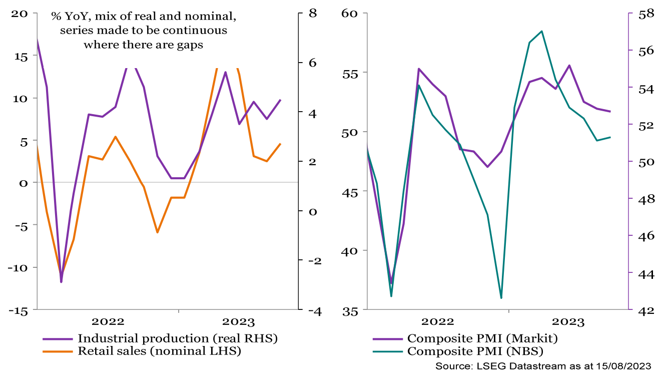
Policy action steps up: Supportive policy action seemed to step up over the summer. Among actions taken, China's authorities cut interest rates; Reserve requirements for banks were cut; authorities also announced more support measures for the property sector (including reductions in downpayment rates); they also announced plans to expand tax breaks for child and parental care and education. However, the forecasts continue to assume that there is a limit to how far the authorities are willing to go, consistent with experience so far and with the policy focus seemingly geared more towards national security than economic prosperity.

Japanification risks

The potential 'Japanification' of China or rather a prolonged struggle ahead against deflation and low growth, remains an occasional recurring theme in economic analysis. Stronger fiscal stimulus might help, as might a resurgence of structural reform. For now, however, stimulus efforts continue to disappoint many China observers; the property sector is large and struggling (though China's property 'bubble' looks much smaller than early 1990s Japan); China's private sector carries a lot of debt. China's authorities have multiple levers they can pull but these could keep underperforming entities alive as much as they could stimulate and there seems to be an appetite to allow a deleveraging of the system including local government funding vehicles which are linked to the fortunes of the real estate sector. Meanwhile, it is not clear that we will see a revival of potentially painful structural reforms that could jolt the economy either, especially things that could require or lead to some decentralisation of power. Meanwhile, China's working age population is falling, posing a big underlying challenge for maintaining China's strong growth rates.

Charts 26: Recent recovery disappoints

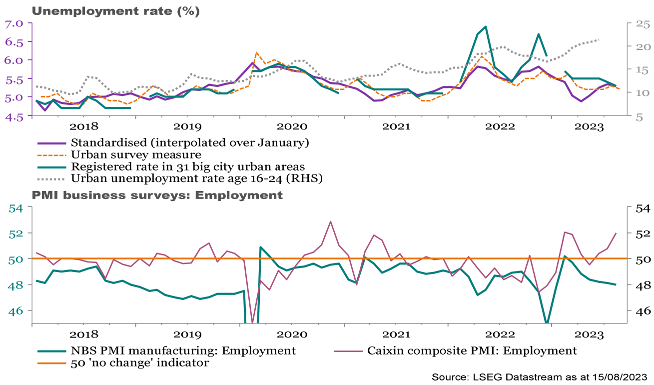
China: Industrial production, retail sales, PMIs



Source: LSEG Datastream, NBS, S&P Global. Data is to August 2023

Charts 27: Labour market indicators not strong

China: Unemployment



Source: LSEG Datastream, NBS, S&P Global. Data to August 2023

Euro area: Still expecting a technical recession

The euro area economy may already be in mild recession and the forecasts continues to pencil one in. Business surveys have deteriorated and look consistent with falling private sector output. Tighter monetary policy will still be feeding through to the real economy. Bank lending conditions have tightened and loan growth has slowed. High domestically driven inflation continues to point to the balance of risks being in the direction of further hikes. 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).

Status update: Surveys moved into recessionary territory during the summer

GDP growth was slightly positive in Q1 and Q2 2023. Activity levels – as measured by real GDP – have been roughly flat since Autumn 2022, continuing to avoid slipping into recession albeit recording very little growth either lately. However, in June the composite PMI business survey measure of private sector activity slipped below 50 consistent with falling activity with the European Commission's economic confidence indicator continuing to signal a weak picture too (Chart 28). Pay growth has risen though against a still low unemployment/high inflation backdrop. The ECB has hiked significantly in 2023.

Slipping into recession? Probably, but there are supports

After downward back revisions to GDP and a sequence of weak business surveys, alongside further ECB rate hikes and more evidence of monetary policy feeding through to tighter bank lending conditions (Chart 29) and into the real economy, the central forecast on page 2 again includes a mild recession.

The global downturn in manufacturing has dragged on overall activity indicators and data indicates a struggling construction sector in Germany for example. Construction is usually one of the most interest rate sensitive parts of any economy and in the euro area as a whole construction output appears to have stalled out with output at similar levels to early 2022. The PMI for construction activity is now well below the 50 'no growth' level. While the business survey data has become downbeat, still strong domestic inflationary pressure, including strong wage growth, has meant more monetary policy tightening has followed from the ECB. Bank lending remains the dominant source of debt financing for firms in the euro area – especially smaller ones – helping the transmission of monetary policy. Rising deposit rates should also be increasing incentives for firms and households to hold back from spending.

However, stronger wage growth and still low unemployment against a background of falling headline inflation should help consumers (Chart 30) and next Generation EU funding can still help support growth, with much less disbursed than had originally been anticipated by this point.

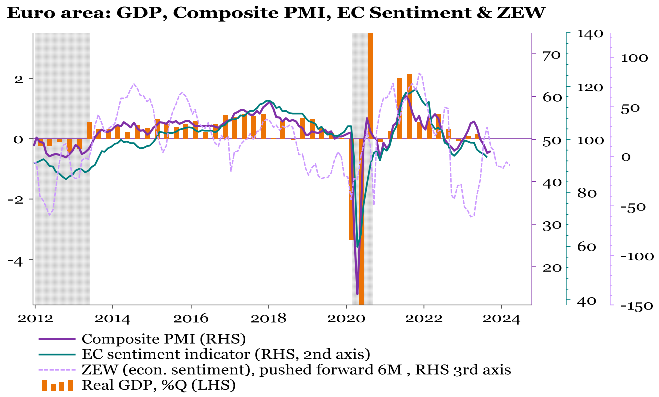
Energy story – revival potential

Last year's worries about Europe's energy supply situation faded (partly reflecting a mild winter). The euro area looks to be in a much better starting position than last winter, with high current levels of natural gas storage (though levels of available storage vary by country). However, a very cold winter could at least revive worries around the European energy situation. Russia is still piping some gas and although there has been massive diversification away from Russian energy supplies, there is now considerable reliance on LNG imports to fulfil Europe's energy needs. Price incentives and strong LNG demand elsewhere could see this LNG diverted (likely to Asia).

Has the ECB done enough?

ECB communication around their September rate hike suggested that Council members think this may well be the peak for rates. The forecasts on page 2 assume that is the case too. The focus now moves more to duration of rates at these levels rather than the level of rates. However, with services inflation strong and wage growth well above levels consistent with hitting a 2% inflation target the risk is that cuts are further away than expected too, despite the downbeat activity data.

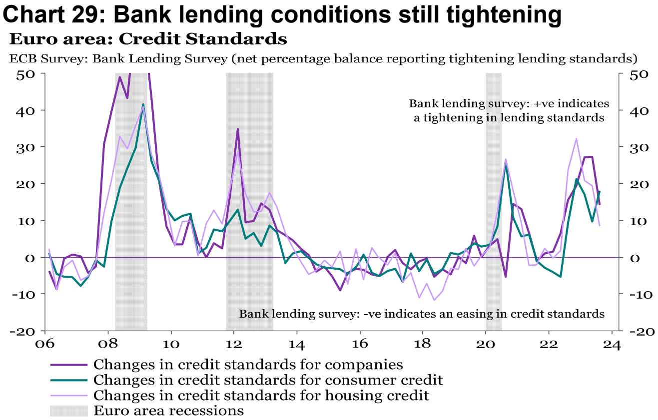
Chart 28: Surveys consistent with falling GDP



Source: LSEG Datastream as at 15/09/2023;

Source: LSEG Datastream, S&P Global, ZEW, EC, Eurostat. Data to September 2023 (except GDP which is to Q2 2023).

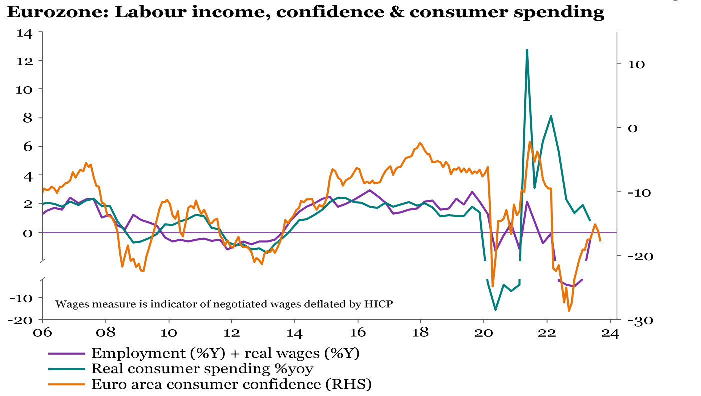
Chart 29: Bank lending conditions still tightening



Source: LSEG Datastream as at 15/08/2023;

Source: LSEG Datastream, ECB (data to Q3 2023)

Chart 30: Real wages more supportive for consumers though



Source: LSEG Datastream as at 15/05/2023;

Source: Source: LSEG Datastream, Eurostat, European Commission. Consumer spending and labour market data is to Q2 2023; consumer confidence is to September 2023.

Japan: Relatively robust for now

Growth in Japan appears to be gaining relatively from loose domestic policy settings. Although the BoJ tweaked yield curve control policies again, risks of a rate rise this year seem to have receded without more evidence that Japan will be able to *sustainably* hit its inflation target. However, inflation remains high by Japan standards and the longer it remains there, the more chance that Japan's inflation dynamics/expectations shift in a sustainable way and the BoJ feel confident enough to lift rates firmly out of negative territory. I assume that there is a small move away from a negative policy rate in 2024.

Status update: Growth OK; inflation holding up

Some core measures of inflation have continued to rise in Japan (Chart 31), even while headline inflation has fallen back a bit following energy subsidies. Notably, services and so-called 'core core' inflation (inflation less fresh food and energy) have continued to rise. As elsewhere, services CPI should better reflect domestically driven inflation pressure than headline inflation. At 2.0%Y in August 2023, that was the highest rate of services inflation since 1998. Diffusion indicators show that the proportion of prices that are rising remains very high. Inflation expectations on the Tankan measure remain at high levels (Chart 32). Wage growth data look somewhat mixed, but wage growth seems to be gradually trending higher.

The picture coming from business surveys and some of the hard data remains *relatively* upbeat compared to some other major developed economies and likely in part reflects continued very loose policy settings and JPY weakness. PMI business surveys seem to be holding up better than in Europe for example, though have weakened alongside indicators of global growth. Q2 GDP growth was strong (potentially seeing some payback in Q3)(Chart 33).

Looser policy settings paying relative dividends

Japan faces somewhat shallower challenges than elsewhere given its loose policy settings. Real pay growth looks less of a drag on consumers having improved from its lows as pay growth appears to have picked up somewhat following the rise in inflation. Meanwhile the unemployment rate remains low and employment growth positive. Bank lending conditions remain 'accommodative' according to Tankan survey indicators. Real rates are negative. Meanwhile, with sustained strong nominal GDP growth for the first time in years, debt levels should be less of a burden too.

China's economic weakness may still prove a relative drag on growth in China via exports, but with very accommodative monetary policy, a weak currency and strong corporate profits, Japan looks much less at risk of slipping into a significant recession than many other economies despite an already weak real trend GDP growth rate. The forecasts continue to assume that Japan doesn't experience recession, but given how low Japan's trend growth is, there is still a good chance of at least one negative GDP growth quarter over the rest of 2023 and into 2024.

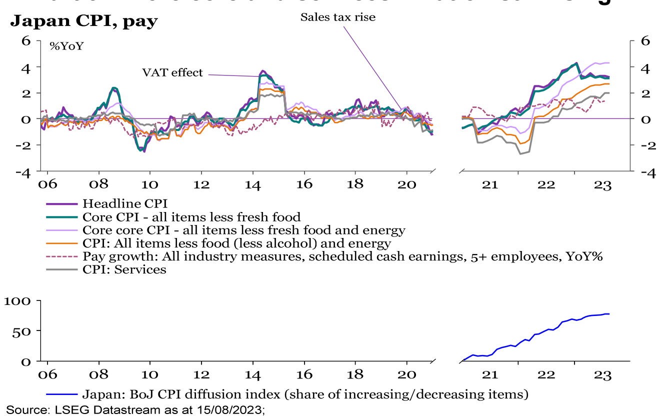
Longer-term prospects for Japan remain hampered by demographic challenges. The 'working age' population aged 15-64 continues to decline and average productivity growth has not been strong in recent years (see More rate hikes, less growth).

New equilibrium? Rate increases?

The BoJ continues to reiterate its accommodative policy message, but July's change to the operation of yield curve control (introducing more flexibility and a higher cap for 10Y yields from 0.5% to 1.0%) was at least a partial response to higher inflation rather than being purely framed (as in December 2022) as being all about market functioning.

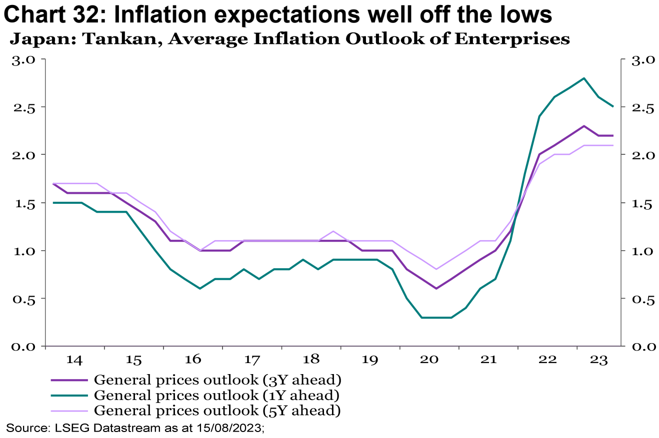
A move out of negative territory for interest rates also looks a reasonable probability in the next 12 months. By October, CPI will have been above target for two years. The BoJ seem to feel they have insufficient evidence in the *sustainability* of target-level inflation to make the shift in policy, but Governor Ueda has said that might change by year end. For now, the BoJ's core CPI forecast is still below 2%Y for 2025 and some will worry that higher pay settlements may just be a one-off response to a very new inflation environment rather than marking any shift in wider Japanese inflation psychology. I would also assume that the BoJ would want to provide additional hawkish forward guidance before a rate move. I have *tentatively* pencilled in a rate rise in the first half of 2024.

Chart 31: Core core and services inflation still rising



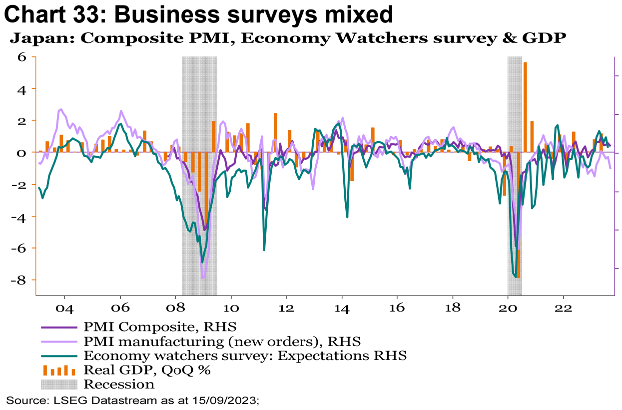
Source: LSEG Datastream, Ministry of Internal Affairs & Communication, Ministry of Health, Labour and Welfare, Bank of Japan as of August 2023.

Chart 32: Inflation expectations well off the lows



Source: LSEG Datastream, Bank of Japan as of Q3 2023.

Chart 33: Business surveys mixed



Source: LSEG Datastream, S&P Global, Cabinet Office. GDP data is to Q2 2023, Economy Watchers to August 2023, PMI to September 2023

United Kingdom: All is Not Well

The outlook is still lacklustre in the UK. 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 that the response of consumer spending and business investment to tight monetary policy will be stronger than in the central case. The effects of rate hikes are still feeding through. The central forecasts assume that 5.50% will mark peak rates, with cuts by late next year assuming no big burst of fiscal support (despite a likely 2024 election) and risks for now are skewed towards later rate cuts... all as an election nears (to be held before end-Jan 2025).

Status update: Turning down

GDP growth has been weak to non-existent since late 2021 and PMI business surveys point to deterioration (Chart 34), falling into recessionary territory over the summer. Housing indicators still look particularly weak. The UK has managed to escape a technical recession so far, but not by much. Meanwhile, the labour market looks looser. While headline inflation has fallen and will fall further, 'domestic' inflation still looks strong (especially pay growth).

Enough for recession, but supports likely sufficient for a modest one

Drags and supports: Improved real pay growth will support consumer spending and consumer confidence is well off its lows. Higher mortgage payments will act as an ongoing drag as successive cohorts roll off low fixed mortgage rate contracts, but the worst of the drag on annual GDP growth *might* be behind us (Chart 18). However, the housing market has slowed – both in terms of prices and activity indicators. Fiscal plans still indicate future tightening (though a few pre-election giveaways wouldn't be a surprise either). Brexit remains a challenge for businesses and may go through periods of being a bigger challenge as regulatory settings diverge. Bank lending conditions have generally been tightening over recent quarters, especially for households. Business insolvencies have risen (Chart 35) which likely *partly* reflects higher costs and interest rates for small businesses (the UK's largest private sector employers). The forecasts continue to assume that the UK will experience a modest technical recession before mid-2024.

The UK still faces significant long-term challenges including an ageing population, unsustainable-looking fiscal finances (longer-term fiscal estimates from the OBR still describe UK finances as on as on an unsustainable path) and sustained weak productivity growth. Encouragingly for potential growth, however, the UK's labour force participation problems have eased as inactivity has fallen (with the high cost of living potentially pushing more into the workforce); the participation rate is nearly back to pre-pandemic levels.

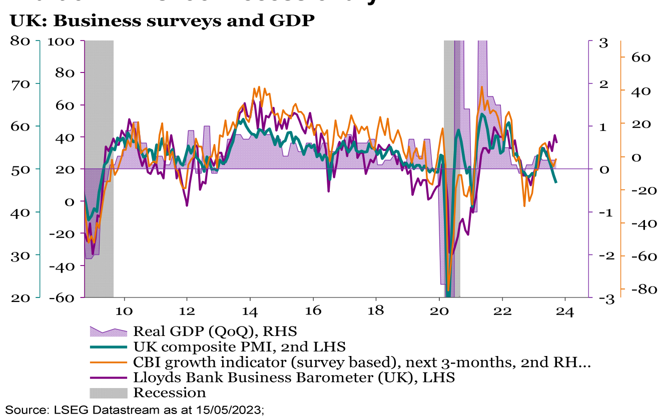
Inflation and monetary policy: Will 5.25% be enough?

The forecasts still assume that CPI falls significantly at headline level, but domestically driven inflation continues to look strong, despite significant BoE monetary policy tightening. The labour market is starting to look less tight and lead indicators of wage growth suggest some slowing ahead but so far, pay growth remains much too strong to be consistent with hitting a 2% inflation target.

Energy inflation should fall significantly further in coming months, as electricity and gas bills don't follow the pattern of last October by rising massively. Core goods price inflation should also fall substantially further and towards zero given the usual relationship with producer price inflation (where both PPI input and output inflation were below 0% as at mid-2023). The worry is still that domestically driven inflation is strong and may prove sticky. The contribution to CPI of the least import-intensive bits of inflation has been *rising* (Chart 36). Past periods haven't shown a clean relationship with the unemployment rate; a bit more slack in the labour market may not be sufficient to bring CPI services back to inflation target consistent levels (likely to be around 4%Y or so). 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.

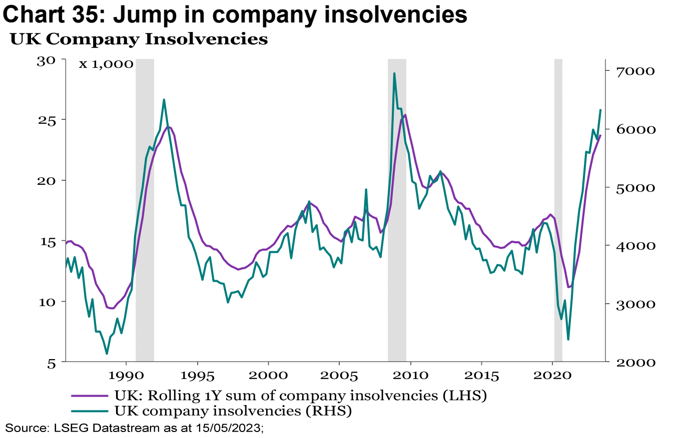
The Bank appear to be responding meeting-by-meeting to evidence of strong domestically driven inflation data. My central case assumes that a slowing economy, more labour market slack and lower energy inflation will see services inflation fall. But, for now, domestic inflation pressure looks strong enough to justify one more hike to 5.50% (with risks, for now, skewed towards them stopping at 5.25% as the labour market loosens).

Chart 34: PMIs look recessionary



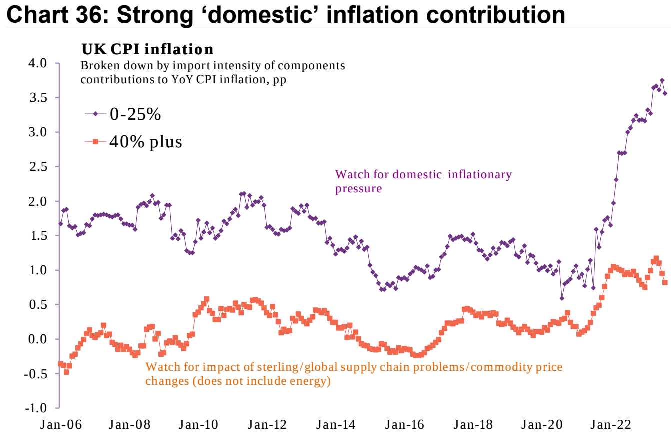
Source: LSEG Datastream, ONS, CBI, Lloyds, S&P Global. Data is to August 2023 except PMI which is to September and GDP which is to July.

Chart 35: Jump in company insolvencies



Source: LSEG Datastream; The Insolvency Service. Data to Q2 2023

Chart 36: Strong 'domestic' inflation contribution



Source: ONS, RLAM. Data to August 2023

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Derivative Risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both Fund losses and gains. The impact to the Fund can be greater where they are used in an extensive or complex manner, where the Fund could lose significantly more than the amount invested in derivatives.

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.

EPM Techniques: The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

Exchange Rate Risk: Changes in currency exchange rates may affect the value of your investment.

Interest Rate Risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity Risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Emerging Markets Risk: Investing in Emerging Markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

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.

Investment risk: The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

The RL Multi Asset Funds are a sub-funds of Royal London Multi-Asset Funds ICVC, an open-ended investment company with variable capital with segregated liability between sub-funds, incorporated in England and Wales under registered number IC001058. The Company is a non-UCITS retail scheme. The Authorised Corporate Director (ACD) is Royal London Unit Trust Managers Limited, authorised and regulated by the Financial Conduct Authority, with firm reference number 144037. For more information on the fund or the risks of investing, please refer to the Prospectus or Non-UCITS retail scheme Key Investor Information Document (NURS KII Document), available via the relevant Fund Information page on www.rlam.com

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