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The world right now

The global economy at a glance

The World Reimagined globes in London, UK - 20 Nov 2022

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1 US: Markets doubt the Fed's intent

The economy is experiencing a strong second half of 2022. Jobs are being created in significant number, wages continue to rise and household keep spending as the Fed signals a step down to 50bp incremental rate hikes, but with a higher ultimate rate than they indicated was likely back in September. Officials suggest they may not cut rates until 2024 given their concern about stickiness in key service sector components of inflation, but their forward guidance needs to be taken with huge handfuls of salt given their recent track record. The "hawkish" rhetoric is likely the result of concern that the recent steep falls in Treasury yields and the dollar, coupled with a narrowing of credit spreads is loosening financial condition – the exact opposite of what the Fed wants to see as it battles to get inflation lower. Nonetheless, the softer core inflation prints seen in October, combined with bad housing market data and weaker business confidence has led the market to anticipate rate cuts from second half of 2023 – in line with our long-held view.

2 Eurozone: Lower energy prices have temporarily stopped the downturn

With lower natural gas prices on the back of the unusual warm autumn weather the downturn in sentiment has been temporarily halted, though most indicators are still weak. With retail sales falling sharply in October a recession over the winter quarters still looks very likely, albeit perhaps not as deep as we previously pencilled in. Thereafter, growth will be subdued at best, as higher interest rates will start to bite, energy prices are likely to remain at elevated levels, while budgetary stimulus is bound to peter out in the course of 2023. Headline inflation fell back in November to a still high 10%, while underlying inflation remains stuck at 5%. The ECB is therefore likely to lift the deposit rate to 2% in December, considered by some members of the Governing Council as the neutral rate. The first quarter might see another 50 bp further tightening, as well as the start of gradual reduction of the balance sheet, though at a very slow pace in the beginning.

3 UK: Calmer markets and delayed fiscal pain not enough to stop recession

Calmer financial markets and some fresh tax rises allowed the Chancellor to put off some of the painful spending cuts until after the next election in 2024/25 in his Autumn Statement. Nevertheless, energy support will become considerably less generous for most households from April, and the housing market is showing very early signs of faltering. Despite the sharp fall in swap rates since September's mini-budget crisis, mortgage rates have fallen much more gradually. A recession now looks virtually inevitable, though it might not be until the first quarter until we see more material signs of slowing. The Bank of England has begun to talk down market rate hike pricing, and investors have taken the hint, but are still probably overestimating what is to come. We expect the BoE to pivot back to a 50bp hike in December, and expect one further 50bp move in February, which is likely to mark the top of this tightening cycle.

4 China: Still dire from rising number of Covid cases

Even the government offers property developers to increase funding channels, uncompleted home projects are yet to be finished. Most of those projects are left in the hands of local governments to find a private company to finish the construction work. This takes time to finish. The housing market is therefore quiet as home price continues to fall. On Covid, more local governments have subtly changed to slightly softer practices to implement Covid measures. But the higher number of Covid cases means that there is limitation on how fine-tuning can benefit the economy. Sporadic lockdowns would continue and still affect retail sales and production adversely. We have already seen retail sales fell into yearly contraction in October, and PMIs showed that could easily repeat for the rest of 4Q22. More, exports should continue to show weaknesses due to high inflation in US and Europe. The only support to the economy is now fiscal spending, which has been in the area of advanced technology and new energy.

5 Rest of Asia: No recession, but certainly slowdown

On the positive side, inflation rates in Asia look to be peaking out, and at levels well below comparable rates in Europe and the US. And this has also meant that although central banks across the region have been raising policy rates, they have not gone up alarmingly, and it feels as if in many cases, we are nearing a peak after the next one or two hikes. On the negative side, Asia is highly geared to global growth through global trade, and so with Europe contracting, China in as weak a state as we have seen it, and the US slowing, it is not surprising to see Asia export figures swinging sharply negative, with Korea and Taiwan the bellwethers for the North Asia, and Singapore's Non-oil domestic export declines performing the same barometer role for SE Asia. Not entirely independently, the global semiconductor downturn is heaping further downward pressure on the region, which is the key production centre for most global technology hardware, weighing on industrial production and exacerbating the export downturn.

6 CEE: Geopolitical misfortune

In addition to the global story of high energy prices and headline inflation, the CEE region is suffering from its own problems. The common denominator is the region's unfortunate geographic location in the current geopolitical landscape and historically strong labour market. The result is significantly higher inflation than in Western Europe, but also high and persistent core inflation, underpinned by a still massively tight labour market that shows no signs of easing despite the coming recession. Moreover, in response to the energy and migration crises at the same time, governments across the region have come up with another wave of household support spending, resulting in massive twin deficits. However, this has been countered by central banks tightening monetary conditions through interest rate hikes, well above global peers, but also often through the FX channel. The resulting picture of this wild mix for next year is thus a shallow recession driven mainly by a fall in household consumption, only gradually slowing inflation with a possible upside surprise, and cautious central bank foot-dragging around the timing of the start of monetary policy normalisation.

7 Rates: To reverse higher first, and then collapse lower as a theme for 2023

2022 is shaping up to be the biggest bear market for bonds in modern times. This might help explain why market rates have reversed lower in recent weeks. But it’s also to do with position squaring, as a decent rump of investors square up on bear market positions taken in 2022. That requires the buying of both duration and risk.

However, this stores up problems for the turn of the year. Arguably, financial conditions (especially in the US) are prone to loosening too much, driven there by falls in market rates. But the Fed is still hiking and needs tighter financial conditions. That should force market rates back up first.

But the biggest narrative for 2023 will be one of big falls in market rates. The Fed and the ECB will peak in the first quarter, and once there, market rates will have a carte blanche to anticipate future cuts.

8 FX: Everyone is asking whether the dollar has topped

At top of everyone’s minds in the FX market is the question as to whether the dollar has topped. Softer US inflation data and some hints of softer Covid policy in China have combined to knock the dollar some 8% off its late September highs. Those arguing for a continued dollar decline are wholly focused on the Fed story and the extension of a Fed pivot into a full-blown easing cycle. We certainly agree that a dovish turn at the Fed – a turn that finally sees short-dated US yields start to fall – is a necessary condition for a drop in the dollar. But a sufficient condition requires investment destinations in Europe and Asia being attractive enough to pull funds out of dollar deposits yielding 4%+. It remains questionable whether either of these necessary or sufficient conditions are met in 2023 and we remain sceptical that EUR/USD will be able to sustain gains above the 1.05 level. Elsewhere, sterling has recovered after November’s fiscal U-turn – a sign that policy credibility has a big role to play in FX markets. And finally, Japanese policy makers will be looking at back at some incredibly effective FX intervention to sell USD/JPY in September and October.

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