

## ING's January Monthly: The heat is on, thankfully

The warm weather in Europe is helping the region to get through the energy crisis, though many central bankers across the globe are still not done with rate hikes



### Back from holidays

Happy New Year. We are gradually returning from holiday and sharpening our minds and pens again for another year of economic excitement. The Christmas break is traditionally a period with very little economic news and data, which allows us to keep the first economic update of the year brief. Our main views for 2023 are still intact and nicely presented in our [Global Macro Outlook 2023](#).

Still, there have been some important developments since the release of our outlook in early December. China has made a full U-turn on its zero-Covid strategy and is now experiencing a surge in Covid cases. For Western economies, an end to zero-Covid in China has always been a double-edged sword. On the one hand, it means that after a wave of surging Covid cases, the Chinese economy could open earlier and faster than initially thought, lowering the risk of new supply chain frictions. On the other hand, this reopening will very likely push up demand and prices for energy.

In Europe, warm temperatures and strong winds since mid-December have not only led to lower

wholesale prices for gas but also lowered gas consumption and filled up national gas reserves again. Unless the continent gets caught out by a severe winter in the coming months, the risk of an energy supply crisis has become extremely low. As a result of lower energy prices and government intervention, headline inflation came down more significantly than initially expected in December. If energy prices stay at their current levels throughout the year, headline inflation could come down quickly. Just taking the energy base effects into consideration, eurozone headline inflation could temporarily even touch 2% towards the end of the year. However, let's not forget that there are still many "pass-throughs" at play and that it is almost normal for headline inflation to drop significantly after energy price shocks, while core inflation could still increase further and stay stubbornly high.

Before getting overly enthusiastic remember that energy prices are highly volatile and recent developments cannot be extrapolated to the entire year. We have revised down our energy price assumptions but still expect an increase in the second half of the year when China starts to accelerate and Europe prepares for next winter.

The central bank meetings in December hinted at a possible central bank divergence in 2023. While the Bank of England turned more dovish and even the Federal Reserve lost some of its uber-hawkishness, the two most dovish central banks of the last decade – the European Central Bank and the Bank of Japan – became more hawkish. The ECB, in particular, seems determined to continue hiking rates whether or not the economy falls into recession, and headline inflation could retreat faster than expected. As much as many central banks got carried away with ultra-loose monetary policy when inflation was low, there is now the risk that they will get carried away with overly restrictive monetary policy. Maybe it is just human for central bankers to want to secure their place in history as the slayers of inflation. In any event, don't expect recent positive inflation developments to change central bankers' minds anytime soon.

Many people start the new year expecting the best but preparing for the worst. We take a different stance. We still expect a difficult macroeconomic year but are clearly preparing for the best.

## At a glance: our house view

### Energy: mild weather eases natural gas concerns

The European natural gas market has come under significant pressure recently with TTF falling by around 50% since early December. Milder weather has reduced heating demand and as a result, Europe is seeing an unusual build in gas storage in the middle of winter. Gas storage is around 84% full compared to a five-year average of around 70%. It appears as though Europe will enter the injection season with comfortable storage, although there are still plenty of risks around the remaining Russian supply and also the potential for increased competition for LNG from China, as the country drops its zero-Covid policy. A more comfortable European market has meant that prices are unlikely to be as strong as initially expected.

However, prices will still need to remain elevated to ensure demand destruction keeps the market in balance through the 2023/24 winter. We expect TTF to average EUR125/MWh in 2023, but uncertainty and lingering supply risks mean the market will remain extremely volatile.

The outlook for the oil market remains bullish. China's Covid policy change should prove supportive for demand in the medium to long run, although admittedly rising Covid infections could weigh on demand in the immediate term. Russian oil supply is still expected to fall due to the EU ban on

Russian seaborne crude and refined products. As a result, the oil market is expected to tighten from the second quarter onwards, which supports our view for Brent to average a little over US\$100/bbl over 2023.

*Warren Patterson*

## **Eurozone: ECB moves into uber hawkish zone**

The fall in sentiment indicators was partially reversed in December on the back of lower energy prices, courtesy of the extremely mild winter weather. That said, the strong fall in industrial production in October still suggests negative GDP growth in the fourth quarter and falling orders, high inventories and weakening hiring activity point to a further contraction in the first quarter. We expect only a weak recovery thereafter, leading to, at best, stagnating GDP for the whole of 2023. The more subdued energy prices and resolving supply chain frictions will push inflation down further, though core inflation is likely to prove more stubborn.

We therefore don't expect headline inflation to fall below 3% before 2024. After a hawkish monetary policy meeting in December, members of the ECB's Governing Council have continued to emphasise a very hawkish message, pencilling in 50bp rate hikes for "a period of time". On the back of this, we expect a 50bp rate hike both in February and March, followed by another 25bp rate hike in May. Bond yields have less upward potential and might fall again in the first half of the year.

*Peter Vanden Houte*

## **US: Fed nears end of hiking cycle as recession draws closer**

Recession worries are mounting in the US as the Federal Reserve continues hiking interest rates despite the economy already bracing itself for a deep housing market downturn and American CEOs being as pessimistic as they were in the depth of the Global Financial Crisis. With more companies adopting a defensive posture we expect to see hiring and investment plans cut back aggressively. The combination of job worries, lingering inflation and falling asset prices are likely to lead to sizeable falls in consumer spending while residential construction will also drag output lower.

We look for a further 50bp of rate hikes in the first quarter given that inflation remains the Federal Reserve's focus. Nonetheless, we believe that the composition of the CPI basket (heavy weighting towards housing and vehicles) is helpful in bringing about sharp falls in inflation from the second quarter onwards. Remember, too, that the Fed has a dual mandate that places a strong emphasis on the job market as well as targeting 2% inflation. With more flexibility to respond to the recession than most other central banks, we see significant scope for interest rate cuts and falling Treasury yields later in the year.

*James Knightley*

## **UK: Bank of England turns more dovish but rate cuts still a while off**

The UK economy has most likely been contracting since the third quarter of last year, and we expect this trend to continue until the summer. Admittedly, a recession is likely to be mild by

historical standards, not least because the job market remains uber-tight, plagued by increasingly persistent labour shortages. We expect a peak-to-trough fall in GDP of a little over 1.5%.

Against that backdrop, it's not surprising that the Bank of England is turning more dovish. December's decision registered a noticeable shift in voting patterns among committee members, which much like the Fed, resulted in a 'smaller' 50bp rate hike. We expect 50bp worth of additional tightening, though the jury's out on whether this will come in one burst or split into 25bp increments. Either way, the BoE is likely to be slower to turn to rate cuts than in the US. Stickier inflation, owing to Europe's energy crisis, and the tight UK job market, suggests the first rate cut is unlikely before 2024.

*James Smith*

## China: no smooth road to recovery

China's lifting of Covid measures domestically and for international travellers will, in time, help the economy to normalise. But we can expect the short term to be dominated by the very high level of Covid cases, which have come at a time when the economy is already very weak.

Looking at other economies in the region which have suffered similar severe waves of Covid (India's Delta wave springs to mind) we would expect this wave to last no more than three months at which time the economy could start to revert to a more normal footing. However, this could also coincide with the US and Europe entering recession, which will weigh on any manufacturing recovery and export growth even as China's domestic issues abate.

The People's Bank of China has set the policy tone for 2023 as stable, strong, and precise, which suggests that policymakers do not envisage much adjustment to interest rates or reserve requirements. Instead, a re-lending programme could be the main tool to inject liquidity into specific industries or for a specific purpose. Fiscal stimulus will focus on supporting long-term economic growth and will likely be delivered in March.

*Iris Pang*

## Asia: region slows as global recessionary fears build

Asian growth is slowing as its major external trading partners slide towards recession while its major regional economic hub (China) battles a new Covid wave. Not helping, a global downturn in semiconductor demand is hitting hard at the major manufacturing sector of the region, and domestic demand is being undermined by higher policy rates and the erosion of purchasing power due to inflation. But it isn't all bad. Inflation, which was never as bad as most of Europe or the US, and has required a more nuanced policy tightening response, already shows clear signs of peaking in many economies. Easier policy and a troughing of the downturn are likely over the middle of the year.

Japan may be an outlier here as it is making tentative overtures towards a normalisation of central bank policy, though we think any steps the Bank of Japan makes this year will be extremely tentative. China, too, will emerge from the current Covid wave within a quarter or two and should begin to grow more strongly, lifting regional exports once more. Overall, although 2023 will not be a stellar one for most Asian economies, they will still mostly grow faster than anywhere else.

*Rob Carnell*

## CEE: New Year's repricing is a reminder that the inflation story is not over

Leading indicators suggest a rebound from the bottom in economic activity, but hard data will continue to underwhelm for a while yet. Still, more attention will be paid to inflation, which we think peaked in Hungary and Romania at the turn of the year. In the Czech Republic, the January repricing should bring inflation back within reach of the September peak. In Poland, on the other hand, we may not see inflation peak until February, and we also expect inflation here to be the most persistent in the CEE region.

However, we do not expect much more action from central banks. In Romania, after the last surprisingly strong inflation number, it looks as though the National Bank of Romania (NBR) may deliver one more 25bp hike to 7.00%. But otherwise, we consider the hiking cycle in the region to be over. So the main question is when inflation in the region will fall enough that central banks will be willing to start normalising monetary conditions. We see the Czech National Bank and the National Bank of Hungary as the first in this race. Conversely, we forecast the NBR will cut rates only at the end of this year with the National Bank of Poland following next year at the earliest.

*Frantisek Taborsky*

## FX markets: dollar to find support as central banks spark abrupt decline

FX markets have shown a little more stability over the last month and the dollar has found some support after dropping around 8% through October and November. The hawkish December FOMC meeting has certainly helped here and provided a counterweight to a surprisingly hawkish ECB. The major outperformer has been the Japanese yen, which received a further boost in December after the Bank of Japan shifted its 10-year JGB yield target. Rarely can there be said to be a more successful case of FX intervention than Tokyo's efforts to sell USD/JPY in the 145/150 area.

Looking ahead, the seasonal trends are more dollar supportive in the January-February window and this may be the more likely period for EUR/USD to make a move lower. Markets price the turn in the Fed cycle and a weaker dollar from the third quarter onwards, though we suspect sustained gains in EUR/USD may be harder to come by as central bankers continue to hike into recessions.

*Chris Turner*

## Rates: set to reverse higher before collapsing lower

2022 saw the biggest bear market for bonds in modern times. A peak in US inflation opened the door for a decent rump of investors to square up on bear market positions in the fourth quarter, requiring the buying of both duration and risk. However, this just stored up pressure for resumed higher market rates ahead. Despite the easing in inflation pressures, the first quarter will have a strong rate hiking theme. The Fed is still hiking and needs tighter financial conditions. That should force market rates back up. With the ECB on a hiking mission too, upward pressure on eurozone market rates will also feature.

While we see resumed upward pressure on rates dominating the first quarter, the biggest narrative for 2023 as a whole will be one of significant 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. Larger falls for US market rates are projected later in 2023, reflecting likely subsequent Fed cuts. But with cuts less likely from the ECB, expect a relative steepening of the US curve versus the eurozone one. This is a classic box strategy where the US curve steepens out (dis-inversion), and the eurozone one re-steepens by less. By the end of 2023, the US 10yr Treasury yield should be back down at 3% and the eurozone 10yr swap rate at 2.5%. But we should not go below these levels for long.

*Padhraic Garvey*

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