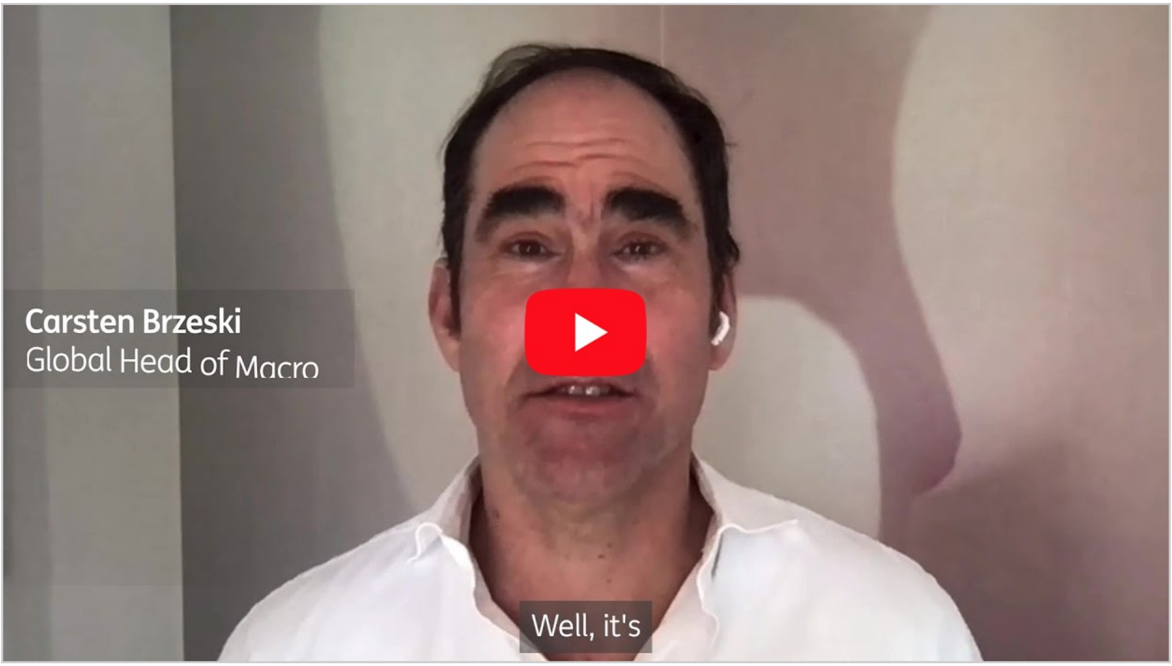
The search for a new equilibrium

Optimism about an imminent strong economic recovery and a change of tack by the central banks was short-lived. We expect a longer period of subdued growth in the eurozone, while we also anticipate a significant slowdown of the US economy. It's no surprise markets and analysts are having a hard time seeing clearly at the moment



The search for renewed balance in the global economy

Watch video

Recent weeks have shown that optimism about an imminent strong economic recovery and a pivot by the major central banks was premature. Markets, economies and central banks are still searching for a new balance, a new equilibrium, of structural transition and cyclical developments, higher inflation and interest rates, stricter monetary policy and loose fiscal policy.

The path to this new balance, wherever it may be, was always expected to be rough and volatile and not linear. In fact, major central banks are witnessing stubbornly high inflation and still very few signs that recent monetary tightening will destroy demand and hence bring down inflation. We have argued before that both markets and central banks are currently too impatient. It simply takes months before tighter monetary policy finds its way into the real economy. And it will. Or put differently, if the greatest monetary policy turnaround in years does not leave any marks on the real economy, we could also close all central banks.

However, since last summer, central bankers seem to have become increasingly afraid that they may lose their grip on inflation. This is why there is currently so little patience and rather a trend of "high or higher for longer". No single central bank wants to be on the wrong side of inflation. Longer-term inflation projections are no longer the main anchor. It is rather a combination of current headline and core inflation, longer-term inflation projections and a large portion of gut feeling. In any case, probably the biggest concern for most central bankers at the moment is relaxing too early. This is why a scenario in which central banks overshoot with their rate hikes is more likely than a scenario in which central banks start cutting rates prematurely. All of this means that the US Federal Reserve and European Central Bank (ECB) will continue to hike interest rates in the coming months.

While the global economy will still experience the full impact of the monetary policy tightening of the last year, major economies are clearly out of sync. The reopening of the Chinese economy is only gradually gaining traction and we expect it to last until the second half of the year before the recovery really takes off. The relief that the reopening of the Chinese economy should at least provide for the European economy will not be enough to stage a strong recovery. The eurozone economy seemed to have avoided a recession before we received downward revisions in German growth data. Now, a technical recession is still possible. Even though lower energy prices and the Chinese reopening could give a short-term boost to industry, the large inventory build-up as well as the ECB's monetary tightening will weigh on the recovery. We expect a longer period of subdued growth in the eurozone.

The resilience of the US economy has been remarkable. However, we do see the first cracks in the labour and housing markets and expect a significant slowdown of the economy. Still, with the Inflation Reduction Act and rich energy supply, the US economy should experience a rather textbook-style slowdown, followed by looser monetary policy and consequently a recovery in 2024.

With economies struggling between cyclical and structural developments, governments moving from short-term stimulus to longer-term investments, stubbornly high inflation and a new era of "high for longer" at central banks, it shouldn't be a surprise that markets and analysts are having a hard time seeing clearly at the moment. Remember Jimmy Cliff, who only saw all the obstacles in his way when the rain was gone? In the global economy, it will still take some time before the rain disappears.

ING's base case scenario

Scenario #1 (base case): Europe avoids recession and central banks stay hawkish – for now

Energy prices
Demand destruction and resilient LNG supply help keep a lid on European gas prices. Storage starts next winter more than 90% full. European gas prices (TTF) average EUR55-60/MWh in second half of the year.

China Reopening
Consumption recovers more quickly than manufacturing, with exports weak as external demand dwindles. Commodity prices rise but not rapidly enough to materially impact global inflation profiles.

Central banks
Federal Reserve hikes in March, May and June, but cuts rates by 50bp by year-end. ECB hikes by 50bp in March and 25bp in May and June – and signals no cuts in 2023.

Economics
Europe avoids recession, suggesting core inflation takes time to come down even if headline rates tumble on lower gas prices. The US experiences a downturn as higher interest rates and low business confidence begin to hit hiring activity.

Markets
Sticky inflation keeps dollar supported through 1Q, but bear trend resumes through second half.

Market rates are pulled lower from the US end, and ECB hikes ensure convergence versus eurozone rates.

2023 growth forecasts

0.5%	0.8%	5.0%
US	Eurozone	China

Markets: End-2023 forecasts

1.15	3.00%	98
EUR/USD	US 10-year	Oil (Brent)

Source: ING

Alternative scenarios #2

Scenario #2: Core inflation is no longer an issue and central banks relax

Energy prices
Chinese LNG demand little changed on 2022, allowing EU to absorb more of 2023's supply growth. Dutch TTF averages EUR 45/MWh in second half of the year.

China Reopening
"Goldilocks" scenario where activity recovery surpasses the pre-pandemic level, but without any resulting squeeze on commodity prices.

Central banks
Central banks become much more relaxed about inflation, enabling earlier rate cuts in Europe and more aggressive cuts in the US.

Economics
Core inflation falls faster than in our base case. Services inflation is less of an issue, partly as lower energy/input prices take the pressure off otherwise competitive consumer industries. Goods prices tumble on healthier supply chains and inventory levels but also on weaker demand.

Markets
Not a big change from base case. EUR/USD probably does a little better given better global growth.

US rates see a bigger pull power, tightening spread versus the eurozone more from the US side.

2023 growth forecasts

1.6%	1.3%	5.6%
US	Eurozone	China

Markets: End-2023 forecasts

1.18	2.75%	78
EUR/USD	US 10-year	Oil (Brent)

Source: ING

Alternative scenarios #3

Scenario #3: Energy prices surge, rates rise further but recession becomes inevitable

Energy prices
Russian gas flows to Europe further reduced. Chinese LNG demand recovers faster than expected, and European gas prices need to rise to compete. Dutch TTF averages EUR135/MWh in second half of 2023. Winter 23/24 brings colder weather.

China Reopening
Industry recovers faster than expected, putting abrupt pressure on global energy and commodity prices. Impact on global inflation slightly mitigated by further improved supply chain reliability. Recession in eurozone and US slows Chinese recovery.

Central banks
Policy rates go another leg higher, and no major central bank cuts rates in 2023. But a deeper recession prompts widespread easing in 2024.

Economics
Core goods price inflation falls less rapidly. Higher gas prices push the eurozone into recession. Government support and boost from Chinese demand provide too little offset. US is more insulated, but higher rates prompt a deeper downturn.

Markets
Dollar rebounds as sticky inflation nixes Fed easing cycle and damages global growth prospects.

Market rates forced to reprice terminal central bank rates higher; abrupt unwind of current richness.

2023 growth forecasts

0.0%	0.3%	4.8%
US	Eurozone	China

Markets: End-2023 forecasts

1.00	4.50%	110
EUR/USD	US 10-year	Oil (Brent)

Source: ING

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