

This could well be a ‘fool’s spring’

We should guard against the premature return of optimism even if things seem better than expected



Watch: New year optimism may be short-lived

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The first month of the new year brought a couple of positive surprises to the global economy. The less complicated-than-expected reopening of the Chinese economy, lower energy prices and a bout of optimism from soft indicators out of Europe didn't only fuel a stock market rally but also led to a wider upward revision of many growth forecasts. However, as much as in times of darkness, even a sunrise is mistaken for a sunset, first signs of optimism do not always point to an upcoming growth party. We have said it before, but better is not necessarily good enough.

Up to now, the sheer fact that the European economy has been holding up better than feared and could even have avoided a winter recession brings welcome relief. The same holds for the US economy, where it takes longer than initially expected before higher interest rates finally take their toll. Together with the reopening of China, the global economy is definitely in a better place than feared only a couple of months ago.

However, we don't think that this is yet the right time to become overly optimistic. In fact, the list of potential risks - but also very real drags - on many economies is still long. In this regard, particularly the idea that the latest improvements in soft European indicators could signal an

upcoming rebound of the economy looks premature. Given that the European economy has now been lagging behind that of the US on so many aspects, be it inflation, monetary policy or growth, it is hard to see why the European economy would rebound when the US is staging a soft or hard landing. The latest soft indicators in Europe could have been like those rays of sunshine in January: temporary relief but too early to foretell spring weather.

The example of the US illustrates that textbook economics still works: excess demand fueled higher inflation, triggered a strong monetary policy reaction, and higher interest rates are now pushing the economy into recession. The first cracks in the labour market have become visible, and the housing market has started to come down. As inflation will retreat sharply, we still expect the Fed to cut rates in the second half of the year, even if a milder recession and somewhat higher core inflation could lead to second-guessing at the Fed.

The example of the US economy is also a good reminder for Europe. Here, headline inflation has also started to come down, but core inflation remains stubbornly high, partly driven by the ongoing pass-through of last year's higher energy prices but also partly driven by fiscal stimulus. The risk here is that what initially was a supply-driven inflation shock could become demand-driven inflation as a result of fiscal stimulus. In any case, the US example should tell the eurozone that higher interest rates do matter and can bring down economic activity: traditional economic wisdom. However, for a long while, the dampening impact of higher ECB interest rates on the eurozone economy seems to have been ignored by many experts and policymakers.

Finally, remember that decoupling between the US and the eurozone economy has never really existed. With a slowing economy, it looks almost impossible to see an outperforming eurozone economy when at the same time, the full impact of ECB rate hikes still needs to materialise, the region is still facing an energy crisis, and the war in Ukraine mercilessly continues to drag on.

The outlook for the global economy has improved, but better is still not good enough. The list of risks is long and the probably most underrated risk is central banks' action to defeat inflation. Nothing's wrong with that, but please remember that at least in the US, eight out of the last nine times the Fed embarked on a series of interest rate hikes to rein in inflation, a recession followed.

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