ING Monthly September: Recession's coat of many colours

We're all facing unprecedented challenges. ING's global team of economists and strategists show you exactly where we are in the world right now, and where we're headed

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US: The higher you climb the greater the fall

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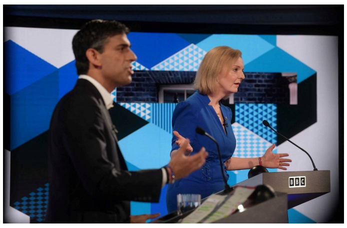

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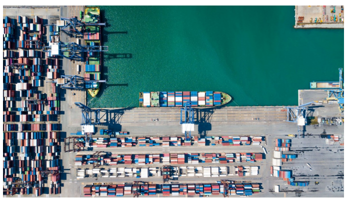

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Recession's coat of many colours: the full ING Monthly report

Different shades of recession are spreading across the globe at record speeds as soaring inflation, geopolitical tensions, and astronomical gas prices...

By Carsten Brzeski

Article | 1 September 2022 Video

ING Monthly: Recession’s coat of many colours

Different shades of recession are spreading across the globe at record speed as soaring inflation, geopolitical tensions, and astronomical gas prices show...

Recession’s coat of many colours

ING's Carsten Brzeski on the different shades of recession spreading across the globe.

Watch video

A return to reality for Europe

Returning from the summer break always helps when looking at the bright side of the world's economic prospects. An often heard truism is that relaxed economists make fewer pessimistic forecasts. But when you're tracking the European and, specifically, German economies, no summer break is long enough to make short-term economic forecasts more optimistic. On the contrary, returning to Europe’s economic reality after the summer means returning to a recessionary environment, as gas prices are moving from one astronomic high to the other and will lead to unprecedentedly high energy bills over the winter. Even without a complete stop to Russian gas, high energy and food prices will weigh heavily on consumers and industry, making a technical recession – at least – inevitable.

The colours of recession

No two recessions, however, are the same. In fact, we are currently seeing different colours of recession across the world. The US economy has actually been in a technical recession – defined as two consecutive quarters of negative growth – but it feels nowhere close to a recession. Our chief international economist in New York, James Knightley, says weaker global growth, the strong dollar and the slowdown in the housing market on the back of higher interest rates, will make it feel like a 'real' recession at the turn of the year, however.

In other regions of the world, we are not currently seeing fully-fledged recessions, but given that China and emerging markets need higher growth rates than the Western hemisphere, the expected sub-potential growth rates can easily feel recessionary. As a consequence, even if Europe currently remains the epicentre of geopolitical tensions, it almost looks as if recession and recessionary trends are a new export item.

Out with the old, in with the new

With different shades of recession spreading across the global economy, but inflation still stubbornly high as a result of post-pandemic mismatches of demand and supply as well as energy price shocks, the dilemma for major central banks is worsening: how to balance inflation and growth. In the past, the answer would have been clear: most central banks would have shifted towards an easing bias. Not this time around.

We are currently witnessing a paradigm shift, recently illustrated at the Jackson Hole conference. A paradigm shift that is characterised by central banks trying to break inflation, accepting the potential costs of pushing economies further into recession. This is similar to what we had in the early 1980s. Back then, higher inflation was also mainly a supply-side phenomenon but eventually led to price-wage spirals and central banks had to hike policy rates to double-digit levels in order to bring inflation down. With the current paradigm shift, central banks are trying to get ahead of the curve. At least ahead of the curve of the 1970s and 1980s.

Whether the paradigm shift of central bankers is the right one or simply too much of a good thing is a different question. What strikes me is that central bankers have implicitly moved away from measuring the impact of their policies by medium-term variables and expectations towards measuring it by current and actual inflation outcomes. This could definitely lead to some overshooting of policy rates and post-policy mistakes.

Looking ahead

We still think that the paradigm shift will not last that long and looming recessions will bring new pivots, forcing the Fed to stop hiking rates at the end of the year and eventually cutting rates again in 2023, and stopping the ECB from engaging in a longer series of rate hikes. Reasons for this out-of-consensus view are that we expect a more severe recession than the Fed and ECB do, and a faster drop in US inflation, in particular, than the Fed expects. Also, in a recession, any neutral interest rate is lower than in a strong growth environment. Finally (and a bit meanly), central banks have not had a good track record with their inflation predictions over the past few years.

In any case, we are back from the summer break and looking ahead to a very exciting autumn. Enjoy reading and stay tuned.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Article | 1 September 2022

Commodities, Food & Agri | Energy

Energy worries intensify

While weaker oil prices in recent months have provided some relief to consumers, the same cannot be said for European natural gas. Gas prices have seen...

Drought is inhibiting nuclear power plants, like this one in France, to make up for lost supplies elsewhere

Oil market more comfortable for now

Oil demand has disappointed so far this year. Higher prices helped lead to some demand destruction, evident when looking at US implied gasoline demand over the summer. However, the big drag on demand this year is China and its insistence on following its zero-Covid policy. There had been expectations that oil demand would bounce back following the easing of lockdowns in Shanghai and Beijing in towards the second half of the year. However, clearly, we continue to see restrictions across parts of China weighing on demand. Global oil demand is expected to grow by around 2MMbbls/day this year, which is quite a bit lower than the more than 3MMbbls/d growth expected at the start of 2022.

Russian oil supply has held up better than expected and Russian oil exports are down only marginally from pre-war levels. This is despite a number of countries imposing sanctions on the country. Several buyers have taken advantage of the large discounts available for Russian oil. This is particularly the case for China and India, which have both increased their Russian purchases significantly. In addition, the EU ban on seaborne Russian oil and refined products only comes into full effect early next year, so we have not seen a significant drop in flows just yet, but this will obviously happen once the ban is in place.

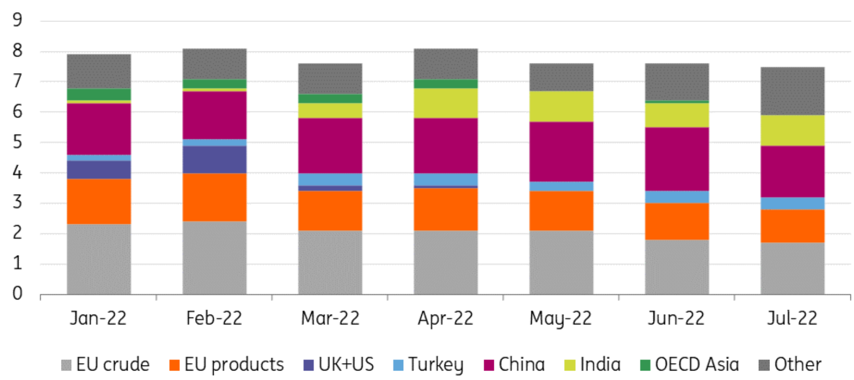
As a result of slower than expected demand growth and sticky Russian oil output, we expect that the oil market will be in surplus for the rest of this year and into early 2023. Therefore, we have revised lower our oil forecast. We expect that ICE Brent will average US$97/bbl in 4Q22 vs. a previous forecast of US$125/bbl. And for 2023, we lowered our Brent forecast from US$99/bbl to US$97/bbl.

Upside risks to this view are if Russian oil flows to the likes of China and India slow from current levels, US supply growth falls short of expectations and demand surprises to the upside - not impossible given that high natural gas prices could lead to some gas-to-oil switching.

The key downside risk for the market is a positive outcome in Iranian nuclear negotiations. Discussions appear to be progressing well and a deal could see in the region of 1.3MMbbls/d of supply added to the market over the course of next year. Although, recent comments from the Saudi Energy minister about the possible need to reduce output, suggest that the floor for the market is not too much further below the recent lows.

Russian oil exports holding up better than expected

Russian oil exports (MMbbls/d)



Source: IEA, ING Research

No respite for the natural gas market

The European natural gas market has seen significant strength over August, up more than 70% at one stage over the course of the month and hitting record levels (on a settlement basis). Concerns over Russian gas flows have only intensified after Gazprom made a surprise announcement that flows along Nord Stream will be stopped for three days for maintenance. The pipeline is only operating at about 20% of capacity right now and there are fears over whether flows will actually restart.

Strong LNG inflows into Europe continue to ensure that storage fills up, despite lower Russian flows. European gas prices trade at a significant premium to Asian LNG, whilst the same trend is seen along the forward curve, which suggests strong LNG imports should continue through the winter.

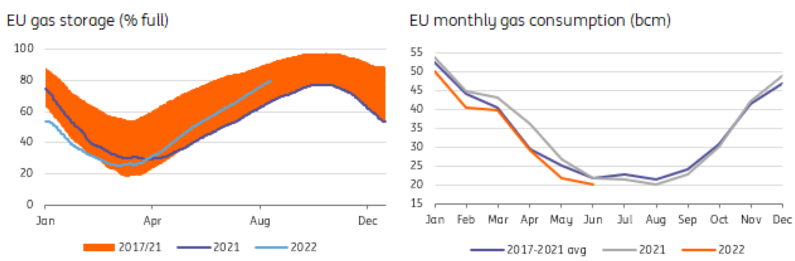
European storage is still filling up at a good pace and the EU has already hit its 80% storage capacity target ahead of the actual date of 1 November. However, if Russia were to end its gas flows to the EU completely, this would still leave the market extremely tight as we approach winter. We can expect some countries to continue increasing storage levels by as much as they can in the coming months despite that 80% target being reached.

Higher prices are already leading to a large amount of demand destruction. EU gas consumption over the first half of the year is down around 6% from the 5-year average for the same period. And this will fall further. In recent weeks, several metal smelters and fertilizer producers have announced further production cuts. If these higher prices are sustained, it is clear that we will see even further demand destruction, particularly as power/gas hedges expire for some industrials, leaving them exposed to higher spot prices. So, the strength of the market comes with increasing economic costs.

The most recent strength in the gas market has not only been driven by Gazprom's announcement regarding Nord Stream. The power market in Europe has also dragged natural gas prices higher. This is evident when looking at clean spark spreads, which have strengthened. Despite rallying gas prices, it is still profitable to burn gas as power prices are also sky high. This will not help lower gas demand from the power sector.

It is clear that the gas market will remain extremely volatile in the coming months; not only is there uncertainty over Russian gas flows, but also around the demand outlook (in the absence of mandatory demand cuts). Low liquidity caused by volatility in markets has led to only further volatility. This is unlikely to change anytime soon and makes it near impossible to come up with sensible price forecasts. However, we believe that European gas prices will need to continue to trade at elevated levels so that the market can balance itself through the winter, by ensuring an adequate amount of demand destruction from industrials and households.

EU hits 80% storage target early as demand comes under growing pressure



Source: GIE, Eurostat, ING Research

A perfect storm for power markets

If a gas crisis were not enough for Europe, the region is also dealing with a broader power crisis. Yes, this is partly a result of what is going on in the gas market but there are a number of other factors which have helped to see power prices skyrocket.

France has experienced prolonged periods of nuclear capacity outages. This is partly due to regular maintenance and refuelling, but reactors have also been taken offline due to more serious weld issues and signs of corrosion. Nuclear output now stands at around 25 GW as a result, well below levels of more than 40 GW seen in August last year. In addition, nuclear output is not helped by high water temperatures limiting the amount of cooling water that can be returned to waterways. Heat restrictions are expected to continue to depress nuclear output as river temperatures are forecast to remain above seasonal norms. France is now facing the highest power prices in Europe, while it used to have the lowest when nuclear power operated at full capacity.

The distress in the French power market is also impacting Germany due to lower exports of electricity to the industry-rich southern part of the country. Forward prices for the winter recently reached €1,000/MWh as a result, but have come down strongly in the past days after the President of the European Commission, Ursula von der Leyen informed the market that the EC is working on "an emergency intervention and a structural reform of the electricity market". Although details are not yet known, the announcement had a sizeable impact with winter prices now trading around €600/MWh.

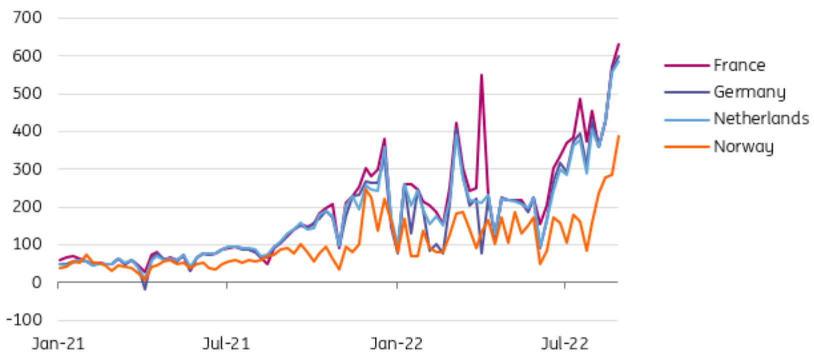
Europe's hydropower market is also negatively impacted by severe droughts that limit replenishment and increase the evaporation of water reservoirs. Hydro stocks in France, Spain, Italy and Portugal are all below the 5-year average. Hydro stocks in the Nordics are still at decent levels historically. But countries are taking steps to preserve hydro reservoirs ahead of winter as fears of a long dry period mount. Norway for example is taking steps to limit electricity exports to the northern power markets on the European continent. And operators of hydropower plants have been told to preserve reservoir stocks.

Finally, Rhine water levels are now below the record lows last seen in 2018. Water levels also came down much earlier in the year compared to 2018. As a result, some river-based coal plants are facing supply issues and cannot generate as they would like.

All in all, record low nuclear power production, hydro stocks and Rhine water levels aggravate an already tight power market with power prices settling at all-time highs. This further fuels the gas market, as power plants continue to be profitable.

Power prices have reached new highs this summer and Norway is now following the rest of Europe

Base load power price in euro per MWh on a weekly basis



Source: Refinitiv

Authors

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Gerben Hieminga
Senior Sector Economist
gerben.hieminga@ing.com

Europe prepares for a hard winter

It is no secret that Europe is heading for a severe energy crisis. Energy prices have already skyrocketed but companies and households will only be...

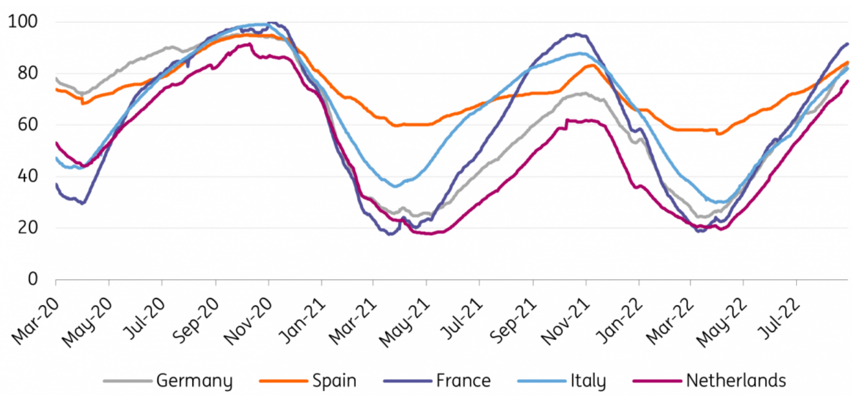
The resumption of Russian gas flows last week was only an ephemeral piece of good news

Europe's gas storage tanks are 80% full

Amid all the doom and gloom, there is at least some positive news in that European countries have been able to fill gas storage ahead of schedule. The European Commission has asked member states to fill reserves up to at least 80% by 1 November. Most countries have already reached that level well ahead of time. Overall, Europe is currently at 80.2%, which is about two months ahead of time.

European gas storage has been filling up

Natural gas, stock level, country total, fill level (%)



Source: Gas Infrastructure Europe (GIE), Macrobond

Governments are stepping in

This means that the EU has chosen to pay a high price to achieve sufficient gas supply ahead of the winter. At the same time, it is no guarantee that shortages will not happen. As Europe still relies on further imports in the winter months, there is a chance that a cold winter still results in shortages. If these shortages occur, it will be at the end of the winter. However, it currently also looks as if energy supply issues could go beyond this winter into next.

While countries are filling their national gas reserves, governments are looking into ways to tackle or at least mitigate the impact of higher energy prices on consumers and corporates. Measures differ between countries, both in terms of magnitude and nature. We provide an overview of the current state of play below and expect more measures to be announced in the coming weeks.

National policies introduced to help consumers with rising energy prices

	VAT/price reductions	Price caps	One-off payments	Other measures
US	/	/	/	Consumer rebates/tax credits enable the installation of energy efficient heating at home (part of the Inflation Reduction Act 2022)
UK	Discount on energy bills from October	/	One-off payments in different amounts for those receiving means-tested benefits, for pensioners and for the disabled	Increase and extension of Household Support Fund
Germany	June to August 2022: reduction of energy tax on fuels to the European minimum & €9 ticket on public transport	/	One-off payments in different amounts for employed, self-employed and business people, for adults receiving benefits from social security system and for recipients of unemployment benefits, child bonus	/
France	Discount on fuel prices	Freezing of gas price until end-2022 Cap on electricity price increase	Tax free bonus for workers Back to school bonus for lower-income households	Inflation indexation of minimum wage Increase of pensions, civil servant salaries & family benefits and social minima
Italy	Reduction of general system charges (2022) Reduction of VAT on nat gas Temporary reduction of VAT and excises on fuels	/	To salary earners and pensioners with income <€35,000	Enlargement of beneficiaries and extension until end-2022 of social bonuses meant to reduce electricity and gas expenditure for poor households

Western Europe

	VAT/price reductions	Price caps	One-off payments	Other measures
Austria	Green electricity subsidy and green electricity flat rate set to zero Compensation for rising energy costs in public transport to prevent price increases (eg,: free rides for schoolchildren)	/	Energy cost compensation One-off payments in different amounts, Cost-of-living bonus, child bonus	50% increase in the commuter allowance and quadrupling of the 'commuter euro' until 30 June 2023 Advance increase of Family Bonus Plus Inflation indexation of social benefits from 2023 Abolition of cold progression
Spain	Many public transport services will offer free or discounted prices Reduction of VAT on energy and of tax on electricity	€40/MWh (until December, with an increase of €5 per month from January; to be in place until 31 May 2023)	Social Electricity voucher (includes all Minimum-Living-Income beneficiaries)	Excess profits tax for energy companies, money to be used to help citizens pay energy bill
Netherlands	Reduction of excise duty on fuel, reduction of VAT on energy and increase of the 'energy bill refund'	/	For lower-income households	Subsidy for vouchers for advice and the purchase of products aimed at saving energy
Belgium	VAT reduction for electricity Reduction of excise duties on diesel and petrol	/	Cheques in different amounts (income dependent) deducted from energy bill Cheque for households heating their house with oil	Baseline of consumer protection remains the inflation indexation of wages, pensions and social benefits Extension of the social energy tariff (introduced during the pandemic)
Ireland	Reduction of VAT on gas and electricity Reduction of excise duty on petrol, diesel and green diesel	/	For Fuel Allowance recipients and electricity credit payment to all households	/
Greece	Subsidies on the electricity bill (higher amount for households included in the Social Housing Tariff (CTO)) Subsidy on natural gas	Cap on wholesale electricity prices and refund up to 60% of all surcharges paid by consumers with annual incomes of <€45k	For all low-income pensioners	/
Portugal	/	€40/MWh (until December with an increase of €5 per month from January in place until 31 May 2023)	To households benefitting from the social energy tariff	/

Eastern Europe

	VAT/price reductions	Price caps	One-off payments	Other measures
Hungary	/	On electricity and gas up to average household consumption On fuel For selected foods the price cannot be higher than the gross retail selling price on 15 October 2021	/	/
Czech Republic	Energy-saving-tariff Renewable energy fee exemption	Price cap on housing (incl. energy) of 30% of income (35% of income in capital Prague)	One-off payment of per child for families with annual income of <40,000 crowns (c.€1,600)	/
Poland	Reduction of the VAT on fuels, heating and electricity, VAT exemption on gas, basic foods and fertilizers Excise duty exemption on electricity sold to households, reductions on selected motor fuels and light fuel oil Temporary exemption from retail sales tax on fuel sales	Poland's energy regulator (URE) sets tariffs for retail consumers until the end of 2027 (tariff protection)	One-off payment based on income, type of heating and number of people in household	Subsidies for purchase and installation of heat pumps in new homes with a higher energy standard (subsidies account for 30-45%)
Romania	/	Electricity and natural gas price caps and subsidies differentiated by beneficiaries	For low-income seniors	Vouchers for scholars, low-income families and seniors, higher meal tickets value

Authors

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Bert Colijn
Senior Economist, Eurozone
bert.colijn@ing.com

Franziska Biehl
Economist
Franziska.Marie.Biehl@ing.de

Central banks: our main calls

Expect more big rate hikes in September from the major central banks, even if many of them are closing in on the end of their respective tightening cycles

Federal Reserve Chair Jerome Powell at this year's Jackson Hole symposium

Federal Reserve

Our call: A third consecutive 75bp rate hike in September with Fed funds hitting 3.75-4% in December. Rate cuts from summer 2023. Quantitative tightening (QT) to continue until rate cuts begin.

Rationale: While there was a technical recession in the first half of the year this was attributed to volatility in trade and inventories. Consumer spending, business capex and job creation are firm, and with inflation remaining stubbornly high and financial conditions not tightening as much as the Fed would like, more rate hikes are coming. But the 2023 global outlook is deteriorating while higher interest rates and the strong dollar are set to weigh on domestic activity, which is already facing a steep downturn in the housing market. We expect rate cuts next summer.

Risk to our call: Two-way. If the labour market remains tight and inflation doesn't fall as quickly as we expect then rate hikes will continue for longer. Conversely, if the economy reacts badly to rate hikes a deep recession will likely prompt a more rapid reversal in Fed policy.

James Knightley

European Central Bank

Our call: A 50bp rate hike in September and another 25bp in October, followed by a long pause.

Rationale: The eurozone is facing a longer recession and financing conditions have already tightened significantly in recent weeks. The ECB will try to bring its policy rate to the lower end of the range for neutral rates as quickly as possible. However, we think that the ECB is still underestimating the risk and severity of a recession. As soon as the recession becomes more evident, the ECB will also turn more dovish. Any neutral policy rate is much lower in a recession than in a strong growth environment.

Risk to our call: The paradigm shift in many central banks and a high acceptance of a worsening recession is the price to pay to fight inflation. The risk is that the ECB will continue hiking way into the recession and would deliver a total of 150bp rate hikes until Spring 2023.

Carsten Brzeski

Bank of England

Our call: A 50bp rate hike in September and November

Rationale: For the same reasons as the ECB, we think the Bank of England is closer to the end of its tightening cycle than the beginning. That said, there is scope for further aggressive action in the near term. While core inflation should fall throughout next year, the jobs market remains tight and the Bank is worried about the risk of persistent wage inflation. We also think a large government energy support package looks increasingly inevitable, and we think that could provide further impetus for the BoE to keep hiking in the near term. The recent weakness in sterling will bolster the hawks' case, even if in practice this isn't likely to move the needle for inflation all that much.

Risk to our call: Two-way. A lack of government support could force the Bank to stop hiking sooner. Equally a 75bp rate hike in September shouldn't be totally ruled out given other central banks' actions, and neither should the risk of Bank Rate hitting 3% later this year. However, that would make rate cuts more likely in 2023

James Smith

Bank of Japan

Our call: Bank of Japan will maintain an accommodative policy stance.

Rationale: CPI will likely stay above 2.5% till the end of 2022, but the BoJ will downplay it as 'cost-push' driven inflation that will prove to be temporary. Labour conditions are expected to become tighter as labour shortages persist, but it is still questionable that this will lead to meaningful wage increases over the coming months. Even if USD/JPY rises above 140, it won't be a reason for the BoJ to change its policy stance.

Risk to our call: If signs of wage growth are detected then the BoJ may reconsider its policy stance, but that will become more likely when Governor Haruhiko Kuroda retires next April.

Min Joo Kang

Authors

James Knightley
Chief International Economist
james.knightley@ing.com

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

James Smith
Developed Markets Economist
james.smith@ing.com

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Article | 1 September 2022

United States

US: The higher you climb the greater the fall

The Federal Reserve looks set to raise interest rates to 4% by year-end as officials signal a clear intent to deal with inflation. But with the global...

Fed Chair Jerome Powell, right, takes a break with fellow bankers, Lael Brainard and John Williams in Jackson Hole

A recession that isn't a recession

The trade and inventory-induced technical recession in the first half of the year failed to dent the Federal Reserve's appetite for hiking interest rates. After all, it wasn't what we might term a "proper" recession given rising consumer spending and the fact that 3.3mn jobs were created between January and July.

Moreover, third-quarter GDP should bounce back nicely with trade and inventories moving much more favourably while the recent decline in gasoline prices has boosted consumer spending power. At the same time, core inflation is likely to rise back above 6% Year-on-Year on September 13th, while the upcoming August jobs employment should be decent given the surprise rise in job vacancies.

Fed pushes back against market pricing

Despite 225bp of interest rate hikes so far and the strong dollar, financial conditions have actually loosened in recent months. This came via tightening credit spreads and falling longer-dated yields as markets increasingly doubted the Fed's intentions and predicted a pivot to rate cuts next year. The Fed fought back at the recent Jackson Hole symposium as officials ratcheted up the hawkishness, affirming that policy will be tightened further - and kept tight - to ensure inflation comes down.

The robustness of the Fed's language seems to have changed perceptions somewhat and it now appears likely it will implement a third consecutive 75bp interest rate increase on September 21st. With more rate hikes at the November and December policy meetings we now see the Fed funds rate peaking at a 3.75-4% range by the end of the year.

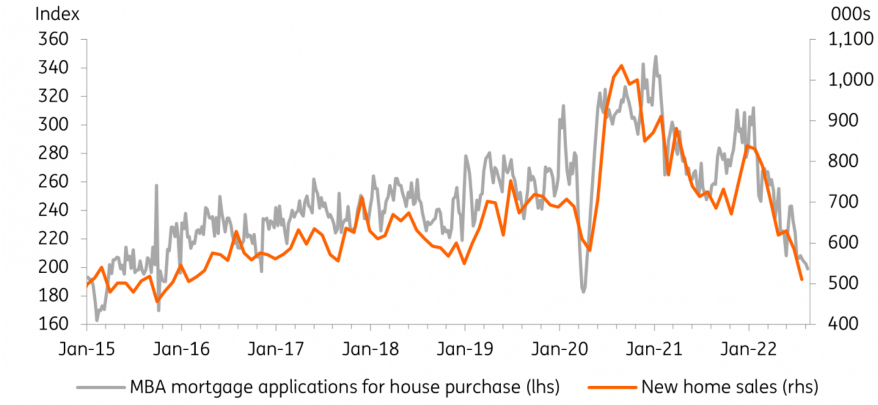
Another key message from Chair Powell's Jackson Hole speech was that the market shouldn't get carried away with the pricing of rate cuts next year, which we suspect was part of the push intended to get longer-dated yields higher to tighten financial conditions to get inflation lower. Unfortunately, we have far less conviction than Powell that there won't be the need for a loosening of policy in 2023.

Real recession risks are rising with inflation set to fall sharply

Residential investment is already a drag on growth due to the rapid downturn in the housing market while the global backdrop is deteriorating due to Europe's energy crisis and China's apparent slowdown. A strong dollar and higher-for-longer interest rates will only intensify the downside risks for growth in 2023 with the potential for what might be termed a "real recession" with rising unemployment and falling spending looking increasingly likely for late 2022/early 2023.

Inflation will stay high through the rest of this year. However, we remain hopeful that inflation can get back to 2% by the end of 2023. Housing and cars account for nearly half of the core CPI basket of goods and services, and the downturn in demand and rising supply will weigh on prices and be a major driver of lower CPI from April onwards. We also expect the weaker growth environment to result in a squeeze on corporate profit margins which will help depress inflationary pressures while a weaker growth environment translating into stagnant payrolls will take the heat out of wage inflation.

Housing demand and transactions continue to fall, prices will follow



Source: Macrobond, ING

Odds continue to favour 2023 rate cuts

Our base case for next year is a broad downturn in economic activity with the labour market losing jobs and inflation falling more quickly than the market and the Fed anticipate. This will open the door to rate cuts in summer 2023.

In order for the Fed not to cut rates, we need to see an environment where inflation stays stickier and the economy doesn't experience as much of a slowdown as we expect. This most likely scenario would be via ongoing falls in gasoline prices (and perhaps food prices on top) spurring consumer demand with inflation pressures rising in other areas in what is a continually supply-constrained world. Additionally, while worker demand slows there continues to be worker shortages and the fight for talent remains strong, particularly in leisure and hospitality.

We would also probably need to see financial conditions remaining loose, which could come via the dollar weakening and longer dates' yield declining, dragging borrowing costs lower more broadly - basically, the market not believing the Fed. In the topsy turvy world of market behaviour, we would also need credit spreads to stay narrow with equities proving resilient. While not implausible, we do not see this as the most likely path ahead, hence our forecast for rate cuts.

Author

James Knightley
Chief International Economist
james.knightley@ing.com

Article | 1 September 2022

The eurozone economy is set to shrink in 2023

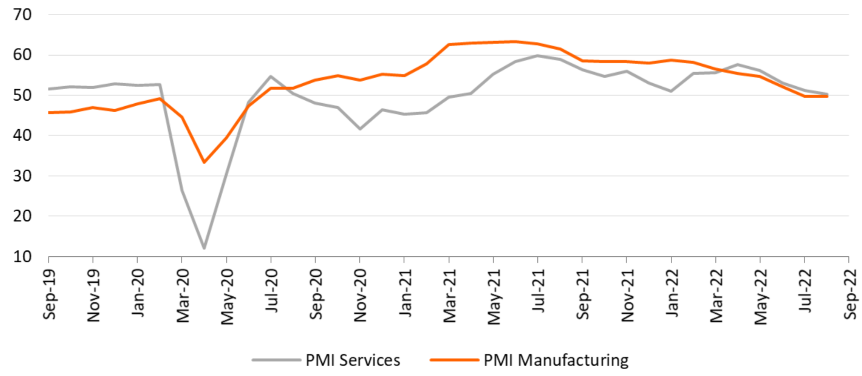
The expanding negative energy shock is likely to initiate a recession from the third quarter and we're likely to see a GDP contraction. Rising natural...

Tough times lie in store for shoppers across the eurozone

Recession is coming

After a relatively strong second quarter (+0.6% quarter-on-quarter) after Covid lockdowns were largely stripped away, the eurozone has now probably fallen into recession. The Composite PMI indicator fell in August to 49.2, the second month in a row below the 'boom-or-bust' level. With the forward-looking new orders component also declining again, it looks as if it is only going to be downhill in the coming months. And the strong inventory build-up will add to production cutbacks.

Survey indicators are at recession levels



Source: Refinitiv Datastream

Energy shock erodes real incomes

The headwinds facing the eurozone are only increasing. The summer drought will not only hurt the agricultural sector, but the low level of the Rhine River is also distorting supply lines for German manufacturing, while in France the lack of cooling water is impacting nuclear power generation. This, however, is small fry compared to the breadth of the negative energy shock Europe is experiencing. Natural gas prices have more than tripled since June, pushing more energy-intensive companies to cut production or idle plants.

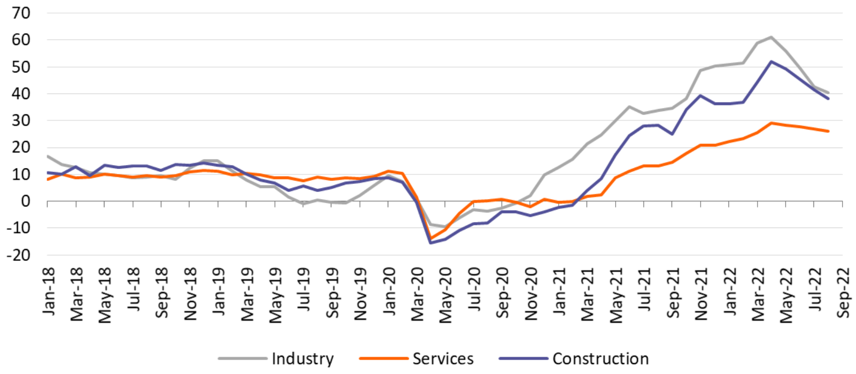
The hit to household purchasing power is massive; real wages are falling more than 5% year-on-year. With consumer confidence hovering at very low levels, chances are slim that households will delve into their savings to uphold their consumption expenditures. And as companies are equally hit by the energy shock, final demand is faltering and financial conditions are tightening and we see business investment falling back in the coming quarters. As we expect the energy market to remain very tight (and prices therefore high) we pencil in three consecutive quarters of negative growth, starting in the third quarter of this year. This still results in 2.6% growth in 2022, mainly on the back of a strong carry-over effect, while for 2023 we now expect a 0.6% GDP contraction.

Inflation to come down only very gradually

As for inflation, the higher cost of natural gas is only partially compensated by slightly lower oil prices. On top of that, a natural gas levy in Germany will add to inflation from October onwards. This will keep headline inflation close to double-digit levels in the next three months. At the same time, underlying inflationary pressures are bound to soften on the back of the economic slowdown.

In the business surveys, selling prices' expectations have now been moderating for a few months in a row, while supply chain tensions and shipping prices have also eased. And the second-round effects, popping up through higher wages, remain muted for now. As a matter of fact, negotiated wages only rose 2.1% year-on-year in the second quarter, according to the ECB. Putting it all together, inflation will only come down very gradually, although we see a return to the 2% level towards the end of 2023 as still feasible provided, of course, that energy prices don't increase much further.

Selling prices' expectations are moderating



Source: Refinitiv Datastream

A more hawkish ECB

The European Central Bank has become somewhat more hawkish. In Jackson Hole, ECB Board Member, Isabel Schnabel, said that the uncertainty about inflation persistence requires a forceful policy response, a statement that was echoed by several members of the Governing Council. We therefore now expect a 50-basis point rate increase in September and another 25bp rise in October. Thereafter we still expect to see a long pause.

Let's be clear about this: if the ECB is consistent with the risk scenarios it published in June, it should already forecast a recession in its September staff forecasts. While the bank might still pull off a rate hike in October, the necessity of tightening further after that, in the midst of a worsening recession, will probably not appeal to the majority of the Governing Council members.

Author

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Article | 1 September 2022 United Kingdom

The UK’s new prime minister faces immediate test as recession looms

With inflation set to hit 16-17% in January, a UK recession looks inevitable. The depth depends heavily on how much support the new prime minister offers...

Opinion polls suggest Liz Truss will beat Rishi Sunak to become Britain's next Prime Minister

Energy bills set to increase six-fold based on latest price data

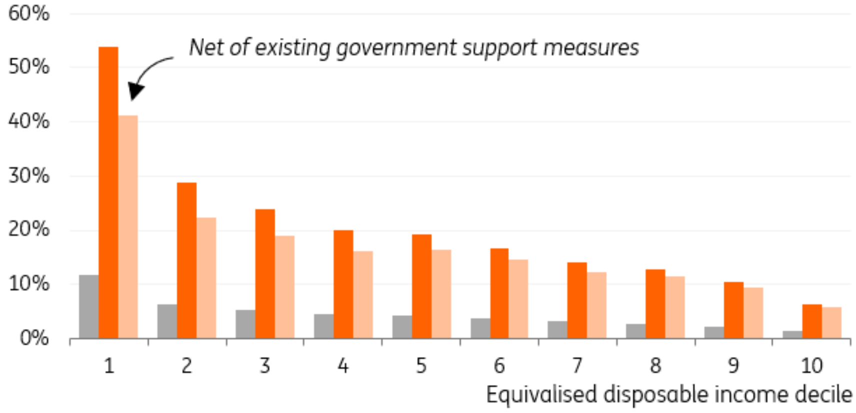
The UK, like the eurozone, looks like it’s headed for a recession. The UK may benefit from greater security of gas supply and larger LNG regasification facilities. But a lack of gas storage means that Britain is vulnerable to price volatility across Europe this winter.

Indeed if wholesale gas prices were to settle at their most recent peak, we could see the average household energy bill hit almost £7,000 on an annualised basis next April. That compares to roughly £1,100 in previous years, and our latest forecasts suggest that inflation could hit 16-17% in January next year – or perhaps even higher.

Unmitigated, that would see most households paying more than 10% of their disposable income on energy, something that could amount to material cuts in non-essential spending. The government has announced £37bn worth of support so far, but that was when energy bills were expected to peak at around £3,000. Households will need to find an extra £65bn to pay for energy bills from October to the same period next year, to offset the further rise in gas prices we’ve seen since the last round of support was announced.

Households in most income deciles set to pay more than 10% of disposable incomes on energy

Household energy bills as a percentage of disposable incomes (by income decile)
Data from **FY2021** (**grey**) compared to our estimates for **Oct 2022-Sept 2023** (**orange**)



Source: ING analysis of ONS Living Costs and Food Survey, Effects of Tax and Benefits, Ofgem, UK Treasury

Government support based on estimates produced by the UK Treasury as part of the 26 May Cost of Living package. For simplicity, we've used 2020/21 equivalised disposable income data, which in practice will have increased. Assumes energy prices increase by same percentage for all income deciles. Disposable income = after income tax/national insurance etc (but before accounting for housing and other costs)

This gives a sense of what the new prime minister, who will be announced on 5 September, will face. Foreign Secretary, Liz Truss, who is odds-on to succeed Boris Johnson, has stated a preference for using tax cuts to help households. However, the sheer scale of the energy bills that are likely to hit next year suggests that this will need to be coupled (or replaced) with additional direct payments to households across the income spectrum.

The most obvious mechanism for that would be to dramatically increase the existing £400 discount on energy bills that households receive from October. Importantly that will probably need to be extended, in one form or another, to small businesses, which are unprotected by the regulator's price cap and are already experiencing potentially-existential price hikes.

Savings stockpile and tight jobs market could insulate economy if government support is ramped up

The key message is that the UK is heading for a recession, though its magnitude depends heavily on the scale of government support. In our base case, we're assuming that support is materially increased and the scale of the economic downturn can be kept relatively shallow, at least by recent historical standards.

Remember that households still have 'excess savings' accrued during subsequent lockdowns, which amount to roughly 8% of GDP – albeit these are heavily skewed towards higher earners. For the time being, the jobs market is also very solid and remains characterised by ultra-low redundancy levels and staff shortages, though higher energy bills for corporates could begin to change that picture. Vacancy levels have begun to decline.

We're pencilling in a hit to GDP of roughly 1%, though this is highly conditional on how much government support is offered.

Markets are assuming that a large government support package would raise the chances of a forceful reaction from the Bank of England. We agree with this assessment even if current swap rates wildly overestimate the scale of tightening that's likely. We expect at least one, if not two, further 50bp rate hikes.

Author

James Smith
Developed Markets Economist
james.smith@ing.com

Article | 1 September 2022 China

Local governments to China’s rescue as risks mount

There are more risks emerging from China's economy: Covid, real estate, regulations on the internet industry and the recent drought. These have...

Real estate continues to be a drag on China's economy. Pictured: a residential construction site in Huaian, eastern China

The economy is facing many headwinds

These are tough times for China. Covid-19 – and the government's tough approach to any new outbreaks – continues to be a drag on the country's economy, notably in the leisure and travel sectors. Real estate is of growing international concern and there are real worries of a major crash; confidence in the sector has nose-dived as many developers go bankrupt. We still have no update on the completion rate of uncompleted residential projects after funds were allocated for these projects. In addition, severe droughts have led to electricity shortages, notably in western China. On top of this, there are now even more regulations in place for the internet sector.

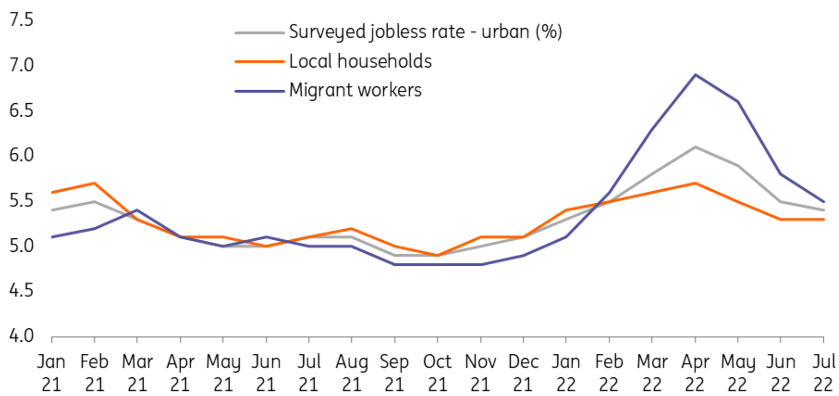
All of this is bad news for the jobs market. Labour demand is not recovering as fast as we had thought it would, and wages seem to be coming down in some important industries, including technology.

Real estate is still the main problem

The financial difficulties of residential property developers have come to the public's attention and some mortgage borrowers have requested delays to repayments on uncompleted residential property sites. Cash tightness is the main characteristic of financially weak property developers, meaning they do not have enough cash to pay their suppliers and complete projects.

The government does not appear to be giving up on deleveraging reforms. Funds are being pooled by policy banks and the central bank in China, and there is also some support from local governments where the uncompleted projects are located. But these support measures are only to be used to finish uncompleted projects so that mortgage borrowers will continue to repay the banks. It could take several quarters to see a positive effect from the announced measures, and it could take years to finish all of the uncompleted projects.

China's surveyed jobless rate



Source: CEIC, ING

Local governments to the rescue?

The risks we mention affect the job market negatively. The surveyed jobless rate in urban areas was 5.4% in July 2022, compared to the recent low of 4.9% in September and October 2021. Migrant workers have been hardest hit as they're predominantly employed across the construction industry's value chain, including raw material mining and processing.

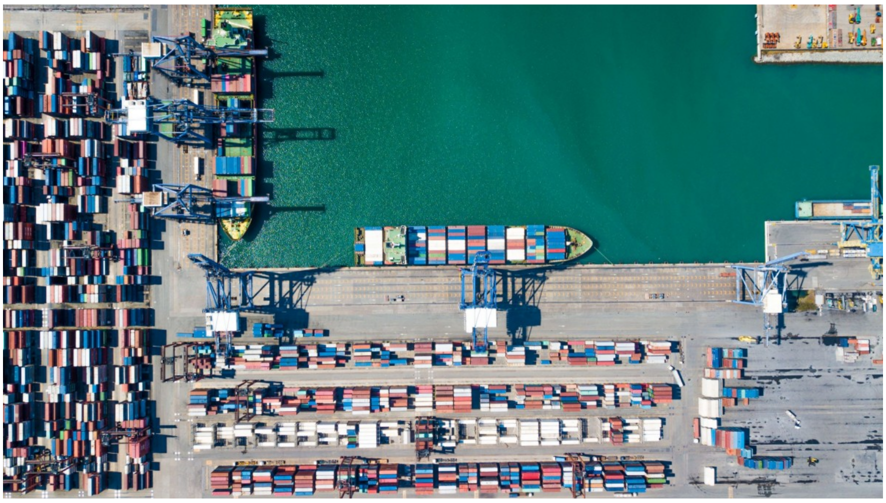
The jobless rate might not fall back to 4.9% without further fiscal stimulus. But what kind of stimulus can quickly stop the economic slowdown?

The central government believes that local government officials have the answer. Recently, it explicitly pressured all local governments to stimulate their local economies. Some could hand out consumption subsidies and others could speed up the construction of infrastructure. These measures should at least stop the GDP growth rate from falling towards 2% (our forecast is 4%) in 2022.

We believe that pressing local governments can help, especially given the timing (just before the 20th Party Congress in October). Those who can prop up their local economies without giving up long-term investment plans might be able to advance their careers in the 20th Party Congress.

Asian exports are softening

Non-China Asian exports are still growing, but the pace of increase has slowed and will slow still further as key export destinations struggle with...



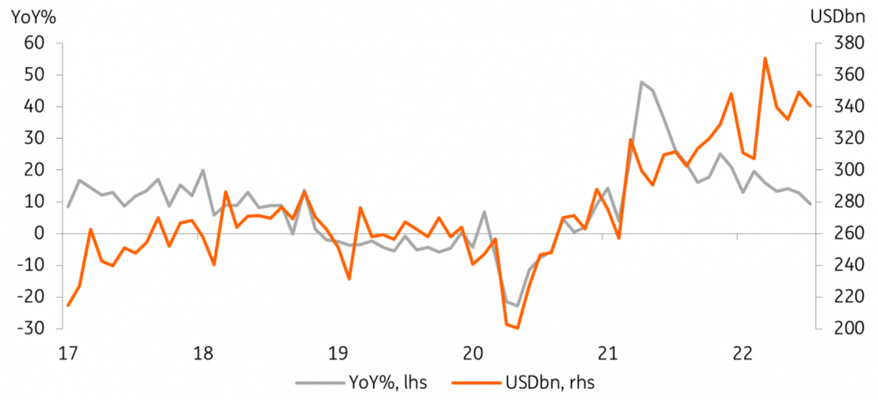
Global exports from Asia are slowing. Pictured: Thailand's Chonburi Laem Chabang Port

Asian exports going sideways

As economies worldwide re-opened after the lockdowns of the Covid pandemic, non-China Asian exports to the rest of the world surged. But that rate of growth looks like it's slowing. Distortions caused by the Lunar New Year always make interpretation of trade data trends at the beginning of the year tricky, and there was an expected jump in March. But since then, the numbers look to be struggling. In year-on-year terms, the rate of overall export growth is now skirting single-digits again. A slowdown in year-on-year terms was inevitable after the re-opening surge, but this slowdown has also become evident in USD terms in recent months.

Non-China Asia export growth slowing

Japan, India, South Korea, Taiwan, Malaysia, Vietnam, Thailand, Singapore, Philippines



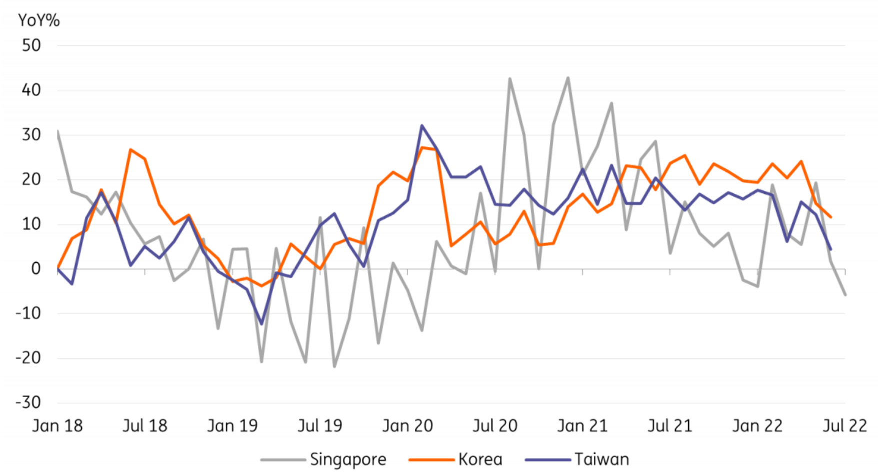
Source: CEIC, ING

Electronics production growth has also moderated

Digging deeper into the Asian export numbers, one of the more surprising aspects is that the electronics sector did not have a stronger recovery in 2021/22. Globally, semiconductor sales grew robustly in 2021, but topped out in December 2021 and have gone only sideways since then. Given the dominance of this sector in Asia, the increase in non-China Asian electronics exports over this period has been disappointing, not matching the strength in global electronics sales.

Explaining this isn't easy. One interpretation is that given shortages in electronics globally, more of Asia's output remained locally - less of it being shipped overseas. But that hypothesis doesn't actually stack up against production figures, which show an equally lacklustre performance since January this year. Instead, this seems to point more firmly to capacity constraints in the industry as the main explanation.

Selected Asian electronics production (YoY%)



Source: CEIC, ING

China's lockdowns played their part, but they are now over

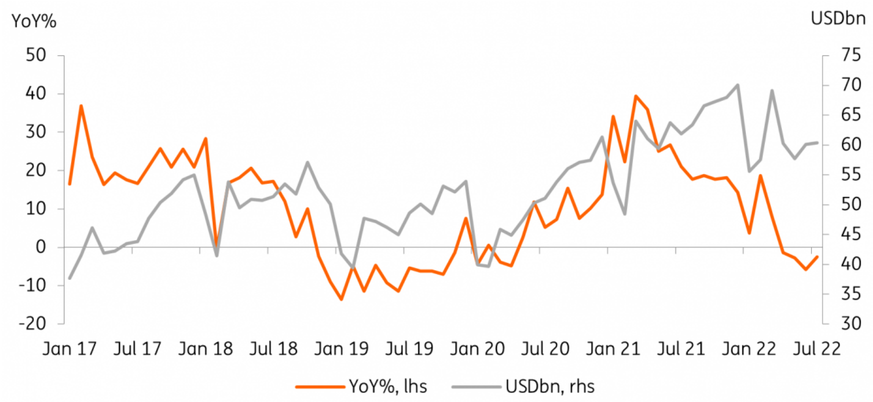
Back in April and May this year, China was struggling with its zero-Covid policy, and the port of Shanghai had its operations disrupted by lockdowns. As the world's busiest port, this will have hurt the exports of firms across the region and beyond. Even though China's Covid cases are still bubbling away in the background, the lockdowns are now much more focused, and the big citywide lockdowns of the second quarter that were so disruptive are not being repeated. Yet Asia's export figures continue to look weak.

As well as potential roles for capacity constraints and lingering supply disruptions, there does seem likely to be a demand element at play. Non-Asian exports to Mainland China have been weakening sharply in recent months. China's macroeconomy is not in great shape currently (see our specific China section). Ongoing, albeit lower intensity Covid restrictions continue to weigh on the economy to some extent. But on top of this, the languishing property sector has also cut demand for building materials. And topping things off, heatwaves, drought and related power shortages have all taken a toll, which an ever-expanding list of government stimulus policies seems only partially able to offset.

It's worth also considering that this may not be an entirely China demand story. Asia's complicated supply chains mean that China is only an intermediate destination for some of Asia's exports, many of which may then be destined for Europe or the US after further processing.

Asia's exports to China

South Korea, Taiwan, India, Indonesia, Japan, Malaysia, Philippines, Singapore, Thailand, Vietnam



Source: CEIC, ING

Recession risks could further undermine Asia's exports

There are some definitional changes to the Harmonized Commodity Description and Coding System (HS) data that can explain some of the declines in exports of some specific items, in particular, exports of smartphones. But these should not adversely impact the broader export figures for the region. And we doubt that China has, despite its best efforts, already managed to become self-reliant in all these areas of technology.

More time and more data will help shed light on the evolution of this sector for the Asia Pacific region over the rest of the year. But if it turns out that capacity issues are a factor, then these are unlikely to be solved before 2023. Likewise, China's activity could pick up slightly over the second half of the year, though will probably still fall well short of the government's 5.5% target for 2022 (about which we hear relatively little these days). The global slowdown outside the region in contrast is only likely to get worse. Europe may already be in recession (see also our European note). The US is technically already there, but the technical nature of its recession may give way to a more substantive recession as we move into 2023 and rate rises bite deeper.

In short, whatever the full reality of the complicated situation we are trying to untangle, Asia's trade sector is more likely to become a drag on economies in the region over the coming quarters. And on top of the drag from inflation on domestic spending power, we may need to reflect this with some more moderate growth forecasts for the second half of this year, and potentially for full-year 2023.

Author

Robert Carnell
Regional Head of Research, Asia-Pacific
robert.carnell@asia.ing.com

Article | 1 September 2022 Czech Republic | Hungary...

CEE central banks are looking for a peak in the hiking cycle

In Central and Eastern Europe, the hiking cycle is coming to an end. in the Czech Republic, we're not expecting any further rate rises. Poland should...

The rate hike cycle in Central and Eastern Europe is coming to an end despite inflationary pressures

Poland: NBP turning dovish, but the peak in inflation is yet to come

Poland's GDP growth in the second quarter surprised to the downside, reaching 5.5% YoY vs 8.5%YoY in the first three months. The sequential slowdown of 2.1% Quarter-on-Quarter (seasonally adjusted) was the second worst in the last few decades, only coming in deeper during the pandemic in early 2020. We think the data exaggerates the magnitude of the economic slowdown in the last quarter and the sharp sequential slide was also caused by statistical revisions. Still, the numbers mark a turning point in activity and the possible beginning of a technical recession in 2022.

July activity figures present a similar picture, with industrial and construction, production, and retail sales surprising on the downside; the backdrop of this data shows the economy is losing momentum. The previous growth engines in manufacturing slowed, and seasonally adjusted retail sales indicate that the consumption boom is fading. Now we see indicators such as the PMI index fall well below 50 and consumer sentiment is worse than during the pandemic. The influx of some 2 million Ukrainian refugees supports the sale of necessities, but growth in durable goods is weakening.

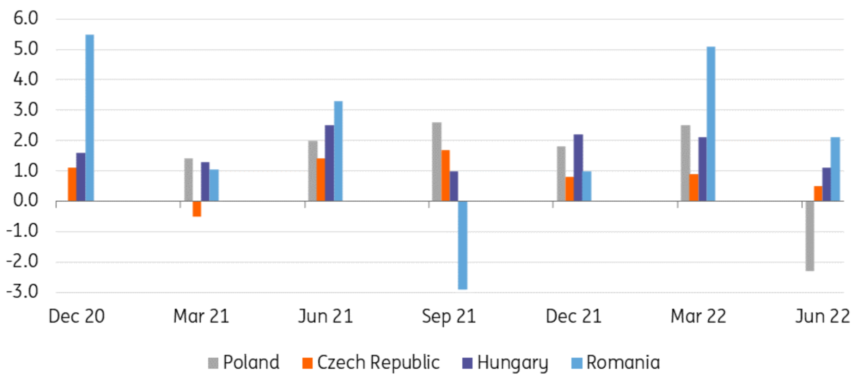
After stabilising during the summer, August CPI figures show inflation pressures are resuming in all categories. Most worrisome is the sequential growth of core inflation, which spiked again after the June-July slowdown. This matches our non-consensus view that CPI should reach its new peak later this year and into next, reaching just below 20% YoY. The energy price shock is largely to blame and the government is preparing offsetting measures but sustaining those is perhaps prohibitively expensive.

The 2023 budget draft presents a sector deficit of 4.4% of GDP almost in line with our forecast and about 4.5% in 2022. We see revenue estimates as reasonable, but worry spending may be higher given the energy crisis. Also, locally funded investment projects may replace the EU Recovery Plan, so raising borrowing needs or the deficit.

Overall, the fiscal stimulus in 2023 should be comparable to over 3% of GDP we estimate for 2022, thus we see an upside risk for the 2023 deficit and higher borrowing needs than planned. Still, Poland seems to be somewhere between Hungary (where pre-election fiscal expansion was very high) and the Czech Republic, which delivered orthodox monetary and fiscal consolidation in 2022.

Poland's Monetary Policy Committee switched to a dovish tone, but the governor withdraw from his opinion of 'one 25bp hike and done'. We downgraded our terminal rate forecast from 8.5 to 7.5%, which is a bit higher than consensus but matches market pricing. We still think that the risk of persistent inflation is high, but the government should mask inflation with additional extraordinary measures and fiscal stimulus would still be directed to households. The economic slowdown would make the MPC less prone to hike, but still recent CPI data from Poland and elsewhere support our view that the energy shock has to pass through to prices and the CPI peak is still ahead of us.

GDP growth in the CEE region (%QoQ)



Source: Macrobond, ING

Czech Republic: CNB is comfortable with the end of the hiking cycle

Second-quarter Czech GDP had shown a slight increase instead of the expected economic contraction; the second estimate brought another upward revision. The main reason for the positive surprise is the rise in inventories, while consumption fell slightly. So, the outlook for the second half of the year has not changed significantly and the slowing economy is confirmed by both leading indicators and monthly data. Inflation surprised to the downside in July for the first time since last May, mainly due to energy prices and the unclear fix/float mix of household contracts. This may imply a slower pass-through of energy prices into CPI, but we still expect inflation to peak around 20% in the coming months.

On the fiscal side, upward pressure on wages and household energy cost subsidies remain, but the government's actions to date do not pose a material risk to our forecast of a government deficit of 4.1% of GDP. Moody's, unsurprisingly, downgraded the Czech Republic's rating outlook from stable to negative in early August following Fitch's earlier decision. We do not expect a downgrade in ratings unless there is a complete cut-off of gas supplies from Russia.

On the monetary policy side, the CNB remains in 'wait-and-see' mode. Our forecast remains unchanged, i.e. no interest rate hike. Although the economic picture is slightly better, surprisingly low inflation has created a solid buffer for the new board to remain dovish in the months ahead. Moreover, the depreciation pressure on the koruna has eased, so we do not see unsustainable intervention costs as a risk for the coming months either. The koruna should hold at current levels near the intervention band of 24.60-24.70 EUR/CZK.

Hungary: The first signs of the winds of change

In general, economic activity in Hungary is doing OK despite the plethora of challenges, which is represented well by the 6.5% year-on-year GDP growth in the second quarter. However, the first red flags have already popped up. The volume of retail sales has been on a downward trajectory for three months, a phenomenon which was last seen during 2008-2009 and in 2012. Hungary fell into recession in both periods. Real wage growth is still holding up (+3.3% YoY in June), but it is slowing quickly. The continued acceleration in inflation (13.7% in July) and the expected peak at 22% means a meaningful deterioration in real disposable incomes in the coming months. Finally, the unemployment rate increased for the first time in six months in June, though the labour market has remained extremely tight.

Against this backdrop, we expect a technical recession in Hungary during the second half of the year. Its impact will mostly be felt in the 2023 average GDP growth (1.0-1.5%), as the strong first half in 2022 will keep this year’s economic performance elevated. However, any economic wobble shouldn’t frighten the National Bank of Hungary and we see the central bank continuing its fight against inflation with interest rate hikes and more. A 14% terminal rate might prove to be enough in our view if the upcoming rate hikes are accompanied by measures which actively tighten excess liquidity in the financial system. This combination could give a temporary boost to the still vulnerable local currency, but the real story of the forint can be found elsewhere, i.e. the gas and EU story. A satisfying conclusion in both (or at least in the Rule-of-Law debate) could free up the forint’s hidden potential.

Romania: Hiking cycle nears peak

Despite high-frequency indicators pointing to a small quarterly growth for second quarter GDP, the flash data again surprised strongly to the upside. Second quarter GDP expanded by 2.1% versus the previous quarter, dashing speculation about an ongoing recession. Corroborating this with the even stronger 5.1% quarterly growth from the first quarter and assuming no significant data revisions going forward, we can safely say that even a stagnant economy in the second half of 2022 would still take real GDP growth to 7.0% in 2022.

On the inflation front, starting in the fourth quarter of this year the inflation profile will start descending gradually and the central bank estimates it will enter the target band (1.5%-4.5%) by the end of its two-year forecast horizon. This is in line with our forecast, though the recent spike in energy prices might complicate things again. We see the year-end inflation rate at 13.6% in 2022 and 7.0% in 2023.

The relative stabilisation of the inflation trend will most likely incentivise the National Bank of Romania to reduce its hiking pace further. With two more policy meetings this year, the pace of tightening is likely to soften to 50 basis points in October and 25 basis points in November, taking the key rate to 6.25% by year-end. However, the broad monetary conditions might not fully reflect the remaining tightening steps. As we move ahead into the second half of 2022 the liquidity picture could improve a bit as the government should speed up its spending if it were to stick to its 5.8% of GDP budget deficit target. As of the end of July, the budget deficit stood below 2.0% of GDP, hence there's almost 4.0% of GDP to spend (approximately RON55bn) in the remaining five months of 2022.

Authors

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

Euro Focus: Germany is facing a perfect storm

At the start of the year, we singled out the German economy as one of the eurozone's shining growth stars. The war in Ukraine has changed...

Dangerously low water levels on the Rhine in Germany are yet another recessionary factor for the country

The German economy is quickly approaching a perfect storm. The war in Ukraine has probably marked the end of Germany's very successful economic business model: importing cheap (Russian) energy and input goods, while exporting high-quality products to the world, benefitting from globalisation. The country is now in the middle of a complete overhaul, accelerating the green transition, restructuring supply chains, and preparing for a less globalised world. And these things come on top of well-known long-standing issues, such as a lack of digitalisation, tired infrastructure, and an ageing society, to mention a few.

In the coming weeks and months, these longer-term changes will be overshadowed by shorter-term problems: high inflation, possible energy supply disruptions, and ongoing supply chain frictions. Last but not least, since the summer the shorter-term problems have become larger as low water levels and a new gas levy have added to inflation and recession concerns.

Low water levels

Like many parts of Europe, Germany has been hit by a long, unprecedented drought. Water levels have been dropping continuously over the summer and last week. Barges can no longer be loaded at full capacity but at a maximum of one-third and some routes will be cancelled. But there's more: industry facilities on the Rhine River shores will increasingly have problems using water for cooling.

Back in 2018, low water levels shaved off some 0.3 percentage points of German GDP growth over two quarters. However, back then, the low water period only came in late September. This time around, low water levels have come earlier and there is little rain relief in sight. To make things worse, waterways are essential for coal transportation, which in turn is needed to offset less gas from Russia. This means that unless the weather brings any substantial relief, the low water levels will do more economic harm than in 2018. We expect the low water levels to shave off at least 0.5 percentage points of GDP growth in the second half of the year.

Gas levy and high energy prices

The German government announced a gas levy for households and businesses, which will come into effect in October. This levy is meant to cover the additional costs incurred by gas providers, as higher wholesale gas prices couldn't be passed through to consumers.

Almost half of all German households are heated using gas and it remains an important energy source for industry. According to government estimates, the levy will lead to an additional cost of around 500 euros per year for a four-person household. However, don't forget that next winter, energy providers will be able to pass through higher energy prices to consumers as they can adjust prices once a year. Households and corporates will be facing energy bills two to four times that of recent years. The government is currently discussing additional compensation measures for lower-income households, possibly an increase in child benefits, income tax reductions or direct financial support.

Recession has become inevitable

An economic recession in Germany was already our base-case scenario at the start of the summer, due to high energy and commodity prices, ongoing supply chain frictions, and the war in Ukraine. With these latest developments, the question is no longer whether the economy will enter a recession; the only question is how deep it will be.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

The dollar rally's still going strong

Long positioning is probably the biggest challenge to a further dollar rally from current levels. Yet the juxtaposition of a very hawkish Fed against...

The US dollar is expected to stay strong for the rest of the year

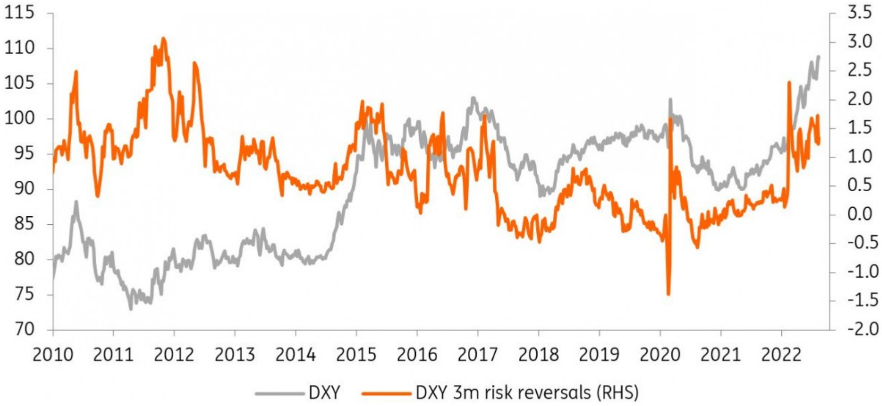
Long positions in the dollar are seen as the most crowded trade

Surveys this summer have seen fund managers reply 'long dollars' when asked what the most crowded trade in global financial markets currently is. Perhaps this should not come as a surprise given the trade-weighted dollar's near 14% rise this year – with only limited corrections.

True measures of dollar positioning remain hard to come by. Traditional gauges, such as net speculative positioning in FX futures markets, do not show extreme readings right now. However, scepticism is growing that this decades-old analytical tool accurately reflects the ever-changing list of participants in the FX market, including the growth of retail.

An alternative to positioning data is to gauge sentiment in the FX options market. Here the 'skew' towards dollar call options (the right to buy dollars) remains quite stretched. But far from calling a turn in the dollar's trend, in our opinion, this extreme bullish sentiment is well justified.

The 'risk reversal' or 'skew' for dollar call options remains quite stretched



Source: Refintiv, ING

DXY Risk Reversal is DXY-weighted of 3m risk reversal for relevant $ FX pairs

Macro factors continue to swing in the dollar's favour

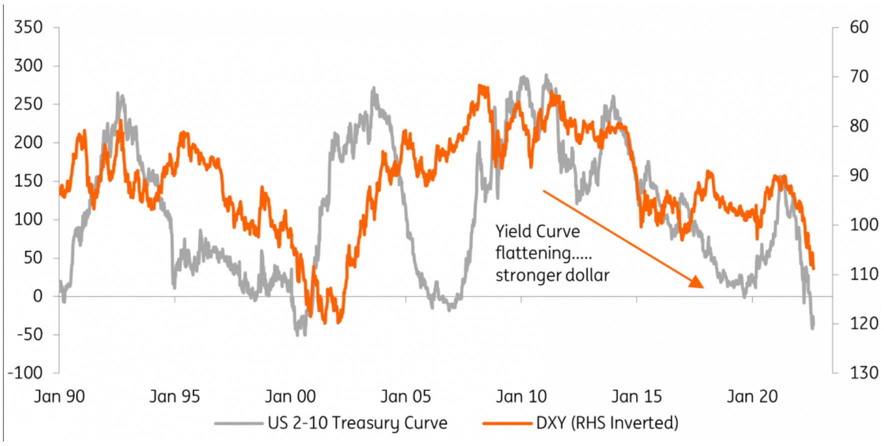
The macro factors that have driven the dollar to these levels are well-documented and remain firmly in place. The Fed is happy to remain very hawkish and drive rates deeper into restrictive territory. The Fed understands and indeed intends that US demand should slow to bring inflationary pressures into balance. Inverted yield curves and equity underperformance are typical of this late-cycle economy; it's an environment that typically sees the dollar outperform. These trends look set to dominate for the rest of 2022 and we do not see a dollar turn until the first quarter of next year if that.

Equally the challenges posed by the energy crisis have taken their toll on the importers in Europe and Asia. We have documented how this has damaged the euro's fair value. And the loss of trade surpluses in Europe and Japan now undermines the status of the euro and the yen as safe haven currencies now that the natural demand from their trade accounts has dwindled.

Additionally, our team still feels that the ECB tightening cycle, rather than the Fed cycle, is more prone to being repriced lower. We look for the recent narrowing in yield differentials to reverse course. This should see EUR/USD remaining under pressure for most of the year, where the 0.95 level may well be tested.

Inverted US yield curve typically occurs late in the economic cycle and is associated with a stronger dollar

US 2-10 year yield curve versus DXY (RHS Inverted)



Source: Refinitiv, ING

Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Article | 1 September 2022

Here's why rates will keep on rising

Market rates are set to rise as financial conditions are not tight enough in the US; the US 10yr yield could even go as far as topping 3.5% again. That...

Remarkably, financial conditions are significantly looser in the US than in the eurozone

So, how do central banks fight inflation exactly?

Central banks impact the macroeconomy by finessing financial conditions. It's not as simple as setting official rates though; it requires the wider financial system to push in the same direction. Most importantly, market rates need to be in tune with central bank thinking. Credit spreads are key too; wider credit spreads add to the all-in funding costs for corporates and households, amplifying the impact of higher market rates. And this together with other central bank liquidity management tools will broadly determine overall financial conditions.

Not sure I'd recognise a financial condition if I saw one ...

- **What can central banks NOT do?**
  - Impact the supply of energy, raw materials, labour and housing (important stuff)
- **What can central banks actually do then?**
  - Impact financial conditions. That's it! (extremely blunt and roundabout means)
- **What helps to tighten financial conditions?**
  - Higher cost of credit & FX, lower risk asset valuations and less availability of credit
- **How does that help?**
  - Tighter financial conditions help to dampen macro demand, thus taming inflation

Source: ING estimates

Eurozone financial conditions are already looking quite scary

In the eurozone, the Bloomberg measure of financial conditions has seen a virtual collapse from June through to August. At the beginning of June, conditions were moderately tight (about 0.25 of a standard deviation below normal). By the end of August, they were extremely tight (some 2.5 standard deviations below normal). This contrasts with extremely loose conditions at the beginning of 2022 (1.5 standard deviations above normal). The ECB of course hiked in mid-July, preceded by an end to bond buying (and targeted longer-term refinancing operation unwinds), which tightened eurozone financial conditions.

Remarkably, lower market rates and tighter credit spreads through July did not prevent an overall tightening in eurozone financial market conditions. In fact, they're looking quite scary right now. They are practically back to the extreme briefly seen when the pandemic first struck, and the only periods where eurozone financial conditions were tighter were during the Great Financial Crisis of 2008 and the Sovereign Debt Crisis of 2011. This suggests that the ECB has less to do. All they need to do is sustain this, not intensify it. Super big hikes are not needed.

Remarkably, US financial conditions are still too loose

There is a remarkable contrast to be drawn with the US, where financial conditions tightened right through to the end of June (1.5 standard deviations below normal), driven by Fed hikes, rising market rates and wider credit spreads. But then it reversed. A notable fall in market rates and a tightening in credit spreads, which ran from mid-June to end-July, loosened US financial conditions quite considerably, pulling them practically back to almost normal by mid-August. Remember the US 10yr yield fell from 3.5% to almost 2.5% during this period, and risk assets rallied. Hence the easing in conditions.

This easing was counter-productive to the Fed's stated ambition to tighten financial conditions, and was a factor underpinning the crystal clear speech from Chair Powell at Jackson Hole: this Fed wants and needs to see tighter financial conditions, and will do its bit to tighten them by hiking the funds' rate at upcoming Federal Open Market Committee meetings. In fact, in the lead-up, and through the second half of August, market rates and credit spreads reverted and started to do what they should be doing at this stage of the cycle, rising and widening respectively.

A stark contrast

Currently, we find a stark contrast between the eurozone and the US. US financial conditions are just 0.35 of a standard deviation below normal, while eurozone ones are 2.5 standard deviations below normal; even though it's the Fed that's done most of the tightening. From the perspective of the US, a required objective is to re-tighten conditions considerably from here, which is code for rising bond yields and widening in credit spreads, to be capped off with a 75 basis point hike from the Fed on 21 September.

For the eurozone, things are more opaque. There is a deeper energy-impacted macro crisis afoot, and financial conditions are already super tight. Higher market rates and wider credit spreads ahead can deepen this further. The ECB can cap this off with a decent hike in September but does not need to do as much cajoling as the Fed might have to do in the weeks ahead. And the ECB does not need to do as much aggregate hiking either, relative to the job the Fed still has to do.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

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Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

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