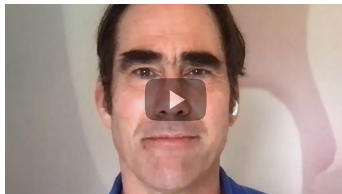


# ING Monthly: The economic twilight zone

For the global economy, the first half of the year was packed with action. The remainder of the year will see a further weakening of the global economy, a rapid fall in headline inflation, and a dearth of central bank rate cuts

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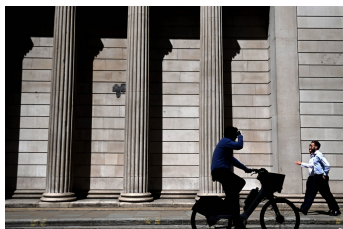
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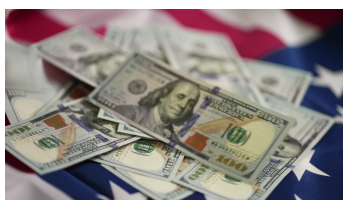


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We think the dollar downtrend is delayed, but should still materialise later this year and in the second half of 2024

By Francesco Pesole

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### **Oomph outweighs angst, pushing market rates up**

The direction for market rates is up for now. There will be a much bigger drop to come ahead, but the dominant move now is towards re-testing highs seen just before SVB went down

By Pádraic Garvey, CFA

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### **ING's July Monthly: The economic twilight zone**

All of the latest from our team on what could be next for the global economy

By Carsten Brzeski

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## Stuck in the twilight zone between stagnation and recession

We predict that in the second half of the year, the global economy will further slow down and 'slowcessions' are likely in several parts of the developed world



## Our three calls for the remainder of 2023

### [Watch video](#)

It's halftime for 2023 but not halftime like at the Super Bowl with Snoop Dogg, Shakira or Rihanna. It's halftime of the economic year, and economists are taking a deep breath with no singing or dancing (even if some of us might have hidden talents). It is simply the moment to assess the first half of the year and to sharpen our minds (and calls) for the second half.

For the global economy, the first half of the year was packed with enough action for an entire year. An energy crisis in Europe that was avoided thanks to a mild winter and fiscal stimulus. A reopening of China that is more sluggish and wobblier than hoped for. A banking crisis in the US and Switzerland which hasn't ended in a global financial crisis as feared. Unprecedented central bank tightening and gradually retreating inflation, with the latter not necessarily the result of the former.

Against this backdrop, the age-old question of whether the glass is half-empty or half-full comes to mind. Should we cherish the current resilience of many economies and the financial system as things could have become much worse? Or should we moan about the missed opportunities, lacklustre growth and a still very long list of potential risks? As is so often the case, the truth is probably somewhere in the middle.

Looking ahead, the risk for every forecaster is the temptation to spread optimism and predict an upturn of almost everything towards the end of the year (or the end of the forecast horizon as many traditional macro models do). We are more cautious. The fact that things didn't get as bad as feared does not automatically lead to a return of optimism or a surge of economic activity.

In fact, the structural themes of the last few years are still pressing and impacting the economic outlook. Think for example of geopolitical tensions, the war in Ukraine, demographics, climate change more generally and more specifically the energy transition, and high government debt. It is impossible to tell how and when exactly these factors will affect growth or an inflation forecast profile but we definitely know that these effects are here and they are here to stay.

Let's be a bit more precise and come back to economic developments in the second half of this year. Bold or not, we have three major calls for the remainder of the year:

- Further weakening and not strengthening of the global economy.
- Headline inflation will retreat faster than central banks currently think.
- Rate cuts are a 2024 but not a 2023 story.

Let's look at these three calls in more detail. The global economy will further slow down and "slowcessions" are likely in several parts of the developed world. The Chinese reopening will continue to stutter, the US economy is likely to experience a winter recession and the eurozone will remain in this twilight zone between stagnation and recession.

Besides negative base effects from energy and food prices, the cooling of many economies will lower wage pressure, reduce inflation pipeline pressures and will increasingly lead to price discounts. Headline but also core inflation are likely to come down faster than central banks anticipate towards the end of the year.

The phenomenon of "slowcessions" is a new challenge for central banks. Reacting to a more pronounced cycle is much easier as it takes much longer to identify a "slowcession". Until central bankers have realised that we are in a "slowcession" for good, they will continue hiking rates, not cutting them. If we are right, central bankers will adjust to the new reality in the last months of the year, acknowledging weaker growth, broader disinflation and no further need for rate hikes.

It might not be as eye-catching as Janet Jackson and Justin Timberlake, but it is definitely an exciting view of the global economy. Have a good summer.

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# Key risks to the global outlook

What happens if central banks overdo it on rate hikes, and how a renewed crisis in the banking system could weigh on the global economy



Source: Shutterstock

First Republic Bank would be the third bank to fail in the past two months after the collapses of Silicon Valley Bank and Signature Bank in March.

## 1 Aggressive interest rate hikes trigger a 'hard landing'

**Our base case:** The most aggressive rate hike cycle in decades will no doubt take its toll. We're more concerned about the US, where a tightening in lending standards post-banking crisis is likely to trigger more noticeable weakness in hiring and investment. Europe is currently enjoying the benefit of lower energy prices, which partly offsets the impact of higher rates in the short term. But the longer-term outlook for Europe remains one of subdued growth at best. In the US, we're not expecting a deep downturn, and developed economies are insulated by the greater prevalence of fixed-rate mortgages relative to past crises. That makes for a longer/more drawn-out transmission to the economy. Stagnation is likely, and the impact of higher rates is less concentrated in any single quarter.

**Risk scenario and how it plays out:** There are three ways things could be worse than we expect. Firstly, central banks hike more aggressively than currently expected – and with rates already well into restrictive territory, that would make deeper recessions in 2024 more inevitable. Rates at 6% or above in the UK and US, or 5% in the eurozone, would be challenging. Secondly, businesses begin to feel the pinch more acutely. Corporates have enjoyed pricing power over the past couple of years as economies emerge from Covid. But that's fading as consumer demand – especially for goods – abates, and the impact of interest rates on unemployment could accelerate as debt servicing becomes a greater challenge.

Finally, a high interest rate environment raises the risk of something breaking in the financial system. March's banking crisis was a taster of that, and despite central banker assurances to the contrary, persistently higher interest rates clearly risk having knock-on effects for financial stability. The feedback loop could tighten lending standards yet further, adding to the pressure on smaller businesses as well as real estate and the construction sector.

**Wider economic impact:** We'd expect to see many major economies enter recession through the early part of 2024, or perhaps earlier. Where economic weakness has so far been concentrated in manufacturing, we'd expect the service sector to enter a downturn too. That would see a corresponding easing in service-sector price pressure, via lower wage growth. Central banks would turn to rate cuts much earlier than we're currently forecasting.

## 2 US banking troubles flare up again

**Our base case:** The European banking system has coped well with the bank worries at the beginning of the year. The positive impact from higher interest rates continues to support European banks, with the negative side effects still contained. The solid liquidity positions of banks have been confirmed by the very limited additional drawings from the ECB's regular funding operations, despite the substantial TLTRO-III maturities that took place at the end of June. The European bank debt markets have also shown some promising signs with some action on the AT1 debt markets in mid-June, despite the full write-down of Credit Suisse's AT1 capital earlier this year.

Concerns over the US banking system have eased in the course of the second quarter. The issues have not spread to larger US banks, we have not seen further severe liquidity stresses and deposit flows have broadly stabilised.

The Fed published its bank stress test results in late June, which confirmed that the larger US banks could weather substantial weakness with their existing capital buffers. The Fed modelled a severe recession including US\$541bn in forecast losses to result in a 230bp decline in the average CET1 ratio of the 23 banks. Large banks retained relatively solid modelled CET1 ratios. Banks with the lowest (and highest) stressed CET1 capital ratios were smaller or mid-sized banks. This group could be somewhat less well-positioned to weather weakness with their existing CET1 buffers.

**Risk scenario and how it plays out:** The US bank problems were driven by a quick loss of confidence on the part of uninsured depositors towards regional banks. If the loss of confidence were to spread quickly to impact more institutions, it could result in several banks struggling to absorb deposit outflows simultaneously. This could create worries over contagion in the system and exaggerate further deposit instability. Finding buyers for assets to safeguard depositors and operational continuity for several, although smaller, banks at the same time could pose challenges.

In the very worst-case scenario, several smaller lenders end up being absorbed by larger ones. The failing banks may, however, come with unforeseen additional risks, which may eventually result in the credit profiles of the larger acquirers weakening more than expected. If the issues are severe enough, they may pose risks to the stability of the larger acquiring banks. If investors start second-guessing the stability of the financial system, this may have severe consequences on financial markets.

**Wider economic impact:** Fresh banking stresses would fuel a further tightening in lending standards than we've already seen in the US. History shows this is almost always followed by a



sharp rise in the unemployment rate and would deepen the recession we already expect. While it's uncertain whether contagion would spread directly to Europe, the prospect of a US downturn would inevitably have wider economic repercussions overseas. Central banks have so far been able to separate out financial stability and monetary policy tools, but such stresses, should they happen, are ultimately borne out of higher interest rates. This scenario would likely herald earlier and more aggressive rate cuts in both the US and Europe.

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# Twitchy gas and rangebound oil

European natural gas has seen increased volatility on the back of supply disruptions, while deeper Saudi oil cuts have done little to lift oil prices



Drilling activity in the US has slowed this year

## Natural gas disruptions leave the market nervous

The European gas market has witnessed plenty of volatility over the last month. TTF rallied from less than €23/MWh in early June to a peak of almost €50/MWh in mid-June, only to fall back to the €30-35/MWh range. The catalyst for this move has been disruptions to Norwegian gas flows due to outages, which led to a significant short-covering rally in the market. Firstly, this shows that market participants are still nervous about potential supply disruptions in the market, and secondly, there was a large segment of the market which was caught short and needed to cover.

The fall in Norwegian pipeline flows since mid-May has been significant because of outages. In April, flows out of Norway averaged almost 313mcm/d (9.38 bcm over the month), whilst in June these fell to almost 232mcm/d (6.96 bcm over the month). While most of this gas infrastructure maintenance was planned, some of it has run longer than planned. However, despite the fall in supply from Norway, storage in the EU is still at very comfortable levels and continues to trend higher. EU storage finished June being 77% full, well above the five-year average of 62% as well as the 58% seen at the same stage last year.

The lack of demand response to the broader weakness in gas prices has meant that storage

continues to fill up at a good pace. In fact, our numbers suggest that the EU only needs to see around 10% demand destruction relative to the five-year average. However, in May it appears as though the EU saw demand around 18% below average. The lack of demand response does raise an important question: how much of the demand destruction since the war is permanent? It will take a while to get a clearer answer on this. In addition, whilst the market has been well within the coal-to-gas switching range, we have not seen a strong demand response for gas from the power sector. This is very likely due to the fact that while it makes more sense to burn gas than coal, spark spreads are still in negative territory.

We still expect that the EU will hit full storage before the start of the next heating season – as early as September and possibly even a bit earlier if demand continues to remain as weak as it is. This suggests that we should see renewed pressure on European natural gas prices as we move through the third quarter. Prices will need to trade lower to ensure that liquefied natural gas (LNG) cargoes are redirected elsewhere. Longer term, if we assume a normal 2023/24 winter, storage drawdowns will be stronger through the heating season relative to last year, and we should exit the 2023/24 winter with storage closer to the five-year average. These stronger draws should provide some upside to prices over the winter months.

There are upside risks to our view for weaker prices in the short term. This includes prolonged Norwegian outages, lower LNG send-outs – something we have started to see more of recently – and finally, the ever-present risk of disruption to remaining Russian pipeline flows to the EU.

## Tighter oil market over the second half of 2023

Fundamentals are not dictating oil prices at the moment. Instead, macro uncertainty and concerns over the China recovery are proving an obstacle to oil prices moving higher. In addition, expectations for a more hawkish US Fed will certainly not be helping risk appetite.

Speculators have reduced their positioning in the market considerably in recent months. ICE Brent has seen the managed money net long fall from a year-to-date high of around 300k lots in February to around 160k lots in the last reporting week. This has predominantly been driven by longs liquidating, although there has also been a fair number of fresh shorts entering the market.

We still expect global oil demand to grow by around 1.9MMbbls/d in 2023, and while this may appear aggressive in the current environment, it is more modest than some other forecasts – for example, the International Energy Agency forecasts demand to grow by 2.4MMbbls/d this year. Whilst we believe that our demand estimates are relatively modest, there are still clear risks to this view. The bulk of demand growth this year (more than 50%) is expected to be driven by China. So far this year, indicators for Chinese oil demand have been positive, as the economy has reopened. However, the concern is whether China will be able to keep this momentum going through the year. The risk is that the growth we have seen in domestic travel starts to wane as the effects of 'revenge' spending ease.

Supply-side dynamics continue to provide a floor to the market. OPEC+ continues to cut and we have seen Saudi Arabia announce further voluntary supply cuts through the summer. Recently-announced cuts from Saudi Arabia, Russia and Algeria amount to a reduction of a little over 1.5MMbbls/d in supply over August 2023. Although, there are doubts over whether the 500Mbbls/d of cuts recently announced by Russia will be followed. It doesn't appear as though Russia has stuck to a previous cut of 500Mbbls/d when you consider that Russian seaborne crude oil exports have been strong for most of the year.

Drilling activity in the US has also slowed this year with the number of active oil rigs in the US falling from a year-to-date peak of 623 in mid-January to 545 recently, which is the lowest level since April 2022. While supply growth is still expected from the US, and output is set to hit record levels, the growth will be much more modest than in previous years. For 2023, US oil output is expected to grow in the region of 600-700Mbbbls/d, while for 2024 growth is expected to be less than 200Mbbbls/d. Higher costs, a tight labour market and an uncertain outlook all contribute to this more tepid growth. While the broader theme we have seen from US producers in recent years is to also be more disciplined when it comes to capital spending.

We have revised lower our oil forecasts for the latter part of the year. A more hawkish Federal Reserve, limited speculative appetite (given the uncertain outlook), robust Russian supply and rising Iranian supply all suggest that the market will not trade as high as initially expected. We still forecast that the market will be in deficit over the second half of the year and so still expect the market to trade higher from current levels. We forecast ICE Brent to average US\$89/bbl over 2H23.

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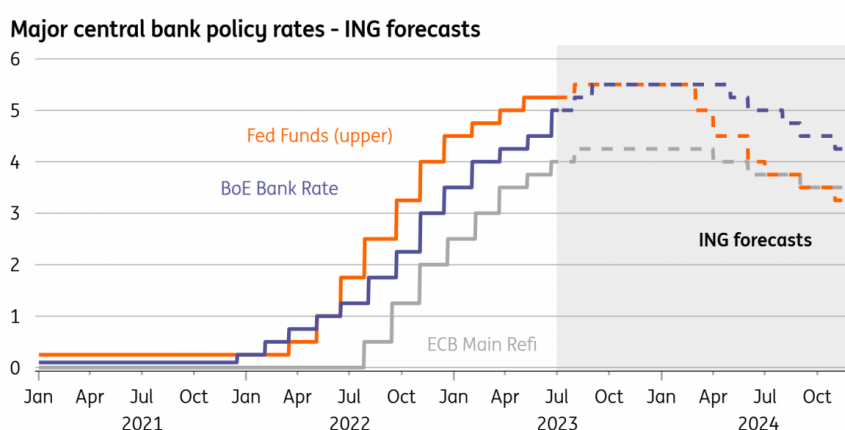
## Our view on the major central banks

We now expect the Federal Reserve to begin rate cuts in the first quarter of 2024, with the ECB and Bank of England following shortly after



Source: Shutterstock  
 Governor of the Bank of England Andrew Bailey, ECB President Christine Lagarde, US Federal Reserve Board Chairman Jerome Powell

### Our projections for the major central banks



Source: Macrobond, ING calculations

### Federal Reserve

Comments from Federal Reserve officials indicate that while progress has been made, there is more work to do to return inflation to target. The June no-change decision was merely a slowing in

the pace of hikes, with the Fed signalling that it sees the need for two additional 25bp interest rate increases before the end of the year.

A July rate rise looks virtually certain given inflation is above target and the jobs market remains tight, but we are not convinced the Bank will carry through with the second hike. The Fed acknowledges that goods price inflation is under control and housing costs will slow rapidly through the second half of 2023, but policymakers are focused on core services excluding housing, which remains hot. There are tentative encouraging signs, which we suspect will intensify as the lagged effects of previously implemented policy rate increases and tighter lending conditions bite.

With core CPI likely to be in the 2%-2.5% region by the first quarter of next year, the Fed may well be inclined to move policy from restrictive territory in the direction of neutral by March as the economy weakens.

## European Central Bank

The message from the ECB since the June meeting has been clear: the job is still not done and more rate hikes will follow.

Despite a weakening growth outlook and headline inflation coming down, the ECB doesn't want to take any chances. The Bank has to be sure that it has slayed the inflation dragon before considering a policy change. This is why it is putting more emphasis on actual inflation developments, and why it will rely less on forecasts than in the past. This is a big risk as we still think the ECB is too optimistic about the eurozone's growth outlook. Historic evidence suggests that core inflation normally lags headline inflation while services inflation lags that of goods. Against this backdrop, further rate hikes increase the risk of a more significant slowing of the economy further down the road.

If we are right and the economy remains weak, the disinflationary process gains momentum and core inflation starts to drop after the summer, the ECB's hiking cycle should end with the September meeting, though the Bank might wait until the December meeting to officially declare it over.

## Bank of England

Financial markets expect Bank Rate to peak at 6.25% by the end of this year or early next. For context that would be the highest since 2001, but far from pushing back against these lofty expectations, the Bank of England opted to double down with a surprise 50bp rate hike last month. That was a strong statement of intent, and we now expect at least two more 25bp moves this year and don't rule out more. It's clear that the committee has lost confidence and patience in its models, and policy will be heavily determined by actual inflation outcomes over the summer.

We're hopeful that some better news on inflation means Bank Rate doesn't need to go quite as high as investors think. But even if we're right, the current level of mortgage rates will exert the most significant squeeze on households for decades, with the exception of a short period in the early 1990s. The greater prevalence of fixed-rate mortgages means the impact is gradual, but the higher loan-to-income multiples on home lending seen over recent years mean that as households refinance over coming quarters there will be a material impact on growth. That suggests rates can't go much above 5% on a sustained basis, and we still expect rate cuts to arrive by mid-2024.

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# How long can core inflation linger in the eurozone?

Eurozone core inflation is set to eventually come down after the summer



Slowly but surely, the inflation outlook for the eurozone is improving. Base effects as well as fading supply chain frictions and lower energy prices have and will continue to push down headline inflation in the coming months – a drop that the European Central Bank deserves very little credit for orchestrating. With headline inflation gradually normalising, the big question is how strong the inflation inertia will be. As long as core inflation remains stubbornly high, the ECB will continue hiking interest rates. How long could this be?

## **Inflation is moving in the right direction, but will core inflation remain stubborn?**

Headline inflation has come down sharply, which is widely expected to continue over the months ahead. The decline in natural gas prices has been remarkable over recent months and while it would be naïve to expect the energy crisis to be over, this will result in falling consumer prices for energy. The passthrough of market prices to the consumer is slower on the way down so far, which means that there will be more to come in terms of the downward impact on inflation.

The same holds true for food. Food inflation has been the largest contributor to headline inflation from December onwards, but recent developments have been encouraging. Food commodity prices have moderated substantially since last year already, but consumer prices are now also starting to see slow. In April and May, month-on-month developments in food inflation improved



significantly, causing the rate to trend down.

## Historical relationships and post-pandemic shifts

Headline inflation – at least in the absence of any new energy price shocks – looks set to slow down further, but the main question now is how sticky core inflation will remain. There are several ways to explore the prospects for core inflation.

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*We know that history hardly ever repeats, but it at least rhymes – and if this is the case, core inflation should soon reach its peak*

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Let's start with the historical relationships between headline and core inflation after supply shocks. Data for core inflation in the 1970s and 1980s are not available for many countries, but the examples below for the US and Italy show that an energy shock did not lead to a prolonged period of elevated core inflation after headline inflation had already trended down. In fact, the peaks in headline inflation in the 1970s and 1980s saw peaks in core inflation only a few months after in the US and coincident peaks in Italy. We know that history hardly ever repeats, but it at least rhymes – and if this is the case, core inflation should soon reach its peak.

History is one thing, the present another. Digging into the details of current core inflation in the eurozone shows a significant divergence between goods and services, regarding both economic activity and selling price expectations. Judging from the latest sentiment indicators, demand for goods has been weakening for quite some time already. At the same time, easing supply chain frictions and lower energy and transport costs have taken away price pressures, leading to a dramatic decline in the number of businesses in the manufacturing sector that intend to raise prices over the coming months.

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*Services inflation remains the largest problem for core inflation and the ECB*

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The services sector is still thriving, however, and enjoying the post-pandemic shift from goods to services. Services most affected by lockdowns are currently experiencing much faster price growth than other services or goods. While the upcoming summer holiday period could still fuel service price inflation, we did see a decline last month. The drop was largely due to cheaper public transportation tickets in Germany, however, so it seems too early to call a significant improvement in services inflation just yet. Finally, services inflation traditionally shows a much stronger correlation with wage growth than goods inflation. With wage growth trending up and probably coming in at around 5% year-on-year in the eurozone, services inflation remains the largest problem for core inflation and the ECB.

Still, a key question remains over how long the divergence between goods and services inflation can last. Historically, we don't see much evidence of an extended difference between the two. Goods inflation typically leads services inflation by approximately six months, which means that

the peak in the former from February suggests that the latter is unlikely to remain elevated for the rest of the year. If we are right and the post-pandemic shift ends after the summer holiday period, we could see services inflation starting to come down before the end of the year.

## Core inflation set to trend down from here on out

While services inflation continues to see some upside risk for the months ahead, core inflation overall looks set to trend down on the back of slowing goods prices. Even services inflation could already be trending down, but perhaps not as fast as policymakers would like it to. When looking at selling price expectations for sectors that sell most to consumers, we see that there has been a steady downturn in the number of businesses intending to raise prices. This generally correlates fairly well with core inflation developments seven months later, which would point to a significant slowdown in the core rate.

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*Experts and central bankers will be hesitant to make an outright call for a sharp drop in inflation*

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At the current juncture, experts and central bankers will be hesitant to make an outright call for a sharp drop in inflation. The latest track record of inflation forecasting is simply not on their (or our) side. Nevertheless, as much as it was once obvious that the era of low inflation had to end at some point, it's now clear that the short period of surging inflation will also cease sooner or later. Historical evidence and the latest developments in both goods and services give enough comfort to expect both headline and core inflation to decline.

We currently expect core inflation to drop below 4% at the end of the year and for it to fall to 2.5% by mid-2024. The risks to that outlook seem to be fairly balanced, with more stubborn core inflation on the back of faster wage growth and a faster drop on the back of weak goods inflation both decent possibilities.

## Could the ECB fall behind the curve again?

For the ECB, this isn't to say that tightening is over. In fact, the central bank can't – and won't – take a chance on this kind of core inflation forecast. Why? Because they've simply been wrong too often in previous years. To put it into ECB language: inflation forecasts are currently surrounded by an unprecedented amount of uncertainty. This is one of the reasons why the central bank has put more emphasis on current inflation developments and less emphasis on its own inflation forecasts for one or two years ahead.

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*The European Central Bank will not change its tightening stance until core inflation shows clear signs of a turning point*

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While such a strategy supports the ECB's credibility, by definition it runs the risk of falling behind the curve. Given the time lags with which monetary policy operates and affects the economy,

central banks should be forward-looking, not now-looking. This is the theory. In practice, however, the central bank will not change its tightening stance until core inflation shows clear signs of a turning point.

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## US downturn delayed

The US economy has been remarkably resilient in the face of mounting challenges, but tighter monetary and fiscal policy will eventually take their toll and prompt the Fed to ease



Source: Shutterstock

President Biden Speaks at National Education Event in Washington, District of Columbia, United States

### Upward revisions to near-term growth and Fed view

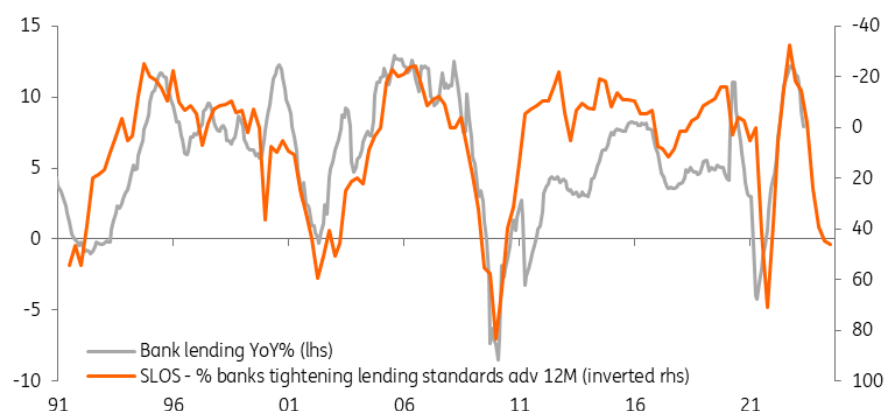
We have made major changes to our US forecasts this month, which see us revising up the near-term growth profile while also inserting a July Federal Reserve rate hike. Inflation is still set to slow sharply, but interest rate cuts, which we have long been expecting, are unlikely to happen before the end of this year.

We expected the economy to have been more impacted by the cumulative 500 basis points of interest rate hikes and a reduction in credit availability than it has been. Certainly, the banking stresses seen in March/April appear to have stabilised thanks to massive support for small and regional banks from the Federal Reserve. Employment creation has been robust, while residential construction has been stronger than expected despite the surge in mortgage rates. The lack of existing homes for sale is keeping prices elevated and is generating demand for new homes.

Inflation is slowing, but not quickly enough for the Federal Reserve and with the jobs market remaining firm officials are taking no chances. The Fed signalled that June's decision to leave interest rates on hold should be seen merely as a slowing in the pace of rate hikes rather than an

actual “pause”. Consequently, a 25bp July rate looks likely, but we doubt the Fed will carry through with the additional 25bp hike outlined in its latest forecasts.

## Bank nervousness points to a contraction in lending



Source: Macrobond, ING

## Recession threat delayed, not averted

This all appears to tally with the Federal Reserve’s own soft landing thesis, but we still see a high probability of a recession. Lending growth is slowing with the Fed’s Senior Loan Officer survey suggesting it could turn negative before the end of this year. Business confidence remains in recession territory based on data from the Conference Board and the National Federation for Independent Businesses, and we know that monetary policy operates with lags with the full effects of higher interest rates yet to be felt.

A key reason that the economy has proved to be more resilient than we expected was consumers’ willingness to run down savings they had accumulated during the pandemic. We suspected they may choose to maintain larger savings buffers, while a \$150bn surge in credit card borrowing since mid-2021, bringing the outstanding total to nearly \$1tn, has additionally financed consumer largesse. But household savings and banks’ willingness to lend are a dwindling finite resource and for many millions of Americans, the financial challenges are going to increase significantly over the next few months. That’s because as part of the deal to raise the US debt ceiling, the pandemic support for 43 million student loan borrowers has ended.

From 1 September, interest is once again being charged on \$1.6tn of outstanding debt and from 1 October payments restart. With the Supreme Court throwing out President Biden’s plans to forgive up to \$20,000 of an individual borrower’s debt this means that from the start of the fourth quarter around 30 million of those 43 million borrowers will have to find an average of \$350 per month to cover the loans - current students don’t pay while some other borrowers have defaulted or have deferred. That works out at around \$130bn in aggregate for a year in interest and repayment, equivalent to around 0.75% of consumer spending.

## Rate cuts are coming as inflation fears subside

With monetary policy set to get tighter, fiscal policy also becoming fractionally more restrictive, external demand looking weak and this student loan story set to hit quite hard, we are struggling to find a positive story that can offset these intensifying headwinds. As such, our narrative is one whereby recession has been delayed rather than averted.

Inflation looks set to continue slowing and we expect headline CPI to end the year below 3% with core inflation running close to 3.5%. The slowdown in housing costs is a key driver, but weakening corporate pricing power means we think even the Fed's 'super core' measure of non-energy services excluding housing will be showing meaningful evidence of moderation.

We are also expecting the data discrepancies – for example, Gross Domestic Product pointing to growth yet Gross Domestic Income indicating recession, nonfarm payrolls rising yet household employment falling, ISM surveys pointing to falling output while official data points to rising output – to reconverge. Unfortunately, by the first quarter of 2024, we suspect it will be coalescing around the weaker trend. With inflation at or close to target by then, we argue this would justify the Fed moving policy to a more neutral setting, which means lower interest rates by quarter-end and through 2024.

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Article | 6 July 2023

## A languishing eurozone economy

Eurozone growth is not picking up, with services now also losing steam. Inflation is clearly coming down, but the ECB is still set for two more rate hikes



Source: Shutterstock

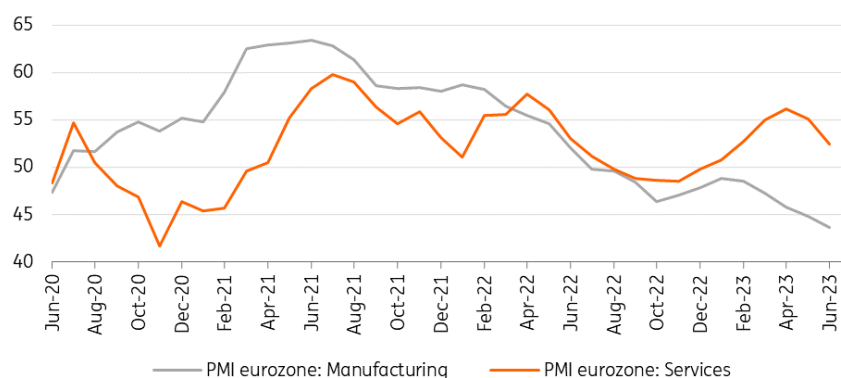
ECB President Christine Lagarde has said that a rate hike in July looks like a done deal

### **(Overly?) optimistic ECB growth outlook**

After negative growth over the winter quarters, the ECB's staff forecasts pencil in a gradual acceleration of eurozone GDP growth to 0.3%, both in the second and third quarters of this year, and 0.4% from the fourth quarter onward. However, eyeballing the most recent data, it doesn't look as if the eurozone economy is accelerating – on the contrary.

The first real indicators for the second quarter, such as retail sales and industrial production, actually came out below the average of the first quarter. And sentiment indicators for May and June rather point to further deterioration. The €-coin indicator, a monthly tracker of GDP growth, averaged -0.3% for April and May. In that regard, we fear that second-quarter growth will be close to 0%, with a non-negligible probability of negative growth.

## Manufacturing in recession and services is slowing



Source: Refinitiv Datastream

## Services are now also slowing

We certainly don't deny that the pick-up in wage growth, in combination with lower energy prices, is boosting consumers' purchasing power, supporting consumption growth over the coming quarters. But at the same time, some increase in the savings ratio looks likely as the economic outlook has become more uncertain (in some member states unemployment has started to increase).

All sectors are now signalling a deceleration in incoming orders, while inventories in industry and retail are at a very high level. Even services, which held up well despite the recessionary environment in manufacturing, are losing steam. The services confidence indicator fell in June below its long-term average. That doesn't necessarily mean that the only way is down – we still expect a strong summer holiday season, supporting third-quarter growth. But after that things might become shakier again, as the US economy is expected to have fallen into recession by then.

The bottom line is that we now only expect 0.4% growth in 2023. Subsequently, on the back of the low carry-over effect, we pencil in a 0.5% GDP expansion for 2024.

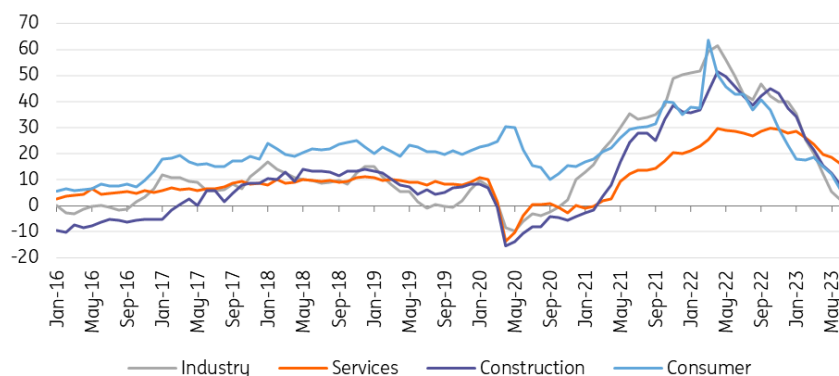
## Downward trend in inflation continues

The flash headline inflation estimate for June came out at 5.5%, while core inflation increased slightly to 5.4%. However, the increase in core inflation is entirely due to a base effect in Germany that will disappear in September. The growth pace of core prices, measured as the three-month-on-three-month annualised change in prices, now stands at 4.4%. That is still too high, but the trend is clearly downwards.

The inventory overhang is leading to falling prices for goods. In the European Commission's survey, selling price expectations softened again in all sectors, while the expected price trends in the consumers' survey fell to the lowest level since 2016. It, therefore, doesn't come as a surprise that we expect the downward trend in inflation to continue, with both headline and core inflation likely to be below 3% by the first quarter of 2024.



## (Selling) price expectations are coming down across the board



Source: Refinitiv Datastream

## Two additional rate hikes

As the ECB has seemingly lost faith in its forecasting models (the staff is expecting 2.2% in 2025), it has been basing monetary policy increasingly on current inflation figures. No wonder that it still believes there is a need to tighten further.

In a rather hawkish speech in Sintra last month, ECB President Christine Lagarde reiterated that a rate hike in July looks like a done deal and at the same time she said that “under these conditions, it is unlikely that in the near future the central bank will be able to state with full confidence that peak rates have been reached”.

Board member Isabel Schnabel added in a recent interview that “given high uncertainty about the persistence of inflation, the costs of doing too little continue to be greater than the costs of doing too much”. That all points to (at least) two additional 25 basis point rate hikes. That would bring the deposit rate to 4% in September. Rates will probably remain at that level until the summer of 2024 when lower inflation is likely to open the door for some cautious easing.

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# UK set for further rate hikes despite mortgage squeeze

The Bank of England is likely to raise rates at least twice more, though better inflation readings through the summer should allow a pause before winter



Source: Shutterstock

The Bank of England headquarters in London United Kingdom. Britain's mortgage costs rise due to speculation on interest rates increase.

## Investors think the UK has a bigger inflation challenge than the US or eurozone

When we asked our clients in a [recent webinar](#), 73% of roughly 200 respondents thought the UK had a bigger inflation problem than the US or eurozone. They aren't alone.

Markets see rates peaking above 6% later this year, and far from pushing back against those lofty expectations, the Bank of England doubled down with a surprise 50 basis-point rate hike last month. And if that message hadn't sunk in enough, Governor Andrew Bailey went further by suggesting markets were prematurely pricing rate cuts – a particularly hawkish statement, when you consider that markets expect Bank Rate to be at or above current levels for the next two years.

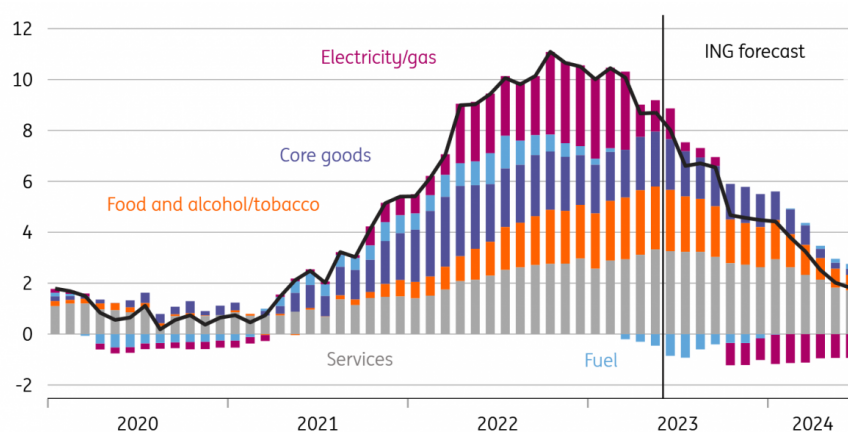
Above all, the latest decision and subsequent comments reflect a growing loss of confidence and patience in the Bank's models, but also the forward-looking inflation indicators that have been

pointing in a better direction for several months now. It's pretty clear that the next few decisions will be guided by actual inflation and wage growth data, and probably not a lot else.

The decision also suggests that the Bank isn't done yet. Previously the bank's more gradualist and pragmatic approach to rate hikes suggested we were very close to the peak. But having returned to 50bp rate hike increments, it's highly unlikely the committee will be content with holding rates at current levels, or only hiking once more by 25bp, in August.

Admittedly, we aren't convinced the 50bp move will be repeated, but we think two further 25bp moves in August and September are likely – and we wouldn't rule out more. Remember that one of the Bank's two arch-doves also left the committee last month, and early signs suggest her replacement will be more hawkish.

## Sticky UK services inflation means headline CPI has been higher than expected



Source: Macrobond, ING calculations

## Inflation data should look a bit better by the autumn

Whether or not the Bank ends up delivering the five extra rate hikes priced into markets heavily depends on whether the inflation numbers show some improvement over the summer. At the headline level they should, though mainly because a 20% cut in household energy bills this month will shave off roughly one percentage point from annual CPI.

In theory, this matters little, but policymakers have put a lot of store in inflation expectations surveys over the past year or so, and the fall in electricity, gas and petrol prices has helped drive these down among consumers and businesses alike. Indeed the plunge in natural gas prices should start to show through in lower services inflation, albeit gradually. By November's meeting, we think there will be sufficient evidence for the Bank to finally end its hiking cycle. Ultimately most – though not all – of the UK's inflation drivers are shared with other developed market economies.

Either way, Bank Rate close to 6% is very restrictive by historical standards. Higher loan-to-income multiples mean that mortgage repayments are now equivalent to roughly 35% of average disposable income. That's a bigger share than when rates peaked ahead of the global financial crisis.

Admittedly most mortgages are fixed for at least two years, which means most households are yet to encounter higher repayments. That means a recession isn't inevitable, but we will see an ever-increasing drag on the UK consumer. The bigger risk in the short-term arguably comes from corporates (particularly small firms), which are typically on floating interest rates and are feeling the squeeze most acutely right now.

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# China to see weak growth and limited stimulus

Weak activity plus limited stimulus equals forecast downgrades



Source: Shutterstock

## The recovery is very narrow

China's recovery continues to underwhelm. In the chart below, we summarise the activity data released over the last three months. All measures are shown as cumulative year-to-date, year-on-year.

The first four columns show industrial production and its three sub-components, manufacturing, mining and extraction, and electricity generation (often used in alternative measures of GDP estimation). What these data points show is a very feeble growth rate of production in the region of 3-4% and not showing much tendency to increase. Mining is weaker at less than 2% and losing momentum. Electricity production is growing, and showing a very slight tendency to firm. Viewing the series as monthly growth rates, sequential growth to May 2023 is slower than it was over the first five months of last year.

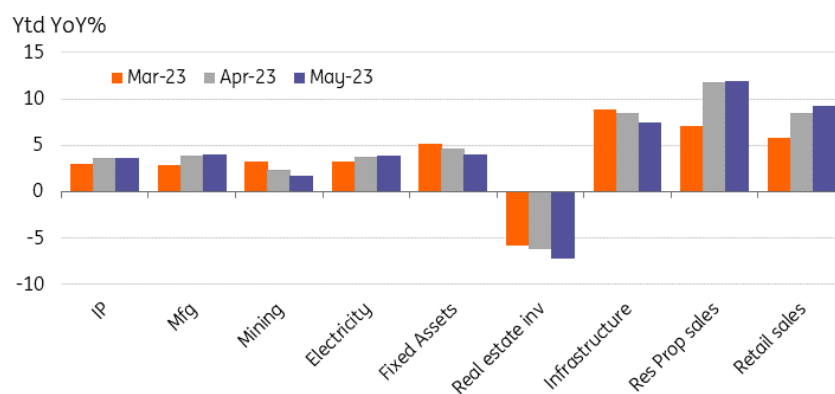
What often comes to the rescue of an ailing Chinese economy is fixed asset investments, with government stimulus programmes boosting infrastructure spending. Yet currently, fixed asset investment growth is clearly slowing. The worsening story in real estate investment is clearly doing most of the damage and is worse than we had expected at this point of the year when we had hoped for more of a flatline than continued deterioration. Infrastructure investment is helping to

offset the drag from property but seems to be losing the battle at the moment, not helped by weak local government finances.

On a slightly more positive note, residential property sales are growing at a decent rate, though the recent increase may be topping out. Moreover, at this time last year, these sales were falling at about a 35% pace (YTD, YoY), so the current growth of just under 12% still means sales are very weak.

Not shown in the chart below are residential house prices. These have risen over the last four months, though the May reading was only just positive, slowing from March and April. Seasonally adjusted, this data would likely have shown a return to falling house prices. And with consumers' willingness to part with their money for property partly a function of how well they think it will perform as an asset class, this is not an encouraging sign.

## China activity summary (YTD YoY%)



Source: CEIC, ING

## Retail sales offer some hope

The other 'bright' spot in the data is retail sales. Like residential property sales, the current growth of retail sales of 9.3% (YTD, YoY) is flattered by weakness in 2022. Even within the retail sales figure itself, the greatest contributor to year-on-year sales is catering, driven by reopening and pent-up demand that has found an outlet in domestic travel and food and beverage-related activities. We are fairly confident that this won't last. Recent data on holiday expenditure, for example, was disappointing. And with the exception of spending on autos, nothing else is really moving the needle on retail sales currently.

We have estimated a real seasonally-adjusted series for retail sales, from which it appears that the level of sales remains well above its trend growth rate, helped by pent-up demand. We expect retail sales to drift lower towards their historical trend over the coming months, reducing the boost to growth coming from consumer spending in the subsequent quarters of the year.

All of this suggests that second-quarter GDP will struggle to increase from the first quarter as weak production is offset by contractions in construction. It also suggests that momentum need not necessarily accelerate in the second half of the year – as many forecasters seem to assume. A flat quarter would still deliver 6.8% YoY growth, though just like much else in 2Q23, this is flattered by weakness in 2022.

With the second quarter looking weaker than we had expected, and the outlook for subsequent quarters also looking challenged, we are revising our full-year GDP growth rate to 5.2% from 5.7%. That still achieves the government goal of "about 5%" GDP growth in 2023, though it illustrates just how unambitious that target really was.

## Stimulus hopes may not be met

So far, the authorities' response has been quite modest. A few weeks ago, we saw a raft of China's numerous interest rate levers being nudged lower. But none were moved more than 10bp, and even with further reductions (at this stage, we believe we will see at least another two rounds of this), this is simply not enough to do more than provide a very minor offset to the economic weakness.

Some markets are bracing for the sort of bazooka stimulus response that we have seen at times in the recent past when China has been struggling economically. But we are not at all sure we will see that this time. For one thing, it does not look as if the weakness in the property sector is causing too much anxiety at a political level. This was a debt-fuelled sector in an economy which is already sitting on large amounts of debt. Allowing this sector's weakness to run its course may hurt growth now, but this is probably viewed as a price worth paying for more sustainable crisis-free growth ahead. Moreover, even with the current backdrop, the 2023 GDP target could still be achieved, so more aggressive stimulus may be saved for when it is really needed.

Instead of a bazooka, therefore, we expect we will see more of a shot-gun approach to stimulus, with many smaller and more targeted measures adopted. More of a micro response than a macro one, including a combination of further very modest monetary policy easings, extended subsidies and tax breaks, but no wall of money.

Part of this policy approach will likely include more tolerance for a weaker yuan. We have already seen the CNY break up through 7.24 during this latest phase of weakness, and 7.30 seems a plausible near-term target. 7.40 would take the CNY to a level not seen since 2007. But while we aren't quite ready to add that level to our forecasts, we are keeping an open mind. There is certainly no inflation concern to prevent bolder currency moves like this from being adopted.

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# Disinflation continues across CEE at varying speeds

Faster disinflation does not necessarily mean faster rate cuts. The local story will play an increasingly important role in the second half of the year



Source: Shutterstock

National Bank of Hungary, the National Bank of Poland and the Czech National Bank

## Poland: Central bank easing around the corner

Second-quarter growth in Poland most likely underperformed (with flat or negative year-on-year growth), given poor retail sales, industrial output and a 45.1 point manufacturing PMI reading in June. Consumer sentiment is improving but from a very low level. Moreover, real wages will just start to grow in the third quarter, after around a year of declines. Plus, the government's cheap mortgage scheme has only recently started, arriving too late to give a boost to housing construction this year. Net exports are to be a key GDP driver this year.

We expect no policy changes from the National Bank of Poland in July. However, we estimate that the chances of a rate cut after the August Monetary Policy Council break have increased to 65-70%. This is following the guidance provided by some MPC members, including President Adam Glapinski, and the lower-than-expected June CPI print. We see more than one interest rate cut in 2023 as possible. Our short-term inflation forecast is optimistic, with CPI falling to single digits in August. Our long-term CPI forecasts are substantially far less favourable, however. Core inflation may stabilise around 5% year-on-year in 2024-25 given the tight labour market, the large rise in the minimum wage and the valorisation of 500+ child benefits.



The zloty continues to benefit from a mix of the current account surplus, more FX sales on the market by the Ministry of Finance, inflows from foreign direct investment, and portfolio capital. Some investors seem to expect a more market-friendly political environment after the parliamentary elections. We expect all those factors to persist at least until the elections. We expect EUR/PLN to gradually sink to, or slightly below, 4.40 in the coming weeks.

Despite higher overall 2023 borrowing needs after the state budget amendment, the government aims to finance them via the reduction of the sizeable cash buffer (PLN117bn as of the end of May) and FX funding, hence limiting Polish government bond (POLGBs) issuance compared to the initial budget bill. In tandem with the expectations for monetary policy easing, this suggests a further drop in yields across the curve and some tightening in asset swaps.

## Czech Republic: Inflation below 10% is not enough for the Czech National Bank

The economy has confirmed weak activity in recent months, but the numbers are more in line with expectations. At the same time, inflation is surprising to the downside and the overall labour market picture is more anti-inflationary than expected. Looking ahead, the inflation profile looks comfortable – probably the best in the region. We expect June inflation to fall below the 10% YoY threshold and the disinflationary momentum to continue through the summer months. However, disinflation will slow in the autumn and winter, making it challenging for the CNB to cut rates. We expect the first rate cut in November when the central bank will have a new forecast in hand, but we see a risk of delaying a rate cut until the first quarter of next year. This again makes the CNB the most hawkish central bank in the CEE region.

On the fiscal side, we also see a big story. The government recently approved a state budget for next year of CZK235bn targeting 1.8% of GDP, by far the lowest figure in the region. We expect a successful legislative process during the summer months, which implies a reduction of next year's borrowing needs to 60% of this year's level. In addition, June's state budget result showed an improvement for the first time this year.

We thus remain positive on Czech assets. Czech government bonds (CZGBs) should maintain strong demand and we expect the market to shift its focus to supply dynamics soon. The Czech koruna has traded at weaker levels than we expected in recent weeks. However, the koruna should benefit most from the EUR/USD recovery and we see room for a reassessment of market expectations for a CNB rate cut.

## Hungary: Technical recession set to end soon

Economic activity has slowed significantly in all sectors except for one. Base effects and favourable weather conditions have boosted the positive contribution from agriculture which could lift Hungary out of technical recession in the second quarter of 2023. In the meantime, we still won't have too much to cheer about. A lack of domestic demand is weighing on retail sales, construction and industrial output, with the latter currently being supported mainly by export sales. We see GDP growth of just 0.2% in 2023.

The only silver lining coming from the weak economy is that the pricing power of companies is rapidly diminishing, thus the disinflationary process has shifted into a higher gear. We see single-digit inflation in November 2023 with the full-year average being around 18%. Disinflation with

preserved market stability helps the central bank's agenda: the ongoing normalisation of monetary policy. We see 100bp of further cuts to the effective rate before it reaches the base rate at the September meeting. After that, we see the National Bank of Hungary remaining cautious.

Weakening economic activity is hitting import demand which, combined with lower energy prices, is helping the country's external balances improve. We expect the current account deficit to narrow to around -2.2% of GDP this year with positive risks. However, the marked drop in consumption is putting significant pressure on the budget's VAT revenue stream, and key challenges loom. With structural improvements in all other aspects though, we do not expect any sovereign credit rating changes from rating agencies in the near future.

We expect EUR/HUF to oscillate in the current range of 368–378, depending on the National Bank of Hungary's communication regarding the rate-cutting cycle and on progress with the EU. Regarding the latter, our base case remains an agreement and partial access to the Cohesion Fund before the year ends. Hungarian Government Bonds can benefit the most from monetary policy normalisation, further supported by government measures and debt agency funding control (for more details, check out our [Monitoring Hungary](#)).

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## FX: The dollar downtrend remains on hold

We think the dollar downtrend is delayed, but should still materialise later this year and in the second half of 2024



The dollar outlook is likely to remain strictly tied to Fed rate expectations

### A prolonged pause in the dollar decline

In previous rounds of forecasting, we had pointed to the third quarter of this year as the period where a dollar downtrend could truly materialise, as the combined evidence of slowing inflation and the economic slowdown would lead the Federal Reserve to a dovish turn. Now in July, we have to acknowledge that it may still be too early for the dollar to take a decisive and sustainable turn lower this summer.

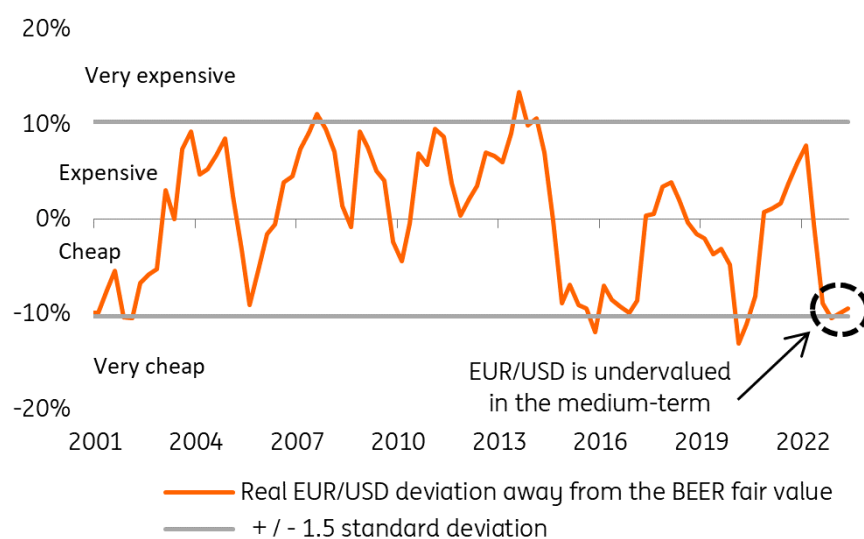
The recent strengthening in FX with short-term rate correlations means central bank divergence remains generally the predominant driver across USD crosses, and the dollar outlook is likely to remain strictly tied to Fed rate expectations. Our rates team believes a drop in short-term USD rates now looks more likely to be a fourth-quarter and early-2024 story, which means EUR/USD could mostly bounce around the 1.08-1.10 range this summer, without a very clear sense of direction, before taking a decisive turn higher to 1.15 by year-end.

The ECB's hawkishness, underpinned by sticky core inflation in the eurozone, can help keep front-end EUR swap rates supported, and offer more support to the euro, but is also unlikely to do the heavy lifting in a longer-lasting EUR/USD bull trend. We expect two ECB hikes, in July and September, and only a gradual abatement of the hawkish rhetoric. Markets however are fully pricing this in, and the magnitude of potential Fed expectation repricing remains considerably larger compared to the ECB's.

## Valuation points to higher EUR/USD

The reasoning behind sticking to our medium-term bullish view for EUR/USD is primarily, but not only, bonded to our core view for a shrinking USD-EUR rate short-term rate gap. Our BEER model – which tracks real medium-term mis-valuation based on economic fundamentals – shows EUR/USD is still around 8-10% undervalued. That mis-valuation gap has remained quite wide because the sharp rebound in the eurozone’s terms of trade (thanks to lower energy prices) has not been matched by a similar recovery in EUR/USD, which has been held back by the Fed’s large tightening cycle. We believe the dovish shift by the Fed – albeit its timing remains uncertain – will prove to be the trigger to a reconnection with unequivocally bullish fundamentals for EUR/USD.

## Economic fundamentals suggest EUR/USD is cheap



Source: ING

## Domestic tightening stories remain key across the G10

Since the dollar is overvalued against all G10 currencies except for CHF, according to our BEER model, the same reasoning can be applied to the more general spectrum of USD crosses. Incidentally, we could see domestic stories – especially on the central bank side – dominate before a clearer dollar trend emerges later in the year.

In the UK, the Bank of England’s aggressive fight against ultra-sticky inflation should keep the GBP curve highly inverted, which can ultimately keep a reserve currency like the pound supported for longer. Japanese authorities look once again on the brink of FX interventions, as USD/JPY trades close to the 145.00 mark, but some help for the yen might actually come from a hawkish tweak to the yield-curve-control policy by the Bank of Japan this summer.

In Europe, Scandinavian central banks are deploying FX-supportive tightening packages. We favour NOK over SEK thanks to a more hawkish Norges Bank stance and elevated domestic risks in Sweden.

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# Oomph outweighs angst, pushing market rates up

The direction for market rates is up for now. There will be a much bigger drop to come ahead, but the dominant move now is towards re-testing highs seen just before SVB went down



The bond bear market bubble has burst

## The journey for 10yr rates is back to March highs

Market rates peaked in March this year. At the time, there was what looked like a relentless rise in rates underway, only to be undercut by the sudden and unexpected implosion of Silicon Valley Bank (SVB), with echoes in Europe as Credit Suisse was forced into a merger. There have been ripples of concern since, but apart from another few manageable banking causalities in the US, there has been a calming of nerves. In fact, we managed to morph from a state of material concern for the system to one of outright 'risk-on'. The coincident rise in market rates is an outcome of this. Plus there's sticky inflation in both Europe and the US (and beyond), and in the US an economy that just won't lie down. So where now?

On the one hand, forward-looking indicators are in a recessionary state, small bank vulnerabilities remain, and lending standards are tight. The eurozone has moved into a state of technical recession, and China is showing only a subdued reopening oomph. That, together with the cumulative effects of rate hikes already delivered, plus the negative real wage growth environment, should ultimately place material downward pressure on market rates as we progress

through the second half of 2023. A peaking out for official rate hikes from both the Federal Reserve and the European Central Bank in the coming months would mark an important point in the cycle. From that point on, market rates should be on the decline, and yield curves should be in a dis-inversion mode.

But we are not at that point just yet. The latest US core PCE number at 4.9% reminds us that the US is still a "5% inflation economy". We think this will change (inflation will ease lower), but for now, it is what it is until dis-proven. In the eurozone, there has been a material easing in inflation rates, but the headline reading is still high, at 5.5%. UK inflation seems to have stopped falling, but it is still close to 9%, requiring the Bank of England to re-accelerate hikes. In the US, the latest consumer confidence number for June popped back out to 109.7 (versus 100 at neutral). All of this places upward pressure on market rates, and these factors are likely to sustain the upward pressure, at least for as long as an underlying oomph factor remains in play.

## **There is more room to the downside for market rates, but we will go up first**

Given all of this, we anticipate that the US 10yr Treasury yield can get back above 4%, back to where it was before the SVB story changed the dynamic. The 10yr could well take out the previous high, and remain elevated for a time. With European central banks tending to show urgency on the inflation issue, there is ample room for eurozone market rates to rise too. The 10yr Bund yield is quite likely to break back above 2.5%, and then trend towards 3%. The cycle high seen when SVB went down was 2.75% – that's liable to be taken out.

We think these are moves that should be faded through, as increasingly we expect the residual oomph factor to be outweighed by an increasing angst factor. Growing unease with respect to the commercial real estate loan portfolios being held by banks will also begin to count. And further falls in inflation should be a natural outcome as demand slows. Once key core inflation readings have moved below 3%, the way will be clear for the Fed to consider rate cuts. A 2% handle is all that's needed (so, for example, 2.9% will be good enough). The ECB won't be too far behind. So sure, anticipate further rises in market rates now, but prepare for much bigger falls ahead.

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# ING's July Monthly: The economic twilight zone

All of the latest from our team on what could be next for the global economy



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