ING

THINK Economic and Financial Analysis

ING Monthly

September 2023

Summertime sadness

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Summertime sadness

Remember that 'back to school' feeling at the end of summer? A tedious car journey home after holiday fun, knowing you'll be picking up where you left off? I'm afraid we've got a very similar feeling about the global economy right now. 'Are we nearly there yet?'. No.

Very few reasons to be cheerful

Lana del Rey's *Summertime Sadness* classic comes to mind as we gear up for autumn. And I'm not just talking about chaotic weather or even, in my case, disappointing macro data. Most of us have had the chance to recharge and rethink over the past couple of months. and I'm afraid all that R&R has done little to brighten our mood as to where the world's economy is right now.

Sure, the US economy has been holding up better than we thought. And yes, the eurozone economy grew again in the second quarter. Gradually retreating headline inflation should at least lower the burden on disposable incomes. And let's be thankful for the build-up of national gas reserves in Europe, which should allow us to avoid an energy supply crisis this winter unless things turn truly arctic.

But that's about as upbeat as I can get. We still predict very subdued growth to recessions in many economies for the second half of the year and the start of 2024. The stuttering of the Chinese economy seems to be more than only a temporary blip; it seems to be transitioning towards a weaker growth path as the real estate sector, high debt and the 'de-risking' strategy of the EU and the US all continue to weigh on the country's growth outlook.

In the US, the big question is whether the economy is resilient enough to absorb yet another potential risk factor. After spring's banking turmoil, the debt ceiling excitement, and more generally, the impact of higher Fed rates, the next big thing is the resumption of student loan repayments, starting in September. Together with the delayed impact of all the other drag factors, these repayments should finally push the US economy into recession at the start of next year.

And then there's Europe. Despite the weather turmoil, the summer holiday season seems to have been the last hurrah for services and domestic demand in the eurozone. Judging from the latest disappointing confidence indicators, the bloc's economy looks set to fall back into anaemic growth once again.

Little late summer warmth

This downbeat growth story does have an upbeat consequence; inflationary pressure should ease further. It's probably not going to be enough to bring inflation rates back to central banks' targets, but they should be low enough to see the peak in policy rate hikes. Central bankers would be crazy to call an end to those hikes officially; they don't want to add to speculation about when the first cuts might come, thereby pushing the yield further into inversion. And there's also the credibility issue - you never know, prices might start to accelerate again. So, expect major central bankers to remain hawkish at least until the end of the year.

In our base case, we have no further rate hikes from the US Federal Reserve and one final rate rise by the European Central Bank. However, in both cases, these are very close calls, and the next central bank meetings are truly data-dependent.

Sometimes, a Golden Fall or Indian Summer can make up for any summertime sadness. But it doesn't look as if the global economy will be basking in any sort of warmth in the coming

weeks. The bells are indeed ringing loud and clear. Vacation's over; school is here. And while I'm certainly too old for such lessons, I'm taken back to that gloomy, somewhat anxious feeling I had as a kid as summer wanes and the hard work must begin once again.

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Our key calls this month:

- **United States:** The US confounded 2023 recession expectations, but with loan delinquencies on the rise, savings being exhausted, credit access curtailed and student loan repayments restarting, financial stress will increase. We continue to forecast the Federal Reserve will not carry through with the final threatened interest rate rise.
- **Eurozone:** The third quarter may still be saved by tourism in the eurozone, but the latest data points to a more pronounced slowdown in the coming months. Inflation is falling, but a last interest rate hike in September is not yet off the table. The European Central Bank will be hesitant to loosen significantly in 2024.
- **China:** The latest activity data has worsened across nearly every component. Markets have given up looking for fiscal stimulus, and have started making comparisons with 1990s Japan. We don't agree with the Japanification hypothesis, but clearly a substantial adjustment is underway, and we have trimmed our growth forecasts accordingly.
- **United Kingdom:** Uncomfortably high inflation and wage growth should seal the deal on a September rate hike from the Bank of England. But emerging economic weakness suggests the top of the tightening cycle is near, and our base case is a pause in November.
- **Central and Eastern Europe (CEE):** Economic activity in the first half of the year has been disappointing, leading us to expect a gloomier full-year outlook. Despite this, we see a divergence in economic policy responses, driven by country-specific challenges.
- **Commodities:** Oil prices have strengthened over the summer as fundamentals tighten, whilst natural gas prices have been volatile, with potential strike action in Australia leading to LNG supply uncertainty. Chinese concerns are weighing on metals, but grain markets appear more relaxed despite the collapse of the Black Sea deal.
- **Market rates:** The path of least resistance is for longer tenor rates to remain under upward pressure in the US and the eurozone and for curves to remain under dis-inversion (steepening) pressure. We remain bearish on bonds and anticipate further upward pressure on market rates from a tactical view.
- **FX:** Stubborn resilience in US activity data and risk-off waves from China have translated into a strengthening of the dollar over the summer. We still think this won't last much longer and see Fed cuts from early 2024 paving the way for EUR:USD real rate convergence. Admittedly, downside risks to our EUR/USD bullish view have grown.

ING global forecasts

	2023					2024					2025				
	1Q23	2Q23	3Q23	4Q23	FY	1Q24	2Q24	3Q24	4Q24	FY	1Q25	2Q25	3Q25	4Q25	FY
United States															
GDP (% QoQ, ann)	2.0	2.1	3.3	0.6	2.2	-1.3	-1.2	-0.3	1.7	0.2	1.9	2.0	2.2	2.0	1.5
CPI headline (% YoY)	5.8	4.1	3.5	3.1	4.1	2.6	2.3	2.1	2.0	2.3	2.2	2.4	2.3	2.3	2.3
Federal funds (%, eop)	5.00	5.25	5.50	5.50	5.50	5.00	4.00	3.50	3.00	3.00	3.00	3.00	3.00	3.00	3.00
3-month interest rate (%, eop)	4.90	5.20	5.40	5.40	5.40	4.90	4.00	3.50	3.00	3.00	3.00	3.00	3.00	3.00	3.00
10-year interest rate (%, eop)	3.50	3.80	4.25	3.75	3.75	3.25	3.00	3.00	3.50	3.50	3.50	3.50	3.75	4.00	4.00
Fiscal balance (% of GDP)					-6.1					-6.3					-5.7
Gross public debt / GDP					99.8					103.7					105.5
Eurozone															
GDP (% QoQ, ann)	0.0	1.0	0.6	0.2	0.6	0.1	0.7	1.3	1.2	0.6	1.6	1.6	1.4	1.4	1.4
CPI headline (% YoY)	8.0	6.9	3.5	2.9	5.3	2.6	3.0	2.5	2.0	2.5	1.9	2.0	2.1	2.1	2.0
Refi minimum bid rate (%, eop)	3.50	4.00	4.50	4.50	4.50	4.50	4.25	4.00	3.75	3.75	3.50	3.25	3.25	3.25	3.25
3-month interest rate (%, eop)	3.00	3.60	4.10	4.00	4.00	3.90	3.70	3.50	3.25	3.25	3.00	2.90	2.90	2.90	2.90
10-year interest rate (%, eop)	2.30	2.40	2.40	2.30	2.30	2.30	2.20	2.20	2.30	2.30	2.30	2.30	2.45	2.60	2.60
Fiscal balance (% of GDP)					-3.9					-3.1					3
Gross public debt/GDP					92.2					90.8					91
Japan															
GDP (% QoQ, ann)	3.7	6.0	0.0	0.4	2.3	0.4	1.2	1.2	1.2	1.0	1.2	1.2	1.2	1.2	1.2
CPI headline (% YoY)	3.6	3.3	3.1	2.6	3.2	2.5	2.4	2.2	2.0	2.2	1.9	1.7	1.4	1.3	1.5
Interest rate on excess reserves (%)	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25
3-month interest rate (%, eop)	0.00	0.05	0.08	0.08	0.08	0.10	0.10	0.20	0.20	0.20	0.20	0.30	0.30	0.30	0.30
10-year interest rate (%, eop)	0.35	0.40	0.70	0.80	0.80	0.80	0.80	0.90	0.90	0.90	1.00	1.00	1.00	1.00	1.00
Fiscal balance (% of GDP)					-8					-7					-5
Gross public debt/GDP					260.0					275.0					280.0
China															
GDP (% YoY)	4.5	4.7	4.1	3.1	4.5	4.2	4.2	5.1	6.1	4.2	5.8	5	4.1	5.20	5.5
CPI headline (% YoY)	1.3	1.0	0.0	0.8	0.5	0.9	1.5	1.5	1.5	1.3	1.6	1.7	1.8	1.9	2.0
PBOC 7-day reverse repo rate (% eop)	2.00	1.90	1.70	1.60	1.60	1.60	1.60	1.70	1.80	1.80	1.90	2.00	2.00	2.00	2.00
3M SHIBOR (% eop)	2.45	2.17	1.95	1.90	1.90	1.85	1.85	1.95	2.05	2.25	2.15	2.25	2.30	2.30	2.30
10-year T-bond yield (%, eop)	2.86	2.65	2.50	2.40	2.40	2.40	2.40	2.65	2.80	3.60	3.00	3.00	3.00	3.00	3.00
Fiscal balance (% of GDP)					-8.0					-6					-4
Public debt (% of GDP), incl. local govt.					131					132					129
UK															
GDP (% QoQ, ann)	0.6	0.8	1.1	0.5	0.5	0.3	0.3	1.0	1.1	0.6	1.3	1.3	1.3	1.3	1.2
CPI headline (% YoY)	10.2	8.4	6.9	5.0	7.6	4.2	2.6	2.4	1.8	2.7	2.0	1.6	1.9	2.1	1.9
BoE official bank rate (%, eop)	4.25	5.00	5.50	5.50	5.50	5.50	5.00	4.50	4.00	4.00	3.50	3.00	3.00	3.00	3.00
3-month interest rate (%, eop)	4.40	5.40	5.50	5.50	5.50	5.40	4.90	4.40	3.85	3.85	3.35	2.95	2.95	2.95	2.95
10-year interest rate (%, eop)	3.50	4.45	4.40	4.00	4.00	3.50	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	3.75
Fiscal balance (% of GDP)					5.0					3.0					2.5
Gross public debt/GDP					103.0					102.0					99.0
EUR/USD (eop)	1.08	1.08	1.10	1.13	1.13	1.16	1.17	1.18	1.17	1.17	1.16	1.15	1.15	1.15	1.15
USD/JPY (eop)	133	145	145	135	135	130	125	125	125	125	125	125	125	125	125
USD/CNY (eop)	6.87	7.24	7.25	7.15	7.15	7.00	7.00	6.80	6.70	6.70	6.50	6.50	6.50	6.50	6.50
EUR/GBP (eop)	0.88	0.87	0.87	0.89	0.89	0.89	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88
ICE Brent -US$/bbl (average)	82	78	86	92	84	85	87	93	96	90	78	75	75	73	75
Dutch TTF - EUR/MWh (average)	53	35	32	50	43	60	52	45	50	52	60	50	40	50	50

Source: ING forecasts

Inflation's second wave: Are we really watching a 70s rerun?

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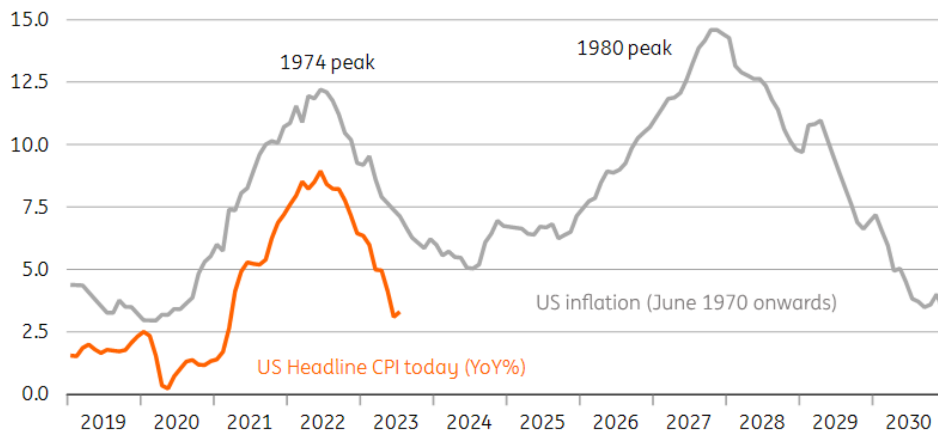
Another wave of global inflation is far from inevitable. But there are good reasons to think inflation will be structurally higher and more volatile over the next decade than the last

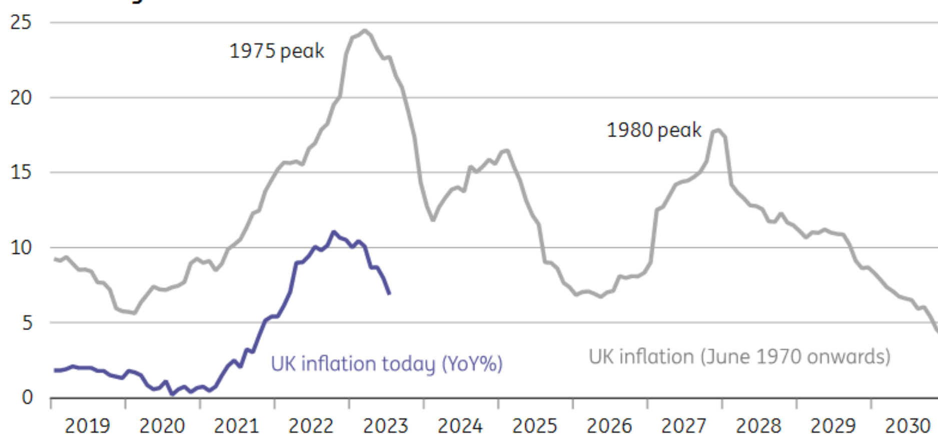
Starsky and Hutch were big in the 70s when inflation rates were similar to those of today

Inflation has only been falling for a matter of months across major economies, but the debate surrounding a possible "second wave" is well underway. Social media is littered with charts like the ones below, overlaying the recent inflation wave against the experience of the 1970s.

These charts are largely nonsense; the past is not a perfect gauge for the future, especially given the second 1970s wave can be traced back to another huge oil crisis. But central bankers have made no secret that nightmares of that period are shaping today's policy decisions. Policymakers are telling us they plan to keep rates at these elevated levels for quite some time.

Inflation: The 1970s versus today





The 1970s inflation series is overlaid on today's data by lagging the series by around 47 years (or 571 months)
Source: Macrobond, ING calculations

Rewind 50 years and not only did inflation fail to return to prior lows in either the US or the UK after the initial 1974 spike, but both countries saw at least one additional spike over subsequent years. Germany fared better, but wages did respond to the second oil crisis, helping to push inflation up again.

The lesson was that for a second wave to really take off, you need a catalyst and an economic environment ripe for inflation to take hold.

The twin oil price shocks in the 1970s fell on a US economy that was already running hot, a byproduct of persistent US trade and fiscal deficits that grew through the 1960s, aided by the often loose monetary policy of then-Federal Reserve Chair Arthur Burns. That excess demand helped end the Bretton Woods system of fixed currencies and the US dollar lost a quarter of its value between 1970 and mid-1973 as the agreement collapsed, amplifying the hit from higher energy costs. And all of this fell upon an economy that was much more manufacturing-centric than it is today, and it was also heavily unionised. Wage growth typically kept pace with inflation.

Back to today, the economy looks very different. But we think there are valuable lessons, and these are our main conclusions:

- A second wave isn't inevitable, but we think there are good reasons to expect inflation to be both structurally higher and more volatile over the next decade. The same is true for central bank rates.
- The US is less vulnerable to energy shocks than in the 1970s, but further gas price spikes are possible, and that could prompt renewed waves of eurozone inflation.

With prices still well above 2021 levels, a shock would likely be smaller. However, a second energy price shock could lead to more pronounced feedback between eurozone wages and inflation.

- Shortages of metals, be it due to lack of investment or geopolitics, are a growing inflation risk, especially amid the green transition. This probably wouldn't generate a 2022-style inflation shock by itself, but it is likely to be a source of constant price pressure in future years. Extreme weather is also likely to make food prices more volatile.
- Unionisation is less widespread than in the 1970s, but there are signs that worker power is increasing amid structural worker shortages. The ability of workers to protect real wages in future inflation shocks is set to grow.
- Tighter fiscal and monetary policy should act as a brake on inflation over the short-to-medium-term. Interest rates aren't likely to return to pre-Covid lows in the foreseeable future, and quantitative easing is unlikely to be used as an economic bazooka. But Covid and the Ukraine war have lowered the bar to big government tax/spending intervention in future crises.

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What central banks are set to do next

We think the Federal Reserve has finished hiking rates, and the ECB and Bank of England aren't far behind

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ECB President Christine Lagarde's future options are somewhat limited

Federal Reserve

At the recent Jackson Hole Fed symposium, Fed Chair Jerome Powell acknowledged that monetary policy is "restrictive" and that policymakers will "proceed carefully" in determining whether to hike interest rates further. September appears set for a pause given recent encouraging signals on inflation and labour costs, but robust activity data means the door remains ajar for a further potential hike. Markets see a 50-50 chance of a final hike while we think rates have most probably peaked.

Households are rapidly running down pandemic-era savings, and rising consumer loan delinquencies indicate growing stresses that will be intensified by the restart of student loan repayments. Amid weakening global activity, we are, unfortunately, in the camp that fears this is more of a downturn-delayed rather than recession-averted story. Fortunately, we think that inflation will continue to slow rapidly and this will afford the Federal Reserve the flexibility to respond swiftly to this challenging environment with interest rate cuts through 2024.

European Central Bank

Macro developments over the summer have caused further complications for the ECB. While the rapid worsening of the economy should come as a surprise, at least judging from overly optimistic ECB growth forecasts so far, the speed with which headline inflation is coming down should still leave the central bank uncomfortable.

Core inflation also remains too high and wage growth up until now signals that even without excessive wage settlements core inflation could stay higher for longer.

We still expect headline inflation to come down significantly after the summer, mainly on the back of German headline inflation falling. However, if the ECB sticks to its stance of putting more emphasis on actual data rather than on expected data, the current inflation picture still argues in favour of another rate hike.

After 425bp of rate hikes in slightly more than a year, a pause in the ECB's hiking cycle at the September meeting would make perfect sense. However, the worsening economy and our expectation of an acceleration of disinflationary risks after the summer could easily transform a pause into an actual full stop. The question is whether everyone at the ECB could live with a terminal rate of 3.75%. We think that the hawks would prefer 4% and will therefore push for one final rate hike at the September meeting. A last one for the road, even if it remains a very close call.

Bank of England

The Bank of England looks poised to hike rates again in September, but November is less certain. Private sector wage growth is at a cycle high and looks unlikely to slow dramatically by the end of the year, and certainly not before November. Meanwhile, services inflation has risen higher again. And while we think the impact of lower gas prices should start to show through here with a lag, progress is likely to be limited by the time of the November meeting.

That said, the wider economy is showing signs of slowing amid higher interest rates, and the jobs market is also noticeably cooling. We're likely to see more evidence of this over the next couple of months. We're erring on the side of a pause in November, but we don't rule out another hike.

Bigger picture, the BoE is clear that it wants to keep rates high for a prolonged period. We've pencilled in the first cut for the second quarter of next year but we acknowledge that may end up being delayed.

Why an impending US downturn may simply be delayed

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The US confounded 2023 expectations that it would fall into recession as households used pandemic-era savings and their credit cards to maintain lifestyles amidst a cost-of-living crisis. But with loan delinquencies on the rise, savings being exhausted, credit access curtailed and student loan repayments restarting, financial stress will increase

We believe a US downturn has been delayed rather than parked

Robust resilience in the face of rate hikes

At the beginning of the year, economists broadly thought the US economy would likely experience a recession as the fastest and most aggressive increase in interest rates inevitably took its toll on activity. Instead, the US has confounded expectations and is on course to see GDP growth of 3%+ in the current quarter with full-year growth likely to come in somewhere between 2% and 2.5%. What makes this even more surprising is that this has been achieved in the face of banks significantly tightening lending conditions while other major economies, such as China, are stuttering and even entering recessions, such as in the eurozone.

Consumers still happy to spend with the jobs market looking so strong

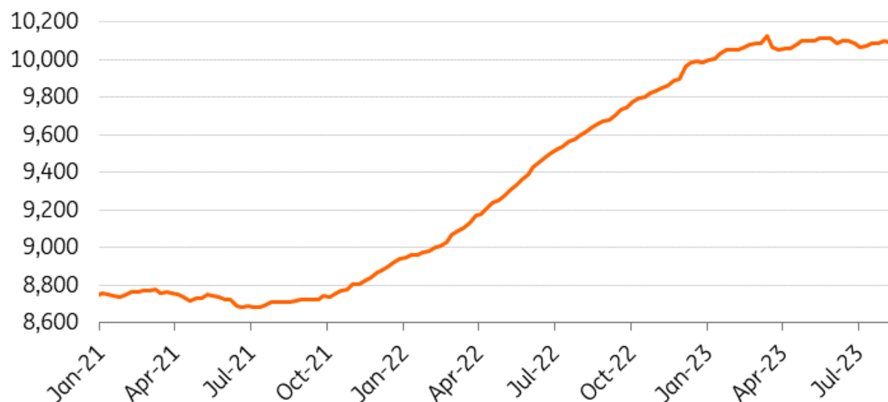
So why is the US continuing to perform so strongly? Well, the robust jobs market certainly provides a strong base, even if wage growth has been tracking below the rate of inflation. Maybe that confidence in job security has encouraged households to seek to maintain their lifestyles amidst a cost-of-living crisis by running down savings accrued during the pandemic and supplementing this with credit card borrowing.

The housing market was another source of concern at the start of the year, but even with mortgage rates at 20-year highs and mortgage applications having halved, prices have stabilised and are now rising again nationally. Home supply has fallen just as sharply, with those homeowners locked in at 2.5-3.5% mortgage rates reluctant to sell and give up that cheap financing when moving to a different home and renting remains so expensive. This has helped lift new home construction at a time when infrastructure projects under the umbrella of the Inflation Reduction Act are supporting non-residential construction activity.

But lending is stalling and savings have been run down

The Federal Reserve admits monetary policy is now restrictive, and while it could raise interest rates further, there is no immediate pressure to do so. With inflation showing encouraging signs of slowing nicely, this is fueling talk of a soft landing for the economy. With less chance of an imminent recession, financial markets have scaled back the pricing of potential interest rate cuts in 2024, with the resiliency of the US economy prompting a growing belief that the equilibrium level of interest rates has shifted structurally higher. This resulted in longer-dated Treasury yields hitting 15-year highs earlier this month.

Outstanding commercial bank lending ($bn)



Source: Macrobond, ING

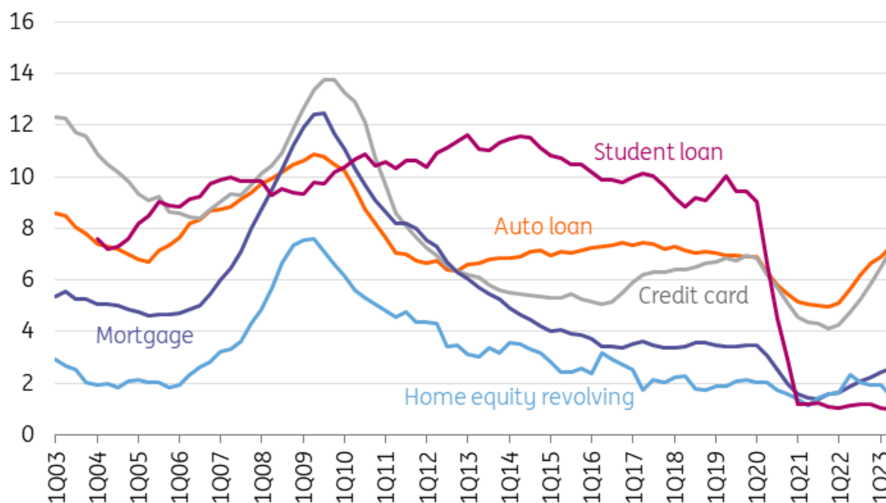
Nonetheless, the threat of a downturn has not disappeared. We estimate that around $1.3tn of the $2.2tn of pandemic-era accumulated savings has been exhausted and at the current run rate all will be gone before the end of the second quarter of 2024. At the same time, banks are increasingly reluctant to lend to the consumer with the stock of outstanding bank lending flat lining since the banking stresses in March, having increased nearly $1.5tn from late 2021. We suspect that financial stresses have seen middle and lower income households accumulate the bulk of the additional consumer debt and have run down a greater proportion of their savings vis-à-vis higher income households so a financial squeeze for the majority is likely to materialise well before the second quarter of 2024.

Rising delinquencies will accelerate as student loan repayments resume

Indeed, consumer loan delinquencies are on the rise, particularly for credit card and vehicle loans with the chart below showing data up until the second quarter of this year. Since then the situation has deteriorated further based on anecdotal evidence with Macy's CFO expressing surprise at the speed and scale of the rise in delinquencies experienced through June and July on their own branded credit card (Citibank partnered). Note too that credit card delinquencies from smaller banks (not in the top 100 largest by asset size) are up at 7.5% already – a record high. With credit card interest rates at their highest level since 1972 and with household finances set to become more stressed with the imminent restart of student loan repayments, something is likely to give. We see the risk of a further increase in delinquencies, which will hurt banks and lead to even further retrenchment on lending, together with slower consumer spending growth and potentially even a contraction.

Percent of loans 30+ days delinquent

4Q moving sum



Source: New York Fed Consumer Credit Panel/Equifax

Downturn delayed, not averted

The manufacturing sector is already struggling and we see the potential for consumer services to come under increasing pressure too. On top of this there are the lingering worries about the demand for office space and the impact this will have on commercial real estate prices in an environment where there is around $1.5tn of loans needing to be

The eurozone's summer tourist boom should give way to a significant slowdown

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The third quarter may still be saved by tourism in the eurozone, but the latest data points to a more pronounced slowdown in the coming months. Inflation is falling, but a last interest rate hike in September is not yet off the table. The European Central Bank will be hesitant to loosen significantly in 2024, limiting the scope for a bond market rally

This outdoor classic car show in Nice, France, helped boost eurozone tourism this summer

Business sentiment in contraction territory

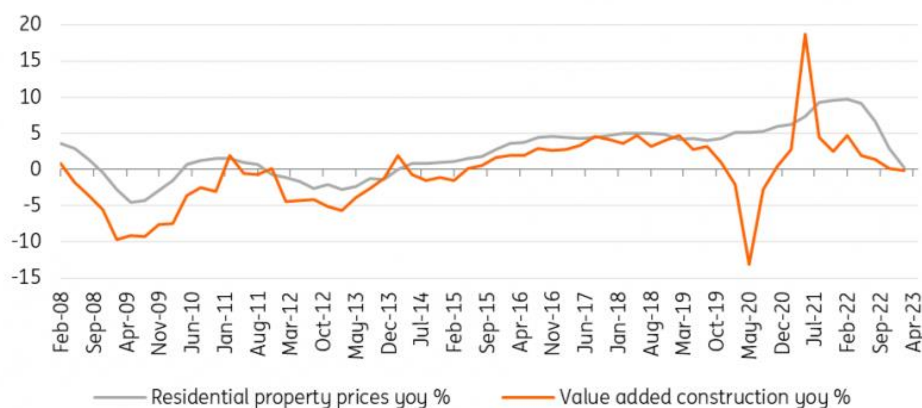
In spite of heatwaves and wildfires, the tourist season seems to have been strong in Europe. It has continued to support growth in the third quarter following a better-than-expected growth figure in the second quarter. However, with the end of the summer in sight, we're now beginning to see a more sobering economic outlook emerge.

The composite PMI survey for August was certainly a cold shower, falling to the lowest level in 33 months at 47 points. While the figure has already been in contraction territory in industry for some time, it has now fallen below the boom-or-bust level in the services sector. Deteriorating order books weighed on confidence in both the manufacturing and the services sector, which also explains why there were job losses in manufacturing while hiring plans in the services sector were put on a slow burner. This will probably stop the decline in unemployment in the eurozone.

Disappointing external demand

A softer labour market might lead to higher savings rates, thereby countering the positive impact on consumption of rising purchasing power. At the same time, the much-anticipated export boost is unlikely to materialise as the US economy eventually starts to cool while the Chinese recovery continues to disappoint. Finally, with a rapidly cooling housing market on the back of tighter monetary policy, the construction sector is also likely to see a slowdown. All of this explains why we still don't buy the European Central Bank's story that economic recovery will strengthen on the back of falling inflation, rising incomes and improving supply conditions. We expect the winter quarters to see close to 0% growth, resulting in 0.6% annual GDP growth for both this year and next year.

Cooling housing market is likely to weigh on construction activity



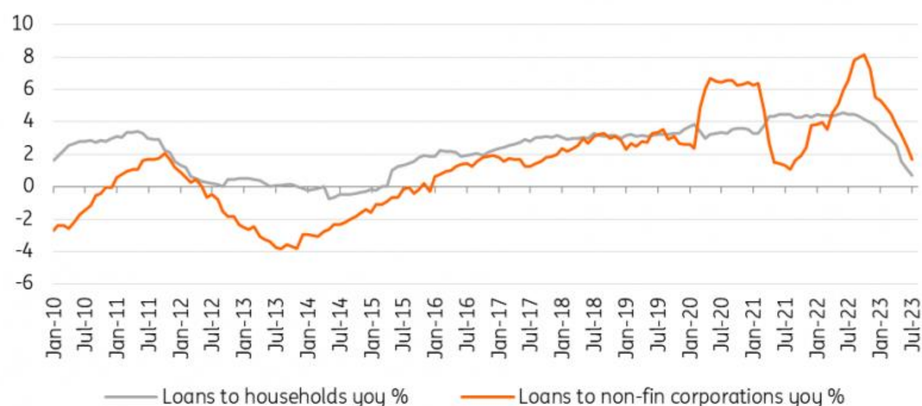
Source: LSEG Datastream

Inflation is coming down, slowly

While inflation is clearly trending down, the pace might still leave the ECB uncomfortable. Industrial goods prices have started to fall, but services prices are still growing monthly above 4% in annualised terms. Negotiated wage growth seems to have reached a plateau just below 4.5%. Still, given the slow productivity growth (with the decline in hours worked as one of the important drags), final demand will have to be very weak to prevent higher wages from feeding into higher prices.

We expect headline inflation to hit 2% by the end of 2024, but over the coming months, core inflation remains likely to hover around 5%. As the recent trend in underlying inflation is one of the key determinants of monetary policy, this would lead to an additional rate hike.

Loan growth is close to stalling



Source: LSEG Datastream

The ECB's job is almost done

With credit growth now close to a standstill and money growth negative, there remains little doubt that monetary policy is already sufficiently restrictive and that the monetary transmission mechanism is working. On top of that, the median consumer inflation expectation for the period three years ahead fell back to 2.3% in June. So, it looks as though the job is nearly done. For now, we're still pencilling in a final 25 basis point hike for the ECB's September meeting – but it's a very close call. A pause would likely mean the end of the tightening cycle, as the faltering recovery will make it harder to continue raising rates afterwards.

While we see the first rate cut by the summer of 2024, we can't imagine the central bank loosening aggressively next year. In her speech at Jackson Hole, President Christine

Lagarde mentioned a number of structural changes that make the medium-term inflation outlook more uncertain, and we think that the ECB will keep short rates relatively high for some time to come. That will probably limit the potential for the bond market to rally strongly in the wake of the expected economic stagnation later this year.

We're worried about China, but things could be worse

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China's latest activity data worsened across nearly every component. Markets have given up looking for fiscal stimulus, and have started making comparisons with 1990s Japan. We don't agree with the Japanification hypothesis, but clearly a substantial adjustment is underway, and we have trimmed our growth forecasts accordingly

China now looks set to endure a period of sub-trend growth. Pictured: a car factory in the eastern city of Tianjin

Deflation is very different to this

A couple of weeks ago, we wrote a piece debunking an argument that was doing the rounds which argued that China had slipped into deflation and was turning into a modern-day equivalent of 1990s Japan.

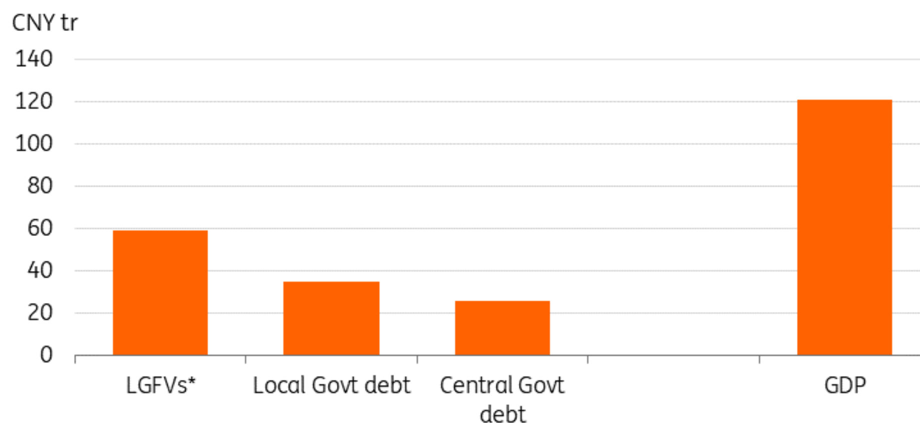
Being old enough to remember that period quite well (unlike I imagine most of the proponents of the idea), it was clear to us that there was no merit to this view.

Firstly, deflation is not negative consumer price inflation. Deflation is a much broader collapse in the general price level, which, in addition to consumer prices includes falls in real and financial asset prices, as well as money wages. And though we have seen some renewed falls in house prices, stocks are not looking very robust, and there is indeed some year-on-year decline in consumer prices, however, money wages are still positive.

Moreover, the single defining feature of 1990s Japan was that it was the result of a monetary-induced bubble and subsequent bust. There was a property element to Japan's problems, but much more besides. Japan's response was a massive fiscal expansion, which failed to do much more than saddle the economy with a mountain of debt, and the rest is largely history.

China's issues also concern the property market, but it is the existence of large-scale local government debt that is the main constraint on the recovery. There is little evidence of any financial or property bubble. As a result, the government responses, of which there have already been a great many, have almost entirely focused on supply-side measures, which are only having a very marginal effect on activity.

Local government financing vehicles swell government debt



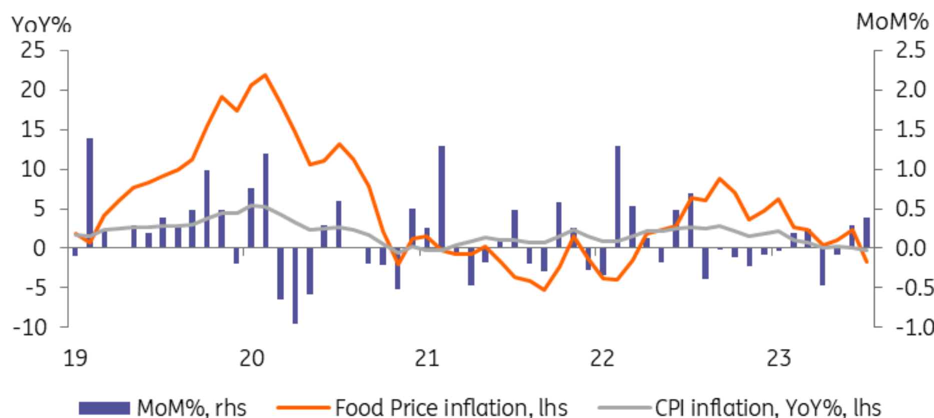
*LGFV = Local government financing vehicle
Source: LGFV debt estimates from the Rhodium Group, CEIC, ING

The outlook is for further weakness in economic activity

China now looks set to endure a period of sub-trend growth while it restructures this debt and alleviates some of the debt-service cost strains that are apparently weighing on some local government financing vehicles. Much of this off-balance sheet debt will need to be brought back on the balance sheet. Clarity over the scale of the existing problem will help determine the central government's response, as at this stage, we suspect that even they don't know. But lower interest rates for official debt and longer payment schedules seem very likely to dominate proceedings. Bucketloads of new debt, however, will not.

We think that China's longer-term potential growth rate is around the 5% mark. But in the near term, even this may present a challenge for policymakers to achieve. We have downgraded our GDP forecast for 2023 to 4.5% as the previous main engine of growth – consumer spending – is faltering. Estimating how long this balance sheet adjustment will weigh on the economy is pure guesswork at this stage, but a wet-finger estimate of two years seems a reasonable starting point. We are not looking for 5% growth to be achieved again until 2025.

Chinese inflation is just unwinding earlier food price spikes



China inflation monthly
Source: CEIC, ING -

Inflation is low, but will recover

Such weakness is likely to keep inflation very subdued in the meantime. Much of the recent decline in overall inflation is due to falls in food price inflation, which spiked up to more than 10% in July last year on the back of swine fever-affected pork prices. This is yet another reason for dismissing deflation claims.

Indeed, if you create a conventional CPI index from China's year-on-year inflation series, then it looks like the price level rose by about 0.3% month-on-month in each of the last two months. So temporary base effects are doing most of the damage to inflation currently, and by November these will have passed. In the meantime, though, further negative year-on-year CPI inflation figures are likely to keep the 'deflation' argument alive for a while longer.

Cracks in the UK economy will give the Bank of England pause for thought

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Uncomfortably high inflation and wage growth should seal the deal on a September rate hike from the Bank of England. But emerging economic weakness suggests the top of the tightening cycle is near, and our base case is a pause in November

The Bank of England itself is now describing the level of interest rates as "restrictive" – a clear signal that policymakers think they're almost done with rate hikes

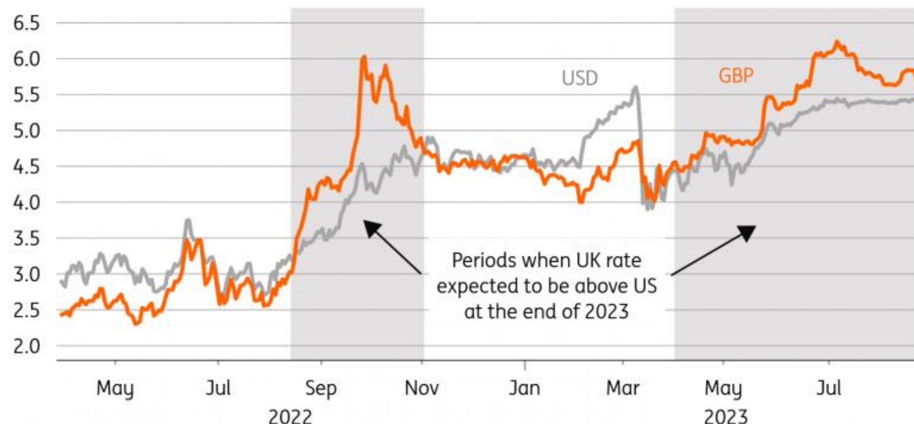
Markets have been reassessing Bank of England rate hikes

Rewind to the start of the summer, and the view that the UK had a unique inflation problem had become very fashionable. At its most extreme, market pricing saw Bank Rate peaking at 6.5%, some 125bp above its current level. Since then, this story has begun to lose traction. The differential between USD and GBP two-year swap rates, a gauge of interest rate expectations, has halved.

That reflects the growing reality that the UK inflation story looks less of an outlier than it did a few months back. Like most of Europe, food inflation has begun to slow, and further aggressive falls are likely judging by producer prices. Consumer energy bills fell by 20% in July, and another 5% decline is baked in for October. The Bank of England itself is now describing the level of interest rates as "restrictive" – a statement of the obvious perhaps, but nevertheless tells us that policymakers think they've almost done enough with rate hikes.

UK and US rate expectations have narrowed

Expected 1M rates in December 2023 (SOFR/SONIA futures) %



Source: Macrobond

A September hike is likely but November is less certain

Still, we're not quite there yet, and recent inflation data has continued to come in on the upside. Private sector wage growth – measured on a three-month annualised basis – is running at a cycle-high of 11%. Services inflation also edged higher in July, although this was partly attributable to some unusual swings in specific categories rather than broad-based moves. A September hike is therefore highly likely.

Whether markets are right to be pricing another hike for November is less certain. We'll only get one round of CPI and wage data between the September and November meetings. Wage growth is unlikely to have slowed much, but we're hopeful for early signs that services inflation is inching lower. Various surveys suggest few service-sector firms are raising prices, and we think that reflects the sharp fall in gas prices.

A lot also hinges on whether we continue to see signs of weakness in economic activity. Like Europe, the UK's PMIs look worrisome and will have prompted some pause for thought at the Bank of England. The jobs market is also cooling, and the vacancy-to-unemployment ratio – which BoE Governor Andrew Bailey has consistently referenced – is closing in on pre-Covid highs. There's also been an ongoing improvement in worker supply.

We're now at a point where survey numbers and various bits of official data suggest that both economic growth and inflation are losing steam. The inflation and wage growth figures aren't there yet, but these are lagging perhaps most out of all economic indicators. A November pause isn't guaranteed, but it remains our base case.

To some extent, we're splitting hairs. In the bigger picture, the Bank is becoming much more focused on how high rates need to go – and instead, the central goal will increasingly become keeping market rates elevated long after it stops hiking. Any further rate hikes should be seen as a means to that end.

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Can Germany rid itself of the 'Sick man of Europe' label?

The current international debate on whether or not Germany is once again the 'Sick man of Europe' could finally bring about the long-awaited sense of urgency for a new reform programme by the government

Germany is in need of new reforms to get its economy going again

It has been the big summer theme in Europe: weak growth, worsening sentiment and pessimistic forecasts have brought back headlines and public discussion about whether Germany is once again the 'Sick man of Europe'. The Economist reintroduced the debate this summer more than two decades after its groundbreaking front page. The infamous headline seems currently justified when looking at the state of the German economy.

The 'Sick man of Europe' debate

The optimism at the start of the year seems to have given way to more of a sense of reality. In fact, the last few weeks have seen an increasingly heated debate about Germany's structural weaknesses under the placative label "sick man of Europe". Disappointing industrial data, ongoing problems in the energy-intensive industry and a long list of structural problems have fuelled the current debate. And indeed, no other eurozone economy is currently facing such a high number of challenges as the German economy.

Cyclical headwinds like the still-unfolding impact of the European Central Bank's monetary policy tightening, high inflation, plus the stuttering Chinese economy, are being met by structural challenges like the energy transition and shifts in the global economy, alongside a lack of investment in digitalisation, infrastructure and education. To be clear, Germany's international competitiveness had already deteriorated before the Covid-19 pandemic and the war in Ukraine.

To a large extent, Germany's issues are homemade. Supply chain frictions in the wake of the pandemic, the war in Ukraine and the energy crisis have only exposed these structural weaknesses. These deficiencies are the flipside of fiscal austerity and wrong policy preferences over the last decade.

Fiscal stimulus during the pandemic years and last year to tackle the energy crisis have prevented the German economy from falling deeper into recession. However, with our current forecast of a contraction of the entire economy by roughly 0.5% over the entire year and yet another contraction next year, the economy would basically be back to its 2019 level in late 2024. There are many varieties of illness and the German economy has clearly caught a few bugs due to its own lifestyle choices.

Has anything changed over the past two decades?

The current economic situation and the public debate in Germany feel eerily familiar to that of 20 years ago. Back then, the country was going through the five stages of grief, or, in an economic context, the five stages of change: denial, anger, bargaining, depression and acceptance. From being called 'The sick man of the euro' by The Economist in 1999 and early 2000s (which created an outcry of denial and anger) to endless discussions and TV debates (which revelled in melancholy and self-pity) to an eventual plan for structural reform in 2003 known as the 'Agenda 2010', introduced by then-Chancellor Gerhard Schröder. It took several years before international media outlets were actually applauding the new German Wirtschaftswunder in the 2010s.

In the early 2000s, the trigger for Germany to move into the final stage of change management – 'acceptance' (and solutions) – was record-high unemployment. The structural reforms implemented back then were, therefore, mainly aimed at the labour market. At the current juncture, it is hard to see this single trigger point. Generally speaking, the current situation is worse and better than the one in the early 2000s.

It is better because 20 years ago Germany breached European fiscal rules, while it currently has one of the most solid public finances of all eurozone countries, leaving sufficient fiscal space to react. What is worse is that there is currently a long list of other problems.

Finally, low unemployment is a bit of a blessing in disguise. While positive for the economy and very different from 20 years ago, low unemployment also seems to have reduced the sense of urgency for policymakers. Given the multifaceted challenges, it will be harder than it was in the early Noughties to find and then politically agree on a policy answer.

Another important difference between the current situation and two decades ago is the external environment. Back then, Germany had some good luck, or put differently, the economic reforms coincided with a favourable macro environment. Think of EU enlargement, which enabled many German corporates to outsource production to much cheaper-wage countries in Eastern Europe. The rise of China on the global stage also brought an almost symbiotic trade partner. China had a strong appetite for German investment goods and at the same time flooded world markets with deflationary policies.

Finally, Germany actually benefitted from the euro crisis and the ECB's "whatever it takes" approach as interest rates were artificially low and the euro artificially weak. None of these factors will sugarcoat any reform efforts at the current juncture. If anything, China has become a rival and competitor and the ECB needs to fight inflation. This lack of any sugarcoating makes the need for reform even more pressing, but will probably also make these reforms initially more painful.

Waiting for 'Agenda 2030'

Structural reforms implemented in the early 2000s were mainly aimed at the labour market. This was known as 'Agenda 2010'. Today, the German economy needs an 'Agenda 2030'. Short-term fiscal stimulus can ease the pain but will do very little to regain international competitiveness and restructure the entire economy.

What Germany needs is a full menu card with policy measures. These measures could be categorised into those boosting confidence and giving companies security and clarity, as well as supply-side improving measures. In the first category, think of an energy price cap for industry. Not for one winter but for several years. Such a measure should be accompanied by a clear schedule for the energy transition. This would prevent more companies from exiting Germany and producing elsewhere. Combined with fast depreciation rules of investments in digitalisation and renewable energies, this could safeguard the economy's industrial backbone. With subsidies for sectors like artificial intelligence, batteries or hydropower, the government could support innovation.

Finally, less bureaucracy, more investment into e-government and consequently faster public tenders and implementation of federal investments at the regional level would strengthen the supply side of the economy. It is a long list that can easily be extended and broadened. One thing, however, is clear: any overhaul of the economy will be almost impossible as long as fiscal austerity remains the dominant tune.

The German economy is in for a longer period of stagnation. The new debate about the 'sick of man Europe' could finally increase the sense of urgency among decision-makers; more than a protracted period of de facto stagnation could.

Gloomy growth prospects ahead for Central and Eastern Europe

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Economic activity in the first half of the year has been disappointing across Central and Eastern Europe, leading us to expect a gloomier full-year outlook. Despite this synchronised bottoming, we see a divergence in economic policy responses, driven by country-specific challenges

The economic forecast for much of the CEE region is looking a little gloomy.

Poland: A weak third quarter so far

The Polish economy started the third quarter on a soft note. All real economy figures for July underperformed, showing generally lacklustre domestic demand, while global conditions remain unfavourable. This indicates that the recovery will be slow and more visible in the fourth quarter than in the third. This suggests downside risks to our 2023 GDP forecast of 1%.

CPI inflation in July came in at 10.8% year-on-year (down from 11.5% YoY in June), largely owing to food (-0.6pp) and energy (-0.2pp) prices. Core inflation receded as well to 10.6%, but subtracted only 0.2pp from CPI. Compared to the CPI peak in February, CPI has already slowed by nearly 8pp, mainly due to fading external supply shocks. We estimate CPI will dip near 10% YoY in August, but not lower. It should decisively reach single digits in September and hover around 7% by the year-end.

We expect the Monetary Policy Council to start its easing cycle in September, even without meeting the governor's guidance on CPI reaching single digits. The recent real economy data proved lacklustre, i.e. the second quarter GDP print of -0.5% YoY came in below the July National Bank of Poland projection (-0.1% YoY), and the outlook for the second half of the year is also subject to downside risks. At the same time, inflation is on a clear path to reach single-digit levels later in the second half of the year. Still, recent MPC statements do not indicate the Council is willing to cut rates by more than 25bp at a single meeting. Consequently, we look for two or three 25bp cuts in 2023.

€/PLN remains range-bound against the euro and it's unlikely to change prior to the mid-October general elections. The zloty remains supported by the trade surplus and presumably Ministry of Finance activity, which offsets rather unsupportive emerging market sentiment. The zloty may ease after the elections, as opinion polls suggest that the political set-up may prevent prompt access to the Recovery Fund. Moreover, we see

domestic demand recovering gradually in the second half, which should trim Poland's trade surplus, given limited external demand.

We expect further Polish government bond curve steepening. The 2024 budget draft presents a strong rise (by 55%) in net borrowing needs (to PLN225bn vs. PLN143bn in 2023), while local banks may cover one-third of it in 2024 vs. two-thirds in 2023, and the Ministry of Finance should rely strongly on foreign demand. Also, core market developments are generally unsupportive for the local long end, while domestic data should maintain, or even strengthen, market views on central bank easing.

Czech Republic: The first rate cut is coming

The Czech economy posted negligible quarter-on-quarter growth of 0.1% in the second quarter and the latest monthly data show moderate growth in industrial and retail sales after very weak numbers in the first half of the year. However, the picture is still mixed. Looking at the details, we see that the only real driver of the economy is the auto sector and demand from abroad. Thus, full-year growth looks like it will be weaker than we previously forecast, but we still expect a rebound in the coming months, which the early data are already suggesting.

Inflation fell to 8.8% YoY in July and was in single-digit territory for the second consecutive month and the lowest in the CEE region. Disinflation should continue in our view in the coming months but at a much slower pace. In addition, fuel prices have surprisingly risen following the excise tax hike, pushing inflation 0.3-0.4pp above our earlier forecast. Even so, inflation should be in the 7-8% YoY range in September. However, thanks to the base effect, inflation will rise back above 8% in October and remain there for the rest of the year. In January, inflation is expected to fall into the 2-3% YoY range, close to the Czech National Bank's target, due to the massive base effect and seasonality.

We continue to expect the Czech National Bank to cut rates by 25bp for the first time in November. However, there is a clear risk that the central bank will want to stay on the safe side and wait for the January inflation number. This would mean delaying the rate cut until the first quarter of 2024.

On the fiscal side, we have seen a big turn to the positive side in recent months. The government budget deficit has stabilised and there is a good chance that the government will deliver on its deficit target. Moreover, the government is continuously discussing further savings for this year. For next year, parliament has already approved a consolidation package in the first round and a continuation of the legislative package can be expected in September. Given the government's majority in parliament, we expect approval during October.

Hungary: The worst may be over

We had high hopes going into the release of second-quarter GDP, and we were sorely disappointed. Hungary has been in a technical recession for four quarters, a new record in modern times. The silver lining remains agriculture, which we expect to pull the country out of the doldrums with a strong performance in the second half of the year. But it won't be enough to keep the economy out of a full-year recession. We now expect real GDP to contract by 0.5% in 2023, possibly the only country in CEE to record a down year.

Shrinking domestic demand (the main driver of the negative momentum) has a positive side effect: the trade balance has been in surplus for five months, while the current account posted a surplus in the second quarter based on preliminary figures. Against this background, we have significantly raised our external balance forecast and now see the current account in surplus by 0.3% of GDP in 2023.

If disinflation continues as expected on the back of weak domestic demand, we see headline inflation below 7% and single-digit core inflation by the end of the year. In this context, the National Bank of Hungary will soon succeed in creating a positive real interest rate environment, especially after the latest signal from policymakers, which warned against excessive rate cut expectations based on market pricing. This hawkish stance could translate into a higher-than-expected interest rate path, at least in the coming months. As a result, we see upside risks to our year-end policy rate forecast of 11%.

Hungary's fiscal situation remains challenging, as evidenced by budgetary developments in the first seven months of the year. So, it is hardly surprising that the finance minister has openly talked about the possibility of a budget revision in September. While it is not clear what a revision could mean in practice, we think it would be a combination of an upwardly revised deficit goal to 4.4% of GDP, accompanied by some additional budgetary measures to achieve the new target. We don't see any problems here from a debt financing perspective, as the additional supply will be raised through FX debt issuance.

Romania: Fiscal adjustments needed to contain the widening deficit

The second-quarter flash GDP print confirmed that the Romanian economy is slowing rather rapidly. GDP advanced by 1.1% in the second quarter and 1.7% in the first half of the year, visibly below our 2.3% estimate. While the detailed GDP data due on 7 September might shed a different light on the growth dynamic, we have already revised our 2023 GDP growth forecast from 2.5% to 1.5%, while maintaining 2024 at 3.7%.

From a monetary policy perspective, the lower growth is likely to offset the marginal higher inflation forecast of the National Bank of Romania and lead to a stable interest rate environment for the rest of the year. We believe that the central bank is not yet contemplating the timing for a dovish pivot, despite the more frequent dovish statements coming from other central banks in the region. We maintain our view of a first rate cut in the first quarter of 2024 with a key rate of 5.5% by the end of 2024.

Particularly relevant for future growth and the interest rates pattern is the final form of the fiscal package which is under discussion at the moment. We are likely to see a budget deficit target of around 5.0% of GDP (up from 4.4%) but how exactly it will be achieved is important. An emphasis on taxes such as VAT (e.g. a generalised VAT hike) will likely skew the inflation profile higher while it might have a lesser impact on growth, while a more aggressive stance on increasing income taxes (e.g. by eliminating some facilities for employees in IT, constructions, agriculture) could be more growth-detrimental in the short term, but more helpful on the inflation side.

Commodities news is dominated by strengthening oil and volatile gas prices

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Oil prices have strengthened over the summer as fundamentals tighten, whilst natural gas prices have been volatile, with potential strike action in Australia leading to LNG supply uncertainty. Chinese concerns are weighing on metals, but grain markets appear more relaxed despite the collapse of the Black Sea deal

We expect the tight oil environment to persist through much of 2024

Oil market tightness to persist

Oil prices have strengthened over the summer, with ICE Brent convincingly breaking above US$80/bbl. The strength in the flat price has coincided with strength in time spreads, reflecting a tightening in the physical oil market. OPEC+ cuts, and in particular additional voluntary cuts from Saudi Arabia, mean that the market is drawing down inventories. We expect this trend will continue until the end of the year, which suggests that oil prices still have room to move higher from current levels.

While the fundamentals are constructive, there are clear headwinds for the oil market. Firstly, it is becoming more apparent that the Fed will likely keep interest rates higher for longer and that, along with renewed USD strength, is a concern for markets. Secondly, Chinese macro data continues to disappoint, raising concerns over the outlook for the Chinese economy and what this ultimately means for oil demand. That said, up to now, Chinese demand indicators remain pretty strong.

We expect the tight oil environment to persist through much of 2024 with limited non-OPEC supply growth, continued OPEC+ cuts and demand growth all ensuring that global inventories will decline. However, we could see some price weakness in early 2024, with the market forecast to be in a small surplus in the first quarter of next year before moving back into deficit for the remainder of 2024, which should keep prices well supported.

The risks to our constructive view on the market (other than China demand concerns) include further growth in Iranian supply despite ongoing US sanctions and a possible easing in US sanctions against Venezuela, which could lead to some marginal increases in oil supply.

Supply risks plague the natural gas market

The European natural gas market has behaved in a volatile manner over the summer. This was sparked by prolonged maintenance in Norway, significantly reducing gas flows into Europe. In fact, further maintenance in Norway again saw gas flows declining more recently. There's also been concern over Australian LNG supplies, with workers threatening to go on strike. Potential strike action would have put supply at three facilities at risk, which make up around 10% of global LNG supply.

These LNG supply risks have eased somewhat with unions and the Woodside company coming to an agreement for workers at the North West Shelf facility. However, negotiations are still ongoing at two other facilities operated by Chevron. These have a combined capacity of 24.5mtpa, around 6% of global supply. This is clearly still a risk to the market, particularly if we see a prolonged strike that would affect all of this capacity and if it runs deep into the Northern Hemisphere winter.

Australia is not typically a supplier of LNG to Europe. However, reduced LNG supply would mean that Asian buyers would look elsewhere for alternative supply, increasing competition with European buyers. This is an upside risk to European gas prices, particularly if it were to occur over the heating season. European gas inventories naturally decline over the winter, with demand basically doubling over these months. If the LNG supply, which Europe is more reliant on now, is also reduced, inventories would fall quicker through winter.

That said, Europe is in a comfortable situation in the near term. Despite Norwegian disruptions, storage has filled up at a good pace and is, in fact, 92% full already. This is above the 79% seen at the same stage last year. It also means that the EU has hit the Commission's target of having 90% storage by 1 November, more than two months before the target date. We believe that Europe will go into the 2023/24 winter with storage basically at 100%. This suggests that in the short term, we will need to see European gas prices weaken and trade at a discount to Asian LNG. This is to ensure that LNG flows are diverted from Europe. Only when Europe starts drawing down storage during the heating season will we see further upside for prices.

China concerns weigh on industrial metals

It has been a summer of downward pressure for most metals. Renewed strength in the US dollar and a growing view that maybe the Fed has more work to do when it comes to monetary tightening has provided some strong headwinds to the metals complex.

However, it is weakness in China which has been the key catalyst for the sell-off seen in most metals. The property sector remains weak, with housing starts and residential floor space sold still in deep contraction, whilst new home prices have started falling once again month-on-month. In addition, China's manufacturing PMI remains in contraction territory. These are two important sectors for metals demand which are clearly struggling. Meanwhile, retail sales in China, which helped to support growth earlier in the year, are also weakening. Metal markets are likely to continue to be largely dictated by developments in China. However, it is difficult to see a swift recovery in China's property sector.

A number of base metal markets also appear to be more comfortable in terms of supply, at least in the prompt market. This is evident with the cash/3M spreads for aluminium, copper and zinc having all weakened recently and trading in contango. In addition, these three metals have seen inventory levels in LME warehouses growing over at least the last month.

Black Sea grain disruptions & Indian food protectionism

It has now been more than a month since Russia decided to pull out of the Black Sea Grain Initiative, which allowed the safe passage of grains from three Ukrainian Black Sea

ports. Unsurprisingly, grain markets reacted strongly to the initial news. However, they have since given back all the gains made following the deal's collapse despite Russia attacking grain terminals along the Danube.

Ukrainian grain exports under the Black Sea deal were significant and helped both Ukrainian and global markets. However, in addition to exporting from Black Sea ports, Ukraine also increased export volumes from the Danube by rail and road. Therefore, even if we aren't seeing exports under the deal, Ukraine can still export to the world market, although admittedly with smaller volumes.

However, what has really provided comfort to grain markets, particularly corn, is that supply growth elsewhere should ensure that global markets are comfortable. Both the US and the EU are expected to see strong growth in corn supply over the 2023/24 season. This means that 2023/24 global ending corn stocks will still increase if we are to lose similar volumes of Ukrainian corn as exported under the grain deal last season. The global wheat market is more vulnerable to supply disruptions, but assuming no significant supply disruptions elsewhere, the market should be able to absorb potential Ukrainian losses.

While the reaction of grain markets to the end of the grain deal was short-lived, we are still seeing another round of food protectionist measures taken by some governments. This is most evident in India. Last year, the government banned wheat exports and more recently, it's also restricted some rice exports. There are also suggestions that the government could ban sugar exports over the 2023/24 season, whilst there are reports that the government could also scrap an import duty on wheat. Part of these domestic food security concerns are due to the impact that El Nino is having on the Indian monsoon this season. And the government may also feel it has to take action to ease food prices with an election next year. However, for global markets, these measures risk pushing some agricultural prices higher.

Rates: Why market rates remain under upward pressure

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Shouldn't market rates be falling by now? No, not yet and we'll tell you why they remain under upward pressure. Most of it reflects US resilience; that's reflected in the market discount to where rates get cut in the future, and that discount remains relatively tame. In fact, delivery of that discount justifies 10yr rates being higher versus now

The big driver of widening American and European spreads is US resilience

The rise in US market rates has been pulling eurozone ones higher

One of the most persistent trends in the past number of months has been the re-widening of spreads between US and eurozone market rates. We tend to look at the 10yr differential here, as it's well clear of a direct central bank influence. The Treasury – (German) Bund spread, the classic reference, is now back out to 165bp. It was below 100bp in April. A better reference is the Secured Overnight Financing Rate (SOFR) – (eurozone) ESTR spread, and that 10yr spread is now out to 100bp. It was around 25bp in April. The big driver of this has been US macro resilience, so much so that the upward pressure on US market rates has been strong enough to pull eurozone market rates up with them. So what now?

A limited rate cut discount limits the ability for eurozone market rates to fall

On the eurozone side, it seems that the European Central Bank is intent on remaining in a hiking mode even as activity gets hurt more, all in an effort to kill inflation. And European inflation has shown itself to be that bit stickier than its US counterpart. As a stand-alone impact, higher ECB rates heighten carry costs and place natural upward pressure on rates right out the curve. But there are also forces there that can cause longer-dated market rates to fall, namely the end of the rate hiking cycle, as longer rates would then begin to focus on where the ECB will be 18 months from now. That's far enough forward to have a reasonable feel. It is currently discounted at cumulative cuts of around 100bp. That's not a lot and provides little room for lower long tenor rates.

Delivery of the US rate cut discount rationalises higher longer tenor rates

In the US, there is a similar narrative in play. The size of discounted rate cuts is more - closer to 125bp - so not dramatically more. Again, that allows very little room for longer

tenor rates to fall. Currently, 1yr SOFR is 5.5%, and 10yr SOFR is just under 4%, for example. So if the 1yr SOFR rate were to fall by 125bp, it would bring it to 4.25%, and that's still higher than the current 10yr SOFR rate of just under 4%.

And remember, when we get to the end of the next rate-cutting cycle, we should have an upward-sloping curve, typically 50bp at minimum. Based on that, longer tenor rates need to be higher than they currently are, both in the US and in the eurozone. And. by the way, in the US, there is an elevated supply projection to get worried about too. It's one that rationalises higher rates and steeper curves with all other things being equal.

We continue to identify net upwards pressure on market rates

That all being said, when - or if - something really breaks in the US, there could be a radical re-pricing rate of cuts to come, pushing the discount towards much lower levels. That would be a game-changer, allowing longer tenor rates some run-way to move lower. But until - or if - that happens, the path of least resistance is for longer tenor (say the 10yr) rates to remain under upward pressure in the US and the eurozone and for curves to remain under dis-inversion (steepening) pressure.

So, to sum all that up, we remain bearish on bonds and anticipate further upward pressure on market rates from a tactical view.

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FX: Real rate convergence still on the cards

Stubborn resilience in US activity data and risk-off waves from China have translated into a strengthening of the dollar over the summer. We still think this won't last much longer and see Fed cuts from early 2024 paving the way for EUR:USD real rate convergence. Admittedly, downside risks to our EUR/USD bullish view have grown

The Fed's rate-hiking campaign has helped pump up the US dollar, but with the Fed on pause will the greenback start to falter?

Still awaiting the turn in US activity data

The underlying factors driving FX markets became "crystallised" over the summer, as investors waited in vain for a negative turn in US economic activity that would justify a dovish shift in both the Federal Reserve's rhetoric and market pricing. However, since forward-looking indicators and evidence from the job market have not shown enough reason to cast doubt on the resilience of the US economy, US yields have faced limited resistance once again. This has made it increasingly discouraging, particularly in real terms, to play the long bearish game through dollar shorts.

At present, the US dollar index finds itself at a critical juncture, trading close to 104 (a multi-month high), and is about to face a month where decisions made by the central banks of both the US and the eurozone will determine whether it can break through to the March peaks (105.60) and beyond. Our economists expect no further interest rate hikes by the Federal Reserve, and while it is a close call, we anticipate the European Central Bank to deliver one final 25bp raise in September. In other words, we have reason to believe that the dollar may have reached its peak around current levels.

Another reason for the dollar's resilience has been the influx of negative news from China. The dollar typically benefits from a deterioration in Chinese sentiment through two channels: directly through yuan depreciation (to which USD is highly correlated) and indirectly through the risk environment channel. It is conceivable that there could be a further deterioration in investor sentiment regarding China in the coming months. However, the People's Bank of China's determined defence of the renminbi means that the dollar may only gain indirectly from these developments.

Looking beyond the near term, monetary policy divergence is expected to remain the overwhelmingly predominant factor driving currency trends into the next year. Another way to consider this is through short-term real rates. For example, EUR/USD has closely followed its short-term real rate spread since 2020. If nominal rate fluctuations have been the primary force behind these real rate changes thus far, the end of tightening cycles may result in a period where the inflation rates, on the right side of the subtraction, gain more significance.

Our EUR:USD real rate forecast

Source: ING, Refinitiv

EUR/USD upside potential remains sizable

Our economics team remains of the view that markets are underestimating the downside risks facing the US economy and that the Fed will need to implement significant rate cuts from the first quarter of 2024. Despite a deteriorating outlook for the eurozone economy, we only expect the ECB to begin to ease policy in the summer of 2024. Based on that, we anticipate the EUR/USD two-year real rate gap narrowing to zero by the end of 2024, allowing the pair to comfortably trade above 1.15.

A broad-based dollar decline should translate into a recovery in the currencies hit most during the period of Fed tightening. We expect Scandinavian currencies to rebound from next quarter, although the Swedish krona's grim domestic outlook means the road should be bumpier compared to its Norwegian peer.

The Australian and New Zealand dollar need to wait for some recovery in Chinese sentiment before unlocking "recovery mode", while the pound remains tied to market expectations for Bank of England tightening that we still deem too hawkish. USD/JPY should remain the barometer of market sentiment on US yields: a turn lower is long due on the overbought pair, but may need to wait later this year given the Bank of Japan's lingering easing bias.

As for emerging market currencies, monetary stimulus will keep the renminbi soft and will also see Asian currencies lag in any rebound against the dollar later this year. Better positioned remain some currencies in the CEE space and Latam (eg Hungary, Brazil) where real rates remain deeply positive despite the start of easing cycles this year.

GDP forecasts

Developed Markets (QoQ% annualised growth)							
	2Q23F	3Q23F	4Q23F	1Q24F	2023F	2024F	2025F
US	2.1	3.3	0.6	-1.3	2.2	0.2	1.5
Japan	6.0	0.0	0.4	0.4	2.3	1.0	1.2
Germany	0.0	0.1	-1.7	-0.8	-0.3	-0.1	1.4
France	2.2	0.2	0.0	0.4	0.8	0.6	1.3
UK	0.8	1.1	0.5	0.3	0.5	0.6	1.2
Italy	-1.4	1.2	1.0	0.8	1.0	0.8	1.0
Canada	1.7	1.4	0.0	-0.8	1.8	0.2	1.8
Australia	1.5	1.0	0.7	0.6	1.5	1.6	2.9
Eurozone	1.1	0.6	0.2	0.1	0.6	0.6	1.4
Austria	-1.6	0.4	0.4	0.8	0.3	0.5	1.5
Spain	1.7	1.0	0.7	0.7	2.2	1.1	1.9
Netherlands	-1.3	0.2	0.6	0.6	0.2	0.7	1.5
Belgium	0.8	0.8	0.0	0.8	1.0	0.7	1.4
Greece	1.1	3.0	0.6	1.5	1.7	1.5	1.7
Portugal	0.0	0.8	0.8	1.0	2.3	1.0	2.0
Switzerland	0.8	0.4	0.4	0.8	0.8	0.8	1.4
Sweden	-3.3	-0.1	-1.4	0.4	-0.5	0.0	1.3
Norway	-0.2	0.6	1.1	1.7	1.3	1.3	1.7

Emerging Markets (YoY% growth)							
	2Q23F	3Q23F	4Q23F	1Q24F	2023F	2024F	2025F
Bulgaria	1.6	1.7	1.7	2.4	1.7	3.1	3.5
Croatia	2.7	3.7	3.6	2.9	3.2	2.7	2.7
Czech Republic	-0.6	0.3	1.2	2.0	0.1	2.2	2.2
Hungary	-2.4	-0.2	1.7	2.8	-0.5	3.4	3.8
Poland	-0.5	-0.2	2.5	2.1	0.4	2.5	3.5
Romania	1.1	1.4	1.3	2.1	1.5	3.7	3.5
Turkey	5.8	2.2	0.5	1.8	3.0	2.5	3.5
Serbia	1.7	3.0	2.9	3.8	2.1	3.0	3.7
Azerbaijan	0.6	3.2	3.4	4.0	1.9	2.5	2.7
Kazakhstan	5.5	5.0	4.5	3.5	5.0	3.8	4.0
Russia	4.9	3.0	2.0	3.0	2.0	1.0	1.0
Ukraine	15.0	3.5	3.5	-	5.9	5.5	-
China	4.7	4.1	3.1	4.2	4.5	4.2	5.5
India	7.8	7.2	6.6	3.2	6.9	6.5	7.5
Indonesia	5.2	5.1	5.3	5.1	5.2	5.0	5.0
Korea	0.9	0.8	1.4	1.5	1.0	1.9	2.4
Philippines	4.3	4.1	4.5	5.0	5.0	5.5	6.0
Singapore	0.5	1.8	2.4	3.3	1.3	2.9	3.0
Taiwan	2.0	3.8	3.9	3.2	0.8	2.8	2.5

[1]Norway: Forecasts are mainland GDP

Source: ING estimates

CPI Forecasts (pa)

%YoY	2Q23F	3Q23F	4Q23F	1Q24F	2023F	2024F	2025F
US	4.1	3.5	3.1	2.6	4.1	2.3	2.3
Japan	3.3	3.1	2.6	2.5	3.2	2.2	1.5
Germany	6.9	5.6	2.8	2.4	6.0	2.3	2.1
France	6.1	4.9	4.0	4.0	5.5	2.7	2.1
UK	8.4	6.9	5.0	4.2	7.6	2.7	1.9
Italy	7.8	5.8	2.5	2.5	6.4	2.1	2.1
Canada	3.5	3.8	3.6	3.2	4.0	2.2	2.1
Australia	6.0	5.1	4.5	4.0	5.6	3.4	2.7
Eurozone	6.9	3.5	2.9	2.6	5.3	2.5	2.0
Austria	8.6	5.5	3.8	3.0	7.1	2.4	2.0
Spain	3.1	2.8	3.5	3.6	3.6	2.7	2.1
Netherlands	6.3	2.8	1.2	3.2	4.3	2.1	1.6
Belgium	4.7	3.2	3.1	2.4	4.6	2.2	2.1
Greece	3.8	3.1	3.2	2.7	4.1	2.3	2.0
Portugal	4.4	3.0	2.9	2.8	4.6	2.3	2.1
Switzerland	2.1	1.6	1.8	2.0	2.2	2.0	1.8
Sweden	6.9	5.7	3.4	2.1	5.7	2.1	2
Norway	6.5	5.2	4.4	4	5.7	3	2.5
Bulgaria	10.8	9.6	8.9	7.1	9.9	4.7	4.9
Croatia	8.1	7.2	5.8	5.5	8.2	5.0	3.2
Czech Republic	11.2	8.1	8.4	2.7	11.0	2.4	2.0
Hungary	21.9	15.4	9.2	5.5	18.0	5.1	3.4
Poland	13.1	9.9	7.0	5.2	11.8	5.3	5.0
Romania	10.6	9.0	7.2	6.5	10.5	5.1	4.2
Turkey	38.2	54.5	63.1	57.3	51.5	50.8	31.6
Serbia	14.1	10.9	8.0	6.4	12.5	5.2	4.8
Azerbaijan	11.6	9.2	5.2	6.7	10.0	6.0	5.6
Kazakhstan	15.8	12.7	10.0	9.1	14.6	8.1	6.2
Russia	2.7	5.0	6.2	6.5	5.6	6.3	4.9
Ukraine	15.5	15.0	15.0	-	16.7	12.6	-
China	0.1	-0.1	0.9	1.3	0.5	1.7	1.8
India	4.6	6.3	4.2	4.5	5.3	4	5.0
Indonesia	3.9	3.8	3.6	3.8	4.2	3.5	3.6
Korea	3.2	2.6	2.7	1.9	3.3	1.8	2.1
Philippines	6.1	4.6	3.5	2.5	4.9	3.3	3.5
Singapore	5.2	4.3	3.9	3.3	4.9	3.1	2.8
Taiwan	2.0	1.9	1.6	1.5	2.1	1.5	2.0

*Quarterly forecasts are quarterly average; yearly forecasts are average over the year, HICP for Eurozone economies

Source: ING estimates

Oil and natural gas price forecasts (avg)

	3Q23F	4Q23F	1Q24F	2023F	2024F	2025F
$/bbl						
Brent	86.00	92.00	85.00	84.00	90.00	75.00
EUR/MWh						
Dutch TTF	32.00	50.00	60.00	43.00	52.00	50.00

Source: ING estimates

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