Research Institute – Interim Forecast Update

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#Global / #Monthly / #Forecast

From global recession to global divergence

Forecast Change

The US is still heading into recession; Europe should avoid a winter contraction but weaken later; China will grow strongly this year. The overall scenario risk distribution is improving.

Key takeaways

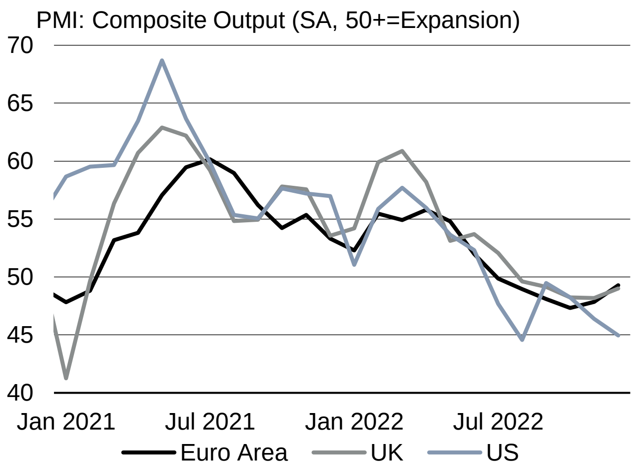
- We've updated our forecasts given the many moving parts in the macro environment. The outlook for the global economy remains weak, but divergence is a key theme. We still think the US is heading for recession, but the global risk distribution is improving.
- Market pricing of a US soft landing has risen, but we retain our recession baseline. The data deterioration is broadening as we expected. But we have revised up GDP a little, and think the probability of a soft landing is slightly higher. We expect just two more 25bp hikes in this cycle.
- We now think the Eurozone can come through its winter challenges stagnating rather than contracting. But persistently strong core inflation means we are revising higher the ECB path. Alongside spillovers from the US, this will lead to a recession later in 2023.
- The rapid spread of Covid through the Chinese population means the shift to endemic living can occur earlier. Our activity index is already improving, and our new forecasts envisage China as the fastest growing major economy in 2023. But Chinese re-opening won't be a tide that lifts all boats globally.
- Divergence remains the central theme within broader EMs. China re-opening "winners" include tourist destinations like Thailand and Malaysia. "Credible pivoters" where inflation has peaked – the likes of Brazil and Chile in LatAm, or Korea and Taiwan in Asia – will see rate cutting cycles get underway. But Emerging Europe is still dealing with exceptionally elevated inflation. And many frontier markets face significant macro imbalances.
- In Japan, despite the overshoot of inflation, underlying price pressures are weaker than elsewhere. Our baseline is still that the BoJ will fight a rearguard action to maintain YCC. But market pressure, partly of the BoJ's own making, means a high risk of letting the policy go.

US recession still baseline amid data weakness, but a narrow path to soft landing remains

Market pricing of a US soft landing has risen, but we retain our long-standing recession call. Admittedly, Q4 2022 GDP growth was solid at 2.9% annualised, but the details of the report were weaker. There are also broadening signs of weakness in the more timely data.

The composite PMI and ISM are in contraction territory (see Figure 1). Hard data show the housing sector in recession and manufacturing potentially joining it, while consumer spending declined at the end of 2022. A robust labour market continues to support income growth, but this is a lagging indicator. In any case, labour market overheating is precisely the imbalance that necessitates a recession.

Figure 1: PMIs paint picture of divergence



Source: Haver, abrdn, January 2023

Moderating core goods prices, reflecting global supply chain easing and the ongoing goods-to-services transition, is pushing down on inflation. Medical services prices are falling, however this is more a technical quirk than genuine deflation. Further out, falling house prices and rents suggest shelter inflation will moderate sharply next year. This might suggest a slightly smaller contraction is necessary to restore price stability.

We expect the Fed to shift to 25bps hiking increments, starting this week. We continue to forecast a 4.875% terminal rate, and then a cutting cycle beginning in H2, the size of which is still underestimated by market pricing.

Europe broadly flat over winter, but faces drag from tighter ECB policy and the US recession later this year

We now think the Eurozone can come through its winter challenges broadly stagnating. This is a meaningful upside relative to our earlier expectations of contraction. The large build-up of gas storage and the return of gas prices to pre-war levels have meant energy rationing will be avoided and consumer real incomes will be higher than otherwise. The high frequency data confirm this improvement, with the composite PMI back above 50.

But persistent core inflation means we have revised higher the ECB policy path. We think the deposit rate will rise from the current 2% to 3.25% come May (including a 50bps hike this week). Moreover, risks are to the upside given recent hawkish ECB rhetoric. Alongside negative spillovers from the US entering recession, tighter monetary policy should still mean a recession later in 2023. So although much better than they were, our Eurozone forecasts remain below consensus.

UK fundamentals remain weak

The UK probably narrowly avoided a technical recession at the end of last year, which, alongside a better European picture, led to upward revisions to our forecasts. But the fundamentals of the economy remain weak, with activity data deteriorating and the labour market overheating.

While headline inflation is now well past its peak, there is little evidence that underlying inflation is on a sustainable path back to target. This is likely to keep the Bank of England (BoE) tightening policy into Q2 this year, while we also now envisage the cutting cycle starting later.

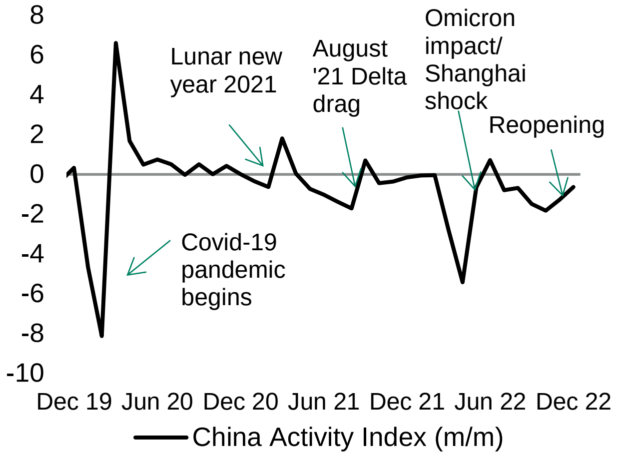
China to be fastest growing major economy this year

The very rapid spread of Covid through the Chinese population means the shift to endemic living can occur earlier than we had previously factored in.

While we are still operating in a Covid data vacuum, "anecdata" suggest 70-90% of the population in urban areas may now have acquired immunity. Subway traffic rebounded in January, showing many Chinese are comfortable "living with" the virus.

Indeed, our activity index is already improving, even if the flat growth reported for Q4 in the official GDP release doesn't look believable (see Figure 2). Our 2023 forecasts are above consensus, and the risks are to the upside. China will be the fastest growing major economy this year.

Figure 2: China activity index already recovering



Source: Haver, abrdn, January 2023

That said, we are still concerned about the multi-year rebalancing of the real estate sector. And we aren't as convinced as some about the pro-growth pivot in monetary and fiscal policy, given the need to contain imbalances.

International spillovers of Chinese re-opening will come through several channels, including tourism flows and commodities demand. But this is a double-edged sword, as stronger growth causes price pressures in an already capacity constrained global economy.

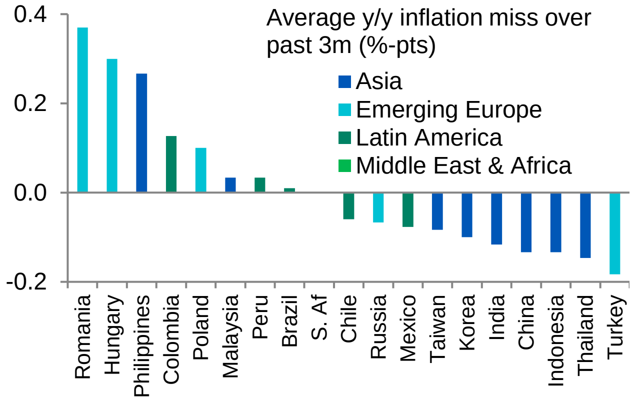
"Credible pivoters", China beneficiaries, or countries with ongoing challenges: EMs are split

Divergence is also the central theme within broader emerging markets (EMs). We've revised up growth in China re-opening winners, mainly Asian tourist destinations like Thailand and Malaysia.

We also identify several "credible pivoters" where inflation has peaked and is now surprising to the downside (see Figure 3), and rate cutting cycles will shortly get underway – these include Brazil and Chile in LatAm, or Korea and Taiwan in Asia.

Most of the emerging markets in Europe are still dealing with exceptionally elevated inflation. Labour markets in Poland and Hungary are far too tight to warrant the pause by the Polish central banks or the monetary loosening at the edges done by the Hungary central bank. And many frontier markets face significant macro imbalances.

Figure 3: EM inflation is surprising to the upside in Eastern Europe, but to the downside in Latin America and Asia



Source: Haver, abrdn, January 2023

In Japan, macro fundamentals don't justify a change in YCC, but market pressure may prove irresistible

Despite the current overshoot of inflation in Japan, underlying price dynamics are actually much weaker than elsewhere. Western core inflation is only 1.6%. This is low by global standards, but it is the fastest pace in Japan in four decades. And unlike most othe advanced economies, core services inflation is also still below the BoJ target.

Our baseline expectation is therefore that the Bank of Japan (BoJ) will fight a rearguard action to maintain yield curve control (YCC).

But intense market pressure, partly of the BoJ's own making, means a high risk that the YCC policy is abandoned this year. Much depends on the appointment of the new governor, expected on or before February 10th. Masayoshi Amamiyais is the continuity candidate, while Hiroshi Nakaso or Hirohide Yamaguchi are more likely to drop YCC.

Our latest global forecasts

	GDP (%)			CPI (%)		
	2022	**2023**	**2024**	**2022**	**2023**	**2024**
US	2.1 (1.9)	-0.1 (-0.6)	0.2 (-0.2)	8.0 (8.1)	3.5 (4.1)	1.9 (2.5)
UK	4.1 (4.3)	-1.3 (-1.7)	0.6 (0.5)	9.0	6.2 (5.9)	2.4
Japan	1.4 (1.7)	0.5 (0.7)	-0.7 (-0.6)	2.3	1.8	0.0
Eurozone	3.5 (3.1)	-0.4 (-1.4)	0.5 (1.0)	8.4 (8.6)	5.4 (5.7)	1.9 (2.3)
Brazil	3.0	-0.4	0.3 (0.0)	9.3 (9.2)	4.8 (4.7)	3.9 (3.7)
Russia	-2.5 (-2.7)	-1.5 (-1.8)	-0.3 (-0.4)	13.7 (14.0)	5.1 (5.9)	3.6 (4.1)
India	7.1 (7.9)	4.1 (3.1)	3.7	6.7 (6.8)	4.2	5.0
China	2.0 (1.9)	5.5 (2.6)	4.8 (5.4)	2.0	2.0 (1.2)	2.9 (2.2)
Global	3.0	2.0 (0.8)	2.0	8.8	6.3	4.1

	Policy Rate (%, year end)				
	2022	**2023**	Implied Rate	**2024**	Implied Rate
US	4.38	3.13	4.47	0.13	3.16
UK	3.75	2.50 (2.25)	4.21	0.10	3.55
Japan	-0.10	-0.10	0.13	-0.10	0.27
Eurozone	2.00	2.75 (1.75)	3.30	0.00	2.73
Brazil	13.75	11.00	13.12	4.50	12.50
Russia	7.50	7.50	8.35	7.50	7.62
India	6.15	4.50	6.01	4.00	5.68
China	2.00	1.80	2.37	1.70	2.76

Source: Bloomberg, Haver, aRI

Green text implies our forecast is more optimistic than consensus (growth higher than consensus, CPI lower), whilst red text implies forecast less optimistic than consensus. Where forecast changes have been made, the previous forecast is in brackets.

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