Quarterly Macro Report - 2nd Quarter 2022

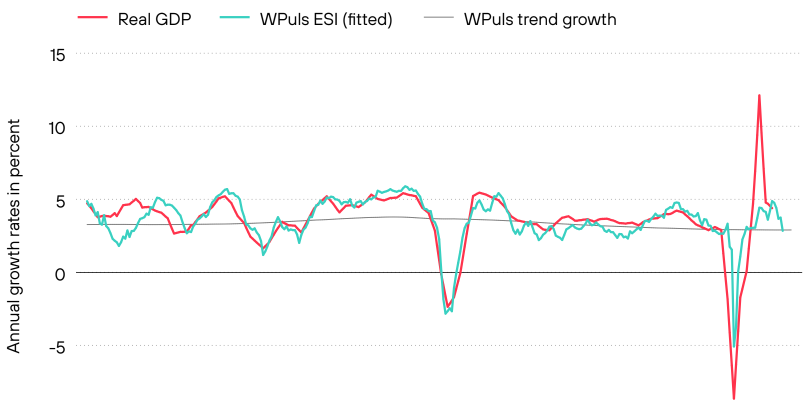
The economic outlook remains positive despite the ongoing war in Ukraine. Following the Omicron wave throughout the winter months, Europe has a lot of catching up to do, but has also a lot of exposure to the war now. The US have less pent-up demand but are also less affected by the conflict. However, high inflation is holding back economic development. With the Ukraine war causing additional inflationary dynamics, the medium-term outlook has deteriorated.

With regards to the economic recovery from the Corona-related slump, the US have always been one step ahead of Europe. After the end of the pandemic, Europe would have been in an ideal position to close the gap with the US. With the lifting of Covid restrictions in recent months, economic sentiment indicators in the service sector jumped throughout the euro zone as well as in the UK and Switzerland. The EU labor market is in good spirits with unemployment at 6.8 percent in February, standing already significantly lower than before the Corona pandemic (7.2 percent). The industrial sector was hopeful that supply chain problems were to ease over the coming months. After the stagnation of industrial production in the last year, the manufacturing industry was facing increasingly full order books.

However, the Ukraine war now represents a turning point in many respects. In the first months of the year, it can be expected that the pent-up demand during the pandemic will ensure robust economic development despite the war. Beyond this, however, uncertainty has increased noticeably. Yet, the direct impact of the war on global trade will be modest. Only 4 percent of European Union exports go to Russia and 1 percent to Ukraine.

More crucially, however, the war will give a further boost to the already high inflation rates via higher energy prices. We estimate that the increase in the price of oil since the beginning of the year will lead to inflation being one percentage point higher on average over the next twelve months in both the US and the eurozone. For the US, this means that inflation will not decrease from the

Fig. 1: World growth expected to be at trend levels in near future



Source: Refinitiv, WPuls

The ongoing war in Ukraine further adds to the already worrying inflationary dynamics. However, the big central banks are likely to implement policy decisions with velvet gloves in order to not choke economic activity. Hefty economic headwinds are currenty challenging China, partly caused by renewed strict lockdowns. At the same time the Chinese government is making significant concessions to the US to prevent further escalations in the trade conflict.

current level (7.9 percent) as quickly as assumed previously. In the eurozone, a possible easing from the record high inflation rate of 7.5 percent depends largely on whether the war will cause further price spikes in the energy markets.

Inflation slows economic development

High inflation rates cause a slow-down in economic development in the longer-term primarily via three channels. First, higher prices mean that households can afford less, reducing real consumer spending.

Second, companies` margins come under pressure unless they can pass on the full impact of higher purchase prices. Theoretically, it would be favorable for companies to increase borrowing, as corporate earnings are growing in line with inflation while interest on debt remains comparatively low. However, a look at the past shows that companies` investment decisions are hardly driven by credit conditions. More significant is the economic outlook, which is usually clouded in times of high inflation. Thus, high inflation and the associated uncertainty are negative for companies.

Third, high inflation rates force central banks to become more restrictive in their monetary policy stance. The European Central Bank (ECB) therefore announced at the beginning of March that it would accelerate the exit from its bond-buying program. The goal is to end bond purchases by the third quarter this year. Only then will the ECB consider possible interest rate hikes. Overall, the ECB is in a difficult position facing run-away inflation rates as well as a slowing economy in an uncertain environment. The US Federal Reserve is a step

> There is an increased risk that market participants will adjust their expectations, propelling inflation to take on a life of its own.

ahead and raised the federal funds rates by 25 basis points to 0.25-0.50 percent at its March meeting, with further rate hikes likely. Details on balance sheet reductions will be decided upon at the next meeting.

Fear of wage-price spiral

Already, inflation weighs on US consumers, pushing consumer sentiment to a new decade low. With the latest increases in European inflation rates, there, too, grows the risk that market participants will adjust their expectations, offsetting wage-price spirals.

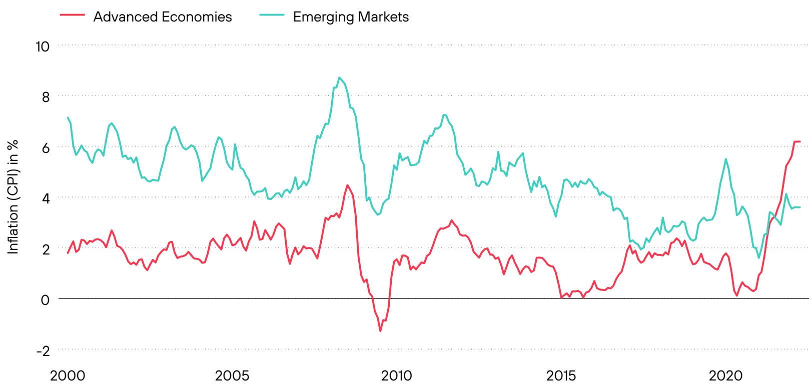
Table 1: Macroeconomic estimates (in %)

	GDP Growth			Inflation		Interest Rates	Money Growth M2
	Trend	2021	2022*F*	2021	2022*F*	Q1 2022	Q1 2022
USA	3.1	5.7	3.1	4.7	6.8	0.50	12.6
Eurozone	2.9	5.3	2.9	2.6	6.4	-0.50	9.1
UK	1.7	7.4	4.1	2.6	7.6	0.75	8.0
Switzerland	1.4	3.7	2.7	0.6	2.1	-0.75	3.8
Japan	1.0	1.7	2.6	-0.2	1.5	-0.10	6.4
China	4.5	8.1	5.4	-1.6	1.7	4.35	4.7
Brazil	1.1	4.6	1.5	8.3	7.9	11.75	1.5
India	5.0	8.1	10	5.1	5.5	4.00	10.3
Russia	–	-	-	6.7	–	20.00	15.8
World	2.9	5.0		4.4	6.5	-	7.0

Source: Refinitiv, WPuls

Fig. 2: Inflation rates in advanced economies outpace emerging markets

Average inflation rate advanced economies and emerging market economies

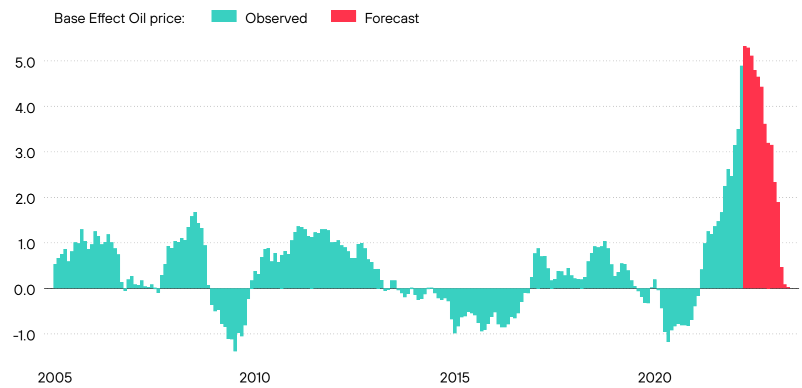


Source: Refinitiv, WPuls

In the past, inflation rates in emerging countries have been 2-4 percentage points above those for western nations, most of them struggeling to even maintain the self-imposed inflation target of 2 percent annually. Recently, this relationship inverted with advanced economies experiencing fast price accelerations. In March, US consumer price inflation stood at 7.9 percent, while its European pendant rose to 7.5 percent.

Fig. 3: Further price increases ahead

Contribution of oil price on inflation dynamics in the eurozone

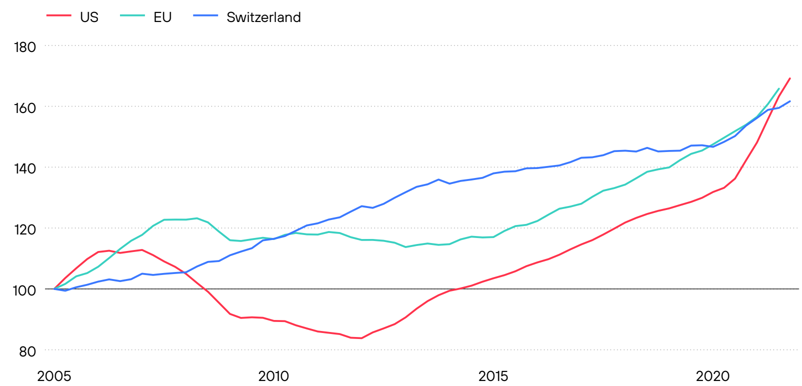


Source: Refinitiv, WPuls

In the eurozone, inflation rates have reached new all time highs. However, an easing is not in sight any time soon, given the importance of energy prices. The key question thus becomes, for how much longer price dynamics will remain that elevated. The longer inflation rates stay elevated, the higher the risk for inflations expectations becoming detached, triggering a wage-price spiral.

Fig. 4: Rising interest rates having little impact so far

Indexed housing prices (2005 = 100)



Source: Refinitiv, WPuls

High inflation rates are forcing central banks to adopt a more restrictive monetary policy. Multiple 0.5 percentage point interest rate hikes by the US Fed are becoming more realistic. A direct channel through which a rise in interest rates has a dampening effect on the economy is the real estate market. Rising interest rates (in the US from below 3% to 4.6% for 30-year mortgages) lead to lower demand for mortgages, thus to falling house prices and lower construction activity - albeit with some delay.

Foreign Exchange

The Russian invasion of Ukraine caused turmoil on the financial markets. Overall, a flight into safety was observed. Besides government bonds and gold, "safe haven currencies" such as the US-Dollar and the Swiss Franc were temporarily highly sought after. However, the market uproar passed almost as quickly as it arose. The US-Dollar managed to hold on to its gains. The Japanese Yen on the other hand – usually a favored currency in times of crisis – disappointed. This was at least partly caused by the reaffirmed commitment of the Japanese Central Bank to economic stimulus while most other large central banks are considering a tighter policy stance. Due to its geographical proximity to the Ukraine conflict the Euro suffered losses, too.

> So far Russia has been able to defend its currency, bringing it back to its February levels.

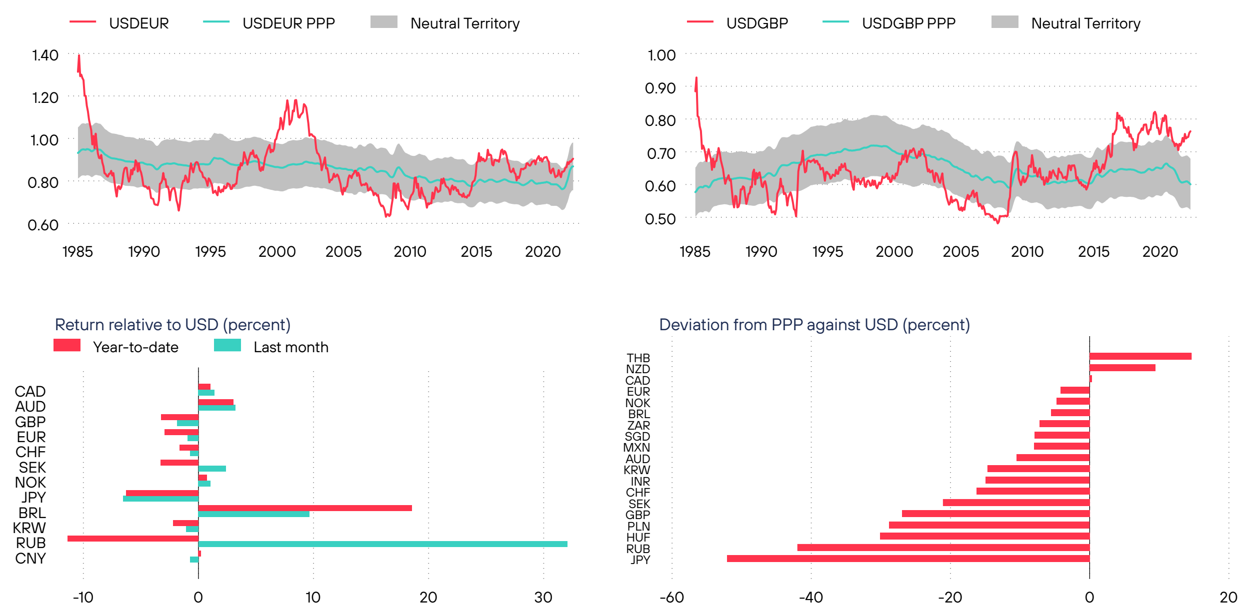
Russian Ruble collapsed and returned

Already struggling, the Ukraine war has become a nightmare for the Russian economy. With international sanctions against the country – amongst them the freezing of internationally held assets by the Russian Central Bank and preventing some Russian banks from accessing international payment systems – the Ruble lost half of its value and rose to over 130 against the US-Dollar. Russia responded promptly with the implementation of capital controls. These include the prevention of foreign investors from exiting their investments. At its March meeting the central bank affirmed its interest rate of 20 percent. Moreover, President Putin demanded all future gas payments by Europe to be executed in Ruble. Following this announcement, the Ruble retracted to its February levels.

Strong Brazilian Real

A side effect of the military conflict in Ukraine is additional pressure on global commodity markets. On the winning side of this dynamic is Brazil. The Real reached its strongest level since the outbreak of the Covid crisis, trading at 4.8 against the US-Dollar despite inflation exceeding 10 percent. An aggressive tightening policy by the central bank, the hope for a less hard impact of the war on the Brazilian economy as well as the elevated commodity prices have been supporting the currency.

Fig. 5: FX performance and valuations



Source: Refinitiv, WPuls

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