Quarterly Macro Report - 3rd Quarter 2022

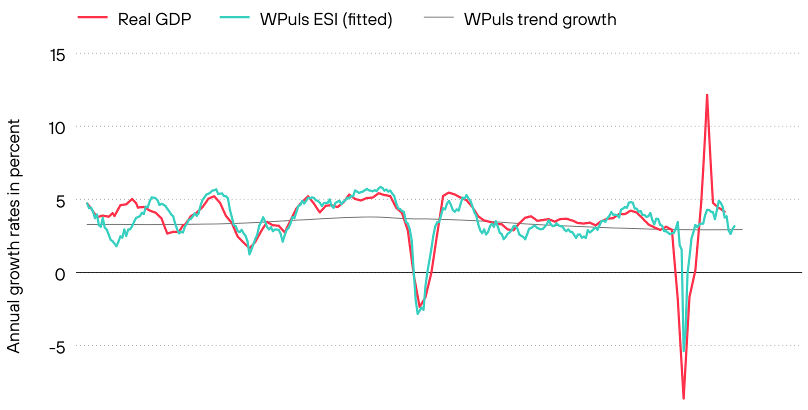
The macro-economic situation has deteriorated sharply in the second quarter of the year. High inflation has reduced consumers' purchasing power to such a degree that Western economies are now facing a serious risk of a recession. However, a slow-down in economic growth will make inflation less of an issue, thus reducing pressure on central banks to tighten monetary policy too aggressively.

The outlook for the world economy has deteriorated sharply over the last quarter. The main reason for that shift has been the relentless acceleration of worldwide inflation dynamics impacting consumer sentiment painfully. In mid 2022, US private household sentiment has fallen to the lowest level ever recorded in the 70-year history of the statistic. Likewise, surveys amongst European consumers regarding the economic outlook have fallen to levels that indicate an imminent recession. As inflation is draining purchasing power from consumers' pockets, the significant drop in asset prices most certainly has added to the unease of private households.

At the same time, optimism in the corporate sector has decreased only slightly between the first and the second quarter of the year. The main reasons for this are the well filled order books, robust profit margins as well as post-Covid catch-up effects especially in the service sector. Furthermore, most corporations were able to pass on higher costs to their end clients. However, this has broadened inflation dynamics beyond energy and food prices only. The core rate of consumer price inflation, excluding those two volatile product categories, has reached 6 percent in the US and close to 4 percent in Europe.

Central banks, who for a long time were reluctant to admit the non-temporary nature of inflation, have now started to adjust their interest rate policies. Unfortunately, their change of course might have come too late. Capital market rates have already increased significantly this year. The reference 10-year US government bond yield shot up from 1.50 percent at the beginning of the year

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.

to 3.50 percent in mid-June. At the same time, the US central bank (Fed) raised the Fed Funds Rate by only 1.25 percentage points. As a result, inflationary expectations have further increased and are now running at 5 percent for the coming year.

Even worse is the situation in Europe, with the European Central Bank turning a blind eye to inflation for the better part of the year. In addition to rising bond yields for better-quality debtors there was a significant widening of credit spreads for the fiscally weaker members of the Eurozone.

Grim outlook for the West, improved outlook for Asia

All of this does not bode well for economic growth in the Western world for the second half of the year. If corporations start to react to weaker final demand from consumers, a recession will be difficult to avoid in the advanced economies. In addition, credit conditions have deteriorated significantly. While this might not be much of an issue for cash-rich corporations that benefited from the easy monetary conditions in the past years, this could turn out to be a major obstacle for real estate construction. Hence, the uptrend in real estate prices and construction activity is likely to come to an end.

On a positive note, the recent developments in China seem to bode well for Asia. As the Chinese government has reduced Covid-lockdown measures, industry sentiment has increased significantly. Together with a renewed policy focus on supporting economic development, we can hope for an improved economic outlook throughout Asia in the coming quarters.

«A recession would break the back of inflation»

While this might keep commodity prices and thus one important source of inflation up, we feel that a recession in the advanced economies would be welcome to break the back of the recent uptrend in consumer price inflation. As such, this could provide much needed relieve for capital market rates and reduce the pressure on central banks to further increase money market rates.

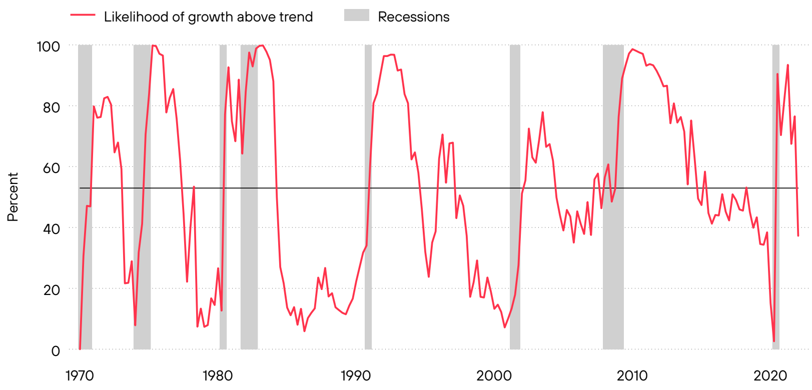
Table 1: Macroeconomic estimates (in %)

	GDP Growth			Inflation		Interest Rates	Money Growth
	Trend	2021	2022*F*	2021	2022*F*	Q2 2022	Q2 2022
USA	1.6	5.7	2.0	4.7	7.0	1.75	7.2
Eurozone	1.0	5.3	2.0	2.6	7.0	-0.50	8.1
UK	1.7	7.4	3.0	2.6	8.5	1.25	7.7
Switzerland	1.4	3.7	2.2	0.6	3.5	-0.25	3.3
Japan	1.1	1.7	1.5	-0.2	2.0	-0.10	5.5
China	4.5	8.1	4.0	-1.6	2.5	4.35	4.6
Brazil	1.2	4.6	0.0	8.3	10.0	13.25	0.8
India	5.0	8.3	6.5	5.1	7.0	4.90	12.2
Russia	–	-	-	6.7	–	9.50	4.3
World	2.9	6.1	2.5	4.7	7.0	-	5.6

Source: Refinitiv, WPuls

Fig. 2: Likelihood of above trend growth has fallen strongly

Probability for growth to remain above trend for the coming two years

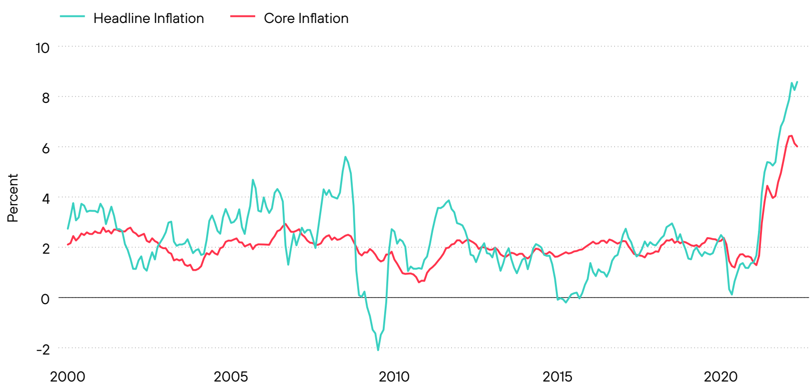


Source: Refinitiv, WPuls

Falling consumer confidence, higher interest rates and an almost inverted yield curve seem to suggest that growth over the coming two years will disappoint. It looks like the strong policy measures taken during the Covid-induced recession, while generating a strong recovery are now taking the toll on the business cycle.

Fig. 3: US inflation close to its peak?

US consumer price inflation

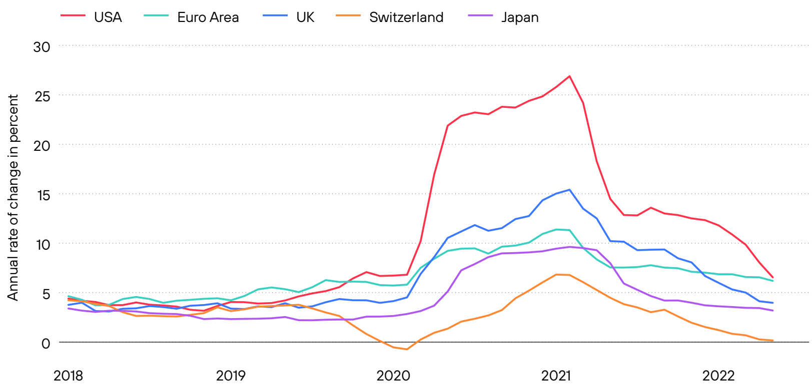


Source: Refinitiv, WPuls

On the back of strong demand for goods and rising energy prices inflation has moved above 8 percent. Core inflation, excluding food and energy prices, has climbed above 6 percent, although slightly receding over the last three months. This might be an indication that the worst of the inflation dynamics is over.

Fig. 4: Money supply is growing more slowly

M2 money supply growth



Source: Refinitiv, WPuls

Tighter monetary policy is now reality, when judged by the money circulating in the real economy. Across all major industrialized economies growth rates of M2 money supply are easing. Adjusting for inflation only Japan still displays positive growth. Shrinking real money supply however adds to recessionary fears in the Western world.

Foreign Exchange

The growing fears of a recession – reinforced by heavy-handed central bank action in Western countries to slow a broadening of the inflation dynamics – have also impacted currency markets. There was a broad flight to safety. Both the US Dollar and the Swiss Franc extended their gains. The Japanese Yen, on the other hand, experienced further losses, approaching its lowest levels in a quarter of a century. Similarly disappointing was the performance of the Pound Sterling over the past months.

At last, the ECB has come to admit that inflation is most likely not a temporary phenomenon.

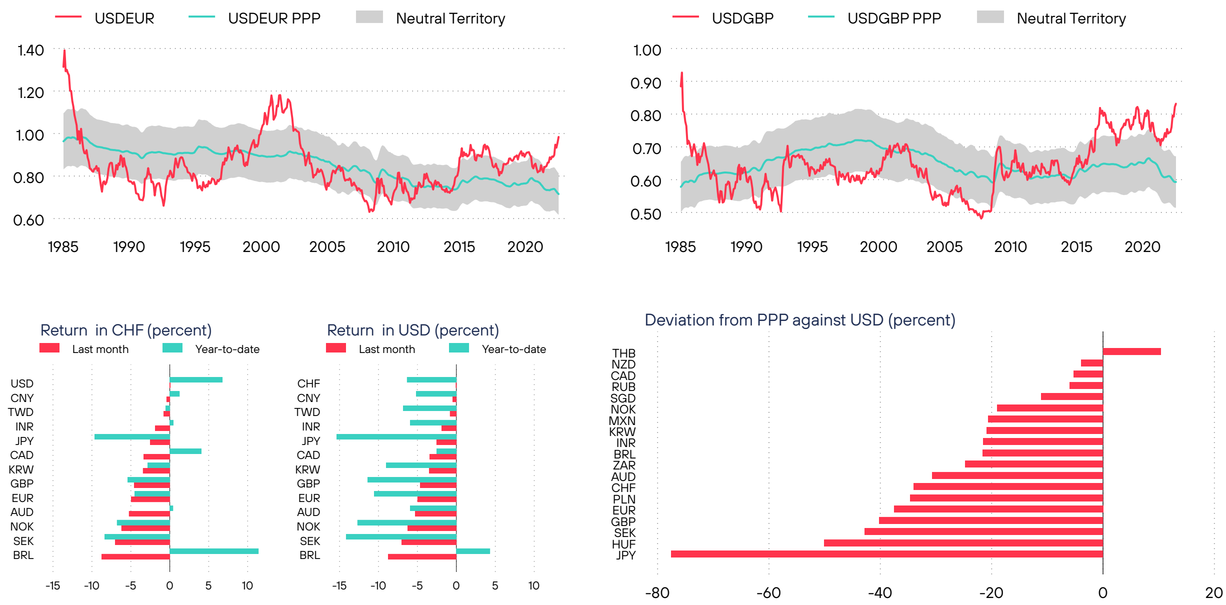
Euro nearing parity with the Dollar

The Euro area is struggling with high inflation, reaching 8.6 percent across the currency union in June. At last, the ECB has come to admit that inflation is most likely not a temporary phenomenon and is now aiming for a tighter monetary policy stance. Since the beginning of July, it stopped buying bonds and a first rate hike of 25 basis points is on the table. Two big challenges remain, however. First, the risk of a cut-off of Russian gas supplies has significantly increased the probability for an economic recession. Second, the widening spread of borrowing costs amongst the member states has forced the ECB to announce counteracting measures in form of a "anti-fracturing-program". Thus, unsurprisingly considering those challenges, the Euro has extended its losses in the second quarter, reaching its lowest level against the US Dollar in 20 years and hovering on the verge of hitting parity.

Japanese Yen extending losses

With most major central banks now tightening policy to combat inflation, the Bank of Japan is defending its commitment to its ultra-loose policy despite inflation reaching 2.5 percent in May. This includes a negative interest rate at -0.1 percent (unchanged since 2016) and the unlimited purchase of government bonds in order to maintain a yield cap of 0.25 percent on 10-year Japanese government bonds. This policy approach has pushed the Yen to its lowest level against the US Dollar in 24 years.

Fig. 5: FX performance and valuations



Source: Refinitiv, WPuls

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