Quarterly Macro Report – 4th Quarter 2022

Sharply higher interest rates are putting stress on financial markets. They are also adding to an increasingly difficult backdrop for the global economy. Stubbornly high inflation rates are eroding consumers' purchasing power in the industrialised world. High inflation also limits how much governments can do to prevent a recession.

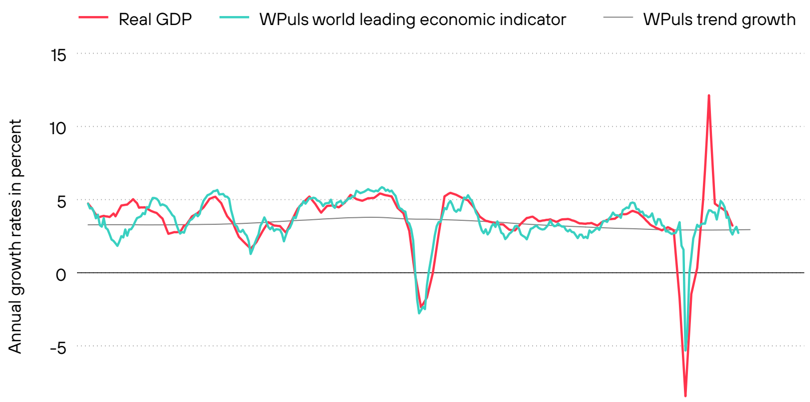
The backdrop for the world economy remains challenging, with high inflation, sharply higher interest rates and, in Europe, the prospect of energy shortages looming over the economy. Strong labour markets and high household savings rates have prevented a sharp slowdown in economic growth in most economies so far, however. In particular, the US economy proved to be quite resilient in recent months. US companies are also still reporting solid earnings and high margins as they can push higher input costs on to consumers.

Central banks fighting against inflation

The flipside of this relative resilience in economic growth has been persistently high inflation. Inflation rates remain at 40-year highs in the industrialised world. In both, the Eurozone and in the United Kingdom it has reached 10 per cent. While sharply higher energy prices remain a key driver of inflation in Europe, prices are now rising across many sectors of the economy. In the United States, inflation is likely to have peaked, as oil and gas prices are no longer climbing. However, as in Europe, inflation is broadening. Core inflation, excluding energy and food, is running at an annual rate of more than 6 per cent.

Central banks are reacting by aggressively raising interest rates. The most aggressive, the Federal Reserve, has hiked rates by 3 percentage points in just 6 months. Central bank interest rates are up 2 percentage points in the United Kingdom and 1.25 percentage points each in the Eurozone and in Switzerland. The Bank of Japan remains the only major central bank in the industrialised world to not raise interest rates.

Fig. 1: An increasingly difficult backdrop for the global economy



The global economy is facing big challenges in the months ahead. Inflation rates remain high despite aggressive tightening by central banks. The leading economic indicators paint an increasingly pessimistic outlook with the energy crisis weighing heavily on European economies.

Source: Refinitiv, WPuls

Monetary and fiscal policy in a bind

Leading indicators for the world economy are pointing to modest growth in the coming quarters and in 2023. Indicators are suggesting a recession is now very likely in the Eurozone and in Great Britain. For the US economy, models suggest a recession may be avoided, but growth to remain weak at rates below trend.

At the same time, overall inflation rates should have peaked in the US and in the Eurozone by year-end as oil prices have stopped rising. Underlying inflationary pressure are likely to remain elevated with rates above central bank target rates, however. Central banks will thus be reluctant to cut interest rates too soon.

As such, higher interest rates will continue to contribute to headwinds for the global economy in 2023, reining in investment and construction activities. High interest rates will also limit the scope of fiscal policy. As governments now face higher financing costs as well, they will not be able to support their economies as much as they did during the Covid-19 recession. Spending programmes risk to push up borrowing costs even higher, in particular in countries with high debt levels and weak fiscal positions.

China still in the doldrums

While the western world is fighting against inflation, the Chinese economy is trapped in difficulties of its own. As the world no longer binges on consumer products as it did during the pandemic years in 2020 and 2021, Chinese exports are slowing. Domestically, the fallout from the end of the real estate boom is depressing economic activity and consumer confidence. Real estate ownership has been the preferred option for Chinese investors in the past and much of the country's wealth is tied up in real estate. Finally, sporadic lockdowns to prevent the spread of the Coronavirus continue to weigh on the domestic economy. As a result, economic activity shows little sign of rebounding.

«Higher interest rates will continue to contribute to headwinds for the global economy in 2023.»

Looking further ahead, much will depend on how rapidly consumer and investor confidence returns after two difficult years for the Chinese economy.

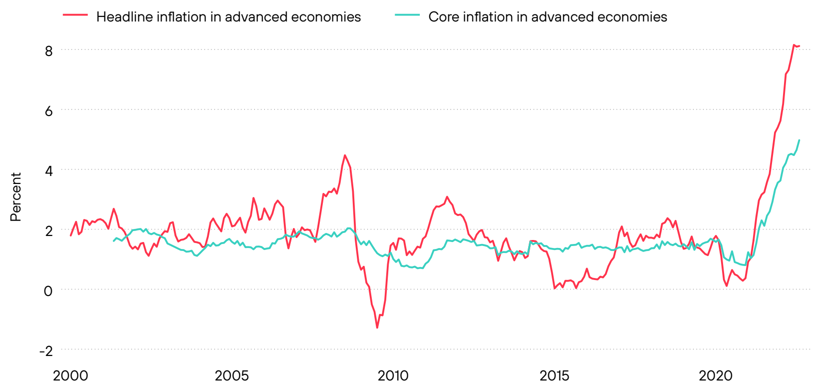
Table 1: Macroeconomic estimates (in %)

	GDP Growth			Inflation		Interest Rates	Money Growth
	Trend	2021	2022*F*	2021	2022*F*	Q3 2022	y/y 9/2022
USA	1.6	5.7	1.0	4.7	7.0	3.25	5.2
Eurozone	1.0	5.3	2.0	2.6	8.0	1.25	7.1
UK	1.7	7.4	2.5	2.6	9.0	2.25	7.6
Switzerland	1.4	3.7	2.2	0.6	2.5	0.5	2.1
Japan	1.1	1.7	1.5	-0.2	2.0	-0.10	5.5
China	4.5	8.1	3.5	-1.6	2.5	4.35	6.1
Brazil	1.2	4.6	0.0	8.3	11.0	13.75	–7.4
India	5.0	8.3	6.0	5.1	7.0	5.9	8.7
Russia	–	–	–	6.7	–	7.5	12.3
World	2.9	6.1	2.0	4.7	7.0	–	–

Source: Refinitiv, WPuls

Fig. 2: Inflation in advanced economies remains stubbornly high

Consumer price inflation in advanced economies

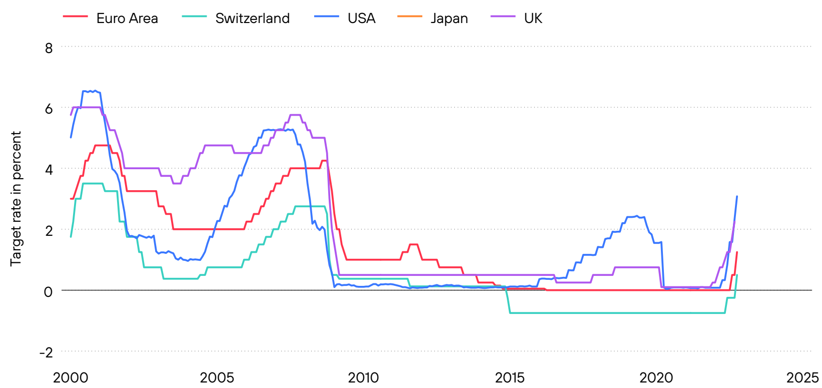


Source: Refinitiv, WPuls

Consumer price inflation rates are likely to have peaked in the US, but they keep going higher in Europe. While higher energy costs are still the key driver of inflation in Europe, more and more sectors of the economy are experiencing higher inflation. Core inflation, which excludes energy and fresh food prices, has been rising in all countries.

Fig. 3: Central banks in the US and in Europe are raising interest rates aggressively

Policy interest rates of the major central banks

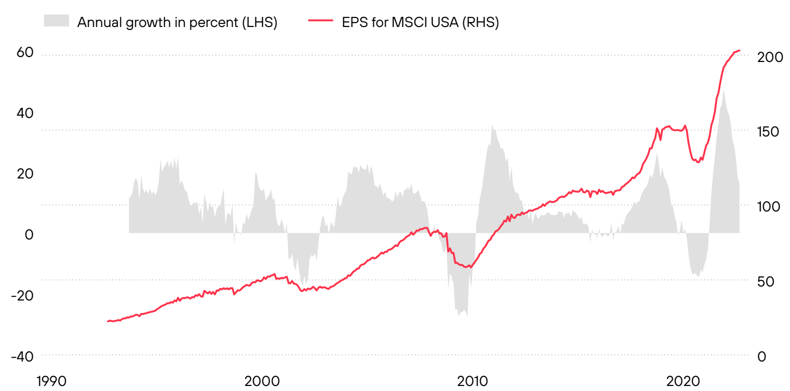


Source: Refinitiv, WPuls

Central banks in the industrialised economies were late to tighten monetary policy as they judged the inflation surge to be temporary. As inflation kept rising, they changed course. The US central bank is now pursuing its most aggressive tightening policy in decades, raising rates by 3 percentage points in the last 6 months. The European and Swiss central banks have increased their policy rates by 1.25 percentage points each so far.

Fig. 4: US company earnings are still growing

Earnings-per-share (EPS) of listed US companies



Source: Refinitiv, WPuls

Listed companies worldwide have been recording exceptionally strong growth in earnings in the aftermath of the outbreak of the Covid-19 pandemic. At the same time, they have also been able to grow their margins. This is coming to an end, however. Margins have started to fall and so has earnings growth as consumers' budgets are dented by high inflation and high energy costs.

Foreign Exchange

Financial market turmoil in combination with a darkening macroeconomic outlook have been impacting FX markets as well. Above all, the US Dollar continued to strengthen against practically all currencies with the Dollar Index reaching a new 20-year high. On the other hand, concerns about the European economy due to possible energy shortages and the ongoing energy price shock are weighing on the Euro, while the Swiss Franc still seems relatively immune. Temporarily, the EURCHF exchange rate fell to 0.95 and remains well below parity, which was only breached in July. Commodity currencies were also weaker last quarter, with the New Zealand Dollar leading the way.

«The US Dollar continues to strengthen.»

Turmoil for the British Pound

Great Britain is currently steering through turbulent waters. After the passing of Queen Elizabeth II and Liz Truss replacing Boris Johnson as prime minister, the announcement of a new, debt financed fiscal package to ease the burden of inflation triggered a steep sell-off in financial markets, sending the currency to a record low of 1.035 against the US dollar. However, market interventions by the Bank of England and a change of course on tax cuts by Truss allowed the currency to erase its losses.

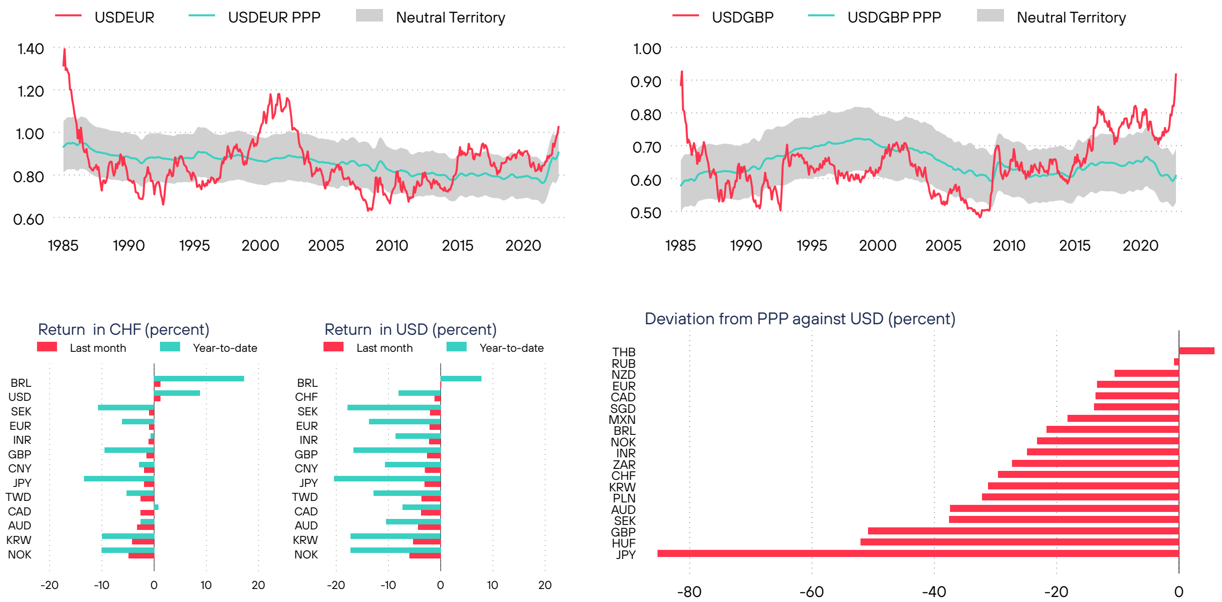
Strong Latinos, weak Asian currencies

No major currency has lost more value this year than the Japanese Yen. This trend continued in the last quarter, and the Yen lost a further 4 percent against the Swiss Franc and 6 percent against the US Dollar. In nominal terms, the exchange rate against the Swiss Franc is at a 40-year low. Recently, the Chinese Renminbi also succumbed to the Dollar strength, falling to its lowest level since 2008. Other East Asian currencies such as the Korean Won and the Taiwanese Dollar have also came under pressure.

The Brazilian Real and the Mexican Peso, on the other hand, have been able to keep up well with the US Dollar. The central banks of these two countries are among the most aggressive in terms of rate hikes. This should now benefit their currencies.

Fig. 5: FX performance and valuations

Based on WPuls purchasing power parity calculations (PPP), a measure for currency valuation



Source: Refinitiv, WPuls

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Published by: WPuls AG, Zürich
Conception: WPuls AG, Zürich
Editorial deadline: October 5, 2022