perpetual wealth

Quarterly Macro Report – 1st Quarter 2023

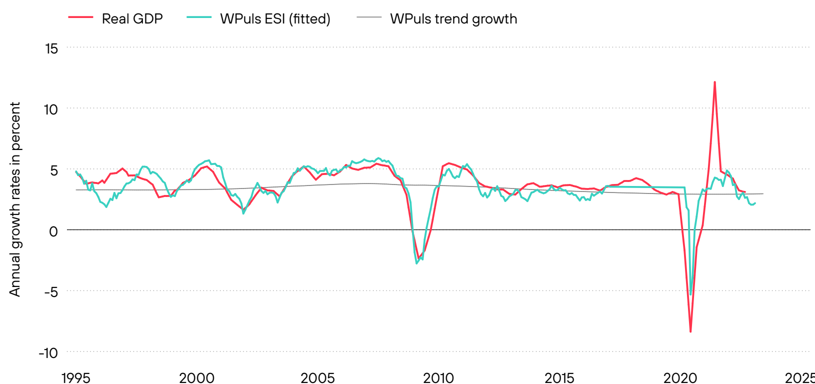
The world economy is currently undergoing a period of significant stress. Inflation, Covid in China and the war in Europe have conspired to lead growth into recessionary territory. Higher interest rates on the back of significant rises in core inflation will continue to be a challenge for the growth outlook and financial markets alike.

Inflation remains the biggest challenge for the global economy and global financial markets in 2023. After years of falling inflation rates, prices have started to rise due to the strong economic recovery in the wake of the Covid crisis. This can best be exemplified by a look at inflation rates on the eve of the war in Ukraine. Already before the violence started, inflation was high and on a clear upward trend. Excluding energy and food prices, US inflation ran above 6 percent at the beginning of 2022. In the Eurozone core inflation ran at 3, in the UK at 4.5, and in Switzerland at 1.5 percent. Consequently, the recent drop in oil and gas prices or an unexpected end to the violent atrocities in the Ukraine will not eliminate the root cause for our inflation issues.

Current inflation is mainly demand driven

Contrary to general perception, the rise in inflation was mainly caused by the significant stimulus of final demand during the Covid crisis and not by energy prices. During 2020 money supply was growing at double digit rates and fiscal deficits were recklessly increased to record breaking levels. The subsequent quick and strong recovery led most industrialized economies to operate well beyond sustainable capacity utilization levels. In particular, consumer demand for goods reached unprecedented levels. The US registered goods consumption was almost twenty percent higher than to be expected under normal circumstances. Delivery issues on raw materials and finished products were symptoms of that development and not the cause of the subsequent rise in inflation.

Fig. 1: Leading indicators signal global recession



Source: Refinitiv, Wellershoff & Partners

Economic sentiment has continued to decline. By now, consumers and corporates alike expect an economic contraction. It will be hard for the global economy to escape a substantial weakening of final demand in the first half of the year.

In order to curb this extraordinary demand, central banks realized that they had to step up their game only after the recovery post Covid was well under way. Historically, central banks needed interest rate levels above the core rate of inflation to fight inflation. Current core inflation stands at close to 6 percent in the US, 5 percent in the euro area, and 2 percent in Switzerland. With that we stand the chance of further rate hikes by the respective central banks. Given that yield curves are already inverted i.e., capital market rates are well below short-term borrowing rates, posing the risk of a further rise in capital market rates. This should then lead to slower construction activity, lower consumption and eventually to lower inflation. It is important to realize that for central banks a global recession is not the problem, but part of the solution to their challenge of containing inflation.

Corporates lose faith in growth

Corporations seem to slowly get to grips with this situation. Over the last quarter business sentiment has continued to deteriorate. In all of the major industrialized economies, both the manufacturing and the service sector are now expecting a contraction in economic activity. Consumer confidence is already at or close to historic lows. The combined economic sentiment has reached levels that are making a global recession very likely.

China in deep trouble

Moreover, the recent and much called for change in China's Covid policy has also taken a toll on demand in the developing economies. Chinese sentiment indicators have reached historically low levels. Large parts of the productive apparatus of the economy seem currently close to a standstill. Together with the usual negative effect on growth due to the New Year festivities, we must conclude that a quick recovery is unlikely. Consequently, China's economic development is likely to aggravate a highly probable global recession in the short term. However, as we have learned in recent years, a recovery after the first impact of Covid can be quite powerful and might come sooner than after normal recessionary episodes.

> «The outlook for the real economy has deteriorated further. »

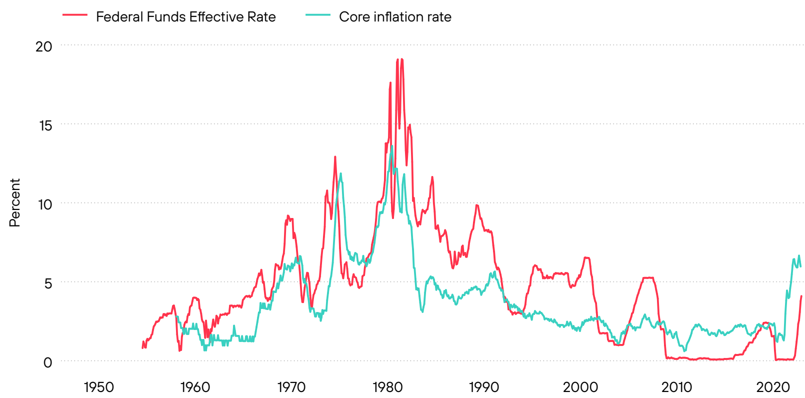
Table 1: Macroeconomic estimates (in %)

	GDP Growth			Inflation		Interest Rates	Money Growth M1
	Trend	2022*E*	2023*E*	2022*E*	2023*E*	Q1 2023	y/y 12/2022
USA	1.6	1.2	0.4	6.2	4.0	4.5	-1.8
Eurozone	1.0	2.2	0.2	8.4	5.0	2.0	2.6
UK	1.7	2.5	0.4	8.9	5.5	3.5	3.6
Switzerland	1.4	2.1	0.5	2.8	3.6	1.0	0.6
Japan	1.1	1.5	1.0	2.3	2.0	-0.1	5.0
China	4.5	3.2	3.8	2.0	2.2	4.35	4.6
Brazil	1.2	1.5	1.2	8.9	4.2	13.75	–4.1
India	5.0	6.5	6.0	6.9	5.0	6.25	10.1
Russia	1.0	-4.0	-4.0	14.0	10.0	7.5	20.1
World	2.9	3.0	1.8	7.0	5.0	–	–

Source: Refinitiv, Wellershoff & Partners

Fig. 2: Interest rates are still below core inflation

US core inflation and money market rates

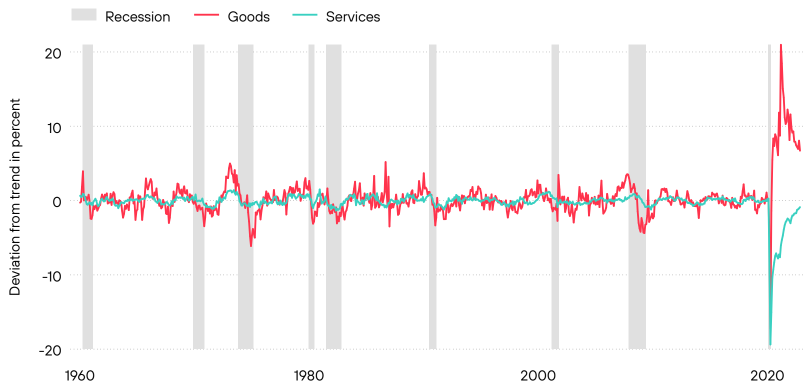


Historically, central banks have raised interest rates well above core inflation when they wanted to put a break on inflation. Only during recessions did they allow rates to fall to inflation levels. Currently, we see inflation still well above money market rates. This seems to suggest that central banks are not yet done raising rates if they are serious about bringing inflation back to their target levels.

Source: Refinitiv, Wellershoff & Partners

Fig. 3: Excess demand for goods is shrinking, but still exists

Deviation from trend of US consumer demand

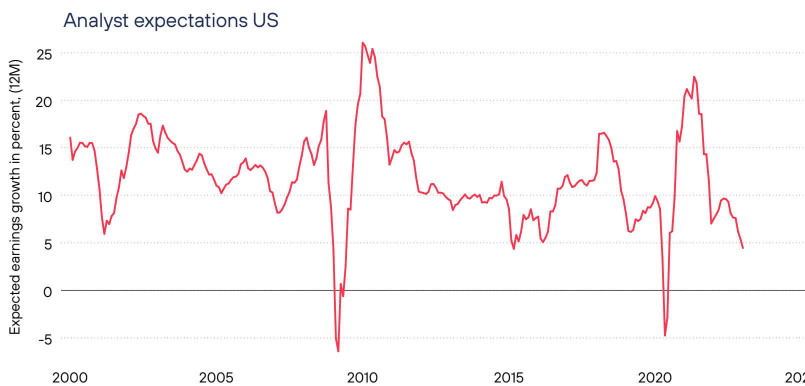


In normal times demand for consumer goods fluctuates in a relatively narrow band around trend levels over the business cycle. Covid has changed this completely. The demand shock that ultra loose monetary and fiscal policy generated was unprecedented. Excess demand for goods is currently subsiding, which is essential for inflation to fall. A recession would speed up this process.

Source: Refinitiv, Wellershoff & Partners

Fig. 4: US earnings expectations are coming down

Expected 12-month earnings growth for US equity



Equity analysts tend to be notorious optimists. In the recent past negative earnings growth was only forecasted after a recession had started. However, over the last couple of months analysts have become more cautious. Current expectations are as low as they can get without a recession.

Source: Refinitiv, Wellershoff & Partners

Foreign Exchange

With the US Dollar having bounced off its recent heights against other major currencies, the likelihood of a trend change in the external value of the greenback has increased. It seems that the Dollar peaked early in October against most major currencies. This comes after a very strong period of the American currency that led the Dollar index to a twenty year high.

«The US Dollar looks toppish.»

Still, the US Dollar remains strongly overvalued. From experience we know that these periods of misalignment can persist for an extended period. But any changes in momentum towards a return to more sustainable levels of currency strength have to be watched carefully. Biggest trading opportunities should be vis-à-vis the Yen, which has been the weakest currency of last year and is clearly undervalued. In addition, monetary policy is likely to be tightened as inflation is now far above bond yields.

Swiss Franc to appreciate further

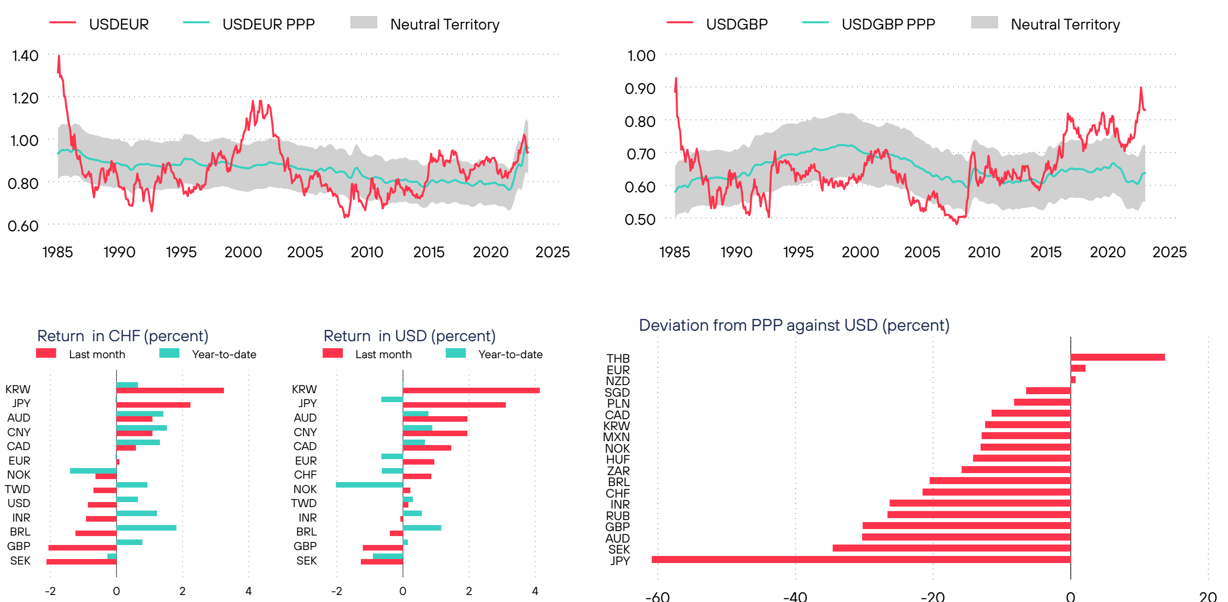
Next to the Yen the Swiss Franc seems to be prone to appreciate significantly over the coming quarters. This is due to the fact that Switzerland has seen much lower inflation than most other industrialized economies. In fact, the inflation differential for tradeable goods prices is running at close to 10 percent per annum, which leads to a rapid drop in purchasing power parity (PPP) values. In the past this has been a clear signal that the Swiss Franc will appreciate over the medium term.

China with competitive devaluation

One of the current measures of the Chinese government to stabilize the economy has been to devalue the Yuan. This has taken place on the one hand by containing inflation at much lower levels than abroad. On the other hand, the central bank has allowed the exchange rate against the USD to move upwards. As the Chinese authority have managed the external value of their currency very close to PPP, we expect that the Yuan will be allowed to appreciate strongly after the recession is over.

Fig. 5: FX performance and valuations

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



Source: Refinitiv, Wellershoff & Partners

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