Quarterly Macro Report – 2nd Quarter 2024

Several economic indicators suggest that the recession in the global industrial sector has bottomed out. However, this potential upturn could pose a significant challenge for the fight against inflation

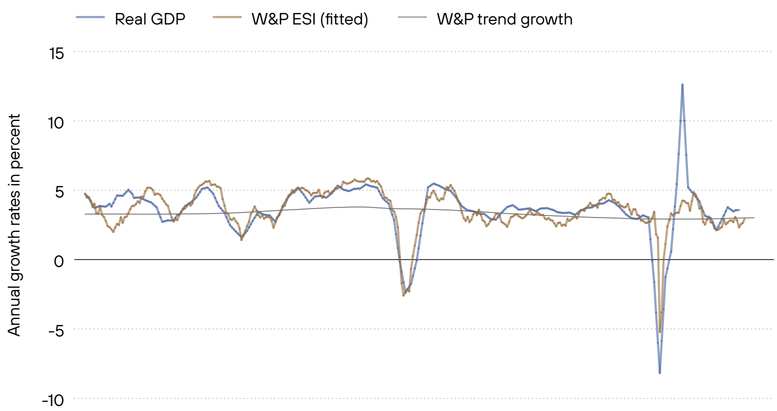
During the Covid crisis, opportunities for consumption were limited. As a result, many consumers felt compelled to invest in goods such as home office supplies or entertainment items, as activities such as going to the movies had been put on hold. This led to oversaturation, which resulted in a significant drop in demand for goods. Instead, consumer spending shifted significantly towards services. As demand for goods remained below the long-term trend level, the industry has fallen into recession worldwide.

The downturn in the goods cycle has led to instability in several industrial-focused economies. China, the world's largest exporter, is experiencing a recession that is being exacerbated by a severe real estate crisis. Germany, the world's second largest exporter of goods and Europe's largest economy, has been struggling with a decline in per capita income since 2022. In general, growth in the eurozone as a whole has not gained strength after the Covid crisis. The fourth quarter of 2023 was the sixth consecutive quarter in which the economy stagnated. Only the US economy was able to escape the downturn and even recorded significant growth in the second half of 2023, which was well above its trend.

Industrial sector bottoming out

However, a silver lining appeared on the horizon at the start of 2024. In January and, to a certain extent, in February, sentiment among industrial companies worldwide recovered noticeably. Although this does not yet justify talking about an upturn, since we observed a slight reversal in March and demand levels are still low, the industrial sector has probably bottomed out. This less pessimistic trend is in line with a stabilization of demand for goods in several economies.

Fig. 1: Global economy supported by stabilizing industrial sector



Source: LSEG, Wellershoff & Partners

The global economy continues to grow above trend, with the United States as the world's largest economy and key emerging markets such as India making a significant contribution. In addition, economic sentiment has improved in recent months, supported by a slight recovery in the global industrial sector.

The stabilization of demand is also reflected in the prices of goods, which have fallen only slightly according to industrial companies. Overall, the worst of the goods recession appears to be over.

"A stabilized global industrial sector could serve as a basis for the recovery of the ailing economies in Europe and China."

Impact on inflation

Nevertheless, this positive news for the global economy also has a downside. An economic upturn usually comes along with higher inflation in many economies. While the inflation trend is shaped by factors such as inflation expectations and income growth, the deviation from the trend is largely determined by the economic cycle. This regularity provides important insights.

First, with the strong economic momentum in the US, a further significant decline in inflation rates seems unlikely any time soon. In recent months, progress in the fight against inflation has slowed or failed to materialize completely. The core inflation rate only decreased from 4.0 to 3.8 percent between October 2023 and February 2024. This limits the scope for the American central bank (Fed) to make significant interest rate cuts.

Second, in the eurozone the position of the central bank (ECB) is more comfortable, meaning that the expectation of significant interest rate cuts are more plausible. In contrast to the situation in the US, the weak economic development in Europe has significantly slowed inflation in recent months. The core inflation rate in the eurozone fell from 4.2 to 3.1 percent between October 2023 and February 2024.

Third, after a prolonged phase of low and even negative inflation rates in China, consumer prices surprisingly rose by 0.7 percent in February 2024. Considering the relationship between inflation and economic growth, this turnaround can be interpreted as a sign of a gradual recovery of the Chinese economy. It is also an indication of a possible turning point in the global goods cycle.

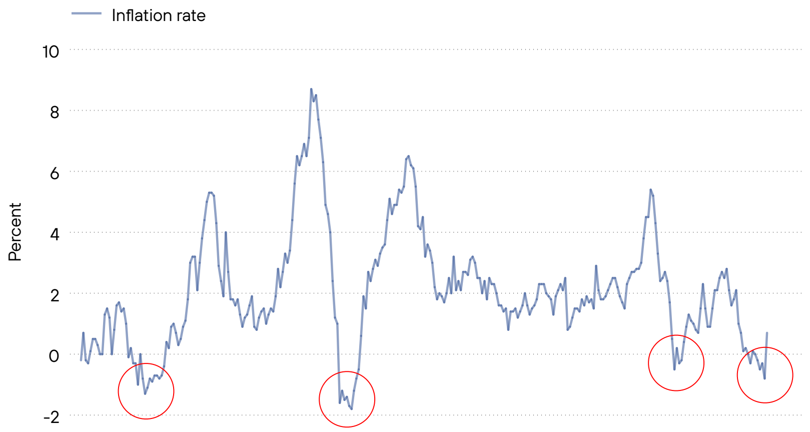
Table 1: Macroeconomic estimates (in %)

	GDP Growth			Inflation		Interest Rates	Money Growth M1
	Trend	2024*E*	2025*E*	2024*E*	2025*E*	Q2 2024	y/y 04/2024
USA	1.8	1.4	1.6	3.2	2.2	5.50	–7.3
Eurozone	1.1	0.6	1.4	3.0	2.4	4.00	–8.7
UK	1.7	0.6	1.5	3.8	3.0	5.25	–8.1
Switzerland	1.3	0.8	1.6	1.5	1.0	1.50	–16.7
Japan	1.1	1.0	1.2	2.0	1.5	0.00	3.9
China	4.5	4.3	4.5	0.8	1.5	4.35	1.2
Brazil	1.4	1.8	1.8	4.0	4.0	10.75	2.8
India	5.0	6.3	5.5	4.5	4.5	6.50	6.7
Russia	1.0	1.5	1.0	5.0	4.0	16.00	8.1
World	3.0	2.8	3.1	4.6	3.8	–	–

Source: LSEG, Wellershoff & Partners

Fig. 2: Chinese inflation as indicator for goods recessions

Inflation rate and goods recessions (red circles) in China

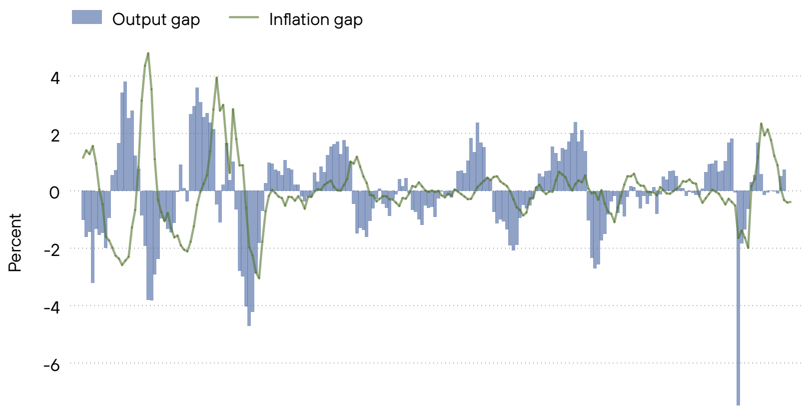


Source: LSEG, Wellershoff & Partners

In recent years, inflation in China has reliably reflected recessions in goods. The recent rise in inflation therefore points to a possible recovery of the Chinese economy. As China is the world's largest exporter of goods, a stabilization in the global industrial sector could support a more positive outlook.

Fig. 3: Economic activity and inflation dynamics in the United States

Output gap and inflation gap of the US economy

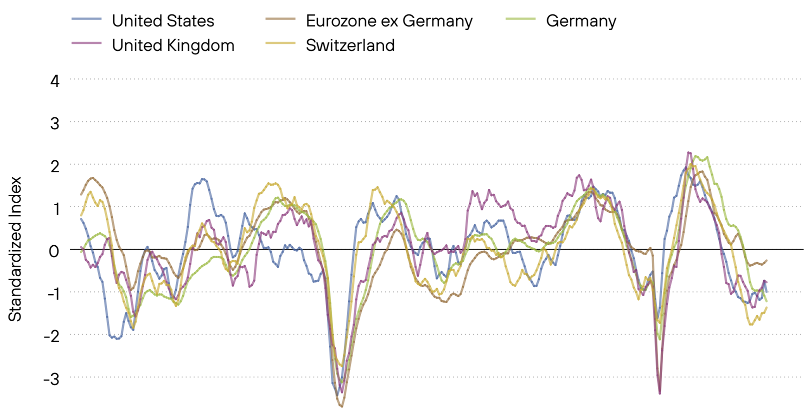


Source:Federal Reserve Bank of St. Louis, Wellershoff & Partners

The chart shows the strong correlation between economic momentum and inflationary pressure. The time lag of this relationship has shortened in recent years. Accordingly, the robust economic growth of the US economy in the second half of 2023 poses a significant challenge to price stability.

Fig. 4: Stabilization of the global industrial sector

Sentiment of industrial companies in developed economies



Source: LSEG, Wellershoff & Partners

While still at recessionary levels, industrial sentiment in most developed economies has stabilized since the beginning of the year. This gives reason for cautious optimism that the recession in Europe has bottomed out. However, it is important to note that an economic upturn is tipically followed by inflationary pressures, which puts the US and its fight against inflation in particular in a difficult position

Capital Market

Towards the end of last year, conditions were favorable for capital market investors. The prevailing mood on the financial markets with regard to inflation and future monetary conditions was very optimistic, which led to a significant fall in long-term interest rates.

> "Persistently high inflation is exerting pressure on long-term interest rates."

Since the beginning of the year, however, there has been a clear shift towards higher interest rates. The yield on 10-year government bonds in the US rose from 3.9 to 4.2 percent in the first quarter of 2024. A similar trend emerged in Europe, where the yield on 10-year government bonds in Germany rose by 30 basis points to 2.3 percent.

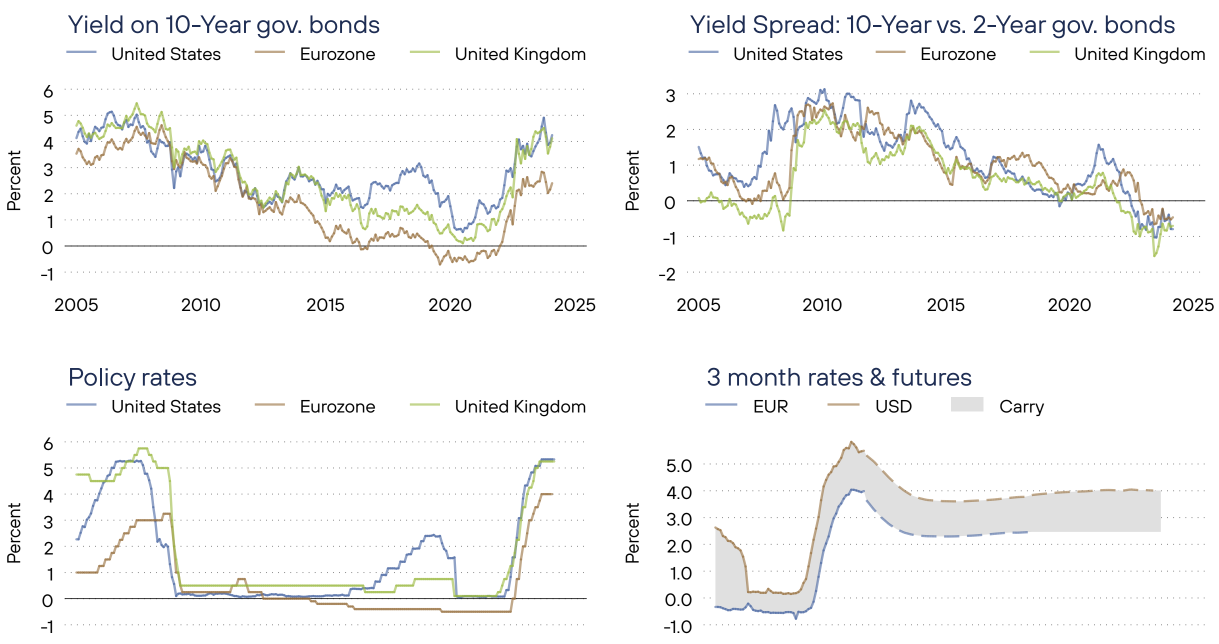
Adjustment of interest rate expectations

The increase in interest rates is primarily attributable to less progress in bringing inflation rates back into the target range. This is particularly evident in the US, where core inflation persists at an elevated level and prices of numerous goods and services continue to rise. While the fight against inflation in Europe has made more progress, the deceleration of inflation has slowed as well.

Disappointments in the fight against inflation have subsequently led to a shift in expectations regarding possible interest rate cuts by the central banks. At the end of last year, investors were expecting interest rate cuts of 150 basis points in both the USA and the eurozone. However, these expectations have since been halved. Given the continuing pressure for higher prices and the strongly inverted yield curve (where the long-term investment horizon is significantly less rewarding than the short-term), these expectations could be further dashed.

The recent interest rate adjustments have not had a significant impact on credit spreads, as risk premiums for corporate bonds remain remarkably low. In particular, risk premiums in Europe remain above those in the US, indicating the cautious economic climate in the region. However, it must be emphasized that the current level of risk premiums may not fully reflect the downturn in Europe.

Fig. 5: Money market and capital market interest rates



Source: LSEG, Wellershoff & Partners

Disclaimer

Imprint

Published by: Wellershoff & Partners Ltd., Zürich
Conception: Wellershoff & Partners Ltd., Zürich
Editorial Deadline: March 27, 2024