26 September 2022

Big Picture

Chilling prospects for the global economy

Key takeaways

- **Global economic momentum is weakening with the tightening of monetary policy and the escalating energy crisis in Europe. Strong labour markets provide a cushion.**
- **The German economy is highly likely to fall into a recession already this year, while the euro area also at risk.**
- **The US economy will see a near-term recovery, but tight financial conditions will increasingly weigh on the economy, leading to a mild recession in H1 2023.**
- **Thanks to policy stimulus and waning COVID-19 lockdowns, the Chinese economy will grow about slightly above 5% in 2023. The Japanese economy will likewise benefit from pent-up demand and loose monetary policy.**
- **Risks to growth are clearly tilted to the downside from higher than anticipated inflation and more abrupt and prolonged policy tightening, especially in Europe.**

Slowing global economic momentum

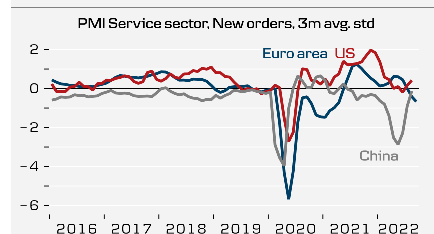
In our last global economic update from June *Big Picture: A (mild) recession in western economies seems unavoidable*, **we warned that the global economy was heading for a mild recession as major central banks would be tightening monetary policy to tackle decade high inflation**. Since then, the energy situation in Europe has taken a turn for the worse with Russia cutting off gas supplies, which has led to spiralling electricity and gas prices. At the same time, central banks have doubled down on fighting inflation, hiking policy rates at the fastest pace for decades as inflation has proved to be higher and more persistent than anticipated.

Amid these headwinds, the global economy is showing signs of weakness. Most notably this is seen in the global manufacturing sector, where demand is hit by shift in consumer demand toward services, fading impact of the fiscal stimulus (in the US) and the surge in inflation. While activity in the service sectors has held up better, notably in the US, the activity in the euro area is waning amid a large slump in real purchasing power and falling confidence amid surging energy and electricity prices. While the US economy witnessed negative GDP growth in H1 22, the labour market and private consumption indicators does not suggest that the US has fallen into a recession yet. Labour markets in both the US and Europe remain a bright spot with very low unemployment rates, providing a cushion to the economic headwinds. While the Chinese economy faced significant h eadwinds during the spring, it recovered swiftly over the summer following the lifting of the lockdowns, but the economic momentum has started to weaken again amid headwinds from the property crisis, continuing COVID breakouts and waning external demand.

Sharp slowdown in the global manufacturing sector...

Source: Macrobond Financials

...While the service sectors holding up slightly better



Source: Macrobond Financials

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Energy shock, high inflation and monetary tightening increase recession risks

We continue to expect a significant slowdown in global economic activity driven by swift policy tightening and declining purchasing power from high inflation. The risk of an economic backlash is most acute in the euro area, and notably Germany, following the sharp rise in gas and electricity prices, which has hurt consumer and corporate confidence and raising the risk of rationing of energy. As a result, we are now expecting the German economy to fall into a recession in H2 2022 and possible continuing into 2023. Given the energy shock is so intense across the euro area, there is also a significant risk of a recession for the euro area as a whole, although our base case is an economic stagnation.

While the energy crisis is much less acute in the US, inflation is still far too high relative to the Federal Reserve’s inflation target of 2%. This has already forced the Fed to implement the most rapid and aggressive tightening of policy in decades. We expect the Fed to continue the aggressive tightening pace in the last two meetings in 2023 and then keep financial conditions tight for a prolonged period. **Hence, while we think the US economy will do relatively well near-term, the policy tightening will increasingly weigh on US growth, and ultimately cause a recession.** While the timing and depth of a potential recession are very uncertain, we expect it to strike around Q2 23.

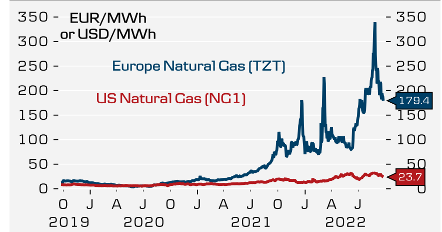
After the brief rebound in the Chinese economy, we expect growth to slow below potential in H2. While the muted inflation pressures enable China to support the economy through expansionary monetary and fiscal policies, China is battling with a property crisis and recurrent lockdowns due to outbreaks of Covid-19. **As a result, we expect the challenges to keep growth below trend in H2 and look for the economy to grow only 2.7% GDP in 2022**, clearly below our estimate of potential growth at 5-5.5%. **In 2023, we expect economic growth pick up more speed**, as we expect an easing of the zero COVID policies (releasing pent-up demand) and more policy stimulus outweighing stagnant external demand.

Inflation outlook—Upside risks in Europe

While US may have seen the peak in inflation, inflation pressures continue to grow in Europe amid the escalating energy crisis. As oil prices have fallen back together with other commodity prices and freight rates due to concerns about the outlook for the global economy, headline inflation in US fell back in August, although it did surprise to the upside. Most leading indicators point towards moderating inflation expectations. In addition, while shelter prices contribute positively to the CPI for now, housing market conditions have continued to cool and consumer goods inflation likely to decrease as companies have built up sizeable inventories. That said, the strong economic momentum and persistent labour shortages continue to push wages higher, creating sticky and broad-based upward pressure on consumer prices as well. **We expect US headline inflation to creep lower, while core inflation pressures will persist a bit longer, implying inflation will approach 2% at the end of 2023**.

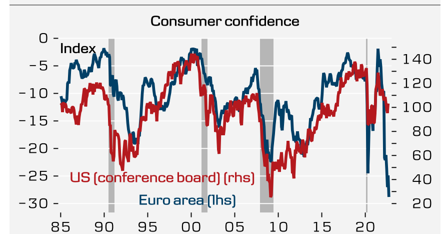
In contrast, Europe is likely to see further increases in inflation given the surge in gas and electricity prices. In August, headline inflation reached an all-time high of 9.1%. Food prices remain on a steep uptrend and although energy price inflation moderated slightly, we think it is 'calm before the storm', with significant increases for gas and electricity prices still looming in coming months. Weaker demand does not yet seem to be an issue for firms' pricing decisions, as both goods and services inflation accelerated further. Inflation expectations ticked up with the latest energy price surge, leaving ECB to highlight the risk

The energy/gas shock is much bigger in Europe



Source: Macrobond Financials

Consumer confidence in the euro area plummeting



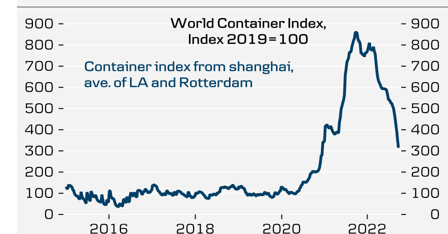
Source: Macrobond Financials

Our base case scenario for GDP growth

	2022	2023
	y/y, %	
Euro Area	2,8%	0,3%
China	2,8%	5,7%
US	1,6%	-0,2%
Japan	1.3%	1.5%

Source: Danske Bank

Freigh rates are declining rapidly



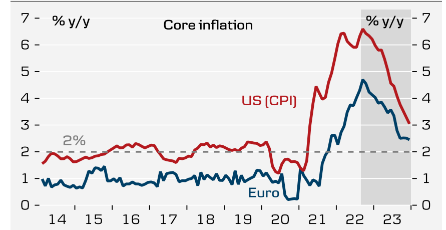
Source: Macrobond Financials

of de-anchoring. Looking forward, we expect inflation to rise further in the euro area but decline during 2023 as recession looms.

In China and Japan, inflation pressures remain much more muted. In China, CPI moved down to 2.5% y/y in August from 2.7% in July. The muted inflation pressures provide room for the Chinese authorities to support the ailing economy. In Japan, while headline inflation increased to 3.0% in August, the core measure (excluding food and energy) only increased from 0.4% to 0.7% while service inflation remains at 0.2%.

While our forecast foresees a decline in both euro area and US inflation, the risks to inflation are tilted to the upside, notably in Europe. One of these upside risks comes from labour markets as they remain very tight, and with signs that labour unions are pushing for higher wages to compensate for the surge in inflation. Furthermore, politicians are also stepping in to support wage earners on both sides of the Atlantic. The Biden administration pushed for a wage settlement with rail workers, involving a large pay increase, while several governments in Europe have raised minimum wages after European Parliament in mid-September approved a new law on setting minimum wages in Europe. This increases the chance of second round effects, which can prolong the inflation pressures. At the same time in Europe, governments are drawing up comprehensive aid packages to business and households to help fend off higher utility prices, but to the extent they increase the budget deficits, they risk prolonging inflation pressures.

Core CPI inflation peaking soon and set to head lower in 2023

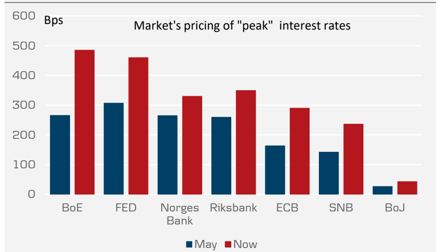


Source: Macrobond Financial, Bloomberg

Monetary policy—more aggressive tightening by Western central banks

Over the past months, major central banks have upped the pace of monetary policy tightening in response to the surge in inflation. The Fed has led major central banks, hiking by an extraordinary 75 bps at the June, July and September meetings. With inflation pressures still way too high compared to the Fed's target and Chairman Powell clearly stating a preference of reducing inflation even if it comes with the price of a recession, we have upped our expectations to the last two meetings in 2022. We now expect two more 75bps hikes in November and December. We then expect the hiking cycle to be done, but anticipate that financial conditions will remain tight for the foreseeable future. While the ECB began their hiking cycle in July, they have generally hiked more than anticipated (50bps hike in July and 75bps in September). Given the surge in inflation and risks of inflation getting entrenched, we have increased our expectations of the ECB hiking cycle, anticipating another 75 bps hike in October, followed by two 50bps hikes in December and February, implying a peak in rates of almost 2.5%, slightly below current market pricing of "peak" interest rate.

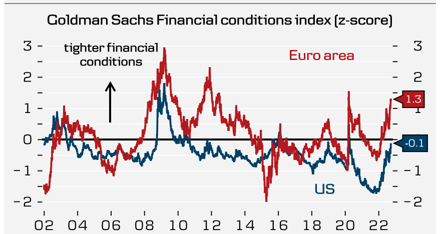
Markets expecting materially higher "peak" interest rates now



Source: Macrobond Financials and Bloomberg

In contrast, the two big Asian central banks, the Bank of Japan and Peoples Bank of China, are pursuing much easier monetary policy given more subdued inflation pressures and, in the case of China, flagging economic activity. The Bank of Japan reaffirmed its commitment to its yield curve control and also kept some of its COVID related support programmes in place at its September meeting. The widening interest rate differential with foreign interest rates have led to significant weakening of the Japanese Yen and to stem the decline the Japanese ministry of finance decided to undertake FX interventions on the back of the BOJ meeting. We expect PBOC to keep supporting the economy modestly for the remainder of 2022 and into 2023.

Financial conditions tightening

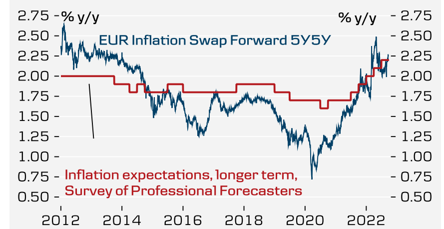


Source: Macrobond Financials

Risks are tilted to the downside: persistent, high inflation and monetary tightening well into 2023 (20%)

The risks to our growth forecasts are tilted to the downside. One of the most prominent risks is the persistently high inflation pressure; in part as gas and electricity prices remain high or increase further but also if inflations expectations and wage growth creep higher. Given the scale of the energy crisis after the cut-off of Russian gas, these risks are most pertinent in Europe. Should inflation pressures remain more elevated than we anticipate, it will also force central banks to continue hiking more and for longer, worsening the recession. Such a scenario would involve marked rises in government bond yields and sharp falls in equity markets. According to calculations using the global economic model, we find that G4 real GDP level (i.e. the weighted average of the US, euro area, Japan and China) would be almost 3pp lower by the end of 2024 than in our baseline. Another key downside risk in our view are continuing COVID-19 related lockdowns in the Chinese economy, which would prolong supply chain problems, as well as reduce global demand. A negative tail risk is Russia massively escalating the conflict in Ukraine, including the use of tactical nuclear weapons. We still consider Russia resorting to nuclear weapons an unlikely option as they must be aware it increases the likelihood of NATO's intervention, but still, the risk should not be ignored.

Inflation expectations on the rise, risking more prolonged inflation problems

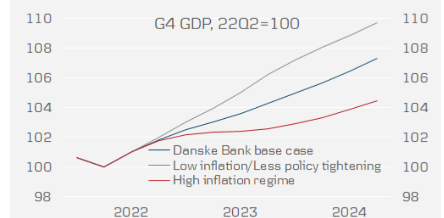


Note: Past performance is not a reliable indicator of future performance.
Source: Macrobond Financials

The 'good' scenario: global recovery as solutions found for Ukraine and corona crisis (10%)

In this scenario, the global economy stages an investment-driven recovery as a peaceful solution is found to the war in Ukraine (or fighting stops) and Covid-19 problems fade. Energy prices decline, particularly gas prices in Europe, reducing inflationary pressures. This boosts consumer confidence and, along with private savings, lifts consumption. Economic activity is also supported by softer central bank forward guidance as inflationary pressures ease. If inflation drops faster than anticipated, it would also warrant less policy tightening by the central banks. Easier financial conditions would support private investment and consumer purchasing power would also be higher. Altogether this means that G4 real GDP would be 2.5pp higher than in our baseline.

Inflation outlook critical for the global outlook



Source: Oxford Economics, Macrobond Financials and Danske Bank.

Country sections

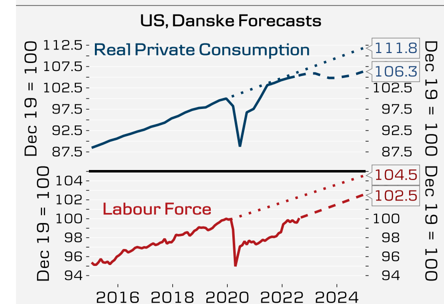
The US economy: Near-term strength makes way for a recession in 2023

While the near-term outlook for US economy remains moderately positive relative to the Europe, recession is still in the cards for H1 2023. Labour demand remains very high in historical perspective despite the looming recession fears and seemingly permanent shift lower in the trend path of labour supply growth. The consequent rapid rise in labour costs continues to create broad-based upward pressure on consumer prices.

Fed needs to see clear signs of demand indicators weakening and labour markets cooling before it can conclude, that underlying inflation pressures are moderating.

We expect Fed to hike by 75bp in both of the remaining meetings of 2022. Even after sufficiently tight level of financial conditions has been reached, it will likely take time for the economy to correct towards a new equilibrium. As we flagged in, *Research US - Fed continues to guide US economy towards a recession*, 1 September, pre-emptive 'pivot' would risk financial conditions easing too early, which could then lead to new waves of commodity-driven inflation.

Fed needs to force a modest recession to bring aggregate demand and supply back into equilibrium

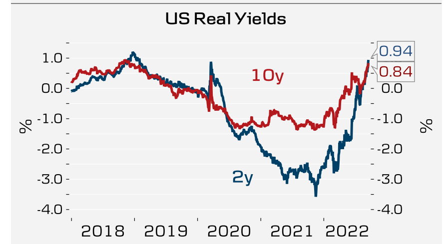


Sources: Macrobond Financial. U.S. Bureau of Labor Statistics (BLS), U. S. Bureau of Economic Analysis (BEA), Danske Bank

Fed cannot afford to risk high inflation becoming entrenched in higher inflation expectations, which remains a key risk in the current environment, where inflation expectations have remained stable and elevated despite the rapid rise in real yields seen over the past months. In y/y terms, headline CPI growth will moderate towards next year due to the negative energy base effects, but the underlying upward pressure on prices will persist unless Fed sticks with the aggressive tightening.

Overall, the recent rebound in real purchasing power points toward a modest recovery in GDP during the H2 of 2022. That being said, **Fed needs to force at least a modest recession in 2023 to ensure inflation comes down for good**. We see US GDP growth at 1.6% in 2022 and -0.2% in 2023. The ongoing tightening in financial conditions will be a significant drag on growth towards 2023, and the clear signs of cooling in housing markets, as well as the turn in order-inventory cycle are clear signs of an approaching recession.

Financial conditions have tightened, but Fed cannot afford to 'pivot' anytime soon



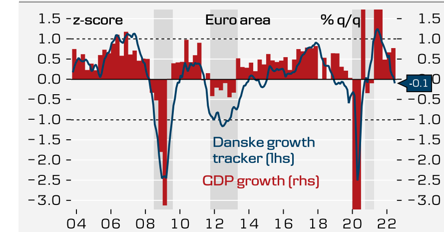
Sources: Macrobond Financial, Refinitiv

Note: Past performance is not a reliable indicator of current or future results

Euro area

Although euro area growth stayed surprisingly resilient in H1 22, recession risks have further intensified for the second half of the year. For a third month in row Europe's beleaguered manufacturers reported a steep drop in production in the August PMI survey. Weaker demand – notably from Asia – and efforts to reduce high inventory levels point to further downside risks to manufacturing activity ahead. Services activity remains more robust, but continued to ease notably during September, amid clear signs that high inflation has led consumers to cut back on non-essential services spending. The flipside of the weaker demand environment remains further evidence of easing supply bottlenecks and price pressures, with selling price expectations softening across sectors. Also, the post-pandemic employment recovery continued, although firms have overall become more reluctant to hire new staff in light of weakening order books. With the threat of energy rationing and outright production stops still looming large later this year if gas flows through North Stream 1 remain suspended during winter, the near-term outlook for the euro area economy remains challenging and we think a recession in H2 22 will be difficult to avoid.

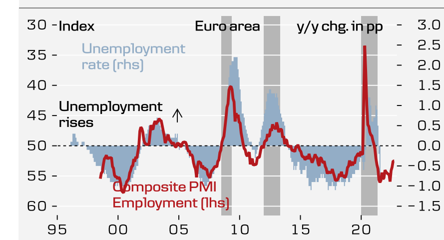
Our euro area growth tracker is negative



Source: Macrobond Financials

Rising recession risks amid stubbornly high inflation are a headache for Europe´s politicians and central bankers alike. For governments, the weakening economy risks drying up tax revenues just at a time when the bill for support measures is increasing by the day and investments in defence, energy security and the green transition have never been more pressing. For the ECB, the economic downturn is sharpening its policy dilemma ahead. Both euro area HICP and core inflation rose to new record highs in August and with the latest rise in energy commodity prices yet to feed through, we expect headline inflation to reach double digit rates in Q4 22. Given the surge in inflation and risks of inflation getting entrenched, we have increased our expectations of the ECB hiking cycle, anticipating another 75 bps hike in October, followed by two 50bps hikes in December and February, implying a peak in rates of almost 2.5%, slightly below current market pricing of "peak" interest rate.

Labour market remains strong



Source: Macrobond Financials

China: challenges continue in H2, moderate recovery in '23

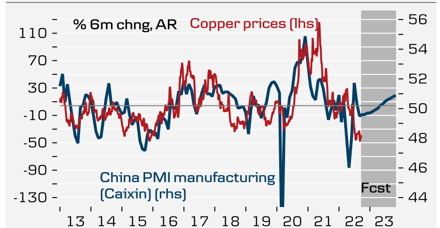
The Chinese economy continues to struggle with growth below-trend as China faces three strong headwinds. First, the zero-COVID policy keeps a big cloud of uncertainty over households and businesses as local lockdowns looms on a running basis. Second, the property crisis continues to roil the economy with both home sales and housing starts at depressed levels. The low consumer confidence and distrust of developers lowers home buyer appetite and funding for developers continues to be a challenge. Third, the Chinese export engine is losing steam after some strong years as consumer demand from the US and Europe is deteriorating. The growth impetus currently comes from state driven infrastructure projects and robust car sales lifted by stimulus measures.

Chinese housing crisis not better yet

Source: Macrobond Financial, NBS

Looking forward, we expect the challenges to keep growth below trend in H2 and look for the economy to grow only 2.7% GDP in 2022, clearly below our estimate of potential growth at 5-5.5% and also below consensus at 3.5%. In 2023, our baseline scenario is a moderate recovery to 5.7%, as we expect China to gradually ease the zero-COVID policy next year and unleash some pent up demand. More stimulus towards the housing market should also contribute to a recovery. The risks are mainly to the downside and could materialize if China sticks to the zero-COVID policy for longer, the property market fails to recover and/or the recession in US and Europe becomes deeper than we envisage.

PMI to remain low for some time – downside risk in the short term



Source: Macrobond Financial, Bloomberg, Danske Bank, Markit

Japan

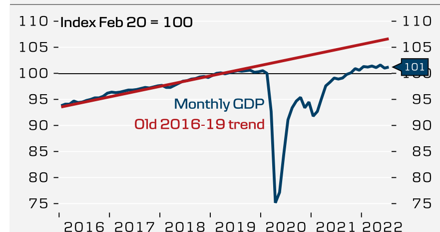
The Japanese economy still has not recovered from the pandemic and the 2019 VAT hike. Q2 private spending was 3.25% below 2019Q3 as particularly service spending is still struggling. There are no signs of a comeback in Q3, not least because the number of COVID infections continues to weigh on service spending as cautious consumers stay home. Service PMI declined below the 50 threshold in August. The outlook for private spending is highly dependent on how the pandemic evolves. Headline inflation has still only increased to 2.8% in Japan, largely driven by energy, but in a country that is not used to inflation, that constitutes a significant blow to purchasing power. We do not see a significant pickup in private spending ahead.

As supply issues gradually loosen up and demand once again becomes the limiting factor to production, Japanese exporters have a substantial competitive advantage as the yen has depreciated to its weakest levels in 24 years. That supports the economy.

UK

The UK economy continue to struggle with inflation far above the inflation target. Twelve-month CPI inflation fell slightly from 10.1% in July to 9.9% in August but is still too elevated and price increases are broad-based. Energy and food prices stand for approximately 50% of the headline inflation, which compares with 70% in the euro area. With inflation running too high, the pressure is on Bank of England to deliver further hikes, which means that households get squeezed on both ways.

GDP still well below previous trend



Source: Macrobond Financial, ONS

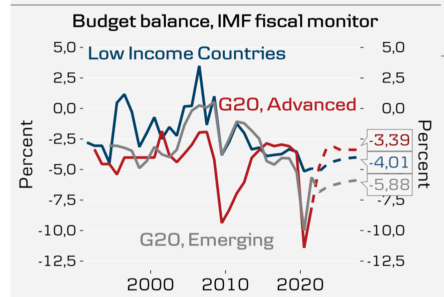
This is also reflected in record low consumer confidence. Retail sales has slumped and have decreased for four consecutive months giving a hint of negative household consumption in the third quarter. According to the monthly GDP figure, the UK economy grew by 0.2% in July, which was a bit weaker than expected. The drag on growth was driven by industrial production and construction, which decreased for the second consecutive month. Services continued to hold up despite inflation eroding the purchasing power, but we expect this will change over coming months and that private consumption will slow from here. Due to

Queen Elizabeth II's death, the UK imposed an additional national holiday which we know historically will weigh on the GDP number.

The Bank of England (BoE) received a lot of attention as the first G-10 central bank that predicted a recession for the economy. However, since then, the newly elected PM Liz Truss has announced an energy relief plan which will cap energy prices for households on current level but also means that households energy bills will 'only' increase by 27% compared to 80% that was expected before the price cap was announced. The price cap has a significant impact on the short-term inflation figures and BoE now sees the peak in CPI inflation to be just below 11% compared to the 13% projected in August. Although we expect fiscal stimulus to dampen the fall, it will not be enough to fully offset the erosion of real wage growth. In our view, the UK cannot avoid a recession if the US and the euro area fall into one.

During September, the Bank of England hiked the policy rate for the seventh time and the Bank Rate is now at 2.25%. We **expect that BoE will continue to tighten monetary policy with another 50bp in November and December and 25bp in February.** This is on the dovish side compared to current market pricing. In fact, after the mini budget was announced with the biggest tax cuts since 1972 a large sell off of government bonds was seen and the peak in rate path was lifted as high as 5.5% from earlier 4.6%. The fiscal package will probably increase households demand and hence increased the probability for both larger hikes and a prolonged hiking cycle than what we are pencilling in. But we for now keep our base case with a peak in the Bank Rate of 3.5%. The labour market is still very tight with high wage pressure, which is a big concern for BoE, although the latest labour market data showed some signs that the labour market is losing some of its momentum with higher inactivity and more people stepping out of the work force.

Emerging economies have less room to provide fiscal stimulus



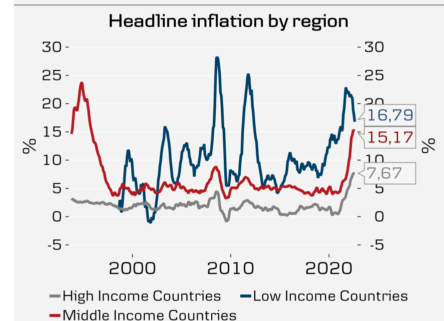
Source: Macrobond Financial, Danske Bank

Emerging markets

In the context of further tightening global financial conditions, stagnating world economy and a stronger dollar, emerging economies that were already being left behind in the global post-pandemic recovery story, will struggle to catch up. Headline inflation is even higher in low-income economies compared to high-income economies, as food and energy play a larger role in the consumption basket of low-income households. Same time, the room for local governments to support their ailing citizens amidst the global cost of living crisis is more limited in emerging economies, as their budget deficits and debt levels remain elevated after the pandemic.

Several emerging economies are already in an acute debt distress and more than 20 countries have sovereign bonds trading at distressed levels. FX shortages are becoming more acute as the burden on dollar-denominated debt servicing grows in the context of higher borrowing costs and stronger dollar. This dynamic is being exacerbated by further capital outflows and a weakening external environment that is weighing on exports, particularly for non-commodity exporters. More than 30 EM economies have used more than 90% of the FX reserves boost they received last year when the IMF made a new SDR allocation to its member countries. We expect more EM debt restructurings going forward while several economies will need further support from the IMF and from bilateral lenders in order to avoid them.

Low income countries suffer from higher inflation



Source: Macrobond Financial, Danske Bank

Disclosures

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