Global Monthly

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Will the energy squeeze threaten the recovery?

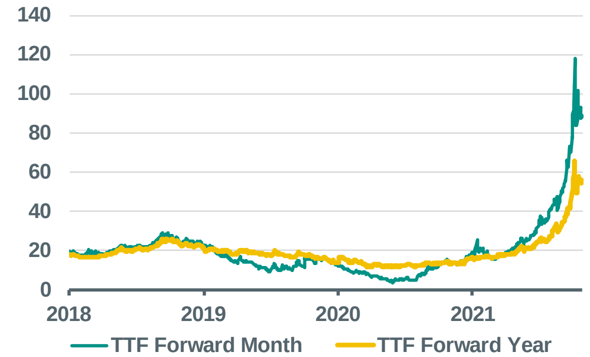
- **Soaring energy prices add fuel to fast-growing shortages that have already been inflationary**
- **Consumers face both direct costs from heating bills, and price hikes as producers try to pass on their cost increases. However, government support is cushioning the blow**
- **For producers, the risk of production outages is high in energy intensive sectors and in energy firms. Small firms are particularly vulnerable**
- **In an economy already facing shortages, these production stops can have large knock-on effects**
- **We expect inflation to continue rising over the coming months. For 2022, we foresee bottlenecks slowly easing, and disinflationary forces re-emerging in the medium term**
- **Regional updates: we dive below the surface of recent inflation developments in *the eurozone*, while in *the Netherlands*, consumption and production faces new headwinds from the gas price rise**
- **In *the US*, the delayed normalisation in consumption patterns means continued upside inflation risks**
- **Growth slowed significantly in *China* in Q3, but policy easing should support a pickup in Q4**

Global View: Will the energy squeeze threaten the recovery?

Supply chain bottlenecks have intensified further over the past month. Soaring energy prices are leaving consumers worried about upcoming energy bills as winter nears, while for firms, energy prices are yet another cost increase on top of already massive supply disruptions. Could this render business models unprofitable and cause widespread production outages? Or, if firms pass on price hikes to consumers, could it throw the post-pandemic recovery off track? In this month's Global View we assess the extent to which energy price increases will spread through the economy and affect consumption and production going forward. We also look at the cushioning effect of both excess savings and government support on people's ability to deal with these price rises. Our take is that while in the short run a demand fallback is likely to be limited, the risks are largely with the supply side of the economy, with more inflation ahead in the coming months which could amplify demand fallbacks over the course of 2022. While this poses downside risks to our economic outlook, we continue to expect above trend growth in the eurozone and the US over the coming quarters.

Gas price spike adds to bottlenecks…

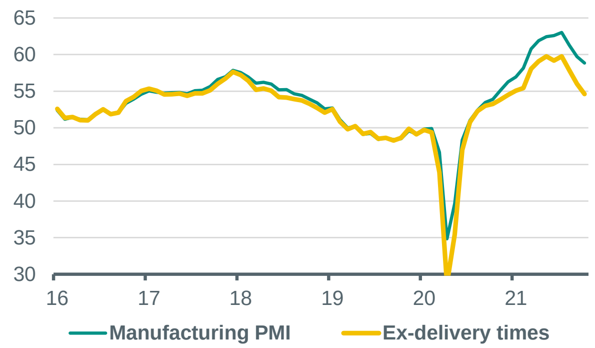
Netherlands gas price, EUR/MWh



Source: Bloomberg, ABN AMRO Group Economics

…that are already weighing on manufacturing

Manufacturing PMI, US & Eurozone average



Source: Refinitiv, ABN AMRO Group Economics

Where are energy prices going?

In big picture terms, we expect upward pressure on energy prices to persist through the winter months, but for prices to fall back by the end of next year – albeit to levels significantly higher than a year ago. For natural gas, the recent spike in prices was mostly in near-term contracts, with the month ahead contract in the Netherlands (TTF) briefly touching EUR 160/MWh, with it currently trading nearer to EUR 90/MWh. The price spike has come on the back of exceptionally low inventories heading into winter, and worries about whether supply would be sufficient in the event of a cold winter. Longer term contracts (one year ahead) are trading at much lower levels, suggesting the market is more relaxed about supply-demand dynamics in the medium term, though at EUR 55/MWh, prices are still around 4x where they were this time last year. Once the winter is behind us, we expect year-ahead prices to ease, falling back to EUR 30/MWh by end-2022 – still double where they were this time last year, and 50% higher than our previous forecast.

We expect a similar pattern in oil and electricity prices over the coming year. Oil demand is likely to continue increasing, although we expect supply to pick up as well via increased OPEC+ production. This should help dampen prices in the course of 2022, but our forecast of USD $70/barrel (Brent) at end-2022 is still almost double the level of this time last year. For electricity, prices are also elevated, due to shortfalls in renewables output and elevated prices of coal, gas, and carbon emissions permits (the EU ETS currently trades at around EUR 60/ton). Electricity prices at present are moving largely in line with gas prices, and there is a similar large difference between near-term contract price and the year ahead price. In tandem with gas, we expect electricity prices to ease once the winter is behind us, but to remain somewhat elevated given the high carbon price. See our latest Energy Outlook for more.

Oil and gas price forecasts

End of period		14-Oct	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Brent *	USD/bbl	*83.94*	80	85	80	75	70	64	65	65	65
WTI *	USD/bbl	*81.13*	76	82	77	72	67	61	61	62	62
Natural Gas (HH) *	USD/mmBtu	*5.70*	5.00	4.50	4.00	3.30	3.50	3.00	2.90	2.90	3.20
TTF *	EUR/MWh	*52.03*	50	40	35	30	30	25	25	23	22

Average		2020	Q4 21	2021	Q1 22	Q2 22	Q3 22	Q4 22	2022	Q1 23	Q2 23	Q3 23	2023
Brent	USD/bbl	43.21	79	72	83	83	78	73	79	67	65	65	66
WTI	USD/bbl	39.34	76	69	79	80	75	70	76	64	61	62	62
Natural Gas (HH)	USD/mmBtu	2.13	5.40	4.00	4.80	4.30	3.70	3.40	4.10	3.30	3.00	2.90	3.10
TTF	EUR/MWh	13.48	53	33	45	38	33	30	37	28	25	24	25

* Brent, WTI and Henry Hub: active month contract; TTF: next calendar year

Energy crunch comes on top of massive supply issues

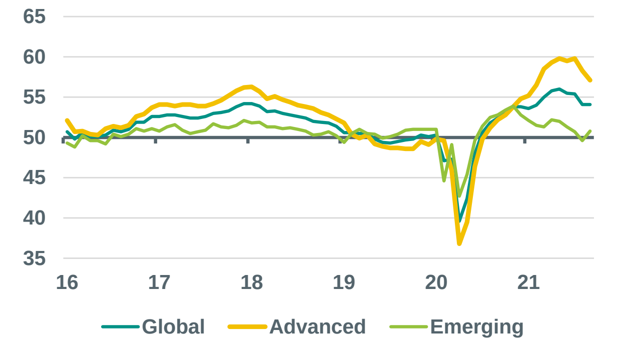
Alongside high energy prices, persistent supply bottlenecks are affecting a fast-increasing number of commodities and manufactured goods, while adding to inflationary pressures. The services sector is also being hampered, mainly by labour supply bottlenecks. While pandemic-related bottlenecks will ultimately ease as vaccination rates rise, economies fully reopen, and policy support is wound down, some bottlenecks are unlikely to ease soon. Disruption from climate change-driven extreme weather events, energy transition policies and shifting patterns of demand (linked to eg. home working) are likely to stay and in some cases intensify.

Weakened manufacturing growth from worsening shortages

Bottlenecks are putting an increasing constraint on global manufacturing. The global manufacturing PMI stabilised at a still relatively high level of 54.1 in September, around two points below the cyclical peak of 56.0 reached last May. This suggests further growth in global manufacturing is still on the cards, but momentum has fallen. The weakening momentum over the past months was initially driven by EMs (particularly China), but the aggregate index for DMs has also fallen with almost 3 points in the past few months, although remaining at a relatively high level (September: 57.1).

Weakening momentum in global manufacturing

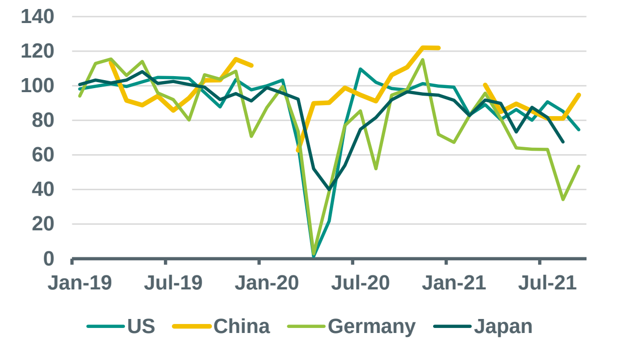
Indices, 50 = neutral mark



Source: Refinitiv, ABN AMRO Group Economics

Car production under pressure

Volume index, average 2019 = 100



Source: Refinitiv, ABN AMRO Group Economics

One shortage that has had a particularly widespread impact on manufacturing is in chips. The textbox below explains how numerous factors are contributing to the current shortages.

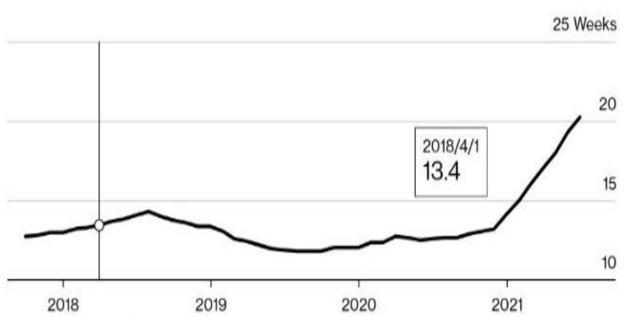
Chips shortage: Not just due to the pandemic

Lead times for semiconductors are reported to have risen to an average of 22 weeks in September, compared to an average of around 12 weeks in the pre-pandemic year of 2019. The semiconductor shortage has had a particularly marked effect on the car industry, with automakers across the globe implementing production stops.

For this sector, growth has not merely slowed, but we are seeing sharp contractions in output. That is particularly true for Germany, although production rebounded somewhat in September. Other high-tech sectors are also facing constraints from this. For instance, Apple just made public that it had to scale back its production of the new iPhone 13 by over 10% this year due to the lack of chips. The production technology of a silicon chip – called wafer fabrication – is currently at about 95 percent of global capacity, according to research by Resilinc, a commodity chain research company. A growing number of applications worldwide in combination with few global players able to produce chips created a vulnerable situation to begin with. On top of that, distortions such as the US-China trade war, Covid-19 infections and extreme weather events (such as a drought that led to long production stops in Taiwan, one of the largest production sites) lowered supply. At the same time, home working and the reopening of economies caused a massive boom in demand. Resulting shortages led to hoarding behavior and stockpiling which made matters worse. Electric vehicle production and car production in general are amongst the worst affected industries.

While reported lead times are still rising, there are also some indications that supply-demand conditions are becoming more balanced. For instance, the delivery times sub-index of the global electronic equipment PMI has bottomed out. Also, with vaccinations rates in Asia rising (although with quite some divergence) and mobility restrictions in countries crucial for semiconductor supply chains (e.g. Taiwan, Malaysia, Vietnam) being lifted again, pandemic-related supply disruptions will be much less likely in 2022 compared to 2020-21.
Another cushioning factor – at least in the longer run – is that policymakers in the US, Europe and Asia have taken measures to support domestic production capacity. For China, reducing foreign dependence on critical inputs such as semiconductors is a crucial aspect of its 'dual circulation' strategy. It will take time however before supply is substantially ramped up.

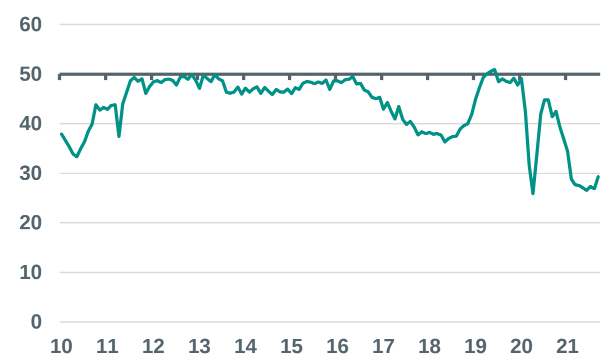
Semiconductor lead time



Source: Susquehanna Financial Group

Delivery times in electronics bottoming out

Global PMI electronics equipment, delivery times

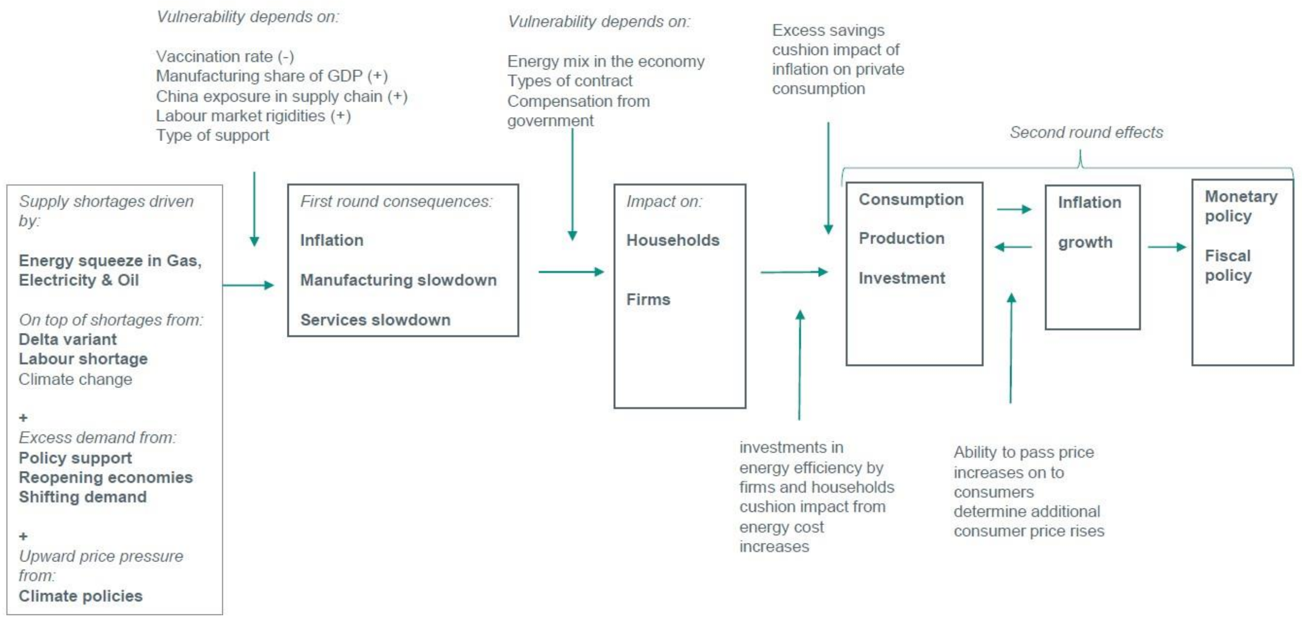


Source: Refinitiv, ABN AMRO Group Economics

Impact on growth

The shortages described above impact inflation and growth through various channels. The scheme below shows the main channels through which the current shortages work their way through the economy.

Simplified scheme of shortages affecting economy

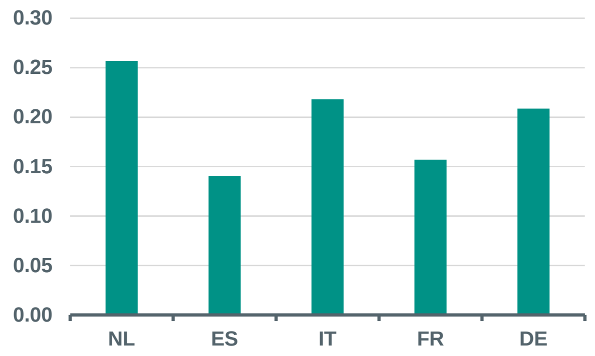


Energy squeeze is mainly a eurozone problem

The rise in energy costs adds to already overshooting inflation. While this overshoot is clearly higher in the US, the additional impact of energy price rises is within recent historical ranges. In the Eurozone however, the recent rise is unprecedented in modern times. The spike in energy prices will have a clear impact on energy-intensive producers and energy companies themselves. The lack of sufficient domestic energy sources and a high reliance on natural gas make the eurozone more vulnerable to the energy squeeze than the rest of the world.

Share of natural gas consumption by households and industry

in total domestic energy consumption



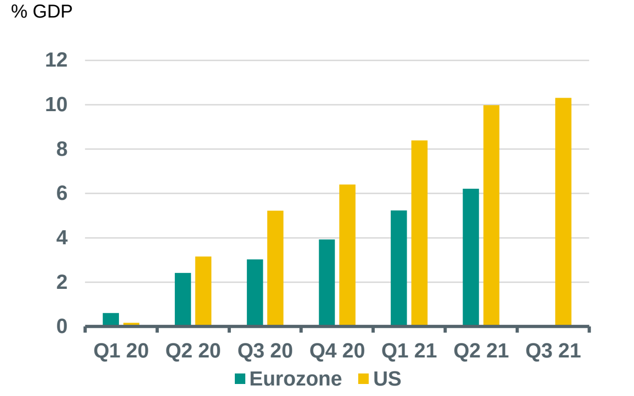
Source: https://ec.europa.eu/eurostat/web/energy/data/energy-balances

Another risk for the Eurozone is that most of the inflation overshoot is driven by something that affects a broad swathe of households. It could have more pernicious effects on consumption than in the US, where the inflation overshoot is more narrow (mainly from cars).

Excess savings could save the day...

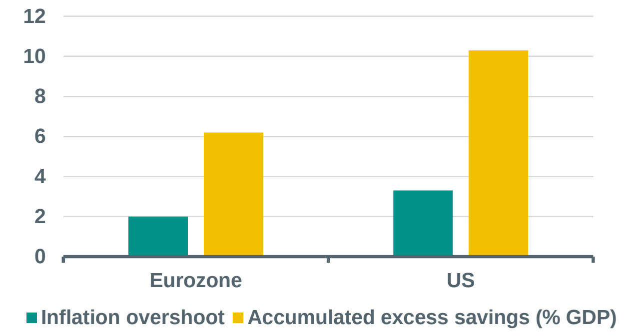
One cushioning effect on private consumption could come from excess savings. During the pandemic restrictions have induced involuntary savings which could now be softening the impact of excess inflation on consumption.

Cumulative excess savings



Source: Refinitiv, ABN AMRO Group Economics

Inflation overshoot vs excess savings accumulation



Source: Refinitiv, ABN AMRO Group Economics

Cumulative excess savings are less in the eurozone, at 6% of GDP, compared to 10% of GDP in the US. Theoretically, this could provide a significant cushion to consumption, as the level of excess savings is clearly much greater than the excess inflation we are seeing (c.2-3pp above the ECB/Fed's 2% inflation target). Excess savings are still accumulating, according to most recent data (Eurozone data runs to Q2; US data to August)

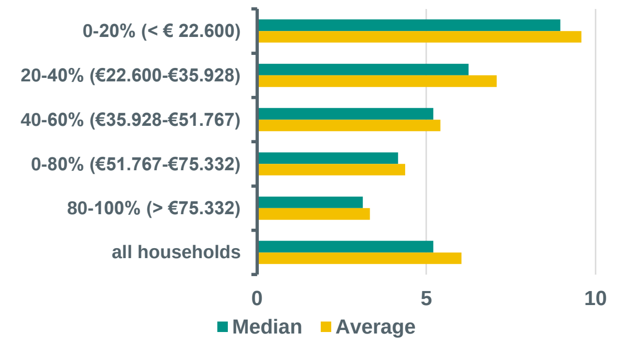
…if only they were available to those who need it most

Unfortunately, however, excess savings have less of a cushioning potential than would appear. While lower income households typically spend a larger proportion of their income on energy bills, excess savings have mostly accumulated in higher income groups.

For the Netherlands the figure below plots the energy quote (proportion of income spend on energy) and for the eurozone the excess savings by income group.

Energy ratio by income group

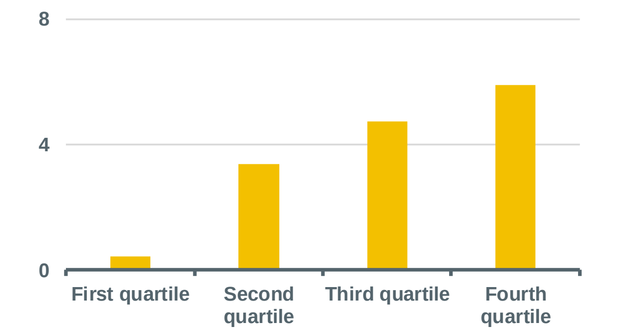
2014, % disposable income



Source: Refinitiv, ABN AMRO Group Economics

Household savings by income distribution

Change in net savings balance, Dec 19 – April 21, Eurozone



Source: ECB, ABN AMRO Group Economics

While not quite as heavily skewed in the eurozone as in the US, where 70 percent of increase in net worth since the pandemic started accrued to the top 20% highest earners, it appears that excess savings will do little to help the lowest income groups in the eurozone who are hit hardest by the rise in energy costs.

European households are being compensated

The European Commission presented a toolbox of measures on 13 October which member states can implement immediately without breaching EU rules. Alongside near-term measures such as compensation for households, the EC suggests medium-term measures such as stepping up investment in renewables and developing energy storage capacity. Furthermore, the EC will look into the benefits of joint acquisition of gas reserves, and will re-evaluate the benefits and drawbacks of the current internal energy market. In presenting this toolbox, the EC is clearly signaling that the near-term policy response to price rises is up to member states themselves. We have summarised the policy response of member states in the eurozone in the table below.

Who	When	What
European Commission	13 October	Short term measures which member states may implement right away, such as: • Provide emergency income support for energy-poor consumers, e.g. vouchers or partial bill payments • Authorise temporary deferrals of bill payments • Put in place safeguards to avoid disconnections from the grid And longer term initiatives, such as: • Stepping up investments in renewables and energy efficiency • Develop energy storage capacity • Study benefits and drawbacks of existing electricity market design (done by European energy regulators) • Explore benefits of voluntary joint procurement of gas stocks by member states See **here** a factsheet with all initiatives within the toolbox.
France	15 September	• An energy subsidy of EUR 100 for the 5.8m poorest households in the country, which may be increased further if it does not alleviate pressure on households enough
	30 September	• Block on any further gas price increases after 1 October (exp. until April) • Limit electricity price hike planned for February to 4% by lowering taxes paid on electricity
Spain	14 September	• Redirect exp. EUR 2.6bn from energy companies using renewable power generators, which make profits from surging electricity prices, to consumers in next six months • Lower taxes, for example tax on energy goes from 5.1% to 0.5%, 7% tax on power generation (which utility companies pass on the consumers) is being scrapped and VAT on electricity bill goes down from 21% to 10% • Limit regulated price increases for fuel at 4.4% in Q3
Italy	23 September	• Q4 system costs (= extra charge added to energy bills covering everything from incentives for renewable energy sources to the decommissioning of nuclear power plants) eliminated in Q4 for gas for everyone and for electricity for families and small companies • VAT on natural gas down from 22% to 5% in Q4
Germany	15 October	• Cut green EEG (Renewables Energy Act) levy on electricity by 43% (from 6.5 cents per kilowatt hour to 3.7 cents), financed by EUR 3bn in revenues from a carbon tax implemented since 2021 in Germany
Netherlands	15 October	• Energy taxes reduced for households (EUR 2.7bn made available by the government) and companies (EUR 0.5bn) in 2022 • EUR 150m made available to support low-income households/households with high energy bill or not well isolated houses

-Memo: UK is a somewhat unique case, in that energy bills are capped until next April. As such, pressure on government to provide support is limited for now, but we will likely see some support measures if prices remain elevated next year. In terms of industry, government has been reluctant to provide aid.

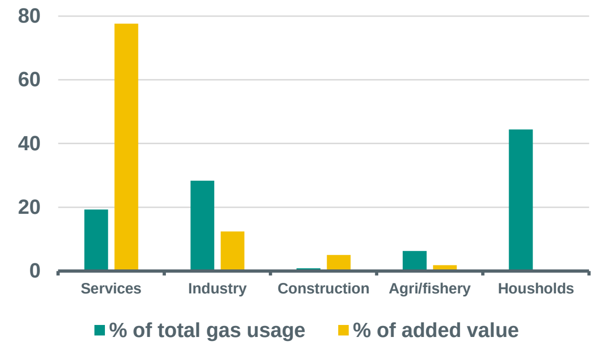
The measures announced clearly focus on the protection of households (i.e. the demand side) and to a much lesser extent on industry (the supply side). In Spain there are even plans to have renewable energy firms pay part of their additional profits to compensate higher consumer energy bills. In the Netherlands, too, budgetary rules state that unless determined otherwise, energy bill relief is to be financed within the current budgetary frame. This could lead to tax increases elsewhere for instance for firms. Overall, we judge that government support will significantly offset the hit from the gas price spike to household disposable incomes, although not fully. Indeed, this is one of the reasons for our below consensus growth forecast for the eurozone in 2022 (3.7% vs 4.3%).

Downside risks from production stops increase

Thus far, evidence of energy-intensive companies and energy suppliers having to (temporarily) halt operations, has remained anecdotal. In the UK, a dozen or so energy companies (with around 2 million customers) have gone into liquidation over the past few weeks due to the gas price spike. For the Netherlands, the energy-intensive greenhouse horticulture sector will be one of the hardest hit sectors. While hard to predict, these problems may last until well into next year (our energy economist does not expect a normalisation in gas prices to happen before 2023). The impact of the energy price spike depends naturally on the share of heavy industry in GDP value added. The Dutch economy relies heavily on services (over 75% of added value), and as such it is less vulnerable to large-supply side disruptions at a macro level. Nonetheless, we believe there are some instructive examples of the kind of disruptions we could expect more broadly, and this is something we look at in the following Box.

Gas-intensity; gas as share of total energy

sectoral share of value added



Source: CBS, ABN AMRO Group Economics

Production fallout in the Netherlands?

Three out of four instances where production was halted due to high energy prices were firms operating in heavy industry (i.e. the production of zinc, fertilizer and aluminium). The fourth instance concerned the horticulture sector (glastuinbouw), in which some firms decided to limit production due to the gas intensity and high share of energy in total costs.

In these instances, firms choose to cut back production rather than pass through price increases to customers. Firms in Dutch industry often participate in a global chain of production where they account for one step of production with limited agency to pass on cost increases, or because prices are set in longer term contracts.

Furthermore, the participation in highly competitive global markets also means that margins are thin for these industrials, making production stops due to sudden sharp increases in gas prices abruptly necessary to prevent business models from becoming obsolete. As such, firms that halt production are most likely to be situated in sectors that are energy intensive and where firms have limited agency to pass-through higher costs and face thin margins. The industrial and horticulture sectors are prone to additional production stops should they arise.

It is unclear whether energy intensive firms have fully hedged their energy costs. It is likely that larger firms, more so than small firms, have the financial room and access to financial instruments to fix energy costs. This does not mean all firms with high energy demand have fixed energy costs, they may opt for flexible rates as means to be more competitive. Either way, it is likely that if a firm choose to fix their energy costs, only a share of the total energy demand is fixed. As the cost of hedging is higher for longer time frames, we suspect gas prices have been fixed for only a few months. This means a lagged effect in the exposure of these firms to higher gas prices.

Which likely pushes inflation higher still...

With the risk of energy price rises adding more pressure to already stressed supply chains, disruptions are likely to push inflation higher still, at least in goods. This process likely still has some way to go, although we are unconvinced that services sector inflation will follow to anywhere near the same extent. Demand for services continues to lag that in goods, particularly in the US but also in Europe. While we expect a continued recovery in services consumption, we do not expect the same above-trend demand that we have seen for goods. As such, demand-side pressures for services should remain contained. This should ensure that major central banks do not overreact to recent rises in inflation (although the Bank of England looks set to be an outlier in this regard).

…while also hitting demand

Higher prices will ultimately trigger falls in demand as consumers become more reluctant to spend. In the US, the recent weakness in the Michigan consumer sentiment has been driven by consumer aversion to recent price hikes, particularly for cars. Thus, to some extent the problem is likely to provide its own solution, insofar that weaker demand eases pressure on supply chains. At the same time, production cuts and stoppages also have knock-on effects in reducing demand for labour as some firms will respond to supply chain challenges by reducing headcount or number of hours worked. This could therefore have knock-on effects on the labour market and on incomes, although this effect at present appears to be dwarfed by strong labour demand elsewhere in the economy.

The supply side will also recover… eventually

A combination of pandemic restrictions, shifting patterns of demand, and distortions from government support and energy policies have caused more longer-lasting disruption to the supply-side than expected (see scheme at the beginning of this article). But with vaccination rates approaching herd immunity levels in most advanced and major EM economies, and government support unwinding, these effects will eventually dissipate. For instance, in shipping, we already see some signs of easing, with freight tariffs from Shanghai to LA falling back 14% over the past month. In the labour market, we are still to see the effects on labour supply of the gradual withdrawal of wage subsidies in Europe, and of the expiry of benefit top-ups and schools reopening in the US. Reduced migration is something that has hampered labour supply in both the US and Europe, and so the recent easing in travel restrictions should help here. Responses to these policy changes is taking longer than expected, but they are still likely to happen. In the meantime, disruptions are putting a dampener on the recovery, raising downside risks to growth, even as upside risks to inflation have risen.

Eurozone: Looking under the surface of eurozone inflation

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- **Energy, taxes, surging factory gate prices and a normalisation of holiday prices explain the acceleration of eurozone inflation**
- **Inflation is likely to accelerate further, but it should fall sharply from the start of next year as factors currently driving higher inflation should dissipate, while wage growth is still subdued**
- **Inflation should end up comfortably below 2% by the end of next year and in 2023**

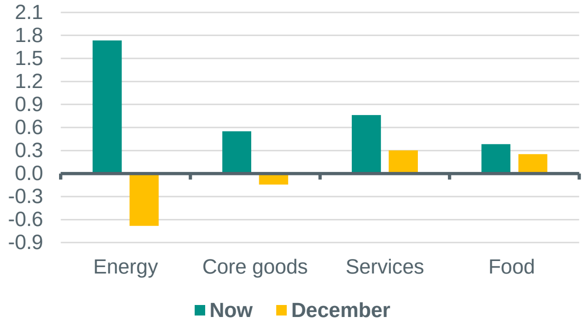
Eurozone inflation was confirmed at 3.4% yoy in September, up from 3% in August and just below 1% at the start of this year. There is a great deal of volatility in the shifts of the components from one month to another, but a better idea of trends can be seen by looking at changes over a longer period. The chart on the left below show the change in the contribution to HICP inflation of the main components now compared to December of last year (when inflation stood at -0.3% yoy). As can be seen, by far the biggest swing factor has been energy inflation, which currently accounts for half of the entire HICP inflation rate. We have also seen an acceleration in core inflation, distributed equally between services and core goods. One factor that has certainly made a contribution to this is a change in the contribution of taxes, especially reflecting the swings in the German VAT rate. Taxes were subtracting 0.1 percentage points from inflation in December of last year, while they are currently adding 0.6 percentage points to HICP inflation. Meanwhile, service sector inflation has been boosted by a recovery in prices of services related to holidays.

As the chart below shows, holiday-related inflation was a major drag on inflation in the second half of last year and the first half in of this year. However, it has bounced back sharply over the last few months. Finally, core goods inflation looks to have been boosted by sharp rises in factory goods inflation, reflecting sharply higher commodity price inflation and supply-chain bottlenecks. The components within the core goods category are not very homogeneous and sometimes difficult to link to the bottleneck narrative in a consistent way. However, it is clear that producer prices for consumer durables have accelerated, and historically these tend to be followed by rising core goods inflation.

Looking forward, headline HICP inflation is likely to accelerate further, to around 4% by the end of the year. However, we think inflation will fall sharply from the start of next year and end up comfortably below 2% by the end of the year and in 2023. First of all, the upward impact of tax rates will largely evaporate. Second, the contribution of energy inflation will likely start to decline, though the really sharp fall in the contribution will be in the second half of next year given base effects and also that it will take a while for the current energy price shock to unwind (see first chapter). Third, holiday-related inflation and hence services inflation is likely to ease, as we judge that the prices of these items have largely normalised. At the same time, wage growth at the eurozone level is still subdued. Finally, the impact on prices of supply bottlenecks should ease over time, even though a complete normalisation of the supply-side could take around a year.

Breakdown of inflation

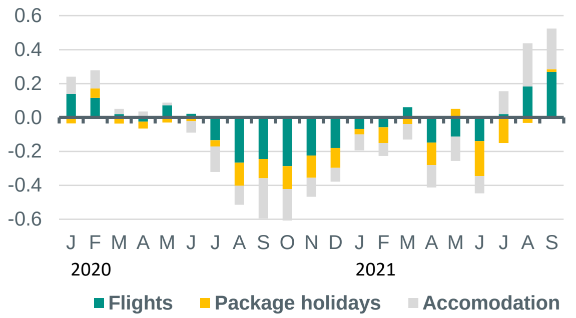
Contribution to HICP inflation, ppts yoy



Source: Refinitiv, ABN AMRO Group Economics

Inflation of holiday-related items

Contribution to services inflation, ppts yoy



Source: Refinitiv, ABN AMRO Group Economics

The Netherlands: Normalization continues, but with downside risks

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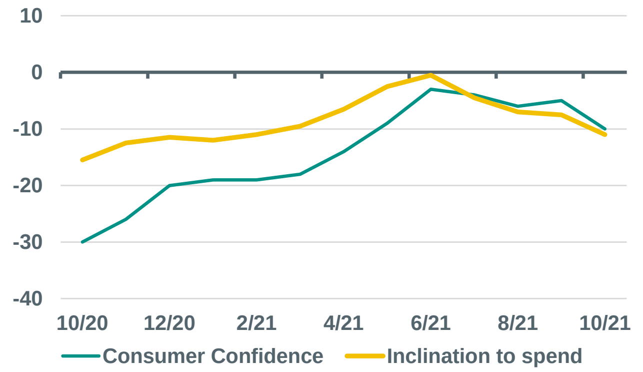
- **Private consumption remains strong, but higher prices are weighing on consumer confidence**
- **Pass through of higher energy prices in industry primarily confined to energy intensive sectors**

In the coming quarter, the Dutch economy will turn the corner from catch-up driven growth resulting from the unwinding of Covid restrictions, towards a more normal growth profile. This shift was confirmed in recent monthly consumption figures for August. These showed that the volume of household consumption was still strong (+3.4% compared to August 2019), although coming off from July highs (which is likely largely seasonal). The decomposition of expenditure however showed a continued reversal of pandemic trends; consumption shifted away from goods and showed stronger growth in services. Services consumption increased by 9.7% compared to pandemic lows in August 2020 and durable goods consumption increased by 3.6% compared to August 2020.

The outlook for consumption points towards a slowdown, something we had expected given the fading catch-up effect. Consumer confidence has also declined in recent months, dipping below the long-term average in October. The main drivers of the decline were the willingness to buy and the expected financial situation, which can be explained to an extent by consumer fears for higher prices stemming from surging energy prices and supply bottlenecks. Indeed, the percentage of consumers expecting prices to rise faster in the coming year than at present rose to 49% in October, a multi-year high. Consumer worries over higher prices should be alleviated by just-announced government support measures that compensate for higher energy bills via a reduction in energy taxes. We ultimately expect inflationary pressure to dissipate during 2022, although these headwinds pose a downside risk to consumption in 2022.

Consumers signal slowdown in consumption

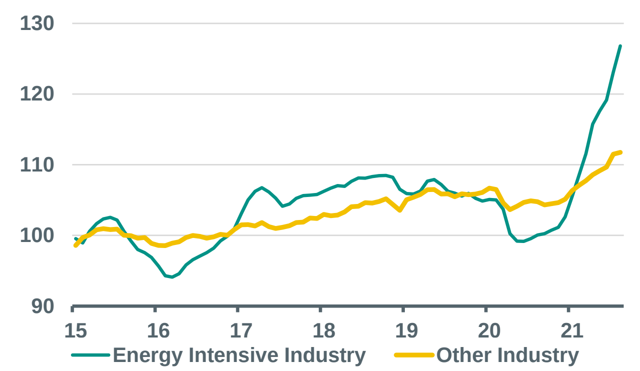
Cons. Confidence and average of components indicating inclination to spend



Source: ABN AMRO, CBS

Pass-through is dependent on energy intensity

PPI-index, energy intensive industry takes 3 subsectors (chemical, basic metals, food) which account for 75% of final energy consumption in 2019.



Source: ABN AMRO, CBS

It remains to be seen to what extent the supply-side of the economy will be hit by the current headwinds. Aside from the sectors hit directly by Covid restrictions, most of the Dutch supply-side was already at pre-covid levels of activity in the beginning of 2021. Producer confidence points towards continued expansion, and increased slightly again in September after the August decline. Industrial production also remains at historic highs. But if the expectations of producers in Germany – a major trading partner for Dutch producers – are any indication, a decline is on the cards, with the IFO index peaking in June and having since declined over the past three months.

One way to assess the impact of higher energy prices on the rest of the economy is to look at the extent to which higher prices are passed on. We find that the energy dependency of sectors matters a great deal in determining how much higher energy costs are passed on. Three sectors in Dutch industry, namely Food, Chemicals and basic metals production account for roughly 75% of total industrial energy consumption. These sectors have raised prices significantly over the past few months. Price rises in other industrial sectors have been notably more muted, meaning that only a relatively small share of Dutch firms are contributing to broader price pressures affecting the economy. All told, we expect these headwinds to weigh modestly on short term activity, but we see bigger downside risks to growth expectations from the second quarter of 2022.

US: Old (pandemic) habits die hard

Bill Diviney – Senior Economist | bill.diviney@nl.abnamro.com

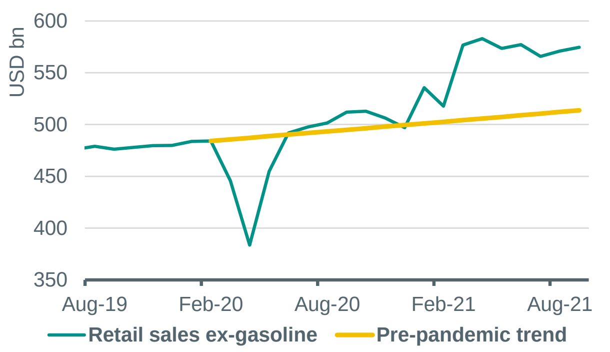
- **Goods consumption remains well above trend, and services consumption well *below* trend**
- **The delayed normalisation in consumption patterns poses continued upside risks to inflation…**
- **…leading us to bring forward our expectation for interest rate rises to early 2023**

The shift in demand from services to goods since the pandemic is taking longer to normalise than expected. This was confirmed in the September retail sales print, which showed an unexpected rise, with August sales also revised upwards. This came despite continued weakness in consumer sentiment, which suggested a pullback in goods consumption. The details showed renewed gains in autos, recreational goods, and general online sales, with eating out showing only a small gain. Indeed, restaurant dining and air traffic data suggest that the services recovery has stagnated since July, with little sign yet that the easing in the Delta wave is triggering a turn-around. The latest hard data (which runs to August) shows that services consumption remains around 5pp below the pre-pandemic trend, with durable goods consumption 7.6pp *above* the pre-pandemic trend; the September data is likely to show little change from these numbers when it is released next week.

Stubbornly strong goods consumption – alongside supply-side bottlenecks – continues to pose upside risks to inflation. Although the past two CPI reports showed relatively normal price growth, we expect a reacceleration in inflation over the coming months, with persistent pipeline pressures likely making it increasingly difficult for producers to avoid passing on higher costs to consumers, and higher wage growth and a shortage of housing putting further upward pressure on rents. While we do not expect price growth to reach the lofty levels seen earlier this year, it will be enough to keep worries alive of a possible drift upward in inflation expectations. Should inflation be persistent enough to push expectations significantly higher, this would be far more consequential for the medium to longer-run policy outlook than the current price pressures we are seeing. Our base case continues to be that a correction in goods consumption, a comparatively tepid services recovery, and a recovery in labour supply will help return core inflation back to near 2% by late 2022. However, the probability of more persistent above-2% inflation has continued to rise.

Goods consumption remains stubbornly strong…

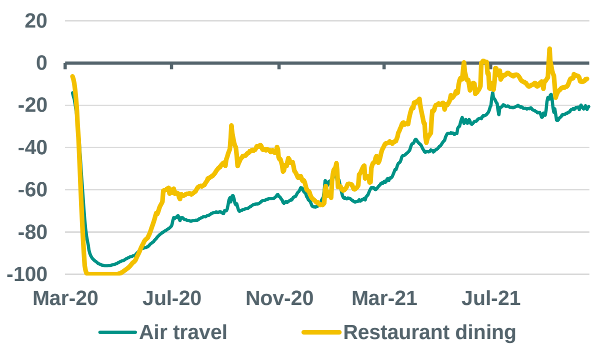
Retail sales, USD bn



Source: Refinitiv, ABN AMRO Group Economics

…with a comparatively tepid services recovery

% vs 2019 level



Source: Refinitiv, ABN AMRO Group Economics

We now expect the Fed to start raising rates in early 2023

Continued upside risks to inflation caused us to bring forward our expectation for the start of Fed rate hikes. We now expect the Fed to have fulfilled its dual inflation and employment mandate by the end of 2022, paving the way for a first hike in the fed funds rate in early 2023. Previously, we expected lift-off to happen in late 2023. We continue to expect only a gradual rise in rates following the first hike, with rates initially rising once every six months, compared to once per quarter in the previous 2015-2018 hiking cycle. The timing of lift-off naturally depends significantly on inflation developments over the coming year. Should inflation re-accelerate more significantly than we currently expect, we would have cause to revisit our view. Another trigger to revisit our view is a shift in inflation expectations. At present, expectations remain well-anchored. If we start to see inflation expectations drifting beyond levels seen in the post-GFC period, this would be a major warning sign that a more forceful policy response would be required. See our Fed Watch for more.

China: Some policy easing after a self-inflicted slowdown

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- **Growth in Q3 slows as expected; some pick-up in quarterly growth foreseen in Q4**
- **With rising headwinds from real estate and energy, we expect some policy easing to support growth**
- **Commodities have driven PPI up, but record gap between PPI and CPI confirms limited passthrough**

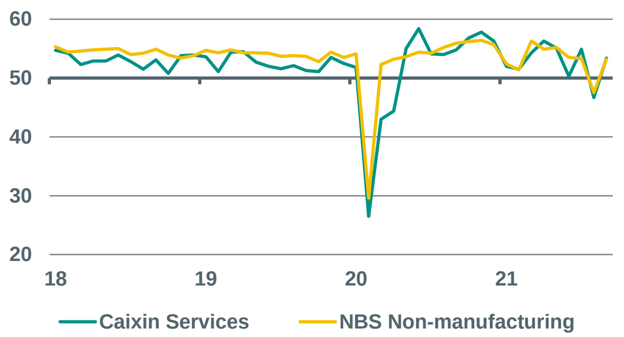
As expected, GDP growth slowed significantly in Q3, falling to 0.2% qoq sa (Q2: 1.2%) and 4.9% yoy (Q2: 7.9%). The key driver of the slowdown was the imposition of regional lockdowns and mobility restrictions following the Delta outbreak in July. This had a significant, though short-lived, impact on activity in the services sector. With restrictions being eased, the full-vaccination rate now at 75% and export strength continuing, we expect a pick-up in quarterly growth in Q4, also assuming further piecemeal policy support. Still, headwinds have risen in real estate (with the Evergrande crisis adding to this sector's slowdown) and from a power crunch. These headwinds – also visible in a further slowdown of industrial production and investment – are to a large extent 'self-inflicted', following measures to reduce risks (real estate) and pollution (power). We leave our growth forecasts for 2021 (8.3%) and 2022 (5.5%) unchanged for now, but risks remain tilted to the downside.

Some easing of policies in the pipeline

While the growth target for 2021 of 'above 6%' will certainly be reached, policy inaction would raise the risk of annual growth in 2022 (our forecast: 5.5%) falling below Beijing's preferred trajectory. The 2022 target will be announced at the annual National People's Congress in early March 2022, although a glimpse of the government's intentions may be spotted during the Central Economic Working Conference in December. We still expect another 50bp RRR cut in the coming months (with the PBoC continuing to safeguard overall liquidity with special operations) and moderate fiscal support – by increasing the room for local governments to step up infrastructure spending. On the energy front, although the government has expressed its commitment to longer-term environmental ambitions, various measures have been taken to safeguard energy provision during the winter season. Coal production has been ramped up again, electricity prices have been liberalised somewhat, and power shortages have significantly reduced. Meanwhile, authorities have stepped in to stop the rise in coal prices.

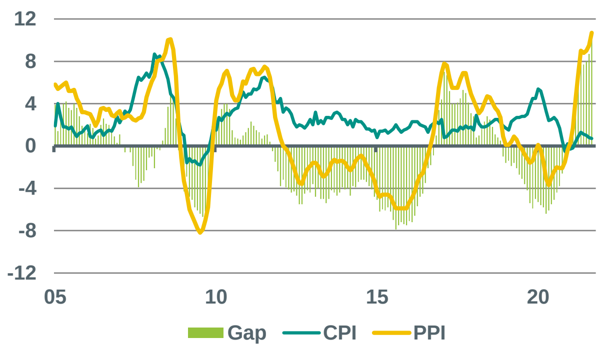
Services rebound from Delta dip

China's services PMIs, indices, 50 = neutral mark



Source: Bloomberg, Refinitiv

Record CPI-PPI gap confirms limited passthrough so far



Source: Bloomberg, Refinitiv, ABN AMRO Group Economics

Producer price inflation at record high, but basically no pass-through yet into headline and core CPI inflation

Producer price (PPI) inflation rose further in September, to reach a record high of 10.7% yoy (August: 9.5%). The renewed rise in PPI inflation over the summer was driven by commodity-related sectors, with a sharp rise in coal and other energy prices coming against a backdrop of production stops targeting energy-intensive industries. Recent government measures should help to ease some of these pressures, although annual PPI inflation will likely stay elevated in the coming months. Meanwhile, headline CPI inflation fell to a five month low of 0.7% yoy in September, driven by food prices, leading the gap between PPI and CPI inflation to a historic high of 10 %-points. Core inflation also remained subdued, at 1.2% yoy. All of this implies that the passthrough of higher PPI-inflation into consumer prices is still very limited, although there are some mild signals of an increasing passthrough. This should leave some room for a moderate policy easing to support growth.

Key views on a page

Supply chain bottlenecks have intensified further, with surging gas prices in particular posing downside risks to the eurozone outlook. Government support should ease the burden on households, but further production stoppages could have significant knock-on effects. Despite the bottlenecks, we continue to expect above trend growth in the eurozone and the US. The services recovery still has a long way to go, and this recovery will be aided next year by the normalisation in labour markets, a pickup in government investment, and some easing in supply side bottlenecks. Despite the cautious withdrawal of pandemic support measures – with the Fed about to begin tapering its asset purchases, and wage subsidy schemes gradually wound down – both monetary and fiscal authorities will maintain a broadly supportive stance for growth. Inflation remains elevated, and risks tilted to the upside, but we do not expect the ECB or Fed to prematurely tighten monetary policy in response to this.

Macro	Central Banks & Markets
Eurozone – We expect continued above-trend growth during the rest of the year and in 2022, despite the persistence of supply-side bottlenecks, and in particular the recent surge in gas prices. The economy continues to shake off the impact of the pandemic. With vaccination rates high, social distancing measures have been unwound further. GDP will return to its pre-pandemic level around the end of the year. Inflation has jumped, and is expected to rise further in the final months of the year, on the back of higher household energy prices (gas and electricity), but is expected to drop sharply lower again next year. Underlying (core) inflation will remain subdued. Labour market slack is abundant and wage growth has slowed already.	**ECB** – The ECB has published its Strategy Review. It has raised its inflation target to 2% from ‘below, but close to, 2%’, previously. The commitment to the target is symmetric, with negative and positive deviations from this target considered to be equally undesirable. Subsequently, in its July meeting, the Governing Council strengthened its forward guidance on interest rates. The new guidance states that the ECB ‘expects the key interest rates to remain at their present or lower levels until it sees inflation reaching two percent *well ahead of* the end of its projection horizon’. This may also imply a transitory period in which inflation is moderately above target. All in all, we think that the ECB could keep policy rates unchanged through 2024.
Netherlands – Growth is set to normalise, as the catch-up effect from the phasing out of Covid restrictions fades. We expect Q3 growth to come in at 1.6% qoq and Q4 growth of 0.5% qoq. With growth normalising, the effects of supply-side bottlenecks/disruptions and surging energy prices will become more perceptible. We expect a limited impact on near-term growth from surging energy prices, but the effect will be more pronounced in 2022.	**Fed** – We expect an official taper announcement in November as a base case, with tapering to start in December. The tapering process should take around 6 months, with asset purchases ending entirely by mid-2022. The Fed has promised not to raise rates until maximum employment is achieved, and inflation is on course to moderately overshoot its 2% target for a time. Given these conditions, we expect the first rate hike by early 2023, although upside risks to inflation could bring this forward.
US – The outlook remains strong, with robust jobs growth, significant scope for further services sector growth, and large-scale infrastructure investment on the horizon. However, consumption patterns are taking longer to normalise, with persistently strong goods consumption conspiring with supply-side bottlenecks to pose continued upside risks to inflation. The services sector recovery meanwhile remains tepid, although the easing Delta wave should help momentum to recover. We do not expect an overheating scenario that prompts aggressive Fed policy action, but continued elevated pipeline price pressures have raised the risk of such a scenario.	**Bond yields** – US Treasury yields continued to rise as the market awaits a tapering announcement by the Fed. We think the recovery has been fully priced in and expect a gradual rise in long term yields accompanying the rate hike cycle over the coming years. However, the market expects a rate lift-off somewhat earlier than we do, and the short end of the US yield curve looks elevated to us. In the eurozone, yields look elevated across the curve, since they were pushed higher by a significant increase in inflation expectations. However, we think that, with inflation likely to fall back sharply next year, Bund yields should also fall back to a level slightly above the deposit rate.
China – Zero-tolerance covid-19 policy drove growth down to a weak 0.2% qoq in Q3, with services particularly affected. With restrictions being eased, the vaccination rate at 75% and export strength continuing, we expect a pick-up in quarterly growth in Q4. Still, headwinds have risen in real estate (partly reflecting the Evergrande fall-out) and from a power crunch. With passthrough of high PPI inflation into CPI inflation still limited, we expect Beijing to continue with piecemeal monetary and fiscal easing. On the energy front, policies have already been relaxed to some extent. All in all, the risks to our growth forecasts for 2021 (8.3%) and 2022 (5.5%) remain tilted to the downside.	**FX/EURUSD** – Momentum has shifted in favour of the US dollar again. The Fed was a bit more hawkish and this supported the dollar. Safe haven demand has also pushed the dollar higher. But the move has lost momentum and EUR/USD is back above 1.17 again. We keep our forecast for the end of this year at 1.18 an end of 2022 at 2022. This is mainly because we expect the Fed to be more hawkish than the ECB in the coming years.

Main economic/financial forecasts

GDP growth (%)	2019	2020e	2021e	2022e
United States	2.3	-3.4	6.1	4.0
Eurozone	1.6	-6.5	4.9	3.7
Japan	0.0	-4.7	2.6	2.5
United Kingdom	1.7	-9.7	7.4	5.3
China	6.0	2.3	8.3	5.5
Netherlands	1.9	-3.8	4.4	3.0
Inflation (%)	**2019**	**2020e**	**2021e**	**2022e**
United States	1.8	1.2	4.5	3.1
Eurozone	1.2	0.2	2.3	1.3
Japan	0.4	0.0	-0.3	0.6
United Kingdom	1.8	0.9	2.3	2.0
China	2.9	2.5	1.0	2.5
Netherlands	2.7	1.1	1.8	1.5
Key policy rate	**21/10/2021**	**+3M**	**2021e**	**2022e**
Federal Reserve	0.25	0.25	0.25	0.25
European Central Bank	-0.50	-0.50	-0.50	-0.50
Bank of Japan	-0.10	-0.10	-0.10	-0.10
Bank of England	0.10	0.10	0.10	0.10
People's Bank of China	3.85	3.85	3.85	3.85

3M interbank rate	14/10/2021	21/10/2021	+3M	2021e	2022e
United States	0.12	0.13	0.25	0.25	0.25
Eurozone	-0.55	-0.55	-0.55	-0.55	-0.55
Japan	-0.09	-0.08	-0.10	-0.10	-0.10
United Kingdom	0.14	0.21	0.10	0.10	0.10
10Y interest rate	**14/10/2021**	**21/10/2021**	**+3M**	**2021e**	**2022e**
US Treasury	1.52	1.68	1.5	1.50	1.50
German Bund	-0.18	-0.10	-0.5	-0.50	-0.50
Japanese gov. bonds	0.07	0.07	0.0	0.00	0.00
UK gilts	1.04	1.20	0.7	0.70	0.80
Currencies	**14/10/2021**	**21/10/2021**	**+3M**	**2021e**	**2022e**
EUR/USD	1.16	1.16	1.15	1.15	1.12
USD/JPY	113.7	114.0	115	115	120
GBP/USD	1.37	1.38	1.36	1.36	1.40
EUR/GBP	0.85	0.84	0.85	0.85	0.80
USD/CNY	6.44	6.39	6.40	6.40	6.20

Source: Refinitiv, ABN AMRO Group Economics.

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