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Global Monthly

Macro Research Team abn.amro.group.economics@nl.abnamro.com Bill Diviney: +31-6-4778-4657

What the banking turmoil means for the outlook

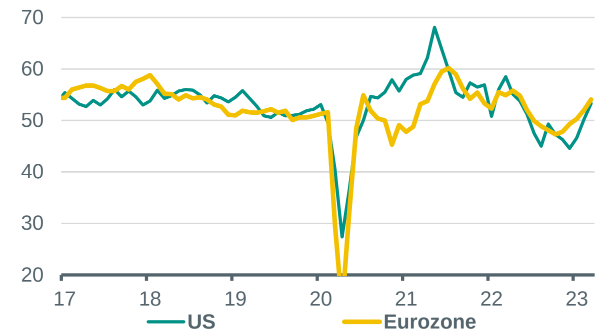
- **Much of the lingering concerns in the banking sector seem driven more by fear than fundamentals**
- **However, market stress can become self-reinforcing, and even assuming financial conditions normalise, the turmoil could yet have a significant impact on lending to the real economy**
- **The turmoil could mean an earlier end to rate hikes. But one way or another, the economy will need to experience some pain for inflation to fall sustainably back to target**
- **Regional updates: Underlying inflation is looking stubbornly firm in *the eurozone*, while in *the Netherlands*, the risk to medium-term growth is to the downside, despite near-term strength**
- **Bad news on the inflation front in *the US* likely means rates stay higher for longer**
- ***China's* recovery looks to be broadening, with the property sector bottoming out**
- **In this month's Spotlight, we explore how shifting trade patterns are raising geopolitical tensions**

Global View: Some economic pain looks inevitable, even if the banking turmoil subsides

The global economy appears of late to ricochet from one crisis to the next. Just when the European energy crisis looked to be abating, financial markets have been thrown into renewed turmoil by a number of bank failures, and the fear of more to come. We ultimately expect that fear to subside, but in the interim, we could be in for some turbulence. In this month's *Global View*, we pose a wide-ranging set of questions to our specialists – taking stock of the banking turmoil, pondering how events might unfold from here, and translating the impact of tighter financial conditions to the economy and monetary policy. Assuming the turmoil does subside, a key question for central bankers will be how much of a mark it leaves on financial conditions, and whether it reduces the need for further interest rate hikes. We think on balance that the Fed and ECB still have a bit further to go, but rate hikes could indeed end sooner if the impact on bank lending – and therefore growth and inflation – is more powerful than we assume. On the other hand, a more rapid easing in financial conditions could mean central banks have to go even further. One thing appears certain: last week's bounce in the flash PMIs, suggesting a rebound in advanced economies, is unfortunately unsustainable. One way or another, economies will unfortunately need to experience some pain to bring inflation back to target, whether that is central bank-induced or otherwise.

The rebound before the storm?

Flash composite PMIs, index; >50 = expansion, <50 = contraction



Source: Refinitiv, ABN AMRO Group Economics

Deposits moving from banks to money market funds

US Money Market Fund assets, USD bn

Source: Bloomberg, ABN AMRO Group Economics

Are we heading for a new banking crisis?

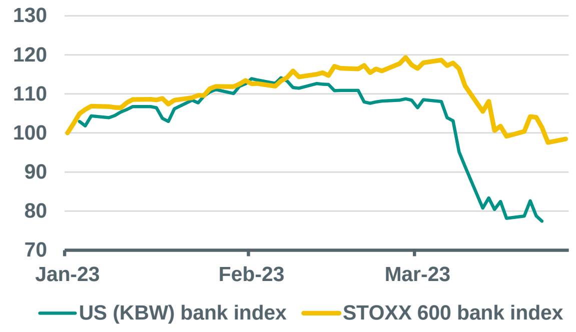
The banking sector has been the focus for financial markets since the failure of some regional US banks, as well as the take-over of Credit Suisse (CS) by UBS. The rise in bank worries resulted in a drop in bank share prices as well as bonds. This has raised the question of whether we are heading for a 2008-style global financial crisis. We do not think so, as we see the troubles on both sides of the Atlantic as idiosyncratic, while authorities and central banks have also acted forcefully.

Banks are much better capitalised than during the GFC 15 years ago (also something stressed by regulators on both sides of the Atlantic), which makes them better positioned to weather headwinds. Banks also have a lot of cash. This is reflected in the average CET1 ratio of 14.2%, and an average liquidity coverage ratio of 148% for the largest banks in the euro bond indices. The end of the negative interest rates era has also supported banks' net interest income, which should be more than sufficient to compensate for any losses stemming from the weak economic outlook. In short, bank fundamentals have clearly improved. Working in the opposite direction, bank funding costs are set to rise due to recent developments (especially the cost of capital), which will weigh on bank earnings and might also result in banks further tightening lending conditions. But on balance, the banking sector looks sound. The lesson from recent developments has nevertheless clearly illustrated that confidence is key, and it is likely to take some time for confidence in the banking sector to be restored.

In recent days, bank equity and bond prices have stabilised somewhat, although markets have remained very volatile. Moreover, the costs of protection against bank defaults have risen strongly, although they have remained below levels seen during earlier times of stress. Having said that, the situation remains fragile.

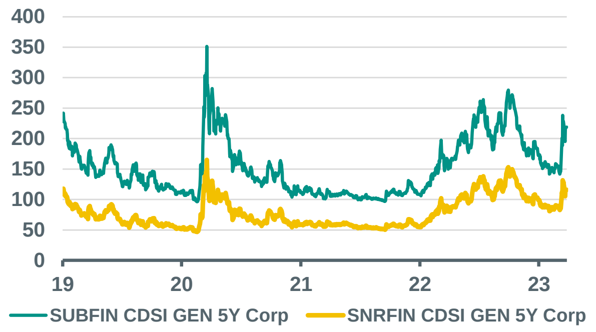
Bank equity have dropped but stabilising

US and EU bank equity indices, rebased with 1 Jan 2023 = 100



Source: Bloomberg, ABN AMRO Group Economics

Protection against bank defaults also coming down



Source: Refinitiv, ABN AMRO Group Economics

Why is the banking stress idiosyncratic?

The problems with the US regional banks, and those of the Silicon Valley Bank (SVB) especially, stemmed largely from the large share of customer deposits that were not protected by the US deposit guarantee scheme (DGS), which protects deposits up to USD250k. This made these banks highly vulnerable to a bank run when customers started doubting their viability. Meanwhile, SVB had not hedged the interest rate risk of its balance sheet, which meant that it would incur large unrealised losses on its investments following the rapid increase in market interest rates (mirroring aggressive policy tightening by the Fed). SVB was able to do this partly because in 2018 US lawmakers voted to reverse part of the Dodd-Frank Act for mid-size and regional banks.

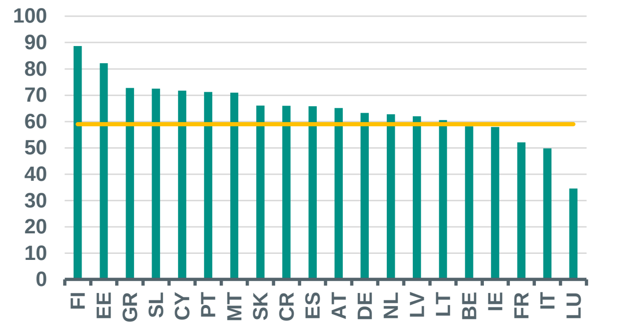
Meanwhile, Credit Suisse had been one of the most beleaguered banks for some time, shrouded in negative headline news as well as doubts about the execution of its strategic review. The bank then almost completely lost market confidence after news about weaknesses in its controls over financial reporting, while the news that its largest shareholder would not be able to raise its equity stake did not help neither. As a result, customers withdrew large sums, culminating in a rescue by UBS.

The situation is different for other banks. For starters, the share of deposits at euro area banks that are guaranteed by the DGS is around 60%, much higher than SVB's 4%. Other US regional banks also have a higher share of insured deposits, although some, such as First Republic Bank, still have a relatively large share of uninsured deposits. However, the US government has protected all uninsured deposits of the failed banks, which should also have restored some calm at other banks. Overall, we judge the risks of more bank runs as limited.

Another reason we think that a new banking crisis is unlikely is that most banks (unlike SVB) hedge their interest rate risk, only exposing their investments to market risks. A study by the ECB published in May 2022 (**here**) showed that euro area banks stepped up hedging activities in the past two years, limiting their interest rate exposure. Meanwhile, the ECB already conducted an exercise at the end of last year assessing the vulnerability of the euro area banking sector to a major flattening/steepening of the yield curve (see **here**). The stress test revealed that most banks were well positioned to cope with such a flattening of the yield curve. Perhaps more importantly, these studies show that the ECB is 'on the case' and aware of the risks that the current interest rate environment poses to banks. As a result, the central bank should also be well positioned to identify the banks at risk, telling them to act if needed.

Share of deposits guaranteed by DGS in euro area

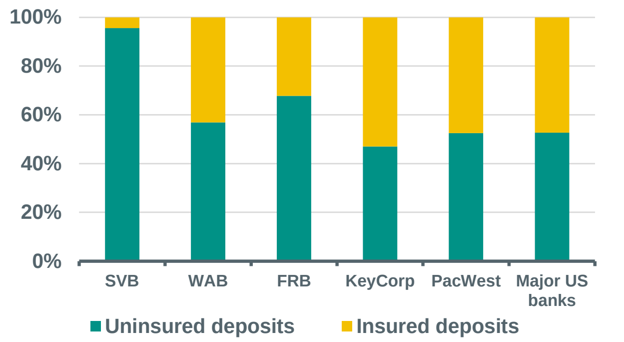
% share of household and corporate deposits guaranteed by DGS



Source: ECB, EBA, ABN AMRO Group Economics

Share of (un)insured deposits at US banks

%



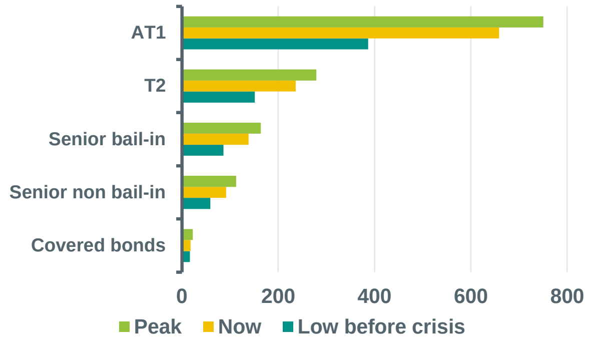
Source: Bloomberg, bank reports, ABN AMRO Group Economics

Have markets entered calmer waters?

Well, only to a certain extent. Euro denominated bank bonds have recouped some of their losses, but spreads remain well above the lows reached earlier this year. The graph below left shows the peak, low, as well as the level of the index spreads by debt instrument in the past few weeks (with a higher level meaning a lower value of the bond). It reveals that the spread level of AT1s, the most sub-ordinated bank bonds, almost doubled compared to the lows of a few weeks ago. This was due to the treatment of AT1s of CS in the rescue of the bank by the Swiss authorities, which left AT1 bond holders worse off than CS shareholders (which is out of sync with the capital structure of banks). However, reassuring statements by EU and UK regulators that this would not happen in their jurisdictions resulted in a tightening of AT1 spreads, leaving them still 270bp above their low.

Spread development of euro bank bonds

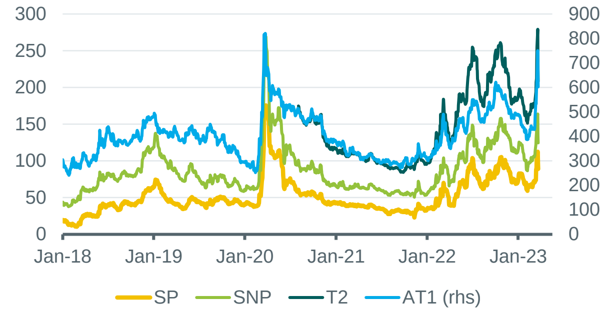
ASW-spread levels in bp, using iBoxx and Bloomberg (AT1) indices



Source: Bloomberg, Refinitiv, ABN AMRO Group Economics

Spreads of euro bank debt by rank of debt

ASW-spread levels in bp, using iBoxx and Bloomberg (AT1) indices



Source: Bloomberg, Refinitiv, ABN AMRO Group Economics

Overall, spreads of euro bank debt have tightened somewhat since the repricing following the flaring up of tensions in the banking sector, although they have far from fully recouped their losses. This reflects that weakness in sentiment towards the banking sector is ongoing, clearly indicating that the banking sector is not out of the woods yet. *(Joost Beaumont)*

How does the banking turmoil impact the growth outlook?

While financial markets have calmed somewhat, it is too early to tell which effects persist and which will fade, and at what point in time. One probable scenario is that the banking turmoil does not flare back up to the levels we saw over the past two weeks, but instead lingers on in the form of elevated tightness in the credit space for the foreseeable future.

Multiple factors could contribute to tighter financial conditions going forward. It has become clear that a goldilocks scenario – with interest rates rising at the quickest pace in decades without any effect on financial stability or growth – now looks highly unlikely. We instead appear to be entering a more challenging phase, where uncertainty and fragile investor confidence leads to tighter financial conditions constraining lending, especially in more risky asset markets. The fact that the shock happened in banking also matters, as a repricing of risk and less confidence in the banking sector could lead to persistent elevated funding costs for banks which they then pass on to clients, either in the form of risk aversion by demanding higher credit standards, or in the form of higher interest rates to recoup elevated funding costs. Even before the turmoil broke out, Fed and ECB loan officer surveys suggested a considerable tightening in lending standards, and that is likely to continue.

Bank lending standards had already tightened…

ECB Bank Lending Survey; >0 = tighter standards

Source: ECB

…and are likely to tighten further

Fed Senior Loan Officer Survey; >0 = tighter standards

Source: Federal Reserve, Refinitiv

Should such a scenario play out, these factors are likely to further constrain (bank) lending to the real economy, above and beyond the impact interest rate rises were already having. Early signs of this effect are visible in financial conditions indices, and as Fed chair Powell noted in the March FOMC press conference, the impact on credit conditions could well be greater than aggregate indices suggest, with the hit to the real economy also correspondingly bigger. Tighter financing conditions do not evenly pass through to the economy. Interest rate sensitive and highly leveraged sectors such as real estate and construction are more at risk. Also, less consolidated sectors with a large share of SMEs, which typically are more reliant on bank funding, are also more exposed to the negative impact of tougher financing conditions.

Finally, it is worth noting two important differences between the situations of the US and the eurozone. Firstly, problems with and confidence in regional banks in the US seem at this point more widespread than the banking issues in the eurozone, which so far have been contained to the isolated (and highly idiosyncratic) case of Credit Suisse. This means the possible effects on bank lending are likely greater in the US. Secondly – and a counter-point to this – the eurozone is much more dependent on bank funding than the US (see chart on next page). Turmoil on a similar scale in the eurozone banking sector would therefore have bigger repercussions here. *(Jan-Paul van de Kerke)*

Will the banking turmoil throw rate hikes off course?

So far, central banks have continued to raise interest rates, despite the risk the recent turmoil poses to the real economy. This is conditioned on the crucial assumption that the turmoil can be dealt with via emergency liquidity (such as the Fed's offer of funds secured against Treasury bonds valued at par) or regulatory measures (such as the implicit extension of deposit guarantees), and that the turmoil will not evolve into a broader crisis. Central banks still have a job to do to bring inflation back down to target, and so as far as possible they would prefer to keep raising interest rates to finish that job than to allow the focus of this to be muddied by financial stability concerns. There is also a danger that if central banks were to pause rate hikes on financial stability concerns, that this would have a counterproductive effect by suggesting to markets that there is a bigger problem in the banking sector than appears.

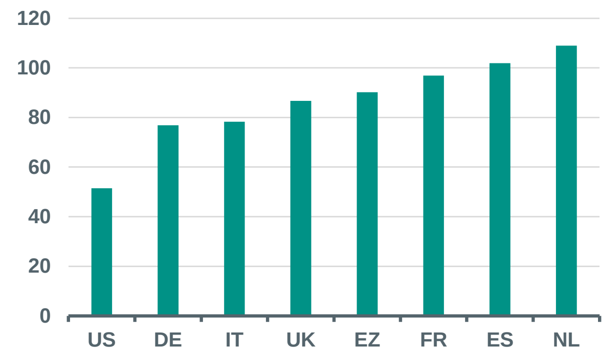
Financial conditions have tightened

US financial conditions index; >0 = accommodative, <0 = tight

Source: Bloomberg

Eurozone economy more reliant on bank lending

Bank credit to private sector, in % of GDP (avg 2015-2019)



Source: BIS, ABN AMRO Group Economics

With that said, central banks cannot ignore the tightening of financial conditions that has resulted from the stress in the banking sector, because to some degree, this does part of the work for central banks by dampening lending to the real economy, reducing aggregate demand, and in turn inflationary pressure. For this reason, we forecast only one further rate hike by the Fed – despite the recent bad news on inflation – while for the ECB, we see the risk to our forecast peak in the deposit rate (3.75%) as tilted to the downside.

But there is significant uncertainty over the degree to which financial conditions will stay tight. Since the rescue of Credit Suisse, financial conditions indices have retraced much of the tightening that occurred since the turmoil broke out. As mentioned above, it is likely that such indices understate the true extent of the tightening in financial conditions, given that they don't capture the likely tightening in lending standards, and this is something we will not have a good handle on for some months potentially. Should the tightening in financial conditions prove to be greater than estimated, central banks are likely to pause rate hikes sooner and could even embark on earlier rate cuts. On the other hand, if financial conditions ease more rapidly from the turmoil, this could be a reason for central banks to hike by even more than we currently forecast, and for rates to stay higher for longer. Indeed, this uncertainty led the ECB to explicitly drop guidance for where it expects interest rates to go, while the Fed – though retaining a tightening bias – significantly softened this bias, remarking in its policy statement only that further rate hikes 'may' be appropriate. *(Bill Diviney)*

Could a situation arise where the authorities are unable to provide an adequate fix?

Events over the past two weeks have demonstrated that the banking sector reforms that were introduced in response to the Global Financial Crisis were insufficient to prevent the demise (or near-demise) of three banks in the US and one systemically important financial institution (SIFI) in Europe. These banks had what one might consider an adequate first line of defence, with robust solvency ratios and yet, concerns about liquidity emerged which then forced the authorities to provide a de facto blanket guarantee on all deposits (in the US at least), and to put in place aggressive liquidity measures to restore confidence in the sector. Even that was not enough. In the end, the UK authorities had to step in to facilitate the takeover of the UK arm of SVB by HSBC, and the Swiss authorities engineered the takeover of Credit Suisse by its larger rival, UBS. These stress events have also resulted in tighter conditions for banks.

The current banking sector stress episode followed a significant dislocation in UK financial markets in September last year, where a 'doom-loop' developed as losses from higher sovereign yields in the pension industry triggered forced selling resulting in further losses. The Bank of England had to step in as market maker of last resort in gilts and crucially, from a monetary policy perspective, the central bank had to delay the start of its pre-announced quantitative tightening programme because of worries related to financial stability. Are these episodes together a signal of more trouble to come? And are there circumstances under which tremors such as these can morph into a crisis? Here, it is important to recognise that:

1) banks and other firms in the financial sector are businesses that take risks, and risks that go wrong can result in failure. This implies that the financial sector will continue to suffer such dislocations in future
2) not all financial sector stress episodes result in a global financial crisis
3) stress in the financial sector can take different forms. It could emerge from within the sector or from outside
4) the authorities have multiple tools at their disposal, and policymakers will play a key role in ensuring that a financial sector stress does not morph into an economic crisis

Events over the past six months have demonstrated that firms in the financial sector will continue to run into trouble, but that these dislocations are manageable as long as the authorities are able and willing to intervene. That remains our central view, but there are risks to that view.

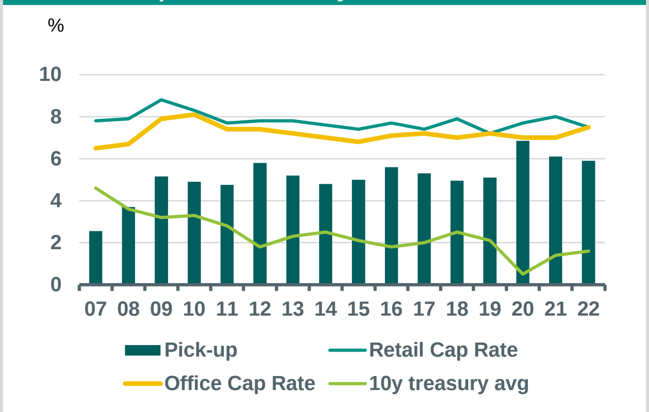
Let's start with the economic backdrop. Central banks have embarked on the most aggressive monetary tightening in decades. Economic activity has slowed, but inflation remains stubbornly high. The supply shocks that have created the divergence is different from the more common demand shocks, where growth and inflation tend to move in the same direction. This divergence is both unusual and uncomfortable for monetary policy.

What *has* been more usual is the response of asset prices to the monetary tightening cycle. House prices are falling in many advanced economies, and the commercial real estate sector is under pressure because of new working patterns in response to the pandemic as well as higher borrowing costs. US banks are exposed to an unrealised loss of USD620bn on securities held either for sale or held to maturity.

Box: US commercial real estate – more of a firecracker than a powder keg (Shanawaz Bhimji)

Large deposit withdrawals eventually led to the demise of SVB, Signature and Silvergate bank, small-sized US banks. With regional banks being large lenders in the commercial real estate (CRE) space, one could obviously ask to what extent they would be still willing to continue lending to the US commercial real estate companies given that they need to be more selective in how they manage available liquidity. Furthermore, a sudden halt of credit to the sector, like we had seen during the great financial crisis, would exacerbate the situation as borrowers would become forced sellers of properties. This would then result in even further tightening in lending, thereby becoming a downward spiral. Indeed, there are reports in the financial press mention another powder keg in the form of lending these regional banks have provided to commercial real estate companies. Especially since a significant amount of CRE borrowing will mature soon, while CRE borrowers are faced with their own troubles such as sky-rocketing borrowing costs which makes meeting return requirements difficult and curbs the sale of properties which have reached the end of the investment horizon. This obviously has bearing on CRE property values.

Decent risk premium held by US CRE

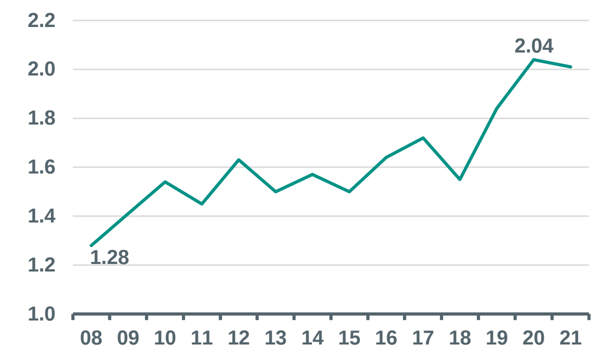


Source: REIS, Bloomberg, ABN AMRO Group Economics

Regarding CRE property values, we note that when comparing CRE property yields to the risk-free 10y Treasury rate, the pick-up had not come down during the period of monetary easing by the Fed, which was exceptionally accommodative during 2020 and 2021. This suggests that the rise in property values has been largely driven by rent growth. Hence, while we acknowledge that higher interest rates are bound to affect property valuations adversely, a significant drawdown in valuations would require a sharp decline in rents as well, which would require a severe recession in the US as well. This is not something we expect at the moment.

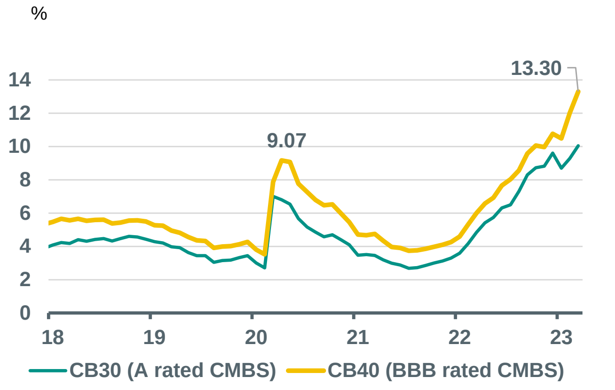
Secondly, we look into how CRE companies can deal with higher borrowing costs, since this will determine how the regional banks would still have appetite to refinance deals as they mature. If CRE borrowers are unable to service their total debt, bank risk officers would likely decline an extension and exacerbate the situation (as this would have knock-on effects on loan spreads as well). We do not avail of bank loan data, yet since banks are able to shift their CRE lending from their balance sheet to investors through a product called CMBS we assume that the loan fundamentals are roughly the same. We use Moody's data on the CMBS market to gauge the health of CRE borrowers. The chart on the left below shows the US CMBS market-wide debt service capacity ratio (DSCR).

CMBS DSCR has shot-up after the pandemic



Source: Moody's, ABN AMRO Group Economics, 2009 data not available

All-in borrowing costs for CMBS rose considerably



Source: ICE BofAML, Bloomberg, ABN AMRO Group Economics

A DSCR reflects to what extent interest expenses on a loan can be covered through net cashflows from rent. Obviously a reading below 1 would signal a default and therefore also discourage banks into refinancing. But the chart shows that the CRE borrowers have built-up a large headroom in DSCR since the great financial crisis, also driven by prudential underwriting standards. Such a buffer would help when interest rates go up and/or when rents are under pressure. We focus on the denominator effect and the chart on the right shows the all-in borrowing costs for single A and triple B rated CMBS tranches. We use these lower rated tranches to reflect the possible higher risks of CRE borrowers on bank loan books (remember these are the credit ratings on the secured loan and therefore take the mortgage and recovery in consideration). Clearly there has been a sharp rise in borrowing costs, and the yield now stand at levels well above what was incurred during the peak market sell-off in early 2020, and this is due to a combination of rise in risk free rates and credit spreads.

What would happen if we were to apply current borrowing costs, as shown in the right hand chart, to the lofty 2 times CMBS DSCR as recorded at the end of 2021? Luckily not all the debt that will mature will need refinancing at 13%, which will limit the decline in DSCR. According to the US Mortgage Banking Association, the total size of the US CRE debt market is $4.5tn, out of which $0.4tn (or 16%) will mature this year. Assuming that this maturity profile also applies at the regional banks, this would still imply that 84% of debt will continue to be serviced at the old coupon, which remains at low levels. Since we only have DSCR data available through the end of 2021 and the CMBS has a 4 year horizon, we take the average of the yield between 2018 and 2021 as a proxy for the old (meaning the debt that does not need refinancing) coupon. Based on the 2.0 times DSCR and this 4% old debt coupon we are able to proxy the level of underlying debt, which we will require to calculate the new total cost of debt and ultimately the new DSCR. We assume that cashflow from rents (the numerator in the DSCR) remains flat. The table below shows our calculations and how the DSCR evolves. If the scheduled 2023 maturities would need to be refinanced at today's CMBS rates, the DSCR falls from 2 to 1.6 times.

From the 2021 to the new DSCR

	Single A		BBB	
	2023 maturities	old debt	2023 maturities	old debt
Split in debt	16%	84%	16%	84%
Coupon	10%	4%	13%	5%
DSCR	2		2	
Old cost of debt (expressed per unit of DSCR)	1		1	
Debt size derived from old cost of debt and old coupon	25		19	
New cost of debt (expressed per unit of DSCR)	0.4	0.8	0.4	0.8
New DSCR	**1.6**		**1.6**	

Source: ICE BofAML, Bloomberg, Moody's, ABN AMRO Group Economics

While this would be a large correction, it would still reflect a healthy level of debt service capacity from a historical perspective (see the chart on the previous page). To summarize, there is still a significant proportion of older maturity loans with low coupons from which CRE borrowers can profit, which will helps in absorbing the blow from higher current market rates for US CRE companies. This analysis does however assume that we have a peak in rates in 2023 and that rates normalise starting in 2024 (which is our base case). Furthermore, we also assume a soft landing for the US economy from the rate hike cycle, which would therefore not drive down rents significantly.

These recent events demonstrate that the first line of a bank's defence, namely its capital and liquidity buffers, is vulnerable to bank runs that result from a loss of confidence. Could circumstances under this backdrop where the second line of defence is also breached? In our view, yes: a plausible scenario could be a wage-price spiral triggered, say, by a government that is tempted to 'fix' the ongoing cost-of-living crisis. Another possible scenario is stubbornly high inflation. The central bank would need to tighten monetary policy to anchor inflation expectations. Asset prices would fall as a result. A scenario such as this could also result in financial markets questioning the government's solvency and that in turn could widen sovereign risk premiums, resulting in higher borrowing costs for the government and a loss in asset prices more generally. *(Amit Kara)*

Eurozone: Underlying inflation not yet easing

Aline Schuiling – Senior Economist | aline.schuiling@nl.abnamro.com

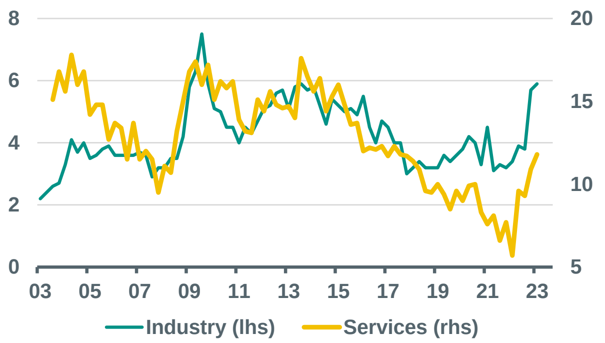
- **The eurozone economy is clearly slowing, but underlying inflation is not easing yet, with wage growth higher than expected in Q4. We still expect moderate contractions in GDP during the next few quarters, as the impact of interest rate hikes hits the economy**
- **After raising its policy rates by 50bp at the March meeting, the ECB dropped all guidance on future policy moves. It seems likely that the ECB's bias is still towards further rate hikes, assuming that market tensions and banking sector worries subside**

Eurozone GDP growth in 2022Q4 was revised lower, to 0.0% qoq, down from the first estimate of 0.1%. The details showed that private consumption and fixed investment plummeted (-0.9% and -3.6% qoq, respectively), whereas government consumption increased (+0.7% qoq). Net exports contributed positively to growth as well (0.9pps qoq), but this was due to a collapse in imports (-1.9% qoq), with exports broadly stable (+0.1% qoq). We expect GDP to contract moderately during most of 2023. Monetary policy tightening by the main central banks will reduce growth in global trade and eurozone exports, while fixed investment will probably decline as unit labour costs and borrowing costs jump higher. A rising percentage of companies report that financial circumstances are limiting the level of production (see graph below left). However, private consumption could be less negative than we thought in the first months of the year, as wage growth accelerates more than expected (hourly wages rose 5.1% yoy in Q4, up from 3% in Q3). We have revised our forecasts for consumption and GDP growth in Q1 slightly upward and now see GDP contracting by only 0.1% qoq. However, the labour market is expected to deteriorate in the course of the year, with unemployment rising. This should reduce wage growth and private consumption.

Headline inflation has dropped from a peak of 10.6% in October 2022, down to 8.5% in February 2023. The drop was entirely due to falling energy price inflation, with food price inflation and the core inflation rate still trending higher. Looking forward, we continue to see both headline and core inflation falling rapidly later in the year on the back of the decline in wholesale energy and food prices, as well as dissipating supply chain bottlenecks. Core inflation will probably be more sticky than the headline rate in the short-term, but should also ease going forward. The lagged impact of higher energy prices on the prices of goods and services should peter out in the coming months. It seems the only part of inflation that could rise somewhat further is services sector inflation, which could be pushed higher by rising wage costs on the back of the labour shortages that emerged in the sector after the pandemic. However, the economic slowdown is expected to limit overall wage growth, which should also reduce services sector inflation in the course of the year.

Interest rate hikes begin to bite

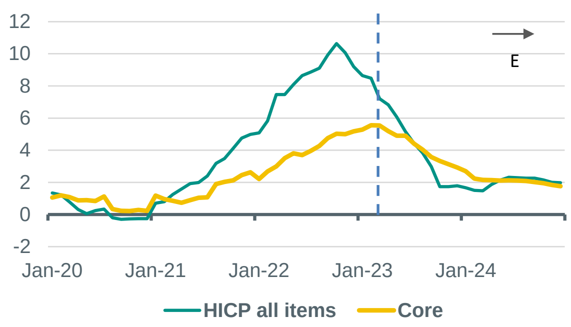
EC Survey: Factors limiting production – Financial



Source: European Commission, ABN AMRO Group Economics

EZ headline inflation to fall faster than the core rate

% yoy



Source: Refinitiv, ABN AMRO Group Economics

At its March meeting, the ECB hiked its key policy rates by 50bp, while dropping all guidance on future policy moves. It seems that the ECB's bias is still towards further rate hikes, at least if its baseline scenario plays out and financial market tensions continue to ease. Our baseline sees the deposit rate peaking at 3.75% in June, before a rate cut cycle begins in December and continues during 2024.

NL: Provincial elections loss is a blow to Coalition plans

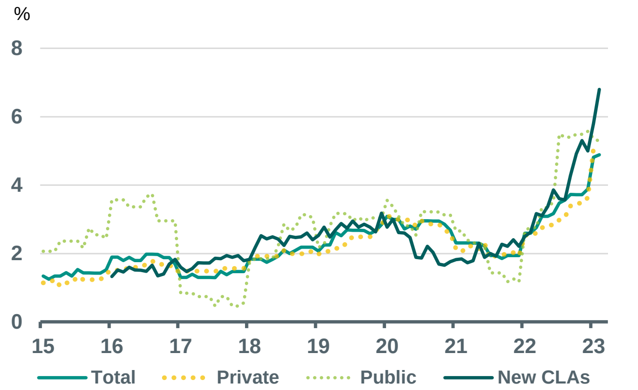
Jan-Paul van de Kerke – Economist | jan-paul.van.de.kerke@nl.abnamro.com
Aggie van Huisseling – Economist | aggie.van.huisseling@nl.abnamro.com

- **We continue to expect below consensus growth as a Eurozone recession and monetary headwinds suppress external and internal demand**
- **We expect annual growth to slow to 1.2% in 2023 (from 4.5% in 2022)**
- **Recent activity data show risks to our near term view are to the upside. In contrast, risks in the medium term are to the downside, given the banking turmoil and strains on the credit channel**
- **A thumping electoral victory by the BBB is a blow to Coalition plans, possibly intensifying the construction gridlock instigated by binding nitrogen norms**
- **We expect a further cooling of headline inflation but an ongoing broadening of price pressures to core. HICP is expected to average 4.7% in 2023 and 4.1% in 2024**

On 15 March Dutch provincial elections were held, which determine the makeup of the senate. The loss for the current coalition proved to be even bigger than expected, with a larger-than-polled win for the new Farmer-Citizen Movement (BBB). The relatively new party, founded four years ago, is expected to become the largest party in the senate, with 17 out of 75 seats. The Coalition, which consists of four parties, lost 10 seats. The main goal of the BBB is to relax the government's environmental policies, and with their large new mandate, changes to these policies are expected. In our view, this risks further delays to solving the nitrogen crisis, as legally binding nitrogen norms will continue to inhibit construction, mainly of housing and infrastructure. This is likely to derail ambitions of the government regarding the construction of houses and other government investment.

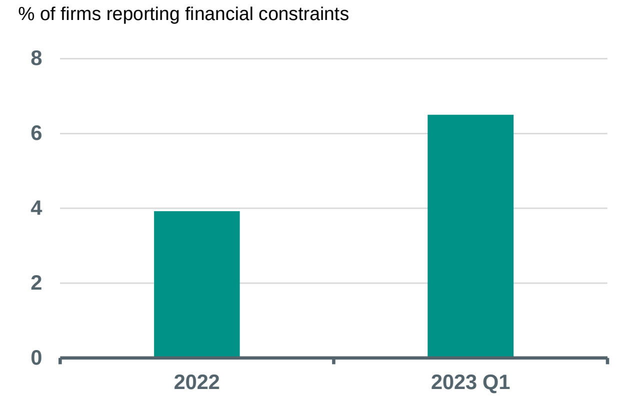
Recent activity data suggest the economy has been resilient moving into 2023. Private consumption declined somewhat in January from the December highs, but remained firm despite the ongoing broadening of inflation. Spending at the start of the year was supported by a number of factors; pension funds have indexed benefits in January by on average 7% (20% of the population receives pensions), the minimum wage – and linked to that social security – increased in January by 10%, boosting purchasing power. Next to that, employment growth is still positive. Fixed tangible investment has not yet shown concrete signs of weakening, despite higher lending costs and tightening credit conditions. These factors mean near term activity may be higher than currently expected. However, signs of a significant weakening of activity over the course of 2023 remain present, with the recent banking turmoil – which risks further dampening the credit channel (see this month's *Global View*) – may increase headwinds.

Wage growth accelerates, with more to come



Source: CBS, AWVN, ABN AMRO Group Economics

Financial constraints on the rise



Source: CBS, ABN AMRO Group Economics

Indeed, we expect growth to slow over the course of 2023, given that: 1) the blow to purchasing power will not be fully offset by government support and wage growth, 2) external demand is cooling, and 3) the impact of monetary policy tightening will be increasingly felt over the course of this year. Thus far, the effects are limited, with modest increases in the number of Dutch firms experiencing financial constraints. However, bigger increases are visible in interest rate sensitive sectors such as construction and real estate. As rate hikes by the ECB are ramped up further (to a peak of 3.75% in June) and higher rates filter through to the economy, these effects will intensify. Despite the expected weakness, however, we continue to expect the Dutch economy to outperform the eurozone throughout the year and grow by 1.2% in 2023 and 1.3% in 2024.

US: Further pain needed to bring inflation back to target

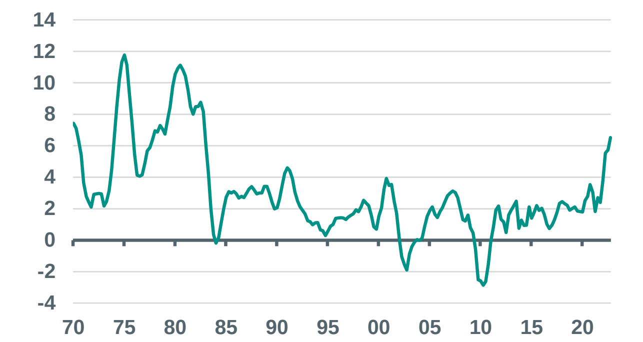
Bill Diviney – Senior Economist | bill.diviney@nl.abnamro.com

- **Following months of improvement, pipeline inflationary pressures are building once again**
- **With the recent financial market turmoil easing somewhat, this makes it more likely that the Fed will raise rates a bit further – and keep rates high for longer – to be sure that inflation falls back to 2%**
- **Tighter financial conditions have led us to downgrade our growth forecasts**

The news on the inflation front has – for the most part – not been good over the past month. Aside from upside surprises to inflation itself, indicators for a number of pipeline pressures worsened, following months of sustained improvement. On the goods side, wholesale used car prices have rebounded sharply, meaning goods disinflation is likely to come to an end in the March CPI report. Bad news was also evident in new housing lease data, with rents also rising again (albeit modestly so far). Finally, the labour market continues to be more resilient than we expected at this point in the cycle, and although nominal wage growth remains well behaved, falling productivity is pushing unit labour cost growth higher – to 6.3% yoy in Q4, which was a sharp upward revision from the 4.5% in the preliminary estimate. It was not all bad news: producer price inflation unexpectedly declined in February, while falling global energy prices – driven by recession fears – are also still supportive of the disinflationary trend. Indeed, we still expect annual inflation to continue declining over the coming months. However, the recent resurgence in certain goods, rents and labour costs does raise the risk that the landing zone could be higher than the Fed's 2% target.

Unit labour cost growth jumps to a four-decade high

% yoy, 4-quarter moving average



Source: Refinitiv, ABN AMRO Group Economics

New lease data suggests rents are picking up again

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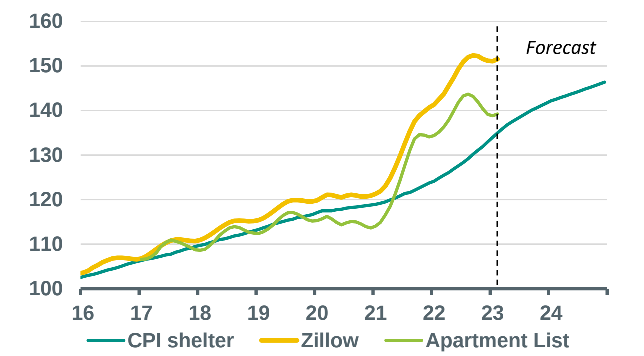


Source: Refinitiv, ABN AMRO Group Economics

Against this backdrop, the near-term growth outlook is looking more positive than we previously thought, but the medium-term growth outlook has darkened. For Q1, the Atlanta Fed's *GDPNow* tracker stands at 3.2% annualised as of 24 March, driven by a sharp rebound in consumption in January, as well as an unexpected recovery in home sales and homebuilding. On consumption, we are sceptical that the strength will survive revisions (strong initial reads on consumption in Q4 were later revised down significantly), while a pickup in the savings rate suggests consumers are reaching a limit in how they can accommodate high inflation by using excess savings. There remains significant excess savings sitting on household balance sheets, but much of this is skewed to higher income groups, leaving lower income groups with little choice but to cut back on consumption in response to high prices. And the headwinds are only likely to get worse: even if the current tightness in financial conditions eases, the Fed is likely to continue tightening policy, as it actually needs to generate some economic weakness (and a rise in unemployment) in order to be sure that it will bring inflation back to its 2% target. Taking all of this together, while we have raised our Q1 GDP forecast, we have lowered our forecasts for subsequent quarters; this leaves our growth forecast at 0.7% for 2023, while for 2024, we lower our forecast to 1.6% from 2.0% previously.

One of the main drivers for our growth forecast downgrade is that we now expect a higher peak in the fed funds rate, and a later start in rate cuts. This assumes, importantly, that financial conditions ease again, and that there will be no sustained turmoil in financial markets that triggers a significant pullback in credit growth (see this month's *Global View*). We now expect one more 25bp hike, leaving the fed funds rate at 5.00-5.25% by May, with rate cuts to start in December – one quarter later than our previous September expectation. See our Fed Watch for more.

China: Recovery broadens, with property sector bottoming out

Arjen van Dijkhuizen – Senior Economist | arjen.van.dijkhuizen@nl.abnamro.com

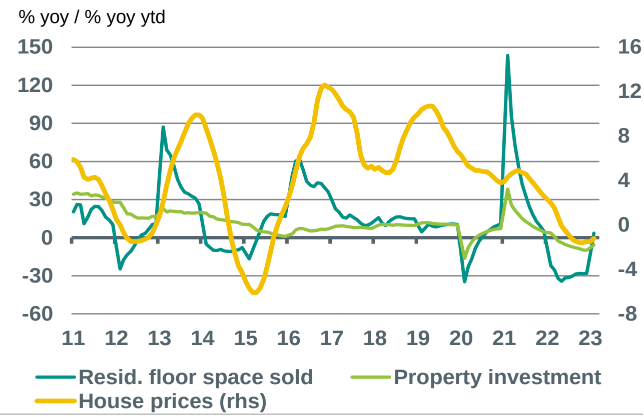
- **Growth target for 2023 of 'around 5%' in line with our expectations**
- **China's reopening rebound broadens, with retail sales firming and the property sector bottoming out**
- **Support to remain targeted/piecemeal, as Beijing aims to contain leverage and prevent overheating**

At the National People's Congress (NPC) early this month, the 2023 growth target was set at 'around 5%'. This was in line with our expectation, but a bit below consensus ('above 5%)'. Meanwhile, Beijing's 'around 5%' target is close to our forecast of 5.2%. Another impression gained from the NPC is that policy support will be kept piecemeal and targeted rather than abundant/aggressive, as Beijing wants to keep overall leverage in check and avoid the overheating issues that arose after China's rapid rebound following the original Covid-19 shock in 2020. The main risks to the outlook include: the slowdown in external demand, with recent bank turmoil in the US and Europe underlining the fall-out from unprecedented sharp rate hikes, and rising US-China tensions on tech, Taiwan and China's position versus Russia – see also this month's *Spotlight*.

China's reopening rebound broadens

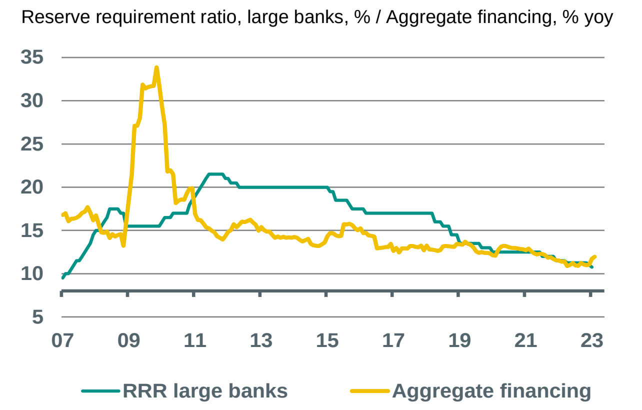
PMI and activity data published recently are in line with our view that China's economic rebound resulting from the rapid Zero-Covid exit initiated in December 2022, is gaining strength and broadening. The rebound is led by the services sectors, which were hit the most by the combination of Omicron flare-ups and strict containment policy. This was illustrated by the February PMIs published early this month, with the services PMIs rising far above the neutral 50 mark. The latest activity data also showed improvement. Retail sales growth accelerated to +3.5% yoy in January/February (December: -1.8% yoy), confirming that private consumption, which was lagging during the pandemic, has the most catch-up potential. The fact that the property market, one of the key drags on the economy last year, is bottoming out, is also important in this respect. This is partly facilitated by more targeted support, coupled with the positive effects of the Zero-Covid exit. Residential property bounced back strongly in January/February, showing annual growth of 3.5% again for the first time since December 2021. Another sign of stabilisation is the turn in home prices, at least in the largest cities. Related to this is a cautious improvement in consumer confidence since the abandonment of Zero-Covid, though confidence remains at relatively weak levels for now.

China's property market shows signs of bottoming out



Source: ABN AMRO Group Economics, Refinitiv

PBoC cuts bank RRRs again to help lending recover



Source: Refinitiv

Policy support to remain targeted and piecemeal, as Beijing still wants to contain leverage and prevent overheating

The policy proposals communicated at the NPC are in line with our view that Beijing will keep support 'piecemeal' and targeted rather than abundant/agressive. The formal budget deficit target was raised to 3.0% of GDP in 2023 (2022: 2.8%), with the broader consolidated deficit expected to be kept at around 7.5% of GDP. Infrastructure investment – typically used by Beijing as an instrument to 'lean against the wind' – will likely slow again, now that the economy is stabilising. On the monetary policy front, the inflation target was kept unchanged at 3%, with piecemeal easing and targeted support to safeguard liquidity and special lending programmes likely being maintained. The recent 25bp cut in bank reserve requirement ratios – in line with our expectations – also fits within this piecemeal easing approach. Specific policies to support consumption will also remain on the menu, as illustrated by recent measures taken at the local level to boost car sales.

Spotlight: China-Russia trade complicates US-China relationship

Arjen van Dijkhuizen – Senior Economist | arjen.van.dijkhuizen@nl.abnamro.com

- **Outlook global trade mixed: Slowdown developed economies versus reopening China**
- **Shifting patterns: Russian trade ties with West shrink, but those with other BRICs strengthen…**
- **…and this complicates the already tense relationship between the US and China**

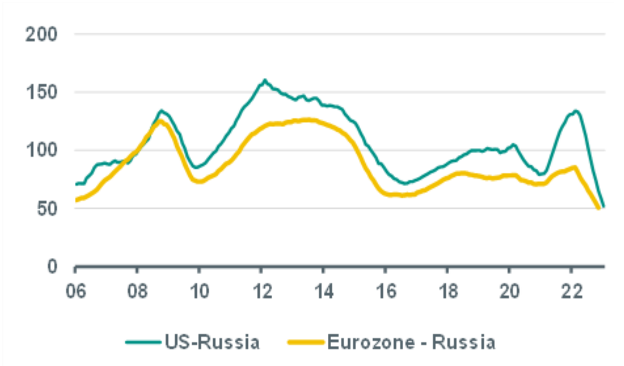
Global merchandise trade slowed materially in Q4-2022, with the CPB's World Trade index, measuring goods trade in volume terms, dropping by 2.1% qoq and 0.2% yoy. This reflects the combination of 1) a slowdown in many advanced economies, impacted by the surge in inflation and unprecedented sharp monetary tightening, and 2) renewed disturbances in China stemming from pandemic outbreaks and a broadening of lockdowns, followed by an abrupt and messy Zero-Covid exit starting in December. Going forward, we expect annual growth in global trade to be subdued this year, more or less halving compared to the pace of 3.2% reached in 2022. The outlook is mixed, as the expected further slowdown in developed economies will be offset by the impact of China's reopening. Meanwhile, global supply bottlenecks and supply-demand imbalances for goods have faded, partly driven by the demand side (see our recent global trade update for more).

Shifting patterns: Trade ties between Russia and West shrink, but Russian ties with other BRICs strengthen

Due to the stepping up of sanctions and the reduction of energy flows, bilateral trade between Russia and the US/eurozone clearly came down during 2022, and a further reduction is likely. The West's withdrawal from Russia has gone hand in hand with a stepping up of bilateral trade between Russia and the other BRIC countries. Although this partly reflects the impact of higher energy prices, this suggests that energy flows between Russia and these other large EMs have held up well. While this helped to contain the upward pressure on global energy prices, it also poses new risks, particularly to the (trade) relationship between China and the US (see below). China stands out among the BRICs given the size of its trade with Russia (which is quite natural between two large, neighbouring countries), but also reflecting its importance for Russia as a key buyer of energy and an important seller of so-called 'dual-use' technologies such as semiconductors and drones.

Trade between Russia and West is shrinking…

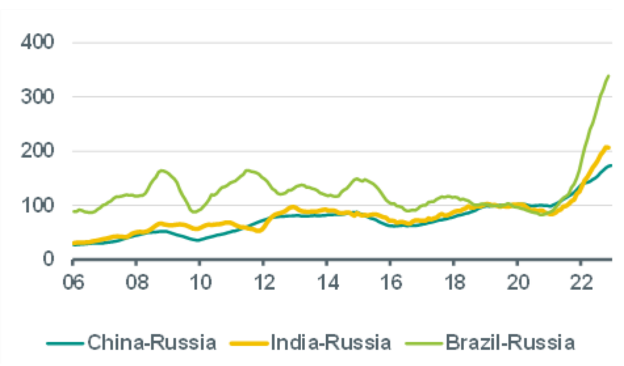
Bilateral trade values, 12 months' rolling indices, average 2019 = 100



Source: ABN AMRO Group Economics, Bloomberg, Refinitiv

…while Russian trade ties with other BRICs strengthen

Bilateral trade values, 12 months' rolling indices, average 2019 = 100



Source: ABN AMRO Group Economics, Bloomberg, Refinitiv

…and this complicates the already tense relationship between the US and China

China's intense trade ties with Russia complicates the already tense relationship with the US/West. The US has made clear that it will not accept China selling lethal military equipment to Russia, and has threatened with unspecified consequences if it does. Apart from this 'red line', a related question is how the US will react if China's role as Russia's key off-taker and supplier keeps expanding, with president Xi just having visited Moscow to discuss China's peace plan amongst other things. This issue comes on top of tensions over recent balloon incidents, Taiwan and technology, with the US having broadened its alliance to restrict the exports of advanced semiconductors and related machines to China with countries such as the Netherlands and Japan. Notwithstanding these tensions, trade between the US and China has clearly picked up from the trough seen after the bilateral trade war and the pandemic, while the annualised US bilateral trade deficit versus China has moved back towards the record levels seen in 2018.

Key views on a page

The easing energy crisis in Europe is leading to more shallow expected recessions in the eurozone and UK, but the recent banking turmoil poses new risks to the outlook. Consumption will continue to be weighed by falling real incomes, and the impact of monetary tightening is being increasingly felt – with housing markets clearly correcting on the back of the surge in mortgage rates. China's exit from Zero Covid is offsetting the slowdown in advanced economies to some extent, but it may also slow the global disinflation process. While headline inflation has begun to trend lower, stubborn underlying inflationary pressures means the Fed, ECB and BoE are likely to continue raising rates in the near term.

Macro	Central Banks & Markets
Eurozone – GDP was stable in 2022Q4. Private consumption and fixed investment collapsed, with growth supported by government spending and a drop in imports. The impact of past and upcoming interest rate hikes will increasingly be felt. We expect GDP to contract moderately during most of 2023. Underlying inflation has not eased yet and wage growth accelerated faster than expected in Q4. Headline inflation will fall rapidly this year due to drops in wholesale energy and food prices as well as dissipating supply chain bottlenecks. Core inflation will be more sticky in the short-term, but should also ease going forward.	**ECB** – The ECB raised the deposit rate by 50bp in March. It dropped all guidance on future policy rate moves. It seems likely that the ECB's bias is still towards further rate hikes, at least if its baseline scenario plays out and financial market tensions stabilise. Our baseline scenario sees the ECB policy rate peaking at 3.75% before a rate cut cycle begins in December and continues during 2024. In case financial market tensions and worries about the banking sector were to escalate, the central bank would probably use other instruments such as liquidity support and asset purchases, instead of amending its rate policy in first instance.
Netherlands – GDP growth of +0.6% qoq surprised to the upside and reflects an easing energy crisis, government support and strong employment growth. We expect further cooling of headline inflation but ongoing broadening of price pressures to core. We raised our inflation forecasts (HICP) to 4.6% in 2023 and 4.1% in 2024. The labour market is expected to soften, but overall tightness is here to stay. Given still elevated inflation, softening external demand and increasing monetary headwinds, we expect annual growth to slow considerably to 1.2% in 2023 (from 4.5% in 2022).	**Fed** – The FOMC raised the fed funds rate by 25bp in March. We expect another 25bp hike in May, but this is conditioned on worries over the banking sector easing. Our base case is that by December, the Fed will be ready to start pulling back from the current highly restrictive policy stance. Following an initial 25bp cut, we expect the cut 25bp at each of the eight meetings in 2024, taking rates back to near neutral levels by end-2024. The risks to this forecast are two-sided: a renewed tightening of financial conditions could bring forward rate hikes, while a rapid easing of conditions could mean further rate hikes.
UK – While the easing energy crisis will soften the blow to household real incomes, the tax burden is set to rise significantly over the coming year. The UK may dodge a recession but the economy is expected to remain weak. The medium term outlook will critically depend on the evolution of labour productivity which remains weak. CPI inflation has rebounded, and wage inflation remains elevated. The risk to inflation is skewed to the upside because of a structural shortage of workers and public sector unrest.	**Bank of England** – The continued risk of a wage-price spiral in the UK led the MPC to hike Bank Rate by a further 25bp at the March meeting to 4.25%. MPC decisions over the next few months will be highly sensitive to financial market developments and incoming data. In our view, the economic weakness that is evident in the activity and employment data will start to exert downward pressure on wage growth. We believe that the MPC will pause for the coming meetings and reverse course towards the end of this year, with the year-end policy rate at 3.5%.
US – The US consumer exhibited surprising resilience for much of 2022, but the twin headwinds of falling real incomes and dwindling excess savings are exerting a bigger drag on consumption. Investment is also expected to remain weak in the near term on tightening credit conditions. Pipeline inflationary pressures have rebounded, while labour hoarding persists. We still expect the NBER to declare a recession later this year. Inflation is expected to continue falling, but there is significant uncertainty over where inflation will settle given labour shortages and residual supply/demand imbalances in the economy.	**Bond yields** – Following recent market turmoil, the market made major adjustments in the yield curves. However, we judge market repricing of the Fed and ECB rate to be overdone and thus, expect some rate hikes to be priced back in. This will lead to a rebound in rates (particularly ST rates) in the near term before returning to a downtrend in the second part of the year. Both central banks would have reached their peak while the recession will weigh on ST rate expectations putting further downward pressure on rates. The 10y UST and Bund yield is expected to reach 3.25% and 2.10% respectively by the end of this year.
China – The 2023 growth target of 'around 5%' adopted at the NPC in early March is in line with what we expected, and with our growth forecast of 5.2%. We expect policy support to be kept piecemeal and targeted rather than abundant/aggressive, as Beijing wants to keep leverage in check and prevent overheating. Meanwhile, the reopening rebound is broadening, with the property sector showing more signs of a bottoming out. Main risks: the slowdown in external demand and rising US-China tensions on tech, Taiwan and China's position versus Russia.	**FX** – We have adjusted our forecasts in EUR/USD following our changes in Fed view and ECB view. As we pushed out most of the Fed rate cuts to 2024, we think there is less upside in EUR/USD in the near-term. Therefore we lower our EUR/USD forecast for the end of 2023 to 1.10 from 1.12. We keep year-end 2024 forecast of EUR/USD at 1.16 though, because of the larger amount of rate cuts we expect for the Fed compared to the ECB in 2024.

Main economic/financial forecasts

GDP growth (% yoy)	2021	2022	2023e	2024e	Inflation (%)	2021	2022	2023e	2024e
United States	5.9	2.1	0.7 ↓	1.6	United States	4.7	8.0 ↑	3.8 ↑	2.3
Eurozone	5.3	3.5 ↑	0.0	0.9	Eurozone	2.6	8.4 ↑	4.9	2.1
Japan	2.2	1.0 ↓	1.1	1.2	Japan	-0.2	2.5 ↑	2.3 ↑	1.3
United Kingdkom	7.6	4.0 ↑	0.1 ↑	1.7	United Kingdkom	2.6	9.1	6.4 ↑	2.1
China	8.4	3.0	5.2	5.2	China	0.9	2.0	2.5	2.5
Netherlands	4.9	4.5	1.2	1.3	Netherlands	2.8	11.6	4.6	4.1
Policy rate	**24/03/2023**	**+3M**	**2023e**	**2024e**	**10Y interest rate**	**24/03/2023**	**+3M**	**2023e**	**2024e**
Federal Reserve	5.00	5.25 ↑	5.00 ↑	3.00	US Treasury	3.38	3.75 ↑	3.25 ↑	3.00
European Central Bank	3.00	3.75 ↑	3.50 ↑	2.00	German Bund	2.13	2.55 ↑	2.10 ↑	1.90
Bank of Japan	-0.10	-0.10	-0.10	0.00	Japanese gov. bonds	0.29	0.55 ↑	0.65 ↑	0.75
Bank of England	4.25	4.25 ↑	3.75 ↑	3.00	UK gilts	3.28	3.00	2.60	2.20
People's Bank of China	3.65	3.60	3.60	3.60					
Natural resources	**24/03/2023**	**+3M**	**2023e**	**2024e**	**Currencies**	**24/03/2023**	**+3M**	**2023e**	**2024e**
Brent - Oil USD/barrel	75.0	80	90	100	EUR/USD	1.08	1.08 ↓	1.10	1.16
WTI - Oil USD/barrel	69.3	75	85	95	USD/JPY	130.7	131	128	124
TTF - Gas EUR/MWh*	59.1	45 ↓	55 ↓	50	GBP/USD	1.22	1.23	1.25	1.28
					EUR/GBP	0.88	0.88 ↓	0.88	0.91
Gold - USD/oz	1,978	1,900	1,900	1,900	USD/CNY	6.87	6.80	6.70	6.50

Source: Refinitiv, Bloomberg, ABN AMRO Group Economics * Brent, WTI: avctive month contract; TTF: next calender year (avg)

Macro Research Team

Sandra Phlippen, Chief Economist | sandra.phlippen@nl.abnamro.com
Aggie van Huisseling, Economist | aggie.van.huisseling@nl.abnamro.com
Aline Schuiling, Senior Economist | aline.schuiling@nl.abnamro.com
Amit Kara, Senior Economist | amit.kara@nl.abnamro.com
Arjen van Dijkhuizen, Senior Economist | arjen.van.dijkhuizen@nl.abnamro.com
Bill Diviney, Senior Economist | bill.diviney@nl.abnamro.com
Jan-Paul van de Kerke, Economist | jan-paul.van.de.kerke@nl.abnamro.com
Nick Kounis, Head of Financial Markets Research | nick.kounis@nl.abnamro.com

FX & Rates Research

Georgette Boele, Senior FX & Precious Metals Strategist | georgette.boele@nl.abnamro.com
Sonia Renoult, Rates Strategist | Sonia.renoult@nl.abnamro.com