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Global Monthly

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When will inflation get back to 2%?

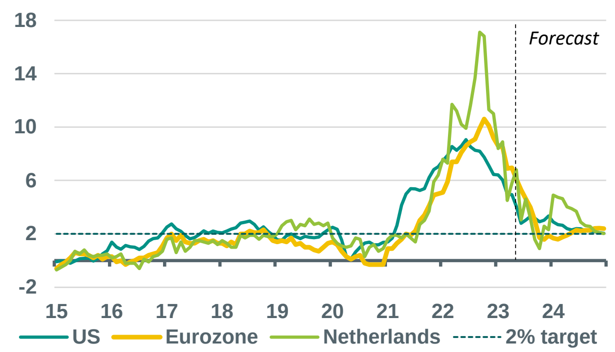
- **Central banks are well on their way to restoring price stability, with inflation rates roughly halving from their peaks over the past year. Inflation is likely to be back near 2% over the coming year or so**
- **However, we think the next stage of disinflation will not be as pain-free as the initial stage, and the normalisation in services inflation is likely to be slower and bumpier than the disinflation so far**
- **A fall in services inflation will likely also require weaker labour markets and a rise in unemployment**
- **Spotlight: We explore the idea of *greedflation* and how it may have contributed to the inflation surge**
- **Regional updates: The *eurozone* has entered a recession, and we expect this to continue in the coming quarters; this external weakness is being increasingly felt in *the Netherlands***
- **We now expect a *US* recession to start in Q4, with Fed cuts also delayed to next March**
- **As *China's* recovery has lost momentum, the authorities are stepping up support**

Global View: A rise in unemployment will likely be needed to get inflation sustainably back to 2%

We have come a long way from the great inflation scare of 2021-22. Inflation peaked in the US last June, at 9.1%, and in the eurozone at 10.6% in October. Since then, inflation has plummeted almost as fast as it surged, by some 5 percentage points in the US and by a similar magnitude in the eurozone. The rapid pace of disinflation – which has so far occurred without a calamitous downturn – gives cause for optimism that a so-called 'immaculate disinflation' (inflation returning to 2% without significant economic harm) may be possible after all. While we do not expect a deep economic downturn, we do think that the disinflation still to come will not be as painless as the initial phase. When it comes to headline inflation, we think central banks may hit (or get close to) their 2% targets relatively soon – within the next six months for eurozone, and within a year for the US. But as data from the UK reminded us this week, the decline in core – particularly services – inflation is likely to be slower and subject to greater uncertainty, given that this will also depend on a cooling in the labour market. Indeed, we continue to think that more weakness in the economy, and a rise in unemployment rates, will be necessary to bring inflation sustainably back to 2% targets. And where excess demand proves to be more stubbornly resilient, such as in the UK or here in the Netherlands, we see inflation holding more persistently above central bank targets.

Inflation is on its long descent back to 2%…

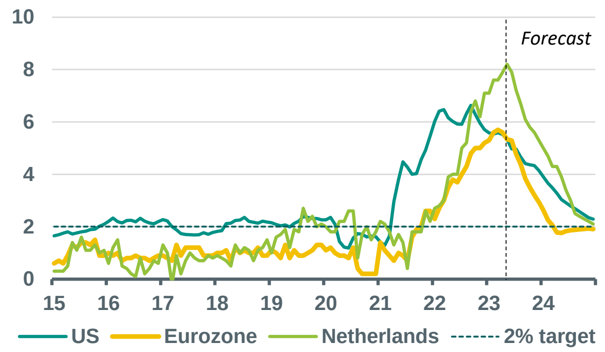
Headline inflation measures, % y/y



Source: Bloomberg, ABN AMRO Group Economics

…but the fall in core inflation will be more gradual

Core inflation measures, % y/y



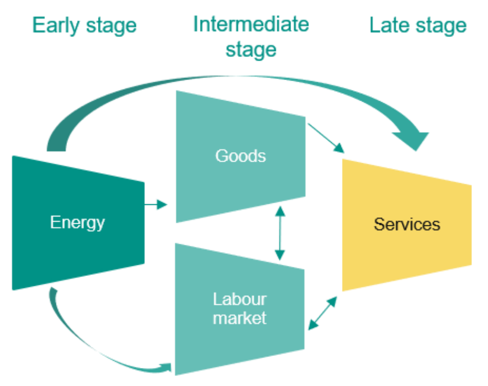
Source: Refinitiv, ABN AMRO Group Economics

Disinflation so far: An energy and goods story

So far, the fall in inflation has been driven by the same factors that led to the initial surge: energy and goods. Falling oil prices have been a persistent drag on inflation since last June, and in the US, energy has been making an outright negative contribution since the turn of the year. In the eurozone, the energy disinflation came much later because of the unique contribution from the energy crisis, which the US was largely unaffected by, but here too energy inflation has been on a steep decline since late last year, and is now just starting to make a negative contribution.

The second stage of the disinflation – in goods – is now fairly advanced in the US and is just picking up steam in the eurozone. In the US, goods inflation had been driven largely by (used) cars, which have since seen price declines as supply chains have normalised. In the eurozone, goods inflation has been driven by pass-through from the jump in natural gas and electricity prices, and this category is now starting to see inflation declines reflecting the collapse in energy prices. More broadly, the normalisation in global supply bottlenecks is helping to lower imported goods inflation – for instance by a collapse in freight costs and a much-improved supply/demand balance in manufacturing. Food price inflation is also finally easing, reflecting the lagged pass-through from lower wholesale prices (which peaked at the outbreak of the Russia-Ukraine war), though in the eurozone, more energy/labour-intensive processed food inflation remains somewhat elevated.

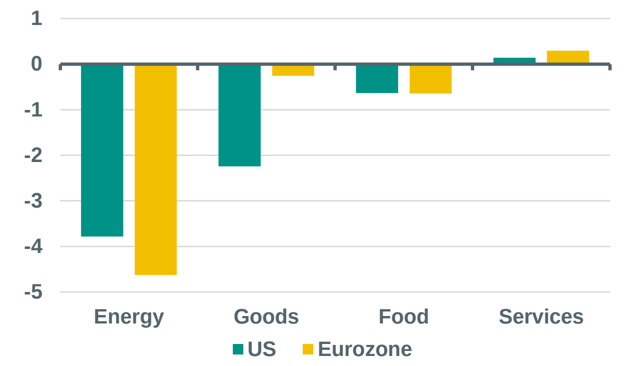
The stages of (dis)inflation



Source: ABN AMRO Group Economics

Disinflation so far concentrated in energy and goods

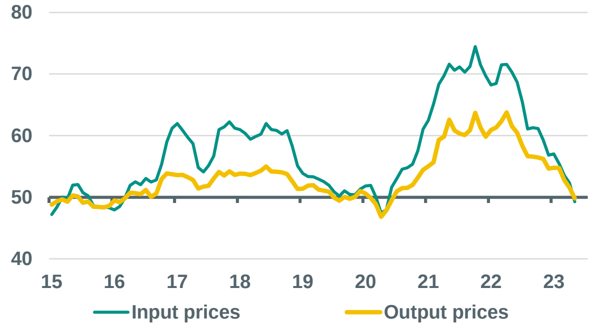
Energy/goods/food = change in pp contribution to inflation from the peak
Services = Change since December (services has yet to convincingly peak)



Source: Refinitiv, ABN AMRO Group Economics

Cost-push price pressures in global industry are fading

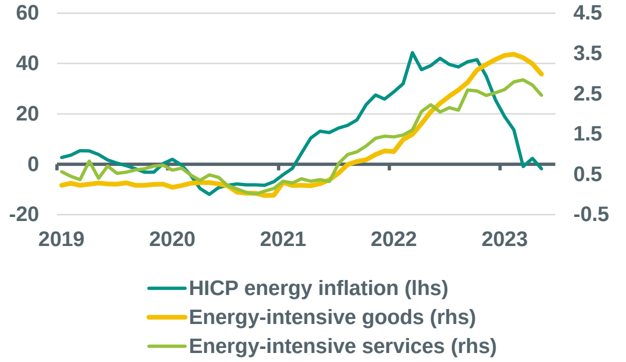
Global manufacturing PMI, sub-indices, 50 = neutral mark



Source: Refinitiv, ABN AMRO Group Economics

Energy intensive goods & services inflation is peaking

Eurozone inflation measures, % y/y



Source: Refinitiv, ABN AMRO Group Economics

Where inflation remains a challenge: Labour market and services

As is often noted by central bankers, tight labour markets have so far not been much of a driver of inflation. But this says nothing of the future. Just as energy and goods disinflation trends intensify, we now see the labour market becoming a more significant driver of inflation, mainly in the services sector. This is important, because unlike volatile energy and goods inflation, services inflation tends to move much more slowly and so is more likely to persist. Services inflation encompasses a broad mix of categories, and – particularly in the US – it is driven by many factors other than just the labour market (see Box 1). But broadly speaking, the longer-term driver of most categories of services inflation is unit labour cost growth: that is, wage inflation adjusted for gains in productivity. And it is here where inflationary pressure is still building. Nominal wage growth is showing some signs of peaking – at least in the US and at the **eurozone aggregate** level (the Netherlands and **the UK** are notable exceptions) – likely due to a cooling off in inflation expectations as energy and goods inflation has fallen back[1]. However, unit labour cost growth has accelerated, largely due to continued strong jobs growth, which has persisted despite the weakening in aggregate demand. This has led to a collapse in productivity.

How will businesses respond to the jump in unit labour costs: with layoffs or price rises?

So far at least, businesses appear to be passing on higher unit labour costs by raising prices (particularly in labour-intensive services where demand is more resilient), and in future they may accept some lowering of profit margins (see this month's ***Spotlight***). We think this will prove unsustainable. With interest rates expected to remain relatively high over the coming year, we expect weakness in aggregate demand to persist, and for this to ultimately drive a rise in layoffs and in the unemployment rate. This should lead to a recovery in productivity, and – given that this will also ease some of the labour market tightness we have seen – this should also further dampen nominal wage pressures. Taken together, we expect this to drive a fall in unit labour cost growth, and over time to lower services inflation back to more normal levels.

With that said, there is a risk that the experience of the post-pandemic period continues to make employers hesitant to let go of workers, out of the fear that it will be hard to find replacements once the economy starts to recover again, i.e. what economists refer to as *labour hoarding*. If unemployment fails to rise over the coming year, we think central banks may have to raise interest rates even further to dampen demand, and/or the rate cuts we currently expect to take place late this year in the eurozone and next year in the US could be delayed.

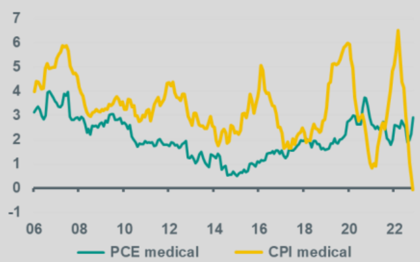
Box 1: US services inflation – mind the CPI-PCE gap (Bill Diviney)

Services inflation is a complex beast in the US, partly due to the unusual dominance of housing (or shelter, which makes up 34% of the CPI basket compared with just 5.6% of eurozone the HICP basket), but also medical services (which is 8% of the CPI but 16% of the Fed's preferred PCE inflation measure). Both housing and medical services behave very differently to many other services inflation categories, and are driven less by labour costs but more idiosyncratic factors.

Housing tends to be driven by supply/demand balance in the rental market, though there is also a cyclical component linked to wage growth (that is, higher wage growth can lead to a 'bidding up' in rents, particularly in a supply-constrained market). New lease rents surged following the first lockdown reopening period in mid-2020, but the way rents feed through to the CPI (which captures the entire market, not only new leases) means that this raised inflation with a very long lag. As such, although new lease rent rises peaked already in late 2021, we are now only just starting to see the peak in US inflation measures. Housing inflation in the US is now likely to gradually trend lower over the coming year. However, the housing shortage in the US raises the risk that housing inflation could settle at a higher level over the medium term – particularly if higher nominal wage growth allows for this.

For medical inflation, the story is even more complex, due to methodological differences between the CPI (which gets the most attention in financial markets as it is more timely) and the PCE (the Fed's preferred measure). Aside from having a higher weight in the PCE index, medical inflation has been much higher in the PCE than in the CPI, due to the unusual method with which medical inflation is measured in the CPI. For the CPI, the Bureau of Labor Statistics uses retained earnings data from health insurers to estimate price changes, but this is only updated once per year in September/October. This causes volatility in the series from year to year that is not apparent in the PCE data. Aside from the increased breadth of the PCE series, we think this is likely another reason the Fed prefers to use the PCE measure of inflation.

CPI medical inflation is much more volatile than PCE medical inflation (% y/y)



What does all of this mean for inflation and the Fed? A number of market observers have noted recently that the core services CPI excluding shelter has been trending lower recently. But this has been largely due to the unusual drag we are seeing from medical inflation – something that is likely to be reversed when insurer earnings are updated in the Autumn. Inflation in other services categories has, if anything, accelerated in recent months. Given this, we think the core services CPI data is giving a misleadingly benign impression of what is actually going on with services inflation in the US. While we do expect services inflation to normalise over time, we continue to think this is going to require some rise in the unemployment rate – as we argue below.

[1] Much of the rise in nominal wage growth – particularly in the eurozone – is likely attributable to the jump in energy, goods and food inflation, where tight labour markets enabled workers to bargain for wage gains that make up for their loss of purchasing power. Given this, it is likely that the fall in inflation in these categories will dampen at least some of the wage pressures.

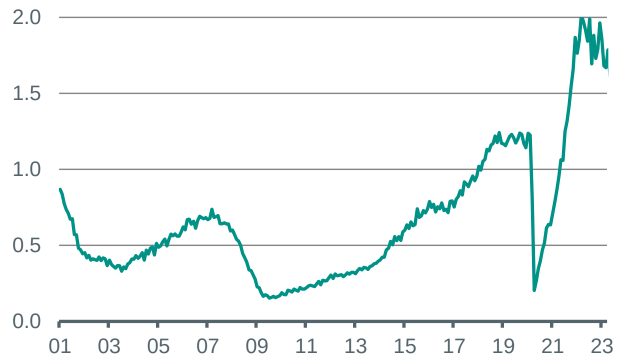
Can labour market tightness be resolved without a rise in the unemployment rate?

A key driver of elevated unit labour cost growth is the rise in nominal wage growth. While wage growth looks to be peaking, persistent labour market tightness in the US and parts of the eurozone could mean wage growth settles at a higher level than before the pandemic. This in turn raises medium term inflation risks. A **recent paper** by Olivier Blanchard and Ben Bernanke – one that is likely to prove influential among central bankers – argues that although tight labour markets were not responsible for the initial rise in inflation, they are likely to play a bigger role in inflation going forward, and that *"controlling inflation will thus ultimately require achieving a better balance between labour demand and labour supply."*

One issue the Bernanke-Blanchard paper homes in on is the role of excess demand indicators such as job vacancies (and the ratio with unemployment). This, they argue, gives a better read on the labour supply/demand balance than the unemployment rate alone. To illustrate why: the US unemployment rate at present is actually fairly similar to where it was before the pandemic, but the job vacancy ratio is much higher than the pre-pandemic level, at 1.8 vacancies per unemployed person. This suggests a much tighter labour market than before the pandemic – reflecting greater excess, unfilled demand. Indeed, in **previous** Global Monthly **publications** we also used a measure of *total labour demand* – employment + vacancies – to help paint a more complete picture of labour supply/demand balances.

US: Job vacancies still point to very tight labour market

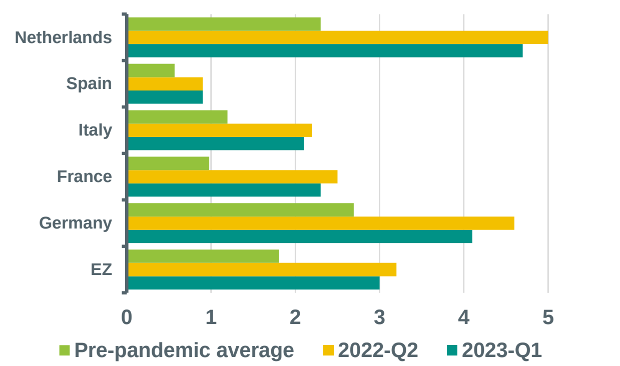
Number of job vacancies per unemployed person



Source: Refinitiv, ABN AMRO Group Economics

EZ: Aggregate masks big regional differences

Change in job vacancy rate since the pandemic; percentage points



Source: Refinitiv, ABN AMRO Group Economics

If we accept the job vacancy ratio as the best indicator of excess labour demand, this raises the question: could the labour supply/demand imbalance be resolved by a drop in job vacancies alone, rather than a rise in labour supply (which – without further rises in already high-participation, as in eg. the Netherlands – implies higher unemployment)? In the US, this has actually been the trend so far: job vacancies have fallen by more than two million over the past year, while unemployment has been remarkably stable. In the eurozone, vacancies have also declined (albeit still on the high side in the Netherlands and Germany), while the unemployment rate has fallen even further. Future developments are unlikely to be as benign. The Bernanke-Blanchard paper argues that – assuming the recent relationship between job vacancies and unemployment holds (what is known as the Beveridge Curve) – unemployment in the US will have to rise above 4.3%, from 3.7% at present, to ensure inflation falls sustainably back to 2% over the medium term. We ultimately expect weakening demand to drive rises in unemployment in both the US and the eurozone over the coming year. Unemployment has already risen in Germany by 0.6pp to 5.6% in recent months, and we expect a rises in the eurozone aggregate unemployment rate to 7.4% by late this year, up from 6.6% currently. In the US, we expect a rise to 4.8% by the end of 2024, up from 3.7% as of May.

Conclusion: Inflation peaking does not necessarily mean it will fall sustainably back to 2%

We judge that inflation has peaked in both the US and the eurozone, and that it will continue its steep downtrend over the coming months. And our base case is that inflation will fall sustainably back to the 2% targets of the Fed and ECB over the next 18 months. However, this base case hinges on a rise in the unemployment rate that corrects labour supply-demand imbalances and brings unit labour cost growth back down to more sustainable rates. Should unemployment fail to rise as we expect, we think central banks run the risk that inflation settles at a level persistently above 2% over the medium term. This could mean further interest rate rises, or a later start to rate cuts than we currently expect.

Spotlight: Greedflation – what is the evidence?

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What is greedflation?

Since the start of 2023, a new factor has come under scrutiny to explain the inflation surge: the contribution from rising corporate profit margins, or in more popular parlance, *greedflation*. As with households over the past 2 years, firms have faced higher input costs, be it energy or higher costs for raw materials. As a consequence they have passed these price rises on to customers. According to the greedflation hypothesis, firms have opportunistically raised prices by more than can be justified by rising input costs alone.

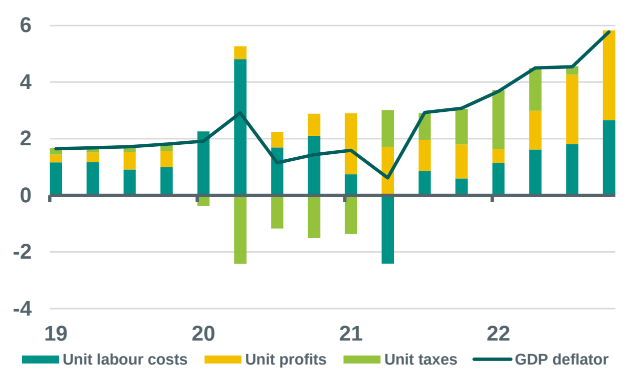
Is there evidence of greedflation?

At the aggregate level there is indeed evidence of increased profits contributing to inflation in advanced economies. The ECB and the OECD have concluded so by decomposing the GDP deflator; the price change of domestically produced goods and services, which is a measure of domestically generated inflation. When breaking down the deflator between profits, wages and taxes two conclusions arise: 1) wages and profits have contributed increasingly to inflation, and this trend has strengthened (in the eurozone) since the end of 2021; 2) profits have become a bigger driver than wages since H2 2022.

What could explain the above? Since the pandemic we have seen a strong but unbalanced economic recovery. Demand has outstripped supply in a number of sectors. The prime example of this is the strong demand for services since lockdowns were wound down, where supply in those sectors could not keep up. Strong demand and constrained supply generally gives firms the opportunity to raise prices. And this behaviour can quickly spread in an inflationary environment, because the opportunity cost (often referred to as menu costs) of raising the price of a particular product is lower when other prices are being raised. Lastly, inflation creates a situation of information asymmetry between firms and customers, where the latter do not know which price rises are due to rising input costs and which are due to margin expansion.

Profits and wages have become a bigger inflation driver

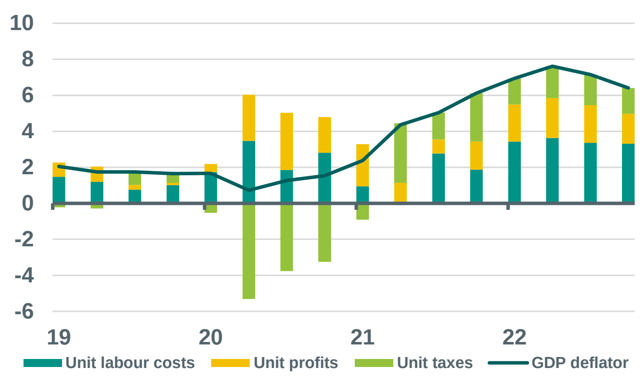
%, Eurozone, 22Q4 latest value



Source: OECD, ABN AMRO Group Economics

But this process looks to be peaking in the US

%, United States, 22Q4 latest value



Source: OECD, ABN AMRO Group Economics

Although rising profits have clearly contributed to inflation, we would caution against interpreting this as a broadbased *greedflation*, for a few reasons. First, these conclusions are based on aggregates. While official data is lacking at the sector level, previous work we have done looking at publicly listed company filings suggests margin expansion is concentrated in a few sectors. Similarly, the OECD research shows differences between countries, and methodological issues also cloud the picture: in countries with a large share of sole proprietors such as the Netherlands, the profits of this group resemble (at least partly) wage income. And lastly, profits show more volatility over time than wage costs. It remains to be seen if the current increase in profits is structural, or rather in anticipation of rising wage (and other) costs down the line.

Why does it matter?

For the trajectory of inflation it is important to know the drivers of inflation. The rising contributions of wages and profits to inflation depict an environment where firms and workers seek to minimise their real income losses by shifting the burden of higher input prices onto the other party. This is the tit-for-tat dynamic ECB President Lagarde has warned of, which could result in a wage-price spiral (or rather a profit-price spiral) where inflation settles at a higher level for longer. Ultimately, *greedflation* is a distributional question of how the burden of (among other price rises) higher energy costs are shared between businesses and workers. This distribution will depend on bargaining between workers, businesses and the government. But judging from the warning of Ms Lagarde, central banks are also monitoring the possible resulting negative wage-price or profit-price spiral closely.

Eurozone: Moderate contractions in GDP expected to continue

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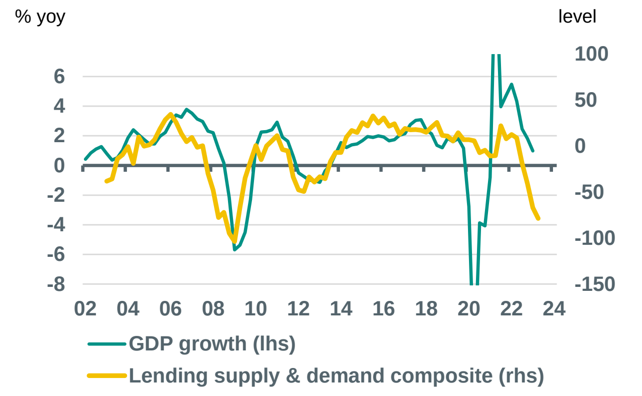
- **GDP contracted moderately in 2022Q4 and 2023Q1; we expect comparable declines during the rest of the year**
- **Core inflation fell in May and should gradually move lower during the rest of this year, also because wage growth looks to have levelled off**
- **The ECB is ready to hike rates again in July and is keeping a hawkish stance**

Eurozone Q1 GDP was revised lower to -0.1% qoq, down from the earlier estimate of +0.1%. Consequently, GDP has contracted for two consecutive quarters (22Q4 also recorded -0.1%), implying that the region has entered a recession. We think the weakness will persist for the rest of the year, and our base case foresees ongoing moderate contractions in GDP. This is due to a number of factors. To begin with, past interest rate hikes by the ECB have already resulted in banks tightening credit standards, and demand for loans is falling (see graph below-left). Actual loan growth has slowed and house prices are declining. Next, the post-pandemic rebound in services seems to have run its course (total services activity contracted by 0.6% qoq in Q1 after it grew by 0.6% in Q4), and goods consumption is edging lower, or stabilising at best. Also, construction contracted in March and April, after it had jumped higher in Q1 due to mild winter weather. Finally, industrial production and exports should remain weak as the global economy has lost momentum.

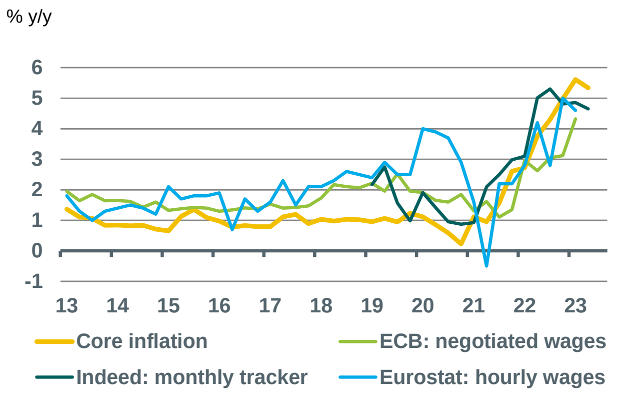
Inflation dropped from 7.0% in April to 6.1% in May. This drop was mainly due to lower food and energy inflation, but the core rate fell as well (from 5.6% to 5.3%), with the inflation rates of energy-intensive goods and services falling by 0.3pp each. Non-energy intensive goods inflation also declined (-0.2pp). Indeed, the only part of inflation that has not yet begun to decline is non-energy intensive services, which is largely driven by wage growth. That said, early evidence has suggested that wage growth has levelled off in the first months of this year (see graph below-right). We expect a further significant easing of wage growth to materialize in the second half of this year, as the expected economic weakness should hit labour demand and result in moderate rises in unemployment. Services inflation should therefore ultimately decline as well, though as argued in this month's *Global View*, this hinges critically on the labour market softening. An early sign of a cooling of the labour market was the drop in the vacancy rate from 3.1% in 2022Q4 to 3.0% in 2023Q1. It peaked at 3.2% in 2022Q2 and has edged lower since then. The vacancy rate in industry and construction declined from a peak of 2.9% in 2022Q2 to 2.7% in 2023Q1, while that in services fell from 3.7% to 3.4%.

Composite Bank Lending Survey results* and GDP



* Combination of changes in credit standards and loans demand
Source: Revinitiv, ABN AMRO Group Economics

Wage growth and core inflation are levelling off



Source: Refinitiv, ABN AMRO Group Economics

As expected, the ECB raised the deposit rate by 25bp in June. It also kept a hawkish policy stance and even appeared to open the door to rate hikes continuing past the summer. Nevertheless, we are sticking to our view that the ECB will hike only one time further in July, taking the deposit rate to 3.75%. This is because the ECB is likely to be surprised to the downside on both economic growth and inflation. As such, we think that by September, it will become clear to the Governing Council that it has done enough to fight inflation, and that it may even have overshot. A rate cut cycle is therefore still likely to begin in December and continue in 2024.

The Netherlands: External weakness increasingly visible in activity data

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- **We expect growth to slow from 4.5% in 2022 to 0.7% in 2023 and 1.0% in 2024**
- **Inflation is declining but underlying pressures remain firm. Inflation to average 4.3% in 2023 and 3.4% in 2024**

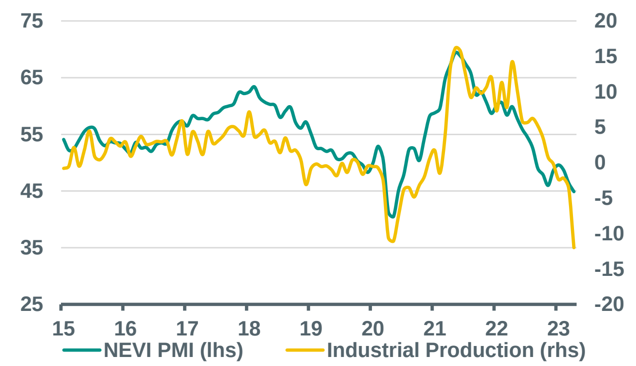
On the back of slowing global growth, the weakening in external demand is becoming increasingly visible in Dutch activity data. As we map out in our May monthly several international indicators are in recessionary territory, and with the eurozone and Germany officially in a recession, if anything, more weakness on the external demand front is to be expected. This primarily affects the sectors that are most exposed to international trade and global value chains. Looking at Dutch industry, we see PMIs clearly in contractionary territory and industrial production is recording the largest year-over-year decline in more than 10 years (see here for a closer look at Dutch Industrial PMIs). Despite the recent declines in wholesale energy prices since the peaks from last year, energy prices are still elevated compared to pre-Ukraine war levels. This explains why energy intensive subsectors such as chemicals and plastics are leading the production declines. Weak external demand does not only affect Dutch industry but has other knock on effects, for instance to other sectors such as transport, and we also see firms clearing out excess inventories in the face of slowing demand. From a macro perspective, we expect net exports to contribute negatively to growth over the year as a whole.

On the domestic front, pockets of resilience are keeping demand afloat, for now. Strong firm as well as household balance sheets are acting as an initial shield to higher rates. The expansive fiscal stance of the government is supporting growth in 2023, and the still very tight labour market supports household spending and is likely to keep nominal wage growth elevated for the coming year(s). Indeed, the labour market has not cooled much since the end of last year. The number of job openings continues to exceed the number unemployed workers, with a stable ratio over the last six months of 1.22. The unemployment rate is hovering around 3.5% since the start of the year, which is historically very low. We see some initial signs that labour demand is on track to normalise; future employment expectations by employers were elevated since the pandemic but are returning to longer term averages. Together with a further cooling of the Dutch economy, a continuation of the upward trend in bankruptcies (still below prepandemic levels) the labour market will cool further but stay tight historically speaking. Unemployment is expected to average 3.7% in 2023.

All in all we expect growth to remain very sluggish in the coming quarters. With the q-o-q decline in GDP in the first quarter, a technical recession is certainly possible. We continue to expect the domestic resilience of the Dutch economy to prevent a serious recession. But risks to the outlook are clearly to the downside, with possibly a larger than expected decline in external activity further impacting the Dutch economy, as well as of course the risks around the inflation outlook.

Weakness abroad feeds through to industrial activity

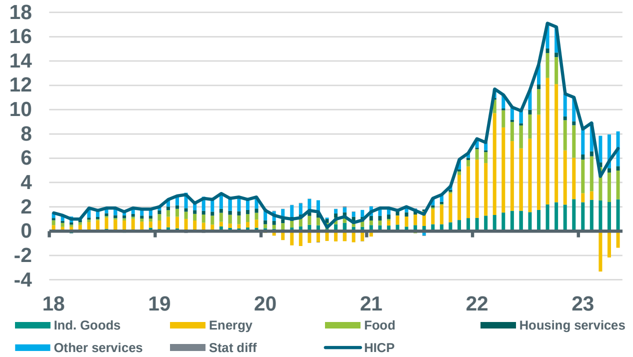
NEVI-PMI, SA, Industrial production SA, yoy,



Source: Refinitiv, ABN AMRO Group Economics

Rises in core inflation keep inflation elevated

%, HICP yoy



Source: CBS, ABN AMRO Group Economics

Indeed, inflation is on a downward trend, falling to 6.8% in May, sharply down from the peak of 17.1% in September last year, but underlying price pressures measured by core inflation are still rising (8.2% in May). We expect inflation to come down over the year and average 4.4% in 2023 and 3.4% in 2024. This means inflation will remain above the ECB's 2% target, mainly because elevated wage growth is likely to feed through to services inflation. With the Dutch economy running above capacity and eurozone core inflation having likely peaked, the risk that Dutch inflation will become a negative outlier in the eurozone, and stay persistently above target, had increased.

US: Recession to start in Q4; Fed cuts delayed to March

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- **We now expect a US economic downturn to begin in Q4 2023. We have upgraded our 2023 growth forecast, but significantly downgraded our 2024 forecast**
- **More near-term resilience will now likely mean a later start to interest rate cuts - and therefore a more prolonged period of highly restrictive monetary policy**
- **We now expect the Fed to hike once more in July, and to start cutting rates in March**

We now see a recession starting in Q4 this year; previously we expected a downturn to begin in the current quarter. The trigger for our change has been the recent resilience in jobs growth and consumption, which has offset weakness elsewhere (particularly manufacturing and housing). While retail sales have essentially flat-lined in real terms (i.e. after adjusting for inflation) in recent months, this will not be enough to drive an outright decline in private consumption in the current quarter given that services consumption continues to recover from the pandemic (albeit at a modest pace). This is being driven partly by continued strength in consumer credit growth, which for the time being is offsetting the weakness in real incomes and the decline in excess savings. Meanwhile, though cracks in labour market strength have appeared in recent months in the form of rising layoffs, jobs growth in aggregate has remained robust for the time being, reflecting persistent labour supply/demand imbalances and labour hoarding behaviour since the pandemic.

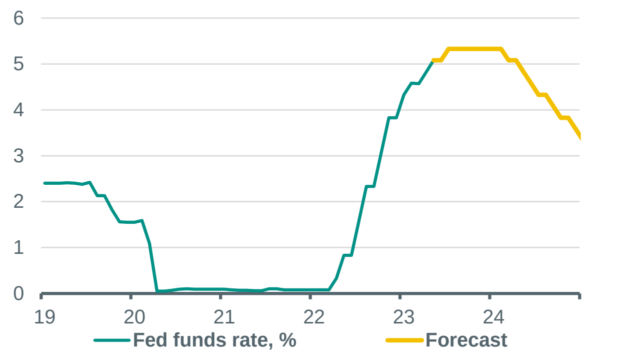
Given that the economy has persistently defied recession expectations so far, it is reasonable to ask whether there will really be a recession at all. We think there will, because we view the drivers of the recent resilience – the strength in both consumer credit and jobs growth – as unsustainable. First, the combination of significantly higher interest rates and much tighter bank lending standards is likely to drive a cooling – and ultimately declines – in consumer credit over the coming months. Second, as consumer demand has cooled, employment growth has considerably outpaced GDP growth in recent quarters, with the result being falling productivity and a jump in unit labour cost growth. For this to continue, businesses would need to accept a sustained fall in profit margins, which we view as unlikely. Indeed, job layoffs have risen recently, it is just that this is being offset for now by strong demand elsewhere in the labour market. It is historically unusual to see such a fall in productivity and a rise in layoffs and for this not to lead to a meaningful rise in unemployment. We therefore think it is a matter of time before job-cutting behaviour spreads more widely, and this should drive a bigger hit to consumption.

A later recession start…

	GDP	Unemployment	CPI	Core CPI
2023	**1.4**	**3.7**	**4.0**	**5.0**
Q1	*1.3*	*3.5*	*5.8*	*5.6*
Q2	1.7	3.6	3.9	5.3
Q3	0.0	3.7	3.2	4.7
Q4	-1.5	4.0	3.1	4.3
2024	**0.3**	**4.6**	**2.4**	**3.0**
Q1	-0.8	4.3	2.7	3.7
Q2	1.2	4.6	2.4	3.1
Q3	2.0	4.8	2.3	2.7
Q4	2.7	4.8	2.1	2.4

Note: Quarterly GDP forecasts are % q/q saar; annual is the % y/y annual average. Unemployment is the average % rate for the quarter (year). CPI inflation is the % y/y average for the quarter (year). Source: Refinitiv, ABN AMRO Group Economics

…to mean a later start to rate cuts



Source: Refinitiv, ABN AMRO Group Economics

Alongside the later recession, we now expect this to mean a later start to Fed rate cuts, leading to a more prolonged period of highly restrictive monetary policy. We now expect Fed rate cuts to start in March 2024, one quarter later than our previous December 2023 expectation. Combined with the additional July hike that we added to our profile following the June FOMC meeting last week, this leaves the fed funds rate 75bp higher at the end of 2024 compared with our pre-FOMC forecast, at 3.50-3.75%. This is still significantly lower than the latest FOMC median forecast of 4.6%, and this is due to the bigger hit to GDP growth and the bigger rise in unemployment that we expect. We think the combination of modestly falling payrolls and m/m core inflation close to – but somewhat above – the Fed's 2% target will be enough to trigger the start of an easing cycle by next March.

China: Beijing steps up support, as the recovery falters

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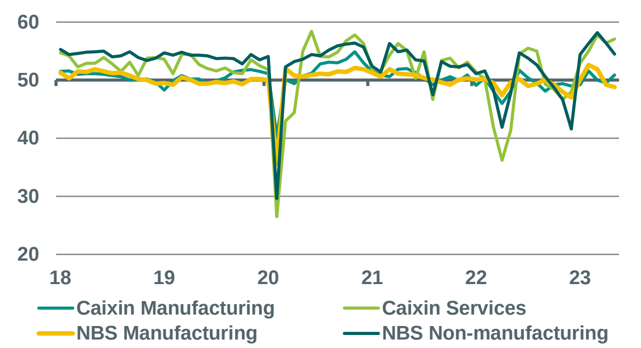
- **Reopening rebound in services/consumption offset by weakness in industry and property**
- **We lower our growth expectations for Q2-23 and cut our 2023 growth forecast to 5.7%, from 6.0%**
- **PBoC resumes piecemeal monetary easing; stepping up of targeted fiscal support on the cards**

Although strong Q1 GDP and activity data confirmed the reopening rebound in services and consumption, the activity data for April and May were on balance underwhelming, and show that headwinds from the global growth slowdown and property remain serious. Although the PBoC has resumed piecemeal monetary easing and more targeted support directed at weak spots – including real estate – is on the cards, we have lowered our growth forecast for Q2-2023, and for 2023 as a whole.

Disappointing April and May data point to ongoing headwinds from slowing external demand and property
Following solid GDP and activity data for Q1 2023, most (but not all) activity data for April and May came in weaker than consensus expectations. This points to an ongoing divergence between still relatively strong – but fading – momentum in services/consumption, which benefited the most from the reopening rebound, and weakness in construction, industry and private investment. The recent data do make clear that the drag from the slowdown in global demand has intensified, while headwinds from property have not yet eased materially so far. In the pandemic years, Chinese export strength was helped by a rotation in global demand from services to goods, and specifically demand for goods produced in China, but more recently the slowdown in global demand following rapid rate hikes worldwide is making itself felt. On the property sector front, momentum in home sales picked up in Q1, but that revival has been short-lived so far, while property investment and new building starts remain clearly in contraction territory (although this partly reflects a policy of prioritising the completion of existing projects). What is also clear is that consumer confidence has recovered only marginally so far, while private investment remains weak (partly driven down by property investment). We expect qoq GDP growth to cool sharply in Q2 compared to the 'reopening bonus' pace of 2.2% qoq in Q1, although yoy growth will surge in Q2 reflecting the base effect from last year. We cut our growth expectations for Q2-2023 and our annual growth forecast for 2023 to 5.7%, from 6.0%.

Divergence between services and industry continues

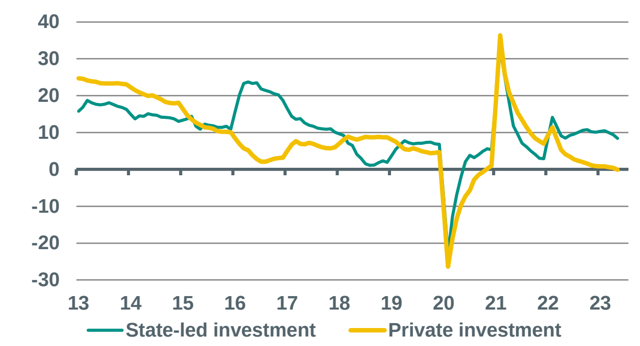
Purchasing Managers' Indices, 50 = neutral mark



Source: Refinitiv, ABN AMRO Group Economics

Weakness in investment is driven by private sector

% yoy ytd



Source: Refinitiv, ABN AMRO Group Economics

PBoC resumes piecemeal monetary easing; more targeted fiscal support on the cards
Following weaker data for April/May, the PBoC resumed piecemeal monetary easing, in line with our expectations. The request to banks to cut deposit rates by 15bp in early May was already a signal that mini cuts in policy rates were forthcoming. In recent weeks, the PBoC cut the 7-day reverse repo rate, the rates on its standing facility, and the 1-year rate on its medium-term lending facility by 10bp, while the 1- and 5-year loan prime rates were cut by 10bp as well. Although these mini cuts in policy rates, the first ones since August 2022, are not substantial in itself, they signal policymakers' preparedness to step up support to safeguard economic growth. Next to further piecemeal monetary easing steps, such as further mini-cuts in policy rates and banks' reserve requirements ratios, we expect Beijing to come with more targeted fiscal support measures as well. This could come in the form of stepping up lending through policy banks, raising/frontloading local government bond quotas, and other specific measures to stabilise the property sector and support domestic demand. Special tax measures have already been announced, including the extension of a tax break for electric vehicles.

Key views on a page

The global economy is sending mixed signals of late, with some clear signs of recession contrasting with other signs of resilience. The impact of monetary tightening is being increasingly felt, with tightening credit conditions pointing to looming recessions, while the eurozone economy already is in a technical recession. China's post-Zero-Covid recovery is offsetting the slowdown in advanced economies, though it has lost some momentum. While headline inflation has begun to trend lower, stubborn underlying inflationary pressures and tight labour markets means central banks are likely to continue raising rates in the near term. More near-term resilience would raise the risk of a higher peak and/or a later start to rate cuts.

Macro	Central Banks & Markets
Eurozone – Q1 GDP was revised lower to -0.1% qoq (was +0.1% earlier). Growth in 22Q4 was also -0.1%, implying that the region has entered a recession. We think that weakness will continue and our base case sees ongoing moderate contractions in GDP during the rest of the year. Domestic demand will be hit by the interest rate hikes by the ECB and exports are limited by a slowdown in global growth. Core inflation seems to have peaked and should gradually decline during the rest of this year. It will be more sticky than headline inflation though, as parts of services inflation will probably continue to rise in the short term.	**ECB** – As expected, the ECB raised the deposit rate by 25bp in June. It also kept a hawkish policy stance and even appeared to have opened the door for rate hikes continuing past the Summer. Nevertheless, we are sticking to our view that the ECB will hike just once further in July, taking the deposit rate to 3.75%. This is because the ECB is likely to be surprised to the downside on both economic growth and inflation. As such, we think that by September, it will become clear to the Governing Council that it has done enough, and may even have overshot. A rate cut cycle still is likely to begin in December and continue during 2024.
The Netherlands – Dutch GDP contracted by -0.7% qoq in 2023Q1. Most recent figures continue to show a slowing but resilient Dutch economy. Dutch GDP is expected to grow by 0.7% in 2023 (revised downward from 1.2%). Due to recessions in the eurozone and the US, external demand will be lower. Monetary headwinds will be increasingly felt over the course of the year. On the other hand, labour market tightness, government spending, and the resilience of household balance sheets are supportive of domestic demand. We expect inflation (HICP) to average 4.3% in 2023 and 3.4% in 2024.	**Fed** – The FOMC kept policy on hold in June, but the Committee made clear that its tightening campaign is not yet over. We expect the Fed to hike once more in July, with the risk tilted toward a further hike in September. We have also pushed back our expected start to rate cuts from December to March 2024. As such, we now expect a more prolonged period of highly restrictive monetary policy, with the fed funds rate likely to end 2024 at 3.50-3.75%. This is 75bp higher than our previous expectation, but still around 100bp below what the FOMC is currently signalling in its latest June projections.
UK – The inflation problem is getting worse, not better. While headline inflation is declining, core inflation has resumed its acceleration, with both April and May readings surprising significantly to the upside. Wage growth also continues to accelerate, posing upside risks to the medium term inflation outlook. With demand also showing signs of rebounding, the recent upside news raises the risk once again of a potentially deep recession triggered by a prolonged period of ultra-high interest rates.	**Bank of England** – The shock core inflation readings for April and May led the BoE to surprise markets with a 50bp hike, taking Bank Rate to 5.00%. We now expect a further two 25bp hikes at coming meetings, with it being a close call whether the MPC hikes by another 50bp in August. MPC decisions over the next few months will be highly sensitive to incoming data. We do not expect rate cuts until next May, and there is a significant risk that rate cuts get delayed even further.
US – We now expect a downturn to begin in Q4 2023. We have upgraded our 2023 growth forecast, but significantly downgraded our 2024 forecast. The expected weakness in 2024 reflects the later start to recession but also a more prolonged period of ultra-tight monetary policy. Headline inflation is expected to continue falling, but core inflation is likely to prove more sticky. There is significant uncertainty over where inflation will settle in the medium term given labour shortages and residual supply/demand imbalances in the economy. Inflation falling sustainably back to target hinges on a rise in unemployment over the coming year.	**Bond yields** – The hawkish tone from central bank meetings last week led to a deeper inversion of the yield curve. However, given our macro and central bank outlook, we judge that the market will retrace part of the repricing in the coming months. We forecast lower US and Euro rates in H2 2023, with both the Treasury and Bund curve inversion peak now likely behind us. As such, we think both curves are set to bull-steepen for the rest of the year and throughout 2024. Indeed, as the economy weakens and inflation continues to slowdown, the market is likely to start repricing rate cuts for 2024, pushing short-term rates lower.
China – Following solid GDP/ activity data for Q1, data for April/May came in weaker than expected, showing that headwinds from a global slowdown and the property sector remain serious. We expect qoq growth to cool sharply in Q2, although yoy growth will surge reflecting the base effect from 2022. We cut our growth expectations for Q2, and our annual growth forecast for 2023 to 5.7%, from 6.0%. Meanwhile, the PBoC resumed piecemeal monetary easing, in line with our expectations, while more targeted fiscal support, including for real estate, is likely as well.	**FX** – We have downgraded our forecasts for EUR/USD. First, we no longer have a rate cut for the Fed this year and fewer total rate cuts in 2023-2024. This is a positive for the US dollar. Second, if the ECB starts cutting rates already in December the euro will suffer. Third, aggressive rate cuts by the ECB in 2024 will put more downward pressure on the euro than Fed cuts will on the dollar. This is because markets have already anticipated large rate cuts by the Fed but not by the ECB. Fourth, the speculative positions in the euro are extremely large. Our new forecasts are 1.08 (end 2023) and 1.05 end 2024.

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