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Q&A on the macro outlook

Downside risks dominate

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FLASH NOTE

SUMMARY

- Following the last eventful weeks, we address some of the most frequently asked questions about the macroeconomic outlook.
- Downside risks abound, including persistently high inflation fuelling central banks' hawkishness, concerns over financial stability, a policy drama in the UK, the escalation of Russia's war in Ukraine, and the never-ending negotiations over energy price caps in Europe.
- Still, we maintain our high-level conviction that core goods inflation will decline sharply in coming months, and that the Fed will take a more cautious approach eventually, although it may reach a higher terminal rate than initially expected.

WHAT'S NEXT FOR THE FEDERAL RESERVE AFTER THE STRONG CPI PRINT?

In short, **persistently hot inflation will likely drive another 75 basis points rate hike at the 2 November FOMC meeting, bringing the Fed funds mid-rate to 3.88%, but** thereafter **we think the Fed will broaden its horizons**. The Fed could re-evaluate the impact of likely weakening momentum in the labour market and deteriorating market liquidity – so a pause in rate hikes in December is possible if the economic data deteriorate sharply while financial conditions tighten further.

The Fed probably intends to continue tightening policy at the December meeting in belief that a 'soft landing' is achievable. But recent labour-market signals point to some weakening that could be more apparent in actual hiring data by December: job openings have started to tumble, and the quit rate has dropped. Also, wage growth is starting to moderate as the Atlanta Fed 'median wage' indicator slowed sharply to +6.3% year-on-year in September from +6.7% in August. Persistently high rental inflation is driving the CPI figure (8.2% y-o-y in September), but it tends to lag behind home prices which have started to drop, so rents may start cooling off by the beginning of next year. **We continue to think that inflation will slow in coming months, driven by goods first, and then services.**

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Interestingly, the Fed has started to (slowly) look beyond elevated core CPI with Governor **Lael Brainard highlighting in a recent speech the importance of lags in monetary policy**. Brainard also emphasised the weakening global economy and the current concerted effort to tighten policy among the major central banks that compound the Fed's actions. The September Fed minutes still prioritise the inflation fight, but there was debate among members about potential side-effects of sharply restrictive monetary policy especially as the global macroeconomic and financial environment becomes much more uncertain.

While the Fed is very likely to hike another 75bps in November, the outcome of the subsequent meeting in December is much more open than widely believed. We think the market pricing of a terminal rate of around 4.9% by March 2023 is too high based on the current (downward-slopping) trajectory of the US economy.

WHERE ARE ENERGY PRICES HEADED FOLLOWING THE OPEC+ DECISION?

The cut in oil production quotas of up to 2 million barrels per day (mbd) from November by the OPEC+ group is the largest since April 2020 – although the effective cut may be closer to 1 mbd. Indeed, many countries are failing to reach their target, and OPEC is collectively lagging by around 3.4 mbd. Meanwhile, **Russia remains constrained in its ability to export, with a gap currently estimated to be around 1.4 mbd. Russian production may well decline further, and the shipping of Russian oil is likely to be limited as the EU implements an embargo on oil purchases as well as ban on crucial services like shipping, insurance and financing.**

Looking at other marginal producers, Nigeria and Angola are also lagging their quotas by about 1 mbd due to structural issues including poor infrastructure, lack of investment and social unrest. Therefore, **the reduction in supply will fall on three countries: Saudi Arabia, UAE, and Kuwait**, with a combined output reduction of up to 1mbd, close to the total drop in OPEC+ output.

On top of macro concerns, the organisation justified its decision by low spare capacities, which amount to 4.2mbd for all OPEC countries, with Nigeria's 0.4mbd and Iran's 1.4mbd new capacities under the Joint Comprehensive Plan of Action looking the most at risk. Saudi Arabia, UAE and Iraq are the three OPEC countries with the largest spare capacities up to 2.2mbd in total.

Meanwhile, US shale oil expansion is unlikely to expand at the same pace forever. Drilling activity is running out of steam with the number of oil rigs stabilising at around 600. US SPR releases are likely to cease by year-end, with 152mb released so far out of the planned 200mb.

The OPEC+ decision should put a higher floor on oil prices while recession fears are intensifying in Western economies and China's recovery remains elusive. We remain comfortable with our year-end target of USD95 for the barrel of Brent.

European gas prices have more than halved since August (from EUR340/MWh in August to below EUR150/MWh today) on the back of high storage (over 90% for EU as a whole), EU price caps discussions, demand reduction and not-too-cold weather. Still, if Western economies recover and China reopens next year, restocking will be much more challenging and costly as competition for gas will be fierce. **We expect all fossil fuel prices (gas, oil, coal) to remain elevated in 2023.**

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WILL CHINA'S GROWTH OUTLOOK FINALLY IMPROVE?

The Chinese economy improved only moderately in recent months. Retail sales rose to 5.4% y-o-y, helped by tax cuts on auto purchases. Fixed-asset investment also expanded at a faster pace in August than the previous month, but exports weakened considerably as global demand softened.

Despite the improvement, major headwinds remain. The property crisis continues, with property investment contracting a further 13.9% in August year-on-year. The People's Bank of China recently launched a special lending programme to help developers complete sold but unfinished projects. This could in time help restore confidence among home buyers and break the vicious cycle in housing.

Ahead of the Chinese Communist Party's 20th Congress, local governments have tightened covid restrictions, causing widespread economic disruption. For example, during the seven-day National Holidays (the "Golden Week"), the number of tourists and revenues dropped by 18.2% and 26.2%, respectively, from one year ago. The number of passenger trips was 58% below 2019 levels. **There is no clear sign zero-covid policy will change soon**. The National People's Congress in 2023 (usually taking place in March) will be the next key event for possible policy shift.

Our Chinese GDP forecast for 2022 remains unchanged at 3.2% but is subject to downside risks. Our 2022 headline inflation forecast stays at 2.0%.

WHAT'S NEXT FOR THE BRITISH GOVERNMENT AND THE BANK OF ENGLAND?

In a spectacular U-turn, PM Liz Truss dismissed Chancellor Kwarteng (replaced by former Foreign Secretary and Health Secretary Jeremy Hunt) and backpedaled partially on the planned tax cuts. The corporate tax rate will end up rising to 25% from 19%, which would end up bringing GBP 18bn in additional fiscal resources.

Truss justified the U-turn by the need to bring "economic stability", even though she also blamed the difficult global economic environment for the UK's current economies woes. Hunt has now the mission to continue reassuring markets about the UK's fiscal discipline as he prepares a fiscal statement and new debt projections to be released before the end of the month. However, economic difficulties won't necessarily change with a simple swap of the Chancellor, and **more might need to be done to solidify investors' trust in the UK's policy-making.**

Meanwhile, the deadline for the extraordinary daily Gilt buying facility by the Bank of England (BoE) lapsed on Friday 14 October, coinciding with the change in guard at the UK's Treasury. The BoE still intends to return to its initial (pre-mini budget) plans to gradually sell its QE portfolio, but we doubt that this will happen at the scheduled pace given the ongoing fragility of the Gilt market. Economic data have been on the weak side of late with GDP falling by 0.3% month-on-month in August (from +0.1% in July), potentially indicating the start of a technical recession. The labour market continues to hold up well, but this may be temporary.

We had previously expected a 75bps hike at the 3 November meeting, but we think **the BoE could front-load its tightening with a 100bps move**. We expect a terminal rate of 4.0%, lower than current market pricing of 5.4%, although this will depend on whether the government is serious on reining in its fiscal plans (and in particular on the credibility of debt-to-GDP projections).

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WILL THE EU AGREE ON COMMON ENERGY PRICE CAPS?

The European bloc is still debating the implementation of **energy price caps**. Measures on **oil** have yet to be unanimously approved but could take effect in early December for crude oil and February for refined petroleum products. Malta, Greece and Cyprus are concerned that their large shipping industries could suffer.

Regard a price cap on **gas**, several schemes are under discussion. One option, inspired by the "Iberian exception", would be to partially subsidise consumption, with households and corporations bearing the cost of gas bills up to a certain level fixed by the EU. This would be based on electricity generation needs, while any additional cost above that level would be paid for by governments. Another option would be to set a rigid maximum sale price, forcing European gas buyers to renegotiate contract prices with their suppliers. The maximum price might be fixed or might oscillate depending on the reference to other energy markets. Greece and Italy have expressed their support for a so-called "dynamic cap". Finally, a third option would be a mix of both measures, with prices on EU gas markets linked to US and Asian prices, for instance within an interval band of +/-5% (a "forked cap") allowing for market forces to match supply and demand. In the event of gas shortage, additional purchase at uncapped prices outside the union would be permitted.

For all the frustration about the long negotiations, the good news is that discussions seem to move in the right direction. **EU leaders may agree on a common price strategy by the end of the month.** Germany' EUR 200bn relief package has fueled irritation among member states amid fears that it would distort the energy market by subsidising German businesses while other countries cannot afford similar levels of spending. However, the German government was said to be more open to the idea of joint EU funding to cover some of the costs.

CAN EURO AREA GOVERNMENTS MITIGATE RECESSION WITHOUT FUELING INFLATION?

We remain of the view that euro area fiscal policy will help mitigate recession risks, but not eliminate them. Real GDP growth is likely to remain positive in Q3 helped by a (largely technical) rebound in industrial output, but a contraction in Q4 2022 and Q1 2023 remains very likely as **households and companies are hit by the largest shock to their real income in a generation**. We expect leading indicators to weaken further, and labour market conditions to start deteriorating soon.

ECB's President Christine Lagarde said this week that euro area countries had avoided recession so far, but other ECB officials have acknowledged that the region was getting closer to contraction. Still, while ECB hawks and doves might disagree on the required degree of monetary tightening, our impression is that a large consensus is building around our baseline scenario. The ECB is likely to hike the deposit rate to 2% by December (we expect 75bps in October, and 50bps in December), before reassessing the situation. Interestingly, a recent media report suggests that the ECB staff sees a lower terminal rate than markets in 2023, at around 2.25%.

Meanwhile, **passive Quantitative Tightening** (QT) of the Asset Purchase Programme will likely start early next year with the ECB phasing out reinvestments gradually (via caps) while reassessing the pace of the process down the road. We also expect the ECB to reduce the amount of bank excess reserves remunerated at the deposit facility rate by introducing a so-called **reverse tiering** mechanism.

HOW MUCH WIDENING CAN BE EXPECTED IN ITALIAN GOVERNMENT BOND SPREADS?

In the last couple of months, the ECB did *not* use the flexibility of the reinvestments under its Pandemic Emergency Purchase Programme (PEPP) to buy Italian debt. On the contrary, net purchases of BTP were slightly negative over August and September, probably due to large redemptions. More fundamentally, the fact that the ECB decided not to activate this first line of defense, after having purchased EUR 10 bn of Italian BTP in the previous two months, suggests that the central bank sees the repricing in peripheral bond yields as broadly orderly so far. But the risk is that reasonably-well behaved BTP spreads without ECB intervention embolden the hawks who may push for higher rates, or faster QT.

If push comes to shove, we believe that the ECB's anti-fragmentation would be credible and effective, but we think **the pain threshold has moved higher for the ECB to intervene**. Intervention levels are a moving target depending on macro, fiscal, and financial conditions but also politics. We still have little indication of the Italian government's intentions. In spreads terms, we believe that the 10-year BTP-Bund spreads could widen a lot more, potentially up to 300bps, before the ECB steps in under some conditions.

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