Ahead of the Curve

Macroeconomic outlook

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Federated Hermes Limited

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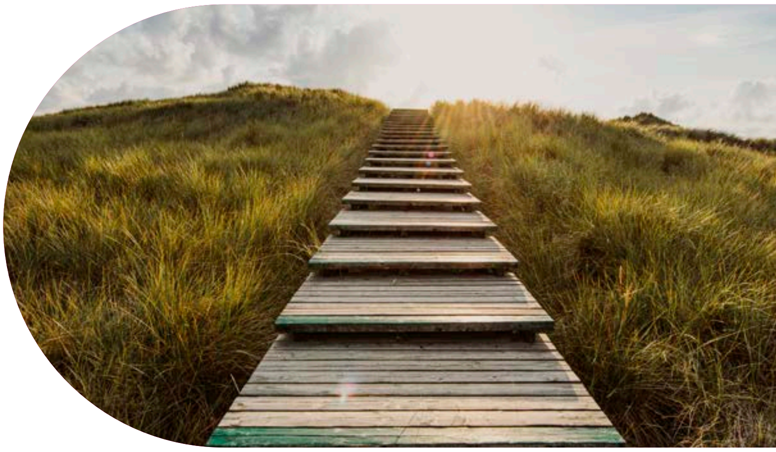
Silvia Dall'Angelo
Senior Economist

As Senior Economist, Silvia is responsible for providing macroeconomic analysis and commentary, non-standard macroeconomic modelling, and developing relationships with key central banks and monetary authorities.



Our macro outlook

In our baseline scenario, global growth will continue to slow in 2023, reflecting a continuation of the themes that dominated 2022. Inflation has moderated but is still running at elevated levels, significantly eroding real disposable incomes. More importantly, the sharp tightening of monetary policy that major central banks (the Federal Reserve notably) implemented in 2022 will pass through to the real economy over 2023. Furthermore, the monetary policy stance is likely to remain restrictive for some time, as inflation is likely to remain above target in 2023.

In our baseline scenario, global growth will slow to about 2.5% in 2023, from just below 3% in 2022 and well below the trend prevailing in the three decades before the Covid recession (~3.5%). That would entail a significant slowdown in major advanced economies including a short and mild recession in the US. Meanwhile, the rebound in China's growth following the decision to rapidly exit its zero-Covid policy in late-2022 is unlikely to significantly lift global growth via indirect effects.

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Risks to the baseline are currently skewed to the upside, in light of the faster-than-expected re-opening of the Chinese economy, the sharp decline in energy prices (in Europe, notably) and the easing in financial conditions at the turn of the year. However, the balance of risks can quickly change over the course of the year, and there is a non-negligible probability of a sharper slowdown occurring either later this year or next year. Indeed, monetary tightening could end up having a larger-than-expected impact on the real economy in an environment of high leverage, with changes in monetary policy taking up to 18 months to fully filter through to the real economy.

It should come as no surprise that inflation is a key component of our 2023 outlook. It probably peaked in the second half of 2022 across major advanced economies and will remain on a downward trend in 2023. Even so, we expect it to stabilise somewhat above target (3-3.5%) in the second half of the year. Whether inflation takes a further step down and converges to target depends on developments in economic activity and, crucially, labour markets. If labour markets remain tight and inflation proves stickier than expected, central banks can be expected to take a more hawkish stance, likely leading to a sharper recession down the line, possibly in 2024.

Against the inflationary backdrop, monetary and fiscal policies are likely to remain broadly restrictive. Central banks are probably close to their peak rates, but, if, as forecast, inflation remains above target this year, they are unlikely to embark on an easing cycle in the second half of 2023, despite markets' expectations to the contrary. Meanwhile, monetary tightening is also coming from the correction of central banks' balance sheets. As central banks focus on fighting inflation and regaining their credibility, there are risks of overtightening. Higher rates, in turn, could expose fragilities in some niches areas of the market.

Finally, geopolitics will continue to be a key driver of economic dynamics across emerging and developed countries. The Russian invasion of Ukraine will weigh on the economic outlook for years to come, notably in Europe, where energy prices are now structurally elevated. More fundamentally, the conflict in Ukraine has been both a manifestation and an accelerator of pre-existing geopolitical trends, pointing towards a more fragmented and unstable international regime. The economic consequences of this – crucially including the increasingly tense relationship between the US and China – will be significant and will play out over extended horizons. In particular, the prospects for globalisation, the main source of productivity gains globally over recent decades, are now uncertain.

Theme 1: Recession risks

Despite the large terms of trade shock from the surge in energy prices in 2022, the eurozone economy performed much better than expected in late 2022.

According to preliminary data, eurozone GDP avoided an outright contraction in Q4 2022 and instead eked out a 0.1% quarter-on-quarter gain. Recent survey developments – the eurozone composite PMI increased to 50.2 in January, from a trough of 47.3 in October '22 – suggest that stagnation is now more likely than a recession in H1 23, and we expect anaemic growth of 0.6% on average for this year. Granted, good luck has played a role as winter temperatures were seasonally mild in Q4 2022, but preparedness and the long tail of post-Covid recovery dynamics have also underpinned economic resilience. Fiscal support partially absorbed the hit to households from higher energy prices and governments made sure gas storage was plentiful at winter's outset. In addition, the eurozone is well positioned to benefit from positive spill-overs from a consumer-driven recovery in China following the end of the zero-Covid policy.

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The contrast, here, is with the US where, at the beginning of the year, disappointing survey data coupled with the persistence of the Fed's hawkish stance renewed recessionary concerns. Both the PMI and the ISM surveys for the US deteriorated over Q4, ending the year in slightly contractionary territory at about 47. Meanwhile, hard data also confirmed a sharp slowdown in US manufacturing activity in Q4 2022, while consumption also showed cracks at the very end of 2022. Despite the strength of the US labour market, there have been tentative indications of cooling: vacancies have come off their record highs, survey-based hiring intentions have moderated and layoff announcements have increased.

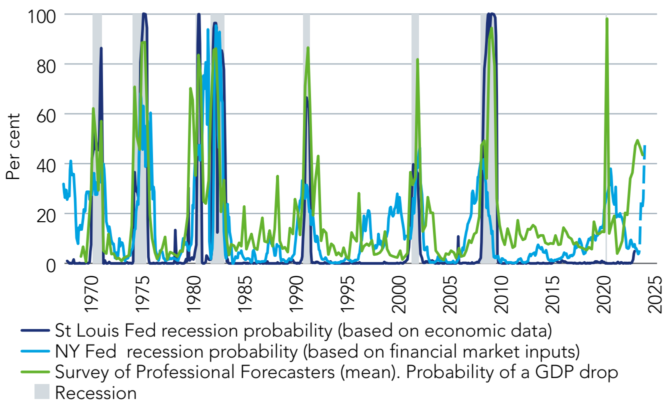
All of this is to say that bottom-line recession risks perhaps now appear marginally more pronounced for the US than for the euro area. While the probability of a recession based on current hard data still seems contained, surveys of economists and market developments (heavily inverted yield curves across both the 3m10s and 2s10s spreads, for instance) point to a recession probability of about 50% in the year ahead (see Figure 1). Historically, such high recession expectations have been vindicated.

The drivers of a US recession are hardly unfathomable. The Fed has implemented its fastest tightening of monetary policy in decades by hiking rates by 450bps in the 11 months since March 2022. Monetary policy affects the real economy with long and variable lags and, according to most estimates, it takes up to 18 months for monetary policy to have its full impact on the real economy. Already, negative wealth effects due to the tightening of financial conditions in 2022 are in the pipeline. Meanwhile, households' real net financial wealth is back to pre-Covid levels in the US, reflecting high inflation and the poor performance of financial markets in 2022. Therefore it's perhaps unsurprising that the US housing market has also cooled markedly: MBA mortgage applications have fallen by about 50% since early 2021, as 30-year fixed mortgage rates rose to above 6%, from below 3% in late-2020.[1]

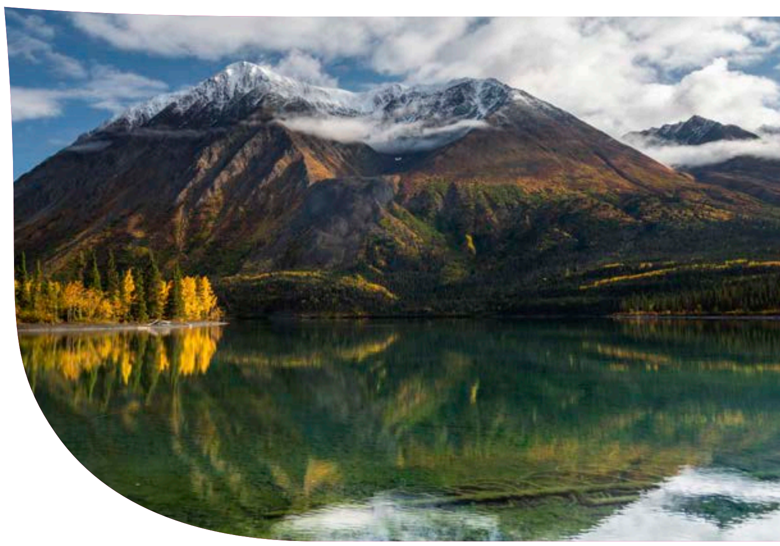
In addition, buffers have been eroded. Estimated households' excess savings fell to US$1.2tn in Q4 2022, from a peak of about US$2.3tn in Q3 2021[2]. As high inflation continues to bite and uncertainty about the outlook increases, the risk is of households becoming more cautious and clinging to their precautionary savings, which, in turn, would accelerate recessionary dynamics.

If the US does fall into a recession later this year, the rest of the world is unlikely to decouple. Specifically, the US cycle tends to lead the eurozone one by a few quarters. Given the significant challenges to growth the eurozone is already facing (namely, structurally higher energy prices and aggressive European Central Bank tightening) the lag this time around could be shorter than is normally the case.

Figure 1: The tide is high: US recessionary risks (probability, %)



Source: Refinitiv Datastream, as of February 2023.



[1] Source: Mortgage Bankers Association data as of February 2023.
[2] Federal Reserve: Excess Savings during the COVID-19 Pandemic, 21 October 2022.

Theme 2: Monetary policy – a question of convergence

Central banks are probably close to their peak rates (see Figure 2), but, given expectations of inflation remaining above target this year, we believe their monetary policy stance will remain restrictive for some time.

While there is some divergence in the pace of tightening between the Fed and the ECB, we believe the Fed, the ECB and the Bank of England will converge to a slower hiking pace and, eventually, a pause over the course of the year.

At its February meeting, the Fed shifted to a smaller rate hike of 25bps to a target range of 4.5%-4.75%. However, it reiterated that ongoing hikes would be appropriate, suggesting they are still comfortable with their December game-plan of a terminal rate of 5-5.25%, to be reached in coming months and held throughout this year. In addition, the Fed is tightening monetary conditions via balance sheet correction, withdrawing more than US$1tn each year from a record high balance sheet of almost US$9tn in mid-2022.

The ECB started its tightening cycle later than the Fed and from lower rates. Accordingly, it has stuck to its aggressive short-term tightening plans. Since the beginning of its tightening cycle in July 2022, it has hiked rates by 300bps to 2.5% in February and an additional 50bps rate hike is on the cards for March 2023, while further moves depend on the evolution of the growth/inflation trade-off. Whether the terminal rate is 3% or 3.5%, the ECB will likely hold it for some time to meet its inflation mandate, bar serious accidents for growth or financial conditions. Also, the ECB will start quantitative tightening in March, initially at a monthly pace of €15bn (about half the run rate of its Asset Purchase Programme redemptions), which will be reconsidered in June[3].

Economist Oliver Blanchard has also highlighted how higher incomes allow for higher savings, while increased uncertainty (stemming from a more unstable geopolitical backdrop, for instance) typically result in stronger demand for safe assets.

Despite its reluctance, the BoE has had to react aggressively to the deteriorating inflation picture over the last year. Since December 2021, it has hiked its policy rate by 390bps to 4% in February. At the same time, it has begun to adopt a less aggressive guidance: while it stated that inflation persistence would require further tightening, it also dropped the reference to a 'forceful' response at its February meeting. Going forward, we see some additional tightening to a terminal rate of 4.25-4.5%, due to pronounced upside risks to the inflation outlook stemming from a tight labour market. However, we believe a weak and fragile growth outlook means the Bank of England could turn dovish earlier than other central banks.

The Bank of Japan (BoJ) has largely bucked the tightening trend for now. It surprised markets by sticking to its Yield Curve Control (YCC) policy at its meeting in January, having tightened its monetary policy stance at its previous meeting in December. We still think that the BoJ will tighten monetary policies over the year in response to building inflationary pressures, but in a gradual and non-linear fashion. The BoJ's exit from YCC won't be predictable, although the change of leadership at the central bank this year could impart some momentum.

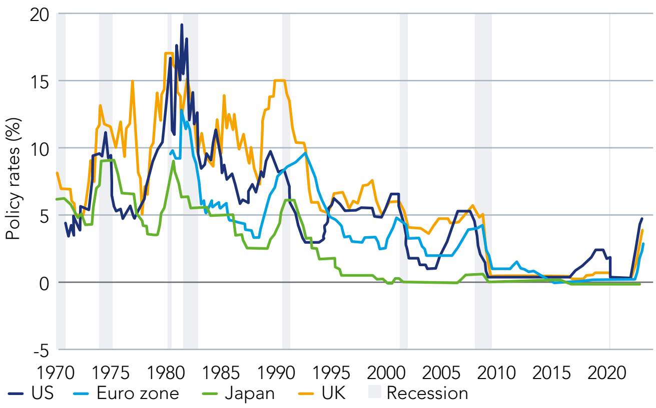
Food for thought: Two longer-term issues to consider

1. **Where is the neutral rate?** This is perhaps more of an academic discussion, given that rates will likely be higher for some time (in other words, the world of nirps and zirps is likely well behind us). Yet, we believe secular forces putting downward pressure on interest rates have not faded and that secular stagnation will still need to be reckoned with. According to a recent analysis by the BoE[4], longevity plays a key driver of interest rates, as an older population tends to save more. Economist Oliver Blanchard[5] has also highlighted how higher incomes allow for higher savings, while increased uncertainty (stemming from a more unstable geopolitical backdrop, for instance) typically result in stronger demand for safe assets.
2. **Should the inflation target be higher?** Maybe 3% rather than 2%. In an environment dominated by low potential growth (due to demographics, but also poor productivity growth in developed markets[6]), it is easier for excess demand to emerge given how low the 'speed limit' for the economy is. Instead, it might be appropriate for policy makers to revisit those central bank mandates and recalibrate them so there is more tolerance for somewhat

[3] Reuters: 'ECB to start offloading bond holdings in March', 15 December 2022
[4] The economic landscape: structural change, global R * and the missing-investment puzzle – speech by Andrew Bailey | Bank of England.
[5] Secular stagnation is not over | PIIE.
[6] Although how much of this reflects mismeasurement? See The Economist: The curious case of missing global productivity growth, 11 January 2017.

higher inflation vs low growth. In other words, mightn't it be appropriate to keep policies somewhat looser, so allowing inflation to run somewhat above 2% and growth to run somewhat above its subdued potential?

Figure 2: The fastest tightening cycle in decades for the Fed, the ECB and the BoE



Source: Refinitiv Datastream, as of February 2023.

Theme 3: Is carbon pricing a recipe for higher inflation?

In recent years, governments have introduced a range of measures to mitigate the impact of climate change – and discussions have begun to explore what their inflationary impact might be.

In general, these mitigation policies fall into three categories: economic incentives, regulations and institutional approaches. Each can affect both the demand and the supply side of the economy and, since these vary over time, so too does the impact these measures have on inflation.

Coming under the economic incentives category, carbon pricing looms large as one of the better known mitigation measures. Designed to reduce CO_2 emissions by charging for them, the exact mechanism for carbon pricing can be determined in different ways. Governments typically resort to either market pricing (whereby they set the maximum amount of emissions, e.g. through the EU Emissions Trading Schemes) or they opt for direct carbon taxation. Combinations of the two approaches, complemented with policies such as standards and regulations, are also possible.

In a recent publication[7], the BoE reviewed the economic literature to assess the macroeconomic effects of these policies, identifying two main empirical findings. First, setting a maximum amount of emissions and allowing the market to set the price (i.e. the market mechanism) typically raises inflation and reduces economic growth.

By contrast, several studies show that setting a carbon price directly through carbon taxes has a broadly neutral impact on inflation and output.

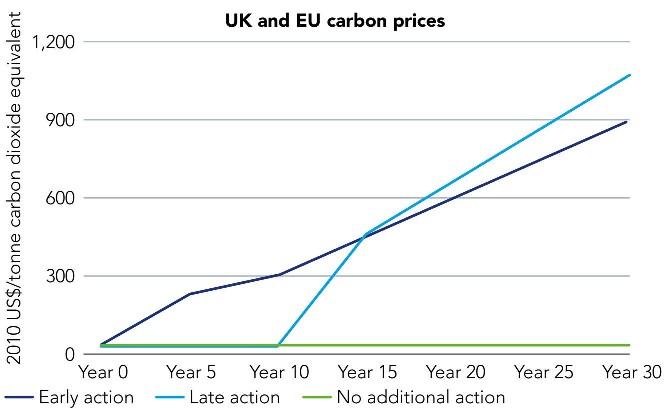
However, these results have significant limitations, given that they are based on historical carbon prices that have been and still are too low. According to most estimates, carbon prices need to be much higher than they currently are to meet net-zero targets. For instance, the Bank of England's Climate Biennial Exploratory Scenario (CBES) estimates a substantial increase in carbon prices, rising from US$30 at end of 2020 to US$900 per tonne of carbon dioxide equivalent (in 2010 dollars) by 2050 under an 'Early Action' scenario (see Figure 3 below). If policy action is delayed ('Late Action'), carbon prices remain at US$30 until 2030 but the estimated increase is more abrupt and results in a higher carbon price towards the end of the forecasting horizon (over US$1,000 by 2050).

In its October 2022 World Economic Outlook[8] the IMF also concluded the inflationary impact of carbon prices should be limited, based on structural modelling. However, our view is that the IMF's results rely on somewhat heroic assumptions, as it models household and corporates as being fully forward looking and adjusting their behaviour in response to policies that are known with certainty. Also, the model only simulates a 25% reduction in emissions.

In general, then, as things stand, our take is that it's still very difficult to draw firm conclusions about the inflationary impact of any single mitigating policy. For instance, the impact of carbon prices also depends on the broader design of the policy, including how revenues are used by fiscal authorities.

Furthermore, there is great uncertainty about the composition and the course policies will have to take in order to meet net-zero targets. One thing we can say: Well-coordinated, swift and predictable policies would likely produce orderly and gradual macroeconomic effects, leading to a 'smooth transition'. By contrast, a disorderly stop-and-go transition would likely result in amplified effects and higher costs for the economy.

Figure 3: Carbon prices need to increase significantly to meet net-zero targets



Source: Bank of England: Climate change: possible macroeconomic implications, Q4 2022.

[7] Climate change: possible macroeconomic implications | Bank of England.
[8] World Economic Outlook, October 2022: Countering the Cost-of-Living Crisis (imf.org)

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