EMBARGOED UNTIL: 11.30AM THURSDAY 13 OCTOBER 2022

THE FORWARD VIEW – GLOBAL

OCTOBER 2022

National Australia Bank

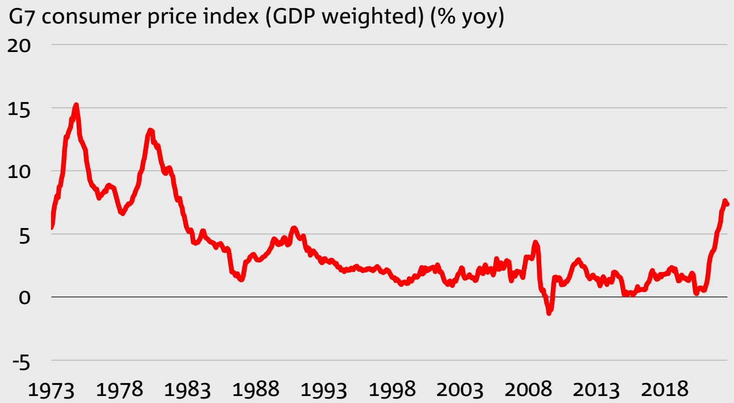
Central banks inflation priority leads to weak growth outlook

- Volatility in financial markets (especially bonds) rose in September. While markets continued to adjust their monetary policy expectations – reflecting the competing forces of persistent inflation and deteriorating economic activity – the UK government's mini-budget was met with a severe market reaction. Yields on 10 year UK gilts rise rapidly above 4% (the highest rates since 2008), forcing the Bank of England to intervene to safeguard pension funds and the government to reverse course on this policy.
- Global inflation remained stable at 8.7% yoy in August (unchanged since June). A range of factors – including slowing growth in producer prices, falling freight rates and food prices – point to weaker inflation in coming months, but there remain some risks, including the impact of the Russia-Ukraine conflict on European natural gas supply and disruptions due to China's zero-COVID policies. In addition, OPEC+ has committed to cuts to oil production, which could limit downside pressure to oil prices.
- Given that inflation remains well above the targets of major central banks, these institutions have continued to increase their policy rates – with the US Federal Reserve implementing its third straight 75 bp hike in September. Despite already slowing economic activity, we expect further rate increases from major central banks in coming months – driving a weak outlook.
- We expect global growth to slow significantly in 2023, down to 2.3%, before modestly recovering to 2.8% in 2024. These increases are well below the long run average of 3.4% (from 1980 onwards). The United States and the Euro-zone are forecast to record no growth in 2023, while we expect a marginal contraction in the UK economy for the full year.
- There is considerable uncertainty around the global outlook. Due to the lagged nature of inflation data, there is a high risk of greater-than-necessary central bank policy rates, resulting in a deeper than anticipated recession in advanced economies. The Russia-Ukraine conflict has persisted, with natural gas flows to Europe restricted and ongoing concerns around grains and fertiliser supplies. China's zero-COVID public health policies remain in place and further lockdowns could negatively impact the currently improving supply chain trends. Geo-political tensions between China and the US could also re-emerge.

Global Growth Forecasts (% change)

	2020	2021	2022	2023	2024
US	-2.8	5.9	1.8	0.0	1.1
Euro-zone	-6.2	5.2	3.2	0.0	1.1
Japan	-4.6	1.7	1.5	1.4	0.9
UK	-11.0	7.5	4.4	-0.1	0.7
Canada	-5.2	4.5	3.2	0.7	0.9
China	2.2	8.1	3.3	5.0	4.5
India	-6.6	8.3	7.3	4.4	5.6
Latin America	-7.0	6.2	2.6	0.5	1.3
Other East Asia	-2.8	4.3	4.5	3.3	3.7
Australia	-2.1	4.9	4.0	1.8	1.7
NZ	-2.1	5.5	2.4	1.0	1.5
Global	**-3.1**	**6.1**	**3.2**	**2.3**	**2.8**

Inflation in major AEs may have peaked but risks persist



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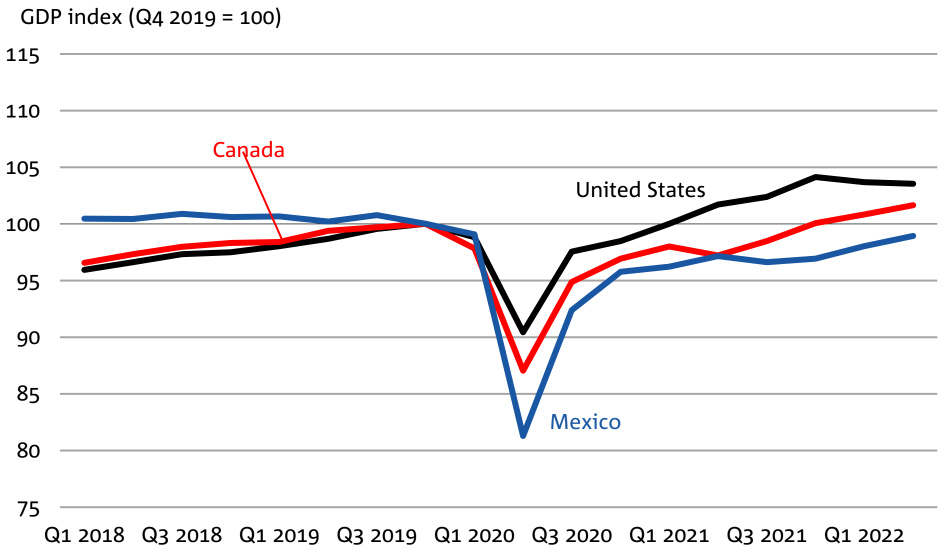
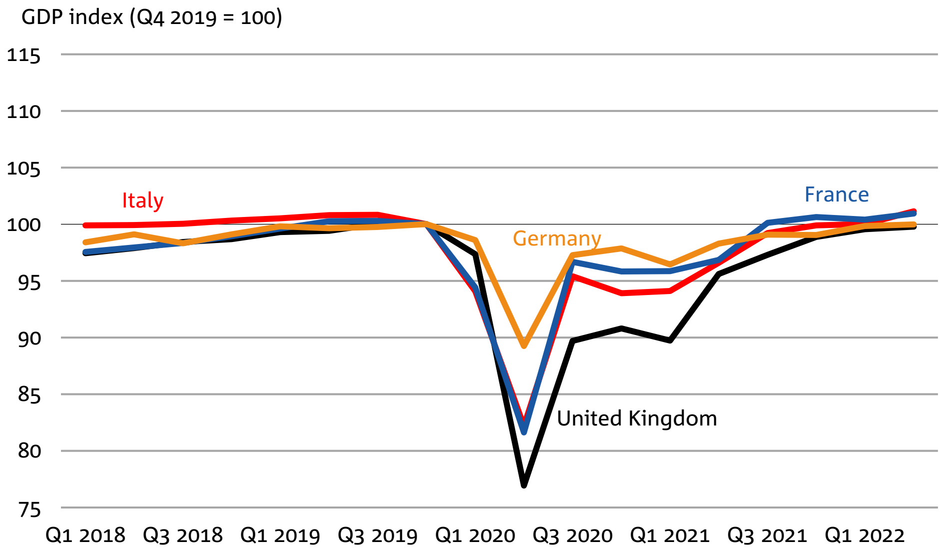
CHARTS OF THE MONTH

The performances of major global economies have differed widely since the start of the pandemic. India, China and other East Asian economies recorded strongest growth, many advanced economies have barely recovered

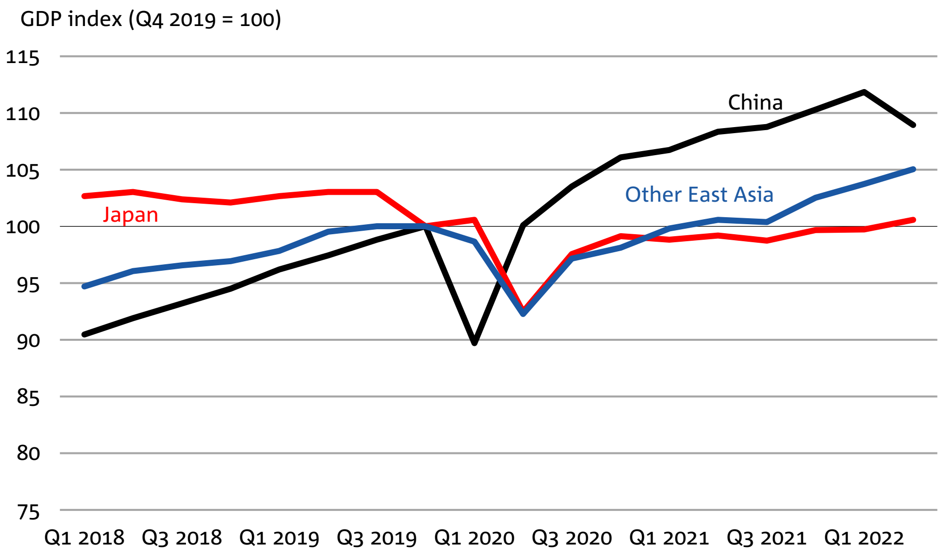
United States the standout among North American economies, though softer trends in recent quarters



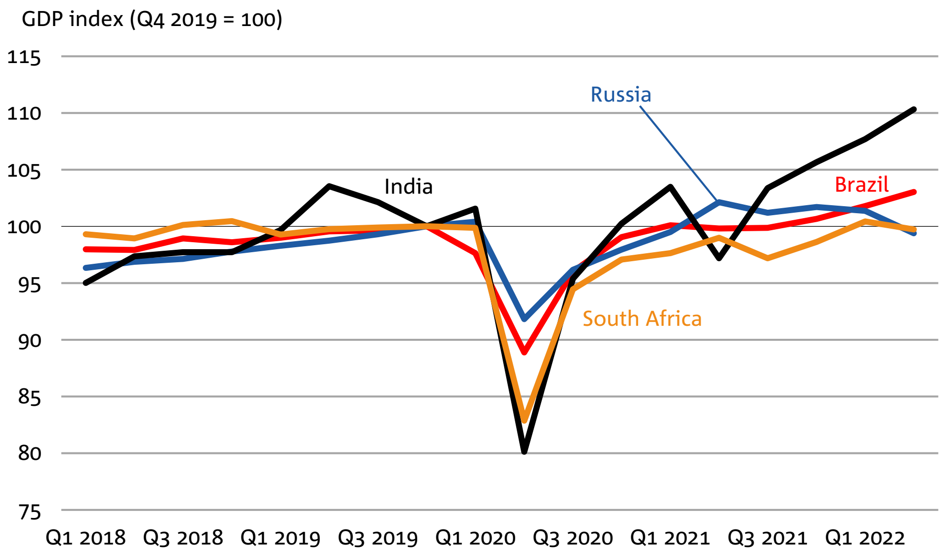
Major European economies have struggled to return to pre-pandemic levels



Soaring exports supported China's pandemic recovery (and boosted EM East Asia) but lockdowns impacted Q2



Mixed trends among other EMs – India performing comparatively strongly, Russia weaker



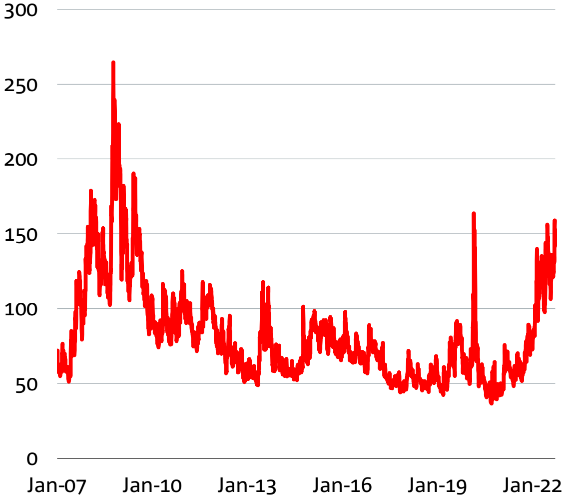
 Sources: Refinitiv, NAB Economics

FINANCIAL AND COMMODITY MARKETS

Proposed UK stimulus fuelled market volatility in September

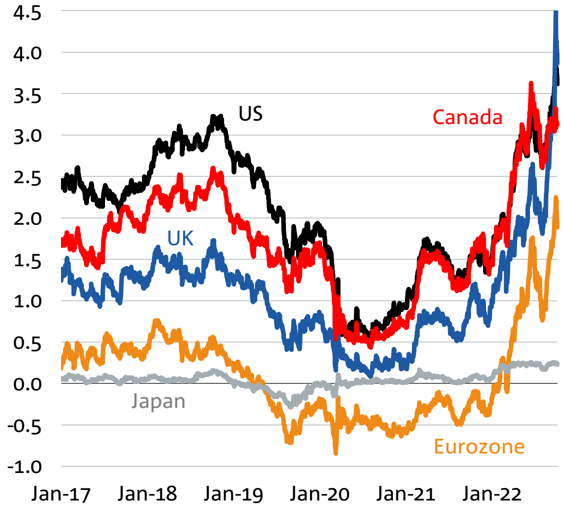
Volatility in bond markets surged higher since early August…

BoAML MOVE bond volatility index (1 month)



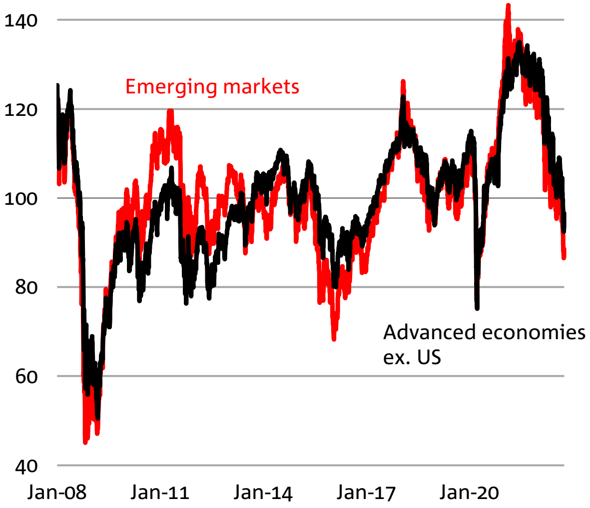
…while bond yields move above pre-pandemic rates

10 year government bond yields (%)



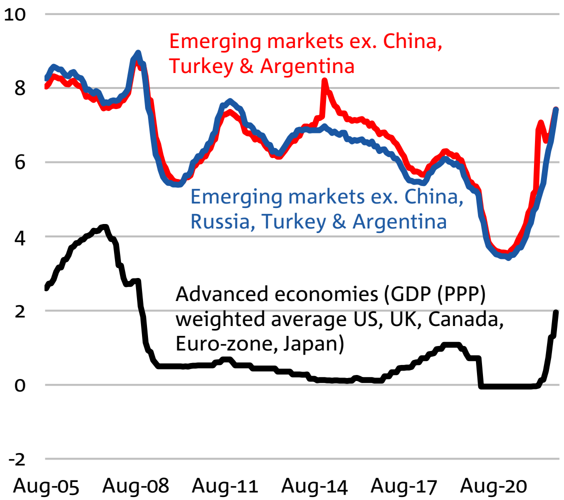
Non-US equity markets have dropped below post-GFC average

MSCI Equity Indices (average 1 Jan 08 to present =100)



Central banks continue to hike policy rates

Average central bank policy rates (%)



- Volatility in bond markets increased in September, with the MOVE index rising in late September to its highest level since July 2009 (excluding a brief spike at the start of the COVID-19 pandemic). Bond yields for major advanced economies have continued to trend higher since the start of August – pushing well above pre-pandemic rates.
- Markets continue to adjust their monetary policy expectations – reflecting the competing forces of persistent inflation and deteriorating economic activity. However, bond markets were further impacted in September by the UK government's plans for significant tax cuts (on top of a substantial energy relief package), despite inflation concerns, and without addressing medium term fiscal sustainability. The negative market reaction saw yields on 10 year UK gilts rise rapidly above 4% – the highest rates since 2008 – forcing the Bank of England to intervene to safeguard pension funds that were facing financial strain.
- Similarly, the VIX index has highlighted an increase in volatility in equity markets in recent months (albeit the increase has been less dramatic than that in bond markets). Global equity market indices have trended lower since mid-August, with both advanced economies (excluding the US) and emerging market indices falling below their average post-GFC levels. Declines in US markets have been less significant, dropping back near levels last seen at the start of 2021.
- Given that inflation remains well above the targets of major central banks, these institutions have continued to increase their policy rates – with the US Federal Reserve implementing its third straight 75 bp hike in September. Despite slowing economic activity, we expect further rate increases from the Fed (in line with forward guidance from Fed governors) along with other major central banks in coming months.
- Consumer price data are widely available up to August and we estimate that global inflation remained stable at 8.7% yoy (unchanged since June). A range of factors – including slowing producer price growth, falling freight rates and food prices – point to weaker inflation in coming months, but there remain some risks, including the impact of the Russia-Ukraine conflict on European natural gas supply and disruptions due to China's zero-COVID policies. In addition, OPEC+ has committed to cuts to oil production, which could limit downside pressure to oil prices.
- Excluding energy, the Refinitiv CoreCommodity CRB index peaked in April 2022 and subsequently trended lower – despite a modest rally between mid-July and late August. At the time of writing, this index was around 14% below the April high – with weaker demand from China's construction sector a key driver.

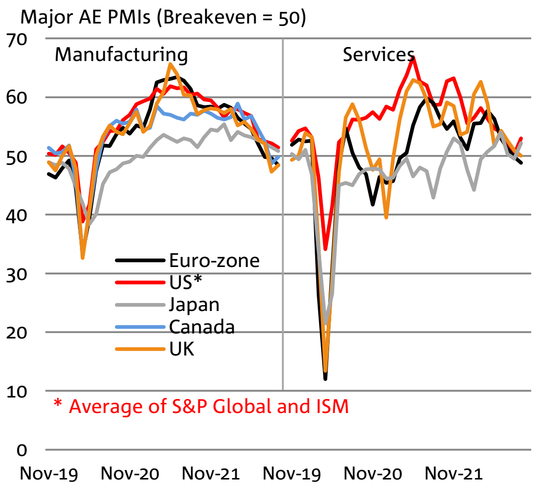
Sources: Refinitiv, NAB Economics

National Australia Bank

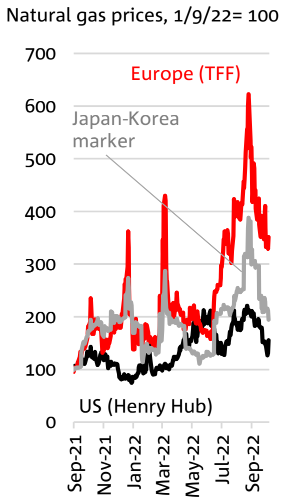
ADVANCED ECONOMIES

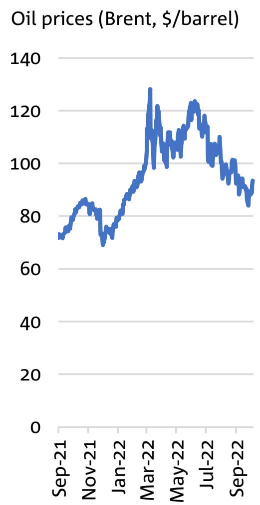
AEs likely to grow in Q3 but energy shock & rate hikes still expected to drag them down

Overall, business surveys still weakening

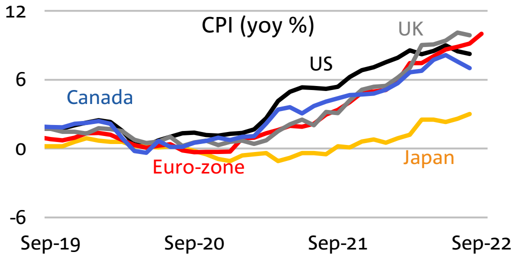


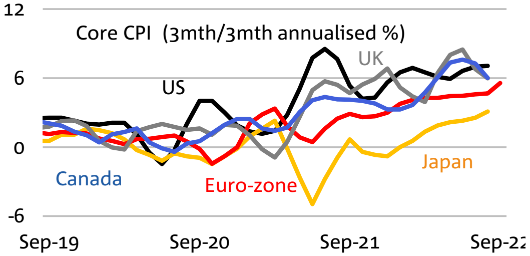
Some relief from falling energy prices, limiting downside risks



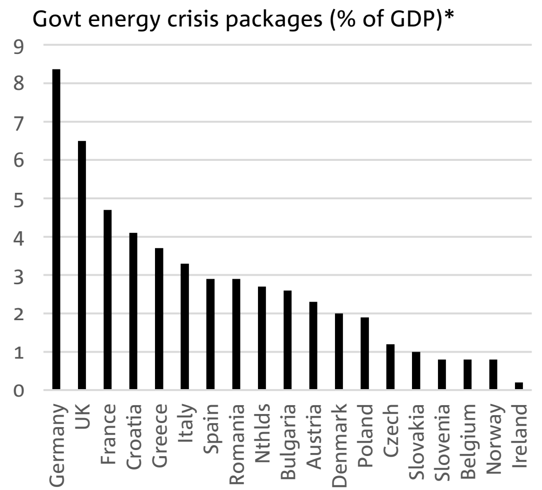


Inflation still elevated, including core (ex energy)





Large European fiscal response to energy crisis



Sources: Refinitiv, NAB Economics. * Estimates by Bruegel of support to households and businesses since Sept '21 up to 21/09/22 supplemented by press reports of packages announced by Germany and France since that date.

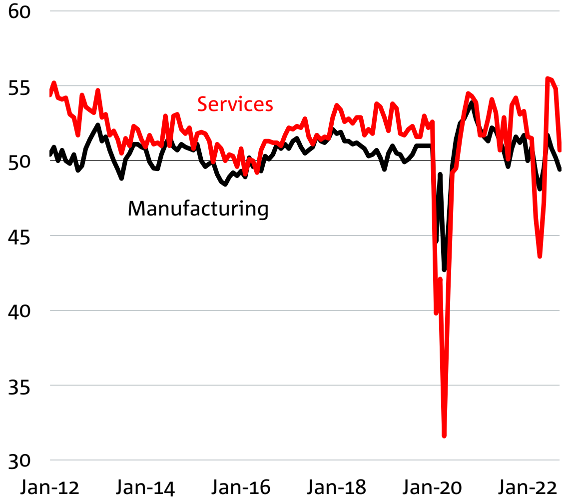
- We expect only slightly lower overall growth in Q3, than in Q2, in the major advanced economies (AEs), with improvement in the US to be offset by slower growth elsewhere, including the Euro-zone and Japan. US partial data continue to point to positive GDP growth (after declines over the first half of the year). The UK is likely to see a small fall in GDP (but Q2 growth was revised up to a small positive instead of a small decline).
- Business survey data generally continue to point to an ongoing weakening in conditions. On a more positive note, after some large falls, the US services sector has stabilised recently and the Japan services sector, through ups and downs due to COVID waves, has gradually recovered.
- We still expect to see the Euro-zone, UK (from later this year) and the US (in 2023) go into recession, and Canada may follow, due to ongoing tightening financial conditions and an energy supply shock.
- Some relief is coming from fading supply chain constraints although labour markets remain tight. The large stock of savings accumulated by households over the pandemic will also help buffer the impact of high inflation; US households have already started dipping into this, limiting the impact of declining real income on consumption. Commodity prices have also declined recently, leading to a softening in inflation in recent months (particularly in the US and Canada but less so in Europe). However, energy supply still remains tight and core inflation remains elevated if not rising. The rise in inflation (albeit still well below that of other countries) is also exposing tensions around the Bank of Japan's loose policy settings.
- European governments are responding to the energy crisis by sourcing alternative energy supplies, setting demand targets and through fiscal measures (including changes in price setting arrangements) aimed at limiting the financial impact on households and businesses. Much of the latter is debt financed and does little to address the underlying energy supply shortage (and risks adding to industry disfunction). Central banks are trying to reduce demand but fiscal policy is moving the other way. That said, by limiting the immediate rise in inflation, the measures reduce the risk of inflation expectations being de-anchored.
- The risks of throwing money at a problem in the current inflation environment was highlighted by the severe market reaction to the UK Government's plan for tax cuts worth over 1% of GDP. The resulting significant tightening in financial conditions (partly in anticipation of additional BoE rate hikes) also exposed financial system fragilities. Although some parts of the plan have been walked back, the passage of the remaining measures are still uncertain. We will adjust our UK forecasts when policy outcomes are clearer.

EMERGING MARKET ECONOMIES

China's efforts to control COVID-19 continues to constrain EM activity

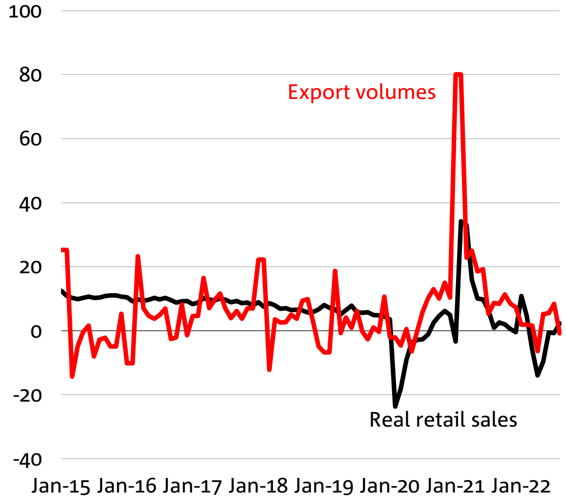
Negative China readings drag EM PMIs lower in September

Emerging market PMI (Breakeven = 50)



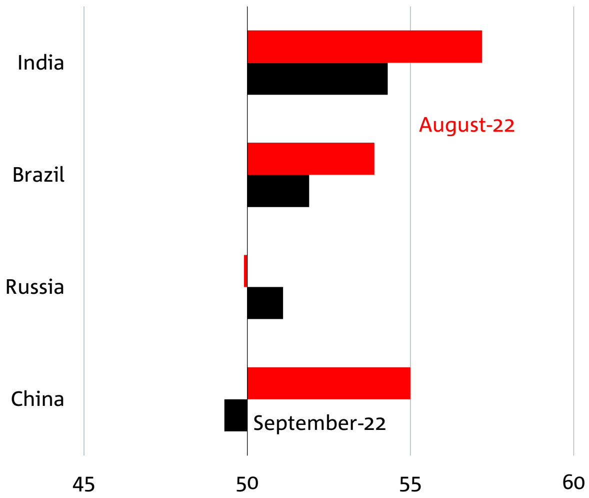
China's manufacturers have been dependent on export markets

% yoy



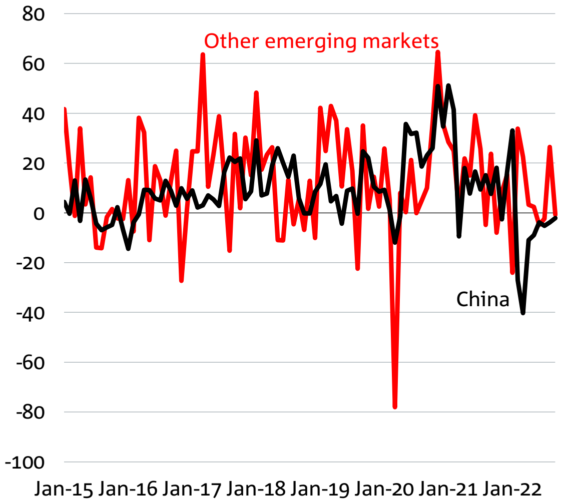
Steep month-on-month decline in China's services PMI

Major EM services PMIs (Breakeven = 50)



Capital flight from China has persisted in recent months

Emerging portfolio flows (US$ billion)



- Economic conditions remain highly mixed in emerging markets. Overall, economic activity in Q2, led by COVID-19 related disruptions in China and conflict and sanction related weakness in Russia – with activity falling by 2.6% qoq and 5.5% qoq respectively. These declines were somewhat offset by a strong rebound in Indian growth – up by 2.4% qoq.
- Trends have remained divergent in emerging market business surveys. While the EM manufacturing PMI moved slightly higher in June (as China's strict lockdown in Shanghai concluded), this measure has subsequently weakened – down to a negative 49.4 points in September (from 50.2 points previously). China's manufacturing PMI fell further into negative territory, while India's was also softer (albeit it remained strongly positive).
- Emerging market manufacturers are more dependent on trade than their advanced economy peers. Trade volumes – which rapidly accelerated between mid-2020 through early-2022 – are showing signs of plateauing in July. Various indicators – such as rising inventory levels and deteriorating container freight rates – point to declining demand in advanced economies. This suggests that EM export trends are likely to soften in coming months.
- This could pose problems for China's industrial sector – which has been highly dependent on export demand since the second half of 2020 (given that China's zero-COVID policies and lack of fiscal support has constrained household demand).
- The EM services PMI fell sharply in September, down to a slightly positive 50.7 points (from a strongly positive 54.8 points in August). Once again, China was the key driver of this trend – with the China services PMI dropping from 55.0 points in August to a negative 49.3 points in September – with a fresh wave of COVID-19 infections cited as the main driver of weaker activity and orders.
- The rapid tightening in advanced economy monetary policy has placed more pressure on EMs in recent months. With the exception of a large inflow in August, capital has flowed out of emerging markets since March – with China accounting for the bulk of these outflows. China's persistence with zero-COVID policies (which may hurt investor sentiment) along with monetary policy imbalance (easing policy rates in August counter to the global tightening trend) likely contributed to this trend.

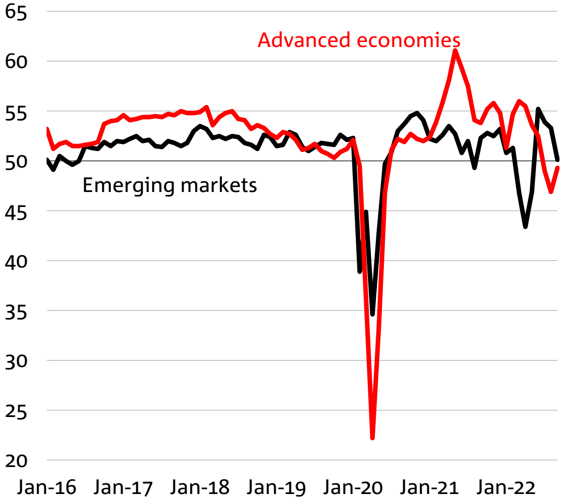
Sources: IHS Markit, IIF, CPB, Refinitiv, NAB Economics

GLOBAL FORECASTS, POLICIES AND RISKS

Central banks determined to lower inflation; tighter financial conditions to sharply slow growth

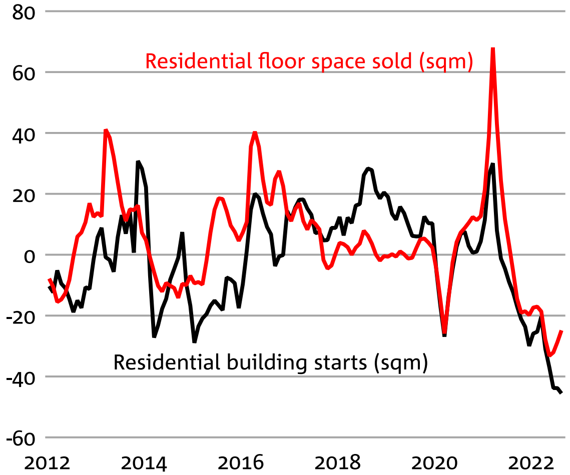
Gap between AEs and EMs narrowed in PMI surveys

JP Morgan global composite PMIs (Breakeven = 50)



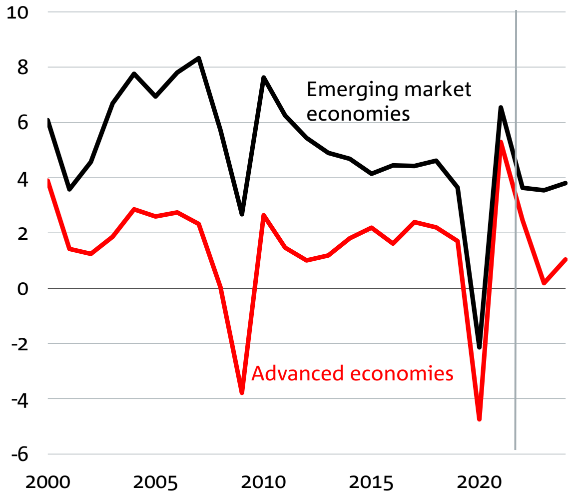
China's property sector continues to deteriorate

Residential property indicators (% yoy 3mma)



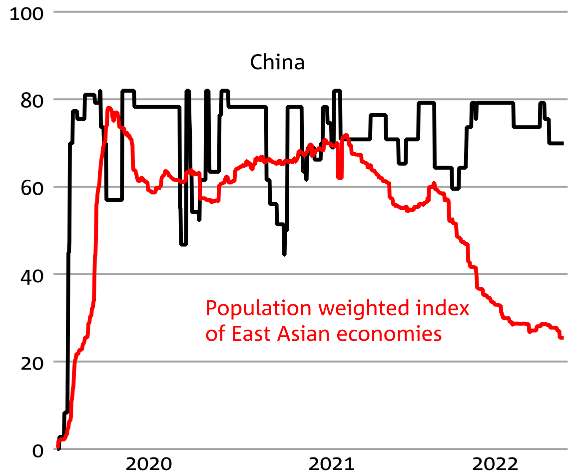
Marginal growth expected for AEs in 2023

Global economic growth & forecasts (%)



China's zero-COVID public health policies remain an outlier

OxCGRT Stringency Index



- Business surveys continue to point to weakening conditions in the global economy. That said, the JP Morgan global composite PMI was marginally less negative in September – at 49.7 points (compared with 49.3 points in August). Key to this outcome was a partial recovery in the services sector reading – which retuned to neutral territory in September – primarily in the advanced economies. Overall, the previously wide gap between PMI measures for advanced economies and emerging markets narrowed significantly in September.
- Improving trends in services are unlikely to persist, with tightening financial conditions in most major markets, along with higher energy costs, driving slowing economic growth in late 2022 and into 2023.
- Overall, there was minimal change to our aggregate global forecasts this month. Some revisions to historical data (most notably in the United Kingdom) have edged our forecast growth for 2022 higher – to 3.2% (from 3.1% previously).
- We continue to expect growth to slow significantly in 2023, down to 2.3%, before modestly recovering to 2.8% in 2024. These increases are well below the long run average of 3.4% (from 1980 onwards). The United States and the Euro-zone are forecast to record no growth in 2023, while we expect a marginal contraction in the UK economy for the full year.
- China's third quarter growth will be released after this report – with downside risk remaining to our forecasts (particularly in 2023 and beyond). The downturn in China's property sector continues – despite efforts by fiscal and monetary authorities to slow the decline – and this could impact local government revenues and their ability to invest in infrastructure projects going forward.
- There is considerable uncertainty around the global outlook. Central banks – most notably the US Federal Reserve – continue to prioritise inflation reduction over economic growth, and due to the lagged nature of inflation data, there is a strong possibility of higher-than-necessary policy rates resulting in a deeper than anticipated recessions in advanced economies. The Russia-Ukraine conflict has persisted – currently around 8 months – with natural gas flows to Europe restricted and ongoing concerns around grains and fertiliser supplies. China's zero-COVID public health policies remain in place and further lockdowns could negatively impact the currently improving supply chain trends. Geo-political tensions between China and the United States could also re-emerge.

Sources: IHS Markit, Macrobond, Refinitiv, NAB Economics

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