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The Forward View: Global March 2023

Bounce in Q1 2023; but bank stress highlights weaker outlook

NAB Group Economics

Overview

- Global central banks find themselves caught between competing forces, namely persistent high inflation (despite steep policy rate increases in much of the world in 2022) and banking sector instability in both the United States and Europe.

- There has been some improvement in advanced economy business surveys early in 2023, and we have revised up our expectations for US Q1 GDP growth, highlighting the resilience of advanced economy (AE) growth. At the same time, a boost to the global economy is evident from China's abandonment of its zero-COVID policies.

- Stress in the US and European banking systems emerged this month. Authorities moved swiftly to limit the fall-out, including through emergency lending programmes. Even with these steps, bank share prices, bond yields and commodity prices have seen large falls, while market volatility has increased.

- Overall, the banking issues mean that there has been a tightening in financial conditions. There may be further fall out from banks tightening lending standards. While central banks will utilise other tools to directly address financial stability concerns, the tighter financial conditions mean there is less need for them to increase rates – as a result, market expectations of future policy rates have come in (with a lower peak and earlier rate cuts now expected).

- We have been expecting growth to slow materially this year, and the banking developments reinforce this view, even though we assume authorities will be able to contain the problem and that the level of stress will subside from here. With AE labour markets still very tight and only slow progress being made in reducing core inflation, if past rate increases (and now banking stress) doesn't do the job, central banks will likely force the issue through further tightening.

- Our global forecasts are little changed this month. While we have revised up our 2023 forecast for US growth, we still only expect global growth of 2.6%, while we have marked down slightly our expectation for growth in 2024 to 2.7% (From 2.8%).

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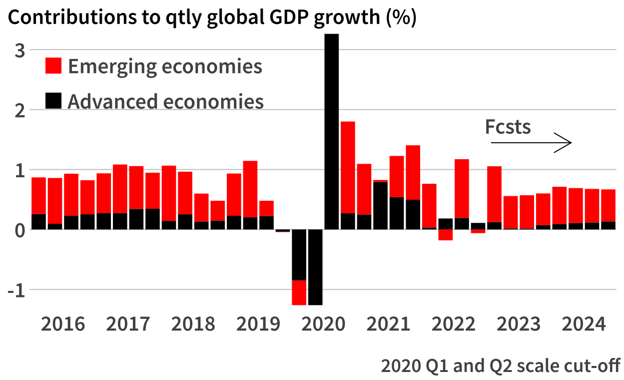
Global growth forecasts

	2020	2021	2022	2023	2024	2025
US	-2.8	5.9	2.1	1.1	0.9	1.9
Euro-zone	-6.3	5.3	3.5	0.9	0.7	1.2
Japan	-4.3	2.2	1.5	0.8	0.6	0.8
UK	-11.0	7.6	4.0	0.0	0.6	0.9
Canada	-5.1	5.0	3.4	0.8	1.0	1.4
China	2.2	8.1	3.0	5.4	4.5	4.8
India	-6.0	8.9	6.7	5.0	6.0	6.3
Latin America	-7.0	7.0	3.4	0.9	1.3	1.8
Other East Asia	-2.8	4.4	4.2	2.7	3.7	4.3
Australia	-1.8	5.2	3.7	1.5	0.6	1.9
NZ	-1.5	6.0	2.4	0.8	0.2	2.3
Global	**-3.0**	**6.2**	**3.3**	**2.6**	**2.7**	**3.2**

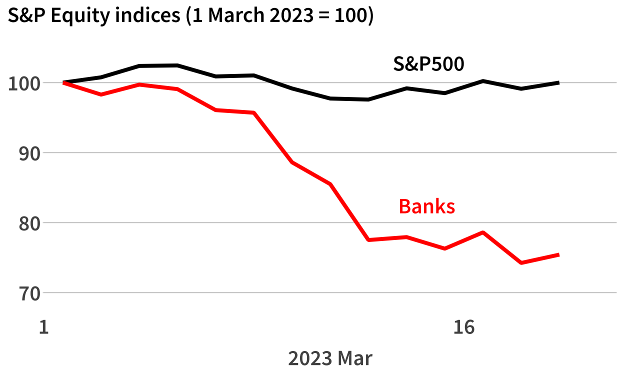
Bounce in Q1 to global growth from China, but expected to slow to below normal growth over rest of 2023 and 2024



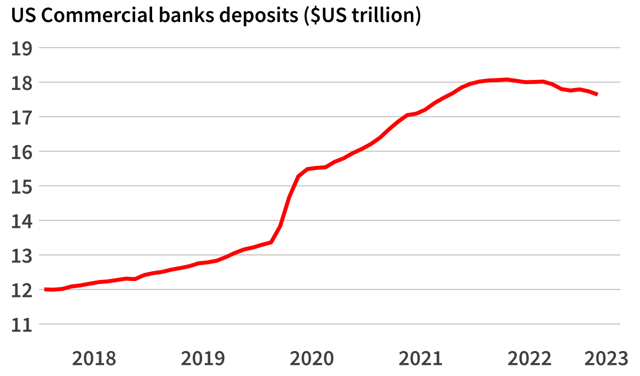
Gerard Burg, Senior Economist | Antony Kelly, Senior Economist | Alan Oster, Chief Economist

Charts of the month: US & European banking turmoil

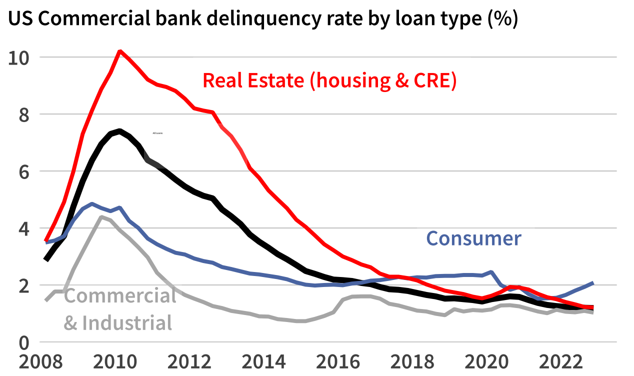
The collapse of Silicon Valley Bank after a deposit run led to contagion fears for the whole banking system – illustrated by large falls in bank share prices



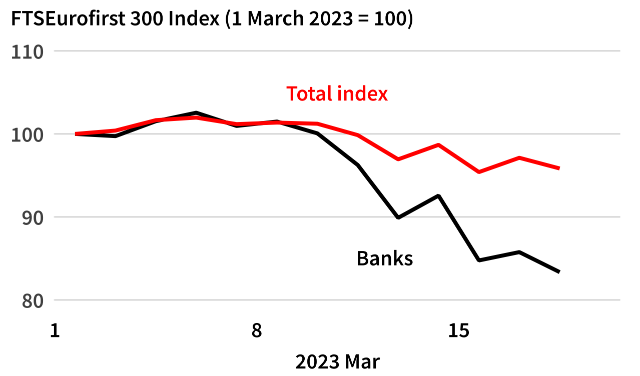
Idiosyncratic factors at play for worst affected banks (narrow customer base, poor balance sheet management) but system wide deposits falling



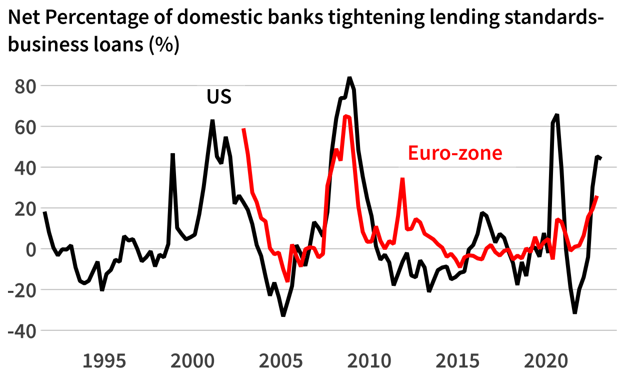
Unlike GFC not a loan quality issue – delinquency rates are low with only consumer loans starting to see some stress in the US



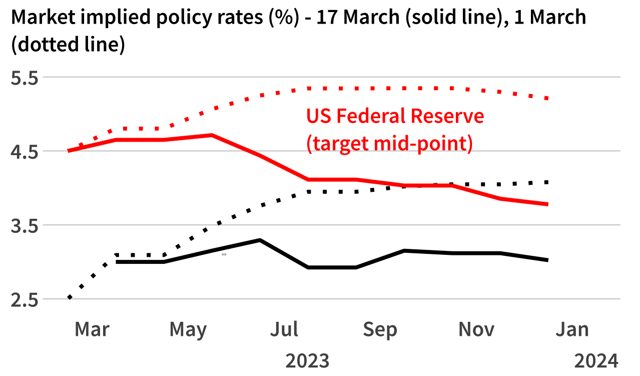
Banking jitters have spread to Europe, with Credit Suisse coming under pressure, resulting in support from the Swiss National Bank and then its takeover by UBS



While asset quality not the cause, one possible response by banks would be a further tightening in lending standards, which would affect the real economy



The banking stress has seen a major repricing of central bank interest rate expectations



Sources: Macrobond, Refinitiv, NAB Group Economics

Financial and commodity markets: central banks face competition between inflation and stability

Global central banks now find themselves caught between competing forces, namely inflation that has proved to be persistent (despite steep policy rate increases in much of the world in 2022) and banking sector instability in both the United States and Europe (in part – though not solely – related to the impact of recent rate hikes on banks' balance sheets).

Broad global inflation data are available to January and continue to highlight the slow retreat from multi-decade peaks. According to our estimate, global prices rose by around 8.4% yoy in January, compared with a 9.6% yoy increase in September 2022, but only modestly lower than the December reading. This gradual easing has been considerably slower than most central banks anticipated, and inflation remains well above central bank targets. This would normally point to further hikes in policy rates, however financial sector instability has rapidly emerged as a concern.

A range of financial institutions in the US and Europe have required emergency funding – with some impacted by the rapid increase in policy rates across 2022. Despite some issues being idiosyncratic to individual institutions, fears of broader systematic risk resulted in a selloff in banking stocks in both regions – potentially adding further pressure to the sector.

This has resulted in a substantial shift in financial market expectations around policy rates. Between the start of March and mid-month, the rate profile moved considerably lower – with markets pricing in cuts to the fed funds rate in June (from anticipating a hike at the start of the month).

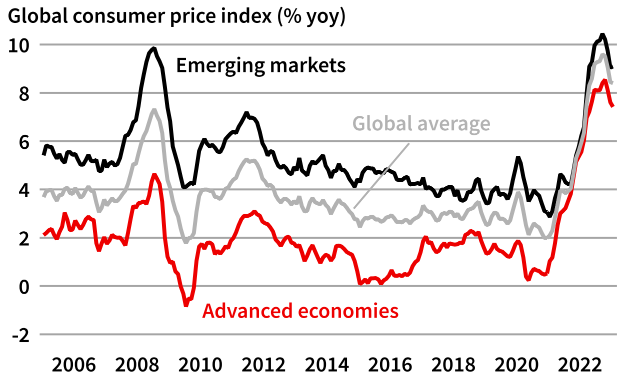
That said, concerns around the stability of the European banking sector were not sufficient to alter the immediate decision making of the European Central Bank – which hiked policy rates by 50 basis points in mid-March.

Volatility in financial markets also increased in response to the banking sector concerns. This was particularly the case in bond markets – with the MOVE index surging in mid-March to its highest levels since 2008 (during the Global Financial Crisis). In contrast, the VIX index – which tracks equity market volatility – trended higher, but was relatively contained.

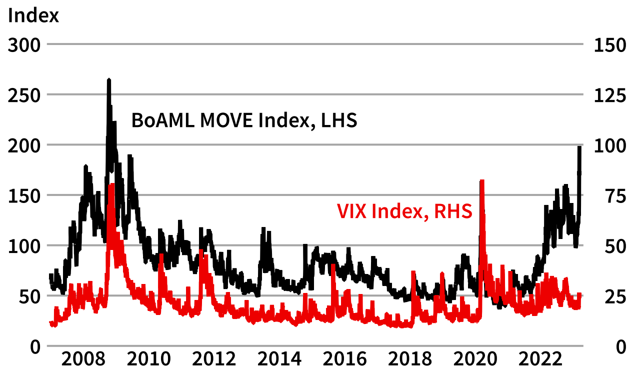
Government bond yields for major advanced economies – which until March had broadly been trending higher – fell by around 50 basis points between early and mid-March.

Similarly, global commodity prices also fell sharply in mid-March – with the aggregate S&P GSCI index down around 7% when compared with the start of the month. This was driven by energy commodities – with non-energy markets essentially flat since the start of March – with oil prices dropping to their lowest levels since Russia's invasion of Ukraine.

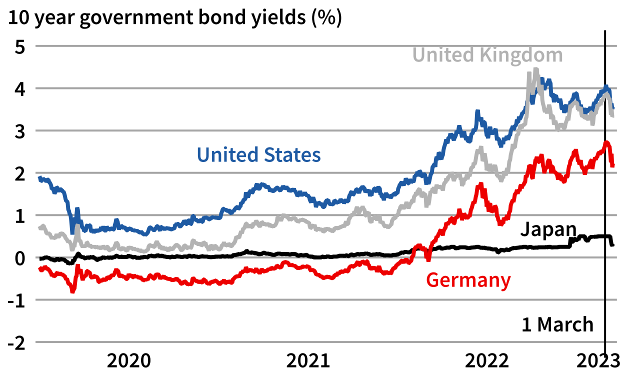
Persistent inflation above central bank targets



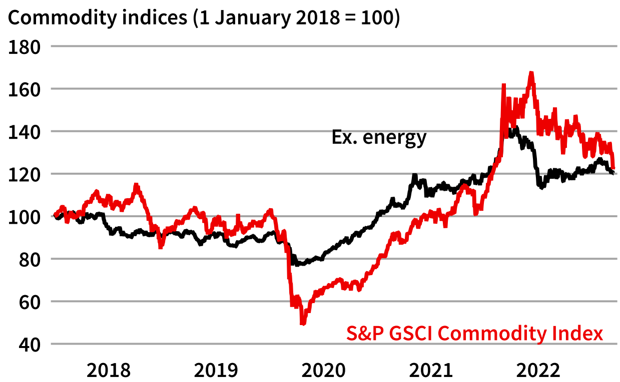
Banking sector fears spark bond market volatility…



…as major government bond yields plunged mid-March



Falling energy prices drive commodity indices lower



Sources: Macrobond, NAB Group Economics

Advanced economies: resilient, but outlook still weak

Updated data confirm that major advanced economy (AE) growth in Q4, outside the US, was very weak. Canada GDP was almost flat and the initial estimates for Euro-zone and Japan were revised down. The revised estimates indicate Japan only grew slightly in Q4 and the Euro-zone economy contracted marginally (-0.03% q/q).

While Q1 is almost complete, in data terms it is still early days. For the Euro-zone, the Q4 revision re-opens the possibility of two quarters of negative growth (and the 'recession' label) but we still expect growth in Q1. Retail sales and industrial production increased in January, and business surveys in February moved further away from contractionary territory. In contrast, we are still forecasting a decline in UK Q1 GDP – albeit smaller than previously anticipated given that UK business survey readings improved in February and January GDP was up 0.3% m/m, reversing some of the December weakness.

US data was almost uniformly strong in January. This might have reflected warmer than normal weather, but initial February data have only shown a modest reversal of the January strength. As a result, we have revised upwards our estimate of Q1 GDP growth (from -0.4% q/q to 1.7% q/q annualised).

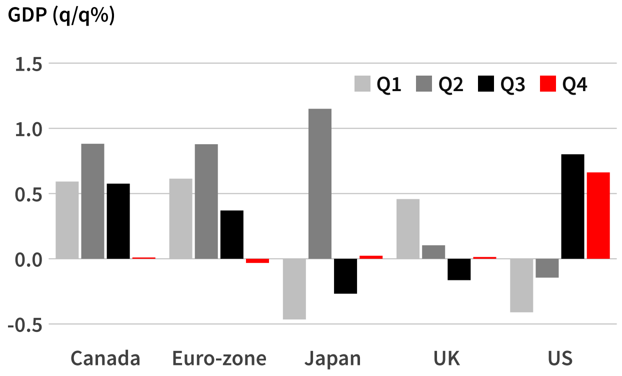
While growth has clearly slowed in some regions, labour markets are still very tight and core inflation measures remain high. The major advanced economies have proved to be resilient against a series of shocks – a rapid tightening in monetary policy, higher energy and food prices and ongoing disruptions in China's economy. Moreover, the decline in energy prices over H2 2022, and China's abandonment of its zero-COVID approach (and rebound in activity) means that the impact of two of the shocks is fading or being reversed.

However, the full impacts of tighter monetary policy are yet to be felt. The current problems with some US and European banks are also a negative for the economy due to the resulting tighter financial conditions and negative impacts of confidence. Banks may well respond with a further tightening in lending standards.

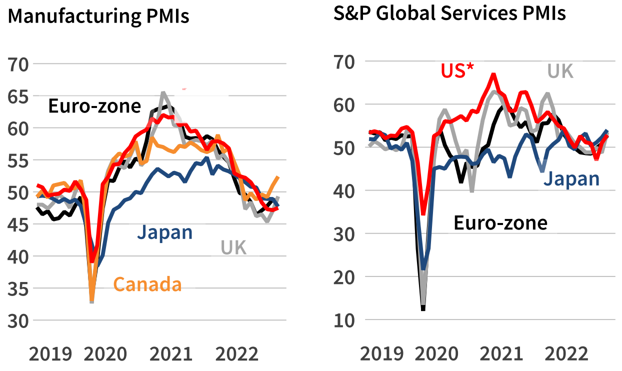
The combination of growth resilience, still tight labour markets and persistent high inflation means central banks are going to be biased towards tightening financial conditions. In the event banking stress materially subsides, expectations of central bank rate hikes will likely move higher.

So we still consider that the outlook over the next 1-2 years for the major AEs is one of weak growth, including the possibility of 'mild' recessions (particularly US and UK). Our baseline forecasts assume that current banking stress is contained, but if the problems broaden and deepen, a steeper fall in activity would be on the cards.

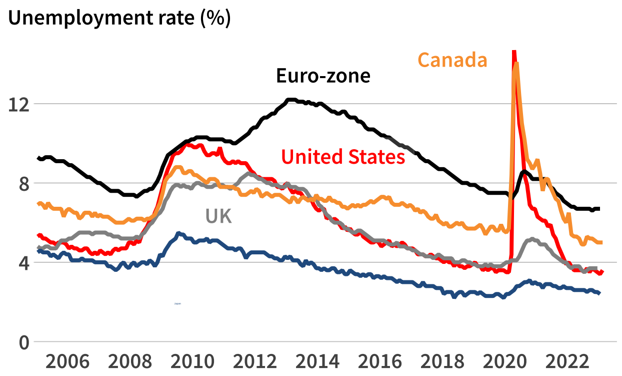
GDP growth stalled in Q4 outside the US



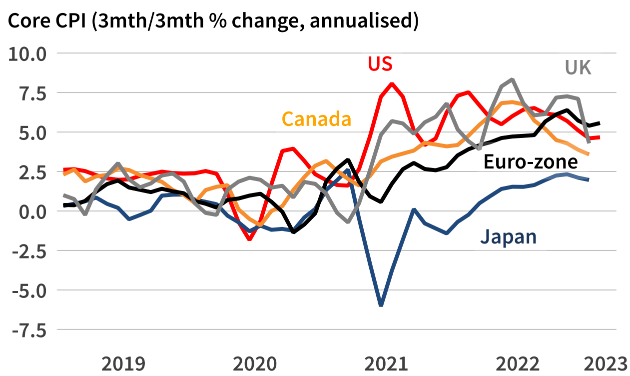
Surveys again improved in February – mainly services



Labour markets remain tight



Core inflation remains high and only slowly coming down



Emerging markets: from a weak end to 2022, EMs searching for non-trade driven growth

Growth in major emerging market economies slowed considerably in Q4, with year-on-year growth at around 2.9% (from 4.2% yoy in Q3) – well below typical pre-pandemic rates. Although weaker trends were evident across the major EM economies and country groupings, slower growth in East Asia (particularly Malaysia and Taiwan) and China were the key drivers of the downturn. It should be noted that Russia's growth was estimated as it is yet to report official data.

In contrast to the negativity of late 2022, PMI surveys were indicative of a rebound in activity in emerging markets in February. The EM composite PMI rose to 53.9 points (from 51.9 points in January and negative readings in October and November 2022). That said, as PMI results showing expansion or contraction are relative the previous month and do not always correlate to official economic data.

The EM manufacturing PMI pushed up to 51.6 points in February (from an essentially neutral 49.9 points in January). This upturn was almost solely driven by stronger readings in China – as its economy continues to normalise post the end of its zero-COVID policy and, more recently, Chinese New Year disruptions.

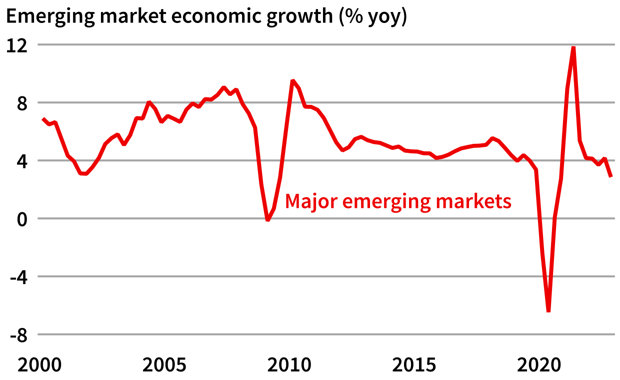
Similarly, the EM services PMI rose to 54.5 points (from 53.1 points in January). Once again China was the key driver of the increase, supported by stronger readings in both India and Russia.

In contrast with the positive survey data, China's partial economic data for January and February was somewhat mixed. Growth remained heavily driven by investment in infrastructure and manufacturing (with real estate investment still contracting). Real retail sales returned to growth, but at modest rates well below pre-pandemic norms – suggesting that we are yet to see any "revenge spending" wave, and international trade activity continues to show signs of slowing.

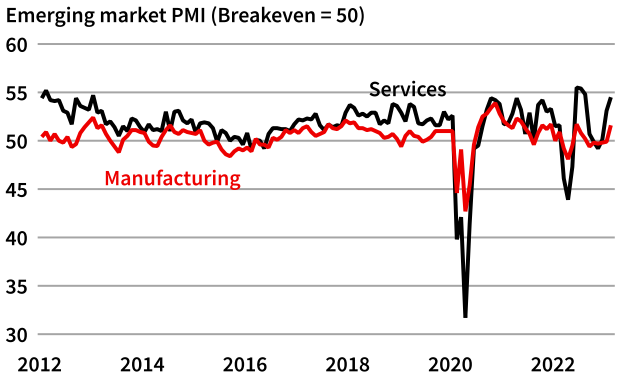
On average, emerging market growth is more dependent on trade than advanced economies, meaning that the slower AE goods demand (driven by tighter monetary policy and a transition in spending towards services) is a headwind for economic activity. According to CPB data, EM export volumes peaked in May 2022 and have subsequently trended lower – with export volumes in December around 7.7% below its peak.

Weaker global trade activity will impact industrial production in emerging markets. EM industrial output rose by just 1.0% yoy in December (down from around 5.2% yoy in September). On a three-month moving average basis, this increase falls below the pre-pandemic trend rate of growth and is unlikely to recover significantly in the near-term.

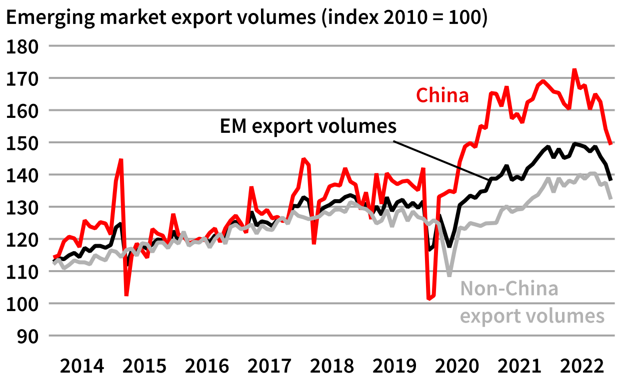
EM growth slowed significantly in Q4 2022…



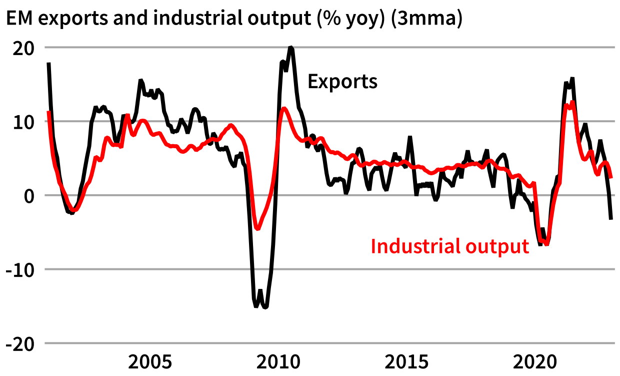
…but PMIs point to China led improvement in early 2023



EM export volumes continue to trend lower



EM industrial production growth weaker



Global forecasts and risks: surveys point to improvement, but global growth set to slow in 2023

Following weakness in late 2022, early indicators of global activity were showing signs of improvement through February 2023. The JP Morgan global composite PMI was fairly robust in February – up to 52.1 points, from a marginally negative 49.7 points in January. In a large part, this reflected stronger sentiment in China that did not entirely align in the country's official data for February.

This rebound was primarily led by services (with the global manufacturing PMI moving back to neutral levels) – with improved readings in both advanced economies and emerging markets.

It is too early to know if the fears around the banking sector in the United States and Europe will remain isolated to individual institutions or whether financial contagion could spread. Even in a best-case scenario, increased caution could lead to a further tightening in lending standards, negatively impacting near-term economic activity.

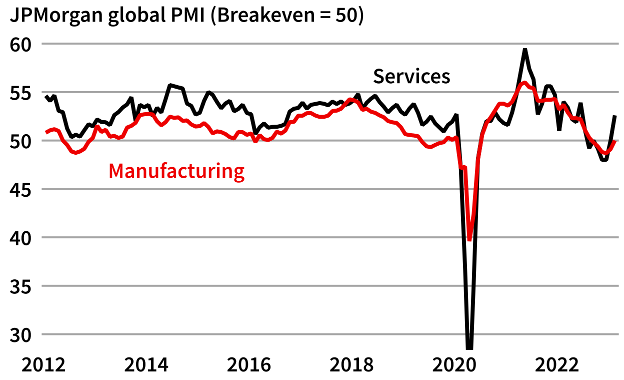
Overall, there has been minimal change to our global forecasts this month. The stronger than anticipated start to the year in the United States has seen the forecast for 2023 edged higher, although this is somewhat offset by a softer outlook for Japan and Canada. The net effect of these changes is that our global forecast for 2023 is unchanged at 2.6%, while our 2024 outlook is marginally weaker at 2.7%. We anticipate a moderate recovery in 2025, with growth at 3.2% (in part reflecting easing monetary policy in 2024) – remaining below the long run average of 3.4% (between 1980 and 2022).

While inflation has persisted for longer than most global central banks had anticipated, supply side pressures steadily diminished across 2022 and into 2023. The Federal Reserve Bank of New York's Global Supply Chain Pressure Index has now returned to normal ranges, and this could increase downward pressure on prices.

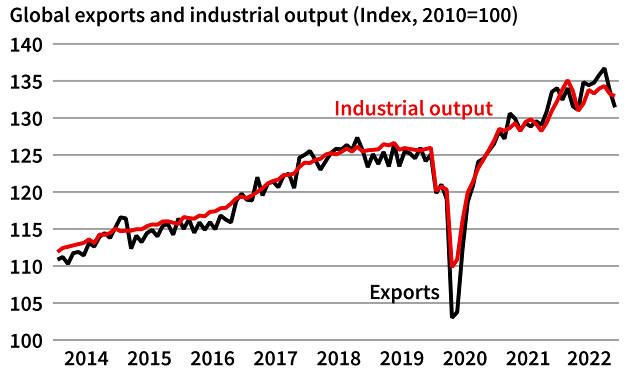
A key source of uncertainty in our near-term forecasts is the strength of the rebound in China's consumption. Chinese authorities have identified consumption as the key driver of growth in 2023, but have offered little fiscal support since the start of the pandemic. While real retail sales grew modestly in the first two months (compared with sizeable declines across much of 2022), the growth was well below the pre-pandemic norms.

Beyond the immediate concerns related to the global financial sector, there are a number of other risks to the global outlook. The Russia-Ukraine conflict continues, and Russia has stated that extending the deal to allow export of grain via the Black Sea is dependent on the removal of western sanctions. Similarly, geo-political tensions have persisted, notably between the US and China – as the US attempts to lock China out of high-tech semi-conductor markets, while US Secretary of State Blinken postponed a trip to Beijing following the spy balloon scandal.

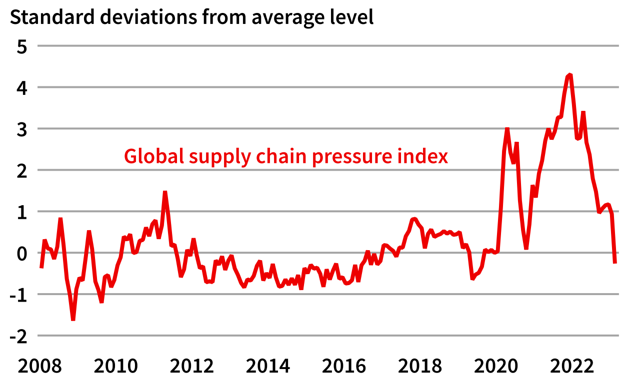
China's services drove recovery in global PMI



Global growth outlook remains below long run average



Global supply chains appear to be returning to normal



China's consumers are yet to fully re-emerge

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