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2023 Global Macro Outlook: scenario update

Central banks could be more cautious as they monitor spillovers from the US regional bank crisis

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FLASH NOTE

SUMMARY

- A liquidity event in the US regional banking sector in recent days has been the catalyst for a dramatic re-pricing of the macro outlook and interest rates cycle.
- Central banks are likely to be more cautious as they monitor the tightening in credit conditions. However, one major difference with previous banking crisis episodes is a more resilient macro backdrop including persistent inflationary pressures. This will make for a difficult trade-off between inflation and financial stability risks, with central banks trying to resist rate cuts for as long as possible.
- We expect the Fed to hike rates by 25bp next week, to 4.75%-5.0%, but stop afterwards. Fed chair Jerome Powell may stress again that monetary policy is working with a lag, and that recent events suggest that more tightening is spilling over to the real economy in order to justify a pause.
- The Fed's balance sheet runoff should continue at the current pace for now, although the path of least resistance would be for central banks to temporarily stop Quantitative Tightening (QT) in case of severe market dis-locations.
- This week, we expect the ECB to deliver the 50bp deposit rate rise it has already flagged, as well as an additional 50bp of tightening by June, to 3.50%.

INFLATION IS BAD, BUT A CREDIT CRUNCH WOULD BE WORSE

There is no escaping the extreme level of uncertainty over the spillovers from the Silicon Valley Bank's (SVB) collapse. The balance of risks has shifted from one extreme to the other in a matter of a few days, leading to a dramatic re-pricing of policy rates and bond yields since last week. The full ramifications of this crisis could take some time to materialise, adding to the case for prudent policymaking.

With these caveats in mind, **our baseline scenario assumes tighter credit conditions but no outright credit crunch in the US and limited contagion to the European banking sector**. We were already forecasting a recession in the US in H2

2023; the balance of risks is now tilted towards a more severe contraction of activity. We continue to forecast a weak recovery in the euro area but no recession.

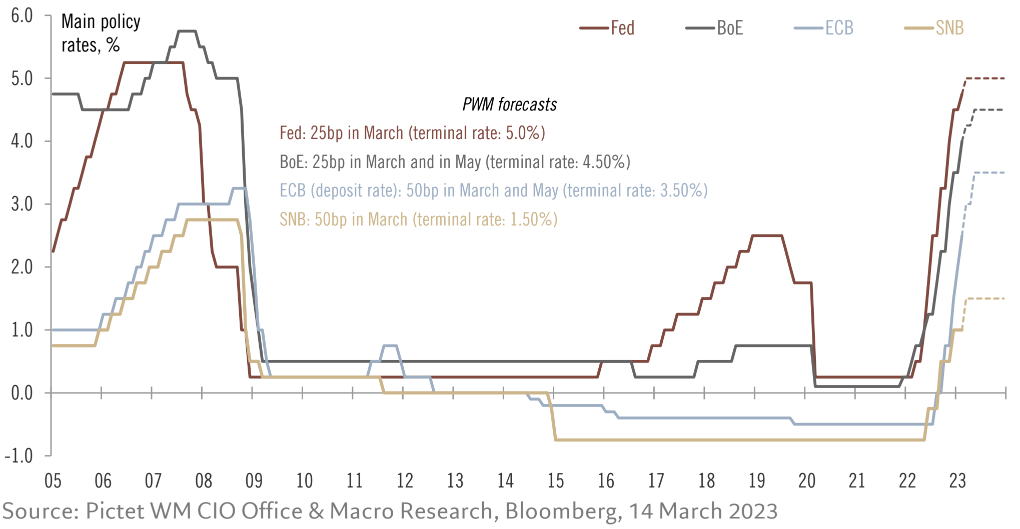
One major difference with previous episodes of late-cycle financial stress is today's resilient macro backdrop, with a tight labour market and persistent inflationary pressures. As a result, **central banks are facing a very difficult trade-off between inflation and financial stability risks**, much worse than in 1998, for example.

While letting inflation run might be bad, presiding over a credit crunch would be worse. Given that we have had the fastest monetary tightening cycle in history, we were expecting 'something' to break eventually. Policy normalisation was never going to be a smooth and linear process. The collapse of SVB is likely to be the catalyst that convinces central banks to proceed more cautiously going forward.

As we get closer to the end of the tightening cycle, the focus will turn to the timing of rate cuts, but also to balance sheet policies and Quantitative Tightening (QT). **Central banks will try and distinguish between their balance sheet (to address financial stability) and policy rates (to set the monetary stance).** Last year's Liability Driven Investment (LDI) crisis in the UK may be viewed as a template for a central bank willing to use its balance sheet to address liquidity and financial stability concerns, only to resume QT and rate hikes once market conditions stabilise.

Today the Fed is accepting collateral at par, not actively purchasing bonds, but a similar logic applies. The ECB is raising rates while reinvesting the proceeds of its Pandemic Emergency Purchase Programme (PEPP) and promising to purchase government bonds via the Transmission Protection Instrument (TPI) to prevent financial fragmentation. We expect these policies to continue for now, although the path of least resistance would be to suspend QT. The ECB could always ease collateral eligibility conditions if not offer new LTRO as a backstop, if needed.

Chart 1: central bank policy rates including PWM projections



Source: Pictet WM CIO Office & Macro Research, Bloomberg, 14 March 2023

We still expect no rate cuts from the Fed before 2024 but reckon that the risks have increased along with recession risks. When central banks start to cut rates, the persistence of inflationary pressure could limit the amount of monetary easing initially, although the Fed would still have room to maneuver to make its monetary stance less restrictive.

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US: THE THIRD MANDATE

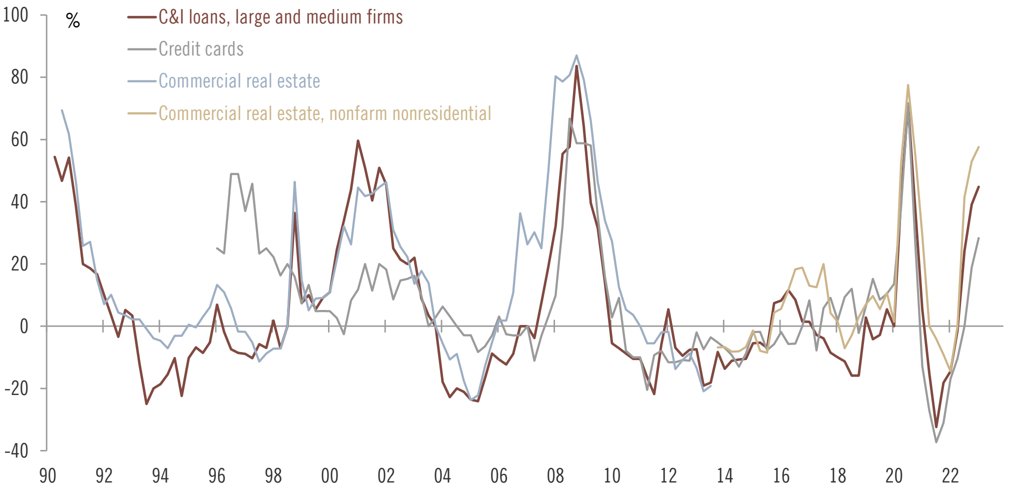
The bias in US monetary policy has shifted rapidly from a hawkish tilt due to an overheating economy to a dovish pivot due to mounting concerns around financial stability. **We expect the Federal Open Market Committee (FOMC) to hike rates by 25bp at its meeting next week while signalling a pause in its tightening cycle** (we previously expected two 25bp hikes in March and May).

The **balance sheet runoff** (QT) of the Fed's holdings of US Treasuries and agency mortgage-backed securities should **continue at the current pace** for now. The Bank Term Funding Program (BTFP), aimed at providing additional funding to depository institutions, could temporarily expand the Fed's balance sheet, but it is not large-scale asset purchases (or quantitative easing). If financial stresses accumulate materially, the Fed **could stop QT early**. However, unless the US enters a very deep recession, **we don't expect a resumption of QE anytime soon.**

We expect the US to enter into a moderate recession in the second half of 2023, with three quarters of contraction averaging an annualised -1.4% each quarter. Inventory destocking and weak capital spending should drive the contraction, along with a continued slump in residential investment.

However, risks of a deeper and an even earlier recession have risen meaningfully. Recent events are already leading to tighter credit conditions, which could slow aggregate demand and become disinflationary. With signs of deposits moving from regional banks to large nationwide ones and a rise in banks' general risk aversion, risks of a large negative shock to consumer and business confidence and a further sharp tightening in lending standards have risen meaningfully (*Chart 2*).

Chart 2: net percentage of US banks tightening lending standards



Source: Pictet WM CIO Office & Macro Research, Federal Reserve, 15 March 2023

Although we don't think interest rates are the primary tool to address financial stability risks, a pause in the Fed's tightening cycle is likely appropriate in the interest of prudent risk management as the FOMC assesses the fallout from SVB's collapse and evaluates the full effect of the cumulative tightening to date.

The banking sector was resilient to aggressive monetary tightening until last week, when poor management of duration risk at SVB exposed the first cracks in the

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financial system caused by higher interest rates. The government has stepped in swiftly to stem concerns of a broader bank run, with the Fed, Treasury and Federal Deposit Insurance Corporation (FDIC) announcing guarantees on uninsured deposits at failed banks. Harking back to the emergency measures it undertook during the global financial crisis and the covid pandemic, the Fed established a new Bank Term Funding Program (BTFP) aimed at providing additional funding to depository institutions by accepting high-quality collateral at par (instead of at fair market value) while easing the terms of banks' access to its discount window.

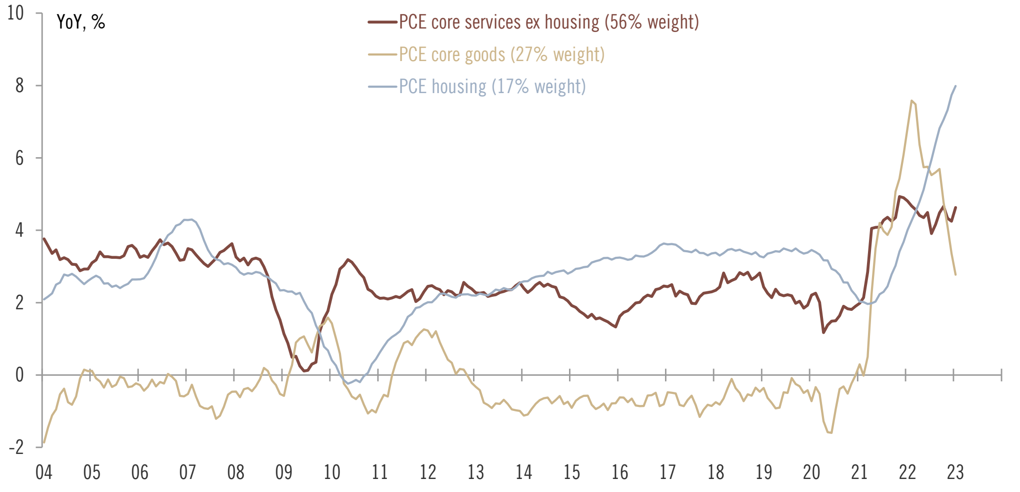
In our baseline scenario, we expect these measures to be effective in preventing broad-based contagion (although individual bank failures cannot be excluded).

Although the Fed does not have an explicit third mandate to guarantee financial stability in its monetary policy goals (it has a purely supervisory role), the central bank's dual mandate of ensuring maximum employment and price stability would likely be jeopardised if it didn't take financial stability risks into account. Indeed, following a series of financial panics, ensuring financial stability was an important factor in the creation of the Federal Reserve in 1913.

To be sure, **economic fundamentals suggest interest rates need to stay high for a while yet**. The labour market remains too tight for the Fed's liking, with strong hiring and historically elevated job openings for every unemployed worker. Although there are signs of softening wage growth, it remains elevated and inconsistent with the Fed's 2% inflation target.

Inflation in the US should decelerate, but the process will be bumpy. The consumer price index (CPI) report for February showed core inflation accelerating on a monthly basis (from 0.4% to 0.5%), with little sign of disinflation in services (ex housing). We expect core PCE inflation (the Federal Reserve's preferred inflation gauge) to end the year at 3.4%, down from 4.7% in January but still well above the Fed's 2% inflation target. Rental disinflation (already evident in industry measures) should start passing through to readings for shelter inflation around the summer. Goods prices should continue to normalise, although supply-chain bottlenecks could also re-emerge if geopolitical risks escalate (*Chart 3*).

Chart 3: US core PCE inflation



Source: Pictet WM CIO Office & Macro Research, Bureau of Economic Analysis, 15 March 2023

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Overall, recent bank failures have led to extreme uncertainty surrounding the US. Just two days before the SVB failure, Fed chair Jerome Powell opened the door to a 50bp rate increase in March and suggested the terminal rate for the Fed funds rate could be higher due to stronger-than-expected economic data. Within a few days, the balance of risks has shifted and the tightening in financial conditions has already called into question the extent to which the Federal Reserve can, and is willing, to push rates higher in its fight against inflation while at the same time guaranteeing financial stability. A sharper-than-expected tightening in credit conditions in capital markets and banks together with a sharp drop in consumer and business confidence could bring about a deeper and earlier recession in the US, raising risks of earlier than expected monetary easing.

In this context, **the Fed is likely to reassess the level of policy rates that is "sufficiently restrictive"** to bring inflation back to target. Powell may stress again that **monetary policy is working with a lag**, and that recent events suggest that more tightening is spilling over to the real economy in order to justify a pause.

EURO AREA: A MEETING-BY-MEETING APPROACH

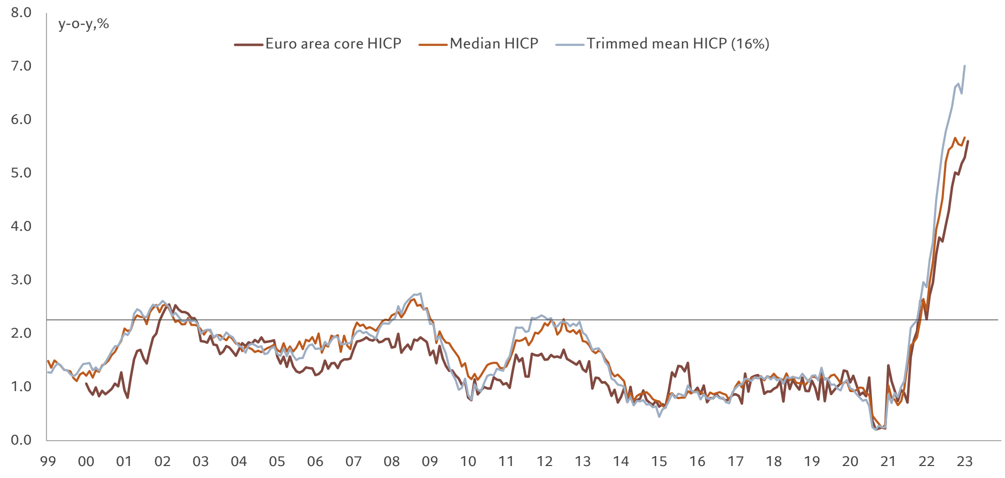
We continue to expect the European Central Bank (ECB) to hike its policy rates by 50bp at its 16 March meeting as we see a relatively high hurdle to deviate from the ECB's "intention". Our forecast has been for another 50bp hike in May, but even under a relatively benign scenario in the US, risks now look skewed towards a slower pace of tightening in the form of 25bp rate hikes instead of 50bp. Either way, we are sticking with our terminal rate forecast of 3.50% for the deposit rate.

ECB President Christine Lagarde should strike a hawkish, albeit noncommittal tone on Thursday, highlighting even more strongly than before that future policy decisions will be data-dependent. Adding to the uncertainty is the sense of growing disagreement within Governing Council members over the appropriate level of policy rates that would be sufficiently restrictive to cool demand and inflation while avoiding a much sharper contraction in bank credit.

For now, European business surveys have remained consistent with positive albeit weak growth in H1 as near-term recession risks retreat. Activity is particularly buoyant in the services sector. The easing of concerns about gas prices and stocks, large-scale fiscal support, fading supply bottlenecks and China's reopening are all factors that are contributing to the improved mood among European corporations and consumers. Sector wise, energy-intensive industries such as chemicals and plastics remain the main areas of weakness while the auto sector continues to pull away from last year's slump.

We expect the second half of 2023 to be more challenging for the euro area given growing economic headwinds in the US, the lagged impact of monetary tightening and the gradual removal of national fiscal stimulus measures. The latest bank lending surveys show a tightening in credit conditions and a fall in loan demand. We are therefore sticking with our 2023 GDP growth forecast of 0.5% for the euro area.

Chart 4: measures of euro area underlying inflation



Source: Pictet WM CIO Office & Macro Research, Bloomberg, 15 March 2023

Crucially, the latest inflation data should keep the ECB in hawkish mode, pointing to strong underlying price pressure in the euro area. Core inflation rose further from 5.3% to 5.6% in February, on the back of strong services inflation. Looking ahead, while we expect energy inflation to continue to decline, core inflation looks set to remain sticky largely due to the lagged pass-through of higher energy and labour costs. We have revised our annual core inflation forecast higher for the euro area, from 3.5% to 4.3% in 2023. Our headline inflation forecast remains unchanged at 5.3% in 2023.

The ECB's new staff projections will account for resilient activity data and a higher starting point for core inflation, but also lower gas prices, higher bond yields, and a stronger currency. In all, we expect a downward revision to headline inflation throughout the forecast horizon, but **an upward revision to core inflation and growth in 2023**. Accounting for a tighter policy stance and a wider output gap, core inflation could be revised slightly lower in 2025, from 2.4% to 2.3%.

The renewed uncertainties following the collapse of SVB will reinforce the case for a meeting-by-meeting approach by the ECB. The Governing Council may not give strong guidance of its future rate path this week and will likely say that future rate decisions will be data dependent. The risk of direct contagion from recent US bank failures to the European banking sector seems limited. But financial stress in the US could lead to tighter financial conditions in Europe and impact confidence, amplifying the drag on the European economy.

SNB: TONING DOWN THE RHETORIC A BIT

The last time the Swiss National Bank (SNB) raised rates was in December, when it increased its main policy rate by 50bp to 1.0% to counter prolonged inflationary pressure. But the most recent inflation data will not reassure the SNB that its job is done, so that it is likely to remain in hawkish mode. Indeed, headline inflation edged higher to 3.4% in February, up from 3.3% in January and above expectations of 3.1%. More importantly, core inflation strengthened to 2.4% in February, its highest level on record, warranting more monetary policy tightening.

We still expect the SNB to hike its main policy rate by 50bp at the end of this month (March 23), bringing it up to 1.50%. The question is what comes next.

A lot will depend on what other central banks do as well as financial stability in light of the recent US bank failures. The SNB has fallen well behind other central banks in this tightening cycle, having hiked by only 175bp so far, compared to the ECB's 300bp and the Fed's 450bp.

Key to watch on the day of the interest rate decision will be the SNB's conditional inflation forecasts. A forecast for annual inflation that is above or at 2% for Q4 2025 would strengthen the case for more tightening over the medium term.

Given inflation remains an issue, keeping a strong currency will remain important to head off imported price pressure. Admittedly, inflation in Switzerland is lower than elsewhere, but the larger the rate differential, the more the Swiss franc could weaken, thus adding to inflationary pressures in the medium term. At the same time, the SNB has the luxury of being able to leverage its balance sheet to keep the CHF strong. In all, we expect the SNB to hike its policy rate by 50bp in March and to tone down a bit its rhetoric while refusing to rule out further hikes thereafter.

CHINA: RECOVERY PICKS UP, BUT NO V-SHAPED REBOUND EXPECTED

After the long lunar new year holiday, the Chinese economy continues to recover. Purchasing manager indexes (PMI) rose sharply in February for both manufacturing and non-manufacturing. The improvement was broad based, with particular strength in the services sector. Rising business expectations are consistent with our view that **China's economic rebound will likely be front loaded to the first half of 2023, with growth momentum perhaps peaking in Q2**.

Having said that, the lingering weakness of the labour market and falling household expectations for income growth will likely constrain the rebound in domestic consumption, while waning global demand will likely weigh on China's exports in 2023. Indeed, the targets for major economic indicators announced by the government during the National People's Congress (NPC) in early March were in line with our relatively conservative view on China's recovery. The 2023 GDP growth target was set at "around 5.0%", which is in line with our GDP forecast but lower than market consensus. The government kept the headline inflation target unchanged from last year at "around 3.0%", which may allow room for pro-growth policy support. Meanwhile, the government work report presented by outgoing premier Li Keqiang again emphasised the aim of stabilising growth. We believe recovery in household consumption and the labour market will likely be one of the government's main focuses this year, leading to prudent and targeted policy support. All in all, while the latest PMI numbers are encouraging, we are not expecting a V-shaped rebound in the Chinese economy this time around as we expect the improvement in household and business sentiment to be gradual. **Our Chinese GDP forecast for this year remains unchanged at 5% for the time being.**

OIL: DEMAND MAY LOSE SOME SUPPORT

The risk of recession in the US will impact global energy markets to various degrees. Oil demand in the US could contract by around 0.4 million barrels per day (mbd) by the end of the year if we have a mild US downturn. However, this would

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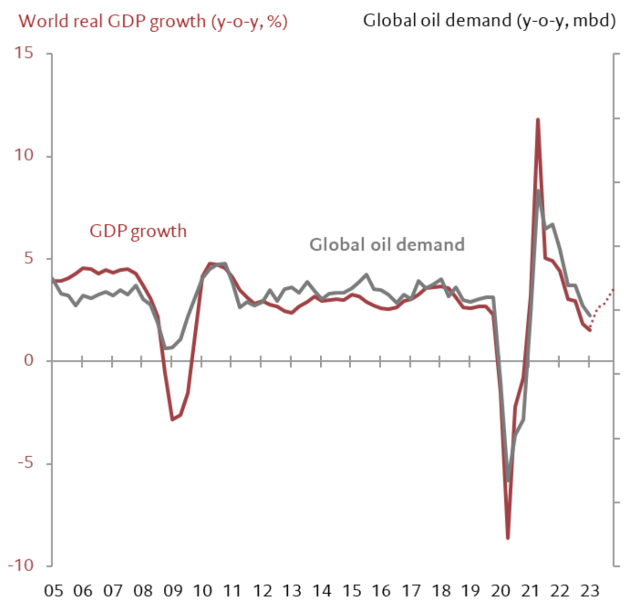
be more than offset by an increase of 1mbd in Chinese demand, as well as an increase in global jet fuel demand of the order of 0.8mbd.

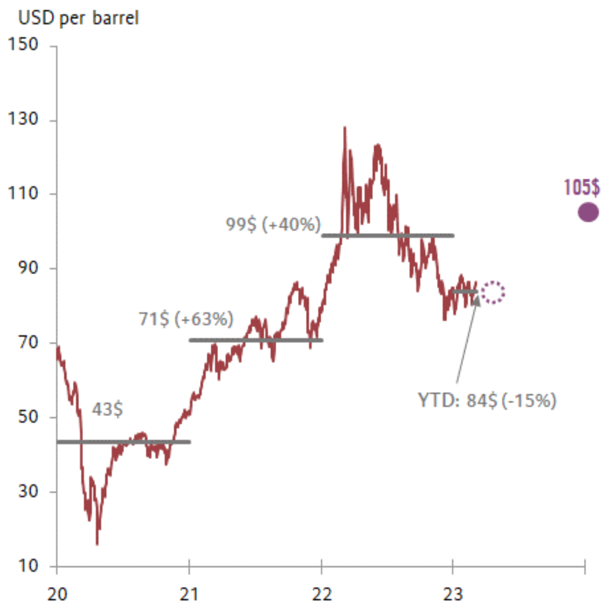
We continue to forecast higher oil prices by the end of the year on the back of China's recovery, relatively healthy emerging economies, Europe's resilience, and limited supply elasticity. But we also recognise that oil demand would be harder hit in the case of a deeper recession in the US. **We have revised our year-end forecast for Brent oil to USD105 per barrel** (from USD115 previously), taking into account a weaker business cycle as well as downside risks to the US economy in H2 2023.

Chart 5: global oil demand



Source: Pictet Wealth Management, International Monetary Fund, US Energy Information Administration, Refinitiv, as of 07.03.23

Chart 6: Brent price forecast



Source: Pictet Wealth Management, Refinitiv, as of 07.03.23

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