24. January 2023

https://blog.en.erste-am.com/tug-of-war/

Tug of war

Gerhard Winzer

© (c) unsplash

The indicators on inflation and those on economic activity are currently competing with each other to see which of the two categories has the greater significance for the financial market. On the inflation side, inflationary pressures are diminishing. On the growth side, the goods sector is weak at the global level, while estimates for GDP growth in Europe and China have been adjusted upward.

Beveridge

The labor market is very tight. The ratio of job vacancies (very high) to the unemployment rate (very low) is currently very high. In economics, the relationship is known as the Beveridge curve. This means increased inflation risks, which is why central banks continue to signal a restrictive monetary policy. A key question for this year is whether there can be a sustained decline in inflation without a sharp rise in the unemployment rate or recession.

Disinflation

Since the beginning of the year, optimism for a sustained decline in inflation (disinflation) has led to price increases in equities and bonds as well as a weaker US dollar. This is a mirror image of last year. This is mainly due to the fading effects of the two negative shocks:

- pandemic (falling goods prices)
- Ukraine war (falling energy prices)

Lower inflation means less restrictive monetary policies and a lower loss of purchasing power. Both points are positive for real economic growth.

Three scenarios

The three broad scenarios for 2023 are

A) “continued disinflation” (including policy rate cuts),
B) “stagnation” (no policy rate cuts this year) and
C) “global recession” (resumption of policy rate hikes in H2 after a pause in H1).

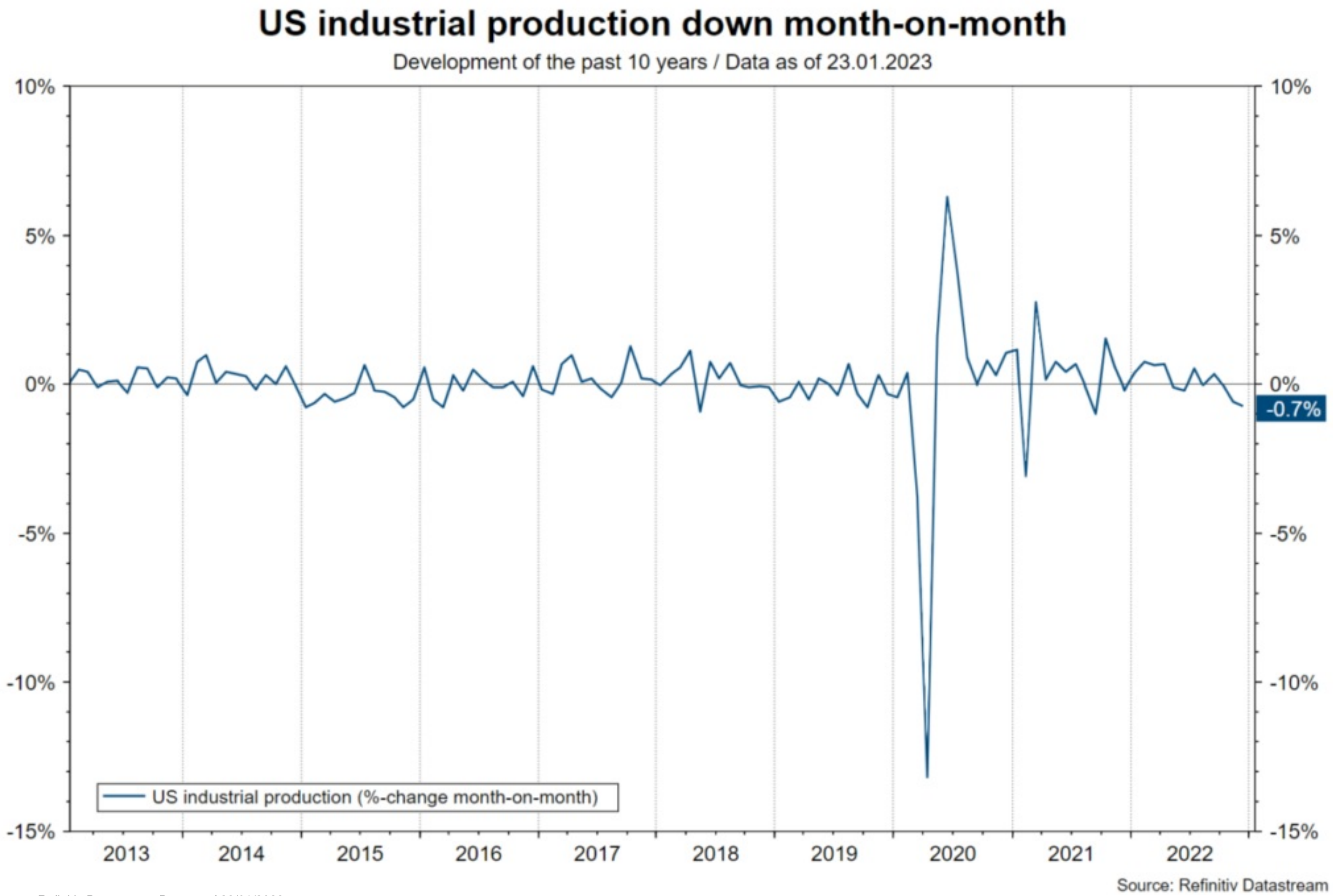
In the current environment, the question is thus whether future economic reports will contradict scenario A (disinflation).

Falling producer prices

December producer prices fell month-to-month in the US and Germany. This week, the U.S. personal consumption deflator will be looked at to see if it fits the disinflation narrative.

Weak goods sector

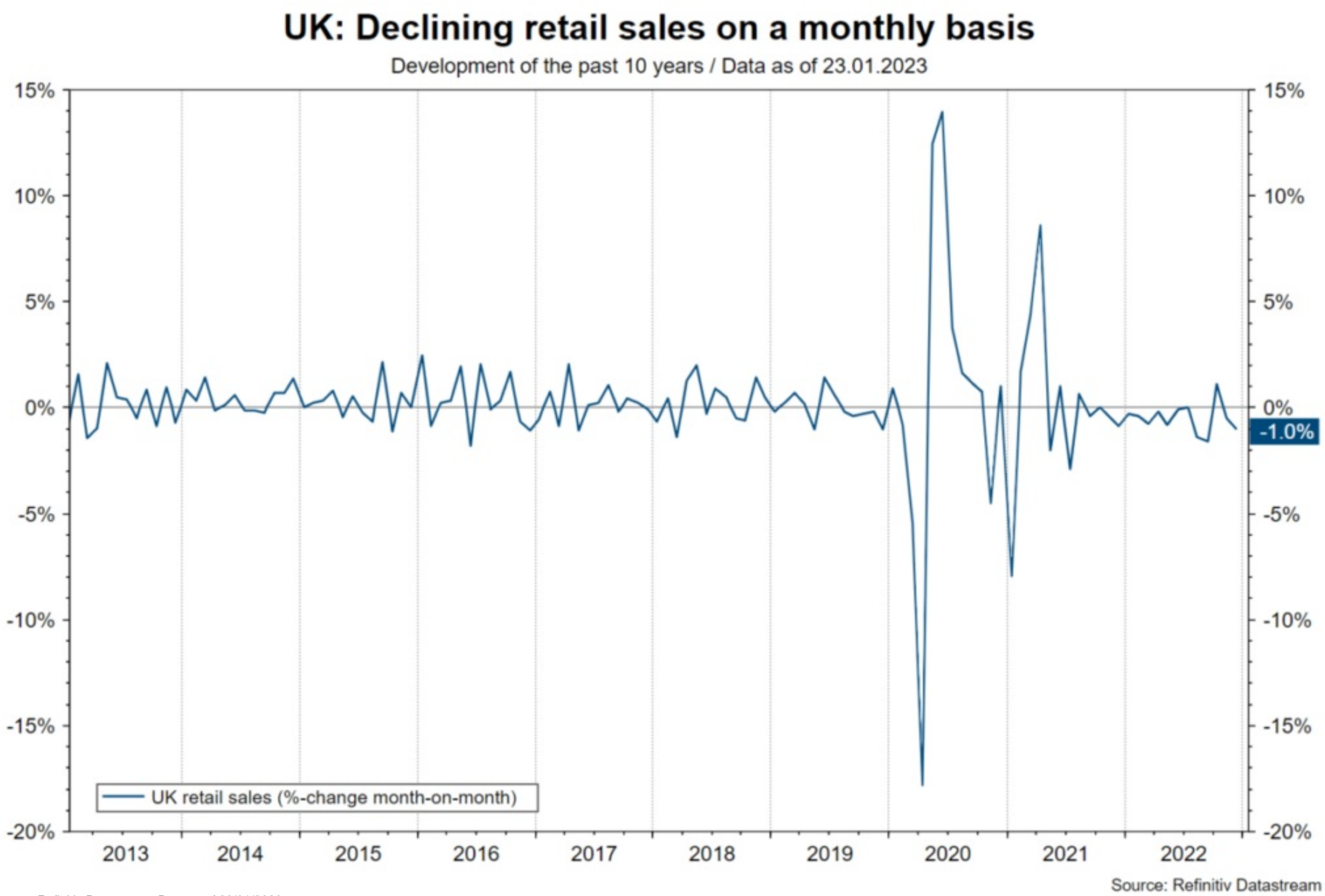
Weak indicators of economic activity have been published in recent days. In the US, both retail sales and industrial production fell month-on-month in December. Two regional Fed reports (New York and Philadelphia) for the month of January point to continued weakness in manufacturing.



Source: Refinitiv Datastream; Data as of 23/01/2023

Note: Past performance is not a reliable indicator of future performance.

Retail sales in the UK also fell in the month of December. In addition, goods exports in the East Asian region – a barometer for global manufacturing – show a strong downward trend. Similarly, real estate indicators remained negative in the USA (building permits, housing starts, sentiment), China (falling prices) and the UK (falling prices).



Source: Refinitiv Datastream; Data as of 23/01/2023

Note: Past performance is not a reliable indicator of future performance.

Falling gas price in Europe

On the positive side, in Europe the rapid decline in energy prices and fiscal support measures have led to an improvement in economic indicators and estimates. Meanwhile, the key gas price futures TTF has fallen slightly below the level just before the invasion of Ukraine at EUR 67 / MWh. Evidence for slight real GDP growth in the first quarter after stagnation in the fourth quarter of 2022 is growing. At the end of 2022, a technical recession had still been assumed (GDP contraction for two quarters in a row). This positive development was supported by the ZEW economic barometer for the month of January. The expectations component for Germany has now risen for the fourth time in a row.

Source: Refinitiv Datastream; Data as of 23/01/2023

Note: Past performance is not a reliable indicator of future performance.

V in China

China’s economic indicators pose a puzzle. Survey-based indicators such as the purchasing managers’ indices have pointed to a contraction in gross domestic product (GDP) in the fourth quarter. It was a big surprise when the GDP report showed only quarterly stagnation. However, the expectation for the 1st half of the year is important. The rapid departure from the zero-tolerance policy toward new infections and the selective support measures for the real estate sector argue for a V-shaped (fast) economic recovery in H1.

Weak growth

This week, the preliminary purchasing managers’ indices for key countries in the developed economies and the IFO economic barometer for Germany will provide new information on economic growth. Currently, the indicators in aggregate point to a weak growth environment but no recession.

Conclusion: Conditionally positive environment

As long as optimism for persistently falling inflation rates dominates growth fears, the environment for risky asset classes such as equities remains constructive – all other things being equal. But that could change quickly. Inflation rates could stabilize at uncomfortably high levels, putting pressure on central banks to continue the cycle of interest rate hikes after a pause in the first half of the year. Even an unchanged restrictive monetary policy (no interest rate cuts) would have a negative impact on economic growth.

Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.