



# Investment Clock – Economic Update

Issue #26, September 2022

## Multi asset views from RLAM

Royal London Asset Management manages £150 billion in life insurance, pensions and third party funds\*.

We have six Global Multi Asset Portfolios (GMAPs) across the risk return spectrum with a full tactical asset allocation overlay.

\*As at 30 June 2022, Subject to rounding

## This month's contributor

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**US:** H1 saw a 'technical' recession, but the combined hit from cost-of-living strains and a lagged response to Fed tightening is assumed to tip the US into a broader (though not deep) recession in 2023.

**China:** China's zero tolerance approach brings the likelihood of repeat waves of disruption to the economy. Macro policy though is becoming more supportive.

**Eurozone:** Energy looks set to drag further on activity growth. A recession is pencilled into the early part of the forecast, which would be worse in the absence of fiscal support.

**Japan:** Inflation continues to rise but rate hikes don't look on the horizon. Both the near-term and longer-term real economy outlook look challenging.

**UK:** The outlook for the UK economy has steadily worsened over most of the year. A recession looks likely. Further fiscal support will be an offset, but more rate hikes are expected too.

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## The three Rs: Recessions, rate hikes and really high prices

**Recessions look likely – on differing timescales – in the US, euro area and the UK as monetary policy continues to tighten, on high energy prices and as households struggle with cost-of-living pressures. Fiscal policy will help ease the pain, but not enough to prevent a downturn. With domestically driven inflation indicators having picked up in Europe, the European Central Bank (ECB) and Bank of England (BoE) now look more likely to follow the US Federal Reserve (Fed) in getting rates more rapidly to restrictive territory. Weaker domestic demand and global inflationary pressure will take the pressure off central banks, but that looks set to be more of a 2023 story.**

## Summary

**Global growth has slowed and more indicators look 'recessionary':** More of the major economy monthly Purchasing Managers' Index (PMI) business surveys signal falling private sector output while consumer confidence indicators remain very weak.

**Central case assumes central banks will stop hiking in H1 2023 and that recessions are modest...but that hinges on inflation and fiscal policy:** The forecasts still assume that most economies see high but falling inflation in short order driven by reduced external inflationary pressure. If inflation stays high, central banks will need to hike more and households will additionally struggle with negative pay growth for longer.

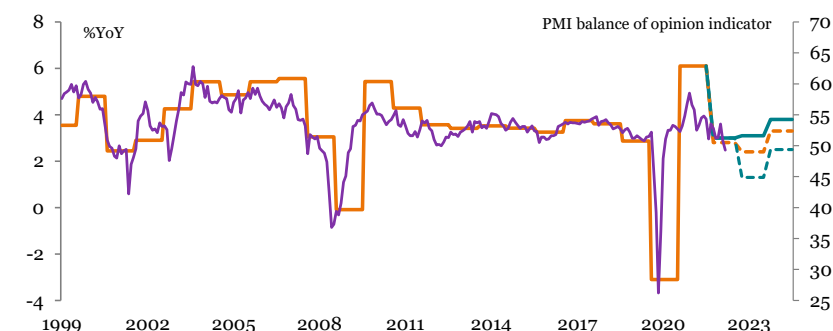
**Four reasons inflation will fall:** 1) Supply chain pressures show signs of easing and are likely to ease further; 2) Commodity prices are off their peak; 3) Even if supply chain pressures and commodity prices stay high, base effects should also be a key driver of lower inflation; 4) Tighter monetary policy will help cool domestically driven inflation pressures.

**Four reasons why recessions will be modest:** 1) Inflation is expected to fall; 2) cash levels of both households and corporates *in aggregate* remain high; 3) Banks look in decent shape; 4) fiscal support will take some of the pressure off household finances, notably so in some European economies.

**How this central forecast could go wrong:** The most obvious way in which these central forecasts may not come close to materialising is because inflation stays high or, rather, declines to levels that are still too high for (central bank) comfort. The inventory cycle could also deliver a sharper downside shock to economic activity. Households and firms may respond much more negatively to monetary policy tightening than assumed. On the upside, inflation may fall faster than expected as supply chains improve, reduce inflation expectations dramatically, easing pressure on household finances.

**Our multi asset team** have a small underweight in equities, where they think the risk is high that the

Chart 1: Global growth central case assumes inflation falls



bear market has further to go once recessions develop and corporate earnings are downgraded. However, with inflation still high and central banks tightening, they also retain an underweight in government bonds. See [Investment Clock](#).

Source: Past actuals are International Monetary Fund (IMF) and S&P Global, forecasts (teal and dashed lines) are RLAM. Data as of August 2022.

## Economic forecast summary

### September 2022 base case

Region	2021			2022e			2023e			2024e		
	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4
US	5.7	6.7	0.25	1.7 <i>1.9</i>	7.7 <i>7.5</i>	4.00 <i>3.50</i>	0.6 <i>0.9</i>	2.9 <i>2.9</i>	4.00 <i>3.25</i>	1.4 <i>1.7</i>	2.7 <i>2.7</i>	3.00 <i>2.75</i>
China	8.8	2.4	-	2.7 <i>3.3</i>	2.6 <i>2.6</i>	- <i>-</i>	5.1 <i>5.3</i>	- <i>-</i>	- <i>-</i>	4.8 <i>4.8</i>	- <i>-</i>	- <i>-</i>
UK	7.4	4.9	0.25	3.5 <i>3.4</i>	9.9 <i>9.7</i>	3.25 <i>2.00</i>	0.1 <i>0.2</i>	2.0 <i>2.2</i>	3.50 <i>2.25</i>	1.5 <i>1.7</i>	2.2 <i>2.3</i>	3.00 <i>2.25</i>
Euro area	5.3	4.6	0.0	2.8 <i>2.6</i>	8.7 <i>6.6</i>	2.25 <i>1.25</i>	-0.2 <i>1.1</i>	2.1 <i>2.1</i>	2.50 <i>1.75</i>	1.5 <i>1.8</i>	2.2 <i>2.5</i>	2.25 <i>1.75</i>
Japan	1.7	0.5	-0.1	1.0 <i>0.9</i>	2.6 <i>2.2</i>	-0.10 <i>-0.10</i>	1.4 <i>1.4</i>	1.1 <i>0.9</i>	-0.10 <i>-0.10</i>	1.1 <i>1.1</i>	0.9 <i>0.8</i>	-0.10 <i>-0.10</i>
Global	6.1	-	-	2.8 <i>3.0</i>	- <i>-</i>	- <i>-</i>	2.4 <i>2.8</i>	- <i>-</i>	- <i>-</i>	3.3 <i>3.3</i>	- <i>-</i>	- <i>-</i>

Source: Refinitiv DataStream, national statistics offices, Bloomberg for past actual data. All forecasts (e) are RLAM. Current data and forecasts are in black. Forecasts from the July 2022 forecast update are grey and in italics. Note: US policy rate is the upper end of the Fed Funds target range. euro area policy rate is the refi rate.

### Key economic policy forecasts

- With taming inflation the priority for central banks, the Fed, ECB and BoE continue raising rates through to the start of 2023, though the pace of rate hikes slow as inflation pressures start to ease.
- The forecasts assume a peak upper limit to the Fed Funds target range of 4.00%, that the BoE hikes rates to 3.50% and the ECB (refi rate) to 2.5%. The more fiscal stimulus that takes place in the meantime, the greater the upside risks to those forecasts.
- The forecasts assume that Quantitative Tightening (QT) continues in the US and UK throughout 2023, though some central banks start to ease rates back down towards neutral in 2024 after a slowdown in the economy and a large fall in inflation.
- Fiscal policy is generally expected to become more supportive in the near term, but less supportive later in the forecast. However, sharp non-Covid related spending cuts are not in the central case, partly as spending to tackle longer-term challenges (e.g. climate change) steps up. In the near-term fiscal stimulus partly reflects pressure for further cost-of-living support.

### Global economic scenarios (Chart 1)

#### Upside scenario (20% probability): Inflation falls sharply and recessions are avoided

- Inflation falls much faster than expected as supply problems ease. Central banks signal clearly that they do not envisage more rate increases in the first half of 2023, helped by lower inflation expectations. The participation rate increases faster than in the base case, helping to keep a lid on domestically driven inflationary pressure.
- GDP growth is stronger than expected as real income growth recovers substantially and as corporates and households dig into their aggregate cash/deposit stocks to a greater degree than assumed in the base case.
- China abandons its zero-tolerance approach to Covid.

#### Base case (60%): Moderate recessions as higher cost-of-living bites and as central banks hike

- After a strong recovery in 2021, challenges have built to the recovery over 2022 and 2022/2023 sees a more serious slowdown in the global economy as households struggle with the high cost of living, companies postpone investment decisions in light of increased economic uncertainty and high costs and as the economy responds with a lag to higher interest rates.
- Inflation remains at high levels through to end 2022 and into 2023 but falls as supply chain problems ease and after falls in commodity prices.
- Monetary policy tightens significantly into 2023, but fiscal policy becomes more supportive in a number of economies.

#### Downside scenario (20%): Deeper recessions

- Slowdowns in economic activity are more serious than in the base case. Recessions are deeper and last longer as firms and households respond to central bank tightening more strongly than in the base case. Central banks continue to tighten policy in 2023, well into restrictive territory, as inflation expectations and domestic inflationary pressure fail to ease as hoped.
- Higher inflation than the base case in 2023 is, however, followed by substantial falls in the later years of the forecast, reflecting greater economic slack and bigger falls in inflation expectations after central bank tightening tips economies over the edge into significant downturns. Rates are cut below central case levels in later years.

**Probabilities are subjective and indicative such that we'd broadly see a 20% chance that the economy performs in line with/better than the upside case and a 20% probability that the economy performs in line with/worse than the downside case.**

## Global economy: A more serious slowing

The pace of activity growth in the global economy has slowed. Part of that is normalisation from unsustainably high rates of recovery from social distancing. That was then followed by a dent from the Ukraine crisis, from the upswing in Covid cases in China and strict social distancing measures put in place there. Growth rates have also been restrained by labour shortage and supply chain issues. These are still affecting growth rates, but appear to have eased. Meanwhile, challenges to the economy from high inflation and higher interest rates have grown. The forecasts assume both further rate increases and that there will be a more substantial pull back in consumer activity in response to cost-of-living issues. High costs and economic uncertainty should also drag on investment. The forecasts on page 2 now assume moderate recessions in a number of economies. Lower commodity prices, weaker domestic demand and easing supply chain problems should help inflation to fall into and through 2023, alleviating the real pay squeeze and the pressure for central banks to hike rates any further. Fiscal support also looks likely to work against more substantial downturns.

### Activity growth: Pushed down

From being held back by supply chain problems, global growth is now likely to be pushed down by struggles related to high inflation and increasingly by monetary policy tightening. The global composite PMI business survey measure is already around levels where economists tend to start talking about global recessions (Chart 2). Supply chain problems and labour market shortages have been holding back activity growth, but the former at least have been showing signs of having eased significantly, see Chart 3. China's zero tolerance approach to Covid remains a threat to supply chains with China's economy likely to record relatively weak growth (by China standards) this year.

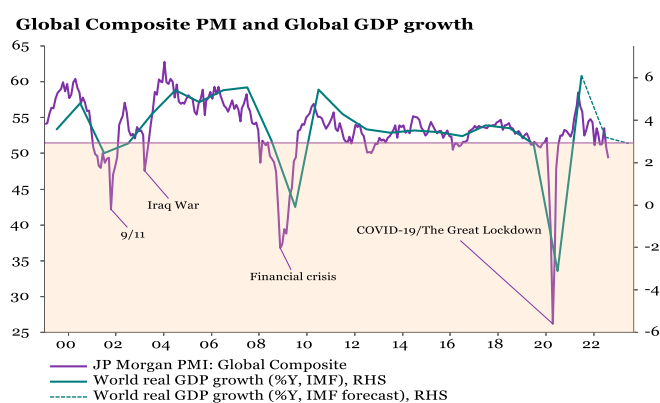
Business optimism has fallen in recent months (Chart 4), hit by high input prices, central bank tightening and recession worries. New orders indicators have deteriorated and trade growth indicators look relatively subdued already (Chart 5).

However, with wages still not keeping pace with those higher prices, households are still experiencing a cost-of-living shock (Chart 6). Wage growth has picked up across major economies, but remains below headline Consumer Price Index (CPI) inflation. Any improvement in real pay growth driven by higher pay growth would also increase the probability of central bank tightening, potentially weighing on activity growth for a more drawn-out period.

### Why I am only forecasting moderate recessions

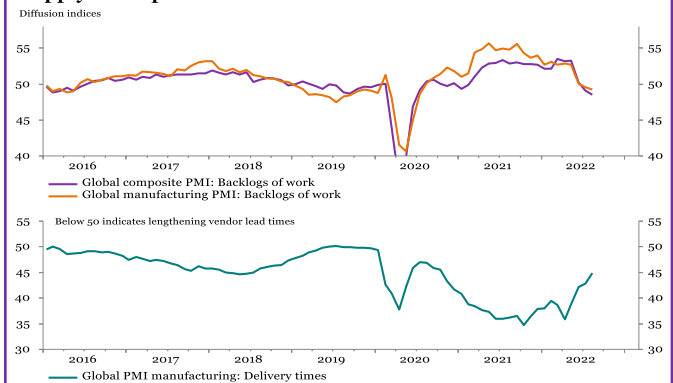
The forecasts on page 2 envisage moderate recessions in major economies reflecting the impact of high inflation and interest rate increases. Modestly negative quarters of GDP growth, followed by rising unemployment are pencilled into the forecast for several economies including the US (in 2023), the UK and euro area (starting in 2022). The scale of slowdown is modest (especially by the standards of the Global Financial Crisis (GFC) or pandemic). That largely reflects: the assumption that inflation falls (taking the pressure off household finances and central banks); that developed economy banks are in relatively good health; still high cash levels of both households and corporates in aggregate; and increased fiscal support.

**Chart 2: Global PMI in recession warning zone**



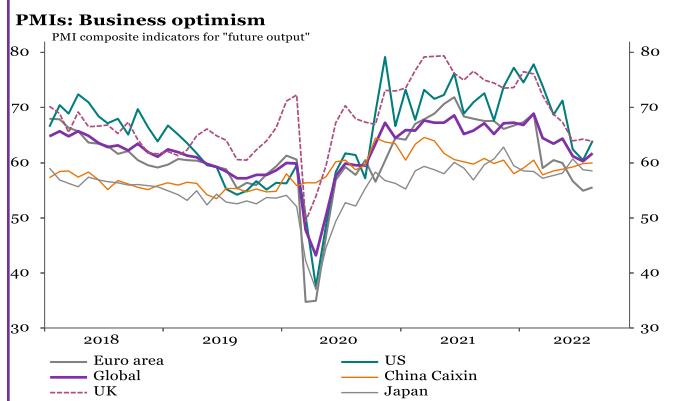
Source: Refinitiv Datastream, S&P Global as at August 2022.

**Chart 3: Supply chain problems ease**  
Supply chain pressures: PMI indicators



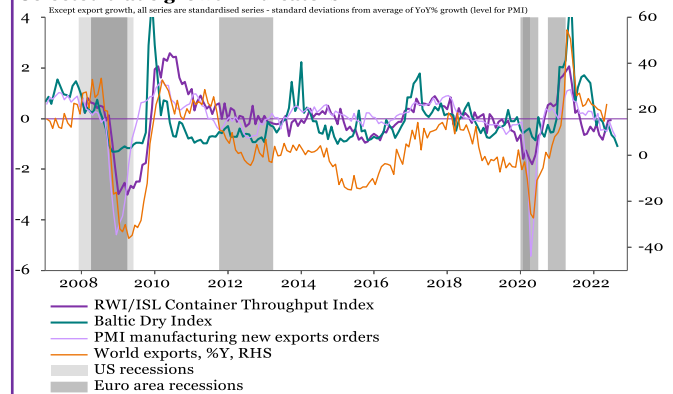
Source: Refinitiv Datastream, S&P Global as at August 2022.

**Chart 4: Business optimism has fallen**



Source: Refinitiv Datastream, S&P Global. Data as at August 2022.

**Chart 5: Trade growth indicators somewhat subdued**  
Selected trade growth indicators



Source: Refinitiv Datastream, ISL, Baltic Exchange, S&P Global, IMF. Export growth data is to May, container throughput series is to July 2022, PMI figures are to August 2022, Baltic Dry series is to 1<sup>st</sup> September 2022.

## Consumers and corporates: Outlook hit (again) by high inflation and higher rates

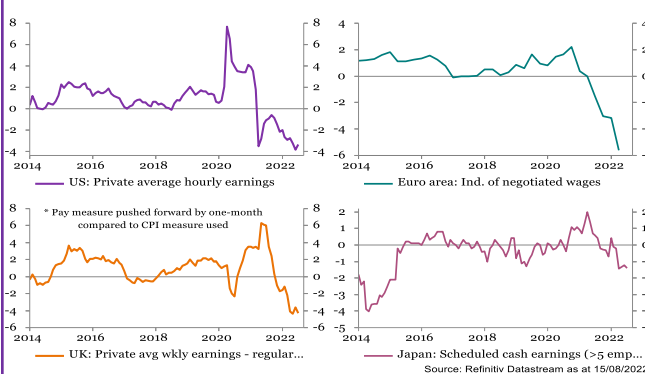
**Mounting challenges to consumer spending:** Higher energy prices, higher food prices, alongside generally high levels of consumer price inflation and higher interest rates pose challenges for real consumer spending. Weaker trends in retail sales are more apparent in some countries than others, but very weak consumer confidence is common (Chart 7). Despite still tight labour markets (Chart 8) and some pick-up in nominal pay growth, real pay growth still looks soft (Chart 6). Higher interest rates add to household debt servicing costs and increase the chance of house price falls (with feedback effects for consumer confidence and wealth effects). For some countries, wider wealth effects could also be negative given falls in stockmarkets this year.

**Less and less of a savings shield:** One upside case for the global economy would have households dipping aggressively into excess savings stocks. Household 'excess' cash deposits remain substantial in nominal terms (Chart 9), but inflation has substantially eroded them in real terms. Data from earlier in the pandemic also suggested that much of these excess savings had been built up by households that already had high incomes/were already wealthy. Higher short-term interest rates don't incentivise households to lower their stocks of deposits either. Household savings rates have already fallen significantly in the US, euro area, Japan and the UK, especially in the US (Chart 10) consistent with households saving less or borrowing more to maintain their consumer spending habits in the face of high inflation. That leaves one natural 'shield' for households against higher costs greatly depleted.

**Chart 6: Cost of living shock: Real pay growth negative**

Selected real pay growth measures

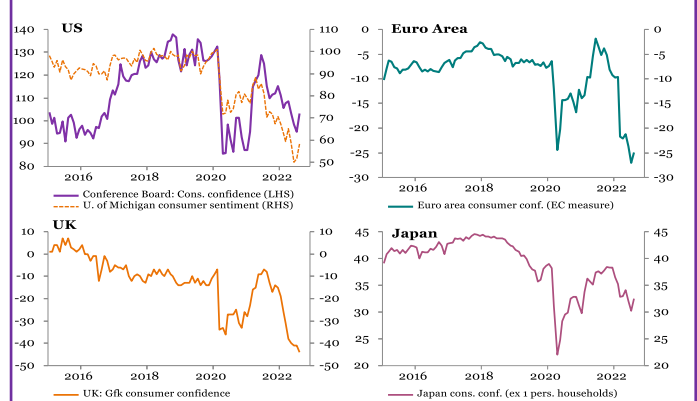
All deflated by CPI; % change YoY



Source: Refinitiv DataStream, Bureau of Labor Statistics, ECB, Eurostat, Office for National Statistics, Japan's Ministry of Health, Labour and Welfare, Japan's Ministry of Internal Affairs & communication. Data to July 2022 except euro area (Q2).

**Chart 7: Consumer confidence very weak**

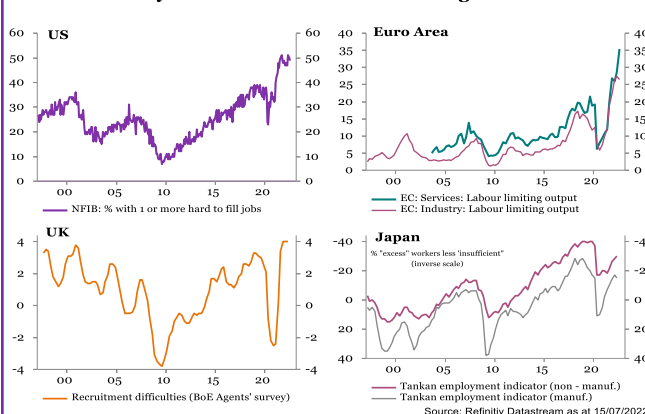
Consumer confidence measures



Source: Refinitiv DataStream, Conference Board, University of Michigan, European Commission, GfK, Cabinet Office (Japan). Data to August 2022

**Chart 8: Labour market shortages still a problem**

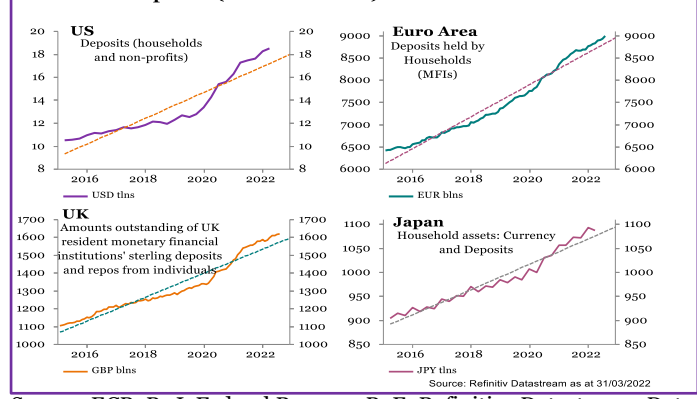
Business survey measures of labour market tightness



Source: Refinitiv DataStream, NFIB, European Commission, BoE, BoJ. Data to July 2022 (US), Q3 (euro area), Q2 (UK and Japan).

**Chart 9: Household deposit levels still elevated (though not in real terms)**

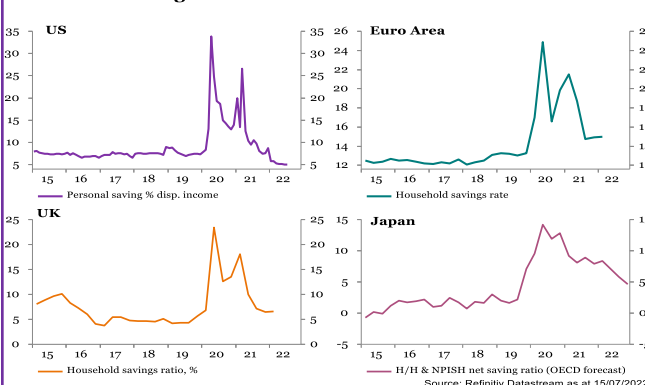
Household deposits (level and trend)



Source: ECB, BoJ, Federal Reserve, BoE, Refinitiv Datastream. Data to July 2022 (euro area, UK), Q1 2022 (US, Japan)

**Chart 10: Household saving ratios lower**

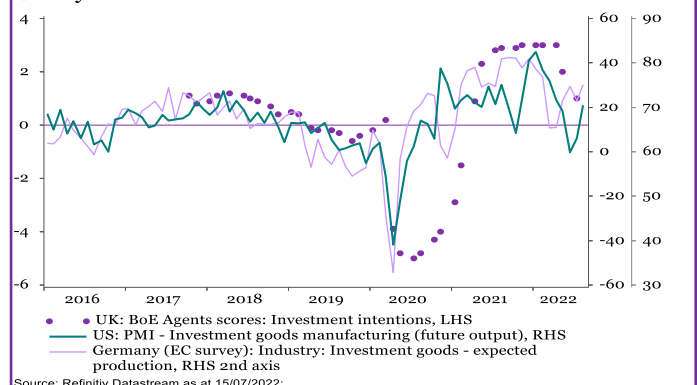
Household saving ratios



Source: BEA, Eurostat, ONS, OECD. Note: Japan data include OECD forecasts. US data to July 2022, UK and euro area data to Q1 2022.

**Chart 11: Investment indicators off highs**

Survey-based business investment indicators



Source: Refinitiv DataStream, Bank of England, S&P Global, European Commission. Data as at August 2022 except BoE (July 2022).



**Business investment - in trouble for now:** Investment indicators are off their highs (Chart 11). In the US, *non-residential* fixed investment was flat in Q2, while residential investment has been hit by both supply and demand problems. In the UK, business fixed investment remains below levels seen pre-Brexit referendum, let alone pre-pandemic (Chart 12). In the euro area it is surprising that capex indicators don't look more downbeat in light of heightened economic uncertainty related to energy supplies. Broadly, across economies, aggregate cash/deposit levels remain elevated (Chart 13), but interest rates are higher and credit conditions are tighter and in real terms these stocks will have been substantially eroded by inflation. Running with higher inventories (Chart 14) will have constrained resources for investment. Planned projects will be rising in cost in the meantime. Business optimism has also deteriorated markedly since the start of the year (Chart 4).

Medium-term, there remain plenty of reasons to expect more of a pick-up in investment though. Those include: low carbon transition; a likely desire to be less labour-reliant post-pandemic and to simplify supply chains (post-Trump, pandemic and Ukraine); shortages of parts/equipment will also have held back investment and those appear to be easing.

### Fiscal policy: Saviour of the cycle? Storing up trouble for the future?

**The forecasts on page 2 assume that countries provide more fiscal support over the coming 12 months:** The US has already passed a new spending bill (albeit not directed to cost-of-living issues and offset with revenue raising measures over a multi-year period). Euro area economies are coming under increased strain in light of high energy prices. Significant fiscal support has been announced already with more likely to follow (see euro area section). In the UK, new Prime Minister Liz Truss has announced (expensive-sounding and temporary) bill freezes for households and businesses. An assumption of more fiscal support is a key reason why the forecasts assume only moderate recessions.

However, more fiscal support in a high inflation-low unemployment environment will likely lead to more medium-term inflationary pressure and monetary policy tightening. It may also be storing up problems for the future as government debt levels rise and depending how the exit from cost-of-living measures proceeds. Tightening measures to improve government finances are likely in the later years of the forecast. However, given spending imperatives associated with demographics and climate change, these are assumed to be a modest rather than a strong overall drag on growth.

### The role of inventories – risks of a sharp shock

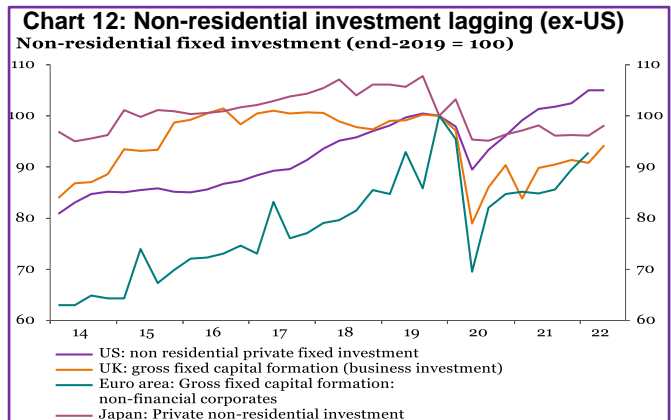
One of the ways the global economy may differ post-Covid (see [More rate hikes, less growth](#), April 2022) is in a shift away from a just-in-time approach to production and away from complex global supply chains. That may mean shorter, more inventory driven business cycles prone to bouts of inflation.

**Firms may move away from a relatively just-in-time approach** to something seen (rightly or wrongly) as more resilient in response to the type of supply chain disruption recently experienced. Part of that may involve running with higher inventories of inputs (Chart 14 shows that the global PMI manufacturing survey indicator for stocks of purchases has been well above 50 for an extended period now) and a so-called 'just-in-case' approach to inventory management. Part of that may be sourcing more domestically/closer to the end customer.

**Running with higher levels of inventory could lead to bigger overaccumulations of stock** when growth slows, for example, which could have the potential to make cycles shorter, downturns more severe as well as making inventory accumulations and decumulations drivers of cycles in the first place and with feedback to the domestic economy potentially stronger if supply chains are de-globalised.

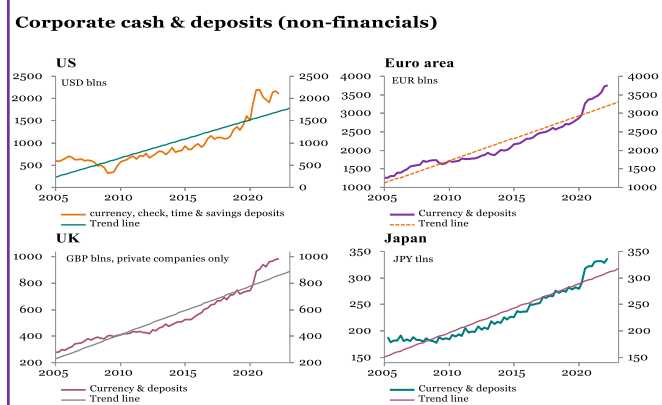
**A destocking could be a key driver of manufacturing output contracting in the coming slowdown too.** Chart 14 suggests that while firms globally continue to build inventories, growth in new orders continues to deteriorate and now looks to be contracting (a PMI manufacturing new orders indicator below 50). It looks increasingly likely that companies will find themselves with an excess of unneeded and expensive-to-store raw materials/production inputs. Unwinding these stocks would exacerbate falls in economic activity.

**In the UK, the situation may have been exacerbated by Brexit** where there was also a significant period of stock-building in 2018/2019. According to the UK manufacturer's organisation Make UK, "Our recent reports have found that investment cash and expansion plans are being shelved because more funds are tied up securing supplies" (see [the Guardian](#), June 2022).



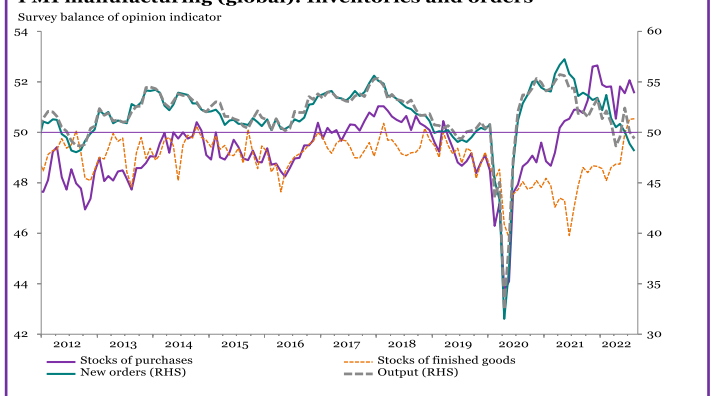
Source: Refinitiv DataStream, BEA, ONS, Eurostat, Cabinet Office. Data is to Q2 2022 (Q1 2022 for the euro area).

**Chart 13: Corporate cash/deposits still elevated (but eroded by inflation in real terms)**



Source: Federal Reserve, ECB, ONS, BoJ. Data to Q1 2022

**Chart 14: Firms continue to build input inventories, while orders drop (message from PMI business surveys)**  
PMI manufacturing (global): Inventories and orders



Source: Refinitiv Datastream, S&P Global. Data to August 2022

## Energy supply

For the rest of this year into 2023, for Europe at least, there are question marks around both energy prices and supply. The Ukraine crisis and tense relations with Russia remain a key reason. Flows of natural gas from Russia remain well below capacity. Another reason is the interaction with climate change. Low water levels limited flows of coal down the Rhine over the summer, raising costs for example. EU members have already pledged to cut gas consumption 15%. Even if Europe muddles through with demand management and more favourable weather this winter, considerable uncertainty has likely been generated for business and households in the interim, itself weighing on growth. If overall power supply needs to be rationed, then the impact on output will be more profound.

## Inflation: Pushing out the peak

The forecasts on page 2 (Chart 15) assume that headline inflation falls significantly in 2023, with the caveat that much depends on the path of commodity and especially energy prices. Central banks, however, will be increasingly focused more on *domestic* inflationary pressures.

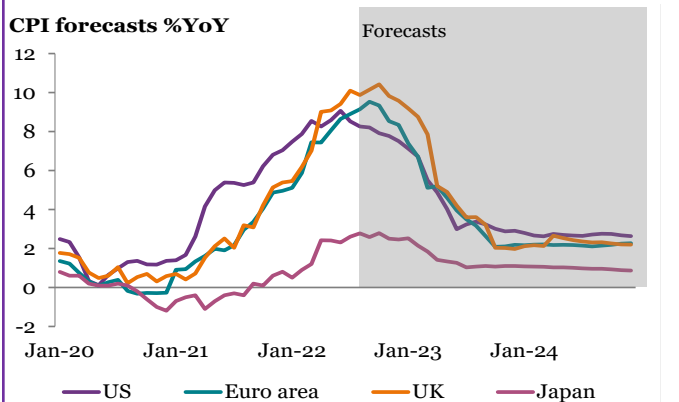
**Core goods inflation easing and likely to ease further:** Core goods CPI inflation, proxied by the CPI measures shown in Chart 16, correlate with business survey measures of manufacturing input prices which have fallen. That fall likely reflects easing supply chain problems (Chart 3) and somewhat lower raw materials/commodity prices (Chart 17). Base effects should also be a key driver of lower inflation – i.e. even if commodity prices remain around recent high levels, rather than fall, the impact on inflation – the year-on-year change in the price level – will fade over a 12 month period.

**Services inflation is the one to watch, not core:** A fall in headline inflation will help take the pressure off consumer finances (assuming wage growth remains robust) and likely prompt some slowing in the pace of rate hikes from central banks as it reduces the risk of inflation expectations de-anchoring. However, with most major central banks having a 2% CPI target it matters where inflation ‘settles’. A key driver of this will be domestically driven inflationary pressure where it is more important to watch pay growth, inflation expectations and services inflation. Services inflation should have a higher ‘domestic’ component (including wages) than goods or energy inflation, though will still be affected indirectly by, for example, energy costs. One reason it is far too early to expect central banks to stop raising rates is that services inflation is now rising sharply (Chart 18).

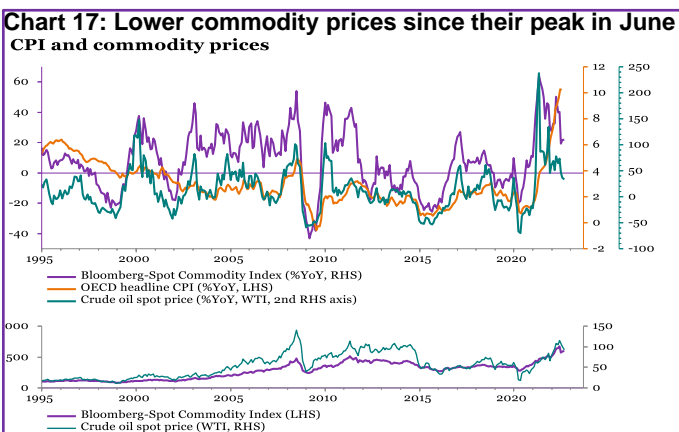
**Prospects for pay growth.** For now, nominal pay growth is likely to remain at relatively robust levels given very low unemployment, that businesses are still indicating labour shortages (Chart 8) and given high inflation. However, a combination of central bank tightening and the cost-of-living squeeze will likely reduce demand (modest recessions), easing labour market tightness and pay growth somewhat in 2023 into 2024. That may be re-enforced by increased labour force participation as higher bills bring more people back into the labour market, having left over the Covid period.

**Inflation expectations – Practice versus policy:** Some measures of medium/longer-term survey-based measures of inflation expectations have reduced (Chart 19). That may reflect both lower petrol prices (one of the easiest to track/widely experienced price indicators households have) and also be a response to central bank tightening. Central banks will likely want to see inflation expectations lower across a broad range of measures, however, and staying at those lower levels. Running with tighter monetary policy and communicating a determination to ‘get inflation down’ should help. Politics may not. Over a two-year horizon, the UK is a concern where new Prime Minister Liz Truss has expressed a desire to revisit the Bank of England’s

**Chart 15: Inflation forecast**

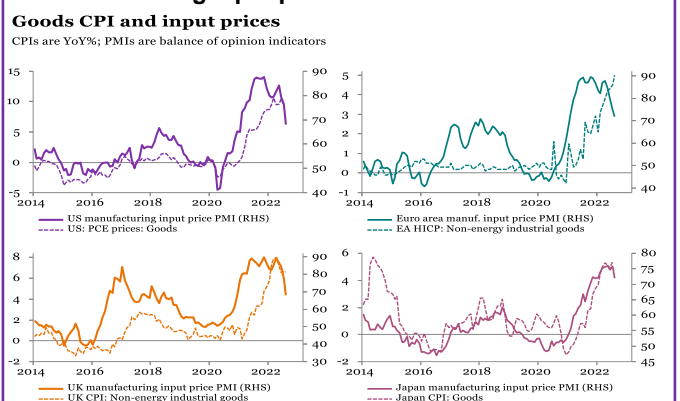


Source: Refinitiv Datastream, BLS, Eurostat, ONS, Japan Ministry of Internal Affairs and Communications. Forecasts are RLAM, consistent with forecasts on page 2.



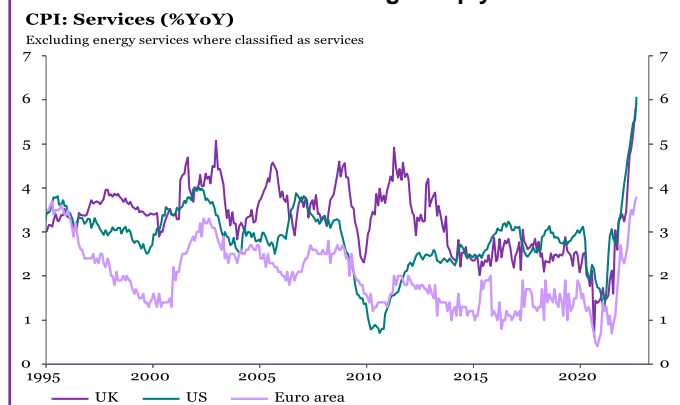
Source: Refinitiv Datastream, Bloomberg, OECD. Data is to 7th September 2022

**Chart 16: Falling input price inflation**



Source: Refinitiv Datastream, S&P Global, BEA, Eurostat, ONS, Ministry of Internal Affairs and Communications, Japan. Data to August 2022 (PMI series), August for CPI series (except Japan which is July 2022).

**Chart 18: Services inflation rising sharply**



Source: Refinitiv Datastream, ONS, BLS, Eurostat. Data is to August 2022

inflation targeting mandate. This mandate is better protected in the euro area where the inflation target is set by the ECB and in the US, President Biden has proven less critical of the Federal Reserve and Chair Powell than his predecessor and there won't be a presidential election until 2024.

**The ongoing low carbon transition is likely to help inflation linger above target medium-term.** Most of the major economy inflation forecasts in Chart 15 show inflation 'settling' a bit above target despite central bank tightening. This partly reflects an assumption that the Covid crisis 'broke the dam' on fiscal policy and people's expectations of it. It also reflects assumed transitional costs from the transition to a lower carbon economy. Those could include, for example, consultancy costs associated with analysing and planning for net-zero or the cost of renting higher quality buildings that emit less carbon. Potential changes in central bank mandates, a shift in firm behaviour around inventories and demographics may also add to inflation pressure in the medium-term (see also [More rate hikes, less growth](#), April 2022).

### Central bank policy outlook: More tightening to go, but are cuts really in sight?

Pinning down how high interest rates will rise this cycle (terminal rates) is difficult and feels like a moving target in an environment where inflation keeps surprising on the upside. With fears of recession rising alongside interest rates, it is also worth pondering how long it might be before we see rate cuts.

**Neutral rates help shape expectations of how far central banks will hike:** The neutral policy interest rate is the interest rate that would sustain output at potential and inflation at the target, if the economy starts from a position of no output gap and inflation at the target. It is normally defined in real terms as  $r^*$ . My estimates of a medium-term nominal equilibrium/neutral interest rate ( $r^*$  plus the inflation target) are currently (only) around 2.25% in the US and UK and 2.0% in the euro area, arrived at by averaging several different methodologies/sources. With inflation currently well above central bank targets and unemployment at very low levels, arguably central banks should be trying to get to at least neutral and quickly. With inflation expectations and inflation so far above target, the direction of risk is for significantly higher-than-neutral interest rates.

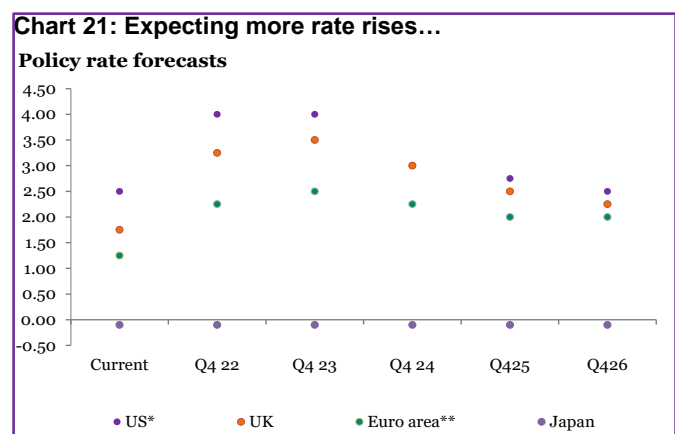
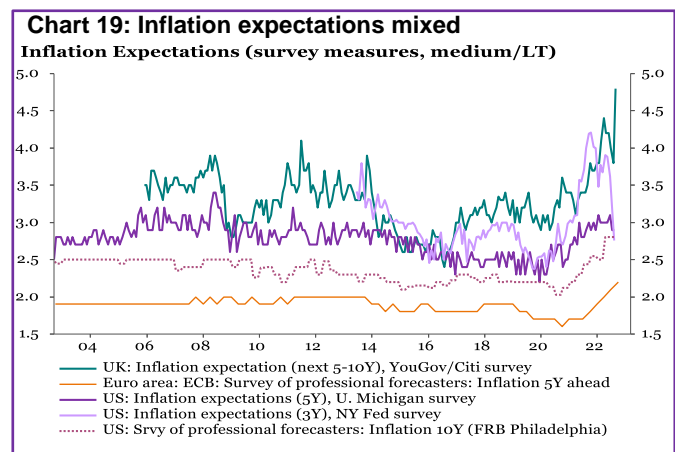
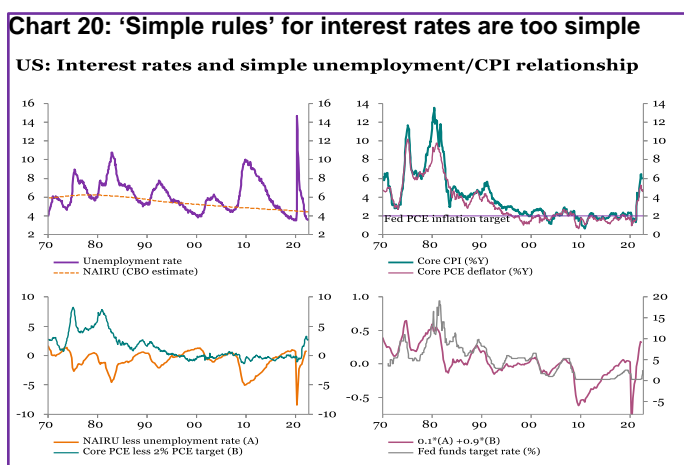
**Fed funds heading for 10%...? Probably not:** Using simple rules has merit, especially when the underlying structural fundamentals of the economy are somewhat unclear: For example, mapping policy rates against a weighted sum of 1) how far the unemployment rate is below the NAIRU (the estimated rate of unemployment below which inflation accelerates) and 2) how far core inflation is above the central bank's overall inflation target, suggests that both UK and US interest rates should be significantly higher (Chart 20). That is a conclusion relatively resilient to different changes in weights (reflective of just how low unemployment is and how high inflation is). However, simple rules are too simple: Several factors are likely mean we don't regain pre-GFC levels of nominal policy interest rates, let alone a double-digit Fed Funds rate:

- There is relatively widespread agreement that neutral rates are lower than they were 20 years ago.
- Inflation is likely to fall later this year, also reducing the risk of higher inflation expectations.
- The cost-of-living squeeze may do some of the work of central banks in cooling demand.
- Quantitative tightening (QT) means fewer rate hikes are needed

**How long until we need to start thinking about rate cuts?** If interest rates go above neutral and into restrictive territory then, as inflation comes back under control, you'd expect those rates to return to neutral. It was notable that the median Federal Reserve participant forecast in June was consistent with rates being cut in 2024. If central banks end up pushing economies into significant downturns, sooner or later we'll be in sharp rate cutting territory again.

**The forecasts on page 2** and in Chart 21 assume that the ECB hikes rapidly to a rate around neutral, slightly above for the BoE and more significantly above in the case of the Fed, but with modest rate cuts later in the profile.

The balance of risk is still to the upside of these forecasts while headline inflation is so high. In the ECB's case, you can also argue that the appropriate policy rate to measure against a neutral rate is the deposit facility rate, rather than the refi rate (suggesting slightly higher rate hikes than pencilled into the latter part of these forecasts).



## United States: From technical recession to 'real' recession?

The US economy entered 'technical' recession in H1, but threatens to move into a more significant recession. Business surveys have turned more mixed and a wider selection of indicators are sending recession warning signals than they were just a few months ago. Housing data has weakened significantly. The economy is still generating jobs, but real pay growth is negative and consumer confidence still weak. The US is not done with rate hikes and the forecasts assume that the peak is reached in H1 2023 at around 4.00%. The combined hit from cost-of-living strains for some and a lagged response to Fed tightening is assumed to tip the US into a broader (though not deep) recession in 2023, but there are significant risks on both sides of the forecast.

### Technical recession

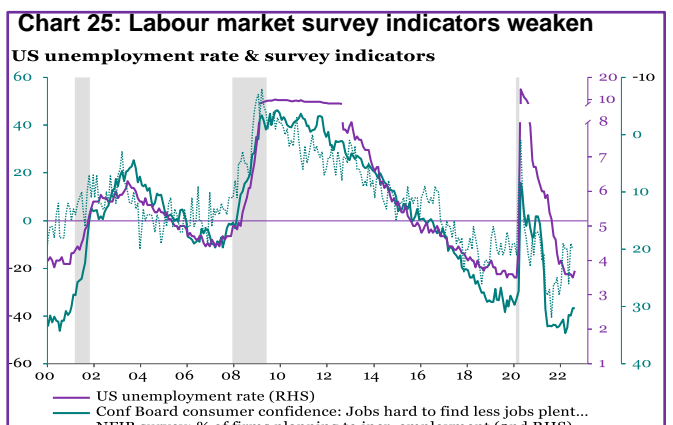
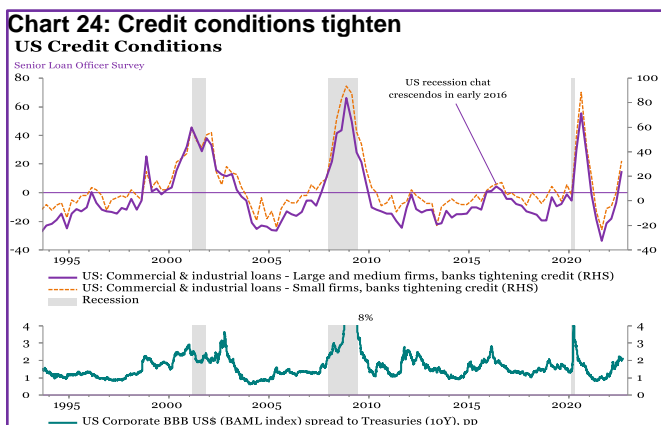
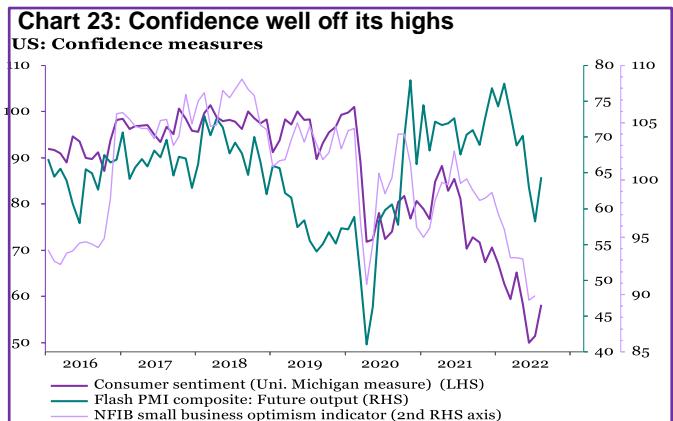
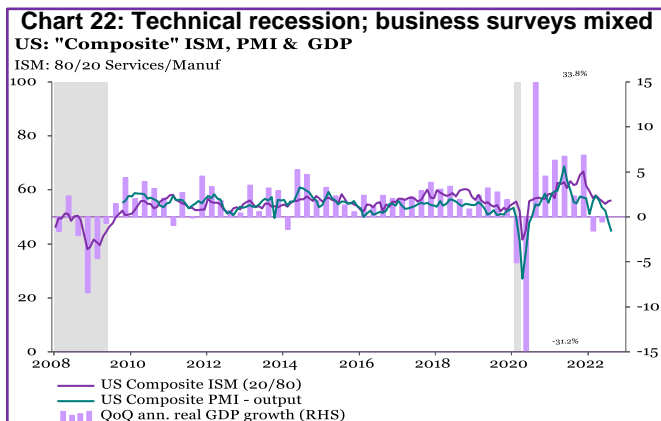
Q2 real GDP fell 0.6% QoQ annualised after -1.6% in Q1 (Chart 22). Two consecutive quarters of falling GDP is often referred to as 'technical recession', but the preferred recession definition is generally the NBER's (National Bureau of Economic Research) who look for a broad deterioration in activity and take account the labour market. Q1's contraction reflected a widening trade deficit rather than weakening domestic demand. Q2's deterioration was broader though. Real consumer spending grew, but there was a big negative contribution from inventories, a fall in fixed investment (mostly residential), as well as government consumption. This broader, more domestically driven fall raises the probability that the NBER will end up calling a recession for this year, but for now Q3 GDP looks more likely to have seen positive growth. Business surveys have been mixed with the composite PMI signalling a contraction in real activity, but the ISM business surveys still looking consistent with relatively robust growth rates (Chart 22). Weak consumer confidence and weakening business optimism (Chart 23), alongside tighter credit conditions (Chart 24) and housing activity deterioration leave the outlook for GDP relatively shaky though. The forecasts assume that a lagged response to Fed tightening eventually pushes the US economy into (moderate) recession (NBER-defined) in 2023.

### Consumer: Expected to slow – but not drastically

The forecasts on page 2 build in a slower growth rate for consumer spending than in the Spring and more rate hikes than a quarter ago. For now, real pay growth remains negative and the forecasts assume that employment growth will slow (Chart 25), as the economy reacts with a lag to Fed rate hikes. Consumer confidence is still weak and households have already been saving less/borrowing more (the savings rate has fallen below pre-pandemic levels), depleting headroom for manoeuvre as prices continue to rise. However, over the rest of 2022 and into 2023, the expected fall in inflation is also likely to lead to some improvement in consumer confidence and real pay growth limiting the likely scale of any downturn.

### Investment: Not so bright

US investment intentions indicators are mixed. However, lower business optimism (Chart 23), higher rates and tighter credit conditions (Chart 24) are likely to weigh on investment, as is increased economic uncertainty. US corporate cash levels look high, but likely relatively concentrated and substantially eroded in real terms by inflation. The mid-terms bring political uncertainty too and the prospect that the regulatory environment becomes less stable. Residential investment has already been hit, with housing indicators generally weak, as mortgage rates have risen and supply constraints have weighed.





## Fiscal policy shifts and a murky outlook

The recently passed Inflation Reduction Bill in theory raises more revenue/reduced spending than it increases spending over a multi-year period, though the balance should be more stimulative near-term depending on take-up of the climate mitigation incentives (e.g. tax credits) in the bill. There is much less pressure for cost-of-living support measures in the US than in Europe. With the November mid-terms fast approaching, however, the likelihood of further such fiscal bills being passed is slim. Republicans are still expected to take the House, increasing the likelihood of political deadlock. That, in turn, could see Biden turn more to executive orders and regulatory change as arenas of policy action ahead of the 2024 presidential election, potentially adding uncertainty around the operating environment for businesses.

## Monetary policy: More and more tightening – chances of a soft landing?

**The forecasts on page 2 assume substantial further rate increases.** The forecasts assume that the Fed continue to raise rates relatively rapidly into restrictive territory into early 2023, however the forecasts also assume a bit of easing in the pace of hikes as the terminal rate approaches (assumed to be around 4% for the upper end of the Fed Funds target range). After such a rapid pace of rate increases, given that interest rates affect the economy with a lag, there is likely to be an increased desire to give policy more time to work. However, for policymakers to be comfortable slowing the pace and pausing, we likely need more significant falls in inflation, including services inflation, and further signs that inflation expectations measures have peaked.

**Soft landing – really?** The Federal Reserve has a less than stellar record at achieving soft landings. The risk has reduced that the Federal Open Market Committee (FOMC) will be pushed by high inflation expectations into a sharp upward trajectory for rates from here. However, with rates likely heading towards 4% anyway, that may be enough to lead to a more substantial slowdown in the economy, especially in combination of what has been a substantial squeeze on household real pay.

**Recession signals increase:** The yield curve inverted again and more convincingly than it did earlier in the year (Chart 26), an ~18 month ahead recession signal. Beyond the yield curve, we have also seen patterns of other data resemble what has been seen before previous recessions, including: credit conditions (Senior Loan Officers survey, Chart 24), residential investment, University of Michigan consumer sentiment. That is before considering that the US economy entered technical recession already in H1.

## Inflation: Less headline inflation, but details matter

**US inflation is still at extraordinary levels:** Headline CPI at 8.5%Y in July is off the highs, but still around the highest since the early 1980s.

**Base effects, lower commodity prices and easing supply chain problems mean US inflation is likely to fall significantly later this year, but with risks on both sides of the inflation projection,** including on the downside if supply chain problems and commodity price rises reverse more than anticipated. However, measures of core inflation including the trimmed mean and the Atlanta Fed's 'sticky' inflation measure are still uncomfortably high and wage growth is still high without an offsetting leap in labour productivity (Chart 27). Interest rates hikes work with a lag, but the Fed are understandably not concluding that their job is done yet.

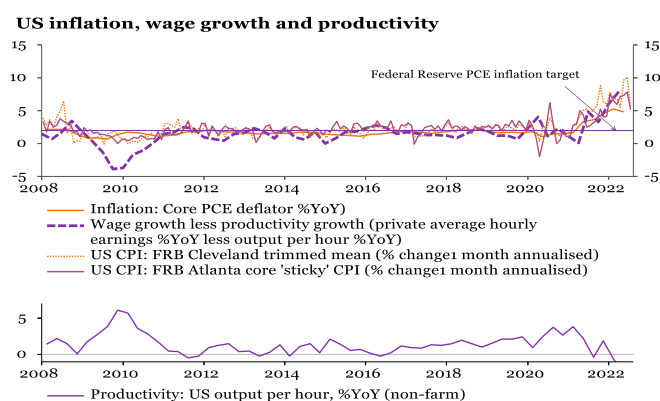
**The labour market remains a source of upside inflation risk:** US wage growth looks very strong given the level of unemployment. Pre-pandemic, this level of unemployment would have been associated with much weaker pay growth (Chart 28). Labour market participation is still weaker than pre-pandemic which won't be helping. The forecasts on page 2 only assume a small rise in participation from here. A stronger improvement would help ease labour market tightness and pay pressure.

Work by [Domash and Summers](#) looking at the post-war period suggests that high levels of wage inflation have been associated with subsequent recession, with history suggesting a very low likelihood that the Fed can reduce inflation without causing a significant slowdown and substantial increases in economic slack.

**Lower inflation expectations lower upside inflation risks a bit:**

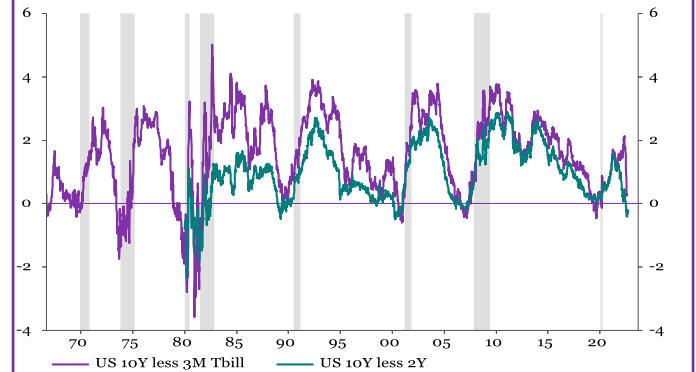
Inflation expectations still look elevated relative to the pre-pandemic period on various measures, but there has been a significant drop in survey-based measures of medium/longer-term consumer inflation expectations (Chart 19), potentially in response to aggressive Fed action.

**Chart 27: Strong wage growth; little productivity offset**



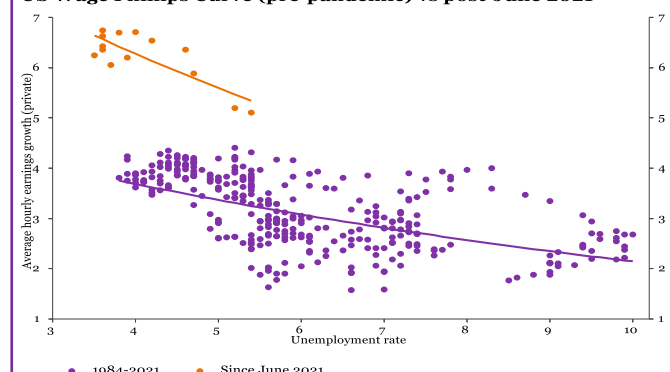
Source: Refinitiv Datastream, BEA, BLS, FRB Atlanta, FRB Cleveland. Data to July 2022 except productivity which is to Q2 2022.

**Chart 26: Yield curve inversion – a recession signal**



Source: Refinitiv Datastream, as at 2<sup>nd</sup> September 2022

**Chart 28: Tight labour market, very strong wage growth and at least a short-term shift in the Phillips Curve**



Source: Refinitiv Datastream, BLS as at August 2022

## China: Covid ups and downs

**China's zero tolerance approach brings the likelihood of repeat waves of social distancing measures and disruption to the economy as Covid continues to circulate globally. Lockdowns, however, have generally been very localised and – as happened elsewhere – authorities/firms/households will likely become even more adept at limiting economic disruption when they do occur. Macro policy has become more accommodative, but policymakers have sent mixed signals on the strength of likely stimulus.**

### Economy slowed sharply in H1, and bounce faltering

Q2 2022 GDP fell 2.6%Q, year on year GDP growth falling to only 0.4%Y – an exceptionally weak pace of growth by China's standards. That followed repeated and substantial disruption to the economy from measures to tackle the spread of Covid, including lockdowns in Shanghai. Although China has succeeded in containing its outbreak to very small numbers relative to population and relative to other major economies, China's continued zero tolerance approach leaves the economy prone to setbacks even if the economy proves less damaged by more recent restrictions. Recent business surveys showed a jump in activity in June (Chart 29), but then some softening in activity again reflecting Covid impacts, as well as muted customer demand, and disrupted power supply. Though some relaxation in managing Covid outbreaks may happen after the National Party Congress, abandoning the zero Covid approach is not assumed in the forecasts.

### Policy: Stimulus signals

China's policymakers continue to signal accommodative policy. The People's Bank of China's (PBoC's) Q2 monetary policy report saw them reiterative that monetary policy would "step up support to the real economy", but they also warned of the risk of higher inflation. Interest rate cuts, though modest, have followed. Any rate cuts seem likely to be modest too, given financial stability concerns. Further monetary policy changes could also include more cuts to the PBoC's reserve requirement ratio (RRR), see Chart 30. Boosting local government spending via special bond issuance/quotas looks set to form a continued key plank of fiscal support and, in late September, Chinese authorities announced a new package of stimulus measures including a quota of around RMB500bn in local government special bonds, carried over from previous years but which needed to be used by October. As the property market has cooled, more supportive policies have been rolled out at local level in that area too.

Policymakers' target growth rate of "around 5.5%" looks next to impossible to achieve this year given Covid disruption. However, given that this year is politically important as it is a National Party Congress year where President Xi Jinping is expected to secure a third term in power, and given the likelihood of further Covid related disruption, the risk is still skewed towards more stimulus rather than less.

### Even less impressive growth now forecast for 2022-23

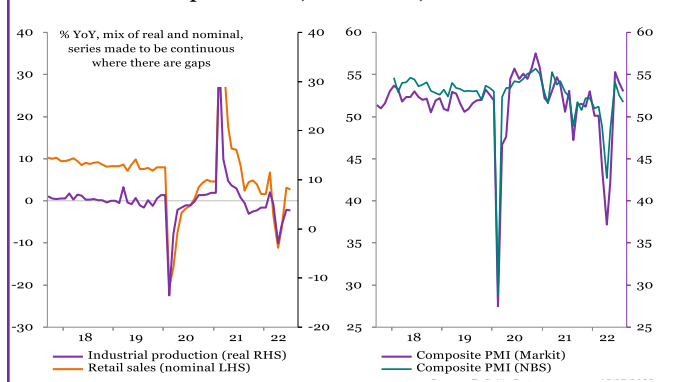
Given the weaker than expected Q2 GDP print, the slowing in the housing market, China's continued attachment to a zero-tolerance Covid approach and a continued far from 'no holds barred' approach to policy stimulus, the forecasts on page 2 assume slower GDP growth in 2022 than they did in the Spring.

The forecasts still assume that growth does not recover back to pre-pandemic norms (~6-7%) beyond that either. That assumes China retains its zero-Covid tolerance strategy. The forecast also continues to reflect an assumption that China's authorities will focus on growth stabilisation, rather than attempting to boost GDP at all costs. Long-term challenges facing China including an overhang of private sector debt and population ageing. Working age population growth has been negative for several years. There are few measures that China can take to successfully address demographic issues in the short term. All of these factors keep the GDP growth forecasts beyond the near-term relatively muted by the standards of recent Chinese history.

### External and domestic risks to the outlook

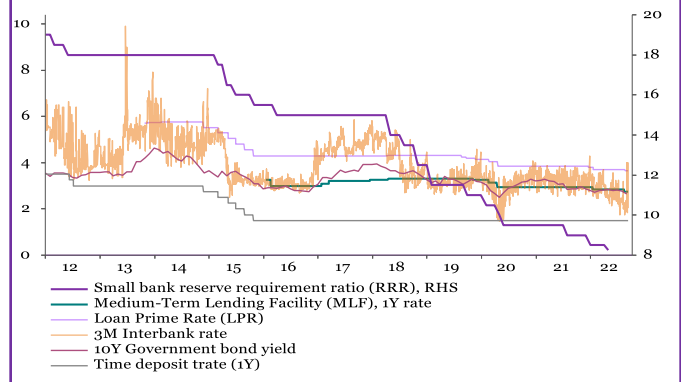
There is a reasonable chance that the forecasts are now too pessimistic in their assumptions around Covid. Several China analysts have noted that mobility has been much more resilient in Covid waves that followed the Shanghai lockdowns earlier this year. That was a pattern seen in Europe too over the pandemic period and was associated with less of an economic hit over successive Covid waves as government measures and business and household responses became less disruptive for the economy, and as technology workarounds were found for more aspects of economic activity. Other risks to the outlook include that China's policymakers fail to come through with expected policy easing measures to the extent expected or come through with considerably more. External economic risks include weaker than expected domestic demand growth in the rest of the world as economies struggle with high inflation and as central banks tighten monetary policy. Trade relations with the US are a source of uncertainty. In recent months there have been reports of the Biden administration considering cuts to China import tariffs as a way of dampening inflation. However, tensions with the US appear to have risen over Taiwan more recently.

**Charts 29: Activity data: Dip then bounce**  
China: Industrial production, retail sales, PMIs



Source: Refinitiv Datastream, NBS, S&P Global. Data is to July 2022, except PMI data which is to August 2022.

**Charts 30: Further monetary policy easing to come?**  
China: RRR and interest rates



Source: Refinitiv Datastream, PBoC, as at 8<sup>th</sup> September 2022 except RRR which is to April 2022

## Euro area: Energy and high inflation to hit growth

The euro area continues to experience very high inflation rates. Wage growth continues to trail well behind. Energy meanwhile has become both an issue of price and potential availability. It is also associated with substantial downside risks for European economies in the event of more severe and long-lasting energy supply disruption. A recession is pencilled into the early part of the forecast. The forecast for 2022 GDP growth would have seen growth revised down further, but euro area economy GDP growth was stronger than expected in Q2, helping provide an offset. Some European governments have also taken strong fiscal actions to offset cost-of-living pressures and to try and alleviate energy-related issues for companies.

### Growth challenges build further

Q2 2022 GDP growth was much stronger than expected, growing 0.8%Q (non-annualised) after 0.7%Q in Q1, both much stronger than I'd pencilled in for GDP growth in the Spring. More recently, however, business surveys suggest a sharp deterioration in activity growth. Although supply chain issues appear to be easing, high prices and worries about energy supply have hit consumer and business confidence. Both the composite PMI indicator and the European Commission's Economic Sentiment indicator fell to levels consistent with modestly negative growth in the summer (Chart 31).

### Energy supply already a big problem for the economy

The euro area economy is vulnerable to natural gas supply disruption given it is the second most important primary energy source after petroleum products and that more than 80% of the gas consumed in the euro area is imported (for more, see [ECB 2022](#)). Earlier in 2022, the ECB estimated that a 10% gas rationing shock would reduce euro area output by 0.7%. Later analysis from the Commission suggested that a halt of Russian gas supplies combined with a cold winter could mean a hit of 1.5% GDP, though good progress appears to have been made filling storage capacity for this winter.

Since then, in July [EU member states agreed](#) to voluntarily reduce natural gas demand by 15% this winter in order to prepare for possible disruption of gas supplies from Russia; natural gas flows from Russia have since seen severe disruption. As if that weren't enough, a host of other problems also hit the security of euro area energy supply over the summer, related to very hot dry weather and water levels/temperature. These variously for example, limited coal transport on the Rhine, limited nuclear output in France and led Norway to threaten to ration hydroelectricity exports. While accelerating the transition to solar and wind power is an obvious policy prescription, there is a limit to how much that can help in the near-term and there are still well published issues with the intermittency of energy supply from these sources.

### Very high inflation – becoming more of a domestic story?

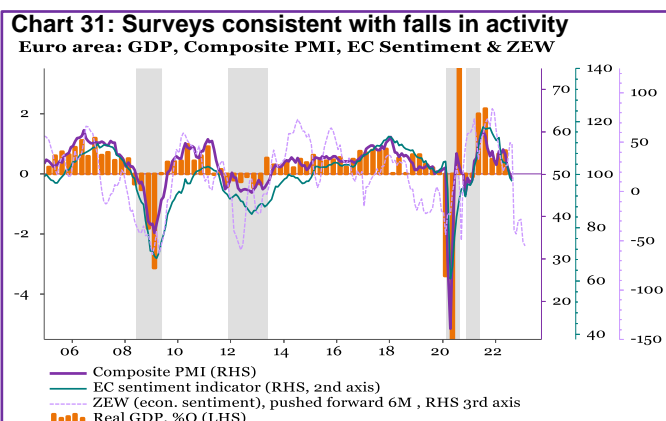
Euro area inflation is at very high levels (Chart 32). The bulk of euro area inflation still looks to be generated by external rather than domestic forces, however year-on-year energy inflation has fallen, while services inflation – which should have more of a domestic element – has risen (Chart 18). Pay growth has also been risen somewhat (on some measures) and inflation expectations remain elevated (Chart 33). The forecasts on page 2 assume that inflation falls in 2023 with risks on both sides of the forecast. Recent agreement among EU energy ministers on capping the price of gas imports bodes well for containing the peak in CPI inflation.

### Consumer spending growth to slow, but not too far

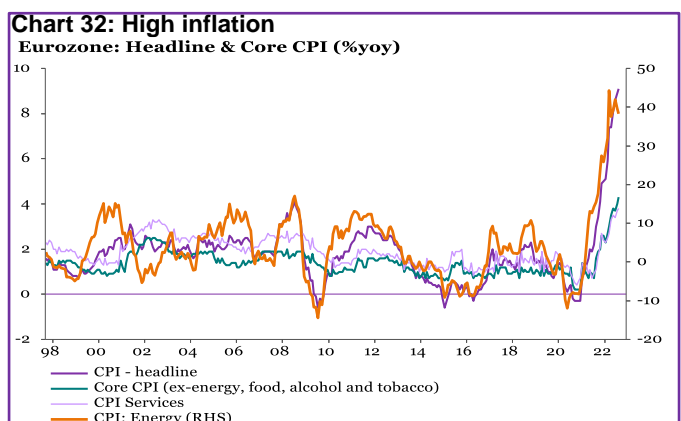
The outlook for consumer spending growth remains weak given strong inflation; real pay growth remains negative for now (Chart 6). Nominal pay growth hasn't risen as convincingly in the euro area as it has in the US and the level of pay growth is already at levels consistent with current unemployment rates (rather than below), see Chart 35. Consumer confidence is still very weak (Charts 7 and 34). Energy prices (and availability) remain a threat, including for job security. However, so far, the unemployment rate remains very low and governments have provided cost of living support for households.

### Business investment postponed

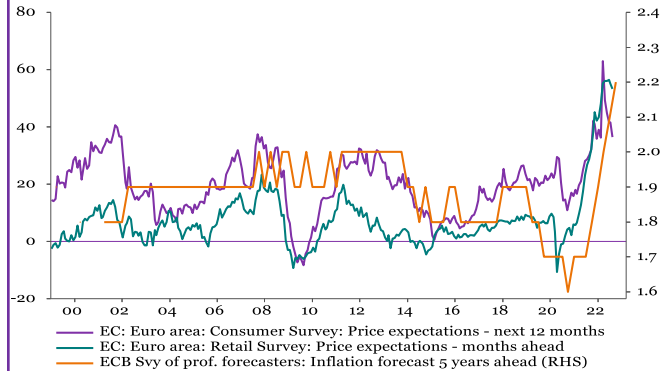
Many of the fundamental supports for a pick-up in investment remain. Business loan growth remains positive and some incentives to invest (including reshoring, the green transition and lowering reliance on labour) should have strengthened over the past couple of years. Improved supply chain problems should also mean improved availability of parts/materials for investment projects. However, the forecasts assume somewhat weaker business investment growth than previously. That reflects: 1) investment indicators have deteriorated further (Chart 36); 2) weaker business optimism; 3) that worries about energy shortages aren't going to be conducive to investment (beyond measures to enhance energy efficiency); 4) higher prices for equipment; 5) tighter credit conditions.



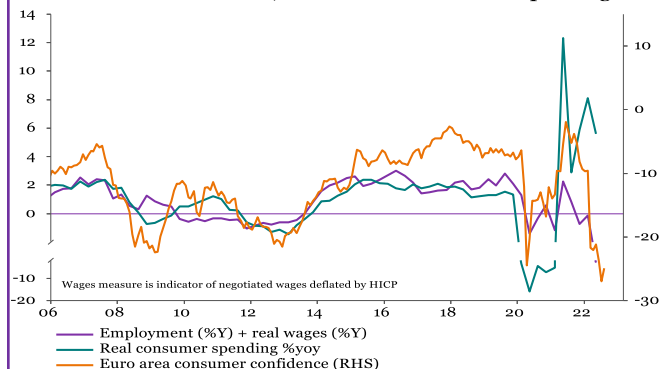
Source: Refinitiv Datastream, S&P Global, ZEW, European Commission, Eurostat. Data is to August 2022 (except GDP which is for Q2 2022).



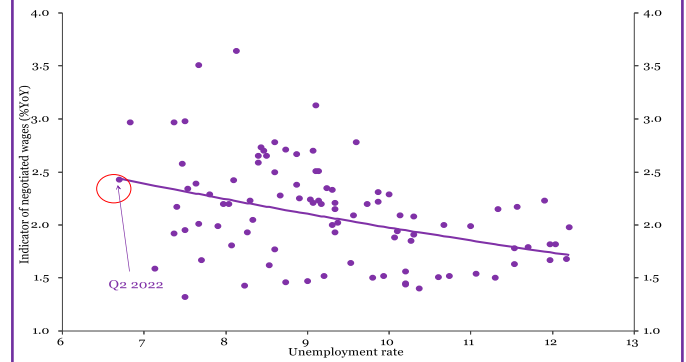
Source: Refinitiv Datastream, Eurostat. Data to August 2022

**Chart 33: Inflation expectations higher****Euro area: Survey measures of inflation expectations**

Source: Refinitiv Datastream, European Commission, ECB. Data to August 2022 (except ECB series which is to Q3 2022)

**Chart 35: Consumer spending, confidence, real wages....****Eurozone: Labour income, confidence & consumer spending**

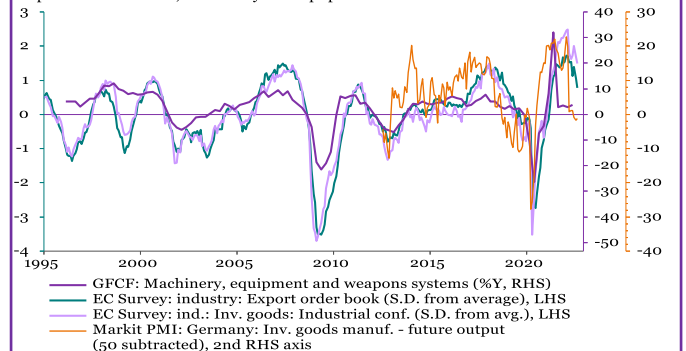
Source: Refinitiv Datastream, Eurostat, European Commission. Data to Q2 2022 except consumer confidence which is to August 2022.

**Chart 34: Pay growth now looks more in line with unemployment trend****Euro area Wage Phillips Curve**

Source: Refinitiv Datastream, Eurostat, ECB. Data to Q2 2022

**Chart 36: Capex indicators weaken****Euro area: Capex and survey indicators**

Capex measure is real, machinery and equipment



Source: Refinitiv Datastream, Eurostat, European Commission, S&P Global. Data to August 2022 except GFCF which is to Q2 2022.

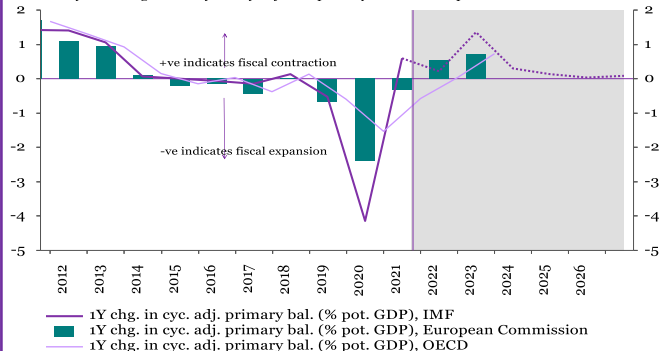
## Economic policy: Temporary fiscal support; lasting monetary policy tightening

**Extra 'cost of living' fiscal support:** Since the Spring, European governments have provided or announced more 'cost of living' support for households such that planned fiscal tightening has been revised down (Chart 37, where the Organisation for Economic Co-operation and Development (OECD) series shows the most up-to-date fiscal estimates). Based on government plans as of June, ECB staff projections at that point built in a 1% of GDP discretionary fiscal response to the war in Ukraine, with most of this representing a response to rising energy costs and most of this directed at households. As of June, they saw risks to the upside of their projections for government support. More government support has been announced since that analysis. That has included a further relief package from the German government costed at some €65bn.

On top of national support measures and the EU-wide agreement to lower gas consumption, more is expected at Commission level. The European Commission President has proposed measures to cap revenues of companies producing electricity with low costs with those 'unexpected profits', as well as a 'solidarity contribution' from fossil fuel companies, then re-channelled to vulnerable households and companies. The Commission has also proposed a price cap on Russian oil imports.

**Chart 37: Estimates of forthcoming fiscal tightening continue to be revised down as governments add support****Euro Area: Fiscal expansion and contraction**

Proxied by the change in the cyclically adjusted primary balance as % potential GDP



Source: Source: Refinitiv Datastream, IMF (updated 22/04/2022), European Commission (17/05/2022), OECD (08/06/2022)

**ECB – More tightening:** The ECB raised rates 75bp in September, signalling a (belated) determination to dampen inflationary pressure. With staff inflation forecasts still above target in 2024, the ECB are far from done yet. The forecasts on page 2 assume that by the middle of next year, the main refi rate is at 2.50% (2.00% for the deposit rate). That projection assumes that more fiscal support for Europe's consumers and businesses will be forthcoming over the winter months, but that energy rationing is not used significantly.

If Europe's energy problems become more severe, ECB tightening may be more drawn out/less than the profile in Chart 21. There are fewer signs of a build in domestically driven inflationary pressure than in the US, hence the forecasts do not assume that rates move significantly above neutral. However, with headline inflation still very high, that is the direction of risk for the forecasts.

ECB President Lagarde said in September that any discussion of quantitative tightening was premature for the ECB, however as monetary tightening continues, questions on QT are likely to recur.



## Japan: A new paradigm? Not yet at least

**Inflation has continued to rise in Japan, even while remaining well below levels seen in the likes of Europe and the US. The Bank of Japan (BoJ) continues to reiterate its easing message. Until there is significantly more evidence of domestic inflationary pressure, the BoJ's monetary policy stance is likely to be maintained, but with risks of changes to yield curve control rising. Meanwhile, both the near-term and longer-term outlook for the real economy look challenging.**

### Inflation rising, but mostly energy and food – still no BoJ tightening trigger

Inflation is rising in Japan (Chart 38). However, so far, there is less evidence of a broadening out of inflationary pressure than seen in Europe and the US and the vast bulk of headline inflation reflects energy and food prices (especially non-fresh food). Nevertheless, there seems to have been some degree of broadening out of price pressures: the BoJ's price diffusion index has been picking up relatively steadily since 2020 (Chart 39); nominal pay growth has been picking up (Chart 38) and inflation expectations have been rising – at least as evidenced by business expectations in the quarterly Tankan survey (Chart 40).

These inflationary pressures, however, look nowhere near as strong as in Europe and the US and follow a very long period of low inflation. The BoJ, has continued to reiterate its accommodative policy message. Until wage growth is significantly higher, that may not change. BoJ governor Kuroda's term ends in April 2023 though. Rate hikes look unlikely yet, but a review of the yield curve control framework could follow the change in BoJ governor. FX intervention is also a risk given JPY weakness against this higher inflation backdrop.

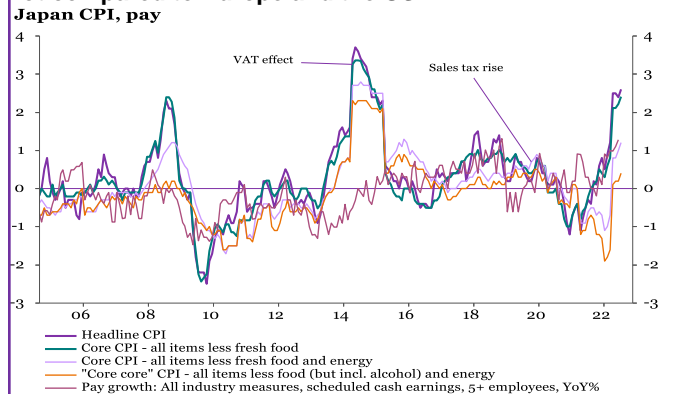
### Outlook not as downbeat as Europe and the US

**Despite several rounds of fiscal stimulus, the activity growth picture remains lacklustre.** The level of real GDP is well below levels seen through most of 2019, pre-pandemic. Activity growth has been bumpy and business surveys suggest that GDP growth may be flat to negative in Q3 (Chart 41). Recessions in the US and Europe would also have some feedback effects for Japan.

**However, the risk of a substantial recession looks lower than in Europe and the US:** Japan's monetary policy remains accommodative and significant monetary policy tightening continues to look unlikely for now. Although real pay growth is subdued (Chart 6), the level of real consumer spending and capex is still below pre-pandemic levels in contrast to the US (Chart 12), suggesting more room for catch-up. Energy inflation, meanwhile, as measured by CPI, was around 16.5% year-on-year in July compared to 33%Y in the US, 40%Y in the euro area and 58%Y in the UK. The forecasts in Japan assume that Japan doesn't go into recession, but the chance of at least one negative GDP growth quarter between now and mid-2023 looks high.

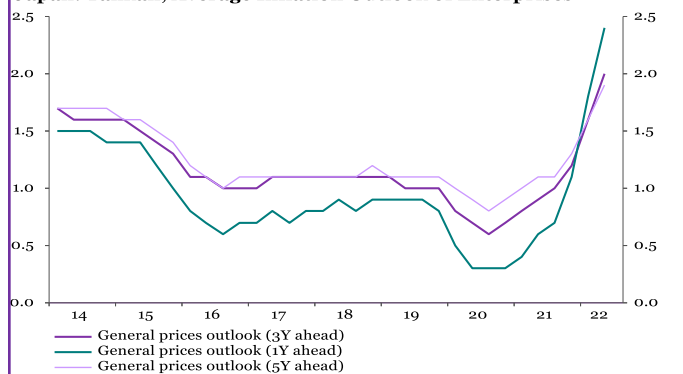
Longer-term prospects for Japan remain hampered by demographic challenges. The 'working age' population aged 15-64 continues to decline and average productivity growth has not been particularly strong in recent years (see [More rate hikes, less growth](#)).

**Chart 38: CPI at high levels... against recent history, though not compared to Europe and the US**



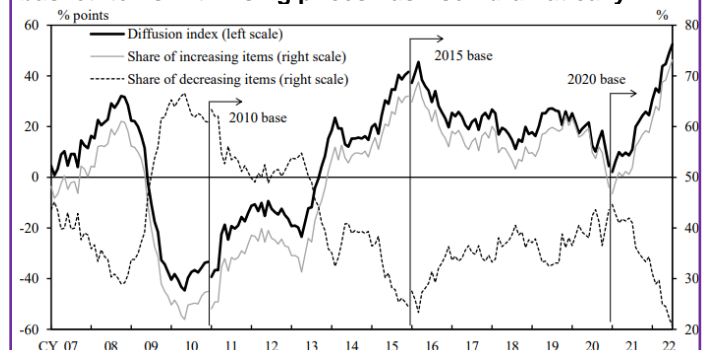
Source: Refinitiv Datastream, Statistics Bureau, Ministry of Internal Affairs & Communication, Ministry of Health, Labour and Welfare, Bank of Japan as of July 2022.

**Chart 40: Higher inflation expectations**  
Japan: Tankan, Average Inflation Outlook of Enterprises



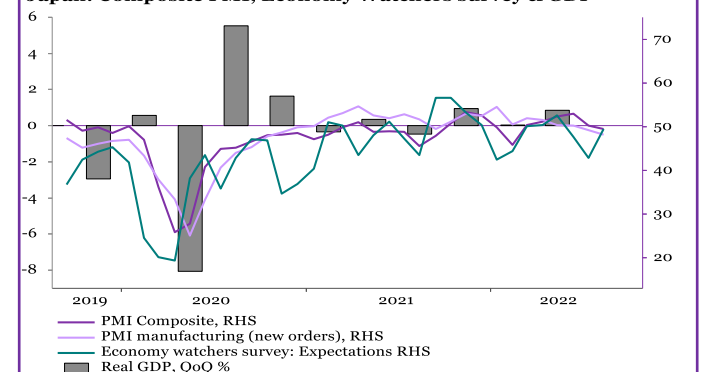
Source: Refinitiv Datastream, Bank of Japan as of Q2 2022.

**Chart 39: BoJ's diffusion indicator shows the share of CPI basket items with rising prices has risen dramatically**



Source: Bank of Japan, July 2022. The share of increasing/decreasing items is the share of items in the CPI (less fresh food) whose prices increased/decreased from a year ago. The diffusion index is the share of increasing items minus the share of decreasing items (in percentage points)

**Chart 41: Business surveys point to flattish Q3**  
Japan: Composite PMI, Economy Watchers survey & GDP



Source: Refinitiv Datastream, S&P Global, Cabinet Office. GDP to Q2 2022, PMI and Economy Watchers data is to August 2022

## United Kingdom: Modest cost of living recession

The outlook for the UK economy has worsened over most of the year as energy prices have risen. With double-digit rates of inflation overall and even considering upcoming energy bill freezes, a (modest) recession is built into the forecasts. The bill freeze for firms is also substantially shorter than that for households. That leaves firms still facing considerable uncertainty, likely to bear down on investment spending. As for consumers, real pay growth remains negative. As elsewhere, lower inflation is forecast over 2023 – easing pressure on both consumers and the central bank. Alongside more supportive fiscal policy, however, signs of broadening out in inflation, higher inflation expectations and robust nominal pay growth make more Bank of England rate hikes look inevitable.

### Stall speed

The level of activity in the UK economy is still only slightly above where it was pre-pandemic (Chart 42). Although UK Q1 GDP growth was robust, Q2 saw a small contraction in activity. The UK composite PMI business survey indicator of activity in the economy deteriorated between March and August 2022 and by August signalled only relatively weak rates of activity growth in the economy (Chart 43).

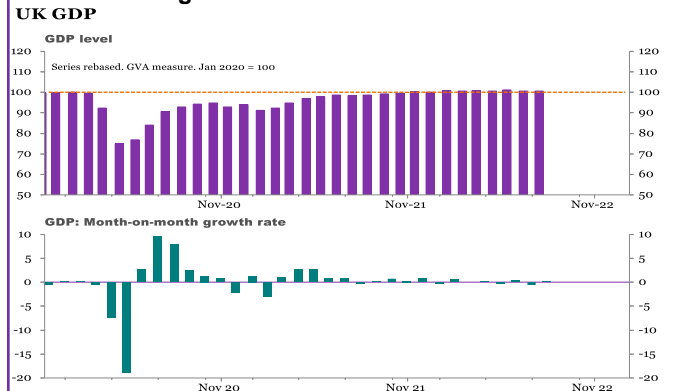
### Very high inflation rates are a serious problem for the economy

**UK inflation rates are very high (Chart 44) and some of the highest rates of inflation are in things that consumers find difficult to put off spending on.** Energy inflation (CPI measure) reached 58% year-on-year in July. Food inflation reached 13.4%Y in August and the combined effects of dry summer weather and high energy prices may well push this higher still. Nominal pay growth has been strong by UK standards, but not anywhere near fast enough to keep up with inflation. Against this backdrop, the financial state of some households will already be very difficult and although the upcoming bill freeze will protect households from most of what had been expected to be an 80% increase in energy bills in October, things will remain difficult for many households. Consumer confidence has plummeted (Chart 45).

**Businesses have been hit by higher energy bills too** and there was a notable jump in insolvencies in Q2 (Chart 46). Business optimism is significantly off its recent highs (Chart 4); investment intentions have dropped (Chart 11). The proportion of firms in the Deloitte CFO survey citing a high/very high level of external uncertainty facing their business has increased and borrowing growth has dropped (Chart 47). Although the government's energy bill freeze will be helpful, it is only set to last six months for businesses, during which time there will be a review with the aim of protecting a more targeted group of "vulnerable" industries like hospitality. In terms of investment (and hiring) planning periods therefore, that still appears to leave many firms open to substantial uncertainty around how the end of the bill freeze will be managed and what levels of energy bills firms will then face. To the extent that more fiscal support leads to more Bank of England rate hikes and higher bond yields, that will also be a challenge for business.

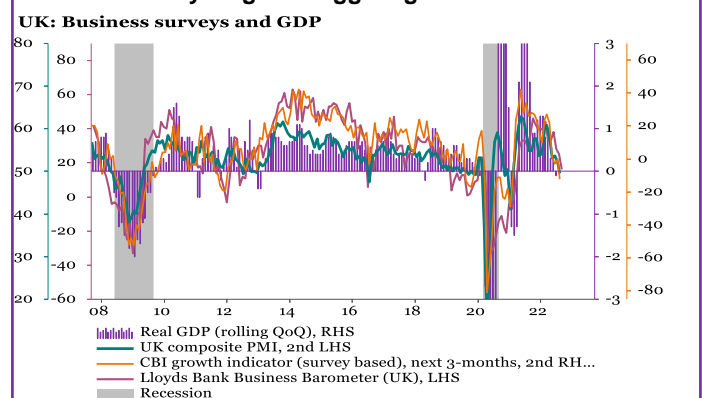
**In light of the very high inflation backdrop, the Bank of England continue to raise rates.** Credit conditions have tightened since the start of the year – with household credit availability reduced (on the latest Bank of England credit conditions survey). Survey-based housing activity indicators look subdued too; housing is generally considered a relatively interest rate-sensitive part of the economy.

**Chart 42: GDP growth lacklustre**



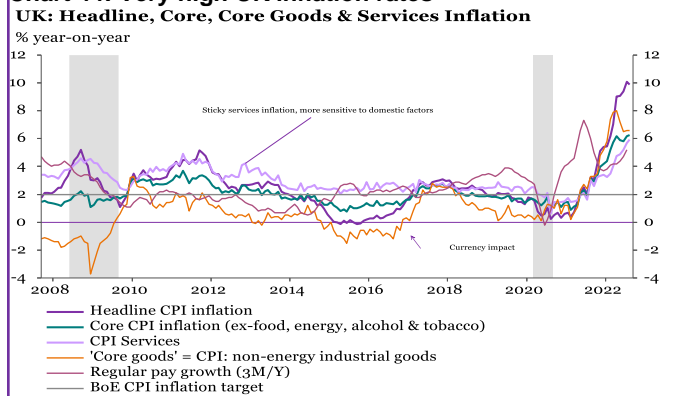
Source: ONS, Refinitiv Datastream (data to July 2022).

**Chart 43: Surveys signal sluggish growth**



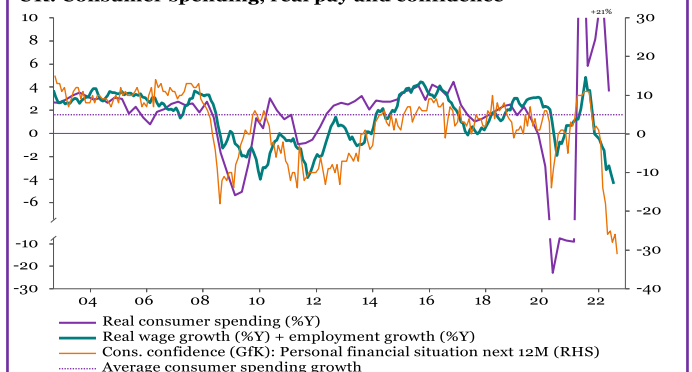
Source: Refinitiv Datastream, ONS, CBI, Lloyds, S&P Global. Data is to August 2022 except GDP which is to July 2022.

**Chart 44: Very high UK inflation rates**

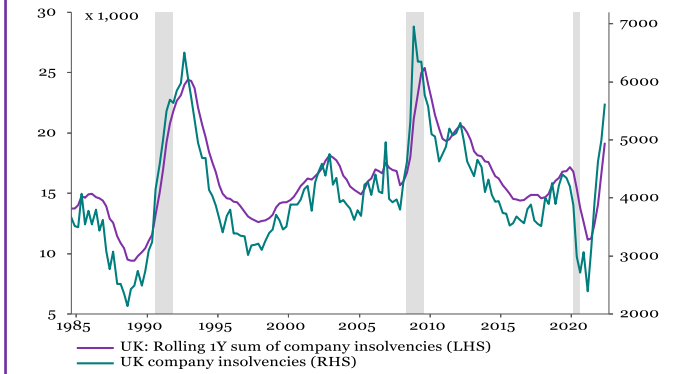


Source: Refinitiv Datastream, ONS, to August 2022 except pay growth (average weekly earnings: regular pay) which is to July 2022

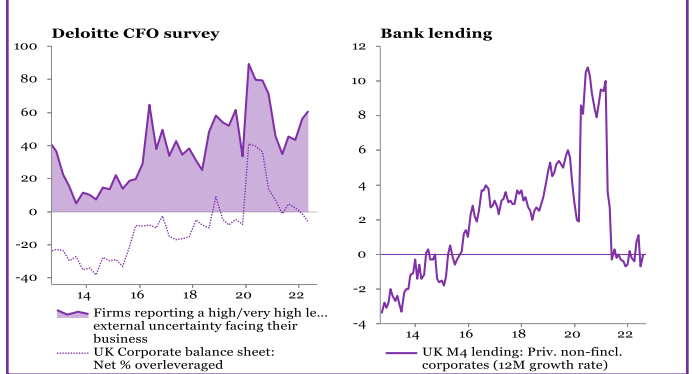
**Chart 45: High inflation hits real incomes and confidence**



Source: Refinitiv Datastream; ONS data to Q2 2022 (consumer spending), July 2022 (wage and employment growth); GfK data (consumer confidence) to August 2022.

**Chart 46: Rise in insolvencies in H1****UK Company Insolvencies**

Source: Refinitiv Datastream; UK Insolvency Service. Data to Q2 2022

**Chart 47: Business uncertainty higher; Loan growth slower****UK firms: Uncertainty and debt**

Source: Refinitiv Datastream; Deloitte, Bank of England. Deloitte data to Q2 2022, bank lending data to July 2022.

## Consumer spending – likely driver of slowdown

Overall real consumer spending, alongside business investment (though levels of the latter are already relatively low) looks set to contract. Real income growth and consumer confidence have been hit by high inflation (Chart 45); real wage growth has plunged (Chart 6). With the overall outlook of the economy weakening this year, the scope for households to increase their hours or move jobs for higher pay may be more curtailed in the months ahead.

## Modest recession assumed for now

The forecasts on page 2 build in only a moderate recession for the UK economy. First, that reflects the substantial fiscal support now promised by the UK government. Second, the banking sector looks in reasonable health. Third, balance sheets are in reasonable shape in aggregate, taking into account cash/deposits built up by firms and households over the pandemic period (but acknowledging that the distribution of these stocks is highly uneven and that in real terms these stocks have been substantially eroded by inflation). Fourth, external inflation pressures appear to be falling.

## Inflation: Finally peaked? Upside risks to the forecast

With energy bills frozen, consumer price inflation may well have peaked (Chart 15). Rather than the energy bill price cap increasing 80% in October it will increase around 27%. That is before including the previously announced bill support of £400, so the actual increase households face will be less, though the 27% will matter for CPI. The forecasts see CPI inflation around the Bank of England's target at end-2023, weighed down by lower external inflation pressures and slower domestic demand. Those forecasts make several important assumptions, however. Those include a lasting improvement in supply chain problems that helps to keep external inflation pressure contained. They also assume that monetary policy and a slowdown in demand already in train in the UK restrains domestic inflationary pressure including helping inflation expectations to fall and constraining wage growth. The forecasts also – at this point – do not assume a jump in energy bills once the energy bill price cap ends. Clearly there are risks to all these assumptions. In particular, the most recent data show rising services inflation and higher inflation expectations – i.e. rising not falling domestically driven inflation. Food prices are also a source of upside risk.

The forecasts also assume that CPI inflation settles a bit above target. The UK is likely to experience repeat bouts of tight labour markets (with its new immigration regime and ageing population). The forecasts do not assume that inflation expectations return to low levels (reflecting household and firms' recent experience of inflation and likely changed public expectations of fiscal policy help during economic downturns). Changes to the inventory cycle are likely to see repeat bouts of rising (and falling) inflation (see global section). Green transition costs are also built into the forecasts – leading to a modest upward bias in the inflation forecasts over the coming years of the projection.

## Fiscal risks and less supportive monetary policy

**A big fiscal package of support for households and firms – but how will it be paid for?** We will have to wait for the forthcoming fiscal statement for more on the new government's overall fiscal plans (likely to include tax cuts in addition to the energy bill freeze). Press reports leading up to the announcement of the energy bill freeze range costed it between £100-200bn, but the bill will be contingent on the wholesale price of energy and therefore inherently uncertain. In terms of how it will be paid for, the Prime Minister was clear that it would not be paid for by an additional windfall tax on oil and gas companies. She admitted that there were no cost-free options, but in terms of defraying the cost, first they plan to ramp up energy supplies (including ending the moratorium on fracking) and negotiate long-term contracts with suppliers to bring down the cost of the policy. She also claimed that her policies would boost the economy, increasing tax receipts. It will be interesting to see what the Office for Budget Responsibility has to say about all this and how much they expect public sector net borrowing will need to rise, but the hypothetical boost to growth is presumably relative to a worse counterfactual and any boost to energy supplies will presumably take time. Tax cuts may not boost growth much (e.g. via incentivizing investment spending) while the economic environment is so uncertain. Either way, gilt issuance looks set to be substantially higher in coming quarters than previously anticipated and at a time when the Bank of England is expected to be selling bonds too (QT).

**Monetary policy tightening – more looking inevitable:** Lower than expected energy bills in October may well help lower inflation expectations. However, it also improves the outlook for household incomes in isolation and therefore should work to raise the Bank's expectations of inflation in the medium-term. The MPC look set to need to hike interest rates into more clearly restrictive territory and faster than I'd previously assumed: Headline inflation is very high; the economy is not in recession quite yet; fiscal support is set to be substantial; inflation expectations of consumers and businesses have been rising and domestically driven inflation in the UK appears to be strengthening (e.g. services inflation in Chart 18).

The forecasts now assume that the BoE raise rates to around 3.50% in 2023. By 2024, with inflation assumed to be substantially lower, the forecasts assume that the BoE lower rates a bit, back towards my estimate of a medium-term neutral rate (2.25%).

**Skew of risk still towards more, rather than less:** My forecasts for the real economy are much less grim than the Bank of England's; the risk to these forecasts is still skewed towards a faster increase in rates to a higher peak, especially as the BoE absorbs the changes in fiscal policy.

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**Derivative Risk:** Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both Fund losses and gains. The impact to the Fund can be greater where they are used in an extensive or complex manner, where the Fund could lose significantly more than the amount invested in derivatives.

**Credit Risk:** Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

**EPM Techniques:** The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

**Exchange Rate Risk:** Changes in currency exchange rates may affect the value of your investment.

**Interest Rate Risk:** Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

**Liquidity Risk:** In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

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**Fund investing in Funds Risk:** The Fund is valued using the latest available price for each underlying investment, however it may not fully reflect changing stockmarket conditions and the Fund may apply a 'fair value price' to all or part of its portfolio to mitigate this risk. In extreme liquidity conditions, redemptions in the underlying investments, and/or the Fund itself, may be deferred or suspended.

**Liquidity and Dealing Risk:** The Fund invests indirectly in assets that may at times be difficult to value, harder to sell, or sell at a fair price. This means that there may be occasions when you experience a delay in being able to deal in the Fund, or receive less than may otherwise be expected when selling your investment.

**Investment risk:** The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

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