



Investment Clock – Economic Update

Issue #27, February 2023

Multi asset views from RLAM

Royal London Asset Management manages £147.2 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 31 December 2022

This month's contributor

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US: There are plenty of recession warning signals in the data – but the same was true several months. The forecasts assume Fed tightening helps tip the US into a modest recession in 2023, but there are significant risks on both sides of the forecast.

China: 2023 should see a robust recovery. The forecasts assume that the post-Covid recovery won't be as inflationary as elsewhere.

Eurozone: Inflation remains high and a very mild recession is built into the forecast... as is more ECB tightening than previously.

Japan: The central forecast doesn't assume rate hikes with price pressures still weaker than elsewhere, but risks are rising.

UK: Challenges for the UK outlook include cost-of-living pressures and tighter monetary and fiscal policy. Growth forecasts have been revised down in recent months.

Please visit [investmentclock](#) for our blog and information about our multi asset range.

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The case for modest recessions

The outlook has improved somewhat for 2023, but I still expect modest recessions in major economies driven by monetary policy tightening; households struggling with the cost of living; and firms holding back on investment in the wake of higher interest rates and costs. Lower inflation, savings stocks and central bank pauses all help stave off worse recessions in the central case. Risk scenarios centre on different paths for inflation and rates. The US and euro area ended 2022 looking more robust than expected and some economies, including the US, may yet escape recession with inflation already substantially lower. China's recovery could be a complicating factor for the global inflation picture though and Europe's energy struggles may well recur.

Summary

In recession already? The global composite PMI business survey measure is still in the 'recession warning zone', even if it is off the lows. It is surprising that more economies aren't in recession already though and the euro area and US economies have generally been showing more resilience than expected. Data in the UK has been less reassuring, however, and central bank rate hikes will act with a lag.

Labour market key: Tighter monetary policy – both further tightening and the lagged effects of past tightening are set to drag on growth in 2023. But how much monetary policy drags on growth will partly be a function of the labour market: Tight labour markets, a degree of labour hoarding and robust nominal pay growth should help recessions stay modest for now. However, if pay growth remains strong, hitting an inflation target may require central banks to hike much more.

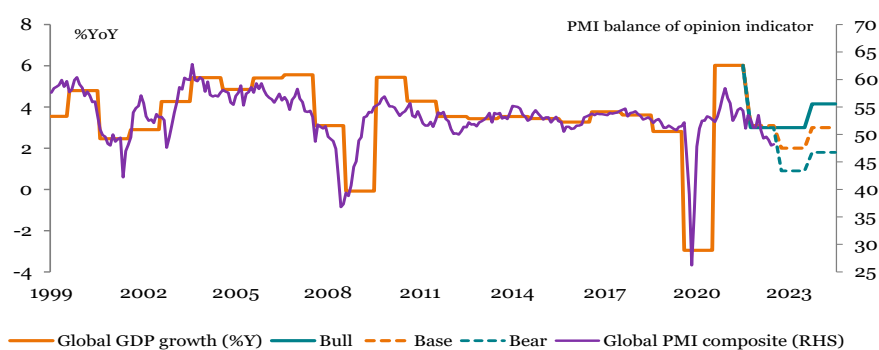
Lower inflation will help: Inflation falls significantly in the central case – driven by weaker goods, food and energy inflation. That should also lead to lower inflation expectations and less wage pressure. Wage growth should cool as demand and supply move into better balance, taking the pressure off central banks.

Keep an eye on China: As China bounces back in 2023, Chinese demand could boost commodity prices and keep inflation supported and therefore require stronger central bank hikes.

Pauses rather than pivots assumed for 2023: How far each major central bank needs to hike rates is a different question to how far they will hike rates, but they will want to feel confident that inflation is sustainably going to hit their target and that will require lower *domestically driven* inflation. In the central case European Central Bank (ECB), Bank of England (BoE) and Federal Reserve (Fed) policy rates haven't peaked yet.

Multi asset team views: Our multi asset funds have benefitted from an overweight tactical position in equities so far this year. However, the team have a more cautious view on the economy in the second half of the year and could move underweight stocks if they see more evidence of stickier inflation causing markets to price in more hikes than currently anticipated. See [investmentclock](#) for more information.

Chart 1: Global growth central case sees modest recessions



Source: Past actuals are IMF and S&P Global, forecasts (teal and dashed lines) are RLAM Data as of December 2022 (PMI), October 2022 (IMF) and forecasts are as of January 2023.

Economic forecast summary

February 2023 base case

Region	2022e			2023e			2024e		
	GDP growth e	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4
US	2.1 <i>1.7</i>	7.1 <i>7.7</i>	4.50	0.6 <i>0.6</i>	3.1 <i>2.9</i>	5.25 <i>4.00</i>	1.1 <i>1.4</i>	2.5 <i>2.7</i>	4.50 <i>3.00</i>
China	3.0 <i>2.7</i>	1.8 <i>2.6</i>	– –	5.4 <i>5.1</i>	– –	– –	4.8 <i>4.8</i>	– –	– –
UK	4.1 <i>3.5</i>	10.8 <i>9.9</i>	3.50	–0.7 <i>0.1</i>	2.8 <i>2.0</i>	4.50 <i>3.50</i>	1.0 <i>1.5</i>	2.4 <i>2.2</i>	3.75 <i>3.00</i>
Euro area	3.5 <i>2.8</i>	10.0 <i>8.7</i>	2.50	0.4 <i>–0.2</i>	2.1 <i>2.1</i>	3.75 <i>2.50</i>	0.6 <i>1.5</i>	2.4 <i>2.2</i>	3.25 <i>2.25</i>
Japan	1.1 <i>1.0</i>	3.9 <i>2.6</i>	–0.10	0.8 <i>1.4</i>	2.0 <i>1.1</i>	–0.10 <i>–0.10</i>	1.1 <i>1.1</i>	1.4 <i>0.9</i>	–0.10 <i>–0.10</i>
Global	3.2 <i>2.8</i>	– –	– –	2.5 <i>2.4</i>	– –	– –	3.0 <i>3.3</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 September 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 remaining the priority for central banks, the Federal Reserve, ECB and Bank of England raise rates a bit further in H1 2023.
- The forecasts assume a peak upper limit to the Fed Funds target range of 5.25%, that the BoE hikes rates to 4.50% and that the ECB raise (the refi rate) to 3.75%. There is also a significant probability (not central case) that Japan raises rates over the forecast profile.
- Fiscal policy is generally expected to become less supportive over the forecast. However, sharp spending cuts are not in the central case, partly as assumed spending to tackle longer-term challenges (e.g. climate change) steps up.

Global economic scenarios (Chart 1)

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

- Inflation falls much faster than expected as supply problems ease and commodity prices fall. Central banks signal clearly that they do not envisage more rate increases in the first half of 2023, helped by lower inflation expectations and pay growth and modest rate cuts are signalled by some central banks for the end of 2023. 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 rebounds strongly, but largely through higher consumer services activity – limiting the impact on global inflation.

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

- 2023 sees the global slowdown continue as households struggle with the high cost of living, companies postpone investment decisions in light of economic uncertainty and high costs and as the economy responds with a lag to higher interest rates.
- Inflation falls as supply chain problems ease and after falls in commodity prices. Domestically driven inflation pressures ease somewhat.
- Monetary policy tightens further and fiscal policy becomes less supportive.

Downside scenario (20%): Deeper recessions

- China's recovery in H1 2023 leads to much higher commodity prices. Central banks continue to tighten policy in H2 2023, well into restrictive territory, as inflation expectations and domestic inflationary pressure fail to ease as hoped.
- 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.
- 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: Slow growth

Compared to September, GDP growth forecasts been revised a bit lower for 2024 and still show only modest or moderate recessions. Recession forecasts are driven by monetary policy tightening, households struggling against cost-of-living pressures and firms likely holding back investment in the wake of high costs and economic uncertainty. The outlook for 2023 appears a bit less downbeat given China's re-opening, a better US real wage picture and fewer European energy worries. The forecast for the UK is more downbeat for now than in the US or euro area. We are getting closer to a pause in major central bank hikes but aren't there yet. Inflation is still high; a return to target is not yet assured. Risks are two-way, but the scenario where central banks hike a lot further than expected (perhaps even after a pause), because inflation proves stickier than expected, is still a particular concern.

Activity growth: In recession? Skirting recession?

Global growth has been pushed down by struggles related to high inflation, an uncertain economic environment and by monetary policy tightening and tighter credit conditions. With wages not having kept pace with higher prices, households have experienced a cost-of-living shock (Chart 2). Year-on-year nominal wage growth remains below headline CPI inflation. Last year's strong dollar won't have helped, exacerbating cost pressures in many economies. The global composite PMI business survey measure is already below levels where economists tend to start talking about global recessions (Chart 3). New orders and trade growth indicators look subdued (Chart 4).

However, moving into 2023 and things don't look as bad as once feared. Inflation is falling, in Europe, worries around energy availability have eased and China has abandoned its zero-tolerance approach to Covid. Business optimism is off its lows (Chart 5). Supply chain problems appear to have eased significantly (Chart 6), although this will partly reflect slower demand.

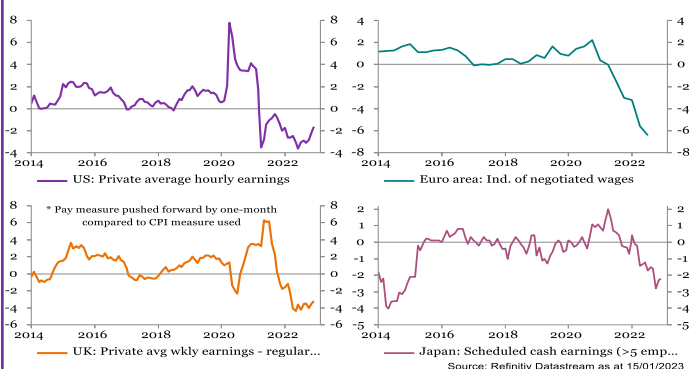
Modest recessions

The forecasts on page 2 still envisage modest/moderate recessions in several major economies. General downward revisions of growth forecasts for 2024 reflect additional assumed monetary policy tightening. In the UK, forecast revisions reflect a generally worse policy mix than I'd originally pencilled in (more fiscal and monetary tightening). In the US, the 2024 revision reflects tighter monetary policy and a sharper tightening in credit conditions than anticipated. In the euro area, fears on the energy supply backdrop have eased, bolstering the 2023 forecast. However, thinking about 2024, more monetary policy than previously assumed weighs on growth. Energy supply worries are also assumed to recur (albeit in a less serious way). Modestly rising unemployment rates are also assumed for major economies.

Chart 2: Cost of living shock: Real pay growth negative

Selected real pay growth measures

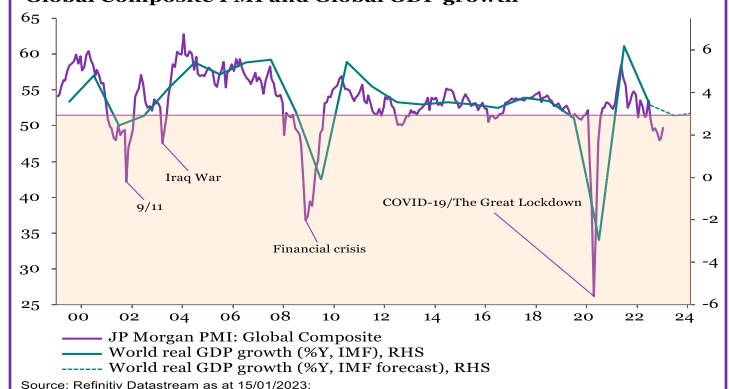
All deflated by CPI; % change YoY



Source: Refinitiv DataStream, BLS, ECB, Eurostat, ONS, Ministry of Health, Labour and Welfare, Ministry of Internal Affairs & communication. Data to December 2022 except euro area (Q3 2022).

Chart 3: Global PMI further in recession zone

Global Composite PMI and Global GDP growth

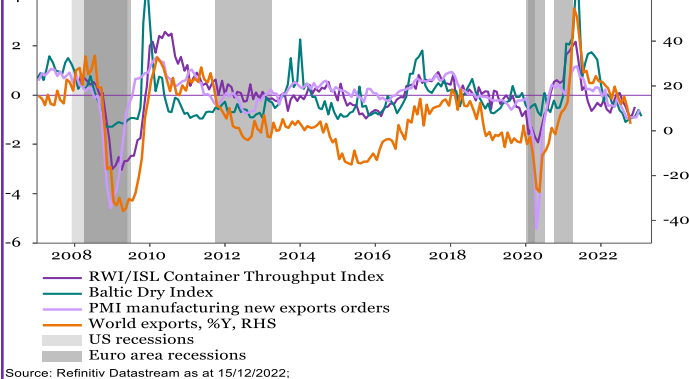


Source: Refinitiv Datastream, S&P Global as at January 2022. IMF forecasts from January 2023.

Chart 4: Trade growth indicators still subdued

Selected trade growth indicators

Except export growth, all series are standardised series - standard deviations from average of YoY% growth (level for PMI)

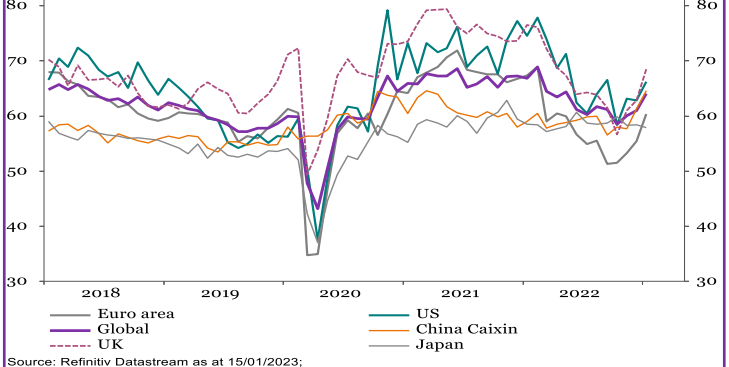


Source: Refinitiv Datastream, ISL, Baltic Exchange, S&P Global, IMF. Export growth data is to October 2022, container throughput series is to December 2022, PMI figures are to January 2023, Baltic Dry series is to 2nd February 2023.

Chart 5: Business optimism rising again

PMIs: Business optimism

PMI composite indicators for "future output"



Source: Refinitiv Datastream, S&P Global. Data as at January 2023.

Consumers and corporates: Lower inflation will help

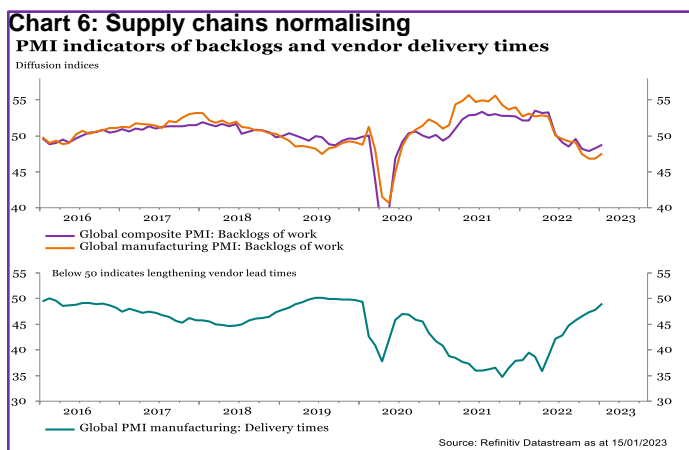
Challenges for the consumer remain acute. Inflation remains high in major developed economies, even if it has fallen significantly in the US. The outlook for labour markets looks less buoyant than it did with business surveys suggesting cooling employment demand. Meanwhile, higher interest rates mean higher mortgage payments (though with differing impacts depending on scale of leverage and relative preference for variable interest rates. Wealth effects are also likely to be weighing somewhat as higher interest rates feed through into falls in house prices in some economies. Consumer confidence remains very weak (Chart 7).

Consumer spending surprisingly resilient. Against a backdrop of negative real pay growth and very weak consumer confidence, perhaps the biggest surprise is that consumer spending indicators aren't weaker (Chart 8). That may reflect: 1) Inflation will overstate the impact on household incomes where governments have provided support to households to compensate for the high-cost-of-living through means other than direct subsidies (as these would not generally be picked up in official inflation series); 2) labour markets remain tight and unemployment rates low so far; 3) higher interest rates may feed through relatively gradually in some of these economies – e.g. in the UK most mortgages are now fixed rate (albeit generally not for terms longer than 5 years); 4) some households will also still have something of a savings shield; 5) month-on-month real pay growth in some economies has turned positive.

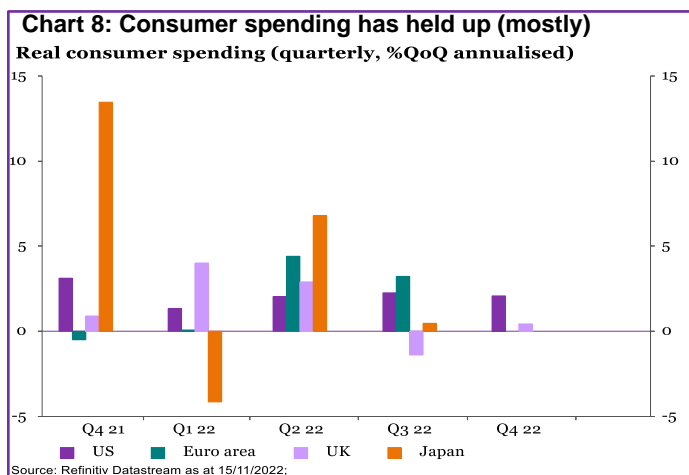
However, the longevity of these supportive factors is limited. Some government support measures are explicit one-offs or planned to become less generous. Labour markets are already looking a little less tight, e.g. job openings and vacancies are well off their highs in the US and UK. Higher mortgage rates will eventually feed through to consumers. Savings 'shields' will have been severely eroded by inflation – households have certainly been saving less helping bolster resources for spending for a while (Chart 9). Consumer spending growth, in other words, could slow before it recovers – we likely aren't over the worst yet in several major economies.

Inflation key for consumer spending: Forecasts of moderate (rather than severe) recession partly hinge on inflation falling while nominal pay growth remains relatively robust. That still makes sense as a central case in 2023 (see inflation section), but there are clearly significant risks of a worse than expected labour market picture or stickier than expected inflation.

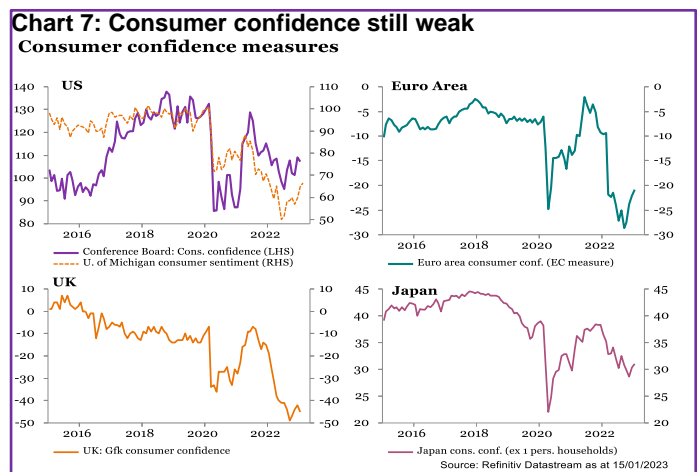
Fixed investment is likely to fall. In the US, euro area, Japan and UK various measures of private non-residential investment (shown in Chart 10 as % GDP) are still below the trajectory they were on before the pandemic. Meanwhile in the US, *residential* investment looks recessionary already (Chart 28) hit by supply and demand problems against a backdrop of problems in input availability post-pandemic and where mortgage rates have risen significantly. Investment indicators have softened (Chart 11). Credit conditions have also been tightening in a number of places. Broadly, across economies, aggregate corporate cash/deposit levels remain elevated, but in real terms these stocks have been substantially eroded by inflation (Chart 12). Business optimism, however, has been improving (Chart 5). Economic policy uncertainty measures still look elevated (Chart 13), even though well below pandemic peaks.



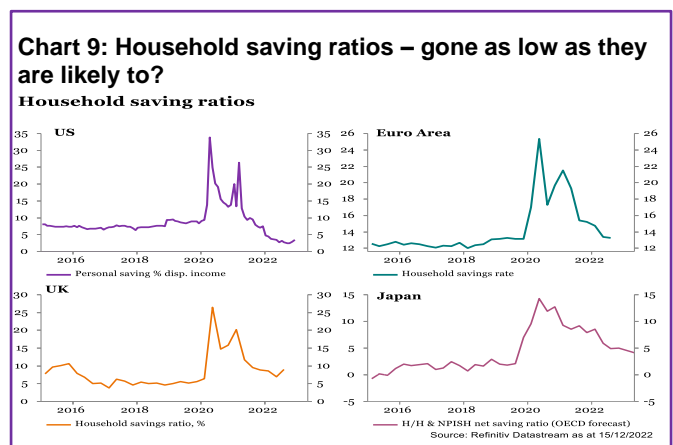
Source: Refinitiv Datastream, S&P Global as at January 2023.



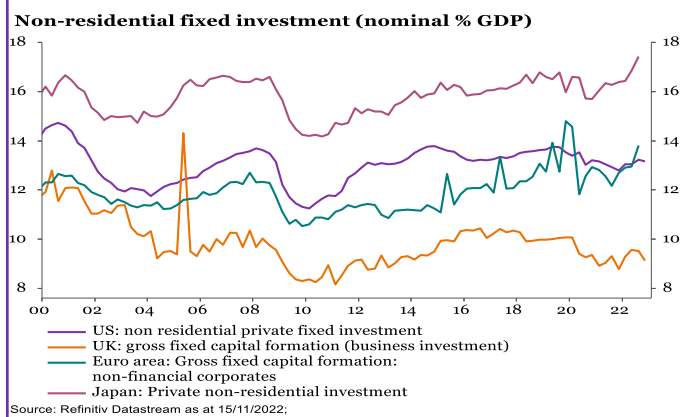
Source: Refinitiv Datastream, National statistics offices.
Data to Q3 2022 (euro area, Japan) and Q4 2022 (US and UK)



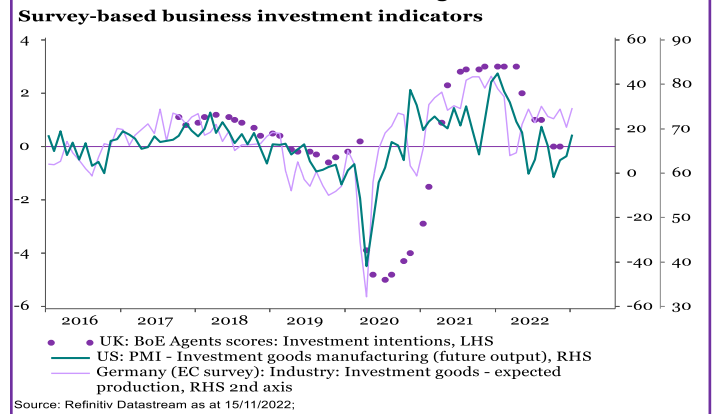
Source: Refinitiv Datastream, Conference Board, University of Michigan, European Commission, GfK, Cabinet Office (Japan).
Data to January 2023



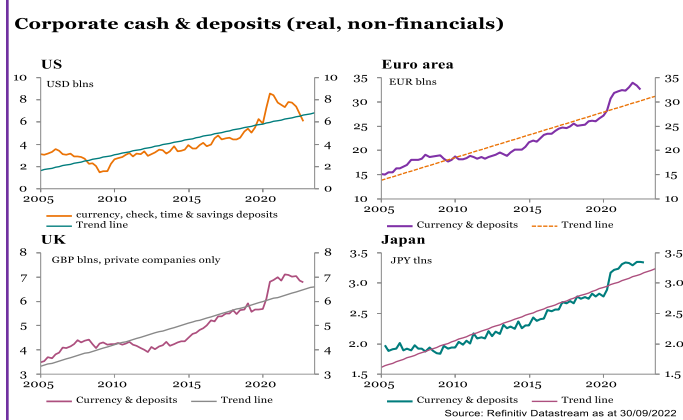
Source: BEA, Eurostat, ONS, OECD. Note: Japan data include OECD forecasts. US data to December 2022, UK and euro area data to Q3 2022 and Q2 2022 respectively.

Chart 10: Non-residential investment remains disappointing

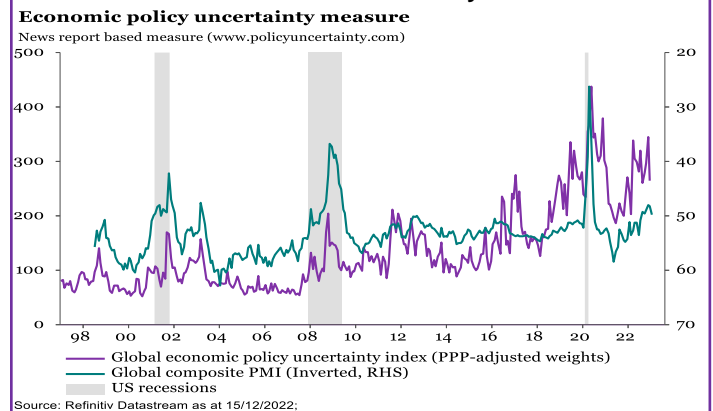
Source: Refinitiv DataStream, BEA, ONS, Eurostat and Japan Cabinet Office. Data as at Q4 2022 except euro area and Japan (Q3 2022).

Chart 11: Investment indicators off highs

Source: Refinitiv DataStream, Bank of England, S&P Global, European Commission. Data as at January 2023 except BoE (November 2022).

Chart 12: Corporate cash/deposits still elevated, but eroded by inflation in real terms

Source: Federal Reserve, BLS, ECB, Eurostat, ONS, BoJ. Data to Q3 2022, except euro area (Q2 2022)

Chart 13: Levels of economic uncertainty elevated

Source: Refinitiv DataStream, policyuncertainty.com. Data to December 2022 (Economic policy uncertainty) and January 2023 (PMI).

Still the potential for an inventory driven kicker to the downturn: One of the ways the global economy may differ post-Covid 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 (see [The 3 R's: Recession, rate hikes and really high prices](#), September 2022). There is some evidence in business surveys already of an unwind in finished goods inventories which may further dent growth.

Growing potential for housing market crashes to worsen downturns: As interest rates rise and labour markets deteriorate, that is likely to lower demand for housing – all else equal – and increase the likelihood of house prices crashes, especially when accompanied by 1) already high levels of household debt and 2) already extended house prices e.g. on a house price to income basis. Looking at comparable household credit to GDP ratios across countries (1), Australia, Canada, Sweden and the UK stand out as vulnerable, though the latter has seen trend improvement since the financial crisis and has moved away from variable mortgage interest rates as the norm (Chart 14). On (2), Canada and the US stand out on OECD data (Chart 15). Some of these economies have already seen substantially lower year-on-year house price inflation.

Rate driven recessions and the role of the labour market

Tighter monetary policy – both further tightening and the lagged effects of past tightening are set to drag on growth in 2023 into 2024. How much will partly be a function of the labour market: 1) tight labour markets, a degree of labour hoarding and likely relatively robust nominal pay growth this year should help any recessions stay modest, but; 2) getting pay growth back to levels consistent with hitting an inflation target may require hard landings via significantly more rate hikes.

- 1) **How the labour market could support growth for now:** The current starting point is very tight labour markets, constrained labour market availability and robust nominal pay growth in major economies. To the degree that remains the case, real demand could be supported and recessions remain very modest. Why might that happen?
 - a. Firms may be reluctant to lay off workers (especially where firms struggled to rehire workers after the pandemic and where, in the US, Japan and UK the pool of workers – the labour force – is no larger than before the pandemic, or smaller in the case of the UK (Chart 16)).
 - b. Lower labour participation could keep the labour market 'tighter' than it would otherwise be. In particular, the labour participation rates of older workers in the US and UK have still not fully recovered to pre-pandemic settings and that may partly reflect harder-to-reverse drivers like early retirement (Chart 17);
 - c. Pay settlements are likely to remain strong this year, even while inflation falls. Price levels have jumped a great deal post pandemic and wages have not kept pace (Chart 6), even as inflation falls back, workers may press to close the gap. Smaller pools of available labour (see a) and b)) should support wage demands too.
- 2) **How that could make a *later* hard landing much more likely:** Central banks need/want to see a significant loosening in the labour market and lower wage growth in order to feel confident that inflation will *sustainably* fall to their inflation targets. The more unemployment stays low and

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wage growth strong, the more we may see central banks push interest rates higher. The higher central banks push rates, the bigger the chance of a more severe recession.

For several economies, wage growth looks uncomfortably high. Crudely, a central bank is likely to feel more comfortable with a particular level of pay growth if unit wage costs (i.e. the wage costs of producing a unit of output) are rising in line with inflation. In other words, ideally, pay growth would be growing in line with target inflation + productivity growth. Wage growth looks above that rate for the US, euro area and UK using a 22-year average productivity growth rate as a proxy for potential productivity growth plus a 2% inflation target (Chart 18).

So, if policymakers need wage growth to fall, how do economies avoid severe recessions? Wage growth is likely to both reflect and cause inflation in economies at the moment; high actual inflation and above average inflation expectations are presumably feeding into wage settlements. So, to the extent that inflation falls – driven by weaker goods, food and energy inflation – that could also lead to lower inflation expectations and more moderate pay settlements. Inflation expectations already look less worrying in general than they did a few months ago. That likely reflects lower fuel prices and monetary policy tightening. We may also see lower wage settlements as the second half of the year progresses.

Supply constraints on the labour market seem likely to ease somewhat. First, the high level of prices and cost of living is likely to push some people into the labour force. To the extent that stocks of savings have helped some people stay out of the labour market, these have been eroded by inflation. Second, we may see labour policies adjust to alleviate the strain in labour markets where these are causing problems in terms of the provision of key services (e.g. immigration policy shifts).

The China factor: How China could be crucial in how things play out

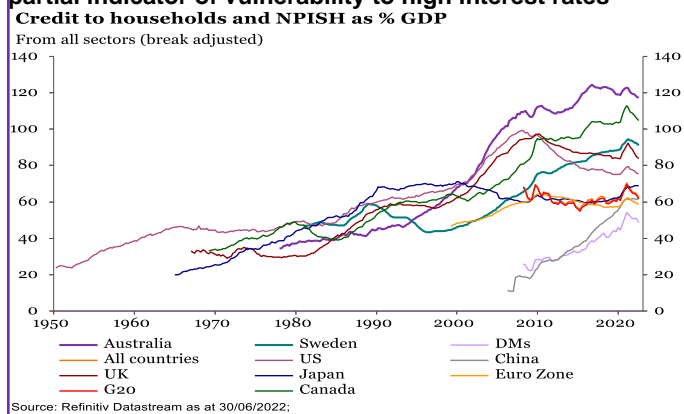
China has the potential to continue growing a relatively out-of-synch way with major developed economies in 2023. Having undergone a rapid loosening of Covid restrictions, a consumer bounce could drive much stronger than expected growth in 2023 just as major developed economies are in a downturn.

Chinese demand could boost commodity prices and therefore keep inflation supported and therefore require stronger central bank hikes elsewhere than pencilled into the central case. This is a risk scenario, rather than part of the central case outlined on page 2. That reflects:

- 1) An assumption that a 2023 bounce in China demand won't be inflationary on a global scale because it will be consumer services centric. A recovery where property or infrastructure investment plays a much stronger role could be more commodity-intensive and therefore more likely to have implications for inflation elsewhere.
- 2) An assumption that demand in several major developed economies will be relatively weak, helping offset the net impact on global demand and commodity prices of a China bounce.

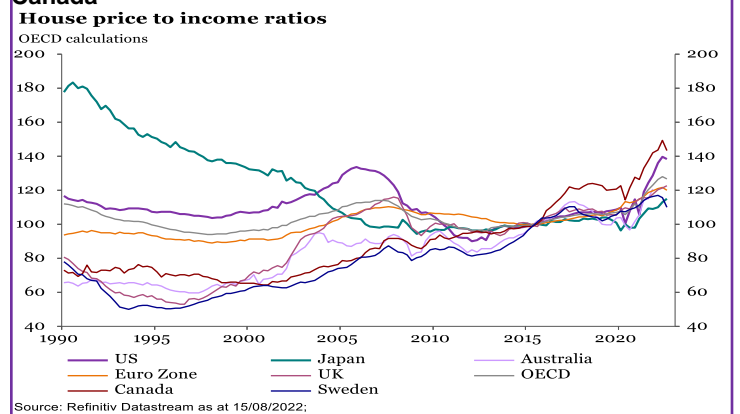
If the timing of recoveries is more synchronous or more commodities-rich, or commodity prices rise strongly in anticipation, China may be another cause of stronger than expected developed economy rate increases and, ultimately, stronger than expected recessions.

Chart 14: Household debt to GDP ratios particularly high – partial indicator of vulnerability to high interest rates



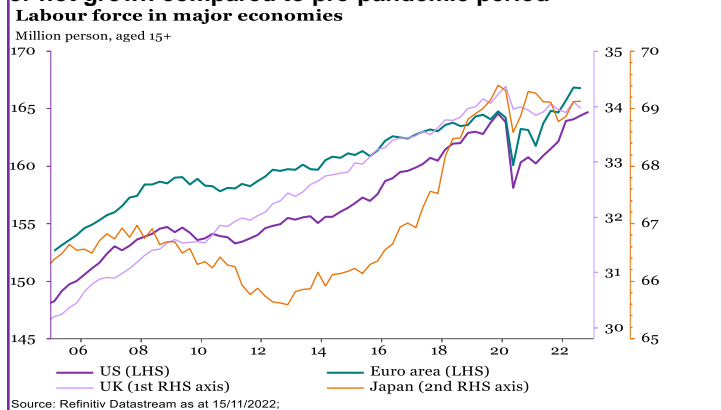
Source: Refinitiv Datastream, BIS. Data as of Q2 2022

Chart 15: House price to income ratios stand out in the US and Canada



Source: Refinitiv Datastream, OECD. Data as of Q3 2022.

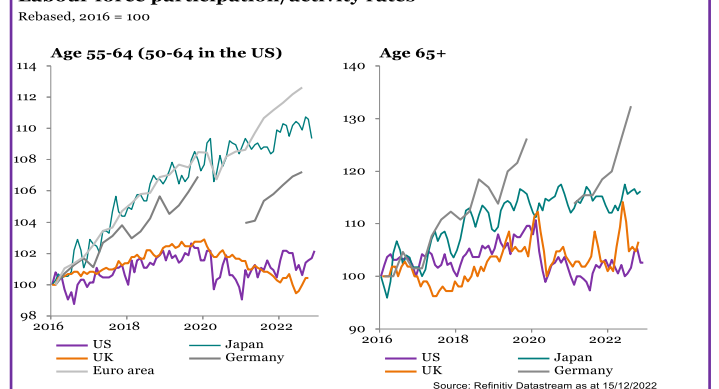
Chart 16: In several major economies, labour force has shrunk or not grown compared to pre-pandemic period



Source: Refinitiv Datastream, OECD.

Data to Q3 2022 except US which is to Q4 2022

Chart 17: Labour participation rates of older workers still not back to where they were post pandemic in US and UK



Source: Refinitiv Datastream, OECD, BLS, Ministry of Internal Affairs and Communications, Japan, ONS, Eurostat. Data as at Q3 2022 (euro area and Germany), November 2022 (Japan), December 2022 (US), September 2022 (UK)

Inflation: Crucial how much it falls

The forecasts on page 2 (Chart 19) assume that headline inflation falls sharply in 2023. If inflation remains surprisingly sticky, especially domestically driven inflation, central banks are likely to hike further than in the central case, risking more severe recessions.

Powerful negative base effects: Powerful negative base effects, especially in the energy component, are likely to pull year-on-year inflation lower. Even if energy price *levels* stay where they are, year-on-year inflation in various energy prices will rapidly decline over 2023 into negative territory, dragging headline CPI lower. Re-enforcing the downward move in some of these components, commodity prices remain off their mid-2022 highs. That should also feed through into some falls in food prices with a lag.

Core goods inflation easing and likely to ease further: Core goods CPI inflation, proxied by the CPI measures shown in Chart 20, correlates with business survey measures of manufacturing input prices which have fallen sharply. Those falls have been helped by lower commodity prices and easing supply chain pressures. Softer domestic demand is likely to help those supply chain problems ease further.

For monetary policy, services inflation is key to watch: A fall in headline inflation will support 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.

To gauge domestically driven inflation pressure, it is important to watch pay growth, labour market slack (and how that feeds through into pay growth), inflation expectations and services inflation (which should have a higher domestically driven component). Falls in services inflation are less conclusive (Chart 21), which is arguably helping give some central banks a reason to keep hiking for now. Recessions should add to downward pressure. The forecasts assume some easing in domestically driven inflation pressure over the next two years of the forecasts, but the bigger driver of falls in inflation in the forecasts from the peak is energy, food and core industrial goods inflation.

There is clearly a significant risk that pay growth is much stickier at high levels than expected. Some would argue that several factors have altered the balance of power between firms and labour (see below). Although US wage growth has cooled in recent months, that trend is more convincing on some measures than others. Private sector pay growth looks particularly strong in the UK.

Several factors are likely to support inflation in the medium-to-longer term. The forecasts on page 2 assume that central banks struggle to get inflation completely to target and to stay there (or below) in coming years. That may mean that central banks will need to keep nominal interest rates at higher-than-expected levels for longer than expected if they remain determined to hit inflation targets:

- **Climate change:** Costs from the transition to a lower carbon economy could include, for example, the cost of renting higher quality buildings that emit less carbon. Extreme weather – especially heat – can also lead to more periods of high inflation.
- **Tight labour markets:** In the pandemic, the labour participation of older age groups fell and has yet to recover in some places. The UK has seen a big increase in those inactive due to long-term sickness. Lower participation leaves the labour market quicker to tighten during upturns and gives the active work force potentially more bargaining power.
- **Fiscal and monetary policy expectations:** After the interventions of the pandemic, the bar has been reset for public expectations of what their governments can do. That might support higher inflation expectations if we are more confident the government will step in during crises.
- **Population ageing:** Age-related demands for public spending include pensions, health and social care. Higher dependency ratios raise the tax burden on the working, meaning pressure for higher pay growth. As the supply of labour shifts down, their bargaining power may increase.
- **Some firms may have permanently moved away from a just-in-time approach,** at least partly, and decide in the medium-to long-term to run with (costly) higher inventories of inputs and to source more domestically in response to recent supply chain disruption. That could leave inventory accumulations and decumulations bigger drivers of cycles again and with stronger feedback to the domestic economy. More frequent boom-bust cycles could mean more frequent periods of high inflation.

Chart 18: Wage growth too strong vs inflation targets

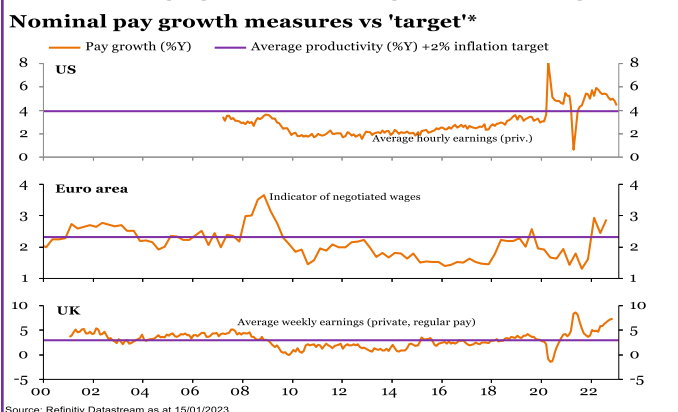


Chart 19: Inflation forecast (update)

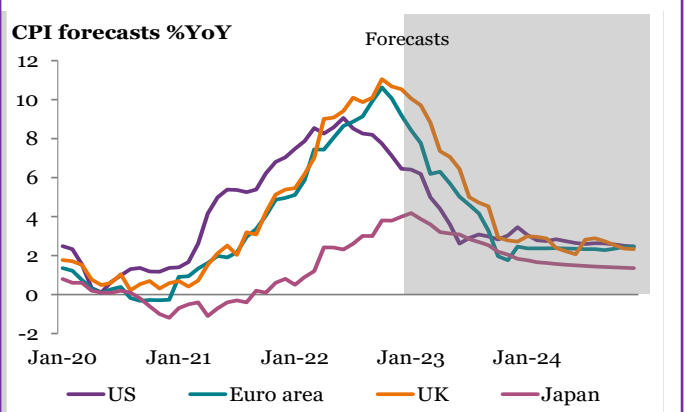
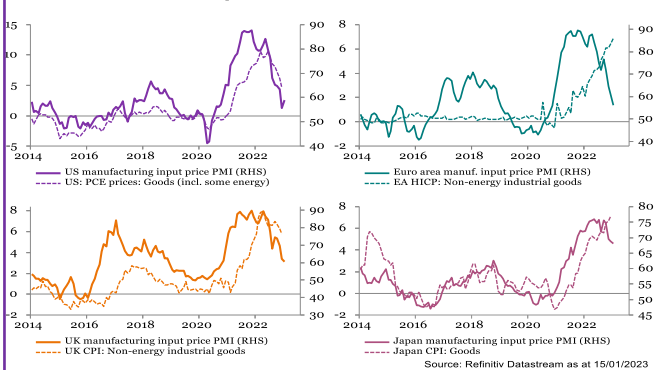


Chart 20: Falling input price inflation

Goods CPI and input prices

CPIs are YoY%; PMIs are balance of opinion indicators

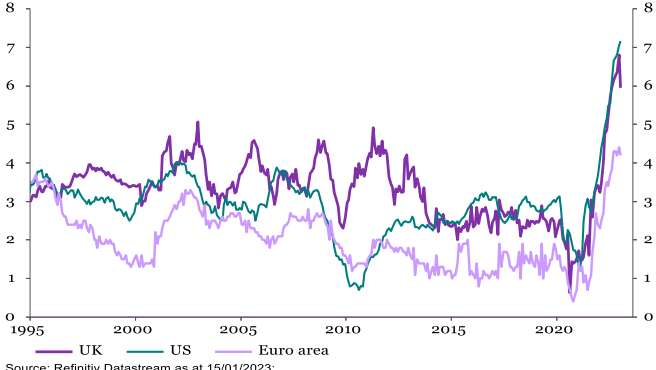


Source: Refinitiv Datastream, S&P Global, BEA, Eurostat, ONS, Ministry of Internal Affairs and Communications, Japan.
Data to December 2022/January 2023.

Chart 21: Services inflation – fewer signs of topping out

CPI: Services (%YoY)

Excluding energy services where classified as services



Source: Refinitiv Datastream, ONS, BLS, Eurostat.
Data is to January 2023 (except UK and US which is to December 2022)

Central bank policy outlook: How close to a pivot?

Pinning down how high interest rates will rise this cycle (terminal rates) is difficult but feels less like a moving target in an environment where headline inflation has now started surprising on the downside. Lower headline inflation should at least alleviate some central bank concern around de-anchoring inflation expectations. Still worried by domestically driven inflation pressure though, central banks may need pay growth lower and, to be confident that slower pay growth is sustainable, they may also want to see significantly higher unemployment rates. In some economies, labour markets are looking a bit less tight around the edges, including the UK and the US, meaning peak rates should be months rather than quarters away.

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 2.5% in the US and UK and 2.25% 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, these central bank rates have moved rates firmly into restrictive territory.

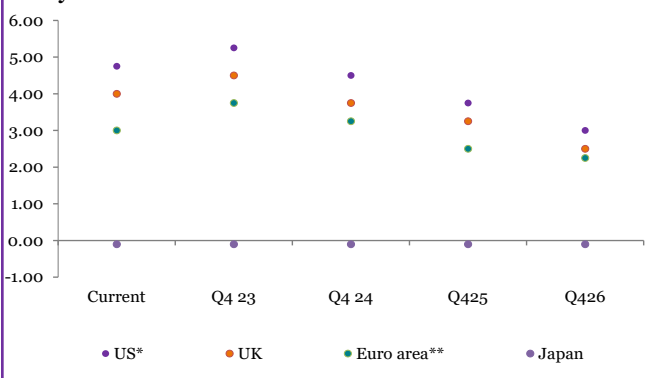
Central banks slow the pace of hikes...with different messages: The Fed, ECB and BoE have continued to raise rates in 2023, albeit stepping down the pace of rates hikes. All three have signalled that care should be taken not to read too much for monetary policy into recent falls in headline inflation. However, the ECB has been much more hawkish than I'd have expected, and is still signalling at least one more 50bp rate hike. Meanwhile, Fed Chair Powell signalled in late 2022 that they would be 'feeling their way' from there and duly dropped to hiking 25bp in February. The 'dot plots' published alongside the December decision signalled that they might not have *that much* further to go, but strong labour market data since have led to some hints that they may have to raise rates further than this. The BoE (not unusually) gave very little to go on in terms of next policy steps in their February meeting.

Part of the difference in tone reflects: that while all three central banks now have rates set around or above the likely neutral rate, all three central banks need to get rates clearly into restrictive territory; estimates for neutral rates for the three economies aren't *that* far apart and the ECB have simply hiked by less so far. From a very low starting point, ECB rates are now 300bp above levels seen during the pandemic. The BoE have now hiked rates 390bp compared to levels reached during the pandemic and Fed funds are 450bp above the lows reached during the pandemic.

How far each central bank needs to hike rates is a different question to how far they *will* hike rates, but all three likely want to feel confident that inflation is *sustainably* going to hit their target and a few months of falling inflation simply isn't enough to pause. That naturally brings back into focus wages, and slack in the labour market as a driver of wages. However, while central banks can do a lot to influence the demand for labour, there's much less they can do about the supply. Considerable uncertainties remain about the outlook there.

Chart 22: Expecting a few more rate rises...

Policy rate forecasts



Source: National central banks/Bloomberg (past actuals).
All forecasts (Q4 2023 onwards) are RLAM estimates.

After the last round of central bank meetings, analysis and commentary, risks to my central bank forecasts have shifted a bit. For the ECB, while I am forecasting a sizeable fall in euro area inflation in 2023, but it doesn't sound like inflation will fall fast enough to stop them hiking at least a couple more times given their hawkishness. Hence a **higher ECB terminal (refi) rate of 3.75% looks a more reasonable central case** and the balance of risk looks to the upside of that forecast. For the Fed's upper end of the target band, a **peak rates forecast of 5.25%** looks in line with the dot plots. I assume they aren't going to be convinced they've done enough for a several more months yet, but with headline inflation falling so far they will be willing to pause rate hikes without seeing significant increases in unemployment. However, although some of the recent activity data has been downbeat, the Fed have been explicit that the US economy *needs* a slowing in demand to get the labour market into better balance. For the BoE, their last set of forecasts from February remain consistent with downside risk to my **forecast peak for UK interest rates at 4.5%**. However, I'm inclined to keep pencilling it in as the peak while domestically driven inflation pressures still look relatively strong.

United States: Still assuming a recession

There are plenty of recession warning signals in the data – but the same was true several months ago and leaves the question of timing and scale unanswered. On scale, housing data – where some of the clearest signals are being sent – look consistent with the early 1990s recession rather than the GFC. The US is still not done with rate hikes and has hiked a substantial amount. Though inflation has fallen a bit, household consumer confidence remains weak. With credit conditions now quite a bit tighter too, the forecasts still assume the combined hit from cost-of-living strains and Fed tightening tip the US into a broader (but not deep) recession in 2023. There are significant risks on both sides of the forecast though, including a reasonable probability that the US avoids recession at all.

A mixed picture so far

Q3 and Q4 real GDP rose similar amounts at close to 3.0% QoQ annualised after falling in H1 (Chart 23). A selection of key data is looking more 'recessionary' though, even if extreme weather at the end of 2022 makes some of it hard to interpret. Some of the November and December 'hard' data such as retail sales has been soft and housing data look clearly recessionary. As for business surveys, the composite PMI still signals a contraction in real activity though ISM services paints a more upbeat picture (Chart 23). Small business and consumer sentiment remain weak, but consumer confidence has improved somewhat since the middle of 2022. Business optimism is off its highs; but isn't at overly weak levels (Chart 24). However, credit conditions have tightened further, to a degree seen before previous recessions (Chart 25) and the Fed continue to raise rates.

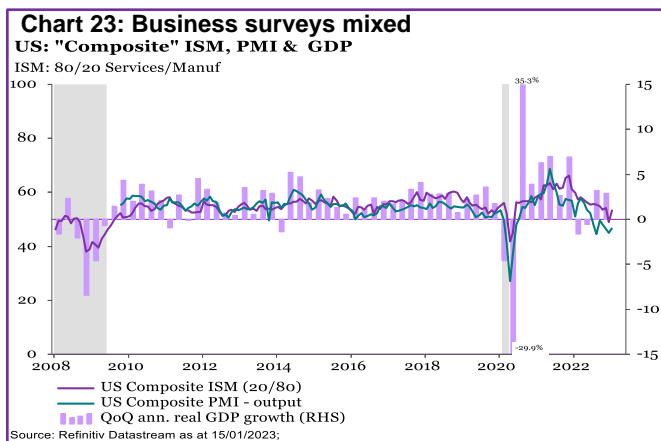
Consumer: Surprisingly resilient

Consumer-related news is mixed. For now, employment gains have been robust, but mortgage rates have risen (though with long mortgage terms, that will not feed through abruptly into higher debt interest costs). Consumer confidence is still weak and the household savings rate is already at low levels. However, real income growth is now positive again month-on-month as inflation has fallen back and real personal spending growth has been surprisingly resilient for several months (Chart 26). Over the rest of 2022 and into 2023, the expected fall in inflation is also likely to lead to some further improvement in consumer confidence and real pay growth limiting the likely scale of any consumer downturn.

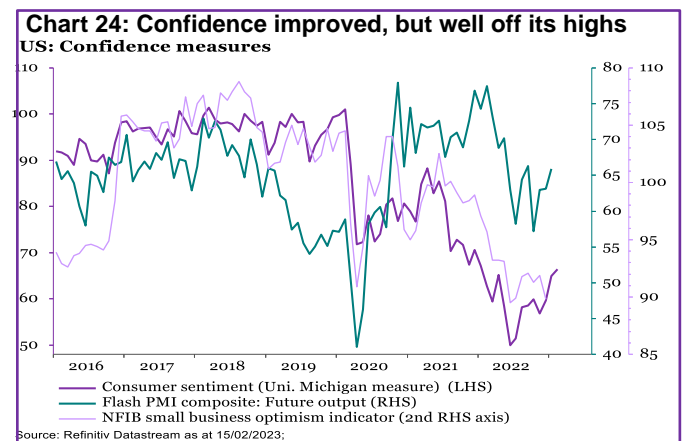
However, without a sharper downturn in consumer spending, it will be harder to see the kind of deterioration in employment demand and increase in labour market slack that would guarantee sustainably lower pay growth and keep the Fed from hiking further.

Monetary policy: More and more tightening – still a chance to avoid recession?

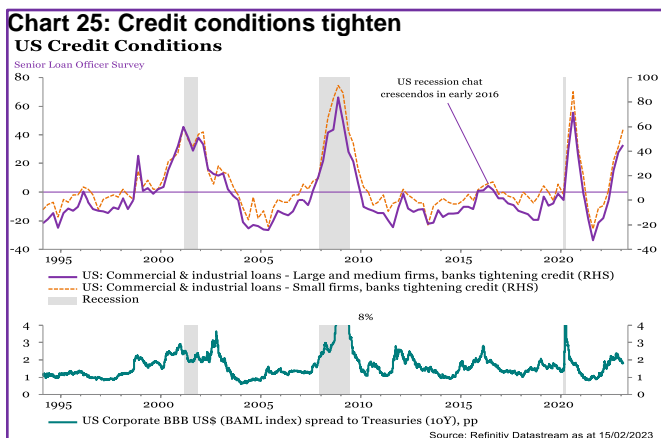
The forecasts on page 2 assume further rate increases in line with current policymaker signalling. The forecasts assume that the Fed continues to raise rates further into restrictive territory in H1 2023 at a 25bp pace, with peak rates likely reached by Q2 2023. After such a rapid pace of rate increases, given that interest rates affect the economy with a lag, not all the impact will have been felt yet. US economists seem divided on how much of an impact to expect and how much has already fed through.



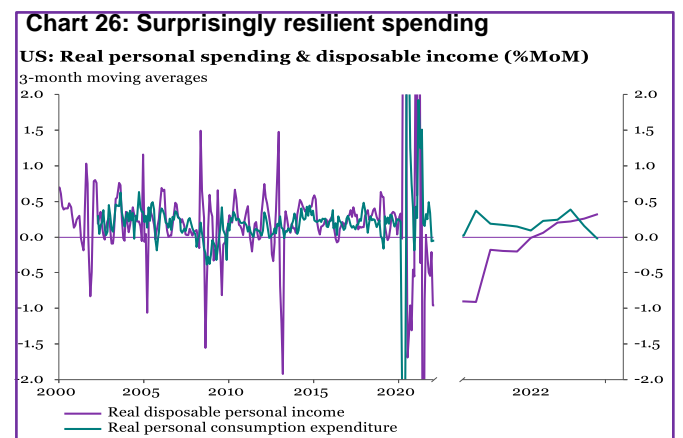
Source: Refinitiv Datastream, BEA, S&P Global. Data to Q4 2022 (GDP), January 2023 (PMI, ISMs)



Source: Refinitiv Datastream, University of Michigan, S&P Global, NFIB. Data as at January 2023



Source: Refinitiv Datastream, Federal Reserve, BAML. Senior Loan Officer survey. Data is for Q1 2023; Corporate bond spread figures are to 7th February 2023



Source: Refinitiv DataStream, BEA. Data to December 2022

Economists also disagree on whether the US will even experience a recession at all (or, at least, one as defined by the NBER requiring a broad-based downturn and likely a significant increase in the unemployment rate) and, relatedly, how much slowing will be *required* to bring the labour market into better balance – enough to bring wage and price growth back to a rate more consistent with sustainably hitting the inflation target (see Chart 18).

The case for a deep(er) recession? The Federal Reserve simply don't have a stellar record at achieving soft landings. Recession 'warning signs' in the data are already numerous, from the convincing inversion of the US yield curve (Chart 27), to credit conditions (Chart 25), to the recessionary 'look' of data in the most interest rate sensitive parts of the economy (Chart 28). Pre-pandemic, current levels of unemployment would have been associated with much weaker pay growth (Chart 29). If the relationship between unemployment and pay growth has sustainably changed, a deeper recession may be *necessary* to achieve the Fed's inflation targeting goals.

The (central) case for something shallower: Most of the recessionary indicators mentioned above could also be consistent with a moderate rather than severe recession. As has been mentioned, real pay growth is already positive month-on-month. A big increase in unemployment may not be 'necessary', either. There are already some signs that the labour market is coming back into a better, less inflationary, balance. Pay growth has started to cool year-on-year, though remains at high levels. Falling headline inflation – and the trend there is much more convincing than in Europe – should help restrain pay demand. Labour supply could increase if cost of living increases persuade more people to return to the labour force; the participation rates of 50-64 year olds have been making substantial progress back to pre-pandemic levels in the US (Chart 17). Labour demand, meanwhile, already seems to have cooled a bit with job openings falling.

There will be a better chance of more balance in the labour market if demand for more labour-intensive services cools. In the food services and accommodation sector at least, real consumer spending looks unsustainably high compared to both trend and employment levels (Chart 30).

Inflation: Less headline inflation, but details matter

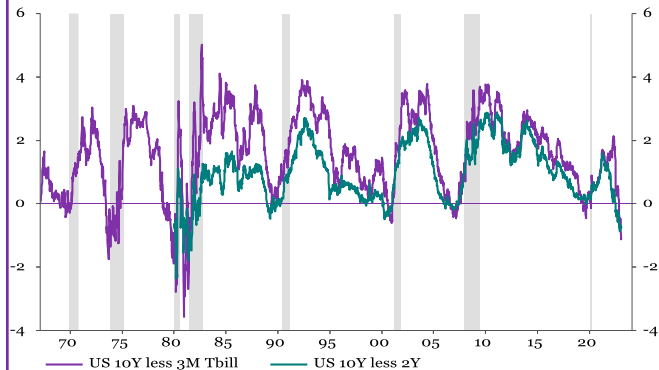
US inflation is falling: Headline CPI at 6.4%Y in January is well off the highs, but still elevated. However, the month-on-month pace of price increase for headline and core CPI has slowed somewhat. Services inflation remains strong, but inflation in the key shelter component should cool given that the housing market has slowed.

Base effects, lower commodity prices and easing supply chain problems mean US inflation is likely to fall significantly this year, but wage growth is still high without an offsetting leap in labour productivity (Chart 18). The Fed are understandably not concluding that their job is done yet, paying more attention to more domestically driven sub-indicators like inflation in core-services ex-housing.

Plenty of risk to the central case

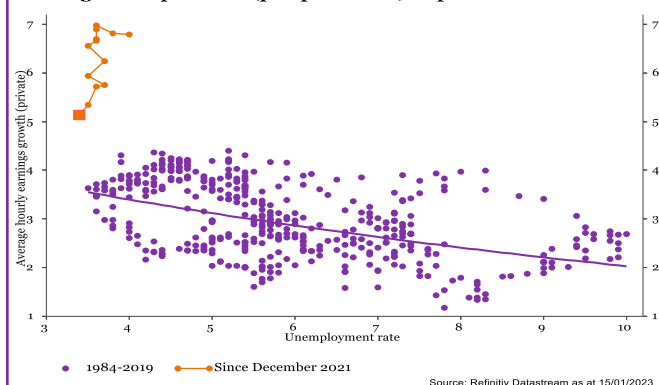
In the central case, inflation falls substantially, helping restrain pay demands and the labour market comes into better balance without a large increase in layoffs. The economy avoids a deep recession but experiences a mild one. However, global inflation pressures could prove stronger than expected, pay growth may run hot for substantially longer – the Fed needing to hike more strongly than expected. As for fiscal policy, we could see a debt ceiling stand-off later in 2023 with Congress now split and an election seeing some on the Republican side try to maximise their leverage.

Chart 27: Yield curve inversion – classic recession signal
US Yield Curve & US Recessions



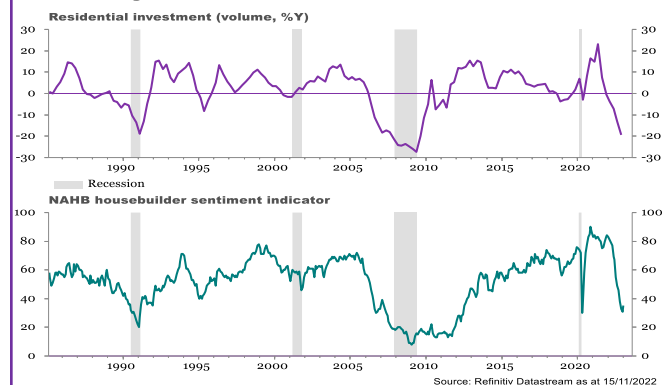
Source: Refinitiv Datastream, as at 03/02/2023

Chart 29: High unemployment needed to get pay down?
US Wage Phillips Curve (pre-pandemic) vs post-June 2021



Source: Refinitiv Datastream, BLS as at January 2023;
Latest data point shown as orange square

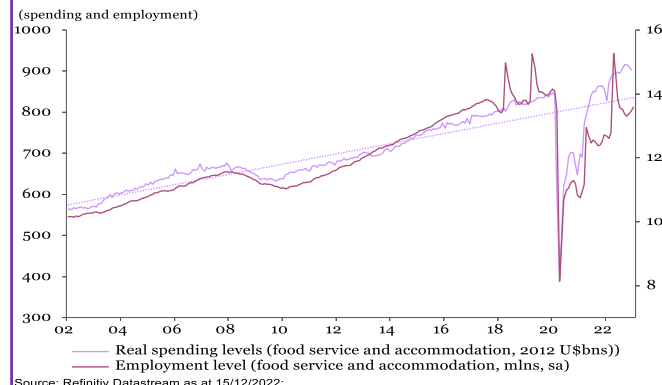
Chart 28: Rate sensitive bits of the economy are hurting
US: Housing and recessions



Source: Refinitiv DataStream, BEA, NAHB.

Residential investment to Q4 2022 and NAHB indicator to January 2023

Chart 30: Labour-intensive sectors need a better balance
US: Food service and accommodation



Source: Refinitiv Datastream as at 15/12/2022;

Source: Refinitiv DataStream, BEA, BLS. Data to November 2022

China: Further Covid downs and ups

The end of China's zero tolerance approach, assuming that Covid in China follows a similar playbook to most developed economies, means a robust economic recovery should follow. However, without the same exceptionally loose policy backdrop that accompanied other Covid relaxations, the recovery may disappoint growing expectations of a strong bounce. It is unlikely too that the recovery will prove quite as inflationary as seen in the US or Europe.

Economy slowed in 4Q again, how strong a bounce?

Q4 2022 GDP was flat (0.0%Q), after a period of combatting numerous Covid outbreaks with localised lockdowns and other measures. The abandonment of Covid restrictions over the turn of the year was relatively sudden. It is unclear how large the wave of Covid infections subsequently experienced was (is) as testing requirements have been dropped. However, high frequency data suggests the impact on activity was substantial, but has seen some recovery already. Pre-Lunar New Year, data such as traffic congestion and subway passenger volume was well off the recent lows, though not strong. Recent business surveys (both NBS and Caixin PMIs), as of January 2023, were consistent with rising output.

Experience elsewhere suggests that GDP growth could experience a significant bounce in 2023 as the Covid wave ebbs and people more fully normalise economic activity (e.g. socialising) in an environment of fewer government restrictions. In the forecasts on page 2, GDP growth has been revised up for 2023 as the end of the zero-tolerance approach to Covid hadn't previously been assumed.

China also faces a different policy backdrop going into next year. The policy backdrop may not be as loose as it was in Europe and the US when Covid restrictions were eased, but in contrast to the pattern in many economies *now*, Chinese authorities have been adding stimulus not taking it away.

What kind of recovery?

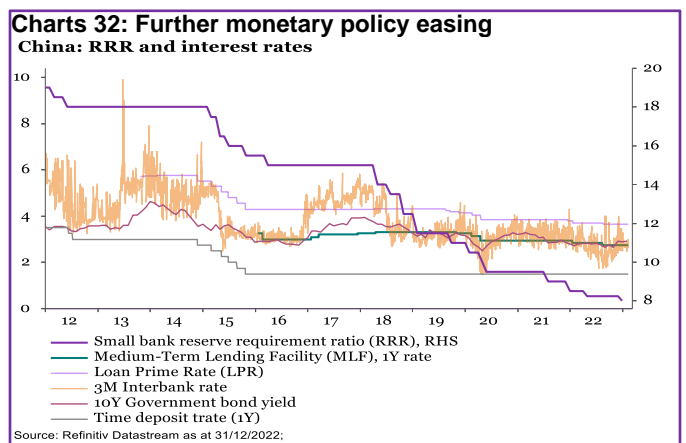
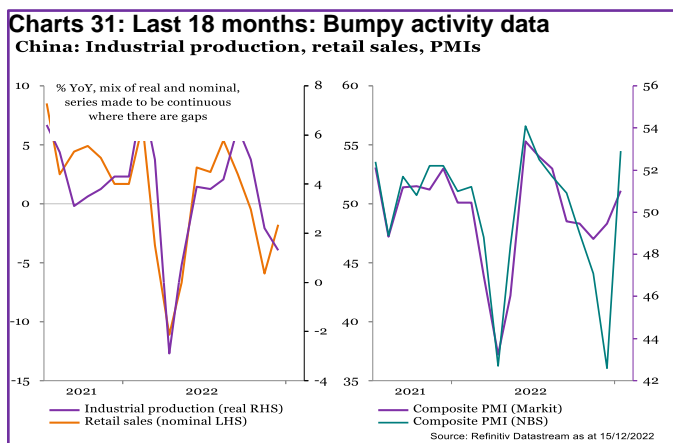
There are a number of things that matter for the character of China's recovery – and the impact it has on the global economy. One will be the reluctance (or otherwise) of Chinese consumers to normalise spending behaviour post-Covid. China's households have built substantial savings in aggregate over the Covid period when spending was suppressed. These savings could fuel strong spending, but economists disagree at how likely Chinese consumers are to run down those savings. Another factor will be how inflationary that recovery is. A combination of factors may work against a strong normalisation of consumer behaviour: Problems in the housing sector where prices have fallen, may have dented both household wealth and confidence; Risk averse behaviour may prove sticky as Covid continues to circulate, with Chinese consumers having lived until recently with a very strong Covid restrictions.

How inflationary will the recovery be? With many developed economies experiencing slower growth, in the central case, the same *global* imbalance of supply and demand doesn't re-emerge in the wake of China's recovery. A lack of very loose monetary policy domestically should help too. If China's recovery does at least resemble that of other major economies, the big area of growth recovery should be higher consumer-services spending which is less resource intensive than spending on goods (or fixed investment) and therefore less likely to strongly push up a wide range of commodity prices. However, China's recovery after such a weak year will provide *some* support for global commodity prices and slow the fall in inflation elsewhere.

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 these factors keep the GDP growth forecasts beyond the near-term relatively muted by the standards of recent Chinese history. China's actions towards Taiwan also present a threat to China's growth outlook. Politics were expected to take a more nationalistic turn following Xi's term extension and selection of new policymakers. A substantial escalation of aggression against Taiwan could result in substantial sanctions against China with serious repercussions for both the domestic and global economy.

Policy: Stimulus signals

China's policymakers continue to signal accommodative policy. The last Central Economic Work Conference flagged "stability" as the main 2023 objective, with a focus on reasonable growth. On Covid, Xi said that it is important to facilitate a smooth transition from pandemic to endemic and policy objectives include boosting domestic demand and support for both private and state-owned enterprises. Meanwhile, from the PBoC, the reserve requirement ratio has been cut further.



Euro area: Energy concerns ease, ECB concerns worsen

The euro area continues to experience very high inflation rates. Wage growth continues to trail behind. Energy has eased as a near-term worry for the economy with European economies securing substantial energy reserves and relatively mild winter weather. However, that doesn't mean that energy challenges couldn't recur. Meanwhile, the ECB has been much more hawkish than previously assumed and monetary policy looks set to become a substantial risk to the outlook for activity growth.

Economy surprisingly resilient in 2H 2022, but growth challenges are substantial

GDP growth was more robust than expected over much of 2022 and despite facing myriad challenges, business surveys suggest that things weren't that bad over the turn of the year either with PMIs in January pointing to relatively flat output (Chart 33). The same goes for the Commission's economic sentiment indicator built up from national industrial and consumer indicators. Moreover, both sets of surveys improved around the turn of the year, likely reflecting reduced worries about near-term energy supply as well as further improvements in supply chain issues.

Energy supply concerns ease, but likely to recur?

The euro area economy remains vulnerable to natural gas supply disruption. For now, following a mild winter, policy efforts to contain demand and rebuild gas reserves, alongside diverted LNG shipments from China (as the economy there slowed), there are fewer question marks around both European energy prices and supply. However, it seems reasonable to still think of this as a multi-year problem and weather could easily prove less favourable next winter. The Ukraine crisis and tense relations with Russia remain an ongoing challenge. 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.

Even if Europe gets through next winter again with demand management, still good levels of reserves, and potentially with weather again playing a role, considerable uncertainty could still be generated for business and households at times, weighing on growth. If overall power supply needs to be rationed at some point in winters to come, then the impact on output will be more profound. Although accelerating the development of alternative sources of energy and improving European interconnectors should be part of the answer to Europe's energy problems, changes are mostly difficult to implement with speed.

Inflation – off its peak, but domestic story key

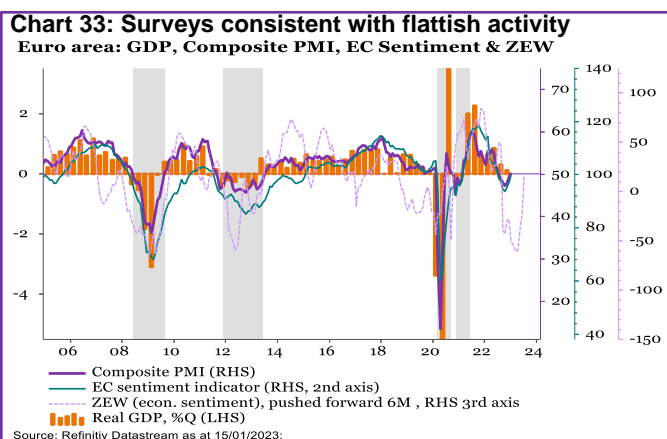
Euro area inflation remains at very high levels (Chart 34), but has fallen from its peak, helped by lower energy inflation and soon likely to be helped more by core goods prices given further improvements in supply chain problems – the improvements particularly apparent in recent business surveys (Chart 35). The bulk of euro area inflation still looks to be generated by external rather than domestic forces. However, services inflation is now at very high levels relative to its history and should have more of a domestic element. Pay growth has also been rising in general – though pay growth isn't as obviously strong as it is in the US and UK. The forecasts on page 2 assume that inflation falls in 2023 driven by base effects and supply chain improvements. With so much ECB monetary policy tightening now seemingly in the pipeline, however, the forecasts assume a bit less inflation than before from domestic sources in the later part of the forecast. As elsewhere, there are significant risks on both sides of the euro area inflation forecast (see Global section).

Consumer spending growth to slow, but not too far

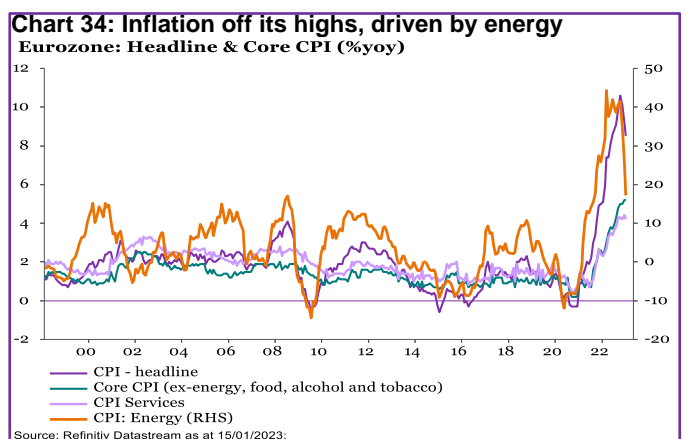
The outlook for consumer spending growth remains weak given strong inflation; real pay growth remains negative for now (Chart 6). Higher nominal pay growth and still very low unemployment rates (by euro area standards) are supportive, but cost-of-living pressures are strong even if ameliorated (to a greater and lesser degree country-by-country) by government action. Consumer confidence is still weak (Chart 36) and looks consistent with negative consumer spending growth as does labour income growth (proxied by real pay growth plus employment growth). The ECB is also raising interest rates quickly now, which may impact the consumer through several channels including savings behaviour and job growth.

Business optimism off the lows but investment outlook subdued

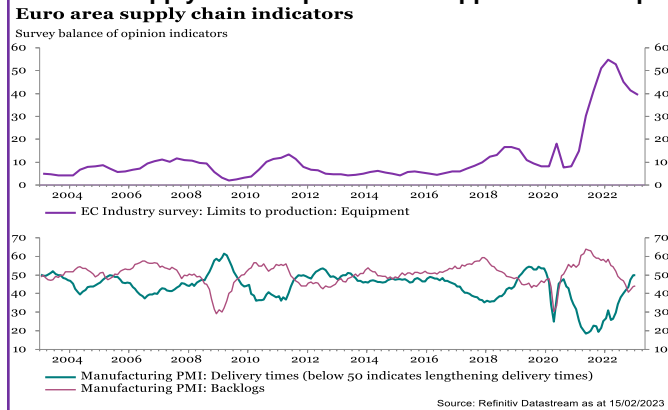
Business optimism has improved somewhat and business survey capex indicators are mixed rather than uniformly weak (Chart 37). However, business loan growth has become less positive, potentially reflecting higher borrowing costs as the ECB has hiked rates relatively quickly. Lending standards have tightened substantially (Chart 38). Some longer-run incentives to invest should remain, including reshoring, the green transition and lowering reliance on labour. However, these are likely to be overshadowed in coming quarters by factors including weaker growth in some major trading partners and ECB rate hikes. Major trading partners including the UK are facing weak growth outlooks and China's prospective recovery may provide limited support for European manufacturers if demand increases are consumer-services centric.



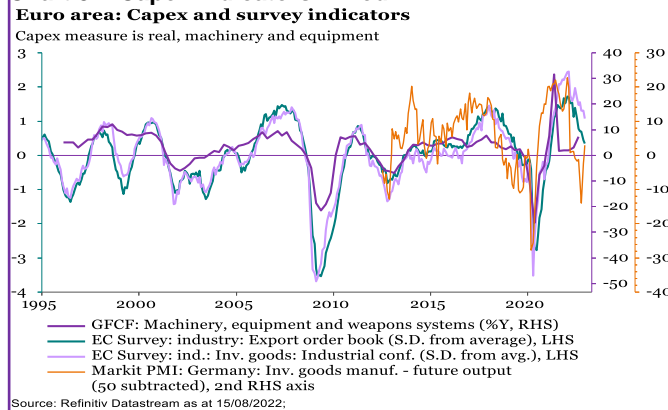
Source: Refinitiv Datastream, S&P Global, ZEW, European Commission, Eurostat. Data is to January 2023 (except GDP which is to Q4 2022).



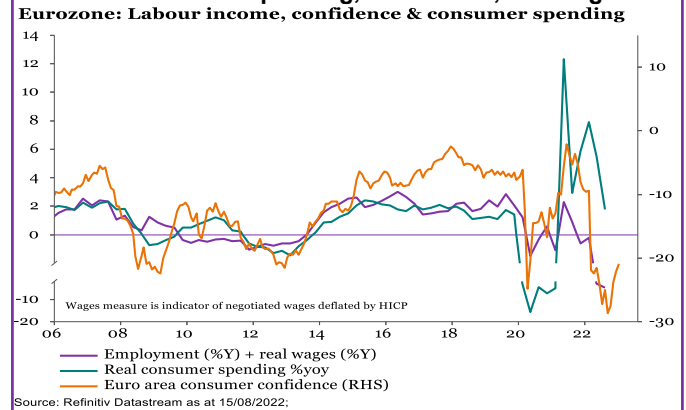
Source: Refinitiv Datastream, Eurostat. Data to January 2023

Chart 35: Supply chain improvements apparent in Europe

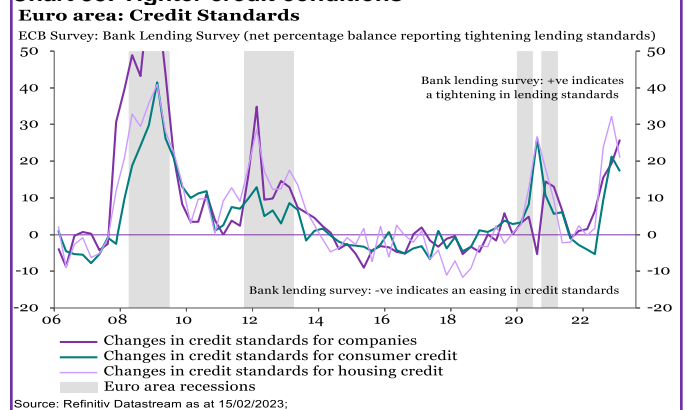
Source: Refinitiv Datastream, European Commission, S&P Global; data to January 2023

Chart 37: Capex indicators mixed

Source: Refinitiv Datastream, Eurostat, European Commission, S&P Global. Data to December 2022 except GFCF which is to Q3 2022 and PMI which is to January 2023.

Chart 36: Consumer spending, confidence, real wages...

Source: Source: Refinitiv Datastream, Eurostat, European Commission. Consumer spending and labour market data is to Q3 2022; consumer confidence is to January 2023.

Chart 38: Tighter credit conditions

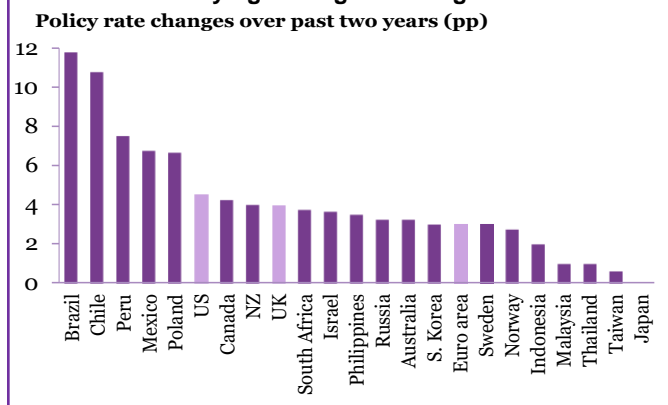
Source: Refinitiv Datastream, ECB (data to Q1 2023).

Economic policy: Monetary policy tightening a growing challenge to the recovery

Extra 'cost of living' fiscal support: European governments continued to provide or announce 'cost of living' support for households and firms during 2022. The recently agreed gas price cap may help somewhat, but analysts disagree on how effective it will be given the significant loopholes permitted by the agreement. Considering higher ECB rates and higher bond yields and large projections already for government debt issuance in the coming year, substantial further fiscal action may be more difficult.

ECB: More tightening: Recent ECB statements and press conferences have been more hawkish than I'd have expected with the ECB still signalling more rate hikes to come, including firm intent to hike another 50bp in March. Part of that hawkishness likely reflects where the ECB see themselves in the rate cycle compared to others. From a very low starting point, ECB rates are 300bp above levels seen during the pandemic compared to 450bp above in the case of the US.

Most of the fall in inflation seen recently has reflected energy price inflation, but the ECB are sounding more concerned about food price inflation and underlying price pressures. The latest set of staff inflation forecasts in December were surprisingly strong. Against a backdrop where falling headline inflation is likely to calm both pay demands and help keep inflation expectations contained, my forecasts for inflation fall significantly over the projection. I am also assuming significantly more ECB rate hikes than previously, in line with recent central bank signalling.

Chart 39: Monetary tightening – ECB lags behind

The forecasts assume an ECB terminal (refi) rate of 3.75%, but ECB rhetoric remains hawkish and although headline inflation is falling now, measures like services CPI (which should better reflect domestic inflationary pressure) are not.

Will the ECB end up overdoing it? There is a significant risk now that the ECB end up hiking too much and that the impact on the real economy and then inflation prove relatively strong. That risk could work through peripheral bond yields. Countries with especially high debt levels, look relatively more vulnerable in a higher yield environment. In the event that there is even a relatively modest recession, pressure to ease fiscal policy could put further pressure on peripheral yields. Although the ECB now have more tools to tackle a widening in peripheral spreads that has the potential to damage the monetary transmission mechanism, these tools are largely unproven.

Japan: How far from hikes?

Although still below levels seen in Europe and the US, Japan's inflation rates have continued to rise. The BoJ continues to reiterate its easing message, but the recent widening of the yield curve control band is likely a prelude to dropping yield curve control in 2023. The central forecast doesn't assume rate hikes, with inflationary pressures still appearing weaker than elsewhere and the global economy in a rough patch. The outlook for the domestic real economy in the near and longer term still looks challenging too. However, risks are rising that Japan finally raises the policy rate into positive territory.

Inflation rising – how domestic a story?

Inflation has continued to rise in Japan (Chart 40), but the underlying data send somewhat mixed messages on underlying domestic inflationary pressure. CPI inflation in December was its highest since 1981, not dissimilar in that sense to recent inflation in the UK though still a world away in terms of the actual inflation rate (4.0%Y compared to 10.5%Y in the UK in December 2022). Stronger year-on-year inflation has been driven by food, communication, furniture/household equipment and housing, although overall energy inflation peaked in March 2022. The weaker yen seen over 2022 has probably played some role in supporting inflation (itself partly reflecting widening interest rate differentials between Japan and many of its major trading partners). BoJ analysis suggests a large proportion of prices are rising (Chart 40). However, CPI ex energy and food inflation is substantially weaker than headline inflation at only 1.6%Y. Meanwhile, even without tightening monetary policy, some measures of inflation expectations are showing signs of topping out (Chart 41). The Spring wage rounds, though, will be important in assessing underlying domestically driven inflation pressure.

Outlook not as downbeat as Europe and the US

The picture coming from business surveys and hard data remains somewhat mixed in Japan, but business surveys look soft. However, by the standards of pre-pandemic Japan, these surveys and hard data aren't particularly weak either, partly reflecting low trend growth in Japan.

Japan faces some of the same challenges to growth as elsewhere. Real pay growth is negative, global growth has slowed and the recently weak Chinese economy is potentially weighing too. However, without substantial tightening of monetary policy and with prospects for China in 2023 lifted after abandonment of the zero Covid approach, the risk of Japan slipping into a recession looks less than it did. The forecasts assume that Japan doesn't experience recession, but the chance of at least one negative GDP growth quarter in 2023 looks high.

Energy-related challenges look significant, partly reflecting Japan's reliance on imports for its fossil fuels and policies towards nuclear power following the Fukushima nuclear disaster. There have been worries around electricity shortages, though Japan has recently u-turned on policies relating to nuclear power. Despite any challenges, CPI energy inflation was (only) 15.2%Y in December 2022 compared to 52.8%Y, for example, in the UK.

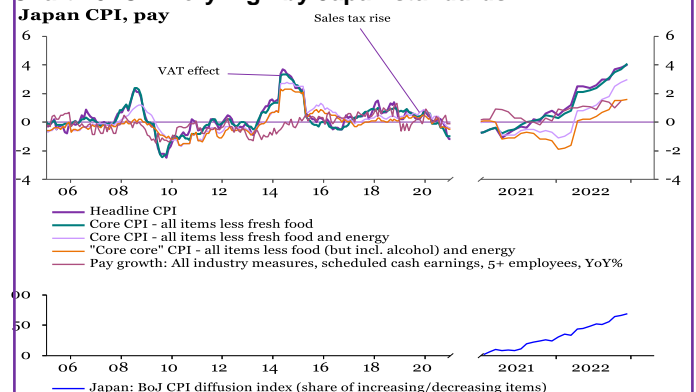
Longer-term prospects for Japan remain hampered by demographic challenges. The 'working age' population aged 15-64 continues to decline and average productivity growth has not been particularly strong in recent years (see [More rate hikes, less growth](#)).

New governor, new BoJ?

The Bank of Japan (BoJ) has continued to reiterate its accommodative policy message, but in a surprise move in December widened the target range for the 10-year bond yield as part of its yield curve control policy. While framing this as being about market functioning it has been seen by many as a precursor to abandoning yield curve control later in 2023 after current BoJ Governor Kuroda steps down. Inflation may not look firmly on a path for sustained 2% rates, but the BoJ has raised its medium-term inflation forecast close to the 2% rate.

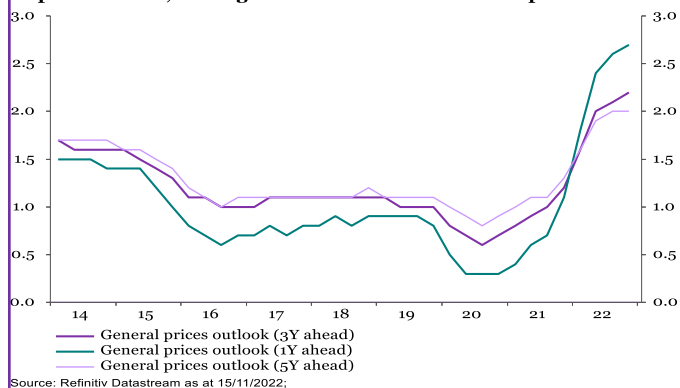
The end of yield curve controls looks likely in 2023, but a move out of negative territory for interest rates also looks a significant probability in the next year or two. Without more evidence that Japan can generate sustainable inflation pressure consistent with the BoJ hitting their 2% inflation target, it remains hard to pencil in rate hikes as a central forecast. But the path of inflation in coming months and the Spring wage rounds will be key to watch.

Chart 40: CPI very high by Japan standards



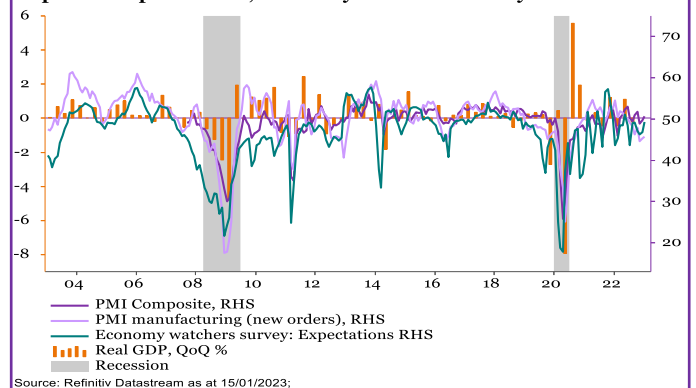
Source: Refinitiv Datastream, Ministry of Internal Affairs & Communication, Ministry of Health, Labour and Welfare, Bank of Japan as of December 2022.

Chart 41: Inflation expectations flattening out?
Japan: Tankan, Average Inflation Outlook of Enterprises



Source: Refinitiv Datastream, Bank of Japan as of Q4 2022.

Chart 42: Business surveys a touch soft
Japan: Composite PMI, Economy Watchers survey & GDP



Source: Refinitiv Datastream, S&P Global, Cabinet Office. GDP to Q3 2022, Economy Watchers and PMI data is to January 2023.

United Kingdom: Bad news

Forecasts for the UK economy look relatively pessimistic compared to those for the US and euro area. Cost of living pressures remain intense, interest rates have risen significantly and fiscal policy is set to tighten. Mortgage rates have risen; the housing market appears to be slowing significantly, consumer confidence remains very weak. Strikes become more disruptive for the economy over the turn of the year and a poorly performing health service may be weighing on potential growth. Brexit remains a drag on the economy. All that said, for now, business surveys aren't as weak as I'd have expected. However, given the litany of challenges, my central case remains that the UK will experience/is experiencing a modest recession.

Recessionary

Q3 GDP growth was revised down slightly (to -0.3%Q), but the UK managed to escape a technical recession (i.e. two consecutive quarters of negative GDP growth) by the slimmest of margins when Q4 GDP growth came in at 0.0%Q. November and December retail sales both fell though and the composite PMI business survey fell further below 50 in January 2023, still pointing to a (modest) fall in private sector activity (Chart 43). The data isn't consistent with the UK sliding into a severe recession, but it is already consistent with a modest recession. The list of economic challenges is long and suggests plenty of potential for the UK to slip into a worse recession as both fiscal and monetary policy tightening bite.

Is the UK really bottom of the class?

Is the UK really in a much worse place than elsewhere? Forecasts in late 2022 from the OECD suggested that the UK's 2023 GDP growth outlook was the worst in the G20 bar Russia over the next two years. Recent IMF forecasts suggested something similar. Is the UK really in a much worse place than elsewhere? For now, the (relative) gloom looks somewhat justified. Cost of living pressures remain intense in the UK with high inflation rates and pay growth lagging behind, and the government have increased the amount of fiscal policy tightening planned for coming years. Mortgage rates may be off their mini-Budget highs, but remain elevated by the standards of recent years, the housing market appears to be slowing significantly – both in terms of prices and activity, consumer confidence remains very weak even if it is off its lows. More strikes are planned and Brexit remains a challenge for businesses and a source of uncertainty (including around the 'retained EU law bill' where up to 4,000 EU-originated laws expire at the end of the year unless ministers specifically decide to keep them).

The UK faces significant medium to long-term challenges as well including an ageing population, unsustainable-looking long-term fiscal finances and sustained weak productivity growth, though similar challenges are apparent in many other major economies too.

However, there are reasons to think that some of the gloominess may prove to be overdone. The UK's vulnerability to higher mortgage rates is easy to exaggerate and the fiscal outlook is not all it appears (not least since there will be a general election before some of the planned tightening takes place). Given the degree of weakness in real pay growth, it is surprising to me that consumer spending isn't already weaker. That weakness may come through with a lag, but might also reflect greater underlying consumer reliance than it appears on the surface. Lower inflation over 2023 should also alleviate the financial pressure on households, some of whom will also benefit from a strong forthcoming uprating in benefits and pensions.

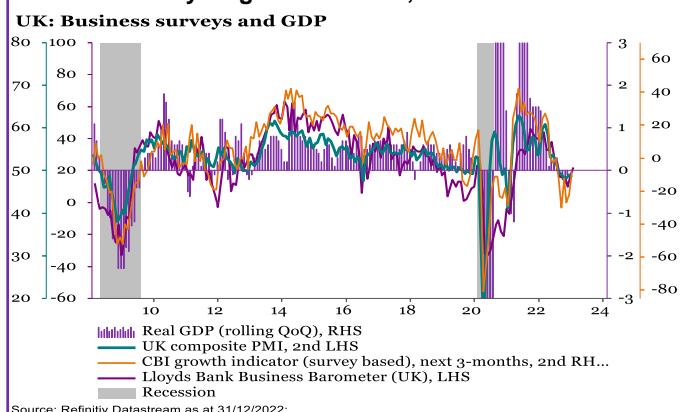
Hit by higher rates

It is very likely that the bulk of the impact from higher rates is still to come through. The Bank of England are still tightening monetary policy and interest rates tend to impact the economy with a lag. Mortgage rates have risen sharply (Chart 44), leaving many worried about the impact on households. The impact will be significant over time. However, most UK households have fixed rate rather than variable rate mortgages. Even if the longest typical term tends to be only five years, it means that the impact will work through over several years by which point many of those same household facing higher mortgage rates may have seen real pay increases. Although only 30% of UK households live in a house where they are paying a mortgage, higher mortgage rates will feed into higher rents too; with many buy-to-let landlords having interest-only mortgages, it is not surprising that there are reports of private rents rising sharply in some areas. The [BoE](#) track the percentage of households with high mortgage debt burdens and expect them to increase over 2023 to levels comparable with the start of the financial crisis.

Businesses have been hit by higher energy bills and interest rates too and there was a notable jump in insolvencies in 2022 (though some of these were probably 'delayed' from the pandemic period. Although business optimism has improved, investment intentions have been weakening in recent periods (Chart 45). The government's energy bill freeze is set to end April and surveys suggests that companies have increasingly cited the cost of finance as a factor likely to limit capex.

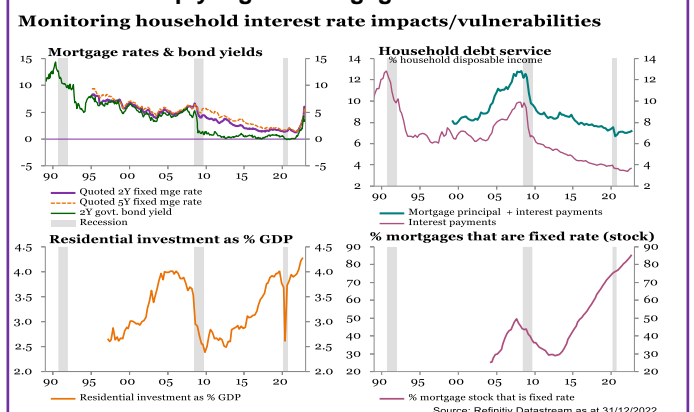
Watch credit conditions and housing. Credit conditions tightened over 2022. Survey-based housing activity indicators look subdued and house prices have been falling (Chart 46). Both could prove triggers of a deeper recession than in the base case. By recent UK standards, residential investment is a relatively high proportion of GDP (Chart 44).

Chart 43: Surveys signal recession, but not a bad one

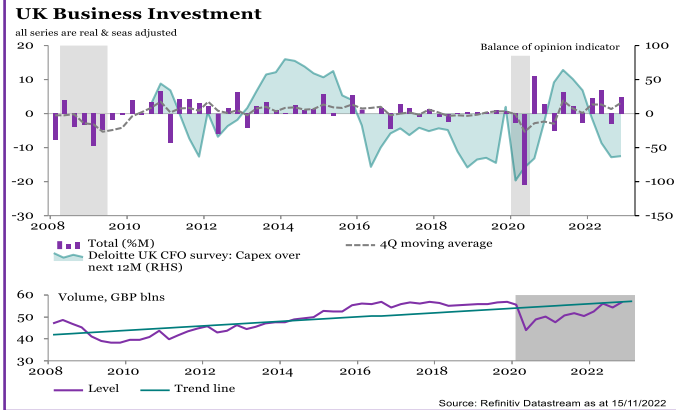


Source: Refinitiv Datastream, ONS, CBI, Lloyds, S&P Global.
Data is to January 2023 except GDP which is to December 2022.

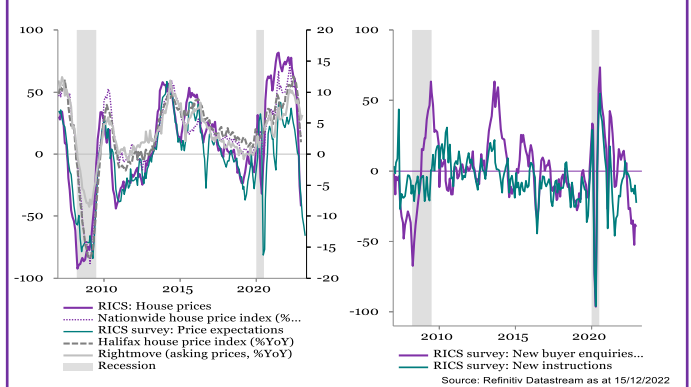
Chart 44: Sharply higher mortgage rates



Source: Refinitiv Datastream; Bank of England, ONS, / Mortgage rate data to November 2022, bond yields to end-2022. Other data to Q3 2022

Chart 45: Business investment intentions fall

Source: Refinitiv Datastream; Deloitte. Business investment as of Q4 2022, Deloitte data as at Q4 2022

Chart 46: House price falls; activity subdued
RICS UK housing market survey and house price inflation

Source: Refinitiv Datastream; RICS, Nationwide, Lloyds, Rightmove. Data to December 2022

Consumer spending – likely driver of slowdown

In the central case, real consumer spending and business investment fall during 2023. Although job vacancies look plentiful for now and unemployment very low, the situation is likely to deteriorate somewhat as the year progresses and vacancies have started to fall already (albeit from high levels); indicators of employment demand have weakened already. It is still surprising though that household real spending has not contracted by more already given cost-of-living pressures. High frequency data had been suggesting that restaurant activity, for example, remained robust. That could be consistent with consumers pulling back substantially with a lag and/or a K-shaped trajectory for the consumer with only lower income households pulling back strongly on their spending. As elsewhere though, lower inflation as 2023 progresses could see wages stretching further. Strong scheduled increases in pensions and benefit payments will help finances for some households, as will planned increases in the minimum wage.

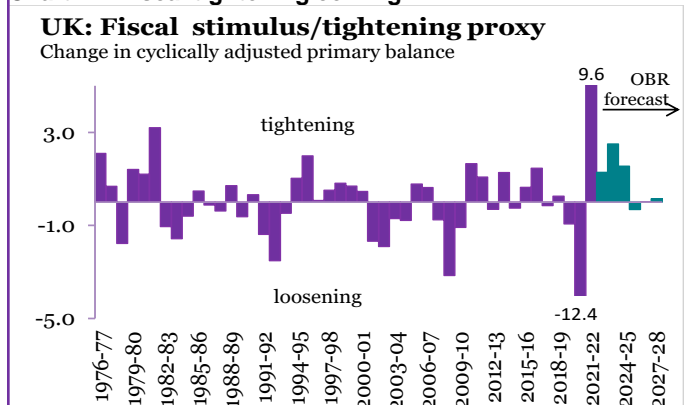
Inflation: Finally peaked

The forecasts see CPI inflation below 3% again in late 2023/early 2024, driven by assumed lower energy price inflation, lower external inflation pressures and slower domestic demand. As elsewhere, there are several risks to those core assumptions and the forecasts assume that CPI settles a bit above the central bank target reflecting some of the medium-to-longer run risks discussed in the Global section. Further bouts of currency weakness could weaken the chances of core inflation falling dramatically and wage growth is a key source of uncertainty for services/core inflation. Wage growth remains strong for now and companies expect substantial wage growth in 2023. However, labour demand seems to be falling and labour supply may react with a lag to the higher cost of living.

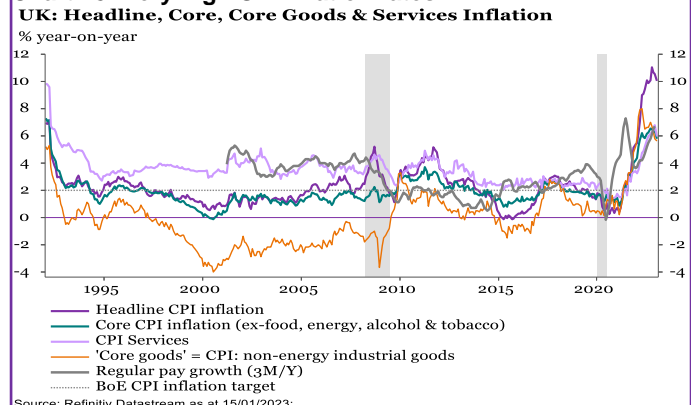
Fiscal and monetary policy both drag

Fiscal gets less supportive: Fiscal policy has been a source of huge market volatility this year and of changing recession probability. Chart 47 shows a proxy measure for the amount of fiscal tightening or loosening that is taking place. UK fiscal policy is getting tighter. It will weigh on growth this year and beyond. The Autumn Statement itself added even more fiscal tightening, though didn't make things worse for the economy in the very near term. The role fiscal policy will end up playing is uncertain though, not least because we will have another election before a large chunk of planned fiscal tightening even goes into effect. Other factors look likely to hinder how far fiscal stimulus could again become more supportive, however, including: 1) Debt interest payments this fiscal year will rival the NHS in terms of scale of cost. Because of the make-up of government debt, UK interest rate costs are vulnerable to inflation and to short-term interest rates; 2) Long-term fiscal sustainability calculations for the UK look awful. That reflects the UK's ageing population but does constrain room for manoeuvre in future years and leaves big questions about the future for NHS and social care provision and funding.

Monetary policy tightening – more hikes: Underlying domestic inflationary pressure in the UK still looks relatively strong, whether looking at wage growth or services inflation (Chart 48), although some measures of inflation expectations have calmed down and services inflation is off its highs. The Bank of England are not clearly signposting their next steps for interest rates and maintain a recession forecasts for the UK real economy, I continue to expect further rate hikes to a 4.50% peak given that domestic inflation backdrop. I worry that Bank of England communication has not been strong enough or frequent enough on the need for higher interest rates and their determination to reduce inflation. That risks domestic inflationary pressure proving harder to contain than expected.

Chart 47: Fiscal tightening coming

Source: Refinitiv Datastream, OBR

Chart 48: Very high UK inflation rates

Source: Refinitiv Datastream, ONS. Data to January 2023 except pay growth (average weekly earnings: regular pay) which is to December 2022

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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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