Short-term solutions jeopardise sustainable progress

Advanced Economies
Economic Outlook Q3 2022

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The global economic outlook has darkened, as inflation remains stubbornly high due to a toxic cocktail of war, Western sanctions, Russian retaliation, and lockdowns in China. Ongoing price surges have drastically changed the prospect for monetary policy. Central banks now seem fully committed to rein in inflation by rapid and aggressive tightening. Advanced economies face a tightrope walk to avoid a recession, but strong household and corporate balance sheets and tight labour markets for now imply sufficient sources of resilience. Further upside inflation surprises could tip the global economy into a recession, however.

Opting for short-term solutions to face the multitude of crises jeopardises further progress on the Sustainable Development Goals (SDGs). The major SDG challenges for advanced economies lie in climate mitigation, biodiversity protection, and reducing inequality. Addressing these issues requires a longer-term perspective. So, despite the current economic turmoil, policymakers should remember that a narrow-minded focus on short-term solutions will be detrimental in the long run.

Short-term solutions jeopardise sustainable progress

Global economic headwinds have strengthened

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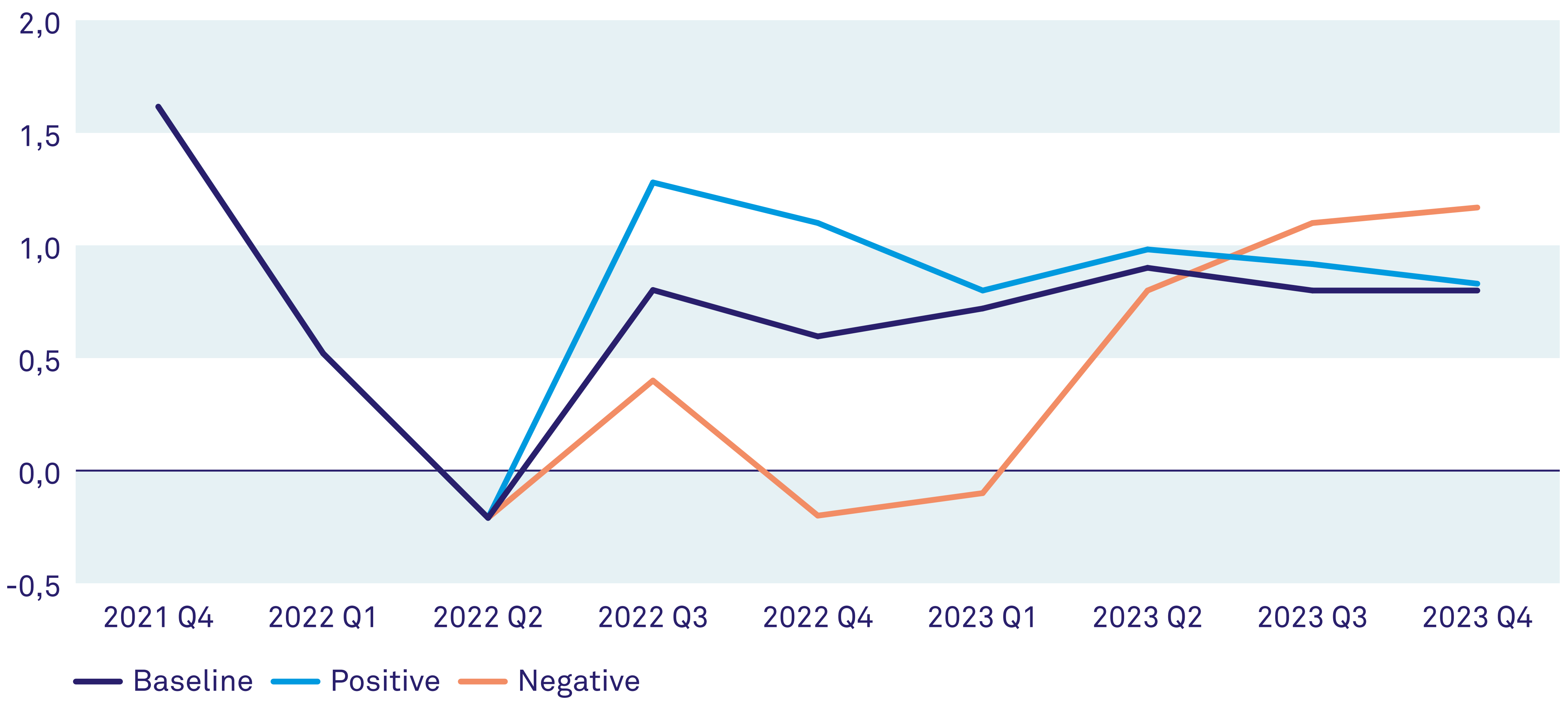
Since the Russian invasion of Ukraine, the headwinds for advanced economies have become more intense. The war and related sanctions back and forth have led to surging food and energy prices, thereby reducing household purchasing power and confidence. China's zero-tolerance COVID policy, meanwhile, worsened global supply bottlenecks, adding to the already significant inflationary pressures. As a result, inflation broadened and rose to new highs across advanced economies, thereby shattering hopes that peak inflation would soon be left behind. This triggered central banks to be far more aggressive than previously expected, which tightened financial conditions through rising interest rates and falling equity markets.

Luckily, many households were able to absorb a substantial part of the price rises by lowering their still elevated savings rates and tapping into their massive excess savings built up during the pandemic. Record-low unemployment provided the necessary job security for continued strong consumption. But many lower-income households increasingly struggled with the surging food and energy prices, resulting in more energy poverty within advanced economies. Companies also cushioned the inflation-induced blow to economic activity, as still elevated profit margins allowed them to boost investment and hiring. Still, the combination of fading household pent-up demand from the pandemic, the ongoing increase in the cost of living, the tightened financial conditions, and the ongoing geopolitical uncertainty inevitably slowed economic growth in advanced economies as the second quarter of the year progressed.

Figure 1 Real GDP growth (Q-o-Q %)



Source: NiGEM, Triodos Investment Management

Despite this economic slowdown, in our baseline scenario we still expect that a global recession will be avoided, as we assume that the current supply constraints (and thus inflation) will gradually fade, allowing central banks to increasingly focus on supporting economic activity. In this baseline, we project global economic growth to be 2.8% in 2022 and 2.8% in 2023. In our negative scenario, supply shocks intensify into a perfect storm, resulting in further upside inflation surprises which would force central banks to be more aggressive. The result would be a global recession with global growth coming in at 2.4% in 2022 and 1.3% in 2023. In our positive scenario, which we deem least likely, the supply constraints would fade quickly, allowing central banks to take their foot of the brake. In this case, global growth would be 3.1% in 2022 and 3.5% in 2023.

Equity market corrections have made valuations fall back to their long-run averages. At the same time, a recession is still not our baseline, meaning we might well have approached peak central bank hawkishness. Additionally, investor sentiment seems to have bottomed out for now. Combined, this leads to a change in our equity allocation from underweight to neutral. We do not want to overweight our allocation, as the outlook still points to slowing growth and reduced liquidity, and further inflation surprises are a realistic risk. With respect to eurozone bonds, we maintain our neutral position, to balance the reality of slowing growth due to the war in Ukraine and the threat of further upside inflation surprises with our call that the ECB seems committed to prevent any significant further rise in the borrowing costs for governments.

Strong sources of continued resilience

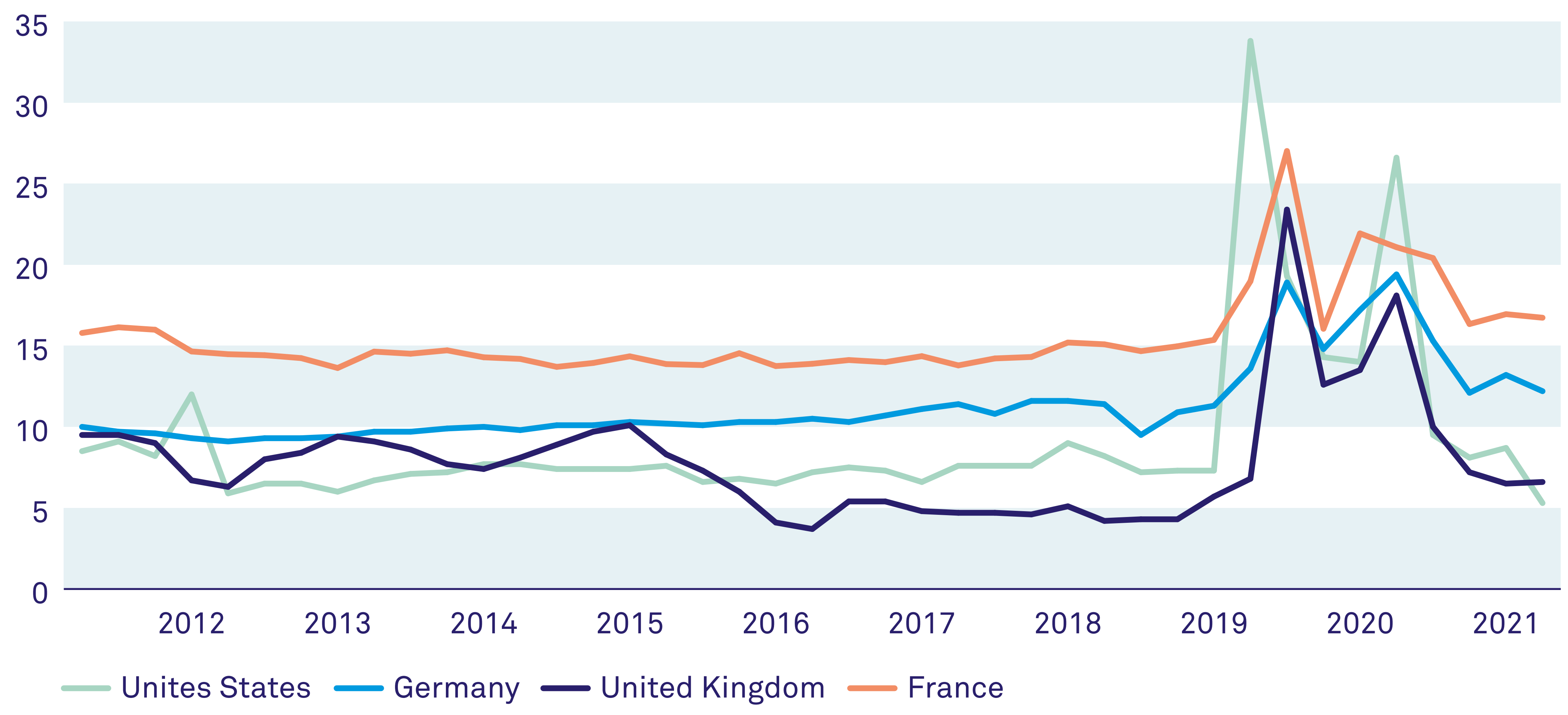
Compared to three months ago, the world now faces a longer period of elevated inflation, more aggressive monetary tightening, and a more extended period of geopolitical instability in each of our scenarios. This will inevitably hamper household consumption, business investment and international trade. Therefore, our new forecasts are considerably lower than the ones we released in April, with our current upside scenario now projecting a lower global economic growth rate for 2022 than our previous baseline scenario (3.1% vs. 3.4%).

Still, our baseline assumption continues to be that a global recession will be avoided. This is partly based upon two strong sources of resilience in all major advanced economies: still huge piles of excess savings sitting at households and still relatively high corporate profit margins and sustainable corporate debt ratios. According to the most recent data, household savings rates have so far stayed above their pre-pandemic levels in all major advanced economies besides the US. This implies that households outside the US were able to grow their already sizable excess savings they accumulated during the pandemic. Combined, the excess savings in the main advanced economies equals 6% of the global GDP.

Of course, the key question is whether households are willing to (continue to) tap into their excess savings. If they consider these excess savings a part of their long-term savings, or if they are unsecure about their job prospects, they could very well refuse to spend most of these savings. However, the fact that household deposits at banks have grown far above long-run trends since the start of the pandemic suggests that a considerable part of the excess savings is sitting at bank accounts and has not been invested. We know that most of these savings are being held by wealthier households, which usually have a lower propensity to spend their savings. But inflation might force them to do so if they want to continue their normal consumption patterns. Extremely tight labour markets also should be favourable for our expectation that at least a part of the excess savings will be put to use. At the same time, we acknowledge the fact that households might be tempted to increase their savings rates in case inflation stays highly elevated for an extended period (our negative scenario).

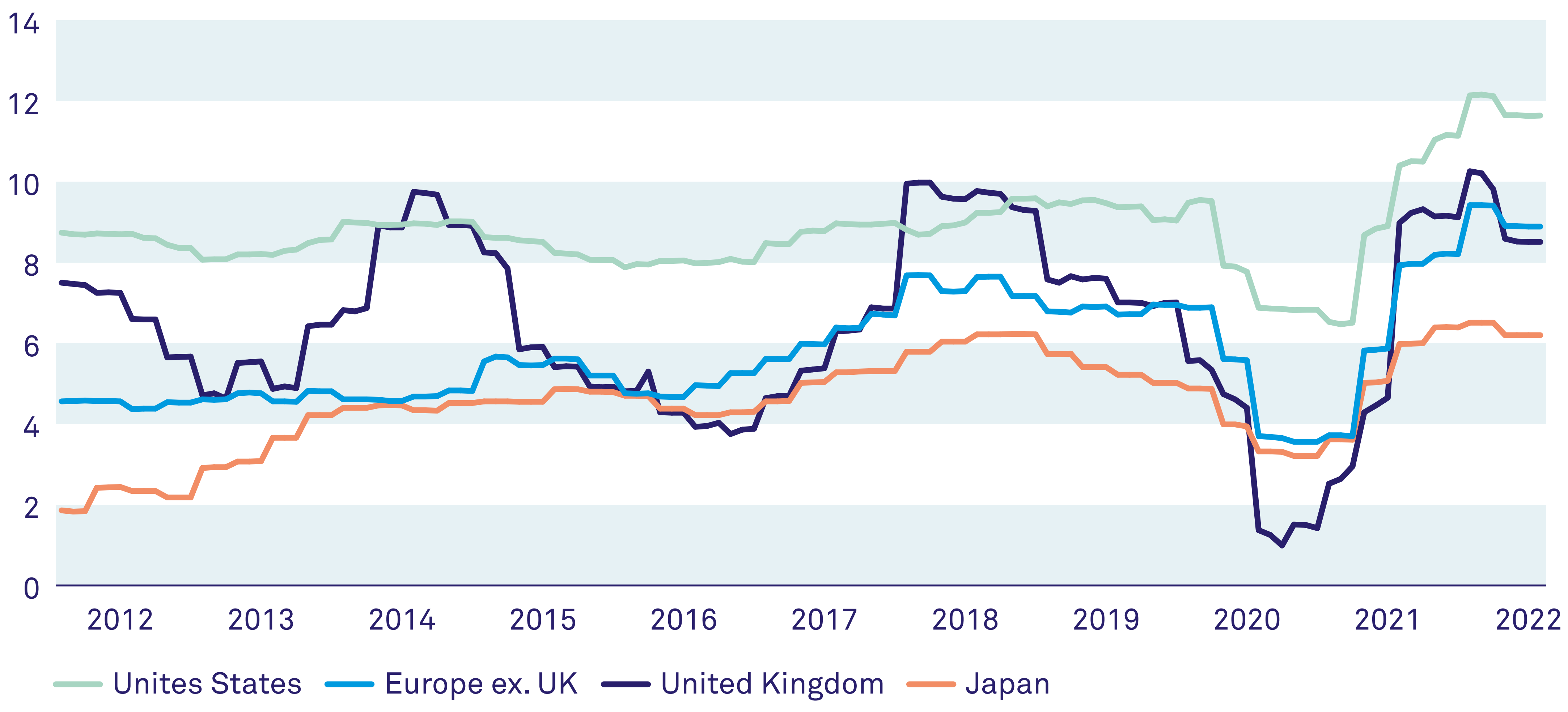
In similar fashion, a healthy corporate sector should mean resilient business investment and hiring in the remainder of the year. Although profit margins have come down from their peaks, they are still hovering at above-average levels, suggesting sufficient pricing power for the time being. Debt ratios are at the same time average to low compared to history, which should protect corporates from rising interest rates.

Figure 2 Household savings rates (% of disposable income)



Source: Refinitiv Eikon, Triodos Investment Management

Figure 3 Net profit margins (%)



Source: Refinitiv Eikon, Triodos Investment Management

Key components to avoid a recession

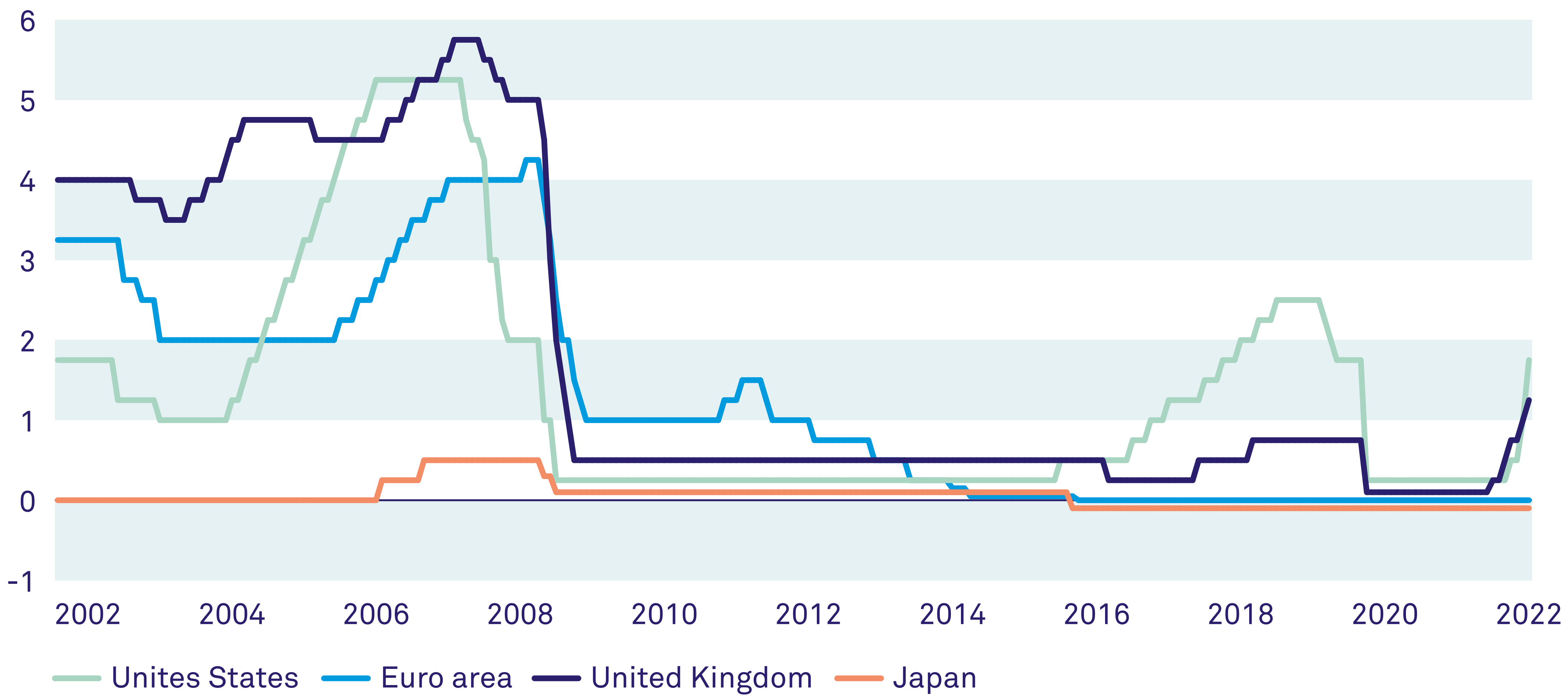
Despite the strong sources of resilience, there are three key determinants that decide whether the global economy falls into a recession or fares better than we currently expect. Our negative scenario assumes a perfect storm of an escalating war, more COVID-lockdowns, and overly aggressive central banks, while our positive scenario assumes de-escalation of the war, no more COVID-lockdowns and only moderate central bank tightening. The risks to our baseline are clearly skewed towards the negative scenario. For our baseline scenario to hold, the following assumptions should be met:

1. War does not escalate
The war remains the dominant factor determining the near-term outlook, especially for the European economies. For our baseline scenario to hold, commodity prices should at least stabilise, which most importantly means Russia should not completely cut its gas supplies to Europe. The West should in turn not impose further significant sanctions that ban key commodity imports. In that case, the current situation continues, meaning peak inflation should be left behind as base effects come into play in the second half of the year, allowing central banks to be less aggressive than recent market expectations. If the war escalates, commodity prices would rise further, resulting in a global recession. The eurozone would in that case be the main culprit as it would also face severe physical supply shortages. The UK and Japan would suffer more than the US, as they are net energy importers.

2. No more COVID-lockdowns
COVID-19 still plays an important role. In case new, more infectious variants emerge, lockdowns might again be imposed across the major advanced economies. We do not expect this in our baseline scenario. The most important risk related to COVID-19 is China, where limited immunity makes the country vulnerable to new COVID-outbreaks. However, we expect the Chinese government to become somewhat more flexible, leaving behind complete city shutdowns. On a global scale, we expect that supply chain pressures continue to ease as demand cools and lockdown-induced supply bottlenecks fade. If new outbreaks do lead to new severe lockdowns in China, that could be an additional push for inflation across the major advanced economies. At the same time, lower Chinese demand will in that case weigh on global economic activity.

3. No central bank policy mistakes
Our baseline scenario assumes that central banks in the major advanced economies will not overplay their hand while trying to tame inflation. Although we do expect the Federal Reserve, Bank of England (BoE) and European Central Bank (ECB) to (continue to) hike interest rates until year-end, we expect the focus to gradually shift to weakening growth. This should be possible, as inflation pressures slowly moderate in our baseline scenario. This implies frontloading of rate hikes over the next few months to combat inflation, with policy rates peaking a bit below the levels that markets until recently had priced in. Especially the ECB will be susceptible to respond to slowing growth, as worries about Southern European debt sustainability have already forced the ECB to announce plans for an ‘anti-fragmentation’ instrument that will limit the spread between borrowing costs of more stable countries and their Southern counterparts. The BoE faces the most difficult situation, as inflation is expected to peak only late-2022 when the default energy price cap will be reset, while the UK is already on the brink of a recession in our baseline scenario. If inflation surprises to the upside, as in our negative scenario, central banks will be forced to act more aggressively, inevitably pushing the global economy into a recession. Rapidly easing inflationary pressures would on the other hand allow central banks to be less aggressive than we currently expect, thereby boosting growth.

Figure 4 Central bank policy rates (%)



Source: Refinitiv Eikon, Triodos Investment Management

Longer-term perspective needed to prevent further SDG stagnation

Obviously, households and businesses across advanced economies are confronted with ongoing deteriorating economic conditions in all three of our scenarios. As we do not expect wage growth to keep track with inflation until late 2022 in each of the scenarios, household purchasing power will continue to decrease. This especially impacts lower-income households, who spend a larger proportion of their total income on food and energy (important contributors to the elevated inflation). Likewise, businesses face cooling demand and possibly energy shortages (particularly in certain European countries).

Unfortunately, the most likely response of policymakers is to address these issues with short-term solutions, possibly with use of money that was meant to address existential, but less visible crises like global warming and biodiversity loss. We have already seen the implementation of generalised measures that lower the price of electricity and gas for everyone and have witnessed the re-opening of coal-fired powerplants. While these actions may well ease the immediate pain for most households, they directly oppose those SDGs for which progress was already stagnating last year and are considered to be the **major challenges** for high income countries: climate change, biodiversity loss, and inequality. Generalised measures go directly against addressing inequality as they equally favour higher-income households, who have more buffers to cope with these price increases. Price reductions and creating additional fossil fuel capacity also do not incentivise a reduction in fossil fuel-related energy consumption and are therefore not in line with carbon emissions reduction targets.

Instead, targeted measures are needed that simultaneously address inequality, climate change, and biodiversity loss. This means direct support for low-income households, re-schooling for workers in ‘dirty’ sectors, and strong investment in a clean energy infrastructure. The US especially has to step it up when it comes to the SDGs, as it is the country amongst the major advanced economies that is has so far showed **the least policy efforts and commitments**. But worryingly, none of the advanced economies so far has an appropriate set of policies in place to achieve the objectives of the 2030 Agenda. Setting and sticking to ambitious domestic targets therefore remains crucial. Advanced economies are also obliged to pursue close global cooperation, as they **generate** the most significant socioeconomic and environment impacts outside their borders, thereby hampering other countries to achieve the SDGs. Going forward, it is of the utmost importance that policymakers do not forget the main SDG challenges while they try to deal with the near-term economic turmoil.

Economic growth projections

		Positive		Baseline		Negative	
GDP growth (%)	2021	2022	2023	2022	2023	2022	2023
Global	6.0	3.1	3.5	2.8	2.8	2.4	1.3
US	5.7	2.5	2.5	2.1	1.7	1.7	0.8
Euro area	5.3	3.0	2.1	2.6	1.2	2.1	-0.3
UK	7.4	3.4	0.9	3.1	0.5	2.7	-0.2
Japan	1.7	1.7	2.0	1.3	1.8	1.0	0.3
China	8.1	4.5	5.5	4.2	5.0	3.5	4.0

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