The pre-pandemic status quo is not good enough

Advanced Economies
Mid-Year 2023 Outlook

Triodos Investment Management

The global economic expansion is gradually losing pace, but activity still stands on solid ground. There are several pockets of strength that have been upheld by ongoing fiscal support. This makes an abrupt break in activity unlikely. We have therefore pushed our call for a mild US recession towards 2024 and foresee a period of modest growth across advanced economies until then. Combined with easing inflation and the end of the central bank rate hiking cycles, these relatively calm waters should be beneficial for risk assets. But current policy measures fail to target the much-needed sustainable transitions and seem merely designed for a return to the pre-pandemic status quo.

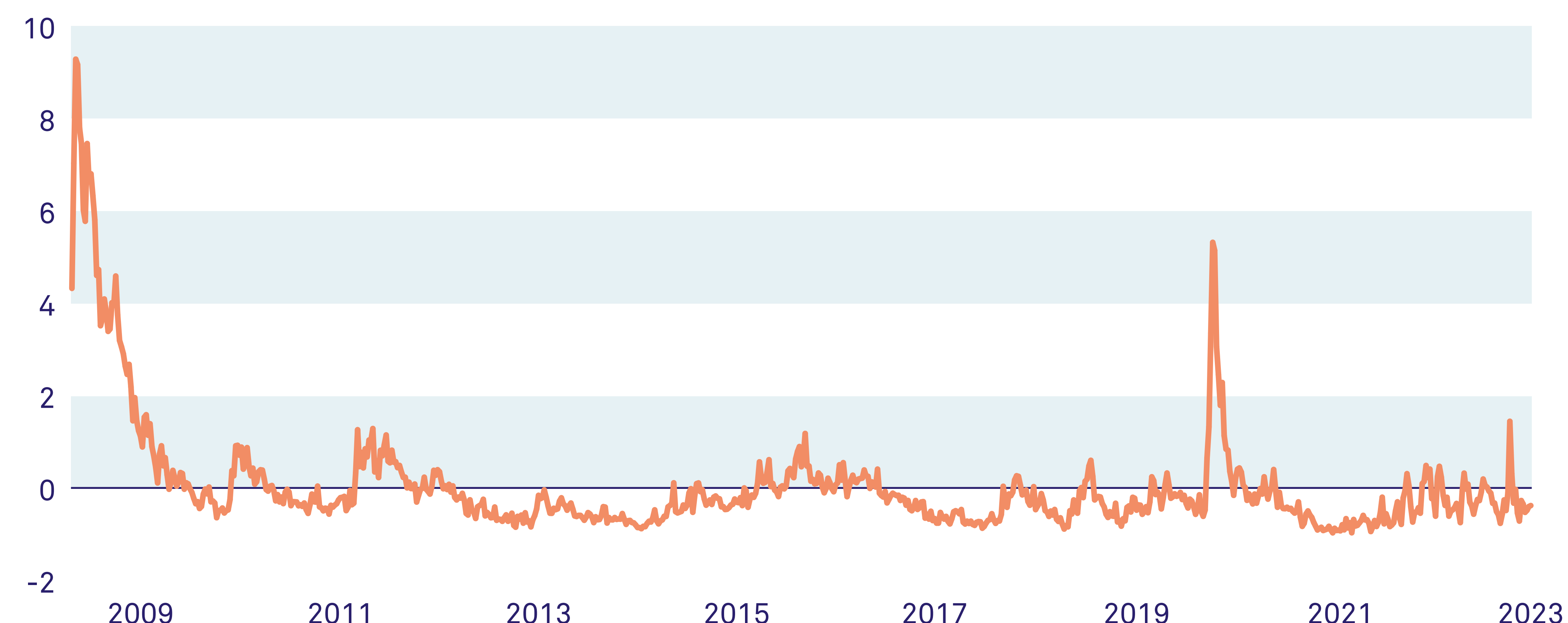
The pre-pandemic status quo is not good enough

Financial stability: the return of goldilocks?

If there is one thing that the second quarter of this year has shown us, it is that near-term financial stability risks are much lower than feared mid-March. The stress that emerged because of the turmoil in the US banking sector and the takeover of Credit Suisse did not turn into a systemic crisis. Policymakers reacted adequately to avoid further turbulence, and financial markets showed trust in the higher buffers across the European banking sector and the largest US banks that were imposed after the global financial crisis of 2008/09. Moreover, the latest bank lending surveys, now including the period of banking sector stress in Q1, indicated that credit conditions tightened, but not as much as feared. Given the relatively healthy corporate and household balance sheets, this credit tightening should be no immediate threat to financial stability.

Figure 1 **US financial stress index**

0 = normal financial conditions; Federal Reserve Bank of St Louis



Source: Refinitiv, Triodos Investment Management

With financial stability concerns quickly fading, the focus returned to economic activity and inflation. Economic activity readings showed that growth slowed for the aggregate advanced economies in the first quarter. This was mostly due to continued weakness in eurozone household consumption, which made that the eurozone economy went through a winter recession after all. But the contraction was so minimal that it can be described more adequately as a period of stagnation. Similarly, household consumption growth in the UK nearly stalled in the first quarter, resulting in only a minor expansion of the UK economy. This relative consumption weakness in Europe was offset by solid growth in household consumption in the US and Japan. Nevertheless, US economic activity slowed in the first quarter due to subdued business investment, whereas Japanese economic activity accelerated as business investment also contributed to growth.

In the meantime, as financial stability concerns faded,market expectations for central bank policy rate paths were readjusted towards higher ultimate policy rates and no rate cuts in 2023. But expectations remained for a near-term end to the rate hike cycle. This belief in an ending of rate hikes was strengthened by a disappointing Chinese reopening boom, slowing activity across advanced economies and sharply easing headline inflation in the US and Europe, all suggesting that the required cooling of the overheated global economy had set in. This revived investor hopes for a ‘goldilocks’ stage, a period without rate hikes and an economy that is neither too hot nor too cold, but just right for risk assets to flourish.

Fiscal support upholding global activity

Looking forward, a near-term break in economic activity does indeed not seem likely. Several pockets of strength across the major advanced economies point towards a more gradual slowdown. Most notable are the strong labour markets, with unemployment rates still being close to their record-lows. There are some signs of labour market cooling, as indicated by the declining number of jobs added to the economy each month and slowly rising US jobless claims. But with 1.7 vacancies per unemployed person in the US, an inflection point seems quite some way off.

Services spending is another clear strength across advanced economies. Since early 2023, business activity (as proxied by surveys of supply chain managers (PMIs)) has decisively reversed its downward path, mostly because of an acceleration in the services sector. Besides reflecting tight labour markets, this indicates inflation has not impacted disposable incomes to the full extent, and shows excess savings built up during the pandemic carry a long way. Of course, the manufacturing sector tells a completely different story by remaining in contractionary territory, and the services expansion has recently lost its pace. But as long as labour markets do not budge, an abrupt halt in spending seems unlikely. According to a recent paper by the San Francisco Federal Reserve, excess savings should be available to support US spending at least into the fourth quarter of 2023.

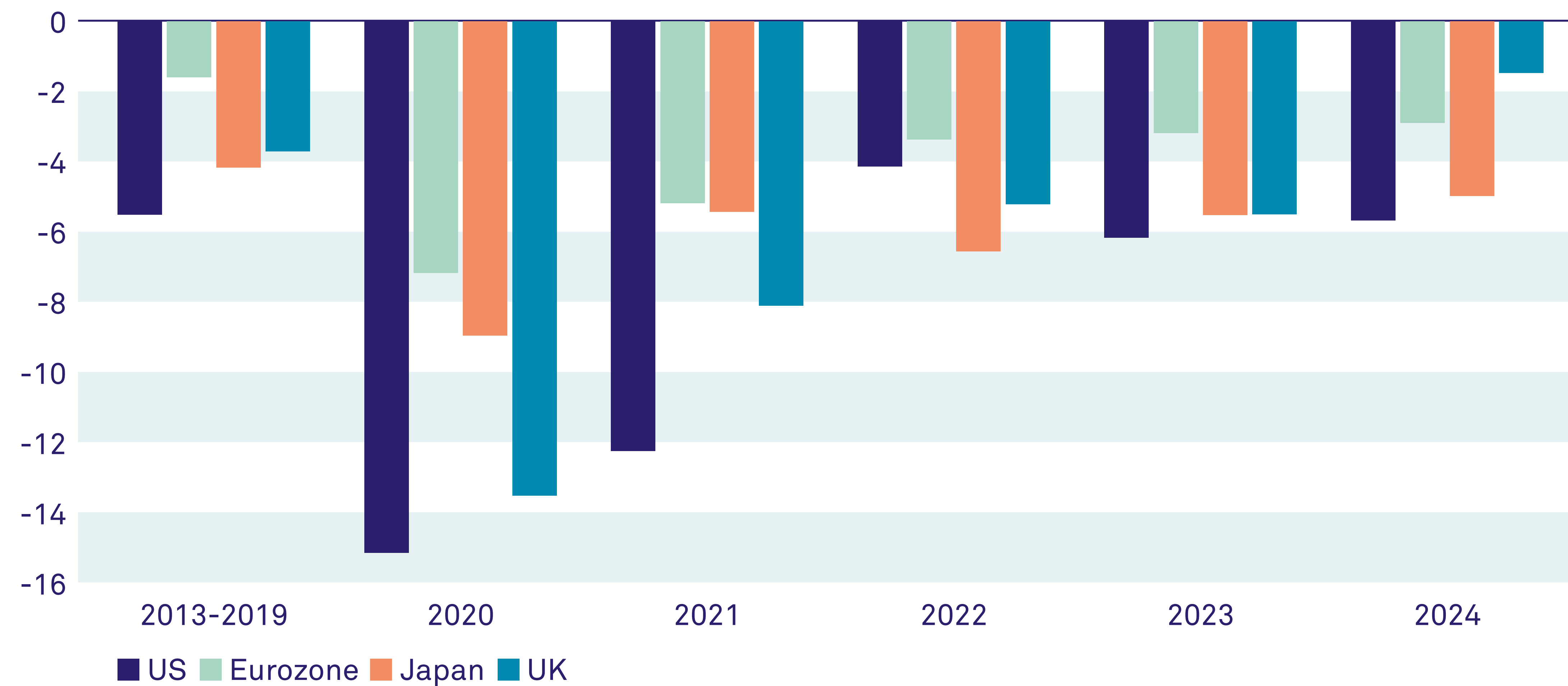
Corporate earnings are also underpinning global economic activity. The most recent earnings reports for Q1 were better than consensus expectations, defying worries about an upcoming earnings recession. Moreover, global forward-looking earnings per share revisions have turned positive since the end of April, meaning upward revisions have started to outnumber downward revisions. And although net profit margins have come down, they are still above the averages of the pre-pandemic decade. This makes imminent lay-offs and significant cuts in capital expenditure unlikely.

These strengths have all one thing in common: they are the result of the massive fiscal support in response to the COVID-19 pandemic and were upheld by ongoing fiscal support (on for instance energy prices) since then. In 2023, fiscal deficits will still run above their 2013-2019 pre-pandemic averages in all major advanced economies. This massive support has prevented companies and households from defaulting on their loans and has thereby underpinned financial stability. The effects of such an extended period of fiscal support will take time to wane off and makes near-term financial instability unlikely. But since these fiscal measures did not have any sustainable earmarks, being designed purely to support aggregate demand and keep all companies afloat, they are by definition targeting a return to the pre-pandemic status quo. This is a lost opportunity to steer towards a more sustainable economic system.

Wage growth keeps core inflation sticky

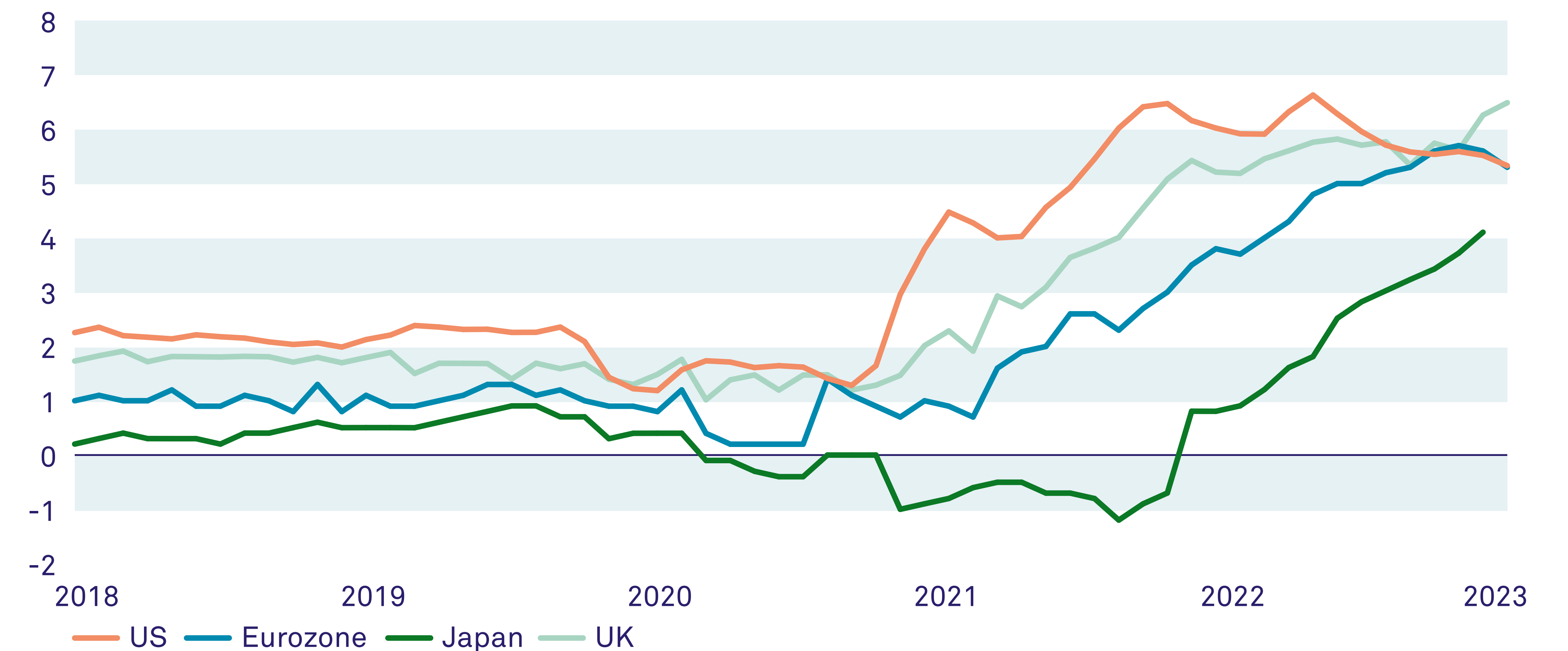
Headline inflation has eased considerably across advanced economies over the last few months. This is mostly because of falling energy prices and easing goods prices. But core inflation has not eased that much in the US and the eurozone and is still on the rise in the UK and Japan. This is mostly the result of stubborn services inflation, with services demand being strong ever since the COVID-reopening effects shifted spending from goods to services. Since

Figure 2 Government budget balance
% of GDP



Source: NiGEM, Triodos Investment Management

Figure 3 G4 Core inflation
Twelve-month % changes



Source: Refinitiv, Triodos Investment Management

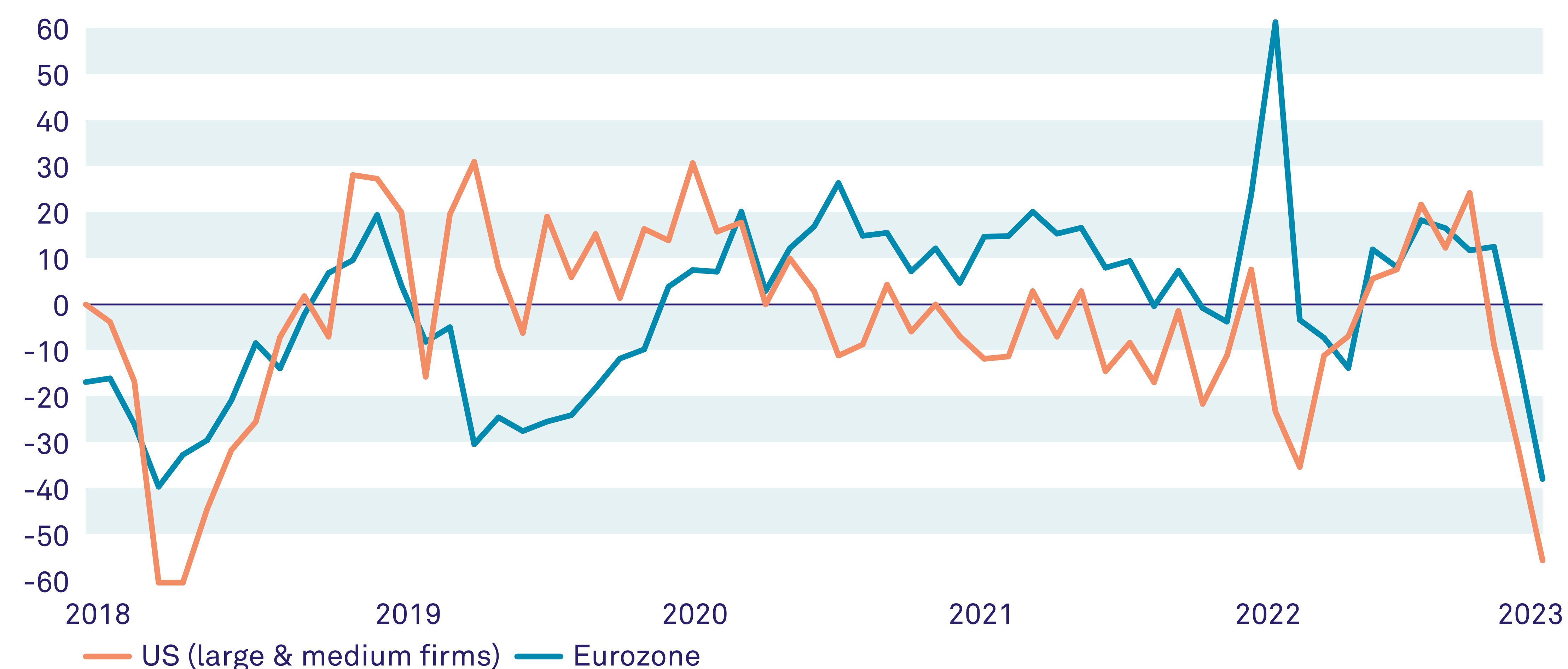
services are relatively labour-intensive, it largely depends on wage growth developments whether the 2% central bank inflation targets will be reached before year-end.

The latest developments show that wage growth is still considerable, slowing in the US and Japan but still on the rise in the UK and the eurozone. But with the notable exception of the UK, the risk of a wage-price spiral seems limited, given that most current wage growth reflects one-off payments and most measures of longer-term inflation expectations are close to central bank targets. Tight labour markets and current worker sentiment make a rapid fall in wage growth nevertheless unlikely, which means inflation will be above central bank targets until at least the beginning of 2024.

Tightening will only really bite in 2024

Even though core inflation remains elevated, most major central banks have signalled that the end of the rate hike cycle is near. This seems sensible in an environment of slowing economic growth, easing headline inflation and relatively anchored inflation expectations, especially when considering that monetary tightening works with a lag. Nevertheless, the ultimate policy rate levels will likely be somewhat higher than we expected until recently, as there are no real concerns about financial stability. We therefore

Figure 4 Corporate credit demand
Net % of banks reporting increase in demand



Source: Refinitiv, Triodos Investment Management

expect one more 25bps rate hike by the US federal Reserve, two more 25bps rate hikes by the ECB, and a total of 75bps in rate hikes by the Bank of England. And since we do not expect inflation to reach the central bank targets before year-end, we assume that after the hiking the policy rates will be left untouched until at least 2024. The Bank of Japan likely remains the odd one out with a continued dovish stance in 2023.

Furthermore, although credit conditions haven't tightened as much as feared, the latest bank lending surveys did show a significant drop in corporate credit demand, indicating companies are now almost as careful as during the global financial crisis in 2008/09. And as we move closer to 2024, the amount of corporate debt that must be refinanced will increase, leading to higher debt costs. Combined, this should slow business investment and decrease hiring demand.

Our key take-aways are that several pockets of strength imply an abrupt break in global economic activity is unlikely. The gradual slowdown will continue, as fiscal support has delayed the effects of monetary tightening. We now expect that these tightening effects will really bite in 2024, when business investment in the US and Europe will be hampered by higher debt costs. Consequently, we have pushed our call for a mild recession in the US towards the first half of 2024. For the eurozone, we expect only a modest recovery from the recent recession, with sluggish growth going forward, and we foresee an even more prolonged period of muted growth in the UK. The global slowdown will also slow Japanese activity growth, while Chinese activity will normalise as COVID-19 reopening effects fade, which will be enough to prevent a global recession.

What about the necessary transitions?

Though price stability is beneficial for all, the current manner of monetary tightening is in no way steering towards an equitable society with healthy ecological conditions. Recent events have confirmed that the financial sector will always be supported by central banks if something breaks (in the name of financial stability), and corporate profit growth is deemed necessary for longer-term productivity. This means the only way for tightening to slow the economy is through rising unemployment and muted wage growth, thereby amplifying inequality. Sharply rising interest rates at the same time increase the return requirements for all investments uniformly, while we know that sustainable

projects related to for instance the energy transition have higher initial costs, and thus will be the first to be impacted by higher rates. Central bankers should therefore start to rethink their uniform approach when it comes to monetary tightening, and central bank officials should refrain from any statements that call upon workers to lower their wage demands to avoid a wage-price spiral. If anything, they should call upon companies to pay their fair share.

Likewise, it would be wise for governments to let go of general (energy) compensation schemes and instead focus on targeted lower-income compensation. Ending fossil fuel subsidies is also much overdue. Budgets should instead be used to support households in making their homes more energy efficient, improving public transportation and setting up more public-private partnerships that spur the energy transition. Targeting a redistribution of wealth is also required, so that lower-income households are not left behind in the required system transformation. Overall, the transformation should be really embedded in both fiscal and monetary policy going forward if we are to achieve the required systemic transformation.

Calm waters allow slightly offensive allocation stance

No rebalancing of our equity allocation
Because of the recent strong performance of our equity holdings, our neutral equity allocation has naturally drifted towards a modest overweight. We have decided not to rebalance towards neutral, based upon several developments: Firstly, the latest earnings season was better than expected, and global 12-month forward earnings per share revisions have turned positive since the end of April. Secondly, we are approaching the end of the central bank rate hike cycle. Thirdly, incoming economic data keeps showing ongoing robustness in economic activity, making a ‘soft landing’ scenario increasingly likely. Lastly, the recent banking turmoil has confirmed our belief that policymakers are determined to step in and ‘go big’ before any emerging financial stress escalates into an actual crisis.

Bonds: consequential underweight
As a result of our overweight in equities, we are now underweight in bonds. The ECB’s financial stability considerations have always been the main reason for us to suspect that the sharp rise in eurozone government bonds yields since the beginning of 2022 was bound to be partly reversed in 2023. The ECB certainly wants to prevent any significant widening of spreads between Southern European countries and the German Bund. We therefore expected a lower terminal policy rate than markets were pricing in. Now that we have upped our policy rate forecast, and markets have started to price in a lower terminal rate, we are in line with market pricing. We have therefore changed our long duration position back towards neutral. Nevertheless, the high interest rate environment could result in corporate financial difficulties further down the road, potentially triggering a rise in downgrades. We therefore continue to prefer high quality names.

Real GDP growth (%)

	2022	2023	2024
Global	3.0	2.6	2.6
US	2.1	1.7	0.4
Eurozone	3.5	0.9	1.0
UK	4.1	0.4	0.6
Japan	1.0	1.4	0.8
China	3.0	5.5	5.3
India	7.2	5.8	6.1

Source: NiGEM, Triodos Investment Management

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