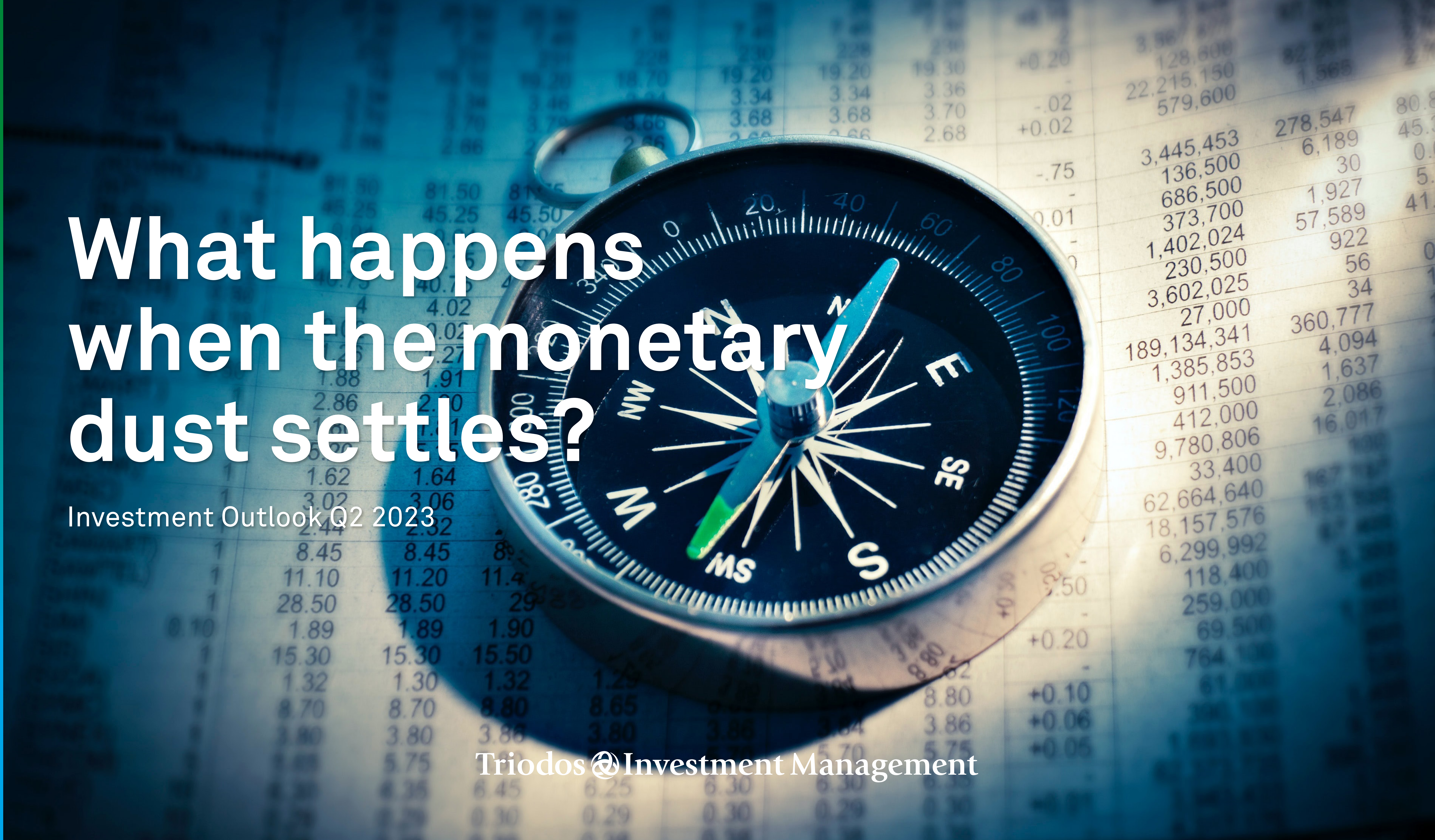
What happens when the monetary dust settles?

Investment Outlook Q2 2023



Triodos Investment Management

The recent stress in the banking sector has reminded us that aggressive monetary tightening is never without consequences. Suddenly, financial stability concerns have become top of mind again. This puts monetary policymakers in a difficult position, as global economic activity has so far remained surprisingly robust, and inflation stubbornly high. For now, the expected regional growth divergence implies a relatively gradual global slowdown going forward, driven by a tightening-induced slowing of private sector investment. But financial contagion risks have added to the outlook uncertainty and are bound to make central bankers more careful. Taking a step back, we can conclude that true system resilience is still far away, despite the lessons we supposedly learned from past crises. And monetary addiction is still holding the system hostage.

What happens when the monetary dust settles?

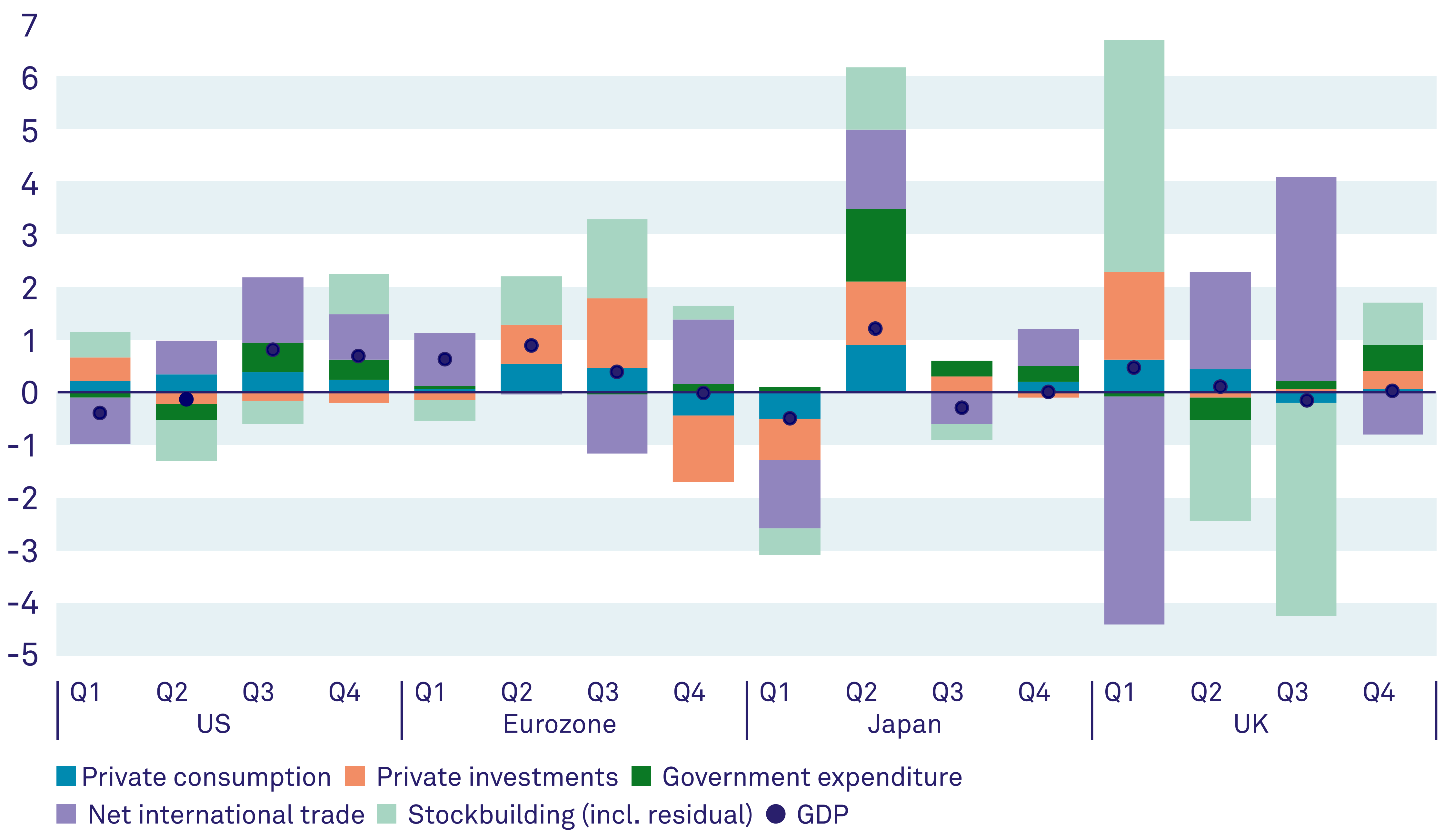
Changed narratives, increased uncertainty

Narratives can change in the blink of an eye, and for the global economy this is precisely what happened. Towards the end of last year, the scene seemed set for a year of weak global economic growth, with rolling recessions in most of the major advanced economies and sub-par Chinese activity expansion.

But only a few weeks into 2023, the mood brightened significantly. An extraordinarily warm European winter and ongoing corporate energy efficiency gains resulted in lower-than-expected gas consumption. In combination with fully stored gas capacity, this led to falling European gas prices. Sizeable fiscal support across Europe in the meantime made sure the still above-average energy prices did not affect household disposable income as much as feared. Consequently, both UK and eurozone economic activity did not contract but remained flat in the final quarter of 2022, meaning both economies narrowly avoided the much-anticipated winter recessions.

The US economy also expanded more than expected, as household consumption continued to grow. Apparently, US households were able and willing to dip further into their (excess) savings, which had been building up during the pandemic. Gradually easing US headline inflation since last summer also supported spending, as did ongoing job creation. And the surprise-decision of Chinese policymakers to abruptly end the strict zero-COVID lockdown policy further improved the near-term global outlook, with an anticipated Chinese reopening boom in the first half of 2023 set to support global activity expansion.

Figure 1 Quarterly real GDP growth 2022
(%) - expenditure components



Source: Refinitiv, Triodos Investment Management

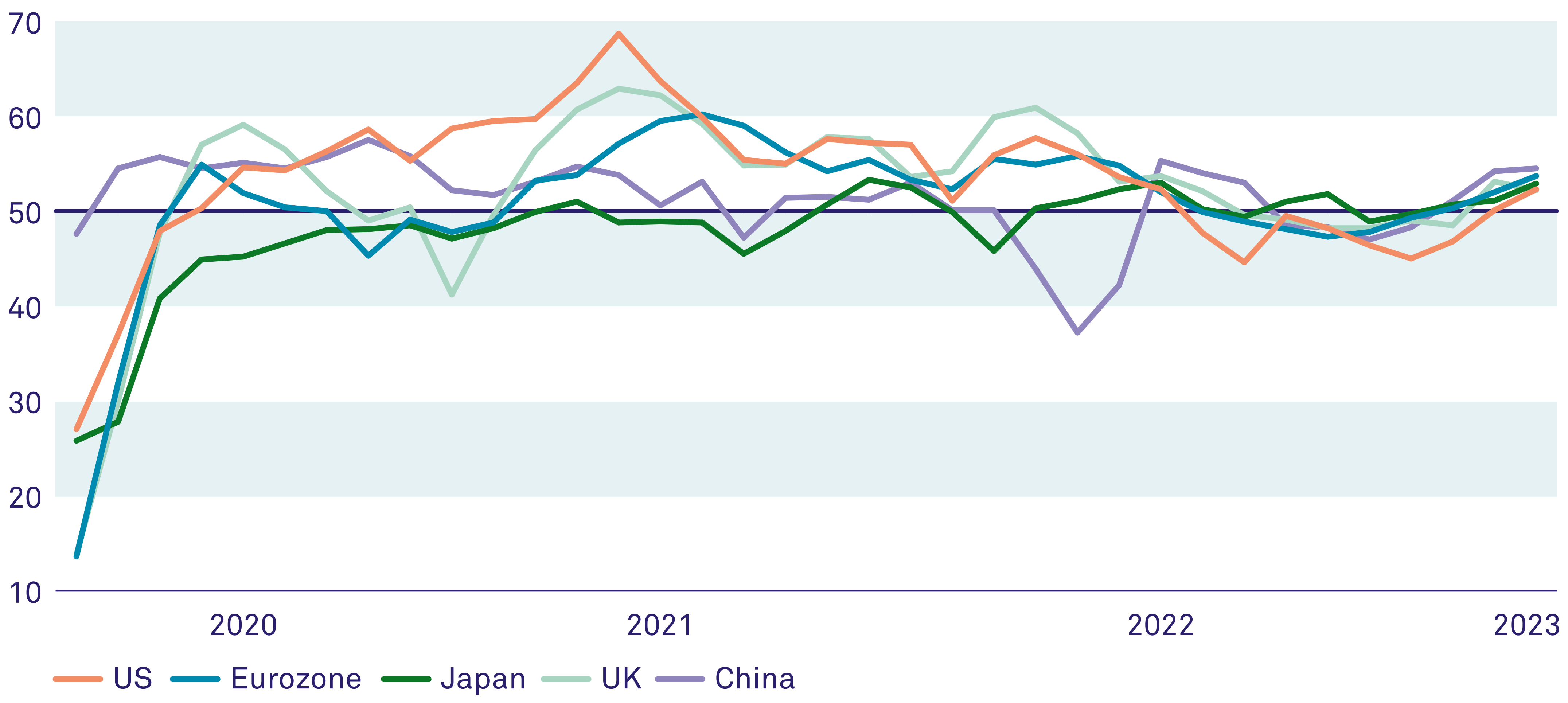
This 'better-than-expected' narrative translated into market expectations for higher central bank policy rates for a more prolonged period, as it would require more tightening to cool down demand and ultimately inflation. Then Silicon Valley Bank, a US middle-sized bank, failed because of bad risk management and aggressive policy rate hiking by the Federal Reserve. Shortly after, Credit Suisse had to be taken over by fellow-Swiss financial institution UBS, further spreading fears across global financial markets. A financial crisis and the corresponding recession including near-term monetary loosening suddenly became a more realistic scenario once again. Consequently, market expectations were rapidly readjusted towards lower policy rates and earlier rate cuts.

Barring contagion, near-term recession risks have faded

For now, we do not expect the recent banking sector stress to transform into a systemic crisis. Investor fears have faded, as it appears that policymakers have reacted adequately to avoid further turbulence.

Even so, the better-than-expected activity readings for the final quarter of last year were no reason for too much optimism after closer inspection, as there were clear signs of a deterioration in European and US domestic demand. But more recent economic indicators suggest this weakness has not gained traction, and even faded a bit in the first few months of 2023. Surveys of supply chain managers (PMIs) indicate business activity has reversed its downward path

Figure 2 Business activity surveys - composite PMIs
Index, 50 = no change



Source: Refinitiv, Triodos Investment Management

across the board since the end of last year, with all major economic regions back in expansionary territory (see figure 2). With no exception, this pickup in activity was predominantly the result of an improvement in the services sector, indicating that households are still willing and able to spend, and COVID-reopening effects are still into play. Consequently, household consumption has likely improved in the first quarter of 2023 in the aggregated advanced economies and especially in a re-opened China.

Savings
In the near-term, the prospects for the global economy remain closely tied to household consumption. Therefore, household savings patterns and developments in household real disposable income remain key. So far, household savings rates across advanced economies have only come close to their pre-pandemic levels, except for the US, where the below-average savings rate indicates that households have started to dip into their excess savings. But even in the US, a considerable part of the excess savings has not been used yet. For the time being, we do not expect consumer confidence to deteriorate drastically, which is why we expect a further modest easing of savings rates in the regions that have not fallen below pre-pandemic levels. In the US, we expect the savings rate to return to its long-term average only gradually. Some support for consumption from savings thus remains, although most of it has played out by now.

Household income
Real household disposable income across the major advanced economies has held up better than expected, mostly on the back of ongoing strong employment growth and sizeable fiscal support. However, going forward, we project US real disposable income growth to stall, as employment growth and (later) wage growth are set to slow. We expect that eurozone real household disposable income will return to growth again in the second half of 2023, although it will remain below pre-pandemic levels until end of next year. UK disposable income will likely struggle even more in the remainder of the year due to elevated inflation, while disposable income in Japan should gradually improve as headline inflation is coming down.

Combined, these projected developments in savings rates and real household disposable income imply modest growth support from consumption in the next few quarters, certainly when the reopening of China is also considered. This support will gradually fade, but it should be sufficient to prevent an abrupt slowdown or contraction in global consumption.

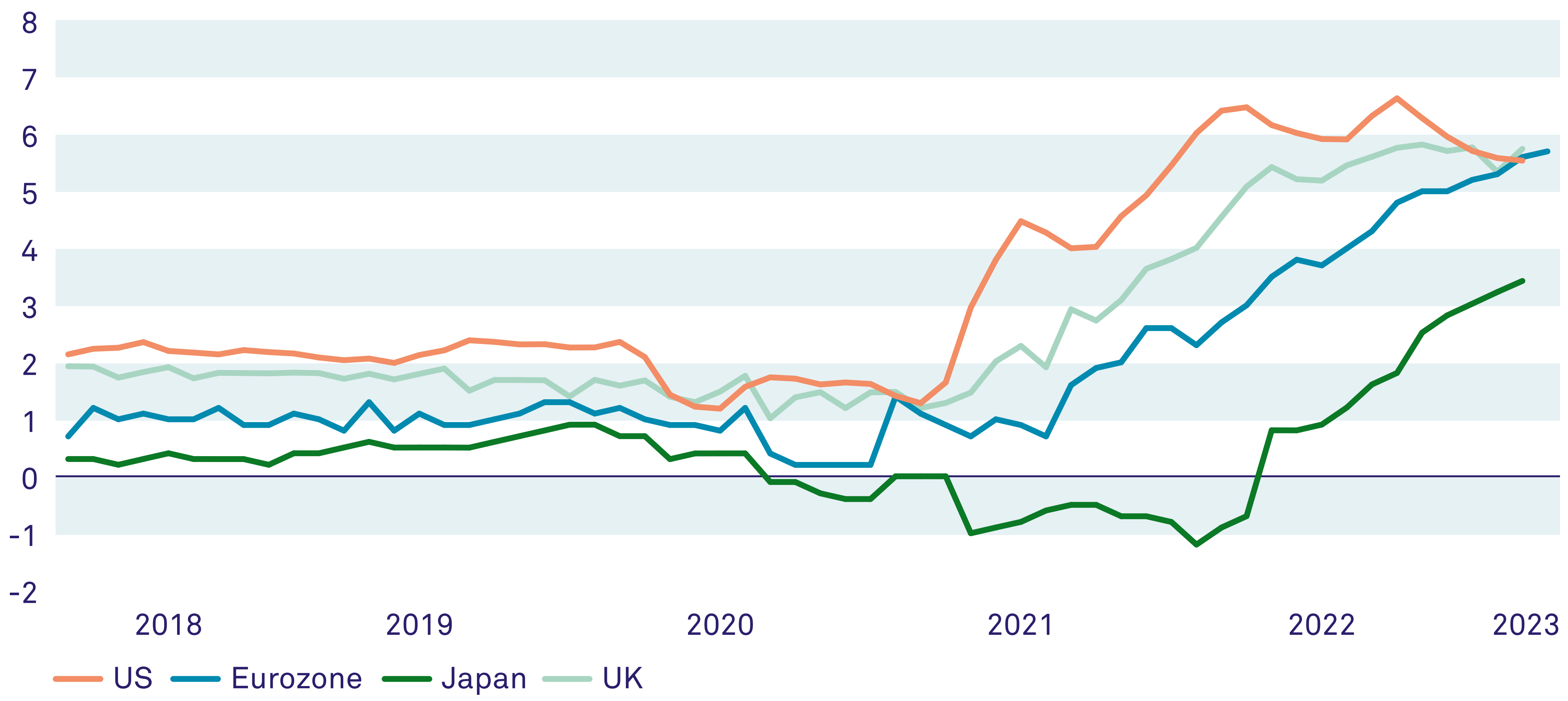
Inflation - What goes up must come down

Of course, robust household (services) spending makes it less likely for global core inflationary pressures to quickly abate. This is precisely what the latest inflation readings indicate. Headline inflation in the major advanced economies, which has driven last year's global price rises, is easing. But this has mostly been the result of falling energy prices. Food inflation has remained firm, although it should ease when the earlier rise in energy prices has worked its way through the food system. However, most concerning for central bankers is the fact that core inflation, i.e., inflation stripped from the volatile energy and food components, has barely eased (US and UK) or continued to rise (eurozone and Japan; see figure 3). Core inflation is much harder to get rid of, as it is more closely related to wage growth and could potentially set in motion a wage-price spiral.

Core services inflation will be crucial going forward, as easing global supply chain pressures and a spending shift from goods to services have taken some pressure off goods inflation. Stubborn core services inflation could lead to a wage-price spiral, as the tight labour market in combination with robust services demand could (continue to) feed into services sector wage growth. In that respect, recent wage dynamics continue to point to persistent core inflationary pressures, as wage growth is still accelerating in Europe and Japan, while the softening in average hourly earnings in the US is only partly confirmed by other wage growth trackers. But since inflation expectations have remained anchored, we don't expect a full-blown prolonged wage-price spiral. Nevertheless, current wage dynamics make it unlikely for headline inflation to decline to the 2% central bank target by year end.

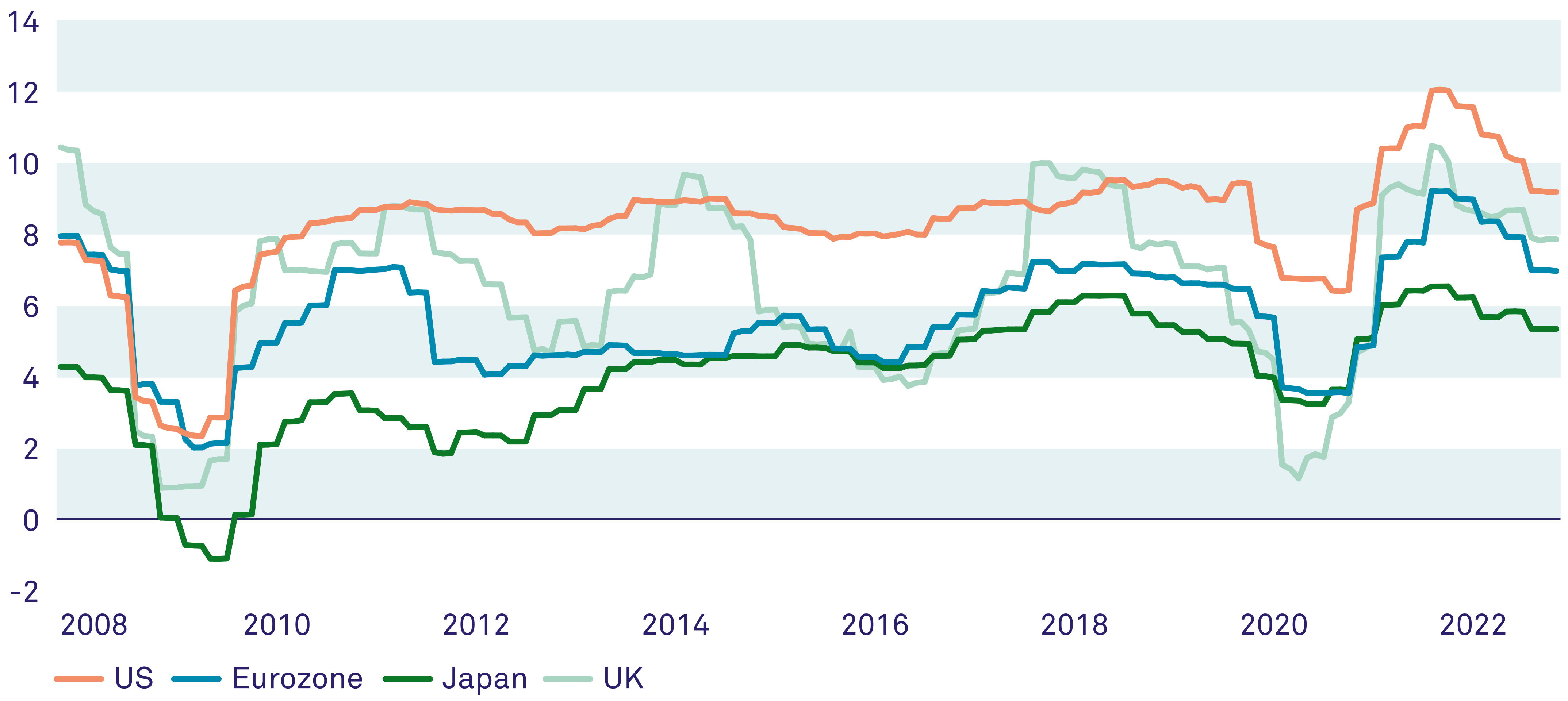
Still, we expect headline inflation to come down significantly across advanced economies as the year proceeds, in line with the recent fall in headline inflation across advanced economies (with UK inflation so far being the notable exception). This is predicated on our assumption that energy prices will remain broadly stable at current levels, as the reopening effects of China will be largely offset by slowing consumption and investment in advanced economies. Wage growth should also moderate once corporate net profit margins fall below their long-run average levels. Profit margins have already come down, but only from highly elevated levels (see figure 4). Corporate labour hoarding has so far prevented the fall in margins to lead to job losses, as the pandemic has shown employers how difficult it can be to find new employees. But as margins fall further, at some point this is bound to result in cost cutting, which would reduce vacancies and eventually increase unemployment rates.

Figure 3 Core inflation
Twelve-month % changes



Source: Refinitiv, Triodos Investment Management

Figure 4 Net profit margins
%



Source: Refinitiv, Triodos Investment Management

Interest rates - Brace for delayed effects of monetary tightening

Over the last few months, we have upwardly revised our forecasts for policy rates, as central bankers made it perfectly clear that containing inflation was the only thing on their mind and that their decisions would be predominantly based on the incoming data. With the better-than-expected activity readings and continued elevated core inflation, this implied more aggressive tightening. However, we continued to count on financial stability concerns becoming part of the debate sooner or later, as monetary policy usually works with a lag and requires forward-looking decisions. Therefore, our rate projections have consistently been lower than the markets'. The recent banking sector stress has indeed brought financial stability concerns back on the table and has made our rate forecasts for the Fed (5.00%-5.25%) and ECB (3.50%) more likely. Going forward, central bankers will have to face the policy trilemma of inflation, economic activity, and financial stability, in which we deem the latter to ultimately prove decisive for policy decisions.

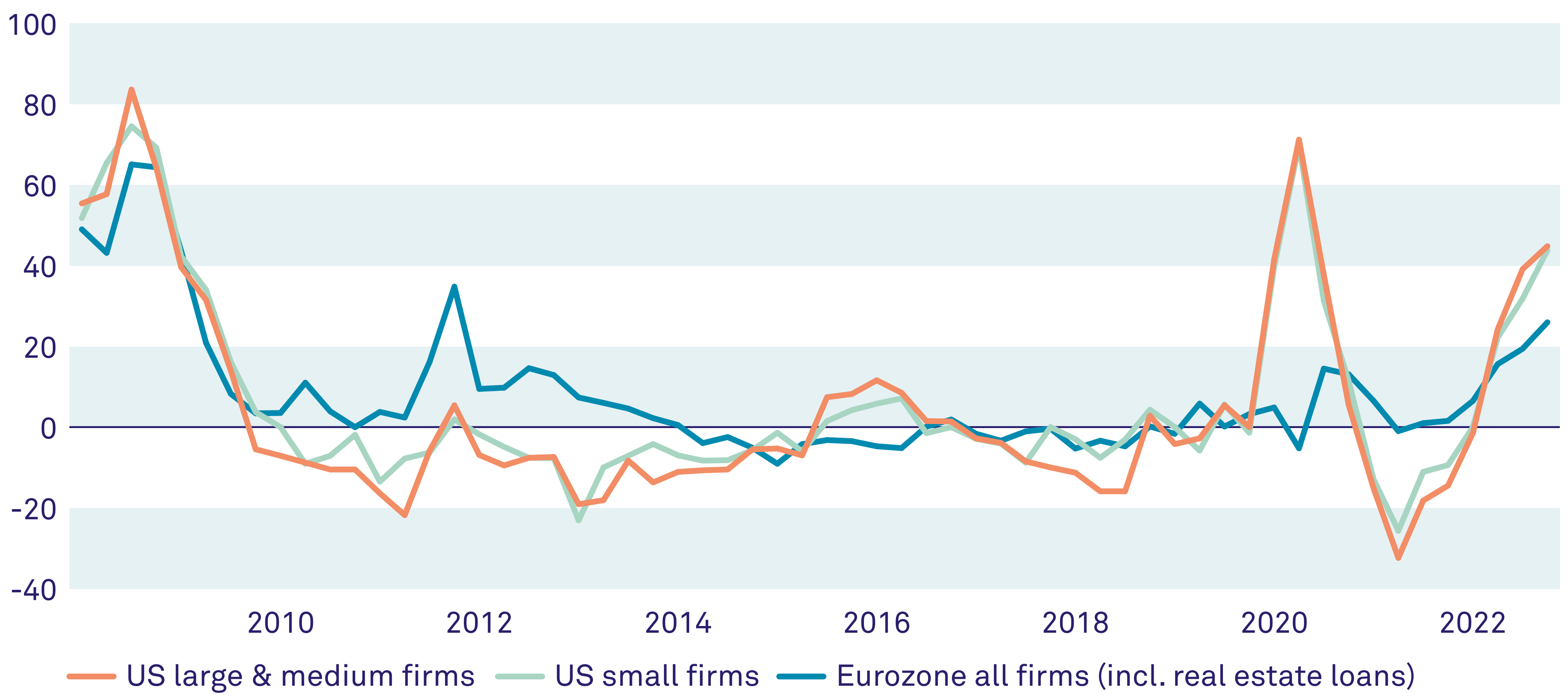
With respect to the Federal Reserve, markets have completely reversed course because of the recent banking stress and are now pricing in a series of rate cuts starting as early as June. As it stands, we deem this unlikely, as central bankers have a variety of tools at their disposal to prevent contagion without having to turn to policy interest rate cuts. For now, we still expect a rate hike pause in Q2 (central bankers taking into account financial stability and economic activity), after which we assume policy rates will be left untouched for the remainder of the year because headline inflation will remain above 3% in the US, the eurozone and the UK.

Tightened credit conditions

Even without a banking crisis, the recent stress will likely accelerate the significant tightening of bank lending standards that was already set in motion before the stress emerged (as indicated by the most

Figure 5 Bank lending surveys

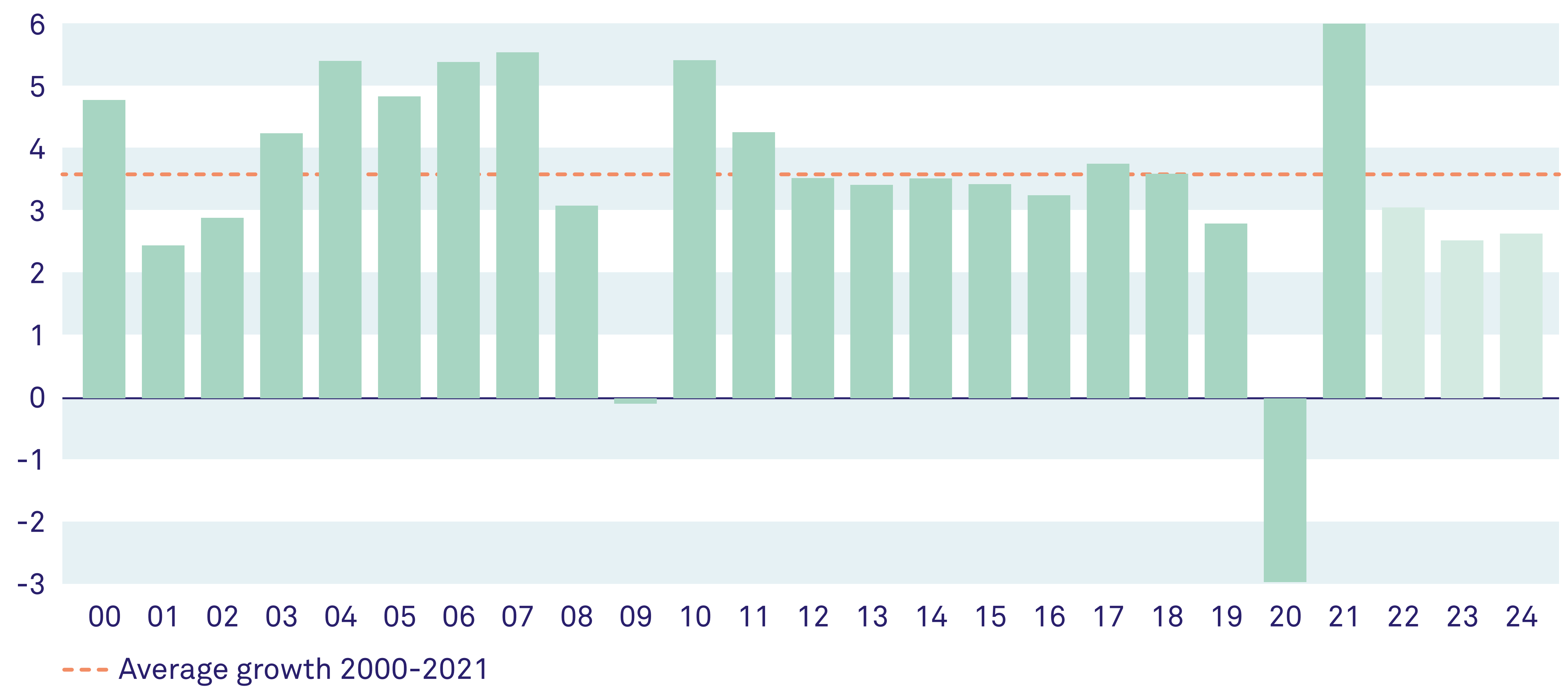
Net % of respondents tightening standards to commercial and industrial loans



Source: Refinitiv, Triodos Investment Management

Figure 6 Global annual real GDP growth

%



Source: NiGEM, Triodos Investment Management recent bank lending surveys that refer to the situation at the end of 2022; see figure 5). For households, this could affect their mortgage expenses and thus consumption in the near-term if mortgages are based on variable rates. However, fixed-rate mortgages are dominant in many countries, and households are on aggregate net creditors, meaning they should in theory benefit from rising rates. In practice this is often not the case, as wealth effects usually dominate. And as credit conditions tighten further, we expect the housing market to continue to cool as well. This likely means a modest overall drag for household consumption in the near-term coming from tightened credit conditions.

More importantly, the housing market cooldown will continue to hamper real estate investment. And on top of that, we expect business investment to turn into the main driver of the global slowdown as the year proceeds, as the rapidly tightened credit conditions will significantly increase the (re)financing costs for corporates, impacting profitability and thereby putting the brakes on capital expenditure.

Gradual investment-driven global slowdown
Concluding, global economic activity is set for a gradual slowdown (see figure 6). Only slowly fading consumption strength and regional divergence mean a global recession will be avoided. But the effects of monetary tightening will become increasingly visible in business investment across the major advanced economies, driving global activity growth downward. In the US, we expect a contraction in business investment starting Q4, which should tip the US economy into a mild recession. We expect sluggish eurozone growth going forward, and an even more prolonged period of close to no growth in the UK. Japanese activity growth will slow going forward, while Chinese activity will remain firm in the first half of the year before normalising.

Heightened uncertainty warrants a neutral allocation stance

In our annual investment outlook for 2023, published late last year, we claimed that monetary policy would remain the dominant force driving financial markets. In a way, this is what we have seen in the first few months of the year. Initially, bond and equity markets performed well. This was partly the result of the surprisingly robust global economic activity and corporate earnings holding up relatively well. But it mostly had to do with investors adjusting their expectations towards lower policy rates and earlier rate cuts. But then, elevated inflation readings and hawkish central bank statements convinced investors policy interest rates would be ‘higher for longer’. This resulted in falling equity markets and rising bond yields. Now, with the recent banking sector stress again leading to expectations for dovish monetary policy, government bond yields have fallen sharply, while equity markets have been supported by lower rate expectations despite the overall risk-off sentiment.

Neutral equity allocation
Going forward, deteriorating macroeconomic fundamentals should result in slowing corporate earnings growth. The recent banking sector stress has made ongoing volatility more likely, and a further tightening of lending standards will add to the difficulties faced by companies. That said, we still believe that the rate hike pauses of the major central banks and eventual forward guidance hinting at lower rates early in 2024 will overshadow the weakening fundamentals. But a scenario of fading stress and ongoing elevated inflation forcing central banks to remain hawkish is still a clear downside risk. Therefore, with uncertainty high, we deem it wise to stick to our neutral allocation stance for the time being.

Neutral in bonds
Financial stability considerations have always been the main reason for us to suspect that the sharp rise in eurozone government bond 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 the Southern member states and the German Bund. The eurozone will also be faced with meagre growth. Therefore, we expected longer-term yields to gradually move somewhat lower in 2023, reflecting disappointing growth, the rate hike pause and eventually a forward guidance towards rate cuts. The reduction of the ECB balance sheet would only partly offset this downward push in the longer end of the curve. We therefore took a long duration position. Now, with the recent stress making a very hawkish ECB less likely, we deem it wise to stick to our long duration call. Nevertheless, the heightened uncertainty and possibility for corporate financial difficulties further down the road, potentially triggering a rise in downgrades, makes us cautious when it comes to bonds. We therefore maintain our neutral allocation stance and prefer high quality names.

Real GDP growth (%)

	2022	2023	2024
Global	2.9	2.5	2.6
US	2.1	1.6	0.4
Eurozone	3.5	0.7	1.2
UK	4.0	-0.4	0.8
Japan	1.0	1.4	0.9
China	3.0	5.2	5.6
India	6.8	5.5	5.9

Source: NiGEM, Triodos Investment Management

Disclaimer

About Triodos Investment Management

With over 25 years of experience as a globally active impact investor, and as a wholly owned subsidiary of Triodos Bank, Triodos Investment Management has developed deep sector-specific insights across Energy & Climate, Inclusive Finance, Sustainable Food & Agriculture, and Impact Equities and Bonds. Offering impact solutions through private equity, debt, and listed equities and bonds, our assets under management amounted to EUR 5.5 billion as per 31 December 2022.

Investing in positive change

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