The Economy at Time of Anxiety

Overview of the current economic & financial environment

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Orcadia AM

Euro Graph webinar
The 27th of June, 2023

Introduction

Major concerns

- War
- Trade tensions
- Inflation
- Purchasing power
- Interest rates
- Climate and biodiversity
- Social cohesion

Introduction

Not completely new

⇒ **last Fall, "the worst was yet to come"**

WORLD ECONOMY

IMF cuts global growth forecast for next year, warns 'the worst is yet to come'

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October 2022

Seemed to have been too gloomy

BUT pessimism is back !

Introduction

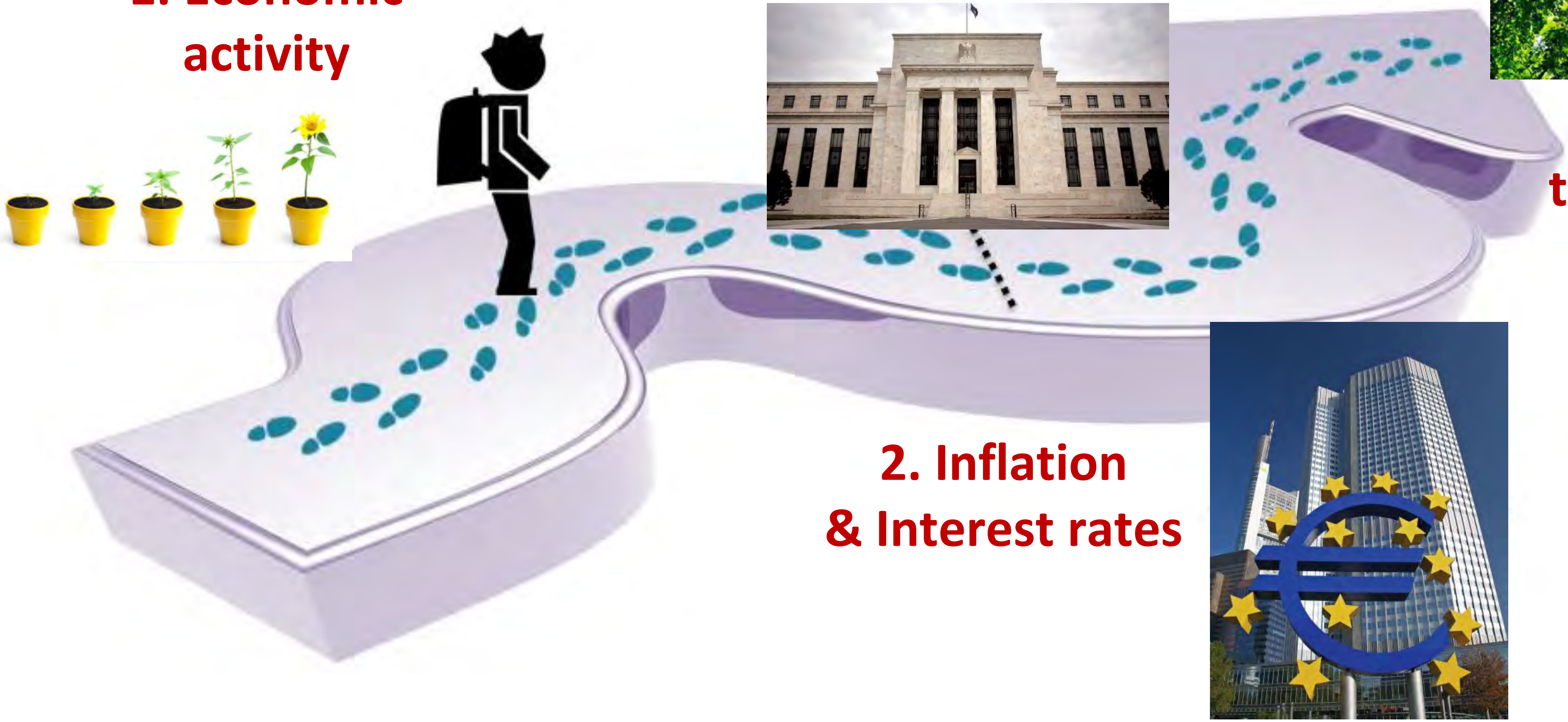
Pessimism at the sector level

European Graphic Paper Statistics

Mar 2023 / Mar 2022	**% change**
Total European Shipments	**-28%**
to Europe	**-30%**
to outside Europe	**-20%**
Total European Demand	**-27%**

Source : Euro Graph, https://www.euro-graph.org/ (June 26, 2023)

Content



1. Economic activity

3. Medium-term outlook

2. Inflation & Interest rates

1. Economic activity

Economic activity

Warning #1 : we know we don't know !

- Economists are poor forecasters

- « *It depends* » (Dani Rodrik)

Federal Reserve Chair Jerome Powell admits 'we now understand better how little we understand about inflation'

Jerome Powell, FED, Sintra, June 2022

Nevertheless, what can be said ?

Economic activity

Pessimism in Germany

German recession will be sharper than expected: Ifo

Reuters

June 21, 2023 11:40 AM GMT+2 · Updated 5 days ago

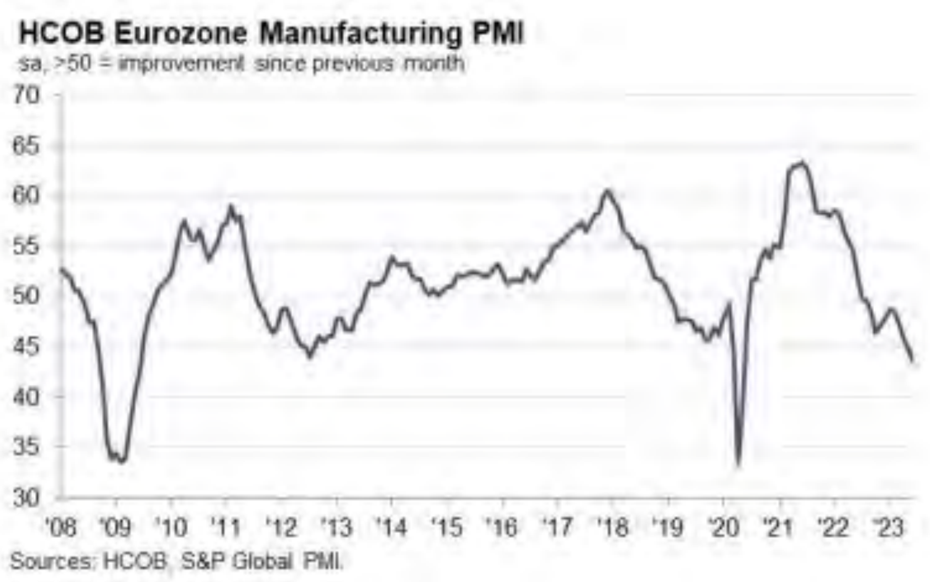
ifo Economic Forecast Summer 2023: German Economy to Shrink by 0.4 Percent in 2023

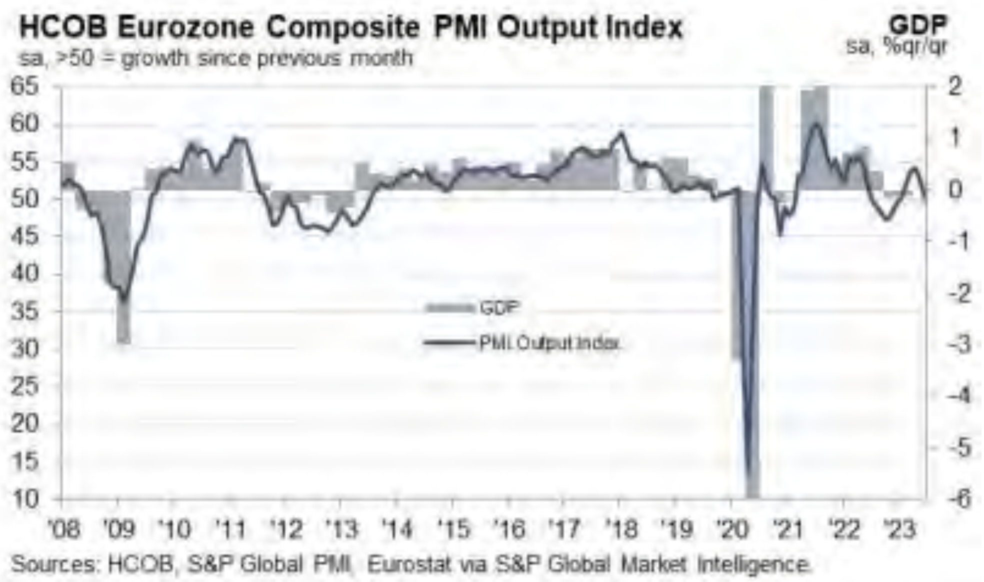
Source IFO & Reuters, https://www.reuters.com/markets/europe/german-recession-will-be-sharper-than-expected-ifo-2023-06-21/

Economic activity

Pessimism at the aggregate manufacturing level

HCOB Flash Eurozone Manufacturing PMI(3) at 43.6 (May: 44.8). 37-month low.





Source : HCOB Flash Eurozone PMI, June 23, 2023

Economic activity

Downwards revision, but still with divergence between services and manufacturing

Eurozone business output growth came close to stalling in June, according to the latest HCOB flash PMI survey data produced by S&P Global, pointing to renewed weakness in the economy after the brief growth revival recorded in the spring. Inflows of new orders fell for the first time since January, employment growth slowed and future output expectations also deteriorated. More encouragingly, the slowdown was accompanied by a marked cooling of inflationary pressures. Input costs rose at the slowest rate since December 2020 and average selling prices for goods and services rose at the weakest rate since March 2021.

HCOB Flash Eurozone Composite PMI Output Index[1] at 50.3 (May: 52.8). 5-month low.

HCOB Flash Eurozone Services PMI Business Activity Index[2] at 52.4 (May: 55.1). 5-month low.

HCOB Flash Eurozone Manufacturing PMI Output Index[4] at 44.6 (May: 46.4). 8-month low.

HCOB Flash Eurozone Manufacturing PMI[3] at 43.6 (May: 44.8). 37-month low.

Source : HCOB Flash Eurozone PMI, June 23, 2023

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Economic activity

USA : Up … but less so

S&P Global Flash US Composite PMI™

US economic upturn slows in June as dependence on services grows

S&P Global Flash US PMI Composite Output Index

Flash US PMI Composite Output Index(1) at 53.0 (May: 54.3). 3-month low.

Flash US Services Business Activity Index(2) at 54.1 (May: 54.9). 2-month low.

Flash US Manufacturing Output Index(4) at 46.9 (May: 51.0). 5-month low.

Flash US Manufacturing PMI(3) at 46.3 (May: 48.4). 6-month low.

Source:https://www.pmi.spglobal.com/Public/Home/PressRelease/6e8efbfbddde43f29eb12c5193939625 June 23, 2023

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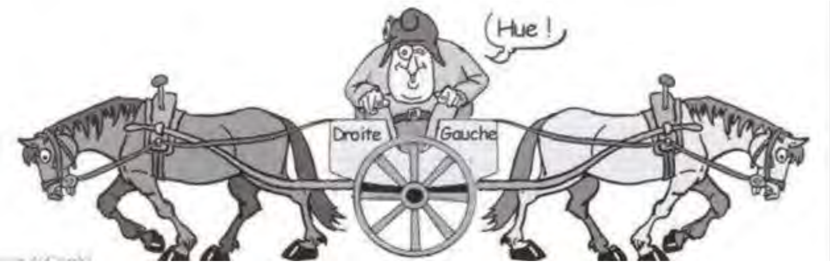
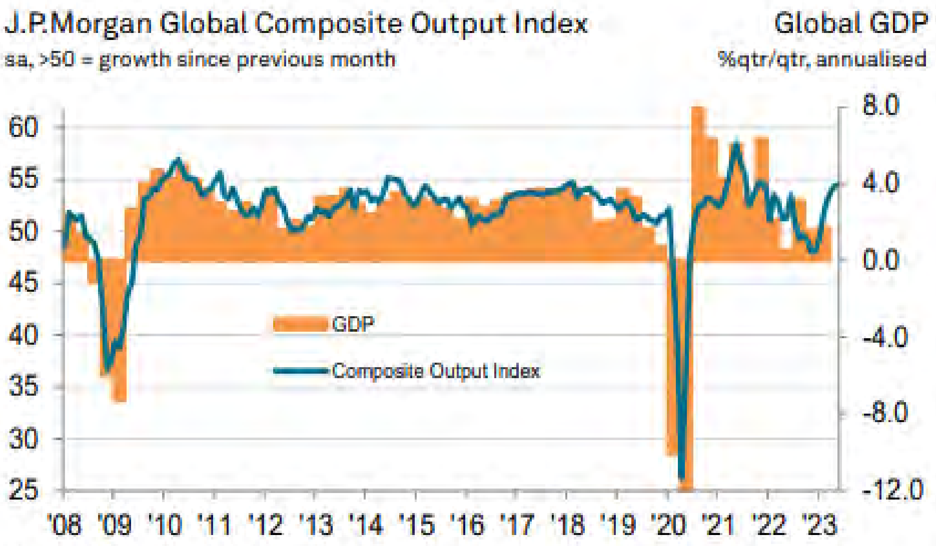
Economic activity

"It depends" illustrated



J.P.Morgan Global Composite PMI™

Growth of global economic activity at 18-month high as service sector upturn remains solid



Source: J.P.Morgan, S&P Global.

Key findings

Global Composite Output Index rises to 54.4

Output growth strengthens in manufacturing and services

Price pressures ease further

May saw the rate of expansion in global economic activity accelerate to a one-and-a-half year high, largely driven by the continued vibrancy of the services sector. Companies reported a further upswing in new order intakes, leading to continued business optimism and solid job creation.

Source:https://www.pmi.spglobal.com/Public/Home/PressRelease/f8065982371144b1926f6539595ddae7 June 5, 2023

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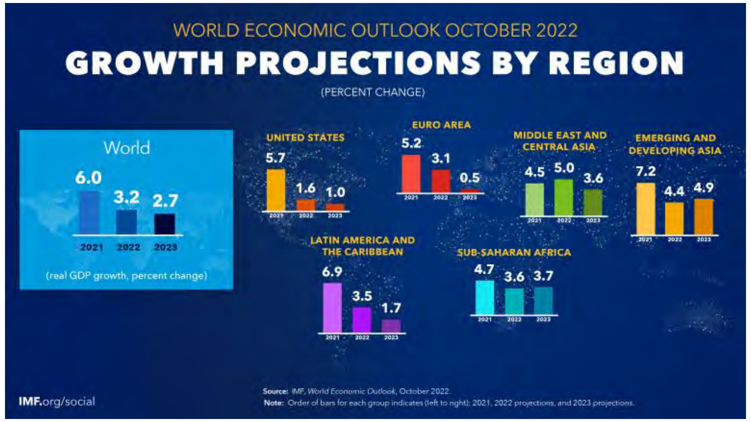
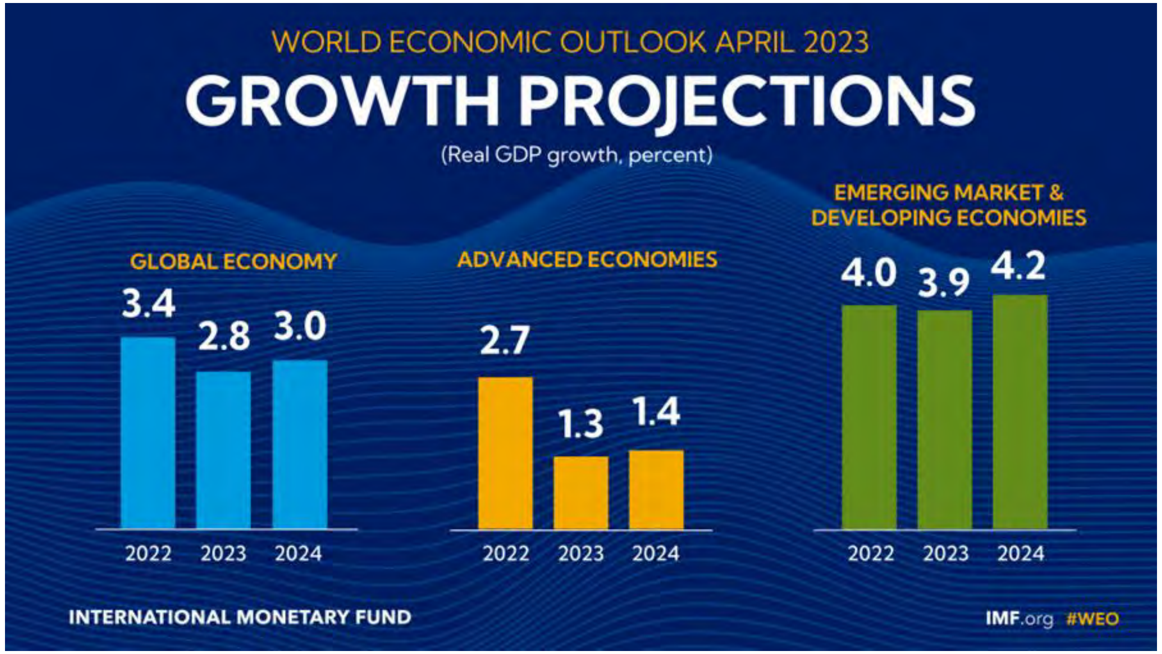
Economic activity

Forecasts : changing fast to stay the same





Source : IMF, October 2022, January 2023, April 2023

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Economic activity

Plenty of imminent threats

- War escalation
- Trade tensions
- Inflation => ↘purchasing power
- Uncertainty => ↘capital expenditure
- Monetary tightening
  - Central banks … with usually a 1-2 year delay
  - Commercial banks (lending standards)
- Financial instability
- Nationalism
- Negative wealth effect
- …

”(…) the impact of monetary policy tended to be felt with a lag on the real economy, of as much as 1-2 years” (JPMorgan, 20 Feb 2023)

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Economic activity

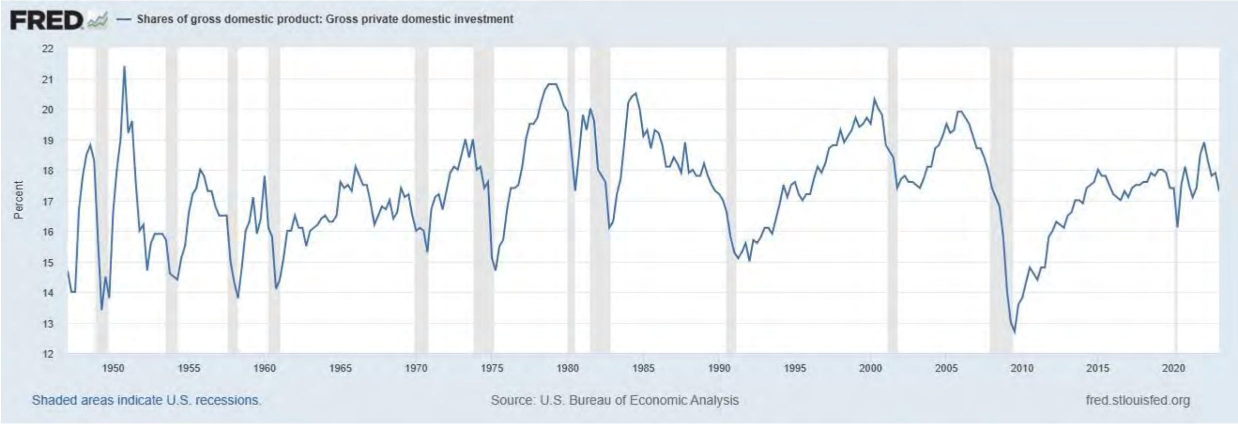
At the entrance to Hell

Economic activity

… but so far corporations do hire and do invest

United States

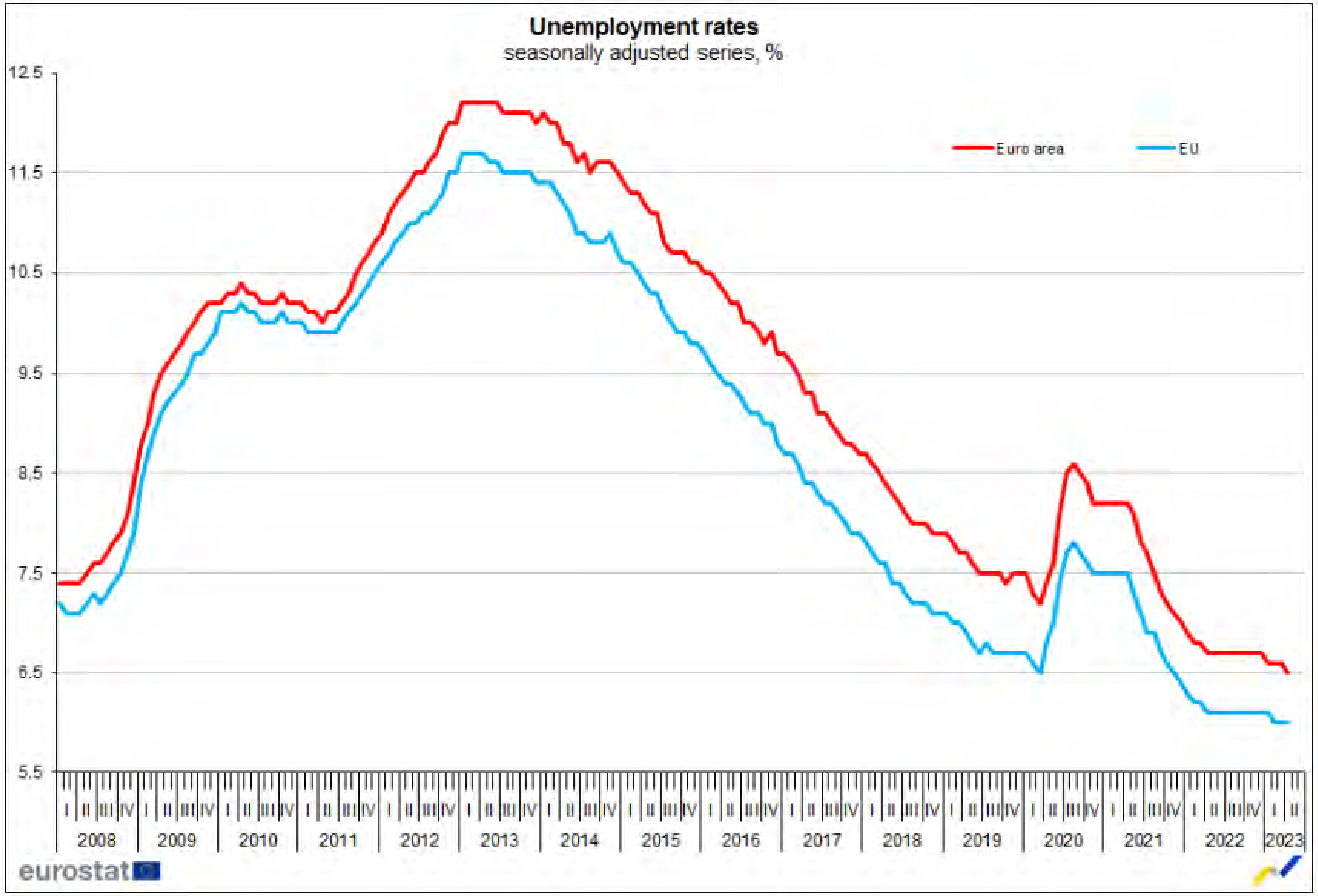
Source: Federal Reserve of Saint-Louis
https://fred.stlouisfed.org/series/LMJVTTUVUSM647S#



Source: Federal Reserve of Saint-Louis
https://fred.stlouisfed.org/series/A006RE1Q156NBEA#

Economic activity

… and unemployment rates are rather low



Source : Eurostat
https://ec.europa.eu/eurostat/documents/2995521/16863929/3-01062023-BP-EN.pdf/f94b2ddc-320b-7c79-5996-7ded045e327e#:~:text=The%20EU%20unemployment%20rate%20was,office%20of%20the%20European%20Union.

Economic activity

… and housing markets are less fragile than in 2008

- Impact of more regulation
- Less of an excess supply
  - inventories are in line
  - Increasing interest rates => lenders are “stuck” / no portability of low fixed rate mortgage contracts
- Low vacancy rates
- Stronger financial position of households

Economic activity

***"When the facts change, I change my mind. What do you do, sir?"* (Keynes or Samuelson)**

… but don't be too versatile

Yesterday's supports are still largely at play

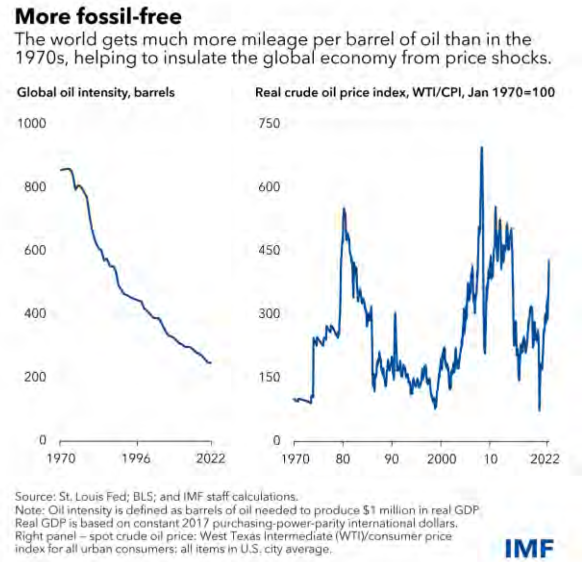
- Private consumption
  - Savings ratio
  - Labor market, with labor hoarding
- Corporations
  - Technology
  - Environmental transition
- Public outlays
  - Low real interest rates (no dogmatism from neither governments nor central banks)
  - Transition
  - Fear of social tensions
  - China : means available to support the economy

Economic activity

***“Stagflation is back”* ? “Comparaison n’est pas raison”**

Mind the difference

• Lower growth + higher inflation	YES
• **Back to the 70s ?**	**NO**
* inflation then	much higher
* inflation anchoring then	absent
* unemployment then	much higher and rising
* oil to GDP ratio then	much higher
* automatic wage indexation then	much more frequent
* trade unionization then	much stronger



Source : Nico Valckx, Lower Oil Reliance Insulates World From 1970s-Style Crude Shock, IMF Blog, May 2022

Economic activity

So so

- A below trend growth in Europe, with possibly a slight recession
- By-product :
  - some convergence, with Germany hit harder
  - less pressure on wages
- Partly for good reasons :
  - some normalization of interest rates (but inverted yield curve)
  - … providing room for easing in case of …
- Partly for not sustainable reasons
  - Fiscal imbalances

2. Inflation and interest rates

Inflation

From Japanese deflation fears to inflation (1/2)

- Covid / supply chain disruptions
- Energy / Russia

AND ALSO

- Less disinflation from trade
  - Higher unit labor cost in emerging countries
  - Less trade / friend-shoring
  - markets no longer emerging / higher wages
- Labor markets
  - Demographics
  - *"Great resignation"*
  - Low productivity gains
  - Mismatch supply/demand
- ./..

Inflation

From Japanese deflation fears to inflation (2/2)

- Changing consumption patterns
  - With asymmetry : |price change| where demand goes up >> |price change |where demand goes down
- Delayed impact of excess money supply ???
- Lack of competition / “Greedflation” / higher margins

7 minute read · March 2, 2023 1:32 PM GMT+1 · Last Updated a month ago

ECB confronts a cold reality: companies are cashing in on inflation

By Francesco Canepa

Source:: Reuters
https://www.reuters.com/markets/europe/ecb-confronts-cold-reality-companies-are-cashing-inflation-2023-03-02/?utm_source=piano&utm_medium=email&utm_campaign=18699&pnespid=7at4UCVLN6Ybh.PSozC1Sp6O5An.CMMsP.iw2_BoqB1mq94Vm3ys2pEAEUN2PS9e1FZGw1cf.g

income distribution between workers and firms. Workers have so far borne the brunt of the “Putin tax”, suffering a large loss of real income while, on balance, firms’ mark-ups remained stable or even increased in some sectors.[14]

Source: Fabio Panetta (Member of the Executive Board of the ECB), Monetary policy after the energy shock, Speech, Feb 16, 2023
https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230216~a297a41feb.en.html

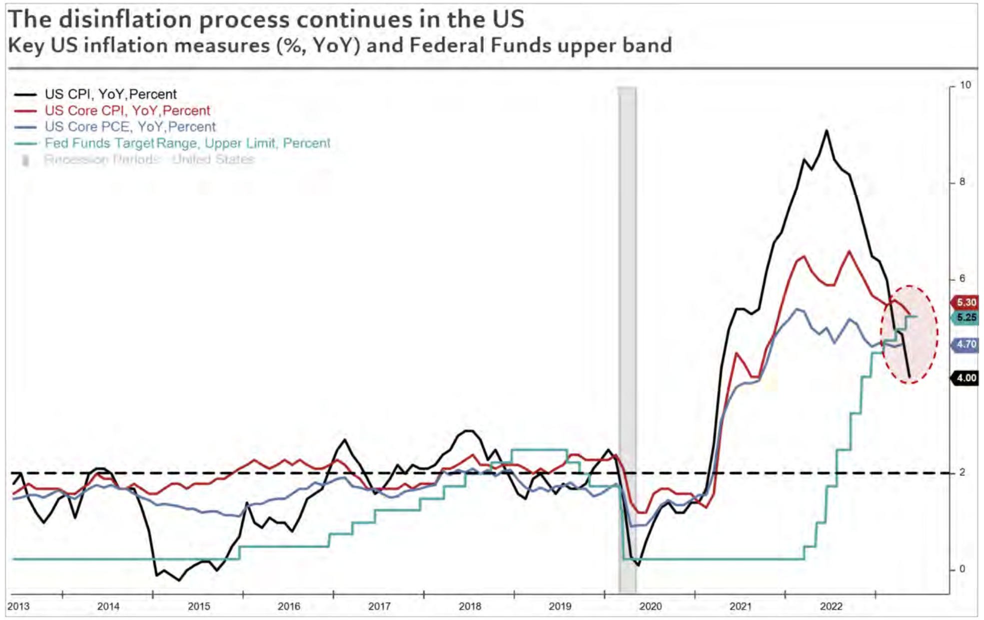
Inflation

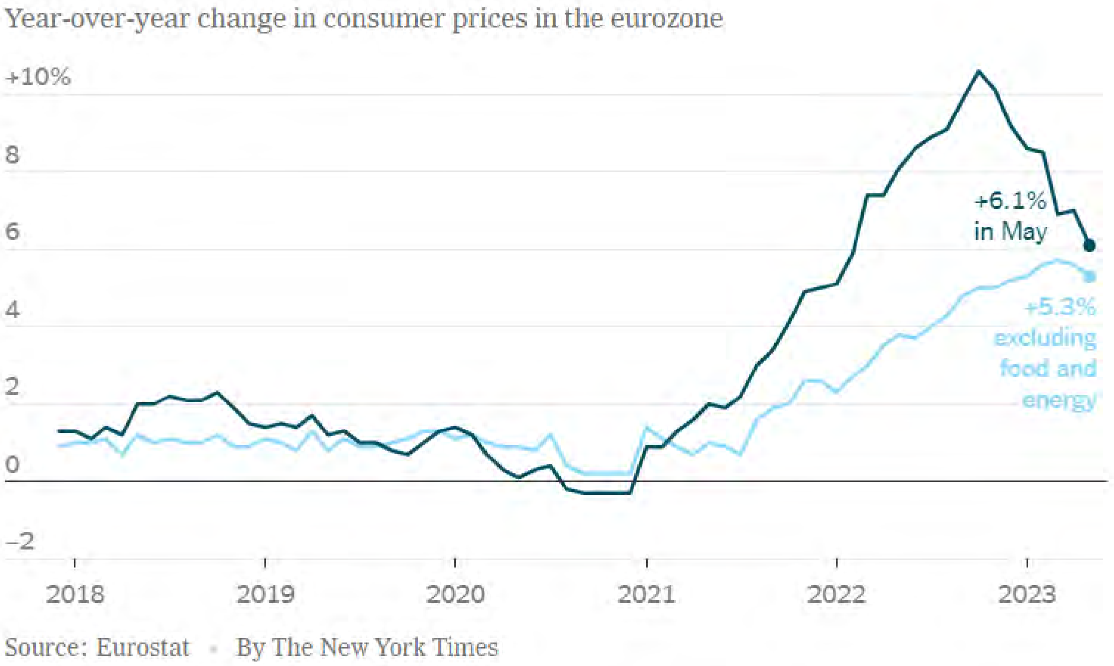
A reversal ? Mind your mind !

Be careful!

Inflation

Declining inflation, especially in the US





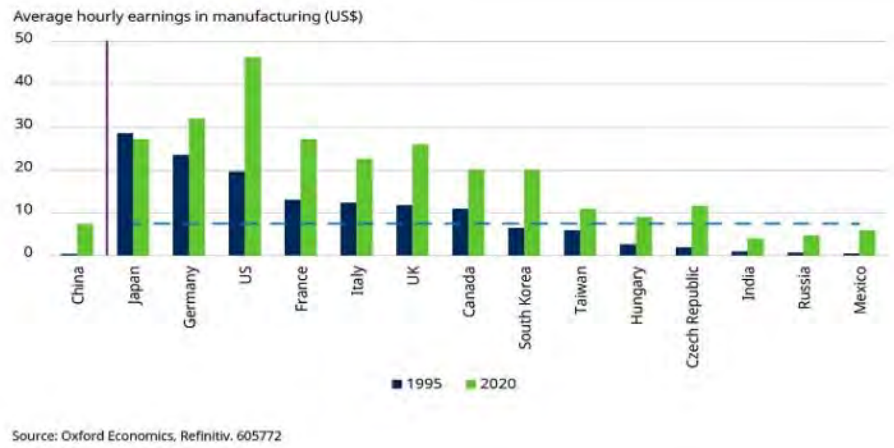
Euro area inflation rate (%), selected aggregates

	Weights (‰)	Annual rate						
	2023	May 22	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23	May 23
All-items HICP	**1000.0**	**8.1**	**9.2**	**8.6**	**8.5**	**6.9**	**7.0**	**6.1**
All-items excluding:								
> energy	897.7	4.6	7.2	7.3	7.8	7.9	7.4	**7.0**
> energy, unprocessed food	852.7	4.4	6.9	7.1	7.4	7.5	7.3	**6.9**

Source : Pictet, June 14, 2023; Eurostat; New York Times
https://www.nytimes.com/2023/06/01/business/eurozone-inflation-may.html

Inflation

Back to « business as usual » ?



Source : Schroder, Is China about to become a source of global inflation?, Sept 1, 2022

Arguments :

- Self-correcting mechanism : with ↗ price, ↗ supply AND ↘ demand
- Declining prices (oil, other commodities, freight, …)
- Bottlenecks are vanishing
- Competition from low wage countries far from being over
- Technology
  - Teleworking => increased competition between workers
  - Increased productivity
- Room for lower corporate margins (revival of competition rules ?)
- Commitment of central banks
- Credibility of central banks still intact

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Inflation

Central banks : poor record, strong credibility

- Inflation first not announced …
- … then seen as temporary

⇒ Major blow

BUT

- Real rates still close to zero, or below 0%
- Limited spread widening
- Markets do follow central banks' guidance

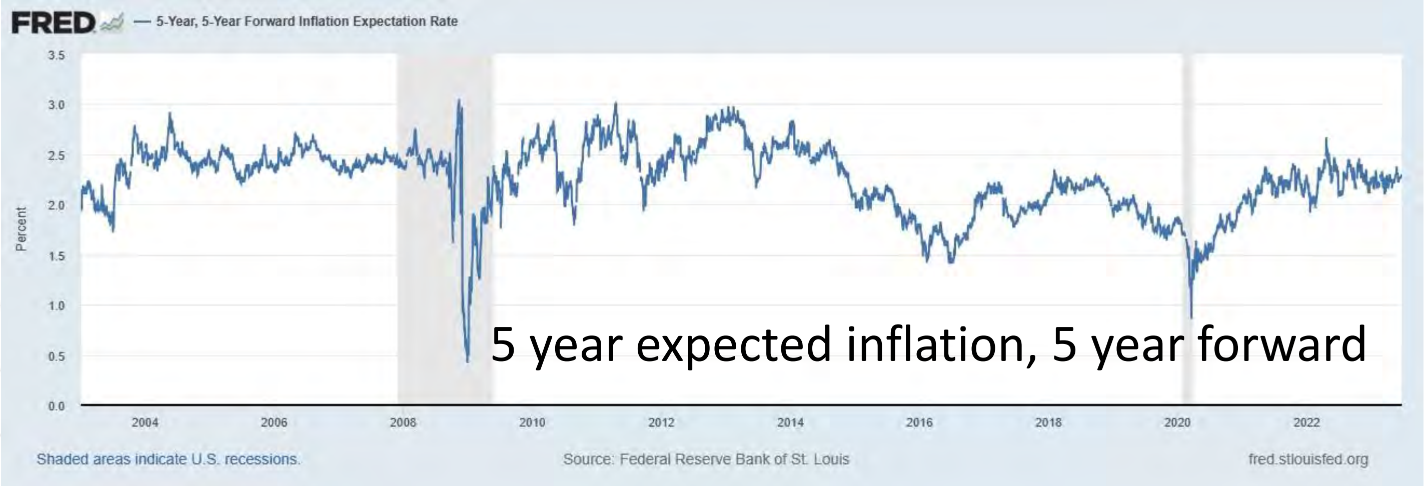
⇒ *Don't fight the Fed*, more than never !

Inflation

Markets do not expect a new inflation regime

United States

Source: Federal Reserve Bank of Cleveland calculations based on data from Blue Chip, Bloomberg, Bureau of Labor Statistics, Federal Reserve Bank of Philadelphia, Federal Reserve Board, Haver Analytics, and the model of Haubrich, Pennacchi, and Ritchken, 2012. "Inflation Expectations, Real Rates, and Risk Premia: Evidence from Inflation Swaps." Review of Financial Studies, 25(5).

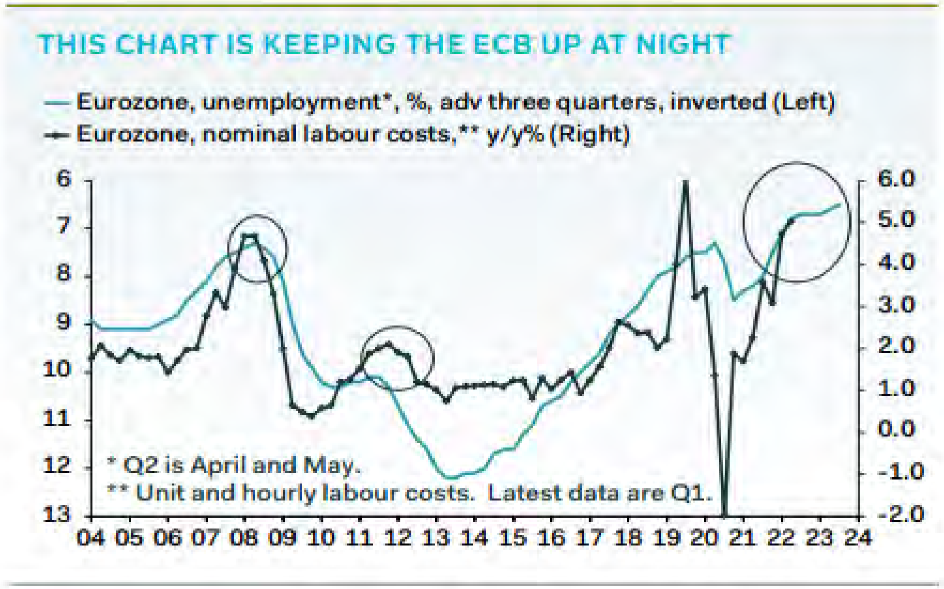


Source : Federal Reserve Bank of Clrveland
https://www.clevelandfed.org/en/our-research/indicators-and-data/inflation-expectations.aspx

Source : FRED
https://fred.stlouisfed.org/series/T5YIFR#

Inflation

A wage-price spiral ? "Too early to say" (Zhou Enlai, 1972)



Source : FRED, https://fred.stlouisfed.org/series/PRS85006111#

Source : Pantheon Macroeconomics, June 26, 2023

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Inflation

It's wise to allow for a slightly higher trend inflation

Arguments :

- Environment
  - Higher taxes, more cumbersome regulation
  - Switch in demand patterns, with asymmetric price effect
  - Lower crop yield, lower labor productivity
  - More expensive insurance premiums

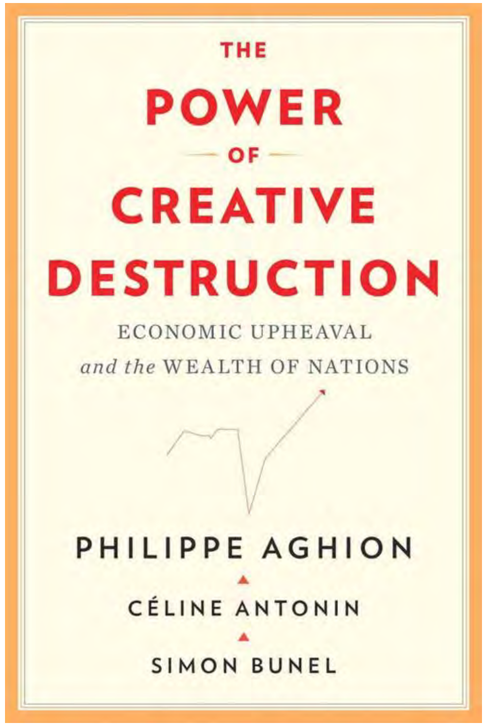
- Increasing production costs
  - Demographics (see Goodhart & Pradhan, 2020)
  - Less disinflation from globalization (nationalism, risk diversification, border tax adjustment, …)
  - End of wage compression

- Economic policy
  - Some higher inflation is desirable ! (see next slide)

Référence détaillée : C.A.E. Goodhart1 and Manoj Pradhan, The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival, SUERF, SUERF Policy Note, Issue No 197, October 2020
https://www.suerf.org/docx/f_fa99ccdbea597263a88f27075bd6eb49_17385_suerf.pdf

Inflation

Inflation, my friend … "Economists against the people" ?



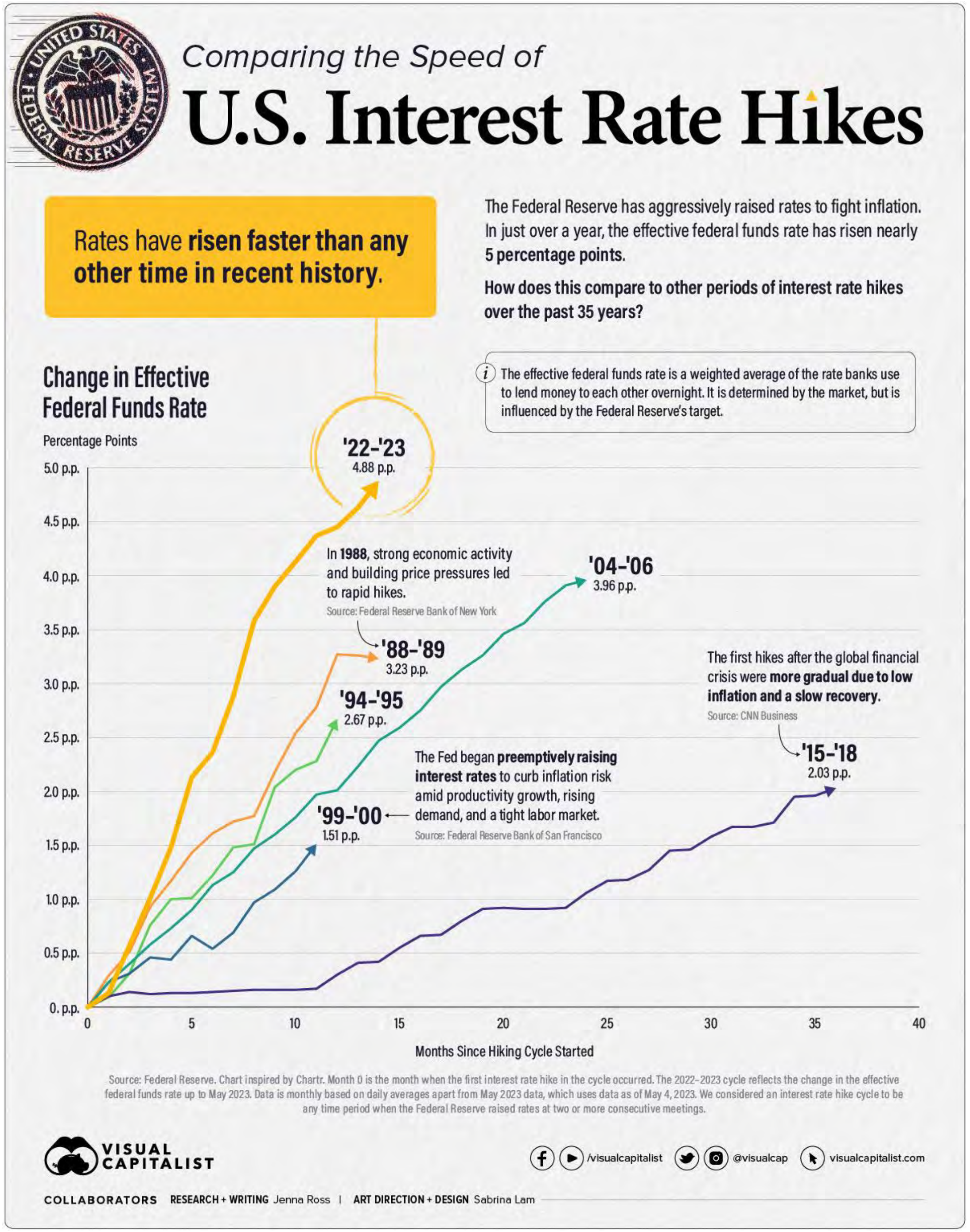
- **Cons**
  - Losers and winners, with adverse social impact
  - Uncertainty => less activity / higher risk premium
- **Pros**
  - Good for indebted authorities … and therefore for macroeconomic & financial stability
  - Penalty on cautious savings => higher consumption and/or more risk-taking
  - Creative destruction; **reallocation of resources** (labor & demand for goods) ; higher productivity
  - Away from the « *zero lower bound* » limit / good for monetary policy
  - Push for anti-trust policies

"How I learnt to stop worrying about public debt and inflation"

Martin Sandbu, Financial Times, Sept 22, 2022

Further reading : Agarwal & Kimball, How Costly Is Inflation ? IMF, March 2022

Interest rates

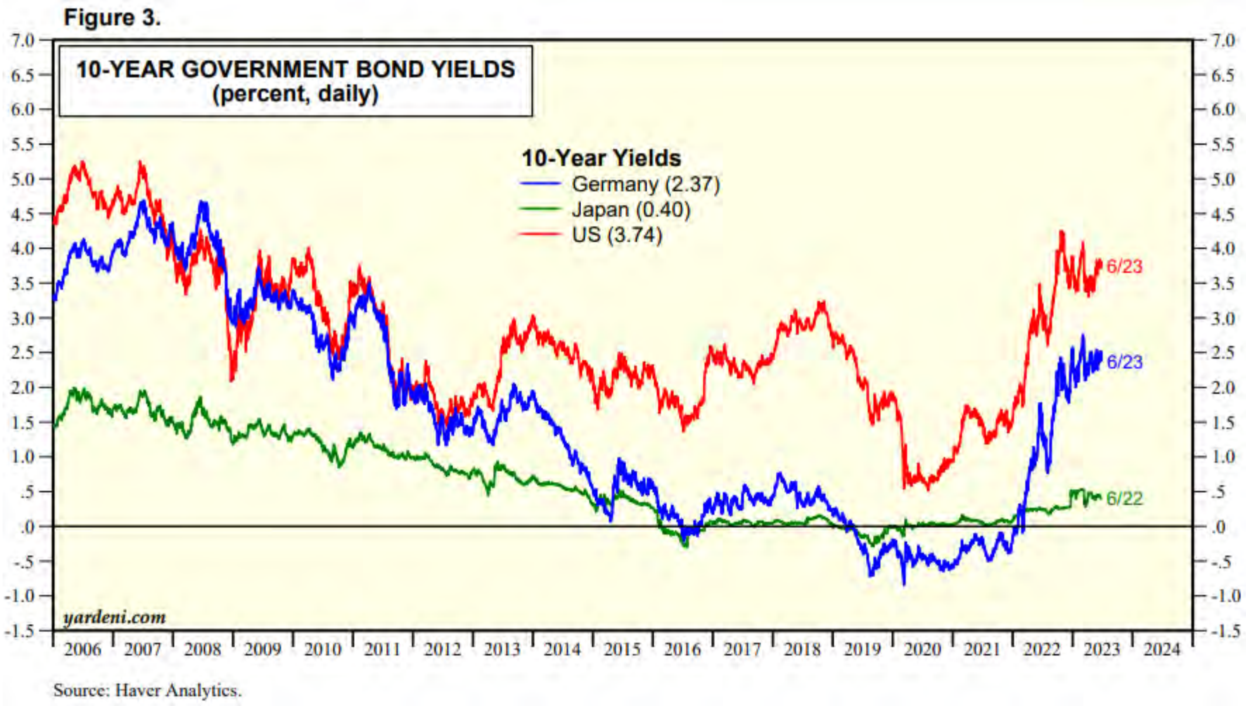


Interest rates

From "Low for long" to "Lower for longer", and "There is no alternative (TINA)"

… to "Higher, Faster, Longer" ?

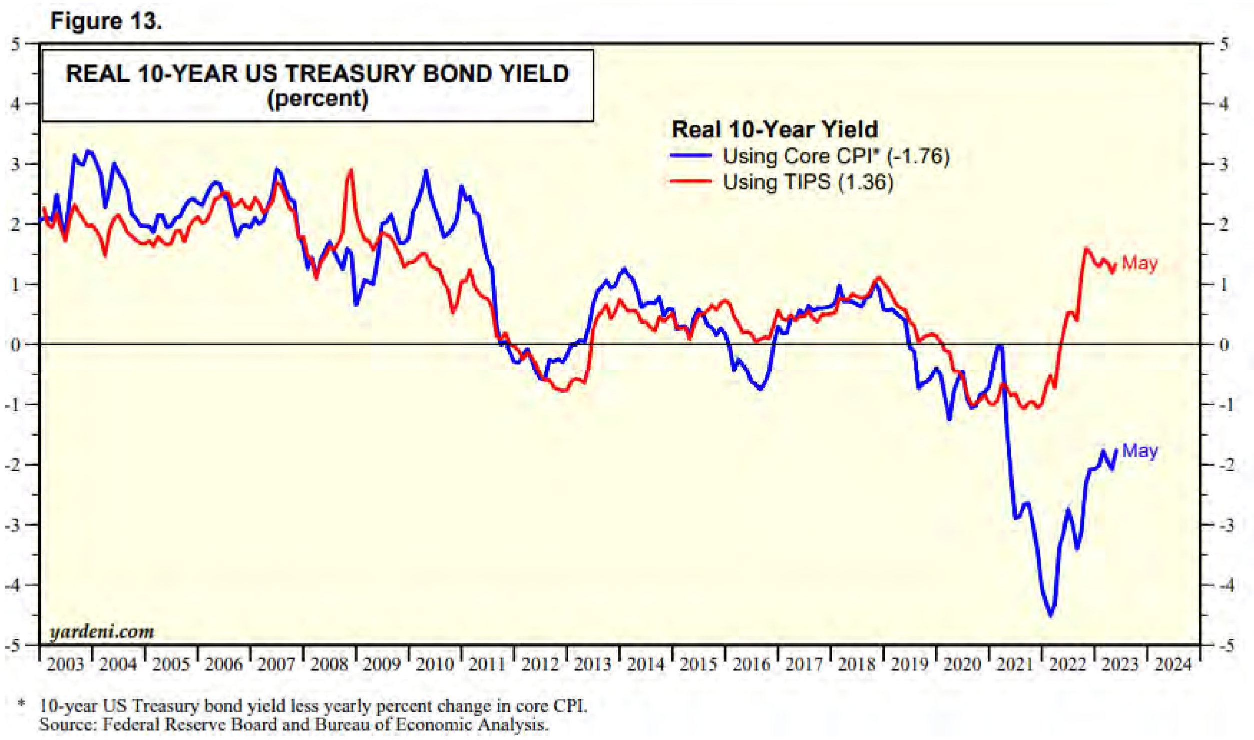
… without forgetting that the starting point was (too) low



Source : Yardeni Research, Global Interest Rates
https://www.yardeni.com/pub/glir.pdf

Interest rates

Real interest rates are still moderate (US), or even abnormally low (Japan)



Source : Yardeni Research, Global Interest Rates
https://www.yardeni.com/pub/nomrealyield.pdf

Source : Les Cahiers Verts, 5 juin 2023

Interest rates

Interest rates : Most of the rise behind us

- Inflation has peaked
- Inflation rate expectations remain well anchored
- That it hurts (economic activity, flexible mortgage, …) will prevent zealous tightening
- No bubble having to be deflated
- *"Necessity knows no law"*
  - States : heavily indebted
    + ageing
    + social discontent
    + financing of the transition (regulations & taxes are way too unpopular)
  - Financial stability requirement (within the Euro Area; financial sector as public sector creditor)

+ Higher rates not efficient to fight against supply-driven inflation (see next slide)

Interest rates

Higher rates, unfitted to fight against supply-driven inflation

- Higher rates against demand-driven inflation, YES
- … but in Europe to a large extent inflation is supply-driven
  - Labor supply shortages
  - Changes in consumption patterns / mismatches
  - Environmental transition
  - Lack of competition

⇒ Tools to be considered

- LOWER rates in order to boost capex (to ↗productivity, to finance transition capex, and to offset declining labor supply) …
- Active labor market policies
- Competition rules, against « *pricing power* »
- Regulation against speculation (on commodities, in particular)
- State regulation (price setting for some sectors, like energy, …)

3. Medium-term corporate outlook

Growth

Low growth in sight ?

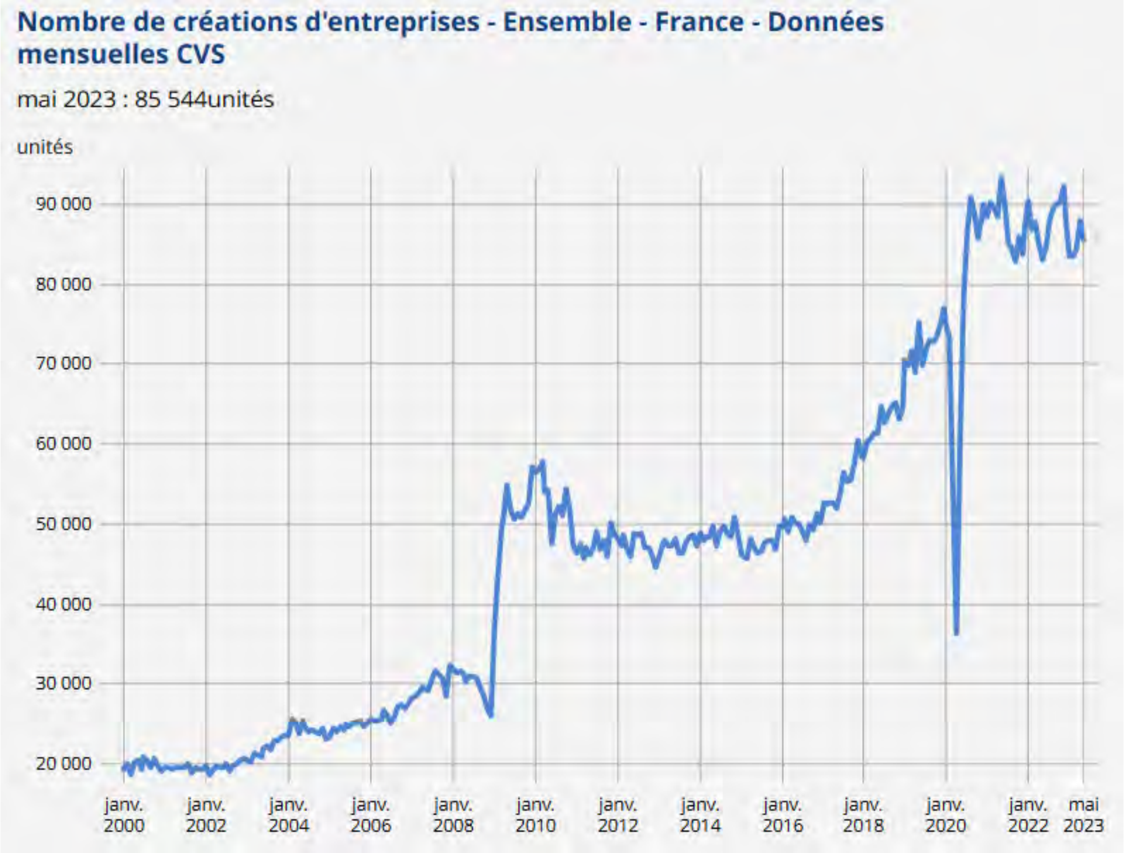
- Demographics
- Uncertainty => less capex
- Negative impact of climate
  - Crop yields
  - Human productivity
  - Disruptions (infrastructure out of order, …)
  - Eco-anxiety
  - Higher taxes/more regulations
- Social tensions & mental health

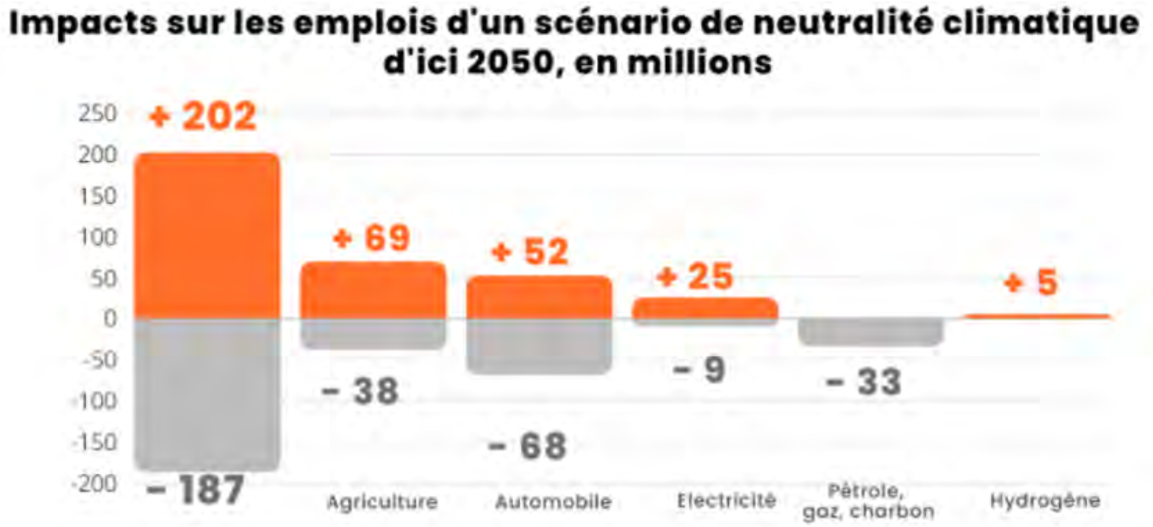
Not so sure !

- End of productivity paradox ("computers everywhere but" …)
- Teleworking => ↗productivity
- Inflation => creative destruction
- More competition => more innovation
- Climate => migration
- Transition => capex, public investments and jobs required

Growth

Entrepreneurship, jobs, and sustainability





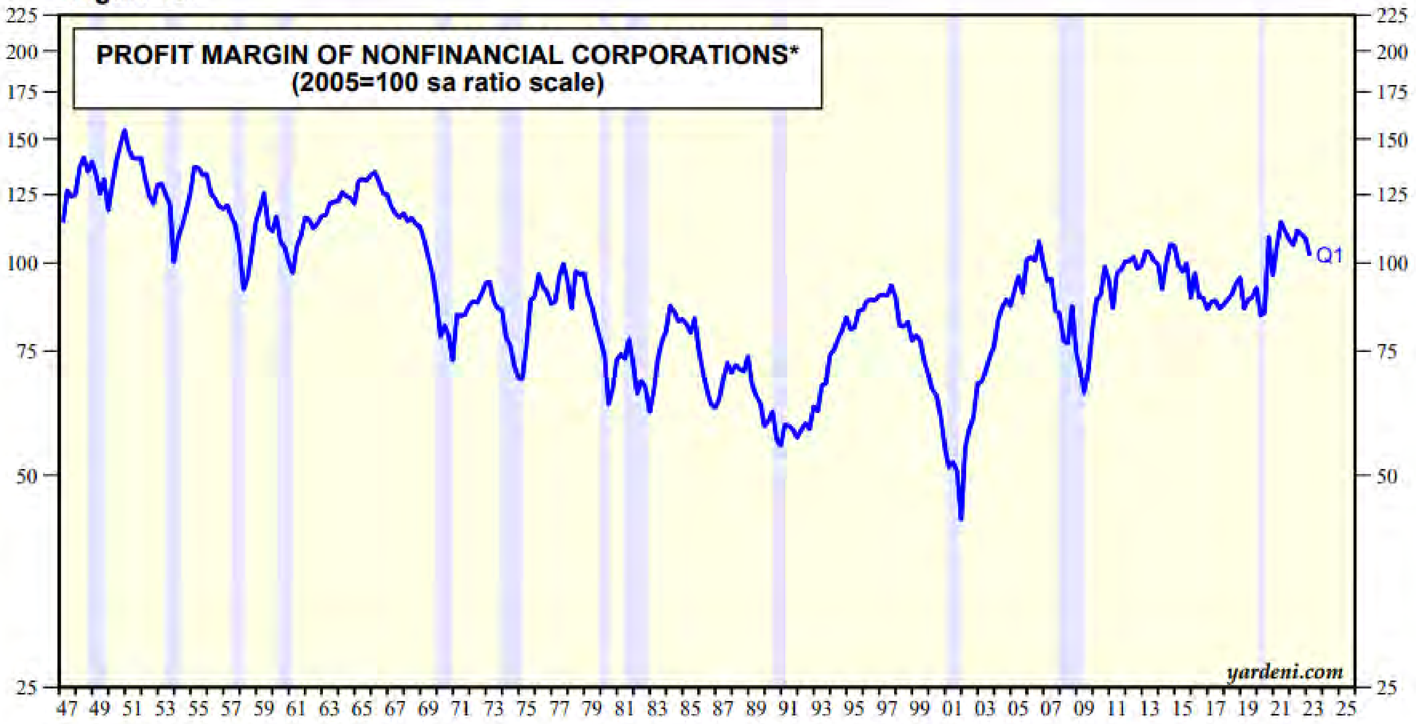
Source : Novethic, Rapport du GIEC : Agir pour le climat ne coûte pas si cher, on vous explique pourquoi en une infographie, 6 avril 2022

Source : INSEE
https://www.insee.fr/fr/statistiques/serie/010755538#Graphique

Corporate profitability

High margins

Figure 12.



Note: Shaded areas denote recessions according to the National Bureau of Economic Research.
* Profits divided by nominal output (real output x implicit price deflator.
Source: Bureau of Labor Statistics.

Source: Yardeni Research, Corporate Finance Briefing, June 21, 2023
https://www.yardeni.com/pub/sp500marginnipa.pdf

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Corporate profitability

Potential threats but …

• Inflation ?	NO, both revenues and costs do increase with inflation
• Lower activity ?	YES, but short-lived
• Higher real wages ?	IF it happens, not a bad macro news
• More competition ?	IF it happens, not a bad macro news
• More environmental regulations ?	Desirable (sustainability requirement)
• Higher taxes on (large) corporations ?	Desirable (level playing field + social cohesion)
• Higher interest rates ?	Desirable (normalization)

⇒ Convergence of interests (win-win)

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Conclusion

A crash ahead ?

The Unavoidable Crash

Dec 2, 2022 | **NOURIEL ROUBINI**

After years of ultra-loose fiscal, monetary, and credit policies and the onset of major negative supply shocks, stagflationary pressures are now putting the squeeze on a massive mountain of public- and private-sector debt. The mother of all economic crises looms, and there will be little that policymakers can do about it.

NEW YORK – The world economy is lurching toward an unprecedented confluence of economic, financial, and debt crises, following the explosion of deficits, borrowing, and leverage in recent decades.

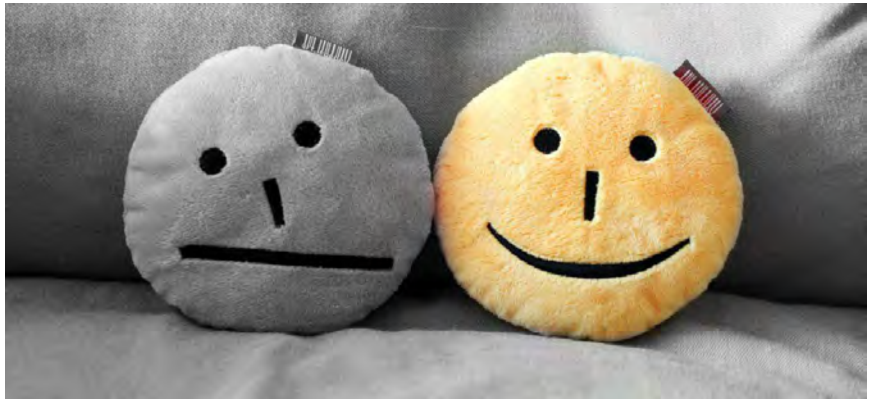
Source : Project Syndicate, Dec 2, 2022

“As soon as there is life there is danger.” (Ralph Waldo Emerson)

Dangers were around (war, trade tensions, environment, interest rates, social unrest, …)

The difference is now a higher degree of awareness

Bad news are sometimes not that bad



- Bad news that are not new
  - Russia (cf. Crimea)
  - China/Taiwan
  - Environmental concerns (Club of Rome 50 years ago !)

- Bad news that do vanish
  - Covid, and a “tsunami of bankruptcies”
  - Worldwide food crisis due to missing grains from Ukraine

- Good news
  - Wake up call in terms of global warming & national security
  - Weakness of Russia
  - Democracies are not that inefficient (zero Covid policy in China …)
  - European integration (anti-fragmentation program)
  - Inflation Reduction Act in the US

Problems are the normality

Crisis ? What crisis ?

• 2008 – 2009	Great Financial crisis
• 2010 – 2012+	EU Sovereign debt crisis
• 2015 – 2016	Migration crisis
• 2020 – 2021	Sanitary crisis

Main lessons :

- Procrastination – *“to kick the can down the road”*
- Pragmatism – *“so far, so good”*

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Conclusion

To sum up

- 2023 a year to forget **AND** 2023 a year on the way to healing
- Uncertainty, yes, … but *“as usual”*
- A recession to be envisaged, but of limited extent
- Inflation to slow down but central banks will have to admit 2% is too low
- Real interest rates to remain subdued, no matter what

Conclusion

To sum up

Conclusion

To sum up

Thanks to H. Marks

Warning

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Past performance is not indicative of future results.

The primary risk of investing is a loss of capital that may be permanent and that may be complete.

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