Economic Update
NBK Economic Research Department I 13 December 2021

International Scene

Omicron risk, China slowdown threaten to knock momentum from global recovery

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Highlights

- **Worries over the Omicron virus strain, restrictions in Europe and slower growth in China have threatened to knock some momentum from the global economic recovery, hitting both equity markets and oil prices recently.**
- **US GDP growth slowed to 2.1% in 3Q21 but should accelerate in Q4 amid signs that the labor market recovery is solid. With inflation at a 39-year high of 6.8%, the Fed may announce a faster tapering of its QE program in December.**
- **A fading reopening boom and range of recent virus-linked restrictions could slow Eurozone growth to below 1% q/q in Q4. But inflation is high at 4.9% and a softening of the ECB's resistance to early rate hikes looks possible.**

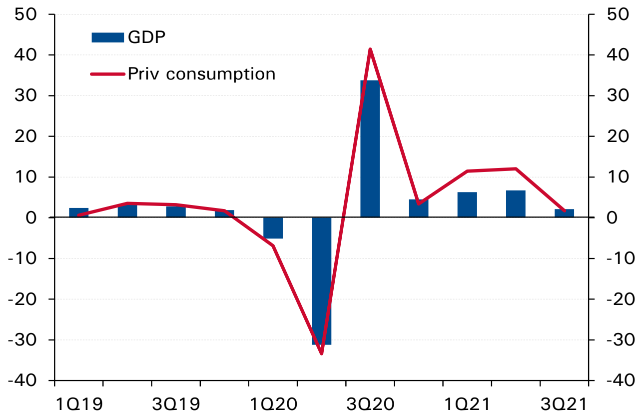
A combination of worries over the emergence of the Omicron virus strain, increasing virus-related restriction measures across Europe and slower growth in China have threatened to knock some of the momentum from the global economic recovery of late. Key equity market indicies in the US, Europe and Japan all fell 3-5% in November, although remain up significantly year-to-date. At the same time, anxieties over rising inflation driven by strong demand, loose policy and supply bottlenecks have intensified (especially in the US and Europe). Indeed, for most major western central banks, high inflation has become the dominant concern and the US Fed in particular looks set to accelerate its policy tightening program imminently – that is unless the worst of the latest concerns about Omicron (and its potential impact on economic activity) materialize. Oil prices also dropped sharply in late November, from $80 to temporarily below $70, though have since partially recovered. OPEC+ opted to stick to its production increase schedule, despite expectations that it might pause given the risk of softer global oil demand.

Fed seen accelerating tapering despite headwinds

US economic growth slowed sharply in Q3 amid the ongoing supply chain shortages and the spread of the Delta variant. GDP growth for Q3 stood at an annualized 2.1% q/q, missing expectations and sharply lower than the 6.7% growth in Q2. (Chart 1.) Consumer confidence (as measured by the Conference Board's index) continued to weaken, falling to 109.5 in November, the lowest since February 2021, with high inflation the main culprit. Despite a relatively weak increase (210k) in non-farm payrolls in November, there are many indicators that the recovery in the labor market is solid: the unemployment rate dropped to 4.2% in November while labor participation increased to 61.8%, both at the best levels since the outbreak of the pandemic. In addition, new weekly jobless claims continued to trend downwards, averaging 208k for the past two readings, which is in line with the level seen just before the pandemic's impact was felt in the US. GDP is expected to grow by around 4% (annualized) in the final quarter of the year.

Chart 1: US GDP

(% q/q, annualized)



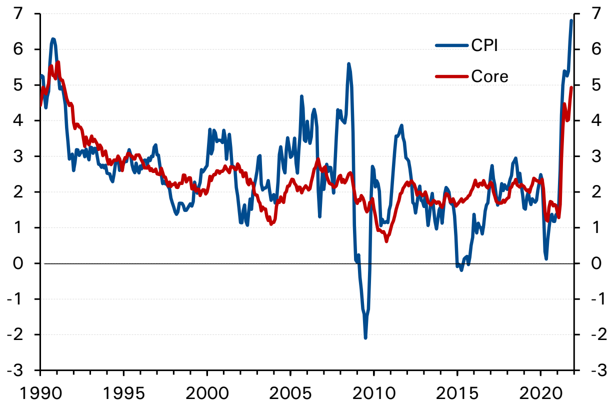
Source: Haver

While the Fed commenced the tapering of asset purchases in November at a rate of $15 billion per month, a decision on speeding up the pace of tapering may come in as early as the December 15 Fed meeting. A likely scenario is doubling the tapering amount to $30 billion a month and wrapping up purchases by March 2022. This will open the door for rate hikes to commence afterward, with two to three hikes plausible in 2022. This is predominantly given accelerating as well as broadening consumer price increases, with high inflation becoming the single most important metric dominating the economic/political discourse in the US. The CPI was up by 6.8%

y/y through November, while the core PCE (Fed's preferred inflation measure) increased by 4.1% in October, both at multi-year highs. (Chart 2.)

Chart 2: US Consumer price inflation

(% y/y)



Source: Haver

Meanwhile, Congress finally passed the $1 trillion infrastructure bill, unlocking funds to a wide range of areas including roads/bridges, railways, ports/airports and water/energy. In addition, the House passed President Biden's social safety and climate bill (Build Back Better Act) for a total value of $1.7 trillion, which is less than half the original target of $3.5 trillion. However, this bill will most likely be amended by the Senate given fierce opposition from Republicans and disagreements among Democrats. On another note, Congress passed a last-minute short-term funding bill that will keep the government running through February 18. Finally, Congress passed legislation clearing the way for the debt ceiling to be increased, which will carry the country until after the November 2022 midterm elections.

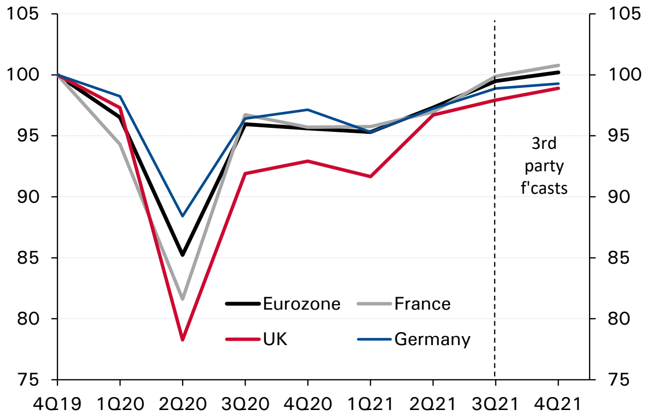
Covid surge triggers European growth slowdown worry

A surge in Covid infections across Europe through October and November – even in some countries with high vaccination rates – ushered in a new range of restrictions that is set to slow the economic recovery in 4Q21 and possibly beyond. This included tighter rules for unvaccinated people in Germany and an even harsher full lockdown in Austria. The economic impact of this wave is likely to be less severe than that associated with earlier ones, not least because vaccinations have lowered the risk of infections causing severe disease (and thus changing people's behavior) and firms and individuals are better adapted to restrictions than before. Still, governments look set to adopt a precautionary approach in terms of public health policy and with some health systems already under severe pressure, restrictions could even tighten if the Omicron variant turns out to be more infectious or deadly than earlier virus strains.

So far, signs of any negative impact on economic activity have been limited. The Eurozone composite PMI remained in solid growth territory at 55.4 in November and up from 54.2 in October; however, the survey's drop in business confidence suggests that the improvement could be short-lived as firms anticipate pandemic-related disruption to increase – potentially worsening supply chain issues. Similarly, the unemployment rate has continued to fall reaching 7.3% in October (versus a pandemic peak of 8.6% last year), but would likely capture a softening of economic conditions only with a lag. But overall, having picked-up to 2.1-2.2% q/q in both Q2 and Q3 2022, Eurozone economic growth is now set to slow to around 0.7% in Q4, with output only just exceeding pre-Covid levels and still far from its pre-pandemic path. (Chart 3.) Looking ahead, growth in 2022 is seen at around 4% versus 5.1% this year.

Chart 3: European GDP

(index, 4Q 2019=100)



Source: Haver / third parties

Although inflation in the Eurozone remains below that in the US, in November it reached the highest since the euro was formed in 1999 at 4.9% y/y, and the core rate rose to 2.6%. Despite some disagreement among officials, the European Central Bank has overall stuck to a relatively dovish (compared to the Fed) tone on inflation which it expects to fall next year and the latest growth worries may reinforce this view. However, the bank's inflation projections are likely to be revised up when it meets on December 16 and although interest rates will remain on hold (main deposit rate at -0.5%), some softening of its stance towards earlier rate hikes is possible. It will also need to announce its next step on asset purchases, with its current €1.85 trillion PEPP package set to expire in March and likely replaced by a new scheme. Uncertainties are considerable, but our base case would be a plan that allows for a tapering of purchases to zero by end-2022, with some flexibility to alter the schedule should economic conditions veer off course.

Meanwhile in the UK, the Bank of England surprised the markets by leaving interest rates on hold in November versus expectations of a 15 bps increase (from 0.1% to 0.25%). The hike could now come at the December 16 meeting instead, although given worries over Omicron even this move seems uncertain. UK inflation jumped to a 10-year high of 4.2% y/y in November driven by energy and fuel price rises and is forecast to peak as high as 6% next April. The economic recovery is proceeding at a decent pace (growth of 1.0% q/q expected in 4Q21 versus 1.3% in Q3) though lagging slightly behind that of the Eurozone in terms of its completeness. With the Omicron virus strain now present and spreading, the government in December announced new restrictions (including quarantine for international arrivals, vaccine passports for public events and work from home guidelines) that are a downside risk for activity in 1Q22. Aside from a potential rate hike, the central bank will also end its QE program this month and no extension is expected even if virus pressures moderately increase.

Japan's economy contracts in 3Q21

Japan's economy contracted by a more-than-expected 3.6% annualized rate in the third quarter (-0.9% q/q). The decline, which followed a gain of 2.0% in 2Q21, was caused by a combination of supply-chain disruptions and the state of emergency that was extended during the quarter to contain resurgent Covid-19. Fixed investment (-8.2%) and private consumption (-5.1%) were especially hard-hit. Economic growth has struggled to take off while the pandemic persists, forcing policymakers to maintain extensive fiscal and monetary support, including a new, record-breaking stimulus package worth ¥56 trillion ($490 billion) which Prime Minister Fumio Kishida unveiled in mid-November. Japan therefore bucked the global trend towards withdrawing pandemic-related support measures, and may see its finances put under further strain in consequence. That said, after a three-month slump, factory output rose in October, by 1.1% m/m, on the back of higher output of vehicles and factory equipment – a trend manufacturers expect to be sustained over the coming months. Moreover, in November, both the manufacturing and services PMIs were more firmly in expansion territory, at 54.5 and 53.0, respectively. For services this was the fastest pace of growth in 27 months. This should bode well for a GDP recovery in 4Q21.

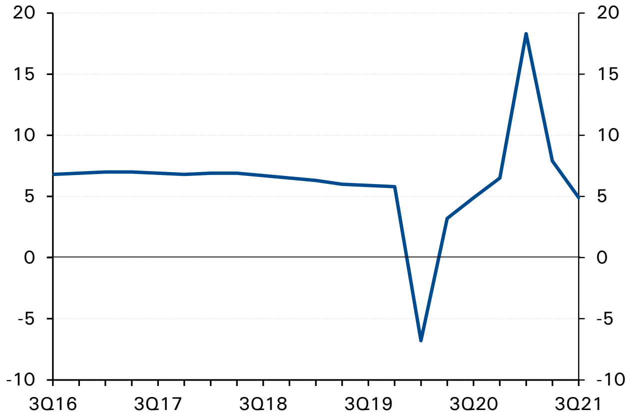
Chinese GDP growth slows in Q3 amid power shortages

China's GDP growth softened to 4.9% in 3Q21, easing from record rates set earlier in the year. (Chart 4.) The quarter was notable for serious energy shortages affecting businesses and industry, a property market slowdown that almost caused real estate giant Evergrande to default on its obligations, and repeated lockdowns imposed on cities across the country as China persevered with its zero tolerance policy towards Covid-19. The energy crunch was exacerbated by government restrictions on carbon emissions and coal usage, which along with soaring commodity prices more generally, pushed producer price inflation in October to its fastest rate since 1995 (+13.5% y/y). Inflation pass-through to consumers was substantially less – the CPI rose by only 1.5% y/y in comparison – suggesting that businesses had so far borne the brunt of the surge in raw materials and input costs.

However, in recent weeks there have been signs that the economic environment may be stabilizing. Industrial activity grew by 3.5% y/y in November after several months of disruption caused by power shortages, while the official manufacturing PMI rose above 50 having contracted in September and October. Still, the property market remains under pressure as the government looks to lessen its dependence on that sector and reprioritize investment in other areas such as high tech manufacturing. Tighter controls on lending to housing projects have been introduced, which pushed growth in new and secondhand residential buildings in October down 0.4% m/m to 3.4% y/y and 2.7% y/y, respectively. Moreover, a question mark hangs over the fate of property developers Evergrande, Fantasia and Sinic that have defaulted on their bond payments. In a bid to bolster economic growth, the central bank in December announced a second reserve requirement ratio cut for banks this year, of 50 bps. The move could free up 1.2 trillion yuan ($188 billion) in long-term liquidity.

Chart 4: China GDP

(% y/y)



Source: Haver

India's recovery sustained in Q3 despite easing growth

India's GDP grew by 8.4% y/y 3Q21 (2Q of FY21-22) moderating from the exceptional 20% in 2Q21, mainly on a fading base effect. By sector, growth in Q3 was underpinned by private consumption (8.6%), government spending (8.7%), investment (11%) and exports (19.6%). Activity and sentiment was also helped by an improvement in virus-related conditions, with new daily infections down to pre-second wave levels of around 26,000 by end-September versus a peak of nearly 400,000 in May (they have since fallen further still to just 8,000). More recent data points to a continued recovery, with the manufacturing PMI reaching a ten-month high of 57.6 in November (55.9 in October) on higher production and demand. Similarly, activity in the services sector strengthened in recent months, with the services PMI standing at a robust 58.1 in November, including the second fastest rise in the output component in a decade.

However, of growing concern, in addition to ongoing virus uncertainty, are rising input prices (wholesale price index up 12.5% y/y in October) stemming from ongoing global supply chain constraints and rising raw materials costs. Although higher input prices are currently being absorbed in large part by producers, they could be passed on to consumers (inflation at 4.5% in October) potentially hampering demand and in turn economic growth. The Reserve Bank of India kept interest rates unchanged at record low levels at its December policy meeting as inflation remains within the target range, but may hike the key interest (repo) rate in the next fiscal year should inflationary pressures continue. Barring these downside risks, the IMF expects India's GDP to grow by 9.5% in the current fiscal year and by 8.5% in FY22-23.

Oil prices drop, but OPEC+ keeps to supply schedule

Having been above $80/bbl for several weeks, Brent crude oil prices plunged in late November, rattled by the spread of the Omicron variant and the prospect of accelerated Fed tapering of its asset purchase program. Tighter monetary policy is typically bearish for commodities. International crude oil benchmark Brent dropped 16.4% in November to close at $70.6/bbl, its worst monthly performance since March 2020. Moves by large oil consuming nations to coordinate a release from their strategic oil reserves (to lower domestic fuel prices) also helped shift sentiment in that month in a more bearish direction. About 85 mb of crude oil is scheduled to be released by the end of 1Q22. By mid-December, oil prices had partially recovered to $75.

OPEC+ held its ministerial meeting on 2 December amid speculation that it would react to the SPR releases and the emergence of Omicron by pausing or even reversing the planned supply increase for January. OPEC+ has consistently maintained that oil demand remains fragile while the virus continues to spread and that oil balances will swing into a heavy surplus as early as 1Q22, posing a downside risk to prices. In the end, OPEC ministers opted to continue increasing supply at the monthly rate of 400 kb/d but also gave themselves the option of adjusting production on the fly should oil demand weaken. The actual supply increase may fall short of target due to supply outages and capacity constraints among some members.

As 2021 draws to a close, the Omicron variant has introduced more volatility into the oil market, though it is too soon to gauge the impact on oil demand. In terms of supply, the impasse on Iran's nuclear program means the timeframe for the return of its oil has been pushed back, simplifying matters a little for OPEC+, which can focus on adjusting supply to demand-affecting events.

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