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Global growth to stay under pressure despite easing inflation worries

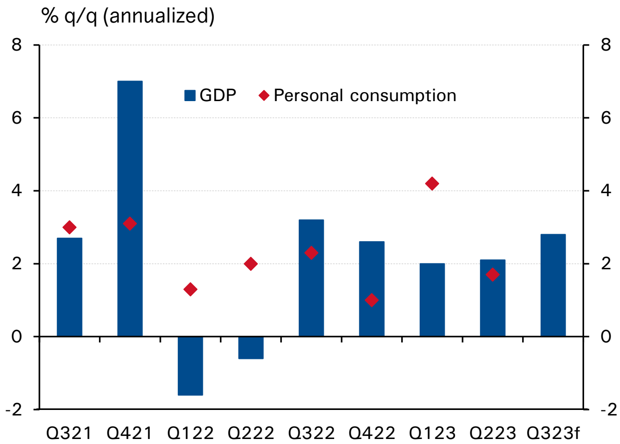
- **The global economy has held up better than expected, especially in the US, where resilient consumer spending and a still-tight labor market continue to support at-or-above-trend economic growth.**
- **Europe's economy has so far avoided a widely-anticipated recession, though remains pressured by high interest rates and the fragile Chinese recovery weighing on exports.**
- **Japanese GDP grew strongly in Q2 as inbound tourism rebounded, but lingering doubts about the domestic economy are making an early reversal of ultra-loose monetary policy less likely.**
- **Recent policy support measures should help China's economy, which grew a modest 0.8% q/q in Q2. A rebound in domestic demand, however, could pose upside risks to global inflation and commodity prices.**
- **With inflation broadly easing, major central banks such as the Fed and the ECB seem near the end of their current hiking cycle. But with oil and food prices rising, early interest rate cuts seem unlikely.**

The global economy continues to hold up better than expected, with resilient consumer spending and still-tight labor markets helping growth in developed markets, especially the US, and severe recession fears waning. Inflation has receded from its highs, supporting consumer and business confidence, and bolstering expectations that aggressive policy tightening by major central banks is at or near its end. However, the recent climb in oil and global food prices, together with still well above-target underlying inflation rates in the US and Europe, are likely to rule out early rate cuts in 2024, which could add to growth headwinds there next year. Meanwhile, weak economic growth figures in China may have helped trigger firmer government policy support recently. If successful in boosting growth, this will have positive knock-on effects on European and Japanese exports though also risks pushing global inflation up.

US shows resilience, Fed rate hikes seen near their end

The US economy has outperformed expectations, with GDP growth surprising positively and dissipating chances of recession this year. GDP growth accelerated slightly to 2.1% q/q (annualized) in Q2 2023 from 2% in Q1 on higher business investment and relatively robust household spending. (Chart 1.) The positive momentum has continued into Q3, with strong increases in industrial production and retail sales in July-August. Sales of new homes have also recovered, helped by a tight supply of existing single-family units. The ISM services activity index in August climbed to a solid 54.5, and even its manufacturing equivalent at 47.6 signaled a slower pace of contraction. The consensus is for another strong GDP print of 2.8% in Q3, though growth in Q4 could be hit by the resumption of student debt repayments in October.

Chart 1: US real GDP and personal consumption growth



Source: Haver, Refinitiv; Note: Q323 forecasts are from third-party

The tight job market remains at the core of the US economy's resilience. Although monthly job gains have eased from their unsustainable rates of last year, the unemployment rate at 3.8% is at near historic lows and real wage growth is now in positive territory. Unless we see widespread cracks in the labor market, consumer spending and the economic outlook should continue to hold up, offsetting the impact of higher interest rates.

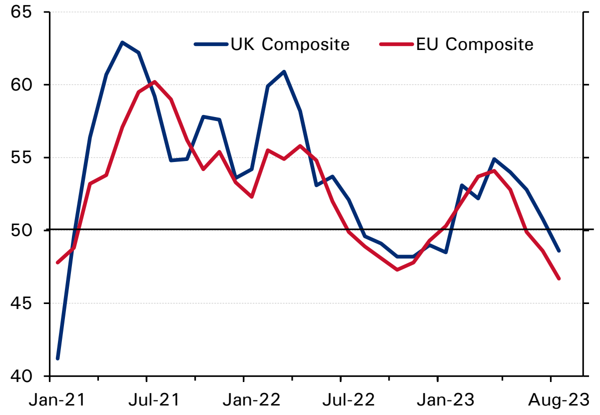
Consumer price inflation remains on a broadly slowing path, with core CPI inflation still above target at 4.3% y/y in August but well off its 6.5% peak last year and further softening seen ahead as the lagged impact of earlier falls in shelter costs feeds through. With the Fed funds target interest rate now at 5.25-5.50%, real policy rates are in positive territory and the Fed is seen delivering perhaps one final 25bps rate hike in November. However, with the economy growing at or above its trend rate, wage growth still high, commodity prices rising again and some narrower measures of inflation remaining sticky, the Fed will be unable to declare victory over inflation very quickly and interest rate cuts are likely to be delayed until the second half of next year.

Europe's economy loses steam

Europe's economy is witnessing growing signs of weakness on a steep rise in policy rates and a fragile recovery in China. The Eurozone's services sector, which was outperforming manufacturing for a long period, has now also come under pressure with both sectors' PMIs coming below the 'no change' 50 mark in August. (Chart 2.) In Q2 2023, Eurozone GDP grew just 0.1% q/q, following a similar rise in Q1. Moreover, a softening global outlook amid ongoing weakness in Chinese demand are likely to weigh on the region's exports. In September, the European Commission cut its growth outlook for the Eurozone for 2023 (to 0.8% from 1.1% in the Spring) and 2024 (to 1.3% from 1.6%), as Germany slips into recession on a slump in manufacturing and exports. Meanwhile, having also escaped recession so far by a narrow margin, the UK economy faces a similarly soft outlook: GDP contracted 0.5% m/m in July versus +0.5% in June and could rise just 0.1% q/q in Q3 (+0.2% in Q2).

Eurozone inflation has halved from its peak in October last year (5.1% y/y from 10.6%), though remains well above the ECB's 2% target. Given high but easing inflation and a weak economic outlook, the bank increased its policy deposit rate by 25 bps in September to 4.0%, but hinted at no change going forward. Inflation in the UK has eased at a much slower pace (currently at 6.4% y/y), but as economic growth loses steam, the Bank of England governor has hinted that the rate-hike cycle is also ending. Another 25 bps increase in the policy rate to 5.5% in September could be the final hike in the current cycle.

Chart 2: Europe PMI Indices



Source: Refinitiv

External sector lifts Japan's Q2 GDP growth

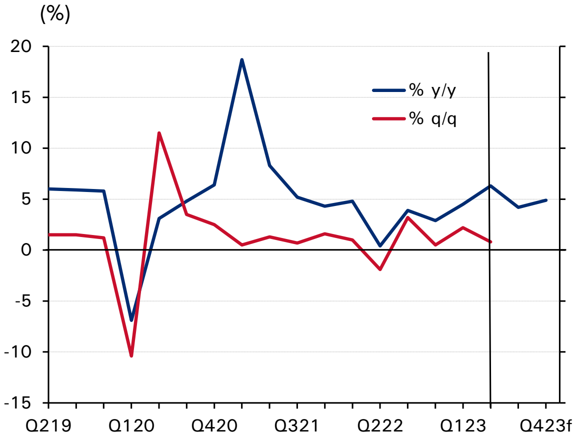
Japan's economy continues its struggle for a robust post-pandemic recovery amid a weaker yen and a softening global outlook. GDP growth in Q2 2023 was revised sharply lower in the final reading, albeit still high at an annualized 4.8%. This was a solid upgrade from Q1, but growth was solely driven by a strong performance in the external sector (helped by a recovery in inbound tourism) while domestic consumption and business investment were weak. Moreover, real wages continued to fall for the 16th consecutive month in July (-2.6% y/y), boding ill for underlying domestic demand.

In light of the mixed data, the Bank of Japan (BOJ) has reaffirmed its stance on maintaining an ultra-loose monetary policy. However, BoJ governor Kazuo Ueda has hinted at shifting away from negative interest rates if the data by the year-end suggest that current high inflation (3.1% y/y in July) looks like being sustained. The BoJ had earlier tweaked its yield curve-control policy to allow up to 1% yields on 10-year government bonds from 0.5% earlier, but hasn't let yields to rise anywhere near this. As Japan is a net creditor to international markets, any repatriation of overseas funds due to higher rates could have a large impact on the global financial system. Ueda's signal on ending negative interest rates seems a step in preparing markets for a policy reversal sometime in 2024 rather than earlier. The signals may also have been aimed at stemming weakness in the yen, which is hovering close to 30-plus-year lows versus the US dollar.

Chinese government continues to ramp up support

Following an initial post-Covid rebound, economic momentum in China has slowed amid ongoing problems in the real estate sector, softer manufacturing activity, and declining exports. GDP growth slowed to just 0.8% q/q in Q2 2023 from 2.2% in Q1, though a base effect pushed growth up to 6.3% in year-on-year terms. (Chart 3.) Pressures on the real estate sector include falling home valuations that have hit homebuyer confidence, declining property investment, and rising liquidity and solvency risks for developers. Falling land prices have reduced local government revenues and raised concerns about the ability of their financing vehicles to service debt, estimated by the IMF to stand at $9 trillion (55% of GDP). The real estate slump has also heightened risks in the country's $2.9 trillion shadow banking sector.

Chart 3: China GDP growth



Source: Haver, Refinitiv. Note: Forecasts are from third-party

Nevertheless, while the prevailing sentiment on the economy remains negative, there have been a few encouraging signs of late. CPI inflation turned positive again in August at 0.1% y/y, having been negative in July. Retail sales growth accelerated to 4.6% y/y in August, while industrial production edged up 4.5%, signaling stabilizing economic activities. The pace of contraction in both exports and imports softened in August, while the official composite PMI rose for the first time since March, though at 51.3 is still signaling only modest growth.

Importantly too, the government continues to roll out measures to support the economy. The central bank slashed the 1-year loan prime rate by 15bps in August, both mortgage rates and down payment requirements for homebuyers have been cut and the government is extending loan relief to troubled developers. The government is also trying to diversify household wealth away from real estate, as it passed some measures to boost stock market performance. These steps, coupled with tentative recent improvements in some economic indicators, suggest that the government could achieve its targeted 5% GDP growth this year.

India's Q1 growth surges, but challenges ahead

India's GDP growth beat forecasts in Q1 FY23/24 (fiscal ending March) at 7.8% y/y versus 6.1% in Q4 FY22/23. A sharp recovery in private consumption growth and elevated investment spending provided impetus. The government has reiterated its forecast of around 6.5% growth for the current fiscal year and leading indicators, including recent PMI surveys, have been robust.

However, signs of fatigue are also emerging, with indirect tax collections exhibiting slowing growth in recent months. Moreover, monsoon rains have been erratic, impacting agricultural production and prompting authorities to control exports of main agri-commodities, including wheat, rice, and sugar. The effects have been felt both locally and overseas, with global food prices spiking. For example, following the ban, Asian white rice prices jumped by around 20% in early August. With a general election scheduled for next year, the government may announce other populist measures to support the rural sector, perhaps pushing government spending higher, despite its goal of narrowing the fiscal deficit to 5.9% of GDP this fiscal year from 6.4% last year.

Higher agri-commodity prices steeply reversed the softening trend in consumer prices, with headline inflation standing at 6.8% y/y in August versus 4.9% in June. The Reserve Bank of India left the repo rate on hold (at 6.5%) at its August meeting but tightened liquidity by increasing the banking sector's cash reserve ratio. The bank also upgraded its inflation outlook for this year to 5.4% from 5.1% earlier.

Table 1: Real GDP growth rate

% y/y

	2022	2023f	2024f
US	2.1	2.0	0.9
Eurozone	3.5	0.6	0.9
UK	4.1	0.3	0.5
Japan	1.0	1.8	0.9
China	3.0	5.0	4.5
India*	7.2	6.2	6.3

Source: Refinitiv (third-party forecasts) Note: * fiscal year ending March of the following year

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