Schroders

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Economic and Strategy Viewpoint

Q3 2023

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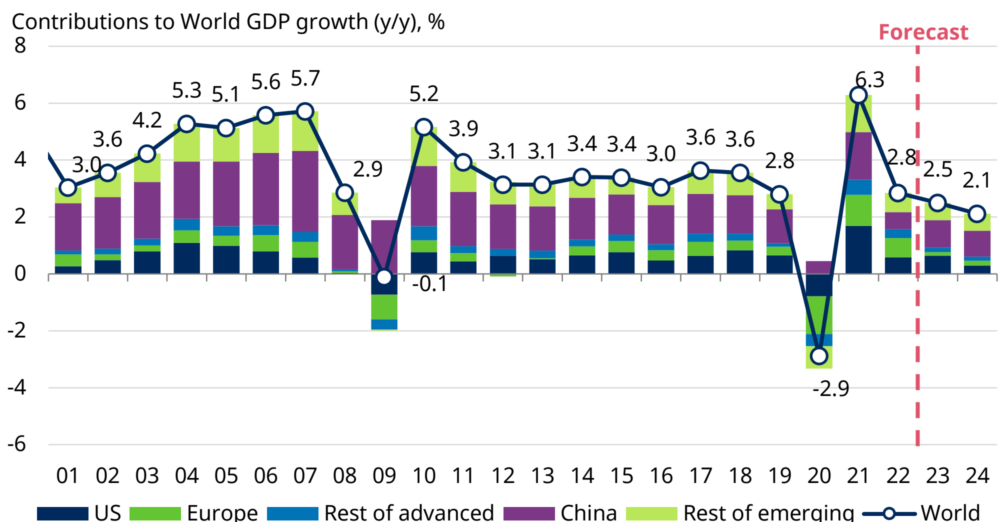
Three challenges on the path to a soft landing

- Falling inflation and resilient growth have boosted expectations of a soft landing, risk assets have rallied and bond yields have risen.
- Our forecasts acknowledge the improvement in the trade-off between growth and inflation and we are no longer forecasting a recession in the US. However, given the consensus move we identify three key challenges to the continuation of the soft landing narrative.
- First, the improvement is not universal. The US and Japan are performing well, but growth momentum in Europe and China has turned negative. Manufacturing heavy economies were always going to suffer as people switched back to services in the post pandemic economy. China also faces significant challenges in its property market.
- Second, further falls in inflation will be harder to achieve as they require an easing of sticky service sector inflation. This in turn will require higher unemployment as companies focus on productivity growth to reduce costs. Thus far, the reduction in inflation reflects the unwind of higher energy and food prices alongside the fall in goods price inflation as supply chains re-opened.
- Third, there are still issues around how effective monetary policy is in the post pandemic world. We see good reasons why the time lags from central bank policy action to changes in the economy have lengthened, but still believe that monetary policy works.
- We are revising up our growth forecasts for the US this year 2.3% (previously 1.5%), but slashing the projection for China to 4.8% (from 6.5%). These moves largely cancel each other out to leave our global GDP forecast little changed at 2.5%. We expect global growth to decelerate further in 2024 to 2.1% as policy continues to bite on activity.
- Global inflation is expected to moderate from 7.2% last year to 4.4% this year and 3.1% next. Within this there is a marked divergence between the AEs and EMs with inflation cooling in the former and rising in the latter as China lifts itself out of deflation.
- Policy rates are close to their peak and will fall next year, although we have pushed out the easing cycle to reflect the challenge of beating inflation.
- The landing for the world economy is not as hard as before, but next year is still forecast to be the weakest for more than a decade (ex. the pandemic year 2020).

Chart: Global growth forecast



Source: Schroders Economics Group. 29 August 2023.
Please note the forecast warning at the back of the document.

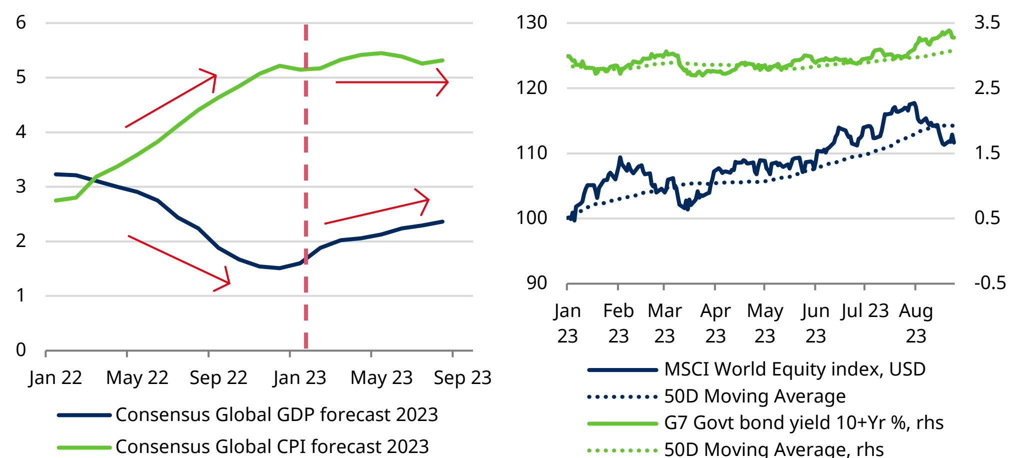
Three challenges on the road to a soft landing

Falling inflation and firm activity figures boost soft landing hopes

The narrative has shifted over the past three months as talk of recession has been replaced by that of a soft landing for the world economy. Inflation has started to decline while growth is proving to be resilient. In marked contrast to 2022, expectations for global growth are rising while those for inflation have stabilised after rising sharply last year (chart 1a).

Nowhere is this more apparent than in the US where headline inflation fell to 3.2% year-on-year in July compared to 8.5% a year earlier, while unemployment remains close to record lows. Forecasts of a recession have been pushed out, or quietly dropped altogether as the economy expanded at a decent 2.1% annualised pace in q2 and looks set to have strengthened in q3. In response, risk assets have performed well with global equity markets rising. However, government bond yields have also risen as markets have factored in a higher profile for real interest rates (see chart 1b).

Chart 1a & b. A turnaround in growth expectations has supported risk assets



Source: Refinitiv, Schroders Economics Group. 29 August 2023.

Despite the air of optimism, the world economy faces a number of challenges. Not all economies are proving as resilient as the US, inflation has declined but is certainly not beaten and there are still issues around how effective monetary policy is in the post pandemic world.

Here we look at these three challenges in turn.

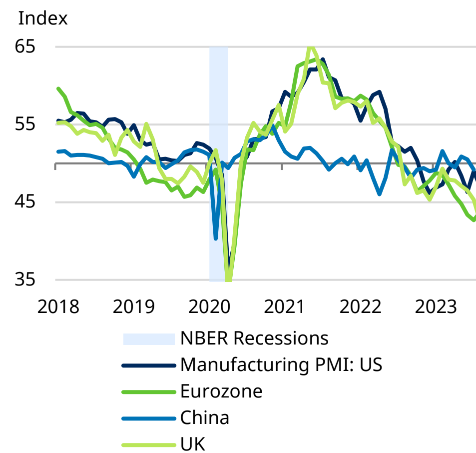
1. The improvement in growth expectations has not been universal

European manufacturing and China's property sector are weak

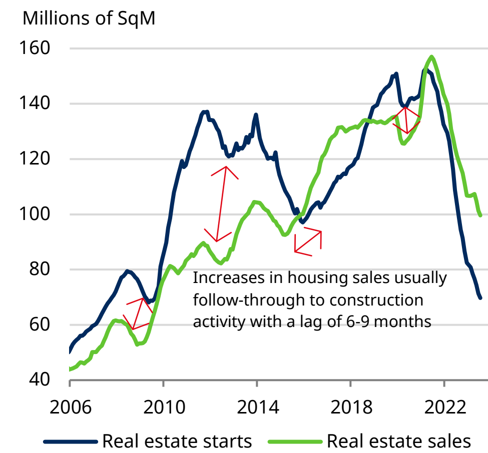
Although global growth expectations have strengthened, the improvement has been confined to the US and Japan. Meanwhile, China and the eurozone have been losing momentum as doubts over growth have increased.

Concerns have been fuelled by a sharp drop in the manufacturing Purchasing Managers Indices (PMI's) with German and French industry slowing sharply and dragging down the eurozone, while the UK has also been weak (chart 2a). As elsewhere, the service sector is doing better in these economies (albeit still in contraction), but the heavy weight of manufacturing in the eurozone economy is taking its toll.

Chart 2a. European manufacturing slumps



2b. China housing starts and sales (12m Avg.)



Source: Refinitiv, Schroders Economics Group. 29 August 2023.

Waiting for policy stimulus in China

Chinese manufacturing is also under pressure and the economy has disappointed with the bounce back from the pandemic proving short lived. The bigger problem though is domestic as following early signs of stabilisation, demand for new housing has fallen off a cliff since May (chart 2b above). Completions of outstanding properties have been continuing. But the pipeline of new projects has dried up, worsening the outlook for construction-related growth next year and adding to the squeeze on liquidity at developers, with Country Garden the latest firm to run into trouble. The authorities have recently announced a package of support measures, including smaller down payments and lower mortgage rates, which will help housing demand, particularly in higher tier cities. However, with speculative demand likely to remain permanently weaker, the broader outlook for the housing sector is not rosy. Given that real estate accounts for around one-quarter of GDP, structurally weaker housing activity is likely to have caused a decline in long term trend growth to 3-4% rather than the 4-4.5% that previously appeared possible.

In response to the deterioration of incoming data, Beijing has struck a more dovish tone in recent communiques and policy rates were unexpectedly lowered in July. But there has been a lack of urgency to boost aggregate demand. This hints at a greater pain threshold for slower growth in the pursuit of better quality growth than we had assumed. Accordingly, while we do expect manufactured exports to benefit from a potential upturn in the global inventory cycle in the months ahead, the lack of a "big bang" stimulus suggests that there will not be a strong recovery next year

Global growth forecast paints a mixed picture

Offsetting regional fortunes, but little change in global growth forecast for 2023

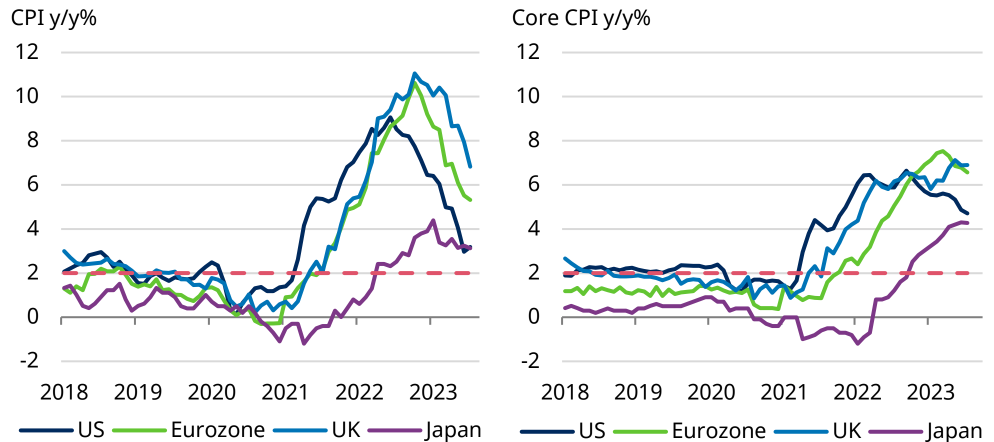
Pulling this together we are taking out the recession and revising up our growth forecasts for the US this year to 2.3% (previously 1.5%. However, we are slashing the projection for China to 4.8% (from 6.5%). These moves largely cancel each other out in global GDP terms.

The eurozone forecast is unchanged with growth forecast to slow from 3.5% in 2022 to 0.6% in 2023. However, struggling Germany, which was in a technical recession earlier this year, has been downgraded further (from zero to -0.2%). The France GDP forecast has been revised up from 0.4% to 0.9%, largely on the back of more resilient household spending. Spain also saw an upgrade (1.9% to 2.3%) thanks to continued strength in services activity, helped by a faster fall in its domestic inflation. Lastly, Italy's growth forecast remains unchanged (0.8%). Meanwhile, the UK is raised such that the net result is a minor upgrade to our global growth forecast for 2023 to 2.5% from 2.4%.

2. Inflation is not beaten yet

The outlook for growth in 2024 largely depends on the behaviour of inflation - the second challenge for the world economy. As noted above, headline inflation has fallen sharply in the major economies, but this has largely been driven by the fall in food and energy prices. Strip these out and the decline in core rates has been less impressive and actually non-existent in the UK (charts 3a & b). Generally, core inflation rates remain at decade highs in the advanced economies.

Charts 3a & b. Headline and core inflation rates



Source: Refinitiv, Schroders Economics Group. 29 August 2023.

Lower commodity and goods prices account for the fall in inflation

In some respects the decline in inflation so far could be described as the easy part. The base effects from the spike in food and energy prices triggered by the Russian invasion of Ukraine were always going to wash through the CPI indices eventually.

In addition to these favourable base effects we have also seen a sharp correction in goods prices. These were boosted during the lockdown as online demand for goods surged. Supply chain bottlenecks exacerbated the effect as stronger demand met restricted supply. With the easing of restrictions supply chains and delivery times have normalised. And, as consumers have been able to go out again, they have been rebalancing their spending away from goods and back to services. The result has been a sharp decline in goods price inflation as net demand has fallen (see chart 4a).

Chart 4a. US CPI goods and services

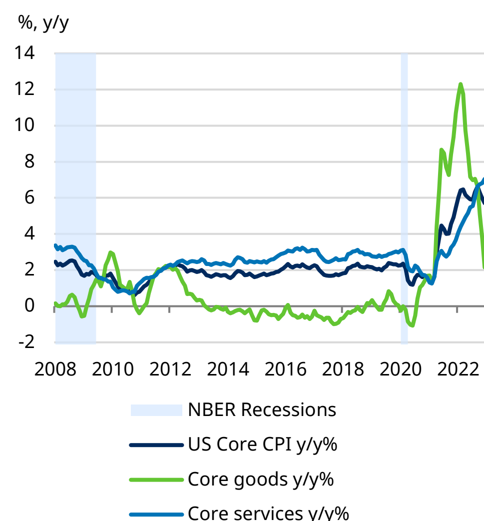
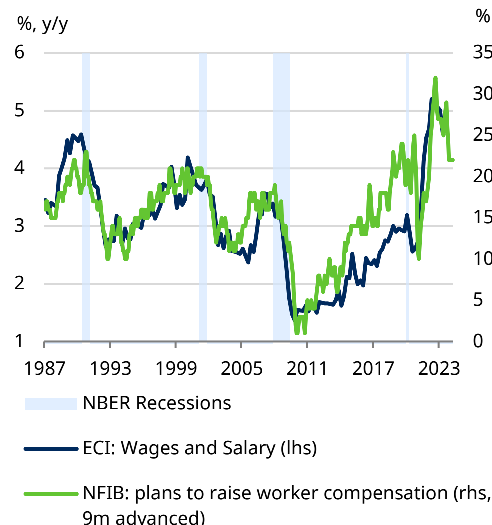


Chart 4b. Surveys point to wage moderation



Source: Refinitiv, Schroders Economics Group. 29 August 2023.

Weaker labour market needed to turn service sector inflation

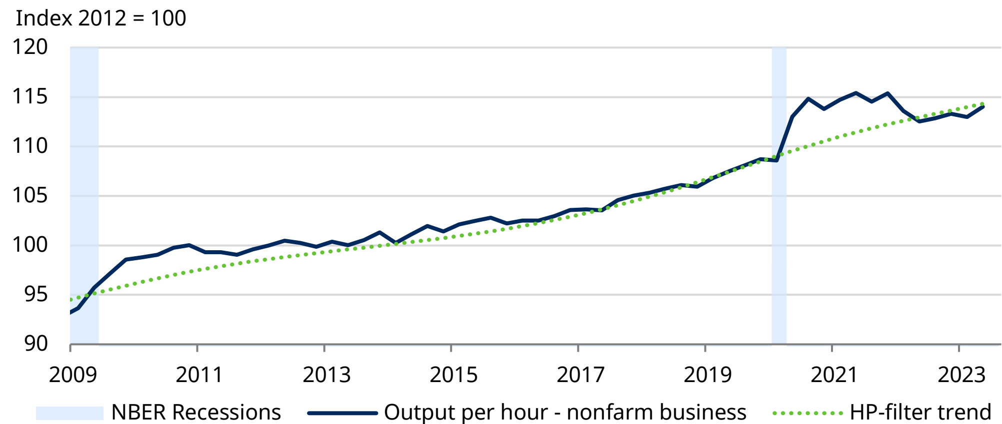
The flipside is that service sector prices have accelerated and have kept core inflation elevated. Getting service sector price inflation down is likely to prove more difficult as prices tend to be "stickier". Compared to commodity or goods prices, service sector prices tend to change less frequently with key items such as rents being set on an annual basis. The service sector is also more affected by rising wages which account for a greater proportion of costs than in the more capital intensive goods and energy sectors. Tight labour markets with unemployment at low levels and high vacancy rates mean that labour is scarce and wages have picked up sharply.

There are signs that labour markets are loosening. In the US the employment cost index (ECI) has rolled over and judging from the survey evidence will decline further in coming months (see chart 4b above). In the UK unemployment is rising, although wage growth has yet to slow having picked up to 7.9% for the private sector in June.

Ultimately though it is not wages, but labour costs adjusted for productivity which matter for companies and inflation. We have highlighted the weakness of productivity in the past as a threat to inflation and profit margins; however, recent data has improved and suggests that output per head is now returning to its pre-pandemic trend based on our estimates (chart 5).

It would seem that the initial weakness of productivity after the pandemic was due to the switch back to lower productivity services as the economy re-opened. The surge in output per hour experienced during the pandemic was driven by the acceleration in the high productivity manufacturing sector. As the economy normalised, productivity has stabilised and now seems to have resumed its previous trend. Rather than being structural, the earlier weakness seems to have been another consequence of the adjustment in the economy after the pandemic.

Chart 5. US productivity returning to pre-pandemic trend



Source: Refinitiv, Schroders Economics Group. 29 August 2023.

No recession, but unemployment to rise as firms focus on productivity

In the forecast our upgrade to US growth has been combined with better productivity assumptions which help offset some of the increase in inflationary pressure from stronger demand. Such a trend will be key to whether the economy can achieve a soft landing and the recent rise in business capex bodes well, for this being sustained. When combined with our indicators for key CPI components such as housing rents we see inflation declining further through 2024. By the end of 2024 we expect US inflation to have fallen to 2.5% with the core a tad higher at 2.6%. The forecast is slightly higher than previously.

Further inflation reduction will come at a greater cost than hitherto

However, unlike the first phase of disinflation the next phase will not be costless in terms of jobs. US growth is forecast at 1.1% next year and we expect the unemployment rate to rise to 4.8% as firms look to maintain productivity growth. We are no longer forecasting a recession, but the harder part of reducing inflation is just beginning.

This would be consistent with the view that the trade-off between growth and inflation (i.e. the Philips curve) is non-linear. When inflation is at high levels it is easier to achieve a 2 or 3 percentage point reduction with little increase in unemployment than when it is low. In other words, achieving another two percentage point fall in US core inflation will require a much greater rise in unemployment.

Forecast summary: growth and inflation to moderate further

Overall we expect global growth to decelerate further in 2024 to 2.1% after 2.5% this year. Both the Advanced (AEs) and Emerging economies (EMs) are expected to slow in line with the US and China. The reduction in the latter largely explains why we have lowered our forecast for EM GDP growth to 3.9% and 3.7% in 2023 and 2024 respectively, from our previous expectation for increases of 4.4% and 3.9%. Weaker activity in China has less impact on the AEs as it is more a supplier of goods than a driver of demand. Economies like Germany with significant exports to China are more affected, but slower growth in the US is more important overall as it remains the locomotive of global activity.

Global inflation is expected to moderate from 7.2% last year to 4.4% this year and 3.1% next. Within this there is a marked divergence between the AEs and EMs with inflation cooling in the former and rising in the latter as China lifts itself out of deflation.

3. Does monetary policy still work?

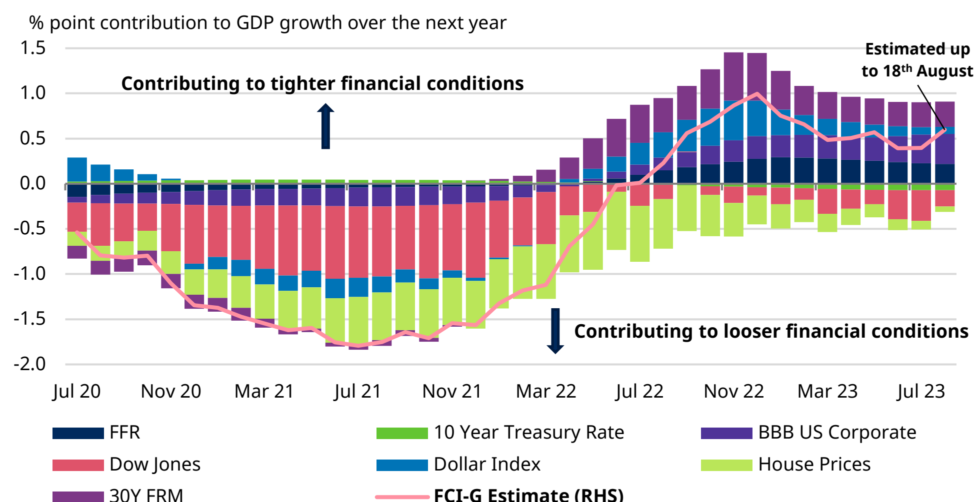
This cycle has been challenging for central banks as many relationships between interest rate changes and activity appear to have broken down. We recently identified

[Four reasons why the Fed is struggling to contain inflation] where we argued that the low starting point for rates, looser financial conditions, loose fiscal policy and pandemic effects have combined to make this cycle different. The Fed and other central banks have had to overcome these factors to get monetary policy to a point where it can be restrictive for the economy and inflation. Consequently the lags between policy action and the economy appear to be longer today.

The lags are long, but policy headwinds are building

An insight into this can be found in the new Financial Conditions Impulse on Growth index (FCI-G) from the US Federal Reserve (Fed) which attempts to take account of the lags from changes in a range of interest rates and asset prices to the real economy. This highlights two important features of the recent tightening cycle which began in March 2022. One is that that it took some time for policy to move from very loose to being restrictive on growth, a point not reached until late summer that year (see chart 6). The second is that the headwind on growth from policy tightening is primarily coming through the rise in mortgage rates and credit yields alongside a stronger US dollar. Equity and housing markets have offset this to some degree as they have been resilient.

Chart 6. US Financial Conditions Impulse on growth index (FCI-G)



Source: Refinitiv, Schroders Economics Group. 29 August 2023.

Focus on roll off of fixed rate deals and maturity walls

The loosening of policy during the pandemic is still being felt as many households and companies took advantage of low rates and ultra low bond yields to refinance their borrowing during this period. Consequently, many have yet to experience higher borrowing costs. This does not mean, however, that policy will not work, rather that the lags are longer as the increase in credit costs slowly percolates through the economy. Central banks will need to pay more attention to the rolling off of fixed rate deals in the mortgage market and maturing of debt in the corporate sector in judging the impact of their actions. Short term interest rates alone will be less of a guide than in the past.

Interest rate forecasts – higher for longer

Rate cuts pushed out as policy stays tighter for longer

For the US, the increase in expected growth means we have pushed out our forecasts for the first rate cut from December this year to March next year. Thereafter we expect the Fed to gradually ease through 2024 and bring the Fed funds target range (lower to upper limit) to 3.5% to 3.75% by year end. On balance, we believe that the Fed funds rate is now at its peak, but the profile is tighter than before with real rates remaining higher for longer.

In the eurozone, inflation has largely also been on track, falling to 6.2% y/y over Q2 compared with 10% in Q4 2022. However, elevated services inflation, and a recent small rise in energy prices has persuaded the European Central Bank (ECB) to keep raising interest rates. The main refinancing rate is now forecast to peak after one final hike in September at 4.50%, with the deposit rate following, reaching 4%. Core inflation is also elevated at 5.1% over Q2, but sub-trend growth across the monetary union, including some recessions, should lower domestic inflation pressures over the forecast horizon. Against this background we expect the ECB to cut its refi rate to 2.75% by the end of next year.

For the UK, a significant shift in the Bank of England (BoE) reaction function has meant that interest rates are now likely to peak significantly higher than in our previous forecast. The BoE rates forecast has been revised up to 6% by the end of this year – 100bps higher than the forecast in May. Rate cuts for next year have been pushed out and scaled back, leaving us with a weaker growth outlook. UK GDP is forecast to slow further to just 0.3% in 2024, only narrowly avoiding a technical recession.

As elsewhere, inflation is forecast to continue to fall back, which allows the BoE to start to cut rates in the second quarter of next year, as it sees a path back to target. In a sticky inflation environment, rates fall back to a still restrictive 4.5% by the end of the year, as inflation averages 3.1%.

Baseline summary

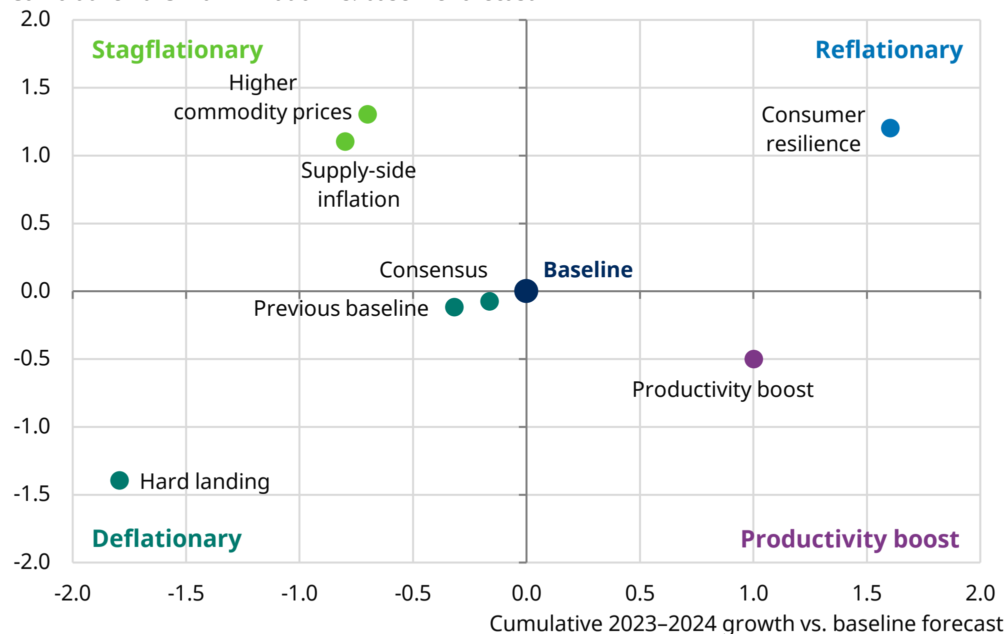
We have reviewed the forecast in the light of recent data and have made small upgrades to global growth and inflation. We still expect inflation to decline further although this will require a slowing in global growth to 2.1% in 2024. The landing for the world economy is not as hard as before, but next year is still forecast to be the weakest for more than a decade excluding the pandemic year of 2020.

Scenarios: the risks around the baseline

New forecast reflects consumer resilience and soft landing scenarios..

Compared to our previous forecast we have moved the baseline in a more reflationary direction by raising our projections for both growth and inflation. The existing scenario which best captures such a move is **consumer resilience** where households continue to spend at a faster pace than in the baseline. This reflects a greater willingness by households to draw on past savings and the continued growth in employment and income as the corporate sector adds more workers. We retain this scenario as, despite incorporating greater spending into our forecast, we recognise that this could persist for longer, posing a risk of stronger growth and inflation as well as interest rates.

Chart 7. Scenarios around the baseline



Source: Schroders Economics Group. 25 August 2023. Please note the forecast warning at the back of the document.

However, this is not the whole story. As noted above, markets have been driven by the rising probability of a **soft landing**, another of our previous scenarios. Our new forecasts do reflect this as we now assume inflation can decline at less cost in terms of slower growth and higher unemployment than in our previous forecast. The increase in our inflation forecast is marginal compared to the rise in expected growth and can largely be accounted for by a higher assumption for oil prices. Hence, the move in our forecasts is largely driven by a more positive view on underlying productivity – a clear step in the soft landing direction.

..but we retain both as risks to the baseline

As with **Consumer resilience** we choose to retain a scenario where this goes further than in the baseline which we have termed **Productivity boost**. This has a similar outcome in terms of a better growth/ inflation trade off as our previous soft landing scenario, but is more driven by stronger capital spending, largely supported by fiscal measures. It also recognises the potential for faster productivity gains as a result of the break throughs in Artificial intelligence (AI).

Two risk scenarios from our previous forecast are dropped as the probability of their occurrence has fallen significantly over the past three months. The lifting of the debt ceiling in the US means we have not seen the return of the bond market vigilantes and although the recent downgrade to the US credit rating by Fitch has caused some jitters, it was not sufficient to retain the scenario.

We have also cut the banking crisis deepens scenario as the problems experienced earlier in the year which culminated in the closure of several banks, including Silicon Valley bank, has not proved systemic. There are still problems in the sector particularly for those exposed to commercial property and bank lending conditions overall have tightened, but we believe these are adequately captured in the baseline.

Both these scenarios were deflationary in that they led to weaker growth and lower inflation than the baseline. We do, however, still see a risk in this direction and have a new **Hard Landing** scenario where central banks overtighten monetary policy and plunge the world economy into recession. In this scenario interest rates are higher thus weakening credit growth and squeezing borrowers more than in the baseline. In China, the property market goes from bad to worse as a further collapse in new

home sales causes more developers to default on their debt obligations, raising concerns about a financial crisis and further denting confidence.

The other new scenario is **Higher commodity prices**. The continued resilience of demand plays a part here, but the main driver is on the supply side where restriction by OPEC+ in energy markets drives oil prices to $120/ barrel. Meanwhile, an intensification of fighting in Ukraine causes the Black Sea trade corridor to collapse, sending grain prices sharply higher. Other foods are also affected by extreme weather events, such as wildfires and flooding, alongside a strong El Niño. Lastly, a severe 2023/24 European winter coincides with an intensification in global competition for LNG shipments and industrial action among some producers. This causes the price of natural gas in Europe to return to the highs not seen since autumn 2022. As in the **Hard landing,** this scenario is negative for growth, but the rise in commodity prices boosts inflation sending the world economy in a stagflationary direction compared to the baseline (chart 7).

This new scenario allows us to retain, but redefine, the **Supply side inflation** scenario to one where the source of inflationary pressure is solely due to the labour market. In this scenario wage pressure is greater at any given level of unemployment and productivity is weaker as shortages cause firms to hoard workers. The result is a more adverse trade-off between growth and inflation. As with the higher commodity price scenario this has stagflationary consequences for the world economy compared to the baseline.

New scenarios skew risks toward stagflationary outcomes

In terms of probabilities, the economics team believes that the balance of risks is skewed toward stagflation reflecting the **Supply side inflation** and **higher commodity prices** scenarios (charts 8 & 9). This would tie in with our view that we are entering a more difficult phase in the inflation reduction process. One which will challenge support for central bank's anti-inflation policies as social unrest is likely to rise in the wake of higher unemployment.

Chart 8: Scenario probabilities

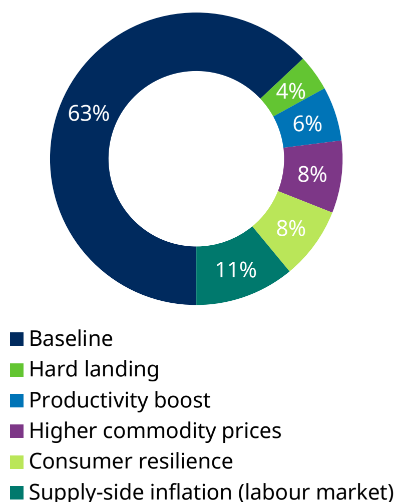
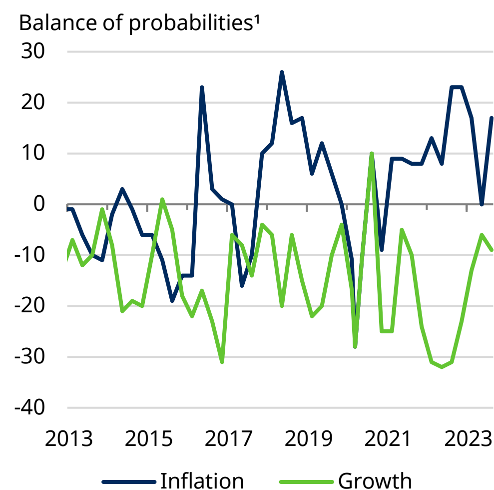


Chart 9: Growth and inflation skews



Source: Schroders Economics Group. 29 August 2023. Probabilities are mutually exclusive. Please note the forecast warning at the back of the document.

Schroders Economics Group: Views at a glance

Macro summary – Q3 2023

Key points

Baseline

– **US:** After a decent 2.1% annualised expansion in Q2, GDP growth looks set to have strengthened further in Q3. A recession now appears unlikely and we have raised our 2023 and 2024 growth forecasts to 2.3% and 1.1% respectively. Stronger growth means that we now expect a more modest easing in inflation from 4.2% in 2023 to 2.8% in 2024. The increase in expected growth and stickier inflation means we have pushed out our forecasts for the Fed's first rate cut, from December this year to March next year. Thereafter we expect the Fed to gradually ease policy through 2024, bringing rates down to 3.75% by the end of the year.

– **Eurozone:** The energy price shock is now unwinding, but in its wake remains high food and services inflation. This is likely to prompt the ECB to deliver one final hike in September 2023, peaking at 4.5% and 4% for its key rates. HICP inflation is forecast to average 5.4% in 2023 before falling to 2.1% in 2024, making space for the ECB to cut rates to 2.75% and 2.25% by the end of the forecast. Growth is likely to remain sluggish. Although falling inflation will help to boost real disposable incomes, higher interest rates will start to bite. GDP growth is forecast to slow from 3.5% in 2022 to 0.6% in 2023, before rebounding to a sub-trend rate of 1% in 2024.

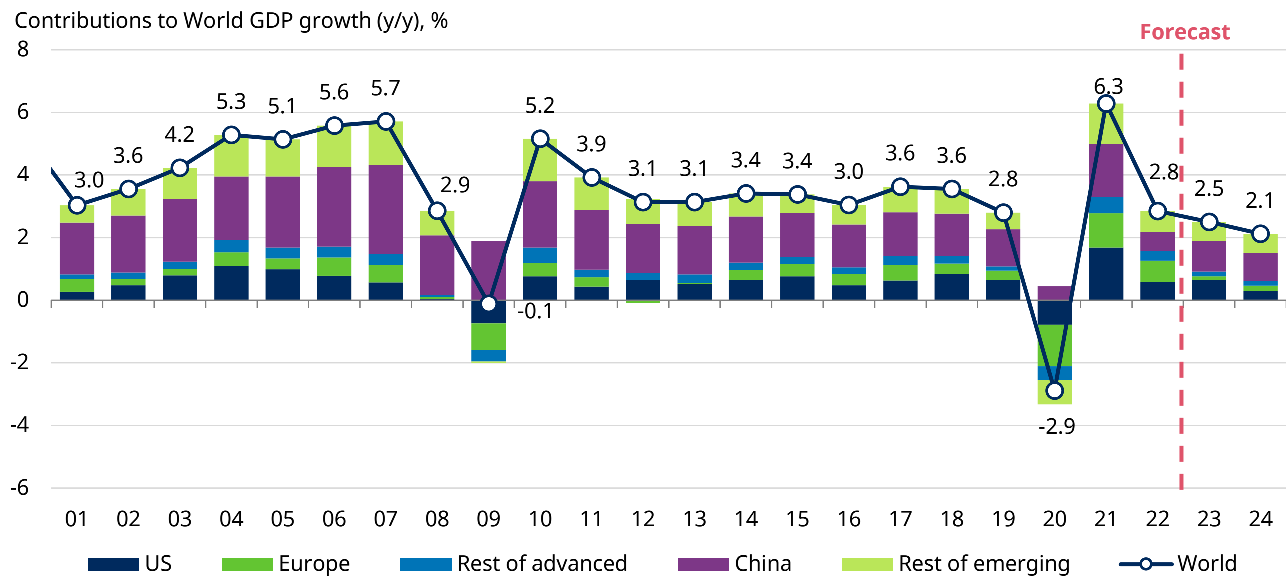
– **UK:** The economy is expected to narrowly avoid a recession, but stagnate for most of the forecast period. We forecast growth of just 0.6% and 0.3% in 2023 and 2024 respectively, as high inflation forces the BoE to tighten policy further. We expect inflation to ease from 9.1% in 2022 to 7.3% in 2023 before averaging 3.1% in 2024. The policy interest rate is forecast to reach 6% by the end of 2023, before cuts starting in Q2 2024 lower it to a still restrictive 4.5% at the end of 2024.

– **Emerging Markets:** A rebound in services activity following the reopening of China's economy failed to translate into broader economic growth as continued problems in the labour and housing markets weigh on confidence. Activity has lost momentum, and although the authorities have recently announced a package of measures, a swift pick up is unlikely. A recovery in manufactured exports may offer some support, but overall GDP growth is likely to be subdued at 4.8% in 2023 and 4.5% in 2024. Elsewhere in the emerging world, falling inflation and interest rate cuts should support some pick up in growth in 2024.

Risks

While we have moved the baseline in a more reflationary direction, the team still judge that the balance of risks is skewed toward stagflation. Of our five risk scenarios, we continue to place the highest likelihood on supply-side inflation This is jointly followed by the stagflationary higher commodity prices and the reflationary consumer resilience scenarios. A slightly smaller probability has been put on the productivity boost scenario, just ahead of the deflationary hard landing scenario.

Chart: World GDP forecast



Source: Schroders Economics Group, 29 August 2023. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2022	2023		*Prev.*	Consensus	2024		*Prev.*	Consensus
World	100	2.8	2.5	↑	*(2.4)*	2.4	2.1	↑	*(1.9)*	2.0
Advanced*	59.6	2.6	1.5	↑	*(1.1)*	1.3	1.0	↑	*(0.6)*	0.8
US	28.3	2.1	2.3	↑	*(1.5)*	1.9	1.1	↑	*(0.0)*	0.6
Eurozone	15.6	3.5	0.6		*(0.6)*	0.6	1.0	↑	*(0.9)*	0.9
Germany	4.5	1.8	-0.2	↓	*(0.0)*	-0.4	0.8	↑	*(0.7)*	0.9
UK	3.4	4.0	0.6	↑	*(0.0)*	0.2	0.3	↓	*(0.9)*	0.4
Total Emerging**	40.4	3.1	3.9	↓	*(4.4)*	4.0	3.7	↓	*(3.9)*	3.9
BRICs	28.3	3.0	4.6	↓	*(5.4)*	4.8	4.1	↓	*(4.2)*	4.3
China	19.9	3.0	4.8	↓	*(6.5)*	5.3	4.5	↑	*(4.3)*	4.7

Inflation CPI

y/y%	Wt (%)	2022	2023		*Prev.*	Consensus	2024		*Prev.*	Consensus
World	100	7.2	4.4	↓	*(4.5)*	4.4	3.1	↑	*(2.9)*	3.0
Advanced*	59.6	7.5	4.7		*(4.7)*	4.6	2.6	↑	*(2.3)*	2.5
US	28.3	8.0	4.2		*(4.2)*	4.1	2.8	↑	*(2.3)*	2.6
Eurozone	15.6	8.4	5.4	↓	*(5.6)*	5.5	2.1	↓	*(2.4)*	2.5
Germany	4.5	8.7	5.9	↑	*(4.5)*	6.0	2.3	↓	*(2.4)*	2.6
UK	3.4	9.1	7.3	↓	*(7.6)*	7.3	3.1	↓	*(3.6)*	3.0
Total Emerging**	40.4	6.7	4.1	↓	*(4.2)*	4.1	3.9	↑	*(3.8)*	3.8
BRICs	28.3	4.1	2.0	↓	*(2.3)*	2.1	2.9	↓	*(3.1)*	2.8
China	19.9	1.9	0.5	↓	*(1.3)*	0.8	1.8	↓	*(2.5)*	2.0

Interest rates

% (Month of Dec)	Current	2022	2023		*Prev.*	Market	2024		*Prev.*	Market
US	5.50	4.50	5.50	↑	*(5.00)*	5.45	3.75	↑	*(3.50)*	4.18
UK	5.25	3.50	6.00	↑	*(5.00)*	5.76	4.50	↑	*(3.25)*	5.28
Eurozone (Refi)	4.25	2.50	4.50	↑	*(4.25)*	3.88	2.75	↑	*(2.50)*	3.14
Eurozone (Depo)	3.75	2.00	4.00	↑	*(3.75)*		2.25	↑	*(2.00)*	
China	3.55	3.65	3.30	↓	*(3.65)*	-	3.20	↓	*(3.65)*	-

Other monetary policy

(Over year or by Dec)	Current	2022	2023		*Prev.*	Y/Y(%)	2024		*Prev.*	Y/Y(%)
US QE ($Tn)	8.3	8.6	7.8	↓	*(7.9)*	-9.3	7.1	↓	*(7.2)*	-9.0
EZ QE (€Tn)	2.8	2.9	2.7		*(2.7)*	-6.9	2.4		*(2.4)*	-11.1
UK QE (£Bn)	803	831	758	↑	*(752)*	-8.7	653	↑	*(647)*	-13.8
China RRR (%)	10.75	11.00	10.25	↓	*11.00*	-	10.00	↓	*11.00*	-

Key variables

FX (Month of Dec)	Current	2022	2023		*Prev.*	Y/Y(%)	2024		*Prev.*	Y/Y(%)
GBP/USD	1.27	1.20	1.26		*(1.26)*	4.7	1.28	↑	*(1.22)*	1.6
EUR/USD	1.09	1.07	1.10	↓	*(1.11)*	3.1	1.14	↓	*(1.16)*	3.6
USD/JPY	146.3	131.9	140	↑	*(138)*	6.1	135	↑	*(120)*	-3.6
EUR/GBP	0.86	0.89	0.87	↓	*(0.88)*	-1.6	0.89	↓	*(0.95)*	2.0
USD/RMB	7.31	6.95	7.10	↑	*(6.60)*	2.1	6.80	↑	*(6.40)*	-4.2
Commodities (over year)										
Brent Crude	84.5	99.0	82.7	↑	*(79.9)*	-16.5	82.7	↑	*(77.5)*	0.0

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data taken as at 21/08/2023. Previous forecast refers to May 2023
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Schroders Forecast Scenarios

Scenario	Summary	Macro impact	Probability*	Growth	Inflation
Baseline	Global GDP growth is expected to ease from 2.8% in 2022 to 2.5% in 2023 and 2.1% in 2024. Among advanced economies, growth is forecast to fall from 1.5% in 2023 to 1.0% in 2024, albeit with some notable regional divergences. While the weak industrial backdrop is weighing on the eurozone, and Germany in particular, the relatively closed US economy is faring better and is now expected to see an modest acceleration in 2023 on the back of resilient household consumption. Meanwhile, emerging market growth is forecast to slow from 3.9% in 2023 to 3.7% in 2024. Within this, China's re-opening boost has proven shorter and less supportive than expected, such that it's economy is now forecast to expand by just 4.8% in 2023 before slowing to 4.5% in 2024. By contrast, most other EMs are starting to turn a corner as easing inflation opens the door to rate cuts, which should see growth pick up in 2024.	We expect global CPI inflation to moderate from 7.2% in 2022 to 4.4% in 2023, before a more modest deceleration to 3.1% in 2024. Last year's sharp rise in energy prices has largely unwound, barring a severe El Niño food inflation should continue to fall sharply in the months ahead. And while core inflation is proving sticky, it should continue to gradually subside. Against this backdrop, interest rates are approaching their terminal level. We expect the Fed to maintain rates at 5.50% across the remainder of 2023 before cutting them to 3.75% by end-2024. The ECB is forecast to hike its main refinancing rate another 25bps to 4.50% before lowering it to 2.75% across next year. Meanwhile, the Bank of England has the most work to do, raising Bank Rate another 75bps to 6.00% this year before lowering it to 4.50% by end-2024. In EM, some central banks have already started to cut rates owing to inflation falling more rapidly, with more set to join them in the months ahead.	63%	-	-
1. Hard landing	Developed market central banks continue to tighten monetary policy in order to stamp out inflation. The Fed hikes to a terminal rate of 6.50%, with the ECB and BoE reaching 5% and 6.75% respectively. But the cumulative effect of further interest rate hikes, along with the eventual lagged impact of past aggressive tightening, hit domestic demand hard. Rate cuts eventually follow, but too late to prevent all major economies from tipping into recession. Meanwhile in China, problems in the housing market go from bad to worse as a further collapse in new home sales causes more developers to default on their debt obligations, raising concerns about a financial crisis and further denting confidence. With Beijing still reluctant to deliver significant stimulus, economic growth slows markedly.	**Deflationary**: Overtightening of monetary policy, demand destruction and subsequent recessions cause negative output gaps to open up. At the same time, commodity prices tumble as the outlook for demand deteriorates, with Brent crude falling to a trough of just $50/bbl in early-2024. As a result, headline rates of inflation fall further than in the baseline, with calendar year averages about 1 percentage point below target in most developed markets in 2024, while China continues to flirt with a prolonged period of deflation.	4%	-1.8%	-1.4%
2. Productivity boost	Initiatives such as the Inflation Reductaion Act (IRA) and CHIPS Act by the Biden administration continue to support strong US business investment, increasingly among non-US domiciled corporates. Other countries seek to replicate this, either through co-operation agreements (e.g. Japan's critical minerals deal, the UK's Atlantic Declaration) or by funding their own incentive schemes. This proliferation of subsidies results in a sharp rise in capital expenditure that delivers immediate productivity gains. Alongside this, the adoption of artificial intelligence is more rapid and widespread than expected, resulting in significant efficiency gains across economies but without significant displacement of labour.	**Productivity boost**: Economic growth is initially bolstered by higher capital expenditure, which is then sustained as projects come onstream and new industries are created. The resulting net productivity gains enable corporates to rein in price increases, with some sectors even seeing outright deflation. This sees inflation fall back more sharply across developed and emerging, aided by a weaker USD which serves to offset modestly higher crude oil prices. Central banks are able to cut rates more aggressively in 2024 and step up the pace of quantitative tightening as a consequence.	6%	+1.0%	-0.5%
3. Higher commodity prices	A perfect storm of events lead to a broad-based and sustained rise in the price of various key commodities. Brent crude oil climbs above $120/bbl owing to further output cuts by OPEC+, Meanwhile, an intensification of fighting in Ukraine causes the Black Sea trade corridor to collapse, sending grain prices sharply higher. Other foods are also affected by extreme weather events, such as wildfires and flooding, alongside a strong El Niño. Lastly, a severe 2023/24 European winter coincides with an intensification in global competition for LNG shipments and industrial action among some producers. This causes the price of natural gas in Europe to return to the highs not seen since autumn 2022.	**Stagflationary**: Higher food and energy prices push up inflation, with global CPI averaging 1.1 percentage points higher than the baseline in 2024. Both the eurozone and UK are among the worst affected, owing to the significance of natural gas in their energy mix. Global growth is weaker as a consequence, with the exogenous energy shock sending several developing countries into a technical recession. Still, central banks respond by raising rates more this year. Although they then begin to loosen policy in 2024, it remains more restrictive than the baseline so as to ward against the risk of second-round effects.	8%	-0.7%	+1.3%
4. Consumer resilience	While excess savings built up during the pandemic have now been mostly drawn down, household spending continues to grow strongly as saving rates do not normalise, real income growth turns positive and consumer credit lines are tapped. At the same time, higher rates struggle to gain traction owing to deleveraging efforts since the financial crisis and because rock bottom interest rates were locked in during previous years across long time horizons. This strong consumer backdrop in-turn bolsters the outlook for corporate profitability, encouraging greater capex and the passing on of costs through higher prices.	**Reflationary**: Robust consumer demand causes core inflation to remain stickier than in the baseline, whereas headline inflation falls back more slowly. Also, strong growth results in a further tightening of labour markets, with the US unemployment rate falling below 3%. Central banks respond by raising interest rates more aggressively. The Fed funds rate rises to a peak of 6.50% in early 2024, while the ECB main refinancing rate reaches 5.75%. Eventually, higher interest rates cause activity to slow, prompting central banks to start cutting rates. Over the two-year horizon, global growth and inflation are both higher than the baseline.	8%	+1.6%	+1.2%
5. Supply-side inflation	Despite an economic downturn, companies choose to hoard workers after the hiring difficulties experienced over recent years. With the labour market remaining tight as a consequence, companies are forced to offer higher pay awards to attract and retain staff, causing wage growth to accelerate further still. These factors weigh on productivity and push up unit labour costs, which are then passed on through price rises, keeping inflation sticky at elevated levels. All the while, the mismatch between worker skills and jobs in the post-pandemic economy means the NAIRU rises and available slack is less than in the baseline.	**Stagflationary**: With companies clinging on to workers, tight labour markets ensure that price pressures endure as wages increase and productivity stagnates. These factors result in inflation proving persistent at above-target rates across much of the global economy. This forces the Fed to raise rates to 6.25%. Other central banks also step up the pace of tightening. Higher inflation, along with tighter monetary policy, chokes off demand leading to economies witnessing below-trend growth and flirting with recessions.	11%	-0.8%	+1.1%
6. Other			0%	-	-

*Scenario probabilities are based on mutually exclusive scenarios. Please note the forecast warning at the back of the document.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

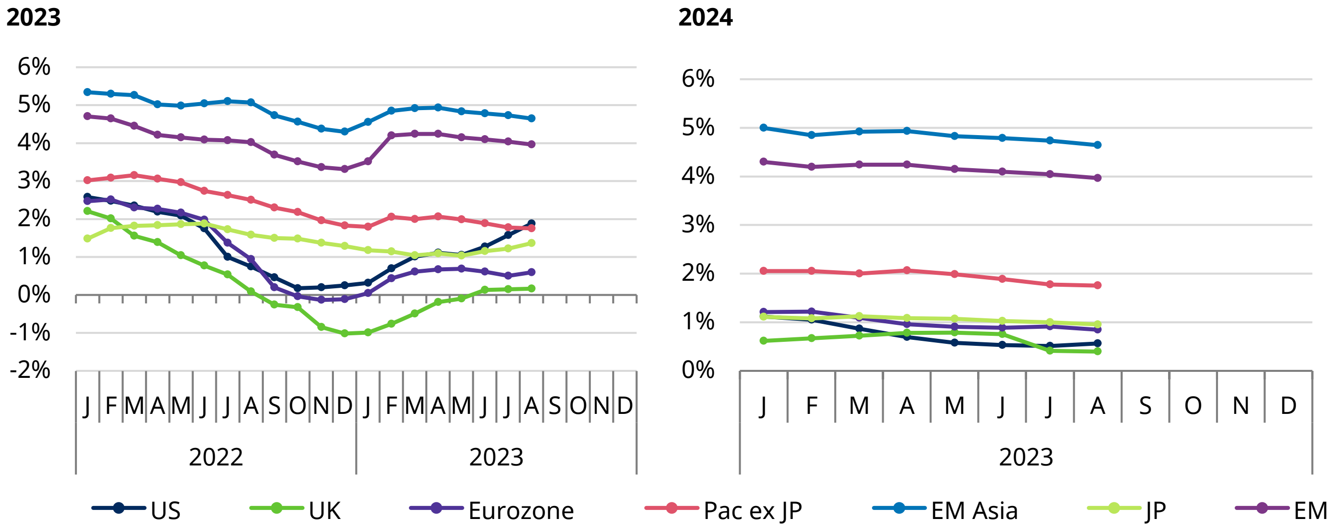
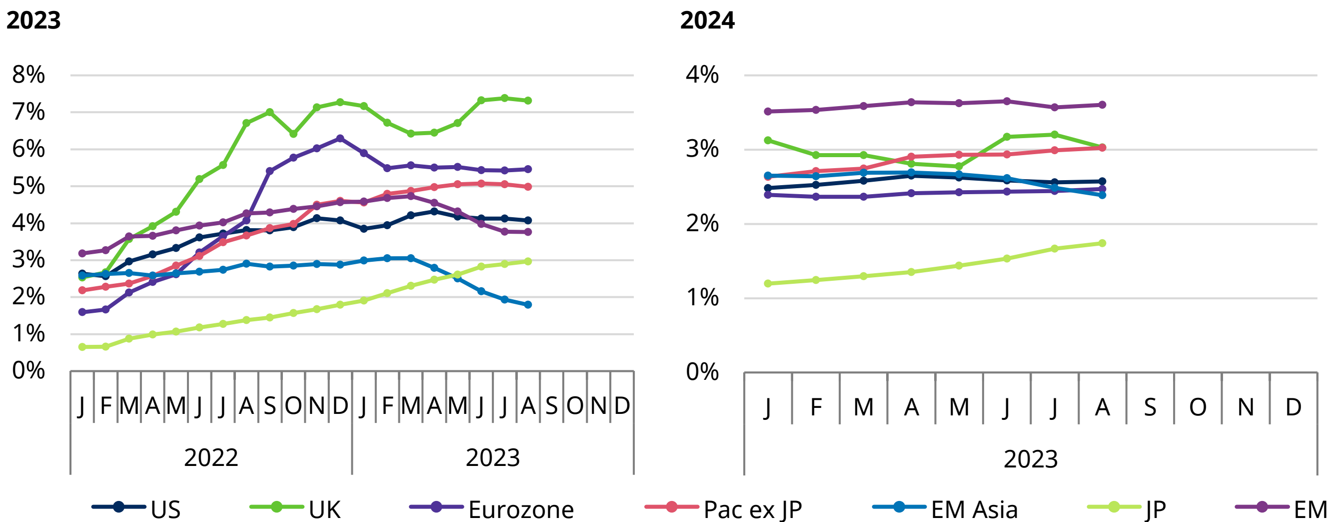


Chart B: Inflation consensus forecasts



Source: Consensus Economics (August 2023), Schroders.
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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