Schroders

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Economic and Strategy Viewpoint

Q2 2023

Keith Wade
Chief Economist and Strategist
(44-20)7658 6296

Azad Zangana
Senior European Economist and Strategist
(44-20)7658 2671

David Rees
Senior Emerging Markets Economist
(44-20)7658 5549

George Brown
Economist
(44-20)7658 7495

Tighter monetary policy starts to bite

– As central banks continue to raise interest rates, signs are appearing that the impact is starting to be felt. Manufacturing activity is trending downwards, especially in Europe and Asia. Meanwhile, services continue to rebound, probably as households continue to rebalance their spending patterns back to pre-pandemic norms.

– Higher interest rates, along with poor management, have contributed to the demise of three significant regional banks in the US. This has raised concerns of a repeat of the Global Financial Crisis. Lending conditions have tightened since rates began to rise, and lending growth has slowed sharply, but we do not see a systemic risk in the banking system as was the case in the GFC. The baseline forecast assumes concerns will ease.

– Similarly, the political split in Washington has raised the prospects that the US federal government may be forced into a technical default of its debt if an agreement cannot be reached to raise the debt ceiling. The baseline forecast assumes that a deal is reached in the end, but there is a risk that concerns in markets lead to heightened volatility and a sell-off in risk assets.

– The new baseline forecast has global GDP growth slowing to 2.4% this year and 1.9% in 2024. This represents an upward revision for this year, mostly driven by upgrades to the US forecast. US households have proven to be more resilient, which in turn has allowed companies to pass on more of their costs through prices increases, but has also allowed them to keep hiring, re-enforcing a robust labour market.

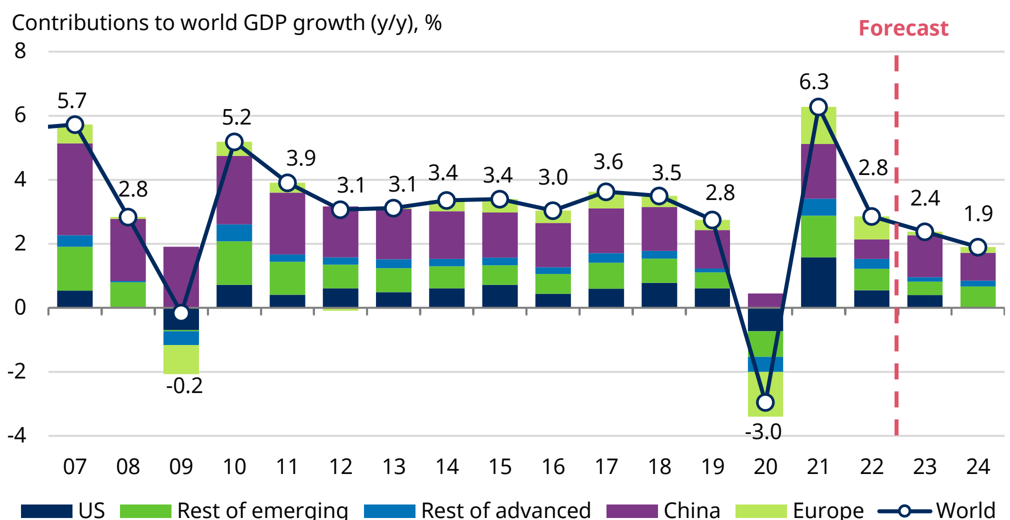
– The US recession has been pushed out by a quarter, and the profile for the Fed funds forecast has been raised slightly. Inflation has started to fall, but has been stickier on the back of higher services inflation.

– The forecast for the eurozone has been revised up slightly as support from stronger export markets is expected to be partially offset by higher interest rates. European inflation has also proven to be more persistent, but should fall back significantly by early 2024, allowing for rate cuts.

– The UK is now forecast to avoid a technical recession, although the economy is expected to stagnate for most of this year. Higher interest rates and fiscal tightening are expected to weigh on households and firms. Lower energy prices will help lower inflation over the forecast, but core inflation is expected to remain elevated.

– China has had a good start to the year as the recovery from zero-Covid policy continues. The rest of the emerging market economies, however, are seeing economic activity soften as the aggressive tightening in monetary policy starts to bite.

Chart: Global growth forecast



Source: Schroders Economics Group. 24 May 2023.
Please note the forecast warning at the back of the document.

Tighter monetary policy starts to bite

In May, the US Federal Reserve raised the target range for the federal funds rate by 0.25% to a range of 5-5.25% - the 10th consecutive increase, and the highest level since August 2007. But how much further do interest rates need to rise?

Tighter monetary policy is starting to impact some parts of the economy

Federal Reserve chair Jerome Powell said in the press conference following the policy announcement that: *"Policy is tight, and you see that in interest sensitive activities. And you also begin to see it in more and more in other activities. If you put the credit tightening on top of that and the QT that's ongoing, I think you feel like we may not be far off or even at that level"* [of sufficiently high rates].

Powell would not confirm that the Fed was ready yet to pause, but did emphasise that decisions moving forward would be taken meeting by meeting, and would be data driven.

There is no doubt that higher interest rates have started to slow activity. Construction, particularly for dwellings, has slowed materially, while other cyclical sectors, such as advertising and technology are retrenching. Indeed, reported company earnings have suffered, and are now contracting for most markets in aggregate.

Manufacturing downturn as services rebound

The manufacturing sector appears to have been more impacted so far. The capital-intensive nature of investment in manufacturing, and manufacturing related goods tends to be more exposed to interest rate cycles. The global manufacturing PMI has been below 50 (the neutral level) since September 2022 (chart 1).

In contrast, the global services PMI has risen for the sixth consecutive month and is at its highest level since November 2021. Services companies tend to be less affected by interest rates, and other factors appear to be supporting demand. Despite higher inflation, demand from households has held up. Excess savings from the pandemic continued to support spending, which have also been supported by a robust labour market. Although hiring has started to slow, wage growth remains elevated due to a shortage of workers and the response to the rising cost of living.

Goods sales enjoyed a boost from the inability of households to spend on services during the pandemic. However, as economies reopened, households have been rebalancing their spending back towards services. This may have some way to run as people become reacquainted with services such as travel and tourism, which were halted during the pandemic.

Manufacturing activity is trending down as services rebound

Chart 1: Manufacturing vs. services

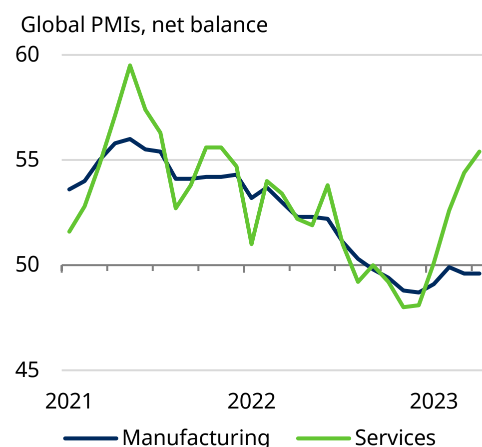
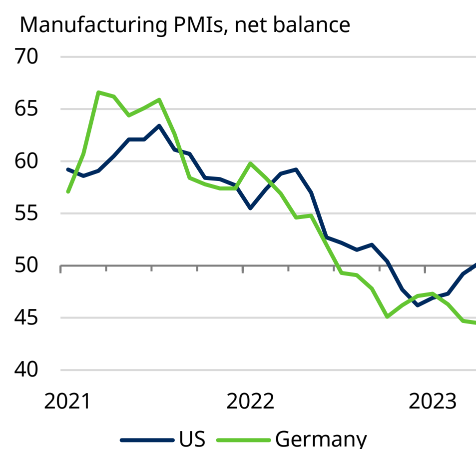


Chart 2: Diverging regions



Source: Refinitiv, S&P Global, Schroders Economics Group. 19 May 2023.

How long can services continue to diverge from manufacturing? Expectations are that as higher interest rates start to impact more households, consumer confidence will weaken, and spending on services will also start to falter. Given that services are the biggest sector in advanced economies, central banks will want to see below trend growth in their services activity before they can be confident that inflation will fall back in due course.

Returning to global manufacturing, it is worth noting that there are also some geographical differences. US manufacturing appears to have regained some momentum after contracting in the previous (to March) five months. However, the April manufacturing PMI rose back above the neutral level of 50 (chart 2). Meanwhile, most manufacturing PMIs in Asia remain below 50, while the European indicators appear to be worsening. Germany's, for example, has fallen to 44.5 – the lowest level since May 2020.

So far, evidence suggests that companies have been able to pass on higher costs by increasing their prices. However, volumes have started to fall back, even if nominal spending continues to perform well. The reduction in the volume of sales has hit manufacturing as shown by the business surveys. This is only likely to worsen over coming months.

Bank failures

Higher rates have also contributed to some bank failures…

The Global Financial Crisis (GFC 2007-2008) remains fresh in the minds of investors, and so when the news broke in March that Silicon Valley Bank (SVB) – a Californian regional bank - was closed and fell into receivership to the Federal Deposit Insurance Corporation (FDIC) to protect depositors, investors began to fear the worst. Had something finally 'broken' in this hiking cycle?

Soon after, Signature Bank (New York) and First Republic Bank (California) followed, and a regional US banking crisis was declared by the media and investment community. While these failures appear to be caused by idiosyncratic factors, there are some commonalities. Poor management is often cited, but also poor management of assets and liabilities, and being on the wrong side of interest rate risks appear to have been factors. These meant that they were less able to cope than others with a general tightening of financial conditions.

Where the current situation differs to the GFC period is the lack of systemic risk, such as a widely owned asset turning bad, or large linkages between banks. Indeed, post-GFC regulations not only worked to reduce cross-bank ownership and exposures, but also to force banks to hold more capital and liquid assets to be able to withstand large recessions.

The exception seems to be in US regional banks, where some of the safeguarding measures, such as deposit insurance, were not adopted, as they were seen as infringing competition. This has now put regional banks in the spotlight as a risk for investors.

Contagion began to spread and soon after, troubled Swiss giant Credit Suisse was forced to take a bail-out from the Swiss National Bank, and then forced into a sale to its rival UBS. Deutsche Bank also came under pressure, but Germany's largest bank came through the period unscathed. As European Union and UK banks have adopted the tougher liquidity rules following the GFC, they are more resilient to such crises than US regional banks.

Our baseline forecast assumes that the banking situation stabilises, but so far in 2023, bank failures in the US have been larger in inflation adjusted terms by assets held than any other year since 1973 (chart 3). For this reason, we have added a new risk scenario to our forecast where bank failures continue and tighten credit conditions further. With banks reluctant to lend in this scenario, the global downturn is deeper and more prolonged, also lowering inflation faster in the processes.

...which have in turn paired back hawkish sentiment in money markets

Chart 3: History of US bank failures

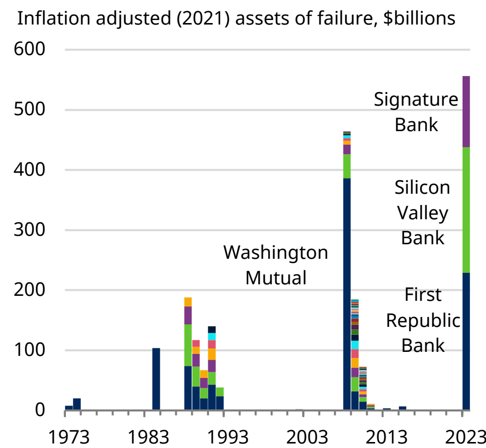
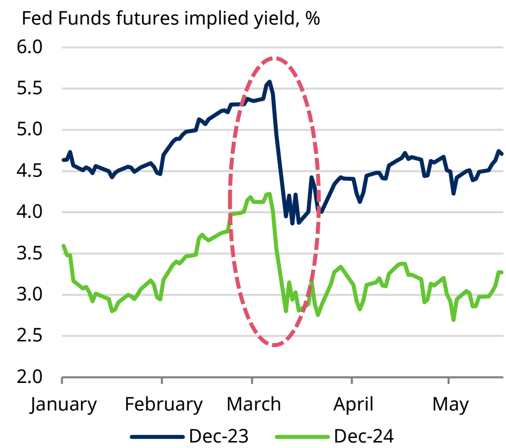


Chart 4: Markets turn dovish



Source: US FDIC, Refinitiv, Schroders Economics Group. 19 May 2023.

So far, the reaction in markets has been varied. Equities initially sold off but have since recovered. Credit spreads widened, especially for financials, while in US Treasury and money markets, investors pared their hawkish Fed bets, pricing in lower rates by the end of this year and next by approximately 100 basis points (chart 4).

Tighter credit conditions an accelerant

As mentioned in Powell's quote above, the tightening of credit conditions is a consideration for central banks in addition to the policy actions taken. Raising interest rates affects demand and credit to households and firms through the price channel. But in addition, banks will often tighten lending criteria and restrict credit further, creating a non-linear inverse relationship between rising interest rates and lending to the real economy.

Growth in bank lending to households and firms had started to slow even before the bank failures began in the US, and is expected to fall further, with the 6-month annualised rates running far lower than the year-on-year measures (chart 5). This is a normal development through the interest rate cycle as seen ahead of and during past recessions.

Credit conditions are being tightened, contributing to the fall in bank lending growth

Chart 5: Bank lending growth

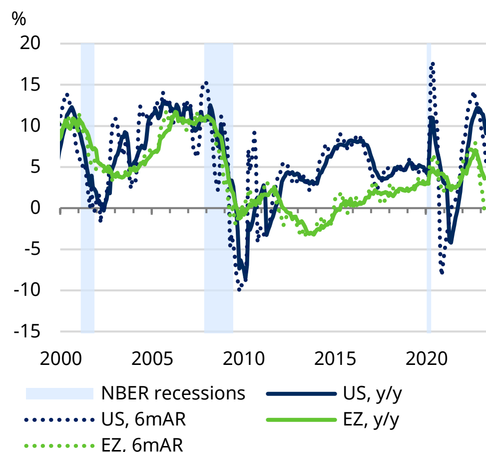
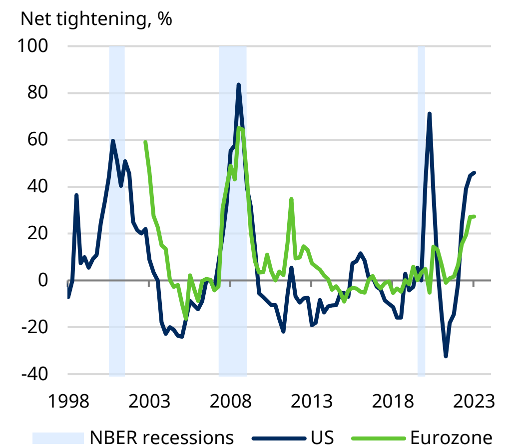


Chart 6: Lending conditions



Source: Refinitiv, Schroders Economics Group. 19 May 2023.

Both the Fed and European Central Bank (ECB) have published the results of their respective credit conditions surveys for the second quarter, and while both have shown additional tightening since the collapse of SVB, compared to past shocks, this one has been fairly muted (chart 6). That said, credit conditions overall are tight. In

the US, they are comparable to conditions during the pandemic, but in the eurozone, they have surpassed those levels, and are now as tight as during the European sovereign debt crisis 11 years ago.

Forecast update: US recession delayed

The latest baseline forecast update has smaller changes than we have had over recent quarters. Better than expected growth in the first quarter of the year has prompted some upgrades for this year, but this has not translated into wholesale upgrades for the entire forecast period. Meanwhile, inflation has been raised, mainly due to higher core inflation, which in turn is expected to lead to tighter monetary policy.

The new global GDP forecast has been revised up for 2023, but down for 2024

Global GDP growth is forecast to slow from 2.8% in 2022 to an upwardly revised 2.4% in 2023 (2% previously) and 1.9% in 2024 (2.2% previously). China is still forecast to lead the emerging markets into an acceleration this year, thanks to the relaxation of zero-Covid policy, but is then forecast to slow in 2024.

Meanwhile, the forecasted recession for the US economy has been pushed out by a quarter, straddling the end of this year and start of next. A stronger than expected first quarter has prompted a large upward revision to the growth forecast, from 0.3% to 1.5% for 2023. Households appear to be more resilient than expected as consumption grew by 3.7% AR in Q1. The economy grew by 1.1% AR over the first quarter, which includes a 2.3 percentage point drag from destocking.

The US labour market remains resilient, as the corporate sector continues to expand its workforce. Firms are continuing to pass costs on to households, with no signs of mass layoffs or cutbacks in spending apparent from earnings communications. This suggests that there is still sufficient demand in the economy, which is likely to lead to stickier inflation than previously forecast.

The US has seen the largest upward revision, as the forecast recession has been pushed back

As for inflation, there has been an improvement. Headline US CPI inflation has fallen from 6.5% y/y at the end of last year to 4.9% y/y in April. However, core CPI inflation has only fallen from 5.7% to 5.5% y/y over the same period.

For the Fed, as mentioned earlier, the funds target has now reached 5% to 5.25%, which is our forecast for the peak in rates, unchanged from our previous forecast in February. However, whereas we previously had the Fed cutting the range twice (25bps each time), we now forecast only one cut in December, owing to the delay in the recession.

With the recession spilling over into the following year, GDP growth has been downgraded from 0.7% to just zero. This is notably lower than consensus estimates of 0.6% for 2024. Higher inflation is partly to blame for the weaker growth profile, as the forecast for CPI inflation has been raised from 2% to 2.3%, although this is lower than consensus estimates of 2.6%. In response, the Fed continues to cut interest rates, ending 2024 at 3.25 to 3.50% - 25bps higher than the previous forecast. Quantitative tightening continues at a steady pace.

Europe: offsetting factors

The eurozone has seen a smaller upward revision, owing to more ECB rate hikes

In the eurozone, wholesale energy prices have fallen further, but higher food price inflation and inflation in services has prompted upward revisions for inflation. The HICP inflation forecast has been revised up from 4.2% y/y to 5.6% y/y for 2023 and from 2.2% y/y to 2.4% y/y for 2024. As a result, the ECB is forecast to raise its main interest rate (refinancing rate) to a peak of 4.25% by July.

The peak in the ECB's policy rate is 0.75% higher than in the previous forecast, which would ordinarily cause a downgrade to the GDP growth forecast. However, stronger growth elsewhere in the world helps offset some of the drag caused by rates, in addition to a stronger start to the year than expected. The latter is especially true for France, Italy and Spain.

Meanwhile, Germany has had a large downgrade to its GDP growth for the back end of 2022, and the revised data for the first quarter (2023) confirm that the European Union's largest economy has slipped into a technical recession. This has prompted a downgrade to the 2023 forecast (from 0.1% to zero), but there is a slight upgrade for 2024 (0.6% to 0.7%) as falling energy prices start to help.

The overall eurozone GDP growth forecast has been nudged higher from 0.5% to 0.6% y/y in 2023 and from 0.8% to 0.9% y/y for 2024. Inflation is forecast below 3% in the first quarter and averaging 2.4% over 2024. This allows the ECB to cut rates gradually, reaching 2.5% by the end of the year.

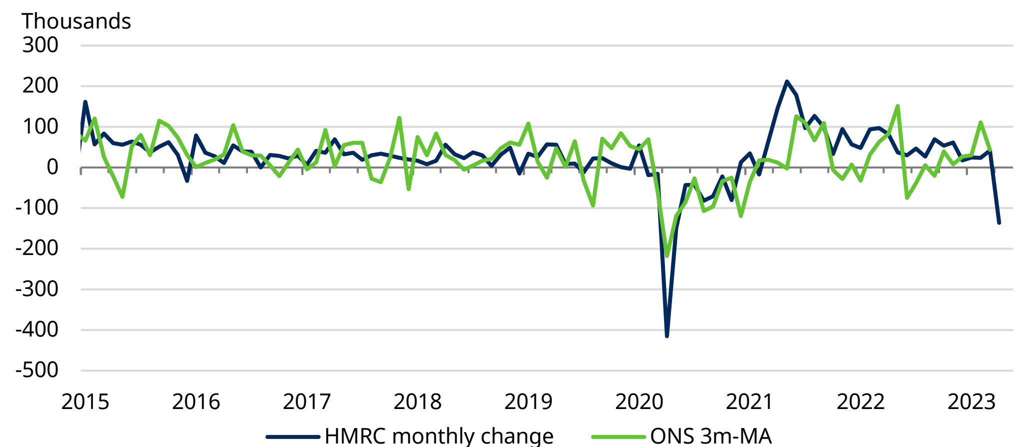
UK: recession avoided, but vulnerabilities remain

Extra bank holidays and the impact of industrial actions has muddied the water when attempting to analyse the prospects for the UK economy. However, what the latest data reveals is that the level of GDP is no higher than September 2022, or when the current prime minister took charge.

It now appears that the UK is likely to avoid a technical recession, but it continues to lose momentum heading into summer. The latest GDP figures showed a significant contraction in March (-0.3%), while the latest HMRC payroll figures showed what could be the start of large job layoffs (chart 7).

The UK is set to avoid a technical recession, but job shedding is underway

Chart 7: Job shedding begins in the UK



Source: Refinitiv, ONS, HMRC, Schroders Economics Group. 19 May 2022.

Additional fiscal stimulus and falling energy prices have helped lift the UK growth forecast from -0.8% to zero for this year, while the forecast for 2024 has been raised from 0.8% to 0.9%.

CPI inflation is forecast to average 7.6% in 2023 compared to 6.5% previously, revised higher mainly due to longer lasting food price inflation. This is still expected to fall back, and as a result, the 2024 CPI forecast has been revised down from 3.8% to 3.6% y/y.

The Bank of England (BoE) delivered its 12th consecutive rate rise in May, taking the main policy rate to 4.50%. Recent hikes have been designed to manage the upside risk to the BoE's inflation forecast, and the latest GDP figures were worse than the BoE had forecast in its May Monetary Policy Report. That said, despite a sharp fall in CPI inflation in April (down from 10.1% to 8.7% y/y) the fall was smaller than expected as services inflation rose further. We therefore expect the BoE to raise rates by 25bps in June and again in August, taking the peak up to 5% (100 bps higher than previously).

The BoE is then forecast to cut rates in 2024 as inflation continues to fall back to target. However, we have revised up the end point of those cuts from 2% to 3.25%

for the end of 2024. This is owing to more sticky inflation engrained in the UK economy due to mostly supply problems.

Emerging markets: China's lopsided recovery set to fade

Emerging market GDP growth is expected to slow from 4.4% in 2023 to 3.9% in 2024. But beneath the headline figures the drivers of EM growth are likely to rotate over the forecast horizon as a relatively strong recovery in China loses momentum and lower interest rates boost the outlook for other EMs as we head into 2024.

China's economy outperformed expectations at the start of the year...

China's economy performed better than was generally expected in the first quarter and, while official activity data undershot expectations in April, should continue to deliver robust growth into the third quarter.

The relaxation of the government's zero-Covid Policy has unleased strong consumption of services, while the housing market should add to growth from a low base. However, the lop-sided consumer recovery is likely to run out of steam as the year progresses. Excess household savings are relatively small, while support from the credit cycle will fade as we head into 2024. As such, we expect GDP growth to slow from 6.5% in 2023 to 4.3% in 2024.

...but the rest of EM is seeing a period of slower growth after large rate rises

By contrast, most other major EM economies face a period of slower growth in the near term as aggressive interest rate hikes over the past year hit activity with a lag, typically of 6-9 months. The good news is that EM inflation has begun to roll over at high levels and should fall sharply into year-end.

Fuel inflation has already begun to decline rapidly, while leading indicators suggest that food price pressures will ease substantially. Survey evidence also suggests that high interest rates will begin to bring down core inflation. That should clear the way for central banks to start cutting rates, potentially in the second half of 2023, improving the outlook for growth in 2024.

Scenarios analysis: Banking crisis risk added

In thinking about risk scenarios, the US debt ceiling issue remains at the forefront of investors' minds. The baseline assumes that a last-minute deal is struck which includes some austerity in the outer years, and as a result, there is minimal impact on financial markets. However, because fears of an actual or near default remain very live, we have retained the **Bond Vigilantes Return** scenario (chart 8).

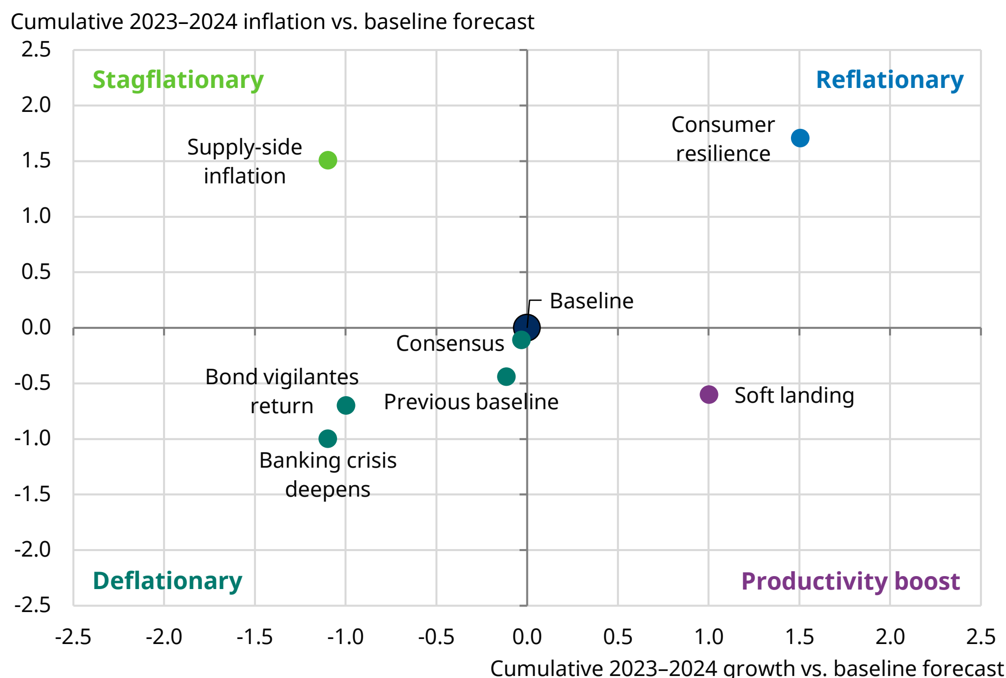
The US debt ceiling is at the forefront of investors' minds

The polarised political landscape in Washington raises a clear risk of government shutdown, ratings downgrades and even default as the US government approaches its debt ceiling. A buyers' strike in the Treasury market could cause huge volatility in global financial markets and see bond vigilantes go after other governments around the world that are running unsustainable fiscal policies. Governments may be forced to retrench, while an abrupt tightening of financial conditions would be bad news for those emerging markets that rely on capital flows. Global growth is markedly slower, although weaker demand does at least bring inflation down making this a deflationary scenario.

We continue to place a higher probability on and have retained the **Supply-Side Inflation** scenario, where the labour market remains buoyant, causing wage inflation to remain high, pushing up costs for companies that in turn continue to raise their prices. This stagflationary scenario requires even more aggressive monetary tightening to reverse inflation pressures.

The Supply-Side Inflation, Consumer Resilience and Soft Landing scenarios have all been retained

Chart 8: Scenarios grid – growth and inflation deviations from baseline



Source: Schroders Economics Group. 24 May 2023. Please note the forecast warning at the back of the document.

On a more positive note, we have also kept both the **Consumer Resilience** and the **Soft Landing** scenarios. The former sees households spend more of the savings that had been accumulated through the pandemic, leading to a reflationary scenario, while the latter has a more positive response from the labour market. Missing workers return to boost output, but also to cool the labour market as supply improves. This is a productivity boosting scenario.

The Banking Crisis Deepens scenario has been added to capture the concerns over US regional banks

Lastly, we have decided to drop the previous **Higher Commodity Prices** scenario as the recent announcement by OPEC to cut production only had a small impact on energy prices compared to the start of this year. While a risk of rising commodity prices remains, we preferred to replace the scenario with one that captures the rising risk of a problem with the banking system – the **Banking Crisis Deepens** scenario.

As discussed earlier, this scenario has been added in response to the events in the regional US banks. The scenario assumes more regional banks face runs and fail. As they do, the rest of the banking system tightens credit conditions further, leading to reduced lending and demand in the economy. This spreads to other countries given the linkages through dollar financing. The scenario is deflationary and would prompt the Fed to halt QT and cut interest rates to stem the crisis.

The forecast overall has moved in a reflationary direction, and Schroders has slightly higher growth and inflation over the rest of this year and next compared to consensus surveys.

Outside of the baseline, the Supply Side Inflation scenario has the largest probability amongst the scenarios, closely followed by Consumer Resilience (chart 9).

Chart 9: Scenario probabilities

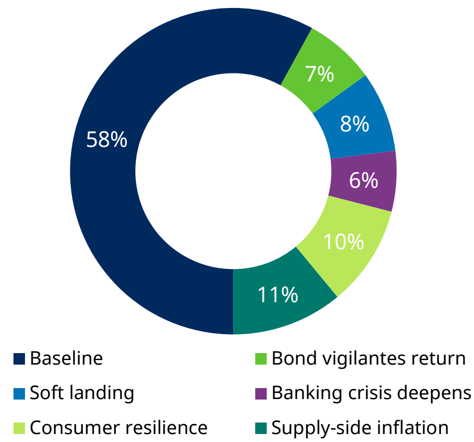
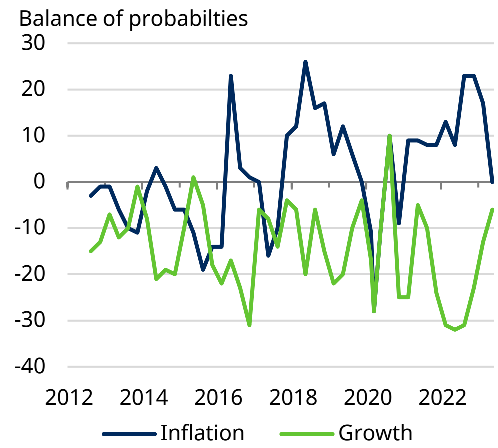


Chart 10: Growth and inflation skews



Source: Schroders Economics Group. 24 May 2023. Probabilities are mutually exclusive. Please note the forecast warning at the back of the document.

Overall, the evolution of the baseline forecast and risk scenarios means that the balance of risks for growth remains skewed to the downside, but it is at its highest level since May 2021 (chart 10). The risk to the inflation forecast has fallen and is now balanced, falling to its lowest level since November 2020.

Schroders Economics Group: Views at a glance

Macro summary – Q2 2023

Key points

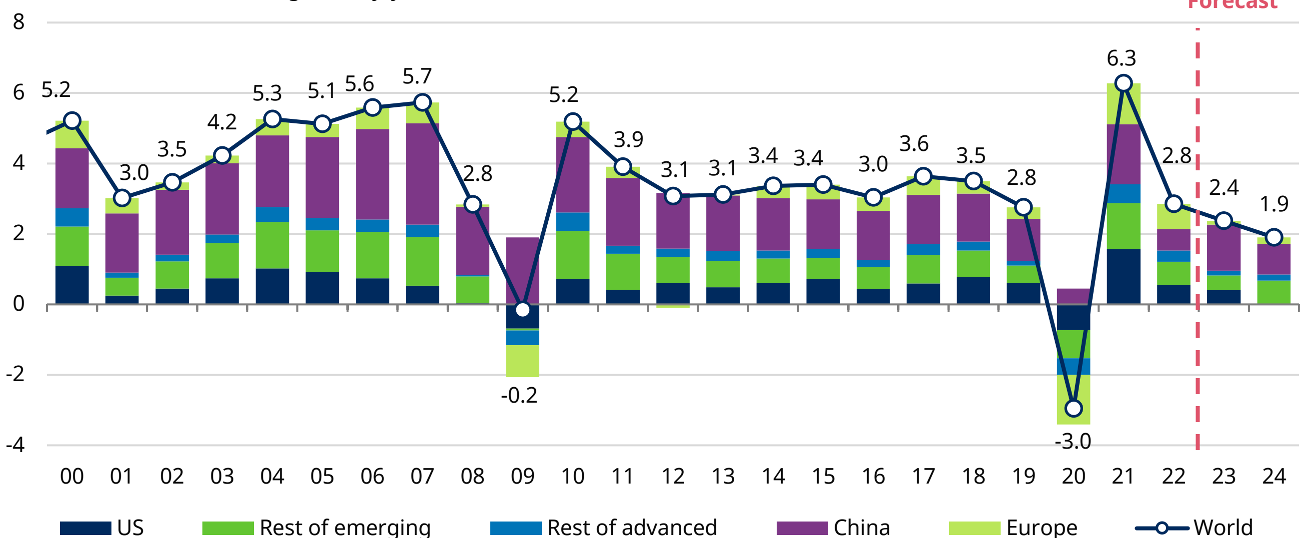
Baseline

- **US:** A resilient labour market has continued to underpin household spending, resulting in a stronger-than-expected start to the year. But with the Fed likely to have reached a terminal rate of 5.25%, this should be restrictive enough to tip the US economy into a mild recession at the end of this year. This would see GDP unchanged over 2024 as a whole following an expected expansion of 1.5% in 2023. Alongside this, inflation is proving sticky but ought to moderate, such that CPI inflation is forecast to ease from 8% in 2022 to 4.2% in 2023 and 2.3% in 2024. This should allow the Fed to cut rates by 25bp before year-end and lower them to 3.50% in 2024.
- **Eurozone:** Although energy prices have fallen further, higher food and services inflation has prompted upgrades to our HICP projections. It is now forecast to average 5.6% in 2023 and 2.4% in 2024. As a result, the ECB is likely to raise its main refinancing rate to a peak of 4.25%. However, the drag from higher rates is more than offset by the combination of a better-than-expected start to the year and a more supportive global backdrop. As such, the eurozone economy is forecast to expand by 0.6% in 2023 and by 0.9% in 2024. And with inflation forecast to fall below 3% early next year, the ECB is set to cut rates to 2.5% by the end of 2024.
- **UK:** Whilst the UK is now forecast to avoid a technical recession, the economy is expected to stagnate for most of this year. This is likely to see growth plateau this year before giving way to a 0.9% expansion in 2024. At the same time, inflation has become more embedded due to supply-side issues, such that CPI is forecast to average 7.6% in 2023 before easing to 3.6% in 2024. In response, the BoE is likely to raise rates by a further 50bps this year, taking them to a peak of 5%. But as inflation falls back towards the 2% target in 2024, we expect the committee will cut rates to 3.25% over the course of the year.
- **Emerging Markets:** China's economy surpassed general expectations at the start of 2023 and should continue to deliver robust growth late into the year. By contrast, most other major EM economies face a period of slower growth as aggressive interest rate hikes over the past year hit activity. Accordingly, EM GDP growth is expected to slow from 4.4% in 2023 to 3.9% in 2024. Still, EM inflation has begun to roll over at high levels and should fall sharply into year-end. This ought to clear the way for central banks to start cutting rates, potentially in the second half of 2023, improving the outlook for growth in 2024.

Risks

For some time, we have judged that stagflation poses the greatest threat to the global economy. But recently the risks to both growth and inflation have become more bimodal. Of our five risk scenarios, we have assigned the highest likelihood to supply-side inflation, albeit only just ahead of the reflationary consumer resilience scenario. This is followed by the productivity boosting soft landing, whereas similar probabilities have been assigned to the two deflationary scenarios; bond vigilantes return and banking crisis deepens.

Chart: World GDP forecast



Source: Schroders Economics Group. 24 May 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	2.4	↑	*(2.0)*	2.2	1.9	↓	*(2.2)*	2.2
Advanced*	60.0	2.7	1.1	↑	*(0.4)*	0.9	0.6	↓	*(0.9)*	0.9
US	26.7	2.1	1.5	↑	*(0.3)*	1.1	0.0	↓	*(0.7)*	0.6
Eurozone	16.7	3.5	0.6	↑	*(0.5)*	0.7	0.9	↑	*(0.8)*	0.9
Germany	4.9	1.8	0.0	↓	*(0.1)*	0.1	0.7	↑	*(0.6)*	1.1
UK	3.6	4.0	0.0	↑	*(-0.8)*	-0.1	0.9	↑	*(0.8)*	0.8
Total Emerging**	40.0	3.1	4.4	↑	*(4.2)*	4.1	3.9	↓	*(4.1)*	4.1
BRICs	27.8	3.1	5.4	↑	*(5.2)*	5.0	4.2	↓	*(4.6)*	4.6
China	20.3	3.0	6.5	↑	*(6.2)*	5.8	4.3	↓	*(4.5)*	4.9

Inflation CPI

y/y%	Wt (%)	2022	2023		*Prev.*	Consensus	2024		*Prev.*	Consensus
World	100	7.1	4.5	↑	*(4.2)*	4.6	2.9	↑	*(2.8)*	3.0
Advanced*	60.0	7.4	4.7	↑	*(3.9)*	4.6	2.3	↑	*(2.1)*	2.5
US	26.7	8.0	4.2	↑	*(3.6)*	4.2	2.3	↑	*(2.0)*	2.6
Eurozone	16.7	8.4	5.6	↑	*(4.2)*	5.5	2.4	↑	*(2.2)*	2.4
Germany	4.9	8.7	4.5	↓	*(4.8)*	6.2	2.4		*(2.4)*	2.7
UK	3.6	9.1	7.6	↑	*(6.5)*	6.7	3.6	↓	*(3.8)*	2.8
Total Emerging**	40.0	6.5	4.2	↓	*(4.6)*	4.6	3.8		*(3.8)*	3.7
BRICs	27.8	3.9	2.3	↓	*(3.0)*	2.8	3.1	↓	*(3.3)*	3.0
China	20.3	1.9	1.3	↓	*(2.3)*	1.8	2.5	↓	*(2.7)*	2.4

Interest rates

% (Month of Dec)	Current	2022	2023		*Prev.*	Market	2024		*Prev.*	Market
US	5.25	4.50	5.00	↑	*(4.75)*	4.66	3.50	↑	*(3.25)*	3.19
UK	4.50	3.50	5.00	↑	*(4.00)*	4.90	3.25	↑	*(2.00)*	4.16
Eurozone (Refi)	3.75	2.50	4.25	↑	*(3.50)*	3.67	2.50	↑	*(1.75)*	2.83
Eurozone (Depo)	3.00	2.00	3.75	↑	*(3.00)*		2.00	↑	*(1.25)*	
China	3.65	3.65	3.65		*(3.65)*	-	3.65		*(3.65)*	-

Other monetary policy

(Over year or by Dec)	Current	2022	2023		*Prev.*	Y/Y(%)	2024		*Prev.*	Y/Y(%)
US QE ($Tn)	8.7	8.6	7.9	↑	*(7.7)*	-8.1	7.2	↑	*(7.0)*	-8.9
EZ QE (€Tn)	2.9	2.9	2.7		*(2.7)*	-6.9	2.4		*(2.4)*	-11.1
UK QE (£Bn)	817	831	752	↑	*(733)*	-9.5	647	↑	*(628)*	-14.0
China RRR (%)	10.75	11.00	11.00		*11.00*	-	11.00		*11.00*	-

Key variables

FX (Month of Dec)	Current	2022	2023		*Prev.*	Y/Y(%)	2024		*Prev.*	Y/Y(%)
GBP/USD	1.24	1.20	1.26	↑	*(1.18)*	4.7	1.30	↑	*(1.22)*	3.2
EUR/USD	1.08	1.07	1.11		*(1.11)*	4.0	1.16		*(1.16)*	4.5
USD/JPY	138.6	131.9	138	↑	*(125)*	4.6	130	↑	*(120)*	-5.8
EUR/GBP	0.87	0.89	0.88	↓	*(0.94)*	-0.7	0.89	↓	*(0.95)*	1.3
USD/RMB	7.03	6.95	6.60		*(6.60)*	-5.1	6.40		*(6.40)*	-3.0
Commodities (over year)										
Brent Crude	76.0	99.0	79.9	↓	*(82.2)*	-19.3	75.0	↓	*(77.5)*	-6.1

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data taken as at 22/05/2023. Previous forecast refers to February 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
			Cumulative 2023/24 global vs. baseline		
Baseline	Global GDP growth is expected to slow to 2.4% in 2023, from 2.8% in 2022, with a further deceleration to just 1.9% in 2024. Developed market GDP growth is expected to be more resilient at 1.1% in 2023, as consumers, buoyed by strong labour market conditions and falls in energy prices, have been resilient. However, growth slows to just 0.6% in 2024 as tighter policy eventually bites. Within that, the US drives the slowdown as its heads into recession, whereas the eurozone and UK are expected to avoid outright declines in output. Emerging market growth is also expected to slow, from 4.4% in 2023 to 3.9% in 2024. Within that, China is expected to deliver growth of about 6.5% in 2023, before slowing to 4.3% in 2024 as the reopening burst of growth fizzles out. By contrast, most other EMs are likely to struggle in the near term, before picking up in 2024 as inflation and interest rate pressures ease.	Inflation is expected to continue to trend down during the course of 2023 as the effects of higher energy prices fall out of the annual comparison and food inflation sees steep declines. Core inflation is also expected to subside, albeit resilient activity means that the adjustment is likely to be more gradual. Against this backdrop, policy interest rates are around their peak. We think that the Fed will pause at 5.25% for most of 2023, before starting to cut rates before year-end down to a trough of 3.50% in 2024. The ECB still has some work to do, lifting the refinancing rate by another 50bp to 4.25% in 2023 but is still set to ease, to 2.50%, in 2024. Similarly, the Bank of England is also expected to raise rates another 50bp to 5.00% throughout the remainder of 2023 before lowering Bank Rate to 3.25% in 2024. Inflation in emerging markets is set to fall more rapidly, allowing central banks to start easing policy in the second half of 2023. Rates in Latin America have the most scope to fall.	58%	-	-
1. Bond vigilantes return	Negotiations to lift the debt ceiling hit an impasse as both sides dig their heels in. As investors fret about the risk of a US default, contagion spreads to other vulnerable debt markets which see higher yields and a greater probability of default being priced in. After some time, an agreement is reached to raise the debt ceiling, but the damage to the US's reputation is done, and a risk premium remains going forward.	**Deflationary**: Higher term premiums across the global economy raises the cost of financing debt, and reduced disposable income. The volatility in markets and currencies also reduce corporate and consumer confidence. The Fed is forced to stop QT and cut rates in an effort to lower yields, which is replicated by its peers in many advanced economies. However, policy rates in most of EM remain elevated to defend their currencies, with some even forced into large emergency rate hikes to stem capital outflows.	7%	-1.0%	-0.7%
2. Soft landing	The trade-off between growth and inflation improves as companies see costs fall back. Higher living costs encourage more workers to return to the labour force, boosting the participation rate. This helps ease wage pressures, and provides firms more resources to generate growth, with less inflation.	**Productivity boost**: Economies that have been hampered by supply constraints – notably the US, Europe and UK – see an increase in growth while inflation pressures subside a little. This relieves some of the pressure on the central banks in the fight against inflation, allowing them to cut interest rates sooner and to lower levels by the end of the forecast period.	8%	+1.0%	-0.6%
3. Banking crisis deepens	Fears about the fragility of the US financial system spur successive bank runs, causing a number of regional lenders to fail. Whilst deposits are protected, lending standards for households and businesses are tightened further across a consolidated banking landscape. As credit dries up and confidence is hit, consumers rein in their spending, whereas firms are forced to retrench as well as cut costs by laying off workers.	**Deflationary**: Activity is hit by the deterioration in credit conditions, tipping the US economy into a recession which sees GDP suffer a peak-to-trough fall of around 2% and the unemployment rate climb to a peak of 6%. In response, the Fed cuts rates and reins in the pace of quantitative tightening. Weaker activity and confidence spreads to the rest of the world, prompting other central banks to cut rates more aggressively than under the baseline.	6%	-1.1%	-1.0%
4. Consumer resilience	Thanks to the build-up of savings during the pandemic, households maintain regular spending patterns, despite rising cost pressures and interest rates. This bolsters the outlook for corporate profitability, encouraging greater CAPEX and the passing on of costs through higher prices.	**Reflationary**: Demand remains robust through 2023, leading to higher core inflation, and headline inflation falling back more slowly than in the baseline. Central banks respond by raising interest rates more aggressively. The Fed funds rate reaches a peak of 6.5%, while the ECB refinancing rate reaches 5.5%. Eventually, higher interest rates cause activity to slow, and the US experiences a technical recession in the second half of 2024. At that stage, central banks start to cut rates again, but over the two-year horizon, growth and inflation are both higher than the baseline.	10%	+1.5%	+1.7%
5. Supply-side inflation	Bottlenecks in the industrial sector re-emerge and prevent goods inflation from falling back, while commodity markets also struggle with supply shortages. Meanwhile, wages accelerate by more than in the baseline in response to tight labour markets. The labour participation rate in the US does not improve, whilst mismatch between worker skills and jobs in the post covid economy means the NAIRU rises and available slack is less than in the baseline.	**Stagflationary**: Supply shortages cause commodity prices to climb further, pushing food and energy inflation higher. Supply constraints and higher commodity prices see goods inflation increase again and tight labour markets ensure that price pressures endure as wages increase. This results in persistent inflation, which does not get back down to target over the forecast horizon. This forces the Fed to raise rates all the way to 6.75%. Other central banks also step up the pace of tightening. Higher inflation, along with tighter monetary policy, chokes off demand leading to shallower recoveries from deeper recessions.	11%	-1.1%	+1.5%
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

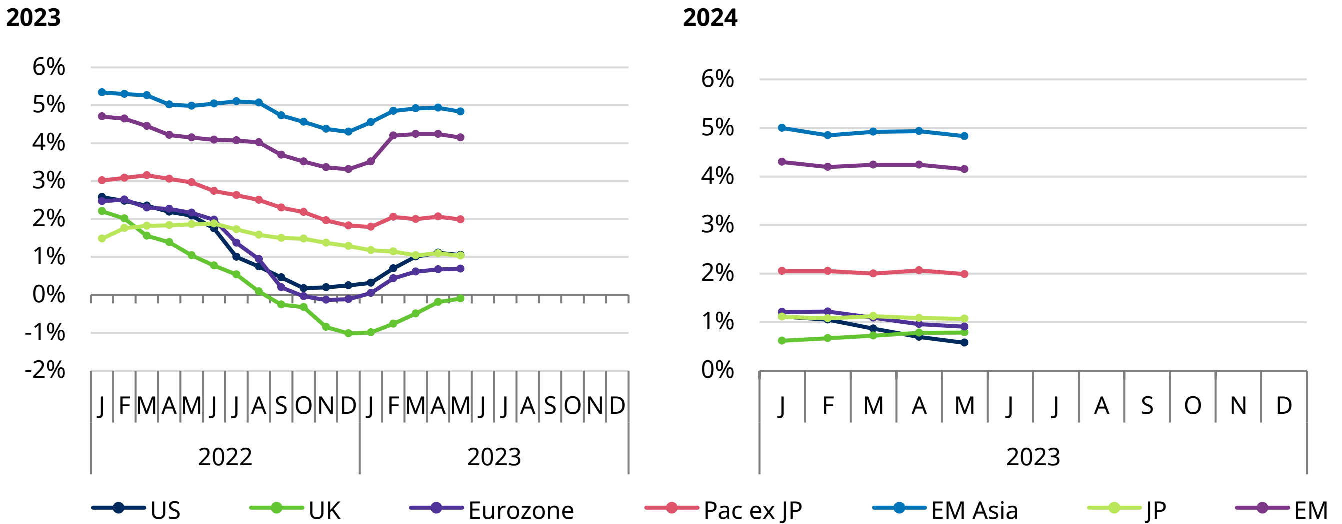
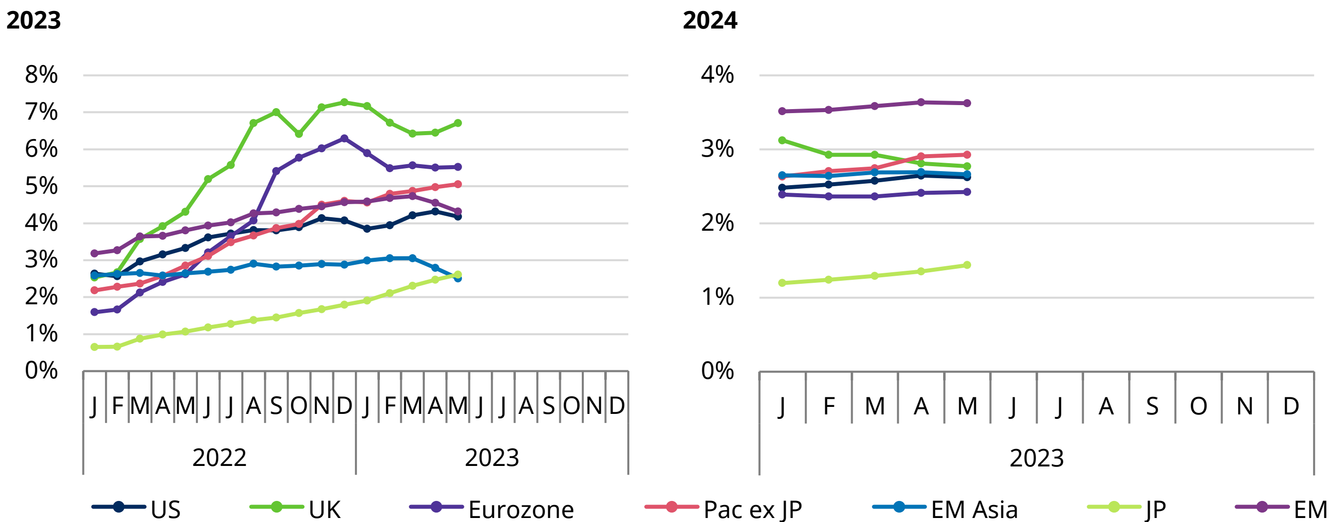


Chart B: Inflation consensus forecasts



Source: Consensus Economics (May 2022), 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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