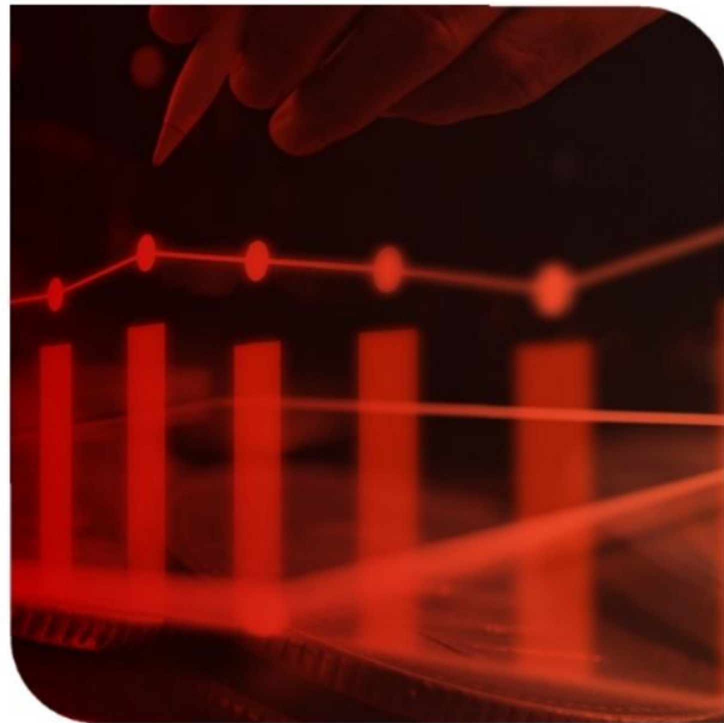

Mature Economies

Quarterly Cyclical Outlook

Quarterly - 2023Q4

Document completed on October 24th.

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Overall assessment

The global economic outlook is characterized by a path of gradual recovery in the wake of the complex repercussions of the post-Covid adjustment, escalating geopolitical tensions and the ongoing struggle with rising living costs. In the face of these significant challenges, the global economy has demonstrated an impressive level of resilience.

However, this resilience is not expected to last. In simplified terms, one could characterize the year 2024 as a pivotal year. While the end of 2023 signifies the conclusion of post-Covid adjustments, with a confirmation of the disinflation scenario and economic slowdown, 2024 represents a transitional year. With traditional factors substantially challenged or transformed by structural changes affecting the way the world operates, 2024 might be a transition to a new regime with potential for stronger growth, with more elevated inflation, higher rates, but also higher global risks.

Inflation dynamics

As we delve into the trajectory of developed economies in 2024, it is crucial to highlight the pivotal role played by inflation dynamics in shaping the economic landscape.

During the second and third quarters of 2023, there has been a noticeable move towards core disinflation. This drop in inflation seems to stem from a decrease in both supply and demand elements, which aligns with the overall economic slowdown. The slowing down of core inflation is projected to persist, particularly in service prices, which tends to be a slower process. This means there is some time before it becomes fully evident, and the rate and timing of its decline will differ based on each country's susceptibility to the factors influencing inflation.

However, despite this general trend of disinflation, inflation levels have not yet reached the targets set by central banks. According to our models, we project that by the end of 2024, the year-on-year headline inflation rates will be 2.5% for the US, 2.6% for the EUZ, 3.8% for the UK, and 1.3% for Japan.

It's crucial to keep in mind that while these figures may seem close to the central banks' targets, they are occurring during a low point in the economic cycle. If economic activity were to pick up, as per our scenario for the second half of 2024 and 2025, we could expect a swift and significant resurgence of inflation, surpassing central bank targets.

Energy prices

The question of energy prices is pivotal in the 2024 scenario. Regarding the outlook for Brent crude prices for end-2023 and Q12024, we anticipate a rise due to a gap between supply and demand resulting from reduced OPEC+ production. This could lead to Brent crude hovering around USD 93 per barrel during this period. As we move further into 2024, with the supply-demand imbalance expected to increase, we anticipate a gradual adjustment in Brent prices towards approximately USD 70 per barrel end-2024.

The impact of ongoing tensions in the Middle East on the oil and gas balance depends on how long the conflict persists. If the conflict escalates, there may be concerns about potential Iranian involvement, which could disrupt international trade flows and increase security risks through the Strait of Hormuz. Additionally, it could raise

questions about the security of infrastructure connecting North African gas suppliers with Europe, adding further uncertainty and volatility to an already constrained market.

Monetary policy trajectory and impact on bond yields

Despite the prospect of inflation converging towards 2.5% end-2024, major central banks remain resolute in maintaining higher interest rates in the short term. This is justified by the overall inflation decreasing too slowly and core inflation remaining too high. Especially since the labor market is close to full employment, and the impact of monetary tightening on the real economy is measured.

The trajectory of monetary policy is not expected to undergo a major upheaval up to mid-2024. It's only in the 2nd half of 2024, under our central scenario of an economic soft landing and labor market deterioration, that central banks might gradually consider lowering rates to mitigate the economic deceleration once they believe that inflation convergence towards the 2% target is nearby.

With Fed Funds rate 100bp above their "neutral stance", the Fed has some room to maneuver, allowing a slight accommodation while remaining restrictive. Consequently, we anticipate that the Federal funds rate would reach 5.0% by December 2024 (25bp decline by quarter starting Q32024). Despite sluggish growth in 2024 and a slight rise in unemployment, the ECB would be less hasty to shift its stance. Given our energy price forecasts, inflation would remain above 3% until Q22024. Therefore, a rate reduction would not occur until the very end of the year. The main refinancing operations rate would stand at 4.25% end-2024 (25bp decline by quarter starting in Q42024). In the UK, The Bank of England, in line with other central banks, is expected to maintain higher for longer Bank Rate. The high level of inflation prevents any BoE monetary adjustment in 2024. In Japan, the BoJ may start to gradually transition away from its ultra-loose policy measures, such as ending negative interest rates and adjusting its yield curve control framework in 2024H1. This potential shift in policy is driven by factors such as rising inflationary pressures and the need to address the side effects of prolonged monetary easing.

Given the transmission lags of monetary policy, it is highly likely that the impact of past rate hikes has not yet peaked. Nevertheless, their diffusion has already begun. The sell-off observed in the bond markets during Q3 2023 reflects this reassessment of the macro environment: the "higher for longer" stance of central banks, fueled by the resilience of the economy and the persistence of elevated core inflation.

This reassessment should be viewed as a series of steps. For the increase in long-term rates to continue in Q4 2023 - Q1 2024, it would require the onset of a new phase in the economic cycle and/or a resurgence in core inflation, which is not aligned with our central scenario. As the factors explaining this resilience diminish, the cyclical scenario for 2024 suggests that a more noticeable slowdown in US economic activity is necessary before any potential rebound can be anticipated. This expected deceleration in activity, coupled with a decrease in wage inflation and a shift in the labor market, paves the way, in sequence, for a stabilization and then a relaxation of monetary policy.

This aligns with our long-term bond yield projections: a stabilization until central banks signals a potential easing (Q1 2024), followed by a gradual slowdown by mid-2024, before a new round of repricing in line with the 2025 expectations of higher inflation and recovery (with a risk of overheating?). Starting from a peak by the end of 2023, the 10-year bond yield rates are then anticipated to converge towards 4.5% in the US, 2.8% in Germany, and 4.5% in the UK by mid-2024. Only Japan, with its gradual adjustment

of monetary policy, is likely to see an increase in its JGB bond yields towards 0.9% by the end of 2024.

In 2024, we see a crucial shift in the economic landscape, marking the end of a cycle. It's important to distinguish this phase from a more fundamental, long-term perspective. If we are indeed concluding the current period of tightening, it's unlikely that we'll return sustainably to the previous targets set by central banks, even though there will inevitably be a cyclical slowdown and reversal in 2024. Monetary policy will continue to be restrictive, surpassing the equilibrium rate, until central bank targets are met. There's a likelihood that these targets may be adjusted at some point in our view. Long-term trends, characterized by stronger, more inflationary, and more volatile growth, are anticipated to push towards a higher interest rate environment for the coming decade.

2024 Advanced Economies' Slowdown

It becomes apparent that a significant growth deceleration is underway. Projections indicate a notable drop from the 2.7% average growth witnessed in developed economies in 2022 to 1.4% in 2023, followed by a further decrease to 1.1% in 2024. This deceleration is characterized by the stronger-than-expected momentum in the United States and weaker-than-anticipated growth in the EUZ.

In 2024, activity will primarily be restrained by the effects of monetary policy, which are expected to peak. The tightening of financial conditions will curb domestic demand. Moreover, the shock will lead to a decrease in global demand, as monetary tightening is a global phenomenon, in a context already marked by a slowdown in global trade, a manufacturing sector in recession, and a services sector beginning to decelerate.

In dissecting specific developed economies, we encounter distinctive trajectories:

US: The US is poised to experience growth of 2.2% in 2023 and 1.5% percent in 2024. These projections reflect upward revisions from previous estimates, attributed to robust business investment and resilient consumption buoyed by a persistently tight labor market. However, a tempering of growth is anticipated in 2023Q4 and in 2024H1 due to factors such as slowing wage growth, dwindling pandemic-induced savings, and firm monetary policy.

EUZ: Growth in the EUZ is anticipated to decline from 3.4% in 2022 to a modest 0.5% in 2023, followed by a rise to 0.7% percent in 2024. These projections signify a downward revision when compared to the previous quarter. Notably, there exists a significant divergence in growth rates across major EUZ economies. Germany is poised to experience a slight contraction, while France exhibits upward growth momentum.

UK: The United Kingdom is expected to undergo a decline in growth from 4.3% in 2022 to a more subdued 0.4% in 2023 and 0.2% in 2024. This decline is primarily attributed to tighter monetary policies and the lingering impacts of energy price shocks.

Japan: In contrast to other developed economies, Japan is projected to experience a notable rise in growth, increasing from 1.0% percent in 2022 to a robust 1.8% in 2023. This surge can be attributed to pent-up demand, tourism surges, accommodative policies, and a rebound in exports.

A 2024 scenario characterized by significant risks.

Three major bifurcation points remain plausible, for which a precise description is, by nature, impossible, and which would suggest “stress exercises” to prepare for critical management decision if such events were to materialize.

Geopolitical events, including uncertainties regarding (a) the next steps in the Russia War in Ukraine and President V. Putin's reactions / gambles / policies, (b) evolution of US-China strategic tensions, and (c) the unfolding of the current resurgence of violence in the Middle East.

For the latter, our view that they primarily reflect changing regional geopolitical conditions clearly suggest that an extension of the conflict may happen, particularly (1) if the direct fight of Israel Defense Forces (IDF) against Hamas proves more complicated and very costly in human terms and for Israel's international standing, (2) if Iran's involvement is demonstrated and pushed Israel to conduct a symbolic attack on Iranian interests and territory, (3) if popular support for Palestine in authoritarian countries or those with politically fragile governments come to a clash with official position and diplomacy.

China's financial system risks, which we assume will remain under control, but the sheer size of credit leverage combined with a structural decline in nominal GDP growth point to increasing defaults risk and financial engineering. A somewhat identical or parallel risk comes from real estate markets in many EM (as well as mature markets), with potential ripple effects on both macro and financial performances, and possibly substantial international ramifications (risk aversion, brutal changes in Chinese financial institutions international positions, …),

Renewed upwards pressures on politically sensitive food prices (impact of El Nino and other climate events) in countries which are already lagging in development path since 2020; political and social disruptions may then occur very suddenly, with both domestic repercussion (likelihood of violence flare-up, paralysis of public decision process, financial disruptions…) and geopolitical implications, and risks of propagation / contagion to neighboring countries.

Exhibit 1 – Real GDP growth forecasts (Avg y/y, in %)

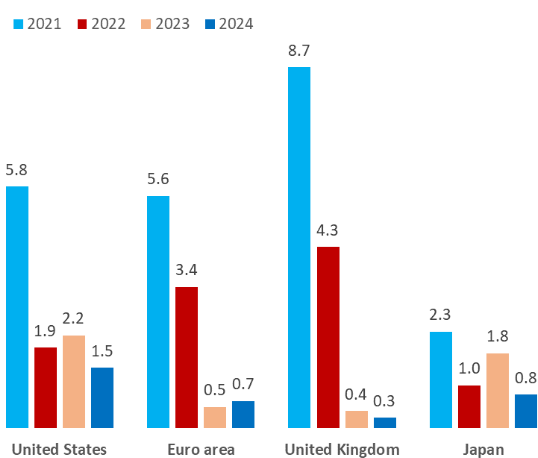
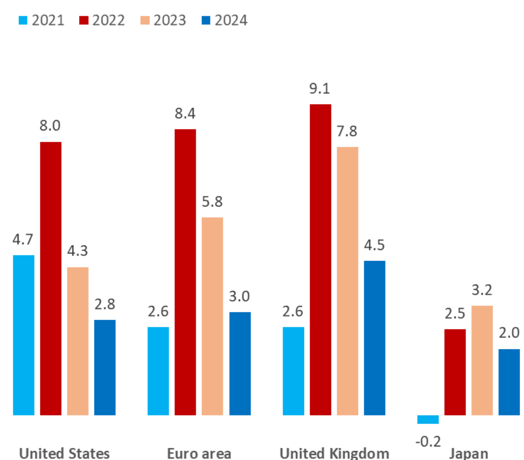


Exhibit 2 – Headline inflation forecasts (Avg y/y, in %)



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