Investec Bank plc (UK)

29 March 2022

Economics

Global Economic Overview

Policymakers face tough decisions

Global

Russia's invasion of Ukraine has represented the biggest shake up in European security since WWII and a renewed downside risk to the global growth outlook. How long the conflict lasts is still very much uncertain, but with some possible areas of compromise a diplomatic path remains open. Under a baseline assumption of a Q2 ceasefire we see a 1%pt hit to global growth this year; now forecast at 3.3%, whilst 2023 is downgraded by 0.3%pts to 3.4%. A key point here is commodities where supply issues risk extending the bottlenecks of the past year and further price increases exacerbating the current cost of living pressures. Note as well that Covid cases have been rising in a number of jurisdictions and that China has implemented several city-wide lockdowns recently, adding to problems.

United States

The Federal Reserve kicked off its tightening cycle this month with a 25bp hike to the Fed funds target range to 0.25-0.50%. Reflecting on the high inflation backdrop, FOMC members also scaled up their rate expectations for the year ahead, with a median view of a further 150bps of hikes in 2022. Our base case is for a softer pace of tightening, especially when compared to market expectations which have another 200bps of hikes priced in this year. Our base case, in contrast, is for four further 25bp hikes by end-year, although we do recognise the possibility of a 50bp increase in May. This is based on the assumption that the risk of a 'hard-landing' will encourage the Federal Reserve to take a more gradual approach to tightening.

Eurozone

The eurozone's geographic proximity to the conflict in Ukraine and its greater trade ties with Russia and Ukraine naturally leave it more exposed economically to the war than other parts of the world. A key worry is energy dependency on Russia; reducing it will not be simple, nor cheap. As such we have cut our 2021 GDP growth forecast from 4.1% to 3.3% (2023: unchanged). But we expect the ECB to stick to a fairly cautious course in moving towards rate hikes, certainly relative to market pricing. Our forecast remains for a first 25bp rate hike in Dec this year, followed by two more rate rises in 2023. The euro's path to strengthening now looks delayed.

United Kingdom

CPI inflation now stands close to a 30y high of 6.2%. Looking ahead, the domestic energy price cap is set to rise by 54% next month, energy futures currently point towards another hefty surge in October and it seems as though the Chancellor's mitigating measures will have no impact on the CPI. Accordingly we now forecast a peak in inflation of 8.9% in October. This leaves household consumption vulnerable. In the recent Spring Statement, the OBR forecast real disposable incomes declining in both 2022 and 2023, with consumer spending supported by the sector's excess savings build up during the pandemic. While we broadly concur, there are clear downside risks and we judge that the short-term yield curve, which is pricing in a Bank rate above 2% by end-2022, is too aggressive. We now expect the MPC to keep rates on hold in May, but maintain our end-year target of 1.25%. We have downgraded our end-year cable forecast to $1.35 from $1.42 previously.

	2022	2023
GDP Growth (%)		
Global	3.3	3.4
US	3.4	2.4
China	4.8	5.0
UK	4.0	2.2
EU19	3.3	3.1
Key Official Interest rates (%, end-year)		
US Fed funds	1.25-1.50	1.75-2.00
ECB Deposit rate	-0.25	0.25
UK Bank rate	1.25	1.75
FX rates (end-year)		
€:$	1.15	1.18
€:£	0.85	0.84
£:$	1.35	1.40
$:¥	120	120
AUD:$	0.80	0.80
€:CHF	1.05	1.10

Please click here for a summary of our economic and market forecasts

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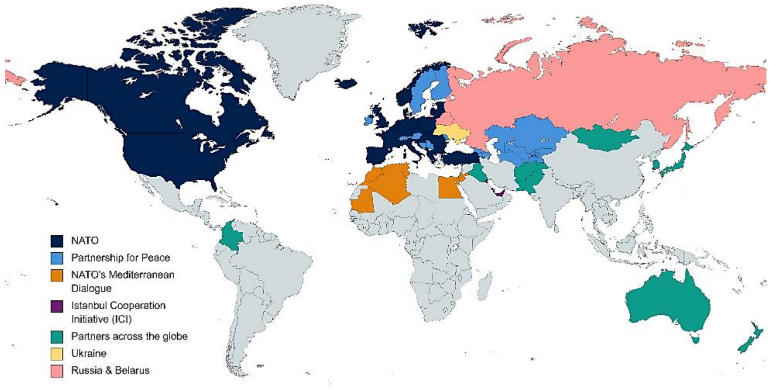
Global

Russia's invasion of Ukraine represents the greatest shift in European security since WWII. But analysis of the situation on the ground suggests Russia's advance has not gone to plan amidst stiff resistance, logistical issues and heavy losses. Will this and sanctions change Putin's approach? A Russian withdrawal without some form of 'win' seems unlikely. But its announcement that it will now focus on the Donbass area hints that it may be scaling back its objectives. Hopes remain over a diplomatic solution, given some areas of compromise, i.e. Ukraine's position on NATO and the possibility of becoming a neutral state. Talks are difficult, but in forming a baseline view we assume a ceasefire is agreed by the end of Q2, although we acknowledge this is far from certain.

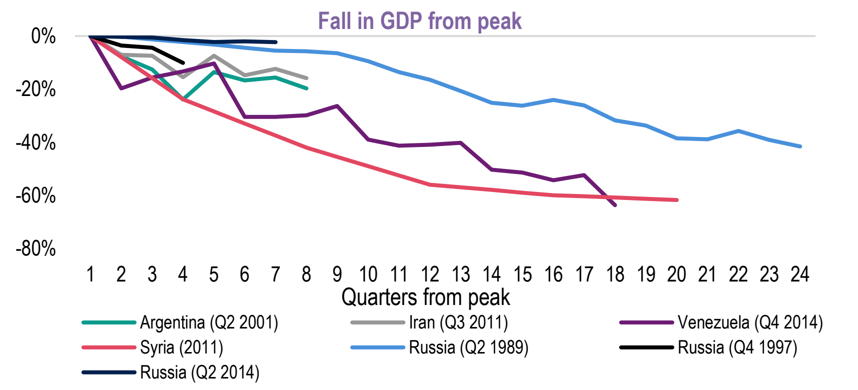
Chart 1: Ukraine's admission that it will not join NATO represents one area of compromise



Sources: NATO, mapchart.net, Investec

As such we assume some, but not all sanctions are unwound. Nonetheless we suspect that sanctions, voluntary corporate withdrawals and a hesitancy to export to Russia will have done their damage. This coupled with a sharp depreciation in the currency – the RUB has fallen 23% (had been as much as 46%) against the USD this year – should see a severe impact on the Russian economy. Trying to estimate a precise figure is difficult. However on examination of countries that have experienced sanctions, a currency crisis or similar, as seen in Chart 2, the outlook looks bleak. Our estimate is that Russia will see a 10% contraction this year.

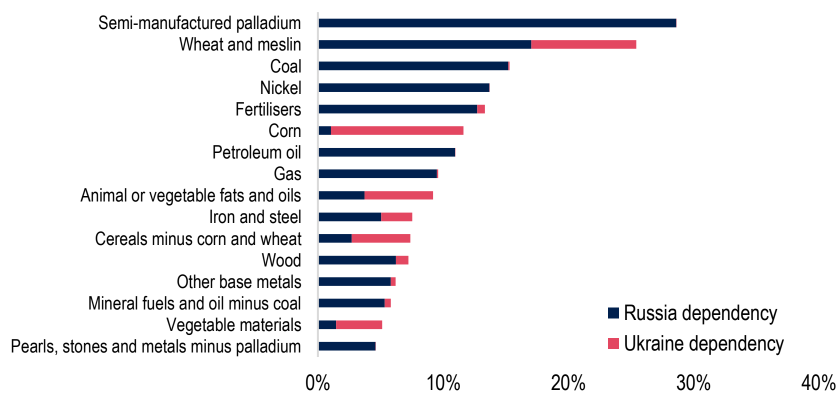
Chart 2: Severe economic shocks in countries suffering currency crisis, sanctions and war



Source: Macrobond, Refinitiv

The impact on activity is set to spread beyond Ukraine and Russia's borders. A key factor here is commodities, with Russia and Ukraine representing sizeable proportions of global trade in energy, wheat, fertilisers and others. Energy has been a focus given Europe's dependence on Russian gas, with little in the way of sufficient and easily available substitutes. To date pipeline gas flows to Europe have largely remained unchanged, but a risk would be if Russia were to cut off supplies leading to shortages and rationing, although this seems unlikely at present. However developments related to foodstuffs are also a key concern. Ukraine and Russia represent almost 30% of global wheat…

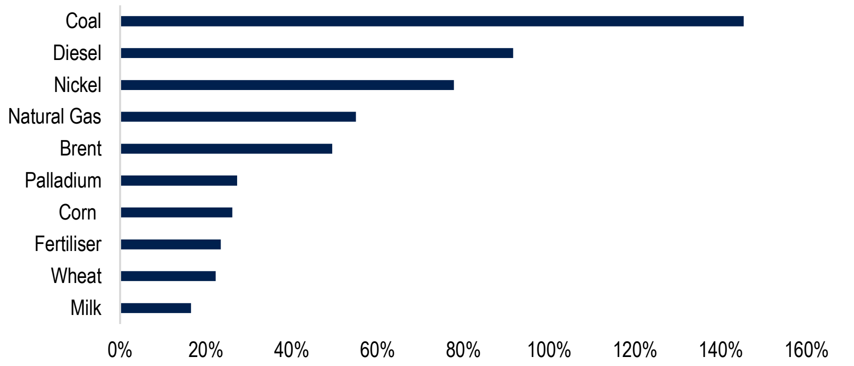
Chart 3: Global exports accounted for by Russia and Ukraine



Sources: BACI, Investec

…exports. Ukraine itself exports around 20m tonnes of wheat per year, the supply of which at least in the short term is at risk of disappearing given the war's impact on exporting capacity and ability to sow. Russia has also introduced a partial wheat export ban. However it is not just wheat that is an issue: fertiliser and animal feed are also set to see an impact, ultimately pushing up food prices, leading to the UN warning of a global food crisis. Commodity prices are rising broadly as a result (Chart 4), which will negatively impact consumers and businesses across the world. Broadly the supply shock in commodities is set to prolong…

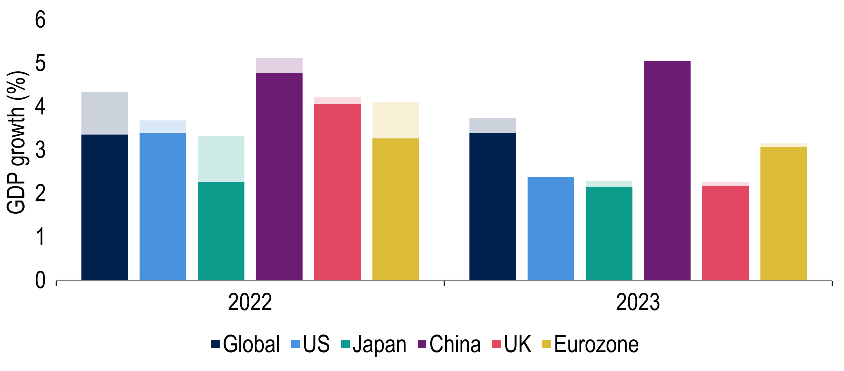
Chart 4: Commodity prices have risen sharply this year (% chg. YTD)



Note: fertiliser prices represented by Urea futures prices — Source: Macrobond, Refinitiv

…some of the supply chain issues that emerged from the pandemic and which we hoped would begin to ease. As such headwinds to global growth are rising; we have pushed down our view of world GDP growth for this year by 1%pt to 3.3%. Notably half of this downgrade is accounted for by Russia and Ukraine. The other 0.5ppts is accounted for by markdowns across the rest of the world, albeit by varying degrees depending on linkages to the crisis. For example, amongst developed markets we assume the Euro area will take the biggest hit, with a 0.8%pt downgrade, the US less so at 0.3%. Our global forecast for 2023 is 0.3%pts lower at 3.4%. Russia we suspect will contract by a further 5%, but we assume the end of hostilities allows a rebuilding of Ukraine, based on something resembling the Marshall plan.

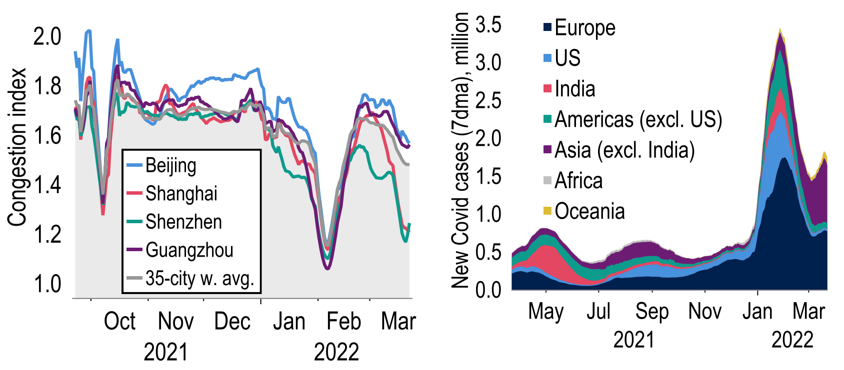
Chart 5: Global growth picture downgraded



Note: Faint areas indicate previous forecasts — Sources: Macrobond, Investec

Although firmly on the backburner news wise, Covid-19 continues to bubble away. Global cases are now rising again (Chart 6, rhs), largely driven by South Korea which is currently reporting an average of 350k cases per day. China meanwhile continues to pursue its zero-Covid strategy, which has seen activity restricted in cities such as Shanghai and Shenzhen (Chart 6, lhs). Despite outperformance in the first two months of the year and likely upcoming policy easing, given the offset of lockdowns and adverse impacts from the war, we judge the net effect to be negative. Our Chinese growth forecast in 2022 is therefore lowered from 5.1% to 4.8%.

Chart 6: Asia driving next global Covid wave; China locks down key cities

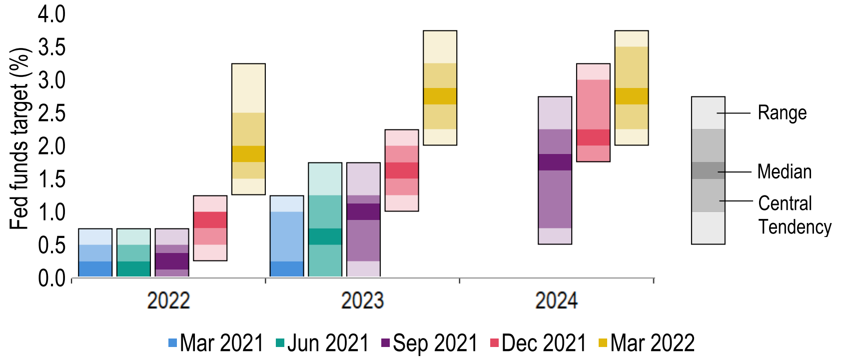


Note: the dip in early February reflects Chinese New Year, not lockdowns — Sources: Macrobond, Investec

United States

In what is expected to be the first in a series of hikes, the FOMC kicked off the tightening cycle in March with a 25bp increase to the Fed funds target range to 0.25-0.50%. The median view on the committee is for this to be followed by a further 150bps of hikes this year (Chart 7), whilst markets have priced in around 200bps for the rest of 2022. In absence of an emergency meeting market pricing would suggest at least two 50bp moves this year. On top of this, Quantitative Tightening is set to begin soon, which Chair Powell estimates to be equivalent to a further rate hike. This aggressive path for tightening reflects the FOMC's unease about the high rates of inflation – CPI hit 7.9% (yoy) in February.

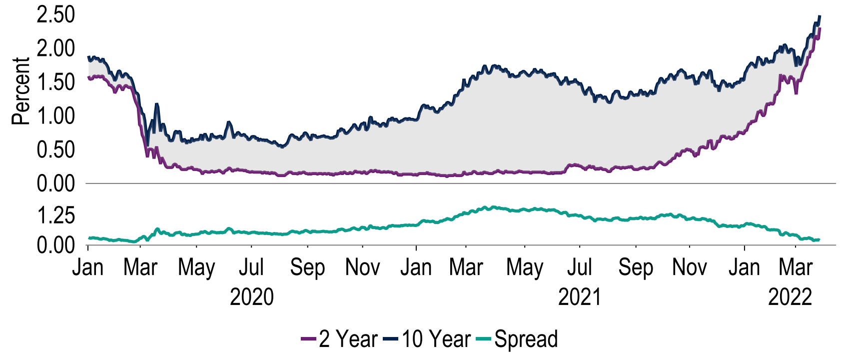
Chart 7: Fed funds rate expectations are considerably higher, but so is the dispersion of views



Note: Projections are given as the Fed funds target range Sources: Federal reserve, Macrobond, Investec

Despite the sharp profile of rate hikes, there is vast uncertainty behind such projections. The range in views among the committee on the appropriate level of the end-year Fed funds midpoint amounts to 175bps. On the markets side, although higher rate expectations have resulted in Treasury yields moving considerably higher across the board, this has been more pronounced at the short end. As such we are seeing a flattening in the yield curve; the 2Y-10Y spread has fallen by around 60bps since January (Chart 8). A flattening in the yield curve often suggests that investors are concerned that tightening plans could choke off economic growth.

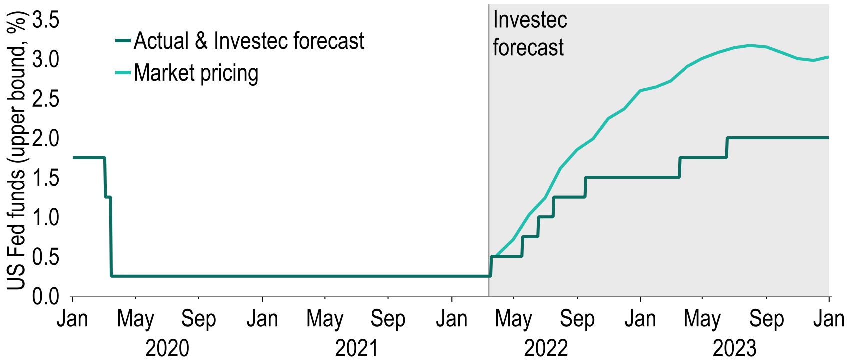
Chart 8: Treasury yields push higher, but the flattening of the curve sends warning signals



Sources: Macrobond, Investec

Although inflation must be addressed, we judge that current market pricing is too aggressive, and if followed, could result in the Fed being unable to deliver the elusive 'soft-landing' for the economy. Some Fed members have even factored this into their own projections, with the dot plot revealing at least two members envisage an easing of rates in 2024. Indeed, with the situation in Ukraine threatening to weigh on growth (our 2022 US GDP forecast has been downgraded by 0.3% pts) we expect in the event, the Fed will take a more cautious approach to tightening. As such, for now we are sticking with our call for four further 25bp hikes this year but recognise the possibility that the Fed may want to signal its tough stance on inflation with a 50bp move in May.

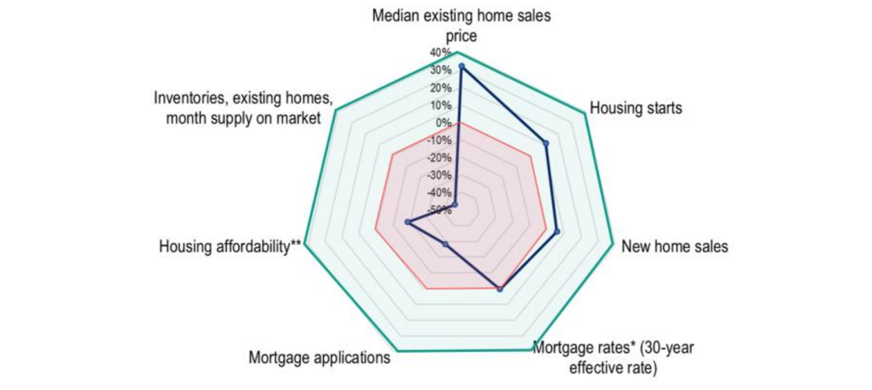
Chart 9: Investec looks for a more measured pace of tightening than markets imply



Sources: Macrobond, Investec

A higher rate environment should act to cool the US housing market. Over the course of the pandemic the housing market has performed strongly; the average house price has gained around 30% as the market has been supported by ultra-low rates and fiscal stimulus. Although many housing market metrics continue to signal strength – inventories are still unprecedentedly low and housing starts are high (Chart 10) – warning signs are slowly appearing. Climbing policy rate expectations are pushing mortgage rates higher, which has weighed on housing affordability and ultimately mortgage applications. The risk of a housing market slowdown on the horizon supports our call for a less aggressive pace of tightening.

Chart 10: Is the housing market boom set to slow? (% change relative to Feb 2020)

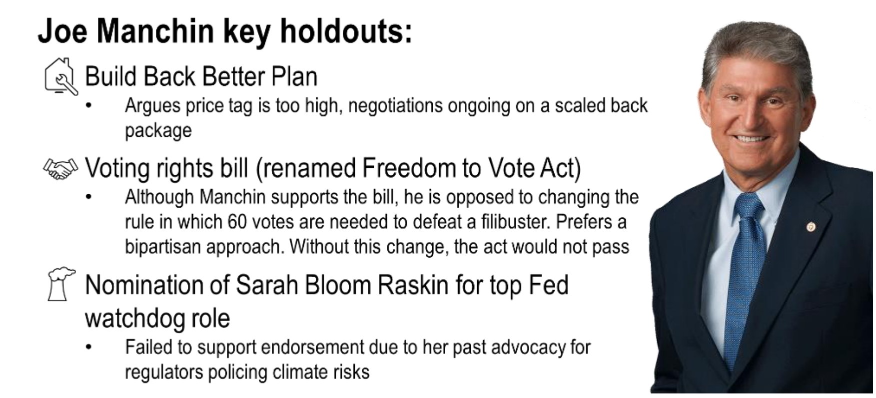


*%pt change in rate
**Latest data Jan 2022

Sources: Macrobond, Investec

The high inflationary backdrop and the various headwinds to economic growth have not been supportive factors for President Biden as he heads towards the November midterm elections. Current polling by FiveThirtyEight places his approval rating at 42%, 11%pts lower than when he took office. The President also faces resistance from within his own party. Due to the razor-thin majorities the Democrats hold, West Virginia Senator Joe Manchin has been able to block key election pledges from passing the Senate (Chart 11). To advance his agenda, the President needs Manchin's support, or a strong performance at the midterms. On current polling, the latter looks unlikely.

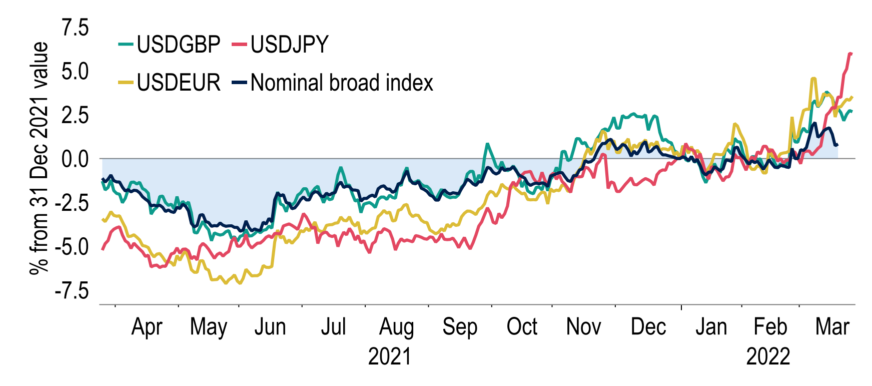
Chart 11: Battle of the Joes



Sources: Investec, www.manchin.senate.gov/about

Since the invasion of Ukraine, the dollar has seen gains via risk aversion, and added upward pressure given the US is better placed both geographically, and dependency-wise, to deal with the crisis. The rapid prospective monetary policy tightening relative to other major central banks also supports USD holders. We still view the dollar as over-valued in general, but we expect it to retain more strength in the medium-term than we had judged previously. Our lowered cable and EURUSD forecasts are detailed later in the report. Meanwhile with the BoJ struggling to keep yields in check the yen has dived this year, which now sits at 124 against the USD. We expect a stabilisation at ¥120 by end-year.

Chart 12: The USD has risen further to what we believe are unsustainable levels

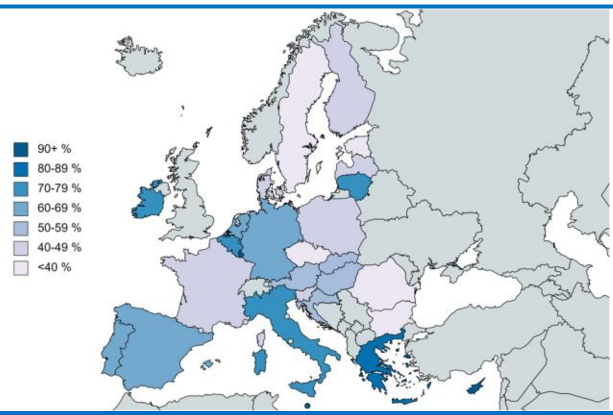


Sources: Macrobond, Investec

Eurozone

Among the major economic regions, the Eurozone stands to be hurt the most by the war in Ukraine – unsurprisingly given its geographic proximity. We have cut our 2022 GDP growth forecast from 4.1% to 3.3% (2023: unchanged at 3.1%). In part that reflects the EU19's direct trade exposure. In aggregate though, that is not huge: exports to Ukraine and Russia were 0.6% and 2.9% of the 2021 total*. But the key concern is that 62% of the Eurozone's energy needs are met through imports (Chart 13), and 15% of energy imports come from Russia. Should these be halted, whether by Russia or by sanctions being extended to the energy sector, this would impart a major hit. That is not our…

Chart 13: Most EU countries heavily rely on imported energy to meet domestic needs

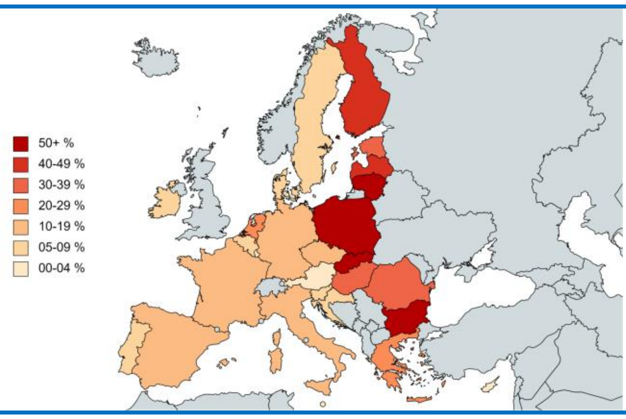


*Goods

Sources: Eurostat, mapchart.net, Investec

…baseline case, but even without this, the lack of easily accessible substitutes has turbo-charged already high European energy prices. Given the cost, governments will only be able to mitigate the impact of this large terms-of-trade shock on household real incomes to some extent. Adding to the fiscal bill will be support for huge refugee flows. On top of that, governments will have to fund some major structural shifts to pivot away from Russian oil and gas. Accelerating the energy transition will be challenging, albeit to varying degrees within the EU19 (Chart 14). The obvious long-term answer is renewables output, but as an interim Germany, for example, is not only building its first LNG terminals but may also delay its phase-out of coal-fired power plants.

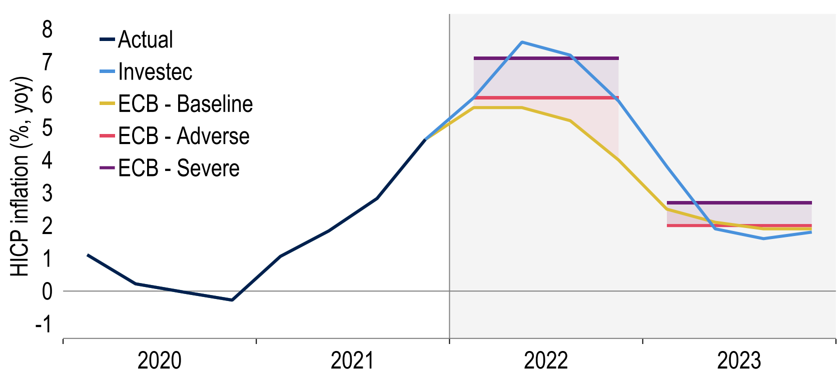
Chart 14: Dependency on Russia as a supplier of imported energy varies across the EU



Sources: Eurostat, mapchart.net, Investec

From the point of view of inflation, the impact of the war in Ukraine on Eurozone prices stands to be substantial. Even with government help to mitigate pressures at the consumer level, an additional boost to already high energy prices is a given. But, crucial though it is, energy is not the only raw material affected. Food prices stand to see extra price pressures, both directly (Ukraine is a substantial wheat exporter) and indirectly (via fertilisers). And supply chain disruptions in some industrial goods, which had just started to abate, may be prolonged too. We have raised our inflation estimates for '22 by 2pp to 6.6% and by 0.5pp for '23 to 2.2%.

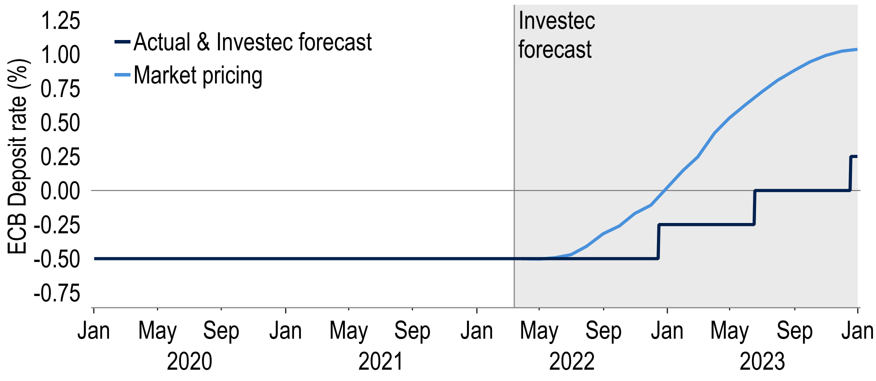
Chart 15: Inflation may fall nearer the ECB's 'adverse' or 'severe' scenarios than the baseline



Sources: Macrobond, ECB, Investec

High though that is, it is below the ECB's annual average CPI forecast in its 'severe scenario', although above the 'adverse' and baseline cases presented in its March *Staff Projections* (Chart 15). These, however, had only incorporated energy price effects rather than wider impact of the war. Still, even the baseline forecast was raised substantially, justifying the Governing Council charting an accelerated path towards tightening. We continue to expect QE tapering to finish in Q3 and a first rate hike in Dec this year, with two more to follow in 2023. Market pricing is more aggressive (Chart 16). But given lags between hiking and impacting inflation, and the weaker growth outlook, a more cautious path seems plausible despite high near-term price pressures.

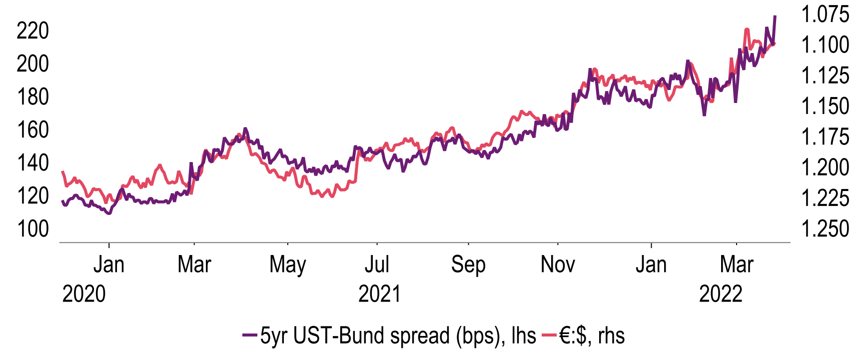
Chart 16: Markets are pricing in a more aggressive ECB rate hike path than we deem likely



Sources: Macrobond, Investec

Relative to the UK and the US, the Eurozone's path to monetary tightening has been modest to date. Prospects of relatively greater economic harm to the EU19 as a result of the war in Ukraine, importantly coupled with the larger bond market selloff in the US than in Germany (Chart 17), have contributed to the euro underperforming further against the USD since the start of the invasion. This extends the previous trend. For the time being, a swift reversal seems unlikely. We have therefore scaled back our euro forecasts, now expecting it to finish the year at $1.15 against USD and $1.18 next. Against GBP we expect an end-'22 level of 85p and 84p at end-'23.

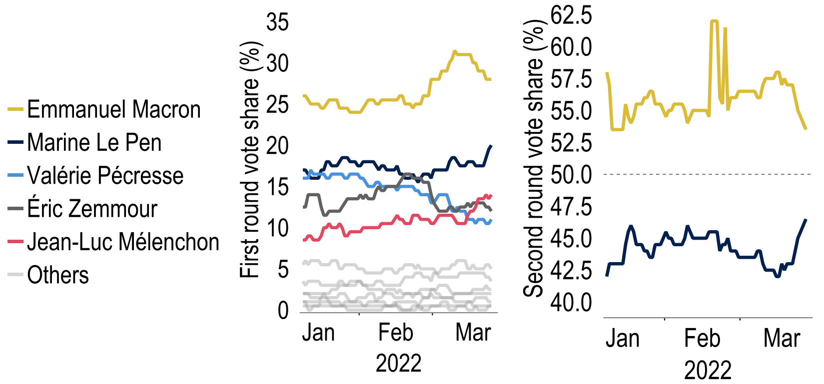
Chart 17: Widening spreads relative to German Bunds have supported USD against the euro



Sources: Macrobond, Investec

The cost of living squeeze is critical for the political landscape too – in France, voters cite 'purchasing power' as the issue that matters most to them ahead of the Presidential election. Polls open on 10 April for the first round, before a runoff vote two weeks later. Emmanuel Macron is vying for a second term in the Élysée, with Marine Le Pen the main challenger. Polls suggest a comfortable victory for Macron. With his challengers mostly at the extreme ends of the political spectrum, and especially in a time of uncertainty, he is viewed as the 'safer' option. In his recently detailed campaign, Macron set out a plan for greater state involvement across the board, which he hopes will bring security to the economy.

Chart 18: Emmanuel Macron is firm favourite to win the presidential election next month



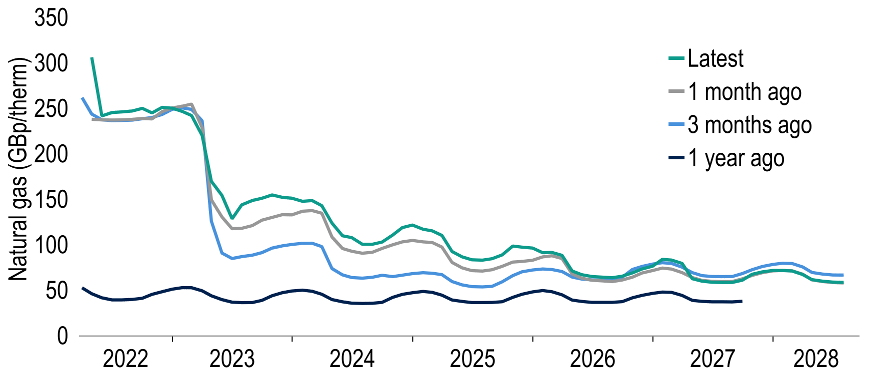
Sources: Ifop, Macrobond

Investec

United Kingdom

CPI inflation now stands at a new near 30-year high of 6.2%. While price pressures are broadening out, an increasingly large driver is domestic gas and electricity costs. A definitive answer has yet to be given on how Chancellor Sunak's measures to cushion households from the 54% rise in the energy price cap in April will be treated in the CPI. But it seems as though they will be classed as an income transfer, not a price reduction. If so, there would be no offset within the inflation numbers to the rise. Also our utilities team estimates October may see a further hike of 48%. We now see inflation peaking at 8.9% (in Oct), but in the event of a sharp drop in the cap next year, inflation could fall below 1% over 2023.

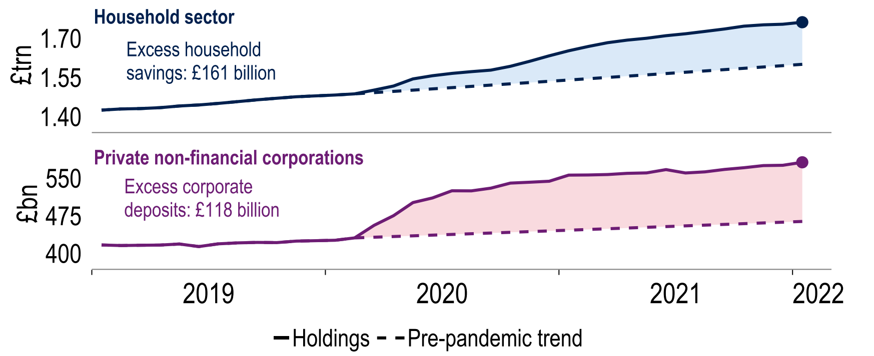
Chart 19: North Sea gas prices to remain higher for longer, adding to utility price pressure



Sources: Bloomberg, Macrobond, Investec

As noted on many occasions, households are benefiting from a cash buffer of 'excess' savings built up over the Covid pandemic. This is material – our estimate is £161bn, 12% of consumer spending last year, which will help many, if not all, households (the distribution is not uniform) to maintain spending patterns in the face of soaring inflation. It is worth noting that corporates also enjoy a similar cushion, which we put at £118bn. A key difference is that this largely results from higher borrowing at the start of the pandemic, rather than fiscal giveaways, such as the furlough schemes in the case of households. Either way it also helps to alleviate fears of a cash crunch.

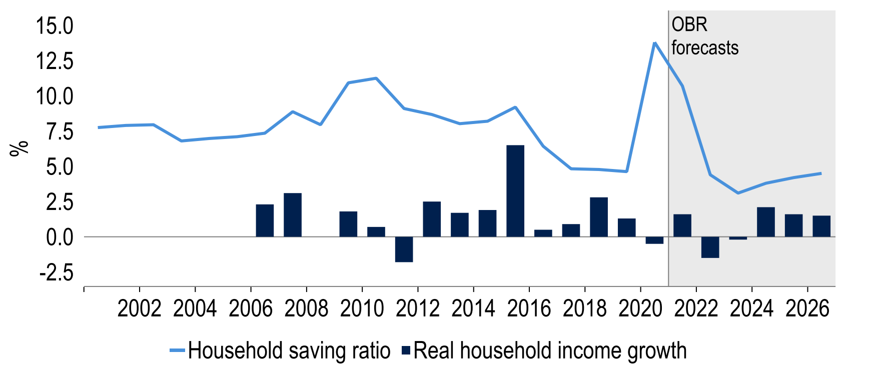
Chart 20: Households and corporates have an extra £279bn stashed away between them



Sources: Macrobond, Investec

The household buffer could be critical. At the Spring Statement the OBR forecast real household disposable incomes falling in 2022 and 2023, with household consumption (+5.4% this year and +1.0% next) supported by a falling saving ratio and in part, by some households drawing down on pandemic savings. While we broadly agree, we are mindful that events may not play out quite as intended. GDP did get off to a good start in January, expanding by 0.8% on the month, after December's Covid-hit 0.2% drop. Even so, we have downgraded our 2022 forecast to 4.0% from 4.2%, with a risk of a softer outturn if consumption dynamics turn out less favourable. Our 2023 forecast stays at 2.2%, but again we are nervous over the downside risks.

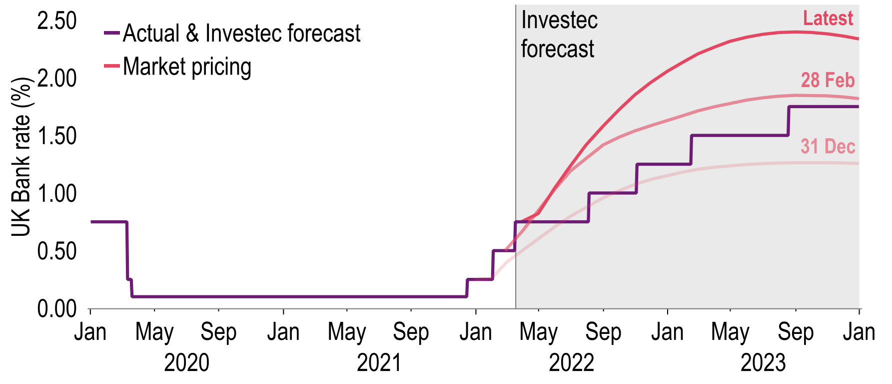
Chart 21: Drop in saving ratio to fuel growth amid falling real household incomes



Sources: Macrobond, OBR, Investec

The tone to the MPC's third successive hike in the Bank rate (by 25bps to 0.75%) was a far cry from the Fed's hawkish narrative (see US section). Deputy Gov. Jon Cunliffe voted for unchanged rates. Also the BoE was cautious over the need for further moves stating, '*some further modest tightening in monetary policy might be appropriate in the coming months*'. By contrast the median FOMC view is for seven hikes this year. Even so, the curve has become more aggressive still, close to pricing in a 2.25% Bank rate by end-year. But our end-year target remains 1.25% and we are now of the view that rates will remain on hold in May, as the BoE's concerns over downside risks to growth take centre stage.

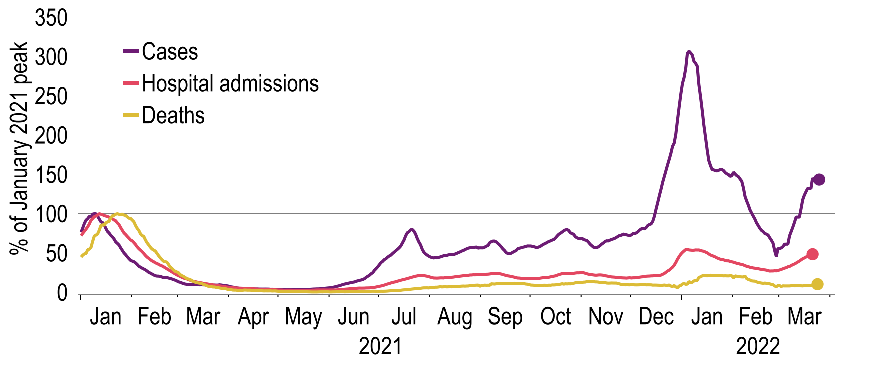
Chart 22: Market pricing 'getting carried away'?



Sources: Macrobond, Investec

Since the government relaxed all of England's remaining Covid restrictions, infection rates have climbed again. This is not on the scale of the surge recorded in parts of Asia, South Korea in particular. Even so the resurgence means that new cases have doubled from late-Feb's trough and are now averaging 86k per day (Chart 23). Fatalities have risen and are now averaging over 130 per day. At 17.4k, the number of Covid patients in hospital is only some 3k below the recent peak in early-Jan. But numbers in mechanical ventilator beds have risen more modestly, offering broad hope that the average severity of infections has eased and that the government's strategy of 'living with Covid' is sustainable for now.

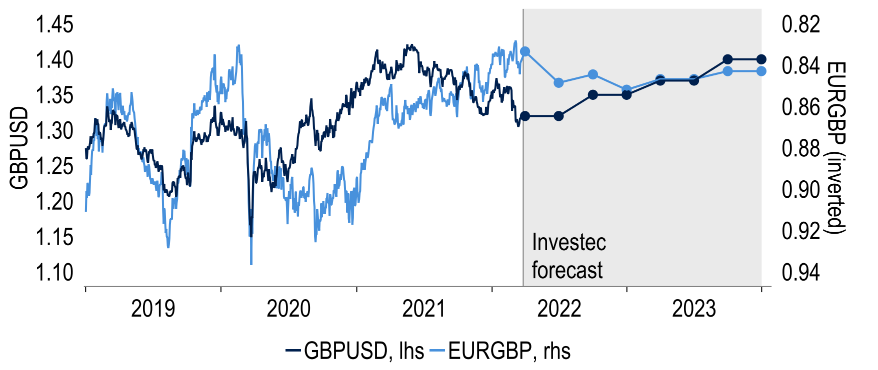
Chart 23: Covid cases are rising again, hospital admissions and fatalities more gradually



Sources: Macrobond, gov.uk, Investec

Cable fell to pre-Brexit deal levels of $1.30 this month following Russia's invasion of Ukraine, and we anticipate downward pressure on the USD if and when the war subsides. But the UK curve looks so overly aggressive that to the extent there is a connection between rate and FX markets, then sterling may be vulnerable should the MPC hold steady in May, as we now expect. Our forecasts now see cable holding at $1.32 through H1 this year, but gains in H2 to $1.35 end-year – a sizeable downgrade from our $1.42 forecast previously – and rising next year to $1.40 end-2023. This translates to a relatively range-bound euro:sterling, which we see ending this year and next at 85p and 84p respectively.

Chart 24: Downgrades to our sterling forecasts – less of a rally against the USD



Sources: Macrobond, Investec

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Global Forecasts

GDP Growth (%)

	Global	US	Japan	China	UK	EU19	Germany	France	Italy
2017	3.8	2.3	1.7	7.0	2.1	2.8	3.0	2.4	1.7
2018	3.6	2.9	0.6	6.7	1.7	1.8	1.1	1.8	0.8
2019	2.8	2.3	-0.2	6.0	1.7	1.6	1.1	1.8	0.5
2020	-3.1	-3.4	-4.5	2.3	-9.4	-6.5	-4.9	-8.0	-9.1
2021	5.7	5.7	1.7	8.1	7.5	5.3	2.9	7.0	6.6
2022	3.3	3.4	2.3	4.8	4.0	3.3	2.3	3.6	3.2
2023	3.4	2.4	2.1	5.0	2.2	3.1	3.4	2.3	2.3

Source: IMF, Macrobond, Investec forecasts

Key Official Interest rates (%, end quarter):

	US Fed funds	Eurozone refi rate	Eurozone deposit rate	UK Bank rate	Australia cash rate
Current	0.25-0.50	0.00	-0.50	0.75	0.10
2022					
Q1	0.25-0.50	0.00	-0.50	0.75	0.10
Q2	0.75-1.00	0.00	-0.50	0.75	0.10
Q3	1.25-1.50	0.00	-0.50	1.00	0.10
Q4	1.25-1.50	0.00	-0.25	1.25	0.25
2023					
Q1	1.50-1.75	0.00	-0.25	1.50	0.25
Q2	1.75-2.00	0.25	0.00	1.50	0.50
Q3	1.75-2.00	0.25	0.00	1.75	0.50
Q4	1.75-2.00	0.50	0.25	1.75	0.75

Source: Macrobond, Investec

10-year government bond yields (%, end quarter):

	US	Germany	UK
Current	2.43	0.57	1.61
2022			
Q2	2.25	0.50	1.50
Q4	2.25	0.75	1.50
2023			
Q2	2.25	0.75	1.50
Q4	2.50	1.00	1.75

Source: Refinitiv, Investec

FX rates (end quarter/ annual averages)

		Current	2022				2023				2021	2022	2023
		29-Mar	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	average	average	average
Euro	€:$	1.097	1.10	1.12	1.14	1.15	1.16	1.16	1.18	1.18	1.18	1.13	1.17
Sterling	€:£	0.840	0.84	0.85	0.84	0.85	0.85	0.85	0.84	0.84	0.86	0.84	0.85
	(£:€)	1.191	1.19	1.18	1.18	1.17	1.18	1.18	1.19	1.19	1.16	1.19	1.18
	£:$	1.307	1.31	1.32	1.35	1.35	1.37	1.37	1.40	1.40	1.38	1.34	1.38
Yen	$	123.5	123	118	119	120	120	120	120	120	110	119	120
	€	135.5	135	132	136	138	139	139	142	142	130	134	140
	£	161.4	161	156	161	162	164	164	168	168	151	158	165
Aussie Dollar	$	0.747	0.75	0.77	0.79	0.80	0.80	0.80	0.80	0.80	0.75	0.76	0.80
	€:AUD	1.469	1.47	1.45	1.44	1.44	1.45	1.45	1.48	1.48	1.57	1.47	1.46
	¥	92.22	92.2	90.9	94.0	96.0	96.0	96.0	96.0	96.0	82.5	90.7	96.0
	£:AUD	1.750	1.75	1.71	1.71	1.69	1.71	1.71	1.75	1.75	1.83	1.75	1.72
Swiss Franc	€	1.026	1.03	1.04	1.05	1.05	1.07	1.08	1.10	1.10	1.08	1.04	1.08
	$	0.935	0.93	0.93	0.92	0.91	0.92	0.93	0.93	0.93	0.91	0.92	0.93
	£	1.222	1.22	1.23	1.24	1.23	1.26	1.28	1.31	1.31	1.26	1.23	1.28

Source: Refinitiv, Investec