



R&R Weekly Column
By Brunello Rosa



2023 Outlook: A Year of Stagflation, Part 1 (Growth And Inflation)

2022 was a year of rising inflation and slowing economic growth; it was a year in which the conventional wisdom of central banks, sell-side research, and consensual forecasts turned out to be mostly wrong about key economic, policy and market views. In particular, consensus forecasts got the inflation outlook wrong: the rise in inflation proved to be persistent and permanent, rather than transitory and temporary.

The consensus view was also that the rise in inflation was mostly driven by excessively loose monetary, fiscal and credit policies. But, in addition to these bad policies there was also plain bad luck, with a series of negative aggregate supply shocks taking place. These included the initial impact of Covid-19 on the supply of goods and services, and on the supply of labor and global supply chains; the impacts of the Russian invasion of Ukraine regarding energy and other commodities prices; and the impact of the continuation – until recently – of China's Zero Covid Policy on global supply chains.

Another opinion held by the consensus was that central banks, as they were phasing out QE and credit easing and raising policy rates, would be able to achieve a “soft landing”: a fall in inflation to the 2% target without a recession or rise in the unemployment rate. That turned out to be incorrect, as now the UK and Eurozone economies are already entering into a recession, and even the Fed expects that a soft landing will be “very challenging”, and thus expects a “softish” landing and some serious “pain”.

Now the new conventional wisdom is that we will experience a “short and shallow” recession (rather than a severe one) that will trigger a sharp drop of inflation and allow central banks to ease by H2 of 2023. The consensus also argues that – consistent with such a mild recession – central banks will remain committed to achieving their 2% inflation target. We continue to have views different from the consensus in these last two debates, after having been correct in the previous debates of 2021-22.

We believe that a hard landing is more likely than a short and shallow recession. Why? First, we argue that although inflation has peaked in most advanced economies, and has started to fall, it will nevertheless remain more sticky than central banks and consensus opinion expects, and thus central banks will be forced to hike more than currently predicted, if they want to push inflation closer to target.

The argument for stickier inflation is based on several points: the war in Ukraine will continue and get uglier, rather than be resolved; the supply bottlenecks in China will remain in spite of the phase out of Zero-Covid Policy, as China will continue its stop-and-go policies towards Covid and a full phase out of the policy will lead to a spike in cases and reduce the available labor supply of healthy workers; even if stronger growth were to resume in China – not our baseline scenario – its impact on commodities demand and prices would be sharper. Commodities prices have declined in the last few months in spite of their spike during H1, mostly because of expectations of lower demand – given the expected global economic contraction – rather than because of much higher supply. Next year commodity prices – and not just in energy – are likely to spike, as many years of under-investment in new capacity will lead to a shortfall in supply, even if demand falls as well.

Secondly, geopolitical factors will continue weighing on economic activity. The war in Ukraine will continue for much longer than people expect. One cannot rule out a military strike by Israel against Iran – that is effectively now a threshold nuclear star – that would lead to a dramatic spike in energy prices. An outright confrontation (not our baseline scenario now) between US and China over Taiwan – where 50% of all computer chips and 80% of high end chips are produced – would be another massive stagflationary shock.

Our Recent Publications

✿ [Global Outlook 2023 - A Year Of Stagflation: Growth Contraction and Still-Elevated Inflation, with Difficult Dilemmas for Central Banks](#), by Nouriel Roubini, Brunello Rosa and Nato Balavadze, 23 December 2022

✿ [The Ukraine War Requires Israel to Strike a Challenging Balance](#), by Giorgio Cafiero, 22 December 2022

✿ [Central Bank Communications Drives Markets Down](#), by Filippo Ramigni, 20 December 2022

✿ [Travel Notes: France - Raising The Red Flag For A Possible Victory By Le Pen in 2027](#), by Brunello Rosa and Nouriel Roubini, 19 December 2022



Looking Ahead

The Week Ahead: Loans To Household And Companies To Decrease In The EZ; Unemployment Rate To Fall In Japan

In the EZ, in November, loans to households and companies are seen falling to 4.1% (p: 4.2%) and to 8.6% (p: 8.9%) respectively.

In Japan, in November, the unemployment rate is expected to edge down to 2.5% (p: 2.6%). Retail sales are likely to slow down to 3.7% (p: 4.3%).

The Quarter Ahead: Zelensky Visited Washington; Additional Aid Is Approved To Ukraine; Covid Cases Increase In China

Zelensky first visited the White House since Russia's invasion in February. Following the visit, the US House of Representatives finally approved the new aid package for Ukraine, as Zelensky warned that Russia could continue attacks over the Christmas break. The new military and economic assistance would amount to USD 50 bn. The US also confirmed it will supply Ukraine with a Patriot missile system. In the meantime, Russia threatened to cut oil output by halting sales to countries that support a cap on Russian oil prices.

Winter storm leaves millions without power in US and Canada. Authorities urged people to avoid all unnecessary travel and thousands of flights have been cancelled. The storm cut energy production across the US, pushing up heating and electricity prices.

China opposes US Defense Bill. The US House of Representatives passed a USD 858 bn defence spending, that provides USD 10 bn to finance the provision of weapons to Taiwan. China expressed "strong dissatisfaction and resolute opposition", while Taipei welcomed the help to boost the island's security.

China estimates about 250 mn people (18% of the population) were infected with COVID-19 in 20 days, causing a fall in travel and economic activity. Shanghai urges citizens to stay at home on Christmas days, while the COVID-19 restrictions have been lifted. The US has called on China to be transparent about increasing COVID cases.

Last Week's Review

Real Economy: QoQ GDP Advanced In US, While Contracting In UK; US PCE Eased Off; EZ Consumer Confidence Recovered Slightly

In the US, in Q3, according to the final estimate, the economy advanced by 3.2% q-o-q (c: 2.9%; p: -0.6%). In November, PCE and core PCE eased off by 5.5% (p: 6.1%) and 4.7% y-o-y (p: 5.0%) respectively. In December, Michigan's Consumer Sentiment increased to 59.7 (c: 59.1; p: 56.8).

In the EZ, in December, the consumer confidence flash estimate recovered slightly to -22.2 (c: -22; p: -23.9). Wage growth slowed down in Q3 to 2.1% y-o-y (p: 3.2%).

In the UK, in Q3, according to the final estimate, GDP growth shrank by 0.3% q-o-q (c: -0.2%; p: 0.2%). On a yearly basis, the economy slowed down by 1.9% (c: 2.4%; p: 4.0%). Business investment fell by 2.5% q-o-q (p: 5.5%) and rose by 1.3% y-o-y (p: 6.2%).

Financial Markets: Stocks Slide; Yields Were Up; Dollar Is Down. While Oil Prices And Gold Prices Increased

Market Drivers: Investors assess the pace of rate rises and hawkish comments from central banks, and as a result US stocks fell. The Bank of Japan's decision to widen the allowed band around 10Y JGB yields drove US rates up and made the Treasury curve steeper. In Europe, shares rose as inflation showed signs of slowing down and consumer confidence slightly improved.

Global Equities: Decreased w-o-w (MSCI ACWI, -0.1%, to 605.78). The US S&P 500 index fell (-0.2% w-o-w, to 3,844.82). In the EZ, share prices were up (Eurostoxx 50, +0.3% w-o-w, to 3,817.01). In EMs, equity prices moved down (MSCI EMs, -0.3%, to 954.78). Volatility fell to 20.9 (VIX S&P 500, 52w avg.: 25.5; 10y avg.: 18.2).

Fixed Income: w-o-w, the 10-year US treasury yields increased (+26 bps to 3.75%). The 2-year US Treasury yields rose (+15 bps to 4.33%). The German 10-year bund yield rose (+24 bps to 2.40%).

FX: w-o-w, the US Dollar Index was down (DXY, -0.6%, to 104.0; EUR/USD +0.3%, to 1.06). In EMs, currencies increased (MSCI EM Currency Index, +0.6% w-o-w, to 1,655.20).

Commodities: w-o-w, oil prices rose (Brent, +7.0% to 85.54 USD/b). Gold prices increased w-o-w (+0.3% to 1,806.0 USD/Oz).



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Abbreviations, Acronyms and Definitions

a	Actual	LN	Northern League, Italy
AKP	Justice and Development Party, Turkey	MSS	Five Star Movement, Italy
ann.	annualized	m-o-m	Month-on-month
ARS	Argentinian Peso	mb	Million barrels
avg.	Average	mb/d	Million barrels per day
bn	Billion	MENA	Middle East and North Africa
BoC	Bank of Canada	MHP	Nationalist Movement Party, Turkey
BoE	Bank of England	mn	Million
BoJ	Bank of Japan	MPC	Monetary Policy Committee
bpd	Barrels per day	NAFTA	North-American Free Trade Agreement
bps	Basis points	NATO	North Atlantic Treaty Organization
BS	Balance sheet	OECD	Organization for Economic Cooperation and Development
c	Consensus	Opec	Organization of Petroleum Exporting Countries
C/A	Current account	p	Previous
CB	Central bank	P2P	Peer-to-peer
CBB	Central Bank of Bahrain	PBoC	People's Bank of China
CBK	Central Bank of Kuwait	PCE	Personal Consumption Expenditures
CBT	Central Bank of Turkey	PE	Price to earnings ratio
CDU	Christian Democratic Union, Germany	PM	Prime minister
CNY	Chinese Yuan	PMI	Purchasing managers' index
CPI	Consumer Price Index	pps	Percentage points
DJIA	Dow Jones Industrial Average Index	pw	Previous week
DJEM	Dow Jones Emerging Markets Index	QCB	Qatar Central Bank
d-o-d	Day-on-day	QAR	Qatari Riyal
DXY	US Dollar Index	QE	Quantitative easing
EC	European Commission	q-o-q	Quarter-on-quarter
ECB	European Central Bank	RE	Real estate
ECJ	European Court of Justice	RBA	Reserve Bank of Australia
EIA	US Energy Information Agency	RRR	Reserve Requirement Ratio
EM	Emerging Markets	RUB	Russian Rouble
EP	European Parliament	SWF	Sovereign Wealth Fund
EPS	Earnings per share	tn	Trillion
EU	European Union	TRY	Turkish Lira
EUR	Euro	UAE	United Arab Emirates
EZ	Eurozone	UK	United Kingdom
Fed	US Federal Reserve	US	United States
FOMC	US Federal Open Market Committee	USD	United States Dollar
FRB	US Federal Reserve Board	USD/b	USD per barrel
FX	Foreign exchange	UST	US Treasury bills/bonds
FY	Fiscal Year	VAT	Value added tax
GCC	Gulf Cooperation Council	VIX	Chicago Board Options Exchange Volatility Index
GBP	British pound	WTI	West Texas Intermediate
GDP	Gross domestic product	WTO	World Trade Organisation
IMF	International Monetary Fund	w	Week
INR	Indian Rupee	w-o-w	Week-on-week
IPO	Initial public offering	y	Year
IRR	Iranian Rial	y-o-y	Year-on-year
JPY	Japanese yen	y-t-d	Year-to-date
k	thousand	ZAR	South African Rand
KSA	Kingdom of Saudi Arabia	2y; 10y	2-year; 10-year



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