CYCLICAL OUTLOOK: KNOWN UNKNOWNS

In the US, the latest Survey of Professional Forecasters (SPF) of the Federal Reserve Bank of Philadelphia paints a rather upbeat picture of the economic outlook. A similar survey of the ECB points towards a gradual pickup in growth this year. In both cases, the level of disagreement is low. This provides reasons to be hopeful about the economic outlook. However, the alternative scenarios are predominantly negative for growth and inflation, and some have totally different implications for the evolution of bond yields. This would mean that as time goes by and the likelihood of the different alternative scenarios evolves, bond yield volatility could be high.

In the US, the latest Survey of Professional Forecasters (SPF) of the Federal Reserve Bank of Philadelphia paints a rather upbeat picture of the economic outlook. Admittedly, growth is expected to slow down in the second quarter of this year, but a healthy pace should be maintained in the following quarters[1]. In the Eurozone, the ECB's Survey of Professional Forecasters points towards a gradual pickup in quarterly growth this year[2]. Economists seem to be in broad agreement on these expected developments. Chart 1 shows, for the US, the dispersion of quarterly real GDP growth forecasts of the survey participants. Unsurprisingly, as the forecast horizon lengthens, the dispersion tends to decline. Forecasters may have strongly diverging opinions about near-term developments -reflected in high disagreement between forecasters- whereas this is less likely in the medium run. Interestingly, for the latest SPF the dispersion across forecast horizons is lower than what was observed at the start of 2022 and 2023. For the latter, the high dispersion might have been due to disagreement about the consequences of rate hikes by the Federal Reserve. At the current juncture, the prospect of rate cuts may explain the limited dispersion of growth forecasts. It should be noted that this dispersion is also well below the average calculated using all surveys since the start of 2022. Turning to the Eurozone, table 1 shows the standard deviation of the survey participants' forecasts for real GDP. Since the survey round of 2023 Q1, this measure of disagreement for the two quarters ahead forecast has dropped significantly. In the 2024 Q1 survey, it declined to 0.4, a number last seen in 2023 Q3. Since the second half of last year, the six quarters ahead forecast dispersion has also declined, dropping to a very low value of 0.2.

A low disagreement does not imply that forecasters do not feel uncertain. It simple means they assess things in a similar way. The user of economic forecasts should welcome low disagreement because the forecast provides a stronger signal[3]. However, in financial markets, low disagreement increases the sensitivity of asset prices to unexpected developments and to a change in the most likely scenario. Consequently, it is important to also look at the sources of risk and uncertainty. Table 2 provides a non-exhaustive overview of key 'known unknowns' and their likely economic consequences.

US: CROSS-SECTIONAL DISPERSION FOR QUARTERLY FORECASTS FOR REAL GDP

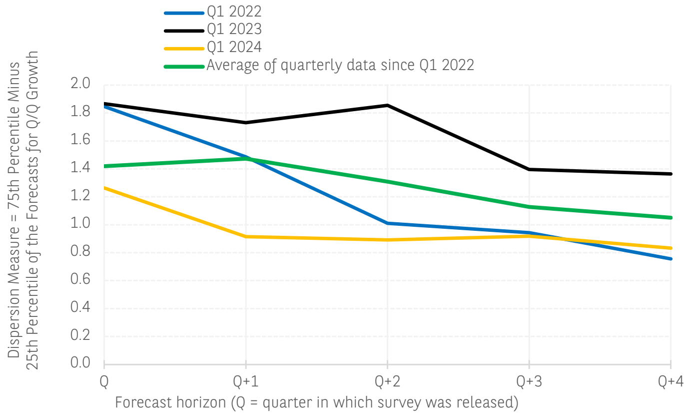

CHART 1 SOURCE: SURVEY OF PROFESSIONAL FORECASTERS, FEDERAL RESERVE BANK OF PHILADELPHIA, BNP PARIBAS

Firstly, there is the issue of the delayed effects of past monetary tightening, which means that part of the effects still needs to manifest itself. This entails a risk that, at present, we are still underestimating the effects of past monetary tightening. As these become clearer, the impact on growth in the US and the eurozone would be negative and the disinflationary process would be stronger causing a decline in bond yields. Secondly, there is the possibility that central banks would adopt a more cautious stance when cutting policy rates. Admittedly, recent statements by Jerome Powell and Christine Lagarde have already cooled down overly optimistic market expectations in terms of the timing and pace of policy easing, but should inflation be stickier than anticipated, policy rates could be kept at an elevated level for longer. Such an outcome would have a negative impact on growth. Eventually inflation would decline more but the disinflation process would have taken more time.

1 Annualised quarter-on-quarter growth is expected at 2.1% in the first quarter and at 1.5%, 1.5% and 1.7% in the following quarters. Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia, 9 February 2024.
2 Non-annualised quarter-on-quarter growth is expected at 0.12% in the first quarter and 0.26% and 0.27% in the two following quarters. Source: Survey of Professional Forecasters, ECB, January 2024.
3 The signal strength can be assessed by comparing the forecast with the forecast dispersion.

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Bond market volatility would be high: yields would initially rise as investors realize that the pricing of rate cuts was too optimistic but, in a second stage, this would be followed by a bigger decline in reaction to lower growth and the decline in inflation.

Thirdly, the US economy might experience a 'no landing' scenario. In the course of 2023, the consensus view has evolved from 'a recession is likely' to 'a soft landing becomes the base scenario'. In a 'no landing' scenario, growth remains strong, which stops inflation from declining sufficiently. Stronger than expected US growth would have a marginally positive effect in the Eurozone on growth -via increased exports to the US- and inflation, to the extent that US growth would underpin commodity prices and/or cause an appreciation of the dollar versus the euro. In this scenario, bond yields would increase. Fourthly, there is the risk of no takeoff in the Eurozone. A potential catalyst would be that companies, expecting a subdued demand outlook, increasingly make staff redundant, which would weigh on household spending and trigger a self-reinforcing negative spiral. The impact of such a scenario should be relatively small for the US given the limited openness of that economy, whereas it would have a clear negative impact compared to the base scenario in the Eurozone, both in terms of growth and inflation. The consequences for US inflation would be non-significant. Eurozone bond yields would decline.

In addition to the economic known unknowns, political and geopolitical uncertainties and risks should also be taken into consideration. Will the elections for the European Parliament in June bring greater alignment between the EU member states? How will the outcome of the US presidential election on 5 November influence the US stance on geopolitical issues? It is unlikely that these uncertainties would have an economic impact in the short run, although risk averse investors might decide to increase their exposure to government bonds as a safe haven. A specific economic point of attention in the run-up to the US election will be the stance of the candidates on international trade and the risk of an increasingly protectionist rhetoric. What matters however is what happens after the election. Should there be protectionist measures, there would be a clear negative impact on growth, higher inflation and higher bond yields.

In conclusion, the consensus view on growth in the US and the Eurozone and the low level of disagreement give us reasons to be hopeful about the economic outlook. However, we should pay close attention to the risks and uncertainties. They are predominantly negative for growth (lower) as well as inflation (lower as well). Importantly, some of the alternative scenarios have totally different implications for the evolution of bond yields. This would mean that as time goes by and the likelihood of the different alternative scenarios evolves, bond yield volatility could be high.

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EUROZONE: STANDARD DEVIATION OF REAL GDP FORECASTS

		Forecast horizon												
		2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3	2023 Q4	2024 Q1	2024 Q2	2024 Q3	2024 Q4	2025 Q1	2025 Q2	2025 Q3
Date of SPF	2022 Q1	1.3				0.5								
	2022 Q2		0.8				0.5							
	2022 Q3			0.8				0.6						
	2022 Q4				1				0.5					
	2023 Q1					0.6				0.5				
	2023 Q2						0.5				0.5			
	2023 Q3							0.4				0.2		
	2023 Q4								0.6				0.2	
	2024 Q1									0.4				0.2

TABLE 1

SOURCE: ECB SURVEY OF PROFESSIONAL FORECASTERS, BNP PARIBAS

IMPACT ON OUTLOOK

	US growth	EZ growth	US inflation	EZ inflation	Bond yields
Delayed effects of past tightening	negative	negative	lower	lower	lower
Slow rate cuts	negative	negative	lower	lower	higher first, lower thereafter
'No landing' in the US	growth remains stronger than expected	marginally positive through trade with US	slower disinflation or even halt	small (commodity prices, stronger dollar)	higher
'No take off' in Eurozone	very small	negative compared to base scenario	n.s.	lower	lower in EZ
Politics and geopolitics: increased uncertainty	marginally negative	marginally negative	n.s.	n.s.	lower (safe haven effect)
Politics and geopolitics: increased protectionism	negative	negative	higher	higher	higher (due to inflation)

TABLE 2

SOURCE: BNP PARIBAS