INCREASING CONCERNS ABOUT THE GROWTH OUTLOOK

The level of activity in the US and the euro area is very high but growth has already slowed down significantly and quarter over quarter growth should remain low for the remainder of the year. Worries about the cyclical outlook are on the rise due to a combination of elevated inflation, geopolitical uncertainty and monetary policy tightening. Survey data on input prices and delivery times have eased but the levels are still very high. Wage growth remains strong in the US and is picking up in the euro area, creating concern that inflation would decline more slowly than expected. In addition, assessing the true state of demand has become very difficult.

The level of activity in the United States and the euro area is very high, as witnessed by huge labour market bottlenecks and order books that are full. However, growth has already slowed down significantly and quarter over quarter growth should remain low for the remainder of the year.

Concerns about the cyclical outlook are on the rise. Although supply bottlenecks have started to ease in the US and the euro area, they still are a headwind to growth, both directly - long delivery times constrain activity - and indirectly, with high inflation weighing on demand. Geopolitical uncertainty remains elevated. High inflation is significantly eroding households' confidence and purchasing power and it is putting pressure on corporate profit margins. Long-term interest rates have moved higher, making external financing for companies more expensive due to the rise in the risk-free rate of interest and the widening of corporate bond spreads. Assessing the true state of demand is difficult: the strong order books may partly reflect a reaction of customers to long delivery times. An easing of supply disruption and slower demand growth may trigger order cancelations.

As shown in chart 1, investment plans of US companies have been scaled back. Financing conditions for households have also deteriorated. In the US, the jump in mortgage rates has been accompanied by a significant increase in the number of unsold homes. Equities are down significantly from their recent peaks under the combined influence of a downward revision of earnings growth, higher risk-free rates and an increase in the required risk premium that reflects mounting risk aversion of investors.

Slowing growth and elevated and rising inflation represent a discomforting combination. The latter forces central banks to tighten policy aggressively to bring it back to target, to avoid an unanchoring of inflation expectations and thus maintain their credibility, but this will increase the worries of households, companies and financial markets about the growth outlook. For the avoidance of doubt, Jerome Powell has stated that the rate hikes of the Federal Reserve will be unconditional. Even if it triggers a recession, the federal funds rate will move higher until the FOMC is confident that it is meeting its inflation target. Unsurprisingly, US recession fears are mounting. On the European side, low quarterly growth means that little is needed to end up in a 'technical' recession. 'Technical' means two successive quarters of slightly negative growth rates. A full-fledged recession seems unlikely in the near term due to the carry-over effect of last year's growth, a catching up of demand in a post-Covid-19 world, the strong labour market to date, accumulated excess savings, a positive fiscal policy impulse and huge investment needs.

The guidance of the ECB has also become more hawkish in recent weeks. Against this background, the easing of price pressures as shown by survey data on input prices and delivery times, is welcome news (chart 2 for the US; a similar evolution is visible in the euro area), although the levels are still very high and the improvement needs to be confirmed in the coming months. In combination with ongoing strong wage growth in the US and a pick-up in the euro area, as well as a risk of further increases in certain commodity prices (energy, food), there is a concern that inflation would decline more slowly than expected, thereby forcing central banks to keep on tightening.

US REGIONAL FED MANUFACTURING SURVEYS: INDEX OF FUTURE CAPITAL EXPENDITURES

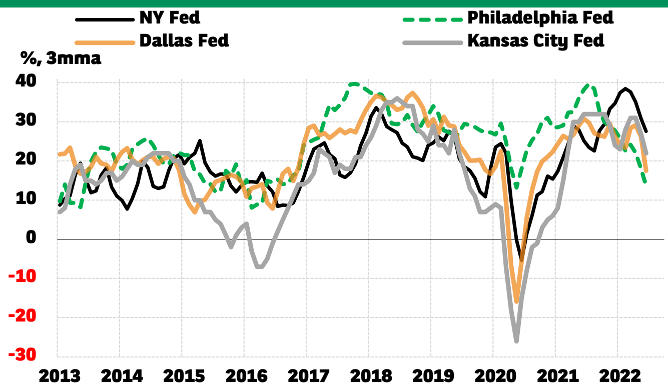

CHART 1

SOURCE: FEDERAL RESERVE BANKS OF NEW-YORK, PHILADELPHIA, DALLAS & KANSAS CITY

US: MANUFACTURING PMI AND INFLATION

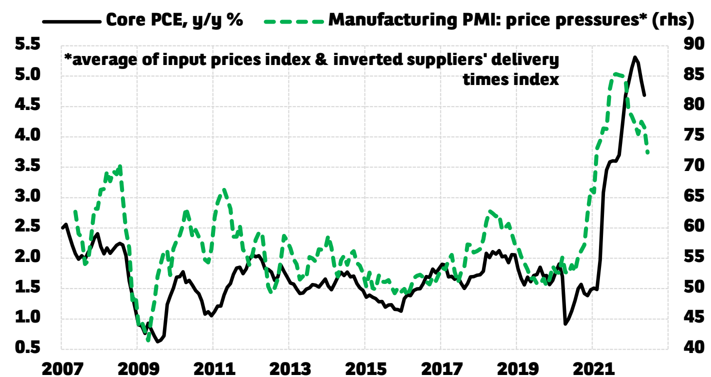

CHART 2

SOURCE: S&P GLOBAL, BEA, BNP PARIBAS

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