

So far, so good

October 20, 2023

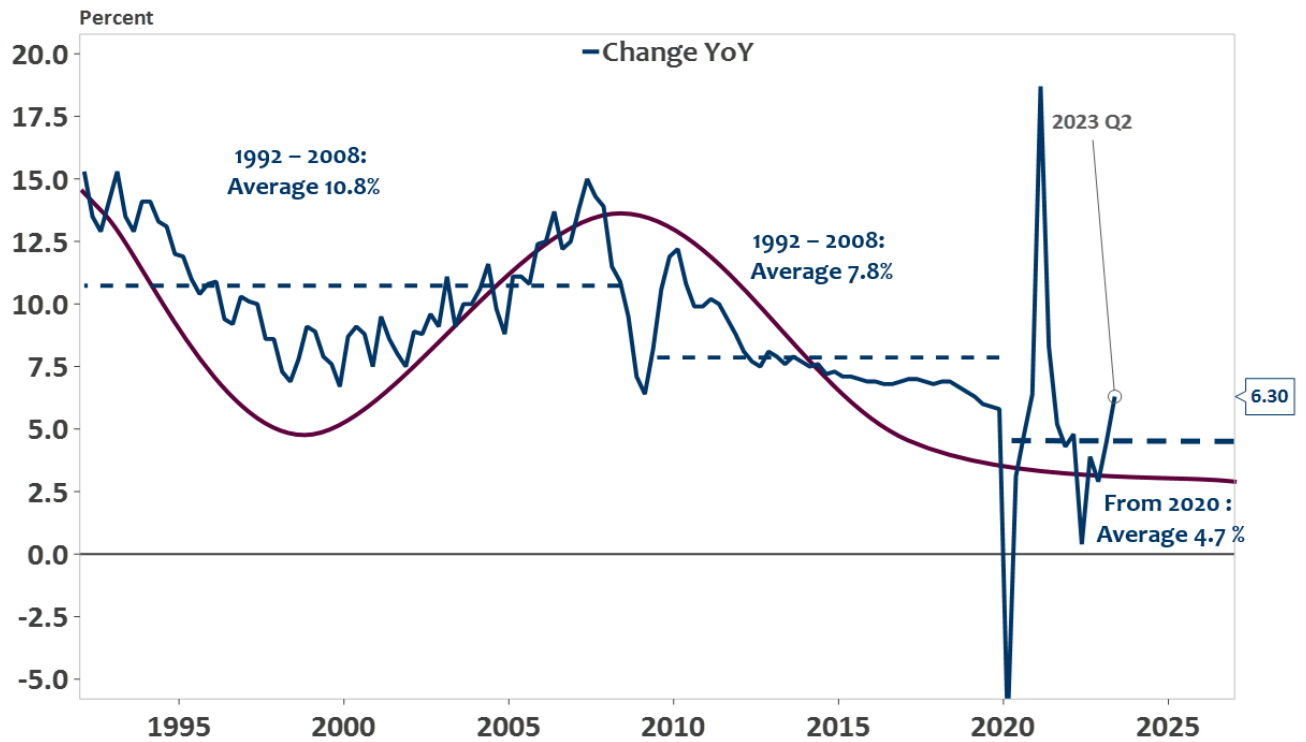
In the past months, growth across regions depicted mixed results with the US outdistancing other economies while EMU stalled, and China revealed worrying signs of slowdown. Core Inflation should continue to decelerate in the wake of lower demand and improved supply chains.

Although China's economic activity didn't meet the expected pace of catch-up following the country's re-opening, the pessimism which prevailed in August primarily stemmed from the challenging state of the Chinese property market. This brought distressed investors to fear for the 'Japanification' of the economy. However, there are signs of cyclical improvement, such as the expansion of Chinese credit and the recovery of trade and PMI data. And although experiencing a gradual rebalancing, China's real estate market differentiates itself from the property bubble experienced in Japan during the late 1990s. This distinction is attributed to China's lower level of urbanisation (approx. 65% in 2022) and its state-controlled economy. The housing sector in China is mostly characterised by an abundant stock of properties rather than disproportionately high price levels. With regards to long-term growth, China still has room to expand and catch-up with developed economies, albeit at a slower pace given lower productivity gains and shrinking population.

Other concerns, this time regarding China's excessive debt, may also be judged overstated given that the government's debt levels remain considerably low compared to those of the US or Europe. Notably, local governments have substantially increased their liabilities over the past decade, with total liabilities making up approximately 54 percent of GDP, in contrast with China's sovereign debt which constitutes only 22 percent of GDP.

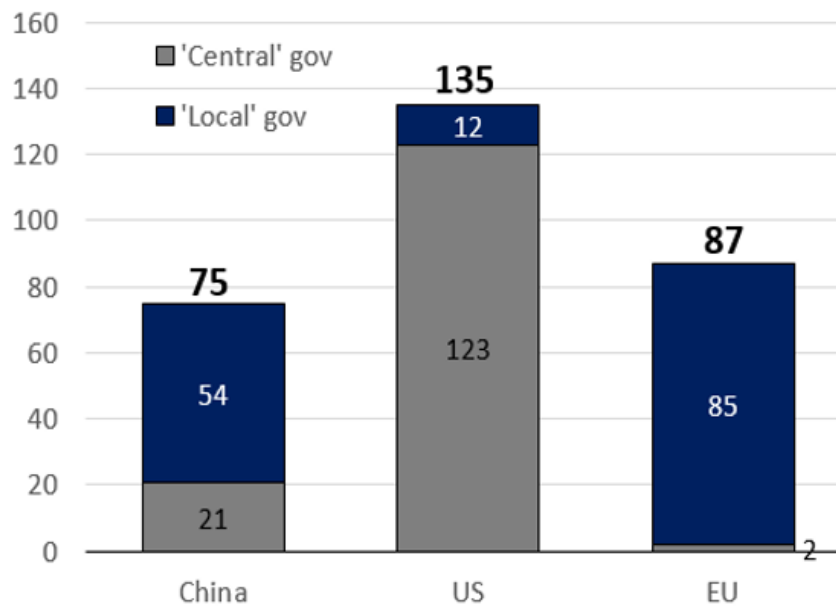
Out of the problematic debt linked to the Chinese real estate market (the sector accounts for 30 percent of GDP), half may eventually be absorbed into the fiscal realm. And in the event of a 15 percent increase in China's public debt through the issuance of Local Government Debts (LGDs) and Local Government Bonds (LGBs), this would bear resemblance with the substantial increase in the debt-to-GDP ratios witnessed in both the EU and the US in recent years, rather than with the trajectory experienced in Japan following the property bubble burst in 1990. **Overall, China's capacity to address its property market crisis is politically driven, necessitating the central government to accept an increased debt level to rectify the situation. We assess this fiscal setback as manageable for China.** Its resolution could also trigger comprehensive improvements in the way local governments operate.

Chinese GDP (constant prices)



Source: H2O AM, Macrobond. Data as of Q2 2023

Government Debt (percent of GDP)



Source: Eurizon. Data as of Q3 2023

Meanwhile, the US economy achieved pre-eminence by virtue of superior demand momentum, consistently exceeding sales expectations. We assess the US as having re-accelerated above its output potential, aided by a significant wave of fiscal packages (ARPA, ESA, IRA) which raised the country's primary budget deficit to 4 percent of its GDP.

It should be reminded that prior to July 2022, the US government displayed fiscal restraint. Since then, fiscal policy shifted course and eased rapidly, providing support to sustain the country's growth outperformance witnessed in 2023. **This pro-cyclical fiscal approach is unconventional, prompting the Federal Reserve to rebalance the policy mix by raising rates in a macro setup characterised by a surge in demand-driven inflation supported by an ever-tight job market, even with supply-driven inflation in a state of steady decline.**

The recent increase in US yields started in early August, following Fitch's downgrade of the US Issuer Default Rating to AA+ (from triple A). Commentary on this matter somewhat downplayed the significance of this event as well as the ensuing discussions on the diminishing reserve currency status of the USD. But the US fiscal outlook is in a clear dire state and asserting the attractiveness of treasuries on the basis that the US cannot default on its debt is an inadequate approach to investment, as there has been no instances of local-currency bonds default in history, apart from Russian GKO's in 1999.

Such fiscal slippage makes debt more expensive, weakens the performance of the economy, and impoverishes people. It also depreciates the country's currency resulting in reduced future reimbursements to foreign bondholders. As such, investors beyond US borders are understandably demanding a higher term premium to hold US debt; a change in regime which should persist over time. Historically, variations in bond yields from countries issuing reserve currencies have not been strongly linked to the fiscal position. Only EM economies have seen their yields rise in line with the worsening of their fiscal conditions.

Conversely, Europe has not implemented any significant fiscal stimulus measures since 2022. In fact, there was a slight reduction in fiscal support, resulting in a divergent trajectory with the US. This became evident as reduced demand in Europe led to an increase in saving rates and a slowdown in credit growth. The latter came as a consequence of the rapid transmission of the European Central Bank's restrictive monetary policy, amplified by a high level of banking intermediation.

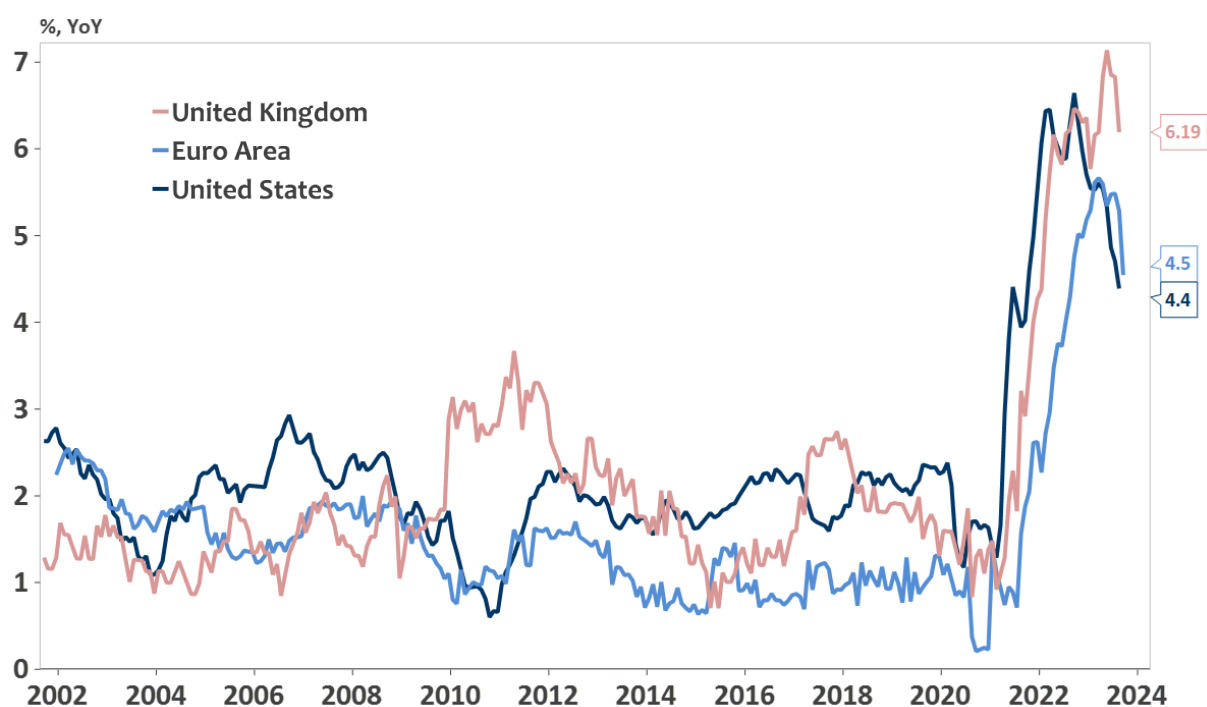
Contending with a decline in real wages due to the disparity between immediate inflation effects and delayed wage adjustments, EU consumers proved less confident about their economic situation. Unlike American households, they hesitated to dip into their excess savings to prioritise current needs over future ones.

Overall, we anticipate that the exceptional economic performance witnessed in the US will not be sustained into year-end. Instead, the economy is expected to align downward with the rest of the world as US demand is progressively met with local headwinds, such as the depletion of savings

accumulated during the Covid-19 crisis, resumption of student loan repayments, and upcoming constraints in fiscal policy.

In this context of global growth re-synchronisation to the downside, our primary outlook remains that of a soft landing, devoid of any foreseeable growth accident. This view is underpinned by economic resilience factors, such as increasing real income, tight labour markets, and a recovering manufacturing sector. Additionally, we observe no significant imbalances in the private sector that could transform a gradual slowdown into a protracted recession. Our projection is that monetary policy rates will persist at relatively elevated levels for an extended period, even though they might have already reached their peak. Central banks should exercise caution to forestall potential risks associated with a resurgence of inflation.

Core Inflation among G3 Economies



Source: H2O AM, Macrobond. Data as of August 2023

It should however be noted that the higher risk premium in bond markets and unsustainable fiscal position of the US have amplified the likelihood of a more noticeable economic deceleration in the forthcoming quarters, particularly within the US. On the other hand, Europe might find support to sustain its growth given its high sensitivity to the Chinese economic performance and the prospects of China nearing a pivotal juncture.

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