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RESEARCH NOTE

Making Up Lost Ground

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In spite of resilient economic momentum in the first half of 2022, global **uncertainty related to the war in Ukraine, commodity shortages, and central banks' resolute fight against inflation darken the outlook**. Our central **Stagflation Shock** scenario, introduced in March, **spelled out most of these dynamics**. In the U.S., consumers equipped with strong balance sheets, excess savings, rising credit, and a strong labor market have a lower sensitivity to higher prices. Reopening of the economy and a strong summer tourism season in Europe were a boon to growth. While data has surprised to the upside, this is no reason to turn bullish on the outlook. In fact, **the stronger underlying momentum is leading most major central banks to aggressively frontload rate hikes to reel in inflation**. We continue to believe that this backdrop will lead the FOMC to hike more than is currently priced into markets. In the euro area, the pass-through of the energy price shock to core inflation has led the European Central Bank to **frontload** rate hikes to rein in price pressures and consumer inflation expectations. Energy storage levels are better than expected, but a colder-than-normal winter would likely require some rationing.

Given these persistent trends, we keep Stagflation Shock our central scenario with 60% odds. The euro area is likely facing a recession this year. While the U.S. is relatively more shielded given energy independence and stronger household balance sheets, higher prices for necessities, rising interest rates, and the likely resumption of student loan payments next year should slow the pace of consumer spending while higher mortgage payments are cooling demand in the housing market. This should set the U.S. up for a material slowdown in growth, particularly in the second half of 2023, with risks of a mild recession. Growth in China is set to disappoint given continued COVID lockdowns, a tepid rebound in internal demand, and property sector weakness weighing on sentiment and credit growth. In Japan, the growth rebound has been sluggish, and weakening global growth will only add to headwinds.

Yet there is still a possibility that growth continues to surprise to the upside, particularly in the U.S. **Strong jobs reports and resilient household consumption have led us to upgrade the probability of our alternative Higher for Longer scenario, from 10% to 20%.** Higher growth and supply-side shocks could keep inflation exceedingly elevated, requiring a more aggressive response from the Federal Reserve than is in our baseline. While monetary policy would tighten, it would not be enough to bring inflation down to target within 12-18 months. Such a scenario would prove particularly challenging for central banks and could lead to greater problems in 2024, as more aggressive tightening would likely be needed and risk a much deeper recession.

Given the high uncertainty on the outlook and lag in economic data, we have reduced the odds of our Steeper Slide scenario from 30% to 20% given the strength in activity so far and the proactive fiscal policy support. In this scenario, underlying economic momentum proves much weaker given poor sentiment and U.S. savings buffers that fail to spur consumption. Central banks tighten but aren't able to hike as much as is currently priced into markets. This proves too much for global economies, the U.S. and Europe fall into recession, and weak growth in China weighs further on global growth.

With most major central banks turning increasingly hawkish, good economic data doesn't mean good news for markets, as policymakers focus on the inflation portion of their mandates, and strong demand likely means more tightening. After a delayed start, central bankers are doing their best to make up for lost ground.

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