Turning a corner: a brighter start to 2023

Economic commentary

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Key points

- After nearly a year spent grappling with the shockwaves from the Ukraine war, the global economy looks to have turned a corner, with recent data coming in better than expected and with business surveys in January showing a clear improvement. Especially noteworthy was the resurgence of activity and sentiment reported by service sector businesses in the USA and in China.

- But the process of getting back to 'normal' will be slow going. The aggressive tightening of monetary policy by central banks during 2022 will take some time to feed through to households and businesses. And commodity prices are unlikely to fall much further, if at all, as China's re-opening boosts demand.

- The UK avoided a 'technical recession' in the second half of last year, albeit only by the narrowest of margins. But its economic performance looks distinctly underwhelming compared with its peers: GDP in the final quarter of 2022 was still nearly 1% lower than at the end of 2019; and, among the G7 economies, only Italy now has a higher inflation rate.

- HSBC has made a slight upward revision to its UK growth forecast for 2023, but still expects full-year GDP to be 0.4% smaller than in 2022. Meanwhile, the Bank of England is expected to hike interest rates one last time in March, taking UK Bank Rate to 4.25%.

The past few weeks have brought a definite improvement in the tone of global economic news. The aftershocks of the war in Ukraine were a dominating theme for most of last year; but it now appears that a corner has been turned, and that some economies will avoid the recessions that were anticipated just a few months ago.

To begin with, it was reported on 26 January that the US economy achieved solid growth in the final quarter of last year, with real GDP expanding by 0.7%. Five days later came news that the Euro Area had avoided a widely-expected contraction of activity, with GDP instead expanding by 0.2% in the final three months of 2022; the economies of Germany and Italy shrank, but not by very much, and those declines were offset by modest growth in France and Spain, and also in some of the region's smaller economies.

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Labour market resilience

It's also clear that the feared increases in unemployment have yet to materialize. In the USA, January was a bumper month of job creation, with a rise of 579,000 in 'nonfarm payrolls' and with the unemployment rate falling to just 3.4%, its lowest in more than half a century. And despite the worries about an impending recession in the Eurozone, the unemployment rate there has remained stable, with the rate of 6.5% reported in October and November being the lowest since the creation of the single currency.

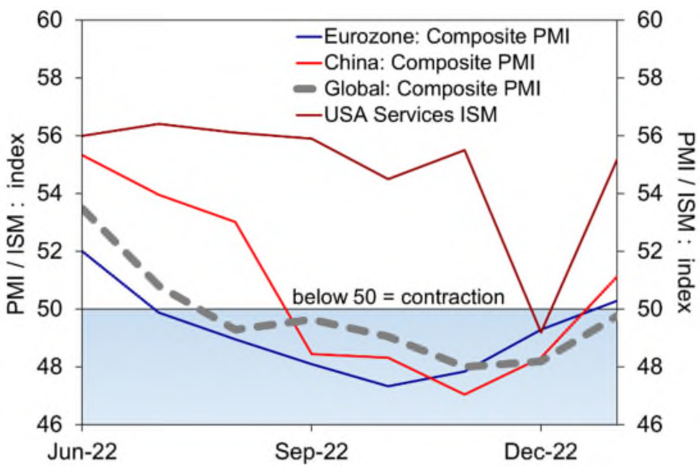
The opening days of February have also brought a clutch of better readings from numerous business surveys. The global composite PMI, based on the Purchasing Managers' Index (PMI) surveys, rose to 49.8 in January, from 48.2 in December, helped by a strong rebound in China's services PMI which rose by almost five points to 52.9. In the USA meanwhile, the ISM survey of non-manufacturing firms (which has a larger sample and a longer track record than the PMI equivalent) registered a dramatic increase of six points, with the headline index for January coming in at 55.2, completely unwinding what now looks like a downside blip in December.

Finally, the UK's Office for National Statistics (ONS) reported on 10 February that Britain had narrowly escaped a 'technical recession' (two consecutive quarterly falls in GDP), with real GDP in the final quarter of 2022 being unchanged from the previous three months. Matters weren't helped by widespread strikes in December, while the pause of Premier League football for the duration of the World Cup is also reckoned to have dampened spending, so that the monthly GDP estimate shows a decline of 0.5% during December.

Reasons to be cheerful

These recent reports provide grounds for cautious optimism that a modest thawing in the global economic climate may be getting under way. It should be stressed, however, that the pulse remains weak, and that many households and businesses will notice little difference for some time yet. On the ground, the difference between GDP growth of 0.1% in any given quarter, as against a decline of 0.1%, is unlikely to be perceptible. Even so, it's important to recognize that the mere fact of avoiding a 'technical recession' can help to bolster confidence, especially among businesses. It's also good news that some of the more dire predictions relating to Europe and its ability to cope with a winter without Russian gas, haven't been fulfilled: Europe hasn't run out of gas; the lights haven't gone off; and rationing hasn't been needed.

Global business surveys: an improving picture at the start of 2023



Source: S&P-IHS Markit; ISM

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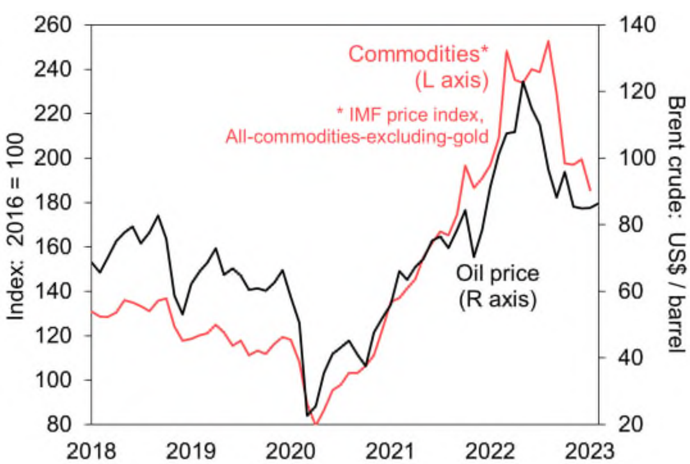
Perhaps the biggest boost to the global economy's short-term prospects is that the spike in commodity prices, which followed Russia's invasion of Ukraine last February, has been largely unwound. Prices fell by a further 6% in January (measured by the IMF commodity prices index), so that they're now around 5% lower than in January last year, and down by more than a fifth from the peak in March. It's true that a revival of demand from China has pushed up the prices of many metals (and some agricultural produce), but oil prices are at a historically normal level at around $85 for a barrel of Brent crude. Meanwhile natural gas prices have been falling: the month-ahead Netherlands TTF price has been below €60 per megawatt hour since 24 January, with the average for January being 45% down from the average for December. Wholesale gas prices in Europe are still three times what they used to be, but they're 80% lower than they were during those extraordinary days in late August. In other good news, the spike in shipping rates, caused by the Covid-related supply logjams, has also unwound in recent months, so that it now costs only fractionally more to ship containers from the Far East into the western US and northern Europe than it did before the Covid pandemic.

But, even at their present level, commodity prices are still some 50% higher than they were in the latter years of the 2010s. And, with China's economy starting to emerge from the wave of Covid infections that swept through the population in the weeks immediately after restrictions were eased, it's unlikely that commodity prices will fall much further; indeed, it's not out of the question that they might now start to edge higher. The world therefore cannot expect to escape quickly from the supply squeeze precipitated by the Ukraine war, but at least it now seems that the squeeze will be less severe than seemed likely in the spring of last year. In time, more supplies will come to market but – with the exception of agricultural produce – this generally takes several years. In the case of natural gas, there are some new fields coming on stream in Qatar, the USA, and Australia, but not much of any significance until 2025 or 2026, which suggests that prices will remain elevated until at least then.

Falling commodity prices, especially for gas and electricity, are also helping to take some of the sting out of inflation rates. With labour markets still tight in many countries, this means that the gap between price rises and earnings growth is starting to narrow. The squeeze on the spending power of households' incomes is far from over, but there is now some light at the end of the tunnel. The same is true for borrowing costs, with central banks now nearing the end of their hiking cycles. Come the spring, policymakers will have interest rates as high as they want to take them; it will then just be a case of sitting and waiting, and hoping that they've done enough.

Commodity prices have eased



Source: IMF, Refinitiv Datastream

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For all that, the global revival will be a drawn-out affair, not least because higher interest rates take a year or two to fully feed through to economic activity. Meanwhile, China's renewed growth is likely to be driven by household spending (rather than by infrastructure investment, as was the case in previous growth surges). This will be good for global travel and tourism, but may not do much for cross-border goods trade, as it's unlikely to offset the decline in imports of goods by the USA. Americans had splurged massively on "stuff" during the pandemic and so, as US spending patterns return to something like normal (admittedly it's taking a long time), the volume of goods imports has fallen, and can be expected to keep on falling as firms work down excessive inventories.

An underperformer

Like the Eurozone, the UK defied expectations of a second quarterly decline in GDP at the end of last year, and thereby avoided a 'technical recession'. But, with economic activity in the UK having flatlined since February 2022, GDP in the fourth quarter of last year was reckoned by the ONS to be still 0.8% below its level in the final three months of 2019. The UK has therefore fared worse than its G7 peers, especially the USA where GDP at the end of 2022 was up by over 5% from its pre-Covid level.

But it's also possible that the statisticians at the ONS have got it wrong. The huge revisions to the figures for business investment, as reported in the latest GDP release, are a reminder that things are not always what they initially seem. It was previously thought that business investment (in real terms) in the third quarter of last year was more than 8% below its pre-Covid level; but suddenly, thanks to revised data and a jump of over 4% in the final quarter of 2022, it's now all but back to where it was at the end of 2019. Some other aspects of the GDP data also don't 'feel right', notably the large falls in output, compared with 2019, in the healthcare and distributive trades sectors of the economy. So, while nobody can deny that the UK economy is in a rather somnolent condition, it might yet turn out that it's not quite as torpid as the official statistics would have us believe.

Taking into account the slightly better-than-expected out-turn at the end of 2022, and also the expectation that inflation will be slightly lower than previously anticipated (thanks to lower wholesale gas and electricity prices), HSBC has made a minor upward adjustment to its UK growth forecast for 2023. We still expect a modest contraction over 2023 as a whole, but we now anticipate GDP falling by 0.4% (rather than the 0.6% decline that we previously expected). And the opening months of the year will still be tough, with activity being depressed by the squeeze on household incomes, by the 'pass-through' of last year's rate rises, and by ongoing industrial action (or inaction). In particular, we still expect modest declines in GDP during each of the first two quarters of this year, meaning that a 'technical recession' has merely been delayed, rather than avoided altogether.

The Bank of England has raised UK Bank Rate by 390 basis points since the autumn of 2021, and HSBC expects a further hike of 25 basis points at the next policy meeting, on 23 March, taking UK Bank Rate to 4.25%. We think that this will be the peak of the current tightening cycle, though the messaging that accompanies the announcement will be determined by the latest labour market and inflation data. Inflation has begun to edge down, but the UK is starting to look like an outlier among the major developed economies, with only Italy having a higher annual rate. And, although conditions in the labour market have started to ease, recruitment of workers remains a challenge for many firms, with vacancy levels still around 300,000 higher than their pre-Covid norm.

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