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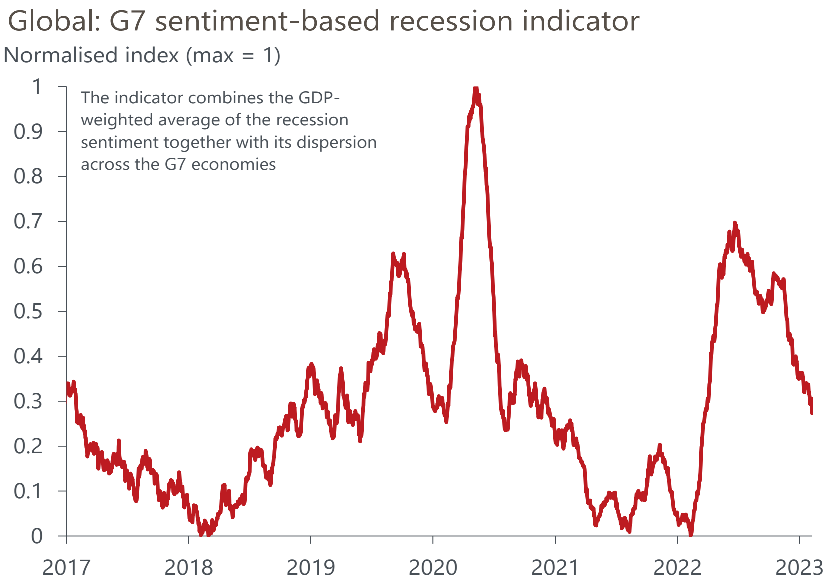
Research Briefing | Global

Recession Watch – Sentiment rallies; inflation still a threat

- **Our indicators suggest global economic sentiment is improving despite the impact of higher interest rates, geopolitical uncertainty, and the squeeze on real incomes. Oxford Economics/Penta data indicate the improved sentiment is being supported by strong wage growth and resilient employment.**
- **Recession concerns among the major economies have subsided in recent months. Not only has sentiment based on mentions of "recession" improved, but concerns are also less synchronised across the world. This suggests a better chance of a soft landing for the economy.**
- **Consumers' relative optimism likely stems from resilience in the labour market. Our employment and, in particular, our wage sentiment indicators have stayed fairly strong in early 2023.**
- **While this is good news for the health of household finances, it also suggests that inflation could be more persistent in the first half of 2023 than expected, which will keep central banks on high alert. If the shift in sentiment is borne out by less-timely official data, it will keep central banks focussed on the risks from persistent inflation and the need to keep policy restrictive.**
- **Subsiding concerns aren't a signal that the economic cycle is re-accelerating, however. Our indicators continue to point to stagnating consumer spending across the US and Europe. And there are pockets of weakness, for example Canada where consumer sentiment is deteriorating more markedly, reflecting the worse outlook for housing markets and credit conditions there.**

In sharp contrast to the end of last year, 2023 has started with a slew of good news including tumbling European gas prices, China's surprise re-opening, and improving US labour market dynamics. This shift in overall sentiment is captured in our unique proprietary sentiment data.

Chart 1: Despite a recent wobble, recession fears have calmed since the autumn



Source: Oxford Economics/Penta/Haver Analytics

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Recession fears have collapsed in recent weeks across the G7 economies, as measured by the sentiment and dispersion of articles mentioning the term in more than 400,000 sources globally (**Chart 1**). Sentiment tends to be much more volatile than actual economic outcomes. But if the improvement is sustained it would imply that the global economic outlook is improving and a better chance that the economy can achieve a "soft landing" after one of the most aggressive interest rate hiking cycles in living memory.

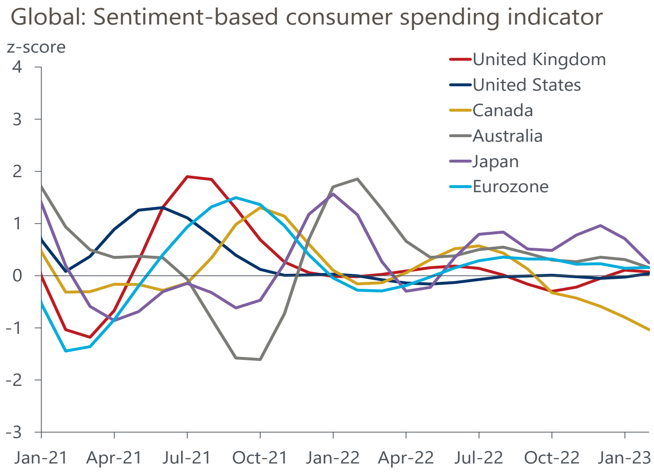
Our sentiment data does still imply a weak outlook though – our recession indicator has only improved to 2019 levels when global recession was a real possibility, albeit not our baseline forecast at the time.

Any recessionary outcome will hinge on the behaviour of consumers. Dissecting the aggregate picture in our data shows that some advanced economies are faring better than others. Almost all economies have seen consumer sentiment (and by implication, spending) weaken in our data since the middle of 2022, but two economy's diverging experiences are notable – the US and Canada (**Chart 2**).

In early February, US consumer sentiment is broadly similar to levels last summer. A slightly lower peak of inflation than in other countries, the use of excess savings, and a buoyant labour market are all likely explanations. In contrast, our data shows that Canadian consumers are feeling the economic headwinds most acutely. Sentiment there has been falling since May last year when house prices first started to drop and sentiment now is well below long-run averages, implying a rapid slowdown in spending in early 2023, in line with our forecast.

The findings from our sentiment-based consumption indicator contrast against the sustained improvement seen in consumer confidence surveys over recent months. But we think that just as the survey measures overestimated the scale of consumer weakness throughout 2022, they are now overstating the rebound. Instead, our sentiment data points to a more gradual decline in consumer spending growth in 2022 – borne out by the data – leading to the current anaemic rate of growth in most advanced economies.

Chart 2: Consumer spending is still set to stagnate, but not collapse



Source: Oxford Economics/Penta

The labour market remains resilient for now

A key support to consumer sentiment in 2022 was the strength of the labour market, and our sentiment indicators suggest this is set to continue at least in the short term. Employment in early 2023 has expanded at a broadly similar pace to 2022 in most advanced economies (**Chart 3**). Italy, Germany, and the UK where job creation has materially slowed this year, appear to be key exceptions.

But over the past 12 months, the labour markets in most advanced economies have consistently surprised to the upside, a feature that was captured at the time by our proprietary sentiment data. While this offers some hope that the expected economic downturn might inflict less-than-usual damage on the labour market, it's also likely to reaffirm the hawkish resolve of many advanced economies' central banks.

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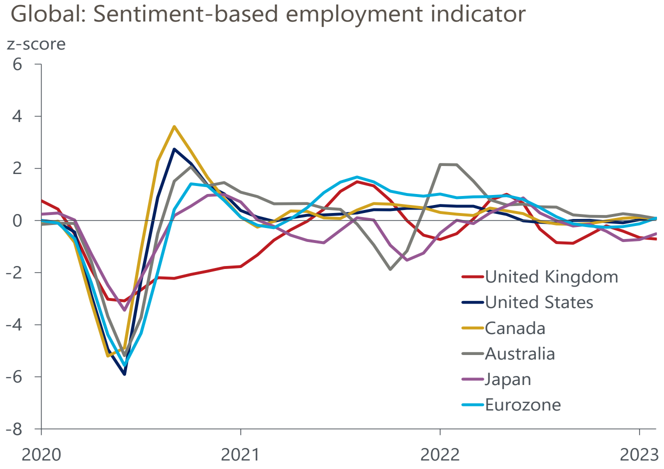
Chart 3: Employment growth remains fairly resilient so far in 2023



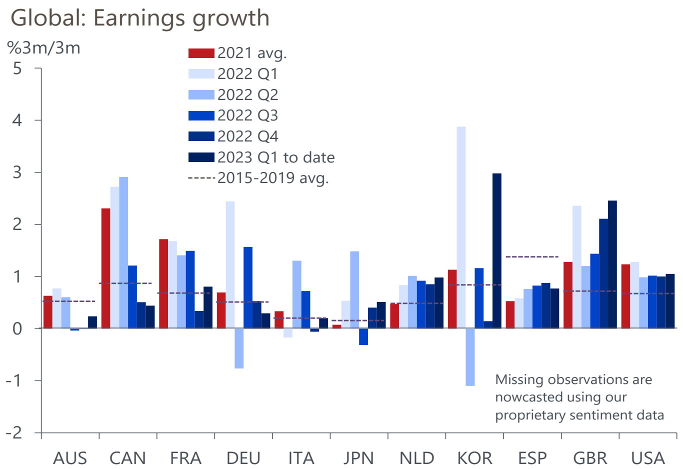
Source: Oxford Economics/Penta

Developments in wages tend to follow those of employment, so it's no surprise that the resilience of employment at the end of 2022 is reflected in our wage indicator. Overall wage growth across the advanced economies remains high by historical standards, and in some cases – the US, UK, France, Japan, and South Korea – we see some evidence suggesting further increases in 2023.

But central banks will be wary of the inflation threat

In the current context of high inflation, central banks will be very wary of the strength of wage growth as a potential sign that expectations of higher inflation are becoming entrenched in pay. This risk of persistently higher inflation is the impetus behind much of the monetary tightening we have seen this cycle (**Chart 4**).

Chart 4: Wage growth is high, implying a gradual descent for inflation

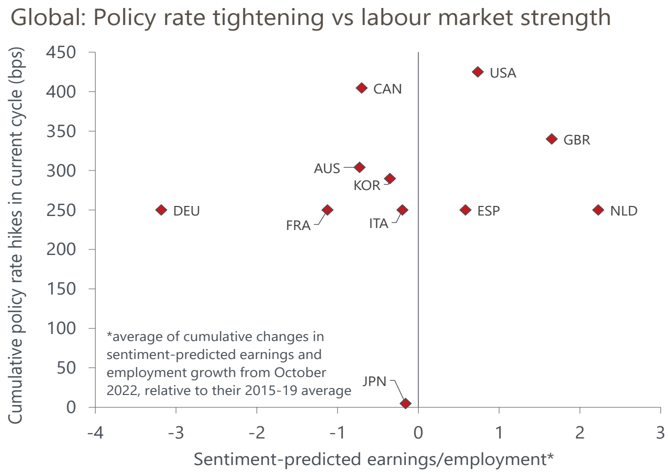


Source: Oxford Economics/Penta/Haver Analytics

The persistent strength of our wage growth indicators highlights the risk that central banks will be forced to tighten monetary policy by more and for longer than many economic forecasters and markets currently expect. But, consistent with the differentiated labour market picture, the risk of further tightening varies considerably across the advanced economies (**Chart 5**).

The US is clearly at most risk given the strength in both employment and wage sentiment. Risks for the UK are also significant due to very strong wage data, but this could prove temporary given that wage developments tend to lag employment growth – our data suggests that UK employment has softened considerably at the start of 2023. Unusually, the labour market is also a source of risk for the Bank of Japan, which may keep pressure on the central bank to adjust policy settings.

Chart 5: Central banks have reacted to the strength in labour markets



Source: Oxford Economics/Penta/Haver Analytics

At the other end of the spectrum, the ECB and the Bank of Canada appear to be facing less of a threat from persistent inflation. Within the eurozone, labour markets in Germany and Italy, the two economies most exposed to the Russian gas supply shock, are softening quickly. Meanwhile in the Netherlands, France, and Spain conditions are broadly stable. This highlights the difficult task for the ECB in setting a single monetary policy across 20 economies. Overall, though, the ECB is likely to be reassured that domestic inflationary pressures remain contained, limiting the case for further rate rises. For Canada, the sentiment data point to much weaker wage growth and lower risks for inflation.