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Economic and Strategy Viewpoint

December 2021

Q4 2021

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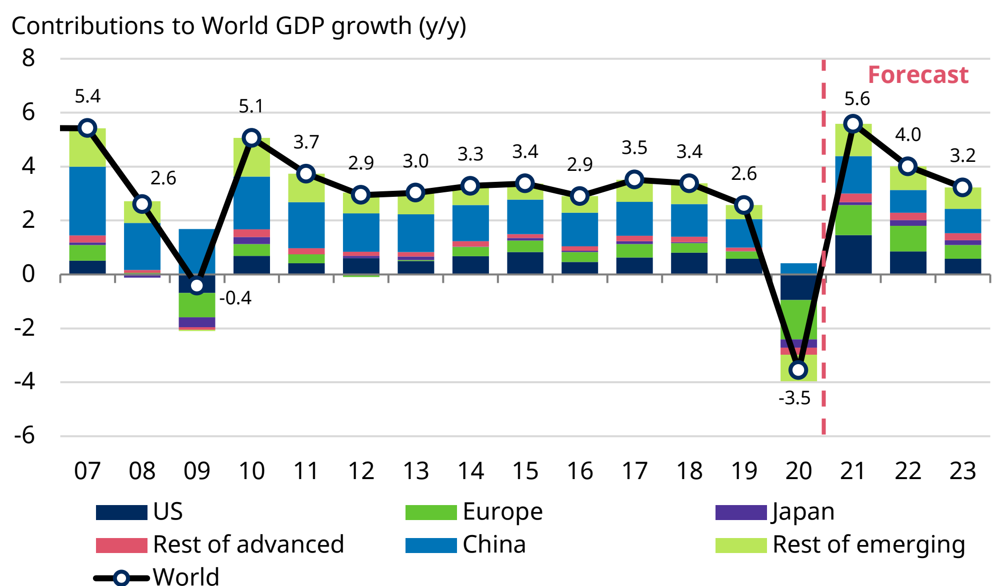
An unbalanced recovery

- After a surge in activity in the first half of the year the world economy hit an air pocket in the third quarter. Bottlenecks in supply chains meant that delivery times soared and firms had to cut production due to a lack of parts. As a result global growth stalled while inflation rose sharply.
- Our near term view is that the third quarter slowdown in growth is temporary and the world economy will re-accelerate in the current quarter, led by the US. An easing of supply chain problems is supporting global industry where orders remain buoyant.
- Looking further out into 2022 we see growth cooling as the massive policy stimulus in response to the pandemic fades. There will be support from consumer and corporate spending, but overall demand is set to ebb. Inflation should then moderate, but we will probably have to wait until the second half of next year to confirm that the rise has been transitory.
- Both the Eurozone and UK have had their growth forecasts downgraded for 2022 as the spike in energy inflation is set to reduce the purchasing power of households. Despite this, growth remains strong as households are still expected to boost consumption and lower their savings rates. However, differing labour market conditions will drive the UK and eurozone to diverge on policy. The BoE is forecast to raise rates imminently, while fiscal policy is also being tightened. In contrast, the ECB is likely to keep QE going, albeit with less purchases, but with fiscal policy still very stimulative for a number of years yet.
- The roll-out of vaccines should ensure less disruption from Covid in emerging markets, but economic growth is set to slow as higher inflation and interest rates weigh on activity. China is ahead of most EM in already experiencing a sharp slowdown. We expect looser policy to stabilise growth by mid-year, setting the scene for some recovery, but we are wary of downside risks stemming from the real estate sector.
- The emergence of the Omicron variant occurred after we finalised our forecast, but clearly increases the risk of new restrictions on activity and renewed supply side disruption. At this stage it is too uncertain to judge the macro impact only that it adds to the stagflationary risks in the world economy.

Chart: Global growth forecast



Source: Schroders Economics Group. 26 November 2021. Please note the forecast warning at the back of the document.

An unbalanced recovery

The world economy hit an air pocket in Q3 as supply constraints hit

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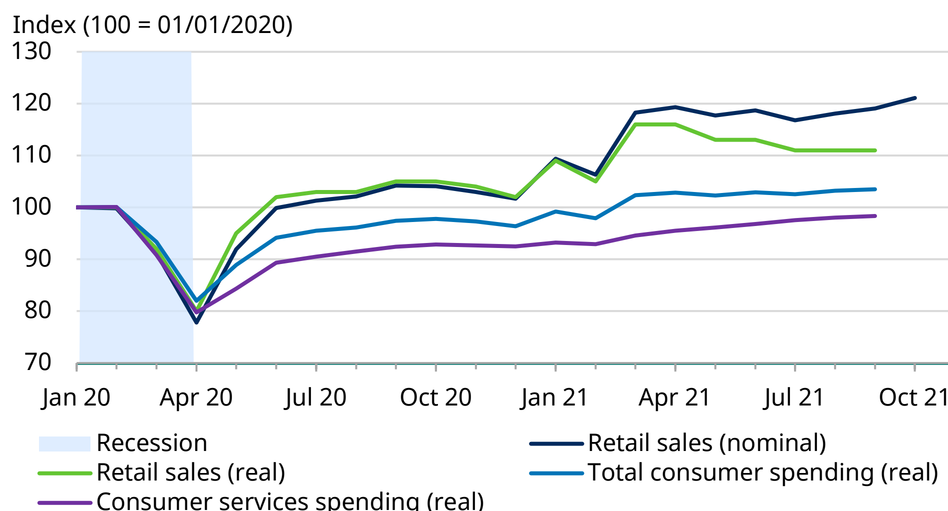
Looking further out into 2022 we see growth cooling as the massive policy stimulus in response to the pandemic fades. There will be some support from consumer and corporate spending, but overall demand is set to ebb. Inflation should then moderate, but we will probably have to wait until the second half of next year to confirm that the rise has been transitory.

Rapid rebound stokes inflation

Before looking at our updated forecasts it is worth highlighting how this recovery has differed from the past and why supply shortages have emerged so rapidly. The recovery has thrown up unanticipated problems in supply chains and labour markets which has pushed inflation and wage rates higher than expected.

The unbalanced nature of the recovery can be seen in figures from the US which show that retail sales volumes are more than 10% above pre-pandemic levels, whilst service sector spending is still some 2% below (chart 1). The recovery has been driven by the goods sector, creating extraordinary pressure on supply chains and commodity prices. It took 4½ years to reach this level of retail sales volumes after the Global Financial Crisis ended in 2009; this time it has only taken 1½ years.

Chart 1: The US consumer recovery



Source: Refinitiv, Schroders Economics Group. 22 November 2021.

Retailers have succeeded in passing on cost increases

The impact of the recent bottlenecks is apparent in the loss of momentum in retail sales volumes. This primarily reflects higher inflation as in nominal terms sales have continued to forge ahead and are some 20% above pre-pandemic levels (see chart 1 above). Faced with restricted supply and higher costs, retailers have raised prices to the consumer. Although consumers bought less, overall revenues continued to rise – an outcome which could be seen in the buoyant Q3 earnings season for the retail sector.

When combined with tight labour markets it should not be surprising that central banks are looking to tighten policy. Higher inflation reflects an imbalance between restricted supply and strong demand and, whilst central banks cannot affect the former (speed up the delivery of cargo or, in the case of renewable energy, make the wind blow harder), they can restore balance by addressing the strength of demand through tighter monetary policy.

Forecast update

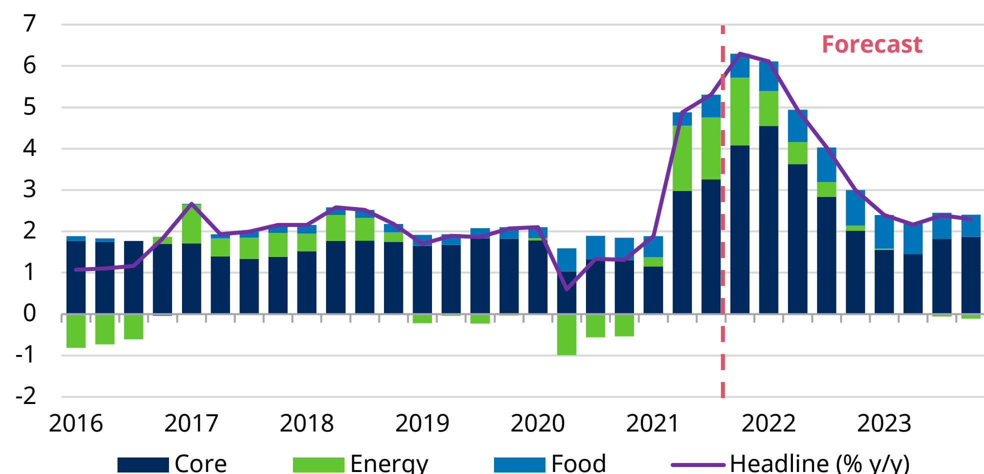
2022 growth forecasts are cut, inflation projections have increased

Although global activity should firm in the near term, these conditions are expected to persist into next year and we have trimmed our growth forecasts for 2022 whilst raising our inflation projections. We now expect global growth of 5.6% this year followed by 4% in 2022, reductions of 0.3 and 0.5 percentage points (pp) compared to our previous forecast. The deceleration in growth is primarily driven by the US and China, although Europe (particularly the UK) is also expected to slow.

Our global inflation forecasts have been raised to 3.4% this year and 3.8% next, increases of 0.3 pp and 1.0 pp respectively. Compared to our previous forecast, the increase reflects higher energy costs (following the increase in oil and gas spot and futures prices) and higher core rates as bottlenecks have persisted for longer. The tightening in labour markets has also been greater than expected and wages have risen by more as a result. The transitory rise in prices is proving more durable than expected only three months ago.

Nonetheless, we still see global inflation moderating in the second half of next year and our forecast for 2023 is for 2.7%. An easing in supply chain pressures and commodity prices are the main drivers. See chart 2 for the profile in the US where, after peaking at 6.2% in Q1 next year, headline CPI inflation falls back to 3% by year end.

Chart 2: US inflation – decline delayed



Source: Refinitiv, Schroders Economics Group. 26 November 2021. Please note the forecast warning at the back of the document.

Policy support fades in 2022

Policy plays an important role in shaping activity in 2022. The massive fiscal stimulus in response to the pandemic is already winding down in the US and UK with the ending of enhanced benefits, one-off payments and furlough schemes. Temporary cuts in indirect taxes have been reversed in the UK and in parts of the eurozone.

After "shock and awe" in 2021, fiscal stimulus fades in the US and UK in 2022

Although government spending will remain strong, overall fiscal policy will be less supportive in 2022. This should not be a surprise after the "shock and awe" fiscal largesse of 2021. In the US the bi-partisan infrastructure bill will start up next year and the larger Build Back Better package currently winding through Congress should help (if it gets through the Senate), but the overall fiscal impulse will be less than in 2021. It is a similar story in the UK where corporate and income taxes are set to rise next year along with higher National Insurance Contributions (payroll taxes).

In contrast the eurozone stands out as fiscal spending is expected to remain strong next year with the European recovery plan called NextGenerationEU (NGEU). Stimulus is less than in 2021, but still significant. Meanwhile, China is expected to bring back fiscal stimulus in 2022 through higher local government borrowing, but also through banks being encouraged to lend more.

On the monetary front we also see a move in a less positive direction in the US and UK where quantitative easing (QE) is ending. We expect UK interest rates to rise in December this year and February next. Meanwhile, a patient Federal Reserve (Fed) is expected to raise rates in December next year after completing its tapering in June. Rates in both economies are then expected to rise further in 2023: to 1.5% in the US and 1% in the UK.

Central bank policy in the US and UK will be less supportive in 2022. Interest rates are still low (relative to R*, or equilibrium), but as with fiscal policy the period of super easy policy will come to an end. Unless there is a significant adverse reaction in credit and equity markets in 2022, the policy impulse from overall financial conditions will not go negative until 2023 as policy rates rise further.

For the eurozone and China we see monetary policy remaining supportive as even though the European Central Bank (ECB) brings the Pandemic emergency purchase programme (PEPP) to an end, we expect other QE programmes to be stepped up and for no change in policy rates.

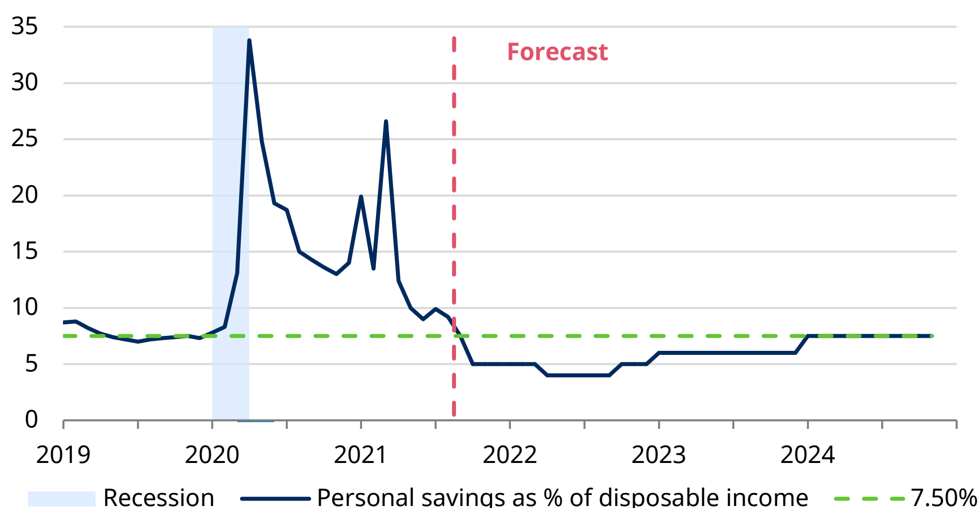
For China there is a balance to be struck between the de-leveraging agenda and the need to maintain growth, but given the scale of the housing downturn we would expect rate cuts and an easing of lending criteria by state banks in 2022. This should result in a turn in the credit impulse in 2022.

Private demand to step up as official support fades

These changes should not be surprising as official support had to come to an end once the recovery had taken hold. However, for growth to be maintained we need to see a hand-off to the private sector.

On this front the consumer is critical and here we are looking for households to spend the savings they accumulated during the lockdowns. We estimate that this amounts to $2.2 trillion in the US and whilst much will continue to be saved we are looking for a boost to consumption of around $576 billion (around 3% of household disposable income) from this source in 2022. In practice this would mean a fall in the savings ratio below its pre-pandemic average of 7.5% as excess savings are spent, before a return to this level by the end of 2023 (chart 3).

Chart 3: US savings rate (actual and projected)



Source: Refinitiv, Schroders Economics Group, Markit, 26 November 2021. Please note the forecast warning at the back of the document.

Consumer spending is dependent on lower savings rates as inflation squeezes real income

The US savings rate has already fallen significantly in 2021, but it is critical for consumption that it continues to decline in 2022 given the squeeze on real earnings from higher inflation. Although wage growth has picked up and is expected to rise further, real income growth is likely to slow next year thus increasing the reliance on pent-up demand from excess savings.

The story in the eurozone and UK is similar although we estimate that households in these economies have yet to begin running down their excess savings. Judging the situation in China is more difficult due to a lack of data, but it is believed that there is less excess saving than in the west.

Divergent policy outcomes

Pulling this together we have scored the different components of policy and the potential for pent-up demand. On this basis we see considerable swings in the US and UK going into 2022 from maximum stimulus to a more modest or neutral stance. The eurozone remains more full on whilst China swings toward more stimulus on both the monetary and fiscal side (see table 1). This divergence between the US/UK and eurozone/China will create opportunities in bond and foreign exchange markets.

Table 1: Growth scoreboard – 2022 (versus 2021)

	US	Europe		China
		Eurozone	UK	
Monetary policy	0 (+)	+ (+)	0 (+)	+ (-)
Fiscal policy	0 (+)	+ (+)	- (+)	+ (+)
Pent-up demand	+ (+)	+ (+)	+ (+)	0 (0)
Total	**+ (+++)**	**+++ (+++)**	**0 (+++)**	**++ (0)**

+/0/- : positive/neutral/negative growth impulse.
Source: Schroder Economics, 26 November 2021.

We look at the risks around inflation and growth in our scenario section below, but first discuss our regional forecasts in more detail.

Regional views

Europe: Energy inflation and covid restrictions lead to downgrades

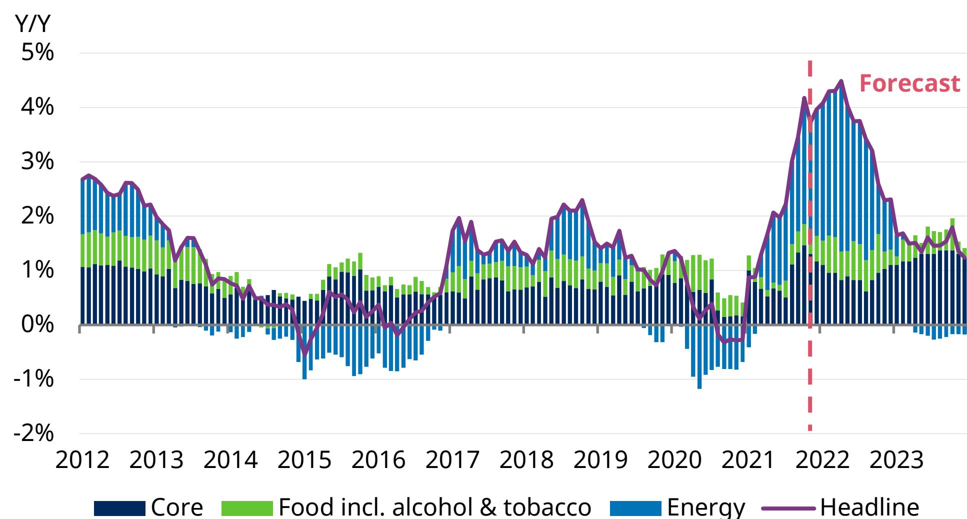
The eurozone economy outperformed consensus estimates in Q3 as it grew by 2.2% q/q, slightly up on Q2's growth of 2.1%. This leaves the level of economic activity just 0.5% below its pre-pandemic peak, meaning that the recovery in GDP should be complete this quarter (Q4). For more on the performance of individual member states, please see: "Eurozone growth beats expectations, as inflation hits a 13-year high".

Higher EU energy inflation leads to growth downgrades for 2022

In terms of the forecast, eurozone growth has been revised up slightly from 5.1% to 5.2% for 2021, but revised down from 5.6% to 4.6% for 2022. The main cause of the major downgrade for next year is higher inflation. Higher wholesale energy prices, mostly caused by the spike in European natural gas prices, have already begun to feed through into higher home energy bills. For more on the causes and impact of this, please see "What does the European natural gas crisis mean for inflation?".

Headline inflation is forecast to rise from an average of 2.4% for this year to 3.5% in 2022. Excluding energy, food, alcohol and tobacco, core inflation is forecast to remain at 1.3%, highlighting the impact from energy inflation in particular (chart 4).

Chart 4: Schroders eurozone inflation forecast



Source: Eurostat, Refinitiv, Schroders Economics Group, 26 November 2021. Please note the forecast warning at the back of the document.

Higher inflation will reduce the purchasing power of households, especially as energy prices are the main cause. Demand for energy is typically price inelastic, and so households are more likely to prioritise spending on home heating over other goods and services. Moreover, as most of Europe's energy is imported, this will at least temporarily, weaken the monetary union's trade balance.

The good news is that most of the inflation expected for 2022 is expected to be transitory. Wholesale energy prices are expected to peak over winter, then fall back along with demand for heating homes by spring. This should help inflation to fall back over the second half of 2022 and into 2023.

For 2023, GDP growth is expected to moderate further to 2.4%, but this remains above trend. Activity will be supported by ongoing fiscal stimulus, which while being less than during the height of the pandemic, will switch spending from healthcare and support for households and businesses, to investment in green and digital infrastructure. Headline inflation is forecast to average 1.5%, but core inflation should rise to 1.8%, as by then, excess spare capacity in the economy is expected to have been used up.

The ECB remains very dovish and is expected to keep some QE going until the end of 2023

The European Central Bank (ECB) remains very dovish. As inflation is forecast to dip back below 2% over the forecast horizon, the governing council feels it can look through the near-term pressures caused by energy. Indeed, ECB president Christine Lagarde mentioned at the last press conference that the council is considering reducing QE purchases at a slower pace in 2022. The portion of purchases done under the pandemic emergency purchase programme (PEPP) is set to conclude at the end of March 2022, which would reduce purchases from €160 billion per quarter to just €60 billion per quarter (as previous QE programmes would continue). We expect the ECB to raise purchases to €90 billion for the second to fourth quarters of 2022, before slowing purchases to €60 billion per quarter for the rest of 2023. We do not expect the ECB to move interest rates over the forecast horizon, but rate rises in 2024 should be expected.

Risks

There are both upside and downside risks to the Eurozone forecasts. The savings rate rose unexpectedly in Q2, meaning that it now has further to fall to return to normality, raising the risk of stronger-than-expected household consumption growth.

From the production side, the backlog of orders for manufacturers remains very high. Although new orders have eased of late, there is still a need for firms to rebuild their inventories, and probably to structurally higher levels than normal given supply disruptions. This would add to growth in the near-term.

To the downside, the tightening of restrictions in Austria and parts of Germany serve as a warning that the pandemic is not over. Confirmed cases of Covid-19 are spiking as relaxations of restrictions have coincided with winter, raising the likelihood of the virus spreading.

In Austria, restrictions initially only applied to the unvaccinated, but national lockdowns have since been brought in and are currently slated to last 20 days from 22 November. In addition, the Austrian government announced that all citizens must be vaccinated from 1 February 2022 in a highly controversial move that sparked protests.

In Germany, restrictions vary by individual states, but they include individuals being required to show they have either been vaccinated, or recovered from Covid to enter certain public areas like restaurants. A negative test result is also required in some areas, and the risk is that Germany could follow Austria if case numbers continue to rise.

UK: Energy inflation to be met by higher interest rates

UK growth has also been downgrade due to higher energy inflation...

The latest UK growth figures were a little disappointing for Q3 as activity slowed from 5.5% to 1.3%. Household spending continued to be the main driver, though strong spending on services after restrictions were lifted was partly offset by weaker spending on household goods, along with clothing and footwear. Government consumption slowed markedly, likely due to the unwind of Covid related spending. However, more concerning was the slowdown in business investment, and the fall in export volumes, both of which may be linked to recent spats between the UK government and European Union over Northern Ireland. Threats to possibly cancel the trade deal are likely to have hit sentiment, and lead to a pause in activity.

Another factor possibly holding back growth may be the lack of available staff. Fuel shortages earlier this year highlighted the staffing issues road hauliers are facing. Again, Brexit has had an impact as not only is it far more difficult for staff to migrate to the UK, but many EU migrants decided to leave in the past year.

Strong demand for labour has helped dramatically reduce the unemployment rate from the highs of the pandemic. The unemployment rate has fallen from 5.2% from the three months to December 2020 to 4.3% on average in the three months to September 2021. However, an experimental series shows the rate may have fallen to 3.9% in September – matching the low last recorded in December 2019. Moreover,

the number of unfilled job vacancies continues to rise, as the share of those employed moving jobs (often referred to as the "quit rate") just hit a record high. Both of these indicators suggest companies are competing for staff, which should mean accelerated wage inflation.

In terms of the forecast, UK GDP growth has been revised down slightly for 2021, but more so for 2022 – down from 6.7% to 5.2%. As with the rest of Europe, higher energy prices are to blame. The UK's energy price cap delays most of the increases until next year, but only for households as companies are not protected. As a result, headline CPI inflation is forecast to top 5.5% by April 2023, and average 3.8% over 2022. This is up from 2.5% in 2021, and is an upward revision from the previous forecast (2.7%).

In a similar pattern to Europe, energy inflation should ease by the end of 2022, and even fall sharply in 2023 owing to base effects. Inflation is likely to fall below 1% by April 2023, with inflation forecast to average just 1.1% for the year overall. Meanwhile, growth is forecast to moderate further in 2023, but remain above trend at 3.1%.

Bank of England expected to raise rates

...but a tight labour market should lead the BoE to raise rates soon

As for recent monetary policy, our recent note "Why UK interest rates now look set to rise in December" outlines the change we made in the rates forecast. We now expect the Bank of England (BoE) to raise the policy interest rate from 0.1% to 0.25% at the December meeting, followed by a rise to 0.50% in February 2022. This is to reduce the risk that higher inflation in the near term feeds through to higher wage growth, especially as the labour appears very tight at the moment.

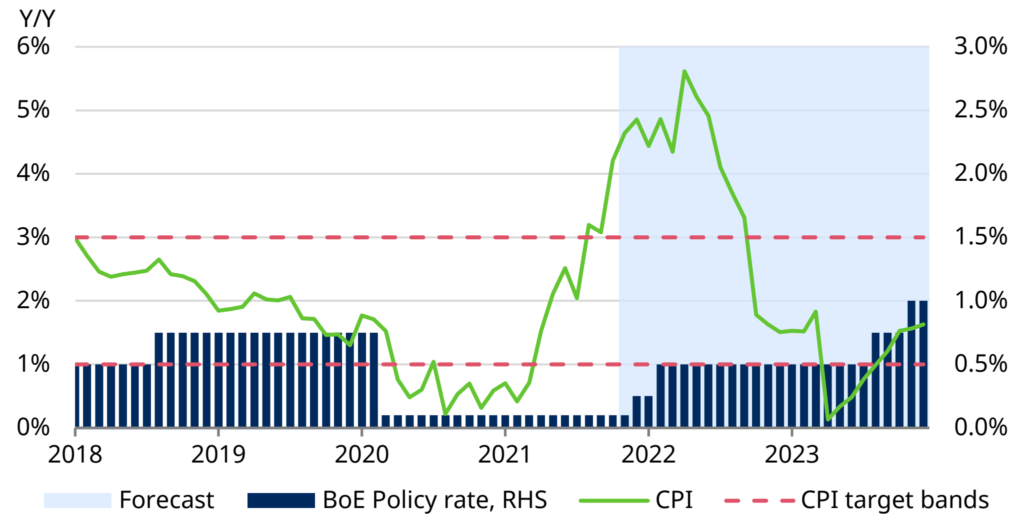
The BoE was expected to raise rates last month, but uncertainty over the ending of the furlough scheme left the committee waiting for more information. More data will be available before the next policy setting meeting, but even if there is a jump in unemployment, momentum in the labour market is so strong that it will not take long to absorb the additional slack.

We expect the BoE to then pause as there will still be some significant challenges for the economy. Higher energy inflation will reduce purchasing power, while significant tax increases in the spring will also likely dent confidence. These remain live risks even for the first two hikes that we have in the forecast.

The BoE has stated that it may be overestimating inflation in its forecast due to the way it looks at wholesale energy price. Our forecast has headline (and energy) inflation falling back quickly over 2023, which is also a key reason for the BoE taking a break from its hiking path.

As shown in chart 5, once CPI peaks in April next year, inflation then falls to below 1% – the BoE's lower target band. It would be strange for the BoE to raise rates while, at the same time, explaining to the government why it is failing to hit its inflation target. But, the BoE should be able to manage two more rate rises in the second half of 2023.

Chart 5: Schroders UK inflation and interest rate forecast



Source: Eurostat, Refinitiv, Schroders Economics Group, 26 November 2021. Please note the forecast warning at the back of the document.

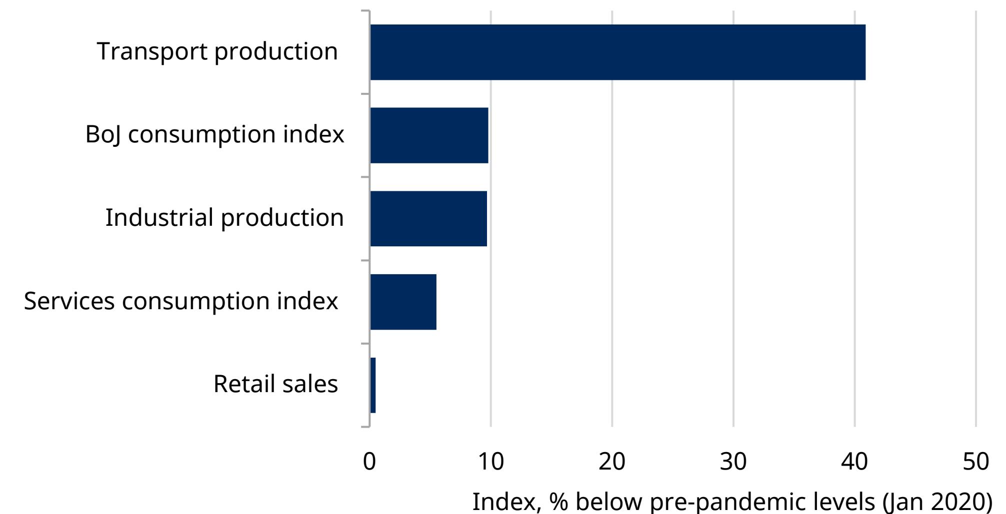
Reflationary outlook for Japan

Bottlenecks have been worse than expected…

The Japanese economy contracted in the third quarter as a weak domestic economy was coupled with a lack of boost from exports. Consumption was hindered by the state of emergency while industrial production was hampered by supply shortages. Activity is still clearly depressed. The stand-out data point is transport production, which is still a whopping 40% below pre-pandemic levels. While not as extreme at this, services consumption is also 5–10% lower than pre-pandemic levels (chart 6).

…but Japan is set to emerge from its tunnel

Chart 6: Snapshot of Japanese industrial and consumer activity



Source: Refinitiv, Schroders Economics Group. 23 November 2021.

And we upgrade our growth expectation for next year

But Japan is set to emerge through its tunnel. Consumption should now pick up strongly as Japan fully reopens its economy, supported by the recovery in wage growth and a huge buffer of savings. Investment plans remain relatively strong and should be bolstered by better corporate profits. Looking to the middle of next year, supply bottlenecks in global supply chains should improve which should boost industrial activity as firms restock their inventory.

In terms of the changes to the forecast this quarter, we revise down our growth expectation for the year from 2.2% to 1.6% as bottlenecks have been worse than expected. However, we push some of this "lost" production into next year and revise

up our consumption outlook following the latest fiscal package, which includes measures to boost household income directly and subsidies for domestic travel. This is partly offset by a less supportive picture of export demand, but still results in an upgrade to our 2022 growth expectation from 2.8% to 3.3%. We expect growth to remain high at 2.7% in 2023 as the consumer remains in good shape, though the drivers of growth fade slightly.

Inflation unlikely to be high enough for long enough for monetary tightening

A quick glance at the inflation numbers does not tell the full story as a cut in mobile phone fees back in April presents a drag on inflation of 1pp. This partly explains why we expect inflation to be relatively volatile from here. Higher commodity prices should push inflation up to 0.4% y/y in Q1. Then the deflationary impact of mobile fees should fall out of the annual comparison, boosting inflation to 1.3% y/y by the middle of next year. In the second half of next year, inflation should then fall relatively sharply as the base effects of commodity prices offset higher underlying price pressures following the closure of the output gap. All in all, this leaves 2023 inflation at 0.6%, still well below the Bank of Japan's target of 2%.

Looking at the big picture, inflation is unlikely to be high enough for long enough to lift inflation expectations, which should keep the Bank of Japan from tightening monetary policy.

Emerging markets

Slower growth and a peak in inflation may present opportunities in EM bond markets

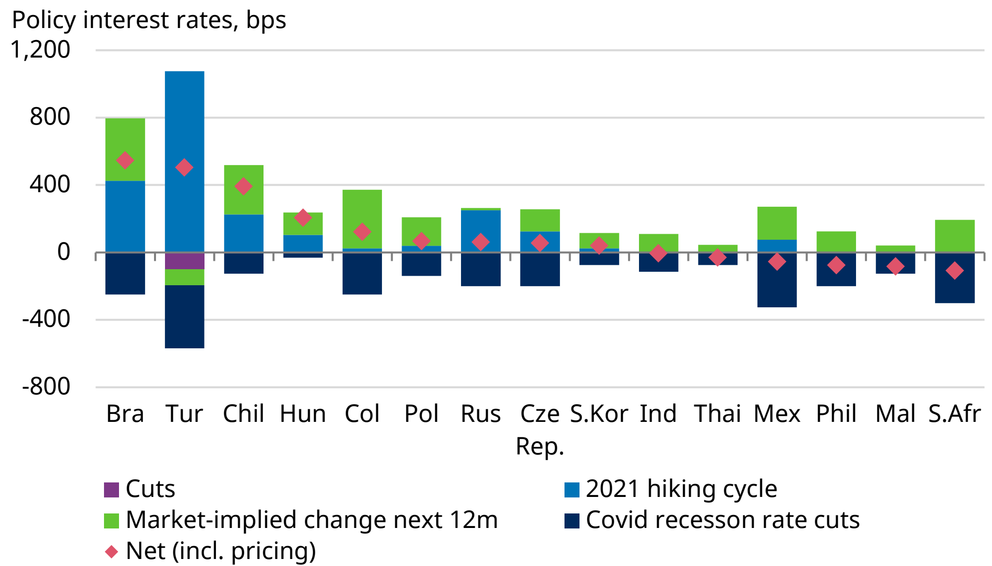
It is unambiguously good news that most emerging markets (EM) will have vaccinated large proportions of their populations as we head into 2022, and that in frontier markets the supply of vaccinations should belated pick up. That should improve health outcomes and also help to alleviate periodic disruption to economic activity from lockdown restrictions.

Nonetheless, it is almost certain that economic growth will slow next year, for at least three reasons. First, most EM economies have now recovered to pre-pandemic levels and in several cases far surpassed them. It will therefore be more difficult to sustain above-trend growth which, combined with the fact that growth in 2021 was flattered by base effects that will not be repeated, will mechanistically weigh on growth.

Second, we have revised down our expectations for growth in the rest of the world. This implies weaker demand for exports, which will be a particular issue for small, open economies.

Third, tighter policy will begin to bite. Most EM central banks have been forced to hike interest rates in response to above-target inflation. We think that inflation will subside during the course of 2022 as food and energy pressures ease. That might ultimately mean that all of the tightening that is priced into markets is not delivered and open a window of opportunity in local bond markets. But the tightening that has already been delivered will hit activity with a lag of six to nine months, while fiscal consolidation may also begin to sap demand.

Chart 7: Climbing inflation has forced EM central banks to reverse course



Source: Bloomberg, Refinitiv, Schroder Economics Group. Market pricing from 3/11/21. 12 November 2021.

All told, we expect EM GDP growth to slow from an expected 6.5% in 2021, to 4.5% in 2022 with a further deceleration to 4.3% thereafter.

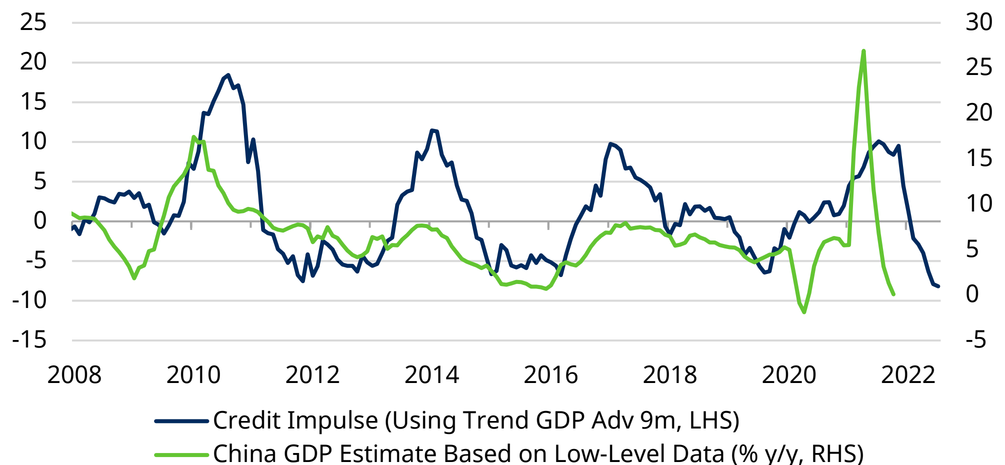
China

Our base case is for a soft landing in China, but at the very least economic conditions will be weak until the summer

Leading indicators have signalled for some time that growth in China's economy would slow into 2022, and the cyclical downturn has been exacerbated by a confluence of other factors. The government's zero-tolerance of Covid has led to periodic restrictions on activity, particularly in the services sector. An energy crisis has resulted in higher electricity prices for the nation's power-guzzling manufacturing sector. And more hawkish policy has triggered a crisis of confidence in the real estate sector.

Our assumption is that the government will provide policy support in order to cushion the economic downturn. However, the authorities clearly have a much higher pain threshold for slower growth than in the past. There have been some signs that the government is leaning towards looser policy with liquidity injections, green financing and promises to bring forward fiscal spending. But the bigger picture is that there has so far not been any significant easing and the further deterioration in leading indicators through to October means that at the very least underlying economic conditions will remain soft until the summer.

Chart 8: China's economy faces a cyclical slowdown at least until summer 2022



Source: Refinitiv, Schroder Economics Group. 12 November 2021.

The upshot is that while our baseline forecast is for GDP growth to slow from an expected 7.7% in 2021 to 4.5% in 2022, it would not take much for the economy weaken further towards our "hard landing" scenario. The real estate sector, which is equivalent to around one fifth of the economy, is the biggest risk in this regard.

India: RBI to begin policy normalisation

Low cases of Covid-19 provides the necessary conditions for strong growth

It seems ironic that India boosted domestic coal production and simultaneously announced its ambition to become carbon neutral. But at least we can breathe a sigh of relief that the immediate risk of coal supply shortages hitting Indian activity did not materialise. Coronavirus cases have also stayed very low, which has provided the necessary conditions for strong growth.

Activity indicators suggest India grew at a healthy 10% y/y in the third (calendar) quarter consistent with robust quarterly growth. We do not make any material changes to the outlook for the rest of the year, leaving our full growth estimate at 8.9%. Our main change to our outlook is for growth next year, where we revise up growth from 6.3% to 8.5%. This partly reflects another favourable annual comparison but also reflects strong business sentiment, which makes us more confident about an improvement in private investment despite sluggish credit growth.

India is past peak liquidity and we now expect the RBI to hike interest rates

Inflation has proved challenging for the Reserve Bank of India (RBI): core inflation has been stickier-than-expected at around 6% (vs 4% target) despite the economy having ample spare capacity using output estimates. In the short term, higher energy prices should push inflation up to 5.8% in Q1 next year, but favourable and powerful base effects should quickly kick in and bring inflation back to 4% by the end of next year. Nonetheless, the RBI will have to act to curb core inflation as growth recovers.

After having stopped the Government Securities Acquisition Programme (or GSAP, the Indian version of quantitative easing), we expect the next policy move to be a reverse repo rate hike in early Q1 next year. A more reflationary outlook leads us to pencil in 75bps worth of repo rate hikes in the second half of next year (vs 50bps before) and another 50bps in 2023, taking the repo rate from 4% today to 5.5%.

Finally, on the reform side, the government finally sold Air India after two decades and three attempts. This brings in 10% of the target divestment proceeds for the fiscal year. The plan to make a “bad bank” announced in the budget earlier on in the year was also followed through. This is a positive step towards cleaning up the banking sector and improving credit growth. So, stepping back, progress continues to be made in a relatively stable political backdrop.

Brazil

Brazilian markets to be volatile in the face of weak growth and a bitter election race

The recovery in Brazil's economy has hit the buffers as output returned to pre-pandemic levels and high inflation has choked off real growth.

Headline inflation returned to double-digit rates for the first time in five years in the second half of 2021 after a run-up in food inflation was exacerbated by hikes in energy costs and further increases in core inflation. We think that inflation will trend down during the course of 2022. But that will be scant relief for the economy given that the central bank has been forced to accelerate the pace of interest rate hikes, which will increasingly weigh on activity in the months ahead. As such, GDP may expand by only about 1% in 2022.

Chart 9: Aggressive interest rate hikes will hit growth in 2022

Source: Refinitiv, Schroder Economics Group. 12 November 2021.

Meanwhile, attention will increasingly turn to the general election that is due to take place in October 2022. Budget wrangling has already rattled markets as the government attempts to increase social handouts and a bitter contest may dent confidence and investment, leading to a volatile period for financial markets.

Russia

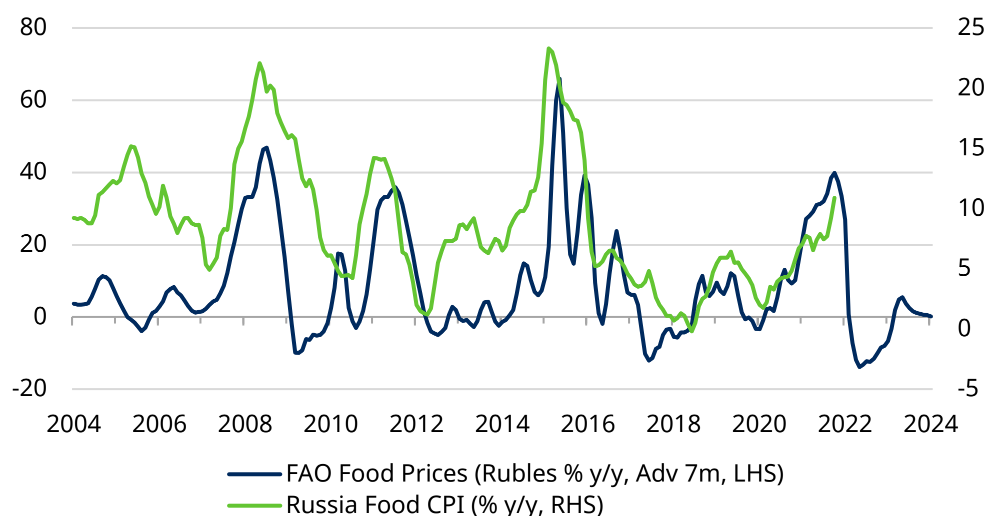
Russia is one of the biggest winners from higher global energy prices

Russia is one of the biggest winners from higher global energy prices. Crude oil prices are expected to remain substantially above the roughly $60 per barrel needed to balance the public finances, leaving the government with plenty of ammunition to boost spending. And as a major supplier to the region, Russia has the added benefit of soaring natural gas prices in Europe.

Potential growth in Russia in low. But such favourable terms of trade should support activity and we expect GDP growth of around 2.5% in 2022.

That being said, it is not all good news and, like in Brazil, Russia's central bank (CBR) has rates interest rates aggressively in the face of higher inflation. Higher food inflation, which was well flagged by our leading indicator, has been a particular thorn in the side of policymakers.

Chart 10: Higher food inflation has surprised markets, but should fall in 2022



Source: Refinitiv, Schroder Economics Group. 12 November 2021.

Food inflation should reverse course in 2022, taking the headline rate down with it. However, as one of the most conservative EM central banks, the CBR is likely to maintain a substantial real policy rate that will eventually begin to weigh on growth.

Scenario analysis

Stagflationary risks predominate

The principal risk to our baseline forecast is that the world economy remains constrained by shortages of labour and components, an outcome captured by our 'supply side inflation' scenario. We would see this as being driven by higher wage growth feeding through into costs and prices. Inflation is higher than in the baseline whilst growth is weaker – a stagflationary outcome.

In addition to this we have added an 'oil shock' scenario where prices rise to $120/ barrel. Again, this has a stagflationary impact on the world economy, and reflects renewed discipline on supply from OPEC+ against a backdrop of buoyant demand.

Deflationary risks are captured by our 'China hard landing' scenario. The authorities in China continue to run a delicate balancing act between easing into the broader slowdown and tightening in the property sector. This scenario is designed to capture the risk of a policy error in China, where the credit impulse continues to decelerate and the authorities leave it too late to reverse the downward momentum in the housing market.

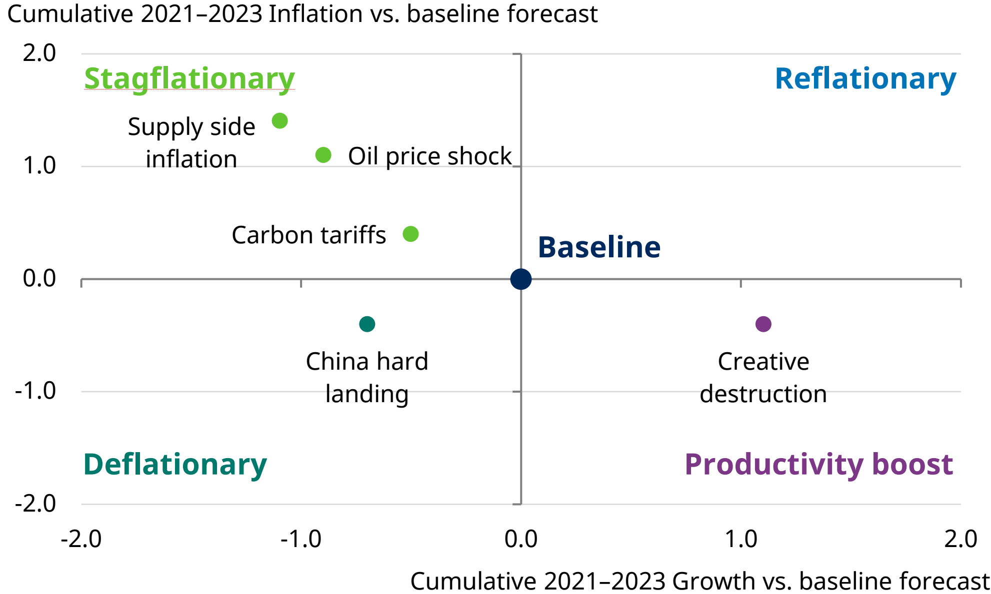
We continue to run the 'trade wars' scenario to draw attention to the increasing risks of carbon tariffs or Carbon Border Adjustment Mechanisms (CBAM). The EU is already lining up such a policy, which is essentially a tariff on carbon intensive imports into the trading bloc. While such a policy would not be introduced for some time, the likelihood of some mechanism emerging is not insignificant given the pressure from companies who see themselves at a competitive disadvantage to those with access to cheap carbon energy.

Otherwise, we retain our 'creative destruction' scenario where productivity accelerates in the post Covid economy as a result of greater use of technology and digitalisation. Output is stronger, but inflation lower as unit wage costs are better contained.

Overall the balance of risks is skewed in a stagflationary direction (see chart). This conclusion is reinforced by the recent emergence of the Omicron variant which occurred after we finalised our forecast. This clearly increases the risk of new restrictions on activity and renewed supply side disruption. At this stage it is too

uncertain to judge the macro impact only that it adds to the stagflationary risks in the world economy.

Chart 11: Scenario grid – growth and inflation deviations from baseline



Source: Schroder Economics Group, 26 November 2021.

Schroders Economics Group: Views at a glance
Macro summary – November 2021

Key points

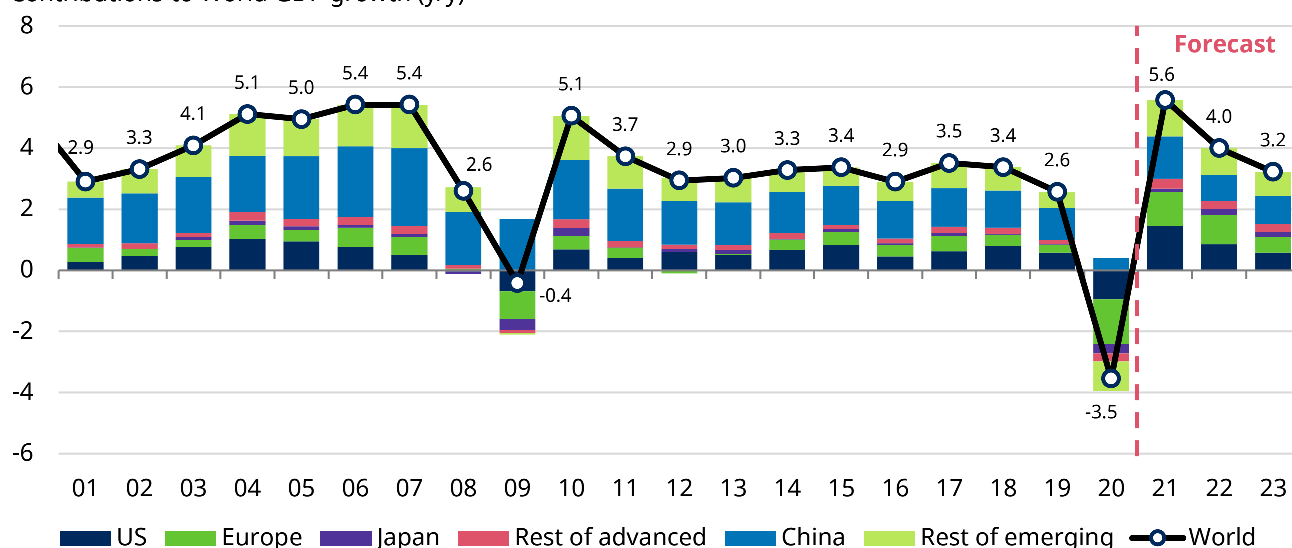
Baseline

- **US:** We expect growth to slow from 5.4% in 2021 to 3.2% in 2022. This stems from a fading of policy stimulus and pent up demand as well as higher inflation. Inflation in the US is expected to remain elevated in Q1 next year at 6.2% as bottlenecks persist pushing up core CPI to 5.6% y/y. Thereafter inflation should fall through 2022 (to 3% by the end of the year) as commodity base effects wash through the index and supply disruptions ease. Core CPI inflation eases but stays above 2% next year and cyclical pressures build again in 2023, edging up inflation to 2.3% in H2 23. The Fed is on track to end QE in mid-2022. We then expect the Fed to raise rates by 25bps in December 2022 with a further 100bps of rate hikes in 2023.
- **Eurozone:** Growth is forecast to slow but remain high at 4.6% as households reduce their savings rate to more normal levels, and activity gets a boost from the government spending as the EU recovery fund kicks in. Annual inflation is expected to rise from 2.4% in 2021 to 3.5% in 2022. However the ECB remains dovish, ending PEPP in Q1 2022, but boosting its pre-pandemic QE, which continues through the forecast period.
- **UK:** Growth should slow from 6.9% to 5.2% as the boost from re-opening the economy begins fade. Household spending remains high as excess savings are reduced, but inflation reduces purchasing power. CPI inflation is forecast to rise from 2.5% in 2022 to 3.8% in 2023, mainly driven by higher energy prices. Meanwhile, a strong labour market paves the way for the BoE to hike interest rates this year and in Q1 next year (taking the base rate to 0.5%). Lower inflation and fiscal tightening lead to a pause, with hikes resuming in H2 2023.
- **Japan:** Growth should pick-up next year to 3.3% as Japan re-opens its economy and bottlenecks in the industrial sector dissipate. Inflation should rise to 0.9% but the BoJ should keep yield curve control policy unchanged.
- **Emerging Markets:** The roll-out of vaccines should ensure less disruption from Covid in emerging markets, but economic growth is set to slow by 2% to 4.5% as higher inflation and interest rates weigh on activity. China is ahead of most EM in already experiencing a sharp slowdown. We expect looser policy to stabilise growth by mid-year, setting the scene for some recovery, but we are wary of downside risks stemming from the real estate sector.

Risks

The balance of risks is tilted in a stagflationary direction as three of our five risk scenarios bring weaker output and higher inflation: oil price shock, carbon tariffs and supply side inflation. We still see the largest risk of supply side inflation though also place a high weight on the deflationary China hard landing scenario.

Chart: World GDP forecast



Source: Schroders Economics Group, 26 November 2021. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2020	2021		Prev.	Consensus	2022		Prev.	Consensus	2023
World	100	-3.4	5.6	↓	(5.9)	5.7	4.0	↓	(4.5)	4.2	3.2
Advanced*	60.9	-4.7	4.9	↓	(5.2)	5.0	3.8	↓	(4.3)	4.0	2.5
US	26.9	-3.4	5.4	↓	(5.8)	5.5	3.2	↓	(3.7)	4.0	2.2
Eurozone	16.8	-6.3	5.2	↑	(5.1)	5.0	4.6	↓	(5.6)	4.3	2.4
Germany	4.8	-4.6	2.9	↓	(3.1)	2.7	4.3	↓	(5.8)	4.3	2.3
UK	3.6	-9.8	6.9	↓	(7.0)	6.9	5.2	↓	(6.7)	4.8	3.1
Japan	6.4	-4.6	1.6	↓	(2.2)	2.2	3.3	↑	(2.8)	3.0	2.7
Total Emerging**	39.1	-1.3	6.5	↓	(7.0)	6.9	4.5	↓	(4.7)	4.4	4.3
BRICs	26.2	0.0	7.3	↓	(8.0)	7.6	4.7	↓	(5.1)	4.7	4.6
China	18.1	2.3	7.7	↓	(8.5)	8.0	4.7	↓	(5.5)	5.1	5.0

Inflation CPI

y/y%	Wt (%)	2020	2021		Prev.	Consensus	2022		Prev.	Consensus	2023
World	100	1.8	3.4	↑	(3.1)	3.5	3.8	↑	(2.8)	3.3	2.7
Advanced*	60.9	0.7	3.1	↑	(2.7)	3.0	3.6	↑	(2.2)	2.8	1.8
US	26.9	1.2	4.6	↑	(3.8)	4.4	4.5	↑	(3.0)	3.7	2.3
Eurozone	16.8	0.3	2.4	↑	(2.1)	2.4	3.5	↑	(1.7)	2.3	1.5
Germany	4.8	0.4	3.1	↑	(2.9)	3.1	3.5	↑	(2.1)	2.5	1.8
UK	3.6	0.9	2.5	↑	(2.3)	2.4	3.8	↑	(2.7)	3.7	1.1
Japan	6.4	0.0	-0.3		(-0.3)	-0.2	0.9	↑	(0.6)	0.7	0.6
Total Emerging**	39.1	3.5	4.0	↑	(3.8)	4.2	4.0	↑	(3.6)	4.0	4.2
BRICs	26.2	3.1	2.6		(2.6)	3.0	3.1	↑	(2.8)	3.0	3.2
China	18.1	2.4	0.8	↓	(1.1)	1.1	2.0		(2.0)	2.1	2.7

Interest rates

% (Month of Dec)	Current	2020	2021		Prev.	Market	2022		Prev.	Market	2023	Market
US	0.25	0.25	0.25		(0.25)	0.08	0.50		(0.50)	0.64	1.50	1.24
UK	0.10	0.10	0.25	↑	(0.10)	0.17	0.50	↑	(0.10)	1.06	1.00	1.21
Eurozone (Refi)	0.00	0.00	0.00		(0.00)	-0.50	0.00		(0.00)	-0.47	0.00	-0.27
Eurozone (Depo)	-0.50	-0.50	-0.50		(-0.50)		-0.50		(-0.50)		-0.50	
Japan	-0.10	-0.10	-0.10		(-0.10)	-0.04	-0.10		(-0.10)	-0.05	-0.10	-0.04
China	3.85	3.85	3.85		(3.85)	-	3.65	↓	(3.85)	-	3.65	-

Other monetary policy

(Over year or by Dec)	Current	2020	2021		Prev.	Y/Y(%)	2022		Prev.	Y/Y(%)	2023
US QE ($Tn)	4.0	7.4	8.8	↑	(8.8)	0.2	9.3		(9.3)	0.1	9.3
EZ QE (€Tn)	2.4	2.7	2.9	↓	(3.1)	0.1	3.4		(3.4)	0.2	3.6
UK QE (£Bn)	422	725	875	↑	(875)	0.2	875	↑	(875)	0.0	875
JP QE (¥Tn)	557.0	703	731	↓	(732)	0.0	743	↑	(737)	0.0	760
China RRR (%)	13.50	12.50	11.50		11.50	-	11.00		11.00	-	11.00

Key variables

FX (Month of Dec)	Current	2020	2021		Prev.	Y/Y(%)	2022		Prev.	Y/Y(%)	2023	Y/Y(%)
USD/GBP	1.33	1.37	1.37	↑	(1.34)	0.2	1.35	↑	(1.33)	-1.5	1.35	0.0
USD/EUR	1.13	1.22	1.15		(1.15)	-6.0	1.13		(1.13)	-1.7	1.13	0.0
JPY/USD	113.2	103.2	115	↑	(110)	11.4	120	↑	(114)	4.3	120	0.0
GBP/EUR	0.85	0.90	0.84	↓	(0.86)	-6.2	0.84	↓	(0.91)	-0.3	0.84	0.0
RMB/USD	6.39	6.54	6.45	↓	(6.60)	-1.4	6.80		(6.80)	5.4	6.80	0.0
Commodities (over year)												
Brent Crude	72.9	43.3	71.9		(71.9)	66.0	79.2	↑	(43.5)	10.2	72.6	-8.4

Source: Schroders, Thomson Datastream, Consensus Economics, November 2021
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 26/11/2021
Previous forecast refers to August 2021
* **Advanced markets**: Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Schroders Forecast Scenarios

Scenario	Summary	Macro impact	Probability*	Growth	Inflation
			Cumulative 2021-2023 global vs. baseline		
Baseline	We expect global growth to slow in 2022 (to 4%) mainly driven by the US and China. Slower growth in the US is due to a fading of policy stimulus and pent up demand as well as higher inflation. Whereas for China, slower growth predominantly reflects tighter financial conditions, weaker real estate activity and consumer weakness from the zero tolerance strategy of COVID-19. Although we have downgraded our forecast for European growth, the region is still expected to outperform the US next year due to stronger pent-up demand and consumption. Meanwhile, growth in Japan and Germany should actually pick up next year as bottlenecks in the industrial sector dissipate and fiscal policy supports activity. Looking ahead to 2023, global growth should slow further (to 3.2%) driven by Developed Markets. While growth in Emerging Markets should slow, growth will likely remain higher given a policy response from China and more excess capacity in wider EM. In terms of changes to the forecast this quarter, the outlook moves in a stagflationary direction as we make broad based upgrades to inflation, mainly driven by higher oil prices and ongoing cost pressures stemming from supply bottlenecks. This has a knock on impact to the consumer resulting in a downgrade for growth.	Headline inflation in the US is expected to remain elevated in Q1 next year at 6.2% as bottlenecks persist pushing up core CPI to 5.6% y/y. Thereafter inflation should fall through 2022 (to 5% by mid-22 and 3% by the end of the year) as commodity related base effects wash through the index and supply disruptions ease. Core CPI inflation eases but stays above 2% next year and cyclical pressures build again in 2023, edging up inflation to 2.3% in H2 23. As the economic cycle matures, we expect a tightening of monetary policy. The Fed is on track to end QE in mid-2022. We then expect the Fed to raise rates by 25bps in December 2022 with a further 100bps of rate hikes in 2023. Meanwhile, a strong labour market paves the way for the BoE to hike interest rates this year and in Q1 next year (taking the base rate to 0.5%). Lower inflation and fiscal tightening lead to a pause, which resumes in H2 23. The ECB ends PEPP in Q1 2022, but then boosts its pre-pandemic QE, which continues through the forecast period. The ECB and BoJ are expected to keep interest rates on hold through to the end of 2023, the latter under yield curve control. China is set to continue to ease monetary policy cutting the RRR and one year loan prime rate (to 11% and 3.65%, respectively, by the end of next year). Elsewhere in Emerging Markets, we expect Brazil and Russia to continue their rate hiking cycle with rates peaking in H2 next year. India lags behind and joins in hiking rates in Q2 next year.	62%	-	-
1. Oil price shock	Strong demand meets tight supply in the oil market, pushing the oil price to 120 USD/barrel, where it remains until the second half of 2022. The knock on impact to demand helps the oil price to fall steadily to 85 USD/barrel by the end of 2023.	Stagflationary: Higher oil prices push up inflation further via energy and input costs. This reduces disposable income and hurts sentiment leaving households reluctant to draw down their savings, which has a knock on impact on consumption. Net exporters of oil gain from the terms of trade shock and raise production. Central banks have different reaction functions, with the Fed and the ECB hiking more than the baseline, while the Bank of England moves a little slower in 2023.	7%	-0.9%	+1.1%
2. Creative destruction	The covid-19 shock results in a permanent increase in the adoption of technology allowing businesses to improve efficiency. Overall, the pandemic sparks new, more efficient ways of working and those unemployed retrain and adapt to areas where there is higher demand for labour.	Productivity Boost: The world experiences higher growth as productivity rises. However, an improvement in supply keeps inflation falling towards sub-2% by the end of 2023. Consequently, central banks remove liquidity fairly slowly as in the baseline forecast, but the Fed and ECB raise rates a little faster.	5%	+1.1%	-0.4%
3. China hard landing	China re-starts its deleveraging drive with the result that the authorities overtighten policy. The credit impulse continues to fall from here and in turn this takes a toll on activity. Growth slows to 1.5% by the end of next year as the RMB slides to 7. Fiscal and monetary policy is loosened, but the rebound sees growth limited to under 4% in 2023.	Deflationary: Lower growth in China presents a demand shock for the rest of the world who take a hit to their exports. Inflation is also lower as a result of lower growth and lower commodity prices. The PBoC respond by cutting the one year Loan Prime Rate (LPR) to 3% and the Reserve Requirement Ratio (RRR) to 8% by the end of next year. The Fed and BoE still raise rates in 2022 and 2023, but by less than in the baseline.	9%	-0.7%	-0.4%
4. Carbon tariffs	As pressure continues for policymakers to fight climate change, the major developed economies decide to enact 25% tariffs on goods with a high carbon content in production. Tariffs are implemented one year after the COP meeting in Q4 2022. The policy also gets the support of protectionists who would like to see more onshoring. China faces the brunt of the tariffs, given it has the highest total carbon emissions embodied in exports, while India is also pressured to make a greater effort to reduce carbon emissions.	Stagflationary: As the policy measures are announced, the US and China get a boost as countries attempt to stockpile imports though this pushes up import and commodity prices. As consumers are faced with higher prices, real disposable income falls along with demand. In turn, weaker trade weighs on global growth. In the short term, capital expenditure is also paused by the need for firms to review their supply chains to greener energy sources. In China, the renminbi is allowed to weaken in order to absorb some of the increase in tariffs, however more punitive levies follow. These reverberate through the supply chain causing economic growth to slow. Responding to weaker growth, the Fed waits to 2023 to hike rates and China cuts rates by more than the baseline. Meanwhile the BoE and ECB respond to higher inflation hiking rates in 2023 by more than the baseline.	4%	-0.5%	+0.4%
5. Supply side inflation	The current bottlenecks in the industrial sector last for longer than expected and have knock on impacts through global supply chains. Commodity markets also struggle with supply shortages. As vaccine immunity fades, countries struggle with the delta variant of coronavirus leading to restrictions which amplify the disruption in supply and cause labour shortages. Meanwhile the labour participation rate in the US does not improve, whilst mismatch between worker skills and jobs in the post covid economy means the NAIRU rises and available slack is less than in the baseline.	Stagflationary: Commodity prices continue to rise due to shortages in supply. This adds to inflation and energy price base effects do not wash out. Meanwhile, this feeds through to underlying inflation, which is also pushed up from supply side constraints and higher costs through global supply chains. Even though growth slows through 2022, demand still outpaces supply in the labour market and wages rise. This results in persistent inflation above 5% in the US through 2022 leaving the Federal Reserve hiking interest rates to 1.5% by the end of the year and 2.75% by the end of 2023. All other central banks hike rates in this scenario except the Bank of Japan.	13%	-1.1%	+1.4%
6. Other			0%	-	-

*Scenario probabilities are based on mutually exclusive scenarios. Please note the forecast warning at the back of the document.

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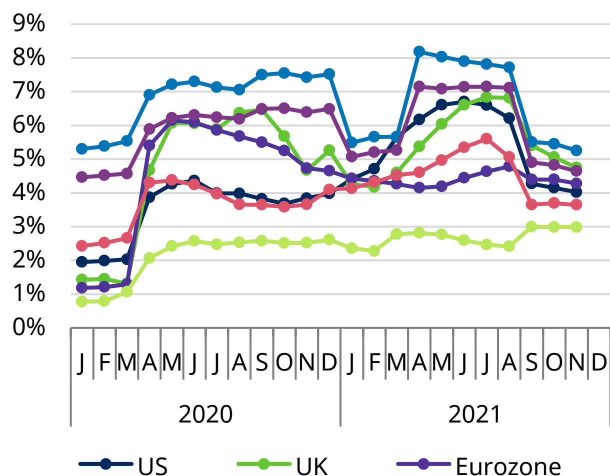
Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

2021



2022

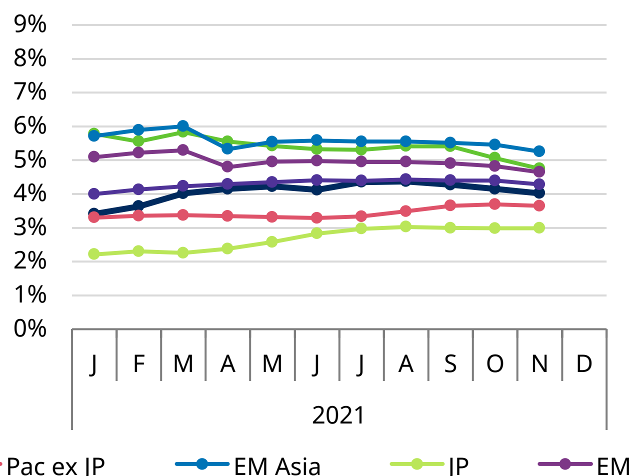
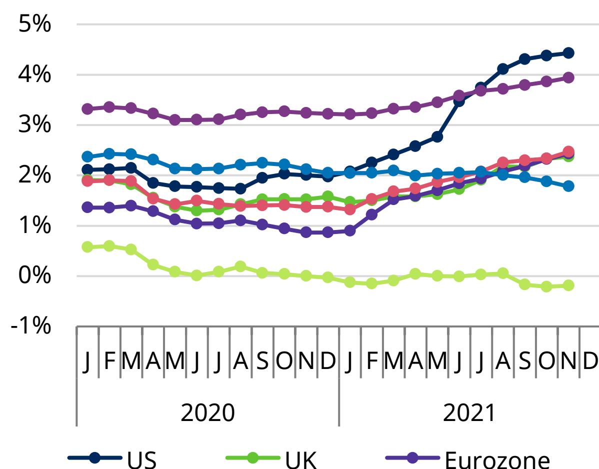
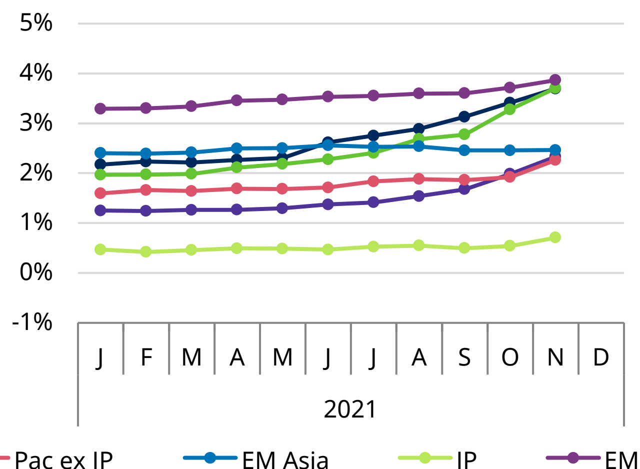


Chart B: Inflation consensus forecasts

2021



2022



Source: Consensus Economics (November 2021), Schroders.
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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