

Great volatility and uncertainty in a large number of markets due to the concentration of incisive events

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The events of the last few months have been tumultuous: persistently high inflation rates well above seven percent in Europe and the USA, large-scale lockdowns in many of China's megacities and a war of aggression in Europe. Any of these events would already be very extraordinary in "normal" times. At present, we are

experiencing a **concentration of very drastic events**. Volatility and uncertainty are correspondingly high in a large number of markets.

In addition, there is an increasing risk that actors will be tempted by the current geopolitical situation to

exploit the confusing situation. If the major powers are absorbed with the major theaters, this offers other countries the opportunity to create facts in their spheres of influence as well. This could provoke even more "extraordinary events" in the coming months. Political and economic **developments are likely to remain unpredictable for some time**. It is therefore all the more important to observe the facts and economic data closely and to place them in their historical context in order to draw lessons from them.

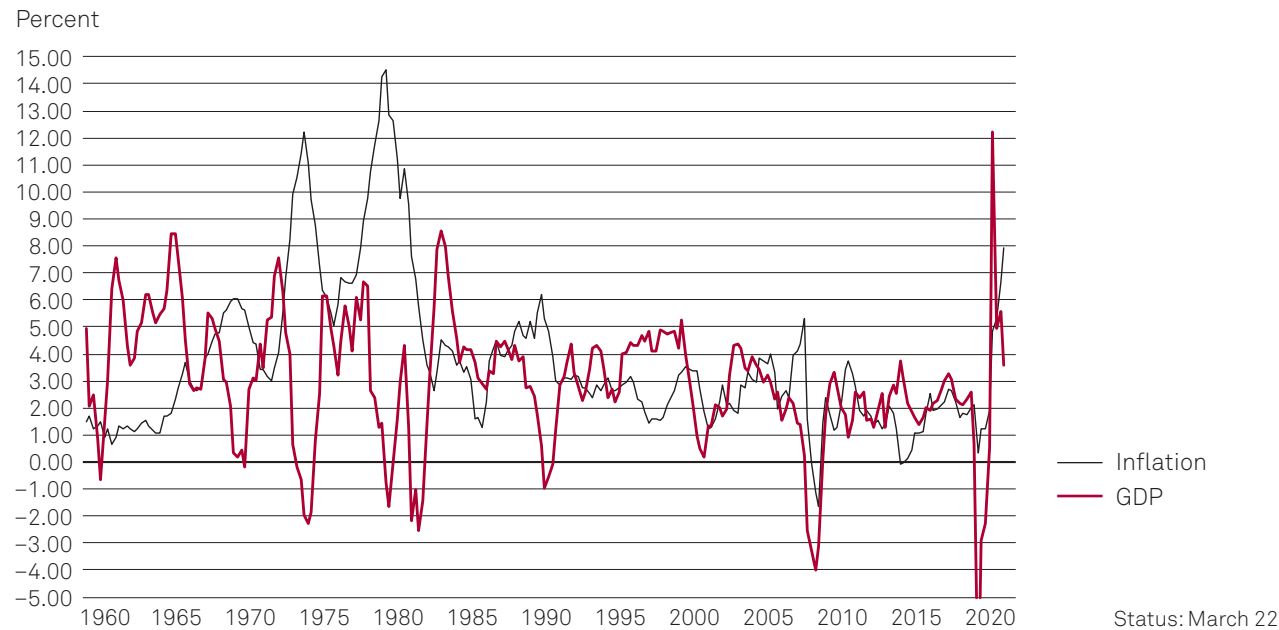


Fig. 1: Inflation rate and GDP growth in the USA compared with the same quarter of the previous year

Source: Raw data OECD and Federal Reserve St. Louis; presentation hpo forecasting

1. Negative correlation between inflation and GDP growth

The Ukraine war and the large-scale lockdowns in China are both exacerbating the already **high inflation**. Inflation is at a level not seen for around 40 years. In April, U.S. inflation fell slightly for the first time since last August (from 8.5 % to 8.3 %), as the base effect from the pandemic wears off somewhat. However, the decline was less pronounced than many economists had expected. Moreover, the inflationary pressure had a broader impact and has now also reached the service sector.

What are the consequences of high inflation for the real economy? For this purpose, we have compared inflation rates and economic growth in the USA for the last 60 years (see fig. 1). The evaluation shows that there is

a clear negative correlation between the two values, especially when inflation rates are high. In other words, **in the past, high inflation so far always provoked a recession in the USA**. Such a recession would have global repercussions. The U.S. Fed is doing everything it can to ensure that the softest possible landing from its expansionary monetary policy is achieved. For an effective fight against inflation to become possible, the overheated economy must be cooled down in any case.

This process is referred to in economics by the martial term “demand destruction”.

2. Zero-covid strategy in China puts even longer strain on supply chains

Disrupted supply chains remain the biggest challenge for the industry. Hundreds of container ships are jammed off Shanghai (see fig. 2). The EU Trade Representative in China, Jörg Wuttke, argues convincingly in

an interview with “The Market/NZZ” why the **zero-covid strategy** with strict lockdowns, which is devastating for the economy, is unlikely to be eased in the coming months: President Xi Jinping’s political future is closely linked to the success of the zero-covid strategy, and a fundamental change of course is not to be expected before the important party congress in the fourth quarter. This coincides with the results of a survey conducted by the German Engineering Federation (VDMA), according to which only a minority of the 850 German member companies based in China expect the situation to improve in the next six months.

Transporting a container from Shanghai to Rotterdam usually takes around seven weeks. The effects of the **hard lockdown** that has been in place since the beginning of April **in Shanghai**, which is home to the world’s largest container port, **will not really be felt in Europe until the end of May**, when container shipments stop on a large scale. Even if, contrary to expectations, the situation in China were to normalize soon, the impact on supply chains would still be felt for months.



Fig. 2: Waiting ships off Shanghai on May 14th 2022

Source: FleetMon

3. Deep tracks in China's economic data

The lockdown measures, which were tightened again significantly from the beginning of April, have left deep marks in the Chinese economic figures. Here are a few facts from Caixin Global and Trading Economics:

- **Consumer sentiment:** down 7.3 points in March compared with February 2022, although at 113 points it is still well above the neutral level at 100 points. The index, collected by China's National Bureau of Statistics, has been consistently in positive territory since 2017 and was at the same level in March as at the peak of the first Corona wave in early 2020. It is likely to have fallen further markedly in April.
- **Services PMI:** down from 42 to 36 points in April (50 points = neutral value)
- **Manufacturing PMI:** down from 48 to 46 points in April (50 points = neutral value)
- **Industrial production:** -2.9% in April compared to the same month last year
- **Retail sales:** -11.1% in April compared to the same month last year
- **New car registrations in China:** -43% in April compared with the same month last year

As long as Chinese policymakers do not make any policy changes to their Corona strategy, the situation is unlikely to brighten significantly. This will not only further

burden global supply chains, but also **dampen demand in the second-largest economy.**

According to estimates by the German news magazine "Der Spiegel", **around half of all foreigners have left China since 2020.** Wuttke estimates that another quarter will leave the country over the summer. The decoupling between China and the West is picking up speed. If this trend cannot be reversed, it will lead to a loss of prosperity on both sides.

4. Consumption and industrial production in Europe still dynamic

In **Europe, retail sales** have been at a very high level for around a year. During the pandemic, this benefited from changes in consumer habits and high government transfer payments. Despite the Ukraine crisis and high inflation, which is eating away at disposable income, consumption in Europe remained very high in the first quarter. European industrial production also remains at a very high level, although the OECD has registered a slight decline since the beginning of the year.

In terms of **order intake**, the **VDMA** reports a year-on-year decline in real terms for the first time in March (-4%). However, the quarter as a whole showed a year-on-year increase of 7%. Demand in the German machinery sector has thus been moving sideways for

around three quarters at a level well above that prior to the crisis. Order backlogs are accordingly still very high, and the biggest challenge remains the disrupted supply chains.

What worries us are the **plummeting sentiment indicators.** Since inflation became an issue for the general public in mid-2021, the Consumer Confidence Index (CCI) has plummeted from a high level and is now deep in contractionary territory (see fig. 3). The Business Confidence Index (BCI) is still in expansionary territory above the 100 level, but is also falling markedly. The two indicators tend to correlate quite strongly and have a reliable leading indicator function for the industry.

5. Consumer sentiment also under pressure in the USA

In the **USA**, too, **consumer sentiment** has fallen sharply since mid-2021 and the rise in inflation, but has recently stabilized at a low level. However, the current value is far below that measured during the height of the Corona crisis.

As in Europe, however, American consumers have not yet been put off by the poor mood and the **retail sector is booming.** On the one hand, the labor market is very dynamic and, on the other, Americans' savings are still high. This is having a supporting effect. A significant normalization of the consumption pattern is still not

observable in the USA. A look at the development of retail sales shows the extraordinary **bubble** caused by the American stimulus packages (see fig. 4).

As American households are on average more heavily invested in equities than Europeans, the sharp **decline**

in the stock markets in recent weeks and months will also have a negative impact on American consumption.

Industrial production in the **USA** recovered only very hesitantly after the deep fall in the initial phase of the pandemic, but has recently gained momentum again.

This is probably due in no small part to high energy prices, which have made fracking economically attractive again. Depending on the source, the US shale gas industry employs 500,000 to around two million workers. US natural gas production is also benefiting from the Ukraine crisis.

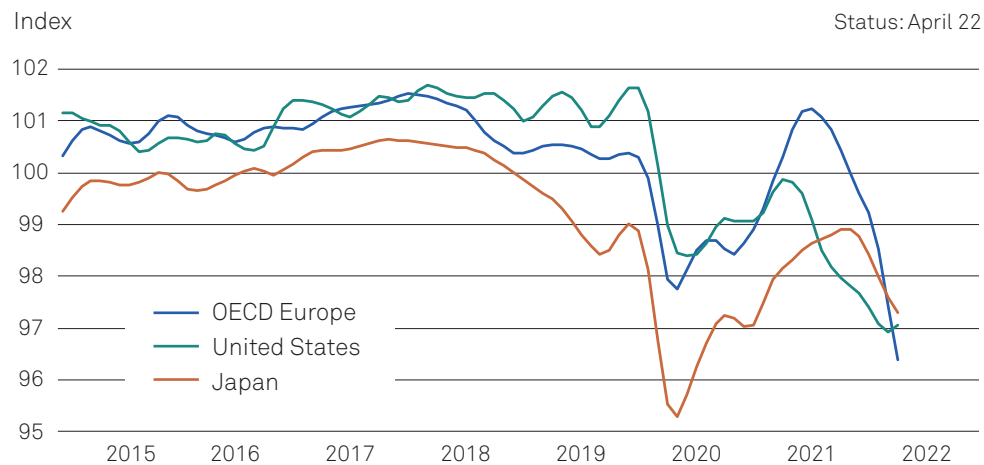


Fig. 3: Consumer Confidence Index (CCI) of selected regions/countries

Source: OECD

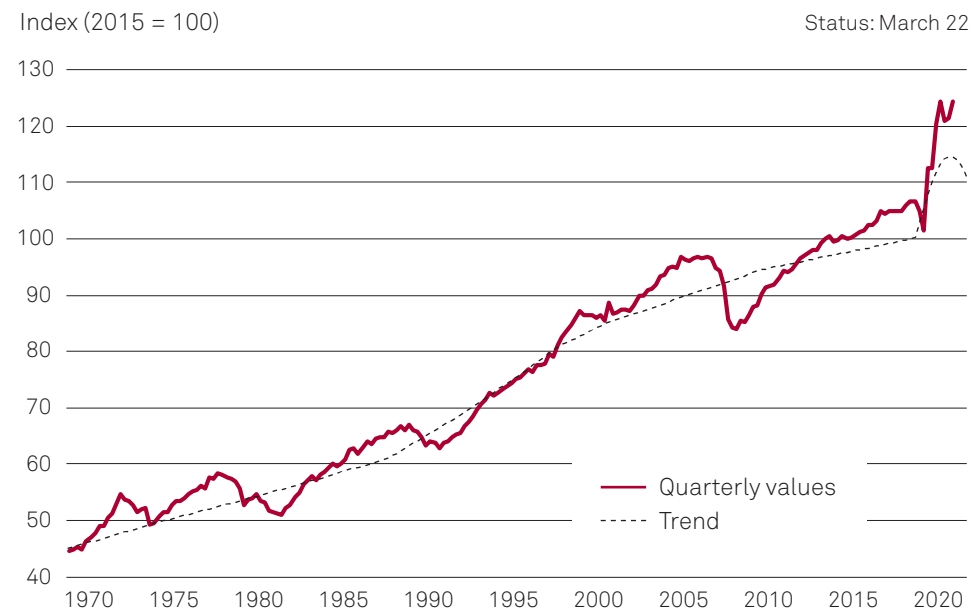


Fig. 4: Retail sales in the USA

Source: OECD

6. Conclusion

In summary, the real economy is still benefiting from **dynamic consumption and strong industrial production in Europe and the USA**. Most manufacturers of capital goods continue to report **high order backlogs**. However, if the leading indicators are correct, a severe **weakening of economic growth and thus also of demand in industry** is to be expected in the coming months.

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Your contact at hpo forecasting



Josua Burkart
M. A. HSG
Managing Director
josua.burkart@hpo.ch
+41 44 787 60 15



Benjamin Boksberger
M. A. HSG
Forecasting Manager
benjamin.boksberger@hpo.ch
+41 41 461 00 22