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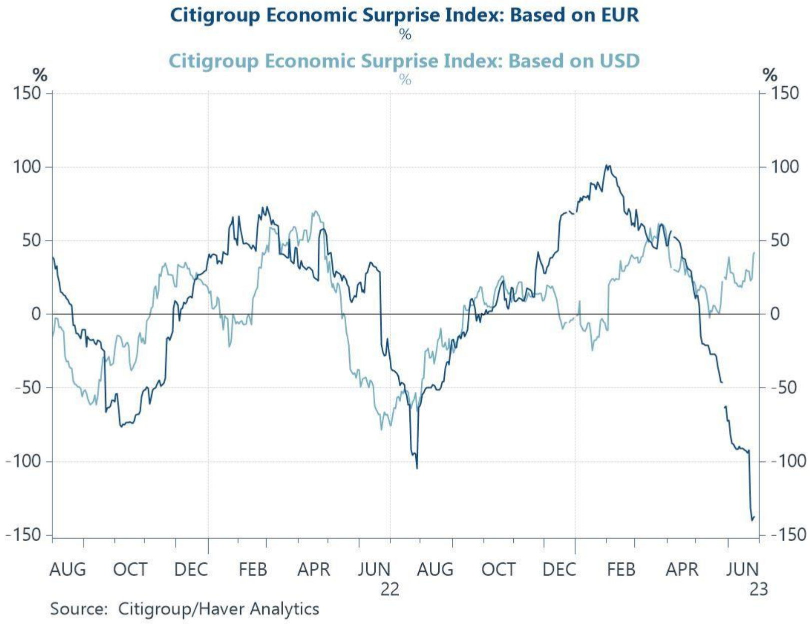
Summary

Financial markets have been a little more unsettled in recent days as recession fears have resurfaced again in several major economies. Those fears have been amplified by some remarks from central bankers at the ECB's conference in Sintra this week suggesting that further monetary policy restriction is likely. Still, most gauges of financial market stress have not signalled any significant instability in recent weeks. This can be partly attributed to relatively sturdy US dataflow (see chart 1). That core CPI inflation appears to have turned a corner in many major economies is arguably another reason for the absence of financial instability (see chart 2). A key exception to this, however, is the UK where core inflation has deviated from global norms with consequences for the gilt market and sterling (see chart 3). Tight labour markets, in the meantime, are one of the factors that's compelling central banks to keep monetary policy on a restrictive path but there are some suggestions in higher-frequency data that employment activity is beginning to ebb (see chart 4). Recent business surveys from the euro area certainly support the notion that activity in that region is now weakening quite sharply (chart 5). A broader and more pronounced global slowdown will arguably now depend on how consumers respond to a tightening of monetary policy, which we explore further in our final exhibit this week (in chart 6).

Data surprises in the US and the euro area

The recession concerns that have engulfed Europe in recent weeks can be traced in part to a raft of disappointing data releases from that region (which we explore further in chart 5 below). Those disappointments, however, stand in stark contrast to the US where incoming data have surprised forecasters on the upside (see chart 1). The US specifics indicate that labour market resilience has combined with a rebound in the housing market and been accompanied by an improvement in consumer confidence as well.

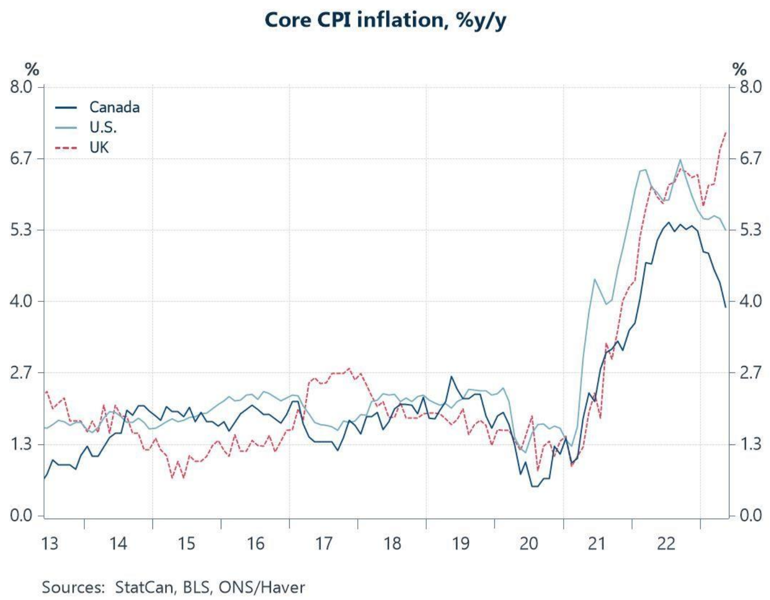
Chart 1: Citigroup's economic surprise index for the US and euro area



Canadian inflation

Brighter news for the US economy has accompanied some good news on the inflation front from elsewhere. Headline inflation rates, for example, have continued to retreat, in large part because of falling energy prices. But core inflation rates have also started to decline over the past few weeks in most major economies as well including in this week's Canadian inflation release for May (see chart 2).

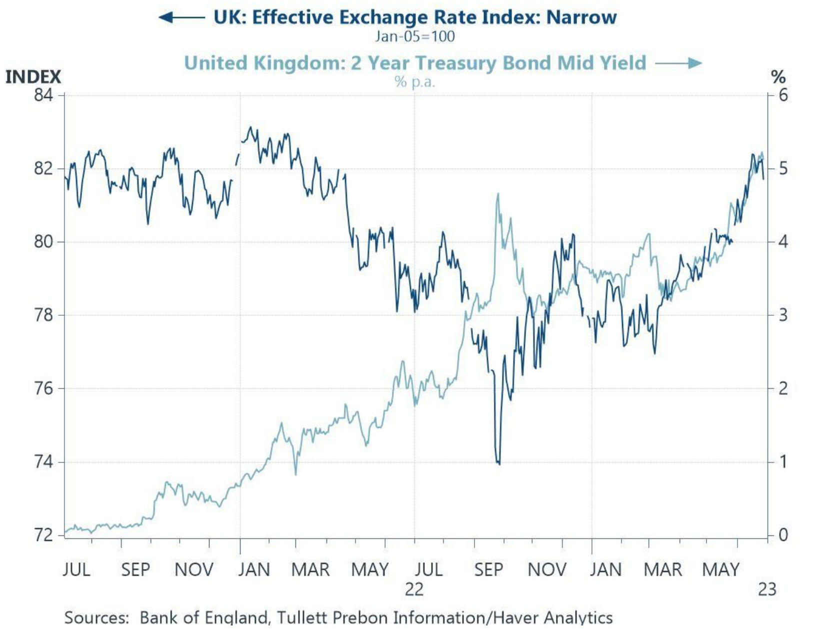
Chart 2: Core CPI inflation in Canada, the UK and US



UK financial markets

As chart 2 above also indicates, however, core inflation in the UK has not conformed to global norms. Coupled with firmer-than-expected wage pressures this has scuppered the idea that the Bank of England (BoE) could be close to completing its tightening cycle. Rising inflation combined with a more prolonged period of BoE tightening have unsurprisingly been met with higher short-term gilt yields and an appreciation in the value of sterling in recent weeks (see chart 3).

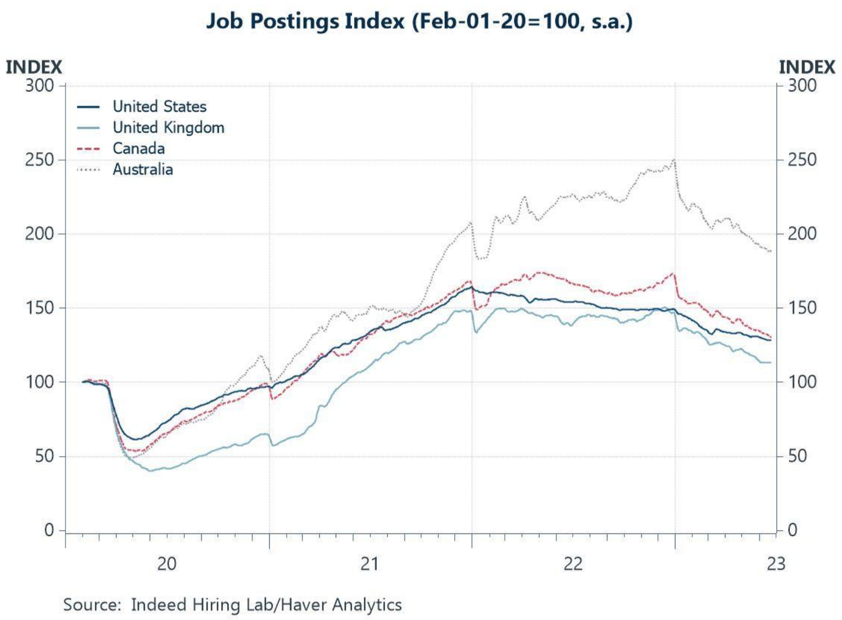
Chart 3: The UK trade-weighted exchange rate index versus 2-year gilt yields



Labour markets

A pivot toward easier monetary policy in the UK (as well as elsewhere) will hinge on how labour market activity evolves in the period ahead. Higher frequency data for job postings in many major economies, including the UK and the US, suggest that employment activity is now weakening (see chart 4). This has found an echo in other labour market gauges in these economies. But the messaging about that slowdown is either inconclusive and/or insufficient to assuage broader inflation concerns at present.

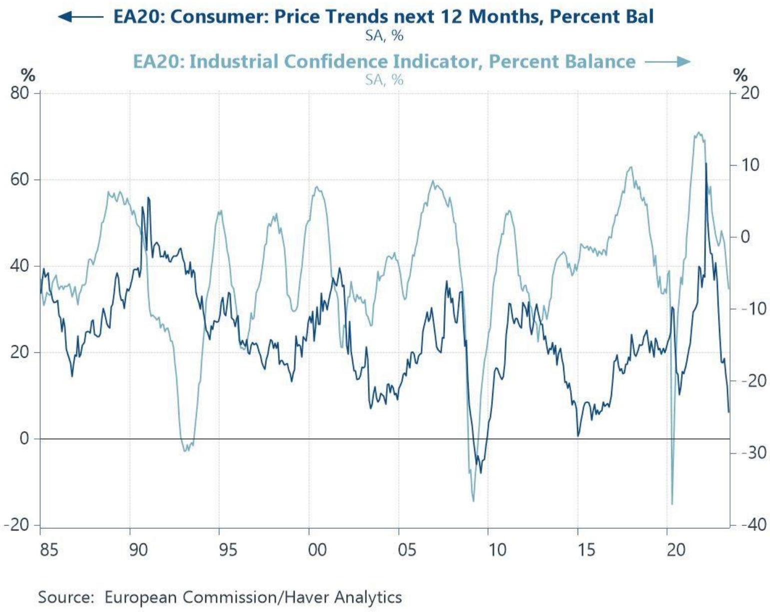
Chart 4: Job postings in the US, UK, Canada and Australia



Business sentiment and inflation expectations in the euro area

The messaging about a slowdown is far more consistent in the euro area. Last week's flash PMI surveys for June, for example, revealed a deepening manufacturing downturn and widespread disinflation. A big echo of this could be seen in this week's European Commission survey of business and consumer confidence as well (see chart 5). That the details of the consumer confidence survey additionally revealed a more than seven-year low in consumers' year-ahead inflation expectations was a noteworthy data point.

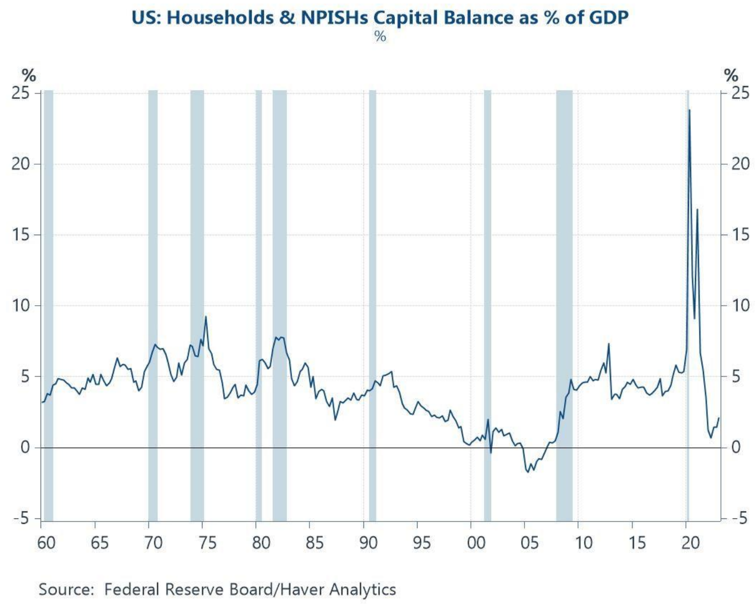
Chart 5: The EC survey of manufacturing confidence and consumers' inflation expectations



US household savings flows

Consumer behaviour more generally will also hold the key to the world economy's evolution and the response from central banks. The latest release of the Q1 flow of funds accounts suggest that US households have been saving a slightly higher fraction of their incomes relative to GDP compared with this time last year. However, a recessionary phase has, in the past, been associated with (or been triggered by) a far more prolonged campaign of balance sheet de-leveraging from households (see chart 6). A key question now is whether Fed policy is restrictive enough to engineer that degree of de-leveraging.

Chart 6: Flow of US household sector savings



ABOUT THE AUTHOR

Haver Analytics is pleased to bring Andrew Cates's commentaries on the state of the global economy to its clients.

Andy Cates has more than 25 years of experience forecasting the global economic outlook and in assessing the implications for policy settings and financial markets. He has held various senior positions in London in a number of Investment Banks including as Head of Developed Markets Economics at Nomura and as Chief Eurozone Economist at RBS. These followed a spell of 21 years as Senior International Economist at UBS, 5 of which were spent in Singapore. Prior to his time in financial services Andy was a UK economist at HM Treasury in London holding positions in the domestic forecasting and macroeconomic modelling units.

He has a BA in Economics from the University of York and an MSc in Economics and Econometrics from the University of Southampton.