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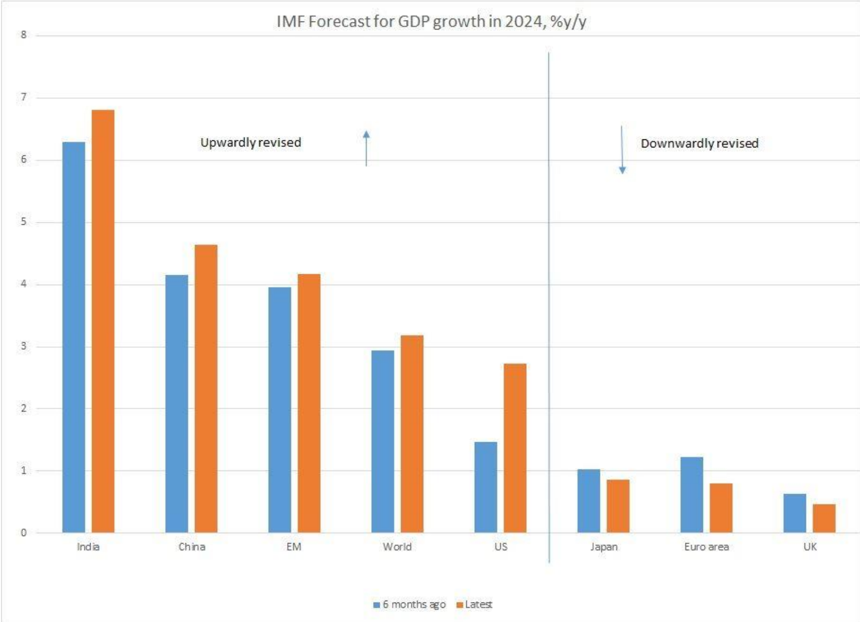
Geopolitics, Oil, the IMF and China

Investors have grown increasingly cautious about the economic outlook in recent days, partly thanks to heightened geopolitical instability in the Middle East. That Fed Chair Powell has also expressed greater concern about the US inflation outlook has not helped, not least as higher oil prices (and the resilience of the US economy) had already been unsettling investors' inflation expectations. The timing of this week's publication of a more optimistic economic outlook from the IMF (see chart 1) also appears a little unfortunate. The extent to which those forecasts may be jeopardized will arguably now hinge on the interplay between geopolitical instability, oil prices, inflation and monetary policy (see charts 2, 3, 4 and 5). It is noteworthy, nevertheless, and against these considerations, that China's economy has also been punching more positively according to some additional data that were published this week (see chart 6).

The IMF's global economic outlook

One of the most notable themes that emerged from the IMF's latest economic outlook this week is the resilience of the world economy in recent months. This resilience has led to significant upward revisions to its GDP outlook for several large economies compared to the projections made last October (see chart 1). The most notable upgrades were made to the US and to several large emerging market economies, including India and China. These were partially offset, however, by some small downgrades to the outlook for Europe and Japan. The factors driving this global outperformance were diverse but mostly revolve around loose fiscal policy, big drawdowns in household savings, and lower inflation, fostered, in turn, by supply-side improvements.

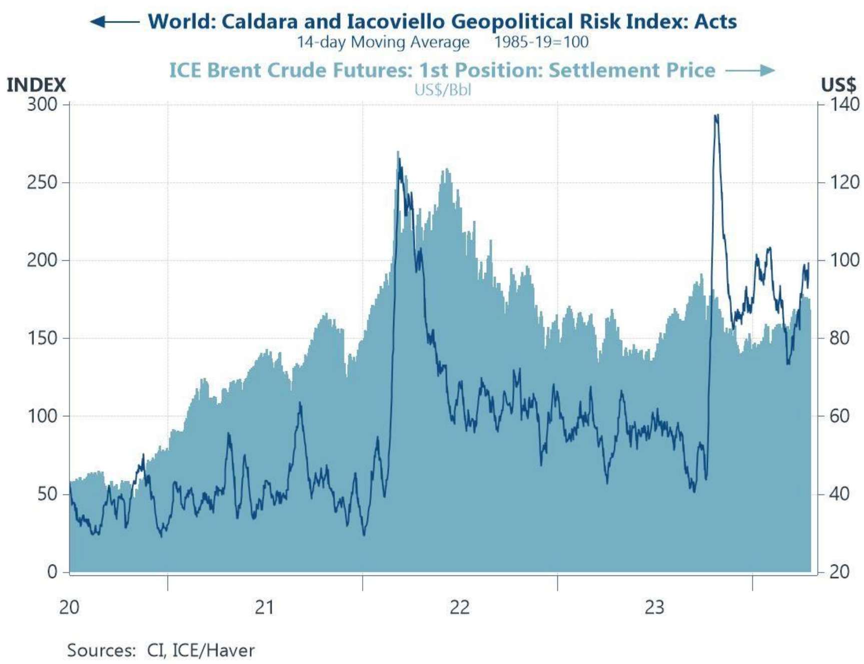
Chart 1: The IMF's latest forecasts for GDP growth in 2024 compared with last October



Geopolitical risk and oil

The extent to which these forecasts are now at risk will hinge on several factors but increasing geopolitical instability in the Middle East is clearly one of them. As chart 2 below indicates, a generic indicator of global geopolitical risk has spiked sharply higher over the past few days, largely thanks to the escalation of tensions between Israel and Iran. The most important channel through which this could generate economic instability is higher oil prices. But heightened risk aversion in the Middle East, and more broadly among global investors, could also hamper economic activity.

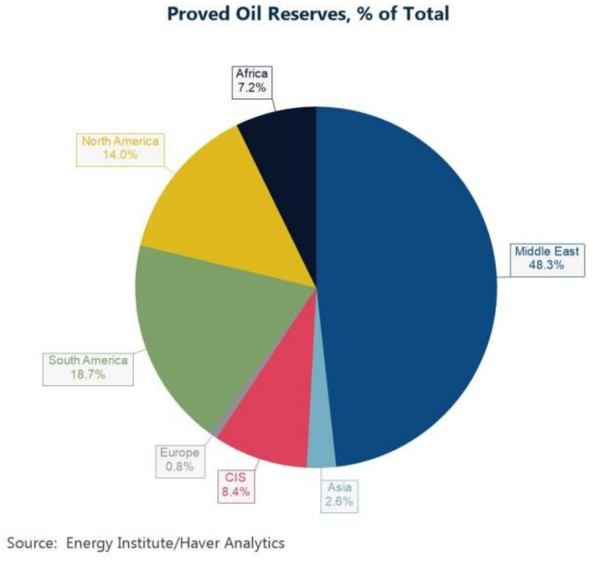
Chart 2: Geopolitical risk versus crude oil prices



Global oil supply

Global oil prices have, so far, remained well-behaved against this backdrop. However, there is no assurance that this stability will continue if geopolitical risks escalate. Iran plays a crucial role in the global oil market due to its significant oil reserves and production capacity. More broadly, the Middle East holds nearly half of the world's proven oil reserves (see chart 3) and accounted for 33 percent of global oil production in 2022. Therefore, any disruptions or changes in the region's oil production or exports could significantly affect the global oil market, influencing both supply and prices worldwide.

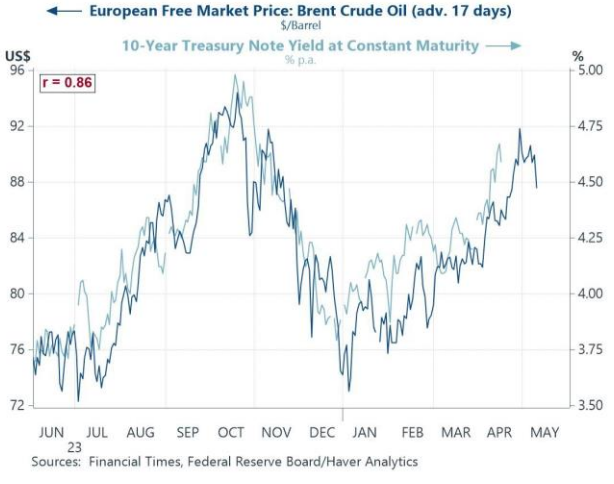
Chart 3: Global oil reserves, regional breakdown



Oil prices, inflation and monetary policy

While oil prices have remained relatively stable in recent days, they have generally been on the rise since the beginning of the year. This increase has been a major factor in slowing down or even reversing disinflationary trends in many countries. Additionally, it has led to reduced expectations for looser monetary policies, especially in the US. It is certainly no coincidence, against that backdrop, that oil prices appear to have enjoyed a close lead relationship with US Treasury yields over the past few months as well (see chart 4).

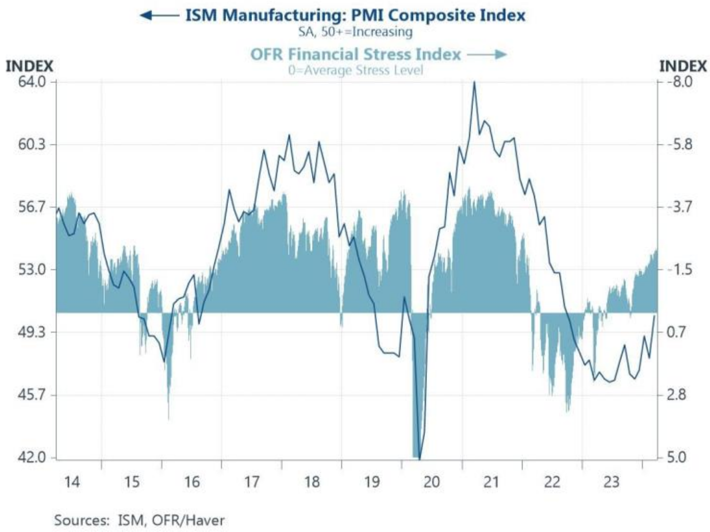
Chart 4: Oil prices versus US 10 year Treasury yields



US financial conditions

A major challenge for central banks in adjusting monetary policy is the feedback loops between economic activity, financial conditions, and monetary policy itself. For instance, earlier expectations of a more lenient monetary policy contributed to looser financial conditions in the US. This, in turn, may have provided greater support to the US economy than the Federal Reserve had anticipated (see chart 5). This indicates that while many metrics suggest that US monetary policy is stringent, indicators of financial conditions present a more nuanced view.

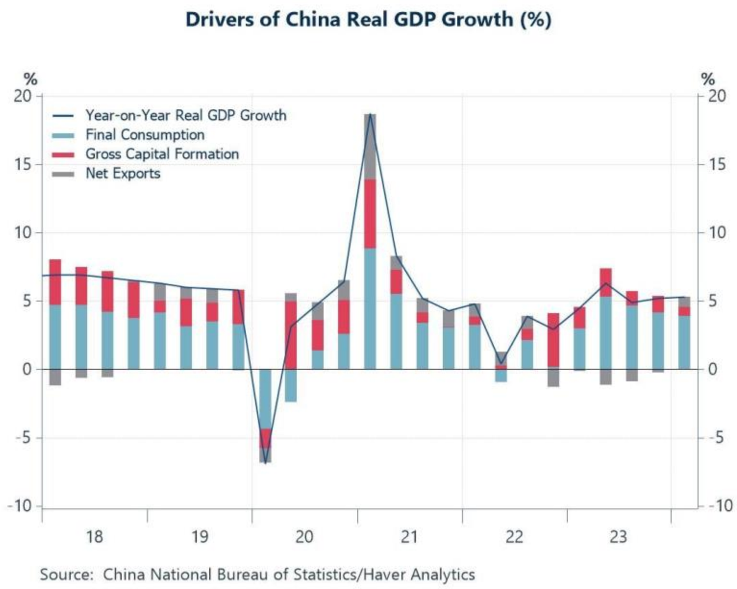
Chart 5: US financial stress versus the composite ISM index



China’s economy

Finally, and on a more positive note, this week’s dataflow for China has offered a more upbeat take on recent economic developments. For instance, GDP in Q1 2024 grew by 5.3% y/y, up from 5.2% in the Q4 2023, and significantly above expectations which were centered on a growth rate of 4.8%. A closer examination shows that net trade significantly boosted economic growth over the past three months, thanks to robust growth in export volumes during January and February. Whether this strength will be sustained, however, remains to be seen not least against the more risky global economic backdrop discussed above.

Chart 6: Drivers of China’s GDP growth



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.

Data featured in this commentary:

Chart 1: The IMF's latest forecasts for GDP growth in 2024 compared with last October
Please refer to Excel file included in the downloadable VG3 zip folder.

Chart 2: Geopolitical risk versus crude oil prices
Series 1: movv(DGLGPRA@ESG,14) [World: Caldara and Iacoviello Geopolitical Risk Index: Acts (1985-19=100)]
Series 2: PZBR01S@DAILY [ICE Brent Crude Futures: 1st Position: Settlement Price (US$/Bbl)]

Chart 3: Global oil reserves, regional breakdown
Series 1: BQ6AC@ENERGY [Middle East: Oil Proved Reserves (Thous Mil Barrels)]
Series 2: BQ7AC@ENERGY [Asia Pacific: Oil Proved Reserves (Thous Mil Barrels)]
Series 3: BS8AC@ENERGY [CIS: Oil Proved Reserves (Thous Mil Barrels)]
Series 4: BA1AC@ENERGY [Europe: Oil Proved Reserves (Thous Mil Barrels)]
Series 5: BS7AC@ENERGY [S & Cent America: Oil Proved Reserves (Thous Mil Barrels)]
Series 6: BA6AC@ENERGY [North America: Oil Proved Reserves (Thous Mil Barrels)]
Series 7: BQ8AC@ENERGY [Africa: Oil Proved Reserves (Thous Mil Barrels)]

Chart 4: Oil prices versus US 10 year Treasury yields
Series 1: PZBRT@DAILY [-17] [European Free Market Price: Brent Crude Oil ($/Barrel)]
Series 2: FCM10@DAILY [10-Year Treasury Note Yield at Constant Maturity (% p.a.)]

Chart 5: US financial stress versus the composite ISM index
Series 1: NAPMC@SURVEYS [ISM Manufacturing: PMI Composite Index (SA, 50+=Increasing)]
Series 2: OFRFSI@DAILY [OFR Financial Stress Index (0=Average Stress Level)]

Chart 6: Drivers of China's GDP growth
Series 1: N924NGPY@EMERGEPR [China: Real GDP: Year-to-Year Percent Change (%)]
Series 2: N924NCT@EMERGEPR [China: Contribution to Real GDP Chg: Final Consumption Expenditure (NSA, %)]
Series 3: N924NFBT@EMERGEPR [China: Contribution to Real GDP Change: Gross Capital Formation (NSA, %)]
Series 4: N924NXNT@EMERGEPR [China: Contribution to Real GDP Chg: Net Exports of Goods & Services (NSA, %)]