

US & Eurozone growth defying gravity

What to watch: Public debt amid lower inflation, further rising interest rates in the UK and the start of monetary easing in Latin America

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Ludovic Subran
Chief Economist

ludovic.subran@allianz.com

Ana Boata
Head of Economic
Research

ana.boata@allianz-trade.com

Maxime Darmet
Senior Economist
maxime.darmet@allianz-trade.com

Pablo Espinosa Uriel
Investment Strategist
pablo.espinosa-uriel@allianz.com

Roberta Fortes
Senior Economist
roberta.fortes@allianz-trade.com

Bjoern Griesbach
Senior Investment
Strategist
bjoern.griesbach@allianz.com

Jasmin Gröschl
Senior Economist
jasmin.groeschl@allianz.com

Maddalena Martini
Senior Economist
maddalena.martini@allianz.com

What to watch

- **Public debt in advanced economies** – enjoying inflation's "snowball effect" while it lasts
- **Bank of England** – joining the club of aggressive (late) rate hikes
- **First rate cuts in Latin America** – what to expect?

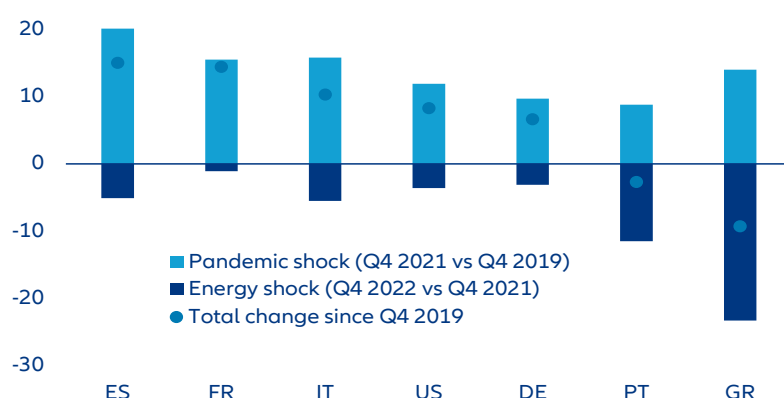
In focus – US and Eurozone growth is defying gravity

- **The US economy stepped up the pace in Q2 2023, with GDP growing above-trend at +2.4% annualized, driven by soaring business investment.** Q3 data continue to show positive signs, including a sharp rise in consumer sentiment and continued solid performance in the labor market. However, incentives for manufacturing plants could be offset by falling consumer credit and a softening business investment.
- **The Eurozone's economic outlook is increasingly challenging, with indications of continued weak performance.** Q2 growth is likely to have remained weak, and July's PMIs confirm a further slowdown in the second half of the year. In light of sticky core inflation, the ECB left the door open for one last hike in September to 4%, leading to tighter credit conditions and reduced investment demand. Weak external demand from major trading partners adds to the headwinds. Divergences among member countries are evident, with Germany lagging and Spain showing comparatively strong momentum, notably thanks to services and public investment.
- **Germany's economic outlook is still gloomy, even though further recession was avoided – with GDP stagnating in Q2.** Indicators signal weaknesses across all sectors, with manufacturing and services experiencing declines. Structural issues, such as high energy costs and worker shortages, are exacerbating the situation, leading to a potential economic downturn. Capital outflows suggest waning attractiveness as an investment destination, posing further challenges for the country's economy.
- **France's economy muddles through prolonged stagnation despite a surprise boost to Q3 2023 growth.** Although Q2 2023 GDP growth was strong at +0.5% q/q, it was entirely driven by a boost from net trade. Exports, in particular, were buoyed up by the shipment of a large cruise ship. But falling corporate credit demand indicates a challenging outlook for business investment in H2, hinting at a marked step down of GDP growth in Q3, which we expect at -0.1% q/q.

Public debt in advanced economies – enjoying inflation’s “snowball effect” while it lasts

Despite generous fiscal spending to cushion the blow of the energy crisis, Eurozone public debt as a share of GDP declined in 2022, especially in Greece and Portugal. Public debt jumped during the pandemic, when governments unleashed large fiscal stimulus to cushion their economies from the Covid-19 shock. Spain and France saw the biggest increases of +15pps and +14.4pps, respectively. But though the energy crisis in 2022 sparked a similar round of generous stimulus in the Eurozone, the debt-to-GDP ratio declined in all large Eurozone economies (as well as the US, Figure 1), with Greece and Portugal seeing the sharpest decreases.

Figure 1: Change in government debt-to-GDP (in pps)

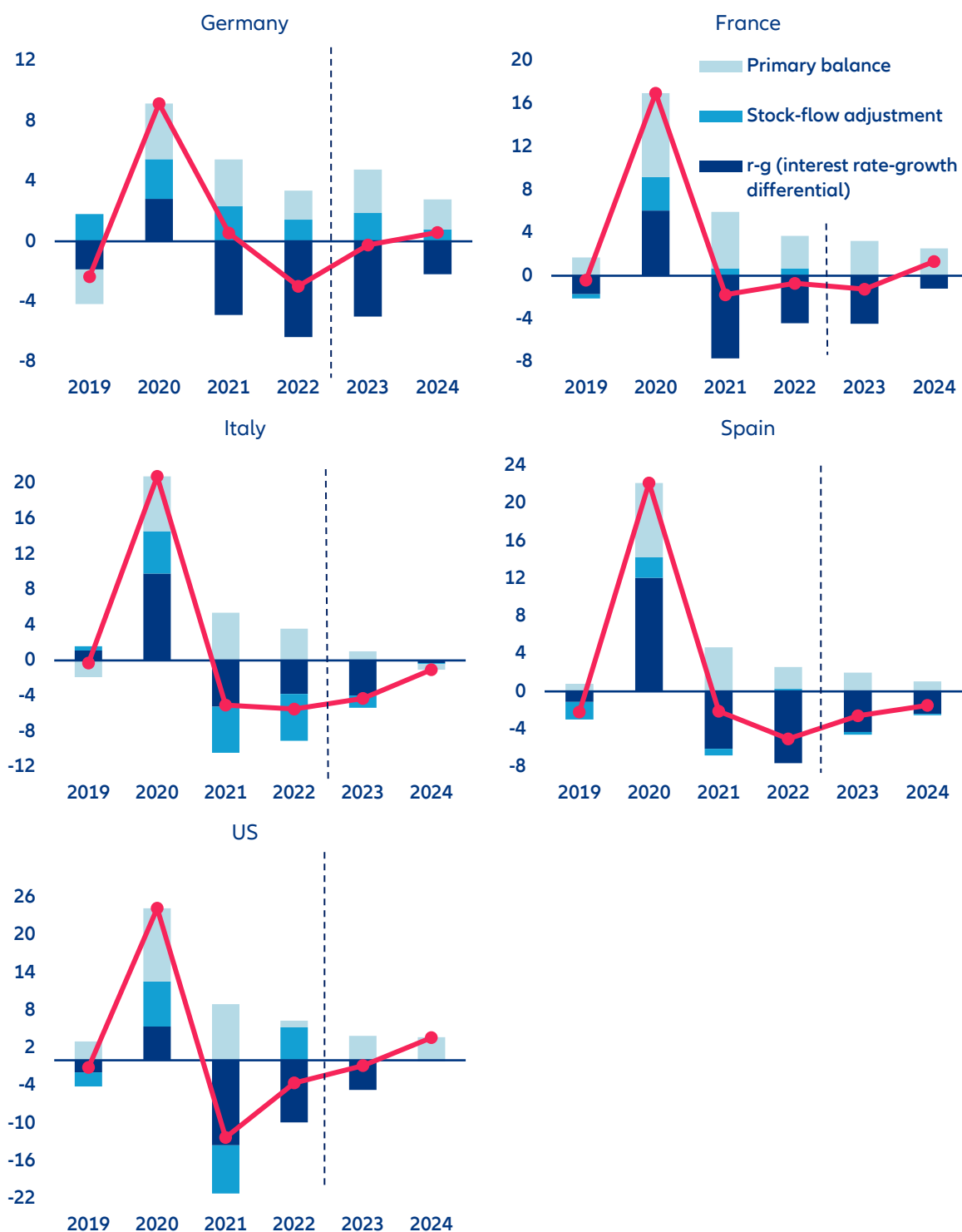


Sources: Refinitiv Datastream, Allianz Research

What’s behind this counterintuitive effect? Countries saw their debt ratios declining, thanks to nominal effects, while higher rates only impacted flows (rollover debt). In Figure 2, we break down the yearly change in the debt-to-GDP ratio by components: the primary balance; the “snowball effect”, i.e. the difference between the effective nominal interest rate on debt and nominal GDP growth, and finally stock flows (one-off government spending or revenues that are not included in the fiscal balance, such as equity injections or the proceeds of asset sales). In 2021 and 2022, we find that high inflation boosted nominal GDP growth (i.e. improving the denominator) while interest payments remained contained, supporting the “snowball effect”. Most of the stock of debt was issued at a low, fixed rate and with a long duration (around eight years on average in the Eurozone and five years in the US). Moreover, high inflation also contributed to reducing primary balances through higher tax revenues, which are tied to nominal tax bases. In Germany, the snowball effect alone reduced the debt-to-GDP ratio by a cumulative -11.3pps in 2021-2022, while in the US the change was an eye-watering -23.5pps.

It is also worth noting that in Germany, stock flows have been large, pushing up the debt ratio, while in Italy they helped reduced it meaningfully. However, generally, primary deficits have remained large, weighing unfavorably on debt dynamics, particularly in France (-3.2% of GDP in 2022) and Italy (-3.6%).

Figure 2: Government debt decomposition (in pps)

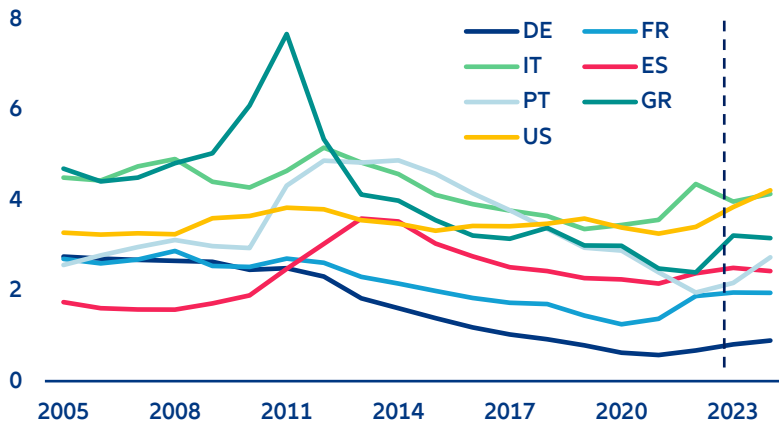


Sources: Refinitiv Datastream, EC AMECO, IMF WEO, Allianz Research.

However, rising debt-servicing costs, coupled with normalizing inflation and low real GDP growth, will complicate the fiscal outlook. Despite a higher overall debt level, sovereign interest payments continued to decline as a share of GDP until 2021. But this trend started to reverse in 2022 and will deteriorate in the coming years (Figure 3). Rapidly rising interest rates have significantly increased governments' debt-servicing costs, raising concerns about debt sustainability. In the US, we expect the debt-reducing snowball

effect to fade significantly in 2023 and to evaporate entirely in 2024, owing both to the impact of the rapid rise in the effective interest rate and the relatively short maturity profile of US debt. In the Eurozone, however, the snowball effect will fade more gradually, with Italy remaining the most challenged by the post-peak inflation environment. The snowball effect should remain the most favorable in Germany in 2024. Overall, by 2024, we expect the debt-to-GDP ratio to remain broadly stable in Germany, Italy and Spain, but to increase in the US and France amid a slow reduction in primary balances.

Figure 3: Government interest burden (% of GDP)



Sources: Refinitiv Datastream, EC AMECO, Allianz Research

Bank of England – joining the club of aggressive (late) rate hikes

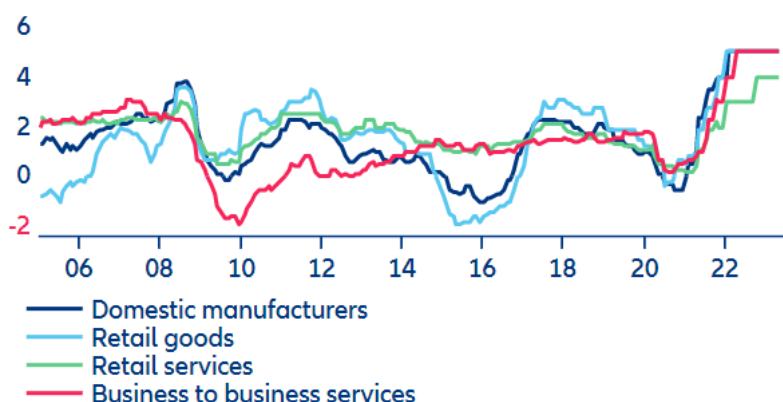
Ahead of the Bank of England’s meeting next week, data suggest inflation is taking longer to come down in the UK. In June, inflation slowed down to 7.3% from 7.9% in May, mainly due to lower energy prices. However, food prices continued to rise. While both the core and services components declined compared to May, they remained high at 6.9% and 7.2%. Looking ahead, we expect inflation to remain around 5% by the end of the year (with core inflation at 6%). Lower energy prices will continue to be the main contributor to lower inflation as households’ energy bill reduced by -17% in July and a further -5% is expected in October which will translate into -20% y/y energy CPI inflation. However, wage growth remains high (Figure 4) despite easing recruitment difficulties and the -20% decline in job vacancies in May 2023. While this should take away some of the wage pressures, alongside more companies freezing new hiring, ongoing labor hoarding and Brexit-induced tightness in the labor market will still keep the unemployment rate low (below 4.5%) and wage growth above the long-term average. The price outlook from companies has stabilized (Figure 5) amid cost deflation on goods imported from China and the fall in commodity prices. Yet, prices are sticky, notably on the services side.

Figure 4: Regular pay 3M y/y vs BoE agents' scores, recruitment difficulties, %



Sources: Refinitiv Datastream, Allianz Research

Figure 5: Price expectations, net balance, %



Sources: Refinitiv Datastream, Allianz Research

The transmission of monetary policy remains very slow compared to previous tightening cycles, which could support a peak in key interest rates close to 6%, with a 50bps rate increase next week. On the assets side, UK households entered the tightening cycle with a large stock of savings, which currently stand at GBP140bn or 4% of GDP. On the liabilities side, the bulk of outstanding mortgages is fixed for either two or five years. This is slowing the rise in effective average mortgage rates on the outstanding stock of debt and is making a difference of at least 200bps on interest rates on the flow and the stock of loans. That said, more and more households are likely to start saving more in order to cope with the future rise in debt repayments, notably in a context of slowing wage growth. However, contrary to the US where real interest rates are already positive, in the UK they are expected to turn positive only towards the end of the year. This gives some additional time in terms of debt sustainability (Figure 6). On the corporate side, more than two-thirds of loans are at variable rate, which means that the average effective rate has now increased to 6%. The wall of debt repayments is expected in 2025-26 for corporates rated high-yield, which could prove challenging. While corporates have been burning cash at a faster rate since the start of 2023, corporate deposits stood at a comfortably high level of GBP130bn in May 2023 (latest available data), -5% in y/y terms. This gives the Bank of England some leeway to continue to increase interest rates so further cool down demand, notably in the services sector. While we expect GDP growth to stay positive, it will remain

very low at +0.2% and +0.5% in 2023 and 2024, respectively. This could open the door for some limited monetary policy easing in the second half of 2024.

Figure 6: Real interest rates in the UK, %



Sources: Refinitiv Datastream, Allianz Research

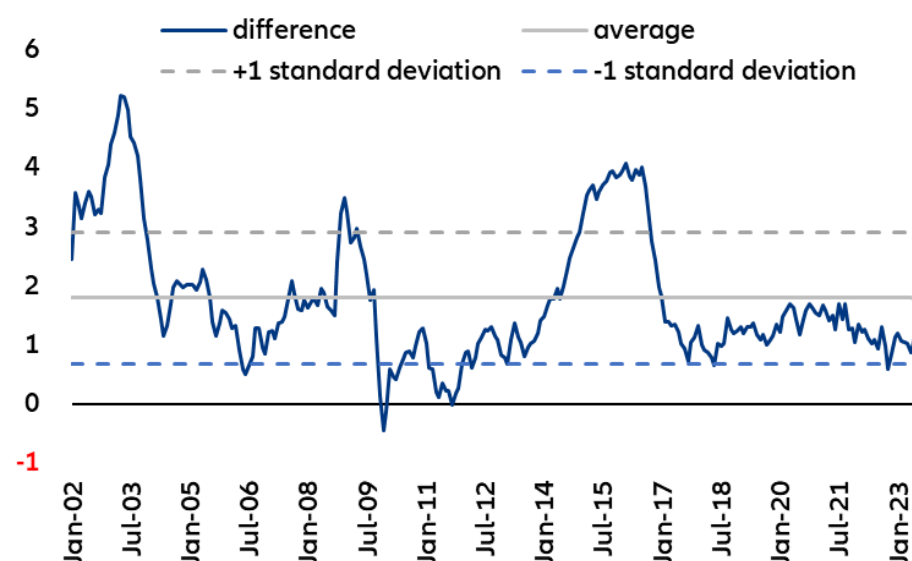
First rate cuts in LatAm – what to expect?

As the US and Eurozone approach the end of their hiking cycles, an easing cycle is about to begin in Latin America. The first rate cuts are due this week, led by Chile and followed by Brazil next week. Their early start to the hiking cycle allowed Latin American countries to better withstand the turbulence of 2022, and to bring inflation under control earlier than many advanced economies. It also led to strong performance for Latin American bonds and equities, with all except Colombia recording double-digit price returns and out-performing the MSCI EM benchmark so far in 2023. The top three best-performing currencies against the USD this year are also from Latin American countries (COP: +23%, MXN: +16%, BRL: 12%). https://euc-word-edit.officeapps.live.com/we/wordeditorframe.aspx?ui=fr&rs=en-US&wopisrc=https://allianzms.sharepoint.com/teams/TEAMSTRIAL/_vti_bin/wopi.ashx/files/d7e0a613f4324331ae7fb92043d88971&wdenableroaming=1&mssc=1&hid=CE8FCAA0-F060-7000-05C0-E32E0A45CD24&wdorigin=BrowserReload&jsapi=1&jsapiver=v1&newsession=1&corrid=7750fbfe-43d9-4153-832e-109905cce6d6&usid=7750fbfe-43d9-4153-832e-109905cce6d6&sftc=1&cac=1&mtf=1&sfp=1&instantedit=1&wopicomplete=1&wdredirectionreason=Unified_SingleFlush&rct=Normal&ctp=LeastProtected

That said, we are entering a new phase of the cycle with very striking features. First, central banks in advanced economies are either continuing with interest rate hikes or pausing them. This means that, at least for the next two or three quarters, nominal rate differentials between central banks in Latin America and advanced economies should narrow¹. Second, the inflation differential is well below the historical average (Figure 7). We expect this to remain the case or even widen in the coming year as inflation in major Latin American countries is expected to be lower than it has been in past decades (Figure 8) while inflation convergence in advanced economies will happen quite gradually.

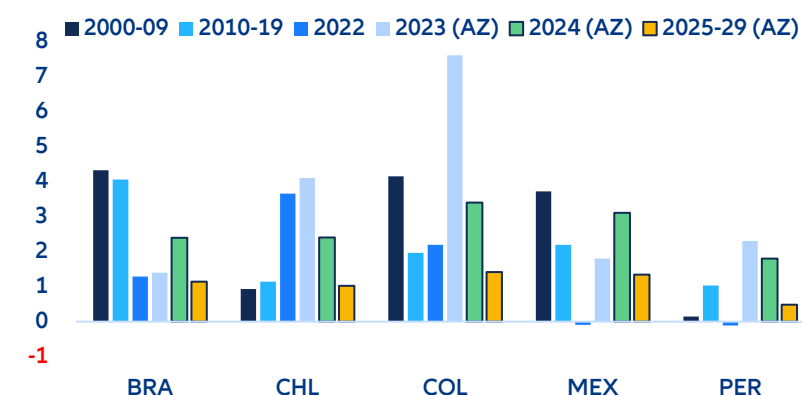
¹ Moreover, although the latest inflation numbers seem to support the pause in still- high core inflation, the fresh memories of the late response in 2021-22 and the – so far – avoidance of a recession creates some upside risks on the rate vs. market pricing.

Figure 7: Inflation differential LatAm-5 - AEs



Sources: Refinitiv Datastream, Allianz Research. LatAm-5 includes average inflation for Brazil, Colombia, Chile, Mexico and Peru. AEs includes average inflation for the US, Eurozone and UK.

Figure 8: Average y/y inflation; historical and Allianz Research forecasts



Sources: Refinitiv Datastream, Allianz Research

We expect the Banco Central do Brazil to lower the Selic rate by 25bps and to end the year at 12.25%, and Banco de la República (Colombia) to keep its current 13.75% rate and end the year at 12.50%, although in this case with risks of smaller-than-expected-cuts (Figure 9). Central banks in these countries have some margin of maneuver as the macroeconomic context seems to favor the region, inflation seems to be under control and their currencies have been among the top beneficiaries from the relative USD weakness in 2022. High but subdued political risks over the past 18 months have also reassured markets, which would look favorably on some rate cuts that do not undermine the fight against inflation while reducing the drag on the economy. As of now, looking at the current real interest differential compared to the levels of the last decades, Brazil appears to have the largest margin for cuts, followed by Chile and Mexico. In contrast, Colombia and Peru have a smaller margin.

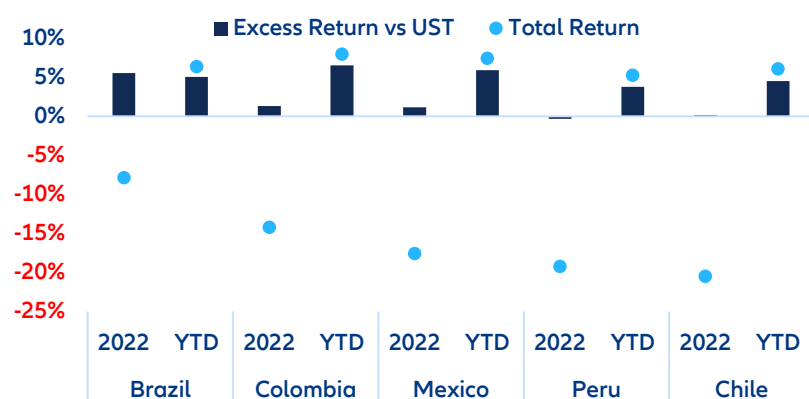
Figure 9: Official interest rates of major Latin American Economies and AZR forecasts.

	Latest	End-2023 (AZ)	End-2024 (AZ)
Brazil	13.75	12.25	10.50
Chile	11.25	9.50	7.50
Mexico	11.25	11.25	11.25
Colombia	13.75	12.50	10.75
Peru	7.75	6.75	5.25

Sources: Refinitiv Datastream, Allianz Research

How will these early cuts impact the comparative performance of sovereign bonds vs. those of major advanced economies? As long as the cuts remain in our expected ranges, we do not expect them to be a game changer for the appeal of Latin American bonds (Figures 10 and 11), which will continue to be popular among market participants. The huge differential that they had in early spring 2022 has been reduced and may continue to narrow. Nevertheless, as we wrote in our latest economic outlook², we rather expect the excess of optimism prevailing since late last year as the main driver of minor adjustments as economic risks remain skewed towards the downside compared to the market positioning.

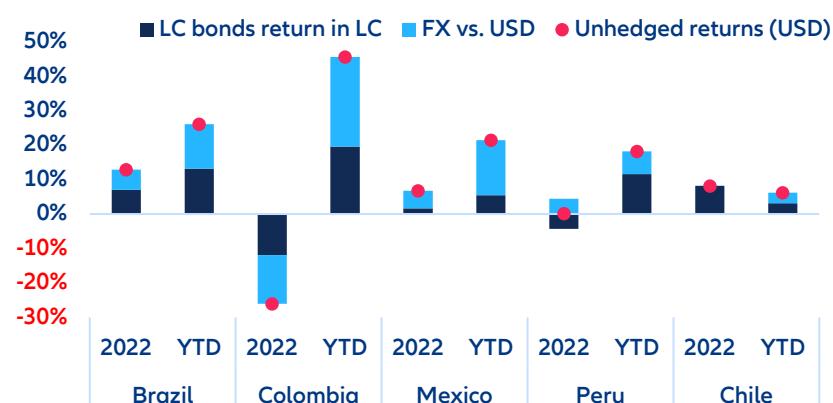
Figure 10: Compared performance of USD-denominated sovereign bonds vs. US Treasuries



Sources: Refinitiv Datastream, Allianz Research. Calculated using BofA indexes.

² See our report [Climbing the wall of worries](#)

Figure 11: Compared performance of local currency sovereign bonds vs. FX gains/losses



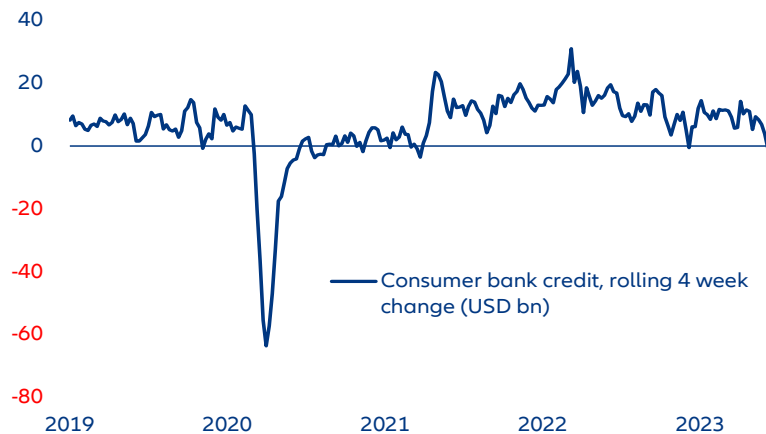
Sources: Refinitiv Datastream, Allianz Research. Calculated using BofA indexes across the whole maturity spectrum.

In focus – US and Eurozone growth is defying gravity

After soaring in Q2, US growth momentum should soften in Q3. US GDP growth soared to an above-trend rate of +2.4% q/q annualized in Q2 2023 (+0.6% non-annualized), after an already strong +2% recorded in Q1. While household consumption softened as expected at +1.6% (from an elevated pace in Q1), the strength of business investment was a surprise, growing by +7.7%, its fastest pace since Q1 2022. Conversely, residential investment was weaker than expected: While housing starts data hinted at the beginning of a rebound, residential investment slipped -15.8%. It is now -23% off the peak reached in Q1 2021. Exports and imports were also weak, slumping -11% and -7.8%, respectively. However, as imports fell more than exports, the contribution of trade to GDP growth was positive. US export volumes are now back to below pre-pandemic levels.

Economic momentum seems to be holding up well at the beginning of Q3, although at much more moderate pace. Consumer sentiment picked up sharply in July (both current conditions and expectations) in the University of Michigan survey, while weekly credit-card data point to consumer spending growing at a decent pace. Meanwhile, the labor market continues to be solid, with lower initial jobless claims reported for the three first weeks of July. The industrial sector remains the weak spot of the economy, although timely data for July point to the sector bottoming out as industrial rail volumes, container exports and trucking demand have recovered from their lows. However, we remain cautious on the Q3 outlook: Weekly bank data point to consumer credit starting to fall in July, after growing robustly post-pandemic. We also expect business investment to soften notably, dragged down by falling office investment (office vacancy rates have continued to increase sharply) and oil & gas investment (as hinted by guidance from energy companies). Strong spending in manufacturing plants, incentivized by the CHIPS Act and the Inflation Reduction Act, should at least partially offset these headwinds. Overall, we forecast below-trend but decent GDP growth of +1.3% in Q3 (+0.3% non-annualized).

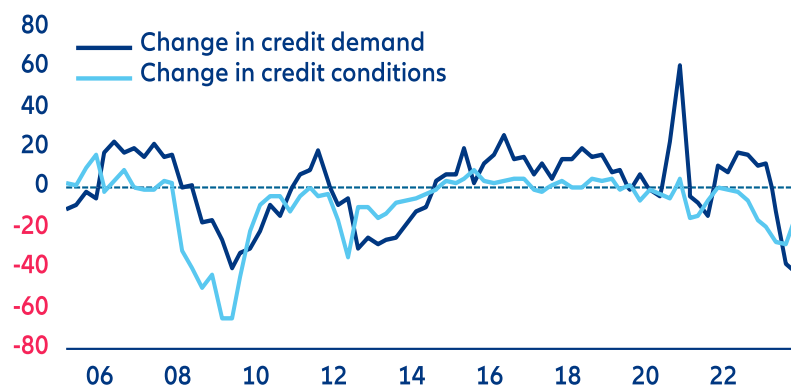
Figure 12: Consumer bank credit, rolling four-week change (USD bn)



Sources: Refinitiv Datastream, Allianz Research

Meanwhile, in the Eurozone, the wall of worries is getting higher as tightening financing conditions weigh on domestic activity. The latest data releases point to further disappointing quarterly growth in Q2 to be reported on 31 July, and July's Composite Purchasing Manager Index (PMI) confirms a further economic slowdown in the second half of this year. At the same time, the ECB's increasingly restrictive monetary policy will dampen growth for the next quarters, given its lagged effect on the economy. This week's 25bps increase not only marks the first anniversary of the current hiking cycle but also brings the total policy rate increase to a historic 425bps. For the next meeting in September, the ECB left the door wide open for another hike. But even if it refrains from further hikes, rising real yields amid falling inflation rates will further tighten credit conditions, dragging down investment demand. The latest Bank Lending Survey confirms these dynamics, showing that demand for loans from the real economy shrank at the fastest pace in the survey's history since 2003 (Figure 13). The dire economic situation is exacerbated by weak external demand, with no meaningful stimulus coming from the rest of the world's large economies. China's Politburo has refrained from delivering significant economic support this week despite acknowledging a weak domestic economic outlook. Amid all these headwinds, the Eurozone is witnessing significant divergences among its member countries, with Germany currently lagging and Spain exhibiting comparatively strong momentum. However, Spain's elections last Sunday point to a difficult government build-up, which could pose further challenges to growth in the coming months.

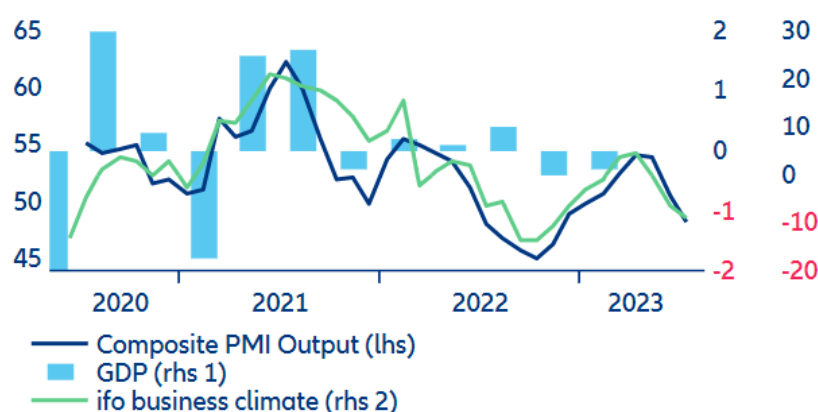
Figure 13: ECB Bank Lending Survey for the Eurozone aggregate (net percentage of banks reporting an increase in credit demand / an easing in credit conditions)



Sources: Refinitiv Datastream, Allianz Research

The outlook for Germany is still rather gloomy for the rest of the year even though the economy just avoided a further recession. In Q2 2023, German GDP stagnated at 0.0% q/q. Looking ahead, several other national indicators signal weaknesses across all sectors. The ifo business climate index deteriorated for the third month in a row in July as manufacturing saw a large drop in sentiment and services marked a decrease mainly driven by a more pessimistic assessment of the current business environment. The evident decline in manufacturing and the deceleration of services momentum align closely with the flash PMIs (Figure 14). In recent months, the robust growth in services has offset the weaknesses in manufacturing. However, the overall growth momentum seems to be slowing down significantly as the services sector also experiences a downturn.

Figure 14: German Composite PMI output, ifo business climate and GDP



Sources: Refinitiv Datastream, Allianz Research.

In Germany, the deindustrialization debate is in full swing. Structural issues have been pending for some time and are becoming more and more apparent, including a toxic cocktail of high energy costs, worker shortages and reams of red tape. Direct investment flows signal that capital is increasingly flowing out of Germany – a warning sign that the location is becoming less attractive. Unless there is an unforeseen reversal, it is difficult to escape the conclusion that Germany is on a path towards a more severe economic downturn, which could have far-reaching implications for the Eurozone as a whole.

France saw an upside surprise to Q3 2023 growth but underlying domestic demand is muted. France's Q2 2023 GDP grew by a strong above-consensus +0.5% q/q. However, the solid outturn was entirely driven by a very large positive contribution of net trade, with exports soaring +2.6%, their fastest pace of increase since Q1 2022. This was partly driven by the shipment of a large cruise ship. Meanwhile, France's ramp up of nuclear production boosted industrial production. However, domestic demand slipped -0.1% q/q – the third consecutive quarterly decline. Household consumption dropped a sizeable -0.4% q/q, weighed down by another sharp fall in food consumption. Total investment gained a lackluster +0.1%. Households' investment in construction slumped for the fourth consecutive quarter and is now -6.2% off the cyclical high reached in Q3 2021.

The outlook for Q3 2023 looks challenging for France. The one-off boosts to industrial production and manufacturing exports are unlikely to be repeated. The July flash PMIs point to deterioration in both manufacturing and services activity. More telling, tighter credit standards reported in the ECB's Bank Lending Survey (BLS) are yet to filter through to lower business credit growth, though credit lines to fund operating cash to corporates have already been drying up (-0.1% y/y in May). The BLS survey also points to a fall in credit demand to fund corporate investment amid high interest rates (Figure 15). Meanwhile, the government announced a +10% hike of the retail electricity price in August, while it had previously committed to refrain from further hikes after the February +15% bills increase. This is weighing on consumer sentiment, which remains depressed, and supports our expectation that consumer spending will recover only moderately in Q3. We expect GDP to slip by -0.1% in Q3, weighed down by weak investment and a negative payback in exports after the strong Q2 one-off performance.

Figure 15: France's investment growth & demand for loans



Sources: Refinitiv Datastream, ECB, Allianz Research.

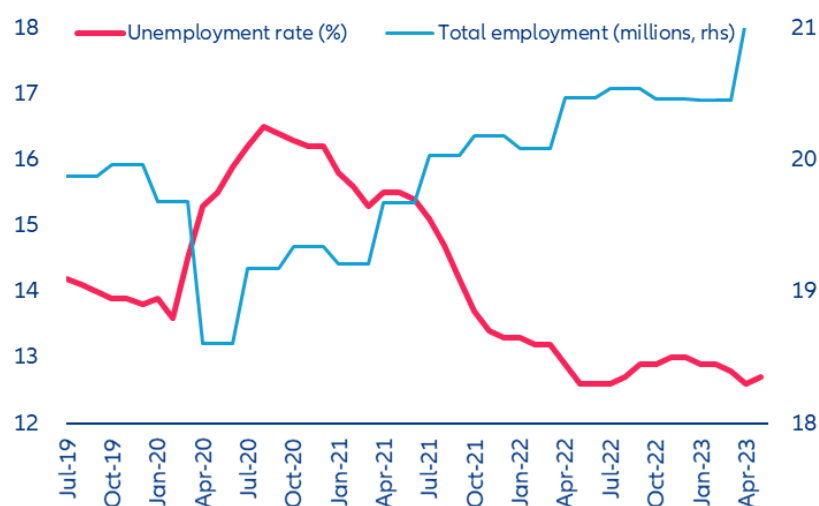
Italy's resilience is being tested. We do not expect Italy's activity to have maintained the solid pace recorded in first quarter of the year (+0.6% q/q), with only a marginal increase likely for the preliminary GDP growth estimate for Q2, to be reported on July 31st. The latest manufacturing and consumer confidence surveys continue to show signs of deterioration. Manufacturing activity marginally increased in May after four consecutive months of decline but the short-term outlook remains gloomy. Credit growth is declining at a rapid pace as households and firms are facing skyrocketing interest rates. On the other hand, labor market conditions remain favorable and unemployment stood at a historically low 7.6% in May. Hence, we could see an upside surprise still from the consumer related services, to offset the – so far- slow implementation of NGEU funds that could play a role in the coming quarters.

Spain, in contrast, is keeping up good momentum. Q2 GDP data showed that the Spanish economy grew by +0.4% q/q after +0.5% in Q1, slightly above our expectations (+0.3%). The breakdown shows an

important contribution from domestic demand, supported by the recovery in private consumption (+1.1% vs. -1.6% in Q1), as well as investment, which registered a strong increase in the quarter (+4.6% vs. +1.7% in Q1). It should be noted that external demand, particularly important for growth earlier in the year, lost momentum, with exports falling to -4.1% from +5.6% in Q1, suggesting an adjustment in the contribution of tourism, which was not enough to offset the slowdown in goods exports.

Over our forecast horizon, we expect the growth rate to be around +0.3% q/q over the next three quarters. We expect a continued (although smaller) positive contribution from net exports while domestic demand should keep its contribution to economic growth relatively modest. In particular, we expect some recovery in private consumption going forward, thanks to a robust labor market (Figure 16) and improvements in real incomes resulting from the rapid decline in inflation (3.8% in 2023 and 3.1% in 2024) and expected wage increases (4.6% in 2023 and 4.1% in 2024). Investments are supported by the NGEU funds, but we see a lot of uncertainty in their short-term impact due to the current political uncertainty stemming from the undefined results of the general elections, in addition to the established bureaucratic delays. Considering today's Q2 data, Spain's growth would be +2.2% y/y in 2023 (we would therefore revise our forecasts upwards from +2%).

Figure 16: Spain – Labor market remains strong



Sources: Refinitiv Datastream, Allianz Research.

These assessments are, as always, subject to the disclaimer provided below.

FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

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