GLOBAL ECONOMICS UPDATE

Resilient interest sensitive activity indicators won't last

- **According to our proprietary interest rate-sensitive indicators, activity in advanced economies has so far proven remarkably resilient to higher interest rates. A lot of this has been due to a rebound in auto sales related to pandemic distortions, whereas housing activity has weakened significantly. But with the bulk of the effects from tightening yet to feed through, we still think activity will fall soon.**

- As central banks embarked on their monetary policy tightening campaigns last year, we created our proprietary Interest Rate-Sensitive Activity Indicators in order to track how activity across and within advanced economies was responding to higher interest rates. The indicators are weighted averages of the categories which we found to have historically been the most negatively impacted by higher interest rates, which are auto sales, mortgage approvals, capital goods orders, housing starts, household goods sales, and construction output, and are expressed as 3m/3m growth rates. (Data and methodology can be found here.)

- **The indicators illustrate the often cited point that activity in advanced economies has been surprisingly resilient so far**, even against the most aggressive coordinated policy tightening cycle since the early 1980s and – at least according to our Financial Conditions Indices – the hardest period to access borrowing since the global financial crisis (GFC). Due to data limitations our indicators only go back to 2006, meaning that the pre-GFC tightening cycle is our only good comparison. But on that basis, our aggregate DM interest rate-sensitive activity indicator has fallen by much less than would be expected. (See Chart 1.)

- There has of course been some variation across economies. **In general, in economies where central banks tightened policy earlier and more aggressively, such as the US, Canada and New Zealand, interest rate-sensitive activity was fairly weak throughout most of last year.** (See Chart 2.) On the other hand, activity in the euro-zone remained positive. (See Chart 3.) These trends appear to have reversed more recently though, with the interest rate-sensitive activity indicator for the US (which is the only country where all the data are available for April) rebounding sharply, whereas that for the euro-zone has started to weaken.

- In a *Focus* earlier this year, we noted that most of the hit from higher interest rates was yet to come, and that the passthrough would probably be slower in some economies like the UK and euro-zone compared to past tightening cycles. But even taking this into account, interest rate-sensitive activity has been unusually resilient. In order to get a better understanding of why, we look at the indicators' various sub-components.

- **A lot of the relative strength in interest rate-sensitive activity can be explained by auto sales, which have historically been the spending category most sensitive to changes in interest rates, giving them the highest weight in our indicators.** As a result, when acute supply shortages triggered a sharp fall in auto sales in late 2021 and early 2022, our DM interest rate-sensitive activity indicator fell sharply too, even though financial conditions were actually still *loosening* at that point. (See Chart 1 again.) So by the same token, as the combination of easing supply shortages and strong pent-up demand paved the way for a rebound in auto sales in the second half of 2022, this pushed up on our DM interest rate-sensitive indicator. (See Chart 4.) Meanwhile, households running down their savings accrued during the pandemic may also have supported sales of normally interest-rate sensitive items like autos and household goods.

- **Another category which has historically had one of the strongest negative relationships to higher interest rates but which has held up relatively well so far is capital goods orders.** (See Chart 5.) In fact, the UK was the only country where capital goods orders fell last year. The resilience in orders might be due to the fact that corporate profits have held up well so far, allowing companies to maintain investment. **But the one area which has clearly been negatively impacted by higher interest rates is housing activity.** Mortgage approvals fell sharply early on in tightening cycles, weighing heavily on interest rate-sensitive indicators in many economies including the US, UK and Canada for most of last year. And although approvals have risen recently as housing markets have stabilised, housing starts have started to weaken. (See Chart 6.)

- **The upshot is that although interest rate-sensitive activity has been surprisingly resilient, there are reasons to believe that it will weaken soon.** We think auto sector rebounds are largely in the past, with auto sales

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falling again in April, while there are early signs that capital orders have started to fall too. And although housing activity may have stabilised, the fact that interest rates look set to rise even further in countries like the UK means that downturns should resume before long. **We think that the bulk of the effects from higher interest rates is yet to come, and that most advanced economies will fall into recessions later this year.**

Chart 1: DM Interest Rate-Sensitive Spending Indicator & DM Broad Composite FCI

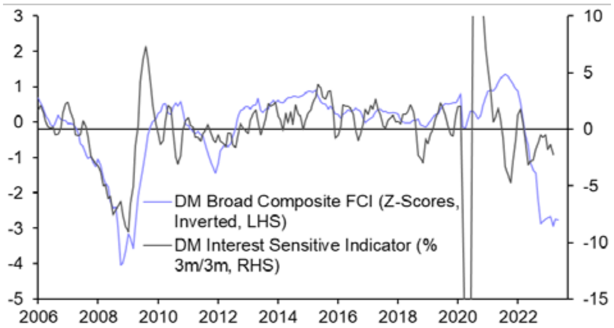


Chart 2: Interest Rate-Sensitive Spending Indicators (% 3m/3m)

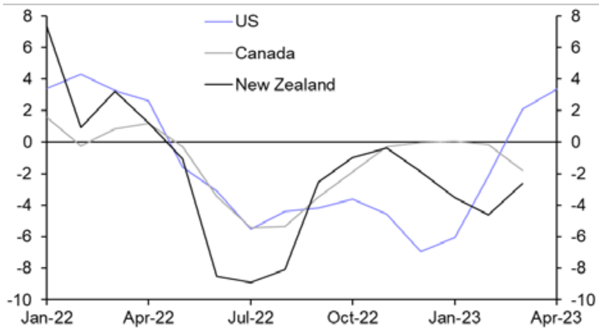


Chart 3: Interest Rate-Sensitive Spending Indicators (% 3m/3m)

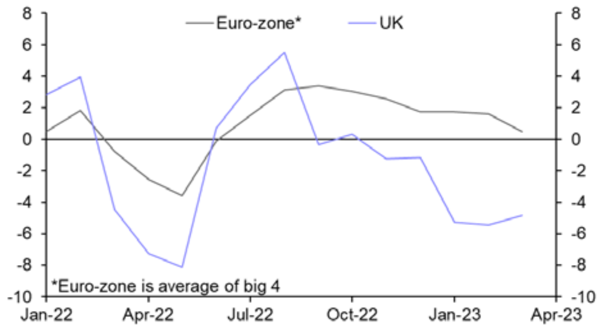


Chart 4: DM Interest Rate-Sensitive Spending Indicator & Auto Sales (% 3m/3m)

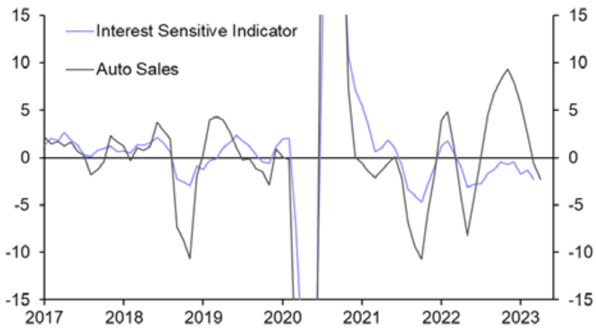


Chart 5: DM Interest Rate-Sensitive Spending Indicator & Capital Goods Orders (% 3m/3m)

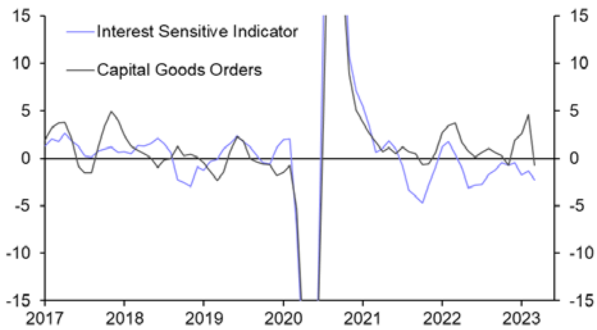
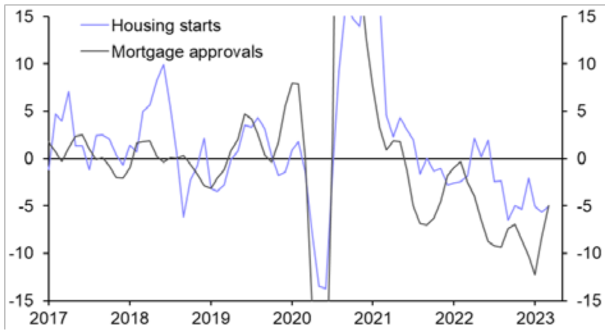


Chart 6: DM Mortgage Approvals & Housing Starts (% 3m/3m)



Sources: Refinitiv, Capital Economics

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