

# Economic and Market Outlook 2023



Down but not out



# Overview

The landscape will shift in the coming year, with a number of trends reversing course and markets taking on new direction. Growth and inflation are expected to be materially lower, with a global recession in the months ahead, corporate profits will be less and margins compress, while policy rates are expected to moderate following record hikes this year. However, recession is expected to be short and imbalances contained. While many imponderables prevail, prospects are likely to improve for both economies and markets after a difficult first part of the new year. Meaningful downside for credit and equities is likely following the 2022 year-end rally, before a sustainable recovery takes hold. Consequently, economic and market prospects seem to us to be a case of down but not out.

It's easy to forget that one of the key problems in 2022 was that economic conditions were simply too strong. Excessive cash post pandemic continued to be spent, pushing inflation ever higher and forcing the hand of central banks from easing, to embarking on one of the most dramatic periods of global tightening on record. Despite the much touted view that the workings of monetary policy come with 'long and variable lags', the pace and scale of hikes this year risk triggering unintended consequences for both the economy and financial markets. While the full economic effects are likely to hit only next year, pushing a number of key economies into recession, financial markets have already shown that pockets of vulnerability can surprise.

The UK pension crisis in October was triggered when gilt yields jumped, revealing the unsighted risks of leveraged bond positions. The crypto crisis in November, with the bankruptcy of the FTX platform, was another warning, while leveraged loans and margin requirements in other parts of the financial system also signal growing stresses. We don't see evidence of a systemic financial or banking crisis in the making, but spiking rates and recessions are dangerous beasts. Consequently, a deft touch will be required by the central banks. We suspect that while hawkish posturing has furthered to run as core inflation is stubborn in places, a true policy 'pivot' towards cutting rates will be forthcoming as recessionary forces are felt later in the year.

Many commodity and shipping prices have fallen dramatically in the past 12 months, while US money supply growth has collapsed and global inventory-to-sales ratios have rebounded. The surging property prices that contributed to inflationary woes in some key markets are also under pressure, with prices now falling from the US and UK to Sweden and Australia. True, wages remain sticky in places with global labour markets still very strong and spill-over from energy prices enduring, but the tide appears to have turned on the inflation front.

As we mark the third anniversary of the global Covid pandemic, the mutating virus remains disruptive in many regions despite vaccination success. Nowhere is this more apparent than in China, where we see the zero-Covid policy remaining until the spring, by which time the combination of greater vaccination rates and improving weather conditions should see a softer approach deployed. In the meantime, domestic growth will continue to be negatively impacted while frustrations and social unrest are a growing risk at a time when youth unemployment and the ongoing property crisis are testing President Xi Jinping. Elsewhere, risks of new Covid setbacks remain, though are not assumed to be economically material for the coming year.

While the political landscape looks a little more settled in 2023, following decisive elections globally in the passing year, geopolitics will remain threatening. We expect continued divergence between the US and China, most notably on the technology front, that will increase frictional costs of doing business, though we are not anticipating a major deterioration in relations in the near term. The ongoing tragedy in Ukraine is assumed to be a war of attrition, with optimism of resolution tempered by concerns of further escalation by invading forces. While Europe has done a good job in reducing Russian energy dependency and building reserves to get by this winter, a more permanent transition to energy security will take continued commitment and funding over a number of years. Although Europe has the potential to use the current crisis to quicken its move to energy sustainability and potentially lower costs of production, energy costs will be a competitive disadvantage for the region in the medium term.

From a financial markets perspective, a few macro themes are likely to dominate, notably recession, a policy pivot, and more limited monetary support thereafter. Consequently, the profile for risk assets is expected to be a much shallower 'V' than in prior cycles. While the recession is probably the most hotly anticipated in history, financial markets are

not priced for the uncertainty and unpredictability that comes when economies actually contract. As a result, we anticipate low double-digit drawdowns for equities, while credit defaults and spreads will rise if recession does indeed materialise. Any policy pivot is inextricably linked to economic prospects, and in that regard, we believe that the key central banks, most notably the Fed, will back off hiking once recession hits. This in turn should be the catalyst that turns US dollar prospects, with a persistent weakening expected thereafter. However, abundant liquidity provisioning and asset purchase programmes are unlikely as concerns around inflation and asset price deflation will linger.

As a result of these thematic developments, government bonds offer the most immediate opportunities through the opening part of the year, before credit markets regroup and lead the recovery, with equities following in their wake. For this transition to risk assets to take hold and herald the start of a new market cycle, a combination of factors is required if history is any guide. This would need to include an improvement in the rate of change in economic variables, actual interest rate cuts, a precipitous decline in markets, or a bottoming in earnings expectations for a new regime to take hold. If not, and it truly is different this time, then the momentum currently building in risk assets needs to be maintained, taking out technical resistance levels and ultimately posting higher lows in any short-term corrections. While we concede that recent market performance is encouraging, and central banks could yet manage to skirt recession, many pieces of the puzzle are missing. However, even our more challenging view implies stock and credit markets are headed down but not out.



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# Global

## Outlook

- Global growth declines further, with a mild global recession expected in 2023
- Inflation is in a peaking process, with goods price inflation already declining
- The end of the hiking cycle is approaching, peak rates are expected to be reached in H1 of 2023

## Implications

- Government bond yields are likely to have peaked, though volatility will remain high into 2023
- Credit to see notable drawdowns in Q1 as defaults pick up, followed by a sharp rally
- Profit recession to impact stocks in Q1, but an improving outlook leaves markets up on the year

## Risks

- Inflation remains sticky, causing central banks to hike aggressively into recession
- The situation around Ukraine deteriorates further, with a broadening out of the conflict
- Credit and equity markets fall sharper and remain under pressure for longer as economic conditions worsen

### Global growth to fall further

Global growth has fallen sharply in 2022 and remains on a slowing trajectory as we enter 2023. The slowdown has been most pronounced in Europe, led by the energy crisis, and China, where property woes and the restrictions of the zero-Covid policy have challenged the economy. World trade has slumped as the stimulus-fuelled boom in the global goods sector has deflated, while services demand remains brisk. Looking forward, growth should fall further as policy tightening combined with the energy and cost of living crises tip Europe and the US into recession, with limited offsets from China and other emerging markets. This would lead to a decline in global growth from a trend-like 2.9% in 2022 to a well-below trend level of 1.7% in 2023, with weakness likely to be frontloaded in the year. This implies a relatively shallow and short-lived global recession. The outlook for the latter part of the year is more encouraging, as falling inflation, a dovish shift in the global monetary policy stance, and a rebound in China growth should allow a modest recovery to gain traction.

### Disinflationary pressures emerging

The expectation of a relatively benign recession hinges on a rapid decline in US inflation. This would allow the Federal Reserve to moderate its hawkish stance and, later during the year, begin to cut rates back towards neutral. Without this support, the recession would likely be both deeper and longer lasting, with larger drawdowns in financial markets. In Europe, by contrast, inflation is expected to remain sticky given energy disruptions.

Inflation is still uncomfortably high, but many of the most disruptive drivers of inflation over the past 18 months are now in retreat, with key commodity prices, shipping costs, China producer prices, and used car prices down meaningfully compared to a year ago. Demand for semiconductors has fallen, supply chain bottlenecks have normalised, and businesses have restocked. While

energy costs are elevated and disruptive, European gas prices are down by around 50% from the August peak and oil prices have fallen significantly. We expect these disinflationary forces to work their way through the global economy over the coming months, taking the steam out of goods price and consumer price inflation in early 2023.

### Labour markets still very tight, but easing ahead

While goods inflation is coming down, services inflation has picked up with a lag, boosted by strong housing inflation and tight labour markets, with demand also remaining brisk—and still catching up with the pre-pandemic level. While housing has already been impacted by surging mortgage rates and a weakening outlook, staff shortages and hiring difficulties prevail, with wage inflation running at a higher rate compared to the past decade. There is no sign of a more vicious wage-price spiral, but central banks are rightly focused on the labour market and want to see an easing before shifting their stances. This is tentatively beginning to happen as job openings have started to decline and more timely survey data indicate that workers are becoming less inclined to move jobs, given elevated uncertainty, while some sectors see hiring freezes and cutbacks. We expect further moderation over the coming months as companies prepare for a recession and households scale back spending.

### The end of the hiking cycle is approaching

Central banks have maintained their tightening bias despite elevated financial market volatility, leaving inflation expectations well anchored. With growth slowing and inflation peaking, the end of the hiking cycle is approaching, and we expect peak rates to be reached in the first half of 2023, followed by rate cuts in some regions, including the US. The dovish policy shift should limit the drawdown in the economy and financial markets, allowing a modest recovery to build over time. There is significant risk around this

relatively benign outlook though, with sticky inflation and a more aggressive policy stance, particularly from the Fed, having the potential to both deepen and extend the downturn. Until inflation falls materially from current levels, uncertainty will remain elevated, which by itself will have an impact on sentiment, economic activity and financial market pricing.

### Government bond yields are likely to have peaked, but volatility will remain high

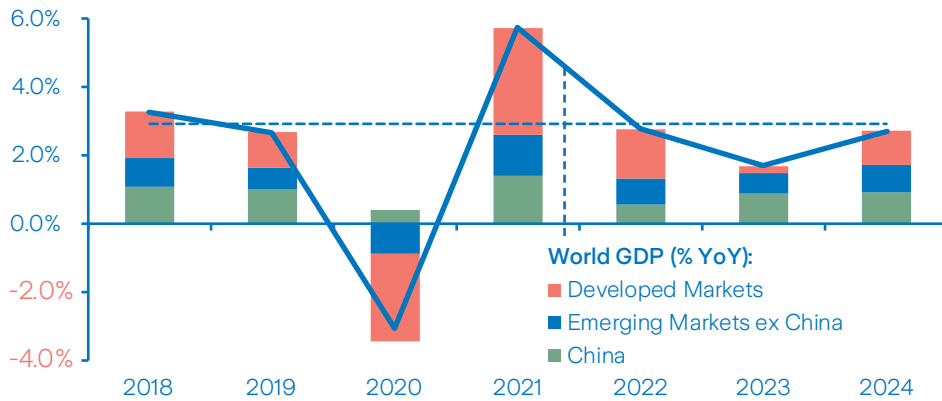
Government bond yields have fallen dramatically since the early 1990s, with the 10yr US Treasury yield down from 9% in 1990 to a low of 0.5% in 2020. This 30yr downward track in yields was finally broken in 2022 as inflation and policy rates surged. Looking forward, we don't expect yields to trace higher from current levels as underlying vulnerabilities in the global economy persist with debt at 260% of global GDP (for the non-financial sector) and weak potential growth, coupled with inflation targeting central banks maintaining their focus on inflation. Indeed, we expect bond yields to have peaked during the market turmoil in October and to see modest further downside to yields from current levels. This is most pronounced for Treasuries given the more encouraging inflation backdrop and potential for dovish policy surprises.

In Europe, we do not anticipate a return to negative yields, given the shift in ECB policy. Periphery government bond spreads should be rangebound and stay broadly around the current levels in 2023. Substantial tightening is unlikely given the weak macro environment and a hawkish ECB. At the same time, a dramatic widening in spreads is unlikely as governments will be careful to maintain investor confidence and the ECB stands ready to intervene via the Transmission Protection Instrument (TPI) if needed.

Bond markets are set to remain volatile until inflation falls back materially, with high policy and data dependence. The energy and geopolitical crisis in Europe is another driver of volatility.



## Global recession expected



Source: ZIG, Bloomberg. Note: The dotted line shows the thirty-year average for global growth.

## Credit in a lull before the storm

Global credit markets are likely to be jolted out of complacency in early 2023, although we expect a sharp recovery thereafter leading credit spreads to end 2022 tighter on the year. We expect US credit to underperform the rest of global credit, while High Yield has notable downside globally. Structured credit is also expected to have mixed performance across regions, with the US likely to outperform Europe, while US Municipals and European covered bonds should be resilient.

Despite strong balance sheets and improved liability profiles, the impact of substantial monetary tightening and slowing growth will be felt on earnings and cash flows, putting pressure on credit metrics and kicking off defaults and downgrades. The lending standards from the Fed's Senior Loan Officer Survey are one of the best leading indicators of US High Yield default rates. The latest print on lending standards already points towards an expected default rate of around 8% in US High Yield. While we expect a lower default rate of 5%, given stronger balance sheets, we think risks to our forecasts are skewed towards higher rather than lower default rates. Lending standards have also tightened in Europe. However, what is crucially important is that these fundamental risks seem grossly under-priced in credit spreads. High Yield default rates in the range of 5% to 8% would be consistent with an 800-1000bps spread for US High Yield, rather than the measly 450bps at offer to investors. This is despite the fact that a leveraged debt deal placement failed recently, and banks are sitting on chunks of unsold leveraged buyout debt, while junk bond issuance in 2022 is miniscule compared to a record in 2021, all of which raises refinancing and default risks. Similarly, in Investment Grade markets, BBBs have outperformed on a beta adjusted basis compared to A rated credit, as the latter was shunned by investors due to higher interest rate risks because of longer duration. However, in a recession, it will be BBBs that will be vulnerable to downgrades to junk while leveraging up risks—the dominant risk for A rated credit—have diminished as evidenced by a drop off in loan demand for M&A. Last but not least, despite elevated cash positions, fund managers are likely to remain wary of further outflows which have been unrelentingly negative in 2022. We expect outflows to continue as investors'

focus moves away from interest rate volatility to recession, and without a bottoming of outflows, a spread rally is normally not sustainable.

However, the darkness will eventually give way to light and once there are signs towards the end of Q1 that recession is being overcome, credit is likely to rally hard, outperforming stocks. Typically credit markets price in binary outcomes and hence once recession is nearing an end, spreads typically tighten sharply with most of the returns being captured in the beginning of a cycle. This is likely to lead to a strong performance for the rest of 2023, causing spreads to end the year tighter. Defaults and downgrades are expected to lag spread moves, with defaults continuing into 2024, although we expect them to peak in 2023.

## Equities to falter again in Q1

Despite the equity rally in recent weeks, 2022 has been an unusually difficult period for financial assets in general, with correlations high and losses substantial. Surging inflation and rising rates have taken their toll on both risk and safe-haven assets alike, with few places for investors to hide. While investor attention and hopes have now turned to a possible pivot by central banks, we see the current rally in equities as premature and ill-founded. That noted, we do see substantial and sustainable gains next year, albeit after what could be a painful drop in the first quarter of 2023.

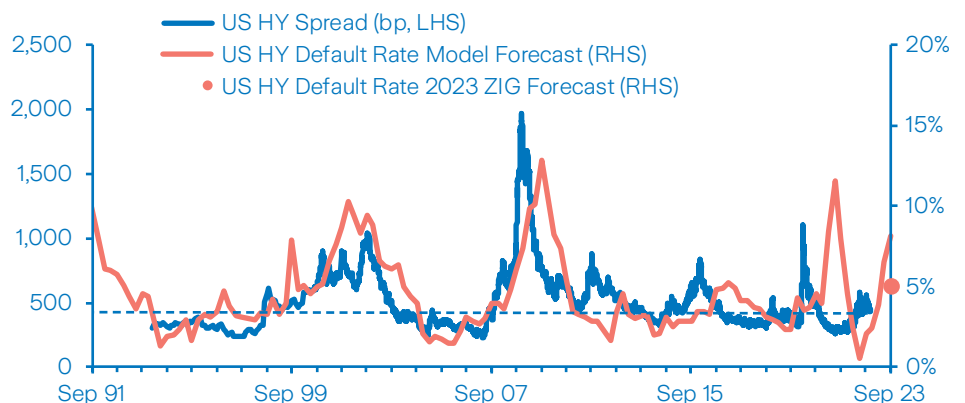
## Prerequisites for a turn in fortunes

Recessions are typically harsh for equity markets. Despite forward looking characteristics, stocks generally fall substantially as recession is entered, profits and margin expectations are slashed, and government bonds are bought. A bottom frequently precedes the trough in economic activity by only a few months. Despite a much-anticipated global recession, earnings expectations for developed markets currently show continued growth rather than a more typical double-digit decline and a commensurate contraction in the margins. While it is true that this cycle has been unusual in nature and may well result in an earlier bottoming pattern for stocks, we suspect that this is more likely to occur in Q1 2023. In our opinion, we need to see economic data improve rather than get worse, which they currently are. We need to see earnings and margin forecasts that are representative of contracting growth and sticky operating costs, and we need to see a true pivot in monetary policy rather than simply hopes of a slower pace of hikes. Currently none of these criteria are being met, though we do acknowledge that perhaps this time is different, and investors are already discounting the worst.

## Prospects will brighten, though not all stocks are equal

While caution is warranted for now, as 2023 develops we anticipate many drivers falling into place and envisage a substantial recovery once they do. That noted, the recovery is unlikely to be a liquidity fuelled bonanza that lifts all assets. More circumspect central banks are likely to be cautious in opening up the spigots, leading to a more idiosyncratic, patchy and nuanced global landscape. Sharp falls in US inflation and prospects of Fed rate cuts later in the year should weaken the US dollar, allowing emerging markets to break from record setting years of underperformance. We see China and Brazil offering good prospects, while US equities are also expected to make up relative ground. European stocks look less appealing. Having performed very well in the closing stages of 2022, higher rates, stickier inflation, and ongoing energy challenges are substantial relative headwinds for Europe. What seems clear is that bouts of volatility will persist.

## High Yield market seems sanguine to the default outlook



Source: ZIG, Bloomberg. Notes: Default rate forecast is estimated using a model that uses Fed's Lending Standards; Spreads used are Option Adjusted Spreads to US Treasury yields; Spread data is monthly prior to 15th August 2000

# US

## Outlook

- The economy is likely to fall into recession in the first half of the year
- Inflation remains high but is expected to fall back substantially in the months ahead
- The Fed is expected to end its hiking cycle once the economy is contracting

## Implications

- Bond yields have peaked with further falls in the coming months
- Credit markets will suffer notably in Q1 before recovering sharply thereafter
- Equities will face further headwinds as earnings contract before recovering

## Risks

- The Fed is forced to tighten even more if inflation is stickier than expected
- The economic contraction needed to bring down inflation is much deeper
- The fallout from recent rate hikes is more severe and spills over to other sectors

### **The US economy is heading towards recession**

There are increasing signs that the US economy is heading towards a recession in the first half of 2023. The ISM Manufacturing Index dropped to 50.2 in October, a post-pandemic low. New orders have dipped below 50 in four of five months since June, pointing at a contraction of manufacturing activity in the months ahead. The service sector has been holding up better so far, as is often the case ahead of a slowdown, and particularly over the past few quarters when there was a lot of pent-up demand as people came out of the lockdowns with the desire to travel, dine out and spend money on all the activities that were limited or not available during the pandemic. Nevertheless, service sector activity has also cooled down over the past few months with the ISM Services Index receding to 54.4, the lowest level since May 2020.

Smaller firms are particularly affected by the current headwinds and the expected growth slowdown. The National Federation of Independent Business' Small Business Optimism Index dropped to the lowest level since early 2013 last summer before recovering slightly. In reaction to the deteriorating environment, capex plans and hiring intentions have been falling over the course of the year.

### **The labour market is still tight**

So far, the employment situation has been holding up very well. Although the labour market has started to soften at the margin it remains tight overall. The unemployment rate has ticked up to 3.7% from 3.5%, which was also the level in February 2020 right before the pandemic drew the world economy into the abyss. The gap between the number of open jobs and the number of unemployed workers remains very elevated although job openings have fallen significantly from their peak and are expected to continue to do so in 2023. Closing this gap will help to reduce wage pressure without creating unnecessary

pain in the labour market. Nevertheless, unemployment is expected to rise further in the coming months as the economy is expected to fall into recession. Wage pressure has risen in response to a very tight labour market but less than could be expected given the difficulty in filling open positions and significantly less than inflation, leaving households with a substantial fall in real wages.

Soaring inflation and the real income squeeze continue to weigh on households' sentiment with the University of Michigan's Consumer Sentiment Index tumbling to the lowest on record in June before recovering slightly. While depressed consumer sentiment has not translated into a substantial fall in consumer spending so far, we think it is only a matter of time until a deteriorating employment outlook, a slowdown in wage growth and the drying up of excess savings will lead to reduced household spending. In addition, falling house prices are likely to add to the headwinds as people feel the negative wealth effect from lower house prices and are less able to borrow against their properties.

### **The housing market is feeling the full impact of tighter monetary policy**

The housing market is the sector where the Fed's aggressive policy tightening is having its most direct and most significant impact. The National Association of Home Builders' Housing Market Index, which tends to lead actual real estate transactions, has fallen every single month since January to the lowest in more than a decade, excluding April 2020 when the pandemic-induced lockdown led to an almost standstill.

Building permits and housing starts, and particularly home sales, have weakened accordingly. In reaction to the significant deterioration, house prices have started to fall. According to the CoreLogic Case-Shiller Index the annual price increase slowed to 10.4% in September from a peak of more than 21% in April 2022, but on a monthly basis

prices fell at the quickest pace since 2009. House prices are likely to fall further in the coming months, which is a healthy development given that recent price increases have not been sustainable.

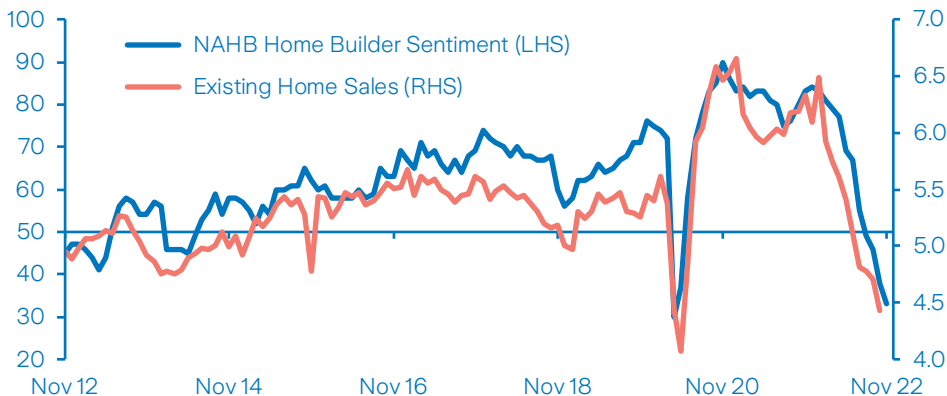
The cooldown in the housing market will have a direct impact on related goods and services spending and the employment situation of construction workers. Importantly, though, lower house prices and increasing supply are expected to have a dampening effect on rents, which have been an important driver of core inflation recently. The Zillow Rent Index has already fallen from an annual growth rate of 17% in February 2022 to less than 10% in October. Crucially, the monthly rate has already fallen back to pre-pandemic levels, an important step towards more moderate levels of core inflation.

### **Inflation remains elevated but is expected to fall substantially in 2023**

Inflation rates have been stubbornly high over the course of 2022, but there are increasing signs that price pressure will slow down significantly in the coming months and quarters. A major factor behind soaring inflation rates was the massive expansion in money supply to protect the economy from the impacts of the Covid pandemic. However, this mechanism will also work in reverse and help to bring down inflation to more manageable levels. From a peak growth rate of almost 27% YoY in February 2021 money supply growth fell to only 1.3% in October 2022. This is the lowest growth rate since 1995 and compares to a nominal GDP growth rate of roughly 10%.

Headline inflation slowed to 7.7% YoY in October from a peak of 9.1% in June helped by base effects and a broad-based fall in commodity prices and other input costs. Manufacturing business prices, measured within the ISM survey, fell substantially in the past few months, usually a good leading indicator for the future path of inflation. Similarly, small businesses' price plans have

## The impact of tighter policy is reflected in the housing market



Source: Bloomberg

fallen sharply since the middle of 2022, also pointing to further substantial falls in inflation. Crucially, the recent slowdown in inflation rates has been broad-based rather than being driven by outliers. The Cleveland Fed's Trimmed-Mean inflation measure, which removes the most volatile components with the smallest and largest price changes, rose at the slowest monthly pace since April 2021 in October.

### Bond yields have peaked and are expected to fall further in the coming months

While we expect inflation rates to keep falling significantly over the course of 2023, the Fed is keeping up its hawkish rhetoric and aggressive tightening policy. Having fallen significantly behind the curve the FOMC is now trying to catch up with one of the steepest tightening paths in history. Given the usual lags for monetary policy to have a visible impact on economic activity and the fact the Fed puts a lot of emphasis on current inflation rather than expected developments, the likelihood of a policy error has increased substantially. The risk of a deeper than necessary recession is also reflected in the steepest inversion of the Treasury yield curve in more than four decades.

Further rate hikes are likely, but we don't think the Fed will be able or willing to aggressively tighten its policy once it becomes obvious that the economy is falling into a recession. On the contrary, we expect the Fed to start loosening its policy over the course of 2023 once the economy is contracting, and inflation is rapidly falling back from its elevated levels. Accordingly, we think that longer-term yields have peaked and are likely to recede further in 2023.

### Credit markets will be jolted out of complacency before a recovery takes hold

The US credit market seems most expensive to us among global credit markets as very little risk premium has been priced into credit spreads for a recession, with investor angst being primarily dominated in 2022 by interest rate risks.

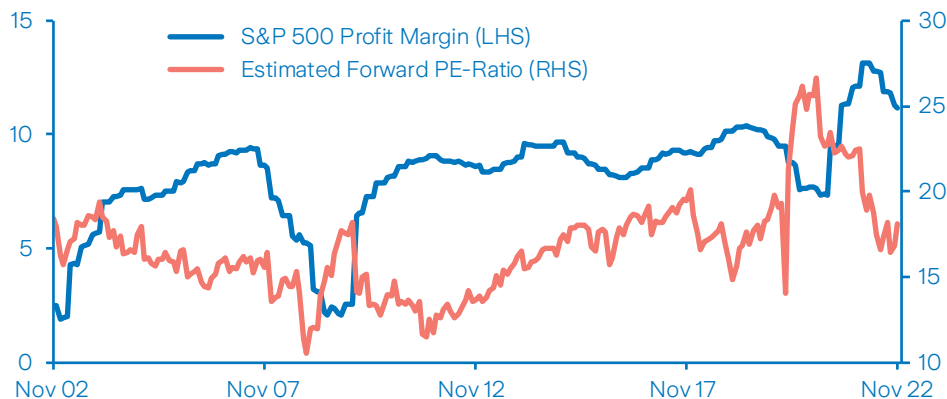
At a spread of 131bps, US Investment Grade credit is far away from a potentially recessionary spread levels of 250-300bps, while in a highly optimistic scenario of no recession, we see spreads having a maximum upside of tightening to a 90-100bp range. The situation in High Yield is even worse, with High Yield to Investment Grade

spread ratios at the lower side of historical data. Notably, at 450bps we believe the downside of 800-1000bps seen during typical recessions is underpriced, current strong balance sheet position notwithstanding. Indeed, stronger balance sheets are the reason why we expect default rates to have a shallower peak than during typical recessions, although the risks remain to the downside. The Fed's lending standards survey points towards a sharper peak in default rates. We are also concerned that the High Yield primary market has been largely shut this year, which is not a healthy sign, making us believe that once supply starts coming to the market, secondary spreads are likely to reprice wider.

US Asset Backed Securities are expected to see higher delinquencies as unemployment picks up, particularly in the subprime segment of the market. That said, senior tranches are likely to remain immune from higher defaults and delinquencies, and we expect spreads to tighten over the year although the beginning of the year is likely to see greater volatility. Municipal bonds are expected to be more resilient over the year as higher yields are likely to entice retail investors in a reversal of the trend seen in 2022 since municipal revenues are likely to remain less impacted by a recession.

Later in the year, however, we expect spreads to rally sharply as monetary policy eases while economic growth troughs. Rallies in credit tend to be sharper, especially at the

### Profit margins remain under pressure



Source: Bloomberg

beginning of a new cycle and we expect credit to outperform other assets in H2 2023.

### More headwinds for equities as margins remain under pressure

Falling bond yields have supported the equity market which has rebounded from their recent lows in October while fading supply chain disruptions and reduced price pressure will remove some of the factors that have weighed on equities in 2022. However, firms are increasingly reporting a deterioration in pricing power as consumers become more reluctant to spend. Profit margins have already started to fall from extraordinarily high levels and are expected to continue to do so as growth slows.

Further headwinds for the equity market are likely as investors shift from worrying about inflation to worrying about growth risks. Earnings estimates have continuously been adjusted to the downside in recent months but still look too optimistic given the looming recession. In light of the substantial drawdowns we saw in the stock market in 2022, a deterioration in profits is already priced in to some degree. However, history and recent corporate events suggest that markets will still fall further once the drop in earnings becomes real. We therefore expect the stock market to face a difficult first half of the year followed by a recovery once the Fed starts to move away from its very hawkish stance and an end to the looming recession becomes visible.

# UK

## Outlook

- The economy is likely to contract in the first half of the year before recovering
- Consumer spending continues to be weighed down by a substantial real income squeeze
- Inflation remains elevated but is expected to fall significantly over the course of the year

## Implications

- Bond yields are expected to fall further as the economic contraction broadens
- Credit markets will outperform global credit and end the year with spreads tighter
- UK stocks should benefit from their defensive qualities and are attractively valued

## Risks

- Inflation is stickier than expected forcing the BoE to tighten even more
- Negative feedback loops exacerbate the economic contraction
- Bond markets have stabilised, but political risks and volatility could flare up again

### The UK economy is in recession

The UK economy had been relatively resilient in the first half of 2022 given the numerous headwinds and a cooldown in global activity. Even the contraction in the third quarter was less pronounced than consensus expected, leaving the annual growth rate at 2.4%. Nevertheless, the economy is now in recession and is not expected to recover before the middle of next year. Business surveys have deteriorated substantially over the past few months and are now painting a bleak picture.

The Manufacturing PMI has been in contractionary territory since August 2022 and fell back to 46.2 in October and November, a post-pandemic low. Reflecting the deteriorating outlook, new order intakes declined at the fastest pace since May 2020. Key reasons for the fall in new orders are a weaker domestic market, already high stock levels at clients, subdued customer confidence and inflationary pressures. None of these are likely to disappear soon.

Service activity has been holding up better throughout the year but is now also showing signs of softening. The Services PMI dipped into contractionary territory in October for the first time since early 2021 and stayed there in November. While increased international travel and the weak pound supported export sales, the slowdown in global economic conditions as well as ongoing Brexit-related trade frictions weighed on activity.

### Wage pressure remains an issue, but the labour market is showing signs of cooling

While the labour market remains very tight, there are signs of a weakening environment. In October, the manufacturing sector reported job losses for the first time since December 2020, reflecting redundancies, cost control measures and difficulty in both recruiting and retaining staff. Meanwhile, hiring remained solid in the service sector mostly because of backfilling vacancies but the rate of job creation was the slowest since March 2021. This was partially due to a

weakening economic outlook but also due to ongoing difficulties filling open positions. These challenges continue to weigh on some sectors and have led to a modest rise in backlogs of work, which may help to mitigate the impact of the looming recession on employment and activity.

Although price pressures have eased, input costs remain an issue for many companies. Nevertheless, service companies reported the slowest pace of input cost inflation since September 2021, helped by reduced freight rates and softer raw material prices. Wages on the other hand are still a major driver of input costs as tight labour market conditions and difficulties in retaining skilled staff remain a challenge. Brexit-related frictions exacerbated companies' hiring challenges, but the expected growth slowdown will remove some of the tightness as hiring activity is likely to slow in the coming months.

### Consumers are facing a substantial real income squeeze

The deteriorating outlook for the economy and the labour market will weigh on consumer spending. Consumer sentiment dropped to the lowest on record in September and has only marginally recovered since then. Households are facing a substantial real income squeeze as wages do not keep up with high inflation. While consumers could dip into their excess savings in the aftermath of the pandemic, savings ratios have continuously fallen and are now basically back at pre-pandemic levels. We expect inflation rates and cost pressure to ease over the course of 2023, but household spending will still be weighed down by the erosion of purchasing power caused by high inflation. The average UK household will also feel the impact of higher mortgage rates as existing contracts will have to be renewed at higher rates. The effects of tighter monetary policy are already visible in the housing market. The number of mortgage approvals has fallen markedly, and house prices recorded the biggest monthly drop

since 2011 in October, excluding the lockdown period in May and June 2021. Although house prices were still 7.2% higher than a year ago this is a substantial slowdown from the peak of 14.3% YoY observed in March 2022, the sharpest annual price rise since 2004.

The government's energy price cap has partially protected households from the jump in energy prices, but as announced in the Chancellor's Autumn Statement, the cap will be lifted in April 2023. This will affect household spending as consumers face another wave of rising energy prices. Tax increases on the other hand will mostly hit wealthier households, which is unlikely to have a substantial impact on consumer spending.

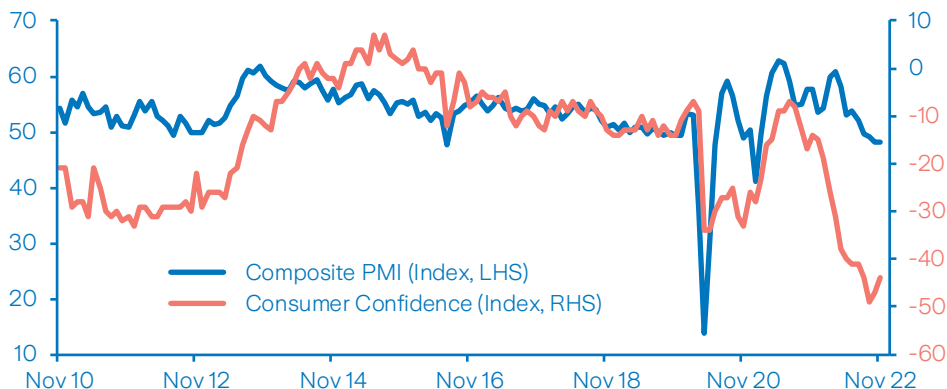
### Inflation is stubbornly high but will fall back substantially in 2023

Inflation rates soared to the highest in four decades with headline inflation accelerating to 11.1% YoY in October, and while core inflation is more muted at 6.5% YoY it is still significantly above the BoE's target. Energy costs have been the key driver of higher inflation, but service inflation has also picked up steam and although there are no strong indications of a looming wage-price spiral, the elevated risks keep the pressure on the BoE to act. The BoE is expected to keep tightening policy despite predicting an extended recession as inflation remains stubbornly high. However, the recent rate hike was not unanimous, with two members voting for smaller increases, revealing a developing dovish countertrend within the Monetary Policy Committee.

Importantly, the BoE pushed back against market expectations regarding the scale of future rate increases, signalling a lower terminal rate than investors expect. While inflation will likely remain above target throughout 2023, we expect clear signs of substantial falls as the economy contracts, the labour market softens, and the pound stabilises following the volatile periods in



## Business and consumer sentiment have deteriorated significantly



Source: Bloomberg

recent quarters. This will allow the BoE to end its tightening cycle by the middle of 2023.

### Bond yields are expected to fall further in the coming months

Longer-term yields have fallen substantially from the elevated levels they reached in the aftermath of Kwasi Kwarteng's mini-budget, which was built around substantial unfunded tax cuts that spooked financial markets. In late November, gilt yields fell back to pre-budget levels as the new government was able to calm markets down based on their goal of getting public debt to fall as a share of GDP. In the coming months we are likely to see a tug of war between inflation and recession worries but we expect the latter to gain momentum and yields to recede further from their current levels.

### Credit should stay supported, albeit the path to recovery will be a rocky one

Sterling credit markets are pricing in significant risk premiums, and we believe largely discounting the recession. Consequently, we expect spreads to end the year tighter, although Q1 is likely to be more volatile.

Sterling credit spreads are even wider than European credit spreads, which we think offer an attractive entry point. However, it is worth noting that the credit quality is slightly weaker, which together with the vulnerability of banks to a weaker housing market and a cost-of-living crisis is likely to cause a slow recovery in spreads, with some volatility probable in the earlier part of the year as investors grapple globally with pricing in a recession.

The cost-of-living crisis with higher mortgage rates and energy costs, along with a deteriorating macro outlook is likely to weigh on house prices and mortgages. While this should impact bank earnings somewhat, the impact is already priced into credit spreads and we expect the impact on banks to be manageable as long as the downturn is not worse than expected, with knock on effects on the housing market. We expect Asset Backed Securities, especially Residential Mortgage Backed Securities (RMBS) to remain under pressure in 2023, with spreads volatile and likely to end close to the current high levels.

### Expected stock market returns are modest despite attractive valuations

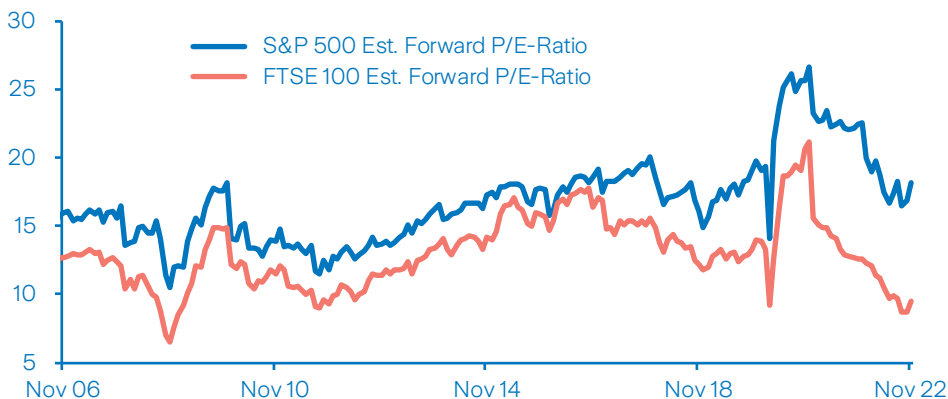
Considering the turbulences observed in many other markets, the UK equity market has been remarkably resilient in 2022. The intra-year maximum peak-to-trough drawdown was around 13%, significantly below other regions. By the end of November, the FTSE 100 was almost at the same level as at the beginning of the year, a substantial outperformance relative to many of its peers. The S&P 500, for example, was almost 17% lower with a peak-to-trough drawdown of more than 27%. The weaker pound played an important role in this, however. Measured in USD terms the FTSE 100's outperformance of the S&P 500 since the beginning of 2022 shrinks to 4%. Sterling's impact can also be seen in this year's relative performance of the FTSE 100 against the FTSE 250, which reached more than 30% at some point before falling back. The small and mid-sized companies in the FTSE 250 suffered much more from the weaker currency than larger, more internationally positioned firms in the FTSE 100.

The high share of more defensive sectors in the FTSE 100, and particularly energy, have been less volatile in 2022, helping the UK's main index to outperform many other regions. This is likely to continue if the US falls into a recession in the first half of next year, which is still not fully reflected in earnings estimates. In the second half of 2023, we expect the Fed to cut its policy rates, which should support the US stock market and would

reduce the relevance of the UK markets defensive qualities. Nevertheless, the FTSE 100's valuation has fallen to multi-year lows and the gap to other equity markets has widened further making UK stocks attractive, particularly for longer-term investors.

Weak sterling boosting earnings in local terms played a big part in this as did energy companies' soaring profits in the aftermath of the Ukraine war. Corporate earnings are expected to come under pressure, however, once the economic contraction broadens. Given ongoing headwinds for the global economy, expected returns for 2023 are therefore rather modest.

### UK stocks haven't been this cheap since the financial crisis



Source: Bloomberg

# Eurozone

## Outlook

- The energy crisis means recession early in 2023 and a slow recovery thereafter
- Governments will provide some offsetting support, but not on the scale of Covid relief
- Headline inflation to fall back sharply, but core inflation will remain sticky

## Implications

- Core bond yields to ease back, before stabilising at lower levels
- Investment Grade credit is priced for recession and set to outperform High Yield and US credit
- Corporate profits will fall sharply, dragging down the region's equity markets

## Risks

- The geopolitical situation gets even worse
- Continued high inflation leads to substantially higher wage demands
- Winter is unusually cold, increasing energy demand

### Recession straight ahead

The energy crisis provoked by the Russian invasion of Ukraine is likely to lead to recession over the winter months in the Eurozone (i.e. Q4 2022 and Q1 2023) and also to constrain the economic recovery thereafter.

Record high inflation is already impacting households' real spending power, while the threat of rationing of gas for certain industrial sectors is depressing overall business confidence and investment and hiring intentions.

However, we do eventually see light at the end of the energy crisis tunnel. The EU has taken significant steps towards achieving energy independence from Russia, reducing dependence on Russian gas from 40 % of total EU consumption before the invasion of Ukraine to less than 10% currently. In December, the EU will further reduce its dependence on Russian energy by severely limiting the import of oil from Russia and subjecting it to a punitive price cap.

At an EU leaders' summit in Versailles on March 10-11, it was agreed to eventually phase out EU dependency on Russian gas, oil and coal imports completely by reducing overall reliance on fossil fuels, further developing an EU hydrogen market and accelerating the development of renewables.

### This winter and the next will be the most difficult

Although investment in alternative sources of energy is accelerating, we anticipate this coming winter and the next one will still be difficult and may require some rationing of gas. However, a lot will depend upon the weather. A much milder than normal winter season (as we have seen so far) may not require much need for gas rationing at all, but a more severe than normal winter could require substantial rationing. Either way, by the end of 2024 we think that energy independence from Russia will largely have

been achieved and that there will no longer be much risk of gas rationing.

### A shorter than normal recession

Overall, we expect negative annual growth in the Eurozone in 2023 of -0.4%, with negative quarterly growth in Q4 2022 and Q1 2023, and then a modest recovery thereafter. The silver lining is that in terms of duration this would be a modest recession. To put a two-quarter economic contraction into context, the COVID-19 induced Eurozone recession during 2020 and 2021 saw four quarters of negative growth overall. The 2011 to 2013 Eurozone debt crisis saw GDP decline for six consecutive quarters. Before that, the Eurozone saw four consecutive quarters of contraction during the 2008/09 Global Financial Crisis.

The bad news is that we expect the recovery from this recession to be less strong than is normally the case because there will still be a need to control gas usage ahead of the 2023/24 winter, and because we expect global economic conditions, in particular a recession in the US, will weigh on the Eurozone as well.

### Fiscal response likely, but less than during the Covid crisis

There has already been a substantial fiscal response to the energy crisis. Most measures announced so far by national governments have comprised energy price caps and subsidies for households and small businesses. In 2023, further such support as well as the restarting of short-time working schemes could be announced. At an EU level, further common debt issuance, similar to the NGEU and SURE funds, could also be in play depending upon how severe the recession is.

However, with the bond market 'vigilantes' back, there will be limits to the fiscal support that governments can provide. For example, in Italy even with a new more radical government, the extent of extra fiscal spending is likely to be limited because of

the need to maintain the confidence of bond market investors. Indeed, the budget announced in November by the new centre-right coalition government left out many of the more radical spending proposals it had made during the election campaign.

### Record high inflation should fall back

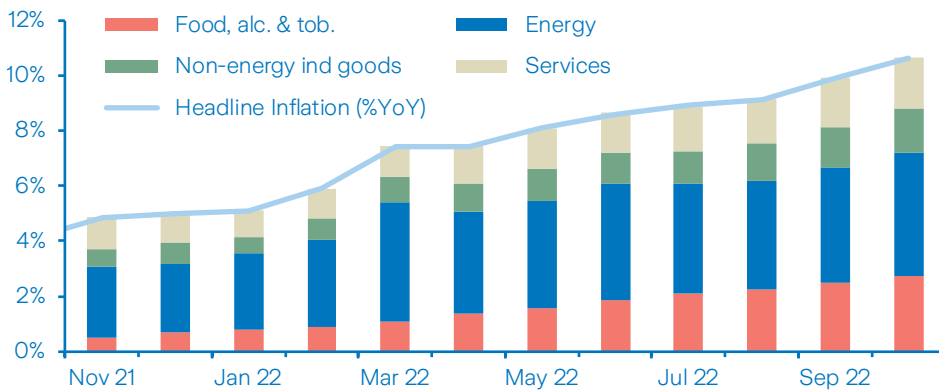
In 2022, Eurozone inflation hit fresh record highs on an almost monthly basis, entering double-digits towards the end of the year. We expect headline inflation to fall back in 2023, possibly very sharply once the winter is over. Currently, around two-thirds of headline Eurozone inflation is due to energy and food prices. Favourable base effects in 2023 are likely to reduce this contribution considerably, especially from energy prices. However, core inflation also rose sharply in the Eurozone in 2022, from around 2.5% at the beginning of the year to around 5% by the end of 2022. Core inflation could prove stickier in 2023 than headline inflation as it tends to be driven more by wage growth, which we anticipate will stay high.

### But the ECB's policy dilemma will remain acute

As the ECB itself has pointed out, there is little that it can do to control energy or food prices. However, it is trying to control inflation expectations to prevent high headline inflation rates from becoming engrained in the economic system and a wage-price spiral developing. Wage growth is currently running at around 3-4% YoY in the Eurozone, higher than in recent years, but nowhere near the level of headline inflation. However, we expect a similar pace of wage growth in 2023, which will keep core inflation high and the ECB on edge.

Overall, we expect the ECB will raise the deposit rate by 50bps to 2% in December 2022 and will only proceed with modest further rate hikes in 2023 before staying on hold as the recession takes centre-stage. However, it may also start to modestly reduce its balance sheet in 2023 (i.e. start Quantitative Tightening)

## Energy and food are the biggest contributors to Eurozone inflation



Source: Eurostat

### Core government bond yields set to fall back

The combination of falling headline inflation and weak growth should lead to a gradual decline in core government bond yields in 2023, though the decline will be limited by still high core inflation and a central bank that is likely to maintain a hawkish tilt. Overall, we expect German 10-year Bund yields to trade in the 1-2% range through most of 2023.

We expect periphery spreads to remain rangebound, trading broadly around their current levels. A weak macro environment and hawkish ECB will probably prevent spreads from tightening substantially, while governments will also be careful not to lose bond market confidence through overly aggressive fiscal policy.

### European Investment Grade credit is set to outperform High Yield and global credit

In contrast to US credit markets, European Investment Grade credit has been pricing in a recession for quite some time, with spreads having widened to within 15bps of the peak reached during the Covid crisis. We believe the market was leading the pricing in other markets to the downside, with stocks, High Yield and US credit relatively complacent so far. While spreads have tightened notably since the peak, we think the risk-reward ratio remains better in European Investment Grade than many other assets. While we expect some volatility in Q1 before an eventual recovery later on in global credit markets, we would be more cautious on High Yield from this perspective.

High Yield to Investment Grade spread ratios are almost as tight as they can get and we believe the risk in High Yield is underpriced as default rates are expected to rise given the recession, and a tightening of financial conditions in general, including a shutdown of the primary markets and tighter lending standards as indicated in the ECB's lending survey. The anticipated Quantitative Tightening by the ECB will also be a negative development for credit markets, which is another spread risk likely to impact not only High Yield spread evolution but also Asset Backed Securities. Despite wider spreads, we expect Asset Backed Security spreads to end 2023 unchanged on a spread basis as house prices are expected to decline and a recessionary environment will cause delinquencies and defaults to rise.

Covered bonds are likely to be a key funding tool for banks, especially after prepayment of TLTRO loans, and hence are likely to witness elevated supply. Higher yields and the safety of covered bonds is likely to entice investors and we expect spreads to have lower volatility than corporate credit and end the year with spreads modestly tighter.

### Equities are vulnerable to declining profits as recession bites

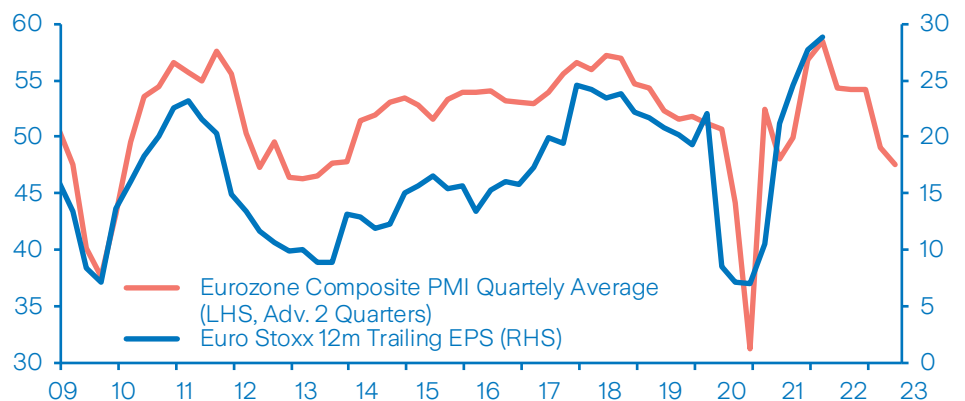
Eurozone equity markets are likely to see a year of two halves. We expect to see declines in the first half of 2023 as the recession hits company profits, but a rebound in Eurozone equities in H2 as the economy recovers and growth stabilises. However, a weaker than usual rebound from recession could limit the upside potential for Eurozone equities. We think the extent to which Eurozone corporate profits will be vulnerable to a slowing economy, especially early in 2023, is currently under-appreciated by the market. However, a lot will also depend upon how the geopolitical situation plays out. An end to the war, or at least a ceasefire and negotiations, could lead to a substantial move up for risk assets in Europe at some point during 2023.

We remain most cautious on those countries that traditionally have been most dependent on Russian gas. Of the big four economies, this would make German equities the most vulnerable. Italy has traditionally been very dependent on Russian gas but has been relatively successful in quickly switching to alternative sources. The ongoing reforms as part of the NGEU initiative should also help

improve structural growth in the Italian economy and could lead to its stock market outperforming Germany's, especially if, as we expect, the new government turns out to not be as radical as feared.

More generally, equity markets with large banking sectors such as Italy and Spain could see outperformance on a relative basis to other Eurozone equity markets as structurally higher interest rates should help improve financials' profitability over the medium term, even if credit quality will suffer because of recession in the near term.

### Business surveys point to sharp declines in corporate profits



Source: Bloomberg

# Germany

## Outlook

- The German economy will struggle over the winter months and during the rest of 2023
- The government's fiscal space will help offset some of the impact of the energy crisis
- Higher wage and energy costs will challenge the traditional German industrial model

## Implications

- Profitability in the corporate sector will suffer, impacting equity market performance
- Lower inflation and weak growth should depress Bund yields in 2023
- A return to negative yields is unlikely, however, with the ECB still likely to have a hawkish tilt

## Risks

- A cold snap leads to the need for rationing of gas over the winter months
- The combination of higher energy and wage costs leads to deindustrialisation
- The crisis in Ukraine escalates even more

### Winter is still coming

Germany is at the centre of the current European energy crisis as its economy is one of the most dependent upon Russian energy supply, especially natural gas. Before the Russian invasion of Ukraine, around 55% of natural gas consumed in Germany was imported from Russia. Furthermore, the German industrial sector was a big consumer of Russian gas, whereas in many other European countries gas was used more by households for heating purposes than directly by industry. The two most intensive industrial users of natural gas are the chemicals and metal sectors, both important German industrial sectors.

Indeed, German business confidence has already taken a substantial hit because of the energy crisis and this will impact companies' investment and hiring intentions. The closely-watched German ifo survey of 7,000 businesses fell sharply over the course of 2022 and is currently consistent with a very sharp fall in business investment in 2023.

Admittedly, Germany has already managed to reduce its use of natural gas from Russia substantially by tapping alternative energy supplies and through some 'self-rationing' and lower consumption by industry and households. Germany is also moving quickly to build offshore LNG terminals to ease the delivery of alternative supplies of gas. The nuclear power stations currently operating in Germany will also be maintained for longer, instead of being wound down by the end of 2022 as was the previous plan.

Gas reserves are close to full capacity helped by the unusually mild weather so far heading into winter. Nevertheless, depending upon how severe the rest of the winter is, rationing of gas could still be necessary, which would likely severely impact industrial output. What's more, after this winter is over, there will still be the need to build up gas reserves again ahead of the 2023/24 winter.

Rebuilding gas reserves in 2023 could be more problematic than it was in 2022. Recall that Russia only cut off the gas supply via the Nord Stream 1 pipeline in June, after gas reserves had already been built up substantially in Europe. Next year, assuming the Nord Stream 1 pipeline remains shut, it will be harder to build up gas reserves ahead of the 2023/24 winter.

The upshot is that even after Germany makes it through the 2022/23 winter, the energy supply and economic situation could still be difficult during the remainder of 2023, unless there is a substantial improvement in the geopolitical situation next year that allows the supply of Russian gas to resume.

### Spend, spend, spend

Fortunately, Germany, unlike many other countries, has a lot of fiscal space to support its economy. The government debt-to-GDP ratio of around 70% is still low compared to most other advanced economies, so it can spend significant amounts to support households and businesses through the energy crisis. Indeed, in 2022 it has already announced a significant amount of extra government spending that will help soften the economic blow caused by the energy crisis.

In late February, shortly after the Russian invasion of Ukraine, German Chancellor, Olaf Scholz, announced an additional EUR 100bn of spending on defence over the next five years on top of the regular defence budget, made available through a special emergency fund.

Then, in September, the German government announced a EUR 200bn (around 5% of GDP) support package for households and businesses financed from the Economic Stabilization Fund (ESF) set up during the Covid crisis. The spending package included a price cap on the gas and electricity bills of households and some businesses and even refunding the December 2022 gas bill for many households and businesses (the

so-called 'free December') as well as many other support measures.

Interestingly, the package was announced just a few days after the September 23 mini-budget in the UK that saw a sharp rise in UK gilt yields in response. For Germany, however, there was no such response to its fiscal stimulus plans, demonstrating its much greater credibility with bond market investors. Such fiscal space is important and will help to reduce the impact of the energy crisis on the German economy.

### But don't break the rules

How has Germany managed to announce such significant spending increases within the framework of its famous debt rules, which are part of the constitution? The so-called debt brake rule ('Schuldenbremse') was enshrined in the German constitution in 2009 and committed the federal government to not run a structural budget deficit that exceeds 0.35% of GDP in any one year, unless there are exceptional circumstances. An exemption was passed in parliament in 2020 and 2021 because of the COVID-19 emergency, allowing the government at the time to finance significant additional spending. The 'traffic light' coalition government formed in autumn 2021 agreed to re-introduce the debt brake, but only in 2023, with 2022 also being classified as an exceptional year.

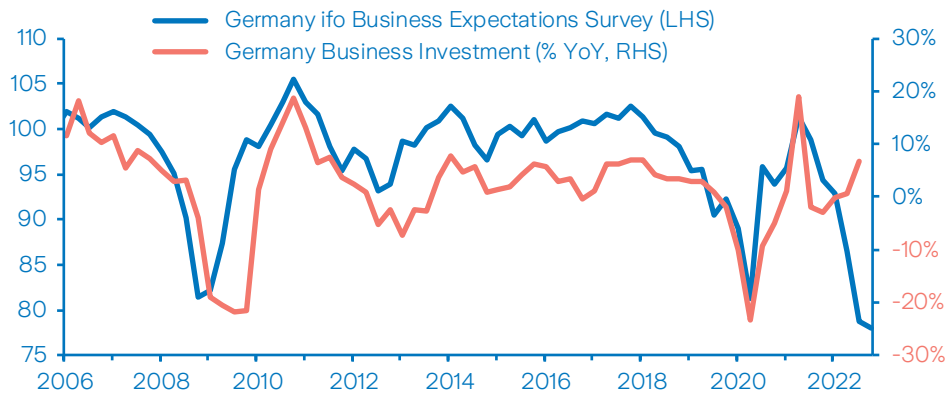
In addition, the new government tweaked the calculations behind the debt rule so that the time at which the special funds were provided is now decisive in determining if they can be classified as exempt from the debt brake rule, rather than the time at which the funds are actually spent, which was the case previously.

### More government spending could make the ECB more hawkish

The extra spending will help dampen the economic impact of the energy crisis in 2023, but it will not be able to completely eliminate it and Germany is still set for recession,



## The ifo survey points to sharp falls in business investment



Source: Bloomberg, Note: Q4 2022 ifo Business Expectations is average for Oct. & Nov.

though with the weather a key variable in how severe it will be. One unintended consequence of the extra spending, however, is that it could make the ECB more hawkish, effectively 'crowding in' rate increases and monetary tightening by the ECB.

### Inflation is in double-digits

Indeed, inflation in Germany and elsewhere in the Eurozone remains a significant problem. German headline inflation more than doubled over the course of 2022 from an already high 5.5% in January to around 11% by the end of the year.

### Wages are also picking up

Wage deals have also become more generous over time. In November 2022, the influential metal-workers union, IG Metall, agreed to a wage deal with employers that meant workers will get a 5.2% increase in salaries in June 2023 and a 3.3% increase in May 2024, plus two EUR 1,500 tax-free payments by February 2023 and February 2024 respectively. Including these additional one-off payments and some other adjustments, this is effectively around a 6% pay increase in 2023 and around a 4% pay increase in 2024. Earlier in the year, the German chemical workers union agreed to a pay increase with employers of 3.25% for both January 2023 and January 2024, plus some additional one-off cash payments. In the public sector, where the collective bargaining round is likely to start soon, labour unions have demanded a wage hike of 10.5%. Though the final deal is likely to be lower, this could be yet another example of higher wage growth in Germany.

### Higher wage growth will be another concern for the ECB

While not as high as headline inflation, significant pay increases are unlikely to be viewed positively by the ECB as acceptable from an inflation perspective. Together with large amounts of fiscal stimulus, this is another development in Germany that could be seen as crowding in further monetary tightening by the ECB, and thereby affecting the rest of the Eurozone.

### German industry is facing a competitiveness problem

The higher wage deals are also in sharp contrast to the pay restraint seen in the early 2000s during the time of the Hartz labour market reforms that helped revitalise the German economy and its industrial sector by

making it more competitive and also helped bring the unemployment rate down. Indeed, higher wages, combined with what are likely to be structurally higher energy costs as Germany reorients away from cheap Russian gas to more expensive alternative supplies such as LNG, could impact the German industrial sector significantly by reducing corporate profitability and competitiveness in the medium term.

While fears over a wave of de-industrialisation are probably overdone, the German industrial sector is likely to face significant challenges over the next few years from a profitability and margins perspective, and this is one of the reasons why we are cautious on the German stock market on a relative basis compared to many other equity markets in the Eurozone.

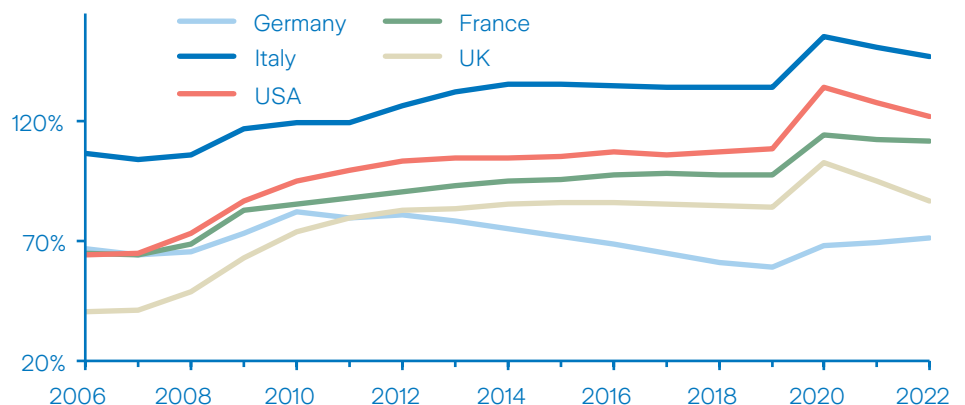
### Bund yields to fall back, but stay positive

In terms of German government bonds, we think the era of negative yielding Bunds is now over as the ECB is unlikely to return to its Zero Interest Rate Policy (ZIRP) anytime soon. However, we think Bund yields can fall back somewhat from current levels given that we expect both growth and inflation to fall in 2023 compared to 2022 and think that the ECB will ultimately be on hold through most of next year, even if it has a hawkish bias. Overall, we expect 10-year Bund yields to trade in a range of 1-2% through most of 2023.

## German equities are likely to underperform on a relative basis

As explained earlier, we are cautious on the German equity market, especially in the first half of 2023 and relative to other Eurozone equity markets. We think the extent to which many German companies are now operating on a new playing field, with structurally higher energy and wage costs that will impact corporate profitability, is being underappreciated by investors. German industry has shown its ability to adapt before, but the process of transition could be painful. German equities also tend to be highly cyclical and are therefore exposed as we go into what we expect will be a global slowdown and recession in 2023.

## Germany's government debt to GDP ratio is lower than peers



Source: Bloomberg, IMF

# Switzerland

## Outlook

- The economy is expected to be resilient, avoiding a recession in 2023
- Inflation should peak in early 2023, with domestic price pressures remaining benign
- Further rate hikes are expected from the SNB, along with targeted currency interventions

## Implications

- Bond yields set to remain rangebound, with upside to yields limited from current levels
- The Swiss franc should remain in demand and supported by the SNB

## Risks

- Disruptions to the energy supply
- A deeper and more disorderly Eurozone crisis
- An unexpected and disruptive shift in SNB policy

### **The mix between growth and inflation is favourable compared to the rest of Europe**

The Swiss economy has been resilient this year, with solid domestic demand and benign inflation. Private consumption has been notably strong, boosted by pent-up demand for services and a healthy labour market. Exports have also held up well, as manufacturers benefit from improving supply conditions, while a highly differentiated and diverse export mix remains in high demand. Investment and construction activity have been more mixed given headwinds from still elevated uncertainty and rising mortgage and funding costs. While businesses continue to invest in machinery and equipment, construction investment is contracting.

### **Softer growth over winter, but a recession should be avoided**

While recession is imminent in large parts of Europe, the Swiss economy is expected to continue to expand in 2023, albeit at a well below trend rate of around 0.8%, down from a projected 2% in 2022. The economy is less dependent on natural gas, the share of gas in energy consumption in Switzerland is roughly half of that in the Eurozone, and rationing of energy is not anticipated. That said, weak conditions in the Eurozone will have an impact on the Swiss economy given strong trade and economic linkages, and we suspect that growth will stall during winter, before recovering.

### **Household finances are healthy, underpinning domestic demand**

Another difference compared to most other European countries is that household purchasing power has held up much better, given more modest price rises, and savings are strong. This gives the household sector a resilience which should support domestic spending. The labour market is also in good shape, with the unemployment rate at a multi-decade low, and businesses continue to report that they are seeking to expand their workforce. While job growth should slow over the coming year, the deterioration is likely to

be modest and coming from a high level. Although private consumption growth should slow compared to its post-pandemic boom, we suspect that spending will be resilient, helping to offset some of the weakness coming from external demand.

### **Inflation will stay benign, despite rising energy costs**

CPI inflation continues to undershoot levels in the rest of Europe, and we expect it to stay relatively benign at 2.3% in 2023, down from 3% in 2022 (average annual CPI inflation), with Core CPI now back below 2%. Large energy price hikes will likely cause inflation to reaccelerate in early 2023, but domestic price pressures are modest, and a stronger franc will limit imported inflation, which underpins our view that inflation will peak in early 2023. While Swiss inflation has picked up strongly from its long-run historical average of around 1%, the divergence vs. the rest of Europe, which is struggling with double-digit inflation rates, is striking. A key reason for this is that energy makes up a smaller share of consumption. In addition, energy costs have not risen as much, given lower gas dependency and a relatively high supply of domestic and renewable energy sources. That said, wage growth, which was tracking at around 2% annually in the first half of 2022, has roughly doubled compared to its pre-pandemic rate. Although this is not enough to push inflation materially higher from its current level, there is a risk that wage growth edges higher, strengthening price pressures generated within the domestic economy. This is one of the reasons why we expect the SNB to maintain a hawkish stance throughout the year.

### **The SNB is not done tightening**

The Swiss National Bank hiked rates by a total of 125bps in June and September, lifting the policy rate into positive territory for the first time since 2014 and ending the era of negative rates in Europe. While the pace of rate hikes has lagged behind that in most other regions, the SNB is also relying on FX

interventions to strengthen the franc, which they no longer consider strongly valued. Looking forward, we suspect the SNB will continue to use a combination of rate rises and FX interventions to slow the economy and bring inflation down. Given this, we forecast that the policy rate will peak at around 1.5% in the first half of 2023, up from the current level of 0.5%. This implies a slightly steeper rate path than what is currently priced in markets, with some further hikes both this year and in early 2023, but a peak rate that is still well below that of most other regions. The SNB may well cut rates towards the end of 2023 or in early 2024, though the outlook is highly dependent on ECB policy.

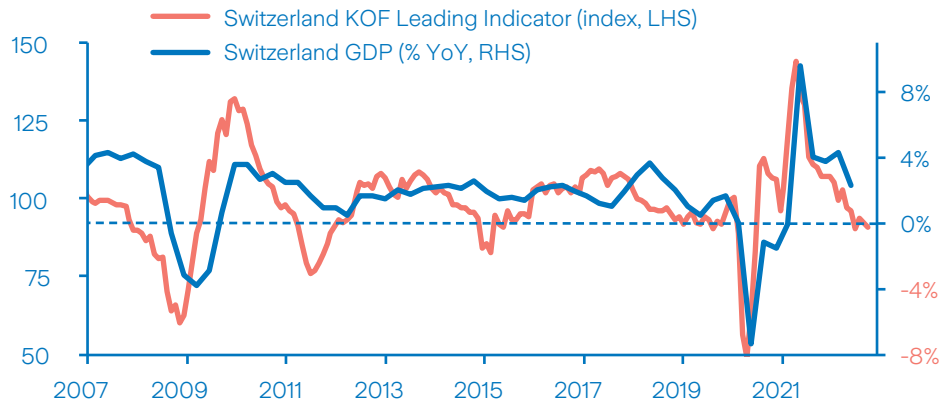
### **Upward pressure on the franc is likely to persist**

The SNB has shifted its long-held view that the Swiss franc is highly valued and is now relying on currency appreciation as a tool to limit inflation. A key reason for this change is that Swiss prices are rising at a much slower pace than elsewhere. This has reduced the real exchange rate – the price of Swiss goods and services relative to those in the rest of the world – justifying a stronger nominal exchange rate. We suspect that there is also a desire to limit the risk of a sharp and potentially disruptive currency depreciation, given aggressive tightening in the rest of the world. Indeed, currency market interventions to strengthen the franc appear to have been material in the second half of the year. Sight deposits held by domestic banks at the SNB, which can be used as a proxy for FX interventions, have fallen by 20% since the June policy meeting, at the same time the nominal exchange rate appreciated by 5% against a basket of currencies.

### **While the economy is resilient, the SNB takes a hit to its balance sheet**

While the economy is resilient, the SNB reported an interim loss of CHF 142bn for the first three quarters of 2022 as its foreign currency positions suffered heavy losses

## Below trend growth, but recession not expected



Source: Bloomberg

amid rising global interest rates and falling stock prices, with moves amplified by the stronger franc. The loss, which was the biggest in the SNB's history, did not come as a surprise given the central bank's large foreign currency exposures, and high share of risk assets in its portfolio. The loss will likely reduce payouts to the federal government and cantons in 2023. We do not expect the SNB to adjust its monetary policy in response to this, but it may rekindle a discussion around the SNB's large and potentially risky balance sheet.

### The housing market is resilient, but construction activity is weakening

Despite a rise in mortgage rates and the reactivation of the countercyclical capital buffer, housing market data show that prices and activity have held up well so far. The house price to rent ratio has risen further, remaining elevated compared to a historical average. Despite the strong economic recovery, house prices are also stretched relative to household income and mortgage lending continues to rise. We suspect the strength of the housing market reflects on the still favourable economic backdrop, with unemployment at historical lows and household finances in good shape, and with the supply of housing constrained. Looking forward, we suspect these factors will remain supportive for the housing market.

That said, construction investment has slowed sharply. While this is a drag on growth, it appears to partly reflect a lack of capacity within the sector, and we suspect conditions will stabilise over the coming year.

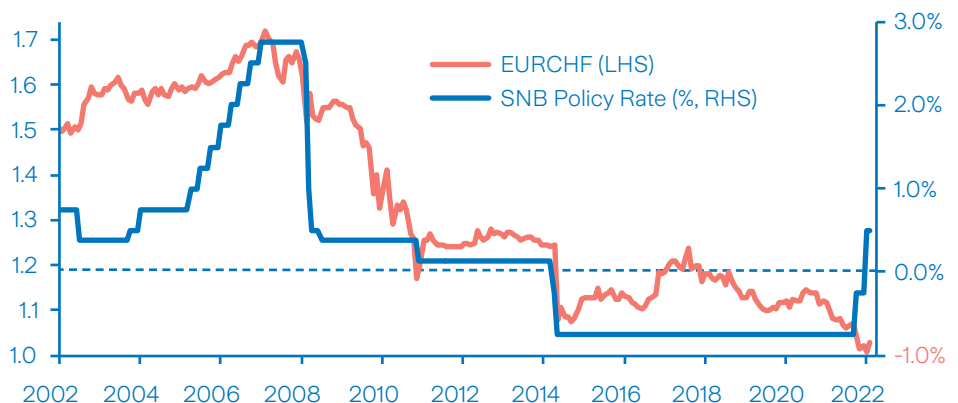
### Swiss government bond yields should remain stable and in positive territory

By the end of 2021, before the Ukraine war and the European energy crisis, Switzerland's entire government bond market traded with negative yields. Since then, the entire curve has turned positive, with the 50yr yield up from -0.13% to close to +1%, and similarly for the 10yr yield. While this is a significant—and fundamentally positive—shift, the surge in yields has lagged that in most other regions, mainly reflecting the relatively benign inflation picture and lower peak policy rates. Spreads between Swiss Confederation and German Bund yields, which had become increasingly compressed over the past decade as the SNB approached the lower bound on interest rates, have consequently widened sharply, returning to levels last seen before the

Eurozone crisis. To some extent, this helps to restore the SNB's ability to set its policy independently of ECB action.

Looking forward, we expect Swiss yields to stay relatively low, tracking at around 1% for the 10yr maturity, both reflecting the benign inflation backdrop and the strong fiscal position. Government debt is close to 40% of GDP, only modestly higher than the pre-Covid period, with the fiscal deficit projected to close in 2023. Fiscal strength and manageable borrowing costs should consequently contribute to the broader economic resilience that we anticipate for the year ahead.

## The end of negative rates



Source: Bloomberg

# Japan and South Korea

## Outlook

- Japan's consumption will benefit from re-opening and tourism, while inflation will dampen confidence in early 2023
- Inflation is expected to creep higher in Japan in Q1 to fresh 40-year highs, but recede later in 2023
- South Korea's economy will be hit by falling tech exports and household income

## Implications

- Japan's equity market is likely to meander sideways before picking up steam later in 2023
- Credit spreads should stay supported in Japan as the default outlook is benign, despite some volatility in Q1
- Japan's government bond market should stay resilient unless Yield Curve Control (YCC) is given up too early

## Risks

- A resurgence of Covid spoils the re-opening party both in Japan and South Korea
- The new Bank of Japan leadership switches to a more flexible monetary policy without preparing market participants in time
- Tensions with North Korea escalate

### Japan avoids sliding into a recession

In 2021 and 2022, consumer confidence as well as retail sales and services consumption were clearly correlated with the various Covid waves, a pattern that is likely to be repeated should Covid not be brought under complete control. Increasing inflation, though far lower than overseas, has become a concern for Japanese consumers, as they had become accustomed to very low inflation or even deflation over the last decades. With this in mind, consumer sentiment is likely to remain very volatile.

However, we note that the current travel discount offers, financed by public subsidies, are helping, and in conjunction with the latest surge in inbound tourism, major segments of the services sector should benefit. An expected drop in imported inflation would also support purchasing power. We acknowledge that these impacts may support and possibly stabilise consumption in the short term, while longer-term concerns about Japan's pension system and deteriorating demographic situation will continue to linger and would suppress any consumption boom.

Capex is likely to remain solid in 2023 due to the continuous need to invest in 'green' and 'digital' transformation, however, overall capex may soften in line with slower exports. Japan's exports will suffer from lower foreign demand due to our expected recession forecasts in the US and Europe. However, increased inbound tourism, categorised as services exports, will help to keep overall exports more or less stable.

### Current high inflation is unlikely to persist

Core CPI inflation (excluding fresh food) moved from negative territory to a 40-year high of 3.6% in November 2022 (Tokyo). A cut in mobile phone charges, implemented by the regulator, negatively impacted the CPI print in 2021 and early 2022 but will have no impact in 2023. We expect core CPI to peak in the first half of 2023 close to 4%, but to recede in late 2023 to slightly above 1%, as

energy and imported commodity prices will fall (a topic we discuss in our Inflation Focus Q4 2022). Meanwhile, we expect wages to increase from below 1% in 2021 to around 2% in 2023, which would be in line with policy targets.

### The Bank of Japan is expected to keep monetary policy stable under its new Governor

There has been speculation that the Bank of Japan will change its current monetary policy stance when BoJ Governor Kuroda and his deputies' terms end in spring 2023. We tend to disagree and believe that the new Governor will focus on the stability of monetary policy before undertaking a thorough policy review.

The new Governor will start at a time when the inflation rate may already be in the process of peaking. We note that though core inflation rates are still inching higher after having reached a 40-year high in November 2022 in Tokyo, the PMI for input prices has already topped out, an early indication that overall inflation is likely to peak with a lag. Were Japan's inflation rate to peak at around 4% and then creep lower towards 1%, chances are slim that any drastic change in monetary policy would take place under the new Governor.

What still seems likely is that some smaller adjustments could be made to cautiously enter a new 'normalisation' regime over time. For example, the current +/- 25bp band around the zero target for the 10yr yield may be expanded to +/- 50bps. We also believe that Yield Curve Control (YCC) is unlikely to be abolished already next year. Only if the new Governor were to push for a quick policy review and then conclude that YCC needs to be tweaked, the central rate may be moved from zero to 25bps, while keeping the +/- 25bps range.

### Fiscal policy is likely to be less expansive

In 2022, two fiscal packages were introduced in April and October, with the latter

underpinned by substantial government bond issuance. Both packages were intended to counter high living costs due to rising energy and food inflation as well as green and digital transformation. With both the LDP leadership elections and the national elections only due to take place in 2024 and 2025, respectively, there is currently no urgency to announce new major packages purely for political reasons. However, PM Kishida's approval ratings have fallen to new lows and ministers have had to step back because of perceived scandals. These factors increase the likelihood of more public stimulus measures, though the net boost to the economy is likely to be smaller in 2023 than in 2022.

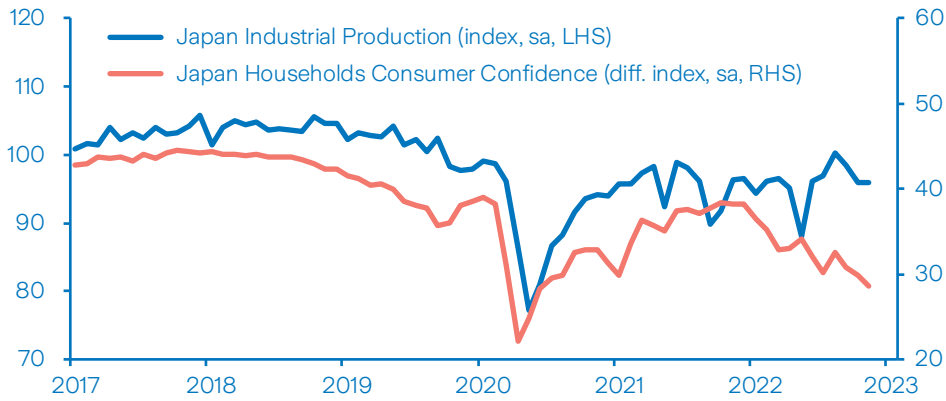
### The equity market is likely to meander in H1, before picking up steam in H2

In 2022, Japanese equities, as measured by the MSCI Japan index, outperformed global equities until July. In the second half of the year, relative performance proved to be volatile, but until the end of November no major relative performance progress has been made in the second half of the year. While our outlook into the first half of 2023 is more cautious, we believe the second half should be more promising, as Japanese equities tend to perform better when the global economy is recovering, due to the more cyclical nature of Japanese companies in the index.

As Japan's economy has started to benefit from reopening through rising domestic and inbound tourism and business trips, domestic sectors tilted towards consumption should also benefit. However, the drop in the global PMI does not bode well for Japan's export-oriented sectors. A slowdown in the global economy in Q1 2023 along with our cautious outlook for China's economy, suggests that Japanese equities will continue to move sideways in H1, before picking up steam into H2, when the global economy begins to recover.



## Japan: Industrial production and consumer confidence



Source: METI, ESRI, Bloomberg

Japanese companies tend to have a cautious earnings outlook at the start of the new fiscal year, which starts on April 1, before taking a more optimistic stance as the year moves on. We believe this pattern will once again be visible in FY 2023, with guidance already becoming more cautious and the earnings revision trend heading south.

However, pessimism is expected to wane in the second half of the year, as both the global and Japan's economy are expected to recover. Were the overseas recessions to be milder than we expect, or central banks pivot earlier than consensus is expecting, Japanese equities should recover quicker. Valuations are expected to remain rather stable but benefit from global monetary policy easing later in 2023.

### Bond market vulnerability to increase only if domestic investors change their view

The outlook for the government bond market is tilted toward stability. However, we note that foreign bond investors had bet on YCC to have ended already on various occasions in 2022, when the BoJ had to defend the 0.25% 10yr JGB yield target. Overall, domestic investors tend to agree that YCC is here to stay for now, which hit foreign speculators.

### Japanese credit should stay supported

We consider current credit spreads in Japanese Investment Grade credit to be attractive, although given the high quality of the market, upside is likely to be limited. We expect 2023 to be a year in which fixed income is back in favour given that global bond yields are expected to decline. Such an environment is typically constructive for credit, although we remain cautious on the US, where we believe risks are being under-priced. Japanese credit spreads appear relatively cheap on a historical basis both on a spread level as well as on the basis of historical percentiles of spreads. Given the relatively constructive view on the Japanese economy we expect spreads to stay supported as the default outlook is benign. That said, Q1 could see some volatility in line with risk assets and especially US credit spreads, which we believe should offer an attractive entry opportunity for long-term credit investors.

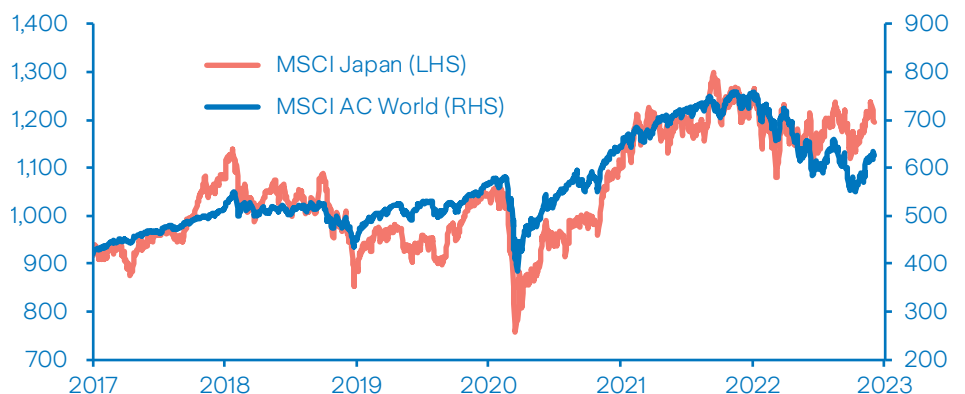
### South Korea's economy will be hit by falling tech exports and falling real household income

Exports tend to be a driver of South Korea's economy but can also be its Achilles heel. The latter is relevant for our 2023 outlook, as export growth slipped from 18% YoY in Q1 2022 to only 6% in Q3 and is likely to fall into negative territory in Q4 2022 and in early 2023. Computers, displays, home appliances, mobile phones, and semiconductors as well as petrochemical, steel and textile exports tumbled in October, suggesting that Q4 export growth will be negative, hitting the export sensitive economy. Auto exports remain the only bright spot. While China's potential reopening in Q2 might bring some relief to South Korea's export performance, the economic downtrend is likely to persist well into the second half of 2023.

Manufacturing capex is likely to be negatively affected by the weak export performance and the downturn of the memory chip cycle, while increasing interest payments and falling real wage growth are expected to negatively impact household consumption, despite a short-term reopening boost once the third Omicron-wave in 2022 starts to fade in early 2023.

South Korea's CPI is already peaking and is likely to fall from close to 6% to below 3% in summer 2023. The Bank of Korea appears to be willing to hike its policy rate toward 3.5% in January 2023 and maintain that level despite lower CPI prints in order to avoid capital outflow risks as the currency is weakening.

### MSCI Japan and MSCI AC World



Source: MSCI, Bloomberg

The MSCI Korea equity index has tumbled about 40% from its high in early 2021 to its late September 2022 low before recovering 18% in October/November 2022. In line with our global scenario, we expect a weak equity market in H1 2023 before a stabilisation and shallow recovery can be expected into H2.

### North Korean threats

The Russian war against Ukraine as well as turmoil in Iran, Myanmar and other hotspots has moved the focus away from North Korea as a geopolitical threat, particularly to South Korea and Japan, but also the US. In 2022, the North Korean regime fired a record number of missiles, including Intercontinental Ballistic Missiles (ICBMs), that landed close to South Korean and Japanese territory, initiating local evacuation measures and railway suspensions. Strong warnings from both countries and the US have gone unheard. We believe that though geopolitical risks to Japan and South Korea cannot be part of our base case economic scenarios for 2023, they should remain a consideration.

# Mainland China and Taiwan

## Outlook

- China's reopening plans following its zero-Covid policy are dependent on booster vaccination among the elderly
- Consumption is expected to pick up steam, with infrastructure investment solid, while exports should suffer
- Property market activity is expected to recover following a period of stabilisation

## Implications

- Both fiscal and monetary policy are expected to support the recovery, with benign inflation remaining a non-topic
- Investment Grade credit to see upside, while caution is warranted on High Yield
- Chinese equities have upside potential, as re-rating will lift valuations, while earnings should grow meaningfully

## Risks

- Social unrest, a delayed reopening
- China's relationship with the US deteriorates significantly further
- Policies to stabilise and rejuvenate the property sector fail

### More stability in the Year of the Rabbit

2022, the year of the Tiger in the Chinese zodiac, was dominated by politics, the downturn in the property market and the negative impact of China's zero-Covid policy. 2023 will be the year of the Rabbit and, when compared to 2022, is expected to be a more stable and solid year in which policymakers can focus on achieving targets in a less turbulent environment.

Politics in 2023 will focus on China's annual National People's Congress (NPC) in March, which will include the handover of major government positions to the new Communist Party leaders who were nominated at the 20th CPC in October 2022. The focus will be on Li Qiang, the former governor of Shanghai, who has been nominated to the second most important Communist Party position behind President and General Secretary Xi Jinping and is highly likely to take over the function of Prime Minister from Li Keqiang. Li Qiang is regarded as a business-friendly politician, even though his policies were seen to have pushed the city of Shanghai into recession following severe Covid related lockdowns.

### Say good-bye to China's zero-Covid policy

In line with consensus, we expect a further relaxation of China's zero-Covid policy restrictions once the NPC has concluded and winter is ending. For that to be achieved, booster vaccinations have to speed up, particularly in the 60+ age category with a special focus on the elderly over 80 years of age, who tend to be sceptical toward vaccinations but are highly vulnerable. As the case of Hong Kong has shown, a dramatic rise in mortality seems likely if booster shots are not sped up significantly. It remains to be seen whether a local vaccine booster shot, a local mRNA vaccine or a potential Chinese version of BioNTech's mRNA vaccine, or nasal vaccinations will do the trick.

In our base case we assume that the share of the population vaccinated will increase significantly enough to allow for a notable

relaxation of China's zero-Covid policy. A reopening policy is expected to spur a bounce in consumption, particularly benefiting the services industry. If these conditions are met, travel restrictions could be eased, which would allow family visits during the 'Golden Week' Labour Day holidays in May 2023, a key period for domestic spending. Meanwhile, we expect a still cautious policy toward overseas trips, with restricted issuance of visas for both outbound and inbound travellers.

Overall, it will take several quarters, if not years, to fill the consumption gap that has built up since Covid erupted. The trend toward a consumption driven society will prevail, though at a slower pace and from a lower level. In order to encourage labour to move from the countryside to cities or for cities to grow from smaller tier categories to larger ones, the long discussed 'Hukou' reform needs to gain speed. The Hukou system allows workers who moved from the countryside to cities to claim official resident status. Social security reform and an improvement in public services will also need to speed up in 2023 to support consumption.

### The property market is expected to stabilise

China's property market contributes both directly and indirectly to about one quarter of GDP, accounts for 60% of household wealth and about one third of local government revenue, mostly through land sales, which makes it critical to take it into consideration.

We expect the drag from the current property downturn to last into early next year. By then a phase of stabilisation is expected as homebuyer interest should slowly recover. Price declines are expected to narrow on improving demand/supply conditions. One prerequisite will be a successful implementation of the government's 16-point program that was introduced in November 2022 to stabilise the property market. The focal points are a stabilisation of financing access for both state-owned and private developers who have to overcome

short-term financing squeezes. The repayment schedule of bank and trust loans to developers facing liquidity issues will be extended by financial institutions and backed by public bond financing.

Another focus needs to be speeding up new home completion. Two major public development banks will issue special bonds to facilitate quicker delivery, while loan officers will not be made responsible if extended loans turn sour as long as the due diligence process has been conducted in a proper manner. Local governments, banks and asset management companies are encouraged to cooperate in finding solutions for the disposal of risky assets to clean up the market. Finally, allowing mortgage relief measures for potential buyers who suffered from lockdown measures as well as relaxing purchase restrictions for second home buyers should boost home buyer confidence.

All these measures are likely to diminish the drag on growth from the property downturn, while the positive impetus from infrastructure investments is likely to prevail. We also note that the boost from investment into the digital and green economy is likely to expand further, even though its multiplier effect on growth remains lower than the one from classic property and infrastructure investments.

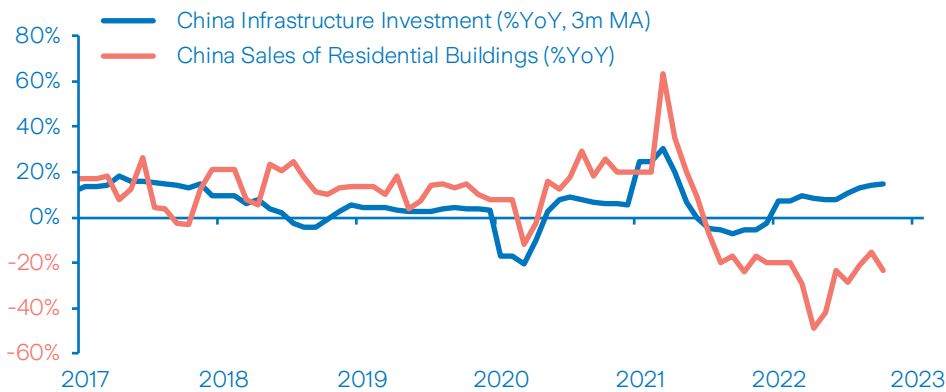
### Exports are expected to suffer

Net exports are likely to be a drag on growth in 2023 as demand from recession-ridden Western economies is expected to shrink further. Leading indicators for China's exports imply that the recent slowdown will persist or even accelerate, while China's demand for commodity imports is likely to grow as the domestic economy picks up steam.

### Monetary and fiscal policy expected to remain supportive

In terms of public policy support, we expect monetary policy to remain loose, following the PBoC's policy and RRR cuts and liquidity injections in 2022. Guidance for private

## Infrastructure investment and residential building sales



Source: Bloomberg

banks and policy banks to increase lending will persist, particularly lending for the property sector. Amid the fact that global central banks are expected to keep raising policy rates into 2023, we do not see further rate cuts by the PBoC, while guidance is expected to keep monetary policy loose.

Fiscal policy should give a bigger boost to GDP in 2023 than in the prior year as the expansion of the fiscal deficit will not be the result of a significant revenue shortfall like in 2022 when land sales income collapsed. Instead, the multiplier effect should be bigger, supporting the economy.

### Inflation will not be a topic in 2023

It may be surprising in a world where inflation is the prime topic among economists and the public that this is not the case in China. Producer prices have just started falling on a YoY basis, and this is likely to persist in 2023 as raw material prices are expected to continue to fall. Consumer price inflation is expected to remain low in the 1.5-2.5% range throughout the year, peaking in Q1 when rising pork prices are likely to roll over.

### We predict the economy will grow by around 5%

Overall, we expect China's real GDP to grow by around 5%, in line with a likely government growth target, which will be defined at the Economic Work Conference in December and officially announced at the NPC next March. This follows our growth expectation of only 3.1% GDP growth for 2022, an 'annus horribilis' considering extended Covid related lockdowns and a collapse of the property market. In a more optimistic scenario, we envisage an even stronger growth rate.

### Chinese equities are likely to recover from the dramatic slump of 2021/2022

The MSCI China Index has tumbled nearly 64% from its February 2021 high on concerns about the government curbing the powers of internet giants and tutorial schools, lockdowns induced by China's zero-Covid policy, and the property sector downturn. Political concerns following the CPC have also added to scepticism about Chinese equities. We believe substantial pessimism by local and foreign investors is already discounted into the price and we see meaningful upside for the MSCI China Index in 2023. Earnings growth, margin expansion, and a re-rating should allow the PE of the index to increase from 10x to 11x, allowing

for upside potential in the order of 15% for the year.

### Chinese Investment Grade credit to be supported, but High Yield likely to remain volatile

China's property sector imploded in 2022 with the High Yield property sector likely to end 2022 with over 40% defaults. This is not entirely surprising, and we have highlighted the issues in the property sector before. The negative sentiment from the property sector along with a weakening macro backdrop in China and the global economy has weighed on Investment Grade credit, where spreads have reached around 200bps, typically an attractive entry point.

With the upside that we expect in stock markets, along with the measures taken by policymakers to improve the prospects of the property market and the economy in general, we believe the pessimism may have been overdone. However, this is better played in Investment Grade credit (including the property sector). We sense a reluctance from policymakers towards blanket bailouts of overleveraged property developers, which is likely to weigh on the High Yield market.

### Hong Kong: The worst seems to be over

Hong Kong suffered from a series of problems during the last four years, including civil unrest, monetary tightening due to the HKD peg to the USD, an Omicron induced surge in mortality following insufficient vaccination among the elderly. Indeed, Hong Kong experienced a global record high per

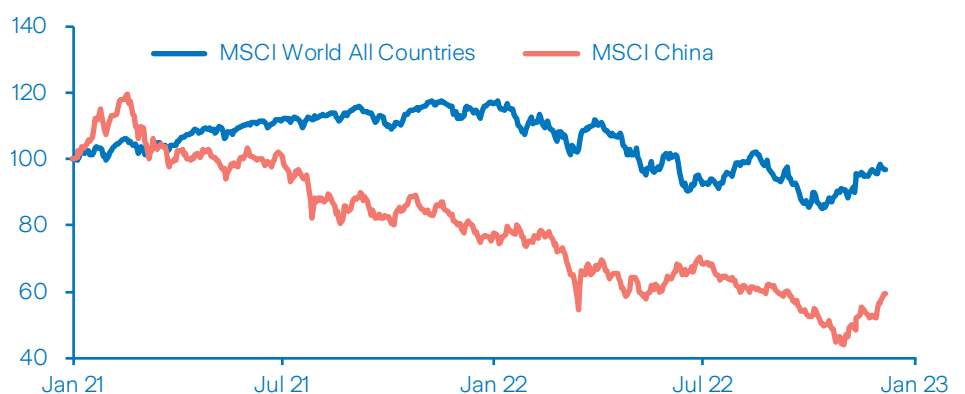
capita mortality. Severe quarantine measures caused a severe recession in 2022. However, the outlook for 2023 is brighter. Hong Kong should benefit from a potential reopening of Mainland China as tourism will boost consumption of goods and services. Recessions in developed Western countries are likely to be a drag on exports for a territory that is highly integrated into the world economy, but fiscal policy should be able to offer countercyclical support, as in the past.

### Taiwan's golden years are not expected to continue in 2023

We do not expect Taiwan's economic success story over the last three years to continue in 2023. From 2020 to 2022, GDP growth exceeded even the pre-Covid three-year growth path, with semiconductor exports and technology driven production being the main drivers. The recent deterioration in economic momentum is best illustrated by the big drop in the Manufacturing PMI New Export Order subindex that tumbled from a peak of 65.5 in May 2021 to 34.2 in September 2022. This deceleration will also have a negative impact on fixed asset investment growth, even though reshoring efforts will help stabilise to some extent. We expect GDP growth to fall from an estimated rate of 3% to around 2% in 2023. However, we need to consider that fiscal policy will support the economy to a great extent, with the fiscal boost expected to reach a 13-year high.

We do not expect Taiwan's equity market to shine amid a vulnerable earnings outlook, rich valuations, and an elevated risk premium amid cross-Straits tensions.

## MSCI China and MSCI AC World indices



Source: MSCI, Bloomberg

# ASEAN and India

## Outlook

- Headline inflation will ease, but the removal of fuel subsidies will increase pressure on core CPI
- Central banks should pause their rate hikes in H1 2023, switching their focus from inflation and FX stability to growth
- Robust FDIs and strong intra-ASEAN trade should help cushion the negative impact from slowing global demand

## Implications

- Regional equities are under pressure amid limited appetite for risk assets
- Bond yields should stabilise on fewer rate hikes and a potential pivot by the Fed
- Adequate FX reserves will continue to help alleviate currency depreciation pressure

## Risks

- Capital outflows intensify, putting pressure on currencies and financial markets
- Inflation proves stickier than envisaged, prolonging the rate hiking cycles of central banks
- China retains its zero-Covid policy for longer, leading to a further delay in the tourism recovery

### ASEAN and India's resilience

Despite surging global inflation, rapidly tightening monetary policy and China's slowdown on the back of its zero-Covid policy, ASEAN's and India's economies have proven surprisingly resilient. Growth has been robust while inflation, though rising, pales in comparison with elsewhere in the West.

Unlike developed markets (DMs), in which consumers were spending excessive savings given generous fiscal support during the pandemic, several countries in ASEAN along with India have only just returned to the pre-pandemic levels of nominal GDP in 2022. Therefore, demand pressure on inflation has been only moderate up until now.

On the supply side, the use of fuel subsidies and, in some countries, administered electricity prices has helped to insulate the region from global energy shocks. Additionally, several countries in ASEAN are net commodity exporters, limiting the impact of rising commodity prices on the economy.

### Growth headwinds to intensify in H1 2023

While having been resilient in 2022, regional growth is likely to decelerate going into 2023. Several drivers are behind this outlook.

First, exports are expected to lead the slowdown as the region's foremost trading partners, including China, the US, and the EU, will likely experience sluggish growth and even a recession in 2023. We expect the spillover effects to intensify in H1 2023.

Second, regional central banks have raised their policy rates swiftly in the second half of 2022, although less aggressively than the Fed and some other DM central banks. The negative impact of past rate hikes should continue to be felt in H1 2023.

That said, headwinds to growth should ease in H2 as central banks are likely to stop hiking rates and global activity improves following a period of slowdown. The easing of China's zero-Covid policy will have positive implications for ASEAN's exports and tourism.

### Intra-ASEAN trade and robust FDIs will help to offset some export weakness

In recent years, intra-ASEAN exports have strengthened, with intra-ASEAN trade accounting for around 32% of regional shipments, overtaking exports to the US, EU, and China in 2021 according to CEIC. We think intra-ASEAN trade should continue to offset some weakness in exports to the West and China.

On the FDI front, inflows remain vibrant. International as well as Chinese tech companies continue to move their manufacturing bases from China to neighbouring countries in the region to minimise operational disruptions amid the US ban on chip exports and China's zero-Covid policy.

Vietnam and Malaysia stand out as the largest beneficiaries thanks to their established infrastructure and, in the case of Vietnam, competitive labour costs. Indonesia is also profiting from the rising demand for nickel, a crucial material for electric vehicle (EV) batteries.

### Headline inflation to ease but core inflation will be a bit higher for longer

With growth momentum moderating, given a significant global slowdown and regional central banks tightening their belts further, inflation should start to soften. Global energy and commodity prices seem to have peaked in Q4 2022 while supply disruptions are easing, reducing pressure on headline inflation.

However, core inflation is likely to stay above trend. As fuel subsidies and certain price controls push up fiscal expenditures at a time when fiscal space is limited, they are not a sustainable way to curb inflation longer term.

Since countries like Indonesia, Malaysia, Vietnam, and Thailand are removing energy subsidies, inflation pass-through effects from still high energy costs to domestic consumer prices should become more evident. As global inflation is expected to

stay above trend in 2023, the region will not be entirely immune.

### Central banks to hike rates modestly

In 2022, regional central banks have hiked their policy rates between 50-225bps in total. Bangko Sentral ng Pilipinas (BSP) was the most aggressive, emphasising concerns about pass-through effects from high energy and food prices to core inflation.

The Bank of Thailand (BoT) has lagged behind its regional peers, hiking only 50bps year to date. Thailand's core inflation has been among the highest in ASEAN. The Thai Baht (THB) has depreciated by around 9% against the US dollar (USD) year to date, one of the weakest currencies in the region, partly due to Thailand's higher policy gap compared to the US. Therefore, we think there should be more scope for steeper rate hikes by the BoT going into 2023, especially once the recovery of the tourism sector becomes more established, putting further upward pressure on inflation.

Overall, it is likely that most central banks will adopt a more measured and gradual pace of rate hikes in H1 2023 and pause in H2 2023, following the Fed. A restrained approach will help to keep inflation and inflation expectations in check while limiting the negative impact on growth.

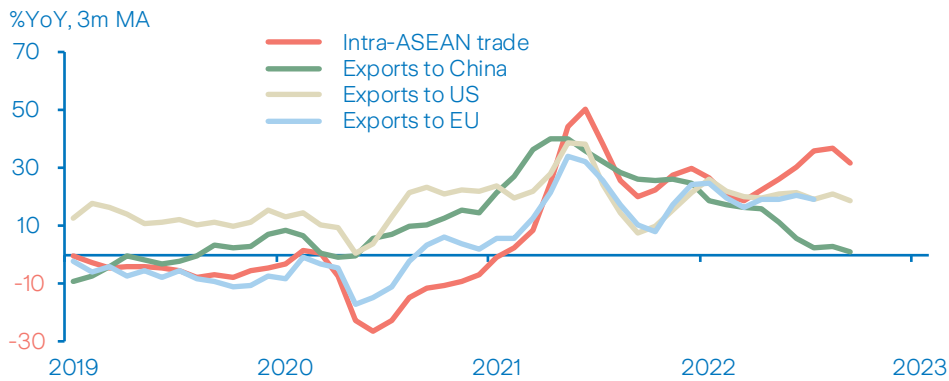
The Monetary Authority of Singapore (MAS) appears to be an exception. The MAS remains tilted towards a hawkish stance given persistent price pressure as Singapore is highly exposed to rising import prices, which are only amplified by a strong US dollar. We think the MAS will continue to tighten monetary policy via its exchange rate framework in H1 until core inflation shows clear signs of deceleration.

### Abundant FX reserves give central banks some wiggle room

With an abundance of foreign reserves, regional central banks could selectively intervene in FX markets to moderate the pace of currency depreciation without the



## Intra-ASEAN trade should absorb some weakness in exports to other markets



Source: CEIC

need to hike interest rates as aggressively as the Fed has in 2022.

The latest data as of September and October showed that Malaysia, Indonesia, Singapore, the Philippines, and Thailand, have enough reserves to finance five to seven months of imports, well above the international adequacy standards of a minimum three months. This should allow regional central banks to be more flexible in determining their rate hike trajectory.

Nonetheless, relying on FX reserves should only be a temporary measure to manage currency risks as foreign reserves can evaporate quickly in the event of rapidly tightening financial conditions. With recession looming in major DMs and investors' potential flight to safety during a downturn, we think regional central banks will need to keep their powder dry for a rainy day, which may be yet to come.

### Malaysia: Resilient domestic demand amid external headwinds

Domestic demand is expected to be resilient given the ongoing recovery of tourism-related sectors and still decent household saving rates. The speed of China's reopening will play a crucial role in the country's consumption outlook given that Malaysia is second only to Thailand as a travel destination for Chinese tourists.

Resilient domestic demand coupled with robust FDI inflows going into 2023 should help mitigate the negative impact of external headwinds. We expect GDP to grow above 4% in 2023, which is encouraging amidst the global slowdown. With already 100bps of rate hikes in 2022, Bank Negara Malaysia (BNM) will likely deliver another 25bps to conclude its rate hiking cycle in H1 2023.

### Indonesia: Still benefiting from the commodity sector

Indonesia should remain a bright spot in the region. While corrections in global commodity prices might have spillover effects on commodity exports, Indonesia should continue to benefit from being an attractive electric vehicle battery production hub for Chinese, Japanese, Korean and Western manufacturers.

Despite that, Indonesia's growth momentum should moderate going into 2023 as Bank Indonesia's rate hikes take a toll. On top of which, it is estimated that the recent subsidy

removal will push up the cost of 90 RON, the most commonly used fuel in Indonesia, by more than 30%. Higher core inflation is likely to dampen consumer sentiment and private spending. We project GDP growth for Indonesia to hover between 4.5-5% in 2023, slowing from a growth rate of between 5%-5.5% in 2022.

### India's growth momentum is likely to slow

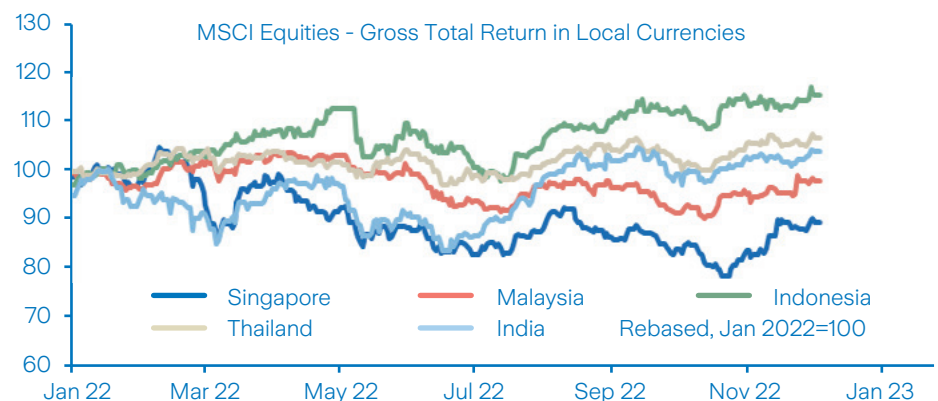
India's consumer and services sectors have recovered robustly following a significant downturn during the pandemic. Despite intensified external headwinds in 2022, India's growth remained vibrant, supported by pent-up domestic spending.

2023 will see a slowdown in growth from almost 7% in 2022 to around 6% in 2023 on the back of a fading post-pandemic recovery and tighter monetary conditions. While growth is likely to take a breather, we think India's economic fundamentals will continue to improve. Strong capex investments are keeping pace with rising demand. The service sector will develop further after years of sluggishness due to Covid restrictions and weak consumer sentiment. We envisage the Reserve Bank of India hiking another 25bps in early 2023 and then pausing as price pressures ease further.

### Bonds are still facing headwinds

As inflation peaks and local central banks stop hiking rates, government bond yields should come down from the current levels. For the first half of 2023, bond markets should be mainly supported by domestic

## Regional equities are under pressure amid global headwinds



Source: Bloomberg

investors given that offshore investors are likely to remain cautious. Indeed, we continue to see foreign outflows from regional bond funds.

However, we think bond markets will start to see foreign inflows in H2 2023 as foreign investors' risk appetite gradually recovers. Once the Fed pauses its rate hikes, pressure on currencies will probably moderate.

### Equities will be under pressure in H1 with a strong recovery expected for H2

While we think corporate earnings are likely to remain resilient, profit margins should be under pressure due to elevated input costs. Key headwinds continue to be the global slowdown and tightening external financial conditions. We suspect ASEAN's equities will be mainly supported by domestic investors in the first half of the year. As global rate hikes come to an end in H2 2023, appetite for risk assets might improve, prompting more foreign inflows into ASEAN's equity markets given the still encouraging growth momentum.

India's equity market was a bright spot in 2022, driven by a marked improvement in the macro environment. Meanwhile, Indonesia's stock market was one of Asia's outperformers, having greatly benefited from the commodity boom. However, we think the upside for Indian and Indonesian equities will moderate in 2023 given less attractive valuations, a fading commodity boom and a diminishing post-pandemic recovery.

Malaysia's equity performance is expected to be rangebound as support from the energy and commodity sectors diminishes along with weaker tech exports in 2023.

After having largely underperformed their regional peers in most of 2022, Singapore's equities have been playing catch-up in recent months. We expect momentum should have further to run in 2023, led by the banking sector, which will benefit from rising interest rates.

# Australia

## Outlook

- Growth will slow significantly in 2023, but the economy is likely to escape a hard landing
- Headline inflation will ease, but core CPI is likely to remain above the central bank's target
- Labour market conditions should deteriorate with unemployment increasing from its all-time low

## Implications

- Bond yields should stabilise as growth slows and the central bank pauses rate hikes
- Equity market performance is likely to be volatile in H1 but improve in H2 given attractive valuations
- House prices are likely to continue to fall as mortgage rates rise, but will likely stabilise towards year end

## Risks

- The RBA ends its rate hiking cycle too early, with inflation pressures becoming more persistent
- Commodity prices fall sharply and adversely impact Australian equities
- China increases tariffs and bans on Australia's exports as the trade spat worsens

### Australia's economy is shifting from overheating to slowing down

In 2022, excess demand stemming from high household savings and positive terms-of-trade amid the global commodity boom have bolstered growth. However, imbalances between exuberant demand and supply shortages have resulted in an overheating economy, pushing core inflation to multi-decade highs. Price pressures have broadened across the consumer basket, and the labour market has tightened rapidly, with the unemployment rate reaching a historic low. Elevated inflation led the Reserve Bank of Australia (RBA) to embark on a swift rate hiking cycle, raising its cash rate by 275 bps to 2.85% year to date.

Meanwhile, global economic conditions have turned unfavourable. China, Australia's largest trading partner, has been struggling due to its zero-Covid policy and a prolonged property crisis. An economic recession is looming in the US and has already hit the Eurozone. Rising domestic interest rates and a global slowdown do not bode well for Australia. Several leading indicators, such as PMIs, and consumer sentiment, are pointing to a marked slowdown in economic activity. Growth is expected to slow further in 2023.

### Rising interest rates will take their toll on consumption

The consumer and housing sectors are the most sensitive to rising interest rates and elevated inflation. With a debt-to-income ratio of almost 190% as of Q2 2022, Australian households come under pressure when interest rates climb. Furthermore, elevated inflation erodes households' purchasing power, especially when wage growth fails to keep up with the rise in consumer prices. The consumer confidence index is only a notch higher than at its pandemic trough.

### The economy will avoid a hard landing

The silver lining is that household savings, while having declined considerably in 2022, remain high compared to pre-pandemic levels. Many households used their excess savings built up during the pandemic to repay a part of their mortgage. These factors should provide some cushion for households and support spending.

Given supply and capacity constraints throughout 2022, business investments, including dwelling investments, have been delayed. We think firms will work through their pipelines instead of cutting investment drastically in 2023, limiting the negative impact on growth. On the policy front, the RBA's less aggressive rate hikes compared to the Fed should also contribute to this soft-landing outlook. Overall, we think 2023 GDP growth will edge below 2%, but should prove better than the RBA's forecast of 1.5%.

### Labour market conditions should loosen from extreme tightness

Strong labour demand coupled with supply shortages due to a decline in net migration has resulted in a very tight labour market, with the unemployment rate hitting a historical low of 3.4% as of October 2022, well below the RBA's estimated Non-Accelerating Inflation Rate of Unemployment (NAIRU).

In 2023, we suspect the labour market will remain tight as interest rate hikes take time to impact the economy. With an economic slowdown, the current sky-high level of job vacancies should ease first before actual employment is impacted. Despite that, labour market conditions should loosen from the current extreme tightness. Also, labour supply should improve given that the inflow of foreign students and workers has picked up noticeably amid normalising international travel.

### Inflation is expected to retreat, although will still exceed the RBA's target in 2023

Headline inflation seems to have peaked in Q4 2022 as global energy and commodity prices fell. However, core inflation will take time to return to the RBA's targets.

Price pressure has broadened beyond headline inflation, lifting short-term consumer inflation expectations. In addition, the second-round effects of businesses passing higher input costs to consumers have recently intensified. Wage growth has also picked up on the back of labour market tightness and wage pressure continues to add upside risks to the inflation outlook.

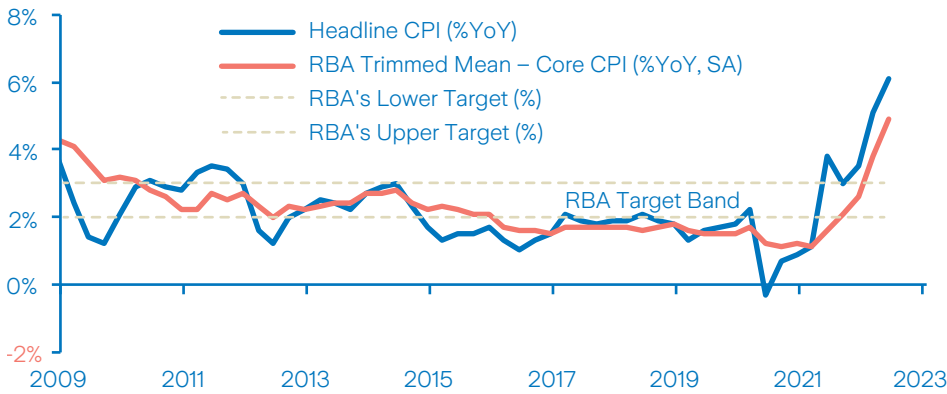
There are reasons to expect inflation to eventually cool, however. Tightening monetary policy is an attempt to rein in demand, while supply shortages have become less entrenched amid easing supply disruptions. It means the imbalances between excess demand and supply constraints, the main culprit of the current high inflation, will be corrected gradually.

### The RBA is likely to stick to a moderate pace of rate hikes

The RBA only raised its cash rate in May, two months after the Fed delivered its first rate hike and is now the first among developed market central banks to slow the pace of rate hikes to 25bps. The RBA appears to be more willing to accept a period of higher inflation in order to reduce the negative impact of rising interest rates on household debt and economic growth.

We think the RBA will follow the Fed by stopping hiking rates next year as the US falls into recession. Given high uncertainties around the inflation outlook, there is a risk that the RBA will pause hiking rates too early, making inflation problems more entrenched, though this is not our base view.

## The RBA will hike its cash rate well into H1 2023 to tame elevated inflation



Source: Bloomberg

### Strong headwinds for the housing market but no material risks to financial stability

Australia's housing sector is highly exposed to rising interest rates, given a large share of home loans with floating and short-term fixed rates. Property lenders were reported to have passed the full rate hikes on to borrowers as of November 2022. Demand for property is likely to slow further as mortgage rates rise and house prices correct further in 2023. We think the peak-to-trough fall in prices could reach approximately 15%. Despite that, corrections in house prices should not pose significant risks to financial stability.

Despite excess liquidity in the banking system in 2021, lending standards have been sound with the loan-to-value ratio staying low. Furthermore, high savings rates should cushion the downside of household balance sheets. Domestic banks are also well-capitalised and have adequate provisions for bad loans. Housing shortages remain a long-term issue for Australia, especially in major cities. As the cash rate stabilises towards H2 2023, we might see value buyers returning to the market.

### Commodity prices are expected to fall, while the Australian dollar should regain some strength

The RBA's commodity price index rallied about 30% in the first half of 2022 but has since moderated. We expect commodity prices will ease further as the global economy cools. China, Australia's largest importer of iron ore, is still pursuing its zero-Covid policy despite recent adjustments while coping with the property market downturn. Consequently, demand for Australia's commodities will likely be subdued.

The Australia dollar (AUD) has depreciated by around 9% against the US dollar (USD) year-to-date, generally in line with the broader trend of USD strength. On a trade-weighted basis, the AUD is hovering around the recent two-year average. Looking ahead, we expect the AUD to stabilise against the USD when the Fed and the RBA pause their hikes. Moreover, Australia's growth is expected to outpace that of the US in 2023, likely providing support to the currency.

### Bond yields should stabilise

The RBA's rate hikes have driven bond yields significantly higher in 2022. The yield curve has flattened in H2, signalling a material slowdown in growth. 10yr government bond yields have eased slightly as the RBA slowed its pace of rate hikes in its November meeting. We think 10yr bond yields will stabilise further as the central bank pauses its policy rate hikes in H2 2023. As the recession bites, risk-off sentiment should also lure investors into government bond markets, supporting our case for lower government bond yields.

### Credit spreads should tighten in 2023, albeit Q1 could still be volatile

The Australian credit market has notably underperformed versus US peers with spreads not being far away from previous crisis and recessions. The Australian credit market has higher average credit quality and a lower credit duration than other Investment Grade (IG) markets in the US and Europe. In contrast to what happened during 2022, the Australian credit market has often outperformed US IG during risk-off periods. The reason why this was not the case in 2022 can be partly explained by investor concerns of an increase in the cash rate, a slowing economic outlook, and significant outflows from Japanese institutional investors. Furthermore, recently spreads of tier-two bank assets also widened as the Australian Prudential Regulation Authority increased call risks for these securities.

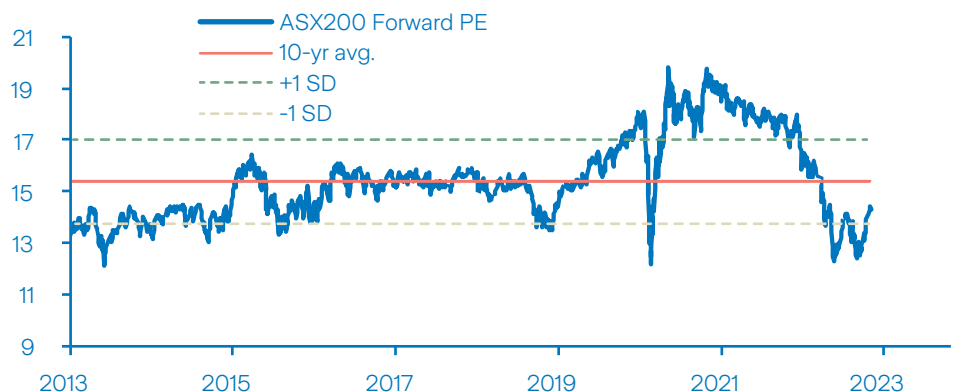
In 2023, we expect spreads to tighten as the Australian credit market starts to offer attractive risk reward, especially versus US credit markets. However, Q1 could be challenging as global risk assets are expected to remain volatile due to economic conditions in Europe and the US. The actual credit quality of the credit market remains decent as leverage on the corporate balance sheets remains limited, and the average credit rating for Australian credit markets remains at a single 'A' level.

### Equity volatility remains elevated amid uncertainty around growth

As the economy slows materially in H1 2023, with uncertainties around inflation remaining, corporate earnings and margins will likely be under pressure. The tailwinds for the commodity sectors have eased given declining commodity prices. We expect equity markets to remain volatile in H1 2023, reflecting uncertainties around growth and inflation.

With the growth outlook starting to brighten towards the end of 2023, light positioning and attractive valuations should encourage inflows into equity markets and boost their performance. Financial stocks should do well in a better interest environment, while the performance of commodity-related equities should be capped as commodity prices fall further on the back of a global slowdown.

### Attractive valuations will support equities once policy headwinds ease



Source: Bloomberg

# LatAm

## Outlook

- We expect economic activity in LatAm to decelerate, growing below trend in 2023, with Chile likely to have a recession
- Mexico is likely to outperform from an economic perspective but with limited structural improvement for the longer term
- Inflation should fall sharply in Mexico and Chile but will likely remain above central bank targets

## Implications

- Monetary policy easing is likely but policy rates are expected to remain above the neutral rate
- Fiscal conditions to deteriorate slightly but should not affect investor confidence and asset prices
- Local assets will likely remain attractive, with Mexico a relative refuge from volatility in LatAm

## Risks

- An increase in political uncertainty undermines confidence, impacting local asset prices and capital inflows
- Sticky inflation forces central banks to maintain higher interest rates for longer
- A deeper recession in the US and a sharp deceleration in Chinese growth impacts economic activity in LatAm

### **Argentina: Macroeconomic imbalances remain a challenge with no visibility of a solution in the short term**

Public investment and the export sector boosted economic activity in 2022, but the outlook remains fragile. Economic growth will likely decelerate sharply in 2023. Consumer confidence has deteriorated while household spending is expected to fall, driven by elevated interest rates, higher inflation, and a depreciated currency. Furthermore, the challenging external outlook is expected to weigh on the external sector, and the drought will likely affect the agriculture sector. Political uncertainty ahead of the 2023 general elections in October should hit private investment well in advance, acting as a further drag on growth.

Inflation is expected to remain under upward pressure. The gap between the official and parallel exchange rates as well as the monetary and fiscal imbalances are increasing the risk of triple-digit inflation. Furthermore, electricity and gas tariffs and public transportation prices need to be adjusted to meet the fiscal target, putting additional pressure on inflation. Credible fiscal consolidation efforts and amendments to the currency policy that would engineer a reduction in the gap between the official and the parallel FX markets are needed to control inflation and reduce macroeconomic imbalances. Nevertheless, as the general elections approach in October, persistently high inflation and lower economic growth will likely increase social discontent and weaken any political support for reducing macroeconomic imbalances. Therefore, we do not expect any significant economic policy adjustment before the October elections, keeping inflation expectations at a very high level.

On the political front, despite the announced intention to reduce public spending and meet the IMF fiscal target, the persistent differences of opinion regarding economic policies within the government coalition

will likely make it difficult for the Ministry of Economy to rebuild fiscal credibility. Financing needs for 2023 are above 5% of GDP, and we think that the government will be required to renew maturing debt and issue more debt in the local market for financing. Therefore, the risk of requiring funding from the Central Bank is high. Furthermore, the net level of foreign reserves remains too low. Despite the negative impact on inflation expectations and economic activity, the government has favoured some measures to reduce the loss of foreign reserves without affecting the official FX exchange rate. Nevertheless, downside pressures against net foreign reserves continue, and considering the potential for net outflows during Q1 2023, the risk of having negative net reserves has increased.

### **Chile: Imminent recession should force the government to adjust its economic policy reforms**

The excess household liquidity from the premature pension fund withdrawals and the aggressive fiscal stimulus during the pandemic continued to boost economic activity in 2022. Domestic demand has been the main driver of economic growth, with consumption being, on average, around 17% above the pre-pandemic level, which is unsustainable. The economy is overheated with demand pressures leading to a rise in prices. Furthermore, the magnitude of household and government imbalances, along with a deterioration in the terms of trade and higher fixed asset investment, increased the current account deficit to a historically high level of 9.9% of GDP in Q3 2022. Nevertheless, economic activity has shown signs of normalisation recently, with the liquidity level returning to its historical trend and retail sales easing significantly.

We forecast GDP growth of around -1.0% in 2023. Private consumption is expected to contract sharply as higher inflation and policy rates weigh on households' disposable income, and liquidity from the pension fund

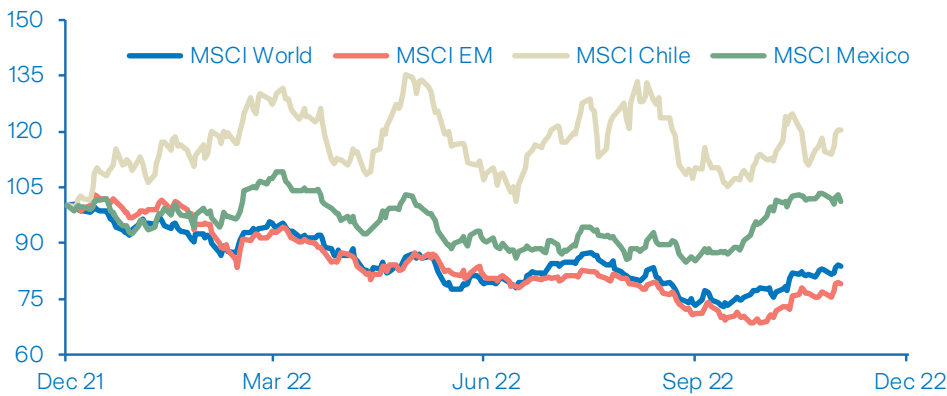
withdrawals is depleted. Furthermore, the labour market will likely continue to soften with lower new job creation and real wages adjusted to the downside. The rejection of the proposed new constitution reduced political uncertainty but was insufficient in itself to reverse the negative trend in business sentiment as the discussion regarding constitutional reform has not ended. Furthermore, the tax reforms proposed by the government, which are currently being discussed in Congress, is negatively impacting investor confidence. However, considering that the government does not hold a majority in Congress, as well as the current economic outlook, we expect changes to be made to the proposed bill before approval. Nevertheless, we expect fixed capital investment to decline as uncertainty remains high and business confidence is not improving.

Lower demand pressures as the economy enters a recession amid high real interest rates and the easing of external tensions on energy and food prices will reduce inflation sharply during 2023. However, the indexation mechanism of the economy, and the currency depreciation will likely keep inflation above target. We expect inflation to be around 4% by year end, converging to 3% in 2024. After hiking the policy rate from 0.5% to 11.25% during the last monetary tightening cycle, we expect the central bank to start easing in April 2023. However, the policy rate will likely remain in restrictive territory, reaching its neutral level only in 2024.

Fiscal spending has normalised, falling ~25% YoY in real term in 2022 and allowing public debt to GDP to stabilise. The budget presented by the government includes an increase in public spending of ~4% in 2023, which we estimate will not put additional pressure on fiscal consolidation. On the political front, tax and pension reform proposals are likely to challenge the government's bargaining ability. If tax reform is not approved, the increase in the minimum



## LatAm equity markets outperformed global stock markets



Source: Bloomberg. Note: Indexed to 100 at December 31st, 2021

guaranteed pension proposed in the pension reform may put pressure on fiscal consolidation in the medium term.

### Mexico: Solid economic activity in 2022 should support a gradual deceleration

Despite a very challenging global outlook, Mexican economic activity surprised to the upside in 2022. Domestic and external demand grew strongly due to resilient consumption supported by solid remittances and strong manufacturing exports. Furthermore, the lagged fixed investment recovery is also supporting economic activity. Nevertheless, current economic growth rates will likely moderate in the coming quarters as economic growth is finally reaching its pre-pandemic levels, and the downside risks for growth in 2023 are increasing. The potentially lower US demand for manufacturing goods, higher and persistent inflation, and restrictive monetary policy will likely suppress economic activity.

The US recession is Mexico's most critical economic risk as its industrial sector is highly exposed to the US. However, as the manufacturing sector output is still catching up to its pre-pandemic level and recovering from supply chain bottlenecks, a reduction in US demand is expected to have a more modest impact on production than in previous recessions. Furthermore, the increase in FDI in the sectors that have high exposure to the US and are in direct competition with Chinese exports could also positively impact the industrial sector.

Inflation has already peaked and is expected to decelerate in 2023, driven by lower demand pressures, more stable commodity prices, and base effects, amid a policy rate that will likely remain in restrictive territory. The stickiness in some core components is still a concern. We expect annual core inflation to decelerate at a slower pace, with annual headline inflation for several months in 2023. However, core inflationary pressures will likely ease during the year as import and producer price pressures wane, and labour costs are expected to decline. Nevertheless, a new double-digit increase in minimum wages is a risk for inflation. The monetary policy tightening cycle is likely to end soon, but we expect the central bank to remain hawkish until inflation expectations stabilise. Banxico is expected to be one of the last central banks in LatAm to start cutting rates,

and the monetary easing cycle will likely begin in Q4 2023 only after core inflation pressures have reduced and the Fed starts to ease. Nevertheless, the policy rate will likely still remain above the neutral rate until 2024.

Political uncertainty in Mexico is expected to remain lower than in the other countries in LatAm. Nevertheless, an additional catalyst is required to boost fixed investment to increase medium-term growth. We expect the solid fiscal stance to remain in place, but with a higher primary deficit driven by lower revenues and robust spending.

### LatAm equities remain resilient despite the hawkish Fed, a challenging global economic outlook and lower commodity prices

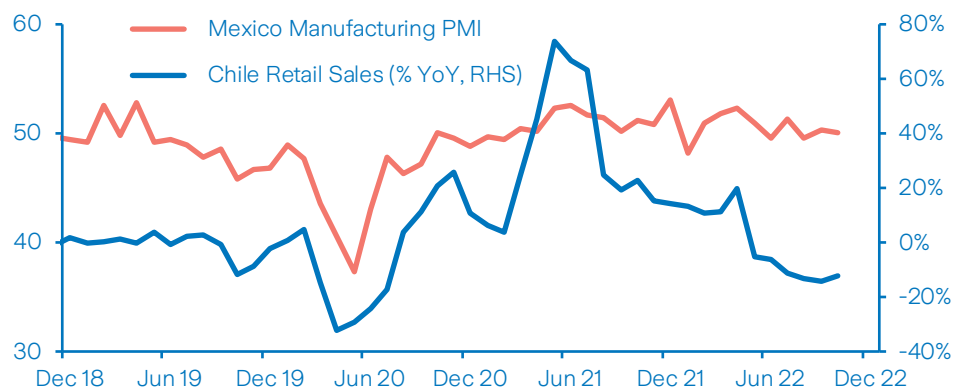
LatAm stocks outperformed both Developed Market (DM) stocks and Emerging Market (EM) stocks in 2022 amid resilient economic activity and solid corporate results. Corporate earnings estimates have been revised up, but foreign flows to the equity market remain at a historically low level as investor confidence has been sapped by global uncertainty and idiosyncratic risk. We expect the equity markets to benefit from the divergence in the monetary policy tightening cycle of LatAm economies versus that of developed market economies and also due to the expected pickup in net foreign flows given the challenging outlook faced by EM stocks. The increase in global uncertainty still poses risks that investor sentiment could deteriorate further before improving. Nevertheless, considering the attractive valuation, we

believe that most of the negative news is already priced in.

Mexico underperformed other LatAm equity markets in 2022 due to its lower exposure to outperforming sectors, such as the commodity sector. Nevertheless, better fiscal conditions, a stable currency, and an equity index bias to lower beta sectors will likely provide less volatility than other equity markets in 2023. Furthermore, corporate earnings are trending higher. The positive earnings season and earnings improvements for 2023 have made valuations more attractive. Nevertheless, its high correlation with the US and the less friendly policy environment for fixed investment may undermine economic activity and the value of local assets.

In Chile, the expected recession will likely weigh on corporate earnings, negatively impacting the equity market. However, a quick resolution of the constitutional process and the approval of pension reform that guarantees the continuity of well-functioning capital markets will likely boost investor sentiment. Likewise, the expected policy rate cut by the central bank should also support the stock market.

### A sharp decline in consumption in Chile



Source: Bloomberg

# Brazil

## Outlook

- Tighter financial conditions and a challenging global outlook should lead to below trend GDP growth
- A gradual monetary easing cycle will likely start in H2 2023
- Inflation should continue to decelerate, but core inflation is expected to remain above the central bank's target

## Implications

- The incoming government will likely moderate its economic agenda to reach agreement with the Congress
- Negative economic news seems to be already priced into the equity market
- Financial assets appear attractive despite the rise of idiosyncratic risks

## Risks

- Loose fiscal responsibility will lead to a longer policy tightening cycle and higher bond yields
- President Lula does not moderate his economic agenda and political uncertainty increases
- There is a significant fall in prices of key commodities produced by the country

### **Economic activity is expected to decelerate in LatAm while inflation is expected to fall, prompting central banks to start the easing cycle**

Higher commodity prices, resilient domestic demand, and strong exports supported above trend economic growth for LatAm in 2022, despite elevated inflation and tighter financial conditions. Most central banks have already ended monetary policy tightening, and the deceleration of economic activity along with an easing of inflationary pressures should allow them to consider kick starting the easing cycle. Nevertheless, core inflation is expected to fall only slowly and remain above central bank targets, forcing policy rates to stay in restrictive territory for some time. Tax revenues rose during 2022, driven by higher commodity prices and economic activity, improving fiscal balances. However, as economic activity decelerates in 2023, some countries will likely increase public spending to support domestic demand.

### **Lula was elected president of Brazil for a third time but without a majority in Congress**

Despite increasing the social cash transfer programs and reducing taxes, the incumbent president, Bolsonaro, did not convince Brazilians to re-elect him. Instead, Luiz Inácio Lula da Silva (Lula) was elected president by a tight margin. The new Congress is more conservative and less fragmented, but more polarized, with the major political forces actually balanced to the centre right. Lula will therefore require political capital and negotiating skills to reach the qualified majority needed to approve any constitutional amendments. Consequently, we believe his economic agenda will moderate during the year, reducing the risk of any significant policy change. Nevertheless, the negotiations will likely be challenging as each political group tries to maintain their agenda as much as possible, increasing the economic and market uncertainty in the short term.

### **The Brazilian economy remains resilient, but tighter financial conditions and the challenging global outlook should weigh on economic activity in 2023**

Economic activity has surprised to the upside, led by resilient domestic and external demand. The economy benefited from higher oil, iron ore, and agricultural prices, which boosted fiscal revenues and exports. The primary public deficit remains healthy but will be one of the main challenges for the incoming administration. On top of that, the increase in the social cash program from BRL 400 to BRL 600 per household supported private consumption in 2022 despite higher inflation. These additional resources for the social cash program were not included in the budget proposal for 2023, but are expected to remain in place, supporting private consumption in 2023. However, as Lula has no majority in Congress, we expect a political agreement to maintain the social program without undermining the public debt outlook and increasing sovereign risk. Nevertheless, uncertainty has increased significantly, negatively affecting inflation expectations and asset prices.

Furthermore, growth in the export sector is expected to ease as the global recession and downward pressure on commodity prices will likely reduce the demand for Brazilian exports. Consequently, we expect economic activity to decelerate, particularly in H1 2023, and then recover in the H2, albeit with GDP growth below trend for 2023.

### **The central bank will likely start a gradual monetary policy easing cycle in H2 2023**

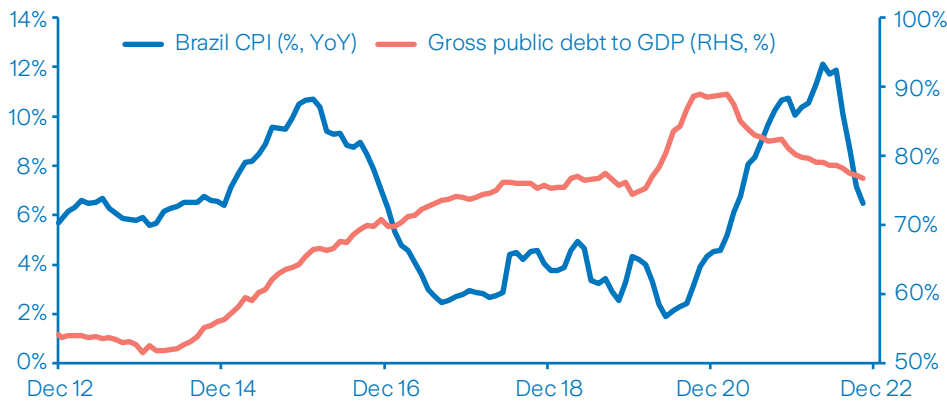
The central bank raised the Selic rate from 2.0% in March 2021 to 13.75% in August 2022 in one of the most aggressive monetary tightening cycles in the world. Headline inflation fell dramatically from 12.1% in April 2022 to 6.5% in October 2022, driven by higher interest rates, tax cuts, and lower gasoline prices. Nevertheless, core inflation remains a concern. We expect inflation to continue to decelerate but at a more gradual

rate. We forecast inflation to be around 5% by year end, with goods prices continuing to fall but upside risks to inflation remain from the worsening fiscal outlook and the potential tax hikes in fuel prices. The central bank has recently mentioned its concern and has signalled its intention to keep the policy rate on hold for a long time to contain inflation expectations. Furthermore, resilient economic activity, above-target core inflation, and the tight labour market will prevent an easing cycle in H1 2023 despite the expected economic deceleration.

### **Debt sustainability to remain, supporting financial assets, despite the recent discussions to increase public spending**

Financial markets in Brazil have been some of the best performing markets globally in 2022. The end of monetary policy tightening, rapid earnings growth due to a solid and robust economic activity and the robust performance of the commodity sector explain the positive performance. However, the equity market has performed poorly in recent weeks after Lula announced he wants to exempt BRL 175bn (USD 32bn) in social cash transfer from the spending cap, which limits the growth of public expenditures to the previous year's inflation rate. The announcement undermined investor sentiment and increased fears of rising public debt, negatively affecting financial assets. Nevertheless, considering the highly divided political landscape and the very conservative Congress, we expect this proposal will not be approved as proposed. We see this highly volatile period as transitory, without expecting any structural changes in fiscal policy that may undermine asset prices in the medium term. We believe the current spending cap needs to be modified to restore its credibility, but it does not mean a deterioration in Brazil's fiscal responsibility. Lula demonstrated in the past that he was very pragmatic, and even though we need to watch the evolution of his social spending plan, we do not expect he will

## Inflation has declined sharply amid improvements in fiscal accounts



Source: Bloomberg

ignore fiscal discipline and deteriorate debt sustainability.

### Negative news on the global economic outlook seems already priced in and an improvement in sentiment should boost this high dividend yielding stock market

Despite the resilience in recent months, the commodity sector, which represents around 20% of the MSCI Brazil Index, could come under pressure in the coming months as the global economy enters a recession, adding further risk to the equity market. Nevertheless, the equity market has lagged the rebound in commodity prices, and most of the bad news regarding the economic outlook is likely already priced in. Moreover, once global economic conditions and risk appetite improve, Brazilian assets are expected to perform relatively well. Furthermore, the high dividend yield and the redirecting of flows from other EMs should positively affect foreign flows to the Brazilian stock market. Also, the expected improvement in international relations with other major economies under Lula's government will be another positive driver for foreign flows into Brazil.

### The local fixed income market suggests attractive investment opportunities, despite expectations surrounding the Fed and the recent increase in sovereign risk

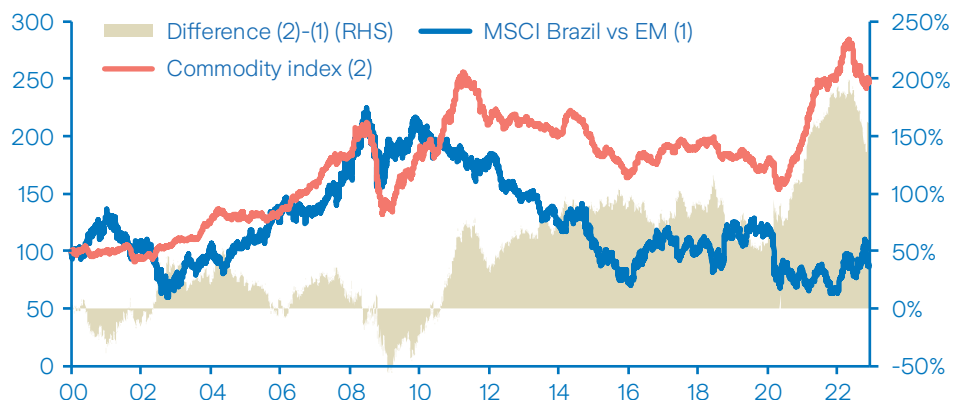
The 10yr government bond yield in local currency has remained relatively high despite the sharp decline in inflation. At the same time, the ex-ante real interest policy rate is above 8%, one of the highest globally. Furthermore, the expected monetary easing cycle will likely reverse the yield curve inversion, offering potential capital gains to investors in a market with high coupon rates. We expect the high interest rates to support flows from foreign investors who have been underinvested in the market for a long time. Also, despite the recent increase in risk, sovereign CDS remains below the level of 2015-2016, and we expect it to decline sharply once the fiscal uncertainty is resolved. However, if the incoming government fails to show a more restrained spending plan for the years ahead, it will likely undermine the positive carry for investors.

### Despite global uncertainty and the recent increase in idiosyncratic risk, financial assets remain attractive

All in all, we are constructive on Brazilian financial assets. The equity market seems

undervalued not only compared to its historical average but also compared to other markets. Cheap valuations suggest political risk and global recession fears are already priced in. Considering Brazil's high beta, we expect local markets to outperform once global economic conditions improve later in the coming year. Furthermore, we expect the Fed to start easing in 2023 and the easing cycle will likely support the equity and fixed income markets. Also, the higher dividend yield and carry should attract flows to the local assets reinforcing currency appreciation and reducing the currency effect on inflation. Furthermore, the EM investable universe has deeply changed. Russian assets are being shunned by many investors, while global investors are less comfortable with building positions in China. Consequently, LatAm, and particularly Brazil, is gaining relevance structurally. Even if China's markets improve on looser Covid restrictions, Brazil should also benefit as a vehicle to gain exposure to commodities, supporting the equity and the currency markets. Nevertheless, we have to recognize the level of risk is elevated, and that fiscal uncertainty may take longer to resolve, adding additional risk and volatility to the financial markets.

### Equity market has lagged the rebound in commodity prices



Source: Bloomberg. Note: Indexed to 100 at January 3rd, 2000

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