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Allianz Research

Economic Outlook 23-24: Keep calm and carry on

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Executive Summary

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Since our last quarterly economic update in September, the deteriorating energy crisis and a challenging policy mix have confirmed our forecast of slowing growth, sticky inflation and rising interest rates. For next year, we have identified eight songs and themes to keep your ear to the ground during the great energy quarantine:

#1. Slow Down. In 2023, we continue to forecast a mild recession in Europe on the back of the energy crisis, and in the US due to the abrupt normalization of monetary and financial conditions. This triaging recession will test resilience. Stronger balance sheets, demand backlog, and fiscal support will help limit the damage. In the emerging world, growth is expected to remain stable in 2023. In 2024, we anticipate a recovery in the US while the eurozone could be stuck in a muddle-through scenario because of the energy stop-and-go.

#2. Cold Heart. The energy gap will continue to pose concerns in Europe. After record gas storage and energy efficiency gains helped avoid a blackout scenario in 2022, prospects for next winter (2023-2024) are limited as substitution to Russian gas imports will not suffice. Uncertain gas supply will create negative confidence effects and put the region's fiscal capabilities to the test to cushion the impact of high electricity prices on firms and households. It will also compel policymakers to find ways to enhance energy efficiency and stabilize gas consumption beyond near term savings, together. The alternative is a repeat of 2012 and a risk of fragmentation in Europe.

#3. Bad Blood. (Geo)politics made a bursting comeback at the forefront of concerns. From a split Congress and a noticeable return to good 'ole protectionism through the Inflation Reduction Act (IRA) in the US, to Europe's red herring policies to the negative competitiveness shock stemming from the energy crisis (sovereignty, re-industrialization), to China's balancing act to exit zero-Covid, and the many important elections upcoming , investors and corporates will have to play coping strategies and buffers.

#4. Dragon Attack. The shift in China's containment measures will alleviate pressures on a slowing global trade, and accelerate the decline of producer prices. The domestic post-Covid rebound could start to be felt in the second half of 2023, and into 2024 as we expect sanitary restrictions to be eased in spring 2023. A faster easing would benefit the global economy while any setback could weigh on global trade and delay the easing of inflationary pressures.

#5. Never Give Up. Emerging markets will face very different challenges and headwinds in the coming months. Political risk has been rising in Latin America, Eastern European countries are being hit harder than most by the energy crisis, and commodity importers throughout the world will have to cope with a strong dollar, high energy and food prices. Credible policy moves will make the difference. Debt sustainability concerns are increasing for some countries in a context of increasing rates and capital flight to safety.

#6. Castle on the Hill. Central bankers are determined to fight inflation and make sure that it does not become entrenched. While the current hiking path is about to moderate, central banks' independence will be tested either way: if erring on the side of keeping their monetary stance more restrictive for longer despite a looming recession, or if throwing in the towel to early and risking stagflation for good. Against the background of moderate quantitative tightening and decreasing system-wide liquidity, there is a risk of squeeze from a policy mistake.

#7. Bad Habits. Since 2020, the war against the virus, and now against Russia have one super weapon: fiscal spending. It will remain at the center stage over the next couple of years, from relief measures to the cost of living crisis, to green industrial policies to help with silent wars (climate change, ageing), to fighting the urge to a massive tax policy U-turn. More targeting for aid, and fewer distortions are welcome to avoid that financial markets become very selective.

#8. Easy on Me. In 2022, capital markets experienced an unmitigated disaster with an unprecedented price correction in both equities and fixed income. Going forward, earnings forecasts still seem too benign, and even a milder recession is not fully priced in. Fixed income is back but mind the risk. Also, as central banks drain excess system-wide liquidity and trading volumes even in historically liquid markets decline, financial accidents needs to be watched out for.

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Global Outlook

Since our last quarterly economic update, the deteriorating energy crisis and tough policy choices have confirmed our forecast of slowing growth, higher inflation and rising interest rates. While inflationary pressures remain stronger than expected, real activity has been more resilient than expected in both the US and the Europe due to a combination of stronger consumption and scaled-up fiscal support.

Global growth: Still headed towards a recession

After a tumultuous year, we anticipate lackluster growth in 2023, followed by differing recovery paths across countries in 2024 (Table 1). Global growth is likely to slow to +1.4% in 2023 (-0.1pp downside revision) and to recover modestly to +2.8% in 2024, with significant divergence across countries. Advanced economies will register a shallow recession of -0.1% in 2023 (after growth of +2.5% in 2022), followed by a rebound to below-potential growth of +1.5% in 2024 (Figure 1). Europe will muddle through the ongoing energy crisis, while the US recovery is constrained by a cautious policy mix. Among emerging markets, growth is expected to remain stable in 2023 at +3.3% – mainly supported by the cautious reopening of China, while most other emerging countries are likely to slow down due to both external and domestic headwinds. A rebound to +4.3% is expected in 2024, supported by the policy pivot as well as the recovery of Chinese demand.

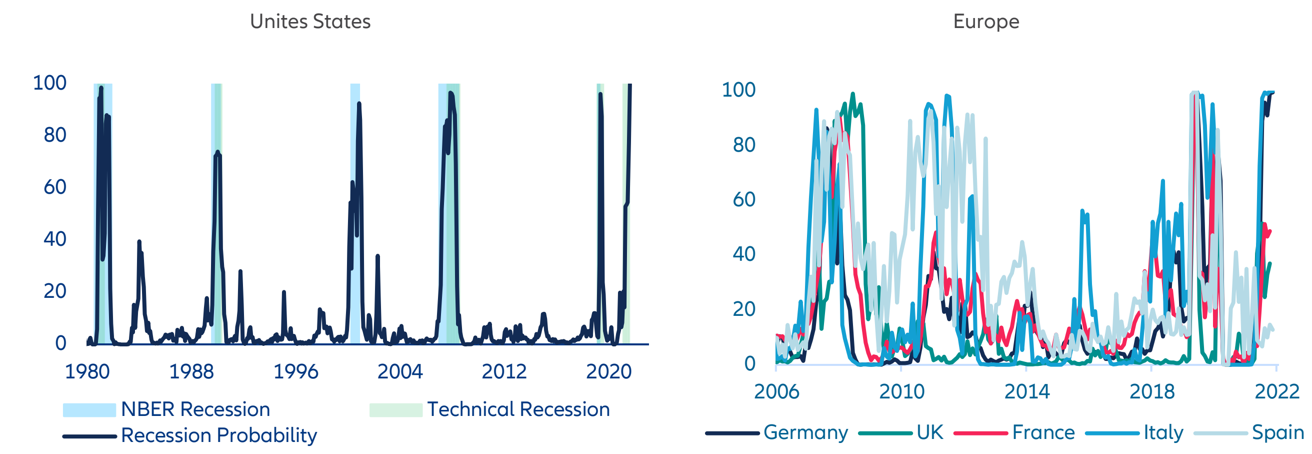
United States: Despite rapid monetary tightening and elevated inflation, the economy has proven resilient so far. This is mainly thanks to strong exports amid a still large backlog of previously unfilled orders in the manufacturing sector while consumption is holding up. Households have reduced their savings and the labor market has remained strong, bolstering consumer spending (Figure 2). However, the housing market has continued to weaken rapidly since the summer: home sales and mortgage demand have dipped amid tighter financing conditions while residential investment is falling. We expect GDP growth to fall by -0.3% in 2023, with the recession starting in Q1 2023. Growth is likely to pick up by a modest +1.6% in 2024, held back by fiscal consolidation and still elevated real interest rates.

Table 1: GDP growth (%)

Growth (yearly %)	2020	2021	2022f	2023f	2024f
Global (PPP exchange rates)	**-3.0**	**6.1**	**3.1**	**1.9**	**3.1**
Global (market exchange rates)	**-3.3**	**6.0**	**2.9**	**1.4**	**2.8**
USA	**-2.8**	**6.0**	**1.9**	**-0.3**	**1.6**
Latin America	**-7.1**	**6.7**	**3.3**	**1.2**	**2.2**
Brazil	-4.2	5.0	2.8	1.1	2.1
UK	**-11.0**	**7.5**	**4.4**	**-0.9**	**0.7**
Eurozone	**-6.3**	**5.3**	**3.3**	**-0.4**	**1.0**
Germany	-4.1	2.6	1.8	-0.7	0.6
France	-7.9	6.8	2.5	-0.4	0.9
Italy	-9.1	6.7	3.8	-0.3	0.8
Spain	-11.3	5.5	4.6	0.2	1.2
Russia	-2.7	4.7	-2.8	-2.9	1.6
Turkey	1.9	11.4	5.1	1.9	3.8
Central and Eastern Europe	**-3.3**	**5.3**	**0.3**	**0.2**	**2.5**
Poland	-2.0	6.8	5.5	0.7	2.3
Asia-Pacific	**-1.0**	**6.1**	**3.2**	**3.6**	**4.5**
China	2.2	8.1	2.8	4.0	5.2
Japan	-4.7	1.7	1.4	0.8	1.1
India	-6.6	8.3	6.7	6.0	6.2
Middle East	**-4.2**	**3.9**	**5.6**	**3.4**	**2.6**
Saudi Arabia	-4.1	3.2	10.2	4.9	3.1
Africa	**-1.7**	**5.8**	**3.2**	**3.1**	**3.5**
South Africa	-6.3	4.9	1.8	1.5	1.4

Source: Allianz Research

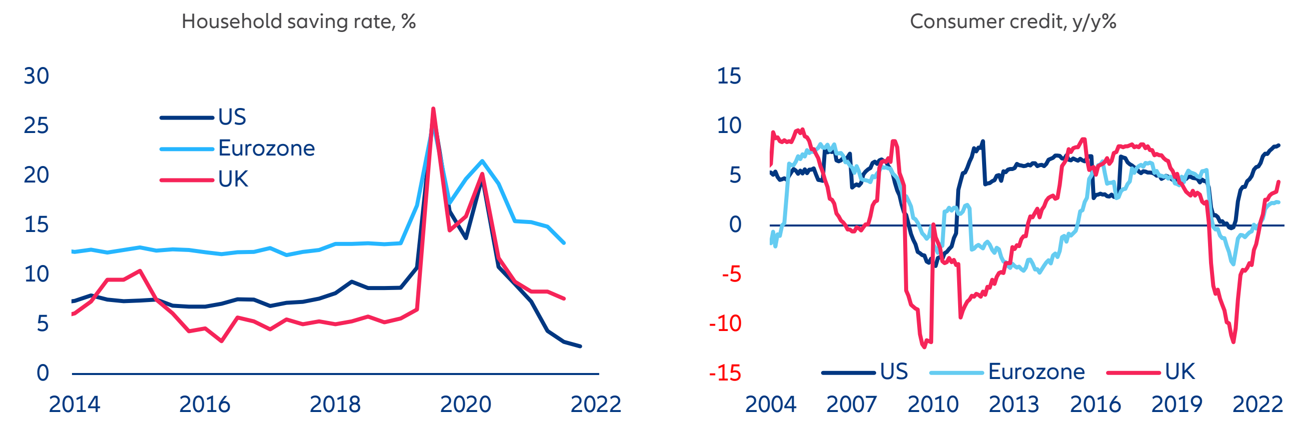
Figure 1: Europe and US: recession probabilities (%)



Sources: Refinitiv Datastream, Allianz Research

Eurozone: While gas rationing is likely to be avoided on the assumption that demand for natural gas can be reduced by at least -10% relative to last year, persistently high energy prices will push the Eurozone into a recession at the turn of the year. We still expect a bottom-out in H1 2023, followed by a shallow recovery below potential growth. Scaled-up public sector support over the past months only partially compensates for households' declining purchasing power and lower corporate profitability. We anticipate only a modest pick-up in 2024-25 for countries with a higher dependence on gas and larger manufacturing sectors (Germany). Spain (and to a lesser extent France) should be more resilient compared with Eurozone peers. The energy crisis will depress growth for another few years, with material downside risks for winter 2023-24 amid a still negative output gap in 2024. We expect GDP growth to fall -0.4% in 2023 before picking up by +1.0% in 2024, which would make the recovery as weak as after the Eurozone debt crisis in 2012. All in all, we see a risk that the energy crisis will put Europe on a lower growth trajectory going forward.

Figure 2: Europe and US: household savings and consumer credit



Sources: Refinitiv Datastream, Allianz Research

China: The coming months are still likely to be difficult. There is a high probability of negative q/q growth in Q4 2022, with overall growth for 2022 likely at +2.8% (down from our forecast of +2.9% previously). We also expect soft growth in Q1 2023. As a result, we have cut our 2023 GDP growth forecast to +4.0% from +4.5% but revised up our 2024 growth forecast from +4.7% to +5.2%. Against the latest socio-economic backdrop, Chinese authorities have made concessions and accelerated efforts to move towards an exit from zero-Covid policies, including: (i) doubling down on efforts and incentives to inoculate the vulnerable population; (ii) easing quarantine conditions for some Covid-19 cases and contact cases (e.g. at home instead of at quarantine facilities) and (iii) reducing the frequency and scope of testing requirements. As a result, our expectations for a full reopening from zero-Covid rules is moved forward by a few months to spring 2023. This means that, after the difficult ongoing winter months where the number of cases surged as a result of relaxed restrictions, the post-Covid rebound could start to be felt a little earlier in the second half of next year, and into 2024. Real estate will remain a structural drag on growth but monetary conditions will continue to be accommodative, notably through selective liquidity. The domestic recovery becoming more sustainable should allow the start of a gradual tightening of monetary policy in H2 2024.

Emerging markets (EMs) and developing economies (DEs) will continue to be impacted by strong global headwinds and many are facing additional domestic challenges, all of which vary across regions or if a country is a commodity importer or exporter. Global headwinds include still tightening global liquidity, a strong USD, elevated food and energy prices and the ongoing slowdown of Chinese demand. Net importers of energy and food will remain particularly vulnerable to the adverse effects of the high prices for these goods on inflation, public and external finances. Central and Eastern European countries will be the most affected as they face an energy-supply crisis on top of the energy-price crisis over the winter as Russia and Ukraine were their main pre-war suppliers. Many DEs in Africa and Asia as well as non-commodity exporters in the Middle East will also continue to suffer from the food- and energy-price surge and are especially vulnerable to increased social risk as a result. Major EMs in Latin America benefit from the commodity price boom, and a strong job market and resilient domestic consumption further helped to boost economic growth in most of 2022. That said, political uncertainties have created headwinds. In Emerging Asia excluding China, growth is expected to take a step down in 2023 (+5.4% after +5.8% in 2022) before recovering mildly in 2024 (to +6.2%). After a year of post-Covid recovery, Southeast Asian economies are caught up by the negative impact of higher inflation and tightening monetary policies (even though less so than in other regions), while the export-oriented Asian Tigers are also weighed down by slowing global demand. In the meantime, the Gulf Cooperation Council economies appear to be the sole winners from the current crises in the EMDEs world, even though they are also large net food importers. They will continue to experience robust growth and improving public and external finances in 2023, while inflation will remain in check in the region, thanks to monetary tightening and targeted fiscal measures mitigating food-price increases. Last but not least, we will be watching the EM election calendar closely as policy mistakes in the run-up to the elections cannot be ruled out: Nigeria (February), Thailand (May), Türkiye (June), Argentina (October), Poland (November) and Bangladesh (December).

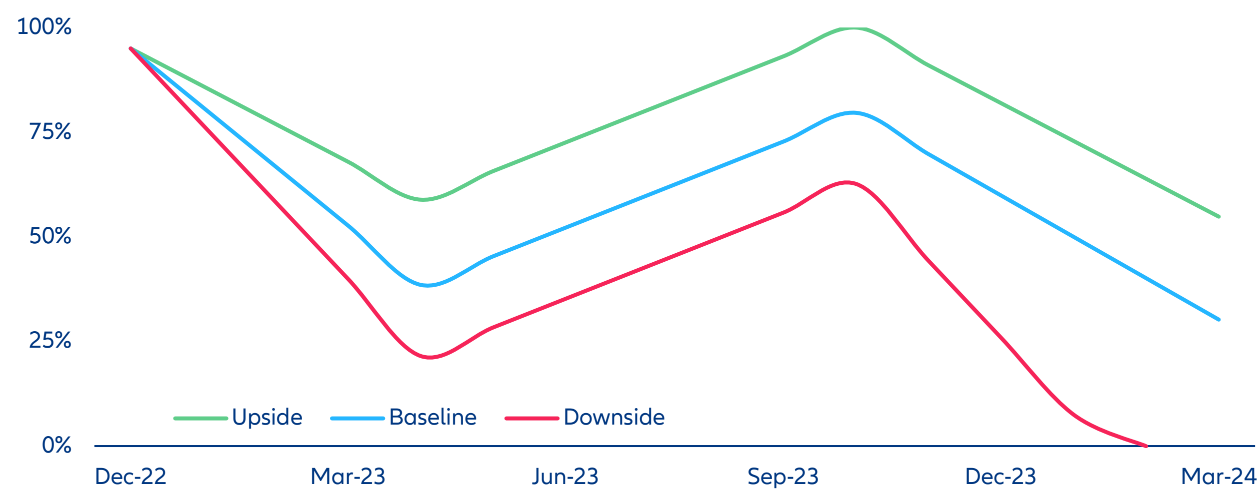
Energy crisis: how much longer?

The evolving policy response to the current energy and food crisis will shape the outlook for next year. The continued uncertainty about gas supply and high electricity and food prices will weigh on consumer sentiment and business prospects, resulting in a stop-and-go growth momentum due to increasingly entrenched negative confidence effects. Europe is the epicenter of the energy crisis and hence, in the short-run, the negative impact will be most pronounced, while risks remain clearly tilted to the downside. More specifically, the depth of the cost-of-living crisis in Europe will depend on how low temperatures fall this winter, how well EU solidarity holds up and how efficiently corporates can wean themselves off Russian gas or switch to less energy-intensive inputs. French nuclear plants are also coming back on the grid later than initially planned, which complicates the current "energy balancing act".

We expect energy prices will remain high over the next two years. We assume that Russian gas flows to Europe via the Nord Stream pipeline will remain at zero until spring, with a low probability of some resumed exports in fall 2023 (potentially triggered by peace talks between Ukraine and Russia). Additional limited supply through the Yamal gas pipeline (via Poland) would be seen as a positive signal by markets. With OPEC+ being conservative and LNG volumes limited, supply should remain constrained both for oil and natural gas. Furthermore, despite some easing in demand due to the global recession penciled in for 2023 and gas-demand destruction, we believe markets will remain tight and prices high for the next couple of years. We expect oil prices to average 95 USD/bbl in 2023 and 90 USD/bbl in 2024, while TTF natural gas prices would average 170 EUR/MWh in 2023 before consolidating slightly to 150 EUR/MWh in 2024. Risks to the upside could come from (i) a softer recession, (ii) further supply cuts from producers or (iii) insufficient gas savings in Europe. Risks to the downside could come from a (i) harder recession and (ii) a faster energy transition (through greater efficiency or increased electricity availability).

A sustained energy-demand reduction will be key in what shapes up to become a more persistent energy-supply crisis. In our baseline scenario, we assume Europe will be entering winter 2023/24 with storage at 65-70% of capacity at best (assuming +20-25pps replenishing of stored gas from end-March 2023 to the start of November). However, as Europe entered Q3 2022 with storage levels above 80%, we are also penciling in sustained energy savings. The greater availability of French nuclear power will provide quite a significant buffer. As a downside scenario, we see 40% of storage at the start of winter 2023, which should double the energy gap and push Europe into its second year of recession (Figure 3). Going forward, key challenges relate to the design of national energy markets and the compatibility of different energy infrastructures (e.g. delivering gas from Spain, where imports outstrip consumption) to other parts of Europe. Scaling up investment in renewable energy infrastructure and viable alternatives to pipeline gas, such as LNG terminals in ports, is also essential, but will take time. In the meantime, effectively mitigating the impact of the energy crisis will require a coordinated fiscal policy response, (1) repurposing the more than EUR200bn of Next Generation EU funds still remaining and/or (2) setting up a new crisis fund at the European Commission, using SURE as a blueprint (backed by government guarantees).

Figure 3: European gas storage scenarios

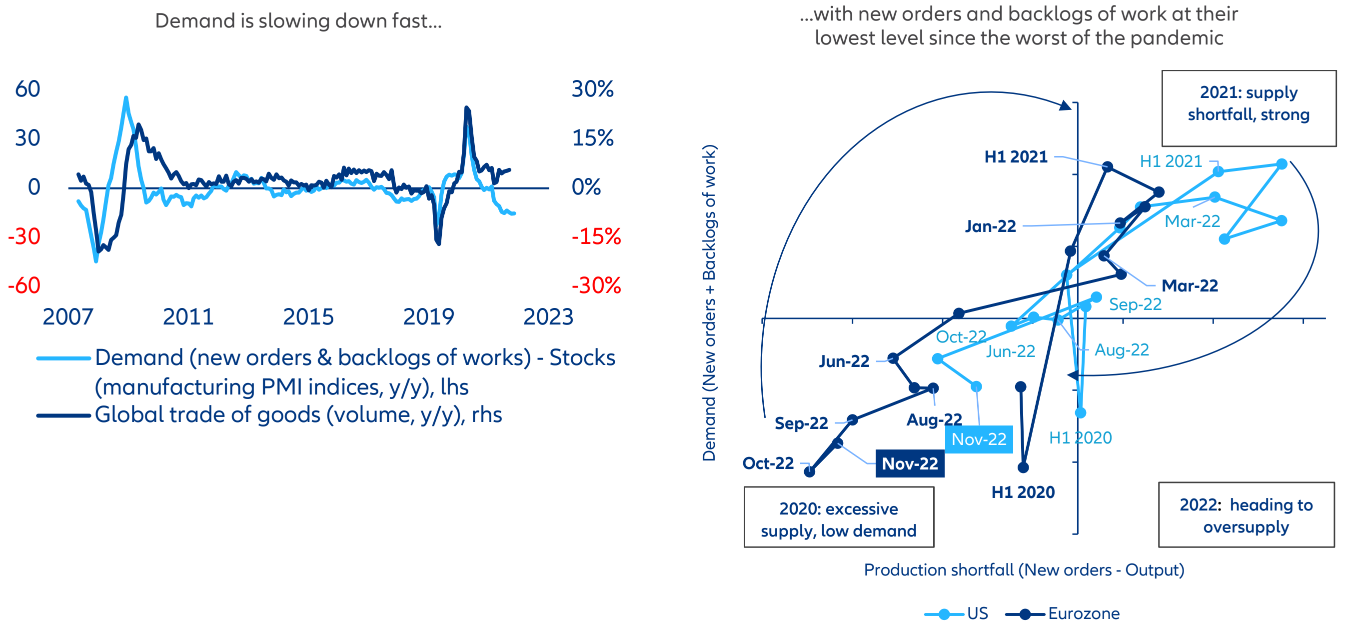


Sources: ENTSO-G, Allianz Research

Global trade continues to slow as industrial activity recedes despite easing supply-side constraints (Figure 4). Oversupply in the manufacturing sector has worsened since Q3 2022, notably in Europe. New orders and backlogs of work are at their lowest level since the pandemic in 2020. Hence, the manufacturing sector is expected to remain in recession in 2023 due to lower demand, mainly for consumer-driven industries, and a more pronounced destocking process from corporates in sectors where oversupply is highest. The largest cliff is expected in cyclical sectors such as construction, consumer goods (electronics, household equipment etc.) and retail. Supply chains continue to normalize, supported by slowing demand and China's progressive reopening. The Global Supply Chain Pressure Index reached its lowest level since early 2020 and freight rates are three times lower compared to the beginning of this year (though still twice higher than pre-pandemic levels). A normalization in supply chains would lower inflation by more than -1pp in advanced economies by mid-2023. A manufacturing recession along with the continued slow recovery of services trade and a correction in price pressures mean that we expect global trade in goods and services to grow by only +0.7% in volume terms in 2023 (-0.5pp from our previous forecast) and to contract by -1.3% in value terms (-0.2pp from our previous forecast). A mild recovery should be possible in 2024, with global trade in goods and services growing by +3.6% in volume terms (i.e. roughly 1pp below the pre-pandemic long-term average) and a neutral price effect resulting from opposing sectoral trends. Beyond the cyclical developments, trade and industrial policies will remain topical over the coming years. While our past research has shown that reshoring was more talk than walk[1] and that critical dependencies on China are too numerous to be disentangled[2], policymakers across the world seem focused on taking action to secure supply chains (e.g. EU Chips Act, US Inflation Reduction Act). Not all trade participants will be hindered by such protectionist measures (e.g. Southeast Asia benefiting from US-China tensions), but global trade may be heading towards lower growth rates in the coming years compared to the pre-pandemic long-term average.

1 See Global Trade Report: Battling out of supply-chain disruptions
2 See Globalization 2.0: Can the US and EU really "friendshore" away from China?

Figure 4: State of global trade



Sources: Markit, Allianz Research

Inflation: reaching the peak

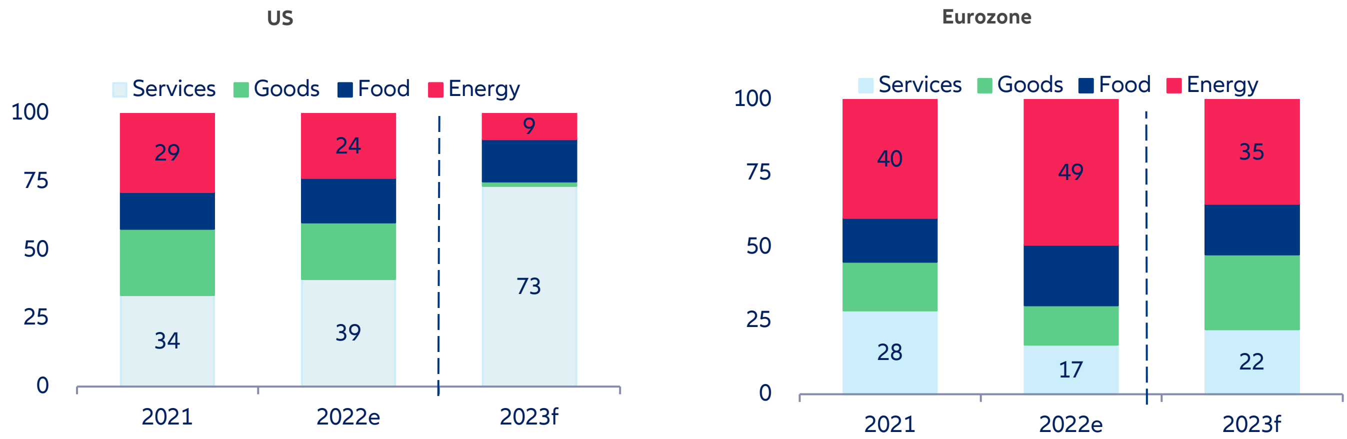
Inflation will remain uncomfortably high over the near term, averaging 6.4% at the global level in 2023 before receding to 3.9% in 2024 (Table 2). It should continue to remain strong over the coming quarters (despite strong disinflationary base effects in 2023), with core inflation remaining rather sticky next year. For instance, in the Eurozone, energy prices should still explain about a third of total inflation compared to almost 50% in 2022 (Figure 5). Besides the lower contribution from supply chains and a negative contribution from demand and monetary policy, a stronger euro should reduce inflation by around -1pp in 2023-24. In advanced economies, we expect inflation to reach 4.7% in 2023 (down from 7.4% in 2022). Continued wage pressures coupled with persistently high energy and food prices will keep inflation at 2.4% until late 2024, especially in Europe. Inflation in emerging markets will decline to only 8.5% (from 10.4% in 2022) and remain elevated at 5.9% in 2024. Structural factors (including demographics) will keep labor markets tight despite the anticipated recession, and policy support will prevent larger adjustments in domestic demand and hence stronger disinflation, notably for services. On the goods side, imported deflation from China starting to be more visible in the coming months. This should shave off at least -0.5pp of inflation in the US, Eurozone and the UK, and support a downward adjustment in inflation expectations. In the US, according to the NFIB survey, the share of small corporates that want to increase prices in the coming months fell to 34% from a peak of 52% in March. In the Eurozone, the same share decreased from close to 60% in April to 44% recently.

Table 2: Inflation (%)

Inflation (yearly %)	2020	2021	2022f	2023f	2024f
Global	**2.6**	**4.3**	**8.6**	**6.4**	**3.9**
USA	**1.3**	**4.7**	**8.1**	**4.1**	**2.3**
Latin America	**11.8**	**13.9**	**16.2**	**14.2**	**10.3**
Brazil	3.2	8.3	9.6	4.8	3.6
UK	**0.9**	**2.6**	**9.0**	**7.5**	**3.5**
Eurozone	**0.3**	**2.6**	**8.5**	**6.1**	**2.6**
Germany	0.5	3.1	8.8	6.8	2.4
France	0.5	1.6	5.8	5.4	2.3
Italy	-0.1	1.9	8.0	5.8	2.2
Spain	-0.3	3.1	8.6	4.8	3.5
Russia	3.4	6.7	14.0	12.0	7.9
Turkey	12.3	19.6	72.6	36.1	20.6
Central and Eastern Europe	**4.5**	**8.1**	**14.8**	**11.8**	**5.6**
Poland	3.4	5.1	14.5	11.8	5.5
Asia-Pacific	**2.2**	**1.7**	**3.7**	**3.2**	**2.7**
China	2.5	0.9	2.0	2.2	2.4
Japan	-0.0	-0.2	2.3	1.9	1.5
India	6.6	5.1	7.0	5.8	4.7
Middle East	**9.9**	**15.8**	**25.0**	**21.6**	**12.9**
Saudi Arabia	3.5	3.1	2.5	2.6	2.1
Africa	**10.0**	**12.4**	**17.5**	**14.1**	**8.8**
South Africa	3.3	4.6	7.0	5.1	4.7

Sources: Refinitiv Datastream, Allianz Research

Figure 5: Eurozone and US: decomposition of headline CPI inflation



Sources: Refinitiv, Allianz Research

Monetary policy: A timid pivot in late 2023

Central banks remain determined to fight inflation, but we expect the hiking cycle to slow in the coming months (Figure 6). Given sticky core inflation, we expect rates in advanced economies to stay at high levels for longer and a less ambitious pivot in 2023 despite the recession. However, during early 2023, the restrictive monetary stance risks becoming increasingly politicized as central bankers are expected to continue prioritizing fighting inflation over supporting growth. This will be the ultimate litmus test for their independence. It will also constrain the pace at which they unwind quantitative easing. The proactive run-off of the US Federal Reserve's balance sheet continues to strengthen the restrictive stance but is unlikely to accelerate to prevent further upside pressure on long-term rates and potentially fueling further volatility spikes in the Treasury market. In the Eurozone, the potential of rising fragmentation risk due to rising peripheral sovereign spreads will limit the scope for rapid quantitative tightening.

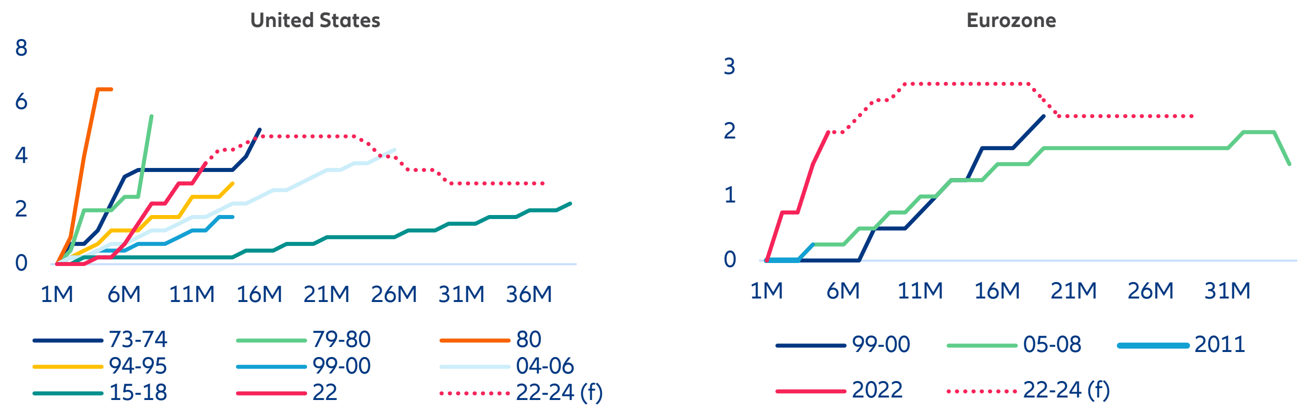
- **The US:** We expect the US Federal Reserve to hike interest rates to 5% by March 2023. A moderate pivot (-75bps) is expected in November-December 2023 against a backdrop of rapidly falling inflation and a weak economy. Nevertheless, monetary policy will remain tight outright, with real rates expected to remain largely positive through 2024. Inflation is clearly cooling down in the goods sector – a sign of softening demand for goods, a stronger USD and the easing of supply-chain disruptions. Elevated core services inflation still looks concerning, but we believe that by Q2 2023 it will start to come down convincingly. Home prices have started to come down on a sequential month-on-month basis, and we believe rental-prices growth will soon soften. Upstream services price pressures are already easing and the upcoming recession should contribute to further downside pressures. We expect the Fed's balance sheet run-off to remain on autopilot over the forecasting horizon, with a roughly USD90bn monthly decline in assets per month, as targeted by the FOMC. Through 2024, though, we expect the Fed to keep running down its mortgage-backed securities holdings but to steady its Treasuries holdings. Banks' reserve balances at the Fed should settle at around 9% of GDP by the end of 2024, a level consistent with sufficiently ample liquid assets. The Fed is not likely to wind down its balance sheet faster for fear of spooking financial market turbulence.

- **Eurozone:** As opposed to the US Fed, persistently high inflation for most of next year will delay the ECB's potential interest rate cuts to 2024. We expect the ECB to slow the pace of rate hikes after the December meeting (+50bps) to reach a terminal rate of 2.75% for the effective policy rate (deposit rate) until May 2023. Slowing growth and rising unemployment will mitigate wage-price pressures as supply-demand imbalances gradually subside. One year after the US Fed, the ECB is likely to kick off the reduction of its balance sheet in Q1 2023, mostly driven by additional (early) repayments of TLTROs. Unwinding QE will focus on the "old" asset purchase program APP while PEPP will remain untouched. In particular, we expect a passive run-off based on scheduled redemptions via a progressively declining cap on reinvestments. As a result, government debt holdings should only decline by up to 5% next year.

- **China:** Monetary policy will remain selectively accommodative over the coming year to support the economy, contain any systemic risk from the real estate sector and facilitate continued fiscal policy easing. We expect just two more policy rate cuts in 2023 (before a stabilization in 2024), meaning that this round of monetary easing will have been more dragged out and less intense than in the past (-40bps over two years vs. -50bps in less than three quarters in late-2019/early-2020). Chinese policymakers are wary of structural vulnerabilities (overall indebtedness, risk of overcapacity) and potential inflationary pressures coming from the post-Covid reopening. The monetary stance is likely to switch to neutral and restrictive in H2 2024, when the post-Covid domestic recovery becomes sustainable.

- **Emerging markets:** Most central banks will need to keep raising interest rates in light of persistently higher energy and food prices and strong downward FX pressures. However, only a few have reached positive real interest rates so far (e.g. Brazil, Mexico, Saudi Arabia, Vietnam). Nonetheless, some central banks, mainly in Central and Eastern Europe (CEE), are likely to be the first to cut rates again in mid-2023 to support the economy in the wake of the sharp global growth slowdown, followed by other regions in Q4 2023. The largest ones will be in Latin America (between 200 to 300bps in Brazil, Colombia and Chile) and smaller ones (50 to 100bps) in the Middle East and very few African and Asian countries. Overall, we expect key interest rates to remain above 2021 levels by the end of 2024.

Figure 6: Eurozone and US: current and past policy rate-hiking cycles (%)



Sources: Refinitiv Datastream, Allianz Research

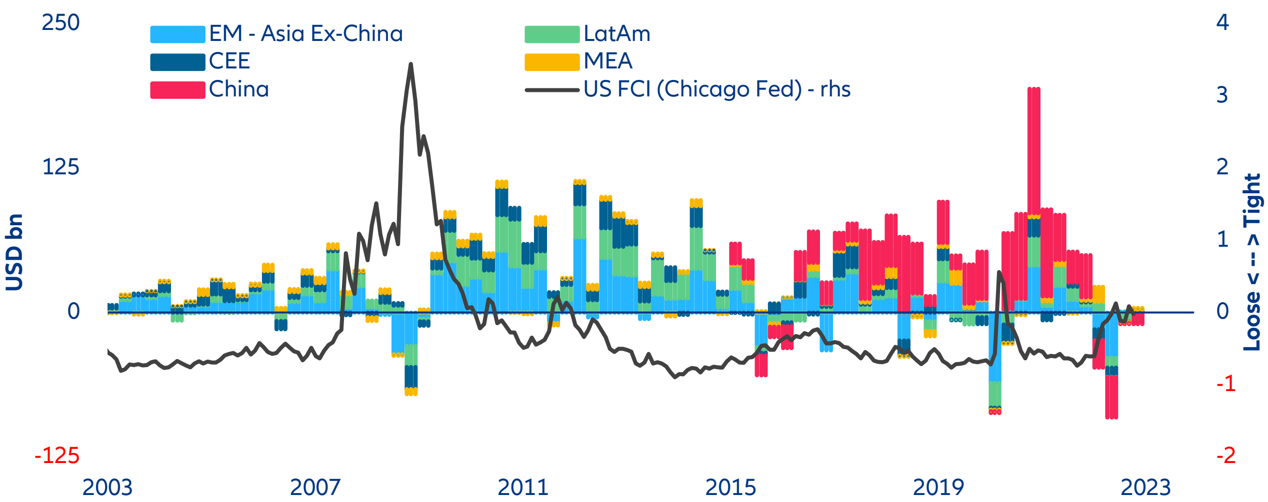
Net capital outflows from EMs and attended FX pressures will continue next year (Figure 7). The widening interest-rate differentials relative to the US and the Eurozone leave the door open to further capital outflows from EMs to appealing advanced economies.[3] This situation will exacerbate in case countries pursue a different monetary policy (e.g. Türkiye) and could lead to liquidity problems, although concentrated in smaller EMs. Moreover, conditions remain largely favorable for the USD, especially in the short term, since the US Fed is expected to maintain a hawkish stance for a while longer while most other central banks are bound to face more pressure to become dovish as domestic demand slows and/or risks to financial stability increase. In addition, the winter weather in Europe and the ongoing Russia-Ukraine conflict also point to the risk of further energy price spikes and risk-off mode - which accentuates the safe haven role of the US dollar. Hence, the USD will remain relatively strong for some time yet. This certainly puts pressure on countries that have a high external debt denominated in USD as they have to buy the greenback to repay their USD debt with cheaper local currencies. Moreover, a stronger US dollar also increases import costs, meaning that major central banks might limit a potential future monetary-easing cycle to contain price pressures.

3These outflows are not only a problem for emerging markets, but they also bring reputation costs to the US Federal Reserve, and leave the door open to other countries seeking to expand their financial influence by providing cheaper credit (e.g. China or GCC). See our full report: Financial globalization: moving towards a polarized system?

Sovereign debt distress has markedly risen during 2022, in particular in developing economies but also in some EMs. The main reasons are the strengthened USD making repayments of USD-denominated debt more expensive (as outlined above), higher interest rates (increased risk premia) complicating the rolling-over of maturing debt, widening budget deficits due to increased subsidies and transfers to mitigate the impact of higher energy and food prices on people and companies, as well as the resumption of debt-service payments for DEs that participated in the G20 debt relief initiative (DSSI) that ended in 2021. In our updated public-debt-sustainability risk analysis, we identify several African countries (Egypt, Ghana, Kenya, Malawi, and Tunisia) as well as Costa Rica, El Salvador, Jordan, Laos, and Pakistan as highly susceptible to debt distress (Table 3).[4] Note that the risk of sovereign default also remains very high in Argentina and has continued to increase in Turkey, although the latter should avoid defaulting, thanks to sizeable swap arrangements between the Turkish central bank and its counterparts in a number of countries (for example China, Qatar, South Korea, and UAE).

4 Out of the 25 countries in Table 3, Zambia, Sri Lanka, Lebanon and Ukraine are already in default or quasi-default. On the other hand, some countries such as South Africa, Brazil, India and Romania appear in the table due to a few very badly scoring indicators but are unlikely to default in the next two years, for example thanks to a low share of FX debt and/or moderate interest payments falling due.

Figure 7: Eurozone and US: current and past policy rate hiking cycles (%)



Sources: IIF; Refinitiv Datastream; Allianz Research. Monthly flows aggregated by quarter. Flows are aggregated as soon as they are reported, but different countries report the data with different lags.

Table 3: Public debt sustainability risk score (25 most vulnerable EMDEs, out of 102 markets scored, as of December 2022)

Rank	Country (from high risk to low risk)	Public Debt Sustainability Risk Score (0 = high risk; 100 = low risk)	Total Public Debt (% of GDP)	Debt Shock (due to Covid-19 and war in Ukraine; increase in public debt-to-GDP ratio)	Foreign Exchange-denominated Public Debt (% of total public debt)	Maturing Public Debt (% of GDP)	Fiscal Balance (% of GDP)	Interest Payments (% of fiscal revenues)	Effective Interest Rate (interest payments in % of public debt at the end of previous year)	Interest Rate - Growth Differential (%)
			max(2022;2023)	2019 -> 2022	2022	2023-2024	2022-2023	2023	2023	2023
1	**Zambia**	**0.0**	115	15	73	8.9	-7.9	35	8.5	4.8
2	**Sri Lanka**	**6.7**	131	48	36	9.3	-9.9	79	9.1	6.7
3	**Malawi**	**6.8**	71	22	54	8.6	-7.7	36	9.8	14.9
4	**Ghana**	**10.8**	85	22	55	3.7	-8.2	50	9.9	17.7
5	**El Salvador**	**11.9**	89	14	64	4.0	-6.6	19	6.7	2.2
6	**Ukraine**	**13.4**	90	38	70	4.8	-17.0	11	8.7	13.7
7	**Egypt**	**13.8**	95	11	26	13.9	-7.4	43	11.2	10.8
8	**Kenya**	**14.4**	70	12	57	4.5	-6.1	25	7.3	5.0
9	**Laos**	**19.5**	109	45	86	0.3	-5.0	22	3.4	10.8
10	**Costa Rica**	**20.4**	67	10	42	9.4	-4.1	35	8.5	2.0
11	**Jordan**	**20.8**	94	15	45	10.3	-6.4	16	4.8	-0.9
12	**Tunisia**	**20.8**	85	16	67	4.9	-9.0	11	3.8	4.4
13	**South Africa**	**22.3**	73	14	33	2.9	-7.8	19	7.9	5.3
14	**Bahrain**	**23.6**	120	17	63	11.0	1.3	21	4.0	0.6
15	**Bangladesh**	**24.0**	29	29	75	1.1	-5.9	27	7.9	2.7
16	**Uganda**	**28.2**	53	15	70	2.3	-4.8	20	6.7	-1.7
17	**Brazil**	**30.9**	93	4	6	7.6	-7.5	22	8.1	-0.6
18	**Pakistan**	**30.9**	78	0	34	3.3	-5.0	40	8.1	3.9
19	**Lebanon**	**32.3**	175	2	38	52.8	-3.2	33	3.6	2.1
20	**Turkey**	**34.4**	44	9	55	2.5	-5.2	11	12.1	1.8
21	**India**	**34.7**	94	14	6	2.3	-9.4	29	7.5	-2.7
22	**Moldova**	**36.3**	45	11	59	2.2	-6.0	6	5.4	3.4
23	**Dominican Republic**	**37.7**	61	7	77	6.5	-2.7	22	6.0	-2.8
24	**Romania**	**38.2**	55	18	51	4.2	-6.3	6	4.1	0.3
25	**Argentina**	**38.7**	81	-10	68	4.9	-4.6	6	4.6	2.5

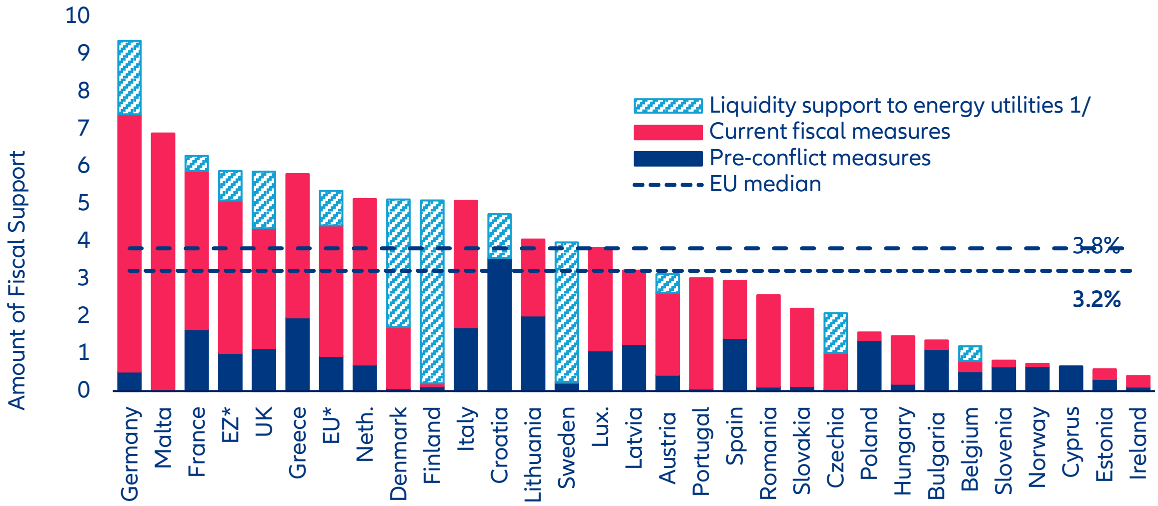
Source: Allianz Research.
Note: For the calculation of the PDSRS, each of the indicators was rescaled from 0 to 100, with 0 denoting the highest risk and 100 the lowest (not visible in the columns 4-11, which show the actual values). Then the PDSRS was calculated as the average of the indicators, thus also ranging between 0 and 100.

Fiscal policy: 2023 another exception year; prepare for fiscal consolidation in 2024

Most countries have taken bold steps to cushion the impact of the energy crisis on firms and households. In Europe, most of the current fiscal measures have been extended into 2023 for a total of more than 3% of GDP on average in Europe (close to 5% of GDP or more than EUR600bn since September 2021) (Figure 8). Unsurprisingly, the fiscal response is somewhat higher in countries with a larger energy-intensive industry and/or greater gas dependence. In most countries, the total measures (e.g. price caps, energy tax cuts, liquidity and equity injections, state-guaranteed loans and furlough schemes) amount to around half of the Covid-19 packages. With the energy crisis – and in turn the inflation hit to the private sector – not yet past the peak, we expect EU governments to increase spending further. However, the big fiscal leaps are behind us as the room for maneuver is much more constrained amid rising interest rates. Governments need to find a way to enhance energy efficiency and stabilize gas consumption beyond near-term savings (which currently stands at only 10%). Indeed, without demand reduction (through market prices or fiscal policy), countries could fall into a vicious cycle of higher prices leading to more fiscal slippage. Conversely, limited fiscal space and ineffective energy policy could further slow economic growth and raise the odds of a longer and deeper recession at a time when rising interest-rate burdens challenge debt sustainability. In particular, diminishing fiscal space could require difficult policy trade-offs as governments also tackle important structural challenges outside the current energy crisis, such as the green transition of their economies and the launch of bold pension reforms, such as in France and Spain. Available fiscal support will reduce the impact of higher energy prices on real disposable incomes and soften the blow on demand. However, it can also slow down the reduction in inflation rates overall. We estimate that current measures directly reduce inflation rates by lowering energy prices most in the UK (-3.7pps in 2023), followed by more than -2pps in Germany, France, Italy and Spain. By doing so, however, they "free" 1.7% of GDP of domestic demand on average as the decline of household disposable incomes in 2023 will be more than halved from -4.3pps to -1.7pps on average (more than EUR1,300 per household). However, coordination at the European level is likely to continue to disappoint, notably as regards the electricity market, which will raise the potential fiscal cost.

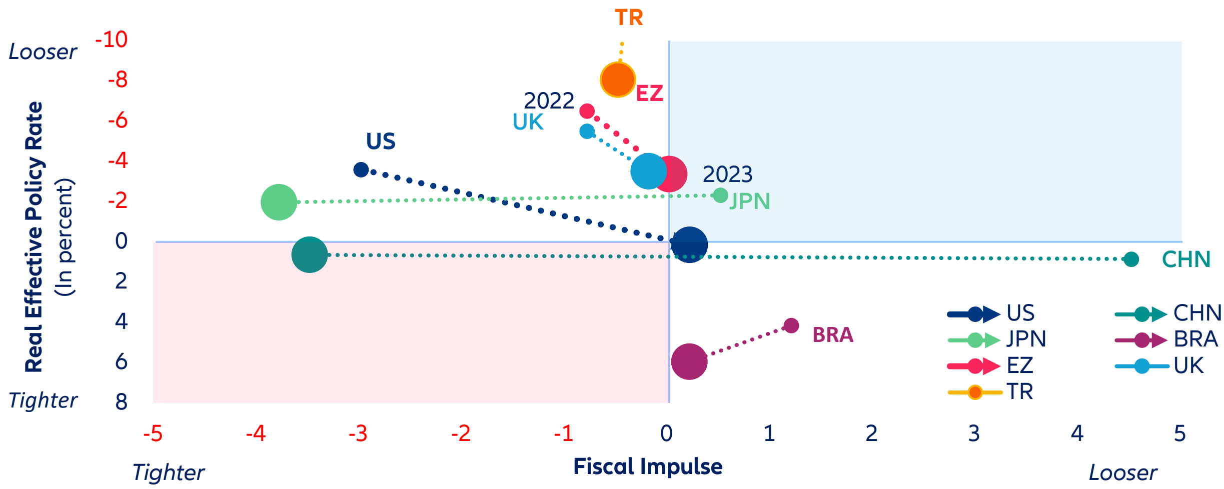
In the US, fiscal policy has decisively shifted towards a restrictive stance since the second half of 2021 (Figure 9). Because of the lagged effects of fiscal policy, it is expected to weaken the economy in end 2022-early 2023, supporting our call of an upcoming fall in inflation and a recession. However, we expect the Democrat-led White House and the Republican-led House to agree on a modest fiscal easing – to the tune of 0.2% of GDP – around the middle of next year to support a flagging economy. In 2024, we expect fiscal policy to turn restrictive again (to the tune of 1% of GDP) despite the Presidential election, amid mounting fiscal imbalances. Public deficits should be close to 7% of GDP in 2023 for the general government, pushed up by a rapidly growing interest payment bill (which we expect to top USD1,000bn by 2024) amid elevated borrowing costs.

Figure 8: Europe - Fiscal support measures to fight the energy crisis (%)



Sources: Refinitiv Datastream, Allianz Research

Figure 9: Fiscal and monetary impulse in advanced and emerging economies (pp)



Sources: Refinitiv Datastream, Allianz Research

Corporates: The trifecta of risks (financing, wages & recession) will bite in 2023

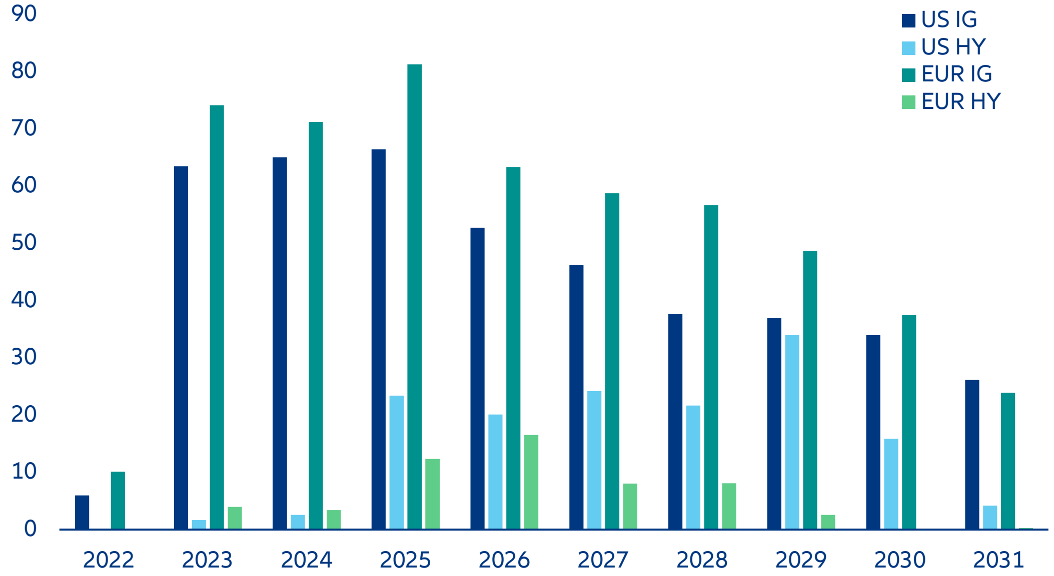
The confluence of slower growth, higher inflation and higher interest rates has increased corporate risks, mainly in the construction, transportation, telecom, machinery & equipment, retail, household equipment, electronics, automotive and textiles sectors. The energy crisis means a massive profitability shock for European firms, which governments can only partially offset. The fiscal packages that have been put on the table for corporates are enough to avoid a strong wave of insolvencies due to profitability losses in most impacted sectors (metals, paper, machinery and equipment, wood, mining) but they will not offset fully the estimated extra energy bill of over EUR150bn for French, German, Italian, Spanish and British corporates. The Q3 earnings season indicated the first cracks, notably in consumer and energy-intensive sectors. However, corporates are rapidly adjusting on the downside their expectations for 2023. With rising uncertainty, business confidence is also decreasing. In addition, the layoff cycle has kicked off, given the rise in labor costs, especially in sectors that experienced a strong boom during the pandemic, such as technology (Table 4).

Table 4: Estimated extra energy bill for corporates in 2023 (EUR Bn / % GDP)

	Extra electricity cost	Extra gas cost	Total	(% GDP)
France	14	3		0.7%
Germany	27	9		1.0%
Italy	29	8		2.0%
Spain	19	6		1.9%
UK	31	9		1.4%
Total	**120**	**36**		**1.2%**

High cash balances and pricing power provided a significant buffer against the monetary policy normalization in 2022, but the worst is still to come. As cash holdings of firms were high and strong demand combined with significant pricing power, corporates showed resilience in 2022 both in terms of revenues and profitability. However, the interest rate shock and the higher wage bill in response to unprecedented inflation could amount to a profitability shock similar to that seen during the Covid-19 lockdown. We forecast that the upcoming rises in key rates in the US, UK and Eurozone should increase average interest rates for corporates by an additional 200bps by mid-2023, which in turn will cut margins by -1.5pp in the US, -2.2pps in the UK and more than -3pps in the Eurozone countries. Italy, Spain and France are most at risk. However, strong bank-lending growth has compensated for more expensive and less liquid corporate bond markets (+22% y/y in new loans YTD), which should help mitigate the refinancing pressure in 2024, when corporate issuers face a wall of redemptions (Figure 10, following page). In addition, more than 50% of corporate loans increased their maturity to above five years, with less than 20% below one year. Many corporates also managed to secure fixed-term loans for longer-term borrowing. Looking at wages, the bill is slightly higher for Europe's industrial sectors compared to the US. Hence, an increase in wages of 4-5% in 2023 could wipe out between -0.5pp to -1pp of margins on average.

Figure 10: EUR & US Outstanding corporate debt maturity profile (in USD & EUR Bn)



Sources: Refinitiv Eikon, Allianz Research.
Note: Excludes debt maturing after 2031 and perpetuals

The balance of risk remains tilted to the downside

In our downside scenario, more disruptive energy-supply constraints, for instance as a result of a cold winter, would require rationing, implying harsher shocks to industrial production, labor markets and broader confidence, pushing 2023 GDP growth deeply into negative territory and increasing the probability of Europe entering a second year of recession in 2024. In particular, the currently benign situation in the labor market, suggesting a rebalancing via a reduction in vacancies rather than higher unemployment (especially in the US), might take more time to adjust but could deteriorate quickly as economic growth slows further. Even without further energy shocks, there is also a risk that inflation could rebound if fiscal support through price caps is lifted prematurely as policy space becomes increasingly constrained by rising interest rates. Higher-for-longer inflation would push central banks to hike more throughout 2023, increasing the risks of a policy mistake (including further reducing market liquidity, which could precipitate a financial crisis).

In our upside scenario, there would be a substantial resumption of gas supply to Western Europe, which would prevent a recession, and central banks would reach their terminal rates by moving more steadily while keeping a tight monetary stance as the better outlook favors more persistent domestic inflationary pressures. Our estimates suggest that Russia can survive without gas exports to Europe for more than a year as it sells more to new markets (e.g. India, China, Türkiye). While a full end of the war seems unlikely in H1 2023, we do see some signs that a ceasefire could materialize in the foreseeable future. A ceasefire would indeed release some of the market pressure as well as supply constraints. A swift reversal of China's zero-Covid strategy could also lead to earlier positive re-opening effects that could revitalize slowing global trade and accelerate the decline of producer prices, which had reached record levels only a few months ago.

A “perma-risk” outlook: volatile times are here to stay

Russia’s invasion of Ukraine triggered the return of geopolitical risk, and we think this is here to stay. We deem the risk of an outright military confrontation between major powers as low, given that governments will likely prioritize tackling big challenges on the domestic front. In Europe, the war in Ukraine and its political and economic implications will continue to dominate the policy debate. The energy crisis threatens to become a political crisis should the EU fail to respond in a unified manner in the next two years, with EU elections scheduled for May 2024. Further political and economic divergence could aggravate the longstanding trend of falling support for the two largest parliamentary groups (EPP and S&D) in favor of Eurosceptic parties. This in turn could mean even more political deadlock and less progress on important reform initiatives. Meanwhile US general elections in November 2024 will show whether Democrats manage to build on recent resilience - which in turn would likely lead to more protectionist policies. The US election results could also have significant international implications, including on to what extent the US will continue to underwrite European security as well as that of Taiwan. Expect China, Russia and other large powers to watch this space closely. Economic warfare via sanctions (mainly on tech) should continue in any scenario, with Southeast Asia a clear economic winner of intensifying US-China tensions. China looks set to prioritize domestic affairs, too – with a focus on generating sustainable economic growth and social peace – after a spike of social discontent over extended Covid-19 restrictions in late 2022 served as a warning shot. In Latin America, the verdict on whether the region will continue to turn left is still out (watch Argentina’s general election in 2023) as tough economic headwinds and rising interest rates are reducing fiscal room for pricey policy promises.

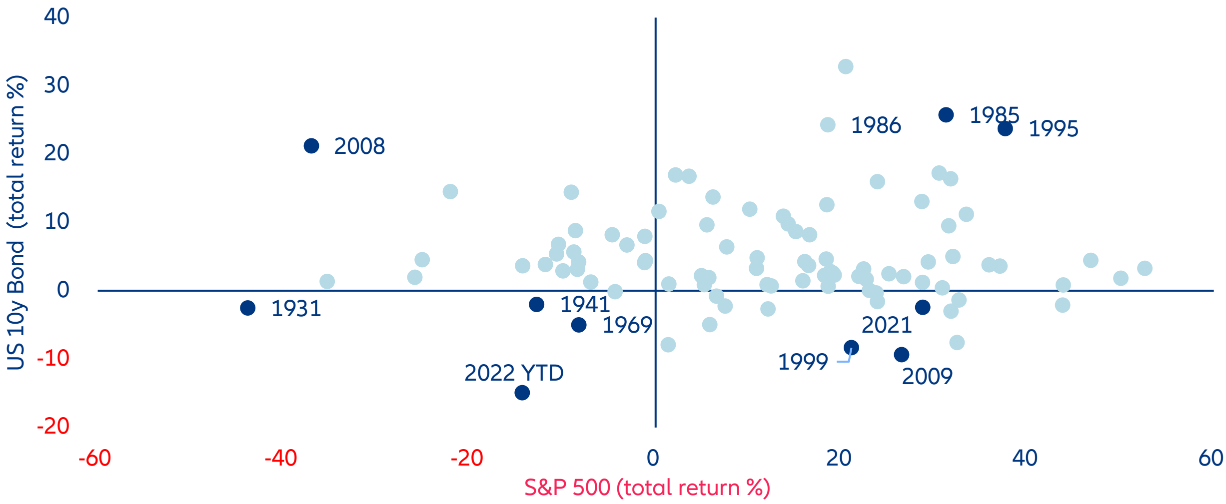
Too early to re-risk!

2022 was an unmitigated disaster for capital markets. The combination of higher interest rates despite slowing growth led to an unprecedented price correction in both equities and fixed income. This left investors with no place to hide and effectively killed any ex-ante diversification benefit, resulting in unseen high interest-rate volatility. In this context, market fractures have started to appear, such as the recent turmoil in the UK Gilt market, as funding becomes expensive and scarce. Despite not representing, as of today, an imminent systemic risk, the combined effect of high volatility and higher funding costs, amplified by leverage and concentration risk, could set off a so-called "liquidity spiral", with funding needs triggered by falling prices increasing demand for safe collateral to cover margin calls and shore up liquidity buffers.

The current volatile market dynamics are likely to spill over into the first half of 2023 as investors attempt to front-run the recovery path. Our economic scenario warrants a defensive tactical short-term positioning and hold-to-maturity investment in quality fixed income in the near term. During the second half of 2023, subsiding inflationary pressures and stabilizing policy rates cushion downside pressures on valuations and allow for some long duration positioning. However, the rebounding momentum will be short-lived as fiscal support is gradually withdrawn going into 2024, with most asset classes slowly converging to (but not reaching) their long-term average returns.

In this uncertain environment, the expected correction in illiquid alternative assets has been overlooked. Less transparent valuations and limited trading make them at risk of being most severely hit in case investors are forced to sell. Because of this, and as liquidity drains and the recession approaches, the likelihood of negative surprises in these segments continues to be high. The good news is that by late 2023, the global economy and markets will start leaving behind three years of extreme market and economic instability to start forming, once again, a much-needed but still timid structural cyclical positive trend (Figure 11, following page).

Figure 11: US equity vs 10y government bond yearly total returns (%)

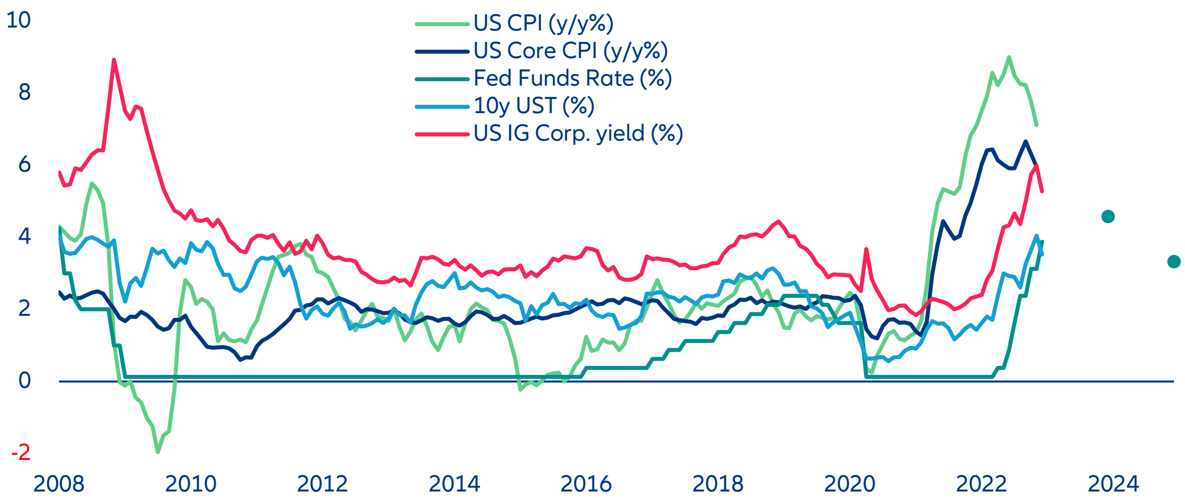


Sources: Refinitiv Datastream, Allianz Research

Given the complexity of the current market and economic context, we see seven themes shaping our 2023-2024 capital market view:

Remain cautious in the short run. Capital markets are bound to remain capricious as the timing and severity of the expected recession (and its implications on policy) remain uncertain. Continued economic uncertainty will continue to which could prevent a structural positive trend reversal until central banks reach peak hawkishness (i.e. Q1 2023). In addition, current valuations suggest that markets still do not fully price in the expected balance sheet erosion of companies (even for those with pricing power) as demand falters. For instance, the correction in equity markets this year has been driven by valuation effects (i.e. reduction in price-earnings multiples) due to higher real rates rather than earnings per se. With earnings expectations trending downward next year, there is still material downside risk for equity valuations at current levels. For instance, our identification method for equity-market bubbles suggests that the correction in US equities has not fully played out. With the S&P 500 perceived return currently standing at about 8% it can be inferred that the S&P 500 could fall by up to -10% over the next 12 months. In general, a typical post-bubble correction tends to depress perceived returns to the low single digits. High-quality credit and defensive equity will most likely outperform in the short run (Figure 12).

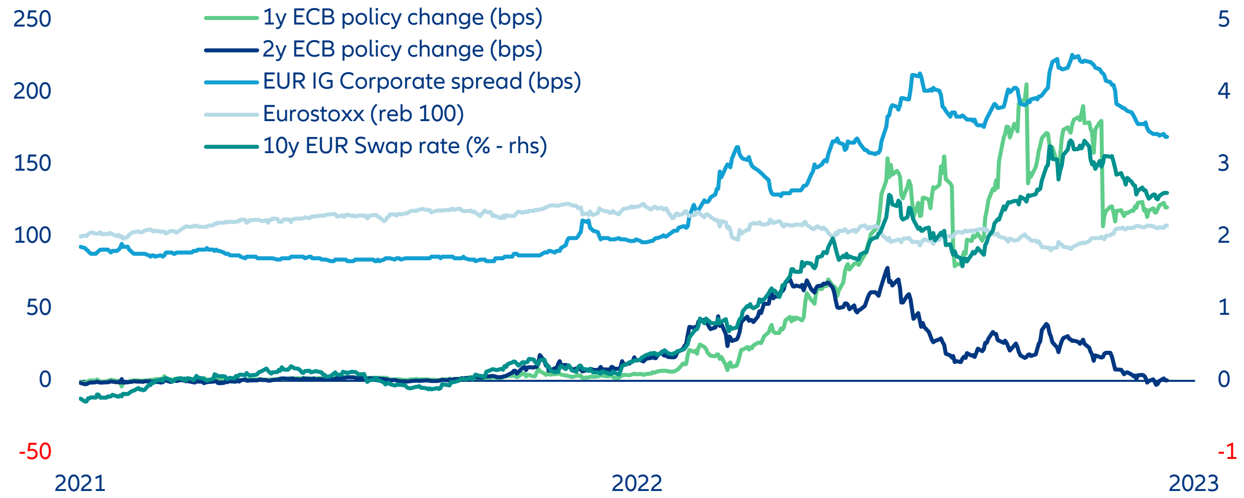
Figure 12: Inflation and monetary policy dominate market performance



Sources: Refinitiv Datastream, Allianz Research

At the mercy of monetary policy. For the past year, market performance has been mainly driven by macro-induced changes in monetary policy expectations and not by corporate fundamentals. While a snapback to fundamentals will happen eventually it is unlikely to occur during the course of next year. As a result, it is worth being cautious in the near term, putting more weight on assets and sectors less sensitive to interest rates. However, after the monetary policy pivot in late 2023, micro fundamentals (i.e. corporate balance sheets) will regain more relevance and start driving market performance (Figure 13).

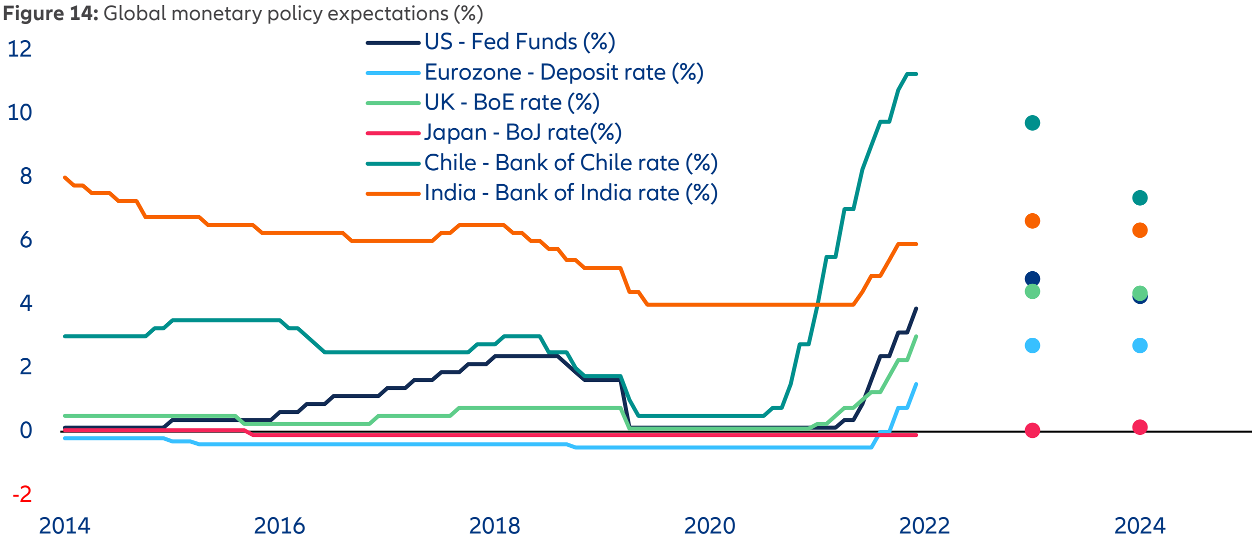
Figure 13: EUR assets vs ECB policy expectations



Sources: Refinitiv Datastream, Allianz Research

Respect the policy pivot line. The current energy crisis has amplified increasing cross-country heterogeneity. Over the next two years with expect even greater divergence within and across regions. Consequently, respecting the policy-pivot cue and the degree of economic resilience of each country will be key to generate positive returns, especially over the next six to nine months. EMs are likely to outperform as the initial conditions are far "cheaper" than those of developed markets, allowing for a stronger rebound that should be further fueled by a global and broad-based re-risking turn (Figure 14).

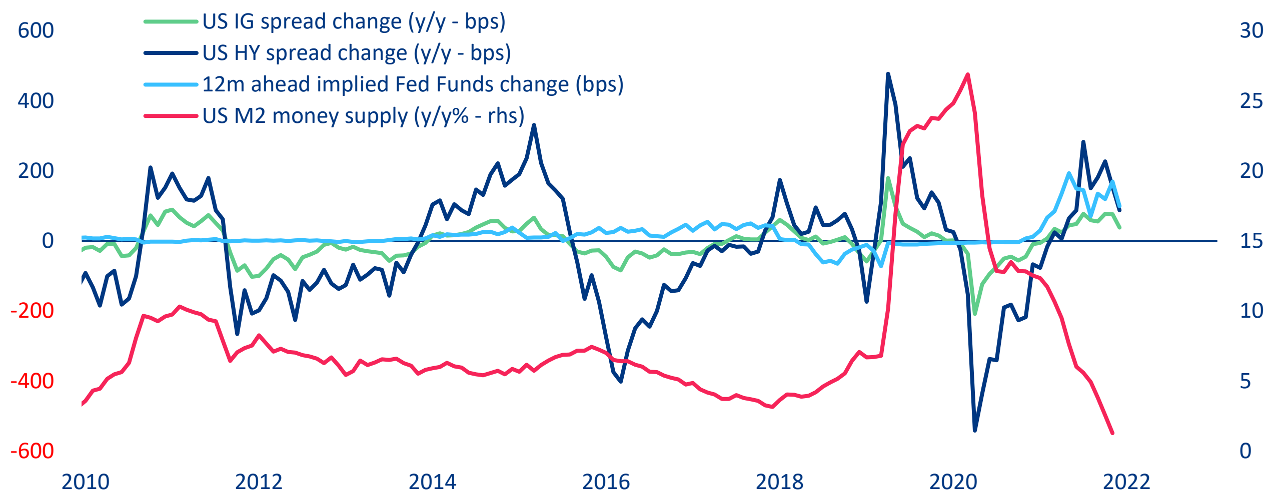
Figure 14: Global monetary policy expectations (%)



Sources: Refinitiv Datastream, Allianz Research.
Note: 1y and 2y ahead policy expectations based on OIS rates.

Large passive sources of market demand are departing. After many years co-living with QE, the era of permanent asset demand is coming to an end. Central banks' gradual pull-back from markets through quantitative tightening (QT) will most likely add some short-lived upward pressures on yields . Our calculations suggest the immediate effect of the push back will be around 10-30bps for both long-term sovereign yields and investment-grade corporate spreads. However, at current yield levels, market participants will be willing to absorb additional supply as yield hunters will increasingly try to lock in higher-income assets. This should especially be the case for investment-grade corporate credit, especially since net issuance will most likely remain neutral or even negative, thus structurally mitigating the effect of central banks pulling back. Of course, this will entirely depend on central banks' approach to quantitative tightening, which we still believe will be moderate (no direct sales). Apart from the direct effect of the lack of central bank purchases, the overall slowdown in money supply due to tightening financial conditions will continue to have a deteriorating effect on risk appetite in the next six to nine months. However, once the hawkish tilt is reverted in H2 2023, markets should start feeling a timid reacceleration of money growth, adding tailwinds for risky assets by pushing valuations higher (Figure 15).

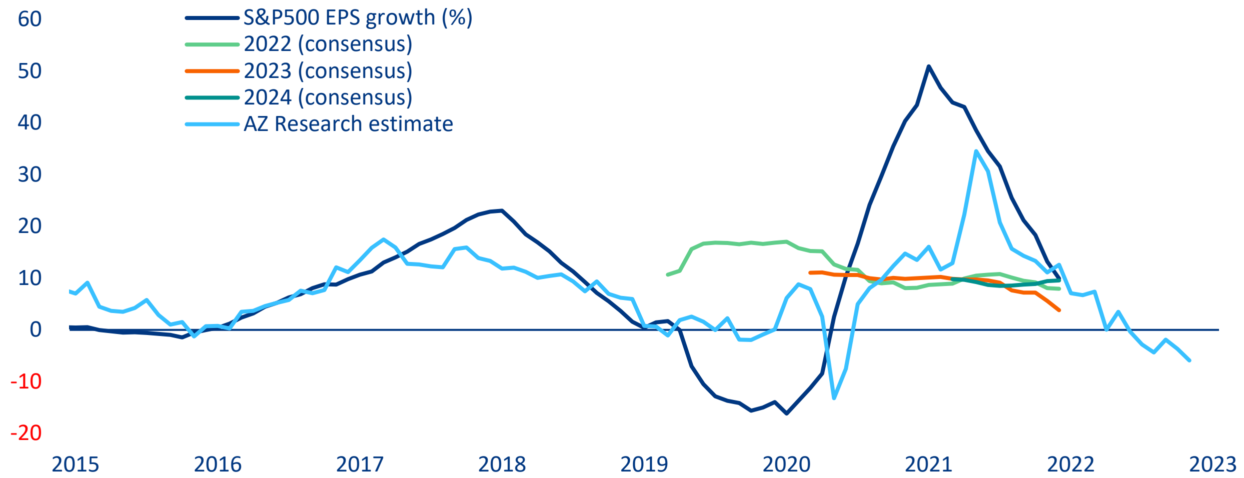
Figure 15: US assets vs money supply



Sources: Refinitiv Datastream, Allianz Research

A mild recession is still a recession. The expected mild recession in most advanced economies next year will directly challenge the still positive and relatively high earnings expectations across major economies. In fact, earnings expectations seem too high at the moment, especially since numerous economic indicators point towards a timid earnings contraction in 2023 (the same holds for corporate margins). Because of this, we believe that equity and high-yield corporates still have some room for correction, with the downside risks outpacing upside potential in the short run. Additionally, this expected direct economic challenge to corporates' top and bottom lines paired with still-high financing costs will most likely lead to a minor acceleration of defaults, though these will remain at historically low levels, and some increase in fallen angels (corporates downgraded from investment grade to high yield). However, and moving into 2024, the still resilient aggregate corporate balance sheets will push through and lead to the beginning of a recovery phase, with micro-fundamentals leading market performance (Figure 16).

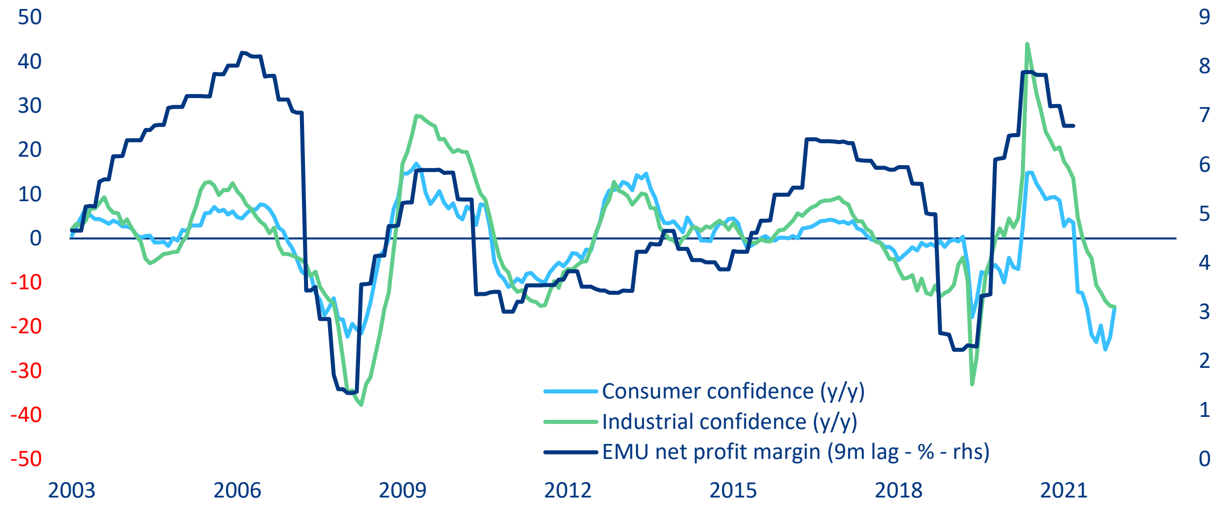
Figure 16: US earnings growth (y/y%)



Sources: IBES, Refinitiv Datastream, Allianz Research.

Do not expect high-performing years. The fine balance between economic, geopolitical, and market uncertainty leaves too many open fronts to shift towards an aggressive investment strategy as a single bad data point has the power to derail markets. Because of this, and given the fact that this situation may continue for longer than markets and economists are currently anticipating, it seems reasonable to assume that the combination of relatively high risk aversion, deteriorating fundamentals, macroeconomic uncertainty and increasing market liquidity issues will put a lid on market performance moving forward. In this regard, our risky assets decomposition models still show that markets are walking on thin ice, especially because the unstable balance between market sentiment and economic resilience will continue to be challenged down the line until a global economic rebound trend is clearly formed (Figure 17).

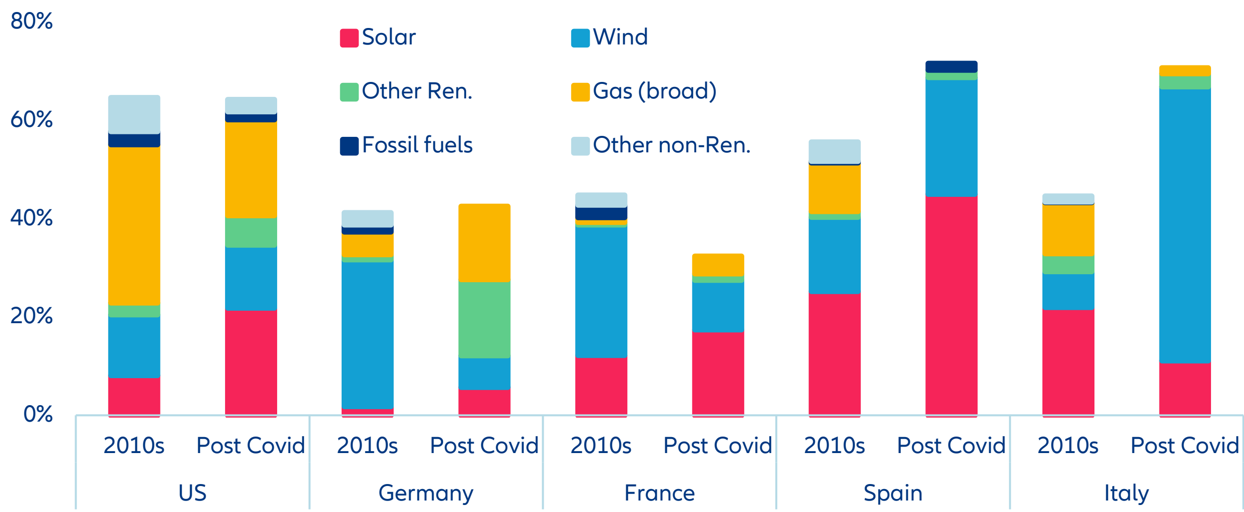
Figure 17: EMU profit margins vs economic confidence



Sources: Worldscope, Refinitiv Datastream, Allianz Research

Board the ESG train. Even though the current energy crisis will most likely lead to a relative outperformance of oil & gas sectors and of energy-rich countries in the short run, the ESG trend will continue to gain relevance in the next two years. Investors are likely to continue transitioning to ESG-intensive investment strategies, with most fresh capital being deployed with such a sustainable bias. This new market rebalancing act is bound to generate a structural outperformance of such assets vis a vis ESG laggards. Embracing the ESG transition within capital markets is likely to act like a downside hedge since most new money and investment strategies will inevitably be scrutinized based on ESG principles. As it is well known, "the trend is your friend" (Figure 18).

Figure 18: Infrastructure investment by type



Sources: Refinitiv Datastream; Allianz Research. Notes: "Ren." is used as abbreviation of renewables in "Other ren." and "Other non-ren"; the category „gas" includes LNG and regasification plants; the category "other renewables" includes geothermal, biomass and hydroelectric.

These themes inform our global strategy. We expect fixed income, especially investment-grade corporate credit, to outperform equities in 2023, particularly towards year-end, but not at any cost. In 2024, equities should slightly outperform fixed income, with emerging markets outpacing both Europe and the US. Importantly, and due to the current high yields, high quality fixed income may already prove interesting for hold-to-maturity investors that can withstand short-term volatility (Table 5). In summary:

Sovereign rates – A bit too early to overweight duration. We expect the prolonged hiking cycle to fully dominate both ends of the sovereign curve next year leading to flattened yield curves. As market expectations are coincident with our economists' policy path a long-duration overweight call is not warranted as there is still a high risk of markets readjusting for higher short-term rates. In the Eurozone, this situation could lead to an increase in fragmentation risk which could keep sovereign spreads persistently higher in the short run. Because of that, we expect US Treasury yields to move timidly lower over the next two years and especially in 2024 due to a decline in the short-end of the curve leading to a timid bull steepening. Numerically, we target a 3.6% 10y US Treasury yield for 2023 and 3.5% for 2024. Moving across the Atlantic, we expect 10y Bunds to follow a similar pattern but with a delay as the ECB policy turn will most probably take slightly longer than the US. In this environment, we expect the 10y Bund to remain flat at 1.9% in 2023 while decreasing 20bps to 1.7% in 2024.

Emerging markets fixed income - Yields are high, but pressures have not left. Rising yields and strong corrections over the last two years make EMs increasingly attractive later in the year. However, the risks coming from a weak macroeconomic outlook remain. Commodities exporters still have an edge in the short-run, but tailwinds from China's reopening and a potential Fed pivot would favor other Southeast Asian countries. We expect a volatile first half of the year for hard currency spreads, that could reach maximums close to 400, but that should compress towards year end (below 350bps in 2023) and even more in 2024 (below 300bps), owing to still high commodity prices and improving macro fundamentals. Similarly, we think there will be interesting entry points through the year in the local currency environment as EM central banks wait for the Fed to move and inflation to cool down. The GBI-EM div. will experience sustained yields decreases (6.5% in 2023 and 6% in 2024).

Corporate credit – Optimizing the risk-return profile. The extreme "macro-based" 2022 fixed income underperformance has pushed corporate yields structurally higher with most of the move triggered by higher long-term rates. In 2023 policy rate expectations will continue to dominate corporate credit performance leaving micro fundamentals out of scope and leading to exacerbated short-term volatility with a high probability of short-lived spread widenings and price underperformance for both investment-grade and high-yield credit. However, corporate spreads are bound to compress due to recovering fundamentals, relatively high cash positions, improving forward-looking economic sentiment during the second half of next year. We expect spreads to remain close to current levels for the remainder of the year, with the possibility of some widening waves in H1 2023 (~180bps for IG). Afterwards we expect a structural compression of spreads, with both IG and HY credit slowly crawling towards long-term averages (~160bps in 2023 and ~140bps in 2024). Within this camel-hump-shaped trajectory, we expect high-yield credit to underperform especially in H1 2023 and to structurally compress in 2024 (~450bps by 2024).

Equities – Caution along the investment horizon. Equity markets have come under pressure in 2022 due to mounting stagflationary concerns weighing on market sentiment. The market leaders of the past 10 years have quickly become the main drag to market performance (around -10 to -20% ytd). However, and despite the increased recessionary certainty, markets continue to refrain from crossing the bear market line and will probably finish the year with a low double-digit negative performance, probably underestimating this cycle's implications on aggregate demand. Because of this, it seems too early to call for an equity market trough and we believe that it is possible to see another sizeable market correction in the short-run should markets readjust for a more aggressive policy path or for a deeper recession. This downside pressure will continue to be exacerbated by the still-high earnings expectations, which will have to readjust in the next 12 months (especially in the US). Moving into late 2023, equity markets should regain some traction as the push coming from declining short-term rates and the overall economic recovery should aid risk appetite (~5% to 8% total return both in 2023 and 2024). Regionally, we expect Europe and EMs to still post single-digit positive price returns in 2023 while the US will most likely remain flat. In 2024, we should see a reacceleration of equity returns, with broad markets performing just short of double-digit returns and with EM showing some growing momentum due to low valuations in some Asian markets, although with the important caveat of important downside risks coming from China and geopolitics.

Table 5: Capital markets 2023 - 2024 Forecasts

year-end figures	Last	Unit		Baseline		
EMU			**2021**	**2022e**	**2023f**	**2024f**
Government Debt						
Policy rate (ECB deposit rate)	1.50	%	-0.50	2.00	2.75	2.25
Policy Rate (MRO)	2.00	%	0.00	2.50	3.25	2.75
10y yield (Bunds)	1.93	%	-0.2	2.10	1.90	1.70
10y EUR swap rate	2.6	%	0.3	2.80	2.20	2.00
Italy 10y sovereign spread	192	bps	136	210	180	160
France 10y sovereign spread	49	bps	37	65	50	40
Spain 10y sovereign spread	104	bps	77	100	85	75
Corporate Debt						
Investment grade credit spreads	167	bps	98	190	170	140
High-yield credit spreads	501	bps	331	520	540	460
Equity						
Eurostoxx (total return p.a.)	-8 ytd	%	23.4	-10	6	7
US			**2021**	**2022f**	**2023f**	**2024f**
Government Debt						
Policy rate (upper)	4.50	%	0.25	4.50	4.25	3.25
10y yield (Treasuries)	3.50	%	1.5	3.75	3.60	3.50
Corporate Debt						
Investment grade credit spreads	137	bps	98	160	150	130
High-yield credit spreads	437	bps	310	480	510	440
Equity						
S&P 500 (total return p.a.)	-14.8 ytd	%	28.7	-15	2	9
UK			**2021**	**2022f**	**2023f**	**2024f**
Government Debt						
Policy rate	3.00	%	0.25	3.50	4.00	3.50
10y yield sovereign (Gilt)	3.3	%	1.0	3.20	3.75	3.25
Corporate Debt						
Investment grade credit spreads	192	bps	115	220	200	160
High-yield credit spreads	651	bps	390	650	680	550
Equity						
FTSE 100 (total return p.a.)	5.2 ytd	%	18.4	4	3	7
Emerging Markets			**2021**	**2022f**	**2023f**	**2024f**
Government Debt						
Hard currency spread (vs USD)	279	bps	295	320	335	290
Local currency yield	6.8	%	5.72	7.1	6.4	5.9
Equity						
MSCI EM (total return p.a. in USD)	-18.5 ytd	%	-2.2	-20	7	7
Others			**2021**	**2022f**	**2023f**	**2024f**
Foreign Exchange						
EURUSD	1.065	$ per €	1.137	1.03	1.06	1.11
Commodities						
Oil Brent*	83	$ per Bbl	78	97	96	90
Natural Gas Dutch TTF*	132	€ per MWh	69	170	173	150

*yearly averages

Sources: Refinitiv Datastream; Allianz Research.

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