GLOBAL MARKETS ANALYSIS
Monetary and Capital Markets

Global Economy and Market Outlook 2023 – Key Takeaways from Market Analyst Reports

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SUMMARY

- This special feature summarizes market participants' outlook on the global economy and financial markets for 2023[1].
- **Global growth is expected to slow down in 2023, driven by a milder and less protracted recession in the US than in Europe.** With the main central banks staying the course, financial conditions should remain tightened, and inflation pressure will moderate gradually.
- **The risks to the global economy are skewed to the downside**. Prolonged inflation pressure and central banks' further aggressive tightening is seen as the most prominent downside risk. In addition, China's Covid-related uncertainty and geopolitical risks are also mentioned as downside risks, given that potential commodity price surges and supply shortages could lead to further inflationary pressure.
- **In the US, markets have divergent views on the probability of a recession and its severity, while there is a consensus on inflation gradually cooling down**. Markets expect inflation to lower in 2023, with the headline inflation drop to 4.3% and the core PCE to 3.5%. The Fed will keep rate hikes and the policy rate to peak in Q1 2023 at around 5-5.25%. Rate cuts are only expected in Q4 2023 or the beginning of 2024. Most analysts believe quantitative tightening (QT) will likely end as early as mid-2023 or the end of 2023.
- **The Euro area and the UK will lead recessions in the advanced economies due to higher energy bills, persistent stubbornly high inflation, and tightening monetary policy**. Markets expect the ECB terminal rates to be 3%, announced in Q1 2023, and remain unchanged throughout the year[2]. The focus of the monetary policy will shift towards unconventional policies with the normalization of the ECB's balance sheet, including targeted longer-term refinancing operations (TLTRO) reimbursements from banks and the scaling down of asset purchase programs (APP) reinvestments. The BoE policy rates will peak at 4-4.25% in the first half of 2023. The BoE is also expected to continue its QT program and reduction of its balance sheet.
- **Stock markets are expected to experience a bumpy road in 2023. While 2022 performance was mainly driven by a valuation compression amid a higher rate environment, in 2023, analysts see the economic downturn as the primary driver with more earnings downgrade**. Volatility should remain high but not necessarily surge to new highs. Market participants set the baseline scenario that S&P 500 will have a rough start and hit bottom by mid-year with a strong finish. A modest upside for European equities is anticipated. In credit markets, spreads are expected to widen. Analysts project Euro IG to tighten but Euro HY to widen. For the FX market, after a strong appreciation in 2022, analysts project the USD to weaken against G10 and CNH.
- **Markets believe economic growth in China could emerge as a key global growth driver after its reopening**. However, the initial stage of China's reopening may be negative to growth due to surging cases and temporary declining mobility, while a significant consumption rebound will be expected afterward from Q2 2023. Risks mainly come from Covid-related uncertainties.
- **In the emerging markets (EM), given the ongoing tightening of monetary policy in the advanced economies, the economic outlook is expected to remain challenging next year**. The median forecast of EM economic growth is 4.0% y/y in 2023, up from 3.1% in 2022, but below pre-pandemic level. Divergence is expected to increase as idiosyncratic factors should continue to play a big role. Broader dollar weakness may support EM currencies, but currencies in countries with weaker external positions and negative real rates may be relatively vulnerable. EM capital flows are expected to be under pressure at least by early next year as financial conditions tighten, while the outlooks may become more optimistic thereafter as the dollar decelerates. EM HY sectors, especially low credit rated issuers may continue to face challenging external financing conditions with limited access to capital markets.

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GLOBAL OUTLOOK: RISKS SKEWED TO THE DOWNSIDE

With inflation stubbornly high and inflation expectations at risk of de-anchoring, central banks are expected to continue to tighten financial conditions. In this context, market analysts expect global growth to slow down in 2023 with a milder and less protracted recession in the US than in Europe. The median forecast of global growth sets at 2.1% in 2023, a downward revision from the projected 2022 at 2.9% (Figure 1). Asian countries like India and some southeast Asian countries are expected to support global growth.

The macroeconomic outlook is uncertain and risks to the global economy remain skewed to the downside with stickier inflation and/or a lack of coordination of monetary and fiscal policy. Most analysts believe prolonged inflation pressure and central banks' further aggressive tightening are the most prominent downside risks. Some argued that if this risk materializes and central banks in advanced economies (AEs) hike policy rates even further by around 100-150 bps above the baseline, global growth could drag lower by 0.3 ppt from their base scenario.

Inflation should moderate gradually but remain at a high level. In this context, central banks should stay the course and continue to hike rates at least until early next year before pausing to assess the passthrough to the real economy. Analysts see rate cuts in the US from no earlier than Q4 2023.

After a synchronized monetary policy tightening to ease inflationary pressure worldwide, the global economy and monetary policy are expected to diverge more, with idiosyncratic factors in 2023 playing out.

China's Covid-related uncertainty is another key risk. A surge in infections, a decline in mobility after reopening, and a sluggish property sector could impact further China's growth, with spillover implications for the rest of the world.

Finally, geopolitical risks are key factors, potentially exacerbating supply-chain disruption and pushing energy and food prices further.

US: SOFT OR HARD LANDING?

Markets have divergent views on the probability of a recession and the severity of the downturn in the US, while there is a consensus on inflation gradually cooling down in 2023.

US recession risk is higher in 2023, with the median forecast of the recession probability at 65%. However, the average estimate of the US GDP growth in 2023 is 0.4%. In the downside case, many market participants believe that the aggressive monetary policy to curb inflation will pull the US into a severe recession together with outright job losses in the second half of 2023. In the upside case, some market participants believe a more positive growth and a rebound in real disposable personal income in the coming year will help the US narrowly avoid a recession.

Markets expect inflation to peak in 2022 and decline in 2023. Headline inflation should fall gradually with an average of 4.3% y/y in 2023 and return towards the 2% objective by the end of 2024. Meanwhile, the median forecast of the core PCE will drop to 3.5% y/y in 2023 and 2.4% y/y in 2024. Monetary policy is expected to remain restrictive to keep inflation on a downward trajectory throughout 2023 (Figure 2).

The Fed policy rate is expected to peak in Q1 2023 at around 5-5.25%. Rate cuts are only expected in Q4 2023 or the beginning of 2024. On QT, some analysts believe QT is likely to end as early as mid-2023 or the end of 2023 to avoid adding and removing accommodation, while others expect the Fed's balance sheet run-off to last over the next several years. Markets expect the Fed to stop the reduction of its balance sheet at around 7-8Trn from the peak of 9Trn to maintain safe levels of reserves, while some argue it could be below 7Trn. On fiscal policy, markets assume limited fiscal support beyond what has been already legislated and normal automatic stabilizers.

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[1] This special feature is based on both buy side and sell side analysts outlook released before the relaxation of the Covid 19 restrictions and the December major central banks meetings.

[2] After the latest ECB monetary policy meeting, which was seen as hawkish, some market analysts changed their calls and are predicting additional policy rate hikes in 2023.

RECESSION IS INEVITABLE IN EUROPE AND THE UK

The Euro area and the UK economy will tip into recession due to higher energy bills, persistent inflation, and tightening of monetary policy.

The Euro area is expected to grow at -0.1% in 2023 and pick up to 1.5% in 2024. The UK is expected to contract more by 0.9% in 2023. High inflation resulting from the energy transition, demographics, and reshoring will continue throughout 2023. Inflation in the euro area will reach 6% y/y, and in the UK, inflation is expected to be 7% y/y on average in 2023.

Markets expect the ECB terminal rates to be 3% announced in Q1 2023 and remain unchanged throughout the year[2]. The focus of the monetary policy will shift away from interest rates towards unconventional policies to normalize the ECB's balance sheet, including TLTRO reimbursements from banks, and the scaling down of APP reinvestments[3]. In the meantime, the Transmission Protection Instrument (TPI) will stand ready for activation.

Persistent inflation pressure should keep the BoE in a restrictive territory. The BoE policy rates will reach the peak at 4-4.25% in the first half of 2023 and there will be no cut before 2024. The BoE is also expected to continue its QT program and the reduction of its balance sheet.

On fiscal support, markets expect supportive and flexible fiscal policy in response to the energy crisis to reduce the risk of a gas-rationing scenario in the euro area. The recession and the fiscal stimulus will keep budget deficits high in 2023, and fiscal consolidation is expected to start in 2024. In the UK, however, fiscal austerity is expected in 2023.

ROUNDUP OF DIFFERENT ASSET CLASS OUTLOOK IN ADVANCED ECONOMIES

Rate markets: higher for longer?

Analysts see the first quarter of 2023 as the turning point for the global bond market. The majority expects the hiking cycle to end in Q1 as they see inflation to peak in Q4. However, inflation should remain elevated, keeping yields near their cycle highs. Moreover, the net supply net of QE/QT is expected to put upward pressure on yields, in particular in the UK and the Euro area where analysts anticipate record supply in January and February. In the Euro area, spreads are expected to widen with yields reaching their peak in Q1 and some analysts state that the probability for the ECB to intervene via the TPI will be highest in Q1. However. The expected global growth down should push yields lower throughout 2023. In the US, analysts forecast that after peaking in Q1, yields should decline. The 10-year yields is expected to fall to around 3.40% and the curve will steepen and comes out of inversion territory after the Fed pause.

Equity markets: "a bumpy road ahead"

Analysts are rather bearish for 2023 and expect global equity market to edge at new lows in 2023. While the earnings were robust for much of 2022, analysts expect an "earnings recession" for next year. The equity selloff in 2022 was driven more by valuation and looking ahead equity prices should reflect the expected economic downturn. Earnings revision have been started in the US and Europe. Most analysts see US equity markets to be under pressure, as it takes more time for markets to regain confidence in growth. The market estimates earnings-per-share (EPS) to fall more than 10% to around $197. It is forecasted that the S&P 500 will end the year at 3900 after hitting its low of 3200 at mid-year. Modest upside for European equities is expected as falling inflation and lower yields may support the market and offset the impact of 10% EPS decline.

Credit markets: Come back to the fundamentals?

According to some market participants, the credit cycle is transitioning into a downturn, the deterioration of fundamentals is seen as the main risk for 2023. Given the aggressive monetary policy tightening leading to higher

[3] ECB decided at its December meeting that the APP portfolio will decline from the beginning of March 2023 as the Eurosystem will not reinvest all of the principal payments from maturing securities, with a decline of about €15 bn per month on average until the end of Q2 2023. Detail of the QT will be announced at the February meeting.

rates, analysts think that rates are now high enough to negatively affect the credit market. While the corporate sector has shown some resilience so far, analysts expect firms to run down liquidity buffers and built-up inventories. In this context, debt/service ratios should deteriorate while some businesses will face a higher refinancing risk.

Analysts project another challenging year for HY markets as slower growth and rising credit downgrading is expected, while more benign for IG markets. US IG year-end spread is expected to widen modestly to around 170bps, which is the typical recession-cycle levels. US HY spread is projected to widen to around 600bps. Euro IG is expected to perform better by tighten to 190bps, but Euro HY is projected to widen to 650bps. Excess returns are expected to move back to positive, owing to higher carry. Global credit issuance is projected to remain at the similar level with growth in HY issuance.

FX markets: A short-lived US dollar dominance?

After a sharp appreciation in 2022, USD is expected to go weaker into H2 2023 against G10. Median forecast of JPY is 125, and that of EUR is 1.10 at the end of 2023. AUD and CAD are likely to strengthen. Gold is forecast to increase strongly. The currencies with higher correlation to Treasury are likely to outperform ones with higher correlation to US equities (Figure 3). The volatility is expected to remain elevated amid data-dependent environment. On the GBP, analysts are generally bearish weighing the idiosyncratic factors (current account deficit estimated at more than 5% of the GDP, high net supply expected).

CHINA REOPENING: A STRONG RECOVERY FROM Q2

Markets believe China could emerge as a key global growth driver after its reopening. The initial stage of China's reopening may be negative to growth due to surging cases and temporary declining mobility, while a significant consumption rebound will be expected afterward from Q2 2023. China GDP is projected to increase at 4.8%, and inflation is likely to remain stable at 2.3% in 2023. Analysts see that risks mainly come from Covid-related uncertainties. A sluggish property sector could also pose a downside risk to China's growth. The monetary policy will remain accommodative to support recovery. Relending programs to provide targeted support to manufacturing and renewable energy, and ease in the property sector are expected. Markets expect slight fiscal consolidation following the domestic economy rebounds.

Markets forecast 16% index returns for major stock indices (MXCN and CSI300) in 2023 compared to negative return YTD 2022. CNY is expected to weaken in 3 months but strengthen in 12 months against USD. The 2023 YE USD/CNY is estimated at 6.90 with long-term forecast for end-2025 at 6.50. The preference is to stay up in credit quality, hence prefer for China Technology, Media, Telecoms (TMT) IG and China Property IG. On the HY front, Macau Gaming HY is preferred.

EM ECONOMY: REMAIN CHALLENGING

The EM economic outlook is expected to remain challenging next year. The continuation of the tightening of monetary policy in the AEs, especially the Fed, should continue to have some repercussions on the EM growth prospects. The median forecast of the EM economic growth is 4.0% y/y for 2023, up from a projected 3.1% for 2022 but still below pre-pandemic levels (4.4% in 2019). Some analysts expect private sector savings to fall come back to the pre-pandemic levels and dwindling private sector savings may test EM's resilience to withstand continued tightening in global financial conditions and weaker global growth. In Asia, export-oriented countries may face headwinds due to sluggish external demands, while domestic-driven countries are expected to outperform. In Europe, the Middle East, and Africa (EMEA), many countries are likely to struggle from lingering inflation, monetary policy tightening, and the war in Ukraine. In Latam, commodity prices, which are expected to be lower compared to the peak of this year but still broadly supportive for exporters, are likely to be a tailwind for the regions, while positive real short-term rates and weak external demands are expected to be the drags on growth, with political uncertainty adding risks.

Inflation is expected to slow down modestly but remain above central banks' targets in many EMs. Declining commodity prices, easing supply constraints, and the impact of monetary policy tightening will be the main drivers of reducing inflationary pressure. However, varying exposure to commodity shocks, fiscal support requirements, and different pace of monetary tightening have contributed to the dispersions across EMs. Some analysts have cautious views on Central and Eastern Europe (CEE), where inflationary pressures have broadened to more domestically driven components and de-anchoring of wage and price expectations remains at risk (Figure 4). In Asia, inflation pressure is expected to be relatively benign compared to other regions. Against this backdrop, monetary policy will likely tighten further in some EMs in early 2023, and most EMs are expected to keep the policy rate at restrictive levels. Latam, which benefits from early rate hikes, is likely to reach the end of the hiking cycle earlier and may open the door to a rate cut in late 2023.

EM MARKETS: IDIOSYNCRATIC FACTORS MATTER

FX Markets

Most analysts see that broad US dollar strength may weigh on EM FX over the short term, but the US dollar is expected to reach its peak and decelerate afterward. EM currencies are likely to benefit from a weak dollar, but idiosyncratic factors also play a big role.

EM external account deficits may improve in some countries as weaker demand and lower commodity prices may help reduce imports, but the deficit is likely to remain historically large as a whole, and currencies in countries with weaker external positions may face difficulty in recovering even against the backdrop of a softer US dollar. One analyst pointed out that their external-resilience metrics, consisting of current account deficit, FX reserves, foreign direct investment, and short-term public debts, among others, show mixed pictures among regions. EMEA region is likely at relatively high risk as current account balances have deteriorated, foreign direct investment has slowed amid relatively low FX reserves and high external debt as a percentage of GDP. Latam also struggles from a current account deficit perspective but looks better on a number of other indicators. Asia is mixed, but despite FX intervention over recent months, the region still looks reasonably healthy from an external perspective.

Another analyst pointed out that after significant rate hikes, real rates are expected to be positive in many EMs, but there are some countries the real rate is likely to be in negative territory in 2023, and currencies in those countries may have relatively high vulnerabilities.

EM capital flow is expected to be under pressure at least by early next year as financial conditions tighten, the US dollar strengthens, and private sector savings decline. Outlooks may become more optimistic thereafter, depending on slowing down the pace of the Fed tightening, falling yields, and weakening the dollar, while the situation may diverge as countries with weaker growth forecasts are likely to face more challenges.

Sovereign Credit Markets

Analysts expect the divergence in the sovereign credit markets to increase, reflecting idiosyncratic factors, especially following the peak in global rates.

The surge in global interest rates and the widening of credit spreads has resulted in primary markets becoming expensive for large parts of the EM HY sector. This backdrop is likely to continue, and the EM HY sector, especially issuers with low credit rating, may face challenging external financing conditions with limited access to capital markets. HY credit spread is predicted to widen, and EM sovereign HY issuance is likely to remain subdued in 2023.

Some analysts project that EM government debt to increase in 2023 as fiscal deficits remain wide. EM sovereign defaults are likely to remain elevated in 2023, given the already elevated number of sovereigns in distress and a number of sovereigns that have shown intentions to restructure. The rising cost of debt level and repayment capacity will remain in focus more broadly.

Positive news for sovereign credit markets is that after massive outflow from EM funds in 2022, positioning in EM assets has lightened up. In addition, EM remained under-weighted in global fixed-income portfolios. Those may support the EM credit sector.

Projections of Market Participants

Market analysts expect slower growth and gradual fall of inflation pressure.

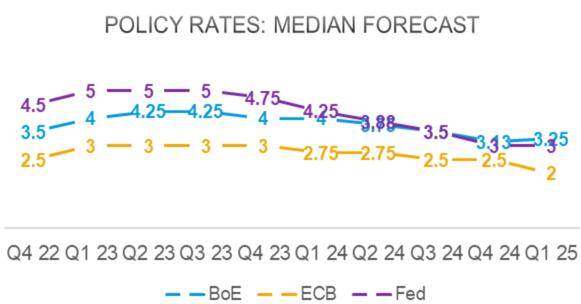
1. Market Analysts' Median Projection of Global Economy

	GDP (%, yoy)					CPI (% yoy)				
	2020	2021	**2022**	**2023**	**2024**	2020	2021	**2022**	**2023**	**2024**
Global	-3.0	6.0	**2.9**	**2.1**	**2.9**	3.2	4.7	**7.3**	**5.1**	**3.4**
AEs	-4.2	5.4	**2.6**	**0.5**	**1.5**	1.0	3.6	**8.6**	**5.4**	**2.8**
US	-2.8	5.9	**1.8**	**0.4**	**1.4**	1.2	4.7	**8.1**	**4.3**	**2.5**
Euro	-6.1	5.3	**3.2**	**-0.1**	**1.5**	0.3	2.6	**8.5**	**6.0**	**2.1**
UK	-11.0	8.5	**4.3**	**-0.9**	**1.0**	0.9	2.6	**9.0**	**6.9**	**2.6**
EM	-0.1	5.8	**3.1**	**4.0**	**4.4**	3.6	3.6	**6.4**	**5.7**	**4.2**
China	2.2	8.1	**3.2**	**4.8**	**4.9**	2.5	0.9	**2.2**	**2.3**	**2.2**

Source: Bloomberg
Note: The table shows median projections of market analysts

Terminal rates expected to peak in Q1 23 and no cuts before Q4 23.

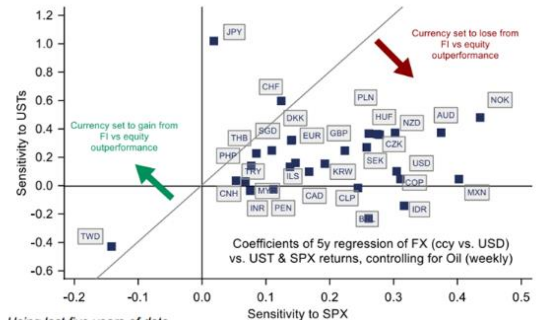
2. Policy Rates Forecasts: Fed, ECB, and BoE
[percentage points]



Source: Bloomberg

Duration-sensitive currencies are likely to outperform equity-sensitive ones.

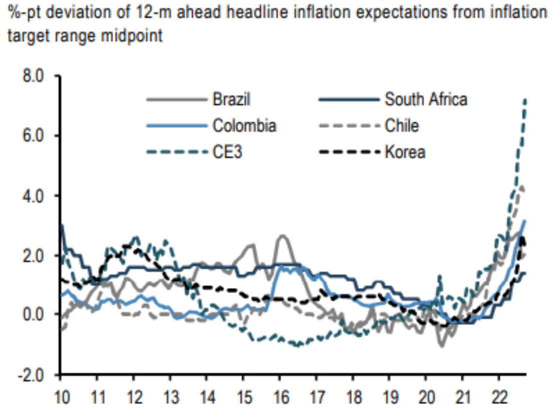
3. FX Sensitivity Correlation to SPX and UST
[correlation coefficient]



Source: BNP Paribas

Inflation expectations are at risk of de-anchoring in some EMs

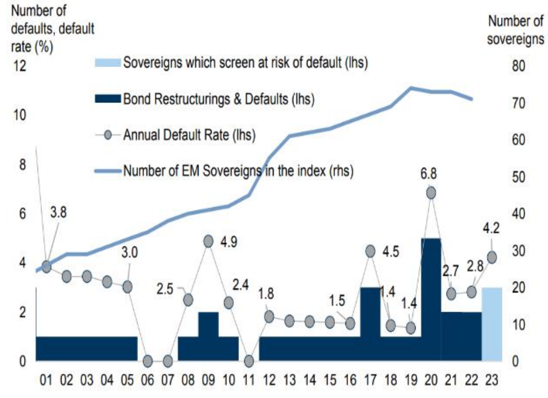
4.Deviation of Inflation Expectations from Inflation Target
[percentage points]



Source: JP Morgan

Sovereign default rate is expected to remain high

5.Sovereign Default Rate
[percentage, number of sovereigns]



Source: Goldman Sachs