

# 2023 midyear economic and market outlook

Global resilience but regional divergence

welcome to brighter

# Contents

# Executive summary



The global economy performed well at the start of the year, supported by factors such as falling energy prices, strong consumer balance sheets and the reopening of the Chinese economy. We expect a modest slowdown as we head into the second half of 2023.

Regional divergence is likely as different economies are at varying stages of the business cycle, with China likely to perform well and the US poorly. Annual global inflation rates should continue to fall due to lower energy prices and normalizing supply chains. However, tight labor markets will continue to drive strong wage growth, keeping core measures of inflation elevated until 2024.

Central banks have aggressively tightened monetary policy to restrictive levels in the developed world and have signaled they will soon pause to assess the full impact of these hikes. The way forward remains uncertain as central banks try to strike a delicate balance between fighting inflation and maintaining financial stability.

Equities have performed well up to late May, with US tech stocks benefiting while bank stocks underperformed. Bond markets have rallied due to expectations of lower inflation and an imminent peak in interest rates. Looking ahead, we see opportunities in emerging market equities and certain segments of growth fixed income despite the uncertain macroeconomic environment.

Some key risks remain, including potential contagion from US regional banks (which may lead to a credit contraction in the real economy), a resurgence in inflation and a further deterioration in the geopolitical landscape.

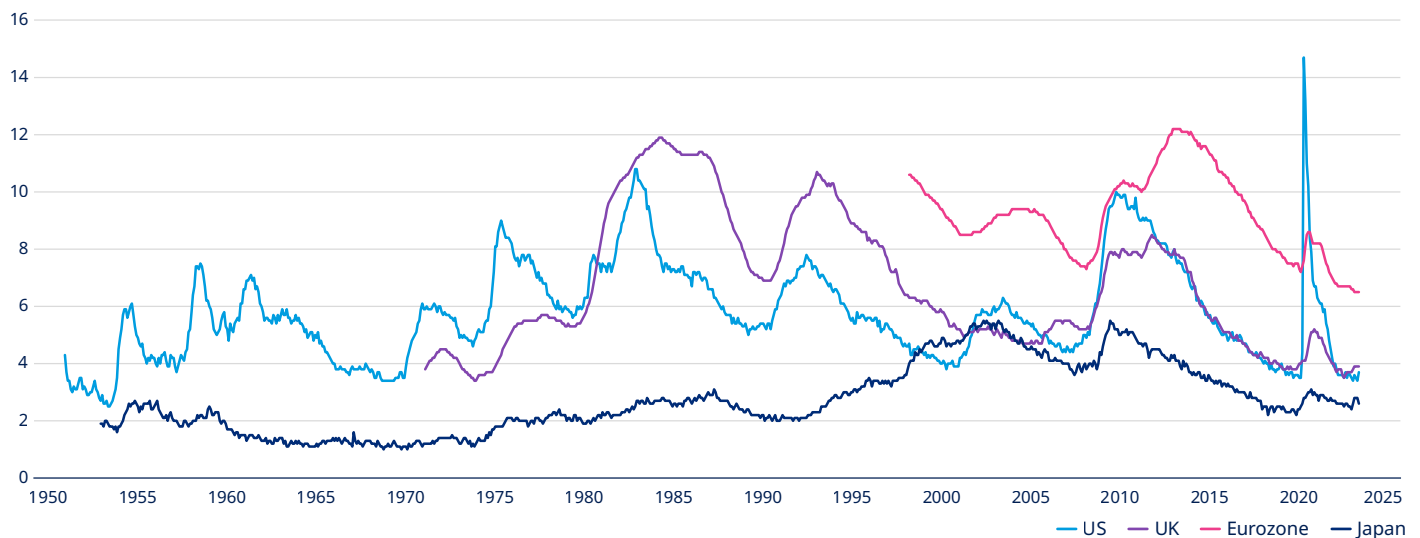
# 1. Growth

## Soft, but globally resilient, regionally divergent

Central banks in most parts of the world — with the notable exceptions of China and Japan — have been tightening monetary policy (using both higher interest rates and quantitative tightening) in an attempt to slow economic growth, ease wage growth and reduce inflation. However, the slowdown has only been modest thus far, with unemployment levels at their lowest in decades (Figure 1).

The global economy's resilience can be attributed to three main factors: a growth boost from China's reopening, broad strength in consumer balance sheets and an assist from lower energy prices. We expect some of these supporting factors to fade, with a more difficult 12 months ahead for the US, even if China remains strong. However, we don't expect uniformity across regions as different economies are at varying stages of the business cycle.

**Figure 1. Historical unemployment rates for select developed economies (%)**



Source: Bloomberg. Data as of May 31, 2023.



**We expect the US economy to stall ...  
We maintain our view that a deep recession is unlikely.**



Figure 2 below illustrates a typical business cycle. The blue line depicts an economy's capacity, which is determined by the amount of labor, capital and total-factor productivity. The red line shows where an economy is, based on consumption, investments, government spending and net trade.

If the red line moves above the blue line, an economy overheats, and tight labor markets lead to higher wages and inflation. In that case, a central bank tightens policy in an attempt to engineer a slowdown and bring the red line back to the blue line.

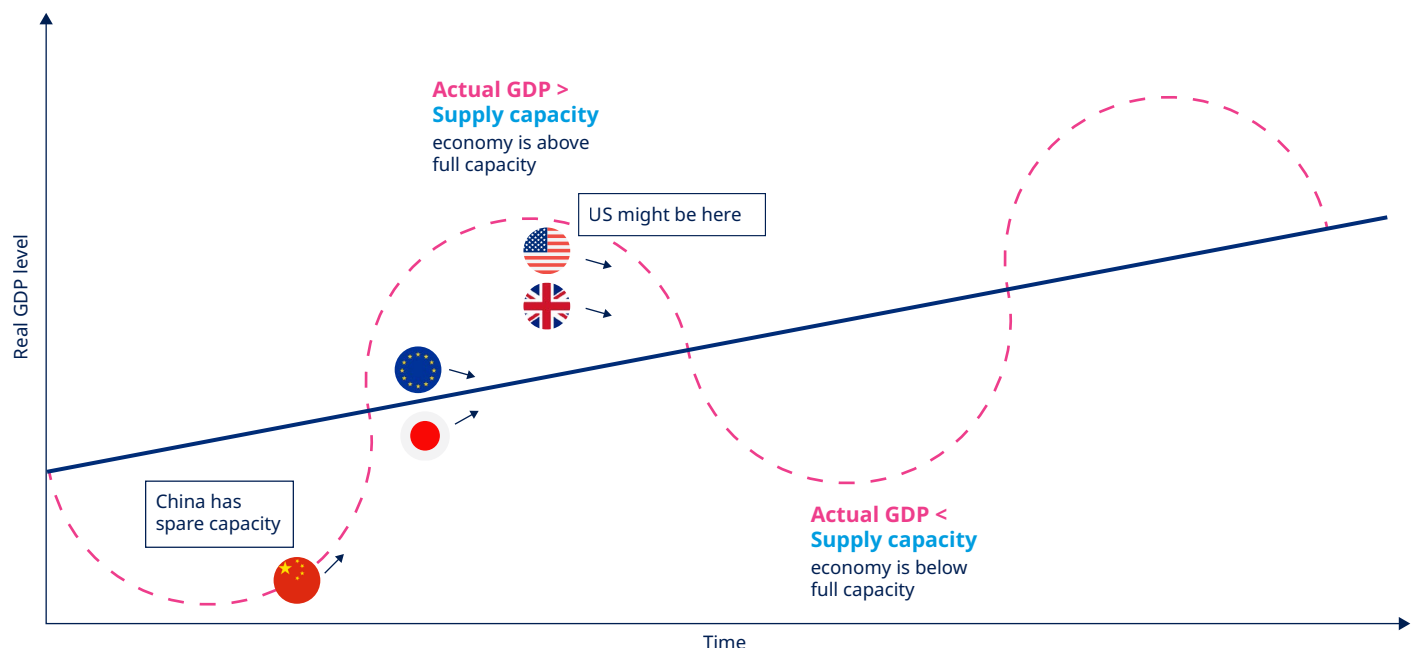
If the red line is below the blue line, a central bank loosens policy in an attempt to stimulate growth. As shown by the flags on the chart, a number of developed economies have overheated and experienced high inflation, prompting aggressive actions by central banks. Meanwhile, China is in a completely different stage

of the business cycle, with plenty of room to grow before overly tight labor markets begin to cause an inflation problem.

At the start of the year, the US economy was supported by lower energy prices and resilient consumption. The US services sector was strong, whereas the manufacturing sector was very weak as consumers around the world retained a preference for services over goods post-COVID.

We expect the US economy to stall in the second half of 2023 and early 2024 as the assist from lower energy prices fades, consumer savings are used up and banks tighten their lending standards. (See Figure 3 on the following page.) That said, we maintain our view that a deep recession is unlikely as consumption should be supported by resilient household balance sheets and healthy income growth.

**Figure 2. The business cycle**



For illustrative purposes only.



## The strength in China will be spurred by a jump in face-to-face economic activity.



Figure 3 below depicts two surveys that measure changes in bank-lending standards to businesses in the US and the eurozone. Above 0% means, on average, banks are tightening lending standards.

The eurozone and the UK appear to have avoided recessions as natural gas prices have fallen sharply, with cost-of-living pressures easing. The extent of overheating in Europe is lower than in the US, so we would expect Europe to fare better in comparison. As shown in Figure 2 above, the US has overshoot its capacity to a greater degree, which

means the slowdown to get back to the blue line could be more significant. Because the eurozone hasn't overshoot its capacity by much, the slowdown should be relatively modest.

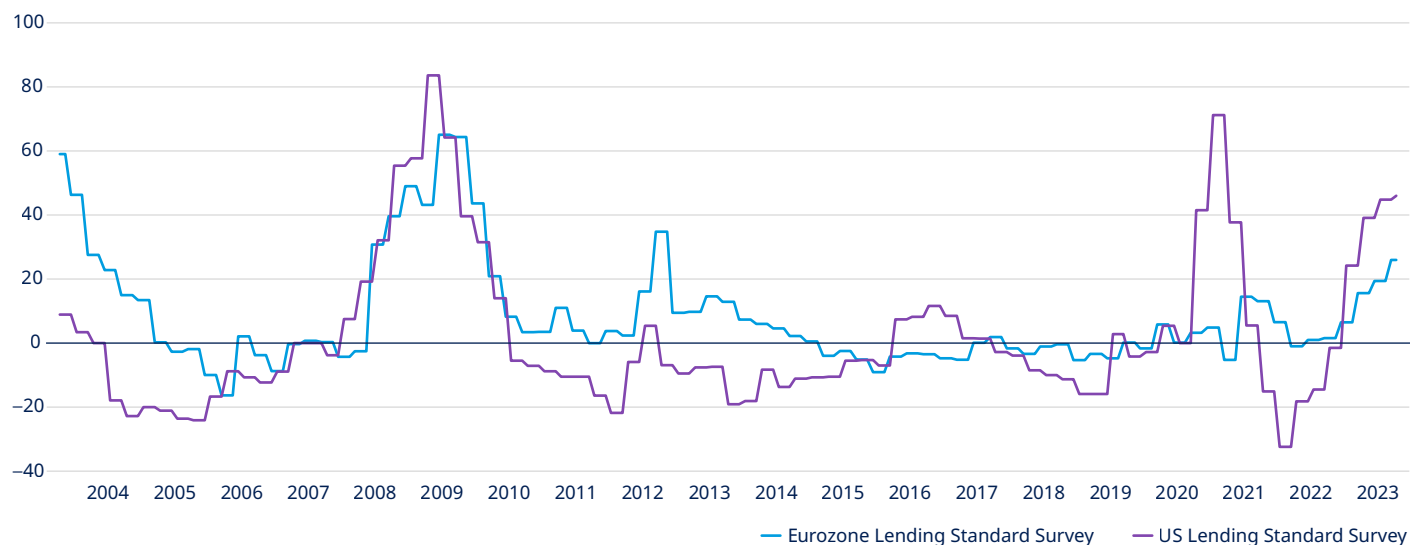
In the near term, we expect Japan to outperform its developed counterparts since it's earlier in the cycle and it has the least overheated economy, with the Bank of Japan (BoJ) having taken no major steps to slow it. Meanwhile, there are signs of service inflation in Japan for the first time in decades. Employers and unions have also agreed to perhaps the biggest wage gains since 1993, indicating further upside risks to inflation and implying that easy monetary policy in Japan may not continue forever.

The Chinese economy had a difficult 2022, driven by restrictive COVID-19 policies and the aftermath of a major regulatory crackdown in its technology and property sectors that started in 2021. China has done very well

in 2023 thus far, boosted by a post-lockdown consumption boom and a recovery in credit creation. It has also been supported by the People's Bank of China (PBoC) maintaining loose monetary policy. The strength in China will be spurred by a jump in face-to-face economic activity, which will have less impact on the global economy than past recoveries driven by construction and investment.

Nonetheless, there should be wide-ranging economic benefits to China's trading partners, especially in relation to tourism. More broadly, emerging market (EM) countries didn't overheat as much as developed market (DM) countries. Their central banks started raising interest rates earlier, and fiscal stimulus wasn't as excessive as in Western countries, creating a more favorable macro backdrop going forward.

**Figure 3. Tightening lending standards (%)**



Source: Bloomberg. Data as of May 31, 2023.

## 2. Inflation

### Disinflation continues but at a slower pace

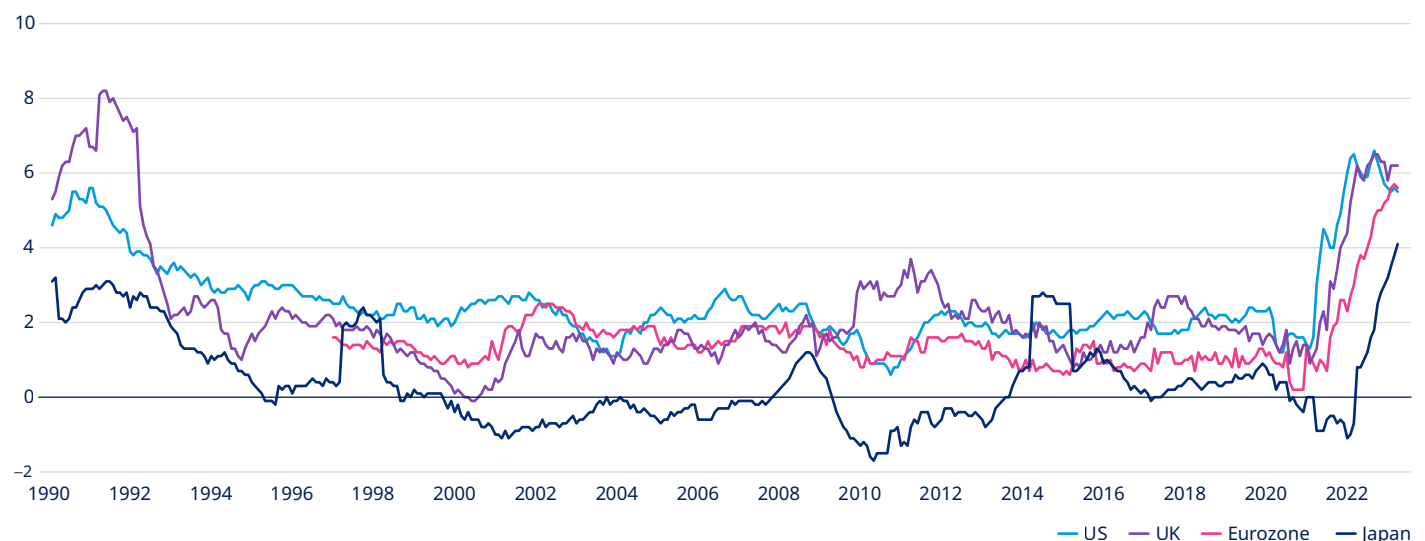
Headline inflation rates are falling in the developed world, driven by lower energy prices and normalizing supply chains. However, at a core level (Figure 4), stripping out volatile food and energy, inflation doesn't appear likely to fall to central banks' 2.0% targets due to ongoing strength in wage growth, which companies often pass on to their customers through higher prices. As with global growth, we're observing divergence in global inflation dynamics.



**In the US, the eurozone and the UK, headline inflation rates should continue their descent in 2023.**



**Figure 4. Historical year-on-year core inflation rates for select developed economies (%)**



Source: Bloomberg. Data as of May 31, 2023.





In the US, the eurozone and the UK, headline inflation rates have fallen from very high levels and should continue their descent in 2023. However, core inflation remains well above the 2% target set by central banks due to factors like high rent and wage growth.

In Japan, inflation is the highest it has been in several decades, with headline inflation at 3.5% and core at 4.1%. Here, it's especially notable as it's happening alongside increases in both wage growth and inflation expectations, raising the probability that Japan has at last exited its long period of deflation. If confirmed, the BoJ would need to begin unwinding its ultra-loose monetary policy.

In China, inflation is very low, with the headline reading at 0.1% and core at 0.7%; unemployment is higher than normal, keeping wage growth low. Inflation is broadly elevated in EMs but not as high as in DMs (compared to average inflation rates).

Looking ahead, we expect inflation to continue to fall but recognize that reducing inflation from approximately 5% to 2% is likely to be a harder and longer process than the jump from 8% to 5%. The key reason for this is that labor markets need to weaken materially for wage growth to fall, and wage growth adjusts slowly and at a lag to economic changes. For inflation to hit 2%, wage growth needs to be close to 3%–4%, with the difference being productivity growth.

**In Japan, inflation is the highest it has been in several decades.**

As it stands in the US, wage growth is closer to 5% — a rate consistent with consumer price inflation of 3%–4%. We observe similar dynamics in the eurozone, the UK and Japan. Tighter monetary policy should eventually lead to higher unemployment and lower wage growth, but this will take time.



# 3. Central banks

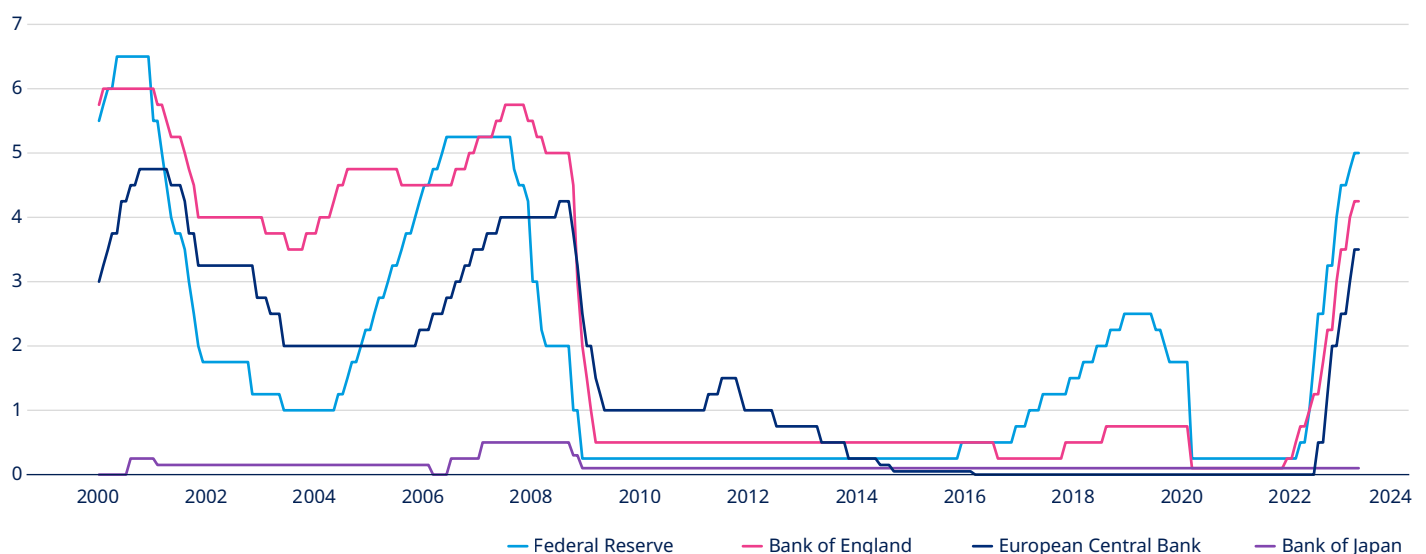
## Pause and assess

Central banks have increased interest rates significantly to bring them above the neutral rate. For reference, the neutral rate of interest is a theoretical policy rate that neither stimulates nor slows economic growth.

Since the start of 2022, the US Federal Reserve ("the Fed") has raised interest rates by 5.0% (from 0.25% to 5.25%) in one of the most aggressive tightening cycles ever. We expect the Fed to hold interest rates at the current level for the rest of the year. Once it has a clear line of sight for core inflation returning to 2.0%, it may begin normalizing policy. In practice, this is likely to mean rate cuts in the first half of 2024. The risk of the Fed having to raise interest rates all the way to 6.0% is much lower than it was at the start of 2023 because of ongoing US regional bank stress and the subsequent tightening of bank lending standards.

**Figure 5. Central bank policy rates (%)**

Official interest rates set by key DM central banks



Source: Bloomberg. Data as of May 31, 2023.

The European Central Bank (ECB) raised interest rates by 3.75% (from 0% to 3.75%). We expect it to increase interest rates above 4% in 2023 followed by a pause for the remainder of the year to ensure inflationary pressures from an overheated labor market subside.

The Bank of England (BOE) has the most difficult job of all, with inflation still quite elevated (both core and headline) despite raising rates by nearly 4.5% (from 0.1% to 4.5%). We expect it to increase interest rates above 5% in 2023 and then pause. Interest rate cuts are only warranted if the UK economy takes a sharp leg down and inflation decelerates at both core and headline levels.

The BoJ has so far resisted pressure to materially tighten monetary policy, which we believe is an increasingly difficult stance to maintain. A resilient economy, elevated headline and core inflation, rising wages, and an increase in short and medium-term inflation expectations all point to the need to tighten monetary policy. We expect the BoJ to relax its yield-curve-control policy in the near term and possibly raise interest rates in 2024 or 2025.

Unlike most central banks, the PBoC continues to ease policy in an effort to stimulate economic activity. We expect that to continue for the rest of the year. Ex-China EM central banks tightened policy early to fight inflation and defend depreciating currencies. We expect them to move toward a less aggressive policy stance and bring interest rates down to neutral levels.



**The BOE has the most difficult job of all, with inflation still quite elevated (both core and headline) despite raising rates by nearly 4.5%.**



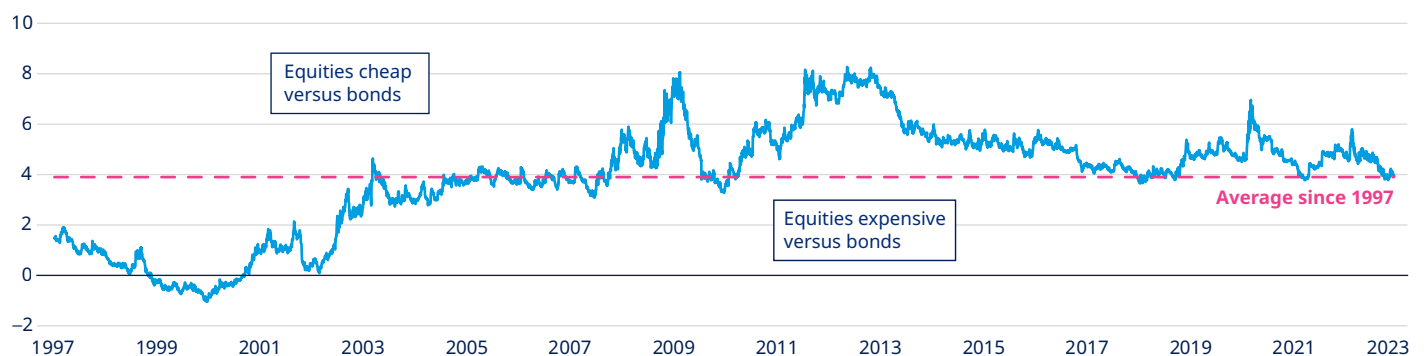
## 4. Markets

### Clip the coupon on growth fixed income in times of uncertainty

Figure 6 compares the earnings yield on equities (calculated by dividing earnings per share by the stock price) with the yield on the US 10-year inflation-linked government bond.

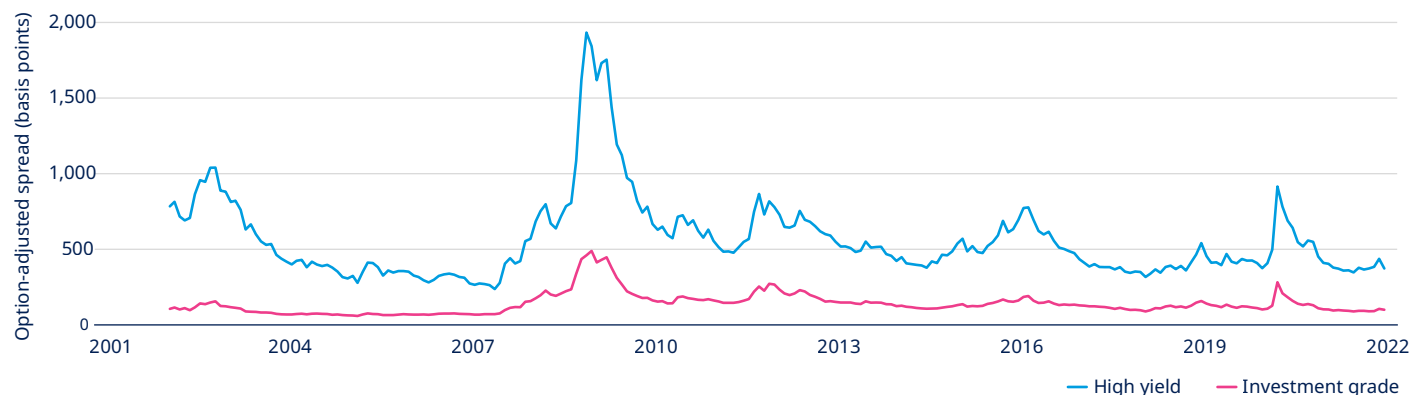
Figure 7 shows the difference between yields on global corporate (high-yield and investment-grade) bonds and government bonds of the same maturity.

**Figure 6. Equity risk premium (%)**



Source: Bloomberg. Data as of May 31, 2023.

**Figure 7. Credit spreads**



Source: Bloomberg. Data as of May 31, 2023.



## Within equities, we see opportunities in EMs on the back of cheap valuations and strong earnings impetus.



So far, 2023 has been a positive year for equities despite the uncertainties surrounding US regional banks, the Fed, high inflation and fears of recession. Global equities have risen 9.4% (in USD terms) as of May 15, 2023. European equities have been particularly strong this year, driven by more attractive valuations, strong demand from Chinese consumers and a material rollover in natural gas prices. EM equities underperformed despite a strong economic backdrop driven by accelerating Chinese growth.

Bonds have rallied in 2023 given expectations of lower inflation, slower growth and a pause in central bank interest rate hikes. US regional bank distress has led to a highly volatile repricing of peak Fed interest rate expectations, driving other bond market pricing too.

Credit spreads haven't moved much year to date (see Figure 7 above). Local-currency EM debt posted 3.4% (in USD terms), whereas hard-currency EM debt returned 1.8% (in USD terms) as of May 31, 2023. In currency markets, we've seen a softer US dollar, stronger euro and sterling, weaker yen, and stronger EM currencies.

We don't hold high-conviction views on equities as an asset class. Although valuations remain unimpressive (see Figure 6 above) and earnings expectations somewhat too optimistic, we find market positioning to be overly bearish, which balances our overall view to neutral. Within equities, we see opportunities in EMs on the back of cheap valuations and strong earnings impetus provided by the rebound in China.

We believe allocations to certain segments of growth fixed income remain attractive and can potentially help create a cushion of income in a portfolio, making it more resilient in times of high macro uncertainty. Both investment-grade and high-yield credit spreads appear to remain at reasonably attractive levels and may offer sufficient compensation for taking on default risk. We think EM local-currency debt is attractive, driven by cheap currencies and attractive bond yields.

We expect the US dollar to depreciate against DM and EM currencies. Softer-than-elsewhere economic growth, unique political challenges, twin deficits (trade and fiscal) and expensive valuations should set up the global reserve currency for multiyear weakness. The yen should appreciate against the US dollar as the BoJ moves toward tightening its monetary policy while the Fed remains largely on hold. We're constructive on both the euro and sterling versus the US dollar as we expect the ECB to be relatively more hawkish than the Fed and the eurozone economy relatively stronger than the US. We're broadly constructive on EM currencies driven by attractive valuations.



## We believe allocations to certain segments of growth fixed income remain attractive.



# 5. Key risks

## Banks, inflation and geopolitics

When asked what keeps us awake at night, we would note the risks below.

### Contagion from the US regional banking crisis

US regional bank distress (Figure 8) still has the potential to spill over into larger banks and to banks outside the US, causing a broader credit crunch. However, we believe this scenario is unlikely due to the significantly improved capitalization of banks, robust bank profitability and the determination of policymakers to ensure the stability of the financial system, which is closely aligned with a stable banking sector.

### Persistent inflation

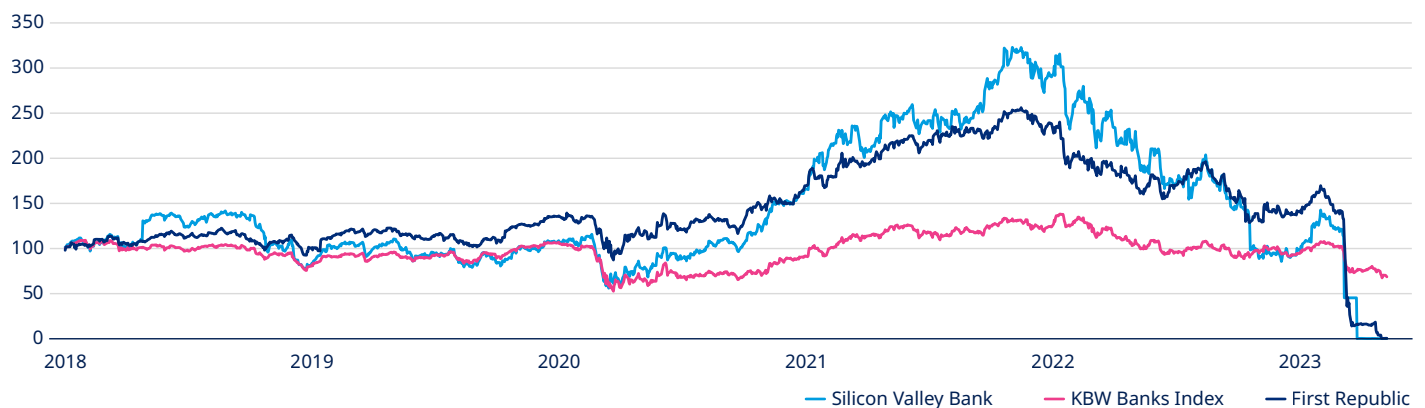
Although we expect headline inflation to decrease significantly in the near term, it's less clear if and when core inflation will fall sustainably to central banks' 2% targets. A delay could force central banks to keep interest rates high for some time or even raise them again after a pause.

### Geopolitics

A further deterioration in US-China relations may lead to additional trade restrictions and potential military confrontations, both direct and indirect, between the two global superpowers. A further escalation of the ongoing war in Ukraine remains a risk, with far-reaching impact politically, economically and, more importantly, in terms of the human cost.

### Figure 8. US regional banks

This illustrates the selloff in US regional bank stocks. Index and stock prices were rebased to 100 as of December 31, 2018. The KBW is an index of the largest regional and nationwide banks in the US.



Source: Bloomberg. Data as of May 31, 2023. Indexed to 100 as of January 1, 2018

## 6. Portfolio positioning

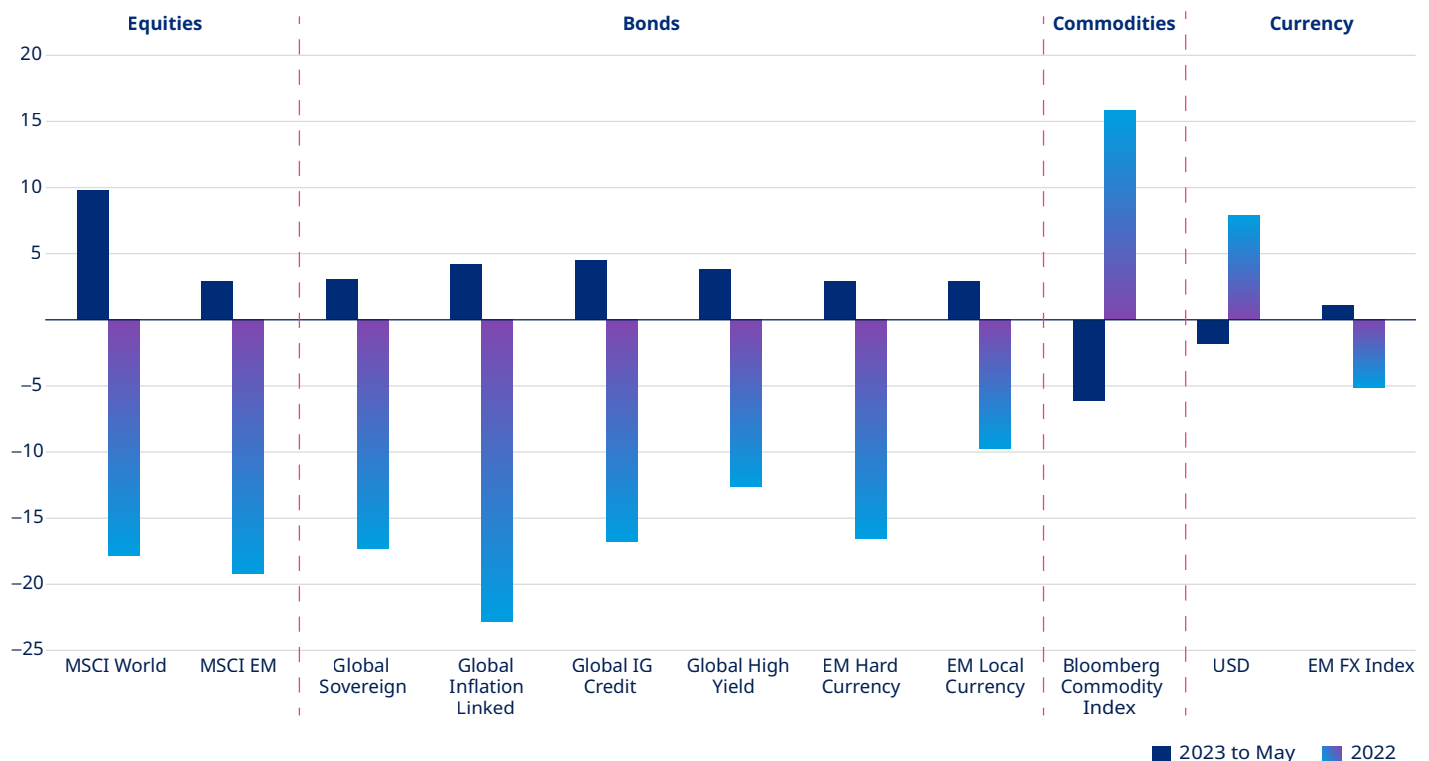
### Rise in yields means fixed income is back

Although uncertainties remain in the macro outlook, we prefer growth fixed income assets (high yield and emerging market debt) to defensive fixed income assets and cash.

We remain neutral on equities as, on balance, valuations look fair. Although further declines in inflation should support equities, we think corporate profit growth won't impress in the developed world in 2023. We remain overweight on emerging equities as we expect the recovery in China to generate strong economic and corporate profit growth. A generally weak US dollar should also support emerging markets.

We expect the US dollar to continue depreciating against DM and EM currencies.

**Figure 9. Performance of major asset classes over various periods to the end of May 2023**



Source: Bloomberg. Data as of May 31, 2023.



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