Global Asset
Management

2023 Outlook: Peaks and troughs

Summary

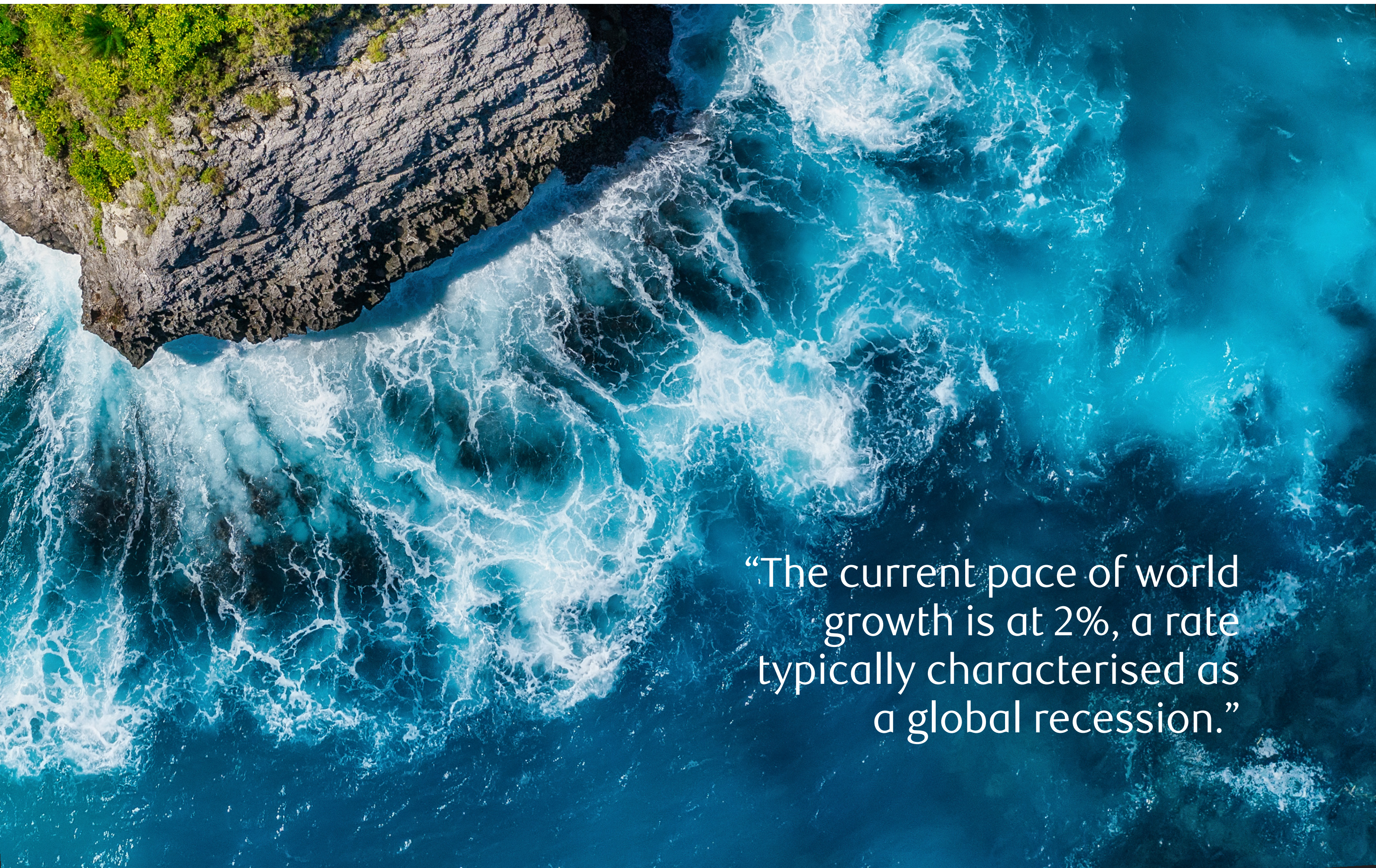
- The year ahead will be characterised by peaks in inflation and interest rates, and a trough in economic activity. With the current pace of world growth at 2%, a rate typically characterised as a global recession, the extent and ability of central banks to adjust policy in response to weaker growth will depend on how far and fast inflation falls.

- The peak in policy interest rates and, most importantly, the US Fed funds rates is typically associated with a rally in risk assets and lower bond yields. But, investors are likely to quickly shift their focus from inflation and interest rates to the deteriorating outlook for growth and earnings.

- Geopolitics – the war in Ukraine and relations between the US and China – will remain potential sources of market volatility. Economic downturns will be less severe if inflation falls more rapidly than forecast and central banks cut rates sooner rather than later. The tightening of global monetary and financial conditions have already exposed some ‘weak links’ in the global financial system, and there could be more ‘breakages’ that weigh on confidence and growth.

- This year’s dramatic tightening in monetary and financial conditions saw central banks belatedly yet aggressively respond to higher inflation, and a consequent sell-off in bond and stock returns. The shift from inflation to recession fears will see the correlation between bond and stock returns turn negative once more.

- In our view, investors should continue to favour defensive rather than cyclical and growth-sensitive assets until the trough of the downturn and subsequent recovery is in sight. Even if recessions are avoided, economic and corporate earnings growth are set to slow meaningfully. Higher nominal yields, core fixed income and high quality credit offer relatively safe income and a favourable risk-reward profile in light of macroeconomic uncertainty.



Falling inflation and growth

After a decade of 'lowflation', 2022 was the year when inflation returned with a vengeance. Far from being 'transitory', inflation reached multi-decade highs, in part due to the disruption to global energy and food markets caused by Russia's invasion of Ukraine. Major central banks led by the US Federal Reserve belatedly, but aggressively, hiked short-term interest rates. However, despite rising inflation and interest rates, the war in Ukraine, and a stuttering China, global growth was solid as pent-up demand was released and unemployment fell below pre-pandemic levels.

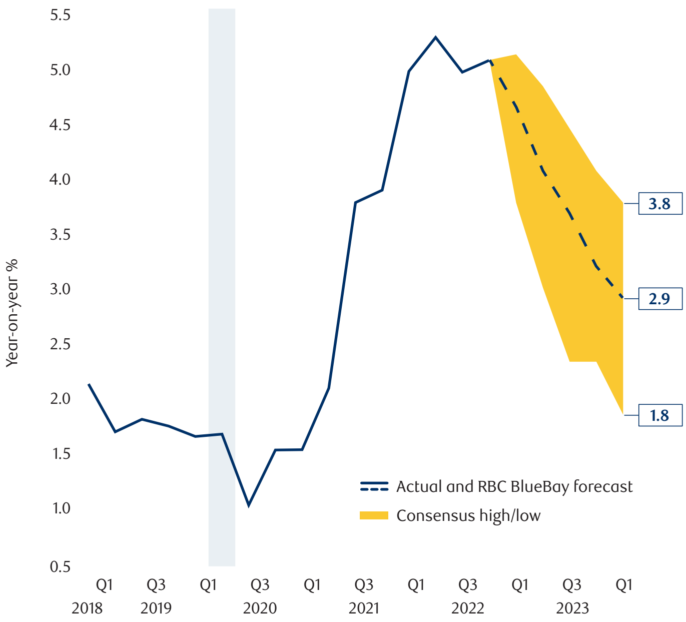
2023 will be characterised by peaks in inflation and interest rates and troughs in growth. Inflation is close to peaking and will be lower by the end of 2023, but how far and fast inflation will fall is a key source of macro and market uncertainty. Central banks will reach the end of rate hiking cycles and the market focus will shift to how deep the economic trough will be.

We are forecasting that the US economy enters a short and moderate recession, contracting by 0.6% in 2023 with the trough late in the year and recovery into 2024. The cumulative impact of the tightening in monetary and financial conditions will meaningfully cool the economy, with unemployment likely rising to around 5% and consumption spending weakening as households exhaust 'excess savings' amidst rising layoffs. Business investment and net exports will also decline, reflecting global economic weakness, while the housing market correction is set to deepen.

The trough in growth will likely be in the middle of 2023 but, as inflation continues to fall, household incomes will start to recover and the Fed will have room to support this recovery with policy easing into 2024. Moreover, the strength of private sector balance sheets and the (regulated) financial system mitigates potentially negative feedback loops that would otherwise result in a deeper and more prolonged recession.

Our baseline forecast is that underlying US inflation (core PCE) will be around 3% in Q4 2023. Even if the economy is not in outright recession it will be well below potential, and the labour market will no longer be 'extremely tight' with falling vacancies and rising layoffs. With the economy at best stagnating in the second half of the year and the Fed funds rate at around 5%, the Fed will have room for modest rate cuts even with inflation above target so long as it is confident

Fig. 1: Falling US inflation - but how far and how fast?



Note: Shaded area shows range of forecasts reported by Bloomberg excluding 10% decile tails.
Source: Bloomberg, RBC BlueBay forecast; latest monthly data for October 2022.

that inflation will continue to fall. If the recession is deeper than we forecast, inflation will fall further and faster and the Fed will start cutting rates sooner and by more.

Europe is already on the brink of recession due to the surge in energy prices and our forecast implies a deeper recession than in the US with a relatively weak recovery through the latter part of the year. Inflation will likely peak around the turn of the year, and headline inflation will fall through the rest of 2023 as the contribution of higher energy and food prices to inflation drop out due to base-effects. However, higher energy prices and tight labour markets are spilling over into core inflation that will stay sticky, prompting the ECB to continue to raise rates to a peak of around 2.5% in the first half of the year.

China is forecast to post modestly stronger growth in 2023 on the back of a pick-up in consumption as Covid restrictions are relaxed. However, the transition away from 'zero-Covid' is likely to be in fits and starts and sensitive to the pace of vaccination, as well as infection outbreaks, and will continue to constrain consumption. The property downturn will also continue to weigh on activity throughout the year.

Fig. 2: Global growth forecast (annual % change)

	2022f Forecast	2023f Forecast
World	3.5	2.0
DM	2.6	-0.5
EM	2.8	3.8
China	2.9	3.8
US	1.9	-0.6
Euro area	3.0	-1.4
Japan	2.5	0.9
UK	4.3	-1.4

Source: Consensus forecasts as reported by Bloomberg, 21 November 2022; RBC GAM forecasts; October 2022.

At 2%, the global economy will expand at its slowest pace in forty years (excluding the global financial crisis and pandemic recessions). The extent that central banks will be able to adjust policy in response to the deteriorating growth outlook will depend on how far and fast inflation falls.

Upside risks for the global economy and financial assets come from a 'soft landing' rather than recession in the US on the back of a faster decline in inflation that supports a pick-up in household income and spending, and allows the Fed to accommodate an easing in financial conditions.

The recession in Europe could also prove less severe than currently forecast with a mild winter so far and ample gas storage. But on the downside, geopolitics could be the source of another shock to the global economy through higher commodity prices which would negatively impact confidence and market volatility. The tightening of monetary and financial conditions could expose more 'weak links' in addition to the collapse of the crypto sector and UK pension fund liability-driven investment strategies.

The return of the bond bull

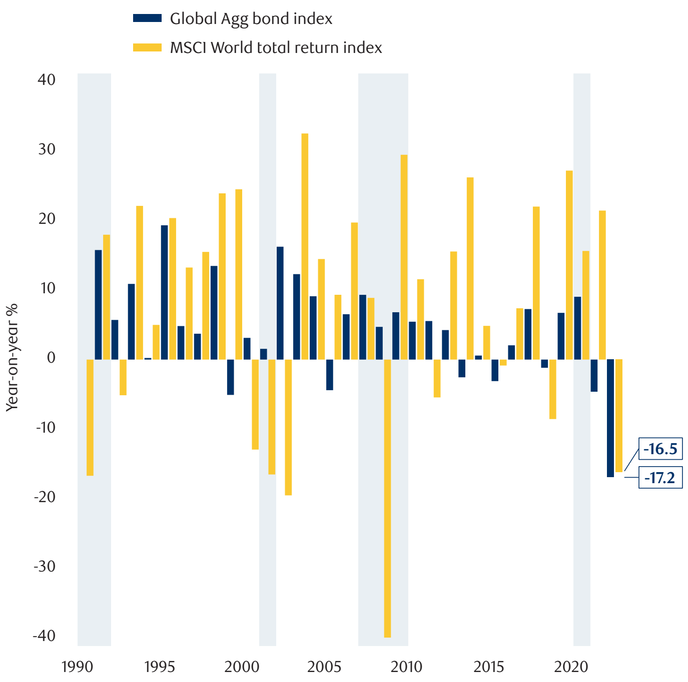
Rising inflation and core rates have been the dominant driver of financial markets and asset performance this year. The combination of high and rising inflation, along with the sheer pace and magnitude of monetary and financial tightening through 2022, left investors with few places to hide. Core fixed income and credit experienced their largest drawdowns in modern history, and global equity markets are also down more than 15%.

2023 will be very different with inflation falling, central bank policy rates peaking in the first quarter and the focus shifting to the trough in growth. In our view, 2023 will be a positive year for interest rate duration – yields on safe government bonds will fall – and for fixed income and high grade credit more broadly. Although risk assets typically rally following the end of central bank, and especially Fed, rate hiking cycles, this is likely to be short-lived as investors focus on the depth of the trough in economic activity.

In the falling inflation and recession scenario – our central case – the US Treasury curve will 'bull steepen' with yields across maturities falling, especially at the short to intermediate maturity (2-5yr) in anticipation of Fed rate cuts by more than yields on long-dated bonds (the orange line in Fig. 4). The correlation between bonds and stocks that was positive in 2022, when inflation was high and interest rates were rising, will switch back to negative. As we can see from Fig. 4, when the yield curve bull steepens, US Treasury bonds typically out-perform the S&P500 (the dark blue bars). Fixed income and high grade credit will out-perform growth-sensitive risk assets, including high yield, in such a scenario.

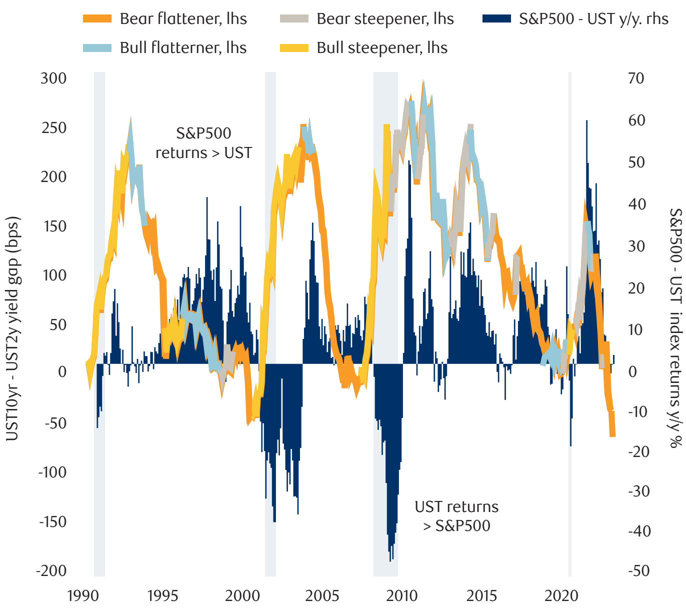
Economic forecasts are rarely accurate (an understatement many would say) but we have high confidence in the direction of travel for growth and inflation through 2023. If inflation falls more slowly than forecast, the peak in central bank policy rates could be higher for longer, but we do not envisage rates peaking dramatically above current market pricing. Even in a stagflation scenario where high inflation is much stickier and rates stay high, intermediate and longer-dated bond yields are likely to rise only modestly. Unlike at the start of 2022, much higher initial yields will provide an income cushion for investors.

Fig. 3: Nowhere for investors hide



Note: Shaded columns denote NBER-dated US recessions; latest data at 21 November 2022.

Fig. 4: US Treasury yield curve regimes & relative performance S&P500 vs US Treasury index



Note: Shaded columns denote NBER-dated US recessions. S&P500 year-on-year total return minus total return on BoA US Treasury index.
Source: Macrobond; BoA; RBC BlueBay calculations; latest month November 2022.

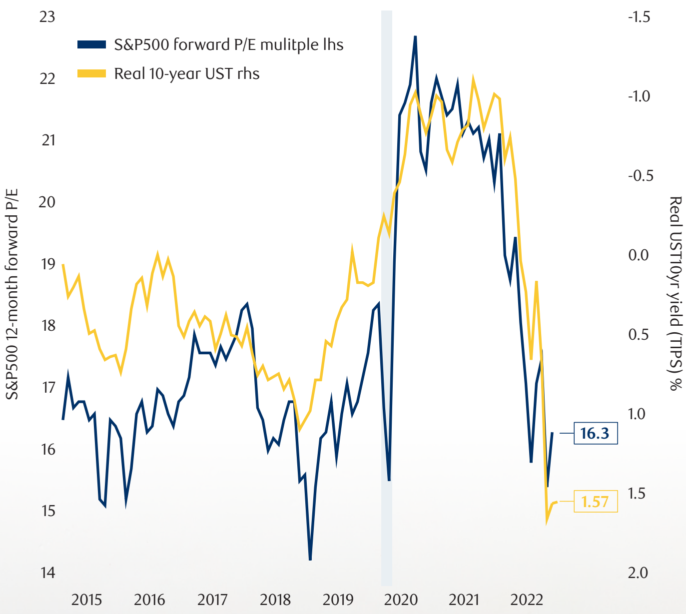
In the positive scenario where growth holds up better than expected and inflation falls faster than forecast – a 'goldilocks' scenario – bonds will still perform positively in my view. Short term rates and bond yields will have peaked and be much less volatile, and investors will also benefit from the carry. In this scenario, investors will benefit rather than be punished by a positive correlation between bonds and stocks, although risk assets, including lower-rated credit, could out-perform core fixed income and high grade credit.

Equities have experienced double-digit drawdowns from their peaks, largely reflecting a re-rating lower of price-earnings (PE) multiples on the back of higher real rates. However, consensus forecasts will continue to assume mid-single digit earnings growth in 2023.

Even without an outright recession, earnings growth is likely to disappoint as some of the decline in inflation will come from a squeeze on corporate profit margins.

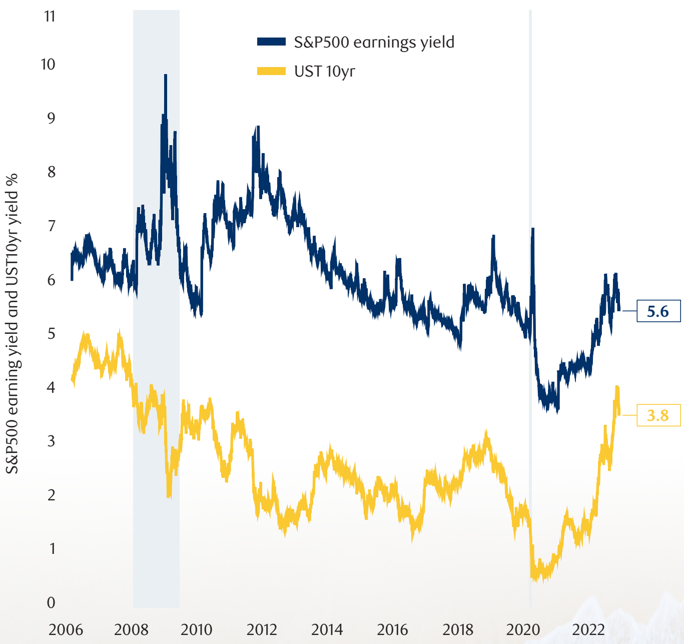
In the 'lowflation' era that preceded the pandemic, investors were forced into riskier assets, including equities, because bond yields were suppressed by zero rates and quantitative easing. But the sharp move higher in nominal and real bond yields has squeezed the equity risk premium – the difference between earnings yields and the yield on safe government bonds – to post global financial crisis lows. If our recession forecasts are correct, the equity risk premium will rise from current levels and, in my view, investment grade credit offers comparable yield to stocks, with less downside risk and volatility.

Fig. 5: S&P500 forward P/E versus 10-year TIPS (real) yield



Source: Macrobond; Bloomberg; latest monthly data at 21 November 2022.

Fig. 6: Shrinking equity risk premium



Source: Macrobond; latest data at 21 November 2022.

End of an era

The 'Great Moderation' was a period of macroeconomic stability underpinned by globalisation and technological advances. The global financial crisis, however, ushered in the 'new normal' of inflation persistently below central bank targets, periodic deflation scares, low and falling nominal and real interest rates, and anaemic economic growth.

Nationalism and protectionism, the rivalry between China and the US, the Covid pandemic, and Russia's invasion of Ukraine, are the nails in the coffin of the 'new normal'. In my view, the retreat of globalisation, aging, climate change and populism heralds a new 'Great Volatility' era.

The rising frequency of natural disasters, extreme weather events and decarbonisation will increase macroeconomic volatility, and the transition to net zero will be a source of 'greenflation'. Dramatically cutting greenhouse emissions will require a much higher price of carbon that is yet to be reflected in the price of goods and services, and in asset values.

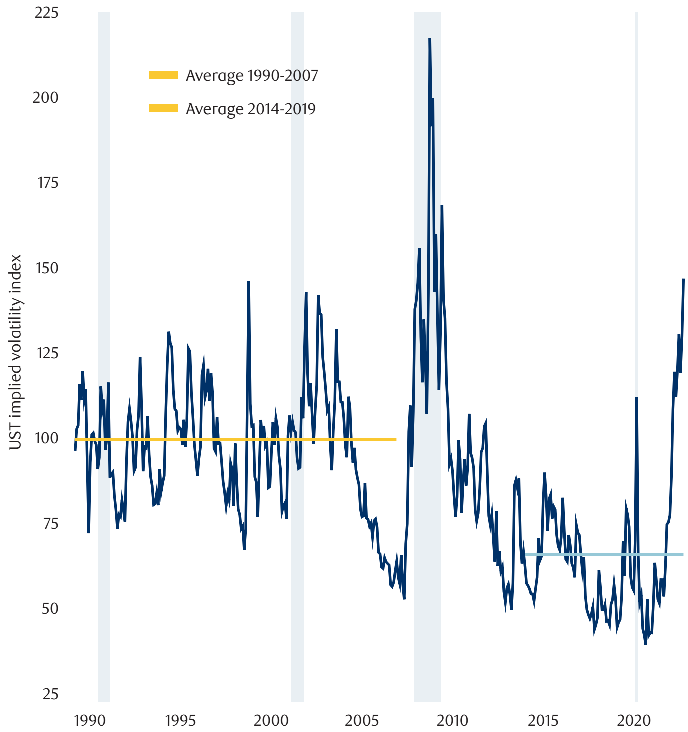
Labour supply is constrained by rising dependency ratios as populations age, weakening the power of capital over labour. As witnessed, the surge in worldwide inflation, the release of pent-up spending after Covid lockdowns, and huge monetary and fiscal stimulus led to a rise in demand that could not be fully met by increased labour supply, putting upward pressure on wages and prices.

Fiscal policy was a crucial 'shock absorber' during the global financial crisis and the Covid pandemic, and governments across Europe are acting to cushion the hit of soaring energy prices to households and businesses.

However, higher inflation and interest rates, and the end of 'QE-infinity', will increasingly put the spotlight on high government debt levels and fiscal sustainability, as the UK government recently found to its cost.

Central banks that dismissed higher inflation as 'transitory' are fearful of losing credibility. The trade-off between stabilising output and meeting 2% inflation targets has become more challenging. Although inflation will decline from current levels, in a world of inflation that is often above target, central banks will be much less accommodating of spendthrift governments, market volatility and episodes of soft economic growth.

Fig. 7: Higher volatility marks the end of 'The Great Moderation'



Note: BoA MOVE index of implied volatility in US Treasury market; latest monthly data at 21 November 2022.

With monetary and fiscal policies constrained and a global economy structurally less well placed to absorb more frequent shocks from climate change, energy markets and geopolitics, investors face a more unpredictable macroeconomic environment. Asset markets will exhibit greater dispersion and volatility adjusted 'beta' returns will be lower. But, investors will also benefit from higher risk premiums and from bottom-up fundamentally driven security selection.

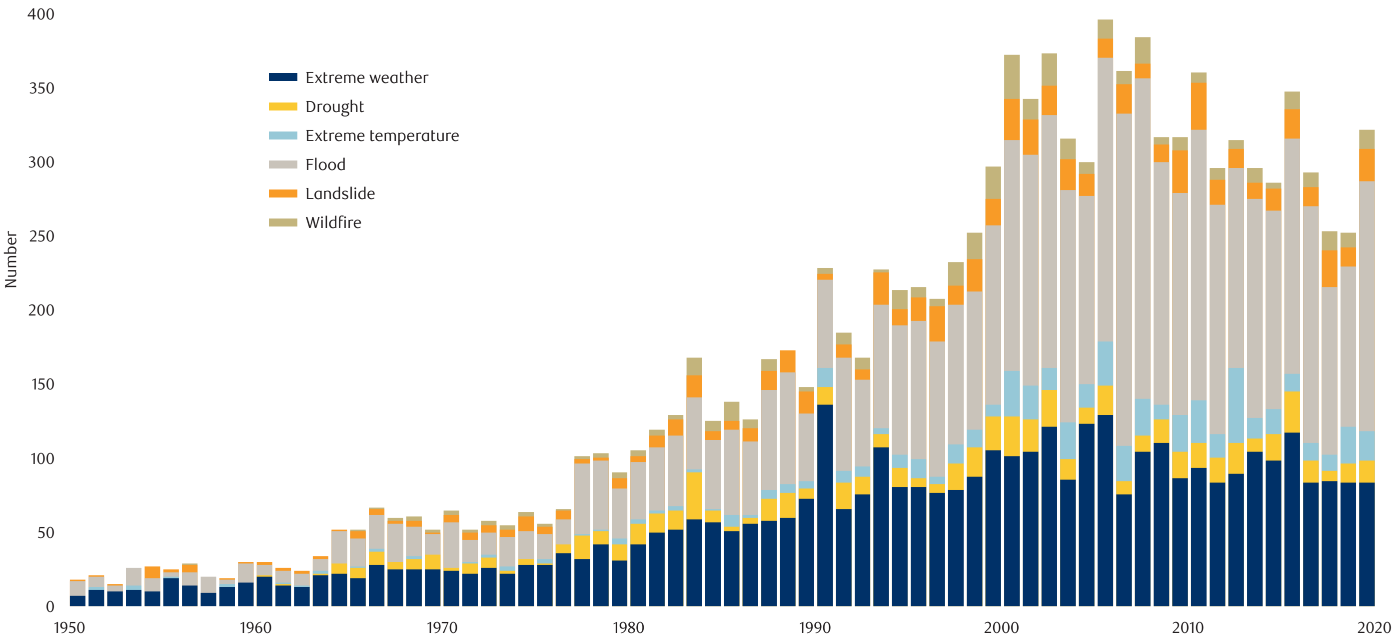
Climate change

Climate change is having a profound impact on the global economy. The disruption to global energy markets caused by Russia's invasion of Ukraine was exacerbated by supply fragilities arising from the transition from fossil fuels to renewables, as well as extreme weather events that have impacted both energy demand and supply. The warmest and driest summer on record across the northern hemisphere has led to widespread crop failures, contributing to a worldwide surge in food prices.

The threat to energy security has led to renewed investment in gas infrastructure and increased fossil fuel production. Yet, if the 2015 Paris Agreement goals are to be met, to limit global warning (relative to the preindustrial age) to well below 2.0°C, preferably 1.5°C, and achieve net zero carbon by 2050, the global economy must reduce 25% of greenhouse gas emissions by the end of this decade.

Tackling climate change and the transition to a low carbon economy will be the key investment theme of the next decade and beyond. Those that dismiss climate change as a long-term issue beyond their investment horizon will fail to benefit from the opportunities, as well as the risks, it presents.

Fig. 8: Rising number of extreme weather events



Source: Our World in Data; latest annual data for 2020.

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